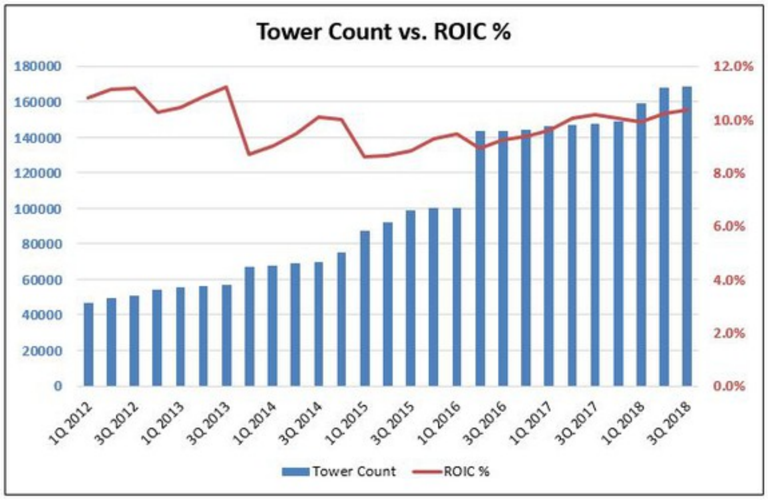
Strong Domestic Growth Continues at American Tower

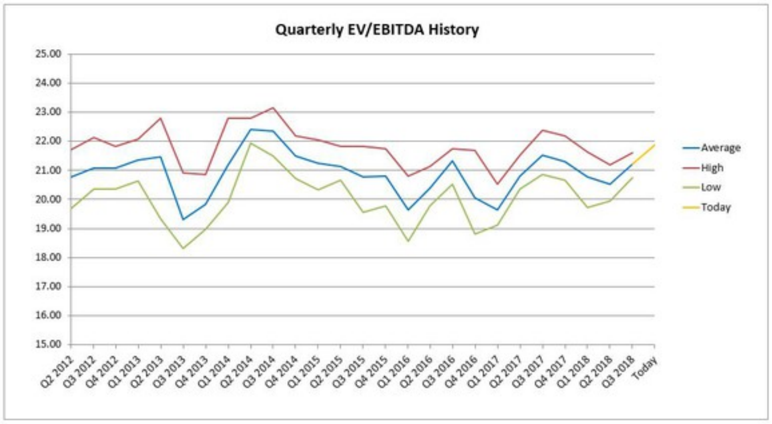
Published Dec 6, 2018 at 2:01PM

Strong U.S. growth continued at **American Tower** (NYSE: AMT) in the third quarter of 2018 as unlimited data plans from wireless carriers continue to gain acceptance and demand for mobile data continues to grow. Thanks to high levels of network investment activity from all four major U.S. carriers, American Tower expects a robust business environment to persist in the U.S. throughout 2018. Since the U.S. business represents 55% of property revenue and 65% of operating profits, this is great to see for American Tower shareholders.

As we expected, international growth should see ongoing weakness in 2018 and into 2019 because of the disruption in the Indian wireless market. However, management has reached an agreement with the Tata Group that will result in a one-time payment of ~$320 million in Q4 2018, offsetting some of the expected churn in India. The U.S. business continues to improve and the international business ex-India is also performing strongly, and American Tower remains on track to continue to increase its revenue and cash flow and expand ROICs across its growing asset base. ROIC in the third quarter of 2018 reached its highest level (10.4%) since 2013, when the company had just 57,000 towers (compared to nearly 170,000 today):



American Tower's stock has been able to easily weather the recent market correction, with the stock actually trading at all time highs as recently as late November. Due to the lease termination agreement with the Tata Group, 2018 guidance was revised sharply higher, leading to a positive reaction from the market. However, I'd caution that this agreement is a one-time benefit, and due to the recent stock price appreciation, American Tower is now trading at valuation levels that are at the high end of its historical range:



What Happened?

CEO Jim Taiclet:

> "In the third quarter, our U.S. property segment delivered strong Organic Tenant Billings Growth of 7.4%, reflecting ongoing investments in 4G technology by our tenants to meet ever-increasing data and video demand. Our International property segment also experienced strong demand for tower space, especially in Latin America. Normalizing for Indian Carrier Consolidation Churn, International Organic Tenant Billings Growth was 8%.
>
> Subsequent to the end of the quarter, we reached a comprehensive agreement with the Tata Group that we believe preserves our ability to achieve our long-term return on investment objectives in India. We expect that this agreement, along with the acquisition of approximately 20,000 Vodafone and Idea towers earlier this year, will position American Tower to benefit from the anticipated recovery in the Indian mobile market."

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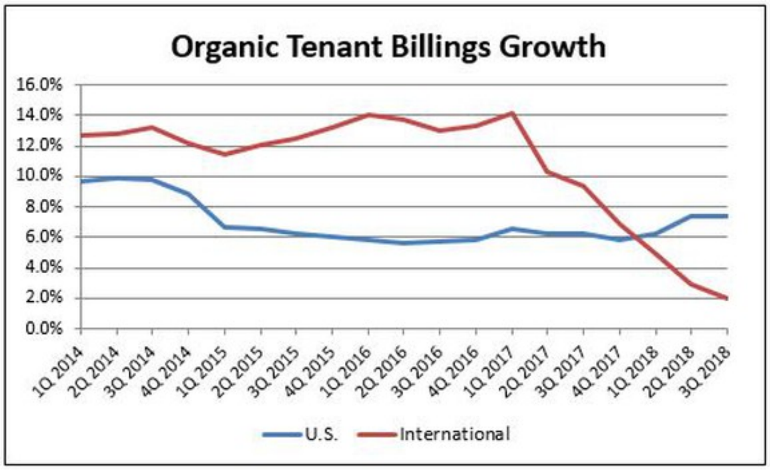
- Q3 2018 earnings presentation
- Q3 2018 10-Q filing

For the third quarter of 2018, organic growth in tenant billings came in at 7.4% in the U.S. and 2% internationally, vs. 6.3% and 9.3% in the same quarter a year ago.

The disruption in the Indian market continued into this quarter (as expected), with -12% organic growth in the company's Asia (i.e. India) division because of an acceleration in consolidation-driven churn. However, management was able to reach an agreement with the Tata Group (one of the carriers that bowed out in India's consolidating wireless industry), terminating the remainder of its leases in exchange for a ~$320 million one-time cash payment to be received in Q4 2018. As a consequence, elevated churn in India is expected to continue for longer than was previously expected (as a consequence of the lease termination agreement and the one-time cash inflow).

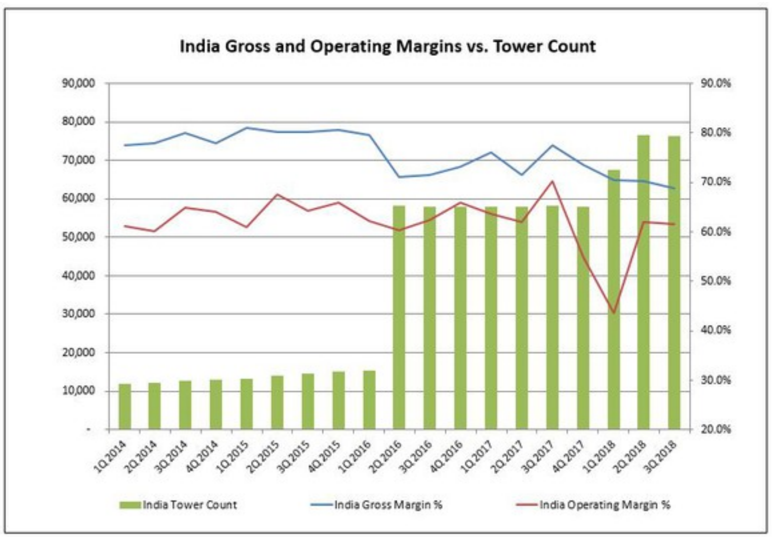
Outside of India, organic growth was more in line with historical growth rates, up 6.7% in Europe, the Middle East, and Africa (EMEA, which includes France, Germany, Ghana, Nigeria, South Africa, and Uganda) and 11.4% in Latin America (which includes Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay, and Peru).



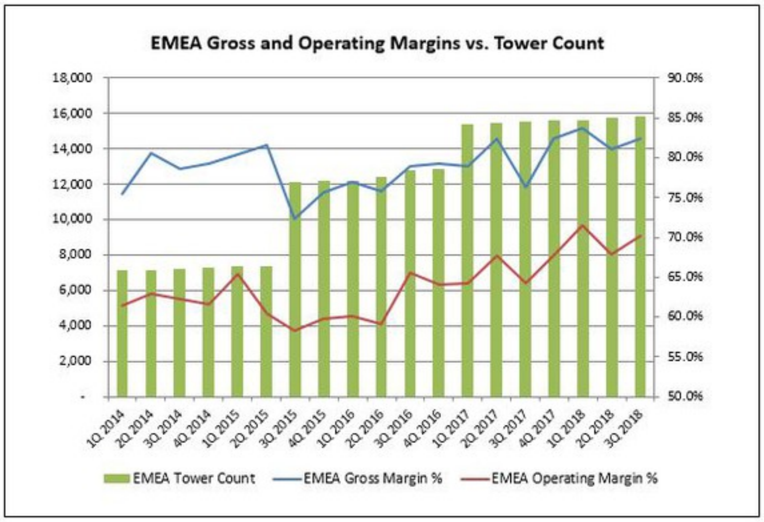
This is the third quarter in a row that U.S. growth outpaced international growth, and given the expected pressure in the Indian market, this result is unsurprising. Once the Indian market stabilizes, international growth should once again eclipse U.S. growth by a few percentage points.

So What?

As we expected, the Indian wireless carrier consolidation has continued to affect growth rates and margins in that market throughout 2018, and that should continue through the rest of the year and into 2019 as a result of the lease termination agreement with the Tata Group. This quarter featured the highest number of cancellations in the Indian market so far, and as a result margins declined slightly:

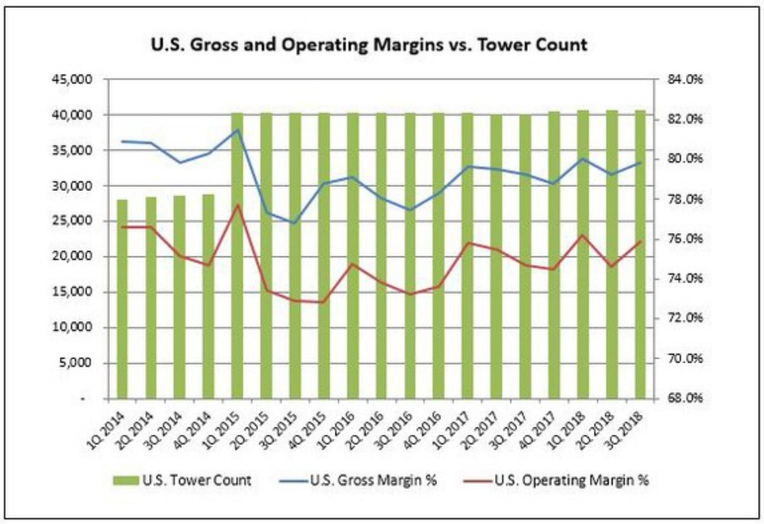


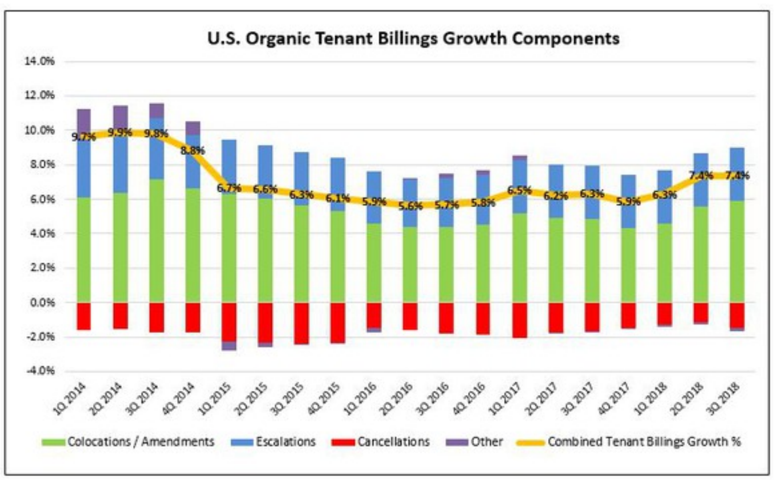
In Europe, the Middle East, and Asia (EMEA) and Latin America, margin trends are positive, and management expects margin expansion over time as the company continues to generate organic growth on its extensive existing portfolio of assets.



As a result, when combining all three regions of American Tower's international business, margins are trending upwards:

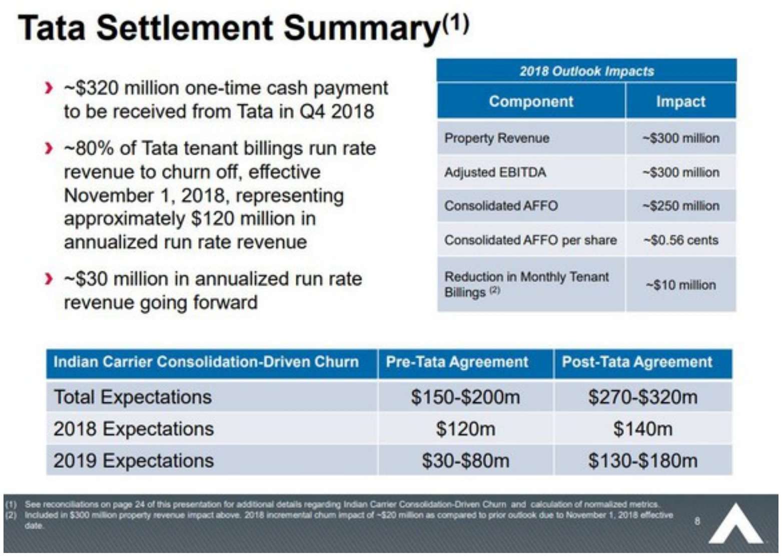
In the U.S., margins are continuing their steady trend upward. TTM gross margins increased year-over-year to 79.5% (from 79.2% a year ago), and TTM operating margins increased year-over-year to 75.3% (from 74.9%). Both the TTM gross and operating margins are at the highest level they've been since the Verizon acquisition in 2015 that acted to lower the margin profile of the entire U.S. business (thanks to the lower tenancy ratio on those new towers). Management has been successful in slowly increasing margins via organic growth of the newly acquired (and existing) assets, and that trend looks set to continue:





Now What?

The third quarter of 2018 represented a continuation of trends that started in the fourth quarter of 2017, as American Tower continued to digest the impact of Indian carrier consolidation, reporting accelerated churn levels in its Asia segment. As a result of the recent lease termination agreement with the Tata Group, churn driven by this consolidation should continue to affect results into 2019 before stabilizing in 2020:



Tata Settlement Summary(1)

- ~$320 million one-time cash payment to be received from Tata in Q4 2018
- ~80% of Tata tenant billings run rate revenue to churn off, effective November 1, 2018, representing approximately $120 million in annualized run rate revenue
- ~$30 million in annualized run rate revenue going forward

2018 Outlook Impacts	
Component	Impact
Property Revenue	~$300 million
Adjusted EBITDA	~$300 million
Consolidated AFFO	~$250 million
Consolidated AFFO per share	~$0.56 cents
Reduction in Monthly Tenant Billings (2)	~$10 million

Indian Carrier Consolidation-Driven Churn	Pre-Tata Agreement	Post-Tata Agreement
Total Expectations	$150-$200m	$270-$320m
2018 Expectations	$120m	$140m
2019 Expectations	$30-$80m	$130-$180m

(1) See reconciliations on page 24 of this presentation for additional details regarding Indian Carrier Consolidation-Driven Churn and calculation of normalized metrics.
(2) Included in $300 million property revenue impact above. 2018 incremental churn impact of ~$20 million as compared to prior outlook due to November 1, 2018 effective date.

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Aside from the Indian market, the rest of American Tower's business continues to perform well. Growth in the U.S. business is as high as it's been since 2014, and prospects for the rest of 2018 and beyond look strong with all four major U.S. carriers in the process of what management expects to be a multi-year rollout of 5G technology.

Data and Guidance

- Current Price: $162.10
- Fair-value estimate: $152 (from $146)
- Allocation: 4.5%, plus 0.8% in January 2019 / January 2019 $80/$135 bull call spreads
- EV/EBITDA (TTM): 20.35

AMT moves to Buy (from Best Buy Now) on valuation, and its fair value increases to $152. We also have 0.8% in bull call spreads, which expire in January. With American Tower trading above our estimate of fair value, we're unlikely to roll out this leveraged position and would recommend closing the bull call spread before the next ex-dividend date, which is on December 27th. Right now, the midpoint of the bid/ask spread for the January 2019 $80 / $135 bull call spread is $54.90 (with a maximum spread value of $55). If you can close the spread for this amount or higher, that would be a good choice. Make sure to close the spread before the ex-dividend date, otherwise you risk being assigned on the short call and owing the dividend payment, which would detract from the returns on the spread.

News about Motley Fool Pro

Published Dec 6, 2018 at 7:46AM

Dear Fool,

I want to start this difficult note by saying how proud I am to have served members like you for more than a decade.

As many of you may remember, we opened *Motley Fool Pro* during a time of extreme economic uncertainty — calamity, really — and we were unsure whether you'd join along with us. But join us you did.

And despite the fact that we launched *Pro* right in the middle of the Great Recession, over the past 10 years the *Pro* portfolio returns have been far ahead of our own inflation-crushing goal and well ahead of the market indexes, too, helping members reach higher financial peaks.

That's why it's with mixed emotions that I share today's news with you:**After 10 years of running this service, I've accepted an opportunity to launch a private investment vehicle that is inspired by the *Pro* strategy and managed by a sister company.**

I think the timing seems right for a choice like this. With the *Pro* portfolio reaching a major milestone, and with The Motley Fool, LLC, evolving its product offerings, *Pro* is at a crossroads. Meanwhile, for years, many of you have been asking, "Why can't you do this *for* me?"

This does mean the Fool will be closing *Pro* over the next month, as my colleagues and friends strongly believe the service is synonymous with an investing approach that centers on its manager.

Below, I share a little more about how I reached this decision, but first, I want to provide details so you know what to expect for your membership.

First and foremost, we want you to know that we are 100% committed to meeting each and every one of our members on their terms and delivering them solutions and guidance that we believe meets their wants and needs.

So, although *Pro* will be winding down over the next month, please rest assured that for Fools who want to continue to do all their own research and trading with our help, we'll make sure you receive ongoing coverage. For many of you, this is your nest egg that you've been managing based on this guidance, and the Fool could not take that project more seriously.

To that end, in the coming year, spearheaded by *Pro* contributor Billy Kipersztok, you'll continue to receive quarterly updates on all *Pro* holdings, letting you know if any guidance has changed to Hold or Sell, as well as thoughts about how to incorporate new Motley Fool ideas into your portfolio.

Billy, of course, has been a key analyst on *Pro* for five years, and along with the quarterly updates, he will update you on all positions as needed — and we'll send you these email updates even if you decide not to remain an active Motley Fool subscriber.

The team has also put together a 2018 Pro Portfolio Review, including a summary of all of the portfolio's positions as well as what to expect from each investment going forward. You can check out Part 1 of this report right here. Or simply go to **profinalreport.fool.com**. We'll send you Part 2 in the coming days. Remember, the portfolio is invested with the next three to five years in mind, and that has not changed today.

As for adding new investment ideas to your portfolio, our team has worked to set you up with the best choices we have to offer for delivering the Fool's top recommendations to you. For details on the *Pro* loyalty package, members can reach out to our Member Services team at help@fool.com.

It's important that you have choices when it comes to TMF serving your needs, so if you'd like to change what you're getting, our friendly reps will work with you to get you set up well.

Reflecting on a decade together

Ten years of *Pro* have represented 10 years of life — for all of us, momentous moments have transpired in that time.

For me: My wife and I watched our son grow up from 3 years old to 13; we've lost parents and loved ones; we've seen four nieces and nephews born! And we've all seen new companies rise from nothing on the public markets to create fortunes, while our country has gone through triumphs and struggles.

As much as I love *Pro*'s sister service, *Motley Fool Options*, the real-money *Pro* portfolio has been the biggest bell on the Foolish jester cap I've been knitting. And while I'm excited about what's next, this community we share makes it all the more difficult to leave this service that I love to go risk something new.

I'm proud of what we've achieved as a community. The friends I've met along the way, what we've learned together, and that so many of you had amazing courage to stand up and join *Pro*'s endeavor right at the start — despite the market environment — will always resonate with me.

Really, though, whether you joined in 2008 or 2018, I appreciate that you placed your faith in the team and me. And I love that you joined our merry band of Foolish investors looking to grow our portfolios strongly while tamping down risk along the way.

I hope that you are happier, and are better off financially, than you were a few years ago, let alone 10 years. As much as that, I hope you are now more confident than ever as an investor, with more tools in your toolbox to make money in any market.

Where you'll find me next

As I work to launch the new company, J.P. Bennett has joined me, and we're eyeing a launch in early 2019. And you'll be among the first to know about it. After more than 20 years of investing fully in the public eye, and of pre-announcing every trade being made, I'm excited to start a *Pro* philosophy long/short vehicle that will invest in private and in real time.

This new project **will initially be open only to a limited audience — including our eligible loyal *Pro* followers.** And I hope to serve as many interested and qualified *Pro* members as possible, ideally for at least another decade.

To all of you who have made career choices in the past — which I'm guessing is almost all of you — thank you for understanding how this change could come about. Even though I'll miss talking and investing with you here each week in *Motley Fool Pro*, I look forward to the new possibilities and the challenges of this new endeavor. Thank you for everything, Fools.

More to come,

Jeff Fischer

P.S. — I hope you'll understand that, due to the many legal and regulatory restrictions surrounding this new venture, I can't give you any further concrete details about it here in this note.

However, please know that the team and I are working round the clock not only to get this new venture up and running... but also to make sure that you have all of the pertinent information about this new offering as soon as possible.

With that in mind, I'd ask you to please keep a close eye on your inbox in the coming days so that you can stay up-to-date on all the latest developments and need-to-know news.

Johnson and Johnson Demonstrates Resiliency

Published Dec 4, 2018 at 12:59PM

Third-Quarter 2018

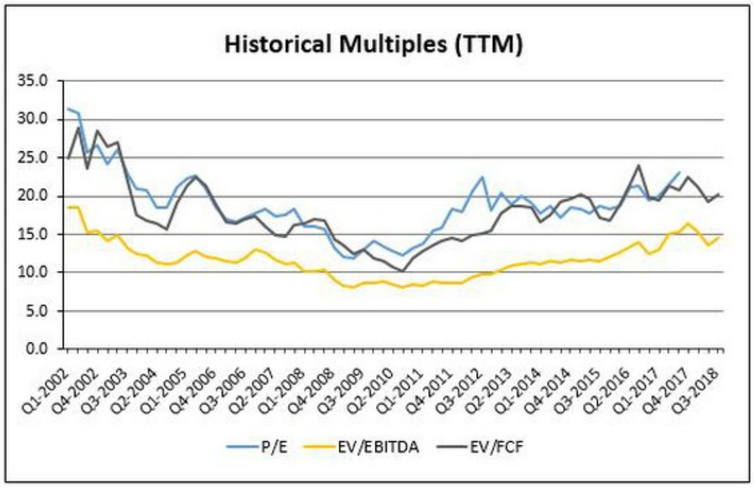
- Press Release
- Earnings Presentation
- Supplementary Sales Data
- Sales of Key Products & Franchises
- 10-Q Filing

Johnson & Johnson (NYSE: JNJ) continued its strong pharmaceutical segment performance in the third quarter of 2018, reporting 8.2% operational growth in pharmaceutical sales. Companywide operational sales growth (i.e., ex-currency and ex-acquisitions) came in at 6.1% for the quarter. On an adjusted non-GAAP basis, J&J posted 7.9% year-over-year earnings-per-share growth for the third quarter. Management increased its operational sales growth guidance for 2018 to 5.75% growth (from 5%) and increased its guidance for adjusted EPS growth to 11.6% (from 11.2%). Since reporting Q3 earnings on October 16, the stock has increased by nearly 11%, with the market assessing the quarter's results favorably.

- **Updated guidance**: Buy (no change)
- **Recommended allocation**: 3.1%, with January 2019 $140 covered calls.

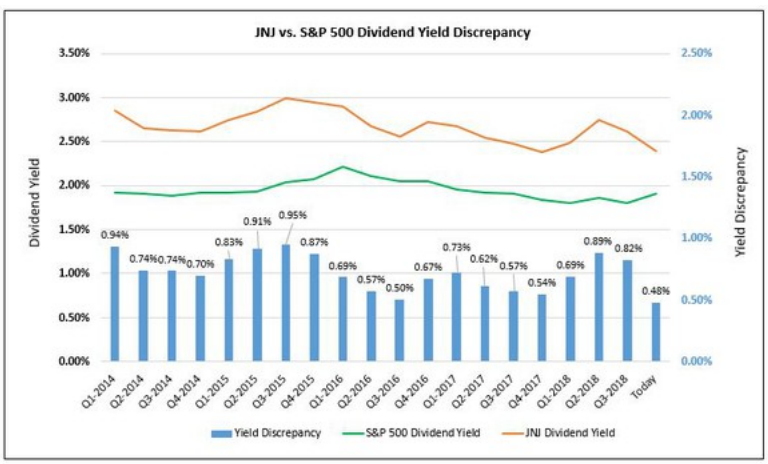
- **Fair-value estimate**: $143 (from $140)
- **Current price:** $148.64

At $148.64 per share, the stock is priced at 16.2 times trailing-12-month (TTM) EBITDA and 22.6 times TTM free cash flow:



Based on management's guidance, J&J is priced at about 18.2 times 2018's expected non-GAAP earnings -- above the S&P 500, which is trading at about 17 times expected 2018 earnings estimates. The stock has fully recovered from its 2018 lows (a 52-week low of $118.62 set on May 29th), setting a new all-time intra-day high today of $148.97. J&J's stock price demonstrated excellent resiliency during the recent market correction; during the period between September 21 and October 29 (when the S&P 500 declined 11.5% peak-to-trough), J&J's stock price declined just 3.7%. This is exactly the type of price stability we expect to see during downturns from a stock we've consistently called one of the safest you are likely to find in the entire investment universe.

However, due to that price stability and the recent highs achieved by the stock, J&J's relative valuation compared to the S&P 500 is as unfavorable as it's been since its inclusion in the Pro Portfolio. Because J&J has such a consistent history of dividend payments, one of my favorite ways to monitor the company's relative valuation is to compare its dividend yield to that of the S&P 500. This comparison strips out the confounding effect of interest rates that occurs if you look at J&J's dividend yield in isolation (since dividend-paying stocks tend to fluctuate in price alongside interest rates). When we make this comparison, the yield discrepancy between J&J and the S&P 500 is as narrow as it's been since we started covering the stock:

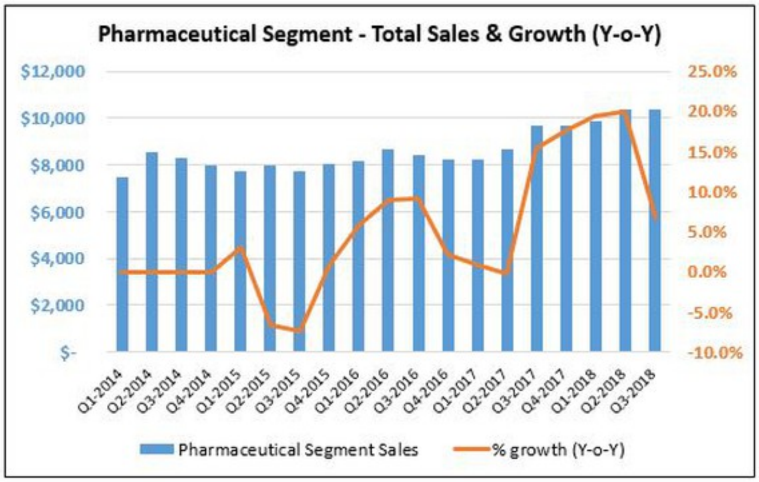


Since 1999, the average yield discrepancy between the S&P 500 and J&J has been 0.61%, and it's currently at 0.48%.

Our fair-value estimate increases to $143, and Johnson & Johnson remains a Buy (with overlaid January 2019 $140 covered calls). Our covered calls are currently in-the-money by 6.2%, and due to the narrowing of the relative valuation between J&J and the S&P 500, we don't plan to roll our calls up and would be content to let our shares go at $140 in January. However, if the stock declines below $140 by January, we'd be happy to hold our shares (and potentially write new covered calls, depending on the stock price and valuation).

Division Performance

J&J's pharmaceutical division finally saw a lapse in acceleration in the third quarter, growing at 6.7% year-over-year compared to 20% last quarter:



The reason for the deceleration of growth is the lapping of the company's 2017 Actelion acquisition, as we're no longer seeing acquisition-related growth. The 6.7% organic growth from the pharmaceutical segment represents strong performance and still leads companywide growth, as the consumer segment grew 2% year-over-year and the medical device segment was flat. On a currency-adjusted operational basis, pharmaceutical growth was 8.2%.

Drugs in the oncology market continued to lead the pace, with Darzalex sales up 57%, Zytiga sales up 43%, and Imbruvica sales up 38%. We expect the pharmaceutical division to continue to be the predominant driver of growth for Johnson & Johnson.

Our Thesis

Johnson & Johnson is is a diversified health-care conglomerate, with more than 260 operating companies organized into three business divisions: consumer, pharmaceutical, and medical devices. At eight out of eight of our *Pro* quality criteria, J&J is a quintessential *Pro*-quality stock. While its large size means we don't expect runaway growth and upside, we do expect to earn North Star-challenging returns with low downside risk from one of the safer stocks you are likely to find in the entire investment universe.

Pro: What to Do Next

Published Dec 4, 2018 at 10:00AM

Introduction

Dear *Pro* member,

For as long as *Pro* has been in existence, we've aimed to own every stock we recommend for at least three years, and ideally longer. And as Jeff and JP leave to pursue their next Foolish opportunity in hopes of continuing to serve investors well, we maintain that three-year outlook on everything *Pro* owns.

It's true that some of our stocks have required at least three years of patience already. But we continue to believe those stocks will eventually produce pleasing returns -- otherwise, we wouldn't still be holding them. As always with investing, act logically and slowly as you go forward. When managing a diverse portfolio that has a long-term outlook, it's rarely in your best interest to rush. Overall, remain calm and optimistic about your investments; they're well-vetted!

Also, please remember that while we all invested together in *Pro*, in the end being part of this service means you made every decision yourself. That means you can and should be confident in your *next* decisions, too. We're here to help you with any choices you might want to make now, or in the coming 12 months as our coverage continues. We've separated our long positions into three "tiers" of conviction. Let's get to it!

Summary by Tier

Tier One: These are the companies we feel most confident about owning over the next three to five years.

- ***New Dec. 10 --*** **Adobe Systems** (NASDAQ: ADBE): A digital-content powerhouse with stellar financials.
- ***New Dec. 10 --*** **American Tower** (NYSE: AMT): Long-term contracts make this business stable.
- ***New Dec. 10 --*** **Broadridge Financial Services** (NYSE: BR): Dominance in shareholder services.
- **CME Group** (NASDAQ: CME): Volatile markets help this business.
- ***New Dec. 10 --*** **Mastercard** (NYSE: MA): Plenty of growth left.
- **Medtronic** (NYSE: MDT): Stability alongside strong earnings growth in a defensive sector.
- **Paycom** (NYSE: PAYC): A long runway will help it keep growing and growing.
- **Verisk** (NASDAQ: VRSK): Pricing power and customers that aren't going anywhere.
- ***New Dec. 10 --*** **Visa** (NYSE: V): We like owning both MasterCard and Visa.

Tier Two: We have great reason to own these companies over the next five years, too, but we think they are at least modestly more risky (either in terms of valuation or business growth) and/or their futures less certain than those of Tier One businesses right now.

- **Amazon** (NASDAQ: AMZN): Its market capitalization means it must keep producing meaningful business growth.
- **Apple** (NASDAQ: AAPL): Smartphone growth is a question, but we believe in the ecosystem and management's ability to keep expanding free cash flow.
- **Facebook** (NASDAQ: FB): Management absolutely must improve. If they do, the stock is cheap. Its properties are still among the most valuable online.
- ***New Dec. 10 --*** **FactSet Research Systems** (NYSE: FDS): Stability and growth despite recent industry headwinds.
- **NVR** (NYSE: NVR): Excellent management should see it through any housing downturn.
- **Oracle** (NYSE: ORCL): We hope to see more cloud success in 2019, but we know there's risk in the growth rates achieved.
- **Skyworks Solutions** (NASDAQ: SWKS): We like it, but its fate still remains closely tied to iPhone sales.
- **Square** (NYSE: SQ): A young powerhouse in the making. We like Square but expect price volatility.

- **Starbucks** (NASDAQ: SBUX): We're watching U.S. same-store sales.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Of China's Internet leaders, we like Tencent best.
- **Zuora** (NYSE: ZUO): This recent software IPO has long-term promise.

Tier Three: Yes, we still like these businesses, too (that's why we still own them), but we have more concerns about them than the others. If you're looking to raise capital, we'd start here. (In Johnson & Johnson's case, we can let covered calls do their work -- or keep the stock if they don't.)

- **Coherent** (NASDAQ: COHR): Low visibility to intermediate-term growth puts this one in our third tier even though the long-term business remains healthy.
- **JD.com** (NASDAQ: JD): Major founder issues gives us major pause right now. This one's a tax-loss candidate.
- ***New Dec. 10 --*** **Johnson & Johnson** (NYSE: JNJ): Our $140 covered calls may sell our shares for us. If not, J&J is Tier Two quality.
- **OpenText** (NASDAQ: OTEX): Consider moving these funds into a stronger, growing software company if you're so inclined. OpenText's reliance on acquisitions is starting to look a bit tired lately.

New Dec. 10 -- **Diagonal Call:** **Home Depot** (NYSE: HD). A well-managed free-cash-flow machine.

Short Call: **Sonos Inc.** (NASDAQ: SONO). Our short thesis is still tracking nicely.

Companies by Name

Adobe Systems

Tier One: These are the companies we feel most confident about owning over the next three to five years.

Adobe is the undisputed king in the creative-software and digital-marketing space, providing industry-standard products and services used by creative professionals to create, deliver, manage, and measure multimedia content and experiences. The company has been executing nearly flawlessly since its then-radical 2013 pivot from legacy product licenses to a cloud-based subscription model.

Adobe has expanded its total revenue from $4 billion to $8.6 billion over the past five years, a 17.1% compound annual growth rate. Over the same time span, subscription revenue as a percent of total revenue has grown from 35% to 88%.

Adobe made two significant acquisitions in 2018: Magento in May for $1.68 billion and Marketo in September for $4.75 billion. The former boosts Adobe's capabilities in digital commerce, and the latter gives it an edge in business-to-business marketing sales lead management. Management has an excellent track record for acquisitions, and these in particular should help fortify Adobe's strong competitive position in its markets.

Adobe's valuation multiples are rich -- it's currently trading at 52 times earnings and 35 times free cash flow -- but strong business momentum should allow the stock to grow into its valuation over time. This is a growing, high-quality business that operates with competitive advantages in two complementary markets, digital content creation and digital advertising, both of which have strong secular tailwinds. And that should lead to a strong chance of North Star-beating returns over the long run.

Amazon.com

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

An integral part of its customers' lives that makes their existences easier in a myriad of ways, Amazon is near or at the top of the list of the most powerful and admirable companies operating today. From its first $25 book sale in 1995, to $220 billion in trailing-12-month revenue as we speak, Amazon has consistently defied skeptics while expanding its product line, warehousing footprint, and delivery capabilities. Today the company achieves strong free cash flow, too -- and, yes, profits.

Lately priced at about $1,500 per share, the stock trades at about 50 times free cash flow and 64 times projected one-year earnings. That gives Amazon relatively little room to disappoint in the short term. So when management announced in its guidance last quarter that fourth-quarter sales might only increase about 15% year-over-year, Wall Street was disappointed. But we continue to think longer-term with Amazon, and we believe it has such a strong position in online retail that its own worst enemy is itself. Amazon needs to keep customers' trust (because there are plenty of competing online sellers) and also thread any regulatory needles carefully.

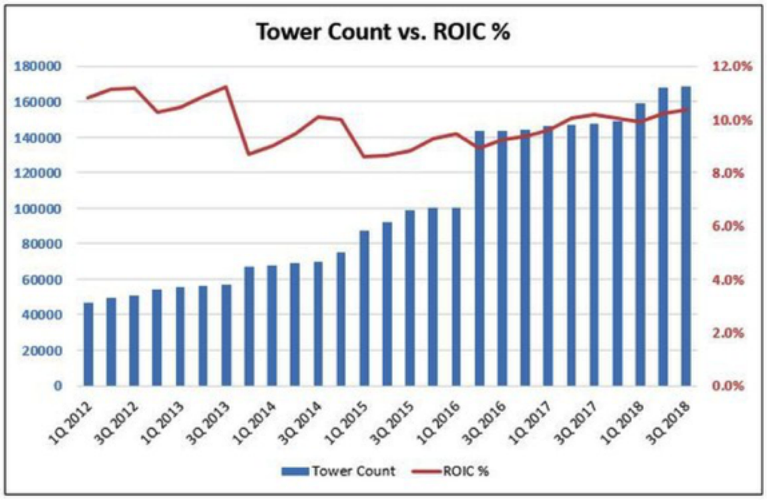
But overall, we believe Amazon will continue to be a winning investment over time and that management will continue to push itself to improve and evolve. That means it's hard to imagine our portfolio *without* a reasonable stake in this business. But be prepared for share-price volatility, perhaps quarterly, as investors start to digest slower growth rates from this giant.

American Tower

Tier One: These are the companies we feel most confident about owning over the next three to five years.

Despite its name, American Tower is actually the most global of the three major U.S.-based tower operators (the other two being Crown Castle and SBA Communications). The company has shown us steady growth, both organically and through significant acquisitions, since its addition to the *Pro* portfolio. It now operates nearly 170,000 towers across 16 countries, compared with 55,000 towers across 11 countries when we first recommended the stock in 2013.

American Tower benefits from excellent economics with high incremental returns on capital, leading to rising return on invested capital (ROIC) over time. In the third quarter of 2018, ROIC reached its highest level (10.4%) since 2013:



American Tower is a well-managed business operating in an industry benefiting from long-term secular tailwinds, and we expect continued strong growth as U.S. and international markets invest more and more in wireless technology.

In addition to our long stock position, we also have 0.8% in bull call spreads, which expire in January. With American Tower trading above our estimate of fair value, we're unlikely to roll out this leveraged position. We would recommend closing the bull call spread before the next ex-dividend date, which is Dec. 27. The in-the-money January 2019 $80/$135 bull call spread has a maximum spread value of $55, so use a limit order and hold out for as close to $55 per spread as you can. Make sure to close the spread before the ex-dividend date; if you don't, you'll risk being assigned on the short call and owing the dividend payment, which would detract from the returns on the spread.

Apple

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

If you think you're having déjà vu when it comes to negative headlines regarding iPhone demand and Apple suppliers, you're not the only one. Over the past few years, in addition to giving thanks and celebrating with loved ones, we've seen the emergence of a new holiday tradition: speculation on whether Apple's best days are behind it. A quick Google search of headlines at this time last year will show you countless articles about weak iPhone X demand and the way iPhone 8 production was slashed in half. Despite those fears, Apple's stock went on to soundly outperform the market -- until this latest round of fear-mongering started.

To be fair, Apple is partially to blame this year; management's decision to stop reporting unit sales has provided plenty of ammunition for those who want to herald the end of the golden age of the iPhone. But we remain optimistic that management will continue to grow its installed base of iPhones in the coming years, and we're also confident that the other business units (including the services division, which expanded by 27% this past quarter to $10 billion) will continue to thrive, making them more than capable of offsetting any future weakness in iPhone unit sales. At just 13 times forward free-cash-flow estimates after the sell-off, the stock appears to have a lot of bad news already baked into the price, providing long-term minded Fools with an attractive entry point. We eye 2019 with a definite plan to keep our shares.

Broadridge Financial Services

Tier One: These are the companies we feel most confident about owning over the next three to five years.

The *Pro* portfolio contains more Broadridge than almost anything else (except Mastercard), which means we have a high level of conviction in this investor communications management and global securities processing giant. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record, and sound capital allocation policies make Broadridge a sturdy portfolio anchor.

The stock has been in a slump recently, declining after its most recent earnings release amid market-wide volatility among technology companies. Since reaching an all-time high of $138.24 in mid-September, Broadridge's stock price has declined by more than 28% as of this writing. There were some surface-level factors in the most recent earnings report that likely contributed to the market's current negative sentiment on the stock, but nothing to suggest that our long-term investment thesis is impaired. In fact, this quarter's results support the argument that Broadridge's business continues to strengthen. After the recent sell-off, Broadridge's P/E multiple is as low as it's been since the fiscal second quarter of 2018 (late calendar 2017), when the stock price ranged between $80 and $90 per share. Our fair-value estimate of $117 per share means we think Broadridge is a bargain at current prices, and we're confident in North Star-beating returns from the current share price.

CME Group

Tier One: These are the companies we feel most confident about owning over the next three to five years.

As we hoped when we recommended it at the beginning of this year, CME Group's stock has benefited from interest rate hikes and market volatility. The more volatility in the markets (and commodity markets), the more investors use futures contracts to manage risk, leading to record volume in futures contracts at CME. With some of the strongest operating margins of any company in the S&P 500, CME is a financial powerhouse that's expanding overseas, too.

A leader where liquidity is key and network effects create competitive advantages, CME Group should continue to pay a healthy dividend that nets an annual yield of about 3% to 5% (we'll learn the amount of the latest special annual dividend soon) -- and that's on top of healthy historical share-price appreciation. CME Group will be affected by ups and downs in trading volume, which sometimes wanes during periods of greater stability, but as we've seen over the past 10 years, the business and stock can excel nonetheless. All else being equal, that makes us confident that we want to own the stock over the next several years, and ideally as a permanent fixture in the portfolio if merited.

Coherent

Tier Three: We still like these businesses, too, but we have more concerns about them than the others. If you're looking to raise capital, we'd start here.

Our worst-performing stock this year, Coherent has issues we've long been exploring. China's retaliatory tariffs on U.S. technology companies have hit this business significantly, and some execution issues at Coherent didn't help. As of the Nov. 6 conference call, management expects 2019 revenue to decline by 8% to 12% compared with 2018 results. Earnings per share will decline year-over-year, too.

On the plus side, Coherent remains an industry leader with strong profits and free cash flow (both of which should continue next year), and the stock, lately priced at about $130, trades at only 12 times expected earnings for the year ahead. Even so, Coherent is among our few Tier Three businesses -- ones we would consider selling to raise capital if you need to, or if you want to take the tax loss and invest the funds somewhere you like better.

Coherent still looks well-positioned to continue to serve the lasers that make our increasingly digital lives possible, including as the Internet of Things takes off and smartphones keep selling. Thus, we continue to believe in its long-term potential for pleasing returns. But we also have exposure to these trends through Apple and Skyworks, among others, so trimming here -- in one of our more cyclical businesses -- could make sense if you want to.

Facebook

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

It's difficult to discern to what extent Facebook's woes are its own fault and to what extent they were unavoidable, given its stature as the largest community ever gathered. The spread of hateful content, false news, and even paid advertising could have been curtailed much earlier, it seems, if management had taken the risks seriously enough from the start. Instead, it seems the issue was pushed aside — or at least pushed down the road. Now, management is spending billions to try to repair the problem, but there's no amount of money that can easily fix a damaged reputation.

At the same time, we have to cut management some slack for their youthful inexperience (CEO Mark Zuckerberg is 34), the novelty of their business, and the gravity of the issues pressuring them -- as long as they're acting honestly and in good faith. That's what we need to be confident about, if we're going to remain investors.

Financially, there is little to argue with so far. But the further Facebook slips in the public trust, the greater the risk that people will abandon its properties, in which case advertising dollars will start to face strain. We're not near that point today. Third-quarter revenue was up 33%, to $13.4 billion. Expenses rose by 53%, to $7.9 billion, but Facebook still generated impressive profits. Increased spending will continue through 2019, but Zuckerberg said, "I know we need to make sure our costs and revenue are better matched over time, and that's something I'm focused on as well."

From a financial perspective, that was the key statement in the third-quarter conference call. Spending velocity will ultimately subside — nobody can keep hiring and investing at this torrid pace — and revenue should keep growing until the two metrics are better aligned again. But it feels as though Facebook can't afford many more missteps before droves of people begin to lose trust in it entirely. The company is on thin ice right now, and the stock price reflects that.

Lately $131 and down about 28% year to date, the stock trades at 17.5 times expected earnings for 2018 and 2019 and 15 times expected earnings for 2020 (when net income is expected to expand more strongly again as spending cools). Should the business prove resilient, these prices will be too inexpensive to last. **Alphabet** (NASDAQ: GOOG)(NASDAQ: GOOGL) has averaged a 29.3 P/E ratio over the past 10 years with a much, much lower operating profit margin than Facebook has today -- even as the latter spends egregiously.

Facebook is lately our third-largest holding. We are comfortable enough to maintain our stake, though we definitely expect much better from management than the things we've been reading about (even if not all of the reporting tells both sides). We hope, and believe, that our long-term faith will ultimately be further rewarded, but we need to have renewed trust in management if we're going to stay committed to the stock for many more years to come. That means we must all be watching management now, and we need to be patient -- because of higher expenses, 2019 earnings may not grow much at all. That said, this should set the stage for stronger earnings growth in 2020, with Facebook already being well prepared for that year's presidential election.

FactSet Research Systems

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

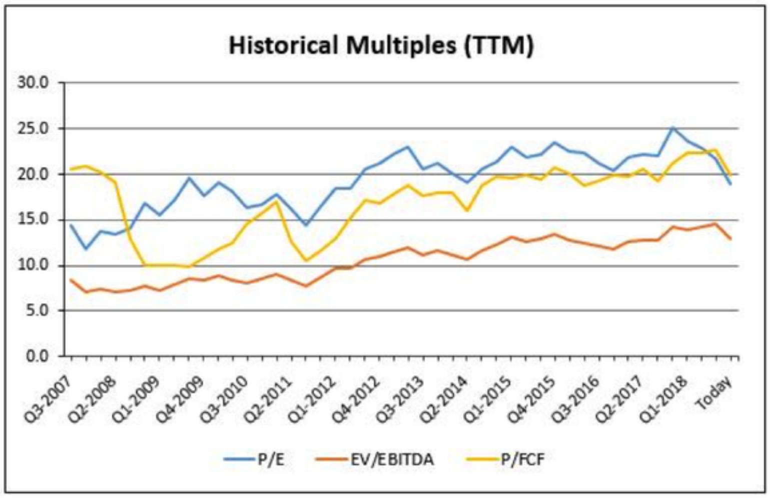
Combining proprietary data and software analytics with data from 220 suppliers, 115 news sources, and 85 exchanges, financial information provider FactSet is a great example of the type of "compounding machine" we seek in *Pro*. This company has reported 37 straight years of revenue growth, and it fits eight out of eight of our *Pro* quality criteria as shared in the original buy report from May 2016.

FactSet's unique data offerings become embedded in its clients' workflows, leading to strong retention rates (95%), significant pricing power (5.7% organic growth in annual subscription value in fiscal 2018), and high free-cash-flow margins (26% in 2018). FactSet's management has also returned an average of 92% of free cash flow to shareholders since 2013. These factors have helped contribute to FactSet's quiet outperformance -- since its inclusion in the *Pro* portfolio, FactSet has generated a 15% compound annual growth rate via capital appreciation and dividends, well above our North Star. With its pricing power and consistent growth, FactSet is a high-quality business that has a good chance of producing healthy long-term returns.

Home Depot

Diagonal Call

Like Broadridge, Home Depot has gotten caught in a downtrend since mid-September, falling from a high of $215.43 to recent prices of about $175 per share -- a decline of nearly 20%. Also as with Broadridge, the falling stock price does not correlate with a weakening business. In the most recent quarterly report for Q3 2018, Home Depot reported 5% year-over-year revenue growth, 5.1% U.S. comps growth, 28% online sales growth, and 36% growth in earnings per share. As a result of the recent downtrend, Home Depot is trading at a P/E multiple of 19, which we haven't seen since 2014:



Home Depot is a well-managed free cash flow machine that has posted consistent sales growth amidst a strong housing market, and as with our other housing-related investment, **NVR**, we believe our original long-term thesis is intact. Our January 2020/February 2019 $110/$185 diagonal call is humming along nicely, with a simple return (so far) of 16% in just more than a year, and with our short call expiring in a couple of months, we'd look to keep this position going by rolling out and/or up (if necessary) or writing a new diagonal call for more income, depending on where the stock price lands by February expiration.

JD.com

Tier Three: We still like these businesses, too, but we have more concerns about them than the others. If you're looking to raise capital, we'd start here.

Ahh, JD. If a bear market for Chinese stocks and concerns about a slowdown in that country's economy weren't enough, JD's management is also dealing with fallout after the U.S. arrest of its CEO, Richard Liu, on allegations of sexual misconduct. Recently, we've seen the company -- and Liu -- trying to assuage fears of "key man" risk, with Liu staying largely quiet during recent earnings calls and announcing a shift in his focus toward new business ventures. However, to date these tactics haven't done much to help.

Also notable was Liu's conspicuous absence from the World Internet Conference this year, and the fact that he wasn't invited to (or declined to attend) a recent symposium with Chinese President Xi Jinping. We could interpret these things as Liu preferring to lay low until his legal issues come to a conclusion, but a skeptic might wonder whether Liu is preparing for an exit and/or whether he has fallen from the good graces of the Chinese government.

Unfortunately, all of this is happening during an investment year for the company as it builds out its logistics business, which has hurt margins and given investors even more reason for doubt. Although our original thesis was never predicated on Liu being the next Jeff Bezos, we'd be lying if we said we weren't concerned about the effects the Liu situation is having on JD.com. At a minimum, it's likely a major disruption for management and a negative hit to employee morale. Outside of a recovery in the Chinese market, we're struggling to find an immediate catalyst for the stock. That makes JD a strong candidate for selling for tax purposes before this year is out; you can then reassess whether it's worth repurchasing shares (once your 30 days are up for wash-sale rules). This thinking puts it among our few Tier Three stocks.

Johnson & Johnson

Tier Three: We still like these businesses, too, but we have more concerns about them than the others. If you're looking to raise capital, we'd start here.

We've slotted this one into Tier Three mainly because we've written January 2019 $140 calls on the stock and are prepared to let our shares go by expiration if necessary. But Johnson & Johnson's business has performed right in line with our expectations ever since we brought it into the portfolio in early 2017. Although the consumer and medical-device divisions have seen sluggish growth, the larger and more important pharmaceutical division (which makes up 51% of companywide sales and 61% of operating profit) has been leading the way. Sales there have expanded by 26% since the end of 2016, with particularly strong performance from the company's oncology drugs. And the stock has held up well during the recent market correction; it's declined much less than the market as a whole and even reached new all-time highs recently.

The J&J position has been a steady performer for us via capital appreciation and dividends, and we've been augmenting the position's return with three separate rounds of covered calls, as well. Our January 2019 $140 calls are currently in-the-money, and given the stock's valuation, we'd be content to let our shares go at $140 in January; that would result in a 22% simple return (11% CAGR) since the position's inception. However, if the stock declines below $140 by January expiration, we'd be happy to hold our shares and potentially write new covered calls, depending on the stock price and valuation.

Mastercard

Tier One: These are the companies we feel most confident about owning over the next three to five years.

The second-largest payments processor in the world (behind fellow *Pro* holding Visa), Mastercard makes money as an intermediary between banks around the world, generating revenue based on the gross dollar volume ("GDV") of activity on the products that carry the Mastercard brand. In 2017, Mastercard products processed $5.24 *trillion* in GDV, demonstrating the size and scale of this global financial giant. (For context, global GDP in 2017 amounted to about $80 trillion.)

And even though Mastercard is one of the largest publicly traded companies in the world by market capitalization, the business is still growing at high rates; in the third quarter of 2018 (on a currency-neutral basis), GDV rose by 13%, net revenue expanded by 17%, and earnings per share were up 36%. Mastercard's strong organic growth is a result of the company's key position as an intermediary in the global economy, robust global economic activity, and continued penetration of electronic payments. Revenue growth looks likely to remain strong, with management expecting "low-teens" revenue growth for the foreseeable future. Mastercard is arguably Pro's most impressive long-term holding – among positions we've held longer than two years, it has the highest position-level CAGR at 28.5% per year since the position's inception in 2011. As Mastercard has proven over time, an asset-light, highly profitable business with healthy growth in organic revenue provides a strong recipe for impressive long-term returns.

Medtronic

Tier One: These are the companies we feel most confident about owning over the next three to five years.

Quietly but surely, Medtronic continues to expand its international sales by more than 10% a year, with a strong focus on China. The U.S. business maintains its dominance, too, placing among the top three in nearly every major area of focus across the medical-devices industry. Last quarter, organic sales were up 7.5% and earnings per share jumped more than 13% year-over-year.

The stock has been a quiet performer for the Pro portfolio, earning North Star-topping returns for the years we've owned it. Medtronic is promising more of the same, suggesting annualized sales growth in the mid-single digits that would lead to earnings-per-share growth of at least 10% annualized.

Health care is both a defensive sector *and* a good holding to have at all times -- assuming you own a business that is steady and growing. Medtronic fills both needs, providing some ballast in a volatile market, yet growing enough to please us. Should Medtronic's international sales begin to falter, we may need to revisit the thesis; we also want to see CEO Omar Ishrak stay in place. Overall, though, we're happy with how Medtronic is positioned, and we continue to foresee North Star-like returns from it. If anything, we could have made it a larger position during past pricing opportunities.

NVR

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

Both revenue and EPS continue to grow at a healthy clip (up 11% and 27%, respectively, this past quarter), but you probably wouldn't have guessed that by looking at NVR's stock. Year-to-date, NVR is down about 30% as fears regarding the effect of rising rates on the housing market have made investors eager to sell homebuilding stocks. Although there could be more near-term pain as the market attempts to make sense of the changing macroeconomic conditions, we still believe our original long-term thesis for NVR is on track.

In the intermediate term, NVR will likely benefit from Amazon's decision to set up a new HQ in NVR's northern Virginia backyard. There are also rumors that Apple is exploring the idea of adding 20,000-employee campus in the same region. And it's worth keeping in mind that weakness in the housing market isn't necessarily a bad thing for long-term investors here -- it affords NVR's management the opportunity to scoop up both lot purchase agreements (essentially option contracts on finished lots, a key part of its business model) *and* its own shares at more advantageous prices. This is a long-term commitment for five years or more.

OpenText

Tier Three: We still like these businesses, too, but we have more concerns about them than the others. If you're looking to raise capital, we'd start here.

We've been clear about our intentions to potentially replace OpenText in the *Pro* port for some time now. The company's sales were up 4% last quarter, and management foresees organic sales growth in the low single digits for the year that just started, with recurring revenue more than 75% of the total. That's not bad, but most of the annual growth remains driven by acquisitions, and as the software environment becomes ever more competitive, we're concerned that the quality of any potential acquisitions may diminish or the cost of this strategy may go up.

Meanwhile, many new software companies are building successful businesses from the ground up, and many may stand a better chance of creating exceptional shareholder value for the next five to 10 years. **ServiceNow** (NYSE: NOW) and **Veeva Systems** (NYSE: VEEV) are two companies that might make good replacements -- with the caveat that those stocks are much more volatile than OpenText's, and we don't necessarily want to add more volatility to the portfolio at the moment. Additionally, OpenText is one of the least expensive software stocks we follow; lately at $32, it trades at only 12.3 times expected earnings this year and 14.3 times trailing free cash flow. So you should feel perfectly content to go on owning it if it suits your portfolio.

Some things to watch for: Acquisitions that seem especially expensive or that don't appear to be working out within the planned time frame; sales growth that stalls or, heaven forbid, turns negative; management citing growing competitive pressures, which they've never done in the past. Although we've known OpenText for more than a decade and could go on owning it for many more years, we've been leaning toward replacing it with something that's growing much more organically. If there are other Fool-recommended software stocks you like more than OpenText, you can consider moving your OpenText funds (a relatively small portion of your *Pro* portfolio) into those stocks instead. (Our own Paycom is one option, as are the businesses mentioned above.) Just keep your tax consequences in mind if you're selling. And if you prefer to go on owning OpenText, we still like the stock for the coming three years, assuming none of the above warning signs or others show up.

Oracle

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

We're hopeful that Oracle will start to get -- and deserve -- much more respect in 2019. It's not as though the business is struggling: In its first quarter of 2019, Oracle's sales were up 2%, but earnings per share jumped 19%, and 91% of the company's revenue is recurring in nature. Plus, Oracle is starting to overcome the drag of transitioning from an all-license software company to cloud sales (for which up-front revenue is smaller, but long-term value to Oracle is higher). The company remained a free-cash-flow monster as it went on building its cloud-server warehouses, and it now competes with the likes of Amazon on cloud hosting (although Bezos and Co. do remain comfortably ahead). More importantly, Oracle is now ready to enjoy a healthy annuity of cloud software revenue from customers.

Plus, recent news that Warren Buffett and his team started a large position in Oracle helped to lift the stock. With time, we believe Oracle's stock could rise as investors slowly realize that its cloud business is substantial, and its license business should be highly regarded, too. Oracle faces competitors on all sides, but we believe it's holding its own. Management expects earnings-per-share growth "in the double digits" (at least 10%) for its 2019, with revenue growth improving by more than 2% in the second half. Recently at about $49, the stock trades at only 14 times expected earnings for the year ahead, and about 15 times trailing free cash flow.

At this price, and with the cash-flow growth rates we anticipate, we believe Oracle should challenge our North Star over the coming three years, as long as everything remains the same or improving with the business. It's in our Tier Two mainly because of the risk that its cloud revenue won't expand by as much as Wall Street hopes, which would keep its value multiple low. And if competitors are taking market share directly from its prospects, we'll eventually see that, and it will hurt. But we're hopeful at the moment. That said, as with OpenText, if you want to replace Oracle with a software company that is growing sales much more strongly, you can consider it.

Paycom

Tier One: These are the companies we feel most confident about owning over the next three to five years.

The cloud-based payroll and human-resources software provider expanded its revenue by 32% last quarter, to $133 million, and earnings per share more than doubled to $0.50, even as Paycom spends to continue to grow. Management expects the current pace of revenue growth to continue, with incredible gross margins of 84% to 85%. Lately at about $121, the stock looks less pricey than you might expect, trading at about 39 times estimated earnings for the year ahead. Beyond that, we like Paycom's long-term potential, as most of its revenue is recurring. And it has a giant market in which to keep taking market share, especially since it's only now starting to proactively target companies with more than 2,000 employees. Management has repeatedly said they believe they're only just beginning to address the market's needs, and we agree. Like Paychex decades before it, we believe that founder-led Paycom may remain a strong, growing stock for years.

Skyworks Solutions

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

One of our favorite semiconductor stocks, Skyworks recently reported its ninth consecutive year of record sales and profits, with fiscal 2018 revenue up 6% to $3.9 billion and earnings per share up 12% to $7.22. Profit margins continue to rise, and its business continues to expand beyond Apple. Customers include Samsung and its flagship phones, **Cisco Systems** (NASDAQ: CSCO), **Microsoft** (NASDAQ: MSFT), **BMW** (NASDAQOTH: BAMXF), **Tesla** (NASDAQ: TSLA), Amazon, and many more. The Internet of Things and the 5G network rollout continue to represent tremendous tailwinds for Skyworks, and the business maintains competitive design and manufacturing advantages that keep others at bay.

But the stock price is back to where it traded several years ago, unnecessarily reminding us that semiconductor stocks can often be a cyclical test of patience. Eventually, however, long-term owners of the best of them are rewarded. We still believe that Skyworks fits the bill, and that the business will be much larger three to five years from now -- as long as Apple remains a major customer. That is easily the largest risk, and it must be watched. We see no signs of Apple looking to move away from Skyworks, but we need to be observant.

Already down largely on fears that Apple iPhone sales are slowing, Skyworks (lately around $70) now trades at 9.8 times expected earnings for the year ahead, the cheapest it has been since a brief stint in 2012. Management expects record revenue and earnings again in 2019, even if growth will be slight that year because of flat phone sales. You should feel comfortable keeping a 2.6% stake in the stock as long as you can also keep a close eye on Apple; you should also ensure your combined exposure to both companies is reasonable. If you need to trim one or the other, we would focus on owning Apple over Skyworks, since Apple is in the position of power in this relationship.

Sonos Inc.

Short call

The post-earnings pop in Sonos' stock price was short-lived; though the market was initially thrilled with management's revenue growth and guidance, after reviewing the results and earnings call, we think our short thesis is still tracking nicely. For starters, much of the "beat" this quarter can be attributed to the company's switching up its strategy and getting more aggressive with its product launch cycle. Previously, the company took an Apple-esque approach to releases, opting to launch only a few products each year.

However, management has now all but acknowledged that increased competition requires a more rapid upgrade cycle and an expanded product line. We think there are a few problems with this, including the fact that this change in approach will continue to exert downward pressure on margins (which is never a good thing when you don't make any money). We're also willing to wager that the company is likely overestimating customers' eagerness to upgrade and/or buy additional Sonos speakers, which could result in both inventory issues down the line and an unforeseen slowdown in sales.

Finally, we think management's newly announced plans to go after market opportunities outside the home are an indirect acknowledgment that the market opportunity inside the home isn't nearly as big as they've represented it, likely because they're losing ground to the competition. With that in mind, we're content to leave our position alone for the time being, watching and waiting for a January expiration that could bring the full profit.

Square

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

One of our best-performing stocks over the past 16 months or so, Square looks like a potential monster in the making. Founder and CEO Jack Dorsey is letting the company find creative solutions for its millions of card-accepting customers, including micro-finance for small businesses, inventory software, and food delivery. Like a mini (very mini) Amazon.com, Square's business is increasingly difficult to nail down, because it includes everything from regulated banking to point-of-sales credit card revenue to software and services. But we like that, because each business relates to the other.

And it's working, because revenue growth rates have been accelerating both sequentially and year-over-year. That's the kind of rare performance that normally makes Wall Street swoon. Adjusted revenue was up 68% year-over-year last quarter (announced Nov. 7), and technically it was Square's first quarter of GAAP profitability. CFO Sarah Friar sees continued momentum in the business, expecting sales growth of about 60% in the current quarter. The longer term points to a much larger market opportunity across all business lines. Such promise comes with a volatile stock, though, and we expect that volatility to remain. We've seen this countless times with young, growing companies, and we know that if the business keeps performing, the end result could be excellent long-term shareholder returns.

Starbucks

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

After languishing for much of the past three years, shares of Starbucks finally started to perk up earlier this month as investors responded positively to the latest quarterly results. Investors also liked management's commentary on China and how the Alibaba partnership will provide "rocket fuel" for their Chinese initiative. Fortunately for investors, although Starbucks the stock may have done a whole lot of nothing the past few years, Starbucks the company remained busy growing on both the top and bottom lines. Combined, these two factors resulted in some significant multiple contraction, with Starbucks' P/E and P/S both falling by almost 50% from peak to trough. This is important because it gives us confidence that the recent surge in the stock price hasn't immediately pushed the stock back into "overvalued" territory. Although the company still has many obstacles to overcome, we believe the odds are in our favor that Starbucks outperforms the North Star over the next three years.

Tencent

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

Like JD, Tencent is also suffering from Chinese stock malaise in addition to business-specific issues. Although many of the headlines surrounding Tencent are currently devoted to the Chinese government's freeze on granting monetization rights for newer games, we tend to view this as a temporary roadblock, not a long-term thesis buster. We believe Tencent is taking the necessary steps to keep itself in the good graces of the government and that many of these moves are designed to simply help the mobile gaming industry catch up to its PC counterpart in terms of regulation. In the interim, despite the hit to the company's financials, this monetization freeze could ultimately end up helping Tencent by essentially starving smaller gaming companies of the oxygen they need to continue developing new games, in addition to making newcomers less likely to enter the space. We were more concerned with the news of management's more siloed approach to using its data (we believe it's more valuable shared across the company). But since we first expressed these concerns, management appears to have take the first necessary steps to address this issue. With many of the company's products still in the early innings in terms of monetization, and new products constantly in development, we still feel confident in our long-term Tencent position.

Verisk

Tier One: These are the companies we feel most confident about owning over the next three to five years.

The market may be well off its highs (at least as of when we're writing this), but you wouldn't know it by glancing at the stock chart of our underfollowed provider of data analytics for the insurance, natural resources, and insurance industries. After a ho-hum couple of years, we like some of the moves the company has made recently, and the market appears to appreciate the changes the new CFO has made to its disclosures. Those changes would normally lead us to expect an expansion in valuation multiples, as the market generally reacts favorably to increased financial transparency (as long as what it reveals is generally positive), but Verisk's valuation is still within a range we would consider to be fair. We still believe this company has years' worth of North Star-topping performance left in it. And that could continue to come with lower-than-average volatility. Like so many of our *Pro* stocks, Verisk has pricing power and recurring revenue in spades.

Visa

Tier One: These are the companies we feel most confident about owning over the next three to five years.

Visa is an even bigger cog in the global financial system than fellow *Pro* holding Mastercard, with a global market share of more than 50%. Like Mastercard, Visa's financial profile is stellar despite its massive size; in fiscal 2018, the company expanded its revenue by 12% and earnings per share by 58%, and it processed more than $8 trillion in total payments volume (up 11%). A newer addition to *Pro* than Mastercard -- we first bought Visa in 2015 -- the company provides additional exposure to the megatrend movement of global financial transactions away from cash and toward electronic payments. The two companies' business models and economics are similar, and holding Visa alongside our Mastercard position represents our strong conviction in the electronic payments space and provides company-level diversification within the industry. Like Mastercard, Visa's giant payment network should continue to be a source of healthy organic revenue growth as electronic money continues to replace cash, supporting earnings growth at least in the mid-teens (and North Star-challenging stock returns) over the next several years.

Zuora

Tier Two: We have great reason to own these companies over the next five years, but we think they are at least modestly more risky and/or their futures less certain than those of Tier One businesses right now.

Zuora is one of the newest additions to our portfolio, and we're optimistic about its long-term potential; we look forward to watching it grow toward profitability over the coming few years. We're comfortable with the small stake to which we just recently added a bit more. Zuora sells software that lets customers more easily recognize revenue and billing in a fluid, modifiable, and recurring fashion. Its software -- and its whole approach -- is much more attuned to today's economy and fluid business models than older offerings. This is helping Zuora sign contracts with many of today's most dynamic young technology companies, as well as with old-school behemoths such as **John Deere** (NYSE: DE) or **GM** (NYSE: GM).

We do need to watch revenue growth rates. Management has suggested Zuora could expand its revenue by about 25% annualized for years to come, so Wall Street now expects that. At the same time, we want to see expenses contained enough that profitability starts to appear on the horizon, even though Software-as-a-Service business models by nature do postpone profitability for a long time as they build the business. Wall Street should remember this with Zuora just as it has with **Salesforce** (NYSE: CRM), from whence Zuora's founder-CEO originally hailed. We like owning a stake in this young business for the long haul.

Conclusion

The last thing we want is for you to be anxious. The *Pro* team has vetted every company in our portfolio time and time again. That doesn't mean the stocks won't go down at times, of course, but we believe in the underlying businesses and the long-term potential.

What's most important over the coming year is that you make sure *your* portfolio is in a place where you remain comfortable and happy with it. We hope to help you stay (or get) there with our continued updates from longtime *Pro* analyst Billy Kipersztok, and we hope this first report is a big step toward helping you decide which few holdings you might want to sell and demonstrating which ones we believe in most strongly (which is most of them!). Our current allocations make sense, and by large they reflect our beliefs (Medtronic and Verisk, for example, could be larger positions, but in general things are aligned). If you so choose, you can sell from the positions lower on our Tiered list and add to some of the stocks in higher Tiers that are still smaller-than-average holdings. But even if you do nothing, we believe Pro's long portfolio should ultimately win nicely as a whole.

It has been our great honor -- the honor of a lifetime -- to serve you in *Motley Fool Pro*. We hope the team's continued coverage over the next 12 months makes it very easy for you to transition in whatever way works best -- and again, we don't expect any big changes are needed in your long *Pro* portfolio today. Finally, we've closed all our shorts and hedges; they were short-term positions, and the market had fallen for us. If you want to hedge the market going forward, you know that we like to set up simple synthetic shorts. The call's strike price should be above the market index, and the put's price should be below it. For the more advanced investor, ratio put spreads remain an option. You can also simply buy puts -- we like to say it's buying insurance. And we've always kept an ample amount of cash for a rainy-day opportunity. We believe that helps add peace of mind to your investing, along with eventual upside through new investments. We averaged less than 75% net long exposure over our lifetime, but returned more than 100% of the S&P 500's return.

We wish you all the best as you continue your Foolish journey, and we hope that you will let The Motley Fool -- if not us! -- continue to serve you well for years to come. Thank you again for making *Pro* possible, including now, in its next evolution.

-- The *Motley Fool Pro* Team

Pro Guidance Changes and Completed Trades: Dec. 3, 2018

Published Dec 3, 2018 at 12:48PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- None.

***Pro* Completed Trades** (see transaction log; trades take a day to appear):

- **Gilead Sciences** (NASDAQ: GILD): Our naked calls expired fully as income over the weekend.
- **Murphy USA** (NYSE: MUSA): We closed our short.
- **SeaWorld Entertainment** (NYSE: SEAS): We closed our short.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

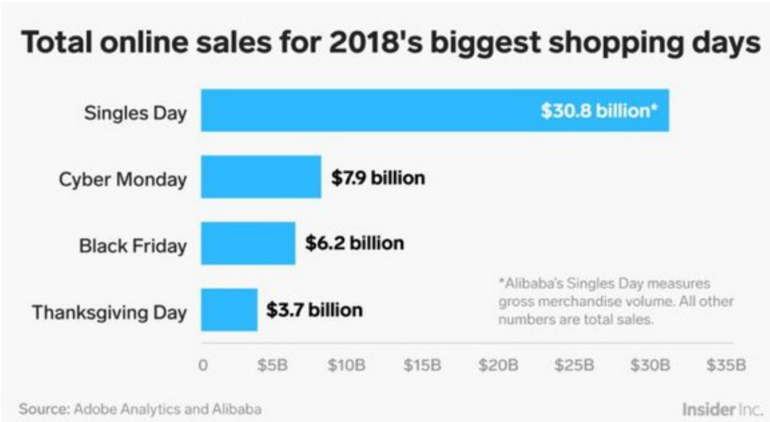
Charts of the Week: E-Commerce in 2018, a Tech Bear Market, and More

Published Dec 3, 2018 at 12:44PM

Dear *Pro* Fools,

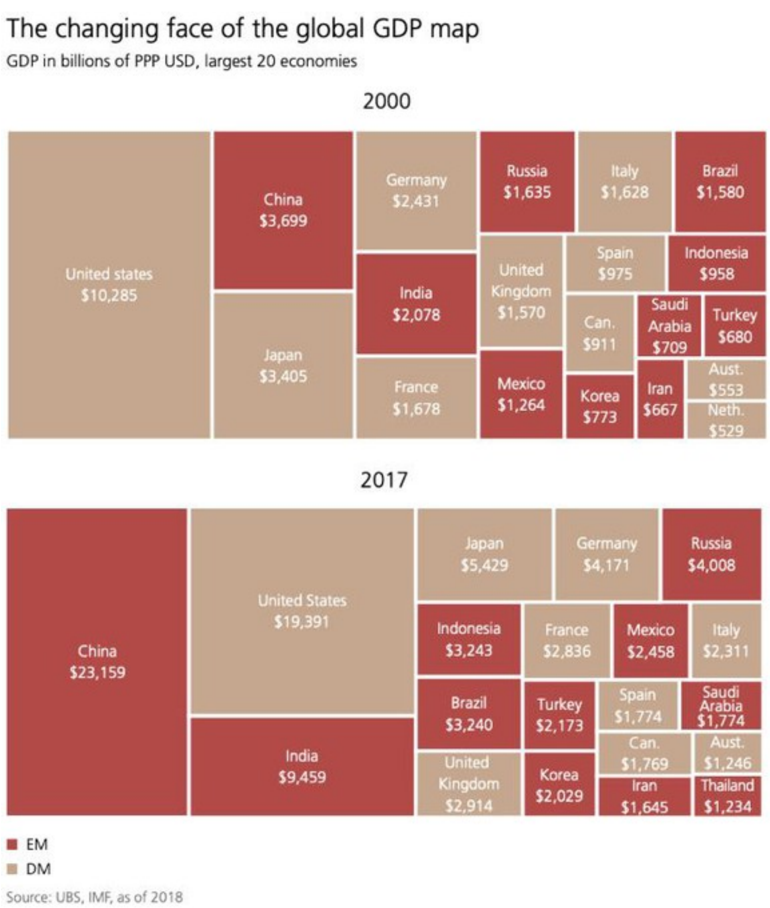
Let's start off our week with another edition of my "Charts of the Week" series. Here are the five most interesting and/or market-relevant charts I've found in the past seven days:

1. E-commerce in 2018



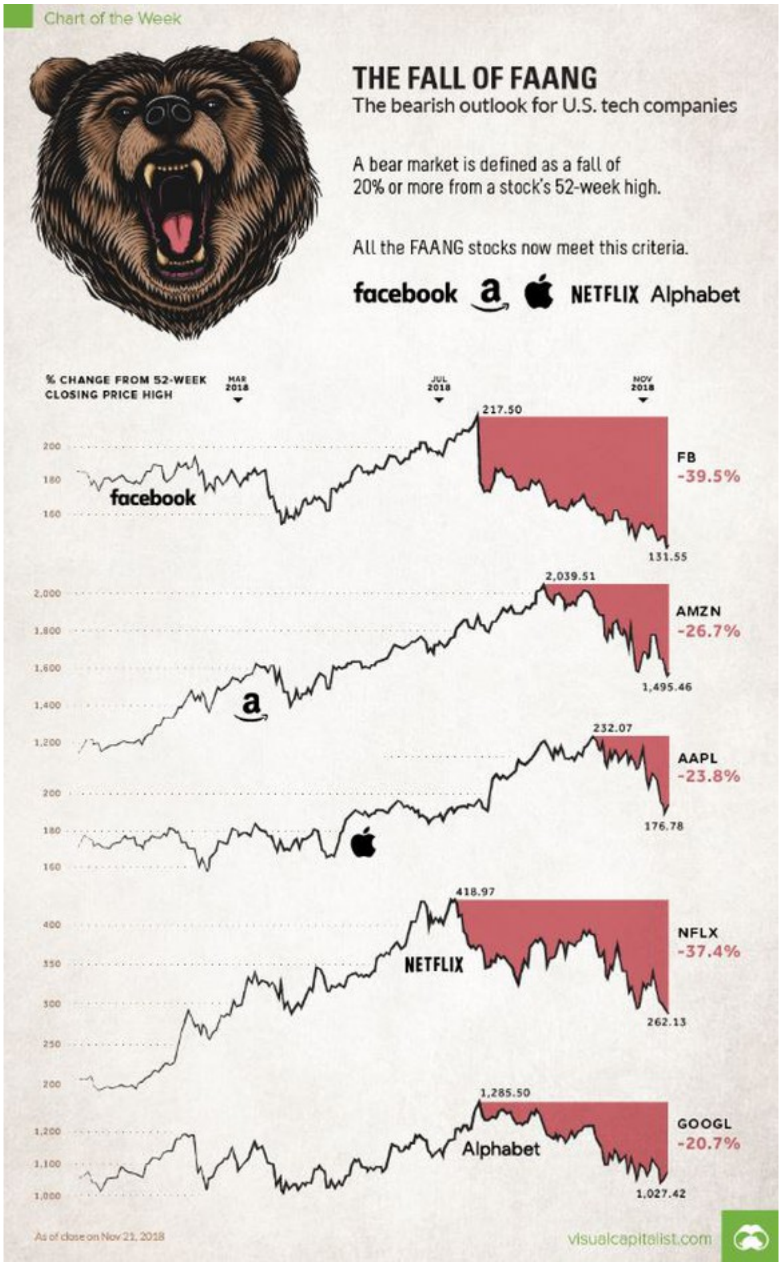
This chart from Skye Gould at BI Graphics shows the total online sales for 2018's biggest global shopping days. If you're not already familiar, [Singles' Day](#) is a holiday with origins in China that has now become the largest offline and online shopping day in the world. And even as online sales rose by 28% on Thanksgiving Day, 24% on Black Friday, and 19% on Cyber Monday, the chart clearly demonstrates the massive scale of China compared with the United States.

2. The Largest 20 Economies in 2000 vs. 2017



Helping to bring home the point from the previous chart, this graphic from [UBS](#) shows the shifting landscape of global GDP. Since 2000, China has overtaken the U.S. in GDP as measured by purchasing power parity, increasing its GDP by more than 500% (a CAGR of 11.4%) since 2000, compared with 89% (a CAGR of 3.8%) for the United States. We can also see the emergence of India over the last two decades; GDP in that nation has increased by more than 450% (a 9.3% CAGR) over the same time span, and it now represents the third-largest economy in the world.

3. The Bear Market in Big-Name Tech Stocks

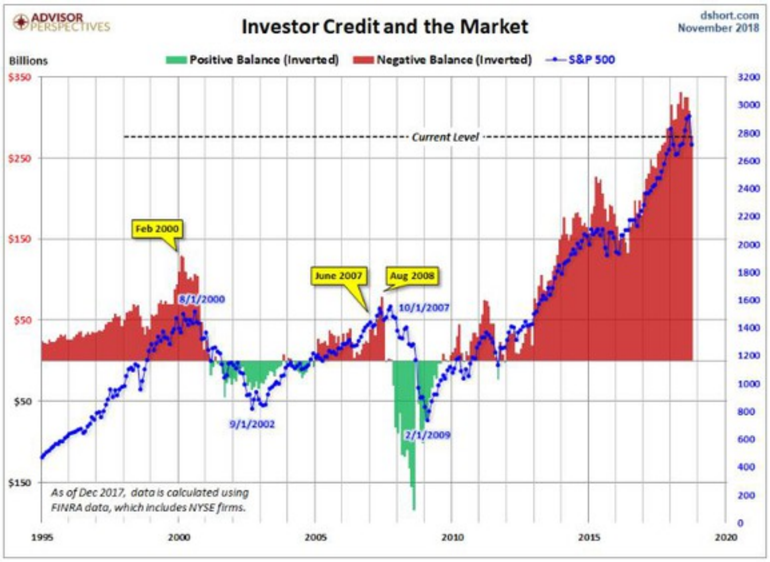


This chart from the Visual Capitalist shows the effect of the recent market correction on the big-name technology stocks. As of market close on Nov. 21, each of the five FAANG stocks was down more than 20% from recent highs, having lost close to $1 trillion in market capitalization from their peaks. The bear market for the FAANG stocks has recovered a bit lately, with each stock trading higher today than the figures from the chart, but the stocks are still well off their summer peaks.

4. The "Powell Effect"

This graph from Eddy Elfenbein's Crossing Wall Street blog shows the effect that the chairman of the Federal Reserve can have on the market. The graph shows the change in value of the S&P 500 index by the minute on Nov. 28, the day Federal Reserve Chairman Jerome Powell spoke at The Economic Club of New York. The spike in the chart at 12 noon coincides exactly with the beginning of the speech, when Powell indicated that interest rates are "just below" neutral. That comment suggests that the pace of interest-rate hikes may slow, which is good for stocks (and hence the spike of the S&P 500, which closed up 2.3% on the day, the market's best day in eight months).

5. Investor Credit Balances vs. The S&P 500



This intriguing graph (as of October 2018) from Jill Mislinski at dshort.com overlays investor net margin debt with the S&P 500. Green areas of the graph represent a net positive balance of investor credit (i.e., more cash than debt), and red areas represent a net negative balance of investor credit (i.e., more debt than cash). The blue line represents the S&P 500.

The graph shows how net margin debt is correlated with the movement of the S&P 500, as peaks in investor margin debt tend to coincide with peaks in the market. Additionally, net positive balances of investor credit tend to coincide with market lows. We can see that despite the recent decline of net margin debt associated with the decline of the market in October, we are still nowhere near a net positive balance of investor credit.

The *Pro* Bottom Line

There you have it, Fools -- this week's edition of my top five charts of the week. Hope you enjoyed it, and bring any questions or comments to the Memo Musings board!

Best,

-- Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Expirations: Mastercard, Square, and More

Published Nov 29, 2018 at 12:50PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Broadridge Financial Services** (NYSE: BR): Buy half of our 6.5% stake.
- **Mastercard** (NYSE: MA): Buy half of our 7% stake to start.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy at least half of our 4.7% stake.
- **Facebook** (NASDAQ: FB): Buy half of our 5.7% stake.
- **NVR** (NYSE: NVR): Match our 2.4% stake.
- **Skyworks Solutions** (NASDAQ: SWKS): Match our 2.5% stake.
- **Square** (NYSE: SQ): Buy half of our 5.6% stake.

Shorts:

- **Murphy USA Inc** (NYSE: MUSA): We are closing the short.
- **SeaWorld Entertainment** (NYSE: SEAS): We are closing the short.

Options:

- See below.

Upcoming Expirations:

- **November:**
  - **Gilead Sciences** (NASDAQ: GILD): Our naked calls are set to expire as income tomorrow.

Bear Market Territory

Published Nov 26, 2018 at 1:27PM

Dear *Pro* Fools,

We're officially in bear market territory. The most recent high for the S&P 500 was set on Sept. 21, at a value of 2,940.91. As of Friday's close, the market was down 10.5% from that peak, to 2,632.56. The trough of the current bear market was Oct. 29, when the index reached a low of 2,603.54, down 11.2%.

Over the past two months, I've had friends contact me wondering if they should be pulling out of bullish positions, fearing a market crash. Is it time to panic?

To answer that question, I find it useful to take a look at market history. It reminds me that periods of declining stock prices are normal. I recently read an excellent blog post from Charlie Bilello at Pension Partners that provided great historical context for market corrections. Bilello noted that since March 2009, there have been 23 periods in which the S&P 500 declined more than 5% from peak to trough, which works out to an average frequency of more than two times per year:

S&P 500 Corrections >5% since March 2009 Low

Correction Period	# Days	S&P High	S&P Low	% Decline	VIX Peak
2018: Sep 21 - Oct 29	38	2941	2604	-11.5%	28.8
2018: Jan 26 - Feb 9	14	2873	2533	-11.8%	50.3
2016: Aug 15 - Nov 4	81	2194	2084	-5.0%	22.9
2016: Jun 8 - Jun 27	19	2121	1992	-6.1%	26.7
2015/16: Nov 3 - Feb 11	100	2116	1810	-14.5%	32.1
2015: May 20 - Aug 24	96	2135	1867	-12.5%	53.3
2014/15: Dec 29 - Feb 2	35	2094	1981	-5.4%	23.3
2014: Dec 5 - Dec 16	11	2079	1973	-5.1%	25.2
2014: Sep 19 - Oct 15	26	2019	1821	-9.8%	31.1
2014: Jan 15 - Feb 5	21	1851	1738	-6.1%	21.5
2013: May 22 - Jun 24	33	1687	1560	-7.5%	21.9
2012: Sep 14 - Nov 16	63	1475	1343	-8.9%	19.7
2012: Apr 2 - Jun 4	63	1422	1267	-10.9%	27.7
2011: Oct 27 - Nov 25	29	1293	1159	-10.4%	37.5
2011: May 2 - Oct 4	155	1371	1075	-21.6%	48.0
2011: Feb 18 - Mar 16	26	1344	1249	-7.1%	31.3
2010: Aug 9 - 27	18	1129	1040	-7.9%	28.9
2010: Apr 26 - Jul 1	66	1220	1011	-17.1%	48.2
2010: Jan 19 - Feb 5	17	1150	1045	-9.2%	29.2
2009: Oct 21 - Nov 2	12	1101	1029	-6.5%	31.8
2009: Sep 23 - Oct 2	9	1080	1020	-5.6%	29.6
2009: Jun 11 - Jul 7	26	956	869	-9.1%	32.8
2009: May 8 - 15	7	930	879	-5.5%	34.1
Average	42			-9.3%	32.1
Median	26			-8.4%	30.3

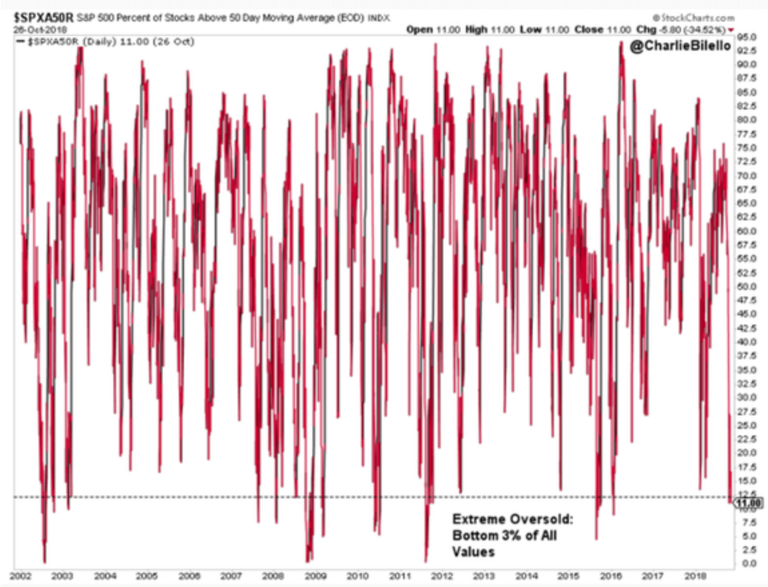
Pension Partners — @CharlieBilello

Source: Charlie Bilello, Pension Partners

We can see from Bilello's table that market corrections don't tend to last very long. Since 2009, the average correction greater than 5% has lasted just 42 days, with a median of 26.

In addition to simple metrics such as length of the correction and percent decline, Bilello also explored a more nuanced metric that he called an "oversold extreme" condition. He quantified this by measuring the percentage of stocks in the S&P 500 at prices above their respective 50-day moving averages. When this percentage reaches a very low level (there are few stocks above their 50-day moving averages), it can be a sign of indiscriminate selling.

As of Oct. 30, the trough of the current correction, Bilello found that only 11% of stocks were above their 50-day moving average. This represented a more oversold condition than 97% of historical readings (with data going back to December 2001):



Source: Charlie Bilello, Pension Partners

After such oversold extremes are reached, Bilello found that stocks tend to rebound quickly, with above-average forward returns in most periods:

@CharlieBilello	S&P 500 Forward Total Returns (Dec 2001 - 2018)							
% Above 50-Day Moving Average	**1-Wk**	**1-Mo**	**3-Mo**	**6-Mo**	**9-Mo**	**1-Year**	**3-Year**	**5-Year**
<12% (Lowest 3% of all values)	0.9%	2.3%	1.9%	9.0%	14.9%	22.7%	56.7%	110.4%
All other values	0.1%	0.7%	2.3%	4.6%	7.1%	9.9%	30.6%	53.9%
Differential	0.7%	1.6%	-0.4%	4.4%	7.7%	12.8%	26.1%	56.6%

@CharlieBilello	S&P 500 % Positive Forward Total Returns (Dec 2001 - 2018)							
% Above 50-Day Moving Average	**1-Wk**	**1-Mo**	**3-Mo**	**6-Mo**	**9-Mo**	**1-Year**	**3-Year**	**5-Year**
<12% (Lowest 3% of all values)	59.5%	69.6%	56.0%	69.6%	84.0%	92.8%	98.4%	100.0%
All other values	57.5%	65.5%	70.4%	76.7%	80.7%	83.5%	81.8%	88.0%
Differential	2.0%	4.1%	-14.4%	-7.1%	3.3%	9.3%	16.6%	12.0%

Source: Charlie Bilello, Pension Partners

The first table above shows that for every period examined except three months, S&P 500 forward returns following an "oversold extreme" have been significantly higher than forward returns after all other market conditions. And the longer the time period, the bigger the differential in performance.

The second table examines the historical likelihood of positive forward returns following an oversold extreme. As with the first table, we see that over shorter time periods, the likelihood of outperformance is more sporadic (three-month and six-month periods were actually less likely to produce positive forward total returns following an oversold extreme). But again, when we look at the longer term, we see a significant difference in likelihood of positive performance for oversold extreme conditions compared to all others. Over the subsequent three- and five-year periods following an oversold extreme, respectively, the S&P 500 produced positive returns 98.4% of the time (with an average of a 56.7% total return) and 100% of the time (with a 110.4% total return).

The *Pro* Bottom Line

All in all, we can conclude that extreme oversold conditions (like the market environment we are in now) tend to result in a higher probability of above-average forward returns than other periods. Does that mean we should expect a stock-market bounce in the near future? Absolutely not. The stock market is a world of probabilities, not certainties. But an oversold market environment, combined with the fact that economic indicators are not yet showing signs of a recession, suggests to me that this market correction is more likely to be a temporary blip with rebounding stock prices than it is to be an enduring market crash. But as usual, I reserve the right to be wrong!

Fool on,

Billy (TMFBillyTheKid)

Gratitude Always Tops Attitude!

Published Nov 21, 2018 at 12:00PM

Dear *Pro* members:

It's a bit of a tradition around here to share our thankfulness with you each year at Thanksgiving (hey, we're not asking for any points for originality!). Some of us are traveling or enjoying time offline today, but we *all* wish you a meaningful, enjoyable holiday tomorrow. And, we want to share some gratitude with you.

Billy Kipersztok

With the Thanksgiving holiday just one day away, soon enough we'll be sitting around a dinner table with our loved ones, enjoying a festive meal and using the holiday as an opportunity to acknowledge what we're grateful for. To me, one of the most important aspects of the Thanksgiving holiday is its emphasis on gratitude. Throughout the rest of the year, it's easy to get caught up in the difficulties of day-to-day life that distract us from how much we have to be thankful for. The Thanksgiving holiday gives us time to reflect and consider how fortunate we are.

Although practicing gratitude on Thanksgiving is great, we should practice gratitude as much as we can, not just because of the holiday. In positive psychology research, people who practice gratitude consistently report many benefits, including:

Physical
• Stronger immune systems
• Less bothered by aches and pains
• Lower blood pressure
• Exercise more and take better care of their health
• Sleep longer and feel more refreshed upon waking

Psychological
• Higher levels of positive emotions
• More alert, alive, and awake
• More joy and pleasure
• More optimism and happiness

Social
• More helpful, generous, and compassionate
• More outgoing
• Feel less lonely and isolated

(Source: Robert Emmons, "Why Gratitude Is Good")

In honor of the benefits of gratitude, I'd like to use this moment to share gratitude for my health, my wonderful family, and the opportunities that I was given as a result of being born in the United States in the late 20th century. I'd also like to use this column to encourage each of you to practice gratitude regularly to receive the multitude of positive benefits it affords! One easy way to practice gratitude is to use a gratitude journal, in which you regularly record the things for which you are grateful (for a description of a gratitude journal and other ways to cultivate gratitude, check out this article). I wish you all a Happy Thanksgiving, and I'll leave you with one more thing I am grateful for: You!

Jeff Fischer

I'm grateful for what Billy just wrote. And I'm grateful to be able to live freely in this country, able to pursue what interests me in hopes of adding to society. I'm grateful to live in a vibrant community filled with others pursuing their passions, and creating for the greater good the culture, food, art, and special events we sometimes take for granted year round in American cities.

I'm grateful for our second-to-none stock market, filled with companies that touch billions of lives, with many of these companies striving to improve our daily experience.

I'm grateful for the weather and the seasons — when the seasons seem out of whack, you quickly realize how integral they are to your own yearly clock and life experience.

I'm grateful for friends and family, both "in real life" and online — and at this point, I think that distinction should fade; online is real life, too. What we've all shared here is as real as what could be shared seated around a dinner table.

I'm grateful for people who are considerate of others. Everyone is dealing with something that's difficult. Kindness makes daily life enjoyable.

I'm grateful for ingenuity. Where would we be on Thanksgiving without the brilliance of electric ovens, heated homes, running water, and — yes — online entertainment. Or board games. Or books and newspapers. Not to mention the medical advancements of the last century.

I'm grateful for the last decade spent in *Pro* and *Options* with members.

We'll never be able to thank you enough for being a Motley Fool member alongside us — that's how we started here, too, as part of the community. We're all one and the same, working together for investing success, and ideally enjoying the ups and downs along the way. Thank you for your long-term approach. That makes The Motley Fool possible. Thank you.

JP Bennett

As the last person to submit his paragraph for today's memo, I had the opportunity to read what both Jeff and Billy had already submitted. I wholeheartedly agree with everything they've already listed (especially all of the amazing Fools we have all over the world. Our community is truly something special!), but I also wanted to add one thing I believe they left off — the Pro and Options team. Having heard countless coworker horror stories from family and friends, it's impossible for me not to feel incredibly blessed to have the opportunity to come into work every day and spend my time with people who aren't just Fools, but also friends.

Have an excellent holiday! And as always, to share any thoughts, please visit the Memo Musings board.

Fool on!

--*Motley Fool Pro* team

Close Your Shorts on Murphy USA and SeaWorld Entertainment

Published Nov 21, 2018 at 12:00PM

Is this for you? This is for all members who followed our recommendation to short **Murphy USA Inc** (NYSE: MUSA) and **SeaWorld Entertainment Inc** (NYSE: SEAS).

How You Participate

- **Action:** Buy to close, or cover, your short position(s) on both Murphy USA and SeaWorld Entertainment
- **Allocation:** Close all of your short — our initial recommendation was to short 1% each.
- **Recent Prices:**
    - Murphy USA: $77.39

- SeaWorld Entertainment: $25.40
- **Price Guidance:** *Use a **limit order***, and aim to pay less than $78.50 for Murphy USA and $26.50 for SeaWorld.

What We're Thinking

Murphy USA

While our gain on Murphy's is modest compared to our other shorts, we want to close our position for now. The stock sold off on quarterly results that were a bit of a mixed bag (revenue beat estimates slightly but earnings fell short), but the recent sharp decline in oil prices — both the U.S. (West Texas Intermediate) and international (Brent) standards have fallen by almost 25% from their October peaks — should result in some relief at the pump after prices surged to start the year. We do have opinions on the more general financial impacts of this price move on Murphy's business, but even so, we would rather step away from the short today as we dig more into what this could mean for the upcoming quarter in particular.

SeaWorld

The trade alert to sell short this entertainment park leader went out on October 5, and as of this morning the short had gained more than 10% for us, in-line with our goal, in a shorter time than hoped. Quarterly results at SeaWorld along the way showed some promise with a decent splash of continued concerns.

This is the type of situation and business that we would want to keep an eye on for future shorting opportunities. SeaWorld has a high level of debt at high interest rates, is an expensive business to run, and operates in a changing environment. People — we think — are caring more about animal welfare than ever before, and the idea of what is amusing is changing. Witness the recent end of Barnum & Bailey's circus after generations of operations. SeaWorld will likely face long-term headwinds with pockets of trouble as it continues to promote Orca whale shows with its existing whales.

And financially, success is no layup. The company will need to pay down debt even as it spends more to promote traffic and transform its parks. But today, in today's volatile market, we'll take our profit on this short while the chips are down (as it were).

Alternative Trades

- **If you set up a synthetic short or set up a bearish spread on either position:** You should close those positions, too.

Pro Can Help

- **Want to discuss this?** Head on over to the Pro short board.

Plumbing the Highs and Lows

Published Nov 19, 2018 at 4:44PM

Dear *Pro* members:

We've been writing since at least early September that volatility was due to return, and we wrote a few weeks ago that it's likely to stay for some time now, for many reasons. But volatility is not the same as collapse. Though now flat for the year, the S&P 500 is merely at prices it last traded at the end of June, well less than a lifetime ago. The soaring stock market from July to the end of the September is the very same market that now makes it feel like we're falling sharply.

We all want to know whether the next leg will be up or down, but the answer is probably that it'll be both. It'll be choppy. In the midst of this choppiness, we have earnings coverage. We'll update you on all of our companies that demand or would benefit from an update. Today, initial thoughts on **Facebook** (NASDAQ: FB) and **Skyworks Solutions** (NASDAQ: SWKS) are demanded, as both are hitting a new 52-week low.

Faceplant

It's difficult to discern to what degree Facebook's woes are the fault of its own, or what was unavoidable given its stature as the largest community ever gathered. The spread of hateful content, false news, and even paid advertising that checked both of those dreadful boxes could have been curtailed much earlier, it seems, if management had taken the risks seriously enough from the start. Instead, it seems the issue was pushed aside — or at least pushed off, and now the end result is Facebook is spending billions to try to reel the problem in, but there's no amount of money that can easily repair a damaged reputation.

We don't know how accurate a picture the recent reporting on Facebook's woes and practices paints, but we're confident there's enough truth in the stories to concern us — again — about management's choices. At the same time, we have to cut management some slack for its youthful inexperience, the novelty of its business, and of the issues pressuring it. As long as they're acting honestly and in good faith. That's what we need to be confident about if we're going to remain investors.

Financially, there is little to argue with — so far. But the more Facebook dings the public trust, the higher the risk that people use its properties less, and advertising dollars start to face strain. We're not near that point today. Third quarter revenue grew 33% to $13.4 billion. Expenses grew 53% to $7.9 billion, but Facebook still generated impressive profits. Increased spending will continue through 2019, but CEO Mark Zuckerberg, 34, said, "I know we need to make sure our costs and revenue are better matched over time, and that's something I'm focused on as well."

That, from a financial perspective, was the key statement in the third quarter conference call, as far as I'm concerned. Spending velocity will ultimately subside — you can't keep hiring and investing at this torrid pace — and revenue should keep growing until the two metrics are better aligned again. But it feels like Facebook doesn't have many more missteps before droves of people could lose trust in it entirely. The company is on thin ice right now, and the stock price is reflecting that.

Lately $131, and down about 28% year-to-date, the stock trades at 17.5 times expected earnings for 2018 and 2019, and 15 times expected earnings for 2020, when net income is expected to grow more strongly again as spending cools. Should the business prove resilient, these prices will be too inexpensive to last. **Alphabet** (NASDAQ: GOOG) (NASDAQ: GOOGL) has averaged a 29.3 P/E ratio the past ten years, and it (Google) has a much, much lower operating profit margin than Facebook even today as the latter spends egregiously.

Facebook is still our third-largest holding at 5.6%, so we're watching it very closely (and miffed our protective collar expired Friday), and making sure we want to keep owning it, or so much of it. So far, we are comfortable enough to maintain our stake, though we definitely expect much better from management than we've been reading about, even if not all of the reporting tells both sides. For now, it remains a buy.

Skydive

Skyworks has been even more disappointing than Facebook, from a returns perspective, but through no fault of its management.

The company just reported its ninth consecutive year of record sales and profits, with fiscal 2018 revenue up 6% to $3.9 billion, and earnings per share up 12% to $7.22. Profit margins continue to rise, and its business continues to expand beyond **Apple** (NASDAQ: AAPL). Customers include Samsung and its flagship phones, **Cisco Systems** (NASDAQ: CSCO), **Microsoft** (NASDAQ: MSFT), **BMW** (NASDAQOTH: BAMXF), **Tesla** (NASDAQ: TSLA), **Amazon.com** (NASDAQ: AMZN), and many more. Internet of Things and the 5G network rollout continue to represent tremendous tailwinds for Skyworks.

Yet, the stock is back to where it traded several years ago, reminding us of something we didn't need to be reminded: Semiconductor stocks are a cyclical test of patience in many cases. Eventually long-term owners in the best of them are rewarded. I still believe Skyworks fits the bill. Largely on fears that Apple phone sales are slowing, Skyworks (lately $70) now trades at 9.8 times expected earnings for the year ahead, the cheapest it has been since a brief stint in 2012. Management expects record revenue and earnings again in 2019, even if growth will be muted. We have a 2.6% stake.

10 Years of Thanks!

In closing, this Thanksgiving week, we want to thank you! Thank you for putting your trust in us, for being Foolish with us, and being patient with us. The Pro team recorded a short video recently to share some memories from the past ten years, as a way to offer our gratitude. We hope you enjoy.

As always, to share thoughts, please visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

Video Bonus: Pro10Year

Published Nov 19, 2018 at 4:43PM

It's been 10 wonderful years since the *Pro* portfolio first began. As we near the Thanksgiving holiday, the *Pro* team gathers together to share memories from the past decade, and to share thanks for all *Pro* members.

{% video %}

Transcript

Jeff Fischer: Greeting *Motley Fool Pro* members, and thank you for joining us for this special brief message to you.

First, introductions. I am Advisor Jeff Fischer. To my left is Ellen Bowman.

Ellen Bowman: Hello.

Jeff Fischer: To Ellen's left is JP Bennett. On Skype we have Billy Kipersztok.

So, I am delighted to share that the entire *Pro* team is here. We're here for primarily one reason, and that is to say thank you. Thank you for being a *Pro* member all these years. Whether its been 10 years or one year we appreciate your trust, and we appreciate your Foolishness, and we appreciate how you invest. As you know we're investing for the long-term, but we also have positions that are short-term in nature such as options in shorting and hedging. So, we know you are stepping up and being a little more active than other investors my be. We appreciate that you have been part of *Pro* for however long you've been with us.

To celebrate our 10 year anniversary which is ongoing right now, we just passed 10 years in October, we are going to share a quick word with you each one of us. Maybe a thought or a favorite memory on what our years at *Pro* have meant to us or taught us. So we'll start. JP Bennett, we'll put you in the hot seat first.

JP Bennett: All right. Well, I'd have to say that my favorite memories who've the past four or five years, however long I've been on *Pro*, always centered around member events. I know the boards don't get as much priority as they used to. You know, maybe we'd like to have more events than we're able to. But, being able to communicate and interact with members, especially face-to-face, at member events and the live chats so to speak have always been a great opportunity to kind of remember why it is you're doing what you do. Really kind of keeps you focused on the bigger picture and putting in the effort.

That's a really broad answer so I'll go down a little bit more and say that I'm also a big fan of humor. There was one particular live chat that was the funnies thing I've ever been a part of at the Motley Fool.

Jeff Fischer: Oh-oh.

JP Bennett: If you go back to February of 2017 there was one live chat where you start bleeding from the face.

Ellen Bowman: Somebody just asked more on Instant Message the other day at work, "Where was that live chat where Jeff started bleeding?" It's legendary.

JP Bennett: I will never forget that. I tried so hard to stay composed.

Ellen Bowman: He did.

JP Bennett: I think I let it out a couple times and it sounded like I was a little girl squealing because I was trying so hard. Then after it was over I probably couldn't stop laughing for 10-15 minutes. But-

Billy K.: You did a good job, you kept semi-professional.

JP Bennett: I tried. I tried.

Ellen Bowman: It was a noble effort.

Billy K.: Yeah, it was.

JP Bennett: And the way you rolled with the punches too, that's what sold it for me.

Jeff Fischer: I love that that tied into a member event because I was just back from a member event in Arizona so my face was dried out. I smiled in the first second of the video and there we go.

JP Bennett: So if you haven't seen that, go watch that.

Ellen Bowman: Absolutely.

Jeff Fischer: JP, great answers. Great answers. Ellen Bowman.

Ellen Bowman: Hello. I have been the editor of *Motley Fool Pro* for eight years now. I have a silly one and a serious one. I'll do the serious one first. This is the service that taught me how to be an investor. I've worked on almost everything at the Motley Fool. I've worked on our cryptocurrency service. I've worked on *Stock Advisor,* I've worked on *One*. But I have half of my 401k right now in *Pro*'s long picks. This is the service that taught me how to buy a basket of stocks that all work together and watch them and see what happens to them. Observe when some of them go up and some of them go down. The temperament of the investors to my left and right, and also in the ether on Skype, and the ones that have worked on *Pro* over the years have made me the investor that I am today. So that is the serious one, and I mean it very much.

The silly one is a few years again when Bryan Hinmon was an an investor on this service-

Jeff Fischer: Who is that?

Ellen Bowman: He and I ... Bryan Hinmon. He's dead now, we don't speak of him anymore.

Billy K.: I just saw Bryan last week. He's doing great.

Ellen Bowman: Yeah, no, no. That was dopple ... Yeah, he's not. We don't talk about him anymore. But we used to have this guy on the service who was an analyst and we did a catch-up report for new members who wanted to get caught up to our portfolio. He was writing it and I was editing it. We were going back and forth with it. For some reason we decided that we would see which of us could get the most puns related to the Austin Powers movies into this catch-up report. I think each of us got more than a dozen. I think he ended up winning. I think he had 15. But nobody called us on it. No members, not Jeff, not any ... I don't think you were on the team yet.

JP Bennett: I wasn't on the ... Nope.

Ellen Bowman: Not anyone. We were so proud ... This is one of my crowning achievements as an editor.

JP Bennett: And it has gone unnoticed until now.

Ellen Bowman: Yeah. Exactly. So maybe it wasn't as brilliant as I thought, but I prefer to think that it was. Its massive subtlety as well as its genius. So, this has been a service that has been ... The people who have worked on *Pro* have been the most fun and remain the most fun people that you could work with. And the best teachers that you could have.

Jeff Fischer: That's very sweet Ellen. I love the humor too. We'll have to, in a memo next week, we'll have to share a link to that video and a link to that article.

Ellen Bowman: Yeah. I'll have to dig it up.

Jeff Fischer: Okay. Billy.

Billy K.: Yes. So, for me I have several great memories. I started in *Pro* back in 2013 a as just kind of an analyst in development. Then really jumped in as a full analyst in 2014. One of the things that I noticed almost immediately about *Pro*. I had been, before I started at the Motley Fool I was a subscriber. I had seen *Stock Advisor* and *Rule Breakers*. But once I joined *Pro* in 2013 and 2014 I saw the community and the discussion boards and sort of this interesting vibe them the *Pro* community that was different than all the other services. It just seemed a really tight knit, really together and everybody was all on the same page. Now that I've been with Pro for more than five years I see that, that was not just something that I felt back then but it's something that persists. That's something that I really enjoy about *Pro*.

Specific to memories. Let's see. I have three written down here. One is, so my TMF name which is TMFBillytheKid was actually given to me during a member contest from all of you guys. That was awesome. So what we did was I wrote on the boards, this was like a particularly slow time. Maybe it was during the summer on the discussion boards and I was like, "Hey, let's liven this up. I'll do a contest to see if you guys can name me." So we did a discussion thread and you guys submitted some names and whichever ones got the most recommendations ended making it to a finalist list. Then I did a randomized thing where whichever digit the S&P 500 landed on corresponded to a particular name and then I ended up with TMFBillytheKid. So, my name is thanks to a fun contest with you guys. So that's one of them.

Another memory, which this is also kind of more on the serious side and more on the investing side, is you guys are really great at stimulating discussions about investing. You guys are really smart about our positions. One thing that stands out in particular is **Papa John's** (NASDAQ: PZZA) where one of the investment decisions that we ended up making, which was selling and closing the position I think back in 2017, was because of a discussion that was kicked off by members. I had written a memo or something about Papa John's and then there was a discussion about how maybe you should start to think about it in a different way. Then we had an awesome discussion on the boards and we ended up selling the position mostly due to the discussion with members. So that was awesome.

Then some of the other things that I really enjoy about being a part of *Pro* and interacting with members is just like JP, is going to interact with you guys in person. I've developed some great relationships with people, to many to name. I really appreciate you guys, I really honestly love you guys. It's been a pleasure to work for you guys, and invest along side you and with the awesome team that we have.

So, those are my memories.

Jeff Fischer: Outstanding Billy. I could double down on everything that all three of you said. It's really great. I don't think I need to say anything now.

What I will say will probably just reiterate what was just said. It's meeting members, both online and in person. Just really kind of changes your life and keeps you focused on who you're working for and what you're trying to achieve together. The community that we have has been outstanding and enjoyable. Working with this team and Ellen for so long too. All of you for so long now has been a great honor so far, and a privilege, and a lot of fun as well. Ellen, you touch on the consistent nature of our investing. That's the nature of our team as well. We've been, I think to think, even tempered. Kept a sense of humor. We're as serious as we need to be during darker times too.

Speaking of that, a few memories. I'll throw some dark memories out there. One was 2011 when the credit rating of the United States of America was downgraded and we happened to be short volatility. That was, I'm glad that Ellen was here-

Ellen Bowman: I remember that.

Jeff Fischer: I'm glad that Billy and JP didn't have to live through that. It was Nick, and Bryan, myself. That was horrible.

Ellen Bowman: Yes. That was legitimately horrible. For members and for us and for America.

Jeff Fischer: Yeah. So, shorting volatility overall is a volatile trade when it goes the opposite direction on you. So we learned lessons from that as well. Yet we still kept trying with it, with SVXY, same thing. Worked until it didn't. But in both cases we kept the position small enough to keep our returns where we want them to be and to learn from what happened.

Another fun memory for members who might remember this.

Ellen Bowman: Oh, dear.

Jeff Fischer: Portfolio 2011.

Ellen Bowman: Oh, man, yes.

Jeff Fischer: Remember? So we had the charter portfolio which is what we've had all along these 10 years. Then for one year we opened a real money 2011 portfolio so that new members would have new money going into the same positions that were in the charter portfolio. So, the sole purpose of portfolio 2011 was to mirror the existing portfolio. So it's kind of convoluted.

Ellen Bowman: A little. Very.

JP Bennett: I have no clue what ...

Jeff Fischer: Oh, my gosh.

Ellen Bowman: It was really hard to explain.

Jeff Fischer: It was so much extra work.

Ellen Bowman: Not that he's not a genius, and I'm not a genius, but it was really hard to explain.

Jeff Fischer: So many extra trade alerts. So many extra hoops to jump through. Then 2011 is the portfolio that had its short volatility called out on it by Schwab. So to match it to the charter portfolio it was ... Yeah. So 2011 was a rough year. But I can honestly say the other nine years have overall been great.

Ellen Bowman: Oh, yeah.

JP Bennett: Please don't jinx it, Jeff. Please.

Jeff Fischer: Knock on wood.

Ellen Bowman: Knock on everything.

Jeff Fischer: So many good memories from member events to the holiday photos that Ellen spearheads.

Ellen Bowman: Yes.

Jeff Fischer: To our end of year, or our Thanksgiving columns, which we'll have another one soon where we just share what we're grateful about. But, sharing with you has been the key through it all. Sharing investment ideas, sharing thoughts about life. Sharing our gratitude too.

Ellen Bowman: Mm-hmm (affirmative).

Jeff Fischer: So we just want to take a minute and say, as we celebrate 10 years, thank you everybody for being here. For being a part of *Motley Fool Pro*. Thank you to the three of you too.

Ellen Bowman: Yes, thank you.

JP Bennett: Thank you, Jeff.

Billy K.: Thank you, Jeff.

Ellen Bowman: Thank you Fools. We love this service. Thank you so much for being part of it.

Jeff Fischer: Fool on.

Ellen Bowman: Fool on.

JP Bennett: Fool on.

Pro Guidance Changes and Completed Trades: Nov. 19, 2018

Published Nov 19, 2018 at 4:30PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Broadridge Financial Services** (NYSE: BR): Per our earnings review, our fair-value estimate increases to $117 and the stock moves to Best Buy Now on valuation.

***Pro* Completed Trades** (see transaction log; trades take a day to appear):

- **Facebook** (NASDAQ: FB): As it expired, we closed our protective collar on half our Facebook shares.
- **Flexion** (NASDAQ: FLXN): We closed our short at our desired profit.
- **HNI Corp** (NYSE: HNI): We closed our short at our desired profit.
- **Kellogg** (NYSE: K): We closed our short at our desired profit.
- **Papa John's International** (NASDAQ: PZZA): We closed our short, and our long protective calls on it, at a combined loss.
- **SPDR S&P 500** (NYSEMKT: SPY): We closed our synthetic short for a profit.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Expirations: Apple, Broadridge, and More

Published Nov 16, 2018 at 1:41PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.8% stake in the stock.
- **Broadridge Financial Services** (NYSE: BR): Buy half of our 6.5% stake.
- **Paycom** (NYSE: PAYC): Buy at least half of our 4.7% stake to start.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy at least half of our 5.1% stake.
- **Facebook** (NASDAQ: FB): Buy half of our 5.7% stake.
- **Skyworks Solutions** (NASDAQ: SWKS): Match our 2.5% stake.
- **Tencent** (NASDAQOTH: TCEHY): Match our 2.1% stake.

Shorts:

- **Kellogg's** (NYSE: K): We are closing the short.
- **Papa John's** (NASDAQ: PZZA): We are closing our short and our protective calls.

Options:

- See below.

Upcoming Expirations:

- **November:**
  - The long puts on our protective collar on **Facebook** (NASDAQ: FB) should be sold to close today (the calls can be left alone to expire).
  - **Gilead Sciences** (NASDAQ: GILD): Our naked calls are set to expire as income on November 30. So far, we need not do anything.
  - **Papa John's:** The protective calls should be sold to close.

Close Your Short on Kellogg

Published Nov 16, 2018 at 1:12PM

Is this for you? This is for all members who followed our recommendation to short **Kellogg** (NYSE: K).

How You Participate

- **Action:** Buy to close, or cover, your short position(s) on Kellogg.
- **Allocation:** Close all of your short — our initial recommendation was to short 1%.
- **Recent Price:** $62.18
- **Price Guidance:** *Use a **limit order*** to close at going prices.

What We're Thinking

In our first short basket alert, we mentioned how we plan to actively manage our collection of shorts. Short positions require a very different mindset than long positions; because shorts are often driven by market sentiment (which can change in an instant), we need to act quickly when necessary.

Our Kellogg short has been a success in its brief history, with the stock down 15% from the price set in the original short alert in late September. Additionally, Kellogg is set to go ex-dividend in a few weeks, with a $0.56 dividend we'd rather not pay. While it's possible that the company could continue to struggle, we're happy to take advantage of a poorly received earnings report and recent market weakness to lock in a comfortable gain on this position in less than two months.

Alternative Trades

- **If you set up a synthetic short or set up a bearish spread:** You should close those positions, too.

Pro Can Help

- **Want to discuss this?** Ask away on the *Pro* short positions board.

Sell Your Long Puts on Facebook

Published Nov 15, 2018 at 3:33PM

Is this for you? Any *Pro* members who own puts on Facebook that are expiring this week can close those for a profit.

How You Participate

- **Action:** Sell to close your Nov. 16, 2018, puts on **Facebook** (NASDAQ: FB) (or other puts, if you have other November strikes).

- **Allocation:** Sell all that are coming up for expiration.
- **Price Guidance:** Use a **limit order** at the recent price, which of course will change over time. And close by Friday's close.
- **Recent Prices (3:15 pm ET):**
  - Facebook: $144
  - Nov. 16, 2018, $145 puts: $1.70 (splitting the bid/ask).
- **Stock Scorecard Status:** Buy Facebook. Allocation is 5.8%.

What We're Thinking

In September, with shares near $156, we recommended setting up a November $170 call/$145 put protective collar on half of your Facebook position. Today, the stock is priced at about $141.

Your short $170 calls, which paid for your puts, are due to expire as income tomorrow. You can let them be to do just that (assuming the stock price stays below $170, a near certainty). Your $145 puts, on the other hand, have value, so you can sell to close those between now and Friday to capture that profit.

Facebook continues to struggle in the public eye. The latest deep bruise comes from a 6,100-word *New York Times* story out last night that suggests Facebook worked with outside organizations to quiet critics, was slow to respond to election meddling, and obfuscated what was happening, among other charges. We are still -- unhappily -- noodling over these charges and what they may mean for our relationship with Facebook.

Facebook's recent earnings results point to a strong underlying business -- third-quarter revenue was up 33% to $13.7 billion -- besieged by problems that the company should, perhaps, have started spending to correct much earlier. Expenses rose 53% in the quarter, to $7.9 billion, as Facebook spends on employees, security, and hardware. After rising by 50% to 55% this year, Facebook expects expenses to expand by 40% to 50% in 2019.

The end result is that earnings-per-share growth will slow considerably -- to a crawl. At about 20 times earnings, the stock is not expensive, but we'll need to see the promise of a resumption in earnings growth before shares are likely to rise sharply again (though one never knows). On the bright side, CEO Mark Zuckerberg said in the third-quarter conference call that management is aware that expenses must line up well with revenue, and they look forward to getting to that point again.

After selling to close these puts, we'll consider another protective strategy if it seems merited.

Please note: Pro *was not able to set up the collar as recommended, as the stock price declined before we acted; we have a different collar, at lower strike prices, that is out-of-they money and dying. So we didn't benefit on this one. But that's OK.*

Pro Can Help

- Questions on this short-term protective position? Visit our option strategy discussion board.

Close Your Short (and Protective Calls) on Papa John's

Published Nov 14, 2018 at 3:11PM

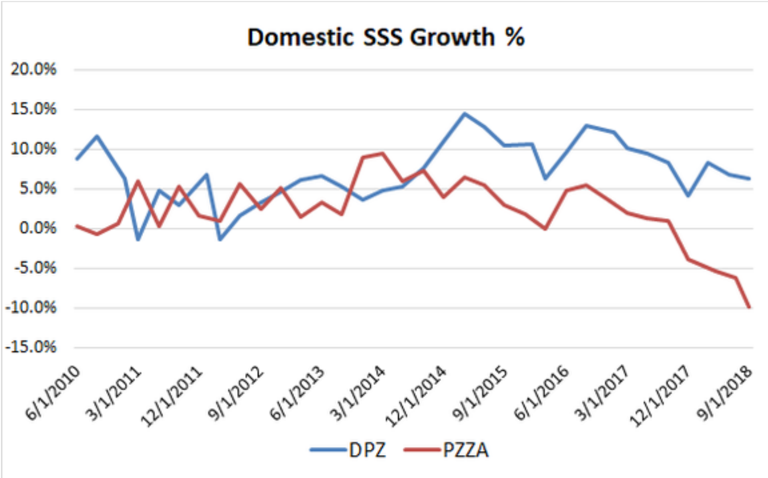
Is this for you? This is for all members who followed our recommendation to short and buy protective calls on **Papa John's** (NASDAQ: PZZA).

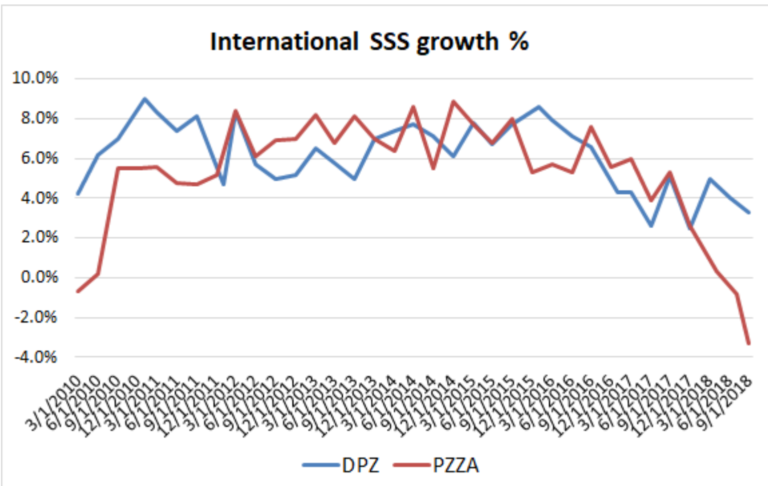
How You Participate

- **Actions:**
  - Buy to close, or cover, your short position on Papa John's.
  - Sell to close your November 2018 $55 protective calls.
- **Allocation:** Close all of your short and sell all of your protective calls.
- **Recent Prices:**
  - PZZA stock: $56.34
  - PZZA November 2018 $55 calls: $1.50/$2.05 (bid/ask)
- **Price Guidance:** *Use a **limit order*** at going prices, aiming to split the current bid/ask. Right now, the trade can be completed for a combined net debit of about $54.57. Our protective calls expire in two days, so aim to get the trade done before then.

What We're Thinking

Shorting is a tough business. Sometimes, even if you're right about the business thesis, the market doesn't care. That's what has happened with our attempted short of Papa John's. Since we initiated our short in late September, the company has continued its financial free-fall, reporting sharply negative comparable sales performance (-9.8% domestic, -3.3% international) in the third quarter of 2018. Papa John's terrible results can be compared to healthy positive results at main rival Domino's (NYSE: DPZ), demonstrating that Papa John's struggles are not an industry-wide problem:





Source: Company filings.

But despite the continued deterioration of the financials, the market seems to care more about the possibility of a buyout than it does about poor business results. Although it's possible that the business will never recover and Papa John's stock is decimated in a few years, it's not worth paying up to see whether that plays out -- especially because it's just as possible that the market remains disconnected from business results for the foreseeable future. With a short like this one, where the market has disconnected its perception of value from what's going on in the business and there is no catalyst in sight to flip that sentiment, it's probably wise to simply take your lumps and move on.

Alternative Trades

- **If you set up a synthetic short or set up a bearish spread:** You should close those positions, too.

Pro Can Help

- **Questions?** Head over to the [*Pro* short positions board].

Close Your Short on HNI Corp.

Published Nov 13, 2018 at 3:45PM

Is this for you? This is for all members who followed our recommendation to short **HNI Corp.** (NYSE: HNI)

How You Participate

- **Action:** Buy to close, or cover, your short position(s) on HNI Corp.
- **Allocation:** Close all of your short — our initial recommendation was to short 1%.
- **Recent Price (this afternoon):** $38.15
- **Price Guidance:** *Use a **limit order***, and aim to pay less than $38.50.

What We're Thinking

One of the downsides to shorting a stock is that while you hold the short position, you're on the hook to pay any dividends the company issues. And because office furniture maker HNI's dividend is non-trivial, we knew from the outset that the company's ex-dividend dates would act as a trigger for us to reassess our position: Is it worth incurring this additional cost to continue shorting the company?

Fast-forward to today and HNI's next payout is right around the corner, with the ex-dividend date scheduled for this Friday, Nov. 16. After mulling over our options for the past week or so, we've decided to take our gain on the stock and close the position for now. The situation is similar to what we saw with International Speedway Corp. -- although our thesis for shorting HNI was long-term in nature, the recent decline has removed a large part of the margin of safety we believed shorting the stock in the $42 to $44 range afforded us. And with the impending dividend payout, we would actually find ourselves in the red if the stock price continued to climb back to the level at which we first shorted shares.

Fools who shorted HNI around the time of our original recommendation should currently have a gain of about 10%, with the stock having fallen more than twice as much as the market since we sent out the original alert -- a more than respectable gain for us in such a short time frame.

Alternative Trades

- **If you set up a synthetic short or set up a bearish spread:** You should close those positions, too.

Pro Can Help

- **Want to discuss this?** Certainly; relax in your comfortable office chair and we'll come to you. Or just click on over to the *Pro* short positions board.

Broadridge Moves to Best Buy Now

Published Nov 12, 2018 at 4:14PM

Fiscal Q1 2019

- Recurring fee revenue growth, year over year: Up 5% to $575 million, or 6.3% trailing-12-month (TTM) growth
- Closed sales growth, year over year: Down 22% to $18 million, or 9.9% TTM growth
- EPS growth, year over year: Up 54% to $0.64, or 32% TTM growth

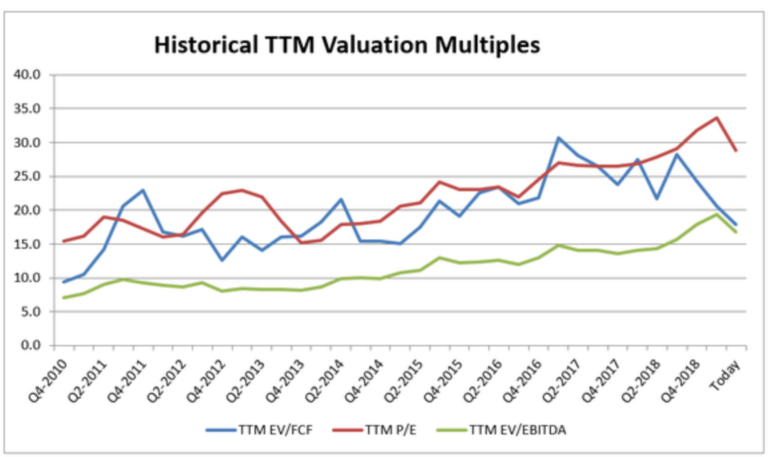
Investor communications guru **Broadridge Financial Services** (NYSE: BR) reported a solid start to fiscal 2019, reporting increased margins, steady revenue growth, and strong earnings growth. However, the market was not happy with the results, sending shares down 11% on the day of the earnings release.

A combination of factors likely contributed to the decline, including a weak quarter of closed sales (which is typical in Q1), an elevated valuation going into the report, and recent market-wide volatility among technology companies. Analysts were also likely displeased with a comment on the conference call about total revenue facing pressure next quarter because of a decline in event-driven revenue (which faces a difficult comparison with atypically huge quarterly results last year).

Despite all of these factors and the sharply lower share price, there is nothing in the earnings report that suggests that our investment thesis is impaired. In fact, this quarter's results support the argument that Broadridge's business continues to strengthen.

- **Updated guidance**: Best Buy Now (from Buy)
- **Recommended allocation**: 6.6%
- **Fair-value estimate:** $117 (from $115)
- **Current price:** $106.50

Based on management's 2019 guidance, at $106.50 per share, the stock is priced at 24 times projected 2019 cash flow and 27 times projected 2019 GAAP earnings per share. Following the recent market volatility and the sell-off after this quarter's earnings report, Broadridge's P/E multiple (my favorite single valuation metric for this company) is as low as it has been since fiscal Q2 2018 (late 2017), when Broadridge's stock price ranged between $80 and $90 per share:



After incorporating Q1 2019 results, **our fair-value estimate increases to $117 per share (from $115)**. The company's valuation multiples have significantly contracted, and Broadridge's stock is a better value than it has been in a long time.

With the current price about 7% below our newly updated fair-value estimate, **Broadridge moves to Best Buy Now (from Buy)** on our scorecard. If you've yet to establish a full allocation, now is a great time.

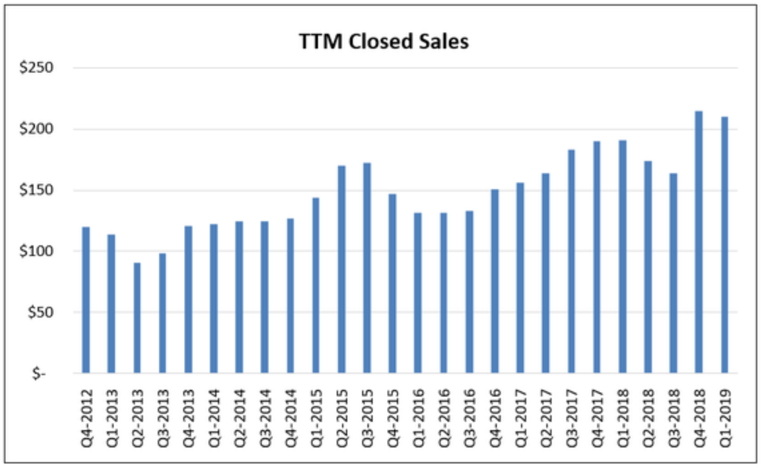
Our Thesis

Broadridge has a near-monopoly on proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers offload technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record, and sound capital allocation policies make Broadridge a sturdy rock upon which to build the *Pro* portfolio. We expect modest growth in fee revenue (augmented by tuck-in acquisitions), slight operating leverage, plenty of free cash flow, and a growing stream of dividends and share repurchases to help achieve North Star-like returns.

The Most Important Things

1. Closed Sales: This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%-plus). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

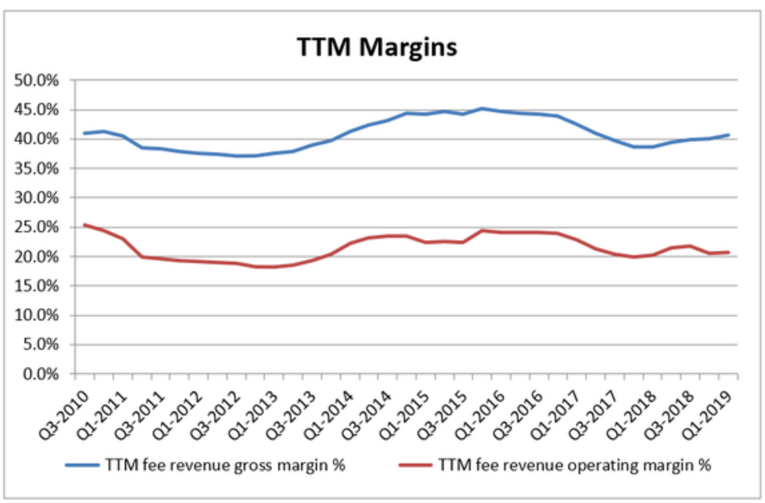
In Q1 2019, Broadridge reported a relatively weak quarter with $18 million in closed sales. This is the lowest figure for closed sales in a quarter since Q1 2016, although the closed metric is very seasonal and Q1 is historically the weakest quarter. When we look at closed sales on a TTM basis to smooth out seasonality, performance is acceptable (if not strong), with $210 million in TTM closed sales, up 10% from the year-ago TTM period:



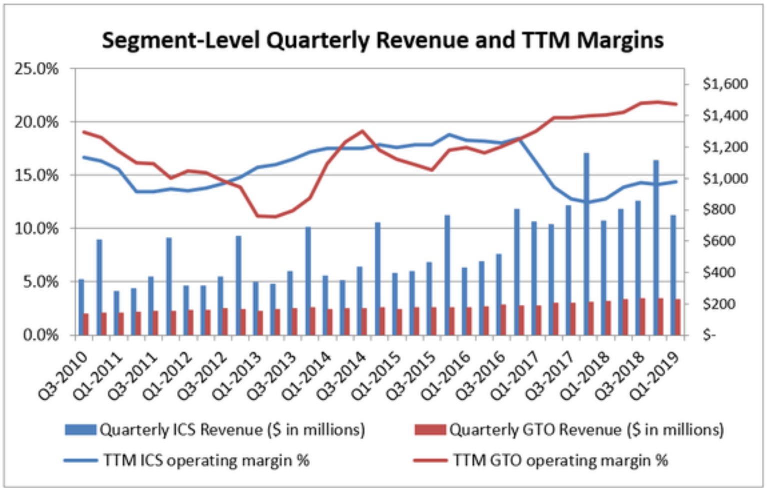
I'm not concerned about the relatively weak closed sales in the quarter given the routine seasonality of this metric and the records set in Q4 2018 (when Broadridge reported $115 million in closed sales). On a TTM basis, closed sales performance is trending upward.

It's only natural that after closing several big deals last quarter, Broadridge saw a slower pace of sales this time. We'll see how the company performs over Q2 and Q3, which historically tend to be stronger than Q1 (but weaker than Q4, which is routinely the strongest quarter of a given fiscal year).

2. Fee-Revenue Margin Performance: In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, ignoring pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers), we prefer to look at trailing-12-month (TTM) margins to smooth out quarterly fluctuations. TTM fee-revenue gross margins came in at 40.7% (up from 38.7% a year ago), and TTM fee-revenue operating margins came in at 20.8% (up from from 20.2% a year ago). Although margins can be lumpy on a quarter-to-quarter basis, Broadridge has done an excellent job integrating its 2016 acquisition of NACC and continuing to improve margins on a year-over-year basis:



When looking at Broadridge's separate divisions, we can see that both businesses are improving. While the Investor Communications Solutions (ICS) business has seen significantly lower (though improving) margins because of the NACC acquisition, the Global Technology & Operations (GTO) business, which is acquisition-agnostic, has shown continued strong margin expansion, generating a TTM operating margin of 21.7%:



Despite the continued margin expansion trends for both parts of the business, this quarter was the first of 11 in which GTO's operating margin percentage was not higher than the immediately preceding quarter (21.7% this quarter vs. 21.9% in the one before). However, on a year-over-year basis, margin percentage is still expanding strongly, with this quarter's 21.7% higher than the 20.7% achieved a year ago.

The longer-term margin expansion trends for both divisions of the business are exactly what we want to see as investors, and we expect this to continue over the long run. Broadridge's financial execution since the NACC acquisition is an indication of excellent management, as integrations don't always go so smoothly.

3. Capital Allocation: In the company's most recent Investor Day presentation, we got a detailed update on how management plans to allocate capital between fiscal 2017 and fiscal 2020: targeting a 45% dividend payout ratio and using up to $1.4 billion in incremental debt capacity and expected free cash flow for share repurchases and merger-and-acquisition activity.

After a significant quarter of share buybacks in Q4 2018 ($247 million), management slowed down its share-repurchase activity in Q1 2019, spending just $1 million in the quarter on share buybacks. I appreciate the slower pace, given that the share price was higher than in the prior quarter (the average quarterly share price was $127 in Q1 2019, vs. $113 in Q4 2018) and multiples were elevated.

I'd love to see a resumption of significant activity in share buybacks in the next quarterly report, given that the stock price has decreased significantly and the stock is a much better value this quarter compared with last quarter. If we see higher buyback activity in next quarter's report, that would be another very strong indicator of prudent decision-making by Broadridge management (and I wouldn't be surprised).

Broadridge made no acquisitions in Q1 2019, but we expect management to continue to be active with M&A throughout 2019 when opportunities arise.

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring organic revenue growth (augmented by tuck-in acquisitions) to translate to stout earnings and cash-flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Pro Catch-Up Trades and Expirations: Amazon, Broadridge, and More

Published Nov 9, 2018 at 11:51AM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.8% stake in the stock.
- **Paycom** (NYSE: PAYC): Buy at least half of our 4.7% stake to start.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% of our 5% stake to start.
- **Broadridge Financial Services** (NYSE: BR): Buy half of our 6.45% stake to start.

Shorts:

- N/A

Options:

- N/A

Upcoming Expirations:

- **November:** We have a collar on **Facebook** (NASDAQ: FB), naked calls on **Gilead Sciences** (NASDAQ: GILD), and long calls on Papa John's expiring during various weeks this month. We plan to close the Facebook collar (anytime), let the naked calls on Gilead expire as income (they're on track), and close the Papa John's calls at some point (currently for a profit), as we manage that short.

Pro Guidance Changes and Completed Trades: Nov. 5, 2018

Published Nov 5, 2018 at 3:10PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Flexion Therapeutics** (NASDAQ: FLXN): We moved the position to Cover or Close (from Short), recommending that we take our 20%-plus gain before earnings on Nov. 7 -- because you never know, and because we've exceeded our initial goal on the short.
- **SPDR S&P 500** (NYSEMKT: SPY): We moved our synthetic short to Close, wanting to take our profits on this market hedge after the worst October for stocks since the Great Recession.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Flexion:** We covered all of our 1,920 short shares at $14.69, booking a 21% gain on the short.
- **SPDR S&P 500:** We closed all of our long Dec 2018 $171 puts and short January 2019 $285 calls (combined, our synthetic short) for a credit of $2.71, booking a profit on the syn short as we consider new hedges.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

10 Years of Pro's Long Stock Strategies

Published Nov 5, 2018 at 3:04PM

Dear *Pro* Fools,

If you've read what I've written over the years in *Pro*, you probably know that I love data. Processing data into useful intelligence via charts, graphs, tables, and other visualizations is one of my favorite ways to communicate information. Just last month, I wrote a Memo based on charts and tables using *Pro*'s historical performance data.

To keep the data theme going, as part of our extended celebration of *Pro*'s 10-year anniversary, I decided to take a look at an important data set that, to date, had never been analyzed: *Pro*'s strategy-level performance. The data set is huge -- it essentially requires accounting for every single single transaction *Pro* has ever made, and it took me more than a month to finish collecting and analyzing it.

Pro has used many different strategies in our 10 years, including long and short stock positions, option-only positions, ETFs, hedges, and commodities; see our strategy guide for more. But for the purpose of this Memo, we're going to include just the positions involving long stocks, which narrows down the data to a more manageable level.

Our long positions are the most important of all our strategies in *Pro*, and they're responsible for essentially all of our long-term returns. An analysis of *Pro*'s strategy-level performance that looks at long stock positions (as opposed to all other types of strategies) provides the most informational value.

I'll start by presenting the data in raw, tabular form, and I'll follow with a discussion and analysis. The tables below show every active and inactive strategy involving long stock since *Pro*'s inception. They are organized by compound annualized growth rate (CAGR), from highest to lowest.

The Data

Active Positions

Date Initiated	Position	Company	Holding Period (Years)	CAGR
7/12/2017	SQ	Square	1.32	125.0%
11/30/2016	PAYC	Paycom Software	1.93	75.0%
9/18/2012	FB	Facebook	6.13	51.6%
1/26/2017	AMZN	Amazon	1.78	47.9%
9/8/2011	MA	Mastercard	7.16	29.1%
4/28/2015	V	Visa	3.53	22.3%
2/14/2012	AAPL	Apple	6.73	20.2%
2/22/2018	CME (2)	CME Group	0.70	19.4%
8/31/2011	OTEX	OpenText	7.19	18.5%
8/22/2012	SBUX	Starbucks	6.21	18.2%
4/27/2010	BR	Broadridge Financial Solutions	8.53	16.8%
5/18/2016	FDS	FactSet Research Systems	2.47	15.7%
7/23/2015	VRSK	Verisk Analytics	3.29	14.9%
5/6/2013	AMT	American Tower	5.50	14.8%
8/5/2014	SWKS	Skyworks Solutions	4.25	12.4%
7/1/2009	MDT	Medtronic	9.35	12.2%
2/22/2017	JNJ	Johnson & Johnson	1.70	11.7%
4/9/2018	ADBE	Adobe Systems	0.58	10.5%
9/17/2009	ORCL	Oracle	9.14	8.4%
6/7/2017	NVR	NVR	1.41	-1.0%
10/25/2017	TCEHY	Tencent	1.03	-6.3%
5/17/2017	COHR	Coherent	1.47	-33.7%
7/17/2018	ZUO	Zuora	0.30	-36.0%
5/22/2018	JD	JD.com	0.46	-59.8%

Inactive Positions				
Date Initiated	Position	Company	Holding Period (Years)	CAGR
9/7/2011	ADSK (2)	Autodesk	0.53	106.4%
9/22/2010	TRAD	TradeStation Group	0.71	70.7%
4/8/2009	FLS	Flowserve	1.16	39.4%
12/9/2016	VRSN	Verisign	1.52	37.4%
10/16/2009	EBIX	Ebix	2.32	34.7%
1/23/2009	ADSK (1)	Autodesk	1.99	32.3%
1/8/2009	CCJ	Cameco	1.95	32.1%
7/1/2010	BRS	Bristow Group	2.19	29.0%
12/13/2011	PACR	Pacer International	2.21	27.7%
10/23/2008	KCI	Kinetic Concepts	2.78	26.5%
11/18/2009	EXPD	Expeditors International of Washington	0.51	23.6%
10/31/2008	INTC (1)	Intel	0.64	23.2%
1/27/2010	PWR	Quanta Services	0.95	23.0%
4/7/2011	DDD	3D Systems	2.57	22.7%
5/29/2012	GNTX	Gentex	5.32	21.5%
4/15/2013	ORLY	O'Reilly Automotive	4.35	19.8%
8/24/2012	AIG	AIG	2.76	19.0%
4/23/2009	JKHY	Jack Henry & Associates	2.38	18.9%
7/8/2010	PZZA	Papa John's	6.79	18.6%
12/2/2008	PCL	Plum Creek Timber	3.45	17.6%
4/3/2009	AFSI	AmTrust Financial Services	8.18	17.4%
2/10/2011	ROC	Rockwood Holdings	2.52	16.7%
6/25/2009	LNN	Lindsay Corporation	1.27	15.5%
9/8/2009	WAT	Waters	0.70	15.3%
5/26/2011	PEB	Pebblebrook Hotel Trust	1.72	14.5%
7/11/2013	AMTD	TD Ameritrade	3.68	14.2%
12/23/2013	PRXL	Parexel International	3.13	12.9%
1/17/2018	COO	Cooper Companies	0.58	12.7%
12/30/2008	PG	Procter & Gamble	2.05	11.7%
2/7/2012	CME (1)	CME Group	1.27	11.4%
6/11/2009	TUP (1)	Tupperware Brands	4.26	10.9%
12/16/2008	GTI	GrafTech International	5.37	9.0%
9/20/2011	BMC	BMC Software	1.88	8.3%
12/17/2009	GSK	GlaxoSmithKline	1.78	8.2%
10/21/2009	NEE	NextEra Energy	1.92	7.1%
6/20/2012	BKE	The Buckle	3.33	6.9%
7/15/2011	CVA	Covanta	1.42	6.3%
7/28/2011	STON	StoneMor Partners	2.68	4.2%
11/5/2013	VMI	Valmont Industries	3.45	3.2%
4/30/2014	GILD	Gilead Sciences	4.20	3.1%
12/10/2010	WFC	Wells Fargo	5.90	2.9%
2/24/2010	INTC (2)	Intel	4.44	2.4%
11/4/2010	LLL	L-3 Communications	1.22	-3.4%
10/15/2013	TUP (2)	Tupperware	2.20	-12.2%
3/12/2012	INVN	InvenSense	0.78	-52.9%

Discussion and Analysis

Pro has initiated a total of 69 strategies involving long stocks, of which 24 are still active and 45 have been completed.

	#	Average Holding Period (Years)	Average CAGR	Total Appreciation ($)	Average Time Since Initiation (Years)
Active	24	3.8	17.0%	$1,497,280	3.8
Inactive	45	2.6	17.6%	$991,971	7.6
Total	69	3.0	17.4%	$2,489,252	6.3

As you would expect, our active strategies have a significantly longer holding period (3.8 years) compared with our inactive strategies (2.6 years). Interestingly, however, the average CAGR of our inactive strategies (17.6%) exceeds that of our active positions (17%).

However, despite the smaller number of active strategies and the lower CAGR they display, our active strategies have added significantly more to *Pro*'s total capital appreciation. This is because of the longer holding periods (allowing more time for the investments to appreciate) and the fact that the active strategies are more recent (it's been an average of 3.8 years since we initiated each active strategy, compared with 7.6 years for the inactive ones). Because our portfolio has appreciated in value over time, a 3% position initiated today has a much higher impact on our total capital appreciation than a 3% position initiated 10 years ago.

Also interesting: Long stock strategies have accounted for *greater than 100%* of *Pro*'s total portfolio appreciation. These positions have added $2,489,252 to our portfolio's total capital, and as of today the *Pro* portfolio has appreciated by $2,440,175 since inception. This means that in aggregate, our option-only positions, ETF strategies, shorts, and hedges have had essentially a net zero effect on our portfolio. (But keep in mind that the returns of the long stock strategies included in this report include the impact of option strategies overlaid on top of the stocks.) This provides confirmation that the long stock portion of the *Pro* portfolio is by far the most important slice of our strategic approach, and it is where we add the most value.

Compound Annual Growth Rate (CAGR)

The positions with the highest CAGR are a good proxy for our most successful strategies. Looking a bit deeper at the CAGR for *Pro*'s long stock positions, the active position with the highest CAGR is Square, with 125% (!) over 1.3 years, followed by Paycom at 75% over 1.9 years. We've done well adding fast-growing young software companies to our portfolio over the past two years. Looking only at positions with a holding period greater than three years (which is a more appropriate analysis period for our long-term investment horizon), the position with the highest CAGR is Facebook at 52%, followed by Mastercard, Visa, Apple, and OpenText.

Active Positions by CAGR, Holding Period > 3 years				
Date Initiated	Position	Company	Holding Period (Years)	CAGR
9/18/2012	FB	Facebook	6.13	51.6%
9/8/2011	MA	Mastercard	7.16	29.1%
4/28/2015	V	Visa	3.53	22.3%
2/14/2012	AAPL	Apple	6.73	20.2%
8/31/2011	OTEX	OpenText	7.19	18.5%

The inactive positions with the highest CAGR are those with short holding periods, including our second position on Autodesk (106% CAGR over 0.5 years) and TradeStation (71% CAGR over 0.7 years). Of inactive positions with holding periods greater than 1.5 years (because our closed positions tend to have shorter holding periods), here are the top five:

Inactive Positions by CAGR, Holding Period > 1.5 Years				
Date Initiated	Position	Company	Holding Period (Years)	CAGR
12/9/2016	VRSN	Verisign	1.52	37.4%
10/16/2009	EBIX	Ebix	2.32	34.7%
1/23/2009	ADSK (1)	Autodesk	1.99	32.3%
1/8/2009	CCJ	Cameco	1.95	32.1%
7/1/2010	BRS	Bristow Group	2.19	29.0%

Holding Periods

When looking at holding periods for *Pro*'s long stock positions, our longest-tenured active position is Medtronic, which we've held for 9.3 years -- that's almost as old as *Pro*! Oracle is second, followed by Broadridge, OpenText, and Mastercard:

Active Positions, Longest Tenured				
Date Initiated	Position	Company	Holding Period (Years)	CAGR
7/1/2009	MDT	Medtronic	9.35	12.2%
9/17/2009	ORCL	Oracle	9.14	8.4%
4/27/2010	BR	Broadridge Financial Solutions	8.53	16.8%
8/31/2011	OTEX	OpenText	7.19	18.5%
9/8/2011	MA	Mastercard	7.16	29.1%

Our longest-tenured inactive position was AmTrust Financial Services at 8.2 years, followed by Papa John's, Wells Fargo, GrafTech International, and Gentex:

Inactive Positions, Longest Tenured				
Date Initiated	Position	Company	Holding Period (Years)	CAGR
4/3/2009	AFSI	AmTrust Financial Services	8.18	17.4%
7/8/2010	PZZA	Papa John's	6.79	18.6%
12/10/2010	WFC	Wells Fargo	5.90	2.9%
12/16/2008	GTI	GrafTech International	5.37	9.0%
5/29/2012	GNTX	Gentex	5.32	21.5%

Capital Appreciation

The tables below show which active and inactive long stock positions have contributed the most to *Pro*'s total capital appreciation. Capital appreciation is important to distinguish from CAGR because it more appropriately accounts for allocation and the duration of the position's inclusion in the portfolio. The active stock with the highest impact on our portfolio's value is Facebook at $209,310, followed by Mastercard, Broadridge, Square, and Apple.

Active Positions by Total Appreciation			
Date Initiated	Position	Company	Total Appreciation ($)
9/18/2012	FB	Facebook	$209,310.28
9/8/2011	MA	Mastercard	$204,037.25
4/27/2010	BR	Broadridge Financial Solutions	$142,956.43
7/12/2017	SQ	Square	$139,845.99
2/14/2012	AAPL	Apple	$130,029.58

The top five inactive positions by capital appreciation are:

Inactive Positions by Total Appreciation				
Date Initiated		Position	Company	Total Appreciation
7/8/2010	3042.00	PZZA	Papa John's	$127,075.80
4/3/2009	3503.00	AFSI	AmTrust Financial Services	$109,667.17
4/15/2013	2030.00	ORLY	O'Reilly Automotive	$59,863.18
10/23/2008	3665.00	KCI	Kinetic Concepts	$54,878.85
5/29/2012	2351.00	GNTX	Gentex	$52,803.93

Strategy Frequency

Another interesting variable to consider is the frequency of strategy initiation. Over our 10 years managing *Pro*, we've initiated a new strategy involving long stock once every two months or so (53 days, to be exact). However, our frequency has shifted a bit over time -- before 2013, we initiated a new long stock strategy once every 32 days. Since 2013, that number has shifted to once every 89 days. Given that we started off in 2008 with a 100% cash portfolio that needed to be allocated, it makes sense that our first five years were more active than the past five. Still, a new long stock strategy once every three months since 2013 is quite a pace for a portfolio with an average holding period of three years.

Accuracy

A critical consideration for the *Pro* portfolio is accuracy. It is the No. 1 principle in the "How We Invest" section of our guidebook. Our aim, in our own words, is to be correct "the vast majority of the time." Have we performed up to our standards? In analyzing our long stock strategies, we can see that only eight of our 69 strategies (five active, three inactive) have produced negative returns. That's an accuracy rate of 88%, which I'd say qualifies as the vast majority.

The *Pro* Bottom Line

All in all, analyzing the strategy-level performance of *Pro*'s historical long stock positions has provided some interesting and useful insights. We have determined the active (Facebook) and inactive (Papa John's) positions with the most impact, found our average holding periods for active (3.8 years) and inactive (2.6 years) positions, noted our positions with the highest CAGRs, and observed the frequency (every 53 days) and accuracy (88%) of our long stock strategies. Historical context is incredibly useful in assessing our performance and in improving our investing process.

While there is a lot of data presented in this report, there is still plenty left to analyze when it comes to our long stocks. Other useful parameters to look at would be sectors and industries. We could also slice up this data from this Memo in a more granular way by looking at each individual year to see how our approach or performance varied over time.

I hope this Memo provides you with a more complete view of *Pro*'s history and how we got to the portfolio positioning we have today, and I hope the insights generated from the data are useful.

Fool on!

--Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Expirations: Amazon, Sonos, and More

Published Nov 1, 2018 at 2:54PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.8% stake in the stock.
- **MasterCard** (NYSE: MA): Buy at least half of our 6.9% stake.
- **Paycom** (NYSE: PAYC): Buy at least half of our 4.7% stake.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy at least half of our 4.7% stake.
- **Broadridge Financial Services** (NYSE: BR): Buy 3% of our 7% stake to start.
- **Coherent** (NASDAQ: COHR): Match our 1.2% stake.
- **Medtronic** (NYSE: MDT): Match our 2.6% stake.
- **Skyworks Solutions** (NASDAQ: SWKS): Match our 3.1% stake.
- **Tencent** (NASDAQOTH: TCEHY): Match our 2% stake.
- **Verisk Analytics** (NASDAQ: VRSK): Match our 2.5% stake.
- **Zuora** (NYSE: ZUO): Match our recently increased 1.8% stake.

Shorts:

- **Flexion** (NASDAQ: FLXN): Close your short, per today's alert.
- **Kellogg** (NYSE: K): Sell short 1%.
- **Papa John's International** (NASDAQ: PZZA): Sell short 1%.

Options:

- **Papa John's International**: Buy to open November 2018 $55 calls to cap risk on your short, buying one call for every 100 shares you're short.
- **SPDR S&P 500** (NYSEMKT: SPY): Close your synthetic short, per today's alert.
- **Sonos** (NASDAQ: SONO): Sell naked January 2019 $15 calls, lately paying you $0.80 each.

Upcoming Expirations:

- **November:** We have a collar on **Facebook** (NASDAQ: FB), naked calls on **Gilead Sciences** (NASDAQ: GILD), and long calls on Papa John's expiring during various weeks this month. We plan to close the Facebook collar soon, let the naked calls on Gilead expire if possible, and close the Papa John's calls at some point, as we manage that short.

Close Your Synthetic Short on SPY

Published Nov 1, 2018 at 12:30PM

Is this for you? This is for members who have a short on this index and who want to book the profit.

How You Follow Along

- **Trade:** Ideally, use a two-legged order to close your synthetic short on the **SPDR S&P 500** (NYSEMKT: SPY) ETF:
  - Sell to close your December 2018 $271 puts.
  - Buy to close your January 2019 $285 calls.
- **Allocation:** We're closing our **entire** position, which is 17 contracts of each option.

- If you prefer to keep half of your hedge -- so 7.5% of the original 15% allocation -- you could. Just realize that we're closing this position entirely, and looking to potentially set up another hedge or more shorts.
- **Prices (10:30 a.m. ET) and Guidance:**
  - SPY: $271.90
  - Sell to close $271 puts: $7/$7.02
  - Buy to close $285 calls: $2.90/$2.94
  - Combined credit (use limit orders that split the bid/ask): About $4.19
- **Later Guidance:** If SPY moves much in price before you act, you should still close these options on the argument that we're closing the hedge to book a profit, period.

What We're Thinking

Living up to its scary reputation, October was the worst month for stocks since 2008, with the Nasdaq falling 9.2% and the S&P 500 down nearly 7%. (The decline actually started in September, so the total is larger still.)

Even so, declines of this magnitude are natural, typically happening up to three times per year. And when they do, we generally want to book our profits on any market hedges, because the decline is unlikely to become more severe or to last. A hedge in a declining market is ultimately only helpful if you take your profit at some point.

Our synthetic short on the S&P 500 ETF has a short $285 call that expires in January 2019 and a long $271 put that expires next month, on Dec. 21.

Lately, the ETF is near $272. That means *all* of the value in our long $271 puts is time value, and it's currently on track to decay by a few percentage points per day until our expiration in just 50 days (many fewer market days). And that decay will increase in velocity over time, and if SPY rises.

If we don't act and SPY doesn't move an inch, the $7 per share in time value in these puts will be gone next month, while selling the puts today is akin to closing a SPY short at $265 -- about 2.5% lower. We'll take that.

Meanwhile, our January 2019 $285 calls on SPY are only 4.8% out of the money -- a distance that the S&P 500 could travel in a day or two if it chose. So we're going to buy to close these short calls, too, to take this side of our short off the table, removing its risk. We've captured more than 60% of what these calls paid us, and we grew that capital by investing it in the $271 puts. Thus, rather than getting fancy and hoping SPY doesn't rise for the next few months, we'll close these, too.

Closing the synthetic short frees us, in a sense, to consider new hedges, which we want to do just as much as we want to book this gain. However, hedging is much more expensive now than when we originally set this up in March, when the markets were more complacent, so we may need to get creative in constructing another index hedge.

We're ready to close this one anyway, because if we never take gains in our hedges, they aren't really serving their ultimate purpose: helping our returns and giving us more cash to invest during and after downturns.

Alternative Trades

- **IRA-Friendly:** Our alternative trade was a January $245/$255 bear put spread that you could have set up in March for about $2.65 per spread. Now, with SPY still well above those strike prices, the spread is worth about $1.45. We suggest closing the spread as a way to keep your loss at less than half of your hedge cost, rather than potentially losing all of it come January. That said, if you'd rather keep this hedge, you of course may do so.
- **Direct Short:** If you shorted SPY directly, you can buy to close or cover that short, if you want to follow us in this decision.

Pro Can Help

- **Want to talk about our hedge strategies?** Please visit our shorts and hedges board.

Close Your Short on Flexion

Published Nov 1, 2018 at 12:30PM

Is this for you? This recommendation is for all *Pro* Fools who shorted **Flexion Therapeutics** (NASDAQ: FLXN) with us.

How You Follow Along

- **Action:** Buy to close, or cover, all of your short shares of Flexion. That's a 0.8% allocation for *Pro*, or 1,920 shares.
- **Recent Price:** $14.50
- **Guidance:** Use a **limit order** to close at the going price.
- **Alternative Trade:** If you set up a synthetic short using options, close those two options, too.

What We're Thinking

As of this morning, we were sitting on a 25% gain in our short of this small biopharmaceutical company, a return earned in about six weeks (the stock fell 10% this past week alone). This put about $7,000 in unrealized profit in our portfolio despite the position's small (1%) size. True to the, well, short-term nature of many shorts, we're going to close this position now to ensure our profit.

With Flexion's market value hovering at about $550 million and the stock price remaining volatile, we could easily see much of this profit disappear if we become too complacent. We could also the stock price decline much further -- we don't have high hopes for earnings next week, or for the company's sole drug in general -- but with a short sale, we'll often take one in the hand as opposed to two in the bush. That's partly because it costs money to short -- each day, you're paying a small fee -- and partly because your potential rewards on a short shrink as the stock price falls, so we have less to gain by waiting around at this point. (Plus, we can always short it again if desired!)

The short has exceeded our near-term hopes for a return, and we'll book our gain. Please note that it's important to use a limit order to cover your shares, so we don't all push the stock much higher. Use a limit order to close your options, too, if you used options to short it. Congrats to those who took the risk of shorting and were rewarded.

Pro Can Help

Pardon me? Want to discuss our shorts? Please visit our shorts and hedges board.

More Market Volatility Seems Certain

Published Oct 29, 2018 at 5:22PM

Dear *Pro* members:

Having just returned from a Motley Fool member event with more than 300 Fools in Denver, I can share that Fools are handling the market's renewed volatility with calm and resilience. Most of us have seen declines before, including some far worse than this against backdrops that were much more unnerving and heartbreaking (including 9/11 and the Great Recession, when millions lost their homes and jobs).

Today's market volatility seems to be brought on more by spectral apparitions and imagined ghouls than by actual current events. I don't mean to discount the real risks; concerns about slowing economic growth, sharply lower international stock markets, trade wars, and rising interest rates are all worthy of a role in the haunted house of investing. But currently, these look like temporary scares, unlikely to do more than jump out at us for a moment and then slip back again as we pass by. The economy is still growing at a strong clip. International stock markets are historically volatile. Trade war resolution will be good for all parties. And interest rates will be higher sooner than we think, so much so that talk will turn to eliminating increases or even a rate drop.

The pendulum swings in both directions. Right now, we're still on the downswing. As of now, the Nasdaq is down more than 13% from its Aug. 29 closing high, and the S&P 500 is down about 11% from its Sept. 20 counterpart; both have dipped into negative territory for 2018. We don't like to anchor on the high points, but this is the best way to convey how far we've fallen, and why you may feel a bit shellacked. A 13% decline in the Nasdaq means many tech-heavy portfolios are down 20% or more. Even the big tech stocks have been hit hard. But declines of this magnitude are historically common.

On Sept. 17, I wrote that it was time to restart our short basket. We sought to add as many as five new shorts per week in the following month or so, and while we fell short of that as many stocks fell before we got to them, we did recommend nine short positions (including two naked calls) and a protective collar on **Facebook** (NASDAQ: FB). With that collar plus our in-the-money covered calls on **Square** (NYSE: SQ), we had half of two of our largest positions hedged alongside the new shorts. We've also been maintaining a large short on the **SPDR S&P 500** (NYSEMKT: SPY) that is now well in-the-money.

But we're still keen on adding to our shorts -- assuming we can find stories of woe at prices where we still want to short. We're also considering adding to our index hedge, which would be quick and easy. The S&P 500 isn't crazily priced (at all) at about 15 times expected earnings, and we expect this market decline will ultimately be an opportunity (every decline in history ultimately was). But for all we know, this particular decline could only be halfway through (or less). We could set up another hedge to help cushion against further declines while still providing us some breathing room if -- or, I should say, *when* -- the market bounces.

We'll see Facebook's earnings tomorrow night, and soon after that, we'll be able to share guidance on our November protective collar on Facebook, which should be rewarding you well now.

We're also watching our shorts closely, of course; we currently enjoy a 22% gain on **Flexion** (NASDAQ: FLXN), a 13% gain on **SeaWorld** (NYSE: SEAS), and an 11% gain on **HNI** (NYSE: HNI). I'm not eager to remove short positions unless we're comfortable with our overall exposure, or if a stock has fallen enough that we no longer want to short it. Having some winners in a down market makes it easier to stay the course and reinvest some money in cheaper stocks. We'd hoped to have more shorts by now, but as mentioned last month, we'll continue adding to our evolving book of short positions. Our "bear pen" of potential shorts, as we've taken to calling it, is expanding.

Again, one never knows, but volatility seems likely to continue in this environment. That said, we also know that we need to short prudently, using Foolish skills equal to those we employ when buying strong businesses. Otherwise, the short positions will prove too costly when stock prices do rise, and that's what we want to avoid. So far we've been able to manage this, despite a 10-year bull market that technically continues today.

We'll be in touch again soon. To share thoughts, please visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: Oct. 29, 2018

Published Oct 29, 2018 at 2:50PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Zuora** (NYSE: ZUO): We're increasing our allocation, recommending an additional 0.5% buy, to bring us to 1.7%.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Facebook** (NASDAQ: FB): Because the stock had dropped before we set up our trade, we had to adjust our strike prices. We sold seven November 2018 $155 calls and bought seven November 2018 $135 puts for a net credit of $0.05, covering half of our shares before tomorrow night's earnings.
- **Gilead Sciences** (NASDAQ: GILD): We sold to open four Nov. 30, 2018, $78 calls, only being paid $0.69 each (as the price had changed). We set up 1% in look-through short exposure.
- **Sonos** (NASDAQ: SONO): We sold to open 23 $15 calls expiring in January 2019, being paid $0.70 each and setting up 1% in look-through short exposure.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Buy More Zuora

Published Oct 25, 2018 at 2:32PM

Is this for you? This is for all *Pro* members who want to invest in this company alongside us.

How You Participate

- **Action:** Invest another 0.5% of your portfolio in **Zuora** (NYSE: ZUO). For *Pro*, that's about another $17,500 worth, or approximately 900 shares.

- **Recent Price Range:** $17.87-$19.15
- **Scorecard Status:** Buy
- **Price Guidance:** Please, **use a limit order.** It's a smaller company, so set a limit near the current price when you make your investment; lately, aim to buy below $19.50.
- **Alternative Trade**: Seeking a potentially lower buy price? Sell to open puts that appeal to you; for example, you can sell to open one December 2018 $17.50 put for every $1,750 in stock you want to buy lower.

What We're Thinking

The business story at Zuora has not changed since our first recommendation to buy shares in mid-July. However, the stock is demonstrating all the puppy-like volatility that befits a recent IPO; it's down by about 25% since that first buy. Of course, Zuora isn't alone in having a lower share price. Most stocks have declined in recent weeks, and younger, smaller companies have typically fallen by more than average. However, historically, smaller companies' stocks have a tendency to eventually bounce back more robustly, as well.

Expecting volatility in these new shares, we began the position in July with just a 1.5% stake, which is now worth 1.2% of the portfolio. Today, we're recommending investing another 0.5% of our assets in Zuora stock, bringing our total initial investment to a more meaningful 2%, and our current stake's value to 1.7%. For future planning, this is likely the size at which we'll leave the position for a some time to come; we're unlikely to invest more until we see more business reasons to do so.

Meanwhile, we expect the stock to remain volatile, of course, partly because $2-billion-market-value Zuora isn't expected to earn GAAP profits for several more years (though that's not uncommon with young Software-as-a-Service businesses), and the stock trades at about 8.7 times next year's estimated revenue of $229 million. Zuora also must continue to invest to reach more customers, and perhaps the easiest customers to convert were the ones who arrived to the fold earliest. But the market for is solutions is large and growing, and Zuora maintains a leadership position against less focused competitors despite its small size.

We also have a relatively young (49-year-old) founder/CEO, Tien Tzuo, who is invested in and passionate about the business and its mission. (In fact, we recently interviewed him, for when you have 30 minutes.) So, as we wrote in July, we're taking a stake for the long term in hopes that Zuora will become a much larger company as the subscription economy grows. We often like to promote buying more of our winners, sometimes recommending that above investing further into current laggards. But in this case, we're following our original thinking by purchasing a bit more of the stock during volatility. Shares could always go lower, naturally, but we're comfortable adding more at today's price given our time frame and the potential.

ZUORA IN 30 SECONDS

WHAT IT DOES

Zuora sells software that helps any company become a subscription-based business by making it easier to track revenue and billing dynamically.

WHY BUY IT

- Zuora is led by a founder who is passionate about expanding what he calls the "subscription economy." Zuora's customers range from Ford to Box, from industrial to energy, as business models evolve to subscription revenue and require software to match it.

- Zuora's business model lets it expand as its customers do. Annual fees to get Zuora's software are complemented by variable fees that go up as a client's volume usage rises; this resulted in a 112% net dollar retention rate last quarter. And Zuora's subscription retention rate with its approximately 450 largest customers is nearly perfect.

- With an intense focus on making recurring-revenue, subscription-based business models work for its clients, Zuora is likely to be an expert at making its own subscription business excel.

Pro Can Help

- Are you subscribed? Visit our Pro Longs board to talk about Zuora.

Pro Catch-Up Trades and Expirations: Paycom, Sonos, and More

Published Oct 25, 2018 at 2:11PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.9% stake in the stock.
- **Paycom** (NYSE: PAYC): Buy at least half of our 4.8% stake.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy at least half of our 5.1% stake.
- **Broadridge Financial Services** (NYSE: BR): Buy 3% of our 7.1% stake to start.
- **Coherent** (NASDAQ: COHR): Match our 1.1% stake.
- **Medtronic** (NYSE: MDT): Match our 2.7% stake.
- **OpenText** (NASDAQ: OTEX): Match our 2.7% stake.
- **Verisk Analytics** (NASDAQ: VRSK): Match our 2.5% stake.
- **Zuora** (NYSE: ZUO): Match our 1.2% stake.

Shorts:

- **Kellogg** (NYSE: K): Sell short 1%.
- **Murphy USA** (NYSE: MUSA) Sell short 1%.
- **Papa John's International** (NASDAQ: PZZA): Sell short 1%.

Options:

- **Gilead Sciences** (NASDAQ: GILD): The company announces earnings tonight. If you haven't written naked calls yet, you can sell to open Nov. 30, 2018, $78 calls for about $0.67 each (less than the $1.10 we originally targeted, unfortunately). Or, wait until after earnings to see what the situation is then.
- **Papa John's International**: Buy to open November 2018 $55 calls to cap risk on the short, buying one call for every 100 shares you're short. Lately they cost $1.75 each.
- **Sonos** (NASDAQ: SONO): Sell naked January 2019 $15 calls, lately paying you $0.65 each. Or, set a limit order at $0.70 (our original desired price) and see if you get that price if the stock rises a bit more.

Upcoming Expirations:

- N/A

Sell Naked Calls on Gilead Sciences and Sonos Inc.

Published Oct 22, 2018 at 4:08PM

Is this for you? These recommendations are only for *Pro* members who are comfortable with the idea of managing a changing basket of short stocks -- and, in the case of today's recommendations, selling naked calls. You need a margin account to participate, or you need to cap your risk by purchasing a higher-priced call at the same time.

How You Follow Along: Gilead Sciences

- **Trade:** Sell ("sell to open") Nov. 30, 2018, $78 calls on **Gilead Sciences** (NASDAQ: GILD)
- **Allocation**: A look-through allocation of 1%. Each contract represents shorting $7,800 ($78 x 100 shares) worth of Gilead shares at $78, so *Pro* will be selling four to five contracts:
  - Current portfolio value: $3,500,000
  - 1% of that is $35,000, which translates into 4.5 contracts ($35,000/$7,800)
- **Price Guidance:** It is critical that you use a limit order. Lately, aim to be paid $1.10 per contract. As prices change, aim to be paid at least 1% per month on the strike price to expiration; with 39 days to go, that's currently $1.01 as a minimum, no lower.
- **Recent Prices**:
  - Stock: $72.72
  - Nov. 30, 2018, $78 calls (bid/ask): $1.07/$1.12
    - Alternative trade: Simultaneously buy to open Nov. 30, 2018, $82 calls (the same number of short calls you write) if you want to cap the risk of your short call.

How You Follow Along: Sonos Inc.

- **Trade:** Sell ("sell to open") January 2019 $15 calls on **Sonos Inc** (NASDAQ: SONO)
- **Allocation**: A look-through allocation of 1%. Each contract represents shorting $1,500 ($15 x 100 shares) shares of Sonos at $15, so *Pro* will be selling 23 contracts.
  - Current portfolio value: $3,500,000
  - One percent of that is $35,000, which translates into 23.3 contracts ($35,000/$1,500)
- **Price Guidance:** It is critical that you **use a limit order** and accept no less than $0.70. If prices fall below $0.70 we will provide updated guidance later in the week.
- **Recent Prices**:
  - Stock: $12.39
  - Jan. 18, 2019, $15 calls (bid/ask): $0.70/$0.80
- **Note**: Unlike with Gilead, we're not offering an alternative trade to set up a bear call spread. This is because Sonos' far out of the money options are still too expensive, in our opinion. But your mileage may vary.

What We're Thinking

Gilead Sciences

A former laggard in the *Pro* portfolio, Gilead is due to report earnings Oct. 25 after market close, providing its call options with a healthy premium heading into that report. We believe Gilead's stock will likely remain below our strike price by Nov. 30 expiration, partly because Hepatitis C drug sales should continue to be lower year-over-year, dragging on annual comparisons. Although Gilead may finally be in a place to expand its total year-over-year revenue in 2019, even that prospect is not certain, as most everything needs to go right: HIV drug sales must keep growing; Hepatitis C drug pricing must hold up for new contracts (the largest risk, in our opinion), and products in the pipeline need to keep advancing for the stock to do well.

Our options only go to Nov. 30, however, so next year's results are mostly beside the point for us. We expect more of the same from Gilead when it announces earnings on the 25th: stable guidance, and optimism for growth in 2019 and beyond. But after a stronger-than-expected second quarter, the stock gave back its gains, and it now continues to linger in a lower price range once more. Investors know any growth on the horizon is likely to be tepid, and Hep C drug sales could still decline further.

Sonos Inc.

Stop me if you've heard this story before: A consumer-goods company in a rapidly growing market goes public under the guise that its first-mover advantage and strong brand will result in excess profits for the foreseeable future, despite rapidly increasing competition. No, we're not talking about Fitbit or GoPro, although we believe these companies provide a road map for what's likely in store for wireless home speaker leader and recent IPO Sonos.

The reason for our skepticism is perhaps best illustrated by two statistics that at first glance sound quite positive:

- In 2018, a study found that Sonos had 84% share in the wireless audio category among industry professionals.
- A Morgan Stanley analyst recently estimated that more than 70% of U.S. households will own a smart speaker with voice commerce capabilities by 2022.

The issue as we see it is that the later category (smart/connected speakers) is likely to replace the former (wireless), and that market leadership in the former doesn't automatically translate into leadership in the later. In fact, the same analyst estimated that Amazon and Google will control 62% and 33%, respectively, of the smart speaker market by the end of this year.

And from our vantage point, this isn't even a clear fight. For Sonos, speakers are everything, but for the big tech companies they're simply a part of a much larger strategy -- their business model doesn't solely depend on selling hardware for a profit, so they're incentivized to offer better products at the same price as Sonos (or similar products cheaper) as a way to win business. A recent teardown of comparable Sonos and Amazon speakers found that the Amazon version likely cost more to manufacture despite being sold to consumers for 25% less.

Add in the fact that Amazon, Google, Apple, etc., are likely to have much stronger preexisting relationships with smart-speaker purchasers, and we anticipate Sonos' market share will dwindle in the coming years. To make the short case even more compelling, there is also the fact that Sonos uses Amazon's Alexa for its smart speakers -- Amazon could, of course, disable this feature with little notice. And finally, Sonos has been unable to generate meaningful profits despite its dominance in the wireless speaker market over the past few years.

Ideally we'd be able to short this company directly, but the current cost to borrow is prohibitively high. By selling the January $15 calls, we are able to generate a healthy yield with a sizable amount of protection, given that these calls are currently 21% out of the money.

The Foolish Bottom Line

Selling naked calls is not a strategy we use often, but as long as you size your positions conservatively, the strategy in some ways presents lower risk than shorting a stock outright (because you're effectively shorting at a higher price). However, your potential rewards are small, being limited to the premium the call options pay you. We write naked calls to short either when shorting is too expensive and difficult, as with Sonos, or when we only want to potentially short something at a higher price, as with Gilead. Writing naked calls with little time to expiration also helps us to reassess regularly, which is always important with shorts.

Pro Can Help

Please bring any questions to the *Pro* Shortsboard!

Pro Guidance Changes and Completed Trades: Oct. 22, 2018

Published Oct 22, 2018 at 4:04PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- N/A

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Facebook** (NASDAQ: FB): We are still trying to set up our November 2018 protective collar on half our shares, setting up seven contracts of each. At current prices, we are looking to sell to open $165 calls (we have to go lower than the $170 in the alert), and buy to open $145 puts, for zero net cost at worst. We'll tell you if and when this fills. The stock has fallen since our alert, so the situation is less favorable to us right now, but it can still serve our purpose.
- **Papa John's** (NASDAQ: PZZA): We bought seven November 2018 $55 protective calls, covering our entire short. We paid $1.75 each using a limit order.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Expirations: Johnson & Johnson, Papa John's, and More

Published Oct 18, 2018 at 2:49PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.9% stake in the stock.
- **CME Group** (NASDAQ: CME): Match our 2.6% stake.

Continue building your portfolio with our Buys, including:

- **Broadridge Financial Services** (NYSE: BR): Buy 3% of our 7.1% stake to start.
- **Coherent** (NASDAQ: COHR): Match our 1.2% stake.
- **Medtronic** (NYSE: MDT): Match our 2.8% stake.
- **Verisk Analytics** (NASDAQ: VRSK): Match our 2.5% stake.
- **Zuora** (NYSE: ZUO): Match our 1.3% stake.

Shorts:

- **Flexion** (NASDAQ: FLXN): Sell short 1%.
- **Murphy USA** (NYSE: MUSA) Sell short 1%.
- **Papa John's International** (NASDAQ: PZZA): Sell short 1%.
- **SeaWorld** (NYSE: SEAS): Sell short 1%.

Options:

- **Johnson & Johnson** (NYSE: JNJ): Roll your October 2018 $135 calls to January 2019 $140 calls. Aim for a credit (lately it's a $0.30 credit), and roll by Friday's close to avoid losing your shares.
- **Papa John's International**: Buy to open November 2018 $55 calls to cap risk on the short, buying one call for every 100 shares you're short. Lately they cost $2.45 each.

Upcoming Expirations (October):

- **Johnson & Johnson**: Our October 2018 $135 short calls are in the money as we hit expiration tomorrow; roll per the alert.

Roll Your Covered Calls on Johnson & Johnson

Published Oct 16, 2018 at 2:49PM

Is this for you? This is for all *Pro* members who wrote October 2018 $135 covered calls on **Johnson & Johnson** (NYSE: JNJ) as per our alert in July. Those who *don't* own the stock can buy at least 100 shares to write these covered calls (so long as you are OK with capping upside in exchange for near-term income). Those who own less than 100 shares as a full allocation can continue to hold them.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
  - "Buy to close" all October 2018 $135 written calls.
  - "Sell to open" the same number of January 2019 $140 calls.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* will roll all seven of our calls.
- **Recent Prices**:
  - Stock: $136.40
  - Buy to close October 2018 $135 calls (bid/ask): $2.04/$2.10
  - Sell to open January 2019 $140 calls (bid/ask): $2.89/$3
  - Net credit to roll: Approximately $0.88 (this price will change)
- **Price Guidance: It is critical that you use a limit order**, aiming to pay as little time value as possible to close your short calls, and aiming to roll for as much of a credit as possible. The midpoint of the bid/ask spreads currently implies about a $0.88 net credit for this roll, although that number will change as prices change. Realize that with expiration on Friday, you should roll these calls before then or your owned shares may be called away.

What We're Thinking

Johnson & Johnson reported earnings today, and the market is pleased with results, with the stock up nearly 2% as of this writing (on a day when the market as a whole is up strongly). In J&J's third quarter of 2018, companywide revenue increased 3.6%, once again led by the pharmaceutical division (with 6.7% year-over-year revenue growth), and adjusted earnings per share rose by 7.9% year over year. JNJ's earnings continue to align with our expectations for the business: that the pharmaceutical division will be the largest growth driver for J&J and should offset the slow to no growth in the consumer and medical-device divisions. We'll have a more detailed update on J&J's quarter once the company releases its 10-Q filing (usually within two weeks from the earnings date).

We're now in a position to roll our calls up and out for a credit, aiming for more income and upside from this position as we roll out to January 2019. If our shares are called in January, we'll be selling at a net price of $140.88, slightly above our fair-value estimate and accounting for a 22% total return (11% annualized) since the position's inception.

Pro Can Help

- **Questions?** Ask any questions on *Pro*'s options board.

Buy Protective Calls for Your Papa John's Short

Published Oct 12, 2018 at 10:40AM

Is this for you? This trade is for members who have an active direct short position on shares of **Papa John's** (NASDAQ: PZZA) -- and who want to pay a bit to cap the risk on it.

How You Participate

- **Action:** Buy protective calls on Papa John's.
- **Trade:** Buy ("buy to open") Nov. 16, 2018, $55 calls.
- **Allocation:** Buy one protective call for every 100 shares you are short, protecting your entire short position. *Pro* is currently short 700 shares, so we will be buying seven calls. If you shorted less than 100 shares or are short an odd lot of shares (i.e., not in multiples of 100), see the Alternative Trades section below.
- **Price Guidance: It is critical that you use a limit order**, initially aiming to split the current bid/ask spread (lately $1.85 or so, but that will change). Prices will fluctuate as the stock moves, with the trade getting more expensive to set up if shares rise, and less expensive if the stock declines. **If prices change a lot**, it's a judgement call on your part depending on how much you want to spend; you should also consider using different strike prices, rolling up or down a strike accordingly to target a better entry price. We may use a different strike price, if necessary, by the time we make our trade.
- **Recent Prices:** Stock, $52.30; Nov. 16, 2018, $55 calls (bid/ask), $1.65/$2.00. Splitting the bid/ask, try a limit of about $1.80 to $1.85. Don't overpay.

What We're Thinking

Since we initiated our short of Papa John's just a few weeks ago, shares are up 12% because of several news items:

- On Sept. 26, shares popped 8.5% on rumors that founder John Schnatter was reaching out to private equities to discuss a buyout of the company.
- On Oct. 1, activist investor Legion Partners Asset Management LLC disclosed a 5.5% stake in Papa John's.
- On Oct. 9, the stock closed the day up 9% on rumors that activist hedge fund Trian Fund Management was considering making an offer for the company.

Shorting is tough -- even if your assessment of the business is right, sometimes factors outside your control can cause the stock price to work against you. We knew a potential buyout was one of the biggest risks to this Papa John's short, and in fact we were already on track to recommend buying protective calls, but the rumors -- and the market -- beat us to the punch.

Now, we're faced with the decision of whether to take our loss and close the short altogether, or pay to cap our risk with protective calls at these higher prices. Although of course it's not ideal that the stock is up so strongly quickly after initiating our position, we are still confident that business results are likely to be poor, and with Papa John's set to announce third quarter 2018 earnings in the last week of October or first week in November, we think it's possible shares could trade significantly lower if business results disappoint and takeout rumors fall through or even just dissipate for some weeks.

That likelihood of a continued deterioration in business fundamentals is enough for us to feel comfortable paying 0.04% of our portfolio's value to cap our risk at a net $56.85 per share (9% higher than the current price and 22% higher than the price in the original short alert). If the share price continues to rise, we're capped at a 22% loss on a 1% position (a 0.22% ding to the port) since the recommendation, and if it declines, we retain exposure to all the potential downside of the stock.

Alternative Trades

- **Are you short less than 100 shares?** Consider closing your short now, or setting up a cover-stop loss order at $55 to $57 or so (your choice).
- **Using options to short?** If you set up a synthetic short, you can cap your risk by purchasing these same calls we're buying. If you only bought puts, your risk is already capped -- no need to take action.
- **Short an odd lot of shares?** You have two choices:
  - Either buy back your odd number of short shares until you are short a multiple of 100 shares, then buy one call for each 100 shares you are short, or ...
  - Short more shares to increase your odd lot of shares to a multiple of 100 shares, then buy one call for each 100 shares you are short.

Pro Can Help

- Questions? Visit our Shorts & Hedges discussion board.

Pro Catch-Up Trades and Expirations: Shorts and More

Published Oct 11, 2018 at 4:03PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.8% stake in the stock.
- **Broadridge** (NYSE: BR): Buy half of our 7.2% stake to start.
- **American Tower** (NYSE: AMT): Match our 3.6% stake.
- **CME Group** (NASDAQ: CME): Match our 2.6% stake.

Continue building your portfolio with our Buys, including:

- **Coherent** (NASDAQ: COHR): Match our 1.2% stake.
- **Medtronic** (NYSE: MDT): Match our 2.7% stake.
- **OpenText** (NASDAQ: OTEX): Match our 2.8% stake.
- **Verisk Analytics** (NASDAQ: VRSK): Match our 2.5% stake.
- **Zuora** (NYSE: ZUO): Match our 1.2% stake.

Shorts:

- **Flexion** (NASDAQ: FLXN): Sell short 1%.
- **Murphy USA** (NYSE: MUSA) Sell short 1%.
- **Papa John's International** (NASDAQ: PZZA): Sell short 1%.
- **SeaWorld** (NYSE: SEAS): Sell short 1%.

Options:

- N/A

Upcoming Expirations (October):

- **Johnson & Johnson** (NYSE: JNJ): Our October 2018 $135 short calls are in the money with about one week until expiry; we'll have guidance on rolling, or letting the stock go, before expiration.

Jeff Interviews Zuora's CEO! Plus, Quick Thoughts on the Market

Published Oct 10, 2018 at 4:42PM

Hear Tien Tzuo, co-founder and CEO of **Zuora** (NYSE: ZUO), answer your questions and explain his company as he talks with *Pro* advisor Jeff Fischer.

Plus, get Jeff's thoughts on today's sharp market decline -- and on the market's recent behavior in general -- in this discussion-board post.

{% video %}

Transcript

Jeff Fischer: Greetings, Motley Fool members, I am Jeff Fischer, advisor of Motley Fool Pro. I'm delighted to be joined today by the founder and CEO of Zuora, Mr Tien Tzuo. Hello team.

Tien Tzuo: Hey Jeff. Thanks for having me on the show.

Jeff Fischer: Thank you. We appreciate it quite a bit and congratulations on your company coming public just this last April.

Tien Tzuo: Thanks, it's a big year. It's been good. Appreciate the Congrats.

Jeff Fischer: You seem perfectly positioned for what we're going to talk about today. Your business model itself is working to empower the subscription economy, a term that you've coined, a phrase that you've coined. We're going to talk about how that sets your company up for the future as the economy does indeed transition into what's becoming more of a service oriented sort of economy.

But, serving Motley Fool investors here in this recording, we also have a lot of just strict business related questions. Let's jump in right with the first one that we like to go to, which is, Tien, Warren Buffett has said as you know, that the number one factor behind his best investments across his whole 72 year investment career is pricing power. How do you view pricing power at your company?

Tien Tzuo: Well, with all due Respect to Warren Buffett, I think the world has actually changed. This is the central thesis of our company. We see that the 120 years has been really characterized by a product based economy. The primary goal of businesses was to come up with a hit product and to sell as many units of that product as possible. To give you more cars, more pens, more laptops. It could be more movie tickets, it could be more seats on an airplane. Whatever it happens to be.

The whole premise of businesses was to say, if I can sell as many units as I can, I can take my fixed costs, spread it over those units, lower my marginal cost, and that's the basis of competition. In that world, pricing power makes a lot of sense because if you have pricing power, then you can have the biggest spread between your marginal revenue and your marginal cost.

We don't live in that world today. In Apple, every quarter that passes you can see they obsess less about how many iPhone 10s do I sell? They instead say, "I have a billion and a half Apple IDs, and I've got all sorts of ways of monetizing those Apple IDs." That's how Facebook thinks, that's how Apple thinks, that's how Amazon thinks, that's how Google thinks, that's how Salesforce thinks. That's how Uber thinks.

In this world, it's not just about pricing power. I would say it's about the strength of your relationship power. Netflix has a 130 million people around the world that view Netflix as TV. This is what they go to when they want entertainment. Yeah they can sign up for Hulu, they can sign up for an HBO, but they're loyal, they're committed to Netflix and the power of the recurring revenue that Netflix has today is what sets up Netflix's competitive advantage.

It's not that price is not important, but the underlying thing now when you're not selling a product but you're building a relationship with customers, is the power of those relationships.

Jeff Fischer: Those are great points. It makes me think of Amazon Web Services where in a sense they're employing the opposite of pricing power. They want to lower their price on a steady basis because they can provide better service at lower cost and by sharing some of that with the customers, they keep their customers longer, make them happier and the customers use the product more.

Just as you touched on, it's becoming in some regards a usage based economy more than a product based economy, at least in the spaces we're talking about. In that case, pricing power could actually be thrown out the window in some regard. Your company, as with so many software as a service companies focuses on a dollar based retention rate. You target 108% to 112% dollar base.

What that means for investors listening who may not know is every year you're looking to make more revenue on your average customer than in the past year. That's due both to customers using more of your products, or just more usage growth because there is a fee attached to that as well.

Back in relation to pricing power just to talk about that for another minute, is there something to the idea that annual contract, dollar based retention rates can be a replacement for the old school way of thinking about pricing and instead, you're just trying to serve your customers more and better even if it's at a lower price point per product but if you're adding more products, of course you're going to grow with your customer?

Tien Tzuo: Well, your Amazon example is a fantastic example because Amazon realizes that the more you use AWS, the more you're going to grow with AWS. There's certainly lots of company that started off and their AWS bills was just tens of dollars a month or hundreds of dollars a month and as their organizations have grown, they're now giving Amazon millions of dollars a year or tens of millions of dollars a year.

I think Netflix gives Amazon a couple billion dollars a year if I remember right, to stream all their videos. You can see that Amazon and Jeff Bezos talks about, it's all about the customer. This isn't just platitudes that don't mean anything, there are actually fundamental businesses built on the customer. People like to contrast on the retail side, Amazon versus Walmart and think that Amazon is an Ecommerce store and Walmart is bricks and mortar store and that's not really the case.

You can see it's a lot more complicated now. Walmart has the Ecommerce, Amazon has physical stores, but Amazon takes everything you do back to your Amazon ID. You walk into Whole Foods today, they want you to use the app to actually scan the purchase. You walk into an Amazon Bookstore and if you swipe your credit card and walk away from the bookstore, they encourage you to go back online and log that transaction to get your Amazon ID because they want to have that one-on-one relationship with you and they want to have a total view of who you are.

Then what they say is, they want you to use that Amazon ID in more and more parts of your lives. Whether it's entertainment, whether it's shopping, whether it's groceries, whether it's reading a book versus Walmart is just saying, look, I want to sell you more stuff. Come into my store and buy some stuff. Focus on the stuff and not focused on the relationship. You talk about pricing power, it's a lot more complicated.

It's not about how do you extract every single dollar from the customer on that single transaction, it's about viewing the customer as a longterm relationship and knowing that if you are able to deepen that relationship, be a more relevant part of their lives either as a consumer or a business, you will find ways of monetizing that relationship.

Jeff Fischer: Great points made it across the board. It has been fascinating to see how quickly Amazon is changing your experience inside the Whole Foods to broaden it and make it deeper, so great example. Tien, of the nearly 500 companies that have annual contract values with Zuora of above $100,000 a year, can you talk about one company or maybe even one whole industry that we would not expect to see as one of your customers using your subscription based revenue software and subscription based billing software? What's a company or industry using your software that would likely surprise us?

Tien Tzuo: You know, for years and years we would paint a picture that the world's moving towards a subscription economy. We would get a lot of pushback that says, well, maybe this is just a software thing or maybe this is just [inaudible 00:07:57] thing. I think as consumers now our lives are so dominated by services. We're buying less and less stuff that we could kind of feel that the world truly is moving towards the subscription economy.

But, the examples that we love to give that really expands people's imaginations are around these physical products because it really shows that this is not a digital trend, but everything can be this way. And so, we talk about Caterpillar, we talk about Komatsu, we talked about Schneider Electric. We talk about Ford, we talk about General Motors.

In the last earnings call, we talked about this company based in Wauwatosa, Wisconsin, have Briggs & Stratton. You might not realize it, but they are the world's largest manufacturer of lawnmowers. And of course, everybody immediately thinks, "Well, how do I subscribe to a lawn mower? Does that mean [inaudible 00:08:52] a month?"

Instead of buying this thing, it's not exactly like that. It's the fact that over the last five years, virtually every manufacturing company has invested to make their products smart, collecting data and sending it over the internet. If you buy a washing machine today, it's probably Wifi enabled. If you buy a car today, it's got 3G in it. If you buy a Briggs & Stratton lawnmower today, it's internet enabled and it's collecting all this data.

They're saying, "Well, what can we do with these things now?" They launched a product with us. It's a product targeting commercial turf companies. These are organizations and they tend to be fragmented and they tend to be small that send teams out to HOAs and commercial buildings and take care of the landscaping using Briggs & Stratton equipment. But, now they're able to build a workforce management system that helps these organizations increase productivity, rdrive more efficiency, drive more use out of their products, figure out where their people are, schedule these projects in a more efficient way.

You can see that once physical products are smart and connected to the internet, this whole digital revolution that we've seen take place in software and media is really going to reach all fabrics of our lives and everything that we do.

Jeff Fischer: Last conference call was fun by the way. InfoHub for Commercial Turf is the product that is ... Does Zuora create customized products for customers frequently? Is that part of your longterm strategy? I imagine there's a lot of work that goes into that and then maintaining that.

Tien Tzuo: Yeah. We understood the power of the subscription based business model based on the previous companies that we worked at, which were software as a service companies. I worked at Salesforce, the biggest [inaudible 00:10:38] software as a service company. And so, it was a mental leap to say, because we were heads down saying, look, we're totally bought in obviously given what we do, that subscription business models will take over the software industry. This is what we see taking place now with Adobe, with Microsoft, with all the software products that we use today.

The leap was to say, is this a universal phenomenon? That was the leap of faith that we really took that said the subscription business model is going to permeate all the industries over time. We also knew that it was really, really hard to run these businesses and the existing software products that companies used to run their business, these so-called ERP systems from SAP and Oracle really don't work.

Our thing was, can we build a universal billing module, a subscription management system that's anchored around billing, revenue recognition and subscriber management, but do it in a way that services all industries, all business models, all around the world? We've invested a ton in making our product customizable.

That's why as you see subscription business models go from software to media, to manufacturing, and we've seen some utilities companies really start to transform themselves. But as it goes from industry to industry and industry, that our product set can actually go into those industries because it's a highly customizable system.

Jeff Fischer: Do you have any examples and perhaps you don't, of a case where it's very difficult or even impossible for a company to transition? I realize that may be partly due to they just don't have enough will to do it yet, but any concrete examples where it's a lot more struggle than a company thought?

Tien Tzuo: Well, we have a lot of conversations [inaudible 00:12:23] also talked about this book that we put out that allows us to reach companies that are trying to understand, what is a subscription based business model about? What is it and how do I do it?

Jeff Fischer: Subscribed is the book. On Amazon, anyone can come pick it up. It's a great book. Congratulations on the book as well. I know how much work goes into writing a book.

Tien Tzuo: Yeah, and we're getting CEOs of Fortune 500 companies reaching out that says, "Look, I read the book. I gave it to my staff. Help us under the transformation." I'll just simplify it down. This model is about starting with the customer. It's about reinventing the customer, or rethinking the customer as a subscriber to your services.

When you look at it that way, any company can really be a subscription business because all companies of customers. But the trick is, how do you transcend thinking about your business model as selling those customers units of your product and think of it as a service that they can offer?

We were talking to a hotel company, and in the classic hotel business model is selling a product. In this case, it happens to be a room, a room night if you will. The way you sell it is, you put it onto as many channels as you can. You put it on bookings.com, you put it to Expedia, you give it to travel agents to sell. And they're saying, okay, what if we transcend that way of thinking?

We have two types of customers. We have travelers on the consumer side and we have local businesses that are around our hotels on the commercial side. And then we have a set of capabilities. We have obviously real estate, we have concierge services, we have food and beverage services. Why can't we unlock these things and when a traveler is coming into a city where we have a hotel, but they're not staying at our hotel, maybe they're staying at a friend's house, maybe they're staying in an Airbnb, they should be able to tap into the concierge service in the same way that they stay at the hotel.

Let's hold onto the traveler in all parts of their lives if you will, in that sphere of travel and become more of a travel brand, versus just selling room nights. It's a whole different way of thinking. Any company can do this. It is a journey and our goal is really to inspire them with stories to help them transition to this new business model.

Jeff Fischer: That makes so much sense. Especially when you remember the fact that as people, we want relationships. We all crave connections and relationships that are ongoing and that become more powerful over time because of that bond. Speaking of longterm, the Motley Fool is 25 years old now. We like to buy companies, buy the stock and keep it and keep it. We recommended Starbucks and Amazon in the 90s, Netflix early this millennium and those are still active recommendations. That's how we view this relationship as well.

You have said, and we love hearing this that your number one goal is to position your company for sustained long term growth and you have a ambitious growth targets. Which financial measures are most important to you today? And then, if you can look ahead five years, what might be most important to you financially five years from now?

Tien Tzuo: Well, you pointed to some amazingly successful companies. What I would say is, the common pattern is that they really identified a longterm trend. Retailing [inaudible 00:15:59] from bricks and mortars to Ecommerce is going to be more customer centric. That's not a five, 10 year trend, that's a 30, 40, 50 year trend.

Entertainment is going to be streamed given high bandwidth, and so we're betting on a business model shift of the subscription economy and it's going to take place over again, not five years, but over a multi-decade standpoint. That's definitely something that we watch quite a bit of.

We have this thing called the subscription economy index where we monitor the growth of subscription businesses. We're seeing that they're growing in any quarter, five to nine times the growth rate of standard businesses, the SMP 500 if you will. We're always trying to get a sense of how fast is the subscription economy growing? We need to make sure that we are the leader in how to talk about it, we're positioned as the leader.

Then fundamentally, is the business model there to create sustained growth over a long period of time? Above and beyond the standard metrics that we obviously report on, this is why we've highlighted ... Look at our number of logos if you will. To make sure that that's continuing to grow.

We do sell to a lot of startups where there's a VC portfolio effect if you will. If you look at all the companies are going public this year, whether it's Pluralsight, whether it's Zoom, whether it's SurveyMonkey, these are all our customers, but we got them when they were young. And, for every box or every SurveyMonkey, there's probably five, six or seven companies that don't quite make it. It's the nature of the venture capital market. So, we draw 100 K line really to exclude that effect so you can get a better year over year compare of the growth of our new customers.

Then the net dollar retention is really to say these companies are continuing to put more transactions through our system and their subscription businesses are successful. This gives us the engine of growth that as an external investor, you can track and measure for us on a quarter by quarter basis.

Jeff Fischer: Perfect. Research and development to speak of some numbers, for years now Zuora has spent about 21% to 22% of revenue on R&D. Is that a goal or has that just happened to fall out that way?

Tien Tzuo: Well, this is a very big product to build. One thing that I would suggest is, we actually do a lot of work about understanding the income statement for the subscription based business models. We actually, if you look at the book, there's a whole chapter on how to recast income statement, to break out recurring revenue in non-recurring revenue. Understand that the fundamental margin structures of a subscription business and understanding that sales and marketing in this model often as a cap X because you're acquiring future revenue, not just today's revenues.

And so, the 21% or 22% is a great number. We also counsel people to look at that as a percent of our subscription revenue versus our total revenue. You can look at it both ways. You can see we're continuing to invest in the product because this is a big production to build. SAP and Oracle's ERP systems weren't built overnight. I think we have a multi-year lead in terms of our ability because we started early to focus on the product, but we definitely don't want to rest on our laurels because there's more capabilities that we want to build into our system that I know our customers are asking for.

Jeff Fischer: That leads me gently to a question about new products, which I don't like to ask so frequently when you have young and vibrant products right now that are growing rapidly and you have all sorts of avenues to grow them and as we just talked about, a very large longterm market to address. How do you think about new products in that case? In general, do you have a roadmap to expand beyond current offerings or are you waiting to see the industry mature a bit more and listen to your customers and hear where they want you to go?

Tien Tzuo: Well, we're more unique. Certainly not completely but for a company of our size, we already have a multi-product strategy. Don't look at us as a one trick pony if you will that's trying to cycle as much as possible. We have essentially two flagship products and they're both related to business models, dynamic business models in the subscription economy.

The first product is billing and the second product is RevPro, which is a product focused on the complexities of revenue recognition in this new model. Then we also have what we call a family of add-on products. These are connectors to tax engines, payment gateways. There's a collections module that we sell to folks that have more complex collections requirements in the subscription economy.

These are add-on products that we typically go back to our customer base and say, "Hey, you didn't have this need before but as your business model is getting more sophisticated, as you're doing more things with billing, more things with revenue recognition, you might have these additional needs as well."

In June, in our annual subscriber conference, we really announced progression and a roadmap across all these things. On the billing side, we're really, really excited about the new orders module that actually formalizes an order concept and allows us to be more of a hub for all sorts of transactions for these businesses. Not just subscriptions transactions, but traditional you one time transactions as well.

We also announced the Collect Product as the newest member of our add-on family. Those products are doing really, really well. It's only been a few months and hopefully we'll have more things to talk about in those products in the future, but we are not stopping. We are continuing to advance in our product, we're listening to our customers and we're committed really to building the broadest and deepest suite of products and help companies build, manage and transform into subscription businesses.

Jeff Fischer: So you have your heads down, you're going after large, evolving and exciting market. Are there any competitors that might keep you up at night? Have you seen anything that any competitors have done lately that you would point to as, "Okay, we need to address that and move in this direction," or is that not the case?

Tien Tzuo: Our belief is that Oracle and SAP's ERP systems were good for the old world, the product economy, but they're not appropriate for this new world. So the question is always, how can we help our companies understand the differences between these two things and why one is necessary for success in the future? But obviously then the question is, how will Oracle and SAP evolve?

We believe that those two companies are buckling under their infrastructure. They're having a hard time innovating. They're acquiring pieces of technologies to keep their revenue growth going, so I would say those are two big companies that we'll continue to keep our eye on, but we feel really good about where we are in position to what those two companies are doing.

Jeff Fischer: Tien, can you name a few of your favorite subscription based businesses?

Tien Tzuo: Well, we see so much. I probably have an occupational hazard of having too many descriptions. I've got [inaudible 00:23:24] subscriptions, I've got Hulu, and HBO, and Netflix, and Amazon. One of the things that we're seeing is really interesting is you used to; if you had $20, $30 to spend on health, you used to give it to the local gym. But, now you've got this proliferation of choices.

You can give it to ClassPass, you can give it to Peloton, Weight Watchers are rebranding themselves as a health brand. So, I'm looking at, gosh, is there a way to direct that spend into something that I should pay for services that are tied to the Apple Watch, but I would take a look at the health and wellness space because I think you're going to see major transformations there in the next 12 months.

Jeff Fischer: That's exciting, that's so necessary. Subscription based businesses I'm in the same boat, I keep joining more and more, but happily so because done correctly they end up saving you money. And as you said, you form a relationship. We have a 13 year old son and we go to movies all the time. I'm this close to joining AMC's subscription based service where you can see up to three movies a week for $19.95 a month, save a lot of money if you see just three movies in a month.

We have just a few minutes left. Again, congratulations on your IPO this spring. If I can get a little personal, I'd love to hear what has changed since the company came public. And we can stick to the positive side, what do you like about being a public company and heading up a public company? Then let's talk for a few minutes about the company culture.

Tien Tzuo: Well, I think we did a good job of saying ... We have a big vision internally. We call it The World Subscribed. All thousand plus of our employees, we call them ZEOs, we call ourselves ZEOs are really focused on one mission and only one mission, which is to help companies one at a time be successful in the subscription economy. That focus is a longterm focus. We talked about hey in this next leg of our journey we will likely flip from going private to public.

It's part of the process. It gives us the capital we need, it gives us the reach we need so it's something that we've been pretty deliberate about over not just the last six months, but really over the last two or three years to build a business model that a public investor would value versus a private venture type of investor.

But, that's just an investor transition. Our vision doesn't change, our mission doesn't change. We certainly celebrated this big milestone that so many employees here have worked hard for, but the day after it was really back to work. I would say that the interesting thing for us then is being public does give us a broader platform to tell our story. To tell the story of the subscription economy and how we're helping these companies really transform. So, even being on your show as an example is something that we enjoy doing and being public is further opportunities to do so.

Jeff Fischer: Thank you Tien. Can you name, you did name just minutes ago a few companies that also recently went public that I'm assuming you respect. Are there a few others? I know DocuSign is a customer of yours and a company we follow as well.

Tien Tzuo: Yeah, we love our customers and we certainly have a block of software as a service companies that are all hitting the public markets today that we grew up with in many ways and hats off to their success. Whether it's [inaudible 00:27:08], DocuSign or Pivotal Software, we're some of the ones that hopefully will be going public later this year.

Jeff Fischer: We love that you call all of your employees, you're all called ZEOs. Here at the Fool as you may know, we've called ourselves fools for the past 25 years. It makes life a lot easier when you can, "I'm a fool. I'm doing my best, but I'm a fool." It's fun. Are there any other cultural innovations at Zuora that you want to point to today that you think make your company a unique and special place to work at?

Tien Tzuo: Yeah. Well, the ZEO is something that really came out folks. We all have so many choices today; movies we can watch, places we can go and obviously companies that we can work at. So ultimately, we're all looking for a company that allows us to be who you are and be the best that we can be.

The mindset that we want to bring into this thing is, we are all ZEOs. Maybe there's one CEO, but there's over 1,00 ZEOs and each of us have a leadership role, each of us are empowered to do what we believe is the right thing. And then, we also have a culture that allows all 1,000 ZEOs to come together and do good work together. The spirit of collaboration is a really, really important part of what we do.

One thing that we said is, we went through a process like many other companies of saying, what are our corporate values and should we write them down? We took a nontraditional approach. We said look, we have a good sense of what our corporate values are, but instead of writing them down, four words, five words which we found inflexible and it didn't really allow the next generation of ZEOs to really participate in shaping that because it's already set in stone, we said we're going to tell our values through a set of stories.

We have a set of stories that we go back to. We're always adding new stories to the mix. It allows every ZEO coming in to engage at an emotional and mental level as to what it means to be a ZEO. And so, we have a nontraditional approach where if you say, "Well, what are our values?" We'll say, "Hey, our value is simple, we're all ZEOs." We'll let every employee and every ZEO really unpack what that means for them and to participate in a broader discussion of how to shape what that means for us as we continue to evolve and grow as a company.

Jeff Fischer: That's fantastic and that's very Foolish with a capital F, something we definitely celebrate. Tien Tzuo, founder and CEO of Zuora. Ticker is ZUO as you fools listening already know. Thank you. Also, author of Subscribed: Why the Subscription Model Will Be Your Company's Future - and What to Do About It. It's a great read fools for anyone who's an investor looking at how the investing landscape is changing today. Tien, we're delighted to begin our relationship as shareholders with your company and we wish you all the best.

Tien Tzuo: Great, thanks for having me on the show. It was a great time.

Pro Guidance Changes and Completed Trades: Oct. 8, 2018

Published Oct 8, 2018 at 4:10PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Facebook** (NASDAQ: FB): The stock remains a Buy with a 6.2% allocation, but today we announced that we'll set up a protective collar on half of our shares.

Pro Completed Trades (see transaction log; trades take a day to appear):

We completed our six recent short sales, shorting a 1% allocation in each of the following:

- **Flexion** (NASDAQ: FLXN) at $18.50
- **Kellogg** (NYSE: K) at $70.25
- **HNI Corp.** (NYSE: HNI) at $42.12
- **Murphy USA** (NYSE: MUSA) at $80.63
- **Papa John's International** (NASDAQ: PZZA) at $50.43
- **Sea World** (NYSE: SEAS) at $28.68

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Set Up a Protective Collar on Half of Your Facebook Position

Published Oct 8, 2018 at 3:05PM

Is this for you? Any *Pro* members who have long exposure to this stock, and who want to protect against downside, should consider this recommendation.

How You Participate

- **Action:** Set up a protective collar on **Facebook** (NASDAQ: FB).
- **Trade:** Simultaneously ...
  - **Sell to open** Nov. 16, 2018, $170 calls.
  - **Buy to open** Nov. 16, 2018, $145 puts.
- **Allocation:** Set up one protective collar (one of each option) for every 100 shares you want to protect. *Pro* will collar 700 of our 1,400 shares, setting up seven collars. This protects 50% of our position, leaving a 3.1% allocation uncovered.
- **Price Guidance:** Use a **limit order** and initially aim to set this up for **credit**. Prices will fluctuate as the stock moves, with the trade getting less expensive to execute if shares rise, and more expensive if the stock declines. Initially, aim for no cost or a credit. **If prices change a lot**, it's a judgement call on your part depending on how much you want to spend; you should also consider using different strike prices, rolling one side or both sides up or down a strike accordingly to target no cost or a credit. We will use different strikes, if necessary, by the time we make our trade.
- **Recent Prices (2:50 pm ET):**
  - Sell to open Nov. 16, 2018, $170 calls (splitting bid/ask): $3.45
  - Buy to open Nov. 16, 2018, $145 puts: $3.05
  - Net credit to set up the collar: **$0.40**
  - Stock: $157.87
- **Scorecard Status:** Buy. Allocation is 6.2%. We are putting a collar on half.

What We're Thinking

Facebook is spending to safeguard its content in a battle that will certainly evolve and continue long into the future. Where people mass online, multitudes of outside parties will seek leverage, often through hidden and evolving means. Facebook may find itself pushing forward its high spending long into the future, and Wall Street wouldn't like that. In the immediate, usage among U.S. visitors -- its most lucrative per capita -- slipped last quarter, and the obvious risk is that this trend continues. For these reasons and others -- including Facebook's inexcusably casual attitude toward protecting user data in the past -- we want to hedge at least half of our shares going into the next earnings report in late October.

Why This Strategy?

A protective collar costs little to nothing to set up, yet it protects you from big downside. Plus, it gives the stock you cover with calls some upside before reaching the strike price of your short calls. In this case, including a credit, we have about 8% upside in the shares we're covering, and we have downside protection on these shares starting about 8% below the current share price. If the stock is trading between our strike prices by expiration next month, the options expire unused. On a large decline in the stock, we could sell to close our puts for a profit, or -- if we wanted -- let our stock get sold at $145. On what we know currently, we wouldn't let that happen, but the story could always change. Finally, if the stock price is above the strike price of our $170 calls, we could sell half our position at that price, or close or roll the calls. Overall, our main goal is to protect half our position from especially nasty downside surprises during an especially uncertain time for Facebook's business.

Alternative Trades

- **Own fewer than 100 shares and want protection?** You shouldn't sell a call option if you own fewer than 100 shares (because the call represents 100 shares), but if your Facebook stake is still a large enough part of your portfolio that you want to protect it, you can buy a put option and have more protection than you need. The Nov. 16, 2018, $145 put is lately about $3.45, so it's $345 for one put, and the stock needs to fall 8% just to hit your strike. But it's insurance for disaster. You can buy this insurance if the cost is worth it to you. We still plan to be in Facebook for the long haul.
- **Own 100 shares?** You could collar all of it, if you're comfortable doing so. Or just plan to ride out volatility.
- **Just own Facebook calls or a synthetic long?** You can effectively collar a portion of those positions, too, if you wish.
- **Not using options?** Make sure you're comfortable with the size of your Facebook position. The stock remains a Buy, though, and we don't plan to sell any shares unless the Facebook story changes. This hedge is a "just in case." If the story does change, we'll of course issue a trade alert with new guidance.

Pro Can Help

- Questions on this short-term protective position? Visit [our option strategy discussion board].

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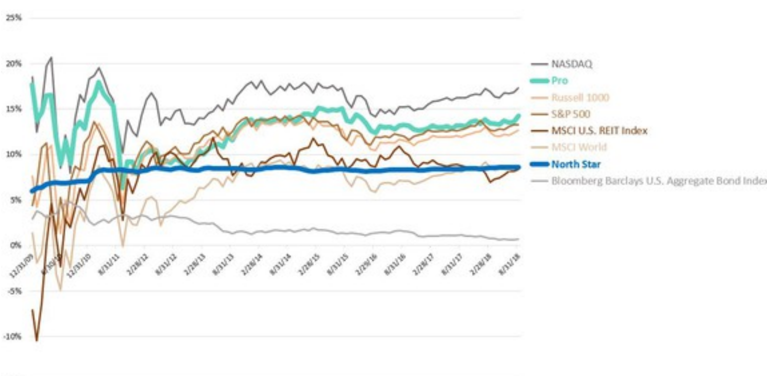
10 Years of Pro Performance

Published Oct 8, 2018 at 1:26PM

Dear *Pro* Fools,

Pro is now 10 years old! Almost 10 years ago to the day, on Oct. 6, 2008, *Pro* was seeded with a $1 million real-money cash investment. That $1 million has appreciated to more than $3.5 million as of today. That works out to a 13.5% annualized return over 10 years, significantly exceeding our guiding North Star (which is up 8.5% annualized). It's been a wonderful journey, and there are many other adjectives we could use to describe the past 10 years of *Pro*: exciting, educational, interesting, difficult, calm, agonizing, and consistent are some that come to mind. I've been a part of the *Pro* journey since 2014, and it's been an absolute privilege to work with the talented investors and support staff that have been a part of *Pro*, and to invest alongside you, our members.

In honor of *Pro's* 10 year-anniversary, I've updated the performance graph from the [North Star section of *Pro*'s Guidebook] (which is a very important section if you haven't read it!), using the most recent data available (as of Sept. 30):



([Click here or on image for larger version.])

To properly interpret this graph, keep in mind that the returns shown here are annualized, not cumulative. While annualized returns allow for easier comparison of data over time, they have some flaws. Over short time periods, annualized returns can appear volatile, while over long periods the data becomes more smooth (which is why the shorter time periods on the left side of the graph look more variable and the longer time periods on the right side look more stable). Additionally, annualized returns over periods of less than one year are not very useful, so I started the data series a little more than a year after *Pro's* inception. I've also included various market indices for comparison, which I hope will provide context for *Pro*'s performance relative to other asset categories.

Additionally, here is a tabular form of the same data, showing return comparisons over different time periods (also as of Sept. 30):

	1 year	2 years	3 years	5 years	Since Inception
Annualized Total Return					
Pro Portfolio	22.9%	17.7%	15.2%	15.5%	14.0%
North Star	9.6%	9.5%	9.2%	8.6%	8.6%
NASDAQ	23.9%	23.1%	20.3%	16.4%	15.8%
Russell 1000	17.1%	17.5%	16.4%	13.0%	12.6%
S&P 500	17.9%	18.3%	17.3%	13.9%	13.1%
MSCI U.S. REIT Index	2.4%	0.8%	6.3%	7.8%	8.0%
MSCI World	9.2%	12.5%	11.3%	7.2%	7.4%
Bloomberg Barclays U.S. Aggregate Bond Index	-3.7%	-3.1%	-1.2%	-0.3%	0.6%

Finally, here is the annualized volatility (i.e., the standard deviation) of the monthly returns for the same data categories:

	1 year	2 years	3 years	5 years	Since Inception
Volatility (Standard Deviation)					
Pro Portfolio	11.1%	8.5%	9.4%	9.4%	11.1%
North Star	0.7%	0.7%	0.8%	1.0%	1.3%
NASDAQ	10.5%	8.6%	11.9%	11.7%	15.5%
Russell 1000	8.5%	7.2%	9.4%	9.5%	13.7%
S&P 500	8.7%	7.3%	9.3%	9.5%	13.5%
MSCI World	8.2%	6.6%	9.4%	9.7%	14.5%
MSCI U.S. REIT Index	12.3%	10.8%	12.5%	13.4%	23.5%
Bloomberg Barclays U.S. Aggregate Bond Index	2.0%	2.6%	2.7%	2.9%	3.5%

What Does This Say About Our Portfolio?

We can see that since inception, *Pro* has outperformed every major index except the NASDAQ, which has appreciated by a robust 15.8% annualized over the past 10 years. Given *Pro*'s relatively lower levels of volatility compared with the major indices since inception (see the last column of the volatility table), this is an impressive feat, and it is a testament to our conservative, volatility-conscious investment approach.

Additionally, we can see that *Pro's* returns correlate much more closely with market indices than with our North Star. This is an important consideration: While we aim to achieve North Star-like returns over long periods of time, we do *not* expect to follow the return trajectory of our North Star over short periods. Our North Star is an abstract concept, not an real, investable asset. In fact, it's much more stable than any asset that will allow for the magnitude of returns we are looking for, and that's because it includes a constant 7% annual appreciation factor. As *Pro* investors, we must understand that to achieve the type of returns we seek (7%-plus), we must be willing to accept short-term volatility.

To illustrate that point, you can see from the volatility table above that the only included asset category that comes anywhere close to matching the stability of the North Star is bonds. However, in exchange for that stability, the annualized returns are far lower than what is achievable from the more volatile equity category. And while we accept that volatility is inevitable, we still work very hard to reduce the *Pro* portfolio's volatility using shorts, hedges, and our sizable cash balance. The table shows that the *Pro* portfolio scores the lowest among all the included categories (except for bonds) in terms of the volatility of our monthly returns since inception.

However, we can also see that over the past year, we've taken on more risk. *Pro*'s one-year annualized volatility is higher than every index except the REIT index. This is likely because of some significant fluctuations in some major holdings this year, including our former largest holding, Facebook, which has ranged from $150 to $220 per share this year, and our SVXY position, which imploded early this year. In exchange for that risk, we've been rewarded with higher returns during this period of rising stock prices. Since the last time we updated this analysis in late 2016, the *Pro* team has widened the gap between our portfolio's performance and the North Star. So far, taking on more risk has been beneficial to our returns, but that may not continue, so we need to be mindful of our risk exposure and volatility in the future.

The *Pro* Bottom Line

All in all, over the past 10 years, *Pro* has done well to outperform our North Star and most other stock categories while still achieving lower volatility with our returns. We aim to continue to achieve our goals as we move forward, keeping our volatility, expected returns, and allocations in mind.

For discussion, please visit the ever-popular Memo Musings board.

Fool on!

-- Billy (TMFBillyTheKid)

Sell Short HNI Corp, Murphy USA, and SeaWorld

Published Oct 5, 2018 at 1:25PM

Is this for you? These recommendations are for *Pro* members who are comfortable with the idea of managing a changing basket of short stocks as part of an ongoing long/short portfolio strategy, and who have margin accounts with shorting availability on these stocks. (You could also employ options, although that's not ideal for what we're aiming for.) You don't need to short if you don't wish. The purpose of having a large book of shorts is to raise extra capital that you can ultimately invest in long positions, as well as to perform better in market declines.

How You Follow Along: HNI Corp

- **Trade:** Sell short 1% in **HNI Corp** (NYSE: HNI).
- **Shares Available** (IB): 2.1 million at an 1.1% annual fee
- **Dividend Yield:** 2.7%
- **Market Cap**: $1.86 billion
- **Recent Price**: $42.56
- **Alternative Trade**: January 2019 $40 synthetic short
  - Sell to open January 2019 $40 calls; buy to open an equal number of January 2019 $40 puts; set up one synthetic short for every $4,200 in exposure you want.
  - Price: Unless the stock price moves, aim for a credit of about $2 to set this up.

How You Follow Along: Murphy USA

- **Trade:** Sell short 1% in **Murphy USA** (NYSE: MUSA).
- **Shares Available** (Interactive Brokers): 1.4 million at a 0.25% annual fee
- **Dividend Yield:** 0%.
- **Market Cap:** $2.67 billion
- **Recent Price**: $81.33
- **Alternative Trade**: January 2019 $80 synthetic short
  - Sell to open January 2019 $80 calls; buy to open an equal number of January 2019 $80 puts; set up one synthetic short for every $8,000 in exposure you want.
  - Price: Until the price moves, aim for a net credit of about $1 or higher (setting up a short at about $81 net).

How You Follow Along: SeaWorld Parks & Entertainment

- **Trade:** Sell short 1% in **SeaWorld Parks & Entertainment** (NYSE: SEAS).
- **Shares Available** (IB): 1.4 million shares at a 1% annual fee
- **Dividend Yield:** 0%
- **Market Cap:** $2.54 billion
- **Recent Price:** $29.13
- **Alternative Trade**: January 2019 $28 synthetic short
    - Sell to open January 2019 $28 calls; buy to open an equal number of January 2019 $28 puts; set up one synthetic short for every $2,800 in exposure you want.
    - Price: Unless the stock price moves, aim for a small credit to set this up.

All prices will change as the shares move, but the stocks will continue to be recommended as short positions in *Pro* until we share otherwise.

What We're Thinking

As ever, the *Pro* portfolio is managed as a whole. Our goal is to earn desirable *overall* returns and to double our real purchasing power every 10 years, ideally while facing lower-than-average downside risk. It's unrealistic to expect every position to make money, and that's especially true with shorts and hedges. Our shorts will be actively managed; if we don't like how one is moving, or we make a desired 7% to 10% return, we could close any short a mere 14 days after starting it. But in most cases, each short will last an average of a few months, and new shorts will be cycled in from a growing list of candidates we keep behind the scenes. This week's additions follow.

HNI Corp

We believe the ideal short candidate is one that offers us an asymmetrical risk/reward trade-off, one that is likely to *at worst* keep up with the market as the market rises, but will underperform the market by a noticeable margin when the next bear market hits. And we believe we've found this type of short in HNI. As one of the largest domestic providers of office furniture, which makes up 75% or so of its sales, HNI's business is closely tied to the economic cycle. However, given the structural headwinds that we believe the domestic office-furniture market is currently facing, we believe HNI could struggle going forward even if the current bull market continues.

Domestic consumption may have finally returned to pre-Great Recession levels, but the increase in telecommuting, the rapid rise of open-office workspaces, and changing preferences toward a simpler, Apple-esque minimalist aesthetic all suggest to us that recent lukewarm industry sales are likely to persist. Plus, we're supposedly in a booming economy right now, with ultra-low unemployment.

In recent years, sales of both occupied space and furniture have noticeably lagged growth in the number of white-collar employees. And despite management's spending close to $300 million on acquisitions since the start of 2007, HNI's revenue is still 17% below its 2006 peak. To make matters worse, domestic production continues to steadily lose share to imports, and one of the company's biggest inputs, steel, has risen sharply in price so far this year, meaning the recent slide in margins and return on invested capital will likely continue. As a final kicker, the remainder of HNI's sales are tied to the housing market, providing a hedge against our two housing stocks.

Murphy USA

With almost 1,500 stores, Murphy USA is currently one of the 50 largest gas-station convenience-store chains in the United States. The company's value proposition largely centers around being extremely competitive on pricing -- you can think of it as the Walmart of gas stations. In fact, for 20 years Walmart had a partnership with Murphy to develop and operate gas stations outside Walmart stores. This has worked well in the past, but we believe that Murphy's best days are currently in the rearview mirror.

For starters, the company is fighting not one but two secular headwinds. Gasoline retail sales per capita have been decelerating for decades, and we see no catalyst to lift the industry up from its current slump. Increases in newer vehicles' fuel efficiency, changes in behavioral patterns including the rise in telecommuting and ride-hailing, and a continued increase in electric vehicle market share are just a few factors, but you don't have to take our word for it — Murphy's monthly gallons sold per store have fallen by 8.5% over the past five years.

There's another headwind in tobacco product sales, which are Murphy's single largest merchandise category and responsible for an outsized portion of the company's operating profits. And remember how we said the company had a partnership with Walmart? The key word there is "had," because in 2016 Walmart decided to end the partnership and operate all new stations itself (Murphy will continue to operate those that were already in existence prior to 2016).

To make matters even more favorable for our short argument, management has been aggressively repurchasing shares over the past few years in an attempt to prop up the share price, but its recent binges have drained the company of much of the cash it raised in the preceding years, and debt issuances have increased leverage to the point where an unfavorable move in gasoline prices could be dangerous if Murphy issues more debt. We expect share repurchases to largely end for the foreseeable future. Meanwhile, any weakness in employment (a.k.a., the economy) goes right to gasoline sales. Murphy looks like a good short in that it hedges this risk.

SeaWorld Entertainment

Even before it became mired in a debate over the logic of keeping giant killer whales in captivity, SeaWorld was struggling to grow. Revenue this year is running at 2011 levels, and net income has been choppy over the past many years without ever gaining traction. The company carries more than $1.4 billion in long-term debt and only $33.5 million in cash, and the bulk of its operating income is eaten up by $80 million in annual interest expenses.

SeaWorld recently saw an uptick in traffic following a long decline, but we question how sustainable those gains will be. Season-ticket buyers, typically the most devoted customers, are driving the latest improvements; to get other, new feet through the gates, management will need to keep spending to rebuild a positive image and inform customers of the new experiences available at the themed amusement parks.

Meanwhile, the threat of more negative publicity hangs in the air, just waiting to make a splash. SeaWorld management vowed to no longer breed or capture additional Orca whales, but its current slew of whales held around the world continues to perform for audiences. The company confirmed that these whales could live as long as 50 years, and would continue to work at the parks. In other words, SeaWorld doesn't plan to end the main show anytime soon, and that only invites more controversy -- eventually.

The stock has seen a resurgence in price from the low teens to nearly $30 per share as traffic to parks improved this summer, and management is showing skill at cutting costs and increasing EBITDA. But now trading at more than 30 times expected earnings for the year ahead -- much pricier than competitor **Disney** (NYSE: DIS) -- we don't believe SeaWorld is a bargain, and any disappointments, let alone a weaker economy, could send it diving.

The Foolish Bottom Line

Once again, these three 1% short positions are part of our growing short exposure. But remember that shorts are usually shorter-term positions. Maintaining a book of shorts is time-intensive and can be demanding, but it's worth it if this helps the portfolio succeed in weak markets. And it makes us better (and more invested!) long investors, too, with better results overall.

Please bring any questions to the *Pro Shorts* board!

Pro Catch-Up Trades and Expirations: Shorts, Zuora, and More

Published Oct 4, 2018 at 1:16PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.9% stake in the stock.
- **American Tower** (NYSE: AMT): Match our 3.6% stake.
- **CME Group** (NASDAQ: CME): Match our 2.5% stake.

Continue building your portfolio with our Buys, including:

- **OpenText** (NASDAQ: OTEX): Match our 2.8% stake.
- **Verisk Analytics** (NASDAQ: VRSK): Match our 2.5% stake.
- **Zuora** (NYSE: ZUO): Match our 1.3% stake.

Shorts:

- **Flexion** (NASDAQ: FLXN): Sell short 1%.
- **Kellogg Company** (NYSE: K): Sell short 1%.
- **Papa John's International** (NASDAQ: PZZA): Sell short 1%.

Options:

- N/A

Upcoming Expirations (October):

- **Johnson & Johnson** (NYSE: JNJ): Our October 2018 $135 short calls are in the money with about two weeks until expiry; we'll have guidance on rolling, or letting the stock go, before expiration.

Close Your Short on International Speedway Corp.

Published Oct 4, 2018 at 11:23AM

Is this for you? This is for all members who followed our recommendation to short **International Speedway Corp.** (NASDAQ: ISCA).

How You Participate

- **Action:** Buy to close, or cover, your short position(s) on International Speedway Corp.
- **Allocation:** Close all of your short — our initial recommendation was to short 1%.
- **Recent Price Range (this morning):** $36.67
- **Price Guidance:** *Use a **limit order***, and aim to pay less that $38.

What We're Thinking

With shares down approximately 15% since we first recommended shorting International Speedway Corp. less than two weeks ago, we believe it's time to close your position and take a victory lap.

Today's large decline on the back of the company lowering fiscal 2018 guidance largely removes the margin of safety we believed we had from shorting shares in the mid-$40s. Although our thesis for shorting the company was long-term in nature, we believe — more often than not — that it's important to take these quick victories when they occur.

Although the stock could fall even lower, we're more than satisfied with this return in such a short timeframe. We can now move to the sidelines for the time being and reconsider shorting this stock in the future if we believe the risk/reward trade-off supports it.

This is how we must run the short part of the portfolio, drawing from a large pool of potential candidates and shorting when we like the risk vs. reward on any stock at a given price. A large short book will change positions quite regularly. As such, this short has played out for now. The checkered flag is waving.

Alternative Trades

- **If you set up a synthetic short or set up a bearish spread:** You should close those positions, too.

Pro Can Help

- **Want to discuss this?** Hit the button above your head to call us for help. Or just click on over to the short board.

Motley Fool Pro Nears 10-Year Anniversary

Published Oct 1, 2018 at 3:30PM

Dear *Pro* members:

This month, we celebrate *Motley Fool Pro's* 10-year anniversary! Although Ellen, J.P., and Billy wanted to rent a Winnebago and tour around the world meeting members, we've opted to stay in town and share our good tidings virtually. We'll devote all month to it.

Ten years is not a long time. We just lived through 3,652 days — or 520 weeks. That's fewer than 2,600 business days. Yet, somehow, we found a way to issue around 500 trade alerts for *Pro*. In other words, ten years is not long, but we've spent a lot of it together, and I've spent the bulk of the time thinking about our investment mix. It has been a privilege to work for you.

We've had our share of agonies, of positions that went against us, tormented us, or that we "missed" and then never considered again (even though it turns out we *hadn't* missed many of them at all, if we had stuck to them). But with many lessons learned, we have more experience now to lean on as go forward. And beyond that, considering everything as a whole, what we have in sum after ten years are returns that we can celebrate, and build on.

The *Pro* Port has 14.2% annualized returns over the last ten years. Our only real enemy is inflation, and we're far ahead of it, vastly growing our real purchasing power in the process. We've also surpassed our guiding North Star (which is up 8.5% annualized), and all of the major market indexes in the U.S. and abroad. That's despite being a more risk-averse portfolio than average, holding cash, and keeping our exposure well below 100% (averaging 74% net long since 2012). Our hedges and shorts have subtracted from our returns, but — like insurance — they would have helped in a downturn. Our end result is still one of success — of goals exceeded.

We wouldn't be here without you. For that, we thank you. At the same time, what we do here is basic. Directing our finite capital into shares of companies that we believe will grow in value is as logical as it gets — and that is what has driven most of our value to date.

When a bear market hits, and nearly every stock falls, we'll be relying on our shorts — which we're building — and on hedges to help us stay ahead of the pack and be better-positioned for a rebound. That, too, is logical — it's just much more difficult partly given that shorting is much more short term than is buying to hold stocks.

But in both cases, what we're doing here is simply hoped to result in you having more money than you began with — much more, we hope. And actually, it's about you having much more purchasing power. That, in turn, should give you and your family more opportunities in life. It's that simple. And that important.

At least doubling our real purchasing power every 10 years was our biggest goal. Our real purchasing power has much more than doubled the last 10 years, with the portfolio up (again) 14.2% annualized before taxes, and inflation running up only about 1.5% annualized (with inflation *plus* 7% running at 8.5% annualized). But our returns have been achieved in a strong stock market, and with low inflation. We need to be ready to be flexible and versatile with our strategies in a persistent down market — or whenever the next recession arrives — and during times of higher inflation.

Right now, we're working on building out shorts, and already we're reminded how timely that pursuit is. **Bed, Bath & Beyond** (NASDAQ: BBBY) was written up to be published as a short, but fell 20% last week after earnings (which we wanted to wait for just in case!). Others have slipped lower for no reason. One other jumped more than 10% in the last week, so now we're reassessing if shorting it is still a logical move, or is the tide turning? All this to get a short book together that should then work as "one," and be actively managed.

Meanwhile, as we get ready to celebrate 10 years with you, we'll be reviewing every position in the portfolio in coming weeks, and talking about what we've learned, what has worked, what hasn't, what we expect, and more. Thank you for being here for this incredible and Foolish journey together! You've made it possible.

To share any thoughts, please visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Expirations: Apple, Zuora, and More

Published Sep 27, 2018 at 3:13PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.9% stake in the stock.
- **CME Group** (NASDAQ: CME): Match our 2.4% stake.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): If you don't have a position, start with a 3% stake. If you don't have a full allocation, now is a good time to consider adding incrementally to your position.
- **Facebook** (NASDAQ: FB): If you don't have a position, start with a 3% stake.
- **Oracle** (NYSE: ORCL): Match our 3.3% stock stake.
- **Verisk Analytics** (NASDAQ: VRSK): Match our 2.5% stake.
- **Zuora** (NYSE: ZUO): Match our 1.4% stake.

Shorts:

- N/A

Options:

- **Oracle**: If you haven't, you can set up a diagonal call on Oracle by buying to open January 2020 $30 calls and selling to open December 2018 $52.50 calls. Lately, the net debit is about $20.24 per diagonal call, or $2,024. We have a 0.5% allocation (cash value) in the long calls.

Upcoming Expirations (October):

- **Johnson & Johnson** (NYSE: JNJ): Our October 2018 $135 short calls are well in the money; we'll have guidance on rolling, or perhaps letting the stock go, before expiration next month.

More Growth Stocks Mean More Shorts

Published Sep 24, 2018 at 1:37PM

Greetings, *Pro* members!

As some of you know, early this year I began working with Tom Gardner and a small team of Fool analysts (Andy Cross, Abi Malin, and Bill Mann) on some of Tom's new *Motley Fool Discovery* services.

It started for me with *Partnership Portfolio*, where we built a collection of companies (mostly small- to mid-size) that are run by their founders. Founder-led businesses tend to outperform. Many of *Pro*'s best stocks share this trait, and in fact, three of them landed in the Partnership Portfolio. Next, I helped the team with a reopen of the *Rising Stars* service, where we recommended a refreshed portfolio of micro-cap stocks -- in this case, companies with market values of $4 billion or less. Small companies historically return more than large ones.

Both experiences only strengthened my belief that young, often recently public companies with bright prospects are the new lifeblood of a portfolio. Without adding many of these companies to your portfolio every decade, you risk losing some relevance and some growth.

Of course, large and established companies can continue to provide outstanding returns for decades; we own several such businesses. But younger and more novel companies have the potential to push your returns to a new level. Where would *Pro* be without having bought Facebook, Paycom, or Square, not to mention Broadridge Financial Services after it went public?

As members of these new services will know, most of the companies we've bought in *Partnership Portfolio* and *Rising Stars* do *look* expensive. *Pro*'s young companies do, too -- and at least on past results, they are. But each company in these services that continues to impressively succeed should easily outgrow its current price within a handful of years. In the meantime, however, any market downdraft is likely to bring the stock price lower, perhaps significantly so. Many Foolish investors don't mind that. They'll add more money to their favorites, or ride it out. But in *Pro*, we have a mandate to tamp down volatility and have winners in up *and* down markets.

And that means shorting.

I want to continue to add more growth companies to the *Pro* portfolio, and doing so means shorting more stocks. That's necessary for balance against a more turbulent stock market and our own more volatile holdings. Even more important than that, we want to manage *Pro* in a long-short fashion that is more active than we've employed until now; it's been a slow build to get here, but we're at a point where we feel that we should.

Some companies are beginning to warn investors that the U.S. trade war with China will affect earnings next year. Interest rates are rising, making borrowing more expensive, which typically slows economic growth. Lower tax rates will be lapped for most companies in 2019, no longer driving extra year-over-year bottom-line growth. Boomers are retiring *en masse*.

All this is happening against the growing influence of a massive wave of millennials who have increasing purchasing power but don't necessarily want all the material trappings of the Boomers before them. Interest rates are still historically low. And technology continues to bring new opportunity and efficiency to the world. The push and pull of opposing forces are playing on the market as giant cycles of life and business evolve, and stock prices are likely to be more volatile as a result. More businesses are going to suffer and die. Some are going to be incredible winners. We want ongoing stakes on both sides of this battle.

But as always, the shorts that we'll recommend and manage aren't for everyone. And as always, they aren't necessary to follow along with *Pro*. It's nearly impossible to make a fortune shorting (unless you short with leverage such as put buying, and get lucky on timing), because your short exposure is by design capped, as are your potential profits. And it's rare that we'll be hoping for even 50% gains with our short stocks, let alone 100%. Mostly, we're looking for small wins. Naturally, we want our short portfolio as a whole to help most during meaningful downswings in the market. It's hard to imagine a new bear market starting until there's a recession on the horizon -- that's when bears almost exclusively occur -- but it's all but impossible to predict recessions ahead of time. So, after years of economic expansion like we've just had, we're ready to more steadily sell short in anticipation of the next contraction. That might mean running shorts for a few years more while we wait.

It's active. It's time-consuming. It has extra risks. It can be expensive. But shorting also teaches you a lot -- about the investments in question and about your long stocks, too. Shorting should make you a better investor. And, shorting might allow you to comfortably own more volatile growth companies for their long-term upside, too -- even if you appear to be buying them initially at premium prices.

If you're only investing in an IRA, though, shorting can be logistically tough. You can use options, and that limits your risk (Travis posted options ideas for an IRA on our four shorts from Friday), but this approach also decreases the appeal. The options positions can be cumbersome to enter and exit at good prices, and they don't give you the benefit of "cash-in" -- you're actually paying cash *out* to set them up in most cases. By shorting a company's stock, we're bringing in cash, and once our short balance is above $100,000, Interactive Brokers even pays us some interest on it. And if and when our short balances go down (and even earlier if we were using leverage), we will have leeway to invest some of this cash in long positions.

As we go forward, realize that most investors never need to sell short and can and will succeed anyway. Continue to only follow *Pro's* longs if that's what interests you -- and our index hedges as a way to lower your market exposure in general, if you wish. We've always been a long/short service, and at times we've been more than 30% short, but so far our long positions have made all the money. Only by running shorts for years, at considerable effort and expense, can we hope to add meaningfully to our returns with them -- and even then, of course, there's no guarantee they will pay us by themselves. But they should help our long investing results, either way, and help us to comfortably own more growth companies -- likely some of our biggest winners.

To share any thoughts, please visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: Sept. 24, 2018

Published Sep 24, 2018 at 1:07PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **MasterCard** (NYSE: MA): Fair-value estimate climbs to $190. The stock remains a Best Buy Now with a 7.2% allocation. Start with half that.
- **Visa** (NYSE: V): Fair-value estimate climbs to $133. The stock remains a Buy with a 3.9% allocation.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **American Tower** (NYSE: AMT): We rolled our short October 2018 $135 calls to January 2019 $135 calls for a credit. Do this *before* the Sept. 27 ex-dividend date.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Sell Short Flexion, International Speedway, Kellogg, and Papa John's

Published Sep 21, 2018 at 3:19PM

Hi *Pro* Fools! We'll have more on our shorting approach in our next Monday Memo and later next week, so, depending on your comfort level, you may want to wait to hear more of our thoughts before implementing these.

Is this for you? These recommendations are only for *Pro* members who are comfortable with the idea of managing a growing basket of short stocks as part of a long/short portfolio strategy, and who have margin accounts with shorting availability on these stocks (there are no IRA-friendly alternatives; the puts are expensive and our timeframe is short). Of course, you don't need to short if you don't wish. The long-term purpose of having a large book of shorts is to raise extra capital that you can invest in long positions, as well as to perform better in market declines.

How You Follow Along

- **Trade:** Sell short 1% in **Flexion Therapeutics** (NASDAQ: FLXN).
- **Shares Available** (Interactive Brokers): 400,000 at a 1.33% annual fee
- **Market Cap:** $714 million
- **Recent Price**: $18.90
- **Alternative Trade**: February 2019 $20 synthetic short
  - Sell to open February 2019 $20 calls; buy to open an equal number of February 2019 $20 puts; set up one synthetic short for every $2,000 in exposure wanted
  - Price: Until the price moves, aim for a net debit of $1.20 or lower (setting up a short around $18.80 net)

- **Trade:** Sell short 1% in **International Speedway Corp** (NASDAQ: ISCA).
- **Shares Available** (IB): 1.1 million at an 0.38% annual fee
- **Dividend Yield:** 1%
- **Market Cap**: $1.1 billion
- **Recent Price**: $44.70
- **Alternative Trade**: December 2018 $45 synthetic short
  - Sell to open December 2018 $45 calls; buy to open an equal number of December 2018 $45 puts; set up one synthetic short for every $4,500 in exposure wanted
  - Price: Unless the stock price moves, aim for approximately no cost or a small credit

- **Trade:** Sell short 1% in **Kellogg** (NYSE: K).
- **Shares Available** (IB): 4.7 million shares at an 0.37% annual fee
- **Dividend Yield:** 3%
- **Market Cap:** $25.4 billion
- **Recent Price:** $73.22

- **Trade:** Sell short 1% in **Papa John's International** (NASDAQ: PZZA).
- **Shares Available** (IB): 350,000 at an 0.86% annual fee
- **Dividend Yield:** 1.9%
- **Recent Price**: $46.70
- **Market Cap:** $1.5 billion
- **Alternative Trade**: If you're experienced with synthetic shorts, you can set one up expiring late this year for about $1 or less in premium to the current share price (so shorting directly is more efficient).

All prices will change as the shares move, but the stocks will continue to be recommended as short positions in *Pro* until we share otherwise.

What We're Thinking

As we wrote last year in this situation, the first point to make is that while this is a mini-basket of short positions, it's only a small part of the mega-basket we'll want to have when ready -- and now is when we want to. We discourage you from setting up just one or two of these four shorts; our advice is either to set up all four and the ones to follow later, or to go with none at all. (Ultimately, of course, it's your call!)

The *Pro* portfolio is managed as a whole, with the goal of earning desirable *overall* returns. It's unrealistic to expect every position to make money, and that's especially true with shorts. Our shorts will be actively managed; if we don't like how one is going, we could close it a mere 10 days from now. But in most cases, each short will last on average a few months, to be steadily replaced with new ones. And the cash we raise from shorting will be available for use.

Flexion Therapeutics

Founded in 2007, Flexion is a biopharmaceutical company that just started selling its first product, called ZILRETTA. A local treatment for musculoskeletal conditions, it's been approved for osteoarthritis (a degenerative arthritis) in the knee. The drug is also in trials -- years from fruition -- for pain applications in other parts of the body.

The treatment is promising. ZILRETTA is a non-opioid therapy that uses proprietary "microsphere" science to provide pain relief, currently in the knee, for up to 12 weeks. The drug is in a late-stage trial to see how patients tolerate and benefit from repeat dosages lasting up to a year. Those results are due by year's end, and odds are they won't disappoint; that's not the story here.

The issue at hand is that last quarter's ZILRETTA sales were $3.8 million, up 73% from the first quarter. Now, more than two full quarters into the launch, the sales numbers appear dauntingly low, calling into question the economic viability of the drug -- or at least the sales system beneath it. Flexion's sales team has already touched base with about 70% of its roughly 3,700 targeted accounts -- that's 2,600. Of those, about 2,240 received a sample or bought ZILRETTA. And more than half have placed a reorder.

This start is unlikely to be strong enough to reach the consensus estimates of nearly $23 million in revenue this year and $120 million next year. And that could be why the stock has been weak since the numbers were revealed.

So far, the company has achieved about $6 million in sales of ZILRETTA, with $170 million in losses the past year. Losses are growing as management spends on sales staff and R&D. And although Flexion has about $340 million in cash and investments, that will steadily burn away, so it can't be counted on as a lasting asset. In short, the company's market value of higher than $700 million looks optimistic given a single product that saw just $3.8 million in revenue last quarter and cost a lot in the process. This may be a case where expectations are too high for this novel product. If that belief continues to set in, we should get our desired 7% to 10% or greater short-term return on the short.

We'll keep a tight rope on Flexion, covering it if it rises much against us. In that case, we might even save it to try shorting again at a later date, all else being equal. Meanwhile, it's not likely to hold up well if the market falls.

International Speedway Corporation

International Speedway Corporation is the largest publicly traded promoter of motorsports-themed entertainment (primarily NASCAR) in the United States, and we believe our short thesis can be best summarized by the following equation:

Structural headwinds + conflicts of interest = suboptimal capital allocation

By themselves, each part of the equation could potentially be enough to make shorting ISCA a worthwhile endeavor. But it's the combination of all three that really caught our eye. Let's take a look at each variable:

Structural headwinds: A lack of star power, increased safety resulting in less exciting racing , the rise of substitute entertainment, increased fuel prices making attendance less affordable, and simply a change in cultural interest -- there's no shortage of theories that have gained traction over the past few years in an attempt to explain the sharp decline in NASCAR's popularity. We believe there is at least a grain of truth to most of these theories, meaning there is little chance of a U-turn back to prior glory days. By our estimate, viewership for the races that took place during the most recent fiscal quarter declined by upwards of 20% from last year (far more than the rise of online streaming can explain). And although NASCAR stopped officially reporting attendance figures in 2013, we feel pretty confident in saying that those are poor as well.

In fact, the attendance figures are even worse than the large swaths of empty seats seen in broadcasts would suggest. That's because ISCA has actually *reduced* the number of seats at its 13 facilities by approximately 24% since 2010! Although these numbers won't correspond with an equally large decline in revenue thanks to the company's current broadcasting deal, which runs through 2024, we're already seeing the fallout with regards to sponsorship. There are well-documented issues even with big names -- the title sponsors for seven-time champion Jimmie Johnson and last year's winner, Martin Truex Jr., both pulled out. NASCAR's own title sponsor will be leaving in 2019, and the organization is planning on taking a new approach to sponsorships, given that nobody is willing to pay anywhere close to what Monster Energy paid for the honor in 2017 (and that amount was already a sizable step down from the previous sponsor). We believe this negative feedback loop will continue for the foreseeable future and that NASCAR will ultimately need to make sizable concessions when it negotiates its next broadcast contract.

Conflict of interest: The France family, otherwise known as the "first family of NASCAR," owns NASCAR and has a controlling stake in ISCA, with more than 74% of voting power. Critically, however, the family's *economic* interest in ISCA is far less than that, which we believe leaves them with the most to gain by having ISCA (not NASCAR) do everything in its power to address the aforementioned structural headwinds -- even if it comes at the expense of ISCA shareholders.

Suboptimal capital allocation: We believe one has to look no further than the returns on invested capital (below 10% for more than a decade and trending lower) and the elevated level of capital expenditures as a percentage of sales (higher than 20% over the past four years) to see what the future holds for ISCA. But don't just take it from us: On a recent earnings call, management noted that they only target an average ROIC in the low to mid-single digits! From our vantage point, this is management admitting they're willing to spend ISCA's money on projects that hurt ISCA shareholders as long as they believe it will help NASCAR.

Kellogg

Kellogg is one of the most venerable American businesses, founded in 1906 and known for its consumer cereal brands including Frosted Flakes, Froot Loops, Rice Krispies, and Raisin Bran. The company has a storied history on Wall Street, having paid a dividend every quarter since 1925. For many decades, Kellogg's products were ubiquitous in American culture, and the company enjoyed a powerhouse position in branded food.

But times have changed. Between 2009 and 2017, cereal sales in the US dropped from $12.7 billion to $10.4 billion (an 18% decline) as new morning challengers such as Greek yogurt, smoothies, breakfast bars, and expanded fast-food breakfast menus have captured share of the market. Cereal has suffered from a reputation of being overly processed and lacking nutritional value.

The cereal category is mature, and long-term trends in nutrition and food consumption suggest that cereal is facing a structural (rather than cyclical) decline. Cereal should continue to struggle as more consumers opt for healthier, fresher breakfast options, and these trends should serve as a persistent headwind for Kellogg moving forward.

The struggles in cereal are represented in Kellogg's financials, with revenue down 12.6% between fiscal years 2013 and 2017 and earnings per share down 27% over the same period. Additionally, Kellogg has been implementing a new distribution model in an attempt to cut costs, but there is financial evidence to suggest that this may be leading to excess inventory in Kellogg's distribution channels (i.e., grocery stores), which suggests possible future underperformance as inventory levels normalize.

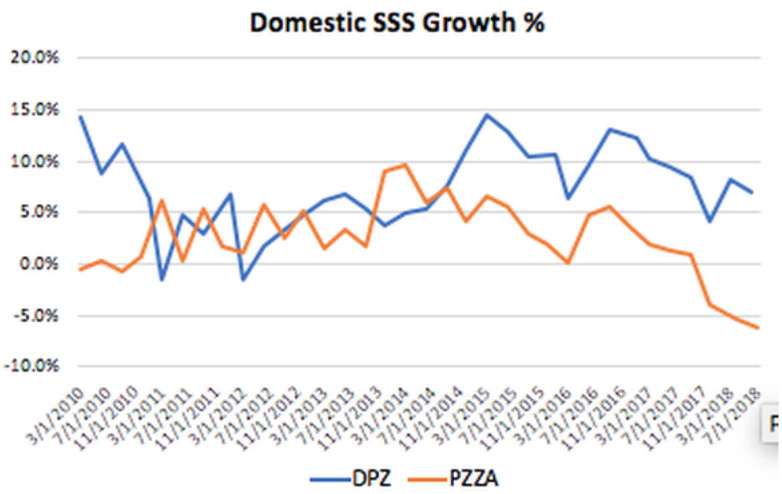
All told, we think it will ultimately be difficult for Kellogg to generate meaningful shareholder returns from its portfolio of mature brands in a structurally declining industry (amid a major distribution overhaul), and with the stock up approximately 30% from its 52-week low of $56.40 (on May 2), we think now is a good time to initiate a short. We don't expect this one to soar in a rising market (and we'll close if it rises more than 10% on us), and it should help us in a market decline.

Papa John's International

Oh, how the mighty have fallen. Papa John's used to be a major source of outperformance in the *Pro* portfolio. We bought our first slice of shares in 2010 at a split-adjusted price of $11.95 and ultimately exited our final holdings in 2017 at $78.56 -- that works out to a 557% ROI over less than seven years (29% CAGR), and that's not including options or dividends.

But since then, Papa John's has faced major troubles, of both the business kind and the "shoot yourself in the foot by doing dumb stuff" kind. The issues started in November 2017 on the third-quarter 2017 conference call, when Papa John's founder John Schnatter (at that point the chairman and CEO) tried to blame subpar business performance in the quarter on NFL players' protests during the National Anthem and "poor leadership" from the NFL. By December, Schnatter was ousted as CEO, stepping down just weeks after the controversial remarks (for which the company later apologized). By February 2018, Papa John's and the NFL ended their exclusive sponsorship.

Since then, perhaps in part because of the controversial NFL remarks but also likely because of managerial turmoil, the company has continued to underperform, posting poor (even negative) same-store sales performance while seeing its rival **Domino's** (NYSE: DPZ) continue to take share of the market with positive growth:



And as if to put a nail in the coffin, in July of this year news broke that Schnatter had used highly offensive, racist language during a conference call with a marketing agency that was intended to *prevent* him from shooting himself in the foot again. Schnatter later confirmed the allegations in an emailed statement to *Forbes*, and he subsequently stepped down from the University of Louisville's board of trustees. The MLB indefinitely suspended its "Papa Slam" promotion with the company, and Schnatter resigned as chairman of the board of Papa John's.

The company has begun removing Schnatter's image from pizza boxes, the University of Louisville is removing his name from its football stadium, and Schnatter's hometown of Jeffersonville, Ind., is returning a $400,000 donation to renovate a historic gym and field house.

And Schnatter, who still has a role on Papa's board and a position as its largest shareholder, is now at war with the company. He continues to talk publicly about his desire to help it make a comeback, and he's even gone so far as to sue Papa John's in response to its adoption of a "poison pill" provision intended to prevent him from amassing a controlling interest in the business.

All told, the stock is down more than 40% since we sold our shares in April 2017, and there may be more room to keep falling. All the points we made in our sell report in 2017 are still valid, business fundamentals are deteriorating, and now the PR nightmare and internal war present another looming overhang for the business's prospects. On top of that, its NFL relationship no longer exists to drive sales this fall, and Major League Baseball is unlikely to be there to help next spring. We're ready to take this opportunity to make a 180-degree turn and short this former *Pro* outperformer.

The Foolish Bottom Line

These four 1% short positions are part of larger short exposure on the way. Remember that shorts are usually shorter-term positions. Maintaining a book of shorts is more time-intensive than long investing, but it's worth it if this helps the portfolio succeed in weak markets and doesn't drag our returns much lower in strong ones (ideally, it won't drag at all -- but that's a high bar).

Bring any questions to the *Pro Shorts* board!

Pro Catch-Up Trades and Expirations: Oracle, Zuora, and More

Published Sep 20, 2018 at 4:00PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Match our 3.7% stake in the stock.
- **CME Group** (NASDAQ: CME): Match our 2.4% stake.

Continue building your portfolio with our Buys, including:

- **Broadridge Financial Services** (NYSE: BR): If you don't have a position, start with a 3% stake. If you don't have a full allocation, now is a good time to consider adding incrementally to your position.
- **Facebook** (NASDAQ: FB): If you don't have a position, start with a 3% stake.
- **Oracle** (NYSE: ORCL): Match our 3.3% stock stake.
- **Skyworks Solutions** (NASDAQ: SWKS): Match our 3% stake.
- **Zuora** (NYSE: ZUO): Match our 1.4% stake.

Shorts:

- N/A

Options:

- **American Tower**: Roll your diagonal calls per today's alert.
- **Oracle**: If you haven't, you can set up a diagonal call on Oracle by buying to open January 2020 $30 calls, and selling to open December 2018 $52.50 calls. Lately, the net debit is about $19.95 per diagonal call, or $1,995. We have a 0.5% allocation (cash value) in the long calls.

Upcoming Expirations (October):

- **Johnson & Johnson** (NYSE: JNJ): Our October 2018 $135 short calls are well in the money; we'll have guidance on rolling, or perhaps letting the stock go, before expiration next month.

Roll Your Diagonal Calls on American Tower

Published Sep 20, 2018 at 2:18PM

Is this for you? This is for all *Pro* members who wrote October 2018 $135 diagonal calls on **American Tower** (NYSE: AMT) as per our alert in March. If you wrote diagonal calls at different strike prices, please see the Alternative Trades section below. Remember that all members should already own an unencumbered 3.7% stock allocation to American Tower, so if you have yet to establish this, do so before considering this additional diagonal call recommendation.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
  - "Buy to close" all October 2018 $135 written calls.
  - "Sell to open" the same number of January 2019 $135 calls.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* will roll all five of our calls.
- **Recent Prices** (1:25 p.m. ET):
  - Stock: $148.13
  - Buy to close October 2018 $135 calls (bid/ask): $13/$13.50 (midpoint $13.25)
  - Sell to open January 2019 $135 calls (bid/ask): $14.60/$15.20 (midpoint $14.90)
  - Net credit to roll: Approximately $1.40 (this price will change)
- **Price Guidance: It is critical that you use a limit order**, aiming to pay as little time value as possible to close your short calls, and aiming to roll for as much of a credit as possible. The midpoint of the bid/ask spreads currently implies about a $1.40 net credit for this roll, although that number will change as prices change and as *Pro*'s collective volume affects the bid/ask spreads. Realize that with expiration 37 days away, the time value on our deep-in-the-money short calls is eroding toward zero, and American Tower's first-quarter ex-dividend date for a $0.79-per-share is Sept. 27. Keep in mind that you should roll these calls soon, and certainly ***before*** Sept. 27, or you risk getting your owned *shares* (rather than calls, assuming both securities are owned in the same account) called away. **We want to avoid that scenario!** So, accept lower credits if need be to complete this trade before the ex-dividend date, but still use a limit order.

  As of the pricing in this alert, the bid/ask spread on the October $135 short call implies about $0.35 or so in time value remaining, so you don't necessarily need to make this trade immediately, but it's getting close. As we approach expiration, time value will continue to erode; the closer time value gets to zero and the longer you wait, the more likely it is that your short calls will be assigned. Again, let's avoid that.

What We're Thinking

The current iteration of our diagonal call strategy on American Tower has now been active for almost two years, having begun in November 2016 when we re-established a diagonal call on the company at advantageous prices. Then, in March and September of 2017 and March of 2018, we rolled our short calls out and up to capture further upside. So far, the position has been a success (recently with a 37% simple return since inception if we were to close the diagonal call), and American Tower's stock price has run up well beyond the strike price of our October $135 short calls.

We're now in a position to roll our calls out again for a credit, aiming to milk some final income out of this position as we approach January 2019 expiration. With this rolling trade, we effectively convert our diagonal call strategy into a bull call spread (with both legs expiring in January 2019). As of right now, our plan is to close this position as we approach January 2019 expiration (likely before American Tower's next ex-dividend date in December), and at that point we will consider whether we want to initiate another diagonal call strategy on American Tower (perhaps using the 2021 LEAPS that list this month), or whether we are content with our simple stock exposure to this company.

Alternative Trades

- **Did you write calls with a higher strike price than *Pro*'s?** If you wrote higher-strike calls than *Pro* did (maybe at the $140, $145, or $150 strike prices), you're in a slightly better position than *Pro*. If your short call is in the money, aim to roll out and/or up for a credit before the Sept. 27 ex-dividend date to be safe. If you can roll to the $145 or $150 strike prices for a credit, those are good choices given our fair-value estimate of $146. If your strike price is out of the money, you can wait until expiration and then write a new iteration of short calls at the $145 or $150 strike prices.

Pro Can Help

- **Questions?** Ask any questions on *Pro*'s options board.

Pro Guidance Changes and Completed Trades: Sept. 10, 2018

Published Sep 17, 2018 at 4:54PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Broadridge Financial Services** (NYSE: BR): After receiving clarification from Broadridge investor relations on a financial disclosure in recent presentations, our fair-value estimate increases slightly to $115 (from $110). The stock remains a Buy, and the current price represents the narrowest premium to our fair-value estimate in all of 2018.
- **OpenText** (NASDAQ: OTEX): On continued free cash flow growth, our fair value estimate increases to $37 (from $35). The stock remains a Buy with a 2.9% allocation.

Pro Completed Trades (see transaction log; trades take a day to appear):

- None this week.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Pro Guidance Changes and Completed Trades: Sept. 17, 2018

Published Sep 17, 2018 at 4:52PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Paycom** (NYSE: PAYC): Our fair-value estimate increases to $118. It remains a Best Buy Now (for now; a decision to potentially move it to Buy is pending).
- **Square** (NYSE: SQ): Our fair-value guess increases to $60. It remains a Buy. We have half of our position covered by $80 calls.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Oracle** (NYSE: ORCL): We sold to open ten December 2018 $52.50 calls, reestablishing our diagonal call on Oracle. We were paid $1.10.
- **Square:** We rolled the September short calls that have been written on half our position to January 2019 $80 calls, for a credit.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

The Short Story on Our Next Shorts

Published Sep 17, 2018 at 3:59PM

Greetings, *Pro* members!

You might remember that we closed most of our short positions early this year. Now, with U.S. market indexes continuing to hit new highs, we're preparing to initiate a new "basket of shorts." For most of our nearly 10-year history, we've repeatedly decided to focus on owning promising companies rather than expending the high amount of energy it takes to run shorts. Too much shorting seemed contrary to the opportunities we were seeing in the market.

But we always said that this would change over time, and it is evolving as we speak (er, write). As interest rates increase, as valuation multiples expand, and as growth prospects potentially weaken while trade battles continue, we see more opportunities to fill a basket of shorts that would both help us navigate a down market better and, ideally, not harm us much in a market that continues to rise.

We're hoping to start as many as five individual shorts this week, followed by more next week, as we fill our basket. Each position will start at an allocation of about 0.5% to 1% -- no larger than that. Our general aim is to earn a decent return of approximately 7% or more on any short, and to cap our losses on any position that is moving against us. Most positions will be shorted directly (borrowing and selling the stock and paying the attendant "borrow fees"), and some will be shorted using options.

With our shorts, we're mainly targeting larger companies (and stocks that aren't likely to soar away on surprise good news). We want to seek out companies that are having trouble remaining relevant, expanding their sales, and achieving profits. We want companies that are the mirror *opposite* of our best long investments -- companies that are struggling to keep their heads above the water, or at the very least, flailing in their attempts to grow.

Here are some Foolish guidelines to consider if you're going to be short-selling alongside us again:

1. Don't sell short unless you're comfortable doing so. It's expensive, tricky, and time-consuming! Many people find it stressful. We seek to minimize that stress by having a large basket of short positions that ideally won't harm us much on the whole as prices rise (though some of them surely will). The positions will also ideally add to our returns overall after costs, especially in a falling market. Assuming our ongoing approach for the foreseeable future is to manage a basket of shorts (which is the assumption), the basket will grow, and change, regularly.

2. Aim to sell short every position with us. We don't know which will work out and which won't. We need to diversify our short portfolio, just as you do with a long portfolio, to benefit from the positions that end up working out best.

3. As shared earlier, stick to our allocations. Don't start giant short positions. We aim to keep our exposure to each one capped at a maximum of about 1% to start. If we get up to 20 positions, then our short book would give us up to 20% short exposure. That's a good start. Even ten positions for 10% is a good start.

4. Don't sweat small moves. They'll happen daily. On large jumps, though, we aim to cap our loss on any individual short to ideally no more than about 10%. We're lowering this bar from 20% knowing that it takes us time to issue alerts and get the position closed. And the math of a loss larger than 10% is harder to make up when shorting.

5. Shorts are usually short-term in nature. For many, it will be just weeks before the position turns over. The rare long-term short does exist, but generally we're targeting modest gains in struggling companies. As a short declines in value, it offers the short seller less potential reward, so keeping a fallen short open becomes less logical. We aim to take our gains when we deem it appropriate.

6. One more time: You don't need to sell short if you don't want to. We also have a hedge running on the S&P 500 index that we'll keep managing with you. And we have cash. And we like what we own.

However, after closing our last short positions, we knew we would want to start another basket at some point. We're now reaching the point where we feel we want to. That doesn't mean we believe the market is about to fall. Obviously, we don't know. It just means we're ready to put more of the "short" back into *Pro*'s long/short equation. Nearly 10 years into this adventure, and assessing on a regular basis, we've been patient about using shorts sparingly; but that was never the permanent plan.

To share any thoughts, please visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

Re-Establish a Diagonal Call on Oracle

Published Sep 14, 2018 at 12:55PM

Is this for you? This recommendation is for all *Pro* members who own 0.5% in long calls on **Oracle** (NYSE: ORCL) as part of the diagonal call we set up early this year. We also own a 3.2% stake in Oracle shares that are rated Buy. Those are separate from this position. If you don't yet own Oracle calls for a diagonal call, see alternatives below.

How You Participate

- **Trade:** Sell to open December 2018 $52.50 calls.
- **Allocation:** Sell one new call for every 2020 call you already own. For *Pro*, that's 10 contracts, representing a 0.5% allocation at current value.
- **Price Guidance:** At current prices, **use a limit order** at $1.10 to sell to open December 2018 $52.50 calls. As prices change, we'll have to accept the going price if we want to complete this trade before the market close on Monday.
- **Prices** (as of 10:30 a.m. E.T.):
    - Stock price: $49.24
    - Sell to open December 2018 $52.50 calls: $1.10 ($1.08 bid/$1.13 ask)
- **Alternative Guidance:** If the volume of trading among *Pro* members results in a significant impact on the options in this alert, or if the stock price changes considerably from the prices in this alert, consider looking at modestly different strikes or expirations for your short calls, but no lower than $50.

What We're Thinking

We bought January 2020 $30 calls on Oracle early this year after the stock had declined with the broader market. At the same time, we wrote $52.50 calls that expired this summer as income.

Since then, we've been waiting for shares to recover from last quarter's earnings report; now that they're back near $50, we can write new diagonal calls and benefit from slightly higher premiums. Oracle's next earnings report is due on Monday, Sept. 17, after the market closes, so we're stepping up to write our new calls before then, looking to earn income again on our long calls.

Why This Strategy?

The January 2020 calls we own are worth about $19.35, so writing $52.50 calls on them for a $1.10 credit pays us a 5.6% yield in just more than three months. We also maintain upside on our long calls to $52.50, and we have not capped upside on any of our shares of stock. This diagonal call is an "add-on" position -- not essential.

But with the diagonal call, we're seeking upside on one of our least expensive businesses, as well as leveraged income. Meanwhile, we believe the stock should at least remain steady and slowly appreciate over time.

However, last quarter's earnings report highlighted the risks that still exist in Oracle. Wall Street could frown again this quarter if cloud growth isn't healthy enough. The way we view it at this point, Oracle needs to keep proving its strategy to us some more, too, or there are companies we can replace it with.

In the meantime, though, we appreciate ownership of a stock that trades at below-average valuation multiples and still remains a highly profitable, recurring-revenue business. If Wall Streets starts to believe in Oracle's cloud business, the shares should be repriced much higher. Meanwhile, our diagonal call serves to pay us income.

More That Matters

- **Maximum loss:** Our entire 0.5% investment in our long calls if Oracle stock is less than $30 at January 2020 expiration, less premiums received from sold calls.
- **Maximum gain:** On this trade, we have upside to $52.50 for our owned call. But we hope to keep the strategy going, rolling our short calls if need be.
- **Follow-up**: By expiration, we'll seek to write new calls or roll our $52.50 calls to a later month and higher strike if the stock is above $52.50. If there are no attractive rolling opportunities, we will consider closing the entire position.

Alternative Trades

- **Not yet invested?** If you don't own long calls on Oracle, you can buy to open a 0.5% stake in January 2020 $30 calls, lately for about $19.35 each ($1,935), and simultaneously sell to open these same December 2018 $52.50 calls for a $1.10 credit, leading to a combined net debit of about $18.25 per diagonal call.
- **Want to cover some of your shares instead?** We see arguments for that, if you want to. Just realize the stock might jump after earnings -- if we're lucky. We're not yet covering our stock itself, but you could cover some of your shares with these same short calls, setting up covered calls, if you really want to. Then manage those short calls the same way we manage ours on our diagonal call.

Pro Can Help

- **Want to know more about this strategy?** The Options U guide to writing diagonal calls can keep you on an even keel.
- **Questions about this trade?** Visit Pro's options board.

Pro Catch-Up Trades and Expirations: Square, Zuora, and More

Published Sep 13, 2018 at 3:18PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Match our 2.9% stake.
- **CME Group** (NASDAQ: CME): Match our 2.3% stake.

Continue building your portfolio with our Buys, including:

- **Broadridge Financial Services** (NYSE: BR): If you don't have a position, start with a 3% stake. If you don't have a full allocation, now is a good time to consider adding incrementally to your position.
- **Facebook** (NASDAQ: FB): If you don't have a position, start with a 3% stake.
- **Skyworks Solutions** (NASDAQ: SWKS): Match our 2.8% stake.
- **Zuora** (NYSE: ZUO): Match our 1.5% stake.

Shorts:

- N/A

Options:

- **Square** (NYSE: SQ): If you're short September 2018 $75 calls, you can roll them to January 2019 $80 calls for about a $0.25 credit, to follow our recent alert. Roll soon, as time value is all but gone, and you risk losing your shares.

Upcoming Expirations:

- **Square**: Our September 2018 short calls are well in-the-money, so we're rolling (see above).

Tracking Pro's 'Fair Value'

Published Sep 10, 2018 at 1:16PM

Dear *Pro* Fools,

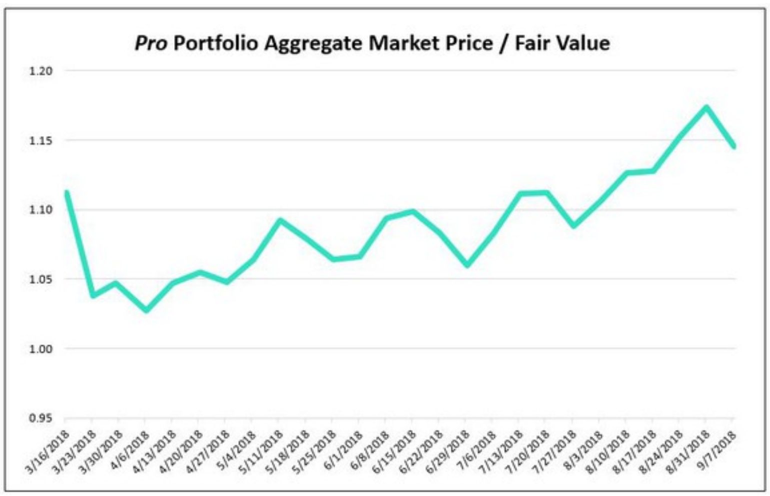
About six months ago, I wrote a Memo detailing a methodology we can use to calculate the theoretical fair value for the long "sleeve" of *Pro*'s portfolio. To summarize: We first use the fair-value estimates for each of our long stocks and compare them to each position's market value. Then, we aggregate all of these individual measurements to find the entire *Pro* portfolio's theoretical fair value.

At the end of that Memo in March, I wrote:

> "By tracking *Pro*'s theoretical fair value (and by tracking the fair value of the stocks that comprise the aggregate portfolio) over time and comparing the discount or premium to the subsequent realized performance, we can determine how good we are at assessing fair value, or whether we are systematically biased with our estimates. I plan to update this data set on a weekly basis and look forward to having enough data to draw historical conclusions."

And although our fair-value estimates are based on long-term (three- to five-year) expectations, now that we have about six months of history to examine, we can take an early look at the data and see if we can find any interesting observations.

The Aggregate Data



Note: The data is calculated on a weekly basis using each position's closing price on Friday.

This graph shows how the *Pro* portfolio's aggregate premium (or discount) to our theoretical fair value has changed since the beginning of the data series in March. Here are some observations from this graph and other relevant metrics:

- The data starts on March 16 with a reading of 1.11 and ends on Sept. 7 with a reading of 1.15, a 3% increase.
- The price-to-fair value ratio ranges from a low of 1.03 (on April 6) to a high of 1.17 (on Aug. 31).
- The average over the data series is 1.09.
- Between March 16 and Sept. 7, the value of the *Pro* portfolio increased by 6.4% (vs. 4.3% for the S&P 500).

It is interesting to note that although the *Pro* portfolio has traded at a premium to its theoretical fair value for the entire duration of this data series, it has still appreciated at a rate higher than the North Star (and the S&P 500).

The significant drop in the price-to-fair value ratio at the beginning of this period is largely attributable to Facebook, which dropped in value from $185.09 on March 16 to $159.39 on March 23 amidst the Cambridge Analytica data-breach scandal. At the time, Facebook was our largest holding; it is now our fourth largest, behind Broadridge, Mastercard, and Square.

Another interesting observation is that the *Pro* portfolio's value has increased at a rate greater than that of our price-to-fair value metric (6.4% vs. 3%). This difference is expected and is driven by increases to our fair-value estimates, which bring downward pressure on the price-to-fair value metric and upward pressure on total portfolio value. Since March 16, we've increased our fair-value estimates for 10 companies and decreased just one.

The Data by Position

In addition to tracking the price-to-fair value aggregate for the entire *Pro* portfolio, I've also been tracking the price-to-fair value metric for each individual position within the portfolio. This helps to demonstrate how undervalued or overvalued each position is, and how the valuation has changed over time. Here's how the individual position-level data looks (red shading indicates overvaluation, and green shading indicates undervaluation. Click to see full size):

In observing the position-level data, here are some relevant observations:

- The data ranges from a minimum of 0.54 (JD on Sept. 7) to a maximum of 2.04 (Square, also on Sept. 7).
- The average price-to-fair value ratio over the entire data series for every position is 1.08, and the median is 1.05.

An interesting insight from this table is that largest positions tend to be our most overvalued (we can see the red shading most prominently on the left side of the table, where our largest positions are found), and our smallest positions tend to be our most undervalued.

Over the life of this analysis (since March), our top five most overvalued positions have been Amazon (with an average price-to-fair value of 1.44), Square (1.41), Paycom (1.29), Mastercard (1.29), and Broadridge (1.28).

Our top five most undervalued active positions have been Coherent (0.64), JD (0.72), Johnson & Johnson (0.92), Skyworks (0.92), and CME (0.93).

The *Pro* Bottom Line

Although six months do not give us enough data to start analyzing for relationships between the price-to-fair value metric and long-term price appreciation (I'd like to start with a minimum of a year's worth), we can still obtain some insights from a preliminary look.

So far, we've seen that the *Pro* portfolio has traded at an aggregate premium to our estimate of fair value for the entire past six months, ranging from a low of 1.03 to a high of 1.17 with a current value of 1.15. This theoretical overvaluation hasn't hindered price appreciation, as the *Pro* portfolio has advanced by 6.4% over this time (vs. a 3% advancement in the price-to-fair value metric over the same time span; the difference was driven by increases to our fair-value estimates).

Additionally, when looking at individual positions, we see that the price-to-fair value metric can vary widely. We've witnessed a range from 0.54 to 2.04, with an average of 1.08 over the life of the data. Our largest positions have tended to be the most overvalued, which makes sense given that our conservative estimates often underestimate the growth and strength of outstanding businesses that compound intrinsic value at high rates. There can also be a lag between real-time market pricing and our fair-value estimates, which are updated at most just four times a year.

This analysis serves as yet another reminder not to anchor too strongly to fair-value estimates, as it shows that our strongest performers have so far been the most overvalued. However, this analysis was performed during a time of rising stock market prices -- and results will likely be much different during a decline.

Finally, *Pro*'s current 15% premium to fair value suggests a headwind to future returns, although as we saw with this analysis, that doesn't necessarily make this a certainty. We'll continue keeping track of this data to see how it trends over time.

Fool on!

-- Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Expirations: Square, Zuora, and More

Published Sep 6, 2018 at 2:44PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Match our 3.7% stake.
- **CME Group** (NASDAQ: CME): Match our 2.4% stake.

Continue building your portfolio with our Buys, including:

- **Broadridge Financial Services** (NYSE: BR): If you don't have a position, start with a 3% stake. If you don't have a full allocation, now is a good time to consider adding incrementally to your position.
- **Facebook** (NASDAQ: FB): If you don't have a position, start with a 3% stake.
- **Skyworks Solutions** (NASDAQ: SWKS): Match our 2.9% stake.
- **Zuora** (NYSE: ZUO): Match our 1.5% stake.

Shorts:

- N/A

Options:

- **Johnson & Johnson** (NYSE: JNJ): If you've yet to write covered calls, you can "sell to open" the October 2018 $135 calls, selling one call for every 100 shares you own and want to cover. Lately, they pay $3.65 each, although with the stock trading for more than $135 today, these calls are slightly in-the-money, with a significant chance of seeing your shares called away at expiration. Those who wish to aim for more upside in the stock in exchange for lower income can consider writing October 2018 $140 calls instead.
- **Square** (NYSE: SQ): If you're short September 2018 $75 calls, you can roll them to January 2019 $80 calls for about a $1.10 credit, to follow our recent alert.

Upcoming Expirations:

- **Square**: Our September 2018 short calls are well in-the-money, so we're rolling (see above).

Pro Guidance Changes and Completed Trades: Sept. 4, 2018

Published Sep 4, 2018 at 3:22PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Broadridge Financial Services** (NYSE: BR): After receiving clarification from Broadridge investor relations on a financial disclosure in recent presentations, our fair-value estimate increases slightly to $115 (from $110). The stock remains a Buy, and the current price represents the narrowest premium to our fair-value estimate in all of 2018.
- **JD.com** (NASDAQ: JD): Per our recent memo, we're lowering our rating to Buy from Best Buy Now for the time being.
- **Tencent** (NASDAQOTH: TCEHY): Tencent's rating is also being lowered to Buy from Best Buy Now (which we also addressed in the aforementioned memo).

Pro Completed Trades (see transaction log; trades take a day to appear):

- None this week.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

The Latest on JD.com and Tencent

Published Sep 4, 2018 at 2:13PM

Fellow Fools,

Despite a rocky start, it looks like the markets will beat our North Star for yet another year, with both the S&P 500 and the Nasdaq posting higher returns than the inflation-plus-7% guide that steers our investing behavior. But that wasn't the case for every index around the world; the Hang Song Index in Hong Kong and the Shanghai SE Composite Index in China have had a rough year, having fallen 16% and 23%, respectively, from their 2018 highs. So it should come as no surprise that our two Chinese holdings — **JD.com** (NASDAQ: JD) and **Tencent** (NASDAQOTH: TCEHY) — have been laggards in the *Pro* portfolio, with the former having declined by more than 41% since February and the latter down 30%-plus since its all-time high in January.

Given that we purchased both stocks with the belief that they would ultimately compound value over the next decade-plus, we're not overly concerned about these near-term fluctuations. After all, situations like this are why we go to such great lengths to construct a properly diversified portfolio. We're more interested in how the two businesses are progressing against our investment theses. Let's take a look.

JD.com

The market's reactions to JD's recent financial results look myopic to us. Five of the first six participants on the conference call asked about margins, most of them with a focus on the near future. For our part, we'd much rather see JD continue to invest in its business instead of trying to juice margins in the near term. But there is some news outside of earnings that has us scratching our heads: Founder and CEO Richard Liu was recently arrested during a trip to the United States (and subsequently released and allowed to return to China) on suspicion of criminal sexual misconduct. Unsurprisingly, Liu's lawyers have said that the speed with which he was released is a strong indicator that no charges will be filed. We'll abstain from passing judgment until we have more facts on the matter, but in the meantime, this will likely result in negative press that could send the stock lower. We believe it's prudent to lower JD's rating as well, to Buy from Buy First.

That said, we're nowhere near being ready to jump ship as we believe JD's financial results continue to suggest our thesis is on track. And recently we've heard reports that merchants are beginning to push back at JD's rival Alibaba and its "us or them" ultimatum, which could be a positive sign for JD's apparel business beginning to recover.

Tencent

Recent performance leads me to assert that the market hasn't been thrilled with Tencent's performance over the past two quarters. Although the company continued its string of 30%-plus year-over-year (YOY) revenue growth, this past quarter marked the lowest sequential (quarter-over-quarter) growth rate since the third quarter of 2014, and net YOY income declined for the first time in more than a decade.

The biggest reason for the slowdown was the sharp deceleration in gaming revenue (up just 6% YOY this past quarter), the result of certain games launching later than anticipated and Tencent's inability to monetize some newer offerings. It's important to note that the latter issue is largely out of the company's control -- China's regulatory bodies in charge of monetization are undergoing restructuring. And while the nation's General Administration of Press and Publication (GAPP) has recently implemented a temporary solution, allowing certain games to be monetized for up to one month as a form of relief for the industry, many of Tencent's bigger new games don't meet the requirements. Fortunately, we could see this ban lifted as soon as this month (a recent Deutsche Bank report that noted that a similar regulatory change nine years ago lasted for six months). And Tencent hasn't just been sitting idly by while all this has been happening; management has been leveraging its massive consumer reach to develop creative ways to monetize its free offerings in the meantime, such as giving away "free" items in its games if users subscribe to Tencent Video.

From our vantage point, Tencent's recent gaming struggles are temporary bumps in the road. In fact, if the cross-product promotions end up creating new, long-term users of Tencent Video and other apps, the regulatory challenges could ultimately end up a net positive for the company. However, the path may not smooth out immediately after the GAPP resumes approving games for monetization; just last Thursday, China's Ministry of Education put out a release about limiting screen time for children and adolescents to reduce the rate of myopia. Most of the content just reinforced prior suggestions (age ratings, time restrictions) that Tencent has previously addressed, but there were also recommendations about restricting the number of games approved for release. This could end up delaying some of Tencent's offerings, but in the long run these regulations might benefit the company. Such rules, and the uncertainty they bring, would likely favor large incumbents who can better roll with the punches because their success isn't overly dependent on a single game.

What concerns us now is a recently published essay written by industry insider Li Guofei and translated by Oxford's Jeffrey Ding. Many of Li's points directly contradict our original investment thesis, which centered around how the whole of the company is worth more than the sum of its parts. We argued that Tencent's involvement in countless aspects of people's lives results in a treasure trove of data that management can use to develop new products, monetize existing products, and gain market share, among other things. However, implicit in this thesis is that the company needs to share data amongst its different divisions. Otherwise they're nothing more than a collection of smaller businesses, united in name only.

Unfortunately, Li's essay cites industry insiders (including some who still work at Tencent) to describe how the company has actually adopted a more siloed approach to data that has it falling behind with regards to algorithms, which affect everything from advertising to product development. This approach has given life to competitor

Bytedance, which has placed a much greater emphasis on algorithms and sharing data among different business units. The result: Though Tencent's daily active users and the total time spent on its applications have continued to increase, its market share has declined by more than 6 percentage points, to 48%, while market share for Bytedance's mobile apps jumped by almost the same amount, to 10% (according to data from Questmobile). We're still optimistic that Tencent will ultimately be able to right the ship, but if it doesn't appear as though management is reevaluating its stance on data siloing in the future, we would consider it grounds for closing our position. For now, we're lowering our rating on Tencent from Buy First to Buy.

Final Thoughts

Before I go, I want to put these recent declines into some historical context, to help explain why, in isolation, they don't bother us. The following table shows data regarding sizable declines for four of the largest and most popular U.S. stocks. The most important column here is the last one, as it illustrates the performance relative to the S&P 500 for any investor who unluckily purchased shares right before each decline (e.g., if you purchased shares of Apple in February of 2015 and held them, you'd be outperforming the S&P 500 by about 32%). As you can see, patience was rewarded handsomely, as all four stocks have soundly beaten the market from their pre-decline peak.

Company	Decline	Performance	Peak to Current Performance	vs. S&P 500
Apple	February 2015 — May 2016	(32%)	69%	32%
Amazon	December 2015 — February 2016	(30%)	190%	150%
Facebook	March 2014 — April 2014	(22%)	147%	92%
Netflix	December 2015 — February 2016	(37%)	183%	99%

Source: S&P Global Market Intelligence. Returns as of Aug 31, 2018.

One might argue that I'm cherry-picking results here by selecting stocks that ultimately regained their footing -- but that's exactly my point. Although we try to be mindful of market conditions, we're humble enough to know that timing our buys and predicting changes in market sentiment are fool's errands with a lower-case "f." What we *can* control is our analysis and understanding of a given business, and our knowledge of how that translates into an investment thesis and the creation of intrinsic value for long-term shareholders. If we focus on the latter, and our analysis is correct, then I think we have every right to believe we'll see Tencent and JD.com on the list above one day.

Enjoy your week, Fools.

-- JP (TMFYossarian)

Roll Your Calls on Square

Published Aug 31, 2018 at 10:14AM

Is this for you? This is for *Pro* members who wrote September $75 (or similar) calls on Square with us as part of a protective collar. With the stock well above that price, we're rolling our calls higher to target more returns.

How You Follow Along

- **Trades:** Ideally, use a rolling order to roll your short calls on **Square** (NYSE: SQ):
  - Buy to close all Sept. 21, 2018, $75 calls.
  - Sell to open an equal number of January 2019 $80 calls.
- **Allocation:** Roll all of your existing contracts. *Pro* wrote calls on half its Square position, and will roll all of them -- 14 contracts, covering 1,400 of our 2,800 shares.
- **Price (9:45 a.m. ET) and Guidance:**
  - Stock: $88.35
  - Buy to close Sept. 21, 2018, $75 calls (splitting the bid/ask): $13.75
  - Sell to open January 2019 $80 calls: $14.75
  - Net credit to roll: $1 (use a limit order and aim to roll for $1 in credit; if that doesn't fill, move your limit down over time by a nickel until it fills)
    - Later guidance: If Square moves much in price before you act, you may want to move your *new* call strike price up or down accordingly, so you can still roll for a credit or no cost to a strike price that is most logical at the time.

What We're Thinking

Somewhat remarkably, shares of Square have soared more than 30% since the company's Aug. 1 earnings announcement. As we've written, results were strong again, with total revenue up 48% and adjusted revenue up 60%. Gross payment volume increased 31% to $815 million. For the first time, half of that payment volume came from larger sellers, those moving more than $125,000 in commerce per year. Square's ability to attract large clients bodes well for its related software sales.

For whatever reason, the stock initially sold lower on the results before reversing. Since then, analyst upgrades have added fuel to the ascent -- as has a strong market for "growth" stocks in general. Square is now valued at about $36 billion, a far cry from the $10 billion market capitalization it sported when we bought shares last summer (or is it? If this is going to be a $100 billion-plus company, the difference isn't that meaningful -- but that's a big "if"). We're working to ascertain how sensible the valuation looks when stacked up against the long-term potential for Square's free cash flow and earnings. Square's business is running right around breakeven now on its march to profitability (as of last quarter), and it's seeing non-GAAP profits.

The stock now trades at 73 times the average estimated guess for earnings in 2020, compared with 25 times when we bought it. Many stocks have seen "multiple expansion" in this bull market, though perhaps not as dramatically as Square. But, taking our lessons from other nascent growth investments we made years ago, we're compelled to remain investors and wait for a still bigger payoff in the long run. A strong young company in a promising market can quickly expand enough to merit a higher share price within a time frame that remains attractive. Square still seems to fit this bill.

Why This Strategy

That said, the position has quickly grown to become one of our largest -- our third-largest, in fact, at 6.6%, tied with Facebook. So, having half of our shares covered at this price with in-the-money options that offer us some volatility cushion doesn't seem like an illogical move. The level of speculation in Square's price is notable, so why not guard some of our position with short calls? Especially given that this is where we are now.

We can roll our short calls up incrementally and get a credit for doing so; in the process, we gain more upside in the stock, and then we get to comfortably sit on sizable short call value that we'll earn if the stock price gives back ground. We've done this before -- with Skyworks, to name one -- when a stock has run up a lot against covered calls. We can roll incrementally, at a credit, and reel in some value if the stock stops rising, and a lot more if it declines. This may take a few iterations, until eventually we earn all the credit; and if it doesn't play out that way, we could eventually let these shares get called (though at a higher strike price than we would have originally). For now, though, we aim to keep this half of our shares in the port with in-the-money short calls on them.

Going into this trade, the stock is 17.7% above our $75 strike, and the short calls have about $0.30-$0.50 in time value (depending when you quote it!). They'll likely always carry a little time value, which is one reason we're not waiting longer to roll. A second reason is that, if the stock rises much more, it could get harder to roll reasonably for a credit. Rolling our strike to $80, we move within 10.3% of the current share price (and less than that counting our $1 or so credit to roll). In this iteration, we gain 8% in additional upside on these covered shares by rolling up and including the credit. In other words, this is a good first step toward capturing more upside without having to pay in to do it.

Alternative Trade

- If you wrote something other than $75 calls, such as $80 calls, assess the time value they still hold and roll appropriately as time value dissipates to something around $0.40 or so. Pro wrote Sept. 21, 2018, $80 calls (the best available when we could place our trade), and we'll plan to roll those out to January 2019 within 30 days to be on the same page as members. If prices change drastically before we trade, we'll adjust as needed after letting members know what we're doing.

Pro Can Help

- **Want to talk about our options positions?** Visit us on *Pro*'s Options Positions board.

Home Depot Rebounds in the Second Quarter

Published Aug 30, 2018 at 12:49PM

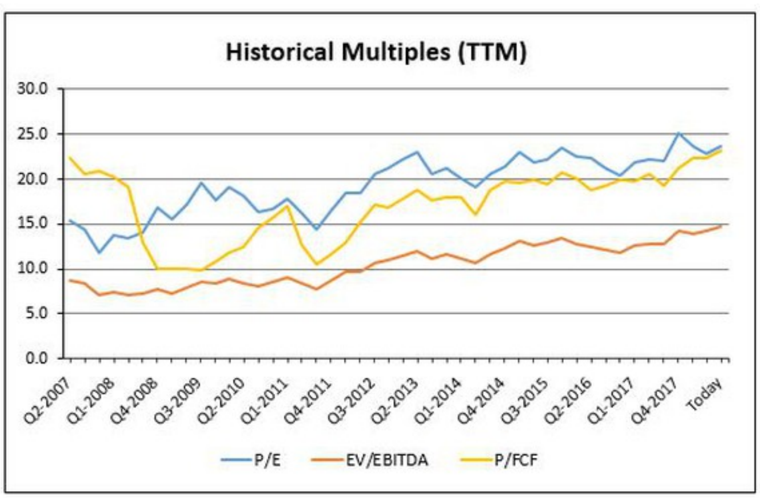
Second-Quarter 2018

- Press Release
- Earnings Infographic
- Conference Call Transcript
- 10-Q Filing

Home Depot (NYSE: HD) rebounded strongly from last quarter's weather-related slowdown, reporting revenue growth of 8.4%, comps growth of 8% (the highest figure since Q2 2013), and earnings-per-share growth of 36%. Growing earnings have led to positive pressure on the stock price, and housing market data continues to support a favorable near-term outlook for this well-managed business. However, rising home price appreciation has led to lower housing affordability, and along with higher interest rates we are beginning to see an effect on the housing market as the supply and demand work their way toward balance.

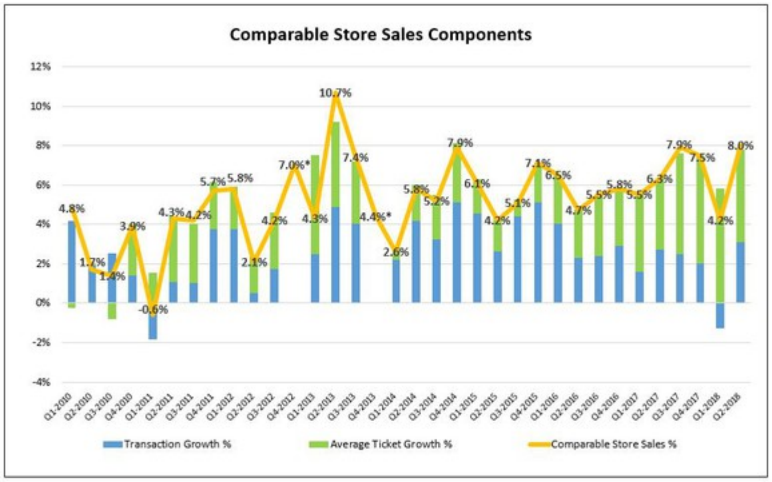
- **Updated guidance**: Buy (Diagonal Call)
- **Recommended allocation**: 1.7% in January 2020/February 2019 $110/$185 diagonal calls.
- **Fair-value range:** $165-$190
- **Current price:** $200

At about $200 per share, the stock is priced at 14.6 times trailing-12-month (TTM) EBITDA, 22.8 times TTM free cash flow, and 23.6 times TTM earnings-per-share (EPS). Management raised its guidance for full-year 2018 EPS to $9.42 per share, and Home Depot is priced at 21.2 times expected 2018 earnings, suggesting multiple contraction if the stock remains at recent prices.

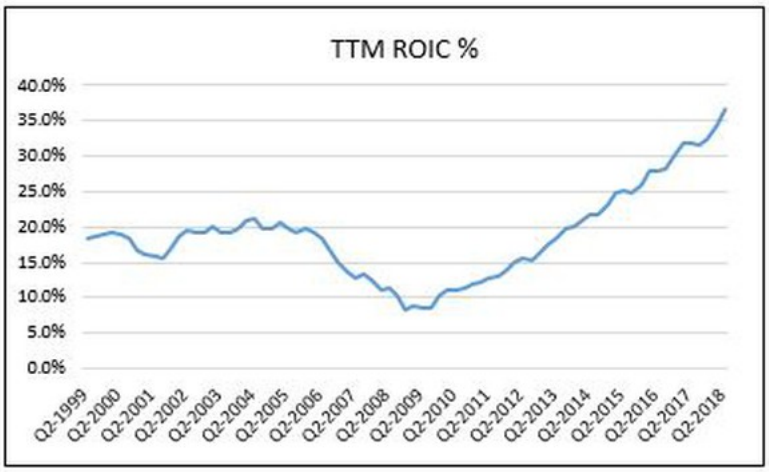


Business Performance

As was expected after last quarter's somewhat weak performance, Home Depot bounced back in the second quarter with strong comparable sales growth. The company reported year-over-year revenue growth of 8.4% and 8% growth in comparable store sales. The 8% growth in comps is the best performance from the company since Q2 2013, and transaction growth rebounded back into positive territory after a decline last quarter. This quarter marked the 29th straight featuring positive comps, a remarkable result for a physical brick-and-mortar retailer in the Amazon era, demonstrating the defensibility of Home Depot's competitive position:



Impressively, Home Depot's ROIC continues to climb. As with last quarter, the acceleration this quarter is thanks to tax reform, as the company's effective tax rate for the quarter came in at 24.7% compared with 36.6% in the same quarter last year. U.S. tax reform continues to be a major contributor to near-term earnings and cash flow growth for many of our companies, and lower tax rates meaningfully increase the cash flows (and thus the intrinsic value) of U.S. businesses:



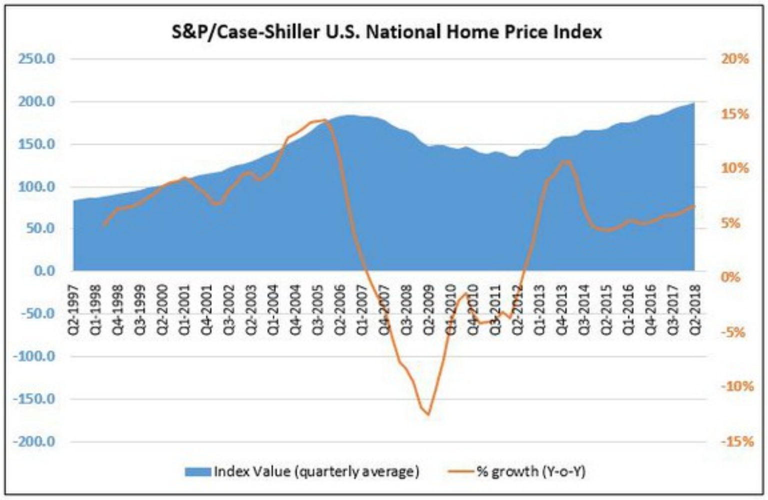
The lower tax rate helped push net margins up to 11.5% for the quarter compared with 9.5% in the same quarter last year, and EPS rose by 36% to $3.05 per share (vs. $2.25 per share last year). Given management's intent to aggressively increase spending on strategic investments (supply chain, new stores, and information technology), lower tax rates should provide most of the boost to earnings in 2018.

Since Q2 is Home Depot's most important quarter with respect to revenue and margins (due to housing market seasonality), strong revenue growth and operating leverage led to higher operating margins, despite an increase in the dollar value of SG&A spending. Quarterly operating margin % rose to a record 16.1%, and 14.5% on a TTM basis. You can clearly see the seasonality trend in margins in the following graph of quarterly operating margins:

Home Depot's "interconnected retail strategy" continues to resonate with consumers, as online sales rose by 26% vs. Q2 of 2017. This is an impressive result given that retail e-commerce sales in the U.S. are rising at about 15%. Home Depot has done an excellent job interfacing its physical stores with its online website (with a sophisticated supply chain network), allowing the company to capture a healthy portion of online sales growth, growing faster than the overall e-commerce market. In fact, Home Depot was the fourth most popular online store in the U.S. in 2017 as measured by net e-commerce sales (behind just Amazon, Walmart, and Apple).

The Housing Market

In addition to Home Depot's strong business performance, recent housing market data suggests continued growth in home improvement spending. Home-price appreciation finally topped out in April 2018 after 21 straight months of acceleration, and the June 2018 reading for the S&P Case-Shiller National Home Price Index shows 6.2% growth compared to June 2017 (down from 6.5% growth in March 2018). Although home-price appreciation is now decelerating, home prices are still certainly rising at a significant pace, and the national index has been above peak pre-crisis levels since January 2017:



Home-price appreciation is being driven by a combination of a healthy economy, low unemployment, and low inventories of homes for sale. There is a pent-up demand for home-buying following the 2008-2009 recession, although low inventory levels are preventing that demand from translating into new household formation. This high-demand/low-supply situation is causing upward pressure on home prices.

Here is an except from the press release that accompanied the announcement of the May Case-Shiller Home Price Index data:

> "Home prices continue to rack up gains two to three times greater than the inflation rate. The year-over-year increases in the S&P CoreLogic Case-Shiller National Index have topped 5% every month since August 2016. Unlike the boom-bust period surrounding the financial crisis, price gains are consistent across the 20 cities tracked in the release; currently, the range of the largest to smallest price change is 10 percentage points compared to a 20 percentage point range since 2001, and a 25 percentage point range between 2006 and 2009. Not only are prices rising consistently, they are doing so across the country.
>
> Continuing price increases appear to be affecting other housing statistics. Sales of existing single family homes – the market covered by the S&P CoreLogic Case-Shiller Indices – peaked last
> November and have declined for three months in a row. The number of pending home sales is drifting lower as is the number of existing homes for sale. Sales of new homes are also down and housing starts are flattening. Affordability – a measure based on income, mortgage rates and home prices – has gotten consistently worse over the last 18 months. All these indicators suggest that the combination of rising home prices and rising mortgage rates are beginning to affect the housing market."

The increases in home prices are certainly affecting housing affordability, and according to the National Association of Home Builders (NAHB) / Wells Fargo Housing Opportunity Index, housing affordability in Q2 2018 was pushed to a 10-year low. 57.1% of new and existing homes sold in Q2 2018 were affordable to families earning, the U.S. median income of $71,900. This is down from 61.6% in Q1 2018, and from 59.4% in Q2 2017. Despite the 10-year low, there is still a long way to go before reaching the lows of 2008-2009 (the affordability index bottomed at 40.4% in Q3 2006). Here are some excerpts from the press release accompanying the announcement of the Q2 index value:

> "Tight inventory conditions and rising construction costs are factors that are holding back housing and putting upward pressure on home prices. Meanwhile, tariffs on Canadian lumber imports into the U.S. are further eroding housing affordability. Builders are struggling to manage these costs to ensure pricing does not outpace expected gains in wage growth.
>
> Rising household formations, along with a strong economic expansion in the second quarter that has fueled job growth, will support housing demand in the second half of 2018. However, growing trade war concerns and the expectation of higher mortgage rates are additional headwinds negatively affecting housing affordability"

All in all, significant demand for housing remains, but low inventory levels, rising costs for homebuilders, and wage growth lower than home price growth are factors influencing a decline in housing affordability. Along with rising interest rates, we're beginning to see affects on the housing market. We'll see how housing trends play out over the rest of 2018, and we may see a home price appreciation start to slow as decreasing affordability impacts home buyer demand.

Pro Catch-Up Trades and Expirations: Broadridge, Square, and More

Published Aug 30, 2018 at 11:33AM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 3.7%.
- **CME Group** (NASDAQ: CME): Buy 2.3%.

Continue building your portfolio with our Buys, including:

- **Broadridge Financial Services** (NYSE: BR): If you don't have a position, start with a 3% stake.

Shorts:

- N/A

Options:

- **Johnson & Johnson** (NYSE: JNJ): If you've yet to write covered calls, you can "sell to open" the October 2018 $135 calls, selling one call for every 100 shares you own and want to cover. Lately, they pay $3.40 each, although with JNJ trading just above $135 today, these calls are slightly in-the-money, with a significant chance of seeing your shares called away at expiration. For those who wish to aim for more upside in the stock in exchange for lower income, you can consider writing October 2018 $140 calls instead.

Upcoming Expirations:

- **Square** (NYSE: SQ): Our September 2018 $75 short calls are now deep in-the-money (as of yesterday) and carry just a smidge of time value. We're preparing to roll them incrementally higher and follow the stock up that way -- to a point, of course. Watch your inbox for a roll alert in the next few days, most likely (unless it turns south).

What We Seek in Pro as Earnings Accelerate

Published Aug 27, 2018 at 1:18PM

Greetings, *Pro* members!

The S&P 500 hit a new high today, probably (one never knows for sure) inspired by recent earnings results across the board. Leading companies are growing strongly, and although the rate of growth should slow next year as lower tax rates are lapped for most, projections see decent growth ahead, too. We'll be managing our hedge (a synthetic short) on the **SPDR S&P 500** (NYSEMKT: SPY) ETF, and our short calls on half of our **Square** (NYSE: SQ) position, as needed, if they keep pushing higher. We'll aim to roll the short calls higher without meaningful cost.

Meanwhile, the *Pro* portfolio is making new highs, too. Not long ago, we were celebrating the tripling of the portfolio at a 200% return, and now our focused portfolio is up 271% as of this morning, well ahead of the North Star and all the indexes we watch. Tragically for their clients, the average hedge fund has returned a tiny fraction of this result over the past 10 years, according to Hedge Fund Research and its indexes. We've purposely shorted and hedged modestly (though we've done our fair share), but that won't always be the case. We've averaged 74.7% net long since January 2012.

From here, this is what's most important to us:

1. As always, be as knowledgable and as confident as possible that we own superior businesses with strong growth prospects.
2. Continue to seek new investments that may improve the portfolio further.
3. Maintain flexibility so a market downturn doesn't handcuff us.
4. Actively consider and manage hedges and shorts so they help us benefit from a downturn.
5. Always remember our time frame of a rolling three years.

We want to own the most promising companies for the coming years, without becoming a portfolio of speculation. We want a mix of young companies and firmly established (but still growing) businesses.

Earnings Acceleration

Meanwhile, it seems the pace of innovation and execution is accelerating at many of our companies.

Square is a primary example, with adjusted revenue up 60% year-over-year last quarter. That's an acceleration from 51% YOY growth the previous quarter. New products, larger customers, and more customer usage keep making Square's interconnected businesses stronger. The company now expects revenue growth of about 55% this year, to $3.2 billion. We're in the process of updating our valuation on Square. The stock now trades at 130 times expected earnings for the year ahead, and 261 times trailing free cash flow, so it's anything but inexpensive. The question is, what is a fair way to measure its valuation at this early stage? Is its market cap, at $32 billion, still reasonable for its potential? We're assessing.

OpenText (NASDAQ: OTEX), which has choppy quarterly results, is finally pushing analysts to analyze it on an annual basis. For its fiscal 2018, which just ended, revenue was up 23% year-over-year to $2.82 billion, and annual recurring revenue represented 73% of that total. Operating cash flow rose 62% to $710 million. Of all this, 5.5% of sales growth was organic, with the rest coming from OpenText's long-running acquisition strategy. The lack of stronger organic growth is probably what has the stock trading at 14.2 times expected earnings for next year, and 18 times trailing free cash flow -- discounts to the broader market. The business has been a good long-term performer for us, and it should fare better than highfliers in a market downturn. That said, our love of software companies continues, and if we need to trim some holdings to add new ones, OpenText and **Oracle** (NYSE: ORCL) are two possibilities. Today, both remain Buys.

Paycom's (NYSE: PAYC) second-quarter revenue was up 32%, with 98.3% of that revenue being recurring. Non-GAAP net income rose 70% to $0.59 per share as business leverage starts pushing margins higher. Management increased 2018 sales guidance to a midpoint of $555 million, up 28% YOY. That's driven by new customer additions. The stock lately trades at 52.3 times expected earnings for the year ahead, and 241 times free cash flow. Before you spit out your coffee in shock, know that Paycom, like Square, is still in building mode; its subscription software model puts the large costs up front and keeps initial revenue modest until the customer base expands. With young software companies, you have to peer into the future to see how the financials will improve as they mature. Importantly, Paycom does continue to sign new clients, taking market share, and sell more to its existing ones. This company is due for a fair-value estimate increase from us.

Long-established **CME Group** (NASDAQ: CME) expanded revenue 15% last quarter, as transaction fee revenue rose by 14%. Average daily volume was up a strong 12% to more than 18 million contracts per day (mostly futures). On May 29, CME had a new peak day with more than 50 million contracts traded. Adjusted net income and earnings per share both jumped 40% for the quarter. Open contract interest across its six product categories is strong, with 123 million open contracts as of July 26, up 10% from the prior year. The stock of the leading futures exchange trades at 25 times expected earnings for the year ahead, a premium price that it has long held. Our fair-value estimate is still higher at $177.

Coherent (NASDAQ: COHR) is one company in our portfolio working through a temporary slowdown. This isn't surprising when you consider its industry -- a capital-intensive behemoth with long lead time, not unlike semiconductor testing equipment. Coherent sees no OLED-manufacturing laser demand problems, but fiscal 2018 revenue in OLED will hit a temporary peak as a diverse new customer base works to set up shop for 2020 and beyond. OLED revenue at Coherent will likely be down 15% to 20% in fiscal 2019 before recovery starts in fiscal 2020. Other business lines, including fiber lasers, will offset much of this headwind, so that 2019 revenue should be within 5 percentage points of 2018's level. The stock trades at 13.8 times expected earnings for the year ahead. Our fair-value estimate is declining from $280, but Coherent remains a well-run, diversified laser business with a promising outlook; we're just in a trough period. It's only a 1.5% position, so we'll consider adding to it at times. That said, if we need cash, this is the type of business we'd consider as a source before many others that have stronger recurring revenue.

We're also in the process of updating valuation estimates on **MasterCard** (NYSE: MA) and **Visa** (NYSE: V).

As September nears, we own a portfolio of heathy businesses, many of which are entering the strongest part of their year. We hope you're enjoying the summer (I fortunately just enjoyed a beautiful lap around central California!), and we thank you for being on this investing journey with us. To share any thoughts, please visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: Aug. 27, 2018

Published Aug 27, 2018 at 1:18PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Broadridge Financial Services** (NYSE: BR): Per our earnings review, our fair-value estimate increases to $110 and the stock remains a Buy.
- **Coherent** (NASDAQ: COHR): Our fair-value estimate decreases to $230. The stock remains a Buy.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Home Depot** (NYSE: HD): We rolled our short September 2018 $180 calls to February 2019 $185 calls for a $1.28 debit today. Be sure to roll yours before market close tomorrow, Tuesday, Aug. 28, to avoid an early exercise.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Expirations: Home Depot, Square, and More

Published Aug 23, 2018 at 2:12PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **CME Group** (NASDAQ: CME): Buy 2.3%.
- **JD.com** (NASDAQ: JD): Buy 2.1%.
- **Tencent** (NASDAQOTH: TCEHY): Buy 2.4%.

Continue building your portfolio with our Buys, including:

- **NVR** (NYSE: NVR): Buy 2.3%.
- **OpenText** (NASDAQ: OTEX): Buy 2.9%.

Shorts:

-
    - N/A

Options:

- **Johnson & Johnson** (NYSE: JNJ): If you've yet to write covered calls, you can "sell to open" the October 2018 $135 calls from our recent trade alert, selling one call for every 100 shares you own and want to cover. Lately, they pay $3.20 each, although with JNJ trading just above $135 today, these calls are slightly in-the-money, with a significant chance of seeing your shares called away at expiration. Those who wish to aim for more upside in the stock in exchange for lower income, you can consider writing October 2018 $140 calls instead.
- **Home Depot** (NYSE: HD): Roll, or start, your diagonal call per Tuesday's alert. As of today, the midpoint of the bid/ask spread implies about an $0.85 debit for this roll.

Upcoming Expirations:

- **Square** (NYSE: SQ): Our September 2018 $75 short calls are in-the-money but still carry a lot of time value. Closer to expiration, or when time value dissipates, we'll manage the short calls to keep our shares. We don't plan to let our shares go.

Roll Your Diagonal Calls on Home Depot

Published Aug 21, 2018 at 2:20PM

Is this for you? This is for all *Pro* members who wrote September 2018 $180 diagonal calls on **Home Depot** (NYSE: HD) as per our alert in May. If you have yet to establish a diagonal call position on Home Depot, or if you established a different alternate position, please see the Alternative Trades section below.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
    - "Buy to close" all September 2018 $180 written calls.
    - "Sell to open" the same number of February 2019 $185 calls.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* will roll all nine of our calls.

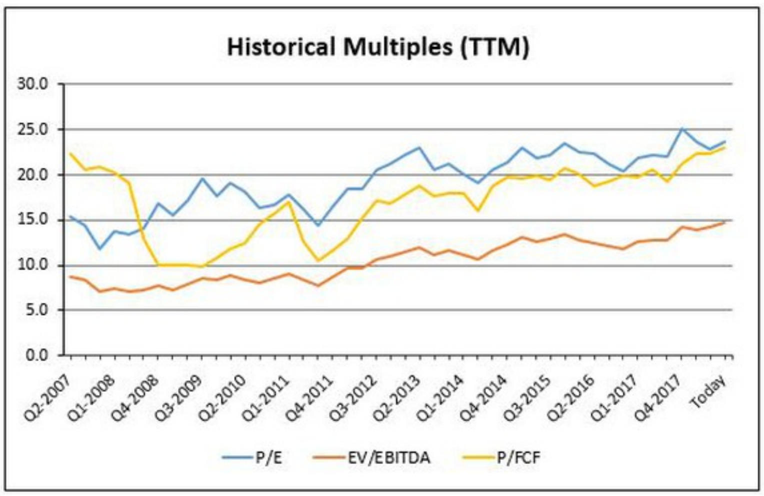
- **Recent Prices** (12:40 p.m. ET):
  - Stock: $200
  - Buy to close September 2018 $180 calls (bid/ask): $20.05/$20.25 (midpoint $20.15)
  - Sell to open February 2019 $185 calls (bid/ask): $19.40/$19.80 (midpoint $19.60)
  - Net debit to roll: Approximately $0.55 (this price will change)
- **Price Guidance: It is critical that you use a limit order**, aiming to pay as little time value as possible to close your short calls and to roll for as much of a credit as possible. The midpoint of the bid/ask spreads currently implies about a $0.55 net debit for this roll, although that number will change as prices change and as *Pro*'s collective volume affects the bid/ask spreads. The September short calls have only about $0.20 of time value left, and Home Depot goes ex-dividend Aug. 29 with a scheduled dividend payment of $1.03. If you don't complete this roll before the ex-dividend date, you will likely see your call assigned as call owners look to capture the upcoming dividend, **so make sure to complete this trade before then.**

What We're Thinking

We've been running a diagonal call strategy on Home Depot since October 2017 to target leveraged exposure to the well-run home-improvement retailer. With a 27% simple return since inception if we were to close the diagonal call today, the position has so far been a success -- perhaps too much of one, in fact, as the stock has risen well above our short call's strike price. This means that, for the second time, we're being forced to pay a debit to roll to keep the strategy going.

Since our last roll in May, Home Depot has reported second-quarter 2018 earnings. Quarterly results were strong, continuing the company's momentum with 8.4% net revenue growth, 8.1% U.S. comparable-store sales growth, and 36% earnings-per-share growth. The company rebounded from a lackluster start to the year, benefiting in Q2 from healthy organic revenue growth (balanced across transaction and ticket growth) and lower corporate tax rates, all of which led to rising earnings, margins, and returns on invested capital.

Home Depot's valuation multiples have significantly expanded since we initiated our position, some of which has been justified by strong business performance in combination with the lower tax rates:



Sources: S&P Global Market Intelligence, company fillings, author's calculations

Despite the higher multiples, if housing and economic momentum remain strong, Home Depot should continue to expand its revenue and earnings, supporting the stock price. Given our assessment of the company's fair value and business momentum, we're content to pay a modest debit to roll our diagonal calls out and up in order to capture further upside and keep the diagonal call position going. In exchange for $0.55 or so in incremental investment, we gain $5 in additional upside to our position, and we extend our expiration out to February 2019, with the flexibility to potentially continue the position as market and business conditions dictate. As we approach February expiration, we'll reassess the position and determine our next course of action.

Alternative Trades

- **Did you write September 2018 $180 covered calls?** If you wrote covered calls, you can make the same rolling trade as *Pro*, rolling your covered calls up and out to February 2019 $185 calls.
- **Did you write September diagonal calls at a different strike price?** If your short call is in-the-money but at a higher strike than *Pro*'s ($185, $190, or $195), aim to roll out and/or up for a credit. The $195 and $200 strike prices look like good choices to us, but you can roll to higher strikes if you prefer to target higher upside, or lower strikes if you prefer to be more conservative and target current income. If your short call is out-of-the-money, you can wait until expiration and then write a new iteration of short calls at the $195 or $200 strike prices.
- **New to the position and have yet to set up a diagonal call?** Do so by simultaneously buying ("buy to open") January 2020 $130 calls and selling ("sell to open") February 2019 $200 calls for a net debit of about $61.50 per diagonal call (this price may change). Invest 1.7% of your *Pro* funds in this diagonal call position (that is, one diagonal call for every $360,000 or so you manage), and keep in mind that this position is "off-reservation" from *Pro*, so if you're not comfortable managing a position on your own, this choice might not be the best one for you.
- **Have a different position not addressed here?** Check in on the *Pro*'s Options discussion board and we will do our best to answer your questions.

Fiscal 2018 Brings Record Sales for Broadridge

Published Aug 21, 2018 at 1:50PM

Fiscal Q4 2018

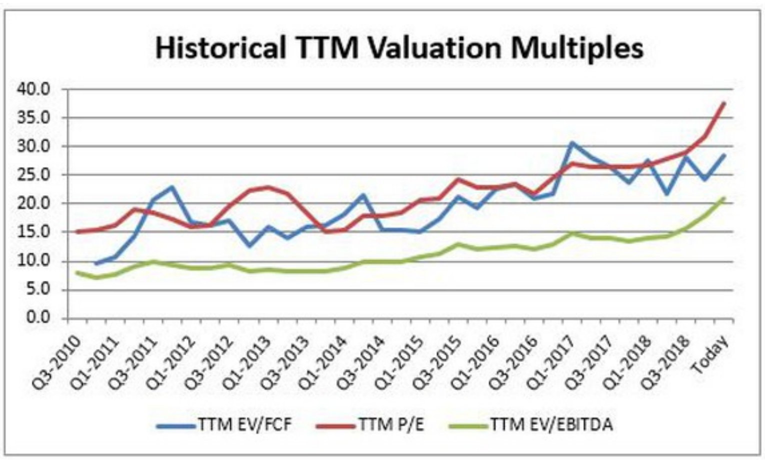
- Recurring fee revenue growth (year over year): Up 6.9% to $862 million (6.5% TTM growth)
- Closed sales growth (year over year): Up 80% to a record $115 million (13% TTM growth)
- EPS growth (year over year): Up 8.8% to $1.72 (31% TTM growth)

Broadridge (NYSE: BR) registered an excellent end to the 2018 fiscal year, reporting a record quarter and full year of closed sales, making up for a slow pace of closed sales through the first three quarters of 2018. With Q4's blowout quarter of $115 million in closed sales (the prior record was $65 million in Q4 2014), Broadridge exceeded the high end of 2018's guidance for closed sales, and 2019 guidance suggests that recent sales momentum will continue, boding well for future revenue growth. Broadridge continues to improve margins and expand its core business at a consistent rate, producing significant amounts of cash flow from a capital-light asset base:

The market responded very favorably to Q4's earnings release, with the stock rising more than 11% on the day of the report. Broadridge has been a notable market-beater in 2018, up more than 47% year-to-date (not including dividends), and as such (and due to Facebook's recent difficulties), Broadridge is now *Pro*'s largest holding by a significant margin at a 7.7% allocation. While we think Broadridge is an outstanding business and we have no intention of selling our shares, the strong recent stock price appreciation may detract from future returns unless the company can continue to outperform our expectations (as it has consistently over the past several years).

- **Updated guidance**: Buy (unchanged)
- **Recommended allocation**: 7.7%
- **Fair-value estimate:** $110 (from $95)
- **Current price:** $133.33

Based on management's 2019 guidance, at $133 per share, the stock is priced at 28.8x projected 2019 cash flow and about 32.9x projected 2019 GAAP earnings per share. Although the forward estimates are more reasonable, we can see that due to the recent stock price appreciation, Broadridge's trailing multiples are significantly elevated:



After incorporating fiscal 2018 results, and updating our valuation model to account for 2019 expectations, **our fair-value estimate increases to $110 per share (from $95)**. The company's valuation multiples are as high as they've ever been during its tenure as a public company, some of which is justified: Lower U.S. corporate tax rates make cash flows more valuable to investors, and the business is as big and strong as it's ever been.

Despite the strong business performance, the current price sits more than 20% above our newly updated fair-value estimate. **Broadridge remains a Buy** on our scorecard, but if you've yet to establish a full position, you may want to consider buying in halves or thirds, or waiting for a narrower premium to our fair-value estimate. However, if Broadridge continues to outperform our estimates, this cautious approach is less preferable to simply buying a full allocation today.

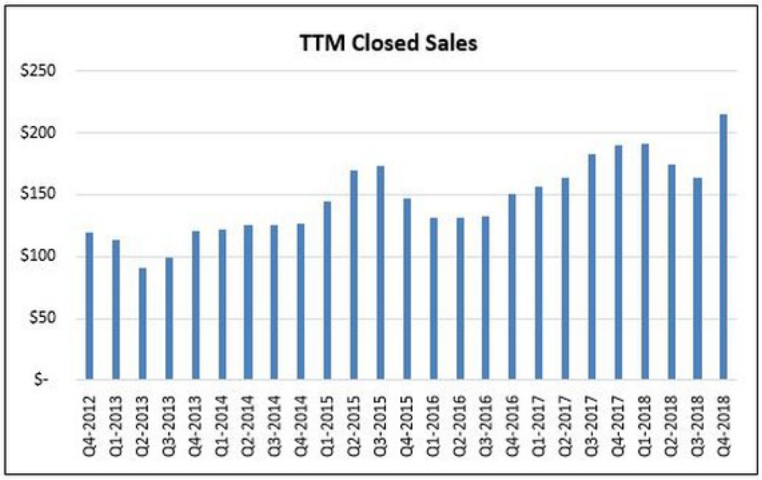
Our Thesis

Broadridge has a near-monopoly on proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers offload technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record, and sound capital allocation policies make Broadridge a sturdy rock upon which to build the *Pro* portfolio. We expect modest growth in fee revenue (augmented by tuck-in acquisitions), slight operating leverage, plenty of free cash flow, and a growing stream of dividends and share repurchases to help achieve North Star-like returns.

The Most Important Things

1. Closed Sales: This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%-plus). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

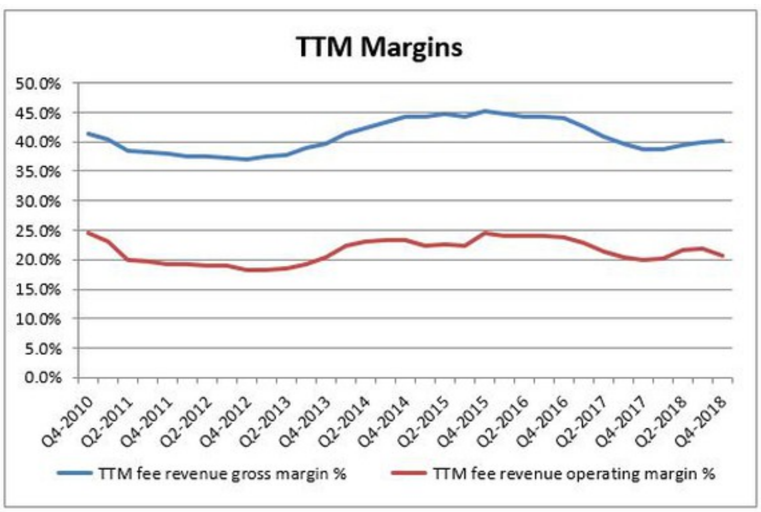
As mentioned above, Broadridge reported a record quarter (and year) for closed sales in Q4 2018 with $115 million in closed sales:



I wrote last quarter that "management and the sales team have work to do to meet reaffirmed guidance of $170 million to $210 million for fiscal 2018", needing "an unprecedented performance in Q4 to reach guided sales levels", and that "I'll be impressed if Broadridge can meet those numbers next quarter".

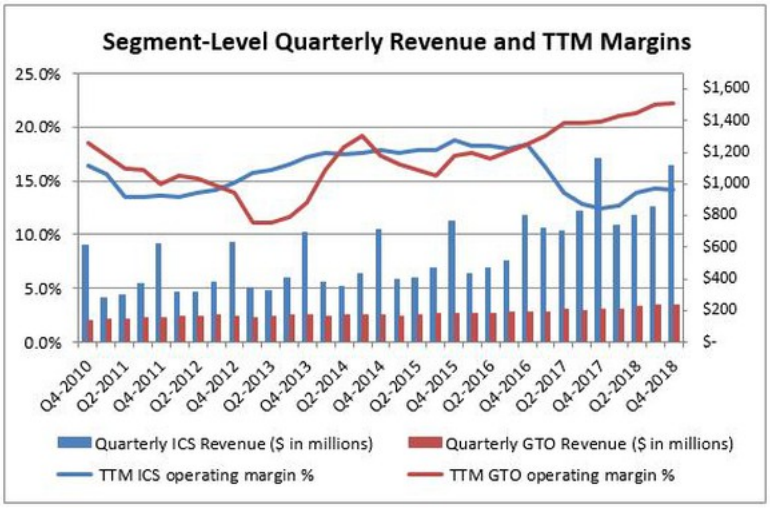
Broadridge not only met but **exceeded** the guided sales levels with a blowout sales quarter that dwarfed the company's previous record quarter of $65 million in closer sales. However, I was a bit surprised by closed sales guidance for fiscal 2019, the midpoint of which suggests a modest decline (-5%) in 2019 closed sales compared to 2018. Broadridge does tend to exceed its own guidance regularly, so we'll see over the next year if management is sandbagging its guidance.

2. Fee-Revenue Margin Performance: In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers), we prefer to look at trailing-12-month (TTM) margins to smooth out quarterly fluctuations. TTM fee-revenue gross margins came in at 40.1% (up from 38.7% a year ago), and TTM fee-revenue operating margins came in at 20.6% (up from from 19.9% a year ago):



We've finally lapped the effects of the 2016 acquisition of NACC, with this quarter marking the first quarter that allows a comparison of fully comparable TTM periods. We can see in the financials that Broadridge has been able to expand NACC's operating margins over time via scale, cost synergies, and improved operational efficiency. We are seeing higher margins (both gross and operating) in the most recent TTM period compared with the prior TTM period. The NACC acquisition integration has been outstanding, and margins are continuing their steady march higher.

When looking at Broadridge's separate divisions, we can see that both businesses are improving. While the Investor Communications Solutions (ICS) business has seen significantly lower (though improving) margins because of the NACC acquisition, the acquisition-agnostic Global Technology & Operations (GTO) business has shown continued strong margin expansion, generating a record TTM operating margin of 22.2%:



The margin expansion trends for both segments of the business are exactly what we want to see as investors, and based on management commentary and recent trends, we expect the margin expansion to continue. The business's financial execution since the NACC acquisition is an indication of excellent management, as acquisition integrations often don't go so smoothly.

3. Capital Allocation: In the company's most recent Investor Day presentation, we got a detailed update on how management plans to allocate capital between fiscal 2017 and fiscal 2020: targeting a 45% dividend payout ratio, and using up to $1.4 billion in incremental debt capacity and expected free cash flow for share repurchases and merger-and-acquisition activity.

Management ramped up its share repurchase activity in Q4 2018, spending $247 million in the quarter on share buybacks. I was a bit surprised to see elevated activity with repurchases given the stock's recent price appreciation, but we do know that management has prioritized share repurchases as a part of their capital allocation policy.

Management was also active in fiscal 2018 with acquisitions, spending $148 million on tuck-in acquisitions over a total of 6 acquisitions, including two in the fourth quarter. The acquisitions have focused on digital delivery, data analytics for asset managers, and corporate issuer services. We expect management to continue to be active with M&A throughout 2019.

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring organic revenue growth (augmented by tuck-in acquisitions) to translate to stout earnings and cash-flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

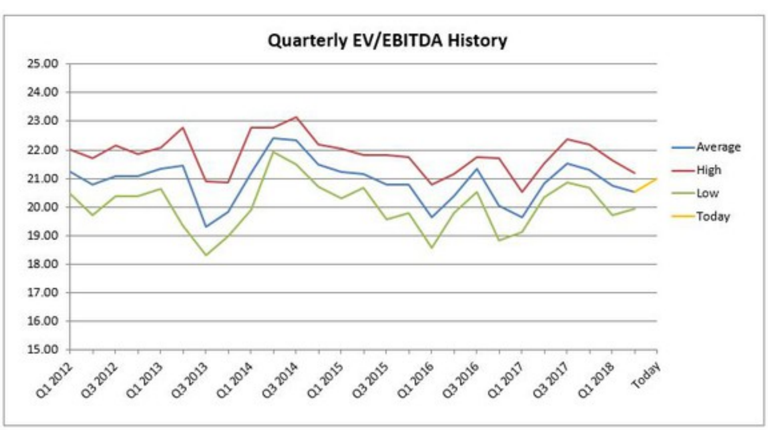
U.S. Growth Accelerates at American Tower

Published Aug 16, 2018 at 3:32PM

U.S. growth picked up considerably at **American Tower** (NYSE: AMT) in the second quarter of 2018 as unlimited data plans from wireless carriers continue to gain acceptance and demand for mobile data continues to grow. Thanks to high levels of network investment activity from all four major U.S. carriers, American Tower expects a robust business environment to persist in the U.S. throughout 2018. Since the U.S. business represents 55% of property revenue and 65% of operating profits, this is great to see for American Tower shareholders.

As we mentioned in our last earnings report, international growth should see ongoing weakness in 2018 because of the disruption in the Indian wireless market. However, the U.S. business continues to improve and the international business ex-India is also performing strongly, and American Tower remains on track to continue to increase its revenue and cash flow and expand ROICs across its growing asset base.

After spending much of the last two quarters trading at the low end of the company's historic ranges, American Tower's valuation is back to average levels, with a current EV/EBITDA (TTM) of 21. The market reacted favorably to this quarter's earnings report (closing up nearly 4% the day of the earnings release), with the stock price breaking out from its 2018 trading range and reaching stock price levels not seen since Q3 2017 (when valuation levels were higher):



What Happened?

CEO Jim Taiclet:

> "The rapid adoption of unlimited data plans in the U.S. wireless market has elevated aggregate year-over-year mobile data usage growth to roughly 40%. This is in turn fueling record levels of U.S. commenced new business for American Tower, resulting in Organic Tenant Billings Growth of 7.4% in the second quarter. Furthermore, given this robust data growth, deployment of new spectrum and the introduction of advanced technology across our U.S. tenant base, we are increasing our full year 2018 expectations for U.S. Organic Tenant Billings Growth to approximately 7%. We also anticipate a multiyear period of elevated demand in the U.S. as our tenants invest in 4G capacity and quality while launching mobile 5G networks, enhanced Internet of Things services and other initiatives that we expect will sustain demand for our comprehensive telecommunications real estate portfolio.
>
> Our Latin America segment posted second quarter Organic Tenant Billings Growth in excess of 12%, reflecting especially strong trends in Mexico and Brazil, and we also saw consistent, steady results in EMEA. In India, where we recently added approximately 20,000 Vodafone and Idea Cellular sites, the carrier consolidation process is progressing as we anticipated. We fully expect the reordered India mobile industry to invest significantly to bring 4G to its subscriber base once the carrier mergers that are under way are completed. Taken together, we expect our highly diversified international business to deliver strong, sustainable growth for many years to come."

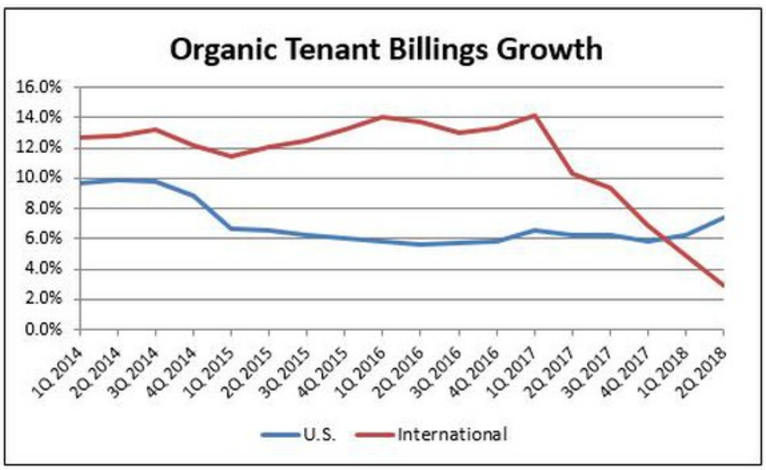
Get More

- Q2 2018 press release
- Q2 2018 supplemental materials
- Q2 2018 earnings presentation

For the second quarter of 2018, organic growth in tenant billings came in at 7.4% in the U.S. and 2.9% internationally, vs. 6.2% and 10.3% in the same quarter a year ago.

The disruption in the Indian market continued into this quarter (as expected), with -10.2% organic growth in the company's Asia (i.e. India) division because of an acceleration in consolidation-driven churn. Management expects that 2018 will be the high-water mark in terms of Indian carrier consolidation-driven churn "by a fairly wide margin," so while there may be continued pressure on this segment throughout 2018, growth should start to normalize in 2019 and be back to typical levels by 2020.

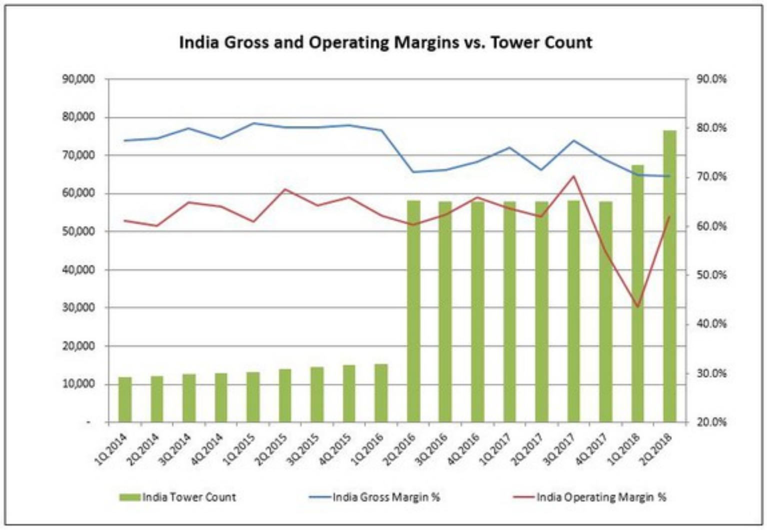
Outside of India, organic growth was more in line with historical growth rates, up 6.8% in Europe, the Middle East, and Africa (EMEA, which includes France, Germany, Ghana, Nigeria, South Africa, and Uganda) and 12.4% in Latin America (which includes Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay, and Peru).



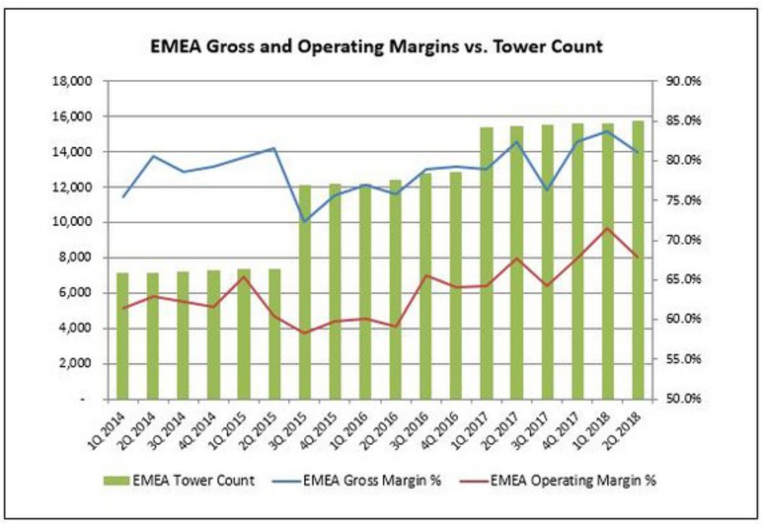
This is the second quarter in a row that U.S. growth outpaced international growth, and given the expected pressure in the Indian market, this result is unsurprising. Once the Indian market stabilizes, international growth should once again eclipse U.S. growth by a few percentage points.

So What?

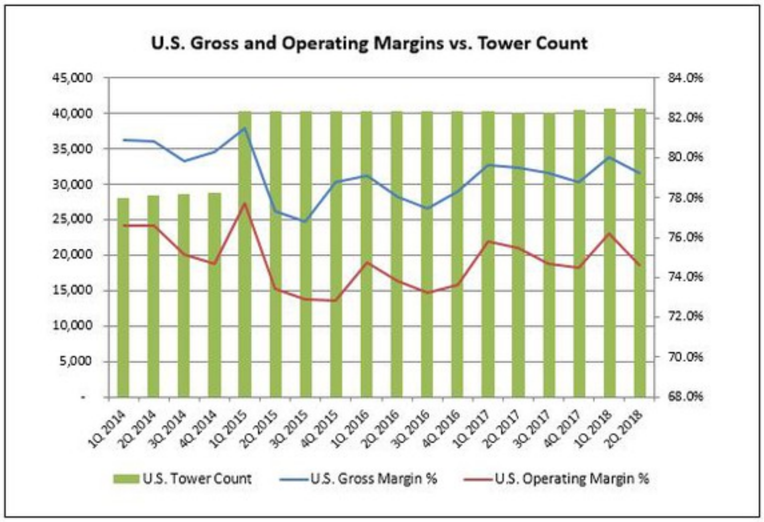
As we expected, the Indian wireless carrier consolidation has continued to affect growth rates and margins in that market throughout 2018, and that should continue through the rest of the year. This quarter featured the highest number of cancellations in the Indian market so far, but impairment charges and bad debt expenses were lower than in the last two quarters, so operating margins bounced upwards back toward historical levels:

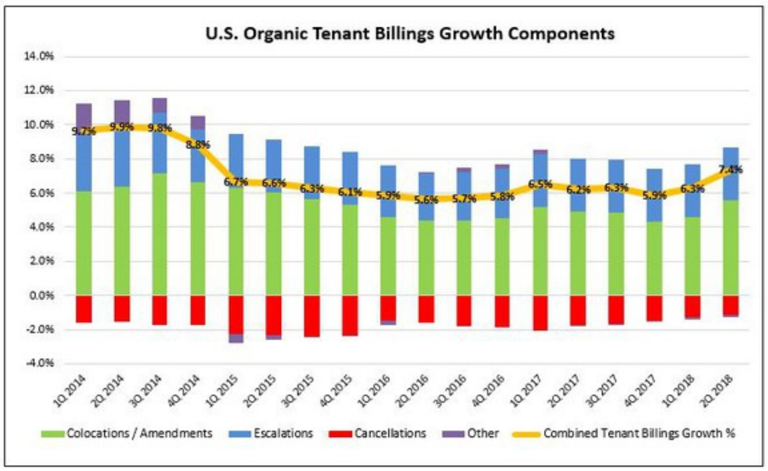


In Europe, the Middle East, and Asia (EMEA) and Latin America, margin trends are a bit lumpy because of some non-core factors (a default on a TV Azteca note in the Latin American segment, volatile foreign currency exchange rates, straight-line expense recognition, lower pass-through revenue), but growth trends are positive and management expects margin expansion over time as the company continues to generate organic growth on its extensive existing portfolio of assets.



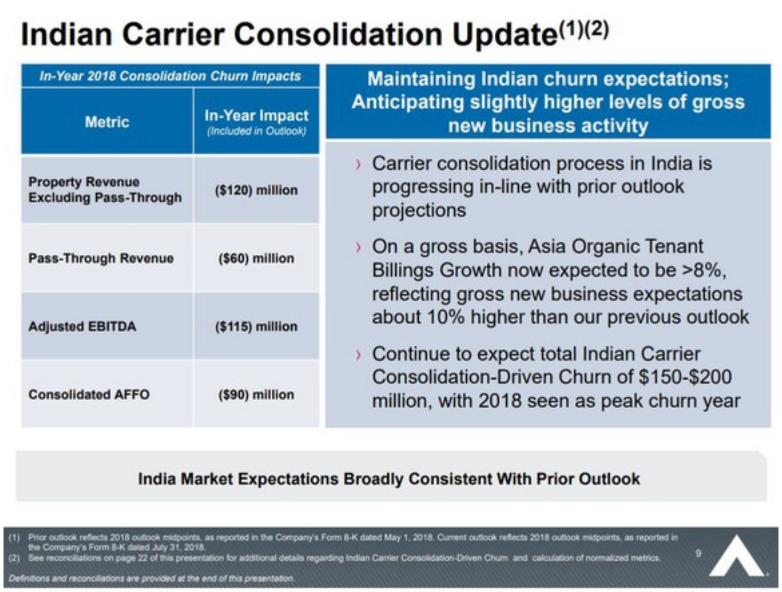
In the U.S., margin trends continue to improve. TTM gross margins increased year-over-year to 79.3% (from 78.8% a year ago), and TTM operating margins increased year-over-year to 75.2% (from 74.6%). We can see in the graph below that, since the significant **Verizon** (NYSE: VZ) acquisition in 2015 that acted to lower the margin profile of the entire U.S. business (thanks to the lower tenancy ratio on those new towers), management has been successful in slowly increasing margins via organic growth of the newly acquired (and existing) assets:



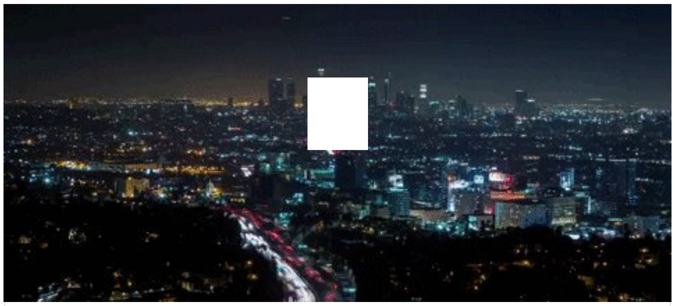


Now What?

The second quarter of 2018 represented a continuation of trends that started in the fourth quarter of 2017, as American Tower continued to digest the impact of Indian carrier consolidation, reporting accelerated churn levels as a result of Aircel's bankruptcy. Churn driven by this consolidation should continue to affect results throughout 2018 before stabilizing in 2019 and returning to normal levels in 2020:



Aside from the Indian market, the rest of American Tower's business continues to perform well. Growth in the U.S. business is accelerating, and prospects for the rest of 2018 and beyond look strong with all four major U.S. carriers in the process of what management expects to be a multi-year rollout of 5G technology. For example, see:



Verizon News
@VerizonNews

5G is coming. This is what you need to know: vz.to/2IZQ2Oy

37 6:58 AM - Aug 16, 2018

20 people are talking about this

Data and Guidance

- Current Price: $150.11
- Fair-value estimate (unchanged): $146
- Allocation: 3.8%, plus 0.7% in January 2019/October 2018 $80/$135 diagonal calls
- EV/EBITDA (2018 Outlook): 19.22

AMT remains a Best Buy Now, and its fair value is unchanged at $146. We also have 0.8% in diagonal calls, which expire in October (and the long calls expire a few months later in January 2019). With American Tower's next ex-dividend date likely to be sometime in late September, we'll have to make a decision before then about how to proceed; either closing our entire diagonal call position, rolling the short call out to 2019 to convert the position into a bull call spread, rolling out the long calls to 2020 or 2021 to continue a diagonal strategy, or exercising the long calls into stock. As we approach the ex-dividend date, we'll make our decision based on which choice we like best.

Pro Catch-Up Trades and Expirations: American Tower, Cooper, and More

Published Aug 16, 2018 at 2:40PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 3.8%.
- **CME Group** (NASDAQ: CME): Buy 2.3%.
- **JD.com** (NASDAQ: JD): Buy 2.4%.

Continue building your portfolio with our Buys, including:

- **NVR** (NYSE: NVR): Buy 2.4%.

Shorts:

-
    - N/A

Options:

- **Johnson & Johnson** (NYSE: JNJ): If you've yet to write covered calls, you can "sell to open" the October 2018 $135 calls from our recent trade alert, selling one call for every 100 shares you own and want to cover. Lately, they pay $1.60 each.

Upcoming Expirations:

- **The Cooper Companies** (NYSE: COO): Our August $230 (or $240, if you wrote those from the original alert) covered calls expire on the 17th. We plan to let our shares get sold through the covered calls -- taking no action. With the stock price north of $255 today, it looks like our shares will be called away this weekend.

Pro Guidance Changes and Completed Trades: August 13, 2018

Published Aug 13, 2018 at 3:53PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- None in the past week!

Pro Completed Trades (see transaction log; trades take a day to appear):

- **SPDR S&P 500** (NYSEMKT: SPY): Managing our synthetic short hedge, we sold to close our January 2019 $255 puts and bought to open an equal number of December 2018 $271 puts, paying a net debit of $1.38 to roll higher and in (not out) one month.
- **Square** (NYSE: SQ): We sold to close our September 2018 $55 puts for $0.19 each.

You can see all of our guidance, positions, returns, and transactions on or from the [Recommendations page](#).

Pro Catch-Up Trades and Expirations: Cooper, NVR, and More

Published Aug 9, 2018 at 4:11PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **CME Group** (NASDAQ: CME): Buy 2.3%.
- **JD.com** (NASDAQ: JD): Buy 2.4%.

Continue building your portfolio with our Buys, including:

- **NVR** (NYSE: NVR): Buy 2.4%.

Shorts:

-
    - N/A

Options:

- **Johnson & Johnson** (NYSE: JNJ): If you've yet to write covered calls, you can "sell to open" the October 2018 $135 calls from our recent trade alert, selling one call for every 100 shares you own and want to cover. Lately, they pay $1.54 each -- considerably better than last week. For those who wish to aim for more upside in the stock in exchange for lower income, you can consider writing October 2018 $140 calls instead.

Upcoming Expirations:

- **The Cooper Companies** (NYSE: COO): Our August $230 (or $240, if you wrote those from the original alert) covered calls expire on the 17th. We plan to let our shares get sold through the covered calls -- taking no action. So, unless something drastic changes, we are doing nothing and letting our shares get sold away after expiration next weekend.

Sell to Close Your Puts on Square

Published Aug 7, 2018 at 2:58PM

Is this for you? *Pro* members who own September 2018 $55 puts and who want to recover about 30% of their cost can make this closing trade. If the money you'd receive by closing isn't worthwhile to you, you can keep owning the puts as a form of insurance against a (low-probability) big decline in the stock sometime soon.

How You Participate

- **Action:** Sell to close your Sept. 21, 2018, $55 puts on **Square** (NYSE: SQ). (Leave your short calls on Square alone for now.)
- **Allocation:** We're selling all of the $55 puts we own.
- **Price Guidance:** Use a **limit order** at the going prices when you go to enter your trade. Lately, that's $0.25.
    - Stock: $70.50
- **Stock Scorecard Status:** Buy. Allocation is 5.5%.

What We're Thinking

Hybrid payment processor, software and services seller, and small-business lender Square reported accelerating growth again last quarter, with net revenue up 48% to $815 million and adjusted revenue up 60% year-over-year to $385 million. The adjusted revenue compares with 51% annual growth in the first quarter. GAAP net loss in the quarter was $6 million compared with $16 million a year ago in Q2, as Square rolls closer toward GAAP profits.

For the year, the company increased its adjusted revenue growth rate to an estimate of 55%, up from the previous guidance of 49%. This is pretty heady growth, and investors were pleased, sending Square's stock higher -- and helping our portfolio jump ahead of our North Star again so far this year.

Why This Strategy?

We're closing these puts because the stock is lately 22% above our strike price, and with 45 days to expiration -- and good news on Square so far -- it seems unlikely that the stock will lurch back toward $55. Lately, we can recapture about $350 ourselves by selling to close these $55 puts now; that's about 30% of what we paid for them (and that was paid for by selling calls on Square, so this would add to our net credit so far).

Meanwhile, we're leaving our short calls alone. Most members wrote $75 calls as the original alert targeted. By the time we could place our trade more than 24 hours later, the $80 calls paid as much, so we wrote those and bought $55 puts, still at a credit. We'll guide you on the $75 calls as needed, as the time value dissipates. For now, they serve as a small cushion for us, with more than $2 in time value waiting to be earned as long as Square remains below $75. So, let those be for now, is our thinking. We'll close or roll them later if it seems pressing. Or, we'll let them expire if that's their fate.

Meanwhile, we'll continue to consider ways to hedge or protect our Square position, which is now 5.5% of the Pro portfolio -- our fourth-largest position. We'll especially look to do so around the next earnings report.

Pro Can Help

- Questions on this short-term protective position? Click over to *Pro*'s Options board.

Pharma Growth Accelerates at Johnson and Johnson

Published Aug 7, 2018 at 2:40PM

Second-Quarter 2018

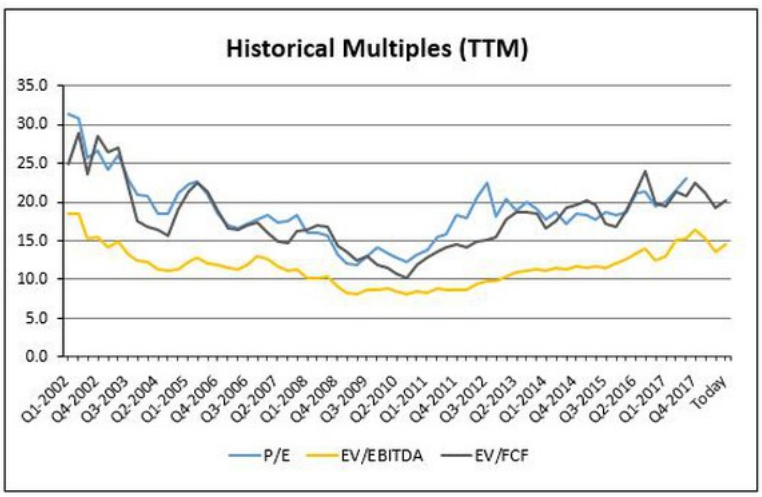
- Press Release
- Earnings Presentation
- Supplementary Sales Data
- Sales of Key Products & Franchises
- 10-Q Filing

Johnson & Johnson (NYSE: JNJ) continued its strong pharmaceutical segment performance in the second quarter of 2018, reporting acceleration in pharmaceutical sales growth for the fourth straight quarter and year-over-year total sales growth of 10%-plus for the fourth straight quarter. Companywide sales growth of 10.6% was paced by 19.9% growth in the pharmaceutical division, which now accounts for 50% of total sales.

Companywide operational sales growth (i.e., ex-currency and ex-acquisitions) came in at 6.3% for the quarter. On an adjusted non-GAAP basis, J&J posted 14.8% year-over-year earnings-per-share growth for the second quarter. Management increased its operational sales growth guidance for 2018 to 5% growth (from 4.5%) and slightly increased its guidance for adjusted EPS growth to 11.2% (from 11%). Since reporting Q2 earnings on July 17, the stock has increased by nearly 6%, with the market assessing the quarter's results favorably.

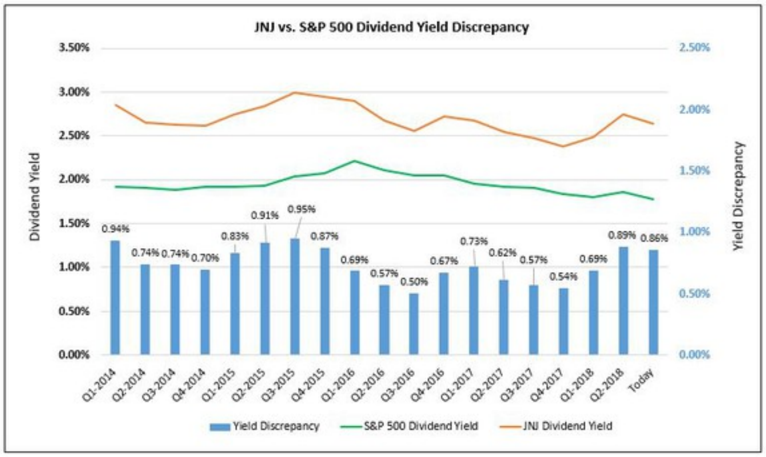
- **Updated guidance**: Buy (no change)
- **Recommended allocation**: 2.6%, with October 2018 $135 covered calls.
- **Fair-value estimate**: $140 (no change)
- **Current price:** $131.84

At about $132 per share, the stock is priced at 14.5 times trailing-12-month (TTM) EBITDA and 20.3 times TTM free cash flow:



Based on management's guidance, J&J is priced at about 16.3 times 2018's non-GAAP earnings -- slightly below the S&P 500, which is trading at about 17.8 times expected 2018 earnings estimates (and 16.5 times 52-week forward earnings estimates). The stock has recovered a bit from recent lows, although the price is still below where it started the year and is 11% below its all-time high of $148.32 set in mid-January.

Because J&J has such a consistent history of dividend payments, one of my favorite ways to monitor the company's relative valuation is to compare its dividend yield to that of the S&P 500. This comparison strips out the confounding effect of interest rates that occurs if you look at J&J's dividend yield in isolation (since dividend-paying stocks tend to fluctuate in price alongside interest rates). When we make this comparison, J&J looks attractively valued relative to the S&P 500, although not as attractive as last quarter:

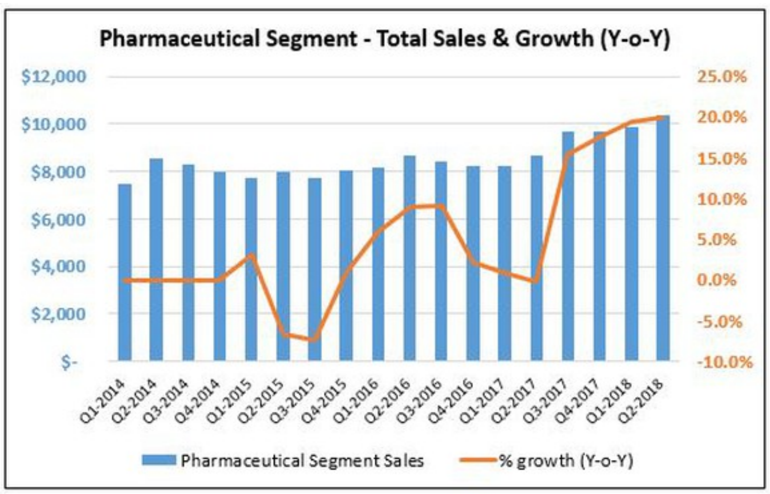


The yield discrepancy between J&J and the S&P 500 has narrowed a bit since last quarter, but is still about as high as it's been since the fourth quarter of 2015. Since 1997, the average yield discrepancy between the S&P 500 and J&J has been 0.65%, and it's currently at 0.86%.

Our fair-value estimate remains at $140, and Johnson & Johnson remains a Buy. Members who have yet to start or fill out their positions can feel comfortable doing so at current prices. We also have October 2018 $135 covered calls, and if you've yet to write these covered calls, pricing is attractive and you can do so now if you wish. With these covered calls, by October expiration we're prepared to sell our shares at or above $135 (if we have to), or if we can roll our calls out and/or up attractively, we will consider that as well.

Division Performance

J&J's pharmaceutical division continued its strong growth in the second quarter, bolstering the entire company's results given that this division is the company's largest by sales volume:



Pharmaceutical sales growth accelerated to 19.9% year over year (18.1% TTM y-o-y growth), up 11% excluding the impact of the Actelion acquisition. Drugs in the oncology market continued to lead the pace, with Darzalex sales up 71%, Zytiga sales up 63%, and Imbruvica sales up 38%. JNJ's pipeline remains promising, with two new launches in 2018 (Erleada and Tremyfa) and the expected regulatory approval of eight other new drugs by 2021, each of which has $1 billion in peak revenue potential. Tremyfa, a new treatment for psoriasis, was called out in the conference call, having launched earlier this year and posted $126 million in sales in the quarter (up from $72 million last quarter). Tremyfa now has more than 15,000 patients on therapy, and already has a 5% share of the psoriasis market. The pulmonary hypertension drugs acquired from Actelion continue to see accelerating growth. We expect the pharmaceutical division to continue to be the predominant driver of growth for Johnson & Johnson.

In addition to the strong growth from the pharmaceutical division, the consumer division and the medical device division posted year-over-year revenue growth of 0.7% and 3.7%, respectively. The company held a review meeting for the consumer and medical device businesses in May, and there were some comments from Jorge Mesquita (the executive VP and chairman of the consumer business) that I found particularly interesting, showing that management at the consumer business is aware of the challenges it faces and that they will need to continue to innovate and market effectively to avoid remaining stagnant:

> "What we're seeing is that the competitive advantages upon which the FMCG industry has been built are not as relevant today as they once were. So for example, it used to be that large companies like J&J had a competitive advantage in terms of attracting the best talent. But what we're seeing today is that for students joining the workforce, joining a smaller company, a start-up enterprise that is more entrepreneurial, has certain appeal to them. It used to be that building and nurturing brands was something expensive that only large companies like ours could do, but the reality is that it's relatively affordable now for you to build a brand online and to create an active community of loyal users very efficiently. It used to be that manufacturing assets, large plants, was a moat, a barrier for entry. But again, you see today across the world that small companies, new entrants can access excellent contract manufacturing in just about every region.
>
> "Retailer relationships are very important, and we're very proud of them. But if you are a newcomer to this industry, you can sell directly to your consumers online efficiently. Innovation, as I said, has been and will continue to be an important source of differentiation. But these small entrants that join our industry can do so as well by outsourcing some of those elements of innovation. And then lastly, financial firepower, a great strength of Johnson & Johnson, is not an impediment for a new entrant to come to this industry. Given this relatively low interest rate environment, abundant VC capital, even crowd financing, it's relatively easy to raise the money you need to start a new business."

Management reiterated multiple times during the review meeting that both the consumer and medical device businesses are "aggressively taking action" to position themselves for better growth in 2018 and beyond, and over time we'll see if the initiatives they are working on will spark growth in those two challenged business segments.

Our Thesis

Johnson & Johnson is is a diversified health-care conglomerate, with more than 260 operating companies organized into three business divisions: consumer, pharmaceutical, and medical devices. At eight out of eight of our *Pro* quality criteria, J&J is a quintessential *Pro*-quality stock. While its large size means we don't expect runaway growth and upside, we do expect to earn North Star-challenging returns with low downside risk from one of the safer stocks you are likely to find in the entire investment universe.

After NVR's Earnings Report, Pro Is Staying the Course

Published Aug 6, 2018 at 3:38PM

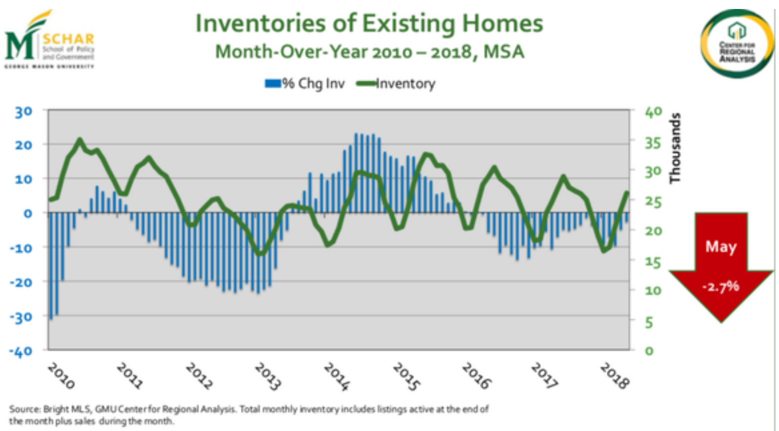
Fellow Fools,

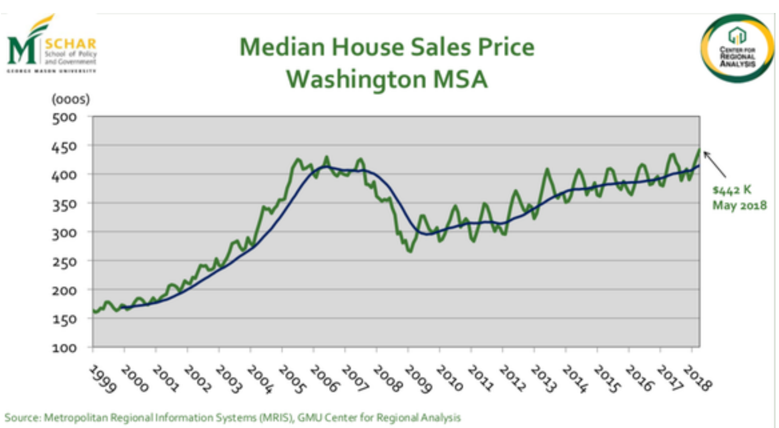
It's not very often you see a stock fall by over 8% after reporting decent quarterly results — and especially where revenue and diluted earnings per share rose 16% and 39%, respectively — but that's exactly what we saw late last month with **NVR** (NYSE: NVR).

If forced to hazard a guess as to why, I'd point to the deceleration in new orders which, at 6% year over year growth, was the slowest we've seen since the first quarter of 2016 and a sharp contrast to the 17%, 18%, and 21% growth we saw in the preceding three quarters. Since new orders are a leading indicator for what the company's financial statements will look like in the future, these numbers probably deepened some investors' fears that rising home prices and rates could lead to an extended slowdown in the housing market.

It's important to keep in mind that we didn't purchase shares of NVR with a short-term thesis in mind; however, we still optimistic that we're not headed for a repeat of a 2007-2008. For starters, NVR's new orders don't look nearly as bad when you look at the results on a six month basis — the 11% growth in the first half of 2018 was the fastest start to a year since 2015.

Although the company is running up against difficult comps for the remainder of the year (new orders rose 19% in the second half of 2017), we believe NVR could be poised for a rebound in 2018 as regional demand appears to still be outpacing supply. That is a favorable setup for NVR, when you consider the continued decline in existing home inventory. And although housing prices have steadily risen, we believe the imbalance between supply and demand will result in the market being able to absorb these price hikes.

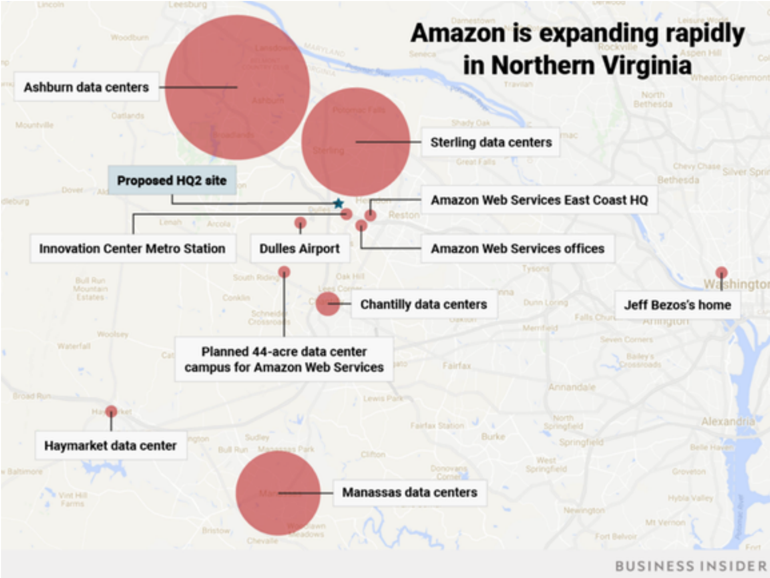




source: GMU Center for Regional Analysis

We'd also be remiss if we didn't mention the potential windfall coming if **Amazon** (NASDAQ: AMZN) decides to build its second headquarters in the region. With three of the 20 finalists located in the DC metro area, Jeff Bezos' ties to the area, and the company already expanding in the region (Northern Virginia's Dulles Technology Corridor has been referred to as both "the Silicon Valley of the East" as well as "Data Center Alley," and was previously estimated to house up to 70% of Amazon Web Services' IP addresses), it's not unreasonable to think that Amazon HQ2 will make its home here.

And with Amazon stating that its expects to bring as many as 50,000 jobs with an average salary of $100,000 to wherever it constructs HQ2, the region's homebuilders would likely benefit for years to come if Northern Virginia, D.C., or Montgomery County win.



Source: Business Insider

That's not to say that there aren't any potential headwinds for NVR.

Outside of a potential slowdown in the housing market, NVR may also have to finally contend with labor issues — namely, a lack of quality builders and rising wages. After years of being able to avoid labor issues that have affected many of the national builders due it to its smaller, regional footprint, NVR now finds itself thrust into the middle of a political battle that could change all that.

As it currently stands, El Salvador is set to lose its Temporary Protected Status next year, meaning an estimated 262,500 Salvadorians currently residing in the U.S. must leave by September of 2019. At less than a tenth of one percent of the population of the U.S., this might initially sound insignificant from an economic perspective — but, ironically enough, this will likely end up being a huge blow to the area, since the greater Washington region relies heavily on foreign born, non-citizen workers. Almost one in every six workers in the region fits this criteria. And the largest country of origin? You guessed it: El Salvador.

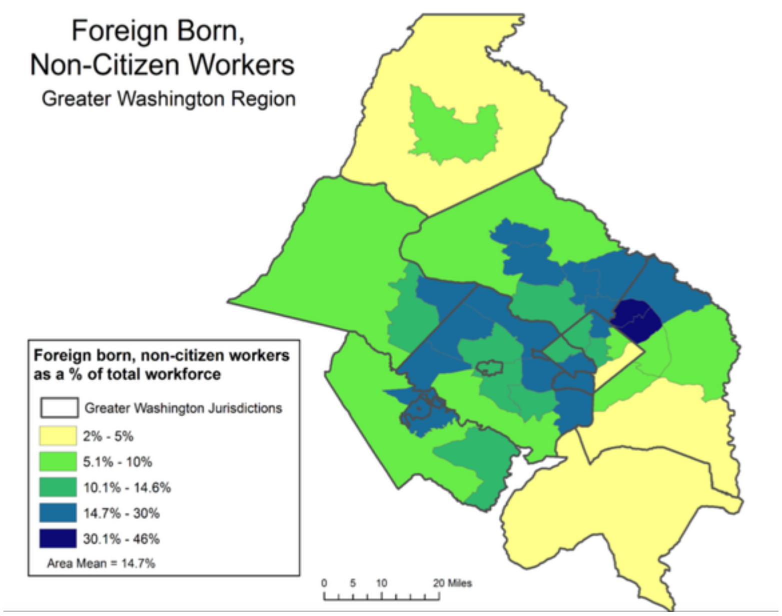
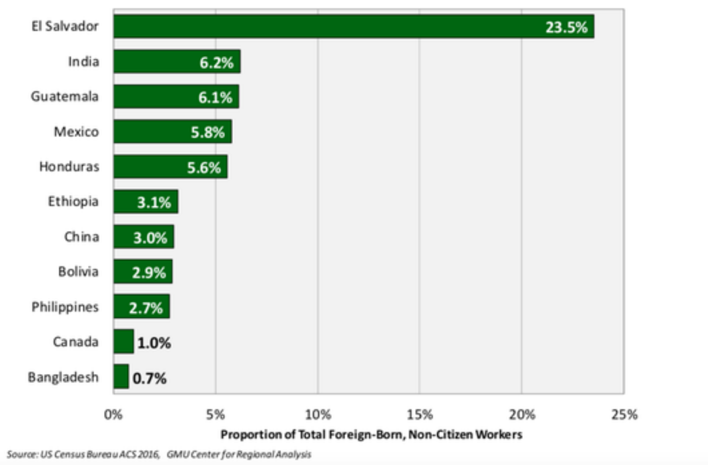


Figure 5: Foreign-born, non-citizen workers in the Greater Washington region by country of origin



source:GMU Center for Regional Analysis

And for the construction industry, it's even more troublesome. It's currently estimated that more than 52% of the industry workforce is comprised of foreign-born, non-citizen workers, with almost a quarter of the total construction workforce coming from El Salvador. With many of these individuals filling lower paying jobs within the industry, odds are, this will hurt the industry's margins if the situation doesn't change before next year.

Figure 7: Proportion of foreign-born, non-citizen workers in different occupational groups

Occupation Group	Foreign-Born, Non-Citizen Workers	% of Total Occupation Workforce
Construction & extraction	65,940	52.4%
Cleaning & maintenence	52,750	48.6%
Farming, fishing, & forestry	1,150	38.0%
Food preparation & serving	43,770	32.6%
Production	14,220	28.0%
Healthcare support	10,300	21.6%
Personal care & service	21,160	21.3%
Transportation & material moving	22,870	20.7%
Life, physical, & social science	10,890	18.1%
Installation, maintenance, & repair	9,190	16.6%
Sales	33,990	14.1%
Computer & mathematical	21,520	10.1%

source: GMU Center for Regional Analysis

With the uncertainties surrounding the business (both good and bad), we've decided to keep our Buy rating on NVR unchanged. However, we are still very optimistic that the company will soundly beat the North Star over the next five years and are increasing our fair value to $3,100.

In the interim, however, odds are good that NVR's share price will continue to fluctuate wildly. Mr. Market's opinions on NVR swing from positive to negative at a moment's notice. But long-term minded Fools should view this volatility favorably, since this provides management with opportunities to repurchase shares at attractive prices.

Pro Catch-Up Trades and Expirations: Apple, Square, and More

Published Aug 2, 2018 at 12:51PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.9%.
- **CME Group** (NASDAQ: CME): Buy 2.3%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): If you don't have a position yet, we're happy to list Apple here as it surpasses $1 trillion in market value today! Buy 3% to start, and later up to 5.2% if you want to match us. We're watching closely to have confidence Apple will keep growing.
- **Facebook** (NASDAQ: FB): If you don't have a position, start with a 3.5% stake.
- **Zuora** (NYSE: ZUO): Per last week's trade alert, buy 1.6%, ideally for less than $26 with a limit order.

Shorts:

- **New to the SPDR S&P 500** (NYSEMKT: SPY)**?** If you do not yet have a synthetic short set up and you want one, sell to open Dec. 21, 2018, $287 calls and buy to open an equal number of Dec. 21, 2018, $271 puts. Lately, this can be set up for a net credit of a few cents per synthetic short, or at worst no cost. Set up one synthetic short for every $27,100 in look-through short exposure you want via owned $271 puts and every $28,700 of potential short exposure via short $287 calls. *Pro* has a 15% look-through position, or 17 contracts of each.
- **Rolling your SPY puts?** As in this week's trade alert, roll your January 2019 $255 puts up to Dec. 21, 2018, $271 puts, if you wish (as we are doing) to make them more responsive. The cost is lately a $1.87 debit per put.

    - **Bearish SPY spread instead?** If you're not comfortable setting up synthetic shorts, but do want a short position on SPY, then consider a bear put spread instead. Using a spread order, simultaneously sell to open Dec. 21, 2018, $265 puts, and use the proceeds to buy an equal number of Dec. 21, 2018, $280 puts. Lately, this costs about a $3.50 debit per spread, with a potential maximum value of $15 per spread achieved if SPY ends the expiration below $265, or at least 5.8% lower. If SPY remains above $280, then the spread ends without value. So, every $350 that you risk per spread will be lost in that latter case.

Options:

- **Johnson & Johnson** (NYSE: JNJ): If you've yet to write covered calls, you can "sell to open" the October 2018 $135 calls from our recent trade alert, selling one call for every 100 shares you own and want to cover. Lately, they pay $2.53 each -- considerably better than last week. For those who wish to aim for more upside in the stock in exchange for lower income, you can consider writing October 2018 $140 calls instead.
- **Square** (NYSE: SQ): If you haven't set up the protective collar yet, earnings are out, and the stock is up, so the collar does not look necessary at this time. But you never know. So, if you still want to set it up, set up a collar on half of your shares by (now) selling to open Sept. 21, 2018, $80 or $85 calls, and using the proceeds to buy an equal number of Sept. 21, 2018, $60 puts. You'll still have some proceeds left over. This does cap upside on half your shares, though, and again -- it appears we won't need this extreme protection unless the market really goes south. So, only set it up at your discretion. We will manage our existing collar as needed before expiration -- or let it expire if Square remains between our strike prices.

Upcoming Expirations:

- **The Cooper Companies** (NYSE: COO): Our August $230 (or $240, if you wrote those from the original alert) covered calls expire on the 17th. Before then, we'll have guidance as needed.

Celebrating Apple and Paycom

Published Aug 1, 2018 at 1:37PM

Greetings, *Pro* members,

Today, I moved aside other obligations to instead spend some time celebrating with you -- with this surprise column. I do this not only to celebrate, but in hopes of making a few Foolish points to remember.

First, **Apple** (NASDAQ: AAPL) is up 5% as I write this, hitting a new all-time high after last night's earnings, which revealed revenue that was up 17% and earnings per share that had risen 40%. At $200, Apple's stock is just a few dollars away from giving the company a $1 trillion market value, which would make it the first company to hit that milestone on the public U.S. market. Given Apple's guidance for the next quarter and the stock's valuation, it's probably only a matter of time -- perhaps days -- before we're all reading the "Trillion Dollar Apple" headline everywhere.

But what can we learn from this? When *Pro* first bought Apple in 2012 (after writing options on it that ended in income in 2011), I remember going a few extra miles to try to make the write-up convincing. I was certain that members would think, "Why Apple now? Aren't we late? Apple is already so big." Indeed, it was the most valuable tech company on the planet in 2012, worth more than $400 billion. Today, it's still the most valuable tech company on the planet, worth nearly $1 trillion.

Although the report provided plenty of details, our main argument was simple. (You can see it atop the report here.) In a nutshell, I wrote that shares were cheap because the world doubted Apple's staying power. And the market opportunity was still large, in our opinion, because mobile computing was still in its infancy. That remains true today. Sure, Apple's phone unit sales indeed seem to have peaked for now (and perhaps forever), but it's making more money per phone, and service revenue continues to increase sharply.

Our investment -- to which we later added a tiny bit more -- is up about 183%, about 190% when you include dividends. So, since our first buy report on Valentine's Day 2012, we're close to tripling our money in Apple in six and a half years. And this was a stock that I was a bit leery to recommend because I knew we would look like latecomers to the iPhone party (even though the iPhone was less than five years old at the time).

Now, companies do of course face greater challenges as they get ever larger (offset at least somewhat by greater advantages), and we should expect lower returns, overall, from the giants of our time. But lower isn't the same as lackluster. As long as Apple and its enormous tech peers (which I don't need to name) can continue to increase value for their customers, keep employees excited, and serve the community, they should be able to expand their value. And how enormous are these companies, really? The market and the economy for tech are all but worldwide now, and still a majority of people aren't connected. Those people typically have the least resources, but over the coming decades, that should change.

Although the ripest fruit has largely already been picked by the tech giants, there's likely still plenty more to harvest -- and enjoy -- from our connected world in the years to come. 5G speeds, advancing artificial intelligence, and safer social communities will all help speed more business online. The opportunity comes from investing in some of the giants, of course, but perhaps even more so from investing in some smaller newcomers.

To that end, one of our Best Buys Now, **Paycom** (NYSE: PAYC), is up 17% today as I write this -- 17% in *one day*, soaring to new highs. It's up more than 20% over the past two days. And in the 21 months since *Pro*'s November 2016 buy recommendation, the stock is up 190% for us -- like Apple, it's nearly tripled. The biggest mistake I made was only buying a 2% stake. That's now 4.6%, the seventh-largest position in the portfolio. And even that starting stake has been enough to make a real difference.

That's not the point I want to make about Paycom today, though. Instead, I want to point out that the stock is up 17% in a day, and most of us are probably just nodding and saying, "Yes, that's right. This is what we expect our stocks to do -- go up." And we move on with our day, a little more happily (I hope). But when a stock *falls* 17%, the anguish we feel can be extreme. Our boards usually light up, too. "What's happening?! What do we do?" And that's natural. That's human nature.

But that's why today we should pause and recognize that these two differing reactions point to somewhat *illogical* human nature. Stocks go up and down. We should be no more surprised by a drop than by a pop. That just happens. Sure, we want to investigate big declines and make certain we want to stay invested; but we shouldn't be anguished by the decline, or feel we did something terribly wrong. It just comes with the territory of investing in stocks. If we're going to accept big jumps as a "given" -- like Paycom today, or **Coherent** (NASDAQ: COHR), which is up 15% today (albeit after a steep decline in past months) -- then we should do our best to accept drops as a given when owning individual stocks, too.

They happen.

In either case, it's enriching to then work to figure out *why*. Why is Paycom up so much today? (I don't know yet, because I haven't had a chance to comb through last night's earnings.) And when a stock falls sharply, we want to know why then, too. But they're two sides of the same coin. And the more calmly you can accept a price decline, the more rational your next investing choices will likely be.

So here's to Apple, and Paycom, and Coherent today! And here's to the drops we'll see with some stocks on another day. If stocks didn't fall sometimes, they wouldn't reward us so well. We need movement in both directions to make the market work the way it does. Here in *Pro*, we do our best to avoid big losers, but we've had our share. We do our best to keep from feeling anguished by them. Instead, we work to rationally learn from what's happened, and improve our next choices from there.

To share any thoughts, please visit the Memo Musings board. And Fool on!

-- Jeff (TMFFischer)

Set Up a Protective Collar on Half of Your Position in Square

Published Jul 31, 2018 at 12:55PM

Is this for you? Any *Pro* members who own at least 100 shares of this stock, and who want to protect against downside, can consider following this recommendation before earnings at market close tomorrow, Aug. 1.

How You Participate

- **Action:** Set up a protective collar on **Square** (NYSE: SQ).
- **Trade:** Simultaneously ...
    - **Sell to open** Sept. 21, 2018, $75 calls.
    - **Buy to open** Sept. 21, 2018, $55 puts.
- **Allocation:** Set up one protective collar (one of each option) for every 100 shares you want to protect. *Pro* will collar 1,400 of our 2,800 shares, setting up 14 contracts of each. This protects half of our position, leaving half of our shares -- a 2.6% allocation -- uncovered.
- **Price Guidance:** Use a **limit order** and initially aim to set this up for **credit**. Prices will fluctuate as the stock moves, with the trade getting less expensive to execute if shares rise, and more expensive if the stock declines. At recent prices, you would aim for a credit of $0.45 or so. If prices change a lot before you make your trade, consider using different strikes, rolling both options up or down accordingly to target no cost or a credit. We will use different strikes if we need to when we make our trade tomorrow.
- **Recent Prices (10 a.m. ET):**
    - Sell to open Sept. 21, 2018, $75 calls (splitting bid/ask): $1.76 credit
    - Buy to open Sept. 21, 2018, $55 puts: $1.31 debit
    - Net credit: $0.45 per collar (use a **limit order**). As that price changes, still aim for any credit, or no cost.
    - Stock: $65
- **Scorecard Status:** Buy. Allocation is 5.3%. We're putting a collar on half of our shares.
- **Special Note:** Square announces earnings tomorrow, Thursday, Aug. 1, after market close, so we plan to execute our trade before that time.

What We're Thinking

Our investment in Square has appreciated about 150% in 13 months, becoming our fourth-largest position, at 5.3%. Today's trade is simple insurance against a price decline of 15% or more in the coming weeks after tomorrow's earnings, while still giving us 15% upside on the covered shares, to $75. By collaring half of our shares for the duration of these options, we lower our allocation risk in the stock to a more reasonable 2.65%. Square has run up fast and is difficult to place a reliable value on. If Square pleases investors with its earnings, the stock could resume its march higher. If not, like Twitter or Facebook before it, it could be taken down a few pegs. Hence, our insurance policy.

Why This Strategy?

A protective collar is a friendly hedge because it can cost little to nothing to set up (or even pay you, as in this case), yet it protects you from big downside. Plus, it gives the stock you cover with short calls some upside before reaching the strike price of your short call. In this case, we have about 15% upside in the shares we're covering, and we have downside protection on these shares starting about 15% below the current share price. We are protecting against big disappointment, and still allowing for big upside.

What happens next? If the stock stays between our two strike prices, the options would be on track to expire unused, and we've earned a small credit. If the stock falls below our long put's $55 strike price, we can sell our puts at a profit, or sell those shares of our stock at the strike price. We would decide that when appropriate (today, we lean toward just selling to close the puts). Finally, if the stock rises above our short call's $75 strike price, we could let our covered shares be sold at $75, or we could close or roll the calls if we want to keep our shares (we would likely need to pay to do so). Half of our position continues to enjoy uncapped upside and the accompanying downside risk.

Alternative Trades

- **Own fewer than 100 shares and want protection?** You shouldn't sell a call option if you own fewer than 100 shares (because the call represents 100 shares), but if your Square stake is still a large enough part of your portfolio that you want to protect it, you can buy a put option and have more protection than you need. The Aug. 17, 2018, $55 put is lately about $0.60, so it's $60 for one put, or about 0.9% of the stock's recent value, and the stock needs to fall 15% to hit your strike. You can buy this insurance if the cost is worth it to you (and I'm saying August rather than September to keep your cost down).
- **Own 100 shares?** You could collar all of it, if you like, even though we're only collaring half of our holdings. It's simply your choice whether you want to collar all or none of your shares.
- **Just own Square calls or a synthetic long?** You can effectively collar a portion or all of those positions, too, if you wish.
- **Not using options?** Make sure you're comfortable with the size of your Square position. The stock remains a Buy, and we don't plan to sell any shares unless the story changes. This insurance is a "just in case." If the story does change, we'll of course issue a trade alert with new guidance.

Pro Can Help

- Questions on this short-term protective position? Click over to *Pro*'s Options board.

Roll Your Long Puts on SPY

Published Jul 30, 2018 at 3:10PM

Is this for you? This is for *Pro* members who set up a split-strike synthetic short to hedge this ETF with us in March (or at later dates) and who now own puts on it that are at least $10 out of the money. We're rolling our puts up (and in) to make them more responsive to a market decline. We're leaving our short calls in this synthetic short alone for now; we plan to address those at a later date. (Here's a reminder about why and how we hedge in the first place.)

How You Follow Along

- **Trades:** Ideally, use a rolling order to roll your long puts on the **SPDR S&P 500** (NYSEMKT: SPY):
  - Sell to close all January 2019 $255 puts.
  - Buy to open an equal number of Dec. 21, 2018, $271 puts.
- **Allocation:** Roll all of your existing put contracts. *Pro* originally hedged 15% of its long investments (cash excluded), which for us meant a hedge with a look-through value of approximately $433,000. So we set up 17 puts. At home, for a 15% allocation, you would own one $271 put for every $180,000 or so in long stock you own. But if you already set up this synthetic short in March, just roll all the January 2019 puts you own to December 21, 2018.
- **Price (11:50 a.m. ET) and Guidance:** With the ETF at $280.50, you'll get about $3.95 in credit to sell to close the January 2019 $255 puts, and you can buy to open the new Dec. 21, 2018, $271 puts for the cost of about a $5.95 debit -- for a total net debit of about $2 (or $200) per put you roll. These prices will change a bit as SPY moves.
- **Later Guidance:** If SPY moves much in price before you act, you may want to move your *new* put strike price up or down accordingly, to continue to roughly target puts that are about 3% out-of-the money from SPY's price. If SPY's price changes much before *Pro* can make its rolling trade, we'll adjust our put new strike accordingly.

What We're Thinking

Since we set up this split-strike synthetic short in March as a broad market hedge, the S&P 500 has gained more than 4%. To refresh your memory, the SPY ETF traded at $267 when we recommended a $255/$285 spread on it, and now -- after a good run in July -- the ETF is at about $280. Being well out of the money now, the $255 puts we own will be less responsive when the market declines. In fact, today the delta on these puts is 0.19, meaning they'll only move about 19 cents for every $1 move in SPY itself. By rolling up to $271 puts, we'll reset to a 0.33 delta, so these new puts should be 74% more responsive than our old $255 puts -- and that responsiveness will grow if and as SPY falls.

Other than put ratio spreads -- which require a commitment to potentially buying shares and become a liability during a large decline -- I've yet to find a hedge that doesn't cost you something. You pay for a hedge, just as you pay for insurance. But we can minimize the cost, as this strategy has done so far. We paid almost nothing out of pocket to set up our synthetic short in March, and today we would have to pay about $4 per spread to close it entirely, while the ETF has gained $13 per share. If we had shorted SPY directly, our cost to hedge (or our loss) would be about three times larger than it is. So, the syn short has served us well.

Anyway, rather than paying about a net $4 cost to close our synthetic short entirely, we're paying about $2 just to roll our puts up and earlier to December. Again, this makes the puts more responsive, and still keeps our position going as a hedge. We're keeping our short January $285 calls open for now, given the ample time value they hold. It would be illogical to roll them in to an earlier month; we'd collect less time value by doing so. Instead, we'll manage both options as needed, looking to close both at better prices if and when SPY declines meaningfully anytime between now and Dec. 21.

Why This Strategy

As a refresher, the strategy we're using is called a *split-strike* synthetic short because the two strike prices differ (and now, with today's put roll, our expirations will differ by a month as well -- a not particularly meaningful variance). The two options' effect on our portfolio is similar to that of shorting SPY, but with some leeway or distance on both sides. A synthetic short like this ends in losses if SPY rises above our short call's strike price by expiration. The synthetic short provides gains if SPY declines and we close it early, or if SPY declines below our long put's strike price by expiration (at which point we'll close it). If SPY remains between our two strike prices ($271 and $285 after this roll) and we don't act beforehand, the position will expire unused.

Of course, you don't need to set up any hedge if you don't want to. Only do so if it makes sense for your situation. And if you don't want to roll your existing $255 puts, you can continue waiting. Just realize that those long puts won't be very responsive to a market decline right now, which takes away from the effectiveness of our current hedge -- that's why we're rolling them higher. Plus, we're rolling the puts to December to make them more responsive over the next few months, and to pay less to roll up. It makes sense to roll in and pay less for new puts because we're already planning to close the whole synthetic short around November or early December, depending on the situation at hand.

Alternative Trade (advanced investors only)

- **IRA-Friendly:** If you're using an IRA and can't set up a synthetic short, you can consider a bear put spread. If you did that in March, you sold to open January 2019 $245 puts, and bought to open an equal number of January 2019 $255 puts for about $2.66 per spread. Today, with SPY higher, that spread is worth about $1.24. You can roll it to a Dec. 21, 2018, $270/$260 spread for a new cost of about $1.78 per spread -- so a total net debit of about $0.54 per spread, while rolling your long puts up $15 in strike price. That's a good roll in and up for a potentially more effective spread. Newcomers can consider just setting up this new spread, selling to open Dec. 21, 2018, $260 puts and buying to open an equal number of Dec. 21, 2018, $270 puts -- lately for that $1.78 or so cost per spread. The spread will end worthless if SPY stays above $270. And it will end worth $10 if SPY is at $260 or lower by expiration.
- **Short SPY directly:** You could sell short SPY shares directly if you prefer, in your preferred allocation. It's an immediately responsive position, up or down. You'll need to pay out the quarterly dividend yourself. And you have a growing dilemma as SPY rises -- when do you close the hedge? If you're short SPY directly, you can see we're staying short our $285 calls for right now, and keeping our synthetic short going.

Pro Can Help

- **Want to talk about our SPY hedge strategies?** Visit us on our *Pro* Shorts & Hedges discussion board!

Pro Catch-Up Trades and Expirations: Facebook, SPY, and More

Published Jul 26, 2018 at 3:27PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Buy 3%.

Continue building your portfolio with our Buys, including:

- **Facebook** (NASDAQ: FB): If you don't have a position, start with a 3.5% stake. Note that Facebook moves to Buy from Best Buy Now on lower sales growth and higher costs. Jeff's initial thoughts on today's decline can be found here.
- **NVR** (NYSE: NVR): Buy 2.6%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.2%.
- **Zuora** (NYSE: ZUO): Per last week's trade alert, buy 1.5%, ideally below $26 with a limit order.

Shorts:

- **SPDR S&P 500** (NYSEMKT: SPY): If you do not yet have a synthetic short set up and you want one, sell to open Dec. 21, 2018, $290 calls and buy to open an equal number of Dec. 21, 2018, $271 puts. Lately, this can be set up for a net credit of a few cents per synthetic short, or at worst no cost. Set up one synthetic short for every $27,100 in look-through short exposure you want via owned $271 puts and every $29,000 of potential short exposure via short $290 calls. *Pro* has a 15% look-through position, or 17 contracts of each.
    - **Bearish SPY Spread Instead?** If you're not comfortable setting up synthetic shorts, but do want a short position on SPY, then consider a bear put spread instead. Using a spread order, simultaneously sell to open Dec. 21, 2018, $265 puts, and use the proceeds to buy an equal number of Dec. 21, 2018, $280 puts. Lately, this costs about a $3.20 debit per spread, with a potential maximum value of $15 per spread achieved if SPY ends the expiration below $265, or at least 6.3% lower. If SPY remains above $280, then the spread ends without value. So, every $320 that you risk per spread will be lost in that latter case.

Options:

- **Johnson & Johnson** (NYSE: JNJ): If you've yet to write covered calls, you can "sell to open" the October 2018 $135 calls from our recent trade alert, selling one call for every 100 shares you own and want to cover. Lately, they pay $1.86 each -- considerably better than last week.

Upcoming Expirations:

- **The Cooper Companies** (NYSE: COO): Our August $230 (or $240 if you wrote those, from the original alert) covered calls expire in about a month. Before then, we'll have guidance as needed.

Initial Thoughts on Facebook: Stay the Course

Published Jul 26, 2018 at 1:31PM

Facebook's (NASDAQ: FB) stock is down almost 20% today after a second-quarter conference call Wednesday night that spooked the market. The company said it is expecting lower revenue growth over the next two quarters, as well as a lower operating margin in the coming years. Sales growth should slow as Facebook faces currency headwinds, increases user privacy options, and promotes new content strategies. Margins should decline as it invests in both timely and long-term needs and grows its headcount.

I think Facebook is taking positive steps for the ongoing health and relevance of its community and its business, and it remains a sensible (and still promising) long-term investment in a diversified Foolish portfolio. But investors should prepare for volatility and will need to remain patient as this unfolds.

For more on all this, keep reading.

Facebook reported 42% year-over-year revenue growth for its second quarter but guided for revenue growth rates to decline from that level by the high single digits in each of the next two quarters (think roughly 34% sales growth in the third quarter and 26% in the fourth). That was much steeper than investors expected, considering the reasons given were just modest currency headwinds; more use of "Stories" and other engaging content that aren't yet fully monetized; and users having more say over data privacy.

Meanwhile, the company said it expects operating margins to trend down toward the mid-30% range over the next handful of years. That's down from a huge 44% operating margin in the quarter just ended. This, again, is related to what we believe are worthwhile moves hiring more employees to help safeguard its users and investing in artificial intelligence, virtual reality, video, data centers and more.

It's worth noting that the European Union's new privacy laws took effect the last month of the second quarter, and so far, the vast majority of users have opted to let Facebook keep using extensive data to improve the ads delivered. But Facebook reminded that if more users opt for greater privacy, that could affect ad revenue growth, and it expects some of that may occur. And the company is embracing giving users still more privacy options; spending to combat malicious content; and requiring transparency from all advertising partners.

The best way to look at this may be that management is striving for community quality before ad quantity. Beyond that, Facebook admitted that it is opting to target lower operating margins as a baseline in exchange for ample funds to run the business as it wants. It's a sensible long-term exchange — one that will still leave the company with large annual profits.

Meanwhile, key metrics continue to move in the right direction in the second quarter. Advertisers and site visitors remain engaged and growing. Mobile ad revenue grew 50% and made up 91% of total ad sales. The average price paid per ad increased 17%, and ad impressions grew 21%. Advertisers are sticking with Facebook, and using it more. Daily active users on Facebook grew 11% to 1.47 billion, while monthly active users were 2.23 billion, also up 11%. So, users are sticking with Facebook, too. Against this growth, total expenses grew 50%, while headcount was up 47%. As expected, Facebook reiterated guidance for expense growth of 50% to 60% the rest of this year.

Returning to revenue: Facebook's new revenue guidance suggests approximately $13.8 billion in sales next quarter, and $16.5 billion in the fourth quarter, adding up to $55.4 billion for all of 2018. That would represent 36.4% annual sales growth. With expenses climbing, earnings per share (EPS) will likely grow considerably less than that. The current average estimate calls for 19.8% EPS growth, to $7.38 per share in 2018. The stock is currently trading around 23.9 times that estimate. This looks inexpensive for a business of Facebook's quality, reach, and long-term optionality — remember, many under-monetized Facebook properties are continuing to grow users.

However, the days of steady new highs for Facebook's stock are likely gone until Wall Street gets comfortable with lower growth targets and higher spending at the social media giant. Facebook is likely making the correct long-term choices for its community quality, but the choices come at a cost that could stretch for at least some quarters, and likely longer. Invest with that in mind, and a good dollop of patience, and Facebook still appears likely to return to its winning ways down the road.

Skyworks is Still on Track

Published Jul 23, 2018 at 4:16PM

Long-term investing always rules supreme! We don't have any guidance changes or completed trades in the past week.

Greetings, *Pro* members,

Quarter after quarter, management at **Skyworks Solutions** (NASDAQ: SWKS) hosts one of the clearest thinking, most well-spoken quarterly earnings conference calls of any that I listen to or read. Perhaps CEO Liam Griffin is able to talk about the results and the outlook for Skyworks so well in part because the business is perfectly positioned for the growing, Internet-connected economy.

Even so, last Thursday Skyworks reported quarterly earnings that initially sent the stock higher, until it reversed and went lower. The catalyst for the price swing is not 100% clear, as things are looking promising. The business is doing well, third-quarter results exceeded both revenue and earnings expectations, management issued healthy guidance for the rest of the year, and margins are still marching higher toward a 53% operating margin goal. Plus, the long-term opportunities ahead are monumental, namely in 5G technology and in connected devices or the Internet of Things (IoT). IoT now represents more than 30% of revenue (mobile phones are the rest), while 5G revenue should start to materialize by 2020.

If there are any faults in the results, it's that China isn't "as robust as we would have expected," as CEO Griffin said at the end of the conference call. Skyworks thought its operations in China "would be a little bit better," even though some sequential sales growth was achieved. China is approximately 25% to 30% of sales, Skyworks said, and the trade war — tariffs — have *not* affected Skyworks at all yet, because the company exports product into China rather than out. But the ban on telecommunications equipment-maker ZTE has evaporated $25 million to $30 million in quarterly revenue for Skyworks (though, as a reminder, Skyworks *still* exceeded total expectations). And although at last word the U.S. ban on ZTE has been lifted, it will take at least a few quarters for that revenue to return. Lately, sales to ZTE represent about 3.3% of Skyworks' total $894 million in quarterly revenue.

Other than ZTE's problems, Skyworks is well-positioned in China. Its products are platform agnostic, and it thrives by offering personalized solutions to every device manufacturer — and it's providing products for China's telecom infrastructure buildout, too. The company continues to avoid the "commodity" side of the mobile phone market, forgoing some low margin revenue. That may play a role in management's ongoing comments suggesting they're waiting to see more growth from some phone providers as those providers move upstream to better devices.

Despite the complications in China, Skyworks guidance for the next quarter is healthy and suggests the usual year-end seasonal strength, with revenue expected to rise 11% to 13% sequentially, to just over $1 billion, and earnings per share of $1.91, up 16% sequentially. But note, Skyworks said "sequentially." Both of those guidance numbers are basically flat year-over-year compared to 2017, suggesting that the company's largest customer, **Apple** (NASDAQ: AAPL), is looking to have another good end to the year, but no stronger than a year ago. That stands to reason as Apple struggles to sell more than 50-some million phones each quarter (the world can only take so many iPhones every 90 days). Apple is able to grow earnings by increasing the price of a phone and its services revenue, and Skyworks typically grows its hardware content sold into each unit and thus increases its own revenue per phone, too. So, the lack of year-over-year revenue growth for the rest of 2018 is likely holding the stock back.

That looks like short-term thinking, though. The arrival of 5G technology is going to bring an enormous wave of innovation to mobile computing and the Internet of Things as both speed and latency improve by leaps and bounds, making all kinds of new applications and artificial intelligence possible across the board. Skyworks is a leader in helping make this possible. It has made the investments and has prototypes in play already. Plus, the spread of 5G should help Skyworks continue to move away from having too much reliance on Apple. Its "broad market" Internet of Things business should continue to grow revenue by the low- to mid-teens year over year, becoming an ever-bigger part of the business. Skyworks' customer list, from **Amazon** (NASDAQ: AMZN) to **Alphabet** (NASDAQ: GOOGL) (NASDAQ: GOOG) to **BMW** (NASDAQOTH: BAMXF), is already impressive. Ericsson estimates 29 billion connected IoT devices by 2022.

Lately around $96, Skyworks stock trades at 12.6 times expected earnings per share for the year ahead. Its price is above 21 times free cash flow, but the company has lately spent more capital expenditures to prepare for seasonal product ramps and even 5G, too. Overall, Skyworks expects capital expenditures to still average about 10% of revenue. Indeed, showing confidence, management just raised the dividend a hefty 19% (giving the stock a 1.6% yield), and continues to buy back shares.

The stock remains a "Buy" here in Pro, with a fair value estimate of $105. We have a 3.2% stake. We like it. But, given the reality of iPhone sales remaining perhaps flattish for a long time to come (Apple has other ways to grow profits, so we shouldn't worry too much about Apple yet), we might again start to write covered calls on Skyworks to target income and a potential sale of at least some of our shares at higher prices. We're also mindful of our total exposure to Apple via that stock, Skyworks, and **Coherent** (NASDAQ: COHR), whose share price moves more with Apple's fate now than it used to. We're looking to manage our collective "Apple exposure" carefully, and evolve it over time as directed by our research and the unfolding results at our companies.

To share any thoughts, please visit the Memo Musings board. And Fool on!

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Expirations: SPY, ZUO, and More

Published Jul 19, 2018 at 3:07PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy up to 3.7%.
- **CME Group** (NASDAQ: CME): Buy 2.4%.

Continue building your portfolio with our Buys, including:

- **Coherent** (NASDAQ: COHR): Buy 1.5%.
- **FactSet Research Systems** (NYSE: FDS): Buy 2.1%.
- **Zuora** (NYSE: ZUO): Per Tuesday's trade alert, buy 1.5%, ideally below $26 with a limit order.

Shorts:

- **SPDR S&P 500** (NYSEMKT: SPY): If you do not yet have a synthetic short set up and you want one, sell to open December 21, 2018 $289 calls and buy to open an equal number of December 21, 2018 $265 puts. Lately, this can be set up for a net credit of a few cents per synthetic short. Set up one synthetic short for every $26,500 in look-through short exposure you want via owned $265 puts and every $28,900 of potential short exposure via short $289 calls. *Pro* has a 15% look-through position, or 17 contracts of each.
    - **Bearish SPY Spread Instead?** If you're not comfortable setting up synthetic shorts, but do want a short position on SPY, then consider a bear put spread instead. Using a spread order, simultaneously sell to open December 21, 2018 $260 puts, and use the proceeds to buy an equal number of December 21, 2018 $275 puts. Lately, this spread costs about a $3 debit per spread, and has a potential max value of $15 per spread, achieved if SPY ends the expiration below $260, or at least 7.1% lower. If SPY remains above $275, then the spread ends without value. So, every $300 that you risk per spread you set up will be lost in that latter case.

Options:

- None today. We're watching for better pricing, though. Argh.

Upcoming Expirations:

- **The Cooper Companies** (NYSE: COO): Our August $230 (or $240 if you wrote those, from the original alert) covered calls expire in about a month. Before then, we'll have guidance as needed.

Re-Establish Covered Calls on Johnson & Johnson

Published Jul 18, 2018 at 1:57PM

Is this for you? This is for *Pro* members who own at least 100 shares of Johnson & Johnson, and who wouldn't mind capping upside in return for near-term income. Those who *don't* own the stock can buy at least 100 shares to write covered calls, matching our 2.6% allocation. Those who own less than 100 shares as a full allocation can continue to hold them.

How You Participate

- **Action:** Sell to open October 2018 $135 calls on **Johnson & Johnson** (NYSE: JNJ).
- **Allocation:** Write ("sell to open") one call for every 100 shares owned. *Pro* will cover 700 of our 724 shares owned, representing about 2.5% of the portfolio.
- **Price Guidance:** Prices will change as the stock moves, but **use a limit order** to split the option's current bid/ask spread. When we quoted it, that was $1.28.
- **Prices** (12:40 p.m. ET):
    - Stock: $127.36
    - Sell to open October 2018 $135 calls (bid/ask): $1.26/$1.30
    - $1.28 pays 1% ($1.28/$127.36) in 93 days
- **Important dates:** Johnson & Johnson's next ex-dividend date is August 27th, so we'll need to monitor pricing as we approach that date to make sure we avoid any dividend-poaching complications with this trade.

What We're Thinking

After an earnings report yesterday that beat analyst estimates, Johnson & Johnson's stock bounced up more than 3%. Companywide revenue increased 10.6%, paced by the pharmaceutical division (20% year-over-year revenue growth). The earnings results are aligned with our expectations for the business, that the pharmaceutical division will be the largest growth driver for J&J and should offset the slow-to-no growth consumer and medical device divisions. We'll have a more detailed update on J&J's quarter once the company releases its 10-Q filing (usually within two weeks from the earnings date).

In the meanwhile, although the stock is down slightly today after yesterday's bounce, we'll use this bump in the stock price to reinitiate our covered call strategy on this position, started in March with our first round of covered calls. As we mentioned in the first covered call alert, the options premiums are low because of the company's lower-than-average volatility and its healthy dividend (which lowers pricing on calls as the options market prices in the dividend). Additionally, we will have to watch out for dividend poaching around ex-dividend dates, but ultimately, we think a covered-call strategy should help us achieve our desired returns for this position over the long run. This covered call strategy is not an attempt for explicit income, it's just a way to squeeze out extra yield from our J&J position while still achieving an effective sell price that we're okay with.

If our shares are called in October, we'll be selling at a net price of $136.28, 97% of our fair-value estimate and accounting for about a 16.5% total return (about 9.7% annualized) since the position's inception. We'll manage the calls as needed with future trade alerts, and as is always true with covered calls, we may need to let our shares go if we can't roll our calls higher at a reasonable cost.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call's strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up:** If the stock price rises above our strike price by expiration, we may let our shares get sold, or we may roll our calls to a later date and/or higher strike. We'll cross any such bridge near expiration (or the next ex-dividend date), once time value is dissipating from the calls.

Pro Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.

Submit

Buy Zuora

Published Jul 17, 2018 at 3:05PM

Is this for you? This is for all *Pro* members who want to invest in this company alongside us.

How You Participate

- **Action:** Invest 1.5% of your portfolio in **Zuora** (NYSE: ZUO). For *Pro*, that's about $53,650 worth, or about 2,150 shares.
- **Recent Price Range:** $24-$25.50
- **Scorecard Status:** Buy
- **Price Guidance:** Please, **use a limit order.** It's a smaller company, so set a limit near the current price when you make your investment; lately that's $25.20. And aim to buy below $26.
- **Alternative Trade** (we like the stock purchase best): Seeking a lower buy price? Sell to open puts that appeal to you, selling one put for every $2,250 or so (choose a strike price) in stock you want to buy. The August or September 2018 $22.50 puts pay well; or, sell to open $25 puts if you prefer.

What We're Thinking

ZUORA IN 1 MINUTE

WHAT IT DOES

Zuora sells software that lets any company become a subscription-based business.

WHY YOU SHOULD BUY IT

- Zuora is led by a founder who is passionate about growing what he calls the Subscription Economy. Zuora's customers range from Ford to Box, from industrial to energy to tech, as business models evolve to subscription revenue and require software to match it.

- Zuora's business model lets *it* grow as its customers grow. Annual fees to get Zuora's software are complemented by variable fees that go up as a client's volume usage grows. This resulted in a 112% dollar retention rate last quarter. And Zuora's subscription retention rate with its 441 largest customers is nearly perfect (one client lost in three years).

- With an intense focus on making recurring-revenue, subscription-based business models work for its clients, Zuora is likely to be an expert at making its *own* subscription business excel.

KEY DATA

- **Website:** https://www.zuora.com/
- **Latest Presentation:** April 2018 PDF
- **Market Cap:** $2.7 billion
- **Revenue (TTM):** $187.3 million
- **Earnings (TTM):** ($58.5 million)
- **Free Cash Flow (TTM):** ($34.1 million)
- **Revenue (2016/'17/'18):** $92.2 million / $113 million / $167.9 million
- **Earnings (2016/'17/'18):** ($48.2 million) / ($39.1 million) / ($47.2 million)
- **Free Cash Flow (2016/'17/'18):** ($40.6 million) / ($28.8 million) / ($29.5 million)
- **Cash/Debt:** $203 million / $10.8 million

Financial data from S&P Global Market Intelligence. Data taken on July 16, 2018.

AMC Theaters recently sent me an email asking if I'd like to subscribe to its new Stubs A-List program: For $19.95 per month, I could view up to three movies every week. A movie ticket usually costs around $10 to $12, so if you see two movies per month, the subscription is a money saver, let alone if you see 12. I'll consider subscribing, but I know this is just one of many subscription choices I'll be making soon. You will be, too.

Welcome to the Subscription Economy! That term was coined by the co-founder and CEO of California-based **Zuora** (NYSE: ZUO). Zuora believes that a shift to subscription business models across industries is a giant, unfolding economic wave. As investors, we should cheer this sea change. *Pro* has always been drawn to companies with recurring revenue. It makes a business more stable and predictable, and it provides a steady base from which to grow. And for customers, subscribing spreads out the cost, sometimes lowering it.

As the world embraces the benefits of subscription business models, you're going to see opportunities to subscribe to your favorite restaurants, clothing retailers, car providers, everyday consumer products, airlines, and much more. Corporations are subscribing to one another's services more than ever, too. In both cases, Zuora's software helps make this new wave possible.

The Story

Zuora's mission is to help any company in any industry successfully launch and manage — and become — a subscription business. As companies move from the one-off sales model of our industrial yesteryear to ongoing service-oriented relationships with customers, they'll need versatile software to match. Zuroa estimates that this long-term shift should allow it to achieve 25% to 30% annualized sales growth for years.

MGI Research estimates that Zuora's core recurring billing management software market should grow from $1.8 billion in 2017 to $9.1 billion by 2022. And Zuora believes — and is proving — that it can take market share from legacy enterprise resource planning (ERP) software companies, which Gartner estimates will be a $40.6 billion market by 2021. ERP software was built to track linear sales cycles, rather than the fluid subscription relationships we'll be seeing more of. If Zuora can capture even a slim minority of the ERP and subscription management software markets, it could pull in much more than the $187 million in revenue it rang up over the past year. And it has the products to do so.

Zuora's software, which is sold through a subscription model itself, offers several modules including pricing and payments, subscriptions ordering, accounting, analytics, and more. Access starts with a fixed annual fee of $25,000 to $500,000 and up, depending on a company's needs; and fees paid to Zuora go up with usage or transaction volume. Most contracts are for one to three years, billed annually. And it's sticky. Since fiscal 2015, Zuora has only lost *one* customer that started with a contract worth $100,000 or more. All others renewed. In fact, Zuora's dollar retention rate was 112% last quarter, meaning customers on average pay more as time goes on.

Zuora's two flagship products are called Billing and RevPro. Here's a little more on each:

- Billing drives a client's product and pricing strategy to help foster subscription growth, while automating the recurring ordering, invoicing and collections. In addition to subscription fees, Zuora charges for the dollar volume flowing through Billing, effectively collecting a small toll that grows as volume grows. Last quarter, $7.2 billion flowed through Zuora's Billing platforms, up 46% year over year.

- RevPro is an industry-leading revenue management program for fluid business models, a necessity in today's complex compliance environment. RevPro tracks a company's revenue and performance obligations (which are promises to transfer goods or services); it pulls in related data from third-party software; accounts for acquisitions; and more. Again, the more revenue a client moves through the software, the more Zuora charges. And, increasingly, Zuora's software serves as the system of record for the customer, making it still stickier.

More than 50% of Zuora's approximately 950 customers are in non-technology industries, including transportation, manufacturing and consumer services, and no single customer accounts for an outsized portion of revenue. But Zuora had 441 customers as of last quarter with annual contract values of at least $100,000 each. These companies represent 80% of Zuora's annual earned contract value — and again, the customer retention rate here has been near perfect.

Lately, 70% of revenue is subscription-based, while 30% comes from professional services. It takes months for Zuora's staff to set up most new customers, and Zuora runs its labor-intensive professional services at breakeven, knowing it will make money later on subscriptions. This lowers gross margins for now, but as the subscriber base grows, professional setup costs will shrink in comparison. In other words, high service costs today are a leading indicator to higher subscription sales tomorrow, so we should welcome them.

Co-founder and CEO Tien Tzuo, 49, was employee No. 11 at **Salesforce.com** (NYSE: CRM), the software-as-a-service giant, and he was responsible for building its first billing system. Recognizing early that industries were turning to subscription business models, he and two colleagues launched Zuora in 2007 (the name is a combination of letters from their last names). Tzuo has been CEO all along. With its pure focus on providing software to run subscription business models — and being one itself — Zuora is focused on the long term. That's probably one reason it's received recognition as a top place to work from Glassdoor, the *Silicon Valley Business Journal*, and multiple other publications. Employees are called ZEOs — each is in charge of their Zuora career. Tzuo owns more than 7% of the company's shares, worth more than $200 million, and seems committed to his vision of building the Subscription Economy.

Our own digging and Forrester's Wave tell us that Zuora is a (perhaps *the*) focused leader in its field, and its recent IPO increased its profile.

Zuora leads Forrester Wave 2017. Source: Forrester Wave and Zuora.

Many young software companies lose money for years but remain top-performing stocks because Wall Street sees profits on the horizon. We believe Zuora fits the mold. It's not expected to make money for at least three more years. The company is spending to reach new customers and to fund R&D to keep its offerings tip-top. As annual subscription revenue climbs higher, if all goes to plan, profits should eventually arrive and then quickly grow. When it comes to young SaaS companies, investors seem to treasure revenue growth first and foremost -- because you're in the costly building phase for years. But even while young and small, Zuora is showing how its operating loss shrinks, as a percentage, as revenue grows. The company's GAAP operating margin improved from (52%) in fiscal year 2016, to (32%) in fiscal 2017, to (28%) in fiscal 2018.

In the most recent quarter (reported May 31), Zuora grew revenue 60% to $51.7 million, with subscription revenue up 39%. For fiscal 2019, which is now underway, Zuora guides to about $220 million in revenue, up 31%, and a GAAP loss of about $53.5 million. Zuora had more than $200 million in cash and equivalents as of April 30.

How It Fits Into Pro

Pro is about 13.2% invested in pure software plays, but given the attractive dynamics of the industry, and how most all businesses are software customers now, we are not worried about this exposure. In the short term, sector volatility will strike us harder than average. But in the long run, we expect these businesses we own to each individually deserve and earn strong returns. And we'll trim those that don't. As we see Zuora start to prove out, it may compel us to earlier trim some of our other software companies that are lagging.

Overall, Zuora has a business and mission that we want to be a part of. We believe subscription-driven business models will spread for the rest of our lives. It takes time to change how you do business, but we have time, and change is already unfolding while we wait for more of it. In the mode of **Square** (NYSE: SQ), **JD.com** (NASDAQ: JD), or **Paycom Software** (NYSE: PAYC), among others, Zuora can hopefully drive exceptional future growth in *Pro* and keep our portfolio highly relevant. We're starting small at a 1.5% stake, knowing we can add anytime. Also, a total loss would only nick us, but several doubles over the years would aid us greatly. Meanwhile, since Zuora has been public for only one quarter, expect a lot of stock volatility.

The Bottom Line

Let's run down a non-exhaustive list of what we like about Zuora:

- Recurring subscription revenue with high retention and growing customer value
- A business model that lets Zuora grow as its customers grow
- A large, expanding, worldwide market as the Subscription Economy expands
- A founder-led business with high insider ownership and a vision
- Industry leadership with a pure-play company
- A-level customers, including **FedEx** (NYSE: FDX), **Nvidia** (NASDAQ: NVDA), HBO, **Delta Airlines** (NYSE: DAL) and **DocuSign** (NASDAQ: DOCU)
- A recognizable path to profitability, one that's been well-trodden by countless small companies before it
- Strong revenue growth and the promise of much more for years

We'll close with the words that chief ZEO Tien Tzuo used to open Zuora's first conference call as a public company:

> "Thank you for letting me share our story about Zuora and about the overall Subscription Economy. ... For those of you that are new to Zuora, welcome, welcome to our journey. Welcome to joining our customers, our partners, our shareholders and the roughly 1,000 ZEOs worldwide that make up our company. Welcome to a journey into the future."

Pro Can Help

- Are you subscribed? Visit our Pro Longs board to talk about Zuora.

Pro Guidance Changes and Completed Trades: July 16, 2018

Published Jul 16, 2018 at 12:32PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- None in the past week!

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Gilead Sciences** (NASDAQ: GILD): We sold our shares at $76.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): We sold our shares at $47.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Pro Portfolio 2018 Mid-Year Review

Published Jul 16, 2018 at 12:32PM

Dear *Pro* members,

Now that we're more than halfway through 2018, it's time for our *Pro* portfolio mid-year review! In this Memo, we will discuss the *Pro* portfolio's performance, inflation, market volatility, portfolio activity, and talk about major drivers of our performance. With the information from this review, we can determine how our results or approach have changed over time (if at all), and we can potentially use this information to our benefit.

The Review

The *Pro* portfolio's performance has been right on track with our goal over the first six months of 2018. Our year-to-date performance as of June 30, 2018, is 5.4%, outperforming both the S&P 500 (up 2.6% during the first six months of the year) and our North Star (up 5.3% in the same time frame). The strong Nasdaq, and our desired concentration there, is a significant contributor to the *Pro* portfolio outperforming our North Star (and the S&P 500) so far this year.

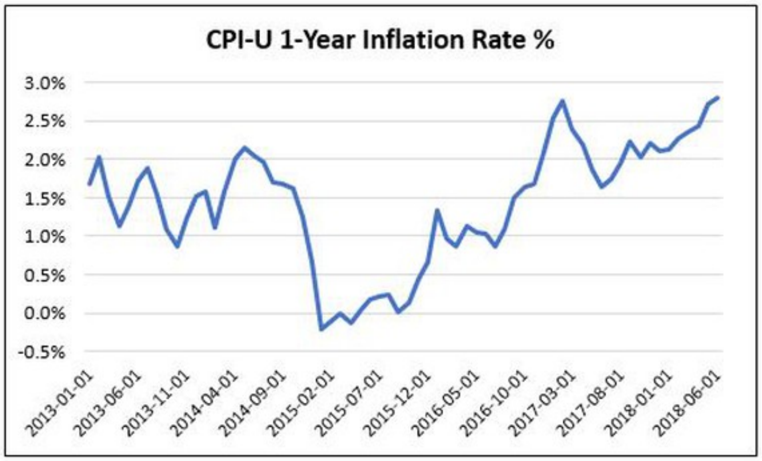
Our net long exposure as of June 30th is about 81%, higher than our historical average of about 74%, indicating our slightly more aggressive stance during the current economic period of tax reform and accelerating U.S. GDP growth. Here's a comparison of the performances of *Pro*, the S&P 500, and our North Star over the first *halves* of 2013, 2014, 2015, 2016, 2017, and 2018:

Year	*Pro*	S&P 500	Nasdaq	North Star
2013	22.4%	12.6%	12.7%	4.1%
2014	7.4%	7%	5.5%	4.4%
2015	9.4%	1.2%	5.3%	4.6%
2016	1.4%	3.8%	-3.3%	5.1%
2017	7.5%	8.2%	14.1%	3.5%
2018	5.4%	2.6%	8.8%	5.3%

Source: U.S. Bureau of Labor Statistics seasonally adjusted, indexed, monthly CPI-U data series.

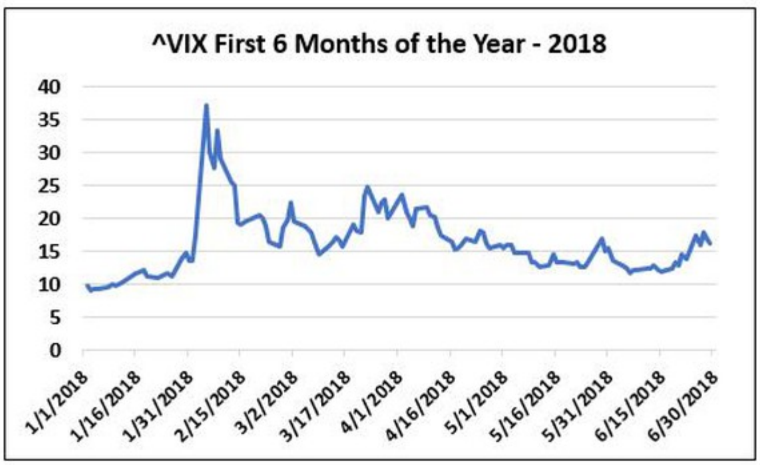
Inflation

Inflation (as measured by the U.S. Bureau of Labor Statistics CPI-U index) has picked up in the first half of 2018 — not a surprise considering the accelerating GDP growth and rising interest rates. The most recent figure from the BLS shows 2.8% year-over-year inflation, which is the highest rate since February 2012. Since inflation is an input for our North Star (which is calculated as inflation + 7%), we need to keep an eye on the inflation rate. With the North Star as our guiding light, we have a higher expectation for future returns as inflation rises, and this dynamic plays a role in our portfolio-level risk tolerance and decision making process.



Volatility

Volatility (as measured by the ^VIX index) started the year at a low level, continuing the trend of low volatility that persisted throughout 2017. However, in early February, a strong jobs report led to a surge in interest rates, spooking the markets and causing significant volatility, leading to a peak ^VIX level of 37.32 on February 5th (the highest ^VIX level since August 2015). Since then, volatility has settled down, but volatility levels remain generally higher in 2018 than they were throughout the abnormally calm 2017.



Source: S&P Capital IQ.

Portfolio Activity

Here's how *Pro's* portfolio activity breaks out for the first halves of 2013-2018:

	2013	2014	2015	2016	2017	2018
New Purchases	2	2	1	1	4	4
Allocation Increases	3	1	0	1	2	1
Options for Income	8	8	8	13	10	5
Options for Leverage	1	1	1	0	0	3
Shorting	1	0	2	2	1	0
Hedging	4	4	4	4	4	3
Sales (or short covering)	3	3	1	4	8	6

Note: 2018 activity includes trades made between June 30 and today.

As we did in 2017, *Pro* has been active both closing older positions and adding new positions. In 2018, through the first six months of the year, we've added a buy/write covered call position on **The Cooper Companies** (NYSE: COO), and new long stock positions in **CME** (NASDAQ: CME), **Adobe** (NASDAQ: ADBE), and **JD.com** (NASDAQ: JD). We also increased our allocation to **Tencent** (NASDAQOTH: TCEHY) with a tactical quarterly dividend reinvestment.

As for closing older positions, we've taken a bucket approach. We closed our positions on **SVXY** (NYSEMKT: SVXY), **SRS** (NYSEMKT: SRS), and **Shake Shack** (NYSE: SHAK) in one fell swoop, and closed our positions on **Gilead Sciences** (NASDAQ: GILD) and **DGS** (NYSEMKT: DGS) in another batch trade. We also closed our position on **Verisign** (NASDAQ: VRSN) by way of option assignment.

We've slowed down a bit compared to the last two years with respect to options for income. However, with the higher volatility levels of 2018 compared to 2017, perhaps this is an area we can target for more activity in the second half of the year.

Our options for leverage strategies have included a new diagonal call position on **Oracle** (NYSE: ORCL) (we await a chance to restart a short call), and maintenance trades on our two other active diagonal call strategies (on **American Tower** (NYSE: AMT) and **Home Depot** (NYSE: HD)). The new Oracle diagonal call position has not so far worked in our favor (currently down about -6%), but the American Tower (up 32% in less than two years) and Home Depot (up 26% in less than a year) positions have been working out well.

Our strongest-performing stocks so far this year have been **Square** (NYSE: SQ) (78% return in the first half of the year), **Amazon** (NASDAQ: AMZN) (45%), **Mastercard** (NYSE: MA) (30%), **Broadridge** (NYSE: BR) (27%), and **Paycom Software** (NYSE: PAYC) (23%).

Our worst (again, so far) stocks have been SVXY (-90%), **Coherent** (NASDAQ: COHR), (-45%), **NVR** (NYSE: NVR) (-15%), **Starbucks** (NASDAQ: SBUX) (-15%), and Oracle (-7%).

All in all, the first six months of 2018 have been more volatile than last year, and that volatility in early February led directly to the severe impairment of our SVXY position, taking a big bite out of our returns. For context, if we exclude the effect of SVXY's collapse on our results, the *Pro* portfolio would have returned 8.3% over the first six months of 2018 (rather than the realized performance of 5.4%). (Of course, that still includes SVXY's earlier gains.)

However, 2018 so far has also been kind to technology companies, which has been a boon to many of our largest positions, boosting our results. That we can take a 90% loss on one of our positions and still post a six-month return that is higher than the S&P 500 and our North Star is a testament to 1) our diversification, and 2) the performance of our larger positions dwarfing the effect of our smaller positions.

Despite a near-implosion of one of our positions and weak performance from others, the *Pro* portfolio as a whole is performing well in a rockier market. We've used the last two years to start to reposition our portfolio, selling out of positions where our confidence had waned, and buying new positions that we like for the long term. We have outperformed both the S&P 500 and our North Star over the first six months of 2018, and though we know we must keep evolving — including on our shorts and hedges — we believe we can continue to set ourselves up well to achieve our collective goals over the long term.

The *Pro* Bottom Line

Pro's low-turnover approach is patient, flexible, and focused on an absolute-return strategy. While we aren't perfect with every decision, we try to keep our underlying philosophy in mind with every choice we make. We like the portfolio moves we've made in the first half of 2018, and we think that our general strategy of closing laggards / non-core positions and adding strong, Pro-like businesses should be beneficial to our results over the long run. I like to conclude our mid-year review columns with a nod to the first *Pro* mid-year review column written in 2014. It's still completely applicable today, demonstrating the consistency of our investing process. Here it is, with edits in brackets only to change the reference to the year:

> "While we aren't market prognosticators and we can't tell you what to expect from the market over the second half of [2018], we can tell you what our approach to portfolio management will be. We will continue to invest in core stock positions (i.e., compounding machines) when the balance of risk and reward looks favorable. We will continue to use options strategies either for income, to add to our positions at lower prices, or for leverage, depending on what opportunities present themselves. We will seek to short weak, disadvantaged companies that appear poised for a stock price decline, and we will manage our net long exposure via index hedges as market conditions dictate."

Fool on!

— Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Expirations: Adobe, SPY, and More

Published Jul 12, 2018 at 2:09PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.9%
- **CME Group** (NASDAQ: CME): Buy 2.4%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.6%.

Continue building your portfolio with our Buys, including:

- **FactSet Research Systems** (NYSE: FDS): Buy 2.1%.

Shorts:

- **SPDR S&P 500** (NYSEMKT: SPY): If you do not yet have a synthetic short set up and you want one, sell to open January 2019 $285 calls and buy to open an equal number of January 2019 $270 puts. Lately, this can be set up for a net debit of about $0.25 per synthetic short. Set up one synthetic short for every $27,000 in look-through short exposure you want via owned $270 puts and every $28,500 of potential short exposure via short $285 calls. Pro has a 15% look-through position, or 17 contracts of each. Be mindful that SPY is closer to $285 now than it was when we originally set up the position.

Options:

- **The Cooper Companies** (NYSE: COO): If you've yet to write covered calls yet, you can now "sell to open" the August 2018 $240 calls from the original trade alert, selling one call for every 100 shares you own and want to cover. These are slightly in-the-money, but that's OK. Lately, they pay about $8.80 each. (We'll manage our August $230 calls as needed, later, as time value dissipates.)

Upcoming Expirations:

- None until mid-August.

FactSet's Steady Earnings

Published Jul 9, 2018 at 3:21PM

Greetings, *Pro* members,

In late June, **FactSet Research Systems** (NYSE: FDS) announced earnings that sent the stock a bit lower -- and it's still recovering. Lately at $204, FactSet trades 4.6% lower than it did right before earnings. But the news itself was fine: The specialized investment data provider increased GAAP revenue by nearly 9% in the third quarter, to $340 million, and adjusted diluted earnings per share jumped 18%. This growth was helped by a lower tax rate, which dropped to 16.5% from 23.2% last year. In 2019, FactSet will see a full year of benefits from lower taxes, helping the bottom line further.

But for us, the real story of FactSet is steady free cash flow growth. From $265 million in the year ended August 2014, free cash flow has grown each year to hit $320 million in the year ended August 2017. Now, trailing-12-month free cash flow is $380 million. Free cash flow increased 42% last quarter compared to a year ago. With about 90% of customers renewing, a relatively low-expense business, and annual price increases, FactSet is a steady free-cash-flow machine. And hosting nearly 5,000 clients and 89,000 workstation users, FactSet has the depth to go after new markets.

The company is positioned to serve a lot more desks at a lower price point that still provides a good profit margin for the business. Overall, even as it adds smaller clients, operating margins are expected to increase. Another new product called "Open: FactSet Marketplace" has shown a promising start since its recent launch. This is a royalty-based model in which data providers publish their content into the FactSet system, gaining access to institutional clients. FactSet ties the data sets to other relevant data sets, increasing the value. Royalties are paid to FactSet by users and shared with the data providers. As investors look farther afield for an edge, they want everything from social media data to smart satellite-driven analysis of traffic flow to more quant data and beyond.

Basically, if you're not a passive index investor and you are concerned about relative returns, it's more important now than ever to prove your worth by earning returns above those of the passive investors, and various sets of data can help. Money managers and wealth management offices are on the hunt. That said, the overall industry environment for FactSet's business is still cost-challenged. Most investment shops have spending restraints, and those that underperform continue to close. But FactSet has been able to grow by pursuing new markets. Organic annual subscription value (a form of revenue) in Asia was up more than 13%, and FactSet just opened its first office in China, in Shanghai. It is already finding advantages in the new office compared with its previous arrangement, under which it served China from Hong Kong.

FactSet bought back 620,000 shares last quarter for $122 million, or about $196 per share. And it increased the dividend by 14% to $0.64 per share quarterly, for a 1.25% current yield. It's not a lot, but it's something. For the year, earnings per share should increase by about 16%, and the stock trades at 21.7 times estimated earnings one year ahead. The company put together a good summary of its financial results in a nifty presentation.

The stock is up by an average of 27% for us (we've made a few purchases) since our first purchase just over two years ago. With dividends, it's up about 30%, in line with a strong S&P 500, and above our North Star. **Shares remain a Buy. We have a 2.1% stake. Our fair-value estimate increases to $205.**

A Closing Reflection

"Nobody gets everything." My wife repeats that fact frequently. Some people have amazing children but live in poverty. Some are rich but lack friends. Some are young but have poor health. Nobody gets everything. Further, most people are forced to accept loss as a part of life early on, and then forced to revisit it again and again. Whether you lose your home in a storm, or lose a friend or parent to illness, or lose some of your energy (or hair!) over the years, we all know loss.

Investing losses are typically much less devastating, and we aim in *Pro* to ensure they are never catastrophic. No loss or event should derail our long-term strategy. Nobody gets everything, but when it comes to investing, it's just a matter of increasing a numerical value. We want to be set up to have our numbers work out in the end no matter what. That's why owning the portfolio -- being diversified -- and sticking to the strategy are so important. Nobody gets everything, but investing success is one thing we should all achieve here.

To share any thoughts, please visit the Memo Musings board. And Fool on!

-- Jeff (TMFFischer)

P.S. Nobody gets every investment winner, either, but we look forward to adding some new potential winners to the port. :)

Pro Guidance Changes and Completed Trades: July 9, 2018

Published Jul 9, 2018 at 3:20PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **FactSet Research Systems** (NYSE: FDS): Fair-value estimate increases to $205. The stock remains a Buy with a 2.1% allocation.

Pro Completed Trades (see transaction log; trades take a day to appear):

- None the past week.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Sell Gilead Sciences and DGS

Published Jul 2, 2018 at 2:42PM

Is this for you? This recommendation is for all *Pro* members who own these shares and are following our portfolio moves.

How You Participate

- **Actions:**
  - Sell all 1.9% held in **Gilead Sciences** (NASDAQ: GILD).
  - Sell all 1.7% held in **WisdomTree Emerging Market SmallCap Dividend** (NYSEMKT: DGS).

- **Guidance:** Sell.
- **Price Guidance:** Please don't rush; **calmly use a limit order** to sell each investment around the going price when you place your trade. Without rushing, *Pro* will sell within the next 30 days. We hope to get more than $70 for Gilead and more than $47 for DGS, but we'll see what the market gives us when we're ready to trade.

What We're Thinking

The *Pro* Portfolio is as invested as it has ever been, holding only 5.6% cash. Steadily investing the cash we held as of a few years ago has been lucrative, leading us to buy stocks in several new companies that are highly profitable as a group -- some greatly so individually. But it has reduced our cash balance, even after we recently sold our shares of **Verisign** (NASDAQ: VRSN) through covered calls.

We have some new buys in our sights now, but we don't want to take our cash down to basically zero, so we're going to sell some laggards -- stocks in which we now lack much conviction -- to raise some cash. In the coming 30 days, as we sell, this will raise 3.8% more cash at current prices, bringing our cash balance to 9.4% of the portfolio. That's enough to leave us with some left over even after we make some new buys and options positions.

Meanwhile, these two positions have been among our longest-term disappointments. We've given both investments a long time to improve, and both have come up short so far.

Gilead Sciences' Hepatitis C sales have continued to fall precipitously as competition leads to much lower prices and lost market share. Although management believes these sales will stabilize this year, we have concerns that when new contracts are written for 2019, pricing will likely decline again. There is still a lot of margin left in the drugs, so competitors will likely continue to compete on price to maintain and gain new business.

Gilead's future relies on its world-leading HIV franchise and a drug pipeline that will require some years of further patience to potentially bear fruit. If we were steadily adding new cash to *Pro*, we might be inclined to sit and wait for this proven company to eventually succeed anew. But given our limited cash -- and our desire for it to perform -- such a wait may be one luxury we don't want to afford. Just as importantly, we knowingly strayed from our *Pro* principles when we bought Gilead. The company lacks several key elements we look for: pricing power, an expanding market for many of the products that drive its revenue, and recurring revenue (at least in the Hepatitis C division). Being low on our checklist for *Pro* qualities makes Gilead high on our list of stocks to cut. As of last quarter, management believes its business can return to earnings growth in 2019, but we're still not compelled to hold out.

Meanwhile, WisdomTree Emerging Markets Small-Cap Dividend Fund has been even more disappointing, though this is through no fault of its own. Emerging-market stocks have lagged U.S. stocks severely over the past decade. Our ETF has outperformed the other emerging-market indexes we've watched, but its performance has still resulted in only very modest annualized returns, including dividends. That trend appeared to be changing early this year as our ETF jumped, but at-risk trade agreements around the world, and a big drop in China's market, have taken emerging-market stocks back down to where they started the year.

In addition, here in *Pro*, we've been buying shares of **Tencent** (NASDAQOTH: TCEHY) and **JD.com** (NASDAQ: JD), and we now have a combined 5.5% position in these two Chinese leaders. We follow these companies closely and we have high conviction in their potential, so at this point we'd rather put our capital into these ideas rather than into an emerging-market ETF. We believe we can perform better using our hard-won knowledge about investing in individual stocks.

How These Decisions Fit Into *Pro*

We continue to evolve and strive for better. Our ultimate goal in *Pro* is to steadily improve over time -- alongside you, we want to become better and better investors, with an ever-stronger collection of investments in the portfolio. We will almost always have some problem positions and some that disappoint, but our drive in those cases is to learn. We want to give positions as much time as they might need, but not let them go to seed longer than may be beneficial.

In addition, *Pro* wants to focus on companies that have sustainable competitive advantages that ideally grant them some pricing power, as well as recurring-revenue business models and ample opportunity to reinvest cash flow into new opportunities that have attractive returns.

With Gilead, we assumed that the hepatitis market would build over many years, creating investor confidence along the way, rather than exploding higher in just a few years and then crashing as it is doing now. With emerging markets, we assumed a price recovery from the Great Recession which, surprisingly, has only occurred in very modest fashion. But looking ahead, neither stock matches the profile of the type of individual business (or investment) we want to own in *Pro*, so even if they recover, these holdings would be oddities in the type of portfolio we're striving to build and maintain.

We'll sell our positions in these two stocks in the next one to 30 days.

Pro Can Help

- Questions on these sells? Please visit our recent trade alerts board.

Pro Guidance Changes and Completed Trades: July 2, 2018

Published Jul 2, 2018 at 2:13PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

Thanks to increased earnings estimates and a higher fair-value estimate of $186, **Facebook** (NASDAQ: FB) joins our recently revised Best Buy Now list. The full list, which debuted last week, is repeated below with the addition of Facebook:

- **Gilead Sciences** (NASDAQ: GILD) moves to Sell, per our trade alert.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS) also moves to Sell.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Tencent** (NASDAQOTH: TCEHY): We bought 130 more shares at $50.37, bringing our total stake to 2.8%.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Buy (More) Tencent

Published Jun 27, 2018 at 2:57PM

Is this for you? This recommendation is for all *Pro* members who have year-to-date dividends to reinvest, or who have ample cash to make a small additional investment and want to match us.

How You Participate

- **Action and Allocation:** Buy 0.18% more in **Tencent** (NASDAQOTH: TCEHY), increasing your position size to 2.78%. At recent prices, *Pro* will buy about 130 more shares.
- **Price Guidance:** Use a **limit order** at the prices available when you place your order. We'll buy in the next one to 30 days.
- **Recent Price (June 27, 2018):** $48.23
- **Guidance:** Tencent is rated a Best Buy Now with a fair-value estimate of $50.

What We're Thinking

With shares down roughly 20% since Tencent's stock set an all-time high this past January, we believe now is a great time to invest the $6,313 in dividends we collected in the first quarter of 2018 and pick up some additional shares. We think there are two most likely culprits for the decline in the share price of our favorite Chinese powerhouse in the worlds of social media, payments, gaming, venture capital, and more:

1. Management acknowledged that they are more than willing to sacrifice margins in the near term in order to position the company for long-term success. The market reacted myopically, but we believe this is ultimately the right move to ensure Tencent doesn't become the next AOL or MySpace.
2. The recent tensions between the political leaders in the U.S. and China. In the long run, we believe these will sort themselves out.

Besides that, though it's pretty much impossible to keep up with everything Tencent is doing, there have been plenty of headlines over the past few months that suggest our thesis is still on track:

- Tencent Music may go public later this year as one of the largest tech IPOs ever
- Meituan, the Tencent-backed 'one-stop super app,' files for IPO in Hong Kong
- *League of Legends* was selected as an Official Demonstration of Sport for the 2018 Asian Games, and eSports will become an official medal event at the 2022 games
- WeChat mini games have now amassed roughly half a billion users (despite many skeptics calling Tencent's mini program a flop when it first came out)
- Tencent's $300 million investment for 40% of Epic Games is now worth upwards of $12 billion (that's an annualized return of 85%!)
- China's share of global venture capital funding was 24% last year, up from less than 5% a decade ago. Consulting firm McKinsey recently estimated that Tencent and Alibaba alone accounted for upwards of 50% of fund flows in China. We see this as a positive because we think Tencent investments provide the company with new ways to make its current products even stickier and greatly reduce the risk of the company losing relevance over the next decade.
- We are likely to see shares of major Chinese public companies listed on domestic exchanges by the end of the year, which could be met with strong domestic demand. (For context, the current situation is roughly analogous to a world in which Facebook shares are un-investible for most U.S. residents.)

Those bearish on the company frequently like to point to Tencent's large market capitalization and "expensive" valuation as signs that it's destined to underperform the market going forward. But the same could have been said for Microsoft in 1998 -- the year it first became the largest publicly traded company in the world and boasted financials not too far off from what we've recently seen from Tencent.

Metric	Microsoft (fiscal 1998)	Tencent (TTM)
Financials		
3-year revenue growth rate	37%	47%
Net income margin	29%	31%
3-year net income growth rate	46%	49%
ROE	33%	32%
Valuation		
Earnings multiple	69x	39x
Free cash flow multiple	46x	44x
Market cap	$267 billion	$493 billion
Inflation adjusted market cap	$412 billion	
Size rank as a public company	2nd (Microsoft's fiscal year ended in June and by September it had claimed the top spot)	9th

Source: S&P Global Market Intelligence

With the benefit of hindsight bias, we can see that size and valuation were certainly not the enemy of performance for Microsoft — including dividends, the stock has outperformed the market by 5% annually since the end of its fiscal 1998. Only time will tell whether Tencent will be able to follow a similar path and beat the market over the coming decade-plus, but we believe it's misguided to hold Tencent's size against it. And if our thesis plays out as we hope, Tencent will have little trouble growing into its current valuation.

The Foolish Bottom Line

We were a bit more tactical with our dividend investment this time around , preferring to wait until we saw an attractive opportunity instead of redeploying the capital as soon as the quarter finished. Sentiment for Chinese stocks may remain muted if the current political environment doesn't improve, but we believe Tencent's current valuation represents an attractive opportunity for long-term-focused investors. Nudge this position up by 0.18% or so if you have dividends you want to reinvest or more than ample cash and want to follow along. Helping to make this economically feasible, our trading commissions at Interactive Brokers are very low. Hopefully, given the commission wars going on, yours are, too. Fool on!

Pro Can Help

- **Questions?** Please visit the *Pro*'s Long Stocks or Help With Recent *Pro* Alerts message boards

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Mr. Market, and Oracle

Published Jun 25, 2018 at 1:53PM

Note: We don't have any guidance changes or completed trades to share over this past week. A continued huzzah for status-quo, long-term investing!

Greetings, *Pro* members,

The stock market has entered one of its (presumably) typical periods of decline, something that usually happens a handful of times per year, with stocks falling a few percent (3%, 5% ...) in a matter of days.

Some volatility seems merited given the ascent many stocks have enjoyed since April earnings. Whatever the market is trading on right now -- presumably trade-war-related concerns -- earnings will come into focus again in a few short weeks, and with them, valuation. The S&P 500 on average remains reasonably valued at about 16 times expected earnings, as long as those earnings don't decelerate. Perhaps trade tariffs represent the biggest risk to near-term earnings right now, because of the risk poised to global commerce.

Is the White House aiming for short-term pain in hopes of long-term gains? Who knows. Time will tell whether any strategy works. Most countries have enough to lose that they'll want to find solutions.

Oracle's Fate

Meanwhile, last week **Oracle** (NYSE: ORCL) reported earnings that sent the large-cap stock tumbling. This leaves us with a choice. We can sell this beaten-down stock because we fear it's a long-term value trap and reinvest the money somewhere we like better. Or we can keep investing in Oracle's potential to continue evolving into a cloud company that regains Wall Street's respect and a better valuation.

Let's talk about the results, and the stock.

Revenue was up 3% to $11.3 billion. That's nothing to write home about, but keep in mind that tepid revenue growth is expected as Oracle continues to shift from long-term licenses to monthly cloud revenue. This will eventually result in higher margins -- and even higher revenue -- once cloud infrastructure spending slows and the cloud revenue base is large enough, but initially it increases costs and lowers immediate revenue. Next year, Oracle expects revenue growth to tick upward, toward 5%, and earnings-per-share growth to remain above 10%. That's nothing to sneeze at on the bottom line, but Wall Street seems bored by it.

Lately at $44, the shares are back to lows last seen in March 2017. That doesn't sound bad, but this price level was first hit in late 2014, so if you bought at that point, you've had nothing but dividends to show for it for three years as Oracle transitioned to the cloud. The stock now trades at 13 times expected earnings for the year ahead, as low as it's been valued since early 2016, and 9.2% below its five-year average of 14.2.

Oracle trades at 13 times forward earnings. Source: S&P Capital IQ.

At today's price, it seems reasonable to assume Oracle's downside should continue to be minimal -- even more so than usual. It's only been a few days, but the stock has held up during the recent market meltdown. More importantly, will growth pick up from here to at least get the stock's return near our North Star?

The bottom-line earnings growth expected (of at least 10%) and a 1.7% dividend, coupled with aggressive share buybacks, suggest the North Star could be in reach. Management has bought back $11.5 billion worth of shares over the past 12 months, at an average of $48.31 per share. And they said last week they view the stock as "very inexpensive," so they'll continue to ramp up the buyback.

For the year just ended (Oracle's 2018 ended May 31), total cloud services and license revenue grew 7% to $26.3 billion. Non-GAAP EPS was up 11% in constant currency, and 14% in U.S. dollars. Free cash flow was up 13% year-over-year in the past year, to $13.7 billion. And ideally all these growth rates will be stronger in the 2019 that just started.

In the next quarter, revenue is expected to grow 1% to 3% in constant currency, with non-GAAP EPS growth of 9% to 13%. For the year, revenue growth should be closer to 5%.

But with cloud growth still tepid, Wall Street is left waiting and wanting. We need to decide if we want to wait and see whether cloud revenue finally begins to spring upward along with margins, or decide whether our patience is running out.

Right now, I believe our money invested in Oracle will certainly (as certainly as possible in the market) do better than cash and inflation. It could -- from this price -- even challenge our North Star over the next three years. So, if we're going to move money from Oracle, we need to be highly confident in where we put it next, since most stocks we're considering right now will likely have higher risk than Oracle at this point.

Market Opportunities?!

And with that, I'm going to head off from this column and plug into the market to see if there are any pricing opportunities that we like enough to act on already this week.

To share any thoughts, please visit the [Memo Musings board](). And Fool on!

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Expirations: Cooper Companies, SPY, and More

Published Jun 21, 2018 at 3:26PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **CME Group** (NASDAQ: CME): Buy 2.4%.
- **JD.com** (NASDAQ: JD): Buy 2.8%.
- **Tencent** (NASDAQOTH: TCEHY): Buy 2.6%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy 4.7%
- **Medtronic** (NYSE: MDT): Buy 2.4%.

Shorts:

- **SPDR S&P 500** (NYSEMKT: SPY): If you do not yet have a synthetic short set up and you want one, sell to open January 2019 $285 calls and buy to open an equal number of January 2019 $260 puts. Lately, this can be set up for a net debit of about $0.70 per synthetic short. Set up one synthetic short for every $26,000 in look-through short exposure you want via owned $260 puts and every $28,500 of potential short exposure via short $285 calls. Pro has a 15% look-through position, or 17 contracts of each.

Options:

- **The Cooper Companies** (NYSE: COO): Although the stock price is higher than it was when we issued the adjusted $230-strike-price recommendation last week (for those who hadn't made the original trade yet), we decided in favor of writing the August $230 calls ourselves. Naturally, they now pay more than before (lately about $10.20). If you're new to the trade, buy shares in 100-round lots and sell to open these same August $230 calls, capturing some intrinsic value and a more than 2.5% yield in just over two months. (As we said in the adjustment alert, if you wrote the $240 calls originally, you can continue to keep those open instead.)

Upcoming Expirations:

- None

Record Revenue and Earnings for Adobe

Published Jun 19, 2018 at 1:20PM

Second Quarter 2018

- Press Release
- Earnings Call Script and Slides
- Investor Datasheet
- 10-Q Filing

Adobe (NASDAQ: ADBE) continued its recent business momentum in the second quarter of 2018, achieving record quarterly revenue and earnings-per-share of $2.2 billion (+24% year-over-year, +25% trailing-12-months) and $1.33 (+78% year-over-year, +51% TTM), respectively. Earnings growth was bolstered by lower-than-expected tax rates due to the new U.S. Tax Act. Revenue growth is balanced across the company's two major segments, with the Digital Media (i.e. content creation) segment posting +28% year-over-year growth and the Digital Experience (i.e. digital advertising) segment posting +18% year-over-year growth.

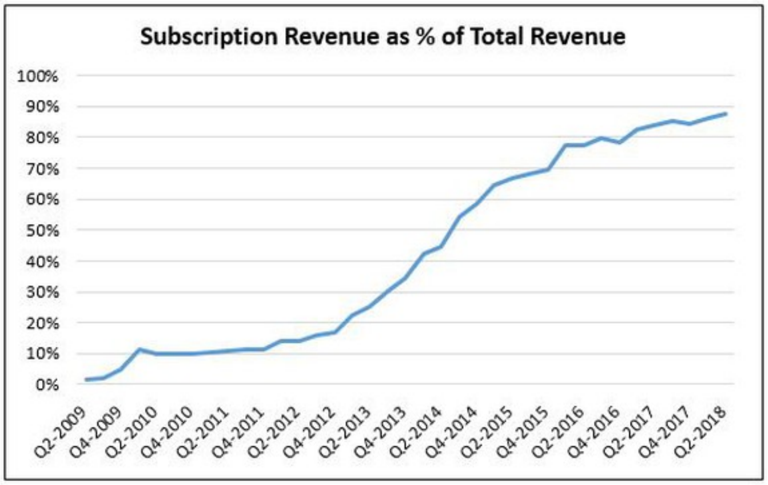
Adobe also made a relatively big acquisition in Q2, a $1.68 billion acquisition of Magento Commerce, a market-leading commerce platform. Adobe plans to integrate the Magento Commerce Cloud into the Adobe Experience Cloud, delivering a single platform that serves both business-to-business (B2B) and business-to-consumer (B2C) customers. This acquisition should bolster Adobe's Digital Experience business as it broaden's the company's addressable market by an estimated $13 billion, and it should help Adobe cross-sell its current offerings to a wider customer base.

The company outperformed its guidance in the quarter across almost all of its metrics...

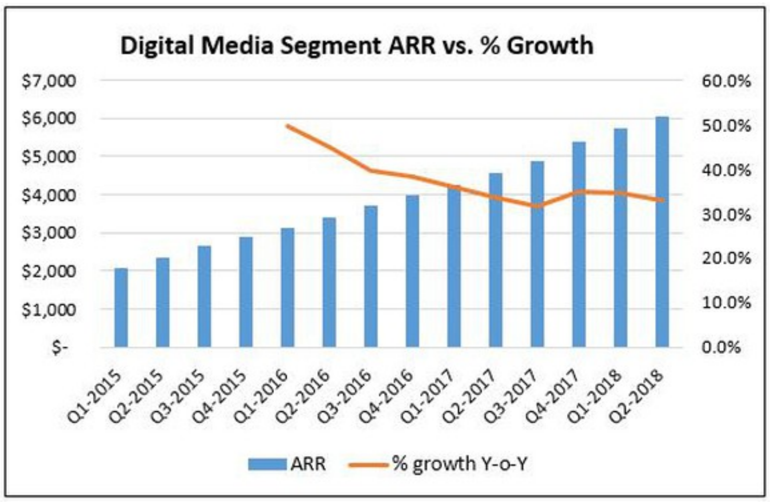
Metric	Q2 Guidance	Q2 Actual
Total Revenue	$2.15 billion	$2.20 billion
Digital Media Revenue	25% growth	28%
Digital Experience Revenue	15% growth	18%
GAAP Earnings-Per-Share	$1.16	$1.33
Net New Digital Media Annualized Recurring Revenue (ARR)	$330 million	$343 million

...and management expects business momentum to continue in the second half of 2018.

The company continues to do an excellent job at converting legacy license users (and adding new users altogether) to subscription-based products, and subscription revenue accounted for a record 88% of companywide revenue in the quarter:

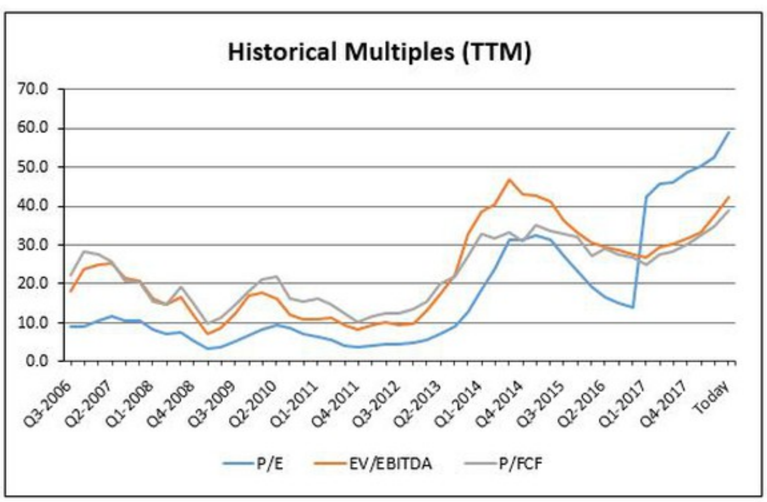


Annualized recurring revenue (ARR) in the Digital Media segment is now greater than $6 billion, and the recurring revenue base is still growing at a robust 30%+ pace:

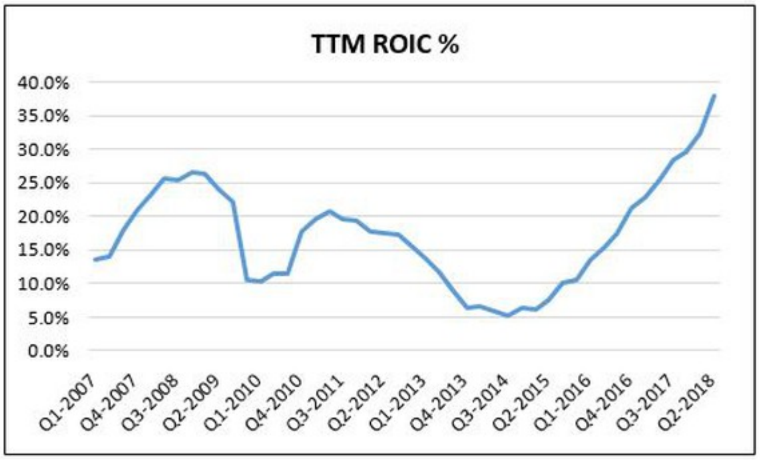


- **Updated guidance**: Best Buy Now (from Buy)
- **Recommended allocation**: 2.9%
- **Fair-value estimate**: $235 (up from $220)
- **Current price:** $255

At about $255 per share, the stock is priced at 59 times trailing-12-month (TTM) earnings-per share (EPS) and 39 times TTM free cash flow:



The stock has appreciated strongly over the last several years; up 216% over the last three years, 79% over the last year, 42% year-to-date, and up 12.7% since we added the company to the *Pro* portfolio in April. Although the business has been growing very strongly, the stock has been appreciating faster than earnings and cash-flow growth, leading to expanding multiples. Nonetheless, the company's expanding free cash flow generation and positive ROIC trends provide support for those higher multiples:

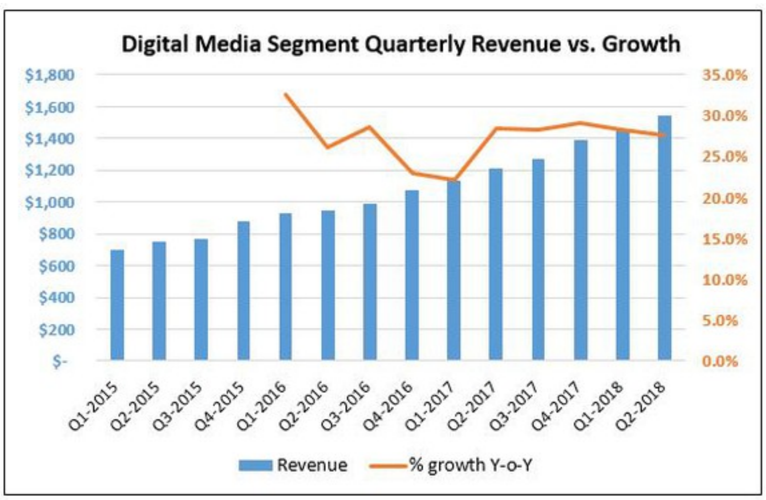


Despite the expanded multiples, we think that Adobe is likely to continue its recent business momentum, allowing the stock to grow into its valuation. We expect continued strong growth in revenue, earnings, and free-cash flow, although the stock's elevated multiples may eventually put a lid on stock-price appreciation until the business can catch up.

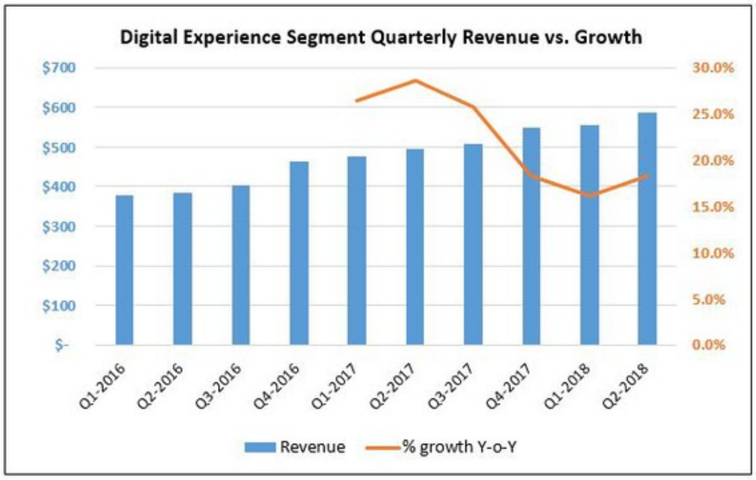
Our fair-value estimate increases to $235 (from $220), and Adobe moves to Best Buy Now (from Buy). With our new interpretation of the "Best Buy Now" terminology (outlined here in a recent Memo from Jeff), we think that Adobe is one of the highest-conviction ideas in the *Pro* portfolio, with a strong ability to earn healthy returns over the coming three years and beyond. Members who have yet to fill out their positions can feel comfortable doing so at current prices. However, due to recent stock price appreciation, Adobe is approaching the upper end of our valuation range, and we'd start to become a bit more cautious once the stock price reaches levels of about $265 or so.

Segment Performance

Looking at the individual business segments, the Digital Media segment (which is Adobe's largest and most profitable segment, representing 70% of TTM companywide revenue and 78% of companywide gross profit) continues to post strong, consistent growth. Revenue in Q2 for the Digital Media segment came in at $1.55 billion, up 28% year-over-year. Revenue growth in this segment is slowly decelerating (as we expect it to), but growth is still very healthy at 25%+ rates, and management is guiding for ~25% growth in the segment in the third quarter:



The Digital Experience (i.e. digital marketing) segment is also performing very well, although growth is less robust than in the Digital Media segment. Q2 Digital Experience revenue came in at $586 million, up 18% year-over-year. Management is guiding for ~15% growth for the segment in the third quarter. Due to higher competition in the digital advertising business, and due to Adobe's newer presence in this segment and its shifting product offerings (in part due to acquisitions), growth will likely be lumpier in this segment than in the larger, more stable Digital Media segment:



Our Thesis

Adobe is one of the largest software companies in the world, providing products and services used by creative professionals to create, deliver, manage, and measure multi-media content and experiences. Adobe a growing, high-quality business that operates with competitive advantages in two complementary markets with strong secular tailwinds (digital content creation and digital advertising), and the company should be able to increase its revenue and earnings at healthy rates for years to come, giving us a strong chance at North Star-beating returns over the long run.

We Evolve to Keep Performing

Published Jun 18, 2018 at 3:47PM

Greetings, *Pro* members,

I'm usually eager to admit and discuss our mistakes, because we learn valuable lessons from them, and we try to view mistakes as an opportunity to grow. But I believe we can learn even more from our exceptional investments. The Motley Fool as a whole has evolved in its ability to spot potential winners, knowing to focus on companies with unique offerings, driven leaders, and something that protects their profits from copycats, among other factors.

Our 25 years of investing in the service of our members has led the Fool to become ever smarter and do ever better, and we still keep progressing. The pace and scope of change in the world only accelerates. Companies need to adapt, too, or suffer at the hands of those that do. Investors need to adapt or risk weaker returns and, potentially, some big, permanent losers.

Pro Nears 10 Years

All of our mistakes included, *Motley Fool Pro* has achieved exactly what it set out to do at the outset. As we near our 10-year anniversary this fall, we have achieved a decade of fairly steady returns with less volatility than the stock market, and with less risk (or less market exposure) because of our ample cash and hedges along the way. Thanks to an unwavering belief in our economic recovery and a time-honored Foolish approach of letting our winners run, we've in fact done much better than we hoped.

We've returned 13.6% annualized (not counting the very strong June we're having), while our never-negative North Star -- our guiding light -- has returned 8.5% annualized. Our total return through the end of May is 241.8% against 120% for the North Star (see, compounding leads to larger discrepancies in total returns -- in our favor, here -- than the annualized number would suggest). You can always see our returns at the bottom of the portfolio page.

Overall, we're in an enviable position as we approach our 10-year anniversary. We're achieving what we set out to do, and we've greatly enjoyed our time with you (a handful of really stressful events aside). But ... I think we can do even better. Everyone needs to evolve; *Pro* needs to keep evolving, too, while maintaining its overarching goal of steady returns with reasonable risk.

I've been saying for years now that we need to keep adding younger, growing companies if we hope to maintain a lead on the North Star even during periods of low market returns. Such younger companies could lead the way during those times, because they'll likely keep growing. Under this argument, we added **Facebook** (NASDAQ: FB) when it was relatively wee -- and more to the point, we brought smaller companies like **Paycom** (NYSE: PAYC), **Square** (NYSE: SQ), and even **JD.com** (NASDAQ: JD) on board as well.

We should be adding more each year. We're now at a point where we generally need to raise cash to buy new stocks, which means selling laggards or selling some winners. It might be easier to add cash to *Pro* on a regular basis, but, good Fools, that's not our mandate. The cash we deposited in 2008 is what we have to work with. And we like the challenge. So, among those in the bubble to potentially be sold in whole or in part are **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS), **Gilead Sciences** (NASDAQ: GILD), and **Oracle** (NYSE: ORCL).

Why? Well, we probably don't need to tell you, being the wise market observer that you are. But just in case ...

Emerging-market economies like those DGS represents may suffer if the U.S. continues to get tougher on trade. In direct contrast, smaller U.S.-based companies, especially those selling software or other intangibles, should largely sidestep those trade concerns. Gilead, as we all know, has disappointed investors for a long time, mainly because the Hepatitis C market become competitive quickly. And Oracle will be a challenge to maintain at our full allocation *if* it doesn't start to gain traction on its cloud results.

Several young, growing software companies interest us right now. We'll see Oracle's earnings Tuesday after the market closes, and that may help us with our next step.

At the same time, the stocks above remain Buys in *Pro*. We need to be mindful that so-called "growth stocks" are lately soaring -- we've benefited from this ourselves -- and this obviously brings more valuation risk. We need to proceed carefully, using the "first, do no harm" rule. We don't want to sell a stable if sleepy business for a shooting star that's about to enter a long, North-Star-trailing descent, even if it eventually recovers.

Yet evolve we must, doing our best to keep buying stock in young companies that will continue to perform exceptionally well. Many of today's darlings will find challenges ahead, so we need to choose carefully. But we're going to keep moving *Pro* forward with small batches of trades, like the one we completed two weeks ago. Stay tuned.

The *Pro* Boards

A word to the Foolish! We've created some new *Pro*-only discussion boards and closed some others. Please get the rundown here, and then look forward to the *Pro* team visiting our focused *Pro* boards as you have questions for us. Meanwhile, also enjoy the entire Premium Community world to which you now have access! There, you can discuss countless companies, including *Pro* holdings, alongside other Foolish investors who share similar goals.

To share your thoughts, please visit the Memo Musings board. And Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: June 18, 2018

Published Jun 18, 2018 at 2:54PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

Thanks to increased earnings estimates and a higher fair-value estimate of $186, **Facebook** (NASDAQ: FB) joins our recently revised Best Buy Now list. The full list, which debuted last week, is repeated below with the addition of Facebook:

- **Adobe Systems** (NASDAQ: ADBE); our fair-value estimate also increases today to $235 from $220
- **American Tower** (NYSE: AMT)
- **CME Group** (NASDAQ: CME)
- **Facebook**(NASDAQ: FB)
- **JD.com** (NASDAQ: JD)
- **Mastercard** (NYSE: MA)
- **Paycom** (NYSE: PAYC)
- **Tencent Holdings** (NASDAQOTH: TCEHY)

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Oracle** (NYSE: ORCL): Our June $52.50 short calls expired as income. Sometime after earnings on Tuesday, we'll make our next decisions for our diagonal call.
- **The Cooper Companies** (NYSE: COO): We sold to open August 2018 $130 calls on our long shares, selling four contracts at $11.59 each.
- **Verisign** (NASDAQ: VRSN): All 500 of our shares were sold as our June $115/$110 covered strangle reached expiration. We don't have a Verisign stake as of now.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Expirations: Cooper Companies, JD.com, and More

Published Jun 14, 2018 at 2:06PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **CME Group** (NASDAQ: CME): Buy 2.4%.
- **JD.com** (NASDAQ: JD): Buy 2.9%.
- **Tencent** (NASDAQOTH: TCEHY): Buy 2.7%.

Continue building your portfolio with our Buys, including:

- **Coherent** (NASDAQ: COHR): Buy 1.5%.
- **Medtronic** (NYSE: MDT): Buy 2.4%.

Shorts:

- N/A

Options:

- **The Cooper Companies** (NYSE: COO): Although the stock is now above the adjusted $230 strike price recommendation we issued this week (for those who hadn't made the original trade yet), we still plan to write these August $230 calls ourselves. Naturally, they now pay more than before (lately about $9.25). If you're new to the trade, buy shares in 100-round lots and sell to open these same August $230 calls, capturing some intrinsic value, and a more than 3% yield or return potential in just over two months. Finally, as we said with the adjustment alert, if you wrote the $240 calls originally, you can continue to keep those open instead.

Upcoming Expirations (June 15):

- **Oracle** (NYSE: ORCL): Our short $52.50 calls -- as part of our 2020 diagonal call -- will expire as income this weekend. We're watching to write new ones when they pay enough.
- **Verisign** (NASDAQ: VRSN): Our short $110/$115 covered strangle is in-the-money on the call side. As explained in a recent Monday Memo, we plan to let our shares go, meaning no action is required. Our shares will be sold this weekend. Given they were capped, they haven't contributed to our returns for some time now. We'll raise 2% cash through the sale.

Trade Adjustment: Cooper Companies Covered Call

Published Jun 13, 2018 at 10:26AM

Is this for you? This is for *Pro* members currently participating in our covered-call position on **The Cooper Companies** (NYSE: COO), especially those who have yet to fulfill our May 22 trade alert. *Pro* was unable to follow that May 22 guidance; if this applies to you, too, you can join in the updated guidance below. If you *did* complete that original covered-call trade already, you don't need to do anything today but wait for August.

How You Participate

- **Action:** Write ("sell to open") August 2018 $230 calls.
- **Allocation:** Write ("sell to open") one call for every 100 shares you already own.
- **Price Guidance: It is imperative that you use a limit order, given the wide bid-ask spread for the August calls**. With shares at **$227.80,** the minimum to accept is currently **$6.70.** We'll provide updated guidance this Thursday in our Catch-Up Trades column.
- **Prices** (10:03 a.m. ET):
  - Cooper Companies: $227.80
  - Sell to open August 2018 $230 calls (bid/ask): $6.60/$7.20
  - Current bid-ask midpoint: $6.90

What We're Thinking

Timing was not on our side with our recent Cooper Companies covered-call recommendation. With the stock at about $234, we were hoping to collect a decent yield writing the August $240 calls ahead of earnings. But the stock declined shortly after our alert went out, taking the $240 call premiums with it. Since the calls currently pay less than half of what we were initially targeting, we're left with two options -- either adjust our strike price, or stay on the sidelines and wait for the stock to recover before writing calls. Lowering our strike price increases the odds we'll need to roll this position come August expiration, but we're willing to take that risk to help fill the income vacuum left by our soon-to-be-closed Verisign covered strangle. Assuming we're unable to roll up and out come August (the upside worst-case scenario), we'd be locked into a 2.4% loss on the stock and a 7.1% option yield on our initial purchase price earned since our Jan. 17 initiation.

Why didn't we do this sooner, or accept a lower yield on the August $240 calls? Because *Pro* must wait to make our trade until 24 hours after we issue our recommendation, and by that time, our target yield was no longer achievable. Thus, we felt it was best to wait to see what earnings would bring. Now that earnings are past, and with no foreseeable catalyst to drive the stock much higher over the next few months (although of course one never knows!), we're comfortable with the idea of lowering our strike price and advising members who are still sitting this one out to do the same. This is, after all, an income position, so we want to keep targeting reasonable income.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call's strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up:** If the stock price rises above our strike price by expiration, we may let our shares get sold; right now, though, it's more likely that we'd roll our calls to a later date or a higher strike. We'll cross any such bridge near expiration, once time value is dissipating from the calls.

Alternative Recommendations

- **Coming new today?** Buy stock in lots of 100 shares. Then, write ("sell to open") one August 2018 $230 call for every 100 shares owned. Aim for a net debit (what you pay for shares, less what you are paid for writing the call) of roughly **$221.30.**

- **Want to write puts?** Currently, you can write the August 2018 $220 puts for **$4**, or a 1.8% yield in 65 days.

Pro Can Help

- **Blurry vision?** You're probably going to want to get that checked out, but if you have any Cooper-related questions, please head on over to our *Pro* Trade Alerts board.

Breaking News on Best Buys Now

Published Jun 11, 2018 at 4:07PM

Greetings, *Pro* members,

Our Best Buys Now in *Pro* have always represented what we believed were our strongest risk-vs.-reward investments. When seeking stocks for the list, we asked ourselves: Which stocks will provide our desired return (or greater) with the least amount of risk to the thesis -- and probably a lower-than-average amount of price volatility as a result?

This approach meant that our Best Buys Now were often less volatile stocks, such as **Oracle** (NYSE: ORCL). If we believed a stock would return at least 10% annualized with lower-than-average risk, we thought *Pro* members should buy it before others that appeared to have much higher risk.

However, when our more volatile stocks went on sale -- which happened with **Square** (NYSE: SQ) in past quarters and with **Facebook** (NASDAQ: FB) at several points over the years -- we'd move those to Best Buy Now status as well, because the potential reward had grown to dwarf the risk. Facebook stayed a Best Buy Now for a long, long time, and it could arguably remain one today.

But *Pro*'s approach to Best Buys Now has evolved recently to better match the Motley Fool-wide definition of the term. From here forward, our Best Buys Now are our highest-conviction ideas, period. These stocks are those we think have the strongest ability to earn healthy returns over the coming three years and beyond. The time frame is always the next three years -- and we roll our thinking forward day by day, indefinitely. We're less concerned about potential volatility now, and more focused on the ultimate outcome.

Why do we believe so strongly in these Best Buys Now for the coming years? Because the current share price allows for handsome appreciation -- and each business is in a special position to keep on winning. **American Tower** (NYSE: AMT) enjoys long-term tower rental contracts that have price escalations, and connectivity needs are only growing. **CME Group** (NASDAQ: CME) dominates in many areas of futures trading, should continue to see record trading volume as interest rates rise, and enjoys remarkable margins. With a giant payroll market to address, **Paycom** (NYSE: PAYC) trades at 39 times expected earnings for the year ahead -- not a crazy premium for a company estimated to expand earnings per share by 56% from 2018 levels by 2020.

And on the list goes. You can see our latest Best Buys Now here. We'll write a summary paragraph with each Best Buy Now update going forward, too, so you'll have more (and very current) context.

Our Best Buys Now are not likely to change that often (remember our long-term outlook), but we'll officially provide an update once each month, and we'll make a change at any point when we see new opportunities. If one of our holdings declines sharply without good reason, for example, or a business is excelling and we want to move it to Best Buy Now status right away, we'll send that update that day.

As you review the updated list, please realize that we could make *half or more* of the stocks in our portfolio into Best Buys Now and feel great about that. We have a concentrated portfolio of about two dozen positions, meaning we need to believe strongly in all of them (and we do; when we have issues with a position, we let you know). But for the purposes of Best Buys Now, we work to whittle the list down and focus on a handful, guiding *Pro* members into half a dozen stocks or so to start.

Bottom line: *Pro* is a full portfolio service, so remember that we like (and/or have hope for) all of our holdings. That includes current laggards, or we wouldn't keep them! Also, we don't know which stocks will ultimately create the most value for us, so we suggest owning all of them, as you're meant to with a portfolio.

The Market

According to S&P Capital IQ, today the S&P 500 trades at 16.6 times expected earnings per share for the year ahead. According to FactSet, the average for this multiple over the past five years is 16.2; over 10 years, it's 14.4. Generally speaking, the S&P is trading about where we'd expect it, especially if companies continue to grow well. Earnings for the index as a whole are expected to expand by 19% in the quarter now under way (another good showing after 24% last quarter) as revenue growth picks up pace over prior years. Like everyone else, we're studying to see how international trade may shake out.

To share thoughts, please visit the Memo Musings board. And Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: June 11, 2018

Published Jun 11, 2018 at 12:35PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

Our updated Best Buy Now list is:

- **Adobe Systems** (NASDAQ: ADBE)
- **American Tower** (NYSE: AMT)
- **CME Group** (NASDAQ: CME)
- **JD.com** (NASDAQ: JD)
- **MasterCard** (NYSE: MA)
- **Paycom** (NYSE: PAYC)
- **Tencent Holdings** (NASDAQOTH: TCEHY)

Every other position is rated Buy, except **Verisign** (NASDAQ: VRSN), which is a Hold as our shares are slated to be called away this coming weekend.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): We sold all of our shares last week at $13.48.
- **ProShares Ultrashort Real Estate** (NYSEMKT: SRS): We covered all of our shares at $29.74.
- **Shake Shack** (NYSE: SHAK): We covered all of our shares at $62.25.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Expirations: Coherent, JD.com, Paycom, and Tencent

Published Jun 7, 2018 at 2:15PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **JD.com** (NASDAQ: JD): Buy 2.6% per our recent alert.
- **Tencent** (NASDAQOTH: TCEHY): Buy 2.5%.

Continue building your portfolio with our Buys, including:

- **Coherent** (NASDAQ: COHR): Buy 1.5%.
- **Paycom** (NYSE: PAYC): Buy 3.9%.

Shorts:

- N/A

Options:

- N/A right now.

Upcoming Expirations (June):

- **Oracle** (NYSE: ORCL): Our short $52.50 calls -- as part of our 2020 diagonal call -- are on track to expire as income before earnings next week. We're watching to write new ones, if and when they pay enough.
- **Verisign** (NASDAQ: VRSN): Our short $110/$115 covered strangle is in-the-money on the call side. As explained in Monday's Memo, we plan to let our shares go, meaning no action is required.

Verisign and the Great Valuation Debate

Published Jun 4, 2018 at 3:45PM

Performance as of 5/31/2018

	Annualized		Total Return	
	Since Inception	Rolling 3-Year	YTD	Inception
Pro Portfolio	**13.6%**	**11.4%**	**5.1%**	**241.8%**
North Star	**8.5%**	**8.9%**	**4.5%**	**120.0%**
S&P 500 Total Return	12.6%	11.4%	2.0%	215.2%
MSCI World	7.2%	5.6%	-0.5%	95.1%

*Start close of 10/6/08.

Pro is up 13.6% annualized since inception, and 5.1% year-to-date.

Dear *Pro* member:

When we initially set up our covered strangle on **Verisign** (NASDAQ: VRSN) a little more than 17 months ago, we were seeking both income and capital gains. We expected a slow recovery in the stock price after what we considered to be the market's overreaction to an influx of speculative domain-name purchases by Chinese investors. But although we were correct about the recovery, its pace surprised us -- the stock is currently up 70% from when we first purchased shares, and we've been playing catch-up for much of the time we've had Verisign in our portfolio. In each of our four subsequent strangle-rolling trade alerts, we ended up rolling our short call's strike price higher. Recently, this meant little to no additional income as we tried to keep up with the stock's market-beating returns.

Today, our short call's strike price of $115 is well below the stock's recent price of $134.85. The only way we could conceivably keep the position alive would be by paying a significant net debit to roll our short calls higher. (That debit will be nudged upward by the effect *Pro* member volume will have on option prices -- but we're not complaining!) After considering the possibilities, we've decided the best course is to let our shares be called away unless the stock price falls by a noticeable amount before June 15 expiration.

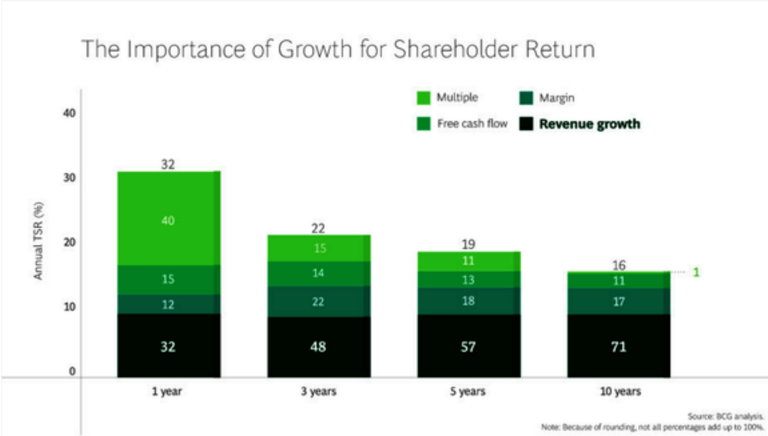
Foolish or foolish?

As the promo for this Memo notes, our decision here was largely driven by valuation concerns. This may seem surprising at first, given our general stance that selling shares of a great company for valuation reasons frequently ends up looking foolish (with a lower-case "f") down the road. But we believe our position in Verisign currently qualifies as an exception to this rule.

To see why, we need to get back to basics. What determines exactly how much a company is worth? If a company's value is ultimately based upon how much money it can make in the future, then I think we can value that company by trying to solve for two variables: growth and margins. Everything else that could have an effect — excellent management, intangible assets, competitive positioning, total addressable market, etc. — ultimately ends up being reflected in the company's growth rate and/or margins.

We'll take margins first: A quick glance at Verisign's financial statements is all it takes to see that the company is anything but average. As the sole registry for .com and .net top-level domains, Verisign has little need for marketing, maintenance spending, and other activities that typically eat away at margins. The end result is that, year in and year out, Verisign remains one of the best public companies around when it comes to margins and returns on invested capital -- this business converts more than 56% of its revenue (!) into free cash flow. (Contrast this with the S&P 500, whose constituents convert, on average, less than 15% of revenue into free cash flow. In a good year.)

The issue is that Verisign simply doesn't have all that many opportunities to invest new capital to expand the business beyond the low-single-digit rate we've forecast for the foreseeable future. Think about the companies that are citied as classic examples of why selling based on valuation is foolish — Google, Amazon, Apple, Facebook, just to name a few. There's one thing these businesses had in common when people thought their stocks were "expensive": growth. Specifically, a giant addressable market and business model that allowed them to grow at an above-average rate for far longer than even most bulls thought possible. In fact, The Boston Consulting Group has found that the longer your timeframe, the most important growth becomes. Their study of the top-quartile value creators in the S&P Global 1200 from 1993 through 2013 found that revenue growth accounted for 71% of 10-year total shareholder returns:



Verisign is a great company, but the part of the business that brings in most of its revenue and profits — the .com registry — is mature, and there is nothing management can do to change this. There may be an infinite number of .com domain names available for registration, but the vast majority of these domains will remain worthless (I'm currently selling the sdgwedgs353234sdser45gsrfs.com domain name for the low, low price of $1 million, if you're interested?). And the massive size of the .com registry means any other new initiatives to generate additional registry-based revenue will have a marginal impact on the overall results of the business unless the company moves away from its current modus operandi of focusing on its core business and buying back shares by the fistful -- and we'd be opposed to that. The end result is a business where 5% annual revenue growth appears to be the best-case scenario.

Why is below-average revenue growth problematic? Because there's currently a big disconnect between the current stock price and our estimate of Verisign's fair value. This means that either (a) our fair-value estimate is wrong or (b) the stock is overvalued. For the former to be true (and to be able to justify keeping the position open), we would need to be significantly underestimating how fast the company can grow, how high margins can ultimately climb, or some combination of the two. And it's hard to believe we're being too conservative, given that our current estimates of Verisign's incremental operating margin hover around an extremely impressive 85% (meaning the company generates $0.85 of operating profits on each additional dollar of revenue it collects). There simply isn't much room for margins to go any higher. This means the burden of reconciling our fair value with the current price falls largely on Verisign's growth rate, but even if we aggressively increase our estimates for top-line growth, our estimate still lags the current price by a noticeable margin.

The Foolish Bottom Line

When we originally recommended setting up a covered strangle on Verisign, our our five-year price target (2021) for the stock was $135 to $145, meaning today's price of $134.85 is within striking distance of our target -- more than three years ahead of schedule. To date, we have yet to see anything in the company's financial results to suggest that our estimates were overly conservative. What we have seen, however, is significant multiple expansion. At more than 30 times free cash flow, Verisign could end up struggling to beat the North Star over the next three to five years, especially if our position requires us to put a significant amount of capital in the position to play catch-up with the current stock price. Because of this, we plan to say bye.com to Verisign as of June 15, expiration, barring a big drop in the stock.

To discuss Verisign, please visit its board.

Pro Guidance Changes and Completed Trades: June 4, 2018

Published Jun 4, 2018 at 1:06PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **JD.com** (NASDAQ: JD): Moves to Best Buy Now from Buy.
- **Medtronic** (NYSE: MDT): Moves to Buy from Best Best Now on recent sharp price appreciation.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **JD.com**: On May 25, we bought 2,400 shares at $36.93, starting a 2.6% position.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Spring Is Off to a Late Start for Home Depot

Published May 31, 2018 at 2:40PM

First-Quarter 2018

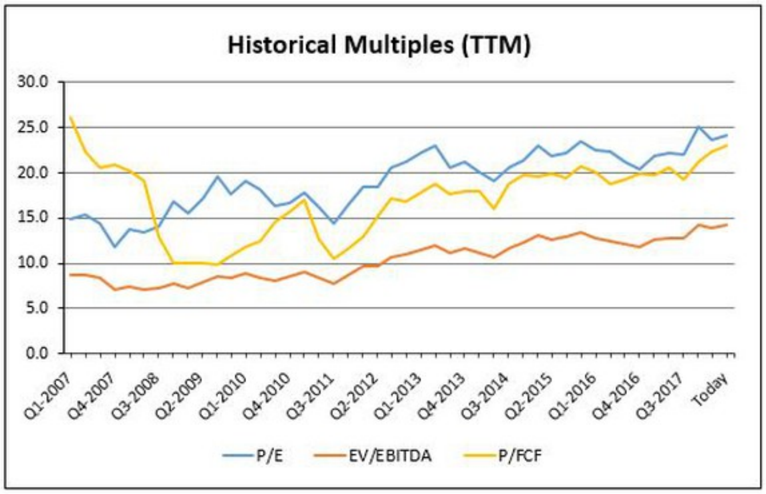
- Press Release
- Earnings Infographic
- Conference Call Transcript
- 10-Q Filing

Home Depot (NYSE: HD) had a weather-related slowdown in growth in the first quarter of 2018, reporting revenue growth of 4.4%, comps growth of 4.2%, and earnings-per-share growth of 24%. Despite a volatile stock price over the past six months or so, Home Depot continues to post steady sales growth and housing market data continues to support a favorable forward outlook for this well-managed business.

- **Updated guidance**: Buy (Diagonal Call)
- **Recommended allocation**: 1.7% in January 2020/October 2018 $110/$180 diagonal calls.
- **Fair-value range:** $160-$190

- **Current price:** $185.79

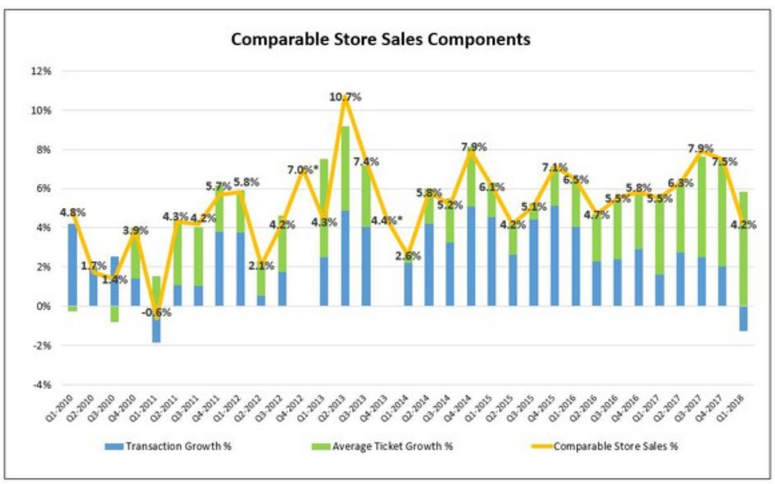
At about $186 per share, the stock is priced at 14.1 times trailing-12-month (TTM) EBITDA, 22.7 times TTM free cash flow, and 24.1 times TTM earnings-per-share (EPS):



Based on management's guidance of $9.31 for full-year 2018 EPS, Home Depot is priced at about 20 times expected 2018 earnings, suggesting significant multiple contraction if the stock remains at recent prices. As we can see from the graph above, since 2013 Home Depot has rarely traded at (or below) a P/E multiple of 20, indicating likely upward pressure on the stock if the company can expand earnings in 2018 as it expects.

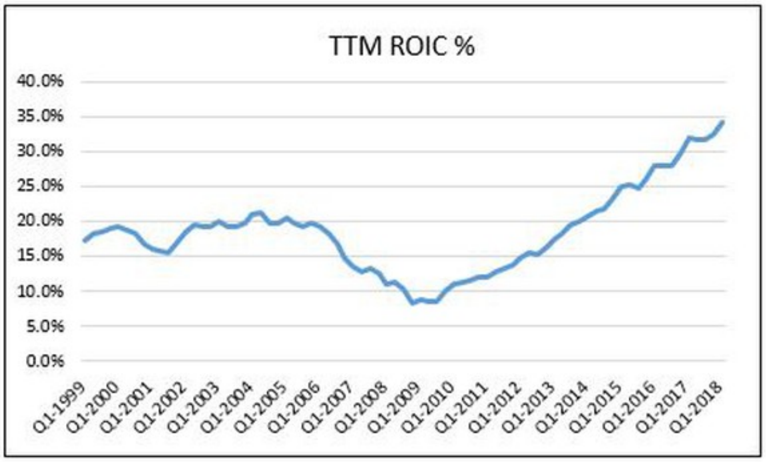
Business Performance

As has been typical of Home Depot since its inclusion in our portfolio in October 2017, business performance in the first quarter of 2018 was strong. The company reported year-over-year revenue growth of 4.4% and 4.2% growth in comparable store sales. This quarter marked the 28th straight featuring positive comps, a remarkable result for a physical brick-and-mortar retailer in the Amazon era:



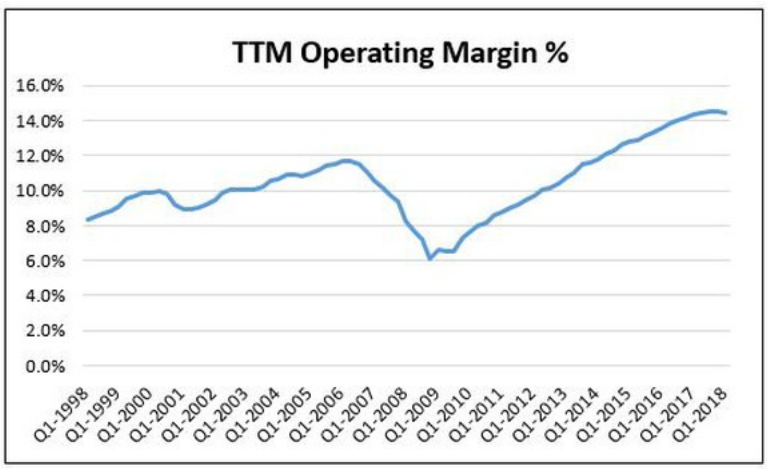
However, as we can see in the graph above, comps performance was a bit lighter than usual. This quarter was the lowest growth figure for comps since Q2 of 2015, and the first quarter since Q1 of 2011 that transaction growth was negative compared with the prior year. Management's explanation for the somewhat weaker performance this quarter was unusually cold weather, which seems reasonable given the record cold and snow in the northern U.S. in April (weather was also the culprit for that weak quarter back in Q1 of 2011). Additionally, management mentioned on the earnings call that so far in May, comp sales are double-digit positive as lost sales from April are seemingly being recaptured.

Home Depot's ROIC continues to climb. This quarter it's mostly thanks to tax reform, as the company's effective tax rate for the quarter came in at 23.5% compared with 35.2% in the same quarter last year:



The lower tax rate helped push net margins up to 9.6% for the quarter compared with 8.4% in the same quarter last year, and EPS rose by 24% to $2.08 per share (vs. $1.67 per share last year). Given management's intent to aggressively increase spending on strategic investments (supply chain, new stores, and information technology), lower tax rates should provide most of the boost to earnings in 2018.

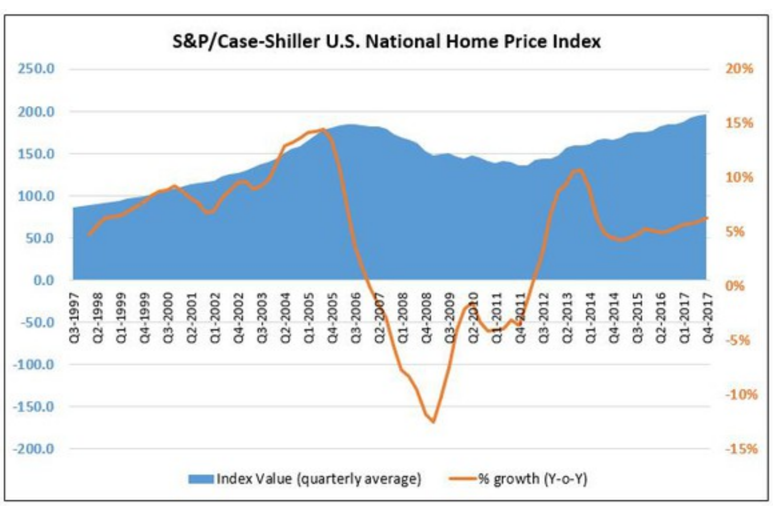
We can already see the effect of higher spending on the company's operating margins, as SG&A spending increased from 18.3% of sales in the same quarter last year to 19.2% of sales this quarter, leading to lower operating margins:



Home Depot's "interconnected retail strategy" continues to resonate with consumers, as online sales rose by approximately 20% vs. Q1 of 2018. This is an impressive result given that retail e-commerce sales in the U.S. are rising at about 13%. Home Depot has done an excellent job interfacing its physical stores with its online website (with a sophisticated supply-chain network), allowing the company to capture a healthy portion of online sales growth. In fact, Home Depot was the fourth most popular online store in the U.S. in 2017 as measured by net e-commerce sales (behind just Amazon, Walmart, and Apple).

The Housing Market

In addition to Home Depot's strong business performance, recent housing market data suggests continued growth in home improvement spending. Home-price appreciation is accelerating, with the most recent reading in March showing 6.5% growth in the S&P Case-Shiller National Home Price Index. This is the highest growth rate since May 2014, and we've seen home-price growth accelerate on a year-over-year basis for 21 straight months:



Home-price appreciation is being driven by a combination of a healthy economy, low unemployment, and low inventories of homes for sale. There is a pent-up demand for home-buying following the 2008-2009 recession, although low inventory levels are preventing that demand from translating into new household formation. This high-demand/low-supply situation is causing upward pressure on home prices.

Here is an except from the press release that accompanied the announcement of the March Case-Shiller Home Price Index data:

> "Looking across various national statistics on sales of new or existing homes, permits for new construction, and financing terms, two figures that stand out are rapidly rising home prices and low inventories of existing homes for sale. Months-supply, which combines inventory levels and sales, is currently at 3.8 months, lower than the levels of the 1990s, before the housing boom and bust. Until inventories increase faster than sales, or the economy slows significantly, home prices are likely to continue rising. Compared to the price gains of the last boom in the early 2000s, things are calmer today. Gains in the National Index peaked at 14.5% in September 2005, more quickly than Seattle is rising now."

As further evidence for the robustness of housing demand, the NAHB/Wells Fargo Housing Market index (a measure of builder confidence) rose to 70 in May after a downward revision in April. Here is an excerpt from the press release for the NAHB index:

> "Builder confidence in the market for newly built single-family homes rose two points to a level of 70 in May after a downwardly revised April reading on the National Association of Home Builders/Wells Fargo Housing Market Index (HMI). This is the fourth time the HMI has reached 70 or higher this year.
>
> "The solid May report shows that builders are buoyed by growing consumer demand for single-family homes," said NAHB Chairman Randy Noel, a custom home builder from LaPlace, La. "However, the record-high cost of lumber is hurting builders' bottom lines and making it more difficult to produce competitively priced houses for newcomers to the market."
>
> "Tight housing inventory, employment gains and demographic tailwinds should continue to boost demand for newly built single-family homes," said NAHB Chief Economist Robert Dietz. "With these fundamentals in place, the housing market should improve at a steady, gradual pace in the months ahead.""

Pro Catch-Up Trades and Expirations: JD.com, Paycom, and More

Published May 31, 2018 at 12:41PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

Continue building your portfolio with our Buys, including:

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.9%.
- **Coherent** (NASDAQ: COHR): Buy 1.5%.
- **JD.com** (NASDAQ: JD): Buy 2.6% per our recent alert.
- **Paycom** (NYSE: PAYC): Buy up to 4.1%.
- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): We're selling our entire 0.3% position, per today's alert.
- **The Cooper Companies** (NYSE: COO): Buy 2.7% to write covered calls (so at least 100 shares) per that alert as the stock recovers.

Shorts:

- We'll be buying to close two positions -- **UltraShort Real Estate** (NYSEMKT: SRS) and **Shake Shack** (NYSE: SHAK) -- per today's alert.

Options:

- N/A right now.

Upcoming Expirations (June):

- **Oracle** (NYSE: ORCL): Our short $52.50 calls -- as part of our 2020 diagonal call -- are on track to expire as income. We're watching to write new ones.
- **Verisign** (NASDAQ: VRSN): Our short $110/$115 covered strangle is in-the-money on the call side. We'll have guidance before expiration, but we expect to let our shares go unless pricing changes.

Close Your Positions on SVXY, SRS, and Shake Shack

Published May 31, 2018 at 12:41PM

Is this for you? Everyone with these positions open should consider this recommendation. These positions are small, and we're cleaning house.

How You Follow Along

- **Trades:**
  - Use a limit order around the recent NAV or higher to sell all shares of **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY). We have a 0.3% allocation.
  - Use a limit order around the recent NAV or *lower* to close (cover) all short shares of **ProShares Ultra Short Real Estate** (NYSEMKT: SRS). We have a 0.1% allocation.
  - Use a limit order at the going share price or lower to close (or cover) all short shares of **Shake Shack** (NYSE: SHAK). We have a 0.7% allocation.
    - Take your time and use limit orders. *Pro* has 30 days to complete these trades.

What We're Thinking

With a mature portfolio, it often makes sense to make position adjustments and changes in small baskets of trades, two or three at a time, with the context of the whole portfolio in mind. Today's alert is the first time we've made such a change in awhile, but it won't be the last. In fact, it's just the start of some housecleaning in store at *Pro*, making room for new positions and strategies we like better. That's especially true in cases where we're clearing out failing positions.

After these three trades are completed, we intend to move forward with more trade alerts, making other adjustments, working to get the portfolio back to pure 100% conviction. We've been patient with these three, perhaps to a fault; we sometimes allow our conviction to dip for months on some positions, in hopes that the tide will turn. This patience is also what helps us keep our long-term winners in the portfolio during times of duress, and overall, patience rewards us much more than it hurts.

So why now? Let's run through the thinking behind these three closures.

SVXY

Why Close? This exchange-traded note's price crashed in February, when VIX futures increased more in one day than ever before. Afterward, SVXY changed its mandate; instead of being short the short-term VIX futures on a 1:1 ratio, it began targeting just *half* of the inverse of those futures' price move. That has made the vehicle much less volatile, and less likely to suffer catastrophic losses. But this also makes appreciation slower (and perhaps more difficult) for the ETF to achieve. In short, the vehicle is no longer what we invested in; it isn't set up to appreciate the way it once had.

What's Next? After selling our shares (and getting a tax loss), we'll consider a *different* way to short VIX short-term futures on a 1:1 basis again -- and different ways to profit on volatility, period. So, we're not done with this strategy, but we need to change our vehicle and approach. We're closing our 0.3% stake at a large percentage loss, but we're confident over time that we should profit using a different method of investing against VIX futures.

SRS

Why Close? This position is basically now the cigar-butt ending of a successful short. Our 0.1% short in this ultra-short real-estate ETF has made us a majority of what it can. Meanwhile, the ETF is tiny now, with only about $25 million in assets (so be very, very careful closing it! Use a limit order, and don't push it above its NAV price). It's currently so small, in fact, that shares to short aren't easy to obtain anywhere. At Interactive Brokers, they now cost 7% a year to borrow, with only 2,000 shares lately available for the purpose (and sometimes none). In other words, this is a tired position with much more risk than reward remaining, and now that it's again near its all-time low (after a big spike to start the year), we're cleaning house by closing it here.

What's Next? The gains we made on this short are fully offset (for tax purposes) by the losses on the other shorts we're closing. So, at least it's a tax-free profit. Next up: With interest rates rising, we will tread cautiously into any future real-estate investments. We're happy that we already hold **NVR** (NYSE: NVR) and **American Tower** (NYSE: AMT) in the *Pro* port, along with a diagonal call on **Home Depot** (NYSE: HD). We have exposure to real estate that we like.

Shake Shack

Why Close? We've gotten this one very wrong so far. We shorted Shake Shack, the little hamburger chain that could, when it traded at more than 60 times expected earnings. But rather than see Wall Street let that valuation shrink, as we'd hoped, we've watched investors push shares much higher, to a level that's now more than 100 times expected earnings. Although our predictions -- lower store traffic, higher expenses, slowing earnings growth -- all came true, the stock has soared. The only things we did right here were to start small and never add to the position, despite temptations along the way.

What's Next? Still, even as we close this short sometime in the next 30 days, I don't believe we're done here. Shake Shack has grown from 0.5% to 0.7% of the portfolio, even as the whole port is much more valuable. Since we've been so wrong on Shake Shack so far, closing to end this hurt is sensible. But once it's closed, I want to reassess the situation, and consider other strategies to invest against Shake Shack that we've been considering, mainly using options. I wouldn't be surprised if we could eventually make back the $12,000 or so we lost on this short with some sensible neutral-to-bearish strategies.

So, we may soon return to investing against this one. But only some time apart will tell us for certain if that's the next move we want to make. Other pending portfolio changes, including new shorts, will also play a role in our eventual decision. Either way, you'll be the first to know through a trade alert.

The Foolish Bottom Line

Each November, I look at my own personal portfolio and consider selling persistent laggards or struggling businesses whose losses I could use to offset taxable gains that year. We're partly doing that exercise early this year for *Pro* (and will again near year-end). It feels like the right time, right now, to exit struggling or played-out positions and focus on those -- including new ones -- that we like much better. Periodically clearing out "dead wood" is an excellent way to set the stage for future growth. And it helps clear your mind in a way that you only realize once you've done it.

In this spirit, we're selling SVXY as it changes its return objective to one-half of what it used to be. We're closing SRS because its triple-leveraged status offers too much risk for just 0.1% of the portfolio in potential return remaining. And we're closing Shake Shack because the share price keeps rising despite its valuation and other business pressures, so we must be missing something. As shared above, we might revisit two of these three theses soon in new ways or vehicles. Once we clean house a bit more, we'll see if that's what we still want, and we'll issue alerts if so.

In closing: While two of these positions are among our biggest percentage losers ever, and both hit us this year, our portfolio's winners are leading us to new highs right now anyway. And we're ahead of the S&P 500 for 2018, and close to our North Star. This says that allocation and diversification matter a lot. We must keep sizing riskier positions appropriately, and leave our most promising positions alone to keep appreciating. This refresh is driving us to do more of both those good practices.

Alternative Trades

- **iShares U.S. Real Estate ETF** (NYSEMKT: IYR): If you own shares of IYR rather than shorting SRS, sell those shares. We aren't providing coverage and do believe that rising interest rates could be a long-term headwind, along with changing consumer habits when it comes to malls. We like our existing real estate investments in *Pro* better. Move money there if you lack those, or raise a little cash.
- **Are you short VIX futures through other means?** If you're comfortable with your short -- perhaps you're short the **iPath S&P 500 VIX Futures ETF** (NYSEMKT: VXX) -- then you can keep it open. We're considering such vehicles, after all. SVXY's story has changed, though, so we're selling it.
- **Are you short Shake Shack in other ways?** We don't know how you're expressing this position, so please post on the board below if you have questions about it. Most likely, you'll want to close it, but not necessarily. It'll depend on your strike prices and strategy.

Pro Can Help

- **Questions pertaining to your situation with these positions?** Please head to the Making Pro Fit You board.

Pro Guidance Changes and Completed Trades: May 29, 2018

Published May 29, 2018 at 2:34PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Broadridge Financial Services** (NYSE: BR): Our fair-value estimate increases to $95 from $82. The stock remains a Buy. We have a 7.1% holding, and recommend newcomers start with 3%.
- **Verisign** (NASDAQ: VRSN): Moves to Hold from Buy, because we might let the stock go next month via our covered strangle.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **JD.com** (NASDAQ: JD): We bought 2,400 shares at $36.93, starting a 2.6% position.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Broadridge's Valuation Grows on Tax Reform and Strong Business Performance

Published May 25, 2018 at 10:24AM

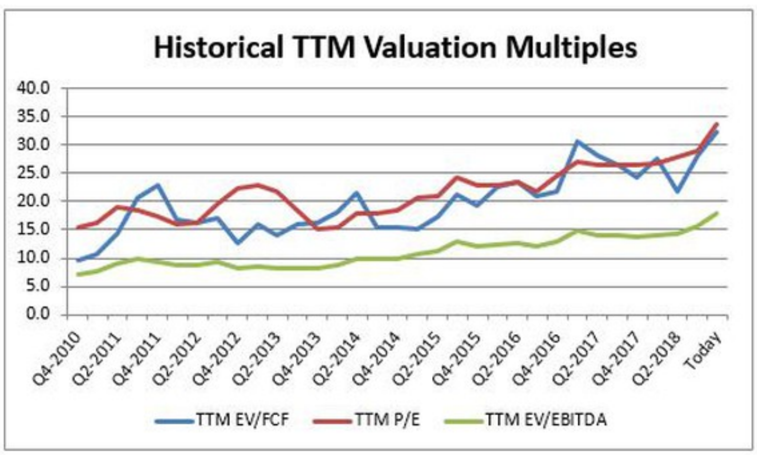
Fiscal Q3 2018

- Recurring fee revenue growth (year over year): Up 7.9% to $639 million (11.4% TTM growth)
- Closed sales growth (year over year): Down 20.8% to $38 million (-10.4% TTM growth)
- EPS growth (year over year): Up 43.2% to $0.90 (33.5% TTM growth)

Broadridge (NYSE: BR) reported an excellent fiscal third quarter for 2018, and as a result, management raised its full-year guidance for earnings per share. However, closed sales for the fiscal year have been lackluster to date, and the company will need to make up the sales deficit in fiscal Q4 in order to meet its guidance. Nonetheless, recurring fee revenue continues to grow at a steady pace, and Broadridge is poised for continued growth through the end of fiscal 2018 and beyond. Our provider of investor communications continues to improve margins and expand its core business at a consistent clip, producing significant amounts of cash flow from a capital-light asset base. Broadridge is well positioned to continue to achieve North Star-like returns over at least the next three years, although the strong recent stock price performance (up 28% year-to-date) may detract from future returns unless the company can continue to outperform our expectations (as it has consistently over the past several years).

- **Updated guidance**: Buy (unchanged)
- **Recommended allocation**: 7.2%
- **Fair-value estimate**: $95 (from $82)
- **Current price:** $115.90

Based on management's recently raised guidance, at $116 per share, the stock is priced at about 28.5 times projected 2018 cash flow and about 32.5 times projected 2018 GAAP earnings per share:



After incorporating fiscal Q3 2018 results and adjusting for the impact of tax reform, **our fair-value estimate increases to $95 per share (from $82)**. The company's valuation multiples are as high as they've ever been during its tenure as a public company, some of which is justified: Lower U.S. corporate tax rates make cash flows more valuable to investors, and the business is as big and strong as it's ever been.

Despite the strong business performance, the current price sits more than 20% above our newly updated fair-value estimate. After fiscal Q4 2018 results next quarter, we'll get management's guidance for 2019 and make the big annual adjustment to our valuation model. **Broadridge remains a Buy** on our scorecard, but if you've yet to establish a full position, you may want to consider buying in halves or thirds, waiting for a narrower premium to our fair-value estimate, or waiting until we have the increased clarity of fiscal Q4 results (the company's most important quarter) and a fully updated valuation model before filling out your position.

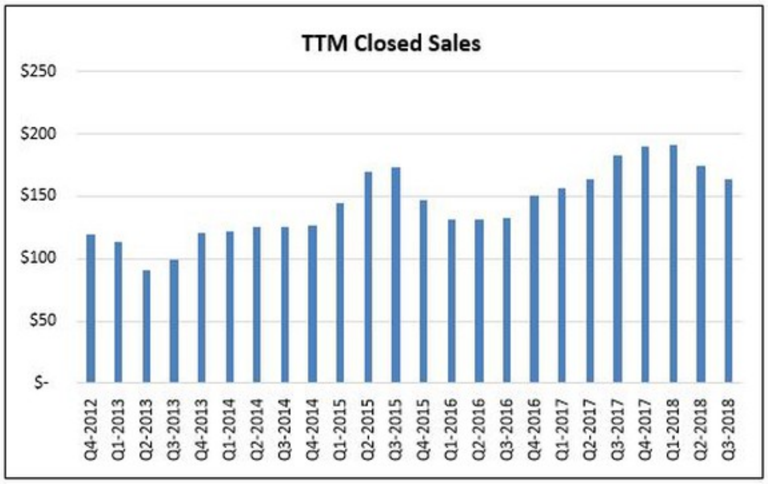
Our Thesis

Broadridge has a near-monopoly on proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers offload technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record, and sound capital allocation policies make Broadridge a sturdy rock upon which to build the *Pro* portfolio. We expect modest growth in fee revenue (augmented by tuck-in acquisitions), slight operating leverage, plenty of free cash flow, and a growing stream of dividends and share repurchases to help achieve North Star-like returns.

The Most Important Things

1. Closed Sales: This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%-plus). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

For the second straight quarter, closed sales were underwhelming despite a strong showing on almost all other metrics. Broadridge reported $38 million in closed sales for the second quarter, down 21% from the second quarter last year. For the second straight quarter, closed sales were lower than in the same quarter a year prior:

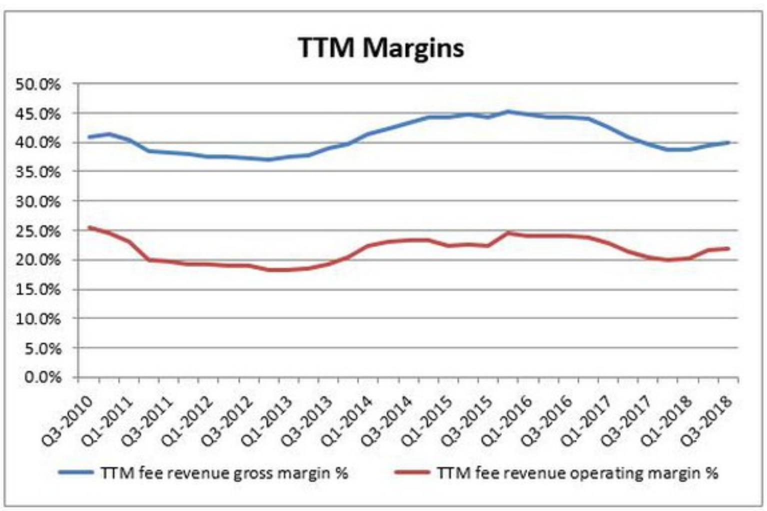


Although closed sales performance does tend to be lumpy and weighted toward the back half (or final quarter) of the year, management and the sales team have work to do to meet reaffirmed guidance of $170 million to $210 million for fiscal 2018. With just $100 million in closed sales through the first three quarters of the year, the company needs to post at least $70 million in closed sales in fiscal Q4 to hit the low end of guidance. The company's highest quarter of closed sales in its history is $65 million (set in Q4 2014), so we'd need an unprecedented performance in Q4 to reach guided sales levels. However, revenue has increased by 70% since the last record quarter, so I think the implied closed sales guidance for Q4 2018 ($70 million to $110 million) is feasible, if not challenging. I'll be impressed if Broadridge can meet those numbers next quarter.

Here are some relevant comments on the earnings call from CEO Richard Daly:

"We remain on track to hit our full-year sales targets, as we expect a very healthy close to fiscal 2018. As you know, Broadridge's quarterly Closed sales results have historically been weighted toward the fourth quarter, and results for any single quarter can be heavily influenced by the timing of large deals. Our pipeline today is very strong, and it includes some large deals where we are in active dialogues with clients. These dialogues are progressing well, and we expect one or more of these deals to contribute meaningfully in the fourth quarter."

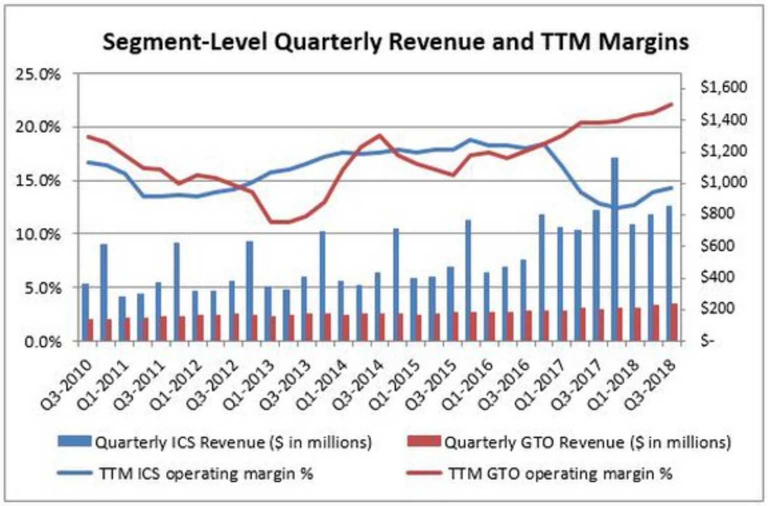
2. Fee-Revenue Margin Performance: In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers), we prefer to look at trailing-12-month (TTM) margins to smooth out quarterly fluctuations. TTM fee-revenue gross margins came in at 39.9% (up from 39.9% a year ago), and TTM fee-revenue operating margins came in at 21.8% (up from from 20.4% a year ago):



We're finally lapping the effects of the 2016 acquisition of NACC, with this quarter marking the final quarter in which TTM margin percentage comparisons are still affected by the impact of pre-NACC margin levels. Next quarter will represent the first quarter that allows a comparison of fully comparable TTM periods.

Even without a fully comparable TTM period, we can see in the financials that Broadridge has been able to expand NACC's operating margins over time via scale, cost synergies, and improved operational efficiency. Even including a quarter where NACC's margin-reducing impact was not present, we are still seeing higher margins (both gross and operating) in the most recent TTM period compared with the prior TTM period, which is impressive. The NACC acquisition integration has been outstanding, and margins are continuing their steady march higher.

When looking at Broadridge's separate divisions, we can see that both businesses are improving. While the Investor Communications Solutions (ICS) business has seen significantly lower (though improving) margins because of the NACC acquisition, the acquisition-agnostic Global Technology & Operations (GTO) business has shown continued strong margin expansion, generating a record TTM operating margin of 22.1%:



The margin expansion trends for both segments of the business are exactly what we want to see as investors, and based on management commentary and recent trends, we expect the margin expansion to continue. The business's financial execution since the NACC acquisition is an indication of excellent management, as acquisition integrations often don't go so smoothly.

3. Capital Allocation: In the company's most recent Investor Day presentation, we got a detailed update on how management plans to allocate capital between fiscal 2017 and fiscal 2020: targeting a 45% dividend payout ratio, and using up to $1.4 billion in incremental debt capacity and expected free cash flow for share repurchases and merger-and-acquisition activity.

Interestingly, we've recently seen the pace of Broadridge's share repurchases slow as the stock price has climbed over the past year. After spending more than $240 million combined in Q3 and Q4 2017 on discretionary share repurchases when Broadridge's stock price was between $65 and $78 per share, the company has spent just $30 million on share repurchases in the first half of 2018 (mostly to offset share dilution, by the looks of it), with the stock price ranging between $73 and $110. I appreciate management's non-mechanical approach to share repurchases.

Additionally, management has been a bit more active lately with acquisitions and purchase of IP. In fiscal Q3 2018, management spent $25 million to acquire Israeli company ActivePath, which focuses on technology to enhance the consumer experience associated with statements, bills, and regulatory communications. The company also spent $40 million in the quarter for the delivery of a new blockchain technology application related to its 2016 acquisition of IP from Inveshare.

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring organic revenue growth (augmented by tuck-in acquisitions) to translate to stout earnings and cash-flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Pro Can Help

- **Questions?** Bring them over to the Broadridge discussion board.

Pro Catch-Up Trades and Expirations: CME Group, JD.com, and More

Published May 24, 2018 at 12:39PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **CME Group** (NASDAQ: CME): Buy 2.3%.

Continue building your portfolio with our Buys, including:

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.9%.
- **Coherent** (NASDAQ: COHR): Buy 1.6%.
- **JD.com** (NASDAQ: JD): Buy 2.6% per our recent alert. [Note: this said "2.8%" in an earlier version. That was an error. But if you bought 2.8% it's also fine. Once we buy our shares it may round toward that, and either way, it's a small difference. Apologies for the error.]
- **OpenText** (NASDAQ: OTEX): Buy 2.8%.
- **Paycom** (NYSE: PAYC): Buy up to 3.9%.

Shorts:

- N/A

Options:

- N/A right now.

Upcoming Expirations (June):

- **Oracle** (NYSE: ORCL): Our short $52.50 calls -- as part of our 2020 diagonal call -- are on track to expire as income. We're watching to write new ones, and have been, but we're hoping for a higher share price on the stock.
- **Verisign** (NASDAQ: VRSN): Our short $110/$115 covered strangle is in-the-money on the call side. We'll have guidance before expiration.

Buy JD.com

Published May 22, 2018 at 3:24PM

Is this for you? This is for all *Pro* members who lack exposure to **JD.com** (NASDAQ: JD) and wish to match *Pro*. If you already have exposure to the company by way of our recommendation over in *Motley Fool Options*, consider your look-through exposure (the value of your position should your puts be exercised) in relation to our recommended allocation.

How You Participate

- **Action:** Invest 2.6% of your portfolio in JD.com. (That's $2,600 for every $100,000 you manage; for *Pro*, that's 2,400 shares, or $86,900 worth.)
- **Price Guidance:** Use a limit order to buy at going prices, lately about $36.60 per share. Later, the stock will remain a Buy until we guide otherwise.
- **Guidance:** Buy
- **Fair-Value Estimate:** $50

For our money, there's no better way to achieve *Pro*'s goal of doubling our real purchasing power every 10 years than by investing in strong businesses riding long-lasting secular tailwinds. For some time now, we've thought that the Chinese e-commerce market was just such a tailwind, and it's pretty easy to see why. At more than $1.1 trillion in sales, China's e-commerce market is already 2.4 times larger than the United States', and last year it expanded at twice the pace (32% growth vs. 16%). We believe the conditions are ripe for this market to eclipse even some of the loftiest expectations over the next decade, and with the recent sell-off of JD.com, China's second-largest e-commerce platform and its largest online direct sales retailer, we think we've found the perfect company to invest in and ride this tailwind for the next decade.

Why We Like the Industry

Despite its massive size, we believe China's e-commerce market is set to continue to outpace its U.S. counterpart, growing by 20% to 30% annually for at least the next three to five years. There are many reasons for this, but here are what we consider to be some of the most important:

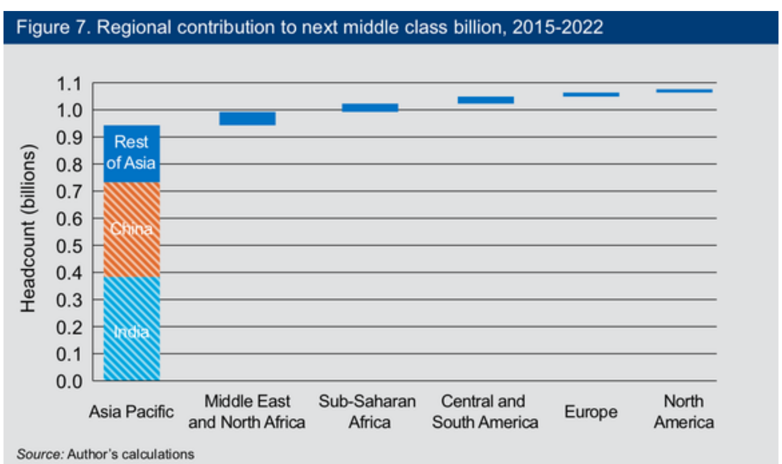
More shoppers ...

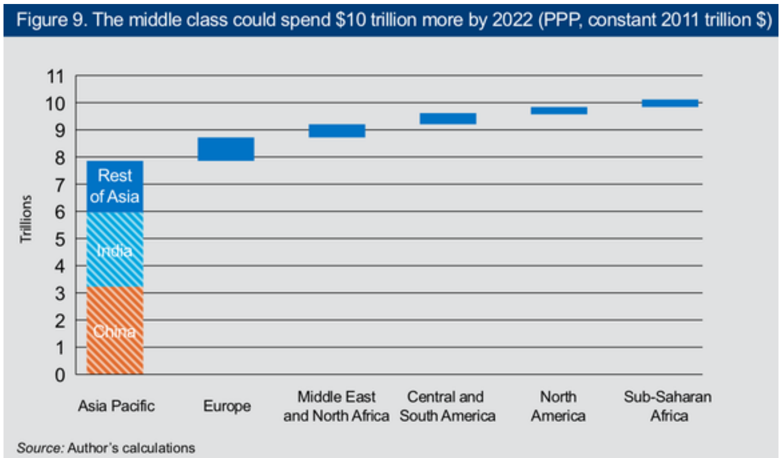
Consisting of more than 533 million shoppers last year, China's e-commerce market was 1.6 times bigger than the entire population of the United States. That may sound like it doesn't leave much more room for growth, but consider that China's Internet penetration rate is still more than 25 percentage points behind that of the U.S., and e-commerce adoption (as a percentage of total internet users) is still a full 10 percentage points behind. Currently we're forecasting that 150 million more shoppers will come online as early as 2020 as these two figures slowly converge with their Western counterparts.

Making more money ...

In just the past decade, we've seen the percentage of urban Chinese households classified as "middle income" or better rise by more than 30 percentage points, to higher than 85%. And with urban incomes averaging about 2.5 to 3 times their rural counterparts, it's no surprise that we've also seen a massive rural-to-urban migration. Income for those who have already achieved middle-class status will likely continue to grow in the mid- to high single digits, but the massively positive impact of this migratory trend on China's consumer economy is likely far from over: China's current 57/43 urban/rural population split, while up from 50/50 in 2010, is a long way from the U.S.' 81/19 -- closer to what we typically see in more advanced economies.

With many of China's larger cities approaching what the government considers to be maximum capacity, much of this growth will be centered around lower-tiered cities (where e-commerce is just starting to take off). If China is able to successfully transition to relying on lower-tiered cities for growth — and although the process may be rockier than some are expecting, we ultimately believe it will — odds are the nation will continue to be a driving force behind the continued rise of the global middle class.





source: Homi Kharas, Brookings Institution

And shifting more of their purchases online

We currently expect China's retail sales growth rate to average somewhere in the high single digits over the next decade, continuing to decelerate until it more closely approximates growth in disposable income. But we expect e-commerce to continue rapidly gaining share of the total retail pie, averaging between 20% and 30% growth over the next five years at a minimum.

Many of the reasons for our optimism parallel what we said about Tencent back in October. Specifically: Inefficiencies in the status quo have resulted in a Chinese consumer who is eager to adopt new technologies. Chinese brick-and-mortar retail is not only highly fragmented — the top 20 retailers command a market share of just 14%, compared with 47% in the U.S. — but it also has an underdeveloped infrastructure and an inefficient distribution system. In 2015, China's logistics and supply chain management spending as a percentage of GDP was almost twice as high as in the United States.

But don't just take it from us. China's urban e-commerce shoppers are already making their voices heard with what ultimately matters the most to retailers: their wallets. We currently estimate that these shoppers are spending roughly half as much as their American counterparts on online orders, despite having less than a seventh of the disposable income.

Most e-commerce shoppers understand that the added convenience of buying online often comes at the cost of speed, meaning that time-sensitive purchases remain one of the final bastions for brick-and-mortar stores. However, we believe this defense will soon be dismantled in China. One big reason why: Ninety-four percent of the country's population is clustered east of what is known as the Heihe–Tengchong Line, an area that covers roughly 43% of China. That means more than 1.3 billion people in an area roughly 51% the size of the contiguous 48 states plus D.C., resulting in a population density that's almost 10 times higher than in the States.

We believe this density will continue to help China lead the way in making same-day delivery more widely available and cost-effective. This should create a positive feedback loop: Faster deliveries mean customers spend more on e-commerce, meaning companies invest even more in logistics, resulting in even faster delivery times and even more e-commerce spending. Not only that, but widely available same-day delivery opens up entirely new segments of the retail industry to e-commerce disruption. For example, we currently anticipate that fast-moving consumer goods (FMCGs -- think milk, gum, aspirin, etc.), a market set to eclipse $2 trillion over the next three years, will be the next area where e-commerce takes off.

Why We Like JD.com

At this point, you might be wondering, "Why not Baba?" In addition to its dominant consumer-to-consumer (C2C) marketplace, Taobao, Alibaba's Tmall has a commanding share of the business-to-consumer (B2C) e-commerce market (where JD.com competes), and its lower-cost business model results in higher margins and returns on capital. To be fair, we believe the industry tailwinds are so strong that both businesses could ultimately end up beating the market over the next decade. But we ultimately consider JD.com to be a more attractive investment today for multiple reasons, including the following.

The Tencent partnership

It's hard to overestimate the value of Tencent -- the company behind WeChat, arguably the most dominant social app in the world -- as both a partner and an investor (it's JD.com's largest shareholder, at more than 18%). For example, in 2015, JD.com saw a 130% spike in orders on Singles Day — globally the biggest single e-commerce day of the year — thanks in large part to Tencent's social apps, which were responsible for delivering 52% of new first-time buyers. And in Tencent's latest conference call, management noted that daily active users and transaction volume for the retailer category of "mini programs" (essentially apps within the WeChat app) increased 50% from the previous quarter. Going forward, we anticipate that Tencent's ecosystem will only get stickier, and we have a hard time seeing this as anything but a huge positive for JD.com.

Logistics

From the start, JD.com has differentiated its business from its biggest competitor by its approach to logistics. In contrast with Alibaba's higher-margin, capital-light approach of outsourcing logistics, JD.com's management prefers to have as much control over the entire value chain as possible. The initial rationale was that delivery was the company's only in-person touchpoint with the consumer, so controlling it was imperative for building customer loyalty. But we believe this approach gives the company a distinct advantage in the battle for same-day delivery, and as a result it should help JD.com continue to take share from Alibaba and other competitors.

Market share opportunities

As the online retailer that built its brand around customer satisfaction and product authenticity in an environment where poor quality and fake products are commonplace, it should come as no surprise that surveys have constantly shown JD.com to be the preferred e-commerce retailer among higher-income Chinese households. If this continues to hold true, the continued rise of household income across China should bode well for JD.com's market-share aspirations. We also believe the company has more than a fighting chance to capture significant market share in FMCG, luxury, and other emerging e-commerce battlegrounds.

Valuation

With a market cap of $52 billion and a stock price that's down almost 30% from its all-time high, we believe JD.com is presenting us with a flash-sale-esque opportunity. The stock's recent decline appears to have to do with concerns about the effects of increased competition with Alibaba on JD.com's business plan, which is similar to that of Amazon -- heavy investments now with the aim of generating outsized profits later.

Although we agree that the pathway to profits isn't as straightforward here as it is for Amazon in the U.S., where it's essentially a one-horse race, we believe JD.com's long-term plan is still on track. Interestingly enough, one of the biggest reasons for the market's concern is something we just listed as a long-term competitive advantage — JD Logistics. Increased spending in this part of the business has hurt overall margins, and many analysts no longer expect the logistics business to start generating operating profits for up to three years, but we believe the stock would still be undervalued today if it took more than five. As it currently stands, JD.com is priced similarly to various brick-and-mortar retailers here in the United States.

Risks

Our thesis for JD.com is predicated on the belief that the company's investments will ultimately lead to market-share gains and outsized profits, so it goes without saying that if things don't play out this way, we'll likely be disappointed with the performance of the stock. We're also somewhat leery of JD.com's international aspirations. With such a large opportunity domestically, we'd consider it a major red flag if the company ends up shifting too many resources toward international growth. And as with Tencent, although we believe JD.com is currently in good standing with the ruling political party, at the end of the day we're investing in a Chinese company, and we need to be aware of the additional risks this entails.

Pro Can Help

- Come visit our new JD.com discussion board to let everyone know about your latest e-commerce steal or ask questions about our newest recommendation.

Write Covered Calls on The Cooper Companies

Published May 22, 2018 at 11:52AM

Is this for you? This is for *Pro* members currently participating in our covered call position on **The Cooper Companies** (NYSE: COO). If you're new to this position, please see the alternative trades section at the end of this report.

How You Participate

- **Action:** Write ("sell to open") August 2018 $240 calls.
- **Allocation:** Write ("sell to open") one call for every 100 shares you already own.
- **Price Guidance: It is imperative that you use a limit order, given the wide bid-ask spread for the August calls**. Fools should aim to split the bid-ask spread as long as it results in a per-month yield higher than 1.1% (option premium/current price of the stock). With shares at $233.91, the minimum to accept is currently $7.38. However, please check current prices first before submitting a limit order for this amount -- with a current bid of $7.40, you're leaving free money on the table if you submit a limit order for $7.38.
- **Prices** (11:34 a.m. ET):
  - Cooper Companies: $233.91
  - Sell to open August 2018 $240 calls (bid/ask): $7.40/$7.70
  - Current bid-ask midpoint: $7.55

What We're Thinking

With our first round of covered calls on Cooper Companies having expired worthless over the weekend, we see little reason not to immediately write new calls. Having already collected $10.12 per share, we're hoping to collect at worst an additional $7.38 this round, resulting in a 7.4% yield on our initial purchase price and a total return of roughly 9.3% in seven months if we need to let our shares get called away in August.

First-quarter results, which were reported back in March, were largely in line with our expectations. CooperVision (75% of the business) continued to post impressive results despite difficult one-year comparisons (up 12%) in its Americas segment, as consolidated revenues rose 14% (up 8% on an organic basis) and gross margins came in at 67.1% (up 4 percentage points). CooperSurgical saw revenues increase 32%, but most of this growth was inorganic, the result of the recent PARAGARD acquisition. Gross margins rose to 68.8%, but this was also primarily the result of the PARAGARD deal; the hormone-free birth control device has margins higher than 90%.

Cooper's consolidated operating margin came in at 27.6%, putting the company on pace to hit its 2021 target of 28% before the year is out (mid-30s is a reasonable long-term expectation here). We believe the rest of the year is shaping up favorably for CooperVision. Comps in the Americas will become easier as the year progresses, which might mean we should wait for a higher strike price to become attractive before writing new calls. But we believe the $240 strike is more appropriate, given the potential for the positives in CooperVision to be largely offset by additional growing pains associated with the PARAGARD deal over in CooperSurgical.

Further steering us toward the $240 strike price was the announcement of the retirement of former CEO Robert Weiss. Although we believe this has been in the works for quite some time now, given both his age (70) and tenure (41 years), we're in the "wait and see" camp with respect to how we feel about the replacement. While management said it will be business as usual under the leadership of the new CEO, Albert White, his previous role as CEO of Cooper Medical (the parent company of the CooperSurgical segment) worries us somewhat. We think White might end up misallocating resources away from CooperVision, our favorite part of the business, to CooperSurgical.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up:** If the stock price rises above our strike price by expiration, we may let our shares get sold; it's more likely right now, though, that we'd roll our calls to a later date or higher strike. We'll cross any such bridge near expiration once time value is dissipating from the calls.

Alternative Recommendations

- **Coming new today?** Buy stock in lots of 100 shares. Then, write ("sell to open") one August 2018 $240 call for every 100 shares owned. Aim for a net debit (what you pay for shares, less what you are paid for writing the call) of roughly $226.40.
- **Want to write puts?** Currently you can write the August 2018 $230 puts for $7.50, or a 3.3% yield in 87 days.

Pro Can Help

- **Blurry vision?** You're probably going to want to get that checked out, but if you have any Cooper-related questions, please head on over to our Cooper Companies discussion board.

Coherent and OpenText Offer Promise Ahead

Published May 21, 2018 at 3:28PM

Greetings, *Pro* members,

As of last Friday, 93% of companies in the S&P 500 had reported first-quarter results, and 78% of those exceeded expectations. Companies manage this. More important is the fact that, [according to FactSet](), the blended earnings-per-share growth rate in Q1 was a stellar 24.5%. That's the best quarterly result since the third quarter of 2010. And even if a third of that gain is driven by a lower tax rate, it's impressive, especially because revenue rose more than expected at 77% of companies, too.

Now the S&P 500 trades at 16.4 times expected earnings per share for the year ahead. The five-year average multiple is 16.1. The 10-year average is 14.3. Generally speaking, the S&P 500 is trading right where you would expect it to in relation to the past five years, especially if companies continue to top estimates. All else equal, in a bear market, the index would have to fall by 12.8% to trade at its 10-year average multiple.

At any rate, we have a few more earnings reviews, after which we can look over the whole portfolio and finalize some possible (and likely) changes.

Coherent Keepin' It Real

Laser provider **Coherent** (NASDAQ: COHR) reported 14% sales growth, to $481 million, with its microelectronics division posting 23.9% revenue growth to drive $3.37 per share in non-GAAP earnings. The microelectronics division accounted for 54% of sales, followed by materials processing at 28%, and OEM components, instrumentation, science, and government making up the rest of laser sales. Other product and services revenue -- parts, accessories, consumables -- rose by 21% to $132 million, 27% of total sales. For the third quarter under way, Coherent expects revenue of between $480 million and $500 million.

The company is booking business for 2019 already, but management only provides guidance one quarter at a time, so we don't know how booked it is. We know that the OLED market continues to be soft because of flagging smartphone unit volume, both at Samsung and **Apple** (NASDAQ: AAPL). Rumor has it that three new Apple phones will debut this fall (two reportedly with OLED screens, one with LCD), but what drives Coherent's smartphone OLED business most of all are the new fabrication facilities being built. A few are slated to open in 2019, and Coherent is already taking some orders for machines to fit them. More new fab facilities are expected to be announced soon.

The company's semiconductor-related business remains strong, with double-digit (at least 10%) booking growth in the quarter. A directive called Made In China 2025 calls for that country to reduce its dependence on integrated circuit imports, so the country is investing $150 billion (to start) to produce its own supply. This should keep demand for Coherent strong there, as will the burgeoning Internet of Things, connected cars, the artificial intelligence industry, and more. The digitization of the world feeds directly into Coherent's line of business in semiconductor manufacturing. Relatedly, Coherent's advanced packaging market (safeguarding delicate semiconductor parts) is running at five-year highs on continued growth in demand. This shouldn't relent.

Coherent's materials processing business was also "very strong across all submarkets," CEO John Ambroseo said in the conference call. Its fiber laser orders were up significantly for cutting and welding, driven by Chinese customers. Fiber components also benefited from strong China demand.

The company addressed the market's microLED concerns head-on. First, microLED is a long way from becoming a commercial product that replaces OLED, and second, if microLED is commercialized, it should be a net benefit to Coherent. Coherent is in a leading position to help commercialize microLEDs with its laser manufacturing, and doing so could lead to market expansion for the company into new display screens. But for now, OLED remains the screen of choice for mobile displays, restrained by capacity constraints -- another factor in recent softness, because Samsung is the only company making quality OLED screens at quantity, supplying Apple and others.

Beaten up, Coherent trades at 7.1 times EBITDA, 17 times trailing earnings per share, and 10.7 times expected earnings for the year ahead. It's at 15.5 times free cash flow. For a growing business operating in many key areas of today's sophisticated manufacturing processes, the company is well positioned to keep growing in relevance and in market size. We only own a 1.5% stake now, as the portfolio has grown while Coherent has shrunk. We're content with that size as we watch to see how 2019 starts to shape up -- but adding to the position isn't off the table. It's rated Buy for long-termers like us.

OpenText Bores 'Em This Time

Results at enterprise information management company **OpenText** (NASDAQ: OTEX) didn't excite the market during the company's seasonally softer third quarter. Yet revenue was up 16% year-over-year, to $686 million, and operating cash flow hit a record $271 million, up 73%. Cloud revenue rose 18% to $209 million. Organic growth, though, remains in the low single digits, with acquisitions driving most gains. On the plus side, the company's net-debt-to-adjusted EBITDA ratio declined to 2.1 from 3 a year ago, as the balance sheet strengthens after large buyouts.

Year-to-date, revenue is up 27% to $2.06 billion, and annual recurring revenue grew 26% to $1.53 billion. The cloud business is at $611 million in sales year-to-date, up 17%. Confidence led the board to increase the dividend 15% to $0.1518 per share.

Looking far ahead, management is aiming for $1 billion in operating cash flow by 2021 (the company's market cap is below $10 billion today) and adjusted operating margins of 36% to 40%, up by 200 basis points from earlier goals.

OpenText seems sleepy compared with the software leaders that grab headlines, but it has gained 1,550% in the past 20 years while the Nasdaq gained 343%. Over the past five years, the stock has returned 15.6% annualized, well above our North Star. In the past three years, it gained 13.5% a year. Although the stock hasn't moved much since September 2016, our patience should be rewarded eventually should the business keep trending the way it has.

It's trading at 12.5 times expected earnings for the year ahead and 18.8 times trailing free cash flow, and we see fair value a bit higher than today's price. We target a North Star-beating return on a rolling three-year basis. Shares remain a Buy at our 2.8% allocation -- although we reserve the right to replace them with something we like better, of course, should it come to that.

To share thoughts, please visit the [Memo Musings board](). We look forward to what's next with you.

Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: May 21, 2018

Published May 21, 2018 at 2:58PM

Pro Guidance Changes (see any related [trade alerts]() or [earnings coverage]()):

- N/A

Pro Completed Trades (see [transaction log](); trades take a day to appear):

- **Home Depot** (NYSE: HD): We rolled our short May $175 calls to September $180 calls for a small credit, keeping our diagonal call going.

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Expirations: CME Group, Paycom, and More

Published May 17, 2018 at 2:15PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **CME Group** (NASDAQ: CME): Buy 2.4%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.7%.

Continue building your portfolio with our Buys, including:

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.8%.
- **Paycom** (NYSE: PAYC): Buy up to 3.9%.

Shorts:

- N/A

Options:

- **Home Depot** (NYSE: HD): Roll, or start, your diagonal call per yesterday's alert.

Upcoming Expirations (May):

- We have written calls expiring on **The Cooper Companies** (NYSE: COO), **Gilead Sciences** (NASDAQ: GILD), and Johnson & Johnson on May 18. All three are set to expire as income.

Roll Your Diagonal Calls on Home Depot

Published May 16, 2018 at 1:04PM

Is this for you? This is for all *Pro* members who wrote May 2018 $175 diagonal calls on **Home Depot** (NYSE: HD) as per our alert in December. If you have yet to establish a diagonal call position on Home Depot, or if you established a different alternate position, please see the Alternative Trades section below.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
  - "Buy to close" all May 18, 2018, $175 written calls.
  - "Sell to open" the same number of Sept. 21, 2018, $180 calls.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* will roll all nine of our calls.
- **Recent Prices** (11 a.m. ET):
  - Stock: $186.65
  - Buy to close May 18, 2018, $175 calls (bid/ask): $11.60/$11.80 (midpoint $11.70)
  - Sell to open Sept. 21, 2018, $180 calls (bid/ask): $12.40/$12.55 (midpoint $12.48)
  - Net credit to roll: Approximately $0.78 (this price will change)
- **Price Guidance: It is critical that you use a limit order**, aiming to pay as little time value as possible to close your short calls and to roll for as much of a credit as possible. The midpoint of the bid/ask spreads currently implies about a $0.78 net credit for this roll, although that number will change as prices change and as *Pro*'s collective volume affects the bid/ask spreads. The May short calls expire on Friday, so you need to complete this trade promptly or risk getting assigned on your short calls.

What We're Thinking

The current iteration of our diagonal call strategy on Home Depot has now been active for almost seven months, having begun in October last year when we initiated a diagonal call position on the company with the goal of leveraged upside and income with moderate risk. In December, we rolled our short calls up and out for a modest debit to capture further upside. So far, the position is working out exactly as we intended, with a 20% simple return since inception if we were to close the diagonal call today (compared with a 14% return for Home Depot stock over the same period).

Home Depot reported somewhat tepid earnings yesterday, including the lowest comparable-store sales growth since the second quarter of 2015. The fact that 4.2% growth represents the lowest figure in 11 quarters demonstrates the strength of Home Depot's business -- few other retailers have posted such consistently positive same-store sales during a challenging time for brick-and-mortar sales. Additionally, management indicated on the earnings call that comp sales in the first quarter were affected by unusually cold weather, as record cold and snow prevailed across the northern U.S. in April. Although weather is a common excuse for poor performance among retailers, given the quality of Home Depot's business and management team, I'm inclined to believe them. As evidence to the veracity of the claim, management mentioned on the earnings call that so far in May, comp sales are double-digit positive as lost sales appear to be recaptured.

With respect to our diagonal call, we're now in a position to roll our calls up and out again for a small credit, aiming to capture further upside in this high-quality business. With this rolling trade, we increase our upside by $5 and extend our expiration out to September. As we approach September expiration (or a relevant ex-dividend date prior to expiration), we'll reassess the position and determine our next course of action.

Alternative Trades

- **Did you write May 2018 $175 covered calls?** If you wrote covered calls, you can make the same rolling trade as *Pro*, rolling your May 2018 $175 calls up and out to September 2018 $180 calls.
- **Did you write May diagonal calls at a different strike price?** If your short call is in-the-money but at a higher strike than Pro ($180 or $185), aim to roll out and/or up for a credit. The $185 and $190 strike prices look like good choices to us, but you can roll to higher strikes if you prefer to target higher upside, or lower strikes if you prefer to be more conservative and target current income. If your short call is out-of-the-money, you can wait until expiration and then write a new iteration of short calls at the $185 or $190 strike prices.
- **New to the position and have yet to set up a diagonal call?** Do so by simultaneously buying ("buy to open") January 2020 $125 calls and selling ("sell to open") September 2018 $190 calls for a net debit of about $57.90 per diagonal call (this price may change). Invest 1.8% of your *Pro* funds in this diagonal call position (that is, one diagonal call for every $320,000 or so you manage), and keep in mind that this position is "off-reservation" from *Pro*, so if you're not comfortable managing a position on your own, this choice might not be the best one for you.
- **Have a different position not addressed here?** Check in on the Home Depot discussion board and we will do our best to answer your questions.

Pro Can Help

- **Questions?** Ask away on the Home Depot board.

Square Rolls On!

Published May 14, 2018 at 4:07PM

Note: We don't have any guidance changes or completed trades to share over this past week. A continued huzzah for status-quo, long-term investing!

Greetings, *Pro* members,

The *Pro* portfolio has lately been setting new all-time highs, up more than 243%, despite the Nasdaq Composite and S&P 500 still trading decently below their respective high-water marks. Our results are being driven by many of our larger positions, including **Square** (NYSE: SQ). Let's continue our earnings review there.

Square Stacks Up

Square (NYSE: SQ) continued to roll forward, and increased its velocity. Once again, sales increased both year-over-year and sequentially, with adjusted first-quarter revenue up 51%. As a result, management massively increased sales guidance for the year; they now target 44% year-over-year revenue growth in 2018, compared with the guidance given just 90 days ago for 34%. This result would see Square expand sales even faster in 2018 than it did in 2017, putting this year's net revenue at more than $3 billion and adjusted revenue at about $1.4 billion.

But rather than rising along with sales, guidance for Square's earnings before interest, taxes, depreciation and amortization (better known as EBITDA) stood pat at $245 million. That's because Square plans to reinvest even more dough into its many growth opportunities. We agree with heightening investments to capture more opportunities, and we hope this situation will remain for years. For 2018, Square still expects its adjusted non-GAAP earnings per share to be $0.46 at the midpoint of its guidance. That hasn't changed.

Going beyond guidance to see what's driving results, we note that Square's "omnichannel" commerce products are easy for customers to implement, and they expand as a business does. Gross payment volume (GPV) was up 31% to $18 billion last quarter, and Square's commerce transaction-based ecosystem creates numerous opportunities to add software subscription sales (on top of the 1.09% average fee Square earned on each transaction last quarter), fueling additional growth. Subscription and service-based revenue was up 98% in the first quarter to represent 32% of Square's adjusted revenue, up from 24% a year ago.

As larger sellers are attracted to Square, more fuel is added to the growth fire. They're making the move because they value the cohesion of Square's products, their cost, and the ease of getting started. Adjusted revenue from sellers with retail sales of at least $300,000 per year was up 60%, and more than half of Square's largest customers used two or more Square products in 2017.

Products leading in popularity include Instant Deposit (which lets a business collect its revenue quickly for a small fee), Caviar (for restaurant delivery), and Square Capital (small, short-term loans). Cash Card is also growing fast. And the new Square Register product helped hardware revenue — which is not essential to the story here — expand by 60%.

Beyond all this, Square recently announced that it will acquire website-building business Weebly for $365 million in cash and stock. Weebly will bring Square 625,000 new subscription-paying customers who maintain a website with Weebly, with nearly 40% of them outside the U.S., helping expand Square's international footprint. Because Square wants to provide complete commerce solutions online and off, a website offering seems essential and expands its customer base to new and varied niches.

Revenue from Square's commerce customers is already nicely spread, with about 20% of gross payment volume from retail, 20% from restaurants, and services, health, and beauty each hitting the high teens. Square is working to serve each niche better with targeted software products, or "verticals." Operating today in the U.S., Canada, the U.K., Japan, and Australia, Square has large international opportunities ahead and should move as efficiently as possible to enter new markets, because competition exists.

The stock is expensive, but the price signifies the market's recognition of the opportunities ahead as Square's ecosystem keeps locking in new customers. Recently $54, shares trade at 102 times expected earnings for the year ahead. We've seen this before with high-growth companies. If management keeps executing well, the stock may not look back much. Either way, as with most young growth companies that keep growing, the business won't likely look traditionally valued for some years to come. Now at a 4.6% allocation, up 113% in less than a year, Square remains a Buy.

Fool on!

-- Jeff (TMFFischer)

Recent Trends Continue at American Tower

Published May 11, 2018 at 1:18PM

American Tower (NYSE: AMT) reported a solid first quarter for 2018 that showed a continuation of trends from the fourth quarter of 2017. Consolidation-driven churn in India accelerated as local wireless carrier Aircel filed for bankruptcy in the quarter, leading to impairment charges and bad debt expenses that reduced companywide profitability.

Although international growth should see ongoing weakness in 2018 because of the disruption in the Indian wireless market, the U.S. business continues to improve, and the international business is performing strongly outside India. The Indian market should start to normalize in 2019 and be back to typical growth levels by 2020.

With the stock trading at the low end of the company's historic ranges (the current EV/EBITDA multiple is 19, compared with a long-term average of 21), American Tower's valuation reflects the near-term weakness in India as well as recent uncertainty surrounding the announcement of a merger between T-Mobile and Sprint. Management spoke about the merger on the earnings call, noting that they are "highly confident" that the transaction will be neutral to positive for the U.S. business, thanks to an expected increase in capital expenditures and network densification for the new combined entity. The potential for an accelerated 5G deployment by the wider U.S. mobile industry in response to 5G network investment plans by the Sprint/T-Mobile combined entity should provide another boost.

What Happened?

CEO Jim Taiclet:

> "The strong demand we experienced in late 2017 for our telecommunications real estate further accelerated in the U.S. as well as in our Latin America and EMEA regions in the first quarter of 2018. Notably, record levels of new business commencements, along with a robust pipeline of applications or both amendments and new colocations resulted in our increase in expectations for full year U.S. Organic Tenant Billings Growth to approximately 6.5% in 2018.
>
> Significant network investment initiatives announced by the major U.S. wireless carriers, coupled with aggressive network deployments in key markets such as Mexico and Brazil, enabled us to drive Consolidated AFFO per Share growth of nearly 10% in the first quarter while growing our common stock dividend by approximately 21%. We remain confident that our U.S. macro tower business, complemented by our franchise small cell installations, extensive international portfolio and emerging innovation initiatives will continue to drive strong growth and attractive total returns for many years to come."

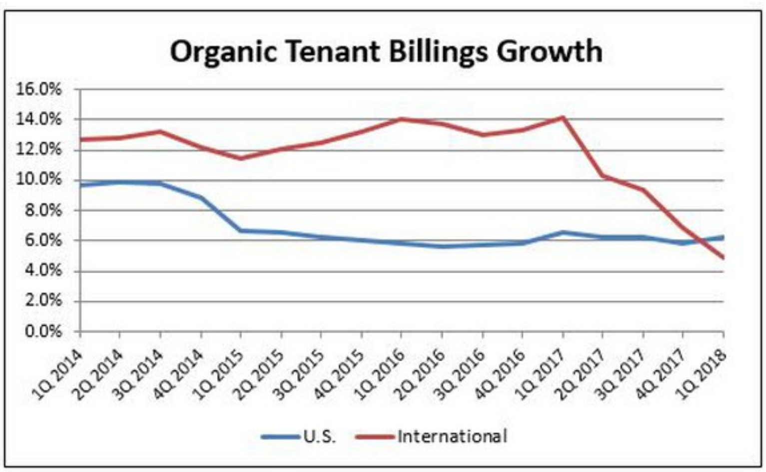
Get More

- Q1 2018 press release
- Q1 2018 supplemental materials
- Q1 2018 earnings presentation

For the first quarter of 2018, organic growth in tenant billings came in at 6.3% in the U.S. and 4.9% internationally, vs. 6.5% and 14.1% in the same quarter a year ago.

The disruption in the Indian market continued into this quarter (as expected), with -4.7% organic growth in the company's Asia (i.e. India) division because of an acceleration in consolidation-driven churn, a result of the bankruptcy of Indian mobile carrier Aircel. This is the first quarter of negative organic growth in India (or any geographic region) since American Tower began breaking out region-specific data in 2014. Management expects that 2018 will be the high-water mark in terms of Indian carrier consolidation-driven churn "by a fairly wide margin," so while there may be continued pressure on this segment throughout 2018, growth should start to normalize in 2019 and be back to typical levels by 2020.

Outside of India, organic growth was more in line with historical growth rates, up 7.4% in Europe, the Middle East, and Africa (EMEA, which includes France, Germany, Ghana, Nigeria, South Africa, and Uganda) and 11.7% in Latin America (which includes Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay, and Peru).

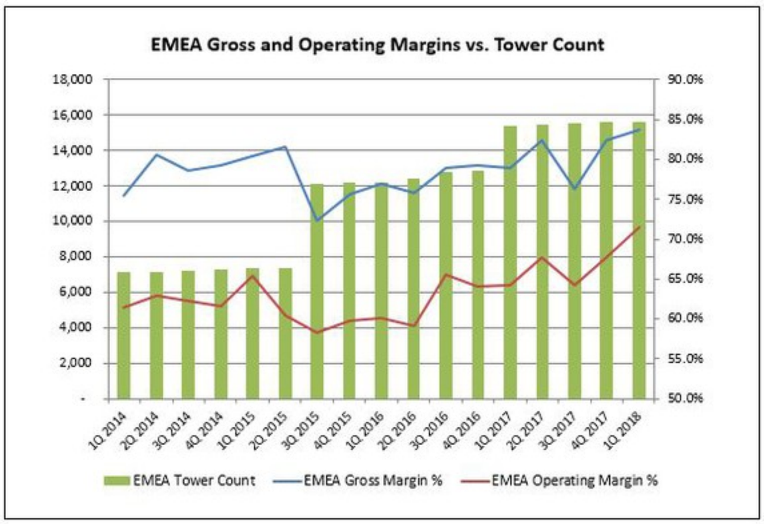


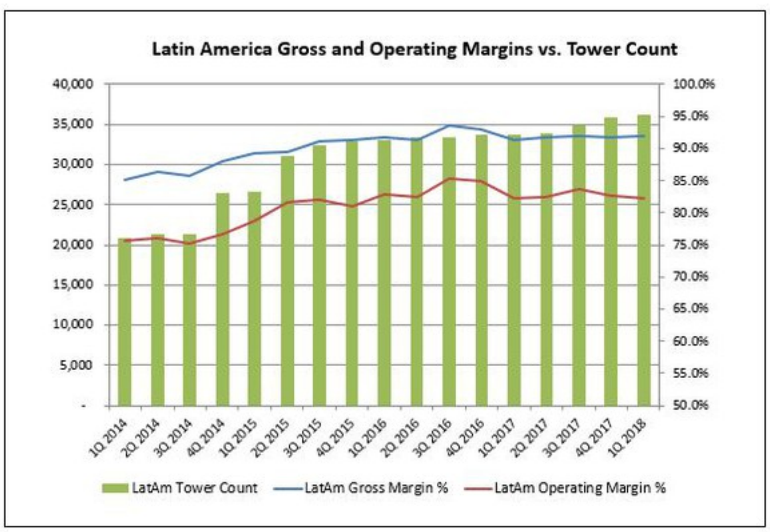
This is the first time since I've been covering American Tower that U.S. growth outpaced international growth in a given quarter. Given the expected pressure in the Indian market, this result is unsurprising. Once the Indian market stabilizes, international growth should once again eclipse U.S. growth by a few percentage points.

So What?

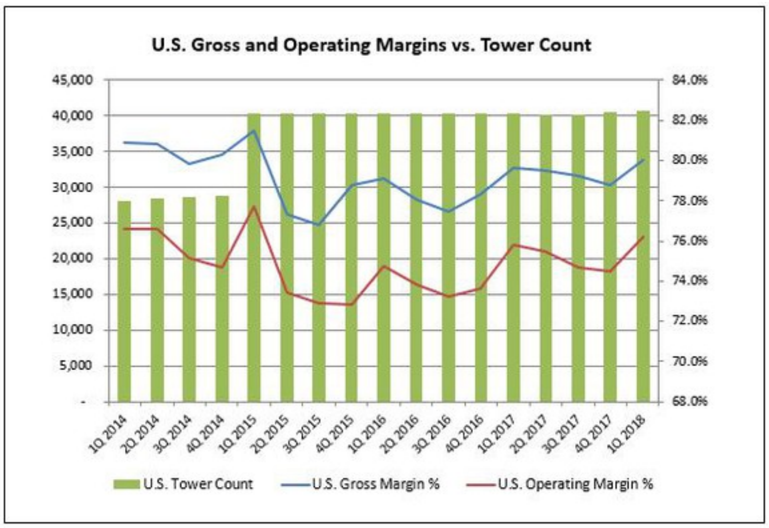
As we expected, the Indian wireless carrier consolidation has continued to affect growth rates and margins in that market throughout 2018, and that should continue through the rest of the year. Similar to last quarter, the company booked another impairment charge ($147 million) and some bad debt expenses ($29 million) in the first quarter related to India carrier consolidation. The graph below shows how margins were affected in India both before and after adjusting for the one-time expenses:

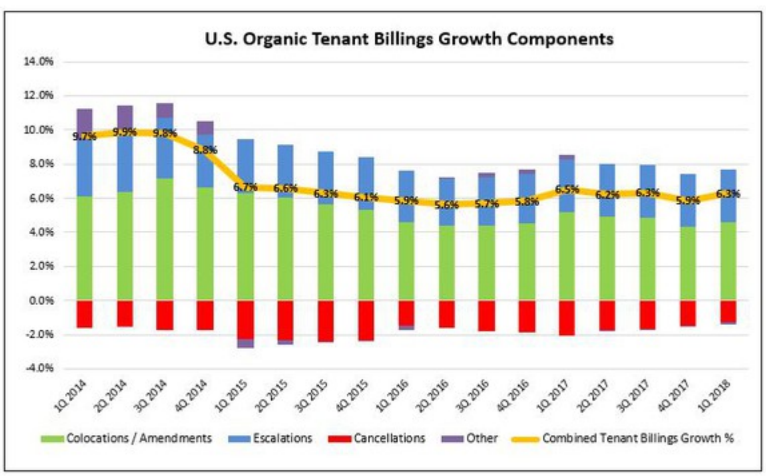
In EMEA and Latin America, margin trends are positive and management expects margin expansion over time as the company continues to generate organic growth on its extensive existing portfolio of assets.





In the U.S., margin trends continue to improve. TTM gross margins increased year-over-year to 79.4% (from 78.4%), and TTM operating margins increased year-over-year to 75.2% (from 74.1%). We can see in the graph below that, since the significant **Verizon** (NYSE: VZ) acquisition in 2015 that acted to lower the margin profile of the entire U.S. business (thanks to the lower tenancy ratio on those new towers), management has been successful in slowly increasing margins via organic growth of the newly acquired (and existing) assets. We've now seen five straight quarters of TTM gross margin percentage improvement and eight straight quarters of TTM operating margin percentage improvement for the U.S. business:

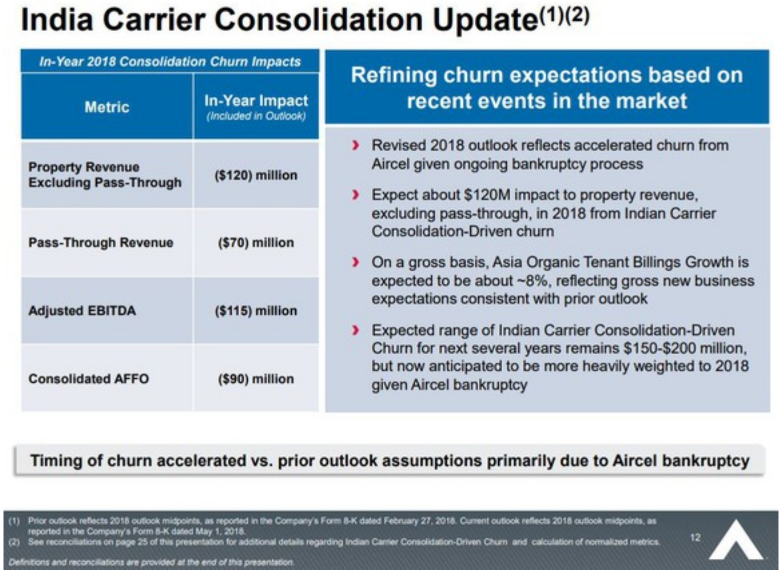




Continued improvement in the U.S. business is especially nice to see given the disruption in the Indian market, and given that the U.S. business still generates about 55% of companywide revenue and 65% of operating profit.

Now What?

As noted, the first quarter of 2018 represented a continuation of trends that started in the fourth quarter of 2017, as American Tower continued to digest the impact of Indian carrier consolidation, reporting accelerated churn levels as a result of Aircel's bankruptcy. Churn driven by this consolidation should continue to affect results throughout 2018 before stabilizing in 2019 and returning to normal levels in 2020:

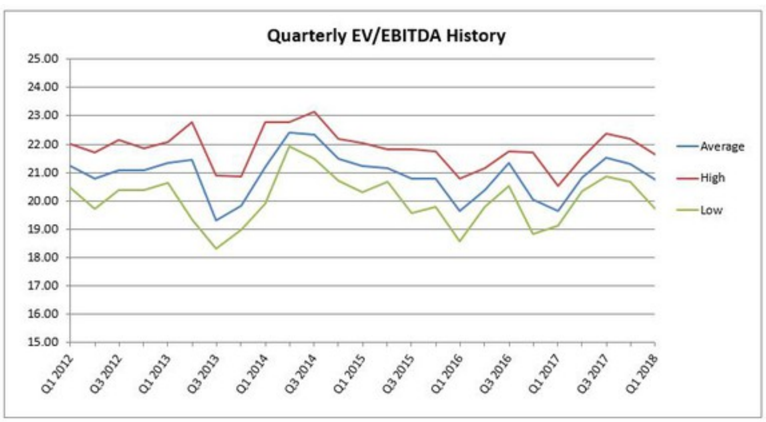


Aside from the Indian market, the rest of American Tower's business continues to perform well. The U.S. business is showing continued growth and margin improvement, and EMEA/Latin America are expanding at a rate higher than that of the United States. Management has an outstanding track record of growth and capital allocation over the past decade, and we expect that to continue despite the near-term disruption in India.

Data and Guidance

- Current Price: $139.69
- Fair-value estimate (unchanged): $146
- Allocation: 3.8%, plus 0.7% in January 2019/October 2018 $80/$135 diagonal calls
- EV/EBITDA (2018 Outlook): 19.22

American Tower is trading at EV/EBITDA levels at the low end of the company's ranges since 2012, as the stock has generally spent most of its time with an EV/EBITDA multiple higher than 20. However, there is plenty of uncertainty that accounts for the reduced multiple (Indian market pressure, the Sprint/T-Mobile merger in the U.S.):



AMT remains a Best Buy Now, and fair value is unchanged at $146. We also have 0.7% in diagonal calls, which expire in October (and the long calls expire a few months later in January 2019). By January 2019, we will need to decide whether we want to close our entire diagonal call position, roll out the long calls to 2020 or 2021, or exercise the long calls into stock.

Fool on!

-- Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Expirations: CME Group, Coherent, and More

Published May 10, 2018 at 12:12PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **CME Group** (NASDAQ: CME): Buy 2.3%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.7%.

Continue building your portfolio with our Buys, including:

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.7%.
- **Coherent** (NASDAQ: COHR): Buy 1.6%.
- **Facebook** (NASDAQ: FB): Buy at least half of our 7.6% stake.
- **Paycom** (NYSE: PAYC): Buy up to 4.2%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.4%.
- **Square** (NYSE: SQ): Buy up to 4.5%.

Shorts:

- N/A

Options:

- **Oracle** (NYSE: ORCL): Invest 0.6% to "buy to open" January 2020 $30 calls. Once you own those, wait for a price recovery to write diagonal calls with us at about a $50 to $52.50 strike price for a worthwhile yield. We'll have an alert when we're ready.

Upcoming Expirations (May):

- We have written calls expiring on **The Cooper Companies** (NYSE: COO), **Gilead Sciences** (NASDAQ: GILD), and **Home Depot** (NYSE: HD) on May 18. We'll have guidance soon. Right now, we only need to roll the Home Depot $175 diagonal calls.

Pharma Spurs Growth at Johnson and Johnson

Published May 7, 2018 at 1:54PM

First-Quarter 2018

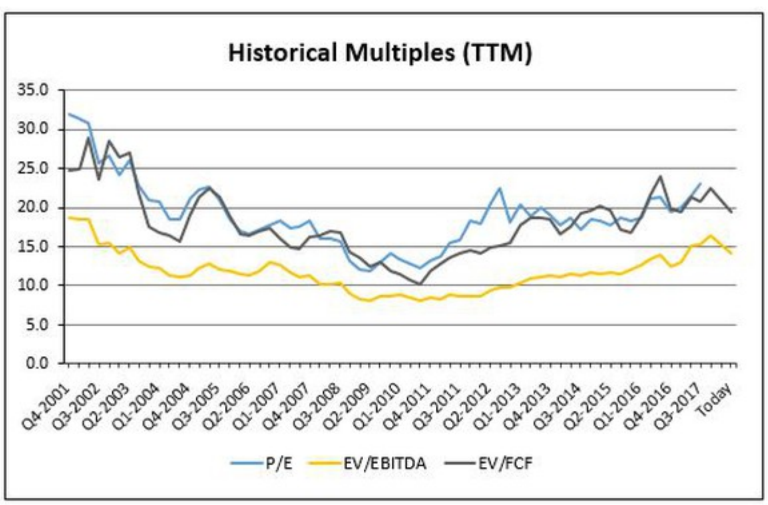
- [Press Release]
- [Earnings Presentation]
- [Supplementary Sales Data]
- [Sales of Key Products & Franchises]
- [10-Q Filing]

Johnson & Johnson (NYSE: JNJ) continued its recent business momentum in the first quarter of 2018, reporting acceleration in revenue growth for the fourth straight quarter. Company-wide sales growth of 12.6% was led by 19.4% growth in the pharmaceutical division, which accounts for 48% of total sales. On an adjusted non-GAAP basis, J&J posted 12.6% year-over-year earnings-per-share (EPS) growth for the first quarter. Management increased its sales guidance for 2018 to 6.5% revenue growth (from 6%) and reaffirmed its guidance for 11% adjusted EPS growth.

Although J&J's stock price has come under pressure in 2018 because of rising interest rates, the business is performing up to our expectations. J&J will hold an Analyst/Investor Day on May 16 to discuss its consumer and medical-devices businesses, and I'm looking forward to hearing about how management plans to maximize value from those slower-growth segments.

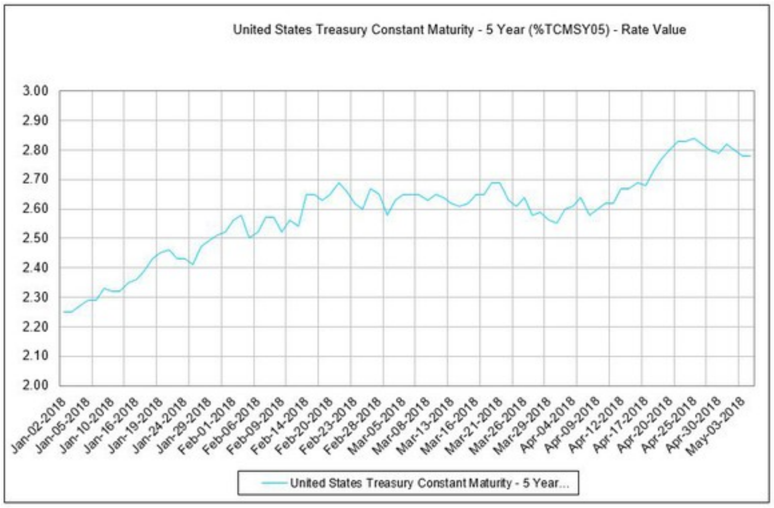
- **Updated guidance**: Best Buy Now (no change)
- **Recommended allocation**: 2.7%, with May 2018 $135 covered calls that are set to expire as income next week.
- **Fair-value estimate**: $140 (up from $137)
- **Current price:** $124.80

At about $125 per share, the stock is priced at 14.2 times trailing-12-month (TTM) EBITDA and 19.6 times TTM free cash flow:

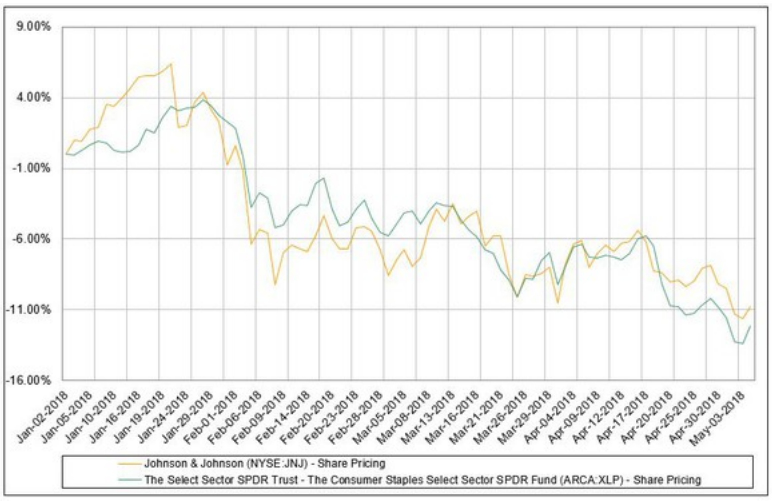


Based on management's guidance, J&J is priced at about 15.4 times 2018's non-GAAP earnings -- attractive compared with the S&P 500, which is trading at 17.2 times expected 2018 earnings estimates. The stock has experienced multiple compression in 2018, with the price yet to recover from the early February volatility spike that rocked the market.

This is likely because of its association with the consumer staples sector, which in turn has an inverse correlation to interest rates (because dividend-paying consumer-staples stocks are seen as replacements for other interest-yielding assets, such as U.S. Treasury bonds). As the five-year yield has increased from 2.25% to start the year to 2.78% as of Friday's close...

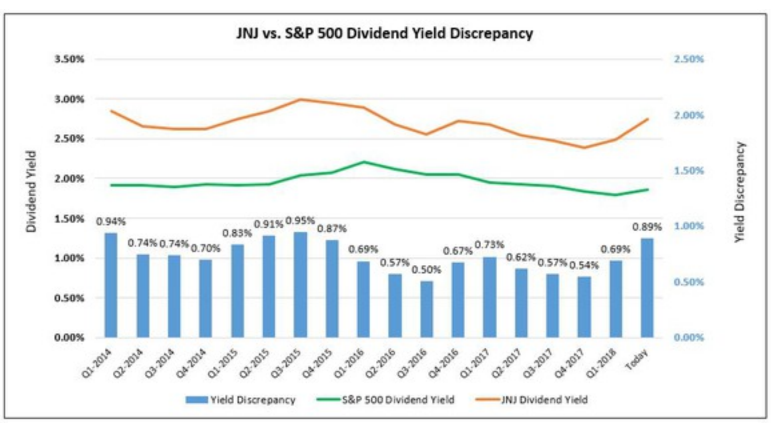


... the consumer staples sector has declined by about 12% and J&J has declined by about 11% over the same span:



If interest rates keep rising, J&J's stock price may remain pressured. If that happens, J&J's dividend yield should keep rising thanks to consistent yearly dividend increases. J&J recently increased its dividend from $0.84 per share to $0.90 per share (a 7.1% increase), meaning that the current forward dividend yield is 2.9%, a level we haven't seen since Q1 2016 when the stock was trading a about $100 per share.

Because J&J has such a consistent history of dividend payments, one of my favorite ways to monitor the company's relative valuation is to compare its dividend yield to that of the S&P 500. This comparison strips out the confounding effect of interest rates that occurs if you look at J&J's dividend yield in isolation (since dividend-paying stocks tend to fluctuate in price alongside interest rates). When we make this comparison, J&J again looks attractively valued:

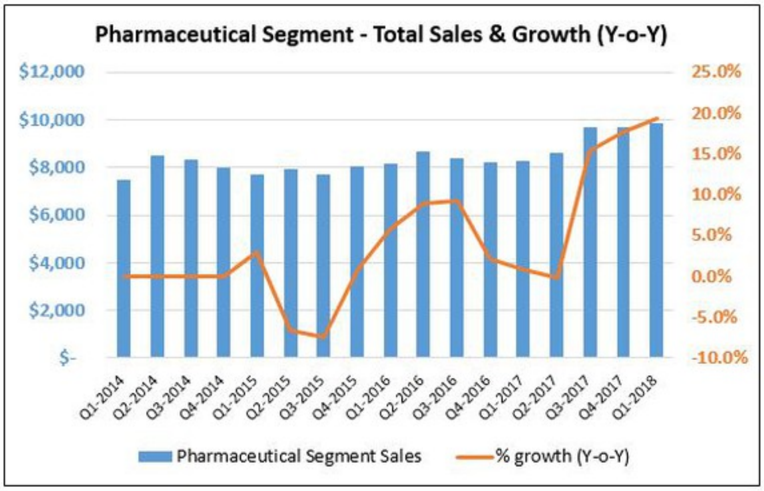


The yield discrepancy between J&J and the S&P 500 hasn't been this high since the fourth quarter of 2015. Since 1997, the average yield discrepancy between the S&P 500 and J&J has been 0.63%, and it's currently at 0.89%.

Our fair-value estimate increases slightly to $140 (from $137), and Johnson & Johnson remains a Best Buy Now. Members who have yet to start or fill out their positions can feel comfortable doing so at current prices. We also have May 2018 $135 covered calls, which look set to expire as income next week. We will let those calls expire and wait for higher stock prices to reinitiate the covered-call strategy.

Division Performance

J&J's pharmaceutical division continued its strong growth in the first quarter, bolstering the entire company's results given that this division is the company's largest by sales volume:



Pharmaceutical sales growth accelerated to 19.4% year over year, up 7.5% excluding the impact of the Actelion acquisition. Drugs in the oncology market continued to lead the pace, with Darzalex sales up 69%, Zytiga sales up 62%, and Imbruvica sales up 44%. JNJ's pipeline remains promising, with two new launches in 2018 and the expected regulatory approval of eight other new drugs by 2021, each of which has $1 billion in peak revenue potential.

In addition to the strong growth from the pharmaceutical division, the consumer division and the medical device division posted year-over-year revenue growth of 5.3% and 7.5%, respectively. Companywide operational sales growth (ex-acquisitions) came in at 4.3% for the quarter.

Our Thesis

Johnson & Johnson is is a diversified health-care conglomerate, with more than 260 operating companies organized into three business divisions: consumer, pharmaceutical, and medical devices. At eight out of eight of our *Pro* quality criteria, J&J is a quintessential *Pro*-quality stock. While its large size means we don't expect runaway growth and upside, we do expect to earn North Star-challenging returns with low downside risk from one of the safer stocks you are likely to find in the entire investment universe.

Pro Can Help

- **Questions?** Bring them over to the J&J discussion board.

Pro Guidance Changes and Completed Trades: May 7, 2018

Published May 7, 2018 at 1:28PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Apple** (NASDAQ: AAPL): Our fair-value estimate increases to $172. The stock remains a Buy at a 5% allocation.
- **Johnson & Johnson** (NYSE: JNJ): Our fair-value estimate increases to $140. The stock remains a Best Buy Now at a 2.7% allocation.
- **NVR** (NYSE: NVR): Our fair-value estimate increases to $2,900. The stock remains a Buy at a 3% allocation.
- **Shake Shack** (NYSE: SHAK): This short moves to Hold as we assess our options following a large move against us. See Friday's commentary for more.
- **Verisign** (NASDAQ: VRSN): Our fair-value estimate increases to $102.

Pro Completed Trades (see transaction log; trades take a day to appear):

- N/A

You can see all of our guidance, positions, returns, and transactions on or from the Recommendations page.

Good Earnings Results Help Drive Our Portfolio

Published May 7, 2018 at 1:20PM

Greetings, *Pro* members, from Hong Kong!

I've just been part of a dinner event with Fool members here in celebration of the launch of www.Fool.hk. It was great to meet members and share our passion for investing while getting to know each other better. You all live amazing lives!

Today's Memo shares the earnings summaries that I have ready so far. But before we dive in: The *Pro* team and I have been talking about continuing to improve our approach. I know that permanent losses of capital are a part of investing, but I still want to avoid them more than we have lately. The *Pro* process of buying stocks and shorting is strong. It's when we *stray* (giving in to a desire to push boundaries) that we most often get hurt. **Shake Shack** (NYSE: SHAK) wasn't our usual "buzzard bait" short, and now we have an issue to address. We're considering using options on it, as well as other possibilities, including closing it. More before long.

Meanwhile, the *Pro* Port is nearing new highs again on earnings results from our largest holdings. Let's look at some results.

Earnings Roll In

CME Group (NASDAQ: CME): In its first quarter of 2018, the world's largest derivative marketplace reported record quarterly average daily volume in five of its six product categories, with total volume up 30% to 22.2 million average daily contracts. As financial markets become more volatile, investors turn to the options and futures listed on CME's exchange to hedge risk in interest rates, equities, energy, metals and more.

Last quarter, CME's revenue rose nearly 20% to $1.1 billion, and net income was up a strong 49%. The company maintains market-leading operating margins of more than 60%. Its U.S. business is strong, but small and fast-growing markets overseas may hold the most long-term promise. Volume rose by 41% in Asia and 37% in Europe last quarter, with non-U.S. customers making up more than 30% of this business.

Despite record results, investors focused on CME's market data revenue, which fell 2% year-over-year to $95 million. CME notes that this number fluctuates partly because of the resolution delay for trade settlements; overall, this revenue is running at similar levels to last year. Meanwhile, a price increase went into effect April 1 (from $85 to $105 per screen). At less than 10% of the total, market data revenue should be kept in perspective as long as it remains healthy.

CME Group is slated to buy NEX Group for its foreign exchange and fixed-income cash execution platforms. This should continue CME's long history of growing by smart acquisition. The company has also been able to return $9.8 billion in free cash flow to shareholders since 2012, averaging about a 5% annual cash yield, along with market-beating stock appreciation. Lately at about $157, the stock trades at 23 times expected earnings for the year ahead -- a premium valuation multiple, but a lower one than in recent years. It's a Best Buy Now here at 2.4%.

Facebook (NASDAQ: FB): Despite investing heavily in its business, Facebook is growing strongly. Ad revenue was up 50% in the first quarter of 2018, and mobile ad revenue jumped 60% to $10.7 billion, representing 91% of total ad sales. The average price per ad rose by 39%, and ad impressions served increased by 8%. Against this strong growth, total expenses rose 39%, leaving Facebook with about $5 billion in first-quarter free cash flow and a top-notch 46% operating margin. For the year, Facebook still expects expenses to increase by 50% to 60%.

Investors may be willing to look past those costs as long as ad revenue continues to increase nearly as rapidly and traffic stays healthy. Daily active users on Facebook properties climbed 13% from a year ago, to 1.45 billion, led by growth in India, Indonesia, and Vietnam. Monthly active users grew 13% to 2.2 billion. With the largest, most engaged Internet audience in the world, Facebook remains focused on making its advertising business effective, transparent, and safe. It has tremendous room to keep increasing this revenue, and down the road management could also monetize Messenger, Marketplace, and countless other services if it so desires. This optionality is valuable.

But CEO Mark Zuckerberg opened the conference call focused on the multiple efforts under way to make the Facebook community a force for good, including tools that automatically remove dangerous content, transparent ads that users can eliminate if desired, limiting the data that app developers see, and continuing a policy of never selling data. An advertiser can target you based on stats, but does not know who you are. Facebook also shared that advertisers haven't left.

At $178, the stock trades at about 24 times expected earnings for 2018 and 26 times its free-cash-flow run rate. Facebook remains a high-conviction recommendation here, and our largest position at 7.5%.

Gilead Sciences (NASDAQ: GILD) surprised Wall Street last week. That was evident in the stock's sharp drop. Although management maintained and reiterated the total annual sales guidance they gave three months ago, calling for $20 billion to $21 billion in 2018 revenue, investors seem skeptical after revenue only clocked in at $5.1 billion in the first quarter, down from $6.5 billion a year ago. Sales for the HIV franchise were up just 2%, to $3.3 billion; for the Hepatitis C franchise, they fell a giant 59% to $1 billion, with competition weighing on results.

Management suggested last quarter that Gilead's Hepatitis C market share and some pricing stability were around the corner. Pricing has now "largely stabilized," they said last week, and they expect market share to stabilize by mid-year. They maintain Hep C revenue guidance of $3.5 billion to $4 billion this year. That said, it's easy to be skeptical, because they also foresee a continued, slow, steady decline in patient starts.

On the bright side, management is calling 2018 a trough year for Gilead's earnings, with confidence that earnings growth will return in 2019. At this point, after a few years of poorly managing Wall Street's expectations, investors like us would need to see it to believe it. With the Hepatitis C franchise shrinking, the HIV franchise remains the key pillar holding Gilead high. Generic pressures in Europe are being addressed with new drugs, but we've still been burned by having added a company here that doesn't meet our usual *Pro* requirements, such as pricing power and recurring revenue. We're debating what to do next, whether covered calls or something else. If Gilead can truly start to grow again next year -- *if* -- then the stock should do much better. But will it? For now, it remains a buy at just 1.8%. It trades at 10.4 times earnings expected for the next year -- but without growth, the struggle would continue.

Mastercard (NYSE: MA) reported first-quarter earnings-per-share (EPS) growth of 43% on revenue gains of 27%. Excluding the impact of accounting changes, currency, and special items, net revenue growth was still 20% and operating income was up 27%.

Business is strong around the world as economic activity remains robust. Worldwide gross dollar volume rose by 14% in local currency, 10% in the United States. Results are strong enough that management increased 2018 revenue guidance to suggest growth in the high teens (up from the mid-teens). As the company continues to invest in new initiatives, expenses are expected to grow as well, with those numbers now in the mid-teens up from the low teens.

Mastercard continues to expand its business in numerous related but novel directions. It's working on faster payments with its PromptPay, which enables bank transfers using a mobile number or citizen I.D. VocaLink, an acquisition from one year ago, is part of that. The company has a broad partnership with PayPal, including debit. And in other ventures, it's working on a standard checkout button for e-commerce, where sales were up 25%. Mastercard's services revenue was up 33%, including data analytics, and it's ready for Europe's General Data Protection Regulation in late May. In fact, Mastercard founded an independent trust, named Truata, to offer commercial data analytics based on anonymized data that meets GDPR requirements.

Meanwhile, Mastercard's debit business in India is taking off and holds great long-term potential. The company continues to seek approval to be a domestic processor in China, where it currently works with AliPay and TenPay "in a number of ways," CEO Ajay Banga said in the call, noting that "[CFO Martina Hund-Mejean] actually has willingly raised our expectations for the year ... which is a first."

The stock trades at 28 times year-ahead earnings estimates, a premium, but in line with the EPS growth rate. As with **Visa** (NYSE: V), management sees transaction growth of above 10% this year. It remains a Buy here with a 6.7% allocation. (Visa is a Buy at 3.7%.) If you're just starting, you can even those allocations out a bit more if you like; just realize that MasterCard is a smaller business and the stock has recently outperformed Visa again.

There's plenty more, but to spare Ellen as she edits, it'll have to come a bit later. [*Editor's note: This is not actually how editorial decisions are made, I promise.*] **Square** (NYSE: SQ) had strong results. Visa did, too. **Apple** (NASDAQ: AAPL) and **Skyworks** (NASDAQ: SWKS) did not disappoint, either.

Have a Foolish day!

-- Jeff (TMFFischer)

Shaken by Shake Shack

Published May 4, 2018 at 3:14PM

Dear *Pro* Member:

Even after years of investing, lessons will be learned and relearned. In most cases, they're learned after the fact, and it's only in hindsight that you wonder why you didn't see something earlier. In other cases, a Fool's overriding desire to leave investments alone for the long term rather than fiddling with them can lead to growing losses, but that long-term outlook should still produce many more wins for you overall.

That's our situation with **Shake Shack** (NYSE: SHAK). It's now the worst-performing short in *Pro*'s history, soaring today on earnings that were surprisingly bland. The stock is up on positive "same-shack" sales growth of 1.7% and revenue growth that was modestly above expectations. But traffic to stores dropped yet again, and it's unlikely any business can keep raising prices as often as Shake Shack has, so the overall story here hasn't changed. Nonetheless, investors are climbing aboard and short-sellers are getting squeezed out.

We will likely be closing our short in the coming days, too, with an official alert to you. I'm hesitant to issue that alert today — the best day ever for the stock — especially in light of the apparent short squeeze artificially pushing shares higher. Assuming we do close soon, though, we'll lock in a loss that has cost about 0.2% of the portfolio. At last count (the last day of April), the *Pro* port was up more than 1% for the year, while the S&P 500 is down a fraction. We're trailing our North Star, but we're in the green overall and doing better than the index. However, the hits we've taken this year haven't been fun.

What happened with Shake Shack is telling. Our thesis -- weaker same-shack sales, slowing sales growth, and higher costs -- has played out. But despite negative same-shack trends over most of the past year, the stock price has held up. In fact, now it's even jumping -- on same-shack sales guidance of just flat to 1% this year. And that guidance was issued only because this quarter improved. The rest of the year, it's still going to be a struggle to improve this metric.

Wall Street is instead focused on total revenue growth, up 29% last quarter, and Shake Shack's goal of 200 domestic-owned shacks by 2020 and 450 in the long run. The store count should increase by 36% to 39% this year. Expanding expenses and lower foot traffic will keep profits and revenue from growing nearly as much (look for a figure in the mid-20s instead). Yet the stock now trades at more than 70 times expected earnings, making it the most expensive among its profitable peers.

We are not likely to keep fighting this stock's trend. We're on the losing end for a reason. Investors simply like the long-term story, the management, the stable revenue growth. They like the brand. They like the company's digital initiatives. Overall, we've been wrong to short it. The numbers show that plainly.

How can we do better next time? Several ways, which start here in *Pro* immediately.

1. We're not going to short brands with buzz and well-known founders or management.
2. We never short on valuation alone, but when valuation is a core argument, we also need a business that is stagnant or shrinking, not growing.
3. We're going to stick to our 20% "max loss" rule on shorts. We reviewed this short every step of the way, and opted to keep it, as an exception. We shouldn't do that. We need to stick to our rules on shorts to contain losses.

One thing we did do exceptionally right: We never added to the short. We started it at a small size of about 0.45%, and we never shorted more. We considered adding to it often, in the high $30s and low $40s, but a strong enough reason to short more of it was elusive. The risks seemed too large. Our exposure was ample. This only reinforces our ongoing belief that shorts should start very small and you should add to them rarely, partly because a short grows anyway as it rises.

All told, this was a poor short choice. I should have seen that. I was not — am not — impressed by the product or the company's long-term plan against the backdrop of its current share price. The stock is already pricing in at least 200 stores, if not 300. It will take years to get there. If you discount that value to today, even assuming the best-case results for earnings, the stock is priced to an extreme that it is hard to imagine lasting forever. But we also don't want to stay short forever and risk a growing loss. We can exit soon and still have a strong, thriving portfolio, and still be in the green for 2018 so far, too. We can exit and be wiser for it, more lessons learned and relearned. We'll write about those with time.

Finally, there's another change I want to start in *Pro*:

Any position we short in *Pro*, I'm going to short it myself, too. I haven't always in the past, largely because our trading restrictions put hurdles in place. But now I want to. Just as I own most *Pro* stocks and want to get to a point of owning them all, I will short every stock we short in *Pro* right from the start -- a few days after our alert. That should help us all succeed better together.

In closing, to be clear, this isn't a close report. I'm hoping the stock gives back some of these gains as the short squeeze relents. But we could issue a close report as soon as next week. We'll see. And we'll be in touch. We've had some hits this week with earnings, but our largest positions are doing very well and carrying the portfolio. That's generally how it's hoped, and meant, to work. Your winners keep winning and growing more important. Your losers you end up cutting, especially with a short. We're on watch to do that soon with Shake Shack, because even if the momentum changes at some point down the road, hanging on is risky while we wait. We'll want to clear it out and do much better with our next short decision.

On a personal note, I'm traveling with a band of Fools to Hong Kong right now, where next week we'll celebrate the launch of Fool Hong Kong! We're happy to keep spreading Foolishness around the world. Thank you for being a key part of it. Have a good weekend.

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Expirations: CME Group, Paycom, Square, and More

Published May 3, 2018 at 1:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 3.8%.
- **CME Group** (NASDAQ: CME): Buy 2.4%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.7%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.7%.

Continue building your portfolio with our Buys, including:

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.7%.
- **Coherent** (NASDAQ: COHR): Buy 1.6%.
- **Facebook** (NASDAQ: FB): Buy at least half of our 7.5% stake.
- **Paycom** (NYSE: PAYC): Buy up to 4.1%.
- **Square** (NYSE: SQ): Buy up to 4.1%.

Shorts:

- N/A

Options:

- **Oracle** (NYSE: ORCL): Invest 0.6% to "buy to open" January 2020 $30 calls. They're lately about $16.50 each. Once you own those, wait for a price recovery to write diagonal calls with us at about a $50 to $52.50 strike price for a worthwhile yield. We'll have an alert when we're ready.

Upcoming Expirations (May):

- We have written calls expiring on **The Cooper Companies** (NYSE: COO), **Gilead Sciences** (NASDAQ: GILD), and **Home Depot** (NYSE: HD) on May 18. We'll have guidance beforehand. Right now, we only need to roll the Home Depot $175 diagonal calls (the stock is $183 lately).

Volatility Re-Examined

Published Apr 30, 2018 at 1:34PM

Note: We don't have any guidance changes or completed trades to share over this past week. A continued huzzah for status-quo, long-term investing!

Dear *Pro* Fools,

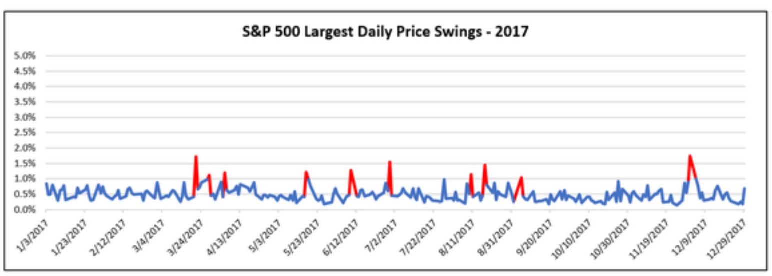
Last year at about this time, I wrote a Memo called "The Least Volatile Market Period in History." In that distant, faraway time, we had just endured exactly what the title said: literally the least volatile market period in history. The S&P 500 had recently gone 64 consecutive trading days without a 1% intraday move, by far the longest streak of low volatility in market history (crushing the previous record of 34 consecutive days set in 1995).

That Memo discussed the persistently low levels of volatility in the CBOE Volatility Index, or ^VIX, and the association of low volatility with higher stock prices over the next year. I closed it with a warning:

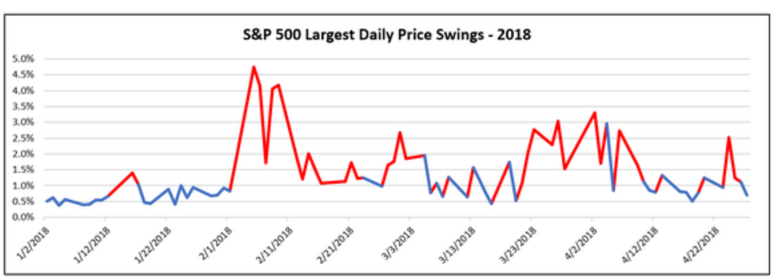
> "Will volatility increase in the future? The answer is most likely yes, as volatility is mean-reverting and market swings of 1% or more are very common. The relatively higher volatility of stocks (compared with bonds or other asset classes) is one of the reasons why stocks generate higher returns over time, as the risk/return principle implies that higher risk is correlated with higher returns.
>
> "After enduring such a long period of low volatility, it is easy to allow psychological biases (such as the recency bias) to trick you into believing that low volatility is the norm. The next period of significant market volatility may feel especially jarring when compared with the current calm. However, keep in mind that volatility is very normal, and significant swings in stock prices will happen -- it's just a question of when. If you mentally prepare yourself in advance for such volatility, it will take you a long way toward making proper decisions when the time comes."

Oh, How Times Have Changed

Upon reexamining volatility in 2018, we see that the warning note from that Memo has proved prescient. As you may have noticed, 2018 has been a far cry from the atypical low-volatility environment of 2017. Take a look at this set of charts, which details the largest intraday price swings (measured via the highest and lowest intraday price from each trading day) for 2017 vs. 2018, with swings greater than 1% shown in red:



In 2017, maximum intraday price swings ranged between 0.15% and 1.73%, averaging 0.51% per day. There were 10 trading days (out of 251 for the whole year) where the maximum intraday price swing was greater than 1%. Now here's 2018:



Whoa. If we were shown the two preceding graphs without any titles or context, we'd think we were looking at two completely different systems. This example of the inconsistency of data when measured across differing time periods is one of the defining characteristics of stock markets. (And it's one of the main reasons why stock-market predictions based on linear models or normal distributions don't work.)

In 2018, maximum intraday price swings have ranged between 0.38% and 4.75%, averaging 1.39% per day. So far, out of 81 trading days this year (not including today), 45 of them have seen intraday price swings greater than 1%.

Volatility and Market History

While 2017 was atypically calm, 2018 has over-corrected to the opposite extreme of the spectrum. When measured by the number of 1% intraday moves (up and down), 2017 was the least volatile year since 1972. Conversely, when the data from 2018 so far is extrapolated out to a full year, it marks the most volatile year since 1938:

S&P 500: Number of 1% Up and Down Days (1928 - 2018)								
Year	1% Down Days	1% Up Days	Year	1% Down Days	1% Up Days	Year	1% Down Days	1% Up Days
1928	27	40	1958	5	13	1988	31	37
1929	48	66	1959	14	8	1989	14	26
1930	70	58	1960	17	14	1990	42	33
1931	97	69	1961	3	11	1991	25	34
1932	95	86	1962	34	24	1992	11	17
1933	75	87	1963	3	3	1993	7	10
1934	59	61	1964	3	0	1994	15	12
1935	40	51	1965	7	1	1995	4	9
1936	29	59	1966	25	16	1996	17	21
1937	62	55	1967	9	10	1997	31	50
1938	67	74	1968	9	10	1998	32	47
1939	52	52	1969	18	7	1999	40	52
1940	35	36	1970	33	30	2000	54	48
1941	29	25	1971	14	18	2001	54	51
1942	26	33	1972	6	4	2002	72	53
1943	17	25	1973	43	35	2003	37	45
1944	8	8	1974	67	47	2004	20	21
1945	21	25	1975	35	45	2005	17	13
1946	37	39	1976	14	25	2006	13	16
1947	30	30	1977	12	5	2007	34	31
1948	26	28	1978	24	19	2008	75	59
1949	15	17	1979	13	17	2009	55	62
1950	22	33	1980	37	43	2010	37	39
1951	17	19	1981	30	24	2011	48	48
1952	8	5	1982	38	44	2012	21	29
1953	16	8	1983	26	29	2013	17	21
1954	5	10	1984	16	25	2014	19	19
1955	19	23	1985	7	22	2015	31	41
1956	21	23	1986	25	35	2016	22	26
1957	25	17	1987	42	53	2017	9	1
						2018	*78**	*62**

Note: 2018 represents a full-year run rate based on the data as of April 27.

Based on the mean-reverting nature of volatility, I'd guess that the rest of 2018 won't be as volatile as the beginning of the year (although I reserve the right to be wrong!).

Low Volatility and Higher Stock Prices

In last year's volatility Memo, I also examined a phenomenon I'd noticed: In every single instance following a long streak of low volatility, the S&P 500 has been higher one year later. Now that we're more than a year removed from last year's data point, we can see that the relationship between low volatility and higher stock prices has held in this case. Last year's streak of 64 consecutive trading days without a 1% intraday move ended on March 20, 2017; one year later, the S&P 500 was higher by 14.5%.

The *Pro* Bottom Line

After an atypically placid 2017, we've shifted gears into a turbulent start to 2018. Although we knew volatility was likely to increase from 2017's historically low levels, it would have been difficult to predict that this turnaround would lead into a period of volatility that will, if the pace continues, be the most extreme in 80 years.

Nonetheless, we know that volatility is a normal and healthy part of stock-market investing, and we know that volatility is one of the main reasons why stocks generate higher returns over time compared to other, less-volatile asset classes. And because we didn't allow the tranquility of 2017 to lull us into a false sense of security, we were able to weather the beginning of 2018 with composure, using the volatility as an opportunity to initiate new positions and to reexamine our approach to hedging.

Fool on!

-- Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Expirations: CME Group, Facebook, and More

Published Apr 26, 2018 at 1:57PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **CME Group** (NASDAQ: CME): Buy 2.5% per our recent alert.
- **Oracle** (NYSE: ORCL): Buy 3.4%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.7%.

Continue building your portfolio with our Buys, including:

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.7% per our recent alert.
- **Coherent** (NASDAQ: COHR): Buy 1.5%.

- **Facebook** (NASDAQ: FB): Buy at least half of our 7.5% stake.
- **Visa** (NYSE: V): Buy 3.7%.

Shorts:

- **Shake Shack** (NYSE: SHAK): You can short 0.5%, but please realize that we may close this soon if the short doesn't start to go our way after earnings in early May.

Options:

- **Oracle**: Invest 0.6% to "buy to open" January 2020 $30 calls. They're lately about $17.50 each. Owning those, wait for a price recovery to write diagonal calls with us at about a $52.50 strike price for a worthwhile yield.

Upcoming Expirations (May):

- We have written calls expiring on **The Cooper Companies** (NYSE: COO), **Gilead Sciences** (NASDAQ: GILD), and **Home Depot** (NYSE: HD) on May 18. We'll have guidance well before then. Right now, we only need to consider rolling the Home Depot diagonal calls.

Pro Video Chat, May 2018

Published Apr 24, 2018 at 12:53PM

The *Pro* team held **a live video chat on this page at 2 p.m. Eastern on Thursday, May 24**! A replay and a transcript are available below.

Jeff Fischer: Greetings, *Motley Fool Pro* members and welcome to the May *Motley Fool Pro* chat. I'm joined at the table by JP Bennett...

JP Bennett: Happy to be here.

Fischer: ...and via phone we have Billy Kipersztok.

Billy Kipersztok: Hey, Jeff.

Fischer: Hey, Billy. How are you doing?

Kipersztok: Doing well, thank you.

Fischer: And we are grateful that you're here, as well. We are, as usual, taking your questions in real time at Slido.com. If you go to Slido.com and enter #ProChatMay, you can and should get into that forum and ask your questions. Thumb up the questions that you like best and we'll answer them in order of popularity for the most part, assuming we have an answer, and we'll try to answer all of them over the course of the live time spent with you.

As for *Pro* itself, we are now five months through the year, practically, JP...

Bennett: Time is flying.

Fischer: It's been an interesting year.

Bennett: Yes, it has.

Fischer: The S&P, after a record-strong start pretty much, is now up about 2% on the year, including dividends, I believe, and PRO port was up a little more than that. We have some dividends to reinvest. We'll have dividend reinvestment trades soon (that's the plan), and we have had some new positions put into the portfolio this year, already, including Adobe and just this week JD.com and others that we look forward to talking about.

Overall, if I had to rate ourselves on the portfolio, I'd say we're doing pretty well. You can do very poorly in investing. You can have large losses. Most major hedge funds have done horribly the past five to 10 years. We're doing well -- overall very well -- this year. I wish we were a little stronger given the strength in Nasdaq holdings, where we benefitted so far with Facebook, Square, Paycom and things like that.

But we've had some hits this year, as well, some hits meaning some negative hits from (SVXY), Gilead, and Shake Shack short. We have our mix of wins and losses, as usual, but a few more losses this year than we normally would have in a flat year. But overall our largest positions are the ones driving the portfolio and are where we spend the most time, because they're the most important.

It's great to see new leadership climbing through the ranks of our holdings. By that I do mean Paycom, Square, and Tencent, to some degree, are already growing enough to rise up to become larger holdings among our 25 positions. Our top 10 positions are about 55% of the portfolio, and we really like all those stocks, as well as our smaller stocks, which are less consequential, but to which we might be adding to or letting go of to move into something we like better.

So, it's always fun, always Foolish, and we're glad to be here with you, and that you're here with us. I look forward to the rest of the year. We just wrapped up most earnings. Medtronic reported yesterday and looked quite good. As we wrap up, you know we frequently follow earnings season with some trades as we adjust the portfolio and look forward with it, so we can probably look forward to that very soon, too.

Without much further ado, let's get into the questions that we have so far, here. We'll start right at the top. We have Lon asking, "Hey, *Pro* Fools, may I again request a return to monthly chats. Thank you."

Lon, we are chatting almost monthly with you. We have a chat in *Options* and a chat here in *Pro*; therefore, we do have at least face-to-face time almost every month between these two services. But it's really about the Fool's resources and what the Fool wants to do across its many services and how it uses studio time.

We enjoy these chats. The Fool appreciates them, too, and wants us to have access to you, obviously, and vice versa, and so we'll see. This is, as we said when it rolled out, kind of an experiment to see how it goes bimonthly or quarterly instead. We're only two quarters into this, but we'll see what we can decide. I better not say much more. Your question, your comment is duly noted and definitely heard.

Bruce has leapt up into the lead right now with, "What is the plan for Coherent trading below the recommended price? For those who have less than a block," (I imagine he's saying 100 shares), "what alternatives will be considered?"

Well, Coherent is now a 1.7% position. It was never more than 2.0-2.5% when it started. I think 2.0%? Billy?

Kipersztok: I'll check on that.

Fischer: OK. And we have added to it in at least one small amount once with a dividend reinvestment and maybe twice, I want to say. Anyway, it's still a pretty new position for us. Just over a year old or so. I don't know that anything needs to be considered for it. A block isn't important unless you're trying to use options on it. You don't need to own 100 shares, which is about $17,000 worth of stock.

More important, of course, is your allocation and we're comfortable with our sub-2% allocation right now. I just wrote about Coherent in the recent memo this week. The business is doing well. Revenue is growing. Earnings are growing. They're booking new business for 2019. The market is concerned about MicroLED evolution. Where most screens, right now, are made in LED, OLED; MicroLED would be a new way of making screens. That said, Coherent addressed that, again, with the strong belief that they are in a position to benefit should MicroLED become the next thing.

They believe it's still a ways from commercialization -- quite a ways from it -- but they're already working with manufacturers and they already have product on the market being tested to aid in the manufacture of that new technology. They think it would actually expand their market to bigger screens, as well.

So, overall, Coherent is on track. The market hasn't liked the long-term risk of technologies changing, but let's keep in mind Coherent is more than 50 years old. Technology has changed constantly in the laser space. They're typically one step ahead of the game and they seem to be right now, too.

We're not overly concerned, although we are, of course, watching that they're about to lose their strategic positioning. I don't believe that's the case. I think that company is most likely to keep growing and so right now we're keeping our stake, keeping it at a buy, and we consider adding to it, as we do all our positions pretty much every quarter. If we decide to do that, you'll get an alert to that extent.

Right now, we recommend everyone have the position size that matches us -- 1.7% or so -- and we are delighted to be owners in that business for the coming five years and longer, hopefully. As long as it keeps performing financially, we think the stock will eventually follow suit.

Kipersztok: To clarify, Jeff, we did start with a 2.5% allocation.

Fischer: OK, thanks, Billy. That hurts. Now it's 1.7% because the portfolio has risen. Coherent has fallen about 30% the last I looked, so it's shrunk, but in a way that's good. In most ways that is good when your losers become less meaningful, but I don't think Coherent is going to be a long-term loser. It was, in fact, a winner just a quarter or two ago. It was up around $300 a share. It's a volatile stock, and I think in those cases, especially where the business is one you believe in, it bodes well to hold onto shares rather than sell when it's down.

Now we get to hear from somebody else, thankfully, meaning JP, because Lana is asking, "Could we elaborate on our thoughts on China regarding JD.com, please?" JP, your thoughts on JD, other than we know it's the initials you like. They're kind of close to yours...

Bennett: Yes. That, now, is the sole reasoning behind...

Fischer: Close enough.

Bennett: ...the sole reasoning behind my recommendation. How much time do we have? Can I use the rest of our *Pro* chat time here?

Fischer: Knowing how much we've talked about JD in the past two months and how long you could go on, I think I have to put a limit on you.

Bennett: OK, fair enough.

Fischer: Let's say four minutes. Three minutes.

Bennett: Fair enough. In a nutshell, for me the biggest concern was I didn't want to be investing in a company that I thought would get caught up in a winner-take-all market two, three, or four years down the road. You layer that risk -- being the company that doesn't win -- on top of country-specific risk and China and political risk and it just wasn't that appealing to me.

I would say the vast majority of the time starting out was just looking at China and the e-commerce market. Not only that, but for me, when you have a really complex issue like this, I prefer to take a step back and try to come up with a couple of really key questions (questions I believe will ultimately drive the thesis) and spent all my time drilling into those and yet using those questions to move the research forward. It was something like this.

It's incredibly easy to get caught in the weeds, get bogged down, and go off on weird tangents, and then you take a step back and it's like, "Wow. I just spent two days doing something that was completely useless." I wanted to get more comfortable with what disposable household income is going to look like going forward. Ultimately, I felt like that was probably going to be the biggest driver when I was done with everything. That was the first question.

The other three were how much people are going to spend, what are savings rates versus consumption rates going to look like, and where are they going to spend it? You have that money. You can spend it wherever you want. They're not going to spend it all on retail. I needed to get a better feel for what retail slice of the consumer-spending pie was going to be like, and then what is e-commerce's share of that retail spending going to be.

Ultimately, what it got down to was after spending Lord knows how much time on it, I felt pretty confident you're going to see 20-30% growth in e-commerce for the next five years and for the next decade in all likelihood it's going to continue to outpace the U.S. e-commerce market, which obviously gets all the attention. It's not a perfect comparison, and oftentimes I hesitate to compare Chinese companies to U.S. companies or Chinese markets to U.S. markets.

In that case, I feel like because the Chinese market is just so big, there's so many people. They're spending all this money. Even though they're spending a fraction of what they ultimately could be spending, one of the most interesting things is that the savings rate in China is just incredibly high. There are a bunch of reasons for that, and I actually don't think that's going to change in the next five to 10 years. If it does, it would be a huge boom to the economy, but I don't believe it's going to change. I think they're still going to have an extremely high savings rate.

But you look at all of that stuff and ultimately I felt like using the U.S. helps put it in perspective -- that this opportunity is so massive, even though it's already bigger than you could really fathom -- so, once we got to the point where this market is huge, the opportunity is huge, we would love to invest in it more directly than by way of Tencent, because obviously Tencent has, in addition to their stake in JD, fingers in a bunch of other companies.

They have got countless investments. I know, just like a reign of statistics, that Chinese companies (primarily like Alibaba and JD) accounted for I think was upwards of like 40-50% of venture capital funding last year on a global basis. They are investing heavily in the next leading companies. We wanted more exposure to that, so then it was how we were going to do this. Do we want Alibaba? Do we want JD? They're obviously very different business models.

I was sitting on the sidelines, not really sure what to do, and then you just watch JD get absolutely clocked. This makes it a much easier decision. The final stepping point for me was just modeling out. Assuming what I believe to be somewhat conservative expectations are correct, this stock is simply too cheap. It's just way too cheap. And whenever that happens, I always get extremely nervous, because [I'm concerned] I'm missing something.

We ultimately had enough conviction (I know you looked at it, too, for both *Pro* and some other Foolish services and recommendations). You just thought the opportunity was so big it was worth taking it. Two and a half percent may not seem like a big stake, and that's perfect, because if it doesn't work out, the stock's not going to do great, but like you mentioned early, it's not going to hurt us to the point where we can't overcome it. But if it works out, it's not going to be just like a 5-7% growth annually. We're talking about huge returns and it will get to the point where it will definitely have a huge positive impact on the portfolio.

Fischer: Definitely. That leads right into the top-rated question from Lance. "Hello, Fools. I saw a commentator on CNBC who said that Alibaba is a Raymond James top pick. Can you discuss Alibaba versus JD?"

I'll throw in that personally I like JD.com better, obviously, for a few reasons. You can't simplify -- we don't want to oversimplify...

Bennett: I didn't have enough time to go into the details.

Fischer: ...the two, though JD is more of the Amazon model, where they're holding inventory. They're fulfilling delivery. They control the whole experience start to finish. Alibaba is more an eBay model, where they put disparate buyers and sellers together from across the country. It's interesting, because early on eBay looked like such a better business compared to Amazon. In fact, I bought more eBay than Amazon back in the day.

EBay was profitable. It was, of course, growing quickly. Amazon was growing sales, but growing its losses to an even greater degree, so I thought eBay looked like the better business. But in the long run, Amazon has proven to be, by far, the more valuable business, and I think that's because it controls the experience start to finish. It's the company that has the relationship with the customers. It controls the whole value chain in a nutshell, and that has allowed it to pro revenue to outrageous proportions compared to eBay, and that revenue produced, all these years, cash flow for Amazon that it could then invest into other projects. Look at how that's turned out really well.

I think JD.com is hopefully much more like Amazon than...

Bennett: Both in company and stock performance.

Fischer: Exactly. And Alibaba, while it's interesting and we've recommended it in other services like the Everlasting Portfolio (we put some options on it there, as well), between the two we like JD's long-term prospects better.

Bennett: And I would say as full disclosure, I own both companies. That paints a picture for what I think about the e-commerce opportunity.

Fischer: And you filed, because you're a majority stake owner in...

Bennett: Yes, exactly. That is the case, so I have to make the disclosure. For me, it was a couple of things just laying on top of what you said already, and they're all interrelated. You look at where e-commerce is going. For me, the next battleground is in getting delivery times as low as possible. We talked a little bit about why we thought that would be the case in terms of population density and opening other segments of the retail market for e-commerce disruption. I just believe that is going to be a huge opportunity. I think having complete control over the logistics of all of that is going to prove to be extremely valuable.

You've seen Alibaba recognize that they can't just continue to go down the path they were going in terms of completely pushing away and not dealing all that much with taking a majority stake in Cainiao. Trying to copy a little bit in terms of what JD is doing with logistics. But I believe that that push, that lead that they're investing so heavily to stay in front will ultimately pay off.

The big fear, like I alluded to in the write-up, is that all these investments that JD is making is to simply stay in place. To tread water as opposed to furthering their advantages, because some investors think Alibaba is going to ultimately catch up in that respect and whittle away at their advantages. And if that's the case, then Alibaba's got the better higher-margin business model and they'll end up being a better investment.

But I don't believe that's the case. I think they are following the Amazon idea of investing heavily, trying to continue to gain additional advantages, push the envelope and, ultimately, they'll be able to reap the rewards in terms of moving consumer goods and other segments.

And if you take a step back and look at it, as both companies build out their offerings and the market becomes a little bit more mature, and the user acquisition costs are lowered over time, you have to think about what is going to determine who goes with JD and who goes with Alibaba. It will largely center around consumer experience. Whoever offers the better experience will win.

I believe that JD's focusing on the right things to have the better experience. If you look at surveys in Tier 1 to Tier 2 cities, the higher-income individuals, by and far, prefer shopping on JD.com. They think it's a better experience. They get the authentic products or the assured reinforcement that they know buying on JD is the way to go. They don't have to deal with fakes and they don't have to deal with all the headaches that may come with working with an eBay seller. I know buying stuff on eBay sometimes was a bit of a hassle for me.

I think having the better experience will ultimately lead to them being able to not just establish a niche but establish themselves and take a big slug of the business-to-consumer marketplace and hopefully generate a lot of free cash flow and profits and give us a good stock return.

Fischer: Great. Thank you, JP. It's anecdotal, but just this month I was in Hong Kong as we launched Motley Fool Hong Kong, and it was great to meet several Fool members, both from Hong Kong and those from China who came in for this event. And several of them -- the majority of the ones I spoke with -- were most excited by JD.com.

I didn't go fishing for it because we were working on this report, so I didn't say anything. You were working on the report here, but when talking about Chinese companies, JD came up as one that was taking the right steps, as you just described. Obviously, Alibaba's a little more well-known and had a longer track record on the market, anyway, for appreciation. That's why they like JD better, because it's quietly behind the scenes building up for something much bigger. This, again, parallels a little bit eBay and Amazon way back when.

My next thought is I misspoke. It wasn't Alibaba that we did options on in Everlasting Portfolio.

Bennett: Baidu.

Fischer: It was Baidu. It's interesting how even though I wasn't thinking about it, your mind still corrects you a few minutes later. *Oh, you made a mistake*.

Bennett: It always happens on live TV, right?

Fischer: It's still working. My mind is still working well, except I maybe just archived the right question.

Bennett: Remotely asking is dangerous. Do you remember what it was?

Fischer: Maybe I didn't. I don't think I did.

Bennett: If Jeff prematurely archived your question, put it in again, and put in all caps, "JEFF GOT RID OF THIS QUESTION."

Fischer: There you go.

Bennett: So, everyone knows to bump it back up.

Fischer: Thanks, JP. That's why we need Ellen, here, for so many reasons, as one who would be able...

Bennett: We'd fall apart without Ellen.

Fischer: ...to manage it. I know this was the top next question, though, so I think we're okay. Bruce is asking about our preliminary thoughts on the VeriSign roll.

Bennett: Well, I plan on having a memo for this in the coming weeks. I don't believe it will be ready for the following week, but two or three weeks. And spoiler alert. Odds are if the stock stays where it is, we're just going to let it go.

To me this centers around valuation, and that's always a hot-button topic. Why sell based on valuation? Great companies continue to compound, and they always make people who sell Amazon when it's at $100 or Apple presplit $50 look like fools down the road. They compound so incredibly well over time.

That is true but for me, when it comes to valuation, there's two things. There's the margins and growth, and that will ultimately determine the value of the company. We've got a pretty firm handle on what the margins are going to look like, and that is where VeriSign is so special.

My estimates are that the incremental gross margins on each additional dollar that they generate is somewhere around 90%. They generate an additional dollar and they capture 90 cents of that. That is insane. And then their operating margins aren't that far behind. Their incremental operating margins, by my estimate, are 80-85% which, again, is pretty much unheard of for most public companies, so we know that part of the business is extremely special. That was part of the reason we were attracted to it when it got hit and it sold off based on those fears surrounding China.

But that, alone, can't compound because there is a natural ceiling that you hit in terms of generating impressive free cash flow growth over time. You can't have 200% gross margin -- it's impossible -- so the way those companies that I alluded to earlier are able to compound value at such an impressive clip over the long run is yes, many of them have great margins, but they're able to grow. Their total addressable market is just massive, and their ability to sustain above above-average growth defies expectations. That's where you really see the drivers play out in terms of the stock doing much better than anyone expected.

Let's be perfectly frank. We do not have that with VeriSign. That's simply not the case. At best, you're going to see 4% revenue growth. That is the best-case scenario. In many years over the next decade we may see 2-3%. This is excluding a proven price increase for dot-com. If you see that, you'll see a one-time bump, and then it will go back to the low single digits.

Essentially what we are dealing with, here, is an annuity that has a tail risk that if they lose dot-com, this business is worth a fraction of what it was originally worth, but that's beside the point. It's essentially an annuity, and those businesses aren't that hard to value. From my perspective, I just can't see how this is a price that is worth chasing and putting additional cash back into the position to try and go up higher, because to be perfectly frank, I think the stock is overvalued by a noticeable margin.

Fischer: So, sometimes paying 30x free cash flow for a company that's only growing revenue at 3-4% is tough to do compared to paying that multiple for a Visa or Mastercard when it's growing revenue at 18%, so it's a big difference.

Bennett: Yes, my best-case scenario, excluding a dot-com price increase. When the stock was trading in the $70s and $80s, and it was trading 10x or 11x EBITDA, it's much easier to look at that in terms of optionality. You're not banking on it, but you think, "Ooh, if that happens, that is a huge additional plus to our thesis." I don't want to hang my hat for this thesis on that, so I try to put that aside, especially when you're dealing with a stock that has moved up so. I mean, the multiples have essentially gone up 50% since we bought it. They're somewhere around that mark.

Fischer: Yes.

Bennett: And so, you look at the valuation, and best-case scenario over the next five to 10 years is that the free cash flow growth is 5% or so. That is best case for what I believe can happen. And you go back and you look at what I was modeling when we bought the stock. I looked at my notes yesterday when we were talking about it, and the numbers they've produced compared to what we were modeling for are pretty much spot-on and my notes were like "best-case scenario, in five years this is like a $138 stock." Well, guess what? We're only eight dollars away from that and only two to two-and-a-half years into owning it. So, what are our prospective returns?

Now we're at a scenario where if you can't have the option premiums to juice the position and layer that on top of the capital gains -- because these guys don't pay a dividend and they're not going to for the foreseeable future -- that's the only way you will get to North-Star-like returns. At this valuation I simply don't see it and I feel uncomfortable because (a) should we roll up, I would not advocate for writing puts, because I don't want to write puts at a strike price that I believe is still overvalued.

And (b) that would switch to just making this a covered call position. Well, I don't want to keep funneling cash into a position that the strike we roll up to, even if it's still noticeably below the stock price, is still overvalued. It would be the worst-case scenario. You pay to roll up and the stock gets hit, so (a) you've put money into the position that is now gone, because the stock finished below your call strike price and then (b) you've also lost capital gains, because the stock has fallen, and it's the exact opposite of what you want to happen. You want capital gains and premiums to go along with it as the stock rises. Well, I'm not excited about the idea of the opposite happening, and I think the chances of that happening are much higher.

Fischer: So, odds are very high, Fools, that VeriSign will be let go in June, in just a few short weeks. It's been a great investment. The stock itself is up about 61% for us in under two years. We've made some put option income as well.

Bennett: Unless the stock falls and then a covered call roll is attractive. That would be the one thing that would make us consider it, potentially; but, even then, you have to remember this is one of the positions where the options aren't traded all that frequently, so *Pro* volume tends to have a huge negative impact on prices. We have been burned net pro when we go in to make our trades. We have been burned for the last two or three times by a dollar, two dollars, or more.

Fischer: That's very true. Thank you, JP. That concludes VeriSign for now, unless the stock falls a fair amount and we talked about that yesterday, too. We let it go and we watch it. It's one of those businesses where if everything else stays the course with its business and the stock falls in the next market downturn, we can look at writing puts or getting back in. It's good to raise a little cash, too. We've been spending cash, lately, on new things.

A question about the Shake Shack short. "Updates and thoughts." We've been talking about that one a lot each week in our meetings, too. It's a 0.7% position. It's down a lot for us as a loser. A short debt has risen against us, of course. What bothers me most, right now, are just the growing monthly fees that we pay to short it. I haven't looked at the fee ratio lately (in the last few days), but, of course, the position is larger than it used to be, so our fees go up because of that.

And so, I still believe in the thesis. The stock is very expensive. That said, shorting on valuation is a tough thesis. You don't want to do that alone. We're also shorting on weakening fundamentals, which I think we've seen. Same-store or same-Shack sales have stagnated since we shorted, and expenses have gone up. They're adding more stores now than they are growing revenue. Let me make sure I get that right. Yes. They have to add more stores to grow their profits only two-thirds as much, so if they grow the store base 35%, their profits might grow 25%. You don't really like to see that with a retailer of any sort.

So, I'm comfortable with the short, still, especially at our position. That said, we might turn it into an option short, instead. A synthetic short with a split strike. Something to give us more room on the upside and something that would capitalize if the stock fell a lot. It's either going to hold up, obviously, or keep rising because the market just likes the story.

Or once it does disappoint the market, it's likely to fall a lot, because shares trade at more than 100x expected earnings; basically, in my opinion, pricing in all the growth through at least 2020 or 2021, and that assumes everything goes perfectly. There's a really good chance the stock is much lower before then. Do we want to sit on our short and wait for that and pay fees every month to do it? Not really. Not when it's going against us like this. And I also don't like just letting the short grow and grow on us.

So, we might change that position up and turn it into options, or just close it outright, see how we feel, and then get back into it via options or some other way. But right now, I'm not uncomfortable keeping it. I like having at least that short in the portfolio. I think our thesis has been right. The market just hasn't agreed with us and when valuation is part of your shorting thesis, you're more likely to be wrong, because the market won't readily agree with you on valuation most of the time in a lot of cases. We've been right on the business and how it's happened, so I'm glad about that, but we might have some news on the Shake Shack short before long.

Now let's start moving quicker. We have questions piling up and we're about halfway through. I'll try to set a good example. "Please discuss overall technology sector exposure. It's very high."

I don't think it is that high. I think most companies, these days, use technology. A lot of our companies are selling technology of a sort. Our biggest positions are not really technology companies. Facebook is a community company. It makes money on advertising. Amazon makes money on web services (so that's technology), but also on retail. Broadridge Financial is proxy statements. It's corporate communications. Mastercard and Visa -- you want to call those technology or financial services. It's kind of a combination.

We never really do invest by sector or sector allocations. We invest in the best businesses we can find. A lot of them happen to combine financial businesses with use of technology or technology itself to reach large amounts of people (and that's very true), but I'm comfortable with what we own, and I think these companies will continue to lead the charge in the coming five to 10 years, as well. And I think almost every company is going to need to use technology in order to compete. We want to own companies that are using it well and that are selling it well, too, in cases where they're selling it.

We're also heavy in software. We're aware of that and there are other software companies I want to add, so we may sell some software providers. But I've been saying that for years, so don't hold your breath. This is how I've invested for 25 years (as far back as I can remember), and it's probably how we'll stay concentrated because we're all drawn to these types of dynamic businesses. With pricing power and recurring revenue, they're in the middle of things right now with growing demand and a growing market potential, as well. So, a great question.

Bennett: For me, just a quick add-on is what's the future? Industrials to me aren't the future. Manufacturing isn't the future. The future is technology, like it or not, so even if you look at it from a traditional perspective, maybe we're overweight technology, but if that's where things are headed, it would be a detriment to not have as much exposure to that as you feel comfortable.

Fischer: JP, really quickly. Any adjustments to Cooper's yet? We recommended covered calls just a few days ago. The stock has fallen a bit since then, so the calls pay much less. Personally, we're waiting and hoping the stock recovers a bit, and then we'll write the same August 2040 calls.

Bennett: Yes, we were chatting about this, this morning with the one-two punch of the stock and members hitting pricing, it just didn't make sense for us to place our trades; so, we're waiting. For those who are super eager for income, I guess you could write at the money ($2.30s), but I would advocate for waiting a little bit to see. Hopefully the stock will recover some and pricing will mellow out and then we can get the $2.40s for a decent price.

Fischer: So, we may not get $7.00 per share as originally thought, but maybe above $6.00 per share to write those calls is our hope right now. Of course, we take a chance by waiting, but it's a chance we're willing to take. "Any *Pro* activities planned for FoolFest?"

In a way, nothing specific; but in a way, yes. And we can't wait to see everyone at FoolFest. There are more than 800 Fools coming into Alexandria, Virginia next Friday, June 1, for the big day of FoolFest and Thursday, May 31 for the *Motley Fool ONE* event. We're talking about shorting. We're talking about top market opportunities. You and Jim Mueller are talking about option income.

These festivals are more centered around investment styles and themes than they are services. That's how the Fool does things partly because a lot of Fool members have multiple services and they've put together their own portfolio that way. That's why it's more themes like growth companies, income, and shorting instead of *Pro* and *Rising Stars*, etc. But we look forward to seeing you there and talking about it with you.

Lance: "If you could choose only one of these war-on-cash stocks," which is a tough choice, "which would you choose? Mastercard, Visa, or Square?" Well, we have all three, so our choice is a basket of all three. I can't think of a scenario where you could only choose one, given that commissions are so low, now, so put a little money in each one.

"If you had to choose just one?" Well, you don't have to, so I don't know if I'll play that game, Lance. I like being put into a corner. If you had to, I'd probably choose Mastercard because it's smaller than Visa. Obviously much larger and more established than Square. It's growing nicely. A multiple similar to Visa. I like Square a lot, clearly, but it's still more speculative at this early stage in its life.

"Have we thought about adding PayPal yet?" Yes, we have. We've talked about it, but we have a lot of exposure to the space.

Bennett: I would personally advocate against it. I own PayPal. I still think there's a lot of opportunity, there, but I think PayPal's valuation is reliant upon it being extremely successful outside of the U.S., as well, and to no surprise to some people, I think that the Chinese companies with their digital payment offerings are going to make it extremely hard for them to win, especially with how aggressively they are planning on pushing outside of China with regards to payments, whether it's directly pushing their services out there or investing in local businesses that are essentially offering the same thing.

It can't be understated the extent to which the Chinese consumer has adopted digital payments gives, at least in my opinion, those companies a big head start in terms of understanding how to make a product that benefits the local consumer, that does everything they want to do, and is able to be adopted at a fast pace.

Fischer: PayPal is recommended in other services and JP has done options on them in *Motley Fool Options*, as well.

Bennett: And I own it, so it's not like I am a "let's go short PayPal" type of person right now. I just think there's definitely enough concerns that I don't feel strongly about advocating for getting it into *Pro*, as well.

Fischer: A Fool member is saying, "I'm almost fully invested in *Pro*." Thank you for your trust. We appreciate that. "It represents about 70-80% of my RRSP assets. Looking to retire within one to two years and am concerned about the transition." I think they mean the transition to retirement. "Any tips?"

I think the most obvious tip is to have living expenses not in the market. To have cash that you'll need in the next three years or so not invested in stocks so that you can rest easy. And if you're always doing that so you always have a three-year cushion of cash, you should not worry nearly that much about your stocks knowing they really have time to recover. Most market declines -- even 2008 and 2009 -- start to recover in earnest well within three years.

I think that's just the golden rule. Don't invest the money that you need in the next year or two. As far as your investments themselves, especially if you're early in retirement and you're just starting, you should have a long life ahead of you. A long, active life ahead of you, and so being invested in companies that are dynamic and growing is most likely going to be the way to go. You still want your money to grow more than inflation and just grow, period, so I think the *Pro* portfolio is a good representation of how you should look to invest in retirement, at least for the good part of your assets.

I hope that helps. Congratulations on your one-to-two-year time frame until retirement. That's exciting. I hope you have a lot of fun things planned. If you have more questions, you can visit the retirement board in *Pro* and please post them. We have many retired *Pro* members.

"Has *Pro* ever considered swapping out Oracle for, say, Microsoft; a more expensive company but seemingly for good reason? Firing on all cylinders."

Microsoft has had a few great years, at least, and is doing very well. Oracle -- we're invested in the transition of the company from on-premise licensed software to cloud software, which ultimately should drive much stronger revenue and margins, and so stronger earnings, too.

That roll off into cloud has been a long time coming -- three or four years at least -- but it's happening now, and so we're really hoping that we will see Oracle get more respect in the market as its results improve from that transition. If not, then we've done okay with Oracle. It hasn't been that great, but it's done well for us from the start. But if it really doesn't start doing better with its cloud business within the coming few quarters (where our time frame is), then we have to really consider moving that substantial amount of funds into something more dynamic. We'll see.

Another question for me. "Is Gilead a long-term loser? Will it ever regain $80? Will it top $100?" Well, who knows? Should we take a loss and move on? Possibly. The last quarter was disappointing. Management in the first quarter was very optimistic about the year and mainly about the hepatitis C market stabilizing, and then that market really got hit.

Revenue fell 59% last quarter, and they're still saying market share is in transition and pricing, they think, is stabilizing. But, I'm not so sure. I think pricing could again, next year, when contracts reset be hit again, because there's competition out there around the world, so they really got hit in Europe, as well.

The lesson, here, is we strayed from a *Pro*-type business that has recurring revenue and pricing power. Gilead has the opposite. It was opportunistic that we did it. I'm glad we did it. We learned from it. We've lost a bit of money, but not enough to change the dynamics of where we're going or the ultimate outcome.

What we do now with it -- it's less than a 2% position. It will have less influence on our future by itself than if we were to sell it and invest it elsewhere. If we can do that right, then that would be better, I think, at this point.

So, as we're talking about after earnings, we're talking about many positions. Gilead is one of them, as I shared in a memo, recently, that's on the docket for potentially being replaced unless we can make decent income on it from covered calls and we want to keep it, as well, for its own merits.

But other than that, we may sell it and move on this year because it's been disappointing and my confidence in management after the last several quarters has curtailed quite a bit. I think they've made some mistakes along the way, at least in their estimates, and I'm also concerned that they're really dependent, now, on the HIV market almost entirely and there's competition, there, too, of course.

It's not a *Pro*-type company. We didn't want to hold it forever, and we may just have to move on from it. Right now, it's still a buy. It's super cheap stock and it's a great business that's done really well over the years, and so we're not discouraged owning it. I'm glad to own it. I think it's a quality of company that deserves to be with us, but it may just not fit where we're trying to go next.

"Can you discuss IPGP versus Coherent?" In a nutshell, Bruce, IPGP is fiber lasers that are used for manufacturing primarily. Coherent is lasers that are used, more, for microelectronics and semiconductors. That's what drew us to it -- its connection to AI, the Internet of Things, semiconductors, iPhones and iPads, etc., as opposed to just manufacturing which is mostly what IPGP does.

And Coherent, also with this Rofin acquisition, has gotten into fiber lasers for manufacturing, as well, and that business side is growing, especially in China. They have both going now. I like the prospects of Coherent having that dual kind of business model, but IPGP has been an outstanding business and stock and is a full recommendation elsewhere, as well. Both probably have good long-term prospects given that lasers are essential to so many forms of manufacturing, now.

Now with about 13 minutes to go, let's go into speed mode, if we can and try to answer these questions as much as we can. Anonymous: "With JD as a new position, is it possible to give us an options strategy instead of just the common stock?" I'll say, JP, we really want our members to buy the stock at this price.

Bennett: Yes.

Fischer: Any thoughts to add to that?

Bennett: Not really. I was starting to write up the alternative trades at the bottom of the trade alert and I was [thinking], "You know what?"

Fischer: You can write puts.

Bennett: Yes.

Fischer: You're writing puts on it in *Motley Fool Options*.

Bennett: That was our way to get into it, and then it just kept falling. We needed to take a more bullish stance on this in *Pro*.

Fischer: So, if you're looking for put writing, check out *Motley Fool Options* trades, there, just recently on JD.com. Hey, [JohnnyLovesBeaches]. Great to see you. Johnny would like to ask if we think an overweight position in Apple would be reason enough to use puts for Skyworks. "Thanks for the great work." Thank you for the kind words. We appreciate that.

It's funny. We've been talking about Skyworks and Apple lately, as well. Apple's doing great. The stock has really surged since earnings. Skyworks has been typically volatile. But having the two become really sizeable positions in the portfolio, combined, especially makes us more aware of the connection with Skyworks where about 40% of Skyworks' revenue comes from Apple. That's a risk we're aware of and we were talking about potentially putting the collar out of the money on Skyworks just in case to be safe.

Meanwhile, though, Skyworks feels very good about its long-term relationship with Apple, and products are being planned a few years out, so we know that is good. But the minute that relationship was to scale down or go away, Skyworks would get hit hard. That's our biggest risk in Skyworks. And it may be worth minimizing your exposure to the two of them combined, or at least keeping a really close eye on it and hedging some of that risk, and we're talking about that, as well.

Premier Pass, Miles. We're all part of Premier Pass. It consolidates content -- recommendations from across the Fool Universe -- and puts them into kind of a portfolio format for members, depending on what members are looking for. That's all of us, not just me (all the analysts at the Fool). JP, do you want to share anything more about Premier Pass? Any other thoughts on that? It's a pretty new service. It's popular. You get Motley Fool research from across most services, I believe.

Bennett: Yes, it's just a quick and easy way to get what most analysts believe are their best ideas right now. Just a streamlined way to go about it.

Fischer: Thank you for the question, Miles. And if you have more questions about Premier Pass, I think I did maybe a "C" on that answer...

Bennett: We did both sort of a C+.

Fischer: ...give a call to Member Services. I'm so focused on *Pro* and *Options*. Premier Pass uses AI. There's a lot of "I" to go around here, and they're using "A" to bring it together. Does that make sense? The intelligence of Fool analysts and they're putting it together into Premier Pass.

Bennett: That sounds about right.

Fischer: All right. Bob: "I sold a put on Coherent and got an assignment due to the price drop in the stock. What should I do? Covered call?" No, Bob, I would just own the stock. We own the stock. It's a 1.7% position and we like it for the long term. No need to use options on it right now.

Nate. "Why not buy puts?" We talked about that. We're looking at possibly an out-of-money synthetic short, Nate, to stop paying fees every month, because it may just take a lot longer for this to play out. We might have a thought on that soon, but yes, you could consider puts. But buying puts alone on Shake Shack is expensive. You'll pay probably as much as we are paying or more in fees.

"What kind of puts would you do in JD?" You can go to *Motley Fool Options* and look at that with the stock around $37 or $36 for puts because we like it.

Bennett: Yes, we're bullish enough that depending on how much income you're looking to generate and what your risk appetite is for taking shares, you can go as close to the money as you want. Obviously, we're buying shares, so we're pretty bullish, but the last I knew they paid halfway decent, so you can go to 3-4% out of the money and still get an attractive yield.

Fischer: Yes. "Our relationship to the new Market Pass." Again, the service brings in research from across Fool services, and mostly Best Buys Now. Those from *Pro* will show up in there. That's about the extent of our relationship with it. It consolidates research and highlights it for members depending on what members are looking for.

Skyworks -- this is good. We talked about it. About 40% of revenue at Skyworks comes from Apple. Maybe it's 35% now. It's shrinking as their Internet of Things business grows. Something we keep a really close eye on (that relationship), but it's definitely a risk that we planned out since day one. So far that relationship stays strong and, in fact, Skyworks is getting more content in Apple products rather than less. And as these phones become more complex, that becomes truer. 5G is a big opportunity for Skyworks and a lot of other companies, too.

"Any thoughts on Amazon doing a split soon," Todd is asking. JP? Ten seconds on that?

Bennett: I have no thoughts on it, really. I have no idea whether or not they're interested in splitting the stock.

Fischer: It wouldn't change anything. Make it easier to own more shares, but not a greater dollar amount. So, I don't know. We'll see. It would be better for options use, so I would welcome it. We'll have to give Jeff a call and see what he thinks. Tweet to him.

"Can we discuss the plan on SVXY?" You know, we're discussing that ourselves, too, and with our portfolio transition we might do something with that, because it now trades at half the volatility of the short-term VIX futures and I'd rather have full exposure. So, we might adjust our SVXY, our short volatility exposure soon. Right now, though, it's a tiny position. Kind of irrelevant. That's another reason to address it and make it more of a factor, again.

AC is asking, "Hey, Jeff and team. Are you using your cash position as a de facto hedge against the market rather than too much actual short exposure with 92% long?" Yes, a great question, AC and yes, the answer is we've used cash for quite a while as a de facto hedge. As an opportunity within our portfolio to invest it when the market falls. We haven't really seen that that much, though, and it has allowed us to not short as much which has been a good thing for the most part.

Now, though, I think our long-term exposure is as high as it's been in a long time (maybe ever), and so again, as we transition after this quarter, we're looking at that and possibly bringing our cash up a bit. Or, shorting and hedging more to get our net exposure back down a little bit. A great question, but cash, AC is, as you know, a great way to hedge without the stress of shorting.

"Can I use the *Pro* portfolio for retirement drawdown and take out 4% a year forever?" JP, I definitely have thoughts on that; that you could do that. That's certainly our goal that you should be able to take out 4% a year forever, and the portfolio should still ultimately grow. Now, not every year. Some years will have down years, but over every three to five years, hopefully the portfolio is higher than it was three to five years prior, even as you take out 4%. That's my thought.

Bennett: I will just add to that. It, to me, would depend on how comfortable you are with volatility, because like you said, we're not a bond, so we're not going to be super stable and reliable in terms of the amount of appreciation or income we'd generate year in and year out. So, if your portfolio is of a size that those types of fluctuation don't really matter to you and say there's a year where we only do 1%, 2%, 0%; maybe you have a slightly down year because the market is down, too. And that doesn't impact you because you can still withdraw your 4% and you're still fine in terms of your capital base being large enough for them, I don't see why not.

Fischer: The top question, right now, is Gilead, which we talked about quite a bit, and so we're considering that very same thing (what to do with it next). Thank you for the recommendation, GlobalRhino. It's true. Tax considerations differ based where you are and, in some cases, where the company is located. We'll add that to our list of possible considerations to add to the portfolio. Our space there is limited, otherwise we could have more things on there.

Lance has a question about JD. "Are third-party sellers similar to Amazon?"

Bennett: Yes, they are. They're the largest direct e-commerce retailer. In that space they're the largest. They do also work with third-party sellers. That's an area where they've increased their focus as of late. Alibaba still, unsurprisingly, dominates that space, but this is an area of increased focus for them, especially in terms of when they're building out their warehouses. They now have all these logistical capabilities -- warehousing and things like that -- that they want to be able to work more with them and create a more competitive and attractive offering and pull in some of those companies to work with them, as well.

Fischer: I think we can fly through these and answer almost all of them, which would feel great. "Please explain why North Star returns are different from *Pro* returns." Well, North Star returns is inflation plus 7% a year and that's a set amount. So, whatever inflation is plus 7% each year is what North Star will be.

Pro, so far, thanks to the strong market, in part, and thanks to steady management, has done better than the North Star since inception (quite a bit better), but during weaker markets it's going to be challenging to keep up with the North Star all the time, but we'll work our best to do it, because North Star is always positive. But, Miles, we have more in the Pro Guidebook about the North Star and how it's calculated. It's a steady thing.

"FAZ shorts still going for me. Any thoughts on keeping it going or closing it out?" I still have it short personally, as well. And if you're not paying fees to short it, as I'm not at TD Ameritrade, why not keep it going as long as you believe in the thesis, as I do? We've looked at adding it back to *Pro*, but the costs have just been prohibitive, so far, and we have a lot of financial exposure, as it is.

"So, what's with all the buying? We have so many good companies now. There's nothing to sell. What a dilemma." True, [Fox]. [ThinkingOutsidetheFox.] I think I might know who this is. A good comment. It is great that we're finding companies that we like to buy, even now, and speaking of that, the S&P 500 trades at 16x expected earnings for the year ahead. That's a five-year average.

"A synthetic long on JD?" Arista [Networks] is a recommendation in other Fool services. We've taken a look at it. They're doing a great job with their software.

Bennett: There are a couple of questions on the interest of a synthetic long on JD. I think you're going to have to pay around 5% total to go out to 2020 if you do it at the money syn long, so it's not unattractive. It was just something where we wanted direct exposure. Although we believe in the long-term possibilities, there is a significant chance that at some point it gets hit, and so [we decided] we'd have the cash. We think we can do better with it and we know that we may be adding to it, again, in the future, so it made sense to just buy the stock.

Fischer: We are basically out of time, but I think in the last minute we can answer all these questions. No more questions today, please, Fools.

Bennett: Everybody submit your questions right now.

Fischer: "Setting covered calls up on Coherent?" I'd say no, not while the stock price is this low. We wouldn't do it and it's so volatile.

Fair value estimate on Shake Shack is around $30 per share, which would be around 48x earnings. It's still generous, even with the growth rate that it has, and that's on the *Pro* portfolio page, too.

"FoolFest. Can we bring a guest? Does it cost?" I don't know. I think it's free to members and yes, you can bring a guest, but I think that door is closed for this year's FoolFest. It's all booked up. Hopefully next year. We'd love to have everybody. We just fill the rooms that we have. We fill all the space we have. I don't know how they go about doing that (how they contact people).

Anything else that you guys want to answer?

Bennett: Where is Baidu in the JD/Alibaba? Well, they are obviously more like Google than Amazon or eBay, so they're a player in terms of investments, venture capital, and things like that, but they're not necessarily a direct competitor in terms of e-commerce and retailing.

Fischer: "Why not go through the questions faster in the first half of the call next time?" That's true. That's good hindsight.

Bennett: You can say that every time we meet.

Fischer: You could, because you start calling, we just want to hang out with you and then we realize, "Oh my gosh, the time is flying by." We'll try next time. It's fun to just to luxuriate in a few answers, though, and it was good to talk about JD, a new position, for quite a long time.

Bennett: It also depends on the rate they come in, because we're trying to manage our questions and how quickly we answer them.

Fischer: True. If everyone puts their questions in early, then we know what we have to manage. "Why does the put side of a covered strangle add to the margin requirement when you already own the stock?" Well, because when you sell a put, you are committing to buying more stock, and so that's why there's a margin requirement. Remember, selling a put is just an agreement to buy the stock if it falls. If you already own the stock, that doesn't matter. That agreement is still out there to buy more stock. So, that's very important to know. Anytime you sell a put, even if you own the shares, you are obligating yourself to buy more stock.

Finally, thank you guys for not asking more questions. That's awesome. "*Pro* team, what's your view on the potential disruption of AMT?" We can work Billy into the chat, finally, if he's still here.

Kipersztok: Yes, I'm here.

Fischer: That's good.

Kipersztok: So, I'll answer this one. The first question I've had the entire chat about any of my holdings, so I take that as a good sign, meaning that I'm keeping you updated on the site with my communications. But yes, potential disruption of American Tower is something that we've discussed in the past. Small cells or maybe even satellites could disrupt American Tower, but that's not technology that is expected to take effect in the marketplace anytime soon.

Even as we talk about 5G, which is the next generation of wireless technology and the next stage; macro towers, which is the model that American Tower uses, still seem to be a very important part of managing a network for the wireless carriers. So long as you continue to use cell phones, and you are using data through those phones, and you're still subscribing to companies like Verizon, T-Mobile, and Sprint, American Tower here in the United States should still be a big part of delivering that content. Disruption is quite a way off, but we still do have our eye on that.

Fischer: Thank you, Billy, and regarding Visa, Mastercard, and plastic, of course Visa and Mastercard's transactions are going largely to digital and you have less need for your card. Apple Pay is leading the way in that, in fact, in the U.S., which is interesting to see.

As far as cryptocurrencies, it's something we certainly keep an eye on. We think it's a long way from becoming common-use currency. Visa and Mastercard, for what it's worth, believe the same thing and are watching it very closely. But for a lot of reasons, it's maybe a long time, if ever, before we see cryptocurrency being a multinational or global currency that people use to buy a pack of gum at the airport, for example.

We have our eye on that. Right now, though, we love the relationships Visa and Mastercard have with the PayPals of the world (Apple Pay, etc.) They're doing a great job staying entrenched in the latest digital movement of currency into just being bits and bytes, so we feel good about that and clearly the market does, so far, about those companies, too.

And *Options* opened Slido a few days before the chat to get answers in sooner. I think, Jim, that's a great idea, and we'll have to try to remember to do that next time with *Pro*, as well, so we can have questions in earlier and see what they are and manage them better.

Thank you all for joining us today. We appreciate it a lot. Thank you, JP and Billy.

Kipersztok: Thank you.

Fischer: I apologize after the fact for talking so much. It was in an effort to get through as many questions as possible that I just plowed through. Hopefully the answers were passable, at least.

We look forward to the next half year with you. We have seven months to perform this year, anyway. We're really thinking longer term than that, but we look forward to the rest of 2018 with you. Hope your summer gets off to a good start next month. We'll see you soon in an *Options* chat, I hope. That's the plan. Maybe we'll see you at FoolFest next week. All of you will be with us in spirit, there. In our spirits you're with us. Take care. Thank you for joining this chat.

Bennett: Fool on!

Kipersztok: Fool on!

[End]

Earnings and Pro Port Considerations

Published Apr 23, 2018 at 2:19PM

Note: We don't have any guidance changes or completed trades to share over this past week. Huzzah for status-quo, long-term investing!

Greetings, Fools,

We hope you're feeling well and rested, because the next few weeks promise to be action-packed! We're about to be treated to another round of earnings reports, starting with bigwigs **Facebook** (NASDAQ: FB) and **Visa** (NYSE: V) due Wednesday, and **Amazon.com** (NASDAQ: AMZN), **Starbucks** (NASDAQ: SBUX), **Verisign** (NASDAQ: VRSN), and portfolio newcomer **CME Group** (NASDAQ: CME) on Thursday.

All eyes are on Facebook's financials as it shows us how much more money it's spending on hiring (largely for community security) and how much advertising revenue is growing despite the reconfiguration of its news feed to be more personal for users. Wall Street expects revenue to expand by a hearty 42%, as ad prices climb close to 40% compared with last year and monthly active users rise by 13%. These are strong numbers.

If Facebook doesn't deliver, or delivers moderated guidance for the year, we should expect the stock to stay tepid, just as it has been since the Cambridge Analytica scandal broke in March. We expect the conference call to cover the data breach extensively. Despite any black eye, it's a positive that the stock trades at only 22.8 times expected earnings for the year ahead. I think the odds favor Facebook trading much higher the next few years as it continues to grow.

Visa, which trades at 27 times expected earnings for the year ahead, is expected to increase its non-GAAP earnings per share by 26.7% this year as transaction growth continues, including lucrative cross-border transactions. That a company Visa's size can grow like a small cap gives us the benefit of its size and scale alongside the enjoyment of accelerated return prospects. That's a combination we often seek, whether it's through Visa and **MasterCard** (NYSE: MA), **Adobe Systems** (NASDAQ: ADBE), or CME Group.

Next up: Amazon.com. Excluding results from Whole Foods, sales should grow 29%; that number is 42% including the grocer, to more than $50 billion total. Wall Street is looking for hearty cloud revenue growth of 46%, to $5.3 billion for the quarter. That will drive profits, which are expected to be a modest $1.22 per share. Amazon still isn't valued on its earnings (and rightly so, as it keeps investing in distribution and international), but it does trade at about 76 times trailing free cash flow despite ongoing massive capital investments.

There's a good chance Amazon truly will ultimately be one of the most amazing companies of our lifetime. Assuming the trajectory it's on continues in even a moderated fashion, it's going to be one of the largest companies the world has ever seen, selling more items than any other, in more places around the world.

But that excellence is true of many of our stocks. Apple generates more profit than any other. Facebook reaches more individuals than any other. These giants are awe-inspiring, but we also need to ferret out great emerging companies like **Paycom** (NYSE: PAYC) and **Square** (NYSE: SQ) -- to own positions that could compound more easily from here. We want to have a stake in both types of companies.

Port Considerations

As we think forward, a few considerations are nearing completion. **Shake Shack** (NYSE: SHAK) has worked against us despite our thesis (stalling same-store sales growth and higher costs) playing out. Wall Street is happy because new stores keep revenue growing at more than 30% anyway. If the coming quarterly report doesn't turn things our way, we will likely exit the short rather than fight the trend.

Skyworks (NASDAQ: SWKS) is an excellent business at a very good price, but its dependence on Apple makes down periods for both stocks twice as hard. We're comfortable writing lucrative options on Skyworks, so we might start writing covered calls on it again for income -- after we see earnings and hopefully a pop in the share price on the results.

Speaking of Apple, we need reassurance from **Coherent** (NASDAQ: COHR) management that the company's long-term outlook continues to look bright. We believe it does. But here, too, as with dozens of other stocks, the market is trading Coherent alongside Apple's prospects. Having all of these shares move together isn't ideal for us, so we might also employ Coherent's lucrative options after this earnings report (assuming earnings are encouraging). We have a small stake, so we may write puts targeting income, or consider covered strangles.

Gilead Sciences (NASDAQ: GILD) is expecting to have a more stable year when it comes to revenue, yet the stock has given back all the gains it made on that news. Hopefully earnings will help send it higher again, and we'll look to keep making covered-call income on it. Same with **Johnson & Johnson** (NYSE: JNJ).

Finally, **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY) is relatively sleepy now that it inversely tracks only half of the daily moves in the VIX's futures. How will this change alter its long-term prospects? We may come to want to swap this for a vehicle that is more true to our original intentions. We'll see.

I'm glad to share some thoughts that are "in the works," but realize there's nothing final about them. Earnings could change other dynamics of the portfolio. Time will tell! Let's enjoy the week.

Foolishly,

Jeff (TMFFischer)

Pro Catch-Up Trades and Expirations: Adobe, Coherent, and More

Published Apr 19, 2018 at 2:05PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 3.8%.
- **CME Group** (NASDAQ: CME): Buy 2.5% per our recent alert.
- **Medtronic** (NYSE: MDT): Buy 2.4%.
- **Oracle** (NYSE: ORCL): Buy 3.4%.

Continue building your portfolio with our Buys, including:

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.7% per our recent alert.
- **Coherent** (NASDAQ: COHR): Buy 1.6%.
- **OpenText** (NASDAQ: OTEX): Buy 3%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.4%.
- **The Cooper Companies** (NYSE: COO): Buy 2.7% to later cover with calls.

Shorts:

- **Shake Shack** (NYSE: SHAK): You can short 0.5%, but realize we may close this soon if the short doesn't start to go our way after earnings.

Options:

- **Oracle**: Invest 0.6% to buy to open January 2020 $30 calls. Then wait for a price recovery to write diagonal calls with us at about a $52.50 strike price for a worthwhile yield.

Upcoming Expirations (May):

- We have short calls expiring on Cooper, **Gilead Sciences** (NASDAQ: GILD), and **Home Depot** (NYSE: HD) on May 18. We'll have relevant guidance well before then.

Pro Guidance Changes and Completed Trades: April 16, 2018

Published Apr 16, 2018 at 3:33PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Adobe Systems** (NASDAQ: ADBE): The stock joined our merry *Pro* portfolio with a Buy recommendation at a 2.7% allocation.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Adobe Systems:** We bought 400 shares at $226 and change, to get to our 2.7% allocation.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Helping Hands in Puerto Rico; Facebook Avoids a Facepalm

Published Apr 16, 2018 at 3:22PM

Dear *Pro* Fools,

Last week, I joined seven of my full-time Foolish colleagues and one Fool member (CMFFuskie) on a Fool-sponsored trip to Puerto Rico. There, we volunteered with our holiday Foolanthropy partner, All Hands and Hearts, working with them in two of the regions on the island that were hardest hit by Hurricane Maria in September. Many of the people in these two areas are still without power.

Joining forces with other All Hands and Hearts volunteers, we did muck and gut work on ruined homes, repaired roofs, remediated mold, chainsawed downed trees, and more, putting in an intense week of work by day and sleeping in screened-in common rooms full of bunk beds by night.

(From left to right, back row first: Hassan Malik, Kelsey Ryan, Nick Travis, Jeff Fischer, Lauren Danker, David Deitch, Anne Henry, Jen Parker and Taylor Harris)

We especially enjoyed meeting our fellow Americans in Puerto Rico and their families who were most affected. Their resilience and kindness -- bringing us coffee, snacks, lunch, and smiles -- was remarkable on the heels of six months without power and without much outside help.

We left glad to have had an opportunity to help for a few days, but knowing that months -- truly years -- of work lie ahead. Life will never be the same for many who live there; in fact, as widely reported, so many have moved off the island since the storm. The hillsides and roads feel more quiet than usual.

Damage remains widespread across the broad third of the island that we traveled, with downed power lines, street poles, signs, and trees commonplace. Be sure to stop at each intersection: In many cases, the traffic lights aren't working. The giant wind-power turbines that we saw on the east coast were stuck still, inoperable, half of them missing their blades, destroyed by the wind.

Now that Motley Fool employees have worked with All Hands and Hearts on the ground in both Houston last year and Puerto Rico last week, we can endorse the organization's helpful activities even further. Puerto Ricans on the street walked up to ask us for help, and All Hands set up new appointments with them. The organization plans to be on the island for at least the next few years. Most everyone doing the hard labor is a volunteer, some there for days like us, others for weeks or months -- even years.

If you're getting a tax refund, or just want to help, you can still donate to All Hands and Hearts in Puerto Rico, and you can do it through our Fool page. Every dollar counts. The Fool vetted this transparent and effective charity thoroughly before partnering last year. Members like you stepped up and donated more than $150,000 in our holiday drive (they're still very grateful, and said so repeatedly). That money helped put countless people back in their homes. Thank you for anything you give.

The Investing Beat Goes On

While I was away, Billy issued the **Adobe Systems** (NASDAQ: ADBE) buy report that we (the team) had been talking about at our meetings in recent weeks. The company's business has greatly accelerated in the past few years, and its margins with it. But we believe there's much more ahead as Adobe has positioned itself to help any customer develop and deliver their digital experience to the world. From that digital media division, to its Creative Cloud for design, to Adobe Spark for video and more, all of Adobe's product lines are driving growth. Revenue was up 24% in the quarter just reported. We're glad to start a 2.7% stake.

Back in my adopted hometown of Washington, D.C., Mark Zuckerberg appeared on Capitol Hill last week and explained to lawmakers what **Facebook** (NASDAQ: FB) does and how it made mistakes. We'll see whether lawmakers get around to putting meaningful regulations in place soon; I'd give that a 50/50 chance at best. In the meantime, Europe remains far in the lead with data privacy laws, including new ones that go into effect next month. Facebook and other tech giants will need to adapt to Europe's demands.

Overall, though, as Fool co-founder Tom Gardner adeptly points out, more regulation may actually make Facebook's competitive moat stronger. If it becomes more expensive and more difficult to operate social networks, it becomes harder for new or smaller entrants to succeed. Zuckerberg avoided committing any facepalm moments in his testimony, but Facebook's regulatory future is still in flux, and we expect volatility from the stock. Over time, we expect the business to keep growing nicely, despite higher costs.

Visit the Memo Musings board to share your thoughts! Thank you again, and Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades and Expirations: Adobe, CME Group, and More

Published Apr 12, 2018 at 2:21PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 3.9%.
- **CME Group** (NASDAQ: CME): Buy 2.5% per our recent alert.
- **Medtronic** (NYSE: MDT): Buy 2.4%.

- **Oracle** (NYSE: ORCL): Buy 3.3%.

Continue building your portfolio with our Buys, including:

- **Adobe Systems** (NASDAQ: ADBE): Buy 2.7% per our recent alert.
- **Facebook** (NASDAQ: FB): Buy half of our 7% position to start. Expect volatility.
- **Gilead Sciences** (NASDAQ: GILD): Buy 2.1% to later cover with calls.
- **OpenText** (NASDAQ: OTEX): Buy 2.9%.
- **Square** (NYSE: SQ): Buy at least half of our 4.1%.
- **The Cooper Companies** (NYSE: COO): Buy 2.7% to later cover with calls.

Shorts:

- **Shake Shack** (NYSE: SHAK): You can short 0.5%, but realize we may be closing this soon if the short doesn't start to go our way.

Options:

- **Oracle**: Invest 0.6% to buy to open January 2020 $30 calls. Then wait for a price recovery to write diagonal calls with us at about a $52.50 strike price for a worthwhile yield.

Upcoming Expirations (May):

- We have short calls expiring on Cooper, Gilead, and **Home Depot** (NYSE: HD) on May 18. If they don't seem set to expire as income, we'll have guidance closer to expiration.

Pro Guidance Changes and Completed Trades: April 9, 2018

Published Apr 9, 2018 at 12:58PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- Nothing new over the past week. See all of our Best Buys Now and Buys.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Johnson & Johnson** (NYSE: JNJ): Running low on time to make our recommended trade (we need to within 30 days of issuance), we sold to open May 2018 $140 calls, covering 700 of our shares. We were paid $0.49 each. We'll of course continue to manage these covered calls in the way that is best for members, waiting for expiration or acting earlier with a new alert.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Buy Adobe Systems

Published Apr 9, 2018 at 12:25PM

Is this for you? This is for all *Pro* members who lack exposure to this company and wish to match *Pro*.

How You Participate

- **Action:** Invest 2.7% of your portfolio in **Adobe Systems** (NASDAQ: ADBE). (That's $2,700 for every $100,000 you manage; for *Pro*, that's about 400 shares, or $89,000 worth.)
- **Price Guidance:** Use a limit order to buy at going prices, lately about $223 per share. Later, the stock will remain a Buy until we guide otherwise.
- **Recent Price Range:** $219-$224
- **Guidance:** Buy
- **Fair-Value Estimate:** $220
- **Alternative Trades:**
  - **Seeking a lower buy price?** Sell to open any puts that appeal to you, selling one put for every $19,000 to $22,000 (or choose your strike) in stock you can afford, up to a 2.7% allocation.
  - **Want upside with less capital?** Set up a synthetic long. Sell to open January 2020 $220 puts and buy to open an equal number of January 2020 $220 calls, aiming to pay little time value in the process. Each synthetic long represents exposure to 100 shares worth $22,000.

The Business

Adobe Systems is one of the largest software companies in the world, offering products and services in two main business divisions: digital media and digital experience. The digital media division provides products, services, and solutions that enable individuals, teams, and enterprises to create, publish, and promote their digital content. The digital experience segment provides solutions and services for creating, managing, executing, measuring, and optimizing digital marketing and advertising campaigns across multiple channels.

The media division's flagship product is Creative Cloud, a subscription service that allows members to use Adobe's creative products integrated with cloud-delivered services across desktop, web, and mobile devices. Creative Cloud includes programs such as Photoshop, Illustrator, Premiere Pro, InDesign, and Lightroom. Adobe's digital media products are the gold standard of content creation software, and the company's products are mission-critical among the worldwide community of creative professionals (including artists, web designers, graphic designers, photographers, videographers, animators, and other creative minds). The digital media division also includes Adobe's Document Cloud business, built around the Acrobat family of products that allow users to view, create, manipulate, print, and manage files in Portable Document Format (PDF).

The digital experience division consists of the Adobe Marketing Cloud, the Adobe Analytics Cloud, and the Adobe Advertising Cloud. These solutions allow customers to create and manage personalized marketing campaigns, gain intelligence about their customers, and manage advertising across TV and digital formats.

Pro Quality Checklist

Here's how Adobe scores against our *Pro* Quality Checklist criteria:

1. Sustainable Competitive Advantage

Yes, especially within its digital media offerings. Adobe has an essential monopoly in creative software, with its products serving as the industry standard among its customer base. No other creative software company can match the breadth of products, robust feature sets, and functionality of Adobe's highly specialized solutions. Adobe's creative software products are taught to students in higher-education design programs, creating a renewable source of users who rely on its products to perform their jobs. A significant level of training and experience is required to learn and properly use the software, which means switching costs for anyone who wants to make a change.

The digital experience division has many more competitors, including Google, IBM, Oracle, and Salesforce.com. However, Adobe's synergistic presence in content creation makes it stand out from the pack, and solid growth in this division indicates that Adobe is carving out a defensible niche in a large and growing market that has room for several winners.

2. Pricing Power

Yes, especially in digital media. Adobe's products are mission-critical to its users, and the company has the leverage to slowly increase pricing over time. In fact, Adobe began to increase prices in its Creative Cloud subscription in March of this year, after announcing the coming increase in October.

3. Dependent Customer Base

Yes, especially in digital media. Adobe's products are taught in higher-education design programs, and customers rely on its industry-standard offerings for digital content creation across a wide range of creative professions.

4. Predictable Revenue

Sort of. Adobe's successful transition from license-based sales to subscription-based sales has done wonders for the company's recurring revenue. Since fiscal 2014, in the Creative Cloud business, Adobe has increased its subscription-based revenue from 61% of total revenue to more than 95%. And in Q1 2018, a record 88% of companywide revenue was described as both subscription-based and recurring -- but I'm not so sure about "recurring." We're currently in the midst of an economic expansion and a growing market for advertising and digital expenditure. If and when a recession comes around, I'd suspect that advertising and creative budgets will be reduced, employment for creative professionals will come under pressure, and churn rates for Adobe's subscriptions will be much higher than they are now.

5. Growing Free Cash Flow With Compounding Returns

Yes. Adobe generates copious free cash flow, with about a 38% margin. Its return metrics are strong and increasing as margins rise thanks to scale and revenue growth. Adobe has plenty of opportunity to reinvest its cash flow into research and development, expansion of product lines, and acquisitions with high rates of return.

6. Financial Resilience

Yes. Adobe has a cash-rich balance sheet with more than $4.2 billion in net cash, and its recurring revenue base (which should remain robust even in the face of recession-related churn) and strong free cash flow give it plenty of cushion to absorb more difficult times.

7. Expanding Possibilities

Yes. As mentioned above, Adobe has plenty of opportunity to use its money on hand -- and its ample free cash flow -- to introduce new products, expand into complementary lines of business, and make acquisitions. Digital content creation and digital marketing are growing markets, and Adobe's resources and strong competitive position make it an excellent candidate to profitably capitalize on both.

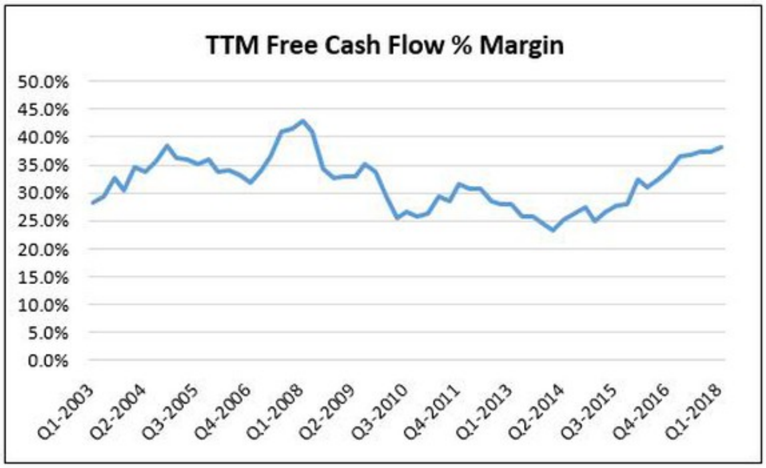
8. The Three C's of Management (Clarity, Consistency, Capability)

Yes. Adobe has a strong record of allocating capital soundly and generating excess returns. Management expertly anticipated the transition to cloud-based software delivery and capitalized on that opportunity much earlier than many companies, leading to the strong growth and expanding margins we see today in its financials. CEO Shantanu Narayen is very highly regarded, with a 97% approval rating on Glassdoor that places him as the 19th highest-rated CEO among large companies in 2017.

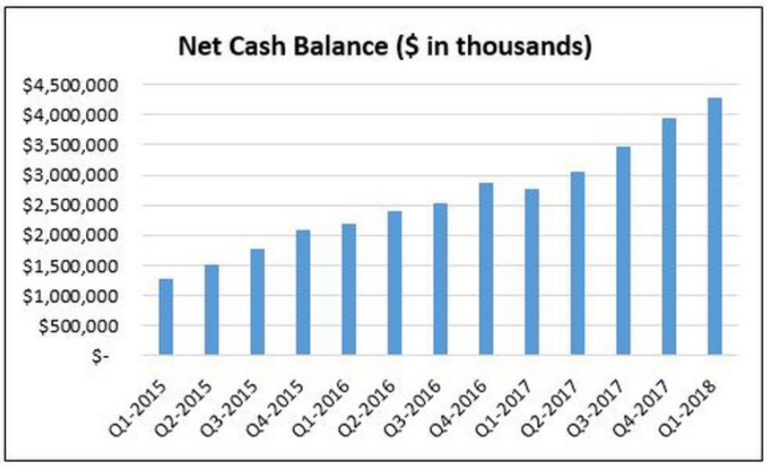
Financials and Valuation

Adobe's financial profile is sterling. The company's successful transition from product-based to subscription-based revenue has given customers more flexibility to pick and choose which apps they need, and lower initial price points and "revenue optimization initiatives" (i.e., differential pricing) have invigorated user growth and and reduced the incentive for customers to illegally pirate Adobe's software. As a result, since mid-2015, Adobe has consistently increased its revenue at 20%-plus per year, a rate that should continue through 2018, though it may slow to perhaps the mid-teens beyond that as subscription revenue growth decelerates.

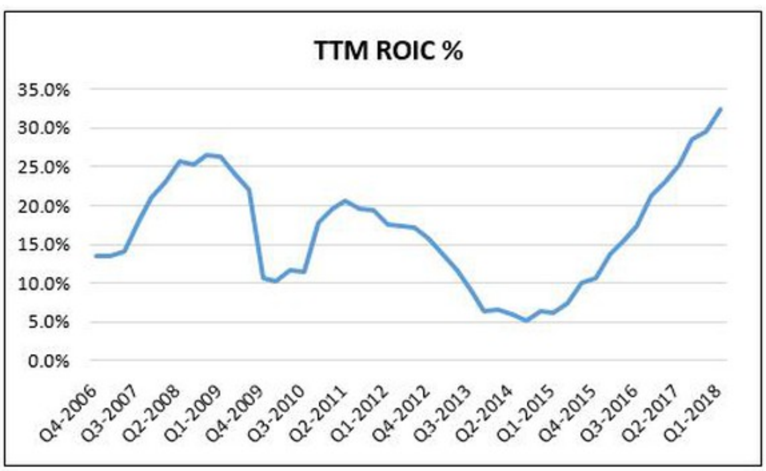
The company generates strong free cash flow, with margins lately north of 35% (and rising) ...



... leading to about $3 billion per year of free cash flow, of which management spends only about $200 million to $250 million (about 3% of annual sales) on capital expenditures. The rest goes to share repurchases (more than $1 billion went to buybacks in fiscal 2017), acquisitions ($460 million), and research and development expenses ($1.2 billion), and some also finds its way back to the balance sheet in the form of Adobe's growing cash balance:



The company's strong competitive advantages are evidenced by its return on invested capital (ROIC) trends. ROIC has accelerated upward over the last few years as Adobe has increased its revenue and cash flow rapidly without investing much additional capital:



It's difficult to value a large company that is expanding its revenue and margins as quickly as Adobe, but a conservative multiple-based approach leads to a fair-value range of $200-$250 per share, with a point estimate of $220. Conservative assumptions from this range lead us to North Star-like returns over the next three to five years, and based on the company's recent financial trajectory, there is a decent likelihood of significant outperformance.

The *Pro* Bottom Line

At 7.5 out of 8 of our *Pro* quality criteria, and with a stellar financial profile and trajectory, Adobe definitely fits the bill as a *Pro*-level stock. Adobe is a growing, high-quality business that operates with competitive advantages in two complementary markets with strong secular tailwinds (digital content creation and digital advertising), and the company should be able to increase its revenue and earnings at healthy rates for years to come, giving us a strong chance at North Star-beating returns over the long run.

Pro Can Help

- Are you a digital artist? Show us your chops on the new Adobe discussion board! (Or just ask questions. That's fine, too.)

Pro Catch-Up Trades and Expirations: CME Group, Square, and More

Published Apr 5, 2018 at 3:22PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Amazon.com** (NASDAQ: AMZN): Buy 4.4% (or start with half if preferred).
- **CME Group** (NASDAQ: CME): Buy 2.5% per our recent alert.
- **Medtronic** (NYSE: MDT): Buy 2.4%.
- **Oracle** (NYSE: ORCL): Buy 3.3%.
- **Tencent** (NASDAQOTH: TCEHY): Buy 2.9%.

Continue building your portfolio with our Buys, including:

- **Facebook** (NASDAQ: FB): Buy half of our 6.7% position to start. Expect volatility.
- **Gilead Sciences** (NASDAQ: GILD): Buy 2.1% to later cover with calls.
- **OpenText** (NASDAQ: OTEX): Buy 2.9%.
- **Square** (NYSE: SQ): Buy at least half of our 4.1%.
- **The Cooper Companies** (NYSE: COO): Buy 2.7% to later cover with calls.

Shorts:

- **Shake Shack** (NYSE: SHAK): You can short 0.5%, but realize we may be closing this soon if the short doesn't start to go our way.

Options:

- **Oracle** (NYSE: ORCL): Invest 0.5% to buy to open January 2020 $30 calls. Then wait for a price recovery to write diagonal calls with us at about a $52.50 strike price for a worthwhile yield.

Upcoming Expirations (May):

- We have short calls expiring on Cooper, Gilead, and **Home Depot** (NYSE: HD) on May 18. If they don't seem set to expire as income, we'll have guidance closer to expiration.

Pro Guidance Changes and Completed Trades: April 2, 2018

Published Apr 2, 2018 at 2:47PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- Nothing new over the past four days. See all of our Best Buys Now and Buys.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **American Tower** (NYSE: AMT): Using a rolling order, we rolled our diagonal calls today for a $0.15 credit, buying to close all five of our April 2018 $130 calls, and selling to open five October 2018 $135 calls.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Rocky Days Are Here Again!

Published Apr 2, 2018 at 2:33PM

Dear *Pro* Fools,

The good news is: As of the end of March, our portfolio was up a bit for this year.

Performance as of 3/31/2018

	Annualized		Total Return	
	Since Inception	Rolling 3-Year	YTD	Inception
Pro Portfolio	**13.3%**	**10.2%**	**1.1%**	**228.7%**
North Star	**8.5%**	**9.0%**	**2.9%**	**116.7%**
S&P 500 Total Return	12.5%	10.2%	-0.8%	206.6%
MSCI World	7.1%	5.2%	-1.7%	92.6%

Pro Port up 1.1% YTD.

We're trailing our hero, the North Star, but plenty of months remain in 2018 to get closer to it. Last year, after suffering some early losers, we recommended new buys to reposition our portfolio to slug it out, and we closed out 2017 up a hearty 21.5%. That capped six consecutive years of gains for us, and we averaged 73.5% net long over those years (about where we sit today, too). We would be mighty pleased if the portfolio ended 2018 in positive territory again, but we won't be surprised if the investing environment makes that difficult.

This morning, China said it would impose $3 billion in tariffs on 128 U.S. products; that news likely drove investors to sell. The U.S. president reportedly has $50 billion in additional tariffs in the works for China, so we might expect those soon; Beijing has already said it would respond in kind. This already looks like a trade war, and we might already know the end result all too well: higher prices for consumers, putting a strain on the economy.

Meanwhile, the amount of daily uncertainty regarding the American playbook on the global economic stage means we need to expect more surprises, perhaps often. That will likely continue to drive higher stock-market volatility. Investors generally like stable policies that lend some visibility into the future. When clouds form, it's harder to guess where earnings will go from here. Add rising interest rates to today's mix, and the siren song of competing investment classes increases volatility, too.

The good news is that we already hold many stocks in the portfolio that look inexpensive. That's surprising, given how much we've gained in recent years, but if we're right, our analysis bodes well for our future returns. **Facebook** (NASDAQ: FB), **Oracle** (NYSE: ORCL), **American Tower** (NYSE: AMT), **Skyworks** (NASDAQ: SWKS), and many of our other positions -- including the larger ones -- look attractively priced.

That's encouraging. (We might even go to Disneyland!) Assuming earnings hold up and grow -- which is a lot to assume, but still seems likely at our companies -- these stocks should do well over the time frame that matters to us, even if they're being battered in a storm along with everything else right now.

When it comes to Facebook, the height of its volatility might arrive around the same time CEO Mark Zuckerberg testifies before Congress later this month. We obviously can't know yet, but I don't believe Facebook is ultimately going to be accused of nefarious actions -- only of making very bad choices, lacking any foresight about its own risks, and being much too lax about data security. Those are all faults that it can admit and address, and it has started to do so of late. Baby steps, at least.

Other stocks in our portfolio that are limping along, wounded, include Oracle and **Coherent** (NASDAQ: COHR). I don't believe either business is suffering or that the stocks merit the beating being dished out. Oracle is on track to expand its margins as its cloud revenue expands, something we've been watching it work toward for years. And Coherent's business is all but booked for the year, with management investing for growth in 2019. Both trade at valuation multiples ranging from about 12 to 14 based on 2018 earnings and free cash flow expectations. That's inexpensive.

The S&P 500 is down more than 10% from its Jan. 26 high, and it's down about 3% year-to-date as of 1 p.m. today. Of course, some volatile stocks are down much more. But it's encouraging that we can already see good value in some of the stocks that have declined, including many of the ones we own. We're happy with our holdings, and it will only get easier to add more money to some of them -- either by buying more stock or by using options -- if they get cheaper.

Given that we likely have a long year of surprises ahead of us, we're still aiming to be patient. We're also looking at additional market hedges and at adding a new basket of shorts, and we're always considering whether we should sell or lighten up on anything we own. We may sometimes move slowly, but we move with purpose, and with our eyes focused on the results we want to achieve down the road.

Visit the Memo Musings board to share your own market musings. (Share 'em now, before earnings season starts next week!) Thank you, and Fool on!

— Jeff (TMFFischer)

P.S. Did you know that David Gardner and I met Donald Trump for an hour in his office many years ago? You can read David's take on it here. That we were once short the sitting U.S. president simply sounds like good Foolery, whatever your politics.

Pro Catch-Up Trades and Expirations: CME, Facebook, and More

Published Mar 29, 2018 at 1:40PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Amazon.com** (NASDAQ: AMZN): Buy at least half of our 4.3% stake.
- **CME Group** (NASDAQ: CME): Buy 2.5% per our recent alert.
- **Medtronic** (NYSE: MDT): Buy 2.4%.
- **Oracle** (NYSE: ORCL): Buy 3.3%.
- **Tencent** (NASDAQOTH: TCEHY): Buy 2.9%.

Continue building your portfolio with our Buys, including:

- **Coherent** (NASDAQ: COHR): Match our 1.8%.
- **Facebook** (NASDAQ: FB): Buy half of our 6.8% position (so, 3.4%) to start. Expect volatility now, but we also expect the business to grow over the coming years.
- **Gilead Sciences** (NASDAQ: GILD): Buy 2.1% to later cover with calls.

Shorts:

- N/A

Options:

- **Oracle** (NYSE: ORCL): Invest 0.5% to buy to open January 2020 $30 calls. Then wait for a price recovery to write diagonal calls with us at about a $52.50 strike price for a worthwhile yield.

Upcoming Expirations (April 20):

- **American Tower** (NYSE: AMT): We recommend you roll your $130 diagonal calls.

Roll Your Diagonal Calls on American Tower

Published Mar 29, 2018 at 10:27AM

Is this for you? This is for all *Pro* members who wrote April 2018 $130 diagonal calls on **American Tower** (NYSE: AMT) as per our alert in September. If you wrote diagonal calls at different strike prices, please see the Alternative Trades section below. Remember that all members should already own an unencumbered 4.1% stock allocation to American Tower, so if you have yet to establish your stock allocation, do that first before considering this additional diagonal call recommendation.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
  - "Buy to close" all April 20, 2018, $130 written calls.
  - "Sell to open" the same number of Oct. 19, 2018, $135 calls.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* will roll all five of our calls.
- **Recent Prices** (10:20 a.m. ET):
  - Stock: $144.50
  - Buy to close April 20, 2018, $130 calls (bid/ask): $14.50/$15 (midpoint $14.75)
  - Sell to open Oct. 19, 2018, $135 calls (bid/ask): $14.80/$15.50 (midpoint $15.15)
  - Net credit to roll: Approximately $0.40 (this price will change)
- **Price Guidance: It is critical that you use a limit order**, aiming to pay as little time value as possible to close your short calls, and aiming to roll for as much of a credit as possible. The midpoint of the bid/ask spreads currently implies about a $0.40 net credit for this roll, although that number will change as prices change and as *Pro*'s collective volume affects the bid/ask spreads. Realize that with expiration 23 days away, the time value on our deep-in-the-money short calls is eroding toward zero, and American Tower's first-quarter ex-dividend date is on April 10. Keep in mind that you should roll these calls soon, and certainly before April 10, or you risk getting your owned *shares* (rather than calls, assuming both securities are owned in the same account) called away. **We want to avoid that scenario!** So, accept lower credits or even pay a slight debit if need be, but still use a limit order. As of the pricing in this alert, the bid/ask spread on the April $130 short call implies about $0.25 or so in time value remaining, so you don't necessarily need to make this trade immediately, but it's getting close. As we approach expiration, time value will continue to erode; the closer time value gets to zero and the longer you wait, the more likely it is that your short calls will be assigned. Let's avoid that.

What We're Thinking

The current iteration of our diagonal call strategy on American Tower has now been active for more than a year, having begun in November 2016 when we re-established a diagonal call on the company at advantageous prices. Then, in March and September of 2017, we rolled our short calls out and up to capture further upside. So far, the position has been a success (with a 27% simple return since inception if we were to close the diagonal call today), and American Tower's stock price has run up well beyond the strike price of our April $130 short calls. We're now in a position to roll our calls up and out again for little to no cost (and hopefully for a small credit), aiming to capture further upside. With this rolling trade, we increase our upside by $5 and extend our expiration out to October. As we approach October expiration, we'll reassess the position and determine our next course of action.

Alternative Trades

- **Did you write calls with a higher strike price than *Pro*'s?** If you wrote higher-strike calls than *Pro* did (maybe the $135, $140, $145, or $150 strike prices), you're in a slightly better position than *Pro*. If your short call is in-the-money, aim to roll out and/or up for a credit. If you can roll to the $145 or $150 strike price for a credit, those strikes are good choices given our fair-value estimate of $146. If your strike price is out-of-the-money, you can wait until expiration and then write a new iteration of short calls at the $145 or $150 strike price.
- **Have a different position or question not addressed here?** Check in on the American Tower discussion board and we will do our best to help.

Pro Can Help

- **Questions?** Consume data and ask your questions on the American Tower board.

Facing Down Facebook

Published Mar 26, 2018 at 3:38PM

Dear *Pro* Fools,

As of noon today, the S&P 500 was *down* nearly 2% year-to-date, while the *Pro* portfolio was up 1%. Our North Star, though, will be up by 2% at the end of this month. Of course, we dream of always being near our North Star (just as we dream of unicorns and translucent dragons), but we know that won't always happen. Instead of a goal, the North Star is meant as a guide to our decisions. It quietly continues to be just that. Volatility in stocks is a given -- that's why the market generates returns that beat everything else over decades -- but our steady North Star reminds us that we want to own the most *resilient* businesses we can find, and hedge ourselves reasonably.

Resilience, Thy Name Is Facebook?

Is **Facebook** (NASDAQ: FB) going to prove resilient? We believe so, but we're disappointed in its leaders today. The stock has declined from its perch as our largest portfolio holding, ceding that spot to sleepy **Broadridge Financial** (NYSE: BR). What's much more upsetting to me, though, is that Facebook knew in 2015 that the data of 50 million customers (and let's face it: probably many more) had been compromised.

As you probably know, the allegations are that a professor who had legitimately acquired massive amounts of data from Facebook decided to go against Facebook policies and sell that data. Among the purchasers was British-based Cambridge Analytica, which then used the data to drive election-based campaigns, including the Trump presidential campaign. When Facebook learned of this improper data use back in 2015, the proper thing to do would have been to tell authorities, alert the affected users, investigate how this happened, put in place systems to keep it from happening again, and then be forthright with *everyone* about this chain of events and its new solutions. Apparently, the company did none of that.

Only now is Facebook management saying it will work to make sure this doesn't happen again. Sure, the company has changed how much information outside apps can get about users, but the changes sound slight, and as yet there's no solution to what I'll dub "data spread" -- the illegitimate sharing of Facebook data originally purchased legitimately. So, all Facebook users remain vulnerable to further breaches, even as we have no idea who already has our data and how they're using it. That cat is out of the bag, and even Facebook can't coerce it back.

Facebook's board of directors is a relatively small lineup of seven men and two women, dominated by insiders and founders. Kenneth Chenault, formerly CEO at **American Express** (NYSE: AXP), was a welcome addition in February (he may be regretting it right now). Prior to that, the highest-profile members outside of Facebook officers were Reed Hastings from **Netflix** (NASDAQ: NFLX), serving as a board member since 2011; venture capitalist Marc Andreessen, on the board since 2008; and Susan Desmond-Hellman, CEO of The Gates Foundation, on the board since 2013. I deeply hope that the board members all knew contemporaneously about the data spread in 2015 -- but assuming they did, it's incredibly disappointing, almost unforgivable, that they didn't vote to inform the public at the time. For now, we have to assume that we don't know the whole story, and that people of this caliber wouldn't be so reckless without good reason.

But last week didn't add much to our confidence regarding Facebook's savvy. The company's leaders were mum on the issue until Wednesday. A much better PR approach would have been incremental involvement with the public: On day one, tell us you're on it, invite confidence, and say you'll have another update soon; on day two, share more information; on day three, even more. Saying nothing for five days was an absurd choice compared with immediately starting an incremental dialogue that Facebook itself could have then controlled, in the process showing itself to be in charge.

As investors, meanwhile, we're concerned with more than the PR department (though it clearly needs help). We want to make sure that the company's financials are secure and that earnings and cash flow will grow. So far, that's almost certainly the case. User numbers in North America have flattened, but last year Facebook still added nearly 1 million new users per day, most of them international. Odds are that the service will hit 3 billion monthly active users (up from 2.2 billion monthly last quarter) in the next four years. How well Facebook can monetize those users will depend on how effective advertising is on the site, whether regulations impinge on the ability to monetize data, and how actively users want to be on Facebook, among countless less influential factors.

So far, we know that advertising is becoming more effective, and customers have been willing to pay much more per ad on Facebook over the past year. As for regulation, Facebook has said that it welcomes some oversight, and with the FTC investigating it and Congress demanding hearings, such a result is ultimately likely. Barring a breakup of Facebook properties, my belief is that most forms of regulation won't add much risk to the business, and some may even help it. Facebook wants all advertisers to be required to state where their funding comes from, for example. But overall, regulation uncertainty remains a risk. As for active users: In international markets, Facebook is one of the cheapest ways to stay connected with friends, family, and news (which puts even more responsibility on Facebook to squash destructive content). And in North America, Facebook is ingrained into how many people use the Internet itself. For one, Facebook is the way many sign into apps. And network effects work to keep bringing users back into the site.

Still, we don't take repeated user visits for granted. It's easy to delete an app from your phone, where most repeat traffic is derived. And even a giant like Facebook is vulnerable to changing whims. So we're watching its next steps very closely -- and we expect much more from its leaders. Facebook is sitting on perhaps the most detailed trove of user data ever assembled on the Internet. If they don't respect it and protect it, bodies of power will gradually conspire across the globe to defang this business. And either way, we believe some regulation is in order.

But that's not just true for Facebook. **Alphabet** (NASDAQ: GOOG) (Nasdaq: GOOGL) has years of data on users, too. **Twitter** (NYSE: TWTR) is rich with data and reeks of abusive accounts. **Apple** (NASDAQ: AAPL) is painting itself as an ethical protector of privacy and data rights, but while the company isn't known to have sold any of its user data, it does retain reams of it, meaning Apple should be monitored, too. Its leaders will change over the years, perhaps bringing different attitudes to this issue, and its data pile will keep growing. And those are just some of the relevant companies -- we should also mention **Comcast** (NASDAQ: CMCSA) and **AT&T** (NYSE: T). And **Equifax** (NYSE: EFX) and **Target** (NYSE: TGT). And **Amazon.com** (NASDAQ: AMZN). And others.

The reality is, as the Internet has become an indispensable part of our daily lives, the regulations governing it have not grown to match. Nothing you do online is private. Along every touchpoint, someone is collecting data about you. What you "like" on Facebook might belong among the *least* of your concerns, given that Google knows what you've searched for, Amazon knows what you buy, and so forth. That said, Facebook's breadth, reach, and data manipulation by outsiders makes it the primary target today, and that's not likely to change this year. What gives us hope is an indication that CEO Mark Zuckerberg and company want to do right. They don't want to destroy what they're building. They know they need to find solutions that will work for multiple parties. The first paragraph of their January 31 press release said they want to make sure Facebook is good for society.

We believe that Facebook -- perhaps like Equifax, whose stock has recovered considerably from last year's low -- will prove its staying power and its financial resilience. Recently at $159, Facebook stock traded at 21.3 times expected earnings for the year ahead. This is not expensive for a company expected to increase that earnings number by more than 20% annually over each of the next two years. But until Wall Street has confidence in the staying power of those earnings, we're likely to see the stock bounce around with the news headlines. We still have Facebook as a Buy, and as of now, we believe today's setbacks present a long-term opportunity for investors. But when it comes to the issues at hand, this prognosis assumes management will start to do much better than it has in the past.

To discuss Facebook, please head to our Facebook board.

— Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: March 26, 2018

Published Mar 26, 2018 at 3:33PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **CME Group** (NASDAQ: CME): Moves to Best Buy Now, with a 2.5% stake.
- **Coherent** (NASDAQ: COHR): Moves to Buy (from Best Buy Now) as we watch the OLED market. Our overall positive view on this business and its price has not changed.
- See all of our Best Buy Nows and Buys.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Johnson & Johnson** (NYSE: JNJ): Unfortunately, we at *Pro* did not get our desired price to sell covered calls, as the stock fell. We're still waiting.
- **SPDR S&P 500** (NYSEMKT: SPY): We set up our January 2019 synthetic short, selling to open $185 calls, and buying to open an equal number of $155 puts. For a 15% allocation, we set up 17 contracts of each. Our net debit was $1.21 per synthetic short.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Expirations: Facebook, Oracle, and More

Published Mar 22, 2018 at 12:15PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Johnson & Johnson** (NYSE: JNJ): Buy 2.8%.
- **Medtronic** (NYSE: MDT): Buy 2.4%.
- **Oracle** (NYSE: ORCL): Buy 3.3%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy 4.5%.
- **Facebook** (NASDAQ: FB): Buy half of our 7% (so, 3.5%) to start. Expect volatility now, but also expect the business to grow the coming years.
- **CME Group** (NASDAQ: CME): Buy 2.5% per our recent alert.
- **OpenText** (NASDAQ: OTEX): Buy 2.9%.
- **WisdomTree Emerging Markets Small-Cap Dividend Fund** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Home Depot** (NYSE: HD): If you've yet to join our diagonal call position, you can do so today by simultaneously buying ("buy to open") January 2020 $125 calls and selling ("sell to open") May 2018 $175 calls for a combined net debit of about $50.40 per diagonal call (that's $5,040). Invest about 1.6% of your Pro funds in this diagonal call position.
- **Oracle** (NYSE: ORCL): Invest 0.5% to buy to open January 2020 $30 calls. Wait for some price recovery to write diagonal calls at around a $52.50 strike for a worthwhile yield.
- **SPDR S&P 500** (NYSEMKT: SPY): Set up a $285/$255 synthetic short per our recent alert. If you use the same strikes as the alert, note that because SPY is a bit higher now, the position can be implemented for about a $1.70 net debit.

Upcoming Expirations (April 20):

- **American Tower** (NYSE: AMT): Our $130 diagonal calls will expire, and the stock goes ex-dividend on April 11th with a dividend of $0.75 per share. We plan to roll soon, and certainly before the ex-dividend date to avoid dividend poaching.

Tencent Is Investing in Its Future

Published Mar 22, 2018 at 5:21AM

Tencent Holdings (NASDAQOTH: TCEHY) announced fourth-quarter 2017 results on Wednesday morning, detailing higher-than-expected earnings driven by the sustained momentum of its social media platforms, smartphone games, and wildly popular video-streaming services.

But the Chinese tech giant also outlined plans to ramp up strategic investments aimed at taking market share and driving long-term growth, sparking concerns from skittish investors over its near-term profitability.

With shares down around 3% as of this writing, let's take a deeper look at how Tencent ended the year, as well as what we can expect in the coming quarters.

Image source: Getty Images.

Tencent Results: The Raw Numbers

Metric	Q4 2017	Q4 2016	Year-Over-Year Growth
Revenue	RMB 66.392 billion ($10.161 billion)	RMB 43.864 billion	51.4%
Net profit attributable to Tencent shareholders	RMB 20.797 billion ($3.183 billion)	RMB 10.529 billion	97.5%
Earnings per diluted share	RMB 2.177 ($0.33)	RMB 1.108	96.5%

Data source: Tencent Holdings.

What Happened With Tencent This Quarter?

- On an adjusted (non-GAAP) basis, which excludes non-cash items and acquisition expenses, profit attributable to shareholders grew 42% year over year to RMB 17.454 billion ($2.671 billion), or RMB 1.827 per diluted share ($0.28).
- Tencent doesn't provide specific quarterly guidance. So for perspective -- and while we don't usually pay close attention to Wall Street's demands -- consensus estimates predicted lower adjusted earnings of $0.27 per share on higher revenue of $10.5 billion.
- Fee-based registered subscriptions for Tencent's value-added services (VAS) grew to 135 million for growth of 22.1% year over year -- up from 125 million last quarter.
- Weixin and WeChat monthly average users grew 11.2% year over year to 989 million and exceeded 1 billion following the Chinese New Year.
  - Accelerated growth was driven by a fine-tuned Weixin user interface to more prominently feature Mini Programs and Mini Games.
- Monthly active user (MAU) accounts on Tencent's QQ instant messaging service fell 9.8% year over year to 783 million. However, smart device MAUs grew 1.7% to 683 million, driven by growth in both time spent by and the number of younger users (aged 21 and below).
- Qzone MAUs declined 11.7% year over year to 563 million, and smart device Qzone MAUs declined 9.1% to 554 million.
- VAS revenue grew 37% year over year to RMB 39.947 billion, including the following:
  - Online games revenue grew 32% to RMB 24.367 billion, driven primarily by growth in both existing smartphone games, like *Honour of Kings*, and new smartphone games, including *Kings of Chaos* and *Legacy TLBB Mobile*.
  - Social networks revenue grew 45% to RMB 15.58 billion, driven by growth in subscription video streaming, live broadcast, and in-game virtual item sales.
- Online advertising sales climbed 49% to RMB 12.361 billion, including the following:
  - Media advertising grew 22%, driven by Tencent Video, which is now the largest streaming platform in China, with over 137 million mobile daily active users and 56 million paying subscribers (up from 43 million last quarter).
  - "Social and other" segment ad revenue grew 68%, driven by Weixin and Tencent's ad network.
- Other business revenue grew 121% to RMB 14.084 billion, driven by payment and cloud services.
- Free cash flow grew 41% year over year to RMB 24.17 billion.

What Management Had to Say

Tencent Chairman and CEO Ma Huateng stated the following:

> During 2017 and continuing in 2018, Tencent made important strategic moves that reinforced our leadership. Our streaming video service became the China market leader with the most mobile daily active users and monthly subscriptions. Our Weixin Mini Program platform rapidly expanded its developer base and user adoption. Our QQ *Speed Mobile* racing game and *PUBG: Exciting Battleground* shooter game achieved absolute leadership in, and grew the audiences of, their respective genres. Looking forward, we are substantially increasing our investment in areas including video, payment, cloud, AI technologies, and smart retail, which will impact our near-term earnings but which we believe can generate long-term value and growth opportunities.

Looking Forward

More specifically, Tencent says it will "more aggressively invest" in 2018 with the aim of strengthening its positions in "areas including online video, payment services, cloud services, AI technologies, and smart retail."

Of course, the market is unsurprisingly frowning at the prospect of that growth coming at the expense of Tencent's short-term profitability, which helps explain today's modest pullback. Meanwhile -- and putting aside the fact that forsaking profits in the name of driving top-line growth and securing market share is hardly an uncommon approach -- long-term investors will recognize that Tencent is making these investments from a position of strength.

This article comes from our Fool.com team of specialists, as part of our commitment to bring you Foolish coverage of news that matters. It does not necessarily reflect the current thinking or guidance of your premium services team. Rest assured, if your premium services team has more to add, it will follow up on your website.

Pro's Theoretical Fair Value

Published Mar 20, 2018 at 2:47PM

Dear *Pro* Fools –

Last week, *Pro* member spiggy unearthed an old discussion on the boards from 2013 (before my time with *Pro*). This discussion focused on an analysis from longtime *Pro* all-star, FoolishRob99.

In this post, Rob assessed whether the *Pro* portfolio was trading at an aggregate discount or premium to its fair value. To do this, he analyzed the theoretical fair value of the long portion of the *Pro* portfolio based on our "Fair Value Estimates," then compared the theoretical fair value of the portfolio to the actual market value.

What Is Fair Value?

Before we dive any deeper into Rob's methodology of determining the *Pro* portfolio's theoretical fair value, let us first define what "Fair Value" means. Without understanding how to interpret "Fair Value," calculating *Pro*'s theoretical fair value is of little use. Here's an anecdote from Rob's original post, which is excellent:

> *Pro includes "Fair value" prices on all its companies. That is sometimes confusing to members. The question comes up again and again: why should I buy above fair value? The answer is twofold. One, fair value isn't an absolute number, but rather the convergence of a series of possible futures. So it's inherently inaccurate. You might call it the "highest probability single value" if that means anything. Or the weighted average of values considering the likelihood of possible futures. Second, fair value advances at a discount rate, typically 10% per year. If it did not advance, fair value wouldn't be "fair" for the buyer.*

Here's how *Pro* defines "Fair Value," from the Glossary at the bottom of our "Pro Portfolio" page:

> "**Fair Value**: The price from around which we estimate investors will earn a fair annualized, long-term return. We lean conservative, and our fair value estimate will increase as the company grows."

And here are a few additional resources that help provide additional context into how we think about fair value:

- A memo from Jeff titled The Flaws of Fair Value
- A couple of board posts with further detail on fair value

Determining Pro's Fair Value

With a discussion of fair value out of the way, now we can take a look at Rob's methodology. Here it is in his words:

> *The following table takes Pro's fair value estimates along with the actual holdings, and determines what the resulting fair values of each of those positions actually are. If a stock has a FV of 30, and we have 100 shares, that position has a FV of 3,000. (100 * 30 = 3,000). We can then sum up all the position FV numbers and get a total portfolio FV, and see if we are trading at a net discount or premium to portfolio FV.*

After running his analysis, Rob determined that, at $1,437,214, the *Pro* portfolio was trading at a 2.9% discount to its theoretical fair value. He then concluded that we could expect a potential advancement in the *Pro* portfolio of $215,337 over the coming year, comprised of:

- The 2.9% advancement to fair value
- Expected dividends
- 10% annual return from increases in fair value

Since the Pro portfolio had a market value at the time of $1,886,897 (which includes cash, shorts, and options), the $215,337 expected increase in the long book could be expected to push *Pro* to an 11.4% gain by the beginning of 2015. So, how did his hypothesis perform in accordance with reality?

Well, *Pro's* ending portfolio balance on 12/31/14 was $2,321,001, a 23% gain. We did better than Rob's back-of-envelope calculations, which is due to one of two reasons (or possibly a mixture of both):

1. Our estimates of fair value were too conservative, and the fair value of our companies advanced more quickly than what was implied by our expectation of 10% annual advancement
2. The market bid up the price of our companies beyond the advancement in their true economic fair values, leading to a premium to fair value

In order to determine which of the two above reasons explains the observed reality most closely, we'd need much more data and we'd need to track *Pro*'s theoretical fair values over time and compare them to the subsequent realized returns. I plan to start doing that on a weekly basis starting now, and below is the first entry of this new and exciting data set.

Pro's Current Theoretical Fair Value

As of last week's closing prices on Friday, here is what the calculation of *Pro*'s theoretical fair value looks like:

Date	Stock	Ticker	# of Shares	Position Market Value	Position "Fair" Value	Allocation	Day Closing Price	Fair Value Estimate	Price/FVE
3/16/2018	Facebook	FB	1400	$259,126.00	$246,400.00	8.8%	$185.09	$176.00	1.05
3/16/2018	Broadridge	BR	2100	$225,288.00	$172,200.00	7.6%	$107.28	$82.00	1.31
3/16/2018	Mastercard	MA	1200	$219,060.00	$180,000.00	7.4%	$182.55	$150.00	1.22
3/16/2018	Amazon	AMZN	100	$157,168.00	$117,000.00	5.3%	$1,571.68	$1,170.00	1.34
3/16/2018	Apple	AAPL	896	$159,505.92	$148,736.00	5.4%	$178.02	$166.00	1.07
3/16/2018	Square	SQ	2800	$153,692.00	$123,200.00	5.2%	$54.89	$44.00	1.25
3/16/2018	Paycom	PAYC	1300	$142,974.00	$117,000.00	4.9%	$109.98	$90.00	1.22
3/16/2018	American Tower	AMT	924	$135,412.20	$134,904.00	4.6%	$146.55	$146.00	1.00
3/16/2018	Skyworks	SWKS	1200	$132,756.00	$126,000.00	4.5%	$110.63	$105.00	1.05
3/16/2018	Oracle	ORCL	2400	$125,448.00	$115,200.00	4.3%	$52.27	$48.00	1.09
3/16/2018	Visa	V	958	$119,299.74	$101,548.00	4.1%	$124.53	$106.00	1.17
3/16/2018	Tencent	TCEH.Y	1808	$107,163.78	$90,400.00	3.6%	$59.27	$50.00	1.19
3/16/2018	Open Text	OTEX	2800	$101,668.00	$98,000.00	3.5%	$36.31	$35.00	1.04
3/16/2018	NVR	NVR	32	$97,934.40	$88,000.00	3.3%	$3,060.45	$2,750.00	1.11
3/16/2018	Cooper Companies	COO	400	$94,276.00	$96,000.00	3.2%	$235.69	$240.00	0.98
3/16/2018	Johnson & Johnson	JNJ	724	$96,784.32	$99,188.00	3.3%	$133.68	$137.00	0.98
3/16/2018	Starbucks	SBUX	1600	$94,400.00	$83,200.00	3.2%	$59.00	$52.00	1.13
3/16/2018	CME Group	CME	500	$82,560.00	$88,500.00	2.8%	$165.12	$177.00	0.93
3/16/2018	Medtronic	MDT	1000	$81,290.00	$80,000.00	2.8%	$81.29	$80.00	1.02
3/16/2018	Verisk Analytics	VRSK	757	$79,310.89	$66,616.00	2.7%	$104.77	$88.00	1.19
3/16/2018	FactSet Research Systems	FDS	360	$77,248.80	$67,320.00	2.6%	$214.58	$187.00	1.15
3/16/2018	Gilead Sciences	GILD	900	$71,766.00	$72,000.00	2.4%	$79.74	$80.00	1.00
3/16/2018	Coherent	COHR	307	$68,049.62	$85,960.00	2.3%	$221.66	$280.00	0.79
3/16/2018	Verisign	VRSN	500	$62,960.00	$50,000.00	2.1%	$125.92	$100.00	1.26
			TOTAL	$2,945,141.67	$2,647,372.00	100.0%			1.11

Pro's long book is currently trading at an aggregate premium to its theoretical fair value of about 11.3%. This suggests a headwind to future returns, which is not surprising given the strong advancement in the stock market over the last year and a half. Jeff often mentions that he doesn't like when the market goes up too much, because in essence it is "stealing from future returns." The idea of a premium to fair value and the headwind on future returns is what he is referring to.

The *Pro* Bottom Line

By comparing *Pro*'s theoretical fair value to its current market value, we can get a sense of whether we might experience higher-than-expected or lower-than-expected performance over subsequent periods. Right now, *Pro*'s 11.3% premium to fair value suggests a headwind to future returns, although that doesn't necessarily mean that lower future returns will certainly occur.

By tracking Pro's theoretical fair value (and by tracking the fair value of the stocks that comprise the aggregate portfolio) over time and comparing the discount or premium to the subsequent realized performance, we can determine how good we are at assessing fair value, or whether we are systematically biased with our estimates. I plan to update this data set on a weekly basis and look forward to having enough data to draw historical conclusions.

And thanks to FoolishRob99 and spiggy for inspiring this Memo!

Fool on,

--Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Expirations: Gilead, Square, SPY, and More

Published Mar 15, 2018 at 2:05PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Medtronic** (NYSE: MDT): Buy 2.4%.

Continue building your portfolio with our Buys, including:

- **CME Group** (NASDAQ: CME): Buy 2.5% per our recent alert.
- **OpenText** (NASDAQ: OTEX): Buy 2.9%.
- **Square** (NYSE: SQ): Buy up to 4.4% (if you're worried about volatility, start with half that size, or go up to 3%).
- **WisdomTree Emerging Markets Small-Cap Dividend Fund** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Gilead Sciences** (NASDAQ: GILD): If you don't have a position yet (or haven't covered your shares and want to), buy at least 100 shares up to a 2.1% (or so) portfolio allocation, and simultaneously sell to open May 2018 $85 calls. Sell one call for 100 shares owned. These calls lately pay $1.50 each, for a 1.9% yield on the $79.63 share price in just more than two months. Your net debit to set up this buy/write covered call trade is about $78.13 per share, with upside to $85.
- **Home Depot** (NYSE: HD): If you've yet to join our diagonal call position, you can do so today by simultaneously buying ("buy to open") January 2020 $125 calls and selling ("sell to open") May 2018 $175 calls for a combined net debit of about $50.20 per diagonal call (that's $5,020). Invest about 1.5% of your *Pro* funds in this diagonal call position.
- **Johnson & Johnson** (NYSE: JNJ): Sell covered calls on your shares if, like us, you're comfortable capping them for upside. The May 2018 $140 calls lately pay $1.42, with the shares at $133.29. This is the minimum to accept today -- this or a few pennies less if you don't mind.
- **SPDR S&P 500** (NYSEMKT: SPY): Set up a $285/$255 synthetic short per our recent alert. If you use the same strikes as the alert, note that because SPY is higher now, the position can be implemented for about a $1.50 net credit. For a synthetic short with more breathing room and responsiveness, however, you would now probably want to set it up at least one strike price higher than the alert, selling $290 calls and buying $260 puts. This costs about a $2.10 net debit per syn short, with SPY lately at $275.61.

Upcoming Expirations:

- **Facebook** (NASDAQ: FB): Our $170/$200 protective collar *would* have expired tomorrow, March 16, but we closed it early.

Write Covered Calls on Johnson & Johnson

Published Mar 12, 2018 at 3:30PM

Is this for you? This is for *Pro* members who own at least 100 shares of Johnson & Johnson, and who wouldn't mind capping upside in return for near-term income. Those who *don't* own the stock can buy at least 100 shares to write covered calls, matching our 2.8% allocation. Those who own less than 100 shares as a full allocation can continue to hold them.

How You Participate

- **Action:** Sell to open May 2018 $140 calls on **Johnson & Johnson** (NYSE: JNJ).
- **Allocation:** Write ("sell to open") one call for every 100 shares owned. *Pro* will cover 700 of our 724 shares owned, representing about 2.8% of the portfolio.
- **Price Guidance:** Prices will change as the stock moves, but **use a limit order** to split the option's current bid/ask spread. When we quoted it, that was $1.52. Later, aim for at least a 0.5% yield (option premium/current stock price) per month to expiration; with shares at $133, the minimum to accept when writing these calls is thus about $1.50.
- **Prices** (10:40 a.m. ET):
  - Stock: $133.67
  - Sell to open May 2018 $140 calls (bid/ask): $1.50/$1.55
  - $1.52 pays 1.1% ($1.52/$133.67) in 68 days
- **Alternative Trades:** You can write calls at the $135 strike if you want to trade off lower upside to your strike price for higher income now.
- **Important dates:** Johnson & Johnson will report earnings in mid-April. The next ex-dividend date is not until late May, so we'll avoid any dividend-poaching complications with this trade.

What We're Thinking

Our latest earnings update on Johnson & Johnson detailed our thinking for this position. A quick summary of our thoughts would be that JNJ's business is doing well, with a resurgent pharmaceutical division making up for slower growth in the company's other two divisions. We're pleased with the way our investment thesis is playing out, but we don't expect runaway upside from this steady, low-growth stalwart. We'd mentioned in the earnings writeup that we might consider using covered calls to add additional income to the position, so here we are.

Why This Strategy?

As the third-highest-yielding position in the *Pro* portfolio (behind Gilead and DGS), Johnson & Johnson is already an income producer for us. At current prices, the company's dividend yield should approach 2.7% once the company announces its yearly dividend increase sometime in late April. Johnson & Johnson is a Wall Street "dividend aristocrat," one of only 25 U.S.-listed stocks with a history of at least 50 consecutive years of dividend increases (this year will mark 56).

Given the healthy dividend yield and the fact that the business is a slow grower, we think covered calls should help us achieve a North Star-level return from the position. We're not too worried about losing our shares should the stock price run away from us, because we don't have much interest in chasing J&J's valuation too far above our fair-value estimate. Additionally, if we lose our shares because of these covered calls, we can turn around and write puts to target additional income and aim to reinitiate our position at lower prices.

Given the recent spike in volatility, the VIX (the "volatility index") is reaching higher levels than we've seen since initiating our J&J position in February 2017, and we think now is a good time to initiate a recurring "options for income" strategy on our position. Options premiums are modest because of the company's lower-than-average volatility, and we may have to watch out for dividend poaching around ex-dividend dates, but ultimately, we think a covered-call strategy should help us achieve our desired returns for this position over the long run.

If our shares are called in May, we'll be selling at a net price of $141.52, above our fair-value estimate and accounting for about a 20% simple return (about 18% annualized) since the position's inception . We'll manage the calls as needed with future trade alerts, and as is always true with covered calls, we may need to let our shares go if we can't roll our calls higher at a reasonable cost.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call's strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up:** If the stock price rises above our strike price by expiration, we may let our shares get sold, or we may roll our calls to a later date and/or higher strike. We'll cross any such bridge near expiration, once time value is dissipating from the calls.

Pro Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the J&J discussion board.

Submit

From Square to SVXY!

Published Mar 12, 2018 at 2:50PM

Dear *Pro* Fools,

The *Pro* portfolio finished last week at new highs, driven by many of our newer investments. We continue to see great promise in the likes of **Paycom** (NYSE: PAYC), **Tencent** (NASDAQOTH: TCEHY), **Amazon** (NASDAQ: AMZN), **Skyworks** (NASDAQ: SWKS), and our focus today: **Square** (NYSE: SQ).

Square Squared Up

Payment processor. Lender. Software provider. Our strongest performer of late, Square's shares have doubled since we bought them eight months ago. Growth has accelerated sequentially over each of the past four quarters as larger customers embrace the growing Square ecosystem. But let's step back.

In 2017, Square processed $65.3 billion in gross payment volume (GPV). Its own net revenue rose by 47% last quarter. Sellers generating more than $500,000 in annualized GPV made up 20% of Square's total GPV, up from 16% a year ago. Those selling at least $125,000 per year accounted for 47% of last quarter's GPV, another rise. This is important because larger customers not only drive more profits to Square via transactions, but they also have more money to spend on Square software and services.

The company's subscription and services businesses expanded revenue by 96% last quarter, to roughly $79 million. Ranging from invoicing to inventory to payroll software, analytics, and data (and much more), Square's services have high margins, and that's where the most long-term value will likely be created. But payment transactions are holding their own, too. Square's transaction-based profit as a percentage of customer GPV grew to 1.07% of each dollar last quarter, up from 1.04%.

Square is building an ecosystem that provides financial tools and flexibility to anyone building or running a business, and to consumers as well through its Cash App. Business customers arrive through any of a multitude of Square offerings, such as Appointments, or Loyalty, or Point of Sale (all of which are self-explanatory). Most customers add more Square products over time. These virtuous cycles are driving strong growth even as Square spends relatively little on marketing. Newcomers arrive by word of mouth and brand recognition, and the upsell cycle soon begins.

Management at Square expects 44% adjusted revenue growth in Q1, and 32% to 35% adjusted revenue growth for all of 2018. That would bring between $1.3 billion and $1.33 billion in adjusted 2018 revenue. Management estimates an EBITDA margin of 19%, with non-GAAP earnings per share of $0.43 to $0.47 this year. Even as Square spends to develop new products and grow internationally, its margins are headed higher, and GAAP profits should arrive by next year.

Just as the stock is bursting past its boundaries, the business is hard to contain in a few words, too. Square goes through pains in six paragraphs to try to describe everything it does. It's also hard to pinpoint its greatest opportunity -- because it has many, from lending to software to transactions. It's not easy to value a young, fast-growing company, so take numbers from *anyone* with a grain of salt. But we see much more opportunity ahead, and our newly increased fair-value estimate of $44 just represents a snapshot in time. The stock remains a Buy, and we have a 4.3% stake.

Half Its Former Self

ProShares recently announced that its ETF, the **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY), will adjust to track its corresponding VIX futures index at negative 0.5 times the value of the index per day. That's rather than the full negative value of the index it used to track. This is a good change for anyone, like us, who wants to see the ETF last a long time. Being short VIX futures with half as much exposure as before means it would take at least a 200% one-day jump in VIX futures to put the ETF in mortal danger -- and that has never happened before. In practical terms, it means that now if VIX futures jump by, say, 20%, SVXY will only fall by half as much.

But this also means that a price recovery, if we get one, is going to take much longer. When the VIX futures lose value, as they do on a majority of trading days, our ETF will gain only half as much as the index loses -- instead of the full amount. Still, I welcome this change. The ETF is now likely to weather giant storms much better than it did in early February.

Meanwhile, from its low near $16 in 2016, SVXY had increased to $130 by the end of 2017. Gains from here of even half that amount -- or even much less -- would still be attractive, especially if the ETF *loses* much less when volatility spikes. With this news, we may be waiting longer for any such gains, but we have less risk during market downturns and spikes in volatility. We maintain a 0.3% position, rated a Buy.

(For the curious, see the biggest VIX jumps here in CBOE's PDF; and realize that VIX futures usually move less than than VIX itself.)

In closing, it's a pleasure to spend some time with you here today. Our dialogue with you naturally continues -- with more trade alerts, more market commentary (including sequels to "Where Pro Stands"), and more earnings updates coming. Enjoy your investing!

— Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: March 13, 2018

Published Mar 12, 2018 at 2:16PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Square** (NYSE: SQ): Our fair-value estimate increases to $44. The stock remains a Buy at a 4.3% allocation.
- Don't miss the slew of guidance adjustments shared last week.

Pro Completed Trades (see transaction log; trades take a day to appear):

- None since last week.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Paycom, SPY, and More

Published Mar 8, 2018 at 2:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Coherent** (NASDAQ: COHR): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.8%.
- **Medtronic** (NYSE: MDT): Buy 2.4%.

Continue building your portfolio with our Buys, including:

- **CME Group** (NASDAQ: CME): Buy 2.5% per our new alert.
- **NVR** (NYSE: NVR): Buy 2.8%.
- **Paycom** (NYSE: PAYC): Buy up to 4.2%.
- **WisdomTree Emerging Markets Small-Cap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Facebook** (NASDAQ: FB): In case you missed the alert, we recommend selling to close your long puts in your protective collar, and closing the collar.
- **Home Depot** (NYSE: HD): If you've yet to join our diagonal call position, you can do so today by simultaneously buying ("buy to open") January 2020 $125 calls and selling ("sell to open") May 2018 $175 calls for a combined net debit of about $50.20 per diagonal call (that's $5,020). Invest about 1.7% of your *Pro* funds in this diagonal call position.
- **SPDR S&P 500** (NYSEMKT: SPY): Set up a synthetic short per our recent alert. Using the same strikes as the alert, since SPY is higher now, the net debit for the syn short is lately about $0.20.

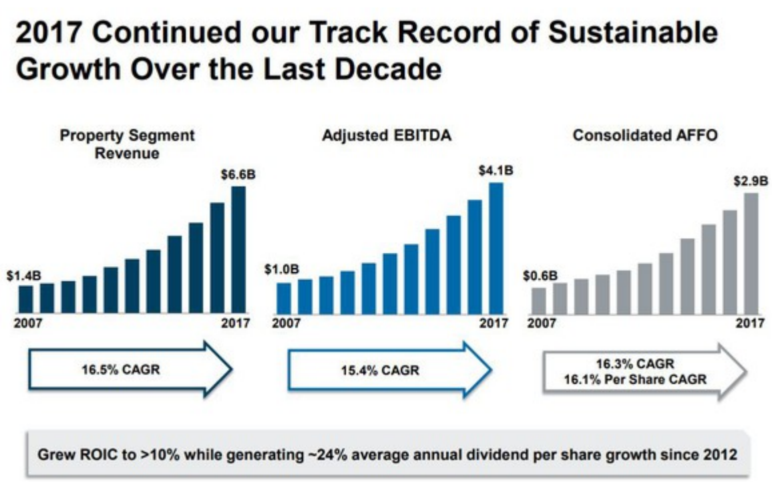
Upcoming Expirations:

- **Facebook**: Our $170/$200 protective collar *would* expire on March 16, but we closed it early.

American Tower Faces Near-Term Weakness in India

Published Mar 7, 2018 at 2:43PM

American Tower (NYSE: AMT) reported a noisy fourth quarter for 2017 as wireless carrier consolidation in India led to lower companywide profitability. Culprits included elevated levels of customer churn, one-time impairment charges, and bad debt expenses related to Indian operations. Despite the near-term weakness, 2017 capped off an outstanding 10-year period for American Tower during which the company was able to exceed its long-term strategic goals laid out in 2007. Management's goals for 2017 were to have 100,000 communications sites (they achieved 150,000-plus) and to generate $6 per share of consolidated adjusted funds from operations (AFFO) -- they reported $6.72 per share in full-year 2017.



Although international growth will be a bit slower in 2018 because of the disruption in the Indian wireless market, the U.S. business continues to improve, and the international business should rebound once the Indian market normalizes. American Tower's valuation reflects the near-term weakness in India, and the stock is currently trading at 18.5 times adjusted EBITDA guidance for full-year 2018, which is well below the company's long-term average of about 21 times adjusted EBITDA. This suggests that shares are priced attractively today.

What Happened?

CEO Jim Taiclet:

> "In 2007, American Tower initiated a long-term aspirational strategy which included a target of quadrupling both the size of our communications site portfolio and our financial performance over a 10-year time horizon. Based on our 2017 results, we have far exceeded both objectives, with over 150,000 sites versus a goal of 100,000 sites, and $6.72 per share of Consolidated AFFO versus a goal of $6.00 per share. Moreover, in 2017, we delivered growth of nearly 16% in Consolidated AFFO per Share, expanded our return on invested capital, increased our common stock dividend by more than 20%, and repurchased approximately $770 million in stock.
>
> "As we look forward to 2018, we expect strong organic tenant billings growth of over 6% in the U.S., driven by unlimited data plans, increasing mobile video consumption, announced spectrum build-outs in the 2.5 GHz and 600 MHz bands and the planned FirstNet deployment. We also expect consistent demand for tower space in Latin America, notably in Mexico and Brazil, as well as robust activity in our key markets in the EMEA region. Finally, we have incorporated into our 2018 outlook the expected impacts of the ongoing carrier consolidation process in India. We continue to have a high level of confidence that once the consolidation activity concludes, the Indian mobile industry will be positioned for major network investments to bring 4G service to the country's 1.3 billion people, providing strong growth opportunities for our extensive portfolio in India."

Get More

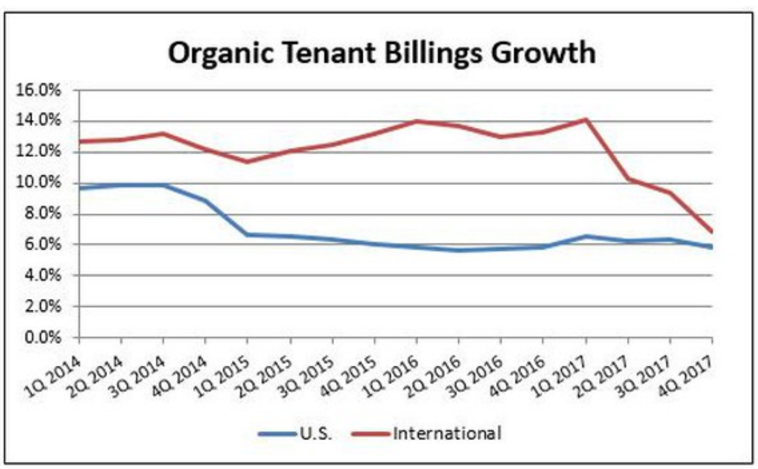
- Q4 2017 press release
- Q4 2017 supplemental materials
- Q4 2017 earnings presentation

For the fourth quarter, organic growth in tenant billings came in at 5.9% in the U.S. and 6.9% internationally, vs. 5.8% and 13.3% in the same quarter a year ago.

Internationally, there was significant disruption in the Indian market as wireless carrier consolidation resulted in a significant amount of churn (i.e., customer cancellations) in the quarter. Here is some management commentary about the current situation in India:

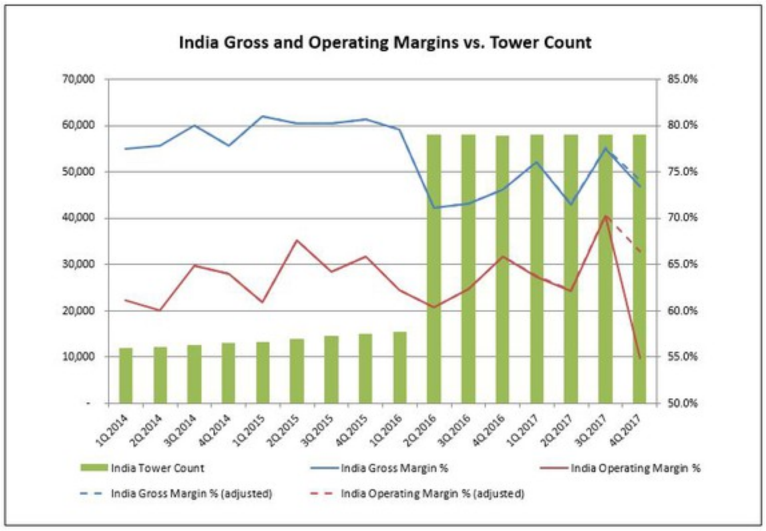
> "While we always expected a significant operator consolidation in the Indian market, Reliance Jio's bold launch of its 4G network significantly disrupted the incumbents, driving them to rapidly merge their businesses in response. Consequently, an orderly consolidation process that we expected to run over 4 or 5 years is being compressed into a much tighter time frame. As a result, we anticipate that ATC India, along with all tower operators in the market, will experience substantial churn in 2018. And this is included in our outlook. We then expect these elevated churn levels to begin to subside in 2019, and by 2020 and thereafter, that the reordered market will gradually return to more typical organic growth rates over the long run. Over the mid to long term, we believe a rational Indian wireless market, with 3 or 4 national mobile operators and 2 to 3 major tower companies, that includes ATC, will more than make up for the short-term churn impact of this consolidation process in the short term.
>
> "Consequently, we have applied our practice of acquiring quality tower portfolios during times of short-term market disruption because they're acquired at reduced asset prices. This is the logic behind our signed agreements to purchase the non-Indus Communications real estate assets of Idea and Vodafone. Over our planning period, we expect that these towers may eventually prove to be among the highest-return assets in the company given their low purchase multiple and the market's future long-term growth prospects."

As a result of the carrier consolidation, Indian organic growth came in at 2.6%, down sharply from 19.1% a year ago. Outside of India, organic growth was more typical, up 8.3% in Europe, the Middle East, and Africa (EMEA, which includes France, Germany, Ghana, Nigeria, South Africa, and Uganda) and 9.9% in Latin America (which includes Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay, and Peru).

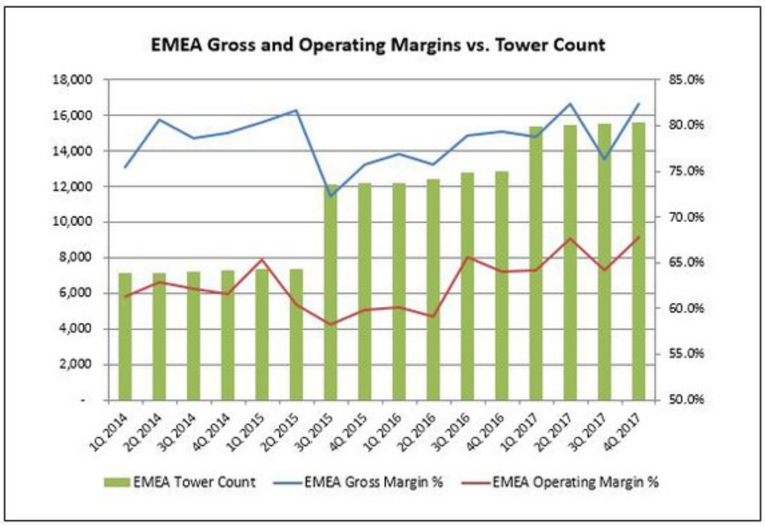


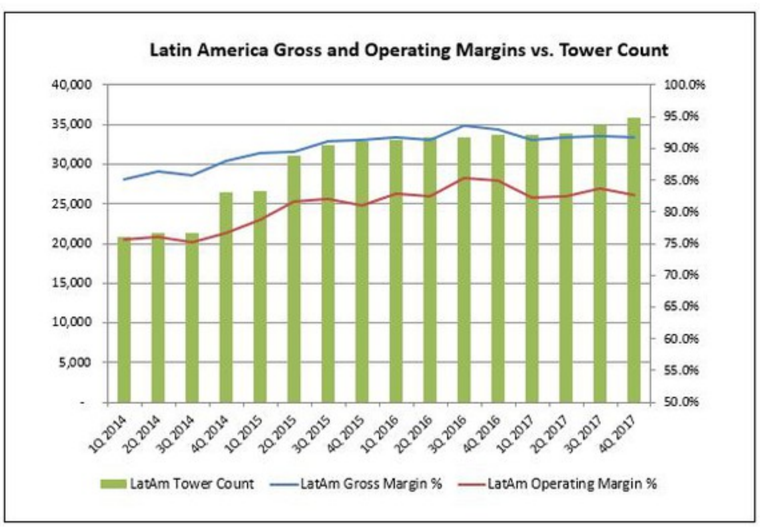
So What?

The Indian wireless carrier consolidation should continue to affect growth rates and margins in that market throughout 2018. The company booked a $209 million impairment charge and $18.7 million in bad debt expenses in the fourth quarter, all related to India carrier consolidation. The graph below shows how margins were affected in India both before and after adjusting for the one-time expenses:



In EMEA and Latin America, margin trends are positive and management expects margin expansion over time as the company continues to generate organic growth on its extensive existing portfolio of assets.



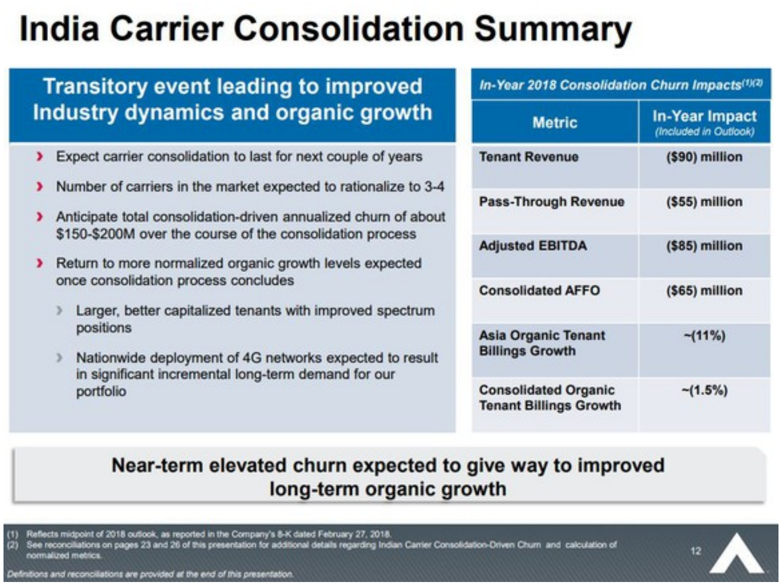


In the U.S., margin trends continue to improve. TTM gross margins increased year-over-year to 79.3% (from 78.2%), and TTM operating margins increased year-over-year to 75.1% (from 73.9%). We can see in the graph below that since the significant **Verizon** (NYSE: VZ) acquisition in 2015 that acted to lower the margin profile of the entire U.S. business (thanks to the lower tenancy ratio on those new towers), management has been successful in slowly increasing margins via organic growth of the newly acquired (and existing) assets:

Continued improvement in the U.S. business is especially nice to see given the disruption in the Indian market, and given that the U.S. business still generates about 60% of companywide revenue and 75% of cash flow.

Now What?

This fourth quarter represented an atypical misstep for American Tower as unexpectedly swift carrier consolidation in India led to significant one-time impairment charges and lower organic growth rates that should persist throughout 2018. However, the Indian market turmoil allowed management to acquire new assets at reduced prices, and by 2020, management expects that the Indian market should return to more typical growth.



Aside from the Indian market, the rest of American Tower's business continues to perform well. The U.S. business is showing continued growth and margin improvement, and EMEA/Latin America are growing at a rate higher than that of the United States. Management has an outstanding track record of growth over the past decade, and we expect that to continue despite the near-term disruption in India.

Data and Guidance

- Current Price: $139.20
- Fair-value estimate (unchanged): $146
- Allocation: 3.8%, plus 0.7% in January 2019 / April 2018 $80 / $130 diagonal calls
- EV/EBITDA (TTM): 19.63

AMT remains a Best Buy Now, and fair value is unchanged at $146. We also have 0.8% in deep-in-the-money diagonal calls, which expire in April. Our April $130 short calls still have more than $1 in time value remaining, and we'll likely aim to roll those calls out and up as we near April expiration.

Fool on!

-- Billy (TMFBillyTheKid)

Close Your Protective Collar on Facebook

Published Mar 5, 2018 at 2:37PM

Is this for you? For *Pro* members who set up a protective collar on some of these shares expiring March 16, we recommend that you sell the puts to capture their value, and close the calls for pennies to uncap upside.

How You Participate

- **Action:** Close your protective collar on **Facebook** (NASDAQ: FB).
- **Trades:**
  - **Sell to close** your March 16, 2018, $175 puts.
  - **Buy to close** your March 16, 2018, $200 calls.
- **Allocation:** We had collared more than one-third of our Facebook shares. We'll close all the contracts.
- **Price Guidance:** Sell to close the puts for the current value, using a limit order (lately about $1.65, but check your current pricing). Buy to close the calls for no more than $0.03 each (you could also wait and let the calls expire March 16, assuming the stock doesn't gain more than 12% to top $200 by then).
- **Recent Prices (noon ET):**
  - March 16, 2018, $175 puts (bid/ask): $1.64/$1.67
  - March 16, 2018, $200 calls: $0.02/$0.03
  - Stock: $179
- **Scorecard Status:** Buy. Allocation is 7.5%. Fair-value estimate is $176.
- **Special Note:** We're looking at future collars for future earnings reports, though right now they're a bit expensive. We have time.

What We're Thinking

We started this collar in January with these words: "What are we thinking? We're thinking we probably don't need this protection." As it turns out, we haven't needed it -- but it *has* helped. The protective collar gave us peace of mind as Facebook fell after January's earnings and during the market swoon. And, because the collar was set up for a small credit, we can close it today -- specifically, we can sell the puts we own today -- for a profit on the strategy overall. And that's nice.

Meanwhile, Facebook's strong financials continue to grow stronger. In its latest results, the social media leader reported fourth-quarter 2017 revenue growth of 47%, to $13 billion, while income from operations rose by 61%. The company's operating margin expanded from a stunning 52% a year ago to an even higher 57% last quarter -- more than twice Google's recent operating margin. Facebook is extremely profitable even as it spends billions on data centers and new employees. For all of 2017, revenue was up 47% to $40.7 billion, and operating margins averaged 50%. Free cash flow rose 50% year-over-year to $17.5 billion, representing a world-class 43% free cash flow margin.

These incredible numbers are likely to soften this year because Facebook expects its spending to ramp up all year long, growing ever higher as the year progresses. But given how its average revenue per user is increasing in every region, healthy growth at Facebook still appears on tap this year. That's because advertising on the site is becoming more effective, so advertisers are willing to pay more per ad, and they're increasing ad budgets, too. This is likely to be the case for some time to come -- perhaps a long time.

Ad revenue is growing even as Facebook makes site changes that are materially decreasing the amount of time an average user spends on the flagship site. Facebook is focused on delivering visitors more user-generated "friends and family" content rather than third-party streaming content, hoping to increase the quality of the experience. If people make better, deeper connections on the site (rather than streaming random videos), it should lead to more long-term value for everyone.

Lately at about $179, the stock trades at 25 times expected earnings for 2018 and 40 times free cash flow. It remains a high-conviction stock at *Pro*, as it has been for many years. However, given that it's our largest position at 7.5% and this is a transitional, high-cost year for Facebook, we'll continue to consider putting protective collars on some of our stake around earnings reports if pricing is reasonable. The next earnings date will be late April or early May.

Why This Strategy?

A protective collar is friendly because it can cost little to nothing to set up (or will even pay you, as it did in our case), yet it protects you from downside. Right now, if the stock stays between our two strike prices, the options would expire unused. But given that we only have 11 days until these options expire, and Facebook is not extremely likely to fall below $175 in that time, we are recommending that you sell to close the puts to capture their value. You can also buy to close your short $200 calls for a few pennies to guarantee you keep your shares if Facebook soars above $200 in the next 11 days. Such a jump is very unlikely, but ... stranger things have happened. Some brokers don't charge a commission for closing an option at less than $0.05.

For now, we'll uncover our Facebook shares again, leaving them currently unprotected. We made several hundred bucks on this collar (as of today), although it hasn't come into play yet and probably won't. If we were to wait and do nothing, it would likely expire without value.

Alternative Trades

- **Only bought puts last time?** If you simply bought puts in January, sell to close those puts.

Pro Can Help

- Questions on this short-term protective position? Click over to our Facebook board.

Pro Guidance Changes: Medtronic, Paycom, SPY, More

Published Mar 5, 2018 at 2:37PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Apple** (NASDAQ: AAPL): Fair-value estimate increases to $166. Shares remain a Buy with a 4.7% allocation.
- **CME Group** (NASDAQ: CME) arrives to the *Pro* Port as a Buy at a 2.5% allocation. Please see our alert.
- **Facebook** (NASDAQ: FB): Close your March 2018 protective collar, per our guidance in today's alert.
- **Medtronic** (NYSE: MDT): Fair-value estimate increases to $80. Shares remain a Best Buy Now at a 2.4% allocation.
- **NVR** (NYSE: NVR): Fair-value estimate increases to $2,750. Shares remain a Buy with a 2.8% allocation.
- **Paycom** (NYSE: PAYC): Fair-value estimate jumps to $90 on increasing margins and strong growth. Shares remain a Buy at a 4% allocation.
- **SPDR S&P 500** (NYSEMKT: SPY): For those who want to hedge, set up a synthetic short per our new alert. As of this afternoon, the net debit to set up this short is down to about $1.60 per syn short, considerably lower. And that's fine.
- **Verisk** (NASDAQ: VRSK): Fair-value estimate increases to $88. Shares remain a Buy with a 2.3% allocation.

- **Verisign** (NASDAQ: VRSN): Fair-value estimate increases to $100. Our covered strangle is set to expire in June.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **CME Group**: We bought 500 shares (a 2.5% allocation) at just more than $165.
- **Oracle** (NYSE: ORCL): We set up 10 contracts each of a diagonal call (a 0.6% allocation), buying to open January 2020 $30 calls and selling to open June 2018 $52.50 calls for a combined net debit of $20.33 each.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Set Up a Split-Strike Synthetic Short on SPY

Published Mar 2, 2018 at 12:44PM

Is this for you? As ever, take your time. Assess. We're not worried, just adding some extra prudence. So see if this makes sense for you. This is for any *Pro* member who *wants* a market hedge and who uses a margin account. This split-strike synthetic short will gain and lose value as the underlying index falls or rises. Those wanting to hedge in an IRA, or short SPY directly, can consider the alternative trades at the end of this report. Here's a reminder about why and how we hedge in the first place.

How You Follow Along

- **Trade:** Use a spread or two-legged order to set up a synthetic short on the **SPDR S&P 500** (NYSEMKT: SPY):
  - Sell to open January 2019 $285 calls.
  - Buy to open January 2019 $255 puts.
- **Allocation:** *Pro* is hedging 15% of its long investments (cash excluded), which for us means a hedge of approximately $433,000. So, we're setting up 17 contracts of each option, or shorting exposure of 1,700 shares at $255, which is worth $433,500. At home, for a 15% allocation, you would set up one syn short for every $173,000 or so in long exposure you carry. Said differently, set up one of each option for every $25,500-equivalent hedge you want (that's based on the $255 put strike price times 100).
- **Price (11:50 a.m. ET) and Guidance:** With the ETF at $267.24, a debit of about $4.40 is necessary (that's $440 per syn short). That price will go higher if SPY falls, and be cheaper if SPY rises. (If you want to decrease the cost of the syn short, you can buy puts at a lower strike, but they won't be as responsive.)
- **Later Guidance:** If SPY moves much in price before you act, you may want to move *both* of your strikes up or down accordingly, to continue to roughly straddle SPY's price with calls that are about 7% out of the money and puts that are about 3% to 4% out of the money. If the price changes much before *Pro* can make its trade, we'll adjust accordingly.

What We're Thinking

After a lot of noise in January and February, the S&P 500 is (lately) just about flat on the year. The severe swings in the market -- up 7.4% in a few weeks in January, then down 10%, then back up a bit -- suggest that investors are having a hard time deciphering the current economic picture. And why wouldn't they?

Tax rates are headed lower, which should boost earnings at most U.S. companies. Unemployment is low, but overall GDP is growing at about the same rate as it has for years, and wages aren't rising much. Inflation is ticking higher and faster now, and interest rates are, too. Bonds are being punished. The dollar is falling to the euro. And it currently looks like the president is likely to slap high-profile tariffs on some items (why the White House has the ability to impose tariffs unilaterally is an interesting debate for another time!). The economic landscape is shifting in multiple directions at once, and in light of that, investors are attempting to arrive at a reasonable valuation for stocks based on future growth. It's a battle between buyers and sellers.

Meanwhile, in the past few years we've bought several promising companies as we continue to position ourselves evermore for an economy that runs on data (sorry, Dunkin'!). From Paycom to Square, from Verisk and Skyworks to Tencent, we're investing in companies that are capitalizing on the cloud, mobile, data, connectivity, gaming, and more. But this also means that our net long position has grown -- from an average of 67.7% in 2016 to 81% in 2017 and now to 91% net long.

We wanted to increase our long investments, knowing that once we did, we would move to reduce our net long exposure with shorts. Our increased longs should drive our total portfolio value -- even with added shorts -- higher than we would have enjoyed without them. If the market rises, putting pressure on our syn short, we're banking on our long investments to carry us much higher overall. Meanwhile, this position gives us 7% breathing room before SPY hits our short calls, so overall we can still target North Star-type returns for the portfolio as a whole in 2018 -- as long as our 90% allocation to long investments in aggregate outperforms the drag of this 15% short, which we believe it will.

Why This Strategy

This particular position is a *split-strike* synthetic short, because the two strike prices differ. Its effect on our portfolio is similar to that of shorting SPY, but with some leeway. This syn short ends in losses if the S&P 500 goes nowhere (we lose what we paid to set it up) or if SPY rises above our short call's strike price, which would increase our loss. The syn short provides gains if SPY declines and we close it early, or if SPY declines below our long put's strike price by expiration. (There's also our cost to set it up, so that would be about a 6% decline in SPY from current prices.) If SPY remains between our two strike prices ($255 and $285), the position will be on track to expire, only costing us the initial setup price, which is about 0.3% of the portfolio.

If SPY rises, we could end up accepting short shares of SPY through our short calls (rather than closing those calls for a loss). And we might-could (a favorite phrase) write covered puts on those shares until we end the position. On the flip side, if SPY falls, we can sell our puts for a profit anytime, or turn them into short shares and stay short. We'll cross that bridge! Overall, we like this syn short because it gives us significant upside breathing room (6.8% right now) on the index before our short calls are actually in-the-money.

Of course, you don't need to set up this short if you don't want to. Only do so if it makes sense for your situation. Given *Pro*'s goals, we want to take more steps to earn profits on a decline -- profits we can then reinvest in long positions. This short is one step among several we are taking or plan to take to profit on a flat or falling market.

Alternative Trade

- **IRA-Friendly:** If you're using an IRA and can't set up a synthetic short, you can consider a bear put spread. Sell to open January 2019 $245 puts, and buy to open an equal number of January 2019 $255 puts. This will lately cost you about $2.66 per spread (again, not cheap right now, but that's all you risk, no more -- $266 per spread). Set up as many spreads as you care to risk. The position has a maximum value of $10 ($1,000) if SPY ends below $245, and the spread ends worthless if SPY stays above $255. If SPY moves much in price before you set it up, you may want to move your strikes accordingly, still aiming to pay less than $3 for a $10 spread. Just realize a spread like this needs to be closed near expiration to earn most of the profit.
- **Short SPY directly:** You could sell short SPY shares directly if you prefer, in your preferred allocation. It's an immediately responsive position, up or down. You'll need to pay out the quarterly dividend yourself. We like that our syn short gives us 6.8% upside until our short call strike, but you may not care about that.

Pro Can Help

- **Want to talk about our SPY hedge strategies?** We have a discussion board for that.

Pro Catch-Up Trades and Upcoming Expirations: Coherent, Oracle, and More

Published Mar 1, 2018 at 1:57PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Coherent** (NASDAQ: COHR): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.8%.
- **Oracle** (NYSE: ORCL): Buy up to 3.6%.

Continue building your portfolio with our Buys, including:

- **CME Group** (NASDAQ: CME): Buy 2.5% per our new alert.
- **NVR** (NYSE: NVR): Buy 2.8%.
- **WisdomTree Emerging Markets Small-Cap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Cooper Companies** (NYSE: COO): With a buy/write order, set up a covered call by simultaneously purchasing shares and selling one May 2018 $240 call contract for every 100 shares you purchase. Recently, this position could be set up for a net debit of roughly $221.60. Our target position size is 2.5% to 3%.
- **Gilead Sciences** (NASDAQ: GILD): Per our recent alert, sell to open May 2018 $85 calls, lately paying you about $1.77 each, or 2.2% on the recent share price of $79.26. Sell one call for every 100 shares you own and want to cover.
- **Oracle**: Per our recent alert, set up a diagonal call on Oracle with about 0.6% of your capital by simultaneously purchasing January 2020 $30 calls and selling an equal number of June 2018 $52.50 calls. Aim to do so for zero net time value. Recently, with shares at $50.30, that translates into a combined net debit to set up both sides of the diagonal of roughly $20.30 or less.

Upcoming Expirations:

- **Facebook** (NASDAQ: FB): Our $170/$200 protective collar expires on March 16. We plan to close it before then, for some value, with a trade alert.

Your Questions Answered on Facebook, Paycom, Coherent, SVXY, and More

Published Feb 28, 2018 at 2:23PM

The *Pro* team held a live video chat recently to answer members' questions. Here are some of the most popular questions and answers!

Q: Some report that Facebook (NASDAQ: FB) is losing teenagers at a rapid pace. Does this concern you?

Jeff: I've read those reports too, and we saw them ... I looked back and we saw them as early as 2012, 2013, when we first bought shares and calls, and so far it doesn't concern me. It's a very tiny part of their obviously enormous user base, and it's mostly U.S. teenagers, and a lot of them are moving to Instagram instead. I think a lot of Facebook users cycle in and out of the service, but the stickiness of it is that so many of your peers and friends are there that you'll come back to it; as of right now, it doesn't concern us, but it's something we have our eye on. Even more than that, as we talked about this morning as a team, we want to see how Facebook's changing algorithms for its news feed change traffic this year. We believe they can manage their revenue very well given the demand that they have for their advertising, as long as ad prices stay up -- and that depends on traffic being responsive to the ads.

But we may keep a collar on Facebook ... at least for the next few quarters, just because of the unknown regarding how they're managing the business. I believe, as said earlier, that they want to manage the quality of the community even more than their financials, and they'll take short-term hits to do that. Which is fine with us, but we're going to hedge. Since it's a large position, we plan to hedge a portion of it around each earnings report. That said, our current collar is running its course, it's at a small profit right now. We may just close it soon, because no earnings are on the corner and it expires in less than a month. But currently, we're not concerned about watching the teenage story.

Q: Facebook is on the defensive about Russian interference in the election. Are we still comfortable?

Jeff: We're comfortable with our position as it stands, and we're looking at putting a collar on it during our financial results for at least the next quarter or two. But it's news that we're watching closely, and we do believe Facebook wants to do right and to make the community stronger and make it all legit and weed out as much as they can. And hopefully, with time, you can almost entirely weed out fake accounts and bots and things that are destructive like that. You have to hope so. But we're watching that, and we continue to be comfortable with our stake as it is. That said, newcomers to Facebook should start with -- as we say with every position across the board -- no more than 3% to start and go from there.

Q: Given the current market volatility, should we be more or less ready to write puts?

Billy: I can jump in on that one. I think as we start to see more volatility and the VIX level goes higher, puts become more attractive to write, because the premiums are going up as the time value is affected by that volatility. I'm not sure if you're really asking this from a general perspective or from *Pro*'s perspective. In our meeting today, Jeff and JP and I discussed potentially writing some puts on some of our ideas, so we are throwing that idea around. But I think more important then current market volatility when it comes to writing puts is whether or not you want to buy the shares of the companies that you're writing puts on.

That's really the reason that you write a put, and you have to be ready to accept shares of whatever company you're writing a put on. If you don't want to buy shares, then you probably shouldn't be writing those puts. So if there are companies that you like that you're interested in buying and you want to target a lower price, now might be a good time to think about writing more puts, because we have an elevated VIX level -- much higher than it's been over the last year or two years. So you'll get paid a little bit better, but make sure that you really want to buy the stocks that you're targeting.

Jeff: It has been nice to see the VIX higher for that pro-rating purpose, and it's made us look -- as Billy has said -- at other potential income or option positions. And when we add the diagonal call on Oracle to the portfolio, we are looking at having five income-based positions: American Tower diagonal call, Home Depot diagonal, Cooper covered calls, Verizon covered strangle, and then Oracle, so five alone there, and we'll have staggered expiration dates a lot of the times.

J.P.: We may even have some more coming down the pipe, too.

Jeff: That's exactly right, so we're not stopping there. So, yes, I would be more ready to use options in general now that volatility is up a bit.

Q: Paycom (NYSE: PAYC) is the only Pro position I don't have. I've written puts a couple times, but no shares. How to proceed? Buy at this price or wait for a pullback?

Jeff: The stock is ready to buy, and it's above our fair-value estimate, which is in the process of being updated. But as a buyer, you can buy some shares. We have, I think, 3.5% -- let me make sure and check -- 3.8% now, a 3.8% position. I would say buy part of that, maybe you start with 1.5% and then wait and see what happens from there, and look to write puts when the premiums are good, or buy more on a big dip.

The stock is $97 now; it's really been a strong performer, and the good thing about that is, in a lot of cases anyway, strong performers continue to be strong performers. And Paycom has a sort of runway for its revenue and its profits that make it look like it could be a strong three- to five-year performer going forward, as well; that's our hope. It is rated Buy -- as many shares as you're comfortable with up to around 3.8%. Maybe you start with a third of that, or half, but seeing the latest earnings, we're not taking it off of Buy. It's staying at a Buy.

Q: Has your position on Coherent (NASDAQ: COHR) changed?

Jeff: It has not. The stock is rated Buy; I have posted an update. The shares fell despite record results and a record outlook for 2018, which is basically all booked already, and they're billing capacity for 2019. Shares mostly fell, it sounds like, because of concern out there about OLED screens moving aside in favor of micro LED, even though that technology is really years away from being available at a consumer level.

OLED continues to advance, and they find new ways to make it better and more efficiently; OLED is likely to stay with us for a long time to come. Why is this important? Because part of what Coherent designs and sells are laser systems that help you make OLED screens. That said, you can bet that they're working on micro LED technology lasers to help you make those next, so they should meet that demand when it arises. I'm a little surprised how concerned the market is, and that's why I'm looking to learn more about that, and learn why investors are as concerned as they seem to be with Coherent. That said, the stock does trade with volatility; it has for the past year or two, at least. Now it's at about 14 times earnings, 17 times cash flow, and we rate it a Buy. We're staying at a Buy. Our position size is 2% flat, and it's a Best Buy Now, so our stance hasn't changed; it's recommended as a 2% holding.

I should add that Coherent management itself says they see no change in the market right now regarding OLED, and they're not concerned about Apple, either. Apple is investing in micro LEDD producers as well, though, so I think it's the market overreacting right now with some concerns about Square and a possible pullback.

Q: How do you view Square (NYSE: SQ) relative to Mastercard (NYSE: MA) and Visa (NYSE: V)? Similar exposure, similar industry, but different type of business.

Jeff: What I like about Square is that they are agnostic as to how you pay -- they're just a means of payment. They're a transaction interloper, transaction middle person, basically, and whether you use Visa or Mastercard or PayPal or, they say, any future form of payment, they want to be there and be able to provide it. I view them in some sense as a little bit of diversification potentially away from MasterCard and Visa, if those two forms of payment start to lose out to some other new form of e-payment. Or PayPal -- Mastercard has a big partnership with PayPal, too. Square may benefit by being agnostic and being able to switch quickly to whatever platform is taking off, so I do like that about it. If Square were only tied to Mastercard and Visa, then I don't know that we would have bought it, because we'd have too much exposure to those two brands in that case.

Q: I bought about 2% of my portfolio's worth in SVXY (NYSEMKT: SVXY) at about $11. Do I keep it?

Jeff: That's a great question. The easy answer is, are you comfortable keeping a whole 2% in it? We had 2%, up to 3% at one point before we learned just how quickly it could lose 80%. You have to be comfortable with potentially losing all 2% overnight, because it could happen. If that doesn't feel good to you, then cut it down until you are comfortable. Shave it to 1.5%, then 1%; get to the point where you are comfortable. We only have 0.3% ourselves. Any thoughts you two would like to add?

J.P.: I would say my view on these type of vehicles -- and I guess one of the great things about working on *Pro* and for the Fool in general is that we all have slightly differing opinions -- in my view, for a lot of these of vehicles, [you can] be a little bit more tactical and methodical with your approach in terms of setup. "OK, I want to trim back to this after I've achieved a certain measure of profits, and maybe I'll cut half after I've made a certain amount, and then if it falls, I can add to it, assuming I still like it." But like you said, the overriding factor here, before you even consider anything like that -- like how much or how long do I want to hold it and stuff like that -- is, "OK, am I comfortable with risking this much?"

Because this is not a business that is compounding intrinsic value day in and day out. This is a completely different beast, and so the inherent advantages that come from buying stocks of great companies and holding them for extended periods of time are not embedded in buying something like the SVXY. So you just have to be comfortable with knowing that the risks -- the going-concern risk, the risk that this position for some reason or other goes away overnight -- are, in my opinion, exponentially higher than with something like Apple. Pick any company in the portfolio, any long position, any short position -- this one clearly has the highest risk, so you need to take that into consideration when you're deciding the allocation size. I don't know this individual's risk tolerance, their goals for this position, their goals for investing in general, and so it's really hard to give a more tailored answer than to say, "Know thyself, know what you want out of it before you decide what to do."

Jeff: It's true, J.P., and I should add that my original hope for the position is not working out ... is no longer playing out. The hope was that it could rise 100% and then 200%, and when it did decline it would decline 30% to 50%, but then it would climb again from there, so that it would over the years compound. That's why we bought this vehicle instead of shorting VXX. The hope was it'll grow over time. Now we can no longer hang our hat on that, and that's why we're we're ditching the whole hope that SVXY will add long-term value to the port. We're looking to make up for that with new positions.

J.P.: I would say also that it's worth reconsidering, what is the risk or the odds that something like this happens again? We saw billions of dollars wiped out overnight, and so you would think that the speed at which capital flows back into this type of vehicle is going to be a lot slower. So if that's the case, then maybe there is an argument for us returning to your original thesis, where the vehicle slowly grinds higher and any declines -- even though they may be sizable -- are ultimately recoverable.

That's another thing to consider when you decide whether we should hold or sell it, and so my kind of off-the-cuff guess is ... maybe we are getting back to that environment. Maybe we're going to look back here five years from now and be like, "Man, the single smartest decision we made it for the portfolio was not selling SVXY because that thing has come roaring back." You don't know, but that is something I am actually thinking is a possibility, and at least for the time being argues for holding it and maybe even adding to it.

Jeff: I'm trying to get in touch with ProShares to learn how they managed it during periods of extreme volatility like we just saw, because the reason they stayed alive is they didn't trade the futures in the aftermarket hours, which were just insanely off the charts -- that's what killed XIV. It rolled its futures and had nothing left to roll with, and ProShares held off and waited until the futures prices came back down. So if they have a lot of flexibility in rolling when they want to, like if they could even wait days to roll and let the futures come back down first, then SVXY will have staying power, because they can just sit on their old contracts and wait. They have a few months. But if they believe they need to roll each day, then the risk is higher. But the prospectus ... doesn't dictate that they need to roll each day; it leaves that unclear.

That's what we're trying to clarify. And who knows, J.P.; maybe if they have some ability to keep managing it better than just a daily roll, then maybe we'll like it more than we do right now. Final thing I'll say is that we invested 1.3% on Day One in SVXY -- the recommendation was for 1.2%, but we invested a bit more because it went up and so we wanted to match members. Keep that in mind; maybe you bring your 2% down to what we originally invested, because we never added to it after that.

Johnson & Johnson's Pharmaceutical Division Propels Growth

Published Feb 28, 2018 at 12:57PM

Fourth-Quarter and Full-Year 2017

- Press Release
- Earnings Presentation
- Supplementary Sales Data
- Sales of Key Products & Franchises
- 10-K Filing

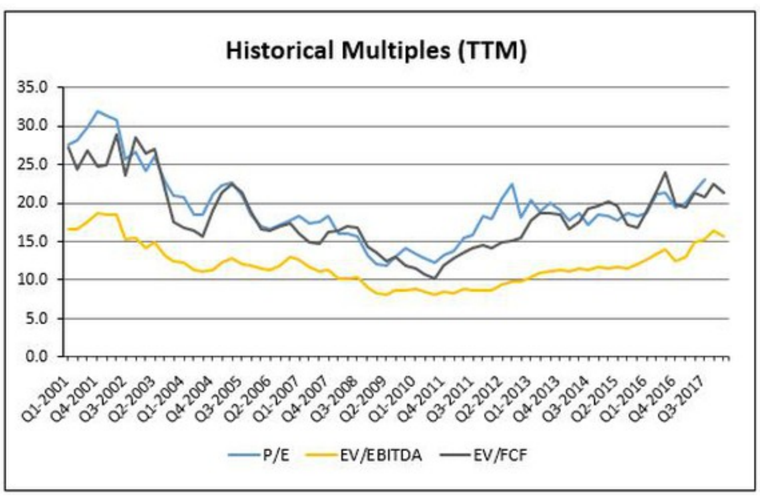
Johnson & Johnson (NYSE: JNJ) posted a good quarter and capped off a resurgent year in Q4 2017, reporting continued acceleration in revenue growth driven by the company's pharmaceutical division. J&J reported 11.5% company-wide sales growth, led by 17.6% growth in the pharmaceutical division, which accounts for 48% of total sales.

GAAP earnings for the quarter were negative, reflecting a provisional charge of $13.3 billion for the recently enacted tax legislation. On an adjusted non-GAAP basis, J&J posted 10.1% year-over-year EPS growth for Q4 and 7.6% EPS growth for full-year 2017. Management's guidance for 2018 is for 6% revenue growth and for 11% adjusted EPS growth.

While 2017 was an excellent year for revenue growth after a couple of years of stagnation, the company's GAAP earnings and margins were significantly affected by the $30 billion Actelion acquisition and tax legislation. I'm curious to see how the pharmaceutical segment continues to perform in 2018 and how the company's margins trend once the non-recurring items (acquisition costs and tax legislation) normalize. Additionally, J&J is holding a deep-dive presentation in May about the consumer and medical-device businesses, and I'm interested to hear more from management about how they plan to manage those businesses -- particularly the former, which continues to experience an eroding moat.

- **Updated guidance**: Best Buy Now (no change)
- **Recommended allocation**: 2.9%
- **Fair-value estimate**: $137 (no change)
- **Current price:** $131.27

At about $131 per share, the stock is priced at about 15 times trailing-12-month (TTM) EBITDA and about 21 times TTM free cash flow:



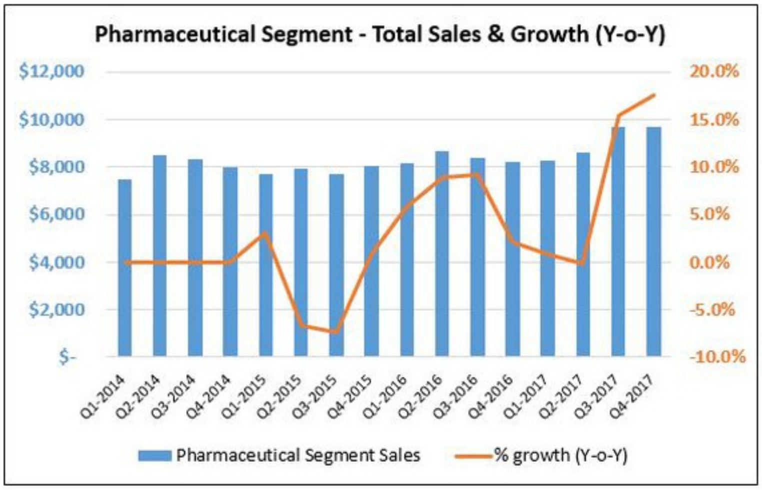
Having sold off a bit since earnings, the stock is currently about 11% below the level it was trading at before the Q4 earnings release. Based on management's guidance, J&J is priced at about 16 times next year's non-GAAP earnings, which is attractive considering that the S&P 500 is currently trading at about 25 times earnings. Additionally, J&J is set to increase its dividend next quarter, and the dividend yield will likely approach 2.7%, a level we haven't seen since early 2017 when the stock was trading around $120 per share.

Our fair-value estimate remains at $137, and Johnson & Johnson remains a Best Buy Now. Members who have yet to start or fill out their position can feel comfortable doing so at current prices, although it is important to keep expectations in check with this stock. Because of its large size and modest revenue and earnings growth, JNJ is not likely to produce outsized stock-price gains.

Since our original purchase in February 2017, the stock is up 7.8% and we've collected more than $2,000 in dividends, good for a 2.7% yield on our original investment, combining for a 10.5% total return. This is exactly the type of return we expected from J&J when we made our original investment, and we can continue to expect a growing stream of dividends and modest earnings growth to propel our investment to North Star-challenging returns over the long run. We may also consider utilizing covered calls to add additional income to the position.

Segment Performance

JNJ's pharmaceutical division continued to experience strong growth in Q4 2017, bolstering the entire company's results given that this division is the company's largest by sales volume (48% of TTM sales):



The Actelion acquisition continues to show benefits, as JNJ's pharmaceutical division posted 17.6% year-over-year growth (up 7.6% excluding acquisitions). We also continued to see strong growth from drugs in the oncology market, with Darzalex (sales up 86% this quarter) and Imbruvica (up 51%) leading the pack. The company's oncology drugs look set for continued growth and should help offset declines in other drug products that are declining (Remicade) or facing upcoming competition later this year (Stelara, Zytiga). Additionally, JNJ's pipeline is promising, with the expected regulatory approval and launch of 10 new drugs by 2021 (with two approvals expected in 2018) that each have $1 billion in peak revenue potential.

In addition to the strong growth from the pharmaceutical division, the consumer division and the medical device division posted year-over-year revenue growth of 3.1% and 8.3%, respectively. Companywide operational sales growth (ex-acquisitions) came in at 2.4% for the quarter.

Our Thesis

Johnson & Johnson is is a diversified health-care conglomerate, with more than 260 operating companies organized into three business divisions: consumer, pharmaceutical, and medical devices. At eight out of eight of our *Pro* quality criteria, J&J is a quintessential *Pro*-quality stock. While its large size means we don't expect runaway growth and upside, we do expect to earn North Star-challenging returns with low downside risk from one of the safest stocks you are likely to find in the entire investment universe.

Pro Can Help

- **Questions?** Bring them over to the J&J discussion board.

Write Covered Calls on Gilead Sciences

Published Feb 26, 2018 at 3:23PM

Is this for you? This is for *Pro* members who own at least 100 shares of Gilead Sciences, and who wouldn't mind capping upside in return for near-term income. Those who *don't* own the stock can buy at least 100 shares to write covered calls, matching our 2.2% allocation. Those who own less than 100 shares as a full allocation can continue to hold them.

How You Participate

- **Action:** Sell to open May 2018 $85 calls on **Gilead Sciences** (NASDAQ: GILD).
- **Allocation:** Write ("sell to open") one call for every 100 shares owned. *Pro* will cover all 900 shares owned, representing 2.2% of the portfolio.
- **Price Guidance:** Prices will change as the stock moves, but **use a limit order** to split the option's current bid/ask spread. When we quoted it, that was $2. Later, aim for at least a 0.7% yield (option premium/current stock price) per month to expiration; with shares at $80.60, the minimum to accept when writing these calls is thus about $1.82.
- **Guidance Change:** The stock moves to Buy (and Write Covered Calls if you can) at a 2.2% allocation.
- **Prices** (11:15 a.m. ET):
  - Gilead: $80.60
  - Sell to open May 2018 $85 calls (bid/ask): $1.99/$2.01 (at your broker, click "See All" strike prices to see these)
  - $2 pays 2.4% ($2/$80.60) in 81 days.
- **Alternative Trades:** You can write a higher strike (May or June $87.50) if you want more breathing room, or a slightly lower strike if you want a higher payment.
- **New to this position?** Ideally using a covered call order, but at least 100 shares and simultaneously sell to open these calls, selling one call for every 100 shares you buy and want to cover. Lately, the net debit per share is about $78.60, with upside to $85.
- **Important dates:** Gilead will go ex-dividend for its quarterly $0.57 per share payment on March 15 and we will see earnings in late April or early May.

What We're Thinking

We've been waiting for stability in Gilead's young and giant — but shrinking — Hepatitis C franchise, and this year management suggests it's coming. Competing drugs are no longer arriving on the market, so pricing should stabilize; and patient starts are falling into a more predictable pace and pattern. "Falling" is still the right word, though.

Gilead still expects 2018 revenue to decline considerably from last year. Top brass predicts $20 to $21 billion in total 2018 sales, down from $25.7 billion in 2017, all due to Hepatitis C declines. But investors are just happy to hear the word "stability" when it comes to this franchise as 2018 advances. CEO John Milligan said this month (a little prematurely), "After years of having to be defensive about HCV revenues declining, it's very nice to be on the other side of that and talk about the positive trends going forward..." By mid-year, Gilead expects its market share in the market to be stable.

Meanwhile, Gilead continues to dominate the HIV drug market (its second-largest revenue generator), and new drug approvals promise that it will continue to treat patients more effectively than competing drugs. Still, HIV and new acquisitions in Kite Pharma and Cell Design Labs aren't enough to kick Gilead's business back into growth right now. But the shares are inexpensive enough that we're comfortable keeping them and returning them to "Buy," and we're comfortable writing covered calls (as we have done several times now) for income.

The $80.60 stock trades at 12.5 times expected 2018 earnings per share, and about 8.1 times our estimated free cash flow this year of $13 billion.

Why This Strategy?

Last year, writing covered calls helped us achieve a North Star return on Gilead. The stock yields 2.8%, and with covered calls we can work toward at least a 10% annualized return, ideally, even if the shares are rangebound. Our first covered calls on Gilead this year pay us 2.4% on the current share price in 2.7 months, while still giving us 5.4% in upside to our strike price. We'll manage the calls as needed with future trade alerts. We're also writing calls because, lacking revenue and earnings growth, it seems likely that Gilead's stock won't take off on us. But if it does, as is always true with covered calls, we may need to let our shares go if we can't roll our calls higher at a reasonable cost.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up:** If the stock price rises above our strike price by expiration, we may let our shares get sold; it's more likely right now, though, that we'd roll our calls to a later date or higher strike. We'll cross any such bridge near expiration once time value is dissipating from the calls.

Pro Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the Gilead board.

Submit

Pro Guidance Changes: CME Group, Broadridge, Gilead, SVXY

Published Feb 26, 2018 at 3:23PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **CME Group** (NASDAQ: CME) arrives (returns!) to the *Pro* Port as a new Buy at a 2.5% allocation. Please see our new alert.
- **Gilead Sciences** (NASDAQ: GILD): Shares move to Buy (from Hold), at a 2.2% allocation, with the caveat that it's a Buy/Write Covered Calls position. We recommend selling May 2018 $85 calls. See the new trade alert.
- **Broadridge Financial Solutions** (NYSE: BR): Fair-value estimate increases from $79 to $82. The stock remains a Buy.
- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): Moves to Buy (from Hold) at a 0.3% allocation, with the caveat that you have to be ready to lose this whole investment if VIX futures skyrocket in a single day (up 100% or more) and ProShares decides to roll their futures that day anyway. It's that simple (in February, they waited to roll the futures, and stayed alive as a result). So only invest what you're comfortable losing. We intend to manage/trim this position if and when it grows.

Pro Completed Trades (see transaction log; trades take a day to appear):

- We are still working to complete our recently recommended trades on **Oracle** (NYSE: ORCL) and **CME Group** (NASDAQ: CME) ourselves. We hope you got 'em done!

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Broadridge Benefits From Event-Driven Revenue

Published Feb 22, 2018 at 3:31PM

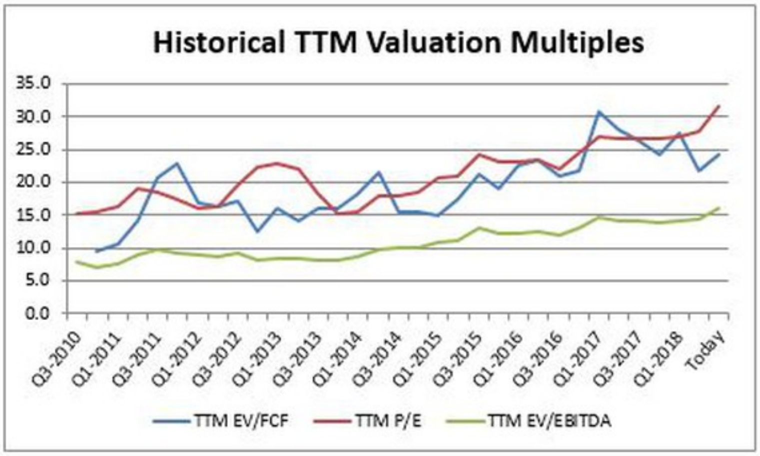
Fiscal Q2 2018

- Recurring fee revenue growth (year over year): Up 4.9% to $562 million (16% TTM growth)
- Closed sales growth (year over year): Down 30.4% to $39 million (6.4% TTM growth)
- EPS growth (year over year): Up 108% to $0.52 (28% TTM growth)

Broadridge (NYSE: BR) reported a solid fiscal second quarter for 2018, and as a result, management raised its full-year guidance for revenue, earnings per share, and free cash flow. However, the strong performance for the first half of the year can be partially attributed to record event-driven revenues that are both non-recurring and unpredictable. Additionally, closed sales for the quarter were somewhat lackluster, and the company will have to make up the sales deficit in the back half of the year. Nonetheless, recurring fee revenue continues to grow at a steady pace, and Broadridge is poised for continued growth into fiscal 2018 and beyond. Our provider of investor communications continues to improve margins and expand its core business at a consistent clip, producing significant amounts of cash flow from a capital-light asset base. Broadridge is well positioned to continue to achieve North Star-like returns over at least the next three years.

- **Updated guidance**: Buy (unchanged)
- **Recommended allocation**: 6.4%
- **Fair-value estimate**: $82 (from $79)
- **Current price:** $100

Based on management's recently raised guidance, at $100 per share, the stock is priced at about 25 times projected 2018 cash flow and 30 times projected 2018 GAAP earnings per share:



After incorporating fiscal Q2 2018 results, **our fair-value estimate increases to $82 per share (from $79)**. Although the stock is up 11% since our last guidance update about two months ago, valuation multiples have stayed in the same range because of growing earnings and cash flow. Despite the strong business performance, the current price sits more than 20% above our newly updated fair-value estimate. **Broadridge remains a Buy** on our scorecard; if you've yet to establish a full position, you may want to consider buying in halves or thirds, waiting for a narrower premium to our fair-value estimate before filling out your position.

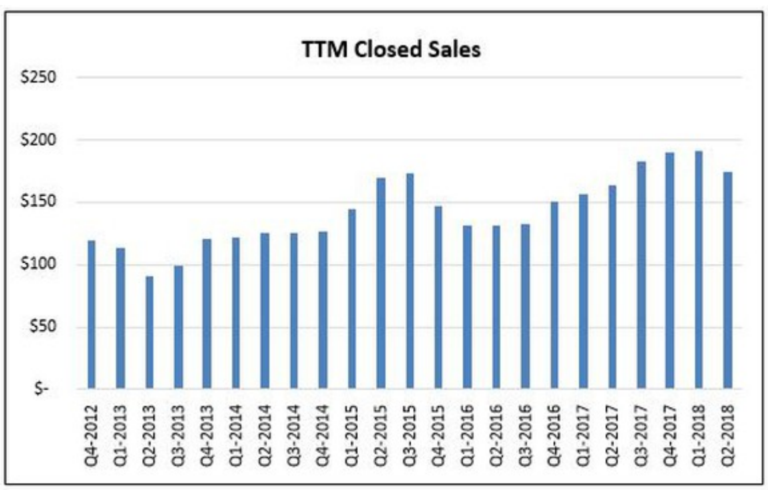
Our Thesis

Broadridge has a near-monopoly on proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record, and sound capital allocation policies make Broadridge a sturdy rock upon which to build the *Pro* portfolio. We expect modest growth in fee revenue (augmented by tuck-in acquisitions), slight operating leverage, plenty of free cash flow, and a growing stream of dividends and share repurchases to help achieve North Star-like returns.

The Most Important Things

1. Closed Sales: This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%-plus). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

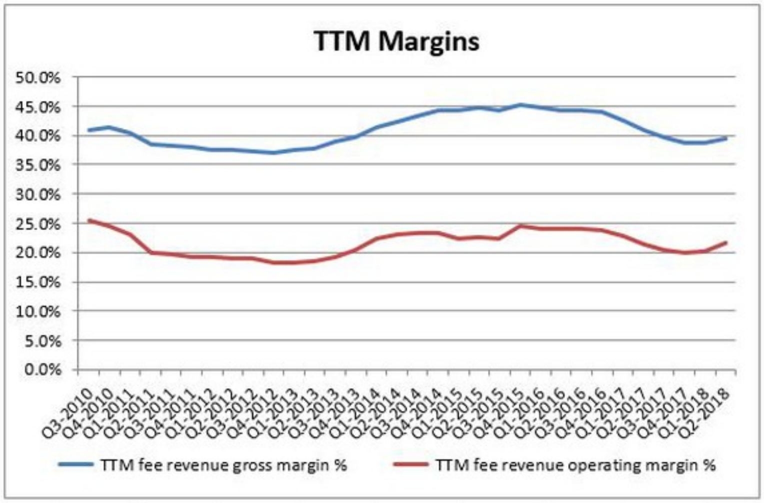
Of all the relevant metrics we follow for Broadridge, perhaps the most lackluster in Q2 2018 was closed sales. Broadridge reported $39 million in closed sales for the second quarter, down 30% from the second quarter last year. This was the first quarter since Q2 2016 that closed sales was lower than in the same quarter a year prior.



Management's guidance for closed sales for fiscal 2018 is $170 million to $210 million, and management reaffirmed that guidance in the conference call, mentioning a strong pipeline of sales. With just $62 million in closed sales for the first half of the year, the guidance implies that closed sales will be heavily back-end-loaded for the rest of fiscal 2018.

Closed sales do tend to be historically weighted more heavily toward the back half of the fiscal year, but the sales staff needs to pick it up in Q3 and Q4 to meet their annual guidance. The company beat the high end of its guidance for closed sales in fiscal 2017, and we'll see if Broadridge is able to repeat that performance in 2018.

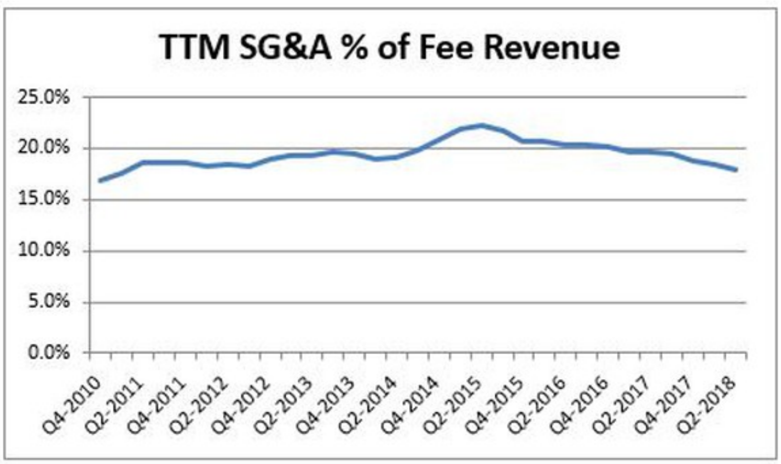
2. Fee-Revenue Margin Performance: In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers), we prefer to look at trailing-12-month (TTM) margins to smooth out quarterly fluctuations. TTM fee-revenue gross margins came in at 39.5% (down from 40.9% a year ago), and TTM fee-revenue operating margins came in at 21.5% (up from from 21.3% a year ago):



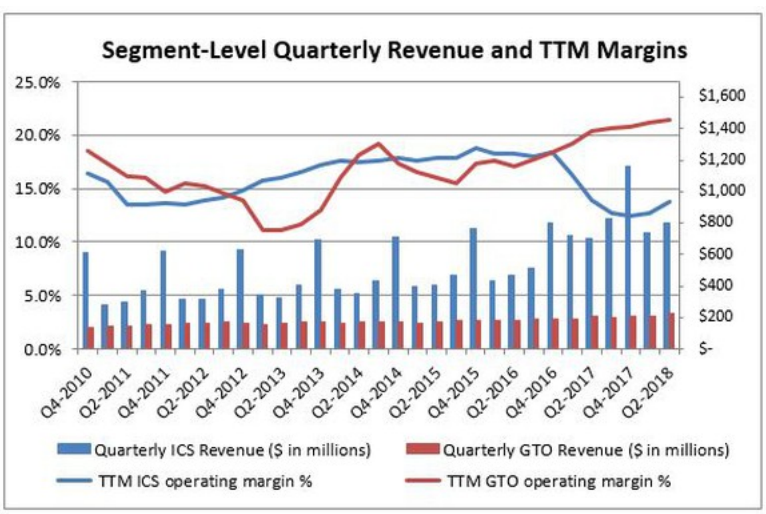
The reason for the decline in margins is the 2016 NACC acquisition. That business has a lower margin profile than Broadridge's legacy businesses, and it represents about 30% of total companywide revenue, so it drags down the margin profile overall.

However, Broadridge should be able to expand NACC's operating margins over time via scale, cost synergies, and improved operational efficiency, and we're seeing that play out in the financials.We can see from the graph above that both gross and operating margins have bottomed out, and the company reported expanding gross and operating margins on a quarter-over-quarter basis for the second quarter in a row.

An excellent indicator of Broadridge's ability to expand operating margins over time is the SG&A margin, which ideally will continue to drop over time as Broadridge continues to grow and improve the efficiency of its labor:



When looking at Broadridge's separate divisions, we can see that the non-NACC business continues to improve. While the Investor Communications Solutions (ICS) business has seen significantly lower (though improving) margins because of the acquisition, the Global Technology & Operations (GTO) business has shown strong margin expansion, generating a record TTM operating margin of 21.4%:



We'll want to monitor the ICS division's margins (expecting continued margin expansion as we progress through fiscal 2018 and beyond) to make sure the NACC integration is on track, and we also want to watch GTO to see whether recent margin expansion trends continue.

3. Capital Allocation: In the company's recent Investor Day presentation from December, we got a detailed update on how management plans to allocate capital between fiscal 2017 and fiscal 2020: targeting a 45% dividend payout ratio, and using up to $1.4 billion in incremental debt capacity and expected free cash flow for share repurchases and merger-and-acquisition activity.

Interestingly, we've recently seen the pace of Broadridge's share repurchases slow as the stock price has climbed over the past two quarters. After spending more than $240 million combined in Q3 and Q4 2017 on share repurchases when Broadridge's stock price was between $65 and $78 per share, the company has spent just $3 million on share repurchases in the first half of 2018 with the stock price ranging between $73 and $92.

Instead, management has preferred to let cash pile up on the balance sheet. Perhaps the company is gearing up for an acquisition, or perhaps management is being cognizant of valuation when repurchasing shares. In either case, I appreciate the non-mechanical approach to share repurchases.

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring organic revenue growth (augmented by tuck-in acquisitions) to translate to stout earnings and cash-flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Pro Can Help

- **Questions?** Bring them over to the Broadridge discussion board.

Buy CME Group

Published Feb 22, 2018 at 12:57PM

Is this for you? This is for all *Pro* members who lack exposure to this company. Why buy it now? Beyond being a strong long-term operation, the company should benefit from more interest rate volatility and asset pricing volatility that results.

How You Participate

- **Action:** Invest 2.5% of your portfolio in **CME Group** (NASDAQ: CME) (that's $2,500 for every $100,000 you manage; for *Pro*, that's about 500 shares, or $81,000 worth).
- **Recent Price Range:** $161-$163
- **Price Guidance:** At current prices, use a limit order for less than $161.50. Later, the stock remains a Buy until we guide otherwise.
- **Fair-Value Estimate:** $177
- **Alternative Trades:**
  - Seeking a lower buy price? Sell to open any puts that appeal to you, selling one put for every $15,500 to $16,000 (or choose your strike) in stock you can afford, up to a 2.5% allocation.
  - Want upside with less capital? Set up a synthetic long. Sell to open January 2020 $160 puts and buy to open an equal number of January 2020 $160 calls, aiming to pay little time value in the process. Each synthetic long represents 100 shares exposure worth $16,000.
- **Special Considerations:** CME yields 1.7% with its quarterly dividends; it also pays a special dividend in December that has ranged from 2.2% to 3.3% a year. That's a total dividend of about 4% to 5%, making it an income stock along with business growth.

What We're Thinking

As the world's largest exchange and clearinghouse for futures contracts, **CME Group** (NASDAQ: CME) is where the world goes to manage risk. And now, after years of low volatility for interest rates and equities, that risk (when defined as volatility) is likely beginning to revert to higher levels. Should this trend continue, it should lead to more business for CME. In the U.S., interest rates are headed higher, and in Europe, rates are likely to awaken from a long slumber, too. Currencies and energy prices are showing more volatility, and weather adversity causes uncertainty in crop prices, too. All this points to more need for risk management. Enter the leader: CME.

The Business

Investors, corporations, governments, and others all flock to CME for futures contracts they use to manage pricing and exposure risk. As a mostly electronic intermediary, the company requires few physical assets to run its business, and as a result it's one of the most profitable companies in the S&P 500.

Investors use CME's exchange because of its size, liquidity, transparency, and breadth of products. The company creates trading instruments, provides a market for them, matches prices, ensures settlement, sells market data, and serves as the counter-party on most transactions in order to reduce credit risk. In 2017, 16.3 million investment contracts traded on CME's exchange in an average day. The business serves six broad needs. Here's how volume shaped up last quarter:

Product Line	Average Daily Volume (in thousands)*	Percentage of Total
Interest Rates	7,970	50%
Equities	2,632	16.5%
Foreign Exchange	941	5.9%
Energy	2,489	15.6%
Agricultural Commodities	1,278	8%
Metals	616	3.9%
Average Daily Volume	15,925	99.9% (rounding leads to this!)

*Q4 2017, ended Dec. 30. Source: Q4 earnings release.

Last year, 85% of CME's revenue was earned from transaction and clearinghouse fees; 10.7% came from market data and information services; and 4.3% came from market access, communications, and other fees.

The company's expenses are largely fixed, so its profit rises with trading volume, which has steadily climbed the last decade. CME expands its business by introducing new products, attracting more investors, and entering new markets. CME also offers *options* on futures — for those who *really* love exotic investments.

What Are "Futures"?

A futures contract is a standardized agreement between two parties to trade a specific asset or instrument at a set price (the "future" price) by a set date (the delivery date). Futures have been used for hundreds of years, initially allowing farmers to ensure a specific price for their crops. Today, companies, governments, farmers, producers and others use them to hedge any number of costs: fuel costs, metal costs (in manufacturing), food prices, currencies, interest-rate risk, and more. Like an options contract, futures contracts offer leverage, too.

What Is CME Group?

CME Group owns the Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), the New York Mercantile Exchange (NYMEX), and the Commodities Exchange (COMEX). It also owns 90% of the Dow Jones' namesake market indexes (Dow Jones retains a 10% stake). CME Group was founded in 1898, and is headquartered in Chicago.

We expect U.S. trading volume to continue to grow, and CME is excited by the expansion opportunities that remain in Europe, Asia, and Latin America. In 2016 (the latest year available), only 24% of CME's trading volume occurred outside the U.S., though 50% of market data revenue was international.

Financials

CME's net income margin tops 40%, putting it among the highest of any holding in the *Pro* portfolio. Its immense marketplace provides customers with liquidity that many competitors can't match. CME owns 90% of the Dow Jones Industrial Average namesake market indexes and offers equity futures contracts on the Nasdaq and S&P indexes, some of them in exclusive deals.

In 2016 (again, the most recent year available), 82% of CME's business was conducted by exchange members who pay fees to take part. In the risk department, in that year 13% of trade and clearing revenue came from one member, and 11% from another, so it's important that CME maintains healthy relationships with its members. However, in the event that a clearing member leaves, its experience is that another one picks up the dropped volume.

The company's market value is $55 billion, its balance sheet is healthy, and shares trade at an estimated 29 times free cash flow (we await the annual 2017 10-K filing) and 24 times our estimated earnings for the year ahead. However, this is on the heels of a long period of low volatility for equities, interest rates, and currencies. January ended with record open interest (contracts that will likely be closed later) on all of CME's products, and about 18% growth in volume to new records (as of Feb. 1); and this was before the market went wonky. When trading volume picks up, CME's earnings can grow quickly.

Management affirmed confidence in its free cash flow on Feb. 7 by increasing its quarterly dividend by 6% to $0.70 per share, for a 1.7% annualized yield. Additionally, at the end of each year, CME pays a special dividend in relation to that year's earnings. It looks to dole out a large portion of its cash flow, and this extra dividend payout has averaged 2.7% since 2012, bringing the total dividend yield to above 4% annually on average. We'll take that strong yield alongside the prospect for long-term capital growth in a business that has a competitive moat and room to keep growing.

The *Pro* Bottom Line

CME qualifies as an excellent business at a good price. Volume in trading on its exchange has grown steadily over the years, and is lately hitting new records. We believe this increase will continue as volatility returns to more traditional levels on more assets. It doesn't hurt that we're entering unchartered waters, with the U.S. government adding fiscal stimulus and federal deficits despite a strong economy. That should breed uncertainty both now and when the next recession arrives. Meanwhile, we expect CME to lead its industry with new offerings (including its new cryptocurrency futures), to expand in newer markets organically, and to grow through acquisitions, all while managing its finances well for shareholders like us.

Pro Can Help

- Visit our CME Group discussion board to ask us questions or discuss it.

Pro Catch-Up Trades and Upcoming Expirations: Coherent, Oracle, and More

Published Feb 22, 2018 at 12:48PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Coherent** (NASDAQ: COHR): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.9%.
- **Oracle** (NYSE: ORCL): Buy up to 3.6%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 3.2%.

Continue building your portfolio with our Buys, including:

- **CME Group** (NASDAQ: CME): Buy 2.5% per our new alert.
- **NVR** (NYSE: NVR): Buy up to 3%.
- **OpenText** (NASDAQ: OTEX): Buy 2.9%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2.3%.
- **WisdomTree Emerging Markets Small-Cap Dividend** (NYSEMKT: DGS): Buy 2.1%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Cooper Companies** (NYSE: COO): With a buy/write order, set up a covered call by simultaneously purchasing shares and selling one May 2018 $240 call contract for every 100 shares you purchase. Recently, this position could be set up for a net debit of roughly $224.20. Our target position size is 2.5% to 3%.
- **Oracle**: Per our recent alert, set up a diagonal call on Oracle with about 0.6% of your capital by simultaneously purchasing January 2020 $30 calls and selling an equal number of June 2018 $52.50 calls. Aim to do so for zero net time value. Recently, with shares at $49.95, that translates into a net debit to set up both sides of the diagonal of roughly $20.

Upcoming Expirations:

- **Facebook** (NASDAQ: FB): Our $170/$200 protective collar expires on March 16. We plan to close it before then, for some value, with a trade alert.

Pro Guidance Changes and Completed Trades: Feb. 20, 2018

Published Feb 20, 2018 at 2:03PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **OpenText** (NASDAQ: OTEX): The stock moves to Buy (from Hold). We have a 2.9% stake. Fair-value estimate increases to $35.
- **Oracle** (NYSE: ORCL): We added an options strategy to our position, aiming for a 0.6% diagonal call position in addition to our 3.6% stock position. The stock remains a Best Buy Now.

Pro Completed Trades (see transaction log; trades take a day to appear):

- As per our recent dividend reinvestment alert:
  - **NVR** (NYSE: NVR): We bought 1 share, bringing our allocation to 3.1%.
  - **Tencent** (NASDAQOTH: TCEHY): We bought 58 shares, bringing our allocation to 3.1%.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Facebook, Tencent, and More

Published Feb 15, 2018 at 3:04PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Facebook** (NASDAQ: FB): Buy 3.8% (half our stake to start).
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.9%.
- **Oracle** (NYSE: ORCL): Buy up to 3.7%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 3.2%.

Continue building your portfolio with our Buys, including:

- **NVR** (NYSE: NVR): Buy up to 3%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy up to 3.8%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2.2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Cooper Companies** (NYSE: COO): Set up a covered call by simultaneously purchasing shares and selling one May 2018 $240 call contract for every 100 shares you purchase. Recently, this position could be set up for a net debit of roughly $223.75. The recent spike in volatility has meant that the $240 strike still meets our monthly income guidance despite the decline in the stock price. Our target position size is 2.5% to 3%.
- **Oracle**: Per our recent alert, set up a diagonal call on Oracle by simultaneously purchasing January 2020 $30 calls and selling an equal number of June 2018 $52.50 calls. *Pro* trading volume and today's stock-price increase of about 2% have resulted in a spike in the cost to set up this position; however, members should still aim to do so for zero net time value. Recently, that translates into a net debit of roughly $20.40.

Upcoming Expirations:

- None imminent.

Set Up a Diagonal Call on Oracle

Published Feb 14, 2018 at 1:34PM

Is this for you? This recommendation is for all *Pro* members who have matched our 3.6% stock allocation to **Oracle** (NYSE: ORCL) and would like to establish an additional diagonal call position to target leveraged upside and income. If you don't own stock in this Best Buy Now position already, we think you should match *Pro*'s 3.6% allocation first, then consider establishing this diagonal call position.

How You Participate

- **Trades:** Use a "diagonal call" or "calendar call" or "spread" order on Oracle to simultaneously:
  - Buy to open January 2020 $30 calls (click "view all strikes" if you don't see them) and ...
  - Sell to open an equal number of June 2018 $52.50 calls.
- **Allocation:** Invest approximately 0.6% of your *Pro* funds in the purchase of the 2020 calls. At recent prices, this most closely equates to setting up one diagonal call position for about every $320,000 you manage; for *Pro,* that's 10 contracts of each position. We'll spend about $19,700 to buy 10 calls. This is a small position by design, so be careful not to over-allocate. We already own 3.6% in the stock, and our exposure to Oracle grows to 4.2% with this long call. *Pro* members with smaller portfolios should see the Alternative Trades section at the end of this report.
- **Price Guidance:** At current prices, ideally the market makers will let you pay about an **$18.50 net debit** to set up the diagonal call (the cost of both buying the long calls and selling the short calls). Check current pricing, adjust as needed, and please **make sure you use limit orders,** aiming to split the wide bid/ask spreads, and move incrementally higher if need be; don't rush to complete this trade at any price! As prices change, continue to aim to pay no net time value to set this up (your short calls should pay for the time value present in the long calls; currently, the long calls have $1.04 in time value and the short calls pay you $1.20). Overall, ideally don't pay more than a total of $19 net to set up the diagonal call.
- **Prices** (as of noon E.T.):
  - Stock price: $48.66
  - Buy to open January 2020 $30 calls (bid/ask split): $19.70
  - Sell to open June 2018 $52.50 calls (bid): $1.20
  - Net debit: $18.50 per diagonal (or $1,850 each)
- **Alternative Guidance:** If the volume of trading among *Pro* members results in a significant impact on the options in this alert, or if the stock price changes considerably from the prices in this alert, consider looking at various other strikes for your long and short calls. Also consider looking at various other expirations for your short call, depending on what you like best. If you choose this route, be aware that *Pro*'s course of action may diverge from yours, depending on what strikes and expirations you choose, and depending on the stock-price movements of Oracle.

What We're Thinking

Lately up 113% for us and paying a 1.6% yield, our Oracle shares have slowly (and arguably safely) more than doubled members' money despite steady criticism from Wall Street -- and that criticism is not entirely unmerited. The company has only managed to increase its revenue by 0.9% annualized over the past five years, putting it well behind faster-growing software peers. In Oracle's defense, the shift from license software sales to cloud sales has meant taking a large upfront hit, though the company later earns greater revenue and cash flow from those same customers as they pay a monthly cloud fee (which adds up). So, there should be coiled-up potential hidden in Oracle's weak-looking growth, potential that will start to unfold in the next few years.

We've been waiting for this a long time. Assuming it starts to present itself, the growth will be further fueled by expanding margins at Oracle as the costs of building the cloud get spread over more customers. The cloud is now at an annual run rate of about $6 billion in revenue for Oracle -- and growing -- out of the company's more than $30 billion in annual software sales. Meanwhile, in December, Oracle shared that its pipeline of new business is larger than it has ever been.

The Business

Last quarter, Oracle's on-premise software license revenue rose by 1% to $6.3 billion, while cloud SaaS revenue jumped 55% to $1.1 billion. Total cloud revenue grew 44% to $1.5 billion, and total revenue grew 6% to $9.6 billion. Non-GAAP earnings per share grew 14%, continuing an impressive trend of growth above 10%.

In January, Oracle launched its first autonomous database -- a "smart," self-driving system that doesn't require humans to manage or tune it. Using A.I., it promises 99.995% availability time. When asked if customers are leaving Oracle, Chairman Larry Ellison pointed out that even such big names as Amazon.com, Salesforce, and SAP are sticking around. (That said, there are rumors are that Salesforce would like to migrate off the Oracle database by 2023, and we all know Amazon is wily and likes to control its own fate.) Regardless of those big names, CEO Mark Hurd added that Oracle continues to expand its business above the market growth rate.

The roughly $48 stock trades at about 15.7 times estimated earnings one year ahead and 17.4 times trailing free cash flow, making shares appear attractive. That's assuming Oracle can continue to convert customers to its more lucrative cloud offerings, and that its long-term goal of 50% operating margins materializes.

Why This Strategy?

Oracle's stock may not soar, but if it can gain 20% by 2020 -- to about $58 -- our calls should gain nearly 50% in addition to the income we earn on them along the way. We would obviously like that boost to our overall Oracle return, and we like the opportunity to target income now that options pay better, too. If Oracle *does* soar and our diagonal call shares need to be closed, we'll still own our shares, unencumbered. Meanwhile, our risk here should be reasonable. We're comfortable increasing our exposure to Oracle marginally and leveraging our cash via call options that also serve as an income platform.

More That Matters

- **Maximum loss:** Our entire 0.6% investment if Oracle stock is less than $30 at January 2020 expiration, less premiums received from sold calls.
- **Maximum gain:** On this trade, we have upside to $52.50 for our owned call. But we hope to keep the strategy going, rolling our short calls if need be.
- **Follow-up**: By expiration, we'll seek to write new calls or roll our $52.50 calls to a later month and higher strike if the stock is above $52.50. If there aren't attractive rolling opportunities, we will consider closing the entire position.

Alternative Trades

Members for whom one contract would over-allocate their portfolios can consider a few choices:

- If you're cash-rich, at least consider buying 0.6% more in stock, bringing your stake to 4.2%. Realize you won't benefit from the leverage calls provide, although you will have a better breakeven price and no expiration.
- Consider allocating 0.6% at most to a 2020 bull call spread. The in-the-money $40/$45 bull call spread offers attractive annualized returns if the stock price remains above the $45 strike price at expiration. Lately, use a limit order of about a $3 to $3.10 net debit. This gives you room to earn at least $1.90 per share on your $3 to $3.10 investment. (Our sister service, *Motley Fool Options*, offers what we think is an excellent overview of bull call spreads here.)

Pro Can Help

- **Want to know more about this strategy?** The Options U guide to writing diagonal calls can keep you on an even keel.
- **Questions about this trade?** We keep our own database on this company on our Oracle board.

Buy (More) NVR and Tencent

Published Feb 13, 2018 at 2:18PM

Is this for you? This recommendation is for all *Pro* members who have 2017 fourth-quarter dividends to reinvest, or who have ample cash to make a small additional investment and want to match us.

How You Participate

- **Action and Allocation:** Buy 0.1% more in each **NVR Inc.** (NYSE: NVR) and **Tencent** (NASDAQOTH: TCEHY), raising these positions to a 2.9% and 3.1% allocation, respectively. At recent prices, *Pro* will buy one more share of NVR and about 58 more shares of Tencent.
- **Price Guidance:** Use a **limit order** at the prices available when you place your order. We'll buy in the next one to 30 days.
- **Recent Prices:**
  - NVR: $2,919.94
  - TCEHY: $54.40
- **Guidance:** NVR is currently rated a Buy; Tencent is a Best Buy Now.

What We're Thinking

With the recent decline in the stock market, we believe now is as good a time as any to reinvest our 2017 fourth-quarter dividends into two stocks in which we have high confidence, both of which have fallen some from recent highs. In the fourth quarter (October through December), we collected $6,069.80 in dividends, which we're splitting between the two stocks.

NVR

Although NVR's stock is still outpacing our North Star by a meaningful amount since we first purchased shares in June of last year, the start of 2018 has not been kind; the stock is down by more than 20% since setting an all-time high of $3,700 a mere 25 days ago. Although the recent market weakness is likely partially to blame here, the bigger culprit appears to be the market's apathy toward NVR's fourth-quarter results.

Because the company doesn't hold quarterly earnings calls and receives very little sell-side coverage, the stock has a habit of trading based on headline numbers. And in the case of NVR's Q4 results, those numbers -- which showed net income and EPS declining by 17% and 24%, respectively -- appeared downright abysmal. But as you know, looks can often be deceiving. A quick skim of NVR's results reveals that this decline was largely the result of the December Tax Cuts and Jobs Act, which required the company to reassess its deferred tax assets (of which it had $171 million on the balance sheet at the end of 2016), resulting in a charge of $63 million in the fourth quarter. That helped raise the company's effective tax rate to more than 52%.

	Three Months Ended December 31, 2017	
	Income Tax Expense	EPS Impact
GAAP Income Tax Expense	$136,699,000	
Less: Impact of Tax Cuts and Jobs Act	(62,702,000)	$(14.53)
Add: Impact of excess tax benefits recognized	13,960,000	$3.24
Adjusted Income Tax Expense (non-GAAP measure)	$ 87,957,000	

source: Company filings

But if we look beyond this one-time, non-cash charge, we can see that the underlying business continues to chug along. New orders and NVR's backlog of homes sold but not settled (both of which are leading indicators for revenue over the next year or so) increased by 18% and 24%, respectively, in the fourth quarter. A decrease in the average sales price (primarily the result of NVR's expansion into lower-priced geographies) continues to apply downward pressure on revenue, but the additional unit sales have enabled the company to more than offset this with operational efficiency -- gross profit and earnings before taxes for the homebuilding segment were up 12% and 16%, respectively, in the fourth quarter.

Moreover, as a company with purely domestic operations, NVR has never had the luxury of keeping profits offshore. So, going forward, NVR stands to benefit from the lowering of the effective tax rate to 21% (which is well below the 35%-plus rate NVR has reported for the past five years). And although rising interest rates will likely be a headwind for the housing industry going forward, we believe the positives (lackluster housing formation over the past decade, restricted supply, etc.) still outweigh the negatives, leaving NVR poised to deliver North Star-beating returns over the next decade. We're still waiting for the company to file its 10-K before we update our fair-value estimate (and possibly move the stock back to a Best Buy Now), but in the meantime, we're more than comfortable adding to our position.

Tencent

Like NVR, Tencent's stock has fallen by more than the market during the recent swoon after strongly outperforming in 2018. We've already devoted quite a bit of time to discussing this Chinese technology Goliath (see our original buy report, follow-up articles one, two, and three, and recent earnings coverage), but even so, we've only just begun to scratch the surface of its potential. Tencent isn't scheduled to report earnings until late March, so this buy should be viewed more as a signal of our confidence in the business than as a response to an updated fair-value estimate. And, hey, with the recent 48% spike in **Snap Inc.** (NYSE: SNAP) stock after that company reported fourth-quarter earnings, even Tencent's widely panned move to increase its stake in the Snapchat developer appears to be paying off. (Yes, it may be hard to believe, but we're partial owners of Snap through our Tencent stake.)

The Foolish Bottom Line

Only time will tell if last week's 10% index sell-off was the end of a recent market correction (making it the fastest on record outside of market crashes)or a harbinger of things to come. That's why we spend our energy on analyzing businesses, not markets. And we're confident that today's purchases will deliver more than acceptable returns over the next decade, regardless of what the rest of 2018 has in store, thanks to the underlying strength of these two businesses.

Pro Can Help

- **Questions?** Please visit the NVR and Tencent boards.

Pro Guidance Changes and Completed Trades: Feb. 12, 2018

Published Feb 12, 2018 at 3:53PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **Amazon.com** (NASDAQ: AMZN): The stock moves up to Best Buy Now (from Buy) as its financials improve and its dominance expands; our fair-value estimate (which is a much bigger guess than usual) moves up to $1,170. We have a 4.3% allocation.
- **New Buy Guidance: OpenText** (NASDAQ: OTEX): The stock moves to Buy (from Hold). We have a 3.1% stake. Fair-value estimate increases to $35.

Pro Completed Trades (see transaction log; trades take a day to appear):

- N/A

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Our Guide to Hedging Like a Pro

Published Feb 12, 2018 at 3:40PM

Fellow Fools,

In pursuit of our North Star, the *Pro* portfolio explores every corner of the market: We go long, we go short, we use options. That flexibility and creativity helps us find upside, but it also means that if we're not careful, we can be exposed to risk from every corner of the market, too.

We mitigate this by carefully using hedges. A hedge is a position that reduces a portfolio's overall exposure to risk, and over the course of *Pro*'s history, we've hedged in several different ways. In every case, we begin by deciding what exactly we want to accomplish with our next hedge. As we drill down on how exactly to rein in our exposure to risk, we focus on:

1. **Target selection.** What kind of potential decline are we trying to guard against -- a black swan, or a more moderate, run-of-the-mill slump? What are the risk factors that make us want to hedge, and which vehicle should we choose? Would an index do the best job of isolating those risks and protecting us against them, or do we want to target individual stocks?
2. **Size.** How much of the portfolio do we want to hedge out? Will this be the only position we'll use to do it, or will we have other approaches to reducing our long exposure in place as well?
3. **Time frame.** How long do we want the hedge to last? Do we prefer a set-and-forget type strategy, or one that requires maintenance?

Developing answers for each of these criteria has traditionally been a good way of narrowing down our possible hedging strategies to a select few. From there, if there are still two or more hedges we like equally, we'll consider pricing to try to break the tie. Here, we're considering the potential trade-off between the costs -- both direct (option premiums or losses on shorts) and indirect (missed upside from holding cash) -- and the potential benefits, given the current market environment and our portfolio positioning.

We'd love if there were a simple checklist to apply to every hedge, one that would both simplify the process and ensure we achieve our desired results every time. Sadly, it doesn't work that way. Hedging, like all of investing, is both an art and a science, one that requires constant learning and evolution for long-term success. That said, there are some hedging maxims we always keep in mind when picking a strategy:

- **Be miserly.** It's possible that at a given point in time, paying up for a hedge might be the right thing to do -- but the odds are heavily stacked against you in the long run if you do so repeatedly. (Just look at all the failing hedge funds.)
- **The goal of hedging is twofold.** In order for *Pro* to continue to achieve its lofty goals over a full market cycle, our hedges must do more than just reduce volatility; they will also need to provide us with enough capital that we can be aggressive during significant market declines.
- **Do no harm (or at least as little as possible).** Since 1896, the market has risen 78 years out of 119, or 66% of the time. This means you need to pay just as much attention to the risks of your hedge as you do to the potential benefits, since odds are you won't end up needing it. In most cases, a hedge will be a drag on your returns.

And now for the details behind our favorite approaches to hedging. Many of these strategies use options, so look for links to the relevant section of *Motley Fool Options*' Options U if you need a quick refresher.

Cash

- **How it works**
  - Arguably the most straightforward hedging strategy, cash works as a hedge by reducing a portfolio's long exposure. For example, a portfolio that has a 20% weighting in cash (and is thus only 80% long), all else equal, exhibits only 80% of the volatility of a similar portfolio that's fully invested.
  - Maximum gain: Interest earned on the cash
  - Maximum loss: You typically lose to inflation

- **Advantages**
  - Simplicity. Time spent constructing and monitoring more complex hedges is time *not* spent looking for the next long position that could double or triple in five to 10 years. Using cash to hedge your portfolio requires only a small initial investment in time and essentially zero maintenance.
  - Flexibility. Besides protecting a portfolio from untimely declines, one of the major reasons we hedge is as a source of funds: money you can use to take advantage of said declines by purchasing shares of your favorite companies at a discount. Some hedging strategies can be difficult to unwind at a moment's notice, meaning you could miss a buying opportunity, but that's not the issue with cash, which can be immediately deployed.
- **Drawbacks**
  - Missed upside. During bull markets, holding cash comes with a meaningful opportunity cost. Although you're not explicitly paying for a hedge out of pocket, you *are* missing additional upside on the cash you don't have invested. Compounded over multiple years, those missed gains add up. Consider two $100 portfolios: one that is fully invested and one that is only 80% invested, with the remaining 20% in cash. Assuming an average market return of 9% over various investment horizons (as well as a 1.5% annualized return on your cash), you can see how the cost of holding excess cash really adds up the further out in time you go.

	Portfolio A	Portoflio B	
year	100% long	80% long & 20% cash	difference in portfolio returns
1	9%	8%	1%
2	19%	16%	3%
3	30%	25%	5%
4	41%	34%	7%
5	54%	45%	9%
10	137%	113%	24%
15	264%	216%	48%
20	460%	375%	85%

- **When to use**
  - For investors seeking a straightforward approach to reducing volatility who are less concerned with missing out on upside, cash works as a standalone hedging strategy.
  - It also works as a great compliment to other hedges, especially those that are options-based and cannot be closed until close to expiration.

- **What to target**
  - Your primary considerations here are: By how much do you want to reduce the volatility of your portfolio? and What role will cash take in your overall hedging approach? *Pro* typically targets a net long exposure (long-shorts and hedges) of 70% to 80%, with cash being only part of our overall strategy for volatility reduction. Historically, we've targeted about 15% in cash (resulting in a reduction in volatility of 15%, *ceteris paribus*), though we've taken this number as low as 6.4% and as high as 22.8%. In an ideal world, our cash position will act as a counterbalance for the portfolio. As markets fall, our cash balance will fall, too, as we take advantage of depressed stock prices. But as markets climb higher, our cash holdings will likely rise as we sell out of overvalued securities (or investments where the thesis has run its course) and wait for better opportunities.

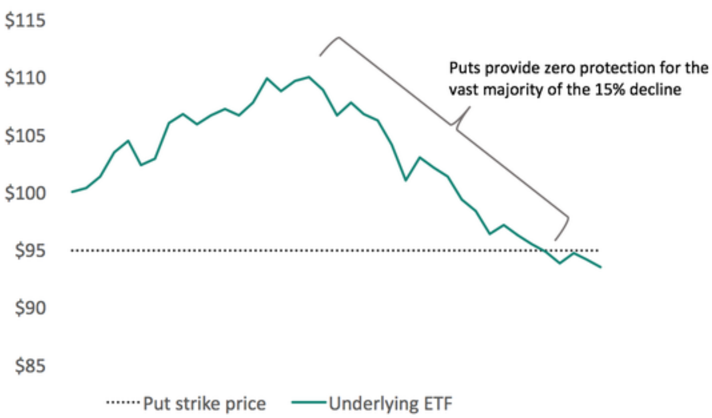
Shorting an ETF

- **How it works**
  - Another straightforward approach, this is when you to sell short the ETF of a relevant index (e.g., the **SPDR S&P 500 ETF Trust** (NYSEMKT: SPY) or the **PowerShares QQQ Trust** (NASDAQ: QQQ)). For example, if you had a $1,000,000 portfolio and wanted to hedge out 20% in order to reduce your net long exposure to 80%, you would short $200,000 in your desired index ETF.
  - Maximum gain: Achieved if the ETF falls to zero
  - Maximum loss: Technically unlimited, but realistically confined to the amount the ETF can rise during the period you hold your short position open
- **Advantages**
  - Simplicity. Pick your ETF and your desired short weighting, then sell borrowed shares into the market at the current price.
  - Reactive. With a direct index short like this, if the underlying ETF falls by 2% the day after you set up the short, you can close your hedge and capture that gain immediately if you so desire. Many hedges, especially those that combine multiple options, are not nearly as immediately reactive.
  - Potential for outperformance over cash. An investor who targeted a net long position of 80% in a long-plus-cash portfolio would need to hold 80% of that portfolio in stocks. But in a long/short portfolio, this goal can be achieved with a greater weighting in stocks, as long as the short position results in a net of 80% long (e.g., 90% long and 10% short, 100% long and 20% short, 120% long and 40% short). If the "extra" long holdings (say, 20% in the case of a portfolio that's 100% long, 20% short) over the long-plus-cash portfolio outperform the ETF underlying the short, the long/short portfolio will outperform the long-plus-cash portfolio.
  - Liquid. In relation to being reactive (covered above), these positions can be put on and taken off at a moment's notice, which means you can take advantage of declines by reinvesting hedging profits as soon as you want.
- **Drawbacks**
  - Losses if the market rises. Unlike cash, shorting an ETF has a direct cost associated with a rising market. (Remember, when you short something, your payoff diagram is reversed: You make money when the underlying instrument declines in value and *lose* money when it rises.) The higher the market climbs, the greater your loss on the short, and potentially the larger a percentage of your portfolio the short becomes.
  - Shorting fees. Although they tend to be modest on larger ETFs, these fees do add up and weigh on returns if the short is held for long enough.
- **When to use**
  - When you're looking for a straightforward, highly reactive hedge, you're OK with paying a fee to borrow shares, and you don't mind that the hedge will act as an anchor on the portfolio if the market rises.
- **What to target**
  - As with cash, your primary consideration here is your desired target net long weighting for your portfolio as a whole, and what role you want this particular strategy to play.
  - Given how common this approach is, prices don't fluctuate much, so pricing discipline and discovery aren't much of a concern. The issue is more whether you're willing to pay up to use the hedge.

Buying Puts

[Options U link]

- **How it works**
  - For an up-front payment, puts protect the portfolio (or a position in it) from all downside below the strike price.
  - Maximum gain: Achieved if the underlying falls to zero
  - Maximum loss: The premium paid to purchase the puts
- **Advantages**
  - Simplicity. This is arguably the most straightforward options-based approach to hedging.
  - Upside exposure. You don't risk missing out on upside should the market move higher while your hedge is active. You only risk losing what you paid for the puts.
  - Accessible. This is a strategy that most investors will be able to set up in their accounts even if they have limited options-trading permission.
  - Reactive. This single-legged strategy will show profits if the underlying instrument falls by a large enough degree prior to expiration, in which case you don't need to wait until close to expiration to close.
- **Drawbacks**
  - Cost. Cost-wise, buying puts is essentially the opposite of using cash to hedge: You're not at risk of missing upside should the market rise, but you *are* required to make a payment in order to set up the hedge. Depending on the market environment, you could end up spending a significant percentage of your assets (say 3%-5%) per year for strike prices that are only reasonably out of the money -- meaning the strategy really starts to drag on portfolio performance if used for long enough. It's not impossible to imagine a situation in which the gains you receive when your hedge finally pays off — which will probably require multiple rounds of buying puts, unless you get really lucky with your timing — fail to even offset the cost you've incurred to buy those puts time and again, meaning you're actually worse off for hedging despite witnessing a decline in the market. At *Pro*, we guard against this by trying to find various ways to finance our put purchases, such as writing puts on longs we like to pay for the protective puts we buy.
  - Timing matters a lot. For the most part, puts only start paying off once they are in-the-money, so you run the risk that your hedge might be largely irrelevant by the time the market finally declines. For example, if you buy puts that are 5% out-of-the-money, but the market rises 10% before falling 15%, your hedge would only be reactive for the final 1.4% of the decline.

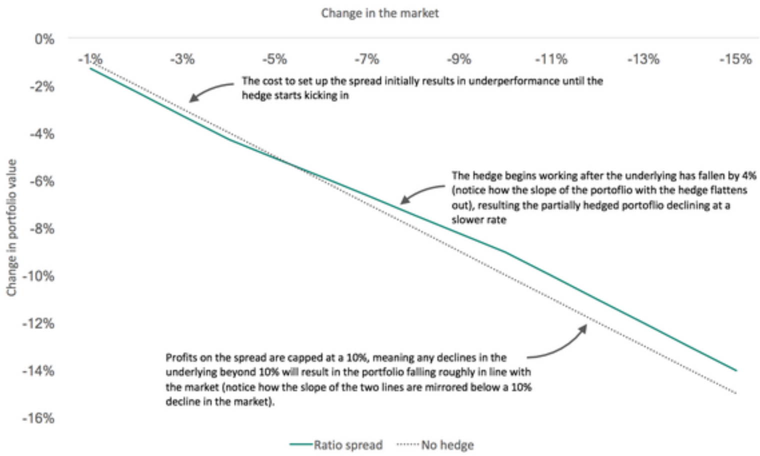


- **When to use**
  - When option prices are cheap (i.e., they favor the buyer) and your concerns about missing upside outweigh your dislike of paying to set up a hedge.
- **What to target**
  - There are two approaches you can take when looking to hedge by buying puts. The first is to target an intermediate length of time (typically 11 months or less) you'd like the hedge to be in place, then look to purchase puts, knowing it's likely you'll lose the entire premium you've paid if you hold them until expiration. When *Pro* takes this approach on an individual stock, we typically target puts that are somewhere around 10% out-of-the-money and pay no more than 5%-6% of the holding's value per year, with hopes that we'll sell the puts and get at least some of that back. The second approach is to purchase long-dated puts (typically expiring in a year or longer) and plan to roll them to a higher strike price if necessary to keep them closer to the underlying ETF's current price (and therefore more reactive as a hedge). In this case we target put strikes typically 10% to 15% out-of-the-money, and still aim to pay no more than about 6% per year of the position's value, initially, with hopes of recouping some of that when we sell, whether we roll up or not.

Bear Put Spread

[Options U link]

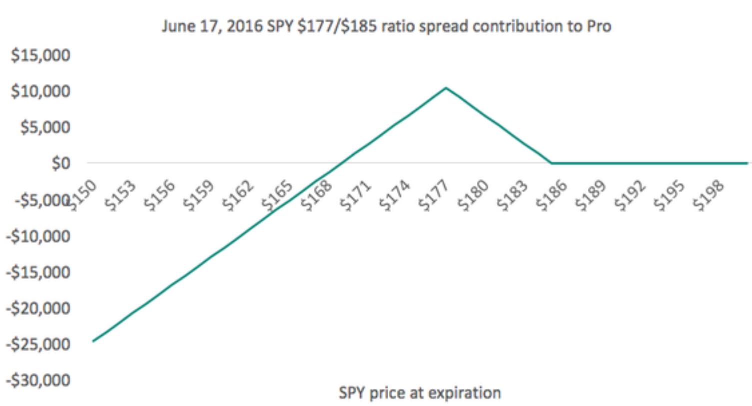
- **How it works**
  - With this options-based hedge, you purchase a put on an index or stock while financing some of the cost by simultaneously writing (selling) a lower-strike put with the same expiration date.
  - Maximum gain: Achieved if the underlying falls at least to the lower strike price of the written put
  - Maximum loss: The net premium paid to set up the spread
- **Advantages**
  - Cost, relative to just purchasing puts. Because you're selling puts with a lower strike price, you're able to meaningfully reduce the cost of setting up the hedge. This serves to minimize the drag on the portfolio if the market does not decline, while also raising your breakeven price and increasing the odds that your hedge makes money if the underlying instrument *does* go down.
  - Upside exposure. You don't risk missing out on upside should the market move higher while your hedge is active.
- **Drawbacks**
  - Cost. Although a bear put spread is cheaper than buying puts outright, you're still making an up-front payment for something that may never actually benefit you.
  - The amount of downside you can capture is limited. Selling puts helps reduce the cost, but it also caps the maximum profit you can make from a given spread.
    - To see these two drawbacks in action, let's say you set up a 20% hedge using a spread that starts making money when the underlying ETF falls by 4% and has a maximum gain at a 10% decline. Such a spread would leave you worse off in any market situation that's *better* than a 4% decline, because you had to pay to set up the strategy -- but once the hedge did kick in, your portfolio's value would decline at a slower pace than without it. However, that's only true until the decline reaches 10%. After that, you won't receive any additional protection.



- **When to use**
  - As with buying puts, you can set up a bear put spread if you desire a hedge that doesn't result in any missed upside (just the cost of your spread). But because your maximum gain on the hedge is capped, you should generally limit its use to situations where you're not overly bearish.
- **What to target**
  - Although you can set up a spread of any size and duration, typically we target a spread that is roughly 3% to 5% out-of-the-money, with about a $10 difference between strike prices. The cost for this type of hedge will largely depend on its duration, but a four-month position should cost about $2-$5 in most market environments. Your maximum profit in this example is $10 per spread, or at least a double, which is what we target since we risk a 100% loss of capital along the way. We generally target large ETFs including SPY, IWM, and QQQ, though you can also hedge individual stocks.

Ratio Spread

- **How it works**
  - A two-part, options-based hedge, a ratio spread requires the investor to sell twice as many puts as they purchase for a given expiration date. The written put's strike price must be lower than the purchased put's strike price. (For example, you might write 20 January 2018 $175 puts while simultaneously purchasing 10 January 2018 $190 puts.) At worst, the spread is set up for a very small debit; breakeven, or even a slight credit, can at times be achieved. It provides protection starting at the strike price of the purchased put, but if the underlying instrument falls far enough below the strike of the written put, the spread becomes a liability that also shows a loss.
  - Maximum gain: Achieved if the underlying falls to the strike price of the written put, but not below
  - Maximum loss: Achieved if the underlying falls to zero
- **Advantages**
  - Cost. Because you can set it up for little to nothing out of pocket, a ratio spread overcomes one of the most common drawbacks to hedging, which is that the long-term costs might outweigh any gains achieved when the market finally does fall.
  - Upside exposure. You don't risk missing out on upside should the market move higher while your hedge is active.
- **Drawbacks**
  - Cash necessity. Since written puts are a potential obligation, you need buying power or free cash to keep this position open, and that's cash that isn't invested elsewhere in most cases.
  - Downside protection is limited. That's the tradeoff for not spending any money out of pocket: A ratio spread's maximum gain is captured if the underlying falls exactly to the written put's strike price, but if it continues to fall beyond that, the protection the hedge provides starts to lessen. If it declines enough, you eventually arrive at breakeven, which can be calculated thusly: Written put strike price — (purchase put strike price — written put strike price). Below this price, the hedge is actually a liability.



- **When to use**
  - Ideal for situations when you are bullish but looking to hedge for small to moderate corrections.
  - When pricing is favorable (see below).
- **What to target**
  - There are a lot of moving parts here, but generally speaking, here's what to aim for:
    - Set up the position for a slight net credit or breakeven (a small debit is the worst-case scenario for this type of hedge, and that's not bad) while also achieving all of the criteria listed below. If pricing is unfavorable, consider an alternative hedge.
    - Your purchased put's price should be about 3% to 5% less than the current price of the underlying ETF.

    - Your written put's price should provide an acceptable gap between the purchased put's price and your maximum profit. (The smaller the gap, the greater the risk your ratio spread becomes a liability.) For shorter ratio spreads of three months or so, this can be as small as 5%, if that makes the spread between the maximum profit and the current price of the underlying instrument at about 10% (so, you earn your max profit if the index falls 10%). For ratio spreads of nine months or more, the gap between maximum profit and the current price of the underlying ETF should be 15% or more.
    - Expiration dates can be tailored as needed. We have previously targeted spreads from as short as three months to as long as one year.

Synthetic Short

Options U link

- **How it works**
  - This is an options-based approach that mirrors the performance of directly shorting an ETF by selling an at-the-money call in order to finance the purchase of an at-the-money put.
  - Maximum gain: Achieved if the underlying falls to zero
  - Maximum loss: Technically unlimited, but realistically confined to the amount the ETF can rise during the period you are short it. (This is calculated as the current price of the underlying less the short call's strike price.)
- **Advantages**
  - Reactive. As with purchased puts, this strategy should show a profit even if the underlying immediately falls after the strategy is set up (because the puts will start gaining value while the calls lose it).
  - Fewer fee events. By using options to short an index ETF, you avoid paying shorting fees on the ETF, and you don't need to pay out any dividend payments the index pays, either.
- **Drawbacks**
  - Losses if the market rises. You will not only miss out on upside above the written call's strike price, you'll also begin to see losses on the hedge in a rising market.
  - Costs. Setting up two options may cost more commissions than would just shorting the ETF directly for short periods of time.
- **When to use**
  - When looking for an alternative approach to directly shorting an ETF.
- **What to target**
  - Depending on the position of your strike price in relation to the underlying instrument, you should be able to set this position up for little to no cost. Generally speaking, you should use the single strike price on both the calls and puts that is closest to the current ETF share price, while adjusting both options up or down a strike or two (while still using the same strike on both option) if you want to avoid paying to set this up.
  - As with cash and directly shorting an ETF, the primary consideration here is your desired target net long weighting for the entire portfolio. Consider the role you want this particular strategy to play within that context.

Split-Strike Synthetic Short

- **How it works**
  - Essentially a more conservative, options-based alternative to shorting an ETF. With this strategy, you purchase an out-of-the-money put while simultaneously selling an out-of-the-money call. Both have the same expiration date, and the call typically offsets the cost of the put.
  - Maximum gain: Achieved if the underlying falls to zero
  - Maximum loss: Technically unlimited, but realistically confined to how much the ETF can rise during the period you are short it. (That's calculated as the current price of the underlying instrument less the short call's strike price.)
- **Advantages**
  - This strategy is more conservative than directly shorting an ETF. Because you're shorting an out-of-the-money call, your hedge has some headroom before it starts to guarantee you a loss on the short calls at expiration. Essentially, you're trading the ability to profit from small declines for more wiggle room on your short should the market rise.
  - Reactive. This strategy will, however, show a profit if the underlying instrument immediately falls after setting up the strategy, because the puts will start gaining value while the calls lose it.
  - Cost. By selling calls, you're typically able to offset a large portion of the cost (and sometimes all) of the purchased puts.
- **Drawbacks**
  - Losses if the market rises enough. You see a loss on this hedge if the ETF ends above the written call's strike price.
- **When to use**
  - If you're looking for an approach that's similar to directly shorting an ETF, but more conservative.
- **What to target**
  - As with most of the options-based approaches, there is a lot of flexibility here depending on how aggressive -- or defensive -- you want to be. More aggressive approaches start capturing declines sooner but risk showing losses with smaller increases in the underlying instrument, while more conservative strategies don't show losses as quickly but require the underlying instrument to fall further before showing gains. We generally like to target a small net debit in order to purchase puts closer to the current price of the underlying instrument (for example, we might purchase puts that are 5% out-of-the-money and sell calls that are 7% out-of-the-money).
  - There's a lot of flexibility possible with expiration dates, too. You can go short-term (three to four months) with the goal of just holding the position until expiration, or longer-term (nine months to a year) with the intention of being more active and periodically rolling the position higher or lower if need be.

Buying a short ETF

- **How it works**
  - A friendly trade for those with restrictions on their accounts, this establishes a short position by buying shares in an inverse ETF (e.g., the ProShares Short S&P 500 (NYSEMKT: SH).)
  - Maximum gain: Achieved if the underlying falls to zero (so, for example, the ProShares Short S&P 500 achieves its maximum gain if the S&P 500 falls to zero).
  - Maximum loss: Limited to your initial investment.
- **Advantages**
  - Ease of use. Since you're buying shares, you don't need permission to short or trade high-level options, although some short ETFs have extra requirements for ownership.
  - Reactive. This strategy should show a profit if the underlying instrument falls immediately after you set it up.
  - Imperfect tracking. We'll discuss this in greater detail in the "drawbacks" section, but these instruments deliver their inverse performance on a daily basis -- an imperfect measure and one that can at times work in your favor.

- **Drawbacks**
  - Losses if the market rises. If this happens, the ETF will decline in value.
  - Imperfect tracking. These ETFs seek to replicate the inverse of the daily performance of an index, but their long-term results will almost always differ from the true inverse of that performance. For example, over the past five years (as of Feb. 12, 2018), the S&P 500 has risen by 72.40%. Over that time, arguably the most well-known S&P 500 index, the Spider S&P 500 (SPY), has risen by 72.02%. But the corresponding short ETF, the ProShares Short S&P 500, has only declined by 51.71%. This discrepancy is most pronounced over long stretches of time, but it can occur over shorter stretches, as well. (In those cases, it's usually less extreme and can even work in your favor.)
  - Cash outlay. Since you're buying shares, this form of hedging reduces your cash balance on day one.
- **When to use it**
  - When restrictions on your account prevent you from participating in other strategies.
- **What to target**
  - As with cash, the primary consideration here is what you want the target net long weighting for your portfolio to be, and what role you want this particular strategy to play within it.

Hedging an Individual Stock in Your Portfolio

- **How it works**
  - When you have a large position in a single stock that you'd like to hedge (instead of hedging the entire portfolio), you can reduce volatility by hedging out that single stock using any one of the strategies listed above.
  - Maximum gain: Depends on the strategy
  - Maximum loss: Depends on the strategy
- **Advantages**
  - Pinpoint accuracy. Foolish investors tend to have stocks that aren't perfectly correlated with a single ETF, meaning an ETF-based hedge doesn't completely remove company-specific risk from the portfolio. By targeting a specific stock, you're able to exercise greater control over the business risk you hedge against.
- **Drawbacks**
  - Market risk. The odds are higher that a single stock won't correlate with the market than that an entire portfolio will go rogue, meaning you run the risk of hedging out a stock that continues to crush its performance while the market (and your overall portfolio) tanks.
- **When to use**
  - When you're primarily concerned about a single stock, but aren't ready to sell your shares just yet (perhaps you just want to hedge through earnings).
- **What to target**
  - Depends on the strategy selected.

Thoughts? Questions? Don't hedge your bets! We're here for you on the Hedging discussion board.

Where Pro Stands, Part 1

Published Feb 9, 2018 at 5:24PM

Dear *Pro* Fools,

As I update this on Friday after the market close, the S&P 500 is down 8.7% from its intra-day high reached on January 26, and down 2% year-to-date. Our North Star is up nearly 1% year-to-date. The *Pro* portfolio is down 3.3% in that time, much of that because of one small position that blew up. We have catching up to do, and we know the path we want to take to do so.

First, though, it's instructive to look back a bit. The major market indexes now trade at the same level they were at in late November, about 70 days ago. During all of last year (and the years before that), we largely refrained from systematic shorting and hedging because the market environment seemed so highly positive.

That means we have likely saved many thousands of dollars by *not* actively shorting and hedging the market with responsive shorts. For example, we contemplated synthetic shorts on the market indexes several times over the past year, and we kept passing on them. We also considered paying out for insurance by purchasing puts, but ultimately chose not to. The strategy would have cost us at least 3% a year to cover about 20% of the portfolio -- expensive, and (so far) not worth it. The market is still at a higher price than it was each time we considered hedging in 2017.

Also, as you know, we've always worked to configure a portfolio that generates our upside goals without investing all of our cash. When your portfolio only averages about 73% net long, as ours has, and you want to keep pace with your North Star (and incidentally a strong stock market), you need to calibrate some extra risk into your portfolio to get there. Since inception, we have earned 191% of the North Star's steady return, and about 106% of the S&P 500's total return -- despite only being 73% net long on average since 2012 (and even less before then). We could only accomplish this by avoiding large misses -- and by investing in some risk, including **Facebook** (NASDAQ: FB) before it was loved, **Mastercard** (NYSE: MA) when it looked expensive, and others.

Part of the reason we had a strong 2017 was the risk we took by owning the **ProShares Short VIX Short-Term VIX Futures ETF** (NYSEMKT: SVXY). This position added a substantial 2% in value to the portfolio last year. We made the conscious decision to give ourselves additional exposure to upside with this *small* position, which brought us outsized returns in a rising market but only risked 1.3% of our assets when we set it up. And it worked just as hoped: Despite being one of our smallest positions to start 2017, SVXY brought in the second-highest unrealized gains in the port, second only to Facebook. En route, it increased about 200% last year. But we missed our chance to sell some.

Now, SVXY sets us back. (The stock was down by an incredible two-thirds on Tuesday ; we hope to share more about what happened to it in after-hours trading last Monday as we learn more about the bizarre VIX futures trading that took place then.) In losing nearly 3% of our portfolio's value (2% of which were its unearned returns), we lost two years' worth of 1% annual portfolio gains, and we're left needing to earn 3% back to return to plan. We plan to do so by taking bullish positions in great *Pro*-quality companies -- buying more stock, using call options, and writing more options as long as they continue to pay more.

In other words, we're no longer relying on SVXY to give us the extra boost it once did in a strong market. (We obviously can't rely on it for that now, even in a rising market.) We've always relied most on our long-term buy-and-hold businesses to increase in value over time, and now we're looking to invest additional funds in our favorites, both old and new, to ideally get us back on track.

As we increase our long exposure to stocks and options, our plan is to expand our hedging, as well. We still want to maintain reasonable net long exposure (70% to 80%), because that's part of our roadmap.

Now, about hedging ...

Because SVXY helped us keep a bit more cash out of the market, it played a small role in dissuading us from hedging more often (because we had ample cash). And that saved us some money the past few years. We might have lost more than 1.3% of the portfolio on steady insurance and hedging -- insurance can easily cost several percentage points of a portfolio each year, and being short the index as it rises can cost just as much or more. That said, we typically seek to hedge market declines of 7% or more, and now we're back to looking at the same hedges we considered last summer -- when the market was still lower than it is now. So that's good.

More on potential hedges soon. For now, some thoughts on some positions in our portfolio on Hold. We always want each position in the portfolio to have a purpose, and here are updates on those whose purpose we're considering.

- **Gilead Sciences** (NASDAQ: GILD): In a market that has many stocks at assertive valuation multiples, it's nice to own some that are inexpensive. We'll decide soon whether we're moving Gilead to Buy again and keeping it as a buy/write covered-call position, writing calls against it for income as we did last year. Expect our update by the end of this month, after we go through this week's earnings and updated outlook.
- **OpenText** (NASDAQ: OTEX): OpenText is also an inexpensive-looking company in an industry (software) that's mostly expensive. After a strong quarter, we're moving the stock back to Buy and committing to it, in theory, for at least the next three years again. That said, we could of course sell it anytime for something we like better, as is true of everything we own. But for now, we like it again at this price after recent strong results.
- **SVXY:** It's now only an 0.2% position, so we plan to keep it and see what we can learn from it -- see how it plays out over time. As soon as we believe there's no longer an imminent or likely risk that it will go to zero, we'll move it back to Buy, but only for members who are comfortable risking 0.2% (even then, it could still go to zero!). We believe we can learn more by continuing to follow it than we could by selling it; the capital at risk is slight now, and over many years, could it recover? (That said, one reason we might sell it someday is to offset gains we take in any particular year. Or, if it does seem like it's plummeting to worthlessness, we may choose to get out first.)

All of our other stocks are rated Buy or Best Buy Now, and with the downturn hitting everything this week, all are trading at more attractive valuations than they were a week ago. Take a look.

Now About That Market

When the latest *Barron's* Roundtable, chock-full of investment experts, was blue-sky bullish in January, I joked that it was time to be worried. But the speed and depth of this market decline surprised me, too. We have lower taxes and higher earnings to look forward to this year; earnings are already coming in strong, with more to come. The S&P 500 trades at about 17 times expected earnings (one year ahead), too -- not a crazy number.

With good reason, many are suggesting that this decline is because interest rates on bonds have gone up, and it's true that higher "risk-free" interest rates usually bring lower stock valuations, although stocks don't *always* fall when rates rise (and interest rates are likely to remain historically low even after slight increases). Further, I don't believe this market decline is *all* about interest rates, because financial stocks have been falling as badly as everything else. If this were about interest rates jumping, financial stocks would stand to benefit -- they'd be a safety net for investors, and their prices would rise. But that's not what we've seen.

Most likely, interest rates sparked concerns, but this is a decline that was just waiting to happen either way. Too much speculative money moved into the market, looking for a quick return, and now that money is fleeing because the market is falling. Sellers are unloading stock to stronger hands, and eventually the decline will subside. This story is as old as time (or as old as markets, anyway).

There are other things to worry about -- there always are. The dollar is getting weaker. The U.S. deficit this year might top $1 trillion, double last year's, and we're selling more debt even as buying interest overseas may be waning (driving rates higher). Higher rates also makes our debt more expensive to carry. And we're stimulating the economy with tax cuts and extra spending even though the economy is already growing. Usually, you want to save stimulus for the next downturn. So, this is uncharted territory. But overall, we know that owning excellent, world-leading companies at fair prices is the first and largest step toward building your portfolio's value over time.

Until next time: enjoy your weekend. Keep your long-term perspective. As always, be grateful for what you have, life and health being top of the list. Meanwhile, we'll keep working to improve our investing.

In closing, my colleague and friend Jim Gillies wrote an excellent column about the market today -- be sure to check that out.

— Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: Coherent, Facebook, and More

Published Feb 8, 2018 at 1:14PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Coherent** (NASDAQ: COHR): Buy 2%.
- **Facebook** (NASDAQ: FB): Buy 3.9% (half our stake to start).
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.9%.
- **Oracle** (NYSE: ORCL): Buy up to 3.6%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 3%.

Continue building your portfolio with our Buys, including:

- **NVR** (NYSE: NVR): Buy up to 2.8%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy up to 3.8%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Cooper Companies** (NYSE: COO): Set up a covered call by simultaneously purchasing shares and selling one May 2018 $240 call contract for every 100 shares you purchase. As of this morning, this position could be set up for a net debit of roughly $220. The recent spike in volatility has resulted in the $240 strike still meeting our monthly income guidance despite the decline in the stock price; however, more conservative Fools who favor income over upside can consider selling the May 2018 $230 calls instead. Our target position size is 2.5% to 3%.

Upcoming Expirations:

- None imminent.

Pro Video Chat, February 2018

Published Feb 7, 2018 at 2:41PM

The *Pro* team will be holding **a live video chat on this page at 2 p.m. Eastern on Wednesday, Feb. 21**! We'll be using Slido to communicate with members during the chat; to join in, visit slido.com and enter code **#ProChatFeb**. We recommend opening Slido in another browser tab (or on a mobile device) so you can see both the video and the Slido questions at once. See you soon!

Transcript

Jeff: ... With our members, you. We appreciate you being here. I'm joined at table by JP Bennett.

J.P. Bennett: Happy to be here, Jeff.

Jeff: And through Skype, we have Billy Kipersztok down in Florida. Hey, Billy.

Billy K.: Jeff, J.P, hey. How you guys doing?

J.P. Bennett: Great.

Jeff: We're doing great. We just had a Pro meeting among the three of us this morning as well so if we seem like we're getting along well, it's because we are. We just finished a one hour meeting to talk about the Pro portfolio. We hope you're doing well too. Please, as you enjoy the lovely visuals and audios of this video itself, also go to slido.com. Enter ProChatFeb. We're lazy today, so we just shortened. ProChatFeb, F-E-B. There you can ask your questions and Slido vote up other questions that your fellow members ask, and we will answer them generally in order of popularity. But we might also go more quickly this time, depending on the volume of questions and just each of us will go around the table and select one from the list and go right through them that way.

Either way, we hope to answer all the questions or as many as we possibly can with answers that are indeed helpful to you. That's our whole point. So, ProChatFeb, and we'll get started with your questions in just a minute. As a short preamble before that, I'll say that the Pro portfolio as of 11:30 this morning, two hours ago, was up 2.2% year to date right in line with the SMP at 2.2% and, coincidentally, right in line basically with the North Star as well, which is up around 2%. Inflation is ticking higher, which is gonna make our North Star get above 10% a year, maybe 11%, maybe push towards 12 soon, and we'll do what we can to invest in the spirit of our North Star and grow our money with reasonable risk. Anything you want to talk about, JP or Billy before we get started?

J.P. Bennett: I would say just as a precursor, because I haven't done any of my quarterly earnings write ups that by and large it seems like what we're seeing from our Pro companies is pretty positive I know. I just went through Verisk this morning so it's kind of top of mind for me but I was pleasantly surprised or impressed with what I saw not just that because they have a new CFO, I was super impressed with the changes they're making in terms of their disclosure and how they're going to present their business going forward to kind of clear up some of ... I don't want to say confusion but just the lack of clarity and uncertainty that was surrounding things because if you think they are a subscription, largely subscription based business so you would think it would be really easy to predict what they're going to do quarter in quarter out and the changes would be more on a yearly basis or multi-year basis.

But there were some pretty significant kind of I'm going to use air quotes here for those of people who aren't looking at me you know misses in terms of what they did versus sell side estimates and that kind of had to deal with the way they disclose their business or the way they presented their financials. So what did they do? They got a new CFO, they went around talked to a bunch of their biggest shareholders and said, "What do we need to do to be kind of a more shareholder friendly company in terms of disclosures and how we present the business," and I'm really optimistic not just in terms of where the business could be going but also in terms of the better understanding we're able to achieve with the business going forward. Then you look at even some of the businesses that sold off like NVR because of the one time tax hit and maybe some of the concerns regarding rising rates but the underlying business seems good.

I think the local housing market where they're situated seems like it could the current dynamics could last for a little bit longer and so I don't know about you guys but so far I'm pretty pleased with what we saw from the Pro companies.

Billy K.: Yeah, I would agree with that JP and I think we're starting to see some sort of economic expansion here in the United States and globally as well and I'm curious to see how that plays out for our companies over the coming year as well as the impact of the tax reform for a lot of our US based companies I think. Jeff was talking about this earlier the market maybe underestimating the impact that tax reform has on the earnings for these companies so even as we have some volatility early in the year, it looks like the economy and the businesses that we own are doing well so we'll see what happens.

Jeff: I would agree. I'm pleasantly surprised by earnings so far and we're starting to see some headwinds, I'm sorry some tailwinds from the tax reform, the money that's going to come back overseas back to the States is likely to benefit shareholders most of all.

J.P. Bennett: Yeah, don't get me started on that one.

Jeff: And the thing that we are talking about, the Pro team, you should know is this environment of higher inflation, interest rates headed higher, still you have stimulus in the economy which is very unusual during a time of an expanding economy, is growing deficits which is also very unusual so although things look good right now and perhaps stronger this year over time month by month the year may get stronger, longer term, we have some concerns about how it all plays out in the end but we remain or I remain ... We don't want to think about the market short term but I remain bullishly oriented. I think this year you have more tailwinds than headwinds and it's probably a bit more likely that stocks will rise this year than not although nobody knows but-

J.P. Bennett: Hedging your bets.

Jeff: We are working to hedge our bets. I like what we've seen so far, we have some new potential buyers right around the corner in the Pro portfolio but on top of that we're looking to get more invested in some really high quality names that we'd love so that we're also then going to put on more hedges and possibly shorts to balance out the portfolio in both directions as best we can. That's what we're looking at right now; inflation, interest rates and strong earnings growth as well so let's go to your questions on slido.com, again that's ProChatFeb, if you want to go into slido.com and ask questions, Karen is asking our latest thoughts on SVXY, the ProShares short term futures on VIX and I can share hopefully within just a minute or two our thoughts on that.

Big picture right now it's at 0.3% position so it's our smallest position. It's down about 67% so it's down a lot from where we bought it and down for members even more who bought it later and that's after seeing it more than double. To have a go from about a 3% position to 0.3, obviously a big hit just in the last few weeks on the portfolio and yet cold comfort maybe but true facts the portfolio is up as much as the market this year, we're still in our positive territory so that's good.

J.P. Bennett: Diversification.

Jeff: Yeah, diversification pays off and again in keeping this position small but we missed our chance to reduce our position even though we had planned to, that's no excuse we didn't execute in time. We still would have held probably a one to one and a half percent position instead of 2.7%, so our latest thoughts on it though is now that it's this small that we want to keep it and see how it plays out. ProShares was able to keep SVXY going despite the futures rising more than 100% in one day but we now know for certain that there is a risk that if the VIX doubles or more, this like XIV which is gone now could disappear. We always knew it could fall very rapidly if you read our original report we said it could be worthless very quickly or close to worthless but now we know for certain that it could be worthless if the VIX were to double or more so we need to keep the position small but we are keeping it and doing so we do plan to move it back to buy and tell members only to buy 0.3% or less and be ready to lose that money because it could happen.

But what we hope will happen, more likely to happen is that over time it will appreciate and we'll gradually trim it, and trim it and manage it and eventually exit it perhaps years down the road but eventually exit because it's not ... we'll find other ways to invest in volatility or against volatility. We don't want to hold an instrument in prop or indefinitely that can go to zero on a whim so we're going to manage it and keep it small but we are keeping it and we want to see what will learn from it. We talked about it this morning too among us some and we do think there's a fair amount of evidence that this was an unusual event given that so many people had invested in short volatility that when the VIX finally did spike those trades had to unwind and it resulted in these exacerbated movements in the futures market that fed on themselves and basically killed the very instruments that were betting against them.

We may not see that again for years unless people slowly go back and SVXY or things like it and use them to short volatility again but these have become so big, these few ETFs that they accounted for about 25% estimated of the VIX futures trading on the Chicago Board of Options Exchange itself so there was a lot of volume in there and it unwound in an ugly fashion even when the market didn't fall that much. It was definitely surprising and definitely unfortunate.

J.P. Bennett: We saw or at least I saw as early as 2016 there were some people that were kind of pointing out how the dynamics were changing. You look at it from a 10,000 20,000 foot view and you think okay, the SVXY is based on the VIX so the VIX determines SVXY but because like you said they were tracking so much money and the positions they were having to take were so large, the dynamic was actually starting to reverse and you could basically based on whether they needed to be, all of the VIX based instruments, needed to be net long or net short a particular month. You could kind of predict what was going to happen to the VIX and so this is kind of ... I don't want black swan but it was definitely unforeseen because even back then it's like all right this is a new dynamic, you need to understand this when you're investing in those products and I guess we kind of understood that there were these risks but you cannot really anticipate how exactly they put, you can't really simulate this in advance it's all about proper risk management like you said.

Unfortunately, we had basically decided a couple of days prior, it's hit that mark or we're going to trim some of it. We need to at least pull out all the money we put in so we're basically using quote unquote house money and it's just one of those things where sometimes timing just doesn't work out for you. We had some great timing with some of our buys the past couple years and this one just wasn't in our favor but that's investing. We are not that perfect but we're not going to.

Jeff: Yeah, it's true JP and a reminder to those who weren't here when we first bought SVXY three years ago I believe, almost, maybe.

J.P. Bennett: Man time flies.

Jeff: It does. It fell 58% right off the bat on us so we've been at this size of a loss before and we didn't add to it.

J.P. Bennett: So you're saying it's going to come back.

Jeff: No I'm not saying ... We want to learn still. It was a new position we want to learn rather than add to it and we're in the same position now. We don't plan to add to it we want to learn what seeing this huge dislocation.

J.P. Bennett: What happens now.

Jeff: Let's see what happens next but thankfully it's again a small position. It was never so large that it could harm us indefinitely and as we talked about this morning every although it may be impossible for you to know this I should share more potentially if I can every time we've taken a hit whether it was American Airlines, call options or SVXY now or even when we lost Intel and I didn't really want to I was bummed about that, I've turned that negative energy into something positive into-

J.P. Bennett: I does kind of motivate you, right?

Jeff: Yeah, motivates you to find a really great buy like Paycom or Skyworks replaced Intel and this is motivated us to look at a few other companies that make it in the portfolio very soon and then in the long run we'll make a lot more money I believe because of that than we would have otherwise so in some ways we've been too smooth and too easy going. We should have more mistakes because they do motivate us to then do even better in the next leg of our performance so SVXY, amazing experience. Right after we bought it we saw it fall about 58% when the VIX I have to go back and look it up I meant to this morning but ran out of time, I think the VIX nearly doubled so that gave some what turned out to be false comfort like okay of the VIX can soar and SVXY only falls 20% in the day or 30% and it comes back.

To see it fall 80% was impossible to foresee at least in one day I guess you could say and. It's a new experience but we have been in this hole before I'm not saying JP It will climb back but over a long we may slowly-

J.P. Bennett: That was just a joke.

Jeff: I know, I don't think any of us believe that because that took two years or so of very low volatility which can continue, which can happen again but we're not banking on it and thankfully SVXY has now no real bearing on our future performance. I used to put some weight on it thinking in this is a small position but it will gain 100 or 200% in a good market over a few years time and add a few percent of the to the portfolio which is real and those are real returns and it did that exactly and now we don't count on that at all so we're going to make up for that in other ways with better longs with real companies and with more options with companies themselves I should say. Let's get to more of your questions that was a lot on that one stock, one ETF.

J.P. Bennett: I'm going to assume that there are a lot of questions in here.

Jeff: I'm sure, so SVXY we're keeping it where it is at, 0.3% buy no more than that. Hold it only if you're comfortable with potentially losing all that money overnight you have to know that it could be gone tomorrow if the VIX doubled again so we're okay with that we want to learn from this now and see what happens next with it. I feel at this position sizing we're not being irresponsible with the money as long as you know the risks that are involved and act accordingly for yourself so we're holding it for now. Anonymous is asking, "Some reports that Facebook is losing teenagers at a rapid pace. Does this concern you?"

I've read those reports too and we saw them ... I looked back and we saw them as early as 2012, 2013 when we first bought shares and calls and so far it doesn't concern me. It's a very tiny base part of their obviously enormous user base and it's mostly US teenagers and a lot of them are moving to Instagram instead. I think a lot of Facebook users cycle in and out of the service but the stickiness of it is that so many of your peers and friends are there that you'll come back to it but as of right now it doesn't concern us but it's something we have our eye on. Even more than that as we talked about this morning as a team is we want to see how Facebook's changing algorithms for its news feed change traffic this year, we believe they can manage their revenue very well given the demand that they have for their advertising as long as ad prices stay up and that depends on traffic being responsive to the ads.

But we may keep a collar on Facebook over each other earnings quarter at least for the next few quarters just because of the unknown regarding how they're managing the business. I believe as said earlier that they want to manage the quality of the community even more than their financials and they'll take short term hits to do that which is fine with us but we're going to hedge. Since it's a large position we plan to hedge a portion of it around each earnings report. That said our current collar is running its course, it's a small profit right now and we may just close it soon because no earnings are on the corner and it expires in less than a month but currently not concerned about watching the teenage story. Who wants to talk about current market volatility. Should we be more or less ready to write puts?

Billy K.: I can jump in on that one. I think as we start to see more volatility and the VIX level goes higher puts become more attractive to write because the premiums are going up as the time value is affected by that volatility. I'm not sure if you're really asking this from a general perspective or from Pro's perspective. In our meeting today Jeff and JP and I discussed potentially writing some puts on some of our ideas so we are throwing that idea around but I think more important then current market volatility when it comes to writing puts is whether or not you want to buy the shares of the companies that you're writing puts on.

That's really the reason that you write a put and you have to be ready to accept shares of whatever company you're writing a put on and if you don't want to buy shares then you probably shouldn't be writing those puts so if there are companies that you like that you're interested in buying and you want to target a lower price now might be a good time to think about writing more puts because we have an elevated VIX level and much higher than it's been over the last year or two years and so you'll get paid a little bit better but make sure that you really want to buy the stocks that you're targeting.

Jeff: It has been nice to see the VIX higher for that prorating purpose and it's made us look as Billy has said at other potential income or option positions period and when we add Oracle the diagonal call to the portfolio, we are looking at having five income base positions; American Tower, Diagonal Call, Home Depot, Diagonal Cooper Covered Calls, Verizon covered Strangle, and then Oracle so five alone there and we'll have staggered expiration dates a lot of the times.

J.P. Bennett: We may even have some more coming down the pipe too.

Jeff: That's exactly right so we're not we're not stopping there. So, yes I would be more ready to use options in general now that volatility is its up a bit. Member is asking, "Paycom is the only Pro position I don't have, I've written puts a couple times but no shares how to proceed. Buy at this price or wait for a pullback." The stock is ready to buy and it's above our fair value estimate which is in the process of being updated but as a buyer you can buy some shares. We have I think at 3.5%, let me make sure and check 3.8 now, 3.8% position. I would say buy part of that, maybe you start with 1.5% and then wait and see what happens from there and look to right puts when the premiums are good or buy more on a big dip.

The stock is 97 now it's really been a strong performer and the good thing about that is in a lot of cases anyway strong performers continue to be strong performers and Paycom has a sort of runway for its revenue and its profits that it looks like could be a strong three to five year performer going forward as well that's our hope. It is rated buy as many shares as you're comfortable with up to around 3.8%, maybe you start with a third of that or half but seeing the latest earnings we're not taking it off of buy. It's staying at a buy.

JA has kind statement of support to the team here for the feedback provided on SVXY early this month. Thank you for that very much it's very kind. These challenging times when they arrive are times when we especially want to be available to you and process our own understanding and mistakes as quickly as we can so that we can then share with you what we're thinking. It never gets easier when you have a big mistake just because you've had several in your life and in investing I should say mostly in investing thankfully so far it's. It's still a challenge to process it quickly and share with you our team the Pro team, all of us what we think we're going to do next and why and what the situation is. We know you all have real money invested with us and any money is real money is what I mean to say and. Thank you for the positive feedback and we'll keep trying to be as available and expedient and yet useful in our thinking as we can.

SVXY is going to go down as one of those things that we will look back on as a lesson like the American Airlines call options for a long time to come and hopefully we'll learn from it and again as I said earlier I think ultimately make greater profits because of it. I was going to throw one more thing on there but I'm going to write a memo soon about our losers and look back at all our losers and what we gained from those so thank you JA that's appreciated. Let's go to a question that someone else can speak to and then I'll talk about Coherent in a few minutes. More strangles ... I think general it's good see you Jen. We just covered that, we are looking at more options in this more volatile market so I will archive your question Jen about Skyworks. I'll say to Skyworks I don't want to cover it right now I think the stock is too ... Well I'll look at the options well out of the money but the valuation is appealing on Skyworks it's a buy.

I'm not sure I want to cover it again we finally got our money made back on that covered call situation. Is there anything one of you want to talk about please jump in and then I'll cover Coherent and square and what not.

Billy K.: I can tackle this question from Lone about IYR and real estate. I'm going to assume Lone that you own the IYR as an alternative possibly to the short of SRS that we have which is still a position we have in our portfolio. A 0.2% allocation it's on hold because we can't recommend it to members as it's very difficult to short now but IYR is a real estate elite index fund basically and it tracks the elite sector and interestingly actually the largest holding in IYR is Pro holding American Tower and that's a 6% position and IYR and IYR also has significant exposure to the other tower companies as well and that would be Crown Castle and SBAC and together they make up more than 12% of this IYR.

What we've seen this year in 2018 is that even in the beginning of the year before the volatility and that big market crash in February when all of the indices aside from real estate were up strongly S&P 500 at its peak this year was up 7%, NASDAQ was up 9%, Dow Jones up 7% but the Reindex in the REIT industry has been doing poorly this year and right now year to date in just 2018 it's down 11% and that's likely almost certainly due to the fears of rising interest rates which we touched on a little bit in the beginning of the chat here. This is something that we've talked about and we've discussed as a risk factor for American Tower for many years as we've been covering it in 2013 and other years when the Fed's kind of tapering tantrum happened and the REIT sector was hit with some volatility.

Any time there is a speculation that interest rates are going to rise, the tendency is for a REIT pricing to fall and that's because REITs provide a yield generally because they're required to pay out a portion of their earnings and that yield when right rates are rising becomes more competitive for people to buy alternatives to REITs when you're looking for income whether that be bonds or anything else that might provide a yield. In our case and what we're thinking about how it affects the companies in our portfolio specifically with respect to American Tower, I've touched on this a lot in the discussion boards, interest rates really don't make a big impact on the company's cash flows and the company's earnings. It may affect just a little bit as far as their cost of debt, America tower does use quite a bit of debt in funding their business and the cost of that would go up but it doesn't make a very big impact.

This is all to say that the impact that we see to the reach sector in response to REIT rising is really kind of a knee jerk market reaction and a lot of times the REIT sector has a tendency to really trade all together and all the stocks are very highly correlated but in reality the forces that are driving the success of the individual businesses that make up the REIT index is kind of more varied and interest rates are not really the biggest factor when it comes to whether or not those businesses are going to be successful. To answer your question more succinctly I've been kind of rambling a bit there but real estate right now is kind of challenged and as rates continue to rise you might see more pressure in the real estate sector but what that means is that there may be more opportunity for you to dive into that real estate sector and find the specific companies that you like where maybe the market is throwing the baby out with the bathwater.

Specifically in our case for Pro, American Tower is a good indication of that as the REIT sector has come down significantly in price, American Tower now is more attractively priced and it's been in quite some time and we're seeing valuation levels American Tower that corresponds most closely to other times of low multiples for that stock. That's my long winded answer to your question, Lone.

Jeff: It's a great question and SRS in the last five years is down 60% so the short has performed, IYR is up including dividends roughly about 30, 37% but a lot of that is the dividend itself with a four percent yield. We didn't plan to keep the short this long per se but IYR we've always viewed as a very long term investment if you're going to make it and you're doing it largely for the yield and hopefully to get a North Star return overall but so far it hasn't quite done that the last five years at 30% returns or hasn't done it by a long shot actually 30 versus 50%. I guess Lone, it depends on how well it fits into your portfolio and if you like owning it or not as Billy said our SRS is such a small stake now and the ETF itself is so small that nobody can really short it anymore. It might hover us to just close that out, take away any confusion with new members but for now it's a 0.2% position. JP Do you have any questions you would like to answer?

J.P. Bennett: They only thing is a lot of questions that I have a little bit further down ... they're kind of geared towards the stocks that I cover are quite a ways down and I don't want to skimp out on the ones that have 10, 12.

Jeff: I can jump onto those then. I'll talk about ... I can talk about Coherent and square and we can all talk about Facebook and FAZ as well so let's tackle the top five. We have about half an hour remaining already so we can try to cover all these questions in that time if I'm quick. Our position on Coherent has not changed. The stock is rated by, I have posted an update on the board and in full life well when you quote the stock itself you'll get our update on it too on the page and it's still a buy. The shares fell despite record results and a record outlook for 2018 which is basically all booked already and they're billing capacity for 2019. Shares mostly fell it sounds like because of concern out there about OLED screens moving aside for micro LED, in favor of micro LED even though that technology is really years away from being available at a consumer level.

Said, OLED continues to advance and they find new ways to make it better and more efficiently and OLED is slightly likely to stay with us for a long time to come. Why is this important? Coherent part of what they design and sell are laser systems that helps you make OLED screens. That said, you can bet that they're working on micro LED technology lasers to help you make those next so they should meet that demand when it arises and I'm a little surprised how concerned the market is and that's why I'm looking to learn more about that and learn why investors are as concerned as they seem to be with Coherent. That said the stock does trade with volatility and it has for the past year or two at least and now it's at about 14 times earnings, 17 times for cash flow, and we rate it a buy and we're staying at a buy and our position size is, you can see on the page 2% flat and it's a best buy now so our stance hasn't changed and it's recommended as a 2% holding.

I should add Coherent itself says they see no change in the market right now regarding OLED and they're not concerned about Apple either. Apple is investing in micro LEDD producers as well though so I think it's the market overreacting right now. Some concerns about Square and a possible pullback. Nobody knows what it will do of course Square will announce earnings February 27th, so in six days if you're waiting to add the position you could wait and see how those earnings go and then you'll have more knowledge obviously and you can make your investment based on that. Whether or not you get a lower or higher price, nobody knows time will tell. We rate the stock a buy and I'm not ... as long as the financials keep tracking the way they have been I'm not concerned about the business itself, the valuation is a little ahead of our estimate which is a difficult estimate to arrive at given the youth of this business and that it's just turning profitable.

It's going to be a more speculative more volatile position than most that we hold but the business is on a great track right now it appears in the financials are getting there as well. So, a lot of promise and looking ahead three to five years three years we're hopeful that it will continue to create value for us so you can wait on earnings on the 27th or not, Billy, yes.

Billy K.: I was going to ask you a question Jeff I'm curious to hear your answer to this and how do you view Square relative to MasterCard and Visa. Similar exposure, similar industry but different type of business.

Jeff: What I like about Square is that they are agnostic as to how you pay they're just a means of payment. They're a transaction interloper transaction middle person basically and whether you use Visa or MasterCard or PayPal or they say any future form of payment they want to be there and be able to provide it. I view them in some sense as a little bit of diversification potentially away from MasterCard and Visa if those two forms of payment start to lose out to some other new form of E-payment or PayPal which MasterCard has a big partnership with PayPal too then square may benefit by being agnostic and being able to switch quickly to whatever platform is taking off so I do like that about it Billy. If Square were only tied to MasterCard and Visa then I don't know that we would have bought it because we'd have too much exposure to those two brands in that case.

Billy K.: Thank you.

Jeff: Of course Billy, thank you. Great question. Facebook, anonymous is asking, "Facebook is on the defensive about Russian interference in the election, are we still comfortable?" We're comfortable with our position as it stands and yet we're looking at putting a collar on it during our financial results for at least the next quarter or two but it's news that we're watching closely and we do believe Facebook wants to do right and to make the community stronger and make it all legit and weed out as much as they can and hopefully with time you can almost entirely weed out fake accounts and bots and things that are destructive like that. You have to hope so but we're watching that and we continue to be comfortable with our stake as it is that said newcomers to Facebook should start with as we say every position across the board no more than 3% to start and go from there.

All right and I'll say briefly about FAZ. If you're short FAZ, you could stay short well pro re up that position potentially. We're looking at several new positions right now and how those play out may dictate whether we set up a synthetic short on FAZ or not but I'm still short myself and don't plan to close it anytime soon the original thesis still stands so members can stay short FAZ if they're comfortable and happy to do so.

Billy K.: And also especially now after the recent spike of volatility you may want to not consider closing it because your short position is now ... you have a higher obligation to repay because of that volatility so if you were considering closing it wait for that volatility to die down.

Jeff: Good news on Gilead fulls anonymous is asking about it I'm sure and many of you have the same question. In the quarter just reported Gilead said that they expect the hepatitis market to stabilize this year. It had been fall in the last couple of years and revenue for it had fallen sharply due to new competition pricing declines and even volume declines so they expect it to stabilize by the second half of this year and be stable from there on out. There are no, at least in the intermediate term, there are no new competing drugs on the market, pricing has stabilized and even customer flow is stabilizing. The market was happy to hear that with Gilead and now we have to see a few quarters if it holds true and last Gilead did very well with their forecast for hepatitis C so that's promising.

The stock has rebounded a bit because of it and our current plan, I don't know if I should pre-announce it but we've talked about this morning, I've said it before on the boards I think I know I did and the recent where Pro stands part one column two I said our plan is to move it to a buy and turn it into an official buy right position where we're going to write covered calls on it and manage those as well as we can to earn income as well as keep some upside in the shares. That is short on the list and should happen fairly soon so expect to see that soon down the road. It will become our sixth active income position again targeting some upside as well ideally so hopefully we'll see stable results from Gilead this year as they expect.

Chris has a great question as well that is a tough one to answer she or he bought around 2% of their portfolios worth in SVXY around 11 do they now keep it? It's a great question. The easy answer is are you comfortable keeping a whole 2% in it. We had 2% up to 3% at one point before we learned just how quickly it could lose 80%. You have to be comfortable with potentially losing all 2% overnight because it could happen. If that doesn't feel good to you then cut it down until you are comfortable. Shave it to 1.5% then 1%, get to the point where you are comfortable. We only have 0.3% ourselves. Any thoughts you two would like to add?

J.P. Bennett: I would say my view on these type of vehicles and I guess one of the great things for working on Pro and just not a fool in general is that we all have slightly differing opinions. It's encouraged to be modest enough and have different opinions about different stocks and things like that in my view for a lot of these of vehicles especially something SVXY is to be a little bit more kind of tactical and methodical with your approach to it in terms of set up okay I want to trim back to this after I've achieved a certain measure of profits and maybe I'll cut half after I've made a certain amount and then if it falls I can add to assuming I still like it but like you said the overriding factor here before you even consider anything like that like how much or how long do I want to hold it and do stuff like that is, "Okay, am I comfortable with risking this much." because this is not a business that is compounding intrinsic value day in and day out.

This is a completely different beast and so the inherent advantages that come from buying great stocks and holding them or buying stocks of great companies and excuse me for that and holding them for extended period of time is not embedded in buying something like the SVXY and so you just have to be comfortable with knowing that the risks, the going concern risk, the risk that this position for some reason or other goes away overnight is in my opinion exponentially higher than something like Apple. Pick any company in the purport for their right any long position, any short position, this one clearly has the highest risk and so you need to take that into consideration when you're deciding the allocation size.

I don't believe having a percentage of your portfolio kind of like what we're doing right, we're not completely selling because we think okay at this point you know it makes sense and to keep at least some of it in the portfolio buying it after it's gone and absolutely you know walloped and you know that at least for right now it's still going to continue to exist that's not a bad move. That's potentially a very smart move but it all comes on the position sizing and I don't know this individual's risk tolerance, their goals for this position, their goals for investing in general and so it's really hard to give a more tailored answer than to say, "Know thyself, know what you want out of it before you decide what to do."

Jeff: It's true JP and I should add to that that my original hope for the position is not working out ... is no longer playing out. The hope was that it could rise 100% and then 200% and when it did decline it would decline 30 to 50% but then it would climb again from there so that it would over the years compound. That's why we bought this vehicle instead of shorting VXX .

J.P. Bennett: Yeah, there's definitely added advantage to doing it this way.

Jeff: Yeah, the hope was it'll grow over time. Now that we can no longer hang our hat on that and that's why we're we're ditching the whole hope that SVXY will add long term value to the port and we're looking to make up for that with new positions and set in companies that will own that can indeed compound because that's our hold back here. We want to compound our results I hope was SVXY could add to that even when it periodically declined 50% but if it can decline 80, 90%, that is just out the window that's not going to compound for us.

J.P. Bennett: I would say one other thing to consider and I haven't spent as much time because there are so many other things as earnings are doing some like that are going on that again we're giving more time to simply because of how small this is. Now it's worth reconsidering what is the risk or the odds that something like this happens again? We saw billions of dollars wiped out overnight and so you would think that the speed at which capital flows back into this type of vehicle is going to be a lot slower and so if that's the case then maybe there is an argument for us returning to your original where it slowly grinds higher and any declines even though they may be sizable or ultimately recoverable. T

hat's another thing to consider when you decide whether or not we should hold or sell it and so my kind of off the cuff guess based on not having done a ton of research on kind of the lay of the land currently is that we may be pivoting back I almost think about in terms of like bubbles or market cycles right there is clearly ... you could tell, you look at Twitter you look anywhere you could tell that kind of the volatility trade, I don't know if I want to say long in the tooth but everybody was cutting in especially the retail investor was really getting in on this and so it was definitely a quote unquote yeah, their time amusing of course this call. It was a crowded trade and everybody is piling in and as we know housing, tulips, tech, those type of environments, there are repercussions and there are ... you have consequences for that and what you've see well I can't speak of tulips because I don't know what happened after the first place but you look after housing and tech and stuff like that right there was growth that resumed after the market settled and things readjusted.

So, maybe we are getting back to that environment. Maybe we're going to look back here five years from now and be like, "Man, the single smartest decision we made it for the portfolio was not selling SVXY because that thing has come roaring back." You don't know but that is something I am actually thinking is a possibility and at least for the time being argues for holding it and maybe even adding to it. I don't know I'm not going to say did it win in one way or another but maybe we'll come to that conclusion after a month of studying and getting a better lay of the land currently.

Jeff: One thing I'm trying to get in touch with ProShares to learn how they managed it during periods of extreme volatility like we just saw because the reason they stayed alive is they didn't trade the futures in the after market hours which were just insanely off the charts and that's what killed XIV. It rolled its futures and had nothing left to roll with and ProShares held off and waited until the futures prices came back down so if they have a lot of flexibility in rolling when they want to, like if they could even wait days to roll and let the futures come back down first then SVXY will have staying power because they can just sit on their old contracts and wait they have a few months. But if they believe they need to roll each day then the risk is higher but the prospectus says they ... doesn't dictate that they need to roll each day it leaves that unclear.

That's what we're trying to clarify and who knows JP, maybe if they have some ability to keep managing it better than just a daily roll then maybe we'll like it more than we do right now. Final thing I'll say to Chris is that we invested 1.3% on day one in SVXY the report was for 1.2% but we invested a bit more because it went up and so we want to match members. Keep that in mind maybe you bring your 2% down to what we originally invested because we never added to it after that. Okay guys, we have 15 minutes left,

J.P. Bennett: Lightning round.

Jeff: Let's do lightning round so we'll try to answer every question I think we maybe can but if our answers are brief it's because of lack of time solely. Karen is asking which holdings do we think will be most affected by rising interest rates and that's positive and negative. Any thoughts to share there from either of you?

J.P. Bennett: Just quickly I would say a lot of them. The obvious examples are like NVR and housing and American Tower being a REIT and things like that but I would say a lot of the company is just in terms of pricing where there be inputs or outputs or stuff like that but this kind of gets back and hopefully I'll be able to kill two birds with one stone because I think I saw another question further down the Q talking about, "Hey, how are you guys going to adjust to this, are there any change you're going to be?" One of the things, one of the hallmarks that has been in Pro since day one, one thing I hear you say day in and day out is we want companies with pricing power. We want companies when inflation and interest rates and all those things kind of kick up it doesn't affect their business because they're able to pass through price increases with without skipping B and so the negatives are completely offset and so hopefully the goal here is that the positive dynamics behind the companies that we have invested in are going to more than offset any negatives from rising interest rates or inflation or things like that

So the answer is you know either directly or indirectly all of them but I believe or I have conviction at least that those companies will be able to kind of just continue on compounding value.

Jeff: And periods of rising interest rates don't always ultimately result in a poor stock market. Typically, the stock market does appreciate during periods of inflation and modestly rising rates. When rates soar of course stock market usually does badly. We're also looking at companies that benefit from more volatile interest rates as new potential buys. Mikey, hello Mikey is asking, "What juice do the options give the Pro port and how do you make a decision to add an option trade or not within the parameters of the North Star?"

An Update on SVXY

Published Feb 6, 2018 at 5:02PM

Dear *Pro* Fools,

Pro has always wanted to push boundaries. Our very first position in 2008 was investing in Japanese yen using a young ETF. Not long after, we used options to take positions (both long and short) on volatility via the "fear index" -- the CBOE Volatility index, or VIX -- and on brand-new VIX vehicles. All along the way, however, our core focus has been on building a strong portfolio of companies that should compound in value and carry us to success. That is still our central mission, and it's still what carries us.

Would *Pro* be *Pro* without its other, more unique positions, though? I haven't thought so. I've always believed part of the allure of *Pro* has been our willingness to go where others haven't or don't -- to sell short (an act of rebellion by itself), to wade in and buy call options instead of stocks, to set up hedges on market indexes that actually earn us money even when stocks rise. But in investing as in life, when you try new things, you're going to learn new lessons.

Remember: Many of us have been working on buying winning companies for decades, so we're fairly good at that. In *Pro*, we haven't sold a core company at a loss for years. (In fact, have we ever? I'll have to look and see. We have sold speculative stocks for a loss, but we went into those saying they were speculative.) Alongside those winners, with some new ETFs and new strategies, we've certainly had big losers.

But if we took away the losers from our approach, our winners would look different, too. Again as in life, we are what we do. Your good points and your ... less great attributes, your flaws and your virtues, they all play together to make you *you*; one side doesn't come without the other. At *Pro*, the bulk of our effort -- perhaps 90% -- is in finding great companies to drive our results. And historically about 5% goes toward finding unique, new opportunities you won't see elsewhere that may or may not work out, but that certainly expand our experience. The other 5% is dedicated to remaining humble -- and to minimizing our exposure to unknown risks in new ventures.

SVXY Update

- **Summary: ProShares VIX Short-Term Futures** (NYSEMKT: SVXY) moves to Hold.
- **Reason:** We need to reassess the staying power of the ETF following today's extreme drop in price. Any stock or ETF can go to zero, but this one is more prone to it, and all investments are about risk vs. reward. Is SVXY worth it? We need to decide again.
- **Risk and You:** While it was a 1.3% position when we bought it (and grew to about 3%), our risk is smaller than ever now: SVXY is only 0.3% of the portfolio today. Don't be anxious about that (for one thing, it does you and your body no good). Even today, as SVXY lost a majority of its value, the *Pro* portfolio is *up* on the day. For 2018 so far, we're down a mere 0.4%, and we can still work to chase our North Star this year, of course.

Background

For several reasons, in late 2014, we invested 1.3% in the ProShares VIX Short-Term Futures ETF. We wanted the benefits of being short volatility over the long term, without the risk of being called out of short shares. We also wanted a position that limited our initial risk to the amount of our small initial investment, 1.3%. And we wanted a position that could grow unhindered over time. Finally, we planned to manage it accordingly. The last factor is where we missed the mark.

By January of this year, SVXY had grown by more than 200% for us -- at its peak, it became about a 3.1% position in the portfolio. The *Pro* team recently met and discussed cutting that position basically in half. JP wanted to. Billy agreed. I said we'd do it. That was our intent, and it was next on our list of trade alerts to write. Of course, the fact that we talked about SVXY regularly but had incredibly bad luck in our final timing does not excuse the 68% loss on our investment (as of this writing). We missed a chance to sell some at a gain.

Yesterday was historic -- the largest one-day jump in the VIX ever recorded, from 17.3 to 37.3, or more than 100%. If you're a fund that shorts VIX futures, and you need to close your positions daily to reset them, you're potentially closing with zero value left. You may need to liquidate, as the **VelocityShares Daily Inverse VIX ETN** (NASDAQ: XIV) is now set to do later this month. Our holding, SVXY, is set up as an ETF, not an exchange-traded note, and it should have more staying power (part of the reason we chose it). But it isn't invulnerable. More leaps in the 100% range for the VIX could spell its end. It's not that likely. But it's possible. It always will be.

There's plenty of time to discuss the merits of investing in vehicles like this at all. I think that if we do so in small amounts, and with full explanations -- our original buy report noted that SVXY could lose all of its value very quickly -- there's still a place in *Pro* for such experiences and opportunities. We'll only get good at it if we keep at it. But it's imperative that members keep allocations small. Even now, the most anyone here should be down (if you matched us at the top of SVXY) is about 2.8% of your portfolio -- a large but recoverable amount. We lost that, too, from SVXY's peak. We'll build it back. That's what we're here for.

What matters now with SVXY, though, is what we do next. With our allocation risk now slight (0.3% of the port), we need to calmly and rationally assess what we want to do next with our stake. We have several choices:

- **Keep our shares.** They don't risk us much now, and over time, as long as volatility isn't this intense again, they should slowly recover. If we're still worried, we can consider buying puts to protect them, though that gets costly over time.
- **Sell our shares.** If volatility leaps by about 100% again in one day (until yesterday, that had never happened before), the ETF could indeed end without value. Liquidation is always a risk when shorting, and we know that risk. We could just exit now.
- **Add to our shares.** This would require high confidence that SVXY is here to stay and will operate as it should. And once we've recovered some gains, we should cut the position expediently this time.
- **Sell some shares.** Should we cut our 0.3% stake down to 0.15% and keep that much to see if it recovers and what we can learn? It's not much, but 0.3% is still real money. We might want to take some out.

As we consider these choices, and perhaps others, we've put the ETF on Hold. I believe our decision will boil down to SVXY's likely staying power, and our desire to risk our remaining capital in it -- or not.

If SVXY likely has greater staying power than currently feared, we'd be wise to stay in it and let it slowly recover. Although the instrument only started trading in 2011, data that simulates SVXY's behavior over the previous two decades shows 80% drawdowns followed by eventual recovery. One reason we bought SVXY, and used other VIX vehicles in the past, is that it isn't levered, which helps us here. And as an ETF, it should be able to continue operating. That said, though, if a VIX spike of 100% occurs again, even SVXY could be vulnerable.

In closing (for now), it's clear that any position of this sort needs to be reasonably sized. We've been saying that since 2009. But should positions like this be in the *Pro* port at all? Should we instead just focus on owning companies, traditional shorting and hedging, and standard use of options? That's something we'll have to decide together, with some time to discuss it. We have plenty of room to keep improving, and we always want to. In the short term, our SVXY position is small enough that we have some time to decide what to next. But you should still know that it could go even lower -- it could even go to nothing. We have to be comfortable with that for as long as we hold it. That's always been true. It's true of every stock on the market, but more true here, as today shows us.

To discuss SVXY, please visit its board.

Best,

— Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: Feb. 5, 2018

Published Feb 5, 2018 at 2:11PM

Pro Guidance Changes (past two weeks; see any related trade alerts or earnings coverage):

- **Amazon.com** (NASDAQ: AMZN): The stock moves up to Best Buy Now as its financials improve and its dominance expands; our fair-value estimate (which is a much bigger guess than usual) moves up to $1,170. We have a 4.3% allocation.
- **Facebook** (NASDAQ: FB): Fair-value estimate increases to $176. The stock remains a Buy. We have a 7.9% allocation, with one-third currently collared (optional).
- **MasterCard** (NYSE: MA): Fair-value estimate increases to $150. The stock remains a Buy. We have a 6.1% allocation.
- **OpenText** (NASDAQ: OTEX): Fair-value estimate increases to $35. The stock remains on Hold as we consider whether we're eager to keep it for at least three years or replace it with something else. This quarter was a step in the direction of keeping it.
- **Square** (NYSE: SQ): The stock moves from Best Buy Now down to Buy after appreciation and as we await earnings due Feb. 27.
- **Visa** (NYSE: V): Fair-value estimate increases to $106. The stock remains a Buy. We have a 3.4% position.

Pro Completed Trades (past two weeks; see transaction log; trades take a day to appear):

- **Facebook** (NASDAQ: FB): We set up a protective collar on about 30% of our shares, selling five March 16, 2018, $200 calls, and using the proceeds to buy five of the same-dated $170 puts (we adjusted down from $175 on price changes). We did this for a net credit of $0.43. Everyone with a collar can leave it in place. Those without one can decide whether they want to set one up now, post-earnings. You can still set ours up for a credit. The immediate uncertainty of earnings is now gone.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Lessons From the Rearview Mirror

Published Feb 5, 2018 at 1:50PM

Dear *Pro* Fools,

I'm convinced that if aliens landed on Earth and observed us, they would believe half of us were crazy. For years now, so many investors have been obsessed with the "risk" of a "correction" -- meaning a decline of 10% or more. And yet, when some downside finally appears, they seem surprised and upset by it, rather than prepared to acknowledge this as a natural part of investing. The S&P 500 has doubled since February 2012. People have been talking about corrections the whole time. If we now see a drop of 10% or even 20%, investors will still be far ahead of where they likely assumed they would be, let alone ahead of those who stayed on the sidelines. And those who use a "dip" to finally buy stocks would still be paying much higher prices than they would have earlier. But I digress.

We're not here to look ahead today. I will remind you, though, that bear markets almost always coincide with recessions, so unless a recession is around the corner, the market's current volatility is probably just a normal fluctuation rather than the start of a new bear market. We showed you how often market downdrafts occur in an October 2017 Memo called "Recessions and Declines: Face Your Fears." Drops are natural. We work to minimize their impact in *Pro*, especially when they grow to 7% and larger. We also have cash we can employ. Meanwhile, it's good to see volatility rising and options finally starting to pay more. If this persists, it will help us make more income.

Rather than keep prognosticating about the future, though, today we're going to look back at the past once more. Last week, we reviewed our 2017 performance. Today, let's discuss some lessons and reminders drawn from last year.

2017 Lessons

We had a successful 2017, with the portfolio up 21.5% -- despite some losers that reminded us of truths we had to relearn.

Even Companies You've Known for Years Can Disappoint

I've followed **AmTrust Financial Services** (NASDAQ: AFSI) since it went public in 2006 at an adjusted $3.24 per share. At its peak in October 2015, it was up more than tenfold. From the beginning, I watched AmTrust build its business by entering new markets, offering new lines of insurance, and making acquisitions. Knowing the company from Day One was a definite advantage, one that gave me confidence to stay with it when short-seller attacks first materialized about 2008 or so (after it had doubled for the first time). It went on to rise much more in the ensuing years, even as attacks escalated.

Though AmTrust is one of *Pro*'s largest realized gains, we missed out on selling most of our shares at much higher prices than we finally accepted. (We did sell some portions along the way for more.) Warnings emanated from short sellers and in the press,but none of those I watched for came to fruition. At times warning signs showed in the numbers, but I was used to seeing those numbers improve. Combined, a history of success at AmTrust perhaps made me more confident than I might have been. I thought 11 years of hard-fought results wouldn't turn foul.

But AmTrust did prove to have material weaknesses in its reporting, big ones: Results were overstated, and the business wasn't as profitable as it had said. The new valuation made the choice to sell easy. *Pro* still earned a strong return, but newer members lost money. And a lesson was relearned: Even companies you've followed for years, from Day One, can surprise and disappoint you. We like to trust our oldest friends unconditionally, but we can't treat companies the same way. That's because the people running companies vary and change, as does their temptation to cut corners. To be clear: We never slacked on AmTrust. To the contrary, we spent more time analyzing it than any other company we've owned. And yet, we missed selling before a large drop, perhaps because I was partly too optimistic. There's another lesson in that, but it cuts both ways: Sometimes being optimistic will cost you a higher sales price. But overall, being optimistic has led to our success as investors.

Bottom line: Any company can surprise or disappoint you. All get a steady critical eye from us.

Lack of Recurring Revenue Is Always a Risk

We bought **Gilead Sciences** (NASDAQ: GILD) nearly four years ago, and as it turns out, we were late to the game. True, the stock was trading at just 11 times expected earnings, and its massive Hepatitis C drug had launched mere weeks before our buy recommendation -- $21 billion in brand-new sales (a tripling) would unfold in the next two years. And yet we were late! The stock had already risen sharply even before all this new revenue arrived. We thought Wall Street was still underestimating the Hep C market opportunity, and it was; Gilead's revenue from selling its cure for Hep C exceeded early expectations. But that revenue started to waver by 2016, as patients were slower to enroll and drug prices were slashed in light of competition. The market was, in a sense, already anticipating this slowdown when we arrived on the scene in 2014.

Wall Street values recurring revenue far, far more highly than it does one-time revenue. We know this. Gilead's Hep C revenue peaked so fast that it only briefly served as a boon to the stock after the drug launched. Ironically, had the Hep C market grown more slowly and revenue kept growing with it, the stock likely would have done better, longer. But here we are, four years later, with a nearly flat stock that's on Hold. The stock is now at 9.2 times earnings, and we're seeking to write covered calls again to aim to earn our North Star this year.

Fellow biotech giant **Celgene** (NASDAQ: CELG) has also seen its stock falter. When key products (in this case drugs) lose earnings power, it's hard for a business to compensate. Companies that lack naturally recurring revenue (software subscriptions, insurance premiums, transaction-based fees) face an uphill battle to compound growth. We usually buy recurring-revenue businesses. When we don't, we know our risks are higher. Pharmaceuticals/biotech drugs face this risk.

What You Read May Eventually Influence You

Last year was the year, according to the media, that old-timey retail all but died. Those headlines and sentiments were everywhere. After weeks or months of reading about this, the idea seemed to permeate Fool analysts' chatter around the office, too. The next victims, the media story went, included auto-parts retailers. Autonomous cars, ride-sharing, electric cars, **Amazon.com** (NASDAQ: AMZN) -- all would conspire to shrink old-school auto-parts businesses, including **AutoZone** (NYSE: AZO) and *Pro* stock **O'Reilly Automotive** (NASDAQ: ORLY).

And those stocks indeed started sliding as same-store sales began to slip. We set up a protective collar to potentially sell our shares of O'Reilly at $220, and eventually did so. (Members without puts unfortunately sold much lower.) Again, we earned a strong, market-beating return on our investment, but newer members lost money. Across the Fool, most auto-parts retailers were sold from other Fool services. Today, O'Reilly's stock is $255; we're still cautious on its multiyear prospects, but the best-run retailers are not, in fact, dead -- or even dying -- yet.

When a drum is beating incessantly, you're prone to eventually start moving to its rhythm. Whether you're drawn into buying Bitcoin at $19,000, or selling a stock when the doomsday drumbeat is loudest -- as we've done a handful of times, with less-than-ideal results -- it's hard to escape others' influence. This is especially likely to happen with stocks in which you lack 100% confidence to begin with. You need to be as mindful as possible that the decision you're making is your own, not someone else's. We were at least somewhat influenced by the constant chatter -- if we didn't read the news and constant opinions in this case, I wonder if we would still own O'Reilly today? Perhaps not. We wanted to reposition the portfolio. But even so, we'll keep this lesson in mind during future media flareups around our stocks -- for example, as we've done when naysayers attack **Apple** (NASDAQ: AAPL) periodically. (No, we don't think "peak cell phone" means the end of Apple's dominance.)

Just be aware, we are all susceptible to undue, external influence. It helps to check back on why you bought a stock to begin with, and see if those reasons remain in place today.

Winners Often Keep Winning

The SEC requires mutual funds to state that "past performance is not indicative of future results." That's a sensible reminder for fund investors, but it flies in the face of reality when it comes to those who are the very best at what they do. The top investors -- Warren Buffett is the obvious example -- have had strong results for decades. And the very best companies have shown that past results *are* indicative of future results, because they go on winning. In fact, David Gardner likes to say that past results are often a great indicator of future results. In the best cases, that's true, as it was last year with **Facebook** (NASDAQ: FB) and **Broadridge** (NYSE: BR), **MasterCard** (NYSE: MA) and **Apple** (NASDAQ: AAPL), all among our Most Valuable Players last year -- *again*. As AmTrust reminds us, we must stay diligent, but we should also expect decent odds that many of our industry-leading winners will remain on top.

Shorting Is Difficult for This Reason

Risk vs. reward is *one large reason* why shorting is so difficult. When you short a stock, rewards are typically modest, while your risk is always much higher . That's why it's important not to give your shorts a long leash: When a company you've shorted may be improving, you must seriously consider closing -- or face growing consequences. We closed our **Gogo** (NASDAQ: GOGO) short at a small loss because the outlook for the business improved (briefly, it turned out); the stock is back down now. We closed **GoPro** (NASDAQ: GPRO) for the same reason: Management projected profits after a stronger quarter. We closed for a tiny gain as the shares jumped. Best to be safe, right? The stock has been cut in half since then; GoPro's turnaround is failing. Our short would have worked.

Shorting will always be difficult because you want to keep from playing chicken with a position. As soon as any business results look counter to your thesis, you typically don't want to wait around to see whether the early improvement will continue. So, you often close to be safe. However, next your thesis might play out without you. That's how shorting often goes when you're disciplined about capping your risk. To be safe, you close on an updraft of better results. That's just discipline. But then later, the company often falters again. Missing that stings.

Meanwhile, **Shake Shack's** (NYSE: SHAK) business is facing more meaningful headwinds than before, yet the stock has risen. So far, we're waiting it out, and even considering adding to the position. Unlike the two companies mentioned above, the financials here have not improved, and thus we feel we can wait; and yet, proving again how difficult shorting is, the stock is rising while we do so.

You Need to Be You

Finally, 2017 served as a good reminder that you need to be *you*! When you invest, it's an expression of yourself, and of your knowledge and comfort level. We're all different. I wanted to put **Square** (NYSE: SQ) into the portfolio. JP wanted to buy **NVR** (NYSE: NVR). Billy added **Johnson & Johnson** (NYSE: JNJ). They're three very different investments, all doing well so far, and all reflections of ourselves in various ways. You need to be you when you invest. As a team, we at *Pro* work well together. Being the best "you" means incorporating the gifts of others into what you do, too.

Please post any comments or questions on the Memo Musings board. And thank you for being a *Pro* Fool with us!

Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: Facebook and More

Published Feb 1, 2018 at 1:09PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Coherent** (NASDAQ: COHR): Buy 2.3%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 2.9%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 3%.

Continue building your portfolio with our Buys, including:

- **Facebook** (NASDAQ: FB): Buy at least half of our 7.9% stake if you haven't bought yet.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **None.** Do NOT set up the protective collar on Facebook if you haven't yet. For those who have, of course, we'll manage it through official trade alerts.

Hedges:

- N/A

Upcoming Expirations:

- None imminent.

Set Up a Protective Collar on Some of Your Facebook Position

Published Jan 30, 2018 at 12:31PM

Is this for you? Any *Pro* members who own at least 200 shares of this stock, and who want to protect against downside, should consider this recommendation for some of their shares.

How You Participate

- **Action:** Set up a protective collar on **Facebook** (NASDAQ: FB).
- **Trade:** Simultaneously ...
  - **Sell to open** March 16, 2018 $200 calls.
  - **Buy to open** March 16, 2018 $175 puts.
- **Allocation:** Set up one protective collar (one of each option) for every 100 shares you want to protect. *Pro* will collar 500 of our 1,400 shares, setting up five collars. This protects 36% of our position, leaving 64% of our shares -- a 5% allocation -- uncovered, while collaring the other 2.7% that we own.
- **Price Guidance:** Use a **limit order** and initially aim to set this up for **small credit**. Prices will fluctuate as the stock moves, with the trade getting less expensive to execute if shares rise, and more expensive if the stock declines. Initially, always aim for no cost or a credit. **If prices change a lot**, it's a judgement call on your part depending on how much you want to spend; you should also consider using different strikes, rolling up or down accordingly to target no cost or credit. We will use different strikes if we need to by the time we make our trade.
- **Recent Prices (Noon ET):**
  - Sell to open March 16, 2018 $200 calls (splitting bid/ask): $3.90
  - Buy to open March 16, 2018 $175 puts: $3.60
  - Net credit: $0.30 per collar (use a **limit order**)
  - Stock: $187.60
- **Scorecard Status:** Buy. Allocation is 7.7%. Fair-value estimate is $168. We are putting a collar on 500 of our 1,400 shares, or 35.7% of our holding.
- **Special Note:** Facebook announces earnings tomorrow, Wednesday, Jan. 31, after market close, so we plan to execute our trade before that time.

What We're Thinking

We're we thinking? We're thinking we probably don't need this protection. But that's why it's called a hedge -- you're hedging an investment that you *believe* will do just fine, but that could (as always) disappoint you. In this case, we're hedging a portion of our Facebook shares (about 35% of our holding), partly because after a 600% gain it is our largest position, and partly because the company is facing a transitional year.

Management plans to spend enormous sums of money in 2018 hiring people and investing in better content controls; at the same time, Facebook is reconfiguring its "news feed" to show more content from friends and family, and less from news creators. This *may* affect advertising revenue, at least in the short term. Also weighing in our decision to be cautious is our belief in Mark Zuckerberg. Yes, our belief.

I believe Mark Zuckerberg cares more about the quality of the Facebook experience, and its reputation, than he does about near-term profits. We like this. We even believe this will eventually lead to greater long-term profits for the business. But Wall Street is rarely patient during performance hiccups if and when they occur, and Zuckerberg is not afraid to incur them for the greater good of Facebook.

We also recently bought **Tencent Holdings** (NASDAQOTH: TCEHY), a social media giant in China. It's a similar business, even if its advertisers differ. But it means we have a large investment in social media (10.7% to be exact, between these two), so a hedge on some of it makes still more sense. We have a 3% allocation to Tencent.

Returning to Facebook: Lately at $187, the stock trades at a reasonable 29 times expected earnings for the year ahead, and 47 times free cash flow. This isn't expensive for this business right now. So, once again, we don't believe we'll need this protection. But that's precisely why it's a hedge: It exists just in case. We're protecting some of our largest position against the possibility of surprise downside.

Why This Strategy?

A protective collar is friendly because it can cost little to nothing to set up (or even pay you, as in this case), yet it protects you from crazy downside. Plus, it gives the stock you cover with calls some upside before reaching the strike price of your short call. In this case, we have about 6.6% upside in the shares we're covering, and we have downside protection on these shares starting about 6.7% below the current share price. This collar could protect us into mid-March if we keep it open. Namely, it gets us through tomorrow night's earnings report and a possible update on 2018 guidance.

What happens next? If the stock stays between our strike prices, nothing. The options expire unused. If the stock falls below our long put's $175 strike price, we can sell our puts at a profit, or sell our 2.7% allocation in stock at the strike price. We would decide that at the time. Finally, if the stock rises above our short call's $200 strike price, we could let our covered shares be sold at $200, or we could close or roll the calls if we want to keep our shares (we would likely need to pay to do so). But again, most of our position continues to enjoy uncapped upside and the accompanying downside risk.

Alternative Trades

- **Own fewer than 100 shares and want protection?** You shouldn't sell a call option if you own fewer than 100 shares (because the call represents 100 shares), but if your Facebook stake is still a large enough part of your port that you want to protect it, you can buy a put option and have more protection than you need. The March 16, 2018 $175 put is lately about $3.60, so it's $360 for one put, and the stock needs to fall 6.7% just to hit your strike. You can buy this insurance if the cost is worth it to you; but you may be better off keeping your position unprotected. We still plan to be in Facebook for the long haul.
- **Own 100 shares?** You could collar all of it, but realize that's not our intention here; we're only collaring about one-third of our holdings. But it's your choice whether you want to collar all or none of your shares.
- **Just own Facebook calls or a syn long?** You can effectively collar a portion of those positions, too, if you wish. But make sure you want to go through the trouble of it.
- **Not using options?** Make sure that you're comfortable with the size of your Facebook position, and adjust if needed. The stock remains a Buy, though, and we don't plan to sell any shares unless the Facebook story changes. This hedge is a "just in case." If the story does change, we'll of course issue a trade alert with new guidance.

Pro Can Help

- Questions on this short-term protective position? Click over to our Facebook board.

Pro's 2017 Results, Reviewed!

Published Jan 29, 2018 at 1:44PM

Dear *Pro* Fools,

We hope that you're feeling prosperous in every way as 2018 welcomes us. And welcome us it has, with the S&P 500 already up more than 7% to start the year, fueled by worldwide GDP growth, higher earnings, lower taxes, and -- shall we say -- some animal spirits.

We don't like to make market prognostications, because we don't like to look foolish (small f), and it's not at all necessary for successful investing. But on our weekly radio show and podcast, *Motley Fool Money*, I nonetheless made a reckless prediction in December that the stock market would gain 21% *again* in 2018. Maybe that fun, silly prediction will bear fruit? I almost hope not, though, because that gain would just be stealing from future returns.

Anyhoo! Before we contemplate the future, let's revisit the past year.

2017 Redux: $574,955 Appreciation

The *Pro* portfolio appreciated by $178,000 in 2015 and again in 2016, and last year, we tacked on another $575,000 in a 21.5% gain. We started the year about 79% net long, averaged 81%, and are currently at 86%. So our exposure to the market grew over the year, and it's currently at the highest level since our inception. We have 15% in cash.

Below, check out our five-year annual returns and our three-year annualized gains. Over the past three years, we averaged 73.8% net long, yet we're well ahead of our North Star and the major market index.

Interestingly (to a nerd like me), we can see inflation ticking up via our North Star measure, which increased by 8.2% in 2015 and 9.5% last year. That's a meaningful jump; we keep our eye on inflation.

Vehicle	2017 Return	2016 Return	2015 Return	2014 Return	2013 Return	3-Year Annualized Return
Pro	21.5%	7.3%	7.5%	17.5%	35.1%	12.3%
North Star	9.5%	9.3%	8.2%	8.5%	8.7%	8.8%
S&P 500	21.8%	12%	1.4%	13.7%	32.4%	11.3%
MSCI World	20.1%	5.3%	(2.7%)	2.9%	24.1%	6.5%

Pro Average Net Long 81%	67.7%	72.8%	74.7%	74.6%	73.8% Three-year Average Net Long

The largest contributors to our jump in 2017 were **Facebook** (NASDAQ: FB), which gained $86,000 for us; **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY) was second, gaining more than $67,000 in value; **MasterCard** (NYSE: MA) grew $57,000 and **Broadridge** (NYSE: BR) $51,000. A little position, the ProShares ETF cited above gained more than 200% to make it our second-largest dollar contributor. **Apple** (NASDAQ: AAPL) and **Paycom** (NYSE: PAYC) were four and five in our dollar winners.

But our six brand new buys last year, combined, were the real winners, scoring us unrealized capital gains of $127,737, even though they were added as the year progressed. **Amazon.com** (NASDAQ: AMZN), **Coherent** (NASDAQ: COHR), **Johnson & Johnson** (NYSE: JNJ), **NVR** (NYSE: NVR), **Square** (NYSE: SQ) and **Tencent Holdings** (NASDAQOTH: TCEHY), all new, all nicely in the green.

Our biggest money losers in 2017 were two we sold during the year, **AmTrust Financial Services** (NASDAQ: AFSI) and **O'Reilly Automotive** (NASDAQ: ORLY). The first lost more than $74,000 in value for us last year before we sold (options offset that loss by a small amount), and O'Reilly lost more than $40,000 in port value before it was sold via $220 puts. O'Reilly has bounced back from that price, but our new buys are doing even better, and we're still concerned about long-term consumer retail habits.

Net Realized Capital Gains: $305,734

We were not tax-efficient in 2017 -- just as we said we wouldn't be when the year started. We wanted to position the portfolio better for the new realities we're seeing unfold in the world, and that adjustment continues today. It means we sold some long-term holdings. We booked big gains by selling AmTrust, **Gentex** (NASDAQ: GNTX), O'Reilly, **Papa John's** (NASDAQ: PZZA), **Parexel** (NASDAQ: PRXL), and **TD Ameritrade** (NASDAQ: AMTD). We had no meaningful losers to offset this. I guess that's a "problem" we'll accept.

Dividends: $27,561

Our dividends held steady despite us selling some dividend payers, including TD Ameritrade and AmTrust (formerly our largest payer), and buying more "growthy" companies that don't pay dividends, including Amazon.com and Square. Increased dividends at our dividend payers helped, and we added Johnson & Johnson.

When you look below, remember that our dividends are down since 2015 because we sold other big payers including **The Buckle** (NYSE: BKE), **Tupperware** (NYSE: TUP), and **Wells Fargo** (NYSE: WFC). On the whole, with those sells we avoided the Buckle's undoing (sorry -- that's a bad pun, but I had to take the opportunity!).

Year	Dividends Received
2017	$27,561
2016	$27,192
2015	$32,304
2014	$25,387

Our largest absolute payers in 2016 were **American Tower** (NYSE: AMT), Apple, Broadridge, and **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) -- and J&J.

For the first time last year, we reinvested our dividends quarterly starting in April. This definitely helped our returns so far, as we bought more shares of **FactSet Research** (NYSE: FDS) (quite a jump lately, eh? Unexpected!), and WisdomTree; more Coherent and **Verisk** (NASDAQ: VRSK); and more American Tower and Johnson & Johnson. All of those additional buys are making money, as is the additional purchase we made of **Visa** (NYSE: V) in March.

We'll continue to reinvest our dividends quarterly this year, assuming we like our opportunities. Our dividends last year represented just more than a 1% yield on our starting port value for the year, though; if we want to increase this, it will need to be a conscious effort. Right now, we seek dynamic companies more than we do greater dividends.

Option Income: $15,474

Despite a very low CBOE VIX (the volatility index measure) all year long -- which drove our SVXY position up big -- we made some option income. Not a lot. But some.

Year	Option Income
2017	$15,474
2016	$21,492
2015	$16,774
2014	$7,491

Three rounds of covered calls on **Gilead Sciences** (NASDAQ: GILD) and strangles on **Verisign** (NASDAQ: VRSN) and **Skyworks Solutions** (NASDAQ: SWKS) led the way, along with a strangle on **Expeditors** (NASDAQ: EXPD) that ended last January. We also wrote puts on Gentex and diagonal calls on American Tower, among others.

Combining this income with our dividend income, we earned a 1.6% yield on the portfolio's starting value last year, despite having a good amount of cash. We would like this yield to typically be above 2% (in volatile times, very much so), but the low-VIX environment makes that tough without taking chances we don't want (or need!) to take right now.

Short Stocks: ($912) in Realized Losses and ($1,036) in Fees

We paid more than $1,000 in shorting interest fees last year, and realized a net loss on our shorts of more than $900. That damage was minimal in the rising stock market. Much of our short losses were realized in the **Domino's** (NYSE: DPZ) paired trade short, and **Gogo** (NASDAQ: GOGO) was closed at a loss, too, offset by gains earned in shorting **Caesar's** (NASDAQ: CZR), **CurrencyShares Euro Trust** (NYSEMKT: FXE), and **GoPro** (NASDAQ: GPRO).

Last year, I criticized myself for not acting on some of our shorts sooner than we did, but hoping it would work out anyway. Alas, that ended up costing us some. That said, we backed off from placing several shorts last year that have subsequently gained ground -- so we were wrong on those shorts, but right to hold off.

Takeaway: Our shorts were nearly a wash in a very strong market.

Hedges: ($41)

We set up two put ratio spreads on the **PowerShares QQQ Trust** (NASDAQ: QQQ), one of which just expired. At our original pricing in the alerts, we would have ended with a small credit for our hedges (huzzah!), but we had to pay small debits for our trades. We're not complaining -- again, we lost almost nothing on hedges last year in a strong market.

Year	**Hedge Gain (Loss)**
2017	($41)
2016	$7,950
2015	$811
2014	($34,673)

In 2014, we had direct shorts of **SPDR S&P 500** (NYSEMKT: SPY), and naturally we lost on those as the market climbed. In 2015, we wanted to improve on that approach and stuck to ratio spreads. That has helped us greatly over the past three years, keeping hedging costs down and bringing in gains in an up market. Now we are looking to evolve to other hedging approaches. Watch for a new hedging guide from us on its way to you soon.

Active, but With Moderate Long-Term Turnover

Staying steady, we issued 43 trade alerts in *Pro* last year, or nearly four per month. (We also issued 108 alerts in *Options*, making *Pro* and *Options* the most active services at the Fool. That was up from 84 alerts in *Options* the year prior. I knew it felt busy over there!)

Year	***Pro* Trade Alerts**
2017	43
2016	45
2015	43
2014	34
2013	42
2012	55

We want to keep our stock turnover low, so much of our activity is related to options, but last year we sold more long stocks than usual (six), and closed a lot of shorts early in the year. That proved smart given how the market increased, but some of our shorts that we closed still fell.

We ended the year with 23 core company investments, the same as 2016 and up from 21 in 2015. We also hold two ETFs.

Our top 10 positions currently represent 46.3% of the portfolio's value (up from 44.5% last year, and 42% in 2015). Winners often keep winning.

Biggest Lessons and Improving Again

Last year started with a lot of question marks, and with volatility in some of our top holdings. Making those sell decisions wasn't easy, but they were part and parcel of moving into companies that we believe will have tailwinds and advantages for years to come. We also sensed risk to our shorts, and closed a lot of them early. By mid-year, we were feeling better, and we focused on putting still more new companies into the portfolio; those are so far doing very well.

We can't ignore the strong market for driving prices higher. We believe we're good at recognizing companies with advantages that will hopefully carry the day through harder years, too, but right now many stocks are rising. That said, the average fund that could be long or short returned less than 10% last year according to Morningstar, and has returned only 5.5% annualized over the past three years (6.5% over the past five). We've about doubled that, and topped the S&P 500, too, by taking a stand and being mostly long -- even at just 73.8% long on average -- while hedging with minimal cost.

Now our minds are on reasonably protecting what we're building while still allowing our portfolio to grow -- we believe that good business growth is still in the cards over the next three years and beyond. This is *Pro*'s 10th year in business! But we still feel that we have a lot to achieve -- in fact, we think most of it is still ahead of us. And we need to keep evolving while still sticking to the disciplines that we know work.

Please post any comments or questions on the Memo Musings board. In closing today, thank you for being a *Pro* Fool with us! We enjoyed spending last year with you, and we thank you! Now we look forward to this year with you...

Fool on!

— Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: Jan. 29, 2018

Published Jan 29, 2018 at 1:07PM

Pro Guidance Changes (past two weeks; see any related trade alerts or earnings coverage):

- **The Cooper Companies** (NYSE: COO): A new addition, the stock starts at a Buy on our scorecard, with a covered-call position as well.

Pro Completed Trades (past two weeks; see transaction log; trades take a day to appear):

- **The Cooper Companies:** We bought 400 shares and sold to open four May 2018 $240 calls.
- **Powershares QQQ Trust** (NASDAQ: QQQ): Our January 2018 ratio put spread expired unused.
- **Skyworks Solutions** (NASDAQ: SWKS): Our January 2018 $105 covered calls expired as income.
- **Verisign** (NASDAQ: VRSN): We rolled our January 2018 $105 calls to June 2018 $115 calls, and we sold to open new June 2018 $110 puts, recreating our covered strangle. Our January 2018 $100 puts expired as income.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Coherent, Skyworks, and More

Published Jan 25, 2018 at 2:39PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Coherent** (NASDAQ: COHR): Buy 2.5%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 3%.

Continue building your portfolio with our Buys, including:

- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.4%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2.1%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **The Cooper Companies** (NYSE: COO): Set up a covered call by selling one May $240 call for every 100 shares you purchase, per our recent alert. As of this morning this position could be set up for a net debit of $228.60, or a 5% return in 3.8 months. The recommended allocation size is 2.5%-3%, with more information on position sizing located in the "alternative trades" section of the report.

Hedges:

- N/A

Options expirations:

- None imminent.

It's All Relative

Published Jan 22, 2018 at 2:21PM

Fellow Fools,

- Is paying $700 per square foot for a given home a good deal?
- How good is my favorite football team?
- Is Apple undervalued?

How would you go about answering these questions? For many, the process would begin, and in some cases end, by attempting to assess the relative value of the item in question. How much have comparable homes sold for in that neighborhood recently? What is the current standing of my team in its division? How does Apple's valuation compare to the S&P 500 and similar tech companies?

Our brains seem to be predisposed to making comparisons, and assessing the intrinsic value of something can range from extremely difficult to just about impossible (do you know the objective intrinsic value of a Granny Smith apple? Me neither). So the fact that we reach for relative value when making decisions shouldn't come as much of a surprise. But while it's not inherently wrong, there are times when this can end up doing more harm than good.

Let's say you and five friends enter a contest in which a random group is chosen to win an undisclosed sum of money, with the prize to be arbitrarily distributed amongst the winners. Upon receiving your prize envelope in the mail one morning, you're ecstatic to open it and see a check for $10,000. "Free money! This is the best day ever!" you say to the dog. But shortly afterward, you get a call from one of your friends. You learn that they all won more than $50,000, with your best friend since grade school having won $100,000. You should have been overjoyed about winning a sizable sum of money for doing nothing more than writing your name on a piece of paper, but that night you lie awake in your bed, unable to shake the thought that you deserved more and life is a cruel, cruel mistress.

This story may be unrealistic, but when it comes to investing, the outcome is anything but. The longer a bull market lasts, the more you hear about people who've managed to generate impressive, and in some cases life-changing, returns over the span of a few years. Regardless of how respectable your own progress might be, the more you hear about other people being *more* successful, the greater the odds you'll find yourself dissatisfied with your own portfolio -- perhaps even so much so that you'll change your process to more closely mirror those who've seen such triumphs.

Just like with relative valuation, there's nothing inherently bad about attempting to learn from other successful investors. But as with most things in life, there's a catch. For the vast majority of us, investing is about tangible goals: having a comfortable retirement, putting our kids through college, buying a home, achieving financial independence, leaving our children and grandchildren with funds to pursue their dreams. For us, investing is *not* about keeping up with the Joneses down the street who got into Bitcoin early or leveraged their stock portfolio to the max in early 2009. Many of the success stories you'll hear about during extended bull markets were only made possible by the excessive risk-taking these markets tend to encourage. And for some investors, given their personal circumstances, this is exactly the right way to invest. But it's not the right way for everyone. It certainly isn't for *Pro*, and if your goals are similar to ours, it may not be for you.

In addition to potentially leaving you dissatisfied, focusing on other investors' results can make your decision-making process myopic as you spend too much time chasing similar results (and we all know the dangers of chasing historical returns). Instead, focus on your performance in relation to what *you* need to meet your goals. For *Pro*, this means any action needs to be considered in the context of whether it increases our odds of doubling our real purchasing power every 10 years, while also generating positive returns over every rolling three-year period. That is our measuring stick, our guiding light, our North Star. And while only 81% of our portfolio, on average, was in long stocks over the course of 2017, we managed to increase our lead over the North Star by a meaningful amount. That lead might be even larger if we'd been more aggressive, but we wouldn't change our approach. If the market hadn't been kind to investors in 2017, being overly aggressive could have undone all of our progress over the preceding few years.

If you haven't done so recently, the start of a new year is as good a time as any to take a moment to review your investing process and ensure you have a correct frame of reference for evaluating your performance. Investors hear a lot about thesis drift, but using the wrong reference points can bring process drift, with excessive risk-taking along for the ride. It can become ever more difficult to stay disciplined during an extended bull market, but that's often when the payoff for doing so is the biggest. Our goal is to beat the North Star, not the Joneses, and we need to ensure that we remain focused on doing exactly that.

Enjoy your week, Fools.

-- JP (TMFYossarian)

Pro Guidance Changes and Completed Trades: Jan. 22, 2018

Published Jan 22, 2018 at 11:46AM

Pro Guidance Changes (past two weeks; see any related trade alerts or earnings coverage):

- **The Cooper Companies** (NYSE: COO): A new addition, the stock starts at a Buy on our scorecard, with a covered-call position as well.
- **Oracle** (NYSE: ORCL): The stock moved to Best Buy Now from Buy. We have a 3.5% stake.

Pro Completed Trades (past two weeks; see transaction log; trades take a day to appear):

- **The Cooper Companies:** We bought 400 shares and sold to open four May 2018 $240 calls.
- **Powershares QQQ Trust** (NASDAQ: QQQ): Our January 2018 ratio put spread expired unused.
- **Skyworks Solutions** (NASDAQ: SWKS): Our January 2018 $105 covered calls expired as income.
- **Verisign** (NASDAQ: VRSN): We rolled our January 2018 $105 calls to June 2018 $115 calls, and we sold to open new June 2018 $110 puts, recreating our covered strangle. Our January 2018 $100 puts expired as income.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: The Cooper Companies, Oracle, Square, and More

Published Jan 18, 2018 at 2:28PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 3.7%.
- **Oracle** (NYSE: ORCL): Buy 3.5%.
- **Square** (NYSE: SQ): Buy 3.3%.

Continue building your portfolio with our Buys, including:

- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **American Tower:** If you've yet to join our diagonal call position, you can do so today by simultaneously buying ("buy to open") January 2020 $95 calls and selling ("sell to open") April 2018 $140 calls for a combined net debit of about $40.85 per diagonal call (that's $4,085). Invest about 0.7% of your *Pro* funds in this diagonal call position.
- **The Cooper Companies** (NYSE: COO): Set up a covered call, following our new trade alert.

Hedges:

- N/A

Options expirations (Jan. 19):

- **PowerShares QQQ Trust** (NASDAQ: QQQ): Our ratio put spread, put in place as a hedge, is on track to expire unused. We need do nothing.
- **Skyworks Solutions** (NASDAQ: SWKS): At current prices, our $105 covered calls are on track to expire as income, although the stock is challenging our strike price as we approach expiration. Keep an eye on Skyworks' stock price tomorrow -- we may need to take action if the stock price rises above our $105 strike price, since we want to keep our shares. We will need to "buy to close" the calls tomorrow (still earning most of the profit) if the stock price rises above $105 before the market close; we will alert you if this happens.
- **Verisign** (NASDAQ: VRSN): We are rolling our covered strangle up and out to June with this recent trade alert. Our January $100 puts are set to expire as income tomorrow.

Write Covered Calls on The Cooper Companies

Published Jan 17, 2018 at 3:03PM

Is this for you? This is for *Pro* members looking for a position that can bring them income with upside, and who have a large enough portfolio to remain properly diversified after buying at least 100 shares. For alternative trades, please see the end of the report.

How You Participate

- **Action:** Complete a "buy-write" order by simultaneously:
  - Buying shares of **The Cooper Companies** (NYSE: COO), and ...
  - Writing ("sell to open") May 2018 $240 calls.
- **Allocation:** Write ("sell to open") one call for every 100 shares you purchase, in order to establish a new 2.5% to 3% position. Here's the math for *Pro*:
  - *Pro* portfolio value: $3,401,000
  - Value of a 2.5% position: $3,401,000 x 0.025 = $85,025
  - Number of shares to be purchased, rounding to the nearest 100: $85,025/$235 = 362, rounded up to 400 shares, resulting in a 2.8% position size.
- **Price Guidance: It is imperative that you use a limit order, given the wide bid-ask spread for the May calls**. Fools should aim for a minimum yield of 1% (option premium/current price of the stock) per month to expiration; with shares at $235.14, the minimum to accept is currently is $9.50. We have a little over 4 months till expiration, so patience and limit orders are our friend here. If you don't utilize limit orders you will likely fill at a price well below this.
- **Prices** (12:40 p.m. ET):
  - Cooper Companies: $235.14
  - Sell to open May 2018 $240 calls (bid/ask): $10.30/$10.90
  - $10.60 pays 4.5% ($10.60/$235.14) in 121 days.

Why Write Covered Calls on Cooper Companies?

- Myopia, or nearsightedness, is already common. We believe it's guaranteed to become even more prevalent, in part because of environmental factors and in part because of increasingly frequent behaviors that people appear unwilling to change.
- We believe Cooper Companies, currently the third-largest contact-lens manufacturer in the world, is the best way to gain exposure to this seemingly unstoppable phenomenon, thanks to its competitive positioning within the industry.
- The contact-lens industry is attractive in its own right. Combining what we see there with Cooper's current valuation, we believe the risk/reward tradeoff from starting a position today is heavily in our favor.

What We're Thinking

They really didn't see it coming: In 2012, researchers in East and Southeast Asia were caught by surprise at the results of their study on myopia in young adults. Their data showed a likely frequency of between 80% and 90%,meaning hundreds of millions of nearsighted people in need of glasses, contacts, or corrective surgery. Worse yet, although that high rate may not (yet) be matched anywhere else in the world, this isn't just an Eastern Hemisphere phenomenon. It's currently estimated that more than 40% of all U.S. citizens are myopic, and global data suggests that about 50% of the population, or almost 5 billion people, will have the condition by 2050.

Prevalence of Myopia Estimated for Each Global Burden of Disease Region between 2000 and 2050

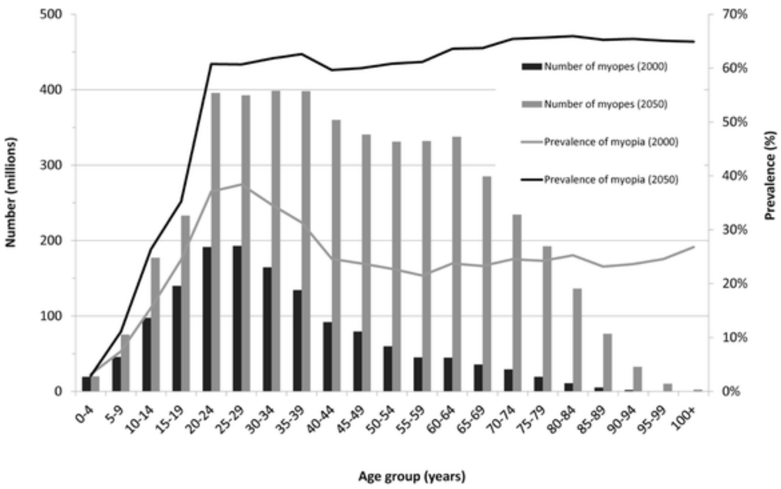
	2000	2010	2020	2030	2040	2050
Andean Latin America	15.2%	20.5%	28.1%	36.2%	44.0%	50.7%
Asia-Pacific, high income	46.1%	48.8%	53.4%	58.0%	62.5%	66.4%
Australasia	19.7%	27.3%	36.0%	43.8%	50.2%	55.1%
Caribbean	15.7%	21.0%	29.0%	37.4%	45.0%	51.7%
Central Africa	5.1%	7.0%	9.8%	14.1%	20.4%	27.9%
Central Asia	11.2%	17.0%	24.3%	32.9%	41.1%	47.4%
Central Europe	20.5%	27.1%	34.6%	41.8%	48.9%	54.1%
Central Latin America	22.1%	27.3%	34.2%	41.6%	48.9%	54.9%
East Africa	3.2%	4.9%	8.4%	12.3%	17.1%	22.7%
East Asia	38.8%	47.0%	51.6%	56.9%	61.4%	65.3%
Eastern Europe	18.0%	25.0%	32.2%	38.9%	45.9%	50.4%
North Africa and Middle East	14.6%	23.3%	30.5%	38.8%	46.3%	52.2%
North America, high income	28.3%	34.5%	42.1%	48.5%	54.0%	58.4%
Oceania	5.0%	6.7%	9.1%	12.5%	17.4%	23.8%
South Asia	14.4%	20.2%	28.6%	38.0%	46.2%	53.0%
Southeast Asia	33.8%	39.3%	46.1%	52.4%	57.6%	62.0%
Southern Africa	5.1%	8.0%	12.1%	17.5%	23.4%	30.2%
Southern Latin America	15.6%	22.9%	32.4%	40.7%	47.7%	53.4%
Tropical Latin America	14.5%	20.1%	27.7%	35.9%	43.9%	50.7%
West Africa	5.2%	7.0%	9.6%	13.6%	19.7%	26.8%
Western Europe	21.9%	28.5%	36.7%	44.5%	51.0%	56.2%
Global	22.9%	28.3%	33.9%	39.9%	45.2%	49.8%

Source: Holden BA, Fricke TR, Wilson DA, et al. (2016) *Global prevalence of myopia and high myopia and temporal trends from 2000 through 2050*.

There are some optimists out there who think this trend is reversible, but we're clear-eyed realists here at *Pro*: We think the squints are here to stay. Myopia was once thought to be largely genetic, but recent research suggests that lifestyle choices -- including spending time indoors and on electronic devices -- contribute meaningfully to the proliferation of poor eyesight around the globe, especially for young people.

Changes in the global economy over the past 20 years have resulted in people spending more time inside for both work and pleasure. (And we weren't all lumberjacks to start with: A U.S. Environmental Protection Agency study found Americans were already spending 87% of our time indoors by the mid-1990s.) And you need only to look around any public setting to see countless people with their eyeballs glued to their electronic screens. A recent 2016 survey found that 50% of teens self-reported as being "addicted" to their smartphones, likely underestimating the true rate of addiction by a meaningful margin given what we know about psychological biases.

Worse yet, as in East Asia, many regions report the highest rate of myopia among the younger generations. That means only one thing is necessary for the rate of myopia to rise: the passage of time. As the years go by, older people with better eyesight are replaced by younger ones with a higher rate of myopia, as can be seen in the following chart.



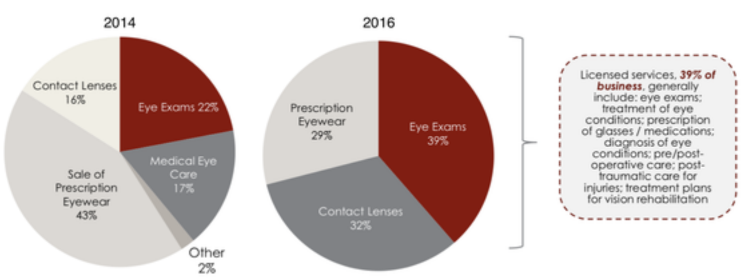
Source: Holden BA, Fricke TR, Wilson DA, et al. (2016) *Global prevalence of myopia and high myopia and temporal trends from 2000 through 2050*.

This is exactly the type of backdrop we like when writing covered calls — a slow and steady trend that seems immune to changes in the economy or stock market. And with Cooper Companies, we believe we've found something even better: a company within an attractive niche market, poised not just to ride this tailwind but to outmaneuver its competitors and continue to take share. Let's take a look at a few industry- and company-specific reasons we like Cooper in particular.

The Contact-Lens Industry

- Contact lenses are largely **recession-resistant**; yearly sales numbers go up by 4% to 6% on average, with growth only decelerating slightly, to 3%, during the worst of the global financial crisis in 2008 and 2009. Market sentiment many change during bear markets, but odds are Cooper's business will continue to compound its intrinsic value thanks to a steadily growing end market.
- With four top players controlling more than 95% of the market, this is a **classic oligopoly** -- one that has avoided pricing wars and enabled the largest players to earn excess profits. There is fear that the industry's shift away from unilateral pricing policies (which prohibited their lenses from being sold for less than a specific price, like what you see with iPhones), could spell the end of the golden age of contact-lens manufacturers. We believe this fear is misplaced, and even if it isn't, we believe Cooper is poised to profit regardless -- read on.
- Contact-lens customers are loyal; the average wearer sticks with a given brand for seven years. The big four's manufacturing advantages and customer relationships, and the slow rate of adoption of new lenses even from established brands, make for an industry where the **threat of new entrants is quite low**.
- Technological advances, and clever marketing, have resulted in a steady uptake in the adoption rates of **daily disposable lenses**, which bring anywhere from a 400% to 600% increase in annual revenue for manufacturers. Globally, only about 28% of wearers use daily lenses, and the U.S. in particular is still several-plus years away from hitting the saturation point. This shift is one reason contacts are becoming an increasingly important source of revenue for optometrists here in the U.S., expanding from 16% at the start of 2014 to 32% as of the end of 2016.

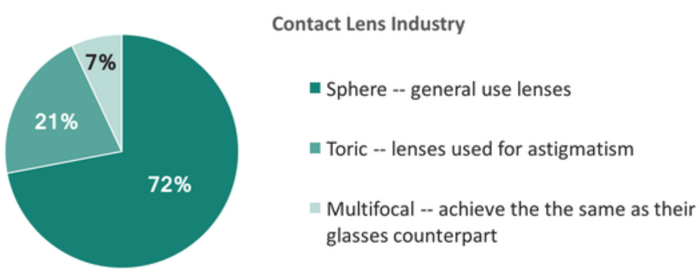
Optometrist Services Segmentation



Source: Harris Williams & Co (2015) *Vision Industry Overview*; Harris Williams & Co (2015) *Vision Industry Update*

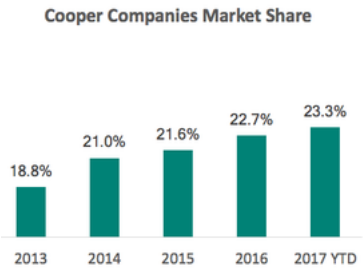
Cooper Companies In Particular

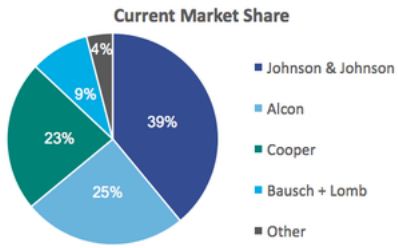
- The contact-lens market consists of three basic categories: sphere, toric, and multifocal.



Source: Cooper Companies

- Cooper is the **current market leader** in toric and multifocal lenses, which combined to account for 41% of Cooper's vision based revenue in the past quarter. Both are expected to grow at above-market rates (8% and 9%, respectively) over the next five years. Better yet (for investors, anyway), toric and multifocal lenses are 50% and 100% more expensive, respectively, than the basic spheres.
- A strong product portfolio and a smart reduction in acquisitions have helped Cooper consistently **gain share on its rivals**, many of which are part of bigger companies that are likely to be distracted by other business units.





Source: Cooper Companies

- As an example, consider silicone hydrogel, commonly considered the best material for lenses. While Cooper got off to a slow start in the space, management later invested heavily to not just catch up to its rivals but in many respects surpass them. Cooper is currently the only manufacturer offering two price tiers of daily silicone hydrogels, and the only one offering daily disposable silicone hydrogel toric and multifocal lenses. Although we've recently seen some competitors take steps to refocus on the contact-lens market and stop ceding share, we believe Cooper's strong product portfolio, accelerated investments in its sales force (despite gaining share in recent years, Cooper had lacked salespeople compared with its competitors), and customer stickiness have positioned it to **continue to take share** in the coming years.
- In addition to online retailers, independent eye-care providers (ECPs) also contend with retail chains including Visionworks, Costco Optical, Walmart Vision Center, and Lenscrafters. Independents still count for the majority of patient visits, but the chains have managed to capture an outsized slice of the revenue pie. This has forced smaller ECPs to attempt to find ways to differentiate their services, and **private-label contact lenses** are one approach. About 30% of current lens revenue comes from private-label offerings at Cooper, which was the first large manufacturer to fully embrace private labels and continues to offer the largest selection. This has helped forge strong relationships with many ECPs and boost sales of Cooper products.
- But that's not to say Cooper is choosing independent ECPs over big retailers in this battle. Take a peek at a box of Costco or Walmart **store-brand contact lenses** and there's a good chance you'll see Cooper listed as the manufacturer of those, as well. Management is pretty tight-lipped about its private-label business, but they did disclose that in 2016, margins there were actually in line with their branded offerings -- perhaps surprising, given mega-retailers' reputation for being ruthless with retailers.

Risks

Now that I've sold you on the contact-lens industry and Cooper's dominance therein, I should probably mention that Cooper Vision will only account for 75% of the company's revenue next year. The rest will come from a health-care business that is focused on providing products and services that focus on women's health, fertility, and diagnostics. Although we expect it to continue to deliver acceptable returns on invested capital, we believe the risk of a misstep is much higher in this line of business, especially since Cooper has relied heavily on acquisitions here for growth.

With the FDA having classified contacts as Class II or Class III devices since the 1970s, regulations have actually benefited the largest contact lenses manufacturers by helping dissuade new entrants. Recently; however, the call for contacts to be treated more like a commodity has become louder. Ultimately, we believe the risk is low in the intermediate term given the uniqueness of soft lenses (though they've garnered a reputation for being commodity-esque, soft lenses are all unique in terms of their polymer characteristics, ionicity, oxygen permeability, base curves, radii, thickness, moduli, and edge profiles), but any changes to the classification of contact lenses would likely be a hit to Cooper.

The *Pro* Bottom Line

Ultimately, we believe that Cooper's clear runway for steady growth for the foreseeable future makes it an ideal candidate for covered calls, and the supplemental income from those options should help our position outpace the North Star for as long as we keep it in the portfolio. And with the stock currently valued at less than 20 times forward earnings and 25 times our 2018 estimate for free cash flow, we believe the risk of permanently losing money with this position is low.

Alternative Trades

- **Want to write puts?** Currently you can write the May 2018 $230 puts for $9.7, or a 4.2% yield in 121 days.
- **Worried about remaining properly diversified?** At most, we believe you can dedicate 5% of your portfolio to this covered-call position, meaning you can follow along with this covered call as long as your portfolio is worth at least $470,000. If that's not the case for you, consider just buying 2.5% worth of shares. We believe Cooper Companies has a fighting chance to more than keep up with the North Star, but we're looking to have our cake and eat it too by generating both income *and* capital gains.

More That Matters

- **Maximum gain:** The stock's upside is capped at our written call's strike price.
- **Maximum risk:** The full stock value, minus call premiums received.
- **Follow-up:** With our calls set to expire in May, we're going to sit and watch the paint dry with this position before considering our options closer to expiration.

Pro Can Help

- **Blurry vision?** You're probably going to want to get that checked out, but if you have any Cooper-related questions, please head on over to our new Cooper Companies discussion board.

The Global Gaming Giant, Part 1

Published Jan 16, 2018 at 4:08PM

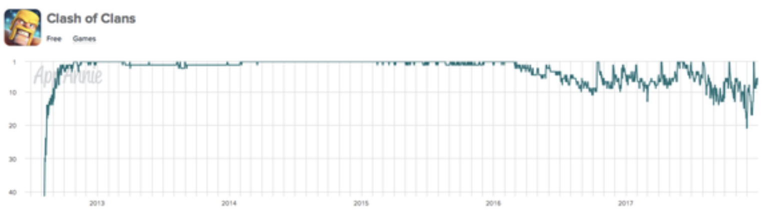
Deep Dive on Tencent: In our surveys and member communications, longer-tenured *Pro* Fools often express a desire for more educational content. So we're trying something new with our recommendation on **Tencent** (NASDAQOTH: TCEHY). Our initial alert laid out the thesis for our investment as usual and provided you with all the info you need to buy along with us. Subsequent additional pieces like this are meant to give you deeper insights into why we're investing in China for the first time in *Pro*'s history. Thoughts? We're here for you on the Memo Musings board!

The makers of the popular mobile game *Candy Crush* may have chosen to name their company "King," but there's little doubt that when it comes to video games, Tencent is the only company that can truly lay claim to the throne. In the first half of 2017, Tencent's lead over second-place Sony actually widened to more than $3.7 *billion* as Tencent's mobile gaming business continued its torrid growth (up 84% this past quarter to more than $2.75 billion).

I haven't always been glued to my phone, investment-wise. In fact, I was bearish on the mobile/social gaming industry when I first started at the Fool. Having seen several lightning-in-a-bottle mobile-game developers disappear -- and, of course, Zynga's spectacular fall from grace in 2012 -- I was convinced that the only place for this industry in *Pro* was on the short side. But when I began doing research for short ideas in earnest, I realized that my long-held opinions were in need of an update. Not only does the current industry bear little resemblance to the Wild West environment of its formative years, but a few companies appear to have cracked the code to achieving long-term success in this flourishing industry.

Long Live the King

Those bearish on Tencent like to note that countless new games are released every day, thanks to low barriers to entry. They say the mobile gaming industry is simply too volatile and too risky for a long-term investor. However, take a look at the following chart.

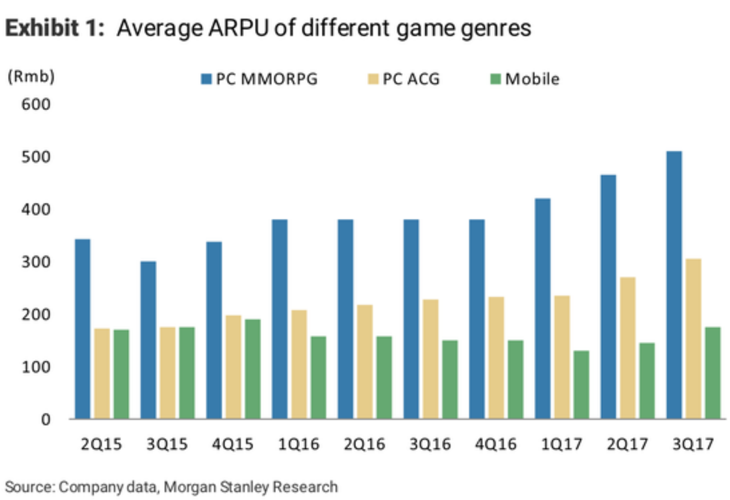


Source: App Annie

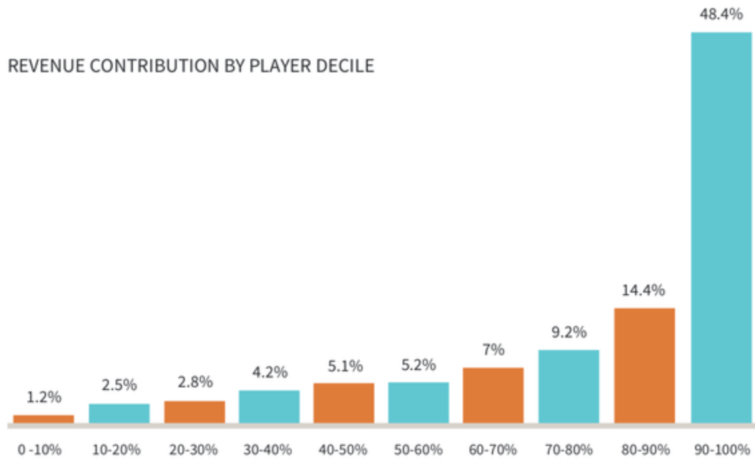
What we have here is the U.S. App Store ranking, based on gross revenue, of *Clash of Clans* (developed by Tencent-owned Supercell). Released all the way back in 2012, the app is currently ranked No. 6 for all apps in the iOS App Store and No. 2 in the Google Play store. This type of longevity is unheard of in console gaming and rare in almost any form of entertainment (quick, name any movie that spent *five years* at the top of the box office). As the industry has matured, the largest players' accrued advantages — bigger balance sheets, current player bases, access to desirable IP, distribution and marketing, etc. — have meant the mirroring of a pattern we know from console gaming, where for every one game that seemingly comes out of nowhere, we see 25 blockbusters created by top developers and/or based on proven IP. *Clash of Clans* is a poster child for this new reality in mobile gaming, one where a single hit game can have a lifespan measured in years, not weeks or months.

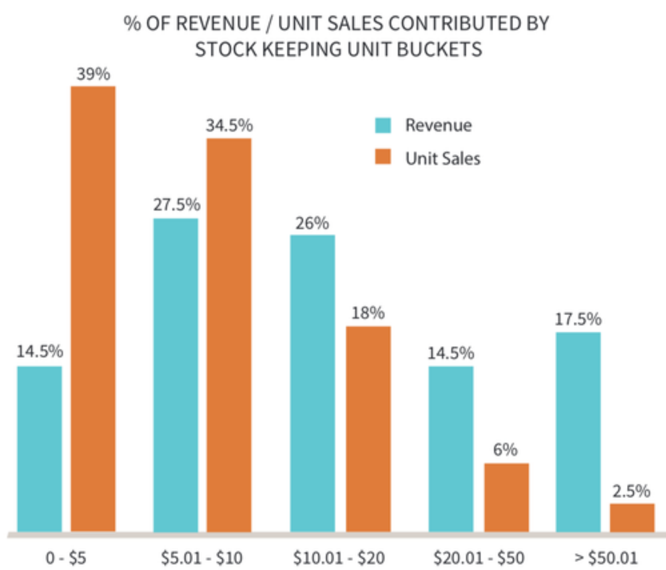
But those advantages alone don't fully explain the longevity of games like *Clash of Clans*. To really understand, you have to look at the games themselves, which arguably resemble a psychological experiment as much as they do a traditional video game. That's because consumers and the industry alike have developed a strong preference for the "freemium" (otherwise knowns as "free to play," or "F2P") business model, where games are downloaded and played for free with the option to purchase various things (cosmetic enhancements, in-game advantages, a lack of advertising) from within. In fact, only two of the current top-100-grossing gaming apps in the iOS store require you to pay to download. In general, there are two keys to success with a freemium game:

1. **You need to attract a large player base**. Publishing an F2P game is a bit like trying to find a needle in a haystack, with the needle being players who will actually spend money. A 2016 study that analyzed monetization data from 20 million mobile gamers found that only 1.9% of them actually made in-app purchases. This large percentage of people who refuse to pay is why most companies' mobile game ARPU (average revenue per user [gamer]) is lower than for other formats, such



as PC.
However, it is important to realize that a lower ARPU isn't necessarily indicative of a bad business model. The low to nonexistent marginal costs of mobile gaming give developers a great incentive to make their haystack (player base) as big as possible in hopes of finding more needles (paying players).
2. **You need to keep players coming back for more.** One of the most attractive aspects of the freemium business model for game developers is that it's a form of price discrimination: Users get to decide how much they pay. Putting the power in the consumers' hands might not sound like a smart business decision (imagine if Starbucks gave you the option to pay whatever you wanted for your favorite drink every morning), but it's one of the biggest reasons F2P games can be so lucrative. You see, some gamers have shown a willingness to spend far more than any rational developer would dream of charging for their game, more than making up for the ones who don't pay at all. Various studies have found that the top 10% of spenders tend to account for 45% to 60% of an app's total revenue (after accounting for other revenue sources, like advertising) and upwards of 75% of in-app purchases. Known as "whales" within the industry, the big spenders will often spend thousands, or in some cases millions, on a F2P game. Needless to say, the longer you can keep these gamers around, the better.



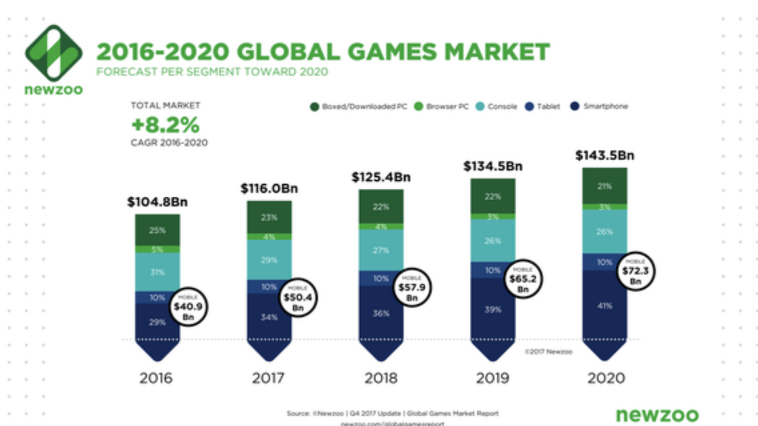


Source: swrve

But with 115 new iOS mobile gaming apps coming online *every day* in 2016 -- and low switching costs -- achieving both of these goals is extremely difficult. Developers need to create games that hook players from the start and then keep them constantly coming back. This is where the various psychological tactics come into play. Although this topic extends far beyond the scope of this Memo, the skeptic in me believes it's safe to say that many developers frequently make design choices that deliberately blur the line between fun and addiction. For those interested in reading more, here's a primer on some of the tactics used by developers. It's fascinating stuff.

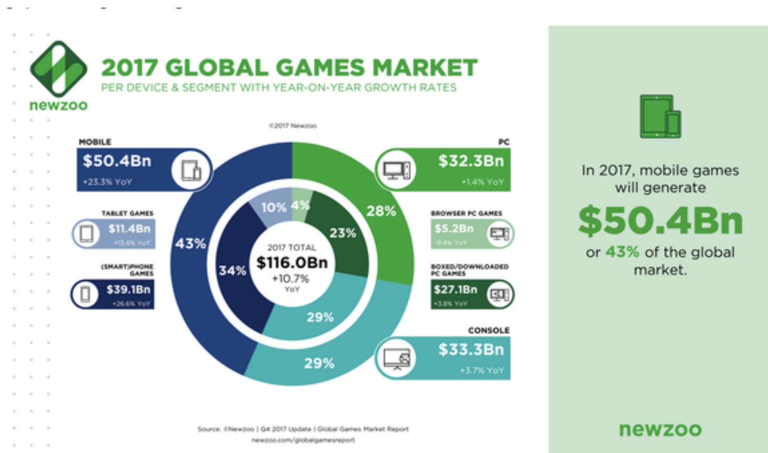
From Downloads to Dollars

Few forms of entertainment can match both the size and growth rate of video games, which generated more than 3 times the revenue of movie tickets in 2016 and are expected to see a revenue boost of 10.7%, to $116 billion, in 2017. And if you include revenues from console gaming hardware ($10 billion) and PC gaming systems and peripherals ($23 billion), gaming is actually a bigger global business than sports (which includes media rights sales, sponsorships, merchandise, and ticketing).



Source: newzoo

As with Tencent, mobile is currently leading the way for the industry as a whole. At $50.4 billion, mobile gaming currently accounts for 43% of the global gaming market, and it's likely to become the single largest contributor within the next three years. This is quite amazing when you realize that less than a decade ago, mobile gaming accounted for just 4% of total gaming revenue in the U.S. and many other countries.



Source: newzoo

But there's a lot more to like about the economics here than just robust growth. Tencent doesn't provide too many granular details, but by looking at other companies, we can get an idea of the numbers behind its biggest hits. *Candy Crush* parent King generated more than $1.9 billion in free cash flow and reported net income margins and returns on invested capital in excess of 25% and 38%, respectively, for the three years following *Candy Crush*'s launch (and before King was acquired by Activision Blizzard). And in 2016, Supercell (which Tencent now owns) reported $2.2 billion in revenue and $792 million in net income, good for a profit margin of more than 35%. With only 213 employees, that means Supercell and its four App Store offerings generated more than $10 million in revenue and almost $4 million in profits per employee in 2016, which was more than Facebook ($559,000), Apple ($394,000), Alphabet ($270,000), Microsoft ($147,000), or Fannie Mae (the Fortune 500 company with the highest profit per employee, at $1.8 million).

Most of the large pure-play video game companies are currently valued at between 6 and 7.2 times their revenue. With a strong stable of games already out and a promising pipeline for the the year ahead, we believe Tencent can generate somewhere between $18 billion and $20 billion in gaming revenue in 2018 (at current exchange rates). That translates to a valuation of $108 billion to $144 billion for the gaming business, or roughly a quarter of Tencent's current market cap. However, as we've said on multiple occasions, we believe the whole is worth more than the sum of the parts for this company, and the gaming division doesn't exist by itself. So in our next deep-dive piece on Tencent, we'll examine why Tencent has been so successful in mobile gaming, what we expect from the gaming business going forward, and what we believe the company as a whole is worth.

Enjoy your week, Fools.

--JP (TMFYossarian)

Roll Your Calls and Write New Puts on Verisign

Published Jan 11, 2018 at 3:21PM

Is this for you? This recommendation is for investors already participating in our **Verisign** (NASDAQ: VRSN) covered strangle strategy. If you lack any position, consider the Alternative Trades at the end of this report to get on board.

How You Participate

- **Assuming you own shares and strangled them as we did ...**
- **Actions:**
  - Buy to close your January 2018 $105 calls. (We're leaving our January $100 puts alone to expire next week; you could also buy to close them if the extra exposure worries you.)
  - Sell to open June $115 calls.
  - Sell to open June $110 puts.
- **Allocation:** Sell one strangle (one of each option) for every 100 shares you own and every additional 100 shares you could buy. *Pro* has a 1.7% stake -- 500 shares -- and the strangle could potentially double that stake.
- **Price guidance:** As I write this, you would use a **limit order** and aim to roll your strangle for a **net credit of $3.15**. The stock looks likely to close above $105 by expiration Friday next week, so we need to get the trade completed before then or we'll lose our shares. We're sending the alert now because we want members to have plenty of time to act, and because most of the time value is gone from our short $105 calls. Please use a limit order, and pay as little time value as possible, to close your $105 calls. Lately, you would pay about $7.35 to $7.40, or $0.10 to $0.15 in time value.
- **Prices** (2:30 p.m. ET):
  - Stock: $112.22
  - Sell to open June $115 calls, bid/ask: $5.40/$5.60
  - Sell to open June $110 puts, bid/ask: $4.95/$5.15
  - Buy to close January $105 calls, bid/ask: $7.20/$7.50
  - Bid/ask split: Sell to open at $10.55; buy to close at $7.40. Combined **limit order** for $3.15. Inch it downward, toward $3, if that doesn't take.

What We're Thinking

Today's trade alert marks the fourth time we've rolled our covered strangle on Verisign, a global leader in Internet domain-name registry services that's mission-critical to keeping the Web up and running, since initiating the position at the end of 2016. Just keeping this position alive proved somewhat of a challenge in 2017, with the stock rising almost 50%, but we've actually managed to extract a respectable amount of income to date to go along with our capital gains. We're looking to bring in even more of both with today's roll, but please keep in mind that because they're thinly traded otherwise, Verisign's options prices can be widely affected by the volume *Pro* brings. Please use a limit order and adjust as needed.

In our previous rolling alert, we noted that we'd be happy to purchase shares at the strike price of our $100 put, which is about where we expected our fair-value estimate to close out the year. Assuming Verisign's fourth-quarter results (due out Feb. 8) are in line with our expectations, that estimate will remain accurate. That said, the stock continues to benefit from the expansion of its valuation multiple, and we as options investors find ourselves in a situation where the underlying stock price is above both our short call's strike price and our fair-value estimate.

After considering our options, we've decided to roll our position "up and out" yet again. Baring an unforeseen acceleration in the business, our 2018 **year-end** fair value for Verisign will be slightly higher than $115. This means that we can be comfortable rolling our strangle above our current fair-value estimate, because we believe our net start price for our new written puts will be below the stock's intrinsic value by year end. (This is not standard practice for us; we consider Verisign to be a unique case given the extreme stability of the business.) That said, it also means we're front-loading the position this year, looking to capture most, if not all, of our annual capital gains right out of the gate. Should the stock continue to run higher in the coming months, our plan is to either:

1. Roll the position out (not up and out, as before) to collect additional income.
2. Close down our options strategy and continue to hold the shares.
3. Let our shares get called away if we can't find an attractive rolling option and repurchasing our short calls is too costly.

Though we'd love to keep this strategy in the portfolio for years to come, No. 3 may well be the only rational choice if the market continues marching higher. We want members to be aware of this ahead of time.

The relationship of the stock price to our fair-value estimate is also why we're opting to go with June as our expiration date over March. We're not keen on paying to roll our covered strangle upward and write new puts above our current fair-value estimate when we don't have plans to chase the stock higher should it continue appreciating.

Alternative Trades

- **New to this position?** If you can afford a potential $22,200 or so in shares, buy 100 shares today and then "sell to open" the same June 2018 $110/$115 covered strangle described above (sell one call for every 100 shares now owned, and sell one put for every additional 100 shares you could buy). Using a limit order, you could lately collect about $10.55 per share in combined credits to write both options; demand a minimum of $10.55 for now.
- **New and only want to write puts?** Sell to open March 2018 $110 or June $110 puts, lately for about $3 and $5 (or a bit higher), respectively.
- **Have you previously only written covered calls?** You'll need to roll those calls, assuming you want to keep the position going. Roll them by buying to close them and selling to open the June 2016 $115 calls, lately for a net debit of about $2. That price will change as the stock moves, but you'll need to get this trade completed before next Friday or your shares will be called away. As always, sell one call for every 100 shares you own and wish to cover.
- **New and only want to write covered calls?** Use a buy/write order to buy shares in 100-round lots and simultaneously sell to open June 2018 $115 calls, selling one call for every 100 shares you buy. Lately this can be set up for a net debit of about $106.70, with initial upside of 7.7% to $115.

Pro Can Help

- Register a domain name that speaks to your soul on our Verisign discussion board!

Pro Catch-Up Trades and Upcoming Expirations: American Tower, Coherent, and More

Published Jan 11, 2018 at 2:23PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 3.7%.
- **Coherent** (NASDAQ: COHR): Buy 2.7%.
- **Oracle** (NYSE: ORCL): Buy 3.5%.

Continue building your portfolio with our Buys, including:

- **Broadridge Financial Solutions** (NYSE: BR): Buy half of our 5.8% position to start.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.6%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **American Tower:** If you've yet to join our diagonal call position, you can do so today by simultaneously buying ("buy to open") January 2020 $95 calls and selling ("sell to open") April 2018 $140 calls for a combined net debit of about $40.50 per diagonal call (that's $4,050). Invest about 0.7% of your *Pro* funds in this diagonal call position.

Hedges:

- N/A

Options expirations (Jan. 19):

- **PowerShares QQQ Trust** (NASDAQ: QQQ): Our ratio put spread hedge is on track to expire, unused.
- **Skyworks Solutions** (NASDAQ: SWKS): Our $105 covered calls are on track to expire as income. We may close them a bit early to be sure (depends on the stock price); if so, we'll of course issue a trade alert.
- **Verisign** (NASDAQ: VRSN): We currently need to roll the short $105 calls on our covered strangle; you should receive a trade alert from us soon.

Pro Guidance Changes and Completed Trades: Jan. 8, 2018

Published Jan 8, 2018 at 3:58PM

Pro Guidance Changes (past week; see any related trade alerts or earnings coverage):

- **Oracle** (NYSE: ORCL): The stock moves to Best Buy Now from Buy. We have a 3.5% stake.

Pro Completed Trades (past week; see transaction log; trades take a day to appear):

- N/A

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Deliberate, Patient, Optimistic

Published Jan 8, 2018 at 3:53PM

Dear Pro Member:

Welcome to 2018! We hope the new year finds you happy, feeling good, and enjoying each day.

How are we? Thank you for asking! We're great. We're here, ready for earnings season to start, assessing what we want to buy and short next, and considering other changes to make to the portfolio. Last year was only the *beginning* of our transition to owning *more* companies that we believe will have multiple tailwinds coupled with growing profitability for years to come.

Now, about our promised 2017 review: Our broker, Interactive Brokers, does not have our 2017 year-end statement ready yet, so it's not practical to review our performance in detail today, but that should occur sometime next week. But the portfolio gained 21.5% last year, well ahead of our North Star's 9.5%, and nearly tied with the S&P 500's 21.8% -- yet our portfolio averaged only 81% net long last year, so our results exceeded what could reasonably be expected (especially in a year of some notable losers).

Our North Star seeks steady results with much less volatility, rather than home runs. That said, our long-term track record of exceeding the market's total return while being only 73.5% net long on average is something we definitely aspire to continue.

Last year again rewarded investing Fools like us who follow a steady approach to *staying* invested. Our results were driven by strong gains from **Facebook** (NASDAQ: FB) and **Broadridge Financial Solutions** (NYSE: BR), from **Paycom Software** (NYSE: PAYC) and all of our new buys -- **Amazon.com** (NASDAQ: AMZN), **NVR** (NYSE: NVR), **Square** (NYSE: SQ), **Johnson & Johnson** (NYSE: JNJ), **Coherent** (NASDAQ: COHR), and already **Tencent Holdings** (NASDAQOTH: TCEHY). Plus, **Proshares Short VIX Short-Term Futures** (NYSEMKT: SVXY) climbed from $45 to $128, growing from a 1% stake to lately 3.2%. That last one helped make up for the fact that options prices are low in this time of low volatility, so we're writing relatively few options.

As we look ahead, our approach and mood are best described as "deliberate, patient, and optimistic." We don't feel *rushed* to buy or short anything. We like our portfolio. We are patiently considering new positions and strategies. We look forward to earnings and to the insights provided. We're optimistic over the coming years.

As for this year, nobody knows. But it's being reported this morning that investor bullishness has climbed to a seven-year high. Sometimes high-water marks like this can mean stocks are due to retreat or rest, because if you're bullish, you're likely already invested, so where will the new buyers come from?

But this year we also have lower tax rates on the way, most notably a much lower corporate tax rate and incentives to bring hundreds of billions of dollars currently overseas back to the U.S. That is going to fuel more share buybacks. This alone can't keep the stock market up, but is one factor to keep in mind.

What happens in the near term shouldn't matter much to any Foolish investor anyway. We want to earn steady returns, and we know that sudden, large gains in the market basically steal away from future returns. We would rather have steady results, while accepting that setbacks will occur regularly.

To continue our progress in 2018 and beyond, our strategy remains boringly the same. We're focused on buying more companies with competitive advantages and bright management that portend years of growth ahead; shorting companies that are in decline or stocks that look far overpriced; hedging market indexes against any decline; using options for enhanced exposure and income; and enjoying and reinvesting dividends.

And that's all I'll say as I keep refreshing our Interactive Brokers page for our year-end statement. We'll be back soon with our 2017 review. Fool on!

Pro Catch-Up Trades and Upcoming Expirations: Amazon, Tencent, and More

Published Jan 4, 2018 at 2:13PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Oracle** (NYSE: ORCL): Newly moves to Best Buy Now. Buy 3.5%.
- **Square** (NYSE: SQ): Buy up to 3.2%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.9%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.6%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- N/A

Hedges:

- N/A

Options expirations (Jan. 19):

- **PowerShares QQQ Trust** (NASDAQ: QQQ): Our ratio put spread put in place as a hedge is on track to expire, unused.
- **Skyworks Solutions** (NASDAQ: SWKS): Our $105 covered calls are on track to expire as income. We may close them a bit early; if so, we'll of course issue a trade alert.
- **Verisign** (NASDAQ: VRSN): We'll currently need to roll the short $105 calls on our covered strangle. We plan to do so soon, with a trade alert to you.

Roll Your Diagonal Calls on Home Depot

Published Dec 21, 2017 at 1:10PM

Is this for you? This is for all *Pro* members who wrote January 2018 $170 diagonal calls on **Home Depot** (NYSE: HD) as per our alert in October. If you have yet to establish a diagonal call position on Home Depot, or if you established a different alternate position, please see the Alternative Trades section below.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
  - "Buy to close" all Jan. 19, 2018, $170 written calls.
  - "Sell to open" the same number of May 18, 2018, $175 calls.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* will roll all nine of our calls.
- **Recent Prices** (1 p.m. ET):
  - Stock: $188.39
  - Buy to close Jan. 19, 2018, $170 calls (bid/ask): $18.45/$18.85 (midpoint $18.65)
  - Sell to open May 18, 2018, $175 calls (bid/ask): $16.90/$17.40 (midpoint $17.15)
  - Net debit to roll: Approximately $1.50 (this price will change)
- **Price Guidance: It is critical that you use a limit order**, aiming to pay as little time value as possible to close your short calls and to roll for as much of a credit as possible. The midpoint of the bid/ask spreads currently implies about a $1.50 net debit for this roll, although that number will change as prices change and as *Pro*'s collective volume affects the bid/ask spreads. The January short calls still have about 30 days until expiration (and more than $0.20 of time value left), so you have some time to complete this trade. As we approach January expiration, the remaining time value on the short call will erode, but realize that if Home Depot's stock continues to rise, rolling at attractive prices may become more difficult.

What We're Thinking

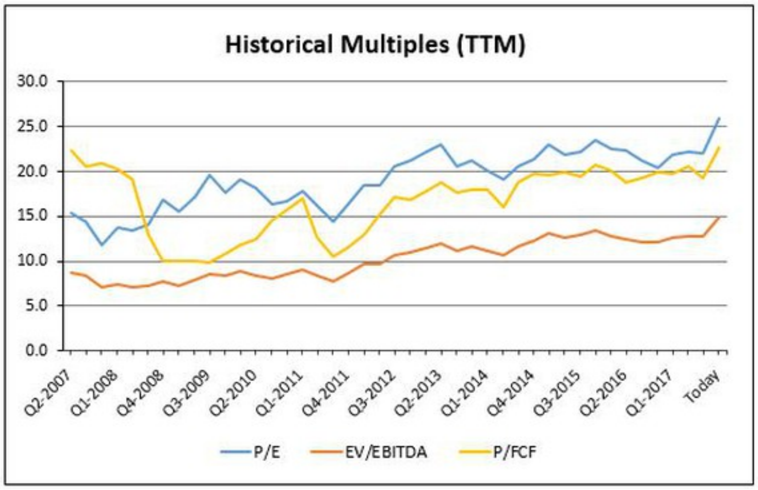
In late October, we decided to initiate a diagonal call position on Home Depot in order to target leveraged exposure to the well-run home improvement retailer. With a 13% simple return since inception if we were to close the diagonal call today, the position has so far been a success -- perhaps too much of one, in fact, as the stock has risen well above our short call and is forcing us to pay a debit to roll to keep the strategy going.

Since October, Home Depot has reported third-quarter 2017 earnings and held its 2017 Investor and Analyst Conference, outlining its long-term financial targets. Quarterly results were strong, continuing the company's momentum with 8% net revenue growth, 7.7% U.S. comparable-store sales growth, 15% earnings-per-share growth, and expanding trailing-12-month operating margins (14.5%, up from 14% in the same quarter last year). Financial targets for the longer term, through fiscal 2020, include compounded annual sales growth of 4.5% to 6%, operating margins of 14.4% to 15%, and a near-doubling of the company's investment spending, with a focus on reinvesting in the existing store base, IT and online features, and supply-chain initiatives.

In addition to Home Depot's strong business results and guidance, housing data has also been upbeat. The NAHB Housing Market index reached a level of 74 in December, the strongest reading of builder confidence since July 1999:

In addition to high levels of builder confidence, the most recent data from private residential construction (up 7.2% year-over-year), new single-family home sales (up 18.7% year-over-year), and housing starts (up 13.7% year-over-year) all suggest continued momentum in housing into 2018. As a result, the market has bid up Home

Depot shares and the company's valuation multiples have significantly expanded since we initiated our position:



Sources: S&P Global Market Intelligence, company fillings, author's calculations

Despite the rising multiples, if housing and economic momentum remain strong, Home Depot's stock should continue to do well. Given our assessment of the company's fair value and business momentum, we're content to pay to roll our diagonal calls out and up in order to capture further upside and keep the diagonal call position going. In exchange for $1.50 or so in incremental investment, we gain $5 in additional upside to our position (a 233% return on incremental capital in about four months), and we extend our expiration out to May, with the flexibility to potentially continue the position as market and business conditions dictate. As we approach May expiration, we'll reassess the position and determine our next course of action.

Alternative Trades

- **Did you write January 2017 $170 covered calls?** If you wrote covered calls, you can make the same rolling trade as *Pro*, rolling your January 2018 $170 calls up and out to May 2018 $175 calls.
- **New to the position and have yet to set up a diagonal call?** Do so by simultaneously buying ("buy to open") January 2020 $120 calls and selling ("sell to open") May 2018 $185 calls for a net debit of about $59.50 per diagonal call (this price may change). Invest 1.7% of your *Pro* funds in this diagonal call position (that is, one diagonal call for every $350,000 or so you manage), and keep in mind that this position is "off-reservation" from *Pro*, so if you're not comfortable managing a position on your own, this choice might not be the best one for you.
- **Have a different position not addressed here?** Check in on the Home Depot discussion board and we will do our best to answer your questions.

Pro Can Help

- **Questions?** Ask away on the Home Depot board.

Pro Catch-Up Trades and Upcoming Expirations: Oracle, Square, and More

Published Dec 21, 2017 at 12:56PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 4%.
- **Medtronic** (NYSE: MDT): Buy 2.5%.
- **Square** (NYSE: SQ): Buy up to 3.1%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.7%.

Continue building your portfolio with our Buys, including:

- **Oracle** (NYSE: ORCL): Buy 3.5%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.5%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 1.9%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.6%.

Options:

- See today's trade alert on **Home Depot** (NYSE: HD).

Hedges:

- N/A

Options expirations (January 2018):

- **PowerShares QQQ Trust** (NASDAQ: QQQ): Our ratio put spread as a hedge is on track to expire, unused.
- **Skyworks Solutions** (NASDAQ: SWKS): Our $105 covered calls are on track to expire as full income. We may close them early in early 2018 to capture much of the gain and have our shares uncovered for a recovery -- we're not closing the short calls now because that would book a large tax gain this year.
- **Verisign** (NASDAQ: VRSN): We'll currently need to roll the short $105 calls on our covered strangle.

A Strong Year Nears Its End

Published Dec 18, 2017 at 4:31PM

Greetings, Fools,

Sure, the stock market is up sharply this year, and the *Pro* portfolio is up more than the S&P 500. But it has still been a challenging year. We suffered hits on **AmTrust Financial Services** (NASDAQ: AFSI) and **O'Reilly Automotive** (NASDAQ: ORLY), both of which we sold (O'Reilly through a protective collar). We also decided to sell **Papa John's International** (NASDAQ: PZZA), happily at much higher prices than today's, and we also sold **TD Ameritrade** (NASDAQ: AMTD), among others.

Deciding to sell is rarely easy, but it's an especially taxing decision in a bull market. Stocks are rising, so who wants to swim the other way? But we wanted to position the portfolio for what we believe will be a better future, so we sold several holdings, and we soon bought positions in **Square** (NYSE: SQ), **Coherent** (NASDAQ: COHR), **NVR** (NYSE: NVR), **Johnson & Johnson** (NYSE: JNJ), and, more recently, **Tencent** (NASDAQOTH: TCEHY). We had bought **Amazon.com** (NASDAQ: AMZN) to start the year, too.

These are just a fraction of the investment decisions we made this year (both long and short, buying and selling). This was being done against a backdrop that I find discouraging. Living in Washington, D.C., I'm accustomed to political bickering in my backyard, but it seems as if we've been on a long slide backward when it comes to civility and rational discourse among politicians. Congress's moniker as "the Greatest Deliberative Body in the World" has become a joke on its face. Bills are being pushed through with less than zero deliberation -- without even knowing what's in them.

We've probably all watched what's happened in D.C. this year. It has likely consumed a fair amount of attention from many of us. I couldn't end the year without mentioning that it affects us here in *Pro*, too -- in this context, by testing our investing resolve and process. We only want to own superior businesses that can withstand storms of any nature and wind up larger three years from now (and beyond). Early in 2017, we reassessed all of our positions and sold ones we thought might be less than superior.

AmTrust's accounting issues called into question its return on equity and book value. TD Ameritrade had to lower its commissions again, and probably will again later (it's weathering this dynamic well so far -- in a bull market). O'Reilly faces risks with changing consumer shopping habits and, eventually beyond that, cars with fewer parts. Papa John's grew expensive and faces increasing competition in food delivery. (Politics later helped bring its stock lower, too.) We like the switches we made -- the sells and the new buys.

What's *less* fortunate is how strong the stock market has been this year. Big up years like this inevitably take away from future returns by pulling them forward. If the market drifts for a few years after this, or declines some, we need to see that as fair payment for the strong gains we've seen this year and in the many years preceding it. At *Pro*, we'll seek to ride out fallow periods with much more option income, with shorts and hedges (some of which we can take on quickly and in large size), and by owning companies that still grow. And we may now be nearing the point where we're ready to short and hedge more; as more of our stocks start to trade at earnings and free cash flow multiples closer to 30 than 20, the clarion call of hedging to get defensive sounds ever louder.

As for broader U.S. and worldwide trends: The lower corporate taxes that might be coming can't hurt companies' bottom lines, but investors have likely priced that news into stocks already. Expanding GDP around the world is a definite plus -- may it continue. Earnings growth this year is finally less than anemic for many U.S. companies. Interest rates are still low and will remain very low in Europe and elsewhere for years to come. Against this backdrop, we have millennials -- the largest generation ever, surpassing baby boomers -- reaching the ages where it's typical to start families and buy homes (in other words, spend a lot). And boomers are retiring.

Review of 2017 Coming

But before we try to look ahead, we'll soon look back. In early 2018, we'll review *Pro's* 2017 performance and see where our gains came from. We've had some laggards, and we've had some positions carry more than their weight. We've avoided big losers in shorts except one -- **Shake Shack** (NYSE: SHAK) -- but we're not done shorting. We've just waited in this environment. Before that review, though, we bid you a wonderful holiday break. Between Dec. 24 and Jan. 1, The Motley Fool does not publish except in cases of trading emergencies, so *Pro* plans to go quiet starting next week. Enjoy your break! And we look forward to seeing you very soon in 2018.

Meanwhile, everyone here at *Pro* and at The Motley Fool **thanks you again** for your continued trust in us. We're a fun place, and we get to wake up every day thinking of ways to invest smarter, and to serve you better. We're grateful for that opportunity that you bestow upon us.

As always, to share any thoughts, please visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: Dec. 18, 2017

Published Dec 18, 2017 at 4:06PM

Pro Guidance Changes (from past two weeks; see any related trade alerts or earnings coverage):

- **Broadridge** (NYSE: BR): Fair-value estimate increases to $79. The stock moves from Best Buy Now to Buy on valuation.

Pro Completed Trades (past week; see transaction log; trades take a day to appear):

- **American Tower** (NYSE: AMT): We bought 24 more shares at $143.53, bringing our stake to 4%.
- **Johnson & Johnson** (NYSE: JNJ): We bought 24 more shares at $140.82, bringing our stake to 3.1%.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: American Tower, Johnson & Johnson, and More

Published Dec 14, 2017 at 2:01PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 4.1%.
- **Coherent** (NASDAQ: COHR): Buy 2.7%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1%.
- **Medtronic** (NYSE: MDT): Buy 2.5%.
- **Square** (NYSE: SQ): Buy up to 3.2%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.7%.

Continue building your portfolio with our Buys, including:

- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.5%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 1.9%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.6%, but as we also noted last week, this company is hitting new 52-week highs, and that momentum may continue for awhile. If you're not comfortable with that, you may want to wait and see. We are considering adding to our short.

Options:

- N/A

Hedges:

- N/A

Options expirations:

- None until January.

Broadridge Updates Its 3-Year Growth Objectives

Published Dec 12, 2017 at 3:12PM

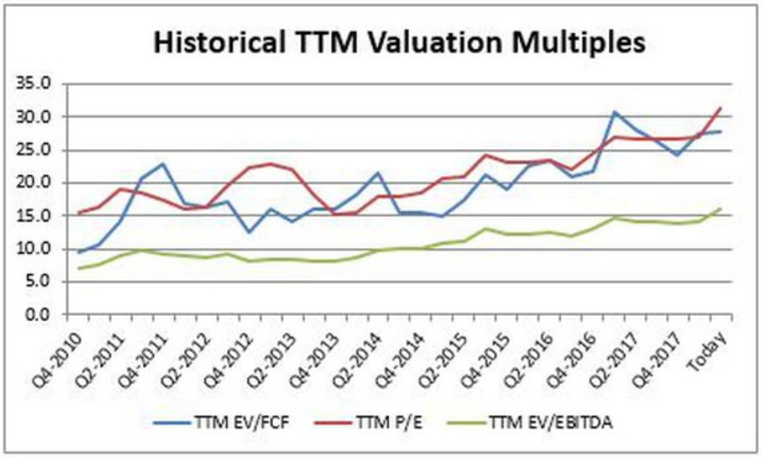
Fiscal Q1 2018

- Recurring fee revenue growth (year over year): Up 6% to $548 million
- Closed sales growth (year over year): +6% to $23 million
- EPS growth (year over year): +52% to $0.42

Now that **Broadridge** (NYSE: BR) has fully lapped its significant acquisition of DST's North American Customer Communications (NACC) business, the company is poised for continued growth into Fiscal 2018 and beyond. Our provider of investor communications continues to expand at a steady pace and produce significant amounts of cash flow from a capital-light asset base. Companywide margins are improving after a temporary depression due to the NACC acquisition, and margins should expand over time as the acquisition is integrated and operational synergies are achieved. Management has released their Fiscal 2017-Fiscal 2020 expectations, with 7%-9% annual growth in recurring fee revenue, about 50 basis points of operating margin expansion per year, and 9%-13% annual earnings-per-share growth over the next three years. We believe these expectations are reasonable and Broadridge is well positioned to continue to achieve North Star-like returns over at least the next three years.

- **Updated guidance**: Buy (from Best Buy Now)
- **Recommended allocation**: 5.8%
- **Fair-value estimate**: $79 (from $77)
- **Current price:** $89.80

Based on management's guidance, at $89.80 per share, the stock is priced at about 28 times projected 2018 cash flow and 28 times projected 2018 GAAP earnings per share. Both of these valuation metrics are elevated relative to the company's history:



After incorporating Fiscal Q1 2018 results and updating our valuation to account for the company's new three year growth objectives, **our fair-value estimate increases to $79 per share (from $77)**. The stock is up 10% since our last guidance update about two months ago, valuation multiples have expanded (as you can see in the graph above), and the current price sits nearly 14% above our newly updated fair-value estimate. As such, **we're moving Broadridge back to Buy (from Best Buy Now)** on our scorecard.

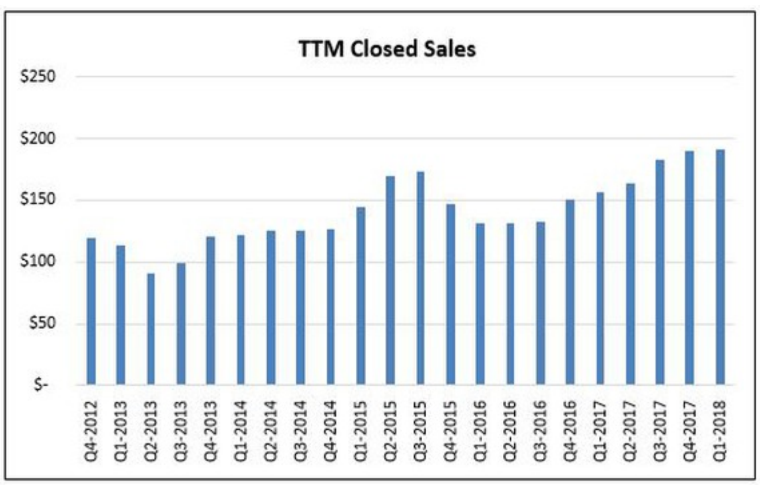
Our Thesis

Broadridge has a near-monopoly on proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record, and sound capital allocation policies make Broadridge a sturdy rock upon which to build the *Pro* portfolio. We expect modest growth in fee revenue (augmented by tuck-in acquisitions), slight operating leverage, plenty of free cash flow, and a growing stream of dividends and share repurchases to help achieve North Star-like returns.

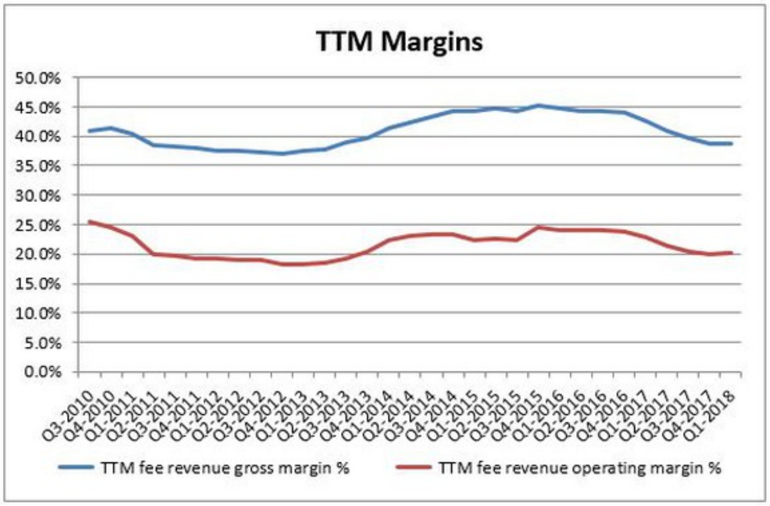
The Most Important Things

1. Closed Sales: This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%-plus). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

Broadridge started Fiscal 2018 with $23 million in closed sales for the first quarter, up 4.5% from last year. Management's guidance for closed sales for Fiscal 2018 is $170 million to $210 million, and closed sales for the first quarter puts Broadridge on track to meet guidance (closed sales is historically weighted more heavily toward the back half of the fiscal year). The company beat the high end of its guidance for closed sales in Fiscal 2017, and we'll see if the company is able to repeat that performance in 2018.

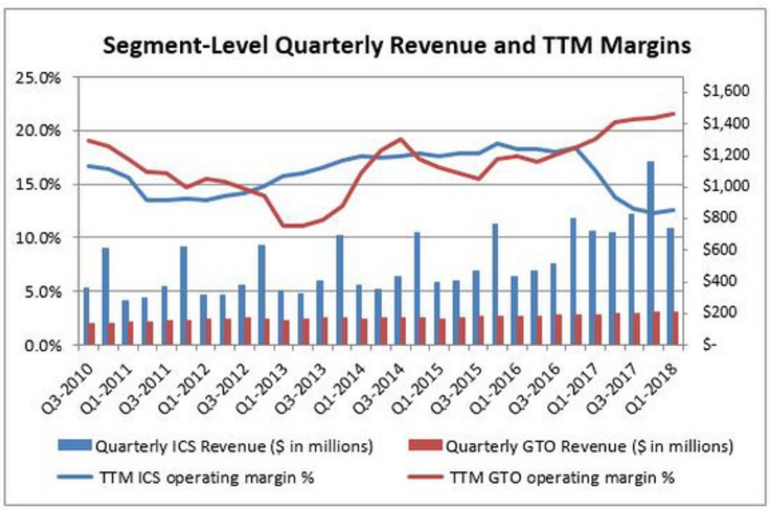


2) Fee Revenue Margin Performance: In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers) we prefer to look at trailing-12-month (TTM) margins to smooth out quarterly fluctuations. TTM fee revenue gross margins came in at 38.7% (down significantly from 42.5% a year ago), and TTM fee revenue operating margins came in at 20.2% (down from from 22.9% a year ago):



The reason for the decline in margins is the 2016 NACC acquisition. That business has a lower margin profile than Broadridge's legacy businesses, and it represents about 30% of total companywide revenue, so it drags down the margin profile overall. However, Broadridge should be able to expand NACC's operating margins over time via scale, cost synergies, and improved operational efficiency. I mentioned last quarter that now that we've fully lapped the acquisition, we should hopefully start to see margin expansion as we progress through Fiscal 2018, and that's what we started to see this quarter as TTM margins bottomed out and the company experienced expanding operating margins on a quarter-over-quarter basis (20.2% in Q1-2018 vs. 19.9% in Q4-2017).

When looking at Broadridge's separate divisions, we can see that the non-NACC business is doing quite well. While the Investor Communications Solutions (ICS) business has seen significantly lower (though improving) margins because of the acquisition, the Global Technology Operations (GTO) business has shown strong margin expansion, generating a record TTM operating margin of 21.6%:



We'll want to monitor the ICS division's margins (expecting longer-term margin expansion as we progress through fiscal 2018 and beyond) to make sure the NACC integration is on track, and we also want to watch GTO to see whether recent margin expansion trends continue.

3. Capital Allocation: In Broadridge's last Investor Day presentation in 2014, the company outlined plans for Fiscal 2015 to Fiscal 2017 to target a 45% dividend payout ratio, to increase levels of share repurchases, and to target $400-$600 million in tuck-in acquisitions to drive growth. Now that Fiscal 2017 is in the books, we can see that the company achieved its objectives:

- Total dividends of $3.60 per share between 2015-2017 vs. $7.59 in earnings per share, a 47% dividend payout ratio
- 12 acquisitions with a total spend of about $800 million
- $764 million spent on share repurchases (vs. $420 million the three years prior), reducing the share count by 4.1%

With the company's recent Investor Day presentation from last week, we got a detailed update on how management plans to allocate capital between Fiscal 2017 and Fiscal 2020: targeting a 45% dividend payout ratio, and using up to $1.4 billion in incremental debt capacity and expected free cash flow for share repurchases and merger & acquisition activity. Based on these capital allocation plans, we expect to see further share repurchases and tuck-in acquisitions over the next three years to help augment Broadridge's relatively slow organic growth.

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring organic revenue growth (augmented by tuck-in acquisitions) to translate to stout earnings and cash-flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Pro Can Help

- **Questions?** Bring them over to the Broadridge discussion board.

Pro Guidance Changes and Completed Trades: Dec. 11, 2017

Published Dec 11, 2017 at 3:34PM

Pro Guidance Changes (from past two weeks; see any related trade alerts or earnings coverage):

- **American Tower** (NYSE: AMT): Fair-value estimate increases to $146. The stock remains a Best Buy Now.

Pro Completed Trades (past week; see transaction log; trades take a day to appear):

- **American Tower**: We bought 24 more shares at $143.53, bringing our stake to 4%.
- **Johnson & Johnson** (NYSE: JNJ): We bought 24 more shares at $140.82, bringing our stake to 3.1%.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Coherent, Skyworks, and More

Published Dec 7, 2017 at 1:18PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 4.1%.
- **Coherent** (NASDAQ: COHR): Buy 2.7%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1%.
- **Medtronic** (NYSE: MDT): Buy 2.5%.
- **Square** (NYSE: SQ): Buy up to 3.4%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.6%.

Continue building your portfolio with our Buys, including:

- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.6%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS).

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.6%, but as said last week, too, realize that this company is hitting new 52-week highs, and that momentum may continue for a while, so be comfortable with that or wait and see. We are considering adding to our short once it settles down.

Options:

- N/A

Hedges:

- N/A

Options expirations:

- None until January.

Buy (More) American Tower and Johnson & Johnson

Published Dec 4, 2017 at 3:03PM

Is this for you? This recommendation is for all *Pro* members who have year-to-date dividends to reinvest, or who have ample cash to make a small additional investment and want to match us.

How You Participate

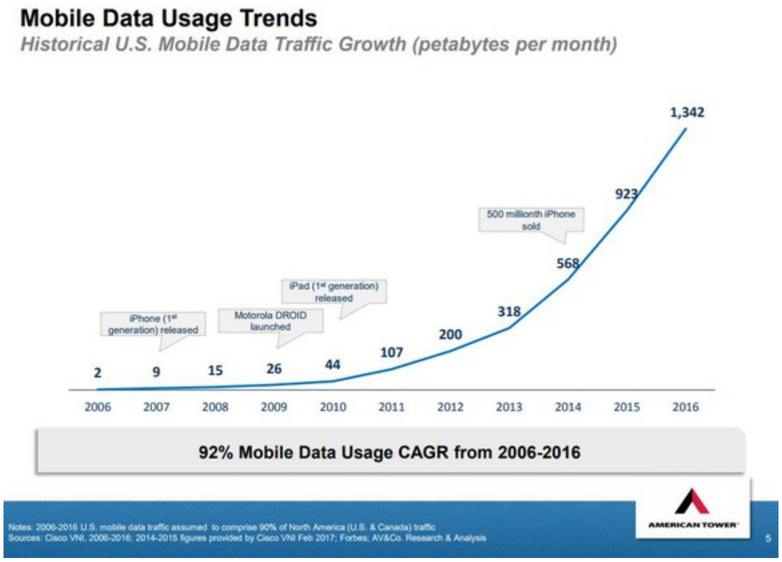
- **Action and Allocation:** Buy 0.1% more in **American Tower** (NYSE: AMT) and 0.1% more in **Johnson & Johnson** (NYSE: JNJ), raising these positions to a 4% and 3.2% allocation, respectively. At recent prices, *Pro* will buy about 24 more shares of American Tower and about 24 more shares of Johnson & Johnson.
- **Price Guidance:** Use a **limit order** at the prices available when you place your order. We'll buy in the next one to 30 days.
- **Price Ranges (Dec. 4):**
  - AMT: $140.03-$144.39
  - JNJ: $139.30-$141.50
- **Guidance:** Both are rated Best Buy Now; American Tower's fair-value estimate is $146, and Johnson & Johnson's is $137.

What We're Thinking

This is now the third quarter in which we're reinvesting our dividends when we see incremental purchases we're happy to make. This is always assuming we'll still be comfortable with our cash balance post-investment, which in this case we will; we have plenty of cash today at about 16% (ex-shorts), and we can afford to invest the net dividends we've collected since our last reinvestment in April. In the third quarter (July, August, September), we collected $6,616 total in net new dividends that we're now going to reinvest. This time around, we're targeting two stocks that have experienced fair-value increases post-earnings. Here's what we're thinking.

American Tower

Since its inclusion in the *Pro* portfolio in 2013, American Tower has been one of our most consistent companies, generating business performance that aligns with our investing thesis and valuation expectations. One needs only to read our quarterly updates over the past three to four years to to see that the business has been phenomenally consistent with its strategy, growth plans, and execution. We saw much of the same in third-quarter 2017, with American Tower reporting organic growth of 6.3% in the U.S. and 9.3% internationally. Notably, the company's U.S. growth was supported by the widespread adoption of unlimited data plans among subscribers of all four national mobile operators, which clearly indicates U.S. consumer demand for increased data consumption. This should directly benefit American Tower as the wireless carriers continue to invest in their networks to meet that demand for data:



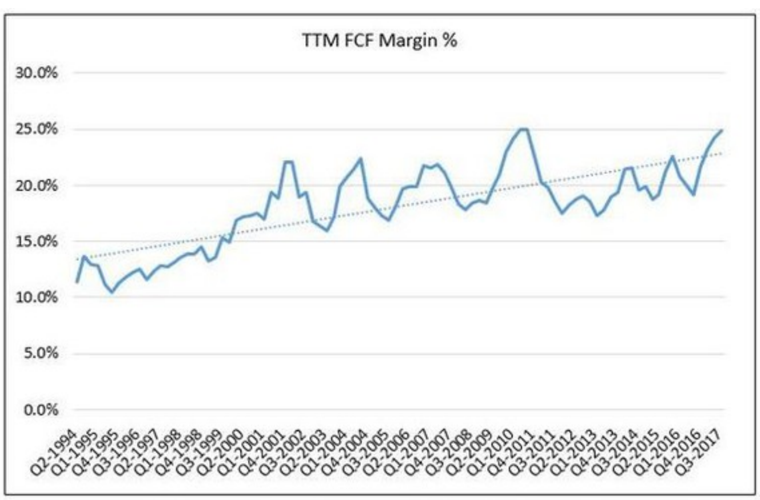
Margins are increasing in American Tower's U.S. business as it continues to integrate and lease up lower-margin towers acquired in 2015 from Verizon. Management has also maintained its focus on expanding internationally (e.g., a recent acquisition of 20,000 sites in India), which we like because international growth should be higher than U.S. growth over the short, medium, *and* long terms. We have a favorable view of the leadership team, led by 56-year-old CEO Jim Taiclet, who has been with the company since 2001 and has been named to the *Harvard Business Review*'s list of "The 100 Best-Performing CEOs in the World" for six consecutive years. We expect that the company will continue to invest selectively overseas and slowly increase margins both within the U.S. and abroad. In the meantime, we will continue to benefit from dividends and capital appreciation as sales and cash flow keep growing consistently over time. The stock is rated Best Buy Now, and we recently increased our fair-value estimate to $146 per share.

Johnson & Johnson

This is our first addition to this position, which was initiated in February and has returned roughly 15% (not including dividends) so far in less than 10 months, well outpacing our North Star over that short time frame. Our original write-up and investment thesis on Johnson & Johnson focused on how well the company fit our eight-point *Pro* Quality Checklist, and at 8 out of 8 qualities, JNJ is a quintessential *Pro*-quality stock. Since February, the business has performed well, which in part explains the stock-price appreciation we've experienced.

Accelerating revenue growth in the third quarter was driven by the company's $30 billion acquisition of Actelion and its suite of pulmonary hypertension drugs. The company beat analyst expectations on sales and earnings, and management raised 2017 guidance in response to the strong performance. Sales growth in the quarter was the highest reported since the fourth quarter of 2007, and the pharmaceutical division benefited from the Actelion drug portfolio and from promising growth of some newer drugs (Darzalex and Imbruvica) in the oncology market. This division continues to be a potential source of upside, with JNJ's strong pipeline set to help offset declines in older drug products over the medium to long term.

Management is also doing a good job managing expenses; the company's free cash flow margin is rising, meaning more dollars are available to distribute back to shareholders via ongoing stock buybacks and dividends:



We expect to continue to benefit from JNJ's healthy 2.4% dividend yield, modest earnings growth, and consistent stock buybacks. The stock is rated Best Buy Now, and we recently increased our fair-value estimate to $137. JNJ is one of the safest stocks in the *Pro* portfolio, and while we don't expect runaway growth and upside, we do expect to earn North Star-challenging returns with low downside risk.

The Foolish Bottom Line

As we reinvest each quarter to take advantage of the long-term benefits doing so will provide, we plan to pay at least a bit of heed to the fact that much is unknowable. Though what we're doing isn't "auto-reinvestment," in some senses we want it to be *like* that. We don't want to overthink it -- we want to think just enough. Nudge these two positions up by about 0.1% each if you have dividends you want to reinvest or more than ample cash and want to follow along. Helping to make this economically feasible, our trading commissions at Interactive Brokers are very low. Hopefully, given the commission wars going on, yours are, too. Fool on!

Pro Can Help

- **Questions?** Please visit the American Tower and Johnson & Johnson boards.

The Last Time We Were Here

Published Dec 4, 2017 at 2:55PM

Fellow Fools,

Thirty-six percent.

That's the premium the S&P 500 was fetching on a P/E basis this past Friday, compared with its July 2007 peak. A little more than ten years ago, that peak was the beginning of a 57% slide over the next year and a half. So if we're more than a third above that now, it's probably safe to say that now is the right time to batten down the hatches and completely hedge out the *Pro* portfolio, right?

Patterns. Patterns Everywhere

Burton Malkiel, the economist most famous for his work on "random walks" and the efficient market hypothesis, once showed a stock chart to one of his friends who practiced technical analysis. The friend's response was enthusiastic, to put it mildly:

> [He] practically jumped out of his skin. "What is this company?" he exclaimed. "We've got to buy immediately. This pattern's a classic. There's no question the stock will be up 15 points next week."

The only problem? There was no underlying stock. The chart had been produced by Malkiel's students simply by flipping a coin; if it landed on heads, they'd mark the stock as rising by half a point, and tails was the reverse.

Pattern recognition makes a lot of sense from an evolutionary perspective ("The last time I tried to get a drink out of this river, that hippo over there tried to maul me, so I think I'll go a little farther downstream before I try that again"). And it provides modern humans with a ton of everyday utility, too, helping us to learn faster, reducing mental strain, and freeing up cognitive capacity so we can deal with simultaneous stimuli. However, when it comes to investing, I'd argue that pattern recognition may in fact do more harm than good.

And that's not just with respect to technical analysis. Sure, pattern recognition can help identify common traits among successful investments, streamlining the process for finding new ideas. But this can lead investors to place too much importance on one or two factors while turning a blind eye to critical differences. It also helps explain why so many investors love backtesting and drawing conclusions based on comparing the current state of affairs with various points in history.

Mining for Headlines

And that's the reason for today's Memo. Recently, I've noticed a resurgence in commentaries featuring lines like the one I led with above: "We're now at levels not seen since right before the XXX bear market!" These pieces frequently end with the author suggesting that some type of meaningful decline is imminent, but I've always found this logic to be puzzling, given the sample size.

Think about it: Since 1980, we've seen a whopping total of four bear markets in the S&P 500. Would you be willing to fly in a new kind of commercial plane if it had only been through four hours of test flights? (Currently, the requirement is 4,000-5,000.) Would you be willing to try a new medicine with potentially harmful side effects if its clinical trials only required four participants before receiving approval? Would you claim to know the political leanings of a country as large as the U.S. after sampling four citizens? Extenuating circumstances (you're a daredevil, you're ill and not currently being treated) aside, I'm willing to bet your answers to those questions would range from "no" to "are you out of your mind?!" So why would you make investment decisions based on a handful of valuation data points from the past? That's especially important because the number of variables that are *different* between now and a given historical reference point vastly outweighs the number that are similar. Commentaries with these comparisons make for great headlines, but statistically speaking, they simply don't hold up.

Comparing a single data point (today's P/E) with one or two reference points in the past makes for a great headline, but without context, it says almost nothing about whether the current market is under-, fairly, or overvalued. It's tempting to want the market's fair value to adhere to some kind of simple rule -- say, a P/E less than 17 means something is undervalued, between 17 and 20 means fairly valued, and higher than 20 means overvalued. But in reality, fair value is based on the interplay of a myriad of factors, including the U.S economy, the global economy, labor participation and productivity, index composition, company profitability and growth runways, dividend yields and reinvestment rates, buybacks, interest rates, bond yields, fiscal policy, the industries of the constituents of the index, fund flows, preference for active vs. passive investments, retail investor sentiment, institutional investor sentiment, government investments in equities, and monetary policy ... just to name a few.

Pro's Take

The point of today's Memo isn't to predict smooth market sailing for the foreseeable future. In the current environment, both bulls and bears can make coherent and convincing arguments for either stance. To us, this means *Pro* should adopt a somewhat cautious approach, while of course remaining optimistic about the long-term opportunities in investing in best-of-breed businesses trading at fair valuations.

Rather, we hope that today's Memo will serve as a reminder to never let yourself be swayed by a headline or single data point. Because truth be told, the last time the market was trading at a valuation similar to last Friday's wasn't right before the last bear market that began over 10 years ago. The S&P 500 has actually been trading in a valuation range similar to today's since late April of 2016. That means that any investor who was swayed by articles calling for a market decline the first time we returned to the current valuation range, more than 19 months ago, has completely missed out on the 26% rally in the market -- a rally that has been especially kind to winning *Pro* businesses including Amazon, American Tower, Apple, NVR, Paycom and Visa.

Have a great week, Fools.

-- JP (TMFYossarian)

Pro Guidance Changes and Completed Trades: Dec. 4, 2017

Published Dec 4, 2017 at 12:20PM

Pro Guidance Changes (from past two weeks; see any related trade alerts or earnings coverage):

- **American Tower** (NYSE: AMT): Fair-value estimate increases to $146. The stock remains a Best Buy Now.

Pro Completed Trades (past week; see transaction log; trades take a day to appear):

- N/A

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Amazon, Skyworks, and More

Published Nov 30, 2017 at 1:29PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **American Tower** (NYSE: AMT): Buy 4%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3%.
- **Medtronic** (NYSE: MDT): Buy 2.5%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.8%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.6%.
- **Facebook** (NASDAQ: FB): Buy 4% to start (we have 7.6% total).
- **Oracle** (NYSE: ORCL): Buy 3.6%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.9%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5% (but realize that this company is hitting new 52-week highs, and that momentum may continue for a while, so be comfortable with that or wait and see).

Options:

- N/A

Hedges:

- N/A

Options expirations:

- None until January.

What's Your Exposure?

Published Nov 27, 2017 at 1:54PM

Greetings, Fools,

We hope you had an excellent weekend! For today's Memo, I'll get right to the point: market exposure.

When we talk about our returns, it makes the most sense to talk about them in relation to how "net" invested we are in stocks. As a long/short portfolio, *Pro* can always be as long or as short as we wish, and we can change our market exposure all but instantly if we like. For example, by selling short a giant stake in the **SPDR S&P 500 Depository Receipts** (NYSEMKT: SPY), we could offset all of our other exposure to long stocks, basically turning market-neutral in a day. Will we ever do that? I would be surprised if we *didn't* at some point. Sometimes you want to be neutral, but without selling anything you own.

Since our inception, though, we've taken a much more bullish approach. We found it ironic that hedge funds at large were remaining market-neutral *after* the epic 2008-2009 meltdown, at a time when it made much more sense to us to steadily invest in beaten-down stocks. So we did. And for all these years, every quarter, if not all the time, we've been considering *shorting* more stocks, too, though in the end we've rarely been compelled to short or hedge all that much. Judging by market history, that'll change someday.

Instead, we've sought to be about 70% net long and still earn strong returns -- ideally our North Star (inflation plus 7% per year) or more. The rising stock market has put us far past our North Star, but we've also been able to do much better than the S&P 500 index despite our much more conservative exposure. If we're 70% net long and the market rises 100%, you should expect us to rise only about 70% -- unless we're above-average stock pickers.

Fortunately, we've risen more than 100%, in this example, and more than the market since inception. In fact, with only about 74% net exposure, we've actually earned about 115% of the market's total return.

Below is our average, historic market exposure since January 2012 -- so over nearly six years. Unfortunately, I didn't track these numbers until then, and our change of brokers midstream makes recreating our past a more arduous task than we have time for at the moment. Suffice it to say that in our early years, from 2009 through 2011, we were *less* invested than we were in 2012 and beyond -- we were still building then. By 2012, we finally became more than 90% invested (long) on average, and 70% net long.

Year	Average Net Long exposure	Average Long Exposure	Average Short Exposure
2012	70.1%	90.9%	21.2%
2013	71.1%	84.3%	11.4%
2014	74.6%	86.1%	10.9%
2015	74.7%	86.9%	17.6%
2016	67.7%	81%	14.6%
2017 YTD	81%	84.6%	4.7%
Average	**73.5%**	**85.6%**	**13.4%**

Over this history, our average gross exposure (longs plus shorts) has been 99.8% (again, by design). But it's our net long exposure that tells us how invested (or exposed) we were in long stocks, and that has averaged 73.5%. Including positions that were hedged out by in-the-money covered calls, that drops to an average of 71%.

By the way, it may appear that we have not hedged or shorted much at all in 2017, but do note that we've been carrying a put ratio spread all this time. Sized at about 15% of the portfolio to begin with, this position would bring our short exposure much higher if the market were to fall significantly. Stocks have risen so much, however, that our option strikes are far out-of-the money, so we don't count the position as short exposure until that changes. That position expires in January.

Overall, it gives us great pleasure and some Foolish pride to earn these returns for you, our members, while keeping our exposure, and thus risk, lower than average. That should help us in downturns, too.

To discuss, please visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: Nov. 27, 2017

Published Nov 27, 2017 at 11:47AM

Pro Guidance Changes (from past two weeks; see any related trade alerts or earnings coverage):

- **American Tower** (NYSE: AMT): Fair-value estimate increases to $146. The stock remains a Best Buy Now.
- **FactSet Research** (NYSE: FDS): Fair-value estimate increases to $187. The stock remains a Buy.
- **MasterCard** (NYSE: MA): Fair-value estimate increases to $128; the stock remains a Buy.
- **OpenText** (NASDAQ: OTEX): Our fair-value estimate increases to $33, but the stock moves to Hold for now. Confidence has ebbed that we'll keep our investment at least another three years, although we still hope to have reason to.
- **Paycom** (NYSE: PAYC): Fair-value estimate increases to $61. The company remains a Buy, despite trading well above that.
- **Shake Shack** (NYSE: SHAK): The stock remains a Short, and our fair-value estimate is set to $26.
- **Square** (NYSE: SQ): Our fair-value estimate increases to $36. The company for now remains a Best Buy Now despite being above that price.
- **Visa** (NYSE: V): Our fair-value estimate increases to $100. The company remains a Buy.

Pro Completed Trades (past week; see transaction log; trades take a day to appear):

- N/A

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Big Gets Even Bigger in Tencent's Third Quarter

Published Nov 22, 2017 at 3:44PM

Third-Quarter Results Quick Take

- **Firing on all cylinders:** Tencent is easily beating analyst estimates on both the top and bottom lines.
- **Everybody's doing it:** Monthly active users (MAU) for WeChat increased by 16% year over year to 980 million, and the number of advertisers using the WeChat "moments" platform increased 30% over the previous quarter. Social advertising revenue rose 63%.
- **Do you think this is a game?** Both mobile and PC games delivered strong growth (up 84% and 27%, respectively) and cash flow, though the latter's player base saw a slight decline because of the continued migration toward mobile gaming.
- **It killed the radio star:** The company's video platform now leads its field in mobile daily active users and subscriptions.
- **Tencent's investments are also paying off in the public markets:** The company was an early investor in two of China's hottest IPOs in recent memory, as well as in Chinese search engine **Sogou** (NYSE: SOGO), which completed its IPO on the NYSE earlier this month.

As we keep pointing out, our latest recommendation, Chinese app behemoth **Tencent** (NASDAQOTH: TCEHY), may be one of the biggest public companies in the world, but that doesn't mean the "law of large numbers" makes a slowdown in its performance inevitable from here. In the most recent quarter, Tencent reported its fastest quarterly revenue growth since the second quarter of 2010. It also managed to soundly beat analyst estimates for net income with a year-over-year increase of 69%, despite having invested heavily in content.

WeChat, We Advertise, We Profit

I won't spend much time on WeChat's results -- if you're curious, we've got all the detail you need in [a deep dive called "What's WeChat Worth?"](). But I do want to call out the continued strength in advertising, with Tencent reporting a strong increase in both revenue (63%) and the number of advertisers on WeChat Moments (30%; Moments is a platform similar to Facebook's contextual ads). And with 1.36 billion mobile phone users in China at the end of June 2017, WeChat's reported 980 million users translate to a penetration rate higher than 70%. As impressive as that sounds, eMarketer actually predicts that WeChat's user share in mobile messaging apps and smartphones will finish the year even higher, at 85% and 79%, respectively.

Gaming Joins the Major Leagues

Online gaming revenue was up 48% in the quarter, to $4 billion, as Tencent continued to capitalize on the secular growth story that is mobile gaming. Thanks to strong performance from Tencent's latest blockbuster, *Honour of Kings*, mobile gaming revenue increased by 84% to account for 55% of total gaming revenue. Big news was made earlier this month, however, when competitor NetEase was able to end *Honour of Kings*' year-long run as the top iOS game in China (though it still remains the top-grossing app). The rapid ascension of NetEase's new game (the title of which is loosely translated as "Survival in the Wilderness") was made possible by a recent global surge in the popularity of the survival genre, but don't think Tencent is just sitting idly by. The company recently released its own take on the genre via an update of its popular *CrossFire* franchise, which actually helped Tencent retake its spot atop the iOS rankings (at least as I type this). It's also secured exclusive Chinese rights to the game that's primarily responsible for the aforementioned global surge in survival-game popularity -- and purchased a 5% stake in its developer.

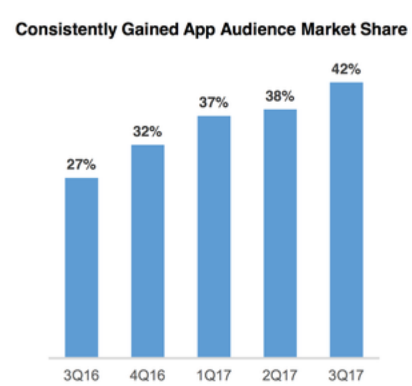
On the PC gaming front, while users in general continued their move to mobile, average revenue per user (ARPU) increased across most of Tencent's titles to bring a year-over-year increase of 27%. Tencent also hosted the seventh *League of Legends* world championship this fall; yep, that's an e-sports championship played live. Management initially invested in e-sports as a way to expose its games to more people as well as increase engagement with current fans -- in other words, to increase a game's lifespan, popularity, and ARPU. That's all well and good, but there may soon come a day when e-sports themselves provide a boost to Tencent's bottom line. A recent survey by Limelight Networks found that millennials were more interested in watching e-sports than traditional sports, and although we don't have the official viewership/attendance figures, the following picture from the championship, held in China's Bird's Nest Stadium (the same one built for the 2008 Summer Olympics), speaks volumes for just how far e-sports have come:

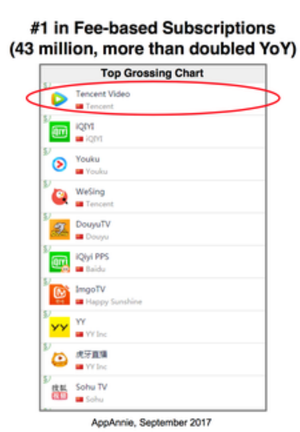
Source: lolesports

Here in North America, 2018 will mark a transformative year for professional *League of Legends* players. The game's developer, Riot, has switched its league structure from a relegation system (think European soccer league) to a permanent partnership system (think NFL or MLB), a move that should attract bigger names and bigger investments. And although you might not recognize [the names of the teams that have been accepted]() (and required to pay $10 million to $13 million to join), you'll recognize the investors -- the owners of the Golden State Warriors, the Cleveland Cavaliers, the Milwaukee Bucks, the Texas Rangers, the New York Yankees, and the Houston Rockets, among others. Oh, a little company called Disney, too.

Netflix + YouTube = Tencent Video?

While the video industry will continue to generate losses for at least the near future, Tencent continues to invest heavily in the space because management believes it's one of the best ways to keep users inside the Tencent ecosystem (it's behind only social in terms of time spent). In the third quarter, video revenue growth eclipsed 100%, driven by both advertising and a doubling of the subscriber base to 43 million. In fact, Tencent Video is the top-grossing app in the entertainment category, and management thinks it's tops in market share now, too, based on average daily active mobile users.





source: Tencent Q3 2017 results presentation

Like Netflix and other U.S. companies, Tencent has recently been investing heavily in original and exclusive content in order to attract and retain users. During the earnings call, the company's president, Martin Lau, provided an update for the company's approach to content, including drama, variety shows, animation, movies, documentaries, and more. He noted that drama is the most popular and revenue-generating genre and that Tencent has been entering into partnerships to create anime based on Chinese online literature IP. Ultimately, I envision Tencent becoming somewhat of the Chinese equivalent of Disney: a company that is able to repackage IP for multiple business units. For example, Tencent owns China Literature, which is ranked No. 1 for online titles that were adapted into major domestic entertainment products, including:

Metric	**Market Share**
Top 20 domestic adapted films in terms of box office	65%
Top 20 domestic adapted TV series in terms of ratings	75%
Top 20 domestic adapted Web series in terms of viewership	70%
Top 20 domestic adapted online games in terms of cumulative downloads	75%
Top 20 domestic adapted animated works in terms of search rankings on Baidu	80%

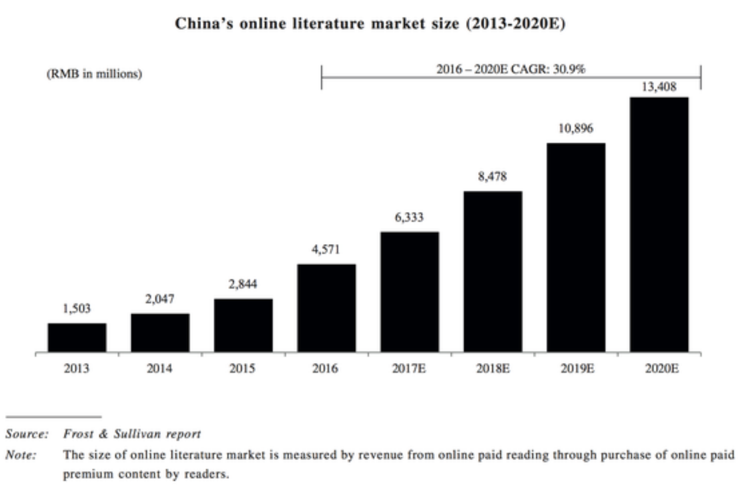
Tencent also made waves with recently announced plans to spend $1.5 billion to set up a revenue-sharing agreement with creators of "open media" (Tencent's term for YouTube-style content). The company will also spend an additional $1.5 billion for additional resources including start-up spaces and IP protection. The latter is especially important given that Chinese open-media producers aren't generally afforded the same level of protection as their Western counterparts (or producers of traditional content such as film, music, and games), so they often earn far less.

Going forward, we should expect video to remain an anchor on company margins as Tencent continues to invest in exclusivity and original content to help drive user and revenue growth. Is this the right call? We believe so. The company's other business units are more than able to pick up the slack, and these investments increase the odds that WeChat will remain the dominant app in China for years to come.

E-Books, Automobiles, and Search, Oh My!

What do China's leading online literature platform, its largest online car retailer, and its No. 2 mobile search engine have in common? They've all recently participated in successful IPOs -- and all three count Tencent among their strategic investors.

Hong Kong-listed China Literature's recent IPO was 625 times oversubscribed (that's the equivalent of 1 in every 20 Hong Kong citizens!), resulting in an 86% first-day gain for the company, in which Tencent still has a 62% stake. I won't deny that this sounds a little bubbly, but there's hope that the thriving, profitable business will eventually grow into its valuation. (Full disclosure, though: We're nonetheless applying a discount to Tencent's stake when valuing the business.) China Literature delivered an 11% net income margin for the first half of 2017 and appears poised to continue to benefit from a rapid rise in the popularity of online literature. The company has more than 9.6 million literary works (good for 72% market share) and over 191 million monthly active users, and an influx of new readers, some fleeing copyright clampdowns in other areas, has resulted in some impressive growth for the industry. The annualized rate for 2013 to 2016 was 45%, and most are expecting this to continue for the foreseeable future:



Source: China Literature prospectus

Yixin Group's IPO was a less impressive (relatively speaking!) 560 times oversubscribed; the stock was up 32% at one point during its first day of trading, although it did give up much of those gains in the following days. As China's largest online auto retail platform with roughly 19% market share, Yixin is using technology to shake up an industry that has been around for generations. China has been far quicker than the U.S. to embrace online car buying; for the first half of 2017, sales volume increased by 88% to 160,000 and aggregate value increased by 94% to a little less than $2.5 billion. Tencent still owns roughly a fifth of the company, as well as providing backup for Yixin on accounts, user traffic, risk management, and more. There are plans to integrate online payments platform Tenpay into the mix, as well.

Not to be outdone, Sogu -- China's second-largest mobile search engine in terms of market share and its No. 4 Internet company in terms of monthly active users (511 million as of September) -- began trading on the NYSE earlier this month. Baidu is still the Chinese equivalent of Google when it comes to search, but we think Sogou's relationship with Tencent leaves it better positioned for the future than the U.S. bridesmaid, Microsoft's Bing. That's because Sogou, unlike Bing, has actually been grabbing some market share in mobile search as of late, with its piece of the pie growing by 206 basis points to 17.8% for the six months that ended in September. Tencent's stake in the $5.3 billion company is currently valued at a little north of $2 billion.

Pro's Take

Treat yourself to a slice of pumpkin pie, Fool (or whatever your Thanksgiving dessert of choice may be): *Pro*'s first investment in China is up almost 25% since we bought shares less than a month ago. Odds are we won't be writing a novella every time Tencent reports from now on, but we wanted to give you just a taste of how many moving pieces the Tencent juggernaut has (and we didn't even cover them all!). Overall, we're pleased with the results, and we believe management is continuing to demonstrate that they think like Foolish long-term shareholders by willingly sacrificing some short-term profits in exchange for long-term value creation.

Questions? Thoughts? Bring them to the Tencent discussion board, and Fool on!

Pro Catch-Up Trades and Upcoming Expirations: Medtronic, Tencent, and More

Published Nov 22, 2017 at 1:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Johnson & Johnson** (NYSE: JNJ): Buy 2.9%.
- **Medtronic** (NYSE: MDT): Buy 2.5%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.9% (see our new trade alert).

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.4%.
- **Facebook** (NASDAQ: FB): Buy 4% to start (we have 7.8% total).
- **Oracle** (NYSE: ORCL): Buy 3.5%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Home Depot** (NYSE: HD): Set up a diagonal call; buy to open January 2020 $110 calls, and sell to open an equal number of January 2018 $175 calls.

Hedges:

- N/A

Options expirations:

- None until January.

Pro Guidance Changes and Completed Trades: Nov. 20, 2017

Published Nov 20, 2017 at 3:10PM

Pro Guidance Changes (see any related trade alerts or earnings coverage):

- **FactSet Research** (NYSE: FDS): Fair-value estimate increases to $187. The stock remains a Buy.
- **MasterCard** (NYSE: MA): Fair-value estimate increases to $128; the stock remains a Buy.
- **OpenText** (NASDAQ: OTEX): Our fair-value estimate increases to $33, but the stock moves to Hold for now. Confidence has ebbed that we'll keep our investment at least another three years, although we still hope to have reason to.
- **Paycom** (NYSE: PAYC): Fair-value estimate increases to $61. The company remains a Buy, despite trading well above that.
- **Shake Shake** (NYSE: SHAK): The stock remains a Short, and our fair-value estimate is set to $26.
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- **Visa** (NYSE: V): Our fair-value estimate increases to $100. The company remains a Buy.

Pro Completed Trades (past week; see transaction log; trades take a day to appear):

- N/A

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

American Tower Continues to Ride the Mobile Data Wave

Published Nov 20, 2017 at 1:30PM

American Tower (NYSE: AMT) notched another strong quarter, continuing the company's multi-year momentum and posting solid organic growth and improved margins across its growing global asset base. Management also recently announced another acquisition of approximately 20,000 sites in India; in general, the company continues to steadily expand internationally, where growth is stronger than in the U.S. and where most future growth will occur.

The company remains a Best Buy Now, with an **updated fair-value estimate of $146 per share** and an allocation of 4% (and a diagonal call allocation of 0.8%) in the *Pro* portfolio.

What Happened?

CEO Jim Taiclet:

> "Our strong third quarter performance was driven by robust organic tenant billings growth of 6.3% in the U.S. and 9.3% internationally. Notably, in the U.S., our organic growth was supported by the widespread adoption of unlimited data plans among subscribers of all four national mobile operators. According to independent industry analysts, subscribers who switch to these unlimited plans consume up to two times more mobile data on a daily basis.

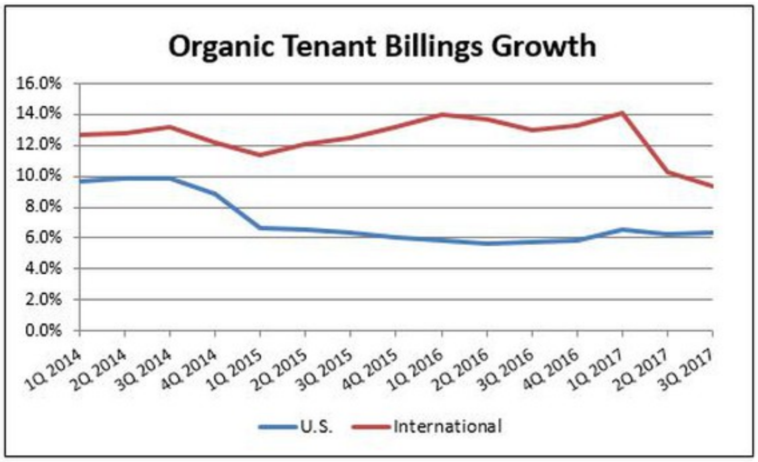
Consequently, we expect that annual mobile data usage in the U.S. will continue to expand by an average of at least 25-30%, and will grow even more rapidly in our international markets over our next five year planning period. As a result, we anticipate ongoing aggregate U.S. wireless capital investments on the order of $30 billion per year, complemented by material network investments in our international markets. We expect these global trends to drive substantial demand for tower space and support solid long-term AFFO per Share growth for American Tower."

Get More

- Q3 2017 press release
- Q3 2017 supplemental materials
- Q3 2017 earnings presentation

Organic tenant billings (growth attributable to tenant co-locations, lease amendments, and price escalations, net of cancellations) came in at 6.3% in the U.S. and 9.3% internationally (vs. 5.7% and 13% in the same quarter a year ago).

International organic growth was broad-based across all regions, up 8.4% in Asia (i.e., India); 9.1% in Europe, the Middle East, and Africa (EMEA, which includes France, Germany, Ghana, Nigeria, South Africa, and Uganda); and 10.2% in Latin America (which includes Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Paraguay, and Peru).

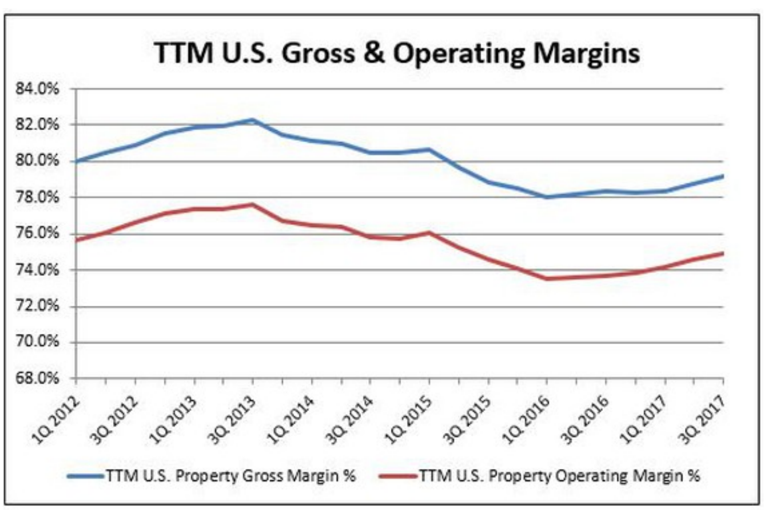


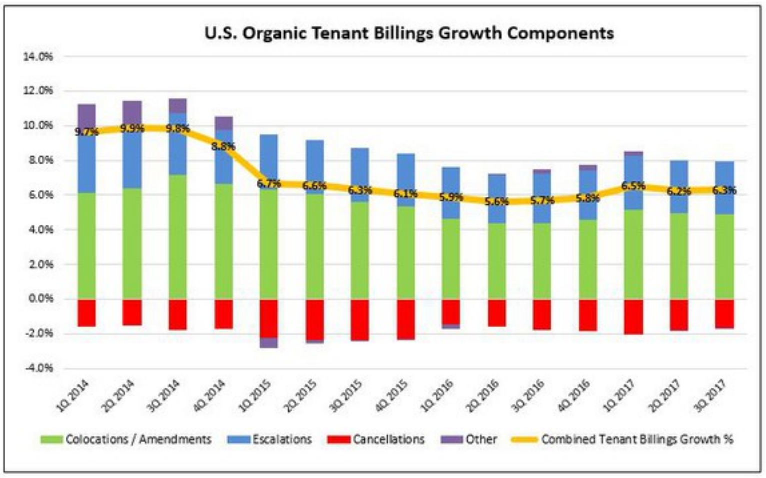
So What?

The deceleration in international organic tenant billings growth continued, although this slowdown was expected and is in line with management's outlook. International growth should settle at about 2% to 4% above the rate of U.S. growth over the medium to long term as wireless operators in American Tower's international markets continue to invest in improving their wireless infrastructure.

Margins increased in the quarter thanks to the strong organic growth, cost controls, and the continued integration and lease-up of more than 70,000 low-tenancy sites built, leased, or acquired since the end of 2014. Management expects a broad margin expansion trend as the company continues to generate organic growth on its extensive existing portfolio of assets.

U.S. gross margins increased year over year to 79.2% (from 77.4%), and U.S. operating margins increased year-over-year to 74.7% (from 73.2%), reflecting those trends. This next graph shows U.S. gross and operating margins on a trailing-12-month (TTM) basis, which smooths out the lumpiness of individual quarters and shows the longer-term trend in margins. We can see that since the significant Verizon (NYSE: VZ) acquisition in 2015 that acted to lower the margin profile of the entire U.S. business (thanks to the lower tenancy ratio on those new towers), management has been successful in slowly increasing margins via organic growth of the newly acquired (and existing) assets:



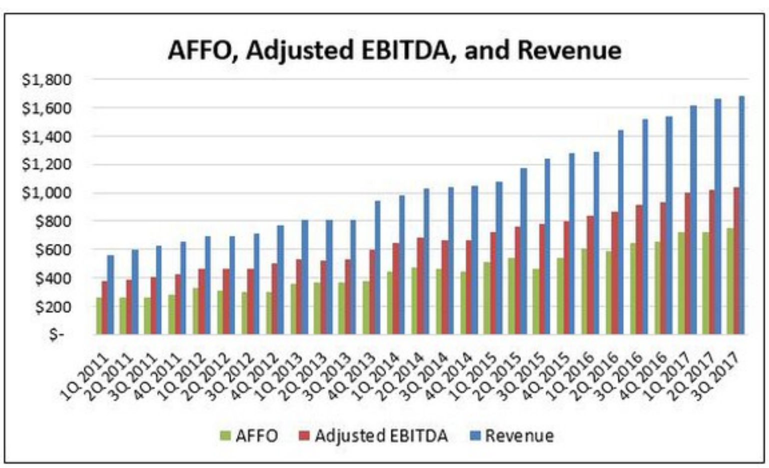


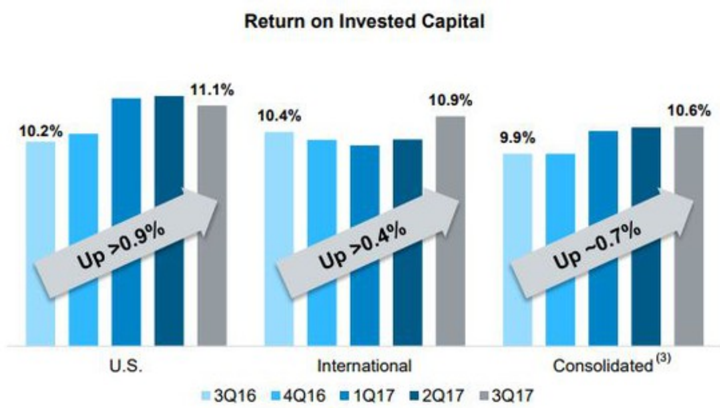
Internationally, margins increased sequentially (gross margins up to 83.9% from 82.4% a year ago; operating margins up to 74.9% from 72.6% a year ago) as the company continues to integrate its recently acquired assets:

As for debt, the company continues to de-lever and ended the quarter with a net leverage ratio of 4.4, the lowest the leverage ratio has been since the third quarter of 2013. Yearly distribution growth continues to track in line with management's 20% long-term growth target, coming in at 20% growth (at $0.66 per share, a 1.8% forward yield on the current share price). Twenty percent annual distribution growth continues to look like a more than reasonable target for 2017 and beyond.

Now What?

This quarter's report confirms that our investment thesis -- that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time -- is continuing to play out. The company's impressive operating history, excellent management, and strong competitive position in a growing industry give me confidence that American Tower will continue to increase revenue and cash flow at high rates for a long time, providing strong returns on capital (ROIC). The company's portfolio of nearly 150,000 sites worldwide positions it to benefit from secular mobile data demand trends on five continents, and acquisitions and incremental leasing activity should continue to drive revenue, cash flow, and ROIC higher over the long term:





Data and Guidance

- Current Price: $146.26
- Fair-value estimate (**updated**): $146
- Allocation: 4%, plus 0.8% in January 2019 / April 2018 $80 / $130 diagonal calls
- EV/EBITDA (TTM): 20.9

AMT remains a Best Buy Now, with an updated fair-value estimate of $146 per share and an allocation of 4%. We also have 0.8% in deep-in-the-money diagonal calls, which we recently rolled out and up to April 2018.

Even as the stock has gained 37% year to date, the company continues to generate shareholder value, and our fair-value estimate continues to rise along with the stock price. If you've yet to start a position, now is as good a time as any to match us.

Fool on!
-- Billy (TMFBillyTheKid)

What's WeChat Worth?

Published Nov 20, 2017 at 1:11PM

Deep Dive on Tencent: In our surveys and member communications, longer-tenured *Pro* Fools often express a desire for more educational content. So we're trying something new with our recommendation on **Tencent** (NASDAQOTH: TCEHY). Our initial alert laid out the thesis for our investment as usual and provided you with all the info you need to buy along with us. Subsequent additional pieces like this are meant to give you deeper insights into why we're investing in China for the first time in *Pro*'s history. Thoughts? We're here for you on the Memo Musings board!

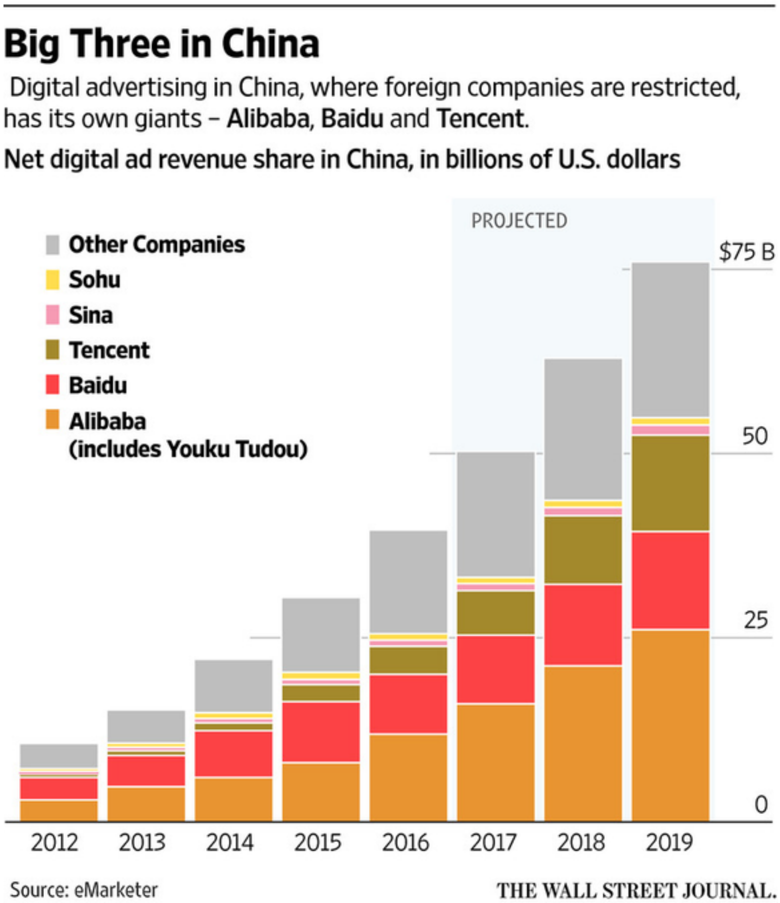
Conventional wisdom would have you believe that given its market cap of roughly $500 billion, there's no way Chinese Internet company Tencent could be undervalued. However, as with Apple, Amazon, Google, and Facebook, we believe the lack of a historical counterpart makes the market myopic on this one. Because one of the easiest and most common ways to understand and value businesses is to look at historical examples, we think investors tend to under-appreciate both the durability and the growth runway of these innovative behemoths. Today, then, we're beginning our discussion of what we believe Tencent could ultimately be worth by taking a look at the first of the many monetization opportunities for its behemoth instant-messaging app, WeChat: advertising.

Before we start, please note that although we'll look at divisions of the business in an attempt to make things easier to understand, Tencent is a great example of a whole that's truly more valuable than the sum of its parts. This is because each division serves to reinforce the value proposition of the others. For example, having a hit mobile game linked to the user's WeChat account simultaneously reinforces the value of both the mobile game and WeChat -- WeChat drives more players to the game and keeps them playing for longer, and the game keeps users in "WeChat's world" for longer.

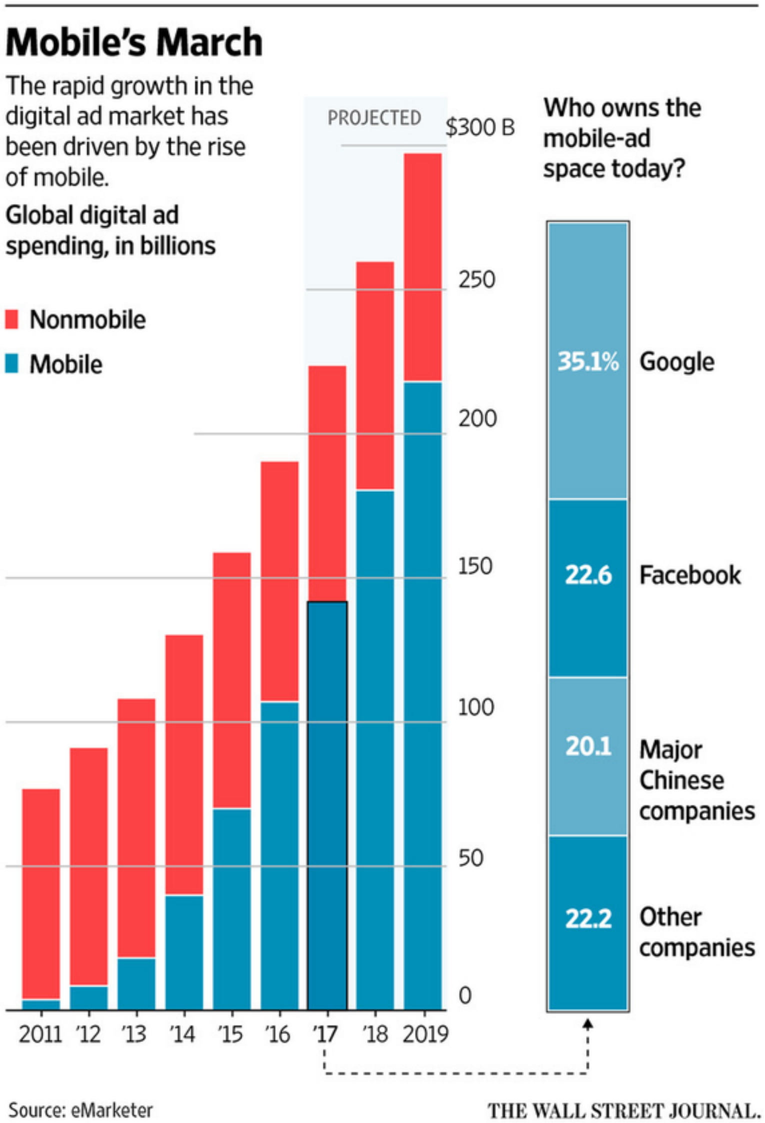
The U.S., Everywhere Else, and China: One of These Is Not Like the Other

Nobody likes ads. Everyone I know tries to avoid them whenever possible. Yet as an industry, the advertising juggernaut continues to power forward, with an 18% global increase in spending forecast for 2017 to $229 billion, according to researcher eMarketer. Unsurprisingly, Google and Facebook are the dominant players in the space, commanding an estimated 49% of digital ad expenditures. Here in the U.S., the dynamic duo is even more dominant, capturing 63% of the $83 billion digital market.

The U.S. market's maturity means it's expected to grow more slowly than the global market (relatively speaking -- low- to mid-teens growth isn't mature by conventional standards). In China, digital ad spending continues to flourish, with an expected leap of 27% this year to just more than $50 billion, followed by another 50% over the next two years to finish 2019 above $76 billion. As much as Google and Facebook would love to get a piece of this rapidly growing pie, government restrictions keep these two out of the country, enabling China's big three — Baidu, Alibaba, and Tencent, or BAT — to establish a stranglehold on their home market.



The big three currently hold 62% of China's digital ad market, and we think industry shifts could give them another 800 basis points of market share over the next two years -- and that's a conservative estimate. Of the three, we agree with most industry experts that Tencent will gain the most share, because we think mobile will continue to be the primary worldwide driver behind ongoing rapid growth in the global digital ad market. That's especially true in China, where forecasts show mobile accounting for close to 82% of digital ad spending (and almost 60% of total media ad spending) by 2021 as advertisers respond to consumers' love of the platform.



Tencent generated $3.9 billion in revenue from online advertising in 2016, up 44% year-over-year. While WeChat and its other products offer a clear value proposition for advertisers, Tencent has been slow to ramp up its ad sales, meaning it's only got about 14% market share in mobile advertising despite making up about 55% of all mobile internet traffic in China (WeChat alone is nearly 30%). Focusing on user experience first is definitely Foolish if your goal is ultimately to create an ecosystem that users can't imagine living without, even if it means sacrificing short-term results. But just how far away are we from what Tencent could ultimately achieve?

Economics 101: Revenue = Volume x Price

Comparing Tencent with Facebook certainly isn't apples-to-apples, given the differences in the products they offer and the countries in which they operate. But we do think it's telling that during the second quarter of 2017, Facebook's global average revenue per user (ARPU) was 5.5 times larger than Tencent's by our estimate. (Its North American ARPU was 23 times larger.) Even a small convergence between the two companies would result in a meaningful bump for Tencent, and we think that's ultimately inevitable given Facebook's head start on inventory. For some context: Tencent has only recently begun to test displaying two ads per day in certain cities. If the company did this with every user, WeChat would deliver about 2 billion impressions per day. That's not even a third of the number Facebook delivered ... in *2012* (on both an absolute and per-user basis)!

When it comes to pricing, though, things aren't as straightforward. Facebook ads can be purchased on both a cost-per-click (CPC) and a cost-per-1,000-impressions (CPM) basis; with the former, you pay for a set number of clicks on your ad, and with the latter you pay for a set number of people to see it. In the second half of last year, advertisers paid roughly $0.28 and $7.20 on a CPC and CPM basis, respectively. Tencent, meanwhile, currently offers WeChat advertisers two options: traditional banner ads or "moments" ads, which are very similar to the contextual ads in a Facebook timeline. Banner ads are lower-priced because they perform worse, at a CPC and CPM of $0.075 and between $1.60 and $2.20 (depending on city) respectively. Moments ads, though, are currently in strong demand, partly because of Tencent's reluctance to show too many of them. This lets Tencent charge a premium for these ads, however fancy they are and wherever they're shown:

Estimated Ad CPM, Q2 2017

City size	Text & picture	Video
Core city	$21.25	$26
Large city	$14.25	$17
Other	$7.00	$9

source: WalktheChat, author calculations

Core cities: Beijing, Shanghai. **Large cities**: Guanzhou, Chengdu, Shenzhen, Hangzhou, Wuhan, Suzhou, Chongqing, Nanjing, Tianjin, Xi'an, Guiyang, Changsha, Qingdao, Ningbo, Zhengzhou, Dalian, Xiamen, Jinan, Harbin, Fuzhou.

These prices are much higher than Facebook's averages, which to us demonstrates how much demand there is for these ads relative to the supply. Because of this, we don't think we'll see a simple, linear relationship between the number of ads shown and the price Tencent is able to charge. As outsiders, we don't have enough information to know precisely where equilibrium is here, but we're willing to bet pricing will continue to, at worst, hold steady until the number of ads has increased significantly.

While it was the last of the big three to move into artificial intelligence (AI), Tencent's recent aggressive moves into the AI arms race led Quartz to refer to it recently as "the sleeping giant in global AI." Tencent has poached the former head of Baidu's Big Data Lab and formed an alliance with several top minds in the space, including the "father" of Google's self-driving car, Sebastian Thrun. The scale of the data Tencent can gather is also essentially unmatched, at 600-plus possible data points per user and counting. If these AI plays work out, they'll ultimately benefit both the advertisers (better targeting, context, and effectiveness) and WeChat users (more relevant, less intrusive ads).

That's Billions With a Capital B

Ultimately, we believe Tencent's advertising revenue could eclipse $10 billion by the end of 2019. We think the company could very well overtake Baidu over the next five years (and we're not alone here). It's worth looking again at Facebook, which first reported trailing-12-month revenue of more than $10 billion in July 2014. The market valued that business at slightly less than $200 billion at the time; that's about 42% of Tencent's current valuation at today's exchange rate. Tencent's advertising business doesn't have Facebook's global reach, so it stands to reason that a discount is warranted. But we can't just slap a 30% discount on that $200 billion and call it a day, because with the benefit of hindsight, it looks like Facebook was massively undervalued at the time -- it's beaten the market by almost 110% since then.

In fact, assuming Facebook's riskiness justified a 20% discount (roughly double the market's return and almost assuredly overly punitive), the business should have been worth more than *$280* billion in July 2014. That would mean it was undervalued by 40% at the time -- 35% if you use our current fair-value estimate as a starting point. Based on assumptions we think are conservative, including revenue that decelerates much faster than Facebook's did and 2019 growth less than half the rate of Facebook's from a similar starting point, we think Tencent's advertising business (including non-WeChat sources but excluding video) should be worth north of $250 billion. That's 44% to 53% of the valuation Tencent will need to achieve if we're to hit our North Star by 2019, for a part of the business that currently only makes up 17% of revenue.

What's the rest of Tencent worth? Why in the world did Tencent invest even more in Snap? What is Snap? Will JP ever return to having normal-colored hair? All of these questions and more will be answered in our next deep dive on Tencent, so stay tuned!

Earnings Roundup: Coherent, MasterCard, Paycom, and Square

Published Nov 20, 2017 at 12:59PM

Greetings, Fools, and happy Thanksgiving week!

We have so much to be grateful for, including the fact that we're all reading this right now. People who are able to save and invest are among the most fortunate on the planet when it comes to finances. It is estimated that more than 70% of the world's population still lives on $10 or less per day, and despite what we hear, it remains difficult to move up into a middle income bracket. So people like us who are able to invest are fortunate even when stocks go nowhere.

And our *Pro* portfolio has gained 21.3% this year (as of Friday), topping the S&P 500 by several percentage points and doubling our North Star even as we maintain a 15% cash balance. The Foolish approach to investing in superior businesses -- and holding them -- continues to deliver. We are grateful that you've put your trust in us here at *Pro*, and we carry that gratitude with us daily. We hope you and your family have an excellent holiday this week!

But hold on. Before you run off to season the turkey, we have *more* earnings coverage for you. Let's cover the quarterly vibe on four more *Pro* holdings, three of which have yet to pass the year mark in our portfolio.

Coherent (NASDAQ: COHR)

- Buy
- 3% allocation

Investors pay up for predictability, and laser machine maker Coherent is delivering. As a result, the stock is performing as we estimated, rising 24% since our May recommendation to reach (and pass) our initial fair-value estimate of $280. Record sales, gross margins, and earnings per share for both the fourth quarter and the full year put the company on track to slice out a record 2018, too. In fact, its newly expanded capacity is already almost fully booked for the next year, and growth will come from full use of that capacity, more expensive tool installation, and an increase in service revenue. This past quarter, products and services accounted for 26% of sales, up 79% over last year. Total fourth-quarter revenue was $490.3 million, nearly double year-ago numbers (thanks largely to the Rofin acquisition) and up a healthy 6% sequentially.

Across the board, Coherent sees strong demand. Semiconductor manufacturing demand for laser products is at record levels, with orders growing more than 10%; Internet of Things devices are driving greater service demand for installed laser systems; and all sorts of industries -- materials processing, battery welding for electric vehicles and energy storage systems, battery packs in general, consumer packaging, additive manufacturing, consumer electronics, and many more -- increasingly depend on lasers. Coherent is addressing companies' needs early in the planning stages, adding clarity to the picture of its long-term demand. Management feels strongly positioned for another "record-setting year in fiscal 2018."

Last quarter, microelectronics accounted for 54% of revenue, materials processing 30%, original equipment manufacturer (OEM) components and instrumentation 11%, and scientific and government business 5%. Total backlog sits at $1.3 billion, or nearly a year's worth of sales. At a recent $302, the stock trades at 19.9 times expected earnings for the year ahead. Our $280 fair-value estimate stands for now but will likely be increased in early 2018, as we near the one-year anniversary of our holding. For what it's worth, competitor **IPG Photonics** (NASDAQ: IPGP) fetches 30 times forward earnings estimates.

MasterCard (NYSE: MA)

- Buy
- 5.5% allocation
- Fair-value estimate increases to $128

The No. 2 credit card processor increased its net revenue by 17% and earnings per share by 23% last quarter, citing -- as did **Visa** (NYSE: V) -- a generally positive economy around the world, especially in Asia and Europe. MasterCard is seeing greater than 10% volume and transaction growth in most of its markets.

Areas of continued focus include security (after the Equifax breach), digital or mobile transactions (including the growth of MasterPass), blockchain (MasterCard uses it and is integrating it with banks), Fast ACH technology (making money transfers instant), and behavioral biometrics and artificial intelligence (leading to more data sales to customers). MasterCard also expanded its close partnership with **PayPal** (NASDAQ: PYPL) into a worldwide reach.

Lately $149, the stock trades at 29 times expected earnings for the year ahead and 31 times trailing free cash flow. There's no question it fetches a premium. Our fair-value estimate is 13% lower, at $128, and puts the stock at 20 times expected *2019* earnings. If MasterCard didn't have such an exceptional business model, we might question recommending it at this level, but we know well enough how the company could continue to outperform expectations. We want to own it for the long haul as long as the business keeps growing.

Paycom (NYSE: PAYC)

- Buy
- 3.3% allocation
- Fair-value estimate increases to $61

The human-resources cloud-software provider has been in our portfolio for nearly one year (our recommendation went out Nov. 30, 2016), and it's already gained a heady 95% as of this morning. Though we (unfortunately, so far!) never added to our original stake, the stock price has soared to make this our 10th largest position. Sales were up 31% last quarter to $101 million, and 98% of that was recurring revenue. Total adjusted administrative expenses were only up 20.7%, to $59.3 million, showing the leverage in the business. The company's adjusted gross margin is a whopping 84%. Earnings per share rose by 93%.

For the year ending in December, management increased their revenue guidance to about $431 million, a 31% rise. We should expect that growth rate to slow next year, but it should remain healthy as the company continues to open new offices. Of its 45 current locations, nine are still maturing (getting ready to truly produce, a process that takes about two years). New offices will continue to roll out.

This quarter's conference call lacked real revelations; the business is simply growing as it adds new customers and cross-sells more services, and the stock continues to be priced at a premium given the recurring, high-margin nature of the revenue. Lately at about $80, shares trade at 54 times expected earnings for the year ahead. Compared with the earnings growth rate, that multiple has logic, but it's still a premium price.

It's important to remember that Paycom is in its early growth phase; it's just now investing in new corporate headquarters and continues to open offices around the country, so its cash flow will look relatively depressed these days. As investments start to produce, the business should show its additional earnings power. Meanwhile, cloud software leaders including **Salesforce** (NYSE: CRM) and **Workday** (NASDAQ: WDAY) continue to fetch big premiums, too, at 59 times and 123 times forward earnings, respectively. Wall Street recognizes the powerful annuity stream offered by leading cloud software businesses, and the long runway for growth.

As it stands, we hope to have great reasons to keep our Paycom shares for years as the company continues to grow.

Square (NYSE: SQ)

- Best Buy Now
- 3.9% allocation
- Fair-value estimate increases to $36

In earnings announced Nov. 8, Square's adjusted revenue was up 45% year-over-year, and its sales growth rate again accelerated compared with the previous quarter. The reason: Outperformance across the board. Even more importantly, as CFO Sarah Friar said, "more and more virtual loops" are being created in the business, meaning more customers are using more and more of Square's services -- and adoption of one leads to the addition of others. Besides processing credit transactions, services include loans, payroll, human resources management, data analysis, and more.

This ecosystem is getting another boost from Square Register, the company's new hardware offering. Aimed at larger merchants, Square Register combines proprietary hardware, software, and payments into one product that doesn't require a third-party mobile phone or tablet. It's ready to use out of the box, and customers can use it quickly and without help. It's a big feather in Square's quiver of omnichannel solutions for commerce. Relatedly, subscription and services-based revenue was up 84% year-over-year, and large sellers who generate more than $500,000 in annualized payment volume rose by 64%. Even so, Square's profit level held steady at 1.05% of gross payment volume. And total gross payment volume rose 31% to $17.4 billion in the quarter.

For the second time since we've owned Square, management increased its guidance for the year; they now see 2017 net revenue of $2.18 billion to $2.19 billion, and EBITDA of about $133.5 million, with a massive 7-percentage-point improvement in margins. Despite that jump, management projects continued margin improvements of about five points a year.

From Square Cash (person-to-person transactions), to Square Capital (Square loans to small businesses), to payroll-as-a-service, to Square Marketing (customer relationship management software) and more, Square is many businesses in one: in its own words, a "comprehensive e-commerce platform." It's not easy to value what the whole company could be worth, but there's promise in its many potentially high-margin businesses. In fact, Square has already generated more than $100 million in free cash flow over the past 12 months, and it's just getting started in most of its business lines.

The stock has been a Best Buy Now since our trade alert was issued in July. As of this morning, shares are up 74% for us since then. Our fair-value estimate is rising because margins have risen more than expected, as has the top line. But keep in mind that this remains a speculative investment. The stock trades at more than 100 times expected earnings for a year ahead, but I actually believe the whole company would be worth much more to a buyer than our $36 value estimate suggests. As with Paycom, we hope to have good reasons to keep our stock a long time as the company grows. We expect price volatility in the meantime.

In Summary ...

Many leading stocks trade at premium prices today, a common occurrence in a bull market. In a bear market, leaders will still usually be priced well above lesser companies. With economic growth revisiting much of the world, and with earnings growing, these prices are arguably merited (the market says so!) -- for now. But we have to expect drops along the way. Our three-year outlook mitigates much of the near-term concern, and as long as we believe a superior business we own can at least earn our North Star with reasonable risk, we can stand pat. If and when the market begins to worry us more, we'll look at quick hedges and other protective or defensive strategies.

To discuss any of these companies, please visit its board!

Thank you again for being a Fool with us! We appreciate it even more so this week as we pause to do nothing ... but be grateful. (Want to share good tidings with fellow investor/members? Please visit the Social Banter board!)

Fool on!

-- Jeff (TMFFischer)

Earnings Roundup: Gilead, OpenText, Shake Shack, and Visa

Published Nov 16, 2017 at 2:39PM

Greetings, Fools!

Every quarter, we're granted another snapshot of how our companies are performing. With this information, we can incrementally add to our knowledge and shine our flashlight a little further into what the future may hold. It's that kind of long-term-minded insight that may make us decide to add to, or perhaps reduce, some positions. It takes us several weeks to comb through results from all two dozen of our companies, but it's worth it. Today, we've got updates on several more. Meanwhile, our portfolio as a whole continues to outperform.

Gilead Sciences (NASDAQ: GILD)

- Hold (don't buy or sell)
- 2% allocation

Shares of the biotech leader are at $71.53 as I write this, meaning they've been perfectly flat over the year to date. Thus, all of our returns here have come from the 2.9% dividend yield, plus the $3,716 we made in 2017 by writing three rounds of covered calls (all of which expired as 100% income) -- at current prices, that brought in another 5.7% in returns. At this share price, then, our 2017 return on Gilead will be 8.6% including the December dividend. We're shy of the 10% or so North Star return we sought, though any tick higher in the share price could get us there. But we got lucky with the timing of our covered calls, and this is still a disappointing return compared with this year's strong market.

At this price, the stock trades at 8 times earnings, 10 times forward estimated earnings, and a mere 5.8 times estimated EBITDA. It's cheap. But the business isn't growing, and this year's big acquisition of Kite Pharma won't change that anytime soon. Worse, the business could shrink again in 2018. Total product sales declined 14% last quarter, with Hep C sales in the U.S. down 31% year-over-year. And the full impact of new Hep C drug pricing and Gilead's market-share losses will start to be felt in the next quarter and roll into 2018.

That's the headline, and that revelation alone has us considering a sale of our shares by year's end. We need to make that decision in the context of the whole portfolio and other opportunities we see. But right now, it appears that Gilead may face some challenges again in 2018. The company continues to rake in strong free cash flow, but without growth, shares may remain cheap. To Gilead's credit, its 2017 Hep C revenue is right in-line with the guidance management gave in February. But it's telling that this hasn't been enough to drive the stock higher. We'll decide what we're doing next with Gilead soon.

OpenText (NASDAQ: OTEX)

- Hold (changed from Buy, because confidence is currently ebbing that we'll keep it three years or longer; that could, of course, change)
- 2.9% allocation
- Fair-value estimate increases to $33

Trading at $33, our content-services and managed-services software vendor fetches 17 times free cash flow and 13 times expected earnings over the next 12 months. The stock is up about 8% year-to-date, including modest dividends, so it has been a laggard -- though not a loser. Total revenue was up 30% to $641 million in the most recent quarter, and annual recurring revenue accounted for 76% of that. Customer renewal rates on software subscriptions topped 90% again, and adjusted earnings per share rose by 26%. Operating margins are at 31%, trending toward goals of 34% to 38% in 2020.

OpenText made about $300 million in acquisitions during the quarter, including $221 million for Guidance, which puts the company in a new market for information security. The pace of acquisitions has brought net debt from just $95 million in 2013 to nearly $2.4 billion now, and with annual interest payments now $121 million, we're closely watching the balance sheet. These acquisitions need to earn a strong return, or they'll end up destroying value. With more than $350 million in annual free cash flow, the debt can be serviced, but the recent rash of expensive acquisitions needs to prove worthy.

Also, OpenText potentially owes the IRS $590 million as a years-long dispute continues to drag out. The company does not believe the IRS is correct.

For the current quarter now under way, management foresees revenue growth of 5% to 9%. The company is taking **Oracle**'s (NYSE: ORCL) approach of selling both in the cloud and on premises. It has acquired itself a chair at the head of the table in its industry, but now we need to make sure the whole entity can move forward and perform while continuing to expand. We have a fairly small position at 2.9%.

Shake Shack (NYSE: SHAK)

- Sell short
- 0.5% allocation
- Fair-value estimate set at $26

Same-store sales declined again at the small burger chain, dropping 1.6%. The underlying reality is a bit uglier, with a 3.8% drop in traffic offset by a 2.2% increase in pricing mix. In my opinion, the chain is too young to be posting declines in traffic of this size already -- something competitors like Chipotle rarely did early on. Management blames its small store base that's focused in New York City, but if your brand is growing in relevance with society, your traffic will grow rather than decline. Shake Shack is likely starting to face the headwinds of the crowded (and getting tired?) mid-scale hamburger restaurant boom.

Shake Shack is *definitely* facing the headwinds of more expensive labor, as new laws increase wages around the country. Those costs are expected to accelerate in 2018, along with other investments, to the extent that the stock is more expensive on forward earnings estimates than on past results -- and that's despite aggressive plans to open 32 to 35 new domestic owned Shacks in 2018, representing unit growth of 36% to 40%, its fastest pace in a long time.

The $38 stock trades at 62 times trailing earnings and 73 times expected earnings for the year ahead. Unsurprisingly, free cash flow is negligible as management invests in new locations, but the company does have $77 million in net cash. In other words, financially it's fine, but lackluster earnings growth leaves a lot to be desired at this valuation. Any little trip in results could send shares to the kitchen floor, and perfect execution may only provide modest aid. We're keeping our short open for now, and are considering adding to our small exposure.

Visa (NYSE: V)

- Buy
- 3.3% allocation
- Fair-value estimate increases to $100

With its share price lately at $110, Visa trades at 27 times estimated earnings for the year ahead and 33.5 times trailing free cash flow. Its purchase of Visa Europe and big customer wins including Costco and USAA drove strong growth over the past year, which ended in October, but the company highlighted that "economic growth around the world has been strong," too. Visa's full-year net revenue and earnings per share both jumped by 22%, to $18.4 billion and $3.48 respectively. Payment volume continued to increase by more than 10% globally, and healthy cross-border volume was driven by increased travel.

Visa is renewing multiple contracts as we speak, which means client incentives (rewards to keep doing business with Visa) will increase substantially in the first half of 2018. This leads management to estimate 2018 net revenue growth of less than 10% ("high single digits"), with revenue growth starting below that level in early 2018 and growing to "low double digits" (higher than 10%) in the second half, with the highest growth in the fourth quarter of next year. The outlook for earnings-per-share growth next year is "at the high end of mid-teens" -- so, perhaps 16% or so.

Visa should generate more than $9 billion in free cash flow next year, and management expects to deploy it in buybacks, dividends, and reinvestment. In the past year, the company returned more than $7 billion to shareholders, including a recent purchase of $1.7 billion of stock at $102.54. Diluted share count is down 10% since 2012. Even with so many buybacks, there's no question that Visa is adequately investing in growth prospects and will continue to do so. Payment competition in China from the likes of our own **Tencent** (NASDAQOTH: TCEHY) was mentioned in the call. Visa is keeping a close eye there, and its Visa Direct continues to develop. Data processing for clients is also a fast-growing, lucrative business that may add to its moat.

Our fair-value estimate on Visa ticks up from $97 to $100. The stock remains a Buy.

To discuss any of these companies, please visit its board! Thank you for being here.

Fool on!

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: JNJ, Medtronic, Tencent, and More

Published Nov 16, 2017 at 12:18PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often about 3%).

- **Johnson & Johnson** (NYSE: JNJ): Buy 3%.
- **Medtronic** (NYSE: MDT): Buy 2.4%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.8% (see our new trade alert).

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.5%.
- **Facebook** (NASDAQ: FB): Buy 4% to start (we have 7.8% total).
- **Oracle** (NYSE: ORCL): Buy 3.7%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Home Depot** (NYSE: HD): Set up a diagonal call, following our trade alert.

Hedges:

- N/A

Options expirations (November):

- **Skyworks Solutions** (NASDAQ: SWKS): Our Nov. 17 $92.50 puts are on track to expire as full income this Friday. No action required as long as shares stay above our strike price.

Pro Guidance Changes and Completed Trades: Facebook, JNJ, and More

Published Nov 13, 2017 at 2:09PM

Pro Guidance Changes (past two weeks; see any related trade alerts):

- **Apple** (NASDAQ: AAPL): We've increased our fair value to $155; the stock remains a Buy.
- **Facebook** (NASDAQ: FB): Our fair-value estimate increases to $168. The stock remains a Buy.
- **Johnson & Johnson** (NYSE: JNJ): The stock moved to Best Buy Now, and its fair value estimate increased to $137.
- **NVR** (NYSE: NVR): We've increased our fair-value estimate to $2,650; the stock remains a Buy.
- **Skyworks Solutions** (NASDAQ: SWKS): Our fair-value estimate increases to $105. Shares remain a Buy.
- **Verisk** (NASDAQ: VRSK): After strong price appreciation in reaction to the company's third-quarter results, we're moving the stock back to Buy from Best Buy Now.

Pro Completed Trades (last two weeks; see transaction log; trades take a day to appear):

- **Home Depot** (NYSE: HD): We set up a diagonal call by buying to open nine January 2020 $110 calls and selling to open the same number of January 2018 $170 calls for a net debit of $53.90. This starts a 1.5% cash value position in Home Depot calls.

- **Skyworks Solutions** (NASDAQ: SWKS): We rolled all of our November 2017 $95 covered calls to January 2018 $105 calls, gaining $10 in upside for a net debit of $6.10.
- **Tencent Holdings** (NASDAQOTH: TCEHY): We bought 1,750 shares at $44.82, for a 2.5% stake in this new Best Buy Now.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Facebook, Skyworks Shine Bright

Published Nov 13, 2017 at 1:58PM

Greetings, Fools,

Another quarter of earnings is wrapping up, and we'll have most of the rest of our coverage to you in the coming days. The general story: healthy growth. The U.S. economy is growing, as are economies around the world, and most of our companies have customers internationally -- perhaps none more so than Facebook. Let's start there.

Facebook (NASDAQ: FB)

- Buy
- 7.7% allocation
- Start at 3%

I must begin by quoting the conference call's opening, from CEO Mark Zuckerberg:

> "Our community continues to grow, now with nearly 2.1 billion people using Facebook every month and nearly 1.4 billion using it daily. Instagram also hit a big milestone this quarter, now with 500 million daily actives. And we saw good results in the business where total revenue grew 47% year-over-year, and we had our first-ever quarter with more than $10 billion in revenue. But none of that matters if our services are used in a way that doesn't bring people closer together or the foundation of our society is undermined by foreign interference ... What they did is wrong, and we're not going to stand for it."

He goes on to add, "I am dead serious about this. I've directed our teams to invest so much in security on top of other investments we're making that it will significantly impact our profitability going forward. And I wanted our investors to hear that directly from me."

Calling Russia out for using Facebook to sow distrust and discord, the company is going to double the 10,000 people it has working on security, change how it discloses advertisers, and work on new laws with Congress, among other investments. It believes these moves will make the community much stronger, and benefit Facebook in the long run. It's not hyperbole to say that bad parties could fundamentally put Facebook's future at risk, so these investments are all but necessary, as well as value-based.

Management expects expenses to grow by 35% to 40% this year (down from an initial 40% to 45%), then by another 45% to 60% in 2018. That's a large jump during a time when revenue will likely only grow in the 20% to 30% range. However, I'm skeptical that Facebook will be able to spend that much money that quickly. The company is spending $7 billion on capital expenditures in 2017, and expects that to about double in 2018, alongside new investments in people.

On the revenue side, Facebook has about 6 million active advertisers (mostly smaller businesses), and mobile ad revenue was up 57% this quarter to $8.9 billion. Video is a driving force of growth, as are higher ad prices. Ad impressions were up only 10% as inventory growth continues to slow, but the average ad price rose by an impressive 35% as marketers are willing to pay more for slots. This dynamic may continue in 2018, especially if ads continue to become more effective and inventory growth continues to wane (as it should). I suspect we'll see healthy top-line growth offsetting a fair amount of the company's increased spending. Sporting a 50.1% operating margin last quarter, Facebook can afford to give up some margin as it invests in its future.

In other ventures, Messenger is used by more than 20 million businesses, and artificial intelligence is a growing presence; Marketplace is used by 550 million people to buy or sell items; and Workplace is now used by more than 30,000 companies. Facebook continues to push forward on virtual reality, with a new $199 Oculus Go headset shipping next year.

The $178 stock trades at approximately 45 times free cash flow, 34 times trailing earnings, and 28 times the average earnings estimated for a year ahead. Earnings per share jumped 77% in the last quarter. That growth will of course slow as expenses grow, but Facebook should still have years of expansion ahead of it. Social media captures a sliver of total advertising dollars, and other mediums are struggling to enlarge their audiences. That being the case, analysts appear too pessimistic about next year, now estimating only 11% earnings-per-share growth for Facebook in 2018. We'll take the over on that. **Our fair-value estimate climbs to $168**, or 25 times a still-conservative 2018 earnings estimate.

Skyworks Solutions (NASDAQ: SWKS)

- Buy
- 4.1% allocation

Another excellent quarter of growth for the mobile connectivity leader saw revenue up 18% to $985 million as earnings per share rose 24% to $1.82. For the year just ended, operating cash flow jumped 35% to $1.5 billion on revenue of $3.7 billion, up 11%. Earnings per share were up 16%, and operating margins rose yet again (and continue to move higher).

That total revenue line tells you Skyworks is still a relatively small company, despite selling massive amounts of product to **Apple** (NASDAQ: AAPL) and other smartphone giants. Even better, the company's design win pipeline continues to expand. From Samsung to Bosch, Sonos to Amazon, Cisco Systems to DirecTV, drones to virtual reality, smartwatches to GPS devices, Skyworks just scored new wins, and management sees the connected economy gaining "significant momentum."

Connected homes, AI, wearables, autonomous cars -- are all expected to drive global media data usage up fivefold between 2017 and 2021, and that estimate may be conservative. There's a digital traffic jam looming, one that will need to be solved by rolling out 5G technology -- another major opportunity for Skyworks that will play out over years. Speeds in 5G can be up to 100 times faster than 4G, with almost no latency; this will drive countless new applications. Today, the broad Internet of Things market is about 26% of revenue at Skyworks, with smartphones making up the bulk.

For the next quarter, management expects revenue to grow about 15% and earnings per share to hit $1.91, up 19%. At about $110 each, shares trade at 20.5 times trailing free cash flow and earnings, and 15.5 times expected earnings for the year ahead. **Our fair-value estimate moves up to $105**, or about 13 times expected earnings for next year. Again, we seek to be conservative. We currently have $105 covered calls on our stock (only recommended to those who have been managing this strategy for a long time), but we plan to eventually wrap up that strategy.

To discuss these compelling companies, please visit the Facebook or Skyworks boards. Our next earnings coverage, included in updates coming this week and next, will feature Shake Shack, Gilead, OpenText, Paycom, Coherent, Square, Visa, and others -- arriving to your inbox when ready.

Thank you for being here and for putting your trust in us! We appreciate it every day. Fool on!

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: Nov. 8, 2017

Published Nov 8, 2017 at 12:59PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often around 3%).

- **Johnson & Johnson** (NYSE: JNJ): Buy 3%.
- **Medtronic** (NYSE: MDT): Buy 2.4%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.7% (see our new trade alert).

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.5%.
- **Oracle** (NYSE: ORCL): Buy 3.8%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2.2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Options:

- **Home Depot** (NYSE: HD): Set up a diagonal call, following our new trade alert.
- **Skyworks Solutions** (NASDAQ: SWKS): If you haven't yet, you can still roll your November 2017 $95 calls up to January 2018 $105 calls (buy to close the $95 calls, and sell to open the same number of January 2018 $105 calls). Today, lately, this can be done for a net debit of about $7. Aim to pay as little time value to close the $95 calls as possible.

Hedges:

- N/A

Next options expirations (November):

- **Skyworks Solutions**: Our Nov. 17, 2017, $92.50 puts are on track to expire as income. No action required as long as shares stay above our strike price.

Johnson & Johnson Moves to Best Buy Now

Published Nov 8, 2017 at 11:35AM

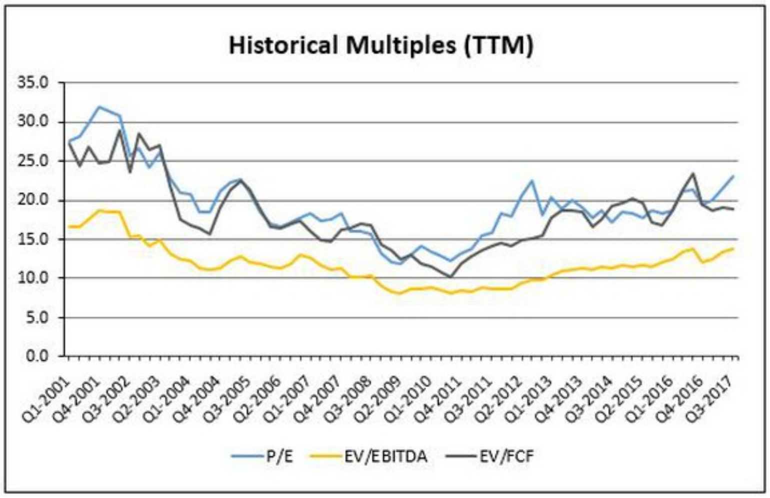
Third Quarter 2017

- Press Release
- Earnings Presentation
- Supplementary Sales Data
- Sales of Key Products & Franchises
- 10-Q Filing

Johnson & Johnson (NYSE: JNJ) reported a strong third quarter in 2017, demonstrating accelerating revenue growth driven by the company's $30 billion acquisition of Actelion (and its suite of pulmonary hypertension drugs). J&J reported 10.3% company-wide sales growth, led by 15.4% growth in the pharmaceutical division, which accounts for 47% of total sales. The company beat analyst expectations on sales and earnings, and management raised 2017 guidance in response to the strong performance. The market was pleased with the company's report, bidding shares up 3.4% on the day of the earnings release.

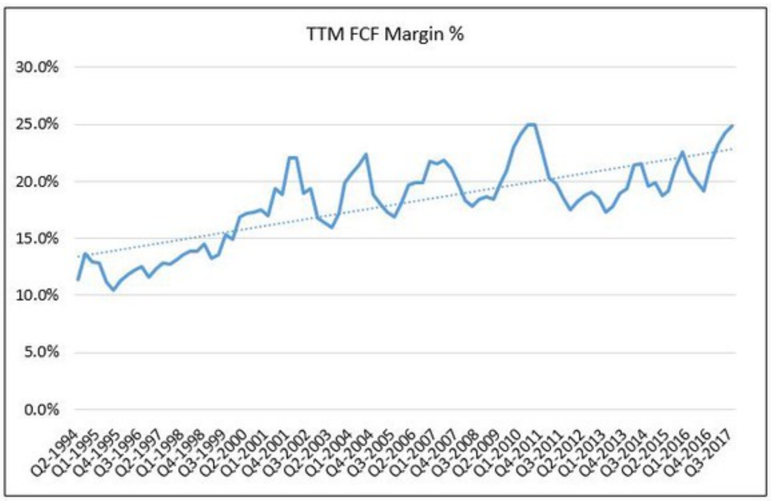
- **Updated guidance**: Best Buy Now (from Buy)
- **Recommended allocation**: 3%
- **Fair-value estimate**: $137 (from $123)
- **Current price:** $140

At $140 per share, the stock is priced at about 24 times trailing-12-month (TTM) GAAP earnings and about 16 times TTM EBITDA. Both of these valuation metrics are elevated relative to the company's recent history:



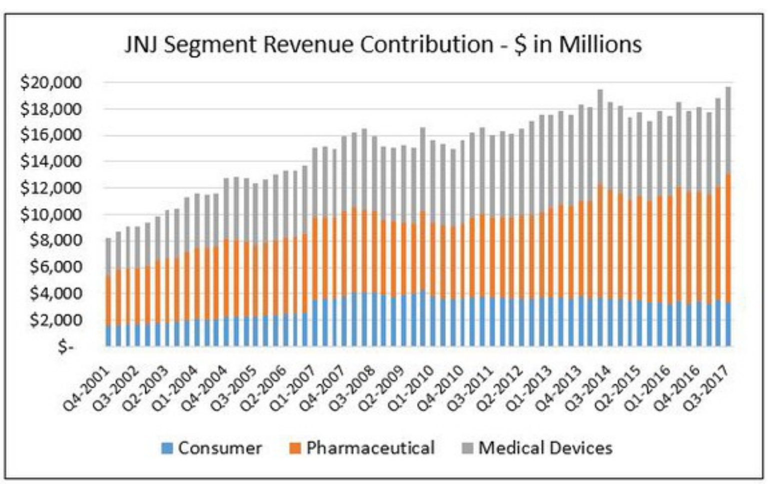
To support the expanded valuation multiples, Johnson & Johnson's business is benefiting from positive momentum as the company's Actelion acquisition is boosting the pharmaceutical division's growth, leading to strong overall sales growth (+10.3% year-over-year net sales growth in Q3 2017, the highest reported growth since Q4 2007). Upside in the company's pharmaceutical division is one of the key aspects to our investment thesis for J&J, so it's nice to see positive results from this division early along in the position's history. We'll keep an close eye on the pharmaceutical division over time as it is likely to be an important driver of J&J's long-term growth.

And as sales are increasing, the company's free cash flow margin is rising, meaning more dollars are available to distribute back to shareholders via the company's ongoing stock buybacks and dividends:

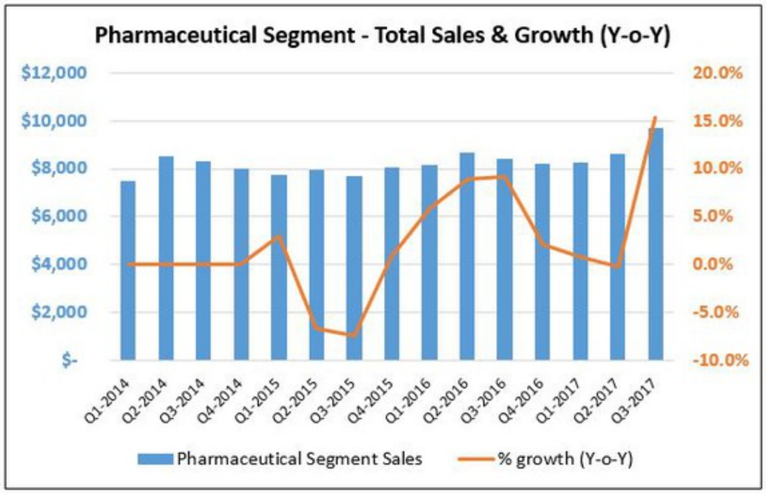


After incorporating Q3 2017 results and updating our valuation assumptions, **our fair-value estimate increases to $137 per share (from $123), and Johnson & Johnson moves to Best Buy Now (from Buy) on our scorecard.** Members who have yet to start or fill out their position can feel comfortable doing so at current prices.

Segment Performance: JNJ's three business segments are (1) consumer [currently 18% of total sales] , (2) pharmaceutical [47%], and (3) medical devices [35%]. Here is a graph that breaks out how much each segment contributes to overall revenue, and how that breakout has changed over time:



As mentioned above, the company's pharmaceutical division experienced strong growth in Q3 2017, bolstering the entire company's results given that the pharmaceutical division is the largest segment by sales volume (47% of TTM sales):



Thanks in part to the company's Actelion acquisition, JNJ's pharmaceutical division posted 15.4% year-over-year growth (+7% growth excluding acquisitions). Although JNJ will be facing generic competition for some of its major drug brands over the next few years, I am encouraged by the strong growth of some drugs in the oncology market, including Darzalex (whose sales are up 95% this quarter) and Imbruvica (47%). The pharmaceutical division continues to be a potential source of upside as new sales from JNJ's strong pipeline should help offset declines in older drug products over the medium to long term.

In addition to the strong growth from the pharmaceutical division, the consumer division and the medical device division posted year-over-year revenue growth of 2.9% and 7.1%, respectively. Companywide operational sales growth (i.e. ex-acquisitions) came in at 3.8% for the quarter.

Our Thesis

Johnson & Johnson is is a diversified health-care conglomerate, with more than 250 operating companies organized into three business segments: consumer, pharmaceutical, and medical devices. At eight out of eight of our *Pro* quality criteria, J&J is a quintessential *Pro*-quality stock, and it is one we expect to hold for the long term. While its large size means we don't expect runaway growth and upside, we do expect to earn North Star-challenging returns with low downside risk from one of the safest stocks you are likely to find in the entire investment universe.

Pro Can Help

- **Questions?** Bring them over to the J&J discussion board.

Earnings From Apple, NVR, Starbucks, and More

Published Nov 6, 2017 at 2:54PM

Fellow Fools,

With earnings season in full swing, here's where we stand on five essential *Pro* holdings.

Apple (NASDAQ: AAPL)

Can an almost $900 billion company be misunderstood -- even undervalued? With its Q4 2017 results and Q1 2018 guidance, Apple tried once again to convince investors that the answer is "yes." Revenue growth accelerated to 12% thanks to strong growth in the services division (up 24%, excluding a one-time gain) and demand for the iPhone 8 and 8 Plus -- the latter of which, as CEO Tim Cook mentioned, has had the best start of any iPhone Plus model ever. Mac growth rose 25%, and the Apple Watch saw unit growth of 50%. (The latter number included yours truly, even though I was never previously a fan of wearing watches. I'm also now a subscriber to Apple Music.) Looking forward, Apple's guidance suggests that strong iPhone X demand will result in the largest first-quarter revenue increase in three years (after adjusting for the extra week in Q1 2017) and margins more or less in line with recent averages. We continue to believe that Apple has years of modest, steady growth ahead of it, and we're updating our fair value to $155, or 17 times earnings. The stock remains a Buy.

NVR (NYSE: NVR)

Management at homebuilder NVR doesn't hold quarterly earnings calls (though they'll take your call if you ask), so a short press release and 10-Q is all the automatic insight into the business investors get each quarter. So far, we're pleased with what we've seen from NVR since it was added to the portfolio, and with the stock up 13% over the past two days in reaction to third-quarter results (and nearly 35% since we first purchased shares less than five months ago), it's clear the market likes it, too.

Management's focus on local dominance and efficient production means this best-in-breed business posts impressive results during strong and weak markets alike. Excluding the excess tax benefit from adopting a new accounting standard, EPS was up 27%, thanks to a 35% increase in homebuilding income. That, in turn, was largely driven by a 6% increase in settlements, as well as an increase in the average settlement price. The company's cancellation rate for new orders has also declined nicely, to 13% from 18% in the third quarter of 2016. Looking forward, robust growth in both new orders (up 21%) and backlog (up 16%) suggests that investors should expect more strong results from NVR in at least the near term, as long as pricing holds up.

Valuation multiples can be deceiving for cyclical companies like NVR, since they say nothing about where we are in the cycle. I still believe there's at least some room to run in the housing market as long as the overall economy holds up, but NVR simply isn't as cheap as it was six to 12 months ago, despite the impressive financial performance. So we've lowered the stock to a Buy from Best Buy Now on the scorecard, even as we *increase* our fair-value estimate by $100, to $2,650. That's OK -- with the stock having already delivered roughly four years' worth of North Star returns, we think it deserves a bit of a break!

Starbucks (NASDAQ: SBUX)

Talk about a caffeine crash! The coffee giant's stock fell by 5% or so on fourth-quarter results after market close on Thursday, but on Friday morning the price actually popped by more than 2%. The initial decline likely had two causes: management's lowering of long-term guidance, and results that came in near the bottom of analyst estimates for the quarter. We've long called Starbucks' long-term targets "aggressive," so the former move didn't come as a surprise to us, given an industry that's now much weaker than when those targets were first published. However -- and this is worth emphasizing -- we've continued to hold our shares despite our skepticism because we believe in the stock's ability to deliver North Star-like returns even if management fails to achieve its own lofty goals.

This is especially true with respect to comparable-store sales, or comps. We expected these to settle at 3.5% to 4%, a forecast that may have once seemed bearish but now falls squarely within Starbucks' newly lowered 3%-5% target range. Lower comps leave a smaller margin for error when it comes to new store openings, and commentary on that front was sparse, though management did once again note that new U.S. locations aren't cannibalizing existing stores' sales and mentioned their 2018 net new store target of 2,300 stores (a 4.5% increase). We'll be watching closely to see whether Starbucks is reconsidering its total addressable market (TAM); any meaningful decline would require us to reconsider our thesis.

Overall fourth-quarter results were essentially in line with what we've come to expect given brick-and-mortar retail struggles. China continues to be a bright spot, with fourth-quarter comps up 8% against 3% in the Americas (after adjusting for the impact of recent hurricanes) and 2% worldwide. Combined with a global net store increase of 603 and solid results in the channel development division, revenue was up a net 8% after adjusting for the extra week in 2016. Margins remain pressured by increased store and partner investments and an ongoing shift in product mix; the latter can be attributed to the continued growth of Starbucks' food offerings, which contributed 2 points to American comps for the third consecutive quarter and now account for 21% of sales (management's 2021 target is 25%). Starbucks Rewards membership rose by 11% in the U.S., while member spending was up 8% in the fourth quarter, well above the overall U.S. rate. Though they account for only 18% of unique customers coming through Starbucks stores, Rewards members contributed about 36% of fourth-quarter revenue, so we're glad to see their spending continue to increase even if the newest members aren't always the most diehard Starbucks customers. It'll soon be time for our annual review; in the interim, the stock remains a Buy and our fair value is unchanged at $52.

Verisign (NASDAQ: VRSN)

Verisign's third-quarter results were exactly what we've come to expect from the company, with modest revenue growth translating into high-single-digit EPS growth thanks to increased operating leverage and share repurchases. In fact, the only notable thing from the company's earnings call was how quickly it was over -- only one analyst bothered to call in and ask a question. Third-quarter domain-name registrations (8.9 million) and renewal rates (expected to finish up 130 basis points to 74.3%) continue to trend in a positive direction, giving us confidence that the global leader in domain-name registry services will continue to create shareholder value going forward. The stock currently sits near the upper bound of our estimate of fair value, but given the quality of the business, we have every intention of rolling our January covered strangle at some point if the market permits.

Verisk (NASDAQ: VRSK)

After its first two quarters were received poorly by the market, Verisk looks back on track with solid Q3 results. Organic growth in the data analytics provider's insurance division finally reaccelerated to 9% (7% excluding the one-time benefit from recent hurricane activity), and most signs indicate that subpar growth is finally in the past. Recent acquisition Wood Mackenzie, where organic growth was 3.3%, continues to show signs of strength in a market (energy, metals, and mining) that appears to have stabilized at last; in fact, recent strength in new subscriptions suggests even better results on the horizon once most of the subscriptions signed during the worst of the recent energy bear market are gone. And new partnerships with Argus all but guarantee that Verisk's financial services division will reaccelerate in Q4 and beyond.

Verisk remains active on the capital-allocation front -- by my count, the company acquired 15 businesses for an aggregate purchase price of $583 million in just this past quarter alone. Although the argument for purchasing each is compelling, it remains to be seen whether the multiples Verisk paid are justified. In fact, while I acknowledge that acquisitions are frequently the best way for Verisk to enter a subset of its core markets, I currently believe they're one of the biggest risks to Verisk shareholders -- specifically, that the core business is *so* strong that management feels emboldened to destroy value by becoming too aggressive with what it buys. That being said, if you believe -- as we do -- that WoodMac will return to a growth rate higher than that of the consolidated Verisk at some point in the next few years, the odds are favorable that shares can once again return to their market-beating ways. For those keeping track, the recent pop in the stock means that Verisk has caught back up with the market and is now outpacing the North Star since we first bought shares. We're moving the stock back to a Buy from a Best Buy Now.

That's it for now, but we'll likely have more updates on various *Pro* holdings later this week. Enjoy the rest of your day, Fools!

-- JP (TMFYossarian)

Returns

	Annualized Return Since Inception	Annualized Return, Rolling 3 Years	Year-to-Date Returns	Return Since Inception
Pro	13.6%	14.3%	19.1%	219.0%
North Star	8.4%	8.5%	8.3%	108.8%
S&P 500	12.7%	11.7%	16.9%	196.4%
MSCI World	7.3%	6.2%	16.3%	89.8%

Pro Guidance Changes and Completed Trades: Apple, Verisk, and More

Published Nov 6, 2017 at 12:39PM

Pro Guidance Changes (see any related trade alerts):

- **Apple** (NASDAQ: AAPL): We've increased our fair value to $155; the stock remains a Buy.
- **NVR** (NYSE: NVR): We've increased our fair value to $2,650; the stock remains a Buy.
- **Verisk** (NASDAQ: VRSK): After strong price appreciation in reaction to the company's third-quarter results, we're moving the stock back to Buy from Best Buy Now.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Home Depot** (NYSE: HD): We set up a diagonal call by buying to open nine January 2020 $110 calls and selling to open the same number of January 2018 $170 calls for a net debit of $53.90. This starts a 1.5% cash value position in Home Depot calls.

- **Skyworks Solutions** (NASDAQ: SWKS): We rolled all of our November 2017 $95 covered calls to January 2018 $105 calls, gaining $10 in upside for a net debit of $6.10.
- **Tencent Holdings** (NASDAQOTH: TCEHY): We bought 1,750 shares at $44.82, for a 2.5% stake in this new Best Buy Now.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Nov. 2, 2017

Published Nov 2, 2017 at 12:02PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often around 3%).

- **Medtronic** (NYSE: MDT): Buy 2.5%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.5% (see our new trade alert).

Continue building your portfolio with our Buys, including:

- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1%.
- **Oracle** (NYSE: ORCL): Buy 3.8%.

Shorts:

- N/A

Options:

- **Home Depot** (NYSE: HD): Set up a diagonal call, following our new trade alert.
- **Skyworks Solutions** (NASDAQ: SWKS): Roll your November 2017 $95 calls up to January 2018 $105 calls (buy to close the $95 calls, and sell to open the same number of January 2018 $105 calls). Today, lately, it appears this can be done for a net debit of about $6 and change. Aim to pay as little time value to close the $95 calls as possible.

Hedges:

- N/A

Next options expirations (November):

- **Skyworks Solutions**: Our November 2017 covered strangle ($92.50 puts, $95 calls) will expire on the 17th. We're leaving the puts alone to expire, and rolling the $95 calls to January 2018 $105 calls.

Roll Your Covered Calls on Skyworks Solutions

Published Oct 31, 2017 at 1:28PM

Is this for you? This recommendation is for *Pro* members who have written November 2017 covered calls on **Skyworks Solutions** (NASDAQ: SWKS). Those who have not yet written covered calls should leave Skyworks stock uncovered and just go on owning it; we're playing catch-up here, rolling our in-the-money calls higher. The stock remains a Buy at a 4.3% allocation. (Members following the *Motley Fool Options* put-writing trades in that service should be careful not to grow your exposure beyond a reasonable allocation.)

How You Participate

- **Trade:** Use a rolling order on Skyworks options to:
  - Buy to close all November 2017 $95 calls, and ...
  - Sell to open the same number of January 2018 $105 calls.
  - Note: We are leaving our November $92.50 puts from our previous strangle alone to expire as income, although you can buy to close them for lately $0.15 if you prefer.
- **Allocation:** *Pro* will continue to write calls on all 1,200 shares owned.
- **Recent Prices (12 p.m. ET):**
  - Stock: $113.80
  - Buy to close November 2017 $95 calls (bid/ask): $18.90/$20.30 = $19.60
  - Sell to open January 2018 $105 calls: $11.80/$12.20 = $12
  - Net debit to roll: Approximately $7.60
  - Upside gained on stock: $10 per share, and a 31.6% return on incremental investment
- **Price Guidance:** Prices will change, but lately use a limit order and aim for a $7.60 or lower net debit to roll. No matter what, aim to pay minimal time value to close the $95 calls.
- **Stock Guidance:** Buy 4.3%. As mentioned above, don't use options on this stock today if you don't have them in place already.
- **Fair-Value Estimate:** Remains $100, but will be updated after earnings.
- **Note:** Earnings are due Nov. 6 after the market closes. We aim to roll before then to give our stock more upside breathing room ... just in case.

What We're Thinking

Shares of Skyworks Solutions have soared to new highs this week, greatly diminishing the time value that was safely lingering in our short calls until now. As the company gets ready to announce earnings Nov. 6, there's no reason to expect anything but a healthy, growing business poised for a strong 2018. The only impediment to that -- and it is possible! -- is if **Apple**'s (NASDAQ: AAPL) new iPhones disappoint. Apple remains a major customer, accounting for about 40% of Skyworks's revenue, so we watch this relationship intently.

Right now, it's all systems go, with Skyworks and Apple working closely on analog semiconductor designs and solutions for Apple products. Beyond Apple, Skyworks has a fast-growing Internet of Things business (lately about 25% of sales) and sells to just about all major phone makers in the world. China remains a giant tailwind, too, as that country slowly catches up to newer-generation cell technology.

Lately at about $114, the stock trades for about 16 times expected earnings for the year ahead and 20 trailing times free cash flow, making it appear reasonable. We got caught with covered calls at the wrong time, and have been playing catch-up the past year by writing covered strangles. We've collected healthy credits on our written puts in the past, but this time we're just rolling our calls. We have ample exposure to Apple and Skyworks already, and the cost of rolling our calls is largely absorbed by the income earned on the puts we wrote that expire Nov. 17. For now, we're just going to manage our covered calls and see if we can continue to catch up.

Alternative Trades

- **Wrote other calls expiring in November?** In most cases, rolling those now per this alert will make sense for you, too. Roll up by a $10 strike price increment, or any amount that pleases you. Ask on the Skyworks board if you have questions.

More That Matters

- **Maximum gain:** The stock's upside is capped at our written call's strike price.
- **Maximum risk:** The full stock value, minus call premiums received.
- **Follow-up:** We'll continue to manage our covered calls, rolling for upside or more credit as needed, as long as we like the prices. We plan to keep the stock for the long term as long as the business and valuation seem to merit it, and to start and end our covered-call strategy opportunely, too. Yes, we're breaking our own rules here a bit -- out of necessity, it seems to us.

Options Can Help

- **Questions about this "highly connected" trade?** Please visit the Skyworks board.

The Rise of the Everything App

Published Oct 30, 2017 at 4:21PM

Deep Dive on Tencent: In our surveys and member communications, longer-tenured *Pro* Fools often express a desire for more educational content. So we're trying something new with our recommendation on **Tencent** (NASDAQOTH: TCEHY). Our initial alert laid out the thesis for our investment as usual and provided you with all the info you need to buy along with us. Subsequent additional pieces like this are meant to give you deeper insights into why we're investing in China for the first time in *Pro*'s history. Thoughts? We're here for you on the Memo Musings board!

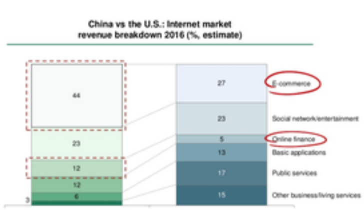
What propels a product like Tencent's WeChat from just another app to one so dominant it accounts for 30% of internet traffic in its home country? Hall of fame Yankees pitcher Lefty Gomez often quipped that he'd "rather be lucky than good," and although the notion of relying on luck for success runs counter to the prevailing American mythos that hard work is all it takes, the truth is that being at the right place at the right time can be key to countless companies' fates. So, in an attempt to lay the groundwork for our upcoming discussion on the future of WeChat, today we'll look at what Tencent did right and why the timing was perfect for an app like WeChat to come along.

Right Place, Right Time

Would WeChat have been just as successful if it had launched in the U.S. instead of China? Of course, we can't know for sure. But given how different the internet landscape in these two countries was in 2011, we believe the answer is no. The U.S. was already a developed nation by the time the internet, and subsequently mobile technology, started to play a meaningful role in the global economy -- but China was (and still is) not there yet. Unsurprisingly, this meant the U.S. could cement its place at the vanguard of the industry early on while China played catchup.

But it's not always a bad thing to be a little late to the party. Because most industries in the U.S. were fully mature, with processes already entrenched, by the time the internet rose to prominence, many were slow to adopt new technologies and improvements. On the other hand, China -- a developing nation with larger economic inefficiencies and pain points -- presented a fertile landscape ripe for disruption by the internet and mobile computing, populated by users eager to adopt newer technologies to improve their quality of life. And when this was combined with supportive government policies, China found itself with the perfect blueprint for skipping over many inefficient, outdated technologies and practices to catch up with those it once trailed.

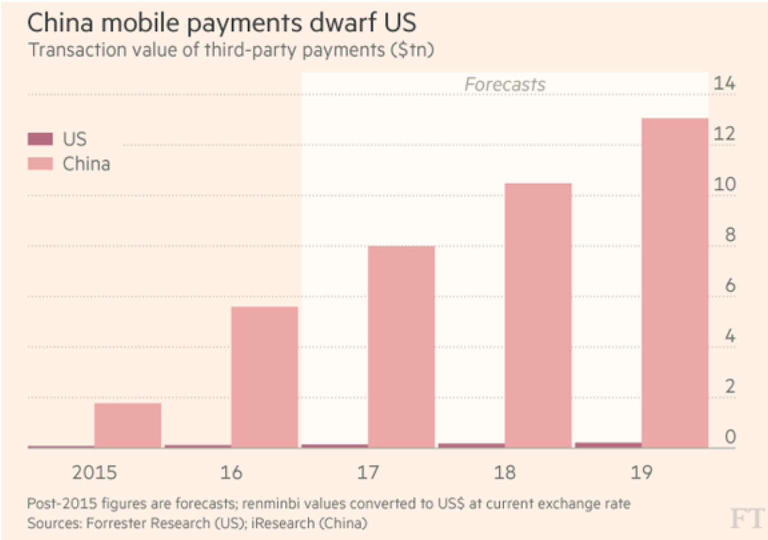
To see how powerful this combination of factors can truly be, consider retail and mobile payments. In 2005, there was 63 times more retail floor space per thousand people in the U.S. than in China. (The business-to-consumer e-commerce market was still in its infancy in China at that time, at just $0.3 billion.) And independent channels (think small corner stores) accounted for 53% of grocery sales, vs. just 18% in the U.S. Although this isn't an apples to apples comparison, these statistics suggest that the industry was both inefficient and not fully meeting all of its customers' needs. Or in other words, it was ripe for disruption from the online channel, which is exactly what we saw:



Source: The Boston Consulting Group (2017), *Decoding the Chinese Internet, A White Paper on China's Internet Economy*

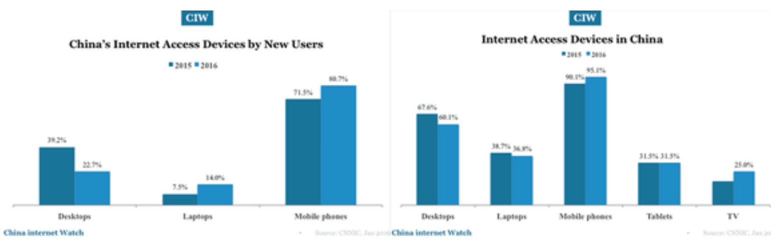
In the U.S., where debit and credit cards had been in wide use for years, people accustomed to the convenience of not having to carry cash could afford to ignore the incentives of adopting a new technology like mobile payments. But compare that to China, where in 2011 the average citizen had just 0.2 cards (vs. 1.7 in the United States), and where even someone who did have a credit card couldn't necessarily use it everywhere -- there were just 36 point-of-sale terminals per 10,000 people in China that year, vs. 287 in the United States. Enter mobile payments, in which transactions can be completed simply by scanning a QR code with your smartphone.

In a recent study of Chinese consumers jointly published by Tencent, 84% of the 6,500 respondents said they wouldn't mind going cashless. And even if Tencent's involvement causes you to question the validity of that finding (which you always should, when a company is involved in a study that reports favorable findings!), the industry statistics speak for themselves: Chinese mobile payments reached $8.6 trillion in 2016 and accounted for 74 percent of all online payments, with 42 percent of in-store purchases made with non-cash options.



Source: Financial Times (2017), *China mobile payments dwarf those in US as fintech booms, research shows; difference between the $8.6 trillion for 2016 noted above and the 2016 figure in the chart is likely due to the chart using older data*.

So the timing was right for Tencent technologically, but it was also serendipitous from a user-base perspective. The average internet user in China is 14 years younger than her U.S. counterpart, according to The Boston Consulting Group, and younger generations are generally more open to new technologies. And remember how we mentioned leapfrogging? Many Chinese internet users made their first foray online by way of a mobile device, completely skipping over the desktop.



Source: China Internet Watch (2017), *Whitepaper: China Internet Statistics 2017*

This "mobile first" mentality also means many Chinese people use multiple mobile devices, making WeChat's ability to easily create a digital identity that is shared across devices even more desirable. And it's helped WeChat quickly become accepted as the preferred method of communication in the workplace -- a recent survey of 20,000 professionals found that almost 90% liked WeChat best, dwarfing email (77.4% reported not using that at all), phones, and other forms of communication. Chinese internet users are also far more open to relying on just a few apps, with about 60% of installed apps being used two times or less (that number is about a third in the United States). Lastly, we'd also be remiss if we didn't mention the fact that Facebook and other popular Western social-media apps are blocked by the Chinese government , creating a void that needed to be captured by a native company. It certainly doesn't hurt to have some of the biggest threats to your business stuck on the outside looking in.

Catching Lightning in a Bottle, Again ... and Again ... and Again

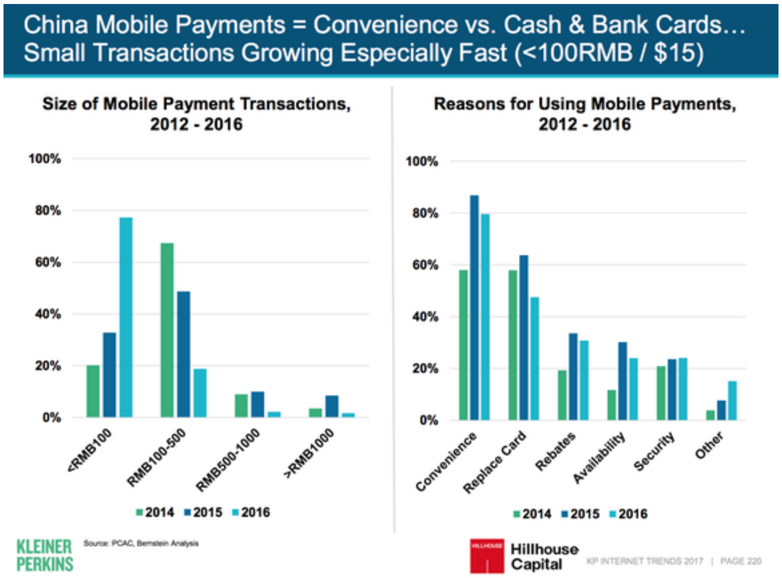
Tencent has:

- the dominant desktop app
- the dominant mobile messaging apps
- the largest video game business in the world
- the largest social networking services app (Qzone)
- the top news services when ranked by daily active users
- the top mobile video service when ranked by views
- the top music streaming platform
- the top online content library and publishing platform
- the top mobile browser
- the top app store

So it's probably safe to say that its success isn't just the byproduct of fortunate timing. But what specifically did the company do that enabled WeChat to become so pervasive in its users' lives? Here are three savvy decisions that will also tie into future discussions on WeChat and its monetization potential.

- **Keep it simple:** The dominant messaging apps of the time, including Tencent's own QQ, were both cluttered and gaudy, leading some users to assume that WeChat was actually developed by a Western company because of its Apple-esque minimalist design. Besides helping with the "cool" factor, these design choices resulted in an app that simply worked better on mobile.
- **Today messaging, tomorrow the world:** WeChat's initial value proposition to consumers was both straightforward and obvious: In a country where mobile use was skyrocketing but mobile messaging remained expensive, WeChat let you communicate for free. But this was just the first phase of Tencent's master plan. It's standard in the West to use different apps for different tasks, but in China, apps are multitaskers. By slowly rolling out additional features, Tencent was able to keep users in the app for longer, creating a powerful network effect: Increased user engagement attracted other users and businesses/developers to the platform, which in turn attracts more users, repeat ad infinitum.
- **Payments:** In the buy report, we mentioned Tencent's mobile payment offering, TenPay, and how it's quickly gaining share at the expense of the once-dominant AliPay. A single marketing tactic has propelled much of this growth: In 2014, Tencent created a viral sensation with its "gamification" of the Lunar New Year tradition of gifting hongbao (red envelopes with money inside). The craze is still going strong -- last year, there were 33 red packets given for every living being in

China. By requiring people to link their bank accounts to give or receive, Tencent was able to overcome the largest mobile-payments hurdle and accelerate adoption of TenPay. And with their Tencent digital wallets suddenly full of money, people began using TenPay to make daily purchases online and in stores (because if you've got the money, you might as well spend it).



Source: Mary Meeker (2017), *Internet Trends 2017 -- Code Conference*

Ultimately, we believe it was the combination of smart decisions on Tencent's part and a environment that was ready to embrace an "everything app" that enabled WeChat to become so dominant. In our next follow-up article, we'll take a look at what this means for the future of WeChat. Bring your thoughts about the company to the Tencent board, and Fool on!

Pro Guidance Changes and Completed Trades: Oct. 30, 2017

Published Oct 30, 2017 at 3:37PM

Pro Guidance Changes (see any related trade alerts):

- None.

Pro Completed Trades (see transaction log; trades take a day to appear):

- **Tencent Holdings** (NASDAQOTH: TCEHY): We bought 1,750 shares at $44.82, for a 2.5% stake in this new Best Buy Now.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Oct. 26, 2017

Published Oct 26, 2017 at 2:26PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often around 3%).

- **American Tower** (NYSE: AMT): Buy up to 4%.
- **Medtronic** (NYSE: MDT): Buy 2.6%.
- **Tencent Holdings** (NASDAQOTH: TCEHY): Buy 2.5% (see new trade alert).
- **Verisk** (NASDAQ: VRSK): Buy 2.1%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.5%.
- **MasterCard** (NYSE: MA): Buy 3% to start (building to 5% or more later).
- **OpenText** (NASDAQ: OTEX): Buy 3.1%.
- **Oracle** (NYSE: ORCL): Buy up to 3.8%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Short 0.5%.

Options:

- **Home Depot** (NYSE: HD): Set up a diagonal call, following our new trade alert. (Make sure you don't have a similar position already from *Motley Fool Options*.)

Hedges:

- N/A

Next options expirations (November):

- **Skyworks Solutions** (NASDAQ: SWKS): Our November 2017 $92.50 put/$95 call covered strangle will expire on the 17th of next month. With shares lately above $104, we're likely to roll our calls higher, or close them for a partial profit of late. We'll see soon, depending on how pricing goes.

Set Up a Diagonal Call on Home Depot

Published Oct 25, 2017 at 1:23PM

Is this for you? This recommendation is for all *Pro* members who would like to establish a diagonal call position on **Home Depot** (NYSE: HD) to target leveraged upside and income with moderate risk.

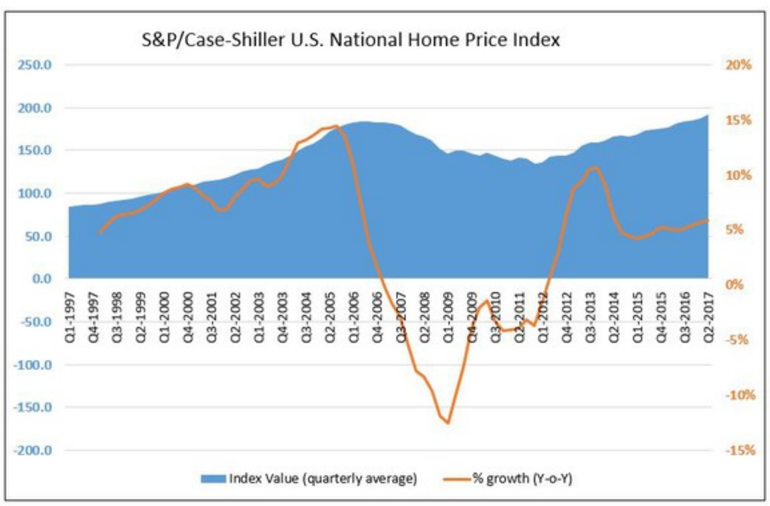
How You Participate

- **Actions:**
  - Buy to open January 2020 $110 calls and ...
  - Sell to open an equal number of January 2018 $170 calls.
- **Allocation:** Invest approximately 1.5% of your *Pro* funds in the net purchase of these diagonal calls (the aggregate cost of both buying the long calls and selling the short calls). At recent prices, this most closely equates to setting up one diagonal call position for about every $350,000 you manage; for *Pro,* that's about nine contracts.
- **Price Guidance:** As with all options transactions, limit orders are **required**. The 2020 options are thinly traded and bid/ask spreads are wide. Aim to pay a net debit no higher than $54.50. Lower is always better, and don't be afraid to wait for your price.
- **Prices** (1 p.m. 10/25/17):
  - Stock: $165.70
  - January 2020 $110 calls (bid/ask): $55.10/$60.00
  - January 2018 $170 calls (bid/ask): $2.96/$3.15

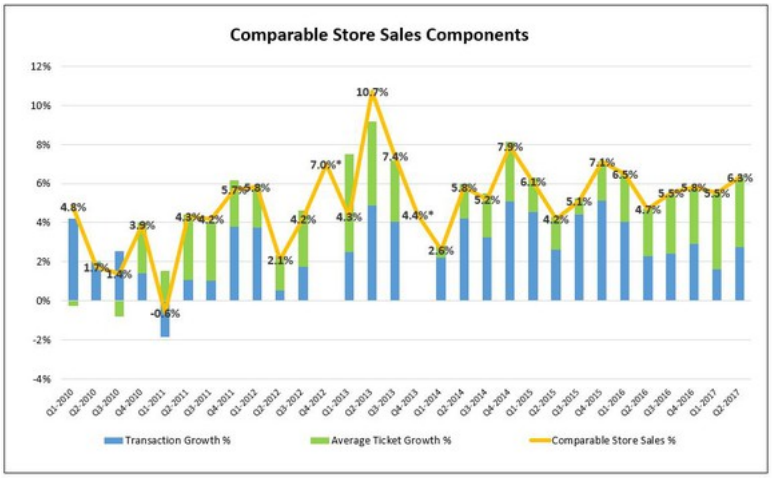
What We're Thinking

Home Depot (NYSE: HD) is the world's largest home-improvement specialty retailer (and the sixth-largest global retailer in general), with nearly 2,300 warehouse-format stores throughout the United States, Canada, and Mexico. The company provides building materials, home improvement products, and lawn and garden products as well as a range of related services. Home Depot has been wonderfully managed since emerging from the 2007-2008 credit crisis, and the company remains primed to benefit from a broad, long-running, slow improvement in housing.

If you've been in the market for a home in the last few years, you probably know that the U.S. housing market is doing quite well. Although we haven't reached the peak levels seen during inflation of the housing bubble (probably because the subprime mortgage loan market isn't as -- ahem -- robust as it used to be), all housing metrics (private residential fixed investment, housing starts, new houses sold, and existing home sales) have rebounded well off their recessionary lows. And home price appreciation remains strong, with the most recent reading of the Case-Shiller U.S. National Home Price Index in July indicating year-over-year growth of 5.8%, the highest rate since the second quarter of 2014:



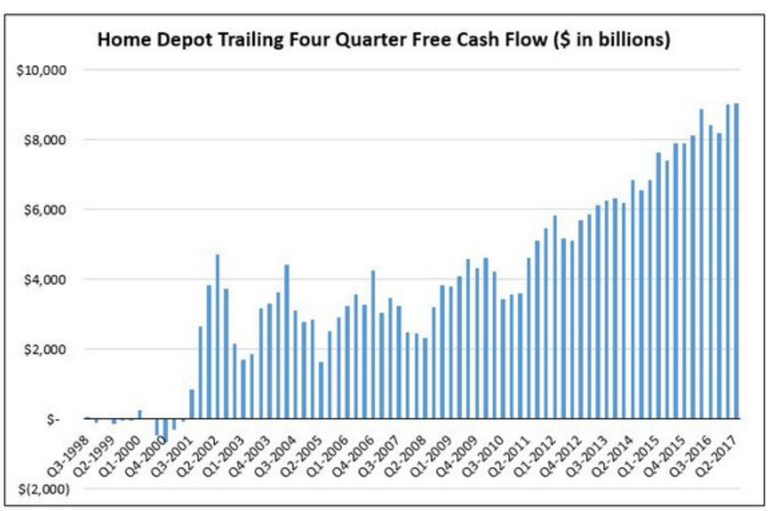
As has been the case since the end of the credit crisis, a steady labor market, low housing inventories, historically low interest rates, and positive long-term demographic trends all support the likelihood of continued home-price appreciation, which helps stimulate new construction and housing investment activity. All of these trends in housing have found their way through to Home Depot's sales performance, as management has done an excellent job generating balanced growth in both the number of transactions and average ticket size. A diagonal call on Home Depot is a means of capitalizing on these continuing trends:



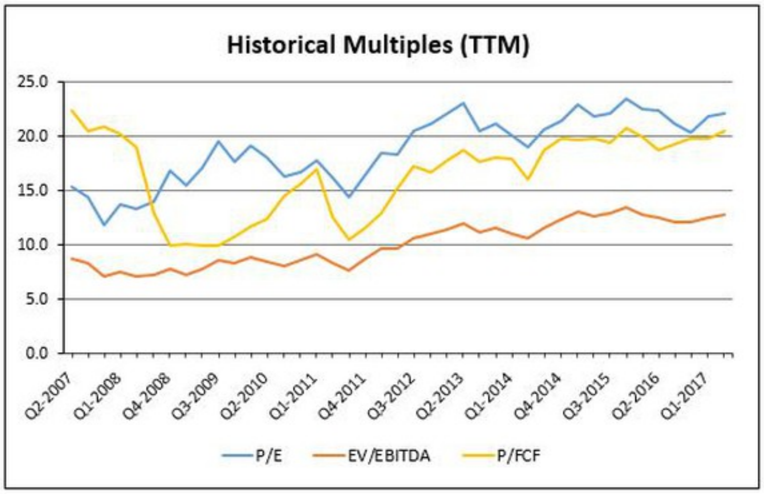
Note: Fourth-quarter 2012 and 2013 transaction growth percent and ticket growth percent are omitted due to an additional week in the fiscal year that impacted year-over-year comparisons.

There are several reasons Home Depot is so well-positioned to capture profitable growth. The U.S. home improvement retailing market is essentially a duopoly, with Home Depot controlling about half the market while **Lowe's** (NYSE: LOW) commands about a third. These two industry giants have strong competitive advantages over smaller players in distribution, sourcing, and advertising, thanks to their scale. Home improvement retailers are also uniquely unlikely to be "Amazoned" -- they're somewhat insulated from e-commerce competition because a lot of their products aren't cost-effective to ship (say, new hardwood or tile flooring) and because they stock products people need immediately for construction jobs, home repair, and so on.

These competitive advantages can be seen in Home Depot's margins, returns on capital, and free cash flow over time. These metrics are currently sitting at all-time highs, and it's reasonable to think they'll expand further (so long as the housing market continues its steady growth), especially as the company increases its sales faster than its expenses and continues to optimize its supply-chain efficiency:



All in all, Home Depot is a well-run free-cash-flow machine, and the company is very well-positioned to benefit from continued improvement in the U.S. housing market. And although valuation multiples are higher than they've been in the past ...



... we think that positive industry dynamics and the company's strong and improving financial metrics justify the multiple expansion. We peg fair value somewhere in the range of $150 to $170 per share, and assuming the housing market remains robust over the medium term, as we expect it will, our Home Depot diagonal should result in healthy profits for us by the time we close our position.

Why This Strategy?

At the beginning of this year, I wrote a Memo detailing four strategies we hoped to use in 2017 to help us on our quest to continue to challenge our North Star (inflation + 7%). The four strategies are:

1. New Long Stocks With Potential for Strong Growth
2. Intelligent Leverage Strategies
3. Protect Against Downside
4. Target Monthly Income Whenever We Can

We've done a pretty good job of executing on some of these strategies so far in 2017, adding five new stocks (Amazon, Johnson & Johnson, Coherent, NVR, Square, and now Tencent), all of which (except the brand-new Tencent) have experienced healthy appreciation since our purchases (up 19%, 17%, 6%, 32%, and 24%, respectively), and all of which appear poised for continued growth in business metrics.

We've also done a good job protecting against downside by using protective collars on some of our positions (O'Reilly and AmTrust), continuing to employ hedges (such as our QQQ hedge), and selling stocks that we feel less confident will generate strong growth over the next three to five years (including Parexel, TD Ameritrade, Papa John's, Valmont Industries, AmTrust, O'Reilly, and Gentex).

And we've done an OK job targeting monthly income by continuing our covered strangle position on Verisign and writing covered calls on Gilead Sciences.

Where we may have lagged in 2017 is in employing new leverage strategies. This Home Depot diagonal helps us with our objective of using intelligent leverage, plus it contributes to our goal of targeting monthly income whenever we can. We are risking just 1.5% percent of our capital to gain about 4.8% look-through exposure to a well-run, competitively advantaged business. We also create an opportunity for further income, assuming we can write more short calls against our long call in the future.

Additionally, Home Depot allows us to gain some measured exposure to retail (a category we've intentionally avoided because of the threat of Amazon) and increase our exposure to the housing market, which we initially targeted with our purchase of NVR. Over time, if the diagonal call strategy plays along, we may end up turning our long calls into stock, allowing us to benefit over the long run from a strong, competitively advantaged, *Pro*-like business.

More That Matters

- **Maximum gain:** If Home Depot closes at the written strike price ($170) in January 2018, our estimated return on invested capital at that time will be about 13.5%. Don't get too excited, though, Fools: This would have another two years to run (and possibly more), so measuring profits or losses after three months is misleading.
- **Maximum risk:** Equal to our originating net debit of $54.50.
- **Follow-up**: When our written calls expire in January, our owned January 2020 calls should retain significant value. At that time, we'll either roll our written calls out and/or up (if the stock price is higher than our $170 strike), or write new calls to reestablish the diagonal following worthless expiration of our January 2018 calls.

Alternative Trades

- **Want to establish your diagonal with more potential upside or, conversely, a lower cost?** Adjust accordingly:
  - **A more conservative choice** would be to move up the strike on the written call, leaving more upside room for the stock to rise. The January 2018 $175 calls look OK to us, or you could choose a later expiration date (February or March 2018) in order to earn higher premiums at higher strike prices.
  - **A more aggressive choice** would be to move up the strike on the purchased call. You could substitute the January 2020 $120 call for a net debit of less than $45.72, but realize the trade-offs -- you're buying less room for Home Depot to fall in a pessimistic market.
  - **You could use covered calls** instead, selling one January 2018 $170 call for every 100 shares you can afford to purchase and wish to cover for income. Aim for a stock allocation of 2%-3% of your *Pro* capital if you choose to use covered calls instead of a diagonal call.

Options Can Help

- **Want to know more about this strategy?** You can do it. We can help ... with our guide to diagonal calls.
- **Questions about this trade?** Bring them to our newly constructed Home Depot discussion board.

Buy Tencent

Published Oct 25, 2017 at 12:03PM

Is this for you? This is for all *Pro* members who are comfortable investing in one of the most dominant public companies in China. We have our usual long-term outlook: a minimum of three years, and ideally much longer.

How You Participate

- **Action:** Buy 2.5% in **Tencent Holdings** (NASDAQOTH: TCEHY)
- **Price Guidance:** Please use a **limit order!** Today, ideally pay less than $45.50. Later, the stock will remain a Best Buy Now until we change that status with an update.
- **Current Price:** $45.04
- **Guidance:** Best Buy Now
- **Fair-Value Estimate:** $50

Our $0.02 and More: In our surveys and member communications, longer-tenured *Pro* Fools often express a desire for more educational content. So we're trying something new with our recommendation on Tencent. Today's initial alert lays out the thesis for our investment as usual, and it should provide you with all the info you need to buy along with us. But in the coming days, we'll be sending additional content that takes a deeper dive into the valuation, our expectations, and more. Stay tuned!

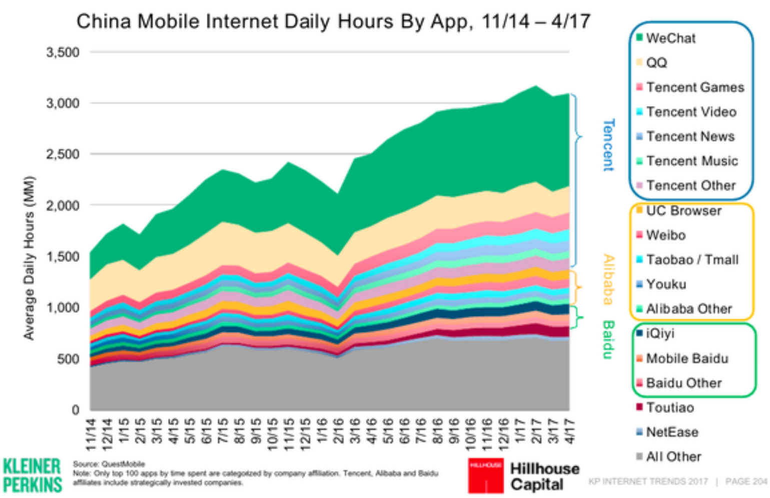
- Follow-up part 1: The Rise of the Everything App
- Follow-up part 2: What's WeChat Worth?
- Follow-up part 3: The Global Gaming Giant, Part 1

It's WeChat's World

Technology is with us from the moment we wake up until we drift off to sleep, making our lives more convenient and keeping us entertained and (hopefully) productive. Here in the West, we've become accustomed to relying on different applications for most daily tasks, but ask anyone who's spent time in China about this approach and they might say it's like stepping back in time. You see, in China, a single app — Weixin (WeChat) — that started out as nothing more than a smartphone messaging platform has since embedded itself into the daily lives of almost a *billion* internet users, enabling them to complete countless tasks in one digital place.

Tencent originally got a taste of success when it released its desktop instant-messaging (IM) service, QQ, in 1999. Despite cries of unoriginality, the app quickly gained a rabid user base, and by the late aughts, it had solidified its dominance with an estimated 76.2% of the Chinese IM software market. But co-founder and current CEO Pony Ma recognized early on that China's future was in mobile computing, not the desktop. His solution was to start an internal competition among several teams to create an app to address this perceived inevitability, and WeChat (which was initially developed by a team of just 11 employees) ultimately won out.

From there, the app has been a blockbuster success, dominating China's social-media landscape with 963 million users as of June 30. A recent study found that, of the roughly 3.1 billion hours Chinese people spend on mobile each day, WeChat captures about 900 million -- or almost 30% of all mobile internet traffic. More than 50% of users spent at least two hours with the app every day, and a third spent more than four. (Collectively, users spend 1.7 *billion* hours a day on Tencent apps -- more than they spend on all other apps combined.)



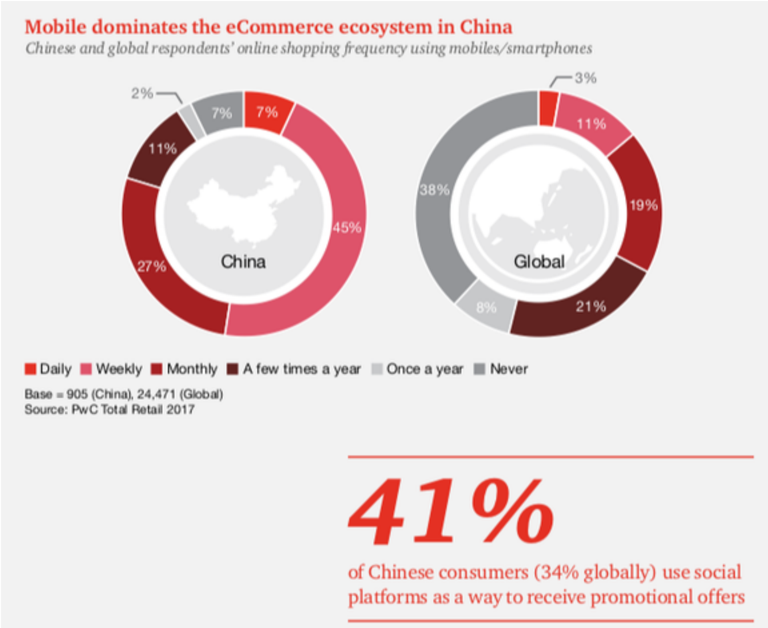
Source: Mary Meeker, Internet Trends 2017

One big reason for this success is that Tencent didn't just make an excellent smartphone messaging app and stop there; instead, it pushed to turn WeChat into a pseudo-operating system like iOS or Android. Need to talk to a friend, hail a cab, read the news, order a new shirt, pay for coffee, pay your water bill, play a video game, watch a video, listen to music, buy movie tickets, monitor your workout, or send someone money, just to name a few? All these things can be done without leaving the WeChat app. The end result has been a network effect and competitive positioning to make even WeChat's most successful Western counterparts envious.

In one of our forthcoming follow-up pieces on Tencent, we'll focus on the monetization of WeChat. For now, let's just say the potential is as impressive as we've seen in quite some time. We're excited about advertising -- some forecasts show the rapidly growing mobile market accounting for 60% of total media ad expenditures and more than 80% of digital ad spending in China by 2021. Chinese users' heavy reliance on just a few select apps ultimately reinforces the competitive positioning of the established market leaders and leads us to believe that advertisers will spend ever more money to get their messages onto the dominant platforms. If so, then it stands to reason that Tencent will disproportionately benefit from this trend.

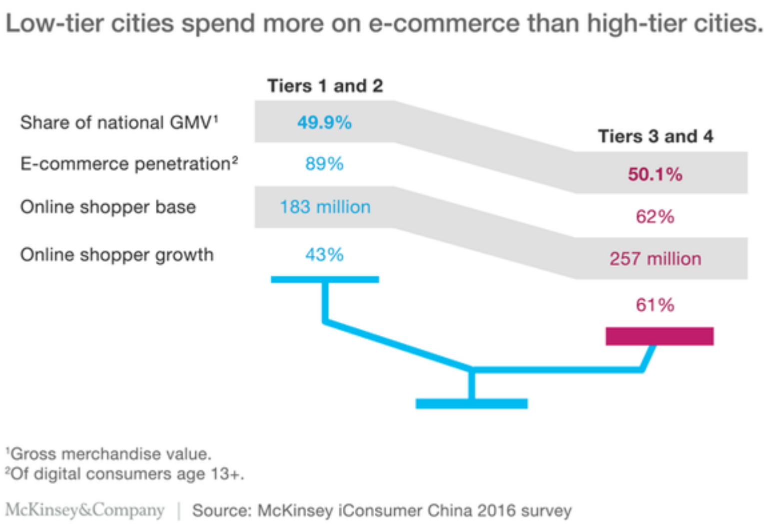
Facebook is the current gold standard for effectively applying user data in social-media advertising, but Tencent's integration into multiple aspects of its users' digital existence makes it able to gather far more relevant data than Facebook can. (Recent estimates are for 600-plus data points for advertisers on Tencent, vs. the 98 available on Facebook as of last year.) Prioritizing the user experience over monetization, the company has been slow to take advantage of this aspect of the business — management began testing the display of a mere two ads per 24 hours in select cities recently. But over time, we think its average revenue per user should begin to catch up.

We also believe that WeChat will ultimately be able to monetize the value it is creating by facilitating countless business-to-consumer (B2C) and consumer-to-consumer (C2C) interactions. Consider e-commerce: According to PwC, in China, the sector saw 32.1% growth to more than $210 *billion* in the first quarter of 2017 -- more than twice what was reported here in the United States. That's thanks in part to Chinese consumers' preference for shopping online via mobile.

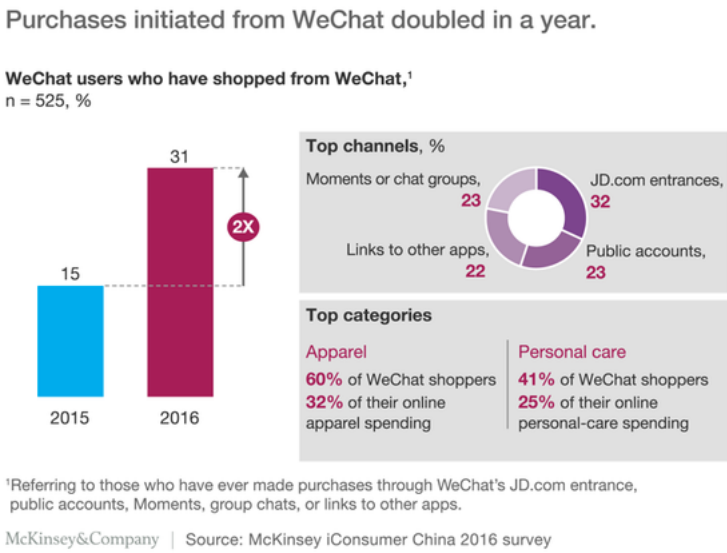


Source: *PwC China, eCommerce in China - the future is already here*

Despite this massive size, the Chinese e-commerce machine still has a long runway ahead. Although they contain 74 million more online shoppers, lower-tier cities' e-commerce spending only caught up with that of their higher-tier counterparts in 2015. And the low rate of penetration means that the number of people who use some online services, but don't yet *shop* online, in low-tier cities nearly equals the total number of online shoppers in high-tier cities.



Tencent is already far ahead of its Western counterparts when it comes to getting users of a social app to buy stuff online. You may not have heard of Singles Day, Nov. 11, but worldwide, it's the biggest online shopping day of the year -- and in 2015, more than 50% of the first-time Singles Day customers at huge Chinese online retailer JD.com came by way of WeChat and QQ. WeChat has also seen a huge influx of official brand accounts over the past year, and more than a third of these are already selling some form of product through the app (with 12.5% already generating at least 10% of their revenue this way).

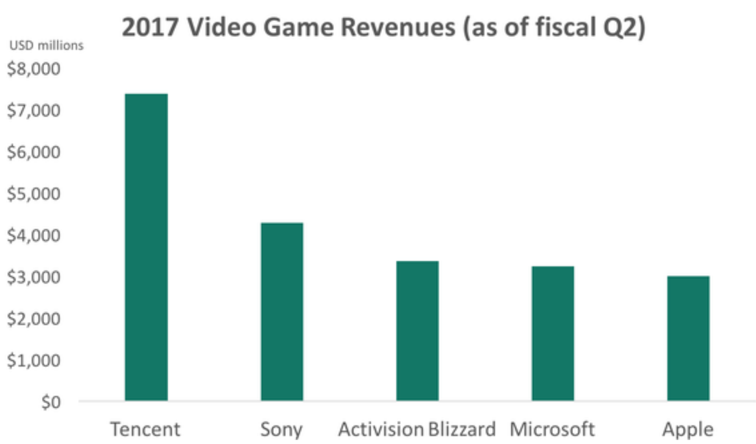


One way Tencent could ultimately monetize these transactions is through its digital payments platform, TenPay, which already has a monthly active user base roughly three times the size of PayPal's. TenPay is currently the second-largest digital payments platform behind Alibaba's alipay, with 40% market share vs. 54%. The Chinese mobile payments industry is a $5.5 *trillion* market (that's 50 times the size of its U.S. counterpart), and Tencent has rapidly been taking share from Alibaba as the former's WeChat integration has made it the go-to payment platform for peer-to-peer payments and cheaper purchases.

Long Live the Gaming King

"What's the largest video game company in the world?"

Ask any gamer -- or investor -- this question, and I suspect most wouldn't even list Tencent in their top three. But Tencent is in fact the largest, and it isn't even close:



Source: newzoo

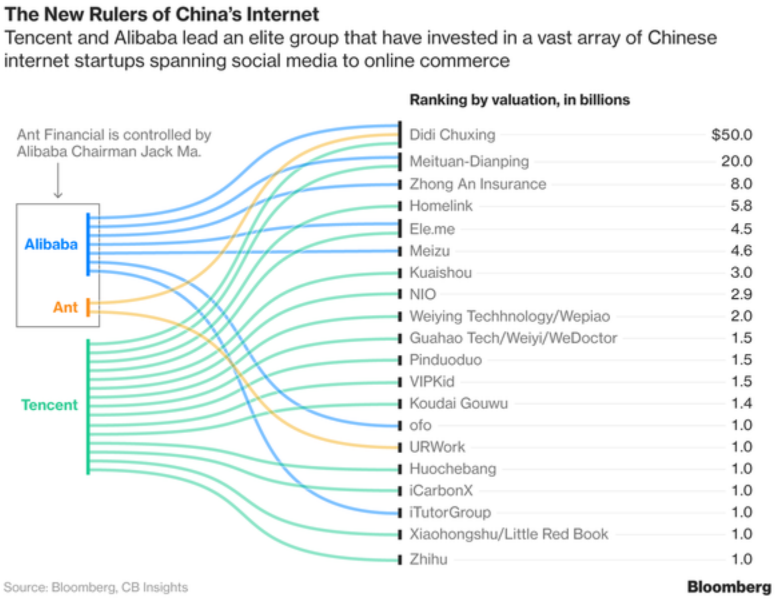
League of Legends, Tencent's PC crown jewel, is considered by many to be the most successful game ever created, given its longevity and massive player base. As of September 2016, *League* had more than 100 million monthly active players, representing a 16% compound annual growth rate since 2014. (If you created a country out of every individual who plays *League* at least once a month, it would be the 14th most populous country in the world!) It's not so surprising, then, that despite being "free-to-play," *League* was also the world's highest-grossing video game in 2016, generating more than $1.7 billion in revenue according to SuperData. And lest you think Tencent is a one-hit PC wonder, it's also the Chinese publisher for the third highest-grossing game, *CrossFire*.

But you don't get this big by focusing exclusively on desktop games. CEO Ma's focus on mobile has extended to Tencent's aggressive moves into mobile gaming, as well — an $8.23 billion market that Niko Partners forecasts will more than double, to nearly $18.5 billion, by 2021. In 2016, the company was responsible for publishing 25 of the top 100 mobile games in China; its latest smash hit, *Honour of Kings*, has actually become so successful that the *People's Daily* (the Communist Party's newspaper) has called it "poison." With a daily active player base of 70 million to 80 million people, *Honour of Kings* is on pace to generate roughly $3 billion in revenue in fiscal 2017. In 2016, Tencent also led a group that purchased 84.3% of Supercell, the Finnish publisher of the wildly successful *Clash of Clans* and *Clash Royale*.

If You Can't Build It, Buy It

"Tencent's services are so pervasive in China that startups there find it difficult to refuse forging alliances with or accepting investment dollars from the company. 'It's a little bit like the Godfather Don Corleone saying, "I'm going to make you an offer you can't refuse,'" says Andy Mok, founder and president of Beijing-based consultant Red Pagoda Resources LLC. 'If you don't take their money, and they invest in a competitor, it can be deadly.'" -- Bloomberg, June 2017

Tencent's success in multiple high-ROIC business lines has given management cash to invest in opportunities to ensure that Tencent becomes as inextricably intertwined with its users' daily lives as possible. TenPay and *Honour of Kings* are great examples of this, but the company's reach extends far beyond internally developed offerings. Management has made more than 40 investments in 2017 alone, and Tencent has meaningful stakes in several notable Chinese Internet startups:



We currently estimate that Tencent's major investments (a list that excludes many of these startups, despite the attention they're currently garnering) are likely worth upwards of $6 per share. That's for the company's positions in video games (including the aforementioned stake in Supercell as well as a 5% stake in Activision Blizzard), e-commerce (Tencent owns roughly a 20% stake in JD.com), online-to-offline (O2O) services (it owns a large minority stake in Meituan Diaping, the world's largest O2O platform with a reported gross merchandise volume of $35 billion in 2016), search (it has a stake in China's second-largest mobile search engine, Sogou), and other notable investments (like a 5% stake in Tesla, a 5.2% investment in China's second largest wireless telecom, China Unicom, and a meaningful minority stake in "the Uber of China," Didi Chuxing). We expect that valuation to rise sharply in the coming years -- plus, these products will add value by keeping users in Tencent's ecosystem, thanks to their integration with Tencent's social platforms.

Risks

One of the biggest risks with Tencent is a dwindling user base. If users abandon WeChat, it could result in a vicious cycle that undoes everything WeChat has accomplished. There's also a risk that the primary reason for WeChat's success -- the fact that it allows users to do everything in one place -- could ultimately become its downfall if the user experience becomes too cumbersome and cluttered. And from a valuation standpoint, I wouldn't be surprised if we begin to hear cries of peak Tencent when WeChat's user base starts to stagnate (unlike Facebook, Tencent has struggled to find success outside its home country). If this does happen, we'll likely see it as a buying opportunity, given the untapped revenue streams embedded within WeChat and the secular tailwinds powering the rest of Tencent's businesses. There is also the unavoidable risk that is the Chinese government, especially given a recent announcement that it may look to purchase sizable stakes in the largest Chinese tech companies.

The Foolish Bottom Line

The case for Tencent is perhaps best summarized thusly: Are you interested in investing in a company with similarities to Facebook, WhatsApp, Instagram, YouTube, Netflix, PayPal, ApplePay, MasterCard, Visa, Spotify, Apple Music, Gmail, Nintendo, Activision Blizzard, EA, Uber, Lift, Yelp, Groupon, and more? In 2014, *The Economist* questioned whether Tencent's $100 billion valuation made sense. With the benefit of hindsight, we can now see that the answer to this question was an unequivocal No -- but because the company was vastly *under*valued, not too expensive as the article suggested. Today's investors must similarly question whether a $424 billion valuation makes sense. While risks do exist, we think it's likely the answer will yet again be No -- and this time, as before, it will be because the market is failing to see Tencent's true potential.

Pro Can Help

- **Looking to get social?** Head on over to our new Tencent discussion board.

Pro Video Chat, October 2017

Published Oct 24, 2017 at 4:28PM

The *Pro* team will be holding **a live video chat on this page at 2 p.m. Eastern on Monday, Oct. 30**! We'll be using Slido to communicate with members during the chat; to join, click here and enter the code **#ProChatOctober**, or click here to join the chat directly. We recommend opening Slido in another browser tab (or on a mobile device) so you can see both the video and the Slido questions at once. See you soon!

Transcript

JP Bennett:Greetings Fools and welcome to the monthly live chat for pro. I'm JP Bennett and I'm joined today by the irreplaceable Jeff Fischer. How is it going Jeff.

Jeff Fischer:Nobody's irreplaceable JP, but I'm doing well. How are you?

JP Bennett:I'm doing great. By phone or Skype we have the unparalleled Billy Kipersztok. How is it going Billy?

Billy:It's going well JP. I'm here by phone. I'm having some glitching issues with my Skype video so unfortunately here by phone. Also, yeah I don't know about unparalleled, but thank you.

JP Bennett:I'm laying on the compliments to hope to get this chat off to a good start, but the fact that you can't connect by Skype means that we're not off to the best start today. Our standard reminder Fools, we want this to be as interactive as possible, so please go on over to Slido and click the link above this video in order to do so.

If it prompts to add in a hashtag to get to the page, the code this month is prochatoctober. I'm on top of things so I actually know it this month, unlike the chat for options. Enter that in, find the questions that other people have entered in that you agree with, thumbs them up, add other questions that you haven't seen in the chat yet that you want to be answered, because the goal here for us is to answer as many questions as possible. With that in mind, unless either of you have opening statements we can just jump right into the questions.

Jeff Fischer:Sounds good JP. The first question is from [Lan 00:01:30] it's about Celgene, which is a company I of course follow most closely. We have written puts on it in pro in the past. I'll start with questions, but before I do that I'll say that the portfolio is up 18.2% as of this morning, year to date. So the portfolio is doing well. We're still about 74% net long. Does that include Tencent? I might have to update that number, so 75-ish, 76% net long. Well ahead of north star, ahead of ... Yes?

Billy:What was that number Jeff, the year to date return?

Jeff Fischer:18.2% for pro.

Billy:So it looks like on our portfolio page year to date we have through September 30th was 12.9%, so we had a really good October.

Jeff Fischer:That is true Billy. It's been driven by everything from Facebook to the MasterCard and Visa, to Amazon now, to NVR.

JP Bennett:Square.

Jeff Fischer:Square, Johnson & Johnson had a big jump too. It's been good. What I love seeing about the portfolio, and this is very true to life, or for a portfolio anyway, not everything is doing great, but the things that are doing well are doing well enough to give us a very pleasing return. Hopefully in future months, or even a year or two, the things that are lagging will hopefully have better goes at it as well.

JP Bennett:The first vacation is a beautiful thing when it works out.

Jeff Fischer:When it does work out it is. Speaking of that, Celgene. I wanted to end my preamble by saying I hope you're having a great year, enjoying yourself. We, the three of us, are. We love our team. We love working together. We love working for you and we love what we do, so we hope to continue to provide you with a pleasing service for years to come in Motley Fool Pro. That's both long and short, we continue to look at shorts, but so far it's very good that we were not compelled to short almost anything, because most things would have worked against us. The few that did work out, if we had shorted a bunch of things, they wouldn't have made up for the things that haven't worked out.

That sounds a little like market timing, maybe, but it isn't. It's just when you see an opportunity that you want to act on, you act on it. But in this market we haven't seen. We take the macro in consideration, we haven't seen things we wanted to jump on short-wise. We just saw a GDP growth of 3%, which adds more fuel to that fire. That's pretty strong growth for our country. Economies are growing even more all around the world, so it's been a good year for earnings growth because of that.

Alright, now enough, into Celgene. So, Lan and other Fools are interested. I am looking at Celgene. The news on it just broke Thursday or Friday, so I'm still looking at it afresh. But for those who don't know, the shares have fallen from 140 all the way to 100 or so after one of its promising drugs in the pipeline has been canceled at phase two trials. It didn't show positive results, so that's gone. That's unfortunate.

Then one of their lead drugs, or their lead drug, had weak sales and the quarter just ended. Management admitted they really got it wrong on their forecast for what that drug could do. That extends further down the line too. So they had to lower their guidance not only for this year but more importantly for 2020. Years ago they took the chance of guidance all the way til 2020, saying, "We'll grow earnings per share about 25% annualized," and sales by some high, high teens number annualized as I recall. Now, they lowered that earnings per share growth guidance to 20% annualized. 5% a year is a large difference. That goes far to account for the stock falling so much.

That said, shares now trade at about 13 times earnings, last I looked. About eight times 2020 earnings estimates if they hit those estimates. So we are looking at it seriously, that said we do not want another Gilead on our hands, meaning a high quality business, which both of there are, at a very attractive looking price. But if you don't have the growth that Wall Street wants from it, and in most cases that means surprise growth, more than what's already expected, you may not see the type of returns that you're hoping for.

We want to make sure Celgene, and still Gilead, which we still keep analyzing every quarter, is not a so-called value trap, a cheap high quality business that is not on track to grow the way we would hope. I don't believe Celgene is, as of yet, but it does have the added risk of only having a few big products drive the most of its sales and profits. That's not a pro-like feature. It also doesn't have pricing power, once a drug is out for a long time it has anything but pricing power. The price has to go down of course. Third point was, but I do want to say it has a great pipeline. About 50 compounds in trials, many of those look promising.

Overall, I lean positive on Celgene, but not certain that we're going to bring back into the portfolio yet. But I'm looking at it for maybe a bull call spread we talked about, maybe writing puts, because if we can get shares even cheaper that might be hard to pass up. Last time we wrote $100 puts on it for about $6 or $7 each and made that income. Let's end on that happy note. We've made more by writing a put on Celgene than shareholders have made since, that was more than a year ago I think. Yeah, it's a good business overall and I think it will hopefully earn a north star, but we're still thinking about it. Next question from someone else to talk is JP.

JP Bennett:Alright, hold on I'm pulling that back up. Question's on Starbucks' role in the pro portfolio. Yeah, that is a great question because it goes back to what you said, in terms of not every stock is doing amazing in the portfolio. Especially this past month you've had great winners but Starbucks is not really one of them. I'm pulling up the chart. It's been kind of muddling along since August, after it got hit. Where you had that run up on the unicorn frappuccino, or something along those lines. And then it got hit afterwards, when people realized that that was more of just a one hit wonder. We have earnings coming up, I believe they'll be on Thursday this week, November 2nd I believe.

Jeff Fischer:I know they're soon, they're this week.

JP Bennett:Yeah. I believe it is this Thursday. That's basically one of the wait and see companies. We haven't had much news from Starbucks in the interim. Until we get that, you don't want to run and make a rash decision, so we want to get earnings, digest them. We know that they're in a pretty tough spot, right? But it's looking out the next three, five years, can they continue to execute, continue to generate really great returns on invested capital, on their new stores, continue to open them up. Kind of right the ship in terms of the new initiatives in their existing stores that they're putting out there to try to help bump up their same store sales.

We're in wait and see mode with Starbucks, kind of, "Show me what you can do and if you can still execute. Even if the stock doesn't follow suit, that's not necessarily a bad thing, because what happens if the business continues to create value and compound but the stock price doesn't go anywhere, assuming they're not overly aggressive with their stock comp, the valuation is going to increasingly get cheaper, and that makes the company increasingly attractive in terms of an investment. That's where we stand with Starbucks.

Jeff Fischer:Well said. As David Gardner likes to say, "Past performance often reflects future performance."

JP Bennett:[crosstalk 00:09:37]

Jeff Fischer:Not always but frequently. So far we have to give Starbucks the benefit of the doubt after a few decades, even longer, of overall strong performance, as with all companies that's had its pockets of weakness. But even as we look at the challenges that it faces right now, and we take them to heart, our bias is still to give this team the benefit of the doubt because they've put in place a system and a business hopefully that really has staying power and the ability to grow.

JP Bennett:Yeah. If you think in terms of a portfolio and diversification, Starbucks is one of the names we still feel comfortable in having that retail-esque exposure. I would much rather own Starbucks than a Bucco, a company that we sold previously. That's another kind of additional value that Starbucks for having it in the portfolio. Ultimately at the end of the day we want all of our stocks to offset each other when they're struggling. So we want companies that are doing good to zig when the companies that are doing bad zag, and then the other ones that are doing poorly can hopefully pick up the slack when our leaders slow down for a little bit.

Jeff Fischer:Especially if they're all high quality businesses. Which we're trying hard to-

JP Bennett:That's the key, right? You can't hold a stock just because you say you want diversification. It has to actually be a good business.

Jeff Fischer:Speaking of irreplaceable, [Fusky 00:11:01] is asking, or saying, hey Fusky, "What one pro company would you think is irreplaceable? What one pro company would be the first one you would replace if you had to?" Great question. Billy, have you had time to think about that?

Billy:Yeah, I took a look at that one. It looks like a great question as well. I guess I can give my answer to that, and then I'd love to hear what you guys think for your answers as well.

For the one company I would think is irreplaceable it's really tough to decide because obviously when you're running a portfolio, you're not really banking on the results of any one position. You want to be, as we mentioned earlier, kind of broadly diversified. It's really the aggregate of all of your positions together that create your portfolio's performance.

But with that said, I think one of the good ways to answer this question would be think about it in terms of our pro quality checklist. Which is the eight qualities that we look for in our pro stock. I can run through them really quickly. One is a sustainable competitive advantage, another is pricing power, another is a dependent customer base, another is predictable revenue, growing free cash flow with compounding returns, financial resilience, expanding possibilities and then good management.

Among the positions that I cover, one of the companies that fits all of our pro qualities really, really well is Broadridge. I actually wrote a memo I think in 2016, last year, running Broadridge through our pro quality checklist, and it scored and eight out of eight on our checklist, which is awesome. It has all of the qualities we look for in a pro stock. I really love that company in the context of our goals.

We look for stocks that are stable, not too volatile, that have good pricing power, that can be really consistent and provide good earnings over time. I think Broadridge fits that category really well, as evidenced by its eight out of eight score on our checklist. For me, if I had to pick one it would be Broadridge.

Now the company that I would be the first to replace if I had to, I think Jeff and JP know the answer to this answer. We kind of talked about it a little bit. I'm not too keen on Open Text. I've advocated a couple of times for maybe considering replacing that with something else. But yeah, that would my answer, Broadridge for the irreplaceable and Open Text for the one that would the first to replace. What do you guys think?

Jeff Fischer:Alright, I like that answer. Broadridge is our second largest holding now too. JP do you have thoughts, or do you want me to go?

JP Bennett:I can go because Billy did both of us a favor by going first and giving us some time to think, because it took me a little while to think about this one. I think I'll take a bit of a different approach from Billy in looking at the companies for the ones I would want to hold for extended of time, I go back to a lot of the research that shows that ultimately it is the strong secular industry tailwinds that propel the winners for an extended period of time. If you are a company that is able to establish yourself in those industries that just have years and years and years of above average growth and strong returns on invested capital, then unless you're run by a bunch of chimpanzees, you're probably going to do pretty well.

So in that light, I would go with either Visa or MasterCard in terms of the companies that I would want to buy and hold them for an extended period of time. I don't need to spend much time talking about it, right? We all know about how great of a setup that is for the next 10, 15, 20, 30 years potentially. That would be my pick.

As far as the companies I would sell, the ones that I was the bearish in terms of coverage are names that I ultimately got rid of. To that end, I don't have any that are currently in my coverage universe that I'm eager to unload, because I don't really have an answer for that one. There are some companies that maybe Billy or Jeff follows that I don't understand as well because I'm only in the group discussions and that last mile in terms of really understanding. The business doesn't fall me and so that's where I may have some pause. But it's a question that I don't feel comfortable making, knowing that I don't have complete information, or a full grasp of everything going on within the business.

Jeff Fischer:Fair enough, and a very reasoned answer. Interestingly I viewed it a little bit differently from both Billy and JP, but similarly at the same time. So, irreplaceable I took to interpret as something that you wouldn't ... assuming you couldn't duplicate it, there wouldn't be anything else like it. So I chose Facebook. If Facebook were to go away and you weren't allowed to make a social media site or they just didn't exist.

JP Bennett:Tencent would probably be pretty happy if Facebook went away.

Jeff Fischer:See, so the nuance of my thinking needs to be described better. If social media had never come along ... Well, I guess that's true of every business, but anyway, I view Facebook as something that's difficult to duplicate, at least in this country at this moment. Because if Facebook did go away, a bunch of different social media apps would probably rush to fill in the gap, and who knows if one would congregate people the way Facebook had, has. Maybe they would but maybe not, maybe people would disperses and that would be it.

So for whatever reason, I view Facebook as irreplaceable as a platform of two plus billion people around the world. If it went away I don't know that something would step in and fill that gap as cohesively as Facebook is, flaws and all at Facebook.

As far as one I could or would replace, I view everything in the portfolio as actually replaceable and nothing as irreplaceable, when you really get down to it. But to play the game, I would say Gilead Sciences are one stock that is on hold, is the one that we could sell at any time to replace with something we like better. It's been on hold for a long time, when the stock rose some people who didn't buy were not happy about that. And now the stock is all the way back down, so hopefully they're happy about that. It's been hold for a reason.

Yeah, I hope that answers your question Fusky. We've got MasterCard, Visa, Broadridge, Facebook. Not surprisingly all big holdings in the portfolio. And then the ones we would replace, Billy mentioned Open Text. Part of his reasoning there is we have quite a few software companies. I mentioned Gilead Sciences.

Billy:Great question.

JP Bennett:Yeah. I like those questions that beyond asking about what's going on currently with a company, kind of the bigger philosophical questions.

Jeff Fischer:Make you think, yeah.

JP Bennett:Yeah.

Billy:You can see that we all have different answers to that. It's because it's more of a general type of question, we can all put our own spin on it.

Jeff Fischer:This is true. Let's see what we have next, we have Bob V, hello Bob, asking, let's see. Well, let me read it because he's writing. "I jump in on a Tencent transaction, or Tencent investment. I've always been weary of Chinese stocks due to transparency issues. Do you share any of those concerns?"

JP Bennett:I would say, yes of course we share concerns. There's no risk-free investment, so there's always issues. Especially when you're dealing with a Chinese company, right? We're getting ownership, or rather we're getting a stake in the company by way of an ADR, so there are definitely some potential issues there, should things play out in an unadvantageous manner.

However I would counter, with respect to all really big corporations, there's tons going on behind the scenes that you have no idea. Go back to Wells Fargo. We flash back a couple of years, it is by most people's standards the best large bank in the US. They have such high ethical standards. They're an upstanding company that really can't be duplicated. Warren Buffet loves it, lots of the Motley Fools advisors, analysts, members, they all love it.

Jeff Fischer:Everybody trusted it.

JP Bennett:Yeah, and then look what happened, right? So there's always going to be things that you really can't fully understand or grasp. So you just have to think to yourself, do the potential positives for the business and the investment kind of, not necessarily offset but outweigh the risks? In this case we believe that the answer is yes, just because although it's already a huge business, the competitive positioning that they've had, it's something that I really haven't come across.

We all know how amazing Facebook is, but in terms if you're looking at just China and Tencent and Facebook only in the US, it's, yes Facebook is further along in terms of monetizing advertising and things along those lines. But Tencent has been able to integrate into so many more aspects of its users' daily lives. It gives them so much optionality there. The opportunity for this business the next three, five, 10, 15, 25, go on and on, the opportunity there is huge. It was something that we talked about and considered, but at the end of the day we felt that the positive justified at least starting out at a 2.5% stake.

Jeff Fischer:Yeah, and that's another good point, it's one position in the portfolio and so that mitigates the risk as well. Okay, thank you JP. Karen, hello Karen, is asking to talk about Gilead Sciences. "Is it creepy or is it okay?" I haven't gone through the results from last week in depth yet, but they look more along the lines of middling. Once again, hepatitis C is more spooky than euphoric, I guess.

That market, there's pricing pressure, there's volume pressure. It quickly became, as you know Karen, Gilead's largest revenue driver, and then we've had to watch that contract without other things to pick up all of the slack. HIV, unfortunately but fortunately, is doing well. It's fortunately helping people, but that franchise continues to grow. Overall, our story hasn't changed in that Gilead has strong management, strong products, strong balance sheet, although now that they acquired Kite that's going to change. Overall we're right back where we were. We have a very inexpensive company, inexpensive stock that doesn't grow in the bottom line, that we're looking to write covered calls on.

We purposely did not before earnings because the earnings results could have driven shares much higher, you never know. We're always looking to make a small amount on covered calls, as you know the 1% a month or so. So why risk missing a bunch of upside for that little yield, which we can now, now that earnings are out, we can go to the stock and write covered calls on it more safely presumably. Yes, at a lower strike price, but with more knowledge. That's the trade off on that one. So our strategy there stays the same and we're close to on track to ... we're actually right on track to earning a north star, a better return on that stock this year with our covered calls and the dividend yield. But that said it's still on hold and we don't think it's worth newcomers getting into the stock when we could let it go at any time. We've driven newcomers instead to our other new positions, which have done on the whole much better than Gilead has this year. So good question Karen.

Quarter by quarter we see how this hepatitis C industry is shaking out. Unless it picks up steam soon, I think Gilead is likely to keep treading water. Hopefully it doesn't have much of a low from here, much lower, but it's hard to see it going much higher either with earnings from its recent acquisition not arriving until at least 2020. We'll take that in mind as well and we may indeed close the position if we want to raise cash, but meanwhile look to keep monetizing it. If we ever think the downside risk is very large from here, of course we'll let you know when to sell right away.

Anonymous is asking, "With the market running so high, are there more protective strategies we could use on our portfolio?" There are many, and we can address maybe why we haven't so far. I can say for my own thinking, is that one, we see earnings growth for the first time in a long time year over year, strong earnings growth. You see the macro economy doing well. You see policy that's going to aim to keep interest rates relatively low. You see very importantly growth in Europe and Asia again, most of Asia. So really at no time since the recession have we seen, so no time I can remember really, all major world economies growing at the same time. We're seeing that right now. We're also only about 75% net long. We have a lot of cash. We like what we own. We sold things we didn't own, or we didn't like, to be defensive. So we feel good about the portfolio and that's why we haven't spent money yet to put on more protective strategies, but when we feel compelled to we will.

JP Bennett:I could also add that now that we have Tencent out, that was perhaps the biggest distraction or takeaway in terms of preventing me from continuing on with our hedging series and pushing forward to the potential next hedging update and potential strategy. Now that Tencent is out and in the portfolio we're going to be able to shift gears and put more time behind that initiative. Potentially you could see something reasonably soon, however it gets back to what you said, we're not of the mind currently to pay an arm and a leg to setup a hedging strategy, especially given where we are in terms of our percentage net long and what the overall economy is looking like.

Jeff Fischer:You also have a market- Sorry Billy, go ahead.

Billy:Yeah, I was going to add, also in the context of this question, whenever I see a question that starts of like that, it's like, "With the market running so high ... " I always like to reinforce and give a reminder, that is a normal tendency to feel like, okay, stocks are up, the market is high. You have to have a crash coming soon, or it's going to drop back down.

It's a very normal feeling to have, but we have to always keep in mind that just because stocks are high doesn't necessarily mean that there's a decline coming or anything like that. Stocks are high, yes, but take a look also at, as Jeff and JP mentioned, the economy. Look at global GDP and look at the graph of what global GDP looks like, and that's also at an all time high in the world's history. So as populations continue grow and economies continue to grow, you would expect naturally that stock markets will grow alongside that. You can't always think, just because the market is high we should be scared. That's kind of a normal thing actually.

Jeff Fischer:Well said Billy. A final thought from me is that we are looking at protective strategies for some of our largest positions, and that's not a fear of the market but just a way to be smart about where our risk is concentrated. There are ways to do that, including buying puts or setting up collars. But I guess the bottom line is the three of us are thinking about it and are always looking for the portfolio to reflect our current thoughts.

JP Bennett:I think another thing we could also quickly throw out there is, if there is a company that is already a large allocation in the portfolio, if you want to reduce your long exposure for the portfolio overall, one potential way you could that if you're concerned about the company running into earnings or something like that, look to set up a hedging strategy on just that one name for very little cost.

Jeff Fischer:Anonymous is asking a simple question now, "What are you thoughts on Skyworks options with the recent rise?" Indeed, the last two days the stock has risen a lot on Apple iPhone X chatter. I was hoping we'd get under the bell on that so to speak and close that out before earnings. Earnings are coming up on the six of November I believe, and my plan, the plan we have, is to close the short calls on Skyworks before then, let the puts expire because they're well out of the money.

Although their value is shrinking so much we may just close those too and then see where we are after earnings. I don't want to keep it covered through earnings right now because the stock is still reasonably priced. We've earned back a lot of the stocks upside with the puts we've written, not with the calls. We've kept chasing it but the puts we've written have paid us pretty well. So we're sitting pretty well overall. After earnings we can see where things are and consider writing calls again. I don't plan to write puts again on it though, because our exposure is plenty high. So yes, we'll probably take care of those calls soon, and then look to write new ones potentially after earnings in about a week.

JB is very conflicted, getting old. I think we're all conflicted, I am, about time. But it gets richer as you get older too. Yes, richer experiences and what not. GB is happy with following pro but curious about our advice about switching the great allocation to bonds. Billy or JP, if you have any thoughts on that. We have talked about it with pro members in the past, where it's, the most simply put, it's a matter of having more cash, we usually carry at least 20% cash, which is kind of a bond equivalent these days practically with bonds paying so little. Or, owning less of our stocks, try to own all of them because it's a whole portfolio approach, but put smaller allocations in them. What you don't put in, you put into bond.

So if you want a 20% bond allocation or 30% or what have you, just be sure whatever money you're putting into bonds you're going to keep in the bonds for the whole duration so that you get the full value of the bond at the end. If you're doing that, it's simply a matter in my opinion of what sort of allocation you want, what percentage in bonds. Put the rest across all of our stocks.

JP Bennett:Yeah, I think this question really gets to understanding each individuals setup in terms of their temperament, their age and their goals and their financial status. That is probably dealt with a financial planner, just because of all the things that you need to take into consideration. But it something that even they are yielding very little, it often does make sense as you get older to switch your allocation to some percentage waiting in bonds. But without knowing the specifics and with the qualification, I'm not a financial planner, it's definitely a question where I don't necessarily feel comfortable giving a detailed example.

Billy:One way I like to think about pro in the context of greater portfolio planning is, even though we do stocks and options and EPS and shorting, I like to think of the entire pro portfolio as though it were like a stock basket. If you go to a financial advisor and they recommend 60%-40% stock and bond, if you have 50% of your overall portfolio in pro, you could consider pro as that stock portion of your portfolio.

That's how I like to think about pro, even though yes, we are in those different asset classes, we really do behave on a aggregate portfolio basis like a stock portfolio, but a more sort of conservative type of stock portfolio that doesn't bounce around or have as much volatility as the overall market. A lot of that is due to the fact the we hold some cash, but also due to the fact that we do try to take consideration to protect downside and do hedging and also pick companies that tend to be more stable and less cyclical. That might be some help.

Jeff Fischer:Sounds good, thank you Billy. We have about 23 minutes left so let's go into a semi speed round. We have quite a few questions here, thank you for asking your questions. Let see how many we can get through with decent answers still.

Anonymous is asking JP, "What is a reasonable steady state percentage of our pro portfolio to hold in the Chinese market, for example Tencent and any future Chinese recommendations?" Good question.

JP Bennett:It's a good question and I personally don't have a definite answer. I think it goes on a company by company basis, with an acknowledgement that them being located in the Chinese market there's definitely some risk, especially with regards to the government. So we haven't' given that much thought to it yet, just because we only have one investment in it. But I would say there's definitely a hard that cap, that assuming we research more Chinese companies and really like them and want to invest in them, that we run up against and we wouldn't want to push above.

Jeff Fischer:Yeah, I think I'm personally at 7% or 8%. I'm probably not going much more above that. I think I can go more than 10% in China myself, but we'll see what pro does.

JP Bennett:It also gets back to something we've talked about on countless occasions in the past in terms of a lot of our other companies already have ... Starbucks, Apple, the list goes on and on, we already have a lot of companies that have exposure to China.

Jeff Fischer:What impact if any do you see for Facebook from fake news? Do either of you want to share a thought on that, or do you want me? Stock I cover, I guess I can do it.

Billy:Yeah, go for it man.

Jeff Fischer:I guess, I love that confidence.

JP Bennett:It's the one you listed as irreplaceable too, so ...

Jeff Fischer:It's true. I feel like I'm talking a lot so I wanted to ... and frankly I know they want to fix the problem and I think with time they'll be able to. I think the way they've dealt with it so far has not been nearly as forthright it seems, or as expedient, as I would have liked to have seen. I think Zuckerberg has been embarrassed and even feels a bit ashamed about this happening. He has a very idealistic view of Facebook and what it should be and what he thought it was. He believes of course getting people together will make the world better, and he's learning, we all are learning perhaps, that bringing people together can also lead to unfortunate outcomes.

They need to find a way to, one, to find what's allowable and what's fortunate versus unfortunate, and two, make that happen on the site and make it safe and positive for everybody. I don't think there'll be any real impact to the business though from what's happened so far. If it gets worse, if it continues and grows, it could then lead to some sort of impact, if advertisers don't want to be associate with the Facebook name. But I think we're a long from that right now, and from all accounts it sounds like they're working to really get on top of this and hopefully eradicate, all but eradicate fake news from the site. When you think about it, fake news has been a part of the world in one form or another for as long as humans themselves, I guess.

Billy:I think it's also gets to another thing that you can tie in to general investing. Which is the power of social proof, where if you see a large group of people believing in something or sharing something, there's a natural tendency for the next person to just believe it, without really vetting it. It's just another example of how powerful those forces are of social psychology, that really are kind of ubiquitous in investing.

Jeff Fischer:So true, and then, this not directly related but the internet brings you closer to other parts of the world in a sense, but also keeps you very distant from them. Some of the things that fake news centered on are right around the corner from us in DC, so we can go there and know it not to be true, and yet people at the other end of the country don't have that familiarity with it.

The internet can easily conjure up what isn't real. Great question, it's going to be intereresting to see how they deal with it. We, as investors, are very concerned how it might affect financials at Facebook. So far, I'm not concerned about that. We'll see soon. Keep in mind, Google also has had big problems with fake news, as well as Twitter it sounds like at least a little bit, if not a lot. Google just reported, Alphabet just reported strong results.

Bumper Cars is asking, "Current thoughts on Gilead?" We did talk about that and so we can move on. We are planning to write more options. I think, well I'll just move on. Okay, Lance, "What are your thoughts on how today's developments ... " Okay, we have a political question, but not really. "How will this affect stock prices?" It's a great question. You might argue that stocks, some people argue that stocks have risen on the hopes of this administration, and it's true, stocks have gone up since November a lot.

I would argue at least half of that is driven really by the fundamentals, by earnings growing and GDP growing as we talked about earlier, and having clarity on interest rates as well. Do you guys have thoughts?

Billy:I personally do not. I'm not really following this investigation all that closely, so don't feel qualified to comment.

Jeff Fischer:I would say if doubts arise about the administration staying power for example in the extreme, you would expect we'll see more volatility. But in the longer run, meaning even a year or two, the stocks will be valued based on earnings.

JP Bennett:I would also throw out there that even if more and more starts to come out in terms of the worst case scenario, so then just in terms of what's getting out there, I'm not taking a side on the political sense. But worst case scenario, in terms of he's continuing to find more and more things that he can go forward on, and so all of these uncertainties start to arise with regards to what's going to happen, you may see some volatility but in the even intermediate term, in the long run, you don't really know how the market's going to react.

If you flash back to the election, market's rising because Clinton is a sure thing. It could be more the status quo, and we love the status quo. The market's been rising, so it's awesome. Then what happens? Trump wins, and before that everybody's like, "If Trump wins the market's going to tank because who knows what's going to happen?" Well, he wins and then what happens, the market continues [inaudible 00:38:45]. You don't really know what's going to happen. Maybe a lot of people get removed from the administration, they basically lose a lot of the power and the political capital that they had, and the market sees that and it loves it and it continues to rally, because man, maybe this administration wasn't cut out to do good things for businesses. So the fact that they're losing their power is a great thing. You really don't know what's going to happen. You have to watch it and see how things play out.

Jeff Fischer:That's a great point, especially because during this investigation playing out, you'll have all these other factors playing out that are economic, and that will drive prices as well. Which companies in pro do you feel have the best untapped pricing power?

JP Bennett:Tencent.

Jeff Fischer:Tencent.

Billy:I have a no brainer answer to this question, mine would be Amazon for sure.

Jeff Fischer:I like that answer, both good.

Billy:Yeah, they have the prime membership, which I think they raised from $79 to $99 per year a couple years ago. They saw very little blip in renewal rates. just thinking about me, personally, what I would pay for that Prime service is well over that $99 per year amount. I get a lot of value out of that, and not to mention they keep adding all kinds of different features and streaming and other things that you can utilize as being a Prime member. I think Amazon has a lot of room to increase their membership rate and grow profit that way.

Jeff Fischer:Nice. Tencent is a great one, Amazon, that's a great one, and kind of unexpected. I'll throw an expected on there, Verisk has great pricing power, raising prices each year. But many of our companies do, Starbucks is one of them, we'll see how long that continues. I think it can to modest amounts.

JP Bennett:Don't jinx it Jeff.

Jeff Fischer:Yep, exactly. 15 minutes to go, so we'll move even more quickly. Jim is asking a question related to FAZ. He's still short FAZ, any thoughts? I would stay short it if you can. We're waiting for 2020 options and then we may setup a synthetic short, perhaps. It depends where the portfolio is at at the time. I personally have stayed short FAZ as well through TD Ameritrade. It's such a small position now I'm just letting it go for now. I'm just keeping it short. You can do so as well and we conveyed that on the boards and in a memo as well. You can keep it if you like it.

JT Northern, would we ever consider including Alphabet in the service? We've talked about it. We own Facebook though, which is driving revenue from the same source, from online advertising. So far we've liked Facebook better, but there's a good argument to be made for owning Alphabet as well. I think we all do own shares of Alphabet too personally, but we just haven't put it pro, mainly because we put a lot into Facebook when it was beaten so. We have a large Facebook position.

Are we thinking Tencent could become another Amazon? JP?

JP Bennett:Perhaps this is a question that isn't best suited for the lightning round. The short answer, and I'll try to be somewhat pithy here, is no, just because that's not really what they're doing. They're more of a facilitator and enabling online transactions. They're like, they'll push you to, what is it, jd.com or some other retailer. They're not really the one that is holding the inventory, making the sale and things like that. They're kind of the facilitator that is enabling those online transactions and driving incremental transactions just because they're able to get people to buy stuff through [inaudible 00:42:21] and things like that. But they're not really looking to go after Alibaba and JD and the other big players in the space.

Jeff Fischer:Which small caps, mid caps and international stocks do you currently recommend other than Tencent? We'll move on from that one because that's a lot to cover in a short discussion, but we have some smaller caps in the portfolio itself. Paycom was one, still is sort of one. Square's qualified as a mid cap. Coherent is relatively small. Things that are in portfolio are what we recommend, both in pro and in Motley Fool options. We also own the international stock ETF for small caps, that's DJS. But we continue to look at other international companies as well. Thanks Lance for the question.

RS is asking about Disney, which is Motley Fool options. We will continue. The plan is to continue diagonal calls there or some sort of position there, as long as we believe in Disney. We'll cover that over in options itself. Right now there's a new trade coming there before long, it's the plan.

Jim is wondering about holdings for SVXY. It's grown to become more than 2% position for the portfolio. We're looking at trimming it perhaps, probably at some point, but we're happy with how it's done so far of course. Even though volatility is low we know it can stay low for a long time. We're happy to keep that as it's been a buy all this time and everybody should own some shares. Any plans to include crypto stock to pro?

Billy:We actually have some limited crypto exposure, somewhat, with Broadridge. They do have blockchain operations. They made some acquisition last year, of a company that focuses on blockchain technology. They're now integrating that into their communication solutions and trade processing, sort of architecture. Yeah, with Broadridge we get a little bit of exposure to that kind of crypto/blockchain space. That is definitely something that, I don't if any of you guys who are on the chat were in Chicago at our meetup this year, I didn't mention that one of the big trends in the market and the economy is cryptocurrency and blockchain technology. That is something that I'm looking at and researching. So yeah, that would be something I'm interested in and maybe potentially space for another long idea in that area in the pro portfolio.

Jeff Fischer:Sounds goods. My Boss David is asking, "Any thoughts on adding Shopify to pro?" You know, I love the questions we get about Nvidia or Shopify or MercadoLibre or things that are doing really well in recent years, because it means you're plugged into other services as well. You've heard about these stocks somehow. If you like them from day one, you should own them. We can't add them all to pro, being a focused portfolio. If we were an idea service that could have 100 or 200 ideas, they would be in there. They're in the Fool universe as it is. I think we appreciate that pro is seen as a high water mark if a stock gets added to pro, but we won't always be right, obviously, and we don't at all buy everything that we would like to buy because we can't. So we've looked at Shopify, it's a position in Motley Fool options now. I liked Square better than Shopify when I compared the two earlier this year, so that's something we added. Shopify is obviously on our radar and it's in Motley Fool options. I don't know if it will show up in pro.

"I didn't jump into Tencent because I don't trust Chinese stock. Am I crazy?" Instead of throwing every one these to JP I'll just say, it depends what you're comfortable with. If you're not comfortable with something, by all means, your comfort is more important than owning something. There are a lot of great companies to own. We felt the same way for a long time, or I did anyway, and have come around in the last year or two, to starting to own Chinese stocks. Start small, it's what I did, and see if your comfort level grows. That's how pro is starting too with just a 2.5% position. Maybe you want even smaller to dip your toes into Tencent. I do know that we like the company a lot obviously and see a lot of potential for it. So if you want to start with a little bit you could, if you're comfortable.

"Any current thoughts on hedging?" We did talk about that Mike, maybe 20 minutes ago. This will be recorded and available for you. Sprint-T-Mobile merger effect on AMT Billy?

Billy:Yeah, that's been something that analysts and investors have been concerned or talking about for quite some time with American Towers, ever since there was chatter about this merger. Last year, I think November, American Tower sent out a press release detailing the business that they do with T-Mobile and Sprint. What we're concerned about here for a merger is only areas on the Towers were both T-Mobile and Sprint share equipment that would be redundant. Because if those two companies do merge, and they have equipment on the same tower that is redundant, they would just remove one of those pieces of equipment and keep the one that they need.

So we're only concerned about that overlap, and according to American Tower's press release, which they released last year, I think it was areas where Sprint and T-Mobile had overlap on their towers, was 4% of their revenues. So it's not insignificant, I mean 4%, it's not a tiny amount, but it's not huge either. That doesn't mean that for the area of overlap every single one of those pieces of equipment would be coming down. There's also cost associated with bringing down equipment that American Tower would actually benefit from. I don't think it would make too big of an impact. Also, there was news today that that merger is kind of breaking down, or the deal talks are breaking down. Now we see today that cell tower stocks are up quite a bit.

I think American Tower today is up 3%, Crown Castle today also up 3% on that news. Which makes sense because, okay, if we're talking about 4% of revenue is represented by that overlap, if that deal goes away now the market's bidding up shares by 3%. I don't know, I'm not too worried about that. I don't think that really affects the long term trajectory of the business, which they're more now positioned internationally, where there's a lot of growth potential in markets where cellular and data services are far behind where they are in the United States. That's where a lot of the growth is going to come from. The United States is quite mature at this point, although it is a big profit driver for American Tower it's not going to be where most of growth comes from in the future.

Jeff Fischer:Thank you Billy. Member Morris Pearl is asking for Home Depot for the long in the money call. What reasons did we have for choosing the particular call strike that we did, as opposed to a different strike? Since Billy just talked quite a bit I'll just throw in there that we're looking to minimize time value on the call that we purchase and minimize the amount of capital that we're putting into the trade, and still look to target a good leverage return if the stock does rise. Billy, unless you have anything else to add there?

Billy:No, not really. You do have a tendency, or at least I do, to look at delta, which is how the option moves in relation to the stock price, which is basically a reflection of how much time value is embedded in the premium. That particular strike was where there was a little bit of an inflection point in the delta, where the time value for that strike was quite a bit lower than the time value for the next strike. That one looked particularly attractive to my eyes, but it does change.

Jeff Fischer:Very appropriate for the holiday tomorrow, Karen is asking, "What is the scariest thing about the pro portfolio at the moment?" Scariest thing, maybe I'm too complacent but nothing in it scares me. I really believe in all the companies we own. We all know the market could fall at any moment, and fall significantly. We also know, historically that has always been temporary and prices have come back. We have cash that we can invest when the market does fall. We own companies that we're going to be comfortable owning, even in a decline. So short answer for what's scariest, it's probably SVXY, because it's something that-

JP Bennett:Good answer.

Jeff Fischer:Yeah, it could get cut in half pretty quickly and go from a 2.6% position to 1.3% if the VIX say went from 10 to 25, which of course it could do. You guys have scary things that keep you awake at night? No, but things that scare you?

JP Bennett:I don't know [crosstalk 00:51:26] Go ahead Billy.

Billy:I was going to say SVXY as well.

JP Bennett:I don't know if this necessarily qualifies as scariest, but one the big driving factors for me is when you're working on something and you always, in the back of your mind, especially if it's a timely options position, it's like, "Can I get it finished in time before the event plays out or something happens to make all of this work worthless or to miss the opportunity?" Because I know, talking about shorts, we've had how many shorts where we're on the hunt, and we're getting really close and then something happens and the thesis plays out maybe a day or two before we're ready to go.

Jeff Fischer:You just keyed into it like a key anxiety. Now I'm very nervous again JP. That's what keeps me awake at night, literally. We do miss quite a few things, but look how it works out anyway, but yeah, that's a good answer JP. Thanks for making me anxious.

JP Bennett:I do what I can.

Jeff Fischer:Hello Marc. Marc is asking, "With the unknown surrounding the upcoming tax legislation what are out thoughts about any risks to NVR?"

JP Bennett:I would say personally for me that's the one thing where I want to watch and see, because if you think about it, let's say something does play out and it's a negative for NVR, like a meaningful negative, not just a bump in the road and the business is going to adjust and continue to compound. If it's a permanent impairment type of situation, odds are because of what this is, it's not like a biotech where their drug doesn't make it through and so the stock gets clocked 30% on a single day. This is something that would play out over time, so maybe the news comes out and the stock gets hit 3%, 4% or something like that as the market starts to digest it. We'll still have plenty of time.

If it's permanent impairment type situation and it's going to ultimately drive the stock down 30%, 40%, I believe we would still have time. With that kind of framework I don't want to rush to judgment or try to anticipate the future, because this is politics, who knows what the heck is going to happen. This is another situation, and I think in investing in general if often pays to be in wait and see type of mode. If we need to react, we'll react. But then again, you look at this, we can't hedge out the position so to speak just because of the issues with the options not being existent and the stock is super highly priced. So even if they were, the odds are most members fall through. How many shares do we have? Could we even do buying puts or setting a type of-

Jeff Fischer:[crosstalk 00:54:08] options.

JP Bennett:... some type of option strategy, even if-

Jeff Fischer:We have 31 shares.

JP Bennett:See, we couldn't even do it.

Jeff Fischer:We could overpay for [crosstalk 00:54:16]

JP Bennett:Yeah, so it would either be sell your shares or continue to hold. As of right now, we're still of the mind to continue to hold.

Jeff Fischer:Mariano is asking, have we thought about creating an ETF for pro and making it public? I would love to, that'd be exciting. Can't say it's in the works right now but maybe some day, you never know. It would make a lot of sense in a lot of ways to have an ETF, and then people can invest and all the trades are done for you, there's not the delay, there's not all the writing. We also love what we do and love that we know that many of you love doing it yourself. But there's something to be said for a service like pro, and something to be said for an ETF that was pro like, which would be exciting. Maybe some day.

Alex is asking about comment about Chic Shack. Yes, Chic Shack has risen up with the market the past month or two. It's now, the short is down 13% for us. It's still a 0.5% position. I'm not concerned about the performance in this market. It's legging the market in small caps since we've been short it. Trends has been the last three quarters, whenever it reports results it falls and it slowly climbs its way back up, or at least this time it did. If it goes much higher and we see results that we still don't love, we might add to it finally. Every time it hits the high 30s we've thought about adding. If our thesis has to change we'll close it and there's very little harm done. If we like it we'll keep it and potentially add to it. We'll see earnings soon on Chic Shack. Right now it's status quo and hopefully no big surprises around the corner from their results.

My Boss David, he sold out SVXY thinking he was selling at a high. Do you think he should sell puts to match pro's allocation? It's a tough question.

JP Bennett:I would say for starters no, just because of what Jeff said, we could pare that down. Let's say you sell puts to open up and match us straight out of the gate, and then two days later we're like, "Hey, guess what? We're closing half of our position."

Jeff Fischer:As it tanks.

JP Bennett:Yeah, that wouldn't be a pleasant experience. Then the other thing to keep in mind too is how quickly this thing gets gutter. Selling puts with the knowledge that that premium could really not justify the risk that you're currently taking on, unless it's a situation where it's already gotten hammered and the volatility is really high, and so the IV's high and so the puts pay a really high price. Personally I've done that, but in terms of writing puts I've always waited when doing most things options related to the VIX, I've always waiting until volatility spikes, just because that's when they pay the best.

Jeff Fischer:As always, write puts if you're willing to buy the shares and keep them. [inaudible 00:57:07] Ross is asking, how do we avoid groupthink. That's a great question we could talk about for quite a while if we had time. The number one answer I would say is that we, for the most part, work independently on our research and our thinking. We only come to the team when we start to develop a thesis and have a pretty strong understanding of our argument. Then the other analysts take a look at it with a fresh perspective, their own perspective. It's not from day one that we're all working together on the same thing and cheering each other on. We're each independently typically working on different things, our own things. A lot of which we don't even tell each other about, except for the broad stroke brushes of it. I think that helps us avoid all thinking the same way about issues.

JP Bennett:Yeah. I would also add too, one of the big benefits of the team being together for such a long stretch of time in terms of pro's history, because I know in the past we had quite a bit of turnover, is that you start to develop trust with the people that you're working with. That trust is really important because it basically makes it a lot more likely that you won't take any disagreements or discussions as a personal attack on your character. If I bring something to the table and Billy points out a huge flaw, in my head I'm not like, "Oh man, Billy thinks I'm a horrible analyst. He's attacking me personally. What's this guy doing? I can't trust him anymore. I don't like him."

That's not how it works out, right? We've worked with each other long enough that we trust each other. We ultimately only want what's best for pro. So if I bring something to the table and the other two can point out what's wrong with it, that's actually a win for us. A, I get to learn something valuable, and so hopefully I don't make the same mistake twice. B, I didn't put something horrible into the pro portfolio and have members suffer as a result.

Jeff Fischer:Well said. We only have about a minute left so we should probably wrap up. Are there any that are timely that we must answer that are pro related and timely?

JP Bennett:I'll grab on from Fusky, who was saying that China just had held the national congress of communist party, cementing Xi's power for the next five years and codifying his theory and part constitution. What does this mean for pro? This is obviously in relation to our latest investment in Tencent. It's something that we actually gave a lot of wait to and spent a good amount of time thinking about. I know I have plenty of discussions with Jeff around our desks as this was happening. One of the things that you saw come out of it was the rumblings that China's potentially going to take up to a 1% stake in some of the largest companies, and maybe even with the goal of having some more say in their future decisions as far as the businesses are concerned.

Obviously this is a big risk, and once again why only started at a 2.5% position, but ultimately we felt like odds are they would want to not overly hurt the ... they ultimately want to do something that is good for the country but also good for the business, because at least our assessment of the situation is you wouldn't want to spend all these years trying to become a global powerhouse, to compete with the US and create these companies that can finally stay in toe to toe with the behemoths in the US, only to then turn around and neuter these companies, make them weak and unable to compete and see all the value that they've created over the years dissipate just in the name of doing what they thing the communist party should ultimately do.

I think there will be a lot of incentive to work with these companies and make sure that they're toeing the party line so to speak. It's a risk. We're definitely watching it, but you saw Tencent, they put out an app where you could clap for Xi and it was kind of ... they're going to do thing to try to stay on their good side and work with one another. As long as we see that happening, we think that the positives of the business will ultimately outweigh any type of potential drag on the business that the Chinese government can cause to happen.

Jeff Fischer:Excellent. Thank you JP. Another timely one I see is from Ross. He's asking about options on Home Depot. He has a diagonal call there. Ross, go over to Motley Fool options, that service, and ask there. Because that particular position you have is from Motley Fool options. Now pro just started a Home Depot position but it's different than that one. Then once you get your answer there you can probably meld it with pro's coverage over time and marry what we have.

Oggy Dog is asking plans to reinvest our dividends like we have done in the past. Yes, certainly. We do that every quarter when we like, when we want to, when we see things we want to buy. We do plan to do it again and we're due to in early November.

JP Bennett:Yep.

Jeff Fischer:I think with that we need to wrap it up, although I like the top question, so let's end on a retirement question. 3,000 a month, that's $36,000 a year in Costa Rica. That's a lot of money in Costa Rica, where the average family I think still makes $6,000 or less in median income. The average house, decent house is $80,000 to $120,000. So yeah, you can live comfortably on that budget and pretty well in Costa Rica. They have a good healthcare system, better infrastructure than people give it credit for, great climate, good food.

Yeah, you can live there for $3,000 a month. But what I would do first is go down there and rent a place and get to know it that way, get to know different areas, rent for a few months at a time and get to know different areas, because there are so many different climates there and different areas. You want to find one that you like best before you really put down roots. Thank you guys. Thank you JP Bennett for being here.

JP Bennett:Thanks for having me Jeff.

Jeff Fischer:Thank you Billy.

Billy:Thank you Jeff, great to be here.

Jeff Fischer:Great to see you, or to speak with you. We hope you have a great Halloween tomorrow if you're celebrating. We thank you for being a Motley Fool Pro member with us and a Motley Fool ... with the Motley Fool. We appreciate that you have trust in us and are following us. We hope you're enjoying your investments this year with us. We look forward to our November chat with you next month. Fool on.

JP Bennett:Fool on.

Billy:Fool on.

Pro Guidance Changes and Completed Trades: Oct. 23, 2017

Published Oct 23, 2017 at 2:13PM

Pro Guidance Changes (see any related trade alerts):

- **NVR** (NYSE: NVR): Shares move to Buy (from Best Buy Now) after significant price appreciation.
- **Visa** (NYSE: V): Shares move to Buy (from Best Buy Now) after significant gains.

Pro Completed Trades (see transaction log; trades take a day to appear):

- None.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

At NVR, the Numbers Speak for Themselves

Published Oct 20, 2017 at 12:56PM

Management at homebuilder **NVR Homes** (NYSE: NVR) doesn't hold quarterly earnings calls. When we asked about this the first time we called them, before we bought shares (they'll take your call if you ask!), their response was that although they aren't opposed to communicating with investors -- and to their credit, they've been very responsive thus far -- they'd much rather spend time focusing on running their business. As shareholders, we like this approach, although it does mean that a short press release and 10-Q is all the insight into the business that investors get each quarter. So far, we're pleased with what we've seen from NVR since it was added to the portfolio, and with the stock up 13% over the past two days in reaction to third-quarter results (as well as almost 38% since we first purchased shares a mere four and a half months ago), it's clear the market likes it, too.

This quarter was more of the same from this best-in-breed business, whose focus on local dominance and efficient production means impressive results during strong and weak markets alike. Excluding the excess tax benefit from adopting a new accounting standard, EPS was up 27%, thanks to a 35% increase in homebuilding income. That, in turn, was largely driven by a 6% increase in settlements, as well as an increase in the average settlement price to $393,000. The company's new order cancellation rate has also declined nicely, to 13% from 18% in the third quarter of 2016. Looking forward, robust growth in both new orders (up 21%) and backlog (up 16%) suggests that investors should expect more strong results from NVR in at least the near term, as long as pricing holds up. (The average new order price declined more or less back to third-quarter 2016's average settlement price of $384,000.)

Valuation multiples can be deceiving for cyclical companies like NVR, since they say nothing about where we are in the cycle. I still believe there is at least some room to run in the housing market as long as the overall economy overall holds up, but NVR simply isn't as cheap as it was six to 12 months ago, despite the impressive financial performance. We'll be updating our fair value for the company once the 10-Q is filed, but for now the stock moves down to a Buy from Buy First. That's OK -- with the stock having already delivered roughly four years' worth of North Star returns, we think it deserves a bit of a break!

Watching Apple Watch

Published Oct 19, 2017 at 2:13PM

Dear *Pro* member:

Apple (Nasdaq: AAPL) doesn't break out details of its Watch sales, but GBH Insights is reporting a couple of interesting data points: About 70% of the sales of its new Series 3 model are going to first-time Watch buyers, and 80% of unilts sold include cellular connectivity. Both numbers could be meaningful to Apple's future.

Apple has likely sold about 32 million Watches since 2015, yet the device still hasn't cracked two digits' worth of Apple's total revenue (it probably hovers at about 5%). However, margins on the watch should compete with those on the iPhone, and mainstream adoption of the wearable square could eventually turn it into another "repeat sale" hit for Apple, not unlike the iPhone. (About half of Apple Watch owners were already interested in an update before the new Watch was released.)

Do robust early sales data indicate that Apple has cracked the code to draw in millions of new wearable customers? The Series 3 can be used as a phone, and while talk time may be limited to an hour or so, this feature is certainly helping to push newcomers (including our own J.P. Bennett) to try it out. And the more customers who buy it, the more viral attention it gets, with word-of-mouth recommendations weighing heavily in new tech product sales.

Apple Watch sales increased 50% year-over-year last quarter, and IDC estimates had earlier put Watch unit volume ahead of the iPhone's during its earliest years (which you would expect, given Apple's customer base today). Growth is rising enough that the next few years may indeed be soon enough to tell us whether the Watch will break into the mainstream, becoming a real contributor to Apple's revenue.

Meanwhile, Apple's stock and that of its suppliers -- including **Skyworks** (NASDAQ: SWKS) -- are lower today on rumors (just rumors) that Apple is greatly scaling back iPhone 8 production already. If that's the case to any extent, it may be because customers are waiting for the iPhone X, due Nov. 3. Without more information to go by, right now we would consider any slowdown in production of the iPhone 8 models to be unsurprising; and we don't believe the long-term strength of Apple's franchise product is in trouble.

Apple remains a Buy in our portfolio, with a 4.5% allocation.

Do you own an Apple Watch yet? Do you like it? Are you getting one? Tell us about it on the Apple board!

Pro Catch-Up Trades and Upcoming Expirations: Oct. 19, 2017

Published Oct 19, 2017 at 1:41PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. But remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your portfolio — start there! Follow our allocation shown on our Portfolio page if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio (often around 3%).

- **American Tower** (NYSE: AMT): Buy up to 4%.
- **Broadridge** (NYSE: BR): Buy up to 5.7%, or, if you've yet to start a position, consider buying a one-half or one-third position, looking to fill out the rest over time. You could also (or instead) "sell to open" November 2017 $80 puts, lately paying you $0.75, or nearly 1% in 29 days.
- **Coherent** (NASDAQ: COHR): Buy 2.5%, or "sell to open" November 2017 $230 puts, lately for about $5 each, for a 2.1% yield in 29 days. (Or choose another strike price.) Sell one put for every 100 shares you want to buy.
- **FactSet Research** (NYSE: FDS): Buy 2.1%.
- **Medtronic** (NYSE: MDT): Buy 2.5%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.5%.
- **OpenText** (NASDAQ: OTEX): Buy 3.1%.
- **Oracle** (NYSE: ORCL): Buy up to 3.8%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Short 0.4%.

Options:

- N/A

Hedges:

- N/A

Next options expirations (October):

- **Gilead Sciences** (NASDAQ: GILD): Oct. 20, 2017, $86 calls, currently out-of-the-money, on track to expire as income with (as of now) no action required.

Pro Guidance Changes and Completed Trades: Oct. 16, 2017

Published Oct 16, 2017 at 12:49PM

Pro Guidance Changes (see any related trade alerts):

- None this week.

Pro Completed Trades (see transaction log; trades take a day to appear):

- None.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Face Your Fears: Recessions and Declines

Published Oct 16, 2017 at 12:44PM

Dear *Pro* member:

Countless investing conversations center on the *one thing* many speculators seem to fear most: recessions. Yet many can't even define the term. A recession consists of two quarters in a row in which gross domestic product, or GDP, declines year-over-year. When this happens, many companies report a decline in earnings per share, and that usually sends stocks lower.

But truly, how common and drawn-out are most recessions? When you get to understand your enemy, they're often not as fearsome as you thought. Take a look.

Recession	GDP Decline	Duration	Time Until Next Recession
August 1929-March 1933	(26.7%)	3 Years, 7 Months	4 Years, 2 Months
May 1937-June 1938	(18.2%)	1 Year, 1 Month	6 Years, 8 Months
February 1945-October 1945	(12.7%)	8 Months	3 Years, 1 Month
November 1948-October 1949	(1.7%)	11 Months	3 Years, 9 Months
July 1953-May 1954	(2.6%)	10 Months	3 Years, 3 Months
August 1957-April 1958	(3.7%)	8 Months	2 Years
April 1960-February 1961	(1.6%)	10 Months	8 Years, 10 Months
December 1969-November 1970	(0.6%)	11 Months	3 Years
November 1973-March 1975	(3.2%)	1 Year, 4 Months	4 Years, 10 Months
January 1980-July 1980	(2.2%)	6 Months	1 Year
July 1981-November 1982	(2.7%)	1 Year, 4 Months	7 Years, 8 Months
July 1990-March 1991	(1.4%)	8 Months	10 Years
March 2001-November 2001	(0.3%)	8 Months	6 Years, 1 Month
December 2007-June 2009	(5.1%)	1 Year, 6 Months	8 Years, 4 Months (so far ...)
Median Recession	**(2.7%)**	**9 Months**	**4 Years, 2 Months**

Source: National Bureau of Economic Research. Table shows that since 1929, the median recession sees GDP shrink 2.7%, the median recession length is nine months, and it takes on average four years and two months until the next recession.

The median recession since 1929 lasted all of nine months before GDP began to grow again -- that's just three quarters. After that, the median time until the *next* recession was greater than four years.

In other words, once every five years or so (roughly 20% of the time), investors will go through a recession before seeing GDP grow again. You could say these recessions are basically the "cost" of being an investor in your economy and its stocks. As long as you believe the country will continue to get more things right than wrong, and thus that growth will resume, each recession is an opportunity to buy a greater share of economic output at lower prices.

How much do stocks fall, and how wide is your window in which to purchase? That, of course, depends. With GDP falling 2.2%, the 1980 recession was sizable, but after gaining 31% in 1980, the S&P 500 only lost 4.1% in 1981. And 1981-'82 saw *another* recession, with GDP dropping 2.7%, yet the S&P 500 was up more than 20% in 1982.

Another example: In the 1990-'91 recession, the S&P 500 only lost 3.1% over the first year, then soared 30.5% in 1991. Take a look below to see how infrequently stocks *actually* have dismal years. (The yellow shows the longest winning streaks.)

S&P 500: Total Returns (1928 - 2017)

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	43.8%	1946	-8.4%	1964	16.4%	1982	20.4%	2000	-9.1%
1929	-8.3%	1947	5.2%	1965	12.4%	1983	22.3%	2001	-11.9%
1930	-25.1%	1948	5.7%	1966	-10.0%	1984	6.1%	2002	-22.1%
1931	-43.8%	1949	18.3%	1967	23.8%	1985	31.2%	2003	28.7%
1932	-8.6%	1950	30.8%	1968	10.8%	1986	18.5%	2004	10.9%
1933	50.0%	1951	23.7%	1969	-8.2%	1987	5.8%	2005	4.9%
1934	-1.2%	1952	18.2%	1970	3.6%	1988	16.6%	2006	15.8%
1935	46.7%	1953	-1.2%	1971	14.2%	1989	31.7%	2007	5.5%
1936	31.9%	1954	52.6%	1972	18.8%	1990	-3.1%	2008	-37.0%
1937	-35.3%	1955	32.6%	1973	-14.3%	1991	30.5%	2009	26.5%
1938	29.3%	1956	7.4%	1974	-25.9%	1992	7.6%	2010	15.1%
1939	-1.1%	1957	-10.5%	1975	37.0%	1993	10.1%	2011	2.1%
1940	-10.7%	1958	43.7%	1976	23.8%	1994	1.3%	2012	16.0%
1941	-12.8%	1959	12.1%	1977	-7.0%	1995	37.6%	2013	32.4%
1942	19.2%	1960	0.3%	1978	6.5%	1996	23.0%	2014	13.7%
1943	25.1%	1961	26.6%	1979	18.5%	1997	33.4%	2015	1.4%
1944	19.0%	1962	-8.8%	1980	31.7%	1998	28.6%	2016	12.0%
1945	35.8%	1963	22.6%	1981	-4.7%	1999	21.0%	2017	14.2%

Pension Partners — @charliebilello — Source: Pension Partners

Even the Great Recession in 2008, which was torturous, doesn't look that bad through the wider lens of time: Stocks gained for five years in a row before 2008, then declined 37% that year -- but by 2009 the index had popped back 26.5%, and you know what happened from there.

This isn't to belittle how difficult recessions are as they happen. If you depend on your portfolio for income, watching its value fall 20%, 30%, 40%, or more rips at your heart and bends your mind. Part of that is because of anchoring: Most of us fixate on our portfolio's highest-ever value and measure everything against that. (Try not to! It can help to always mentally consider your portfolio as being worth 20% less than its recent peak, so declines are less jarring.) Either way, it is natural to feel fear and hurt during declines, even when you're buying more stock. We don't discount those feelings. We just recommend keeping these facts in mind, too.

How often do declines happen? You can see above that the S&P 500 posted an annual loss in 12 years since 1960, and it increased the other 45 years. So, 21% of years since 1960 saw a negative return -- right in line with our stat about recessions occurring about 20% of the time. But we know that recessions aren't the only precursor to volatility. Usually stocks fall "just because." Call these situations corrections if you want; they're basically just periods of time with more sellers than buyers, sometimes brought on by surprising news or a rise in uncertainty. If recessions represent the No. 1 fear on Wall Street, then corrections are next in line. But these typically *intra-year* declines are common.

Market Decline Size (1900-December 2016)	Average Frequency (1)	Average Length (2)
(5%) or more	Approximately three times per year	47 days
(10%) or more	Approximately once per year	115 days
(15%) or more	Approximately once every two years	215 days
(20%) or more	Approximately once every three and a half years	341 days

Source: Capital Research and Management Company. Measures DJIA. (1) assumes 50% recovery rate of lost value. (2) measures market high to market low. Table shows: Market declines of 5% to 10% typically happen several times a year, and larger declines occur every two to three-and-a-half years, and all last less than a year from top to bottom.

Although we haven't seen a 10% (or even 5%) decline in the S&P 500 since January 2016, we should expect the former at least once every year, and the latter several times. Larger declines are less frequent, but still occur every few years (and typically take much longer before recovery). *However*... even the largest declines (on average and historically) experience a selling peak in less than one year, after which recovery can begin. Aside from rare back-to-back years of losses, the brevity of most market declines leads to the slew of positive annual returns shown in the table farther above.

In fact, while the S&P 500 showed a negative return in 26% of years since 1928, it has only experienced back-to-back losses in three periods outside of the Great Depression (1939-1941, 1973-1974, and 2000-2002). All other annual losses were greeted with a gain the very next year. And today more than ever, more and more of us are set up to buy stock automatically each month in retirement plans, perhaps increasing the odds for a similar type of recovery.

So what's the takeaway? We should all expect meaningful market declines at some point each year -- and, yes, another recession eventually. But knowing that these rising and falling tides are natural, and usually not prolonged, should help all of us keep our investment strategies on an even keel, and take advantage of opportunities as we see them.

Comments, pushback, questions? Please visit the [Memo Musings board](). Fool on!

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: Oct. 12, 2017

Published Oct 12, 2017 at 1:30PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio — start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week, to buy in approximately the size shown or (if you prefer) equal-weight at your own typical starting size:

- **American Tower** (NYSE: AMT): Buy up to 4.1%.
- **Broadridge** (NYSE: BR): Buy up to 5.6%, or, if you've yet to start a position, consider buying a one-half or one-third position, looking to fill out the rest over time. You could also (or instead) "sell to open" November 2017 $80 puts, lately paying you more a bit than $1, or more than 1.2% in 36 days.
- **Coherent** (NASDAQ: COHR): Buy 2.5%, or "sell to open" November 2017 $230 puts, lately for about $6.30 each, for a 2.7% yield in 36 days. (Or choose another strike price.) Sell one put for every 100 shares you want to buy.
- **Medtronic** (NYSE: MDT): Buy 2.5%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.5%.
- **Oracle** (NYSE: ORCL): Buy up to 3.8%.

Shorts:

- N/A

Options:

- N/A

Hedges:

- N/A

Next options expirations (October):

- **Gilead Sciences** (NASDAQ: GILD): Oct. 20, 2017, $86 calls, currently out-of-the-money, on track to expire as income with (as of now) no action required.

Pro Guidance Changes and Completed Trades: Oct. 9, 2017

Published Oct 9, 2017 at 12:17PM

Pro Guidance Changes from the past two weeks (see any related trade alerts):

- **Broadridge Financial Services** (NYSE: BR): Rejoins the ranks of our Best Buys Now (which today numbers eight companies -- check them all out here by sorting the "What to Do" column). Our fair-value estimate for Broadridge increases to $77, and we have a 5.6% allocation. Start with 3% and build as close to our position as you wish.

Pro Completed Trades from the past two weeks (see transaction log; trades take a day to appear):

- None.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Oct. 5, 2017

Published Oct 5, 2017 at 2:13PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio — start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week, to buy in approximately the size shown or (if you prefer) equal-weight at your own typical starting size:

- **American Tower** (NYSE: AMT): Buy up to 4.1%.
- **Broadridge** (NYSE: BR): Buy up to 5.6%, or, if you've yet to start a position, consider buying a one-half or one-third position, looking to fill out your position over time.
- **Coherent** (NASDAQ: COHR): Buy 2.4%, or "sell to open" November 2017 $230 puts, lately for about $10.75 each, for a 4.6% yield in 43 days. (Or choose lower-strike puts to be still more defensive.) Sell one put for every 100 shares you want to buy.
- **Medtronic** (NYSE: MDT): Buy 2.6%.
- **Verisk** (NASDAQ: VRSK): Buy 2.1%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.5%.
- **Oracle** (NYSE: ORCL): Buy up to 3.8%.
- **Starbucks** (NASDAQ: SBUX): Buy 2.9%, or "sell to open" December 2017 $52.50 puts, lately for about $0.95 each, for a 1.8% yield in 71 days. Sell one put for every 100 shares you want to buy.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- **Gilead Sciences** (NASDAQ: GILD): Sell to open Oct. 20, 2017, $86 calls, selling one call for every 100 shares you already own (the stock remains on Hold). As of this morning, these pay about 0.6% in 15 days, or $0.50 on the $82.60 stock. (Set your option quote chain to "See All" strike prices.)

Hedges:

- N/A.

Next options expirations (October):

- **Gilead Sciences:** Oct. 20, 2017, $86 calls, currently out-of-the-money, on track to expire as income.

Broadridge's Fair Value Increases

Published Oct 5, 2017 at 2:13PM

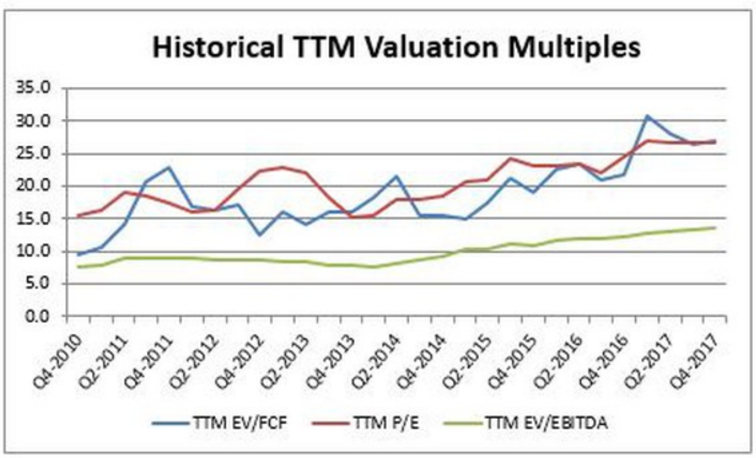
Fiscal 2017

- Recurring fee revenue growth (year over year): Up 29% to $2.5 billion (+6% organic growth, ex-NACC acquisition)
- Closed sales growth (year over year): +25% to $188 million
- EPS growth (year over year): +7.4% to $2.72

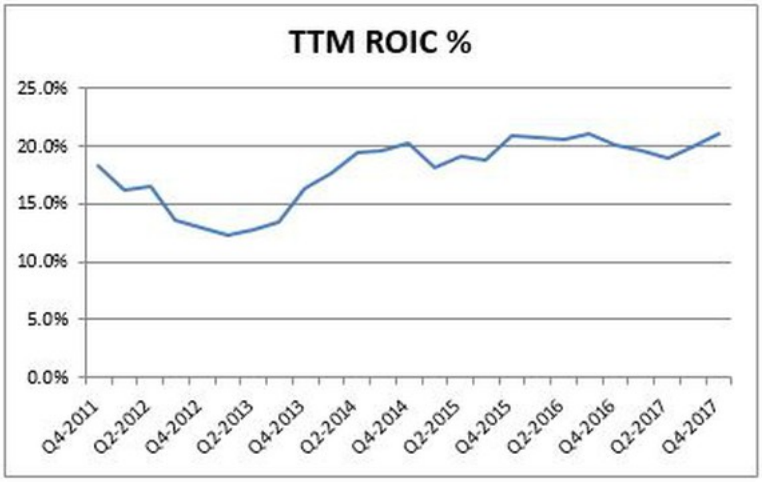
With a full year of acquisition-boosted results under its belt, Broadridge is poised for continued growth into fiscal 2018. Our provider of investor communications continues to expand at a steady pace and produce significant amounts of cash flow from a capital-light asset base. Although companywide margins are lower after the recent $410 million acquisition of DST's North American Customer Communications (NACC) business, Broadridge reported organic growth in recurring revenue of 6% in fiscal 2017, and margins should expand over time as the acquisition is integrated and operational synergies are achieved. We look forward to Broadridge's next Analyst/Investor Day, when management will provide updates on its longer-term financial plans and goals.

- **Updated guidance**: Best Buy Now (from Buy)
- **Recommended allocation**: 5.6%
- **Fair-value estimate**: $77 (from $65)
- **Current price:** $81.66

Based on management's guidance, at $81.66 per share, the stock is priced at about 25 times projected 2018 cash flow and 26 times projected 2017 GAAP earnings per share. Both of these valuation metrics are elevated relative to the company's history:



However, Broadridge features stable cash flows, a steady growth profile, excellent management, an increasingly strong competitive position, and margin expansion opportunities, with the company's return on invested capital (ROIC) trends serving as evidence of that point:



After incorporating a full year of results that include the NACC acquisition and accounting for management's 2018 guidance, **our fair-value estimate increases to $77 per share (from $65), and Broadridge moves to Best Buy Now (from Buy) on our scorecard.** Members who have yet to start or fill out their position can feel comfortable doing so at current prices.

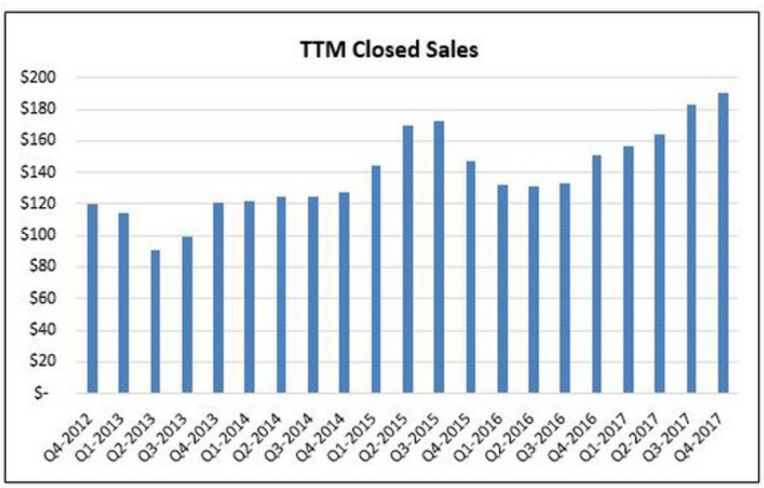
Our Thesis

Broadridge has a near-monopoly on proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record, and sound capital allocation policies make Broadridge a sturdy rock upon which to build the *Pro* portfolio. We expect modest growth in fee revenue, slight operating leverage, plenty of free cash flow, and a growing stream of dividends to help achieve North Star-like returns.

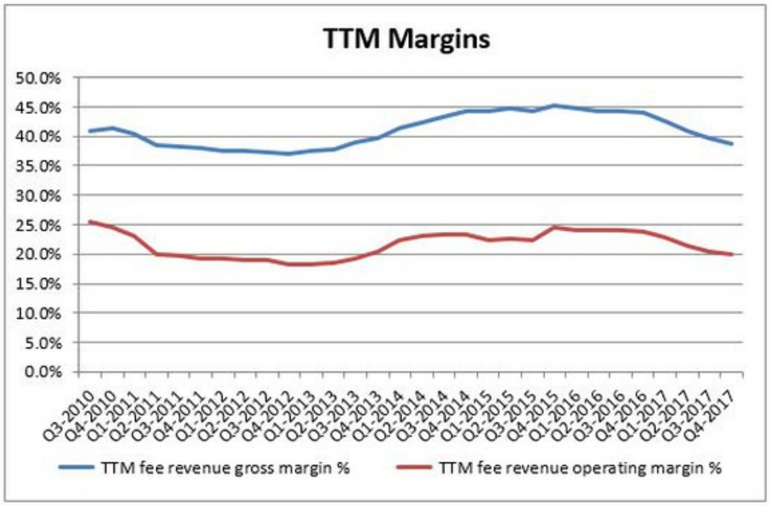
The Most Important Things

1. Closed Sales: This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%-plus). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

Broadridge has had a strong fiscal 2017 with respect to closed sales, which came in at a record $188 million, up 25% compared with 2016's $151 million. Fiscal 2018 guidance calls for closed sales of $170 million to $210 million for fiscal 2018, up 27% from last year's guidance. Management continues to feel confident about the company's sales pipeline, and momentum is strong, with fiscal 2017's closed sales beating the high end of last year's guidance. Broadridge's success in closed sales is a reflection of continued investment in and expansion of the company's products and services as it continues to cement its position as a leading provider of infrastructure to the capital markets.

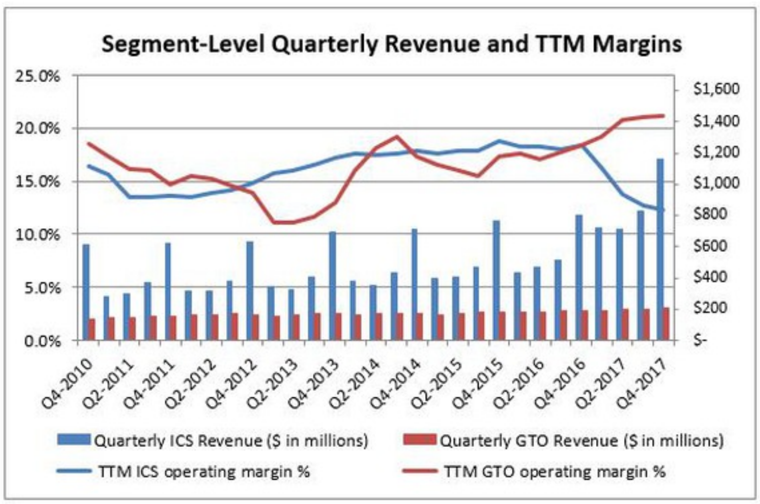


2) Fee Revenue Margin Performance: In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers) we prefer to look at trailing-12-month (TTM) margins to smooth out quarterly fluctuations. TTM fee revenue gross margins came in at 38.7% (down significantly from 44% a year ago), and TTM fee revenue operating margins came in at 19.9% (down from from 23.9% a year ago):



The reason for the decline in margins is the 2016 NACC acquisition. That business has a lower margin profile than Broadridge's legacy businesses, and it represents about 30% of total companywide revenue, so it drags down the margin profile overall. However, Broadridge should be able to expand NACC's operating margins over time via scale, cost synergies, and improved operational efficiency. Now that we've fully lapped the acquisition, we should hopefully start to see margin expansion as we progress through fiscal 2018.

When looking at Broadridge's separate divisions, we can see that the non-NACC business is doing quite well. While the Investor Communications Solutions (ICS) business has seen significantly lower margins because of the acquisition, the Global Technology Operations (GTO) business has shown strong margin expansion, generating a record TTM operating margin of 21.1%:



We'll want to monitor the ICS division's margins (expecting longer-term margin expansion as we progress through fiscal 2018) to make sure NACC integration is on track, and we also want to watch GTO to see whether recent margin expansion trends continue.

3. Capital Allocation: Although Broadridge is a slow grower, it generates a lot of cash and has low reinvestment needs. Between fiscal 2015 and fiscal 2017, management had very clear plans to put that cash to work: targeting a 45% payout ratio, using incremental debt capacity to make acquisitions, and using the rest for share repurchases. At an Analyst/Investor Day sometime before the end of this calendar year, management plans to provide updates on its financial goals for the next three to five years; after that, we'll have a better idea of capital allocation plans going forward.

On the dividend front, the company has paid out $1.32 per share on a TTM basis, good for a 49% payout ratio and about a 1.6% yield on the current price. Management also bought back $343 million in shares in fiscal 2017.

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash-flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Pro Can Help

- **Questions?** Bring them over to the Broadridge discussion board.

Video

Published Oct 5, 2017 at 1:20PM

Pro Guidance Changes and Completed Trades: Oct. 2, 2017

Published Oct 2, 2017 at 11:28AM

Pro Guidance Changes from the past two weeks (see any related trade alerts):

- **Gilead Sciences** (NASDAQ: GILD): Write covered calls if you own 100 or more shares. The stock remains on Hold.

Pro Completed Trades from the past two weeks (see transaction log; trades take a day to appear):

- **Gentex** (NASDAQ: GNTX): We bought to close our December 2017 $17.50 puts for $0.39 each, ending the position.
- **Gilead Sciences:** We sold to open Oct. 20, 2017, $86 calls for $0.89 each, selling one call for every 100 shares we own.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Sept. 28, 2017

Published Sep 28, 2017 at 11:51AM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio — start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week, to buy in approximately the size shown or (if you prefer) equal-weight at your own typical starting size:

- **American Tower** (NYSE: AMT): Buy up to 4%.
- **Coherent** (NASDAQ: COHR): Buy 2.4%.
- **Medtronic** (NYSE: MDT): Buy 2.6%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.6%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3%.
- **Oracle** (NYSE: ORCL): Buy up to 3.8%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- **Gilead Sciences** (NASDAQ: GILD): Sell to open Oct. 20, 2017, $86 calls, selling one call for every 100 shares you already own (the stock remains on Hold). At today's market open, these pay about 0.7% in 22 days, or $0.62 on the $82.55 stock. (Set your option quote chain to "See All" strike prices.)

Hedges:

- N/A.

Next options expirations (October):

- **Gilead Sciences:** Oct. 20, 2017, $86 calls, currently out-of-the-money, on track to expire as income.

Pro Guidance Changes and Completed Trades: Sept. 25, 2017

Published Sep 25, 2017 at 1:03PM

Pro Guidance Changes from the past two weeks (see any related trade alerts):

- **Gilead Sciences** (NASDAQ: GILD): Write covered calls if you own 100 or more shares. The stock remains on Hold.

Pro Completed Trades from the past two weeks (see transaction log; trades take a day to appear):

- **American Tower** (NYSE: AMT): Per our alert, we rolled our short October 2017 $120 calls to April 2018 $130 calls for a net debit of $7.05 per spread. This keeps our diagonal call going longer, with more upside. [Correction: We previously wrote that we rolled $130 calls to $140 -- we apologize for the error! It was $120 to $130, as the trade alert instructed.]
- **Gentex** (NASDAQ: GNTX): We bought to close our December 2017 $17.50 puts for $0.39 each, ending the position.
- **Gilead Sciences:** We sold to open October 20, 2017 $86 calls for $0.89 each, selling one call for every 100 shares we own.
- **GoPro** (NASDAQ: GPRO): We closed our synthetic short for a net credit of $1.40 each, ending the short position with a decent profit.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Sept. 21, 2017

Published Sep 21, 2017 at 1:54PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio — start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week, to buy in approximately the size shown or (if you prefer) equal-weight at your own typical starting size:

- **American Tower** (NYSE: AMT): Buy 4.2%.
- **Medtronic** (NYSE: MDT): Buy 2.7%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2.1%.
- **Visa** (NYSE: V): Buy 3.3%.

Continue building your portfolio with our Buys, including:

- **FactSet Research Systems** (NYSE: FDS): Buy 2%.
- **Oracle** (NYSE: ORCL): Buy 3.8%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy up to 4%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2.1%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- **Gilead Sciences** (NASDAQ: GILD): Sell to open Oct. 20, 2017, $86 calls, selling one for every 100 shares you already own (the stock remains on Hold). Lately, these pay about 1% in 29 days, or $0.86 on the $82.67 stock. (Set your option quote chain to "See All" strike prices.)

Hedges:

- None today.

Next month's options expirations (October):

- Gilead Sciences: Oct. 20, 2017, $86 calls, currently out-of-the-money, on track to expire as income.

Do You Behave Like a Pro?

Published Sep 21, 2017 at 12:56PM

From the *Pro* Archive

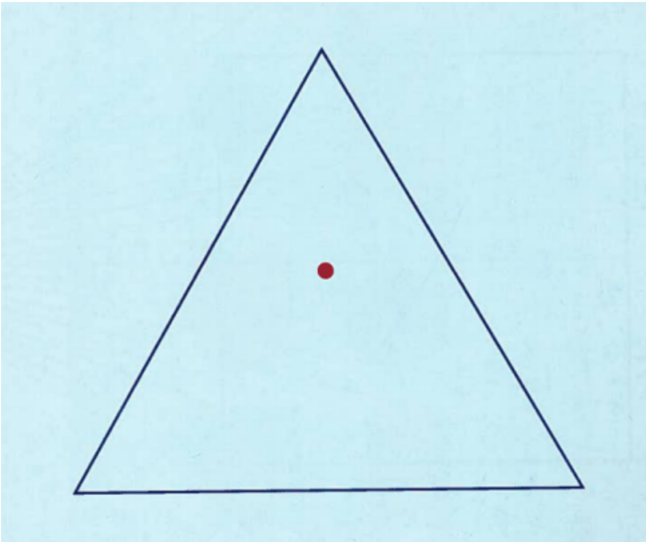
One benefit of longevity? A bevy of past lessons, successes, and losses to learn from. Today, in a bonus column, we go far back to April 2011 to revisit classic advice from long-term Fool Nick Crow. Fool on! -Jeff

At least half of being a *Pro* investor is having the right temperament. Fortunately, if you weren't born this way, it's something you can learn. In today's Memo, I'll show you how to improve your ability to think about investments.

Heuristically Thinking

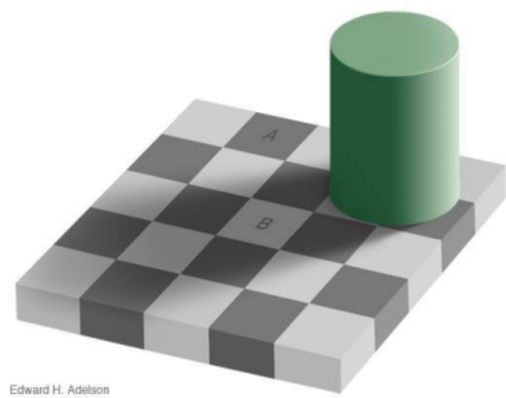
Our brains are hard-wired to help us survive in the wild — just think about our fight-or-flight instinct. But we often have to solve problems that can run counter to our pattern-seeking, choice-comparing, fleeing-to-safety mental coding. So we use heuristics, experience-based methods learned through trial and error, to quickly solve problems. This elaborate system of shortcuts serves us very well in "the real world," but when it comes to investing, heuristics might cause you to zig when you should be zaggin'. Check it out:

Is the red dot halfway up the triangle?



If you're like most people, the dot appears to be higher than halfway up, even though halfway is exactly where it is. Here's another example, just for fun:

Which square is darker, A or B?



It might take some convincing, but both squares are exactly the same shade of grey. They look different because we use our eyes to determine the color of objects in the world — not the amount of light being reflected off a surface. Our visual system, like the rest of our cognitive systems, is very good at solving particular problems but not other, related problems.

To tie all this back to investing, it would be good to know when we might be as easily tricked; that way, we can fight back.

Cognitive Errors

The field of behavioral finance has helped identify the mental shortcuts we use and the cognitive errors associated with them. Here are a few cognitive errors *Pro* investors should defend themselves against:

Anchoring: Focusing on a number is one of the most dangerous traps investors can fall into. If you've ever hesitated to make an investment simply because the price moved a bit, you were probably anchored. Alternatively, if you're holding a losing position just to get back to breakeven, you're anchoring on the price you originally paid.

- *Pro* tip: Focus on value, not price, and allocate your money to the most promising opportunities — even if that means recognizing loss [or adding more to big winners! -JF].

Hindsight Bias: Through the deceptive gift of hindsight bias, past events appear to be more predictable than they were in real time. Worse yet, when we look back, we actually believe that we knew what would happen before it did, even if we didn't make a prediction.

- *Pro* tip: The future is inherently unknowable. Keeping a journal and writing down the reason you traded a stock or your thoughts on the market will help keep you from tricking yourself.

Myopic Loss Aversion: We are more sensitive to investment losses than gains, and we measure outcomes too frequently. In fact, our emotional ability to take on risk increases the less frequently we measure results. When we measure results too frequently, we make decisions based on the next minute, day, or month rather than a longer period consistent with our investing goals. This results in higher stress and lower returns over time because our decisions are inconsistent with our actual time horizon.

- *Pro* tip: Check your portfolio performance infrequently, and base your decisions on your actual investing horizon.

Overconfidence: In the example above, how sure were you that the "B" square was lighter than the "A" square? Even upon close inspection of the graphic, you may have doubts. Overconfidence is being surprised more frequently than you anticipate. For example, analysts might set their valuation ranges too narrowly (i.e., the high end is too low and the low end is too high), which can lead to surprises when a stock quickly outruns their top-end valuation scenario. That's one reason *Pro* doesn't always insist on selling when a stock reaches our fair-value estimate.

- *Pro* tip: Let your winners run (and let us let your winners run, too). [This has sure been valuable since 2011! -JF]

Investors make interesting choices when faced with risk and uncertainly. After all, what's investing if not risking capital to earn a return in the uncertain future? By being aware of your biases and using our tips, you too can behave like a *Pro*.

Give Back

Investors join *Pro* because they want to steadily grow their portfolio while managing their risk. The team works vigilantly to deliver on this goal. But after they join *Pro*, many members express their amazement not about the *Pro* team's efforts but about our vibrant community. If you haven't visited or posted on the boards recently, you're missing out! Here are some easy boards to participate in:

- Meet & Greet: Light social atmosphere. Get to know your fellow *Pro* Fools and even share success stories, like paying off your membership in one week.
- Philosophy & Strategy: Talk about *Pro*'s strategy and investing tenets in general. It's a great board for general investing discussion.
- Social Banter: If you have something to talk about that's not related to investing, this is the place to go. The bar is low here: If *you* find it interesting, someone else will, too.

There's also a message board for every *Pro* holding, past and present. Just head here and look for the ticker you're interested in whenever you need the latest scuttlebutt or want to share your analysis. Some members thrive on doing their own research or on sharing their expertise in the industry in which they've made a career. We love that, too!

Pro Fools are always polite and use descriptive subject lines when they post to our boards. We hope to see your posts soon!

Foolishly,
-- Nick Crow (TMFCrow)

- Questions about this Memo? Post them on our Memo Musings discussion board.

Write Covered Calls on Gilead Sciences

Published Sep 18, 2017 at 12:48PM

Is this for you? This is for *Pro* members who own at least 100 shares of Gilead Sciences, and who wouldn't mind capping upside in return for near-term income. Those who own less than 100 shares can continue to hold them.

How You Participate

- **Action:** Sell to open Oct. 20, 2017, $86 calls on **Gilead Sciences** (NASDAQ: GILD).
- **Allocation:** Write ("sell to open") one call for every 100 shares owned. *Pro* will cover all 900 shares we own, representing 2.5% of the portfolio.
- **Price Guidance:** Prices will change as the stock moves, but **use a limit order** to split the option's current bid/ask spread. When we quoted it, that was about $1.02. Later, aim for about a 1% yield (option premium/current price of the stock) per month to expiration; with shares at $83.18, the minimum to accept is thus about $0.85.
- **Guidance:** The stock remains a Hold at a 2.5% allocation.
- **Prices** (12:40 p.m. ET):
  - Gilead: $83.18
  - Sell to open Oct. 20, 2017 $86 calls (bid/ask): $1/$1.04 (at your broker, click "See All" strike prices to see these)
  - $1.02 pays 1.2% ($1.02/$83.18) in 32 days.
- **Alternative Trades:** You can write a higher strike if you want more breathing room, or a slightly lower strike if you want a higher payment. We're using Oct. 20, though, to ensure the calls reach their expiration date before the next earnings report.

What We're Thinking

The long-awaited "major" acquisition expected from Gilead was announced Aug. 28, so unless there's *really* something up its sleeve, we shouldn't expect another large acquisition anytime soon. (That said, it could always buy a few drugs from another business, so we should keep that in mind.) Gilead shares have gained about 10% since the news was announced last month, even though the $12 billion acquisition of **Kite Pharma** (NASDAQ: KITE) -- while it has long-term promise -- won't bring earnings anytime soon.

Kite is a development-stage company working on novel immunotherapy-based cancer treatments, with a substantial pipeline of mostly early-stage candidates. Management at Gilead doesn't believe that Kite will add to its earnings for least three years. Gilead's shares remain reasonably priced today, trading at 10.3 times expected earnings one year out and yielding 2.5% in annual dividends. But without earnings growth, the stock may again be rangebound as investors wait to see how the volatile young Hepatitis C market plays out quarter by quarter.

As we've said for several quarters now, we want to hold the shares to target at least a North Star-level return by periodically writing covered calls on them (covered strangles down the line are also something to ponder), collecting the dividend yield, and eventually enjoying stock upside. So far this year, shares are up 15% (mostly in the past month), and the dividend and our two past covered calls bring our total 2017 return on the position to 20% (we made a 3.7% return on the *current* share price with our two previous covered-call positions that expired this year). That means we have almost two years' worth of North Star returns this year.

Even so, our sense is that we can write another covered call today to pad our returns, assuming the stock stays below our strike price over the next month. Next quarter's earnings report will occur *after* our Oct. 20 expiration date. Just be aware that anytime you write covered calls, you run the risk of missing out on a large run-up in the stock, and you may have little recourse in that case. So we need to be ready to let the shares get sold at our strike price if that should occur.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up:** If the stock price rises above our strike price by expiration, we may let our shares get sold; it's more likely right now that we'd roll our calls to a later date, or simply close them. We'll see as expiration nears.

Pro Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the Gilead board.

Submit

Pro Guidance Changes and Completed Trades: Sept. 18, 2017

Published Sep 18, 2017 at 12:00PM

Pro Guidance Changes from the past two weeks (see any related trade alerts):

- None. See all current guidance on the portfolio page.

Pro Completed Trades from the past two weeks (see transaction log; trades take a day to appear):

- **American Tower** (NYSE: AMT): Per our alert, we rolled our short October 2017 $130 calls to April 2018 $140 calls for a net debit of $7.05 per call. This keeps our diagonal call going longer, with more upside.
- **Direxion Financial Bear 3x** (NYSEMKT: FAZ) ETF: Our entire short position was closed by Interactive Brokers. There's nothing you can do when a broker initiates a forced buy-in. The 1.4% short is now closed. We're considering setting it up in another form (such as a synthetic short), and we'll let you know our decision soon. Members still in the position can stay in it. For more, please see last week's Memo.
- **GoPro** (NASDAQ: GPRO): We closed our synthetic short for a net credit of $1.40 each, ending the short position with a decent profit.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Sept. 14, 2017

Published Sep 14, 2017 at 12:10PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio — start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.2%.
- **Coherent** (NASDAQ: COHR): Buy 2.6%.
- **Medtronic** (NYSE: MDT): Buy 2.7%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2%.

Continue building your portfolio with our Buys, including:

- **FactSet Research Systems** (NYSE: FDS): Buy 1.9%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy up to 4.3% (perhaps starting with 3%).
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2.1%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- N/A

Hedges:

- New ones being considered.

This month's options expirations:

- None.

Pro Guidance Changes and Completed Trades: Sept. 11, 2017

Published Sep 11, 2017 at 1:55PM

Pro Guidance Changes from the past two weeks (see any related trade alerts):

- **Apple** (NASDAQ: AAPL): Fair-value estimate increased to $150. Remains a Buy.
- **American Tower** (NYSE: AMT): Fair-value estimate increased to $142 (from $135). It remains a Best Buy Now.
- **Facebook** (NASDAQ: FB): Moves to Buy (from Best Buy Now).
- **Gentex** (NASDAQ: GNTX): Moved to Sell.
- **GoPro** (NASDAQ: GPRO): Moved to Cover. We're closing our short exposure.
- **MasterCard** (NYSE: MA): Fair-value estimate increased to $119 (from $105). Remains a Buy.
- **Medtronic** (NYSE: MDT): Moves to Best Buy Now (from Buy).
- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increased to $100 (from $96). Remains a Buy.
- **Visa** (NYSE: V): Fair-value estimate increased to $97 (from $93). Remains a Best Buy Now.

Pro Completed Trades from the past week (see transaction log; trades take a day to appear):

- **Direxion Financial Bear 3x** (NYSEMKT: FAZ) ETF: Our entire short position was closed on Friday by Interactive Brokers. There's nothing you can do when a broker initiates a forced buy-in. The 1.4% short is now closed. We're considering setting it up in another form (such as a synthetic short), and we'll let you know our decision when ready. For more, please see today's Memo.
- **GoPro:** We closed our synthetic short for a net credit of $1.40 each. Our short exposure is now ended.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Takes the Windy City; Plus, Our FAZ Short Is Closed

Published Sep 11, 2017 at 1:55PM

Our thoughts are with everyone affected by Hurricane Irma.

Dear *Pro* Member:

On Friday afternoon, Billy Kipersztok, Jim Gillies, Jim Mueller, Toby Bordelon (TMFEpsilon), and I joined about three dozen *Pro* and *Options* members for a gathering at Gino's East pizza parlor just outside Chicago. We offer great thanks to members marksrjm, RockyTopBob, and HeckCreek (I'm using TMF names, so you can more easily know them!) for setting up the party, which they did well. Deep-dish pizza was loaded onto steel-reinforced tables (*Pro* likes to mitigate risk), and cold beverages were served. What more do you need but conversation?

Happily, we had that in spades as well. RockyTopBob led the initial introductions of team members, and we then went around the room hearing introductions from the exceptional group of Foolish investors who attended, many of whom have been with *Pro* since the early days. I won't name a few because I would prefer to name them all: They're listed here. After this (and some mingling!), we kept up an extended Foolish conversation and Q&A session about investing throughout the evening. It was a pleasure.

Chamonyx asked us to name our biggest mistakes of omission and commission. Many past lessons (i.e., mistakes) were sprinkled throughout the conversation, but our early answers included closing **American Airlines** (NASDAQ: AAL) call options when they had almost no value (they went on to a full rebound without us), as well as not buying more calls or setting up more synthetic longs in general on various stocks.

We spent a fair amount of time discussing the difficulty of finding good short candidates when the risk-to-reward ratio is so stacked against a short, and the market continues to be so strong. We've done fine with our shorts in a bull market, but we've spent an inordinate amount of time on the strategy. Shorting doesn't seem worth it these days, but it probably will (if we execute) during a bear market, so we're not stopping the pursuit of individual shorts. Meanwhile, we know that we can throw on a market hedge -- shorting a market index -- instantly if we feel the desire. We could become a "market-neutral" portfolio in 24 hours if so moved. That we haven't yet is fortunate.

We also talked valuation. Both of the Jims, Billy, and I agreed that valuation models shouldn't be taken to heart more strongly than business quality and long-term prospects. A valuation is a snapshot in time even as it attempts to predict 10 or 20 years down the road, and the best companies are adding new opportunities all the time; your valuation model is not initially going to capture that. *Pro*'s valuations are meant to be conservative -- what we seek from our companies are high odds for a North Star-like return from current prices, and we hope we're buying businesses dynamic enough to exceed even that.

Consider that strong companies continue to grow even after decades -- our own **Johnson & Johnson** (NYSE: JNJ) is an example. But as Billy reminded us during the conversation, valuation models typically apply a "terminal value" that assumes just a few percent annual growth after a decade or two. That drastic slowdown is not what happens at companies that keep winning, and this makes an enormous difference in a fair valuation.

We discussed some investments we like today (even as we like our whole portfolio); names included **Skyworks** (NASDAQ: SWKS) (the stock and written puts), **Square** (NYSE: SQ) (ditto), and **Lowe's** (NYSE: LOW), particularly in light of J.P.'s trade alert on Friday for *Motley Fool Options*. (His recommendation, writing puts, made sense to us given current events, as Lowe's largest two markets are Texas and Florida.) Billy also pivoted to offer a speculative name in telehealth, **Teladoc** (NYSE: TDOC). Speaking of J.P., we missed him, and his famous hair was spoken of fondly by the group, which also mentioned missing Ellen and her charming, energetic wit. [*Editor's note: I like you people. I will not forget this when the revolution comes.*]

Before the evening ended, we heard about the 18,000-mile road trip around the U.S. that couple John (JSergeant) and Anna have just begun. They mapped it to stop at this event first. From there, they're circling the country in their **Tesla** (NASDAQ: TSLA), hoping over the next two months to take the lead position in a national contest to see who can visit the most Tesla supercharger stations. They're already ahead of the pack. We root them onward! (Track them above, through John's screen name.)

As always, the event went by far too quickly. If you've yet to meet your fellow Fools in person, we highly encourage doing so the next chance you get! At 8:30 p.m. Friday, I took off from Gino's East, near O'Hare Airport, to catch a 10 p.m. flight -- from *Midway*. It was tight, but in the end I did make it back to D.C., while the rest of the group pressed on to a casino. I'm told that pink martinis were had (not for the first time!) by Jim Gillies and his better half, among others.

We again say thank you to our kind and good-humored hosts, and thank you to all of the members who traveled from near and far to attend. It was excellent to see each of you, and to have a few precious hours to talk investing! (And if you missed the party, a recap thread has already been started here.)

From left to right: Jim Mueller, Billy Kipersztok, Toby Bordelon, RockyTopBob, Jeff Fischer, Jim Gillies, Luan Z.F. (S.O. of Jim Gillies; her last name abbreviated by me for privacy!)

Our FAZ Short Has Been Closed

One important order of portfolio business: Interactive Brokers closed our short of the **Direxion Daily Financial Bear 3X** (NYSEMKT: FAZ) ETF on Friday. When a short gets "bought in" like this, there's *nothing* you can do. The broker could no longer borrow the shares, and so they had to return them to owners, taking them from short sellers like us. Many members using Interactive Brokers were closed out on FAZ last week, too.

So, our 1.4% short on FAZ was closed at gains of 91.5%, 86.5%, and 6.1%, respectively (we recommended it twice in 2013 and once this March). It's a shame that this happened after four years; not only does it mean the end of a profitable position, but the tax man will come running after our profits. Alas, there's nothing a short seller can do in such a situation. Now we have to decide whether we want to enter the position again in another way (using options, such as a synthetic short), invest more in our favorite financial stocks instead, or do nothing.

The FAZ ETF is *short* financial leaders such as **Visa** (NYSE: V) and **MasterCard** (NYSE: MA); since we were short FAZ, we were effectively *long* the financial giants through our position. This leveraged long via a flawed short ETF was the cherry on top of our already sweet long financial exposure, which we of course maintain. Our portfolio's net long exposure declines by 1.4%, to less than 80%, as this short is closed, while our true long exposure declines to just more than 75%. We usually run closer to 80%, and we don't have a strong reason to change that now, so we may be increasing our exposure one way or another.

Members who are still short FAZ should sit tight and see what we decide to do. We'll let you know. If we set up a similar position using options, you can stay short FAZ. If we go about getting more exposure some other way, you can decide then whether you want to follow us on that path or stay short FAZ instead. To ask questions, please visit the FAZ board.

Thank you for reading! Foolishly,

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: Sept. 7, 2017

Published Sep 7, 2017 at 3:22PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio — start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.4% (or start with 3%).
- **Coherent** (NASDAQ: COHR): Buy 2.4%.
- **Medtronic** (NYSE: MDT): Buy 2.7%.
- **Square** (NYSE: SQ): Buy 2.5%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2.1%.
- **Visa** (NYSE: V): Buy 3.3%.

Continue building your portfolio with our Buys, including:

- **FactSet Research Systems** (NYSE: FDS): Buy 1.9%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1%.
- **MasterCard** (NYSE: MA): Buy up to 5.5% (starting with 3%).
- **Skyworks Solutions** (NASDAQ: SWKS): Buy up to 4.2% (starting with 3%).
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2.1%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- N/A

Hedges:

- New ones being considered.

This month's options expirations:

- None.

Pro Video Chat, September 2017

Published Sep 7, 2017 at 3:19PM

The *Pro* team will be holding **a live video chat on this page at 2 p.m. Eastern on Wednesday, Sept. 20**! We'll be using Slido to communicate with members during the chat; click here to join directly, or go to slido.com and enter the code #ProChatSeptember. We recommend opening Slido in another browser tab (or on a mobile device) so you can see both the video and the Slido questions at once. See you soon!

Transcript

JP Bennett: Greetings Fools, and welcome to our monthly live chat for Pro. I'm JP Bennett, and I'm joined today by Billy Kipersztok down in Florida; and our fearless leader to my right, Jeff Fischer. How's it going, you two?

Jeff Fischer: Hey, JP. Great, how about you?

Billy K: Going well, JP, thank you.

JP Bennett: Awesome, all right. Before we get going, let me just quickly remind you all that, once again, this is supposed to be an interactive hour. It's not just an hour of us rambling about whatever suits our fancy. In order for that to work, we need you all to go to Slido and submit your questions. Make sure you thumbs up the questions that other people submit, that you want to make sure we answer before the hour is out. And if you click the link above this video, you'll go straight to Slido. And, if for some reason it asks you to submit a password to get to the Pro page, I believe this month it's "pro chat September." Am I correct here?

Billy K: I think that's right, yeah.

Jeff Fischer: Pro chat September. It might say on the page, "options chat September." That's a mistake.

JP Bennett: Just a bit of a typo. All right. But, as is normally the case, before we get to the interactive portion we're just going to ramble here for a bit, so I'm gonna backtrack on what I said; just to give you all time to submit your questions. As we are getting to the end of September, we're essentially rounding third base and heading for home in the year, and I thought, "This is as good a time as any to quickly reflect on what we've done so far this year, and what we hope to accomplish before the year is out; giving members something to hold us accountable for. We can't just coast for the last three months.

Jeff Fischer: Great, great.

JP Bennett: I'm gonna look here, and I'm going to read off my computer to make sure I get it right, so Jeff doesn't criticize me. But as of 1:00 PM, the Pro port is up 13.1% year-to-date, essentially in line with the S&P 500 total return index, which is the one that reinvests dividends. We are 75.4% net long, excluding our QQQ hedge that is pretty far out of the money. If you step back and you take a look at that, and peel away the layers of the Pro port, you'll see that we've actually been far more active on the long side than we were in 2015. At this point last year, I can't remember offhand how many long positions we had added to the portfolio, but we added almost 2x so far this year.

And so far, they've actually been doing pretty nicely, Amazon and NVR, they're both up over 17%. Pretty much across the board they're strongly contributing to our returns, in addition to the stalwarts that were already in the Pro portfolio. And I feel like, if you look at Pro as a trifecta: longs, hedging and shorts all working together. Longs are always going to be our top priority, in terms of ... If we have an option to work on all three, we're going to prioritize longs more, simply because of the return on time you get for longs. So, let's look at Paycom. Paycom has been in the portfolio for, what? Almost two years? It was added last year, I believe, right?

Jeff Fischer: November of last year, so 10, 11 months almost.

JP Bennett: All right, so we're getting there. And last time I checked it's up almost around 75%. It's an amazing performer. But, if you compare that, let's say instead of Jeff working on Paycom, he had worked on a short. We set up a 1% short position on a stock that did the best case for short. It went straight to zero. Well, we actually have been able to, so far, generate twice the amount of returns as we would have if that short ended up in portfolio and Paycom didn't. If the short was a percent and a half, which is kind of our upper limit for a short. We'd essentially be breakeven. But, the best part with Paycom is, hopefully, knock on wood. This table isn't wood, so I don't know if it necessarily counts. But, hopefully we still have years more. Knocking on your head? All right. I guess that works. Hopefully, we still have years' worth of returns to go in the future.

The return on time you ultimately get from finding a great long company and adding it to your portfolio; it's almost always going to be higher than finding that perfect short or setting up that perfect hedge. And so, for those of the members that really want to see what's going on behind the scenes at Pro right now, I will note that there are actually a few longs that are seriously being considered; and I would be shocked if at least one of them didn't make it into the Pro portfolio before the year is up. We still have more work to do on that side, but that's not to say that we're excluding hedging and shorting. They are a key part of Pro's strategy, and personally, I believe they will be the deciding factor with regards to whether Pro is able to hit our lofty objectives during the next bear market. We don't know when that's going to come, but those are going to be the key.

We're not just completely disregarding them. We haven't been as active on that front, but we are working. It's important to stay ahead of the curve and not wait until we're kind of, "Oh my gosh, we need shorts. We need hedges. The economy has really deteriorated, and we're about to be in trouble." There is more work going on behind the scenes then actually makes the light of day, the hedging and shorting side of things. And we hope to have something on hedging relatively soon, though. I'm pretty sure you're going to shake your head in agreement when I note this, that option pricing has been quite poor with regards to hedging, and so we don't want to press and either set up a hedge that is unfavorable, in terms of breakeven potential losses and things like that, because we want to make sure we can set up for roughly breakeven. Or, pay an arm and a leg to set up a hedge that ultimately expires, worthless. There are a lot of things going on behind the scenes. We've been pretty active, and I think there is actually quite a bit that we hope to get accomplished before the year is out.

Jeff Fischer: All right. Thank you, JP. Definitely good thoughts to start on, and to serve as a springboard from here. Go to Slido.com if you haven't. And you can, from the video page, you can click directly to join the Slido.com chat. Put your question in there, thumb up the questions you want to see answered, and we will start on those right now. You'll have two windows open if you want to have Slido open, and the video portion as well. The first question, JP, is perfect. It's from Mark, who is asking us to discuss hedging strategies and times Pro is considering. I assume that means time frames.

Some strategies we're considering are synthetic shorts, bearish spreads; not put-ratio spreads right now, but other spreads. And the timeframe that we're looking at is anywhere from a few months down the line, to a year or two down the line, very long term. We're also looking at just buying puts outright. We're looking at strategies where we'll minimize our cost, and yet we acknowledge we're gonna have to pay something to hedge, in most cases. That would work over a long enough period of time that, hopefully, they'll be there when we need them; and that, ideally, will not grow if the market keeps going up, will work against us. We're leaning towards buying put options strategically, long-term and repeating that process, even though we know there is a cost to that, obviously.

But, as JP mentioned, our focus has been elsewhere. And so far, that's been for good reason. We've gone through many possible shorts this year, but we've worked just as much, if not a bit more on longs, for other reasons JP mentioned; but also, because that's what we're compelled to work on in today's environment. We watch the economy, we know that most bear markets, almost all of them, start because the economy deteriorates, because we hit a bear market, because earning start to shrink. Instead, we're having earnings grow this year in the S&P 500. We're having the economy moving at a moderate, but stable pace of growth. Until we see reasons to doubt that that can continue, we're more compelled to work on the long side than the short side.

You short at the wrong time and that can be as bad as shorting the wrong thing, period. Even if it would ultimately work out, it may hurt you too much while you're waiting. We look at all factors, and then we move in the direction in which we are compelled. I completely agree with JP, that during bear markets or sharp, so-called "corrections," our hedges and our shorts are going to make a big difference in our performance. They remain key to us, but I think it's also good that we continue to follow our instincts and invest how we feel is most appropriate for now.

JP Bennett: Yep. If you look at the two main goals for Pro: positive rolling returns over three year periods, and then double real purchasing power every 10 years. For me, the second goal, which was kind of the big focus, what you really want to do, because even if you have a shorter investing horizon, you don't want to be overly concerned with shorter periods like three years; unless you have to make a significant payout, or you're nearing retirement of something like that, where you really have a hard deadline. The longs are going to be what ultimately drives that 10 year performance and gets us that goal. We need to make sure our long book is watertight; that we really like exactly what we have in the portfolio, and we firmly believe that they're going to drive us there.

The hedges and the shorting, those are the ones that are gonna steady the ship and help us navigate those rockier, short-term movements. They play a bigger role when we start to have more concerns over, "All right, what do we think the market's gonna do over the next three years?"

Jeff Fischer: So true, and that's been part of our transition this year, selling positions where have a few too many concerns or questions, and buying new positions that we hope are going to drive returns, or help drive returns the next three to five years. In a world economy and world business landscape that is changing so rapidly, we want to own companies that are riding the wave instead of caught behind the tide, so to speak. And we think we're doing that with the new buys that we're making. It's fascinating how quickly business is changing, and how software is driving so much value creation. If you're not developing a relationship with your customer; like a deep, meaningful one, you stand a good chance of being left behind.

JP Bennett: I think the benefit we have with a lot of those type of companies is that, at least from my perspective, the way I view most technologies is that people, when they first hear about it, they immediately overreact to how quickly it's going to disrupt an industry, but they constantly underestimate how long the tailwind is and how much disruption will always take place. Amazon first bursts on the scene, "Oh man, it's gonna really disrupt the book industry." People get super hyped up about it, and then maybe they lose enthusiasm for it. Well, let's fast-forward a couple years. Look what's happening: they're disrupting multiple industries, and the tailwinds behind the business are getting stronger day-by-day.

Jeff Fischer: So, to close up on hedging and shorting, it's on our radar. All of the hedges we've considered this year I then track, watch loosely; and of course, none of them would've paid out. Most would've cost us considerably. The large basket of shorts that we've been watching, which has mostly been retail focused would have been neutral, at best. Several of them have fallen quite a bit, but others have risen substantially. So, in this environment where, generally speaking, earnings are growing, the economy is stable, shorting, we need to be very confident in any short that we put on; because one, the returns are skewed against you. Two, the rewards are small, so why take the big risk? Three, four, so forth, so forth. We need to really believe in our shorts. But, Mark, hedging and shorting is still one third of what we do.

Russ is asking, "Interested in hearing about opinions about increasing our exposure to European equities." I'll throw out there quickly, and then you guys can share whatever you think as well. So many Pro positions have exposure to Europe. We look at that as we consider our purchases as well. We want companies that have opportunities, not just in the US, but around the world; including Europe. And we've looked at plenty of European companies, especially last year and early this year, and even some European ETF's. We haven't liked them as much as what we have bought, the half-dozen or so new names that we've bought in the last 10 months or so. We're looking, but we tend to favor companies, so far, that operate here and have a lot of exposure to international sales as well.

JP Bennett: Didn't you write a memo on this a few years back, Billy?

Billy K: On European exposure?

JP Bennett: I just remember on looking at ... Was it international exposure?

Billy K: Yeah. I think what I did is I went and analyzed the percentage of revenue from different geographies among all of our companies. So I did; I can try and find that in, of course, this chat, and see if I can link to that.

Jeff Fischer: We like the idea of looking at international equities, of course, to diversify our risk a bit more away from just the US. We've been looking at a lot of China-based companies, as well as European ones. Anonymous is asking, "Any thoughts on Goldman's downgrade to sell on J&J today?" Billy, have you had a chance to see Goldman's argument?

JP Bennett: I did, a bit. Let me pull that up again. But, I think the gist of the argument was just that the valuation is a little bit, I think "stretched." And it's ironic; I actually hadn't seen that report before the three of us, Jeff and JP had a meeting this morning, and we were talking about how Johnson & Johnson's valuation multiples is getting a little higher than it has been in the past. It is something that you want to monitor and watch, but also, Johnson & Johnson is a very high quality business. I have this Goldman report here right now, or at least some comments from the media about the report, and they mention that ... Okay, the Goldman analyst predicts that Johnson & Johnson will grow its earnings-per-share 7% annually during the next five years, versus her 10% industry average forecasted.

When we invested in Johnson & Johnson, we kind of did so under the pretense that we know that it's not going to be a super-fast grower. It's not going to be that type of a company that's going to generate 10, 15, 20% earnings-per-share growth. But, it is going to be the type of company that fits into the Pro portfolio as a stable ballast, where it's going to be a steady performer with consistent earnings-per-share growth in a dividend, and we should probably see a pretty high likelihood of Northstar matching returns over time. Johnson & Johnson has a dividend around 3%, and the analyst who did the downgrade here is predicting that they're gonna grow earnings-per-share by 7%. So, 7% earnings-per-share, 3% dividend, 10% total return; assuming, of course, that the valuation multiple remains the same. But, I would be pretty happy with 7% earnings-per-share growth, alongside that 3% dividend, and I think that bodes well for Johnson & Johnson's stock price.

Also, we've mentioned in the past about Johnson & Johnson, that we could've done something differently, as far as our allocation by implementing options, or maybe making it a bigger allocation; but we chose to keep it at a lower allocation to give us the flexibility, such that if the stock does decline, we have the flexibility to implement new option strategies. And that's something that's definitely still on the table. If the evaluation is stretched and it doesn't grow for a while or we see a pullback in the price, we can start to think about using options to help generate further returns from that position.

Jeff Fischer: Thank you, Billy. Lon and Rockytop Bob are asking about a 10 year Pro celebration. Pro turns 10 almost exactly a year from now next October, early October; and the hope is, next year to have a Pro member gathering. It may tie into Fool Fest in May or June, in the spring, actually; a bit before 10 years. But, we are talking to the Fool about possibilities for hosting such an event, so let's hope it happens. It was great to see members, including Rockytop Bob in Chicago just a week or two ago. It's always great to see members, and very rewarding in so many ways. So yes, we're looking forward to hopefully having a get together for Pro's 10 years next year. I think that would mean a lot of presentations on our part. It's mainly on you, JP.

JP Bennett: Hooray.

Jeff Fischer: You're gonna review what we've done, all the mistakes we've made.

JP Bennett: All the mistakes I've made.

Jeff Fischer: What we've learned, how we've done well anyway. That's the real take away from long-term investing. So, thank you both for your interest in that. Anonymous is asking, "I presume Gilead is still on hold," yes, "given the recent acquisition. Any thoughts on exiting or removing the hold?" I love the question. I'm mildly discouraged that the question exists, because we've written about Gilead in a memo, and then with a trade alert, which linked to the board and the memo. We've covered it two or three times, and we keep trying to get our message out. It just tells me our communication needs to keep improving.

Our thoughts are, the acquisition looks promising for the long term, but Kite Pharma does not have any products to speak of on the market right now, and it won't add to Gilead's earnings for at least three years. But it's promising, the stock is up about 10% since the news. The stock is still on hold, because more importantly right now, we want to see how the hepatitis C market develops over the next few quarters. As we get more and more clarity on that, we have, hopefully, more confidence or not to move the stock back to buy, assuming we want to. But right now, we're still in a wait-and-see period. So, we're content to hold it; we're running covered calls on it to increase our returns, ideally, but it remains on hold.

Members who do not buy it, the definition of hold means don't act, don't buy it, wait-and-see what we do. Members who own it, you should keep on owning it and write covered calls on if you can, as well. I hope that helps answer the question. We'll have updated guidance as soon as we have it. But right now, we're waiting for quarterly results the end of October, early November. Let's see ... Anonymous is asking us to comment on the merits of selling puts or covered calls on some of our favorite Pro companies, such as Paycom, Coherent, Square. Do you guys have thoughts?

JP Bennett: I feel like the latter is pretty easy, in that we would never set up a cover call on those names unless we bought additional shares, with the specific purpose of setting up a covered call position. Because we go back to options investing 101, covered calls, the number one thing is do not sell calls against the stock you hope to own for the long term. If you look at those three names, those are names where that long-term mindset is imperative. If Paycom, or Square, or Coherent go on to do great things, it'd be pretty tough to sit there and say, "Man, I'm super happy I got that two bucks to sell that covered call that expired in three months, and subsequently missed out on a double over the next couple of years. Those of pretty rough. They can almost hurt more than not doing anything, sitting on the sidelines and watching a stock run away from you.

With regards to that, I don't think you'll see that anytime soon, unless it is a specific, "Buy these shares and set up a covered call, because we want the extra income." With regards to puts, that is something that is something that could definitely be seen in the future. I know in the past we've opted to just nibble on something like a coherent, like a Coherent, like a Verisk, or fax it and buy some shares to increase our allocation. But, we're always considering, "Hey, at this level do we want to add to the position to make it a bigger weighting in the portfolio? And if so, why do we want to do it, and what do we hope to get out of it?" If it's a case where we want to buy it, and we think that eventually it's going to turn the corner, but we don't know exactly when, and the puts pay a pretty nice premium; that is something that we definitely will consider. If it's something where we want to buy it right now because we think the catalyst is about to materialize, it's best not to get greedy and just buy some additional shares.

Jeff Fischer: So true. We said in various places that you could write puts on Paycom, Coherent or Square if you so desire, but we hope that you'll own our allocations, because we own them because we like the upside potential. It's important with covered calls to keep in mind your intention with each position that you own. As JP said, we're owning these for upside; so then, somewhat randomly or opportunistically even, you hope, writing covered calls on them goes against your purpose, and can ultimately cost you in not only returns, but in clarity of purpose. We have positions that we want to own for the long-term, we have others that we set up for income; and it's good to have a distinction between the two and not blur the line too frequently. But, if you lack these positions, they are rated buy or buy first, but if you'd rather target a lower price, as JP said as well, you could look at puts to sell.

JP Bennett: I would also quickly note that, with businesses like this that are growing really fast, there is always the possibility where the gains in the stock don't mirror the growth in the company. The gains can all be concentrated in a really short time, and then it can languish for a while. Paycom or Square, they can continue to compound value and grow the business really quickly, but if there are some concerns that investors have, maybe the stock does nothing for a year. And then, once that headwind or cloud over the company disappears, then all of a sudden you just see the stock shoot up. And, those are the cases where you can't even roll unless you're just pumping in tons of money, and then it kind of defeats the purpose.

Jeff Fischer: One-Eyed Man is asking, "Your trade desk recommendation in the options showed confidence in a long-term expectation of growth. Why is not the stock or the sin long a good fit for Pro?" It might be, it just showed up in options first. And in our meeting this morning, I actually said maybe it could fit into Pro. I know the company pretty well from following it the past the handful of months, several months actually, but I'd like to see a few more quarters. If it merits a place in Pro as well, then we'll do that. But behind the scenes, keep in mind that we were recommending it to the same base of members. If you're in Pro you also get options, so we know you've received this recommendation in options, and that if it's a good fit for you, you'll do it. So, if we then recommend it in Pro as well, we feel like some people view that as doubling down, and some people will double down.

We have to be really mindful before we recommend, in our two services, the same thing in both services; because we know some members will set it up twice and have twice the exposure. We've always viewed options as a complement that add on to Pro, and Pro members, as experienced investors who follow the Pro portfolio as much as they want; and then, add on any options positions, Motley Fool options positions as well that they like. We hope that's how you best see to using the two services, if you want to. "What did we not see," Drew is asking, "in Gentex when we sold it? It's up about 14% since the recommendation. Looking through the rear view mirror, I know, but what's happened?" It's funny, we talked about that this morning too. I don't know, Billy, if you want to say anything, or ...

Billy K: Yeah. Obviously, when you sell a stock you have no idea where it will go in the short term. Stock prices kind of move randomly over the short term, even up to a one year period. And then, when you're selling, you're not really thinking about, "Okay, how's it going to perform in the month ahead? And based on that, was my sale a mistake?" We also want to keep in mind, we sold Gentex not because we think that the businesses is doing poorly and that it won't continue to do well from here, it was more a portfolio consideration, thinking about how the position risk has changed over time as the automotive industry is changing very significantly, as I'm sure a lot of you know with the advent of electric vehicles, and the commitments by a lot of specifically European automakers, but also United States automakers to go to electric vehicles. And then, what does that mean for potentially any of the automotive suppliers, which includes, obviously, Gentex; talking about self driving cars and how that is changing the industry as well. There's lots of question marks for Gentex, and these questions marks didn't necessarily exist 5, 10 years ago, but they definitely exist now.

That position is certainly more risky than it was when we initially invested in it. And add to the fact that it appears that the auto industry in the United States has peaked, and we're now entering a slower period, and it's not accelerating anymore. We just thought it was a good idea to exit the Gentex position and move on, and try to find companies that we think are better suited for the next three to five years to provide consistent growth, and be less cyclical and more resistant to a potential recession.

Jeff Fischer: Spot on. Sounds good, Billy. By the way, we our 1750 puts for December will be closed tomorrow. We haven't closed them yet, but our 30 days are coming up. We'll buy to close those, and then our Gentex position will be entirely closed. Looking at our transaction, we sold our shares at 1850. Let's see ...

Billy K: I want to add, also to that comment. Gentex, going back to a previous question about the European exposure, Gentex was one of the companies that we had in our portfolio that had significant European exposure; and that is referring to those European automakers that I mentioned, like BMW, Mercedes, any of those companies. But, that segues into the previous question about European exposure, and I was able to find that memo that JP was referring to, and I'm going to type a link to it into the chat. And, I just click send here. Now it's at the bottom coming from Anonymous, that's me. That link there is to our international exposure memo. This is old; it's from 2015 in April and the data that I used for that memo was from the fiscal year 2014. So, now we're looking at almost three years old data. But, I think it's probably still in the same ballpark.

The Pro weighted average revenue was 60% domestic in the United States and 40% international at that time. You can see that we have significant international exposure, of which some of that is European, not all of it. We do have significant Asian exposure as well, especially with Apple and Skyworks. But, 6040 domestic international, that gives you a sense that we do have significant international exposure, given the international companies that we own.

Jeff Fischer: Thank you, Billy. Anonymous is asking, "Despite a rising market, Pro holding Starbucks, FactSet, and Verisk have not done much of anything for us the past two years. Thoughts on prospects going forward?" I think we need to look at the numbers, JP, if you can look up Starbucks and Verisk, because the perception is frequently not as accurate as reality, when it comes to moving prices. I know FactSet, which we recommended in May of last year, so a year and four months ago is up more than 10% since the recommendation went out. And we added a little bit to the shares at a price lower than today's as well; so we've slowly bought more of that. So, overall our position is only up modestly, from the initial rec it's up less than the market, but it is up.

It's had headwinds as the business struggles to replace customers who are closing up shop. Funds, actively managed mutual funds are being pressured by passive funds, which happens in a bull market, especially. But FactSet's business is doing fine. Their earnings-per-share growth and free cash flow is strong. Prospects going forward, most importantly, look healthy; and the stock has held up okay despite headwinds. Verisk, we have a more than 10% return on as well, I believe.

JP Bennett: Yep. If you just kind of take a step back and don't really look at timing, and entry points and stuff like that, I think he's probably just generally looking at stock charts. If you look at, just over the past year, using today as the ending point, Verisk and Starbucks are pretty close to being flat, and FactSet is down less than 10%. So, just keying in on markets rising, these ones aren't following suite. What's going on? And I think that always goes back to just understanding that there's always going to be stocks that zig when other stocks zag, and that's kind of what you want in a portfolio, so to speak. As long as you still believe in the underlying dynamics of the thesis, and the business, and the ability to compound value over the long term.

I think it's a bit of a copout if people just keep a stock in the portfolio, just because. Not everything can outperform, sometimes things are going to do bad, but it will recover, right? The key is making sure you still like the businesses, even if they're going through a rough patch. Not everybody is going to be a secular grower for 20 years straight, and never post a year or a quarter's worth of results that are little bit troubled, excuse me. I think that's kind of what you get with a lot of these. If you just look Verisk in particular, this is one where we understand that until they reinvestment in the energy business ... And I'm not just talking about traditional fossil fuels and things like that, because they are moving into solar, and alternative energy and things like. They are investing heavily in those business lines. Until that reinvestment renormalizes, so to speak, you won't see Verisk really take off; because they're almost doing like countercyclical investment. The industry right now is still a little bit weak, so they're trying to find the best of breed businesses in those lines, and buy them up now when maybe there are motivated sellers, and things aren't working out the best for those. So, the returns are muted on those particular business lines.

One could argue that they paid too much for Woodmac, they got in a little bit too early, the market fell a little bit, and then they snapped it up because they were worried about it going public or someone else acquiring it. That is a debate that, I think, you should give them a little bit more time to play out. But, we still obviously believe in the business; we bought more recently. And we think once that re accelerates, that business re accelerates, I think you're going to really see the stock take off again. It's kind of like what I said before, in that it is a stock that, right now, it looks like it's setting up to just muddle along for a while. And then, once the business wakes up the multiples could re-rate, or the business really accelerates; so the stock just begrudgingly has to follow along higher.

That's kind of where we sit. If we still like the business, we're okay with suffering through one or two years worth of maybe not amazing results, because we still believe in the ability to compound value over the long run.

Jeff Fischer: Yeah, we did add a tiny bit more to FactSet in April, and more Coherent and Verisk in August, our dividend reinvestment; which are small, but they're a vote of confidence. If we're buying more of anything, it means we like it quite a bit. Well said, JP, I won't add to that. It's true, you have some businesses that will not go far, stocks that won't go anywhere for a while; but as you believe in them, we keep them. Of those three, I'm probably most concerned about Starbucks.

JP Bennett: Yeah. And I would also, just a quick note before we jump to the next question. When we said that we're, "Sticking with Starbucks," we called out that, "Hey, this isn't a 'everything is okay now, and the company and the stock are going to take off.'" We sat here, I know we had during our meetings when the stock subsequently started going higher, it seemed like day in and day out, and it pushed above 60, where we were just sitting here and we're like, "Well, I know the Unicorn Frappuccino is a good one-time boost for these guys," but all the headwinds we identified and were concerned about didn't it disappear. We're not sure why the stock is going gangbusters; and so it's kind of just pulled back to the level it was, when we were like, "Okay, we're cautiously optimistic so we're sticking with it."

I feel like that recent struggle in the stock is a little bit misleading, in terms of the business all of a sudden now hitting a rough patch. It was a rough patch before, and I guess the hoopla from the Unicorn Frap just maybe disguised the underlying struggles, or just gave people something to focus on and draw the stock higher.

Jeff Fischer: Another one of our holdings that has been flat the past year is OpenText. That's one we've been talking about as well. The business continues to perform fine; the share valuation multiples have contracted, so hopefully with a good quarter or two it will start to get re-rated to higher valuation multiples, and we'll see it appreciate a bit more. But yeah, we'll always have some lagging stocks, and hopefully those will perform better down the road, whether the market is then weak, or strong, or what have you. As long as we believe in the thesis and the business is still performing. Sam is saying, "They are still short, FAZ, and paying 8.5% annualized short interest fees. Are we any closer to a decision as to how Pro will succeed? Good seeing you all in Chicago." You as well, Sam.

We have written that you should stay short FAZ, if you still are. No reason to close it and initiate a tax when we still believe in the position long-term. We were called out of it involuntarily. We've looked at the options, and you can set up a synthetic short for 2019, for a reasonable cost, but we're going to wait and see 2020 options, which should come out soon, and then see where the portfolio as a whole is. We're looking at other financial positions as well, because this is basically a long financial position, shorting FAZ. If it still fits into the portfolio better than other possibilities, then we probably will short using a 2020 synthetic short, once again. But members can stay in it, and if we think you should close that short, we'll of course let you know with an official report. But for right now, even with that fee of 8.5%. I like to think of it, remember it's a 3x short, so it only takes a few percentage move in the index to earn that fee back. That said, you should keep the fee in mind and make sure it's worth it for you.

John is asking, "What's happening to iRobot?" That's not a recommendation in Pro or options. The stock, I do know, happen to know it fell on word of competition from LandShark, I believe the name is called, another vacuum cleaner maker. But you should check out, I guess, Supernova or Motley Fool One to get the latest on iRobot. Yeah, enter the quote into the Fool page and go to the services that cover that stock.

JP Bennett: And also, there was an active short fund that put out another "hit piece" on the company, and it's obviously having a negative impact on the stock.

Jeff Fischer: Bruce is asking, "Any new healthcare stocks Pro is considering? Or, are we happy with our current positions as sufficient?" I'll just start off by saying we're looking at Medtronic. And when the stock dipped considered adding more; if it would fall a little bit more we might add a little more to Medtronic. Billy talked about J&J just recently, and if you two have anything else to add about ...

JP Bennett: Nope, nothing on that one.

Billy K: Yeah. There are a couple of industries ... Sorry, I'm getting some feedback in my headphones. There we do. A couple of sub industries in the healthcare industry that I'm interested in want to look at more closely for some long research. One of them, if you were there in Chicago at our little member meet up, you know that I have been looking in the telemedicine industry; which is like videoconferencing and being able to provide medical advice and consultation via teleconferencing, rather than in person. I think that is a burgeoning industry with a lot of potential, but it's very new, and regulations in that industry are changing quickly. It's hard to identify which company in particular is going to be a winner. That's going to require maybe some more time for the industry to shake out, or some more research on my part.

And then the other area in the healthcare industry that I'm interested in would be software. We started off this chat by mentioning how software is changing the economy as a whole. And it's definitely doing that in the healthcare industry as well, which is an industry that, in the past, has been burdened with tons of paperwork and administrative overhead. Software is taking a lot of that out of the picture and making it a lot easier for companies. There's opportunities, I think, in those two sub sectors of the healthcare industry, and deserving of more research.

Jeff Fischer: We also continue to look another biotechs, including Celgene which we flirted with in the past, but didn't get shares writing puts. Of course, Gilead is under active monitoring for what we want to do next with it. Thanks for the good question, Bruce. We're down to about 15 minutes left, so we'll go into our speed round.

Billy K: Speed round.

Jeff Fischer: We have quite a few good questions here, we will to answer succinctly. A question on Intel: is Mobileye the saving grace? Are they on the right path? Intel isn't active in Pro or options, so I'll move quickly from it. I still follow the company. I don't have a strong opinion either way, other than to say that shares look inexpensive right now. I've been looking at possible diagonal calls again on it, but no strong opinion right now. Debbie is asking, "Are we looking at stocks that tend to stay steady or go up in a recession? If so, what are those companies?" In most true recessions, almost everything goes down. What we're trying to buy are companies that will be stronger than average, even in a recession. Indeed, even companies that may grow earnings despite a recession. Many of our stocks did, shockingly, grow earnings even in the 2008, 2009 period. We're hoping to have plenty of those that can grow, despite the next recession.

JP Bennett: Or, they took a little hit and they recovered far quicker than the overall economy. I think, personally, the thing I'm looking for is the businesses. Even if their earnings get hit, they have the capital available to further solidify their dominance in the market, or increase their competitive position so that when things rebound, they're far better off. It's kind of like what Verisk is doing right now, or something like NVR, where there were a lot of people getting hit and really hurting in the home building market during the downturn, the GFC and the housing bubble collapse and everything like that. Well, because they're an asset light home builder that didn't have a ton of debt, they're able to go, "Hey, look at this market, this market, this market. We would really love to be a bigger player in these markets. We have the capital, other people don't; let's go in and make sure that we can dominate during the next upswing."

Jeff Fischer: It's so true. If you have a strong company, a recession becomes an opportunity for it. It can step in and take business away from weaker companies. Anonymous is saying, "I've been avoiding shorts. Every one I've started as a non-winner; I don't think I get it yet." I'll just say, shorts are not for everybody. They're difficult, especially in a rising market. I feel gratitude that our shorts have, on the whole, made us some money. Our direct shorts of companies, despite this bull market ... but, not enough to make a difference. Not surprisingly, they haven't made enough money to make a difference. So, if shorting is not for you, you will not suffer long-term because of that. If you want to keep trying at it, then the next time we short something, short a tiny bit; and hopefully, you'll learn as you go. The Domino's Pizza, for example, was a paired trade, shorting Dominoes while owning Papa John's. That's different than a direct short.

Nuance in shorting is very important, as well as context, but we're sorry it hasn't worked out for you so far. If you want to keep learning more about it we are a good place to do that, even if it takes a long time, because we're not actively addressing it right now. But there will come a time, as this chat started, with the topic on shorting being a much bigger part of what we do. That will happen.

Skyworks? I don't know yet why Skyworks is down $5 today, so I have to go into the news to try to suss out what's going on. I'll leave it at that. We are short deep in the money calls on it, which have completely eradicated the decline today, so that's nice to have it hedged out on a day like today. But yeah, the news is more important, and I'll be looking at that. Charlie is asking, "JP: Duncan, have you considered a diagonal call?" That's a Motley Fool options position. Your thoughts on that?

JP Bennett: Really quick take is yes, we considered it. We opted for just doing a cover call in options, because of the income focus and getting the addition of dividends. And also, somewhat related to that is part of the thesis behind Duncan is the ability to do debt restructurings and to recapitalize the business slowly over time, because they are a franchising business that is far more stable than if you were actually taking ownership of those restaurants. I know [inaudible 00:45:10] doesn't like to call them, but taking ownership of the restaurants and selling everything yourselves, it's a far more stable business. It enables you to support a higher leverage ratio, and whenever they do that they obviously, over time, free up additional capital to either A: return to shareholders through special dividends, or buyback shares.

Obviously, if they are just buying back shares it's good for covered calls, it's good for diagonals, but if they're issuing special dividends when you buy those long calls, the calls may not have factored into; because it's hard to know ahead of time how much additional debt they're going to raise during the life of the call, and so how much additional capital they're gonna free up to potentially offer in the form of a special dividend. If you just want to play it safe and you're okay with potentially missing on the leverage gains from the long call, a cover call is a far safer way to capture that additional income.

Jeff Fischer: Oracle: are they going to succeed with the cloud ambitions? I think so. Cloud revenue at Oracle grew 51% last quarter, year-over-year. They estimate it will grow about 43% this next quarter, and that estimate is, I think, what mainly drove the stock lower, because it was a little lower than Wall Street hoped. But, they're one of the largest companies, at scale, growing the fastest in the cloud. They're growing faster than a lot of competitors. I think their installed customer base, their transition to the cloud or letting you stay on a license if you prefer; I think their whole, comprehensive approach is going to work for them, and their margins are going to keep going higher. This dip in the stock should be an opportunity, for anyone who doesn't own it yet. And we'll put that out there and catch up trades.

I think they are on the path that they want to be on towards becoming a more cloud-centric company. Cloud will never be all of their revenue; they think it'll be more than half at some point, and that'll be just fine, is the hope. Jim is saying, "I have a 2018 syn long on Starbucks. I plan to roll to 2020. Any comments on the timing of that?"

JP Bennett: It's awfully hard to predict what a stock is going to do for the rest of the year. At the end of that he noted, is there going to be parts improvement, or did Hurricane Harvey eliminate that? With respect to that, it all depends on what the market ultimately thinks. You can use hindsight, being 20-20, and after the company reports, if the stock popped, well then it's clear that the market under appreciated how well Starbucks would be able to withstand that. So, maybe the results aren't as bad as the market expected. Or, maybe they end up being worse than expected, and the stock get hit. It's something that the market is obviously trying to digest, but it's really rough to tell how it's going to play out once they report earnings.

Jeff Fischer: On the option, since you're trading one call for another, the sooner you sell your 2018 call, the more time value you'll recoup; but the sooner you buy the 2020 call, the more time value, so it washes out. Just roll when you're ready, and take taxes into mind. If you sell that 2018 call this year and have again in it, you'll pay the taxes this year. Or, you could move it into next year if you wait. Mentioning the hurricanes makes me think of Gentex as well. Gentex, the car makers, and pulling Gentex along with it, increased quite a bit in price as the hurricanes hit, and that's back to an earlier question. That's part of the reason the stock rose so much in the past month, unfortunately.

Billy K: If you get a chance, take a look at the ETF CARZ, C-A-R-Z, and the recent price action in the last month. It's up 8%, and year to date up 16, 17%

Jeff Fischer: A member is saying, "Gilead's been on hold. It's frustrating to sit out on covered calls and the share is going up. What's the plan?" We put things on hold if we're not certain that we're going to own it the next three years, if we don't believe strongly enough that we are going to own it the next three years. We do that because we don't want you to buy and have you lock in a loss. We understand your frustration, but we are trying to operate this way to help more members, rather than harm them. It's a fairly small position for us, since it was around 2% when it was on hold. The shares are up maybe ... They're up about 15, 20% the past year. We understand that you've missed that gain and we apologize, but we are trying to have a hold process that keeps you from entering a position, and then having to sell it in a short timeframe, potentially at a loss.

As our confidence grows in the business, assuming it does, we may reach a point soon in a quarter or two where we move it back to buy. Meanwhile, it does remain on hold. Thank you, Foolish Fox, for the virtual hug. I'll accept that on my behalf and the whole team. Give some to JP, some to Billy, some to Anne behind the glass. Thank you very much. Do I look like I need a hug? Maybe, I don't know.

JP Bennett: It's one of those days.

Jeff Fischer: I'm feeling pretty good today. Why is the lighting in your faces so dark? It makes you look sketchy.

JP Bennett: That's why we need a hug.

Jeff Fischer: Yeah, that's why we need it. But I know you're not sketchy, JP. Anne is like, "I don't know. The lights are like, normal." I don't know. Good question, though. We can work to improve upon that too.

Billy K: Upon your sketchiness.

Jeff Fischer: We have less than 10 minutes left, let's see if we can fly through these. "Explain how to calculate the price at ..." A tough one, right off the bat. What are our thoughts on IPG versus Coherent? I looked at both. I like Coherent's growth rate. I like Coherent's focus on microelectronics, and coherent is now moving into fiber lasers as well, which is IPG's sweet spot. They're both great companies, the Fool recommends both of them. We were the first to recommend Coherent.

JP Bennett: Gotta get that in, right?

Jeff Fischer: And so far, the only ones. Just for context, IPG has been recommended for years, and Coherent just this year by us; so keep that in mind too. Over the long term, Coherent has outperformed IPG as a stock, but they've both been really great. I think some members own a bit of both. I'm just partial to Coherent, just for the reasons just mentioned; but both have done well over time. Now, to Greg. "Please explain how to calculate the price at which a short in the money option would likely be assigned." You guys want to just touch on the time value?

Billy K: Yeah. What you want to look at is the amount of time value remaining. Obviously, the difference between strike price and the stock price is going to be your intrinsic value. And then, the difference between the intrinsic value and the value of the option itself will be time value. Any time when time value is approaching zero, or is getting very close to zero, that is when you are at risk of assignment for a short option. Particularly in the case of calls, when there's a dividend, if you're around the ex-dividend date, and the amount of time value left in the option is lower than the expected dividend on that ex-dividend date, you are also at risk of being assigned. Just keep an eye on that time value. If it's a call, make sure you're monitoring dividends and dividend dates as well.

Jeff Fischer: Awesome. Thanks, Billy. With five minutes to go, let's challenge ourselves and see if we can touch on every question remaining. Please don't enter any more questions. Questioning period is closed. Charlie says that we spoke to guidelines for buying calls.` How much downside and what data can you revisit? So, generally speaking, we look to buy a call option that's about 20% to 10% in the money, and that minimizes the time value that you pay. We seek to pay no more than 3 to 5% time value per year, typically, on a call that we're buying; and ideally less, if you can. As for downside, you realize you're getting maybe 20% of the downside of the stock, and you're paying a 3 or 4% time value per year, generally speaking.

That's how we do it, and we're looking for a call that we believe could at least double, assuming the stock, generally speaking, gains about 20%, 30% or so. We want to believe that the stock could do that over the next few years, and our calls would then line up to at least double [crosstalk 00:54:00]

JP Bennett: One minute down and 22 questions left.

Jeff Fischer: So sorry, that was bad. Doug: "Does the team ever look at special ops, such as spinoffs: investments that might be held for just a year or two?" Too much effort for the return.

JP Bennett: For me, only if it's a company that I had been following previously, just because the time needed to get up to speed on it, like you said, it's not always worth the time.

Jeff Fischer: Yeah. We're open to everything, but we're mostly looking for, ideally, companies that will compound over many years, as JP started today with. We're looking for the most bang for the research buck over the long term.

Billy K: I will say, also, that I do like spinoffs, and that can be a very fertile area to look for good investments. Broderich, one of our companies, is in fact a spinoff. Spinoffs, there is some research that suggests that they tend to do better than the average market. I like looking at that category.

Jeff Fischer: Great point, Billy. Will I be at the Fool One conference at Isle of Palms? It's October 2nd and 3rd. Yes, the inception date I will be there. The inception date of Pro was October 7, 2008. So, almost 9 years ago now. What's our thinking on SVXY? Should we consider reducing? Yes, we're considering that. It's more than a 2% position. We're considering reducing it to 1%, because the VIX is so low. Last I saw it was under 10. And what might we select to profit with a rise in VIX? We looked at VIX options; it's very tricky. You can look at VIX-related ETF's, but again, tricky. You need the VIX to rise a lot and sustain that gain to make a profit in most of these vehicles. It's trading, it's speculating, so I'm not sure that will do it. But, if there's long-term way, perhaps. GB is saying, "My allocations of gotten out of control. Is there a recommended strategy for getting back to roughly in line with what we have?"

JP Bennett: I guess it depends what he defines as "roughly." I would start there and figure out what your target is, in terms of what you want to ultimately get to. And then, once you have that, you should be able to figure how much cash you need to deploy, and then look at Pro and decide, "All right, do I want to put it evenly across the names? Do I want to do just the buy first? Do I want to do buys and then buy first?" It's all a matter of how quickly you want to get into those positions.

Billy K: I'll also say that as long as you're within roughly about a percent or so of our allocations, you should be fine. You don't need to try to get it exact.

JP Bennett: Then, to just quickly finish up, you can either just buy them in all one chunk and get them back, and obviously that is a much more easy process. There's isn't much hassle, I don't have to worry about it, stress about it. Or, you could look to slowly increase those allocations over time, and buy thirds or something like that.

Jeff Fischer: Yeah. And look overall to be in the ballpark instead of precise. I wouldn't sell positions down by small amounts and incur taxes just to get to some exact number, because they will keep changing anyway as the market moves; so be in the ballpark. Current thoughts on FactSet research? We did talk about that. It's still rated a buy. I believe in the long-term attributes and potential of that business just the same. They have pricing power, they have strong recurring revenue, they have strong customer retention. They face some headwinds right now, but when the business starts growing more aggressively again, it should reward us quite nicely, is my belief, on a compounded, annualized basis. We still like it for the long term, but of course, we're watching it closely; as with everything.

Anonymous: "FireEye owns the company that was hired by Equifax to investigate the hacks. Do you see fallout in lawsuits?" Since we're not in Equifax or FireEye, I guess we'll move on, because I don't know enough to say anything. And Anne, do we have maybe five more minutes? Al right. I think we can wrap up in five minutes.

JP Bennett: 16 questions.

Jeff Fischer: Sweet. Is it? Are there that many? It doesn't look like that many. Let's just give five more minutes, see what we can do. "Any plans to implement a stock replacement strategy?" We look at that, and I can't say when or which stocks we'll do it on, but if we want to raise cash and maintain our exposure, upside exposure, and downside to certain company, stock replacement is a pretty easy way to sell the shares, buy a call option instead. Eventually we'll probably do that on something.

Charlie: this question is tricky. "Unless you have a lot of money, contributions far outweigh investing returns, vis-à-vis portfolio growth. Is that right?" I don't want to do all the talking guys, but I'll just say early on when you're saving a lot, your portfolio may benefit most by that savings. That may grow it the most, generally speaking, except during very strong bull markets. Target savings, I'd save as much as you can while still enjoying your life, reasonably.

Billy K: More important ... Oh, sorry Jeff. Didn't mean to cut you off.

Jeff Fischer: Go ahead, Billy.

Billy K: Okay. I would say more important, I think, than contributions is how long you've been invested. Contributions are important, but what's really gonna drive your returns is compounding, and interest that happens many years compounded upon itself.

Jeff Fischer: So true. "Year to date, how have we done, and since inception?" Generally, the portfolio is up more than 13% this year, and 203% since inception. That's mostly all driven by our long positions. We've made some money on options as well, and some on shorts and hedges; but mostly it's driven by the longs, as you would expect in this market. I'm not sure ... Okay, that's the link to our international exposure. We talked about the FAZ synthetic, stay in it. We might join you again, we'll let you know. New hedges, we did discuss at the early outset of this discussion, and this will be archived on the site; so you can check that out.

PayPal: "Should I also buy square, or would that be over allocating?" Good question. We also own MasterCard and Visa. I would say, look at your exposure to the payments industry as a whole, and if you already have enough in these names: MasterCard, Visa, PayPal, then you probably may not also want to add Square as well. Rockytop Bob has a question. His margin to his net account value is around 30%. "Am I playing with fire?"

Bob, it depends what your positions are in, and what's margined, basically. That does sound pretty high, 35%. We generally say if you're going to use margin at all, and we don't. We don't borrow money that is to invest in the market; but if you were going to, to do no more than 10% as far as borrowed funds go. That's just a personal take. I know other people do carry margin. But, the Fool from day one has always said, "Don't use margin. Don't borrow money to invest," and that's just where we stand. So, Bob, you might want to post on the boards what you're doing and let's see if we can get some more insight on the risk that you might be exposed to. We need details to really know what that might be. And we should wrap up. We have one more minute. Any of these questions that you guys see that you want to, and are able to answer?

JP Bennett: I've been following Deer not as closely as I used to, for obvious reasons. It's a case of the business treading water, like we said. We figured it would continue to struggle for the time being. Cost-cutting measures, the market seems to love that because, obviously, valuation multiples continue to rise; though it did get hit some recently, so they came back some. As of this point, it'd be tough to say if we're going to revisit the name, simply because the thesis was, "The business will continue to struggle, and the market is under estimating how long it's going to struggle, and how much of a struggle it's going to be, and they were too enthused on a comeback." Well, clearly the market became even more enthused on a come back. How far it's gonna ultimately fall if things cool down, in terms of market enthusiasm? It's a bit tough to call at this point.

Jeff Fischer: Anonymous is saying, "Rockytop Bob might be pulling our legs on the margin. Maybe he doesn't have 35% margin." Let's let's hope not. One or two more questions here. We do look at protective collars in the portfolio, definitely. We've used them in the past. They're a good way to set up out-of-the money positions that can protect you on a decline, although you do cap your upside a bit about the current share price. And I think that's about it, that we can do today. I thought I saw one more that I could answer quickly, but ...

Billy K: I'll answer more, quickly. "The foreign companies do not have to meet the same accounting standards as the US. How to be sure reports are reliable?" One way to do that is to invest in United States companies that have international operations, and then they have to comply with SEC regulations, which is kind of what we do in Pro with our companies that have extensive international exposure with their business.

Jeff Fischer: Excellent. Thank you, Billy. And Bill is asking about buying long-term calls instead of stock, and the delta. Generally, look for a delta of 0.8 or higher, so you're getting 80% of the stock's move. That will also help you minimize the time value that you pay, generally speaking. I think with that, we need to wrap it up. We do have about 20% in cash, but that's strategic. We hope to use it, or we will use it when we see opportunities; and it's a way to try to meet our rolling three year and 10 year goals, because we know when the market falls, we need to take advantage of that if we really hope to earn stronger than average returns that go towards our 10 year return goals. The cash is there for a reason. With that, Anne, we will wrap it up. Thank you all for being here. JP, thank you for leading us into the chat.

JP Bennett: Happy to give you a break, for once.

Jeff Fischer: It's always good, too. Maybe Billy will do it next month. We hope to see you next month. We appreciate that you are putting your trust in Pro and in the Motley Fool. We thank you for it. And to everyone affected by hurricanes and earthquakes: you're in our thoughts daily as well. It's been a rough fall, as far as natural weather goes. With that, we hope that you're doing well, you and your family; and we hope that you're enjoying your day-to-day life. Thank you for being a Fool with us. Thank you, Billy.

Billy K: Thank you, Jeff.

Jeff Fischer: Thank you, JP, and thank you Anne and Ellen behind the scenes, and many other Fools as well, and we'll see you again soon. Thank you and Fool on.

JP Bennett: Fool on.

Billy K: Fool on.

Roll Your Diagonal Calls on American Tower

Published Sep 7, 2017 at 12:25PM

Is this for you? This is for all *Pro* members who wrote October 2017 $120 diagonal calls on **American Tower** (NYSE: AMT) as per our alert in March. If you have yet to establish a diagonal call position on American Tower, or if you wrote diagonal calls at a different strike price, please see the Alternative Trades section below. Remember that all members should already own an unencumbered 4.4% stock allocation to American Tower, so if you have yet to establish your stock allocation, do that first before considering this additional diagonal call recommendation.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
  - "Buy to close" all Oct. 20, 2017, $120 written calls.
  - "Sell to open" the same number of April 20, 2018, $130 calls.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* will roll all five of our calls.
- **Recent Prices** (11 a.m. ET):
  - Stock: $146.23
  - Buy to close Oct. 20, 2017, $120 calls (bid/ask): $26.10/$26.70 (midpoint $26.40)
  - Sell to open April 20, 2018, $130 calls (bid/ask): $19.00/$19.70 (midpoint $19.35)
  - Net debit to roll: Approximately $7.05 (this price will change)
- **Price Guidance: It is critical that you use a limit order**, aiming to pay as little time value as possible to close your short calls, and aiming to roll for as much of a credit as possible. The midpoint of the bid/ask spreads currently implies about a $7.05 net debit for this roll, although that number will change as prices change and as *Pro*'s collective volume affects the bid/ask spreads. However, realize that with time value on the short calls approaching zero (and with American Tower's third-quarter ex-dividend date likely near the end of September), you should roll these calls soon, or you risk getting your owned *shares* (rather than calls, assuming both securities are owned in the same account) called away. **We want to avoid that scenario!** So, accept lower credits if need be, but still use a limit order. As of today, the bid/ask spread on the October $120 short call implies about $0.10-$0.15 or so in time value remaining. As we approach expiration, time value will continue to erode, so the longer you wait to make this trade, the more likely it is that your short calls will be assigned.
- **Fair-Value Estimate:** After incorporating last quarter's results into our valuation model, our fair value has increased to $142 from $135.

What We're Thinking

In November 2016, we took advantage of U.S. election-related volatility to re-establish a diagonal call position on American Tower at particularly advantageous prices. Then, in March 2017, we rolled our diagonal calls out and up to capture further upside. So far, the position has been a success (with a 22% simple return since inception if we were to close the diagonal call today), and American Tower's stock price has run up well beyond the strike price of our October $120 short calls.

As we mentioned in our second-quarter review, given our assessment of the company's fair value and business momentum, we're content to pay to roll our diagonal calls out and up in order to capture further upside and keep the diagonal call position going. In exchange for $7.05 or so in incremental investment, we gain $10 in additional upside to our position (a 42% return on incremental capital in about seven months, well above our North Star), and we extend our expiration out to April, with the flexibility to eventually convert the position to a January 2019 bull call spread as market and business conditions dictate. As we approach April expiration, we'll reassess the position and determine our next course of action.

Alternative Trades

- **Did you write $125 calls instead of $120 calls like *Pro*?** If you wrote higher-strike calls than *Pro* did, you're in a slightly better position than *Pro*; you can complete this rolling trade at a lower cost. You can roll your October $125 calls out and up to April $130 calls, lately for a rolling debit (i.e. cost to you) of about $2.30 or so. You will be paying $2.30 or so to gain $5 in additional upside (a potential 117% return on incremental capital). If you prefer to target more upside, you can consider rolling out and up to April $135 calls, targeting $10 in additional upside for a rolling debit of about $6.10.
- **New to the position and have yet to set up a diagonal call?** Do so by simultaneously buying ("buy to open") January 2019 $105 calls and selling ("sell to open") January 2018 $150 calls for a net debit of about $39.40 per diagonal call (this price may change). Invest 0.7% of your *Pro* funds in this diagonal call position (that is, one diagonal call for every $450,000 or so you manage), and keep in mind that this position is "off-reservation" from *Pro*, so if you're not comfortable managing a position on your own, this choice might not be the best one for you.
- **Have a different position not addressed here?** Check in on the American Tower discussion board and we will do our best to answer your questions.

Pro Can Help

- **Questions?** Consume data and ask your questions on the American Tower board.

Pro's Portfolio's Leaders Drive Our Fate

Published Sep 5, 2017 at 5:05PM

Greetings, Fools,

We began September with a handful of guidance and valuation updates; most are minor, but be sure to check them out in today's guidance change roundup. You can also see where everything stands just by looking at the portfolio page. There, you'll see that we're also focused down to just 21 long stocks and a few ETFs right now. We've introduced many new names to the portfolio in the past year, but we've sold even more companies, all in the interest of focusing on what we believe will do better over the coming years.

As of today, our updated exposure table is on the portfolio page, too. Here's a copy:

***Pro* Exposure**

Long	82.7%
Short	1.6%*
Net Long	81.1%
Hedged Out	4.3%
True Long	76.8%
Cash Ex-Shorts	22.7%
Short Puts	6.3%

Last updated Sept. 5, 2017. [What do these numbers mean?](#)
*As a hedge, we also have a (lately) 14% allocation to QQQ via a put ratio spread, but until it's near-the-money, it's not being counted as a short, as it doesn't come into play.

We've averaged 76% "true long" this year, and that's where we stand today. That's our long exposure minus our direct short positions (equities and options) and any positions that are hedged out -- right now, our covered calls on **Skyworks Solutions** (NASDAQ: SWKS) hedge out that equity's upside and downside within a price band.

You can see we're light on shorts, especially after closing several this summer. We will likely add more shorts this quarter, if all goes to plan, as well as additional hedges. Our current put ratio spread hedge on the **PowerShares QQQ Trust** (NASDAQ: QQQ) isn't calculated in the above numbers because it's far out-of-the-money. It is, however, about a 14% hedge on the Nasdaq index, albeit with a long put strike price currently more than 13% below the current index level.

That's a lot for the market to fall before it hits our strike price, and this in part points to how far the index has climbed since December, especially because we rolled that hedge up once already. We don't want to roll it any higher, because it carries with it short put exposure (an obligation to buy shares of QQQ). We're considering other hedges instead. But history says that if the stock market falls by about 15%, it usually falls more than that, so even as it stands today, this hedge could come into play in a downturn. If it did, our net long exposure would adjust to about 60% or lower at that point.

Given the strong market all year, we've been fortunate to have shorts that worked out, or didn't hurt us much. The same is true for our hedges to date. Below is our updated returns table as of the Aug. 31 close.

	Annualized		*Total Return*	
	Since Inception	Rolling 3-Year	YTD	Inception
Pro Portfolio	**13.1%**	**12.6%**	**12.3%**	**200.7%**
North Star	**8.4%**	**8.1%**	**6.2%**	**104.7%**
S&P 500 Total Return	12.4%	11.0%	11.9%	183.8%
MSCI World	7.0%	4.6%	11.9%	82.6%

Pro historical returns show 13.1% annualized gains.

Though we've been carrying cash and some shorts all year, have had some notable losers, and have kept our market exposure at about 80%, our returns are pleasing. They've been driven by some of our largest investments. Just check out the strong year-to-date results from these "obvious" (you could say) leading companies. I say "obvious" with a touch of irony (that's what the quote marks are for!), because plenty of people did not expect these giants to continue to rise, let alone by 40%.

- **American Tower** (NYSE: AMT): 37.8%
- **Apple** (NASDAQ: AAPL): 39.7%
- **Facebook** (NASDAQ: FB): 48%
- **MasterCard** (NYSE: MA): 28%
- **Oracle** (NYSE: ORCL): 32%
- **Skyworks Solutions** (NASDAQ: SWKS): 42%
- **Verisign** (NASDAQ: VRSN): 35%
- **Visa** (NYSE: V):31%

Year-to-date returns as of 2 p.m. ET via Google Finance; and excluding dividends!

We've had American Tower, Facebook, and Visa (among others) as "Best Buys Now" (what was once known as "Buy First") for as long as I can remember. Today, Facebook moves down to Buy, simply on price.

It has been a good year to be an investor, but then again, when isn't it? Even when the stock market falls, isn't it better to be a part owner of your world rather than not? That's especially true because while timing the market is folly, as an owner who is paying attention, you can hopefully take advantage of downturns by purchasing more. There's no denying it has been a good year so far for investors who own strong businesses -- and that's Foolish.

Thank you for being here! Foolishly,

Jeff (TMFFischer)

We look forward to seeing and talking with [members in Chicago](#) on Friday from 4-8 p.m.! RSVP and come by if you can!

Pro Guidance Changes and Completed Trades: Sept. 5, 2017

Published Sep 5, 2017 at 4:41PM

Pro Guidance Changes from the past two weeks (see any related [trade alerts](#)):

- **Apple** (NASDAQ: AAPL): Fair-value estimate increases to $150 as we approach iPhone upgrade "super-cycle." Remains a Buy.
- **American Tower** (NYSE: AMT): Fair-value estimate increases to $142 (from $135). It remains a Best Buy Now.
- **Facebook** (NASDAQ: FB): Moves to Buy (from Best Buy Now).
- **Gentex** (NASDAQ: GNTX): Moved to Sell.
- **GoPro** (NASDAQ: GPRO): Moved to Cover. We're closing our short exposure.
- **MasterCard** (NYSE: MA): Fair-value estimate increases to $119 (from $105 -- it was due for an update). Remains a Buy.
- **Medtronic** (NYSE: MDT): Moves to Best Buy Now (from Buy).
- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $100 (from $96). Remains a Buy.
- **Visa** (NYSE: V): Fair-value estimate increases to $97 (from $93). Remains a Best Buy Now.

Pro Completed Trades and Option Expirations from the past week (see transaction log; trades take a day to appear):

- Gentex: We sold all of our shares at $18.49, bringing our stock allocation to 0%. (We are still working to buy to close our December 2017 $17.50 puts, using a limit order lately of $0.65.)

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

American Tower Benefits From Growth in Mobile Data

Published Sep 1, 2017 at 12:31PM

American Tower (NYSE: AMT) notched another strong quarter, continuing the company's multi-year momentum. It had solid organic growth and improved margins across its growing global asset base.

The company remains a Buy First, with an **updated fair-value estimate of $142 per share** and an allocation of 4.4% in the *Pro* portfolio.

What Happened?

CEO Jim Taiclet:

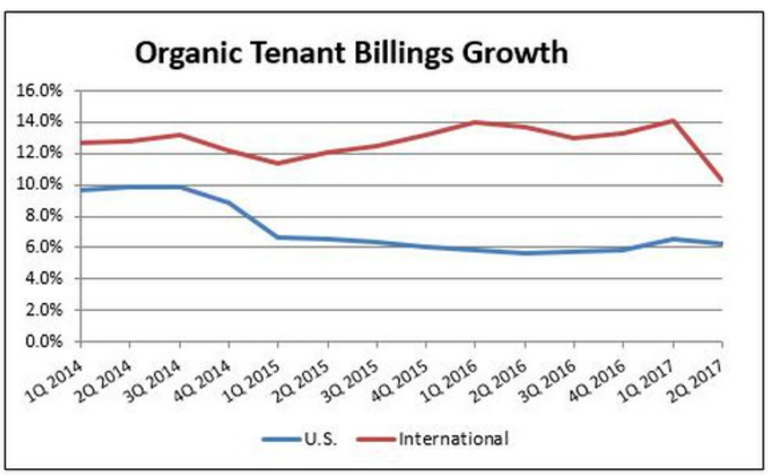
> "The second quarter of 2017 represented our 17th consecutive quarter of double-digit growth in property revenue, adjusted EBITDA and consolidated AFFO per share, driven by strong demand for our tower real estate from Los Angeles to Sao Paolo to Paris. Organic tenant billings growth in the U.S. of over 6% was complemented by organic tenant billings growth of more than 10% in our international markets, where the pace of advanced handset adoption and mobile data usage growth continues to require the addition of substantial network equipment on our sites."

Get More

- Q2 2017 press release
- Q2 2017 supplemental materials
- Q2 2017 earnings presentation

Organic tenant billings (growth attributable to tenant co-locations, lease amendments, and price escalations, net of cancellations) came in at 6.2% in the U.S. and 10.3% internationally (vs. 5.6% and 13.7% in the same quarter a year ago).

International organic growth was broad-based across all regions, up 10.1% in Asia (i.e., India); 8.9% in Europe, the Middle East, and Africa (EMEA, which includes France, Germany, Ghana, Nigeria, South Africa, and Uganda); and 11.2% in Latin America (which includes Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, and Peru).

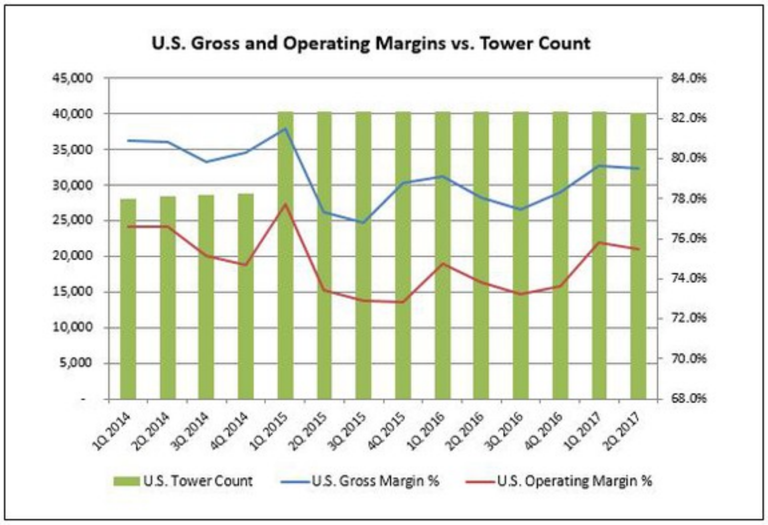


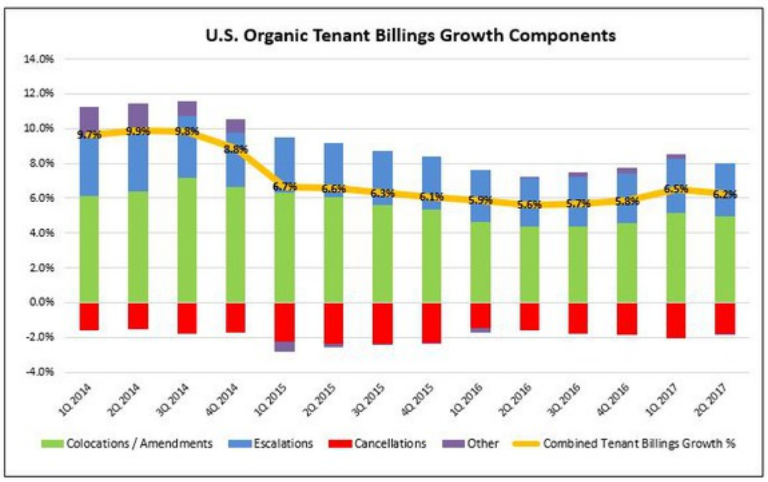
So What?

Although the company experienced double-digit growth internationally, that growth decelerated sharply, with international organic tenant billings growth coming in at its lowest since I've been analyzing the company. The closest to the current 10.3% growth figure was 11.4% growth in the first quarter of 2015. International growth was affected particularly in Asia, where organic tenant billings growth decelerated from 28.5% last quarter to 10.1% this quarter because of elevated consolidation-related churn. Despite the deceleration of growth, management raised its outlook for international organic tenant billings growth to 10% at the midpoint, up from 9.5% at the start of the year.

Margins increased in the quarter thanks to the strong organic growth, cost controls, and the continued integration and lease-up of nearly 70,000 low-tenancy sites built, leased, or acquired since the end of 2014. These include newly acquired towers in the U.S., Nigeria, Brazil, India, France, and Argentina. Management expects a broad margin expansion trend as the company continues to generate organic growth on its extensive existing portfolio of assets.

U.S. gross margins increased year over year to 79.5% (from 78%), and U.S. operating margins increased year-over-year to 75.5% (from 73.8%), reflecting those trends:





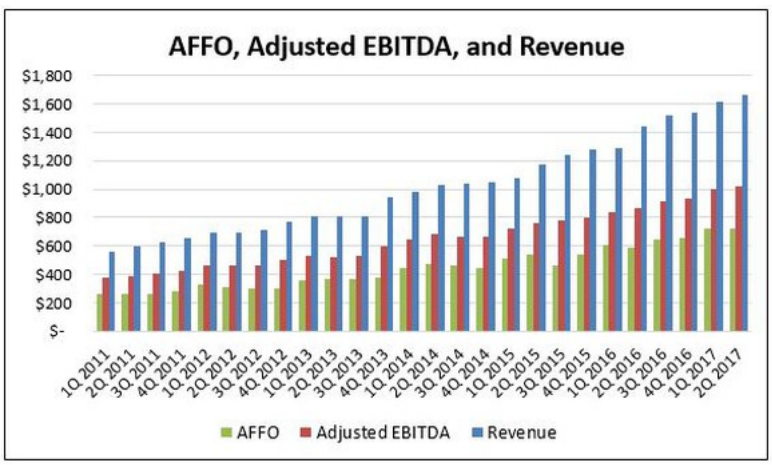
The next graph shows U.S. gross and operating margins on a trailing-12-month (TTM) basis, which smooths out the lumpiness of individual quarters and shows the longer-term trend in margins. We can see that since the significant **Verizon** (NYSE: VZ) acquisition in 2015 that acted to lower the margin profile of the entire U.S. business (due to the lower tenancy ratio on those new towers), management has been successful in slowly increasing margins via organic growth of the newly acquired (and existing) assets:

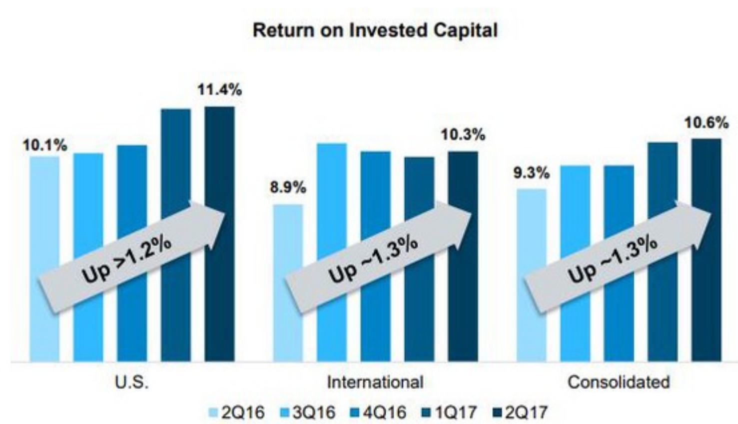
Internationally, margins increased sequentially (gross margins up to 82.7% from 80.7% a year ago; operating margins up to 72.1% from 69.4% a year ago) as the company continues to integrate its recently acquired assets in Brazil, Nigeria, India, France, and Argentina:

As for debt, the company continues to de-lever and ended the quarter with a net leverage ratio of 4.5x, the lowest the leverage ratio has been since the third quarter of 2013. Yearly distribution growth continues to track in line with management's 20% long-term growth target, coming in at 20.8% ($0.64 per share, a 1.7% forward yield on the current share price). Twenty-percent annual distribution growth continues to look like a more than reasonable target for 2017 and beyond.

Now What?

This quarter's report confirms that our investment thesis -- that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time -- is continuing to play out. The company's impressive operating history, excellent management, and strong competitive position in a growing industry give me confidence that American Tower will continue to increase revenue and cash flow at high rates for a long time, providing strong returns on capital (ROIC). The company's portfolio of nearly 150,000 sites worldwide positions it to benefit from secular mobile data demand trends on five continents, and acquisitions and incremental leasing activity should continue to drive revenue, cash flow, and ROIC higher over the long term:





Data and Guidance

- Current Price: $146.80

- Fair-value estimate (**updated**): $142
- Allocation: 4.4%, plus 0.6% in January 2019 / October 2017 $80 / $120 diagonal calls
- EV/EBITDA (TTM): 21.5

AMT remains a Buy First, with an updated fair-value estimate of $142 per share and an allocation of 4.4%. We also have 0.6% in deep-in-the-money diagonal calls, which will be addressed in a separate alert. Given the update to our fair-value assessment, we're content to pay to roll our diagonal calls up and out, so if you feel comfortable acting ahead of *Pro*, feel free to do so.

Even as the stock has gained 38% year to date, the company continues to generate shareholder value, and our fair-value estimate continues to rise along with the stock price. If you've yet to start a position, now is as good a time as any to match us. The stock has had a tendency to experience volatility in the short term because of its correlation to the interest rate-sensitive REIT sector, but over the long term, the underlying strength in business fundamentals should shine through.

Fool on!
-- Billy (TMFBillyTheKid)

What You Don't Know Will Reward You

Published Aug 31, 2017 at 1:17PM

Dear *Pro* member,

Each day, we're thinking of everyone affected by the deadly Hurricane Harvey — if you'd like to help, please consider giving here.

Sometimes, it seems that investing is what happens while you're busy living the rest of your life. But whether it's world events, work, family, adventure, or something else that periodically draws you away, investing remains a faithful companion in the background. You can count on the process working when your attention is elsewhere because the companies you buy into are doing the hard work, striving to grow over time. In fact, your companies don't actually care if you're at the beach instead of checking your stock quotes. And this feeds into our thoughts for the day.

New Value Is Created by the Unforeseen

No one valuing **Apple** (NASDAQ: AAPL) in 2005 assumed the company would, in two years, debut one of history's most profitable products. Years ago, I saw no one suggesting **Netflix** (NASDAQ: NFLX) would start producing its own award-winning content, let alone that **Amazon.com** (NASDAQ: AMZN) would create a new Web services industry. The folly of trying to value any dynamic business is that the business is going to expand its offerings in unforeseen ways.

This is the power of optionality: It's a key part of many of our investments, and those that lack it are given a shorter leash.

Gilead Sciences (NASDAQ: GILD) has gained 15% in the last five days (as of this morning), mainly on news of its planned $12 billion acquisition of **Kite Pharma** (NASDAQ: KITE). Kite is a development-stage company working on novel immunotherapy-based cancer treatments, with a substantial pipeline of mostly early to mid-stage candidates. As luck would have it, just yesterday the FDA made history by approving the country's first gene therapy treatment for cancer (acute lymphoblastic leukemia). It approved a drug by **Norvatis** (NYSE: NVS) that uses science similar to what Kite Pharma is pioneering; this news led to Gilead's biggest stock jump in a long time.

This was all unforeseeable just five days ago. We knew Gilead was working on acquisitions and would likely focus on oncology, but we didn't know what it would buy. We still don't know what sort of value will be created, if any, by the new venture. But that's the point. New value creation — beyond what is already visible and expected — is not foreseeable. A valuation on **Microsoft** (NASDAQ: MSFT) in 1990 did not foresee the emergence of its computer gaming business in 2000, let alone the rise of the Internet.

We want to invest in management teams that remain curious; that accept the risk of being wrong for the sake of eventually being right and growing; and that cradle the pursuit of optionality. **Visa** (NYSE: V) wasn't content to just process transactions, as powerful as that business is; now its related data and services business is growing sharply. Likewise, **Square** (NYSE: SQ) is rapidly growing its small-loans business, creating a new industry — or at least a new way for businesses to borrow capital. This wasn't part of its original plan. In other surprises, nobody I know of assumed the average selling price for an Apple iPhone would go *up* over 10 years. That's unheard of with tech products, but it appears very likely to happen as new iPhones debut next month at even higher prices.

It's What You Don't Know That Will Reward You

When you invest in a healthy business that has the wherewithal to keep exploring its potential, you invest in optionality alongside its traditional business metrics. When you do this, you know that your valuation estimates may be woefully inadequate. All a company needs to do to lay your careful spreadsheet to waste is surprise you with a successful product, or make an acquisition that unlocks much greater combined value.

We don't like to generalize, but it seems the younger you are, the more you think you can know. And the older you get, the more you realize you can't know. With this humility, you may relinquish some of your illusion of control, and instead invest in the unknown. After all, the unknown is going to reward you much more than what's already known (and already priced in).

Today, we're investing during a period of rapid and vast change. For instance, it seems almost inevitable that even the simplest forms of artificial intelligence are going to change life — and consumer habits — across the globe in the coming 10 years. Companies with the optionality to capitalize on our changing ways of life have much better odds to thrive. Those without the ability to pivot risk being left behind in the proverbial abandoned strip mall. If we invest well, it's what we don't know today that will reward us most tomorrow. And that's liberating.

As always, share any thoughts on the Memo Musings board, and Fool on!

Only eight days until a bunch of awesome Fools meet up in Chicago. It's not too late to crash the party! Show up!

— Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: Aug. 31, 2017

Published Aug 31, 2017 at 1:17PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio — start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.4%.
- **Coherent** (NASDAQ: COHR): Buy 2.4%.
- **Square** (NYSE: SQ): Buy 2.5%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2%.

Continue building your portfolio with our Buys, including:

- **FactSet Research Systems** (NYSE: FDS): Buy 1.9%.
- **Medtronic** (NYSE: MDT): Buy 2.7%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- N/A

Hedges:

- New ones being considered.

Next month's options expirations (September):

- None.

Today's Bull Market vs. History

Published Aug 31, 2017 at 11:55AM

The stock market bottomed out in March 2009. If you told someone at the time that stocks would basically go straight up for the following eight years, I'm telling you, not one person in a thousand would have believed you. Including me.

Why? Because there just aren't many periods in history where stocks do really well for eight years. It's only happened a handful of times in the last 100 years.

To put these last eight years of market gains in perspective, let's compare it to other historic bull markets.

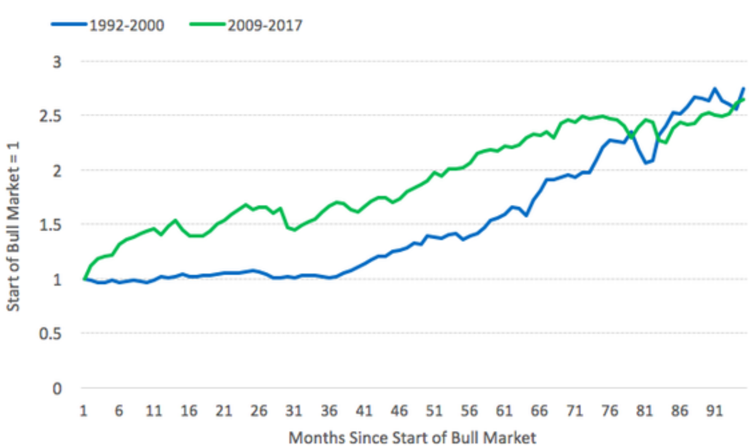
One caveat, and it's an important one: Comparing today's market to the past is not an attempt to argue that today's market will follow the same subsequent path as one in the past, especially in the short run. It's merely context on how far we've come.

The 1990s Bull Market

The dot-com era was born, and the economy roared, making the 1990s one of the most famous periods in market history. For the first time ever, small retail investors (like you!) could participate in the market without the guidance of a broker.

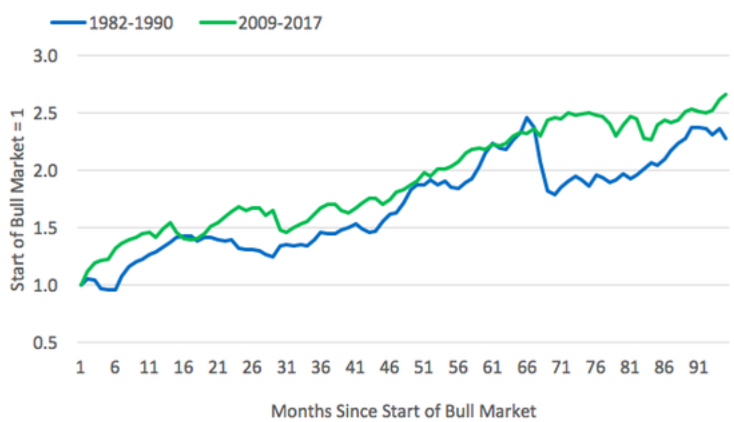
A recession in the early 1990s dragged the market down. Stocks began rallying in 1992, and didn't look back until peaking in 2000.

How do the 1990s compare to the last eight years? Pretty similarly, in both magnitude and duration:



The 1980s Bull Market

The market peaked in the mid-1960s and then went nowhere for the next 20 years, adjusted for inflation. The 1970s and early 1980s were a miserable time to be an investor. But high future returns are born in miserable periods, and by 1982 stock valuations were so low that a new rally was born. Morning In America was here, and stocks surged from 1982 to 1990 — even with the crash of 1987 in the middle:



Here again — both the magnitude and duration of the 1980s bull market is about on par with what we've experienced in the last eight years.

The 1920s Bull Market

Next to the 1990s, the 1920s are the most famous period of market excess and insanity — a period that both soothed the pain of an economy torn by World War I and set the seeds for the pain of the Great Depression. In his diary of the Great Depression, author Benjamin Roth wrote:

As I look back now to the 1921-29 period it seems to me unreal and almost unbelievable. After the war pressure people wanted to have a good time and to spend money.

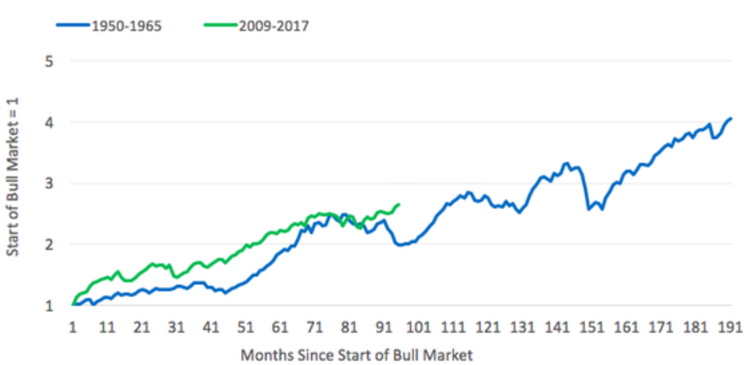
Here's how the 1920s stack up to today:

The 1920s is one of the only eight-year periods when the market performed better than it has in the last eight years. And it did far better: Equivalent eight-year returns would put the Dow at more than 34,000 today.

The 1950s and 1960s Bull Market

We remember the 1950s and '60s as a glorious time for American economic growth — and it was. Global dynamics that came out of World War II combined with an incredible amount of factory productivity learned during the war combined with pent-up consumer demand caused by rations during the war set the stage for 15 years of amazing growth.

Here's how it compared to today's bull market:



The eight-year rally from 1950 to 1958 is about on par with what we've experienced since 2009.

Then came a series of declines — moderate, but not severe. The 1950 to 1965 bull market, if taken as one, was an incredible period of wealth creation.

I left in the whole 15-year period in this chart not to predict what might come next for us today, but to show what's possible over long stretches of time even after big run-ups like we've had over the last eight years.

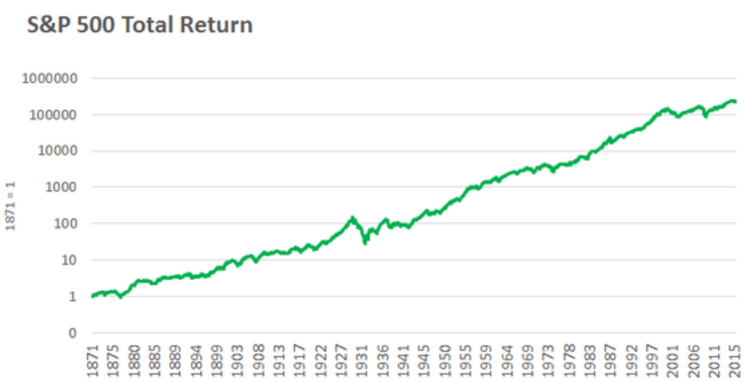
We've Been Here Before

The last eight years is not unprecedented.

What gets dangerous is when you assume we've come too far, too fast, and think that the rally of the last eight years means we're due for crash.

We will have more bear markets. Maybe starting next month, maybe next year, maybe five years from now. The fact that we're surprised at how far we've come since 2009 should be a reminder that outcomes are surprising, not that your prediction of a new bear market is due to come true.

The most important thing any of us can do is contextualize big rallies and big drops against two things: our own personal needs and goals, and the long-term record markets have produced over time:



Pro Guidance Changes, Completed Trades: Aug. 28, 2017

Published Aug 28, 2017 at 3:27PM

Pro Guidance Changes from the past week:

- **Gentex** (NASDAQ: GNTX): Moved to Sell. We're completely closing our long position(s).
- **GoPro** (NASDAQ: GPRO): Moved to Cover. We're completely closing our short exposure.
- **O'Reilly Automotive** (NASDAQ: ORLY) moved to Sell (and was sold from our portfolio via long puts).

Pro Completed Trades and Option Expirations from the past week (see transaction log; trades take a day to appear):

- None last week.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Aug. 24, 2017

Published Aug 24, 2017 at 2:19PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.4%.
- **Coherent** (NASDAQ: COHR): Buy 2.3%.
- **Square** (NYSE: SQ): Buy 2.4%.
- **Verisk** (NASDAQ: VRSK): Buy 2.1%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.8%.
- **Oracle** (NYSE: ORCL): Buy up to 4%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- N/A

Hedges:

- New ones being considered.

This month's expirations (Aug. 18):

- **Gilead Sciences** (NASDAQ: GILD): With the stock below our strike price, our August $75 covered calls expired as income last week. We'll consider new calls with a new trade alert.
- **O'Reilly Automotive** (NASDAQ: ORLY): With the stock below our strike price, our long August $220 puts were exercised this weekend, selling all of our shares. The stock was moved from Hold to Sell on Monday.

Close Your Synthetic Short on GoPro

Published Aug 23, 2017 at 2:08PM

Is this for you? This is for all members who have any short exposure to **GoPro** (NASDAQ: GPRO). We're ending our short.

How You Participate

- **Action:**
  - Buy to close all short January 2019 $12 calls, and sell to close all owned January 2019 $12 puts.
- **Price guidance:** To the best we can judge, this synthetic short can be closed for around a net credit of about $3.20. Use a limit order and experiment to see if you can get that price or higher. If the market makers don't cooperate, you may need to close for a lower credit.
- **Recent prices:**
  - Stock: $9.10
  - Buy to close January 2019 $12 calls (bid/ask): $0.87/$1.58
  - Sell to close January 2019 $12 puts (bid/ask): $4.10/$4.85
  - Mid-range of bid/ask: $1.22 buy to close/$4.45 sell to close = a $3.23 net credit, rounded down to a $3.20 net credit.
- **Allocation:** We're taking our 0.4% exposure down to 0%, closing all of our contracts of each option.
- **Status:** Cover (close) all positions.

What We're Thinking

On Nov. 1 of last year, with GoPro stock at $12.85, we recommended our synthetic short at a net debit of about $0.75. Today, with shares just above $9, or 29% lower, we can close that synthetic short for a net credit of about $3.20. At that price, the recommendation as written has made about $2.45 per share while the stock is down $3.75 per share.

That discrepancy shows the cost of shorting calculated into the options prices. In fact, before shares became unavailable for shorting entirely, it cost more than 80% per year to short GoPro, which was why we went with the synthetic short. The trade has worked out favorably, with shares down sharply despite a strong market. With the business now starting to improve its financials, we're going to close our short exposure. Our shorting conviction is simply lower now than it was last November, and we've already capitalized on the stock's fall in price by nearly a third.

Improvements Coming?

After several quarters of growing losses amid much lower sales, GoPro cut its staff by 20% and lowered operating expenses by a massive 30% year-over-year as of its recent second quarter. While such cuts can be a death knell for a technology company, GoPro's refocus on just a few higher-end cameras, and on making its camera content mesh seamlessly with smartphones, has the potential to succeed. Management has been addressing the lack of focus and poor execution that helped drive our short position.

GoPro's $399 Hero5 Black camera accounted for more than 70% of camera revenue last quarter, and total camera units shipped topped 1 million, up 40% year-over-year. Management now expects total annual revenue growth of more than 10% this year (up from admittedly weak results a year ago) and full-year non-GAAP profitability (both to be achieved in the next four months), as well as growing opportunities overseas. Brian Withers wrote more for Fool.com, if you're interested.

How It No Longer Fits Into *Pro*

My overall skepticism about the company's long-term prospects hasn't diminished that much; I still believe it will be difficult for GoPro to increase profits reliably for years to come as competition grows. But with management committed to producing only enough cameras to achieve about 10% revenue growth and non-GAAP profits this year, and flat-out saying they won't meet any demand above that, I'm convinced they're managing for the long term. And given that, the odds of growing losses at GoPro are greatly diminished. The inventory gluts of the past may be over, and stability alone could help shares slowly recover.

Meanwhile, we have January 2019 options, and expiration is closer than it seems. If GoPro is about to enter a period of modest financial recovery, we don't want to keep our time-constrained synthetic short open. On its current trajectory, and with a new camera model due out this year, GoPro's business could do fairly well at least over the coming three quarters.

Today, we can sell our long $12 puts for about $4.45, providing us an effective net sell price on the stock of $7.55. That's good time value we'll capture with the shares at $9.10. However, we need to pay hefty time value to close our $12 calls, and we're doing that despite the stock only trading at about $9. It's simply not worth the risk to keep our short calls open. Our short has provided us with a profit in a rising market. With the business story starting to evolve, we'll take that gain and move on to the next thing.

Alternative Trades: You probably don't have any, since shares weren't available for shorting. But our advice is to close all short positions. If you just bought puts, sell to close those with a limit order.

- **Questions?** Please visit the Basket of Shorts board.

Sell (Close Your Position on) Gentex

Published Aug 22, 2017 at 1:18PM

Is this for you? This is for all members who have exposure to **Gentex** (NASDAQ: GNTX). We're ending all of our exposure to the company. If you're of the school that *never* sells anything, you don't have to join us, you can hold on; but otherwise, to follow the portfolio, exit the position with us. Note that **this stock is thinly traded, and limit orders are vital.**

How You Participate

- **Actions:**
  - Sell all Gentex shares, using a **limit order** at the active price (lately $17.20, but that will of course change). **This stock is thinly traded. Limit orders are vital.**
  - Buy to close your December 2017 $17.50 puts, using a limit order splitting the bid/ask at the active price (lately $1.15 - $1.20).
- **Allocation:** We're taking our 2.6% holding down to 0%, and we're closing all of our outstanding December 2017 $17.50 written puts.
- **Status:** Sell (close) all positions.

What We're Thinking

As described in our recent report on Gentex's second quarter, there's reason to believe the company's lower valuation multiples may have become its new norm. Gentex is now in a time of greater uncertainty than at any point since we bought the stock in 2012, thanks to a combination of macro factors (slowing U.S. auto sales) and technological ones (the market thinks self-driving and/or mirrorless cars will have a big impact on Gentex's business). Throw into the mix a recent short report that calls into question the validity of the company's financials, with accusations that are difficult to disprove because of the company's limited disclosures, and we've decided that we're happy to view this position through the rearview mirror. We're closing all of our positions in Gentex. As noted above, **this stock is thinly traded. Using a limit order is vital.**

By and large, the position has been a success since its inception in 2012, significantly besting the North Star via a combination of strong capital appreciation, a growing stream of dividends, and a series of options for income. We're content to close our position now rather than risk further erosion of capital based on the growing risks that come with a slowing auto market and a shifting competitive landscape. Although our position has done well over time, Gentex's cyclical nature and lack of pricing power have always kept it from being the ideal *Pro* stock, and we think we can find better places for our capital from here forward.

Alternative Trades: Our advice is to close all positions. (Remember about that limit order.) We're moving on.

- **Questions?** Please visit the Gentex board.

Pro Guidance Changes, Completed Trades, and More: Aug. 21, 2017

Published Aug 21, 2017 at 3:35PM

Pro Guidance Changes from the past week:

- **O'Reilly** (NASDAQ: ORLY) moves to Sell as our August 2017 $220 long puts were exercised, thus selling all of our 500 shares following last Friday's expiration, leaving our allocation at 0%. If you still own shares of O'Reilly and wish to align with *Pro*'s guidance, you should sell all shares you own.

Pro Completed Trades and Option Expirations from the past week (see transaction log; trades take a day to appear):

- Our O'Reilly August 2017 $250 short calls expired fully as income following last Friday's expiration.
- Our **Gilead Sciences** (NASDAQ: GILD) August 2017 $75 calls expired fully as income following last Friday's expiration.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Uncertainty Ahead for Gentex

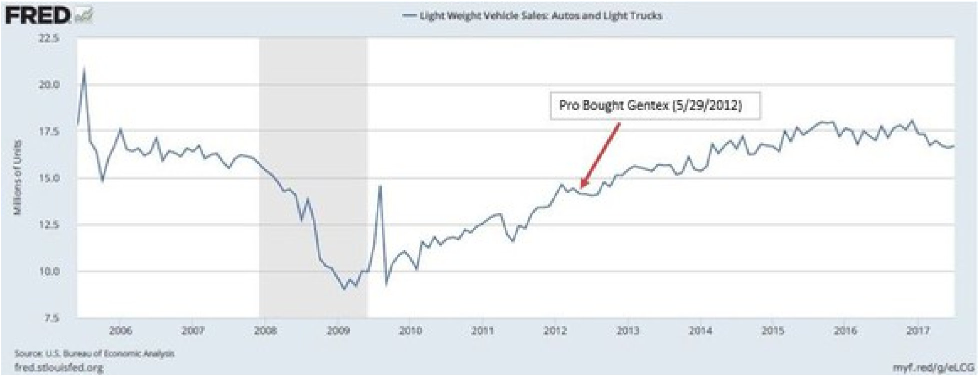
Published Aug 17, 2017 at 10:58AM

What Happened?

- Q2-2017 press release
- Q2-2017 10-Q

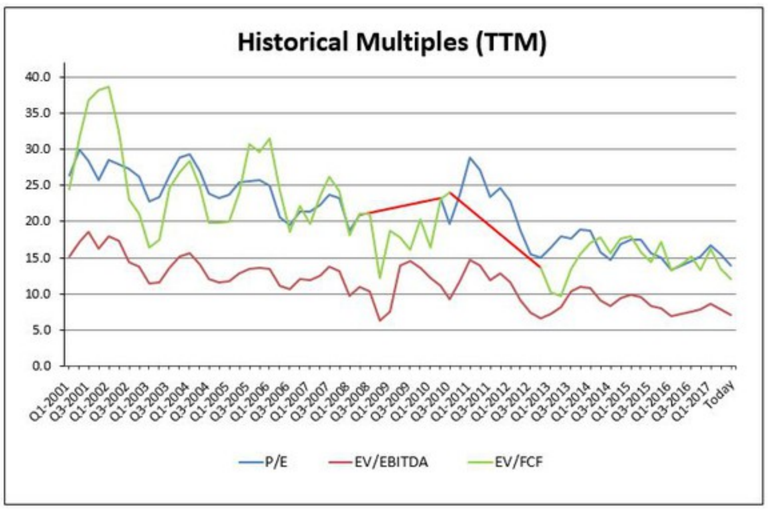
Guidance Update

Our maker of smart auto mirrors, **Gentex** (NASDAQ: GNTX), has released its second-quarter earnings, and after incorporating the results into my valuation model, **our fair value remains unchanged at $20.50 per share.** As mentioned in Jeff's writeup on the company in late July, there are several reasons to be cautious with Gentex, mostly surrounding macro issues and technology. For one, while we've ridden Gentex higher over the course of its history in *Pro* (since 2012), that's been coincident with an upcycle in the U.S. auto market that appears to be moderating:



We bought two blocks of shares in 2012, for a total of 4,400 split-adjusted shares with an average cost basis of $10.05 each. Since then, we've collected $7,248 in dividends and $7,554 in options premiums (net of the market value of our current December 2017 written puts). Including dividends, earned option premiums, and stock price gains since 2012, our annualized return on our original 4,400 shares has been 15.4%.

Although Gentex is now trading at lower multiples than it has throughout its history, we could argue that because of the macro-level and technology-based uncertainty, the stock no longer deserves to trade at the premiums it once enjoyed. Our thesis (summarized below) has come into question, and we are strongly considering exiting our position. But for now, the stock remains on Hold.



Red lines represent omitted outlier multiples that correspond to recession-depressed earnings and free cash flow levels.

- **Updated Guidance**: Hold (no change)
- **Recommended Allocation**: 2.6%, plus 0.9% in December 2017 $17.50 written puts.
- **Fair-Value Estimate**: $20.50 (no change)
- **Current Price:** $17.42

Our Thesis

Gentex will:

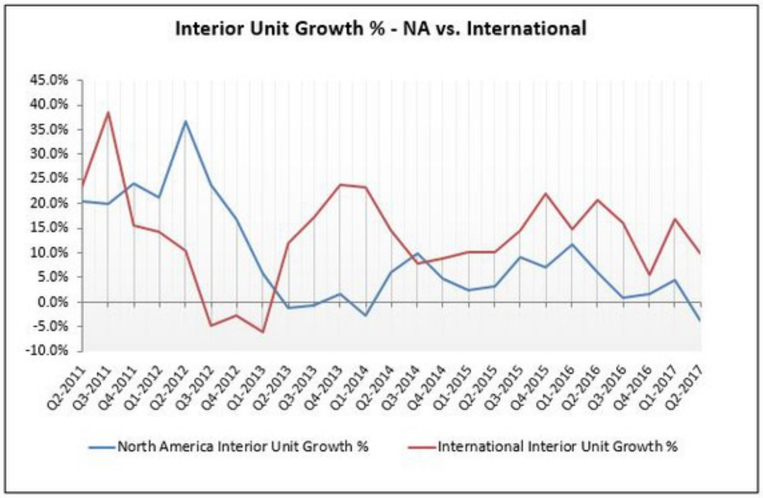
1. continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology, and ...
2. drive up the value embedded in each unit through new technology and functionality.

We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1. Penetration: Unit growth vs. auto production. Over time, we want to see Gentex's auto-dimming mirrors continue to gain market share. If the company is increasing units sold faster than autos are being produced, it's moving in the right direction. In the second quarter, global interior mirror unit volumes grew at 5.2% year-over-year (vs. 15.1% in the same quarter a year ago). This compares to a 1% year-over-year decline in auto production in the company's primary markets, showing that Gentex continues to significantly outpace vehicle production growth and capture market share.

However, interior mirror unit growth was significantly different when looking at North American vs. international markets. Interior units sold in North America for the quarter showed a 3.7% decline, down from 6% a year ago, and the growth rate for international interior units decelerated to 9.9% from 20.6% the year before. Since interior units account for about 72% of total mirror unit volume, trends in interior mirror unit volumes are important.



Exterior mirror unit shipments showed a similar slowdown in North America, with exterior unit volumes down 1.6% in North America from the 9.2% they posted in Q2 2016, but showing growth at 11.5% internationally, up from 8.8% a year before.

2. Pricing and value: Unit growth vs. automotive division sales. Powerful auto makers force annual price concessions on their suppliers, and Gentex isn't immune. Price reductions have recently been in the range of 2.5% to 3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices (ASPs) and gross margins.

In 2016, total units (interior + exterior mirrors) increased by 5.6% and automotive segment sales were up 5%. This dynamic suggests lower ARPU (average revenue per unit) and is consistent with the expectation of annual price concessions.

3. Margin performance. Gross margin came in at 37.7% in the second quarter, down from from 39.4% the year before. Management noted that the decline in gross profit margin is the result of annual customer price reductions (referenced above) that were not fully offset by reductions in purchasing costs. Also noted was the company's inability to leverage fixed overhead costs because of its unfavorable product mix, which itself was driven by a higher percentage of base auto-dimming mirror shipments vs. advance feature mirrors.

Margins have been declining consistently since peaking at 40.5% in the third quarter of 2016, which may indicate increased competition, lower leverage in negotiating with automotive suppliers, or a lack of corporate innovation around new features or reduced production costs.

What We Think Now

Gentex's safety-enhancing mirrors have continued to earn their place in new cars across the globe, and the company anticipates increased adoption of its products over the next few years. However, an increasing rate of change (and potential disruption) in the automotive industry has led to increased skepticism from the market, resulting in lower multiples than the company has seen historically. In the past, technology from acquisitions and in-house R&D fueled new product development and drove adoption of Gentex's feature- and technology-rich auto-dimming mirrors, but we're not so sure of the company's ability to continue that success. The company's competitive advantages may be in question, and the stock is on Hold until further notice.

If you have questions, drive on over to the Gentex discussion board.

Pro Catch-Up Trades and Upcoming Expirations: Aug. 17, 2017

Published Aug 17, 2017 at 10:54AM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week:

- **Coherent** (NASDAQ: COHR): Buy 2.3%.
- **Square** (NYSE: SQ): Buy 2.4%.
- **Verisk** (NASDAQ: VRSK): Buy 2.1%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.8%.
- **Oracle** (NYSE: ORCL): Buy up to 4%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- N/A

Hedges:

- New ones being considered.

This month's expirations (Aug. 18):

- **Gilead Sciences** (NASDAQ: GILD): With the stock below our strike price, our $75 covered calls are currently on track to expire as income this weekend. We'll consider new calls with a new trade alert.
- **O'Reilly Automotive** (NASDAQ: ORLY): With the stock below our strike price, our long $220 puts are on track to be exercised this weekend, selling all of our shares. Assuming this goes as planned, the stock will be moved from Hold to Sell on Monday as a matter of course. We don't believe O'Reilly is destined for failure, by any stretch, but we do believe headwinds in the retail industry in general will continue -- and perhaps grow -- as shopping habits continue to change. Given this concern, we're not comfortable owning O'Reilly at premium prices any longer (and that's where it still trades).

Put a Bow on It: Some Earnings Wrapped Up

Published Aug 14, 2017 at 2:48PM

Dear *Pro* member,

Let's review some earnings. [*Editor's note: These companies are not in alphabetical order as usual, but rather in the order in which Jeff wanted to write about them. We'll call it Jeffabetical order. Square, OpenText, Shake Shack, and GoPro, at your service!*]

Square (NYSE: SQ) reported excellent progress that suggests strong long-term promise. The company appears to be run exceptionally well, is headed in the right direction, has large opportunities, and is set to steadily expand its margins. It's addressing customer problems in ways others aren't -- and creating new markets, and an ecosystem, in the process. In addition, sequential quarterly growth on top of strong year-over-year growth usually speaks volumes about demand and the company's ability to execute on that demand. Well done. On top of all that, subscription and services revenue nearly doubled year over year.

Adjusted revenue was up 41% in Q2 over last year, up from 39% growth in Q1. Gross payment volume grew 32% to $16.4 billion, and larger sellers ($125,000 or more in annual GPV) grew 45% year-over-year to become 46% of total GPV, up from 42% a year ago. Mid-market sellers (more than $500,000 in annual payment volume) grew 61% over last year. Square's transaction-based revenue percentage and profits per dollar held steady even as it added more large customers.

The company's Square Capital loan volume was up 68% year-over-year, to $318 million. Under this unique offering, Square loans capital to businesses based largely on past sales and processes repayment on these loans directly from the company's future revenue. About 49,000 sellers are using this program, earning Square interest on the capital, and the average loan is $6,000. More than 90% of customers are automatically approved thanks to machine learning and analysis of past business results, making the loan process quick and easy. Businesses increasingly use it to bridge cash flow needs. Is there some risk here? Of course, especially early on while we wait for machine learning to steadily improve. So far, the loan loss rate has remained steady at about 4% (higher than at **American Express** (NYSE: AXP), but still a safe level). With improvements in process, it should head lower.

Square increased its guidance for the year to adjusted revenue of about $930 million, and adjusted earnings per share of $0.21 to $0.23. Management puts its revenue opportunity in the U.S. alone at around $26 billion. Most promising, operating margins improved 8 percentage points over last year, suggesting that margins will keep climbing higher over time. Meanwhile, Square targets a three- to four-quarter payback period on its new customer offerings and investments in the business. CFO Sarah Friar says, "We're always making sure we keep the balance sheet pristine." This is a tight ship on a good path. New to our portfolio (and to the Fool universe through *Pro*), Square is a Best Buy Now. We have a 2.4% stake and hope to have good cause to make it larger over time.

OpenText (NASDAQ: OTEX) is growing quickly, with revenue up 37% last quarter to $664 million. When we first bought shares five years ago, the company's sales were just above $1 billion per *year*. Much of this growth is from acquisitions, which is part and parcel of the strategy. Most of OpenText's revenue is recurring, making it easier to grow off the base, while renewal rates remain in the low-90-percent range -- companies need software to manage digital data.

On the heels of some large acquisitions, OpenText has $2.1 billion in net debt. The company also has ample cash flow to gradually pay it down, which is what we want to see. We've also been closely watching a years-old dispute with the IRS, which represents a potential $585 million liability; management, of course, strongly disagrees with this possibility, and discussions with the IRS continue. But on its results, the company is inexpensive, trading at less than 13 times expected earnings per share for the year ahead and 16 times trailing free cash flow. As fiscal 2018 starts, OpenText is focused on operating cash flow growth, margin expansion, and revenue growth, all of which will serve to strengthen the balance sheet. The stock remains a Buy; we have a 3.1% stake.

Shake Shack (NYSE: SHAK) is so far a "flat" short for us, while the Russell 2000 is up more than 14% over the past year. Perhaps the strong market is the main thing keeping the Shack afloat at all. Same-store sales declined 1.8% last quarter, and no matter how much management downplays this (citing a small store base and a 4.3% same-store sales gain a *year* earlier), the lag says something. The whole industry is struggling, but concepts with greater draw -- like **Starbucks** (NASDAQ: SBUX) -- should be able to increase same-store sales anyway. After all, the Shack improved its price and sales mix by 2.5%, yet still saw same-store sales decline because traffic fell 4.3%. Beyond today, as the hot "burger and fry" concept cools in years ahead, the hundreds of new restaurants that Shake Shack promises to open will debut to smaller crowds than in the past, partly because of weaker locations. Yet the stock still trades at 61 times expected earnings for the year ahead.

In a strong market, this short has treated us kindly at a 0% return. Management is on track to open 23 to 24 new company-owned Shacks this year, for unit growth of 37%. And they're doing other things right, too, including their digital efforts. But with labor costs rising and traffic headwinds, and with lower margins ahead, we're keeping the short open at this valuation. We're content to wait and see how much more the concept cools off, and we may finally add to this short if the stock rises to the high $30s again without good cause. We only have a 0.4% short right now (though for a short, that sizing isn't uncommon).

Finally, **GoPro** (NASDAQ: GPRO) surprised with better sales and lower costs than expected, leading to higher operating margins, although losses continued. Management is aiming for full-year non-GAAP profits by year's end. It's a tough call right now regarding what to do with our synthetic short. The company is downsizing, is more focused, and is executing better, and its CEO, Nicholas Wood, is having fun (don't discount the eventual value of that!). Most impressive, GoPro is repositioning its products to be an extension of your smartphone, a savvy (in my opinion) shift to draw new customers. Making GoPro cameras simply mesh with a phone will help, but it still operates in a tough market, and profits are far from guaranteed. We'll decide soon whether we want to keep the short longer or close it up.

To close on this August day, here's a brisk musical outro to see you on your way, with 32-year-old Mari Samuelsen.

As always, share any investing thoughts on the Memo Musings board, and Fool on!

-- Jeff (TMFFischer)

Pro Guidance Changes, Completed Trades, and More: Aug. 14, 2017

Published Aug 14, 2017 at 2:19PM

Pro Guidance Changes from the past week:

- None

Pro Completed Trades from the past week (see transaction log; trades take a day to appear):

- **Coherent** (NASDAQ: COHR): We bought 22 more shares at $219.56, upping our allocation by 0.15%.
- **Verisk Analytics** (NASDAQ: VRSK): We bought 57 more shares at $82.27, upping our allocation by 0.15%.

Some of This Week's Foolishness to Come

- **Coverage:** This week, we'll continue to review earnings from **Gentex** (NASDAQ: GNTX), **Paycom** (NYSE: PAYC), **Facebook** (NASDAQ: FB), **Broadridge Financial** (NYSE: BR), and others, and we'll be looking at new ideas including some shorts and hedges.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Aug. 10, 2017

Published Aug 10, 2017 at 2:29PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week:

- **Coherent** (NASDAQ: COHR): Buy 2.2%.
- **Facebook** (NASDAQ: FB): Buy up to half of our 8.1% stake.
- **Square** (NYSE: SQ): Buy 2.4%.
- **Verisk** (NASDAQ: VRSK): Buy 2.1%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.3%.
- **Oracle** (NYSE: ORCL): Buy up to 4%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.4%.

Pro options:

- N/A

Hedges:

- New ones being considered.

This month's expirations (Aug. 18):

- **Gilead Sciences** (NASDAQ: GILD): Our $75 covered calls are currently on track to expire as income. We'll consider new calls with a new trade alert.
- **O'Reilly Automotive** (NASDAQ: ORLY): Our protective collar remains in place and we're currently on a path to let our stock get sold via our $220 puts. If we do nothing, our $220 puts should sell our shares for us after next Friday. If this plan changes, we'll communicate before expiration.

Touching Base and Fighting Noise

Published Aug 10, 2017 at 2:00PM

Dear *Pro* member:

The S&P 500 is down 0.96% today as I write this, and the Nasdaq Composite is down 1.53%. This is not remarkable, except that we haven't seen much volatility for months. The S&P 500 is now down just 1.6% from its all-time high hit on ... Aug. 8. Two days ago. The only notable thing to change since then has been the saber-rattling taking place between the 71-year old president of the U.S. and the 33-year old dictator of North Korea. I don't have any words of wisdom to share on that front. But second-quarter earnings reports have been healthy, and if consumer confidence remains high, the U.S. economy should remain on stable footing for now (all else equal).

That said, I'm not here to defend the stock market. Stock indexes could easily decline by 10% and still be reasonably valued -- and if that happened, it's likely you'd nonetheless have much more value in your portfolio than you did one year ago. It's important to remember that price fluctuations are natural. Most investors should just wait them out, or use them as long-term buying opportunities.

In *Pro*, we want to protect against market drops with strategies that don't cost us dearly each year, but we're not concerned about market declines of 5% or so. Declines of 10% or greater, though, we do want to have some protection against. We've been working on new shorts and hedges over the past several weeks, along with earnings reports that need our timely attention, so it's likely that we'll have some new positions before long.

We remain confident in the positions we own, and we are ready to add to positions at any time. With our buys, we continue to have a three-year outlook at minimum, meaning today's market slide is not relevant to us. It's noise. Today, let's use the four criteria of noise as defined in Shawn Achor's book *Before Happiness* to help identify it, avoid it, and be more productive and successful as a result. Achor notes that noise is:

1. Unusable: Your behavior won't be changed by the information.
2. Untimely: You are not going to use the information imminently, and it could change by the time you're ready act.
3. Hypothetical: The information is based on what someone randomly thinks could happen, instead of what is.
4. Distracting: The information distracts you from your goals.

It's fair to say that much of the daily news fits these four criteria. And it's fair to say that most of our investing is based on "what is." We work to recognize what is a strong business, and invest in it. To us, "what is" is found in a business' stated financials, its place in its industry, its appeal to customers, its brand, its clear opportunities. These realities stand tall at the best companies, and position investors for growth down the road.

Today, though, we just wait. Meanwhile, it's a quiet time around Fool HQ. Many Fools are wrapping up vacation before school resumes, and we know many of you are vacationing in August! Enjoy, and bring any thoughts to the Philosophy & Strategy board.

-- Jeff (TMFFischer)

Pro Guidance Changes, Completed Trades, and More: Aug. 7, 2017

Published Aug 7, 2017 at 4:13PM

Pro Guidance Changes from the past week:

- **Coherent** (NASDAQ: COHR): Via Friday's trade alert, our allocation increases by 0.15%, to -- lately -- about 2.25%. Shares are a Best Buy Now.
- **Verisk Analytics** (NASDAQ: VRSK): Via Friday's trade alert, our allocation increases by 0.15%, to about 2.15%. Shares are a Best Buy Now.

Pro Completed Trades from the past week (see transaction log; trades take a day to appear):

- **Coherent** (NASDAQ: COHR): Late this afternoon, we bought 22 more shares at $219.56, upping our allocation by 0.15%.
- **Verisk Analytics** (NASDAQ: VRSK): Late this afternoon, we bought 57 more shares at $82.27, upping our allocation by 0.15%.

Some of This Week's Foolishness to Come

- **Coverage:** This week, we continue to go through recent earnings reports from **Gentex** (NASDAQ: GNTX), **Paycom** (NYSE: PAYC), **Square** (NYSE: SQ), **GoPro** (NASDAQ: GPRO), **Shake Shack** (NYSE: SHAK), **Facebook** (NASDAQ: FB), **Starbucks** (NASDAQ: SBUX), **OpenText** (NASDAQ: OTEX),.
- **Next Earnings: Broadridge Financial** (NYSE: BR) will report results on the morning of Thursday, Aug. 10.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Buy (More) Coherent and Verisk Analytics

Published Aug 4, 2017 at 12:04PM

Is this for you? This recommendation is for all *Pro* members who have year-to-date dividends to reinvest, or who have ample cash to make a small additional investment and want to match us.

How You Participate

- **Action and Allocation:** Buy 0.15% more in **Coherent** (NASDAQ: COHR) and 0.15% more in **Verisk Analytics** (NASDAQ: VRSK), raising these positions to a 2.25% and 2.15% allocation, respectively. At recent prices, *Pro* will buy about 21 more shares of Coherent and about 56 more shares of Verisk.
- **Price Guidance:** Use a **limit order** at the prices available when you place your order. We'll buy in the next one to 30 days.
- **Price Ranges (Aug. 3):**
  - COHR: $210.74-$221.98
  - VRSK: $82.23-$83.74
- **Guidance:** Both are rated Best Buy Now, Coherent with a fair value estimate of $280, and Verisk with $83.

What We're Thinking

As you probably recall, last quarter we outlined our plan to begin reinvesting our dividends when we see incremental purchases we're happy to make (assuming we'll still be comfortable with our cash balance post-investment). We have plenty of cash today at about 20% (ex-shorts), and we can afford to invest the net dividends we've collected since our last reinvestment in April. In the second quarter (April, May, June), we collected $9,414 total in new dividends that we're now going to reinvest. Usually we would reinvest in July, but we wanted to wait and see earnings -- so, bully for us! This time around, we're targeting two stocks we believe have been unfairly punished after reporting earnings this week. Here's what we're thinking.

Coherent

With only 24.7 million shares available on the market and $5.3 billion in market value, relatively small Coherent is lately our most volatile stock during a year in which we've had much higher-than-average volatility in several positions (both positive and negative). Coherent's price volatility was highly negative after its third-quarter 2017 earnings report, even though it recorded record results and boasts record backlog. The stock fell 21% the day after earnings, likely because Coherent is facing supply constraints with its recently acquired fiber laser business (it can't make the lasers fast enough), and because its fast-growing microelectronics business is booked nearly through fiscal 2018, so new orders there will start to be filled in fiscal 2019. This is a good problem to have in the long run, but having more business than you can handle right now is also a missed opportunity -- and Wall Street rightly hates that, because some sales will presumably go to competitors instead. Coherent is moving as quickly as possible to meet demand.

The good news in the immediate term is that Coherent's many business lines are performing well, with fast-growing microelectronics making up 52% of revenue, materials processing 31%, OEM components and instrumentation 11%, and science and government 6%. Service and parts (a decent recurring business) accounted for 26% of sales. After a record $464 million in third-quarter revenue, Coherent expects $465 million to $485 million next quarter. Lately at about $215, the stock trades at 15.3 times expected earnings for the year ahead. That's well below its five-year average P/E of 27.7, for what that's worth (we're not saying it deserves that, either; our valuation affords it a multiple closer to 20).

More importantly, the long-term story remains promising. As the need (and it is a need) for lasers in manufacturing increases, Coherent is set to serve existing customers on their evolving needs and countless new customers as applications grow. We need patience, however. The recent acquisition of Rofin-Sinar's fiber laser business is going well, but it will take several quarters before Coherent can meet all the demand it's seeing in that particular market. Thankfully, patience is what we have in spades. We're just weeks into a minimum three-year investment (assuming all goes well), and ideally much longer. This addition to our stake may be just the first.

Verisk

Verisk has managed to keep within striking distance of our North Star since our initial purchase in July of 2015, but it has been anything but smooth sailing for this prototypical *Pro* holding. The biggest reason for this has been the company's 2015 acquisitions of WoodMac, a global leader of commercial intelligence for the energy, chemicals, metals, and mining markets. In retrospect, this acquisition appears to have been mistimed (something we're all too familiar with as investors), leaving investors and analysts alike starting to question whether the deal will ultimately end up creating or destroying value for shareholders.

However, as long-term shareholders, we're not ready to throw in the towel on WoodMac just yet. So far, we've actually been impressed with WoodMac's resilience during one of the worst industry downturns in recent memory, and although we don't know when the energy market will turn in Wood Mackenzie's favor, we still believe that it's a question of when, not if. We want to make sure our stake in Verisk is large enough to see it make a meaningful contribution to the portfolio once the segment returns to mid-teens revenue growth, so we're taking this opportunity to continue building our position. This, our third addition to Verisk, is just another (very) small bite of what could be a larger portion down the road.

Though the stock fell by almost 4% on the heels of the company's second-quarter results, we're actually satisfied with what we saw. The insurance business finally reaccelerated, WoodMac reported positive revenue growth on a constant currency basis, and management continues to manage the company for the long run by making investments to both strengthen its core offerings and expand its total addressable market. One area where management has occasionally come up short over the years is in managing investor expectations. For better or worse, management has historically given aggressive guidance and occasionally downplayed issues that could impact the business in the near term. Although this is a moot point when you consider our position from a long-term investing perspective, it has meant a negative market reaction to what we consider acceptable quarterly results. However, since this affords us the opportunity to pick up additional shares after a price decline, we're willing to cut management some slack this time around.

The Foolish Bottom Line

As we reinvest each quarter to take advantage of the long-term benefits doing so will provide, we plan to pay at least a bit of heed to the fact that much is unknowable. Though what we're doing isn't "auto-reinvestment," in some senses we want it to be *like* that. We don't want to overthink it -- we want to think just enough. Nudge these two positions up by about 0.15% each if you have dividends you want to reinvest or more than ample cash and want to follow along. Helping to make this economically feasible, our trading commissions at Interactive Brokers are very low. Hopefully, given the commission wars going on, yours are, too. Fool on!

Pro Can Help

- **Want coherent answers about verified risks?** Please visit the Coherent and Verisk boards.

NVR and Verisign: Masters of Their Domain

Published Aug 4, 2017 at 11:34AM

What do homebuilders and domain-name registrars have in common? In the case of *Pro* companies **NVR** (NYSE: NVR) and **Verisign** (NASDAQ: VRSN), we're happy to report the answer is a rising stock price. Here's *Pro*'s quick take on both companies' second-quarter earnings.

With NVR's stock popping 8% the day after the company reported quarterly results, I think it's safe to say the market liked what it saw. The best-of-breed homebuilder saw an 11% increase in revenue, driven primarily by a 9.4% increase in settlements and a 2% increase in the average settlement price. Moderating construction costs resulted in an impressive 40% incremental operating margin, above the company's historical norms (high teens to low 20s during upswings in the housing cycle, low teens overall). NVR also enjoyed a $16 million tax benefit after adopting a 2016 accounting standards update; combined, these forces resulted in a 60% increase in diluted earnings per share.

Looking forward, new orders continue to be solid, with an 8% increase this quarter. And NVR's backlog of homes sold but not settled increased by 10%. This growth will likely be offset somewhat in the future by a shift in new orders toward lower-priced communities, given that the average price for new orders declined 2% this quarter, but a single decline doesn't make for a troubling trend. NVR's new order cancellation rate — a metric we track closely because it can give insight into the financial health of those currently shopping for a new home — came in flat for the quarter at 13%, good news to us because it represents a 300-basis-point sequential decline. All in all, this was a very solid start to our relationship with the company, and we still strongly believe it is well-positioned to compound value over the long haul. The stock remains a Best Buy Now.

VERISIGN™

Verisign's stock may not be acting like the ideal candidate for the covered strangle we currently hold (though we're definitely not complaining about a 28% gain in eight months!), but its *business* definitely is. The global leader in domain-name registry services yet again reported modest revenue growth and strong operating leverage, as well as continuing its aggressive share repurchases. As a bonus, management also completed a $550 million debt offering earlier this month; we believe this, too, will largely be used to repurchase shares, given the company's modest maintenance capex requirements. Last month, the company also reported that its .net registry agreement had been successfully renewed without any material changes -- we'd considered this a foregone conclusion, but we were still happy to hear it. This means we'll continue to see wholesale prices rise by 10% annually, with the next increase scheduled for February 2018.

With new domain-name registrations continuing to pace above 9 million per quarter this year (after three consecutive sub-9-million quarters to end last year) and the renewal rate recovering from the decline brought about by the Chinese surge we've [talked about previously](), management felt comfortable raising the company's full-year guidance. Likewise, we feel comfortable raising our fair-value estimate to $90 today.

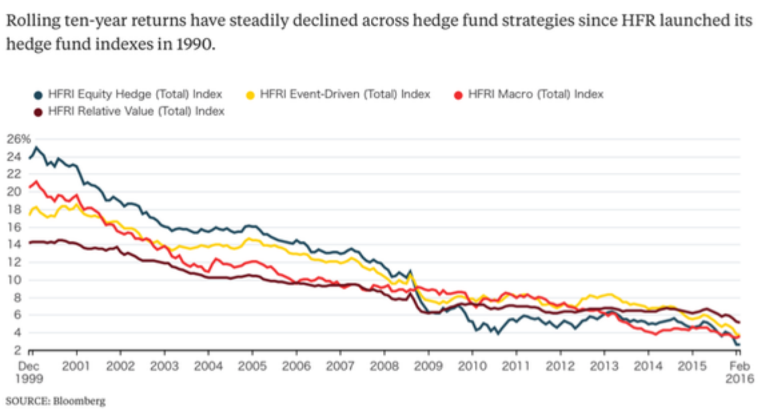
Hedging Our Bets, Part II: Change Is Coming

Published Aug 3, 2017 at 3:38PM

This article is the second in our series about the whys, whens, and hows of *Pro*'s approach to hedging. For the first, [click here]().

First, do no harm.

In recent years, this phrase, which is commonly associated with the Hippocratic oath, has been one of the cornerstones of our approach to hedging here in *Pro*. And to see why, one only needs to glance at how hedge funds have performed over the past many years. Spoiler alert for those who don't follow the industry closely: It isn't pretty. By and large, these funds' attempts to deliver the best of both worlds — above-average returns with below-average volatility — have brought about lackluster results since the 2008 financial crisis. In fact, according to data and analysis provider Hedge Fund Research, 2008 was the last year the industry as a whole outperformed the S&P 500.



Source: Kaissar, N. (2016, March 26). Hedge Funds Have a Performance Problem.

To be fair, there is far more contributing to the industry's woes than just hedging mishaps. But you'd be hard-pressed to make a convincing case that hedging isn't at least partially responsible. There are no free lunches when it comes to investing, so if you want to gain protection from an untimely decline in the market, you need to offer up something in return. And odds are that the more complete the hedge, the more it's going to cost you -- and eat into your returns while you sit around waiting for the market to fall.

This trade-off might be something we'd be willing to stomach if our only goal was wealth preservation, but here at *Pro*, we hold ourselves to an extremely high standard: We seek to achieve positive returns over rolling three-year periods while also doubling our real purchasing power every 10 years. Continuously exchanging upside for downside protection is a luxury we simply cannot afford when our North Star, our guiding light, steadily marches higher day in and day out. At the same time, however, forgoing any type of hedge also places our portfolio at risk of falling short of our investing goals during the next bear market. (Recent history may have lulled some investors into concluding that bear markets are extinct, but we do not share this opinion.)

So, how do you reconcile two ideas that appear to be locked in mortal combat? Although we would never claim to have all the answers here at *Pro*, we believe the best approach is to accept that there is no hedging panacea. Instead, one should look to effectively create a hedging arsenal from which you can select what you believe to be the optimal strategy at a given point in time.

Another Market, Another Approach

For many years, put ratio spreads have been *Pro's* hedging strategy *du jour*. With this options-based approach to hedging, we buy a number of put options, then sell more put options of the same underlying stock and expiration date at a different strike price; this strategy does a great job of minimizing (often completely eliminating) the cost of setting up a hedge, without capping your upside should the underlying ETF move higher. In fact, we've occasionally managed to set them up for a net credit, meaning we actually made money on our hedges when the market was flat or went *up*. As well, put ratio spreads can typically can be set up to start making money after only a modest decline in the market. However, there are two big trade-offs associated with these ratio spreads:

1. In selling twice the number of puts that we buy, we cap our maximum profit, and we run the risk that our hedge might actually start to accumulate losses if the underlying index ETF falls too much. That would mean our hedge could transform into a liability at the exact point when we want it working in our favor the most -- during a big market decline.

2. In most cases, it's hard to realize a sizable profit on a ratio spread prior to expiration, even if the underlying ETF falls to our written strike price. That's because a decline in the markets is usually accompanied by a spike in implied volatility, which in turn makes our our written puts rise in value.

   For example, if the QQQ (the underlying instrument for our current ratio spread) were to fall to the price associated with the maximum profit for our spread ($114 per share) at some point in the relatively near future, odds are we'd have an unrealized loss in our brokerage account in the neighborhood of $5 to $10 per spread. Although this loss would subsequently become a gain if the QQQ remained around this price come expiration (January 2018), the situation would be less than ideal -- we'd be forced to sit on our hands and wait to see whether our hedge would make money, while we'd prefer that it immediately buffer the portfolio from the decline, providing us with additional funds to invest and take advantage of the subsequent recovery.

We still believe that put ratio spreads are a valuable tool in our hedging arsenal, one we'll want to use for smallish hedges that don't cost us, and that position us to buy into the index at a price we favor. However, things have changed quite a bit for put ratio spreads in just the past several months. Let's take a look at a few of the intertwined reasons why.

Pricing

When we first returned to regularly using ratio spreads as a primary means of hedging in 2014, a three-month SPY ratio hedge that started making money after the market fell by 2.5% and would break even on a 15.5% decline could be set up for no cost. Today, put prices have deteriorated to the point where setting up a no-cost ratio spread of a similar duration and starting point would give you a breakeven point just 10% lower. Given that ratio spreads always run the risk of becoming a liability, this shift has made them relatively less attractive.

Macro and Market Uncertainty

We've found ourselves agreeing lately with Oaktree Capital's famous saying of "move forward, but with caution." As Howard Marks, investing legend and Oaktree co-founder, noted about the current environment in his most recent memo:

> The uncertainties are unusual in terms of number, scale and insolubility in areas including secular economic growth; the impact of central banks; interest rates and inflation; political dysfunction; geopolitical trouble spots; and the long-term impact of technology ... Pro-risk behavior is commonplace, as the majority of investors embrace increased risk as the route to the returns they want or need.

Now, as Foolish investors, we know that uncertainty is unavoidable when it comes to investing; in many cases, it's best dealt with by simply acknowledging its existence and getting on with your day. However, hedging and shorting require one to develop a more nuanced approach to dealing with uncertainty than long-only investments (the latter being the only approach where time is almost always on your side). Although we're still cautiously optimistic about the next three years, we don't sense that put ratio spreads are the best fit today given their aforementioned risks, including today's unfavorable pricing.

Valuations and Entry Points

Are market valuations high right now, relative to historical norms? Yes. Does this suggest that mean reversion (i.e., multiple contraction brought about by declining prices) should be a foregone conclusion? Not necessarily.

Over the past few years, we've heard many convincing arguments for why higher valuation multiples are justified in the current environment. However, it's worth noting that over the past three years, the S&P 500's P/E and EV/EBITDA multiples have expanded by 27% and 22%, respectively, while revenues have increased just 4% and margins — save for gross margins — declined slightly. We may very well have entered into a new era in which the justified multiple is higher than in years past, but if history is a guide, market sentiment will swing from its current bullish state to bearish at some point -- at least for a while. And it's not unreasonable to think that the recent multiple expansion could result in an even greater decline in the market if (when) this occurs.

So what does this have to do with ratio spreads? Well, they leave us on the hook to purchase shares at our written put price, and that means we have zero business setting up a ratio spread if our short strike price is not one where we'd be comfortable buying shares in *any type of market condition*. (Our last put ratio spread, rolled in April, has a breakeven price now 26% below QQQ's price, and has a long put strike 12.5% below the ETF's current level.) Given the aforementioned concerns, we've been unable to identify a new ratio spread that fulfills this key requirement. So we've decided to use a new approach for our forthcoming hedge, which we plan to issue to you soon.

Remember, as always, that you don't need to hedge to succeed. However, as part of our goals, in *Pro* we typically carry cash or hedges or both. To discuss this, please visit our hedging board. Fool on!

Pro Catch-Up Trades and Upcoming Expirations: Aug. 3, 2017

Published Aug 3, 2017 at 12:41PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week:

- **American Tower** (NYSE: AMT): Buy up to 4.2%.
- **Coherent** (NASDAQ: COHR): Buy 2.1%.
- **NVR** (NYSE: NVR): Buy 2.8%.
- **Square** (NYSE: SQ): Buy 2.4%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.8%.
- **Oracle** (NYSE: ORCL): Buy up to 4.1%.
- **Verisk** (NASDAQ: VRSK): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.

Pro options:

- N/A

Hedges:

- New ones being considered.

This month's expirations (Aug. 18):

- **Gilead Sciences** (NASDAQ: GILD): In the next few weeks, we plan to roll our August $75 covered calls higher if needed once time value dissipates.
- **O'Reilly Automotive** (NASDAQ: ORLY): Our protective collar hedge remains in place and we're currently on a path to let our stock get sold via our $220 puts. If this situation changes, we'll communicate well before expiration.

Coherent Gets Smacked

Published Aug 2, 2017 at 11:35AM

Dear *Pro* member:

Laser producer **Coherent** (NASDAQ: COHR) is having a very rough day, down 20% as I write this. As you've seen in recent weeks, this stock can be volatile even without news, sometimes rising or falling 5% day by day, but today's move is extreme for any stock. What gives? The company reported record sales, earnings, and backlog last night. Results were above the mid-range of management's own guidance, but fell short of average analyst expectations. Investors wanted still more from the company.

Even so, management shared that backlog demand now stretches out for nearly five quarters (through fiscal 2018), and the company is already investing for 2019 demand. Across the board, sales are strong and growing -- so much so that Coherent can't make enough of its high-powered fiber lasers (one of many types it sells) to meet demand. That, in fact, may be what's hitting the stock hardest. Investors hate to hear about supply constraints, because it opens the doors to competitors taking away sales. Coherent didn't give a time frame for solving this, but management is working as fast as possible to pick up the supply slack and meet all the demand that's out there.

I'm still going through results, but I had a bit more to say in several posts on the Coherent board last night and this morning (starting at post 112, at 5:55 p.m. last night), and members have posted, too. Anytime a stock moves sharply, you can bet we'll be on the appropriate *Pro* discussion board to address it. Shares remain a Best Buy Now, and we have a 2.1% allocation that we're considering adding to. (You will of course be the first to know if we do!) We just have a bit more research work to do first before deciding.

Here's to long-term investing -- and riding through the ups and downs in good companies.

-- Jeff (TMFFischer)

Hedging Our Bets

Published Jul 31, 2017 at 1:37PM

Interested in learning more about our approach to hedging? You're in luck! This is the first in our ongoing series on the whys, whens, and hows of *Pro*'s approach to hedging.

"Why even bother hedging?"

As the current bull market nears the halfway point of its ninth year, investors could be forgiven for asking this question — especially given the recent lack of volatility. However, to understand why *Pro* often has some type of hedge in place, you only need to go back and look at our Strategy Guide:

> Motley Fool Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years.

We believe that it will be impossible to consistently achieve our two primary objectives without thoughtful hedging. Since the start of 1990, the rolling three-year return for the S&P 500 has been negative more than 23% of the time. And although the annualized 10-year return has only been negative 14% of the time, it has come in below the bare minimum return required to double real purchasing power every 10 years, assuming zero inflation (7.18%), a daunting 66% of the time. This means that a single untimely decline in the market could significantly impair our chances of hitting our ambitious 10-year objective.

Data source: S&P Global Market Intelligence, author's calculations

By and large, *Pro* favors investing in companies we believe to be best-of-breed, not index ETFs. However, odds are that this will not be enough to protect our portfolio enough during the next downturn; widespread negative market sentiment often punishes the stocks of great businesses, too. Think of your favorite company during the bear markets brought about by the dot-com bubble and the global financial crisis (GFC). How did the stock perform? Odds are it took it on the chin, even if the performance of the underlying business didn't skip a beat. Among the current constituents of the S&P 500 and Nasdaq Composite, only 2% and 2.9% of them, respectively, had a positive return during the GFC bear market. And even fewer kept up with the North Star (0.6% and 1.8%, respectively). Things are a bit better if you look out three years from the market peak immediately prior to the GFC, but the odds were still stacked against you beating the North Star, with a mere 13% of the stocks in the S&P 500 and Nasdaq keeping pace.

	Peak to trough		Three years post peak	
	Postive return	Kept pace with North Star	Postive return	Kept pace with North Star
S&P 500	2.0%	0.7%	31.4%	13.5%
Nasdaq	2.9%	1.9%	25.0%	13.5%

Data sources: S&P Global Market Intelligence, author's calculations

"But JP," you might say. "Why are you so preoccupied with a recent history that just happens to include two bear markets brought about by bubbles?" To which I might reply, "Dear member, that's exactly the point." At the outset of the 21st century, no one expected two of the largest bear markets ever to hit in the following 10 years. The future is always full of surprises, and by actively hedging our portfolio, we aim to reduce the odds that negative surprises derail us from our investing objectives. Specifically, our hedges seek:

1. To protect our portfolio from a decline that would put us so far behind the pace of the North Star that our 10-year goal of doubling members' real purchasing power becomes unlikely unless we take excessive risks.
2. To provide the portfolio with an additional source of funds with which to take advantage of the eventual recovery in the markets after any meaningful decline, thereby increasing the odds we are still able to meet our rolling three-year target.

From a psychological perspective, these hedges serve as a tool to help us remain calm during a market downturn; they enable us to take positive actions to seize opportunities rather than becoming more defensive. They also serve to greatly reduce our reliance on timing market declines, a welcome benefit given that attempting to call the top in the market has historically been a foolish (lower-case "f") and costly endeavor — in terms of both explicit costs (shorting fees, option premiums) and of lost gains if the market continues to rise.

Because companies like Apple, Facebook, Visa, and MasterCard are continuously creating value for their stakeholders (and thereby justifying a higher stock price), a rising stock market often begets a rising stock market. This continuous value creation also means that "timing" a market recovery after a sizable market decline has become a much easier endeavor — over the past 18 years, the market has risen an average of 31% during the three years following a decline of at least 20%. Though the use of intelligent hedging, we aim to generate gains during market declines, then invest those profits to position the portfolio to earn even more during the subsequent recovery.

To talk about this with fellow Fools, head over to the hedging board.

Pro Guidance Changes and Completed Trades: July 31, 2017

Published Jul 31, 2017 at 11:58AM

Pro Guidance Changes from the past week:

- **Oracle** (NYSE: ORCL): Fair-value estimate increases to $48 from $46. Shares remain a Buy with a 4.1% allocation.
- **Visa** (NYSE: V): Fair-value estimate increases to $94 from $90. Shares remain a Best Buy Now with a 3.2% allocation.
- **Verisign** (NASDAQ: VRSN): Fair-value estimate increases to $90 from $87. Shares remain a Buy with a 1.7% allocation for our covered strangle.

Pro Completed Trades from the past week (see transaction log; trades take a day to appear):

- **Verisign** (NASDAQ: VRSN): Per our alert, we rolled our $90/$95 covered strangle to a $100/$105 covered strangle, expiring January 2018. We paid a $0.49 debit to roll.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: July 27, 2017

Published Jul 27, 2017 at 12:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our actively recommended stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, aim to follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Highlights this week:

- **NVR** (NYSE: NVR): Buy 2.8%.
- **Visa** (NYSE: V): Buy 3.2%.

Continue building your portfolio with our Buys, including:

- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Oracle** (NYSE: ORCL): Buy up to 4.1%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy up to 4.3%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.

Pro options:

- **Verisign** (NASDAQ: VRSN): Roll your covered strangle per yesterday's alert. This morning, you need to pay a small debit to do so, but we plan to before tonight's earnings.

Hedges:

- New ones being considered.

Next month's expirations (Aug. 18):

- **Gilead Sciences** (NASDAQ: GILD): We're going through last night's earnings release and will manage our August $75 covered calls as needed, rolling higher if desired after time value dissipates, or letting them expire if possible.
- **O'Reilly Automotive** (NASDAQ: ORLY): Our protective collar remains in place -- it's just a hedge -- and we're currently on track to let our stock get sold via our $220 puts. But ever wanting to be comprehensive, we'll go through last night's earnings release to make sure this is what we want to do and will update everyone.

The Pro Portfolio Surpasses a 200% Gain

Published Jul 27, 2017 at 12:26PM

Dear *Pro* member:

We're very pleased to announce that, this morning, the *Pro* Portfolio surpassed $3 million in value for the first time. This marks a 200% return since our inception in October 2008, less than nine years ago. About 3,200 days have passed since *Pro* opened its doors, so our $2 million in gains ($1.1 million of which are unrealized) amounts to earning $625 every day. It's equivalent to about a 1.87% yield on our money per month.

We're also happy to reach this milestone with all of our current long positions showing a profit since inception; over our history, more than 75% of our closed positions have made money. Not only that, we can report that looking back even farther -- way back to the original Fool Portfolio, which ran from 1994 to 2004 -- we're the first Motley Fool portfolio since then to return at least 200%.

Now, clearly we were aided by the timing of our launch, in October 2008. But the S&P 500 did fall another 30% after that, hitting its bottom in March 2009; and given our investment approach, even at the end of 2009 we still held more than 35% in cash. What I'm saying is, we didn't pile in during the downturn. We can't credit our gains to that. We simply invested over time -- and that makes our results all the more Foolish. We didn't do anything magnificent; we didn't time things just right (at all); we didn't zero in on one stock that then created most of our returns (although **Facebook** (NASDAQ: FB) is now 8% of the portfolio). In short, we aren't stock market geniuses. Far from it. We just patiently moved our money into strong companies and held them. We invested in some losers along the way, too, as well as (thankfully by design, so far) a rather modest number of shorts and hedges.

What we're saying is, anyone can do this, and the results over your lifetime are bound to surprise you. We may not expect the stock market to continue to rise over the next five years as much as it has in the past five, but the truth is that nobody knows, and we're bound to be invested in some large winners over the next five years regardless. Plus, the S&P 500 is only up 6.9% annualized since its peak in 2007, and its valuation is still within historical averages, so despite the steady ascent we can't write these consistent gains off as an anomaly. The market is just doing what it historically does.

Now what's all the more pleasing is that compounding continues to be our friend -- in fact, a better friend all the time.

To reach a 300% total return, we now need the portfolio to grow by "just" another 33%, to $4 million. From there, we "just" need another 25% gain to $5 million to hit a 400% total return. And so forth. Ever-smaller percentage gains on our portfolio's total value are required to double our original investment dollars. But I think that no matter how many times or in how many ways you consider it, compounding is more powerful than you can fully realize. We need to be in good companies for another nine, 18, 27 years to really see how much it can do. As Warren Buffett demonstrates so well, the vast majority of an investor's wealth is compounded in the last quarter of one's investing life.

That's not to say we won't face rocky periods and big setbacks. The stock market typically falls 20% at least once every 18 months. We're overdue for that. Even with hedges and shorts ideally helping us cushion the hits, we'll still have to build from a lower base after a fall. But that's how it works: Four steps forward, one step back -- sometimes a big step. This almost certainly won't be the only time we pass 200%. We'll likely fall back below this marker many times (even today!), and it may take a long time to get past it for good. But it's worth celebrating today.

We hope veteran members have enjoyed the past eight years and nine months with us, and we thank you profoundly. We also hope to serve new members with satisfying results. We'll do our best to keep improving our investment approach, to learn from our mistakes and weaknesses, and to capitalize on our strengths and successes. We always have a mind to improve the service and our communications, too.

Thank you for being a Fool with us! As always, to chip in with any thoughts or questions, visit the Memo Musings board.

Fool on!

-- Jeff (TMFFischer) -- also writing on behalf of Ellen, Billy, J.P., and all past *Pro* analysts and editors

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Roll Your Covered Strangle on Verisign

Published Jul 26, 2017 at 1:51PM

Is this for you? This recommendation is for investors already participating in our **Versign** (NASDAQ: VRSN) strategy. If you lack any position, consider the Alternative Trades at the end of this report to get on board.

How You Participate

- **Trade:** Use a multi-legged or rolling order on Verisign options to:
  - Buy to close your September 2017 $95 calls.
  - Buy to close your September 2017 $90 puts.
  - Sell to open January 2018 $105 calls.
  - Sell to open January 2018 $100 puts.
- **Allocation**: *Pro* will continue to write a covered strangle on all 500 shares we own. After completing this roll, this will represent a look-through allocation of approximately 3.4% (half in shares, and half through written put exposure).
- **Price guidance:** As we publish this, you would use a limit order and aim to roll your strangle for a net credit of at least $0.90. Prices may change, but should not change much; use a limit order, aiming complete this trade before market close July 27.

Pricing update (market close 7/26): Orders have pushed the cost to roll into debit territory, well below what we initially anticipated. Given that the primary goal of this trade was to capture additional upside by rolling up our short call strike price, we still intend to complete our trade before the close Thursday. But we ask that everyone continue to use limit orders to optimize the price to roll.

- **Prices (1:41 p.m. ET)**:
  - Stock: $101.11
  - Buy to close your September 2017 $95 calls, bid/ask: $7.55/$7.85
  - Buy to close your September $90 2017 puts, bid/ask: $0.63/$0.74
  - Sell to open January 2018 $105 calls, bid/ask: $4.20/$4.45
  - Sell to open January 2018 $100 puts, bid/ask: $5.00/$5.20
- **Note:** Earnings are due after the market closes tomorrow, July 27. We aim to roll before then to give our stock more upside breathing room... just in case.

What We're Thinking

We've been chasing Verisign, having rolled our covered strangle up and out twice this year, but the position is trying its hardest to be the one that got away. With the stock having moved up another 10.3% since our June roll, a strong earnings report later this week *could* push the price up enough that rolling up and out would be too expensive. Because we don't want to give back any of the $5.50 per share in income that we've extracted since setting up the position last December, we're opting to pre-emptively roll the position up and out to potentially capture an additional $10 in stock upside should the stock finish above $105 come expiration.

Although we're once again able to gain both income and upside with this roll, we do acknowledge that adding an additional four months to our current strangle makes two scenarios more likely: either our puts end up in-the-money, leading us to buy more shares, or we find ourselves in a situation similar to today, with the stock price making future rolls too expensive. Regarding the former: The $100 put price represents a purchase price that's 27 times our estimate for 2017 diluted EPS. Given the additional clarity we've received so far this year, we're comfortable with the prospect of picking up additional shares at this price (especially given that it excludes options income). And as for the latter, although it would be unfortunate if the strategy came to a premature end because we couldn't find an attractive rolling opportunity, it would be hard to consider the strategy anything other than a success at that point -- the options will have generated almost $6,000 in income to go along with our 32% return on the stock over 13 months.

Alternative Trades

- **New to this position?** If you can afford a potential $20,000 or so in shares (representing an initial look-through allocation of approximately 3% to 3.5%), buy 100 shares today and then "sell to open" the same January 2018 $105/$100 covered strangle described above (sell one call for every 100 shares now owned, and sell one put for every additional 100 shares you could buy). Use a limit order, you could lately collect about $9.40 per share in combined credit to write both options; you should demand a minimum of $9.30 for now.
- **Have you previously only written puts?** We suggest waiting until they expire before you consider writing new puts.
- **Have you previously only written covered calls?** You'll need to decide whether you want to put additional capital into the position to increase your potential capital gains. If so, buy back your previously written September $95 calls and sell January 2018 $100 calls for a net debit of approximately $0.90.
- **New and only want to write either covered calls or puts?** We're forgoing recommending a new sole put or call write this time around because we don't believe the risk/reward trade-off for either one is all that favorable, given the decline in the option premiums and the current stock price. (With the stock currently close to the $100 strike price, prices for out-of-the-money options in either direction are too low for our liking.)

Pro Can Help

- Questions? Register them on our Verisign discussion board!

Investing for Accuracy as Well as Growth

Published Jul 24, 2017 at 2:06PM

Dear *Pro* member:

The past six months have been a time of unusual transition in *Pro*, with more turnover than has been typical in previous years. We've been selling stocks that concern us and adding new companies, ones we believe are strongly positioned for our changing world and that should enjoy various tailwinds for the coming years.

However, conducting multiple stock transactions has its near-term downsides. It leads to higher costs, and your returns will typically stall or at least slow down as you wait for new positions to start to prove out after taking the place of older ones that typically suffered before you sold them. In this case, though, the strong stock market (and our strong positions) is helping our portfolio to a healthy 11.1% gain so far this year (as of this afternoon), and we're doing well on another measure that matters to us: accuracy.

Since we first launched in 2008, accuracy has been a key goal here at *Pro*. We define this to mean that we want at least 75% of our investments to end profitably. It's a common belief that if just more than half of your long stocks are profitable, you'll do well; Peter Lynch wrote that a 60% success rate is more than enough to "beat the market" in the long run. Our goal here is to come as close as possible to our always-positive North Star, and seeing profits on most of our long stocks is one key step toward that.

So, we're happy to report that all 25 of our current long positions have made money since inception . The strong stock market certainly helps, but plenty of stocks out there have been large losers in recent years, and we've avoided most of them (my ill-timed **American Airlines** (NASDAQ: AAL) call option trades come to mind as an unfortunate exception). We can, and should, celebrate our high accuracy, and call it out from time to time. Most investors accept having many losers as part of the process of investing, and they should -- losers are inevitable, and are great to learn from, so we strive to do so with our own mistakes. But overall, we do our best to avoid losers, period. (This is the perfect moment to note that we *expect* most of our hedges to be "losers," because they're mere insurance policies -- but we still count our accuracy goal against all our positions, including hedges, even though today we're focused on our longs.)

Not all of our 25 long positions have beaten the North Star or the S&P 500 (many don't come close), but all of them, including dividends or any options written on them, have generated a positive return now since inception (dividends aren't shown in our individual stock returns on our portfolio page, unfortunately). This accuracy is one big step in the direction of our two most important goals: earning positive returns every rolling three years, and doubling our real purchasing power every 10 years. The more we can avoid losers, the more likely we'll float close to our North Star over long periods -- as long as we also own some large winners for growth.

Now, I'm well aware that not all members have made money on all of our stocks. Far from it. Newer members are down significantly on positions such as **Gilead Sciences** (NASDAQ: GILD), and have lost on stocks we and veteran members sold for gains, such as **AmTrust Financial** (NASDAQ: AFSI). That's on us. We're working to improve our process. For instance, in limited cases, we want to keep new members from buying into certain positions at prices much higher than we paid, when merited, by erring on the side of caution. (This is reflected in our new Hold guidance definition, where we put anything on hold that we *may not* want to own the next three years.) We've seen how we can improve our guidance to serve everyone better; we're already working under that new construct, and we're looking to further improve on it.

But today's news should be reassuring to all members. Over the years, most of our closed positions have made money, and today all of our active long positions (our most important investments!) show a profit since inception. Even in a strong market, accuracy that tops 75% is something to celebrate, and something we hope to continue for you.

Thank you for being here. Please share any thoughts on the Memo Musings board, and Fool on!

Best,

-- Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: July 24, 2017

Published Jul 24, 2017 at 2:00PM

Pro Guidance Changes from the past week:

- **CurrencyShares Euro Trust** (NYSEMKT: FXE) moved to Cover.
- **Gentex** (NASDAQ: GNTX) moved to Hold.
- **O'Reilly Automotive** (NASDAQ: ORLY): Fair-value estimate decreases to $187. The stock remains on Hold/pending Sell -- the sell is pending via our long $220 puts, which expire in late August.

Pro Completed Trades from the past week (see transaction log; trades take a day to appear):

- **CurrencyShares Euro Trust**: We covered (bought to close) our 440 short shares, paying $111.42 to do so. Our position is now closed.

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Guidance Update: Gentex Moves to Hold; Plus, What Hold Means

Published Jul 20, 2017 at 11:13AM

The Details

- **Gentex** (NASDAQ: GNTX)
- **Recent Price:** $18.58
- **Fair-Value Estimate:** $20.50
- **Allocation:** 2.8%
- **Dividend Yield:** 2.1%
- **Guidance Update:** Shares move to **Hold** from Buy.
- **Option Position:** We are keeping our written December $17.50 puts open -- effectively also on Hold.

What We're Thinking

Seeking to improve our process for members in the wake of **AmTrust Financial** (NASDAQ: AFSI) and other sells made earlier this year, this spring we rolled out new practices and definitions on some key terms (they're detailed in the Glossary at the end of the Recommendations page). One of the largest changes was the following.

For us, "Hold" *used* to mean that members who owned the shares should keep them, but new would-be buyers should wait for us to complete a review of the position, usually within 30-90 days (sometimes we wanted to see a whole quarter). The status meant a short-term pause, so to speak, before a new decision. Now, however, "Hold" means something quite different.

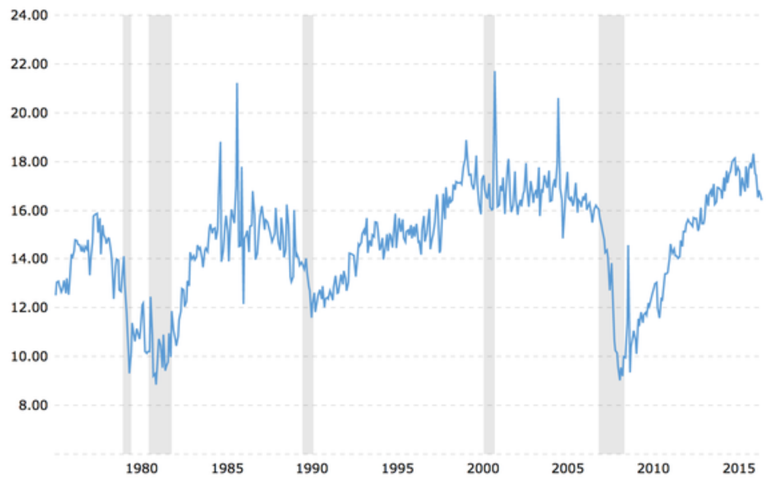
To help prevent new members from buying something that we may sell in months -- or even a few years -- "Hold" is now the label we use for any position that we're currently unsure we'll want to keep for at least the next three years. If we believe the position may be playing itself out (or if concerns are emerging for some other reason) and we're likely to exit a position within a few years, we now put it on Hold.

In doing so, we hope to prevent new members from buying something that we then end up selling too quickly for those new owners to really see results. Price changes in the short term can be random, after all. We saw members buy stocks last fall that we sold this spring, and we would like to avoid that (as much as possible) going forward.

Also, "Hold" now conveys to all members which positions we're currently considering exiting in the near future ("near" meaning less than three years). As you know, you look far ahead as you consider and manage your positions in a focused portfolio. The more transparent we can be with you about our thinking, the better. This ties into our recent decision to email you our meaningful guidance updates any day of the week (rather than sticking to a Monday-only schedule), as well.

Mirrors in the Rearview?

With Gentex, our concerns are mostly macro- and technology-based. On the macro side, auto sales have been nearing record results over the past few years (at 16.4 million annualized as of June), and although growing prosperity in emerging markets will bring still more buyers to the auto market, any slowdown in the U.S. or Europe will be keenly felt by carmakers and Gentex -- and a slowdown is almost inevitable at some point. This is nothing new; business here is cyclical. But after a long run higher, we may want to exit Gentex *before* having to ride through the next down cycle.



Auto and light-truck sales by millions. Source: Macrotrends.net.

Beyond that, we have concerns about technology making Gentex's auto-dimming mirrors appear quaint. "Heads-up technology" that puts data on car windshields, cameras, sensors, and autonomous driving all pose some eventual threat to Gentex's business. Will cars of the future be mirror-free? That sounds ludicrous today, but if you need to see behind you, why not look at a computer screen fed by a smart camera -- perhaps a screen enhanced with warnings and prompts -- rather than a simple mirror? Will Gentex develop the solutions of the future? With Tesla, Apple, Intel, Alphabet, Nvidia and so many others working on technology for cars, rethinking them from the ground up, there's a long-term risk that Gentex could be intermediated.

Beyond that, new concerns raised by a short seller have enough merit to demand more investigation; anytime we have business concerns, we need to shorten the leash, including on companies we have known and held for years.

We'll see quarterly earnings from Gentex tomorrow (Friday, July 21), before the market opens. Billy has successfully analyzed our Gentex stock for us for years, and has also generated significant income for us by writing puts on the stock. After we see earnings, we'll share our updated thoughts and let you know whether Gentex is going to remain on Hold for now, or something else.

For today, it moves to Hold. Owners can stay strapped in, as we are, but we're advising would-be newcomers to refrain from buying shares or writing puts because, at the moment, we may not want to keep our stock for at least three more years.

For any questions, please zoom over to the Gentex board. Fool on!

Pro Catch-Up Trades and Upcoming Expirations: July 20, 2017

Published Jul 20, 2017 at 10:42AM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.2%.
- **NVR** (NYSE: NVR): Buy 2.6%.
- **Square** (NYSE: SQ): Buy 2.5%, per our recent recommendation.

Continue building your portfolio with our Buys, including:

- **FactSet Research** (NYSE: FDS): Buy 2%.
- **OpenText** (NASDAQ: OTEX): Buy 3.1%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- None today.

Hedges:

- New ones are being considered.

This month's expirations (July 21):

- None! Enjoy the summer heat!

Pro Guidance Changes and Completed Trades: July 17, 2017

Published Jul 17, 2017 at 3:26PM

Pro Guidance Changes from the past week:

- **CurrencyShares Euro Trust** (NYSEMKT: FXE): Shares move to Cover (meaning close the short). They were previously on Hold (as a short). We are closing our entire short position, as shared in today's alert.
- **Square** (NYSE: SQ): Shares were introduced to the service last week as a Best Buy Now, with a 2.5% allocation.

Pro Completed Trades from the past week (see transaction log; trades take a day to appear):

- **Square** (NYSE: SQ): For a 2.5% allocation, we bought 2,800 shares at $26.13 average. (Our limit price obtained 1,608 shares at $25.98 the first day we could buy, and we bought the remaining shares at $26.33 the next day.)

You can see all of our guidance, positions, returns and transactions on or from the Recommendations page.

Close Your Short of the CurrencyShares Euro Trust

Published Jul 17, 2017 at 3:26PM

Is this for you? This is for all *Pro* members who are short shares of FXE, directly or using options, and who want to close as we do.

How You Participate

- **Action:** Buy to close (cover) your position in the **CurrencyShares Euro Trust** (NYSEMKT: FXE).
- **Price Guidance:** Use a **limit order;** this is a thinly traded Trust. Today, ideally set your limit at less than $111. Later, since the price is unlikely to move much anytime soon, use a limit order at prevailing prices.
- **Allocation:** We're closing all of our 440 shares, taking our 1.7% short allocation in FXE to 0%.
- **Today's Price Range:** $110.85-$111.06
- **Guidance:** Cover
- **Fair-Value Estimate:** N/A
- **Alternative Trades:** If you're using options to short the euro, and closing those options is logical (meaning they're not about to expire, or they're not nearly worthless, etc.), then close them to exit the position to match us.

What We're Thinking

Happily, our short of the euro via this exchange-traded trust has generated a positive return over the five and a half years we've held it -- and yet the European Union is in *better* shape now than it was when we started the position. That's a win-win for us, and for the world. That said, we don't want to overstay our welcome; several factors suggest that closing our short now is a sensible move.

Jeff's son, Grey, at the Eiffel Tower.

But first, some ancient Roman history: We first recommended this puppy way back in December 2011 using a synthetic short. We later let that position turn to short shares, then added directly to the short in April 2012. When we inked our original report, the euro-to-dollar exchange rate was $1.32. Today, it's nearly $1.15, down 12.9%. On paper, our short gained 14.9%. That's more than the decline in the euro thanks to the costs of the vehicle, but our gain comes to a bit less than the decline in the euro when you add *our* costs of shorting, which started once our synthetic short turned into shares. Still, overall, this has been a rewarding result.

Back to the Euro: At its worst, the dollar-to-Euro exchange rate hit $1.05 in January this year on hopes the new U.S. administration would be a positive for the former. We were looking for parity to the euro from Day One, and we were close to it this year, but then the tide turned. Still, overall, our patience paid off. After shorting FXE in late 2011 and April 2012, we didn't see gains until 2014. Waiting longer then to see how the European Union fared seemed rational, but our current patience has not provided additional payoff as Europe has begun to stabilize, and we think the tide may now be beginning to turn still higher for the euro.

Here's a 10-year chart of the USD/Euro exchange rate.

10-year euro chart. Source: Macrotrends.net.

Several recent factors suggest continued recovery for the euro:

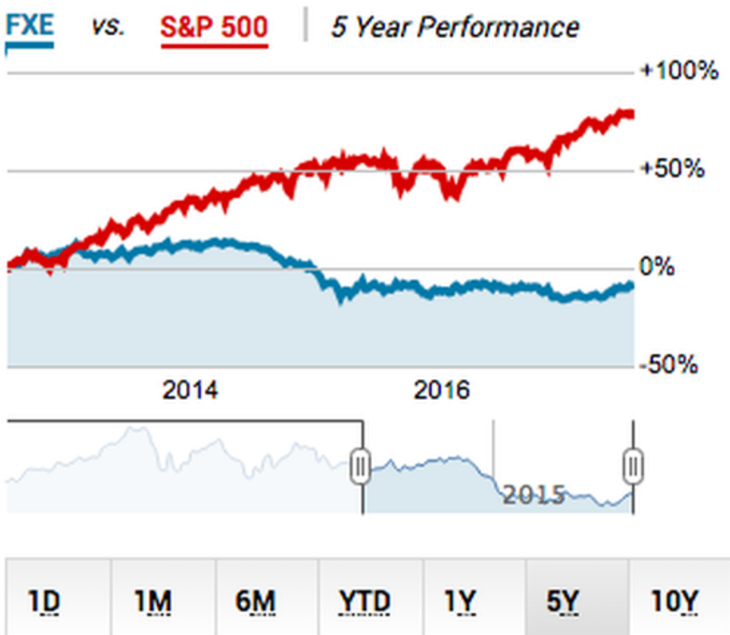
- The European Union's economy appears on pace to expand faster than the United States's this year. As measured by PMI manufacturing orders, new orders in Germany (the heart of the EU) in June outpaced U.S. orders by the widest margin since 2007, and German output prices (a measure of demand) are outpacing U.S. output prices by the widest margin since 2011. Both ramped up recently, suggesting the EU is finally headed toward decent growth, while the U.S. is now tepid.
- The European Central Bank (ECB) is tapering its stimulus now, positioning itself to begin to increase interest rates down the road -- something the markets will anticipate far ahead of time, just as they did with the dollar.
- According to Bloomberg, data shows that leveraged investment funds increased their euro positions to "net long" in June for the first time in more than three years. Whether hedged funds will be right or not, they're going bullish on the euro.
- Emmanuel Macron's presidential win in France is renewing political faith in the stability of the EU, as are some other developments. Greece recently reached an agreement with creditors to release more loans; an anti-establishment faction in Italy lost badly in local elections; and Spain's GDP is about to return to 2008 levels.
- Meanwhile, low inflation in the U.S. may slow the pace of interest-rate hikes in the land of the free, a possibility that hit U.S. bank stocks last week.

- Finally, the current U.S. administration is frustrated by U.S. trade deficits, and a weak dollar policy (whether intentional or as a result of gridlock) could be employed to improve deficits and claim a victory.

Couple all this with a euro that is still relatively depressed compared with its historical levels vs. the dollar, and our reasons to remain short are diminishing. Once, this short position had a lot of possible downside and little potential risk (that we could see), but now that situation has reversed. Our thesis has been played out for now.

How It (Once) Fit Into *Pro*

Our short of the euro served us fairly well. We earned a small gain while the S&P 500 soared over the past five years. A short of many U.S.-listed stocks or ETFs would have been a losing proposition on our strong market since 2012. Like a kid who follows the rules, the euro short caused us no such stress or strain.



S&P gains while euro loses. Fool.com.

And remember, the S&P 500 increased even as the U.S. dollar grew stronger, hitting overseas earnings at multinational U.S. companies, including many that we own. Our short of the euro helped hedge against lower overseas earnings at our companies in at least a small way. Nobody is talking about it yet (that I've seen), but now the weakening U.S. dollar should be a boost to foreign earnings at multinational companies, including all the ones we own. We welcome that.

And over the course of recent years, shorting the euro offered us a large potential return if the EU were to break up, but relatively muted risk if it didn't. That theory proved out.

As we close, we'll keep watching the euro; we could revisit the short if it appears merited. Currencies often cycle in valuation, and if the U.S. dollar just peaked in January, the euro may have years to appreciate now. If it can recover to $1.40 or higher, we may want to short it again, but that will depend on the circumstances, of course. For now, we'll get out of the way, closing our short.

Should we next *buy* shares of FXE, going long? Well, we'll at least consider it. (What do you think? Tell us on the boards!)

Pro Can Help

- **Looking to cash out your short, but have questions?** Visit our FXE discussion board for an exchange rate that's Foolish.

Pro Video Chat, July 2017

Published Jul 17, 2017 at 3:20PM

The *Pro* team will be holding **a live video chat on this page at 1 p.m. Eastern on Thursday, July 20**! We'll be using Slido to communicate with members during the chat; the specific Slido code for the event is #ProChatJuly -- you can join in by clicking here or by going to the Slido homepage and entering #ProChatJuly. We recommend opening Slido in another browser tab (or on a mobile device) so you can see both the video and the Slido questions at once. See you soon!

Pro Catch-Up Trades and Upcoming Expirations: July 13, 2017

Published Jul 13, 2017 at 12:52PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.1%.
- **Coherent** (NASDAQ: COHR): Buy 2.6%.
- **Square** (NYSE: SQ): Buy 2.5%, per yesterday's recommendation.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy up to 4.5%.
- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2%.
- **WisdomTree Emerging Markets SmallCap** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.3% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **Gentex** (NASDAQ: GNTX): Write (sell to open) December 2017 $17.50 puts for an additional 1% potential stock allocation, lately for about $1.10 each.
- **Gilead Sciences** (NASDAQ: GILD): Set up a covered call by selling one Aug. 18, 2017, $75 call for every 100 shares you currently own, per our recent alert. Lately, this can be done for $0.81, or a 1.1% yield in 36 days.

Hedges:

- N/A. New ones are being considered.

This month's expirations (July):

- None! Hey, we figure you're on vacation, right?

Buy Square

Published Jul 12, 2017 at 2:22PM

Is this for you? This is for all *Pro* members who are comfortable with a young, just-turning-profitable recent IPO. We have our usual long-term outlook: a minimum of three years and ideally much longer.

How You Participate

- **Action:** Buy 2.5% in **Square** (NYSE: SQ).
- **Price Guidance:** Please use a **limit order;** this is still a thinly traded stock. Today, ideally pay less than $26. Later, the stock will remain a Best Buy Now until we change that status with an update.
- **Today's Price Range:** $25.16-$26
- **Guidance:** Best Buy Now
- **Fair-Value Estimate:** $26-$34 (putting us at $30 for now)

What We're Thinking

Plenty of Foolish investing success can be achieved simply by being observant in your daily life. Whether it's seeing where lines appear for daily coffee, or spotting how many coworkers' screens are actually on Amazon.com, or noting *how* people are paying for transactions, being mindful of what's happening around you helps fuel new investment ideas, especially in the consumer arena.

Over the past few years, we've witnessed more and more businesses and individuals using Square payment products at the point of sale (POS). Our initial thoughts were that this was a crowded field, that the company lacked advantages, and that we already owned the credit-card giants, so we didn't need to buy Square. But that thinking has changed.

The field *is* crowded -- but with patchwork solutions. In contrast, Square has created a complete e-commerce ecosystem that is proving sticky. Customers are staying with it for its ease, versatility, and data analytics, all at a reasonable cost. It's also worth noting that Square may not ultimately be riding on the credit-card giants, because it *can* be agnostic on payment methods in the future.

And it's not just about moving money around. Square's related software helps a company manage its inventory, employees, payroll, deposits, gift cards, and more. Our own Billy Kipersztok is launching a pizzeria in Gainesville, Fla. (that's the *real* news behind this trade alert!), and he and his business partners went with Square after evaluating several offerings. Billy wrote:

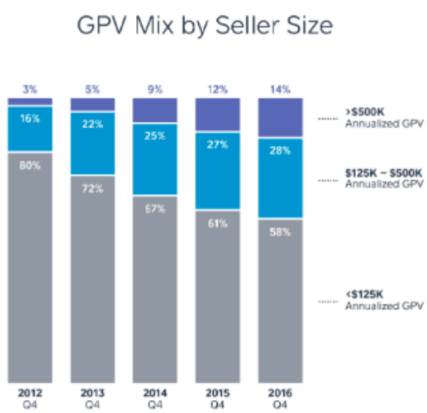
> "They are, from my research, the best and most complete solution. It is incredibly useful to have your POS, payment processing, payroll, loyalty program, and employee management all with one vendor -- with online ordering as well [Square's Caviar service]. This allows us to have one login for all of this data and information that is completely integrated, rather than having to manage several accounts across several vendors. [This also leads to] excellent data granularity and reports for business analysis ... There are many companies who do different links of this chain, but Square is the best, most clean, most professional solution I've seen. Not the cheapest, but the best."

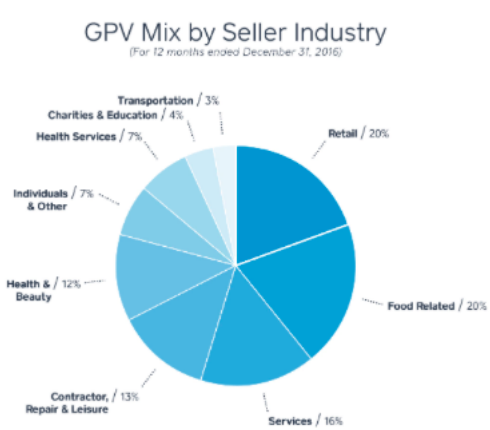
The Business

Founded in 2009 with a mission to spread economic empowerment, Square's app-based commerce ecosystem positions it to run circles around older solutions. Providing the same tools once available only to large businesses, Square is helping smaller sellers succeed -- and doing it well enough that bigger companies are going with Square, too. In a nutshell, Square provides a way for any business to accept digital payments and track and analyze the related data. Square accepts [major credit cards,](#) and its platform should adapt to new digital methods that may arise.

In the year ended Dec. 31, Square processed $49.7 billion of gross payment volume (GPV), which was generated by about 1 billion card payments from approximately 245 million payment cards. In doing so, Square earned $687 million in adjusted revenue, up 52%. Now, Square is increasingly serving larger sellers -- those generating at least $125,000 in annualized GPV. These larger sellers represented 42% of Square's total GPV in the fourth quarter of 2016, an increase from 39% a year before. Square's transaction-based revenue (or "fee") held steady at 2.93% of dollar volume even as customers grew in size. We expect this "take" to slip over time, but it should remain healthy well above 2%.

The following charts from Square's 2016 10-K SEC filing show how its customer base is growing to include more large vendors, and how Square is spread across various industries:





Source: Square 2016 10-K

Many of us have interacted with Square -- buying from a local business, signing the screen and leaving a tip, getting the receipt via email. It's simple, quick, and appealing. It's also mobile. The taxi fleets in Washington, D.C., are adding Square to all cars, for instance. And household services (i.e., plumbers, etc.) account for 16% of GPV, as customers pay the bill on the spot using Square. But while it's attractive, the mobile and countertop hardware that Square offers is not where it makes its money; equipment is offered free, or at a deep discount, to land a customer. Square profits on the subsequent transactions, and increasingly on software and services as well. Its operating system works with Apple and Android, and can be set up so quickly that a vendor can accept digital payments within minutes. Various software modules can be added at the start or later, leaving Square plenty of up-selling opportunities as a customer expands.

Beyond transactions and software, Square offers Square Cash, which individuals can use to send money between themselves free of charge or to pay a business (in which case the latter pays the normal Square fee). And Square Capital, through a partnership with an FDIC industrial bank, makes loans to businesses based on the business's payment processing history with Square. With the use of its data, Square can fund businesses with loans, and better manage the risk of default. From May 2014 through December 2016, Square made 200,000 loans worth $1.3 billion. Finally, as mentioned by Billy above, Caviar is a Square service (a website and app) that makes it easy for restaurants to offer food delivery. Square collects a fee each time. This ancillary business serves Square's sizable customer base that operates in the restaurant industry.

Financials

Square is investing in growth. It won't provide its customer count beyond saying "millions," but that's likely very the low millions, with the opportunity far surpassing its current size. The company remains U.S.-centric, but it's so far launched in Canada, Japan, Australia, and the UK, with more new markets likely. Given its newness, you might expect it to be losing a lot of money today, but Square turned profitable on a pro forma basis last quarter, and increased pro forma profits are expected in coming quarters. Full-year positive GAAP earnings should finally emerge in 2019. Square benefits from about half of its new vendors arriving thanks to word of mouth rather than marketing efforts.

Within a few years, the company should be showing the power of its recurring revenue business, with healthy margins and returns on investment. The brand, market share, market opportunity, and likely profitability should make today's valuation reasonable. We are looking several years ahead and seek to remain invested as long as the financials appear on the right long-term trajectory. To help propel it, Square enjoys $545 million in net cash as of April 30, and earned $56.5 million in positive free cash flow the past 12 months.

Over the longer term, assuming profits increase and its competitive moat holds, Square should be able to maintain a premium valuation multiple in line with those of other payment leaders including **PayPal** (NASDAQ: PYPL) and **Visa** (NYSE: V). The stock trades at about 25 times expected earnings (an educated, but reasonable, guess) for 2020. That's not cheap. But it's also not uncommon for this type of business, let alone one set to grow as much as Square.

Risks

Founder and CEO Jack Dorsey is also CEO of **Twitter** (NYSE: TWTR). We don't like that his attention is divided (especially if he spends much time surfing Twitter itself!), but many successful CEOs are busy in similar ways, whether on corporate boards (or corporate yachts) or overseeing a few companies (or even just multiple divisions in one truly giant company). The competitive risks are many, so we need to be as sure as possible that Square continues to offer a compelling solution with advantages that make it unwise for customers to switch. We face the risk of changing forms of payment or even payment methods (including crypto-currency), and we're already keeping abreast of those amazing developments. Regulations are also a risk for the whole industry. *Pro* already has exposure to **MasterCard** (NYSE: MA) and Visa, so there is overlap here, for sure. Additionally, Square rewards employees with stock, so share dilution will continue.

How It Fits Into *Pro*

We always have a desire to populate *Pro* with more high-quality growth companies -- leading businesses that are strongly expanding revenue and free cash flow. These "next-generation" companies should ultimately boost our returns even more than our investments in large, established giants. We want to invest in powerful long-term trends with branded and profitable leaders, and Square is poised to become that in the digital-payment space. We have significant exposure to the sector called "financial/technology" already, but there's a reason for that, and each investment therein serves a purpose.

Consumer spending still drives 70% of the U.S. economy, and though the retail space (outside Amazon.com and a few others) has been a train wreck, we nonetheless want to invest in the consumer in various ways. MasterCard, Visa, and Amazon are our largest, most obvious investments in consumer spending. But at $135 billion, $220 billion, and $478 billion in market value, respectively, they're not small companies. At $10 billion in market value, we're hoping that Square is another way to invest in consumers -- in commerce in general -- with a company that could grow considerably over the next five to 10 years.

Pro Can Help

- **Want to square up with us?** Please visit our new Square board for a linear experience.

Guidance Update: Paycom's Fair-Value Estimate Increases

Published Jul 11, 2017 at 12:16PM

The Details

- **Paycom Software** (NYSE: PAYC)
- **Recent Price:** $68
- **Fair-Value Estimate:** Increases 9.6% to $57.
- **Guidance:** Despite the premium valuation, the stock remains a Buy at a current 3.1% allocation.
- **Alternative Position:** If you lack shares and want to target a lower potential buy price, consider "selling to open" August or November 2017 $65 or lower puts. Sell one put for every 100 shares you could buy.

What We're Thinking

Paycom runs the payroll and provides human capital management (HCM) software for about 18,000 companies and their more than 2.7 million employees. It offers a complete human resources cloud-based software solution "from hire to retire," covering everything from benefits administration to compliance to expense management. Since the stock was recommended here in November, it's up 61%, running well ahead of expectations.

The quarter that ended in April was the first time the company surpassed $100 million in quarterly revenue (with $119.5 million), increasing sales 39% year-over-year. What's better, those aren't sales it will enjoy just once. A full 99% of revenue was recurring in nature, and that recurring revenue is growing. Once a company signs with Paycom, it's not only likely to stay, it's also likely to give it more business.

While Paycom's sweet spot has always been businesses with between 50 and 2,000 employees, its software does scale well beyond that without meaningful additional costs. Last quarter, Paycom signed a workforce solution company with more than 6,500 employees, and a hospitality company with more than 6,700. As the company swims upstream to larger clients, already high profit margins could trend even higher, and its long-term picture gets still brighter.

All clients must sign up for Paycom's payroll service to get started; after that, they have the option to seamlessly add more than two dozen other human resources-related software modules at any time. Most clients end up using at least half of the available modules, padding Paycom's revenue with each one. And there's plenty of room to grow; Paycom sees its annualized revenue-per-client-employee opportunity at about $400 (as of 2014 – it purposely hasn't updated this since then), but today it earns closer to just $120 annually for each client employee.

Paycom is also gradually opening new sales offices around the country (each one takes time to ramp up), meaning the business has plenty of room to grow organically, geographically, and by increasing its sales to existing clients.

And Wall Street is catching on to the favorable attributes of Paycom's business model, sending shares higher. A founder-run business started in 1998 that had its IPO in 2014, Paycom is still young, and its $4 billion market value is dwarfed by its industry's total size. As long as Paycom continues to take market share and sign on young companies, someday it might be as well-known as a current industry leader, **Paychex** (NASDAQ: PAYX).

Our investment made in November is up 61% so far, well ahead of what we hoped for. Of course, our outlook focuses on the next five years (or longer!), and members should be aware that there's a chance the stock could give back some ground, or go nowhere, for a good while. This is another case (of many) in which we want to own a business for the long term, so we're willing to wait through some potential fallow periods in hopes of higher returns later.

Plus, if we sold now to capture this short-term gain, we might miss any good chance to get back in later -- and after short-term taxes, it'd be tough to come out ahead either way. As well, software leaders can maintain premium prices for years – just look at **Salesforce** (NYSE: CRM). So, as long as we still believe in Paycom's business and the stock's potential, we'll stay in it, as our Foolish investing principles dictate. We have a 3.1% allocation, and the stock remains a Buy as part of our long-term portfolio strategy.

To discuss it anytime, just visit the Paycom board. Fool on!

Pro Guidance Changes and Completed Trades: July 10, 2017

Published Jul 10, 2017 at 3:32PM

- *Pro* Guidance Changes from the past week:
- **O'Reilly Automotive** (NASDAQ: ORLY): The stock moves to Sell from a previous Hold. We still have our protective collar, though, so please read today's update for context.

Pro Completed Trades from the past week (see transaction log; trades take a day to appear):

- **Gilead Sciences** (NASDAQ: GILD): We sold to open nine August 2017 $75 calls, covering all of our shares, being paid $1.29 each.

You can see all of our guidance, positions, and transactions from the Recommendations page.

O'Reilly Automotive: A Sell in Process

Published Jul 10, 2017 at 3:32PM

Is This for You? Yes, if you own O'Reilly Automotive with us. If you have a protective collar, you don't need to do anything; just wait. If you own shares, please be aware that we're waiting to sell ours via our puts at expiration. Since our shares are as good as sold (completely hedged out), those without options should consider selling, too; read on for details.

How You Participate

- **Stock: O'Reilly Automotive** (NASDAQ: ORLY)
- **Recent Price:** $172.74
- **Action:** Those with the protective collar don't need to do anything, just wait; those with only shares should be aware that we're positioned for our shares to be sold in August.
- **Allocation:** 3% -- on track to be sold to 0% by Aug. 18 via $220 puts we own.
- **Scorecard Status:** Moving from "Hold and Protect" to "Hold Pending Sell" because of our put options -- read more below.
- **Fair-Value Estimate:** Roughly $150-$200. The present fog makes things too uncertain for us to publish a more meaningful number; we do know lower same-store sales will hit margins, affecting cash flow, and may change store opening plans. But more important to us now are the changing competitive landscape and expected long-term headwinds.

Foolish Summary: As long as O'Reilly Automotive shares remain below the $220 strike price of the August puts we own (at $172, they're lately 22% lower), we plan to let our shares be sold at expiration on Aug. 18 for $220 apiece. Accepting the long-term gain on our shares in this way is more tax-efficient than the alternative, selling our shares directly and also selling to close the $220 puts, which lately have a nearly 900% short-term gain. By letting the puts be exercised, we avoid the short-term tax bill on the options, booking all of our gains in the long-term stock position instead. We bought at $99, which makes this about a 124% long-term gain in just over four years. For members who joined much later and haven't done well with this position, please read on.

If you have options on O'Reilly with us: Right now, we plan to do nothing and let our shares be sold at $220 via our puts at expiration Aug. 18.

If you just own the stock: We're ready to sell come Aug. 18, and right now we're not inclined to keep our stock, despite its lower price, so Sell is the logical guidance. That said, please be aware that given the negativity of investor sentiment right now, the stock *could* fall enough in the next five weeks to lead us to revise our plan, instead "selling to close" our puts (to capture our gain) and keeping the stock to wait for a recovery. If that happened, we'd have to tell members who previously sold that the stock was returning to Buy. But that's OK. At any rate, it's more likely that we won't change our stance, and we will simply let our shares get sold on Aug. 18.

If the situation changes, we'll update you, and you can adjust!

Scorecard Status: If everyone used options and owned puts, we would just keep the stock at "Hold and Protect," and wait and let it play out. But some members only own shares. Given that, we’re moving the stock to Sell (for them) on the assumption that’s what we’re going to do. This is the most logical step when trying to address both audiences, so the stock is moving to Sell (from Hold and Protect), even though members with options don't need to sell right now -- but should instead use the puts to sell at expiration. It can be costly to call and exercise options early, and we have no pressing reason to do so.

What We're Thinking

Investors have quickly grown leery of auto-parts retailers. The bogeyman named **Amazon.com** (NASDAQ: AMZN) showed its face to the industry early this year, and O'Reilly investors grew increasingly skittish as business the following six months proved tepid -- same-store sales are up just 1.3% against 3% to 5% guidance. Though Amazon isn't making a difference to the business yet, investors are fleeing the company and its competitors. Down the road, a backdrop of more electric cars with fewer parts and more autonomous cars causing fewer accidents doesn't help. All of these concerns are taking a toll on sentiment even as the business has been stable so far in 2017 – sales are even up this year. In most cases, we'd likely view this negative sentiment as an opportunity.

The market looks far ahead with retail, though, and it doesn't seem to like what it sees. One reason *Pro* bought Amazon.com early this year was because online shopping is becoming the *first impulse* habit of more and more consumers. This is a shift: By default, older generations always used to think of running to a store first to buy something. But younger generations look online first, and then only run to a physical store if they need to. For a growing number of shoppers, the Internet is the first place to shop.

O'Reilly believes it's insulated from this risk by the fact that people often don't know which auto part they need; this, plus assistance with installation, often necessitates a physical visit. But if companies (and I mean Amazon, but others, too) are serious about selling auto parts online, artificial intelligence should make it ever easier to discover which part is necessary, order it, and tell you how to install it -- all online. Even before the same-store sales disappointment, members and Fool analysts alike were discussing the long-term outlook for O'Reilly, and how soon distant risks could emerge. It's unfortunate timing that external short-term factors (including weather) hit the business while we considered the long-term risks on our thesis.

Lately, O'Reilly trades at about 15.7 times trailing earnings and 9.2 times EBITDA, both below market averages for a company that has performed far above average for years. The last few quarters may be a short-term anomaly, and the stock may recover nicely if a coming quarter or two are stronger, but odds don't favor the old days returning anytime soon. Even before the stock started to fall, we were considering whether it still belonged in *Pro* for the long haul.

How It Fits Into *Pro* (or Moves On)

As we've shared before, this is a transitional year in *Pro*. We're selling many positions in many cases because we see the competitive landscape changing and headwinds forming. As we replace positions in which we lack faith, we're buying new ones that should have long-term tailwinds. Turnover has costs, and assuming we're right, it will take some time to see most of the benefits.

Because it's a retailer, we wanted to give O'Reilly a short leash no matter what -- to be prepared to sell if we saw challenges forming for the business. Even if the stock price were much higher today, we'd very likely be writing this report and exiting the position because of the long-term challenges likely ahead. It just happens that the stock declined on other factors first. That's unfortunate, especially for new owners, but it's on us now to look ahead and make decisions that should benefit us in future years.

As we position ourselves for the next five and 10 years, it's hard to imagine sentiment turning markedly positive for auto parts retailers -- barring, perhaps, a big surprise jump in same-store sales. Employment, which feeds miles driven, which drives these auto parts businesses, may be about as strong as it can get. The drumbeat of electric cars, autonomous vehicles, and vehicle sharing will continue to get louder. And online sales giants who are willing to cut margins to the bone are a growing threat. At the very least, it's fair to say that the competitive landscape is changing, consumer habits are changing, and perhaps the parts industry itself is going to change as cars evolve.

This all led us to the question of whether O'Reilly still fit into our portfolio, and we set up our protective collar to prepare to potentially sell it. The business itself looks to be facing too many headwinds to fit well with our focused portfolio. If at some point it became incredibly cheap (a cigar-butt value stock), we might want to consider it for a shorter-term value investment. We still believe in management. But right now, the sell price we set up is favorable, and the stock isn't cheap enough for us to merit keeping it in light of the risks.

In Summary

Assuming Gentex remains below $220 (it may not), our protective collar will sell our shares for us at $220 by Aug. 18 if we take no action. That's currently our plan. Since we anticipate a sale, the most accurate guidance for us to give to those without options is also Sell (though it's a pending sell). We doubt this guidance will change, so members should feel free to sell now or as we do next month; but if the guidance does change, we'll alert everyone, of course. We're trying to serve different investors using different tools, so please forgive the awkwardness of that! This situation does show how much more flexibility options can provide.

Questions? We may not be very skilled under the hood, but please visit the O'Reilly board to ask anything germane to this investment.

Our North Star to Guide Us

Published Jul 6, 2017 at 2:41PM

Dear *Pro* Members:

We hope your summer is off to a Foolish start, one dappled with sunshine and glimmering water, time with family and friends, perhaps travel to exotic places, and some new stock investments, too.

Here in *Pro*, we aim to combine all those things into one successful outcome. Over the next few months, we'll be judging how this summer has turned out, and we'll rate our stocks compared with years past ("How are our businesses doing?") and on the returns we find in the years ahead. As we do, we'll be taking stock of the things we do differently here in *Pro* -- one of which is our North Star.

The North Star

In 2011, we introduced the North Star to *Pro* members as a way to guide our investment and portfolio decisions. Our North Star metric consists of the broadest U.S. measure of inflation (the CPI-U), calculated monthly by the federal government, plus 7% per year, added mostly in increments.

Since 1971, this measure has grown by more than 11% annualized, topping the S&P 500's total return index by more than one percentage point per year. This tells you that inflation has roughly averaged 4% per year.

What are we driving at with the North Star? The ideal is that we will at least double your "real" (read: after inflation) purchasing power every 10 years. That's no small feat; historically, it would mean topping the return generated by the S&P 500 with all dividends reinvested. That venerable index tops most investors handily even with dividends excluded.

Guiding Light for Positive Returns

It's important to remind you that the North Star is not a benchmark – it's a guiding light. Having it at the forefront of our minds should help us make decisions that we hope will lead to strong investment returns even as we have less than 100% market exposure (which means lower risk). Lately, we're about 82% exposed to the market. Sometimes, that exposure will go much lower.

A second part of our goal is to achieve positive returns every rolling three years. That goal, plus the pace of our North Star, plus our desire to double your real purchasing power every 10 years, all serve to remind us of our aim to avoid the worst of the market's declines. We can't afford a 40% drop and still hope to meet our three-year goal, for example.

We're not market timers, but by managing our exposure (through all means available: cash, options, hedges and shorts), we hope to be able to decline less than the market when the market declines.

The S&P 500 is not our benchmark, and our North Star reminds us not to chase the market with abandon when it goes up and up, because we have to be set up more defensively than average when the market turns south. Anyone who laments their returns not going up as much as the market when it rises (whenever that happens) should remember that they're less than 100% invested, and they should benefit with a smaller drop when the market declines.

Driving Returns

The next part of our equation for compounding returns demands that we buy good companies. We believe we have done this. Of course, not all of our stocks will always go up -- some will fall out of favor in the marketplace, and others will falter -- but historically we have bought companies that reliably increase their income and free cash flow. Historically, the vast majority of our stocks have grown in value. We hope to improve upon that going forward, fine-tuning our selection process, and getting better at the rare sell decision, too. We can always improve.

And we always want to, because your market exposure and hedging tools mean little if you're not putting the bulk of your money into strong businesses that deliver long-term results.

Keeping Returns

Last month, our North Star passed a milestone: It is up 101% since *Pro's* 2008 inception, less than nine years ago. Up 185%, the *Pro* port has passed the North Star so far (as well as the S&P 500, incidentally), but our gains are vulnerable in the short term to the market's whims, while the North Star's total return will never be lower than it is today. The North Star will keep going up (barring greater than 7% deflation). That's the rigid taskmaster we strive to emulate. We want to keep growing your value in the market over time, and we want to protect what we have achieved so far the best we can, because the North Star will keep growing in that way.

This is what we're working toward as we make our portfolio decisions and share them with you. Today's little missive serves as a reminder to old-timers here, and may even be new to those who've joined us more recently, and I hope you enjoyed this pause for reflection on our overall investing mission.

Thank you for being here. We hope you enjoy the summer evening! Fool on!

-- Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: July 6, 2017

Published Jul 6, 2017 at 2:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.1%.
- **Coherent** (NASDAQ: COHR): Buy 2.3%.
- **NVR** (NYSE: NVR): Buy 2.6%.
- **Visa** (NYSE: V): Buy 3.1%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.4%.
- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.3%.
- **Oracle** (NYSE: ORCL): 4.1%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 4.1% (and don't write calls on it if you're new to it).
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2%.
- **Verisign** (NASDAQ: VRSN): Buy 1.6% and then look to set up a covered strangle.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.4% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **Gentex** (NASDAQ: GNTX): Write (sell to open) December 2017 $17.50 puts for an additional 1% potential stock allocation, lately for about $0.75 each.
- **Gilead Sciences** (NASDAQ: GILD): Set up a covered call by selling one August $75 call for every 100 shares you currently own, per our recent alert. Lately this can be done for $0.85, or a 1.2% yield in 1.5 months.
- **Verisign**: We rolled our June strangle out and up to a September $90/$95 strangle earlier this month. Those who own at least 100 unencumbered shares can look set up this short option strangle for a credit of approximately $4.40. Those lacking the position who can buy at least 200 shares (100 now and potentially 100 later) with it all being a 3% or smaller allocation, lately will pay around $93.50 for the first 100 shares, and can simultaneously write the covered strangle, leading to a net debit of approximately $89.10 per share.

Hedges:

- N/A

This month's expirations (July):

- N/A

Pro Catch-Up Trades and Upcoming Expirations: June 29, 2017

Published Jun 29, 2017 at 12:50PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.1%.
- **Coherent** (NASDAQ: COHR): Buy 2.2%.
- **NVR** (NYSE: NVR): Buy 2.6%.
- **Visa** (NYSE: V): Buy 3.2%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.4%.
- **Apple** (NASDAQ: AAPL): Buy 4.5%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.3%.
- **MasterCard** (NYSE: MA): Buy 5.1%.
- **Starbucks** (NASDAQ: SBUX)**:** Buy 3.3%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2%.
- **Verisign** (NASDAQ: VRSN): Buy 1.6% and then look to set up a covered strangle.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.4% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **Gentex** (NASDAQ: GNTX): Write (sell to open) December 2017 $17.50 puts for an additional 1% potential stock allocation, lately for about $0.85 each.
- **Gilead Sciences** (NASDAQ: GILD): Set up a covered call by selling one August $75 call for every 100 shares you currently own, per our recent alert. Lately this can be done for $1.29, or a 1.8% yield in 1.6 months.
- **Verisign**: We rolled our June strangle out and up to a September $90/$95 strangle earlier this month. Those who own at least 100 unencumbered shares can look set up this position for a credit of approximately $4.30.

Hedges:

- N/A

This month's expirations (June):

- N/A

Write Covered Calls on Gilead Sciences

Published Jun 26, 2017 at 1:09PM

Is this for you? This is for *Pro* members who own at least 100 shares of Gilead Sciences, and who wouldn't mind capping upside in return for near-term income. Those who own less than 100 shares can sell the shares now (since we're accepting that we might lose our shares with this position), or wait to see whether we sell at $75 through our covered calls (if we do, we'll move the stock to Sell on our scorecard).

How You Participate

- **Action:** Sell to open August 2017 $75 calls on **Gilead Sciences** (NASDAQ: GILD).
- **Allocation:** Write ("sell to open") one call for every 100 shares owned. *Pro* will cover all 900 shares we own, representing 2.2% of the portfolio.
- **Price Guidance:** Prices will change as the stock moves, but use a **limit order** to split the option's current bid/ask spread. When we quoted it, that was around $1.35. Later, aim for about a 1% yield (option premium/current price of the stock) per month to expiration.
- **Guidance:** The stock remains a Hold; newcomers are advised to stay out, given that we're accepting a possible sale of our shares. Our fair-value estimate remains at $80, and assumptions are based on revenue stabilizing, which it may not yet.
- **Prices** (12:30 p.m.):
  - Gilead: $71.33
  - August 2017 calls (bid/ask): $1.34/$1.36
  - $1.35 pays 1.9% ($1.35/$71.33) in 54 days. Don't accept much less.

What We're Thinking

Since the June 16 expiration of our previous covered calls on Gilead Sciences, the stock price has increased by 11% to more than $71 per share; the **iShares Nasdaq Biotechnology** index (NYSEMKT: IBB) has rallied 8.8% over the same time frame . We're taking this opportunity to reinitiate our covered call position at a higher strike, bumping up from the $70 strike in June to $75 in August with this alert. We continue to wait to see what unfolds with Gilead's revenue trajectory, while cushioning our risk and targeting income at the same time with our covered calls.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up**: If the stock price rises above our strike price by expiration, we may let our shares get sold, or roll our calls to a later date. We'll see closer to expiration.

Pro Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the Gilead board.

Pro Video Chat, June 2017

Published Jun 26, 2017 at 9:48AM

The *Pro* team will be holding **a live video chat on this page at 3 p.m. Eastern on Monday, June 26**! We'll be using Slido to communicate with members during the chat; click here to learn more about how that works. The specific Slido code for the event is #ProChatJune -- you can join in by clicking here or by going to the Slido homepage and entering #ProChatJune. See you soon!

Transcript

Ellen: Hello, Pro Fools. Welcome to our June live chat. I am Ellen Bowman. I'm the editor and publisher of Pro and this is JP Bennett. He is the JP-est analyst we have. Are you -

JP: The JP-est analyst. I like that.

Ellen: I blanked on if you're a research analyst or I don't remember what your formal title is.

JP: I'm still employed. [crosstalk 00:00:20] For all intents and purposes, I am still employed at the moment.

Ellen: JP is an employed analyst at The Motley Fool. Then we have Billy Kipersztok on Skype. Say hello, Billy.

Billy: Hello, Ellen.

Ellen: Hello! Billy is a senior analyst. We do not have Jeff Fischer with us today because Jeff Fischer is in France enjoying a much deserved vacation. He may be watching. We can't get him to quit us, no matter how hard we try. He might be tuning in, but we do not have him with us in the studio today.

Billy: Jeff, if you're listening, write us a question.

Ellen: Yes. Communicate to us in a secret code. If you would like to join in, which we hope that you do, please use Slido to do so. You're going to want to go to Slido dot com and enter the code ProChatJune, all one word, ProChatJune. There's also a link above this video player on the page that you're watching it. That is where you can enter and vote on questions and then we will answer the ones that get the most votes. We'll just go through the hour doing that and proceed.

Let's look at the first one we got is from Bruce. It says, "Are you suggesting," so we sent a Gilead trade alert as part of our Monday memo, "Are you suggesting that we sell Gilead at 75 dollars? The recommendation seems to suggest that with less than 100 shares, one should exit the position now."

Billy: Bruce, I think we are not explicitly recommending that you sell. I think more the intent of the alert was to provide a choice. For those of you who have less than 100 shares, you have two Options. You have one which is to just sell the shares now because if you remember with a covered call, essentially it's a contract agreeing to sell the shares at a specified price. We're basically agreeing to sell the shares already by writing these calls.

That's one choice. You can sell the shares now or the second choice is wait and see whether the stock price rises above 75 and Pro ends up selling its shares and if and when Pro does that, you can sell alongside us.

The two choices depend upon how much risk you want to take on or whatnot. If you're more conservative and you're fearing downside, you might sell now or if you would like to have Gilead appreciate more or you're looking more for some upside, you might wait and see if we end up selling at 75, but we're not specifically recommending that you sell now. It's just you have a choice to either sell now or wait and see if we sell and sell alongside us.

Ellen: Cool. The next one is from Lon. Hello, Lon. I hope you're having a lovely summer.

Lon says that since Jeff and others are fans of chocolate, he wishes us a Happy Chocolate Pudding Day. That is extremely kind. Thank you.

JP: Thank you, Lon. I love pudding.

Ellen: Yes. We will enjoy Chocolate Pudding Day. Johnny Loves Beaches says, "Greetings to Pro and welcome back to Jeff." He's not back yet. I'm sorry, Johnny Loves Beaches. You'll have to put up with us. "I would love to know your thoughts on O'Reilly since it's been around the 220 range at the bottom of our collar." Thank you, so we will ask JP I think to channel Jeff.

JP: Yep, I will tackle this one. I think there was another question on O'Reilly. Yeah, Bruce asked one down and I'm just going to loop both of those in together and so to start, with respect to O'Reilly, yes it is down near the bottom half of our collar.

If you kind of take a step back and you look at why we set this up, it was go back a couple of months. O'Reilly was struggling versus the market and then The New York Post put out the article about, "Oh man, Amazon's going to get into this industry and it's going to be really competitive," and then people start chattering about autonomic striving maybe coming a little bit quicker than some people had anticipated. Those longterm threats are starting to weigh on this stock.

We looked at those and we're like, "All right, those are serious threats, but in terms of impacting O'Reilly's business, that's more of a longterm plan." That's going to take a couple years to really start to play out, even if autonomic striving does kind of take hold at a much quicker rate than people were originally anticipating.

In the interim, O'Reilly is still a pretty awesome business so the returns on invested capital they're going to be able to generate in that short to medium term would necessitate us, or suggest that we should keep it in the portfolio because the stock had been getting hit, and so the valuation in terms of the returns for the business that they should be able to generate would make sense to keep O'Reilly around and see if that's what played out.

That was our original thinking, but then as time went on, we had more news about retail and Carl Icahn getting into this base and all of these other factors starting to weigh on the stock. When we saw those things, we kind of had to take a step back and say, "All right, this is a big development because this could essentially be the bridge that kind of provides the negative headwinds in the short and medium term and gets us to the longterm." If that is what's going to play out, then O'Reilly is going to be troubled for now to the point where we get to those longterm risks.

Because of that, we still want to give management some credit because they've been able to navigate some issues in the past. We don't want to just be a little bit quick to jump the gun and get rid of the stock when there is still potential there. By setting up a collar, we can essentially give ourselves this time where we can let things shake out, see if it really was just a tax issue, if it was a timing issue with regards to weather being bad when they wanted to be good and being good when they wanted it to be bad, but if we progress through the year and it looks like those aren't just temporary factors and these other bigger issues are starting to take hold of the business, then we have the exit that we were looking for and we're not going to just ride this one all the way back down.

If you go down to the other question in terms of, "I don't have 100 shares of O'Reilly. Should you sell at these levels or hold since you can't participate in our Options trade?" I think it kind of gets back to what I said in terms of our original thesis for O'Reilly. We love having businesses that we can essentially buy and hold forever, right? That's the thing that a lot of longterm investors like to anchor their process around.

However, there are very few businesses that are buy and hold forever businesses. O'Reilly was one of those 15 years ago. Is it one of those today? I don't really think so and so it was more of at this point, we want to have it for the next couple of years, but we understand that there are longterm threats that would probably necessitate us exiting the position sooner rather than later. It was more an issue of timing when we wanted to get out of the position once we saw these longterm threats develop.

If you look at the collar, maybe if prices enable us to roll it down at a very attractive rate, we'll consider doing so, but for all intents and purposes, when we set it up, it was, "If it pushes through the lower half, we're just going to probably let these shares go. If it pushes above the sold calls, then we may look to roll." If you think about it in that kind of frame of mind, if you aren't optimistic about the longterm prospects for the business and you think there are immediate or near-term headwinds and you're really looking for businesses to own that you really think you can own for the next 10 years, it may be a position that if you're looking for cash, that you want to exit.

We are still kind of wait and see mode. We want management to show us that it was temporary issues. There isn't a fundamental shift. You look at something like Brick and Mortar Retail and Clothing and things like that, The Buckle, a position that we had in the past that we had to get out of because there was essentially a fundamental change taking place within the industry and management was, if we're being perfectly frank, doing a horrible job at reacting to it.

There's this fine line where you want a management team to stick to what they're really good at and focus on that and not go down too many different avenues and divert their attention and lose focus, but at the same time, you need them to be cognizant of how the landscape is changing and what role they need to play in order to remain relevant.

Right now, you hear management. They want to stick to their guns. They want to stick to what they do best and they think they still have this potential to continue to compound value at a great rate for the foreseeable future, but we've heard that story countless times before in other industries where that wasn't the case. We're very much in show me mode.

Ellen: That was an excellent answer.

JP: Mm-hmm (affirmative). I'm doing my best to channel Jeff today.

Ellen: Well you did wonderfully. All right, Bruce and Johnny Loves Beaches, I hope that that was a good answer for you because I found it extremely enlightening. [Dabcha 2 00:09:00] says, "NVR has crept up a bit. It's still recommended today in the memo. Any more to elaborate on what confidence we have on the home building sector?"

JP: This one is for me too. NVR is very much a case of if you look at Pro and how it's constructed, we want businesses that zig when others zag. We don't want everything that just goes up and all gets crushed at the same time. If you look at it in that context, we want businesses where we're really optimistic about the next three to five years that they're just going to absolutely crush it, assuming the overall economy and the markets hold up.

NVR is one where the industry tailwinds are more of a longterm play and so it is one where we have a lot of confidence in the five to ten year time span. You want those businesses. You don't want to be overly focused on a near-term objective of having positive returns every rolling through year period and lose focus on our number one goal, our longterm goal, which is the double wheel purchasing power every ten years. You need to have those businesses that you have a strong conviction in over ten years of going to really compound value at an amazing rate and be those winners because although accuracy is one of our top priorities in Pro just because of how Pro is structured and our overall objectives, we are also cognizant of the fact that in many cases, you're going to have a couple positions that just really crush it. The impact they're going to have on the portfolio as a whole is going to be outsized.

I would say you look at something coherent, like an NVR. Those are businesses where if you look at the next ten years, we're really confident in that. If you go back why with respect to NVR, I would say jokingly, "The threat of disruption from Amazon is very little as of right now." [crosstalk 00:10:55]

Ellen: You say that now.

JP: Yeah, as of right now, right? It seems like every business is under threat from Amazon right now, but it is a business where the industry as a whole is extremely fragmented and the benefits from becoming a large national player don't really accrue to those big players like they would in other industries. It's very much about local market knowledge and having that decentralized operation and being one of the biggest players. You can get local economies upscale, right? If you're the biggest player in a small market, you can get huge advantages over your competitors, but if you're the biggest player globally, there aren't as many advantages as you might think if you're much bigger than the smaller players.

It's a really fragmented market, but within that, NVR focuses on like I said, being a really big player in smaller markets. It means if there are tailwinds in the industry, they're probably going to do better than most. If you look at NVR, they have a great track record of sticking to what they do and being the best of the best. That is being an asset-lite home builder that generates insane returns on their invested capital over the full market cycle.

When you think about what delivers returns for stocks, it's not just growth. They have to create value. The businesses themselves have to generate value.

Ellen: Sure, you say that.

JP: I know, depending on who you are in the market cycle, an investor sentiment, right? Over the full market cycle, stocks that go up, it's because they're creating value. NVR does an amazing job in doing that and just kind of sticking to their guns. If you look at ... We believe that, perhaps not as much as some other people in terms of the millennials causing this next huge wave of positive momentum for the home building market, but we think the setup and the overall dynamics in terms of people living longer, staying in their homes longer, the average age that people are staying in their homes is around seven or eight years, which is the highest that it's been on record since some people started tracking that.

In terms of the used inventory coming on the market, there's not a ton of supply that is getting ready to flood the market. Since the bottom home builders haven't been super eager to build new homes, so in terms of supply from new homes and existing homes, there isn't a huge overload of supply that is set to hit the market. In terms of demand, like I said with respect to millennials and a lot of people that were really hurt from the financial crisis, they are kind of getting ready to start to get back into home building because ... Or into buying homes because what do we know from surveys? You might think that because the younger generations favor experiences, they don't want to own a home, but most surveys have found that their desire to home is actually quite high and it's more in line with their grandparents. They, in many cases, think of homes as part of that experience. They want a good home and a good community that's close to shops and close to coffee shops and things like that so they can build a family and have all these experiences.

NVR, it's not just that, it's also where they are in terms of being in mature markets that aren't going to go through as crazy of a boom and bust cycle that you might see in hotter markets out West and things like that. They're in this really great setup in terms of their locations and to benefit from those tailwinds. Our conviction in the next ten years is still very high.

I'm also apparently channeling Jim Gillies today because my answers are extremely long-winded.

Ellen: That's okay. It's like with editing, right? I will let you talk as long as you are saying useful saying useful things, not that I can control whether you talk or not, but -

JP: With respect to whether or not it's useful, I'm not always convinced there.

Ellen: This [rec 00:14:45] was interesting to me anyway, just because since they are such a big home builder here.

JP: Yeah.

Ellen: We're in Northern Virginia. I think everybody who's watching us knows that and they are huge right around here. What you said about boom and bust was interesting because this is one of the parts of the country that's not going to ... I hesitate to say anything about the government, but it's probably still going to be located here for the foreseeable future and so this is an interesting market compared to some out West, like you said in Florida or some of the other places that could be a little bit more peak and valley.

JP: Yeah, and a little bit more insight into kind of how NVR ultimately ended up in the Pro portfolio, so I've owned it personally for a lot longer than it's been in here. It was for the longest time one of my favorite compounders, a business that I really believed over the next ten years is going to do great things, but I had always questioned whether or not it was a good fit for Pro because it is the industry ... At the end of the day, it's a cyclical industry. There's going to be peaks. There's going to be valleys.

For the longest time, I didn't really feel confident in that, but then as you look at what we've done with Pro in terms of continuing to trim the positions we don't have high confidence in and positions that we really thing are going to be like the Johnson & Johnson's, like the Verisign's that are going to really be kind of these steadying positions even if the market over the next year or so is a little bit troubled.

As the portfolio kind of shifted, we felt like we had a little bit more liberty to go with these businesses that may, if we get a little bit unlucky in terms of timing. When we buy NVR, we still have really strong conviction over the next ten years because I think history doesn't always repeat itself, but it is worth mentioning that if you bought NVR right at the peak of the stock, right before the housing cycle went bust and the markets just got crushed.

You would think that because it's a home builder, you would have done horribly, but it's like not only did NVR from that point to today actually meet our North Star guidelines or beat the North Star, it crushed the SMP by 150 percent or something along those lines. It's a great business. It's a really strong management team that has been with the business for a really long time and at least for right now, they are not in The Buckle or O'Reilly position where their industry is undergoing a fundamental shift. They can continue to do what they do really well and hopefully the stock returns will follow.

Ellen: Excellent. There is a question here from Anonymous that I could like to tackle real quick because it is mine to tackle.

"What is going on with Interactive Brokers? Don't understand the rec. Was it supposed to be published in Options and put out under Pro by accident?" Yes, Anonymous. That is exactly what happened and I apologize. We had a recommendation for Interactive Brokers, or sorry, IPR in Options last week and it was published there. Then today, when we sent the Monday memo, it accidentally got swept up into that email. It should not be accessible on the Pro site. If you click that link, it should give you a 404. There should be no way to see that information anymore or act on it. We deleted it as soon as we found out.

If you can access it, please let me know. I'm EBowman at Fool dot com or you can post on the boards and I will track down any traces of it and delete them because that is Options advice, not Pro advice and you should not have seen it. I apologize for the error. Still not entirely sure what happened, but I will track it down and discipline the hamster in question as soon as I found out which hamster it was. I apologize.

There's one that went missing that I have to find. In the meantime, we've got a question from Ron. "American Tower, October 20th, 125-dollar calls are in the money. TDA called to warn me. What's the plan, or Pro's position on the risk of X dividend and potential loss of my shares?"

Billy: All right, Ron so Pro has 120-dollar calls. I see that you have 125-dollar calls, which means that you're actually in a better position than Pro is as far as not being assigned on those calls when the dividend comes.

Let's see. I'm looking at option quotes right now for the October 125's that you have. It looks like you have ... As I click through. Looks like you have about two dollars or more of time value and the dividend is not that much. I'm not sure exactly what it is. American Tower raises their dividend every quarter and I can't remember exactly what the dividend amount is, but it's definitely not two dollars. It looks like you're not really at risk of getting poached out of your position and you should be fine, but as we get closer to October maybe at the next dividend date, if American Tower continues to rise and it's still well in the money and we're now closer to October and there's another dividend, then you might want to start paying attention, but for this round of dividends, it seems like you are okay.

Ellen: Cool, and I found the missing question is also from Lon. "Curious about recent thoughts regarding FXE," which is the currency shares Eurotrust. This has been asked about on the board. "I'm among those with a bear put spread."

Billy: Jeff is doing research right now on the Euro in France, so when he returns, he should have some thoughts.

Ellen: I do not know if that is a euphemism for drinking wine or not.

Billy: Ask Jeff. I don't know.

Ellen: All right, so do you have more to say on that question or are we going to leave it for Jeff when he returns?

Billy: Yeah Lon, I don't follow the short. I don't have much to offer on it. I don't have much to say about the Euro or really the management of that position. It's more kind of a Jeff position. JP, I don't know if you have anything to say there, but no for me, I don't.

Ellen: Okay.

JP: Yeah, it's Jeff's position.

Ellen: It's Jeff's baby, okay.

JP: We'll have more soon.

Ellen: Sorry, Lon. When he comes back from his research, we will share.

"Any good recommendations for visiting Paris?" I've never been. Anybody else?

JP: Nope. [crosstalk 00:20:45]

Billy: Haven't been either. We'll have to ask Jeff on the next chat.

Ellen: This chat without Jeff is maybe not quite the chat it is with Jeff. Billy, please address AMT issued for people with the 120. Sounds like we just sort of did that, but do you want to ...?

Billy: Kind of yeah. Let's do this a little more thorough. I'm going to look up American Tower's dividend so I know exactly how much it is.

Ellen: Okay.

Billy: American Tower's dividend with the X dividend date ... Let's see. The next dividend is going to be in the 60-cent range, probably a little more than 64. The last X dividend date was the 15th of June so that's already passed. It looks like our next X dividend date may be some time in September, so that one we might need to be more careful for, but anyway if the dividend is in the 60-cent range and right now we're looking at the October 120 calls, which is the position that Pro has. The bid ask on the 120-dollar calls is 14 dollars and 10 cents at the midpoint. That means the break even is 134 dollars and 10 cents. The stock is trading at about 132.50, so we are still over a dollar, a dollar-60 cents, dollar-50 cents away from that call being in danger of being assigned because of that dividend.

The 120-dollar calls look fine right now, but there's no upcoming dividend anyway, not until September I believe.

Ellen: Cool. "For those of us who own IYR in lieu of shoring SRS," I do not know off the top of my head what IYR is and I apologize, "How does that play with NVR [inaudible 00:22:27]?"

Billy: IYR is the rate index.

Ellen: Yeah! Okay.

Billy: US rate index.

Ellen: If you own that, then you also own our home builder.

Billy: JP, I don't know what you have to say, but I would say that in many cases, they're not ... Rates and real estate can run the gambit between commercial and residential and a lot of other things in between. NVR is more residential and so IYR gives the exposure to more real estate activities outside of the residential arena. That would be my answer. What do you think, JP?

JP: Yeah, I don't know what IYR is made up of so I would be a little bit hesitant in answering with respect to that. I would say though that NVR, it's not just an industry play, right? It's an industry and business play in that we think they are a best of breed operator. We like those two combinations enough to want to just focus on one single stock, instead of just going with an industry ETF or something along those lines.

Ellen: Okay. There's a question and an answer here from [Hett Creek 00:23:36] and Lon. Hi, Hett Creek, about the weekly calendars from [Mucey 00:23:39] and in a banner that covers up the X dividend dates. I will look into the thread that you mentioned. I'm not going to address this here because I think that it would be confusing to do so via this format, but I will look at the thread that is mentioned and get back to you both on what, if anything, I can do about it.

Dennis says the answers are too long and repeating information. I apologize, Dennis, noted.

Billy: Sorry, Dennis.

Ellen: Yes. Dabcha 2, "Oracle got a nice bump. Sounds like because of its cloud exploits, just like you said. Are you partying yourself on the back? Any commentary, considering?"

JP: Where is Jeff when we need him?

Ellen: I know, right? Jeff is not patting himself on the back. I can tell you that much, that he doesn't know how.

Billy: When we say ... Sorry, getting a little feedback here. When we say it got a little bump, it looks like we are talking about recently the stock price increased from about 45 or so just a few days ago, just six days ago, and now we're up around 51.

I don't have too much to say about that because it's Jeff's position and he covers that stock for us. He doesn't tend to pat himself on the back that much, so I don't think that he would be doing that, but he probably has some commentary to talk about that when he returns. Oracle, we've been waiting for a long time for that stock to really start to appreciate. The transition to the cloud has been long and slow. The revenue affiliated with that transition is delayed and into the future, so it looks like maybe we're starting to see that really pick up, which would be great for our Oracle position because as we talked about it for a couple years now, we've been kind of waiting for that to gain traction. Maybe this is a sign that it is and I'm curious to hear Jeff's thoughts.

Ellen: Cool. Jim, hi Jim! "Thoughts on ..." It could be anyone. It could be one of our colleagues. "Thoughts on Starbucks? I said of a January 18, 60-dollar of a synthetic long in December, 2015 for no cost. If I don't exercise the call, when should I be looking to roll out, 2020 leaps?"

JP: Yep, Jim did a great job of answering his question because that's exactly what I was going to go for. Just wait until those new leaps come out and then that's probably when I would look to roll.

Ellen: Jim is a self-contained question and answer package, excellent. Do you want to elaborate on that, or has he pretty much covered everything you would?

JP: I think he kind of understand why you would want to do it in terms of maximizing the amount of time that you have with your new synthetic long and so it's pretty much just a matter of getting the most bang for your buck and just waiting.

Ellen: Then we will stop it there to show that we have heard Dennis. We are listening to Dennis. Dabcha 2 again says, "Verisk is going nowhere. Are we still hopeful for some movement upon a federal infrastructure bill? Are there any thoughts of trimming or moving out of the position?"

JP: Yeah, it's one where it is very much a position that is just probably going to muddle along until it kind of wakes up. The sleeping giant finally wakes up. If you look at something like Apple where it seemed like, "Oh man, everybody hates Apple. The business is just struggling," and then you finally get that shift in sentiment once things start to look up. What's really going on with Verisk is the energy market in terms of Wood Mackenzie, their acquisition.

It's holding up better than some might thing, given just how hard the energy industry got hit as a whole, but until that business wakes up, you're really not going to see Verisk take off. There's also some issues with regards to cat bond pricing and things in the insurance business that made it so the acceleration that they were expecting as you worked through last year never really materialized, but it is very much a case of you look at Verisk pre-Wood Mac, the growth rates look a lot more impressive and then people maybe just looking at the numbers, they see Verisk post-Wood Mac just because it was such a big acquisition.

The fact that Wood Mac kind of pulled all of the growth rates down makes it so it looks like the business isn't doing as good and so people are probably a little bit more hesitant to buy the stock or be fans of the stock, but that is very much a position where once Wood Mac kind of wakes up and the energy industry kind of starts to normalize in terms of spending, the business should be off to the races.

We're just kind of, for better or worse, we're having to stick around for that because we think that is going to be a large upside for the stock. We had considered covering it in the past, but the Options just, they don't pay halfway decent. It's not something that ... The reward that we get for writing cover calls is is worth the risk of potentially losing shares, should the business take off a little bit sooner than we expect.

It is one where as of right now, we're not considering trimming it or cutting it. We're actually, in the past we've considered adding to it a little bit because it is a business that we still have high conviction in, but for right now, it is kind of just a wait and see, so cap spending, it does have to normalize. Eventually, if people don't return to spending as far as energy and things like that are concerned, then we won't have enough energy reserves and things like that. It has to return. It's just everybody's kind of holding their wallets close to their vest right now and it will potentially be that way for the next year or two.

Ellen: Okay. "Any comments," says Anonymous, "On the Pro shorts?" Sorry, Len. I skipped you. We'll do yours next.

My comment on Shake Shack is that they have one at The Washington Nationals ballpark and it is delicious. That will not help you investing, I apologize. Y'all take it from here.

JP: You want me to go first, or you want me to jump on, Billy?

Billy: Let's see. I'll provide my limited thoughts here. The Pro shorts, I mean we're not talking about very many right now because we've culled our portfolio a little bit over time. We've got, as Ellen mentioned, Shake Shack. We've got our Go Pro synthetic short, which so far is going pretty well and we plan to maintain that and see how far that business can or may fall.

Then we've got the Euro short, which we talked about a little bit. That's kind of Jeff's territory. The financial short we continue to like. That's more really of a long than short. We're shorting a short. We're basically long financials there and you can kind of see that in the rest of our portfolio. We have a lot of financial exposure, MasterCard, VISA, et cetera, Broadridge and then SRS, which is on hold.

Shorts are something that we continue to try to get more of and we would like to have more short exposure so that it can offset some more long exposure and it makes it easier for us to find stocks that we like without feeling that we're adding too much risk to our portfolio by taking on too much long exposure, but at the same time it's very difficult to find shorts and it's a significant time sync and in many cases, the positions are very small. It's hard to find a good return on the time investment it takes to find really good shorts that you're confident about.

That's my thoughts on our shorts. What do you have to say, JP?

JP: Yep. I would say you could almost lump these two questions here together because what I think you'll see going forward in Pro is that now that we feel a lot more confident about our long book. We've trimmed some positions. We've added some new positions that we really like and so that kind of frees up time to kind of work on these other two, the hedging and the shorting.

With respect to shorting, I think the first rule of shorting in my opinion is try to do no harm. You don't want to short a bunch of stuff just so you're shorting it and you want to reduce your long exposure. If that is the case, it's probably far more effective from a risk management perspective to just have a lower long exposure, instead of shorting a bunch of companies just to have a short book.

The second thing is that shorting in many ways, one of the keys to it, is idea velocity because you don't want to bet the house on one or two positions because if you look at something like a home capital group, that was a favorite short for a lot of short sellers and it did get really hard. Then Buffet came in and kind of back stocked the company and the stock just went on a tear higher.

There is definitely a lot of, especially in this market, there's a lot of that idiosyncratic risk that you want to not have a large exposure to with just one or two really big shorts. You want to kind of spread your bets. In order for that to be effective, you need to have that idea velocity where you're constantly moving through a bunch of positions and putting them on when they make sense and taking them off once you've had a return because the best you can do on a short is double your money, but in most cases that's not going to happen and if the catalyst you foresee plays out, you're in most cases happy with maybe a 20, 25 percent positive return for you as the short seller.

Because you're going to be going through a lot of the positions, you have to have idea velocity. You have to be able to spend a lot of time on shorting. It's really hard to do that when you're also focusing on your long book because you're not 100 percent satisfied with where you are with your long positions. Now that we've kind of got the long book in a much better place than it was say six, twelve months ago, it will hopefully free up some time to move more towards focusing on shorting and hedging in the future.

Ellen: Cool.

JP: Just to kind of tackle, like I said, Len's QQQ trade. He said that it's up since they set it up. Would it be worthwhile to roll up for credit? The pros and cons of doing so, so we have in the past rolled it up periodically if the QQQ continues to rise and we kind of end up really far out of the money.

It is something that we will definitely be considering. The one thing to keep in mind though, when you're dealing with a hedge that's kind of long dated like that, there is definitely a risk to being a little bit early to the party in terms of if you roll it up and you put it really close and then the market starts to fall. The risk in terms of bear markets, it tends to be that the way the market declines, you end up in a position, ideally with the ratio spread is we can close it out right and buy leaps loan. Essentially, we can generate some money on the spread and use that to generate additional profits by harvesting those gains and buying leaps for when the market ultimately recovers because that's kind of what the markets do. They fall, but then businesses create value and the market recovers.

If you end up in a position where you roll up and you're super tight to the QQQ after it's gone on a huge gain and that's a lot closer to the top. The QQQ starts to struggle and it starts to fall and we end up in more than just one of those 10 percent down, hit the bid, the stock market quickly recovers and it goes down. It goes down 15, 20 percent and it's this continued slide and maybe we're down to 30. It's an actual bear market.

Then we're in a position where you might not be able to close that spread for a profit. It has the potential to become a liability and so that's just not ideal. With respect to rolling the QQQ, it's not always a case of, "All right, it's now X percent out of the money. We need to roll up." There are other things to consider and so that's why there's no hard rule of thumb for when or why we're going to roll the QQQ.

Ellen: Right. It's not like, "It's hit this threshold, we need this much money."

JP: Exactly. It's on the table, but we don't have anything to say right now. I think our approach to hedging as a bit of a teaser, it could actually change a little bit in the future as we attempt to kind of iterate and continue to get better at it.

Ellen: Okay, cool. Are you teasing a potential Monday memo or commentary coming in the future, or is this more like ...?

JP: If we do it, there will definitely be commentary along with it to kind of give a deeper background into why we're doing it and what we hope to accomplish.

Ellen: That's cool. I'm not only the president of The Hair Club for Men. I'm also a client. Half of my savings are in the Pro portfolio as well as the editor and so I love when they get into deeper explanations of hedging and shorting in particular because I'm still learning about that stuff and I really want to know why we do it because I am also following along.

All right, Anonymous wants to know, "When will the new Starbucks leaps become available?" I think I could Google that, but you could probably Google it faster.

JP: I probably could. Go ahead and Google it because I don't know offhand. I think [crosstalk 00:36:38] ...

Ellen: Billy, can you?

JP: I think the cycle is ...

Billy: I'm going to Google it as well.

Ellen: Okay.

JP: It's like September, October, November when the cycles start to become available. I can't tell you offhand which one Starbucks falls into.

Billy: I will figure it out and let you guys know. [crosstalk 00:36:49]

Ellen: Okay, Billy's working on it while we move on here.

Chris says, "Is O'Reilly still a hold? Has anything changed now that Amazon is going after Whole Foods in groceries? Does an Amazon a threat on O'Reilly alleviate a bit with the new ...?" Okay, so I think what she's saying is, or he, with O'Reilly ... Or with Amazon going after Whole Foods in groceries, does that mean that the threat pulls back a little bit on O'Reilly -

JP: Because they're distracted by Whole Foods, yeah.

Ellen: [crosstalk 00:37:15] Because they're, yeah, they've got this big thing too.

JP: I would say O'Reilly probably hopes that that's the case.

Ellen: O'Reilly would feel good about that, yeah.

JP: Yeah, but I don't necessarily think it is. I think in many cases with respect to the auto parts industry, the balls are already rolling in terms of what Amazon hopes to accomplish there. They probably already have the people that they need deployed working on those relationships, working on those contracts and things like that.

It probably isn't going to. Maybe you get a month or two or something like that, but I don't think that they only have a limited number of resources where they're going to pull everybody from that move and go over and work on Whole Foods. Amazon is definitely going after any industry where there are profits that they think they can steal and are big enough to actually warrant them going there. I think the auto parts business is definitely one that is in their cross hairs just because if you look at the returns that O'Reilly has been able to generate, not just O'Reilly, the other big players in the industry too, those are dollar signs in Amazon's eyes and they probably look at those profits and are like, "Man, this is a multi-billion dollar industry and the returns that these guys are generating are very juicy. Let me get a cut of that action."

Ellen: Yes. Would you like your prime serpentine belt now, or later?

JP: Yeah.

Ellen: Exactly, all right. Billy, anything on the leaps?

Billy: I do, yeah. Starbucks is in cycle one and cycle one 2020 leaps list on September 11th, 2017.

Ellen: Very nice. Thank you. Anonymous asks, "I did not receive the Monday memo. How was it delivered via email? I didn't see it on the site."

The Monday memo has undergone a recent change. There are details about it on the site. I will find them so that I can point you to them directly, but basically we will be sending you a roundup of news every Monday, the same way that we always have, but it is not necessarily going to contain a piece of commentary called the Monday memo. In some cases, if we have more actionable content than that, we will send you that instead, which is what we did today. We sent a trade alert that was Gilead

Sciences and this was where previously ... Billy would have been assigned this week's memo, so he would've been writing a piece of commentary, we'll say, for publication this afternoon.

Instead today, he turned his attention to the Gilead Sciences trade, which was more actionable, hopefully more valuable to members, and more important to get in front of you in a timely way. That sort of took the place of the main content that would've been sent to you in the Monday memo and went out as our Monday publication.

We will still be publishing commentaries and our thoughts and when JP writes his magnum opus about hedging and all that stuff, it might not be on Monday. We will publish it and send it to you when it is ready and when it is the most timely. This change was affected so that we can send you ... It's across the full change, but I think for Pro and Options in particular, it was really important because we found that we were getting some non-timely content that was getting in the way of our trade alerts and our stuff that we really needed to get in your hands as quickly as possible.

I know for Options last Friday and then again today in Pro, we were able to send actual ticker-based real stuff that he needed to act on, instead of being hemmed in by deadlines for stuff that could have gone, maybe any time.

Perhaps this answer is too long as well, but basically the Monday memo will still exist, commentaries will still exist, and you will still get a weekly roundup from us, but you may not see a Monday memo in terms of a long sort of a think piece on a Monday afternoon. You might see a trade alert for example in the place where you would have found that before.

This Monday memo would have hit your inbox as Trade Alert Gilead Sciences Plus Weekly Roundup was the subject line. Hopefully that will help you find it and the explanation for how all of this went down, if you go to the Pro site and you look under Alerts and Coverage, scroll down a little bit and I will ... We'll go onto the next question and then I'll jump in when I have found the right explanation for this, rather than make you sit through this.

All right, Chris says, "Is Skyworks short put at 100 dollars a Pro position or Options position?"

JP: It's an Options position. We have a covered strangle on Skyworks, but the May 26th put right is over in Options.

Ellen: Okay, so we will tackle that in an Options chat.

Anonymous says, "But has Jeff been talking about selling Oracle?" Not from France, at least not that I know of. You guys know?

JP: Is that inside information?

Ellen: Yeah, it is, but you know.

Billy: In my memory, or at least from what I remember, there hasn't been much talk about selling Oracle. I'm not sure exactly to what you're referencing. We've been a little bit kind of muted on Oracle, definitely not listing it as one of our buy first's or being really excited about its growth prospects, but I don't remember Jeff talking about selling it.

Ellen: Cool.

Billy: Do you, JP? Am I wrong?

JP: Offhand, I can't remember. I don't believe so.

Billy: Right, yeah.

Ellen: Anonymous says, "Is Amazon too expensive to consider a synthetic long, similar to what we have on Facebook?"

Billy: I would say unless you're really wealthy, then probably because ... It's 1,000-dollar stock and every synthetic long exposes you to 100 shares so we're looking at, what? 10,000, no 100,000.

Ellen: That's a lot of zeroes.

Billy: Yeah, lot of zeroes is my point. It may very likely be, most likely is too expensive, yes.

Ellen: If it's not, congratulations. Enjoy your synthetic long. "Any thoughts about the shake short?" We kind of touched on that earlier with the roundup of shorts. Are there any specific thoughts about that one in particular?

JP: I would say that that is one that you could probably expect to have an update on, in terms of just being one of the first stocks in general of having an update on once Jeff gets back because it is one that we were discussing prior to him leaving and he's dropped in a couple bullet points while he's been away.

Ellen: Mm-hmm (affirmative). We can't get him to go on vacation, not for real.

The Monday memo that explained the changes to the Monday memo was from June 5th, 2017. If you go to the Pro site and then Alerts and Coverage, scroll down. You will find it. It is called We Won't Miss AmTrust, which is retrospect is a pretty cold headline, Plus Content Changes Afoot so that will explain what we're doing with the memo and why you saw what you saw today.

All right, next is from Global Rhino. "You mentioned changing hedge strategies in future. Should new folks still set up QQQ ratio put spread, or wait?"

JP: I would say ... I don't often know pricing right now, but with respect to just the changing strategies and whether you should wait or not, it's not something where it's going to be a giant change. It's right around the corner so you should just kind of wait and see. It may just be more of an iterative change and in that case, if you want to follow along with Pro while we've already got the spread set up, or the ratio spread set up, and so we're going to have to kind of potentially change that, but from my vantage point as of right now, it looks like that would probably be something that ties into how we iterate and try and improve on our hedging strategy.

It's not like it's going to go away. Even if for some reason, we do decide we have to change that, move it up, move it out, do something with that, you're still going to be aligned with us. It would all depend on pricing and my internet connection is not cooperating right now. I can't tell ... I can't talk about pricing.

Ellen: Okay, no worries, but I think what you're saying is that ... At least I think the way that Jeff has always said to sort of approach our portfolio and what you see on that page is match us as best you can because wherever we go from here, you're going to want to come there from where we are.

JP: Mm-hmm (affirmative).

Ellen: I would assume that new folks are encouraged to set that up as much as old folks have been, as much as anything that's not on hold is ... With the caveat that JP can't look at pricing and so he's not confirming or denying that.

JP: Yep.

Ellen: Fool NSD says, "Will Monday memo's priority be lowered so it doesn't delay recs and other more important, timely matters?" Yeah, basically although ... Priority lowered is probably not what the corporate office wants me to say, but yes. It will definitely be moved so that the more timely stuff that pricing could affect for example will get out faster and so that these guys have time to spend on the stuff that will affect returns before they have to turn their attention to stuff that does not affect returns.

Ideally, it'll make everybody more efficient and it'll make Pro's returns even better and just generally make the portfolio function a little better. I know Jeff in particular has talked about a couple of opportunities that have passed him by because he's needed to write more commentary-based stuff. I don't want anyone to feel like they're going to miss out on any insights that would otherwise have been shared. You might just get them on like, Wednesday instead of Monday if there was something more important going on Monday that we had to get in your hands first.

JP: I would also quickly note too, one of the things I'm most excited about, kind of the change in the content strategy is that it frees us up in terms of potentially creating ... I don't want to say denser, but kind of more meaty educational content. It's not something that we just have to crank out every week, so it's like, "All right, I want to take two weeks instead of just doing a quick hit this week and a quick hit next week." I'm going to spend the time that I would be writing those two pieces to write one more in depth educational piece that kind of delves into a topic related to Pro that we didn't have time to talk about in the past.

Ellen: Yeah, and it speaks to a conversation that's been going on on our boards, especially with some longtime members who are asking, "Where's the educational component of Pro to people who aren't new here?" If I've been here for five years and I really know the basics, what do you have for me to really iterate on and become even more of an expert?

I think the structure will give us, as JP said, more of a chance to do a little bit more in-depth, less rote construction of that stuff. I know there's topics that we've wanted to address, in some cases for months that we have been on the treadmill and have not been able to tackle that now we can. I think ... I know the team is really excited about it. I hope that the member experience is good. If it is not good, I am the person that you tell about that. I am EBowman at Fool dot com and I will listen to you. I will also listen to you on the boards. Keep me posted on how it goes and I promise to listen and provide feedback, if possible.

JP: A perfect example of that would be if the hedging strategy does iterate and we change it a little bit, you'll get content where it'll be maybe, "Here's a quick hit up top, if you just want to kind of follow along and get a couple bullet points of why we're doing this. Here you go," but if you really want to go down the rabbit hole so to speak and really understand, "Here's what we're thinking, here's how this works, here's why we're doing it, here you go. Here's all of it," we'll lay it all out for you.

Ellen: Yeah, and we've had the time and been able to take the care and the pains to really give you a good, solid product here. Yeah, I'm excited, but I'm a dork. That's why I edit this product so hopefully it will be as exciting for the people who read this product as it is for me.

The only ... We have a question here from somebody who's getting a certificate error when connecting. I cannot help you. I hope that that has passed. I do not know what to tell you and I am sorry, Anonymous.

Only one other question from another Anonymous. "Why does the trade alert for Pro also list the recent Motley Fool option strangle on Interactive Brokers?" That was an error. The article has been deleted. The link should go nowhere. You should not follow that advice because that advice should not exist and should not take you anywhere. Options is the only service, that I edit anyway, that has a position on Interactive Brokers and that inclusion in the Pro email was a mistake. I apologize. I'm still figuring out exactly what happened to make that appear, but when I find out, if there's anything I can yell at, I will yell at it until I am sure that it does not happen again.

Then okay, we have one more from another Anonymous. "If our Pro positions are in a 401K," yeah, "That only allows covered calls, do you recommend we hold additional positions in a cash trading account for things like collars?"

Billy: That would be helpful. I know lots of members who do that and I think that's a good idea. You have one account that's an IRA that you can use to your tax advantage and then another account that is a taxable account and instead of thinking of them as two accounts, you think of them as just one big combined account, but you execute the specific strategies in each account that is appropriate for either an IRA or a taxable account.

Ellen: Cool. Lon says, "Hi, JP. Nice to see no hat today. There is hair." There's always hair.

JP: There is always hair. It's just whether or not I style it, yes.

Ellen: You allow the members to see it, yeah.

JP: Something along those lines.

Ellen: I'm sorry. I hope I didn't give anything away. There's always hair. There just always is.

All right. Any more comments on JP's hair, feel free to submit them through Slido and if not, we can wrap this up a little bit early I think. This is the first chat in a long time where we have not had extra questions at the end.

JP: Jeff's not here. [crosstalk 00:50:54]

Ellen: Jeff's not here.

Billy: I think yeah, it's because of Jeff. That's right. We're not as popular, but rightfully so I think.

Ellen: Yeah, rightfully so. I am not ... A Jeff Fischer and you can tell that. The camera knows that. Everybody knows that.

All right, I am however Ellen Bowman. I'm the editor and publisher of Options. You can tell me anything you thought about this chat or the things you learned within it on the boards at Pro, or you can email me EBowman at Fool dot com and I would love to hear your feedback. I will listen to it and I will do what I can to change things that you don't like.

This is JP Bennett. He is our most JP analyst here at Motley Fool Pro.

JP: Something along those lines.

Ellen: Yeah! Billy Kipersztok is our senior analyst. He's on Skype.

Billy: Bye, Ellen.

Ellen: Bye! Jeff Fischer, sorry ... JP's right here. Jeff Fischer is in France right now and could not be with us and so that is why this chat is ending a little bit early today. Miss Anne in the video booth, can you give me a thumbs up? All right. Miss Anne's going to be able to end it early.

Thank you all for joining us very much. We will see you again next month, been a pleasure chatting with you. Take care! [crosstalk 00:51:56]

JP: Bye!

Billy: Thanks fools! Fool on!

Ellen: Fool on!

Pro Catch-Up Trades and Upcoming Expirations: June 22, 2017

Published Jun 22, 2017 at 12:35PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.1%.
- **Coherent** (NASDAQ: COHR): Buy 2.4%.
- **NVR** (NYSE: NVR): Buy 2.6%.
- **Visa** (NYSE: V): Buy 3.1%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.5%.
- **Apple** (NASDAQ: AAPL): Buy 4.5%.
- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.3%.
- **MasterCard** (NYSE: MA): Buy 5.1%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 4.2%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **Gentex** (NASDAQ: GNTX): Write (sell to open) December 2017 $17.50 puts for an additional 1% potential stock allocation, lately for about $0.90 each.
- **O'Reilly Automotive** (NASDAQ: ORLY): Earlier this month we set up a protective collar by selling August 2017 $250 calls and buying August 2017 $220 puts. Our puts are now at the money, making this collar no long attractive for newcomers. Instead look to set up a $210/$230 protective collar by purchasing one August $210 put and simultaneously selling one August $230 call for every 100 shares you own. As of this morning this collar could be set up for approximately a $0.65 credit; however, please note that this collar will behave differently than our $230/$250 collar and may result in you needing to take a different action than *Pro* come expiration should you decide to set up this protective collar.
- **Verisign** (NASDAQ: VRSN): We rolled our June strangle out and up to a September $90/$95 strangle last week in order to prevent our shares from being called away. Those who own at least 100 unencumbered shares can look set up this position for a credit of approximately $4.50 or so.

Hedges:

- N/A

This month's expirations (June):

- **Gilead Sciences** (NASDAQ: GILD): Our June $70 covered call expired as income last week. We'll be looking to write new calls soon -- assuming new calls pay enough at strikes we're comfortable using.
- **Verisign**: We rolled our strangle last week in order to keep shares and generate additional income.

Our Fellow Fools Look Back on American Tower

Published Jun 19, 2017 at 2:33PM

Dear Pro *members: Our Foolish associates at* Motley Fool Explorer *take a fresh look at a trend or theme among David Gardner's growth-stock recommendations, then study a set of those companies to single out one top idea each month. They ask a simple question:* ***Which company offers the best market-beating opportunity over the next three years?*** *They then invest The Motley Fool's money in the winning stocks and keep track of what happens. We thought you might be interested in their recent look back at three years of American Tower. -- The* Pro *team*

We've now reached the three-year mark of our fifth Exploration, which means it's time to retire the fifth stock from our Explorer scorecard. In May 2014, we went searching for lower-risk companies, and liked the solid footing that **American Tower** (NYSE: AMT) was based on.

We believed the world's smartphone data consumption was going nowhere but up, which led us to believe that American Tower — which builds cellular towers and then leases operations to mobile phone carriers — would also dial up quite a bit more business. Mobile device adoption was increasing, and the carriers had no interest in paying the heavy capital costs of building the towers themselves. We expected this would provide for a solid business that simultaneously offered both stability and long-term upside.

Explorer Looks Back: American Tower	
AMT Total Return	56%
S&P 500 Total Return	35%
Return vs S&P	21%

Total returns are from 5/27/14 to 5/27/17 and include dividends.

Let's take a closer look at what's happened during the three years we've had American Tower on our scorecard.

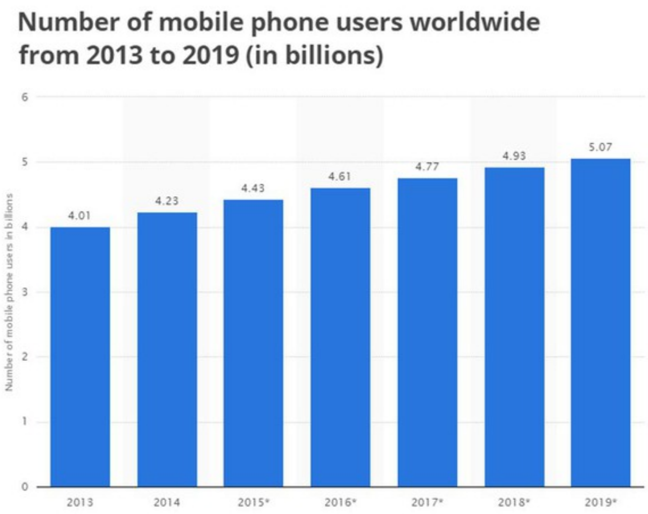
Looking Back at American Tower

Between mobile payments, GPS navigation, and Pokemon Go, the world's population has a growing number of reasons to buy a cellphone.

- **Expanding the Network**

The number of mobile phone users has increased nearly 20% during the past three years, and a shift to smartphones is driving up data usage. The trend is so pronounced that Cisco recently predicted global mobile data traffic would grow at an incredible 53% each year through 2020.

The increasing penetration of smartphones and the increasing data demand have been very good for American Tower's business.



Source: Statista

Capitalizing on the macro demand, American Tower generates revenue by charging non-cancelable leases to the cellphone carriers (like **AT&T** (NYSE: T) and **Verizon** (NYSE: VZ)). These contracts run for a decade or more, and have annual price escalators built directly into them.

These long-term leases and the huge capital costs of building cell towers serve as barriers to entry against smaller potential competitors. Three companies -- American Tower, **Crown Castle** (NYSE: CCI), and **SBC Communications** (NASDAQ: SBAC) — account for the majority of the industry's profits, and each has provided an excellent return for investors during the past decade.

American Tower has had no problem expanding both its top and bottom line. Revenue is still increasing by 25% annually, while adjusted EBITDA and adjusted funds from operations (metrics which serve as a proxy for the cash coming into the business) are both rising at 20%.

- **Shareholder-Friendly Moves**

With its cell towers gushing cash, American Tower's management made some shareholder-friendly moves to amplify its investment returns.

The company converted to become a Real Estate Investment Trust in late 2011. This move reduced the corporation's income tax burden in exchange for paying out 90% of operating profits as quarterly dividends. The steadily rising profit stream has resulted in a steadily rising dividend: The company's quarterly distribution has increased in every single quarter of the past three years.

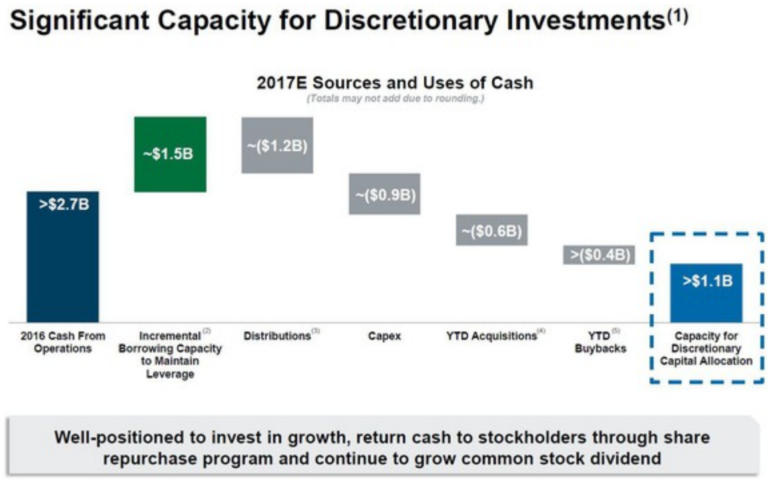
	Q1 2014	Q1 2015	Q1 2016	Q1 2017
AMT Quarterly Dividend per Share	$0.32	$0.42	$0.51	$0.62

To make things even better, management just announced a $1.1 billion share repurchase program earlier this year. By decreasing the outstanding share count alongside its rising profit stream, American Tower's management should be able to increase its dividend per share even further in the coming years.

Looking Forward

American Tower still looks to be standing tall, and we even recommended it again as the winner of our dividend-focused November 2016 Exploration.

Operating cash flow in 2017 should more than cover overall capital expenditures, acquisitions, and dividend distributions. This leaves plenty of discretionary cash for management to find ways to further reward shareholders.



Source: American Tower First-Quarter Investor Presentation

Even with a great tailwind and an excellent business model, there are a few things investors should still keep an eye on. The company's cell-carrier customers are sizable, with the top 13 accounts comprising nearly 80% of total revenue. Though contracts protect the majority of the profit stream, losing any one of the largest customers could put a serious dent in future profits.

Also, building cell towers isn't cheap. The company holds more than $17 billion of long-term debt, which it has used to fund growth. We should monitor the net leverage ratio (net debt divided by adjusted EBITDA) as a way to evaluate whether American Tower is getting too greedy in issuing debt to boost top-line growth. The company's current net leverage ratio of 4.6 is actually about 10% lower than its historical ratio (typically 5.1 to 5.4 during the past three years). We'll watch for that to hold steady in the coming years.

The time may have come for us to retire our first American Tower position from our scorecard. But we think the company still looks capable of producing sky-high future investor returns.

Amazon.com to Buy Whole Foods Market

Published Jun 16, 2017 at 12:13PM

Surprise! Online marketplace **Amazon.com** (NASDAQ: AMZN) has agreed to buy bricks-and mortar grocer **Whole Foods Market** (NASDAQ: WFM) in an all-cash deal of $42 per share, which is about 27% more than Whole Foods' closing price Thursday.

Whole Foods shareholders still need to approve the $13.7 billion deal, but that vote is a technicality at this point, and I'm confident it will go through. The acquisition is expected to close in the second half of the year, and Amazon will finance it with a combination of debt and the $21.5 billion in cash and equivalents it holds on its balance sheet.

Whole Foods co-founder and CEO John Mackey said: "This partnership presents an opportunity to maximize value for Whole Foods Market's shareholders, while at the same time extending our mission and bringing the highest quality, experience, convenience and innovation to our customers." Mackey will remain Whole Foods' CEO after the acquisition.

What's It Mean for You?

There's plenty to unpack here on both sides of the aisle.

For Whole Foods investors, I think this is probably the best outcome for everyone involved. When the deal goes through, you'll receive $42 cash in your brokerage for every share of Whole Foods you own -- a nice premium to the shares' recent price.

Given the competition in the grocery industry, Whole Foods has been forced to compete more and more on pricing to increase traffic to its stores, and that's hurt margins. And not only has management backed off of its 1,200-store target, but it's also been taking its foot off the gas on the new 365 concept to reassess the opportunity. Recent weak results and guidance from rival grocer **Kroger** (NYSE: KR) indicate that the price wars are just getting started.

For Amazon.com investors, this deal looks like a compelling opportunity because the company has been pursuing the online grocery niche. And lest you think U.S. online grocery sales don't amount to much, they totaled $42 billion in 2016, up 156% from 2015. There's plenty of potential here as Amazon.com gains valuable brand credibility in one of the most challenging aspects of the online grocery space -- delivering fresh fruits, produce, and meat. Whole Foods' more than 460 stores should allow Amazon to leverage its shipping and logistics expertise with Whole Foods' physical footprint in densely populated areas as it continues to build out its Prime offerings.

The Foolish Bottom Line

There's still plenty to learn about this deal and how Amazon's strategy will play out. But as it stands, I think it's a good outcome for both businesses. It gives Amazon.com a big boost in the burgeoning online grocery space, and it gives Whole Foods a better opportunity to compete on price without the scrutiny of being a publicly traded company.

When deals like these are announced, you'll often see the stock of the acquirer fall as the stock of the company being acquired rises. Today, shares of both companies are up, so perhaps the rest of the market thinks this is a smart move, too.

For now, you should sit tight on your Amazon and/or Whole Foods shares. If we think you should take any action, we'll alert you ASAP.

Pro Catch-Up Trades and Upcoming Expirations: June 15, 2017

Published Jun 15, 2017 at 11:59AM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

Pro's Best Buys Now are recommended first for your long-term portfolio -- start there! For all long stocks below, follow our allocation if you're matching us; otherwise, equal-weight your new positions at a size that's appropriate for your portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.2%.
- **Coherent** (NASDAQ: COHR): Buy 2.4%.
- **NVR** (NYSE: NVR): Buy 2.5%.
- **Visa** (NYSE: V): Buy 3.2%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.5%.
- **Apple** (NASDAQ: AAPL): Buy 4.6%.
- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.4%.
- **MasterCard** (NYSE: MA): Buy 5.2%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 4.5%.
- **Verisk Analytics** (NASDAQ: VRSK): Buy 2.1%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **Gentex** (NASDAQ: GNTX): Write (sell to open) December 2017 $17.50 puts for an additional 1% potential stock allocation, lately for about $0.70 each.
- **O'Reilly Automotive** (NASDAQ: ORLY): Set up a protective collar on each 100 shares you want to protect. Sell to open August 2017 $250 calls, and buy to open an equal number of August 2017 $220 puts. Lately, with shares down near $230, this collar costs a net debit of about $2.30 per share. Or, you could instead sell to open August $240 calls, then buy the August $220 puts, for a combined net credit of about $0.80.
- **Verisign** (NASDAQ: VRSN): Roll your covered strangle on Verisign up and out to a September expiration and $95/$90 strike prices, as per our alert from earlier this week. Lately this can be done for $3.40 or so.

Hedges:

- N/A

This month's expirations (June):

- **Gilead Sciences** (NASDAQ: GILD): Our June $70 covered calls are on track to expire as income. We'll be looking to write new calls as they do -- assuming new calls pay enough at strikes we're comfortable using. Right now, our $70 calls still have some time value.
- **Verisign**: We rolled our strangle earlier this week in order to keep shares and generate additional income.

Roll Your Covered Strangle on Verisign

Published Jun 13, 2017 at 3:21PM

Is this for you? This recommendation is for investors already participating in our **Verisign** (NASDAQ: VRSN) strategy. If you lack any position, you can consider the Alternative Trades at the end of this report to get on board.

How You Participate

- **Trade:**
  - Buy to close your June $90 calls. Your June $85 puts are set to expire as income, so you can just let them do so.
  - Sell to open September 15, 2017 $95 calls.
  - Sell to open September 15, 2017 $90 puts.
- **Allocation:** Sell one strangle (one of each option) for every 100 shares you own and every additional 100 shares you could buy. *Pro* will continue to write 5 put and call contracts each in order to keep our look-through exposure at approximately 3%.
- **Price guidance:** As I write this, you would **use a limit order** and aim to roll your strangle for a net credit of $3.20. However, please note that you **need** to get your trade completed by Friday, June 16, if the stock remains above $90. Otherwise, your shares will be called away.
- **Prices** (3:13 p.m. ET):
  - Stock: $91.63
  - Sell to open September 15, 2017 $95 calls, bid/ask: $2.18/$2.34
  - Sell to open September 15, 2017 $90 puts, bid/ask: $2.66/$2.87

- Buy to close June $90 calls, bid/ask: $1.75/$1.91

What We're Thinking

It's been a little over six months since we first added Verisign, a global leader in domain-name registry services, to the *Pro* portfolio, and so far our thesis has played out nicely — we've collected over $4,000 in income to go along with our 16% gain on the stock. In fact, maybe it's played out a little *too* nicely. With the company returning to modest growth after the surge brought about by domain-name speculators in China, the stock has run up a bit recently, so we find ourselves needing to pre-emptively roll our position yet again. We want to continue to manage this position for "income with upside," and we'll be able to do that by rolling our strangle up and out to September $95/$90.

We're raising our Fair Value for the stock to $87 as the company continues to make progress. Verisign is compounding value at an impressive clip thanks to its strong operational leverage, and we believe it will receive approval to continue raising .net prices by 10% annually through 2023 (based on the proposed renewal of the .net registry agreement). We do need more clarity on whether the company will be able to increase .com prices in 2018 or beyond. Until then, though, Verisign remains an attractive covered strangle candidate.

Alternative Trades

- **Interested in just buying shares?** We would suggest waiting to see if the stock falls closer to our $87 fair value estimate before purchasing.
- **New to this position?** If you can afford a potential $18,200 or so in shares, buy 100 shares today and then "sell to open" the same September 2017 $95/$90 covered strangle described above (sell one call for every 100 shares now owned, and sell one put for every *additional* 100 shares you could buy). Using a limit order, you could lately collect about $5.00 per share in combined credits to write both options. Invest approximately 3% of your *Pro* funds in this total position on a look-through basis (assuming puts are exercised).
- **Have you previously only written covered calls?** You'll need to roll those calls, assuming you want to keep the position going. Now write the same September 2017 $95 calls, lately for a net credit of $0.45. That price will change as the stock moves, but you'll need to get this trade completed before Friday or your shares will be called away. As always, sell one call for every 100 shares you own and wish to cover.
- **New and only want to write covered calls?** Use a buy/write order to buy shares in 100-round lots and simultaneously sell to open September 2017 $95 calls, selling one call for every 100 shares you buy. Lately this can be set up for a net debit of about $89.40, with making your total return 6.3% should the stock hit $95 by expiration. Invest approximately 3% of your *Pro* funds in this position.

Pro Can Help

- Register a domain name that speaks to *your* soul on our Verisign discussion board!

Winners and Losers Versus Our North Star

Published Jun 12, 2017 at 4:28PM

Fellow Fools,

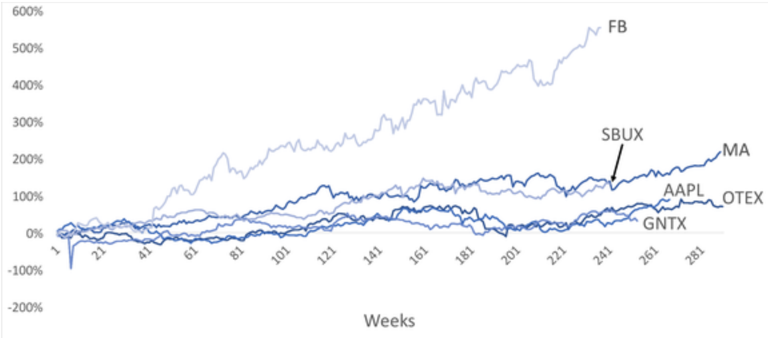
> *Motley Fool Pro*'s mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star.

Ah, the North Star. More than just a cool name, our benchmark lies at the foundation for every decision we make here in *Pro*. No stock, long or short, is added to the profile without significant consideration of whether it actually improves the odds that the *Pro* portfolio will be able to hit our lofty 10-year target. We love huge winners like **Facebook** (NASDAQ: FB) just as much as the next investor, but we recognize that in investing, success is ultimately judged based on how your entire portfolio has performed against your benchmark. This is one of the primary reasons we don't display how our individual positions have faired vs. our North Star, even though "stock vs. benchmark" is standard practice for most Fool services.

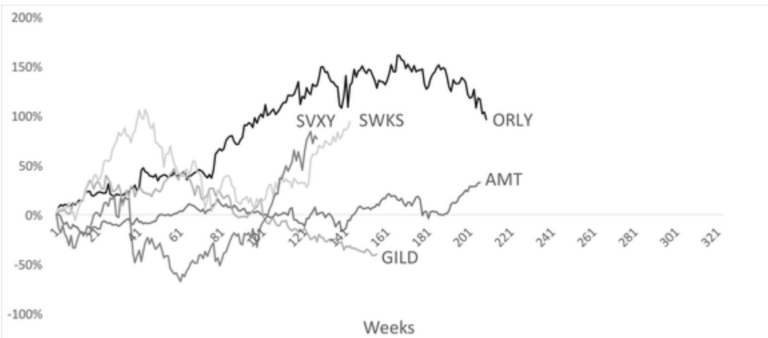
But that's not to say we don't *track* how each of our positions is fairing versus our benchmark. Accuracy is one of our top priorities in *Pro* -- it has to be, given that we're also looking for positive returns over every rolling three-year period. So how have all of our active long positions held up since the original trade alert first appeared in your inbox?

2009-2010

2011-2012



2013-2014



2015-2016 (plus Amazon)

source: S&P Global Market Intelligence, author's calculations

For the most part, these charts mirror what we see when we look at the returns column on our homepage -- Facebook is our largest winner in an absolute sense and vs. the North Star, **Paycom**'s (NYSE: PAYC) strong performance right out of the gate has boosted it nine spots to become the 12th best active performer in our long book and given it a sizable head start over the North Star, and **Gilead**'s (NASDAQ: GILD) recent struggles have made it the worst-performing long position in our portfolio and the second-worst vs. the North Star.

So which name has had the hardest time keeping up with the North Star? That would be the **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS), which currently trails the North Star by almost 70% despite us currently being down only 6%. This underlies one of the strengths of using the North Star as our measuring stick, but also one of the reasons why it's such a challenge -- the North Star never takes a day off. Day in and day out, the North Star is inching higher, meaning that a stock with a stagnate price will steadily lose ground to our benchmark. Now, this may be true of the S&P 500 when the market is rising, but unlike the North Star, the S&P 500 is subject to the whims of Mr. Market, meaning it's not uncommon for it to fall in value or stagnate.

Now, when times are good and the market is seemingly setting new highs on a weekly basis, odds are the market will outpace the North Star. And since investors by and large are competitive people, you might be tempted to keep up with the market when this happens -- even if you are making steady progress toward your investment objectives. But in doing so, you run the risk of repositioning the portfolio to benefit from near-term tailwinds at the expense of long-term objectives. A rising tide may lift all boats, but our North Star necessitates that we ultimately build a portfolio that rises *regardless* of what the tide is doing. This is why we strive to have the right mixture of positions in *Pro* -- some poised to benefit from impending catalysts, and some whose catalysts are harder to time, but should ultimately result in returns that are far in excess of the North Star over the coming decade.

Enjoy your week, Fools!

-- JP (TMFYossarian)

Pro Catch-Up Trades and Upcoming Expirations: June 8, 2017

Published Jun 8, 2017 at 1:39PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Best Buy Now); the portfolio is meant to work together as a whole.*

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- **NVR** (NYSE: NVR): Buy 2.5%
- **Visa** (NYSE: V): Buy 3.2%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.5%.
- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.2%.
- **Oracle** (NYSE: ORCL): Buy 3.8%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 4.5%.
- **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **Gentex** (NASDAQ: GNTX): Write (sell to open) December 2017 $17.50 puts for an additional 1% potential stock allocation, lately for $0.75 each.
- **O'Reilly Automotive** (NASDAQ: ORLY): Set up a protective collar on each 100 shares you want to protect. Sell to open August 2017 $250 calls, and buy to open an equal number of August 2017 $220 puts. Lately, with shares down near $230, this collar costs a net debit of around $2.30 per share. Or, you could instead sell to open August $240 calls, then buy the August $220 puts, for a combined net credit of around $0.80.

Hedges:

- N/A

This month's expirations (June):

- **Gilead Sciences** (NASDAQ: GILD): Our June $70 covered calls are on track to expire as income. We'll be looking to write new calls as they do -- assuming new calls pay enough at strikes we're comfortable using. Right now, our $70 calls still have some time value.
- **Verisign** (NASDAQ: VRSN): Our June $85 put/$90 call strangle has puts on track to expire as income, and calls we need to address. Look for us to roll before expiration.

Set Up a Protective Collar on O'Reilly Automotive

Published Jun 7, 2017 at 1:50PM

Is this for you? Any *Pro* members who own at least 100 shares of this stock, and who want to protect against downside below $220 per share, should consider this recommendation.

How You Participate

- **Action:** Set up a protective collar on **O'Reilly Automotive** (NASDAQ: ORLY)
- **Trade:** Simultaneously ...
  - **Sell to open** August 2017 $250 calls.
  - **Buy to open** August 2017 $220 puts.
- **Allocation:** Set up one protective collar (one of each option) for every 100 shares you want to protect. *(Pro* will collar all 500 of its shares, setting up five collars.)
- **Price Guidance:** Use a **limit order** and initially aim to set this up for a net credit of about $0.60 per collar. Prices will fluctuate as the stock moves, with the trade getting less expensive to execute if shares rise, and more expensive if the stock declines. Initially, always aim for a credit. If prices change much more, it's a judgement call on your part depending on much you want to spend; you can also consider using different strikes, rolling up or down accordingly. We will roll if we need to by the time we make our trade.
- **Recent Prices (12 p.m. ET):**
  - August $250 calls (splitting bid/ask): $5.60
  - August $220 puts: $5
  - Net credit: $0.60 per collar (use a **limit order**, net credit)
  - ORLY: $236
- **Scorecard Status:** Hold (and protect); 4% allocation. Our fair-value estimate is $255.

What We're Thinking

Habits drive the economy, and consumer habits are changing. Technology's key role in this shift could affect O'Reilly Automotive's future. The gutting of retail companies large and small has been headline news over the past year, with everything from **Macy's** (NYSE: M) to **Ruby Tuesday** (NYSE: RT) falling out of grace and out of bed. By comparison, auto-parts retailers including O'Reilly have remained healthy, and stock prices reflect that.

A marquee name in retail, Macy's trades at 11.8 times earnings and yields nearly 7%. O'Reilly, meanwhile, still trades at 21.4 times earnings and doesn't pay a dividend. O'Reilly has maintained a premium valuation because consumers have continued to visit auto-parts stores just as they did before retail imploded, sending same-store sales at O'Reilly at least 3% higher year after year. Last quarter, though, same-store sales were up only 0.8%. This was commendable compared to falling same-store sales at competitors, but not enough to keep the stock from declining. O'Reilly kept same-store sales guidance at 3% to 5% growth for 2017, but Wall Street seems skeptical.

In the first quarter, strange weather impacted sales, as did delayed tax refunds. Store traffic began to increase toward the end of the quarter, but at least one competitor noted weeks later that sales gains never materialized once tax refunds were mailed. Consumers spent that money elsewhere -- in fact, **Best Buy** (NYSE: BBY) actually pointed to sales gains thanks to tax refunds. This suggests the current quarter *could* be a bit light on sales, too -- though we won't know until likely the last week of July.

Over the longer term, a change in consumer habits is a concern we should all share about *any* of our consumer-related companies. Habits drive recurring sales. Going out to retail stores used to be an ingrained habit among most American adults. It was necessary, and you often made multiple stops along the way. Thanks to Internet shopping, habits are changing. We still need to repair our cars when they break, but we're less likely now to stop by O'Reilly to pick up odds and ends on a regular shopping trip, because we're taking fewer shopping trips. Even **Starbucks** (NASDAQ: SBUX) is vulnerable to the "knock-on" effects of consumers making fewer excursions. But we are making more purchases online -- and that means we're more likely to consider ordering some auto parts online, too. (Of course, you need to know exactly what you need; O'Reilly argues that most customers need one-to-one help, and we believe that's often true.)

Even small headwinds, like a decline in traffic of a few percent, affect a retailer's business and ultimately its stock price. In the short term, we're concerned that the valuation O'Reilly enjoys could continue to be compressed unless the business surprises to the upside again next quarter. In the long run, if we keep the stock, we have to keep a close eye on consumer habits. We won't even mention autonomous cars yet -- they're years away -- but they do exist as a potential concern.

Why This Strategy?

This protective collar caps our downside at $220 and still gives us nearly 6% upside over the next two months, to $250, which is right near our fair-value estimate of $255. We can lately set this up for a small credit of $0.60 per share. Our August expiration will see us through earnings in late July. If O'Reilly disappoints again, the stock price could suffer significantly, so our collar may help us in that case. If the business gets back on track, shares should gain, but Wall Street's merited, long-term concerns (that we share) surrounding traditional retail may keep a lid on those gains for now. O'Reilly now needs to prove itself quarter after quarter to chip away at doubts and concerns.

As to what we do next: If the stock falls below $220, something has likely gone wrong. We'll reassess, and we may choose to sell our stake at $220 through our puts. If the stock rises above $250, we'll assess if we want to keep owning it, and if so, close our calls, or perhaps roll the collar higher. If we're ready to exit at that better price, we'll let the position get sold at $250. Finally, if the share price remains between our two strike prices, sending our options to unused expiration, we'll set up another collar (or take other action) if we still want protection. Bottom line: We want to cap our risk on this 4% portfolio holding, and we aren't that concerned about missing some upside in the process. Allowing for 6% upside in the next two months is plenty for now, and then we'll cross the next "decision bridge" when we get to it.

Alternative Trades

- **Own fewer than 100 shares and want protection?** You shouldn't sell a call option in this case (because it represents 100 shares, which would put you "naked short" some shares at $250), but you can still buy a put option and have more protection than you need. That said, it's expensive. The August $220 put is lately about $5, so it's $500 for one put, and the stock needs to fall nearly 7% to hit your strike. You can buy this insurance, but you may be better off keeping your position unprotected and simply selling if we decide to sell, too.
- **Not using options?** You're in a tougher spot, with few ways to protect yourself. Make sure that you're comfortable with the size of your position, and adjust as needed. The stock remains on Hold, but obviously we prefer protecting the position or, if you can't, sizing it right for your comfort.

Pro Can Help

- Questions on this short-term protective position? Drive over to the O'Reilly board.

Buy NVR

Published Jun 7, 2017 at 1:43PM

Is this for you? This is for all *Pro* members, but just realize that **NVR, Inc.** (NYSE: NVR), can be a volatile stock. As ever, we have a three- to five-year minimum time frame.

How You Participate

- **Action:** Buy 2.5%. If you're managing less than $100,000, please see the Alternative Trades section below.
- **Price Guidance:** Use a **limit order**; this is still a thinly traded stock. Today, ideally pay less than $2,400. Later, the stock will remain a Buy until we say otherwise.
- **Recent Price:** $2,370
- **Guidance:** Best Buy Now
- **Fair-Value Estimate:** $2,550

Quick Look: Why Invest in NVR?

- We want exposure to the secular tailwinds of the housing industry as millennials begin forming families and buying houses in earnest.
- NVR isn't your average homebuilder — its asset-light business model enables outsized returns on invested capital when times are good and protects it when the market inevitably struggles.
- We believe NVR's disciplined approach, centered around being a dominant regional homebuilder while returning all excess cash to shareholders through buybacks, will result in strong returns for the stock even if calls for another golden age in the housing market prove to be incorrect.

Welcome to the Neighborhood: What We're Thinking

We talk a lot about riding secular tailwinds (electronic payments, the internet of things, mobile computing) here at *Pro*, and with good reason. Research has found that industry factors, not company-specific ones, often play an outsized role in a company's ability to outperform over the long run. We've done our best to position *Pro* to benefit from multiple secular shifts, but as Jeff noted in a recent Memo, there are areas where we think we're still underexposed. We recently took our first step toward addressing these shortcomings with our recommendation of Coherent. Today's recommendation of NVR, the nation's fifth largest homebuilder, addresses another area where we believe *Pro* is underexposed: U.S. housing.

You'd be forgiven for thinking that homebuilders -- with their reputation for cyclicality, prolonged periods of unprofitability, and average returns on invested capital -- are the last place we'd look for a *Pro*-like business. But NVR isn't your average homebuilder, and we believe it's poised to deliver North Star-beating returns over the next 10 years.

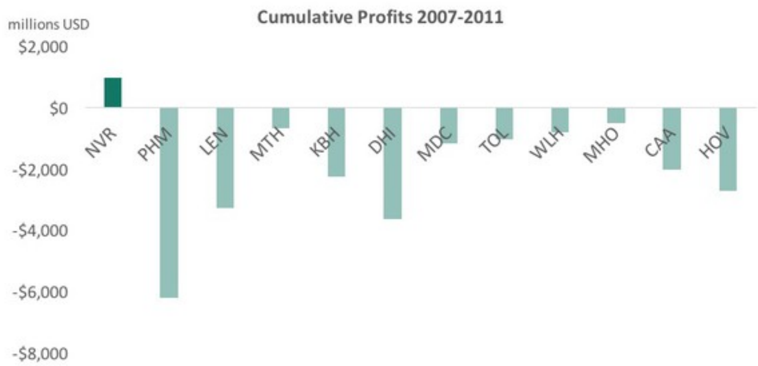
Lot Options, Smart Choices: The Business

NVR can trace its roots all the way back to the late 1940s, but the current iteration of the business was formed in 1987 when NVHomes completed a leveraged buyout of Ryan Homes. This was at a time when many in the industry were calling for the recent strength in the housing market to continue for the foreseeable future, but you know what they say about the best-laid plans of mice, men, and homebuilders. A few years was all it took for the U.S. housing market to experience a modest correction -- but when you're a leveraged homebuilder who also made untimely speculative land purchases, a modest correction is all it takes to send you into bankruptcy.

Interestingly, that bankruptcy was actually the catalyst for NVR to become a *Pro*-worthy company. Rather than blaming the struggles on bad luck, NVR's management did what all great investors do and learned from their mistakes, doubling down on the business model that originally made the company great and divest everything else.

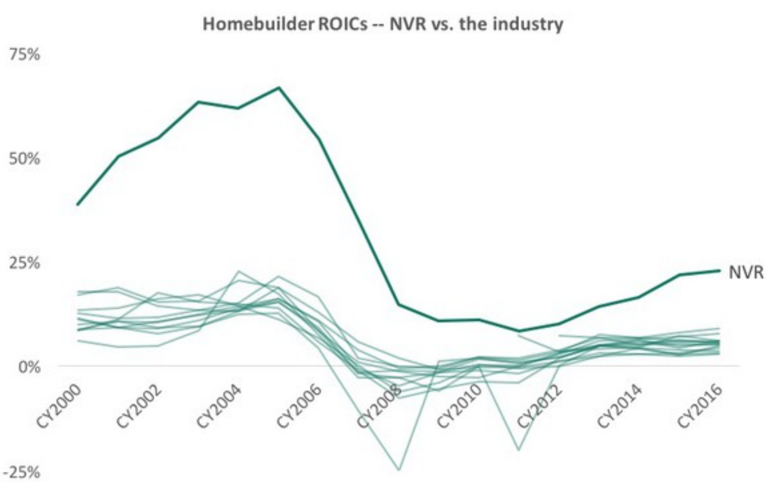
The core of that model is an asset-light approach in which NVR uses lot purchase agreements (essentially option contracts on finished lots) as opposed to the traditional method of land development. At up to 10% of the aggregate purchase price for the finished lots, the cost to purchase these contracts might seem steep, but the benefits are enormous (and should sound very familiar to those who use options to invest!) -- NVR is able to secure the rights to desirable lots for a fraction of the cost of buying them outright while protecting itself from untimely declines in the housing market. Buying up a bunch of lots right before the housing cycle turns can undo years' worth of profitability, as NVR learned the hard way. With lot purchase agreements, NVR is only ever on the hook for the deposits it pays to secure these options, and restructuring is often possible.

NVR isn't the only homebuilder to use lot options, but its decision to rely on them almost exclusively is what enabled the company to remain profitable throughout the collapse of the housing market, even as its competitors (who typically only use options for 20% to 40% of their lot needs) were reporting losses that in many cases exceeded a billion dollars. Not only that, NVR was actually able to go on the offensive and expand into six new markets while its competitors were preoccupied with undoing prior mistakes.



Source: S&P Global Market Intelligence

Better yet, most of these contracts are structured so that NVR can refrain from taking control of a given lot until the home has been sold and construction is about to begin. The approach goes hand in hand with NVR's focus on efficient construction processes (it can complete a home in as little as four months after a purchase agreement is signed), and the result is that NVR more closely resembles a just-in-time manufacturer than your stereotypical homebuilder. It also means returns on invested capital that are the envy of not just NVR's industry, but most public companies.



Source: S&P Global Market Intelligence

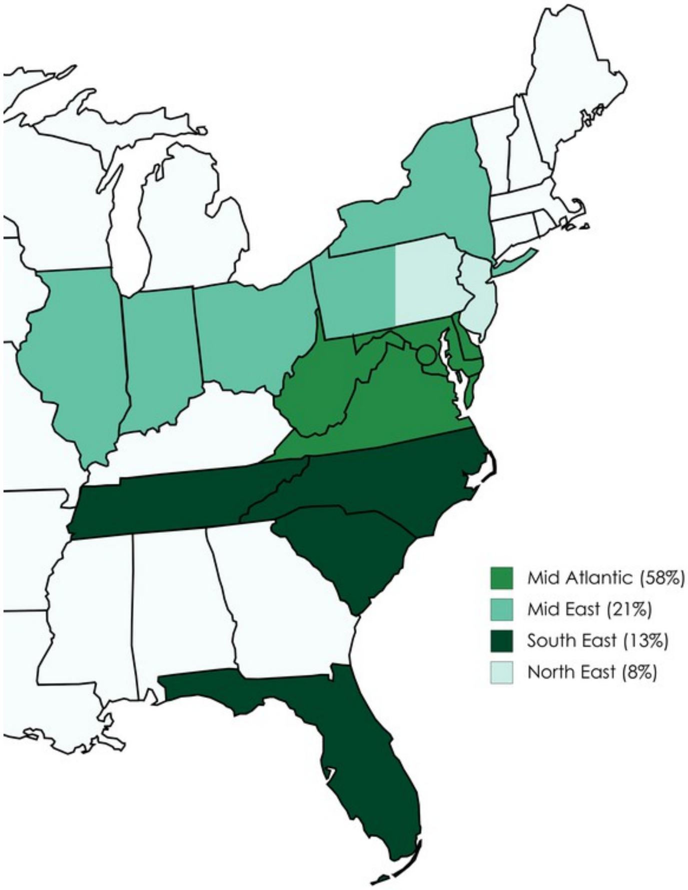
And what does NVR do with those high returns? Unlike some companies whose management might be tempted to go on a spending spree in the name of empire-building, NVR has instead opted for share cannibalization.

- Average change in shares outstanding over the past five years: -5.8%
- Cumulative change over the past five years: -26%
- Cumulative change since 2000: -58%

That's not to say that management isn't investing in the business. Rather, their focus is on occupying a dominant position in certain regional markets and then returning all excess cash to shareholders -- including management, whose compensation comes mostly in the form of periodic long-term equity-based grants.

We're fans of this approach because the housing industry is highly fragmented, and unlike most industries, it doesn't offer significant advantages to those with a national presence. Local economies of scale are what matter most, and because NVR is typically one of the largest players in a given local market, it's able to achieve greater scale than its competitors and to leverage its relationships with contractors and land developers to ensure adequate supply of both labor and land at the best possible price -- two of the biggest current obstacles for many homebuilders. NVR currently has control over 79,000 lots, with more than 44% located in its core Mid-Atlantic market (it's the largest player in the D.C./Baltimore metropolitan areas, with an estimated 35% market share). That's enough to generate more than five years' worth of homebuilding revenue using 2016 prices, and four years' worth at depressed 2009 prices.

NVR's Geographic Concentration by Revenue

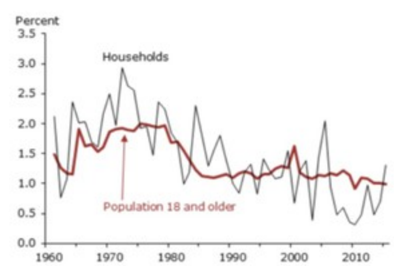


Source: Company filings

Little Pink Houses: The Industry

But why do we want exposure to the housing market in the first place? It's true that we typically shy away from investing in cyclical industries, because of the difficulty in forecasting the magnitude and duration of the cycles. But we believe that when it comes to U.S. housing, the long-term benefits of having exposure to the industry outweigh the potential short-term negatives from mistiming the cycle. Much has been made about the lackluster recovery in the housing market, but we believe the current environment supports an extended recovery.

Part of the reason for this tepid recovery has been the sharp decline in the rate of household formation (adults, married or unmarried, living together away from their parents). Prior to 2008, the pace of household formation exceeded population growth by about 0.2% per year for almost five decades. But from 2007 to 2015, the average difference was roughly -0.5% per year.

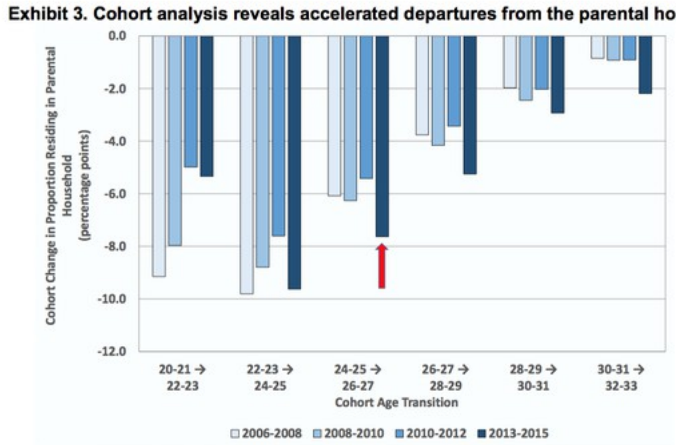


Source: U.S. Census Bureau, Housing Vacancy Survey and Annual Population Estimates; annual rates reflect July year-over-year percent changes.

Source: Fred Furlong (2016). *Household Formation among Young Adults*, Federal Reserve Bank of San Francisco

There's a lot behind these numbers. The strong economy, constantly rising housing prices, accommodative legislative policies, and easy access to credit all contributed to the housing boom of the 1990s and early 2000s, bringing the rate of household formation for those under 30 sharply higher than in the preceding 15 years. The current level is more in line with what we saw prior to this boom, and while we don't expect history to repeat itself, we do believe we're set up to see steady improvement in household formation for years to come now that millennials are the biggest U.S. generation.

While it's well documented that these kids today increasingly favor experiences over physical possessions, many surveys have found that millennials' desire to own a home remains in line with previous generations'. And two of the biggest determinants of household formation for younger adults — income and marital status — are increasing, which bodes well for future housing demand. With many homeowners currently opting to stay in their existing homes for longer, we could ultimately see the more and more millennial homebuyers opting for new construction.



Source: U.S. Census Bureau, American Community Survey.

Source: Fannie Mae Economic and Strategic Research Group (2017). *Starting to Launch: Millennials Are Leaving Mom and Dad's Basement*. Note: Graph shows the change in the proportion of young-adult cohorts living at home as they aged. Because the probability of living at home declines as young people grow older, all values in the chart are negative. The more negative the value, the more rapidly a cohort departed the parental home as it aged.

This potential influx in demand might not mean much for NVR if the industry was awash with supply, but homebuilders have been slow to ramp up production in the aftermath of the latest recession. Recent housing starts continue to hover near 1.2 million annualized, in line with the recent rate of household formation. That said, considering the underproduction of the past decade, a need to replace older units, and growing demand for other uses, some industry experts believe that housing construction will need to average at least 1.6 million units a year for the next decade just to meet demand.

Homeowners Insurance: Risks

With mortgage rates near historic lows in recent years, there is concern about how an impending increase will affect the housing market. Historically, financial well-being and significant life events (starting a family, receiving a promotion, changing jobs) have mattered more than prevailing mortgage rates to new homebuyers, but there's always risk that extended record-low levels have shifted consumer behavior. We'll also be watching NVR's ability to secure lot options at favorable prices; recent scarcity has resulted in increased competition in certain markets. Lastly, we'll want to keep an eye on NVR's cancellation rates, as they reflect the health of its customers. Currently, the company's backlog remains healthy, but this can change in a hurry if cancellations accelerate.

The *Pro* Bottom Line

With a valuation of 12 times EBITDA and 21 times earnings, we believe the market is underestimating NVR's full-cycle earnings power as the company benefits from the aforementioned tailwinds. But given this astute and shareholder-friendly management team, we believe this is a "heads we win, tails we win" investment -- market-share gains and smart allocation could deliver North Star-beating returns even if the housing market recovery remains tepid. Past performance is of course never a guarantee of future results, but we do think it's worth mentioning that investors who bought shares of NVR right at the peak of the housing market have not only completely recouped their losses, they've beat the North Star and outperformed the S&P 500 by more than 100% since then.

Alternative Trades

- **What if you're managing less than $100,000?** Since each share of NVR is lately about $2,370, you need to be managing nearly $100,000 to be able to buy a share and keep it at 2.5% or so of your portfolio (one share, obviously, would be 2.37% of $100,000). If you're managing less than $100,000, you can still buy a share as long as it represents less than 3.5% or so of your holdings, max. That means you should be managing at least $75,000. If you're managing less than that, wait and add NVR as your portfolio grows. It's a very long-term holding.

Pro Can Help

- Questions or comments about NVR? Please visit our newly constructed NVR discussion board.

We Won't Miss AmTrust; Plus, Content Changes Afoot

Published Jun 5, 2017 at 3:39PM

Dear *Pro* Fools,

Longtime Fool "kmbubba" asked on the **AmTrust Financial Services** (NASDAQ: AFSI) board whether members are selling their shares, as *Pro* has, or keeping them. As of this morning, 51% said they're keeping the stock, and 17% said they're selling some shares, but not all. That's 68% who are keeping exposure, with only 31% selling their entire position. And we're not surprised.

The Fool -- led by David and Tom Gardner -- has long downplayed the attraction of selling any stock, with two exceptions: You need the cash for your daily life, or you lack cash in your portfolio and see another investment you like better. The *Pro* port is in the latter situation now. We have about 20% cash, but we would like to *keep* about 20% cash, so if we want to add new positions and maintain our cash balance, we need to sell something. Our impetus to sell is also heightened when a position's risk-to-reward looks skewed against us.

After financial restatements, AmTrust has shown itself to be a weaker business with lower profitability and now a tarnished name (which could slow business further). We would need to see ample potential upside with *less* downside risk to justify keeping it. But today the opposite seems the case. The upside for the stock is likely going to be largely curtailed, but the risk is still potentially large; a rumored SEC investigation could prove true and have teeth, and if so additional years of results may come to need adjusting. So, the lower share price has not necessarily lowered the risk.

An investment in any business is an investment in trust. Any management team can fib about its financials. But the ultra-leveraged businesses of banks and insurers are particularly vulnerable to major pain if there's any dishonest accounting. How many financial businesses have we seen go under because of bad accounting in our lifetimes? A countless number. It's the leverage that brings them down. Since we see limited upside potential in AmTrust for now, still face the potential for more accounting revelations, and can't hedge the stock for a reasonable cost, the choice to exit the position becomes easy.

This is especially true because I've reached a point where I won't regret missing upside in AmTrust. That upside is not worth the risk, in my mind, so even if the stock *does* do well from here, I wouldn't want it in my portfolio. (I personally plan to sell my shares after my trading restriction ends; I hold shares in my and my wife's IRA accounts. I look forward to investing elsewhere.) I would rather own something that I'll comfortably enjoy owning. At some point, the same may be true of **O'Reilly Automotive** (NASDAQ: ORLY) -- the upside it may offer may not be worth the risk if the industry is truly under fire. We're working on an answer to that question.

All that said, some members may feel comfortable keeping AmTrust. It may be one position of 100 that you own. It might be 1% of your portfolio. So why not keep it? As Tom and David like to remind us, your losers become insignificant, and your winners carry the future, so even if you never sell anything, you can win big overall. Tom vows not to sell anything for at least five years. David rarely sells. The math supports this approach. Your sanity does, too. *Pro* is just a different beast for a few reasons: We don't add new cash (so we ultimately have to sell if we want new positions); we want to remain a focused portfolio of around 30 positions or fewer; and we're continually aiming to fill the portfolio with our best ideas to work toward our steady North Star goal -- even while trying to keep turnover low.

At the same time, many of our sells have been extremely beneficial. We sold **Bristow Group** (NYSE: BRS) at about $49.50. The stock is below $7 now. We sold **Contango Oil & Gas** (NYSEMKT: MCF) at $61. Today it hit $5.83. **The Buckle** (NYSE: BKE) was sold from *Pro* for more than $35 less than two years ago. It has since been cut in half. **3D Systems** (NYSE: DDD) is another successful sell for us. And let's not forget the shorts we've covered. **Five Below** (NASDAQ: FIVE) was closed at about $27; it's now $52. Our short of **Caesars Entertainment** (NASDAQ: CZR) was closed in halves at $9.50 and $6.90. It's now $12.45. We closed our **World Acceptance** (NASDAQ: WRLD) short in halves at about $36.60 and $29.85, and now the stock is near $81. All of the above positions were closed with a profit. Our large shorts of market indexes (as hedges) were also closed at prices much, much lower than today's. We're a long/short portfolio, so closing *has* to be a part of our regular way of thinking. Most of our attention to closing goes to shorts, but given our aim for steady improvement in the caliber of our holdings over the years, selling attention must go to our longs, too.

Bottom line: If we no longer believe that the upside in a position is worth the risk, we'd rather not hold it. If risks look modest, we might stick with a stock for years while waiting for annualized North Star-type returns. But not when risks appear heightened. Only time will tell how AmTrust performs, but it doesn't matter to us anymore. We don't care to be a part of it, whatever happens next. It's like when a relationship is over -- it's simply over. We wish the other party well, even though we don't want to be invested in its particular future any longer. Many of our sells *will* do well. With AmTrust, though, we'd put the odds at no better than 50/50, if we had to, having no real conviction as of today.

Trying New Content Plans to Progress

Here at *Pro*, we are trying some new changes starting today, while staying flexible. What I'm writing here is meant to reassure you -- I am optimistic about the effects of these changes on both members and the service -- but I know that even the potential for change is sometimes unsettling, so please know that if anything doesn't work for all parties as intended, we'll change again. The fact is that we want to make both the *Pro* and *Options* services more dynamic, and make our communications more relevant and timely. The editorial and content leaders at the Fool recently challenged us on this point, asking: "Why not issue content when you're driven to, instead of every Monday in *Pro* [or every Friday in *Options*]? And why not issue the most vital content any day of the week, whatever it is?"

In examining the reasons for our current content schedule, we found that most of them were outdated (just because we did it this way nine years ago doesn't mean it's right for today!), and many could be improved. So, we're now going to issue content as we have it, rather than locking ourselves into a schedule in which every Monday features a commentary in *Pro* (or every Friday, in *Options*). Instead, on Monday, we may issue a trade alert, for instance, if that's more compelling and relevant content for you, the members.

Last year, *Pro* and *Options* combined issued 129 trade alerts, more than any other Fool service (*Stock Advisor* issues 24 a year, for instance). Right now, I alone have 17 alerts that I'm working on or toward; many are new, many others are upkeep. Some of these new ones will get away from me because time is always ticking, and prices change fast. I have stars next to eight of these tickers on my list, meaning they're timely. I could have written and issued two of them today instead of this Memo. In future weeks, I'll be able to, because **the Memo is no longer locked into a Monday issuance**. We'll still communicate with members about AmTrust and any other news that needs discussion -- but we'll be free to tackle timely, actionable advice first if that's what's best for the port and for *Pro* members. And then we can issue any commentary any day of the week, multiple days in a week if compelled to, or none at all.

You will continue to receive *Pro's* Guidance Changes and Completed Trades every Monday, along with any commentary (including Memos) that's new or that we care to highlight. You'll now receive our Catch-Up Trades every Thursday -- this important *Pro* content deserves its own email, on its own day. And whenever we have commentary for you, we'll send it, whether it's Monday or not. This may be timely, news-related commentary, or it may be a large strategy guide that's taken shape over a couple of weeks instead of a weekly commentary. Trade alerts are almost always the most timely content we can issue, though, so during some periods you may receive more trade alerts than you otherwise would have -- if this is the case, you may not see additional commentaries during this time.

This is the Fool asking us to be flexible and see if these changes improve the service -- making it more dynamic, more timely, and more valuable to you. That is our only goal! So let's see if this works. I think it will. And we will continue to work until it does.

Here is the planned content schedule now:

- Mondays: *Pro* -- Weekly Roundup (Guidance Changes, Completed Trades)
- Tuesdays: *Options* -- Strategies You Can Start
- Thursdays: *Pro* -- Catch-Up Trades, Upcoming Expirations
- Fridays: *Options* -- Weekly Roundup, and "Always Have a Plan" *monthly* column
- Whenever Timely: Both services -- Trades, commentaries, other new content
- Once a Month: Both services -- Live chat

I believe that this flexibility and additional freedom will lead to more profits from investing ideas, while still keeping you just as informed and in touch as ever -- if not more so -- in a timely fashion. This should be more organic and effective. Working with the editorial team at The Motley Fool, we'll push for that, and we thank you for being a part of the process of improvement! Please ask any questions on the Memo Musings board.

Fool on!

— Jeff (TMFFischer)

P.S. My family and I are headed to France Sunday for vacation. So, starting June 12, I won't be online much the next few weeks! That's not part of this change; I just wanted to be clear on that. Happy summer!

Pro Guidance Changes and Completed Trades: June 5, 2017

Published Jun 5, 2017 at 3:29PM

Pro Guidance Changes from the past week:

- **AmTrust Financial Services** (NASDAQ: AFSI): Moved to Sell from a previous Hold. We also moved our protective collar to Close.

Pro Completed Trades from the past week (see transaction log; trades take a day to appear):

- **AmTrust Financial Services:** Today, we sold our 5,134 shares at $13.30, and closed our June $17.50 call, $12.50 put collar for a $0.20 credit. This freed up 2.3% cash in the portfolio.
- **Gentex** (NASDAQ: GNTX): Today, we sold to open December 2017 $17.50 puts for $0.65 (the best we could get), selling 16 contracts, for a potential 1% additional allocation to the stock.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Sell (Close Your Position on) AmTrust Financial Services

Published May 31, 2017 at 1:02PM

Is this for you? This is for all members who have exposure to **AmTrust Financial Services** (NASDAQ: AFSI). We're ending all of our exposure to the company. If you're of the school that *never* sells anything, you don't have to join us, you can hold on; but otherwise, to follow the portfolio, exit the position with us.

How You Participate

Actions:

- Sell all AmTrust Financial Services shares, using a **limit order** at the active price (lately $12.65, but that will of course change).
- Sell to close your June 2017 $12.50 puts, using a limit order splitting the bid/ask at the active price (this morning $0.70 to $0.75).
- Buy to close your June 2017 $17.50 calls for no more than $0.05 each.

Allocation: We're taking our 2.3% holding down to 0%.

Status: Sell (close) all positions.

What We're Thinking

In the end, this sell boils down to a lack of trust in company management, and a strong belief that we can do better by investing the funds elsewhere.

The accounting missteps at AmTrust that led to the recent restatement of three years of financial results may have been at least partly the result of honest mistakes. But it's also too likely that there was *some* willful intent on the part of some member of management; not intent to do anything illegal, perhaps, but intent to be aggressive with accounting, and perhaps make results look better than they were. In either case, the restatement points to a lack of an airtight operation, a lack of the focus, discipline, and integrity that we want from all of our investments.

In discussions with the team, the opinion that we should sell was clear and direct from both Billy and J.P. "End the misery," Billy said. "It doesn't live up to our standards." "I just don't trust management," J.P. added. What more can you say in that case? It was more difficult for me, having been an investor in AmTrust nearly since its IPO in November 2006. Excluding dividends, the stock is up 290% in nearly 11 years, much more with dividends, while the **SPDR S&P 500** (NYSEMKT: SPY) ETF gained 75% over the same time, excluding dividends. AmTrust outperformed by nearly fourfold.

Pro bought its shares in April and June 2009. We sold some shares in 2012 around today's current price, and we sold much more in 2015 around $34 per share. Overall, AmTrust has been one of the biggest realized winners we've had. Even the final shares we're selling are up nearly 200% -- more with dividends and options. But it doesn't feel like a winner. And that's instructive.

First, we know that newer members have a sizable loss. The stock is down about 50% this year. Second, when the restatements were first announced early this year, the stock fell to about $17 before bouncing back above $20. The company downplayed the seriousness of the restatement, we assessed the likely coming financial changes, and we stuck with it. In hindsight, that may have been the time to simply sell. (We are now weighing the possibility of starting a new practice in *Pro* -- one where we'll exit a stock in most any situation when a company restates years of results, rather than wait or give it a second chance.)

We aim to give our companies room to make honest mistakes, but capital preservation and growth is why we invest, and AmTrust put both of those goals at lasting risk with its restatement revelations. The business is less profitable now than we were led to believe. Book value is less trustworthy. And the value multiples the stock deserves are lower and still questionable. The stock still trades around 1 times book value, and as we've seen from plenty of beleaguered financial companies, it could go much lower if Wall Street is skeptical about that book value.

And it has reason to be. The *Wall Street Journal* reported an unconfirmed ongoing SEC investigation of the company, noting that Harry Markopolis (who cried foul on Bernie Madoff before he was uncovered) is driving an independent march toward charges of improper accounting against AmTrust. Whether baseless or not, this high-profile report could damage AmTrust's business just as it has damaged its reputation.

And that may be playing a role in the company's new decision to raise $300 million from a private share placement sold to family insiders. That insiders would buy $300 million in stock appears as a large vote of confidence, but they have a lot to gain if the stock rises on the news alone. More to the point, that the company is selling shares now and using proceeds to shore up its insurance operations raises more questions than answers. Why sell new shares when the price is down? Why seek funds right now, even when the company plans to sell a majority stake in its compelling fee-based business this year for many hundreds of millions? Meanwhile, the diluted share count at AmTrust keeps rising, becoming a growing drag on value creation if and when acquisitions don't add incremental growth.

The complications of analyzing AmTrust go well beyond what we care to put in this report. Let's just say that the returns we've earned *per hour of work* on AmTrust the past eight years pale compared to the returns we've earned per hour of work on most of our other successful investments, and the risks still remain higher with AmTrust than the others because the accounting is so complex.

Our intention is to reinvest these funds this summer, the sooner the better. We're not selling AmTrust to raise cash. We're selling to remove this blighted position from the portfolio, free up considerable time, and put the money somewhere we like better. Selling **AIG** (NYSE: AIG) to buy **Visa** (NYSE: V) is a past example. And selling **Intel** (NASDAQ: INTC) led me to **Skyworks Solutions** (NASDAQ: SWKS). Selling **Wells Fargo** (NYSE: WFC) helped fuel the discovery of **Paycom** (NYSE: PAYC). Selling AmTrust will lead to something we like better, too, and that should matter most in the end.

That, and the lessons learned. We hope to avoid making the same mistakes again, trusting too much in management when there's smoke that might be fire, and in the process save members from the hardship of a decline like this whenever we can.

In closing, the long June $12.50 puts that we're selling to close are worth nearly 6% of the current share price. That's great, but that's currently all time value, which will dissipate by June expiration. So, we plan to sell in the coming few days at most, using a limit order to get the best price possible.

Alternative Trades: Our advice is to close all positions. We're moving on.

Questions? Please visit the AmTrust board.

Write Puts on Gentex

Published May 25, 2017 at 1:57PM

Is this for you? Because we're looking to add 1% to our current recommended stake in this company, this alert should be applicable (now or perhaps later) to all *Pro* members, whether you already own shares of **Gentex** (NASDAQ: GNTX) or not. If you don't yet own shares, check out the Alternative Trades section at the end of the report.

How You Participate

- **Trade:** Sell to open December 2017 $17.50 puts.
- **Allocation:** 1% — write one put for every $175,000 or so you manage; *Pro* will write 16 contracts. In addition to our current 2.9% stock holding, this would bring our total allocation to about 3.9%.
- **Price Guidance:**
    - **Now:** Use a **limit order** to target $0.85 or greater to start (for a 4.9% effective yield in 205 days). **If we all use limit orders** and the stock price cooperates, we may be able to achieve $0.85 today.
    - **Later:** As prices and time to expiration change, those approaching the position should aim to get paid a yield on time value of at least 0.7% or so ($0.12) per month to expiration.
- **Prices (1 p.m. 5/25):** Stock: $19; options: $0.80 bid / $0.90 ask. Guidance: $0.85.
- **Stock Rating:** Buy, 2.9% allocation; we're now adding 1% in additional exposure through these new puts.

What We're Thinking

Since the expiration of our last written puts on Gentex in December 2016, we've been patiently waiting for an opportune time to reinitiate our long-running income strategy. Now that Gentex's stock price has retreated a bit from recent highs, we're happy to return at the $17.50 strike.

With the income from this strategy at $0.85 per share, if assigned, we'd buy shares at $16.65 apiece. At that price, we'd be buying at 13.3 times trailing-12-month (TTM) earnings, 6.8 times TTM EBITDA, and 12.8 times TTM free cash flow. Given Gentex's recent business execution, we think those multiples are attractive.

More That Matters

- **Maximum loss:** For this iteration of the put strategy alone, our risk is the same as share ownership starting at about $16.65, or 12.4% less than the recent price.
- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At $0.85, that's a 4.9% effective yield in 205 days.
- **Follow-up:** For this iteration of the put strategy alone, we'll buy shares at a net $16.65 if the stock is below our $17.50 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 2.9% allocation first — Gentex's shares are a Buy. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1% of your portfolio, then just buy 1% in stock directly *if and when Pro* does so through these puts (we'll alert you on the boards and in the subsequent Monday Memo if and when we do).
- **Want to write other puts?** Consider writing September 2017 $17.50 puts if the price on those options holds up better than the December puts after this alert is issued. Right now, the bid/ask on the September 2017 puts is $0.45/$0.55 (a 2.9% effective yield in 114 days).

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Check your mirrors and switch lanes over to the Gentex discussion board.

Earnings From 4 Pro Holdings

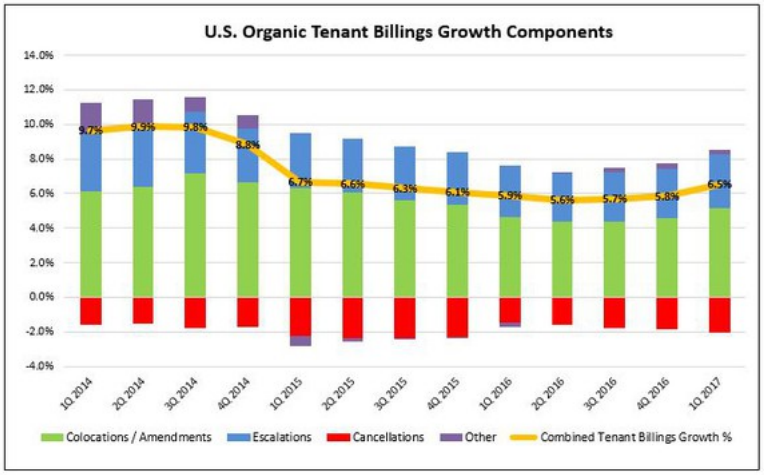
Published May 22, 2017 at 9:07PM

Dear *Pro* Fools,

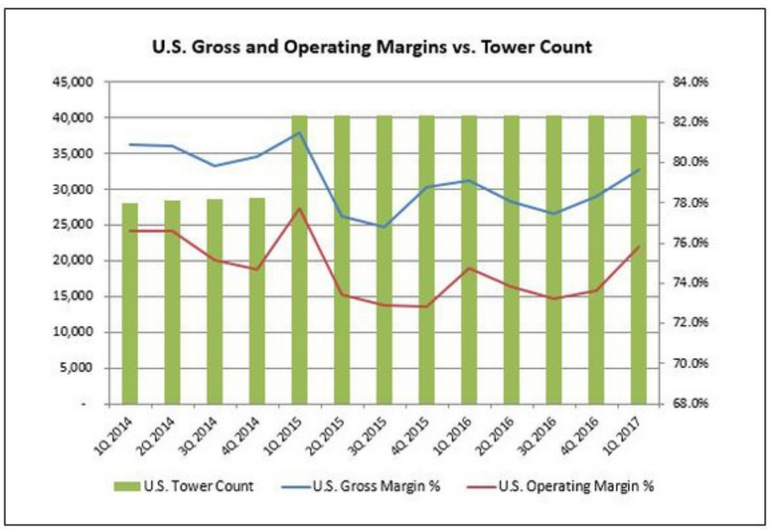
It's been a few months since the last official update on these companies, so with today's Monday Memo, I'll provide you with updated thoughts and guidance on four of the stocks in our portfolio.

American Tower (NYSE: AMT)

So far, our decision in March to roll our diagonal calls up and out to $120 per share looks like a good one. American Tower continues to execute methodically on its operational and financial initiatives, and it's benefiting from strong demand across the globe for space on its portfolio of nearly 150,000 tower sites in 15 countries. The company saw particularly strong results in its largest core market, the U.S. (56% of TTM revenue), where the 6.5% growth in organic tenant billings was the highest since the second quarter of 2015. This was supported by a recently amended master lease agreement with one of the company's tenants:



Additionally, the company continues to make good progress in improving the margin profile of the U.S. business, integrating and adding leases to the lower-tenancy (and thus lower-margin) towers it acquired in the Verizon acquisition in 2015. U.S. gross margins increased year-over-year to 79.7% (from 79.1% in Q1 2016), and U.S. operating margins increased year-over-year to 75.8% (from 74.8% last year).

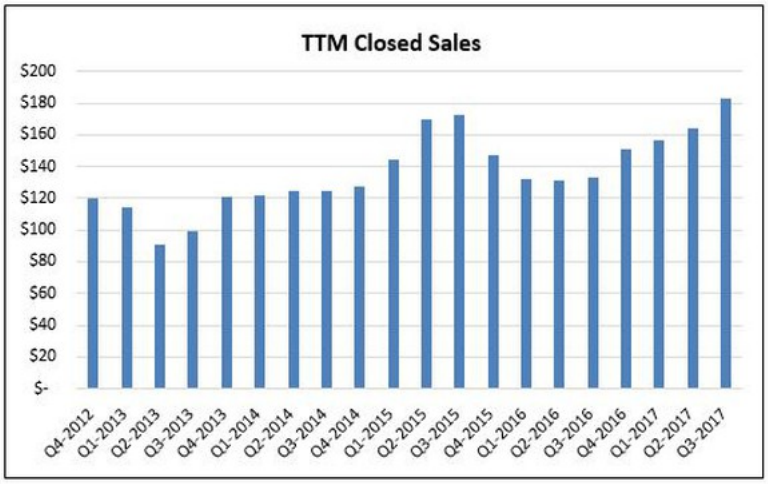


Internationally, margin improvements were a bit more muted as the company continues to acquire and integrate assets in new geographies (including the [recent acquisition of FPS Towers in France]). As a result, gross and operating margins declined from the year-ago period, although the trajectory looks positive:

American Tower's results continue to confirm our investment thesis -- that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time. Future catalysts include the recent conclusion of the [FCC's 600 MHz auction], [FirstNet], and a [potential partnership between Amazon and Dish Network]. The current wireless market environment should continue to support strong, stable growth for American Tower over the long term. **Our fair-value estimate increases from $130 to $135**, and the stock remains a Buy First at a 4.1% allocation, with 0.7% in January 2019 $80 / October 2017 $120 diagonal calls.

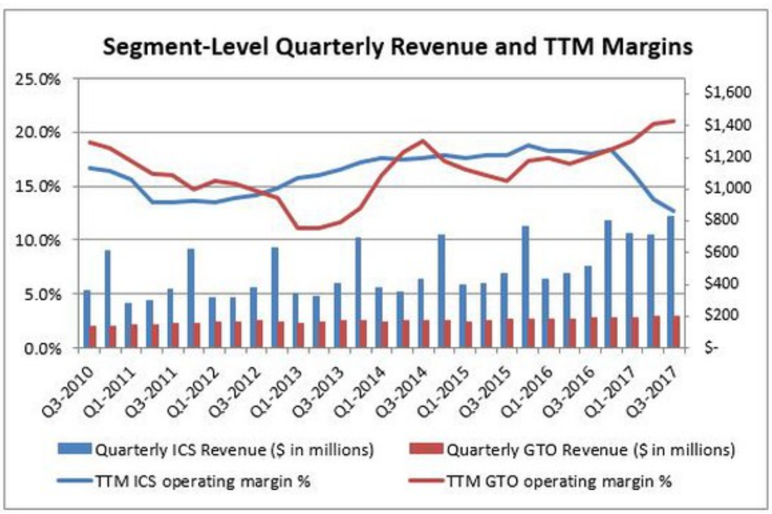
Broadridge (NYSE: BR)

Like American Tower, Broadridge continues to produce steady, stable growth augmented by acquisitions. In the third quarter of 2017, Broadridge reported revenue growth of 46%, growth in recurring fee revenue of 30%, and diluted earnings per share (EPS) growth of 20%. Closed sales (an estimate of expected annual recurring fee revenue for new client contracts) came in at $48 million, up 68% year-over-year, and year-to-date closed sales of $126 million were 33% more than last year's. TTM closed sales are at record levels, which is a representation of higher demand for the company's services thanks to the improved strength and breadth of its product lines.



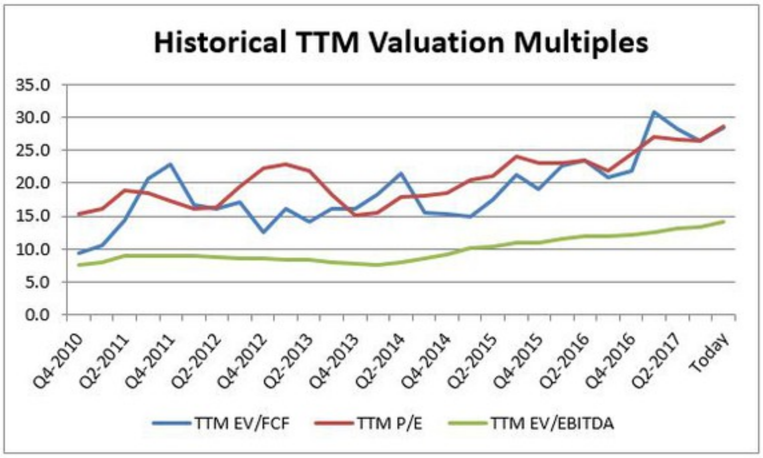
The company's recent acquisition of DST Systems' North American Customer Communications (NACC) business has led to lower companywide margins, but these should rise slowly over time as Broadridge works to integrate the NACC business via scale, cost synergies, and improved operation efficiency.

When breaking out the company's two business segments, we can see that Broadridge's ex-NACC business continues to do quite well. The Investor Communications Solutions (ICS) division shows significantly lower margins because of the acquisition, but the Global Technology Operations (GTO) business has shown strong margin expansion, generating a record TTM operating margin of 21%:



In part because of the heavy seasonality associated with the ICS business, we won't get a good sense of how the integration is really going until first-quarter 2018, when we'll have fully lapped the NACC acquisition. But so far, operational trends look good and the overall business continues to perform well.

Because of the strong performance of the business, Broadridge's stock is at all-time highs, and valuation metrics are elevated relative to the company's history:

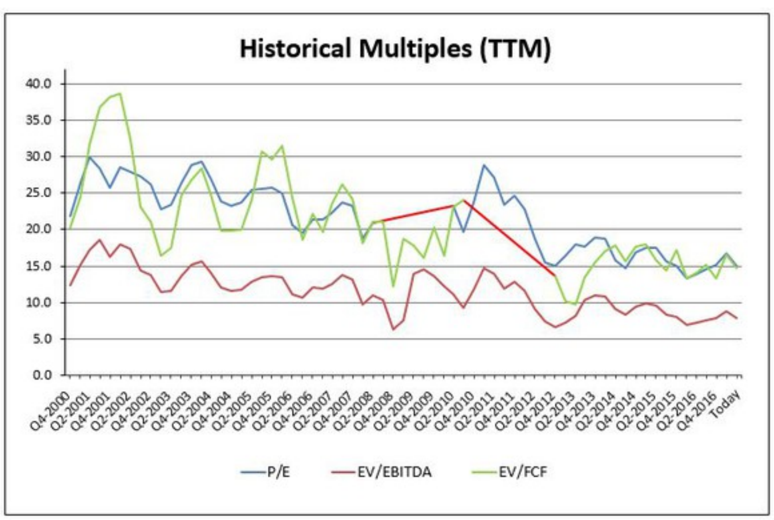


Broadridge has been one of the *Pro* portfolio's strongest long-term performers, as evidenced by its status as our second-largest position. Including options premiums and dividends, the position has generated an annualized return on investment of nearly 15% per year since our initial investment in 2010. Our fair-value estimate remains unchanged at $65 per share, **and the position moves from Buy First to Buy** as recent price appreciation and valuation-multiple expansion have affected the relative value of the stock.

Gentex (NASDAQ: GNTX)

Gentex continues its quest to penetrate the global light vehicle market with its auto-dimming mirrors. First-quarter 2017 revenue was up 12%, and global interior mirror unit volume rose 12.5% year-over-year. Compared with 3% growth in overall vehicle production in the company's primary markets, that shows Gentex continuing to significantly outpace vehicle production growth and capture market share.

Margins declined slightly in the quarter, which is typical as annual customer price reductions take effect in Q1 of each year; management expects improvement as the year progresses. Valuation multiples have compressed a bit as the stock price has declined 15% or so from a March high of $22.12.



The stock is currently trading at 15 times TTM earnings and 7.9 times EV/EBITDA, which is as low as we've seen since 2016. **Our fair-value estimate increases from $20 to $20.50**, and the stock remains a Buy at a 2.9% allocation. Additionally, since the expiration of our December 2016 $17.50 written puts, we've been patiently considering whether to re-initiate the strategy. With this recent decline in price, we're strongly tempted to write a new round of puts. We'll keep you posted.

Johnson & Johnson (NYSE: JNJ)

In the first quarterly update since its inclusion in the *Pro* portfolio, J&J posted a decent, if sluggish, quarter. The consumer division showed operational revenue growth of 1% year-over-year, the pharmaceutical business grew 0.8%, and the medical device division grew by 3%. Gross margin improvements and SG&A leverage added 240 basis points to operating margins, and adjusted EPS were up 7.5% year-over-year thanks to these margin improvements and the impact of ongoing share repurchases.

Management also provided guidance for the expected effects of the company's recent $30 billion acquisition of Actelion. Companywide operational sales are expected to grow at a 5.8% to 6.8% rate (with Actelion providing a 1.8% impact), and adjusted EPS at 5.8% to 8% (with Actelion providing a 1% impact). Additionally, the company recently provided strategy updates for the pharmaceutical side of the business at its Pharmaceutical Business Review Day, archived here. Management announced plans to launch or file 10 new "blockbuster" drugs (that means $1 billion-plus in sales) between now and 2021, and the company's pharmaceutical business looks poised to grow at healthy rates over the next several years, aided by Actelion. **Our fair-value estimate increases from $118 to $123**, and the stock remains a Buy at a 3.1% allocation.

Fool on!

-- Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Upcoming Expirations: May 22, 2017

Published May 22, 2017 at 1:02PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio -- if you're new, start there! Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4.1%.
- **Coherent** (NASDAQ: COHR): Buy 2.5%.
- **Visa** (NYSE: V): Buy 3.1%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.4%.
- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1% (see our recommendation).
- **Oracle** (NYSE: ORCL): Buy 3.8%.
- **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.6% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- N/A

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $83,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $115 puts, and buy to open *half* as many January 2018 $125 puts. Lately, aim to set up this combined trade for a small net credit (a nickel or so), or at worst for about no cost.

This month's expirations (May):

- N/A

Pro Guidance Changes and Completed Trades: May 22, 2017

Published May 22, 2017 at 12:54PM

Pro Guidance Changes from the past two weeks:

- **American Tower** (NYSE: AMT): Fair-value estimate increases to $135. The stock remains a Buy First at a 4% allocation, plus 0.6% in a diagonal call.
- **Broadridge** (NYSE: BR): The stock moves from Buy First to Buy on valuation, with a 5.5% allocation.
- **Gentex** (NASDAQ: GNTX): Fair-value estimate increases to $20.50. The stock remains a Buy at a 2.9% allocation.
- **Johnson & Johnson** (NYSE: JNJ): Fair-value estimate increases to $123. The stock remains a Buy at a 3.1% allocation.
- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $96. The stock remains a Buy at a 4.4% stake.

Pro Completed Trades from the past two weeks (see transaction log):

- **Coherent** (NASDAQ: COHR): We bought 285 shares for a 2.5% stake, paying $247.50 each using a limit order. Shares remain a Buy First.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Buy Coherent

Published May 17, 2017 at 2:58PM

Is this for you? This is for all *Pro* members, but just realize it can be a volatile stock. As ever, we have a three- to five-year minimum time frame.

How You Participate

- **Action:** Buy 2.5%
- **Price Guidance:** Use a **limit order**; this is still a thinly traded stock. Today, ideally pay less than $250. Later, the stock will remain a Buy until we say otherwise.
- **Recent Price:** $242.50
- **Guidance:** Buy First
- **Fair-Value Estimate:** $280

Microelectronics. Miniaturization. Mobile computing. Wearables. Artificial intelligence. The Internet of Things. Moore's Law. All of these help to fuel the business of **Coherent** (NASDAQ: COHR), a leading producer of commercial and industrial lasers and laser services. Coherent was founded near the dawn of the laser, in 1966, and its recent acquisition of peer Rofin-Sinar for $942 million gives today's business a leading breadth of products and worldwide reach -- even as the utility of lasers continues to grow.

The Business

Named for the "coherent light" required to make a laser, Coherent offers virtually every known laser technology, from gas lasers to fiber lasers, from ultrafast lasers to semiconductor lasers to diode-pumped lasers and many more. You don't need to know how they all work (we don't), but you should know what they make possible.

Robust sales at Coherent are driven by the world's growing dependence on electronic devices, many of which can't be produced without the use of laser systems. Smartphones, tablets, televisions, wearables, personal computers, and a growing list of Internet-connected devices are made of integrated circuits, printed circuit boards (PCBs), and display panels that rely on lasers in manufacturing to increase display resolution, boost precision and functionality, and lower manufacturing costs.

Coherent's two main areas of business are microelectronics and materials processing. I looked deep into each for details of how the revenue comes together; read on to dive in with me, or if you'd rather, go straight to the financials.

Microelectronics

Coherent sells laser systems to three major areas of the microelectronics industry: flat-panel display (FPD, or screen) manufacturers; advanced packaging and interconnect facilitators; and what's called semiconductor front-end production (SEMI).

The high-volume consumer electronics market is driving an innovation renaissance in multiple areas, including screens. Flexible organic light-emitting diode (OLED) screens are poised for rapid growth, and Coherent sells laser systems that make them possible. Both OLED and liquid crystal display (LCD) manufacturing rely on laser application. Whatever the technology, FPD demand is growing beyond Coherent's expectations, with the company prepping for even more expansion of its production capacity in 2018.

And growing FPD demand is just a start. Today's tiny semiconductor wafers may not be as visibly omnipresent as OLED screens, but they're just as essential to microelectronics, and Coherent lasers make it possible to cut, scribe, and assemble them into finished products. Modern printed circuit boards (PCBs) also require extremely compact packaging and dense interconnects, which laser technology makes possible.

Coherent lasers are vital for quality control, too. Global 24/7 semiconductor manufacturing wouldn't be possible without automated laser-based inspection systems, which detect and diagnose flaws in the tiny chips as they're being produced, thereby increasing yield. Many of Coherent's UV lasers should see continued adoption in this newly complex, nanometer-scale industry, and the company is also well-positioned to take advantage of an emerging trend toward using sapphire instead of glass in ever-thinner, ever-lighter devices.

Materials Processing

But microelectronics is only half the story at Coherent (literally, at 49.9% of revenue last quarter). Materials processing – the cutting, joining, and marking of materials mostly using fiber lasers – was the other big contributor, at 30.1%. Original equipment manufacturer (OEM) components and instrumentation made up 13%, and scientific and government markets were 7%.

Materials processing was a relative weak spot for Coherent until the Rofin-Sinar acquisition in November. In the first full quarter as a merged company (reported this month), bookings in the division more than doubled from the prior year, and demand particularly jumped from automotive and machine tool OEMs. Coherent's other, smaller markets include bioinstrumentation, for things like microscopy and DNA sequencing; medical surgery products; and worldwide research in areas such as physics, chemistry and health.

The Financials

Coherent's revenue -- and its share price -- have soared lately, but selling lasers and assorted systems can be a somewhat choppy business, one that isn't likely to grow in a straight line. Read on to learn why we're not worried, or if you'd rather, go straight to how it fits into *Pro*.

Although Coherent's revenue is up by 14.7% annualized over the past three years (9% annualized over the past five, all pre-acquisition), further growth is unlikely to be linear. Laser systems are expensive, and orders take time to finalize. This isn't a "typical" *Pro* investment, where we hope to see revenue grow each and every year; this one will require some patience. But we believe that consumer electronics and automated manufacturing have us on the cusp of much greater worldwide demand for laser systems, providing the potential for much greater revenue and reducing the odds for lengthy revenue hiccups over the coming five to 10 years. And investors are catching on to this thesis, as shares of Coherent and other competitors have soared. (We're far from discouraged! This suggests the market is recognizing the long-term potential in the industry.)

Coherent is getting more profitable as it grows, with its return on capital and return on equity rising to 10.6% and 13.4% respectively over the past year, meriting a higher stock valuation. The shares trade at 19.6 times expected earnings one year ahead, while the stock's average P/E since 1994 has been 31.3. (This is in part because of slow cycles during which the P/E soared, but it's still instructive.) For long periods over the past two decades, the stock traded at a P/E in the mid-20s, and today's business is stronger and arguably has more potential than before. With $6.35 billion in market value, the stock trades at 33 times trailing free cash flow, which should grow with the business and as synergies with Rofin improve.

With record revenue backlog and strong visibility toward future demand, management says Coherent is well-positioned to grow, and aims to increase margins along the way. We're investing with our eyes on five and even 10 years from now, when -- given how quickly technology is learning and proliferating -- smart computing devices made possible by lasers may be running our lives.

How It Fits Into *Pro*

Fellow *Pro* holding **Skyworks Solutions** (NASDAQ: SWKS) recently shared industry projections showing Internet of Things volume expanding fivefold to 75 billion units by 2025, driven by "connected homes, smart grids, factory automation, wearables and virtual assistance." Wireless connectivity is Skyworks's sweet spot -- and Coherent lasers will play a part in building many of these connected devices.

The company sells dozens of laser models to dozens of industries, and 26% of last quarter's revenue was recurring (parts, consumables, repairs, and related services). That's nice to have, but the real story here is an ever-greater need for lasers in the manufacturing of ever more electronic devices and other items. This is a volume story -- and a story of rapid change. As the components that companies use in technology products rapidly evolve, the lasers used to build the products and test them must evolve, too, resulting in new sales for Coherent. We see how quickly tech is evolving, so rather than investing in one particular technology, we're investing in a means for putting most any technology together.

Pro Can Help

- Have questions about putting Coherent in your portfolio? Please visit our new Coherent board.

Where Is Pro Looking Next? Plus, Some Earnings Knowledge

Published May 15, 2017 at 3:28PM

Dear *Pro* Fools,

We're in the home stretch of another quarter for our companies, and as always, we're working to give earnings news enough weight without putting too much importance on it. One thing I aim to accomplish every quarter is incremental knowledge: learning something new about each company in our portfolio.

To do so, I usually consult multiple sources, primarily the quarterly conference call and the SEC filing. As an investor, it's best when any new questions that arise in your mind during your reviews can be answered by the company itself. But each quarter is a mere snapshot; what we *really* need to do is make connections -- connections between business events in the world and our companies, between today and the future. Where is each company headed? *That* is what Wall Street aims to estimate in putting a price on a stock.

What's Next in *Pro*?

Speaking to what's coming, where are we likely to invest next in the *Pro* portfolio? This could change, of course, but steady reading and research over the past months has led us to pursue a handful of areas for further investment:

- Miniaturization, microelectronics, mobile computing, the Internet of Things (IoT)
- Artificial intelligence (AI)
- Robotics
- International investments
- U.S. housing
- Trade

Of course, we have investments in most of these areas already, including **Skyworks Solutions** (NASDAQ: SWKS), **Apple** (NASDAQ: AAPL), **Facebook** (NASDAQ: FB), and **Amazon.com** (NASDAQ: AMZN), not to mention **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS). But many other interesting companies are riding what appears to be an enormous long-term trend toward AI, and smarter technology in general. Companies that don't embrace AI -- or that don't use tech to make customer interactions easy and efficient -- are likely to be left behind.

Elsewhere, U.S. stocks have led the world for nine years, but the baton of leadership historically passes back and forth between regions. Is it happening again? International stocks have started to outperform U.S. stocks this year. Nothing is guaranteed, but a change in leadership usually lasts for at least a few years, and either way we see less expensive stocks in Europe and elsewhere.

Another bright spot: The U.S. housing market is likely to continue its slow but steady long-term growth as millennials -- now the largest generation in the U.S. -- buy homes. That's true even as housing starts lag the number of families forming. And finally, trade is going to continue to increase over our long time frame, despite some calls for protectionism.

We look forward to adding new investments to *Pro*. Today, let's touch on earnings from some existing ones.

Learn Something New Each Quarter

AmTrust Financial Services (NASDAQ: AFSI): The stock remains on Hold, and we have a protective collar on it (which is profiting us, because setting it up paid us a credit). The company reported weaker-than-expected earnings for several reasons, sending shares lower. This position has taken more of our time than any other this year, and we have yet to decide whether we'll cut it lose or keep it, but we want to protect it while we debate its fate. The underlying business is attractive, with recurring revenue and healthy profitability, but not if we can't trust the numbers from management 100%. So that's the end result we want. We'll have more info for you well before our protective collar expires in June.

Facebook: Facebook remains a Buy First; given our large 7.4% allocation, newcomers might want to invest half that and see where their comfort level is for several quarters before considering adding more. Trading at 26.8 times earnings estimates for one year ahead, the business is reasonably priced as it continues to grow. As always, though, it could decline in the near term in a weaker market. With nearly 2 billion monthly active users, Facebook has built the world's largest friends-and-family network, and it's now working to build communities, both locally and globally. Increasing advertising revenue is being reinvested in new growth avenues, and billions of dollars in free cash flow are still building the balance sheet. Management is working with outside developers on "bots" in Facebook Messenger as a way to supplant or replace traditional apps.

Gilead (NASDAQ: GILD): Our stalled biotech investment appeased some fears when it kept its 2017 guidance unchanged this quarter, suggesting that some stability might be entering the Hepatitis C market. Still, quarterly revenue was down 12% year-over-year, bringing it back to 2014 levels. Now, Hepatitis C sales are getting slammed when competitors enter Gilead's markets overseas. Though shares trade at only 8.4 times expected earnings for the next year, they remain on hold. We're writing covered calls in hopes of earning 10% annualized (with the help of the 3% dividend yield); in the meantime, the position buys us more time to see what Gilead might do next to grow again. We recognize we might lose our shares in the process, but it's a chance we're willing to take.

OpenText (NASDAQ: OTEX): The company's new AI platform, Magellan, will debut in July, to be available for customers early in the next fiscal year. OpenText continues to drive toward higher margins and 90% recurring revenue by 2020, with revenue up 35% this quarter to $593 million, 85% of it recurring. The integration of some acquisitions brought down margins, but that should be rectified before long. The stock remains a Buy at a 3.2% allocation, and our current $32 fair-value estimate is on track to move to $35 or $36 in a quarter or two.

Shake Shack (NYSE: SHAK): Our short was initially down 10% on earnings news, but then ended 10% higher. How's that for volatility? Same-store sales declined 2.5% as traffic dropped 3.4%. Investors ultimately focused on the seven new company-owned locations opened in the quarter, and new plans for 23 to 24 company-owned Shacks opening in the U.S. in 2017 -- guidance that had been raised by (wait for it) all of *one* unit. Employee costs continue to head higher (as they should -- people need to earn a living wage), and so does the valuation. The stock now trades at 72 times expected earnings for the year ahead, higher than it used to despite lower bottom-line growth. Still, from 72 owned locations today, Wall Street is mesmerized by the idea of 450 locations *years* from now, and the financial metrics per location are strong. As a result, this is *not* a long-term short for us. We want to see Wall Street reprice the stock sooner rather than later, because the very long term should be positive if the brand holds up. For now, it remains a short at 0.5%.

Skyworks Solutions: The stock remains a Buy at a 4.4% allocation. Those without options on it should keep it that way, just owning the shares. Skyworks' customer list reads like a "who's who" of the consumer-technology world, from all of the major phone makers to wearables to the IoT; last quarter, it also secured design wins at three leading car manufacturers. Always-on connectivity is increasingly complex, and Skyworks works closely with customers to create custom architectures. The trend is only growing, and unlike many other microelectronics or "semi" stocks, Skyworks remains inexpensive at 15.1 times expected earnings. Our fair-value estimate has ticked up again, to $96, and that's conservative. Our covered strangle is earning us premiums, and we'll manage it accordingly until we end it.

Please ask any questions on the Memo Musings board. Fool on!

— Jeff (TMFFischer)

Pro Video Chat, May 2017

Published May 15, 2017 at 2:31PM

The *Pro* team will be holding **a live video chat on this page at 4 p.m. Eastern on Tuesday, May 30**! We'll be using sli.do to communicate with members during the chat; click here to learn more about how that works. The specific Slido code for the event is #ProChatMay; click here to be taken directly to the chat, or go to the slido.com site and enter #ProChatMay.

Transcript

JEFF FISCHER:

Greetings, *Motley Fool Pro* members, and welcome to your May 2017 *Motley Fool Pro* chat. I'm joined at the table by J.P. Bennett…

J.P. BENNETT:

Happy to be here, Jeff.

JEFF FISCHER:

…and through Skype with Billy Kipersztok.

BILLY KIPERSZTOK:

Hey, Jeff.

JEFF FISCHER:

Hey, Billy. I'm Jeff Fischer and we're really glad you're here. We're going to talk about the portfolio and get to your questions, today. And I'll start with a little one-minute prelude before we get to your questions.

So you can ask questions. Go to slido.com. You can see, here, on the video page that you can click to slido.com. The code to get in is ProChatMay. Then you can ask your questions, and thumb up questions to get us to the ones that you want answered first. We're going to try to answer all of them, though, and you will be amazed if we do. So go to slido.com, put your question, there, and we will start answering them in a moment.

Before I ramble a bit more, are you guys both doing well?

J.P. BENNETT:

I'm a little bit tired working on my FoolFest presentation…

JEFF FISCHER:

FoolFest is Thursday, Friday.

J.P. BENNETT:

…and some other things we may have in store for members this week or next week at the latest.

JEFF FISCHER:

It's been a busy year on that front. We're on a faster pace of trade alerts than we've done in years and I don't think that will change anytime soon, really. Billy, are you doing well down in Florida?

BILLY KIPERSZTOK:

I'm doing great, Jeff. I am feeling healthy, well, and full of energy.

JEFF FISCHER:

Foolish! That's perfect. Good. That's awesome. So in my one-minute preamble, I'm just going to talk about what Warren Buffett calls *one-decision stocks*. That is a stock where you only have to make one decision on it, and that is to buy it and then hopefully buy more of it.

The reason you are hopefully putting yourself in that position — and it's certainly what we're aiming for with most of our stock purchases — is we're trying to find from day one a company that we'll be able to keep reinvesting in itself (generate cash flow, reinvest that cash flow into new business, and keep growing in that way, and thereby compound its value). Compounding machines, basically, is what we call them.

But in the age of rapid technological change, political change, [and] worldwide change, really (the world's arguably changing more quickly than it ever has, driven largely by tech, but also by some geopolitical factors and the mobility of the population), it's more difficult to find one-decision companies; a company you can just buy and hold forever, especially because we're not really drawn to the Campbell Soups or the Coca-Colas of the world. The staple food or consumer staple business that may not change much over decades.

J.P. BENNETT:

I don't know — they're changing now.

JEFF FISCHER:

Yes, there's a lot to be said for that type of business, but even they have to change a lot, and we're looking for things that are more dynamic, which is why we've ended up in things like MasterCard and Visa, [which] come to mind, and Verisk. And even Apple. Is Apple a one-decision company? That will be interesting if it is. They'll really have to keep innovating. They have a lot more cash than they've needed so far, so they're not reinvesting the way we wish they would, but they're also not burning money, so that's good.

Anyway, we're always trying to find companies that ideally we can own with you for the next three, five, ten years and grow with those companies as they keep investing in themselves to grow even further. And I love the challenge of it, now, because everything is changing so quickly. I'm drawn to technology companies, and I want to find those relatively few technology companies that are going to have the advantages that keep them at the forefront of the industry, even as the industry rapidly evolves.

And that's not easy. Let's remember [that] Apple was nearly bankrupt 15 or 16 years ago and Microsoft bailed them out. I wonder how they feel about that now. That speaks to why we would buy something like Coherent, which makes lasers and systems that help put technology together, instead of buying a technology producer itself. Instead we short GoPro, for example. Coherent is a way of buying the tool provider instead of the product maker, if that makes sense.

But to boil this down into a final statement, we're trying to find companies that have tailwinds the next three, five, and ten years and that ideally we don't have to sell. That we can buy more and more of over time and really enjoy owning. Longtime *Pro* members may say, "Well, you've sold quite a few things in the past," and we have sold things this year, too. I'll say for better or worse, we've had more turnover [of the team than] in the past, and we also didn't have as much focus in the past, either.

In 2008-2009, a lot of what we were wondering was how the economy and markets [were] going to work after this Great Recession. Now I think we're seeing, in large part, they work the same way. That's a good thing, and now we're hoping to invest for the next five to ten years, in that light, in companies that the whole team loves and will continue to own for a long time with you.

So that said, we know landscapes change and we have to remain diligent, as well. That was just diligent.

BILLY KIPERSZTOK:

Is that a real word?

JEFF FISCHER:

I like what I'm trying to say. And as you've seen, we've made several sells this year, as well. So if something's not right for the portfolio, in our opinions, we will sell it. Speaking of that, I'm sure we'll have questions about selling today. Let's go to slido.com and start to answer your questions.

As we move over to that, I'll do the usual summary. We're 80% net long — a little bit more than 80% net long — 82% net long. We're up 8.2% year to date as of this morning, so we're right in line with the S&P 500. We're a little light on shorts, right now. We've closed some shorts, recently, and we continue to look for shorts. I know we'll talk about hedging today, as well. Let's get to your top questions. We have one from Lon. J.P., do you want to read that one?

J.P. BENNETT:

"Hi, *Pro* Fools. With a lot of discussion on the boards about the recent AmTrust 300 million shares to the Karfunkels, what are our latest thoughts?"

JEFF FISCHER:

My latest thought is what was shared a few weeks ago, as well. We have this protective collar on the company. It's coming to an end probably sooner than expiration because in the last five days the stock has gone from under $12 to $14 and now back to $12 something. So our put options, as of right now, are all time value, and they're delta.

The amount that they'll move with the stock has plummeted in just the last few days to $0.34. They'll move about $0.34 right now for every dollar move in the stock, so they don't protect us that much, and its time value is going to dissipate quickly with expiration coming up. We believe that very soon we'll have a decision on our next move. It could be as soon as this week. It will be next week at the latest.

That could be to exit everything, as we talked about before. Just end the position for now and see what plays out next. It could be to keep it, but only if we can keep it protected at a reasonable price, because there's still too much uncertainty to keep even what is now a 2.3% holding in AmTrust unprotected, in my opinion.

J.P. BENNETT:

Even looking at just this $300 million deal, there's a lot of uncertainty around that, too. Like what were the motivations? Is it a captain going down with [his] ship and they're not really able to see what's happening? You've seen that play out with a bunch of businesses that have really struggled when they've fallen from their peaks. Management isn't able to adjust and come to grips with that new reality. Or is it a case where this is a once-in-a-lifetime buying opportunity for them and they're positioning themselves to make a ton of money?

I know in the past — and the past may not be a very good gauge of the future — they've been pretty strategic in when they've bought shares and it's worked out quite well for them. You just have to wonder what's really going on. Did the company need that cash that badly that they had to do a private placement? It didn't do anything to clear up the clouds surrounding the company.

JEFF FISCHER:

I agree. I was surprised. I posted to this last week. It's surprising to me that they would sell shares at this low price and that they're talking about collecting the $300 million and using it to pad the balance sheet. They've always talked about what a strong balance sheet they have and now their financials are supposedly completely clean and they feel adequately reserved. My concern is [whether there] are past under-reserving issues that are going to bubble up and that's why they're padding the balance sheet further. It's just things we don't know, as J.P. said.

So I'd say the $300 million is a push. That said, like you said, they have been good investors in the past. The Karfunkels have stepped in and bought a lot of shares in the past and made money on them. The whole thing is definitely a black eye on us this year — what has happened to AmTrust. It's down by about half. Our hedges have helped a little bit, but still it's been an unfortunate position that we have to remember will happen from time to time.

It's been rare in *Pro* and it's been a long time that I can recall having a stock fall that much. So it surprised me, as well, but we're dealing with it the best that we can in the way we think is best for all of us and for you, primarily … to protect ourselves, not knee jerk sell, and get out just because the stock is beaten up. But to sell for the right reasons if we're going to sell and luckily we have that collar while we make that decision.

BILLY KIPERSZTOK:

It's an especially interesting scenario given that AmTrust accounted for a very healthy gain for the early portion of its positional history.

JEFF FISCHER:

Yes, it's true.

J.P. BENNETT:

And it's always important to keep in mind that every great investor makes mistakes and has positions that don't really work out for them. But it's really important, like Billy alluded to, [that] we had really great gains on the stock, but you almost have to consider those a sunk cost. You can't let that influence your decision going forward and you don't want to, like you said, knee jerk and be like, "Oh, man. I have to try and recoup whatever I can before I give it all back and so I'm going to sell."

[As] we do when we're analyzing businesses, you have to put the stock price in your current return on the position by the wayside and look at the business. Look at what's going on. And then, after that, you can bring that situation back into the fold to help influence your decision.

JEFF FISCHER:

That is true. I was speaking about this with my wife, who is a long-term Fool. She started at the Fool in 1996. She hasn't been here for quite a while, but she was a Fool back in the day, and still is. So we were talking about AmTrust. She's known it since 2006, as well, when we first bought it.

And she said, "If it's a question of trust — if they broke your trust — all of society works on trust, but occasionally all of us, in our lives, have instances where that trust has been broken, and if it is you have to decide if you're going to give the entity that broke your trust another chance, or if you're going to move on from it. If it was a question of a mistake that they made — if it was an honest accounting mistake and you see them trying to correct that, which it appears they haven't — then odds are you want to give them another chance."

I, honestly, cannot decide if it was intentionally done or if it was a mistake, and so…

BILLY KIPERSZTOK:

I don't think we have the ability to know that, given what's publicly available to us.

J.P. BENNETT:

Yes, only time will tell. This is definitely going to be a hindsight story where if it works out, "Oh man, this was so clear that this is just a one-time thing. They're going to recover from it." And if it doesn't work out, "Oh man, the signs were everywhere. Shorters have been calling for this stock to get hammered for years." We should have been able to see it coming, but, again, with investing you can't really let that creep into play. You have to look at the scenario as it currently lays and it's very uncertain. It can go either way.

JEFF FISCHER:

That is true. Let's get to some other questions. We have quite a few about hedging. Crystal is asking, "How much protection does the current QQQ hedge offer? How much of a drop are we protected for? How much is protected of the portfolio? How can we increase it?"

All good questions and we're looking at our hedges, or this hedge, right now and we do every week in our weekly meeting. In the past few weeks, the market has rallied again to brand new highs today with Amazon leading the way.

BILLY KIPERSZTOK:

Amazon, by the way, breached $1,000. It's a milestone.

JEFF FISCHER:

It's hard to believe. I remember when it was — I don't even want to talk about it. I remember in 1997 when we put the buy report out on it. You're looking at a guy who could have bought and held Amazon for the last 20 years like David Gardner did. So how much protection does this offer us?

Right now the market's up so much that our long put option on the Nasdaq starts 11% below their current market price, so we need to roll it, as we've done in the past. We rolled it profitably just a few months ago, and we're looking to roll it higher again. And it looks like we can do so for another credit, so we're making money on this hedge as the market goes up [and] we like that.

But we also have to be careful about our downside exposure in the put ratio spread, which does exist, right now, at $110 per share and the QQQ is $141 per share right now, so it's quite a bit of a cushion before our downside. But as we roll up, that downside will roll up a bit, too. We're hedging about 15% of our portfolio value, including cash, so essentially we're hedging out about five or so long positions, on average.

How can we increase it? You can just buy more puts than you currently own, and you don't have to write put options to buy those puts. You don't necessarily want to increase your downside risk, but, of course, the puts are expensive so we do plan to address this hedge. Improve it. Bring it more up to speed and up to the current price, and trade alerts will get us there.

BILLY KIPERSZTOK:

One thing to keep in mind, Crystal, is I noticed in the question you mentioned protection. You said the word protection three times and then you asked how we can increase our protection. Hedges do protect against a decline in value in your portfolio, but they're not free. Keep in mind that anytime you're hedging something, you're giving up something else in exchange for that.

So hedging is a tool you can use to reduce your risk, but you're always going to give up something in exchange. If you want to increase the amount of protection in your portfolio, you're going to have to give up something to obtain that. That's how you need to think about hedges.

JEFF FISCHER:

That is true, and how much downside protection do we have? How far down? We actually have a $125-$114 put ratio spread. So you look at that spread of $11 and you subtract the $11 from $114 to get down to $103, and that's our breakeven. So all the way down to $103. The index is $141 right now, so that's almost 40% lower. This hedge helps us to that extent. So plenty of room, there, for it to help us if the market does decline. But, again, we're looking to manage our hedges by adding or moving this one, so we should get to that pretty soon.

We have Anonymous asking, "When setting up a LEAP call option, buy to open call on a diagonal call, why do we strike deep in the money?" In other words, why do we buy a call option that has a strike price of say $80 when the stock is $115? And either of you can answer that, I know.

BILLY KIPERSZTOK:

J.P.?

J.P. BENNETT:

It basically gets down to how much you want to pay for that leveraged upside. If you look at the two components of an options buy (the intrinsic value and the time value), the closer you go to being at the money, the more time value you have to pay, and that's the part that's going to waste away if the stock does nothing. We're not a big fan of paying for something that's going to waste away.

You can still get significant upside and significant leverage by moving down in the money and you can significantly reduce the amount of time value you have to pay. If the stock doesn't do anything, that time value whittles away but you're losing a fraction of what you would pay should you go at the money. So basically it is a scenario where we want that leveraged upside, but we're not willing to pay whatever the market wants in order to get it.

JEFF FISCHER:

Exactly. In general, the guidelines (and they should be at *Motley Fool Options*) [are] we don't want to pay more than 3-5% time value per year, and we're looking to buy a call option that's typically 20% in the money, or so, and that we believe could double in the next year or two to compensate for the risk we're taking. And that's typically a double if the stock gains, say, 20% or so.

J.P. BENNETT:

And one of the big counterpoints to that is that people say, "But you could lose that intrinsic value if the stock falls and you can end up with nothing." Like you said, there is a risk to that; but at the same time, it's like buying a stock. We would never set up a LEAP position on a stock if we didn't like the business and really like the price that we're getting into and have extreme confidence.

You can do it to minimize risk. If you want to gain exposure in 100-share increments, you can probably do that for a little bit less than buying the stock depending on where the share price is, but at the same time we want to be cognizant of the amount that we're paying and do it for a cheaper cost, but then minimize the risk.

JEFF FISCHER:

And to clarify, when I was saying buy a call that we hope will double; I was just speaking of a long call by itself. With a diagonal call, frequently we're not looking for that much upside. We'd love to get it.

J.P. BENNETT:

Unless we uncover it. Then we want all the upside.

JEFF FISCHER:

And with the diagonal call, we're hoping to speak to what J.P. said — to earn back the time value in the very first one or two diagonal calls that we write. So again, we're looking to minimize time value. I hope that helps answer the question. If it doesn't, go to the *Options* board and ask again. But I know we do have a guide to diagonal calls — a PDF one-page guide — that speaks about this, as well. I'm pretty certain.

J.P. BENNETT:

And I'm sure there's probably like a weekly on it someplace. I know you were doing a great job of checking off all of those questions that we get frequently in terms of positions and setting them up, so it might be worth checking out.

JEFF FISCHER:

Another good question from Anonymous about our conviction on O'Reilly. Definitely it's right up there with AmTrust. It's been one of the companies we've talked about most this year and for good reasons. J.P., any thoughts?

J.P. BENNETT:

Do you want me to start?

JEFF FISCHER:

Yes. I want you to start, hit a middle, and finish.

J.P. BENNETT:

OK, I'll take all of it. Like we've said in the past, we do think that there are favorable tailwinds that could benefit this particular position and the industry, in general, in terms of the complexity of cars. Millennials' preference for speaking with someone.

But that's not to say that they can completely override potential changes in terms of autonomous driving, and Amazon coming in and trying to make a really big move. Those are definitely things we're considering because they are issues that 10 years down the road we want to be able to double our real purchasing power every 10 years. Those are situations that could permanently impair that prospect. It may make it impossible because the competitive landscape just shifts and makes O'Reilly [no longer an attractive] investment. So we're considering those.

But we don't want to be too quick in pulling the trigger on those, because it's 10 years out. It's impossible to predict how things are going to play out and whether or not they're going to impair O'Reilly as a stock.

The thing that we're honing in on as of late — you're getting a lot of reports, right now, talking about how autonomous driving is the next thing and Amazon is going to kill all of these guys. So that's getting a lot of mindshare in terms of what's being talked about on the news and I think that is definitely having an impact on the stock.

But the thing we're really trying to key in on is if you think about it in terms of like you said in the past, we want really good returns over three to five years and then the prospect of having that position we hold for a really long time. If you look at it in that short of a time frame, the issues that could potentially crop up and hurt O'Reilly may just have to do with the evolving retail landscape.

So if you think about their customers, these are customers that, by and large, for financial reasons, are deciding to do things on their own. They want to save that extra money and they need it really fast. So maybe they could save more with Amazon, but they don't have that time. They need to get to their job.

But if you look at what's going on with retail, which employees, depending on where you look (one in every nine or ten jobs), if that industry becomes structurally impaired, which it looks like it is quickly heading down that route, and a bunch of jobs are lost, and people struggle to regain that income; that could actually end up being a really big headwind for O'Reilly because a huge subset of their customer base no longer really has the means.

So maybe they have to downsize and only go with one vehicle in their family. Or maybe they have to postpone repairs for even longer. Maybe they hear a knock in their engine or the A/C isn't working, but they just stretch it out as far as they can go. And so these are issues that we're trying to focus on, because these are the issues that are really going to have an impact on the business over the next three to five years.

Autonomous driving is something 10 years down the road [and] is playing on investors' psyches. As of right now, it isn't impacting O'Reilly and the business fundamentals, but these other issues are, and so that's kind of where we're at. We're stuck between a rock and a hard place because there are threats for 10 years down the road and then there also appear to be threats for three to five years.

So we don't want to rush, like you said, and just sell the stock when everybody doesn't like it. When it's got so much negative publicity, the stock is really beaten down. One good earnings report and all of a sudden it looks like things are much better and the stock rips higher. We don't want to do that, but we have to be cognizant that there are a lot of factors at play that weren't at play previously, and it may end up being a case where O'Reilly is another one that we need to reconsider.

JEFF FISCHER:

I agree. I'd put our conviction, with all that said, at about a six, probably, out of ten. As we said at the open, we're looking for companies that we hope to own three, five, ten years and J.P. just mentioned three, five, ten years many times in his description of the situation. If we're not confident in the next three to five, then we need to rethink it, as J.P. said, and so we are actively doing that.

That's why I look at something like Best Buy, which was left for dead five years ago, and [it hit] all-time highs last week because they've figured out how to do it. I personally think, as you said, J.P., the autonomous car is further away than people are saying. Even so, though, I don't want to discount it or the tremendous technological changes that are coming to cars soon in the next five to ten years. It's going to be exciting, even if it takes longer than that to get to self-driving cars.

J.P. BENNETT:

Twenty years ago O'Reilly was probably looking like a buy-and-hold forever stock. The landscape has definitely changed, and I will, just to piggyback what you were saying with regards to confidence (and I know we've touched on it in previous live chats), the coming quarters are going to be a very interesting scenario for O'Reilly in that we had a number of potential one-time factors in terms of the delay in refunds and just the wonky weather that we were having in terms of having good weather when we wanted bad weather, and having bad weather when we wanted good weather.

So the past two quarters weren't great [and] the stock got crushed, but there is the real possibility that that was just the market extrapolating one-time issues and just assuming that it was the Amazon effect. *The New York Times* article was published. It took two days and now Amazon is already killing O'Reilly. It could just be those were one-time issues, and if the business normalizes…

I know O'Reilly, and I think AutoZone has well spoke to the run rate exiting the quarter was far better than where they were in the middle and the beginning of the quarter. So if that run rate exiting the quarter holds and the fundamentals return to what we've seen previously, it may be a case where we should continue to hold and just monitor the situation. But if things continue to deteriorate, then there's actually something at play, here, that is potentially structural that we need to really examine.

JEFF FISCHER:

Exactly. Shares are down 11% year to date, so not horrible, but clearly not something we want. The one thing we're trying to do, though, is watch it closely enough that we exit before the ground shifts under their feet. If there's going to be a structural change, as you just said, J.P., we want to be at least respectably ahead of that. It shouldn't hit us upside the head like, "Oh, my gosh. The business has changed."

J.P. BENNETT:

Never saw that one coming. If you look at what happened with The Buckle, we did get out pretty early on. I think we were the first Fool newsletter to sell the stock. But still, we saw it coming, and part of that was what you alluded to before in terms of a turnover in the team. We had to get up to speed. I had to get up to speed with the business and reach a decision, and you don't want to be hasty and not considering the person you just replaced actually really liked the stock.

But that was one where we could have probably pulled the trigger earlier and we definitely saved a lot of gains by doing that, but we don't want to be in a situation… We don't have that scapegoat this time. We can't say there's team turnover.

JEFF FISCHER:

Right. We'll have to turn the team over a bit. Two more really quick thoughts on that — if I can remember what they were. One is O'Reilly is near the top of the list if we want to raise cash to get more defensive. But that's always been the case — that selling a retailer as opposed to a Verisk or somebody with a lot of automatic recurring revenue makes sense for us.

And the other thing is we have buy first, buy and hold. We're contemplating changing our hold to name any company that we're not confident that we want new members buying for the next three years. Just moving it to hold. That speaks to our idea that we're comfortable keeping O'Reilly right now, but if we were to create a three-year list of things we may sell in the next three years. O'Reilly is probably near the top of that list.

So what if we put it on hold for two or three years where those of us who own it keep owning it, but we're not telling new people to own it because we may not own it for our minimum three years from here forward. So just a confusing thought that I wanted to share right now. Actually, we'll lay it out very clearly if we do go that route.

We're already halfway through, so let's go on the speed round for the rest of this half hour.

BILLY KIPERSZTOK:

Yes, we've gone on a pretty slow pace, guys. I think that was maybe three questions in a half hour.

J.P. BENNETT:

Is Gillies a part of this live chat?

JEFF FISCHER:

So the collar we can probably get through. David is asking about the collar. He'll be on vacation (I hope it's somewhere great). "Any issues if I close now? How soon do we expect our recommendation?" There are no issues if you close now, but I don't think I would just close the collar. I would close the whole position, because I don't want you to own shares without protection, even though it's a relatively small position now.

How soon should we have our recommendation? I believe that it will be this week or next week at the latest. This week would be ideal. We'll see if we can get that out. So yes, David, I don't think there's anything negative [from] closing right now if you want to.

CP1 is asking, "How much farther do we think Gilead could drop before hitting the bottom?" Nobody knows, of course, but I'm hoping that it's near. What we need to see is the hepatitis C market stabilize at least for the time being so they can point to that and Wall Street can be calm for a while. Then hopefully they can put some new irons in the fire through their pipeline, or really through acquisitions.

The plan, right now, is to continue to write covered calls on that stock to try to generate a 10% annualized return through covered calls, the dividend, and then the stock itself, but that really banks on hepatitis C sales being stable. They were last quarter and it looks optimistic. The company did not change its 2017 guidance last quarter, either, so they feel okay about it so far.

Hopefully we have seen, by far, the worst in that stock. It, along with O'Reilly and AmTrust are all the ones that we're most likely to sell or raise for cash, which in a way makes sense because all are struggling in some ways and none have a clear path to bright skies for the years ahead. So interesting that members are focused on these three, as well. Billy?

BILLY KIPERSZTOK:

I was just going to say the same thing you just said, Jeff. It's not a coincidence that these are the top questions.

JEFF FISCHER:

Indeed. That's good. And I think if you add it up, those three positions are about 8% of the portfolio, so not meaningless by any means. About half of that is O'Reilly.

Gary is asking when to sell, or raise cash, or simply exit a position. "What positions in *Pro*, if any, are you thinking of selling?"

I can quickly say that we have AmTrust on hold; we have Gilead on hold; we have O'Reilly going back and forth from hold and buy…

J.P. BENNETT:

It was just on hold not too long ago.

JEFF FISCHER:

So those three are near the top barring any big changes or surprises. We also have 20% cash, so we don't need to sell, but if we think a position is going to perform poorly, we'll want to sell it, because cash is safer than a poor-performing position.

J.P. BENNETT:

And I would also note, as we approach the one-year anniversary of FoolFest, last year we gave a discussion on selling stocks. I don't know what the title was for that, but if you are able to find it in *Pro*, that would probably be a pretty good resource, because we did go over a lot of our past sell decisions…

JEFF FISCHER:

Yes, that's true.

J.P. BENNETT:

…and how our thoughts and how our process influenced those decisions.

JEFF FISCHER:

That's true, and this year you've seen some sales, as well, including TD Ameritrade and Valmont. Two more questions. "Broadridge and MasterCard are large positions traded well above your fair value estimate. Neither was mentioned in the last catch-up trades."

BILLY KIPERSZTOK:

I think there's an update, here. It says, "What to do if we have no exposure?"

JEFF FISCHER:

Both are rated buys, so you should start with your exposure. At least, I would say, start with half a position and then add to it over time, whether that takes you several quarters, or one quarter, or a year or more. It's your comfort level.

But we watch both closely. Broadridge is a bit above its fair value. MasterCard's fair value we keep conservative. It is on my list to update it. It's $105 right now and the stock is $121. The shares have run quite a bit in the last few weeks. It's a 5% position. Both of them are 5% range. But if you can start with half a position in each, and then go from there, with any luck we'll get a market downturn. But if not, at least for the time being you have half a position.

BILLY KIPERSZTOK:

And with respect to Broadridge, the fair value estimate tends to only get updated on a yearly basis because this is a very seasonal business, so you can't really project trends and you have to wait for the big quarter. [It] is around filing season [that] is their fiscal fourth quarter, which is going to be, I believe, next quarter for Broadridge.

And then also with Broadridge, three years ago, in 2014, they had a three-year financial analyst day and update, which I used to help me build my financial model and my fair value estimate. That concludes at the end of fiscal year 2017, which again is in either one or two more quarters. I can't remember.

Once Broadridge does their next update of their financial objectives for the next three years, which they should be doing pretty soon, I should be able to update that fair value estimate. I wouldn't really anchor too hard on those fair value estimates, because they can remain static even though the business is increasing in value, and they're very general. I would focus more on our commentary and you can read my thoughts on Broadridge in the memo from, I think, last week. I think that's a great business and I would be happy to own it at today's price.

JEFF FISCHER:

Excellent, Billy. Thank you. I should have let you answer to Broadridge, so I'm glad you did. Anonymous is asking, "Given current market conditions and that some hedge funds are raising cash…" Well, hedge funds have had a rough go of it.

J.P. BENNETT:

Raising cash or going out of business?

BILLY KIPERSZTOK:

I don't know if we want to follow hedge funds.

JEFF FISCHER:

"Any thoughts on doing more hedges?" We talked about that earlier at the top of the hour. Yes, we're looking at other hedges and adjusting the hedge that we have, so definitely. That said we're glad we haven't paid to hedge and that we're not very short, really, since the election. [That's] when we took off our last large and mixed shorts, and that was a tough call.

Anonymous is asking about Activision. "What do you think about Activision as a buy or writing puts?" Activision is a position in *Motley Fool Options*, so please head over to *Motley Fool Options*, because this is the *Pro* chat. There's an Activision board. Jim Gillies and Jim Mueller both follow Activision, so they can help you very well.

Gentex. Billy, we have a question on Gentex. "Your thoughts on Gentex's future." Self-driving cars. Something we talked about in our *Pro* meeting just last week, as well. What will it mean for Gentex if this comes about?

BILLY KIPERSZTOK:

A good question, Luis. This is a question or a topic that comes up a lot with respect to Gentex. I've had some commentary on this on the boards, but our boards' search functionality is not great. It may be difficult to find, so I often find myself saying these arguments multiple times, which is fine, and it's a good thing, because it helps reinforce our thoughts on this question, which is a very good one.

Gentex's future in an evolving car industry — an evolving auto industry — is somewhat similar to O'Reilly and the things that J.P. mentioned. It's going to impact driving behavior. It may impact the way that vehicles are produced. It may impact consumer behavior. But Gentex is a lot different than O'Reilly in that they're not like a retail-to-consumer type of company. They deal directly with automotive manufacturers, and they're kind of embedded in automotive manufacturers' processes. They're a very highly regarded supplier.

A lot of automakers work very closely with Gentex. J.P. mentioned the increasing complexity and technology in cars. Gentex is actively playing a role in that. They're not so much an auto manufacturing company as they are really a technology company. They build various technological features into cars that just increase the functionality of the vehicle. They have a very good R&D department and they can continue to innovate and add things that increase the value of a car, so I'm not too concerned on that front.

Other thoughts I've had on that is that self-driving cars may become something big in the future; however, for the next three to five years it's very unlikely to impact Gentex's results. Gentex signs contracts a year or more in advance, and they have good revenue visibility. They've already projected their revenue for 2018, and they have guidance on that front.

Gentex owns 90% of their market. They're a dominant business. They continue to capture market share. They should be able to continue to grow, even as self-driving cars become more and more prevalent.

JEFF FISCHER:

Thank you, Billy, and great question, Luis. I was grilling Billy about the same thing last week. I think it's great that our concerns are all pointing in the same direction with O'Reilly [and] Gentex. The changes coming to the car industry. AmTrust, of course. Gilead. We all have our fingers on the pulse which is very Foolish. I like the challenge of dealing with positions like this, as long as we can also find new ones that we like, too, to add. So doing both has been fun this year.

A great answer, Billy. We're going to stay on top of Gentex, as much as we are O'Reilly, and make sure that it's part of the future of cars. And if it ever looks like that's not going to be, then we'll be out of there early, well before those contracts come up.

Steve is asking, "I've been with *Pro* for one year and satisfied." Thank you, Steve. "It's been an interesting year, for sure, but the shorts are a bust. Gogo. Shake Shack. The euro. FAZ, even. Why? Why are the shorts not working?"

A great question. In the past one year, the Nasdaq is up 25% and that's one exact year from today. [That's the index which has soared 25%], and a lot of smaller stocks have soared even more. We shorted mostly Nasdaq-listed companies. The S&P in the past year is up 15%.

It's been a strong market, so it's not surprising that we've had shorts work against us in that market. We've also had some work out, but you're right. Most have not in the past year and that's probably going to be true whenever the market rallies quite a bit. I just want to be sure that you know we closed Gogo, so if you haven't closed that we recommend closing that. We closed that a little while ago. Shake Shack we still have. Contemplating adding to it.

The euro is on the table to possibly close, because the EU is looking pretty strong. They're banding together. The French election, which we were waiting for this month has concluded, clearly, and it's in favor of the euro and in favor of the EU. I've been digesting that and wondering if we should get out of the euro.

The only thing that would stop us is interest rates in the U.S. are on track to head higher and that should help the dollar; but that said, I think there are a lot of headwinds to that, as well, with the EU looking a little stronger right now. We'll see Italy's elections, this year, and there's some rumbling about an anti-EU stance there, but I don't think it's worth waiting for. So the Euro is just currency and the euro has gotten stronger.

And FAZ is actually a long of financials. We just happened to set that up right as financials had a cooling-off period and fell a bit, [00:42:49 so FAZ are short, which is in essence a long, because it's short a short is off a little bit]. In the long term we're really confident that that will work out.

I hope that's a somewhat satisfactory answer. We have kept the shorts to a minimum, thankfully, and the portfolio losses have been minimal because the positions are small. But in a raging market like this, it's tough to have good shorts and to our detriment we have not had great shorts. Name a company that cratered and we missed it.

J.P. BENNETT:

You can't win them every year. Some years we were pretty fortunate, but you're right. In a broad-based rally, especially when you're seeing a lot of private equity take out businesses that appeared to be structurally impaired, it's definitely not a bad thing to be underexposed in the short side. Rule numero uno for shorting is *live to fight another day* so you don't want to load up on a bunch of poorly timed shorts. We wouldn't have to unwind our fund, but it would definitely place us in a huge hole in terms of meeting our North Star goal.

JEFF FISCHER:

Luis is asking about American Tower bull call spreads. "Any new ideas for those?" That was in *Motley Fool Options*. Billy, do you want to say a quick word about this?

BILLY KIPERSZTOK:

I think our preferred option position for American Tower right now, within *Pro*, is the diagonal call that we have actively running. It expires in October and there's still plenty of time value there. We'll have to wait and see what the stock price does and that will help determine what we do with that diagonal call position. So far it's doing pretty well.

The bull call spread was kind of a one-off in *Options*, and that was amid a marketwide sell-off. We got a really cheap valuation on American Tower and a good opportunity, there. If we see something like that again, we may initiate one in either *Options* or *Pro*, but right now I think a diagonal call at the current valuation makes more sense.

JEFF FISCHER:

Excellent. Anonymous is asking, "Any regrets about selling Wells Fargo, given the recent run-up?" We can each say a quick word on that. I'll say no, because we've added to Visa, which is doing well. We bought Paycom soon after selling Wells Fargo, which has done well. And I think Wells Fargo speaks to AmTrust, as well. If a company has broken your trust, [and there's no question Wells Fargo was dishonest], do you want to continue a relationship with them?

This is a horrible example and I shouldn't do it, but it's towards the end of the hour. If you have a really wealthy spouse…

J.P. BENNETT:

Your willpower is you can't do that…

JEFF FISCHER:

…and they are dishonest with you, do you stay with them just to have access to their resources? No. Even if their life goes on and gets better and better, you don't want to hit your swag into their star, because they're dishonest with you.

J.P. BENNETT:

I see what you did there.

JEFF FISCHER:

Wells Fargo broke our trust, and I don't regret selling it. I think we'll do better with other companies.

J.P. BENNETT:

I would say more so with financials than with any other industry. They are black boxes. Their financials are almost exclusively based on estimates and so if you cannot trust the people running the company; do you have any business owning shares?

JEFF FISCHER:

Billy?

BILLY KIPERSZTOK:

You guys really said it all. I agree with everything you say. I was the one managing the position who made the decision to sell Wells Fargo. I personally have no regret whatsoever. I'm happy to have sold it and I think, like Jeff said; we've added stocks that we like better. Like J.P. said, we don't trust the management and those considerations, no matter what happened with the stock price after we sold it, we're happy that it's not in our portfolio anymore.

JEFF FISCHER:

We have a question and we're going to really fly the last 12 minutes and try to get through all of these. "Have we considered adding MercadoLibre to the portfolio, as it could be the next Amazon in the developing South America region?"

It has really gone up a lot in the last year. It's a popular stock at the Fool, held in MDP and other services. I've looked at it, I can say, several times, including lately. To fault myself, it has always looked pricey and expensive, so I wasn't driven to add it to the portfolio. I certainly didn't see this rampant soaring, which has happened to a lot of stocks in the last six months and has me a little leery, but I didn't see it coming. So we've considered it, but I haven't done it. If you guys have anything to add to that, please do.

BILLY KIPERSZTOK:

Not really. I think it meshes well with our recent purchase of Amazon, and it gives us exposure to a different geography. It could be something to consider. I own that stock personally in my own portfolio.

JEFF FISCHER:

Thanks a lot, Billy. Why didn't you put it into *Pro*? I'm just kidding.

BILLY KIPERSZTOK:

A good question. You could ask that for a lot of different companies.

JEFF FISCHER:

Indeed.

BILLY KIPERSZTOK:

Right, J.P.?

J.P. BENNETT:

Well, if we need a scapegoat for one of these positions, we know who's on the chopping block since he didn't add MercadoLibre.

JEFF FISCHER:

Well, I know some that you've bought, J.P., that haven't been added yet.

J.P. BENNETT:

That's true, but we're working to rectify that situation potentially.

JEFF FISCHER:

It's funny. You're willing to take more risk for yourself in most cases than you are for members and their money…

BILLY KIPERSZTOK:

Yeah.

JEFF FISCHER:

…and a lot of positions we start as Starter positions and get to know them better, without ever intending to add them to *Pro* unless they then merit it.

J.P. BENNETT:

I think it probably also speaks a little bit to the changes of our process in relation to what's really taking place in the markets, in terms of you go back a couple of years. You want the setup to be perfect. You want the perfect business at the perfect price at the perfect part in the cycle.

And as the markets have marched forward and valuations have started to move higher, it's going back to something we've talked about time and time again. When we're getting well past the initial recovery in the cycle (whether or not we're near the end, who knows), but the further along you get, do you want to place emphasis on cheap businesses that are of lesser quality and could be in for a world of hurt when things finally aren't as rosy as they currently own?

Or do you want to buy those amazing businesses where maybe you're not getting it at the perfect valuation? You're not bottom-ticking the stock, but it's one where you're going to be (a) eager to add to it, should it fall and (b) it's a stock you're going to have conviction in for the next three, five, or ten years regardless of what the market does.

JEFF FISCHER:

That's exactly right and MercadoLibre would check that box for me, I believe, if you're looking at the next three to five years.

Paycom is running above our fair value estimate. The stock is $66 [and] the fair value estimate is $52, so it's well above it. The stock is up 55% for us in six months or so. It's a 3% position now, speaking of high-flying stocks in a short time. The shares do look pretty pricey. I was looking last week. Our fair value estimate will tick up a little bit.

What you could do — we've had it in catch-up trades quite a bit — is you can write put options to try to get shares cheaper, but it does remain a buy, as well. And it's a fairly small position, so maybe you start with 1% or 1.5% of our 3% and go from there, or write puts for the rest.

But it is a buy, so if you wanted to buy the whole 3% you could and, again, this speaks to our three, five, ten-year time frame. When we look out that far, we're happy to have it as a buy, but you have to be with us. You have to be ready for three years to see returns. That's true of any stock, in general, but especially these higher-flying ones.

Gentex, part two, from Luis. Or Louis. Or Luis. It's Luis. You guys see I'm trying to single-handedly bring back the *Miami Vice* look.

J.P. BENNETT:

I missed that reference completely, Jeff.

JEFF FISCHER:

He was a character in *Miami Vice* as I recall, and when I threw this on, I was like, "Oh, that's kind of a strange look." But anyway… Billy, it's okay to laugh.

BILLY KIPERSZTOK:

I just can't see you, Jeff. I don't know what you're wearing, so I can't picture this, but I want to know.

JEFF FISCHER:

New markets. "Are there other areas or new markets that Gentex is looking into?" Really quickly, Billy, and then we're going to get to the rest of these questions.

BILLY KIPERSZTOK:

Not so much in terms of new markets or outside of mirrors. The biggest thing I think they're doing is they're working on this integrated toll module that you put on your dashboard and it will work in all of the different toll systems across the United States. They also have a business in aircraft and in fire safety, but nothing really huge. They're just milking their main, core market for the most part.

JEFF FISCHER:

Still relying on cars and that's what it's going to be for the foreseeable future. Luis is asking about Gilead Sciences. We touched on that quite a bit. Management did maintain their guidance for the rest of the year. Before next quarter's earnings, we will probably have options on it to generate some income, hopefully, and Gilead is also a potential source of cash if we need it, given the three-to-five year outlook is murky.

BILLY KIPERSZTOK:

Good job on the questions, Luis, by the way. Lots of good questions.

JEFF FISCHER:

Yes, they're very good. Thoughts on Under Armour. "Is it undervalued?" We look at it periodically. It's never been in *Pro*. It's been in many Fool services. We look at it for *Pro* or *Options*. It still looks expensive to me and I'll just leave it at that. I'd still be a buyer of Nike before Under Armour at current valuations. That said it's a good brand for the next five to ten years. We'll probably see it do well for owners, I would think. We're still waiting for lower multiples, because they may be in the cards.

Luis has missed out on Amazon. "An update on pricing. Fair value estimate coming sometime soon?" That's a fairly new position, but the update should come by late summer or this fall when it will be three-quarters in or so. We may increase the fair value estimate a bit, but realize with Amazon, there's a lot that's guesswork, really, and it's how large you think this industry can be for Amazon, or Amazon can be in its various industries, really. If you want to own it, it's rated buy and I would buy it, because the fair value estimate is not something to hang your hat on. J.P., Starbucks. Thoughts on what to do.

J.P. BENNETT:

Is that the question? Because I don't have an internet connection.

JEFF FISCHER:

Yes.

BILLY KIPERSZTOK:

That is the question.

JEFF FISCHER:

They haven't been able to establish a position, yet. Any thoughts whether to wait and how to get started.

J.P. BENNETT:

I would say that perhaps one of the biggest drawbacks to this stock is that the options have an abysmal payout.

JEFF FISCHER:

Right.

J.P. BENNETT:

You can't really look into setting up a position through options, so it's either buy the stock or set up a synthetic long using LEAPS or sit on the sidelines. The stock has recovered quite a bit. It seems like it was just a couple of months ago where the pessimism was pretty high, and now the Unicorn Frappuccino… I don't know if it was that, but momentum has completely swung around.

I can't check the multiples on my computer, right now, because obviously I don't have an internet connection for some reason, but it is one where I think if you really do like the prospects for the business three, five, ten years down the road, even so you'd want to leg into this. I wouldn't necessarily advocate for building your entire position at this price. I think it might be one where you would just want to nibble a little bit.

Keep in mind that this is a retailer. It is a company that has a lot of exposure to the retail industry, whether it's stores located really close to bricks and mortar locations. Bricks and mortar individuals who work… The employees… Wow, are we almost done, here, because …

JEFF FISCHER:

Robots? Soon to be robots.

J.P. BENNETT:

Soon to be robots. Robots run on caffeine, right? The employees who obviously go to Starbucks, so there's definitely some potential headwinds there for the company. Some negative news cycle bits going on Starbucks and how that industry is going to impact them. You could see multiples collapse really quickly. Or if the market rolls over, multiples could collapse. So I think it's definitely one you want to…

JEFF FISCHER:

Speed round? And the answer is?

J.P. BENNETT:

Hey, you guys were taking your time. Build it through legging into the position. Start with a little bit and then see how you feel about it.

JEFF FISCHER:

True. It's rated buy, so excellent. I like the context. It's very helpful. Thank you, J.P. and Billy. I'm going to run through three to five questions in a minute. You can time me…

BILLY KIPERSZTOK:

Great.

JEFF FISCHER:

…and meanwhile you can look for three to five, as well.

J.P. BENNETT:

I'm just going to twiddle my thumbs.

JEFF FISCHER:

And J.P., I'll hand you my computer. "So AmTrust covered calls are paying 16% for September — $12.50s. Is the price stable enough to try this?" I wouldn't just because the stock could fall much more than that. It's not worth writing a covered call on a company where you lack trust, unless you're going to use that premium to then buy some puts at, say, $10 or around there.

"Members saying they were able to short GoPro through Interactive Brokers, but the interest rate has been very high." It is high to short it. We shorted it with a synthetic short. "Are we getting close to closing the position?" I wanted to make clear that no, we are not. We're hoping to ride GoPro further down. If they start to turn profitable and have some stability to revenue, then we'd look to close, but right now that short is going well.

BILLY KIPERSZTOK:

Over a minute.

JEFF FISCHER:

Is it? OK, Billy, then you're up.

BILLY KIPERSZTOK:

I'll take the easy ones, here. Lon says, "Hi, Billy. No mask today?" No, that was actually a wedding present for my good friend who is a huge fan of *Lord of the Rings*. That is from the Witch-king of Angmar character. So, no.

I see also Leslie just re-upped for three more years. "Worldly events are too weird for her not to have *Pro* guidance, so have a great summer." Thanks, Leslie, that's awesome and I am with you. Worldly events are too weird for me not to have Jeff's guidance, as well.

JEFF FISCHER:

You guys are kind — too kind.

BILLY KIPERSZTOK:

"Gentex price sliding today, but the $0.85 premium is under 1% yield per month. Is the short put justified?" I wrote a comment about this on the boards. A 1% yield per month is just a guideline. It's not a hard line that we have to hit every time, especially with respect to Gentex, which we've followed for several years and we have a good handle on the valuation.

Maybe part of the reason why the yield is so low is because the market deems it unlikely that the valuation will drop to a level where we've written our puts. Also just because volatility is low. When volatility is low, your choices for options and the implied volatility aren't that great, and sometimes, in order to generate income with options, you have to accept lower yields, and that's what we're doing with Gentex. But yes, I do believe that the yield is worth the risk that we're taking there with that position.

JEFF FISCHER:

Thank you Billy and thank you Leslie. Have a great summer, as well. Anonymous is asking about inviting all *Pro* members to FoolFest. I just want to say we'd love to if we could. The FoolFest, and Fool events, in general, are so far outside of our control, but next year, for *Pro's* 10-year anniversary, we hope to have a *Pro* event.

Will we roll down the QQQ put ratio spread if the market falls sharply? The answer is probably not, because we'd like to instead buy calls on the index. If it falls 40%, such that we would be in a position to roll down, we probably would be better off going long, unless something really strange has happened, as Leslie alluded to.

"Can you purchase short ETFs in an IRA?" It depends on the ETF and the IRA, so please check with your broker.

I think we have to wrap it up there, unfortunately, because it's five o'clock. We got to most of them. I wouldn't write covered calls on Apple right now, personally…

BILLY KIPERSZTOK:

Nope.

JEFF FISCHER:

…unless you own it just as an income position. And this is timely. Mark is asking, "Are we getting the Monday memo, catch-up trades, and guidance changes today?" No we're not, because it's Tuesday. A lot of times with a holiday we do it on Tuesday, but the content structure is changing a bit. We're going to send catch-up trades on Thursdays, from now on, and separate the memo from that. That starts, I believe, this week, but we'll keep you posted on those changes. But no memo today. We're actually working on potential trade alerts and…

J.P. BENNETT:

FoolFest presentations. Stuff that will be able to be turned into future memos or content for everybody.

JEFF FISCHER:

And finally Mark is asking, "Will my long *Pro* portfolio do better with the options and shorts or not?" That really depends on the market. In a rising market like this one, your portfolio is probably better without options or shorts. When the market is flat for a long time or down, the options and shorts should help, and that's been the situation we've been in, on a whole, since we launched, pretty much. We've had a few 20% market declines, but on the whole, it's been a market that's just been good for longs.

That said, the longs are meant to work by themselves no matter what, over time. The options and shorts are meant to complement them whether you use them or not, and if you do use them, to help you in the long run. They should.

So with that, I think we have to exit the studio. Thank you, *Pro* members. Thank you Billy and J.P.

BILLY KIPERSZTOK:

Thanks, Jeff.

JEFF FISCHER:

Good to see all of you. We appreciate that you're here. We hope you're ready to enjoy the summer and we'll see you in June, if not sooner, in the *Motley Fool Pro* service itself. If we didn't get to your question, please ask on the boards and we'll try to answer. Hopefully we'll see it and we'll get you an answer. Thank you again. Thanks guys.

BILLY KIPERSZTOK:

Thanks, guys. Fool on!

JEFF FISCHER:

Fool on!

J.P. BENNETT:

Fool on!

Pro Catch-Up Trades and Upcoming Expirations: May 15, 2017

Published May 15, 2017 at 12:49PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4%.
- **Visa** (NYSE: V): Buy 3.2%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.3%.
- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1% (see our recommendation).
- **Oracle** (NYSE: ORCL): Buy 3.8%.
- **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.6% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- N/A

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $83,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $115 puts, and buy to open *half* as many January 2018 $125 puts. Lately, aim to set up this combined trade for a small net credit (a nickel or so), or at worst for no cost.

This month's expirations (May):

- N/A

Pro Guidance Changes and Completed Trades: May 15, 2017

Published May 15, 2017 at 12:47PM

Pro Guidance Changes from the past two weeks:

- **American Tower** (NYSE: AMT): Fair-value estimate increases to $135. The stock remains a Buy First at a 4% allocation, plus 0.6% in a diagonal call.

- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $96. The stock remains a Buy at a 4.4% stake.

Pro Completed Trades from the past two weeks (see transaction log):

- N/A

You can see all of our guidance, positions, and transactions from the Recommendations page.

OpenText Earnings Appear On Track

Published May 10, 2017 at 11:06AM

OpenText (NASDAQ: OTEX) ended the day down 5.6% on earnings; so, it's now down 0.4% the last month; up 6.3% YTD, and up 20.5% the past year (all excluding the 1.4% dividend). It's up 160% the last five years, more than doubling SPY, and handily topping the Nasdaq's 107% gain.

So, some returns perspective.

Is the business still doing well?

It grew well this quarter, with revenue up 35%, and recurring revenue up 34%. License revenue was up 35%, and cloud revenue grew 20%. Renewal rates were around 90%. But margins ticked a point or two lower across the board, largely due to the costs of integrating acquisitions (namely Dell's ECD division, which came on board in January) and lower margins at acquisitions (again, ECD).

ECD had operating margins in the low teens in the quarter, instead of the mid- to high-20s where it usually resided. As an asset acquisition (rather than buying a whole company outright), OTEX says it will get the margins up to OTEX's standards (the 30s) within 12 months. The integration continues, and integrated OTEX/ECD products will release in future quarters (with cross-sell opportunities). OTEX also inherited some customer contracts with low margins, and they'll honor those contracts through completion.

The 2017 target of 30% to 34% operating margins at OTEX is unchanged. The 2020 goal remains 34% to 38% operating margins and at least 90% recurring revenue.

OpenText will unveil its new AI Platform, Magellan, in July, and it will be available for customers early next year. IBM's Watson AI platform is a competitor, and as reality is starting to dictate, more and more companies are going to need to use AI to compete [I've been looking at AI investments all year, beyond Amazon or Apple, or Facebook and its fledgling start -- and hope to have some more soon. AI in the broadest sense -- as a convenience and outcome enhancer -- risks upheaving a lot of businesses if they don't adapt].

OTEX is priced at less than 14x times forward one-year EPS estimates, and 15x trailing free cash flow, along with a 1.4% yield that is ticking up with a dividend increase. Growth prospects remain in place. More acquisitions targets do, too.

I've gone through today's SEC filing on the quarter. The stock remains a Buy, as ever for the long term. We have a 3.2% stake. Our fair value estimate is currently $32, and has been for a while. That will get an update either this month as I update numbers, or in one more quarter or so (after a full quarter of ECD results), and it should tick upward by as much as 5% to 7%, if all is on track as appears.

AmTrust: Thoughts and an Update From Jeff

Published May 9, 2017 at 3:54PM

AmTrust Financial Services (NASDAQ: AFSI) is not in a strong position to disappoint investors and invite more uncertainty, but that's what happened, and selling this morning dropped the stock price sharply again. AmTrust is still fairly thinly traded on dollar volume, so it doesn't take much selling to lead to a 15% drop -- especially when the buyer pool has dried up after restatements and SEC-filled rumors earlier this year, which are understandably keeping many investors away.

Here's the bottom line on where I stand on AFSI:

- It will take considerable time for trust in management to return to 100%.
- Until that at least starts to happen, I feel we need to protect our position (as we have been, right now with long June $12.50 puts).
- At the same time, we're seeing what the business looks like, and how it performs, under new accounting protocols. The restatements only affected 3% of past revenue, but could have broader implications on profitability.
- Concurrent with that, AmTrust has made large acquisitions the past few years (Tower, Republic, etc.) and we're still seeing how those play out. A large insurance loss this quarter was related to Republic.
- One could easily argue that AmTrust is in the "too hard to follow" category and sell it, as some members have. It will be at least a year before we see how the "revised" business is going to operate, and at what levels, because AmTrust is continuing to invest in better financial controls. AmTrust had $17 million in extra costs this quarter related to getting its annual filing right, and it expects about $5 million in related costs next quarter (and then for this extra cost to keep tapering down). More important, where will the combined and expense ratios gravitate? There are many uncertainties now.
- AmTrust hopes to file its quarterly 10-Q on time, it said in the conference call. I wasn't happy to hear that there was any doubt at all, and I don't think Wall Street was, either.
- AmTrust believes it is adequately reserved for losses, but "unfavorable developments" led to losses on 2016 policies this quarter, reigniting fears that AmTrust doesn't reserve conservatively enough, and that more hits may happen.
- Through all this uncertainty, right now I only want to keep our shares if we can protect them at a reasonable (or no) cost. If that isn't possible in future months, we may choose to exit the stock instead. Currently, I don't want to own the stock without a safety net. This may be as ugly as it gets, but I still don't want to gamble on that.
- We have the shares still on Hold, along with the protective collar.
- Finally, the company is not looking for acquisitions right now. In a sign of how serious it is about getting all of its accounting structure right, accounting is the focus this year. AFSI wants everything in great working order before it considers growth through acquisitions again. This clearly wasn't liked by investors, either. This is basically a year to rebuild and refocus (not the worst thing, but not a year where you're likely to grow).

When you look at the results in isolation, they're not bad, as book value went upward a bit from last quarter, as did assets. But it was definitely a messy quarter, with a lot of bruises.

One was a greater than $25 million catastrophe loss related to wind and hail in the U.S., insured by Republic. Many other insurers suffered losses from this weather, so they're not alone, but this is new to AmTrust via Republic. Republic's personal lines of business are not ceded to Maiden for reinsurance, so they're on AmTrust. AmTrust is evaluating to see how the personal lines of business may or may not fit in with AmTrust. So, there's that uncertainty on top of the losses.

A second loss: $19 million of prior year adverse development in the Specialty Programs. Adverse development means you didn't reserve enough to cover all the losses that end up coming through. You would rather have a favorable development, meaning that you reserved more than enough. When adverse developments happen (and they're rare at AmTrust so far), you have to question if the company is reserving enough. Needing to ask that question today is particularly unfortunate given the recent black eyes. In the very extreme, inadequate reserves can sink an insurance company. At AFSI, the relatively small Specialty Program is now in "run-off" -- they're letting it wind down after struggling with it.

Almost all the casualty-only programs are in run-off at this point. AFSI struggled in these in the past, so they're letting them go.

Third, as touched on, expenses were higher than last year due to service fees related to the 10-K filing. Most of these are one-time fees, but not all, as AFSI continues to invest in professional staff. The business will indefinitely be more expensive to run, at least by nominal terms, due to having much more staff and outside counsel.

Finally, income was taxed at 31.6% rather than 17.2% (lacking off-sets or write-offs), and the rate is probably going to settle around the mid-20% range.

All this caused a much weaker combined ratio of 95.6% compared to 91.9% a year ago; the loss ratio was 68.7% compared to 66.6% (that darn 666 number) a year ago.

To cap it off, AmTrust shared that it is looking to sell 51% of its least risky, most attractive fee-based business to a private partner, likely for more than $1 billion, as a way to monetize this business and put some leverage in it. This would remove about $600 million of goodwill from AFSI's balance sheet, and give it about $1 billion in cash to use as wished, which could include writing more premium or buying back shares. My reaction to this news was negative at first: Why pursue this now? It made it seem like they're defensively raising still more cash, by selling off good assets, and that gave me pause. But it would make sense to raise cash to buy back more stock if they think it's too cheap, as they suggested. And they would still benefit from 49% ownership.

Book value ticked up to $13.91, so lately AFSI is trading below book value.

The optics -- the story -- just looks downright ugly right now at AFSI. I believe in a few years (perhaps starting in 2 years or so) the story will start to look more stable and the stock may start to recover, assuming no other surprises lurk around the corner (we still have the whistleblower rumor hanging over us). This reminds me of Assurant (AIZ), another insurance provider, one which suffered worse credibility hits and restatements than AmTrust. That happened nine years ago, and in the last five years the stock has finally recovered nicely (up 178%). But it took a long time.

The bottom line is that there are thousands of companies on the market to potentially -- ideally -- grow our money. The money we have invested in AFSI doesn't need to stay in AFSI to recover or to grow from here; we can move it other places to recover and then grow it. So, we need to have strong conviction that it makes sense to keep it in AFSI instead. Right now, our protective collar says we don't have that conviction. This quarter didn't ease those concerns. Now we have to see if AFSI files the 10-Q in time. As shared earlier, at this point, I want to keep our position protected. If that gets too costly, we'd close the stock instead.

It's both good and bad to say that the position is down to a 2.4% holding now, and we really don't want to let it go lower than that (we don't want to lose more), so we want to keep it protected until we come to have great conviction in the position again, if that can occur.

Newcomers should not buy the stock. It stays on Hold. We'll see how the options play out ahead of us. We may or may not still have the stock in another quarter, depending on the 10-Q filing, and on what the options cost for protection.

In many ways, the damage has already been done to us, and not much more can be done now. It hasn't been good at all, and I'm still assessing the ways this will change how we invest going forward; because it will change us. Fortunately, the portfolio is still up more than 6% this year, still above our goal so far, but that doesn't excuse a position that has fallen more than 50% on our watch. The lessons have to be learned, shared and applied, to improve going forward.

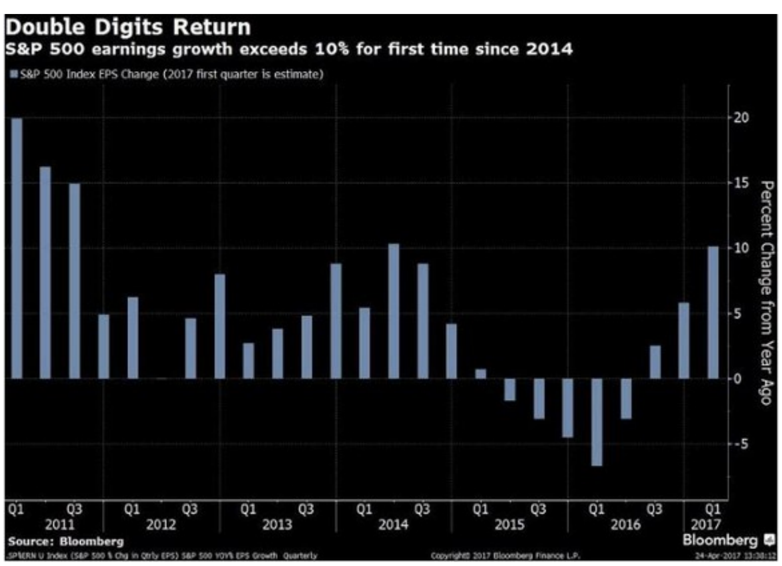
Charts of the Week: Earnings Growth, Perceptions of Uncertainty, and More

Published May 8, 2017 at 3:37PM

Dear *Pro* Fools,

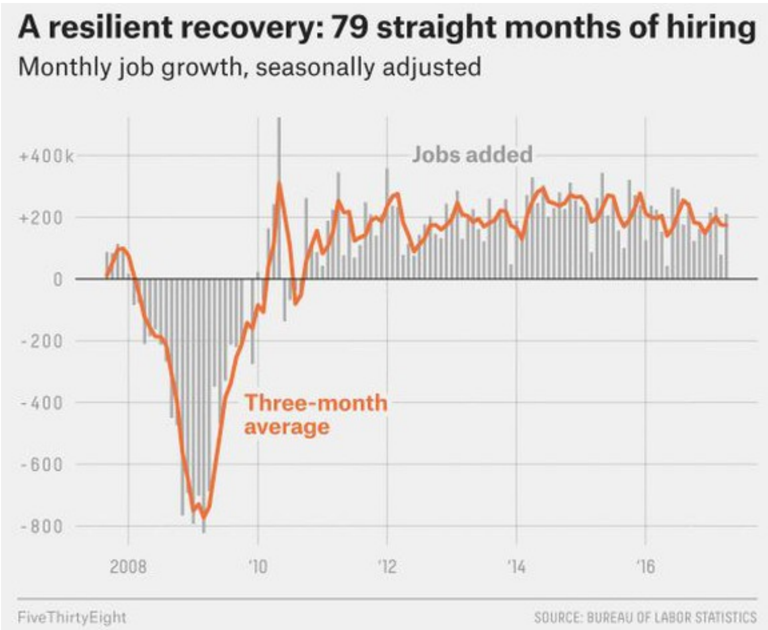
For today's Monday Memo, I'll kick off our week with another edition of my "Charts of the Week" series. Here are the five most interesting and/or market-relevant charts I found this week while perusing the financial/data blogs and websites I frequent:

1. Double-Digit Earnings Growth Returns



This chart from [Dave Wilson](#) of Bloomberg Radio shows how the S&P 500's companies are projected to show earnings growth of 10.1% in the first quarter of 2017, according to data compiled by Bloomberg from results so far and to analysts' projections as of April 24. We can see that the S&P 500's earnings growth rate has sharply accelerated after lapping the oil-price collapse in 2014-2015, and we're approaching earnings growth levels not seen since 2011. *Pro*'s companies have helped contribute to that momentum -- of the 14 *Pro* companies that are included in the S&P 500 and have reported earnings so far, average first-quarter earnings-per-share growth is 18.3%.

2. The Remarkably Durable U.S. Job Market

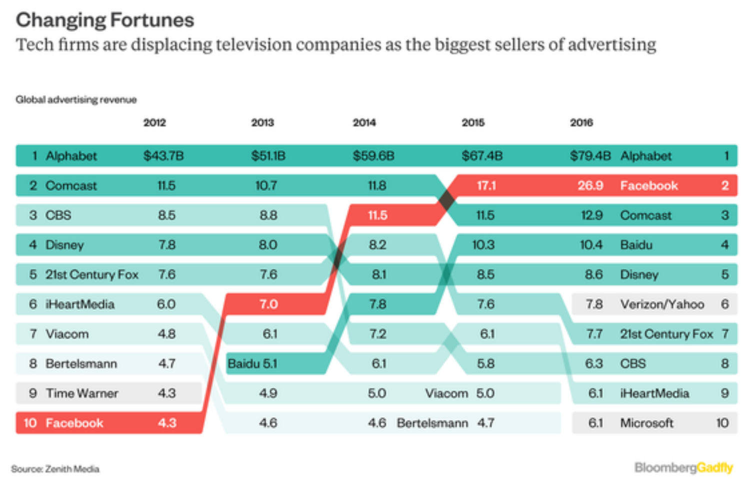


This graph from FiveThirtyEight shows the remarkable durability of the current U.S. labor market. April's report from the Bureau of Labor Statistics showed 211,000 jobs added, marking the 79th straight month of job growth -- by far the longest such streak on record. From FiveThirtyEight's commentary: "Perhaps more remarkable than the recovery's length has been its resilience. Time and again, one or two weak months of hiring have sparked fears that the recovery was nearing its end; time and again, job growth rebounded. The past two months are a good example: Hiring slowed sharply in March, when employers added just 79,000 jobs, but quickly rebounded in April."

3. Seattle Unemployment Rate Matches All-Time 2.8% Low

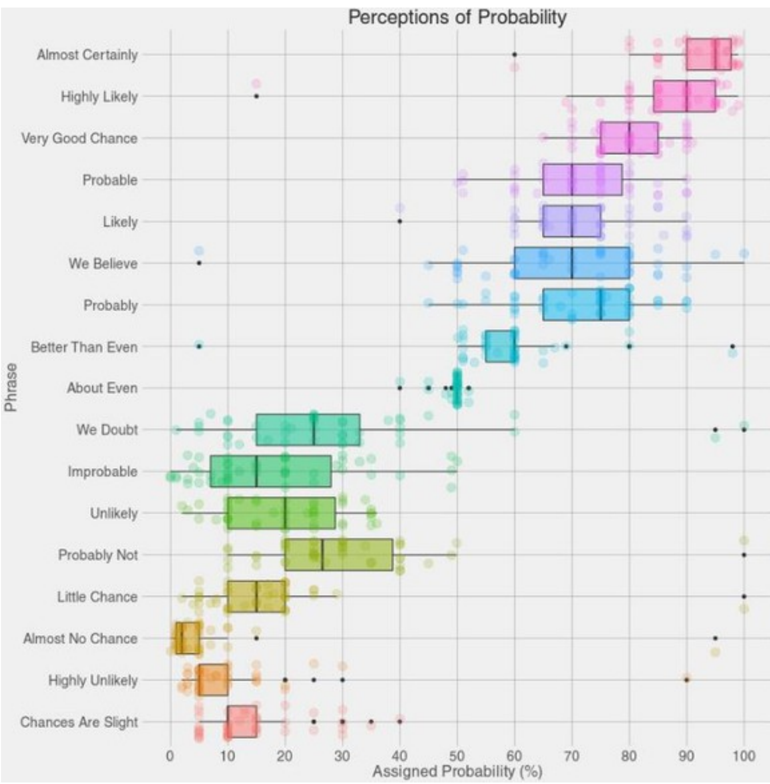
This chart from @TBPInvictus dovetails nicely with the job market graph above. The city of Seattle's unemployment rate is particularly interesting in light of the city's decision to pass a minimum wage law (effective April 1, 2015) that gradually increases the city's minimum wage to $15/hour. Now more than two years into the mandate, the city of Seattle's unemployment rate is at an all-time low. At least in the case of Seattle, it appears that a higher mandated minimum wage can work without a significant negative impact on the labor market.

4. Global Advertising Revenue: 2012-2016



This graphic from Bloomberg Gadfly shows just how fast **Facebook** (NASDAQ: FB) has climbed to become the second-largest player in the global advertising market. The data shows how technology companies are rapidly displacing traditional media companies in the advertising market, likely thanks to unmatched global scale. In 2012, only Google and Facebook were in the top 10. In 2016, half of that list was digital -- including Verizon (with its acquisition of Yahoo!), Baidu, and Microsoft.

5. Measuring Perceptions of Uncertainty



This intriguing and visually pleasing graph from Reddit user zonination shows the varying perceptions of probabilistic terms including "probably," "almost certain," "little chance," and other words of estimated probability. The results are all over the place, and it's easy to see how imprecise words can lead to misunderstandings. One person's "probably" is another person's "almost certainly." Especially in investing, where decisions are made in a world of unclear probabilities, it is useful to understand how communication about probabilities is interpreted.

The *Pro* Bottom Line

There you have it, Fools -- this week's edition of my top five charts of the week. Hope you enjoyed it, and bring any questions or comments to the Memo Musings board!

Best,

-- Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Upcoming Expirations: May 8, 2017

Published May 8, 2017 at 3:23PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

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- **American Tower** (NYSE: AMT): Buy 4%.
- **Visa** (NYSE: V): Buy 3.1%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.3%.
- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3% (see our recommendation).
- **Oracle** (NYSE: ORCL): Buy 3.8%.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.6% via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5% (although note that we're currently reviewing last week's earnings, so this could change).

Pro options:

- **AmTrust Financial Services** (NASDAQ: AFSI): If you haven't set up a protective collar yet and want to, set up one June 2017 collar for every 100 shares you're protecting. Sell to open June 2017 $17.50 calls and buy to open an equal number of June 2017 $12.50 puts. Lately, this can be done for a $0.10 credit, but that price will change as the stock moves. Please note also: AmTrust reports earnings tonight (the 8th) after the market closes.

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $83,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $115 puts, and buy to open *half* as many January 2018 $125 puts. Lately, aim to set up this combined trade for a small net debit (a nickel at most) or no cost.

This month's expirations (May):

- None.

What Is Considered an Excellent Credit Score?

Published May 8, 2017 at 3:08PM

Recent research shows that 60% of Americans don't know their credit score, which could suggest it's a not a number worth paying attention to. The reality is quite the opposite.

Here's more on what you can do with excellent credit, what's considered an excellent credit score, and how to increase your score.

What Can You Do With Excellent Credit?

Simply put, if you have excellent credit, you are better set up for overall financial success than someone with a lower credit score.

The lowest mortgage and loan rates are typically reserved for people with excellent credit, as are the best credit card offers, which can help to earn extra rewards on everyday purchases or to pay down debt balances faster with a 0% APR. The more money saved and remaining in your bank account at the end of the month, the more money that's available to invest and beat your financial goals sooner.

We suggest taking a few steps if credit cards are of specific interest to you.

- **Nail down your primary credit card needs:** Cardholders paying off balances each month to avoid interest charges may be best off considering cash-back and travel-rewards credit cards. The same can't be said for cardholders with debt, who can chip away at their debt balances faster with a balance-transfer credit cards offering a 0% intro APR.

- **Review our recommended credit cards:** For people with good and excellent credit, check out our picks of the best credit cards for excellent credit or the best credit cards of 2017. Cardholders carrying debt may want to consider our picks of the best balance-transfer credit cards to avoid costly interest charges with a 0% intro APR.

What Is Considered an Excellent Credit Score?

A 750 FICO score and above puts you in excellent credit territory. It's important to note that the average American consumer has a FICO score of 700, which barely qualifies for good credit.

Rating	FICO Score Range
Excellent	750 and above
Good	700-749
Average	650-699
Poor	550-649
Bad	550 and below

How the FICO Credit Scoring Model Works

The minutia behind FICO scoring models is a well-guarded secret, but we do know the broader pillars that drive your credit score.

- **Payment history (35% of score):** Do you pay your bills on time, every month?

- **Credit utilization (30%):** How much do you owe on your credit accounts, particularly relative to your credit limits? Credit utilization is reported as a ratio, essentially your debt balances divided by available credit.
- **Length of credit history (15%):** This considers various time-related factors, such as the age of your individual accounts, the age of your oldest account, and the average age of all your accounts.
- **New credit (10%):** Newly opened credit accounts, as well as your recent applications for credit, are included in this category.
- **Credit mix (10%):** Lenders want to see that you can be responsible with different types of credit, so having several different types of accounts (credit card, mortgage, auto loan, and so on) can boost your score.

FICO scores range from 300-850, and most consumers have FICO scores that range from 500 to 800.

How to Increase Your Credit Score

There is no magic behind building excellent credit quickly. It's possible to go from no credit to good credit in a fairly short period, but securing excellent credit takes time.

The general rules to improve your credit score are laid out below:

- Pay your bills on time, every month, without fail. Over time, this step alone can boost your credit score into the next level and payment history is the single, biggest driver of your credit score.

- Keep a low (to no) balance on your revolving credit accounts relative to your available credit. The average person with a FICO score over 800 uses just 4% of his or her revolving credit limits. If you have debt, paying off balances faster to reduce your utilization ratio is one of the faster ways to improve your score. Cardholders can also request a credit limit increase to reduce credit utilization, but we'd only suggest doing so when not tapping those additional funds.
- Let your open accounts age. An average account age of at least five years is suggested to get the best scores and there is no harm keeping no-annual-fee credit card accounts open.
- Use several different kinds of credit (credit cards, mortgages, auto loans and/or leases) over your life as a borrower, which will help maximize your credit mix.

Pro Completed Trades: May 8, 2017

Published May 8, 2017 at 2:55PM

Pro Guidance Changes from the past two weeks (see related trade alerts)

- N/A

Pro Completed Trades from the past two weeks (see transaction log -- recent trades may take 24 hours to show)

- **FactSet Research** (NYSE: FDS): We bought 30 more shares, adding about 0.15% to bring our total stake to about 2%.
- **Gogo**: We covered all our shares.
- **Skyworks Solutions** (NASDAQ: SWKS): We rolled our covered strangle up and out as per our recent alert; we now have a November 2017 strangle, with a $92.50 put and a $95 call, open on our shares.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): We bought 100 more shares, or about 0.15%, bringing our stake to about 2%.

You can see all of our guidance, positions, and transactions from the Recommendations page.

O'Reilly's Series of Unfortunate Events

Published May 1, 2017 at 3:37PM

Fellow Fools,

26.9%.

As I type this on Monday afternoon, that's the amount by which **O'Reilly Automotive**'s (NASDAQ: ORLY) stock has *trailed* the market since setting an all-time high at the end of last July. Over that same period, *Pro* is currently up over 8% (and trailing the market by less than 2%) -- a testament to the power of diversification. But diversification also has its pitfalls; for example, it can make investors overly complacent with troublesome positions, even though we know the odds are unnervingly high that at least one of our stocks will see a catastrophic decline of 70% or more.

In an effort to combat this, as well as the lethargy that can be brought about by bull markets (because a rising tide can lift almost every boat), one of our top priorities here at *Pro* since the start of 2017 has been to put all our current positions through the wringer and ensure each one is something we'd be eager to buy should we see a correction in 2017. This is why, despite our preference for low turnover, we've already closed four long positions and three shorts this year.

Which brings us back to O'Reilly, which released results after the market closed last Wednesday. For the past five years, O'Reilly's steady revenue growth and margin expansion made it one of the standouts in the S&P 500, and it was rewarded with an average valuation multiple 26% higher than the market. But decelerating revenue growth, coupled with rumors of Amazon's threat to the industry, have moved investor sentiment decidedly negative; since the start of February, O'Reilly has traded at a discount to the S&P 500 for 30 out of 59 days. (Before that, it had done so for exactly one day since the start of May 2010.) However, a cheap valuation alone isn't enough of a reason for us to hold the stock -- we need to believe in the future prospects of the business.

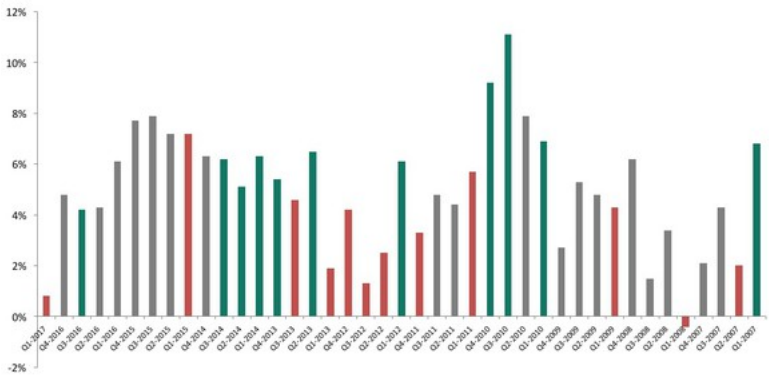
Blame It on the Rain, Yeah, Yeah

Many investors consider "unfavorable weather" to be the classic excuse used by a company dodging responsibility for poor results, but some companies really do struggle if Mother Nature pitches fits. Unlike, say, apparel, where people frequently buy new items they don't technically need, O'Reilly largely depends on customers who *have* to perform maintenance or make repairs to their vehicles. And what increases the frequency of both? Hot summers and harsh winters (though the latter often hurt sales initially, as snow and ice keep people from stores). Unfortunately for O'Reilly, most of the past winter was quite mild. Worse, the company actually benefits from a mild early spring, because it gets people out and working on their vehicles -- but in many parts of the U.S., winter weather only hit at the very end of the quarter.

It's not perfect, but one way to gauge the impact of weather on a given quarter is to look at the difference in performance between East Coast and West Coast stores. In the past, the delta between comparable-store sales for cold markets vs. warm markets has been up to 800 basis points (100 basis points = 1 percentage point); management noted that in this past quarter, this difference was slightly less than 400 basis points, despite some western stores seeing softened demand because of torrential rains.

By my count, since Q1 2007, management has called out weather as a net negative for company comps on 12 different occasions. (Yes, I have a spreadsheet where I keep track of every management comment regarding weather.) Now, unfavorable weather tends to defer purchases rather than preventing them, because customers will still eventually need to perform maintenance and parts have a limited lifespan even in ideal weather. So a lost sale because of weather isn't necessarily a permanent loss.

O'Reilly Automotive Quarterly Comparable Store Sales



Source: Company filings, earnings call transcripts provided my S&P Global Market Intelligence. Red indicates management commentary from the earnings call suggesting weather was a net negative for the quarter, green a net positive, and gray no or offsetting impact.

It's important to try to determine whether the company is doing a good job at recapturing those sales (as well as being honest in its assessment of the effects of weather). To do that, we can look at comps in the quarters following unfavorable weather. This, too, is admittedly an imperfect exercise because of the many factors that affect sales in a given quarter, but based on what we've seen over the past 10 years, it looks like we should give management the benefit of the doubt: Comps tended to be higher for the two quarters following a "poor weather" announcement (vs. all other quarters), and were more likely to show a positive year-over-year difference.

	Frequency	average delta	median
Weather cited as a net negative			
Comps higher in the next quarter?	60%	1.2%	1.4%
Comps higher two quarters later?	80%	0.9%	0.9%
YoY difference in next quarter comps positive?	67%	-0.1%	0.9%
YoY difference in comps two quarters later?	67%	1.0%	1.7%
All other periods			
Comps higher in the next quarter?	45%	-0.5%	-0.2%
Comps higher two quarters later?	48%	-0.4%	-0.1%
YoY difference in next quarter comps positive?	59%	0.3%	1.2%
YoY difference in comps two quarters later?	61%	0.3%	1.0%

When It Rains, It Pours

Besides poor weather, O'Reilly also had to contend with delayed tax refunds. Given the cost of having someone else repair your vehicle, economic necessity has always been one of the driving forces behind the DIY auto parts industry. We can see this in the fact that the vast majority of O'Reilly's purchases take place using cash or debit cards, as well as the seasonal bump in sales O'Reilly and its competitors traditionally see once people start receiving their tax refunds. Early filers in particular provide a strong boost to sales, as many of them were postponing repairs because of a lack of funds. However, this year the IRS delayed some refunds in an attempt to combat tax fraud. This delay really hit O'Reilly hard in February, with management noting during the earnings call that the company "had a bit of a couple rough weeks there" that resulted in the lowest comp in quite some time, one that "wasn't just a little bit negative." Currently, we believe that O'Reilly will ultimately be able to recapture most of this business as customers do receive their refunds, but only time will tell.

What to Watch

We won't be updating our fair-value estimate (which was set at $255 more than a year ago) until we have a chance to see what the rest of O'Reilly's competitors have to say about the current state of the industry, as well as dig into O'Reilly's SEC filing. But we can speak to the two things we'll need to see in the coming months to convince us it's still worthy of a spot in our portfolio.

First, we need to see O'Reilly's comps reaccelerate as we move throughout the year. Similar to Starbucks, the company found itself a victim of its own success this past quarter; O'Reilly was up against very strong 6.1% comparable sales from last year, as well as the sixth highest two-year combined comp since 2008 (13.3%). Although it won't see a truly low hurdle until we lap this quarter's comps next year, the numbers do become increasingly favorable as we move through the year.

The other thing we'll be looking for are changes in customer purchasing habits and preferences. Although Amazon is a very real threat, its ability to steal sales away from O'Reilly and other physical retailers currently looks to be somewhat mitigated by a couple of factors:

- Time and immediate need continue to be the first two deciding factors when it comes to people's preference to head to a store for auto parts rather than shopping online.

- Next on the list is needing advice, which will likely only increase in importance as cars become increasingly complex. Surveys have shown that younger generations actually have a higher preference for going to a store and speaking with someone.

O'Reilly has been a strong performer for *Pro* since we added it to the portfolio in 2013, but this alone isn't good enough. We need to be convinced that the road ahead is just as smooth if we're going to keep holding our shares. We'll have more to say on this matter soon, but for the time being the stock remains a buy.

Enjoy your week, Fools!

-- JP (TMFYossarian)

Pro Catch-Up Trades and Upcoming Expirations: May 1, 2017

Published May 1, 2017 at 3:14PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4%.
- **Visa** (NYSE: V): Buy 3.1%.

Continue building your portfolio with our Buys, including:

- **FactSet Research** (NYSE: FDS): Buy 2%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3% (see our recommendation).
- **Oracle** (NYSE: ORCL): Buy 3.8%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% in some form, via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **AmTrust Financial Services** (NASDAQ: AFSI): If you haven't set up a protective collar yet and want to, set up one June 2017 collar for every 100 shares you're protecting. Sell to open June 2017 $17.50 calls and buy to open an equal number of June 2017 $12.50 puts. Lately, this can be done for a $0.30 credit, but that price will change as the stock moves.

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $83,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $115 puts, and buy to open *half* as many January 2018 $125 puts. Lately, aim to set up this combined trade for a small net credit or no cost.

This month's expirations (May):

- None.

Pro Guidance Changes and Completed Trades: May 1, 2017

Published May 1, 2017 at 3:09PM

Pro Guidance Changes (from the past two weeks -- see related trade alerts)

- **Gogo** (NASDAQ: GOGO) moved to Cover.

Pro Completed Trades (from the past two weeks)

- **Domino's Pizza** (NYSE: DPZ): We closed (covered) our short, and bought to close our short puts.
- **FactSet Research** (NYSE: FDS): We bought 30 more shares, adding about 0.15% and bringing our stake to 2%.
- **Gogo**: We covered all our shares.
- **Papa John's International** (NASDAQ: PZZA): We sold all our shares.
- **Skyworks Solutions** (NASDAQ: SWKS): We are in the midst of rolling our covered strangle up as per our recent alert; three legs are completed, and the order to close our August $85 puts is waiting to fill at a limit price between the bid/ask.
- **Valmont Industries** (NYSE: VMI): We sold all our shares.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Buy (More) FactSet and WisdomTree Emerging Markets

Published Apr 28, 2017 at 12:40PM

Is this for you? This recommendation is for all *Pro* members who have year-to-date dividends to reinvest, or who have ample cash to make a small additional investment and want to match us.

How You Participate

- **Action and Allocation:** Buy about 0.15% more in **FactSet Research** (NYSE: FDS) and 0.15% more in the **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS) fund, bringing each to about a 2% allocation. *Pro* will buy about 30 more shares of FDS and about 100 more shares of DGS.
- **Price Guidance:** Use a **limit order** at the prices available when you place your order. We'll buy in the next one to 30 days.
- **Recent Price Ranges (this morning):**
  - FDS: $162.91-$164.21
  - DGS: $45.07-$45.14
- **Guidance:** Both are rated Buy.

What We're Thinking

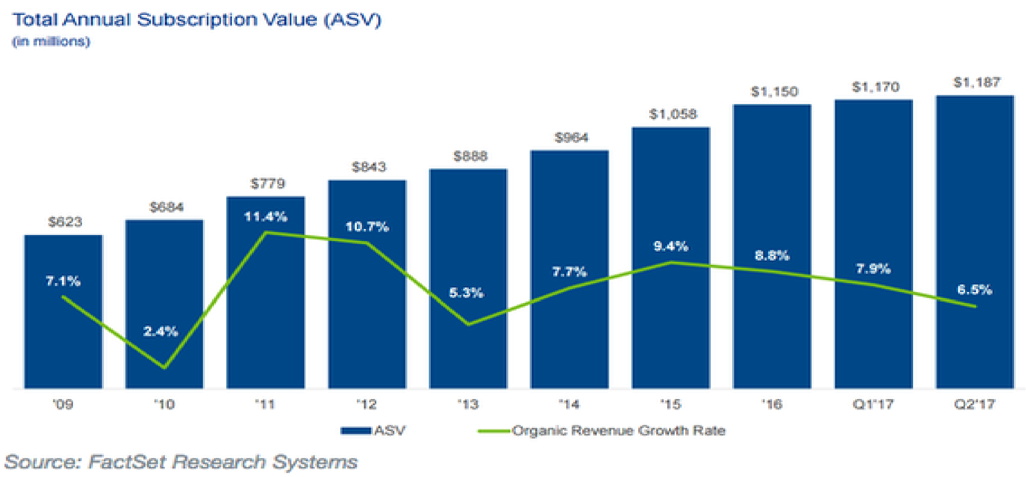
This is our first "dividend reinvestment" following Monday's Memo outlining our new quarterly plan, which is to invest our dividends when we see incremental purchases we're happy to make, as long as our cash balance is already where we want it. We have plenty of cash today at about 22.8%, and we can definitely afford to invest the net dividends we've collected so far this year, which amount to $9,560.90, or 0.3% of the portfolio's value. We're investing roughly that, equally divided as 0.15% to each of these two stocks (our smallest positions) to bring them to about a 2% stake each.

As we reinvest each quarter to take advantage of the long-term benefits doing so will provide, we plan to pay at least a bit of heed to the fact that much is unknowable. Though what we're doing isn't "auto-reinvestment," in some senses we want it to be *like* that. We don't want to overthink it -- we want to think just enough. Here's what we're thinking.

FactSet Research

With 95% of its revenue recurring in nature, FactSet Research is in a good position to continue to grow by adding new clients and new services, and it's currently doing both, with international markets representing a strong long-term opportunity. Even as more investors move to a "passive" approach to investing, investing itself hasn't truly become any simpler -- countless "passive" funds are anything but. FactSet offers analysts and fund managers a growing number of tools for analyzing passive funds, as well as investment approaches that combine those funds. The company is evolving with the market, and it continues to lead in data, analysis, and tools for active investment managers. The next bear market will probably bring a revival in the desire for active managers, as people grow leery of passive funds that only go down for months on end. But even barring that, FactSet is in a good position.

The stock is up 10% including dividends since our original buy report in May 2016, so it hasn't been a market-crusher in these 11 months, but it has run with our North Star despite business headwinds that knocked it back from much higher prices late last year and again in February. Annual subscription value growth has slowed since our purchase (from 8.8% to 6.5% last quarter), so it speaks to the respect the business garners that the stock is up anyway.



FactSet revenue and organic growth have slowed but keep growing.

Shares yield 1.2%; FactSet has increased its dividend for 17 consecutive years, ever since it started paying one in 1999. The stock lately trades at a P/E multiple well below its long-term average, now fetching 19.2 times earnings. We aren't looking for a 30 P/E average again by any means, but we do expect to see the low 20s over time. We'll pick up a few more shares (about 30) with this reinvestment.

FactSet's P/E multiple has fallen below its average. Source: S&P Global Market Intelligence.

WisdomTree Emerging Markets SmallCap

This position gives us some very long-term macro diversification, providing exposure to small-cap emerging markets in the likes of China, Thailand, Taiwan, Brazil, and India with a dividend yield running above 3%. We can't easily obtain this broad international exposure on our own. The fund is well-managed, has reasonable fees for what it does (0.63%), and has outperformed many emerging-market ETFs during the long period of stagnation we've seen in emerging-market stocks. DGS has easily outperformed the likes of much larger ETFs including **Vanguard Emerging Markets** (NYSEMKT: VWO) and **iShares MCSI Emerging Markets** (NYSEMKT: EEM) over the past 10 years. But like emerging markets in general, DGS is still down over a very (very) long period.

Lately, though, emerging markets are performing better than the U.S. indexes, topping the strong gains in the U.S. both year-to-date and over the past 12 months. Economic growth in China and elsewhere has picked up the pace, while commodities have been more stable and the dollar's strength has leveled. Emerging markets remain less expensive than U.S. stocks, and though we don't have centuries of data to go by, the returns so far seem to cycle, with the former ahead for periods of time, and then U.S. stocks taking the lead as they have for the past several years. This suggests that eventually emerging-market stocks will be the much stronger performer again -- this may even be starting now, as U.S. GDP growth remains slight. As long as we don't have a better place for what will be 2% of our portfolio after we add these "dividends," we're content to stay invested in it.

The Foolish Bottom Line

Nudge these two positions up by about 0.15% each, bringing each to about 2% of your portfolio, if you have dividends you want to reinvest or more than ample cash and want to follow along. Helping make this economically feasible, our trading commissions at Interactive Brokers are very low. Hopefully, given the commission wars going on, yours are, too. Fool on!

Pro Can Help

- Questions? Please visit the FDS or DGS board.

Roll Your Covered Strangle on Skyworks Solutions

Published Apr 25, 2017 at 2:32PM

Is this for you? This recommendation is only for *Pro* members who have written August covered calls on **Skyworks Solutions** (NASDAQ: SWKS) at $87.50 as recommended (or perhaps at another strike price if you arrived later), and also for those who have written August $80 puts (or others that month) as part of a covered strangle. Those who have not yet written covered calls should leave Skyworks stock uncovered and just go on owning it; we're playing catch-up here, rolling our in-the-money calls higher. The stock remains a Buy at a 4.4% allocation. (Members following the *Motley Fool Options* put-writing trades in that service should be careful not to double your exposure.)

How You Participate

- **Trade:** Use a multi-legged or rolling order on Skyworks options to:
  - "Buy to close" all August 2017 $87.50 calls and August 2017 $80 puts, and ...
  - ... Write ("sell to open") the same number of November 2017 $95 calls and November 2017 $92.50 puts (though note, the puts are optional).
  - After doing so, you should have the stock you already own, plus a November 2017 $92.50 put/$95 call strangle on your shares.
- **Allocation:** *Pro* will continue to write a covered strangle on all 1,200 shares we own. We don't plan to increase our exposure to more shares, if it came to that, but would instead roll or close the strangle.
- **Recent Prices (11 a.m. ET):**
  - Stock: $104
  - Buy to close August 2017 $87.50 calls (splitting bid/ask): $18.80
  - Buy to close August 2017 $80 puts: $0.85
  - Sell to open November 2017 $95 calls: $15
  - Sell to open November 2017 $92.50 puts: $5.30
  - Net credit collected on all four options: Approximately $0.65
  - Upside gained on stock: $7.50 per share
- **Price Guidance:** Prices will change, but lately you'll want to use limit orders to complete all transactions for a combined net credit of about $0.65. Or, you could trade in two pairs. You'll lately pay a net debit of about $3.80 to roll your calls from $87.50 to $95, and you'll pay about $0.85 to buy back your $80 puts, so that's $4.65 in total debits to close these two options. You should aim to get that money back by writing the new puts for the same amount or more (lately they provide a $5.30 credit, leading to a $0.65 net credit overall on all four options). If the stock moves meaningfully in either direction before you make your trade, adjust your strike prices accordingly by one or two strikes to end up rolling for a credit or no cost, or, if not possible, a small debit. We'll do the same if need be.
- **Stock Guidance:** Buy 4.4%. As mentioned above, don't use options on this stock today if you don't have them in place already.
- **Fair-Value Estimate:** Remains $93.
- **Note:** Earnings are due April 27. We aim to roll before then to give our stock more upside breathing room... just in case.

What We're Thinking

In January, we talked about the strength at Skyworks' business as we rolled our $75 covered calls $12.50 higher to $87.50 without paying to do so, thanks to the time value we captured by rolling to August and also by writing puts. Going into earnings on Thursday, we're going to roll our strangle higher again, for another small credit, in order to capture more of the upside the stock has experienced lately. We again need to roll out to do this at a credit, in this case to November, but we're gaining a likely 8.6% in stock upside in seven months, plus 5.7% in yield on a put with a strike price 11% below the recent share price.

Even now, we're paying about $1.90 in time value to close our August $87.50 calls, but we'll be getting about $6 in time value (and $15 total) by replacing them with November $95 calls. The August $80 puts recommended in January have earned members more than 80% of their potential income, and can now be closed for about $0.85. The new $92.50 puts, if you choose to write them, pay about $5.30 in new time value. Combined, the $20.30 or so in credit that members will receive on both these November options will give your portfolio, as of today, a potential net $115.30 sell price on the shares you own, or a potential net $72.20 buy price on more shares. That's how the positions will behave in your account after this trade.

Why This Strategy?

We're doing this now partly because Skyworks' share price just surpassed the net credits we received in our August strangle. Most members received about $15 to $16 in credit for writing the August strangle, which, on $87.50 calls, resulted in a potential stock sell price of about $102.50 to $103.50 per share. The stock just moved past that price. So, although we need to pay nearly $2 in time value to close our August $87.50 calls, rolling now may help us avoid a more difficult or more costly roll if Skyworks continues to rise in price. Should the stock perform well in coming days or weeks, we would probably need to roll up at a debit, potentially a large one. (We won't write puts at higher strikes, given our value estimate of $93. In fact, these are the last puts we plan to write as part of this strategy.) We hope to better position ourselves pre-emptively today and then adjust later as needed, likely just focusing on our short calls.

All in all, this is another good reminder not to write calls on stocks you're not ready to sell. Ideally, we've learned this lesson for the last time! Although we want to target income here in *Pro* as well, it's always best to do that on positions that have been set up for the purpose. That said, at least we've been able to keep up with the stock gain here, but it has created extra trading and extra downside exposure through our written puts. So, don't expect to see this type of action from us on other positions. This one, at least, is hopefully instructive. And we can celebrate the gains being earned, and the hedge offered by the covered calls.

Alternative Trades

- **Can't or don't want to write puts?** Then simply roll your covered calls, the same way we are. You still capture $7.50 in stock upside for a cost of only about $3.80 or so, nearly doubling that capital in seven months if Skyworks stays above $95.
- **Don't want to close your $80 or other puts?** You can keep them open to potentially earn 100% income at expiration (it appears likely, anyway!). But if you do keep them open, don't write new puts; you'd be doubling your exposure.
- **Wrote other puts or calls expiring in August?** In most cases, rolling those now per this alert will make sense for you, too. Ask below if you have questions.
- Other than that, this is a simple roll to target more upside for those in arrears. So, again, those who just own shares today should continue to do so, and not use options. The stock remains a Buy.

More That Matters

- **Maximum gain:** The stock's upside is capped at our written call's strike price; plus, we can profit by earning the premiums received for writing the strangle.
- **Maximum risk:** The full stock value, plus the full written put exposure, which doubles our stock exposure starting at our put strike.
- **Follow-up**: We'll continue to manage our covered strangle, rolling for upside or more credit as needed, as long as we like the prices of everything. We plan to keep the stock long-term as long as the business and valuation seem to merit it.

Options Can Help

- **Questions about this "highly connected" trade?** Please visit the SWKS board.

Jeff Talks Facebook on CNBC

Published Apr 25, 2017 at 11:35AM

Jeff was on CNBC recently to talk about **Facebook** (NASDAQ: FB). Catch his interview by clicking below!

Pro's New Quarterly Reinvestments

Published Apr 24, 2017 at 3:55PM

Dear *Pro* Fools,

Prepare for *another* mind-altering five minutes with *Motley Fool Pro-o-o-o-oooo*!

In last week's Memo, you learned that since 1980, more than 320 companies in the S&P 500 have been removed from the index because of their shortcomings. That extreme statistic reminds us that a capitalistic economy makes it difficult for any company to retain advantages -- Sony was all the rage, until Apple was. The takeaway is that we must stay on our toes.

By the end of *today's* Memo, you're going to question why you (and we) haven't regularly reinvested our dividends. Cutting to the chase: From here forward, we plan to do so quarterly, gathering up our dividends from the previous three months and announcing where we'll choose to invest those funds by sending you a new trade alert or two. The first (re)investment will happen soon. Now, here's why.

To Reinvest or Not?

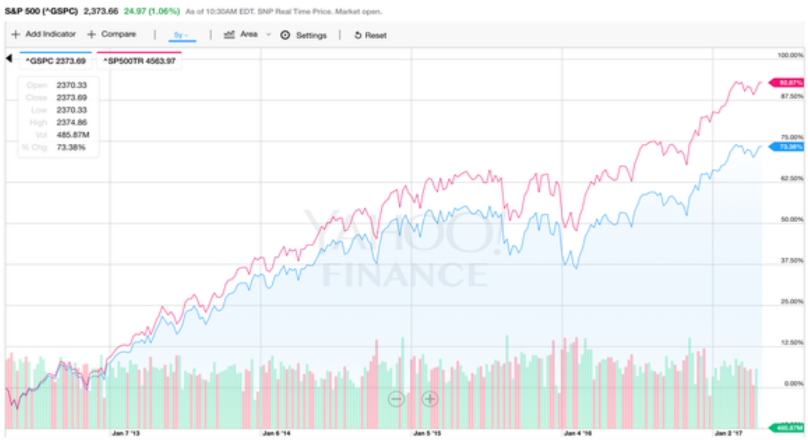
One of our goals in *Pro* is to earn a positive return over every rolling three-year period, whatever the market does. This implies that we need to be defensive, and our dividends coming into the portfolio are a valuable asset in that fight. But unless we need that cash as a protective cushion, or for brand-new buys, our dividends are "extra" income that we're not spending, so we could be doing more with it. History tells us the *best* thing to do is reinvest it.

Some *Pro* members have asked upon joining whether we reinvest dividends or not. We have answered that we plan to invest our dividend proceeds manually, rather than automatically, and this remains true. We personally don't want our dividends being reinvested into partial shares (some brokers do that), or in stocks we may not want to buy more of that month (whether we're ultimately right or wrong). We want to control our allocations and investment decisions more than auto-reinvestment allows. There's only one problem: We haven't made a regular practice of reinvesting our dividends. Instead, we've been adding them to our cash, intending to invest it later, on a rainy day.

But the way the portfolio is managed, we have *always* carried a cash balance, and that's not likely to change anytime soon (unless stocks fall 40% and we suddenly want to invest every penny). Our strategy calls for carrying cash, so our dividends, modest as they are, can afford to be reinvested, working to increase our value. So, from here forward, we plan to reinvest our dividends quarterly. This year, we've collected $9,560.90 in net dividends so far, and we aim to invest that by May. Typically, we'll look to reinvest our compiled dividends with specific trade alerts in April, July, October, and January of each year.

Why Reinvest?

The Motley Fool tracks all of its services against the S&P 500 Total Returns Index, which reinvests dividends in the index automatically. For our credibility, it's a good thing we track against that, because the difference between reinvesting and not reinvesting is stark. Over the past five years measured to this morning, the S&P 500 index price gained 73%. With dividends reinvested, it gained 93%.

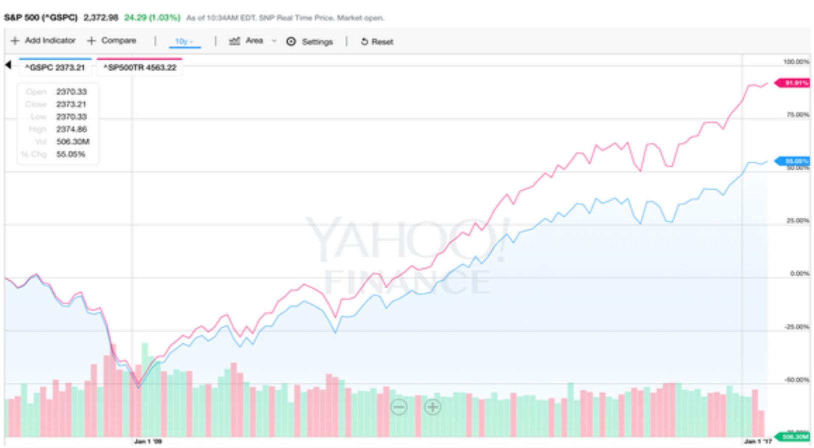


S&P 500 price up 73% in five years; total return 93% including dividends.

And the difference only grows larger the farther back you look; over a lifetime, it's stupefying. A Guinness Atkinson study called "Why Dividends Matter" found that if you had invested only $100 in the index at the end of 1940, it grew to an impressive $12,000 by the end of 2011. But that same $100 grew to $174,000 if you just reinvested the dividends it spun off, rather than spending them.

Read those two sentences again if you need to. $12,000. Against $174,000.

Reinvesting dividends is especially helpful during market downturns, letting you buy more shares cheaply, setting you up for a stronger recovery. It's already 2017 (did you notice how that happened? Me neither), meaning the past 10-year market returns now start near the market *high* of 2007. How's that look? It's not pretty. Over the past decade, the S&P 500 has only gone up 55%. That's it. But with dividends reinvested, you're up 92% -- all thanks to reinvesting a yield of only about 2% a year, at best, over this time. Reinvesting that gained you another 37 percentage points in returns.



S&P 500 up 55% the last 10 years, but 92% including reinvested dividends.

Turbo-Charged Compounding

Over longer periods, dividends matter even more. They have accounted for 52% of the S&P 500's total return since the 1940s, so reinvesting them is a way to super-charge the compounding you get from the market, using the dividends to effectively buy still more dividends -- along with more stock.

As if we need more incentive, studies from Hartford Funds (courtesy of our friends at *Motley Fool Total Income*) found that dividend-paying stocks in aggregate far outperform non-payers, returning nearly 9% annualized against less than 3% annualized for non-payers from 1972 to 2015. (Guinness Atkinson gets even more granular on returns with a chart on page three of its report.) This won't stop us from buying the Facebooks of the world, but most of our stocks pay a growing dividend.

Finally, we know that reinvesting dividends beats inflation, another of our goals at *Pro*. That's partly because strong companies have a habit of increasing the dividend annually.

Your Personal Preference Rules the Day!

We had the best of intentions when we said we would invest our dividends as we saw fit, and in many ways (with new buys), we have -- while still keeping the cash on hand we want. But we believe we'll all be better served by making a formal practice of reinvesting them. Every quarter, we'll now be on the hook to reinvest our dividends with trade alerts that specify that's exactly what we're doing. If we're going to skip any particular quarter (and we remain free to!), we need to explain to members why -- and it better be a good explanation.

To be clear, we are *not* turning on automatic reinvestment. Our broker, Interactive Brokers, offers to auto-reinvest dividends for corporate accounts like ours, but not individuals like you, and it charges the usual commission to do so. But we'd rather tally our dividends each quarter and reinvest the funds as we see fit, accompanied by a trade alert.

If you want to auto-reinvest dividends at home, you could. Many brokers, including TD Ameritrade, Schwab, and Fidelity, offer free automatic dividend reinvestment -- just call and ask, or search for it in your account settings. If you already auto-reinvest, I suggest you keep doing that. But if you want to follow our quarterly dividend reinvestment trade alerts instead, consider that.

Finally, if your dividends cover part of your living expenses, and you need them for your day-to-day, obviously keep taking them out. Last year, our portfolio earned $27,192 in dividends, or less than 1% of our current value. If we spread those funds into four of our stocks a year, it will add less than a 0.25% extra allocation to each, so it won't throw off your general alignment with our allocations anytime soon.

Our dividends are modest, but over a lifetime, consciously reinvesting them should add meaningfully to our returns. Better to start a formal plan now, rather than never. Mainly, I want you to be informed and do what's best for you and your long-term return. In that spirit, our new quarterly reinvestment action will remind us four times a year of the power of reinvesting dividends.

Please ask any questions, offer suggestions, bubble up ideas on how best to do this -- share anything you want on the Memo Musings board. Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: April 24, 2017

Published Apr 24, 2017 at 2:32PM

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Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

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- **Visa** (NYSE: V): Buy 3.1%.

Continue building your portfolio with our Buys, including:

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Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% in some form, via our trade alert.
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Pro options:

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Hedges:

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This month's expirations (May):

- None.

Pro Guidance Changes and Completed Trades: April 24, 2017

Published Apr 24, 2017 at 2:22PM

Pro Guidance Changes (from the past two weeks -- see related trade alerts)

- **AmTrust Financial Services** (NASDAQ: AFSI): Fair value declined to $17.95. The stock remains a Hold.
- **Caesars Entertainment** (NASDAQ: CZR) moved to Cover.
- **Gogo** (NASDAQ: GOGO) moved to Cover.
- **Papa John's International** (NASDAQ: PZZA) moved to Sell, and **Domino's Pizza** (NYSE: DPZ) moved to Cover, ending the paired trade and both positions.
- **Valmont Industries** (NYSE: VMI) moved to Sell.

Pro Completed Trades (from the past two weeks)

- **AmTrust Financial Services** (NASDAQ: AFSI): We closed the June 2017 $15 put/$22.50 call collar, and set up a June 2017 $12.50 put/$17.50 call collar for a credit.
- **Caesars Entertainment:** We closed (covered) our short.
- **Domino's Pizza**: We closed (covered) our short, and bought to close our short puts.
- **Papa John's International**: We sold our stock.
- **Valmont Industries**: We sold our stock.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Close Your Short on Gogo

Published Apr 21, 2017 at 2:10PM

How You Participate

- **Action:** Buy to close, or cover, your short position(s) on **Gogo** (NASDAQ: GOGO).
- **Allocation:** Close all of your short -- our 0.5% exposure will go to 0%.
- **Scorecard Status:** It was on Hold, and we're moving it now to Cover. There's a bug on our scorecard that means it will continue to say Hold there, but we mean for you to cover, or close, it.
- **Recent Price Range (this morning):** $11.83-$12.17
- **Price Guidance:** *Use a **limit order***, and aim to pay about $12 or less today. We will close our short within the next one to 30 days.

What We're Thinking

Usually when you sell a stock short, the time frame is also meant to be short. We knew going into the Gogo short position that we only needed a quarter or two to see whether our thesis would start to play out. So far, it hasn't. Our belief that growing competition would crimp Gogo's new sales, putting the squeeze on a business that's already losing money, is not yet unfolding.

Our argument that Gogo's rollout of new technology wouldn't do much for its business financials, partly because of new competition, is not yet panning out. Instead, Gogo's new 2Ku satellite wifi technology is growing more popular, with more customers signing on and revenue increasing more than expected. The company now expects its levered free cash flow to turn positive in 2019, a whole year earlier than previously thought, thanks to more 2Ku installs on airplanes.

Positive earnings are not estimated until 2020, and the company carries $800 million in high-interest long-term debt, so it's not out of the woods. But with positive sales momentum -- and recurring revenue garnered whenever a customer signs up -- our primary thesis of stalling sales growth as the industry becomes more competitive looks unlikely to occur right now.

The stock has risen 20% against us as of this week, and 20% is where we traditionally take a gut check to see if we want to stay short, short more, or close. Our thesis called for a weakening business, or at best a stalled one -- not one that's improving. Wanting to avoid "thesis creep," we can't create new reasons to stay short the shares in the face of positive changes in the air.

That said, we were ready to close the position last month when news broke of the U.S. laptop ban on flights originating from several countries. The possibility that the ban might spread made us patiently wait to see what happened. But that broader ban appears less likely today, and waiting indefinitely isn't a solid thesis.

We'll keep an eye on Gogo for future possibilities, but today we can close our short for a small monetary loss on a small position. And since more than 40% of shares are sold short, we want to close during relative calm, rather than risk a big event, such as the earnings report due around May 4. Please use a **limit order** to close. Gogo is a small business.

Alternative Trades

- **If you set up a synthetic short or set up a bearish spread:** You should close those positions, too.

Pro Can Help

- **Want to discuss this?** Hit the button above your head to call us for help. Or just click on over to the short board.

Roll Down Your Collar on AmTrust Financial Services

Published Apr 20, 2017 at 2:28PM

Is this for you? This is for *Pro* members who set up a protective $15/$22.50 collar and who, after reading this, want to take some capital out at the expense of capping upside at a lower price. We're adjusting our collar to lower strike prices to take some profits but still remain hedged. The stock itself remains on Hold.

How You Participate

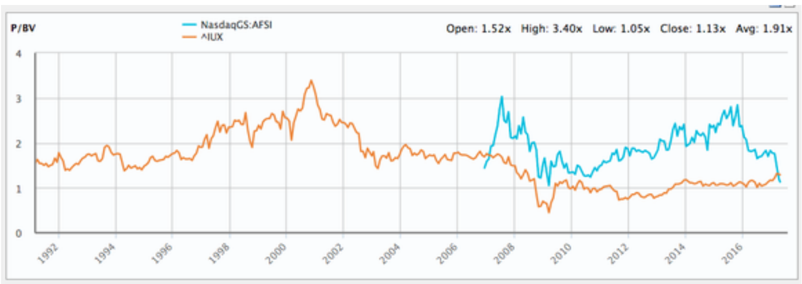
- **Trade:** Roll down your protective collar on **AmTrust Financial Services** (NASDAQ: AFSI)
- **Actions:** Simultaneously ...
  - Sell to close your existing June 2017 $15 puts, and ...
  - Buy to close your existing June 2017 $22.50 calls. Then ...
  - Write a new collar by selling to open June 2017 $17.50 calls, and ...
  - Buying to open June 2017 $12.50 puts.
- **Allocation:** Roll each collar you already have open. You should have set up one protective collar for every 100 shares owned.
- **Price Guidance:** Use **limit orders** and initially aim for a net credit of $1.25 to close the existing collar, and a net credit of $0.45 to write the new one, resulting in a combined net credit to roll of $1.70. This credit will grow larger before your trade if the stock falls, and shrink if the stock rises. So, adjust as needed when you enter your order, using appropriate limit orders at going prices and splitting the bid/ask prices.
- **Recent Prices (12:55 p.m. ET):**
  - **AFSI:** $15.87
  - **Old Collar:**

- Buy to close June $22.50 calls (bid/ask): $0.20/$0.30 -- use $0.25
    - Sell to close June $15 puts (bid/ask): $1.45/$1.55 -- use $1.50
    - Net credit: $1.25
  - **New Collar:**
    - Sell to open June $17.50 calls (bid/ask): $1.10/$1.30 -- use $1.20
    - Buy to open June $12.50 puts (bid/ask): $0.65/$0.85 -- use $0.75
    - Net credit: $0.45
    - **Combined credit on rolldown:** $1.70
- **Scorecard Status:** Hold; 2.9% allocation
- **Fair-Value Estimate:** $17.95

What We're Thinking

All of us in the *Pro* community have felt AmTrust's recent decline in price, which happened on rumors that whistleblower Harry Markopolos and the FBI are investigating the company's accounting. The decline has led to gains in the protective puts members purchased as part of a protective collar. Today, we're keeping a collar in place for protection, but we're rolling it lower in order to take some money out. This trade keeps our downside exposure nearly the same even as we roll our collar down and take money out. So what's the trade-off?

Well, we're rolling our short $22.50 calls down to $17.50 calls, which is a compromise. But given a lower ROE than in the past, we're valuing the business at no more than 1.3 times its new book value of $13.81, or $17.95. So this lower strike price on our short calls accounts for a lower valuation estimate and, thus, more willingness to sell at a lower price than before. AmTrust has long enjoyed a premium valuation to the S&P 500 Insurance Industry group, but given its recent black eyes, it's unlikely to return to that status anytime soon. Here's AmTrust's historic multiple to book value against the S&P 500 Insurance Industry group's average (the longer line):



AmTrust's price-to-book value multiple exceeded the industry average until now.

Source: S&P Global Market Intelligence.

After this trade, our stock protection will start at $12.50 rather than $15, but we will have harvested $1.70 in time value by rolling. Adding that to our new $12.50 strike price, the net result is protection at $14.20 -- not much lower than the $15 price we're rolling down from. The math: Lately, members can get a net $1.25 credit by closing the existing $15/$22.50 collar, and then get another $0.45 net credit by setting up the new $12.50/$17.50 collar, for $1.70 in total credits.

On the flip side, if we *don't* sell our $15 puts soon and the stock remains above that price through our June expiration, we will ultimately forfeit the current $1.50 in time value they carry today. Since the company's financial restatements have been announced already, we'd rather capture that time value (since we should have less to worry about now) and then set up a new, adjusted collar just in case more surprise bad news comes.

All that said, this roll down is optional. If you'd rather keep your current collar -- because it offers more upside and protects you at $15 -- you can do so, and take no action today. Those who do want to take some money out and roll their strike prices down can follow along with this trade.

Never a dull moment with this one, lately! But we will emerge stronger because of it.

Alternative Trades

- **Only bought $15 or $12.50 puts?** You can roll the $15 puts you own down to $12.50 if it's worth the $0.75-per-share or so credit to you. Or, you can just keep the $15 puts in place. Just keep the $12.50 puts in place if you only bought those.
- **Have bull put spreads open?** As above, you can roll your short puts down if the credit and adjusted risk are appealing to you.
- **Not using options?** You're in a tougher spot, with few ways to protect yourself. So, just make sure that you're comfortable with the size of your position. If not, you have the option to reduce it. We currently have 2.9% in AmTrust.

Pro Can Help

- Questions on this short-term protective position? Please ask on the [AmTrust board].

Pro Video Chat, April 2017

Published Apr 18, 2017 at 3:38PM

The *Pro* team will be holding a live video chat on this page at 1 p.m. Eastern on Tuesday, April 25! We'll be using sli.do to communicate with members during the chat; [click here] to go to our chat directly, or go to slido.com and enter the code **#ProChatApril**. We recommend keeping the video chat open in one browser window and the Slido chat open in another (or on a mobile device) so you can follow along with both. See you soon!

Transcript

Jeff: Greetings, [inaudible 00:00:01] pro members and welcome to our April 2017 chat. I'm joined at the table by JP Bennett.

JP: Happy to be here.

Jeff: And by the way, I'm Jeff Fisher and we’re joined … we’re looking at that camera. We’re joined via Skype by Billy Kipersztok.

Billy: Hello.

Jeff: Hey Billy, how are you?

Billy: I'm doing great, how about you Jeff?

Jeff: Good. JP, how are you doing?

JP: Good. There’s a little bit bad weather today but I can’t complain.

Jeff: It’s been raining for several days here in Washington. A little cool and a little rainy but everything is blooming so we have the whole Pro-Analyst team here to host this live chat with you today. Right here on the video you see of course the video portion of the chat but click through to slido.com and then enter the words that you can see right on this page as well. Pro-chat April, Pro-Chat April. That gets into the question part of this chat and then ideally you can keep two windows open, one on the side for the video if you want to see it … you don’t need to and another for the question part. Ask questions and vote up questions that you want answered most and we will go through them in order of … mostly in order of preference by you so we are already a quarter, more than a quarter into the year … JP and Billy.

JP: Time flies.

Jeff: It really, it does. It’s been a busy year. We’ve issued in Pro alone, 20 trade alerts in last three and half months.

JP: Wow.

Jeff: So more than usual. We’ve had more turnover than usual as well and we are looking to reposition the portfolio, at least to some sense into companies that we like better. Good enough companies that don’t live up to our ever-increasing standards. Fixing some mistakes, closing some positions that haven’t worked out. It’s just …

JP: Closing some that have worked out.

Jeff: And some that have worked out very well and it just so happens to be that feel like it’s that time to refocus our portfolios. It’s progressing steadily and the portfolio despite all this activity, which is usually going to hurt you returns anytime that you are very active … I expect your returns to be lower and that maybe a price we pay this year in fact as we at least reshape portions of the portfolio but we are up 6.2% this year so far. Above the North Star, right in line with S&P 500 shockingly to me because we have had some problem positions for sure. We are only 73% Net long but we are in line with S&P, we are below the Nasdaq which has been quite strong … up 10% or so this year already but that’s okay against our goals, we are doing well despite, some losers, some transitions, some kind of refocusing.

Billy: Hey Jeff, tell me one more time how many alerts we did so far in the first quarter?

Jeff: We’ve done 20 alerts so far this year Billy.

JP: Right.

Jeff: And last year we did about … well, I have the number right here in front of me, it was 45 or so all year. Let’s see ...

Billy: I'm looking at that right now that’s why asked so in 2016 we did 45 and in 2015 we did 43. At this pace we will double our activity if we maintain it which we probably won’t for the next three quarters.

Jeff: It’s true and I think we will be pretty active this current quarter too as we look at more income positions, more buys and potentially some more shorts too so far it’s been good. Still our short exposure has been modest and the few shorts that we have done have been on the whole, done all right in a sharply rising market. Any other comments about the quarter or we will probably get to them as we talk about questions in the chat, you guys but if you want to say it in the opening remarks, we’ll just dive into it.

JP: I think we can dive right into the questions.

Billy: Dive in.

Jeff: Alright, sounds good. We’ll at the top here in Slido and again it’s Pro-chat April to get into there @slido.com. John is asking, “Any thoughts to just go in long on Sky Works and the Covered Strangle?” it’s funny you ask John because for the last several days I have been looking at that very position and members who just own shares, the shares are ready to buy and have been for a long time. It's a 4.4% allocation now, members who only own shares should just stay long shares. Those of us who wrote Covered Calls have been rolling those Covered Calls higher to catch up to the stock and we should have ... I'm checking the email, we have a Covered Strength along the stock right now that we are going to keep managing. For now, we are going to keep a Covered Strangle on it but I did look at the possibility of just closing it and keeping the stock but given we also own Apple, and Apple and Skyworks are closely tied together and combine our biggest position. I'm comfortable keeping some in the money Covered Calls on Skyworks right now, we're all comfortable doing that. The good news is that with our Strangles so far we've captured the upside stock has achieved and by rolling the Strangle, I was just looking at it today again. We can again capture Upside and not put money into the trade but we do want to keep those in the money Covered Calls for now given that we have a lot of Apple and a lot of Skyworks. Again if members only own Skyworks without options on them, just keep owning the shares then we are comfortable with it at this moment so good question. We will keep managing it, you should hear from us soon about Skyworks in fact, the announcement is in two days. Lon is curious as our latest thoughts on AmTrust, thank you very much. Lon, I'll just say AmTrust, we have a protective collar on it. We just rolled that down to a 1750 call, which is right around our now … still pretty aggressive for our value estimate at 1.3 times book value. We own 1250 Puts in case the bottom does fall out further so it's a pretty neutral position now at this point. It's a smallish position now to it, 2.9% I believe. AmTrust, It's been a tough year for AmTrust obviously. It's unfortunate to see them [inaudible 00:06:24] results. We always knew as a small fast growing company that they may have been some accounting that would eventually come to light but never thought that would truly happen, not restatements of multiple of years.

If we did that, we wouldn't have kept the stock but we knew that as an acquired companies and integrated them that we were counting on the others and the company to do the best they could. That said, we think they have. BDO is their auditors for years now, as you know they changed to KPMG who wanted to improve their reporting and controls and AmTrust has reported on all of that and made it all transparent and [inaudible 00:07:08] results and took their hits … we think set themselves up to be a stronger business going forward. I actually don't have many concerns about their execution of the business going forward or now that the financials and the valuation. It's more a question of, do we want to keep our relationship going with this company? We didn't cut [inaudible 00:07:29] and why should we cut AmTrust slack. That's how I feel right now, and how the team feels when about it. We want companies that we are 100% behind, we are willing to overlook mistakes, but when they cross the line into possible being more than a mistake, we are not certain we want to stay attached to that in most cases. That's we have a collar and why we are comfortable selling AmTrust if it goes up to our Fair Value at 1750 or if it declines some more, meaning that something is really wrong then our options kick in and we get out of our position. While we continue to digest honestly all that's happened since January … it's a pretty neutral position and will see what happens next. It really comes down to the types of companies that we want to own and recommend and if we can do better and if we believe we can, then we are going to sell a company that has burned us in the past. I hope that helps a little bit Lon, it's not a happy situation obviously. It's been a long term performer for us but for newer members it hasn't been at all and this happens, many companies restate results … Parexel did. Obviously AIG has in the past, we went in and bought AIG so it's not a necessary sell but it's something that we are still really considering … whether we want to maintain this relationship at this point that's why it's a neutral position for us right now more or less. We'll see results in early May for AmTrust and each step will help us in our next decision. Billy the next question from Gary is about Papa John's.

Billy: Sure. Please discuss the pros and cons of selling Papa John's via Covered Calls? I think the answer to this, is … it somewhat depends also on whether you are also following along with the short on Domino's. If you are still short Domino's and you have some coverage of the downside of Papa John's then selling Covered Calls maybe a more feasible or attractive idea but obviously the pros and cons of selling Papa John's via Covered Calls is pretty much the same as with any Covered Call. You are going to get the benefit of potential income, a higher sell price at the expense of exposing yourself to continued downside.

For us, for Pro … we prefer to just sell the shares outright and close the Domino short all together. We have Papa John's value at about 65, $64 per share. It's currently trading about 79, $80 right now so it's about 24, 25% above our fair value estimate so as we have been throughout a lot of the history of this position for Papa John's, we are concerned about the downside because the stock is trading well above our estimate of fair value. We are not keen necessarily to expose our self to further down side in order to chase a higher sell price with a Covered Call but if that's something you're comfortable with personally and you don't mind exposing yourself to the potential downside of Papa John's.

If the market or if some company specific news comes out then you can go ahead and sell it with Covered Calls if that's what you prefer. You will obtain income and potentially a higher sell price but remember that the stock could drop significantly and you may not end up being able to get that sell price anytime soon if it does drop so that's the pros and cons.

Jeff: Very good Billy. It's interesting too from our side of our side of the table whenever we want to make a transaction, we need to … well, we talk about it, we decide on it, then we issue the alert. The alert gets published, this all takes typically … sometimes our turnaround is very quickly but say a day or two and then we wait a day at least to make the transaction and the pricing may change and this and that. What we found is our flexibility is a little bit less than yours and if really we want to get out of a position as Billy said, it's best for us to just sell it. If we believe there's a lot of downside in it we'll say so right away, although we of course, we don't either what's going to happen in the short term but a lot of our positions are stable and strong enough that you write Covered Calls to potentially sell. In a lot of cases for us, if we want to sell it today, we just need to sell it and not mess with Covered Calls but I think Billy spelled it out perfectly who you might be different at home. Joseph asking about Broadridge and Faxet, "I have not moved in an up market so what do we see going forward for the stocks?" While, Billy talked I looked him up and maybe it's mainly about perspective. Broadridge is a 16% in the past year ahead of the S&P, Faxet is up 7% … a bit below the S&P which is up 14%. Its true Faxet has underperformed, it's had an up down ride in the past year. Broadridge has stayed strong and a year to date even, Broadridge is up five and a half percent, just a little behind the market but I can talk to Faxet and just say, "We believe in it long term." We think over the next three years it will do well, we've owned it about a year now? And it's positive for us which is a first step in the right direction but they have hit some head winds as asset managers shed employees because passive investing has been becoming so popular. Think about it in this way, the S&P 500 in the past seven, eight years or so … even longer has been nearly perfect. It's gone up every year, it doesn't cause you to sweat that much, it hasn't been that volatile. It's been nearly perfect, the index has. Whereas a portfolio, even like ours of course has many positions that will cause you stress. That will fall 20, 30%, that will hit your [inaudible 00:13:40] portfolio so we're up against near perfection and a lot of investors are moving to the S&P as a result just in general. Our mutual funds are dropping left and right for similar reason … manage neutral funds but this won't remain the case of course. Eventually the index will have a very rough two, three years or longer and people will move more money into managed funds. Anyway Faxet is already adjusting for rise of passive investing, they have products that offer to those passive investment firms as well and we believe in it long term. Billy if you want to speak about Broadridge.

Billy: Yeah, sure. I think like Jeff mentioned, it really is a matter of perspective. A lot of times it can feel when you are looking for a stock price, be like … "oh, it's been trading in the 65 to 70. Speaking to Broadridge range the last three months, five months. The stock price is going up." Take that longer-term view, really view everything in a more global perspective if you look at Broadridge, it's up 15% in the last year. It's up 30% in the last two years and it's up 213% in the last five years so it depends on how you frame what you mean by an up market. In the last five years it's up 200%, it's definitely moved in that up market. Broadridge, we continue to feel good about it. They just made a big acquisition, they are working to integrate that to bring costs synergy and improve margins for the enterprise. That acquisition did significantly lower margins for the investor communicator portions of their business because the business they acquired … the margin profile for that business as whole was lower than the margin profile for Broadridge before they made that acquisition. When you have margins here for one business and you acquire a business with margin here, the business that becomes merged ends up with margins here. The idea now is find some cost synergies and try to bring those margins back up. That's what Broadridge is doing right now, they're growing revenue at much higher rates now because obviously you can include the impact of the acquisition. We feel good about them, Broadridge continues to be a dominant player in their industry. Continues to have stellar financials and we feel good about that company being able to achieve North Star like returns over the next three to five years. You won't necessarily see Immediate results in the stock price over a two or three month period but if you zoom out to three years, maybe five years, that's when you really start to see what value is being created by that business.

Jeff: Thank you Billy. One thing we love about both businesses is very strong with current revenue and 90% or above, their customers stick with them and renew every year or every quarter really with Faxet. Okay, so let's talk about quarterly dividends. How are they different from cash, why the decision to reinvest dividends? These are our next two questions here. I'll tackle those two first and then we'll talk about free reinvestment. Very briefly, after writing about it yesterday … we are doing this for two reasons, one to reiterate to everybody quarterly, the importance of reinvesting dividends. If you're not using them in some strategic way or in your life because dividends do make up a great portion of a market's total return and when you reinvest them your returns are multiple higher over a life time then if you don't reinvest them. That's just the facts as far back as you can measure so they are a huge differentiator between someone … there's a huge difference between people reinvest them and who doesn't as far as your results will be. I believe most people know that but we just wanted to share it for those who don't, many of you automatically reinvest dividends and that's great. If that's what you want to do, that's great. We decided not to early on because, one … well, we couldn't early on but two even if we can, we want to have more say where we put that money and we also like adding to our cash balance, given our goals as a portfolio. That said our cash balance has for years now averaged around 20% and our dividends which do slowly add to that, can … in most cases be invested quarterly if we see something we like in the portfolio. It's more quarterly reminder to you and ourselves that getting those dividends invested is important to returns and if you can do it at all, that you should be doing it. I think that sums it up JP unless you have something more to add.

JP: I think they are a couple of different things to unpack here with these two questions. The first one, if you go back 10, 15 years ago when transaction costs were much higher, sometimes you could go directly through the company and they would reinvest those dividends and shares for you, for essentially no cost. That was a big … you go back those transaction costs were a big friction, they were a big drag on your returns and so with that you could really accelerate your returns by minimizing transaction costs assuming you wanted to reinvest that money. The other the thing like you said, it does gives us the optionality to go outside of companies that pay dividends. Not all our companies pay dividends and maybe we went to build the positions of some of our newer positions that don't pay dividends overtime because we are waiting for a big drop before we make a big purchase, but if the stock doesn't really do that we can slowly build out on that overtime just by … every couple of quarters buying some additional shares and moving those positions higher. I think one other thing too, you look at studies, and they show you that reinvesting dividends really does dramatically improve your results but I haven't come across a study that teases out. I don't even know if it would be even possible to tease out the implications of who you are reinvesting those dividends in verses just actually doing it right. What you've seen, if you go back and you look at really long studies … even though you normally hear people say that, higher payout ratios come from companies with slower growth profiles. They can't reinvest their money so they pay it out to shareholders. What you can't actually see over long stretches of time, that companies that have higher payout ratios, actually have higher growth prospects and they grow at actually a higher clip in aggregate. You can't really … I'd be interested if you could tease out, what is the percentage of your returns over and above the market from reinvesting dividends, coming from reinvesting those dividends into really good companies versus just actually doing it. Now, that doesn't really come into play if you're just reinvesting the dividends into the market in general but I think the best approach … reinvesting dividends automatically through, a drip program for something like that, is definitely better than not doing it but if you have a broker that has really low transaction costs, and your portfolio is large enough so that you can be more strategic in where you allocate those funds … I think you can actually deliver better returns and that's what we are shooting for here.

Jeff: Well said. It's partly a tool to keep us disciplined, in a sense, in a way and mainly a way to share quarterly thoughts on this. If your broker is offering free automatic reinvestment, would you do that? Now that's really a choice that you could make, if you want to do it you could turn it on. whichever company pays the dividends, that little amount will get put into more stock of that company or you can know that quarterly we're going to issue and alert to buy two of our stocks with the dividends we've collected in the last quarter. If we like anything, that's what we'll do if that can wait a bit but most quarters we will doing that but as JP just said, that if you want to automatically reinvest given the way time flies … that's the way to do it over a life time. You don't even have to think about it, it's like automatically saving.

Billy: I think if you have a much smaller portfolio that must be the most efficient manner just in terms minimizing transaction costs and things like that.

Jeff: That's true. A lot of broker, [inaudible 00:22:12] Fiedelity, don't charge you to automatically reinvest. Interactive Brokers does, I was surprised so it goes. Foolish Fox Is being very kind to us, thank you. At least I think that must be who that is. Ellen working on a total income report, otherwise she wanted to be here in the chat. We haven't seen her for a little while but she says, hello to everybody and she setup this chat for us … thank you Ellen. "You're time and energy in managing positions," great question Garry, "versus new positions." This is something that has weighed on me lately, quite a bit and frankly not of us. We, in any Bull market that goes on shorts and hedges and even options is … looks wasted. You would have better used that time in finding a big company to own and for the ensuing year.

JP: Only in retrospect.

Jeff: Only in retrospect. We couldn't know that. We could change now and just do longs all the time but in retrospect that might wrong so there's certainly some tradeoffs and we're always trying to find the right balance between the time we spent on, shorts and options and hedges versus our longs. We want our long portfolio to be airtight before we do these positions and then we'll always have some problem positions statistically it's impossible to avoid. On average 40% of your positions will be losers, that's true of the market as a whole. That's true, we are doing better than that but we still have problem positions that chew up a lot of mental energy. Man, the amount of time spent on Gilead and AmTrust by all of us the past has been enormous.

Billy: I remember the first time I joined Pro, that was one of the first things I had to do because I joined right when there's was one of those shorter tax [inaudible 00:24:07] I probably spent two weeks doing nothing but AmTrust.

Jeff: Easily you did. The thoughts on that, well we are trying to get better with every new buyer we meet. We are trying to buy companies that we even more research than we've done in the past and we are trying to incorporate all the mistakes we've learned the past and avoid making the same mistakes again. Ideally the goal is to buy a company that you'll never have a good cause to sell. If our buys can be 'buys' that's the ideal, that's what we are working towards. That said, we know a lot of the market changes overtime so we have to stay on our toes even so but that's the goal and you'll just have some years like this. There's a lot of time that's been spent on problem positions but we are working through it and I think we'll get to a better place as a result, with some lessons as a result. If you guys have anything more to add.

JP: I'll add a little bit more there. I've talked a lot about it as a team, I think that's something we have talked about a lot as a team as the guys the mentioned and for me personally, you guys may have noticed, we've sold … within the last year or so, we've sold Wells Fargo, Paraxel, TD Ameritrad and now Papa John's and now closed the Domino's short. For positions that stuck up a lot of time that we were not super confident with moving forward that really don't fit our criteria … it may be a more useful use of our of time to call our portfolio of those problem positions so that we can devote out time more efficiently to finding ideas we like better. Now we have to contrast urge with another factor which is that the longer you follow a company and the better you know a company the better able you are to take advantage of opportunities within that company itself. I wrote a memo a while ago, maybe a year, maybe a couple of years of ago and that memo was about how the positions we have bought have performed for a second time have performed much better than the positions we bought initially. Obviously the longer you know a company and the longer your study it, the better you are at analyzing it. You want to make sure that you have some companies that you spend a lot of time on but at the same time, you want to make sure that you are not spending too much time on companies that you don't feel great about so that's the balance we are working towards. That's what some of our activity has been anchored on early this year.

Jeff: Excellent, thank you Billy. Next question … I'm looking at your poll entries too and they are a lot of good comments there, thank you. Question, Current thoughts JP, on Star Bucks and O'Riley? Star Bucks you just wrote about in the memo extensively after, again doing … see we just don't focus on problem positions. We did several weeks of in depth digging on Star Bucks.

JP: I was trying to get ahead of the curb, to find out if that was going to become one. Since then the Unicorn Frappuccino came out and … based on everything I can tell from Chino Chucks and stuff like that, it was a huge success not just in terms of the insane volume that they drove, which is somewhat interesting to me because it was a drink geared towards Instagram, and most people hated the way it tasted, but it did amazing and it actually helped other sales too because those stores have run out of the Unicorn Frap so quickly, you either had customers who A: Threw a hissy fit essentially and stormed out of stormed out of the store or B: They bought something else. A, not very god but B is pretty good for Starbucks financials, so all in all it was a huge hit.

Jeff: It blew your model out of the water, you have to change your 20 …

JP: My new price target is $100 per share, so it is now …

Billy: JP what is the Unicorn Frap adjusted fair value?

JP: It's $100 a share.

Billy: There you go.

JP: Yeah, so that kind of I think has turned the sentiments surrounding Starbucks around a little bit, because it got so much buzz and so the stock has actually done really well over the past couple of weeks. I still think everything that we talked about last month, the month before that is still in play, and content to hold it. With regards to O'Reilly we have earnings tomorrow I believe, and it's interesting because we've talked about this one a lot to, because we know Amazon got a lot of play a couple month or two ago, when the New York Post article came out saying, "Hey, they're making relationships with distributors and with parts producers and they're really going to go hard in this industry. That is a long term threat, but it remains to be seen what type of market share they can ultimately gain. The way I envision things shaking out is in the medium term is that basically Amazon because of their name, because of their distribution capabilities and things like that, they're going to come online and they're going to make a push and just crush all of the other online players. That's where they're going to gobble up a bunch of market share. We've seen it in other industries and after that we're going to have to watch, to see how much they're able to steal away from the brick and mortar stores, because we know cars are becoming increasingly complex. The younger generations actually becoming increasingly reliant on going to stores, so that they can speak with people, because they're not as familiar, and so being able to work with people face to face, have them diagnose it for you, because you got to check engine late on. If you're not very familiar with cars, you don't even know where to start but if you know you want to try and save money and do it yourself, instead of taking it to someone else. You're going to go to an O'Reilly's and advanced auto parts and auto zone and O'Reilly's is by far the best in my opinion and from everything I've seen, in terms of fulfillment rates, customer satisfaction, they do really good things with educating their employees, and so I think they are really … In terms of the players in the space they're the best positioned to withstand that onslaught. That's what we're watching in the long term. In the near term results could actually be a little bit weak for Q1 and Q2. Now how the stock reacts will depend largely based on expectations, what the market is expecting. What we saw for GPC last week was expectations were pretty low. The quarter for their business wasn't very good, but the stock actually reacted positively, and O'Reilly and some of the other players got a bump of off that, and so management for O'Reilly's and all the other players they got it to a potentially weak Q1, because of the unknowns in terms of how the tax refunds are going to play out, the weather. It was a mild winter for the first part, and then at the very end we got a really strong cold front and some big storms, and how is that going to impact? It could help them because it could help clear out some of that winter inventory, that they went able to sell through or it could hurt them, because people just couldn't get out to the stores because they were dealing with all of this, no. There are those things in play and so we're not really sure how the next quarter is going to be, but we don't want to over react to that quarter, because of our long term concerns, because from my opinion what happens in Q1 and Q2, aren't going to be as a result of Amazon. They're not going to basically steal away O'Reilly's business that quickly.

Jeff: Thank you JP. It's been a long term out performer. Our job is to determine if we believe ii it's going to continue to be a long term out performer.

JP: That's the key.

Jeff: Meanwhile because of greater uncertainties the share price has become less expensive that it's been in years, so that's a trade off benefit to current concerns at least.

JP: Yeah, this is the first time in a couple of years that it's actually traded at a discount to the market. We're definitely in a period of pessimism surrounding the business.

Jeff: Winston is asking about the renewal price for Pro. Will it be the same the next three years, any chance of a discount? We, the team here none of us around here have a say in that. I don't know even what the renewal rate would be or will be. The best we can do is say go call member services when your term comes up for renewal and see what they have on offer. That said I do know and want to share that the full has been re-pricing products, believing that the pricing was not where it should be for many years, so prices on a lot of services are going up and that's where they're standing, and they're talking a pretty hard-line, because we've had some old time Pro members wanting to renew, and when they went to member services they said, "This is where we stand now and this is what we think is right." That's about all I can say. It's not the best thing to say, but it's what I know, but do contact member services and se and hopefully you can get a renewal rate that is good for you. As always we do say go for the longest term possible to get your yearly cost down, and look at that cost compared to your portfolio value and hopefully keep it a small tiny percent of your portfolio, 1% or less I hope, and hopefully you're making money with the service. Every three years, let's say three years is a decent fair time to measure, hopefully you're making far more than your cost and more than the North Star goal, more than your own goal I should say and that way the service more than pays for itself. Hopefully that's what we're able to accomplish, but yeah it needs to be a value for you and you need to feel that you're getting your money's worth. Chris is asking why recommend J & J right now, for dividends not so much growth. Billy your thoughts.

Billy: Johnson and Johnson fits a category of stocks in the Pro portfolio that we think of as stable, balanced or our portfolio. The Pro portfolio is composed of companies of differing characteristics. Some of them are high flying fast growers, others are more stogy or stable, and then we have arrange of other companies in the middle and all together that makes up our portfolio. The Johnson and Johnson position fits more on that end of stable companies, highly profitable. If you read the right up in the original alert, you can see how Johnson and Johnson stacks up against the eight Pro qualities that we look for. Johnson and Johnson you're right, it's a huge company, there's not a lot of growth. There has been some pricing pressure in the pharmaceutical division, also pricing and competitive pressure in the consumer division and a re-organization of the medical devices division, which has all weighted on growth over the last three years, five years for Johnson and Johnson, but those competitive advantages for that business continue to persist. If you've followed the company over the long run this has been an outstanding performer for many, many years, 20 years, 30 years, 50 years and a lot of those advantages still remain, and we think it's going to be a strong long term performer, and also going to be a position that declines less in a downturn and is more stable for us, than some of our higher growth but higher volatility type of companies. I've also mentioned as well both to our team Jeff and JP and to members on the board that, Johnson and Johnson is also a position that w e think might make a good candidate diagonal call strategy. If we get to a point where market sentiment turns negative and the stock price declines, and we have an opportunity to increase our position, like I mentioned earlier with the memo I wrote about how the second purchase we make of companies, is generally better than the first purchase. If we're in a position to make the second purchase of Johnson and Johnson, because of market sentiment or whatever reason, we may consider initiating a diagonal call, which of course leverages the growth, so it's a slow growing company but if you initiate a diagonal call that slow growth is leveraged into much higher returns on your overall strategy. That's something e have in our tool box as well with Johnson and Johnson, to possibly be initiated later.

Jeff: Thanks Billy. The pipeline of change is especially strong looking as well.

Billy: It is. If you … We think potentially the market is undervaluing the potential of Johnson and Johnson's pipeline, and there maybe some significant blockbusters over the next five to 10 years, that outperform analyst estimates and market estimates, and also their recent acquisition of Octillion. They acquired even more products that could potentially turn into blockbusters, so the drug pipeline may reignite and initiate growth for the company in the future, so the future may not look exactly like the past three to five years of stagnate growth.

Jeff: We have about 20 minutes left and I think as it stands right now we can get through all of the remaining questions in that time, if we go a little quicker. The first one, a lot of people want to know, great question. Who does JP's hair? Nice compliment on your hair JP. Do you want to plug who does your hair?

JP: Maria here in Alexandria.

Jeff: Maria?

JP: Yeah.

Jeff: In Alexandria? Does she have a salon?

JP: Salon de Zen.

Jeff: Salon de Zen. You're a very Zen guy.

JP: I try.

Jeff: We talked before we started taping, we both have haircuts scheduled tomorrow. I'm just going to get my hair shaved off. I'm tired of dealing with it. What are you doing?

JP: Same thing as always. The reason it looks so different it's because it's … My natural hair color is actually starting to come through, because it's been such a long time since I have had it done.

Jeff: You may dye your hair more gray again?

JP: Yeah, we're going back to white gray depending on how it comes out.

Billy: Silver.

Jeff: Silver.

JP: Silver.

Jeff: Cool. I saw a woman on Connecticut Avenue about your age 20s with hair dyed silver. It looked go I'm like, "Oh, she should meet JP." Meanwhile if I were ever to dye my hair its d be to get rid of silver, but I haven't done that yet.

JP: I'm not at that age. I'll be there soon enough.

Jeff: No need. Okay, we'll see if I have hair for Thursdays, options check. Live Option check Thursday.

Billy: I think you should just shave it of Jeff. I think it would look good. You'd look good like a Bruce Willis type.

Jeff: Thanks Billy, I'll think about that.

Billy: Yeah.

Jeff: Sitting next to JP with a shaved head and his hair would be a good contrast. All right, so which by stocks would we consider good candidates for righting puts on? I agree with the three that you list there Facebook, Paycom, Faxet if the share price is not an issue for you at 100 shares. Also I would add Starbucks, Gentex and Opentex as three of the potentially right puts on. You could also consider Visa perhaps, although it's a straight-up by. All these stocks are righted by, but yes if you're only targeting a lower by price you can right puts on them. Also Skyworks also even puts well out of the money, pay well if you like exposure there. Any others you guys want to add?

Billy: J & J if you have the money to back that obligation.

Jeff: Sounds good. All right, let's see what else we can get done. SVXY has had a good run since last summer. Predictions for a market correction, is it a candidate for synthetic short? I would never short …

JP: No.

Jeff: We won't short that because volatility … Everything is working in favor of that position going up over most cases. Of course when volatility spikes it can fall quite a bit, but timing that is impossible. Keep in mind the market won't just fall or correct historically for no reason. Not just because it's due for it or it's time to …Sample markets have run much, much longer than this one. What typically causes the market to change direction is some external even, or recession rears its ugly head a surprise like a war, or something significant that. Even a war doesn't do it that much unless it affects earnings for better or worse. It's usually some sort of event that triggers a change in the market.

Billy: I did just write the memo on volatility and how it's been low, but how low volatility has tendency to lead to further low volatility. Just because volatility has been low in the past doesn't mean that we're due for higher volatility. It in fact generally correlates with more low volatility.

Jeff: So short answer. We're learning that position B right now, it's less than 2%. We'll let it keep growing because we believe over time it will, but we will manage if it gets to be too large or if we believe we should trim it, but we're not going to short volatility. We're not going to short, short volatility right now. We're going to stay … We're going to move on. SVXY is righted by still. Couldn't close GoGo at 12 or under, recommend waiting or closing? I would simply close because it's a small position. We actually got our shares closed today at 12.55 or 60. It's a really small stake and just as we talked about earlier just close and move on. It's a short that did not work out, but we'll keep an eye on it.

Close [Inaudible 00:42:39] auto though at current prices when you're ready to close. Do I recommend buying the full position SVXY? Let's see what size it is. I think it's 1.9%. It's 2% now SVXY, so up 100% for us. You could buy 1% at a time or if you are comfortable buying the whole 2% you can. It's righted by and it's still only at 2% position. Just as long s you know it can and will be volatile, it won't surprise you when it happens and if you stay in it for the long run it should work out as we hope.

Billy: SVXY is one of those where you can be opportunistic with your timing. That would be one where I would be inclined maybe by a half position, wait for some market shock and then fill out your position, and you can do really well from that second entry point.

Jeff: Sounds good. Mitch, hallo Mitch. Mitch is asking about FULL phases here. Are there any plans for event, or Pro in the event. I don't know yet. I haven't head. I know Full phased is … Full is doing something new and this is all I know and that is its invitation, because the amount of people who want to attend overwhelms the space. You'll get an invitation if there is one coming to you and I don't know the agenda yet. At some point we hope to have a Pro event. Next year will be our 10 year anniversary, so that will be the year, logical year to do it. I can't speak more to Full phase right now. I know it's a great time every year when it happens here in Alexandria, but I don't know all the details as to who and when members get invited, and we don't know the agenda yet ourselves, but Mitch I hope you're doing well and hope we'll see you at some point.

Billy: Hey Mitch just want to say hey.

Jeff: It was great to meet Mitch a few years ago already now. Usually when Pro puts a hedge into place, you say Pro is hedging about 15% of our total portfolio value why not greater? I'm speaking too much so I'll be very brief and say, we will increase our hedging if we believe that e should. We could also go market neutral all of a sudden. I've read a post … I haven't been able to respond to it yet, that said we're not truly a long short portfolio, but we are and can be if we've just chosen to be mostly long. It's true we don't manage in a market neutral way, because we think you have to take a stand. If you want returns you have to have conviction and take a stand, not be market neutral all the time.

Although that's a talent you can try to foster, that returns are typically going to be like most hedge funds, which is a few percent annualized and we're not in it for that. If we want to be market neutral we could be in an instant by shorting 70% SMP. Right now we're 73% net long. If we want to increase our hedges we can as well, but so far we're comfortable where we are. Right now we're 73% long excluding our QQQ hedge. If that kicks in when the market falls right now about 7% or so, that 15% allocation would take us down to a net 58% net long, so by the market falling for a certain span of pricing, we'd become 58% net long for another large span of time or price range. We're managing our hedges how we want to at the moment.

JP: Yeah, I would just add that what you tend to see is our baseline in terms of we think we can, out of the gate reduce our long exposure to this level while still delivering reruns that meet our North Star, or at least keep up with the market. We don't want to be a little bit too quick with the trigger to go market neural really reduce our exposure, because we don't want to miss out on strong weeks, strong months in the market, because that would really set us back. We know that the markets tend to grind higher over time, so the default position for us should always be to have a pretty good long exposure, and then adjust from there if we think e need to pull back.

Jeff: That is true. A good example of how versatile we can be is we put on a large direct spy short before the election and the uncertainty, and when the market rallied after the election we closed it right away, which as JP just said you don't want to miss large moves up, and thankfully we acted on that and closed. Sometimes the market tells you what you should be doing in a sense.

JP: Be market neutral or really moving round your net long exposure may look cool and it may sound sexy, but if you look at what most hedge funds have done over the past couple of years, being sexy doesn't always equate to good returns.

Jeff: So true. The past 10 years most sales returns have been just, tragic maybe too strong a word, but for so many endowments in universities and government that uses hedge funds, they've earned a few percent on their money annualized instead of 11%/12% and they're paying for that too. What's the right price would we recommend for a put ratio spread on the QQQ? That was in the yesterdays ketchup trade, and as of yesterday and I think still today it was 125 puts you're buying and the 115 puts that you're writing. Check out ketchup trades from yesterday, and you should be able to do that at credit.

Yesterday was about a 30 cent credit, so it may be closer to neutral today but still. Do you guys have any good tools to track stocks and options, and that will also help us invest and prepare tax returns? I can't say that I do. I use my brokerage itself.

Billy: It depends on what you're using to do your taxes and which broker you're using, so it may be worth it for you if that's a significant problem, to consider switching brokers to find one that can integrate with whatever tax software you're using.

Jeff: All right, next question. What are we holding Metronic and Oracle when they're not performing well or haven't performed well? Again it's probably some bit of perspective. In the past year they've done quite well. Oracle was up 16% Metronics up 15%. That's here today alone. The past year Oracle is up 10%, Metronic only 3%,. But the past five years Metronic has been strong and Oracle is up 55% the past five years, which may be lagging … Yes, it's definitely lagging the SMP. It's still a decent return and that excludes …

Billy: Not lagging the North Star.

Jeff: Not lagging the North Star, good point Billy and for the risk that we believe we have in the position it's a good return. We do measure positions on the risk that we think we're taking against the return that we think we can get, and if we think we can get 8%, 9% annualized excluding the dividend with modest risk then we're happy to keep that. Paycom has returned 40% in a year, but we're taking much more risk owning that stock right now. Bottom line was we believe in both businesses. Metronic has just gone through a giant merger which is integrating very well. The margins are going up, they're reinvesting, buying back shares and reinvesting in growth overseas.

Oracle is building its cloud business, which is slow to build up revenue initially, but then leads to higher profits down the road and that continues to grow at a good pace. We think both are well positioned and offer reasonable risk at a good price in this market. I still like them to challenge our North Star over the coming three years. We don't have plans to let those go right now. Is now a good time to short FAZ if we don't have it? Yes I believe it is. By shorting FAZ you're going long giant financials like Visa and MasterCard. We have 1.9% position I believe. Someone can look that up, but yes it's a current short and so you can …

Billy: 1.6.

Jeff: 1.6 only. That's right, okay thanks Billy. You can start that if you don't have it. Let's see. A QQQ put ratio spread. For all members we rolled that out recently. It's still a timely position at 125, 115, 114. Look at that trade alert or look at ketchup trades for Monday and you can still set that up. It's still a good hedge we believe and it's and it's to January 2018. All right and here's Ellen, she's working on a Pro trade and total income. Thank you Ellen. That was very nice of her. And we appreciate that. SVXY we talked about and we've talked about it in months past too.

We hope to keep it for the very long term, because we believe it can compound over the years. You need to do what you're most comfortable with, but we plan to keep it as of right now. That situation could change, if it does you'll get a trade alert but right now we do plan to let it be. Again Billy just said low volatility can lead to more low volatility. Let's try to get something that you guys should talk to. Investable accounts are taxable. Right now this member Davis has a Roth in a mutual fund, how large should it get before it makes sense to allocate as Pro?

Billy: I would say it depends. You can use a combination of accounts to do your Pro portfolio, so keep in mind that you don't need to have the Pro portfolio bucket all in one account. You can have some of your assets in a taxable account, some of your pro assets in a IRA and some of your Pro assets in a Roth, and you can consider which securities or which positions you want to put in each account, depending upon their potential tax consequences. Although we will say I'm not sure how much the pro portfolio costs, right now or how much it costs to join the Pro service, but you do want to keep our advisory fee as a percentage of your portfolio under say 2%, 3%, so I'm not sure how much it cost but I think … What do we say guys? Generally $100000 portfolio, 25000 to start with us?

Jeff: That is yes very generally what we say.

Billy: Yeah.

Jeff: Thanks Billy. Let's see next question. Thoughts on France and potential impacts. Interestingly after the preliminary vote this weekend, the Euro of course has gone up because a pro-EU candidate is heavily favored to win in May, in the final election. May 7th I believe it is. The chance of a radical change in France has been lessened. That said we're still watching it of course, because there could be a surprise, but right now it seems to be that a more moderate candidate is most likely to win and not only stay in the EU, but work to strengthen the EU. In that case we may finally exit our short of the Euro.

We've given it a long time to get weaker and the Euro has held up quite well. If France were to leave the EU or want to that would be a big blow to it, and that's what we've been waiting to see if it would happen, but it looks much less likely to happen right now. Any other thoughts you guys want to add on the geo-political stage?

Billy: I would just ad that it doesn't make too big of a difference to me as far as most of the companies we cover, but of course with that Euro short that would be something to you want to think about.

Jeff: Besides the guide book do we have recommended reading list in the monthly Full Pro guide book in that area? Ellen does list out a lot of recommended reading, but I think what we need to do now in Pro, we just did an options which is we all put together our favorite columns and it's all on one page in Monthly Full options. We'll do that in Pro next and highlight it for you as a weekly column and yeah that's a good idea so thank you. Make a note of that. All right we have Scott, hey Scott. Curious about Pro's strategy on micro caps. Any thoughts on small speculative plays at 1% or less of the portfolio? JP you want to share thoughts on that?

JP: I think it's something that we've discussed on multiple occasions internally, because like you say, it does lead to companies that won't the checklist to a large enough extent that they would be included in the Pro put traditionally, but on occasion there is really good returns, it could be generated if you can find a company that could grow into a Pro like company. The risk is obviously going to be much higher an so in ideal world maybe there would be leaps trading on it, but if you go with really small stocks that's not going to happen, you're going to have to take an equity stake in them, and so it is something that we are debating internally and it may show up, but I don't have much more to say about it right now.

Jeff: Yeah, we've bough companies as small as four or 500 million and that's probably about as small as we can get go in the service, and frankly would want to go, but e are looking ... In fact we're looking at a company right now. Billy it's quite small and that we are interested in.

JP: Yeah one of the issues that we have verses a "hedge fund" of a traditional size or of a similar size excuse me is the fact that they can be very secretive, and lag into positions if they want to take stake in a small company. What happens with is we put an alert of the member, see if all the members want to get in on it and they just bombard the price and then the price, if you're dealing with a much smaller company is going to move dramatically. It hurts members and then it's also going to hurt Pro, because we don't take stance in a company until we put out the trade alert and time passes. There are definitely some headwinds just in terms of technicalities of how Pro is run, that would prohibit us from going with much smaller stocks that have very lightly traded volume.

Jeff: Thank you JP. How do we measure risk? We measure return versus risk. When you have company like Oracle where expectations are low and yet revenue stability is very high, and you have a low valuation multiple the risk looks reasonably low. Can we list a range of valuations, this member is asking. We've talked about that in the past and for various reasons we couldn't on the page, but what we could do perhaps is put a note up, that our fair value estimate is the midpoint of a range that generally can swing 10% in either direction from that point.

Now we've got to wrap up. Skyworks you'll have news on that soon. Any possibility of exiting AM trust? It is possible. We talked about that early on. It's in the cards and our caller signifies that, if it were to rise or fall at the moment right now we would be okay letting it go. I think that's it right now. Thank you to JP for Starbucks comments and I think we're good. There will be a transcript of this chat after it wraps up.

Billy: Let me answer real quick Rods question. Last video call I recommended an Excel plug-in that pulls options prices. That plug-in is called SMF, Sam, Michel, Frank addin.

Jeff: Excellent. Thanks Billy. SMF addin, Sam, Michel, Frank. Then when we reinvest dividends dose the allocation change? It will change very modestly 0.1% typically so it won't be enough to really throw anyone off.

Pro Guidance Changes and Completed Trades: April 17, 2017

Published Apr 17, 2017 at 3:45PM

Pro Guidance Changes (from the past two weeks -- see related trade alerts)

- **Caesars Entertainment** (NASDAQ: CZR) moved to Cover.
- **Papa John's International** (NASDAQ: PZZA) moved to Sell, and **Domino's Pizza** (NYSE: DPZ) to Cover, ending the paired trade and both positions.
- **Valmont Industries** (NYSE: VMI) moved to Sell.

Pro Completed Trades (from the past two weeks)

- **AmTrust Financial Services** (NASDAQ: AFSI): We bought June 2017 $15 puts for $2.50 each. The stock fell before we could place our collar. We're still waiting for a higher premium to write the $22.50 calls.
- **Caesars Entertainment:** We closed (covered) our 1,800 shares, closing the entire short at $9.50 each for a 20.5% gain.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Most of the S&P 500 Fails

Published Apr 17, 2017 at 3:35PM

Dear *Pro* Fools,

Would you guess that since 1980, more than 320 companies in the S&P 500 have been removed from the index and replaced because they were struggling? That's 64% of the total! Our economy is ultra-competitive, and it's difficult for any company to create enduring profits. That's the conclusion of a J.P. Morgan study on diversification and portfolio concentration that the Fool's Tim Hanson shared with Fool analysts today.

Other fun facts include that 40% of all stocks in the Russell 3000 suffer a permanent decline of 70% or more from their peak, never to recover. Over a multi-decade period, two-thirds of all stocks underperformed that index, and about 40% suffered a negative total return. These are numbers we've seen and cited before, and they serve as flagrant reminders that portfolios of stocks will statistically always have several losers. These numbers also dovetail with Peter Lynch's belief that if you're right about 60% of the time, you're doing well. Statistically, that's about as good as you can hope for, no matter how smart you are.

That's because dozens of factors are outside your -- and your companies' -- control. The competitive landscape changes. Technology changes. Laws change. Customers change. Commodity prices change. The study cites many more reasons to worry (sorry) on page 11. In fact, the whole report reads like a graveyard of companies that came, saw, and basically failed. It's instructive to note that the *most* destruction (the greatest number of company failures) occurred in the technology, energy, consumer discretionary, and health-care fields. If you click through the report for a trip down memory lane, enjoy the carnage -- because it's inevitable, and much more importantly, because you can still succeed as an investor despite many losers. Your long-term winners carry the torch to the winner's podium.

Most Investors Lag for Long Periods -- Cut Yourself Slack

The J.P. Morgan study is a strong reminder that getting to that winner's podium includes many knocks, and many rough times, along the way. And that's typical.

As a Davis Advisors study showed us, a majority of the top-ranked, large-cap fund advisors in the U.S. spent at least one three-year period over a decade being ranked among the *bottom* 25% of performers. In fact, a whole 93% of top performers spent at least one three-year period in the bottom half of the rankings. Most of the best long-term investors experience long periods during which they perform among the worst. Remember that the next time you think everything you're doing is wrong.

Part of the reason we all look poor as investors at various times is because we all have big losers during stretches of time. Why? Revisit the first three paragraphs above. And think of it this way: Even when you invest in the S&P 500, you're agreeing -- whether you realize it or not -- to invest in a majority of companies that will *fail* to maintain enough health to stay in the index. You're agreeing to have more than 60% of the 500 companies sold and replaced over four decades because they're suffering. Yet, you invest in the index anyway, and you benefit greatly over the decades.

The endless stock changes in the S&P 500 happen behind the scenes. You don't lift a finger. But if you run your own portfolio, you need to consider your portfolio changes on an individual stock basis, and you have more riding on them, because you don't have 500 companies over which to spread your bets -- you may only have 24 or 30.

Each position matters much more, and the losers hurt more. You hope to get at least 60% right, and not sell the winners too soon.

Assessing Problem Positions

Here in *Pro*, we've had some big losers lately, and it certainly hurts and consumes a lot of time. Overall, we're still tracking ahead of our return goals, and just like all those investors who have down periods and recover later, we'll likely follow suit and head higher. We've had "problem" positions before, and they rarely account for more than 10% of the portfolio at any one time, same as now. We seek to learn from our problem positions, and to improve. When we buy new positions, we seek to buy "better" and avoid the same problems again.

Right now, our focus is on a few problems. We should have an updated fair-value estimate on **AmTrust Financial** (NASDAQ: AFSI) this week, and that will help drive our next decision. The stock remains on Hold. As for **Gilead Sciences** (NASDAQ: GILD), so far other Fool services are sticking with the biotech giant, and we're debating whether we want to as well; meanwhile, we seek a North Star return from here with some help from covered calls. And our **Gogo** (NASDAQ: GOGO) short has run 16% against us as sales contracts grow for its latest WiFi technology. Wanting to avoid thesis creep, we're debating closing even the short though laptop bans in airplanes (if they were to spread) would clock the business. These three positions combined are 5.6% of the portfolio, and we own puts to hedge AmTrust.

But our small amount of exposure, and even our hedges, don't make the situation go away. We want our businesses to be universally strong, and we must weigh our patience as investors against our desire to steadily aim to improve our portfolio. When we make changes, we do so *not* hoping to boost our one-year or even two-year returns, but based on what we hope will drive the best long-term results. In an industry where returns are tracked daily, and where industry watchers give great importance to one-year results even though they're not truly important, the Fool keeps bucking the trend to focus on generational wealth. That's ultimately what the stock market is built to deliver, if you let it -- and that's with losers included, as well. Today's S&P 500 is not yesterday's S&P 500, and our portfolio steadily evolves, too.

Please ask any questions on the Memo Musings board. Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: April 17, 2017

Published Apr 17, 2017 at 3:15PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 4%.
- **Visa** (NYSE: V): Buy 3.1%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.2% (see our recommendation).
- **FactSet Research** (NYSE: FDS): Buy 1.9%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.2% (see our recommendation).
- **WisdomTree Emerging Markets SmallCap** (NYSEMKT: DGS): Buy 1.9%.
- **Verisk** (NASDAQ: VRSK): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% in some form, via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- N/A

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $83,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $114 puts, and buy to open *half* as many January 2018 $125 puts. Lately, aim to set up this combined trade for net zero cost or so.

This month's expirations (April 21):

- None.

Sell Valmont Industries

Published Apr 12, 2017 at 2:21PM

Is this for you? This recommendation is for all Pro members who own these shares.

How You Participate

- **Action:** Sell **Valmont Industries** (NYSE: VMI).
- **Allocation:** Sell your 2.2% stake down to 0%.
- **Guidance:** Moves from Hold to Sell
- **Recent Price Range (this morning):** $149.70-$152.75
- **Price Guidance:** This is a ***very*** thinly traded stock. Please, we beg everyone, don't rush; **calmly use a limit order** to sell around the going price, ideally around $151 or above. *Pro* will sell within the next 1-30 days.

- **Earnings Note:** Valmont will report quarterly results on the morning of April 20th. Not knowing how the stock will react to those results, it's a coin toss whether you should sell before then or after then. We plan to sell before, if we get our price, just to have the trade done and move forward.

What We're Thinking

Valmont shares have gained about 20% since the election in November, and 50% since hitting a low in early 2016. Even when excluding dividends and past covered calls, we now have a small gain on the stock after waiting through three years of cyclically poor business performance. Revenue has fallen 8.6% annualized over that time. Lately at $152, the stock is above our $140 fair value estimate, and shares trade at about 21 times the average earnings per share estimate for this year, and 19 times the average 2018 earnings estimate.For an industrial, cyclical business that is still laboring to grow, the stock looks a bit generously priced, perhaps thanks to an optimistic stock market.

Many investors have become excited by the new White House administration's promise to spend big -- up to $1 trillion -- on infrastructure. Ironically, the administration's first budget proposal all but eliminates funds already earmarked for maintaining and repairing infrastructure. Although we can only guess, it's likely the administration wants to privatize many such projects, or make states responsible, either of which could lead to renewed competitive bidding, sweetheart deals, or both. There's no guarantee that Valmont would win key contracts, or that pricing would support Valmont's margin goals.

Plus, the administration needs to get an infrastructure bill through Congress in a timely fashion before the 2018 mid-elections, and with a failed healthcare bill, a less-than-cohesive Republican majority, and so far the lack of a clear infrastructure strategy from the White House, the challenge grows. Next up on the agenda is tax reform, but we've heard few details, and already some are speculating that a tax bill won't be passed before the August recess. That would push taxes into the fall, and would likely push any infrastructure bill into late 2017 at best. While companies wait for an infrastructure bill and its possible benefits, it's *possible* that some projects will be delayed. Yes, legislative uncertainty across the industry might actually cost players like Valmont some business in the time being.

We're selling Valmont at much higher valuation multiples than where we bought it. It trades at 20 times earnings now compared to 13.3 when we bought, and today it fetches 11.4 times EBITDA compared to 6.8 times when we bought. We bought when the stock was beaten down, in the middle of a cyclical downturn. We're selling when the stock's price has rebounded, its valuation now assuming that growth is around the corner. That growth, or at least its magnitude, may not materialize as hoped, which would likely lead to disappointing returns. Cyclical companies at higher valuations are not something we want to give a long leash unless we have great clarity into the three-year prospects ahead; lacking that today, we're taking our money back following recent price gains.

How this Decision Fits Into *Pro*

Pro continues to evolve since we bought Valmont in late 2013. The company has a tremendous history of value creation for long-term owners, and management has performed admirably during the current downturn by cutting costs, remaining profitable, and staying competitive. Our hat is off to them. However, in *Pro* we want to focus more and more on companies that have sustainable competitive advantages that ideally offer some form of pricing power. Companies that merely operate well are just not enough.

Further, we want to own more and more companies that are "only" rather than "best." You can be the best among many with what you do, or you can be virtually (or truly) the *only* one that does what you do. Valmont is one of many companies providing quality infrastructure and utility work, and because of this we've already seen how price wars can harm its results. Should pricing start to slip in its key irrigation business, too (which seems less likely, but is possible), Valmont would suffer again.

That said, the company is likely to remain a good long-term operator, and the stock may ultimately perform well again -- in fact, we would expect that! But we're going to work to move the funds into a company we believe is more likely to outperform the North Star over short *and* long periods by virtue of having steady, reliable revenue and earnings gains, which can then be invested in still more growth. Valmont largely lacks those qualities except during boom periods, and those periods may lead to more pricing battles as globalization continues to bring more players to the table.

We'll sell all of our 2.2% stake in the next one to 30 days. Please **use a limit order and patience.**

***Pro* Can Help**

Questions on this sell? Please visit our Valmont board.

Close Your Short on Caesars Entertainment

Published Apr 12, 2017 at 2:21PM

How You Participate

- **Action:** Buy to close, or cover, your remaining short position(s) on **Caesars Entertainment** (NASDAQ: CZR).
- **Allocation:** Close all of your remaining short -- our 0.6% exposure will go to 0%.
- **Scorecard Status:** Cover.
- **Recent Price Range (this morning):** $9.60-$9.85
- **Price Guidance:** *Use a **limit order*** and, today, aim to pay around $9.70 or less. We will close our short within the next 1-30 days.

What We're Thinking

We have been more than patient on our short of the country's largest casino chain operator, Caesars.

On Oct. 1, 2014, *Pro* issued a recommendation to open a 2% short position on the stock. Ten months later, we recommended closing half the short at a 42% gain (we were able to close for 35% after the alert). Now, we're saying to close the rest around a 19% profit. Since October 1, 2014, the S&P 500 has *gained* 21%, excluding dividends, so the short has served us very well, especially in this market, and even after fees. But we have perhaps been patient to a fault.

On January 15, 2015, the company filed for bankruptcy protection and we celebrated. Then we watched a nearly two-year back-and-forth battle between Caesars' big-time hedge fund owners and its creditors. In October 2016, Caesars finally reached a deal with its last battling junior creditor. Over those 22 months, the agreed-to payment rate on Caesar's junior bonds went from next to nothing to 66 cents on the dollar, enough to make the bondholders settle in exhaustion. But it was still up to the court to decide if the Caesars approach to bankruptcy was even legal.

The company had restructured itself before filing for bankruptcy protection, moving its most valuable assets to the safety of new business divisions, leaving debt holders with a shell of an asset. This was partly why we sold short: The company was almost surely headed toward liquidation, and before then management moved its still-valuable assets out of reach of debt holders. This should be illegal.

In January this year, without providing clear reasoning for future cases, a Chicago court allowed the restructuring to go forward, paving the way for Caesars to start over. Caesars should emerge from Chapter 11 this summer, its high-interest debt load cut from $18 billion down to about $8 billion. The new company will restructure yet again into two firms, a casino management firm and a REIT that owns the property.

We were disappointed by the ruling, not just for our short, but for future bankruptcy cases. This sets a precedent whereby a corporation can reshuffle its assets egregiously before filing for bankruptcy, thereby denying debt holders -- in most cases, bond holders -- access to the actual assets that they were originally guaranteed rights to. The Chicago court called the ultimate restructuring agreement "extraordinary" and a "monumental achievement" -- which felt like a smokescreen to cover what's really happening here (a wave of the white flag). Thousands of pages long, with countless parties arguing for restitution, the reorganization weighed on the courts for two years. It is amazing that an agreement was reached, but in the end, it was allowed to go forward only after liability releases were modified to be less insulting to debtors, and to mollify the concerns of a U.S. Trustee watchdog. However, the case still weakens the protections historically afforded to secured debtors.

Despite Caesars winning the right to reorganize in January, we waited to close the rest of our short as we worked to figure out what the new business might be worth. After all, existing stock holders *are only getting 6%* of the new entity -- that's about as close to bankruptcy as you can get for a stock without actually going there. Given this diluted ownership, in our estimation the stock should have traded for much *less* after the settlement, not more. But the market has not come around to the same conclusion. Investors continue to bid the stock higher.

Seeing last quarter's results from the businesses that will now form a new Caesars, and trying to ascertain what the REIT might be worth on the market, has still not filled out the full value picture, and management has not provided greater details. On our estimates, once diluted, shareholders today are paying well more than 20 times EBITDA for the new business, a hefty premium for a subpar operation that might deserve one-third that price (unless, perhaps, you argue that the real estate is worth many billions more than thought). But it now seems prudent to put up our hands in surrender and close. Until we see the full financial position of the new entities, we can't reasonably stay short, even as a hedge against a falling stock market (which was part of our reasoning in recent months). Plus, as emergence from bankruptcy approaches this summer, the stock may continue to rise in anticipation. People celebrate new beginnings. Once we see what the "new" company looks like, we might choose to short again. It still will carry billions in debt and operates in a challenged industry.

For now, we will use a **limit order** to close our remaining short shares. Please be smart and use a limit order with us. Paying any price just to get your trade done will only make this less profitable for everyone.

In closing, thank you for participating in this short these past years! It's been quite the attention-grabber. In the end, we all learned a lot about what you can get away with in bankruptcy, among other things. Today, we would be more careful buying corporate bonds, especially high-interest bonds. Only buy quality corporate bonds, because your assumed rights to secured assets can be mitigated away by corporate reshuffling. It's an unfortunate ruling by the court, and if we see it affect bond holders elsewhere in the future, we know we have Caesars to thank.

Alternative Trades

- **If you set up a January 2016 synthetic short, bought puts, or set up a bearish spread:** These should all be done by now, having expired, but if you have any remaining open, you can close them.

Pro Can Help

- **Want to cash in your chips?** Visit our run-down, gaudy, gold-plated, outdated, 1990s-inspired Caesars board.

Sell Papa John's, Close Your Short (and Covered Puts) on Domino's

Published Apr 12, 2017 at 2:21PM

Is this for you? This is for all *Pro* members. We're closing all of our exposure in these two companies.

How You Follow Along

- **Trade:** Sell **Papa John's International** (NASDAQ: PZZA); cover ("buy to close") your entire **Domino's Pizza** (NYSE: DPZ) short, and close ("buy to close") all June 2017 $140 covered puts, closing all positions.
- **Allocation:** Bring all exposure to zero, closing everything.
- **Recent Price Range (this morning):** PZZA: $80-$81.25. DPZ: $174.81-$176.45
- **Price Guidance:** Prices are volatile. **Please use limit orders** to sell your long stock ideally above $80 (it's a fairly small company, so **limit orders are essential**), and use a limit to close your short stock at the going price when you enter your trades, ideally below $176-but volatility may preclude these prices. For the covered puts, use a limit order that comes close to splitting the current bid/ask prices to "buy to close", leaning a bit toward the "ask" side of the current pricing to get it closed.
- **Tax Consideration:** Long-time members have a very large gain in Papa John's (our gain is lately 572%). Consider your own tax situation before closing that position, to make sure the net cash result is attractive to you. We don't believe the business is due for hard times, per se, but we are selling for reasons talked about below.

What We're Thinking

A little more than three weeks ago, I wrote a Monday Memo about *Pro's* combined Papa John's/Domino's long/short paired position, moving our Domino's short from Hold back to an active Short position. After publishing that Memo, our members kicked off an outstanding discussion on the boards about that Memo, questioning its conclusions. In part due to the comments from our members, I took the time to reconsider my original conclusions, and I found myself agreeing with our members on many points. I left that discussion having much less conviction in maintaining our Domino's short, and I promised to further reconsider my conclusions over the following weeks.

As we fast forward to today, we think now is an appropriate time to not only close our Domino's short, but to also sell our Papa John's long position for several reasons, including:

1. The price discrepancy between Domino's and Papa John's has narrowed since three weeks ago.

In the Memo where we moved Domino's back to an active short, Papa John's was then trading at about $76 per share and Domino's was trading at about $184 per share. Today, Papa John's is trading at about $80 per share and Domino's at $176 per share. This means that the short position's impact to our portfolio has been reduced from about $11,000 (a 0.4% impact) three weeks ago to about $5,000 (a 0.2% impact) today.

2. We have long felt that Papa John's valuation is stretched, and we're not confident in the stock's ability to achieve North Star returns over the next three years from this price.

Although we like Papa John's business, in recent years we've consistently been wary of the valuation multiples the market has assigned to the stock. Papa John's expensive valuation is one of the reasons we initiated our Domino's short in the first place, and we've often had to expend significant time and energy devising ways to mitigate downside risk for our Papa John's position. The shares now trade at nearly 30 times earnings, and 29 times one-year forward earnings estimates, even though growth has lately stalled. This is more than double the valuation multiple when we originally bought shares, even though growth rates have slowed rather than accelerated.

3. The competitive landscape in the pizza industry is changing, and we're not sure that Papa John's past five years of performance will be easy to replicate.

The last five years have been good to the big pizza companies, as they have been able to use their size and resources to gain an early lead on smaller operators in technology. Digital ordering now accounts for more than 50% of total sales for both Domino's and Papa John's, and that has been a huge growth tailwind for them. However, there are now many third-party companies that allow smaller pizza operators to compete in the online arena, and the low-hanging fruit of digital ordering in the pizza industry has largely been picked. While online ordering should continue to grow, the pace of growth should slow. Additionally, we've grown to become less enthusiastic about Papa John's "quality" brand positioning, as smaller, local, artisan-style pizzerias have increased the competition in the premium corner of the pizza market.

The *Pro* Bottom Line

All in all, we've decided to close our Papa John's/Domino's long/short paired position for the reasons detailed above. Although Papa John's is a good business, the consistently expensive valuation has made it a difficult position to manage and hold comfortably. Selling frees up capital and time to use on ideas with less risk that we like better, and we think our portfolio should benefit in the long run because of it. But we'll also keep watch of these companies, willing to reconsider them at lower valuations in the next bear market.

Pro Can Help

- Questions? Please bring them to the Papa John's board.

Trust, AmTrust, and Time: Stay Tuned

Published Apr 11, 2017 at 3:25PM

Dear *Pro* Member:

One of the most difficult risks to assess, let alone defend against, is fraudulent or aggressive accounting. One of the largest workers' compensation insurance providers in the world, *Pro* holding **AmTrust Financial Services** (NASDAQ: AFSI) was featured in today's *Wall Street Journal* for that very thing. The article claims the company has been under a SEC investigation since 2014. AmTrust's management responded that the company has no knowledge of any such investigation, suggesting that the article is another smear attack by the short sellers who have been vocal against AmTrust for years.

Adding to the intrigue, last week AmTrust restated its financial results for the past three years, a fact no one contests. The restatement lowered AmTrust's reported net income over that time by about 11%, and increased its reserves for insurance losses. Its new auditor, KPMG, found material weaknesses in AmTrust's financial controls, and AmTrust is taking steps to rectify that, including multiple new executive hires. The company has been transparent about these issues this year.

Where does all this leave us? With a very volatile stock. Down more than 20% today as I write this, and 45% year-to-date, AmTrust is easily our worst-performing stock this year, and one of the worst in our history by this single measure. The company is now a 2.6% allocation, having dinged our portfolio by a few percentage points this year alone. Ironically (or perhaps logically!), AmTrust is still one of our biggest winners since inception, and it's added more value to the portfolio than almost any other holding (we've sold partial stakes off along the way). But that's no comfort to newcomers, and little comfort this year.

What *has* helped this week is the protective collar we recommended March 31 to guard against a further decline in AmTrust's stock. Selling $22.50 calls to buy $15 puts, we capped our downside risk at $15 and our upside at $22.50. This limits our risk while we assess what to do next.

Struggling positions impose many costs on an investor. Aside from the financial harm, there is the very real time it takes to analyze the problems, which leads to opportunity cost -- that's time *not* spent finding better businesses. In fact, new energy spent on flailing positions represents a "doubling down" of your time, which is your most important capital, so odds better be high that your time will be well-rewarded. You don't need to make money back the same way you lose it.

My patience has been said to be noteworthy, but I still reach a limit with some companies, after which I no longer want to invest our money or time. I'm very close to that with AmTrust. Having followed it since its IPO in 2006, I feel I know it well, and I've seen skeptics be critical of it almost since the beginning. After years of steadily working to confirm we should stay invested, I'm starting to feel the energy spent on AmTrust could be put to better use elsewhere, for better rewards with less risk. Like investment firms and banks, insurance providers can be very opaque companies, vulnerable to self-inflicted financial shocks that investors can't see coming.

It's also true that we want the *Pro* portfolio to only hold companies in which we have 100% faith and confidence. This seems more important now than it has in years -- and it has always been important. Expect trades from us in the coming days that move the portfolio closer to where we want it for today's environment, still with an eye on the long term. With AmTrust, the protective collar on the stock buys us the luxury of time to decide our next move, whether we use that time or not.

But it's even more important to us to recommend only businesses that have our full confidence, businesses we would tell our own mothers to buy. As we move *Pro* forward, as ever, we want every stock we recommend to be strong in every way that matters to us, from expanding revenue and reinvestment opportunities, to foolproof management and financials, to a price that suggests North Star potential or better. There's no room for also-rans. We want world-class companies, and not all companies we buy will prove to meet that challenge — in fact, many won't. In those cases, we need to choose between giving them more time, or moving on from them.

At the same time, we're always evolving as people and investors, and demanding more of ourselves and of our investments. The parts of the portfolio that no longer stand up to our criteria will be changed. We're always working to make *Pro* still more successful in the future, and more enjoyable, too. With that in mind, expect new sell and buy guidance to come, all working to benefit the portfolio for the years ahead. That includes our next decision on AmTrust. For now, our "Hold" status with a protective collar represent a decision: The collar caps our risk and sets us up to potentially sell. If you're not using options, make certain you're comfortable holding the shares you own until we reach a conclusion. We thank you for being a *Pro* member.

To discuss AmTrust, please visit our AmTrust board.

Foolishly,

-- Jeff Fischer
Advisor

Where Are They Now?

Published Apr 10, 2017 at 3:24PM

Fellow Fools,

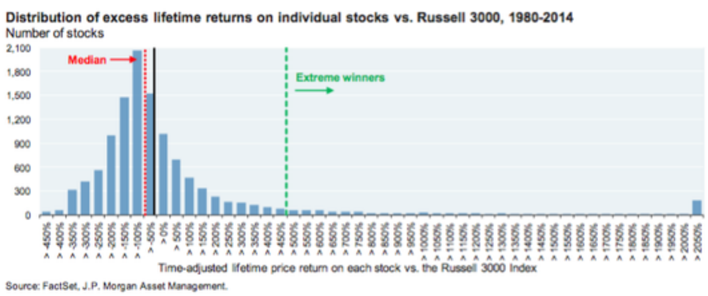
"Should I sell this stock?"

This question might seem straightforward, but I think we can all agree it's one of the hardest to answer when it comes to portfolio management. Psychological pitfalls around this decision abound, with investors stubbornly refusing to sell a losing position until it's back to breakeven, unable to recognize that a thesis is busted because they're only looking at favorable data, becoming sentimentally attached to a stock that has been a huge winner, or simply being overconfident, just to name a few.

Given all this, is it even worth contemplating a sell? We all know a small number of stocks account for the vast majority of the market's returns; in fact, just 14 stocks have created 20% of the market's gains since 1924! So do you really want to risk selling what could potentially become a multi-bagger?

If you were tempted to respond No to that question, you may have fallen prey to yet another psychological trap: framing, the tendency to view a situation differently depending on how information is presented. As written, the question focused on the potential for owning one of the rare stocks that create a life-changing amount of wealth — like a lottery advertisement, which only talks about winning even though 99%-plus of lotto tickets are ultimately duds.

But if I'd phrased it more solemnly, you might have responded differently. The truth is, there are an awful lot of duds in the stock market, too — of the 13,000 Russell 3000 stocks examined in a JPMorgan study, two-thirds underperformed the market. And close to 40% of all stocks experienced what the analysts referred to as a "catastrophic decline," which was a decline of 70% or more, peak to trough, with little recovery afterward.



Although it may be more enjoyable to focus on your winners or look for new ideas, I believe this study provides strong evidence for why being good at selling can create tremendous value. When it comes to stocks, being average means you underperform the market. And although we know being patient and having a long-term focus provides a huge leg up in investing, this attitude can actually be a detriment when it comes to "turnarounds," because they hardly ever turn around. For every Apple — a company that was famously able to reverse its fortunes after the return of its founder — there are countless flops like [Pets.com] and [Webvan].

With three closed positions in the first three months of 2017, I figured now was a good time to take a look at *Pro*'s track record of closed positions. Throughout our history since 2008 -- excluding hedges and options-only positions -- here are the total (stock plus dividend) returns each stock has generated since being removed from the *Pro* portfolio, from worst to best.

sources: S&P Global Market Intelligence, author's calculations.

At first glance, you might think we're just downright awful at timing our sells (or buys, in the case of shorts) — the number of stocks that are up 100% or more far outweigh the few that experienced a significant decline. However, one thing we need to keep in mind is that a strong bull market is like the rising tide, lifting up the stocks of even troubled companies. To account for this, we looked at the excess total returns for these stocks versus the S&P 500; as you can see, that chart looks very different:

Sources: S&P Global Market Intelligence, author's calculations. Negative value denotes the stock underperformed the S&P 500, positive value denotes outperformance.

Approximately 80% of our closed long positions have underperformed the market on a total returns basis since they were removed from our portfolio. One stock, Jack Henry and Associates, has outperformed the market by more than 100%, but it's dwarfed by the number of laggards. On the short side, it's a good thing we didn't double down on any of our positions -- all have outperformed.

Of course, hindsight is always 20/20; I don't doubt we could have done even better by moving to close some positions earlier (The Buckle comes to mind here for me). But I believe this chart suggests that *Pro* is pretty darn good at selling. When you consider that since inception, *Pro* has outpaced the S&P 500 despite being on average about 72% net long, it's likely we've created value on two fronts — removing a lagging position with a dim future, and redeploying that capital into a high-conviction idea.

Ultimately, I believe this potent one-two punch is what makes it so worthwhile to get good at knowing when to sell. Selling a 2% position that's likely to remain a laggard might not seem like a big deal (assuming it doesn't end up falling 50%!), but it really makes a difference if you redeploy that capital into a stock that ends up crushing the market.

Enjoy your week, Fools!

— JP (TMFYossarian)

- **Want to know more?** For details about our selling process here at *Pro*, here's the link to our FoolFest 2016 presentation on this very topic.

Pro Catch-Up Trades and Upcoming Expirations: April 10, 2017

Published Apr 10, 2017 at 2:16PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.9%.
- **Visa** (NYSE: V): Buy 3%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.2% (see our recommendation).

- **FactSet Research** (NYSE: FDS): Buy 1.9%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1% (see our recommendation).
- **Verisk** (NASDAQ: VRSK): Buy 2%.

Shorts:

- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% in some form, via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **American Tower** (NYSE: AMT): Set up a diagonal call by simultaneously buying ("buy to open") January 2019 $90 calls and selling ("sell to open") October 2017 $120 calls for a net debit of about $28.30 per diagonal call (this price may change). Or, sell to open October $125 calls for a debit of about $30.90, but with more upside. Invest 0.6% of your *Pro* funds in this diagonal call position (that is, one diagonal call for every $475,000 or so you manage).

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $83,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $115 puts, and buy to open *half* as many January 2018 $125 puts. Lately, this combined trade can be done for a small **credit**, lately about $0.10 per spread.

This month's expirations (April 21):

- None.

Roll Your Put Ratio Spread on QQQ

Published Apr 4, 2017 at 3:09PM

Is this for you? This is for those who set up a January 2018 put ratio spread on the **PowerShares QQQ Trust** (NASDAQ: QQQ) ETF, with strike prices of approximately $100 and $114, when the market was much lower -- at the end of last year or in early 2017. We're rolling those strike prices higher to make the hedge more relevant again.

If you're new to this position, you may set up today's new put ratio spread, but please see our previous alert for more details on how this strategy works. It exposes you to the downside risk of the market index starting at the strike price of your written put, so you need to be aware of that and allocate accordingly, agreeing to $11,500 in downside market exposure for every put ratio spread you set up. (To clarify, the puts you're selling are $115, so that's $11,500 in downside exposure to the market. The puts you're buying are $125, so that's $12,500 in a hedge.)

Remember, you don't need to hedge to succeed in the long run. It's optional to follow along with this position.

How You Participate

- **If You're Already In the Position: Closing Action**
  Simultaneously:
  - Buy to close all of your January 2018 $100 puts
  - Sell to close all of your January 2018 $114 puts
  - (If you adjusted your trade before placing it, close puts that are at strike prices very close to these. If your strikes are much higher, such that they're close enough in your opinion to today's ETF price already, you can sit tight and keep that hedge.)
- **If You're New to the Position: Opening Action**
  With a Spread/Ratio Order:
  - Sell to open **two** January 2018 $115 puts
  - Buy to open **one** January 2018 $125 put
- **Allocation:** Roll all of your existing put ratio spreads up. If you're new to the position, set up one put ratio spread for every $12,500-sized hedge you want. *Pro* is hedging about 15% of our total portfolio value. To follow that allocation, set up one 2:1 put ratio spread for approximately every $83,300 you manage ($83,300 x 15% = $12,495; that $12,495 is used because we're buying $125 puts, which represent $12,500 in value each). *Pro* sold 70 puts and bought 35.
- **Price Guidance (11 a.m. ET):**
  - Lately, you can close the $100/$114 spread for about a $0.40 credit (you've made money on it).
  - Lately, set up the new $115/$125 spread for about a $0.20-$0.25 credit.
  - These prices will change as the ETF moves. Aim for close to no cost at the worst.
  - QQQ price: $132.25.
    - **Potential adjustment:** If QQQ moves much in price before you set up your new position, you'll likely want to move both of your strike prices up or down accordingly -- as much as QQQ has moved -- while aiming to pay very little debit or get a small credit.

What We're Thinking

In December, we recommended a $100/$114 put ratio spread as a market hedge when the PowerShares QQQ ETF traded at $120.50. That trade paid a small credit, and today the credit is worth more when you go to close the position. We have to like the fact that members have made some money on this hedge, despite the ETF leaping 9.7% higher. Yes, the Nasdaq has rallied since December, meaning that our protective puts in the original spread -- which strike at $114 -- are 13.8% below the recent index price of $132.25. This market index would need to fall nearly 14% for our hedge to start to come into play. That's not much of a hedge any longer.

To make the position more relevant again, we recommend closing both legs of that previous hedge, collecting a credit for doing so (about $0.40 per spread lately), and then setting up a new January 2018 $115/$125 hedge. You'll "sell to open" *two* $115 puts for every *one* $125 put you buy, setting up one 2:1 put ratio spread for every $83,300 in portfolio value you have (that is, if you are closely following the *Pro* port, importantly including our cash allocation, and want to continue following us with this 15% hedge and potential index purchase obligation).

After we've moved our strike prices up, this new hedge will start to come into play when the ETF falls 5.5% from its current price, which matches the intentions of our original position last December. We want our hedges to start to kick in at that level of decline or earlier.

This new hedge reaches its maximum profit at $115, or 13% lower than the ETF's current price. And it offers us partial profits down to $105, or 20.6% below the current market level. Below that price, this hedge becomes an obligation that's in the red.

So, this hedge pays us a credit to set up and will reward us that credit even if the market rises, but it does come with an obligation if the market falls sharply. There's no free lunch! By rolling up, we are moving our risk up, too, agreeing to buy into the ETF at a net $105. (As shared previously, we'd likely buy calls rather than the ETF, and preserve cash that way.)

In summary, since the Nasdaq has moved up so much in just one quarter, our hedge strike prices can be moved up, too. It's nice that the hedge made some money, and the new one pays a credit, too. But always remember that it exposes us to downside risk on a large market decline.

Pro already has a $114/$125 put ratio spread set up -- we weren't able to correctly set up the original one in time, and then we adjusted as pricing dictated. As you roll up to $115/$125, you'll be much more aligned with us, and you'll have a hedge that's closer to the current market price again. If you'd rather write $114 puts as we did (instead of $115), you can do so for a small net debit of about $0.10 per put ratio spread as you buy the $125 puts. This alert suggests $115 to offer you a credit.

As always, you can adjust both strikes by a few dollars either way if you like, to aim for the debit or credit you want at the strike prices you want. Finally, if you don't want to roll up at all, you don't need to. Keeping your original hedge at $100/$114 still gives you protection in a meltdown that drops beyond about 14%, and it doesn't commit you to buying into the ETF until it reaches a net price more than 30% below today's market price. That's some price cushion.

Alternative Trades

- **If you're hedging in an IRA, can't write naked puts, or are managing less than $83,300:**
    - For a small cost, you can set up a **bear put spread** instead, a strategy with capped risk that most IRAs allow. Use a spread order to "buy to open" January 2018 $125 puts and "sell to open" *an equal number* of January 2018 $115 puts (or use a higher strike if you want to pay less for the spread). Recently, this will cost you about $2 ($200) per spread, and that is your maximum risk. Buy as many spreads as you care to risk $200 each on. This strategy would be worth up to $10 ($1,000) per spread on a decline to $115 or any lower price, but you should **be prepared to lose your whole $200 per spread** if QQQ doesn't decline enough by expiration. This spread is out-of-the-money, and only makes you money if QQQ is below $123 at expiration (it's at $132.25 now), so you have to assume it will expire worthless. It's risk insurance.
    - For those who set up a bear put spread last time, you can close both legs if you like for what it will pay you today, which is likely about $1 or a bit more. You'll likely have lost more than half what you originally paid for the spread, but that actually isn't bad -- or surprising -- for an insurance policy that protected you as the market actually rose nearly 10%, rather than falling.
- **To lower your market exposure while following our full official trade (and make the position possible in some IRAs):**
    - Set up the official put ratio spread as recommended, but also "buy to open" additional QQQ puts (with the same day of expiration) at a strike price *well below* $115. Buy *half as many* as the number of $115 puts you wrote. When you do so, all of your $115 puts will then be "covered" -- half by your long $125 puts, and half by the other long puts you choose to buy at a much lower strike. Choose how much you want to pay to protect your short put exposure. To us, the $105 strike or lower looks good, recently costing $1.20 or less, and buying the $105 puts completely caps your risk on the whole position (since $105 is where your risk of loss started). This makes the total cost of your hedge about a $1 debit per spread.
    - If you set up this IRA-friendly hedge trade last time and want to roll higher, you can close all three legs and roll them all up. *Or*, you can keep the lowest-strike *owned* puts you bought last time as the puts that will cap your risk this time, too -- albeit with a larger gap between your written puts and these owned puts, because you're rolling up the entire put ratio spread, just not this protective put.

Pro Can Help

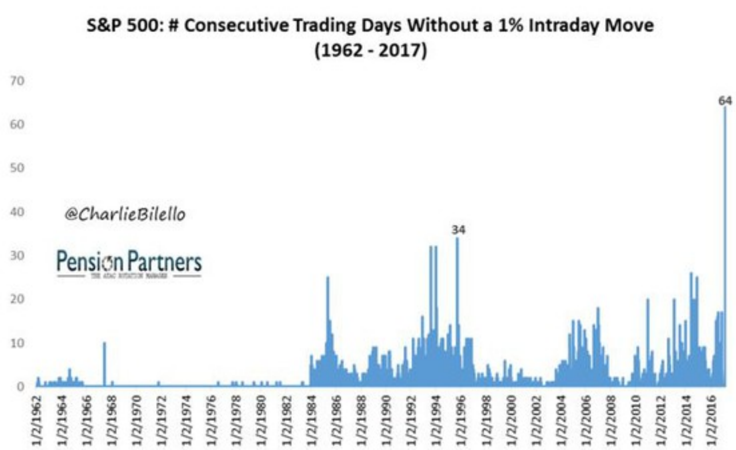
- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about QQQ?** There's no queue on our discussion board.

The Least Volatile Period in Market History

Published Apr 3, 2017 at 3:30PM

Dear *Pro* Fools,

You may not have noticed, in the same way we sometimes don't notice silence -- but we recently experienced the least volatile market period in history. Before the S&P 500's 1.2% decline on March 21, the index had gone 64 consecutive trading days without a 1% intraday move. According to Charlie Bilello at Pension Partners, that 64-day streak is far and away the longest in market history, trouncing the previous record of 34 consecutive days set in 1995:



And before closing at 12.96 on March 24, the CBOE Volatility Index (VIX) had closed below 12 for 11 consecutive weeks, surpassing late 2006 to reach the most persistent period of low volatility in its history:

Volatility Index (VIX): Longest Streak of Weekly Closes Below 12 (1990 - 2017)		
Week Starting	Week Ending	# Weeks
1/3/2017	3/24/2017	11
9/25/2006	11/27/2006	10
12/13/1993	1/24/1994	7
11/7/2005	12/19/2005	7
1/8/2007	2/20/2007	7
6/21/1993	7/26/1993	6
11/20/1995	12/18/1995	5
1/31/2005	2/28/2005	5
6/27/2005	7/25/2005	5
8/16/1993	9/7/1993	4
6/12/1995	7/3/1995	4
7/25/2016	8/15/2016	4
Pension Partners		@CharlieBilello

In my experience, whenever the market endures a long period of positive performance or low volatility, a common response from spectators is that "a crash is coming soon" or "this is the calm before the storm." But is that truly the case? Are periods of low volatility associated with market peaks?

An analysis of the data shows that in fact, following long streaks of low volatility in the past, the S&P 500 has been higher one year later in every single instance. None of the prior examples of low volatility have occurred days or weeks before a major market peak:

S&P 500: Longest Period Without a 1% Intraday Move (1962 - 2017)									
				Forward S&P 500 Total Returns					
Rank	Streak Start	Streak End	# Trading Days	1-Month	3-Month	6-Month	1-Year	3-Year	5-Year
1	12/15/2016	3/20/2017	64						
2	8/3/1995	9/20/1995	34	-0.1%	4.9%	12.0%	19.0%	81.3%	178.5%
3	7/9/1993	8/23/1993	32	0.8%	2.3%	4.1%	4.7%	57.0%	167.5%
4	11/23/1993	1/7/1994	32	0.8%	-4.2%	-3.3%	0.9%	73.3%	185.0%
5	5/16/2014	6/23/2014	26	0.9%	2.1%	6.6%	10.4%		
6	4/4/1985	5/9/1985	25	3.5%	5.0%	8.2%	35.0%	60.8%	116.5%
7	10/31/2014	12/5/2014	25	-1.3%	-1.0%	1.3%	2.9%		
8	12/3/2010	12/31/2010	20	4.1%	6.4%	7.6%	2.5%	55.5%	80.1%
9	1/3/2013	1/31/2013	20	3.2%	7.2%	15.2%	22.3%	33.3%	
10	8/18/2014	9/15/2014	20	-6.0%	1.4%	5.6%	0.5%		
11	1/11/1994	2/3/1994	18	-2.5%	-6.2%	-3.5%	1.2%	74.2%	185.8%
12	12/5/2006	12/29/2006	18	2.2%	1.9%	8.5%	5.6%	-15.7%	-5.4%
13	8/3/2016	8/25/2016	17	0.1%	2.0%	10.3%			
14	11/11/2016	12/6/2016	17	2.8%	8.7%				
15	11/25/1992	12/17/1992	16	0.2%	4.1%	3.3%	9.0%	54.4%	152.5%
16	7/11/2016	8/1/2016	16	0.3%	-1.5%	6.1%			
17	6/24/1985	7/15/1985	15	-2.5%	-3.4%	9.5%	30.6%	57.5%	117.4%
18	12/10/2004	12/31/2004	15	-1.7%	-2.5%	-0.5%	5.4%	30.6%	2.0%
19	6/2/2005	6/22/2005	15	1.6%	0.1%	4.7%	5.1%	18.7%	-0.3%
20	12/19/2013	1/10/2014	15	-0.5%	-0.9%	8.4%	13.2%	30.4%	
Pension Partners									@CharlieBilello

Over the three to five years following streaks of low volatility, the market has been meaningfully higher almost all of the time, except during periods immediately preceding the 2008-2009 financial crisis (in mid-2005 and late 2006). This explanation for this phenomenon is likely simple: because the market has historically tended to rise in value over time.

Nonetheless, this recent period of low volatility is highly unusual, and it is reasonable to expect higher volatility going forward. Since 1928, the average year has seen 29 trading days (out of an average of about 252) with a market decline of more than 1% and 31 days with an advance of more than 1%. That adds up to a 1% intraday move about once every 4 trading days:

S&P 500: Number of 1% Up and Down Days (1928 - 2017)

Year	1% Down Days	1% Up Days	Year	1% Down Days	1% Up Days	Year	1% Down Days	1% Up Days
1928	27	40	1958	5	13	1988	31	37
1929	48	66	1959	14	8	1989	14	26
1930	70	58	1960	17	14	1990	42	33
1931	97	69	1961	3	11	1991	25	34
1932	95	86	1962	34	24	1992	11	17
1933	75	87	1963	3	3	1993	7	10
1934	59	61	1964	3	0	1994	15	12
1935	40	51	1965	7	1	1995	4	9
1936	29	59	1966	25	16	1996	17	21
1937	62	55	1967	9	10	1997	31	50
1938	67	74	1968	9	10	1998	32	47
1939	52	52	1969	18	7	1999	40	52
1940	35	36	1970	33	30	2000	54	48
1941	29	25	1971	14	18	2001	54	51
1942	26	33	1972	6	4	2002	72	53
1943	17	25	1973	43	35	2003	37	45
1944	8	8	1974	67	47	2004	20	21
1945	21	25	1975	35	45	2005	17	13
1946	37	39	1976	14	25	2006	13	16
1947	30	30	1977	12	5	2007	34	31
1948	26	28	1978	24	19	2008	75	59
1949	15	17	1979	13	17	2009	55	62
1950	22	33	1980	37	43	2010	37	39
1951	17	19	1981	30	24	2011	48	48
1952	8	5	1982	38	44	2012	21	29
1953	16	8	1983	26	29	2013	17	21
1954	5	10	1984	16	25	2014	19	19
1955	19	23	1985	7	22	2015	31	41
1956	21	23	1986	25	35	2016	22	26
1957	25	17	1987	42	53	2017	1	1

Pension Partners @CharlieBilello

The important takeaway from this table is that 1% moves in stocks are very normal. If you are averse to volatility, investing in stocks is likely to make you feel uncomfortable. The average year (since 1928) has included between three to four declines of greater than 5%. Since March 2009, we have seen 21 such declines, the last occurring just before last year's election:

S&P 500 Corrections of >5% since March 2009 Low

Correction Period	S&P High	S&P Low	% Decline	"Stocks Fall On..."
2016: Aug 15 - Nov 4	2194	2084	-5.0%	Election Fears/Concerns/Jitters
2016: Jun 8 - Jun 27	2121	1992	-6.1%	Brexit Concerns, Pound Crashing, European Banks
2015/16: Nov 3 - Feb 11	2116	1810	-14.5%	China, EM Currencies, Falling Oil, Middle East, North Korea Nukes
2015: May 20 - Aug 24	2135	1867	-12.5%	Greece Default Concerns, China Stock Crash, EM Currency Turmoil
2014/15: Dec 29 - Feb 2	2094	1981	-5.4%	Falling Oil, Strong Dollar, Weak Earnings
2014: Dec 5 - Dec 16	2079	1973	-5.1%	Falling Oil, Strong Dollar
2014: Sep 19 - Oct 15	2019	1821	-9.8%	Ebola, Global Growth Fears, Falling Oil
2014: Jan 15 - Feb 5	1851	1738	-6.1%	Fed Taper, European Deflation Fears, EM Currency Turmoil
2013: May 22 - Jun 24	1687	1560	-7.5%	Fed Taper Fears
2012: Sep 14 - Nov 16	1475	1343	-8.9%	Fiscal Cliff Concerns, Obama's Re-Election
2012: Apr 2 - Jun 4	1422	1267	-10.9%	Europe's Debt Crisis
2011: Oct 27 - Nov 25	1293	1159	-10.4%	Europe's Debt Crisis
2011: May 2 - Oct 4	1371	1075	-21.6%	Europe's Debt Crisis, Double-Dip Recession Fears, US Debt Downgrade
2011: Feb 18 - Mar 16	1344	1249	-7.1%	Libyan Civil War, Japan Earthquake/Nuclear Disaster
2010: Aug 9 - 27	1129	1040	-7.9%	Global Growth Concerns
2010: Apr 26 - Jul 1	1220	1011	-17.1%	Europe's Debt Crisis, Flash Crash, Growth Concerns
2010: Jan 19 - Feb 5	1150	1045	-9.2%	China's Lending Curbs, Obama Bank Regulation Plan
2009: Oct 21 - Nov 2	1101	1029	-6.5%	Worries About The Recovery
2009: Sep 23 - Oct 2	1080	1020	-5.6%	Worries About The Recovery
2009: Jun 11 - Jul 7	956	869	-9.1%	World Bank Neg Growth Forecast; Fears Market Is Ahead Of Recovery
2009: May 8 - 15	930	879	-5.5%	Worries That Market Has Gotten Ahead Of Itself
Average			-9.1%	

Pension Partners @CharlieBilello

The *Pro* Bottom Line

If it feels like the market has been quiet lately, that's because it has. We just endured the least volatile period (by far) in market history. Historically, periods of low volatility have preceded periods of rising market prices most of the time. However, historical data only describes historical periods, and we cannot expect today's market environment to always fit historical patterns.

Will volatility increase in the future? The answer is most likely yes, as volatility is mean-reverting and market swings of 1% or more are very common. The relatively higher volatility of stocks (compared with bonds or other asset classes) is one of the reasons why stocks generate higher returns over time, as the risk/return principle implies that higher risk is correlated with higher returns.

After enduring such a long period of low volatility, it is easy to allow psychological biases (such as the recency bias) to trick you into believing that low volatility is the norm. The next period of significant market volatility may feel especially jarring when compared with the current calm. However, keep in mind that volatility is very normal, and significant swings in stock prices *will* happen -- it's just a question of when. If you mentally prepare yourself in advance for such volatility, it will take you a long way toward making proper decisions when the time comes.

Fool on!

-- Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Upcoming Expirations: April 3, 2017

Published Apr 3, 2017 at 2:09PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.9%.
- **Visa** (NYSE: V): Buy 3%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3.2% (see our recommendation).
- **FactSet Research** (NYSE: FDS): Buy 1.9%.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1% (see our recommendation).
- **Verisk** (NASDAQ: VRSK): Buy 2%.

Shorts:

- **CurrencyShares EuroTrust** (NYSEMKT: FXE): Sell short 1.6%.
- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% in some form, via our trade alert.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5%.

Pro options:

- **Verisign** (NASDAQ: VRSN): If you have yet to set up a covered strangle or buy shares, you can consider selling the June 2017 $85 puts for $2.15. Write one put for every 100 shares you could buy at $8,500. We have a 3.1% look-through allocation.

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $78,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $114 puts, and buy to open *half* as many January 2018 $125 puts. Lately, this combined trade can be done for a small debit (perhaps $0.05 per spread).

This month's expirations (April 21):

- None.

Pro Guidance Changes and Completed Trades: April 3, 2017

Published Apr 3, 2017 at 2:05PM

Pro Guidance Changes (from the past two weeks)

- **American Tower** (NYSE: AMT): Fair-value estimate increases to $130. It remains a Buy First.
- **AmTrust Financial Services** (NASDAQ: AFSI): Stock remains on Hold awaiting financial results, and we suggested a protective collar.
- **Domino's Pizza** (NYSE: DPZ): The stock moves back to a short position, at an allocation that offsets about two-thirds of your **Papa John's** (NASDAQ: PZZA) long.
- **FactSet Research** (NYSE: FDS): The stock moves to Buy from Buy First; headwinds are keeping sales growth in check, but we still like the long term. It's a buy at a 1.9% allocation.
- **Gilead Sciences** (NASDAQ: GILD): Fair-value estimate declines to $80. It remains a Hold.
- **Starbucks** (NASDAQ: SBUX): Fair-value estimate increases to $52. It remains a Buy.

Pro Completed Trades (from the past two weeks)

- **American Tower**: We rolled our April $110 calls up and out to October $120 calls for a net debit of $4.72 per contract, per our alert. (Please note, we initially rolled to $115 calls -- by mistake -- but then simply rolled those up to $120, as intended.)
- **Gilead Sciences**: We sold to open June 2017 $70 calls to cover our entire position, per our alert.
- **Visa** (NYSE: V): We increased our allocation by 0.5%, per our alert, buying 158 more shares at $89.17.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Set Up a Protective Collar on AmTrust Financial Services

Published Mar 31, 2017 at 12:31PM

Is this for you? Any *Pro* members who own at least 100 shares of this stock, and who want to protect against downside below $15 per share, should consider this position.

How You Participate

- **Action:** Set up a protective collar on **AmTrust Financial Services** (NASDAQ: AFSI)
- **Trade:** Simultaneously ...
  - **Sell to open** June 2017 $22.50 calls
  - **Buy to open** June 2017 $15 puts
- **Allocation:** Set up one protective collar (one of each option) for every 100 shares you want to protect. *(Pro* will collar 5,100 of its 5,134 shares.)
- **Price Guidance:** Use a **limit order** and initially aim to set this up for a **net debit of $0.15** per collar (if that doesn't take after a while, try $0.20; but it should take at today's prices). Prices will fluctuate as the stock moves, with the trade getting less expensive to execute if AFSI rises, and more expensive if AFSI declines. If prices

change much, it's a judgement call on your part depending on much you want to spend; or, you can consider using different strikes.
- **Recent Prices (12:30 p.m. ET):**
  - June $22.50 calls (bid/ask): $0.45/$0.60 ($0.50 likely to be filled on a sell to open)
  - June $15 puts (bid/ask): $0.50/$0.80 ($0.65 may be filled on a buy to open)
  - Net debit: $0.15 per collar (use a **limit order**, net debit)
  - AFSI: $18.60
- **Scorecard Status:** Hold (and protect); 3.4% allocation. No fair value estimate.

What We're Thinking

AmTrust has had a tough year. After hiring KPMG as its auditor in 2016, the company divulged this February that the accounting firm disagrees with some methods of revenue recognition it's used in the past, primarily in its service and fee business; KPMG also identified material weaknesses in AmTrust's internal controls for financial accounting; and AmTrust took a $65 million charge to shore up its reserves. Not a month later, AmTrust announced it would also need to restate financial results for 2014 through the first three quarters of 2016, further delaying its annual 10-K SEC filing. Management advised investors to no longer rely on its previously announced results over this time period. The restated financials will be available as soon as possible, but no deadline was given.

This leaves us in a blind spot. Judging by management's verbal guidance, we don't expect *significant* changes to book value, loss ratios, or other key factors, but we won't know for certain until the results are released. This is why we removed our fair value estimate after this news broke. If the restated financials are remarkably weaker than previously reported, the stock would likely fall accordingly, and our most recent fair value estimate of $24 may need to decline in kind. We simply don't know what the results will be. So rather than wait without a safety net, we're setting up an inexpensive protective collar to limit our downside risk.

Selling to open $22.50 calls allows us to use the proceeds to pay for a majority (about 77% of the cost) of the $15 puts that we'll buy to open for protection. We cap our upside at $22.50, but we cap our downside risk at $15 — really a net $14.85 after costs. That's 20.1% below the recent share price. So, once this collar is set up, the maximum damage that AmTrust can inflict to our portfolio (other than the 34 shares that won't be protected) is another 20.1% decline, which equates to about 0.7% of our current portfolio value — not nothing, but easily survived.

And, for a cost of about 0.03% of the portfolio, we protect against a worst-case loss of 3.4% of the portfolio should AmTrust go to zero. Instead, we would be able to sell our shares at $15. Meanwhile, we still have upside on our shares to $22.50 ($22.35 or so after costs), or about 20.1% higher. If AmTrust's restated results encourage us enough, we'll remove the collar and uncap our upside again for the long haul. We might miss a few dollars per share in gains *if* the stock runs higher than $22.50 quickly, but that would be a small opportunity cost in exchange for protection against any shocking downside.

In sum, not knowing what the restated results will show, we're willing to pay a little money up front for insurance against a worst-case outcome. We'll set up one protective collar for every 100-share lot we own, protecting our entire stake but for 34 shares. We can set up a June expiration for a reasonable cost, and presumably set up another one if the restated results have not been announced by then, although we certainly hope they will be.

Meanwhile, we believe that management is doing the right thing, being transparent about it, and wants to be positioned for long-term success while aiming for best-in-class financials and financial controls. We want nothing less if we're going to remain owners.

Alternative Trades

- **Don't own 100 shares and really want protection?** If your allocation is less than 3.4%, and buying more shares will keep you at that allocation or lower, buy up to a 100-share position and then set up the protective collar. If you can't own as many as 100 shares and still have only a 3.4% allocation, the stock remains a Hold, and you can wait to see the restated results with us; or, you could just "buy to open" one June $15 or June $12.50 put for protection — even though they're expensive when financed all on your own (and even though you'll have more insurance than you need).
- **Not using options?** You're in a tougher spot, with few ways to protect yourself. So just make sure that you're comfortable with the size of your position. If not, you have the option to reduce it.
- **Have written puts open?** You can't set up a collar on written puts since you don't own the shares yet, and if the stock rises, you'll be short calls on shares you don't own. Instead, you can turn your written puts into a bull put spread. Simply use some of the proceeds the puts paid you to now buy to open the June 2017 $15 puts with us, lately for $0.65 each. Buy one put for every put you've written, to cap your downside on those short puts. If $15 puts cost too much for your taste, buy to open June $12.50 puts instead, lately about $0.35 each.

Pro Can Help

Questions on this short-term protective position? Please ask on the AmTrust board.

Buy (More) Visa

Published Mar 30, 2017 at 3:30PM

Is this for you? This recommendation is for all *Pro* members.

How You Participate

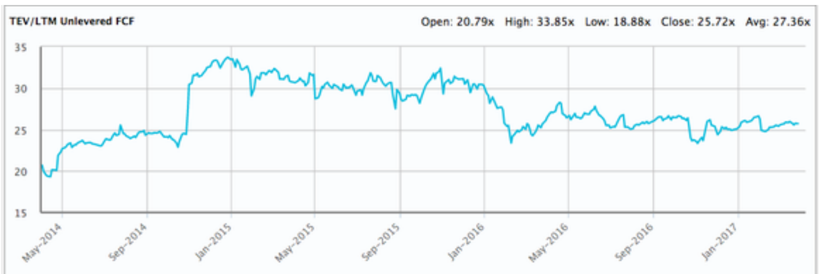
- **Action:** Buy 0.5% more in **Visa** (NYSE: V).
- **Allocation:** We're growing our stake to 3% (from a current 2.5%). *Pro* is adding about 158 shares, or 0.5%.
- **Price Guidance:** Use a limit order at current prices; later, aim to buy below $90. We'll buy in the next one to 30 days.
- **Recent Price:** $89.05
- **Guidance:** Buy First
- **Fair-Value Estimate:** $90

What We're Thinking

In April 2015, we offered our case for investing in Visa even though we already owned a sizable slab of **Mastercard** (NYSE: MA). Visa's worldwide debit and credit card leadership, its strong returns on capital, and its growing markets and profits — plus our belief that it would eventually buy out Visa Europe (at the time, a separate company) — made us eager to "partner" with the company by purchasing shares. In November 2015, Visa indeed exercised its option to buy Visa Europe, and now the companies have begun to report combined results. In the first quarter of fiscal 2017 (ended December), Visa's net revenue grew 25%, and corresponding earnings per share were up 23% on accelerating growth in most regions of the world. Yet operating improvements at Visa Europe are just beginning, and the prospect for long-term growth is strong. Europeans still use credit cards much less frequently than customers in North America. Looking ahead, Visa expects to add 2% to 3% in annual earnings-per-share growth as it integrates and improves Visa Europe.

Meanwhile, prospects are also blooming in India, where the government is pushing society to move to digital forms of payment. Last quarter, Visa enjoyed a nearly 75% increase in payment volume in India, and its processed transactions more than doubled. Visa did not collect processing fees in India through Dec. 31, promising the government it would waive them to spur growth. That revenue started in January. Like India, China is another "green field" opportunity. There, Visa hasn't even started doing business, but it's ready to build its processing infrastructure as soon as China's government provides clarity on its timeline for granting licenses. Visa aims to be ready to start business as soon as it's granted a license. The company is also working with **PayPal** (NASDAQ: PYPL), **Alphabet** (NASDAQ: GOOG) and other many companies to remain integral to online payments whatever the platform.

Over the last five years of a relatively tepid worldwide recovery, Visa has grown revenue 11% annualized and diluted earnings per share by 12.8% a year. EPS growth in the mid-teens (15% and higher) is now estimated each year through at least 2021 — a heady rate of growth that few large companies can deliver. If Visa does it, we see upside of about 50% in the stock from today to the end of 2020. That would suggest shares (assuming a gain to about $133.50 by 2020) would trade at about 24 times estimated earnings that year, maintaining the premium valuation the company has long enjoyed. From a free-cash-flow perspective, shares have averaged a 27.3 multiple the last three years and currently sit a bit below that, at 25.7 times.



Visa trades at a price-to-free-cash-flow of around 27 times. Source S&P Capital IQ.

How it Fits Into *Pro*

We already own a 4.8% stake in Mastercard, which is similarly positioned to grow profits as digital payments proliferate. Bumping our Visa stake from 2.5% to 3% with this alert, we'll own a 7.8% combined stake in these two leaders, basically making "it" our largest position (even if "it" is two companies). Little is likely to stop the long-term volume growth apparent in the industry, but we need to closely watch regulatory risks, which could affect both businesses' bottom lines.

This week, the U.S. Supreme Court declined to "stay" a $7.25 billion antitrust settlement against Visa and Mastercard, effectively clearing the way for collected merchants to seek greater damages. In a legal battle stretching 10 years so far, merchants may also argue that future fees should be capped or avoided. Visa and Mastercard have strong counterarguments given the money they invest to keep networks secure. They do, after all, provide a trusted service that helps improve commerce, and that has real value. Greater regulation by the U.S. government itself seems unlikely with the current pro-business administration. So, lawsuits filed by merchants and regulation overseas likely remain our biggest risks near-term. Any rulings that could clip long-term profit growth would hit the stocks, but we find that prospect unlikely enough for now to add another 0.5% to our Visa stake.

We have about a 33% gain (35% including dividends) on our original Visa position in less than two years. Growing our allocation by another 20% — from 2.5% to 3% — is not a monumental move, but it shows our confidence in the long-term growth trajectory for the industry leader, and the opportunity offered by its shares. Ideally, core positions in a *Pro* portfolio are each 3% or larger, and this gets us there with Visa. The only thing that has stopped us in the past is our ownership in Mastercard, but as growth rates for both companies appear ready to *accelerate*, and rumblings of new regulatory hurdles are quiet, we're comfortable with this small increase in our exposure.

Pro Can Help

Questions on this new buy? Charge on over to our Visa board. And forgive us the bad pun.

Sticking With Starbucks

Published Mar 27, 2017 at 3:57PM

Fellow Fools,

In our most recent earnings coverage for **Starbucks** (NASDAQ: SBUX), we noted that we were holding off on updating our fair-value estimate, taking some additional time to analyze the future prospects for the business. Unlike in the page-turning thrillers I write under an alias, I'm going to spoil the ending up front: Starbucks will remain in our portfolio, and we're setting our fair-value estimate at $52. However, our opinions on the company have shifted quite a bit, so grab yourself a latte and read on for our our updated take.

Fair or Overpriced?

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." This famous Warren Buffett quote pithily summarizes our thinking behind our initial investment in Starbucks in 2012. We were paying almost 75% more for a dollar of Starbucks earnings compared with the S&P 500, but in exchange, we were acquiring shares of a best-of-breed company. However, there's admittedly a lot of uncertainty about what exactly makes for a fair price, which is why our biggest concern over the past few years has been the stock's valuation. Premium valuations don't always spell disaster -- just look at how Facebook, Google, and even Starbucks have done over the years -- but they don't leave much room for error.

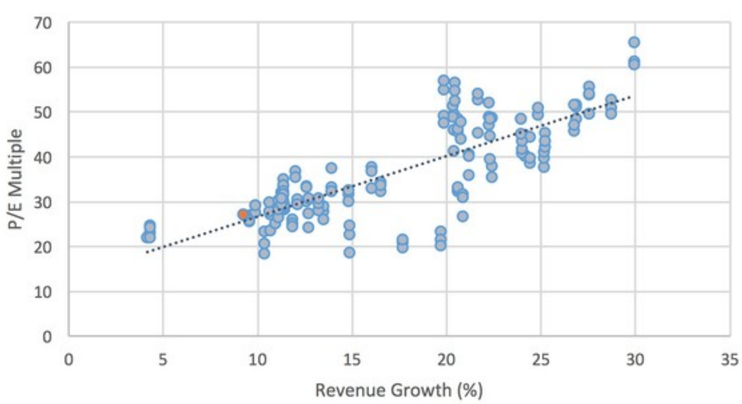
Hindsight is always 20/20, but it looks as though our concerns have proven to be correct. Starbucks' stock has struggled since its all-time high in October 2015, even as the market continued to move higher. This means that Starbucks' premium over the S&P 500 is actually at its lowest since the aftermath of the global financial crisis.

P/E Ratio for Starbucks vs. S&P 500

Sources: S&P Global Market Intelligence, author's calculations. Zero denotes SBUX and S&P 500 multiples are equivalent. A positive number signifies that SBUX has a higher multiple, a negative number signifies the multiple on the S&P 500 is higher. A value of 1 equates to SBUX having a multiple that is double the S&P 500.

Why has this happened? We all know the market loves a good growth story, and to oversimplify, revenue growth has been one of the top predictors of how much investors have been willing to pay for the company's shares since 2000. So when viewed in combination with the recent deceleration in Starbucks' comparable-store sales (comps) and overall growth rate, the decline in Starbucks' premium isn't as surprising.

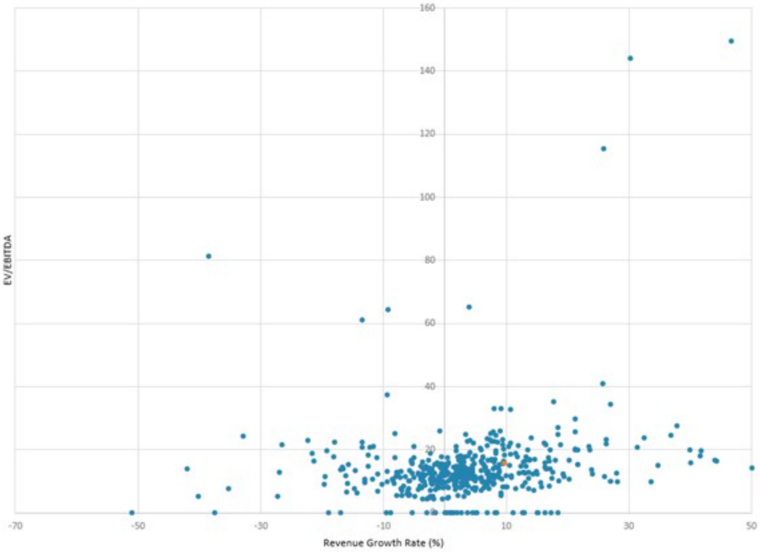
Monthly P/E Multiple and Revenue Growth Rate for Starbucks
(note: orange dot is current)

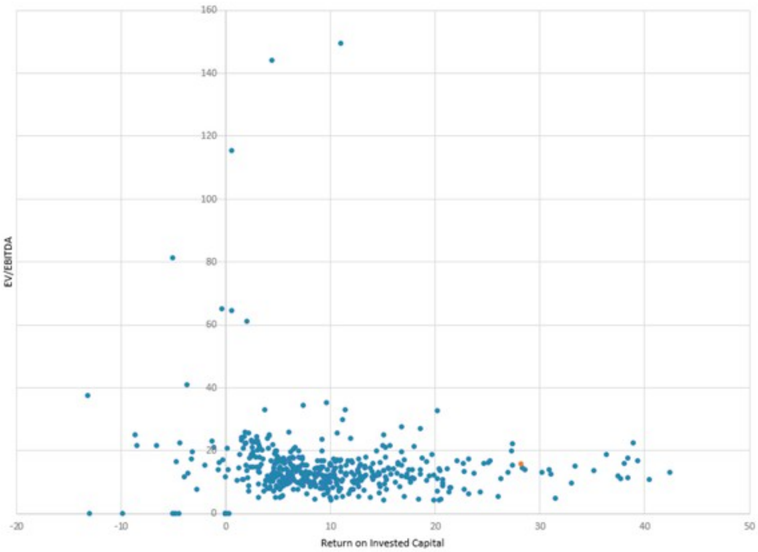


Source: S&P Global Market Intelligence, author's calculations. Orange denotes current earning multiple and growth rate. Outliers from 2009-2010 (Great Financial Crisis) and 2014 (Kraft settlement) excluded.

At 28 times earnings and 14 times EBITDA, some might say Starbucks is still expensive, but the company appears to be fairly priced based on recent revenue growth and returns on invested capital when compared to the other constituents of the S&P 500.

Starbucks (Orange Dots) vs. S&P 500 Constituents





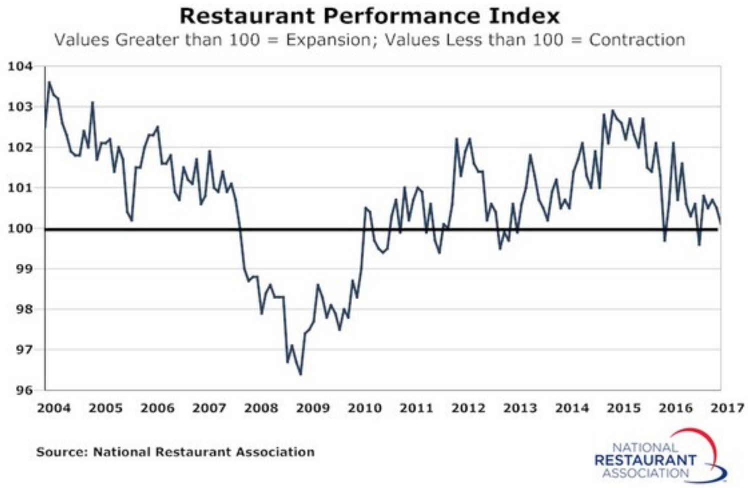
Sources: S&P Global Market Intelligence, author's calculations

That being said, these charts have a big flaw: They're using historical numbers, while market sentiment tends to be based on future expectations. By using a discounted cash flow model and solving backwards to arrive at today's price (instead of making forecasts and seeing what fair value they project), we can get a feel for what investors expect from Starbucks. Roughly speaking, it appears as though the market believes management's claim that they can expand revenue by 10% and earnings per share by 15% to 20% annually through 2021. If this does happen, we'll likely be rewarded with a total return that at least keeps pace with our North Star, so the question we need to ask is whether we agree with management and the market. In order to arrive at an educated guess, we need to examine three key issues.

1. Starbucks' Brand

Pricing power and macroeconomic sensitivity. In lists of the world's "most valuable brands," Starbucks frequently places near the top, but as a self-professed investing curmudgeon, I've yet to adopt the common narrative that this has translated into strong pricing power. I believe Starbucks' success comes from catering to habitual purchases born out of convenience, consistency, and choice, not from its brand (or anything else). Although it might seem trivial, this is an important distinction; it suggests that the company's pricing power in excess of cost inflation is somewhat limited in the long run. It also ties into another point: Starbucks is actually quite reliant upon macro conditions. This may be an uncommon, perhaps unpopular, opinion among Starbucks bulls, but during the UBS Global Consumer & Retail Conference on March 9, management actually acknowledged that this was one of the biggest reasons for the disappointing comps last quarter, noting that "the correlation isn't 1, but it's pretty high." Many restaurant chains have struggled since closing out 2015 on a high note, and Starbucks is no exception.

Source: Company filings, x-axis is in calendar quarters for comparison purposes



And a recent UBS Evidence Lab survey found that affordability was the top reason given for a customer's reduced visits, with 64% of respondents noting that a Starbucks run was getting pricier. This is noteworthy not because it suggests that Starbucks is a bad investment, but because it means results could be lumpier than many have come to expect. The last time Starbucks ran into operational issues (and Howard Schultz had to return as CEO), we also were on the verge of the global financial crisis, so it's hard to tease out specific causes of poor performance. As time passes, our memories tend to become more selective, and I believe the extended favorable macro backdrop since the crisis has made the market complacent, happy to consider Starbucks' results over the past few years without incorporating potential industry or economy struggles.

2. "The Third Place"

Unit economics. Since I began covering Starbucks almost three years ago, I've been continually impressed by its unit economics, given that most of its business comes in the morning hours. Some of the company's earliest public filings contain discussions about store cannibalization, but no longer -- new and existing stores alike are seemingly setting revenue records year-in and year-out. There's a common narrative behind why Starbucks has been able to deliver comps like this over the years: Founder Howard Schultz, it's said, noted the popularity of espresso bars while traveling in Italy and was inspired to create a similar "third place" (not home, not work) in the States.

This may be how Starbucks got its start, but I think much of its success stems from factors that are both inconsistent with this narrative and far less glamorous. However inviting some of its stores may look, Starbucks is a restaurant -- and that means its most valuable customer is the one who takes their order to go. More throughput (more customers) means more orders means more money for Starbucks, and initiatives are in place to increase throughput here in the U.S., its largest market by far. The company is ironing out the kinks with Mobile Order and Pay, as well, which will also provide a throughput boost.

And while drive-thru windows don't quite fit the "third place" idea, Starbucks has also made a strong shift toward adding them to new locations, because they're very profitable. The latest data is hard to come by, but historically, a Starbucks with a drive-thru cost just 15% more to build and was able to generate about 35% more revenue in its first year than a store without one. So it should come as no surprise that 75% of the locations Starbucks opened last year here in the U.S. had a drive-thru window.

Starbucks' comps are a byproduct of two factors -- the number of transactions that take place in store and the size of each order. Throughput and drive-thru locations are about maximizing the first half of that equation, but increasing order size is about understanding human psychology. Some investors like to attribute Starbucks' impressive track record on order size to pricing power, but I believe it's more thanks to the company's mastery of the art of manipulation: getting people to self-select into higher-margin products (think larger sizes) and add-on items (think food, which has grown to 20% of sales). The recent changes to the company's rewards program and the rollout of personalized digital advertising can only help to solidify Starbucks' control over your psyche. (I say this only half in jest ...)

3. There's a Starbucks on Every Corner

Addressable market. When will Starbucks saturate the market? That's the multi-billion-dollar question. Management's current plans are to increase store count by a net 12,000 by 2021, with 3,400 of those stores in the United States. That may sound like a lot for Starbucks' oldest market, where there are already more than 13,000 locations, but I think it's realistic because of what I noted previously: Starbucks is in the business of selling convenience. It's why two locations can successfully exist essentially right next to one another without cannibalization. It is why drive-thrus have been so wildly successful. In fact, I don't think Starbucks could hit its aggressive growth target without drive-thrus; they can thrive in locations where population density makes a traditional store format difficult. And roughly half the stores opened in a given year are licensed, giving the company access to additional desirable locations (airports, colleges, hospitals) to further expand the Starbucks footprint.

And while its international growth targets are aggressive (Starbucks is currently opening up a new store in China every 15 *hours*), I believe they are ultimately achievable. Starbucks is starting from a small base in most of these countries, and our limited sample size seems to suggest that the concept translates well internationally with slight modifications for local customs and tastes. That said, while history doesn't always repeat itself, it does often rhyme. The last time Starbucks became overly focused on rapid expansion, it ran into operational issues that ultimately forced Schultz out of retirement.

The *Pro* Bottom Line

Despite recent underperformance, Starbucks' stock still isn't cheap by any stretch of the imagination. But while it may be a little bumpier than some might like, we still believe Starbucks has a long runway ahead, one that will allow the stock to make a meaningful contribution to the performance of our portfolio and enable us to achieve our investing objectives. My own forecasts see average revenue per store decelerating in the coming years, but I also believe that thanks to the operational leverage Starbucks will continue to gain as it grows, this slowdown won't prevent the company from hitting its EPS target as long as it's also able to meet its store-count numbers. It isn't a certainty, but we believe the odds are in the coffee giant's favor. So for the time being, we're sticking with Starbucks.

Fool on!
-- JP (TMFYossarian)

Note: To prevent this from turning into *War and Peace and Coffee,* I have omitted some relevant topics, including Starbucks' Roastery initiative and its channel development offerings. If you've got any additional questions, please post them to the Starbucks discussion board, and I'll be sure to respond with a minimum 2,000-word reply. [*Editor's note: He's serious*.]

Pro Catch-Up Trades and Upcoming Expirations: March 27, 2017

Published Mar 27, 2017 at 3:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Visa** (NYSE: V): Buy 2.5%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **Verisk** (NASDAQ: VRSK): Buy 2%.

Shorts:

- **CurrencyShares EuroTrust** (NYSEMKT: FXE): Sell short 1.6%.
- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% in some form, via our Friday trade alert.

Pro options:

- **Paycom Software** (NYSE: PAYC): If you don't yet own the stock, it is rated Buy, or you can consider selling to open May 2017 $52.50 puts for about $2, or a 3.8% yield in less than two months. Write one put for every 100 shares you could buy at $5,250. We have a 2.6% allocation.
- **Verisign** (NASDAQ: VRSN): If you have yet to set up a covered strangle or buy shares, you can consider selling the June 2017 $85 puts for $2.45. Write one put for every 100 shares you could buy at $8,500. We have a 3.1% look-through allocation.

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $78,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $114 puts, and buy to open *half* as many January 2018 $125 puts. Lately, this combined trade can be done for about no cost.

Upcoming expirations (April 21):

- **American Tower** (NYSE: AMT): Our $110 diagonal calls are in-the-money. We're rolling them ahead of time.

Pro Guidance Changes and Completed Trades: March 27, 2017

Published Mar 27, 2017 at 3:27PM

Pro Guidance Changes (from the past two weeks)

- **American Tower** (NYSE: AMT): Fair-value estimate increases to $130. It remains a Buy First.
- **AmTrust Financial Services** (NASDAQ: AFSI) moves back to Hold, and our fair-value estimate changes to N/A. With the company's results being restated for the past three years, we need to wait and see the financials before we're able to give guidance again. Our trust in management's drive to do the right thing, and our belief that the new results won't be meaningfully different, lead us to keep our 3.1% position for now.
- **Domino's Pizza** (NYSE: DPZ): The stock moves back to a short position, at an allocation that offsets about two-thirds of your **Papa John's** (NASDAQ: PZZA) long.
- **Facebook** (NASDAQ: FB): Fair-value estimate increases to $145. It remains a Buy First.
- **Gilead Sciences** (NASDAQ: GILD): Fair-value estimate declines to $80. It remains a Hold.
- **FactSet Research** (NYSE: FDS): Fair-value estimate increases to $174. It remains a Buy First.
- **MasterCard** (NYSE: MA): Fair-value estimate increases to $105. It remains a Buy.
- **OpenText** (NASDAQ: OTEX): Fair-value estimate increases to $32. It remains a Buy.
- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $93. It remains a Buy.
- **Starbucks** (NASDAQ: SBUX): Fair-value estimate increases to $52. It remains a Buy.

Pro Completed Trades (from the past two weeks)

- **Direxion Daily Financial Bear 3x** (NYSEMKT: FAZ): We sold short enough new shares to bring our short exposure back to 1.5%.
- **Gilead Sciences** (NASDAQ: GILD): We sold to open June 2017 $70 calls to cover our entire position, per our alert.
- **PowerShares QQQ Trust** (NASDAQ: QQQ): We closed our mistakenly started 2019 put ratio spread, and set up a January 2018 put ratio spread, selling 70 January 2018 $114 puts and buying 35 January 2018 $125 puts for essentially no cost but commissions.
- **TD Ameritrade** (NASDAQ: AMTD): We sold our whole stake, bringing our allocation to 0%.
- **Verisign** (NASDAQ: VRSN): We rolled our March $80/$85 strangle to a June $85/$90 strangle for a $2.17 credit.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Roll Your Diagonal Calls on American Tower

Published Mar 27, 2017 at 1:59PM

Is this for you? This is for all *Pro* members who wrote April 2017 $115 diagonal calls on **American Tower** (NYSE: AMT) as per our alert in November 2016. If, like *Pro*, you wrote $110 calls instead of $115 calls (because the stock price briefly fell before we could make the original trade), please see the Alternative Trades section below. If you have yet to establish a diagonal call position on American Tower, please see the Alternative Trades section below. Remember that all members should already own an unencumbered 3.9% stock allocation to American Tower, so if you have yet to establish your stock allocation, do that first before considering this additional diagonal call recommendation.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
    - "Buy to close" all April 21, 2017, $115 written calls.
    - "Sell to open" the same number of Oct. 20, 2017, $120 calls.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* will roll all five of our calls.
- **Recent Prices** (12 p.m. ET):
        - Stock: $119.91
        - Buy to close April 21, 2017, $115 calls (bid/ask): $4.50/$5.70 (midpoint $5.10)
        - Sell to open October 20, 2017, $120 calls (bid/ask): $5.80/$6.50 (midpoint $6.15)
        - Net credits collected: Approximately $1.05 (this price will change; if AMT stock rises, you'll need to accept a lower credit to get the roll done)
- **Price Guidance: It is critical that you use a limit order**, aiming to pay as little time value as possible to close your short calls, and aiming to roll for as much of a credit as possible (the midpoint of the bid/ask spreads currently implies about a $1 credit for this roll, although that number will change as prices change and as *Pro*'scollective volume impacts the bid/ask spreads). However, realize that with time value on the short calls approaching zero, you should roll these calls soon, or you risk getting your owned *shares* (rather than calls, assuming both securities are owned in the same account) called away. **We want to avoid that scenario!** So, accept lower credits if need be, but still use a limit order. As of today, the bid/ask spread on these calls is wide, but the pricing for the short call implies about $0.20 or so in time value remaining. As we approach expiration, time value will continue to erode, so the longer you wait to make this trade, the more likely it is that your short calls will be assigned.
- **Fair-Value Estimate:** After incorporating last quarter's results into our valuation model, fair value increases to $130 from $125.

What We're Thinking

Back in November, after the U.S. election results led to marketwide volatility, we thought it was a particularly opportune time to re-establish a diagonal call position on American Tower to take advantage of the company's then-depressed stock price. It turns out we were right (so far), with the stock price now back up near $120 per share, from $110 when we issued our original alert. We've also increased our fair-value estimate from $125 to $130 after the company reported solid fourth-quarter 2016 results and recently announced increased guidance and the resumption of its stock repurchase program.

However, thanks to the recent run-up in American Tower's stock price, our April 2017 short calls are well in-the-money, and we will have to roll our options to maintain the position we desire. This rolling transaction adds $5 in additional upside for those with $115 calls (see the Alternative Trades section below if your strike price differs from the one in the official alert), and extends our expiration out to October. As we approach October expiration, we'll reassess the position and determine our next course of action.

Alternative Trades

- **Did you write $110 calls instead of $115 calls like *Pro*?** If you wrote lower-strike calls like *Pro* did, be aware that you will likely have to pay a debit to roll your calls up and out.
    - **If you prefer to be more conservative**, you can roll your April 2017 $110 calls out and up to October 2017 $115 calls rather than $120 calls. If you roll your April $110 calls to $115, the current bid/ask spreads imply a rolling debit (i.e., cost to you) of about $1 or so (this price may change). You will be paying $1 or so to gain $5 in additional upside (a potential 400% return on incremental capital).
    - **If you prefer to be more aggressive (this is the trade *Pro* will take)**, you can roll your April 2017 $110 calls out and up to October $120 calls, matching the position in the official alert above. If you roll your April $110 calls to $120, the current bid/ask spreads imply a rolling debit of about $3.80 or so (this price may change). You will be paying $3.80 or so to gain $10 in additional upside (a potential 63% return on incremental capital). *Pro* will take this approach, not just because we think it's the best one (though we like it fine), but because it has the added benefit of realigning our position to the one in the official alert.
    - **Prefer to not pay a debit to roll?** Consider converting your diagonal call to a bull call spread. You can currently roll your short April 2017 $110 calls out to January 2019 $115, $120, or $125 calls for a credit. The lower the strike, the more you get paid to set up what now becomes a bull call spread, but the lower your potential maximum profit.
- **New to the position and haven't set up a diagonal call yet?** Set up a diagonal call by simultaneously buying ("buy to open") January 2019 $90 calls and selling ("sell to open") October 2017 $120 calls for a net debit of about $26.50 per diagonal call (this price may change), or instead sell to open October $125 calls for about a $28.50 debit or so, but with more upside. Invest 0.6% of your *Pro* funds in this diagonal call position (that is, one diagonal call for every $450,000 or so you manage).

Pro Can Help

- **Questions?** Consume data and ask your questions on the American Tower board.

Write Covered Calls on Gilead Sciences

Published Mar 22, 2017 at 1:48PM

Is this for you? This is for *Pro* members who own at least 100 shares of Gilead Sciences, and who wouldn't mind capping upside in return for near-term income. Those who own less than 100 shares can sell the shares now (since we're accepting that we might lose our shares with this position), or wait to see whether we sell at $70 through our covered calls (if we do, we'll move the stock to Sell on our scorecard).

How You Participate

- **Action:** Sell to open June 2017 $70 calls on **Gilead Sciences** (NASDAQ: GILD).
- **Allocation:** Write ("sell to open") one call for every 100 shares owned. *Pro* will cover all 900 shares we own, representing 2.2% of the portfolio.
- **Price Guidance:** Prices will change as the stock moves, but use a **limit order** to split the option's current bid/ask spread. When we quoted it, that was around $2.05. Later, aim for a 1% yield (option premium/current price of the stock) per month to expiration. Right now, that means about $2 minimum.
- **Guidance:** The stock remains a Hold; newcomers are advised to stay out, given that we're accepting a possible sale of our shares. Our fair-value estimate declines to $80, and assumptions are based on revenue stabilizing, which it may not yet.
- **Prices** (11:30 a.m.):
    - Gilead: $67.80
    - June 2017 calls (bid/ask): $2.01/$2.09
    - $2.05 pays 3% ($2.05/$67.80) in 86 days. Don't accept much less.

What We're Thinking

Only a few things here are known for certain: Gilead Sciences generates strong free cash flow and trades at inexpensive valuation multiples, well below market averages. It yields more than 3% in dividends, and that yield should be safe. Earnings per share are currently in decline, and it isn't known when Gilead will be able to expand them again, barring a large and successful surprise acquisition. The core HIV business, a majority of revenue, is steady. The Hepatitis C (HCV) franchise is falling sharply in value as fewer patients begin the treatment and drug prices drop among competition. HCV revenue could potentially stabilize by next year, but nobody truly knows.

There is a lot more we don't know. Hepatitis C is expected to make up about 30% of Gilead's revenue this year. Will that number grow smaller in 2018 and beyond? Then there's the prospect of the Affordable Care Act being repealed, with millions potentially losing insurance, and Medicaid shrinking -- and there's the new administration's promise to get drug prices lower, too. How might these possibilities affect Gilead? Also, if Gilead makes a large acquisition, will investors like it? Will it be large enough to replace declining HCV sales? Rumors of a possible acquisition of **Incyte** (NASDAQ: INCY) did not help Gilead's stock.

We face much more uncertainty here than with most *Pro* companies. We're not alone. Management expresses surprise at how fast the HCV market grew, and how fast it's declining. They admit they can't actually project what's next. It's a challenging situation.

We could simply sit and wait, then, and trust management to increase value again one way or another, as they have in the past (though that's not usually how we like to invest, obviously). We could sell -- and that has been considered -- though we believe eventually Gilead will be worth more. Or, we could write covered calls, and aim to earn a return that at least matches our North Star each year (about 11%), believing that at this point the stock will fall much less than the dividend and the covered calls pay us. With Gilead trading at about 8 times expected earnings for this year, a "stable stock" outcome is possible, but only as long as the business doesn't keep shedding revenue at a growing pace. Stability in sales and earnings could finally put a floor under the stock.

For now, in the short term, we can cushion our risk, target income, and gain more time to see what unfolds by writing near-the-money covered calls. These yield 3% on the current share price in 86 days, while giving us some upside room, too, of 3.2%.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up**: If the stock price rises above our strike price by expiration, we may let our shares get sold, or roll our calls to a later date. We'll see closer to expiration.

Pro Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the Gilead board.

Domino's Moves Back to an Active Short Position

Published Mar 20, 2017 at 3:55PM

A Quick Word on AmTrust

On Friday, we posted a summary of **AmTrust Finanicial** (NASDAQ: AFSI)'s news that it will restate results from 2014 through 2016. Restatements are very rare for companies in the *Pro* portfolio; we've seen them in some form from **Parexel** (NASDAQ: PRXL) and **Wells Fargo** (NYSE: WFC), but the one from AmTrust may be more meaningful. We still believe management is doing the right thing, taking a short-term hit to improve and building a company that is meant to thrive, but we are moving the stock to Hold until we see the new financials. We are also withdrawing our fair-value estimate, because we need to see results before we can value them. We don't believe this newly revealed restatement is likely to change the company's past or future valuation all that much, but we don't want to make assumptions. Now back to your regularly scheduled Memo! -- Jeff

Dear *Pro* Fools,

A few weeks ago, I shared my take on **Papa John**'s (NASDAQ: PZZA) 2016 fourth quarter. In that article, I discussed how Papa John's continues to execute on its long-term expansion strategy, and I raised our fair-value estimate from $57 to $64 per share.

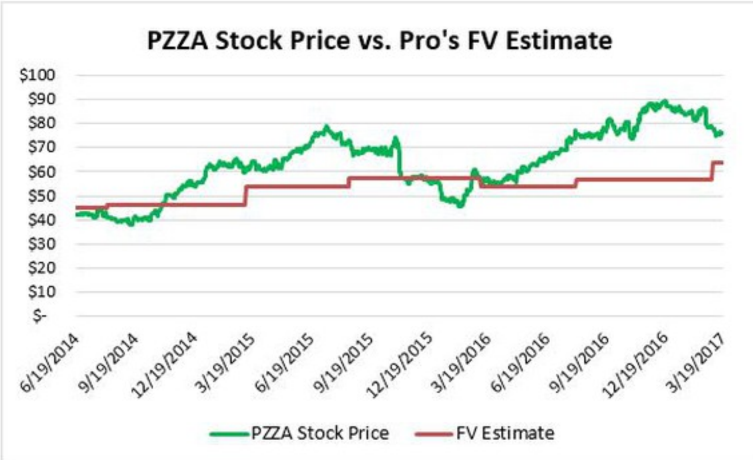
In the same article, I discussed our decision to move our **Domino's** (NYSE: DPZ) short to Hold. As members know, Papa John's and Domino's have made up a paired long/short position for us, and we wanted to reassess whether to maintain this status. So far, our Domino's short has been trouble, with Papa John's stock price up 2% and Domino's stock price up 24% since we initiated the paired position in August 2016. Including dividends and stock price movements, our DPZ short has so far cost *Pro* nearly $11,000, a non-trivial affect on our portfolio value.

In today's Monday Memo, I'll discuss some of the variables we considered with respect to our combined PZZA/DPZ long/short position and share why we've decided to **move our Domino's position back to an active short.**

Papa John's Valuation Has Become More Reasonable

One of the main arguments for our original DPZ short was the discrepancy in valuation between Domino's and Papa John's, so it's notable that the latter's valuation has lately become more reasonable.

After Papa John's recent post-earnings stock-price decline, the stock's current 19% premium to our fair-value estimate is the smallest since mid-2016, suggesting that it's now more reasonably priced (relative to our valuation) than at any time over the past nine months or so:



However, our fair-value estimate for Papa John's has consistently proved to be conservative; the stock-price premium has averaged 18% higher than our fair value over the past five years.

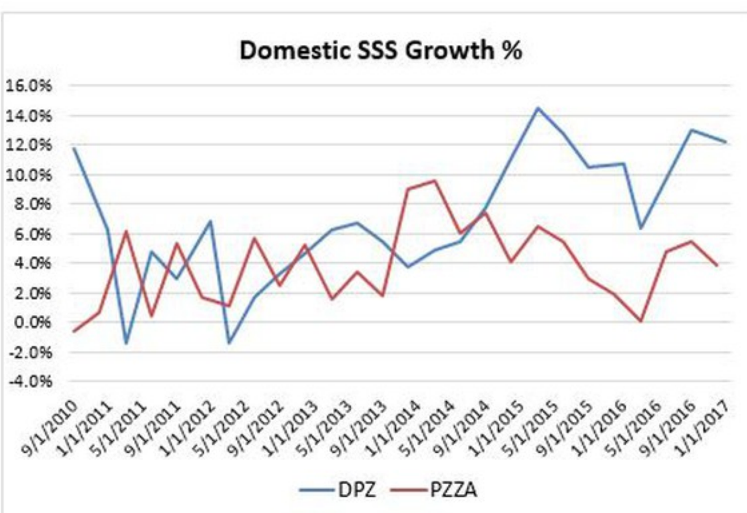
Domino's Valuation Has Become More Expensive

Meanwhile, Domino's valuation has become pricier. Since we are short Domino's and long Papa John's, this is clearly not a desirable result for our combined position. The graph below shows the EV/EBITDA ratio for Domino's vs. Papa John's over the past five years:

As you can see from the graph, the EV/EBITDA valuation premium between Domino's and Papa John's has lately become wider, and Domino's EV/EBITDA premium vs. Papa John's has been higher than the current value less than 9% of the time over the past five years.

Why Is the Multiple Discrepancy Widening?

So why has the discrepancy between the companies' multiples been larger recently? One easy answer is the comparable-store sales ("comps") performance for both Domino's and Papa John's since 2015. Here is a graph of Domino's and Papa John's domestic comps performance since late 2010:



As we can see, since fourth-quarter 2014, Domino's has been outperforming Papa John's domestically, posting scorching comps performance and averaging 11.2% domestic comps growth. For comparison, Papa John's has averaged 3.9% domestic comps growth over the same time span.

Since revenues from the domestic business account for 93% of Papa John's total revenues and 80% of Domino's, comps performance from the domestic business makes a bigger difference to the companies' results than does international comps performance, and investors pay close attention to domestic comps.

The Most Important Question

It's clear that Domino's has recently been outperforming Papa John's domestically. But more important than identifying the performance difference is understanding *why*. To us, the decision on whether to maintain our short position in Domino's comes down to answering that question.

If Domino's has developed some sort of permanent, structural advantage over Papa John's, such that the recent outperformance is likely to continue, then the newly increased discrepancy in their valuation multiples is potentially justified, and our entire argument for shorting (a reversion to the mean of past price performance) falls apart.

However, if Domino's recent outperformance is more temporary in nature and unlikely to continue over the long run, then closing our short position now might end up looking like a mistake in retrospect. Right now, the multiple discrepancy between the two companies is nearly as large as it's been at any time in recent history, and the correlation of their recent stock price performance (one of the main arguments used to justify our original short) is nearly as divergent as it's ever been over the last five years.

Correlation Analysis

To illustrate that point, I ran a more detailed correlation analysis than the one I used in the original DPZ short alert, checking historical correlations over every rolling one-, two-, three-, and six-month period and every one-, two-, three-, and four-year period over the past five years. The purpose of this analysis was to see how the correlation between the two stocks has varied over different time periods, and to compare to the current correlations. The results are shown in the tables below:

HISTORICAL CORRELATIONS	1 month	2 month	3 month	6 month	1 year	2 year	3 year	4 year	5 year
Average	0.49	0.50	0.52	0.67	0.71	0.82	0.89	0.91	0.94
Minimum	-0.80	-0.81	-0.83	-0.53	-0.23	0.53	0.80	0.91	--
Maximum	0.98	0.97	0.97	0.96	0.98	0.95	0.97	0.94	--
25th Percentile	0.27	0.24	0.37	0.60	0.57	0.68	0.82	0.91	--
Median	0.64	0.72	0.75	0.79	0.88	0.91	0.89	0.91	--
75th Percentile	0.83	0.87	0.89	0.89	0.94	0.93	0.96	0.92	--

CURRENT CORRELATIONS	1 month	2 month	3 month	6 month	1 year	2 year	3 year	4 year	5 year
Correlation	0.06	-0.51	-0.75	-0.02	0.80	0.69	0.85	0.91	0.94
Percentile Rank	18%	7%	2%	8%	36%	27%	39%	14%	--

Note: Percentile Rank = percent of time that historical correlations have been lower than the current value.

A few key takeaways from the correlation tables:

- As the analysis period gets longer, the correlation between DPZ and PZZA's stock prices becomes stronger.
- Over short-term periods (up to one year), DPZ and PZZA's stock price movements can even be negatively correlated.
- Current correlations are at the low end of the past five years – for example, the current three-month correlation has been lower just 2% of the time.

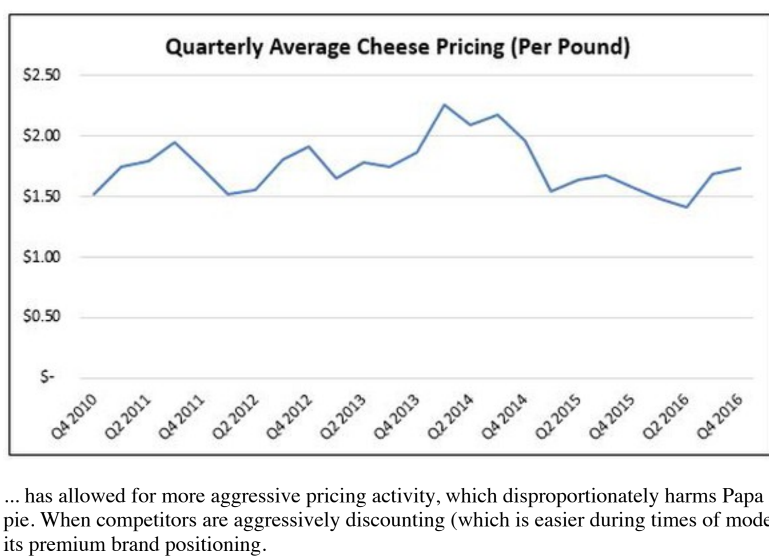
But again, if Domino's has developed a permanent advantage that will allow the company to consistently outperform Papa John's, then this correlation analysis is hardly useful and future stock price performance may look drastically different than the past five years. So, that brings us back to our most important question.

Why Are Domino's Comps Recently Much Higher Than Papa John's?

I went back and read through all of Domino's and Papa John's conference calls since the beginning of 2015 to see if management at either company has offered any explanation for the divergent comps performance.

I found a few key takeaways. For one, Domino's management has often answered questions about strong comps by focusing on the company's aggressive use of technology (such as voice-activated ordering, a newly introduced loyalty program, a new Pizza Tracker app, and the rollout of new, modified delivery vehicles). Domino's management believes that its "unmatched" technology innovation gives it a competitive advantage that has contributed toward gaining market share.

On the other hand, Papa John's has noted that lower commodity pricing since early 2015 ...



... has allowed for more aggressive pricing activity, which disproportionately harms Papa John's because its brand positioning is based on quality and a higher price per pie. When competitors are aggressively discounting (which is easier during times of moderating commodity prices), Papa John's has less room to match pricing because of its premium brand positioning.

Moving Forward

It is difficult to deny that Domino's has been crushing it domestically, mainly thanks to its aggressive investments in technology, marketing, and discounting and its willingness to try new food items on the menu. Papa John's has a much more conservative corporate culture, as evidenced by its slower pace of expansion and technology investment and its less adventurous food menu.

However, the most important question for our Domino's short is whether that current advantage is likely to continue over the long run. Personally, I don't think there's anything Domino's is doing that can't be easily replicated by Papa John's. The latter recently hired a new chief information and digital officer to help the company catch up in the technology arena, and about a month later, management introduced its new Pizza Tracker to match a feature offered by Domino's. As we move forward, Papa John's should be able to continue to innovate on the technology side to challenge Domino's, and if commodity prices increase further (as they have over the last few quarters), Papa John's premium brand positioning will benefit as continued discounting starts to impact competitors' unit margins.

All in all, we think Papa John's continues to do the right thing by staying true to its brand positioning and corporate culture. Over the long run, that consistency should play out in the company's performance metrics. According to management, Papa John's food, pizza scores, service, and culture are at all-time highs, and the company is well positioned to continue to grow steadily.

The *Pro* Bottom Line

So far, our Domino's short hasn't been our tastiest; the stock is up 24% against Papa John's 2% since we initiated our paired position. The divergence is likely thanks to strong comparable-store sales performance on the part of Domino's, which has consistently performed better and captured market share from Papa John's since the beginning of 2015.

When considering whether to continue our short, our key question was whether Domino's outperformance is likely to continue over the long run. After analysis, we think Domino's recent successes are related to short-term, temporal factors rather than long-term, structural ones. We think Papa John's is taking the right steps to match Domino's digital innovation, and may in fact start to catch up to Domino's with the implementation of technology initiatives this year. Additionally, as Domino's valuation has gotten more expensive and Papa John's has gotten cheaper, we think now would be the wrong time to consider closing our short.

Finally, we must consider that our paired long/short position is a hedge on the downside of our Papa John's position. At 28 times trailing-12-month earnings, Papa John's is richly valued, and in a market downturn, the stock is likely to be susceptible to significant downside. Since we initiated our Domino's short, the market has only gone up in value, and we haven't had to worry about -- or experience! -- what happens when markets fall. The value of maintaining our short in the case of market downside is a key consideration.

We will continue to monitor the performance of both companies over the coming year, and we will reassess our paired long/short position each quarter. **But for now, we feel comfortable enough to move our Domino's position back to an active Short from Hold.**

Remember that the Domino's short is a paired position with our Papa John's long position, and the Domino's short is only advisable if you also own a Papa John's long position. The proper ratio is to short about two thirds of your Papa John's allocation in Domino's. However, the Papa John's long position is okay to hold independent of the Domino's short. If you are comfortable with the potential downside of Papa John's, you can own the stock (currently rated "Buy" at a 3.4% allocation) while not simultaneously shorting Domino's (for example if your broker doesn't let you short, or if you don't feel comfortable shorting).

Pro Guidance Changes and Completed Trades: March 20, 2017

Published Mar 20, 2017 at 3:46PM

Pro Guidance Changes (from the past two weeks)

- **AmTrust Financial Services** (NASDAQ: AFSI) moves back to Hold, and our fair-value estimate changes to N/A. With the company's results being restated for the past three years, we need to wait and see the financials before being able to give guidance again. Our trust in management's drive to do the right thing, and our belief that the new results won't be meaningfully different, lead us to keep our 3.1% position for now.
- **Domino's Pizza** (NYSE: DPZ): The stock moves back to a short position, at an allocation that offsets about two-thirds of your **Papa John's** (NASDAQ: PZZA) long.
- **Facebook** (NASDAQ: FB): Fair-value estimate increases to $145. It remains a Buy First.
- **FactSet Research** (NYSE: FDS): Fair-value estimate increases to $174. It remains a Buy First.
- **MasterCard** (NYSE: MA): Fair-value estimate increases to $105. It remains a Buy.
- **OpenText** (NASDAQ: OTEX): Fair-value estimate increases to $32. It remains a Buy.
- **O'Reilly Automotive** (NASDAQ: ORLY): Moves back to Buy at a 4.9% allocation.
- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $93. It remains a Buy.
- **Visa** (NYSE: V): Fair-value estimate increases to $90. It remains a Buy First.

Pro Completed Trades (from the past two weeks)

- **Direxion Daily Financial Bear 3x** (NYSEMKT: FAZ): We sold short more shares to bring our short exposure to 1.5%.
- **PowerShares QQQ Trust** (NASDAQ: QQQ): We closed our mistakenly started 2019 put ratio spread, and have put in an order to set up the correct January 2018 put ratio spread, selling 70 January 2018 $114 puts and buying 35 January 2018 $125 puts for a net credit of $0.05. We'll see if it goes through.
- **TD Ameritrade** (NASDAQ: AMTD): We sold our whole stake, bringing our allocation to 0%.
- **Verisign** (NASDAQ: VRSN): We rolled our March $80/$85 strangle to a June $85/$90 strangle for a $2.17 credit.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: March 20, 2017

Published Mar 20, 2017 at 3:35PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.7%.
- **Visa** (NYSE: V): Buy 2.5%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.2%.
- **Papa John's International** (NASDAQ: PZZA): Buy up to our 3.2% stake.
- **Verisk** (NASDAQ: VRSK): Buy 2%.

Shorts:

- **CurrencyShares EuroTrust** (NYSEMKT: FXE): Sell short 1.6%.
- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% in some form, via our Friday trade alert.
- **Domino's Pizza** (NYSE: DPZ): Sell short 2.3%, to offset about two-thirds of your Papa John's long position.

Pro options:

- **FactSet Research Systems** (NYSE: FDS): April 2017 $170 puts lately pay $1.40, or 0.8%, in 32 days. Write one put for every $17,000 in stock you could buy. We have a 2.1% allocation. FactSet reports earnings March 28.
- **Paycom Software** (NYSE: PAYC): Missed this recommendation so far? Consider selling to open May 2017 $52.50 puts, lately $1.85, for a 3.5% yield in 60 days. Write one put for every 100 shares you could buy at $5,250. We have a 2.6% allocation.

Hedges:

- **PowerShares QQQ Trust** (NASDAQ: QQQ): If you do not have a QQQ ratio spread set up yet, set up one 2:1 put ratio spread for every $78,000 or so you manage, for a 15% look-through allocation. Sell to open January 2018 $114 puts, and buy to open *half* as many January 2018 $125 puts. Lately, this combined trade can be done for a small net credit, about $0.05 per spread. (**Note:** If you have our original January 2018 $100/$114 put ratio spread, you may be able to close that for a profit and set up this new hedge at higher prices, to get your hedge back closer to the current market price. We are pondering issuing this roll as an official alert, but I wanted to offer it here for those who already know they want to roll up of their own accord.)

Upcoming expirations (April 21):

- **American Tower** (NYSE: AMT): Our $110 diagonal calls are in-the-money. We'll be looking to roll as time value disappears.

Roll Your Covered Strangle on Verisign

Published Mar 15, 2017 at 1:45PM

Is this for you? This recommendation is for investors already participating in our **Versign** (NASDAQ: VRSN) strategy. If you lack any position, you can consider the Alternative Trades at the end of this report to get on board.

How You Participate

- **Trade:**
  - Buy to close your March $85 calls. Your March $80 puts are set to expire as income, so you can just let them do so.
  - Sell to open June 2017 $90 calls.
  - Sell to open June 2017 $85 puts.
- **Allocation:** Sell one strangle (one of each option) for every 100 shares you own and every additional 100 shares you could buy. *Pro* will continue to write 5 put and call contracts each in order to keep our look-through exposure at approximately 3%.
- **Price guidance:** As I write this, you would **use a limit order** and aim to roll your strangle for a net credit of $3.90. However, please note that you **need** to get your trade completed by Friday, March 17, if the stock remains above $85. Otherwise, your shares will be called away.
- **Prices** (1:16 p.m. ET):
  - Stock: $86.04
  - Sell to open June 2017 $90 calls, bid/ask: $1.90/$2.24
  - Sell to open June 2017 $85 puts, bid/ask: $2.96/$3.25
  - Buy to close March $85 calls, bid/ask: $1.15/$1.40

What We're Thinking

As we noted in a recent Monday Memo, Versign, a global leader in domain name registry services, reported respectable fourth-quarter results -- which was actually better news than it might seem, because it meant that fears over a potential big loss in renewals turned out to be much ado about nothing. The stock spent the majority of the past four months bracketed by our $80/$85 strangle, but we now find ourselves needing to pre-emptively roll the position to prevent our shares from being called away. There is still a chance that the stock could finish below our $85 call strike price by market close on Friday, but we're issuing this alert today for two reasons:

- We want members to have plenty of time to get the trade completed in time, should the stock stay above $85.
- *Pro* itself couldn't roll its straddle if we waited until Friday, as we must wait 24 hours after issuing an alert before making a trade.

You may have noticed that we're once again being aggressive with our put strike price, albeit this time slightly higher up the chain. If you're tempted to think we might be trying to make up for missed capital gains or succumbing to the lure of large option premiums, please note that we're not! Back in December, we targeted a net buy price we felt comfortable with given the then-upcoming uncertainty over domain name renewals. With the majority of those worries over, we've updated our new desired buy price to the low $80s -- hence the $85 put strike price. And as we noted in the original alert, "We want more positions in our portfolio that aren't solely dependent on a rising stock or rising stock market -- and we want more income. This covered strangle is poised to generate a healthy return even if the stock goes nowhere over the next few months."

Alternative Trades

- **Interested in just buying shares?** We would suggest waiting to see if the stock falls to the low $80s before purchasing.
- **New to this position?** If you can afford a potential $17,000 or so in shares, buy 100 shares today and then "sell to open" the same June 2017 $85/$90 covered strangle described above (sell one call for every 100 shares now owned, and sell one put for every *additional* 100 shares you could buy). Using a limit order, you

could lately collect about $5.15 per share in combined credits to write both options. Invest approximately 3% of your *Pro* funds in this total position on a look-through basis (assuming puts are exercised).

- **Have you previously only written covered calls?** You'll need to roll those calls, assuming you want to keep the position going. Now write the same June 2017 $90 calls, lately for a net credit of $0.80. That price will change as the stock moves, but you'll need to get this trade completed before Friday or your shares will be called away. As always, sell one call for every 100 shares you own and wish to cover.
- **New and only want to write covered calls?** Use a buy/write order to buy shares in 100-round lots and simultaneously sell to open June 2017 $90 calls, selling one call for every 100 shares you buy. Lately this can be set up for a net debit of about $83.97, with making your total return 7.2% should the stock hit $90 by expiration. Invest approximately 3% of your *Pro* funds in this position.

Pro Can Help

- Register a domain name that speaks to *your* soul on our Verisign discussion board!

Countless Ways to Lose; Plus, Portfolio Changes Ahead

Published Mar 13, 2017 at 3:40PM

Dear *Pro* Fools,

We're planning several position changes in the *Pro* portfolio over the coming days and weeks, so it seems about as useful as snowshoes in a snowstorm to touch on some helpful reminders today.

1. Your Cost Basis Is Not Relevant in Relation to Your Decisions

It's common to want to "get back to even" before selling a stock. This is anchoring of the worst kind. What you paid for an asset should hold little to no bearing on your current decision about what to do with it. What matters is your current *belief* -- or lack of belief -- in the investment. If you still believe a healthy return *from today's price* is in the cards, then keep it. If your belief has dissipated and you think the money would be better invested elsewhere, you should likely sell (I say "likely" because nothing is black or white) -- regardless of what you paid for the stock. The market does not know what you paid for anything, and does not care. Neither should you. One handy tip: Look over your holdings *without* looking at your cost, or your current gain or loss, and register your feelings about each one in that sterile environment. In the future, we will be selling some stocks members have a loss in. Of course, that's never our preferred outcome -- but we go into this together knowing that not all of our positions can be winners, and that's OK. What's much more important is investing in something we strongly believe in, rather than waiting to get "back to even" on something. Don't anchor on your cost basis. Look ahead with each decision.

2. We Make Adjustments With the Portfolio in Focus

Sure, we sell positions in which we've lost faith, but even then, we act with the whole portfolio in mind. We may sell partly because we've found a replacement we like better, or because our allocation to a sector has become too large. Or we may simply want to lower the portfolio's market exposure, and some stocks look like the best positions to sell. Our **TD Ameritrade** (NASDAQ: AMTD) sell report on Friday is a good example of this. We don't often believe a stock we're selling will be a poor investment going forward. In fact, I wrote four years ago that most of our sells will be winners. Instead, usually we sell when our thesis has played out, or when new concerns might just be emerging -- new risks we'd rather not face, whether they ultimately arise or not. Regarding TD Ameritrade, both are true (a commission pricing war among the brokers has us a bit concerned), which is enough for us to move on from the position and put the money into other financials we like better now. We do this while working toward an overall vision we have in mind for the entire portfolio.

3. We Pride Ourselves on Low Turnover

We believe the *less* active we are when it comes to selling core holdings, the better our long-term returns will be. Over the past few years, our turnover on core stocks has been less than 10% -- that's lower than nearly all mutual funds. But there do come inflection points when we want to shift several holdings in the portfolio, perhaps because of macroeconomic changes, valuation, or the types of risk that seem most prudent. I believe these wholesale-type changes can be made every several years without putting results in danger; these are not reactive but responsive, because the world does change over several years (whereas a portfolio makeover every year would likely be overdoing it). So while we pride ourselves on low turnover, we will occasionally turn our attention to changing several positions in relatively short order.

4. Take Your Time to React to Trade Alerts

Very rarely do our trade alerts require immediate action. In most cases, you're best off taking your time, reading what we've written, and thinking through whether the recommended changes make sense in your situation. We have 30 days to make our own trades after they're announced to you, and sometimes we use all of those days.

5. We Aim to Think Far Ahead

When we sell something to buy something else, we are not saying that we *immediately* expect that new position to do better than the old. It may not show its worth for a few years or more. We all want the immediate gratification that comes from improving our returns with every trade we make, but we know new positions may take time to prove out, and that they'll often sit in the red for months. Investing is a long-term endeavor. Marrying it to the immediacy of the Internet is incongruently brilliant, and requires mental acrobatics on investors' part. As we think far ahead, we aim to have a portfolio that reflects what we believe will perform well in the future on the whole, while acknowledging that some positions won't work out.

6. We Have Many Ways to Lose

On that note, because *Pro* is a long/short portfolio that uses options, there are countless ways for our positions to lose. A buy-to-hold stock investor only has a few choices to make: what to buy and how much, and then whether to hold, buy more, sell some, or sell all. Meanwhile, the winners in such a portfolio grow and grow as the losers become less and less meaningful. It's brilliantly "simple." But being long-short here at *Pro*, we need to decide how much long exposure we should have, how much we should short, *what* we should short, which options to use, in which direction, whether to hedge, how much to pay to hedge, when to close a short because the risk is uncapped (will we get called out?), and more, along with managing our long positions.

If we have shorts, we will almost certainly have some losers as the market rises. If we have longs, we'll surely have losers as the market falls. We'll *always* have some losers, is the point. And our time is of course limited; are the months we spend researching and following our short positions worthwhile compared with the equivalent time spent finding extraordinary companies to buy? We have to make sure that our sunk cost is at least economical, and that we're not missing the forest for the trees. We *must* be invested well on the long side, because that's where compounding happens.

This is all to say: It's fairly extraordinary that we have had so few losers over our history, and that we've been so well aligned (generally speaking) with the stock market's direction. That won't always be the case. Since we are not long-only, we have countless ways to be wrong, and at times we will be. As you invest with us, please keep it under consideration that the multiple strategies we use expose us to being wrong in every single direction and situation, and recognize that if we can keep our loss rate low and our risk level moderate while still generating healthy returns, we are doing our work well.

Please ask any questions on the Memo Musings board. Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: March 13, 2017

Published Mar 13, 2017 at 1:17PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.7%.
- **FactSet Research Systems** (NYSE: FDS): Buy 2.1%, or see options below.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **AmTrust Financial** (NASDAQ: AFSI): Buy up to 4.1% (or buy in halves). Or see options below.
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.2%.
- **Papa John's International** (NASDAQ: PZZA): Buy half of our 3.2% stake if you lack it, or see options below.
- **Verisk** (NASDAQ: VRSK): Buy 2%.

Shorts:

- **CurrencyShares EuroTrust** (NYSEMKT: FXE): Sell short 1.6%.
- **Daily Direxion Financial Bear 3x** (NYSEMKT: FAZ): Sell short up to 1.5% in some form, via our Friday trade alert.

Pro options:

- **AmTrust Financial**: If you lack a 4.1% stake and want to build toward it but target a lower buy price, sell to open September 2017 $20 puts, lately for $1.35 or so, or a 6.7% yield in just more than six months. Sell one put for every 100 shares you would buy.
- **FactSet Research Systems** (NYSE: FDS): April 2017 $170 puts lately pay $1.70, or 1.5%, in 39 days. Write one put for every $17,000 in stock you could buy. We have a 2.1% allocation.
- **Papa John's:** If you lack a 3.2% position and want to target a lower buy price, sell to open July $70 puts for around $2.40 or more each.
- **Paycom Software** (NYSE: PAYC): Missed it so far? Consider selling to open May 2017 $52.50 puts, lately $2.25, for a 4.2% yield in 74 days. Write one put for every 100 shares you could buy at $5,250. We have a 2.6% allocation.

Hedges:

- N/A

Upcoming expirations (March 17):

- **Verisign**: Our $80/$85 covered strangle expires Friday, and lately the stock is above $85. Except a trade alert to roll to your inbox soon.

Pro Guidance Changes and Completed Trades: March 13, 2017

Published Mar 13, 2017 at 12:56PM

Pro Guidance Changes (from the past two weeks)

- **TD Ameritrade** (NASDAQ: AMTD): Moves from Hold to Sell as we look to reallocate our capital to ideas we like better. Fair-value estimate decreases to $36.
- **Verisign** (NASDAQ: VRSN): Fair-value estimate increases to $85. Our covered strangle is set to expire next month and we plan on continuing the strategy, prices willing.
- **Verisk** (NASDAQ: VRSK): Fair-value estimate increases to $83. It remains a buy at a 2.1% allocation.
- **Visa** (NYSE: V): Moves to Buy First (from Buy) at a 2.6% allocation.

Pro Completed Trades (from the past two weeks)

- N/A

You can see all of our guidance, positions, and transactions from the Recommendations page.

Sell TD Ameritrade

Published Mar 10, 2017 at 2:52PM

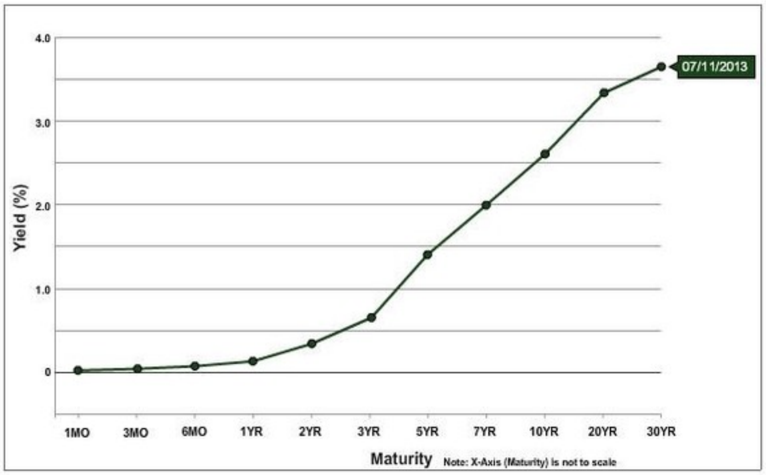
Is this for you? For all *Pro* members who own **TD Ameritrade** (NASDAQ: AMTD), we are moving the stock from Hold to Sell. If you own TD Ameritrade shares and agree with our thinking, follow this alert and sell the stock with us. Read on to find out why we're selling, including portfolio reasons. If, after reading, you want to keep the shares on your own, of course you may do so.

How You Participate

- **Trade:** Sell TD Ameritrade.
- **Allocation:** Sell all shares. *Pro* is selling our 2,000 shares (representing 2.8% of the portfolio).
- **Price Guidance:** It is **critical that you use a limit order** (please!) to aim to sell as close to the going market prices as possible, currently about $39.62.
- **Recent Price:** $39.62
- **Scorecard Status:** Sell

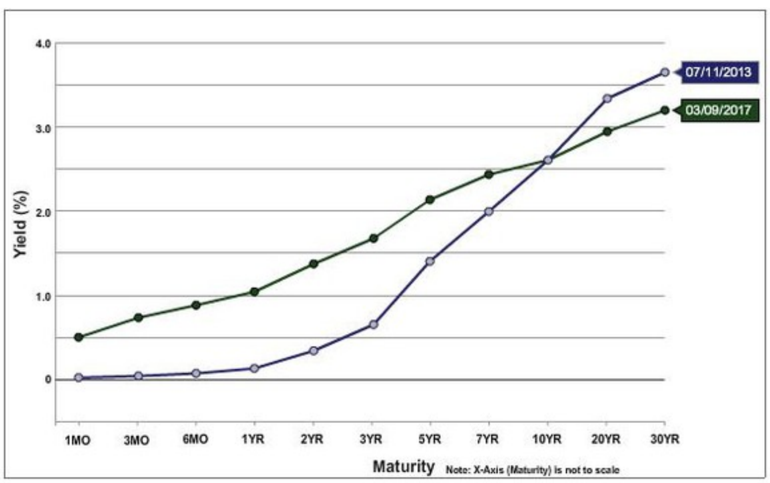
What We're Thinking

In July 2013, we bought TD Ameritrade in anticipation of the potential for higher interest rates. At that time, the treasury yield curve looked like this:



Source: U.S. Department of the Treasury.

A lot has changed since July 2013. TD Ameritrade has done an excellent job of expanding its core business while continuing to position itself to benefit from a higher-interest rate environment. Client assets have grown from $517 billion to $797 billion as of the end of the most recent quarter (a 13% compound annual growth rate, or CAGR). Trailing-12-month (TTM) revenue has grown from $2.6 billion to $3.4 billion (6.6% CAGR), and TTM earnings per share have grown from $1.07 to $1.59 (11.1% CAGR). Additionally, we have finally entered a period of rising rates. Now, the Treasury yield curve looks like this (with July 2013 still shown for reference):



Short-term rates (which affect TD Ameritrade the most because of the short-term composition of its interest rate-sensitive assets) are much higher than they were in 2013, which benefits earnings.

Owing to the company's strong core business performance, the benefits of higher rates, and the market's anticipation that they'll go even higher in future, our position in TD Ameritrade has performed very well since we initiated it in 2013. At current levels of about $39.60 per share, TD Ameritrade's stock price is up more than 54% (excluding dividends) in a little more than three and a half years, or about 13% annualized. Additionally, we've earned more than $5,000 in regular and special dividends since initiating the position, adding to our returns.

Now, with expectations for rising interest rates baked into the current stock price, and with the stock trading more than 10% above our newly lowered fair-value estimate, we're content to sell our stake in TD Ameritrade and chalk up our original investment thesis as a success.

As we explained in our sale of a similar *Pro* investment idea (AIG), *Pro* aims to buy outstanding businesses that will ideally compound our capital for many years to come. Although TD Ameritrade is a good business, we don't think it is a *great*, *Pro*-like business any longer. The company has limited opportunities to reinvest its cash flow, and it lacks pricing power (as evidenced by the recent reduction in its commission rate). Although the commission cut is certainly not the only reason we are selling our shares, the recent price war with competitors provides us with additional impetus to sell today. Even with the recent cut from $9.99 to $6.95, TD Ameritrade still has the highest commission rate among its competitors (with Fidelity and Schwab now at $4.95 per trade). Given current industry trends, we think it likely that commissions can continue to go lower still. Since commissions make up 41% of TD Ameritrade's revenue, price cuts provide a meaningful headwind to the company's results.

The *Pro* Bottom Line

While we know it's certainly possible that TD Ameritrade's stock will continue to do well from the current price (especially if interest rates continue to rise more than expected), we believe that our initial investment thesis has been satisfied, and we're happy to reallocate our investment dollars to companies we think are more likely to compound strongly over the long run, starting with trades as soon as next week.

Pro Can Help

- Questions? Ask away on the [TD Ameritrade discussion board].

Short (More) Direxion Daily Financial Bear 3X Shares ETF

Published Mar 10, 2017 at 2:52PM

Is this for you? This is for all *Pro* members interested; the short itself or one of the alternative trades (buying stock or using options) at the end of the report should be possible for all.

How to Follow Along

- **Action:** Sell short (more) **Direxion Daily Financial Bear 3X Shares** (NYSEMKT: FAZ) ETF.
- **Allocation:** Short enough to get to a 1.5% position (short $1,500 worth for every $100,000 you manage). *Pro* is currently short 0.1%, so we'll short another 1.4% sometime over the next 30 days.
- **Recent Price:** $18.33
- **Price Guidance:** Use a limit order near the current market price when you go to place your order.
- **Short Availability:** At Interactive Brokers, 150,000 shares are available or a 6.2% annualized fee. Most other brokers do not have shares; if yours doesn't, follow one of the alternative trades below. If *Pro* is unable to short shares when we go to make our trade at least 24 hours from now, we'll follow an alternative trade.
- **Scorecard Status:** Short 0.1% (now increasing that to 1.5%)

What We're Thinking

Here in *Pro,* we shorted more than $33,000 worth of FAZ in 2013, and it's worth about $3,500 now, providing us an 89% return on the initial capital at risk. Of course, because this was a short, we never invested our own capital, so this is actually about a $30,000 paper gain achieved without having to touch our cash. The short position is only 0.1% of the portfolio now, and we still believe in the long-term thesis here, so we're bringing it back to 1.5%, where it started. (In fact, this is the second time we'll be returning it to that level.)

As a refresher, this bearish ETF is betting against the likes of **Goldman Sachs** (NYSE: GS), **Wells Fargo** (NYSE: WFC), and **MasterCard** (NYSE: MA). It's managed to provide 3 times (300%) the daily *inverse* results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. The companies mentioned above are three of the index's largest shorts. By *shorting* this ETF, we're effectively *three times long*, on a daily basis, these stocks *and* the entire U.S. large-cap financial sector shorted by this ETF. We expect financial leaders to prosper as interest rates increase and regulations lessen, so this position reflects that belief.

The Vehicle

The FAZ ETF holds nothing but "financial swaps" and cash equivalents that give it short exposure to the underlying index, and it charges a 1.05% management fee, which helps our short. The underlying Russell 1000 Financial Services Index is deceptively comprised of only a few hundred stocks; it's a subset index of the Russell 1000 itself. As of March 9, 2017, the index was concentrated in banks (31.6%), real estate investment trusts (16.5%), insurance (14.4%), and capital markets (14.2%). Top positions as of March 9 were:

Business	Percentage of Index
JP Morgan Chase (NYSE: JPM)	7%
Berkshire Hathaway (NYSE: BRK.B)	6.9%
Wells Fargo	5.6%
Bank of America (NYSE: BAC)	5.5%
Citigroup (NYSE: C)	3.6%
Visa (NYSE: V)	3.5%
MasterCard (NYSE: MA)	2.2%
Goldman Sachs	2%

As these financial giants rise in price, the ETF we're short declines by a greater magnitude. The effects of leverage times three, plus daily compounding, can help our short further on the way down, especially during periods of high volatility. For example, the ETF would be expected to lose about 31% if the underlying index went nowhere in a year, but did experience 25% annualized volatility. So, our short would benefit in a volatile period even if the underlying index ultimately is flat. But with these giants trading at an average of roughly 1.5 times book value, we expect the stocks to slowly gain ground over the coming years, helping our position.

We all know that the financial sector can experience sudden, large shocks, and because this ETF uses leverage and shares are hard to borrow, one of our risks is getting called out of the short on a spike in price. For example, should financial stocks fall 20%, this ETF could rise at least 60%, and our shares could be called away at a costly time. That's why we're keeping the position to a **small allocation, no more than 1.5%** -- and we advise that you do, too. If the short continues to work for us, we'll look to top it off again down the road. If we lose our short and want to maintain exposure, we'll move to one of the alternative trades below. If you can't short FAZ at all -- and that's perhaps a majority of you -- then consider the alternatives below.

Alternative Trades

Options:

- **Non-IRA (preferred):** If your broker doesn't have shares available to short, consider setting up a January 2019 synthetic short on FAZ. Sell to open January 2019 $20 calls, and buy to open an equal number of January 2019 $20 puts. (One downside to a synthetic short is that it moves the tax event to 2019 at the latest, while you can leave short shares in place longer -- though you do keep paying annual fees.)
  - **Price guidance:** Lately, this syn short can be set up for an estimated net debit of about $3 to $3.50 per share (estimated; it's hard to know for certain given large bid/ask spreads), resulting in a short start price of $16.50 to $17. At the midpoint, that's 7.8% below the ETF price, which nearly equals the fee you

would be charged for shorting for just one year. Set up one syn short for every 100 shares you want to short at a start value of around $1,675 – at 1.5%, that's approximately one syn short (one call and one put) for every $100,000 you manage. (See our guide to synthetic shorts for more on the strategy.)

- **IRA (less preferred):** You could simply "buy to open" January 2019 puts at a strike price and for a total cost that you're willing to risk. With strikes near-the-money, we expect you can earn a reasonable profit before expiration, although the puts are very expensive, so this is a "last resort" trade for a very small sum. In other words: **Do not** allocate 1.5% of your funds to this alternative -- just what you're willing to lose. Lately, you can buy to open January 2019 $15 puts for about $3 and change.

Stocks:

- **Bullish on Financials (preferred):** If you can't short this financial index, you could instead buy an additional 1.5% in *Pro* financial stocks, namely **FactSet Research Systems** (NYSE: FDS) or **Visa** (NYSE: V).
- ***Really* Bullish on Financials (less preferred):** We're changing our stance a bit here compared with the past, suggesting you can buy the **Direxion Daily Financial Bull 3x** (NYSEMKT: FAS) ETF in a 1.5% allocation, no more. In periods of lower volatility and generally rising prices, this ETF has provided excellent, sustained (to date) returns. In periods of extreme volatility and falling prices, it can drop severely, but you only risk your initial investment (unlike our short).

The *Pro* Community Can Help

- **Questions?** Visit our Direxion Daily Financial Bear 3X Shares board.

Pro Video Chat, March 2017

Published Mar 10, 2017 at 11:32AM

The *Pro* team will be holding a live video chat on this page at 1 p.m. Eastern on Thursday, March 30! We'll be using sli.do to communicate with members during the chat; click here for an overview of how that works. The specific chat code today is ProChatMarch -- that's ProChatMarch to get into the sli.do chat and ask questions. We recommend leaving sli.do open in another tab (or on a mobile device) so you can follow along with the video and the sli.do chat simultaneously. See you soon!

Transcript

Jeff Fischer: Greetings Motley Fool pro members, and welcome to the March 2017 Motley Fool pro chat. I am Jeff Fischer, joined at the table by JP Bennet.

JP Bennet: Thanks for having me.

Jeff Fischer: And we have Billy Kipperstock on Skype. Hey, Billy.

Kipperstock, B.: Hey, Jeff.

Jeff Fischer: Good to see both of you and good to see all of you here at our monthly chat. The video that you see streaming before you is one part of the chat. It's the part that you stick with if you want to watch us. Then click over to slido.com, S-L-I-D-O.com, and enter pro chat March to get you into the question portion of this chat. Pro chat March. Then you can ask any question that you like and we will answer the questions generally in order of popularity.

This month, we have a bit of a twist. Ellen is away. She has strep throat, unfortunately. We wish her well. With Ellen away, we reconfigured the chat so that you can thumb up a question or if you really want to, you can thumb a question down. Just be kind about it. JP is going through and thumbing down questions already, trolling our members.

Kipperstock, B.: Come on JP.

JP Bennet: Just trying to have a little fun, liven up the chat a little bit.

Jeff Fischer: If you see a question you really don't like, you can politely thumb it down if you want. We'll see how kind you all are.

That's pro chat March, and the questions are starting to build right now. That's what we're going to spend most of the hour doing, answering your questions. Before we get to that, I'll just run through a little bit of where the pro portfolio is at. Now, just about one quarter through the year already. The portfolio is up 5.3% gear to date, as of this morning, as of about an hour ago. That improves a bit upon our 13% annualized return since its inception so far. We're right in line with the market, generally speaking the SMP. We're above our Norstar. We're about 72% net long, so we're happy with these results. Especially, we've had some drags.

Amtrust has been the largest drag on the portfolio down 33% this year as it's restating results, and we'll have more on that soon. It was one of our top five positions. Now Amtrust is number 12 at 3.4%, still a sizeable position. Winners though, offsetting that and putting us well into the green this year have been Facebook, American Tower, Oracle, Apple. A lot of buy first stocks in there have propelled us higher.

Facebook and Apple, JP, how much do you think they're up this year, here to date?

JP Bennet: Putting me on the spot. I have no clue.

Jeff Fischer: I knew you had no clue, so that's why, just take a wild guess.

JP Bennet: Gosh.

Jeff Fischer: Two giant companies. It's only been three months.

JP Bennet: Yeah, I know. Apple is up pretty good, what was it around 110 not too long ago, right?

Jeff Fischer: Yeah, and now it's 142.

JP Bennet: Something like that. Facebook, that's your stock. I don't follow Facebook. I have no clue.

Kipperstock, B.: I would guess 20%.

Jeff Fischer: That's right, Billy. They're both up 24% year-to-date. Now Billy said-

JP Bennet: Efficient markets.

Jeff Fischer: That's right. Whatever Billy says, that's what they do. So we just have to-

JP Bennet: All right, Billy how are we going to finish the year?

Kipperstock, B.: Don't ask me. I don't know. I have no idea.

Jeff Fischer: Even these giants are up 24%. Oracle is up 16%. We have mostly winners in the portfolio so far this year, as you would hope with the market rising as it has. Our buys from last six months are namely Paycom, Verisign, Amazon, Johnson & Johnson. They're all in the green. Paycom is up 33%.

Kipperstock, B.: Take a bow.

Jeff Fischer: Take a bow. It's too early to say it. Especially with a stock like that, but good start. Our shorts in the last few months: GoPro, Shake Shack, and Gogo are collectively about even. Perhaps, we even have a small gain. That's great. That's despite small caps being up more than 20% since the election. Our shorts have not really heard us to any degree and maybe even helped us a bit. I didn't do all the exact math. We can be happy with that too, so far. That's why we're looking for more shorts. As always, looking for more longs and will probably have some trades very soon for you. In fact, I'm sure we will. You guys have anything to say as we kickoff the question part of the chat before we do so?

JP Bennet: I'm ready to jump straight into the question-

Jeff Fischer: You guys feeling good.

Kipperstock, B.: Let's jump in.

Jeff Fischer: The questions are piling up, so here we go. Initially we'll just go through the top questions and then later we'll just each choose a question and go around the table as before. [Lon 00:04:33] is asking, "Pro fools, could you please elaborate," on our feelings about J&J, Medtronic, Gilead Sciences in the wake of last week's, not even a week ago, failed healthcare legislation. Thank you, Lon. Thank you, Lon. Good question. Who wants jump in first.

Kipperstock, B.: I'll take that one, I guess, or I'll start it off and then maybe you could finish up a little bit, Jeff.

Jeff Fischer: Sure.

Kipperstock, B.: We talked about this one right before we started the chat. We mentioned how it really doesn't change our feelings about our healthcare stocks all too much. We own these companies. We have exposure to these companies and all of our long stocks, really, with a long-term perspective in mind. The political environment is going to change all the time. Sometimes it can change really drastically. Donald Trump has mentioned and his administration has mentioned some ideas for legislation that could really significantly affect the value of stock. It's not to say that the political environment doesn't matter, it doesn't make a difference at all. It certainly can depending upon the legislation that's passed. In this case, I mean, we we didn't really put too much stock in the healthcare legislation that was going on. There were talks about some tariffs being introduced. Jeff can speak a little bit more to that. For me, specifically with Johnson & Johnson which is the company of those three that you mentioned that I cover. It hardly changes my perspective at all. It's a big, stable, gigantic company with lots of different revenue streams. We're looking to hold and own that company for 10, 15 years maybe more. Healthcare legislation doesn't play much of a role in how we feel about it moving forward.

Jeff Fischer: I agree, Billy. It's funny, the news last Friday actually made me think of some of our other companies even more than our healthcare stocks such as Valmont. What does this mean for an infrastructure, Bill, getting passed in a timely fashion? Are small caps like our short Shake Shack which would benefit from lower tax rates, but how [single 00:06:45] taxes actually go lower if they do. The failure to pass this bill, as we've all seen or read, calls the question how quickly and how efficiently this government will be able to pass bills period. I agree with Billy about this bill in particular not really changing ... Since nothing changed, nothing has changed.

The administration has talked about trying to get drug prices lower. They haven't laid out how they might do that other than having a competitive bidding process. Tariffs, Medtronic makes a lot of us devices overseas and brings them back in. If tariffs were to to be instilled on that sort of transaction, Medtronic may pay a price for it. It's hard to imagine that going through as well. I think enough people on capitol hill know that I would just hurt their constituents, because it just raises prices for everybody. Anyway, I think Billy summed it up well, and I'm just wasting time right now. It's a watch and see situation. It currently looks like, even today, there is more parson fighting with the president calling out the Freedom Caucus party. Insane, we have to fight them. They're of course 32 republicans. It may be a rough road to get things passed in a timely fashion, which amusingly the markets up on that. Generally the market likes when government stays out of business, generally speaking. Good question though.

Next question is from anonymous and no thumbs down, so we'll answer it. FactSet data systems, please comment. FactSet announced earnings two days ago. Their earnings per share were above estimates, not that we care about that so much. It is good sign. They're growing about 14% on the bottom line. Revenue was a bit light though, because they are seeing some smaller clients reduce their spending, namely by letting staff go. FactSet gets paid both by the client and then the number of seats at the client. Some of these companies pressured by the move to passive investing are letting more their analysts go. So that's fewer seats, means a lower payment to FactSet.

That said, they did pass through their normal price increase, their revenue, and their average subscription value are all growing mid-single digits. They foresee that continuing. They see a lot of opportunity ahead, looking very long-term. They believe their market size opportunity is about 10X what it is right now just based on their current business. Overseas, they have a lot of growth. They see more online coming to them. Overall the picture is positive, but they're not happy with the rate of growth that they have and neither was Wall Street so they sold the stock down a bit. The shares trade right around long-term average value multiple, actually a little bit below it, of about 21 times expected earnings, 23 times free cash flow. For a business of this quality with such strong recurring revenue, which is still 95% recurring revenue, the shares look reasonable. It's still a buy first, as of right now. We may add to our small position which is only around 2%.

Said differently, we're not discouraged by this. It is a headwind. It's a headwind that may last for a bit, well an indefinite time and maybe several more quarters. FactSet is working on ways to get around it and grow nicely, anyway including acquisitions, including more cross-selling. Their hundred largest clients create a vast majority of their profits. They're focused on increasing sales to them, as well while still opening up new markets and new clients, as well. Yes, there are some headwinds and FactSet's shares declined as a result, but we're not concerned about the long-term thesis.

Let's move to something one of you can answer, JP. How about John's ... John just made a comment that you could comment on. He liked your writeup on Starbucks which was very good. How many weeks in the making was your Starbucks deep dive?

JP Bennet: Oh gosh. I don't know how many weeks I ended up spending on that one, but quite a few. My personal process is you build up a reservoir of knowledge for a company and then you periodically update it. Every once in a while you need to go back in and try and do another deep dive on the company just to make sure you don't miss anything, because you get into a process with your periodic updates. You're looking for certain things. You're glossing over other issues. So you just have to go back and make sure you're not missing anything and just refresh your knowledge base.

Kipperstock, B.: Question you're assumptions, basically.

JP Bennet: Yeah, pretty much, right? That's essentially what I was doing with Starbucks. There was a a lot of things to adjust or to look into and memos we trying keep them somewhat pithy, so I really couldn't even adjust of a small fraction of the things I ended up looking into. We're sticking with Starbucks for the time being.

Jeff Fischer: If you head to the Starbucks board on Pro, you'll see JP's answers to some of your questions.

JP Bennet: Slow and steady. I'm working through them.

Jeff Fischer: John has pointed out that Apple's Numbers, which is the equivalent to Microsoft Excel, so Apple's Numbers program supports option and stock prices now. Thanks John for that tip. It's good to know for members who are tracking their results themselves.

Billy, do want to talk about Gentex and the rest of 2017 or as far forward as you care to look?

Kipperstock, B.: Sure. It looks like Gentex should have a decent, solid continued steady year in 2017. In fact 2017 might even be better than 2016. I'm looking at the company's quarter four report. They have some guidance here. For context, in 2017, vehicle production, auto production which is one of the primary determinants of demand for Gentex in the United States was down 1%. In 2018, auto production is expected to rise by 2%. Gentex management and my experience from monitoring the company is that what they say is that their growth rate in unit shipments for their mirrors is generally at a rate of maybe 4% to 10% above market growth, above growth of auto production. In 2016, auto production declined in North America by 1%. In 2018, it's expected to rise by 2%. That's a 3% difference. If auto production forecasts are accurate, then Gentex should have a nice boost to expected growth. If they are able to penetrate their market further and capture further market share, they may be able to increase even more about that.

Not only in 2017, they mention they get their contracts far in advance from the automotive companies that they sell to. They are able to give even 2018 revenue guidance, two years into the future. They're expecting 2018 revenue to be approximately 6 to 10% above the 2017 revenue estimates. The company looks set to continue to grow. They have new products that they're continuing to introduce and gain adoption with such as the full display mirror which is a mirror. Its completely electronic and has a wider field of view. It's really actually pretty cool if you look it up. The videos for it are interesting. They also have another product, an integrated toll module for your driving through tolls. They have some technology built into a toll module that it may integrate across all of the different toll systems in the United States.

They continue to do what they do which is try to introduce new features and bring technology into the mirror and the car in an area that allows for increased functionality. As cars and as technology become more important in cars, Gentex looks like they should be doing pretty well. I feel good about owning that company right now.

Jeff Fischer: Thanks, Billy. Gentex is a buy at 3.3% allocation. In the time we've owned the shares, we're up 112%, so far. The stock yields about 1.7%, add that to the returns as well and then we've written options on Gentex quite a few times. I know Billy continues to watch that for future opportunities. Thank you for the question.

For those of us just joining us and watching this video you can go to slido.com, S-L-I-D-O.com and then enter Pro Chat March, if you want to ask any questions. We recommend you set that up in a separate tab, separate window that you can, if you want to keep the video open as well.

Another question. We have Pablo, hello Pablo, asking about Paycom. For those of us who wrote puts, should we go ahead and buy some shares at 57 or just keep writing 52 puts to get closer to the 52 strike price value? In catch-up trades, we have said, "You can write puts on Paycom." The past several weeks now, they pay pretty well. They were down in the low 50's. I believe it was 52, 50. You can do both. The stock is still a buy. You could buy some shares. We have a two point, let me make sure I get it right, 2.6% position. I realize it's pretty small still.

You can buy some shares and write puts for the rest or you just keep writing puts as long as they pay well. I's a fairly volatile stock. I expect next time the market turns south, Paycom will decline with it for a while at least. There should be other opportunities given the way the stock is priced. It's bound to see some volatility when the market does, but at least you're making money writing puts. If you want to buy some shares again, it's still a buy. It's really your choice. It depends on where your portfolio is and what you feel best doing. Good question. I think either way in the long run it will hopefully work out. We do hope you'll own shares for the long haul at some point.

Dave T is asking, "Are there any plans for wholesale rebalancing or are we pretty much stable with some upcoming modest changes in recommendations?" I'm happy to briefly comment that we generally don't wholesale rebalance. Our mission is more to find companies that will compound value over the long term, generally whatever the short-term brings our way. We're not a part bond, part stock portfolio that rebalances to make everything equal. We're just trying to find outstanding businesses that should grow in value over the years regardless. We like to let our winners run within reason. We are not leery of letting winners get too big. Facebook is now 7-some percent. We do have several recommendations in the works though. Actually, many that will come out to soon. April will be a busy month for us, I'm assuming. You'll see the changes that were making there. We're always thinking with the portfolio as a whole. One change often leads to another. That's how we're thinking as we are actually working right now. We have several positions that may be tweaked or changed in the near term, but it's always with the whole portfolio in mind and with our long-term strategy in mind not just to rebalance, so to say.

Kipperstock, B.: I think you pretty much hit the nail on the head. I mean there's not really much there, right? We like to let our letter winners run within reason. If something gets to big, I know in the past, we wrote cover calls on AmTrust to pair it down some. If an ideas isn't working out, we don't want to leg out of it, we want to get out of it. We don't really rebalance. It's checking individual positions, how our thesis is playing out and is the portfolio as a whole properly diversified by industry, sector, risk exposure. We let that determine the decisions that we ultimately make.

Jeff Fischer: JP, we can go to O'Reilly's now. Then we'll do AmTrust. An update, we've talked about O'Reilly's a lot as a team the past month. Do we want to keep owning it? It's done really well for us. It's one of our largest positions. Amazon has been in the market for quite a while, but is moving in much more seriously now and that's making headlines. We really look at it in that light. Our latest thoughts JP?

JP Bennet: I think that is the big thing to keep in mind here is you don't want to let your prior success jade you and lead you to ultimately just take a pass when this is a position that needs management, that needs to be sold if the threat is real enough. For the time being, we're sticking with this one as well. We need to watch a situation develop, though to be a little bit difficult the first couple of quarters because there are tax refunds, there are some weather issues that will make it hard to tease out the

Amazon impact. What we've seen so far as there is a couple different trends going on here. The first is, obviously, the increased complexity with cars makes it are more desirable for people who aren't very knowledgeable to speak with someone in person to get that face-to-face reassurance that this is the part you need, here's how you do it, we can help you if you if you need that help. That's something to.

What you see actually in the younger generations, as you get to the younger generations, those people actually becoming increasingly uncomfortable with their ability to make minor repairs on their own, right? They want that face-to-face interaction. You actually see, this is the opposite to most industries, is that younger generations actually prefer to go to shops to get their parts, right? Normally, we like to buy our clothes online. We want to buy or video games online. We want to buy everything online and have zero face-to-face interaction, right? In the case of auto parts, we actually want to go into the store and speak with someone. There are factors that are are benefiting O'Reilly. At the end the day, you have people who are going to be, "Price is a number one factor." Right now, surveys across the country basically show the number one deciding factor is, "I need that part right away and I need someone who is knowledgeable, who can help me."

There are people for who price is a more deciding factor, but by and large, they've already moved to online parts. If you look at something like RockAuto, they crush O'Reilly's pricing. They actually beat Amazon's pricing more often than not. If you wanted cheap parts, there are many places online where you can get really cheap parts. To date, that really hasn't had as much of an impact on O'Reilly's, you might think because the delta there. You can be looking at your 20, 30% for certain parts. There's a lot of savings that you can go and grab if you move online.

There is also the issue of RockAuto is not Amazon. There's a big difference, the name, the selection, all of the things that go into Amazon. We haven't really seen that compete with O'Reilly. We have to watch it, right? We don't want to jump the gun, because management has done an amazing job. If you look at O'Reilly versus the other players, I believe O'Reilly is by far and away the best situated to deal with this threat. Again, what is a more deciding factor, I need the part right away. O'Reilly's in stock rates are by far and away the best in the industry. Their distribution center is really, really, it's just amazing for the industry. There is room for these guys to keep going, to keep making the appropriate moves, and to live in an Amazon world, so to speak. We just need to watch that situation closely, I believe. The further through the year we go, I think we'll get a better read on that.

Again, we we don't want to be someone that as soon as Amazon even looks in an industry, we just kind of throw hands up in defeat and just sell any type of exposure we had. I think that will be a mistake to make, because if you look at there are plenty of companies ... You go back to Best Buy. Best Buy did, the stock did languish for a while but it's recovered. It's recovered quite a bit. You look at when Best Buy first started competing with Amazon, it's just a show room. There's no reason for Best Buy to exist. Here we are couple years later. Best Buy's kind of retooled and refocused. We can see that there is most certainly a place for them in the industry.

Jeff Fischer: Good answer, JP. The stock remains a buy. It's our third, really our fourth-largest when you count America Tower including our call options, at 4.8%. As JP just very clearly said we're watching it really closely, but we still believe in it right now. Let's see, a thing we talked about in our meetings, just so you guys know, is trying to preemptively get out. If we see issues on the horizon, our hope is to sell early. If it's a retailer we don't want to give it too much room to get into trouble rather than wait until the numbers are starting to be affected and then sell because by then probably be down a fair amount. None of that may even come to light. They may just keep growing. They're adding 200 stores this year, same-store sales up so far as usual.

JP Bennet: Just to go back on what I said to, just everybody is aware that there are going to be a number of factors at play for the upcoming one or two quarters. There is a risk and I know I've talked about in the past where the market overreacts to maybe some weakness because of those other factors, and just assumes, "This is Amazon. O'Reilly's is dead." It takes to take the stock out behind the woodshed. There is that risk. If you look at great stocks over the long run, maybe a stock moves down 10% on one day but it's up over 300% over a couple of years. You just have to be willing to stomach that. The upcoming quarters are going to be important, but it's going to be very hard to tease out the Amazon effect. That is essentially what we're watching for.

Jeff Fischer: Thank you, JP. Anonymous is asking, "AmTrust, should we buy more stock? I also have a September $20 put option open." I assume written puts. The answer is no on buying stock. We have the stock on hold. We own 3.4% right now which is plenty. We took away our fair value guidance because the last three years are being restated, financials are being restated. It's really hard to know, although we don't expect book value or the loss ratio or return on equity to be affected that much, given what management has said, we can't know for certain. We're not advising a buy of more shares. The stock is on hold. You'll probably hear more about AmTrust from us very soon. Mean while, we wait for the numbers to be restated, to be released which we don't have a timeline for that. We're thing about our current position and what to do while we are waiting. You'll probably hear from us soon about that. No, don't buy more shares. If you have puts open, you can keep those open for now and wait for our next guidance for you on that.

"Given JP's write-up on Starbucks, can we discuss some options that could be advantageous with Starbucks?" Okay, that's a good point. JP you were like, "We're sticking with Starbucks, great company, great execution so far but, you know, looks a little pricey." You're maybe not as certain that the growth management projecting is in the bag. It's a high hurdle. What could someone do possibly with options?

JP Bennet: I would say in full disclosure. In addition to owning shares, I have a running synthetic cover call on it. The issue that I've had with that over the months is just the call options don't always pay very well. It is very hard to even come close to that kind of 1% a month target that we want. You just assume that we start throwing pro member volume at those contracts. You're not even going to come close. I would be perfectly willing if the yield was good enough to close or wind down my position, do it for members. We pretty much all have the same stance that members interest before our own. If there is an option, idea we like that meets the criteria in terms of the ability for the options to hold up and members get good pricing with the volume we're going to throw at it then that comes first.

Maybe later, we can look to do a book though. For me, my personal process is normally I try to run any options position that somewhat or loosely mirrors a pro'er options position in expiration months the kind of off the options or pro cycle. There really is never any competing interest. That's kind of the biggest issue. It is a little bit frustrating in that, I think, for the time being that could be a a lucrative idea. Part of the reason I set up the synthetic cover call though was just because the leaps were very advantageous. It was during one of the, "Oh man, Starbucks, restaurants, everybody they're dead, you know. [Sell 00:28:44] the baby with the bathwater." You're able to set up the synthetic long for extremely, extremely cheap.

It is a little bit frustrating but at the same time you go and you step back and you look at it. It's like, "This is a stock that," and I've personally have to been ready for it for as long as I've been running my options position ... If they prove the doubters wrong, in one quarter this thing could just be off to the races again. We've seen it on multiple occasions with Starbucks. There there are times when the market doubts the company. If they execute, again this is a big if and it's like I said in the write-up, if they execute right, the stock is going to do tremendous over the next five years. Unless we end up in a situation where at the end of those five years, we're in a bear market and it's getting crushed with everything else.

There's definitely a cost benefit analysis. With pro, I don't think I would be comfortable even if the option's paid. I don't think I'd be comfortable with covering our entire position, because you run that risk and then you had a options position in Starbucks. You have that seller's remorse were you're just like, "Oh man, I made some income and now the stock is 25% higher than were my strick price is, really wish I didn't do that." I would hate for us to end up in that position with our long position and have to chase that. Because of the concerns I listed, we already have a pretty full allocation. What is it for Starbucks?

Kipperstock, B.: 3.3%.

JP Bennet: I don't know if I would be comfortable bumping it up to make our second highest position in order to add on another sleeve to enable us to use options, right?

Jeff Fischer: Mm-hmm (affirmative).

JP Bennet: You would really only want to do that if you're really confident underlying business. Although, I think they can achieve it. It's not a gimme and so because of that I am not too inclined to add extra exposure to Starbucks just a we can try and generate some income. I think there are more attractive ways to do it elsewhere while remaining more diversified.

Jeff Fischer: All right. The shares are 58. The fair value estimate we have is 52. If you lack shares, if you lack a 3.3% allocation, you can keep watching for put options that would get you by price closer to 52. As JP said that options don't pay that well but sometimes they pay close enough to 1% a month to make it worth doing. We've recommended them a few times in Motley Fool 1.

JP Bennet: The puts have held up a lot better than the call. It all depends on how the market is skewing the bet for Starbucks. When it's a little bit skeptical those puts tend to pay a little bit well like they did when I set up the synthetic long.

Jeff Fischer: Sounds good. We are 36 minutes in. We have 24 minutes to go. We're doing pretty well on questions here. Facebook is more than 7% of the portfolio. That's because of price appreciation. It's also because we let it be. Do you really recommend new members or those without Facebook invest 7% of the current price. The answer is yes. We make sure every week that we are comfortable with allocations that we have. We're in the fortunate position and have been for a couple years now, I believe it's been that long, of Facebook being our largest position or one of the largest and being one of our favorite companies, favorite opportunities I should say as well for quite a while now. The stock is grown. It's free cash flow. Its earning at such a rapid rate that the shares become less expensive on a multiple basis than it's ever been before even as the stock has gone up and up.

Yeah, I'm comfortable saying invest 7% of the current price in Facebook. If it were a smaller business or something that had not as strong and robust a financial growth as it's seen and such a high ceiling for opportunity ahead, as well and such solid management with such a well laid out three, five, and ten year roadmap drawing traffic, growing engagement among that traffic, still only commanding a small fraction of worldwide advertising dollars. All these things in Facebook's favor make us comfortable with this allocation that we have. That said, with brand-new members, we do say if you want to buy in halves or even thirds, do that. If you want to write some puts, if you can at 140, it's pretty expensive to try to target some shares lower, you can do that. Yes, we are comfortable with the 7% allocation. It's been one of my favorite ideas for at least a few years, JP.

JP Bennet: Mm-hmm (affirmative).

Jeff Fischer: That still remains true. I actually think some ... Well anyway, I won't say anything. Facebook, yes we're okay with it.

JP Bennet: Make of that what you want.

Jeff Fischer: Exactly. You have to be comfortable with it, ultimately. If 5% is your limit then just do 5%. In any case, if one of our positions is larger than what you want just, go up to your maximum comfort level. Really, it's about what you want. Thoughts on how long Gilead's way back will be or AmTrust's? Should we be thinking one year, three year, five years? I'm going to do a little curve ball on that really and and say that our portfolio is up despite these two stocks performance. That's what we're looking at. The portfolio as a whole we want to appreciate. We know we're always going to have some losers. In a lot of ways, we are glad to have some losers because history shows that laggards later become leaders and leaders later become laggards. If you have some of each in your portfolio, it can help smooth your volatility. We don't want everything soaring at once because that likely means everything will crash at once too. The portfolio is still up nicely despite these two losing positions. That's a win. That's success.

That said, we of course evaluate each stock and want to believe that it can recover and grow at a Norstar type of rate. How soon? That comes in the play too. Right now we need at least 10, 11% annualized returns to make the position a Norstar contestant. Gilead, how can it do that? It leans on acquisitions. It needs the Hepatitis C market to stabilize. Both of those are question marks. Gilead's on hold. It's a very cheap stock but the business may not grow for quite a long time. It may indeed lose to our Norstar. The good news is a position as become small enough that it's less meaningful now. We still are about it critically. We wrote covered calls on it just this week to make some we're targeting at least 10% income on it per year, plus it pays more than 3% now in dividends. We're looking to make our Norstar no matter what. If we don't believe that the stock can appreciate and we can't make returns other ways, we'll clear that money out for something we like better.

AmTrust, that could recover as soon as next week if they restate results that are positive and the stock jumps on that news. It could also be a few years, at least. That stock now yields more than 3% as well. The key there, before we give any answer though, is really seeing what they say in their restatement and then we'll have a better idea of how quickly the stock may recover, if we believe it's going to. If we don't believe that, then course we'll sell and make the money elsewhere is the hope.

Good questions. My most general answer, I want to say my best answer I hope, is to think of your portfolio as a whole and not just focus on these positions and when they'll get back. Hopefully your whole portfolio is up no matter what. These positions we still believe in because we still have them. When we no longer believe that they can make a return for us, we'll get rid of them.

Let's see, question. Top question right now is "For those who increase allocations by writing puts, what's the best route from there? No one can predict what'll happen but what's the best road to take now." They're just talking generally. Billy, you want to share thoughts on that?

Kipperstock, B.: Sure. The answer, what is the best route from here. The answer is nobody knows. It depends on what happens with the market. You can never predict in advance whether the market as a whole or whether the specific companies that you're targeting with these puts are going to appreciate in value or depreciate in value. If you knew that in advance, if you knew that the stock over the next five months is going to rise or over the next two years can arise by 10, 15, 20%, then you would want to just buy shares and not write puts. If you know that the stock is going to decrease, you would if you had a choice between writing puts and just buying shares, you would choose the write puts. If you knew that, you might even just wait and then buy shares once it hits. The point is you don't know. It's a trade off. Whenever you write a put, you're just trading off. If the stock continues to rise, then you're not going to get the upside aside from whatever income you receive from writing that put. On the flip side, if the stock retreats, then you're going to end up getting a better buy price on the shares then you would have if you had just bought shares to begin with.

You know this. You mentioned no one can predict what happens, but what is the best road to take now. There is no best road. You just have to understand the risks and the trade-offs of doing one versus the other and don't get too discouraged if the outcome that happens is not the one that you want. The market is ... It can go either way and in a lot of ways it's weighted in a way such that the outcomes go in a 50-50 chance. Hard to know. If you really want to get upside, just buy shares. If you prefer to be more conservative and you're worried that the stock market will decline then maybe write puts. Just be aware that the only way to know the right answer is to be in the future looking backwards. What you can't do.

Jeff Fischer: Well said Billy. If you're in between those two scenarios that Billy laid out, you might want to buy shares, you might want to write puts, if you can, buy some shares and write puts for the rest. That way you are happy either way.

What's the best way to guard against dividend poaching? Is there a way to automate tracking? I'll just say anytime you are writing calls against a stock or a diagonal call, look up and put into your calendar when that stock goes ex-dividend and put in an alert about a week ahead of that ex-dividend date. Men check to see if it's in the money and what the time value is versus the dividend payment. It really comes down to just being on top of the situation. That only happens if you know when the ex-dividend date is coming. Have a spreadsheet or somewhere to your calendar to remind you of these things. We also in the pro and option services, we track in our scrolling calendar ex-dividend dates are in there for all of our positions. You can look there as well.

Kipperstock, B.: I'm going to add something here. In my personal portfolio, I have tracking of the options that I use. There is a guy, just some some guy who did this on the internet himself, he has a up plug-in to Excel that you can look up option pricing. I run formulas for whatever options positions I have. I run this add-in and it's called SMF add-in. You can look it up and download it and put it into Excel. Any options positions I put it into a spreadsheet. I run the SMF add-in and get the current pricing. Then I run a formula to calculate the time value. Whenever you want to check it, you can run the SMF add-in and see how much time value do I have left. Then you can see, "Okay if we're getting below $.50 of time value, now I need to start thinking about it." Check that out. SMF add-in. You can look up option pricing with a formula in Excel.

Jeff Fischer: Great. Thanks Billy. We're at 15 minutes to go so we're going to go into the speed round and answer the rest of these as quickly as we can. I'll start with Pablo's. "Any benefit in doing a QQQ hedge at current prices if we already have the original one." This is really an allocation question. The reason we haven't issued a second one is that you would then have some 30% downside risk to the index itself if you'd enclose the first one. More likely as we're going to advise that it wasn't quite time it on the prices that I looked at, advise rolling up that QQQ hedge in the near future. We're also considering starting some other other hedges as well. I would sit tight for now and perhaps we'll have a rolling trade before too long for that one. I wouldn't set up a whole other put ratio spread unless you close the original one first, because you have to watch your exposure on the downside on those positions.

This I guess is for me as well. Sal, hey Sal, was asking, "If you lack a short of the euro, should you set up a direct short or synthetic short?" If you can short it directly, do that because it's easier. The fee is annualized so it's a very small fee to start. If you set up a synthetic short, you pay the whole fee upfront through your transaction costs, through your friction costs really. Then we might close a position. Indeed, we're waiting to see what happens in Europe, frankly on that one. It looks like U.S. interest rates are not going to go up rapidly enough to cause the dollar to rise that much more quickly against the euro. Now the last kind of pillar in that short thesis is if trouble escalates in Europe with the EU, with the Euro zone. If that happens, the euro could get much weaker. We're waiting to see how elections go there this spring for a start in France. If you wanted set up a direct short, if you can that's the way to do it because it's cheaper than the synthetic short right now in the short term.

Spy, we just talked about that. Let's see anymore ... We're talking about downside exposure there. We have 15% downside exposure to the index right now. We're carefully considering shorts and/or other hedges. You'll be the first to hear about it. I wouldn't just off the cuff add another big block of index downside exposure right now.

A Lulu we can skip because that's a Motley Fool options position. I'm sorry. Seven of you want to hear about it. Four of you don't. That's in Motley Fool options. Please go to Motley Fool options to the Lulu board. It's a Jim Gillies positions. The three of us are not even up to speed on it, but you can get help at Motley Fool options on that one. Sorry about that.

Valmont, I actually have a report written up on Valmont. It'll go out when the time seems right. We're happy to have it on hold. Most of us do own shares now so holding it is as good as owning it. It is owning it. Don't assume that just because it's on hold it'll go back to sell. You're right, it may go to back to buy or we could move to sell it. I'm happy to keep it on hold for now until we know better. As you can imagine we're watching a lot of things in Washington along with in the industries that Valmont operates in. If the company is at a cyclical low which is very hard to estimate, but if it is, we don't want to sell too early. If it isn't, if this last quarter was kind of a head-fake and if this administration is not likely to push through progressive, maybe the wrong word, bills for infrastructure, I know republicans don't want to use the word progressive, then maybe we'll have to sell because there may not be an infrastructure bill coming. Anyway we're watching to see and meanwhile the stock is reasonably priced and we're okay holding it. There too, we might have answered soon. Things seem to be changing every day.

A question about in pro options prices. Someone have thoughts on that?

JP Bennet: I would just say the general guidelines that we use is just patience. It's pretty much what we always preach, because it really is the only way you can go about making sure that you're getting appropriate compensated for the risk that you're taking on. We have the issue in options. We have the issue in pro where we put our prices. We try and set limit guidance for everybody but there are always going to be people who aren't willing to potentially miss out on getting into a position right away by sticking to that guidance. They try and undercut by a little bit and then you end up in a situation where, "Well this guy isn't, you know, following the guidelines so I'm not gonna either." Then someone sees those and they're like, "Well, if they're not, I'm not going to either." You just get a race to the bottom. That doesn't benefit the pro member base at large. We really want to discourage that because again when you're writing options, you're taking on a risk and you want to make sure you're properly compensated for that risk. It's like insurance companies. They need to make sure that when they're underwriting policies, they're getting appropriately compensated, otherwise they go bankrupt. It really isn't a good idea to just kind of try and just throw our guidance to the wayside to make sure that you get into a position right away.

Now we try and update pricing when possible. Sometimes trades just do run away from us. It's not always just because of the volume. It could be we write puts and then the next two days, the stock pops 5% outside of an earnings release or something like that. So the puts just aren't attractive anymore. You're going to miss out on some, but that shouldn't because you know that end of the day, your core portfolio is your long position. That missing a couple options positions shouldn't really you know prevent you from achieving your financial objectives. Remember, with pro we have to wait 24 hours before we make a trade. There are times where we get a fraction of the guidance that we issue and so we are hurt by that too. That hasn't prevented us from achieving the results that we've achieved over the past couple of years. That is something to keep in mind.

I think FactSet, that's a perfect example. There have been two occasions where we issued the buy, the stock did really good and then he got hit really hard, and it basically fell back to where we issued the buy. Then it did really good and here we are back to were up only 2 or 3%. You really never can tell. Investing is a process. It is a discipline were if you don't have a long-term outlook and you're not willing to stay disciplined, if you get you a little bit itchy finger to pull the trigger and to make trades all the time, you're not going to win out. There are countless studies that demonstrate that. As individual investors, I firmly believe time horizon being able to look out those years instead of those weeks or days is the number one advantage that we have. That's essentially my long-winded answer of just saying patience.

Jeff Fischer: With that long horizon, look to catch up trades every Monday in pro. You might be talking about options too and strategies you can start and options every Friday. Then in their alerts themselves, we try to offer flexible pricing guidance so that you can approach it even later and still target the yield that were seeking with our buys. If you're buying an option or a stock, typically that has a pretty long shelf life. He did say buying options. I'm pretty sure, like you thought JP, he's talking about selling to open options.

All right, we have about 10 minutes to go, actually seven. "How many pro members are there and what do we think about the market impact to pro recommendations?" There are as many members as are in this chat, plus many more. We can't tell you, it's private. I would tell you in a second but the fool doesn't want us to.

JP Bennet: The screen would go black as you start to say the number.

Jeff Fischer: I'd get pulled off stage and that's the last you'd see of me. How do we ... The market impact is very real as JP just said. We sold GlaxoSmithKline several years ago and moved that stock lower when we sold it. That's a giant companies. There is a market impact. We're aware of it. That's why we really emphasize to use limit orders and be patient. We will still go after smaller companies like Paycom or even smaller than that if we believe the opportunity is too good to pass up. We're just going to pay a penalty to get in and get out. We will and members often will too. Hopefully as a group, we all do very well anyway. That's the bottom line. Yeah, we do have a market impact.

JP Bennet: I would just also add it probably does hurt us a lot more in terms of options. There are ideas that we would love to have in the pro port in terms of like an options idea and we just can't do it, because we know we would throw too much volume of the strike prices and the pricing would just collapse. We essentially had to stop writing puts on Live Nation, because basically, we are able to get two or three rounds in were the pricing was really favorable for us. Then market makers were like, "Yeah, no more of that." We basically had the walkway from the name in terms of writing puts.

Jeff Fischer: I will say the pro membership number and options as well is study the past many years, because that's the level that it can be at. We execute most things pretty well. We're not growing that number. That stays steady.

Let's see, in the five minutes we left, let's answer as many of these as we can, especially because there some funny ones down there. So really quick answers.

Sources that we use and recommend. We all use S&P Capital IQ which is a pay for service that's really great. Historical data and charts and screens and analytics that you can set up. That's the main thing we use for information. SCC filings are the second thing I use the most which are public to everybody. If you guys want to chip in on sources you use, otherwise we'll keep moving on forward.

Kipperstock, B.: Morningstar. I like Morningstar. Also U.S Bureau of Economic Analysis and just really primary data sources rather than opinion articles from media.

JP Bennet: I'm a big industry guy so I like to go to where I can get industry data. If I'm looking at tech company, I want to get tech data on the industry in general. There are places where you can put that out or where you can find that because there are people who are incentivized to promote their industry and to put that data out. That is another one that I think not everybody ... It's out there, but not everybody thinks about it.

Jeff Fischer: All right. "The Wall Street Journal is saying we could be in for a long losing streak due to loss of confidence in Trump being able to deliver. What is your take?" The market's definitely gone up a lot since November and some of those gains, at least, could be given back if lower taxes, big infrastructure spending do not occur or do not occur in a timely fashion even. The underlying dynamics of the economy are improving still. Earnings were strong for the most part in quarter one and are growing. That's really what will drive the market foremost that and any surprise shock to the downside even more than the administration. It's something definitely that were watching closely. We're also watching macroeconomics. You see China possibly getting stronger, emerging markets looking at a bit better. You have all sorts of things to keep an eye on and to try to project where bottom line, where earnings are going because that's what will ultimately drive stocks.

"Can we anticipate a spy hedge?" Can't make any promises. We have a large QQQ hedge that we'll want you to roll up before we consider any other hedges is my belief, rather than open another one and double your exposure. Watch for that. Billy, do you have a quick answer on Gentex here?

Kipperstock, B.: I do. I'm not sure that there is a typical crash in auto production. We have seen crashes in auto production that occurred around the 2007, 2008 financial crisis. I wouldn't say that's typical. That seemed to be a little bit unusual. I will also say that Gentex is not just the U.S. market. They sell all over the world. I think the U.S. only accounts for about a third of their sales. We're more concerned about what happens all over the world and not just the U.S. No, I do not think it's the aftermarket. I think Gentex's entire business and selling to automotive companies will be generating most of the company's business.

Jeff Fischer: Great. Bank of Internet is the top question right now. We can't speak to that. We don't follow it any longer. I closed it from Motley Fool options a few years ago. You can get opinions on it thefool.com or in other fool services if you're a member there. We just don't have one.

Broadridge, it's still a buy at pro. You could buy some shares or write some puts that are fairly near the money to target a buy at a lower price.

Kipperstock, B.: It may even be a buy first.

Jeff Fischer: Yeah, I was just about to check that and see if I got that right.

Kipperstock, B.: I think it is.

Jeff Fischer: You're right. It's a buy first. It's been a buy first for a long time as well. With that endorsement, consider buying some shares or writing puts right near the money. Let's see. Let's see. Let's see.

Provide more specific for, this is a suggestion that we'll listen to and talk about off camera from [Moores 00:54:44] Time Sensitive Timing Pricing Guidance. Polaris is not in the pro portfolio. It's not in this universe so I think we'll pass on that one. We talked about the president a little bit.

Factset, we talked about at the top of the hour. The long-term thesis there is the same. The company's just seeing some headwinds even as it is growing.

GameStop is a Motley Fool options, Jim Gillies position. Please go to Motley Fool options and the GameStop board there, GME at Motley Fool options and post your question there. Sorry, but that's where it is.

Let's see. We talk about QQQ quite a bit. We'll cross that bridge with our hedges when we get there. If the market correction does happen, we'll have to see where the options prices are respectively on our long and short puts on that index. Anything else that you guys see that you want to answer in our last minutes?

JP Bennet: You could jump down to the GoGo question. I think that would probably be a pretty descent one to-

Jeff Fischer: And fully offer FactSet? Yeah, you can write put options around 160 right now on on FactSet.

GoGo, that's a ... A hold incurs short fees, that's true. But a hold is as good as being short, of course. Rather than view it as a "We don't know." It's a don't initiate the position if you're new to it. As long as were still holding it, we're happy to do so. GoGo has fallen from about 12 to below 11 lately on laptops being disallowed on certain flights from certain countries is, I think, what drove that lower. There's a possibility that that ruling could spread. Right now, we're happy to hold it. We're also looking for other shorts before we close some of our shorts as long as we still like the shorts that we have.

It's a hedge against the market falling as well. Meanwhile it hasn't treated us badly in a rising market all that much. I'm trying to read all these questions and that's about all the time we have for. "What happened to JP's hair?"

Kipperstock, B.: "What happened to JP's hair."

JP Bennet: I though we were going to skip that one?

Jeff Fischer: That's one we have to get to in last minute. We're actually overtime now. JP, you're hair looks great. Did you cut it?

JP Bennet: No, nothing different has happened. I actually need to go get it cut again.

Jeff Fischer: You have to take off the earphones and show us. Can you ruffle it up?

JP Bennet: I think we're okay. Let's keep it professional Jeff.

Jeff Fischer: All right. Billy, the desk. Do you rent that desk for your chats?

Kipperstock, B.: Yeah, this room is normally just completely empty and I rent these just for the chats and that tree behind me is fake.

Jeff Fischer: Excellent. All right. What's the ring? You just put that there to pretend that you exercise?

Kipperstock, B.: Yeah, that ring thing, it is for dips and for push-ups but I never use it.

Jeff Fischer: All right. Someone's asking about Verizon, a recent Motley Fool options covered call position that Billy wrote up. Buy a hundred shares and then write covered calls as quickly as possible. Ideally you would do a buy write order were you buy the stock and at the same time sell the covered calls. With Ellen out sick, we just keep this chat going to see.

JP Bennet: Nobody could tell us to stop.

Jeff Fischer: Anne is behind the glass like, "Hey, stop." Thank you and Henry for hosting the electronic portion of this chat, making it happen. Thank you Motley Fool pro members for being here and asking your questions. I hope we provided satisfactory answers to as many as we could. Thank you Billy, down in Florida.

Kipperstock, B.: You're welcome. Thank you. A pleasure to be here.

Jeff Fischer: Good to see you. Thank you. JP as always, great to see you.

JP Bennet: See you next time.

Jeff Fischer: Thank you fools. Fool on and we'll see you soon.

JP Bennet: Fool on.

Gentex Reflects on a Strong 2016

Published Mar 8, 2017 at 1:20PM

***Pro*'s Take: GNTX Q4- and FY-2016 Earnings**

Gentex (NASDAQ: GNTX)

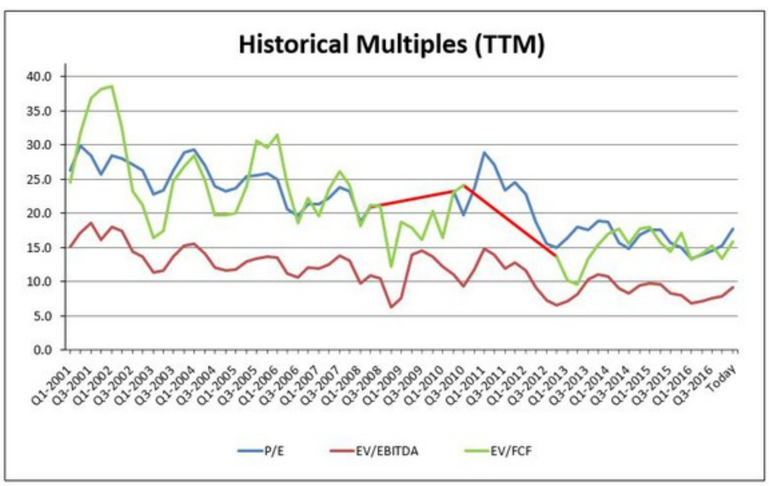
What Happened?

- Q4-2016 press release
- 2016 10-K

Guidance Update

After incorporating this quarter's results into my valuation model, **our Fair Value increases to $20 per share.** Since November 9th, the day after the U.S. presidential election, the stock is up more than 27%, as investor sentiment in the manufacturing sector has improved. Although Gentex is now trading near all-time high stock price levels (and above our FV estimate by about 7%), business performance is certainly strong enough to justify the newly higher stock price. **The stock remains a Buy on our scorecard**, and in the absence of a major global economic slowdown, the stock should be able to earn North Star-like returns from the current price.

At about 17.7 times trailing-12-month earnings and 9.2 times EV/EBITDA, given the recent stock price increase, the stock is now trading above the valuation levels we saw in late 2015 and throughout 2016. The stock is not as much of a bargain as it was during those periods, but the stock is still well within its historical valuation range and the business is as strong as ever. If you've yet to start a position or fill out your allocation in Gentex, you can feel comfortable doing so at current prices.



Note: Red lines represent omitted outlier multiples that correspond to recession-depressed earnings and free cash flow levels.

Additionally, since the last earnings update on Gentex, our December 2016 $17.50 written puts expired fully as income. We will patiently consider reinitiating our written put strategy, depending on whether we are able to achieve favorable pricing.

Updated Guidance: Buy (no change)

Recommended Allocation: 3.4%

Fair-Value Estimate: $20 (up from $19)

Current Price: $21.38

Our Thesis

Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1) Penetration: Unit growth vs. auto production. Over time, we want to see Gentex's auto-dimming mirrors to continue to gain market share. If the company is increasing units sold faster than auto production, it is moving in the right direction. In 2016, global interior mirror unit volumes grew at +10.6% year-over-year (vs. +10.8% in 2015). This compares to ~1% year-over-year growth in auto production in the company's primary markets, showing that Gentex continues to significantly outpace vehicle production growth and capture market share. Interior units sold in North America in 2016 decelerated slightly to +4.8% growth (from +5.4% in 2015) and international interior units sold in 2016 accelerated to +17% growth (up from +14% in 2015).

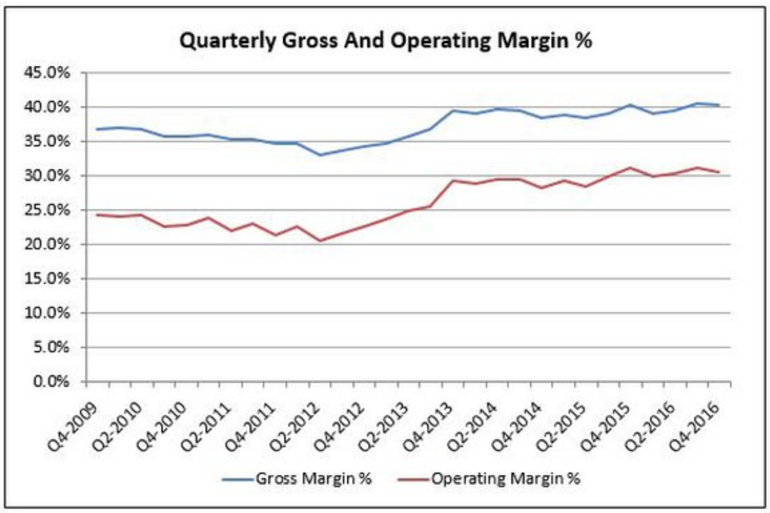
Exterior mirror unit shipments took a breather after a scorching 2015, with 2016 exterior unit volumes up +10% in North America (vs. +37% in 2015) and +6% internationally (vs. +14% in 2015). Due to lower exterior unit growth relative to interior unit growth, the exterior mirror attach rate declined to 38.7% (i.e. 38.7% of cars equipped with interior units also were equipped with exterior units), compared with 40.3% a year ago. Exterior unit growth going forward should be more moderate than 2015 levels, and we expect mid to high single-digit growth for exterior mirrors over the next few years.

2) Pricing and value: Unit growth vs. automotive segment sales. Powerful auto makers force annual price concessions on their suppliers, and Gentex isn't immune. Price reductions have recently been in the range of 2.5% to 3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices (ASPs) and gross margins.

In 2016, total units (interior + exterior mirrors) increased +9.4% and automotive segment sales were up +8.8%. This dynamic suggests lower ARPU (average revenue per unit) and is consistent with the expectation of annual price concessions.

3) Margin performance. In 2016, gross margin was 39.8%, up from 38.1% in 2015 as annual price reductions were more than offset by purchasing cost reductions and the positive impact of strong advanced feature product shipments. Management's gross margin guidance for 2017 is 39%-40%, which implies a slight decline in gross margin in 2017. I suspect that management is being conservative with their guidance and that margins may even expand in 2017 if unit shipments continue at current levels.

2016 operating margin performance was 30.5% (vs. 29.7% in 2015). Selling, general, and administrative (SG&A) and research and development (R&D) expenses came in within normal ranges and are consistent with recent trends. Given current trends in auto product and unit shipments, Gentex should be able to expand operating margins over time as revenue growth continues to outpace SG&A and R&D expense growth:



What We Think Now

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

If you have questions, drive on over to the Gentex discussion board.

Touching Base on 9 Pro Names

Published Mar 6, 2017 at 3:59PM

Dear *Pro* Fools,

Over these past many weeks, my desk at home has been covered in printouts of a few dozen conference calls, SEC filings, and press releases -- and no computer. I find the best way to read calls and filings is offline, in print, taking notes along the way. The annual report is the biggest and most time-consuming of the documents, both for our companies and for us.

Last month, I reviewed five companies in one Memo; last week, JP went through four more. Today, I'll share our thinking on some positions that are challenging us (some of which are on hold). There's one caveat: The *Pro* team is meeting often right now to discuss positions and consider moves in the portfolio, so this is a work in progress. And of course, in a portfolio, one decision can affect others. With that out of the way, here's where we are.

AmTrust Financial Services (NASDAQ: AFSI) moves from Hold back to Buy today, with an allocation of 4.1%. If you don't own shares yet, you could start with half that position and plan to add the rest later this year. Or you could write put options at a $22.50 strike or lower. Don't over-allocate. I wrote about AmTrust last week in a productive exchange with members on its discussion board. The business is seeing higher costs via acquisitions, and in 2016 it hired a new auditor, KPMG, that found internal weaknesses in AmTrust's controls and reporting that its former auditor had missed. The weaknesses will be remediated this year. The market rightly fears such revelations, but I appreciate AmTrust's transparency and its steps to improve. The company's underwriting isn't in question, and its results won't change materially.

Now larger than ever, AmTrust needs to continue to hire more staff to get its controls and reporting to KPMG's standards. Predictably, class action lawsuits are surfacing to capitalize on the fallen stock, and AmTrust is vulnerable to these claims, but that doesn't derail our investment thesis. We'll need patience (and a dollop of extra trust), but I believe AmTrust is striving for excellence as it grows bigger, and long-term rewards should follow given a long history of value creation and growth. The stock yields 3% now.

Gilead Sciences (NASDAQ: GILD) remains on hold a bit longer, with our 2.3% position now yielding 2.9%. We've talked about Gilead in all of our live events over the past quarter. It's an interesting situation: Outstanding business and management, strong free cash flow, a core "legacy" business focused on HIV, and a giant new Hepatitis C cure that ballooned revenue but is now tapering down. Barring a large acquisition, Gilead's earnings may not increase again for several years. The stock trades at about 8.5 times the average earnings estimate for this year. So, you have a top name in biotech at a depressed price. This sort of situation usually resolves itself when the share price resolves to a more reasonable valuation. But when will that happen here? It's possible Gilead's earnings will come close to bottoming out this year. If so, the stock could, too, after which we'd see those better returns. It's impossible to predict the Hep C market with confidence in the coming years, so we're working on making a decision based on probability and optionality (do we like other ideas better?).

We put our 0.5% short position on **GoGo** (NASDAQ: GOGO) on hold last week after the company's quarterly loss came paired with the announcement that management expects to be cash-flow positive in 2019 rather than 2020. The company's new 2Ku satellite Internet for airplanes is seeing rising demand. Gogo expects to add 2Ku to 450 to 550 aircraft in 2017, up from the 350 to 450 earlier projected. And it has agreements (which can be broken, but ...) to add 650 to 750 planes in 2018, also up by 100. Costs should come down in 2018, too, as investments in new technology slow. We went into the Gogo short with a short initial time frame (one to two quarters) knowing the company had a lot riding on 2Ku. It was going to be make or break, basically, given Gogo's expensive debt, growing competition, and lack of a plan B. That airlines are agreeing to adopt 2Ku is the first blow to our short thesis, and it may be enough to make us move on. The position is on hold as we consider our next step. The company still has $800 million in expensive debt and paid $82 million in interest expense last year, en route to losing $124 million.

O'Reilly Automotive (NASDAQ: ORLY) moved to Hold at our 4.8% allocation as we work to assess the long-term risk from the likes of **Amazon.com** (NASDAQ: AMZN). Management itself is surprised by investor concern on the matter, seeing little to no effect so far and arguing extensively in the conference call that their business is about relationships and real-time expertise. When something is wrong with your car, you often don't even know the part you need. You need someone to talk to, someone to test your car (which O'Reilly does), and someone to tell you the parts you need. And then you want the part at that moment. Currently, management doesn't believe their business model is at risk, but we want more comfort. We're seeking more research on how -- and whether -- shoppers are evolving when it comes to buying auto parts. Meanwhile, the business continues to grow, with about 190 more stores planned this year, and margins are ticking higher. The stock is priced at about 21 times 2017 earnings estimates, as low as it has been in years. We're content to hold while we assess.

Powershares QQQ Trust (NASDAQ: QQQ): This is just an update that we hope to correct our put ratio spread to January 2018 (from a mistakenly enacted 2019) soon -- the mechanics of the switch are taking time with the Fool -- and we'll tell you when we do and what strike prices we chose. Those already in the position can sit tight.

Shake Shack (NYSE: SHAK), which we're short 0.5%, is down 13% over the past week after results failed to inspire. Same-store sales growth of 1.6% (thanks to a 3% price increase offsetting a 1.4% traffic decline), with guidance for 2% to 3% this year, wasn't enough for a stock trading above 60 times earnings. With fewer than 100 company-owned domestic locations, the Shack has plenty of room to grow, and management does plan to add 22 or 23 owned stores this year, but shares still look dear. Plus, keeping traffic flowing in a highly competitive environment isn't easy. Add higher labor costs this year and next, and any other headwind to arise could make future results look stale. The biggest risk to our short right now -- as I see it -- is the chance for lower taxes. Shake Shack expects to pay a 40% to 41% effective tax rate this year. The company is well-managed, so if laws bring that down substantially, the stock could enjoy a run. As ever, the hope with our short is that the market reprices the stock to a more reasonable level, about $24. That would still represent 25.2 times expected earnings ... in 2020. If not that, we'd want to see same-store sales turn red, which would likely hit the stock hard. But with shorts, timing is important. We'll see if either happens for us. The stock is still a short, and we're in the green on it even though the market as a whole has soared since November.

SPDR S&P 500 (NYSEMKT: SPY): Many members have been asking if we'll set up more put ratio spreads on SPY. We may before long, and if we do, they'll be shorter-term in nature, expiring in just months as a hedge against downdrafts. Fewer people are seeking to travel to the U.S. so far this year, which could be the first step toward less money velocity and slower growth. Are fewer citizens looking to travel around the U.S., too? These are among several other uncertainties.

TD Ameritrade (NASDAQ: AMTD): We've moved the stock to Hold as we consider last week's news of lower commissions. TDA lowered the cost of a standard stock trade to $6.95 last week, down from $9.95, after competitors Schwab and Fidelity went even lower. TD Ameritrade makes about 40% of its revenue from commissions, so this is a serious change to analyze and get back to you about.

Valmont Industries (NYSE: VMI) is on hold while we consider results that were an improvement on last year's, but still leave the stock looking a bit expensive at 20 times earnings. The market is betting on a cyclical low, but we don't yet have confidence that irrigation and infrastructure spending is about to resume healthy growth for the long term. We're weighing the 2.2% we have in stock against other opportunities (including holding more cash). You'll hear from us once we decide.

A final reminder: We have two overarching goals. We don't want to lose money over any rolling three-year period, and we want to at least double our real purchasing power every 10 years. Those goals are captured in our North Star measure (inflation plus 7% a year), which guides our long-term decisions. Most hedges and shorts aside, we like to think in terms of rolling three-year terms. Ask any questions on the Memo Musings board. We aim to have some portfolio decisions for you soon. Fool on!

— Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: March 6, 2017

Published Mar 6, 2017 at 3:16PM

Pro Guidance Changes (from the past two weeks)

- **AmTrust Financial** (NASDAQ: AFSI): Moves back to Buy at a 4.1% position. See today's Memo for more!
- **Apple** (NASDAQ: AAPL): Fair-value estimate increases to $128. It remains a buy at a 4.4% allocation.
- **Domino's Pizza** (NYSE: DPZ): Our short moves to Hold as we assess results and our paired trade with Papa John's.
- **Gogo** (NASDAQ: GOGO): The short moves to Hold as we reconsider the position after stronger guidance. See today's Memo for more.
- **TD Ameritrade** (NASDAQ: AMTD): Moves to Hold as we consider the new, lower commission schedule it offers. Fair-value estimate decreases to $36.
- **Valmont** (NYSE: VMI): On hold as we assess results and valuation.
- **Verisign** (NASDAQ: VRSN): Fair-value estimate increases to $85. Our covered strangle is set to expire next month and we plan on continuing the strategy, prices willing.
- **Verisk** (NASDAQ: VRSK): Fair-value estimate increases to $83. It remains a buy at a 2.1% allocation.
- **Visa** (NYSE: V): Moves to Buy First (from Buy) at a 2.5% allocation.

Pro Completed Trades (from the past two weeks)

- **Johnson & Johnson** (NYSE: JNJ): As per our recent alert, we bought shares of the company at an average price of $121.75.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: March 6, 2017

Published Mar 6, 2017 at 3:02PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.6%.
- **Visa** (NYSE: V): Buy 2.5%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **AmTrust Financial** (NASDAQ: AFSI): Buy up to 4.1% (or buy in halves over time, given today's volatility).
- **Johnson & Johnson** (NYSE: JNJ): Buy 3.1%.
- **Verisign** (NASDAQ: VRSN): Buy 1.5% (to strangle later).

Shorts:

- N/A

Pro options:

- **AmTrust Financial**: If you lack a 4.1% stake and want to build toward it but target a lower buy price, sell to open April 2017 $22.50 puts, lately for $0.95, or a 4.2% yield in 46 days. Be ready to buy shares, which trade near $22.50 today. Sell one put for every 100 shares you would buy.
- **FactSet Research Systems** (NYSE: FDS): April 2017 $170 puts lately pay $3, or 1.7%, in 46 days. Write one put for every $17,000 in stock you could buy. We have a 2.1% allocation.
- **Paycom Software** (NYSE: PAYC): Missed it so far? Consider selling to open May 2017 $52.50 puts, lately $2.25, for a 4.2% yield in 74 days. Write one put for every 100 shares you could buy at $5,250. We have a 2.6% allocation.

Hedges:

- N/A

Upcoming expirations (March 17):

- **Verisign**: Our $80/$85 covered strangle expires this month, currently with both legs on track to expire as full income. We'll look to continue the strategy with a new alert as this happens.

Papa John's Closes a Solid 2016; Domino's Short Moves to Hold

Published Mar 3, 2017 at 10:52AM

Pro's Take: PZZA Q4 and FY-2016 Earnings

Papa John's International (NASDAQ: PZZA)

....

Q4-2016

Total revenue growth: +5.5% (vs. -2% in Q4-2015)

Operating profit margin: 9.4% (vs. 9.7% in Q4-2015)

Adjusted EPS growth: +11.3% (vs. +19.2% in Q4-2015)

Domestic comparable store sales: +3.8% (vs. +1.9% in Q4-2015)

International comparable store sales: +5.6% (vs. +5.3% in Q4-2015)

FY-2016

Total revenue growth: +4.7% (vs. +2.5% in FY-2015)

Operating profit margin: 9% (vs. 8.3% in FY-2015)

Adjusted EPS growth: +22% (vs. +19.4% in FY-2015)

Net new restaurant unit growth: +204 (+4.2%, vs. +230 and 4.9% in FY-2015)

Domestic comparable store sales: +3.5% (vs. +4.2% in FY-2015)

International comparable store sales: +6% (vs. +6.9% in FY-2015)

....

Quarter Quick Take

Papa John's turned in a solid fiscal year in 2016. Papa John's delivered growth of 22% in non-GAAP earnings-per-share due to higher global restaurant sales growth (+5.2%), expanding operating margins (9% in FY-2016 vs. 8.3% in FY-2015) and continued share buybacks (the company reduced its diluted share count by 5.2% in 2016).

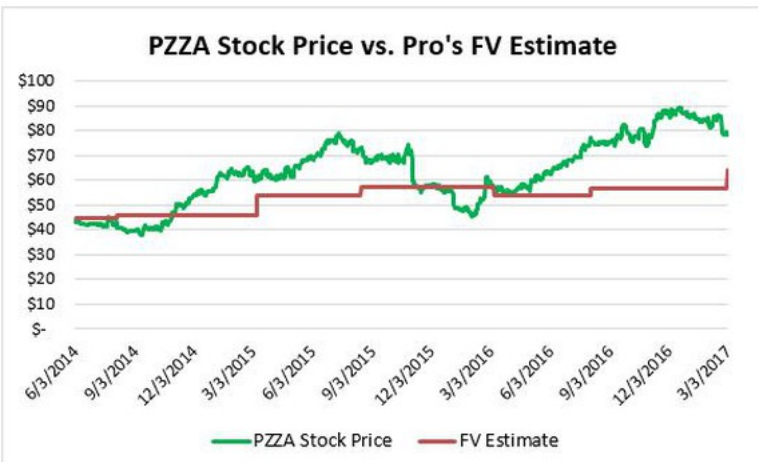
2016 was another example of the formula that Papa John's has successfully used to grow its earnings-per-share at a 5-year compound annual growth rate (CAGR) of +20% since the end of 2011:

	FY-2011	FY-2012	FY-2013	FY-2014	FY-2015	FY-2016
Net Revenue Growth	8.1%	10.2%	7.2%	11.1%	2.5%	4.7%
Global Restaurant Sales Growth*	7.7%	10.6%	6.2%	9.8%	5.3%	5.2%
Operating Margin %	7.1%	7.4%	7.4%	7.4%	8.3%	9.0%
Yearly Reduction in Share Count	4.3%	5.2%	7.1%	5.8%	6.2%	5.2%
EPS Growth**	12.2%	17.9%	18.8%	13.4%	19.4%	22.0%

*This metric includes both comparable store sales growth and net restaurant unit growth

**FY-2015 EPS growth is adjusted for legal settlement expenses and FY-2016 is adjusted for refranchising gains, impairment losses on assets held for sale, and legal settlement expenses.

After accounting for 2016 results and updating our valuation model, **we're raising our fair-value estimate to $64 per share (up from $57).** As I write this, the stock is trading around $78 per share, nearly 22% above our newly updated fair value estimate. However, Papa John's has often traded well above our fair value estimate over the life of the position, as business performance has consistently outperformed our (conservative) business assumptions. Since mid-2014, the average premium of Papa John's stock price to our fair value estimate has been 18%:



The current 22% premium to our newly updated fair value estimate is the narrowest gap since June 2016, suggesting the stock is now more reasonably priced than it has been over the past 9 months or so. **The stock remains a Buy**, but keep in mind that Papa John's is one of the more volatile stocks on the Pro scorecard. If you're comfortable with volatility, you can establish a full allocation to Papa John's today. The stock may continue to do well from current levels, but high expectations mean that the stock price can deflate quickly if performance disappoints. If you prefer to be more conservative, you can consider buying a half-position or writing puts to target a lower buy price.

Pro's current position is a 3.4% long stock allocation to Papa John's, combined with a 2.4% short position in competitor Domino's (NYSE: DPZ). We have also written June 2017 $140 covered puts on our Domino's short position for income and to potentially close our short at lower prices. **We are moving the Domino's short position (and the covered puts) to Hold today to reassess whether we want to maintain our paired long/short position.** You can expect a follow-up article (and/or alert, depending on our course of action) on Domino's sometime in the near future.

To be clear, those who have not established a Papa John's position can buy shares at a 3.4% allocation, and those who have not established a Domino's short position should **not** short shares of Domino's today, as the position is moving to Hold. If you are currently short shares of Domino's, leave that position alone until we have decided whether we want to keep the short/covered put position going or close it altogether.

Guidance: Buy (no change)

Recommended Allocation: 3.4%

Fair Value estimate: $64 (up from $57)

Current Price: $78

Our Thesis

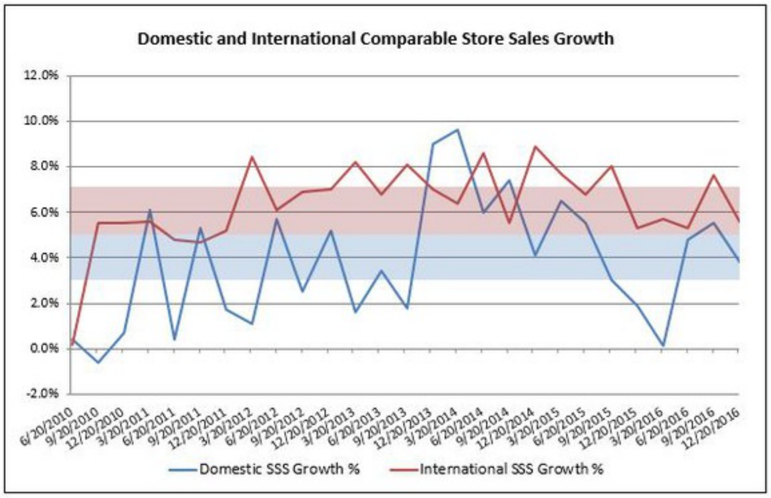
Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main quick service restaurant (QSR) pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only about 1,600 international restaurants the company has a long runway for growth (compare to Domino's which has over 8,400 international stores and Pizza Hut which has over 8,400 international stores). Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

1) Store Performance*:* During Q4-2016, systemwide restaurant sales increased +5.3% (+7% when excluding the impact of foreign currency). Domestic comps increased +3.8% while international comps increased +5.6%.

Domestic comps growth decelerated a bit this quarter as an "extremely aggressive" pricing environment has continued to challenged Papa John's "quality first" brand positioning. For a company that relies on a higher-quality brand message, aggressive pricing from competitors puts the company in a difficult position in terms of increasing comps. Nonetheless, for full year 2016, the company achieved +3.5% domestic comps growth, at the high end of the company's initial guidance of 2%-4% that was set out in Q4-2015. Management's guidance for 2017 is again for 2%-4% domestic comps growth, in line with last year's guidance.

As for international comps, the company continues to churn out mid-to-high single digit comps performance. At +5.6% for the quarter, this marks the 21st consecutive quarter of international comps above +5%:



**Shaded areas represent management's guidance ranges for full year 2016*

The company's measured expansion continued, adding 126 new restaurants (net) in the quarter and 204 for the full year -- of which 151 were international and 53 were in North America. The company now has over 1,600 international stores (up from 822 at the end of 2011, a 15% CAGR in units).

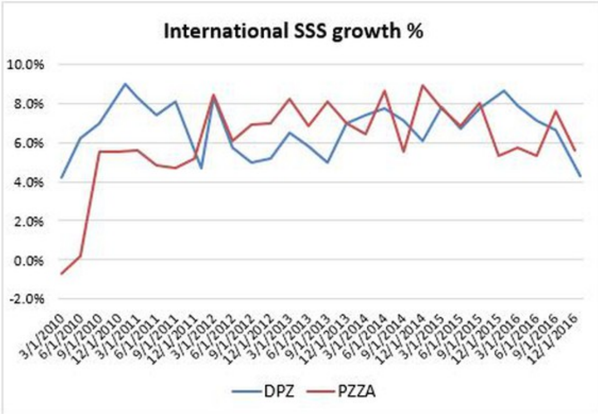
Management expects full year 2017 openings to come in at about 200-250 restaurants, with 75-80% of the net unit growth in international markets. 225 restaurant openings for 2017 would represent +4.4% growth versus the existing store count as of the end of 2016. The company's pipeline remains healthy, with 220 domestic restaurants and 1080 international restaurants, the majority of which are scheduled to be opened over the next six years.

2) Brand: Brand strength is challenging to measure, but we need to monitor it because it is key to the company's brand-based advantages and higher price per pie. Based on recent data, the domestic pizza market grew about 3-4%. So Papa John's 2016 domestic comps of +3.8% suggest that the company maintained market share. On the other hand, Domino's posted 2016 domestic comps of +10.5%, suggesting that Domino's captured market share in 2016 relative to Papa John's.

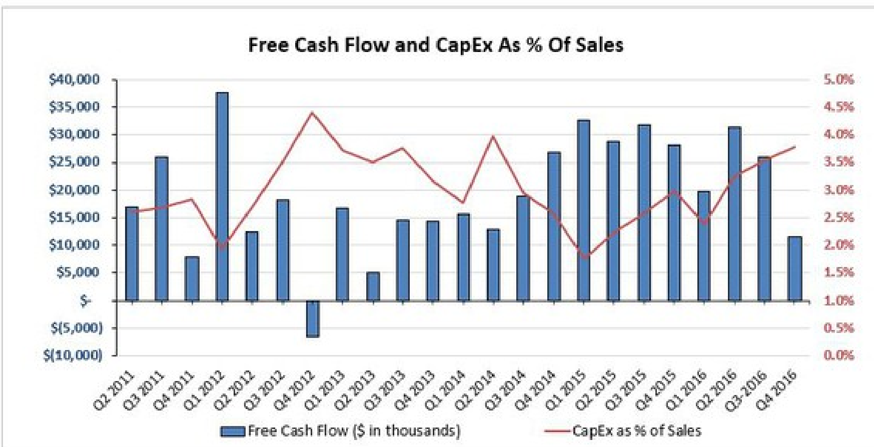
Over the past two years, Domino's has demonstrated excellent operational momentum. Domino's is much more willing to compete on price than Papa John's, which likely helped it earn share during the past two years of lower commodity prices and aggressive pricing. Comps have some cyclicality to them, and Domino's itself doesn't expect the double-digit comps to continue, mentioning that their long-term guidance is 3%-6% domestically, similar to Papa John's guidance range of 2%-4% (an example of how Papa John's tends to err on the conservative side).

But there's no denying that Domino's is on a roll domestically. Domino's is more aggressive strategically than Papa John's, which can lead to higher growth when the company executes well. But it also exposes the company to more potential operational missteps and volatility, which is something that Papa John's has largely avoided over the last several years:

The competition is much closer internationally, where most of future growth will occur. Both Papa John's and Domino's international comps performance suggest that the pizza concept and the two companies' technology advantages and expansion strategies are translating in the higher-growth overseas markets:



3) Margins: We expect Papa John's capital light business model to result in growing operating margins that propels free cash flow generation. In Fiscal 2013-2014, Papa John's dealt with depressed margins and free cash flow due to the roll-out of the company's proprietary POS system (FOCUS). In Fiscal 2015, the company enjoyed higher margins and free cash flow generation, as favorable changes in working capital (related to lower FOCUS inventory levels) and lower capital expenditures lifted free cash flow much higher. In 2016, capital expenditures increased by $16.6 million over 2015 levels due to construction costs for a new domestic commissary in Georgia (which will open in 2017), and investments in the company's online and mobile ordering business. In the graph below, note the inverse relationship between capital expenditures and free cash flow. When capital expenditures are elevated, free cash flow is depressed, and vice versa:



Free cash flow for Fiscal 2016 came in at $88.5 million, down -27% compared to Fiscal 2015 ($121.3 million). Last year, I noted that "free cash flow will likely decrease a bit in 2016 as the company paid the legal settlement in January (in Q1-2016), and the company expects a year of somewhat elevated capital spending (guidance is for $55-$60 million in capital expenditures, up from $39 million in 2015)".

That's exactly what we got this year with the legal settlement reducing free cash flow by $11.6 million, and capital expenditures coming in at $55.5 million for the year. Additionally, changes in working capital items added about $7.7 million to cash flow last year, and unfavorable changes in working capital detracted about $21.3 million from cash flow this year. If we adjust this year's free cash flow figure for the legal settlement payment, and normalize capital expenditures and working capital across 2015 and 2016, free cash flow would have increased this year by about 21%.

In Fiscal 2017, free cash flow should increase as margin expansion continues, capital expenditures slow a bit (2017 guidance is for $45-$55 million), and the ~$11.6 million legal settlement payment is lapped.

What We Think Now

Franchising is a good, capital-light business and we think the Papa John's brand is translating well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. As the Papa John's franchise system continues to add new units (mostly internationally, where about 75-80% of unit growth occurs), the high-margin franchise royalty revenue stream will grow, and Papa John's should continue to deliver improved financial performance.

Pro Can Help

- **Questions?** Stop by our delicious, savory Papa John's discussion board.

Earnings From 4 Pro Holdings

Published Feb 27, 2017 at 3:56PM

Fellow Fools,

Pro's earning season is rapidly coming to a close, so today I'm going to piggyback on Jeff's recent Memo and provide you with updated thoughts on four additional *Pro* companies.

Apple (NASDAQ: AAPL)

It never ceases to amaze me how far sentiment can swing for the largest publicly traded U.S. company. "Apple is finally finished" talk was all the rage less than a year ago, but the company's solid first-quarter results and upcoming 10th anniversary iPhone "super-cycle" have it in Mr. Market's good graces once again.

iPhone unit sales returned to growth after a few consecutive quarters of decline, and by my estimate, Services revenue growth came in at more than 20% after adjusting for one-time items and an extra week in this quarter. I view services to be more of an extension of the iPhone than a separate business unit, and I still believe that combined, the two can grow in the high single digits for the foreseeable future. Management's goal of doubling revenue from services by 2020 seems very likely, and I believe this will boost Apple's already enviable margins even higher. And let's not forget that the company will likely be one of the biggest beneficiaries of any tax reform, given that 94% of its $246 billion in cash is currently located outside the United States. We're increasing our fair-value estimate up to $128.

Starbucks (NASDAQ: SBUX)

Of the four, the only stock not receiving a fair-value increase today is Starbucks. The company occupies what I would consider a precarious position at the intersection of the restaurant industry and brick-and-mortar retail. Multiple analysts have questioned whether we're currently in bubble territory with the former, while the latter is pretty widely acknowledged as an absolute mess. Starbucks may be the best of its breed (and it may not fit neatly into either category), but that doesn't mean it's immune to macro and industry headwinds. And it's having trouble meeting demand with the rapid adoption of Mobile Order and Pay, which is admittedly somewhat ironic given that management initially predicted an immediate *increase* in store productivity. That said, my concern here doesn't stem from these short-term bumps, although I do think they provide insight into some questions around our thesis as a whole. Instead, my ongoing deep dive into Starbucks has so far left me more cautious about the long term than in the past.

To derive a fair-value estimate for a restaurant chain, you need an educated opinion on the number of stores the company will ultimately be able to open, as well as the unit economics. With respect to the former, I don't believe Starbucks is close to market saturation. Starbucks caters to habitual purchases born out of convenience and consistency, which is why its drive-thru locations continue to see massive success (and why management touts the number of those drive-thru locations even though this contradicts the claim that Starbucks' success is based on its role as a "third place"). In fact, first-year unit economics for stores with a drive-thru dwarf typical results from those without.

However, I'm not entirely convinced that the company will be able to achieve its aggressive 2021 U.S. store-count target, something I believe the market is currently pricing into shares given their premium valuation. I also believe the market is extrapolating forward the improvement in store economics that we've seen over the past few years, and I'm actually quite skeptical about that. I'll be back before too long to report the final conclusions from my venti deep dive in another Memo.

Verisign (NASDAQ: VRSN)

Verisign is in the business of handling .com and .net domains on the Internet. Heading into the fourth quarter, the big question on most of its investors' minds was, what would happen to the large number of pending first-time renewals for those domains registered to Chinese speculators? Although the renewal rate for this cohort continues to lag the company's overall portfolio as well as first-year clients in general, the size of the decline (1.9 million) was around what most were expecting given management's prior commentary.

Although a sizable number of these domains remain up for renewal in the first quarter, so far .com has made meaningful strides in recouping last quarter's losses (I estimate that its base has grown by about 80 basis points), though the much smaller .net is still struggling somewhat. The company repurchased another 2 million shares in the fourth quarter to go along with the 5.7 million it had already retired in 2016. For those keeping track, the 7.8 million shares repurchased represent a 6% decrease in the share count in 2016. These are exactly the type of results we were looking for when we set up our covered strangle, and with our options expiring next month, we'll definitely be looking to keep the strategy going. We're slightly increasing our fair-value estimate, to $85.

Verisk (NASDAQ: VRSK)

Fourth-quarter results were a bit of a mixed bag for our data-analytics darling, Verisk. Its 2015 acquisition of WoodMac, which provides data services in the energy space, continues to hold up better than many have anticipated given the extended weakness in that market. And Verisk's financial-services offerings continue to deliver strong revenue growth. But the organic growth rate for Verisk's insurance products, its largest end market, continues to trend in the mid-single digits, thanks in large part to macro headwinds.

Over the past year, we've also seen the cadence of insurance-related acquisitions pick up, and although I think this is largely Verisk being opportunistic, I do believe it's driven in part by increased competition in the space. Although most of Verisk's big catalysts (e.g., WoodMac returning to 10%-plus revenue growth, meaningful contributions from new insurance products) won't materialize in the immediate future, we believe that investors who mirror management's long-term mindset will ultimately be pleased with the performance of the stock. Verisk also gets a slight valuation bump, this time to $83.

Enjoy your week, Fools!

-- JP (TMFYossarian)

Pro Guidance Changes and Completed Trades: Feb. 27, 2017

Published Feb 27, 2017 at 3:54PM

Pro Guidance Changes (from the past two weeks)

- **AmTrust** (NASDAQ: AFSI): Moves to Hold as we assess the company's recent earnings release.
- **Apple** (NASDAQ: AAPL): Fair-value estimate increases to $128. It remains a buy at a 4.4% allocation.
- **Valmont** (NYSE: VMI): Moves to Hold (from Buy) as Jeremy (TMFTank) leaves *Pro* and we reassess the company.
- **Verisign** (NASDAQ: VRSN): Fair-value estimate increases to $85. Our covered strangle is set to expire next month and we plan on continuing the strategy, prices willing.
- **Verisk** (NASDAQ: VRSK): Fair-value estimate increases to $83. It remains a buy at a 2.1% allocation.
- **Visa** (NYSE: V): Moves to Buy First (from Buy) at a 2.5% allocation.

Pro Completed Trades (from the past two weeks)

- **Johnson & Johnson** (NYSE: JNJ): As per our recent alert, we bought shares of the company at an average price of $121.75.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Feb. 27, 2017

Published Feb 27, 2017 at 3:31PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.5%.
- **Visa** (NYSE: V): Buy 2.5%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **Apple** (NASDAQ: AAPL): Buy 4.3%.
- **Broadridge** (NYSE: BR): Buy 5.1%.
- **MasterCard** (NYSE: MA): Buy 4.7%
- **TD Ameritrade** (NASDAQ: AMTD): Buy 3.1%.

Shorts:

- **CurrencyShares Euro Trust** (NYSEMKT: FXE): Sell short 1.6%.

Pro options:

- If you want to attempt to buy any of our stocks lower, you can write (sell to open) near-the-money put options on shares of **Paycom** (NYSE: PAYC), among others. Choose puts that pay you enough to be happy. Realize all these stocks are rated Buy.
- Our **Verisign** (NASDAQ: VRSN) covered strangle is quickly headed toward expiration March 17, with both legs currently out of the money. We have every intention of continuing this strategy as long as pricing is favorable.

Hedges:

- No update this week.

Upcoming expirations:

- As noted above, our covered strangle on Verisign is set to expire March 17; we'll update you before that date.

Buy Johnson & Johnson

Published Feb 22, 2017 at 2:46PM

Is this for you? This recommendation is for all *Pro* members who don't already own shares in this company.

How You Participate

- **Action:** Invest 3% of your portfolio in **Johnson & Johnson** (NYSE: JNJ).
- **Price Guidance:** Use a limit order to buy at going prices, lately about $120 per share.
- **Recent Price:** $119.54
- **Guidance:** Buy
- **Fair-Value Estimate:** $118

The Business

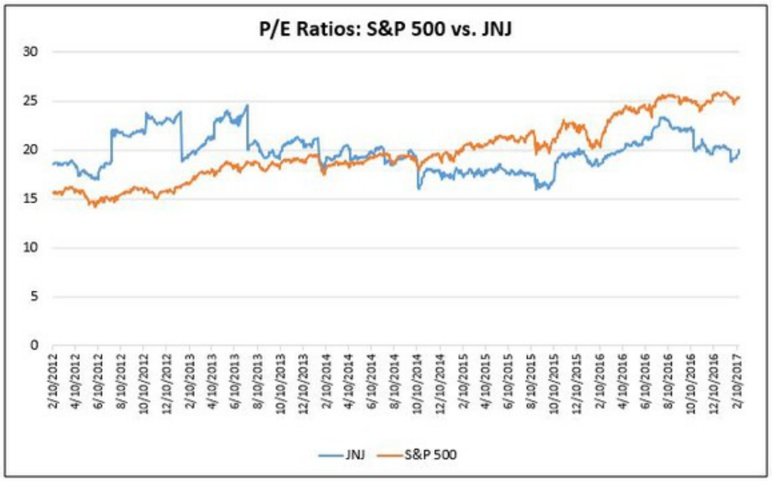
Incorporated in 1887, **Johnson & Johnson** (NYSE: JNJ) is an elder statesman on Wall Street -- especially compared with our other recent buy, **Amazon.com** (NASDAQ: AMZN). The eighth largest company in the U.S. by market cap, J&J is one of the world's leading health-care companies, conducting business in virtually every nation of the globe.

The business is organized as a holding company, with more than 250 operating companies that are separated into three business segments: consumer (19% of 2016 sales), pharmaceutical (46%), and medical devices (35%). The consumer segment sells dozens of familiar brands (think Band-Aid and Listerine). The pharmaceutical business is the company's largest; in fact, J&J is the world's sixth largest pharmaceutical company by annual sales. And the medical devices segment includes a broad range of products used in the orthopedic, surgery, cardiovascular, diabetes-care, and vision-care fields.

Financials and Valuation

For such a large company, J&J has an outstanding financial profile (which provides evidence for the company's competitive advantages). Free cash flow margins historically bounce around 20%, resulting in billions of dollars of free cash flow that management can then return to shareholders. The company paid $8.6 billion in dividends in 2016, and has repurchased about $7.5 billion worth of shares since initiating a $10 billion program for that purpose in the third quarter of 2015.

Over the past five years, J&J's earnings multiple has been roughly equivalent to that of the S&P 500, with five-year average P/E ratios of 19.82 vs. 19.80 respectively. However, recent appreciation of the S&P 500 has combined with heightened drug-price scrutiny on pharma companies to produce one of the largest P/E discrepancies between J&J and the S&P 500 we've seen over this time:



Source: S&P 500 Chart Builder, author's calculations

Our simplistic valuation of $118 per share assumes a 20% free cash flow margin and sales growth of about 5.5% annually over the next 10 years, which should be achievable thanks to the company's pricing power and heavy investment in R&D, plus demographic tailwinds that should fuel growing global health-care expenditures. Using another valuation methodology, our $118 fair value implies about 6.7% annual dividend growth in perpetuity.

Pro Quality Checklist

Here's how J&J scores against our *Pro* Quality Checklist criteria:

1. Sustainable Competitive Advantage

Yes. Johnson & Johnson has several sources of competitive advantage. First, the company has strong brand power (especially within the consumer segment), as evidenced by its ranking within the top 100 best global brands in 2016 (as rated by brand consultant Interbrand). Its large size and strong cash flows allow for heavy investment in marketing and research and development (R&D), continually reinforcing that brand power. Within the pharmaceutical segment, J&J has an intangible competitive advantage with respect to intellectual property, and its global sales and distribution network make it an excellent collaborative partner for smaller biotechnology firms looking to expand markets for drugs in development. And within the medical-device division, many of the company's tools and devices require specific training, meaning switching costs are high.

2. Pricing Power

Yes. Johnson & Johnson's brand power, leadership position across multiple product categories, and continuous product innovation (reinforced by the company's R&D efforts) support strong pricing power. Although that power varies across the company's diverse product portfolio, J&J has been able to use it to maintain strong (near 70%, and recently increasing) company-wide gross margins.

3. Dependent Customer Base

Yes. Johnson & Johnson has a dependent customer base across all three of its business divisions. Within the consumer division, it owns enduring brands that are Nos. 1 and 2 globally across 11 different product categories (including Tylenol, Neutrogena, Listerine, Motrin, Johnson's baby products, Band-Aid, Benadryl, and Aveeno). It produces several industry-leading drugs and, as mentioned, is the sixth largest pharmaceutical company in the world by annual sales. And as for medical devices, J&J owns the world leader in contact lenses (Acuvue) and is the global leader in surgery- and orthopedic-related hospital medical devices.

4. Predictable Revenue

Yes. Although sales of the company's individual products often fluctuate, J&J's revenue diversity and positioning in the growing health-care industry lead to consistent and predictable revenue growth. Since the end of 1993, JNJ has expanded its revenue at a compound annual growth rate of 7.3%. Additionally, because of the non-discretionary nature of its health-care products, the company's revenue is very stable during economic recessions. At the low point of the 2008-2009 economic recession, its worst currency-adjusted sales performance was -2.8% in the third quarter of 2009:

Source: http://www.investor.jnj.com/sales-earnings.cfm

5. Growing Free Cash Flow With Compounding Returns

Yes. Johnson & Johnson is a cash-generating machine, converting about 20% of every sales dollar into free cash flow (FCF). Over the past five years, the company has increased its FCF from $11.4 billion to $15.5 billion, which amounts to about 6.3% annual growth. The company uses this FCF to reinvest back into the business via R&D and marketing expenditures, and management has also spent about 30% of FCF over the past 20 years on acquisitions, which augment internal innovation and help the company maintain its steady revenue growth. The remainder is returned to shareholders via dividends and share repurchases.

6. Financial Resilience

Yes. Johnson & Johnson's large size, diverse revenue streams, strong free cash flow, and recession-proof nature lead to a rock-solid balance sheet. JNJ is one of only two companies (the other being Microsoft) to hold a coveted AAA credit rating from Standard & Poor's, a rating that is higher than even the U.S. government's. As evidence of its financial resilience, J&J is one of only 13 companies to have increased its dividend every year for the past 54 years.

7. Expanding Possibilities

Yes. Johnson & Johnson's R&D engine positions the company for expanding possibilities across all three of its businesses. Consumer-wise, management aims to expand by focusing on its iconic megabrands and by increasing its footprint in international markets; regarding pharmaceuticals, it has a robust pipeline, with 10 potential $1 billion products set for filing through 2019 and two of the top 20 most valuable R&D projects in the pharmaceutical industry as ranked by net present value. And as for medical devices, plans are to grow via internal innovation and by investing in areas where significant needs remain unmet.

8. The Three C's of Management (Clarity, Consistency, Capability)

Yes. Johnson & Johnson has an outstanding record of sound capital allocation and generating excess returns. Management does an excellent job communicating and executing on its strategies across its three business divisions, and CEO Alex Gorsky is very highly regarded, with a 97% approval rating on Glassdoor that places him as the 16th highest-rated CEO among large companies in the U.S. in 2016. J&J was also rated No. 26 among large companies in the Glassdoor "Best Places to Work" list for 2017, and the company's focus on sustainable business practices is reflected in its No. 8 ranking in the 2017 World's Most Sustainable Corporations list compiled by media company Corporate Knights, Inc.

The *Pro* Bottom Line

At eight out of eight of our *Pro* quality criteria, Johnson & Johnson is a quintessential *Pro*-quality stock, and we are excited to introduce the company into our portfolio -- especially as our exposure to health care has declined after we closed our entire position on Parexel. Johnson & Johnson qualifies as a top-notch business, and it is one we expect to hold for a long time. While its large size means we don't expect runaway growth and upside from J&J, we do expect to earn North Star-challenging returns with low downside risk from one of the safest stocks you are likely to find in the entire investment universe.

Alternative Trades

If you already own shares, keep your allocation right where you want it. If you don't own shares yet, we're starting with a 3% stake. We may use options on this stock in the future.

Pro Can Help

- Our new Johnson & Johnson discussion board accepts your FSA dollars!

Pro Guidance Changes and Completed Trades: Feb. 21, 2017

Published Feb 21, 2017 at 3:37PM

Pro Guidance Changes (from the past two weeks)

- **Gilead Sciences** (NASDAQ: GILD): Moved to Hold as we assess 2017 guidance from management.
- **MasterCard** (NYSE: MA): Fair-value estimate increases to $99. It moves to Buy (from Buy First) at a 4.7% allocation.
- **Parexel** (NASDAQ: PRXL): Moved to Sell (the stock) and close all option positions.
- **Valmont** (NYSE: VMI): Moves to Hold (from Buy) as Jeremy (TMFTank) leaves *Pro* and we reassess the company.
- **Visa** (NYSE: V): Moves to Buy First (from Buy) at a 2.5% allocation.

Pro Completed Trades (from the past two weeks)

- **Parexel**: As per our recent alert, we sold our shares at $64.42 and bought to close our covered calls at $1.69, closing the position.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Feb. 21, 2017

Published Feb 21, 2017 at 3:25PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.5%.
- **Visa** (NYSE: V): Buy 2.5%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **Apple** (NASDAQ: AAPL): Buy 4.3%.
- **Broadridge** (NYSE: BR): Buy 5.1%.
- **OpenText** (NASDAQ: OTEX): Buy 3.4%.
- **TD Ameritrade** (NASDAQ: AMTD): Buy 3.1%.

Shorts:

- **CurrencyShares Euro Trust** (NYSEMKT: FXE): Sell short 1.6%.

Pro options:

- If you want to attempt to buy any of our stocks lower, you can write (sell to open) near-the-money put options on shares such as **Paycom** (NYSE: PAYC) and **Starbucks** (NASDAQ: SBUX), among others. Choose puts that pay you enough to be happy. Realize all these stocks are rated Buy.

Hedges:

- No update this week.

Upcoming Expirations:

- Our covered strangle on Verisign is set to expire March 17; we'll update you before that date.

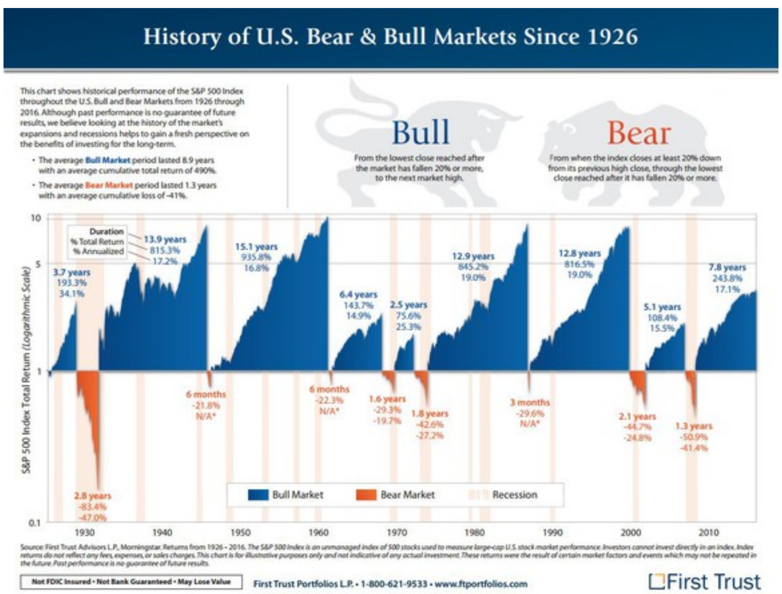
Charts of the Week: U.S. Bear and Bull Markets, Shifting Income Distributions, and More

Published Feb 21, 2017 at 3:20PM

Dear *Pro* Fools,

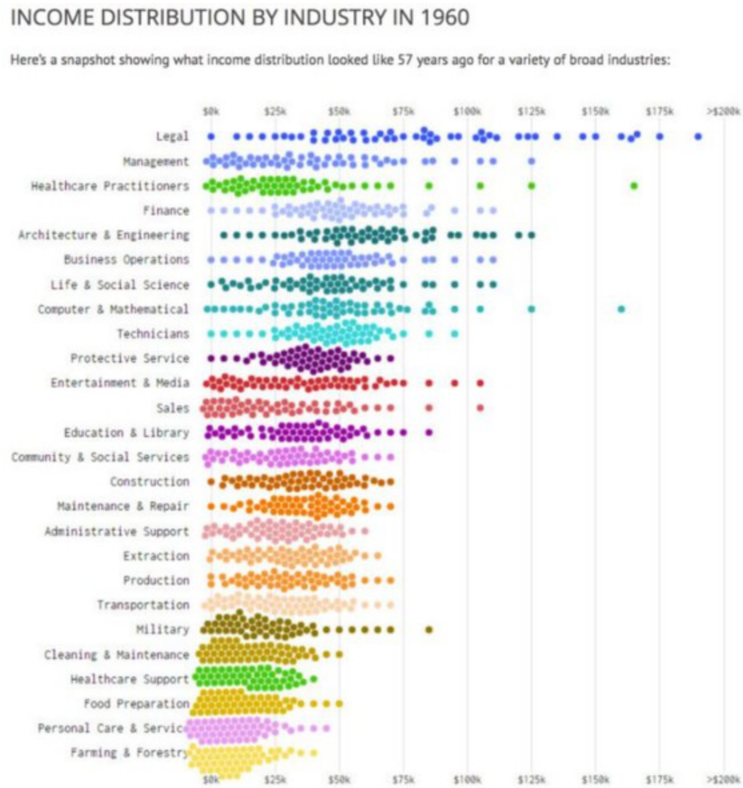
For today's Tuesday Memo (thanks to the President's Day holiday on Monday), I'll kick off our shortened week with another edition of my "Charts of the Week" series. Here are the five most interesting and/or market-relevant charts I found this week while perusing the financial/data blogs and websites I frequent:

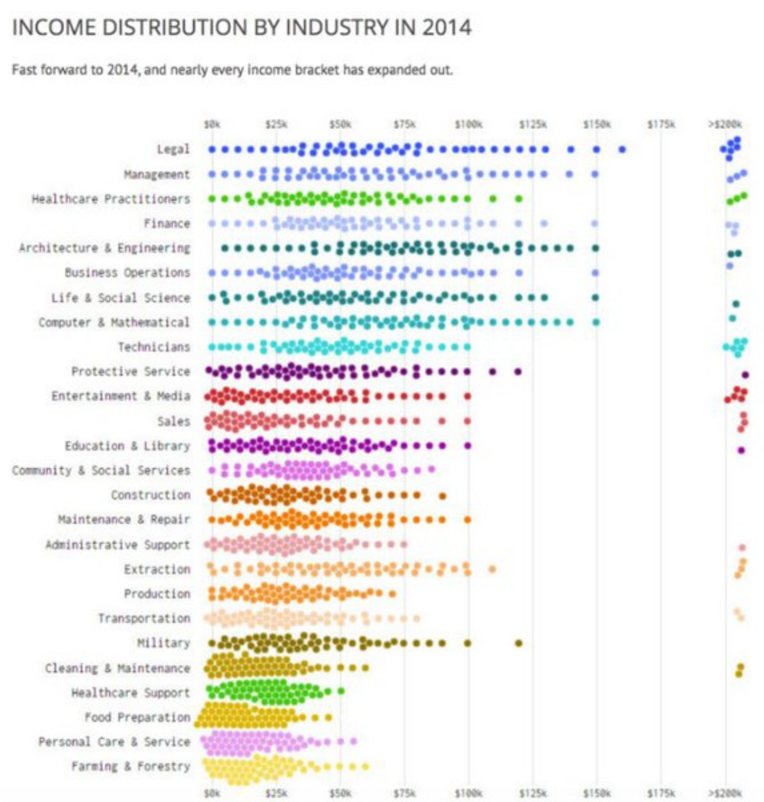
1. The History of U.S. Bear and Bull Markets Since 1926



This graphic from First Trust displays the historical performance of the S&P 500 Index, showing the length and return profiles for all of the different bull and bear markets since 1926.

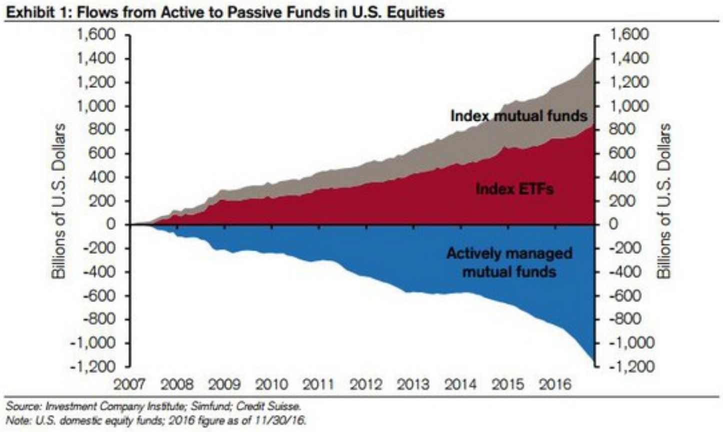
2. The Shifting Income Distribution of American Jobs





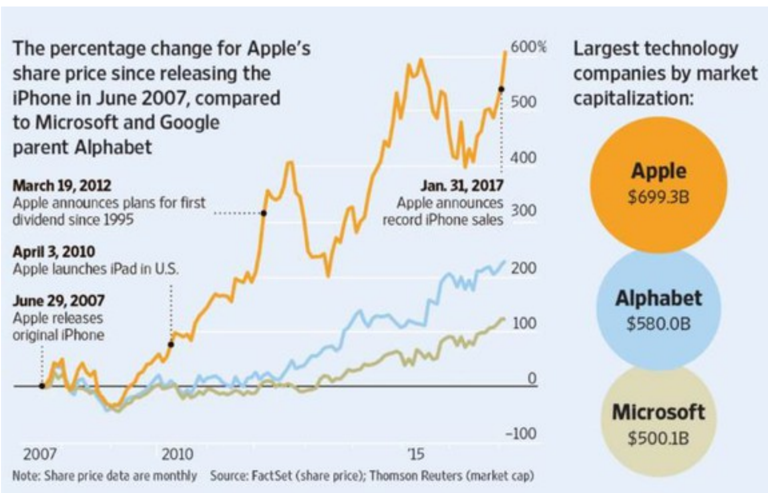
These two snapshot-in-time visualizations from Nathan Yau of FlowingData show the changing distribution of income for American jobs between 1960 and 2014, across various industries. We can see that income distributions have become more widely dispersed over time, and there are now more "super-earner" outliers on the far right end of the distributions. Click here for the full, interactive graphic showing four different time snapshots (1960, 1980, 2000, and 2014).

3. Flows from Active to Passive Funds in U.S. Equities



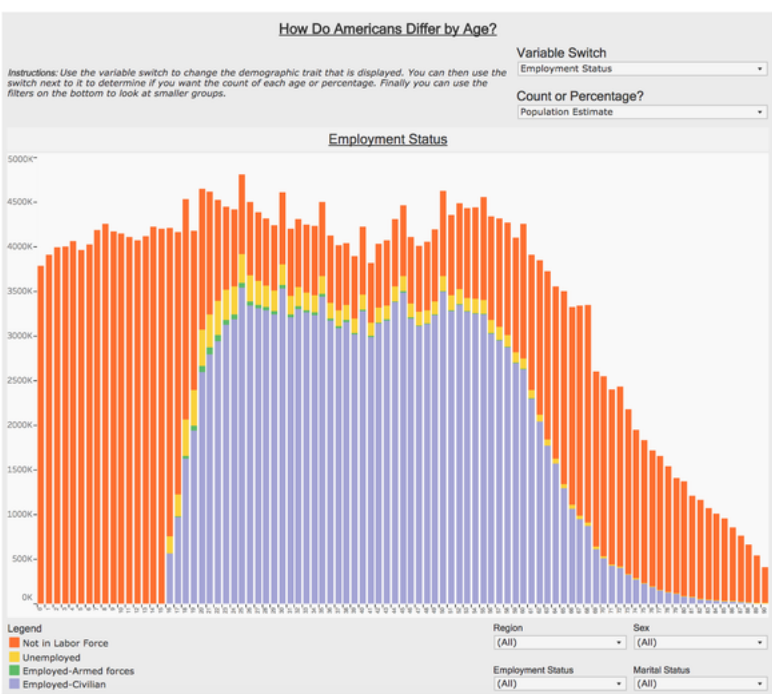
This chart from a January 2017 Michael Mauboussin research paper illustrates the ongoing (and seemingly accelerating) shift from active management to passive management. Since the end of 2006, investors have withdrawn nearly $1.2 trillion from actively managed U.S. equity mutual funds and have allocated roughly $1.4 trillion to U.S. equity index funds and exchange-traded funds (ETFs). Read the entire report [here](#).

4. Apple's New All-Time Highs



With Apple's share price now reaching all-time highs, this graphic from *The Wall Street Journal* (click [here](#) to access the full article if you have a *WSJ* subscription) shows the percentage change for Apple's share price since releasing the iPhone in June 2007, compared with Microsoft and Google parent Alphabet.

5. How Do Americans Differ By Age?



Click the image above for a customizable, interactive version. This graphic from Overflow Data shows age distributions for Americans across multiple demographic traits (such as sex, race, educational attainment, and more). By changing the variable in the "Variable Switch" drop-down menu in the upper right, you can see how that variable is applied to the population pyramid of the U.S. You can also adjust the pyramid in the bottom right to show only certain populations.

The *Pro* Bottom Line

There you have it, Fools -- this week's edition of my top five charts of the week. Hope you enjoyed it, and bring any questions or comments to the Memo Musings board!

Best,

-- Billy (TMFBillyTheKid)

Pro Video Chat, February 2017

Published Feb 21, 2017 at 3:01PM

The *Pro* team held a live video chat on this page at 2 p.m. Eastern on Monday, Feb. 27. A replay is available below this text, and a transcript is coming soon. Fool on!

Transcript

Jeff: Greetings fools and welcome to the Motley Fool February Chat. We are delighted that you have joined us. I am Jeff Fisher, advisor and I'm joined at the table by J.P. Bennett.

J.P: Thanks for having me, Jeff.

Jeff: Great to see you J.P., as always and we're joined through Skype by Billy Kipersztok. Hey Billy.

Billy: Hey, happy to be here.

Jeff: Happy to have you. The three of us, we would like to take a moment and thank Jeremy Myers, Team F Tank for his services. I was about to say services not her, his services to Motley Fool Pro for the last couple of years and to Hidden Gems for about eight years. Jeremy, if you hadn't heard from his memo, has left the Fool for another role. We are off to a rough start here. Had some dry air from the desert from Arizona, it made my skin all crackly.

We're here to take your questions. Remember to keep this window open so you can see the video portion of this live event if you want to. You may not want to see it. You can at least hear it, be sure to hear it and then go to, click to Slide O to get to the question portion of this chat. How am I looking J.P? Am I being murdered? Live TV, you have to love it. I'm about to give up the award to the wrong movie, just wait for that at the end of the show. Go to SlideO.com and login there. Hopefully, you have an account by now, but if you are new it just takes a minute to register and get in there. The keyword for this event is, J.P?

J.P: What is it?

Jeff: I think it's …

J.P: Pro Chat February.

Jeff: That's right. I couldn't remember either. That's why I do it threw it over to you, throw you under the bus.

Billy: Didn't you just tell me that J.P?

J.P: Maybe?

Jeff: Yeah, right before we started the camera we did all say it's Pro Chat February. Pro Chat February gets you in there. We're going to answer your questions. We're going to have a good time, a Foolish time. We recognize there's some red in the portfolio today. I actually wore a red sweater to account for that and I'm bleeding from the face to add to the drama. Hey, you have days like this in investing.

The bigger picture, the portfolios were up well on the year still so far and even today we're not getting hit much at all because Gogo our short, which is up some 16% today is a 0.5% holding. There's a reason for that and it's a small cap. It's going to be volatile.

Amtrust Financial is a small financial company, an insurance company mainly and it's going to be volatile and it always has been as well. It's been public about 10 years now and it's been volatile most of the time. That said, they did have some news in their earnings day that we'll talk about, naturally, and we'll give you our latest thoughts on both situations.

Before we jump into answer questions though, in case you are sitting there with your finger eagerly over your computer wondering if you are about to make a trade, we are not about to say whether you should make a trade. Amtrust moved to hold today, so we can review the news and give you our educated analysis and opinion. We are never knee-jerk here. We are never too quick to act. We want to act with confidence and full knowledge of the situation and then we will guide you, always with our long-term perspective.

That said, as long-term members know, if we don't believe in something anymore we will not hesitate to sell it, but we really have to reach that point honestly with research. Billy, J.P., anything to add before we start to the questions? How's the year looking so far?

J.P: So far so good, it's all about diversification, right? Like you said, when stocks move against us they hurt, but they don't really hurt us to the extent that they would if we made them 10%, 15%, 20% positions.

Jeff: Yeah, just wait until our biggest position does have a rough day like Facebook and then we'll talk about that. But as a whole, the portfolio as a whole is meant to work over the long term and our allocations mean something to that pursuit, so follow them to the full extent that you can. Amtrust today is the top question, notably so as it should be. Shares are down 16% last I looked.

J.P: Something like that.

Jeff: And for a lot of members who bought much later than us, they are down on their position so far. J.P., of the news that we know today, I know you and I have both looked over what we could in our short time that we had this morning, why don't we both just share our thoughts?

J.P: Yeah, my quick take on it is I didn't get a chance to go over the earnings call. I just skimmed the press release, right? Whenever you see a company having to go back and redo their financials from prior years, especially when you are dealing with an insurer where losses from past years can come up and really bite you in the butt so to speak and in certain cases it can make companies insolvent, it gets the market really spooked, right?

Basically, this will just get down to we don't know the size of the restatement. They said for most of it, it will be immaterial, right? It doesn't really change the thesis. There's always obviously the risk of that. It is like where there's smoke there's fire situation. This happens, then you have even more things start to show up. Also, coincides with when they are transitioning auditors, right? There's potentially a good way you can look at it or the bad way.

The first way is okay, these guys just came on board. They want to make sure they have everything perfect, so they are going to take the extra time. They are going to go back and look at the prior stuff and that's a good sign because we want companies in our portfolio that are honest and make sure that they have all of their filings in order.

You can look at it that way or you can look at it the super skeptical, cynic way and say, "Okay, this is, like I said, where there's smoke there's fire. This is just the tip of the iceberg. This is finally the whole thing is going to come unraveled." We want to be able to have time to look at everything and assess the situation like you said and not just have a knee-jerk reaction.

The stock has been volatile in the past. If you go back in the end of 2013, it went from around 20 to 15 in a couple of days and then what did it do? It went from 15, split adjusted to 35 before going back to where we are here. The stock has always been volatile because there is definitely that question surrounding the company because they do, do things a little bit different from your traditional insurer because they are a little bit smaller, a little bit more nimble and people don't necessarily like companies that do things differently and so it's been volatile.

They are also facing just some bigger picture, some industry headwinds right now where things aren't as favorable as they were say two, three years ago and so we just got to take the time to look back, make an honest assessment and not have emotions play a role in what we decide to do moving forward because it is in every position that we hold in the portfolio, it's not what it did in the past. It's what's it's going to do going forward? This happened. It really is unfortunate. It doesn't feel good, but the only thing we could do is to say from here forward what do we think the company can do and make our decision on whether to buy, hold or sell it based on that.

Jeff: Well said. I don't know that I can add much to what J.P. said, but I'll fill in a few of my thoughts as well. As J.P. mentioned, Amtrust decided to move to KPMG as their auditor last year after years with BDO. It was a choice they made in 2016 and KPMG is not yet done with the auditing process for the last year and that's why they have delayed there 10K filing, which will … They do expect to file it on or before March 16, so they expect to meet the extension deadline without a problem. That's just over two weeks away. I imagine if and when it gets filed on time and shows more data that may help the situation, add some clarity at least.

The other thing is in switching auditors and going through all their financials, they found they have some material weaknesses in their internal control structure over their financial reporting. Long-term members might recall we believe in Amtrust. We have owned it. We have recommended it, but all along we have also said it's a small company. In the world of insurance it's a little scrappy. We'd like to see greater controls on their finances. We'd like to see more clarity in some instances.

We have gone up and visited Amtrust in New York two or three times because it was one of our larger positions and it was one of the less transparent ones, hence we wanted to learn all we could by visiting. I'm glad to see that they are shoring up their internal controls on their financials on how they report it and how they reserve for losses and everything that an insurance company has to do. They have always been kind of shoestring in a way, just enough that we were obviously happy to own it and recommend it, but we always did want more and that we are getting that now can be read as a good sign. It is a good sign.

But the devil is in the details, so they are changing auditors to a more reputable firm, which is good. They are adding more staff in their finance department, more executives. They are adding more oversight. That's all good. They are restating some results from the past year or two actually, back to 2015, about $50 million in results. Because of the way they reported it, this is in relation to the warranty business, some of the revenue they took in they recognized right away and now under the new way that they are recognizing it, they recognized it over time as you should, as the warranty runs out … Or not as you should. There were two different ways to recognize it and they chose one way and now they are switching to this way, which is more conservative.

They are making these changes of their own accord and with their new auditor and that's a good thing. They are being transparent about it. That's a good thing. They are willing to take a hit on quarterly results, rather than try to snow us with some numbers. That's a very good thing. That's all the positive side.

The negative is the yes they are restating some results. Two, there are headwinds as J.P. said. In the business, their commercial auto business is facing big headwinds, but that's industry-wide and they are working to reprice and change to account for that. As a result their combined ratio wasn't as strong this time. Their loss ratio was a bit higher and so all these things combined, I'm surprised the stock isn't down more, frankly.

J.P: Don't jinx it, Jeff.

Jeff: We'll see. We will keep going through results and we did put it on hold just today, just now after the results because not because we are suddenly overly-concerned, but because we want to have a full view of the picture before we tell members what to do next. But right now that's where it stands, still happy to own it and until that changes or if that changes, you will know first.

J.P: Just to piggyback off that, there's a question further down the line where they asked whether the situation developed today, is it going to reduce our fair value estimate? To just double back on what we just said, we don't know yet. We have to take the time to go through their earnings call to go through the numbers and to use that to derive our fair value, so not going to sit here and say I know exactly what's going to happen and we have our fair value updated by the second. We're not. We're not sell side, so we don't basically try to have stuff out like ASAP. We want to make sure we take the time.

Jeff: That's true J.P. and thank you for that. J.P., by the way, I'm glad this is recorded so I look forward to going back to it and watching the first few minutes where you are laughing uncontrollably and my mouth is bleeding. I realize what happened. I sat down and then once we started I smiled and … I was just in Arizona over the weekend for a Motley Fool event, my face is dried out like a reptile, and it's maybe age, too, but keep quiet over there young man, and so my lip starts bleeding and I don't want to say that on film. I hope you can see it all right? I put my hand open and went wow. We're being hit all kinds of ways, Amtrust, Gogo, which we'll talk about.

J.P: It's a bit of a train wreck as we start and not the best way to start, but we recovered. I hope we recovered.

Jeff: Yeah, I think so. I think we are fine.

J.P: Made good progress.

Jeff: And I think the portfolios in the green this year nicely and we're going to keep working to manage it to maintain profits and set us on a good trajectory for the next three years. As always, we're looking three years ahead. Greg 145 is asking stocks and bonds are now moving in tandem. Should we add a new put ratio spread or maybe even some [shorts on spy 00:13:18] or the cubes?

Short answer is we are looking at new put ratios spreads on spy that may be short-term as we normally do once it expires in two to three months, while watching our downside exposure, because we obviously always have to watch that. We're looking at various ways to hedge in addition to just that 2018 hedge we're setting up. You should expect new things this quarter, especially once we get through earnings.

As long times members know, earnings, there's always about a five to six week period where we go through all our holdings. Once they all wrap up we can get a full picture, change any positions we might want to and also set up the portfolio exposure how we want to with hedges. Hopefully, the market will keep giving us a little more time for that. There's always that risk that no one knows when things will suddenly change. But good question, we are looking at more hedges.

Here we finally get to go to Billy. I was going to say J&J and Billy, but then I read it and it's not really a question for Billy, but members are asking with J&J now in the Pro Port, is it time to kiss Gilead goodbye? I don't know? Billy, if you have shots and I can share my thoughts, too.

Billy: Well, I think adding some healthcare exposure, it gives us a little bit more leeway to if we want to, reduce our exposure to a name that hasn't been performing up to our expectations. That's something we can now more strongly consider. We like Johnson & Johnson. I think it's a completely different type of company than Gilead. It's really diverse. It's not reliant upon one particular revenue stream, so just because they are in the healthcare industry, it doesn't necessarily mean they are exactly proportionate to each other in terms of the investment characteristics.

I think that depends. I think it's up really to Jeff to analyze Gilead, think about the characteristics of the investment moving forward. But I will say it may make a decision on Gilead perhaps a bit easier now that we have added a company in the healthcare sector.

Jeff: Yeah, I do feel that way Billy. It does help. It takes some of the pressure off of Gilead, but we still want it to perform. As I posted on that board last week I believe, I'm looking at possible options on it to try to get to at least our North Star and the stock now yields about 2.8%.

In a portfolio that's seeking more yield as we are, it may make sense to keep it as long as we believe that the damage is all but done and especially, if we can then possibly write options on it, strangles or covered calls or spreads maybe or an iron condor, who knows to try to target that minimum 10% annualized return, then we would keep it. As Jeff said a moment ago, we'll seek to answer that question very soon as we get through the earnings reports we have and take a full 100 foot view of the portfolio. We're not going to fly to high but 100 feet up. We'll look down at it.

Another one for me. It looks like Gogo earnings for today, does it change our rec? Should we stay short? Great question. As with Amtrust we almost always need more time. It's unusual that we have an answer right away, but the short story so far with Gogo today is the loss was less than expected and they updated and increased their guidance for this year as far as plane insulation. They are looking to install their services on I believe it's about 100 additional planes, 500-some verses 400-some previously estimated this year. That's good news for the company as well as long as each plane doesn't add to losses.

But so far I haven't been able to dig in and see why the loss is smaller and that's really probably what's going to drive our decision. As shared, it's a small position. That doesn't mean we don't take it seriously and we are down about 10% on it now, which in this market is outperforming, believe it or not, the small cap index, which is up with some 23% since November since we put the short on.

All of our shorts, Shake-Shack, Gogo, Go Pro that we started last fall right before the election, I'm actually very pleased with. The market, and these are all smaller companies, has as you have seen catapulted higher and our shorts have really not hurt us in that environment. But on a case-by-case basis we have to judge each one of them as I'm doing with Caesar's, too and Gogo.

We'll hopefully have some news within a week or so on where we stand, a week at the most on where we stand, whether we are going to keep it, close it, possibly add to it. Hopefully, I'll have enough information within a week to make that decision by next Monday's memo. So for now, we are sitting tight on that small short. Let's go to Billy and the second question here and then we'll answer at the top one later. How should we view the current Domino's Pizza short situation, even if we have written the covered puts?

Billy: The Domino's situation, what we are looking at right now is Papa John's just reported their Q4 and fiscal 2016 earnings I think it was yesterday if not the day before. We are going to go through those earnings. We are going to see what's going on with Papa John's. We haven't updated our fair value estimate for Papa John's since I believe August of last year, so it's been about six months. The company is due for a fair value update.

Now the stock after earnings did drop about 7% - 8%. It wasn't a bad report based on a cursory look the company did really well. They outperformed their guidance from the beginning of the year. Growth is steady. It's just not perhaps as much as the market was expecting. Part of the reason we put on the short is because the stock we felt was maybe a little bit overheated in terms of its valuation and we can see that with an earnings report where the company did pretty well, but the stock declined 7% - 8%, you can see the market's expectations are quite high.

Domino's also now reports tomorrow their earnings, so we are going to take a look at Domino's. We are going to see how the market reacts to their earnings. Expectations, again, for Domino's are quite high and reasonably so because the company has been firing on all cylinders.

The Domino's short is, it's a wash for us I think right now. It's risky for us to short a company that's executing so well in Domino's, so we are going to see if the company is able to keep up their momentum. Recently when they report earnings tomorrow, we are going to compare to Papa John's. We'll update our fair value estimate on Papa John's. We'll consider what's going on with our covered puts, which expire in June and we'll adjust our position as necessary. But right now it's not really harming us that Domino's short, I think you are pretty close to even on that trade overall, but we'll see what happens with Domino's tomorrow.

Jeff: All right, thank you Billy. I just put a poll out there for everybody because right before we started Billy said he really needs a haircut and we want to leave that up to you, answer this latest poll and Billy will do whatever you say, right Billy?

Billy: [Crosstalk 00:20:42].

Jeff: Dominoes Pizza earnings tomorrow, always excitement here. SVXY, is there no limit to the upside or should we take profits? Is there a future friction that buys is this to rise some in a steady market? The short answer is in a steady market there is impetus for that position to keep rising slowly and surely. The vix futures are in a state of contango typically and that eats away at the value of the index or the vix's index that this vehicle is short and so that increases the value of SVXY.

That said, when volatility spikes or even goes up, SVXY can lose value, can fall quite quickly. We could see quite a bit of our recent gain, I think we're up 90% or so, in a sudden shift in volatility, we could see half of our again, a good half of it get wiped away the quickly.

I'm comfortable with that view and this is a long-term position that I don't necessarily want to try to time the market and trade in and out of it. We are looking to set up, I think it is a long-term position now, so we have a long-term tax rate on it. I think if we were to look ahead at a typical three-years or so, the value of this vehicle is going to keep going up as it has since it came out, but there will be periods of volatility where we have to be ready to lose a lot of our recent gains. We have talked about in the past J.P. possibly adding when SVXY falls sharply, adding a small trading position on top of this position that we are holding pretty. Any other thoughts from you guys?

J.P: Yeah, mine is that if you can get short something like the VXX and just ride that slow and steady, that instrument to its slow and steady ultimate demise that's great, but because this … You go back a couple years. It really wasn't as much of a known commodity, just the way the futures contracts work and how the instruments that want to track the vix, so to speak. Just because of the nature of having these futures contracts instead of the vix itself, losing value over time as long as the market just muddles along and doesn't do too much. That's a very much a known story now. It's not always feasible or very attractive to short something that just can't directly mirror the decline.

The SVXY, like you said, is extremely volatile and because of that there is the opportunity. So if you go back to I think it was August 2015 where it was in the 90s and then a couple weeks later it was in the 50s or the 40s, right? So you can lose it really quickly, but because of how it is structured those are buying opportunities. It's essentially just like the market in large. Where the market gets hammered that's when it's normally a really good time to buy shares.

If you hold it, like you said, you have to have an extremely long-term mindset. I think to have the best outcomes you have to understand and be willing to use those big declines as opportunities to build your position and so you wouldn't want to just go all in right now and buy your full position. I think it would be best to buy this in thirds or something like that.

Jeff: Well said, I agree with that. Let's get to our … And one other thought I had is the way it's structured, my other hope is that it will over time each time hit higher highs and higher lows when it does rise and then contract. If we just ride that each time with this core position, until it gets so big that we want to trim it. It's less than 2% right now, then hopefully we'll keep seeing higher highs and higher lows until we decide to take some profits. But right now we are not thinking of that, at least not at the immediate moment. We have some other things we are thinking about. Are you looking at any additional REITs to add it to the Pro Portfolio? At the moment I'm not.

J.P: Interestingly enough, Jeremy was the REIT guy for the Motley Fool, him and one other analyst and now that he is gone there's definitely a lack of coverage in that space. I would say that I don't have a ton of familiarity. I'm looking into some of the commercial stuff, just helping out a fellow analyst and digging into that and getting a better lay of the land because I think a lot that you can tease from that industry has direct implications into other ones. Just because I don't have an intimate familiarity with it doesn't mean I'll never want to learn more about it. I am doing some work on it right now, but it is not something where it's like "Oh man, I feel like we need REIT exposure right now, so I need to find something in that space."

Jeff: Yeah and we have been looking at the housing sector in general. The demographics are improving there for house formation, household formation, but looking at a few non-REIT investments. REITs can be decent but also have different tax implications.

Billy: REITs are also very exposed to interest rates and the stock prices can change, pretty volatile depending upon how interest rates change. As interest rates are going up now, it's a period where REITs may be less desirable.

Jeff: The next question, what are pros and cons to setting up the, I assume it's the put ratio spread on the NASDAQ at 130, buying 123 puts, selling 109 puts for probably a breakeven or a small credit versus waiting for a decline and what strikes would currently apply?

I can't look up the strikes right now, if anybody wants to they could, but let me summarize where we stand. We asked the Motley Fool's finance department to answer our 2018 QQQ-Trade, accidentally 2019 was entered. The market kept rising. The way the 2019 options are priced, we are now on a $5000 or $6000 loss in the Pro Port, which is currently showing in our returns on this position alone.

To close it and get to 2018, the options that we want to, we are looking to get that money put back into the Pro Port from the Motley Fool itself because it's not a mistake we made. Our returns shouldn't be penalized by $6000. Once that is agreed to, and it shouldn't be a problem, but then we'll close the 2019 position presumably and open the 2018.

We would use strike prices that are relevant to today, which this looks pretty close, just eyeballing at the $123, $109 because remember when we set up the position in January, it was about 3% - 5% out of the money. The put that we were buying was about 3% - 5% below the current Q price, so this looks comparable to that. But that's what you want to try to mirror, look at the original trade alert and try to mirror those same percentage differences in the current price versus where we set up the spread. I realize that a lot of people are waiting for updated guidance on that and we will do that as soon as we can, as soon as we know what we can do.

Meantime, the good news is these are spreads that do not help you until expiration, in this case 2018, so it's not as if we are missing anything in the short term by not having it. I make regular, monthly contributions to my portfolio. That's excellent, Michael, great job. How best can I add these to my portfolio without disrupting Pro's recommended percentages for each stock? If you're following the Pro Port and you are adding money to your portfolio, how do you best do that each month?

J.P: I guess I can start. Overall, the goal is if you want to mirror Pro to the extent that you want to mirror it in your portfolio, you want to keep your allocations similar to what we have. Buy first obviously are the first ones and then you move down in buys and make sure you keep building them all.

It depends on obviously the transaction costs you have to incur. If you have a really low-cost platform where you can just buy a couple of shares and it doesn't really ding you all that much, then you have a greater luxury to spread it out with each iteration of you buying shares. But just basically over time to make sure you keep them in proportion to one another because there's obviously a rationale to why we have Facebook as 6.8% and why MasterCard's smaller at 4.7%. Apple is at 4.4%. There is a method to the madness so to speak when it comes to diversification. Just keep adding to them over time and keeping them in proportion to one another.

Jeff: Sounds good and keep in mind we add maybe six new names a year more or less on average, whether it's a direct stock or an option position. Having some cash on side for those could also be valuable. Now Bonds is asking with the rally in the stock market, at what point do diagonal calls become untenable to continue? Do you keep rolling the short call if it's very far in the money? Is there any max profit to target? Billy, do you want to share any thoughts on that?

Billy: Yeah, I think is dependent upon the individual situation. It depends how far the short call is in the money and it depends on the implied volatility of the underlying stock. Sometimes you have a stock that's got good volatility so that you can roll up and out and not pay too much of a credit to do so.

The main idea for rolling diagonal calls I think would be the return on the incremental capital invested. Ideally, if you can roll it up and not pay a debit at all and get paid a credit then that's great. But if you have to pay to roll it up, then what you want to do is you want to make sure you are getting an incremental return on that investment to roll the option up that's sufficient.

If you check in Options, over on our Options service, Jim Gillies has written a column about the incremental return on investment that he likes to target for rolling in the money options and I think specifically related to diagonal calls so that would be a good resource for you to use.

J.P: Yep and for those that are curious, I believe it's called "Don't Fall in Love" or something along those lines. Give me one second, I can actually … Yep, it is called "Don't Fall in Love." I have that one bookmarked in my note.

Jeff: Okay, from JSP Colorado. We appreciate your very kind words there that everybody can read and thank you. We take very seriously, of course, every day we know people are invested with us. In many cases it's your life savings that's invested in a Pro Portfolio, just like ours. So we look at our positions every week and make sure that's where we want our money and then a majority of my own funds are only in Pro stocks as well in much the same form as the Pro Portfolio itself.

Thank you, we appreciate it. We are here because of you and we are working for you and we'll keep doing our best to produce satisfying, if not really great hopefully returns over any meaningful time period. We will keep working to minimize mistakes, although of course, we'll always have some, thank you very much, we appreciate that a lot.

Bruce is down about 30% on Gilead. What is our current assessment and thought strategies for the near term? We talked about it a little bit with J&J that we should have a summary of where we stand on it within a short period of time and what we plan to do with it we'll share with you first, of course. Current thought though is it still a really strong business, great free cash flow. It's in no danger financially by any means as a going concern or a viable business that can merit its market cap today. It has nearly a 3% yield now. It trades at eight times expected earnings.

The problem is as you probably all know is that revenue isn't growing. It's actually declining because the Hepatitis C market took off really much faster than anyone thought and now it's cooling down faster than people thought and prices came down sharply.

How soon can the company grow revenue again is the big question and without a big acquisition, it may not happen until at least 2020, maybe later and that's going to keep the stock depressed. We're aware of that. We don't want to bank just on an acquisition prospect. Unless we think we can make the North Star return with it from this point forward, we'll try to find something better. But right now the hope is we can find a way using strategies to make at least 10% annualized and we also still have faith in management and in the business itself, even though we are not blind to the lack of growth right now and that unfortunate situation.

We'll keep sharing our thoughts as soon as we have done and just be aware that our whole portfolio, which thankfully is pretty focused, we're thinking of each position and we will update you as soon as any situation changes. Anonymous is asking, they purchased a shutter stock on the drop today. What recommendations do I have to use options? Please head to the Motley Fool Option Service and the Shutter Stock Board there. That's not a Pro position. It's a Motley Fool Options position put out by Jim Gillies and Billy as well. Head to that board in Motley Fool Options and you can get your question answered, just post your question.

All right, we have a question. It sounds we can all refund. Bill is asking with a less stable political environment, what is our strategy for the percentage of cash as a hedge? We, of course, all talk about that as a team. Every one of our team meetings starts with how's the portfolio look to you? How's our exposure look to you? What would you change?

Right now we are around 20% cash. That may be a bit lower with J&J, which I have to factor in. But right at high teens cash and that's about as low as I would feasibly want it in most cases. That said, we are looking at new investments so we may have to do some maneuvering, but do you guys have thoughts on the environment and the cash?

J.P: Do you want to start Billy or …?

Billy: Sure, I don't think that the political environment makes too much of a difference in terms of our strategy with our cash. We just want to maintain enough cash to be able to be flexible in downturns and initiate positions when market prices are depressed. We have seen, and this is data, this is not a political commentary, but just we have seen consumer confidence and business confidence has increased since the start of the Trump administration and that may have effects on the economy and some of the data and results that our companies report. I just got sent to the "does Billy need a haircut poll?" Let's see? I'm going to say yes.

Jeff: It looks like it took a while for that to go live. It looks like maybe …

Billy: Right, here we go. I'm voting yes. I do need a haircut. What do you guys think? Anyway, yeah, I think the political environment, it's definitely having an impact on the way businesses are operating and then there's going to be, I'm sure, legislation or at least talk of legislation that will impact the stock market, but we are just going to keep doing what we have been doing, which is maintain enough cash to be flexible and opportunistic when good market opportunities present themselves.

Jeff: Perfect and piggying on to that Billy, we're all looking to get better at using that cash during a market decline. We have had a few chances where when the market hasn't fallen for a long time you are thinking, "Well, this is the big drop. It's going to keep falling." Last January 2016, the market fell quite a bit and we were getting ready to buy things and then it snapped back really quickly. We're hoping with the next downturn to be ready, more prepared to be at least buy some calls, start to put some money to work gradually, so having that cash is key to that approach obviously. Thank you, Billy for your perfect summary of that.

Pablo, Pablo lives in Spain and he came out to the Motley Fool One event in Arizona this weekend and it was great to see you Pablo. We actually went bike riding Saturday morning before we all took off and that was fun. It was a little chilly in Scottsdale at 7:30 in the morning but not too bad. Why is QQQ not showing up in the Pro Port?

We addressed that about 10 minutes ago, so hopefully it's clear now. We have a mistaken position. We need to correct it and we will notify you all when we are ready to do that. Meanwhile, members who have set up the 2018 put ratio spread are fine and those who haven't can once we set it hope, which I'm hoping it will be as soon as this week and we will have that all done at that point. Billy, thoughts on writing puts on J&J?

Billy: Yeah, so just like any position, writing a put rather than purchasing shares, you have your trade-offs. With your puts, you can capture some income and potentially buy shares at a lower price if the stock price declines below your strike price.

But on the flip side, you are sacrificing the potential upside of just holding shares, so it depends. Unless you have a working crystal ball, as Fool On likes to say, it's impossible to know which one is better for you now more writing puts or just simply buying shares. If you want to participate in the upside, then buying shares is better and if you have more of a preference to target a lower buy price and you are not so concerned about missing some potential upside, then writing puts should be fine. It really just depends upon what you would like to target and your risk tolerance and how you feel about risk-reward of both strategies.

Jeff: Billy, since you are on a roll, or any take on have you had time to look at American Towers results yet today, any early takeaway?

Billy: Yeah, I took a quick look this morning. The results look pretty good. The market's reaction is neutral, but the stock had been rising in about the week or two prior to the report. It seems like the company met investor expectations for this report. The company is doing really well. There was … Let's see, I have some notes here.

There was 5.8% organic growth in the United States for the full year of 2016, which is a good result. Internationally, organic growth is even stronger. We have seen 13.4% organic growth in Asia, 14.1% organic growth in Europe-Middle East and 13.2% organic growth in Latin America. The company is doing really well. They are expanding across international markets and those international markets are growing at much higher rates, more than double the rates of the United States, which isn't growing so slowly itself at 6%. I continue to expect the company to see strong organic growth.

Now at this point the question becomes is the company going to be able to increase its margins? Because due to significant acquisitions, Viom in India, which increased the international portfolio by almost 100%, margins have come down because when you make an acquisition those assets tend to be lower tendency and lower margin.

Now American Tower is going to have to start leasing up those assets and increasing margins. If organic growth continues and the company is able to sign more tenants and increase the amount of equipment on those towers, then we see should margins increase, assuming that the company does not make any more huge acquisitions that again bring back down those margins. But it looks like everything is on track. The company is doing really well, firing on all cylinders, international growing very strongly, United States growing strongly as well. I don't see any reason why that shouldn't continue.

Jeff: Thank you, Billy and then Bruce is asking about Skyworks and the current option strategy with Skyworks around $95 and we have short calls at a $87.50 and short puts at $85. Overall it looks okay right now that the short calls still have a lot of time and value, $5 or so worth and we'll just keep watching that. If the short calls run low on time value, we'll look to roll. We will keep managing the position to make up that upside that we missed when the stock soared.

I think over time with the size of these premiums and a strangle, we can get back to where we want to be and more importantly, pretty safely so given the performance of the business, Apple's new product rolling out this year, the company's guidance. The fact that they have long-term relationships/contracts with companies, with the companies they work with and given the valuation. I feel comfortable managing a strangle on that position I asked we reel in the upside that has occurred.

Amtrust we have talked about quite a bit. We'll have more thoughts on that soon. We summarized our thoughts on Amtrust top of the hour. J.P. and I started right at 2:00 talking about that. The archive of this video will be available soon after this live event and you can go back to the start of the chat and listen to that five or 10 minute discussion on Amtrust, but know that we are going through it and we will all have our thoughts soon to everybody.

Valmont, so Jeremy covered Valmont for us and before Jeremy, I covered it, so I took coverage back over and I have just went through their earnings last week. Their cost cutting is doing well. Their guidance was better than expected and so we saw the stock jumped quite a bit and that's the depth of my summary right now. Since it's been maybe a year or so since I covered it I need more time to go through it.

But right now I was comfortable enough with everything I saw to keep the stock right at a buy and we are pleased to be in the green, pretty nicely in the green, including dividends I think on that stock right now and it remains a buy. It's around a 2% holding for us. We'll have more once we are all done summarizing it. Len is saying with the market run up, many of our shorts aren't doing well. Can you offer some reassurance of the thesis? Does anyone want to share thoughts on that?

J.P: I can start. I would say I believe the most important thing to do when you are shorting is to always make sure the starting point when you are judging how good you are doing is to judge how good you are doing in terms of the total portfolio. If you are shorting stuff to enable you to take advantage of more things on the long side and still remain at a net exposure that you are comfortable with and your portfolio is moving up at a very nice or steady clip, then even if your individual positions don't work out like you want, it's still a worthwhile endeavor.

Shorting is a very tricky and hard to master beast and you are not always going to get all of them right all of the time because timing is so crucial. Your long-term thesis can be perfect. I think it was a memo or maybe it was a chat in the past we talked about Abercrombie and Fitch, where way back when they probably was just getting started you came out with a bear thesis for those stock. You set up I think it was a bear spread or it was some type of bear spread and the stock goes and doubles or triples and so you lose all your money on that.

Fast-forward three, four years and then the stock just plummets and your thesis was ultimately proven correct, but the timing just didn't work out. That's why the timing aspect makes it really important to ensure you have a properly diversified short basket. You don't have all your eggs in one basket and they're not oversized so that a single short position can move against you and basically ruin your year, ruin your three years, ruin your investing career and make it so you don't want to invest ever again.

Yes, you need to go back and look at every individual position because you can't use that as a scapegoat to say that I don't ever have to be held accountable for an individual position not working out, but that's the starting point. In terms of the individual positions we currently have, I know you already summarized Gogo. Do you want to talk about the other few?

Jeff: Sure, I'm happy to. Gogo, I'll go through earnings again. That just came out this morning and see what's going on there. GoPro has done even worse than we hoped as far as the business. They had a dismal fourth-quarter, which was a key quarter to them with their new camera and their drone delayed and that drone looks quite weak now given all the competition.

Caesar's short is a tricky one, but the shareholders are in the end getting so little equity, 6% of the new company that I think the stock should be worth much less, but the market is not agreeing with me. As J.P. well demonstrated, well explained, do we sit and wait and hope that it comes around in time and meanwhile risk seeing the stock double or do we just get out with our profit and move on? That's the question that's been debated here at the last really couple months since we learned of the equity agreement that finally happened. That's three of them.

Shake Shack hasn't done anything extraordinary either and the stock is about the same. I'm encouraged because it's the same or actually a bit lower than where we initially wanted to short it, the $37, $38 level, really higher than that we wanted to short it but couldn't get shares. That's during the market soaring, so the market has soared and the short, which timing put us into the short in the lower 30s, which is unfortunate but we could live with it and hopefully profit, but since the market has short Shake Shack has really not gone anywhere. Again, to me it just looks like a really expensive stock in a crowded restaurant space. Right now we're comfortable with the shorts, including FXE and the other tiny shorts we have and as soon as that changes you will be at the first to know.

J.P: With respect to timing, at the end of the day we always hope that the timing aspect is way more variable and it's not really in our control. We can only analyze the business and what we think it's truly worth, but we hope those timing aspects where we get unlucky are offset by the pay coms, where we get very fortunate in terms of the timing and we get in it at the perfect time.

Jeff: Yep, that was just brilliance.

J.P: Yeah who wrecked? That was a perfect …

Jeff: I don't know. It came from nowhere.

J.P: Timing the market perfectly.

Jeff: That's what I do … Not. Someone, see I can't even get this right, someone, Anonymous just said that Valmont is marked as a hold on the portfolio page and of course, that reminds me yes, we moved it to hold as Jeremy left and as I took it over, so that I would have some time to get back reacquainted with it and then see earnings and then we will guide you on it again. I may have an updated valuation as well. Yes, it's on hold, but it was a buy right up until last week when Jeremy bid adieu. Billy does not need a haircut Allen says, but the poll is saying otherwise. The poll …

J.P: I was just going to say that.

Jeff: The poll is 53% to 47% to get a haircut, Billy.

Billy: I think the no's are more vocal.

Jeff: Jason and let's see? We have 10 minutes to go and I think for the first time if people don't ask many more questions, we might get through all of them, which would be an accomplishment, assuming the answers have some value. Jason, which stock already in Pro or not, would you most like to see make a 15% drop to buy? That's a great question. Why don't we go around the table and we can each quickly name a couple.

Billy: How about we go one in Pro, one not in Pro, how about that?

Jeff: I'll just do in Pro.

J.P: Yeah, I'm going to keep the one that's outside of Pro a secret because if that happens then it probably will make its way into the Pro portfolio.

Jeff: You can do that Billy if you want.

Billy: Okay.

Jeff: Do you want to start?

Billy: Sure, for the one in Pro, the easy answer I guess for me would be Johnson & Johnson, the one we just added. We are willing to buy the stock now, buying it at a 15% discount would be great. It's a very safe, stable stock. It very rarely has that kind of volatility, so if Johnson & Johnson dropped 15%, we would be very happy about that and would buy that. I'll give a bonus as well. Broadridge would be the other one that I would say 15% drop I would be eager to buy.

Now, outside of Pro would be McCormick, the spices maker. I followed that company for quite some time. It's always seemed very expensive to me, but it seems like a very Pro-like stock. That one would really interest me if it dropped 15% and good question Jason.

Jeff: Yes, J.P.?

J.P: I would say Verisign with the caveat that it isn't falling because the regulation has changed and they are not going to have exclusive control over the dot com registry. If it's something over like the fear of the China investor base and they are going to lose a ton of domains in the first quarter, I think that would be an amazing opportunity for us, but if it is because they are losing the business, then probably not so much.

Jeff: I'll say Verisk and Visa. They are both great businesses. We started them around 2%. We would like to grow them to 3% or larger, so on the drop, which we have been waiting for from the start. We would like to add to both of those businesses. Thanks for the question.

J.P: Yeah, I think just to piggyback off that real quick. If you go and you look at recommended allocation, a lot of those stocks that are of the smaller percentages, those are the ones we want to get hit because if we started it out at a 2%, we don't want to keep it at 2%, but given the market environment, given valuations, we wanted to take a measured approach. But we want those to get hit because we want to make them bigger positions because we wouldn't have bought them if we didn't believe in the companies.

Jeff: Certainly true and well said. Are we planning on additional hedging strategies? We talked about that near the top of the hour and yes, we are looking at hedging strategies of various kinds. I have most of my stocks in Motley Fool Pro and we thank you for your trust very much. We will work to keep earning it.

I get many emails from other Motley Fool services such as Total Income. Is there any reason to use another one? I would ask on the boards what fellow members think of that question? I know many members have multiple services and put together their own portfolio that way. The answer is really about what your objectives are and your goals and Total Income is a new service that focuses on high yield stocks is the primary focus. If you are looking for more yield, having that may make sense for you, but it's really an individual question. Many People Pro is all I have. Many People, they have a few other services, too. Thank you for the question.

Setting up the spread, I'm seeing a $12 spread for breakeven or a small credit instead of your recommended $13 to $14. $12 is close enough to $13 or $14. I do realize with the market rising each time I look at this position again while I'm waiting to update it that now you have to make the spread a little smaller because the market has been on quite a tear. Thanks for the question.

Shorts, we talked about shorts already. Len, I hope you enjoyed the answer as much as you could. Thoughts on Caesar, we talked about that. We talked about Amtrust already at the start of the hour as well, so all these Amtrust questions, the video will be on the site archived soon after we are done wrapping up here at 3:00. Please revisit the site and you can listen to our Amtrust talk right at the start of the chat.

Let's see? Any others that we have here? Shut or Shack, go to Motley Fool Options to ask that question. That's a holding only in Motley Fool Options. Go to the Shut or Shack, Shut or Stock Board there. Shut or Shack, it's what I want to shutter, shake, shack. Any questions you got see here that you want to answer?

J.P: Yeah, I can tackle one. Anonymous asked whether the political environment is going to have a negative impact on Starbucks? It says they took a hit and what do we think the future is looking like for that company? I will say in the memo that will be put out today, I'm covering four of Pro Stocks and Starbucks is one of them. It is actually the only one of the four that isn't receiving a fair value update and that is because I believe there are definitely some legitimate concerns to the long-term thesis for the company.

This isn't just a knee-jerk reaction to the mobile order and pay issues or the lackluster comps, though I think those are actually signs that can give you insight into the long-term issues. But for me it squares away towards what are the potential unit economics that the company can ultimately derive and what is the total adjustable market for Starbucks?

I believe it is a company that is basically in existence to cater to habitual purchases that are born from convenience and consistency and because of that I think they have a very large adjustable market. But I think management's 2021 goals are very ambitious and I think the market is based on the premium that it is currently commanding over the SAP 500, the market is basically taking that and saying 100% it's in the bank.

I think it's anything but 100% in the bank and so I'm still doing some more work on it, but you are correct in noting the future isn't as clear. I think management likes to downplay the macroeconomic environment, the struggles in retail, the struggles in the restaurant business, but I think those are things that … Starbucks is a great company, but they are like a best house in a bad neighborhood in terms of they are not immune to those. When those things have a negative impact on the industry at large or any type of tailwind or headwind, they are going to benefit or be hurt from that.

You are seeing that I think it was around 5 quarters ago, pretty much everybody's comparable store sales here in the US basically started to roll over and Starbucks basically followed suit with everyone else. I'm still doing a little bit more digging. We are not having a knee-jerk reaction to it. I'm not "Oh my gosh, they had a bad result in this quarter so we need to trim the position," but I think there's definitely some things that need to be looked at and reassessed for the company.

Jeff: Sounds good, if our guidance changes you will know first. I see a few questions that I can answer really quickly that seem important. J.P., which is not you J.P. unless you are asking questions through … You know you can always just come to me and asked directly, but J.P. is asking I bought Skyworks naked puts May and August, $85 strikes. Do we still stand behind these trades?

I really hope you mean to say that you sold those puts because we recommended selling the puts, sell to open the puts and not buy them. I think that's what you mean because you said naked. Yeah, you should have a profit on those trades and we still are advising a similar position in Pro and something similar in Options. We are still long Skyworks, the stock is rated a buy and then those who are using Options may have short puts on it as well.

I saw another question here. Someone was asking about Berkshire B shares in an IRA. Go to Motley Fool Options to the Berk Board there to ask your question please. That's a Motley Fool Options position. Finally, I'll do one more. G.B. is asking have we ever thought of hedging the entire portfolio by buying puts? Yeah, that's a fun thought that we throw around sometimes. It would be fun to just go market neutral and take some time to really think without any worry about what the portfolio may do, any real worry.

Yeah, but going market neutral is something we could do at any moment if we really thought we should. There is not great harm in it other than potentially missed upside, although that would have been great harm the past eight years if we were market neutral at any point. Yeah, it's a capability that we have and we consider all capabilities. I think that's it, guys. I think that's all we can answer because it's 3:00 and we need to free up at the studio. We appreciate your being here and joining us for this chat.

J.P: J.P. did sell to open those puts.

Jeff: Oh good.

J.P: I saw his question.

Billy: Good job J.P.

Jeff: Excellent, good, good, good, thank you J.P. for typing that in. Good job of getting the right trade in. That was great, good to hear and so you should be in good shape with that position. Billy and J.P., do you want to close each with your own 30 second thought, your most heartfelt thought at the moment, piece of advice, personal story? I'm throwing this at you. I didn't give them any warning of what you would say to members.

J.P: I'll take the easy way out because I saw a question there you didn't address and that is for me in terms of what do we think with regards to DE, Deer specifically. Anonymous wants to see it in the short basket again and we will have updated thoughts on that soon.

I still think the industry at large, 75% to 80% of those stocks are overpriced. Some of them buy a very large percentage, but the market just continues to shrug off those results and say the turn is coming and when it comes it's going to be huge. That is extremely frustrating for shorts and it makes it a lackluster endeavor and one that doesn't really pay off. We probably with regards to Deer, Caterpillar, anything like that, we will stay at the sidelines and then when we think the opportunity is right we will move back in probably at a smaller percentage to align with the basket.

Jeff: Thank you, J.P. ... J.P. closes with thoughts on Deer. I like it. Billy, what have you got?

Billy: Well, I'm going to go back to something we discussed before we started this chat, you, me and J.P., which is people have a tendency to get a little jittery based upon it may be a single quarter of results or something that happens on a given day. I think some overarching advice I can give people is to always remember we're in it for the long haul. It's about patience, making decisions carefully, analytically and not rushing or making any knee-jerk reactions.

Whenever you get a thought in your head like, "Oh, the stock is down 20% today. Should we do something?" maybe just keep in mind that doesn't necessarily mean we have to do anything at all. Just take your time, analyze and slowly figure out what it is you want to do based upon your analysis and decision-making. That would be my overarching guidance. I also want to say thank you to Heck Creek. I got your message that I do not need a haircut, but I should dye my beard gray to add some gravitas to my persona. I agree. I agree. That would work for me.

Jeff: I disagree, just give it time. Although Heck Creek, I rarely disagree with him and I see his point, but come on. You are only young for a while. You have to enjoy it. I'll close with I'll take J.P.'s route and answer two things I see here. Thoughts on special guidance for newcomers when selling a position, he's thinking of Wells Fargo, he or she. Bought and sold within 30 days at a loss. Not crying over spilled milk but could we have done better?

I'll just say, yeah, we need to do better. We can't foresee the future and we don't know when our thoughts on a position may suddenly change, but it's rare that it suddenly changes. If I were thoughts were evolving and we know we have new members coming in, we do our best to put anything on a hold that we don't think that we'll keep owning for years. Sometimes, and Wells Fargo was a rare example, we tell you to buy something and then soon afterward, telling you to sell. It is unfortunate. We will try to avoid that as much as we can and yeah, we will keep trying to avoid that.

That said, we have some new members come through at almost at any point and in those cases well, we'll just do our best. We try to put things on hold at least a month before we sell if that's reasonable to do. The other question was send out an alert please when you change guidance, buy, sell, hold or fair value estimate.

We do every Monday. Every Monday has the guidance update and typically our guidance updates are made right around Friday or Monday to account for that and not clutter your email with even more emails. On that note, thank you everybody for being here. We appreciate it. Thank you, J.P. Do you want to end laughing like you started?

J.P: No, I think I laughed enough for this chat.

Billy: As he laughs.

Jeff: Thank you Billy, we'll see you next month for the Options and Pro Chat and we'll see at that point whether you have had a haircut or not.

Billy: Thank you, Fool On.

Jeff: Thank you Pro members, Fool On.

Broadridge's Acquisitions Bolster Growth

Published Feb 15, 2017 at 12:22PM

Pro's Take: BR Q2-2017 Earnings

Broadridge Financial Solutions (NYSE: BR)

Q2-2017

Quarterly recurring fee revenue growth (Y-o-Y): +34.4% to $536 million (+6% organic growth, ex-NACC acquisition)

TTM Operating profit margin*: -277 bps Y-o-Y to 21.3%

Closed Sales growth (Y-o-Y): +15.5% to $56 million

Quarterly EPS growth (Y-o-Y): -25% to $0.25

**Operating profit / Fee revenue. This removes the impact of distribution revenue, which is a pass-through cost and distorts the true economics of the business.*

Quarter Quick Take

Broadridge has produced a typically steady start to Fiscal 2017, and it looks like management's revenue and closed sales guidance for the full year is going to be achievable: recurring fee revenue growth of +29%-+31% (YTD +34.4%), and Closed Sales of $140-$180 million (YTD $78 million). Although companywide margins are lower due to the impact of the company's recent acquisition of DST System's North American Customer Communications (NACC) business, Broadridge reported organic growth in recurring revenue of +6%, and margins should expand over time as the acquisition is integrated and operational synergies are achieved.

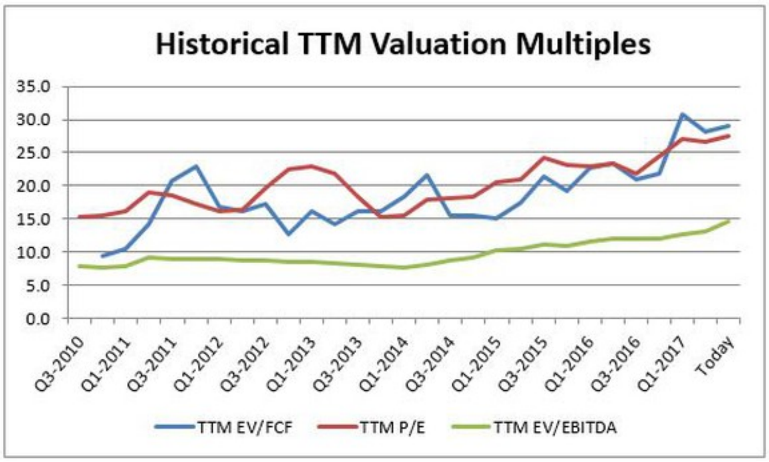
Updated guidance: Buy First (no change)

Recommended Allocation: 5.1%

Fair Value estimate: $65 (no change)

Current Price: $67.78

Based on management's guidance, at $67.78 per share, the stock is priced at about 25x projected 2017 cash flow and 26x projected 2017 GAAP EPS. Both of these valuation metrics are elevated relative to the company's history:



However, Broadridge still features stable cash flows, a steady growth profile, excellent management, an increasingly strong competitive positioning, and margin expansion opportunities. **Our Fair Value estimate remains unchanged at $65 per share, and Broadridge remains a Buy First on our scorecard.** Members who have yet to start or fill out their position can feel comfortable doing so at current prices, or you can write puts if you prefer to target a lower entry price (at current pricing, the $65 puts are a reasonable choice).

Our Thesis

Broadridge has a near monopoly in proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record and sound capital allocation policies make Broadridge a sturdy rock to build the Pro portfolio upon. We expect modest growth in fee revenue, slight operating leverage, plenty of free cash flow and a growing stream of dividends to help achieve North Star-like returns.

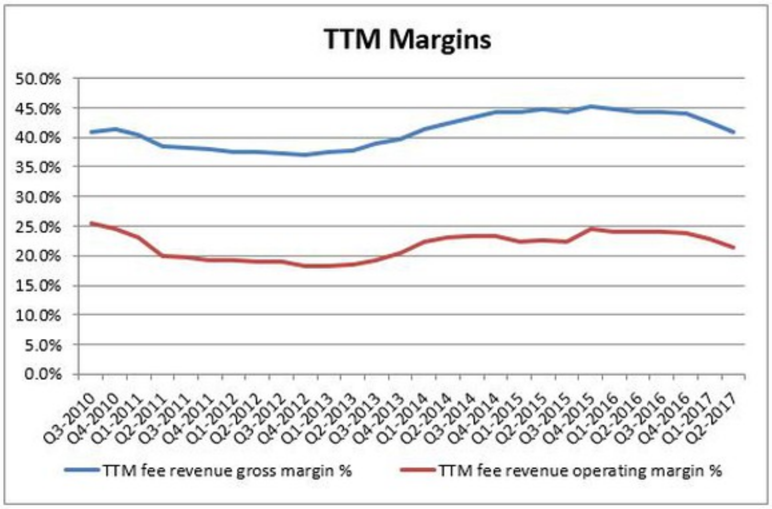
The Most Important Things

1) ***Closed Sales:*** This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%+). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

Broadridge has had a strong start to Fiscal 2017 with respect to closed sales. Year-to-date Fiscal 2017 (Q1 and Q2) closed sales came in at $78 million, which is up +18% compared to the first half of Fiscal 2016 ($66 million). The company reported record Q2 closed sales of $56 million, the highest magnitude for a second quarter in the company's history, and up +16% year-over-year. The company's success in closed sales is a reflection of continued investment in and expansion of the company's products and services.

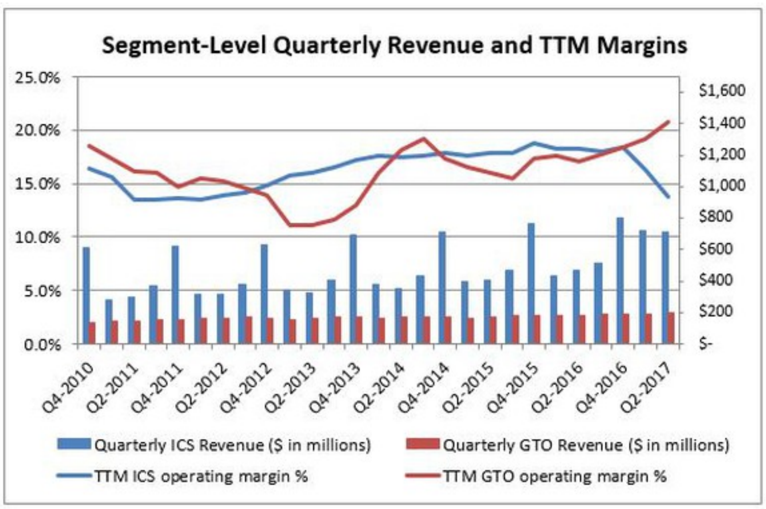
The run-rate for closed sales for Fiscal 2017 implies full-year closed sales of $156 million, which is within the company's guidance range of $140-$180 million. Additionally, Fiscal Q4 is historically the strongest sales quarter of the year, so the company may have room to reach the high end of its guidance for closed sales by the end of the fiscal year.

2) ***Fee Revenue Margin Performance:*** In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers) we prefer to look at trailing twelve months (TTM) margins to smooth out quarterly fluctuations. TTM fee revenue gross margins came in at 40.9% (down significantly from 44.4% a year ago), and TTM fee revenue operating margins came in at 21.3% (down from from 24.1% a year ago):



The reason for the decline in companywide margins is the company's [2016 $410 million acquisition of DST's North American Customer Communications] (NACC) business. The NACC business has a lower margin profile that Broadridge's legacy businesses, so that drags down the company's overall margin profile, given that the NACC business represents about 30% of total companywide revenues. In DST System's 2015 10-K filing, the NACC business generated operating margins of 8.2% (vs. Broadridge's ~17% reported operating margins pre-NACC). However, Broadridge should be able to expand NACC's operating margins over time via scale, cost synergies, and improved operational efficiency.

When looking at each individual segment, we can see that Broadridge's ex-NACC business is doing quite well. While the Investor Communications Solutions (ICS) segment shows significantly lower margins (due to the NACC acquisition), the company's Global Technology Operations (GTO) business has shown strong margin expansion, generating a record TTM operating margin of 20.8%:



We'll want to monitor the ICS segment's margins (expecting longer-term margin expansion once the acquisition period is lapped) to make sure the integration of the NACC business is on track, and we also want to watch the GTO segment to see if recent margin expansion trends continue.

3) ***Capital Allocation:*** Although Broadridge is a slow grower, it generates a lot of cash and has low reinvestment needs. Management has a very clear plan to put that cash to work: it targets a 45% payout ratio, and it plans on using incremental debt capacity to make acquisitions (having targeted $400-$600 million between FY2015-FY2017) and continue share repurchases.

On the dividend front, the company has paid out $1.26 per share on a TTM basis, good for a 51% payout ratio and about a 2% yield on the current price. On the acquisition front, the company has already significantly outpaced its FY2015-FY2017 target, having spent nearly $800 million on a variety of acquisitions and intellectual property that expand the company's breadth and depth of offerings. The company has an excellent acquisition track record (a 20%-plus IRR since Fiscal 2007), and I expect that the company's recent acquisitions and investments will continue to add to shareholder value. As for share repurchases, the company has bought back $101 million in shares in the first two quarters of Fiscal 2017.

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Pro Can Help

- **Questions?** Bring them over to the [Broadridge discussion board].

Let Winning Happen, and a Short Farewell

Published Feb 13, 2017 at 3:37PM

Dear *Pro* Fools,

When I was growing up, I often heard that if you want to achieve success in life, it is best to be a person of action. My parents, teachers, and coaches encouraged me to "take the bull by the horns" and "make things happen" rather than expecting that my goals would somehow come to fruition on their own. That was sage advice that's served me well through many aspects of my life, and I'd imagine that a similar mindset has helped many Fools in the *Pro* community.

Unfortunately, that bias toward action isn't as correlated with success in investing as it is with other endeavors in life. In fact, there's good reason to believe that with investing, more activity actually leads to poorer results over time. Sometimes playing not to lose really is a superior strategy to playing to win.

This idea crystallized in my mind recently as I reread an old Michael Mauboussin white paper about improving the decision-making process. It reminded me of the interesting research done by Simon Ramo for his book, *Extraordinary Tennis for the Ordinary Player*. Ramo's main conclusion was that there's a huge difference between how the pros win at tennis and how the amateurs do. In pro tennis, 80% of points are won by superior shots, but in amateur tennis, 80% of points are actually *lost* to unforced errors. In other words, amateurs can be more successful by simply keeping the ball in play and giving their opponent the opportunity to make the error. Mauboussin's key takeaway for investors: "It's often easier to succeed by making fewer mistakes than it is by being more brilliant."

That lesson immediately made me start thinking about the mistakes I see among my fellow investors (and myself). Which of them might be relatively easy to eliminate? Here are a few examples of missteps I think *Pro* members can easily avoid to improve their odds of long-term investing success.

1. **Don't forget that the devil is in the details.** Because of the various investing strategies we employ, *Pro* is one of the more complex managed portfolios at The Motley Fool. To successfully match the results of said portfolio, it's important to get the blocking and tackling correct. When a new trade is published, read it thoroughly to make sure you understand the strategy and the details of the transaction(s). Triple-check your options trades to make sure you are either buying or selling the correct type of contract. If you realize you made a mistake, close the trade immediately – even if doing so results in a loss – and make the correct trade. Use limit orders, be patient, and don't chase the trade if the price spikes immediately following the trade alert. Prices often drift back down in subsequent days, giving you a better opportunity to make the trade without paying a premium.
2. **Mind the forest *and* the trees.** Managing a portfolio presents a different set of problems than just picking individual stocks. When you're considering adding a new position, it's important to think about how it will interact with the rest of your holdings. Beware of over-weighting toward any sector and potentially exposing your portfolio to too much industry risk. Also, don't fixate on individual positions. Ideally, we want companies that move to their own beat, which means that some positions should be losing at any given time in a properly diversified portfolio.
3. **Anchors away!** Generating a fair-value estimate for a stock is as much an art as it is a science, because there are so many variables we simply cannot know. Too often, these estimates are used with a high degree of false precision, which causes us to anchor to what may be an arbitrary number. That's part of the reason Jeff has openly debated whether we should maintain fair-value estimates at *Pro*. I've personally missed many opportunities over the years by not buying a great company that was a couple of dollars above my conservative price target. Further, many investors only like buying stocks after they've declined in price, but adding to your winners at a higher price can be one of the best ways to compound capital over time. Use our fair-value estimate to inform your buying and selling decisions, but not to direct them.
4. **Avoid the seemingly irresistible urge to act.** When a trade goes against us, our first inclination is usually to try to fix it. But often, the best decision is to just sit on your hands and do nothing. That's a hard pill to swallow for the aforementioned "people of action" I think many of us at *Pro* work to be, but it's important. Before taking action, review whether your original investment thesis remains intact -- and remember that daily volatility is *required* to generate higher returns over the long term. If you've done your homework and invested in a high-quality business, you'll find such big moves often reverse over time, so it's often better just to walk away for a week or two and return to the decision when you're less impaired by an emotional response.
5. **Know that politics can be perilous.** The more rational you can be as an investor, the better -- and few things can impair rational thought like allowing your political beliefs to creep into your decision-making process. That precept has been on full display over the past year, with people across the political spectrum asking if they should sell everything for fear the world is coming to an end. Those who acted on that fear are likely kicking themselves following the recent market rally. Even if we could somehow know the results of elections ahead of time, it's doubtful we could predict how markets would respond to them. To be clear, I'm not telling anyone to ignore their principles -- but I am suggesting it's important to find ways to express them without recklessly endangering your financial future.

The *Pro* Bottom Line

There are enough challenges to succeeding as an investor without placing blockers in our own path. I think it's worthwhile for all of us to look at our processes and identify the unforced errors that may be costing us the win -- in fact, it's the only way we can advance from amateurs to pros in the game of investing. (It also helps to learn from other Fools' mistakes to avoid having to pay all of the "tuition" ourselves. The Lessons I've Learned board is a great place to do this, and to share the lessons you've picked up along the way.)

And finally, it is with mixed emotions that I announce this as the final Memo I'll be penning for *Pro*. I will be leaving the Fool and the *Pro* team at the end of the month to pursue a new, exciting chapter in my career. I have thoroughly enjoyed my time at *Pro* and have cherished the opportunity to learn alongside such a wonderful group of like-minded investors. Since joining the Fool in 2009, I've always admired the unique culture the *Pro* community has nurtured, and I have been honored to spend the past two years working on a team with some of the smartest and hardest-working investors in Fooldom. You should rest easy knowing that the *Pro* portfolio is great hands, and I expect many years of North Star-besting returns to come.

Foolish best,

-- Jeremy (TMFTank)

Pro Guidance Changes and Completed Trades: Feb. 13, 2017

Published Feb 13, 2017 at 3:33PM

Pro Guidance Changes (from the past two weeks)

- **Amazon.com** (NASDAQ: AMZN): Introduced to *Pro* as a Buy, at a 3% allocation.
- **Gilead Sciences** (NASDAQ: GILD): Moved to Hold as we assess 2017 guidance from management.
- **O'Reilly Automotive** (NASDAQ: ORLY): Moved to Hold while we consider the risk Amazon might pose to the auto-parts industry.
- **MasterCard** (NYSE: MA): Fair-value estimate increases to $99. It remains a Buy First at a 4.6% allocation.
- **Parexel** (NASDAQ: PRXL): Moved to Sell (the stock) and close all option positions.
- **TD Ameritrade** (NASDAQ: AMTD): Fair-value estimate increases to $41 from $35. The stock remains a Buy, at a 3.1% allocation.

Pro Completed Trades (from the past two weeks)

- **Amazon.com**: We bought a 3% stake (which turned out to be 100 shares) at $820.48.

- **Parexel**: As per our recent alert, we sold our shares at $64.42 and bought to close our covered calls at $1.69, closing the position.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Feb. 13, 2017

Published Feb 13, 2017 at 3:24PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.4%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **Apple** (NASDAQ: AAPL): Buy 4.3%.
- **OpenText** (NASDAQ: OTEX): Buy 3.4%.
- **TD Ameritrade** (NASDAQ: AMTD): Buy 3.1%.
- **Visa** (NYSE: V): Buy 2.5%.

Shorts:

- **CurrencyShares Euro Trust** (NYSEMKT: FXE): Sell short 1.7%.
- **Direxion Daily Financial Bear 3x** (NYSEMKT: FAZ): Sell short 0.1%, or set up a January 2019 $20 synthetic short for close to zero net cost. Set up one synthetic short for every $2,000 in shares you want to short.

Pro options:

- If you want to attempt to buy any of our stocks lower, you can write (sell to open) near-the-money put options on shares such as **Paycom** (NYSE: PAYC) and **Starbucks** (NASDAQ: SBUX), among others. Choose puts that pay you enough to be happy. Realize all these stocks are rated Buy.

Hedges:

- No update this week.

Upcoming Expirations:

- In March, our covered strangle on Verisign and our covered calls on **Parexel** (NASDAQ: PRXL) all set to expire. We'll update you before that expiration March 17.

MasterCard's Ho-Hum Quarter Was Still Awfully Good

Published Feb 9, 2017 at 3:33PM

Following three straight quarters of easily besting market expectations, **MasterCard's (NYSE: MA)** fourth quarter seemed rather pedestrian. Though the company matched estimates on most counts -- despite stronger than anticipated currency headwinds -- the stock has pulled back about 5% from its recent highs. Even so, MasterCard has been on a great run over the past year and we expect that momentum to continue into 2017. For the full year of 2016, net revenue increased 13% and operating income grew by 14%, showing the continued health of the business.

During the fourth quarter, MasterCard was helped by improving economic activity across most of the globe. European growth is continuing to slowly improve, with Germany at the forefront of those gains. The drop in the British pound caused by the country's Brexit vote has led to a surge in travel to the country. Despite the slower economic growth in Europe than other regions in 2016, MasterCard was still able to grow its gross dollar volume by nearly 20% for the year. This was achieved through a combination of an accelerating conversion to digital payments in the region as well as market share gains.

Turning to Asia, in India MasterCard experienced a 75% jump in processing volume thanks to the government's decision to discontinue the 500 and 1,000 rupee notes in an attempt to reduce corruption and money laundering. With 86% of the country's currency now removed from circulation, there should be rapid growth in the number of digital transactions. Currently, there are only about 1.4 million point of sales (POS) machines in a country that could ultimately support more than 60 million, which provides a long growth runway in the country. Because of the lack of processing infrastructure, MasterCard is encouraging the use of QR codes that allow merchants to accept digital payments without a point of sale device. Also, in China MasterCard continues to wait for the government to finalize its regulations and open its door to outside payment processors. While it waits, the company continues to add to its list of card issuing banks so that it will be able to hit the ground running when the government finally gives the go-ahead.

MasterCard also continues to invest heavily in technology, with a focus on growing the company's MasterPass market share. As the first digital payment service that works across all devices and channels, MasterPass has a solid first-mover advantage which is attracting new merchants to the service. The company is also using the MasterPass technology to power a QR code solution that enables person-to-business transactions. In addition to the India example mentioned above, this solution has been rolled out in 33 African countries.

Altogether, MasterCard's services business, which includes safety, security, data analytics, loyalty and processing, now accounts for 25% of sales and is growing at a faster clip than the overall transaction business. It also provides a diversified stream of higher-margin, recurring revenue and the products should make MasterCard's customer relationships stickier over time.

***Pro* Bottom Line**

We continue to be pleased with how MasterCard's business has been performing and with management's commitment to staying at the forefront of the digital payment technology evolution. After just one year, MasterCard is well ahead on its three-year plan to grow net revenue in the low double-digits and EPS in mid-teens. Along with Visa, the two credit card companies now combine for a 7.1% allocation in the Pro portfolio. We expect both companies will continue to compound value as consumers the world over shift their spending toward digital payments. Shares now trade at about 27 – times trailing free cash flow, which is a bit on the high side, but still consistent with the company's historical trading range. Thanks to MasterCard's leadership and growth potential in international markets we still consider the company a *Buy First*. **We're also bumping up the company's fair value to $99,** which represents a more conservative, though still generous, 25-times free cash flow multiple.

Sell Parexel International (and Close All Outstanding Covered Calls)

Published Feb 8, 2017 at 12:28PM

Is this for you? For all *Pro* members who own **Parexel International** (NASDAQ: PRXL) and/or have followed our recent covered call recommendation, we are moving the stock from Hold to Sell. If you own Parexel shares (and/or have outstanding covered calls on the stock) and agree with our thinking, follow this alert and sell the stock (and close your covered calls) with us. Read on to find out why we're selling, including portfolio reasons. If after reading you want to keep the shares on your own, of course you may do so.

How You Follow Along

- **Trade:** Sell Parexel International and simultaneously close your covered calls, ideally in one single transaction.
- **Allocation:** Sell all shares and close all outstanding covered calls. *Pro* is selling our 1,300 shares (representing 3% of the portfolio) and closing our 13 covered calls, bringing our cash (excluding shorts) up to 18.1%.
- **Actions:** Close your entire Parexel position by simultaneously:
  - Selling ("sell to close") all of your shares of Parexel International.
  - Closing ("buy to close") all of your covered calls on Parexel International.
- **Price Guidance:** It is **critical that you use a limit order** (please!) to aim to close your entire covered call position ("selling to close" your shares and simultaneously "buying to close" your covered calls) at the midpoint of the going bid/ask spread, lately $62.09 or higher (math below).
- **Prices** (as of 10:15 a.m. 2/8/17):
  - Stock price: $63.07
  - Buy to close March 2017 $65 covered calls (bid/ask split): $0.98
  - Net credit: $62.09 ($63.07-$0.98)

What We're Thinking

In November of last year, we moved Parexel to Hold after the company reported its fiscal first-quarter 2017 earnings. Our rationale was based on recurring managerial missteps (two straight non-timely SEC filings, questionable corporate controls, and a tendency to miss its own guidance), and we mentioned in that report that we might choose to close our position outright in future, depending on price. Then, in December, we decided to write covered calls on Parexel to earn income and potentially sell our shares at a higher price. We decided to target opportunistic income as we waited for another quarter of business results to see whether the company could turn around its recent negative trajectory.

After analyzing the second-quarter results released last week, we have decided that we no longer have enough confidence in management to maintain our position (just look at slides 5-7 in the company's most recent earnings presentation for evidence of mismanagement). The company has demonstrated a history of missing and lowering its own guidance, providing excuses for poor results, and underperforming our estimates, and its competitive position may be weakening. We are taking this opportunity to close our entire position in Parexel, banking a North Star-beating return since the position's inception in December 2013.

We bought shares at a net $46.15, wrote puts in 2014 for $0.65 per share, and sold our covered calls in December of last year for $4.05 per share. Now we are buying back our covered calls for $0.98 each, which means our effective buy price on our shares is $42.43 per share ($46.15-$0.65-$4.05 + $0.98). In closing our position at the current price of $63.07, our cumulative return on the position since inception is 49%, which equates to a 13.7% compound annual growth rate since inception, well above our North Star.

While the business has largely performed in line with our initial thesis thanks to beneficial industrywide trends, our confidence in Parexel's management has steadily declined over time. Especially given our portfolio's increased long exposure after adding **Paycom** (NYSE: PAYC), **Verisign** (NASDAQ: VRSN), and **Amazon** (NASDAQ: AMZN) over the past three months, we think now is a good time to sell our Parexel shares in order to earmark that capital for ideas we have more confidence in. Keep in mind that the stock may continue to do well from the current price if management can turn around recent negative trends. But our lack of faith in management is enough for us to sell our shares, bank this three-year-old position as a success, and move on to better ideas.

Pro Can Help

- Questions? Please bring them to the Parexel discussion board.

Pro Catch-Up Trades and Upcoming Expirations: Feb. 6, 2017

Published Feb 6, 2017 at 3:31PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.4%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **Apple** (NASDAQ: AAPL): Buy 4.3%.
- **Gentex** (NASDAQ: GNTX): Buy 3.2%.
- **OpenText** (NASDAQ: OTEX): Buy 3.4%.
- **Paycom** (NYSE: PAYC): Buy 2.4% (see our recommendation).
- **TD Ameritrade** (NASDAQ: AMTD): Buy 3.1%.
- **Verisign** (NASDAQ: VRSN): Buy 1.5% and then sell to open a March 2017 $80 put/$85 call strangle, selling one strangle for every 100 shares you buy.
- **Visa** (NYSE: V): Buy 2.5%.

Shorts:

- **CurrencyShares Euro Trust** (NYSEMKT: FXE): Sell short 1.7%.
- **Direxion Daily Financial Bear 3x** (NYSEMKT: FAZ): Sell short 0.1%, or set up a January 2019 $20 synthetic short for about no net cost. Set up one syn short for every $2,000 in shares you want to short.

Pro options:

- See Verisign above.
- If you want to attempt to buy any of our stocks lower, you can write (sell to open) near-the-money put options on shares such as Paycom, **Gentex** (NASDAQ: GNTX) and **Starbucks** (NASDAQ: SBUX), among others. Choose puts that pay you enough to be happy. Realize all these stocks are rated Buy.

Hedges:

- **PowerShares QQQ** (NYSEMKT: QQQ): We are working with The Fool to correct our mistakenly inputted 2019 put ratio spread to the suggested 2018 spread. For those not yet in the original position, today you would follow the allocation guidance given in the report, but you would sell to open January 2018 $102 puts, and buy to open January 2018 $114 puts, for no net cost or a small credit, selling two $102 puts for every one $114 put you buy.

Upcoming Expirations:

- In March, our covered strangle on Verisign and our covered calls on **Parexel** (NASDAQ: PRXL) all set to expire. We'll update you before that expiration March 17.

Pro's Earnings Are Looking Snazzy

Published Feb 6, 2017 at 3:25PM

Dear *Pro* Fools,

Business is tough. Acquiring customers and turning them into revenue -- let alone increasing that revenue every year -- is not easy for most companies. We hear about the big winners in the headlines, but we forget that most businesses struggle to reach real stature, failing or languishing instead. This kind of survivorship bias exists in investment funds, too: When we read about the best investors, we should remember that they're even better than we think given the thousands of funds that fail. Here at *Pro,* we're trying to own companies that will lead the parade of winners for a decade or longer, growing our investments in the process.

We have two overarching goals: We don't want to lose money over any rolling three-year period, and we want to at least double our real purchasing power every 10 years. Those goals are captured in our North Star measure (inflation plus 7% a year), which guides our long-term decisions. We won't take unreasonable risks to chase the North Star during any given year, because one year is a random amount of time; but we do want to stay close to the North Star over many years. Some years will inevitably encompass a falling market, and short positions are part of the path to better returns when that happens. With the market soaring since November, our shorts are behaving, not harming us much at all. In a down market, hopefully they'll help.

Most of our companies -- both short and long -- use the start of the year to give us a broad view of how the upcoming 12 months or so look to them. Over the past week, I've gone through results from several. While **Apple** (NASDAQ: AAPL) isn't one of them (JP will do that), we're pleased to see the stock hitting new all-time highs; **AmTrust** (NASDAQ: AFSI) is barely $1 from a new 52-week high, too. We'll get to those! But for now, here are the first companies I've reviewed.

Amazon (NASDAQ: AMZN) reported a record $9.7 billion in free cash flow last year, putting the stock's price at about 42 times that amount. The Amazon Web Services business now has a revenue run rate of $14 billion. Last quarter, Amazon increased total sales 22% to $43.7 billion, and earnings per share increased 54% to $1.54. Operating cash flow was up 38% to $16.4 billion over the past 12 months. The company continues to take market share, and is spending aggressively to expand its lead. It added 26 warehouses last year, increased its investments in digital content, Prime Now, AmazonFresh, and fulfillment, and continues to invest in AWS, Alexa, Echo and international growth. And this just scratches the surface of its activities (link opens a PDF -- maybe wait and come back to it!).

As for AWS, management expects to continue to lower prices and work on operating efficiencies -- that has always been the business model. It's adding clients, large and small, in droves. For the first quarter, Amazon expects *total* revenue to grow 14% to 22%. The net income line still hides a tremendous amount of leverage that it could one day unleash. The stock is a Buy with a 3% allocation, and serves as our most recent example of long-term thinking. Why expect a big gain in Amazon in a year? We don't. But we do over five years.

Facebook (NASDAQ: FB) continues to represent our favorite opportunity over the coming years, as indicated by its leading size in the portfolio, at 6.7%. Revenue was up 51% last quarter to $8.8 billion, with advertising revenue up 53% and mobile ad revenue up 63%. Facebook's daily users now number 1.2 *billion*, with monthly users at 1.9 billion. Instagram, Messenger, and WhatsApp also continue to grow. Four million businesses advertise on Facebook, and more than 500,000 are running ads on Instagram.

Meanwhile, Facebook continues progress on its long-term plans, investing in making its community more valuable to its members and advertisers, expanding its reach, and driving new initiatives including video content and virtual reality. Investments will accelerate this year and advertising growth rates will slow, but the stock already seems to have priced that in: Shares trade at 42 times free cash flow and 25.5 times expected earnings for the year ahead. The stock remains a Buy First.

GoPro (NASDAQ: GPRO) shares are down (a plus for our 0.4% synthetic short) following disappointing first-quarter 2017 guidance. Fourth-quarter 2016 revenue was up 24% from last year, to $540.6 million, on the refreshed Hero 5 camera, but despite this -- and the new Hero 5 Black, *and* the relaunch of the delayed Karma drone last week -- GoPro only forecasts first-quarter revenue of $190 million to $210 million. That's disappointing for a company that's selling its first slew of new products in about two years, especially given that GoPro's business has become much more international in that time. Later this year, we can expect a Hero 6 and new accessories, but nothing that suggests a sudden tailwind.

Last year, GoPro sold about 5.3 million units, down 12% from 6 million in 2015. This year could bring another decline. Management said it's focusing on margins and average selling prices rather than units. That's fine, but not when it sounds like an excuse for not reaching more customers. After multiple production issues on new products, the focus is on cost-cutting in a bid to return to profitability this year. The stock looks vulnerable to any market downturn, and unlikely to soar in the meantime. Keep watching our Catch-Up Trades each Monday for ways for newcomers to get on board; right now, this stock is prohibitively expensive to short or use options on.

Visa (NYSE: V) reported strong results that drove the stock to a new all-time high on Friday, pushing it above $200 billion in market value. Driven by the inclusion of Visa Europe *and* strong transaction growth around the world, revenue was up 25% last quarter to $4.5 billion, while earnings per share jumped 23%. Global processed transactions rose 13%, their U.S. counterparts were 11% higher, and cross-border volume was up a strong 13%. All areas of the business benefited, with services revenue up 17% and data processing revenue up 28%.

European and U.K. results were especially strong, with an influx of commerce thanks to the lower euro and the weak pound; Visa's purchase of Visa Europe may have been well timed. Management still expects Visa Europe to add 2% to 3% earnings-per-share growth per year. Meanwhile, they're watching the White House and Capitol Hill for any laws that could change trade or taxes (Visa would like to repatriate billions of dollars sitting overseas), but it's too early to predict anything. The stock trades at about 25 times both trailing free cash flow and expected earnings for the year ahead. Visa remains a Buy at our 2.5% allocation, and that allocation would be larger if we didn't also own 4.6% in **MasterCard** (NYSE: MA). Visa is up about 30% (including dividends) in the less than two years we've owned it.

I covered **Skyworks Solutions** (NASDAQ: SWKS) a bit in our recent rolling report. The company's results and outlook appear strong, with revenue up 9.4% last quarter, record margins, and guidance for sales growth of about 10% this year, with particular strength in the second half. Apple accounted for about 40% of revenue at Skyworks last year, which is a plus and a risk; but the companies' long-term relationship remains intact. And Skyworks is scoring other key customer wins around the world, in phones, Internet of Things ... things, and cars. The need for its complex connectivity solutions is growing, and management itself says 5G cell networks are "going to be a game-changer" as data speeds increase as much as tenfold.

The company's order backlog is "fully booked," and management believes this sort of demand is sustainable, projecting still-higher margins. At about $91, the stock trades at 18.4 times free cash flow and 14.1 times expected earnings for the year ahead (19.4 times trailing earnings), looking fairly priced. It remains a Buy at a 4% allocation. Only those who wrote covered calls on it with us last year (and rolled them in January) should have options on it at this point. If you just own shares, just keep owning shares.

So, that's five *Pro* positions right there. We'll have more reviews soon! Meanwhile, members continue to discuss *Pro*'s performance after Billy's column last week. Bring your thoughts about that, or about our positions in general, to the Memo Musings board. Thank you, and Fool on!

— Jeff (TMFFischer)

More From Motley Fool *Pro*

- *Pro*'s Performance Graph, Updated
- *Pro*'s Biggest Stocks in a New Era
- Navigating Toward Our North Star
- All *Pro* Memos

Pro Guidance Changes and Completed Trades: Feb. 6, 2017

Published Feb 6, 2017 at 3:12PM

Pro Guidance Changes (from the past two weeks)

- **Amazon.com** (NASDAQ: AMZN): Introduced to *Pro* as a Buy, at a 3% allocation.
- **O'Reilly Automotive** (NASDAQ: ORLY): Moves to Hold while we consider the risk Amazon might pose to the auto parts industry.
- **Parexel** (NASDAQ: PRXL): Moved to Hold while we consider management execution issues.
- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $87.50 from $85. The stock remains a Buy, at a 4% allocation.
- **TD Ameritrade** (NASDAQ: AMTD): Fair-value estimate increases to $41 from $35. The stock remains a Buy, at a 3.1% allocation.

Pro Completed Trades (from the past two weeks)

- **Amazon.com** (NASDAQ: AMZN): We bought a 3% stake (which turned out to be 100 shares) at $820.48.
- **Skyworks Solutions** (NASDAQ: SWKS): We rolled our January 2017 $75 calls to February 2017 $75 calls for a $1 credit. Soon after, we rolled those February 2017 $75 calls to August 2017 $87.50 calls for a $1 debit, and sold to open the same number of August 2017 $85 puts for a $1 credit (meaning no cost to roll overall, but 4% more stock exposure through the new puts). We now have an August $85/$87.50 covered strangle on the stock.

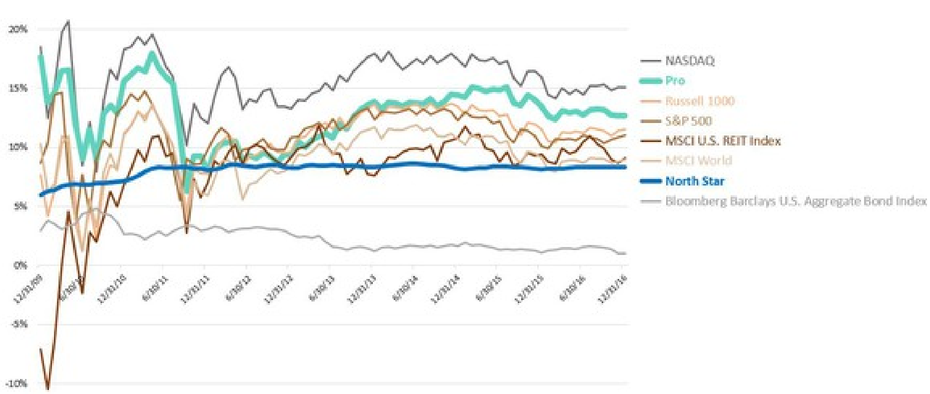
You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro's Performance Graph, Updated

Published Jan 30, 2017 at 3:48PM

Dear *Pro* Fools,

Last week, while I was checking out the North Star section of *Pro*'s Guidebook (which is a very important section if you haven't read it!), I noticed that the charts included there were a bit stale. The graphs included in that section were last updated as of 2012 -- five years ago. So I took it upon myself to recreate the performance graph using our most recent data (from *Pro's* historical monthly account balances):



(Click image for larger version)

To properly interpret this graph, keep in mind that the returns shown here are annualized, not cumulative. While annualized returns allow for easier comparison of data over time, they have some flaws. Over short time periods, annualized returns can appear volatile, while over long periods the data becomes more smooth (which is why the left side of the graph is highly variable and the right side looks more stable). Additionally, annualized returns over periods of less than one year are not very useful, so I started the data series a little more than a year after *Pro's* inception. I've also included a few more market indices for comparison than did the original graph, which I hope will provide more context for our performance relative to other asset categories.

Additionally, here is a tabular form of the same data, showing return comparisons over different time periods:

	1 year	2 years	3 years	5 years	Since Inception
Annualized Total Return					
Pro Portfolio	7.3%	7.4%	10.7%	15.9%	12.7%
North Star	9.3%	8.5%	8.3%	8.5%	8.3%
NASDAQ	8.9%	7.9%	10.1%	17.1%	15.0%
Russell 1000	11.4%	5.7%	7.9%	14.0%	11.5%
S&P 500	18.3%	7.2%	8.8%	11.8%	11.0%
MSCI U.S. REIT Index	7.1%	4.2%	11.8%	10.5%	9.1%
MSCI World	8.2%	3.8%	4.4%	11.0%	9.0%
Bloomberg Barclays U.S. Aggregate Bond Index	0.1%	-0.9%	0.6%	-0.4%	1.0%

Finally, for further context, here is the annualized volatility (i.e., the standard deviation) of the monthly returns for the same data categories:

	1 year	2 years	3 years	5 years	Since Inception
Volatility (Standard Deviation)					
Pro Portfolio	9.4%	10.5%	9.5%	9.7%	11.6%
North Star	0.9%	1.1%	1.1%	1.1%	1.4%
NASDAQ	14.0%	14.4%	13.2%	12.8%	16.5%
Russell 1000	10.6%	11.7%	10.7%	10.4%	14.7%
S&P 500	9.9%	11.7%	10.6%	10.3%	14.2%
MSCI World	10.8%	12.2%	11.0%	11.1%	15.7%
MSCI U.S. REIT Index	16.0%	15.7%	14.9%	14.3%	25.4%
Bloomberg Barclays U.S. Aggregate Bond Index	3.8%	3.5%	3.3%	3.2%	3.7%

This data was originally presented as monthly volatility. The table has been updated to annualize the figures.

What Does This Say About Our Portfolio?

We can see from the graph above that since 2012, Pro has significantly widened the gap between our portfolio's return and our North Star (although that gap has been narrowing since mid-2015). We can likely attribute some of our outperformance to our relatively high allocation to technology, as we can see that the NASDAQ index has been the strongest-performing asset category included in this analysis since *Pro's* inception.

Additionally, we can see that *Pro's* returns correlate much more closely with market indices than with our North Star. This is an important consideration: While we aim to achieve North Star-like returns over long periods of time, we do *not* expect to follow the return trajectory of our North Star over short periods. Our North Star is an abstract concept, not an real, investable asset. In fact, it's much more stable than any asset that will allow for the magnitude of returns we are looking for, and that's because it includes a constant 7% annual appreciation factor. As *Pro* investors, we must understand that to achieve the type of returns we seek (7%-plus), we must be willing to accept short-term volatility.

To illustrate that point, you can see from the volatility table above that the only included asset category that comes anywhere close to matching the stability of the North Star is bonds. However, in exchange for that stability, the annualized returns are far lower than what is achievable from the more volatile equity category. And while we accept that volatility is inevitable, we still work very hard to reduce the *Pro* portfolio's volatility using shorts, hedges, and our sizable cash balance. The table shows that the *Pro* portfolio scores the lowest among all the included categories (except for bonds) in terms of the volatility of our monthly returns.

The *Pro* Bottom Line

All in all, *Pro* has done well to outperform our North Star and most other stock categories, while still achieving a lower volatility of returns. We aim to continue to achieve our goals as we move forward, keeping our volatility, expected returns, and allocations in mind. I hope this update and analysis helps provide a more complete picture of how our portfolio has performed over time.

Bring any thoughts to our Memo Musings discussion board, and Fool on!

-- Billy (TMFBillyTheKid)

More From Motley Fool *Pro*

- *Pro*'s Biggest Stocks in a New Era
- Navigating Toward Our North Star
- *Pro*'s 2016 Results, Reviewed!
- All *Pro* Memos

Pro Catch-Up Trades and Upcoming Expirations: Jan. 30, 2017

Published Jan 30, 2017 at 2:42PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.4%.

Continue building your portfolio with our Buys, including:

- **Amazon.com** (NASDAQ: AMZN): Buy 3% (see our recommendation).
- **Paycom** (NYSE: PAYC): Buy 2.4% (see our recommendation).
- **Visa** (NYSE: V): Buy 2.4%.

Shorts:

- No update this week.

Pro options:

- **Skyworks Solutions** (NASDAQ: SWKS): If you only own stock, keep it uncovered. Shares remain a Buy. If you are trying to roll your pre-existing covered calls that expire in February, roll to the August expiration, $87.50 strike. If you're also writing puts as part of the roll (not for any other reason), sell to open August $85 puts.

Hedges:

- No update for member portfolios. The Fool mistakenly set up a 2019 put ratio spread on QQQ for our account instead of 2018, so we need to close it and open the recommended 2018 position. We'll provide an update on which strike prices we're using once we're able to make that change. But those already in the 2018 position as recommended are fine.

Upcoming Expirations:

- Right now, nothing is set to expire until March, so we'll have updates on those in February.

Pro Guidance Changes and Completed Trades: Jan. 30, 2017

Published Jan 30, 2017 at 2:36PM

Pro Guidance Changes (from the past two weeks)

- **Amazon.com** (NASDAQ: AMZN): Introduced to *Pro* as a Buy, at a 3% allocation.
- **O'Reilly Automotive** (NASDAQ: ORLY): Moves to Hold while we consider anew the risk Amazon might pose to the auto parts industry.
- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $87.50 from $85. The stock remains a Buy, at a 3.9% allocation.
- **TD Ameritrade** (NASDAQ: AMTD): Fair-value estimate increases to $41 from $35. The stock remains a Buy, at a 3.3% allocation.

Pro Completed Trades (from the past two weeks)

- **Domino's Pizza** (NYSE: DPZ): We sold to open June 2017 $140 covered puts, receiving $2.96 each for selling three contracts.
- **Expeditors International** (NASDAQ: EXPD): We closed our January 2017 synthetic long and short $50 calls. We're currently out of the position.
- **ProShares QQQ Trust** (NASDAQ: QQQ): The Fool mistakenly set up a January 2019 $103/$116 put ratio spread for a credit, instead of the recommended 2018 put ratio spread. We need to adjust the position to 2018 and will alert you as we do.
- **Skyworks Solutions** (NASDAQ: SWKS): We rolled our January 2017 $75 calls to February 2017 $75 calls for a $1 credit. Soon after, we rolled those February 2017 $75 calls to August 2017 $87.50 calls for a $1 debit, and sold to open the same number of August 2017 $85 calls for a $1 credit (meaning no cost to roll overall, but 4% more stock exposure through the new puts). We now have an August $85/$87.50 covered strangle on the stock.

You can see all of our guidance, positions, and transactions from the Recommendations page.

How Our Eight-Year Bull Market Stacks Up Historically

Published Jan 30, 2017 at 11:42AM

Fellow Fools, this article was first published Saturday in our Motley Fool One *service, and the team thought* Pro *members might be interested, too. Let us know what you think on our Philosophy & Strategy discussion board!*

No investor is an island.

The Dow passed 20,000 for the first time this week.

The milestone doesn't mean much — the market is 0.02% from where it was two weeks ago, a level no one cared much about.

But what is impressive and deserves attention is the ongoing appreciation for how far the market has risen over the last eight years, and how long this bull market has lasted.

I started writing for The Motley Fool on October 1, 2007. The market peaked two weeks later before embarking on one of the biggest bear markets in history. It bottomed in March 2009. If you told someone at the time that stocks would basically go straight up for the following eight years, I'm telling you, not one person in a thousand would have believed you. Including me.

Why? Because there just aren't many periods in history where stocks do really well for eight years. It's only happened a handful of times in the last 100 years.

To put the last eight years of market gains in perspective, let's compare it to other historic bull markets.

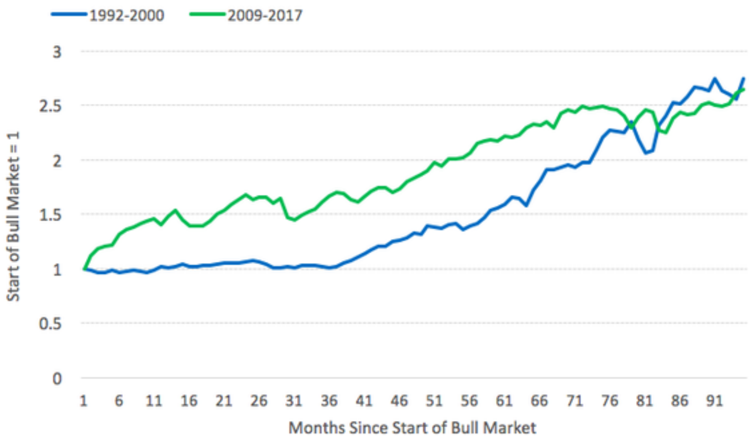
One caveat, and it's an important one: Comparing today's market to the past is not an attempt to argue that today's market will follow the same subsequent path as one in the past, especially in the short run. It's merely context on how far we've come.

The 1990s Bull Market

The dot-come era was born and the economy roared, making the 1990s one of the most famous periods in market history. For the first time ever, small retail investors (like you!) could participate in the market without the guidance of a broker.

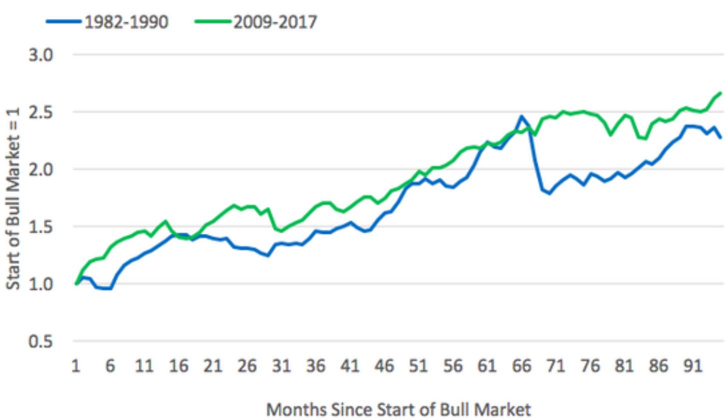
A recession in the early 1990s dragged the market down. Stocks began rallying in 1992, and didn't look back until peaking in 2000.

How do the 1990s compare to the last eight years? Pretty similarly, in both magnitude and duration:



The 1980s Bull Market

The market peaked in the mid-1960s and then went nowhere for the next 20 years, adjusted for inflation. The 1970s and early 1980s were a miserable time to be an investor. But high future returns are born in miserable periods, and by 1982 stock valuations were so low that a new rally was born. Morning In America was here, and stocks surged from 1982 to 1990 — even with the crash of 1987 in the middle:



Here again — both the magnitude and duration of the 1980s bull market is about on par with what we've experienced in the last eight years.

The 1920s Bull Market

Next to the 1990s, the 1920s are the most famous period of market excess and insanity — a period that both soothed the pain of an economy torn by World War I and set the seeds for the pain of the Great Depression. In his diary of the Great Depression, author Benjamin Roth wrote:

> As I look back now to the 1921-29 period it seems to me unreal and almost unbelievable. After the war pressure people wanted to have a good time and to spend money.

Here's how the 1920s stack up to today:

The 1920s is one of the only eight-year periods when the market performed better than it has in the last eight years. And it did far better: Equivalent eight-year returns would put the Dow at more than 34,000 today.

The 1950s and 1960s Bull Market

We remember the 1950s and '60s as a glorious time for American economic growth — and it was. Global dynamics that came out of World War II combined with an incredible amount of factory productivity learned during the war combined with pent-up consumer demand caused by rations during the war set the stage for 15 years of amazing growth.

Here's how it compared to today's bull market:

The eight-year rally from 1950 to 1958 is about on par with what we've experienced since 2009.

Then came a series of declines — moderate, but not severe. The 1950 to 1965 bull market, if taken as one, was an incredible period of wealth creation.

I left in the whole 15-year period in this chart not to predict what might come next for us today, but to show what's possible over long stretches of time even after big run-ups like we've had over the last eight years.

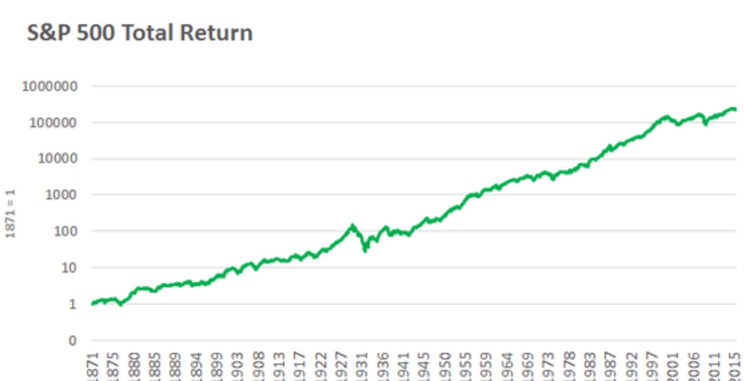
All of which is to say: We've been here before.

The last eight years is not unprecedented.

What gets dangerous is when you assume we've come too far, too fast, and think that the rally of the last eight years means we're due for crash.

We will have more bear markets. Maybe starting next month, maybe next year, maybe five years from now. The fact that we're surprised at how far we've come since 2009 should be a reminder that outcomes are surprising, not that your prediction of a new bear market is due to come true.

The most important thing any of us can do is contextualize big rallies and big drops against two things: our own personal needs and goals, and the long-term record markets have produced over time:



Buy Amazon.com

Published Jan 26, 2017 at 3:25PM

Is this for you? This recommendation is for all *Pro* members who don't already own shares in this company.

How You Participate

- **Action:** Invest 3% of your portfolio in **Amazon.com** (NASDAQ: AMZN)
- **Price Guidance:** Aim to buy below $850
- **Recent Price:** $837
- **Guidance:** Buy
- **Fair-Value Estimate:** $850, or 30 times projected one-year free cash flow
- **Note:** The company announces earnings Feb. 2. We have no idea how the stock will respond that day, but we aim to buy before then, with a long-term outlook.

What We're Thinking

When *Pro* first bought **Apple** (NASDAQ: AAPL) in 2012, it was already the most valuable company in the world, sporting a massive $127 billion in annual revenue. Less than five years later, revenue is up 69%, and our investment (to which we later added) is up 72% excluding dividends. Apple has outperformed a majority of our positions, despite its giant size. Enormous **Amazon.com** (NASDAQ: AMZN) could follow the same path, and may even have superior avenues for sustained growth:

- According to the U.S. Census Bureau, only 8% of U.S. retail sales occur online, but the shift to the Internet continues -- Amazon's revenue rose by 29% last quarter.
- Gartner estimated in 2015 that Amazon Web Services (AWS) for the cloud had 10 times the utilized capacity of its next 14 competitors *combined*, and this lucrative business increased revenue by 70% in 2015.
- Alexa is a leading artificial-intelligence operating system in the home.
- Amazon Prime may have as many as 80 million global subscribers, each paying $99 a year for free shipping and streaming video.
- And more ...

Amazon has so many business arms that a more fitting name could have been Octopus. Consumer retail sales drive massive cash flow to the company daily, but today it's cloud services that generate most of the profits. Amazon's cloud is heavy in machine learning and AI; relatedly, Alexa's early success is driving Amazon Echo and Dot product sales, and manufacturers around the world are now building Alexa into new devices and cars. Amazon has hundreds of fulfillment centers, and investment bank Piper Jaffray says 44% of U.S. citizens now live within 20 miles of one -- that's a strong competitive advantage. Drone delivery is in the works, and Amazon is investing in more of its own delivery to save on costs. U.S. sales account for about two-thirds of retail revenue, but international is growing and largely untapped. In an unconventional surprise, the company is launching a physical bookstore in Manhattan, and Amazon Go grocery stores around the country. And then there's Amazon's award-winning original content.

Sometimes lost in the breathless coverage of all these initiatives is what helps drive the success of each: data. Founder and CEO Jeff Bezos, 53, is driven by the intelligent use of information and cutting-edge technology to do business better than others. As the world's largest online retailer, Amazon has a better understanding of consumer retail behavior than any internet competitor, allowing it to anticipate customer desires. Couple that with the relentless pursuit of improving the customer experience, and Amazon always seems two steps ahead. In its own words, Amazon is "guided by four principles: customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking." Management has a history of reinvesting cash flow for more growth, learning from mistakes, and pushing new boundaries. This bodes well for long-term growth.

Financials

The longstanding critique of Amazon has been its lack of consistent let alone steadily-growing earnings. The company turns 23 soon, so it needs to start pulling its own weight. But this argument ignores Bezos's extremely long-term outlook. You've surely heard it before: Amazon brings in cash from customers before it pays suppliers, resulting in a "float" that keeps it perpetually cash-rich, like a rainforest rich with oxygen. Successfully investing some of that cash in new growth and succeeding some of the time (you'll have your failures) can turn the business into a regenerating compounding machine, one where the winners will outweigh the losers, and the core keeps growing. But until recently, it wasn't clear just how profitable Amazon could be.

In 2015, Amazon made a modest $596 million in net income, or $1.28 per share. The 2016 S&P Capital IQ estimate calls for about $2.3 billion in income, or $4.79 per share. We'll see on Feb. 2. After years of waiting, income finally appears ready to balloon, and that's despite management continuing to invest giant sums in the business. On average (from S&P Capital IQ), Wall Street expects earnings per share to jump another 85% in 2017, to more than $8, and then expand to nearly $15 per share in 2018, and then more than $22 per share in 2019. Amazon doesn't provide guidance, and we know Bezos doesn't mind sudden losses, but we believe these estimates accurately reflect the leverage becoming available to the business when Bezos *wants* to tap into it. In fact, this phenomenon is already unfolding on the top line as various business lines improve: Since 2012, gross profit is up nearly 300%, while revenue has only about doubled. And trailing free cash flow is more than $8 billion, up from just $395 million in 2012, putting the company at about 45 times free cash flow.

That's a lot of numbers in one paragraph, all meant to illustrate one belief: Amazon can be a richly profitable business, once it wants to be. Wall Street believes that will start to happen this year, and if so, the stock should celebrate. If not, we'll likely just need to wait longer before it does. But the past two years of free cash flow growth suggest it's happening.

Amazon.com Metric	2011	2012	2013	2014	2015	TTM (to 9/30/2016)
Cash from Operations	$3,903	$4,180	$5,475	$6,842	$11,920	$14,603
Capital Expenditures	$1,811	$3,785	$3,444	$4,893	$4,589	$6,040
Free Cash Flow	**$2,092**	**$395**	**$2,031**	**$1,949**	**$7,331**	**$8,563**

Source: S&P Capital IQ. Dollars in millions.

What We're Watching

Amazon continues to invest in worldwide distribution, artificial intelligence, the cloud, drones, original content, shipping, and now brick-and-mortar retail stores. The idea of retail might elicit a cringe, but think of retail stores done right: **Starbucks** (NASDAQ: SBUX), **Panera** (NASDAQ: PNRA). Done well, retail can be an excellent long-term investment, but we'll be watching Amazon's results.

Our largest near-term risk is that Wall Street's expectations prove premature, deflating the stock. Our largest long-term risk is that Amazon makes bad moves, putting a profit trajectory at risk. We want to see steadily growing profits and free cash flow as Amazon finally starts to mature (though it'll still be a young company for a few decades more). We're willing to wait for stable growth if it appears imminent, because then the stock should keep performing, but not if a positive outcome starts to appears less and less likely. Then we may have to exit. On the plus side, Bezos has more than $60 billion invested in the stock, so he's on our side. Finally, we view the highly profitable AWS business as a risk: Competition will likely lower margins, so we want to see the sales growth rate remain strong enough to compensate for that on the bottom line. And Amazon has a volatile stock. We have to accept that.

Why Now?

For most of our investments in *Pro*, we want to see a clear path toward increasing profits and free cash flow, and Amazon has always bounced along a dusty road between profits and losses. We knew that was by design, but we didn't know when it could finally turn the corner. It appears to be doing so now, and the profits that could result between now and 2020, and then beyond, could impress everyone. At the same time, online retail will become much more than 8% of U.S. retail sales and will keep expanding internationally. AI is also changing shopping behavior, and Amazon is leading that charge. Combine all these factors, and Amazon may soon have the stellar, smooth financials of a company that you simply "must" buy. We'd rather buy it a bit before the rush. (Amusingly, though, this isn't the first time I've been involved in an Amazon buy: The first was ... 1997.)

Alternative Trades

We assume that many of you already own shares. Keep your allocation right where you want it. If you don't own shares yet, we're starting with a 3% stake. Given the share price, we don't expect to use options on it.

Pro Can Help

- Finally, a *Pro* discussion board for the company where most of us likely do the majority of our online shopping: Amazon.com.

Pro's Biggest Stocks in a New Era

Published Jan 23, 2017 at 3:40PM

Dear *Pro* Fools,

There's change on the horizon. Scratch that. Change is already here.

For one, the United States has a new, hard-driven president intent on keeping and expanding manufacturing in the U.S., with penalties planned for U.S. companies that choose to make products elsewhere and import them for sale stateside. Earlier today, the White House suggested a 35% tax on outsourced items brought back to the country to sell. If even some form of this stance comes to fruition, it's bound to lead to epic changes. One of our largest overseas manufacturers is **Medtronic** (NYSE: MDT), which produces devices around the world that are brought home to sell. Much larger, of course, is **Apple** (NASDAQ: AAPL). We're digging into how these companies may be affected and how they may react.

While changes in import tax laws are probably on the way, major trade deals including NAFTA are simultaneously on the docket for renegotiation. Both situations suggest uncertainty for now, which likely will lead to volatile stock prices. Offsetting this potential "uncertainty headwind," today the White House suggested that up to 75% of current U.S. regulations governing business could be removed, potentially freeing businesses to do more, faster. That promise is difficult to fathom, since most regulations were put together over many years and for specific reasons. The 75% number will likely prove high, but suffice to say that regulations are likely to decrease. Taxes are expected to descend sharply for corporations, too. These two concrete changes could serve as a tailwind to stocks but may already be behind much of the market's gains since November.

Tailwinds plus headwinds generally equals volatility, and that may be especially true in this case because any change is a process: It takes time, it evolves as it happens (adding to uncertainty), and it can't help but upset the status quo. As we look ahead to that sort of environment, we should be asking ourselves, "How does my portfolio look?" Start with your largest positions.

Pro's largest positions, in order, are:

- **Facebook** (NASDAQ: FB)
- **Broadridge Financial Services** (NYSE: BR)
- **AmTrust Financial Services** (NASDAQ: AFSI)
- **O'Reilly Automotive** (NASDAQ: ORLY)
- **MasterCard** (NYSE: MA)

As of this afternoon, those five positions combined accounted for 26.2% of the portfolio's value. At first glance, we're not likely to face any import tariff concerns here. None of these businesses produce tangible items. They're all services, except O' Reilly's, which runs retail stores in the U.S. selling parts made by others.

But this is a simplistic look at the situation. Facebook relies on advertising. If manufacturers are suddenly hit by import tariffs, will they advertise less as they adjust? Will MasterCard be affected by fewer transactions if trade uncertainty slows commerce?

And then what of **Skyworks Solutions** (NASDAQ: SWKS)? With today's put-writing recommendation -- only for certain members, note -- Skyworks Solutions becomes a top potential position for us. It manufactures its tiny chips around the world, and those products are used overseas in phones and devices that Skyworks itself doesn't make or sell. As a result, most of its business starts and ends overseas. It should be clear of import tariffs, but what if its end customers are not, and business slows as a result?

Everything is interconnected, which is ultimately why changes from D.C. should ideally arrive slowly, methodically, after thinking through the ramifications as much as possible. This means we may live with uncertainty for a long time, as potential changes are debated. But that's better than the alternative -- better than changes that are rushed through, leading to cascading effects.

The bottom line is that we're assessing the news as we see it, and thinking about how it may affect our businesses. In most cases, there will not be an easy or early answer, so we need to expect volatility while we wait. We should see volatility as opportunity. Meanwhile, we have a portfolio that has little to do with manufacturing aside from a few positions, so we're fortunate in that sense. But we must still take stock of large potential changes in trade law, and invest how we believe is best. We've been looking at new companies in this light since November.

Overall, our biggest task will be to remain long-term owners in superior businesses, owning the ones that should win despite changes, because the environment is changing for everyone. We should *not* mess with our approach, which has always -- ultimately -- worked in the past and should continue to work over time. But we can tweak, adjust, and aim to get better, so we're tuned into our changing world as it happens.

Bring your thoughts to the Memo Musings board. Fool on!

— Jeff (TMFFischer)

Pro Guidance Changes and Completed Trades: Jan. 23, 2017

Published Jan 23, 2017 at 3:15PM

Pro Guidance Changes (from the past two weeks)

- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $87.50 from $85. The stock remains a Buy, at a 3.9% allocation.
- **TD Ameritrade** (NASDAQ: AMTD): Fair value estimate increases to $41 from $35. The stock remains a Buy, at a 3.3% allocation.

Pro Completed Trades (from the past two weeks)

- **Domino's Pizza** (NYSE: DPZ): We sold to open June 2017 $140 covered puts, getting $2.96 each, selling three contracts.
- **Expeditors International** (NASDAQ: EXPD): We closed our January 2017 synthetic long and short $50 calls. We're currently out of the position.
- **ProShares QQQ Trust** (NASDAQ: QQQ): The Fool mistakenly set up a January 2019 $103/$116 put ratio spread for a credit, instead of the recommended 2018. We need to adjust the position to 2018 and will alert you as we do.
- **Skyworks Solutions** (NASDAQ: SWKS): We rolled our January 2017 $75 calls to February 2017 for a $1 credit.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Jan. 23, 2017

Published Jan 23, 2017 at 2:19PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.4%.

Continue building your portfolio with our Buys, including:

- **Paycom** (NYSE: PAYC): Buy 2.4% (see our recommendation).
- **Visa** (NYSE: V): Buy 2.4%.

Shorts:

- Holding pat right now.

Pro options:

- **Domino's Pizza** (NYSE: DPZ): Use a limit order to write (sell to open) June 2017 $140 covered puts following our new recommendation. Write one put for every 100 shares of Domino's you are short. The puts lately pay around $3.10 or so. If the stock price declines, the puts should pay better.

Hedges:

> No update at the moment. The Fool mistakenly set up a 2019 put ratio spread on QQQ for our account instead of 2018, so we need to close it and open the recommended 2018 position. We'll provide an update on which strike prices we're using once we're able to make that change. But those already in the 2018 position are fine.

Upcoming Expirations:

> Right now, nothing is set to expire until March, so we'll have updates on those a bit later in February.

Roll Your Covered Calls on Skyworks Into a Covered Strangle

Published Jan 23, 2017 at 1:50PM

Is this for you? This recommendation is only for *Pro* members who have written $75 covered calls on **Skyworks Solutions** (NASDAQ: SWKS) expiring Feb. 17. The stock remains a buy at a 3.9% allocation. Those who have not yet written covered calls should leave it uncovered, and just go on owning it; we're playing catch-up here by rolling our calls into a covered strangle, so newcomers don't need to follow along.

How You Participate

- **Trade:** Use a rolling order on Skyworks' options to:
  - "Buy to close" all Feb. 17, 2017, $75 calls.
  - "Sell to open" the same number of August 2017 $87.50 calls.
  - In addition, "sell to open" the same number of August 2017 $80 **puts**.
    After this, participants should have the stock you already owned, plus an August 2017 $80 put/$87.50 call covered strangle written on all of your shares.
- **Allocation:** Write ("sell to open") one new call for every call you are closing. *Pro* is continuing to cover all 1,200 shares owned. We're now writing one new put for every short call, as well, potentially doubling our exposure, though we plan to roll the strangle rather than take shares.
- **Recent Prices:**
  - Stock: $89.90

- Buy to close Feb. 17, 2017, $75 call (splitting bid/ask): $15
  - Sell to open August 2017 $87.50 calls: $10.30
  - Sell to open August 2017 $80 puts: $5.40
  - Net credits collected: Approximately $0.70 (this price will change)
  - Upside gained: $12.50 per share
- **Option Price Guidance:** Prices will change, but lately use limit orders to complete all transactions for a credit of about $0.70 (at recent prices) or more. The price you pay to roll your calls from $75 to $87.50 (about net $4.70), you should aim to get back by writing puts for the same amount or more (lately $5.40). If the stock moves meaningfully in either direction before you make your trade, adjust your strike prices accordingly to end up rolling for no cost or, if not possible, a small debit, such as $0.50 or less. We'll do the same if need be.
- **Stock Guidance:** Buy 3.9%. As mentioned above, don't use options on it today if you haven't yet.
- **Fair-Value Estimate:** Increases to $87.50 from a long-standing $85.

What We're Thinking

Everything that stood out at Skyworks Solutions more than two years ago when we first bought shares came through in spades in last week's earnings report: Skyworks is signing more large customers for its complex connectivity solutions; it is expanding content in the products it serves, taking more market share; and it is increasing its margins and free cash flow. The company sees a healthy 2017 ahead and strength lasting into 2018, for a start. Along with serving all of the major smartphone makers, Skyworks is finding a home in home connectivity products, including those from **Amazon.com** (NASDAQ: AMZN), **Alphabet** (NASDAQ: GOOG), and **Microsoft** (NASDAQ: MSFT); its semiconductor products are also connecting cars to the Internet, with **Tesla** (NASDAQ: TSLA) among its newest customers. Skyworks sees tremendous long-term opportunity in cars because each automobile must process an incredible amount of data every time it's used, so fast, efficient, complex connectivity is key -- that's right in Skyworks' sweet spot.

The company expects revenue growth of greater than 10% this year, and Internet of Things growth above that, at 10% to 15%. Mobile phones account for about 60% of revenue, the broad Internet of Things category 25%, and power amplifiers about 15%. China contributes about 25% of revenue and growing, and overall production is fully booked going into the new quarter.

Management anticipates an especially strong second half and early 2018 on the heels of the new 10-year anniversary iPhone. **Apple** (NASDAQ: AAPL) recently accounted for 40% of company revenue; while that number definitely gives us pause, it also reflects the recent hit suffered by Samsung, due to its exploding phones; Samsung should start to claw back this year. Meanwhile, Skyworks' relationship with Apple is on strong footing, with a partnership that looks years ahead. Even beyond that, Skyworks sees 5G technology as a large opportunity, with data speeds up to 10 times faster than today's 4G and LTE, requiring more complex solutions that it's well positioned to offer.

Why This Strategy?

All of this is great, except that we covered our shares last summer for income, and we've been playing catch-up almost ever since. I knew it was a risk to cover a volatile stock, and we'll discuss lessons learned later; for now our priority is addressing it. Our latest covered call was closed last week for about a 35% gain (we made $3,324 in profit by closing our January $75 calls last week). But to get more upside in the stock now, we need to roll our February $75 calls, and we should do so soon because they now lack time value. With shares at about $90, we can roll up to $87.50, buying to close almost all intrinsic value in our $75 calls, and writing mostly time value in the new calls. Then we're also writing $80 puts (all time value) to capture more credit (note: the put writing is optional!). This allows us to roll our covered calls up $12.50 in strike price without putting in substantial or any additional capital.

But we are accepting more exposure to Skyworks in the process, making the stock our largest position on the surface. Given the $15 per share in credits we'll have on the books after this roll, we'll have a net $65 start price on any potential new shares, and a potential sell price of $102.50 on existing shares. It's a wide range to work in, and our intention is to roll our strangle as we earn credits on it, continuing to manage the position to earn back premium and recapture upside in the shares. We're comfortable with the extra exposure to the stock given the strength of Skyworks' business, reasonable valuation, and our plan for managing this lucrative strangle. But even the best of plans can sometimes get sidetracked, so be comfortable with extra exposure to Skyworks before writing the puts.

Alternative Trades

- **Can't write puts?** Then simply roll your covered calls, the same way we are. You still capture $12.50 in upside for a cost of only about $4.70 or so. It's worth it given the healthy prospects here.
- Other than that, this is a specific roll, with a strategy change, to regain recent missed upside. So again, those just owning shares going into today should continue to do so, and not use options today. The stock remains a Buy.

More That Matters

- **Maximum gain:** The stock's upside is capped at our written call's strike price; plus, we can profit by earning the premiums received for writing the strangle.
- **Maximum risk:** The full stock value, plus the full written put exposure, which is more stock exposure starting at our put strike.
- **Follow-up**: We'll continue to manage our covered strangle, rolling for upside or for more credits as needed, at least until we're satisfied with the returns we've recaptured. We plan to keep the stock long-term as long as the business and valuation seem to merit it.

Options Can Help

- **Questions about this "highly connected" trade?** Please visit the SWKS board.
- **Want to know more about strangles?** Options U has your neck -- er, back.

TD Ameritrade Benefits From Higher Interest Rates

Published Jan 20, 2017 at 1:20PM

Pro's Take: AMTD Fiscal Q1-2017 Earnings

TD Ameritrade (NASDAQ: AMTD)

What Happened?

- Fiscal Q1-2017 press release
- Fiscal Q1-2017 earnings presentation

- [Fiscal Q1-2017 earnings call transcript]

Guidance Update

After incorporating this quarter's results into our model, **our Fair Value estimate increases to $41**, up from $35. Cash flow generation since the last FV update, higher growth in the company's spread-based balance, and increased expectations surrounding interest rates are the factors leading to the increased FV estimate. Nonetheless, at more than $46 per share as of this writing, the stock is still more than 10% above our Fair Value estimate, so we'd advocate some caution (perhaps buying a half position or writing puts to buy shares lower) if you haven't yet established exposure to TD Ameritrade. The stock can be quite volatile as it often trades based upon market sentiment for financial stocks.

Updated guidance: Buy (no change)

Recommended Allocation: 3.3%

Fair-value estimate: $41 (up from $35)

Current price: $46.13

The Numbers

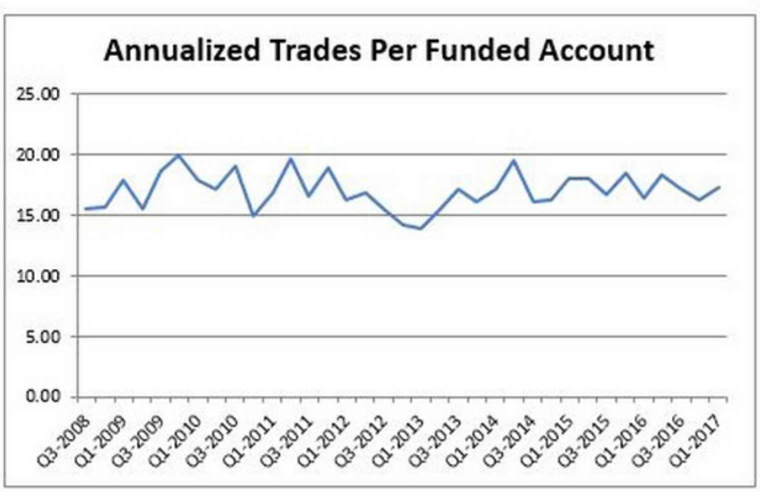
- Net revenue of $859 million (+5.8% year-over-year)
  - **Transaction-based**:
    - Funded accounts grew to 7.05 million (+5.4% year-over-year)
    - Trades per funded account of 4.32 (vs. 4.09 last quarter vs. 4.13 a year ago)
    - Average commissions and fees per trade of $11.65 (vs. $11.82 last quarter vs. $11.90 a year ago)
    - Totals up to:
      - 7,046,000 x 4.32 x $11.65 = **$355 million** in transaction-based revenue (+8.2% year-over-year)
  - **Spread-based**:
    - Total spread-based revenue of **$396 million** (+3.9% year-over-year)
    - Average spread-based balance of $117.7 billion (+14.8% year-over-year)
    - Thus, Net Interest Margin (NIM) =
      - $396 million / $117.7 billion = 0.336% (quarterly)
      - NIM (annualized) = 0.336% x 4 = 1.35% (vs. 1.37% last quarter vs. 1.49% a year ago)
  - **Fee-based**:
    - Fee-based revenue of $94 million (+2.2% year-over-year)
    - Average fee-based balance of $170.4 billion (+7.4% year-over-year)
    - Thus, Investment Product Fee Yield =
      - $94 million / $170.4 billion = 0.055% (quarterly)
      - Investment Product Fee Yield (annualized) = 0.055% x 4 = 0.221% (vs. 0.232% last quarter vs. 0.232% a year ago)
- Record client assets of $797 billion (+14.6% year-over-year)
- Record interest rate sensitive assets of $125 billion (+14% year-over-year)
- Net new client assets* of $18.7 billion (9.7% annualized growth rate)
- Diluted EPS of $0.41 per share (+3.8% year-over-year)
- Trailing-12-month (TTM) average return on equity (ROE) of 16.6% (down from 16.7% a year ago)
- Capital management:
  - Paid $0.18 per share in cash dividends in the quarter (a 1.6% yield on the current share price)

*excludes changes in client assets due to market fluctuations

Analysis

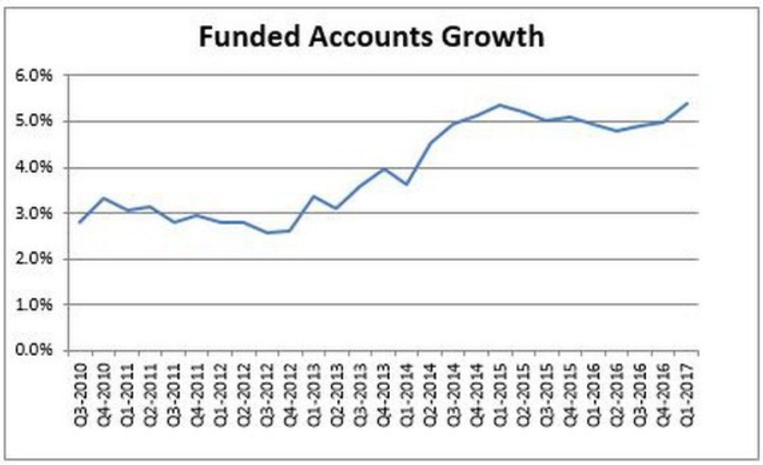
TD Ameritrade continues to gather client assets at a steady pace. In Fiscal Q1-2017, the company reported net new assets (NNAs) of $18.7 billion, a 9.7% annualized growth rate relative to total client assets at the beginning of the quarter. The company's long-term goal is to grow net new assets at a rate between 7-11%, and this quarter is at the upper end of that range.

Trading activity increased this quarter compared to last quarter, averaging 487,000 trades per day this quarter, up 11% year-over-year:

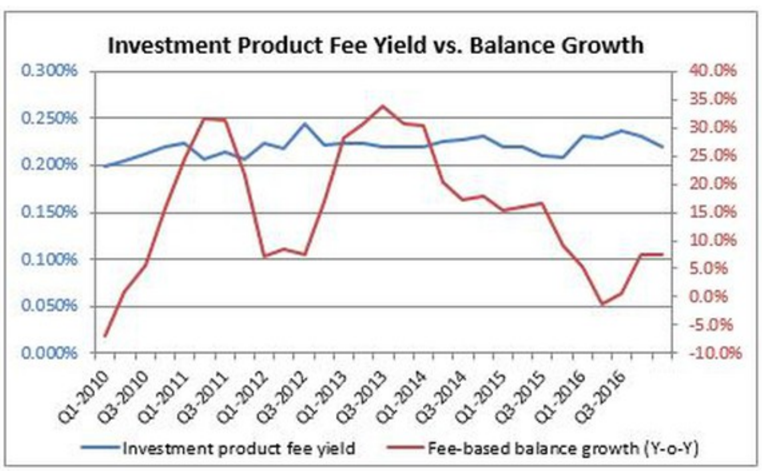


Average commissions and fees per trade came in at $11.65, which is down -1.4% sequentially and down -2.1% year-over-year:

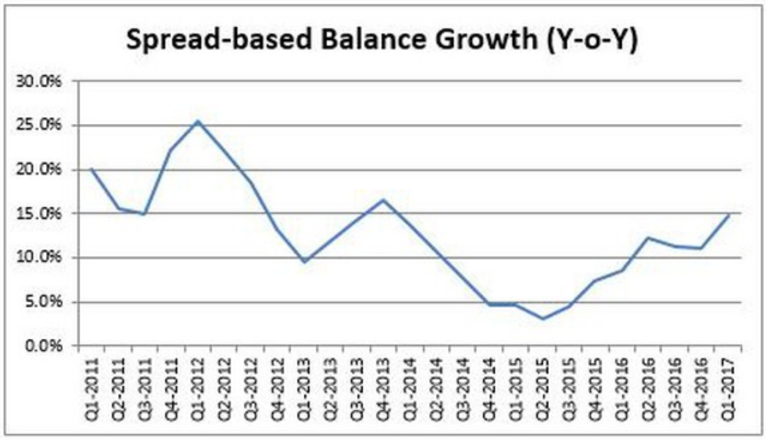
We expect a steady decline (around 3% per year) in commissions and fees per trade over the next ten years due to price competition in the industry. In the short-term, the transaction-based revenue stream will likely continue to bounce around, varying based upon product mix, market volatility, and fluctuations in the commission rate. But over the long run, steady account growth (a 4.4% CAGR over the last 8+ years) has led to persistent upward pressure on transaction-based revenue, and that trend seems likely to continue, as account growth accelerated in this quarter:



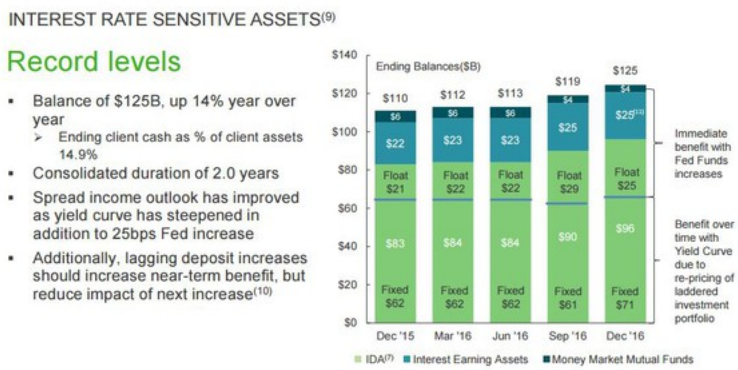
The performance of the fee-based segment of the business moderated a bit this quarter, with fee-based revenue up +2.2% year-over-year. The company's average fee-based investment balance during the quarter was $170 billion, up +7.4% year-over-year. A decline in the investment product fee yield led to the lower growth seen in this segment. We expect modest growth in fee-based revenue (about 4% annually) over the next ten years:



As for the company's spread-based revenue stream, TD Ameritrade reported accelerating growth the in the spread-based balance, which is important given that this segment is highly sensitive to interest rates:



As the interest rate yield curve continues to steepen (as it has post-election with the 10-year treasury up 54 basis points), the larger TD Ameritrade's spread-based balance is, the more the company stands to benefit from higher rates:



Management mentioned that the benefit from the market increase in interest rates is likely to exceed their earlier guidance for a $0.08-$0.10 impact to EPS, due to a steeper yield curve and lower pay rates than anticipated.

What We Think Now

TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and as interest rates increase, the company is positioned to grow earnings sharply.

If you have questions, post them on our TD Ameritrade discussion board.

Upcoming Split: OpenText

Published Jan 18, 2017 at 4:00PM

OpenText (NASDAQ: OTEX) is conducting a 2-for-1 stock split* next week. Here's what you need to know.

- **What's happening?** Sometime after market close on Jan. 24, OpenText shareholders will notice that they have twice as many shares as they used to, each priced at half that day's closing price.
- **What does this mean for me?** Not much! You will still own exactly as much of a stake in the company as you did before. Shares will be a little easier for investors to buy and sell since their price will be lower, but the short-term effect of moves like this is usually trivial. And to long-term investors, it's basically inconsequential.
- **Does this change what The Motley Fool thinks of this stock?** Nope! Fool on!

*This move is technically a stock dividend, but don't sweat the details. As far as your ownership stake is concerned, it's the same as a split.

Close All of Your Calls on Expeditors International

Published Jan 18, 2017 at 11:47AM

Is this for you? This is for *Pro* members who have any call exposure to **Expeditors International** (NASDAQ: EXPD) -- we are exiting our long calls and our short calls. Members with shares can sell those. For other situations, see our Alternative Trades at the end of this report.

How You Participate

- **Trade:**
  - Buy to close all January 2017 $50 (or other) calls.
  - Sell to close all January 2017 $42 (or other) calls.
  - Leave your written January 2017 $42 puts alone to expire Friday, unless you want to close for pennies.
- **Recent Prices:**
  - **Stock:** $53.67

- **Options:**
    - **Buy to close** January 2017 $50 calls: $3.50/$3.90 -- aim for $3.80 or lower (until prices change)
    - **Sell to close** January 2017 $42 calls: $11.50/$11.80 -- aim for $11.70 or higher (until prices change)
    - **Net credit:** That's about $7.90 in credit if you close both with one trade.
    - **Follow-up prices:** As prices change, aim to close both for a reasonable amount of time value of only $0.15 or so each.
    - **Timing:** As as long as Expeditors remains above $50, close your short $50 calls by Friday at the latest (earlier is better) to avoid being exercised. Pay only $0.15 or so in time value. Sell to close the calls you own by Friday, or else they'll turn to stock on Monday; you can of course hold that stock on your own if you want, but *Pro* will have no position in Expeditors after this trade.

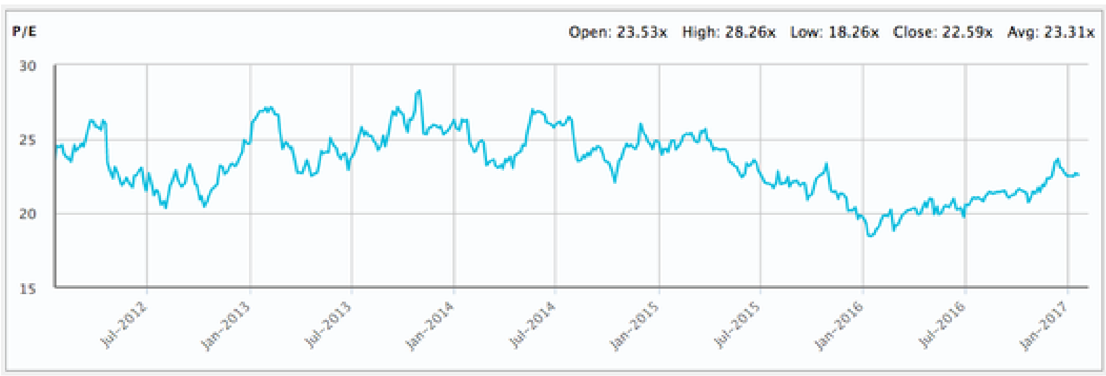
What We're Thinking

We're looking at a greater than $12,000 capital gain on our Expeditors synthetic long in one year. That's a 29% return on the $42,000 in look-through exposure the position gave us.

We also made a net $3,534 in option income on the syn long in 2016, despite having to roll short calls higher several times. That income brings our total return to $15,534, a 37% one-year return on the aforementioned $42,000. On a cash basis, we put no cash in this position and brought in $15,534. As shared in yesterday's Memo, this is a good example of using sensible leverage to enhance our results and keep cash in our coffers for opportunities or as a cushion.

After two years of writing synthetic covered strangles on Expeditors, why stop now? One word: trade. Expeditors leases and rents space on planes and ships to transport customer cargo back and forth between (primarily) Asia and the United States. With tough trade talk commencing under the incoming Trump administration, it's at least possible that trade will slow, and Expeditors is already not expected to grow much in 2017. In fact, revenue has flattened since 2011, but cost-cutting helped move earnings upward the last two years. That led to stock appreciation, which makes the shares more vulnerable to any slowdown.

The $53 stock now trades at 22.6 times earnings, 21.8 times expected earnings for the year ahead. These value multiples remain slightly below average for the stock in recent years, so in most situations this would not concern us. But given the specifics here -- future trade policies are a question mark, and the value multiple is up considerably since 2016 started -- the valuation is not low enough that we want to continue an income strategy.



Source: S&P Global Market Intelligence.

Given our desire to be defensive in this situation, we'll close our position and watch from the sidelines for now, rather than take shares or roll our synthetic long to 2018. Presidents have considerable, independent executive power when it comes to trade, so we'll watch for new opportunities after we start to get more clarity on how trade deals may trend with the new White House.

Alternative Trades

- **If you own stock and/or have covered calls:** You can let your shares get called away to match our exit of this position, or sell the shares outright if you don't have in-the-money calls on it. With our closing trade, it effectively becomes a Sell on our scorecard.
- **If you wrote puts last time:** Those are expiring as income. We're not suggesting new ones today.
- **If you have a 2018 synthetic long:** It's always possible we'll reinitiate the position later, but we can't be sure. If you want to match us, close your 2018 syn long -- and exit any positions related to it.

Pro Can Help

- **Questions?** Just ask! Ship yourself on over to our Expeditors board.

Roll Your Covered Calls on Skyworks Solutions

Published Jan 18, 2017 at 11:47AM

Is this for you? This recommendation is only for *Pro* members who have written Jan. 20, 2017, $75 calls with us. Those new to this position should just own stock at this point; do not write covered calls at least until after earnings Jan. 19. *Pro* members who aren't writing calls at all can continue to own this Buy-rated stock in a 3.4% allocation. (And finally, *Options* members who wrote $72.50 *puts* expiring Friday are on track to earn full income without needing to take any action. If the stock falls below $72.50 before then, *Options* will issue an alert to roll or close.)

How You Participate

- **Trade:** Use a rolling order on **Skyworks Solutions** (NASDAQ: SWKS) options to:
    - "Buy to close" all Jan. 20, 2017, $75 calls.
    - "Sell to open" the same number of Feb. 17, 2017, $75 calls.
- **Allocation:** Write ("sell to open") one new call for every 100 shares you are covering. *Pro* is continuing to cover all 1,200 shares owned, representing 3.4% of the portfolio.
- **Recent prices**:
    - Skyworks Solutions stock: $78.08

    - Jan. 20, 2017, $75 call (splitting bid/ask): $3.95
    - Feb. 17, 2017, $75 call: $5.10
    - Net credit to roll: Approximately $1.15
- **Option price guidance:** Prices will change, but use a limit order to roll for ideally about **$1.05 in net credit** or higher. If the stock remains above $75 by Friday, you *must* roll for the credit you can get then to avoid losing your shares.
- **Stock Guidance:** Buy 3.4% (you don't need to use options on it if you haven't yet).

What We're Thinking

With Skyworks Solutions' volatile stock a few dollars higher than the strike price of our $75 covered calls expiring Friday, we're going to roll the calls in order to keep our shares. With earnings being released on Thursday evening, we're going to roll before then to get another dollar or so in credit; that will make it easier if we need to roll still higher *after* earnings, and rewards us a bit more if the stock falls and stays lower after earnings. In other words, given that we're keeping the stock covered for now, there's little reason not to roll. An administrative note: We need to send this alert now so we can make the trade ourselves on Thursday, after our 24-hour waiting period -- and so you have some time to make it, too. Adventurous members who want to see where the stock trades *after* Thursday's earnings report could wait and roll Friday if need still be, though the advantages of that are likely slim.

Looking ahead into 2017, *Pro*'s current plan is to continue an income strategy on Skyworks. At about $77, shares trade at 15 times trailing earnings per share and 12.7 times expected earnings for the year ahead, according to S&P Global Market Intelligence. But the business trades at 24.5 times free cash flow, and shares are likely to remain volatile. We believe we can ultimately make more returns writing calls than we would by solely waiting for upside in the stock (though we see potential there, too). We'll manage these calls as need be.

Investors may view Skyworks favorably this year, given the big expectations for the 10th anniversary iPhone from **Apple** (NASDAQ: AAPL) due this fall. Apple remains Skyworks' largest customer. The promise of a big finish to 2017 could benefit both stocks both now and later. Of course, it remains to be seen whether the iPhone will deliver enough "wow" to drive record unit volume. We believe so, but we're biased. While we wait, we'll manage our covered calls on Skyworks for upside and for income. Over the longer term, the company's semiconductor products continue to drive connectivity in nearly all of the major smartphone models and in Internet of Things devices, cars, and more. The long-term outlook remains healthy as long as Skyworks' margins continue to appear safe from erosion, as they do right now.

Enough talk. We need to roll and then see how earnings come out Thursday night. Exciting -- even with our calm, long-term outlook and approach.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up**: We'll continue to manage our covered calls, rolling for upside or more credits as needed.

Options Can Help

- **Want to know more about this strategy?** Our guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the SWKS board.

Navigating Toward Our North Star

Published Jan 17, 2017 at 4:02PM

Dear *Pro* Fools,

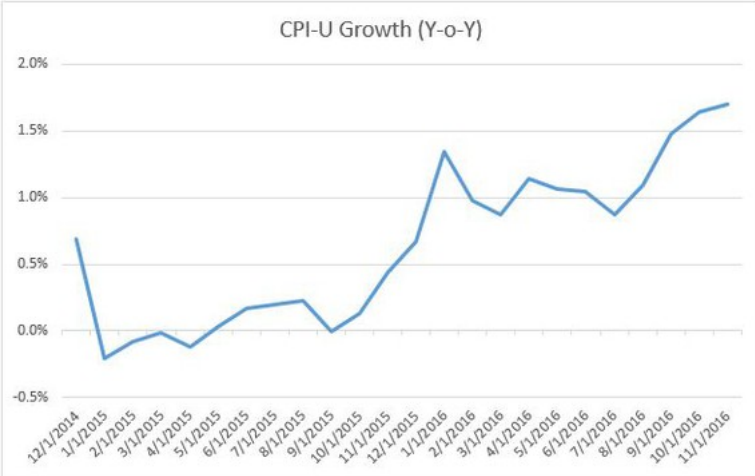
Jeff looked back on *Pro's* 2016 results in last week's Memo, detailing our portfolio appreciation by category, reviewing our activity, and sharing lessons learned. As he mentioned, last year was the second time in five years that we trailed our North Star (inflation + 7%), although our prior performance has been enough to ensure we are still ahead of it since inception and over the most recent rolling three-year period.

For some context on our North Star, *Pro* has two primary goals:

1. To achieve positive returns over every rolling three-year period.
2. To double our real purchasing power every 10 years.

Last year's results put us on track to achieve goal No. 1, but trailing our North Star means a little more pressure as we pursue goal No. 2. To double our real purchasing power in 10 years, we first need to beat inflation (as measured by the Consumer Price Index), and then we need to compound our capital at about 7% annually -- that's why the North Star is structured as it is.

Inflation + 7% is a very challenging target, especially as inflation continues to rise as it's been doing since the beginning of 2015, increasing our target for portfolio appreciation:



Source: Federal Reserve Bank of St. Louis.

During one of our regular investing meetings last week, the *Pro* team discussed four specific ways in which we plan to position our portfolio moving forward to continue to achieve our North Star goal. In this Memo, I'll share the ideas we discussed and provide some examples to help illustrate them.

1. New Long Stocks With Potential for Strong Growth

Although we are a portfolio that utilizes longs, shorts, options, and ETFs, the vast majority of our portfolio appreciation has come from our long stocks. We are firm believers in long-term buy-and-hold investing, aiming to own great businesses that will compound our capital over time. We have developed our *Pro* Quality Checklist to help us find and prioritize these long investments.

Because we tend not to be fully invested (we've averaged about 70%-75% net long over *Pro*'s history), it's all the more important to find long stocks that fit our criteria and can appreciate at rates above our North Star, helping drive our returns upward. Examples of stocks that have helped drive our returns include **Broadridge** (NYSE: BR), which has appreciated by 20% annually (including dividends) since we initiated the position in 2010; **AmTrust** (NASDAQ: AFSI), up 29% per year since our original 2009 recommendation; and **O'Reilly** (NASDAQ: ORLY), up 31% per year since we started our position in 2013.

We aim to find more long stock ideas that will appreciate strongly over time, helping drive our returns upward toward our North Star goal.

2. Intelligent Leverage Strategies

Thoughtful leverage can help generate strong returns while risking relatively little capital. A leveraged strategy that works favorably for us can go a long way toward helping us achieve our North Star goal. Our bought calls on **Facebook** (NASDAQ: FB) are a great example of an intelligent leverage strategy: In September 2012, near a low point for sentiment on Facebook stock, we purchased long-term calls. We risked just 1.2% of our funds, eventually exercising half of those options into owned stock at expiration in January 2014. The Facebook shares we now own started off as long calls that cost us less than $10,000 to initiate; those same shares are now worth nearly $180,000.

3. Protect Against Downside

It almost goes without saying, but we will have a very difficult time generating North Star-like returns if we allow our portfolio to suffer enduring losses. We must protect against downside where we can, utilizing shorts and hedges to make sure we have some positions that will generate positive returns in a market downturn.

It's important to note that we are OK with regular volatility in our long stocks. As equity investors, we must accept volatility as one of the risks necessary to generate long-term returns. Short-term price volatility is OK as long as we continue to expect the businesses we own to grow and compound our capital over time. But in the meanwhile, we can use shorts (such as our paired short on **Domino's** (NYSE: DPZ), half of a position that includes our Papa John's shares) and hedges (such as our **QQQ** (NASDAQ: QQQ) put spread ratio) to buffer some of our downside exposure.

4. Target Monthly Income Whenever We Can

As shared in Jeff's review column from last week, *Pro* generated $21,492 in option income in 2016 as we aimed to have some options expiring every month. Option income in 2016 accounted for 12% of our total portfolio appreciation for the year, and added nearly 1% to our overall returns for the year, a significant outcome. Income from options will not be the sole determinant of North Star-like returns, but it helps augment our long-term stock appreciation and dividend income. If we can earn a 1% or so return from options each year, that goes a long way toward achieving our long-term North Star (inflation + 7%) goal.

Examples of options for income include our series of written puts on **Gentex** (NASDAQ: GNTX), our written put on **Celgene** (NASDAQ: CELG), and our long-running strangle on **Expeditors International** (NASDAQ: EXPD). We intend to continue to target income with options in 2017 and beyond to help supplement our returns.

The *Pro* Bottom Line

In sum, because of the challenging nature of our North Star goal, we know we can't afford to rest on our laurels and trust our prior portfolio decisions to be enough to propel us to our goals moving forward. We know we have work to do to find strategies that will help us in our ongoing quest to achieve long-term North Star returns. We think that if we can can execute on these four specific strategies in 2017, we'll be happy about how we've positioned our portfolio for the future.

Fool on!

-- Billy (TMFBillyTheKid)

Pro Catch-Up Trades and Upcoming Expirations: Jan. 17, 2017

Published Jan 17, 2017 at 3:32PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.4%.

Continue building your portfolio with our Buys, including:

- **Medtronic** (NYSE: MDT): Buy 2.8%.
- **Paycom** (NYSE: PAYC): Buy 2.2% (see our recent recommendation).
- **Starbucks** (NASDAQ: SBUX): Buy 3.4%.
- **Verisign** (NASDAQ: VRSN): Buy 1.5% and write a covered strangle for another 1.5%, as per our recommendation. Lately you can be paid $4.10 to $4.40 for selling to open the strangle.
- **Verisk** (NASDAQ: VRSK): Buy 2.1%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5% if you haven't.

Pro options:

- **American Tower** (NYSE: AMT): Set up a diagonal call if you haven't yet, following our recommendation but altering it so that you sell April $110 calls instead of the $115 calls originally mentioned. Lately, this can be set up at a net debit of about $26.80 per diagonal. Set up a 0.5% allocation, but only risk what you can afford to lose.
- **Domino's Pizza** (NYSE: DPZ): Use a limit order to write (sell to open) covered puts following our new recommendation. Write one put for every 100 shares of Domino's you are short. The puts lately pay around $3.50 or so. If the stock price declines, the puts should pay better.
- **Verisign:** Please see above under Buys.

Hedges:

- **ProShares QQQ Trust** (NASDAQ: QQQ): If you haven't set this up yet, today you would sell to open January 2018 $103 puts, and buy to open half as many January 2018 $116 puts, for a small net credit. Set up a 15% allocation using the guidance in our alert.

Upcoming Expirations (this Friday, Jan. 20):

- **Expeditors International** (NASDAQ: EXPD): Our synthetic covered call (which started as a synthetic covered strangle) has done well as the stock has risen the past year. Watch your inbox for guidance this week before the position expires Friday.
- **Skyworks Solutions** (NASDAQ: SWKS): Our $75 calls expiring Friday have earned some premium, but remain in the money. Skyworks will announce earnings after the market closes Jan. 19, one day before our options expire, but given our one-day delay on trades, we need to issue a decision before then. Watch your inbox!

Pro Guidance Changes and Completed Trades: Jan. 17, 2017

Published Jan 17, 2017 at 3:27PM

Pro Guidance Changes (from the past two weeks)

- None

Pro Completed Trades (from the past two weeks)

- **QQQ** (NASDAQ: QQQ): Tweaking our recent recommendation, we are looking (at today's prices) to set up a January 2018 $103/$116 put ratio spread for no cost or a small credit. These strike prices will change, up or down, as prices change. We want a $13 to $14 spread for no cost, with the top strike price about 5% below the current QQQ price.

You can see all of our guidance, positions, and transactions from the Recommendations page.

CES 2017: Interview With Skyworks Solutions CEO Liam Griffin

Published Jan 10, 2017 at 4:28PM

While at the Consumer Electronics Show this January, *Supernova*'s Odyssey 2 mission lead David Kretzmann spoke with Liam Griffin, the relatively new CEO of **Skyworks Solutions** (NASDAQ: SWKS). Listen in (or read the transcript) to hear David and Liam discuss the future of technology, how Skyworks plans to capitalize on 5G connectivity, and a few key points for investors to watch with the business in the next few years.

About 6 minutes.

Transcript

DAVID KRETZMANN:

David Kretzmann here with *Motley Fool Supernova* and I'm thrilled to be joined by Liam Griffin, the relatively new CEO of Skyworks Solutions, a multiple recommendation in several of our Motley Fool services. Liam, thank you so much for taking time out of your busy schedule to talk with us.

LIAM GRIFFIN:

It sounds good, Dave. I really appreciate it.

DAVID KRETZMANN:

Let's just start off with a little bit about your background, how you came to Skyworks, and the highlights of the past year since you became CEO last May.

LIAM GRIFFIN:

Sure, thank you. I joined Skyworks back in 2002 when we started our company. We rang the bell in the Nasdaq. I think we were a $4 stock and in the middle of the "can you hear me now" era. Fifteen years later, I was fortunate, under the guidance of Dave Aldrich, our exec chair, to be given the opportunity to be the CEO. I'm thrilled by the opportunities that the market presents to us today [and] our ability to capture share and drive mobile connectivity. A phenomenal opportunity. I'm really excited about it.

DAVID KRETZMANN:

And something that comes up in Skyworks' press releases and other presentations is the wireless networking revolution. Can you say a few words about what that is and why it's important?

LIAM GRIFFIN:

That's religion to us. That is religion. If you think about this market today... If you think about **Facebook** (NASDAQ: FB)... If you think about **Amazon** (NASDAQ: AMZN)... In fact, the leading five S&P companies today (**Apple** (NASDAQ: AAPL), **Alphabet** (NASDAQ: GOOG) (NASDAQ: GOOGL), Amazon, Facebook, **Microsoft** (NASDAQ: MSFT)) are all driven by mobile connectivity, mobile platforms, whether it's client, or client to cloud.

If you think about all this, and translate that to how it works from bits and bytes, all of that technology runs through mobile solutions invariably produced by Skyworks. So we underpin that tremendous new economy that we see — a shift from bricks and mortar — to kind of the clicks and clacks that you see on your keyboard. But it's very powerful and it's still early innings.

DAVID KRETZMANN:

And what would you say Skyworks does that your competitors can't do, or can't do effectively?

LIAM GRIFFIN:

A great question. So having said all these great things about mobility and the revolution, it's very, very complex and challenging. Our customers are faced with increasing burdens to deliver these higher data rates with more efficient solutions. Less consuming of battery.

What we do well is craft individual solutions and configure these customer by customer. We integrate filtering technology, gallium arsenide semiconductors, [and] switches, and integrate these into unique systems that are perfect for each and every customer.

DAVID KRETZMANN:

And for investors who are new to this space, I think a common risk or question that comes up is how a semiconductor company, or a backend technology company, can do something so that they don't become commoditized? What does Skyworks do to ensure that your products don't become commoditized down the road?

LIAM GRIFFIN:

It is all about performance today. I don't think anyone that uses a smartphone today — even the latest and greatest technology — is being dwarfed by the burden for demand. The burden for data. So our job is to be best in class around performance. To provide the greatest connectivity experience available. It's a challenge for our engineers, but ultimately it's perfect for our customers.

DAVID KRETZMANN:

Over the past year, your broad market segment has made up about 25% of sales. Can you just explain a little bit about what goes into that segment, and what will be the main driver of that segment over the next three to five years?

LIAM GRIFFIN:

That's a great, great point. It's often misunderstood at Skyworks. We have made our money — and our bread and butter has been mobile phones — but ultimately that connectivity core spans into IoT. We have a Wi-Fi portfolio. A Bluetooth portfolio. A technology called ZigBee for short range. So you'll see these in consumer products. You'll see this in diversified audio. You'll see it in automotive. You'll see it in headsets. You'll see it in your Wi-Fi router. That broad market business has been growing phenomenally. It has a tremendous tail going forward.

DAVID KRETZMANN:

What do you think investors should be watching most closely, in general, with Skyworks over the next three to five years?

LIAM GRIFFIN:

The way I would look at it is if you're a believer in mobile... If you're a believer in the internet economy... If you're going home and browsing your smartphone and you're putting your kids on an iPad and enriching your experience through mobility, then you're a bull on Skyworks. That's what we do. We provide that. We build that wireless pipe. We make it faster and better every day.

DAVID KRETZMANN:

You're someone who's closely tied to the tech space, so a question I want to ask you. What's one piece of technology that Skyworks isn't involved in that really excites you? We're at CES. Is there any certain tech trend or product that really excites you as a consumer? An investor?

LIAM GRIFFIN:

I think one of the areas that we are entering is the autonomous car. I think that is a phenomenal market. We have a piece today, and our piece will continue to grow as connectivity becomes more and more vital. But I think some of these things that we didn't dream about are going to really come to fruition. We'll play a role. We want a bigger position in those markets and we look forward to the challenge.

DAVID KRETZMANN:

Great. And last question. There are some rumblings about 5G. What does that mean for consumers and when will 5G become something that's applicable to everyday consumers?

LIAM GRIFFIN:

5G is absolutely on the horizon. What that's going to do is vastly expand your data pipe, which is going to give you higher speeds and lower latency or refresh time. Applicable for autonomous driving. Important for some of these densified urban environments. We need a high data rate in a small space. 5G is going to be vital for Skyworks. We have the right technology cores. Our teams are working on solutions now. Three to five years it will probably be 20% of our business, if not more.

DAVID KRETZMANN:

And the last question. Looking forward, do you see any particular regions around the world, whether you're talking about domestically here in the U.S., or internationally like Asia, that investors should be watching most closely?

LIAM GRIFFIN:

We do a phenomenal job and have a phenomenal business in developed markets, and that's important; but if you think about the emerging economies, the smartphone is often the only tool that you have for connectivity. So if you think about the unique value and utility a smartphone brings to some of these emerging countries, it's tremendous. So we think the next 2 billion subscribers are going to come onboard in emerging markets, adopt this technology, and take it to the next level.

DAVID KRETZMANN:

Awesome. Well, we'll leave it at that. Liam Griffin, thank you so much for taking time to talk with us. We always appreciate it and we look forward to seeing you next year at CES if not sooner.

LIAM GRIFFIN:

Sounds good. Thank you, Dave.

DAVID KRETZMANN:

Thank you and Fool on!

Pro Video Chat, January 2017

Published Jan 9, 2017 at 3:52PM

The *Pro* team will be holding a live video chat on this page at 2 p.m. Eastern on Friday, Jan. 27. We'll be using sli.do to communicate with members during the chat; click here for details on how that works. The Q&A portion of the chat can be find by going to slido.com and entering #ProChatJanuary, or you can reach it directly by clicking here. We recommend leaving the video open in one tab and sli.do in another (or on a mobile phone), so you can follow along with both. Fool on!

Transcript

Speaker 1: Please stand by. Our stream will begin shortly.

Jeff Fischer: Greetings, Motley Fool Pro members, and welcome to our January Motley Fool Pro chat. I'm Jeff Fischer. I'm joined by, to my left, JP Bennett.

JP Bennett: How's it going, Jeff?

Jeff Fischer: JP, good to see you. To my right, Jeremy Meyers.

Jeremy Meyers: Happy Friday.

Jeff Fischer: Thank you, and we have on the phone Billy Kipersztok in Florida. Billy, how are you?

Billy K.: I'm doing well, Jeff. Thank you.

Jeff Fischer: We have the whole Pro analyst team here and we're here to answer your questions, once again, this month. As you have the video on your screen right now, we're going to ask you to also open a separate browser page and go to slido.com or you can just click the link here on the video page itself, above the video that's playing right now. Slido.com, and there enter the Pro chat January as your code name, #prochatjanuary. That will get you into this chat question, the question portion of this chat. Now we're asking you to, if you want to hear and see us as you ... You need to keep your video page open because Slido ... I'm still thinking of throwback, old chats we had. Slido is you only ask the questions and we answer them here on the video. No matter what, keep your audio on and we'll answer the questions in Slido here in the video as we go forward.

Now, any question in Slido that you like, click it to thumb it up. The ones that are most popular are the ones we'll answer first, or try to answer first I should say. We'll go through as many of them as we can. If you have questions about earnings, portfolio as a whole, strategy, any personal questions about one of the four of us, it's all on the table here this Friday. We look forward to helping you. With that, guys, I don't have much to say to kick off this first chat of the year, but I'll point out, as we all know, it's been a very strong January. The NASDAQ is up about 5%, about twice as much as the SMP 500. Pro has benefited from that because we're pretty heavy in technology and NASDAQ companies. We're doing well along with the NASDAQ this year. Our exposure is about 80% net long, so we're more long than we have been in the past. That doesn't include our put ratio spread, which is well under the money and expires a long time from now. It's not really in play right now.

We're, of course, looking at other hedges and shorts because it's been a pretty happy stock market lately and prices are, they still make it challenging, as they have for a few years, to find companies at a bargain price. For sure, those are hard to find. What we've been doing instead of just buying quality companies at a acceptable price, which as Warren Buffet had said, better to pay up for high quality than anything else. It's helped us over the years that we've been investing. Let's get to our questions. We have a lot of you asking about Starbucks. I know right off the bat JP and I can talk about Starbucks, and anyone else who has thoughts. A pro member is asking what are our thoughts. The quarter, the earnings call, the CEO transition. Are we adjusting our fair value estimate?

JP Bennett: Well, there's a lot to talk about there, right? First thing: CEO transition. For me, not really much of an issue. We knew that it would come eventually. He's tried it once in the past and didn't turn out so well, though it did take quite a few years for it to come to a head and for Schultz to need to come back to the company. I think it might be a case similar to Apple where, if you look at Apple, Jobs tried it once, though he was kicked out. He found a replacement, but then he was kicked out and then he came back in. Concerned about his legacy, so he didn't want to make the same mistake twice. He definitely put a lot more thought into what's going to happen after he goes. I think you see a similar type of situation happening with Starbucks in that Schultz, concerned about his legacy, concerned about the future of the company, realizes he did it once in the past, didn't work out good. Let's not make the same mistake twice.

I think he probably spent a lot more time considering what's going to happen after he steps down. It's also important to recognize that he's not leaving the company. He's still going to be very involved with their future prospects, with advancing and pushing the brand into a more upscale, premium type brand. I think the leash for him to step back in and do something about it, if he thinks he sees something off, will be much shorter. That's not an issue for me. What we say, [China comps 00:04:58] were good. The big issue here is the US. We're seeing a slow down, it's specifically in traffic. One of the issues there is obviously the rewards program adjustment where previously you had people separating orders into multiple transactions to essentially game the system and earn more rewards. You can't do that anymore, so those have consolidated into one order.

That has a downward effect on the number of transactions that takes place, but even if you strip that out and you just look at the transactions that are occurring naturally, that's actually fallen some. What's going on there? I think it is probably undeniable to think that they are 100% immune to what's going on in retail and people not going out as often. They are, I think, the best of breed in that space and they will continue to perform well above their peers, but they aren't immune to what's going on in that space. There's going to be some impact for that. The other thing to take into consideration is they're definitely having some throughput issues, as we discussed earlier today in terms of mobile and things like that.

The transition that's taking place, it's going to take some time to work out the kinks. They're doing it because they want to stay relevant in a society that's moving towards digital ordering, fast-paced get-my-stuff-go type of mentality, not spending a lot of time in stores. It's not a seamless transition. I think they'll be able to figure that out over time, but that's the one thing that I think we need to watch and keep our eye on. As far as our fair value adjustment, I've just begun putting the numbers in my spreadsheet so I don't have anything to say here. I don't want to overreact. We have said for, I believe a few years now, since I basically came on and started covering Starbucks, I said, "Hey, Starbucks is a great company, but this valuation is pretty pricey."

The great thing about it is that the stock really hasn't done much recently, so it's essentially grown into its valuation because the company has been firing on all cylinders. Earnings, revenue, free cash flow, they're all moving higher. If the stock does nothing, what does that mean? It means the multiple contracts. Even still, we're still priced well above the market, so it's not like I would say that this is a back-up-the-truck type of opportunity. We need to remain diligent, but you're not going to see me come out and move this thing to a sell, slash the valuation by 50% or something like that. I think it's something worth watching, but I'm not ready to just pull the ripcord right now.

Jeff Fischer: Sounds good, JP. The thoughts I have going through the call this morning are, I'll just try to complement some of what you said. They're opening one new store in China every 15 hours.

Jeremy Meyers: It's amazing.

Jeff Fischer: Yeah, it's amazing. Especially when Schultz says, and we foresee that going on many, many years into the future.

JP Bennett: I think it will become the biggest market sooner than a lot of people think.

Jeff Fischer: Schultz was in on the call. As you said, he's much more involved than he was before. They have so many initiatives already in place that are multi-year initiatives, so the company knows where it's going and presumably how to get there. I agree with you. They'll iron out the throughput kinks, I think, in the mobile app order and pay process. They're hoping to grow revenue seven to 9% this year now, and earnings per share around 10%, 11%. Long term, they still hope for that 10% annualized revenue growth. If that's the case, then the stock at 25 times earnings, more or less one year forward, is probably worth that price in the way that a paycheck's is or a solid company where the certainty of the results are very high. You're going to pay a premium price for that. I agree with you. I think our stake is good where it is. If Starbucks gets hit hard in a bad market, it's one that we'd look to, potentially add to.

JP Bennett: Yup. In here or maybe even another service. Hint, hint.

Jeff Fischer: Yes, maybe.

JP Bennett: I'd also just double back and say, because I'm not the overly optimistic rose-colored glasses person. That one thing I will be watching is their new initiatives and what happens there. We saw with alcohol it's not really working out. Their evening ideas haven't really panned out like they wanted to. One of the issues they ran into when Schultz left previously was they really went into go go growth mode, trying a bunch of new things. That really tends to force a company to spread themselves really thin and not stay true to what made them great. You saw that, the delusion of the brand, the email that was leaked that Schultz sent out to the company that was like, "Hey, guys. We knew what made us special and we're not doing that anymore. We need to get back to it."

These new initiatives I think are really important. They have great opportunities, but they can't get side tracked and step away from what made them great. I think that's actually one of the great things about them actually having already gone through that. They understand the need to continue to develop new ideas and new initiatives, but they've already seen what happens when they get too focused on those and lose the core of what makes Starbucks great. I don't envision that happening, but we need to watch that going forward.

Jeff Fischer: Starbucks is a 3.2% position right now. It's rated a buy. It's been a strong performer for us since we bought it. More than doubled, 127% up. The past year and a half or so it's been flat, as JP said, growing into its valuation. That's flat excluding the dividend, which is close to 2%. Right before that year and a half of range-bound performance, it was strong. Given time, should be again, given the nature of that business. Let's get to our other questions. Number one is from Gary. "In recommending Amazon while at its all time high, any thought regarding waiting on this [fall to stock 00:10:55] to enter?" Fall, rather than. It's up to you if you want to. My years of investing, I've had better experience just buying a stock when I'm ready to buy it. In a lot of cases, I look to a new highest confirmation that they're doing something right. I've bought many of my companies at new highs. Whether or not that's the best move six months down the road is a ...

Jeremy Meyers: I know I've missed a lot of opportunities just wanting a dollar less. You know, just slightly cheaper, whatever it may be. When you're dealing with great companies like this that compound over time, you can at least, I think JP talked about laying into a position. You can get a starter position. If you don't feel entirely comfortable now, wait for a pull back to happen and add to it. A lot of times, if you don't at least get that starter position nailed down, it jumps up 10% and then you're chasing and it just feels more and more expensive, so you're anchored to where you were before, so you have a different problem then.

Jeff Fischer: That's so true. I mean, the market falls sharply on average every couple years at most. During that time while you're waiting, the stock would rise up so much that when it does finally fall, you're still buying at a higher price.

Jeremy Meyers: That's true.

Jeff Fischer: I've had that happen many times. It's up to you and what you're comfortable with. We were comfortable with moving forward on it. Again, it's a very long-term position. It's another one where if we get a market downturn, we'd be looking to potentially add to it. Now, I keep saying that. That means we have to manage our cash accordingly and be prepared for future opportunities. Next question. "How serious are you about hedging the overall portfolio? I'm concerned about the new president, the policies, the effect on the market. I would like a timeframe." Well, great question. Does anyone want to voice their thoughts?

JP Bennett: I can go, or if you want to talk, Billy, you can take it first.

Billy K.: Yeah, sure. We've talked about this on some of our other chats before. We are aware that policies are going to change and the new administration is going to implement some new ideas that would change how companies operate and tax regulations and things of that nature. We're taking an approach where we're not expecting to change anything too drastically until something has changed in reality as well. Our hedging strategy is going to be largely consistent with what we've done in the past, which has been hedging for those larger declines, 10 to 20, 25%. Not really worrying too much about a five to 10% decline. We're aware of the new administration and the possibility of change, but we're not altering our strategy all that much.

Jeff Fischer: Yeah, and we are looking for new shorts as well as a way to attack a potentially lower market that we like even better, trying to find companies that we want to be short no matter what. With earnings rolling out, usually that shakes out new research for us. It doesn't obviously lead to a recommendation every quarter, but it may. Yeah, we would really like to keep growing the short portion of the portfolio and have some more timely hedges, not just the one that we have expiring. It's recommended to expire in 2018. We have to set that up ourselves yet. It's on QQQ. Our exposure is around 80%, maybe a bit higher. As Billy said, we were managing that exposure, probably bring it lower over the coming months. It doesn't mean we'll sell things, but by hedging and sorting, hopefully.

Jeremy Meyers: It's good to remind everyone, the hedging can be expensive over time and a decent drag on your performance if they market would continue to rise. Insurance is not free, and certain times there's more volatility. It becomes even more expensive.

Jeff Fischer: Definitely. You're paying a dear price if you're short the indexes right now. That's been true since November, obviously,

JP Bennett: Which is also why cash can be such a great hedge over time, right? It reduces your volatility. Although in prior years you would get paid a lot more for having that cash, at least it's not costing you and it really will reduce the volatility of your portfolio. Also just to add on one quick little thing, like Billy said, we're not concerned with 10% declines in terms of hedging and shorting and things like that, but those are also great opportunities for out performance. We won't be overly concerned with them on the downside, but we may be looking to be more proactive. Especially if we end up in a more volatile market that isn't constantly setting new highs, but kind of moving between where we currently are, down 10%. Maybe it rallies and moves up a couple percent, then we get another sell off. If that's the type of environment that we're in, which some intelligent people have been calling for because of valuations and where we are in the economic cycle, that's really where you're going to see out performance come from. We have to take advantage of those opportunities.

Jeff Fischer: Next question. Let's review our decision to hedge the NASDAQ QQQ as opposed to SPY. The reason we did do that is indeed largely due to the tech portion of the portfolio, which is a large part of the portfolio, more than 20%. Much more. The new administration is seen as not being so friendly to tech in a general sense. There's the prospect of net neutrality going away, which could cost companies like Amazon or Netflix or even Google a lot of money.

Jeremy Meyers: [crosstalk 00:16:31]

Jeff Fischer: It could change the whole landscape, so we want to hedge out some of that tech risk. We won't step away from SPY indefinitely by any means. It may be the next thing that we hedge. Yeah, SPY is still in our toolbox as a way to hedge, and also as a way to make income. We've been talking about diagonal calls on SPY forever, but hoping for a drop in SPY before we set them up, speaking of that, and that hasn't happen. Yeah, we hear you. QQQ is a specific hedge right now for specific reasons. Can we discuss the mechanics of exiting a diagonal call or rolling it, which is different from exiting? Rolling diagonal calls or closing them. I'll talk to closing them. If someone wants to get ready to talk about rolling, and a diagonal call is no different than owning a stock with a covered call on it, in one sense. You close it by selling the close, the call you own; buying the close, the call that you've written.

You do that typically when you're nearing expiration and don't want to continue the position any longer. Usually six months before your long call expires, we look to potentially close it so that you don't risk a sharp drop those last six months wiping out your gains that you've taken maybe a few years to make? We usually close a long portion of a diagonal call, but before expiration. What about rolling a call forward? Does anyone want to speak to when you roll a diagonal call forward and how you do that?

Billy K.: Sure. Yeah, so rolling a diagonal call, you're going to want to do that when your short call is in the money and approaching expiration. What you're going to do, basically, depending on how far in the money your short call is and what your valuation estimate for the underlying stock of the diagonal is. You're going to buy back that short call, and then you're going to sell another short call at a later date, typically three to five months later. Hopefully, you're going to be able to do that for a credit, ideally.

Jeff Fischer: All right. Next question. They're starting to pile up, so we'll move forward here. How do you integrate Supernova with Pro? Anyone have experience with that?

Jeremy Meyers: I think the best option there is probably to post that onto our boards and see which members are actually doing that and how the approach that they've taken because we look at Pro as a standalone portfolio and don't manage that portfolio thinking about Supernova or anything. You're probably best off finding other fools who are actually doing it actively and have some better advice than, I think, we could probably offer.

Jeff Fischer: That's great advice. We should probably open a board on Pro saying managing Pro with the other services. Some sort of, that topic. That very topic, so you could all talk about it. Maybe we'll do that. I know our list of boards keeps growing, but that's a really good topic.

Jeremy Meyers: We run the danger of also having to have opinions on all the companies and positions in every other service, also, which is impossible for us to do.

Jeff Fischer: We can just say, "We have no idea. [crosstalk 00:19:33] Members, just discuss how you do it because we have no ..."

Jeremy Meyers: We might disagree, or whatever it is.

Jeff Fischer: Yeah. Great advice, Jeremy. See what other members are doing on the boards. I know you'll get a lot of help there. Let's talk about the put portion of Skyworks, the rolls. Should we change the strike? We did. Our trade executed the end of yesterday with a limit order and we sold to open $85 August puts, which is a little aggressive, but that's where I am on that position right now. We got $6 per put that we sold, so our cost to roll from February to August, 87.50 calls and $85 puts. The cost to roll was zero, so we gained $12.5 on the upside. Of course, we took on more exposure to Skyworks. That's really the cost of rolling that we've taken on. Hopefully the stock will now consolidate around these levels and we'll earn a lot of that premium and we'll roll up again as the time value dissipates in this strangle or roll to whatever direction we need to.

Yes, you can adjust your put as Trade Alert shared. Adjust either call or put to get to a roll that doesn't cost you much or anything at all. We'll have updated guidance, timely guidance, Monday in catch-up trades as well. Question. The question is, "Jeff, you wrote about preferred sectors such as tech, financials, and services." True. How do we feel about healthcare, especially like United Health? We still do like our exposure to tech, financials, and services, and that business model in general when they're highly profitable. I don't think our overall exposure there is about to decrease anytime soon. Healthcare, we're looking more into healthcare as we speak. We have been for several months. We do have Medtronic. [Par-sell 00:21:32], which may be sold through covered calls. We have Gilead Sciences, which has been disappointing so far. We're looking at other possible positions. I can't speak to United Healthcare much. I looked at it around November. I don't know where the health insurance industry is going to go in the country.

JP Bennett: Nobody does.

Jeremy Meyers: Yeah.

Jeff Fischer: I'm not sure, but I'd love to hear your thoughts. If UNH is a stock you like, go to the Pro Stocks You Like board and please post any thoughts that you have on it. Anyone else have thoughts to share?

Jeremy Meyers: I think we all still believe that the same secular tail wins and demographics are in place that we've been thinking about for a long time. Opportunities where there's a little more uncertainty like this is when some of the better run companies go on sale, and we have the opportunity to bounce on it.

Jeff Fischer: Yeah, and speaking of that, healthcare is I think our third largest allocation after tech and financials. All right. What are our thoughts on O'Reilly with the recent news at Amazon? We issued the Amazon report.

JP Bennett: There's our hedge, right?

Jeff Fischer: We were working on Amazon long before that. A long time coming for that. I can't really speak to why. I probably need to lay down on a couch to figure out why it took so long to get that report out. I figured so many members own Amazon. Speaking to O'Reilly, we're still thinking about it, frankly. That news is new to us. We knew Amazon was selling auto parts, obviously, and has been for a long time, but that they're now going after it with one-on-one relationships with the part makers themselves and under cutting pricing.

Now, they've come a long way just the last few years to having same-day delivery, which is what people want when they're under a car working on it. Amazon is more of a threat now, both on pricing and on convenience. The one area they don't have covered yet, but I wouldn't put it past them to try, is on service, where if you have a question, you can't yet call Amazon and say, "Hey, I'm looking at this part of my car, and what do I need?" That's where O'Reilly really shines. Amazon's a serious competitor, so we're considering this risk seriously.

JP Bennett: Yep. For a little bit more context for those who didn't see the news, I think pretty much most of the investor community knew that this was happening. Big markets, fashion, auto parts. Things like that. They're all basically in Jeff [inaudible 00:24:03] cross hairs. Those are industries he thinks he can disrupt and beat by being a low-cost provider. We knew that, but the details on it were a little fuzzy. Some information was leaked going out into the markets that in some cases Amazon is paying manufacturers around 30% more for the same parts. Like you said, they've been establishing direct relations with some manufacturers. In doing so, because they have such skill, they can offer certain parts at a price that's over 20% cheaper than what you might get if you go to your local O'Reilly or AutoZone or things like that. That really spooked the market there.

A couple of things I think to consider in relation to this and why we don't want to overreact. Obviously, the first thing is, like you said. The area that's ripe for disruption is the do-it-yourself market. That's a lot more consolidated already. It's a lot slower growth. It's not as big of an opportunity for O'Reilly, I think, because they've already established themselves. In that instance, people probably will be looking for cheaper parts. You've seen the rise of, what's it? I think it's called RockAuto, the online, really cheap. Their website is extremely basic. It looks like it's from the 90s, unless they updated it since I checked last. That market is ripe for disruption, I think. There still will be those people who prefer to just go to the store and get it same day because, unfortunately, we don't yet live in a world where everybody is within reach of a distribution center of Amazon to get same-day delivery.

That will be right for disruption. The other part of the market, that do-it-for-me part of the market, it's going to be hard for Amazon to move in and quickly displace that because, again, it's "do it for me," right? I need this part. I don't know how to put it on my car, my vehicle. Can you do it for me? Amazon's model currently doesn't involve that. It's not like O'Reilly is going to be completely destroyed over night. I think something to just keep in the back of your mind. Rewind 10 years. What kind of world do we live in? We live in one where Amazon was moving hard against Best Buy and everyone was like, "That's the perfect case study. Best Buy is dead. There's no way they can compete on pricing. They're just a showroom for Amazon." Basically what we had in December was Best Buy stock, the company isn't dead. They were within striking distance of hitting a 10-year high on the stock price.

Yes, it got hit on the interim, but the business didn't go completely bust as quickly as some people were thinking. You don't want to have a knee-jerk overreaction and things not pan out like you expect. We're watching it, like you said, but we don't want to ... We want to give O'Reilly management team, let's just say they've been one of the best management teams of the past 25 years out of any public company. You want to give them a little bit of leeway and more than just one leaked news report be the reason that you sell the stock.

Jeremy Meyers: Amazon's been great a force [inaudible 00:27:09] in the market. If you're not a great operator, if you're not best of breed, if you don't have dynamic and flexible management, then they're going to push you out. If you can offer a unique customer experience in some way, like if you think of how well Costco's performed and grown at the same time, where Amazon has come in and they're competing on price and undercutting them in some way. They offer a unique experience that the people appreciate and they have loyalty to that brand. I'd imagine over time, O'Reilly has built up that credibility and they're not going to be displaced over night.

JP Bennett: I think the immediate consideration is multiple contraction. The stock has been a stock that has justifiably traded for a premium for a long period of time. I know in the past, Jeff, you put it on hold because you're like, "Oh man, this valuation." It's a great company, but this valuation doesn't make a lot of sense. Then what happens? The company crushes it. The stock keeps going higher. Then you're like, "Okay, it's growing into its valuation." The more uncertainty that comes out, the more likely the market decides, "Okay, I'm not willing to pay as much of a premium," and so you may see some downward pressure in the stock. Again, we don't want to overreact to something like that.

Jeff Fischer: I agree. On the flip side, if we see good quarters rack up again this year, the stock could celebrate by an even great degree as people think, "Well, they have ways to get around this no matter what." That said, the mild winter is probably the bigger, more near-term concern that we should have for O'Reilly because extreme weather really drives auto parts sales, extra sales, and we haven't seen that this winter. It might be a little light. Suffice to say, I'm looking at O'Reilly as we get into earnings and at our allocation and I want to learn more about the Amazon competition threat too. An answer I don't have is would Amazon sell parts to repair shops, to car dealers, to I don't know? Okay. Next question. Do we feel that Gilead Sciences is well positioned for 2017 growth and is it a good time to add shares if one is not up to the recommended allocation? Which is pretty small now. It's only a few percent.

I'm checking to see exactly what the percentage is. The stock is a buy. As far as growth for the business, I don't think it is well-positioned. It's a 2.3% position that we have and we're down 9%, excluding dividends. The company is expected to grow earnings this year or the next couple of years at least because of the drag of the hepatitis C market pricing going down there and volume leveling off, competition growing. The one thing Gilead has in its back pocket is a lot of money and a lot of equity to make acquisitions that could then, ideally, drive some growth again. I don't know that you want to bank on just that, but right now that's what we are doing. By default, we own the stock. We haven't seen the argument for selling it. We've looked at it. Every time we meet, we talk about it. It looks extremely inexpensive for a really top quality business and management, with a lot of optionality going forward, mainly though through acquisition or merger.

The pipeline is okay. The current drug portfolio is obviously strong. Billions in free cash flow every quarter. It's a deep value stock. The question is, will it be a value trap for the coming years? Where we land is we have a 2% allocation, so we don't have that much at stake, 2.3%, if it does continue to languish for now. Suffice to say, we've been disappointed and I wouldn't rush out to buy it, but I like having it in our portfolio right now. Until we have a better place for that money and need cash, the money will stay there as it stands right now. That said, we'll see how the results come in in a few weeks. The stock is a buy. It's a high quality business and management and valuation across the board. It's a unique situation. A good learning experience. The blowout product that levels off so quickly. It can lead to a much cheaper stock. The stock was 12 times earnings when we bought 11 or 12, and now it's six times.

If you're just joining the chat, we're about halfway through. As you watch the video, you can go to Slido.com and enter any question that you. You enter prochatjanuary and enter any question that you have and we'll try to answer your question. We have a lot of them here, though, so this last half hour, we'll try to move quickly. This may be right up your alley, JP. How do we take advantage of the lowest VIX, or volatility index, since 2006?

JP Bennett: Yeah, I was actually up late crunching some data on the VIX for the weekly, though I ended up not using much of it. Yeah, we are in a very interesting situation in that we are really close to breaking sub-10 for the first time in years. Closing before 10 is something that's only happened nine times since 1992, so that's out of 6,314 trading days, if my memory's correct. It really doesn't happen very often. What does that mean? Well, for starters, that means the sample size of really low VIX values is extremely small. What you can deduce from that is very limited and very questionable. What can we do? I think for one thing is it's just worth staying on guard because when the market becomes complacent, opportunities on both the long and the short side tend to crop up. On the long side, if the market's complacent and we get a sell-off, well, it might be time for us to buy more shares of the companies really alike.

If the market is complacent, some overvalued companies could become even more overvalued, so maybe we should short them. In terms of direct instruments, like buying calls or buying an ETF that benefits from a rise in the VIX, those over time tend to have fundamental flaws that work against them, so that's more of a near-term play. Personally, I wouldn't be too inclined to do that. As far as personally, or what we might end up doing for Pro is one of the more interesting things to look at is to kind of just sit back and wait for the VIX to spike, and wait for uncertainty to hit. A rise in VIX, what do we know? If it spikes, it doesn't stay elevated for forever. That may be a time for us to act. In terms of basically saying, "Okay, now it's time for us to bet for the VIX to spike," I wouldn't really do that.

What you saw in early 2007, we actually had a clustering of really low VIX closing values. Well, we actually had a period of the market actually continuing to move higher. The market didn't roll over as soon as we hit that period. Perhaps we are in an environment, let's put politics in and thoughts regarding the economy aside. We may be in an environment where the market continues to drift higher for the foreseeable future or for at least a small period in time. Buying short-dated options contracts, betting on a spike, or setting up just maybe buying an instrument, betting on a quick spike and so making a few bucks on a quick trade, it's not something I would suggest doing.

Jeff Fischer: Yeah, the VIX around 10 or 11 and averages 18 or 19 historically, so it's well below that average. That said, earnings look pretty good so far. You have a pro business administration. You have tax rates that are probably going lower, so maybe that all speaks to why the VIX is so low. The hope is that the year will be a win for business as a whole in the country. A little VIX, as you said, could lead very well to the next volatile market. We would hope so, as far as option writing goes.

JP Bennett: Yes, yes. We would.

Jeff Fischer: Premiums are lower right now.

JP Bennett: It's been years since we started praying for an increase in volatility, so those put premiums or those covered call premiums start returning more towards what we like in our guidelines.

Jeff Fischer: We've done some ratio spreads on the VIX in the past. Like JP said, though, the VIX options trade on the VIX futures, and those premiums are giant and are not responsive to real time VIX prices, so it's a tricky trade. With the VIX this low, we look at the premiums and think about it at least. What are our thoughts on American Tower? It has lately been down. Billy.

Billy K.: Sure. Yeah, I think we have to distinguish between when we talk about the fact that American Tower is growing steadily for a while, but lately has been down. We're talking about the stock price. The stock price is down, but actually the business is performing very well. They, in 2016, made a really big acquisition, increasing their towers in India by almost doubling them. American Tower continues to grow very quickly overseas. They are focused on expanding. In the last year, they have investments in new markets in Nigeria, in Tanzania, in France. They're focused very much on expanding internationally. They are the tower company that is doing international expansion the most.

International markets are growing faster than the United States markets, so that is attractive for American Tower. I'm curious to see, when they report earnings next month, how that continues to break out as far as the growth in the United States and the growth internationally. I think when we talk about the stock price being a bit weak lately, I think there's a couple of reasons for that. For one, American Tower is a [inaudible 00:37:01]. As the new administration has come in, interest rates have gone up. When interest rates go up, generally [reads 00:37:09] as a category kind of decline in value. That's what we're seeing with American Tower. Then also, more specifically with respect to regulations, some of the concerns in the wireless industry have been that in the United States we may see some consolidation of wireless carriers. Where right now we have four big carriers and if we see a merger between Sprint and T-Mobile, we'll end up with only three.

If we end up with only three carriers, then there's only potential for three tenants on American Tower's towers. That's a bit of a concern, but I think both of those two concerns together are a bit overblown at this point in time with the consolidation of the carrier industry and then also the rates. The reason I say that is because, right now, we can see that American Tower is trading at the lowest valuation level. When you look at the EV to EBITDA ratio, that it's been since 2013. Even as the company is growing at rates similar or higher than they have been in the past five years. Right now I think American Tower, the business is doing really well. I'm curious to see how the results come in when they report earnings. I think we should see strong growth. There is some political uncertainty and risk in the United States, but they are so diversified internationally that the United States is not a huge concern for us. We're more concerned with how the international operations grow over time.

Jeff Fischer: Thanks, Billy. Karen is asking about Broadridge. Hello, Karen. We hope you're well. Broadridge is a large chunk of the portfolio. It's true. It's one of our top three holdings, but it's a really quiet business. Mainly proxy statements and SEC filings for companies. Are there any updates on this position and the long-term view?

Billy K.: Yeah. I would say that there's not really any updates on the long-term view. I mean, Broadridge is such a boring, steady stable business and nothing really is looking like it's changing there. It's a company that's going to grow its revenue anywhere between five to 10%, and will grow its earnings a couple of percentage points above that. You've seen very strong stock price appreciation over time from that company. They dominate their market. There's not too much competition for them. Steady. Stable. Demand is very consistent. I personally don't have very many updates. We're going to get earnings beginning of February on February 8, so we'll get an update then as far as how the business is going. They did make an acquisition recently, I think earlier this year or last year acquiring some block chain technology, which is data security. That's a little bit of a business update. Other than that, slow and steady.

Jeff Fischer: I don't have enough shorted Dominoes shares to write the protective puts, or the covered puts. Would you recommend closing the short at this time?

Billy K.: I would say probably not. Actually, definitely not. You don't need to write those puts. The puts are just a way for us to earn some opportunistic income from this hedge that we have with our Dominoes and Papa John's combined position. If you don't have enough shares to write those puts, don't feel like you need to close the short. The short is there to hedge our Papa John's exposure, so we have a combined exposure that together equals a certain amount. Those puts are not completely necessary to that position. It's just an augmentation to add some income. If you can't write the puts, don't worry about it.

Jeff Fischer: All right. How much of a disadvantage are fools modeling the Pro portfolio in an IRA and not being able to use the options recommendations? You could use many of the options recommendations when we do covered calls or diagonal calls in many IRAs, or anytime we buy options, or cash secured options, if you just have the cash in your IRA. I'd say the disadvantages in a healthy market are slight to none. In a lot of cases, you're better off just owning stock in a good market. In a flat market, the options come in handy. Extra returns from them can be garnered. In a fallen market, depending on the hedges that we have, you may miss out on some of the profits there, including like last year our option hedge paid us nicely last January. That's the answer. It's a variable answer. It depends on how the market does.

Overall, though, I hate to say this. Overall it may be a wash whether you have options or not. Options will, at times, cause you losses. Just owning stock for the long term may ... If your only goal is to have the most money possible in your account 20 years from now, then just owning the best stocks you possibly can is probably the way to get there. If your goal is to manage volatility and have income and have some winners in a down market, then you add options in. That doesn't necessarily mean that you'll make more money overall than the all stock person. There's a complex answer to your question. Use options to the extent that you enjoy them and that they add some returns that you're seeking, whether that's income or hedging returns or things of that nature.

Jeremy Meyers: I was just going to add, if you're investing in an IRA, you probably have a longer term outlook also. You can afford to take or bear a little more volatility. Where hedging that isn't quite as important. It might also depend on how long it's going to be until you're going to actually need that cash.

Jeff Fischer: Well said. CP1 is asking, "Will the relationship between Shop and Amazon provide a life for Shop value, and how much?" Shop isn't in the Pro universe, or Pro portfolio, so we'll move on to another Pro stock instead. I've been looking at Shop because it's recommended at The Fool. I think it leads one or two services. The relationship with Amazon has been in place for a long time, but it got more news media in recent weeks. I don't have an answer to that question today, but so far Shop has risen on the news that it has this relationship with Amazon. The market seems to think it will provide more value for Shop. The QQQ hedge has been tough to execute for even a penny credit, even with adjusting the strikes. That's so true and we share your frustration. We don't have the position properly set up either. It was accidentally executed at 2019 options for us. I've written about this on the site, but in case you didn't see.

We have the 2019 options. We need to close those and open 2018 options. It's very hard to do so out of credit, even adjusting the strikes right now. We're hoping for the market to fall because that makes it easier to set this position up, but the market has just risen and risen. We'll have updated guidance as we see a position we like. Within, I think we have about 15 more days now, so soon we'll have updated guidance on what to do there. If you have the existing position set up already, you're good. Just let it ride. The VIX, we talked about the VIX earlier so we can move on from that. We are looking at the VIX down at 10, as JP said. It's tough to find positions there, but we're mindful of it and what it may mean for the market and what we may want to do about it.

Are we planning any shortage from hedges, like the ones previously done on SPY? The short answer is yes, and SPY would probably be the vehicle of choice when we start doing rolling hedges again. They may not be put ratio spreads because we may not want more downside exposure, but some sort of option hedge is possible as the market keeps rising. SPY is a top candidate to possibly do that. That said, what we recommended for 2018 will help us a lot if the market is lower, come January 2018. At least that's some good insurance to have. Next one. Amazon. If you can't afford the outlay for Amazon, would a synthetic long be advisable? The short answer is no because each option represents $83,000 worth of stock. A $830 stock, each option is one contract, and a synthetic long is the same exposure as shares. That'd be very expensive. Even if you just by one share. If one share of Amazon is 3% of your portfolio or less, then you're following the allocation guidance. Let's talk about Facebook. I'm talking a lot lately, so anyone want to talk about Facebook?

JP Bennett: It's your stock, Jeff.

Jeff Fischer: It is mine.

JP Bennett: It's in your coverage universe.

Jeff Fischer: You guys talk about it. I think Facebook is performing perhaps better than ever as a business. I think more and more communities joining, getting together through Facebook. Some of the largest demonstrations and process in the history of the world have now happened thanks to Facebook. It was interesting to see people are now posting things on Facebook as kind of a ... that they plan to go back to in four years. I'm posting this now so I can revisit it. I'll be reminded of it four years from now in my timeline. That shows you how committed people are to Facebook as a platform and as a sharing medium. I think as far as the stickiness of the site, I think that's largely growing for most people. I think the financials will be strong despite increased spending this year. What we have to watch are ad rates and advertiser participation and effectiveness of ads. We'll get an update on that in about a week here.

Overall Facebook is right now still a buy first. I'm glad it's been buy first for a long time despite the price, and it's not even that far above our fair value estimate. I think it's so far showing itself to be one of the best companies of the decade, but what we care about more is the next decade. Will that continue? Right now, we still own it and believe that it's worth owning. Any plans to sell covered calls? I would say after earnings, we're always looking at the possibility. What we like is what we did last year, selling covered calls that expire before the next earnings report so that we don't get caught. That said, even a simple income strategy like on Skyworks worked against us when Skyworks jumped and our shares got called away.

In a era of low volatility, you're drawn to volatile stocks like Skyworks to get option income and that can bite you. I got bit by that myself. I'm like, "Oh, these premiums are good. They're the only good ones. Let's do them and manage them." As I posted on the boards, I think we'll make up for it over time, but it's still a lot of time and energy spent. Short answer, though, uncovered calls is opportunistically ...

Jeremy Meyers: Yes. Always watching, but there's not a lot of good opportunities right now. There's a reason.

Jeff Fischer: Jeremy and I talk about Oracle every week. We write covered calls here and they just don't pay anything.

Jeremy Meyers: It would've been fantastic, but you just feel like you're just picking up pennies. You know, it's probably not worth the risk.

Billy K.: We talk about low volatility, historically low volatility, so that harms covered calls as well.

Jeff Fischer: Yup. Covered calls on GameStop? That's not in Motley Fool Pro, it's in Motley Fool Options. I ask you to please go to Motley Fool Options and the GameStop board there. Jim [Gillies 00:48:13] can help you out. Are any of us going to the Fool event in Scottsdale the end of February? I think I am. I've been told I am. I don't know the full roster though yet. All I heard is save the dates to go to Arizona. I will be there is the plan. Hopefully other Motley Fool Pro and Options analysts, they should be there, so let's hope so. We look forward to seeing you. Updates on Caesar's? I've been looking at Caesar's almost daily the past few weeks. Really it's a few months. Time flies. Because the end of December they were cleared for bankruptcy and we're getting a better picture into the amount of equity shareholders we'll be left with, which is about 6% of the new combined company, which is not much, obviously, 6%.

I think the stocks should be much lower than it is, but I'm trying to figure out why it isn't before I lose the position, assuming that's what we choose to do, or keep it, assuming the bottom's going to fall out eventually once people see the actual financials tied to this equity, what the equity is actually worth. Right now it's hard to see because the companies haven't merged yet. You don't see the earnings power. I pieced the two together and it looks slight to none. The stocks should be much lower, in my opinion. We're sitting on our small short. We've covered half of it at a nice gain. Yeah, that's a question, Mark. What the stock will do next, I think the business will continue to putter along though, frankly. More updates there likely this year because we can't wait forever.

Any of us can answer this, I would think. Why is there even a reason Pro missed the run-ups in Texas Instruments, Nvidia, AMD, Avago. Didn't they catch your eye? For myself, speaking for myself, I looked at the industry and liked Skyworks best. I think Skyworks has more than doubled since we bought it, so it's done well. The chip industry, as a whole, is competitive and there's usually pricing problems or competition. Nvidia, I've started to look at again. David's recommended it a few times and it's not just a chip business, per se, it's all kinds of interesting businesses. Not entirely in my wheelhouse would be my answer.

JP Bennett: I would say that and just diversification. I mean, hind sight bias? Yeah, we should've loaded up on all of those, but at the time, do you really want to put all your eggs in one basket and double down on an industry that you haven't covered for very long not in your wheelhouse that has historically been pretty volatile and been subject to pricing wars, like you said? For me, it was, "All right, we've got one that we think is best of breed. We don't really need another one."

Jeff Fischer: Yeah. I felt that way too. AMD was highly speculative. Texas Instruments kind of is too. Nvidia, I think, I keep looking at it. It looks expensive to me because it was up 200% last year. Yup, can't get them all. There are a lot more winners than that that we've missed, for certain. We bought some losers instead. Overall, we're hopefully meeting or exceeding our goals over time, and that's how we can sleep at night still and not have too many regrets. When will we see recommendations from Pro in the defense sector, thinking that defense spending will increase dramatically? People are looking at me.

JP Bennett: Take the lead.

Jeff Fischer: We've owned defense in the past and it's not something I love investing in. It's not in my wheelhouse. It's reliant on big government contracts that can come and go. Any administration may only be around four years, and then the whole policy changes over again before things even get rolling. I don't like to bank on the government for my investment decisions because it's changing all the time. I don't know that will go to defense. Yeah, I don't know. We'll see. I'd put the odds at low. I don't know if there are that many defense stocks across the Fool universe recommended.

JP Bennett: Probably not. I think there are some opportunities in there, but like you said, it seems like something that everybody kind of wants to get into because of the new administration, so it could become a crowded trade, like you see with some of the industrials and some of the people banking their hopes on making America great again through investing in infrastructure and things like that. You got to be careful with that one, right?

Jeff Fischer: I probably would by Boeing before I bought defense because at least it has enormous commercial demand, not just government demand.

Jeremy Meyers: It's really hard to analyze a lot of these businesses because you don't have a lot of clarity on the contracts. Their multi-year, sometimes multi-decade even. They can be cut pretty easily and a lot of things are classified that you can't get the information on it or you have to know people within the industry to have a really deep understanding of the drivers of the business.

Jeff Fischer: Yeah. As you know, in Pro, we try to focus on companies with strong recurring revenue and growing opportunities to take their cashflow and reinvest it in more growth. Most defense contractors that I know of don't fit those dynamics. We're into lightning round with five minutes to go. Why don't we each choose two or three questions and we'll go around the table and answer them?

JP Bennett: I can take the first couple because the seem to be relevant to stocks that I cover.

Jeff Fischer: All right, JP. Fly.

JP Bennett: The first one. Any plans to write covered calls on Apple? I would say at the current time, no. Apple seems to go through periods of extreme hopelessness where the stock is doomed, the company's going to be out of business in a couple years to extreme optimism. We don't want to get tied into a situation like Starbucks. Not Starbucks, excuse me, Skyworks. It's a much cheaper valuation, but if the new iPhone comes out, the 10-year anniversary iPhone, and blows everybody's expectations out of the water, feel pretty confident that demand is going to be extremely high and so you may see the return of, "Oh, boy. Apple is the king of tech again." It'd just shoot and we don't want to miss that out because we get greedy for a couple extra pennies, like Jeremy said.

Do we plan on shorting Deere again? Oh, boy. Industrials, right? They report in February and at this time I probably would want to see those results and see how the market reacts to that. You look at Caterpillar who just reported. Basically, we're one month away from 50 consecutive months of declining sales. The stock is within a couple dollars of getting back to 10-year highs or something along those lines. It wasn't that far long ago where management was basically promising that we're going to have earnings in EPS in the teens in 2017. Now what are we at? A couple of dollars at best. Despite that, we have the stock moving constantly higher. It's a very interesting environment. We may consider it.

Personally, I do think a lot of companies in this sector are very overvalued because they're being bid up because people think that we're going to return to growth. I don't think, if you look at macro factors, it's not going to happen. A irrational market can last for a lot longer than you can stay short a company. We may do it smaller size. Probably going to prefer to see earnings first. I'll just take one quick one since it tied into what I talked before.

Jeremy Meyers: I'll circle back [Valmont 00:56:03] part of it.

JP Bennett: Yup. SVXY, it's moved strongly to the upside. Do we anticipate continuing to hold, consider writing calls on a portion or position, et cetera? This is something like I said before. We're currently considering VIX all time lows may be a good opportunity for us to do something like that. We had a period of extended low volatility in the early 90s. What happened? The market went on to rally like crazy for the next five, six, seven years. We had very low volatility right before the housing bubble burst and we had the great financial crisis. Low volatility doesn't necessarily guarantee that the market is going to crater. We don't want to bet the house on that, but you are correct in noting that is actually a position we are currently discussing and there may be something to do there. Being a little bit more active in taking advantage of opportunities like that may be worthwhile in volatile securities like that.

Jeremy Meyers: I would say we are not, at this point, thinking about pairing down the Valmont position. Deere was not a direct short. It was a partial hedge against Valmont because only about 25% of Valmont's revenue comes from its irrigation equipment. The rest is tied to infrastructure spending. If we're potentially going to get a huge wave of stimulus spending from the new administration, Valmont should be a prime beneficiary. If that does happen, even if the agriculture market stays weak for an extended period of time, I think that the gains in the other areas will far outweigh how investors are perceiving Valmont's future.

Jeff Fischer: Sounds good. I can jump on a few. Lon, happy rooster to you as well. Soon, very soon. I think Saturday. What's a good limit to sell Expediters at if I haven't sold? It's around 53 now, which is a good limit as any. Expediters is one of the most shorted stocks on the market because people are afraid trade may be disrupted. We're out of our synthetic long and covered strangle, but we watched the company for a possible reentry. If you're still in it and don't want to be, Lon, then 53-ish is a good limit. Coca-Cola was in Motley Fool Options. I'll just say the premiums are so low on the options right now that that's why it was closed and we're not doing anything right now, but it's possible. Starbucks we talked about early on. It's just down a little bit because sales were a little light. Same store sales were a little light, but long-term they're working to fix that. Any others here that we should address before we sign off?

Billy K.: Sure. I've got a couple about my companies I can address very quickly. Talk about Papa John's. My shares were called away. Papa John's we have as a combined position with our Dominoes short. Ideally when you covered your position, you covered just the amount of our Dominoes short so that you still have some Papa John's remaining. If you didn't and you covered all of your shares and you no longer have any Papa John's, you could do one of two things. You could either now buy the difference between our Papa John's allocations and Dominoes short, which is about 1.4, 1.5%. You could buy that right now and be matched up with Pro's exposure. If you feel like the stock is a little bit too expensive because it's well above our fair value estimate, you could buy maybe a half position or you could write some puts to try to buy into Papa John's, again, lower.

Similar question. I had my [ParkCell 00:59:21] shares called away. Would you reenter it or stay on the sidelines? ParkCell is a little bit of a different story. We covered that because management has had some concerns there and we want to wait for another quarter of results. I would way until we get some results. We'll have some guidance affiliated with our analysis of the quarter. Based upon what we do, or if we change our strategy, roll our covered call, or just let the position go, you can see what we do and then act accordingly.

Jeff Fischer: All right. Thanks, Billy. With that, we do have to wrap it up. If we didn't get to your question, please consider posting it on The Motley Fool Pro discussion boards. Choose an appropriate board and we will hopefully see it. Write us an email if we don't because we'll answer there. A lot of these questions that are left, thankfully there aren't that many, a lot will be best answered on a discussion board anyway. Thank you for being here. We really appreciate it. We appreciate that you are a Pro member and a Motley Fool member with us, a fool like us. We hope you're enjoying the start of the year. Hope you're enjoying the long-term process of investing, of having an ownership stake in great businesses in our country and around the world, and enjoying the appreciation that comes with that. Thank you for being part of Pro. I would also like to thank Ellen Bowman for once again setting up this live chat.

Pro's 2016 Results, Reviewed!

Published Jan 9, 2017 at 3:25PM

Dear *Pro* Fools,

I hope 2017 finds you optimistic about your investments for the coming years (note: plural!), and I hope we're all feeling wiser given another year of experience behind us. Here in *Pro* (and in *Options*), we had a decent if somewhat forgettable 2016, and that's saying something given all the excitement: The year began with the worst January for stocks in history, Britain voted to leave the EU, the U.S. is moving forward with an unconventional president, and our interest rates are headed higher. And yet the stock market ascended in the end.

Before we begin 2017 in earnest, let's review how our discipline -- or breaches of discipline -- treated us in 2016, and what we might learn. First, how did 2016 turn out for us?

2016 Redux: $178,604 Appreciation

Pro had a decent-to-good 2016, helping maintain a strong three-year annualized return, which is our first goal. (Our second goal is doubling our purchasing power every 10 years.) The *Pro* portfolio started 2016 worth $2.49 million and ended at $2.67 million, up 7.3%. Our $178,000 in appreciation last year is exactly what we achieved in 2015, too (what are the odds?). On average, we were 67.6% net invested over the year, using cash, shorts, and hedges to lower our exposure (in 2015, we were 67.7% net invested). Our returns were especially good in the context of our cash holdings and a growing basket of shorts in a market that ultimately rallied. The rally in the S&P 500 favored industrial stocks and energy, both of which we lack by choice. As a result, our return for the year more closely mirrored that of the Nasdaq, which was up 7.5%. Other comparisons:

Vehicle	2016 Return	2015 Return	2014 Return	2013 Return	Current 3-Year Annualized Return
Pro	7.3%	7.5%	17.5%	35.1%	10.7%
North Star	9.3%	8.2%	8.5%	8.7%	8.3%
S&P 500	12%	1.4%	13.7%	32.4%	8.9%

MSCI World	5.3%	(2.7%)	2.9%	24.1%	1.8%

Last year was the second time in five years that we trailed our North Star, and the first in four in which we trailed the S&P 500. Measuring at our 67% exposure level, as other funds would do, we didn't trail the S&P by much, and we topped the Nasdaq and other indexes. Our largest position, **Facebook** (NASDAQ: FB), gained 9.9% on the year, as did **O'Reilly Automotive** (NASDAQ: ORLY); but our other large positions, including **AmTrust Financial Services** (NASDAQ: AFSI), **MasterCard** (NYSE: MA), and **Oracle** (NYSE: ORCL), were down or relatively flat. **Gilead Sciences** (NASDAQ: GILD) declined more than 30%, and **Medtronic** (NYSE: MDT) and **Parexel** (NASDAQ: PRXL) fell as health-care performance suffered. In fact, industry-wise, technology and health care badly trailed industrials and energy last year. I think this will turn positive for us this year and/or in the near future.

Our strong 2016 winners included **Broadridge Financial** (NYSE: BR), **Gentex** (NASDAQ: GNTX), and **OpenText** (NASDAQ: OTEX), all up 20% to 30%; **Valmont** (NYSE: VMI), up 33%; and **Papa John's International** (NASDAQ: PZZA), which gained 53%. **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY) jumped 80%. And our longstanding short of **Direxion Daily Financial Bear 3X** (NYSEMKT: FAZ) fell 47% for us, making the annual fee to short it more than worthwhile.

Other stalwarts, including **Visa** (NYSE: V), **Verisign** (NASDAQ: VRSN) and **Starbucks** (NASDAQ: SBUX), didn't go much of anywhere last year, but earnings were up, and the subsequently improved valuations may add to our future returns. MasterCard and Visa have jumped to life so far already this year.

Net Realized Capital Gains: $47,559

We booked more than $47,000 in net realized gains last year; about $20,000 of that was long-term, the rest short-term gains. This is much lower than the $94,751 in net realized gains we booked in 2015, and this decrease is good. For those following *Pro* in taxable accounts, we don't want to give you an unnecessarily large tax bill every year. Our $125,000 in *gross* realized gains in 2016 were offset by $78,000 in realized losses.

Much of our realized gain came from selling **Wells Fargo** (NYSE: WFC) and **Skyworks** (NASDAQ: SWKS) (with Skyworks unfortunately getting called away) and from closing the rest of our **World Acceptance** (NASDAQ: WRLD) short. Most of the remaining gains were written options that expired as income.

Our only true realized losses were $22,000 in **American Airlines** (NASDAQ: AAL) calls and a net $14,000 loss on a **Deere & Company** (NYSE: DE) short; almost all of our other "losses" were options that were part of a spread, expected to end as a loss.

Dividends: $27,192

We said last year that our dividends would likely decline in 2016, because late in 2015 we sold big payers **The Buckle** (NYSE: BKE) and **Tupperware** (NYSE: TUP). And our dividends did dip last year.

Year	Dividends Received
2016	$27,192
2015	$32,304
2014	$25,387

Our largest absolute payers in 2016 were AmTrust, Broadridge, and Wells Fargo, and we have since sold Wells Fargo. We'll now consider new positions that could bring in more dividends, because these payments play a large role in the market's total return -- and our own. We've collected nearly $85,000 in dividends over the past three years. That said, we continue to seek the "Facebooks" of the market, as well: those that don't pay dividends but offer large upside.

Option Income: $21,492

Our option income increased again last year as we aimed to have some options expiring every month, a goal we maintain this year.

Year	Option Income
2016	$21,492
2015	$16,774
2014	$7,491

Much of our option income was earned on our original **American Tower** (NYSE: AMT) diagonal call, which we recently restarted in a new position. A good chunk of income came from writing a large put contract on **Celgene** (NASDAQ: CELG), multiple puts on **Gentex** (NASDAQ: GNTX), a strangle on **Expeditors** (NASDAQ: EXPD), and some covered calls on Gilead and others. Options didn't pay that well last year except during spikes of volatility.

Combining this income with our dividend income, we earned a 2% yield on the whole portfolio, despite having about 20% cash. But this income excludes the fees we paid to short. (It also excludes the money we made writing ratio put spreads, which goes into our hedging return.)

Short Stocks: ($1,762) in realized losses and ($2,608) in fees

We had realized losses last year on our individual short position on Deere, which lost a net $14,200 -- though Deere also helped us to keep Valmont, which is up more than that so far. The loss on Deere offset a $9,900 realized gain in the remaining portion of our World Acceptance short, and a $2,500 gain from shorting **Pier 1** (NYSE: PIR). We paid a meaningful $2,608 in shorting fees (or interest) last year, adding to our realized shorting loss. With the stock market up strongly, our shorting loss was slight, and we saw unrealized gains elsewhere on our shorts. Still, we keep an eye on our fees and make sure we want to keep the shorts we have.

Hedges: $7,950

After closing one in January of last year for a $9,000 gain, we set up several ratio put spread hedges on the **SPDR S&P 500** (NYSEMKT: SPY) ETF in 2016. With a rising market, none of these paid off the rest of the year, but most did pay us a credit of a few hundred dollars. In November after the election, we gave back about $4,000 in gains on our synthetic short of SPY. We exited that open-ended short right after the election. Here's how the year panned out compared with recent years:

Year	Hedge Gain (Loss)
2016	$7,950
2015	$811
2014	($34,673)

In 2014, we had direct shorts of SPY, and naturally we lost on those as the market climbed. In 2015, we vowed to improve on that approach and stuck to ratio spreads, earning income despite a flat stock market. Last year's combination of ratio spreads and a brief synthetic short on SPY worked out overall, even though the November short cost us. I believe setting up that short was appropriate given the uncertainty surrounding the election: A surprising result was indeed possible, like Brexit. Our portfolio on the whole jumped anyway.

Recently, we suggested a 15% allocation ratio put spread hedge on **PowerShares QQQ** (NYSEMKT: QQQ) that goes until January 2018. We'll have more hedges in future, as well. Remember, you *expect* to lose on a hedge -- it's insurance against a shock to your portfolio, and it allows you to be more invested on the long side. So, net-net, hedges should lead to larger long-term gains for the portfolio, even though they don't usually pay you anything. But of course, if we can minimize our losses on the hedges themselves, we will.

Active, but With Low Turnover

We issued 45 trade alerts in *Pro* last year, or 3.75 per month. This is in line with recent years. (We also issued 84 alerts in *Options*, making *Pro* and *Options* the most active services at the Fool according to the math.)

Year	Pro Trade Alerts
2016	45
2015	43
2014	34
2013	42
2012	55

We seek to keep our core stock turnover low, so much of our activity is related to options and hedges. But we did close some longs and shorts last year, including American Airlines, Deere, Pier 1 (all three new to *Pro* last year), and Wells Fargo. Overall, we had low turnover last year with about half a dozen positions closing. As long as we believe our positions are capable of challenging the North Star over time with reasonable risk, we're unlikely to close, unless we need the capital for something we like better.

Some other new names to debut in *Pro* included **Celgene** (NASDAQ: CELG), **Paycom** (NYSE: PAYC), and **Verisign** (NASDAQ: VRSN), along with several new shorts. We ended the year with 23 core stock investments, up from 21 a year ago. Our top 10 positions currently make up 44.5% of the portfolio's value (up from 42% last year).

Biggest Lessons and Improving Further

So, that's a lot of numbers on another positive year for *Pro*, a portfolio that's able to be as long, or as short, as it wishes. What were some key lessons learned this year?

Easily the largest one for me was related to our American Airlines call options. We started the bullish position in January on the argument that airline profitability was here to stay. As the year progressed, competition continued to drive down revenue per passenger mile at American, and the stock slid as if the company was going out of business. After an 80% drop in our calls, I sold them to avoid a complete washout. This move was somewhat defensive, but in retrospect made little sense. We had little still invested in the calls -- little left to lose -- and had we waited, the position would be back near breakeven today (we couldn't have known that, but again -- we had little financial reason to sell at that point). Adding insult to injury, Warren Buffett started buying airline stocks after we sold, using some of the same arguments we cited in January. One lesson I take away from this: Buying into an industry that's new to you increases your risk of bailing at the wrong time, just as we did. Lacking a history of knowledge, I didn't have the confidence to stay in it. A second: When you have little left to lose, you can more easily let time be your ally. We didn't need to sell at that point. I think we learned some other good lessons as well, though, as shared in the sell report.

Another regret is not buying more aggressively during the January swoon in prices. Some of the stocks we're watching fell close to our desired price -- close enough -- but rebounded quickly. We also wanted to add to our positions. We need to be ready to buy during swoons, even if we start small and average in; next time, we may start sooner. In the same vein, I took a very long time to make some of my shorting decisions, including on **Gogo** (NASDAQ: GOGO), **GoPro** (NASDAQ: GPRO), and **Shake Shack** (NYSE: SHAK). I wanted to short all three up to a year before we did so, and when they were at (sometimes much) higher prices. I still believe in the shorts at the prices we ended shorting at, and caution is merited before any short position is started, but I want to become more efficient when I "know" I want to short something. I tested the theory for months -- I can shorten that process.

Overall, we stayed disciplined more often than not, and avoided many large mistakes, allowing us to return more than 7% while being 67% net long and carrying cash. We topped most long/short funds out there (the average long/short fund returned 4.9%). But I still, and always, feel humbled by the market and a need to improve. Finally, did we enjoy ourselves? That's key, too. For the most part, we did.

So, Fools, we start 2017 hoping to again enhance how we think and act when it comes to our investing, and thus improve our long-term results. Expecting the unexpected (which is an oxymoron!), this year we want to keep earning income, continue to add shorts and hedges, and buy more top-tier stocks (or long call options) when we see opportunities for our specific portfolio. We'll also be seeking smaller growth companies. Many of you customize your Foolish portfolios to your own situation; consider studying your results from 2016 to see where you did well and what can be improved. Post comments or questions on the Memo Musings board. Meanwhile, thank you for being a *Pro* Fool with us! We enjoyed spending last year with you, and we thank you! We look forward to sticking to our discipline in 2017, and using what we we've learned.

In closing, 10 years ago today, in Foolish fashion, Steve Jobs introduced one more thing ... the iPhone.

Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades and Upcoming Expirations: Jan. 9, 2017

Published Jan 9, 2017 at 3:11PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.5%.

Continue building your portfolio with our Buys, including:

- **Paycom** (NYSE: PAYC): Buy 2.3% (see our recent recommendation).
- **Starbucks** (NASDAQ: SBUX): Buy 3.4%.
- **Verisign** (NASDAQ: VRSN): Buy 1.5% and write a covered strangle for another 1.5%, as per our recommendation. Lately you can be paid $3.40 to $3.45 for selling to open the strangle.
- **Verisk** (NASDAQ: VRSK): Buy 2.1%.

Shorts:

- **Shake Shack** (NYSE: SHAK): Sell short 0.5% if you haven't.

Pro options:

- **American Tower** (NYSE: AMT): Set up a diagonal call if you haven't yet, following our recommendation. Lately this can be set up at a net debit of about $29 per diagonal. Set up a 0.5% allocation, but only risk what you can afford to lose.
- **Domino's Pizza** (NYSE: DPZ): Use a limit order to write covered puts following our new recommendation. Write one put for every 100 shares of Domino's you are short. The puts lately pay around $4, but we're holding out a bit longer, hoping for $4.50 or so. If the stock declines, the puts should pay better.
- **Verisign:** Please see above under Buys.

Hedges:

- **ProShares QQQ Trust** (NASDAQ: QQQ): If you haven't set this up yet, today you would sell to open January 2018 $103 puts, and buy to open half as many January 2018 $116 puts, for a small net credit. Set up a 15% allocation using the guidance in our alert. We need to make our trade soon and will adjust accordingly.

Upcoming Expirations (Jan. 20, 2017):

- **Expeditors International** (NASDAQ: EXPD): Our synthetic covered call (which started as a synthetic covered strangle) has done well for us this year, bringing in income while our core long calls are also up 155%. We'll bring the position to a close before expiration, likely all at once; an alternative is to accept shares and write strangles on them, though one consideration there is how international trade may be affected in the coming years.
- **Skyworks Solutions** (NASDAQ: SWKS): We'll close early if we've earned much of the premium, or roll the calls near expiration. Skyworks will announce earnings after the market closes Jan. 19, one day before our options expire, so we'll have a decision before then.

CES 2017, Day Three: Under Armour Thrills Crowd With Star-Studded Keynote

Published Jan 9, 2017 at 2:48PM

About 3 minutes 30 seconds. Scroll down for transcript.

Friday was the third and final day of CES 2017 for us at The Motley Fool. We have been on the front lines talking to CEOs, engineers, and other industry experts to gain insights that investors can use to reap rewards over the long term. We continued those explorations today — featuring, among other things, a wrap-up keynote from Under Armour CEO Kevin Plank — and didn't leave disappointed.

The Internet of Things

As expected, the Internet of Things (IoT) was on everyone's minds here at CES. Businesses are looking for ways to connect more devices to the Internet in an effort to help people automate and enhance various daily tasks. **Gartner** (NYSE: IT) estimates that the number of connected "things" will grow from 6.4 billion in 2016 to nearly 21 billion by 2020. As investors, the exciting part is identifying which companies are likely to lead the pack in enabling the number of connected devices to more than triple over the next several years.

One of the businesses enabling this growing wave of mobile connectivity is **Skyworks Solutions** (NASDAQ: SWKS). Another company blurring the lines between hardware and software to create a back-end technology platform for IoT is **NXP Semiconductors** (NASDAQ: NXPI). NXP's platform powers the voice activation of a wide array of devices, including the **Amazon** (NASDAQ: AMZN) Echo. Like other semiconductor businesses, NXP is also making inroads into developing the computers and sensors necessary for autonomous vehicles.

In October, it was announced that **Qualcomm** (NASDAQ: QCOM) plans to acquire NXP for the cool sum of $39 billion. Qualcomm set the standards for mobile communication with 3G and 4G data speeds, and acquiring NXP would diversify Qualcomm into other areas like automotive, mobile payments (through NXP's near field communications (NFC) technology), security, and more. Qualcomm made waves of its own at CES, particularly by sharing its vision for the next stage of mobile communication with 5G — meaning far faster data speeds and much slower lag times (or latency) — and what it means for the IoT. As reported by CNET:

Think of it this way: If 3G ushered in the picture era and 4G was about video, 5G will be about tying our entire world together. What will we get? Live-streaming VR, autonomous cars that respond to real-time conditions, and connected cities where everything from the houses to the street lamps talk to each other.

"5G will have an impact similar to the introduction of electricity or the automobile, affecting entire economies and benefiting entire societies," says Qualcomm CEO Stephen Mollenkopf. This shift toward 5G won't happen overnight — the infrastructure still needs to be developed and put into place — but large players like Qualcomm and **Intel** (NASDAQ: INTC) are both testing the waters with 5G technology starting later this year. In our conversation yesterday with Liam Griffin, CEO of Skyworks Solutions, he says he expects 5G solutions to make up 20% or more of the company's total revenue within the next three to five years.

As more devices come online and cars increasingly become computers or robots with four wheels, the behind-the-scenes companies mentioned here are among the ones investors should watch closely to get a sense for how the IoT is taking shape.

Bringing Education Online

Innovation can happen in unexpected places, and when it does, we want to be ready as investors. The traditional model of higher education could be one of those spaces slated for some major changes in the coming years. I spoke with Chip Paucek, co-founder and CEO of **2U** (NASDAQ: TWOU), which partners with top universities to build quality online degree programs.

When you think of online college education, says Paucek, most people think of University of Phoenix, not Yale. 2U, however, is working with top universities like UC Berkeley, UNC Chapel Hill and, yes, Yale, to bring their curriculums online. This means that students can still get a quality online education from a reputable university without having to uproot their lives. It's an attractive proposition for universities: 2U provides funding to get the program going and the online platform itself, and universities can admit more students online than they would otherwise have in their classes.

Paucek says the sleeping giants of higher education are awake, with more and more nonprofit schools coming online. UNC Chapel Hill's MBA program alone has over 1,000 students going through its courses via the web. 2U's model is attractive because it aligns its success with both the universities and the students. The company signs a 10-year contract to share student tuition with the university, so 2U only succeeds if students successfully complete their online degrees. When students drop out, 2U takes a financial hit.

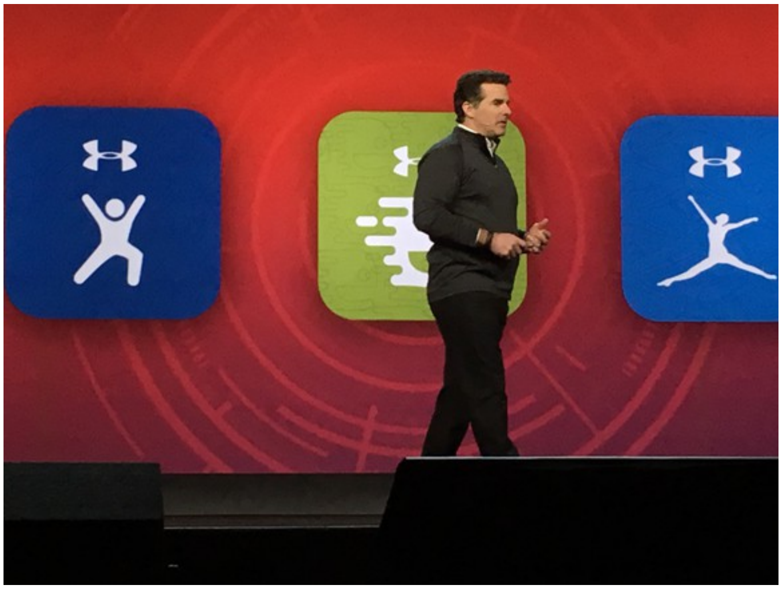
When 2U went public three years ago, it was adding new programs at a pace of about four per year. Today, the company is on pace to add 10 new programs this year. Paucek says 2U investors should pay close attention to the new universities it brings into its portfolio, since that is the main growth catalyst for the company in the coming years. Innovation can happen in hidden places, and 2U is a prime example of a young company bringing an innovative new approach to a long-established industry.

Under Armour

Kevin Plank, founder and CEO of **Under Armour** (NYSE: UA) (NYSE: UAA), was greeted on Friday with high expectations for his keynote presentation. It might seem strange for what is supposedly an apparel and shoes company to be giving a keynote at a tech conference, but Plank made the case that Under Armour is — and always has been — a technology company. "We are not just a logo slapped on a shirt or shoe," says Plank.

Plank is one of the most competitive business leaders in the world today, and has his eyes set on Under Armour surpassing **Nike** (NYSE: NKE) as the leading athletic brand in the world. That's no small order: Nike generated $33.5 billion in revenue over the past four quarters, compared to $4.7 billion for Under Armour. Plank used a colorful metaphor to distinguish his competitive spirit. To create fire, says Plank, some people rub sticks and others hit rocks to try to create sparks. Plank says he lights a match and dumps 100 gallons of kerosene on it.

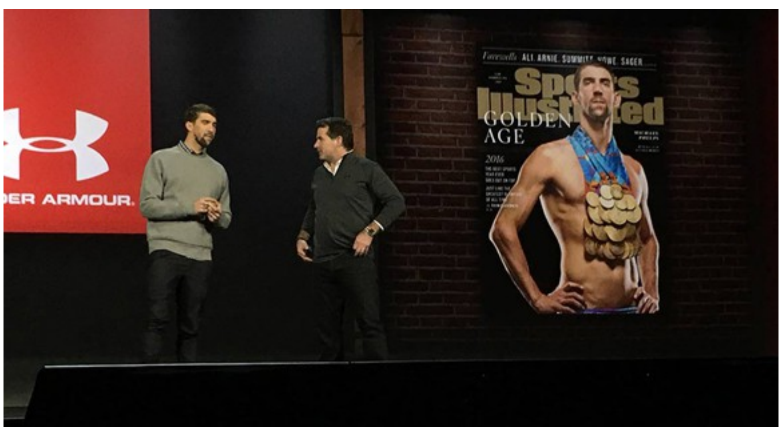
One way Under Armour is working to change how apparel is designed and manufactured is through its local-to-local manufacturing initiative, where the company aims to manufacture apparel in the respective countries in which it is sold (Brazil goods will be manufactured in Brazil, U.S. goods in the U.S., and so forth). Up until now, says Plank, apparel and shoes have been manufactured the same way for 80 or 100 years. Plank calls that "criminal." Under Armour's new 70,000 square foot Lighthouse — an innovation and design lab of sorts based out of its Baltimore HQ — is one of the company's early steps to shift to the local-to-local model.



Under Armour has taken big steps into the connected fitness space over the past several years. The company collectively spent $710 million acquiring three different fitness and nutrition apps (MyFitnessPal, Endomondo, and MapMyFitness). Plank made it clear that Under Armour's platform will remain hardware agnostic, meaning the apps can be used whether on an Apple Watch, a FitBit, or any other device. Except in certain instances where hardware can be integrated into its apparel and shoes, Plank says Under Armour plans to stay out of the hardware game.

What these three apps — which collectively have more than 194 million registered users, with nearly 100,000 new users joining each day — do very well is collect massive amounts of data. Whether users are logging the meals they eat, runs they take, or other fitness and wellness preferences and habits, Under Armour is gaining direct insights into the behavior and preferences of its customers. Plank showed the crowd an example of "user heat maps" in four major worldwide cities, where Under Armour can segment out different users based on whether they are walking, running, or using a bicycle. More than anything else, Under Armour's push into connected fitness is a way for the company to gather more data and better understand the needs and habits of its users — and hopefully sell more apparel and shoes as a result.

Plank says Under Armour strives to solve problems that people never knew they had. One of these oft-overlooked problems, according to Under Armour, is getting ample time for rest, sleep, and recovery. Plank announced a new line of Under Armour's connected fitness sneakers which are equipped with UA Record — an app that brings together all of Under Armour's connected fitness tools. Not only do these shoes automatically track data for athletes, but coming in February, Under Armour is launching a new feature where athletes can go through tests with the shoes to determine how hard (or not) they can/should push their body for that workout. Olympian swimmer Michael Phelps joined Plank on stage to showcase this new feature and explained how this data is vital for helping athletes both rest and perform better.



Plank then dug deeper into explaining the important role that sound sleep plays in maximizing performance, whether as an athlete or throughout life. Like exercise and sleep, explained Plank, sleep also needs a strategy. Arianna Huffington, founder of the Huffington Post and author of *The Sleep Revolution,* joined Plank to expand on an exciting new partnership with Under Armour. The company also connected with John Hopkins Medicine scientists to study and unlock the science of sleep, leading to a new product line of sleepwear (backed by Under Armour athlete Tom Brady) packed with technology that is supposed to lead to a better sleep.

It remains to be seen whether Under Armour's new PJs are indeed a product we didn't even know we needed, or if this is a case of the company pushing its luck with its brand power. This move into sleepwear makes sense to me, because Under Armour is now able to capture a wide array of data on people's sleeping patterns and habits and should be able to see whether certain products help improve the quality of sleep and subsequent performance.

In any case, this goes to show the power at Under Armour's fingertips as it looks to do to the connected fitness category what **Facebook** (NASDAQ: FB) did for social, Amazon did for online retail, and LinkedIn did for job search. Data is a powerful tool, and Under Armour just might be getting the data it needs to maintain its impressive growth trajectory in the years to come.

Foolish Bottom Line

And with that, our time at CES 2017 is a wrap. I hope you have found these reports useful, and come away from our reports with a better sense of what trends, companies, and technologies to watch in the months and years ahead. And now, we're going to follow Under Armour's advice and get some quality rest after a long, exciting week.

Thank you for following along with us!

Foolish best,

David Kretzmann

Transcript

DAVID KRETZMANN:

Greetings, and welcome to day three of CES 2017 here in Las Vegas, Nevada. I'm David Kretzmann of *Motley Fool Supernova* and I'll walk you through some of the highlights that we experienced today at CES.

First we had a chance to visit NXP Semiconductors, a company doing a lot of work bringing more devices and more items in our world online into the Internet of Things along with the connected home and other key trends like that that we've been hearing a lot about here at CES.

Among other things, NXP Semiconductors is really the company enabling that voice-activation technology in Amazon's devices like the Echo. The company is doing a lot of other work to bridge that gap between the hardware side and the software side of the Internet of Things, so we were able to explore more with NXP and what the company is doing there with the Internet of Things.

We also had a chance to talk with the founder and CEO of 2U. 2U is a company a lot of people probably haven't heard of. It's a company that's partnering with a lot of high-level colleges and universities (including the University of North Carolina at Chapel Hill, UC Berkeley, and many others), bringing their traditional curriculum online. Essentially enabling people around the U.S. and potentially around the world to take these courses from these great universities and colleges online [and] bringing the higher-education space online. So we had a chance to hear more about what 2U is doing and key trends to watch with higher education moving online in the 21st century.

Last but not least, and certainly the highlight of the day and potentially the highlight of the week, was the keynote presentation from Under Armour founder and CEO Kevin Plank. The bulk of the presentation really focused on the company's efforts in the connected fitness space.

Over the past three years the company has spent over $700 million acquiring three different apps that [have] nearly 200 million collective users today. The company, with those acquisitions, is really seeking to acquire data from its customers. So get a sense for what people are eating. When they're exercising. How long they're exercising. What type of exercise they're doing. Capturing that data and using that data to more effectively see the needs of those athletes and serve the needs of those athletes.

The bulk of the company's new platform has a lot to do with sleep, rest, and recovery. The company brought out Michael Phelps, the Olympian swimmer. Bought out Arianna Huffington, who's done a lot of research on the importance of sleep and recovery to maximize performance as an athlete and as a human being in terms of productivity.

This really seems to be a new area of focus for the company — bringing products to consumers that consumers didn't even know that they wanted. The goal is that once consumers are using these products, they'll wonder how they ever could go back to life without these Under Armour products. So a lot of high-level vision from Kevin Plank, as usual. He is a very competitive CEO. A driven entrepreneur. We learned more about what Under Armour is doing in that connected fitness space.

You can learn about all of this, and more, in my report today from CES, and be sure to check out the other two reports that we've put out this week from CES highlighting some of the key trends, businesses, and technologies that we think investors should be paying close attention to, to reap long-term rewards.

Thank you so much for tuning in, and we'll see you again soon. This is David Kretzmann live from CES signing off. Fool on!

Supercharge Your Portfolio With the Biggest Trends of 2017

CES 2017, Day Two: 3 Key Tech Trends for Investors

Published Jan 6, 2017 at 1:48PM

Thursday was our second day at CES 2017 in Las Vegas, NV, and our crew of Fools were back on the front lines to get a deeper understanding of the biggest trends and technologies we should be watching as investors.

About 3 minutes 30 seconds. Scroll down for transcript.

Let's dig right in!

Self-Driving Cars

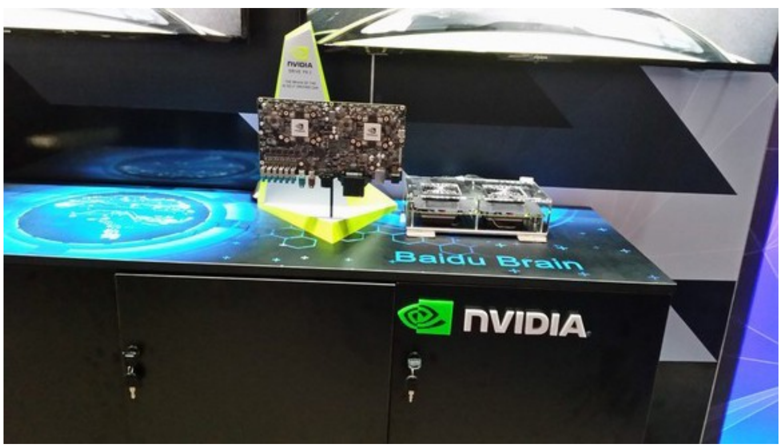
NVIDIA's (NASDAQ: NVDA) keynote on Wednesday evening set the tone for CES this year, and self-driving cars have been one of the event's biggest focuses. On Thursday, we had a chance to meet with AImotive, a European start-up that is developing software to make self-driving cars a reality. Interestingly enough, NVIDIA was a seed investor in AImotive, and the two companies continue to have a relationship today. NVIDIA's bread and butter is computer hardware — such as the supercomputers that power autonomous vehicles, big data analysis, PC gaming, and more — while players like AImotive are focusing on the software side of the equation.

Another company making a splash in this space is **Baidu** (NASDAQ: BIDU), which is commonly referred to as the Google of China. Baidu is well known as a popular search engine, but it's also making a serious push into providing software for autonomous vehicles. The company formed a new division — Baidu IV (Intelligent Vehicle) — in September 2016, which is already staffed with 150 employees, all working on Level 3 autonomous driving technology.

There are six "Levels" to autonomous driving, from Level 0 (absolutely no self-driving capability; a human must always be in control) up through Level 5, which requires no human control at any point in the driving process. Level 3 (the focus of Baidu's new IV division) still requires some control from a human driver, but enables a car to safely take over for a human in certain cases.

An interesting note: even before Baidu launched its Level 3 division in September, the company also had a Level 4 division in place. This is a clear sign that companies like Baidu are not only dreaming big, but are also making incremental progress on the path to fully autonomous vehicles. CES 2016 — which I attended last year — brought a lot of hype surrounding self-driving cars. There is still significant excitement this year, but the trend is focusing more on these smaller, decisive steps.

Baidu has already partnered with more than 60 auto manufacturers, with its "intelligent vehicle" software being integrated into over 150 car models so far — including both consumer and commercial models. Through its HD Map service, Baidu is the largest mapping provider for autonomous vehicles in China. This means that no company knows China's roads better than Baidu from the perspective of autonomous vehicles, which packs a powerful punch when Baidu is looking to form partnerships. Baidu partnered with NVIDIA in September to develop its software platform for autonomous vehicles. Its "Baidu Brain" software is powered by NVIDIA's hardware.



Media and eSports

Barry Diller — the media heavyweight who currently serves as chairman of IAC/InterActiveCorp and Expedia — had some words of caution about the movie and TV business. Due to the growing popularity of on-demand and streaming services like **Netflix** (NASDAQ: NFLX) and **Amazon** (NASDAQ: AMZN), Diller says a "profound dislocation" is coming in the industry over the next five to 10 years. For example, more people are increasingly opting for commercial-free television — paying a monthly fee to companies like Netflix, HBO, and Amazon — rather than suffering through commercials on linear TV. This is a troubling trend for TV advertisers, says Dillard, because eventually the people who are still watching linear TV in future years won't have money to buy the goods being advertised.

Diller was particularly critical of the business of making movies in this evolving media landscape, with the notable exception of one movie studio: **Disney** (NYSE: DIS). Put another way: In a world where movies serve as tentpoles for brands, characters, and franchises, Disney reigns supreme above all other movie studios.

eSports is another area where we are seeing media companies direct their resources. Yesterday, NVIDIA co-founder and CEO Jen-Hsun Huang said it is "very, very likely" eSports will one day become bigger than all other traditional sports *combined* — we're talking football, basketball, baseball, hockey, soccer... *everything*. Even established broadcasting companies like Turner Sports — the company behind sports broadcasts on TNT, TBS, and TruTV — are bringing eSports under their umbrella. I spoke with Christina Alejandre, Vice President of eSports at Turner Sports, who says Turner Sports is treating eSports in the same way it treats any other sport.

Alejandre says the biggest misconception people have about eSports is that it is still just a lot of kids playing video games for fun in their mom's basement. In reality, eSports is a full-time job for these players, who spend 40-to-60 hours each week practicing, reviewing replays of themselves and competitors, and perfecting their craft. The main difference between eSports and traditional sports is the technical issues that can arise with eSports — such as a computer server going down in the middle of a tournament — but otherwise they are both approached in a very similar manner by players, fans, and broadcasters alike.

Alejandre says the games that resonate most with audiences are the ones that are simple and straightforward. She used Counter-Strike as an example, a shooter game where the competition is made up of two teams of five. The first team to annihilate the other team wins. Simple, straightforward, and easy to follow.

As for what investors should be watching for over the next several years, Alejandre says we should pay attention to non-endemic sponsorships. If you are like me, you have no idea what that means at first mention. Let me explain non-endemic sponsorships are and why they're important. "Endemic" sponsors are the group of advertisers directly connected to a sport. In the case of basketball, for instance, endemic sponsors would include **Nike** (NYSE: NKE), **Under Armour** (NYSE: UA) (NYSE: UAA), Spalding, and so forth. "Non-endemic" sponsors would be outside advertisers that aren't at all connected to the sport, such as **Home Depot** (NYSE: HD) or **McDonald's** (NYSE: MCD).

Alejandre says these non-endemic sponsors are just starting to come on the eSports scene. As more non-endemic sponsors allocate their advertising dollars to eSports, Alejandre expects that to uplift the entire eSports ecosystem. This makes non-endemic sponsors a useful tool for investors to measure the rise of eSports.

Embracing the Connected World

In a world where more devices are getting connected to the internet, **Skyworks Solutions** (NASDAQ: SWKS) is a key provider of the technology that enables that connectivity. I spoke with Skyworks' CEO Liam Griffin, who explained that what Skyworks does best is craft individual solutions for each of its customers. In other words, Skyworks builds customized hardware solutions for its customers — something that can only be done if the company forms close and long-standing relationships. This gives the company a competitive advantage that can't be easily replicated by its peers, and helps explain its strong (and improving) margins and cash flow production despite operating in the competitive semiconductor industry.

The bulk of Skyworks' revenue has long come from smartphones, but its "broad markets" segment now accounts for about 25% of total sales. This includes everything from connectivity solutions in autonomous vehicles, the Internet of Things, headsets, WiFi routers, and more.

As consumer demand for faster and more reliable data continues to increase, don't be surprised if you hear more about 5G in the years ahead. Griffin explained that 5G connectivity will vastly expand the data pipe (meaning higher data speeds and less lag time), and expects 5G solutions to account for 20% or more of the company's overall revenue within the next three to five years.

Under Armour

We also stopped by Under Armour's booth on Thursday to find any clues for what might be coming in the company's keynote presentation on Friday. The company is plugging its ecosystem of connected fitness apps and apparel (especially its shoes with sensors built in), as well as a new line of sleepwear that is supposed to help people sleep better. This sleepwear line is backed by Under Armour athlete Tom Brady, and we saw another Under Armour athlete — Bryce Harper — swing by to talk about the importance of rest and sleep, among other things.

We're excited to see if Under Armour's keynote tomorrow can match — or top — NVIDIA's presentation and slew of announcements. Maybe Under Armour founder and CEO Kevin Plank will unveil new products, or perhaps offer more details on the company's vision with wearable technology and connected fitness. But if fancy PJs are the extent of the company's announcements, I'll be more than disappointed. Don't let us down, Under Armour!

Foolish Bottom Line

And thus wraps up another packed day for us at CES. We have more interviews and presentations lined up for Friday, and you can bet we'll be on the ground learning and reporting our findings back to you. Thank you for following along with us thus far — the Fool crew is just getting started!

Transcript

DAVID KRETZMANN:

Greetings and welcome to CES 2017. I'm David Kretzmann of *Motley Fool Supernova*. We're thrilled to be here at CES reporting from the front line.

Today there are really three highlights that stuck out to me. This morning we had a chance to really delve deeper into self-driving cars, which is a big theme, here, at CES this year, as it was last year. We initially were able to meet with AImotive, which is a European start-up based in Hungary with a recent office in Silicon Valley. This is a company providing software that's hardware-agnostic — so really to any automaker — to enable these cars to have that self-driving functionality. And Nvidia is actually a seed investor in this company, so it's interesting to get more of that backend perspective of what goes into artificial intelligence and enabling these cars to be self-driving or more autonomous.

We also had a chance to sit down with Baidu — which is commonly known as the Google of China — the biggest search engine in China with over 600 million monthly active users. But Baidu is actually the leading mapping company for self-driving vehicles in China and this was the first year that their self-driving auto unit came to CES.

This is a division of the company that just started in September, 2016, but they already have 150 employees dedicated to pushing this self-driving technology (software and hardware) into the Chinese market and potentially beyond. So a lot of companies that you might not expect on the surface are actually very much involved in pushing forward self-driving technology.

Next we had a chance to meet with the vice president of eSports at Turner Sports, which is commonly known for the traditional sports programming on TBS, TNT, and all those Turner Broadcasting networks. We were able to get a better feel for how that space has evolved for Turner Sports — bringing eSports under that umbrella of other sports programming at Turner.

ESports is a big, emerging category and has certainly been a big theme, here, at CES. Yesterday the founder and CEO of Nvidia said eSports at some point in the future will become bigger than all the other traditional sports like basketball, hockey, soccer (you name it), combined. So certainly a lot of growth opportunity left in eSports and we were able to hear a little bit more about how Turner Sports is approaching that emerging category.

Last but not least we had a chance to talk with the CEO of Skyworks Solutions, which is a recommendation in multiple Motley Fool services and a holding in several Motley Fool portfolios, as well. Skyworks is really on the front lines of the mobile connectivity revolution, as the company puts it.

This is a company that's powering the mobile connectivity of your smartphones [and] it's increasingly branching into the Internet of Things — a new category that makes up about 25% of the company's total sales over the past year — things in the Internet of Things whether it's autonomous vehicles, the connected home, Wi-Fi routers. You name it — Skyworks has an important role to play if there's any sort of mobile connectivity involved. So we were excited to get a chance to talk with the new CEO, Liam Griffin, at Skyworks Solutions.

Those were some of the highlights for me today. You can read more about it in my report and we'll be reporting back to you the rest of the week with our findings here on the front line at CES. Thanks for tuning in, and Fool on!

CES 2017, Day One: NVIDIA Sets a High Bar

Published Jan 5, 2017 at 3:10PM

Greetings from Las Vegas! We've made it to CES 2017. This four-day tech extravaganza, now celebrating its 50^{th} anniversary, isn't lacking for things to see — the show covers nearly 2.5 million square feet this year. Our Motley Fool team hit the ground running to get an initial glimpse of the tech and trends that will define the rest of the week.

I expect a lot of talk this week about virtual reality (VR) and augmented reality (AR) — relatively new computing platforms that carry the potential to transform how people interact with technology. At present, there is no clear winner yet with either of these emerging platforms. **Facebook** (NASDAQ: FB) has Oculus, and Google is doing its part with Daydream. Another key player in the virtual reality landscape is HTC Vive, which recently hosted an event showcasing the company's latest developments in VR.

It can be difficult to understand the potential of VR until you try one of the headsets on for yourself. Consider this: while at CES, I tested a VR experience that simulates a fireman putting out a fire in a home. I was outfitted with a special fireman's jacket which produced more heat as the size of the simulated fire grew. To put out the fire, I had to use a prop firehose controller which responds with jerking motions and increased pressure depending on the flow of the water in the simulation. For firemen in training, such a simulation — with the heat from the jacket and the pressure of the firehose — could be a component of their training routine that normally can't be safely simulated in the real world. I'm sure there are thousands of other potential use cases for VR well beyond the world of gaming.

About 4 minutes. Scroll down for transcript.

I also had the chance to check out a more typical shooter game, where I was outfitted with a heavy gun controller and put on a vest that provides haptic feedback — in other words, the vest would vibrate in different areas as I got shot by the aliens in the simulation.

David Kretzmann
@David_Kretzmann

Checking out the wonderful world of virtual reality with HTC Vive. That gun is heavy & the vest gives haptic feedback #CES2017 #FoolsAtCES

2 8:20 PM - Jan 4, 2017

See David Kretzmann's other Tweets

Both of these props made the simulation all the more immersive, and perhaps a little more realistic. My arm was tired from holding the gun by the end of the three-minute simulation (maybe I just need to lift weights more). Those aliens put up a good fight!

VR still hasn't broken out into the mainstream in the same way smartphones burst on the scene around 2007 with the launch of the iPhone. Some of the main limitations for VR include a limited selection games and content (at least today), still-pricey VR systems (Oculus costs $600 and HTC Vive costs $700, and that's without an even pricier PC to run the system through), and the fact that VR systems require a lot of space.

One way HTC Vive is combating these VR shortcomings is via arcades. This opens the door for people to experience VR without having to pay up for a console or headset. HTC Vive recently stated its goal was to turn "public virtual reality gaming" into a $100 million industry over the next two years. I see this as an attractive model to bring VR to a wider audience in a time when VR systems aren't personally accessible.

Look ma, no hands!

Another area that we're sure to see more of at this year's CES is self-driving cars, also known as autonomous vehicles. Yesterday, we made our way to an event put on by Hyundai, which gave us the opportunity to go for a ride in the company's autonomous Ioniq model.

Much of the technology used in the car (such as sensors and cameras) was developed in-house by Hyundai — with the exception of a Mobileye camera — and is still early stage. Once the human driver got us out of the parking lot, the car went into autonomous mode and proceeded to take us around the block without a human touching the steering wheel. The car stopped at a red light, turned when the light went green, and performed all the typical driving functions that you'd expect from a car.

NVIDIA

And this brings me to **NVIDIA** (NASDAQ: NVDA), which stole the show for the day — and possibly the week — with its keynote presentation on Tuesday evening. Shares of NVIDIA more than tripled in 2016, making it the top-performing stock of the S&P 500 for the year. Since the company's founding in 1993, NVIDIA has largely been tied to PC gaming graphics. The company has since branched out to use and develop its technology for other applications like autonomous vehicles, virtual reality, and machine learning (helping computers find patterns in complex sets of data, for instance).

NVIDIA's co-founder and CEO Jen-Hsun Huang made several big announcements during the presentation, starting with the gaming space. Huang called gaming the world's largest sporting event, stating that he believes it is "very, very likely" eSports will one day reach a bigger audience than all other sports combined. Of the two billion PCs around the world today, only half of them have the necessary technology (like NVIDIA's graphic processing units (GPUs)) to play games. Until now, that is.

NVIDIA announced that it has developed a "supercomputer" that stores its state-of-the-art graphics technology in the cloud, which tens of millions of gamers will be able to access. Think of it as on-demand video gaming on virtually any Mac or PC, meaning players will be able to stream a game wherever and whenever they want. This service — GeForce Now — will open in March, and could broaden the video game market to millions more players.

NVIDIA is also making strides with the connected home, announcing upgrades to its Shield TV streaming device. Shield TV will now include Google's AI (Google Assistant) — meaning the TV can be activated and controlled through voice commands — as well as a wider reach of 4K content from the likes of **Netflix** (NASDAQ: NFLX) and **Amazon** (NASDAQ: AMZN). NVIDIA also announced the Spot, a small WiFi speaker that plugs directly into an outlet and can pick up voice commands within 20 feet. Roll the Shield TV and Spot together, and NVIDIA is packing a powerful punch in the connected home.

Finally, NVIDIA had a slew of announcements related to its efforts with self-driving cars. Huang calls NVIDIA's efforts with self-driving cars "the most impactful work we're doing for society," given the potential to lessen the number of deaths, injuries, and financial costs that occur each year due to human error on the roads. NVIDIA is making strides developing an artificial intelligence (AI) supercomputer for vehicles, which enables a car to go on full autopilot (imagine getting into your car, saying "Take me to Starbucks," and never touching the steering wheel once) or "copilot" where the AI is still assisting the human driver (with heads-up warnings like, "A motorcycle is switching to the center lane behind you.").

NVIDIA has announced a host of new partnerships with multiple mapping companies around the world (including **Baidu** (NASDAQ: BIDU), the leading mapping company for autonomous vehicles in China), which will set the foundation for the next generation of self-driving cars to navigate roads worldwide. The company is partnering with two leading global auto suppliers to begin producing its AI computer for autonomous driving (which will start shipping later this year). And, finally, NVIDIA announced a partnership with Audi to produce the "next generation" of AI-powered autonomous vehicles by 2020. Jokingly, Huang said, "Let's make sure none of our kids ever have to drive."

With $3.7 billion in net cash, accelerating sales growth, and a leading position to power the computers behind key trends like autonomous driving, eSports and gaming, virtual and augmented reality, and the connected home, I can see why NVIDIA had a blowout year in 2016. Based on the company's presentation and announcements at CES this week, that business momentum seems poised to continue in 2017 and beyond.

Foolish Bottom Line

We're just at the beginning of CES 2017, and already NVIDIA has set the bar high for the week. The Motley Fool team will be back at it in the coming days, reporting from the front lines on the trends, technologies, and businesses that investors should be watching closest in the years ahead.

Stay tuned for more from us tomorrow. In the meantime, Fool on!

—David Kretzmann

Transcript

DAVID KRETZMANN:

Greetings from CES 2017 in Las Vegas, Nevada. I'm David Kretzmann, the Mission Lead for Odyssey 2 in *Motley Fool Supernova*.

Our Motley Fool team is here on the ground at CES and today was more of an introduction day for CES. There are a lot of vendors and businesses still setting up on the show floor, but we did get a chance to visit a few events today and get a taste for what we'll be experiencing the rest of the week here at CES and much more.

One of the highlights for the day was a visit to HTC Vive, an event that HTC put on to showcase the Vive virtual reality platform. It's a virtual reality headset and platform, and it was really interesting to get a chance to be up close and personal with a variety of virtual reality games. So whether you're a firefighter putting out a fire in a kitchen and feeling the heat on your chest and the pressure of the fire hose, or you're in a shooter game, where you're feeling the bullets hit your vest and you feel the weight of the gun, you can definitely see the potential for the virtual reality platform.

Obviously it's still a space with a lot of fragmentation. Whether you're talking about HTC with its Vive platform, Facebook with its Oculus platform, [or] Google with Daydream, there are a lot of players in this space. There's not one clear winner, but it will certainly be an interesting space for us to watch in CES and beyond.

Another highlight for CES this year will most certainly be self-driving cars. Today we had a chance to take a test drive in a self-driving car that Hyundai has been developing largely in-house. The technology is still early stage compared to some of the other solutions out there, but we were able to be in the car and get a sense for how that technology works [and] a sense for how the sensors and the cameras work to create or enable that autonomous driving experience.

And that really leads into what was certainly the highlight of the day and could prove to be the highlight of CES, which was the Nvidia keynote presentation. Nvidia covered a variety of topics, including self-driving cars. The founder and CEO described the company's efforts with self-driving cars as the most important thing the company is doing today — the most influential thing the company is doing for the good of the world — just in terms of being able to use self-driving technology to reduce the amount of accidents and deaths caused by human failure when it comes to driving cars.

Nvidia announced a whole lot of partnerships, including one with Audi, where the companies are essentially committing themselves to creating an artificial-intelligence-powered vehicle by 2020. Within the next three years they should have an AI-powered, self-driving capable car.

So Nvidia continues to be a powerhouse of a company. Obviously the company had an incredible 2016. It was the top-performing stock in the S&P 500. It more than tripled. The company has released a slate of new products and new partnerships.

And the company continues to power ahead in the video game space. The company today announced essentially an on-demand video game platform where players, even if you don't have a high-powered computer with an Nvidia processor or an Nvidia computing system [will] still be able to subscribe to this cloud gaming platform and play a variety of games from Electronic Arts, Activision Blizzard, and a whole lot of others. So that's certainly a first in the video game space, and that could have broad implications for PC gaming and video gaming in general, going forward.

So that was certainly an interesting announcement. There's a whole lot more from Nvidia that we'll cover in our daily dispatches, but for now that gives you a summary of what we experienced at our first day at CES. Stay tuned for more from the Motley Fool crew here at CES where we will share with you all of our findings on trends, products, businesses and where we think investors should be watching for long-term rewards.

Thanks for watching and Fool on!

Write Covered Puts on Domino's Pizza

Published Jan 5, 2017 at 11:54AM

Is this for you? This recommendation is for *Pro* members who are short at least 100 shares of Domino's Pizza as part of our paired trade, in which we also own Papa John's.

How You Participate

- **Trade:** Sell to open June 2017 $140 puts on **Domino's Pizza** (NYSE: DPZ).
- **Allocation:** Write ("sell to open") one put for every 100 shares of the stock you are short and want to cover. *Pro* will cover 300 of the 353 shares we are short (leaving 53 shares uncovered by necessity).
- **Price Guidance:** Prices will change as the underlying stock moves, but **use a limit order** to split the bid/ask price spread at going prices.
- **Prices** (11:00 a.m.):
  - **Stock:** $163
  - **June 2017 $140 put (bid/ask):** $4.20/$5.10
  - **The math:** $4.65 is a 2.9% yield on the current share price in about 163 days (five months or so).

Since we initiated our short position on Domino's in late August as a paired hedge with our long position in **Papa John's** (NASDAQ: PZZA), the two pizza stocks (which were both highly valued to begin with) have only continued to climb in price.

The downside volatility we were hedging for with our short hasn't yet come to fruition, but the paired position has largely performed as we might have expected. Between late August and Jan. 4, Domino's stock price is up 9.5% and Papa John's is up 16%; as a result, the EV/EBITDA "multiple discrepancy" we mentioned in our original alert has decreased from 4.5 to 3.3 (closer to the five-year average of 3.05), which benefits our paired position.

Stock Prices		
	DPZ	PZZA
8/30/2016	$148.85	$ 74.72
1/5/2017	$163.00	$ 86.66
Total Return	9.5%	16.0%

EV/EBITDA Multiple			
	DPZ	PZZA	Multiple Discrepancy
8/30/2016	21.1	16.6	4.5
1/5/2017	21.4	18.1	3.3

After all this, our 353 short Domino's shares have cost us $5,262 (including dividends, which we owe as short sellers), and the portion of our long Papa John's shares that offset the Domino's short have increased our portfolio's value by $8,637 (including dividends, which we're paid as stock owners). The total gain we've experienced with this paired short position is $3,374, or 0.12% of our total portfolio value as of today. This is a good outcome given the very strong historical price correlations between the two stocks. Lest we forget, the paired trade also helped to keep us from selling some of our Papa John's shares, which would have meant paying taxes on those gains.

However, despite the positive outcome so far, we have not yet been able to cash in on the primary objective of this paired short -- protection of downside risk. So far, both stocks have simply continued to rise in value, and Papa John's stock price is now more than 50% above our fair-value estimate.

We think the expectations built into both companies' stock prices are very rosy, and we think there's still significant downside risk to both pizza stocks if an industry-specific or market-wide downturn were to occur. As such, our plan for now is to maintain our short position in Domino's until the company's stock price declines to valuations that are closer to our estimates.

In the meantime, we've decided to target some additional income with our Domino's short by selling covered puts against it. We still like our paired position, and income is a secondary consideration (it's not why we originally opened the short). But we do have to ask anew, "At what price would we be inclined to consider closing this position?" If we know the price at which we'd be happy to close our short, we might as well write covered puts around that strike price for income as we wait for our hedge to benefit us in a downturn. And if Domino's tanks significantly and we want to close our short position, we can close it all with these puts.

In that scenario, we'll have simply guaranteed our strike price (plus any premiums collected) as a closing price. We may miss some additional downside (actually upside for our short), but we've chosen a strike price at which we're OK with that.

These June $140 covered puts yield 2.9% in a little more than five months -- not a screaming yield, but one we'll accept given the risk and reward of the overall position. We have to think differently about these puts than "typical" ones written for income, because with this particular strategy, income is a secondary objective. We're simply trying to offset some of the costs (and risks) of shorting while maintaining a "cover" price we like. Any yield is a plus.

Alternative Trades

If you are long Papa John's at a 3.8%-plus allocation (like us) and you haven't yet shorted Domino's, you could set up the entire strategy today. To do so, you'd sell short a 2.1% allocation of Domino's (to offset 2.1% of your Papa John's exposure), and simultaneously sell to open these covered puts on the shares of Domino's you sell short -- one put for every 100 shares. Make sure not to sell too many put contracts; you don't want to end up obligated to buy more shares than the amount you have shorted.

More That Matters

- **Maximum gain:** The stock's downside (i.e., our upside as short sellers) is capped at our put's strike price, and the potential gain on the covered put is the premium it pays us. The total combined gain is the put strike plus the premium received, leading to our net potential cover price of $135.35 (about 9% below our initial short price, and 17% lower than the current price).
- **Maximum risk:** Theoretically unlimited, although our Papa John's long ideally acts to offset upside risk on this short.
- **Follow-up**: We will monitor the stock prices of Papa John's and Domino's to help decide our ongoing course of action. Depending on stock-price movements, we may continue to leave our paired position alone, we may close the entire position, or we may pursue some alternative strategy. If the covered puts expire as income, we may look to write more puts. If the stock price is below the strike price at expiration, we may either let our puts get assigned (covering our short shares at a net $135.35), or look to roll out and/or down in order to capture further income or upside for our position.

Options Can Help

- **Questions about this trade or strategy?** Head over to our hot-from-the-oven Domino's discussion board.

Learning and Growing Together in 2017

Published Jan 3, 2017 at 3:32PM

Fellow Fools,

Happy New Year! It's a privilege to kick us off with the first Memo of 2017, following another year of solid performance by the *Pro* portfolio. Though I've always found it a bit arbitrary to measure successes and failures based on a calendar year, January does present as good an opportunity as any to take account of the year that's passed and look forward to the year ahead.

Don't worry, I won't be joining the herd of market strategists making predictions about what will happen in 2017. Following the string of largely unimaginable events that punctuated 2016, it's easy for me to avoid that temptation. And because studies show that the vast majority of New Year's resolutions fail, I'll spare you those as well. Instead, I'd like to take this opportunity to share something more tangible -- a few of my favorite tools and resources, the ones I use regularly and simply can't live without. You may already be familiar with many of these, but if I can add just one or two new resources to your repertoire, that might make for an even better 2017.

Pump Up Your Daily Reading

I spend much of my day reading voraciously, trying to distill some sort of signal from the market's noise. Many investors stick to the major news sources (*The Wall Street Journal*, Bloomberg, *The New York Times*, *The Washington Post*), but there's a lot of value to be found by stepping out of the mainstream.

- If you want to find quality blog posts, interesting research, and non-consensus thinking, curated daily "link-fest" websites like Abnormal Returns and Real Clear Markets are invaluable. These sites are an efficient way to see the top financial stories of the day and make sure nothing important falls through the cracks.
- Ever wonder why your favorite stock is up (or down) 10% in a day, but can't find any news that's causing the move? I've found that StockTwits is one of the fastest ways to search Twitter by ticker and see what investors are talking about. Maybe it's random noise, or maybe it's a little-known research report or financial filing that has the market in a tizzy. This is the fastest way to find out.

Learn From the Best

It used to be that attending a top-tier MBA program or working for an elite asset management shop were the only ways to gain access to the top minds in finance and investing. Thanks to the Internet, you can now learn from some of the best writers, educators, and practitioners in the financial industry, all from the comfort of your own couch.

- If you take nothing else from this Memo, please bookmark this archive of white papers from Michael Mauboussin, compiled and updated on the Hurricane Capital blog. Over his career at Legg Mason and Credit Suisse, Mauboussin has compiled one of the most exhaustive instruction manuals for equity analysis available to the public. He covers everything from business-model analysis to prediction techniques to behavioral finance and a whole lot in between. Just beware that once you start reading, it's easy to get sucked down the rabbit hole.
- When it comes to teaching and writing about equity valuation, nobody does it better than Aswath Damodaran. The esteemed professor maintains a blog where he discusses current business topics and the valuation of popular companies, and best of all, he records his lectures and gives free access to everyone. This is the best education you're going to find in stock valuation short of registering at NYU.
- Michael Kitces is one of the most highly respected financial planning experts in the country, and his Nerd's Eye View blog contains a wealth of knowledge. Though he mostly writes for other financial planners, his site is a wonderful resource for do-it-yourselfers as well.

Save Time and Money

Ben Franklin quipped nearly three centuries ago that, "a penny saved is a penny earned." Little has changed since, except the relative value of a penny. At *Pro,* we spend a lot of time discussing how to generate better investment returns, but when it comes to wealth generation, many people are just as well served finding ways to spend less and save more.

- You'd be shocked at how much money gets lost over time and goes unclaimed for various reasons. Run by the National Association of Unclaimed Property Administrators, Unclaimed.org lets you search multiple government databases for property that belongs to you or a loved one. It's free and reminds me of what it feels like finding a $20 bill in an old pair of jeans.
- As a dedicated research analyst, I often spend way too much time researching various household items before I buy. I've found that sister websites The Wirecutter and The Sweethome allow me to outsource that research and make those buying decisions in a fraction of the time. For example, The Sweethome spent 20 hours of

research just to decide on the best ironing board. Who has time for that?

If you are among the 83% of Americans who shopped at Amazon at least once in the past year, you probably already appreciate the value of an Amazon Prime membership. However, if you really want to up your Amazon game, here are a couple of sources to make sure you're getting the best deal available.

- CamelCamelCamel allows you to search for any item on Amazon and see how its price has changed over the past year. You can also set a target price for an item and the website will notify you when it drops below that threshold.
- Honey is a browser add-on that compares multiple merchants on Amazon and points you to the best deal on any given item. As a bonus, when you're shopping on other websites, the tool can search numerous deal sites and automatically apply coupon codes to make sure you're getting the best price available.

Make Life Easier

- I recently bit the bullet and spent the time to consolidate my passwords into a single password manager. It was well worth the effort. Not only do I have the peace of mind from more secure passwords on my financial accounts, I only need to remember one main password. Also, the program's auto-fill function saves a ton of time. I ended up going with Dashlane, but LastPass and 1Password are other highly rated options worth considering.
- My memory isn't what it used to be, which is why I've started saving all of my investment research on Evernote. I read several dozen news articles each day, and I find the ability to quickly save and search my archives invaluable. It's also useful in my personal life when researching a big purchase, or even doing something as simple as sharing a synchronized shopping list with my wife.
- I might hear groans from the serious audiophiles in the crowd, but Sonos has completely changed the way I listen to music. The app is incredibly intuitive, the speakers are high-quality, and the user experience keeps improving with periodic software updates.

The *Pro* Bottom Line

Like many of the Fools in the *Pro* community, I'm on a perpetual quest to improve my skills as an investor, a little bit of improvement each year compounds to make a big difference. Though we spend most of our time focused on maximizing our investing returns, it's important to remember that there are a lot of ways to create additional "household alpha." Whether that's achieved through the quest for more money, more time, better relationships, and/or improved health is all up to you, but the *Pro* community is here to help however we can. To that end, if you'd like to share a few of your favorite things with your fellow Fools, head on over to the Memo Musings board and fire away!

Here's to a prosperous 2017!

Foolish best,

-- Jeremy (TMFTank)

More From *Pro*

- Valuing Verisign
- *Pro* and *Options* Prepare to Wrap Up 2016
- *Pro* Quality Checklist: Visa
- All Past Monday Memos

Pro Catch-Up Trades and Upcoming Expirations: Jan. 3, 2017

Published Jan 3, 2017 at 3:22PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.5%.
- **Facebook** (NASDAQ: FB): Buy 6.1%.

Continue building your portfolio with our Buys, including:

- **Apple** (NASDAQ: AAPL): Buy 3.8%.
- **Gilead** (NASDAQ: GILD): Buy up to 2.5%.
- **Medtronic** (NYSE: MDT): Buy 2.6%.
- **Paycom** (NYSE: PAYC): Buy 2.2% (read our recent recommendation).
- **Verisign** (NASDAQ: VRSN): Buy 1.4% and write a covered strangle for another 1.4%, as per our new recommendation.

Shorts:

- **Gogo** (NASDAQ: GOGO): Sell short 0.5% if you haven't.
- **Shake Shack** (NYSE: SHAK): Sell short 0.5% if you haven't.

Pro options:

- **Parexel International** (NASDAQ: PRXL): Write $65 covered calls for every 100 shares you own**,** if you haven't. At $3.65, the calls offer a 5.6% yield on the current $65.70 stock price in 73 days. See our recent recommendation.
- **Verisign:** Please see above under Buys.

Hedges:

- **ProShares QQQ Trust** (NASDAQ: QQQ): Over the coming days or weeks, look to set up a spread in the spirit of our recent trade alert, ideally for a credit or no cost.

Upcoming Expirations (Jan. 20, 2017):

- **Expeditors International** (NASDAQ: EXPD): Our synthetic covered call (which started as a synthetic covered strangle) has done well for us this year, bringing in income while our core long calls are also up 155%. We'll bring the position to a close this month, either by accepting shares for ownership to write options on them, or by closing the options to consider new ones.
- **Skyworks Solutions** (NASDAQ: SWKS): Our $75 covered calls are earning some premium back, capturing more upside from the stock position. We'll likely roll the calls near expiration and keep targeting income with upside on our shares.

Pro Guidance Changes and Completed Trades: Jan. 3, 2017

Published Jan 3, 2017 at 3:20PM

Pro Guidance Changes (from the past two weeks)

- **Gentex** (NASDAQ: GNTX): Shares moved from Buy First to Buy as the stock price approached our fair-value estimate.
- **PowerShares QQQ Trust** (NASDAQ: QQQ): We recommended setting up a put ratio spread on QQQ to hedge our portfolio for 2017.

Pro Completed Trades (from the past two weeks)

- **Deere & Company** (NYSE: DE): We closed our short shares at $101.46 and sold to close our protective calls at $8.94, ending the short.
- **Gentex** (NASDAQ: GNTX): Our December $17.50 puts expired as income.
- **SPDR S&P 500** (NYSEMKT: SPY): Our December put ratio spread expired for a little income.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Valuing Verisign

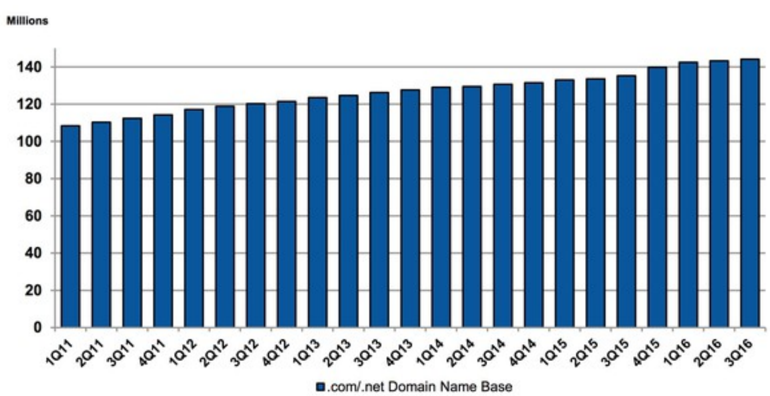
Published Dec 19, 2016 at 4:10PM

Fellow Fools,

You may know that when it comes to writing puts, we at *Pro* like to target a strike price 5% or so out of the money, regardless of whether the position stands alone or is part of a more complex income-generating strategy. You may also have noticed that when we issued our recent covered strangle on **Verisign** (NASDAQ: VRSN) , the puts we sold were only 2.5% out of the money. Why deviate from our own guidelines, exchanging downside protection for extra income?

Primarily thanks to our estimate of the stock's fair value. We examined the impressive economics of the business in our recent trade alert, so I thought today's Memo would be the perfect opportunity to go over the other primary determinant of a stock's valuation -- expectations for the future. Specifically, we're going to focus on the three key drivers for the ".com"/".net" business in which Verisign operates: new registrations, renewals, and pricing.

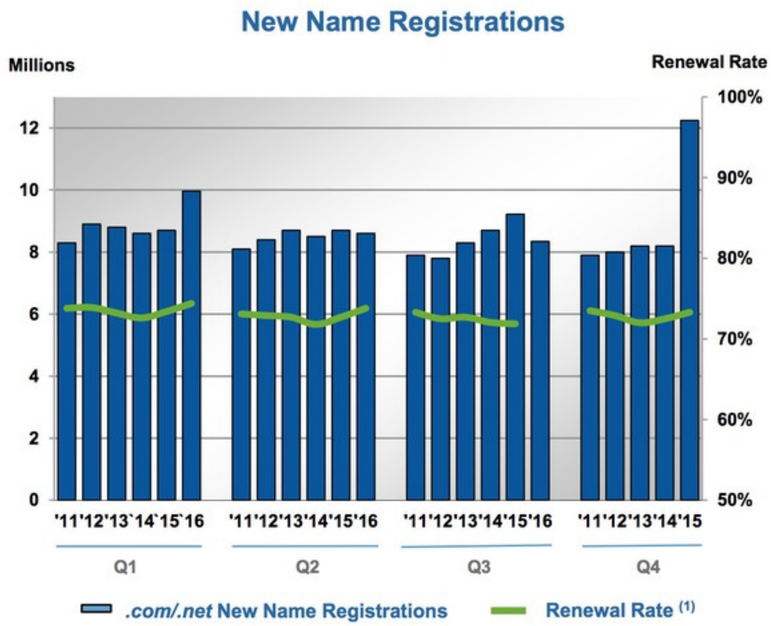
New Registrations



When it comes to steadily growing businesses, Verisign's registry business is hard to beat. People are still registering millions of new domains every year despite both top-level domains (TLDs -- ".com" and ".net") being 30-plus years old. And there's still plenty of room for growth, too, with 95% of possible five-character domain names and 99% of six-character combinations still available. Granted, the number of *desirable* domains is likely far less than the total available, so I don't believe the majority of these combinations will ever registered. But even if the number of new registrations does start to decline, we believe this will occur at a glacial pace. There are no current signs of a slowdown, but to be conservative, our valuation is based on an estimated growth rate of 8 million new registrations per quarter -- a figure not seen since 2012 and well below the five-year average of 8.5 million.

Renewals

A steady stream of new customers doesn't mean much if most of your existing customer base doesn't stick around. But in Verisign's case, although first-year renewals tend to hover at about 50%, the rate for previously renewed domains continues to improve, currently heading toward a very impressive 85%. The blended average for these two groups is in the low 70s at the moment, but we expect the overall rate to slowly trend higher; our expectations for new registrations imply that the existing base of domains older than one year will become a larger percentage of the yearly renewal cohort over time, pulling the overall ratio higher.



Source: Verisign Q3 2016 earnings release

However, it is worth pointing out once again that we expect to see some deviation from this trend in the upcoming quarter. Domain-name investing is big business, with the most coveted names in a given year selling for millions. Unsurprisingly, this has speculators buying up various domains in hopes of striking it rich, just like you see in the stock market. Although this activity can boost Verisign's new registrations in a given year, it's also one of the reasons the renewal rate for first-year domains is so low. The new-registration surge we saw in 2015 was likely the result of Chinese speculators, which is why we believe the renewal rate for the fourth quarter will likely fall well below average.

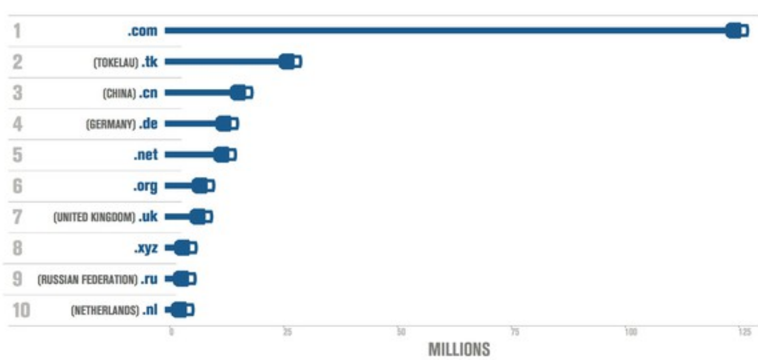
There were 143 million domains registered as of Dec. 18, down from 144 million at the end of last quarter. Assuming the net decrease for the upcoming quarter exceeds management's expectations (in a bad way!) to close in on 3 million, Verisign's steady-state revenue base (in which new registrations only offset non-renewals) is about $1.1 billion.

Pricing

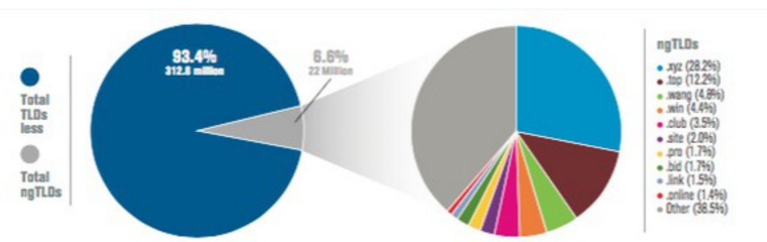
Given that Verisign has a monopoly on the registry business for the largest generic TLD (gTLD) in existence -- ".com" -- you'd think the company likely has tremendous pricing power. And you'd be right. However, the Department of Commerce also noticed this when it examined the TLD registry industry, and it decided to restrict Verisign from raising prices without prior approval.

Some investors were disappointed to see that the recently signed agreement to extend Verisign's ".com" registry contract until 2024 did not include permission for a price hike. However, based on the language of the contract, we believe Versign will request permission for such a hike in 2018; we expect that request to be granted, resulting in the first price hike for ".com" domains since the start of 2012.

Believe it or not, when these restrictions were initially set in place, ".com" was even more dominant as a TLD than it is now. But its slow decline in market share over the years -- from 42% in 2009 to 38% in the second quarter of 2016 -- hasn't come about because the number of ".com" domains is shrinking. Rather, it's because of an initiative started by Internet watchdog ICANN to increase competition, with new gTLDs capturing more than their fair share of new registrations.



Sources: Verisign Domain Industry Brief, Sep 2016; Zooknic, Q2 2016; Verisign, Q2 2016; Centralized Zone Data Service, Q2 2016.



Sources: Verisign Domain Industry Brief, Sep 2016; Centralized Zone Data Service, Q2 2016; Zooknic, Q2 2016.

While it may sound counterintuitive, this increased competition is actually a good thing for Verisign in terms of pricing power. The DOC's initial decision was based on Verisign's influence on the market as a whole, but this concern lessens as new gTLDs gain share. Moreover, with many new gTLDs charging upwards of $20 to register a domain, ".com" is actually becoming one of the most affordable gTLDs on the market, despite the disproportionate amount of value it delivers as the TLD most people associate with the internet.

From Forecasts to Fair Value

Assuming 8 million new registrations per quarter over the next few years and an overall renewal rate that slowly inches higher, we'll likely see revenue growth of 3% to 5% just from the increase in the domain base. And in 2019, we believe we'll see revenue growth reaccelerate into the low to mid-teens based on a .com price hike between 7% (the most recent ".com" increase) to 10% (the annual increase for ".net").

When combined, these conservative estimates show Verisign generating approximately $880 million in operating profits five years from now, up from $606 million in 2015. This means Verisign's stock should trade for about $115 in five years. However, when you factor in how much capital the company returns to shareholders through share repurchases -- almost $6 per share in just the past 12 months -- we believe the stock's intrinsic value will be closer to $130. Discount this back to today using a 10% rate and you get a fair-value estimate of about $83, which is 8% higher than the average net start price for our position (assuming our puts are exercised).

And don't forget that we didn't include any of Verisign's other businesses (security services and other TLD registries, for example) in our valuation. At the moment, we consider these divisions to be equivalent to call options on the business -- they're not currently worth much to shareholders, but they may create significant value down the road. In fact, Verisign recently bankrolled a bid to win the rights to ".web," the new gTLD that some have called the only possible threat to the originals' (".com," ".net," and ".org") market share.

So why not just buy the stock, you ask? It's currently undervalued, perhaps significantly so if our our forecast is in fact conservative. One reason is because of *Pro*'s goals as a portfolio: As we mentioned in the trade alert, we're looking to add positions that will generate healthy returns regardless of what happens in the market, and covered strangles do just that. Moreover, with the primarily catalyst for a change in the stock (a ".com" price hike) not set to arrive until 2018, we believe sentiment will remain muted in 2017, providing us with the perfect opportunity to generate income. Once 2018 rolls around, we'll likely leave our stock uncovered, hoping to generate significant capital gains to go along with our option income.

Enjoy your week, Fools!

-- JP (TMFYossarian)

Pro Catch-Up Trades and Upcoming Expirations: Dec. 19, 2016

Published Dec 19, 2016 at 3:54PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.6%.
- **MasterCard** (NYSE: MA): Buy 4.6%.

Continue building your portfolio with our Buys, including:

- **AmTrust Financial** (NASDAQ: AFSI): Buy up to 5.3%.
- **Apple** (NASDAQ: AAPL): Buy 3.9%.
- **Medtronic** (NYSE: MDT): Buy 2.7%.
- **O'Reilly Automotive** (NASDAQ: ORLY)**:** Buy up to 5.2%.
- **Paycom** (NYSE: PAYC): Buy 2.2% (read our recent recommendation).
- **Verisign** (NASDAQ: VRSN): Buy 1.5% and write a covered strangle for another 1.5%, as per our new recommendation. Today's net debit is nicely lower than in the original alert.

Shorts:

- **Gogo** (NASDAQ: GOGO): Sell short 0.5% if you haven't.
- **Shake Shack** (NYSE: SHAK): Sell short 0.6% if you haven't.

Pro options:

- **Verisign:** Please see above under Buys.

Hedges:

- **ProShares QQQ Trust** (NASDAQ: QQQ): Over the coming days or weeks, look to set up a spread in the spirit of our recent trade alert, ideally for a credit or no cost.

Upcoming Expirations (Jan. 20, 2017):

- **Expeditors International** (NASDAQ: EXPD): Our synthetic covered call (which started as a synthetic covered strangle) has done well for us this year, bringing in income while our core long calls are also up more than 200%. We'll bring the position to a close next month, either by accepting shares for ownership to write options on them, or by closing the options to consider new options. We'll decide in January based on the portfolio's exposure and the stock's valuation.
- **Skyworks Solutions** (NASDAQ: SWKS): Our $75 covered calls are earning some premium back, capturing more upside from the stock position. We'll likely roll the calls near expiration and keep targeting income with upside on our shares.

Pro Guidance Changes and Completed Trades: Dec. 19, 2016

Published Dec 19, 2016 at 3:50PM

Pro Guidance Changes (from the past two weeks)

- **Parexel** (NASDAQ: PRXL): We recommend writing covered calls on this whole position, which remains on Hold.
- **Verisign** (NASDAQ: VRSN): This new position is rated a Buy at a 1.5% stock allocation, plus 1.5% more in a written covered strangle.
- **PowerShares QQQ Trust** (NASDAQ: QQQ): We recommended setting up a put ratio spread on QQQ to hedge our portfolio for 2017.

Pro Completed Trades (from the past two weeks)

- **Verisign** (NASDAQ: VRSN): We set up a strangle by:
  - Purchasing 500 shares at $79.42.
  - Selling to open five March 2017 $85 call contracts at a price of $1.83.
  - Selling to open five March $80 put contracts at a price of $4.16.
- **Deere & Company** (NYSE: DE): We closed our short shares at $101.46 and sold to close our protective calls at $8.94, ending the short.
- **Gentex** (NASDAQ: GNTX): Our December $17.50 puts expired as income.
- **Parexel** (NASDAQ: PRXL): We sold to open thirteen March 2017 $65 calls, covering all our shares, for $4.04 each.
- **SPDR S&P 500** (NYSEMKT: SPY): Our December put ratio spread expired for a little income.

You can see all of our guidance, positions, and transactions from the Recommendations page.

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10 Tips for Harvesting Investment Losses and Reaping Wealth

Published Dec 19, 2016 at 12:55PM

This article is brought to you by Robert Brokamp, the advisor of *Motley Fool Rule Your Retirement*.

Somewhere in your portfolio, you probably have a loser — an investment that is now worth less than what you paid for it. However, all is not lost. If that investment is in a non-retirement account — so, not in an IRA, 401(k), or annuity — you can sell it, take the loss, and use it to reduce your taxable income. Capital losses are first used to offset capital gains and then — if there's any loss left over — used to reduce taxable income up to $3,000 a year. Losses greater than $3,000 can be used in following years as long as you're a living, breathing taxpayer.

Even if you don't have losses in your taxable accounts, there are ways to be a tax-smarter seller — perhaps even intentionally realizing some gains this year, or passing them on to heirs (tax-free!).

Does a smaller tax bill sound good to you? Such a future could be yours, especially if you heed these 10 Foolish considerations.

1. Tax-Loss Selling Isn't Just for Stocks

Any stock, bond, mutual fund, ETF, or option contract that is below the price you paid can feel the wrath of your loss-harvesting hoe. So don't limit your search to just individual stocks. (Unfortunately, you cannot claim a taxable loss on property held for personal use, such as a house.)

2. Sell Now — but Wait Before Buying Back

If you decide to sell an investment to take the loss on your tax return, don't buy it back within 30 days of your sale date. Otherwise, the loss is considered a "wash sale" (which has nothing to do with discounts on a Maytag). A loss that violates the wash-sale rule will be disallowed — that is, you won't be able to enter it on your Schedule D to offset your gains or ordinary income. If you lose your calendar and accidentally buy the investment back within the 30 days, the disallowed loss is added to the cost basis.

The 30-day clock starts the day *after* the sale. Also, we're talking calendar days — not trading days.

Of course, if you have no intention of buying back the investment, then you don't have to worry about all this wash-sale hullabaloo.

3. No Cheating Allowed

Right now, you may be scheming ways to get around the wash-sale rule so you can still essentially own the investment *and* take the capital loss. Well, you might want to spend your mental energies on more fruitful pursuits ... because the IRS has been around this block. Here are some other ways to violate the wash-sale rule. Don't do these! And make sure your spouse doesn't, either.

- You buy the investment 30 days or less *before* you unload your original unprofitable stake. So the wash-sale rule actually covers 61 days: the day you sold the investment, the 30 days before that day, and the 30 days after. For example, if you sold a stock on July 31, the wash-sale period would include all of July and all of August.
- You buy an investment that is "substantially identical."
- You buy the investment in another account, including IRAs or other tax-advantaged retirement accounts.
- You buy a call option on the investment. As for other options strategies, it can get complicated. For example, you can sell a call at a loss, buy the stock, and not violate the wash-sale rule if circumstances meet certain criteria. The bottom line: Do your homework before mixing tax-loss harvesting and options.
- You buy an investment that could be converted into shares of the sold investment, such as a convertible bond or preferred.
- You get an award of company stock within 30 days before or after selling other shares of the stock.
- You sell an index fund or ETF based on one index and buy another ETF that follows the same index.

All that said, there are still ways to gain similar exposure to an investment while you wait for the 30 days to pass. For example, in the case of the last bullet point above, you could sell an ETF based on the S&P 500 and buy an ETF based another index. You could also sell shares of a particular stock and then buy a fund or ETF that invests in the same industry, even if it holds shares of the company you sold. For example, an investor could sell shares of **Intel** (NASDAQ: INTC) and invest the proceeds in the **SPDR S&P Semiconductor** (NYSE: XSD) ETF and not run afoul of the wash-sale rule.

4. It's Not All Roses and Lower Taxes

Like any transaction, buying and selling investments — even for tax-loss purposes — has its costs. You'll have to pay commissions and bid-ask spreads. Plus, the investment you sold could increase by an amount greater than the value of the deduction before you get a chance to buy it back. Of course, if the investment declines before then, that's a bonus.

Historically, the S&P 500 has risen in value in about 59% of the months from 1928 through October 2014, according to Yardeni Research. But the market tends to get festive in December — that's the month with highest percentage of positive months (74%), and it ties with July for the highest average monthly return (1.5%). So if you're going to engage in tax-loss selling in the next couple of weeks, historically you'll run a greater risk of missing out on some gains if you choose to keep the proceeds in cash.

Is that potentially forgone growth worth buying an investment for just 30 days, especially when you figure in the potential of short-term capital gains taxed at ordinary income rates? That's up to you, but factor your tax situation into your sales decisions to determine whether this year or the next might be the best time to recognize losses or gains (for example, if you expect to be in a higher tax bracket next year, consider putting off any tax-reducing decisions until 2017).

Historical Monthly Performance of the S&P 500

January 1928 to October 2014	Up	Down	% of Months With Positive Returns	Average % Change
January	55	32	63%	1.2%
February	46	41	53%	-0.1%
March	54	33	62%	0.6%
April	54	33	62%	1.3%
May	49	38	56%	-0.2%
June	48	39	55%	0.8%
July	49	38	56%	1.5%
August	51	36	59%	0.7%
September	39	47	45%	-1%
October	51	36	59%	0.4%
November	50	36	58%	0.6%
December	64	22	74%	1.5%

Source: Yardeni Research

5. You've Bought More Shares Than You Think

If you made multiple purchases of an investment — either deliberately or through dividend reinvestment — your holding has more than one cost basis. So it's possible that you have a mix of gains and losses.

Let's say you bought **General Electric** (NYSE: GE) 15 years ago in a taxable account and have been reinvesting dividends ever since. You originally bought the stock at a split-adjusted $47.06 in 1999, but it dropped as low as $21.30 in 2003. It eventually rebounded to $42.15 in 2007 but then plummeted to a close of $6.66 on March 5, 2009 (four days before the S&P 500 hit its low of 666). It closed at $28.88 on Nov. 1, 2016. You would have endured quite a ride with a stock previously considered among the bluest of the blue chips — and you'd have accumulated many shares with a wide range of gains and losses.

The lesson: When perusing your portfolio for profits — and lack thereof — don't just consider the purchase price of your first foray into the holding, or the average cost basis. You might have more losses than you remember. Even if you have nothing but gains, you can manage your tax bill by choosing the specific gains you'll realize when you want to sell a portion of a holding.

6. Specify Which Shares You're Selling

If you've determined which shares you'd like to sell, don't just click the "sell" button on your broker's website. Make sure you understand your account provider's options for assigning a cost basis and holding period to investments, and then choose the method that's best for you — before you sell. It can usually be done on the company's website or in writing but not over the phone.

The rules can differ from one type of investment to another. Here are the essentials:

- **Stocks and ETFs:** The default method is "first in, first out" (FIFO) — that is, you sell the shares you've held the longest. The other, more Foolish choice is choosing specific shares.
- **Mutual funds:** You have same two choices, but the default is usually a third option available only to funds: average cost, which as you might guess, is the total cost basis of all your shares divided by the number of shares. The default holding period will probably be FIFO. For example, if you bought 100 shares two years ago and 50 shares six months ago, the default cost basis would be the average of all 150 shares, but the first 100 shares you sell would be considered long-term because you held them for more than a year. Don't like that method? Then you should change it. Once you've sold shares of a mutual fund using one method, you have to stick with it for any shares you've bought up until then. You can choose a different method for newly acquired shares.
- **Bonds:** You can choose FIFO or identify specific bonds if you're not selling your entire holding in the same issue. The rules pertaining to bonds bought at a premium or discount — that is, a price different from par value — can get sticky, but the main thing to know is that the basis is adjusted each year so that it's very close to par when the bond matures. But there are exceptions — such as bonds from bankrupt companies — so do extra research or get professional help. Also, the interest from some types of bonds (such as Treasuries and municipals) might be exempt from state or federal taxes, or both. However, capital gains are still taxable, and capital losses can reduce your tax just like losses in other investments.

Up until 2011, financial-services firms were required to just report the gross proceeds of sales to the IRS. However, they now must also report the cost basis and holding period, so they're doing a better job of keeping records. If you own investments bought before 2011, you might find that your broker doesn't have the cost basis information for specific shares, so you'll have to unearth it yourself from your account statements. Plus, it's always possible that the info your broker has it wrong. Even FINRA, the self-regulatory organization run by the financial-services industry, recommends that investors regularly review their account statements for potential inaccuracies. So it's important to keep past account statements and trade confirmations, as well as documentation of your chosen disposition method.

7. When Tax-Loss Selling Doesn't Make Sense

Although it may be tempting to take a tax-reducing loss whenever possible, you may want to resist if you expect to buy back the investment and expect to be in a higher tax bracket in the future because of higher income or congressionally imposed higher tax rates. Why? Because when you sell a stock and then buy it back later at a lower price, you now have a lower cost basis — which could lead to more taxes later.

By way of illustration, consider the following two scenarios.

Scenario 1

- You bought shares of **Stinktronix** (Ticker: PU) at $100
- It drops to $80
- You sell it and take the $20 capital loss
- Thirty days after the day you sold the stock, you buy it back at $80 (for simplicity's sake, we'll assume the price didn't move)
- Years pass and the stock is worth $150
- You sell and now have a $70 taxable capital gain ($150 minus the $80 cost basis)

Scenario 2

- You bought shares of **Stinktronix** (Ticker: PU) at $100
- It drops to $80
- You resist the urge to harvest losses and just hold on
- Years pass and the stock is worth $150
- You sell and now have a $50 taxable capital gain ($150 minus $100 cost basis)

In the first scenario, you lowered your cost basis in the stock — from $100 to $80 — which resulted in a higher taxable capital gain down the road ($70 compared with $50). If you will be in a higher tax bracket in the future, harvesting the losses today may not be the right move because the benefit of taking the loss today may be outweighed by paying a higher tax rate on a bigger gain in the future.

On the other hand, if you'll be in lower tax bracket in the future, then taking the loss now might be smart given that you'll get more bang for your deductible buck. Plus, given the time value of money, taking the loss this year might still make sense, as a lower tax bill theoretically means you have more to invest.

8. Harvest Gains, Too!

Are you single and will have less than $37,650 in *taxable* income — that is, gross income minus exemptions and deductions — this year? Or married and will have less than $75,300? Then I have good news: You won't pay any taxes on long-term capital gains. Just sell the investment and take the profits. You can even immediately buy back the investment; the 30-day wash-sale rule applies only to capital losses, not to gains. This will give you a tax-free stepped-up cost basis, which you'll appreciate if you're in a higher tax bracket or if capital-gains tax rates are higher when you sell in the future.

You see, taxpayers below the aforementioned income thresholds are in 15% tax bracket or lower — and they don't pay taxes on long-term capital gains or qualified dividends. (Short-term gains are still taxed as ordinary income.) Remember, we're talking about *taxable* income — in other words, gross income minus all the exemptions ($4,050 per each member in the household for 2016), deductions (at least $6,300 for singles and $12,600 for married folks), 401(k) contributions, credits, etc. So you might be closer to the 15% tax bracket than you think.

Consider this very simplified example (taxes are rarely *this* simple!). A married couple has $100,000 in annual gross income. Their taxable income *could* be just $64,300 in 2016, which puts them squarely in the 15% tax bracket.

Gross income	$100,000
Minus two exemptions ($4,050 each)	- $8,100
Minus standard deduction ($12,600)	- $12,600
Minus 401(k) contribution	- $15,000
Taxable income	**$64,300**

Just know that the capital gains themselves will increase your taxable income, which could tip you into the next tax bracket. But that's not as bad as it may sound. The long-term gains up to that point still enjoy the 0% tax rate; only the long-term gains that crept into the next tax bracket will be taxed at 15%.

9. Know the Bracket Racket

One of the cornerstones of tax planning is so-called "bracket arbitrage": deliberately recognizing more income in years when you're in a lower tax bracket and deferring income as much as possible in years when you're in a higher bracket. But to do that, you need to know which bracket you fall into.

It all starts with your taxable income. Unless your financial situation is significantly different in 2016 than it was in 2015, the best way to estimate this year's taxable income is to start with last year's tax return — specifically, Line 43 on your 1040. Then adjust that number up or down to account for how this year's return will differ (for example, you received a raise or a bonus). With that figure in hand, check out the tax brackets for 2016 below. Remember that qualified dividends are taxed at the same rate as long-term capital gains.

2016 TAXABLE INCOME

Rate	Single filers	Married couples, filing jointly	Rate on long-term capital gains*
10%	$0-9,275	$0-18,550	0%
15	9,276-37,650	18,551-75,300	
25	37,651-91,150	75,301-151,900	15%
28	91,151-190,150	151,901-231,450	
33	190,151-413,350	231,451-413,350	
35	413,351-415,050	413,351-466,950	
39.6	415,051 and above	466,951 and above	20%

Source: Internal Revenue Service *and qualified dividends THE WALL STREET JOURNAL.

10. Avoid Gains by Helping Heirs and Others

Since we're discussing non-fun topics, permit us to bring up something besides taxes that is certain: death. You can carry capital losses forward to future tax years indefinitely — but not eternally. Your losses die with you. If the losses were incurred in a jointly owned account, only half the losses can be carried forward after one owner passes away.

Once you reach a point in life when you're earmarking specific investments as assets you'll be passing on to the next generation, remember that the cost basis of inherited assets is the value of the investment as of the date of death. That's good news if you pass on investments with large embedded gains, since neither your estate nor your heirs will ever pay taxes on those gains. However, if you pass along an investment that is worth less than what you paid for it, the ability to write off those losses is gone forever.

Because we're speaking of giving investments to others, we'll include a quick note about the power of donating long-term appreciated investments to qualified nonprofit organizations. You might be able to deduct the value of the donated investment (subject to certain conditions and restrictions). Plus, you avoid selling the investment and thus paying taxes on the gain. The lucky recipient organization of the investment will probably sell it, but qualifying nonprofits don't have to pay capital-gains taxes. Everyone wins! Make sure you do your research before making a donation, and you can start with IRS Publication 526: Charitable Contributions.

The Foolish Bottom Line: Don't Let the Tax Tail Wag Your Investment Dog

It's never fun to have an investment that doesn't pan out. But if it's in a taxable account, don't think of it as a mistake; it's now a "tax asset" to be deployed as befits your circumstances. If you are in a high tax bracket or will probably sell the investment anyhow, go ahead and take the loss. On the other hand, if you still believe in the longer-term prospects of the underwater asset and you expect to eventually be in a higher tax bracket, holding on for now might be your best move.

But whatever you do, don't let tax consequences be the sole reason you bid adieu to an asset. And if you sell an investment that you plan to buy back, don't forget to put in that order 31 days later. Some of the best investments in Motley Fool history have been stocks that were down 50%, 70%, or more. An investor who sold those stocks to harvest the losses but didn't repurchase any shares lost out on some of the biggest returns.

Hedge: Set Up a Put Ratio Spread on QQQ

Published Dec 16, 2016 at 12:29PM

Is this for you? At *Pro*, we use hedges to target returns during a market decline; this one applies if the market falls by the start of 2018. You don't need to hedge to succeed with *Pro*, but if you are at least 74% net invested in stocks (as we are) and *want* to hedge your market exposure, then consider following along. Those without a margin account can consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $76,000. Newcomers should note that this is a complex trade, but you have literally weeks (if not months) to learn how to set it up. This strategy initially becomes more lucrative to set up when the market is falling, and it can't reward us until close to expiration.

How You Participate

- **Action:** Use a spread order to set up a put ratio spread on the **PowerShares QQQ Trust** (NASDAQ: QQQ) ETF.
- **Allocation:** Set up one ratio spread for every $11,400-sized hedge you want. *Pro* is hedging about 15% of our total portfolio value. To follow that allocation, set up one 2:1 put ratio spread for every $76,000 you manage ($76,000 x 15% = $11,400; that $11,400 is because we're buying $114 puts, which represent $11,400 in value each). *Pro* will sell 70 puts and buy 35.
- **Trade:**
  - **Use a ratio spread order to simultaneously ...**
    - Write ("sell to open") **two** Jan. 19, 2018, $100 puts, and
    - Buy ("buy to open") **one** Jan. 19, 2018, $114 put.
    - Click "view all" at your broker to see all strikes.
- **Price Guidance (as of 11 a.m. 12/15):**
  - **Sell to open two $100 puts:** Lately $3.40 x 2 = $6.80 credit
  - **Buy to open one $114 put:** Lately $6.78 debit
  - **Net debit or credit:** Lately about **$0.02 credit** per spread -- but this price will change. As it does, simply aim for a credit or no cost; at worst, pay a tiny debit, always using a limit order.
  - **QQQ price:** $120.50

- **Potential adjustment:** If QQQ moves in price before you set up your trade, you'll likely want to move both of your strike prices up or down accordingly -- as much as QQQ has moved -- while still aiming for a net credit. We ourselves will make such an adjustment if need be, and tell you about it. We have 30 days to complete our trade; keep in mind that if the market falls sharply, this position initially pays you *more* to set it up, because the lower-strike puts will become more sensitive to volatility.

What We're Thinking

Any number of things could bring about a market downturn by 2018: higher interest rates slowing the economy; China trade fights; the fact that the market on average declines every three years; flying monkeys attacking Capitol Hill. Here at *Pro*, we aim to have winners in down, flat, and positive markets -- and that means we need to address all three possibilities at once in our portfolio. That said, we remain oriented toward the long term, and we are majority invested in strong businesses. A hedge on a market index is simply a hedge against a near-term lower market while the rest of our stocks remain free to appreciate. We generally don't try to manage for market declines of 5% or less (that's just standard volatility), but when *Pro* is functioning as desired, lasting declines of more than that should result in some of our positions, such as these spreads, becoming nicely profitable. At the same time, the put ratio spreads we use:

- Are harmless to us if the market goes higher (they don't ding our returns)
- Are typically cash-free to set up (they often pay us a small credit -- essentially income)
- Have a low probability of long-term loss

What's the trade-off? As with any written put, we need to be ready to buy the underlying investment; for today's position, that means we're prepared to buy into the Nasdaq 100 index if the price falls below $100, or about 17% lower. If this index tracker declines by more than about 29%, to below $86, this hedge becomes a liability for us, with QQQ falling below our break-even point. If that does happen, we would plan to buy *long-term call options* on QQQ instead of shares, saving most of our cash in the process. We don't believe there's much probability of long-term loss, because we believe that in a situation like the above, QQQ will recover. But to participate, you need the cash and capability to buy those calls in a market meltdown.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2,710,000
- Fifteen percent of that value: $406,500
- January 2018 spread:
    - Buy to open $114 puts -- 35 contracts representing 100 shares each = $399,000 in look-through exposure, or a 14.7% hedge on our current portfolio value, cash included.
    - Sell to open $100 puts -- 70 contracts, half of which are *not* covered by long puts and thus become a potential obligation at a net $86, for a current 11.1% possible stake in QQQ. Of course, as the market falls, our portfolio value will likely fall, too (unless we're really well positioned!), so this potential stake would be larger -- up to nearly 16% if our portfolio falls 29% with the market.
    - At home, you would buy one $114 put and sell two $100 puts for every $11,400 in portfolio value you want to hedge, or every $76,000 in value you have.

Return Details

QQQ Price at Jan. 19, 2018, Expiration	Value of 1 Purchased Jan. 19, 2018, $114 Put	Value of 2 Written Jan. 19, 2018, $100 Puts	Our Total Cash Return (or Loss) on 1 Ratio Spread	QQQ Price Change (%) From Recent $120.50
$114 or higher	$0	$0	$0.00 gain per spread -- or any credit or debit for setting up the trade	No result (just the initial credit earned) on any increase in SPY's price, or any decline of less than 5.4%
$112	$2 x 100 = $200	$0	$200	(7.1%)
$110	$4 x 100 = $400	$0	$400	(8.7%)
$108	$6 x 100 = $600	$0	$600	(10.4%)
$106	$8 x 100 = $800	$0	$800	(12%)
$104	$10 x 100 = $1,000	$0	$1,000	(13.7%)
$102	$12 x 100 = $1,200	$0	$1,200	(15.4%)
$100	**$14 x 100 = $1,400**	**$0**	**$1,400 (Max profit per spread)**	**(17%)**
$98	$16 x 100 = $1,600	($2) x 200 = ($400)	$1,200	(18.7%)
$96	$18 x 100 = $1,800	($4) x 200 = ($800)	$1,000	(20.3%)
$94	$20 x 100 = $2,000	($6) x 200 = ($1,200)	$800	(22%)
$90	$24 x 100 = $2,400	($10) x 200 = ($2,000)	$400	(25.3%)
$86	**$28 x 100 = $2,800**	**($14) x 200 = ($2,800)**	**$0 (break-even)**	**(28.6%)**
$80	$34 x 100 = $3,400	($20) x 200 = ($4,000)	($600)	(33.6%)
$70	$44 x 100 = $4,400	($30) x 200 = ($6,000)	($1,600)	(41.9%)

If QQQ declines more than 5.4% from recent levels, this hedge starts to come into play. Our maximum profit is earned on the spread if QQQ declines 17% from its recent level of $120.50, to $100, by our distant 2018 expiration. Beyond that, the spread will help us a little bit on an index decline of as much as about 28%; deeper than that, and our short puts turn into an obligation in the red.

Follow-Up

Assuming we set this spread up for a credit or no cost, it pays us something or costs us nothing even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $100 put obligation (starting with a net buy price of $86) if QQQ falls to a territory below either of these strikes at expiration.

If that does happen, our plan is to close our puts and buy long-term QQQ calls (or something we like better, whether calls or a stock) instead of buying the ETF directly. We should be able to do so at a reasonable strike price for about 25%-30% of the cost of buying QQQ shares. So, our potential 11.1% stake (potentially larger as our portfolio's value falls) in QQQ shares will only require about one-third of that put toward QQQ calls instead. We should be happy to buy calls on the index at depressed prices and still keep most of our cash available for other stock or call purchases.

How It Fits Into *Pro*

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Alternative Trades

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Hedge: Set Up a Put Ratio Spread on QQQ

Published Dec 16, 2016 at 12:11PM

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Follow-Up

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How It Fits Into *Pro*

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Alternative Trades

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up to $10 ($1,000) per spread on a decline to $104 or any lower price, but you should **be prepared to lose your whole $260 per spread** if QQQ doesn't decline enough by expiration. This is out-of-the-money, and only makes you money if QQQ is below $111.40 at expiration (it's $120.50 now), so you have to assume it will expire worthless. It's risk insurance.

- **To lower your market exposure while following our full official trade (and making the position possible in some IRAs):**
  - Set up the official put ratio spread as recommended, but also "buy to open" additional QQQ puts (with the same day of expiration) at a strike price *well below* $100. Buy *half as many* as the number of $100 puts you wrote. When you do so, all of your $100 puts will then be "covered" -- half by your long $114 puts, and half by the other long puts you choose to buy at a much lower strike. Choose how much you want to pay to protect your short put exposure. To us, the $80 strike or lower looks good, recently costing $1 or less. You will only need cash in your account to cover the difference between your two lowest strike prices (if you buy $80 puts, that's $20 per share), and your risk is capped at less than that, making this potentially IRA-friendly. This makes the total cost of your hedge about a $1 debit, with $6 per share in capped risk (an $86 break-even vs. $80, at which you have total protection), and it still has $14 in potential ending value if QQQ is at $100 at the end. Easy as pie?

Pro Can Help

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- **Want to talk about QQQ?** There's no queue on our discussion board.

Close Your Short Position on Deere & Company

Published Dec 14, 2016 at 1:56PM

Is this for you? This is only for *Pro* members who have positions -- including short shares and/or long protective calls -- on Deere & Company. All others should ignore this recommendation, or bring your questions to the Deere & Company board.

How You Follow Along

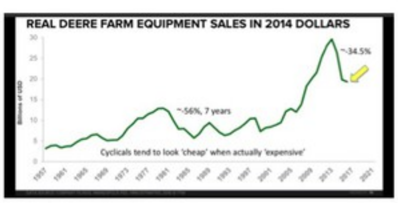
- **Trade:**
  - Buy to close (or simply close) all remaining shares of Deere that you are currently short.
  - Sell to close all Dec. 16 protective calls you have purchased.
- **Price Guidance** (as of 12:21 p.m. 12/14/16):
  - **Stock price:** $101.20
  - **Sell to close Dec. 16, 2016, $92.50 calls (bid/ask split):** $8.70 (these expire Friday, so you should sell to close them by then).
- **Related positions:** If you set up any alternative bearish strategy, we recommend you close that as well.

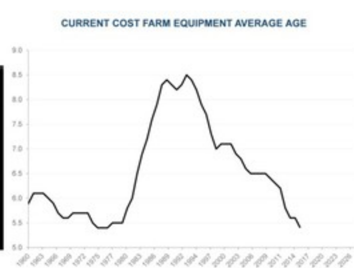
What We're Thinking

When we first recommended shorting **Deere & Company** (NYSE: DE) in January, we predicted that both the business and its industry would perform poorly in the coming months. Deere's 2016 results were actually even worse than we projected, but nonetheless, we're closing this short position today because the market continues to disagree with us about the stock's valuation. The share price is higher despite weaker recent earnings and initial 2017 guidance that once more calls for slightly lower revenue and income. With the market bidding shares higher in anticipation of a distant business recovery, we see little reason to hope this dynamic will change anytime soon, so we're taking our loss this month. One reason we're doing so now: to lock in the capital loss for this calendar year. If you have tax gains you want to offset, closing this losing short can help do that. After 30 days have passed for taxes, we'll reconsider this short, but in a smaller allocation (around 0.5%, if we go with it) as we continue to build our basket of shorts.

Now, what were we thinking, and what happened?

When a cyclical industry sees a rapid, extended increase in sales that takes away from future demand, the flipside -- a protracted decline in sales, followed by a muted recovery -- often follows. The U.S. housing market is a perfect example of this: Though the bubble peaked more than 10 years ago, housing starts and new home sales are still well off their highs. This basic precept was one of our cornerstones for shorting Deere. From our perspective, management's 2014 claim that 2015 would be the bottom of the heavy-machinery cycle for agriculture and other industries was overly optimistic, and the stock was overvalued because the market was giving management the benefit of the doubt and pricing in a speedy recovery. The last time we saw this type of over-investment in the industry, it took decades for Deere's sales to recover after adjusting for inflation (which is relevant here, given how much higher inflation was back then).





Source: Jay Van Sciver, Hedgeeye

We anticipated that four quarters of declining results at Deere, with no signs of a robust recovery on the horizon, would be more than enough to drive the stock lower in most market situations. But although we were largely correct about company and industry performance, we were wrong about the market's response. Despite management's attempts to stimulate sales with more attractive leasing terms, sales and net income have fallen every quarter, and manufacturing currently sits at less than 50% for most of the company's large facilities. But the market has downplayed these issues, focusing instead on management's promise to cut additional costs in the coming years. Deere's stock has also benefited from a broader sector rotation into cyclical stocks that has taken place this year, with many "industrials" soaring even more than Deere. We considered both of these possibilities at the outset; however, we underestimated the potential extent of such a market reaction.

Although we don't like making mistakes, we understand at the start of any position that they're at times unavoidable, so we size our positions, and hedge, accordingly. As importantly, we know that mistakes are wasted opportunities if you don't use them to learn and improve. So what can we take away from our experience shorting Deere?

- Pay attention to changes in the narrative

Stock valuation is about both the numbers (financial results) and the narrative (expectations for the future). For some stocks, such as Apple, the emphasis is on the hard numbers; for others, like Tesla, the narrative matters more. Deere's sales started to decline in 2014, and as the end of the year approached, management attempted to shift investor focus away from the numbers -- specifically, their preliminary estimate for 2015 results to be below what they called "trough levels." When it became obvious that 2015 would not be the nadir, management then shifted its emphasis away from industry weakness and toward cost-cutting initiatives. We thought investors would pay attention to the numbers, but management was able to shift attention to a different narrative instead.

- Timing does matter with shorts, which is why you need to diversify on the short side

Time may be your greatest ally in traditional investing, but it is often an enemy to your short positions -- you're fighting the natural tendency of the market to drift higher over time, you have to pay a fee to borrow shares, and you're responsible for any dividends the stock may pay out. For these reasons and more, timing matters in shorting. That said, we all know trying to time the market is a fool's errand with a lower-case "f." An example: In October 2009, *Pro* set up a bear put spread on **Abercrombie & Fitch** (NYSE: ANF) with the stock in the low $30s. While it currently trades for less than $15, it wasn't until the end of 2014 that the stock moved below $30 for good -- and in the interim, it came close to $80. *Pro*'s thesis was ultimately proven correct, but investors sure had to exercise a lot of patience to see it come to fruition.

This is where diversification comes into play. You already know how important it is for your long portfolio, and given the unique risks involved, it may be even more essential when you go short. This is why we place an emphasis on creating a basket of shorts. The positions in our basket are meant to pay off in aggregate; individual performance will be less predictable almost by definition (see above re: timing).

- Position sizing also matters

On the day we initially shorted Deere, the *Pro* portfolio was valued at $2,350,221. As I write, the monetary impact of closing this position on the *Pro* portfolio is as follows:

Dividends paid	- $1,080
Profits on purchased calls	+ $1,859
Capital losses on stock sold short	- $15,994
Total	**- $15,215**

Despite how much the stock has moved against us, the negative impact to the *Pro* portfolio is well less to than a full percentage point -- (0.647%). It's also important to remember that the reason we kept our position in **Valmont Industries** (NYSE: VMI) this January was because we were shorting Deere -- and Valmont's stock is up more than $20,380 in the same time, plus $1,607 in dividends and option premiums. In this context, the effects of Deere on our portfolio are reduced even further, all the way to a net gain.

Situations like this are why we focus so strongly on portfolio management. Don't get me wrong: We would love to be right and make money with 100% of our investments. But even the best investors in history have made mistakes, and so will we. Happily, success as an investor -- and the ability to meet one's financial objectives -- is judged based on the performance of a portfolio *as a whole*. This is why our top focus here in *Pro* is our North Star. We manage *Pro* with the intention that no single position should be able to make or break our year, let alone our ultimate success. In doing so, we shift the burden of performance from one or two "lucky bets" to a long-term process -- something we believe we can control and repeat, and learn from, over time. Chalk this short up as a good lesson on shorting cyclical stocks: The market may focus on the far future even as a business is weakening, leading the stock to rally without evidence of any real recovery.

To discuss this position, please visit the Deere board.

Pro Video Chat, December 2016

Published Dec 13, 2016 at 1:32PM

The *Pro* team held a live video chat on this page at 2 p.m. Eastern on Friday, Dec. 16. Here are Jeff's answers to the questions that we couldn't get to during the hour! Watch the replay below, and a transcript should be coming soon.

Pro and Options Prepare to Wrap Up 2016

Published Dec 12, 2016 at 3:33PM

Dear fellow Fool,

A tumultuous year is coming to a close on a strong note, with all the major U.S. indexes hitting new highs. Lest we forget, this year began with the worst January for the stock market in its history. Prices bottomed in mid-February, but by June and again in early November, the S&P 500 was all but flat on the year.

That choppiness invited more chances for second-guesses and errors (and we've had a few, which I look forward to reviewing), but investors in good companies who stayed the course are coming out ahead. As of Friday, the S&P 500 is suddenly up more than 10% this year, a good showing by any measure. It's also a *surprising* showing, given that earnings growth is muted, political uncertainty is high, and interest rates are heading higher. Nobody can call the market boring or predictable.

Pro and *Options* have had a busy year. I have to say that from a personal perspective, this year went by extremely fast. The Fool has been busy trying to offer our services to qualified individuals who will stay the course, and we've been working to welcome those new members while continuing to improve our investing results for everyone. Let's review some of the stats from the past year.

Between *Pro* and *Options* (remember, all *Pro* members receive *Options* free for the life of their *Pro* membership), we've issued 122 trade alerts so far this year -- 44 in *Pro* and 78 in *Options*. That comes to about 2.5 per week. We also publish a *Pro* Monday Memo every week, and the *Options* Weekly every Friday, making for another 100 or so (counting holidays!) pieces of content sent to you per year. This means a *Pro*/*Options* member receives about 4.5 emails from us in an average week -- plus, between the two services, we have at least two monthly live events. It's important to realize that once your *Pro* portfolio is set up, only our trade alert emails are truly *necessary*. We hope you enjoy our content in both services, but we don't want you to stress about the volume.

Members often ask us about the best way to use *Pro* and *Options* together. Our answer: *Pro* is a premium portfolio service. When you buy it, you're paying for a portfolio of long, short, hedged, and options positions, constructed and managed in a specific way. If you want to get the most from *Pro*, follow the portfolio as closely as you can -- even if you only buy our longs. Then, if you find you have room for more ideas beyond *Pro*, add *Options* ideas that suit you. *Options* is an *a la carte* service, offering individual ideas without allocation or portfolio guidance. Those ideas can complement your *Pro* portfolio.

We're having a good year in *Options,* as well. We started 16 new strategies in that service this year, 14 of which are profitable. Some highlights include lucrative bull call spreads set up on **Apple** (NASDAQ: AAPL), **Alphabet** (NASDAQ: GOOG) (NASDAQ: GOOGL), and **American Tower** (NYSE: AMT) during the market downturn; several profitable written puts on **Skyworks Solutions** (NASDAQ: SWKS); a new diagonal call on **Disney** (NYSE: DIS) that's up 34%; and a new **Home Depot** (NYSE: HD) diagonal call that's up 27%. The two new losers in *Options* this year are diagonal calls on **Nike** (NYSE: NKE) and **Anheuser-Busch** (NYSE: BUD), but we're confident that with time, both can turn around. In *Options* overall, more than 90% of our strategies continued to end profitably.

Here in *Pro*, the portfolio is up 8.1% year-to-date as of Friday, above our North Star, in line with the Nasdaq Composite, and a few points back from the S&P 500 and the Dow Jones 30. Industrials have come on strong to end the year, and we're on the wrong side of that particular trend -- we prefer owning the long-term consistency often found in less capital-intensive businesses with strong competitive advantages (such as pricing power). Given our 20% cash position and the fact that we remain 73% net long, our returns should please us, even as we always strive for better.

We're adding more growing companies to the portfolio, more income positions, more hedges, and more shorts. In other words, the living, breathing entity that is our portfolio continues to inhale fresh oxygen. We eschew high turnover or selling positions unnecessarily, but we always seek to improve our prospects with new holdings, balance our risk, and have some returns in any market. Early next year, once the ink has dried, we'll review the *Pro* portfolio and our wins and mistakes in 2016. Mistakes in particular are a useful topic, offering ways to improve, while studying your winners should lead to having more large gains down the road.

To discuss anything today, please visit the Memo Musings board. Thank you for being here, and Fool on!

-- Jeff (TMFFischer)

More From *Pro*

- Pro Quality Checklist: Visa
- Five Tips for Investing Success
- On Yearly Gains, and Earnings News
- All Past Monday Memos

Pro Guidance Changes and Completed Trades: Dec. 12, 2016

Published Dec 12, 2016 at 3:26PM

Pro Guidance Changes (from the past two weeks)

- **Parexel** (NASDAQ: PRXL): We recommend writing covered calls on this whole position, which remains on Hold.
- **Paycom** (NYSE: PAYC): This new position is rated a Buy at a 2% allocation.
- **Verisign** (NASDAQ: VRSN): This new position is rated a Buy at a 1.5% stock allocation, plus 1.5% more in a written covered strangle.

Pro Completed Trades (from the past two weeks)

- **Paycom** (NYSE: PAYC): We bought 1,300 shares at $42.57.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Dec. 12, 2016

Published Dec 12, 2016 at 3:25PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

New here? Make your way through the Portfolio Building Reports linked on our Guidebook page, starting (unsurprisingly) with No. 1, which focuses on our Buy First stocks. Speaking of which ...

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.5%.

- **FactSet Research Systems** (NYSE: FDS): Buy 2%.

Continue building your portfolio with our Buys, including:

- **Medtronic** (NYSE: MDT): Buy 2.7%.
- **OpenText** (NASDAQ: OTEX): Buy up to 3.2%.
- **Paycom** (NYSE: PAYC): Buy 2.2% (read our recent recommendation).
- **Verisign** (NASDAQ: VRSN): Buy 1.5% and write a covered strangle for another 1.5%, as per our new recommendation. Today's net debit is nicely lower than in the original alert.
- **Visa** (NYSE: V): Buy 2.3%.

Shorts:

- **Gogo** (NASDAQ: GOGO): Sell short 0.5% if you haven't yet.
- **Shake Shack** (NYSE: SHAK): Sell short 0.6% if you haven't.

Pro options:

- **American Tower** (NYSE: AMT): If you haven't yet, set up diagonal calls per our recent alert -- except, instead of selling to open April 2017 $115 calls, sell to open $110 calls. Follow allocation guidance in the alert, and ask any questions on the AMT board linked at the end of the alert.

Hedges:

- None right now.

Options expiring next (Dec. 16, 2016):

- **Deere** (NYSE: DE): Our $92.50 protective calls are in the money -- we'll have guidance on closing them this week.
- **Gentex** (NASDAQ: GNTX): Our $17.50 puts are on track to expire as income. No action needed as long as GNTX remains above the strike price.
- **SPDR S&P 500** (NYSEMKT: SPY): Our $180/$190 put ratio spread is on track to expire unused, paying us a little income. No action needed.

Write Covered Calls on Parexel International

Published Dec 12, 2016 at 12:39PM

Is this for you? This recommendation is for *Pro* members who own at least 100 shares of Parexel, and who wouldn't mind capping upside and potentially selling their shares at a net $69.15 if the stock price is above $65 at expiration. If you don't own shares yet, we don't recommend that you start a position today -- Parexel shares are trading above our fair-value estimate, and the position is on Hold.

How You Participate

- **Trade:** Sell to open March 2017 $65 calls on **Parexel International** (NASDAQ: PRXL).
- **Allocation:** Write ("sell to open") one call for every 100 shares of the stock you own and want to cover. *Pro* will cover all 1,300 shares we own, representing 3.1% of the portfolio.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a **limit order** to split the bid/ask price spread at going prices. Aim for as close to a 2% yield (that's option premium / current price of the stock) per month to expiration as possible, accepting a bit less if need be.
- **Prices** (12:20 p.m.):
  - **Stock:** $65.22
  - **March 2017 $65 call (bid/ask):** $3.90/$4.40
  - **The math:** $4.15 is a 6.4% yield on $65.22 in 96 days

We initiated our long stock position on Parexel International in late 2013, and including one round of written puts that expired as income in 2014, the stock has appreciated by more than 43% in just less than three years. That's equivalent to a nearly 13% compound annual growth rate (CAGR), besting our North Star by a significant margin; we have a 3.1% allocation to Parexel today. For reasons described below, we recently placed the stock on Hold, and today we're recommending covered calls as a way to earn income and potentially sell shares at a higher price.

While the business has largely performed in line with our initial thesis, the life of our Parexel position has been fraught with volatility. Significant customer concentration in its industry, contract research organizations (CROs), tends to make for lumpy results as a rule, and management has struggled to properly forecast and anticipate new business wins and customer project cancellation rates. And that's not to mention the multi-year restructuring program intended to improve margins, the surprise resignation of the company's CFO, and (in the past two quarters alone!) misappropriation of company funds *and* accounting errors leading to restatements of revenue and earnings.

All in all, despite Parexel's strong competitive position in a growing industry, it's safe to say we've lost some confidence in the management team. We recently placed the stock on Hold in order to wait for the next set of quarterly results, which will help to either confirm or reverse the recent negative trends. In that report, we mentioned that "we may decide to close our position if the stock drifts upward in the near-term, depending on price." With this covered-call alert, we are taking a more moderate, but still defensive and opportunistic, approach. Selling in-the-money covered calls allows us to earn income, buffer part of any potential share price decline, and target a potential sell price above our fair-value estimate.

These calls are only slightly in-the-money, yet they yield 6.4% in a little more than three months. If the stock ends higher than $65 in March (and if we don't decide to roll our calls), we will sell our shares at a net $69.15, 17% above our fair-value estimate, for a 52% total return on the position since inception (a 13.9% CAGR).

Parexel's next earnings report is due sometime around late January; the biggest risks to our position are continued signs of mismanagement and/or another set of poor results. However, we have no way of knowing the future in advance, and we've already indicated our willingness to wait for another quarter of results and assess ongoing business trends before making a call. While we wait, we believe it's a good idea to target some income at the same time -- especially because we are not averse to letting all of our shares get sold through our calls, should it come to that.

The *Pro* Bottom Line

In line with *Pro*'s goal of earning regular income by writing options while still running a portfolio that is mostly exposed to long-term upside, this position should result in additional income by March, whether we end up selling the stock or not. If you don't own shares yet, we don't recommend that you start a position today -- Parexel shares are trading above our fair-value estimate, and the position is on Hold.

There are no alternative trades today. If you own the stock and can't write covered calls on your shares, simply continue to hold and wait for future guidance. If our shares are called away, we will then advise you to sell.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call's strike price, and the potential gain on the covered call is the premium it pays us. The total combined gain is the call strike plus the premium received, leading to our net potential sell price above $69.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up**: After the next set of quarterly results from Parexel, we will decide our ongoing course of action. If the covered calls expire as income, we may look to write more calls, or we may sell our shares outright. If the stock price is above the strike price at expiration, we may either let our shares get called away at a net $69.15, or look to roll out and/or up in order to capture further income or upside.

Options Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** Post your questions on our Parexel International discussion board.

Set Up a Covered Strangle on Verisign

Published Dec 9, 2016 at 2:59PM

Is this for you? This recommendation is directed to all *Pro* members managing at least $270,000. If you're managing much less than that, we suggest sitting out this income position, unfortunately. We'll have others!

How You Participate

- **Actions:** Set up a covered strangle by entering a multi-legged order to:
  - Buy shares of **Verisign** (NASDAQ: VRSN) in 100-share round lots.
  - Sell to open a number of March 2017 $85 calls (one for every 100 shares you buy) that is equal to the number of ...
  - ... March 2017 $80 puts you *also* sell to open (one for every 100 *more* shares you could buy).
- **Allocation:** Invest approximately 3% of your *Pro* funds in this total position on a look-through basis (assuming puts are exercised). At recent prices, this most closely equates to buying 100 shares and setting up a covered strangle for every $540,000 you manage. For *Pro*, this equates to buying 500 shares and selling five put and five call contracts. *Pro* members with portfolios between about $270,000 and $540,000 should see the Alternative Trades section below.
- **Price Guidance:** To start, look to split the bid/ask spread on the combined option prices and set up the entire position (including the stock buy) for a net debit of about $75.70 per share. Some reasonable deviation from this is fine!
- **Prices** (as of 1:31 p.m. 12/9/16):
  - **Stock price:** $81.98
  - **Sell to open March 2017 $85 calls (bid/ask split):** $3.00
  - **Sell to open March 2017 $80 puts (bid/ask split):** $3.28
  - **Net debit:** $75.70 ($81.98-$3.00-$3.28)

Temperament Needed

- Comfort with potentially significant option volatility.
- Comfort with the possible need to manage this position (with our official guidance) every quarter or so.
- Comfort with the potential requirement to buy additional shares, should the stock decline below the put strike price.
- Happy to generate income in exchange for potentially missing out on additional capital gains in the stock.

Why Set Up a Covered Strangle on Verisign?

- This cash cow of a company provides services that are mission-critical to the Internet.
- Verisign is able to convert close to 60% of its revenue and more than 100% of net income into free cash flow, which it primarily uses to repurchase shares and provide additional support to the stock price.
- In October, the company entered into an agreement to extend the contract that is the primary source of revenue for Verisign through November of 2024.
- The company's high-growth days may be behind it, but at 11.75 times EBITDA and 24.5 times earnings, we're essentially paying a market multiple for what we believe to be a far-above-average company while simultaneously generating a healthy option yield.
- So why not just buy stock alone? We want more positions in our portfolio that aren't solely dependent on a rising stock or rising stock market -- and we want more income. This covered strangle is poised to generate a healthy return even if the stock goes nowhere over the next few months.

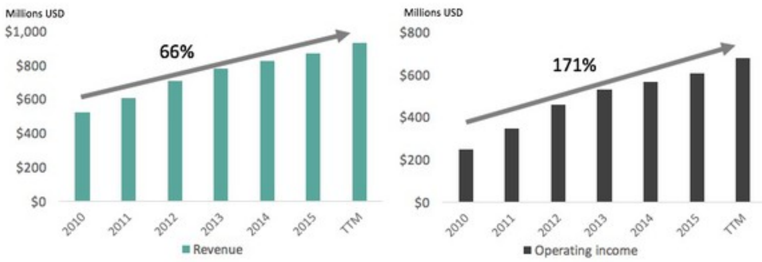
Want to Know More?

It may not be a household name like Starbucks or Facebook, but you might actually interact with Verisign more often than you do either of those staples. Whenever you type "fool.com" into your Web browser, Verisign is working behind the scenes to ensure that you actually end up at The Motley Fool's website. And the company doesn't just do this for fool.com, awesome though we are; Verisign handles more than 120 *billion* requests each day in providing this service for each and every 144 million ".com" and ".net" domain name currently in existence. To oversimplify, Verisign is kind of an old-school telephone operator for the Internet: Its servers convert the address you see in your browser (a person's name in the phone book) into a numeric IP address (a phone number) that the servers hosting the website (the phone) are able to understand.

Verisign also acts as the exclusive registry for ".com," ".net," and other top-level domains (TLDs). This means that Verisign receives a fee — currently $7.85 for the former domain and $7.46 for the latter — whenever someone registers or renews a domain name in a given year. This is actually how the company derives most of its revenue, and it's incredibly lucrative.

Every cost to a company can be put into one of two basic buckets: variable or fixed. Variable costs depend on the output a company produces; fixed costs do not. If a company's total costs are heavily skewed toward the latter, it becomes more profitable as it grows; this is referred to as operational leverage.

Verisign's registry business is a textbook example of this concept. The costs associated with maintaining its registry remain relatively unchanged as the number of domains registered grows over time. At 60%, Verisign's operating margin is already one of the highest among publicly traded companies (the S&P 500's operating margin tends to hover at about 14%), and incremental margin — the operating profit Verisign is able to generate on each new dollar of revenue it collects — is even more impressive at 85%. As Verisign grows, most of the revenue it collects flows straight down the income statement.



Source: Company filings.

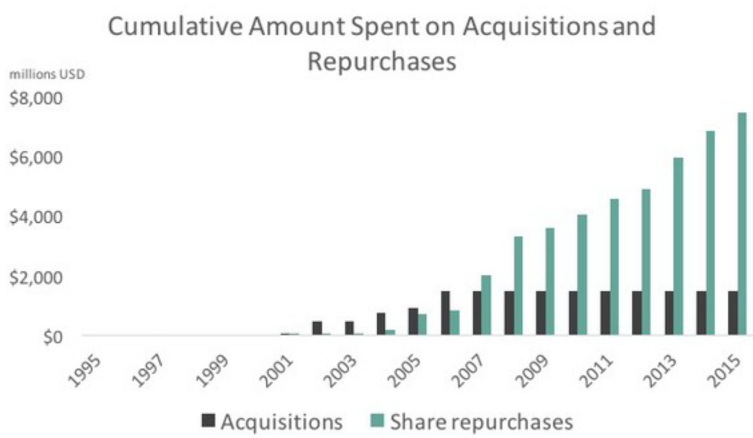
But the impressive economics don't stop there. Verisign might not be growing as fast as some of the other companies currently in the *Pro* portfolio, but it more than makes up for this with its efficiency in converting revenue into free cash flow. On a per-dollar-of-revenue basis, Verisign is able to generate more free cash flow than all of our other, already strong current holdings (examples below).

Free cash flow conversion for various Pro holdings

	FB	MA	AAPL	PAYC	FDS	VRSK	VRSN
FCF/Revenue	35%	41%	25%	15%	25%	18%	56%
FCF/Net income	116%	108%	116%	111%	84%	69%	144%

Source: S&P Global Market Intelligence.

So what's a company to do with all that cash? Fortunately for us, the current management team has a track record of being disciplined capital allocators. A former CEO in the previous decade had ambitions to turn Verisign into a diversified technology powerhouse by way of expensive acquisitions, but in the six years since the company decided to refocus on its core business, it has instead been busy returning capital to shareholders by way of share repurchases. Since the end of 2010, the number of shares outstanding has fallen from 160 million to 105 million.



Source: S&P Global

What We're Watching

Because Verisign's financial statements make it easy to see just how profitable the registry business is, there's always been a fear that someone or some entity, be it an attention-seeking politician or a competitor eager to steal profits, would try to put a stop to it. But to date these fears have been misplaced, and just two months ago, Verisign actually entered into a new agreement to extend its ".com" registry agreement until 2024. Moreover, the language for both the ".com" and ".net" registry agreements provides that they will be renewed unless Verisign is found in breach of certain provisions and is unable to cure said breach. Although it's hard to predict what the future might hold, it is worth noting that for more than 18 years Verisign has maintained 100% operational accuracy and stability for both ".com" and ".net."

The upcoming quarter is poised to be somewhat unique for Verisign. For most of 2015 and the start of 2016, the company saw an elevated number of new registrations coming from the Asia/Pacific region. Given that first-year renewal rates for domain names tend to be much lower than Verisign's overall average (50% vs. 70%-plus), this atypical activity will likely result in a net decline in the ".com"/".net" domain-name base in the fourth quarter. But we expect the business to return to its steady, if slow-growing, ways once this domain cohort passes its one-year anniversary, and we hope to continue using Verisign's stock for income for the foreseeable future.

Alternative Trades

Members who are unable to set up a 3% covered strangle because they manage less than $540,000 can instead consider setting up a covered call on Verisign -- necessitating just half that portfolio size. If you mange about $270,000, then buying $8,200 of stock is about a 3% holding. Do this and simultaneously aim to sell one March $85 call for every 100 shares you purchase, lately at a net purchase price of about $78.98 ($81.98-$3). Reasonable deviation is fine! And if you'd rather write a put, then sell to open one March $80 put (for $3.28) for every 100 shares you'd be willing to purchase.

***Pro* can help**

- Register a domain name that speaks to *your* soul on our new [Verisign discussion board]!

Pro Catch-Up Trades and Upcoming Expirations: Dec. 5, 2016

Published Dec 5, 2016 at 3:31PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

New here? Make your way through the Portfolio Building Reports linked on our Guidebook page, starting (unsurprisingly) with No. 1, which focuses on our Buy First stocks. Speaking of which ...

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.5%
- **Facebook** (NASDAQ: FB): Buy up to 6.2%, in halves or thirds over time.
- **FactSet Research Systems** (NYSE: FDS): Buy 2%.

Continue building your portfolio with our Buys, including:

- **Paycom** (NYSE: PAYC): Buy 2.2%. Read our recent recommendation.
- **Oracle** (NYSE: ORCL): Buy 3.6%.
- **Visa** (NYSE: V): Buy 2.3%.

Shorts:

- **Gogo** (NASDAQ: GOGO): Sell short 0.5% if you haven't yet.
- **Shake Shack** (NYSE: SHAK): If you have not shorted 0.5% yet, you can do so now.

Pro options:

- None currently.

Hedges:

- None right now.

Options expiring next (Dec. 16, 2016):

- **Deere** (NYSE: DE): Our $92.50 protective calls are in the money -- we'll have guidance on closing them before expiration.
- **Gentex** (NASDAQ: GNTX): Our $17.50 puts are on track to expire as income.
- **SPDR S&P 500** (NYSEMKT: SPY): Our $180/$190 put ratio spread is on track to expire unused, paying us a little income.

Pro Guidance Changes and Completed Trades: Dec. 5, 2016

Published Dec 5, 2016 at 3:28PM

Pro Guidance Changes (from the past two weeks)

- **Paycom** (NYSE: PAYC): This new position is rated a Buy.

Pro Completed Trades (from the past two weeks)

- **Paycom** (NYSE: PAYC): We bought 1300 shares at $42.57
- **Deere & Co** (NYSE: DE): We bought to open three Dec. 16, 2016, $92.50 calls, capping risk on half of our short Deere stock.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Quality Checklist: Visa

Published Dec 5, 2016 at 1:38PM

Fellow Fools,

Since introducing our updated *Pro* Quality Checklist a little more than a year ago, we've used this eight-part analytical framework to turn our lens on nine of our current portfolio holdings, break down a previous short which has since been covered, and even circle back on a lingering watch-list idea. It's been awhile since we've run a new company through the checklist, though, so in today's Memo, I'll take a closer look at **Visa** (NYSE: V) and explain why we're still bullish on the company. Though management is working through the transition to a new CEO and the complex integration of the Visa Europe acquisition, those are just a couple of bumps in the road for a rock-solid business.

Take a look at how Visa stacks up against the characteristics of an ideal *Pro* company.

1. Sustainable Competitive Advantage

Yes. Visa has an enviable competitive position within its industry; as one of three dominant credit-card brands, it benefits from strong network effects. Consumers demand to use Visa's credit and debit cards because of the convenience, security, and rewards they provide, which forces merchants to accept Visa's cards to satisfy those customers and earn their business. This positive feedback loop makes the entire network more valuable over time and prevents newcomers from gaining traction.

Visa also possesses multiple intangible advantages. The company has spent decades building a trusted, globally recognized brand through massive advertising campaigns like the one we saw at this year's Summer Olympics in Rio. And the 83 billion-plus transactions Visa processed in 2016 add to a huge database of valuable proprietary information that can be used to offer ancillary services and make customer relationships even stickier.

Because of these advantages, Visa is insanely profitable. The company's operating margin is consistently higher than 60%, and its return on capital (in the mid- to high teens) is well above its cost. Those profits have attracted an ever-growing cadre of competitors trying to capture a tiny piece of the pie, but Visa's relative size allows it to invest heavily in research and development to maintain a technological edge and fend off the newbies.

2. Pricing Power

No. Though there are only a few credit-card companies in the market, they compete fiercely for the right to stamp their names on cards issued by banks and large retailers. Visa recently stole USAA from MasterCard and outbid both MasterCard and American Express to win Costco's business. Though every deal is structured differently, a recent upswing in costs related to incentives and rebates suggests that Visa is pulling out all the stops to win those big accounts. Also, the fees credit-card companies charge are regulated by law -- for example, the Durbin amendment of the Dodd-Frank Act, which limits fees paid by retailers on debit-card transactions.

3. Dependent Customer Base

Yes. Visa is deeply ingrained in the day-to-day business of its customers, both merchants and banks. Card-issuing banks sign on with Visa for the privilege of using its network to process payments. The banks then market the cards to consumers, who also receive any ancillary perks that come with the card. Merchants don't want to miss out on a sale, so they're generally willing to accept any form of payment. Over time, Visa has developed a portfolio of add-on data services related to things like security and marketing, which makes those relationships even tighter.

4. Predictable Revenue

Yes. Every time someone makes a purchase with their Visa credit or debit card, whether in a physical store or online, Visa's cash register also rings. If the global economy stays reasonably healthy and consumers continue to transition from cash to electronic payments, we can expect Visa's share to expand as the whole pie does. Further, Visa does not take on the risk of issuing credit to consumers, leaving that business to the card-issuing banks. Instead, in exchange for a small piece of each transaction, Visa ensures the digital money moves smoothly from customer to merchant.

5. Growing Free Cash Flow With Compounding Returns

Yes. Visa is a cash-generating machine, turning nearly half of each dollar of revenue into free cash flow. Over the past five years, the company has increased its free cash flow from $3.5 billion to $5 billion, which amounts to about 7.5% annual growth. That may not seem all that impressive, so it's worth noting that the $5 billion in fiscal 2016 is well below the $6.6 billion Visa banked in 2014. The company is currently digesting its recent, massive acquisition of Visa Europe, which is expensive and clouds the financial performance of the core business. But it's reasonable to believe that Visa will be able to blow through that high-water mark again within the next few years. One of the mixed blessings of generating a high return on capital is that it's hard to find opportunities to reinvest that cash at a similar level of return. For that reason, Visa returns the vast majority of its free cash flow to its investors through dividends and share buybacks.

6. Financial Resilience

Yes. Thanks to a strong balance sheet, fat profit margins, and the low capital intensity of the business, Visa is built to weather a storm. The payment industry is experiencing a massive secular change from cash to digital payments, and Visa is perfectly positioned to benefit. This trend was evident when Visa managed to continue growing during the Great Recession, only posting a loss in 2008 because of a $2.7 billion charge for a legal settlement. Unfortunately, these legal costs seem to have become a regular occurrence every few years; perhaps that's the cost of doing business as part of an oligopoly. Thanks to the copious cash generation mentioned above, Visa can easily digest these huge payouts and quickly get back to business. Management also issued about $16 billion in debt this year to help fund its purchase of Visa Europe. That number sounds huge in absolute terms, but Visa should have no problem servicing the interest, and the company's return on equity should benefit from the addition of a modest amount of leverage.

7. Expanding Possibilities

Yes. Eighty-five percent of the world's transactions still take place in cash, so capturing just a few percentage points of additional market share could make a huge difference in Visa's results. The company has invested heavily in new technology, such as mobile-wallet payments, ensuring it's available whenever and wherever the consumer is ready to make a purchase. In addition to payments, Visa offers a growing number of data services which will deepen the company's relationship with clients and help diversify its revenue stream over time. Meanwhile, all of the credit-card companies are also waiting patiently for China to open its doors to foreign payment processors. It will take years for Visa to develop the requisite relationships with Chinese card-issuing banks and then install the local infrastructure needed to process payment, but down the road, China stands to be another huge growth opportunity.

8. The Three C's of Management (Clarity, Consistency, Capability)

Sort of. This would have been a clear "Yes" a few months ago, but in October, longtime Visa CEO Charles Scharf announced his resignation for personal reasons (he'd been running a San Francisco-based company when his family lives in New York). He is being replaced by Alfred Kelly, a member of the Visa board of directors and 23-year veteran at **American Express** (NYSE: AXP). Thanks to his deep industry experience and knowledge of Visa's inner workings, Kelly likely checks the "capability" box, but it will take a while to establish "clarity" and "consistency" with investors. Even so, a CEO can only have so much influence on a massive global organization like Visa, where there already exists a deep bench of managerial talent. We'll be watching how Kelly leads the Visa Europe integration and whether he makes any meaningful changes to Visa's current capital-allocation strategy.

The *Pro* Bottom Line

As you've seen in previous installments of this checklist, a company doesn't have to score a perfect 8 out of 8 to make it into the *Pro* portfolio (or to become a winning investment!). Coming in at 6.5 out of 8, Visa qualifies as a top-notch business and one we're likely to hold for a long time. Though Visa is one of our smaller positions, accounting for only 2.3% of our portfolio, it combines with our position in **MasterCard** (NYSE: MA) to give us a solid 6.9% allocation in the two leading credit-card companies. We're big fans of this business and think both companies still have a lot of growth ahead of them, which should keep investors like us happy for years to come.

Here are links to additional *Pro* quality checklist articles on active *Pro* positions:

- **FactSet Research Systems** (NYSE: FDS) -- 8/8
- **Gentex** (NASDAQ: GNTX) -- 5/8
- **American Tower** (NYSE: AMT) -- 7.5/8
- **Broadridge** (NYSE: BR) – 8/8

- **Oracle** (NYSE: ORCL) -- 8/8
- **O'Reilly Automotive** (NASDAQ: ORLY) -- 6/8
- **TD Ameritrade** (NASDAQ: AMTD) -- 5.5/8
- **Valmont Industries** (NYSE: VMI) -- 5.5/8
- **MasterCard** (NYSE: MA) – 7/8

Have a great week, Fools!

Best,

-- Jeremy (TMFTank)

Buy Paycom Software

Published Nov 30, 2016 at 1:43PM

Is this for you? This recommendation is directed to all *Pro* members.

New here? This stock is rated Buy on our scorecard. If you haven't yet caught up with all of the Buy First stocks in our first Portfolio Building Report, consider doing that first before moving on to this and the rest of our Buys.

How You Participate

Paycom Software (NYSE: PAYC) is a profitable, young, cloud-based provider of payroll and human capital management (HCM) software, which manages the employment life cycle for employers and employees. It's differentiated by its comprehensive, integrated Software-as-a-Service (SaaS) solution that saves customers money and makes HR systems more efficient.

- **Action:** Invest 2% of your *Pro* portfolio in this new, Buy-rated stock.
- **Price Guidance:** You **must use a limit order; this is a thinly traded stock.** Right now, set a limit to pay less than $44.50. As time passes, the stock remains a Buy until we say otherwise.
- **Recent Price:** $43.70
- **Market Value:** $2.7 billion

Temperament Needed

- A long-term outlook of at least three to five years.
- Comfort with high price volatility.
- Comfort with the potential for at least a partial loss of capital.

Why Invest in Paycom?

- Revenue has compounded at 46% annualized over the past three years, and profitability and free cash flow much more rapidly than that.
- Sporting more than 15,000 clients and storing data on 2.1 million employees, Paycom's average three-year retention rate (recurring revenue) was 91% as of Dec. 31, 2015. In the most recent quarter, 98% of revenue was recurring.
- With $300 million in annual sales, Paycom can grow for years before it takes significant market share in the immense payroll and HCM industries. Its comprehensive and growing HR solution is ahead of competitors', promising market-share gains for years.
- The stock trades at 31.8 times expected non-GAAP earnings for 2018, in line with the company's estimated growth rate.

Want to Know More?

Founded in 1998 by payroll industry veteran Chad Richison, Paycom Software (which has only been public since 2014) is a rare combination of attributes:

- High and profitable growth with increasing returns on capital
- An invested founder (owning 13% of the shares) who has run the company for 18 years and counting
- A differentiated product that's taking market share from industry giants
- A long runway for growth, with market analysts IDC putting the payroll industry at $12 billion today and the HCM market at another $9 billion by 2020

You would expect Paycom to trade at a premium, and it does, but the price appears reasonable for the growth on hand and the long-term potential. With a relatively modest $2.7 billion in market value, Paycom has the runway to greatly exceed our North Star (inflation + 7%, lately about 10% annualized growth) over the long haul, especially given management's goal of maintaining current growth rates of north of 30% per year.

Payroll software is the company's bread and butter; clients must buy this to get access to the rest of Paycom's human capital management applications, or "modules," which currently number 26 and counting. Using a single, cloud-based database for everything it offers, Paycom propels HCM into the 21st century, improving on previous solutions in which multiple systems had to be pasted together. Paycom's single-login solution covers all the bases: applicant tracking and hiring, new-employee onboarding, time and labor management, paycheck reconciliation. It also offers performance management, learning and training, health-care and overtime compliance, and much more – with more modules on the way. Beyond the base payroll offering, companies only pay for what they use, so clients add more modules as they need them, and pay more to Paycom.

This ability to offer a complete solution in one place improves outcomes and removes errors for the small to medium-sized businesses (usually 5 to 2,000 employees) that use Paycom – and it helps clients save money. Paycom focuses on smaller companies which have historically not been served with comprehensive HRM software, but its solutions can also serve giants, and management expects more large companies to come knocking (its largest client to date has about 10,000 employees). Revenue is booked with each client through a fixed payment per month, plus a fee per employee or per transaction processed, with more fees as more modules are used. As new clients are added, revenue grows more quickly than Paycom's incremental costs, and larger clients aren't generally more expensive to add than are small ones.

Another longtime income driver hides in Paycom's payroll services -- specifically, the cash for clients' payroll checks that Paycom holds before releasing them, lately $660 million. Some cash is held for mere days, some for weeks. When interest rates are higher, Paycom can earn meaningful interest – all profit -- on this growing pile of cash.

On the road to growth, Paycom had 42 sales teams in 24 states as of Dec. 31, 2015, and continues to add new teams. Many major urban markets remain untapped. Each Paycom client is assigned a specialist and a dedicated welcome team, and ideally kept happy with personalized attention. Recurring revenue is highly profitable, so customer retention is integral to Paycom's approach.

The company has $74 million in cash, up from $7 million in 2011, and $29 million in long-term debt. The founder and CEO has been at the helm for 18 years, the CFO for 10. Lately, the CEO has bought more shares. Initially launched with a credit-card loan, the business has essentially been profitable from the start. Consistent leadership has led to financials that are now attractively ramping upward (dollars in thousands).

	2015	**2014**	**2013**	**2012**
Recurring Revenue	219,987	148,207	105,560	75,420
Total Revenue	224,653	150,929	107,601	76,810
Cost of Revenue	35,473	27,318	20,891	16,326
Operating Income	34,435	15,700	9,472	6,133
Net Income	20,945	5,663	607	(406)
Cash Flow Statement				
Cash from Operations	43,000	22,300	17,000	11,000
Capital Expenditures	16,500	14,300	17,200	6,000
Free Cash Flow	26,500	8,000	(200)	5,000

Source: 2015 10-K Filing and S&P Capital IQ

What We're Watching

Paycom checks most of the boxes for a strong *Pro* investment, but it lacks pricing power. The industry is competitive, with ADP, Paychex, Paylocity, Salesforce, Workday, Ultimate Software, SAP, *Pro* holding Oracle and others all offering products in the various niches that Paycom serves. Paycom's comprehensive HCM package provides advantages – almost all new Paycom clients are signed away from a competitor – but the company must still be price-conscious. There's execution risk in the plans to expand the sales staff. If Paycom's data is ever hacked, growth could halt. And 5% of revenue is related to the Affordable Care Act. If that law is rescinded or changed, this line of revenue could change or disappear. On the whole, new legislative risk exists as the White House turns to a new party that also holds Congress. Paycom could also be disproportionately affected by a recession or hiring slowdown. Finally, the stock is priced for high growth, and even small disappointments could send shares lower. And we do expect growth to slow at times.

Alternative Trades

We encourage you to use a limit order to buy shares directly, with a 2% allocation to start, for the long haul. It is rated Buy. If you would rather write puts, you can "sell to open" January, February or May 2017 $45 or $40 puts to target a lower potential buy price. Sell one put for every 100 shares you would buy.

***Pro* Can Help**

- Thinking of adding Paycom to the ranks of your portfolio? Visit our new discussion board for HR-approved conversation.

{% video %}

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5 Tips for Investing Success

Published Nov 28, 2016 at 3:23PM

Dear fellow Fool,

You joined The Motley Fool, and *Pro*, to help you succeed with your investments. You like to manage your own money, but you also know it takes a lot of time, research, and upkeep to remain current on companies you own, and to manage a sensible portfolio that should perform the way you hope. In addition, investing only works well over many years, so you know you need to commit to it for the long haul. *Pro* is more than eight years old (and represents a way of investing I've worked on for 16 years), but we're still very early in our lifespan. Imagine where our returns could be -- should be -- when we're 20 years old, or 25.

As we welcome new *Pro* members this week, it's worth revisiting some investing truths. After 20 years of helping investors to invest, two of the key underlying challenges I see again and again relate to temperament and patience.

Temperament problems pop up most when investors put too much capital into a position or two that fail to work out, instead of remembering from the start that a balanced portfolio will protect you from this common pitfall. If any single position is causing you to lose sleep, you likely put too much into that position and should correct it. At *Pro*, while we have low turnover and don't rebalance just to rebalance, we look at our allocations weekly to make sure we're comfortable with what we own and how much. That's key to succeeding during tough times, too.

Patience problems typically occur whenever we enter a downturn. That's when some investors display unhappiness, citing lower account values, even though *Pro* has never been a service that advocates selling in the short term. Under our philosophy, a downturn should represent a buying opportunity, or at worst just something to wait through; we have a minimum three-year outlook for any stock we buy. We will sell early if our investment case is proving suspect, but in most cases we can avoid that mistake from day one by buying "right" -- and then being patient.

Investing is not complicated, but it is difficult. It's difficult because emotions too often enter the equation. As noted, in my experience this typically happens when an investor concentrates too much risk in a few positions (or takes on too much risk overall), or when someone forgets that patience is the rule of investing. If you manage your allocations sensibly, you'll avoid many temperment problems. If you remain patient, you'll avoid most others -- and further benefit by having a clear head during downturns, helping you seize opportunities.

Members new to *Pro* are joining a community of investors that's truly exceptional; among other reasons, we know this because these concerns are addressed on our discussion boards. We see members helping fellow members on a daily basis, and often on these two very issues. If you have a question *or* an answer, we recommend the *Pro* community as an oustanding place to share it.

Five other tips to help you be a calm, ultimately successful investor:

- Focus on your portfolio as a whole. That's what needs to grow. Never expect gains in every position you hold -- instead, focus on increasing the total return of the portfolio.
- Here in *Pro*, we expect some positions to be losing at various times. It's not realistic to expect our shorts to all win for us when the market is rising, for example. They're mainly there for when the market is falling. And that's fine. That gives us more balance.

- Studies show that lagging stocks later become leaders, and vice versa, so you don't necessarily want your whole portfolio to rise all at once -- if it does, it may well fall in unison, too. We seek more diversity than that, and smoother returns, again looking to win overall in the long run.
- Let the past be the past. We all make mistakes. Learn from mishaps, but then don't dwell on them to the point that they harm your future. If you learn from mistakes, they can actually be turned into gains -- into future profits -- thanks to better choices made down the road.
- Forfeit a sense of short-term control over pricing; there's no such thing. Thinking you can control short-term results is folly. The longer the term over which we invest, the *more* "control" we have over the outcome. Short-term maket moves are completely unpredictable, but long-term cash flow at well-run companies is predictable, and that ultimately drives stock prices.

Finally, new and old members alike should always take their time. Invest gradually. You should be enjoying the process. If you're not, you may be moving too quickly, before you're ready. Ask questions and move at a pace that makes you happy. As we move toward 2017, vow to lower any stress in your investing, and increase your big-picture contentment. Keep in mind patience and the big picture as we issue new recommendations, too.

Earnings

I touched on earnings from several *Pro* stocks in last week's Memo. Additionally in *Pro* last week, we saw earnings from long-term holding **Medtronic** (NYSE: MDT) and our short position **Deere & Co.** (NYSE: DE).

I've posted initial thoughts on Medtronic -- the stock remains a Buy at our 2.8% allocation. Deere, meanwhile, remains on Hold. We're likely to decide to close half of our short on Deere via our purchased $92.50 calls (which capped our risk). We're still deciding about the other half; you will of course hear first once that decision is made.

In closing, we welcome new members to *Pro*, and we thank veteran members for making *Pro* what it is! For questions, please visit the Help board. And if you missed today's live chat at 2 p.m. ET, we'll have another one coming up in December, and we urge you to enjoy the replay in the meantime.

-Jeff (TMFFischer)

More From Motley Fool *Pro*

- On Yearly Gains, and Earnings News
- Missing the Forest for the Trees
- MasterCard and Visa Notch Another Solid Quarter
- All Past Monday Memos

Pro Guidance Changes and Completed Trades: Nov. 28, 2016

Published Nov 28, 2016 at 3:22PM

Pro Guidance Changes (from the past two weeks)

- **American Tower** (NYSE: AMT): Shares moved from Buy to Buy First, and fair value increased to $125 from $120.
- **Deere & Co.** (NYSE: DE): This short position moved to Hold, and we bought protective calls on half of it.
- **Facebook** (NASDAQ: FB): Our fair-value estimate increases to $124. The stock remains a Buy First.
- **Gilead Sciences** (NASDAQ: GILD): Fair value decreases to $95. Shares remain a Buy.
- **MasterCard** (NYSE: MA): Our fair-value estimate increases to $90. The stock remains a Buy First.
- **Parexel** (NASDAQ: PRXL): Shares move to Hold as we consider recent news. We'll have an update, of course.

Pro Completed Trades (from the past two weeks)

- **American Tower** (NYSE: AMT): We bought to open a 0.5% stake (five contracts for us) via January 2019 $80 calls. We have not written the short calls yet to complete our diagonal, as pricing since fell far away from us.
- **Deere & Co** (NYSE: DE): We bought to open 3 Dec. 16, 2016, $92.50 calls, capping risk on half of our short Deere stock.
- **Expeditors International** (NASDAQ: EXPD): We rolled our November 2016 $50 calls to January 2017 $50 calls. Our short puts expired as income.
- **SPDR S&P 500** (NYSEMKT: SPY): We bought to close our short Nov. 18, 2016, calls, ending the synthetic short.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Nov. 28, 2016

Published Nov 28, 2016 at 3:16PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

New here? Start with our Portfolio Building Report No. 1, which focuses on our Buy First stocks. Speaking of which ...

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Facebook** (NASDAQ: FB): Buy up to 6.4%, in halves or thirds over time.
- **FactSet Research Systems** (NYSE: FDS): Buy 2%.

Continue building your portfolio with our Buys, including:

- **Medtronic** (NYSE: MDT): Buy 2.8%.
- **OpenText** (NASDAQ: OTEX): Buy 3.3%.
- **Visa** (NYSE: V): Buy 2.4%.
- **Verisk** (NASDAQ: VRSK): Buy 2.2%.

Shorts:

- **Gogo** (NASDAQ: GOGO): Sell short 0.5% if you haven't yet.
- **Shake Shack** (NYSE: SHAK): If you have not shorted 0.6% yet, you can do so now.

Pro options:

- None currently.

Hedges:

- None right now.

Options expiring next (Dec. 16, 2016):

- **Gentex** (NASDAQ: GNTX): Our $17.50 puts are on track to expire as income.
- **SPDR S&P 500** (NYSEMKT: SPY): Our $180/$190 put ratio spread is on track to expire unused, paying us a little income.

On Yearly Gains, and Earnings News

Published Nov 21, 2016 at 3:03PM

Dear fellow Fool,

Here at *Pro*, we pride ourselves on owning strong companies -- businesses with enough durability to *more than* make up for the losers (and mistakes) we know to be inevitable in investing. As an investor, the more action you take in a given time period, the more likely you are to make mistakes. But if most of your assets are invested in growing businesses, your portfolio as a whole should grow over time, allowing the errors to fade away.

Our *Pro* portfolio is up 6.6% this year (as of this afternoon), a healthy showing that's close to our North Star goal and in line with the major market indexes. We've achieved this while currently being 71% net long, with 22% of the portfolio in cash. One year's results don't usually mean much in the long run, but it's still much better to have a solid year than a losing one. *Pro's* returns over the past five years:

Year	Return
2012	14.3%
2013	35.1%
2014	17.5%
2015	7.5%
2016 YTD	6.6%

The S&P 500 was flat in 2015 (up 1.4% thanks to dividends); in fact, it's been pretty flat for nearly two years, only today breaking into new highs. But over the same time period at *Pro*, we've been able to add to our returns. Assuming the strong companies we own continue to grow and to improve the way they do business, then our best days are still ahead of us, and we will again see years with 10% returns (and higher). This may take a while due to today's valuations -- unless organic earnings growth revives after a few tepid years -- but it should happen. (You can see more of our returns on the bottom of the *Pro* Portfolio page.)

Like all of us, sometimes I focus too much on my mistakes. But our returns overall are what we have to show for our efforts when a year closes out. We keep moving forward, grateful for what we have, and seeking to improve -- and enjoy! -- our process. We believe our businesses are the same, always striving to improve. Today, let's review recent results from three *Pro* long positions and one new short.

Earnings Wrap-Up

Gilead Sciences (NASDAQ: GILD) is the cheapest stock we own, trading at 7 times expected earnings per share for the year ahead, even as earnings are falling from their record year-ago levels. This quarter, revenue declined 9% year-over-year, to $5.1 billion, on a 37% drop in Hepatitis C (HCV) sales; the decrease was mainly because of lower pricing. Sequentially, however, HCV sales were about flat compared with the second quarter (excluding unusual gains), suggesting the decline in the sector is slowing. Results were helped by Gilead's new Epclusa drug for genotype 2 and genotype 3 HCV patients; Epclusa sales hit $593 million in their first full quarter. Overall, an estimated 50,000 to 60,000 patients started HCV therapy each quarter over the past year, and Gilead maintains very strong market share.

Elsewhere, Gilead's HIV and anti-viral sales were up 32% year-over-year and 19% sequentially. Ten million people take a Gilead product everyday. The company continues to evaluate acquisition and partnership possibilities for growth. Meanwhile, Gilead has bought back many of its own shares at an average of $90 each, and management believes it's getting a great deal. We rate the stock (with its 2.5% yield) a Buy at our 2.5% allocation. That price is currently about 5% below our average cost. But as cash flow tapers, our fair-value estimate has to come down to $95.

OpenText (NASDAQ: OTEX) reported healthy growth and expects more on the way. Driven by acquisitions (as has been partially true for years), revenue was up 14% to $492 million, with $431 million of it (that's 87%) recurring. Software license revenue rose 18%; cloud and subscription revenue gained 15%. For the year that just started, management expects revenue growth of at least 10%, bolstered by its $1.6 billion acquisition of EMC's Enterprise Information Management business. By 2020, OpenText models 34% to 38% non-GAAP operating margins, with 50% of revenue from the cloud and 90% recurring revenue. Recently near $61, the stock trades at 14.4 times expected EPS this year, and 16.1 times trailing free cash flow. Shares remain a Buy at a 3.2% allocation. The stock yields 1.5%.

We have a short position on **Shake Shack** (NYSE: SHAK), where management is expanding the business as one would expect for a small restaurant chain adding new locations. Revenue was up 40% last quarter, and same-store sales gained 2.9%. Management is on track to open 19 new locations this year, for 43% store growth, with another 21 to 22 locations expected in 2017, representing 35% unit growth. But even this early in the game, some signs of age are creeping in. In the previous quarter, same-store sales growth was thanks to a 3.6% increase in price and menu choices, while traffic declined 0.7%. Next year, revenue is expected to increase by about 32%, which again is less than unit growth, and that includes price increases of up to 2% in January. Margins also face pressure as the company opens less profitable locations compared to its earlier iterations. At about $36, the stock trades at 81 times earnings and 68 times estimates for next year's earnings.

Shake Shack is well-run, but in a crowded "burger, fries, and shake" landscape, one where customers have a lot of choice, we don't believe the Shack deserves today's frothy valuation. At the very least, the stock is unlikely to gain a lot of ground, and in a weak market it should suffer, making our short's risk-to-reward ratio attractive. We remain short at a 0.6% allocation. We may consider adding to the short if that appears to fit the portfolio.

Finally, **Skyworks Solutions** (NASDAQ: SWKS) is defying skeptics. The stock is up 2.5% this year, and shares of its largest customer, **Apple** (NASDAQ: AAPL), are up 6% despite a year-over-year decline in iPhone unit sales. For its fiscal 2016 just ended, Skyworks hit record revenue of $3.3 billion, expanded its margins, and showed record operating cash flow of $1.1 billion. As an increasingly mobile-centric world takes shape, more devices connecting to the Internet mean more potential devices dependent on Skyworks' wireless technology. The company's revenue is expected to increase by 7% to 9% sequentially in the current quarter, and year-over-year growth should resume in the second quarter of 2017. Looking ahead, 5G technology will be another significant driver for the business. At the same time, Skyworks is diversifying beyond just phones, with the broad Internet of Things market now representing 25% of its sales and phones at about 60% (and 15% elsewhere). At $78, shares trade at 12.6 times one-year EPS estimates and 25 times trailing free cash flow. We own a 3.5% stake in this Buy-rated position, and we've written $75 covered calls for income. Today, you would write January $80 calls (as shared in our Catch-Up Trades).

Questions or comment? Please visit the Memo Musings board!

-Jeff (TMFFischer)

More From Motley Fool *Pro*

- Missing the Forest for the Trees
- MasterCard and Visa Notch Another Solid Quarter
- Trick or Treat With Scary Stocks
- All Past Monday Memos

Pro Catch-Up Trades and Upcoming Expirations: Nov. 21, 2016

Published Nov 21, 2016 at 2:26PM

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- **Facebook** (NASDAQ: FB): Buy up to 6.4%, in thirds over time.

Continue building your portfolio with our Buys, including:

- **Gilead Sciences** (NASDAQ: GILD): Buy 2.5%.
- **OpenText** (NASDAQ: OTEX): Buy 3.2%.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.5%.

Shorts:

- **Gogo** (NASDAQ: GOGO): Sell short 0.4% if you haven't yet.
- **Shake Shack** (NYSE: SHAK): If you have not shorted 0.6% yet, you can do so now.

Pro options:

- **Skyworks Solutions:** If you're just buying your shares now, you can "sell to open" Jan. 20, 2017, $80 calls on them, selling one call for every 100 shares you buy to cover.

Hedges:

- None right now.

Options expiring next (Dec. 16, 2016):

- **Gentex** (NASDAQ: GNTX): Our $17.50 puts are on track to expire as income.
- **SPDR S&P 500** (NYSEMKT: SPY): Our $180/$190 put ratio spread is on track to expire unused.

Pro Guidance Changes and Completed Trades: Nov. 21, 2016

Published Nov 21, 2016 at 2:23PM

Pro Guidance Changes (from the past two weeks)

- **American Tower** (NYSE: AMT): Shares move from Buy to Buy First, and fair value increases to $125 from $120.
- **Deere & Co.** (NYSE: DE): This short position moves to Hold, and we're buying protective calls on half of it.
- **Facebook** (NASDAQ: FB): Our fair-value estimate increases to $124. The stock remains a Buy First.
- **Gilead Sciences** (NASDAQ: GILD): Fair value decreases to $95. Shares remain a Buy.
- **MasterCard** (NYSE: MA): Our fair-value estimate increases to $90. The stock remains a Buy First.
- **Parexel** (NASDAQ: PRXL): Shares move to Hold as we consider recent news. We'll have an update, of course.

Pro Completed Trades (from the past two weeks)

- **American Tower** (NYSE: AMT): We bought to open a 0.5% stake (five contracts for us) via January 2019 $80 calls. We have not written the short calls yet to complete our diagonal, as pricing since fell far away from us.
- **Expeditors International** (NASDAQ: EXPD): We rolled our Nov. 2016 $50 calls to January 2017 $50 calls. Our short puts expired as income.
- **SPDR S&P 500** (NYSEMKT: SPY): We bought to close our short Nov. 18, 2016 calls, ending the synthetic short.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Buy Protective Calls on Half of Your Short Position in Deere & Company

Published Nov 18, 2016 at 11:25AM

Is this for you? This trade is only for members who have a direct short position on shares on **Deere & Company** (NYSE: DE). All others should ignore this recommendation, or bring your questions to the Deere & Company board.

One of the most important aspects of managing a portfolio -- the actual, hands-on management of that portfolio -- is also one of the most routinely unappreciated factors in investing success. That kind of management is exactly what we're doing today by covering half of our Deere position ahead of the company's earnings report. By spending a small amount (0.028% of the portfolio), we can take this defensive action while still retaining the potential in our short position should market sentiment toward this cyclical equipment manufacturer finally shift.

How You Participate

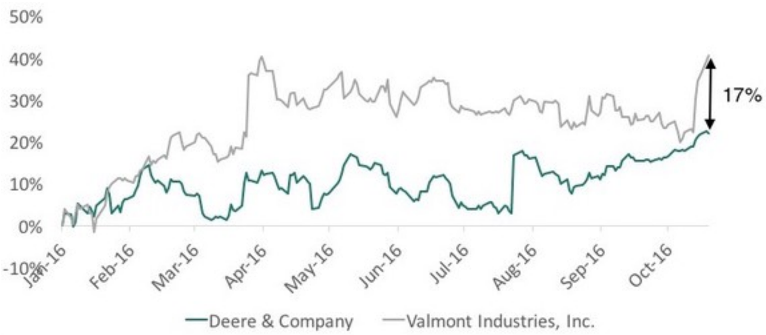
- **Trade:** Buy to open Dec. 16, 2016, $92.50 calls.
- **Allocation:** We're covering *half* of our position here, so buy one call for every 200 shares of Deere that you're short. *Pro* is short 600 shares and will be purchasing 3 contracts. If you're short between 100 and 200 shares, purchase one call; if you are not short at least 100 shares, close half of your position.
- **Price Guidance:** Initially, use a limit order of $2.47 or lower. If necessary, we'll pay more, because we want to set this up before the company reports earnings on Nov. 23.
- **Recent Prices** (10:30 a.m. ET)**:** Stock, $92; December $92.50 calls (bid/ask), $2.45/$2.49
- **Special Notice:** Deere will report earnings before the market opens next Wednesday, Nov. 23, so we want to buy this protection before then.

When we first established our short position on Deere & Company this Jan. 28, we noted two things we meant to accomplish. As with any short, our ultimate goal is to make absolute returns regardless of what happens in the market. But we also thought shorting Deere would serve to lower our exposure to the market by acting as an effective hedge for both the U.S. economy and our position in Valmont Industries. (We had considered closing our Valmont position because of industry struggles before deciding to short Deere.)

The market bottomed out shortly after we sent out our trade alert, and our goal of absolute returns hasn't come to pass so far. But hindsight is 20/20, and at the time, it seemed like anything but a sure bet that the market would snap back as quickly as it did. After years of a steady rise, the January pullback was the second sharp decline in six months, and the VIX -- the "volatility index" -- was sitting near five-year highs. But while our position has been in the red pretty much from the get-go, up until a month ago, Deere *was* serving as a worthwhile hedge on the market.

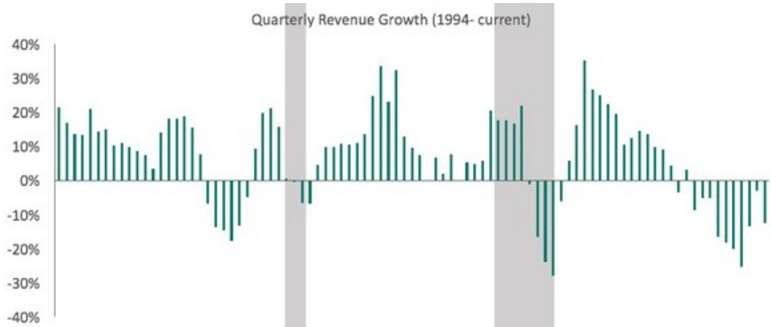
Source: S&P Global Market Intelligence

And it's served as a great hedge for Valmont, given how much sentiment has changed surrounding Valmont's stock so far this year.



Source: S&P Global Market Intelligence

A stock price is essentially a reflection of two things: how the underlying business is performing and investor sentiment, or how much investors are willing to pay for the current business based on expectations for the future. With respect to the former -- operational performance -- so far we've been spot-on. For the three quarters since we began our position, Deere's revenue has declined by 13%, 3%, and 12%, respectively, while net income has fallen by 34%, 28%, and 4%. To be fair, management has done well cutting costs during this downturn, but there's really only so much they can do to stem the operational deleveraging that takes place when you're a manufacturer stuck in the worst downturn you've seen as a public company.



Source: Company filings. Grey bars denote U.S. recessions.

Management, and those bullish on Deere, have been calling for a bottom in the cycle for more than a year now, but so far, signs point to weakness for the fourth quarter and continuing into 2017. The old adage for cyclical companies is that you should buy them when they're expensive, but that's only good advice when the cycle is about to turn and things are going to get better — something we currently don't believe to be the case with Deere.

U.S and Canada Ag. Business

	Industry	Deere
July 2016 Retail Sales		
2WD Tractors (100+ PTO hp)	-26%	less than the industry
4WD Tractors	-43%	more than the industry
Combines	-23%	more than the industry
August 2016 Retail Sales		
2WD Tractors (100+ PTO hp)	-26%	more than the industry
4WD Tractors	-39%	more than the industry
Combines	-17%	more than the industry
September 2016 Retail Sales		
2WD Tractors (100+ PTO hp)	-9%	in line with the industry
4WD Tractors	-18%	more than the industry
Combines	-27%	more than the industry

Source: John Deere monthly retail sales commentary. Industry results reported by the Association of Equipment Manufacturers.

But operational performance doesn't exist in a vacuum. The market at large is strong right now, and investor sentiment on cyclical stocks is improving -- **Caterpillar** (NYSE: CAT) is the best performer in the Dow so far this year by a wide margin, though its situation is similar to Deere's. This has put us in a tricky situation: We still believe in our thesis, but it's important that we don't let that belief get in the way of proper portfolio management.

To date, we've been wrong about how the market would respond to Deere's poor financial results. With earnings due next Wednesday, Nov. 23, we want to take preemptive action in case that continues. We're covering only a portion of our position, which enables us to pay less than we would have to cover our entire position at a higher strike price. By paying less, we stand to benefit more if the stock falls, and the lower strike price ensures we'll be better off as the stock rises until about $100. And a Dec. 16 expiration lets us hedge the uncertainty surrounding earnings but still expires before the year is out, enabling those who follow *Pro* in a taxable account to offset some of their capital gains this year should we ultimately need to exercise our calls and reduce our position.

With this hedge in place, the stock could rise to $100 by expiration and the negative impact to our portfolio would be just 0.13%. We may exercise our calls, bringing the position more in line with the others in our short basket, or we may decide to close the other half of our position as well. We'll analyze what we find in the earnings report and let you know.

More That Matters

- **Maximum Loss:** On this trade, we only risk what we pay to buy the calls, which end without value if Deere remains below $92.50.
- **Maximum Gain:** These calls will go up along with Deere shares, offsetting any losses in half of our position above $92.50.
- **Follow-Up:** After earnings, we'll decide whether to use our calls to cover half our short if Deere is above $92.50, or whether we want to keep our short (and perhaps hedge it again) if shares remain below $92.50.

Close Your Short Calls on SPY

Published Nov 17, 2016 at 12:48PM

Is this for you? This is for all *Pro* members who are short in-the-money calls on the market index expiring tomorrow, as a result of our synthetic short trade from Nov. 2. (This does *not* relate to *any* put ratio spreads we have on SPY, which are due to expire unused as income. So, only focus on short -- or written -- SPY *calls* in your account that are now in-the-money, with a strike price below SPY's current price, and that expire tomorrow.)

How You Follow Along

- **Trade:** Buy to close all short in-the-money calls on **SPDR S&P 500** (NYSEMKT: SPY) expiring Nov. 18.
- **Price Guidance:** Since this expires tomorrow, and SPY options are very liquid, just use a limit order at current prices to close your short calls.
- **Related position:** The November *puts* that we have on SPY are out-of-the money, have little to no value, and can be left alone to expire.

What We're Thinking

That was interesting.

On Nov. 2, we recommended a synthetic short on the **SPDR S&P 500** (NYSE: SPY) ETF as a simple hedge against an election surprise. Hillary Clinton went in with about 90% odds of winning the election, and ended up losing the electoral vote handily. Initially, U.S. stock markets dropped nearly 5% in overnight trading, before rebounding and *rising* the next day. Investors are apparently hopeful that a pro-business administration -- one where Trump favors more stimulus, more investment, tax cuts, and more U.S.-centric trade deals -- could ultimately drive more growth our way, and thus stocks have been bid higher. Or so one theory goes.

Our hedge was set up for an election shock, and meant to expire soon after (the soonest date feasible) so that we didn't mindlessly keep the hedge going. Although we were correct to think the election could surprise the world -- and Brexit was our biggest indicator -- we did not see the market react as we would have assumed. So now we are going to pivot, too. With the Dow hitting new highs, and the S&P 500 very close to doing the same, we're going to "buy to close" our short calls on SPY, take that loss for 2016, and reassess our next move. We still want to hedge the uncertainty that is ahead, but in the face of new market highs, we don't want a direct SPY short right now -- it could get too costly if the market trend continues. We are instead likely to revert back to put ratio spreads that can pay us credits, and add more direct shorts to our basket of shorts.

This hedge served us as wished. We didn't end up needing it, but it has not stopped our portfolio as a whole from rising sharply with the stock market. At a recent $218, SPY is up 2.8% from the original $212 short price in our recommendation, so even at a 10% allocation, it has influenced the typical member portfolio by only 0.28% -- a price we're fine paying for the insurance we had through the election, and the subsequent rise in the market and our portfolio that we kept long.

Alternative Trades

- **IRA-friendly:** The $210/$200 spread you set up as our alternative trade is on track to expire. There's no action to take.
- **Short SPY directly:** If you shorted SPY directly, you can close that as well -- unless you prefer to keep a direct short on SPY as a hedge. (Remember, a hedge is a personal choice; it's just a form of insurance against market declines, so you can keep them on or take them off at will, as you wish.)

Pro Can Help

- **Want to talk about our SPY hedge strategies?** [We have a discussion board for that].

Roll Your Short Calls on Expeditors International

Published Nov 16, 2016 at 2:42PM

Is this for you? This is for *Pro* members who have an existing income position on **Expeditors International** (NASDAQ: EXPD) with currently in-the-money call options expiring Nov. 18.

How You Participate

- **Trade:** Use a rolling order to simultaneously:
  - Buy to close all Nov. 18, 2016, $50 calls, and ...
  - Sell to open an equal number of January 2017 $50 calls.
  - Leave your written puts alone to expire Friday, unless you want to close for pennies.
- **Prices and Guidance (2 p.m.):**
  - **Stock:** $51.15
  - **Options:**
    - **Buy to close** November: $1.10/$1.60
    - **Sell to open** January: $1.90/$2.20
    - **Approximate net credit** (estimating $1.30 to close, $2 to open): $0.70 credit
    - **Timing:** As as long as Expeditors remains above $50, close your November $50 calls by Friday to avoid being exercised. Pay minimal time value -- $0.10 to $0.20 -- to close the November calls. If the stock falls below $50, you can wait to close if you want to watch it, as long as it stays below $50 through the end of Friday.

What We're Thinking

We've done well with our synthetic long on Expeditors, turning a net credit to start the position (and only about $8,400 in cash obligations) into more than $8,000 in unrealized profits so far since January, *not* including option income made along the way.

Our synthetic long expires in January, and before then we'll decide what to do: let it turn into shares, close and move on, or set up another synthetic long. Either way, we want that tax gain in 2017, not right now. Right now, we *do* need to close our Nov. 18 $50 calls because the stock is above that strike price. We can leave our puts alone to expire Friday, but will roll our calls to January for another credit and to cushion against a fall of about $2 in the stock.

We are not writing new puts right now because they don't pay enough. So, we'll only have our 2017 synthetic long and be short January $50 calls.

More That Matters

- **Maximum loss:** Our synthetic long has the same exposure as 1,000 shares of stock (or 2% of the portfolio).
- **Maximum gain:** Our upside will be capped at $50 plus the premium received.
- **Follow-up:** By early January, we'll decide our next move with our expiring synthetic long.

Alternative Trades

- **If you wrote covered calls last time and want to keep doing that:** Roll your November $50 calls to January 2017 $50, just as we're doing, for the same rough credit as above.
- **If you wrote puts last time:** Those are expiring as income. We're not suggesting new ones at current prices.
- **If you're new to the position:** We suggest waiting until January to see what we do next. You can get on board then if we keep it going.

Pro Can Help

- **Questions?** Please ask, Fools! Ship yourself on over to our Expeditors board. We can all help you, especially if you're new!

Pro Video Chat, November 2016

Published Nov 16, 2016 at 12:17PM

The *Pro* team will be holding a live video chat on this page at 2 p.m. Eastern on Monday, Nov. 28. We'll be using a service called slido to take members' questions during the chat; for a brief overview of how that works, click here. The Slido chat code is #ProChatNovember (direct link is here). We advise that you keep Slido open in a separate window so you can follow along with the chat and the questions at once. See you soon!

Transcript

Jeff F.: Greetings fools. Welcome to your November 2016 Motley Fool Pro live chat. Joining me today is Jeremy Meyers, Team [F-Tank 00:00:10] on the discussion boards. I'm Jeff Fischer, co-advisor of Motley Fool Pro. We're delighted to be with you here today after the, for US citizens, holiday weekend. Long holiday weekend. We hope you all had a great time with family, friends.

Jeremy M.: Everyone is out of their turkey comas.

Jeff F.: What was your favorite part of the holiday, Jeremy?

Jeremy M.: Well, for me it was I finally got out of my sling. I had shoulder surgery a month ago, and finally got to take that off and look somewhat normal again.

Jeff F.: The protein. We've been through the ringer a little bit.

Jeremy M.: That's right.

Jeff F.: Jeremy had surgery about a month ago, as you just said, just had your sling off just recently. J.P. had some surgery last week. He was okay with us sharing that. He's been out, but he'll be back this week and he's doing well. Ellen is okay, but a little under the weather today.

Jeremy M.: Cold. [crosstalk 00:01:01] after the holiday and all the hugs and handshaking.

Jeff F.: Exactly. Yeah, that's true. A lot of cold snow.

Jeremy M.: Don't want to get a cold.

Jeff F.: Billy, we don't know how he is, but he's in New Zealand travelling.

Jeremy M.: Yes. For two weeks.

Jeff F.: Hopefully he's doing great. The Pro teams kind of ... we're doing fine though, but we're kind of rocky couple of weeks in some ways. Everyone's healthy or getting there, so that's the key thing. For today's chat, Jeremy and I are hosting. Please go to see the video portion of the live chat on your page right now if you're on the Pro video chat page. You can go to slido.com. That's S-L-I-D-O.com. Then enter the hashtag "ProChatNovember", and that will take you to the question portion of this chat. If you want to ask your own question, and we highly encourage that you do, then we will see your question. All other members will too. You can vote on the questions that you want answered. Most, and we'll answer the questions one by one. Right now we only have three questions, so it may be a quiet or a short chat.

Jeremy M.: I see a few more coming in. It looks like you have about eight or more.

Jeff F.: Okay, so they're starting to come in. Thank you for joining the chat, and asking your questions. I don't think we have much of a preamble before we get to your questions today. It's end of November. We're looking forward to December and the end of the year, and making sure the portfolio is where we want it as the year ends. Kind of last, end of year house keeping, so to speak. Maybe taxes will play a role in some choices we make.

The portfolio, Jeremy, is up about 6% year to date last I looked, which is last I looked, about in line with the market. Close to the North star, and we're about 70% long right now. This year we've averaged about 75% long. We're pretty happy with that. A gain is never to be frowned upon.

Jeremy M.: It's been a tough year on the long and the short side for most investors. For how the year started, one of the worst starts ever. To the recovery and post-election rally. That there's a lot of Brexit and other unexpected news that the market's had to digest. I think overall we're probably in a pretty good place.

Jeff F.: Jeremy, I read the average hedge fund is up about 1 or 2%. 1 1/2% this year, so again they're doing badly compared to the market. So many of them, of the top 50 hedge funds performance-wise, the majority took positions prior to the election that have hurt them since they got out of financial as well. We sold one as well, but we kept the most of our financials. They shorted healthcare, thinking Hillary Clinton would win and that would hit healthcare. The opposite has happened, of course, and the healthcare has soared, financials have soared.

Jeremy M.: I'll tell you that's hit my watch list also. Of the companies that I was looking at on the long and the short side. Where some of the more regulated industries have just taken off. Up 25, 30% over the last couple weeks. A number of other longs just don't look quite as attractive now as they did. I feel like there's an entire ... all the sector rotation just happened so quickly, that it's hard to determine how much of it is warranted. How much is it an overreaction of everyone being on one side of the boat, and then just running as fast as they can to the other side. How realistic these expectations are as far as the fundamentals of some of these businesses.

Jeff F.: Exactly, how much will the bottom line move?

Jeremy M.: Our portfolio, you look at [Valmont 00:04:39], which is up probably 20% or more since the election, with only anticipation of infrastructure spending, without any actual funding, any actual projects launched. Looking out two three years, the markets a forward-looking instrument. There's some speculation there, right? When you start to digest whether or not those prices make sense, or if things are getting a little ahead of themselves.

Jeff F.: Definitely. When a price moves as much as 10 20% or more, it does require that kind of reassessment. In most cases, the companies we own are worth continuing to own, but would we want to buy more at this price? Or has it already priced in too much optimism? As you said, yeah, keeps you on your toes. You're right, its been a rocky year. I think the more you trade, the more chance you had to make mistakes this year. Many of the trades we made, luckily we don't make that many, turned out to be in the short-term, to not add to our returns. In some cases, take away from our returns. The more active you are, the more likely you are to be wrong in the short-term.

Jeremy M.: Sitting on your hands is the right decision, sometimes. Doing nothing is sometimes the smartest thing you can do.

Jeff F.: We're of course, hoping to be smart and right in the long-term, and so far, that's what we're doing. That's what we have to look back on. Eight years of Pro doing well, but we're just getting started as I wrote in today's memo. We're still just getting started. It's the next 10 years that we're most excited about. With that kind of overview of rocky volatile year, but we like the 23 positions in the Pro portfolio. For the most part. One or two are on hold right now, as we reassess. We like the shorts that we have. We're looking for new shorts. There's some new longs that will probably be in the portfolio before long. Some that take into account the new administration. Potentially the chance for lower tax rates on corporations, especially mid and small companies benefit from that.

Yes, we're moving as the world kind of leads us to move. Although, we like to chart our own course at the same time. We'll shine a light in every corner and see what we find.

Jeremy M.: As things settle down, we can start writing some options for income and return back to some of those strategies that we had been working on earlier in the year, where things were a little bit slower.

Jeff F.: That's true. That's true this year about volatility too. It has come and gone. It's jumped up, the VIX above 20 and then right back down to 13. Interesting year. Overall, we have a decent gain along with the market. We have plenty of cash, which we'll talk about in a second. Plenty of opportunity looking ahead. Jeremy, let's start in on the questions. Thank you again, Fools. We have quite a few. Jeremy and I, our goal is to answer all the questions today. We have 52 minutes still to do it. I think we can do it. Go to slido.com, if you haven't yet. Slido.com. Enter "ProChatNovember", and you can ask your question.

Now, Jeremy, let's get started. The first question is from Len. We'll go in order of most thumbed up, so if you see a question you really want answered, thumb it up and that will move it to the top of the list. Len, thank you for being here, and thank you to new Pro members as they start to join this weekend. This past weekend. Len is asking, "Will we be exercising our John Deer protective calls or what will be the direction I'm currently holding them? Thanks."

About a week ago, we bought call options to cap the risk on half of our short of John Deer. We bought 92 50 calls. Those have come in handy as the stock has risen after earnings. They capped our loss. We can now use them to offset half of our short position, and we probably will close half of the short at least. J.P. wanted me to share that he is looking at Deer right now, and should have a decision what he wants to do, in the near term. Then the team will discuss that, and we'll have a decision. Jeremy had some early thoughts looking at the results as well.

Jeremy M.: It's very similar to last quarter. The results, the guidance doesn't look great, but management is able to continue to paint a rosy picture. That they see the bottom of the cycle is coming anytime now, and they've been talking about that for over two years. They're able to just keep kicking the can down the road and investors are willing to give them the benefit of the doubt. It seems, more than anything, we've seen this shift in sentiment where despite results that leave a lot to be desired, despite use inventory piling up and farmers continuing to struggle and there is a very long article in Bloomberg this weekend about the family farmer, and how hard this has been with the record crops and falling commodity prices.

Even in that environment, people are looking out a year, two years. I think Deer's probably benefited a little bit from the shift into industrials. It is a brand that's sort of Americana. That people are rooting for. I think investors are willing to pay a little bit more, even though results right now have not been very good.

Jeff F.: It's been interest. Of course, the short hasn't worked out either, except in that we kept Valmont because of it. They're equally sized positions and Valmont has gained, I believe as much as Deer has. Maybe a bit more.

Jeremy M.: Yeah, it's more less since the election results, has matched Deer. They've offset each other. Previous through the year, is outperformed Deer overall. It was a net positive.

Jeff F.: A net positive. That said, we know some members may not own Valmont. May of just on the short, despite saying it's a paired trade. Overall, we want each position. Our goal is for each position to do well. That's the ideal goal. We know the short hasn't worked out, clearly, so far. Half of it is probably on track to being closed. The other half we'll decide what to do with soon. I think one of the big lessons, again, is allocation. It's been a small position, so it has nicked the portfolio by about 0.5%, even now. Even rounding 35% up. The short is up 35%, or so.

Jeremy M.: It's important to remind members that think about the portfolio as a whole. Think about those allocations and weightings and how a lot of these things offset each other. That's how a portfolio is supposed to work over time. You don't want perfect correlations, you want things to move in different directions. Emotionally, selling and shorting are two of the most difficult things that investors have to do. Through that lens, you sort of see red on your shorts and react a little more strongly than you do on a long position that might be losing by the same amount. At least, specially when you consider the allocation.

Jeff F.: That's true. Shorting is extremely difficult. It isn't for everybody, but we enjoy it. We'll help you do it if you want to, as many members do. Overall, shorting should be a net benefit to the portfolio, because it also allows us to be ... to have more long exposure. Our net long exposure is where we want it. Our gross exposure is higher than it looks like, and we benefit as those stocks go up.

Every single one of our long positions, except one I believe right now ... DGS. Emerging markets ... is up. We own those in part, because we've had shorts and hedges to offset that risk. Overall, we benefit. Jeremy's exactly right. That's the thing to keep in mind.

Deer is high on our radar, and we'll have an update for you as soon as we're ready to. Next question is from Gman1946. He's a new Pro member.

He or she. Thank you for being here. They're asking, "I notice that you have about 25% of the portfolio in cash. How is that varied over time, and how is it determined? Were you ever fully invested?"

I have the spreadsheet right here, that I keep, so I can speak roughly to this. We have been gross invested ... meaning what you're talking about is long invested. On the long side, we've been in the 89 to 90% invested range from 2014 ... we were even in the 90%s in 2011, 2012. 94%, 97%. The answer is, we've been close to fully invested at many times, but on average we've been 87% long over our lifetime, on average. 15% short, and net longs 72% on average. If you add that all up, we're 102% gross invested, on average. Yeah, we're using our whole portfolio, and we're using some cash strategically. We typically have averaged 12 ... No, I'm sorry. 15% cash has been our average over our lifetime. Right now, we're a bit higher than that.

That cash is used to hold options positions. That's cash free of the shorts that we have to cover. As a tool to hedge the portfolio, hedge against risk, and buy things when we see opportunity. That's where we are on cash right now, but it will change. That's been the average. Jeremy, if you have any other thoughts to add.

Jeremy M.: I think it just sort of represents our opportunities set, and what we're seeing out there over the last year or so. We haven't felt like there is a lot of screaming deals out there, even when there's a pullback of sort of post-Brexit, that the thinking was the opportunities might even get better. You notice that we didn't have to rush to ... it would have been nice to make a couple more purchases than we did, but we can afford to be patient. Over time, I think that's going to pay dividends when there is a meaningful pullback if they last longer, that you can really take advantage of.

I think we've been fortunate to perform as well as we have versus the market, and as the markets climb continuously since the recession. When eventually there is a pullback, we're going to be in a much better spot.

Jeff F.: Well said. Thank you Gman for the question. We have the next question from a Pro member asking, "Stocks are at all-time highs. Is there a plan to write more call options against Pro positions? Covered calls as defensive income small hedge."

Jeremy M.: I would say yes. We were talking about this morning, and if you look back to some of the stocks we've covered over the years, we're still looking at those same companies and looking for opportunities where we can harvest a little bit of volatility. If the yields are appropriate.

Jeff F.: Excellent. MacGregUSA. MacGregUSA asks, "What are your thoughts on writing put options to offset short positions? In other words, covered puts? For example, John Deer." We considered that with Deer, in fact. The main trade off, the main downside is once you write a covered put ... so say you're short 200 shares of Deer at 100, and you sell $95 put to bring in some income. Of course, then you're capping your potential gain at 95 plus your premium, so say 93. If the stock really falls, you don't benefit. Yet you still have all the risk of the stock rising. On a risk reward basis, writing covered puts, although it can eat away at the loss that you have in a short, it skews your risk reward in a way that's not favorable. That's why we typically shy away from doing that, but we do consider it.

Who knows, we might consider it for the rest of our Deer position. We'll see. It's a tool that you should know about, that we sometimes use, but do keep in mind how it immediately changes your risk reward. You now have this short that you're paying for, and that has unlimited upside risk ... not that theoretically ... and yet you have very little to gain by capping the short, because you have capped the short potential for yourself if you write a put on it. Be careful doing that.

JeffThinkingMan. Hello, Jeff, good to see you. Thank you for being here. "Is your plan to renew put writing on expediters?" Not anytime soon. Not right now, anyway. Our position is coming up to expiration in January. A synthetic long has done quite well. We're deciding whether we want to take shares, or close the position. Then we'll go from there. If we take share, we might continue to strangle them with writing covered strangles, but that remains to be seen. For now, we'll wait and see. The stock is up quite a bit this year. It still looks reasonably priced, but we just want to make sure that we want that double exposure that comes from writing more puts when we already have puts on it written, of course.

WarrenBetty is asking or commenting. They have a discussion board gripe. "Newcomers in Motley fool options can, at times, jump the gun on alerts and not use limit orders." We're happy to always talk about that. To use limit orders when we issue a trade, Jeremy.

Jeremy M.: It's easy to get excited when you see the trade come out and you just want to make sure you get it done. Definitely pay attention to our price guidance, and try to set the limits and be patient, because depending on the liquidity that's available in the stock, you can make that price move very quickly to the point that it doesn't make sense to make the trade anymore. Not only are you going to end up in a trade yourself, that won't be as profitable as we would like, you also limit the potential of other Pro members to be able to follow and make a similar trade. The market makers in the options market are very good at taking advantage of market orders. They come in, or if you set your limits, at the wrong price. You're putting profit in the market makers pocket, instead of your own.

Jeff F.: Well said. Let's all keep using limit orders. Anonymous is asking, "Any thoughts on small cap marijuana stocks with new legalization votes, particularly in California?" We've had the benefit of seeing legalization in many states for a handful of years now, and in the past the Fool has looked at some small cap stocks in that area, but the one's that I've seen wouldn't qualify as a Pro company. They don't have the amount of recurring revenue. They can't say ... they don't have the financials that would support a purchase in Pro. They're also typically too small for our service and audience.

Jeremy M.: There's probably not enough liquidity. Management generally doesn't have a track record that we're that knowledgeable about. I actually think, over time, if this is going to be a wave that sort of starts sweeping across the nation, that you're going to see larger companies start to come in and take advantage and compete some of that away. I just don't know from a competitive advantage standpoint. They might be the first movers, but I don't know from scale and from ... I don't know how capital intensive it is. If there's a lot of other sort of industry related dynamics that we haven't really cleared up.

Jeff F.: As with almost any new industry, it'll get a lot of press, and we'll be drawn into reading some of that, and out of curiosity looking at the companies that maybe float to the top. Jeremy, do you know if any Fool service has recommended any related stock? I can't think of any.

Jeremy M.: Not that I can think of, no.

Jeff F.: I think most are just too small. Among other possible issues. JeffThinkingMan, again is asking, "He still holds Wells Fargo shares and the call options. In Motley Fool options we own, we recommended call options on it. Your thoughts on it's future? Would you still look to sell?" I can speak to that, definitely. We've sold Wells Fargo shares in Pro, for very specific reasons. We already have a lot of exposure to financials in Pro. We don't want exposure to any financial company where we don't trust management and where we can't predictably, reasonably see what future cash flows are going to be.

The jury is still out on how much Wells Fargo business may be harmed. Especially in relation to new accounts being opened. We are content to sell it for now, and see where things start to play out. The call options in Motley Fool options, I presume is a much smaller position. I've kept that in options and we might write calls against it, or we may just sell. We're close to even on those now. That said, just before we started live, Jeremy and I were talking about the move the stock had made and was that merited.

Jeremy M.: Sure. Yes. It was one of those stocks that benefited from less regulation. Financials in general, banks in general and higher interest rates. We've seen bond prices increase basis points or so in just a few weeks, which is a huge move. There's almost a round trip from what the bonds have done from the beginning of the year falling to a low or almost an all-time low and then back up to where they were. With that balance, it should help the profitability of a lot of our financials. Once again, looking at the portfolio, looking at our other holdings, you know do we want that capital? Do we want to take that risk on Wells Fargo, or would we like to redeploy it in some of the other companies where we feel a lot more confident about the long-term prospects of the business?

Jeff F.: WiseGuy1971 is asking about a watch list in Pro. Stocks or options that Pro is considering. What are our thoughts on that. I'll start by saying occasionally we do share companies we're looking at and considering. Typically we share that in a Monday memo or on the discussion board called stocks that interest you. For now, I think that's how we'll continue to share idea that ... some of the idea that we're considering rather than make it formal. I feel like the formal watch list could potentially confine us too much.

In the past anyway, we've seen people act on idea that are not official yet. With sometimes good, and sometimes not great outcomes. What then happens, is people then ask for follow up on those companies, even though they're not in the universe yet. It can get a little messy, and that's why I'm not, right now, in favor of a formal watch list.

Jeremy M.: A lot of those stocks can sit on our watch list for several quarters, a year. We might never get to them. Other times we'll just bind something that's not even on the watch list. You also don't want to have the argument, "Hey, you didn't put this on the watch list, and then you bought it." That it's not formalized in the process, gives us a lot more flexibility I think.

Jeff F.: I agree. We appreciate the feedback. We will share ideas when sometimes it just seems right to share an idea. It seems like it's safe to do so. We'll do that in the memo or on the stocks that interest you board. Also, please post any stock that interests you on that board, because that's how it could get on our watch list. Share you watch list, if you would, because we are always looking for new ideas. It's one of the things that we enjoy doing most. Thank you for the question.

Anonymous is asking, "I'm new to options, and wondering about good resources that examine income tax considerations. Such as long-term holding on non-dividend stocks." Think I understand that, but generally what are the tax considerations with options? I can summarize that any option you write or sell to open, is a short-term gain or loss. Any option that you buy to open and hold for more than one year, qualifies for long-term tax gain or loss.

We have a tax guide in the Motley Fool options options you site. Little 1500 words on the basics of top taxes and options. Which is, I think a great place to start. It really gives you a good overview. Then post any questions on the boards as well.

Jeremy M.: It's worth the time to read, right? Because, if you can end up boosting your returns through managing in the most efficient way possible, that's almost a guaranteed return. Versus taking risk and getting every idea right. You can bet almost 100% just by reading the guide and making sure you're not making any of those mistakes and being as efficient as possible.

Jeff F.: To start, go to Options You in Motley Fool options, and see our tax guide there as a start. David In Alexandria, and I wonder if that's Virginia here. Could be, but there are a lot of Alexandria's in the country. In the world. David is asking, "As a new member, I'm looking at your three shorts. ShakeShack, GoGo, and GoPro. GoPro is now under 10. Should the strike price to open the synthetic short be 10 now?" Generally, the answer to that is yes. With a synthetic long or short, you use strike prices that are as close to the current share price as possible. Assuming the option pricing is attractive to you. No matter which strike prices you use on a synthetic long or short, as long as you use the same strike prices. 12 and 12 or 10 and 10. No matter what, you're setting up the position that will mirror the stocks movement from that point on.

From it's current price on. The only difference is whether you start with a net credit or a net debit. That shouldn't really matter to you, but one thing to keep in mind, taking into account taxes, is if you write or set up a synthetic short for a big net credit, that's going to be a short-term gain no matter what. It might be better to set up a synthetic short right near the money that you get. You pay a little for, or get little back on. Then if you own the puts for more than a year, you'll get a long-term hopefully gain on those put options that you own. Yes, David, GoPro the strikes would now be moved to 10. In a week or two, we'll have a Pro positioning report for new members that will guide you on how to get into our shorts and our current options. If you want to wait for that you could, but if you want to go forward now, then you would use 10 on that synthetic short.

ShakeShack meanwhile, and GoGo can be shorted directly at the current prices. In fact, they're in today's catch up trades that you'll be getting momentarily in your email box. Thank you David, and welcome to Pro. We're glad you're here. Jeremy, do you want to ... I'll read it. Member asking, "So we sold Wells Fargo, and we do not have a bank stock. Do you think we should add some banks?"

Jeremy M.: I think we need to have a good argument of why we need to own a bank stock, specifically. We have other financials. If we were to buy a bank stock, I think it would be because we think that it's trading at a huge discount. That it has the ability to grow or that it has some sort of key advantage in the market. I don't think we specifically need to own a bank, where we T Ameritrade, we own Visa and Mastercard. We own a bunch of financial services companies, and make their profits from the bank. In a lot of ways, they have business models that are easier to understand.

One of the issues we've always had with banks, is a lot of times they're black boxes. It's hard to really understand what's going on inside the bank. What we saw with Wells Fargo, where it's so big and so many divisions, and management is diluted to a degree, it's harder for, I think, the CFO to affect change on the business, other than helping set the culture. Which is what happened with Wells Fargo, but with a very complicated business, it could be years, like we've seen, before you finally realize how serious their problem was. I think that there's other businesses where the business model is easier to understand, easier to analyze, and longer term probably have better growth prospects. First, what we'd like to look at.

Jeff F.: That's true and we, as Jeremy said, we do own several companies that benefit from higher interest rates or that will. We're looking at some others. I think Jeremy answered perfectly with his very first statement, which is we need a good compelling reason to own a bank. If we see that, we'll definitely buy a bank again. We could even buy Wells Fargo again. We want to be flexible and stay flexible even while we, as you know, work to keep turnover low. We're not an active trading service, we're investors. We know that's how you compound your money. We are flexible. We'll admit mistakes. We'll return to something that we may have gotten wrong in the past, if we feel that we now have a line on a good investment there, so yes.

Jeremy M.: It usually comes down to opportunity cost, right? It's either that business versus our next best option, which might be something we own already. Might be a new idea. Or, it's cash and the optionality of holding cash in the event that there's a market downturn. We try to think about it in the context of all those different options.

Jeff F.: Excellent, so the next question is ... and if you're just joining us, we're halfway through the chat, but it will be archived on the site, along with a transcript in a few days. If you're just joining us, and watching the video portion, you can go to slido.com. S-L-I-D-O.com, and enter Pro Chat November to ask your own questions, and we will work to answer them. It looks like Jeremy we're in pretty good shape. I need to refresh my page. [crosstalk 00:31:38]

Jeremy M.: The list is growing.

Jeff F.: Is it?

Jeremy M.: Yes.

Jeff F.: The list is growing.

Jeremy M.: Which is great. It's fantastic.

Jeff F.: That is great. Look at all these questions. I was going on an old list. See, as an admin, it doesn't update automatically for some reason, so you have to refresh it. Here we are now. People were wondering, "What's going on? Where's the top question?" Bruce is in the lead right now. Nine thumbs up. "As a member who joined in November 2015, are there any trades that would help with Gilead's 30% decline? I'm wondering about stock repair."

I've looked at stock repair on Gilead, but the main concern we have with that is the stock is so cheap. A stock repair does max out your returns when the stock rebounds. When you set it up typically, it just gets you back to break even, but doesn't allow for gains beyond that. With shares trading at below 7 times earnings, management talking about how they're in the market for acquisitions that could make a difference. The HIV franchise doing very well. Their leadership in Hepatitis C holding strong. That market even looks like stabilizing at a very healthy rate for Gilead's cash flow.

I don't want to cover the stock or cap it. It's one of those top tier companies that it's unfortunate that some of us, including myself, have a loss on the shares, but with time I think that will be corrected. We'll be very careful. We have written covered calls on it a few times. We'll carefully do that again if we see an opportunity, but overall I want to be careful about capping that stock.

Jeremy M.: If you have a larger decline, it could be an opportunity for tax loss harvesting. Going into the end of the year with the idea that you can very easily buy it back 30 days out from now.

Jeff F.: I agree with that. With anything where you have a loss, now is the time to start to look at it. See if you want to sell it to offset a gain that you have, and then get back in. A fool is asking, "On writing put options, if we missed the price guidance, how do we determine what a next reasonable price is to jump in?" In Pro, we haven't had that issue much. You're probably speaking to Motley Fool options, and there we have every Friday strategies you can start. It used to be called Trades you can make. Every Friday, strategies you can start that give you updated pricing, especially on our most recent recommendations.

You'll see there how to get on board with a recent recommendation. Also, as Jeremy said earlier, read the alert itself carefully, because we frequently have flexible guidance in there. We say aim for 1% a month yield, so you can do that math yourself to expiration and see if you can write the put option at that time. We do try, and we're trying ever harder, to give very specific guidance that is flexible as well as time goes on. Hopefully that will help in the trade alert, but also follow strategies you can start in Motley Fool options every Friday, and pro catch up trades every Monday to see updated guidance on options.

JeffThinkingMan is asking, "Are we looking for another spy hedge?" The short answer is, yes. Our December 1 is well out of the money. We closed a spy direct short soon after the election results, because the market was surprising us with an upside move. We're looking at new ways to hedge since then, that will not be as affected as the market keeps rising. Yes, watch your inbox for that.

Bruce is asking, "Current thoughts on Papa Johns? I sold some shares earlier when Pro shorted the stock. It's an IRA. Would selling puts make sense right now?" Jeremy, I don't know if you have thoughts on that. I can ...

Jeremy M.: I don't follow Papa John's specifically that closely, but I just want to point out that we shorted Dominoes as a hedge, so that we wouldn't have to sell all of our Papa John's, or the half that we wanted to cover and have the tax implication, and have to pay taxes on the gain. Definitely think about those two together, and that the exposure that we have to Papa John's is only, I believe, half the shares were actually long. If you offset it with a dominoes hedge.

Jeff F.: Then on writing puts, I would wait for now. The stock is risen a lot lately, which we're happy about, but it's a volatile stock. Still a smaller cap company, and in a downturn, you should get a better chance to try at put options and we'll try to alert you to that as well with the catch up trades. I mean, Papa John's last year fell some 40%. This year I think it's nearly doubled. It's been volatile, but a giant winner over the long-term. I think the trends favor that [crosstalk 00:36:47] ultimately.

Jeremy M.: I don't like putting words in Billy's mouth, but based on the price target and some of our conversations, it sounds like he thinks that the stock's significantly overvalued and that we could have an opportunity to even buy back at a much more attractive price in the future.

Jeff F.: MikeB is asking about Wells Fargo again. We did speak to that, so we can maybe just share a few quick words. "For those who haven't sold yet, should we wait and see before selling?" It's a good question. Jeremy spoke to it earlier. I can add that it depends on your personal comfort level with Wells Fargo. Did you own it before you came to Pro? A lot of people have or did. Do you have as much financial exposure as we do, because it's still our largest sector industry by far. That's part of the reason we're comfortable letting Wells Fargo go. It has jumped a lot since the election, so this may be an opportunity to sell it. That said, the animal spirits in the market could continue for a long time if rates indeed start to head higher soon.

Maybe a good compromise is to sell part of it, and let the rest go. It's really, I would say, what you're comfortable with. It's hard for us to say, because we've made our decision, and you, for some reason, didn't. I don't want to force you to do something that you haven't yet, because you might have very good reasons for keeping it.

Jeremy M.: It's a stroke of good luck. Sometimes it's worth just saying, "hey this was a good win." Sometimes, luck goes the other way. You can take your gains. The other question is, whether or not you want continued coverage of the stock or whether you feel comfortable just owning it and covering it on your own, or keeping track of it on your own.

Jeff F.: Yep. We're out, and we'll still watch it and see how customer accounts grow or not in coming quarters. That could tell us a lot about how long it may take them to recover. We do, as we said earlier, have several companies that benefit from higher rates. We're looking at some other ones too. Higher interest rates. A fool member is asking, "I'm heavily invested in Bank of America. It's almost 95% of my portfolio. Aside from selling, how can I protect myself from the recent run up?" Jeremy, they must be an employee of Bank of America, perhaps.

Jeremy M.: I would assume so if ... that's a huge amount of the portfolio, and I think most financial planner would say that's way more risk concentrated in one industry and one company, than what's probably reasonable. That depends on your age. It depends on your overall assets. There's a huge amount of variables that go into that as well.

Jeff F.: Hopefully, none of us want to relive 2008 2009, but you never know. That typical bank stock fell 80 90% at that point. You have to ... most advisors would say we have to diversify beyond this, at least by a meaningful amount. If you just want to protect yourself, it will be expensive, but you could buy put options on the portion of the shares you want to protect. You would buy one put for every 100 shares you want to buy. In your case, if you plan to keep the stock a long time, you might as well buy the very long-term put option. 2019, now. That time value will hold up better than other options. In a year or two, you can whittle that position down, or get rid of it if your situation has changed. If you have less Bank of America at that time. Right now, you could pay a pretty penny in insurance and buy long-term put options to protect as many shares as you want, in Bank of America.

Jeremy M.: Sometimes I find that people don't want to sell a stock that's appreciated, because they don't want to assume any taxes. You really should not let the tax tail wag the dog in this investment decision. You know at this point that if the risk is a possible much larger decline, and loss of capital may be the smart decision to just pay a portion. Sell a part of it. It doesn't have to be an all or none type of deal. I'm also just curious of the reason of not wanting to sell at all. There's always complicating factors.

Jeff F.: All right, Jeremy, so we have about 20 minutes left and maybe 20 questions so far. I have to refresh, maybe there are more. We'll go into kind of a speed round, and try to answer each question. Yeah, many more questions. Okay, so Leon is asking, "Visa has come off it's highs recently. Any thoughts on writing the March 1777 50 puts to potentially get in line with Pro?" I would say right off the bat, you can get in line by buying 2.4% stake. We own 2.4% in stock directly. Shares are around 78 last time I looked.

Jeremy M.: 79.50 right now.

Jeff F.: We are about to talk about possibly buying a bit more. We'll see, who knows, but we like the company as much as ever, and results were healthy last quarter as Jeremy wrote about a few weeks ago in the memo. We recommend just buying 2.4%. If you would really rather target a lower price, you can write those put options definitely, but just realize you may not get shares. You may just get income. Good question.

Dave is asking about a Pro renewal request. "Is three years the best deal? Does everyone receive the same type of offer, or what is the best offer?" I don't know. We are not involved in the marketing of Pro. There should be a wall, and there pretty much is. The best that we can have a wall. I never know the prices they're asking, or the deals that they're offering. I do know that every price I've seen in the past, the longer term is by far the better deal. To the extent, that you can get the longest term you can because it makes your part of your costs, obviously much lower.

I did see on the boards this morning, that some people talking about the three year deal, and saying it was a good deal. For any Pro member who wants that, they can call in to customer service and get that. Those are the few things I do know. Can you comment on Medtronic? I wrote about Medtronic on Friday. Or was it Wednesday, on the discussion boards? Then it's in today's memo too. A link to that. The stock is remaining a buy. The shared price decline looks overdone. The affects that nicked Medtronics revenue a little bit, and their bottom line was still above expectations, because they're doing a great job on costs.

Their revenue was a bit light on things that are largely out of their control. For instance, their new insulin product pump was approved much sooner than they thought. Which is great news, but they won't have it to market until April or so, and now companies are waiting for that new, much better product instead of buying the existing pump. Things like that have hit revenue a little bit, but I think in the long-term it will be fine. The stock remains a buy. It's at 2.8% allocation, and it's a buy still.

We have a question about Amtrust. MackGregUSA owns some Amtrust, but not the whole Pro allocation, which is a little over 5%. Is this a good time to move some funds from Wells Fargo, which I haven't yet sold into Amtrust. Jeremy, do you have thoughts on that?

Jeremy M.: I would say you could move into Amtrust. You could move into any other positions fractionally, if you're trying to build out your portfolio, I would go with the buy first stocks first, and feel bad I don't know if Amtrust is a buy or a buy first.

Jeff F.: It is a buy right now.

Jeremy M.: It's a buy. I know that it's pulled back significantly over the past year. I would say sure. That could be a good opportunity right now, but I would also suggest you look across portfolio and see if there's any other chances to sort of add to a couple positions, rather than just move all your chips from one spot to another concentrated spot.

Jeff F.: Yeah, I agree with that. In the same vein, you don't have to put all 5.7% into Amtrust. Maybe you build Amtrust to 4%, and add a bit more Factset instead. We only have 2% in Factset. Maybe make it 2 1/2%. As Jeremy just said, kind of balance it out across other financial positions. I do in general like that Amtrust hasn't gone anywhere for more than a year. It's kind of just ... it's evaluation gets more and more attractive, because the business is still growing. Yeah, that gradual move can make a lot of sense.

"If Gilead is so cheap, why isn't it a buy first?" Rgregory is asking. The short answer is, buy first isn't just about valuation, it's about risk reward and potential for the stock as we see it in the next couple years. Gilead, the way we view it, could easily go no where in the next few years. I don't feel a great urgency to buy it. Thus, it's not buy first. That said, we think the downside is very modest. We hope so at this price and with this quality business. Yeah, it was a buy first not so long ago. Months ago. Now it's just a buy.

Also, since we are a whole portfolio service, our hope is that you own every company sooner or later, because the whole portfolio is meant to work together. The buy firsts are just a way to get you started into the ones that we think offer a good risk reward balance [crosstalk 00:46:49].

Jeremy M.: Buy still means we think it's a buy at this point in time. The buy firsters, like Jeff said, there can be a lot of reasons why we think that it's fractionally better. One is fractionally better than the other. Looking as Mastercard versus Visa, it's just business momentum right now. Visa's going through a transition. Mastercard is continuing to grow and will probably be able to take advantage of that while they're distracted with consolidating Visa Europe and a new CEO coming in. In the next few quarters, the next year or two, then we just feel like that's probably a better place to put your money first.

Jeff F.: All right, lets see. A Motley Fool options member is asking, "I am taking a beating with the Budweiser January call spread. Are you planning on getting out before expiration?" Definitely not. That's a Motley Fool options position, headed up by Jim Muler. He knows the company very well, including the new merged giant company. We set up, I believe, it's a 2018 spread diagonal call that we will also roll to 2019, 2020. It's something that we're in for the long-term.

Keep in mind that a call option is very responsive to a stock moving. The stock is down some 20%, which is a fair amount for a large cap. The option then will be down twice that. 50% say. It looks painful, but when the stock recovers, we'll earn that back, and we do believe it will recover. Meanwhile, we're earning pretty decent income by writing diagonal calls on that company. To wave the white flag on a company like Anheuser, when we're down, just wouldn't make sense to us. This stock remains a value. The business remains healthy. We're going to keep that position going. Again, that's a Motley Fools options and not in Pro. If you have questions, head over to Options and to the BUD board over there.

All right. Let me refresh my page, Jeremy, and see what we've got. Winston is asking, "Jeff, how long have you been with Pro, and how long do you plan on continuing to manage Pro?" If I could see into the future. I started full time at the Motley Fool in 1996, and from 2004 until now I've been managing a Pro-like portfolio. Pro itself from 2008 until now. For eight years in Pro, and I really look forward to us getting to the 10 year mark and having 10 year returns and the relationships that we built over the years continuing to get richer.

Jeremy M.: Jeff's still a young guy.

Jeff F.: Thanks, Jeremy.

Jeremy M.: He's got another 10, 15, 20 in front of him. I don't want to commit you to anything.

Jeff F.: I mean, sure. Yeah, I don't have plans to leave. I think as long as I enjoy it, and we enjoy working together on it, that we'll be here. As long as it's ... as long as we're succeeding, we'll hopefully be here a long time. Thank you for the question, in all seriousness. It's an important question because your basing our investments on the team, and you're making a long-term commitment when you buy a stock, so you want to know that the team will still be here. That I can definitely say, as we have a strong team and the team, as a whole, will be here no matter what. I also hope to be here, but we're all on the same page regarding the portfolio and how we invest. You have a good team here to rely on, and like any good company, we hope to set that up indefinitely so things can just continue on.

[inaudible 00:50:34] asking, "How does Motley Fool Pro relate to million dollar portfolio? Are they redundant? Am I doing a disservice to myself by monitoring both?" Jeremy, do you have thoughts?

Jeremy M.: I'd say the two services are not redundant. They have an entirely different mandate. The [inaudible 00:50:52] portfolio is only pulling investment stock ideas from other Motley Fool services. They do not employ options or shorting. I don't know what their cash balance is, at this point, but their investments are almost entirely long. Where at Pro, our strategy is entirely different. Our returns should also look very different over time, just because of our intention to not be as correlated with the market and using an options income and other things, to lower our volatility. Plus our mandate of thinking in absolute return perspective, versus a relative return perspective. Changes our behavior and how we think about investment.

Jeff F.: All right, next question is, "Does Pro look at options on things like FAZ, which we're short, or SVXY, which we're long? These are both ETFs." When they reach opposite ends of their trading range. I'll say FAZ hasn't really had a trading range. It's down some 85% for us, which is great as a short. We look at adding to it, and we're overdue to maybe add to it. Although, it's difficult to borrow. SVXY, we're now up 15 some percent in ... has it been a year or a year and a half? I don't know. It's getting close to our North star goals, which I think over the long run, it will exceed. We will look to add to it potentially, when it falls a lot. When the market gets very volatile. On SBXY, we may indeed trade around it a little bit on the downside, but FAZ is just a long-term short that we may want to add to next time it jumps, or at any point. Good questions, but they're both ... the key thing is they're both long-term minded positions.

InternationalWaters is asking, "I have a Polaris position from my time in Motley Fool 1. Are they staying the course or have they given up in disgust?" No, Motley Fool 1 own Polaris, believes in it, and is invested for the long haul. Especially with an equipment maker. Snow mobiles, ATVs, motorcycles, they need to be long-term minded, because it can be a cyclical business like automobiles. They still believe in it, because they really believe in management. They still-

Jeremy M.: Yeah, it's a well run company. I would probably argue it's best to breed with in that industry. It's a tough market right now for them.

Jeff F.: They're still believing in it. "What are your current thoughts on the Deer short?" We did talk about that, and will have an update soon as well. An official update on our thoughts. We're still going through the results. We're probably going to let half our short close via our calls. Okay, we have just five minutes left, Jeremy. I think we can do it.

Jeremy M.: Probably need to update, if you haven't.

Jeff F.: Do I need to update?

Jeremy M.: You might be.

Jeff F.: Oh no. All right, yeah I am behind. Man this is going fast. Okay, if the Fed finally raises rates in December, should I sell my bonds now or is the price already factored in and should I keep them?" That's a great one for you, Jeremy.

Jeremy M.: Immediately following the election, interest rates have increased dramatically pretty quickly. It seems like the market is already priced in that that increase is going to come, and probably subsequent increases are much more likely now. To make that sort of decision, I would think the Fed probably has the all-clear to make this next raise, and then going forward is what's going to determine how bonds respond from there. I think most market prognosticators that I've read ... that that for what you will ... believe they were probably in for measured increases over the next several months going into 2017.

Jeff F.: Casey is asking about four companies. Bud, Casey, Costco, DPLO. They're unhappy with them, are we staying long? None of those are on Pro. The only one I know, and follow, is Bud, which we talked about a moment ago. We own the calls. Diagonal call, we're definitely keeping that going. Follow Motley Fool options for updates on that. That's a long-term position we should be fine on. The other I don't know, Jeremy. I don't know where they come from.

Jeremy M.: It looks like some stock advisor, and maybe a hidden gems of some of the others.

Jeff F.: Please, enter the ticker on the Fool webpage itself. Enter the ticker and it should show you which service it comes from. Then you can go to that service, and get their update on that company on the discussion board or in the service content itself. "Skyworks was called away", a fool is saying, "Please advise what I should do." What we issued ... our recommendations to buy the shares back, and then write the January $75 call options to collect all that premium. You can do that right now, last I saw.

Few more here that we can get through. Jeremy, why don't you look ahead and see any that you want to answer and you can jump in. Meanwhile, when you're ready just say so. GoPro synthetic short. The orders still good. What to do at the NetDebit? Yeah, you won't get the same NetDebit anymore, because the shares are down quite a bit, but I'll have to look at the $10 synthetic short on GoPro and see what that costs. I'll update that on the basket of shorts board. I'll go there.

Jeremy M.: Question from Len, "You mentioned the rise in bonds recently. Does Pro or any Motley Fool service look at bonds or fixed income as part of a total portfolio?" I would say, that I don't believe there's any service other than [Roy 00:56:44] Retirement, that directly advises on bonds or bond holdings. They do have a asset allocation model portfolio that they include bonds, and write about it fairly frequently. We do look at what the bond market is doing, that a lot of times rapid increases are decreases could sort of predict some sort of volatility in the market. I would say, overall we don't spend a lot of our time thinking about bonds or interest rates. We're at a secular, almost all-time low. Odds are, they will probably increase going forward, but I don't know how much, how fast and exactly how the market is going to be reacting.

Jeff F.: Sounds good. Let's get to a few more we can answer in the last couple minutes. Let's see, I just saw one that's timely. Jim is asking expediters, which goes ex dividend tomorrow. Today, we may have our short $50 calls exercise on us. That would be fine. I posted on the board this morning. If that's the case, we'll be short expediter shares, but we own deep in the money calls, that offset that. We'll probably use that opportunity. All the time values gone from the calls at that point, because they were exercised. We may just close the position at that point. It remains to be seen if we get exercised. With the spread so wide on the option, we just have to wait and see if anyone gets exercised. If you do, just post it on the board, so we know on the expediter's board. We'll see where we are tomorrow, and issue an update to everyone if we need to.

Jeremy M.: There's a question on AMT. "What effect do you expect rising interest rates to have on AMT? Hire debt expense and possibly writing down of asset values?" That is true. With interests increase, discount rates increase. The cost of debt increases. At the same time, you have to ask why interest rates are increasing. If it's because economy activity is also increasing, then they're able to grow faster. The fundamentals of the business might be able to outrun any sort of that weight from increased debt cost. The thing that you're seeing in REITs in general right now, they just got broken out of financials at the end of August or the beginning of September. With the market having a lot of sector based ETFs, it's a lot easier for investors to trade in anticipation of what's going to happen with interest rates.

If interest rates go up, their decision rules say sell [REITs 00:59:12]. Sell high dividend stocks. You could have the entire sector moving in more correlated way, where the reality of the fundamentals of the business can be completely different. You're more likely to get some price dislocations, and that's what we're really looking at and why I think Billy likes AMT a lot right now; because the long-term secular trend of wireless has not changed.

Jeff F.: That's for sure. One, two more quick questions. Maybe three, but it is 3:00 so we have to wrap up. How to position now? The answer to that is we like the portfolio as it is now. We're about 72% net long. 22% cash. New member get our portfolio building reports to your inbox, which show you how to go step by step. Take your time. I read about that in today's memo too. Get to a exposure level that you like. We only have 23 companies that we own long, and we like all of them except for one, it's on hold right now. Move into those gradually with those portfolio building reports.

Basket of shorts. Is it still recommended? Yes, all three that we did a few weeks ago are still recommended. There was one more I thought we could get to, but that may be it, because we need to wrap it up we're told. Thank you everyone for being here, in the November Pro chat. Please post any question you still have, on the Pro getting started and help board, or whichever board is linked to from this chat page once the archive is up. We'll be there to answer the questions there. Jeremy, thank you for joining today.

Jeremy M.: Thanks for having me. Welcome to new members, and we look forward to seeing you on the discussion boards.

Parexel Moves to Hold

Published Nov 15, 2016 at 12:33PM

Pro's Take: PRXL Fiscal Q1-2017 Earnings

Parexel International (NASDAQ: PRXL)

What Happened?

- Q1-2017 press release
- Q1-2017 10-Q
- Q1-2017 presentation

....

Q1-2017

Sales growth: -3% Y-o-Y

Backlog growth: +6.8% Y-o-Y

Gross profit margin: +104 bps Y-o-Y to 34%

Operating profit margin: +380 bps Y-o-Y to 10.7% (+65 bps Y-o-Y when excluding one-time restructuring costs)

GAAP EPS growth: +58% Y-o-Y (-4.3% Y-o-Y when excluding one-time restructuring costs)

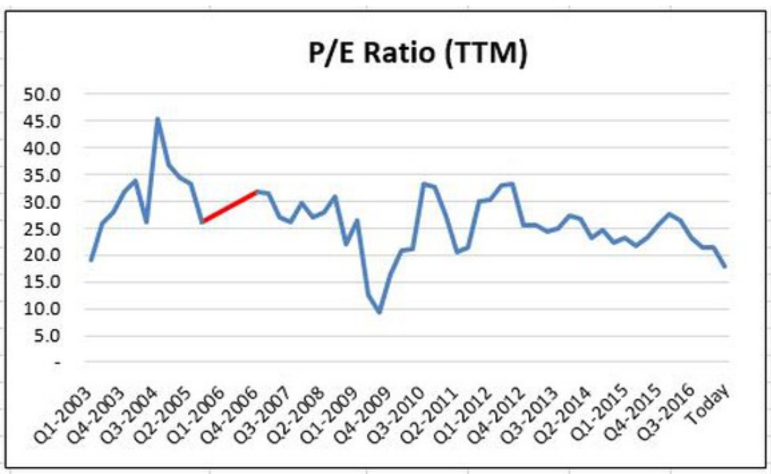
non-GAAP EPS growth: +1.4% Y-o-Y

....

Guidance Update

Parexel **moves to Hold** as we wait to see if management can improve the trajectory of the business and correct its recent slew of mistakes. The company has had two straight quarters of non-timely SEC filings, the first due to a misappropriation of corporate funds by a former employee and the second due to a mistake in revenue recognition in its largest business segment. This is in addition to the surprise resignation of CFO Ingo Bank in July (Bank is now the CFO at OSRAM in Germany). Management has often underperformed expectations during the life of Parexel's position in *Pro*, and our patience is wearing thin.

We may decide to close our position if the stock drifts upward in the near-term, depending on price. The business's financial metrics have generally tracked well against our thesis since the position's inception, but recent missteps and underwhelming financial performance relative to the rest of the industry have shaken our faith in the management team and suggest that Parexel is possibly losing share to competitors. The stock is now as inexpensive it has been since we initiated our position in late 2013, but the lower multiples may be justified by managerial mistakes and a potentially weakened competitive position:



Note: Red line represents outlier multiples that have been removed from the data series.

Updated guidance: Hold (changed from Buy)

Recommended Allocation: 2.8%

Fair Value estimate: $59 (down from $65)

Current Price: $57.13

We are reducing our fair value estimate from $65 to $59, reflecting an adjustment of the weighted probabilities of my bear/base/bull valuation cases, slightly offset by recent growth since the last valuation update. Our new $59 fair value estimate implies a TTM P/E ratio of 18.7x (GAAP) and 17.1x (non-GAAP) and a TTM EV/EBITDA ratio of 9.8x. It also implies a forward P/E ratio of 15.8x (GAAP) and 15.2x (non-GAAP) based on expected Fiscal 2017 earnings. If the company's recent performance is a short term concern (as management has suggested), these multiples are reasonable, if not relatively cheap.

However, if Parexel continues to lose share to competitors moving forward, the stock may have further room to fall. Members lacking a position should refrain from purchasing shares today, and those with current positions should wait until *Pro* changes its stance from Hold. If you are more risk-averse and prefer to sell your shares instead of waiting to see if the recent concerns are short-term in nature, that would be a reasonable choice, but *Pro* is content to either wait for a better selling price or for the potential of improved financial performance.

Our Thesis

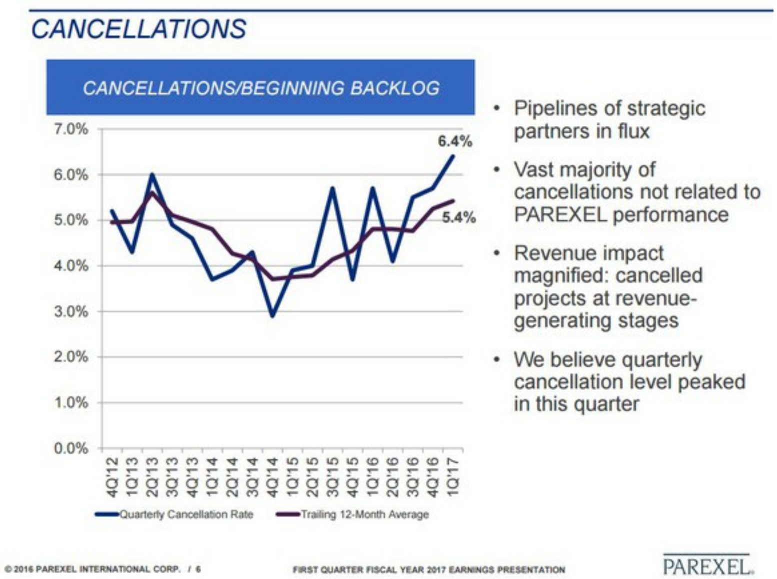
Because of its reputation, global reach, and technology prowess, Parexel International will win its fair share of the growing pharmaceutical development market. In addition, we expect the proportion of R&D dollars outsourced to contract research organizations to grow as large biopharma companies adopt the strategic partnership model and smaller biotechs become responsible for more drug discovery. Finally, as new business wins mature, the true earnings power and margin potential of the company's business will shine through.

The Most Important Things

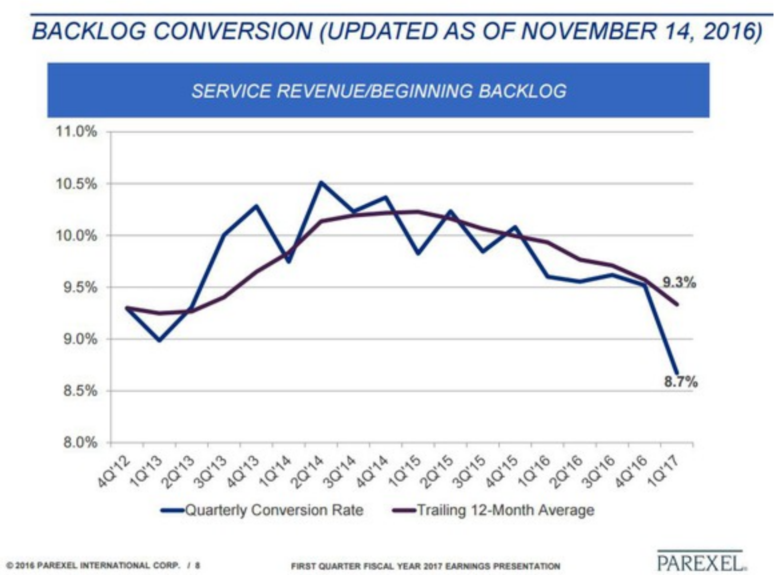
1) ***Penetration and Backlog*:** Penetration refers to the proportion of biopharma R&D dollars that go to CROs versus being used in-house for development and increased penetration provides evidence that the biopharma/CRO partnership model is proving out. We can compare the growth of the biopharma industry R&D spend to the growth in Parexel's backlog to determine whether the CRO industry is experiencing continued outsourcing penetration. We also monitor backlog trends to ensure Parexel is sufficiently adding future business – backlog that converts to sales usually represents ~80% of the sales in any given quarter, so strong backlog growth suggests strong future sales growth.

According to recently released industry data, biopharma R&D spend was up by 4.7% from 2014 to 2015, and it is expected to grow at a 2-3% CAGR from 2015 to 2022. For comparison, Parexel's year-over-year backlog growth in Fiscal Q1-2017 was 6.8%, so we can see that Parexel's backlog is growing at a rate higher than that of biopharma R&D spending. This indicates that the CRO industry -- and Parexel in particular -- is continuing to experience increased penetration of biopharma R&D spending.

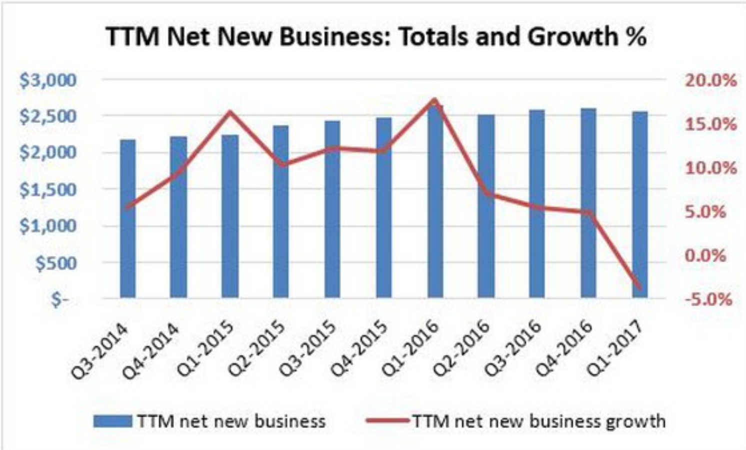
Despite the increased market penetration, recently, Parexel's net new business wins have been slowing, due to both higher cancellation rates...



...and lower conversion rates (pressure on both sides of the backlog equation):



Management continues to emphasize that the increased cancellations are not related to Parexel's performance, but the fact that the increased cancellations and lower conversion are not equivalent across the rest of the CRO industry suggests that there may be more to it than management suggests.



For example, as Parexel's latest Y-o-Y growth figure for TTM net new business is -3.8%, competitors Quintiles (NYSE: Q) and Icon (NASDAQ: ICLR) reported 10% and 2.1% growth in that same figure, respectively, over the same time span. These metrics potentially suggest that the changing dynamics of the biopharma R&D industry may be creating opportunities for some CROs at the expense of others.

However, given the significance of customer concentration in the CRO industry and the fickleness of clinical trials (which can be cancelled on a whim), it's also possible that Parexel is simply experiencing normal lumpiness. In Parexel's quarterly presentation, management stated that they "believe (the) quarterly cancellation level peaked in this quarter", so they're definitely placing a stake in the ground as far as their expectations for future performance. But given the continued managerial missteps, I'm not inclined to give them the benefit of the doubt.

We'll be carefully watching Parexel's backlog conversion and cancellation rates to determine whether or not we think Parexel's competitive position is weakening. Management has long stated that revenue conversion should reach a steady-state sometime in Fiscal 2017, so this year is an important one as far as the trajectory of financial metrics. We want to make sure that Parexel continues to win healthy amounts of new business and continues to grow its backlog at rates in excess of bipharma R&D spending. If the company can do that, the stock price returns from here should challenge our North Star.

2) ***Margin Performance***: Companywide gross margin was down sequentially and increased +104 bps year-over-year. The company's largest segment (representing 76% of total revenue), Parexel Clinical Research Services (CRS) increased gross margins to 30.3% from 29.9% a year ago, but the margin has declined since Q2 last year as revenue growth has slowed.

As for the other two business segments, Parexel Consulting (PC) gross margins declined to 44.7% (from 48.6% a year ago), most likely due to the company's acquisition of Health Advances (which was folded into this segment). I'd expect PC margins to improve over the next few quarters as the company improves upon the cost structure of the newly acquired business. The PC segment represents 11% of companywide revenue.

For the final business segment, Parexel Informatics (PI), gross margins increased to 46.2% (up from 43.3% a year ago). The PI segment represents 13% of companywide revenue.

Management continues to expect significant margin expansion over the rest of the fiscal year, although that expectation depends on satisfactory revenue growth, which at this point is a question mark.

3) ***PI Business Trends:***

Technology is a core competence for Parexel. The company's PI segment is the lifeblood of innovation for transforming the traditional clinical trials process into a more efficient, more effective, technology-driven one. We want to see this business perform well to ensure it remains a competitive differentiator for Parexel and helps it win business in its CRS and PC segments. Now reaching scale, we also expect PI to exhibit operating leverage and become a more meaningful portion of profits.

Revenue growth in this segment was solid at +4.5% year-over-year, coming in at $65 million in revenue for the quarter. The last three quarters have been OK for the PI segment, but I've ratcheted down my expectations slightly for this segment as performance has come in under my prior expectations. My valuation expects PI to grow revenue by 8% annually and achieve 53% gross margins by 2021 (I've lowered these expectations from 10% annual growth and 55% margins by 2020).

What We Think Now

Helping pharmaceutical companies get drug candidates to market, Parexel is poised to benefit as those companies gradually outsource more of this process to select CRO partners who can perform the work better, faster, and cheaper. We also expect margin expansion as recent investments and restructuring pay off and continued growth of the Parexel Informatics technology segment.

Pro Can Help

- Post your questions on our Parexel International discussion board.

Missing the Forest for the Trees

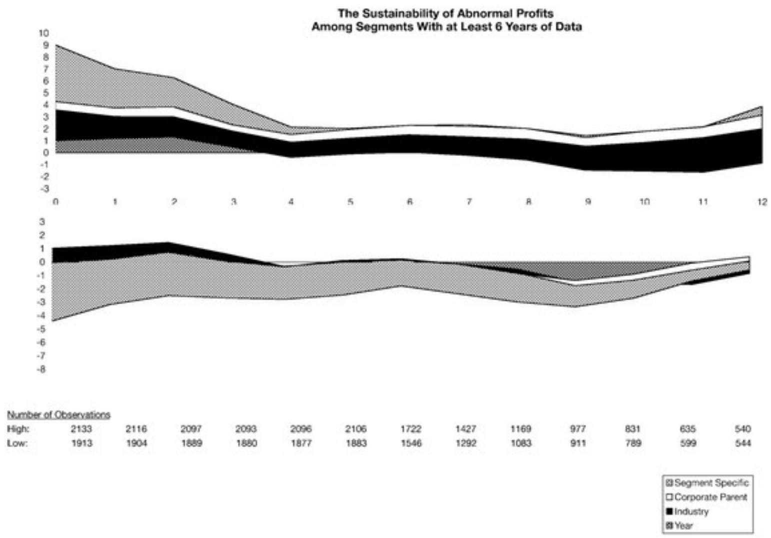
Published Nov 14, 2016 at 2:50PM

Fellow Fools,

What makes a company great? As long-term investors focused on finding great businesses for years to come, we know this question is at the core of what we do at *Pro*. So, if you would, take a moment to consider some of the traits you look for when considering whether to invest in a company. When you look over your list, do you see any common themes?

I've asked this question of myself and others many times over the years, and I've found that people tend to focus primarily on company-specific factors: a great management team, strong revenue and free-cash-flow growth, high returns on equity, and a strong balance sheet. These are important considerations, but they can distract investors from one key factor that plays a huge role in just how great a company can be: the industry within which it operates.

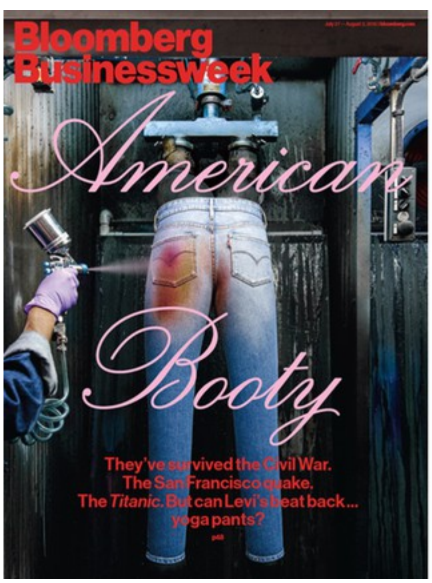
In a 2003 study, A. M. McGahan and M. E. Porter took a look at the data available from publicly traded corporations from 1981 through 1994, attempting to determine what differentiated the high performers from the low. Unsurprisingly, company-specific factors were the primary driver behind the emergence of high performers. But when it came to *sustaining* that outperformance, it was actually industry effects that had the largest influence. This can be seen by looking at the top graph of the subsequent chart. (The larger the bar, the higher the impact a factor had on performance in a given year.)

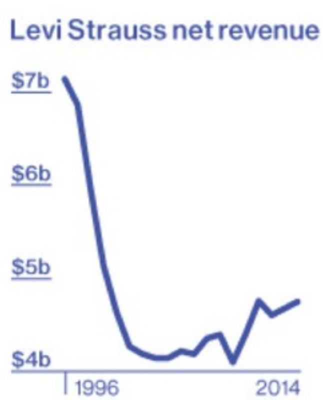


Source: McGahan & Porter (2003), The Emergence and Sustainability of Abnormal Profits

As bottom-up investors focused on finding individual companies, we tend to spend a great deal of time reading and analyzing company-specific information -- annual reports, proxy statements, earnings releases. However, as this study shows, investors who rely too heavily on company-related data in reaching an investment decision are at risk of missing the forest for the trees.

A little more than two decades ago, Levi Strauss & Co. was larger than Nike, adidas, The Gap, you name it. Its financials were very impressive, and although growth was somewhat lumpy, few doubted that the denim empire would continue to expand. After all, the company had been around since the 1850s, and jeans were never going to go out of style, right? Unfortunately for Levi's, the phrase "past performance is not necessarily indicative of future results" is just as applicable to businesses as it is to hedge funds, mutual funds, and ETFs. Sales peaked in the mid-1990s for Levi's, and to this day, the company that's synonymous with denim for many Americans remains a shadow of its former self.

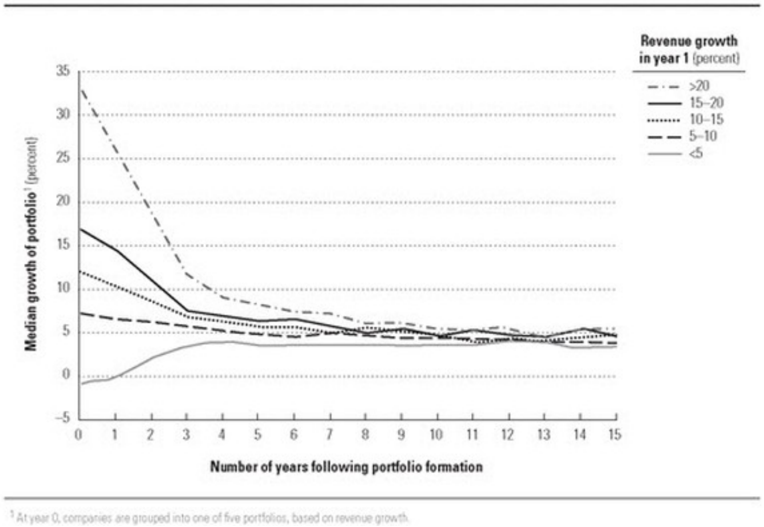




Source: Bloomberg, *Distressed Denim: Levi's Tries to Adapt to the Yoga Pants Era*

Although an evolving industry landscape wasn't the only reason for Levi's precipitous decline, it played a huge role. Most management teams don't want to acknowledge it, but things outside of a company's control (a large customer going belly-up, changing consumer tastes, the emergence of new competitors rejecting industry norms) play a large role in deciding just how great a company can be. You could put the best management team in the world in charge of an automobile manufacturer and it still wouldn't come close to being as profitable as **Verisk Analytics** (NASDAQ: VRSK) because of the differences between the two industries.

So what do we like to look for here in *Pro* when analyzing an industry? Essentially, we're looking for the one-two punch of attractive growth prospects *and* strong returns on invested capital (ROIC), because either one in isolation can actually lead a company to become a value trap. A secular growth industry or a large total addressable market makes for a great story, but growth actually *destroys* shareholder value if the company is investing in projects that generate returns below its cost of capital. Additionally, sustaining above-average growth for an extended period of time is actually extremely difficult, as can be seen in this chart from McKinsey & Company. The companies below were grouped based on how quickly they were growing, and even the portfolio of highfliers saw their growth rates revert to the mean after just a few years.



Source: Ensemble Capital, McKinsey & Company

Similarly, things may look great on the surface if a company is currently generating a high ROIC, but if management is running out of high-ROIC projects to invest in, then future results are likely to look very different. It can be tempting to pat yourself on the back for a job well done and just buy shares if a company appears to be checking off all the right boxes during your initial analysis. But in doing so, you run the risk of turning a blind eye to the full context. (And if you don't believe me, just ask Levi's management team.)

The purpose of today's Memo isn't to scare you away from investing in a company that operates within a subpar industry. Industry is not destiny, and companies can carve out a profitable niche in otherwise unattractive areas. However, absent a clear understanding of where this profit is coming from and whether it's likely to persist, investors are better off looking elsewhere.

One of the wonderful things about investing is that you don't have to take a stance on every stock. You can look for situations where the odds are stacked in your favor because of the confluence of both company- *and* industry-specific factors, which is exactly what we strive to do here in *Pro*. A company that exists within the most attractive industry in the world can make for a horrible investment if the business is run by a bunch of fools with a lower-case f, and the opposite is also true. Or, as Warren Buffett has often quipped: "When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."

Enjoy your week, Fools!

-- JP (TMFYossarian)

More From Motley Fool *Pro*

- MasterCard and Visa Notch Another Solid Quarter
- Trick or Treat With Scary Stocks
- Pro Quality Checklist: AMERCO

Pro Catch-Up Trades and Upcoming Expirations: Nov. 14, 2016

Published Nov 14, 2016 at 2:40PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Facebook** (NASDAQ: FB): Buy up to 6.5%, in thirds over time given new uncertainty in the marketplace.

Continue building your portfolio with our Buys.

- That said, we're not highlighting any in particular this week. Instead, we're going through earnings and trying to assess how the incoming presidential administration may change some industry landscapes.

Shorts:

- **Shake Shack** (NYSE: SHAK): If you have not shorted 0.5% yet, you can do so now. (Note that we have not added more to our short yet.)

Pro options:

- None this week.

Hedges:

- We'll have more on hedges later this week.

Options expiring next (Nov. 18, 2016):

- **Expeditors International** (NASDAQ: EXPD): We'll address our November $48 put/$50 call synthetic covered strangle this week -- watch for a trade alert in your inbox.
- **SPDR S&P 500** (NYSEMKT: SPY): Our November $200/$210 put ratio spread is on track to expire unused (resulting in some income). We're not likely to do anything. Meanwhile, our November synthetic short will be either closed this week or allowed to turn into a direct short of SPY. That decision is in the making. Watch your inbox for an update.

Pro Guidance Changes and Completed Trades: Nov. 14, 2016

Published Nov 14, 2016 at 2:37PM

Pro Guidance Changes (from the past two weeks)

- **American Tower** (NYSE: AMT): Shares move from Buy to Buy First, and fair value increases to $125 from $120.
- **Deere & Co.** (NYSE: DE): Moves to Hold as we consider the situation with this short.
- **Facebook** (NASDAQ: FB): Fair value estimate increases to $124. The stock remains a Buy First.
- **MasterCard** (NYSE: MA): Fair value estimate increases to $90. The stock remains a Buy First.
- **Parexel** (NASDAQ: PRXL): Shares move to Hold as we consider recent news. We'll have an update, of course.

Pro Completed Trades (from the past two weeks)

- **American Tower** (NYSE: AMT): We bought to open a 0.5% stake (five contracts for us) via January 2019 $80 calls. We have not written the short calls yet to make it a diagonal, since pricing fell far away on us.
- **Gogo** (NASDAQ: GOGO): We sold short a 0.5% stake (1,300 shares) at $9.69 (click here for this and the next two shorts).
- **GoPro** (NASDAQ: GPRO): We set up 10 contracts, a 0.45% look-through value, of a January 2019 $12 synthetic short for a $1.08 net cost.
- **Shake Shack** (NYSE: SHAK): We sold short a 0.5% stake (400 shares) at $32.47.
- **SPDR S&P 500** (NYSEMKT: SPY): We set up a 10% synthetic short using options.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Set Up a Diagonal Call on American Tower

Published Nov 9, 2016 at 2:38PM

Is this for you? This recommendation is for all *Pro* members who have matched our 3.8% stock allocation to **American Tower** (NYSE: AMT) and would like to establish an additional diagonal call position to target leveraged upside and income. If you don't own stock in this Buy First position already, we think you should match *Pro*'s 3.8% allocation first, then consider establishing this diagonal call position.

How You Participate

- **Trades:** Use a "diagonal call" or "calendar call" or "spread" order on American Tower to simultaneously:
  - Buy to open January 2019 $80 calls (click "view all strikes" if you don't see them) and ...
  - Sell to open an equal number of April 2017 $115 calls.
- **Allocation:** Invest approximately 0.6% of your *Pro* funds in the net purchase of these diagonal calls (the aggregate cost of both buying the long calls and selling the short calls). At recent prices, this most closely equates to setting up one diagonal call position for about every $500,000 you manage; for *Pro,* that's about five contracts. This is a small position by design, so be careful not to over-allocate. We already own 3.8% in the stock. *Pro* members with smaller portfolios should see the Alternative Trades section below.
- **Price Guidance:** These options are very illiquid, so **it is extremely critical that you use a limit order,** aiming to split the bid/ask spreads. At current prices, ideally you'd pay about a $29.90 net debit on the aggregate diagonal call purchase (again, the cost of both buying the long calls and selling the short calls). Since the bid/ask spread is very wide, that price guidance may not be applicable once *Pro*'s collective volume enters the trade. **So please, make sure you use limit orders, aiming to split the bid/ask spreads, and don't rush to make this trade!**
- **Prices** (as of 2:20 p.m. 11/9/16):
  - **Stock price:** $109
  - **Buy to open January 2019 $80 calls (bid/ask split):** $33.25
  - **Sell to open April 2017 $115 calls (bid/ask split):** $3.35
  - **Net debit:** $29.90 ($33.25-$3.35)
- **Alternative Guidance:** If the volume of trading among *Pro* members results in a significant impact on the options in this alert, or if the stock price changes considerably from the prices in this alert, consider looking at various other strikes for your long and short calls. Also consider looking at various other expirations for your short call, depending on what you like best. If you choose this route, be aware that *Pro*'s course of action may diverge from yours, depending on what strikes and expirations you choose, and depending on the stock-price movements of American Tower.

What We're Thinking

In July, *Pro* closed our diagonal call position on American Tower after the stock had run up well above our $111 short call strike price. At the time, the stock was trading at about $117 per share, very close to our then-current $120 fair-value estimate on the stock. We were content to close our position with a nice 49.5% total return over the life of the entire position (which began in December 2014 with a simple call purchase).

Since then, American Tower has reported good third-quarter 2016 results, *Pro* has raised its fair-value estimate to $125 per share, and American Tower is down about 6% today on unexplained volatility, almost certainly related to macroeconomic (rather than company-specific) factors.

After analyzing the company's most recent results, we feel as confident as ever that American Tower's portfolio of nearly 150,000 sites worldwide (compared with just more than 100,000 sites to begin this year) positions the company to benefit from secular trends in mobile data demand on five continents, and acquisitions and incremental leasing activity should continue to drive revenue, cash flow, and ROIC higher over the long term.

Thanks to that conviction, and to the current volatility that once again provides us with a significant discrepancy between the stock's current price and our estimate of fair value, we think now is a particularly opportunistic time to reestablish our diagonal call position in the hopes of earning current income and leveraged upside.

We aim to keep our position small with a 0.6% allocation, knowing that American Tower may see some further volatility because it tends to trade alongside the volatile, interest rate-sensitive REIT sector. If the stock price continues to fall because of volatility, we may have an opportunity to add to our stake at lower prices. If not, we still benefit from leveraged upside.

This diagonal call purchase will increase our total look-through exposure (both owned shares and calls) to 5.8%, making American Tower in effect our second-largest position. Between this company's demonstrated operational execution, its excellent management, its strong industry tailwinds, and its attractive economics, we think today's diagonal call will prove a smart decision.

More That Matters

- **Maximum loss:** Our entire 0.6% investment if American Tower stock is less than $80 at January 2019 expiration, less premiums received from sold calls.
- **Maximum gain:** On this trade, we have upside to $115 for our owned call, but we plan to keep the strategy going, rolling our short calls if need be.
- **Follow-up**: By expiration, we'll look to write new calls or roll our $115 calls to a later month and different strike price if the stock is above $115. If there aren't attractive rolling opportunities, we will consider closing the entire position.

Alternative Trades

Members for whom one contract would over-allocate their portfolios can consider a few choices:

- Buy 0.6% more in stock, bringing your stake to 4.4%. Realize you won't benefit from the leverage calls provide, although you will have a better breakeven price and no expiration.
- Consider allocating 0.6% to a 2019 bull call spread at small strike increments. The in-the-money $90/$95, $95/$100, and $100/$105 spreads all offer attractive annualized returns if the stock price is above the higher strike price at expiration. Out-of-the-money spreads offer higher returns but an increased chance of total capital loss. The bid/ask spreads are very wide on these bull call spreads, so be very careful with limit orders and keep in mind that spreads with higher strike prices should offer a higher return. Don't be fooled by wide bid/ask spreads, and be demanding with your limit orders. (Our sister service, *Motley Fool Options*, offers what we think is an excellent overview of bull call spreads here.)

Pro Can Help

- **Want to know more about this strategy?** The Options U guide to writing diagonal calls can keep you on an even keel.
- **Questions about this trade?** Consume data and post your questions on our American Tower board.

What a Trump Presidency Means for the Market

Published Nov 9, 2016 at 6:47AM

A special message to all Motley Fool members from Andy Cross, Chief Investment Officer of The Motley Fool

Dear Fools,

In one of the greatest upsets in U.S. politics, Donald Trump has won the 2016 presidential election.

What's that mean for investors? Well, ahead of the opening bell, U.S. market futures are down about 2% — but we don't pretend to know where stocks will go from there.

We all have questions about what a Trump presidency might bring and which laws Congress might pass in the coming years.

And we'll bet that many of you are also wondering what this election means for your stocks — not just tomorrow or next month, but for the next four years. Although we have no predictions that the market will snap back with the same velocity we saw after the U.K.'s surprising Brexit vote, we believe in American capitalism regardless of who goes to work in the Oval Office or the Capitol.

What We're Doing (The Same Thing We've Always Done)

Today and the days ahead, we'll probably see movements in stock prices. Don't let your emotions get the better of you. Don't overreact. Markets will always swing during times of uncertainty, but remember: You're a true investor in businesses that create value for customers, employees, partners, and shareholders, and you're looking out years, not days or months.

Here at Fool HQ, your advisor teams will be studying and analyzing our Foolish companies to understand how a Trump presidency might affect their long-term prospects. To say there are a lot of moving parts is an understatement. But we're analysts, and we'll be doing what any good analyst does: take in new information and revise opinions accordingly. If our opinions change on any of our companies, you'll be the first to know.

Our love of investing in stocks is as steady as ever, and your own faith in the market shouldn't waver now, Fool.

Finally, remember that today is just one day in the market. We Fools will keep investing for the future, with optimism, as we always have, in the way we always have. We're honored that you're doing the same.

Fool on,
Andy Cross
Chief Investment Officer

Verisk Stays the Course

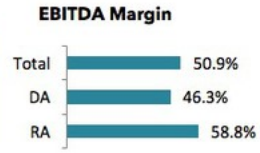
Published Nov 8, 2016 at 4:39PM

As usual at **Verisk Analytics** (NASDAQ: VRSK), the most recent quarter was likely another good baseline for what we'll see in the near term, until capital expenditures in the oil and gas industry start to rebound. Verisk's risk assessment division continues to deliver organic growth in the mid-single digits, although previously announced staff realignments put downward pressure on the EBITDA margin.

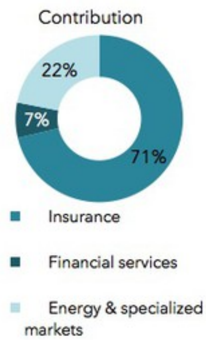
VRSK Q3 2016

Consolidated Results

		change
Total Revenue	$498 million	20.6%
EBITDA	$233 million	22.5%
GAAP EPS	$0.74	13.8%



Segment Results ($ in millions)	Revenue	change
Decision Analytics		
Insurance	$174	7%
Financial services	$34	25%
Energy & specialized markets	$109	0%
Total	$317	6%
Risk Assessment		
Industry-standard insurnace programs	$138	5%
Property-specific rating & underwriting	$43	5%
Total	$181	5%



Source: Company filings

Position Guidance

- **Updated Guidance:** Buy (unchanged)
- **Position Size:** 2.2%
- **Fair Value Estimate:** $80 (unchanged)

Pro's Take

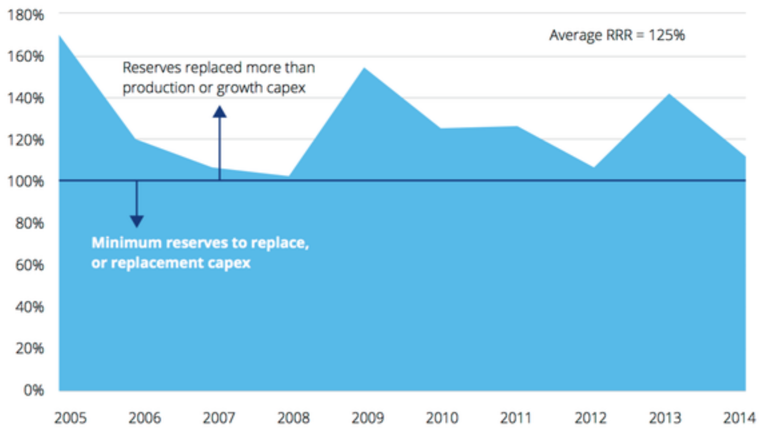
Earlier this year, management suggested that growth was likely to accelerate in Verisk's insurance offerings toward the end of 2016. But although this quarter's results were respectable, the acceleration hasn't materialized yet. Management stated on the call that they still expect it, noting that its absence this quarter was driven primarily by the soft reinsurance market and the fact that some of the company's newer customers are taking longer than initially planned to integrate its solutions into their workflow. Given that these events are largely outside of the company's control, I'm willing to give management a pass this quarter, but if this excuse becomes a common theme as we move forward, we'll need to readdress the situation.

All this might suggest that I'm disappointed by Verisk's insurance unit, but that isn't actually the case. Verisk's product pipeline for 2017 and beyond looks strong, and management continues to find new opportunities to cross-sell as it creates new solutions from existing ones. A great example of this is the recently launched unit providing insurance services to insurers in the commodity sector.

Verisk's energy business continues to be a focus for most investors, especially because it's the division that's currently struggling. I probably sound like a broken record, but it's worth repeating once again that given the current environment, slightly positive organic growth (ignoring the impact of foreign currency) is quite respectable. Customer retention continues to be strong, and additional tuck-in acquisitions have increased Verisk's customer base from 1,000 to 3,000 and created more cross-selling opportunities.

Management also noted the possibility of expanding WoodMac's consulting team next year. That's a really good sign if you think spending on discretionary consulting is a leading indicator of the health of the underlying market, as some sell-side analysts have suggested. I don't know when oil and gas capital expenditures will start accelerating again, but I do know the current run rate is not sustainable. The oil and gas industry needs to replenish drawdowns from current demand and meet demand growth of 1% to 2%, all while dealing with the productivity decline each well experiences over time. According to Deloitte, replacement capex (to maintain current reserves) accounted for about 80% of total spending compared with 20% for growth capex over the prior 10 years. As the authors of the report said, "It takes a lot for the industry to just stay flat." And as the charts below illustrate, current operations are well below the required breakeven.

Figure 1. Oil and gas reserve replacement rate (major oil and gas companies)

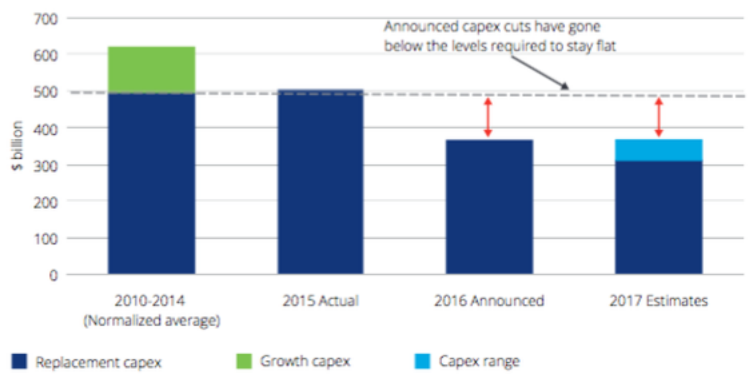


Note: Major oil and gas companies consist of top 50 resource-seeking oil and gas companies listed worldwide, which constitute 27 percent of global oil and gas production.

Sources: Deloitte Market Insights, Capital IQ, Bloomberg, SEC filings

Save PDF to Evernote

Figure 2. Global upstream spending (ex-MENA, $ billion)



Notes:
- Normalized annual capex during 2010-2014 is adjusted for upstream capital cost inflation until 2014.
- Analysts (as of early March 2016) expect a fall of 10 percent to no growth in the industry's 2017 capital spending.

Sources: Deloitte Market Insights, Barclays, J.P. Morgan

Source: Deloitte

Deloitte estimates that at a minimum, the industry will require investments of about $3 trillion from 2016 to 2020 to maintain its long-term health; on an annualized basis, that's 40% higher than 2016's expected level. Whether we'll get there remains to be seen, especially given that Deloitte's estimate greatly outstrips the expected operating cash flow over the same time period, but any growth in CapEx is a definite positive for Verisk.

We first purchased shares of Verisk back in July of last year. At the time, we thought the stock was likely to outpace our North Star target, but we were most excited about its prospects once the company's countercyclical investments in the energy sector started to bear fruit. The resiliency of the energy business during this low point in the cycle continues to increase our confidence that we made the correct decision, and we'll likely add to our position at some point before our expected result comes to pass.

Apple's Core Continues to Expand

Published Nov 8, 2016 at 4:28PM

Late last month, **Apple** (NASDAQ: AAPL) reported results that were essentially in line with expectations, with revenue falling 9% for the quarter even though demand for the latest iPhone outstripped supply. Given that these results did nothing to derail our investment thesis for Apple, we're staying put with our position, even though the stock is down close to 7% since the late-October report.

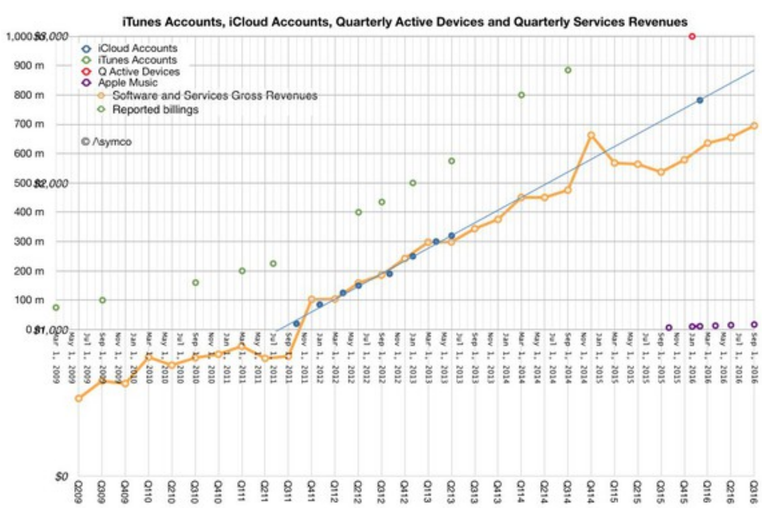
Source: Company filings

Position Guidance

- **Updated Guidance:** Buy (unchanged)
- **Position Size:** 3.8%
- **Fair-Value Estimate:** $122 (unchanged)

Pro's Take

Apple's customer base continues to expand, further increasing the value of its services business, which management expects to generate as much revenue as an entire Fortune 100 company next year. The services division continues to be one of the company's bright spots, with revenue growth up 6% for the quarter and 24% for the year. And while watching iPhone revenue fall 13% this fiscal year might have led some to think Apple's end is nigh, the fact is that Apple is still selling more devices than the number that go out of service, which means it's increasing its user base -- and the number of customers who could end up buying its services. Importantly, Apple is continuing to capture new customers *and* entice its existing customers to sign on for new services, as evidenced by the steadily growing number of accounts.

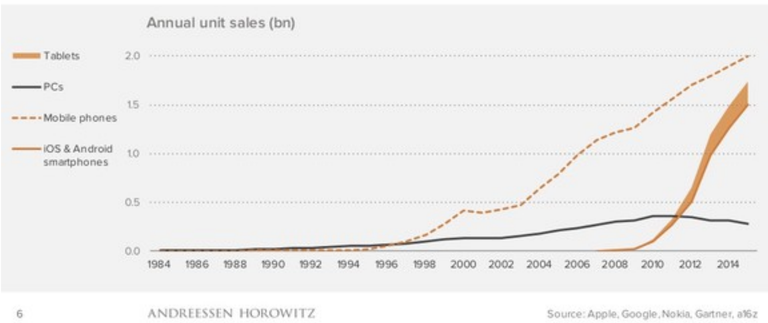


Source: Horace Dediu, Asymco

The importance of this should not be understated. Without these new customers, the only way Apple could expand its services business would be by selling more stuff to its existing customer base and/or raising prices. There are industries that do rely on this approach to a large extent (the mobile game industry, for example); the danger, of course, is that you might eventually alienate your core customers by charging them too much.

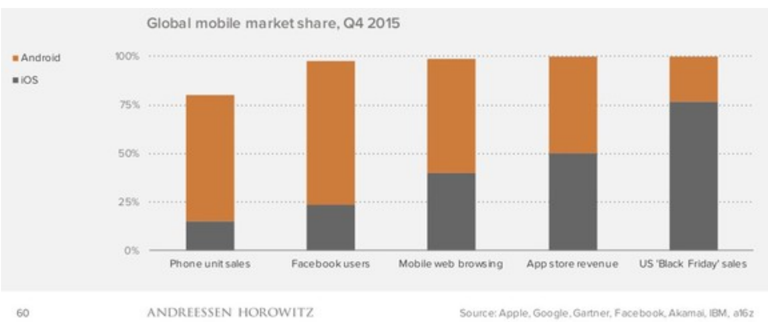
But as long as Apple continues to bring more users into its ecosystem, its business model and our investment thesis both still have legs, despite any yearly fluctuation in iPhone sales. The more users Apple has, the more attractive it is for developers to make apps, services, and content available to Apple users. This in turn attracts more users and encourages them to spend more money within Apple's ecosystem, which in turn attracts more developers and encourages *them* to develop products for Apple's ecosystem, and so on. This self-reinforcing loop is currently working in Apple's favor, but it's important to note that it could also work in reverse should customers start turning elsewhere.

Pricing the company at roughly 11 times free cash flow, the market really isn't expecting much from Apple in the future. From my estimate, embedded in today's price is the expectation that free cash flow will increase at a 2% to 3% rate over the next five years before tapering to 0% for year 10 and beyond. (You can actually model in negative terminal growth if you assume free cash flow will grow in the mid-single digits over the next five years.) We think Apple can do better than this and deliver North Star-beating returns, but for those returns to materialize, the company will likely have to continually demonstrate its staying power. Until then, the market will be tempted to conclude that Apple is just another fallen hardware giant. We believe that thinking is shortsighted, especially because mobile has displaced the PC as the new core ecosystem after a multi-decade reign.



Source: Benedict Evans, a16z

Some might believe that mobile is a winner-take-all market, but I believe both Android and iOS can coexist, given the different value propositions they offer for both developers and consumers. Android smartphone sales may dwarf iPhone sales, but as Apple CEO Time Cook noted on the earnings call, Apple's App Store generated 100% more global revenue than Google Play once again this quarter. And it's not just App Store revenue where iOS captures more than its fair share:



Source: Benedict Evans, a16z

It's not the most exciting company at the moment, but we're more than content to stay the course with Apple, given our belief that its value proposition offers a great risk/reward tradeoff today.

Pro Guidance Changes and Completed Trades: Nov. 7, 2016

Published Nov 7, 2016 at 3:21PM

Pro Guidance Changes (from the past two weeks)

- **American Tower** (NYSE: AMT): Shares move from Buy to Buy First, and fair value increases to $125 (from $120).
- **Wells Fargo** (NYSE: WFC): Shares moved to Sell last week, on Oct. 31.

Pro Completed Trades (from the past two weeks)

- **Gogo** (NASDAQ: GOGO): We sold short a 0.5% stake (1,300 shares) at $9.69 (click here for this and the next two shorts).
- **GoPro** (NASDAQ: GPRO): We set up 10 contracts, a 0.45% look-through value, with a January 2019 $12 synthetic short for a $1.08 net cost.
- **Shake Shack** (NYSE: SHAK): We sold short a 0.5% stake (400 shares) at $32.47.
- **Wells Fargo:** We sold all our shares at $45., ending with a positive but North-Star losing return.

You can see all of our guidance, positions, and transactions from the Recommendations page.

MasterCard and Visa Notch Another Solid Quarter

Published Nov 7, 2016 at 3:21PM

Fellow Fools,

On this Election Day Eve, I'll spare you another prognostication about what a win by candidate A or B might mean for the stock market. As the world waits on pins and needles to learn who will become leader of the free world tomorrow, we at *Pro* are still knee-deep in earnings reports from our favorite *Pro* portfolio holdings, so we'll stay focused. We can rest a little easier because *Pro* is prepared for market volatility thanks to our hedges on the S&P 500 and our growing basket of shorts. We also focus on businesses with resilient business models and durable competitive advantages, like **MasterCard** (NYSE: MA) and **Visa** (NYSE: V) -- companies that aren't likely to be rocked by any single event. Just know that when the dust clears on Wednesday, regardless of who wins, life, the economy, and the stock market will carry on, and *Saturday Night Live* will revert to being less funny.

As I did last quarter, I've chosen to review MasterCard and Visa together; doing so gives a good snapshot of both the global economy and trends in the payment industry. These two positions now account for a combined 7.3% of the *Pro* portfolio, up from 6.8% last quarter thanks to their strong performance over the past three months. Though the world remains volatile, MasterCard's and Visa's strong quarterly results provide further confirmation that the global economy is still humming along.

According to management at both companies, U.S. business remains on a path of slow but steady growth, a recovery is taking hold in the non-U.K. parts of Europe, growth in India is healthy, Brazil looks to be bottoming out, and business confidence is strong in Australia. On the negative side, exports and imports from China are both down sharply, and in the U.K., the long-term implications of the Brexit vote are unknown but the cheap pound sterling is attracting tourists to London. Both companies are seeing increases in cross-border transaction fees thanks to lower currency volatility (with the exception of the U.K.), and both are benefiting from the modest recovery in oil prices. Also, both companies are seeing rebate and incentive costs growing faster than revenue growth as the result of competition for a number of large, multi-year deals. We'll continue to watch this closely, because irrational bidding leading to a price war is the last thing we want to see.

Now, on to the individual results.

MasterCard

4.8% portfolio allocation

MasterCard reported a fantastic quarter in which net revenue increased 14% and diluted EPS was up 19%. Total operating expenses rose by just 12%, impressive considering the amount the company is investing in new technology. Management is focused on expanding its portfolio of services, employing the company's huge, proprietary database to create value for customers through data analytics, loyalty programs, and enhanced security. Revenue from these offerings was up 23% during the quarter. That said, as noted above, growth in rebate and incentive costs outpaced growth in revenue once more, increasing 21% for the quarter. I expect this trend to continue as the payment companies compete fiercely to win new long-term contracts and retain their largest customers.

Management put particular emphasis on the worldwide success of MasterPass, which enables a wide range of digital transactions through mobile payment apps, including Apple Pay and (soon) Android Pay, Microsoft Wallet, and Samsung Pay. Also, the MasterCard Send platform is being adopted by companies like Uber and Lyft to allow instant payment to drivers, and by insurance companies like Allstate to send claims payments directly to customers by debit card for instant access.

MasterCard's ability to spend heavily on research and development is an important competitive barrier to entry, and it should help build stickier relationships over time as the company's products become more ingrained in customers' day-to-day business. CEO Ajay Banga confirmed this strategy during the call, suggesting that analyst should not expect the company to experience significant margin expansion. Instead, they will continue to invest heavily in technology and new product development to maintain MasterCard's competitive edge and create a more diversified revenue stream than just payment processing.

In other news, MasterCard is moving forward with the acquisition of ACH payment company VocaLink as it waits for an antitrust review from U.K. regulators. And while progress in China has been slower than expected, MasterCard continues to sign deals with card-issuing Chinese banks as the government irons out the regulations.

MasterCard remains a Buy First at a 4.8% allocation. After topping expectations for a second straight quarter, it's clear the company has business momentum on its side. MasterCard is signing new clients at a rapid pace, and it remains on the forefront of technology innovation in the payment industry with its new service offerings.

Visa

2.5% portfolio allocation

Visa continues to perform well, just a bit less well than its peer MasterCard. That's understandable given the company's focus on integrating its massive Visa Europe acquisition, which is expected to take years. Management also recently announced a leadership change, with current CEO Charles Sharf to step down in December to be replaced by Alfred Kelly, a 23-year veteran at American Express and four-year member of the Visa board. Thanks to Kelly's extensive experience in the consumer credit market and his intimate knowledge of Visa's inner workings, I expect this transition to be relatively seamless. This news does highlight the challenge of running a global business that's increasingly focused on expanding in Europe and China.

In the U.S., payment volume was up 19% on increasing contributions from Visa's still relatively new partnership with Costco and a similar deal with USAA. Internationally (excluding Europe), the increase was 9%. Currently 19% of revenue, client incentive costs are expected to increase to about 21% in fiscal 2017 as the effects of Europe, Costco, and USAA are seen over the next few quarters. Also, interest expense is set to rise 40% as a result of the $16 billion in debt the company issued last December, as well as an additional $2 billion management plans to issue before the end of the year. Operating expenses were up 27% during the quarter, partly because of Europe and partly thanks to $110 million of severance costs as redundant positions were eliminated. However, again excluding Europe, management did an excellent job of controlling costs in fiscal 2016, with operating expenses only up 1% for the year. This is impressive considering management's continued heavy investments in developing its new service offerings, not to mention the fact that Visa was a major sponsor of the Rio Olympics.

Overall, management thinks the Europe integration is going extremely well, though it will take a few years to completely combine the relevant technology platforms. When an analyst asked whether that process could be accelerated, management noted that they need to maintain a measured pace so their merchant and bank customers can keep up with the changes. Management also expects European processing volume to become gradually more profitable over time, bringing yield more in line with what MasterCard is able to achieve in the region.

Like MasterCard, Visa is investing heavily in its mobile payment application (Visa Checkout). Management also announced that it is opening the Visa platform to card issuing banks and partners, like Google's Android Pay, to allow for better integration and faster authentication and checkout. They're also investing in expanding Visa's portfolio of service offerings, including recent advertising products that allow merchants to better measure the efficacy of their ads and optimize their spending. Visa Direct, which enables push payments from mobile phones, is seeing rapid adoption and should be popular in less developed markets, enabling customers and merchants can use their phones to make a transaction without any additional hardware. To accelerate the development of additional services, Visa has opened five innovation centers in San Francisco, New York, Miami, London, and Singapore, intended to improve collaboration with its customers and improve the time it takes to get a solution to market.

Looking forward to fiscal 2017, management expects net revenue growth between 16% and 18% and EPS growth in the mid-teens. Excluding Europe, expense growth is expected to return to the mid-single digits. Though management is still finalizing its spending requirements in Europe, we know they will be spending heavily to roll out Visa Checkout across the continent and begin the process of merging technologies; the tech investment alone for the merger is expected to cost between $450 million and $500 million over the next three years.

Visa remains a Buy at a 2.5% allocation. The company will have its hands full with Visa Europe over the next few years. In the short term, the business should benefit from a number of improving macro trends likely give growth a boost in the coming year. Even so, of the two businesses, MasterCard currently looks to have the most momentum and could possibly benefit from Visa's divided attention.

The Foolish Bottom Line

If you invest in global capital markets, you'll need to navigate through uncertainty caused by geopolitical events -- it's just part of the package. One group of people will end tomorrow upset, and they may well declare the U.S. doomed and exhort that the world as we know it is coming to an end. That's to be expected following one of the most divisive elections in modern history, but it won't take long for markets to digest the news and look forward to the next potential crisis. (Here's looking at you, upcoming Italian referendum and December Federal Reserve meeting.)

Looking at the big picture, 85% of the global population is still using cash for purchases, which means there's plenty of room for both MasterCard and Visa to grow alongside each other. We're happy to have our portfolio concentrated in high-quality businesses like these, companies that will benefit from a huge secular trend for years to come. For that reason, we remain confident in our current allocation to the payment industry and suggest that members try to match us if they haven't already.

Questions? Comments? Join us on the Memo Musings board!

Foolish best,

-- Jeremy (TMFTank)

Pro Catch-Up Trades and Upcoming Expirations: Nov. 7, 2016

Published Nov 7, 2016 at 3:20PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Facebook** (NASDAQ: FB): Buy up to 6.5%, perhaps in halves or thirds over time.
- **FactSet Research Systems** (NYSE: FDS): Buy 2%.
- **Gentex** (NASDAQ: GNTX): Buy up to 2.8%.

Continue building your portfolio with our Buys:

- **Oracle** (NYSE: ORCL): Buy up to 3.5%.
- **O'Reilly Automotive** (NASDAQ: ORLY): Buy up to 5.1%.

Shorts:

- **Direxion Daily Financial Bear 3X Shares ETF** (NYSEMKT: FAZ): Sell short 0.2% if your broker has shares. If they don't, then set up a January 2019 synthetic short, selling to open January 2019 $30 calls and buying to open an equal number of January 2019 $30 puts. With FAZ at about $31, see if a limit order for a $1.50 net debit gets taken.
- **Gogo** (NASDAQ: GOGO): If your broker has shares, sell short 0.5% per this alert. Earnings were out last week.
- **GoPro** (NASDAQ: GPRO): It's still expensive to short, post earnings. The January 2019 $12 synthetic short (sell to open $12 calls, buy to open $12 puts) will cost an estimated $3 debit to set up, for a $9 start price on a $10.70 stock. Still, the company is suffering and we're staying short right now.

Pro options:

- **Gentex** (NASDAQ: GNTX): Sell to open Dec. 16, 2016, $17.50 puts, aiming for at least $0.80. Sell one put for every 100 shares you could buy at a net $16.70. Selling 23 puts, *Pro* is looking to add 1.5% to our stake, for 4.3% total in stock.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY): Set up the **December $180/$190 put ratio spread** as shared in this alert. Lately, today, it can be set up for a small debit ($0.05); or you can wait for a market drop, which may improve pricing.
- **SPDR S&P 500** (NYSEMKT: SPY): If you want another hedge (this one a 10% stake) set up a synthetic short per last week's alert. Lately, with SPY again back at $212.50, you can sell to open Nov. 18, 2016, $214 calls and buy to open an equal number of Nov. 18, 2016 $210 puts for a net debit of about $0.10 per syn short. This expires in just 11 days, so it's just a hedge against surprises between now, Tuesday's election, and the 10 days after.

Options expiring next (Nov. 18, 2016):

- **Expeditors International** (NASDAQ: EXPD): We'll roll our $48 put/$50 call covered strangle soon, with expiration now 11 days away, as long as the stock stays outside our $48-$50 price range. Watch for a trade alert in your email.
- **SPDR S&P 500** (NYSEMKT: SPY): Our November $200/$210 put ratio spread is in play with SPY around $212. If SPY stays above $210, we'll do nothing and the position expires. If SPY falls below $210, we'll "sell to close" those puts near expiration. And we'll look to set up a new hedge either way.

American Tower Continues Its Global Growth

Published Nov 7, 2016 at 12:07PM

What Happened?

- Q3 2016 press release
- Q3 2016 supplemental materials
- Q3 2016 earnings presentation

CEO Jim Taiclet:

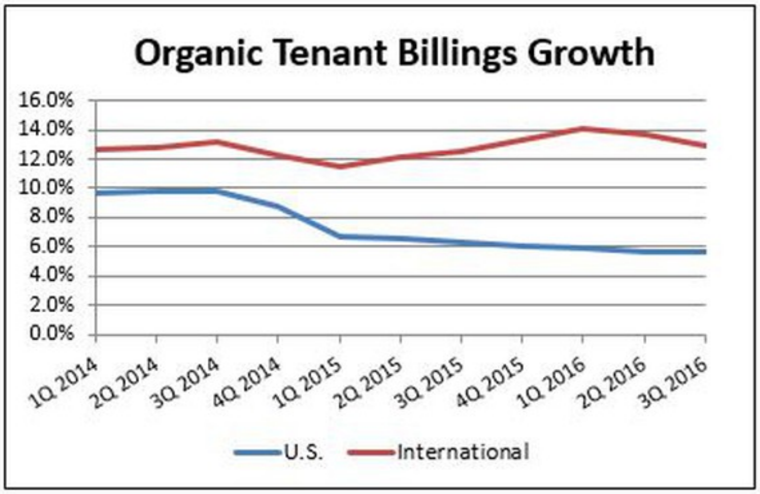
> "In response to rapid growth in mobile data usage, our tenants continue to utilize a combination of incremental spectrum assets, advancing technology and our diverse portfolio of real estate to expand their mobile networks and deliver top quality service to their subscribers. Our global asset base of nearly 144,000 towers and over 700 small cell systems is uniquely positioned to benefit from these continuing investments, and as a result, we were able to extend our long track record of generating double digit growth in property revenue, Adjusted EBITDA and Consolidated AFFO per Share in the third quarter."

So What?

American Tower (NYSE: AMT) reported yet another good quarter in Q3 2016, continuing the company's multi-year momentum with solid organic growth and expanding margins across the entire (growing) global asset base, achieving record levels of new business commencements in the quarter.

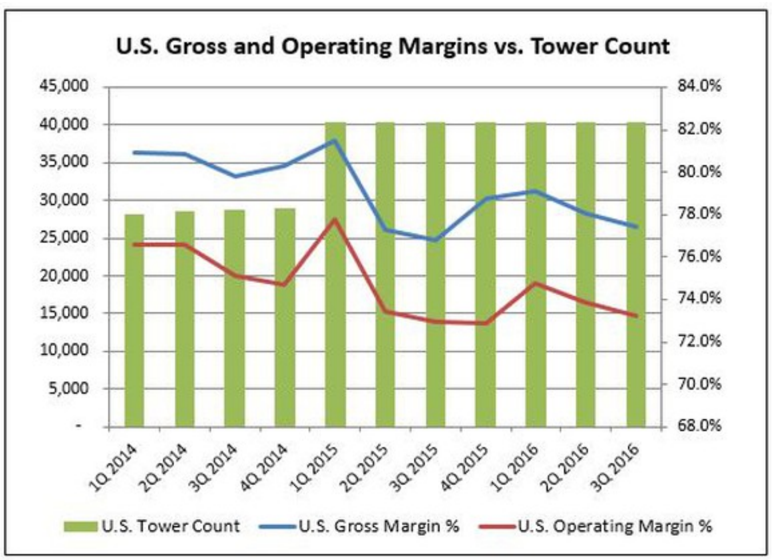
Organic tenant billings (growth attributable to tenant colocations, lease amendments, and price escalations, net of cancellations) came in at 5.7% in the U.S. and 13% internationally (vs. 6.3% and 12.5% in the same quarter a year ago).

International organic growth was broad-based across all regions, up 11.2% in Asia (i.e., India); 12% in Europe, the Middle East, and Africa (EMEA, which includes Germany, Ghana, Nigeria, South Africa, and Uganda); and 13.9% in Latin America (which includes Brazil, Chile, Colombia, Costa Rica, Mexico, and Peru).



Margins increased in the quarter thanks to the strong organic growth, cost controls, and the continued integration and lease-up of nearly 70,000 low-tenancy sites built, leased, or acquired since the end of 2014. These include newly acquired towers in the U.S. (acquired from Verizon), Nigeria (acquired from Airtel), Brazil (acquired from TIM), and India (acquired from Viom).

U.S. gross margins increased year-over-year to 77.4% (from 76.8% in Q3 2015) and U.S. operating margins increased year-over-year to 73.2% (from 72.9% last year), reflecting those trends:



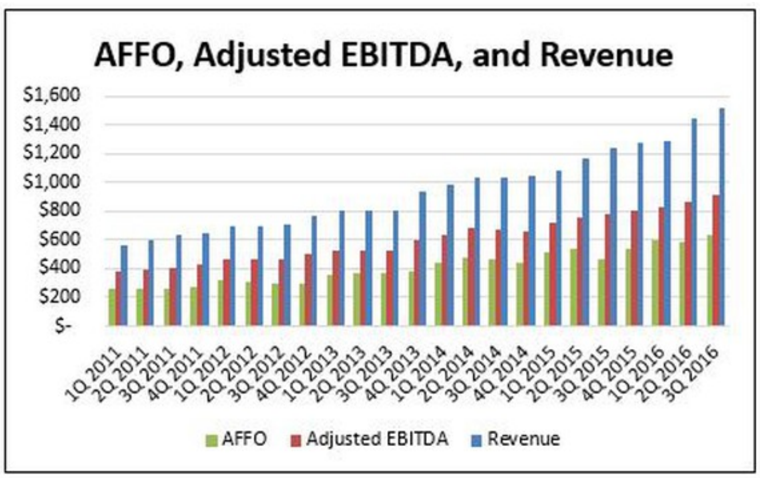
Internationally, margins increased sequentially as the company continues to integrate its newly acquired assets in Brazil, Nigeria, and India:

As for debt, the company's net leverage ratio came in at 5.0x, meeting management's expectation a full quarter early of ending 2016 at 5 times leverage or below. The company has plenty of liquidity (more than $3 billion), and no significant debt maturations until 2018.

Yearly distribution growth continues to track in line with management's 20% long-term growth target, coming in at 20% ($0.55 per share, a 1.9% forward yield on the current share price). Twenty-percent annual distribution growth continues to look like a more than reasonable target for 2016 and beyond.

Now What?

This quarter's report confirms that our investment thesis -- that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time -- is continuing to play out. The company's impressive operating history, excellent management, and strong competitive position in a growing industry give me confidence that American Tower will continue to increase revenue and cash flow at high rates for a long time, providing strong returns on capital (ROIC). The company's portfolio of nearly 150,000 sites worldwide (compared to just more than 100,000 sites to begin this year) positions the company to benefit from secular mobile data demand trends on five continents, and acquisitions and incremental leasing activity should continue to drive revenue, cash flow, and ROIC higher over the long term:



Data and Guidance

- Current Price: $115
- Fair-value estimate (**updated**): $125
- Allocation: 3.9%
- Market Cap: $48.9 billion
- EV/EBITDA (TTM): 19.8

AMT moves back to Buy First, with an updated fair-value estimate of $125 per share and an allocation of 3.9%. If you've yet to start a position, now is as good a time as any to match us. The stock may experience volatility in the short term because of its tendency to trade alongside the interest rate-sensitive REIT sector, but over the long term, the underlying strength in business fundamentals should shine through.

Fool on!

-- Billy (TMFBillyTheKid)

Set Up a Synthetic Short on SPY

Published Nov 2, 2016 at 2:06PM

Is this for you? As ever, be calm and cool and take your time. Assess. This is for any *Pro* member who wants another market hedge in place this month, and who uses a margin account. This split-strike synthetic short will closely mirror price movements in the index, once our strike prices are met, benefiting if the market falls more than a few percent. Those wanting to hedge in an IRA, or just short SPY directly, can consider the alternative trades at the end of this report. This hedge does not change our November or December put ratio spreads, which remain in place.

How You Follow Along

- **Trade:** Use a spread order to set up a synthetic short on the **SPDR S&P 500** (NYSEMKT: SPY):
  - Sell to open Nov. 18, 2016, $212 calls
  - Buy to open Nov. 18, 2016, $208 puts
- **Allocation:** Set up one of each option for every $20,700-equivalent hedge you want (that's based on the $208 put strike price times 100). With this position, *Pro* is hedging 10% of its total portfolio value (cash included), or approximately $261,000, so we're setting up 13 contracts of each option for exposure to 1,300 shares at $208.
- **Price (1 p.m. ET) and Guidance:** With the ETF at $210.20, a small debit of about $0.05 is necessary. That price will change, and you may need to change strikes, too, but generally aim to pay no more than $0.15 per spread to set up the synthetic short.
- **Later Guidance:** If SPY moves much in price before you act, you may want to move both of your strikes up or down accordingly, to continue to roughly straddle SPY's price and set up a split-strike synthetic short for a debit of less than $0.15.

What We're Thinking

Election results always have the potential to surprise, and the stock market rarely loves surprises. Going into Britain's European Union vote in June, polls showed a tightening race, but a lead for voters opting to stay in the EU. Bookies actually put the odds of the UK staying at 90%. But you know how that vote turned out, and in the next two days the S&P 500 declined more than 5%. Why were the polls wrong? Any number of reasons, but some believe it's because young voters didn't show up on voting day, and the assassination of UK lawmaker Jo Cox days before the vote apparently changed moods, and minds, in a way polls couldn't capture at the last minute.

This year's U.S. presidential race has been the most toxic in memory; everyone just wants Tuesday's election over with. Polls and odds-makers give the likely win to Hillary Clinton, but it's still possible the election could go to Donald Trump, which would surprise many. Right now, the Upshot election model gives Clinton 88% odds to win, but that means an upset would be an even bigger surprise, even as polls are tightening. Whichever candidate wins, the market could become volatile in response. Assuming more Democrats win on Capitol Hill, a Clinton victory would likely lead to higher tax rates in general. A Trump win would represent a wild card, because other than wanting to lower taxes, not many of his policies are spelled out, and he lacks a political background. Uncertainty could also result if the election is contested or drawn out for any reason.

In this environment, we're simply going to set up another hedge – *just in case*.

Why This Strategy

This particular position is a *split-strike* synthetic short, because the two strike prices differ modestly. Its effects on our portfolio are similar to those of direct exposure to the underlying investment, as a short in this case. This position will benefit if the S&P 500 declines on any surprise, but we may be looking to close it before the Nov. 18 expiration. Although history doesn't repeat, the S&P 500 recovered most of its losses after the Brexit vote within just four trading days, and all the losses (and more) within eight.

This synthetic short gives us losses if the S&P 500 rises above our short call strike, and provides gains if SPY declines below our long put strike. Between those two strikes ($208 and $212), the position will be on track to expire with basically no cost to us, and no harm.

This hedge complements our November $210/$200 put ratio spread, which we set up in August for a credit (and which can be set up for a *debit* of about $1.55 each today -- a bit rich for my taste, but if you wanted to match us, that's the price today). That hedge and our December put ratio spread remain unchanged in the portfolio. Unlike those put ratio spreads, this new synthetic short provides unlimited upside potential for us as the market falls and unlimited losses as the market rises. It's very similar to just shorting SPY itself. The reason a synthetic short is being used instead is that it gives us a little leeway for SPY to rise before we start to show losses by expiration. Plus, the expiration date helps keep us true to our purpose: We only want this for right now, mainly to cover election uncertainty, and then we'll reassess.

If SPY rises and we *do* end up accepting short shares of SPY through our short calls, for instance, we might write covered puts on them until we end the position. On the flip side, if SPY falls, we can sell our puts for a profit anytime, or turn them into short shares and stay short.

You of course don't need to set up this short if you don't want to. Only do so if it makes sense for your situation. Given *Pro's* goals, and our 6% return so far this year, we want to take steps to protect some of our gains should a steep downdraft occur. Our various hedges and shorts are one step in that direction. Our Nov. 18 $210/$200 put ratio spread, set up in August, *was* intended in part to protect against election risk. But today it seems there's greater chance for a "November surprise," or at least unrest, and thus ... today's alert, tacking on another hedge.

Alternative Trade

- **IRA-Friendly:** If you're using an IRA and can't set up a synthetic short, you can consider a bear put spread. Sell to open Nov. 18, 2016, $200 puts, and buy to open an equal number of Nov. 18, 2016, $210 puts. This will lately cost you about $2.43 per spread (again, not cheap right now, but that's all you risk, no more). Set up as many spreads as you care to risk $243 each on. The position has a maximum value of $10 ($1,000) if SPY ends below $200, and the spread ends worthless if SPY stays above $210. Keep in mind that you might already have a similar (or identical -- it was our alternative guidance in August) spread set up as per our earlier put ratio spread trade for November. In that case, only add more spreads if you want to pay more money into your insurance pool (that's what these hedges are: a form of insurance). If SPY moves much in price before you set it up, you may want to move your strikes accordingly, still aiming to pay not much more than $2 for a $10 spread.
- **Short SPY directly:** You could just sell short SPY directly if you prefer, in your preferred allocation. It's an immediately responsive position, up or down, without a price cushion above the current price, but also without a need to wait for results on a decline.

Pro Can Help

- **Want to talk about our SPY hedge strategies?** We have a discussion board for that.

Sell Short GoGo, GoPro, and Shake Shack

Published Nov 1, 2016 at 2:56PM

Is this for you? Take your time. Be calm. Assess. These recommendations are for *Pro* members who are comfortable continuing to build a basket of short stocks, who have margin accounts that have shorting availability on these stocks (there are no IRA-friendly alternatives; the puts are expensive), and who intend to remain with *Pro* for help managing the shorts (shorting is hands-on, and we can't give you further guidance if you're no longer here). Of course -- and as always in *Pro* -- you don't need to short if you don't want to. Because short shares are hard to find, many members may need to consider setting up synthetic shorts instead, which are alternative trades directly below. Whichever path you choose, even if it's none, you'll get the entertainment and education of watching us sell short!

How You Follow Along

- **Trade:** Sell short 0.5% in **GoGo** (NASDAQ: GOGO)
  - Timely note: Earnings are due Thursday, Nov. 3, before market open.
- **Shares Available** (Interactive Brokers): 600,000 at a 4.48% annual fee
- **Recent Price (and Guidance)**: $10 (use a limit order for $9.70 or higher; adjust lower if needed, but use a limit)
- **Alternative Trade**: January 2018 $10 synthetic short
  - Sell to open January 2018 $10 calls; buy to open an equal number of January 2018 $10 puts
  - Price: Aim for a net debit of $0.70 or lower

- **Trade:** Set up a 0.5% synthetic short in **GoPro** (NASDAQ: GPRO)
  - Timely note: Earnings are due Thursday, Nov. 3, after market closes.
- **Shares Available** (IB): None found
- **Recent Price:** $12.85
- **Official Trade**: January 2019 $12 synthetic short
  - Sell to open January 2019 $12 calls; buy to open an equal number of January 2019 $12 puts
  - Price: Aim for a net debit of $0.75 or lower

- **Trade:** Sell Short 0.5% in **Shake Shack** (NYSE: SHAK)
  - Timely note: Earnings are due Wednesday, Nov. 9, after market closes.
- **Shares Available** (IB): 500,000 at a 3.15% annual fee
- **Recent Price (and Guidance)**: $32.10 (use a limit order for $31.75 or higher; ditto the "adjust" advice above for Gogo)
- **Alternative Trade**: January 2018 $30 synthetic short
  - Sell to open Jan. 2018 $30 calls; buy to open an equal number of Jan. 2018 $30 puts
  - Price: Aim for a net **credit** of $1.70 or higher

All prices will change as the shares move, but the stocks will continue to be recommended as Short in *Pro* unless we say otherwise; we'll update guidance for newcomers as necessary in the weekly Catch-Up Trades we send on Mondays. You can short before the earnings dates above, or wait until after if you prefer. We hope to act before earnings, not because we have a crystal ball but because earnings will likely help some shorts in our basket and not others, and our time frame is generally a year or more.

What We're Thinking

The first point to make is that while this is a mini-basket of short positions, it's only a *small part* of the mega-basket we hope to continue to build. Having many small short positions should decrease the risk to our portfolio during a sharply lower stock market because historically a majority of stocks -- including the best companies -- decline in price when the market falls. And these three don't qualify as "the best," as each has their own shortcomings or challenges that we'll outline. We expect our current short basket -- these three positions, plus our other shorts -- to grow over time, but we want each position to start small. This approach means that any particular short that runs sharply against us (and some will!) shouldn't hurt the portfolio much. And if a position does rise, we should still have some room to short *more* of it if we decide that's the optimal next move.

So, we discourage you from setting up just one or two of these shorts; our advice is to set up all three or none at all. (Ultimately, of course, it's your call!) Keep in mind that the *Pro* portfolio is managed as a whole, with the goal of earning desirable *overall* returns. It's unrealistic to expect every position to make money, but we aim to make money overall, ideally while facing less risk than a long-only portfolio. One of the ways we mitigate risk is by employing shorts like these as a separate, intermediate-term, complementary strategy to our long-term investments. So with that out of the way, why these stocks?

GoGo

If you fly even a few times a year, you've probably run across Gogo's services in an airplane. The leading provider of in-flight Internet connectivity, Gogo offered WiFi on approximately 9,600 planes at the start of this year, or approximately 20% of the world's passenger and business fleet. As 2016 began, Gogo had contracts to install its equipment on approximately another 800 planes, off-set by about 220 *de*-installations as older planes fly off to a happy retirement. The company's initial ground-to-air WiFi was universally panned as slow and unreliable, but its new 2ku technology is getting much better reviews. That said, we're not here to argue about technology, or management, or future installations. The short argument here is much more broadly based: Connectivity is an expensive business to provide, and it's unlikely Gogo will ever make enormous profits providing it. The fees Gogo pays to satellite providers, its costs to install, monitor and maintain its equipment, and the increasing competition that will likely push prices it can charge lower: All of these points demonstrate that this is a tough industry, one where even the leader lacks strong financial advantages.

To date, Gogo has racked up negative $857 million in retained earnings, nearly equivalent to its current $791 million in long-term debt. Expected to lose more than $1.50 per share each in 2017 and 2018, the company isn't estimated to turn a profit until 2020, when the current guesses predict a $0.28-per-share gain. That assumes that many things go right (pricing holds up, airlines stick with GoGo as competition from **Viacom** (NASDAQ: VIA) and **Panasonic** (PCRFY) grows, technology doesn't leapfrog it). But perhaps most challenging, Gogo needs to manage its own costs and debt effectively even while trying to expand. The company's latest $525 million in six-year debt (issued this summer) carries a 12.5% interest rate, showing how risky its investors deem the business.

Even so, we're not banking that Gogo will take a steep dive and never recover, though that could happen. No matter where it's provided, Wi-Fi connectivity has proven a challenging business for all but the few giants that serve the home. What we're really banking on here are sustained economic losses at Gogo over the next few years, which should combine with growing competition to keep the stock in a holding pattern at best and send it lower when the stock market hits turbulence. We may take our profit if we get a 20% or 30% gain from recent prices, or we may add to our position if the stock rises at least 20% against us and we still feel the odds are stacked against sustained, large profits for Gogo down the road. We'll short 0.5% directly, assuming our broker still has shares. If not, we'll set up the synthetic short.

GoPro

The action camera retailer has issues. Its Hero 5 camera is rejuvenating its tepid sales, and may even bring profit back again for a few quarters, but that's about where the good news seems to end right now. Apparently because of supply constraints, the company stopped providing the Hero 5 through **Amazon.com** (NASDAQ: AMZN) after its early-October debut. Reports from analysts at Longbow suggest those issues are still present. New delays for the company's new drone, the Karma, only add to the difficulties GoPro seems to be facing. After earlier delays that stretched months, the company set an Oct. 23 ship date for Karma in September, but last week we saw that date bumped to Nov. 14 and then again to Nov. 28. At least some potential Karma buyers for the holidays are likely now shopping elsewhere, because competing drones are abundant -- and they're good (by some arguments, already superior to Karma and at lower cost). But even if Karma is a moderate hit, GoPro's financial challenges will likely persist for the long term.

Over the past 12 months, GoPro's revenue of $1.24 billion was below the $1.39 billion seen in 2014, and well below last year's $1.62 billion. Net losses ballooned, hitting $215 million in the last 12 months as margins fell through the floor. Unless it's selling cameras in volume and at lofty prices, GoPro's expenses outweigh its profits. (Welcome to the highly competitive, fast-changing world of consumer electronics.) The other challenge GoPro faces is the uncertain size of its end market. Adventure cameras are still a niche product; the company shipped 6.6 million cameras in 2015, up 27% from 2014, but still a tiny number relatively speaking. For most people, the camera on their phone is their go-to device. But more concerning than units shipped are the challenging financials; despite selling more cameras last year, GoPro's GAAP and non-GAAP profits fell sharply year-over-year (down 72% and 46%, respectively). Profit margins declined as the company sold cheaper cameras. Margins may improve this coming quarter with a move away from that strategy, but unit volume may not. GoPro is expected to lose more than $1 per share this year, then show a smaller loss in 2017 before turning modestly green again in 2018 -- but that's a distant guess based on hope. For that to happen, the market for action cameras and GoPro drones needs to sustainably grow, and given rampant competition, it may not.

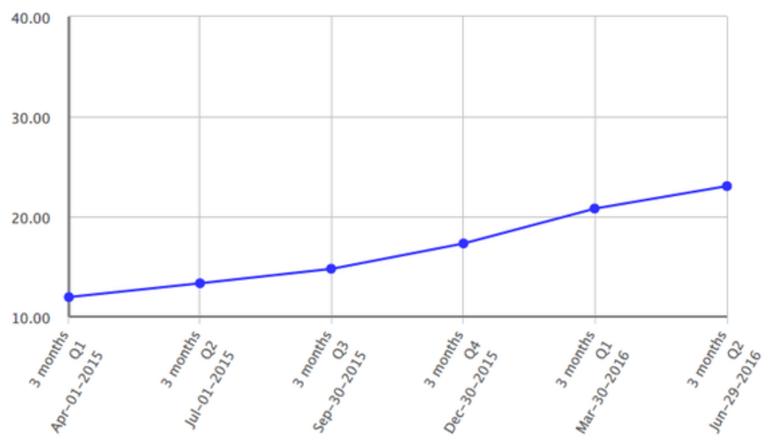
As with Gogo, the odds appear stacked against GoPro generating robust profits in a sustained fashion -- at least anytime soon. Although we expect the stock to be volatile during the holidays (for better or worse), the longer-term story should be one of challenge: The company must figure out how to keep selling more high-end action cameras and drones at premium prices, even after the holidays and the novelty have departed. It won't be easy, so what will matter more than holiday volume will be the outlook for the months after. With shares unavailable to borrow, we're setting up a small 0.5% synthetic short.

Shake Shack

Here's a profitable company selling popular burgers and shakes, seemingly well-run by management, and treating its employees well. The only beef we have with the business itself -- other than burgers and shakes being an incredibly *crowded* category -- is that Shake Shack's international franchise model doesn't lend itself to a good handle on food quality, which risks tarnishing the brand in far-flung locations around the world. But that aside, Shake Shack is doing well in the U.S. with its company-owned stores, with revenue-per-store metrics that are the envy of the industry. So why are we shorting Shake Shack at all? It's just that there aren't many locations yet, and won't be for years, making it hard to justify the company's valuation.

As of June 29, the company operated 51 domestically owned Shacks; six others are licensed in the U.S., and all 38 international locations are licensed. Because the revenue on licensed locations is small, we're going to focus on the owned Shacks. With Shack's recent $1.18 billion market value, owned locations are being valued at about $23 million each. Shake Shack reported $64.4 million in sales for the 13-week quarter ending June 29 (excluding $2 million in fees from its licensed locations). Spread across 51 company-operated restaurants, there's about $1.2 million in revenue attributable to each owned Shack for the quarter. Multiply that by four and you get $4.8 million in annual sales each. That's outstanding, but when valued at $23 million each, each location is priced at 4.8 times sales. Most chains command multiples of less than half that. Sure, Shake Shack is growing more quickly than most, but its growth rate is slowing, and each new location expands the whole pie by a smaller percentage, meaning it will take years for that value multiple to contract -- unless the stock declines.

So far, that appears to be the Shack's path; the stock is cooling off, down steadily since coming public, but it's still expensive for most any business, let alone a burger chain. The company is expected to top $1 in earnings per share ($1.12 to be exact) ... in 2020. So, at $32, shares trade at 28.5 times expected earnings looking ahead *four years*. Even if the business does well, that's a long time to wait for a near-30 P/E. And if the business hits a rough patch, or the market does, shares will likely sell lower because of valuation. Meanwhile, the number of average diluted shares outstanding has been growing sharply:



The Foolish Bottom Line

These three small 0.5% positions are meant to be part of a bigger whole -- a book of shorts we continue to build in the *Pro* portfolio. Remember that shorts are usually shorter-term positions, and we're likely to close any that aren't working out within mere months rather than waiting much longer. Maintaining a book of shorts is more time-intensive than long investing, but it's worth it if this helps the portfolio succeed in weak markets and doesn't drag our returns much lower in strong ones (ideally, it won't drag at all -- but that's a high bar). Each of these companies has strengths and weaknesses that makes it an interesting, but not risk-free, short. Gogo leads its market, albeit unprofitably. GoPro leads its niche, albeit unprofitably of late, and it's fighting an uphill battle to consistently expand at the price points it needs for high profits. Shake Shack is an admired young chain, but that's about as far as the novelty goes -- give it time, and it's likely another aging hamburger-and-shake store in a crowd of many. Maybe it will outdo the others operationally, but trading at nearly 30 times expected 2020 earnings, the stock appears likely to stay stalled or slip for the time being.

Bring any questions to the new *Pro* Basket of Shorts discussion board!

Pro Catch-Up Trades and Upcoming Expirations: Oct. 31, 2016

Published Oct 31, 2016 at 2:57PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **FactSet Research Systems** (NYSE: FDS): Buy 2%.
- **Gentex** (NASDAQ: GNTX): Buy up to 2.8%.

Continue building your portfolio with our Buys:

- **Oracle** (NYSE: ORCL): Buy up to 3.5%.
- **Valmont** (NYSE: VMI): Buy 1.9%.
- **WisdomTree Emerging Markets SmallCap** (NYSEMKT: DGS): Buy 1.8%.

Shorts:

- **Direxion Daily Financial Bear 3X Shares ETF** (NYSEMKT: FAZ): Sell short 0.2% if your broker has shares. If they don't, then set up a January 2019 synthetic short, selling to open January 2019 $30 calls and buying to open an equal number of January 2019 $30 puts. With FAZ at about $31, see if a limit order for a $2 debit or less will work.

Pro options:

- **Gentex** (NASDAQ: GNTX): Sell to open Dec. 16, 2016, $17.50 puts, aiming for at least $0.85. Sell one put for every 100 shares you could buy at a net $16.60. Selling 23 puts, *Pro* is looking to add 1.5% to our stake, for 4.3% total in stock.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY): Set up the **December put ratio spread** as shared in this recent alert. Lately, today, it can be set up for a small debit ($0.07); or you can wait for a market drop, which may improve pricing.

Options expiring next (Nov. 18, 2016):

- **Expeditors International** (NASDAQ: EXPD): We'll look to roll our $48 put/$50 call covered strangle closer to expiration, which is in 18 days, if the stock is outside the $48-$50 price range.
- **SPDR S&P 500** (NYSEMKT: SPY): Our November $200/$210 put ratio spread is still in play with SPY around $212. If SPY stays above $210, we'll do nothing. If it falls below that level, we'll close our put(s) near expiration. And we'll look to set up a new hedge either way.

Trick or Treat With Scary Stocks

Published Oct 31, 2016 at 2:57PM

Dear *Pro* Member:

Goblins and ghouls are out roaming the streets tonight, but that's not the only place to find them -- a few are haunting our portfolio, too. That said (to adroitly switch motifs), a baseball team can lose 67 games in a season (only winning 58% of its showings, like Cleveland), and still end up leading the World Series. Likewise, investors can never expect perfection; instead, we seek to win *overall*.

That doesn't mean we ignore problem positions. On the contrary, our problems get much of our attention here in *Pro*, because we have limited funds and we want our money (strategic cash ultimately included) positioned to perform. With that front-of-mind, let's run through the handful of gremlins in the portfolio today.

Ghoulish-Looking Positions

Deere & Co. (NYSE: DE) **Short:** Deere's sales and outlook have driven lower since we initiated our short early this year, but the stock price is up as investors bank on a bottom to the heavy farming, mining, and construction-equipment sales cycle. We believe the end of that cycle may yet be years away, but if our short (currently down 17%) moves 20% against us, we'll automatically reconsider it. We may take protective action or close altogether to limit our loss. We believe in our thesis, but only arrogance would have us convinced that the market needs to see it our way, too -- in fact, the market may differ from us eternally on this one. So we're waiting to see what the stock does next. You'll be first to know if we change our position.

Gilead Sciences (NASDAQ: GILD): The Hepatitis C and HIV drug giant has suffered a brutal year, judging by the 27% decline in its stock (we ourselves are down 6% for the year, not including dividends). Why so glum? Because revenue has topped out. Until Gilead produces a giant pipeline hit or acquires something big, total sales are not likely to grow. That's because revenue from the company's hepatitis drug, though healthy, is falling below peak debut levels, and current drug pricing suggests the biggest annual profits for the franchise have already been made. The hepatitis drug should nonetheless be a blockbuster cash cow for years, though, and with the stock trading at only about 6 times earnings, we can't bring ourselves to give up on it. Management is adept at increasing value and is spending much of each waking day working on that very thing. We can give them the benefit of the doubt and lend them our patience because the business remains so financially strong. We're comfortable with our 2.5% stake, and Gilead remains a Buy.

Oracle (NYSE: ORCL): We have a 67% gain on this position, but that was earned more than a few years ago; since then, the stock has disappointed. The company's cloud strategy is gaining traction (Oracle has some of the fastest growth rates and biggest customer adds of anyone in cloud), but there's no denying the decline in its legacy database software business. Software is changing all the time, and even the biggest leaders aren't immune to nimbler competitors. And Oracle was late to the cloud server business. But shares are inexpensive, and the business healthy enough, that we want to see how results continue to shake out. We're comfortable with our 3.5% stake, rated a Buy, and its risk/reward profile.

ProShares Short VIX Short-Term Futures (NYSEMKT: SVXY): This isn't much of a problem position; it's up a bit for us. But this small 1.1% position has mainly just bounced around for the nearly two years we've held it. That's largely because volatility has been choppy, and SVXY will only steadily gain ground when volatility is stable. We continue to plan to own shares for the long haul, expecting compounded gains eventually. However, we're also considering adding complementary positions to this one, and if SVXY falls sharply again (say, 30% or 40%) as it did in January, next time we may add some temporary shares in anticipation of a rebound.

Valmont Industries (NYSE: VMI): We bought our first shares of Valmont when the business was already in a down cycle, but that cycle deepened and, in unprecedented fashion, came to encompass every business line at Valmont. Given this, the stock has held up better than one might fear (we're down 11.6% as of Friday). For now, we're content to wait and see how this well-run company can manage its recovery. We're hopeful some light is showing through the darkness, and Valmont is aiming for 10% earnings-per-share growth this year. It's only a 1.9% stake, and we have ample cash in the port right now, so we don't need to sell anything we still believe in; thus, Valmont remains a Buy. But if we don't believe this company can ultimately meet our North Star, we'll need to move the funds elsewhere.

WisdomTree Emerging Markets SmallCap (NYSEMKT: DGS): Our second-largest loser among all our long and short stock positions (down 16% excluding dividends), DGS is nonetheless enjoying a good year, up 16.7% as of Friday. I don't view this 1.8% stake as a problem position, but as a macro diversification. This fund is well managed, and we believe funds of its breed in emerging markets will create long-term value. That said, this has been poor deployment of our capital so far, doing nothing for our portfolio (it's closer to even including dividends). But the problem is, that's how macro investments often work: They don't, until they do, and that's only if you stick with them. You're not timing the market by adding emerging markets to your portfolio – you're diversifying into different markets for the long haul. For now, we're happy to keep the diversification and it's rated Buy.

It's All Less Spooky in the Morning

For years now, we've avoided big blow-ups with our stocks; our biggest loser at the moment, our Deere short, is down 17%, and yet it's hedging recent gains in Valmont. I've always said that we should expect swings of up to 20% in short-term volatility from any stock -- that we can basically just call that "market noise," up or down. Over the years, a winning business will compound well beyond 20% based on its real merits. But a decline greater than 20% suggests we overpaid, or made a poor choice, or have bad luck -- or a combination of the three. We hope to minimize our losers and the size of our losses, but we know we'll never be perfect. That's not even a realistic goal when investing. The positions we just reviewed have disappointed us over the past few years, but we have reason to believe in them. And we have cash. So, we only need to sell these if our beliefs change or if we later need the cash for something we like better. Right now, we can wait. And that's largely what investing is all about.

Visit the Memo Musings board for questions! And Happy Halloween from the Fool!

-- Jeff (TMFFischer)

More From Motley Fool *Pro*

- Pro Quality Checklist: AMERCO
- An Underappreciated Four-Letter Word
- The Likelihood of a U.S. Recession, Revisited
- Charts of the Week
- The Facts on FactSet

Pro Guidance Changes and Completed Trades: Oct. 31, 2016

Published Oct 31, 2016 at 2:36PM

Pro Guidance Changes (from the past two weeks)

- **Wells Fargo** (NYSE: WFC): Shares move to Sell today. We're ending our entire stake.

Pro Completed Trades (from the past two weeks)

- **Celgene** (NASDAQ: CELG): Our $95 puts expired as full income.
- **Gilead Sciences** (NASDAQ: GILD): Our $85 covered calls expired as full income.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Sell Wells Fargo

Published Oct 31, 2016 at 1:49PM

Is this for you? All *Pro* members who want to follow the *Pro* portfolio should follow this alert and sell **Wells Fargo** (NYSE: WFC) with us. Read on to find out why we're selling, including portfolio reasons. If after reading you want to keep the shares on your own, of course you may do so. *Options* members should continue to follow our guidance in that service. We have not sold our 2018 calls on Wells Fargo yet, and we may not. That is still under consideration.

How You Follow Along

- **Trade:** Sell **Wells Fargo** (NYSE: WFC)
- **Allocation:** Sell all shares. *Pro* is selling our 2,400 shares, representing 4.2% of the portfolio, and bringing our cash (excluding shorts) up to 23%.
- **Price Guidance:** Use a **limit order**, please, to sell at the going price, lately $46.15 or higher.
- **Note:** Wells Fargo goes ex-dividend on Nov. 2. If you have dividend-related tax considerations, you may prefer to wait until after that date to sell in order to obtain the dividend. Otherwise, it shouldn't matter whether you sell before the ex-dividend date or after, as the stock price should fall by the amount of the dividend.

What We're Thinking

After significant deliberation about the highly publicized scandal regarding fraudulent accounts at Wells Fargo, we at *Pro* have decided that the best decision for our portfolio is to exit our position, hoping to reallocate those funds to other ideas in which we are more confident. Our rationale:

1. We are not confident in the company's ability to continue to generate North Star-beating returns.

Since we initiated our Wells Fargo position in December 2010, the stock has been an underwhelming performer. I went back and analyzed *Pro*'s position-level returns for Wells Fargo over the life of the holding, and including both dividends and option income, our annualized rate of return since inception is just 4.7%, well below our North Star. Over the same period, the S&P 500 has returned 15.6% annualized.

While a good portion of the underperformance can be attributed to the stock-price decline associated with the recent scandal, that's not the only reason the position's returns have been weak. A full percentage point of our annualized returns is thanks to our options activity; without options, the stock has returned just 3.8% annualized.

Additionally, a portion of our long-term thesis has involved waiting for the U.S. economy to pick up steam, leading to increased long-term interest rates and thus higher lending spreads (and higher profit) for Wells Fargo. That simply hasn't happened yet, and it appears that interest rates may remain low for the foreseeable future, leading to continued pressure on the company's interest-income profit stream.

2. Structural industry headwinds persist.

Wells Fargo's return on equity has been in a persistent slump since 2014; the company has reported year-over-year declines in ROE for the past 10 consecutive quarters. We expect ongoing pressure on ROE from long-term interest rates that remain low, increased regulatory scrutiny (especially in response to the scandal), higher capital requirements, and necessary investments in cybersecurity and risk management.

3. The scandal is having an impact on the company's business.

While the effects of the scandal were not immediately noticeable in the company's corporate-level earnings results, Wells Fargo has released some data showing that consumer behavior is certainly changing as a result of the negative publicity.

The malfeasance was reported in September. Just that month, consumer checking account openings declined 25% year-over-year and credit card applications were down 20% year-over-year. Other areas of the company's business were affected as well, with mortgage referrals from retail banking down 24% in September from August.

While the declines will likely moderate over time as the scandal fades, the company's reputation has certainly taken a big hit. Another of the core tenets of our Wells Fargo investment thesis was that the company's conservative culture and strong reputation should help it continue to attract new customers, and this scandal brings that assumption into question.

Additionally, millennials are now the largest demographic group in the U.S., and in a 2015 consumer research survey on banking performed by Accenture, millennials were the most likely age group to switch from their primary bank. Eighteen percent of millennials had switched their primary bank within the past 12 months, compared with 10% of customers 35 to 54 and 3% of those 55 and older. Given this information and given additional pressure from the scandal, we think that future retail customer growth for Wells Fargo is as questionable as it has ever been.

The *Pro* Bottom Line

We have decided to sell Wells Fargo because we are not confident in the company's ability to generate North Star-beating returns, and we think we can find other long investments that we prefer and are more comfortable owning.

It's important to note that although we are selling Wells Fargo, that doesn't mean we think the stock won't continue to earn positive returns for its shareholders. While the company's 3.8% annualized return since our position's inception in 2010 doesn't beat our North Star, it handily beats the 0% return on cash.

With an amply covered 3.3% dividend yield and a price-to-book multiple that's as low as it has been in several years, we don't think much further downside is all that likely. Additionally, if macro-economic conditions improve, it is possible that Wells Fargo could see strong appreciation as lending spreads rise and profits increase.

However, with *Pro*'s mandate to deliver North Star-beating returns over every rolling three-year period, we are making the decision to sell an underperforming stock in a company with a damaged reputation in the hopes of reallocating the cash to other ideas we like better. Because we run a portfolio that does not add funds, it's imperative that we only remain invested in positions we believe will perform up to our standards over time. Any morality issues aside, the odds look stacked against healthy growth in Wells Fargo's business anytime soon, and we believe we can reinvest this money someplace better.

For new members who recently bought shares: We're long-term investors, and we intended to keep Wells for years when we recommended it to you. But stories change, and in this case, we're moved to sell soon after you bought. At *Pro*, we always give time the benefit of the doubt, and we maintain a long-term view -- but we have to remain flexible. Often, sudden changes mean nothing for our positions. But when they are meaningful and have an impact on our investment thesis, it's our responsibility to respond.

-Billy, Jeff and the *Pro* team

Pro Can Help

- Questions? Please bring them to the Wells Fargo discussion board.

Pro FAQ

Published Oct 26, 2016 at 12:08PM

Welcome to our Frequently Asked Questions about *Motley Fool Pro* and how you can get the most out of the service. Have a question that's not addressed here? Ask us on the Member Suggestions & Help discussion board!

About Pro

What is Motley Fool Pro?

Motley Fool Pro is a $1 million real-money portfolio being managed for accurate, recurring, and absolute profits (rather than relative returns). The portfolio buys all types of equities, uses several different options strategies, and employs ETFs, hedges, shorts, and other advanced strategies to make money in flat, down, and up markets. Over the years, however, the main bent of the portfolio should be that of long-term stock ownership. All trades are announced to *Pro* members well before we make them, and all returns are tracked publicly for you.

How can I see a list of the team's holdings?

You can see the *Pro* team's holdings here: Tom Gardner | David Gardner | Jeff Fischer | JP Bennett | Billy Kipersztok | Ellen Bowman

Recommendations Help

If I'm a new member, where do I begin?

Begin by establishing a position in our Buy First stocks, then follow our moves in that portfolio. We'll preannounce trades just for you — always sending you a "Trade Alert" email before we make a move — to help you build your portfolio with us.

What do Best Buy Now, Buy, Hold, and Sell mean?

- **Best Buy Now:** If your portfolio doesn't yet mirror ours, start by matching our percentages in these stocks. They represent the most attractive risk-to-reward opportunities today.
- **Buy:** We suggest you buy these strong stocks next as you build your portfolio.
- **Hold:** This means to keep your shares if you own them, but don't add more cash or open a new position in the stock.
- **Sell:** We're selling all or a partial stake in this position, and we recommend you do, too. You'll get a full sell report with any position we decide to jettison.
- **Short:** We recommend you sell short these positions. If you haven't shorted before, get a lesson from our Guide to Shorting.

What do the three portfolio tabs contain?

- Open Positions includes all active positions in the portfolio.
- Closed Positions offers details on positions that are no longer active (this does not include positions that have been *partially* sold).
- Transactions is a complete list of every transaction we've made from the start: buys, sells, dividend payments, interest on cash and more.

Building Your Portfolio

What is a good broker to use?

From Scottrade to TD Ameritrade, ThinkorSwim to OptionsXpress, Schwab, Interactive Brokers, and others, *Pro* members use 'em all. If you're looking to trade options, just about any discount broker will work, but some have stricter options permission policies than others, and IRA policies differ. Do your homework! The Motley Fool's Broker Center is also a great resource.

Should I buy every stock at once right now?

In a volatile market, it pays to move steadily. In building out your *Pro* portfolio, consider our **Buy First** holdings first; those are the companies we think are the best opportunities for your money right now.

How much of each Pro stock do I buy?

If you want to mirror *Pro*'s portfolio, see our buy reports and buy our committed (or actual) allocation so far.

How should I use Pro if I'm already fully invested?

Don't sell everything you own at once. You own your stocks for a reason! Begin by reviewing your current holdings, then consider selling your least-favorite stocks to free up cash as you need it for new *Pro* trades. Gradually move freed-up cash into our Buy First stocks and then our Buy stocks. Consider your sector allocations and stay diversified as you add *Pro* buys.

How should I use Pro if I'm adding new cash over time?

Averaging new money into stocks over time helps you achieve better returns. Do this if you can. Determine how much you plan to contribute over the next year and base your target allocations on *that* figure rather than on your current portfolio value. If you have $50,000 and expect new cash will grow it to $60,000 by year-end, keep that in mind as you allocate. Be mindful of commissions as you build your positions — ideally, you want commissions to cost less than 2% of any trade. A $20 commission for a $500 investment, for instance, would be 4% — that's not cost-effective. (This is much less true when writing options, where you simply want the cash you're paid to be worthwhile; commissions will typically be a larger part of your overall trade.)

I'm using an IRA for Pro. How should I proceed?

IRAs are tax-deferred accounts, so they're ideal for income-generating trades like covered calls, high-yielding dividend stocks, and any ETFs with large, taxable distributions. IRAs are *not* so great for more speculative trades because any losses generally cannot be used to reduce your taxes. Keep in mind that IRAs do not allow short selling or buying on margin, and will not allow more aggressive option strategies, such as writing puts on even modest margin. Consider opening a separate non-IRA account to take advantage of these *Pro* strategies. Then, manage this second account and your IRA together as *one* portfolio.

Should I reinvest dividends?

You can go ahead and reinvest any dividends, if you'd like, on any *Pro* stock that is rated a Buy or Buy First. *Pro* is *not* reinvesting dividends simply because it's difficult for us to track. It results in partial shares, which also complicates option strategies on the stock. We take all dividends as cash and will invest them ourselves.

Where can I learn more about ETFs?

Please read our guide, The ABCs of ETFs, for more on exchange-traded funds.

What broker does Pro use? Does Pro reinvest dividends? Pay commissions? Rebalance the portfolio?

- *Pro* currently trades via Interactive Brokers.
- We do not reinvest dividends so that we can deploy our cash to the best opportunities at any given time (that could be the company the dividends came from, but it may not be).
- Commissions vary per trade, but all costs are shown on our transactions page, and commissions are included in our prices and returns.
- Finally, though we won't rebalance in order to meet certain arbitrary allocation guidelines, we will manage the portfolio to avoid excessive risk in any one position.

How do you track your performance?

The Motley Fool measures the *Pro* portfolio's performance from its launch date in October 2008. The portfolio's cash balance is included (lowering returns when we have cash). We track relative returns for members' benefit, focusing on annualized rolling-three-year periods (which is consistent with our mission), even though *Pro* is managed for absolute returns (profits, period). *Pro*'s total returns and the S&P 500 Total Return Index include dividends. Our North Star is measured using the CPI-U (the Consumer Price Index for All Urban Consumers, as calculated by the Bureau of Labor Statistics) as its measure of inflation. For more on our North Star, click here.

Options Help

What should I know before investing in options?

Read our Options 101 guide and our Options Glossary to become familiar with the terms, strategies, and purposes behind using options before you consider placing any option trades. If options are new to you, we recommend that you watch a few of our trades play out before you start to follow them in your own portfolio.

What is a good broker to use?

From TD Ameritrade to ThinkorSwim to OptionsXpress to Schwab to Interactive Brokers — and others! — *Pro* members use them all. Just about any discount broker will work, but some have stricter options permission policies than others, and IRA policies differ. Do your homework! The Motley Fool's Broker Center is also a great resource.

How do I apply for option trading?

Ask your broker for full options approval, typically level 2 or 3 (it can vary by broker). Fill out, sign, and mail in a simple one-page document. After a week or two, you'll be approved! Slide on over to our All About Options board if you have any questions, and watch our Options in 3 Steps video for a visual walk-through of the process.

How much money do I need to trade options?

To buy an option, you need very little money: just enough so that your commission is, ideally, less than 2% or 3% of your total transaction cost. To write options, you need to have a margin account. Also remember that different brokerages have different requirements. You'll need anywhere from $10,000 to $50,000 to gain brokerage approval for option writing, depending on your broker. We recommend that you have at least $25,000 in your portfolio if you want to trade options with Pro, and $100,000 if you want the flexibility to follow along with most options trades we make. The smaller your portfolio, the more likely you'll need to pick and choose which of our options trades you follow.

What level of options permission do I need?

It varies by broker, but level 2 to 3 (the ability to buy and write calls and puts) is typically sufficient for now.

Can I make option trades in an IRA?

Yes, you can buy options and write covered calls in an IRA, tax-free. Some IRAs will also let you write cash-secured puts. Ask your broker.

I can't sell puts because of brokerage restrictions. What should I do?

Focus on buying stocks in our preferred buy price range to give you the largest margin of safety. Also, read up on our covered-call strategy. This is another way to generate income from options and is allowed by most brokers and even in IRAs.

CAPS and the CAPShot

What is CAPS?

CAPS is The Motley Fool's vibrant investing community filled with stock pitches, blogs, screens, and a host of proprietary data based on members' ratings of every stock's ability to outperform over time. For much more about CAPS and how to get involved, check out Meet CAPS and Using CAPS to Find Great Stocks. Here at *Motley Fool Pro*, we use proprietary CAPS data as another screen to find great stocks, sectors, and ETFs.

What is a CAPShot report?

Coming soon!

We created a special checklist to help *Pro* members find the strongest growth stocks in the CAPS universe -- those with leading growth rates, strong margins, and healthy financials. The CAPShot Report checklist rates stocks on four CAPS criteria and eight of our own hand-picked fundamental criteria. It then applies a score from 1 to 12, with 12 being highest. Few stocks will score 11 or 12, but when they do, you can bet that we'll be taking a closer look. We're currently working on getting the CAPShot report up and running and will notify you when you can begin generating your own reports.

My Scorecard

What is My Scorecard?

My Scorecard is your personalized one-stop shop for information about the stocks that matter most to *you*. It's part scorekeeper and part coverage collector:

- Add your holdings, and we'll track your performance for each position, as well as your overall returns versus the market.
- Add stocks you're interested in but don't own (enter the ticker, but don't add purchase data), and we'll track those companies' prices, too.
- Below your list of stocks, you'll see an activity feed of all your premium Motley Fool services' coverage of your companies — updates, articles, discussion board posts, and more. You can filter this list to zero in on just the type of content you're looking for.
- Finally, at the top of the page, you'll see quick bites of personalized information and Foolish fun facts. Every time you visit, you'll see a different set, so refresh the page and come back often!

Can I have a watchlist in My Scorecard?

Any stock you add without entering purchase information is treated as a watchlist pick. You will see the current price and commentary will start to appear in the feed. However, it will not affect your overall returns.

Can I enter the number of shares I own?

Now you can! When you add a stock, enter the number of shares you bought, along with the date and price of each position. We'll show you how much of your portfolio each stock makes up.

How are my returns calculated?

- **The overall return of your scorecard**, shown at the top of the page, is calculated using the annualized effective compounded return rate, commonly known as the internal rate of return (IRR). The best way to think about this return is as an interest rate — it represents the interest rate you would need to earn over the period you have been investing to end up with your current position. This takes into account all of your active and sold positions, as well as the dates you bought and sold each holding. IRR is an annualized figure, so if you've returned 40% over two years, your IRR will be 18.3%. Dividends are not automatically included for the individual stock positions, so you'll need to manually adjust your purchase price to account for dividends.
- **S&P Return** is calculated the same way, by mirroring each of your investments with similarly sized investments in the dividend-adjusted SPDR S&P 500 ETF (SPY).
- **The weighted average returns**, at the bottom of the Active and Sold tabs, are calculated using a the cost-weighted average of all your active or sold positions. Unlike IRR, the weighted average doesn't include the total of all of your positions (just the active or sold), and it is not annualized.

How do I add multiple tickers?

Just type them into the box below your scorecard (separated by commas or spaces) and they will appear in your scorecard. Click on Edit for each stock to add the purchase information.

How do I add a closed position?

Click sell and then enter all the information in at once. Your position will then be moved to the Sold tab of My Scorecard.

What happens when I delete a stock?

Poof! It's gone. When you delete a stock, it's gone from My Scorecard, and so is all the content associated with it. (We've put in a pop-up that checks to make sure you meant to delete it.) If you deleted a stock by accident, you can always readd the stock, and the appropriate information will reappear.

Does My Scorecard support splits and other corporate actions?

No. You will have to make these adjustments manually, by changing the purchase price.

A stock is newly listed on the NYSE or Nasdaq. Can I add it to My Scorecard?

Your Fool tech team will manually add these to our database. If you find a ticker that needs to be added, just give us a holler on the boards.

Getting the Most Out of My Scorecard

My Scorecard isn't a comprehensive portfolio tracker. It doesn't track options, warrants, mutual funds, and stocks on foreign exchanges. It also doesn't track cash; however, there is a workaround for tracking cash explained here. For corporate actions such as dividends and splits, you'll have to change a holding's Buy Price to adjust your cost basis.

The tool is a work in progress, though, so if you have suggestions or ideas for My Scorecard, bring them to our feedback discussion board, and we'll let you know what we can do!

Where can I get the latest information about the Foolish plans for My Scorecard?

You can find the latest and greatest information about what's next on the Foolsaurus page for My Scorecard, and if you have any questions, post them on the My Scorecard Feedback discussion board.

Emails, Memos, Audio Extras, and Guides

What are "Trade Alert" emails?

"Trade Alert" emails come to you at least 24 hours and no more than 30 calendar days before we make our trade. This gives you the chance to beat our price. You can manage the email you get from *Pro* and any other Fool services here.

When is the Monday Memo made available? Can I print it?

You can find our weekly news update both in your email box and here on the *Pro* site every Monday (imagine that!) at 4 p.m. ET. If Monday is a holiday, we'll publish it on Tuesday.

To print the Monday Memo, just look for the "Print This Page" link at the bottom of the page.

I'm feeling overwhelmed by all the guides and lessons on Pro. Where should I start?

Follow our simple three-step plan to help pace yourself. Reading a few of our recent (and brief!) Monday Memos is another great way to catch up. Just take your time. By reading just one of our feature articles or guides each week, within a few months you'll have read all of them, and you'll be completely in-the-know with *Pro*.

I want to learn all I can from Pro. What are the essentials?

Visit our resources page for the *Pro* team's favorite guides and investing lessons.

How can I view a list of all published articles?

Just go to our Alerts & Coverage tab and make your choice of content (Alerts, Memos, or Extras) on the sub-navigation bar. You'll see an archive of all *Pro* content in that category; click "Next" at the bottom of the Articles page to continue further back through our archives.

Will you post transcripts of your Audio Extras?

Yes! Transcripts of all Audio and Video Extras will be posted soon after publication.

Community and Discussion Boards

How do I use the discussion boards?

The basics: Only *Pro* subscribers can access the *Pro* community, whereas the at-large Fool Community, with more than 4,000 active boards, is accessible to anyone. For more general information on Fool discussion boards, visit the Fool's Help Centerfor a tutorial.

How can I keep up with the discussion boards when I only have 15 minutes a week?

Just check the "Most Recommended Discussions" section of *Pro*'s Community tab for members' favorite posts of the week.

Click the **heart** on each *Pro*discussion board that interests you. Now you can access it in the My Boards section of your My Fool page.

If you just want to find responses to your own questions, follow the Favorites & Replies link in the navigation bar at the top of the board page, and then click "Replies to Your Posts." Your replies will be automatically filed for you.

When using the discussion boards, what do "unthreaded" and "threaded" mean?

Unthreaded means the posts are listed in chronological order. This is our default setting. *Threaded* discussions are grouped according to a specific subject. For example, you might start a thread by posting on the subject of "Intel's Earnings." If I respond to your message, my post will be "Re: Intel's Earnings," and so forth. All of the replies to your subject will be kept together. This makes it easy to follow each small discussion on a board. The difference between threaded and unthreaded is that threaded takes the subject into consideration first and the chronological order second. If you have questions about this or are still confused, email customer support at FoolBoards@fool.com.

How do I write a post?

On every message, there's a link called "Post Reply." Just click there. A new page will come up, with the original post and a box to type your message in. Once you finish the message, click "Preview Reply" to make sure it looks like what you thought it would look like (if it doesn't, no worries; just click "Edit Reply" to make any fixes). Then click "Submit Reply," and it's on the way! Your message will show up as the last message on the board in chronological order.

Once you've posted a message, you can't go back and delete or edit it.

Technical Support

How do I change my username and password?

To change your username or password, click here. Please note: You can only change your username three times per year. Your password must have at least six characters (no spaces or special characters, please). You can change your password as often as you like.

My email address changed. How do I update it?

Note: When you change your email address, your account will be suspended temporarily. We'll send an email to your new address, with a link to a page that will unlock your account. Click that link and follow the instructions on the page. Please be sure to let us know when you change your email address. Failure to do so may result in the delay or non-delivery of online products or messages regarding any paid subscriptions.

What is your refund policy?

We sincerely believe in everything we sell. Yeah, it sounds hokey, but it's true. If you're not completely satisfied for any reason, just let us know within the first 30 days, and you'll get a complete refund. If you joined or renewed as part of our special three-year promotion in August 2011 or January 2012, you can cancel for a full refund anytime during your three-year subscription. Otherwise, after the first 30 days, you'll receive a pro-rated refund for the remaining portion of your subscription term. Our complete refund policy can be found here.

How do I renew my subscription?

You don't have to lift a finger. Your subscription will be automatically renewed each year on the same day that you originally purchased. Thirty days before your subscription renewal, we'll send you an email renewal reminder. If you don't want your subscription automatically renewed, or if you want to change your billing preferences, just contact us at membersupport@fool.com.

How do I change my billing or shipping address?

To update your mailing address, click here. Or click on the "Edit Your Account" link on your My Fool page or the newsletter's website.

What if I need more help?

If your question has gone unanswered or you are experiencing difficulties accessing the site or downloading an issue, please contact us at membersupport@fool.com. In your email, answer as many of the following questions as you can:

Are you using a Mac or a PC?

What operating system and version are you using? (Windows 98, Windows NT, Mac OS 9, Mac OS X, etc.)

What version of Adobe Acrobat are you using?

Did you see any error messages? What did they say?

Valmont Industries Sees a Distant Light in a Long, Dark Tunnel

Published Oct 25, 2016 at 12:16PM

Valmont Industries (NYSE: VMI) continues to fight through the dregs of a concurrent industrial/mining/agricultural downcycle as sales declined 3.5% for the quarter. The big contributors to the disappointing quarter was combination of falling steel prices, two unexpected kettle failures in the company's Coatings business, and continued weakness in European utility investment, As a result of Coatings segment challenges, management lowered their 2016 EPS guidance by about 2%, but they still expect the business to achieve 10% EPS growth for the year, which is in line with the long-term goals the company shared during the 2016 Investor Day held in February.

On a more positive note, management is starting to see signs of improving demand in two of the company's largest segments and the company continues to deliver on management's restructuring initiatives, achieving over two-and-a-half percentage points of operating margin improvement year to date. Those savings amount to an additional $17 million of additional operating profit and management is still targeting $30 million of annual savings. In the third quarter, management began the restructuring of the company's Australian manufacturing facilities which should result in an additional $5 million in annual savings in 2017.

Valmont's balance sheet remains strong, with a manageable $408 million in net debt, and the company continues to generate a ton of cash. Year to date operating cash flow has been $127 million with capital expenditure coming in at only $42 million. Valmont repurchased $18 million of its shares during the quarter at an average price of $129 and there is $139 million remaining in the current repurchase authorization

Segment Updates

- **Engineered Support Systems (~29% of Sales)**

ESS sales were slightly higher for the quarter thanks to improving commercial and infrastructure construction. The segment is also seeing an uptick in sales inquiries related to the Highway Bill that was signed at the end of last year. Lights and guardrails are installed toward the end of those projects, so management does expect a meaningful contribution from those sales until sometime in 2017. Also, U.S. telecoms have pulled back on some of their wireless infrastructure spending, but demand remains strong in the Asia Pacific region thanks to continued investment in 4G network upgrades in Australia.

- **Utility Support Systems ~(25% of Sales)**

Utility revenue was down for the quarter thanks to drop in steel prices -- which get passed on to customers -- but volumes are growing and market sentiment is improving. Also, a large European project expected to deliver this quarter was pushed into the fourth quarter. Order lead times are increasing which is a positive sign that capacity utilization at plants are tightening. Though management believes that there is still an oversupply of manufacturing in the market, lengthening lead times often result in pricing increases down the line.

- **Coatings (~11% of Sales)**

Demand for the coating business dropped unexpectedly during the quarter thanks to a combination of lower demand from for custom products for the solar energy industry and less internal demand from other segments. Also, the segment experienced temporary equipment failures at two plants which were quickly repaired, but hurt short term operating performance. Analysts on the call questioned whether these failures were the result of cost cuts and underspending on maintenance capex. Management explained that both incidents were unfortunate, but not the result of deferred maintenance. Also, management has taken measures to pre-emptively cut additional costs from the business in anticipation of lower demand for the remainder of the year.

- **Energy and Mining (~13% of Sales)**

Management reported that it seeing a marked improvement it the operating performance of the Energy and Mining segment, but weak end markets continue to be a drag on the business. The improvements were the result of better grinding media profitability and better operating performance for the Access Systems business, which is trying to diversify into adjacent industries.

- **Irrigation (~23% of Sales)**

Commodity crop prices remain depressed thanks to another record harvest in the U.S., so it's little surprise that the outlook for the Irrigation segment remains depressed. Further, a rainy growing season in the U.S. resulted in less run time for installed irrigation systems, resulting in less need for maintenance and replacement parts. Thankfully, pricing has held up in the U.S. as competitors have remained rational and internationally Brazil is holding up surprisingly well and should continue to rebound as the country's political issues are resolved.

Pro Bottom Line

Our thoughts regarding Valmont's prospects are little changed from the previous quarter – this is a well-run business slogging through a tough market. It seems that investors keep trying to anticipate the bottom of the cycle only, to be disappointed with each ensuing quarter. It would be nice to just sell and sit on the sidelines until the economy improves, but by the time there is a clear evidence that the fundamentals are improving, we're likely to miss the move in the stock. It will likely only require a meaningful improvement in one of Valmont's end markets to see the increased operating leverage from the cost restructuring start to kick in.

As we've noted previously, Valmont hasn't performed to our expectations and is lagging our North Star return expectations, but it does provide some industry diversification in a portfolio that is admittedly overweight financials and software/technology companies. It also has multiple high quality businesses that should benefit from long term global economic growth if we can remain patient. Now that the company has mostly completed its reorganization, it's likely that management will have the bandwidth to pursue acquisitions to grow the business. At about 20-times forward earnings Valmont doesn't look particularly cheap, but that's normal for a quality company that seems to be near the bottom of the cycle. **Valmont remains a Buy and I'm maintaining the current $140 fair value estimate.**

Pro Catch-Up Trades and Upcoming Expirations: Oct. 24, 2016

Published Oct 24, 2016 at 3:32PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Broadridge Financial Services** (NYSE: BR): Buy up to 5.1%.
- **FactSet Research Systems** (NYSE: FDS): Buy 2%.

Continue building your portfolio with our Buys:

- **Oracle** (NYSE: ORCL): Buy up to 3.5%.
- **Starbucks** (NASDAQ: SBUX): Buy 3.2%
- **Valmont** (NYSE: VMI): Buy 1.9%

Shorts:

- **Direxion Daily Financial Bear 3X Shares ETF** (NYSEMKT: FAZ): Sell short 0.2% if your broker has shares. If they don't, then set up a January 2019 synthetic short, selling to open Jan. 2019 $30 calls and buying to open an equal number of Jan. 2019 $30 puts. With FAZ around $31, see if a limit order for a $2 debit or less will work.

Pro options:

- **Gentex** (NASDAQ: GNTX): Sell to open Dec. 16, 2016, $17.50 puts, aiming for at least $0.90. Sell one put for every 100 shares you could buy at a net $16.60. Selling 23 puts, *Pro* is looking to add 1.5% to our stake, for 4.3% total in stock.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY): Set up the **December put ratio spread** as shared in this recent alert. Lately, today, it can be set up for a very small debit ($0.07); or you can wait for a market drop, which may improve pricing.

Options expiring next (Nov. 18, 2016):

- **Expeditors International** (NASDAQ: EXPD): We'll look to roll our $48 put/$50 call covered strangle closer to expiration, in 25 days, if the stock is outside that $48-$50 price range.
- **SPDR S&P 500** (NYSEMKT: SPY): Our November $200/$210 put ratio spread is still in play with SPY around $215. If SPY stays above $210 we'll do nothing. If it falls below $210, we'll close our put(s) near expiration. And we'll look to set up a new hedge either way.

Pro Quality Checklist: AMERCO

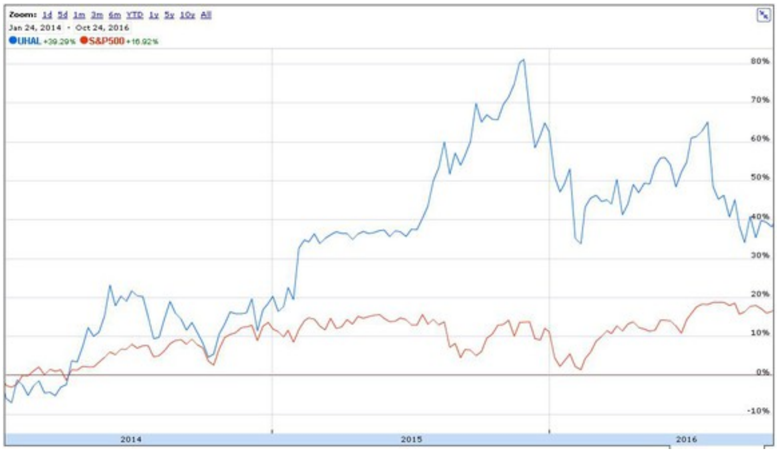
Published Oct 24, 2016 at 3:32PM

Dear *Pro* Fools,

Back in early 2014, I wrote a Memo about **AMERCO** (NASDAQ: UHAL), the holding company for do-it-yourself moving and storage business U-Haul.

In that Memo, I discussed how I was intrigued by the business and presented some info about the business in a "watch list" format, with the idea of keeping an eye on the company and its stock price in order to see if it might eventually be worthy of a spot in the *Pro* portfolio.

Since that column, here's how AMERCO's stock price has compared to the S&P 500:



Source: Google Finance

AMERCO has been a market-beating stock performer since that "watch list" Memo, up 39.3% vs 16.9% for the S&P 500 over the same period. However, lately AMERCO has been in a bit of a swoon, down 24% since achieving an all-time high of $436.89 per share in late 2015.

The falling share price, caused predominantly by weak earnings results, has drawn my attention to the business once more, and I thought it would be an interesting exercise to run the company through our Pro Quality Checklist to see how the company stacks up. Without further ado...

1. Sustainable Competitive Advantage

Yes. AMERCO's truck rental business is part of a 4-way oligopoly (including Enterprise, Penske, and Ryder) that dominates the truck rental business. Those four businesses control 50.9% of the truck rental industry in the U.S., with the remaining 49.1% largely composed of local and regional operators that each generate less than 5% of overall industry revenue. AMERCO's national scale is a source of competitive advantage relative to its smaller competitors.

Additionally, compared to its bigger peers, the company's large network of more than 21,000 rental locations (compared to 800 for Ryder, 2200 for Penske, and 229 for Enterprise), focuses on the do-it-yourself moving market (as opposed to commercial truck rentals). Its 70+ years of operating and optimizing a system tailored to one-way moves gives the company an additional source of competitive advantage.

2. Pricing Power

No. Pricing in the company's businesses can be highly competitive and dependent upon market rates. However, the company's large network gives it a source of relative pricing power for long-distance, one-way moves in regions where competitors don't have a market presence. But for the most part, AMERCO doesn't have significant pricing power across its entire business.

3. Dependent Customer Base

No. AMERCO's customers are not dependent upon AMERCO for truck rental, self-storage, or insurance, and there are many other sources for similar products and services.

4. Predictable Revenue

No. The do-it-yourself moving market generally ebbs and flows with the housing market, which is unpredictable. However, the company's growing self-storage business exhibits stable and recurring revenue, although it still comprises less than 10% of companywide revenue.

5. Growing Free Cash Flow With Compounding Returns

Yes. AMERCO continues to invest heavily in growing its truck rental and self-storage operations. As the company grows and continues to gain scale, the company should continue to earn rates of return on investment that exceed its cost of capital.

6. Financial Resilience

Sort of. The company has a significant debt load, with about $2.8 billion in debt, compared to $650 million in cash on the balance sheet. However, the company's debt load is easily manageable when compared to the company's cash flow, as debt maturities are reasonably paced and interest expense is well-covered by profits.

7. Expanding Possibilities

Yes. AMERCO continues to grow its truck-rental business, building on its strong position in the do-it-yourself moving business. Additionally, the company's self-storage business continues to grow nicely, with revenue up 16% in the most recent fiscal year. The company operates nearly 50 million square feet of rentable storage space, making it one of the largest self-storage companies in the industry. Self-storage companies trade at high valuations because the revenue streams are stable and recurring, the properties require very little maintenance expenditures, and margins are high. AMERCO continues to invest in and grow its self-storage business, which is complementary to the company's core truck-rental business.

8. The Three C's of Management: Clarity, Consistency, Capability

Yes. Current chairman/president/CEO Joe Shoen (son of founder Leonard Shoen) runs the business, and Shoen family members litter AMERCO's organizational chart, with most of them having worked with the company for the majority of their adult lives. The Shoen family owns more than 55% of the company's common stock, and executive pay is modest — perhaps even excessively so — for a company with more than $2 billion in annual revenue (total CEO compensation including incentives is consistently around $1 million or less). What this means is that the vast majority of the Shoen family's wealth is concentrated in AMERCO stock. We can rest assured that the leadership team is running the business with a long-term mindset that's well aligned with that of common shareholders.

The *Pro* Bottom Line

With just 4.5 out of the 8 *Pro* quality characteristics we look for, AMERCO doesn't exactly check off all of the qualities that we look for in an ideal *Pro* investment. However, the company has enough positive attributes to warrant taking a closer look. At just over 6.8 times EV/EBITDA, the company seems cheap for a growing, competitively advantaged business. If our valuation work suggests the company is undervalued, we might be interested in boxing up this stock to store in our portfolio.

Fool on!

— Billy (TMFBillyTheKid)

More From Motley Fool *Pro*

- The Likelihood of a U.S. Recession, Revisited
- Charts of the Week
- The Facts on FactSet
- Resist the Easy Explanation

Glossary

Published Oct 24, 2016 at 11:43AM

- **Recommended Allocation %**: If we were building a portfolio today, we'd invest this much (match us!).
- **Fair Value**: The price around which we think investors will earn a fair return for the risk taken.
- **Buy First**: Start here when building or adding to your portfolio. This is the best place for limited capital.
- **Buy**: After matching the Recommended Allocation % of the Buy Firsts, turn here next. We expect North Star-like returns or better over the next three years.
- **Hold**: This position is under review.

Pro Resources

Published Oct 24, 2016 at 11:37AM

Getting Started

- Getting Started discussion board
- What to know if you're investing in an IRA

Need Tips for Using Pro?

- *Pro*'s options guides
- A guide to our North Star
- Some thoughts from Jeff on fair value

Portfolio Management Guidance

- Allocation calculator
- Finding Great Companies: *Pro*'s 8 Qualities

Our sister service, *Motley Fool Options*

- The *Motley Fool Options* brokerage discussion board

Pro Account & Settings

- Manage your email settings
- FAQ
- Contact member services

Your October Chat Questions, Answered

Published Oct 21, 2016 at 2:41PM

We had a few questions left over at the end of our October live chat -- here are Jeff's answers!

Q: With the oil market stabilizing a bit any thoughts on stocks like NOV?

A: We've looked the energy sector but don't like the competitive dynamics and lack of pricing power at so many of the companies in it this crowded space. We lean toward companies with long-term competitive advantages, multiple growth avenues, and pricing power.

Q: The ETF structural (my term) shorts seem more successful than the outright stock shorts. Will you be looking for more of those?

A: We are seeking more (or to add more to our) shorts of flawed ETFs.

Q: Seems to me that the Fool universe has a tendency to hang onto positions just to get them into the positive. Why not just sell/move on w/ something else?

A: Pro differs as a focused portfolio that doesn't add cash. We do sell stocks to buy things we like better.

Q: Interested in the two hedges, Deere & Domino's. Why hedge just tractors & pizzas? Why not everything (or nothing)?

A: We're hedging the whole S&P 500 with our SPY put ratio spreads, and we'll add other hedges over time. These two hedges were specific: We weren't going to keep PZZA or VMI longs without these hedges.

Q; What would be the best route to rebalance allocation in defense of a market down turn.

A: We believe a portfolio should always have a balance of longs/shorts/cash and options that leads to market exposure you're comfortable with. If you can get to 70% market exposure(or less if you wish), as we are, you may find less need or no need to rebalance. We manage our exposure, rather than focus on balancing assets. We want some positions that will make some money in all market environments.

Q: When you sell a covered call on a dividend stock are you paid dividends during the option period?

A: Yes. As long as you own the shares, you get the dividend. That's true even if you write covered calls on the stock. Just make sure the calls are out-of-the-money (or have more time value than the dividend) on the ex-dividend date, so you don't lose your shares to a dividend poacher. Other than that, all fine.

Q: Should I hold FIT, WSM, TRIP UA? All are not doing well.

A: We haven't recommended any of those, and unfortunately don't know them well enough to offer advice. Please ask at the sponsoring Fool service that recommended them!

Q: Where do we stand with the spy November 18 puts

A: We're fine. They're due to expire unused right now, but they're there for us should the market fall before then.

Q: What about the DPZ short, after a great results

A: We expect strong results from PZZA, too, and meanwhile we're OK with this hedge — though assessing DPZ's results to make sure.

Q: this market getting long in tooth...........I have troulble committing $400k to your old, 6/8 years

A: Keep in mind we only own things we want to go on owning, and new recommendations are not always better than previous ones (often not). We believe in each stock we recommend (that isn't on Hold). If you're concerned about the market, move gradually, averaging into our Buy stocks over time.

Q: Did you comment on VMI?

A: We did at the outset. We're going over earnings and will provide an update! Thank you!

Q: You sold DDD a while ago. Comments today as I own shares?

A: I'm not up to date on DDD, but last I looked a few quarters ago, I wasn't compelled to invest in it again. But you really should ask a sponsoring service at the Fool that recommends the shares! Sorry!

Pro Catch-Up Trades and Upcoming Expirations: Oct. 17, 2016

Published Oct 17, 2016 at 2:50PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **FactSet Research Systems** (NYSE: FDS): Buy 2%.

Continue building your portfolio with our Buys, including these highlighted today:

- **American Tower (NYSE: AMT):** Buy 3.9%.
- **Starbucks** (NASDAQ: SBUX): Buy 3.2%
- **Valmont** (NYSE: VMI): Buy 1.9%

Shorts:

- **Domino's Pizza** (NYSE: DPZ): Sell short 2%, along with *owning* 3.6% in **Papa John's** (NASDAQ: PZZA). This is a paired trade.
- **John Deere** (NYSE: DE): Sell short 2%, along with *owning* 1.9% in **Valmont** (NYSE: VMI). This is a paired trade.

Pro options:

- **Gentex** (NASDAQ: GNTX): Sell to open Dec. 16, 2016, $17.50 puts, aiming for at least $0.70. Sell one put for every 100 shares you could buy at a net $16.80. Selling 23 puts, *Pro* is looking to add 1.5% to our stake, for 4.4% total in stock.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY):
  - Set up the **December put ratio spread** as shared in this recent alert. Lately, today, it can be set up for a small debit ($0.05); or you can wait for a market drop, which may improve pricing.

Options expiring next:

- **Celgene** (NASDAQ: CELG): Our Oct. 21 $95 puts are on track to expire as income. We'll consider writing new ones as that happens.
- **Gilead Sciences** (NASDAQ: GILD): Our Oct. 21 $85 covered calls are currently on track to expire as income.

An Underappreciated Four-Letter Word

Published Oct 17, 2016 at 2:50PM

Fellow Fools,

Members new to *Pro* often find it easy to get excited about learning how to use options and short positions to manage risk and improve returns. We love those approaches too, but it's critical not to overlook some of the less novel -- but just as important -- strategies we use to achieve our North Star goal over the long haul. During a recent *Pro* stock talk meeting, I heard my fellow analysts use the phrase "better than cash" several times when discussing positions in the portfolio that are currently treading water and under review. For that reason, I thought this might be a good time to circle back on one of the risk-management tools that often goes underappreciated in the *Pro* portfolio -- our cash.

But first, a disclaimer: Remember that the cash I'm referring to is meant to live within your dedicated *Pro* portfolio. You shouldn't be double-counting your rainy day fund or your savings for a large upcoming purchase, like a down payment on a house. We intend to put our portfolio cash to work in the future, so it shouldn't be earmarked for other competing purposes. If you'd like to match the performance of the *Pro* portfolio, don't get a stuck in a situation where you're forced to decide between buying shares of your favorite company at fire-sale prices or replacing the broken air conditioner in your house (those things only seem to conk out on the hottest day of the year). With that said, let's move on to why we maintain a cash position in the *Pro* portfolio.

The Joys of Cash

We've written before about the benefits of cash as a hedge on market volatility, but we believe it will also play an important role in boosting our returns over time. That may sound strange at first -- wouldn't cash drag have reduced our returns over the past few years as stocks rocketed upward? All else equal, investors who were fully invested in stocks over that period did perform better, but anyone who's been around for a couple of market cycles knows that won't always be the case.

We consciously manage the volatility in the *Pro* portfolio, intentionally forgoing some of the upside of the market today so we're better able to react optimally when a market decline suddenly occurs. It's during those periods of market turbulence that savvy investors with cash to spare are often able to dramatically improve their long-term returns. When thinking about the benefits of maintaining a cash position, few have articulated it as well as Alice Schroeder, Warren Buffett's hand-picked biographer, who explains how he thinks about cash. According to Schroeder, "He thinks of cash differently than conventional investors. He thinks of cash as a call option with no expiration date, an option on every asset class, with no strike price."

For investors like us who use options regularly, it should be obvious why that sort of flexibility holds value, but there's even more to like about cash in today's market. As investable assets become more expensive relative to their intrinsic value -- a situation I believe we're seeing now in multiple asset classes -- the opportunity cost of holding cash approaches zero. Add in limited depreciation risk thanks to historically low inflation rates, and the cost to hold cash has rarely been lower. That explains why even though our long-term target is to have about 5% of the portfolio in cash, our cash balance today (excluding shorts and cash-secured puts) has grown to nearly 19%.

Learning to Let Go

That said, it's not good enough just to have cash during a market decline -- you also need a plan for how to redeploy it when opportunities abound. Most people think they'll have no problem buying when stocks go on sale, but in reality, it's tempting to hold on to that cash like a life preserver when you're not sure how deep the decline is going to be. To combat that tendency, some investors suggest using a mechanical approach to buying into a market decline, which is similar to what happens with our **SPDR S&P 500** (NYSEMKT: SPY) put ratio spreads. During the initial drop, our long puts become a source of cash, but after a certain point the short puts become a liability that obligates us to buy into a declining market. Having exposure to that downside risk can be a bit scary, but it also solves for a number of psychological biases that might otherwise keep us from pulling the trigger.

Further, we maintain a growing watch list of companies that meet our *Pro* quality criteria and that we'd love to own at the right price. After following those businesses over many years, we expect to be excited to buy shares when they're eventually thrown into the bargain bin. By considering cash a viable option for our hard-earned capital, we're able to remain patient and wait for those opportunities rather than risk overpaying and earning mediocre returns or worse.

The Foolish Bottom Line

The funny thing about cash is that there never seems to be enough when you need it the most. I'm sure many of us experienced that frustration in the wake of the 2008 financial crisis and/or the bursting of the dot-com bubble; in both cases, high-quality businesses were beaten up as badly as the rest of the market. In those days, fortunes were made by investors who could provide the market with liquidity. To be clear, we're not trying to be market timers, jumping in and out of investments based on our opinion of where stocks are heading. Instead, our decision to carry a larger cash position than "normal" at this time is the consequence of a limited opportunity set and the understanding that even though the return on cash is 0%, the value of its optionality is substantially larger.

Thoughts? Bring them to our Memo Musings board. Have a great week, Fools!

Foolish best,

-- Jeremy (TMFTank)

More From Motley Fool *Pro*

- The Likelihood of a U.S. Recession, Revisited
- Charts of the Week
- The Facts on FactSet
- Resist the Easy Explanation

Pro Resources

Published Oct 17, 2016 at 1:10PM

Getting Started

- Allocation calculator
- What to know if you're investing in an IRA
- Getting Started discussion board
- FAQ

Options/Hedging/Expanding Your Skills

- *Pro*'s options guides
- Our Guide to Hedging Like a Pro
- Our sister service, *Motley Fool Options*
- The *Motley Fool Options* brokerage discussion board

***Pro* Philosophy**

- Some thoughts from Jeff on fair value
- A guide to our North Star
- Finding Great Companies: *Pro*'s 8 Qualities
- Why most investors fail, and how we avoid it
- How we target *Pro*'s returns

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- Manage your email settings
- Contact member services

***Pro* in 300 Words or Less**

Motley Fool Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star.

We expect most of our gains to occur in our long-term stocks, since we target owning companies that are "compounding machines" -- those special few earning outsized profits that are protected by long-term competitive advantages, and that invest those earnings in still more profitable growth. Alongside stock ownership, we sell short weaker companies to profit on downside and market declines; we use options to generate income, leverage our results, or protect ourselves. And we hedge market indexes as an extra form of insurance.

Many *Pro* members only buy our stocks. Because we are a portfolio service, we recommend that you buy as many of our long stocks as possible, and try to match or come close to our allocations. You don't need to short or use options unless you want to. We run a concentrated portfolio (typically fewer than 30 long positions); we aim to have very low turnover (we want to own long-term winners and let them compound); and we construct our portfolio to be diversified, but still invested where we see the most opportunity and best business models.

We're glad you're here at *Pro*! We hope that our streamlined yet powerful approach -- whether you use our shorts and options or not -- will help guide your investment portfolio to new highs over time. -- *Jeff Fischer, advisor*

Using Scorecard in Motley Fool Pro

Published Oct 17, 2016 at 11:01AM

Welcome, *Pro* Fool! This TMF scorecard app does not track options positions at this time, but we do have options tracking spreadsheets for download here, here, and here. You can, of course, still track your *Pro* long and short positions here, and you can also:

- Personalize the coverage you get from us. Follow (for example) FB in Scorecard, and you'll get a daily or weekly email (your choice) whenever there's any coverage of FB in any of your TMF services. For *Pro*, that means earnings coverage, updates on strategies, and info from all of our Monday Memos.
- Keep a watch list of stocks you are interested in and track their hypothetical returns.

For questions, please come to the Member Suggestions board. Fool on!

-- The *Motley Fool Pro* team

Pro Guidance Changes and Completed Trades: Oct. 10, 2016

Published Oct 10, 2016 at 3:00PM

Pro Guidance Changes (from the past two weeks)

- **Pier 1** (NYSE: PIR): *Pro* has decided to cover its short on Pier 1 after the acquisition of a significant stake by a "vulture" fund. If you're still short Pier 1, we recommend you close your short now.

Pro Completed Trades (from the past two weeks)

- **SPDR S&P 500** (NYSEMKT: SPY): We set up our December 2016 $180/$190 put ratio spread, as described in the alert, for a credit of $0.06.
- **Pier 1** (NYSE: PIR): We covered our entire short position at $4.52 per share.

You can see all of our guidance, positions, and transactions from the Recommendations page.

Pro Catch-Up Trades and Upcoming Expirations: Oct. 10, 2016

Published Oct 10, 2016 at 3:00PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **American Tower** (NYSE: AMT): Buy 3.7%.
- **Broadridge** (NYSE: BR): Buy 5.3%.
- **FactSet Research Systems** (NYSE: FDS): Buy 2%.

Continue building your portfolio with our Buys, including this highlighted today:

- **Oracle** (NYSE: ORCL): Buy 3.5%

Shorts:

- **John Deere** (NYSE: DE): Sell short 2%, along with *owning* 1.9% in **Valmont** (NYSE: VMI). This is a paired trade.

Pro options:

- **Gentex** (NASDAQ: GNTX): Sell to open Dec. 16, 2016, $17.50 puts, aiming for at least $0.55. Sell one put for every 100 shares you could buy at a net $16.95. Selling 23 puts, *Pro* is looking to add 1.5% to our stake, for 4.4% total in stock.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY):
  - Set up the **December put ratio spread** as shared in this recent alert. Lately, today, it can be set up for no net cost ($0.00).

Options expiring next:

- **Celgene** (NASDAQ: CELG): Our Oct. 21 $95 puts are on track to expire as income. We'll consider writing new ones as that happens.
- **Gilead Sciences** (NASDAQ: GILD): Our Oct. 21 $85 covered calls are currently on track to expire as income.
- **Wells Fargo** (NYSE: WFC): Our Oct. 14 $50.50 covered calls are on track to expire as income.

The Likelihood of a U.S. Recession, Revisited

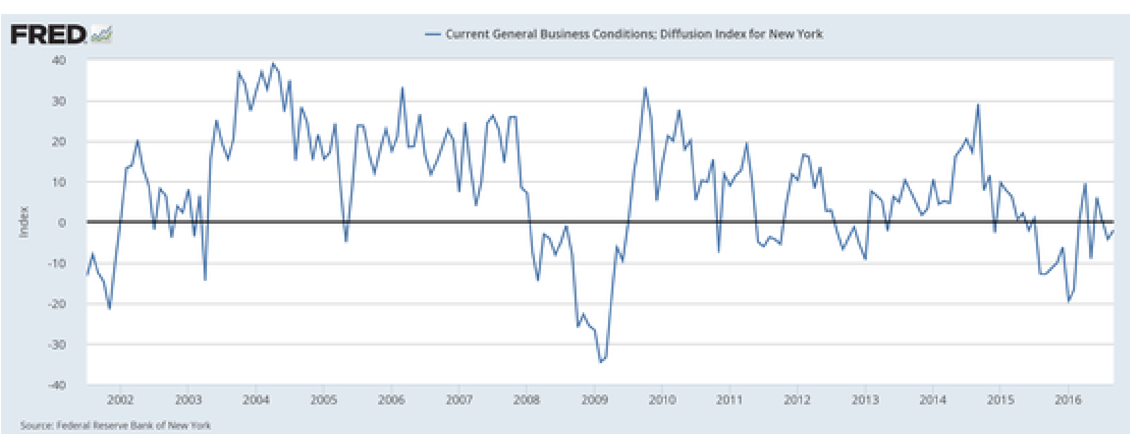
Published Oct 10, 2016 at 3:00PM

Dear *Pro* Fools,

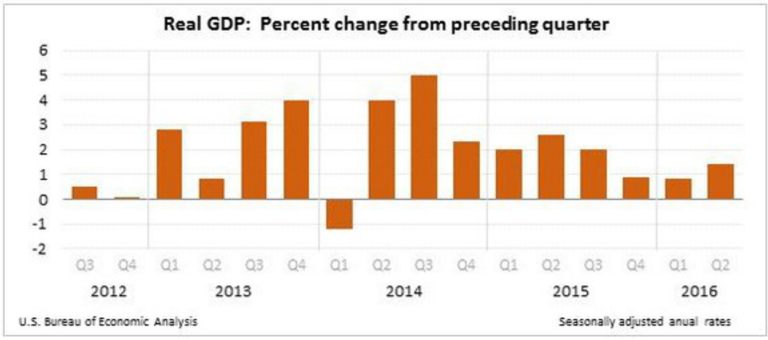
After the significant stock market volatility we experienced early this year, in late February I examined the likelihood of a near-term U.S. economic recession. Based upon an examination of three important data series, I concluded that the likelihood of a near-term U.S. economic recession was quite low. In retrospect, that conclusion has so far been correct. Crude oil prices have recovered from their lows, up 46% since the column in February:

Source: Bloomberg

The U.S. manufacturing sector is improving from its early in-the-year swoon, with the New York Fed's Empire State Manufacturing Survey up significantly from the low that was observed during the prior Memo (the index is at -1.99 for September, vs. -19.37 in January):



And according to the most recently released estimates from the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.4% in the second quarter of 2016 (after being up 0.8% in the first quarter):



It's now clear that the U.S. hasn't been in a recession during the first half of 2016. But that doesn't mean one won't happen in the future, or that a recession isn't currently unfolding now. In this Memo, I'll revisit the three data series I examined last time, and see whether the data suggests that the likelihood of a recession has changed.

1. Job Growth

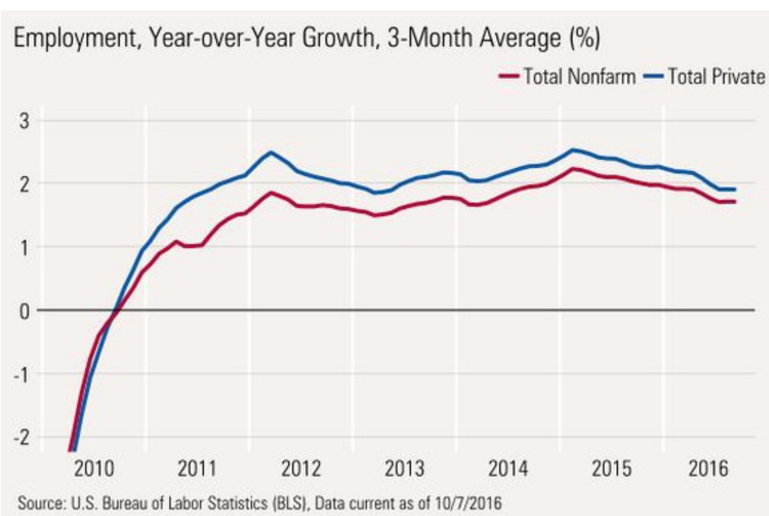
Higher unemployment rates are one of the most widely recognized indicators of a recession. For example, in December 2007, the national unemployment rate was 5%, and it had been at or below that rate for the previous 30 months. At the end of the recession, in June 2009, it was 9.5%.

As of the most recent reading, the U.S. unemployment rate is 5%, and it's been bouncing around that level since October of last year:

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2006	4.7	4.8	4.7	4.7	4.6	4.6	4.7	4.7	4.5	4.4	4.5	4.4
2007	4.6	4.5	4.4	4.5	4.4	4.6	4.7	4.6	4.7	4.7	4.7	5.0
2008	5.0	4.9	5.1	5.0	5.4	5.6	5.8	6.1	6.1	6.5	6.8	7.3
2009	7.8	8.3	8.7	9.0	9.4	9.5	9.5	9.6	9.8	10.0	9.9	9.9
2010	9.8	9.8	9.9	9.9	9.6	9.4	9.4	9.5	9.5	9.4	9.8	9.3
2011	9.1	9.0	9.0	9.1	9.0	9.1	9.0	9.0	9.0	8.8	8.6	8.5
2012	8.3	8.3	8.2	8.2	8.2	8.2	8.2	8.1	7.8	7.8	7.7	7.9
2013	8.0	7.7	7.5	7.6	7.5	7.5	7.3	7.3	7.3	7.2	6.9	6.7
2014	6.6	6.7	6.7	6.2	6.2	6.1	6.2	6.2	6.0	5.7	5.8	5.6
2015	5.7	5.5	5.5	5.4	5.5	5.3	5.3	5.1	5.1	5.0	5.0	5.0
2016	4.9	4.9	5.0	5.0	4.7	4.9	4.9	4.9	5.0			

Source: Bureau of Labor Statistics

The pace of job growth is slowly creeping downward, with a current reading of 1.7% vs about 2.1% in early 2015:



Recessions are strongly correlated with declining job growth. So the current decline in the pace of job growth indicates to me that all else equal, the likelihood of a recession has increased since the last time we examined this data series.

2. Wage Growth

Decelerating or falling wages are another strong indicator of a recession, as wage growth often declines in a recession.

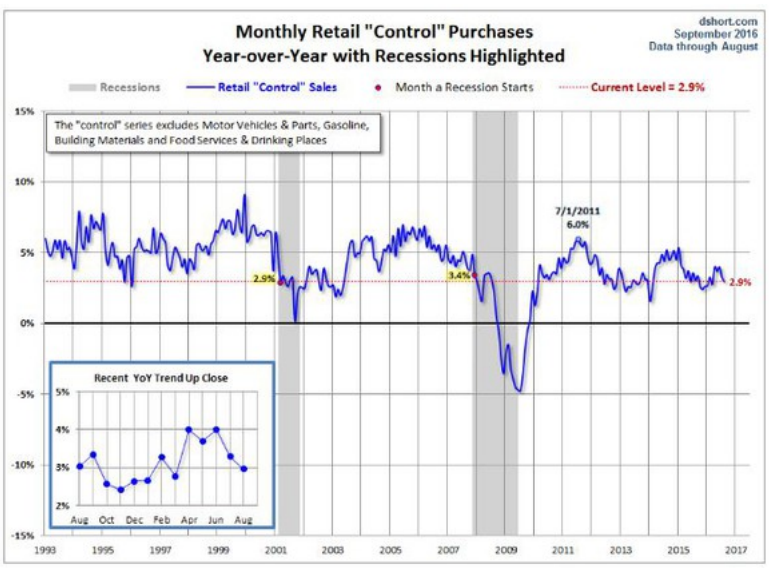
Private Sector Total Wage Growth and Components	Total Wage Year-over-Year % Change 3-Month Average	Inflation Year-over-Year % Change 3-Month Average	Real Total Wage Year-over-Year % Change 3-Month Average
September 2015	4.9%	0.1%	4.7%
October 2015	4.8%	0.1%	4.7%
November 2015	4.7%	0.2%	4.5%
December 2015	4.7%	0.4%	4.2%
January 2016	4.6%	0.8%	3.8%
February 2016	4.5%	1.0%	3.5%
March 2016	4.3%	1.1%	3.3%
April 2016	4.2%	1.0%	3.2%
May 2016	4.3%	1.0%	3.2%
June 2016	4.3%	1.1%	3.2%
July 2016	4.2%	1.0%	3.2%
August 2016	4.0%	1.0%	2.9%
September 2016	3.9%	1.0%	2.9%
Average (12 Months)	4.4%	0.8%	3.6%

Source: Bureau of Labor Statistics, Morningstar Calculations

Lately, real wage growth (i.e., adjusted for inflation) has been decelerating, at a three-month moving average of about 2.9% in September 2016 vs. 4%-plus late last year. As inflation rates have slowly crept higher, real wage growth has been pressured. This situation is likely to get worse in the coming months as energy inflation increases (see the recovery of crude oil prices above), pressuring real wage growth further. Again, this data series suggests to me that all else equal, the likelihood of a recession is higher now than it was in February.

3. Retail Sales

Slowing retail sales are yet another sign of a recession:



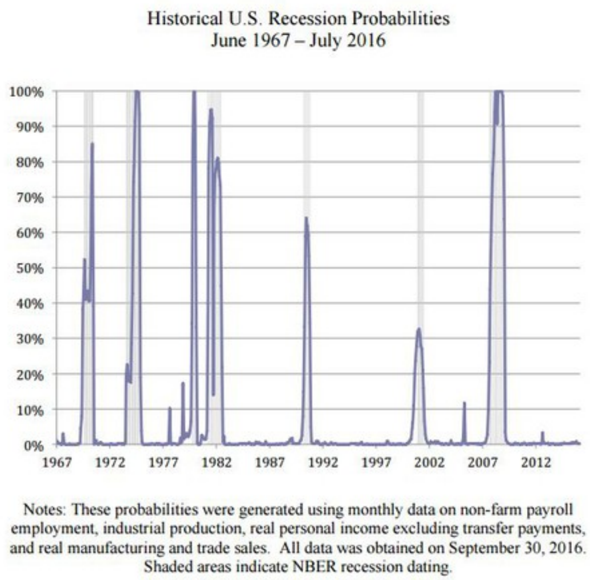
Source: advisorperspectives.com

The graph above examines "control" retail sales, which excludes motor vehicles and parts, gasoline, building materials, and food services and drinking places. This data series strips out certain volatile data series that can distort the true picture of the state of retail sales. As you can see in the graph above, the immediate trend is that "control" retail sales are experiencing decelerating growth.

The *Pro* Bottom Line

Despite strong stock market performance since my previous Memo on this topic in February, based on the data examined here, it appears to me that the likelihood of a near-term U.S. recession has increased since the beginning of this year. Given slowing job growth, deceleration in real wages, and slowing retail sales, there is reason to be somewhat more cautious about the state of the U.S. economy as we continue toward the end of 2016.

Of course, this data is a look back at what has recently happened, and although trends are worsening, what's happening now -- or about to happen -- could change that. And the less positive data doesn't necessarily mean a recession is right around the corner: According to the most recent data point (July 2016) from a [mathematical model that predicts the probability of a U.S. recession](), the likelihood is only 0.2%.



Fool on!

-- Billy (TMFBillyTheKid)

Pro Video Chat, October 2016

Published Oct 7, 2016 at 2:36PM

The *Pro* team held a live video chat on this page at 2 p.m. Eastern on Thursday, Oct. 20. Click below for a replay, or see below for a transcript!

Transcript

JEFF FISCHER :

Good afternoon, Motley Fool PRO members, and welcome to our October Chat. You'll see the live video on the screen that you're currently on and you can go to Slideo.com and enter the code, "PRO Chat October", that's "PRO Chat October", and ask your questions there and we will answer as many as we can.

Joining us on the chat today, as usual, is the PRO team with an extra, some added spice as well. Starting to the far left, we have Jeremy Myers, Team F-Tank. Jeremy?

JEREMY MYERS:

Hi Jeff.

JEFF FISCHER :

Good to see you again.

JEREMY MYERS:

Always excited to be here.

JEFF FISCHER :

Yeah, it's one of our favorite things of the month is to chat with you. And we're welcoming back to PRO, J.P. Bennett.

J.P. BENNETT:

An old face, but might be a new face to some people who just joined recently.

JEFF FISCHER :

That's right, new members may not recognize J.P. yet, but J.P. has been with PRO for quite a while. He took three or four months to work on The Motley Fool Asset Management Team and now he's back in PRO. So welcome back to PRO, J.P.

J.P. BENNETT:

Thank you.

JEFF FISCHER :

And we have on Skype, joining us from sunny Florida, Billy Kipersztok. Hey, Billy.

BILLY KIPERSZTOK:

Hello, great to be here.

JEFF FISCHER :

Good, we're all looking forward to seeing what you have in your surrounding environments today.

BILLY KIPERSZTOK:

I'm ready for it.

JEREMY MYERS:

We all reminded him to clean up before the video started.

JEFF FISCHER :

That's right, get the laundry done. And Billy told us he did get a bookcase.

BILLY KIPERSZTOK:

There is a bookcase, I can confirm.

JEFF FISCHER :

Excellent. So we only have, I should say at the outset, we have 45 minutes. We need to end at 2:45 today because of another event that's happening right on the heels of us . So we're going to get as much accomplished as we can in 45 minutes and we'll start by talking for a few minutes while you enter your questions into Slideo that we'll get to.

We'll start by talking about a few positions that are top of our minds, and we assume the top of your minds as well.   Let's jump right in with a stock that is on hold, Billy, and that's Wells Fargo, which just announced earnings last Friday as well, and our latest thoughts on that, Billy.

BILLY KIPERSZTOK:

Yeah, so I'm still parsing through their earnings report and I'm really trying to take my time with this one. I'm trying not to rush a decision as far as what we want to do with Wells Fargo. My initial thoughts on their quarter, immediately there's not much of a tangible impact from the scandal that you can see in their numbers. Their return metrics and account growth and certain other things, they seem to be pretty stable, although there were some other metrics that when you look just at September, which is when the scandal occurred, which was the last month of a quarter that was just reported, certain metrics including new account openings, when you look year-over-year from last year September to this year September. Mortgage referrals, certain other things took a significant decline, and that's most likely in response to the scandal that's been going on with Wells Fargo that you all know about.

So we're still kind of incorporating our thoughts about what happened this quarter and how the scandal is going to affect our long-term thesis. I will say that as far as our considerations for PRO are going, we want to consider; to make a decision about this, what we really want to think about is is our investment thesis significantly and materially changed? That's the first thing. Then the second thing is do we still trust management enough to maintain exposure to this position, because if we don't trust management, we shouldn't continue to hold Wells Fargo.

So those are the two questions that we really want to answer.   How is our investment thesis impacted moving forward and do we still trust management? We are still kind of processing and trying to determine the answer to those questions. As of right now, if I had to say which way we would be leaning towards, I would probably say that we may be leaning towards exiting the position, but again that determination has not yet been made and we are still processing the information. So that's our recap on our Wells Fargo position.

JEFF FISCHER :

Thank you, Billy. One good part about the time of year is it's the end of the year, or it's getting there, and we're reassessing the whole portfolio, as we shared toward the end of last month. We like to look at the end of the year, at all of our holdings, with extra scrutiny and potentially sell positions that are not living up to our expectations, that we think we can do better than.

Selling does a lot of things. It refocuses you. It makes you work harder in some ways to find something that you like much better than the sale, because you do feel that hole in the portfolio, that loss of exposure. But it really holds us to our standards. We really only want to own things that we believe in strongly, that we believe will match or exceed our North Star with reasonable risk, and if something is falling down on that account, we want to have the gumption to get rid of it, to move on and do better, to find something better.

So recently the PRO team met just a few days ago, and we talked about the handful of challenging positions in the portfolio, which included Wells Fargo and included Gilead right now and Valmont and Oracle as well. I'll talk about Gilead for a moment and then Jeremy can share some thoughts on Oracle and Valmont and where we stand at the moment.

But just so you know, we're always looking at each position, of course, and we're a concentrated portfolio so we're able to spend ample time on each position, and the ones that are not working out or that are lagging, we really want to make sure we still want you to own them , and that's what we're always working to make certain of.

So when it comes to Gilead, we decided as a team to keep the position for now. It's a high-quality business making incredible amounts of free cash flow. Revenue and earnings should hold fairly steady, at least the next couple of years, giving management time to perhaps make acquisitions to grow or buy at least part of a pipeline, or for it's own pipeline to offer more promise.

The stock is very inexpensive at around six times earnings, and even if free cash flow were to stay steady, we think the shares are worth more than this at this point. But that's only as of right now. We'll see earnings again in a few weeks and we'll again reassess and see if we want to keep it. Because we don't want to keep a value that is not going to grow, even if it's extremely cheap. If the business is not going to create value, we're not going to keep it, but for right now we're waiting to see how the next quarter comes out and what management has to say at that point.

Then Jeremy on Valmont reported today.

JEREMY MYERS:

Yes, let's start there because we have some actual news to cover. The stock was down about 5% earlier today, but it looks like it's bounced back. I've read through the earnings report; still working through the conference call. I would say it's more of the same, for the most part. There's not a big change quarter to quarter. We have them put in the bottom of the cycle and they're not bouncing back.

Their coding segment, they sell galvanized steel for infrastructure, structures, poles, things like that. Demand in the US was down a little bit, and especially from some of the solar power producers, less demand for custom projects, but there are some bright spots. I'll add in that the agriculture segment, the irrigation segment, is still down, which has some implications for the Deere short, which sort of confirms that they don't expect anything to improve anytime soon.

Very consistent with what Lindsay said, which is their biggest competitor there. But the one thing that Lindsay had said that you're seeing in Valmont's reports is that pricing has stayed consistent. They're at least being rational and they're not trying to just undercut each other. So the company continues to manage the business pretty well. They're cutting costs, they're starting to see improvements there, operating margins up about two-and-a-half percentage points year-to-date, so that's an additional $17 million in profits they've been able to achieve. They're starting to see improvements in the utility sector on Asian telecom and some of the overseas agriculture markets are actually improving a little bit.

So a few bright spots looking forward. The quarter was sort of a ho-hum quarter. I think that the initial reaction was probably the market just waiting and becoming frustrated, trying to time the bottom and it's still not here and there's no indication that it's going to be the next quarter too.

JEFF FISCHER:

Thank you, Jeremy. I see we have a lot of questions here. I'm the admin today on this as well, so Ellen can work on other projects right now. Please thumb-up the questions that you would like to see answered first and foremost. I think we can go right to questions because the other positions that we've talked about lately, as positions that we're focused on for what to do next, including Deere and Oracle, as we just talked about, they're showing up in your questions, so I think that's a way we can address them.

And let's go through quickly your questions and get to as many as we can. As shared, we only have until 2:45, so we have just over half an hour and let's see if we can get all of your questions answered.

We'll start with Kathryn, who is the most thumbed-up. Kathryn's new to PRO. Welcome, Kathryn. We're glad you' re here, and we hope you'll be here for many years, long enough to see what we're about and to prosper because of it, I hope.

Wells Fargo, will we have a stock repair for this? Billy just spoke to this, J.P., if you want to reiterate what Billy said or where we stand on Wells?

J.P. BENNETT:

I mean we're still considering, right to [inaudible] response. We're still considering it. There are challenges th ere, but if we don't like management, we really don't see a reason to own the stock. Well could in fact be a value trap, and that's what we try to avoid, right? We'll never hold a stock just because it's cheap. Sure, it's cheap on a historical basis, but it may be warranted, just with the changes, both company-specific and industry landscape, right? Maybe you think about regulations becoming more stringent, the capital they have to hold being higher. You've seen for a lot of banks, just the returns that they're able to generate on their investments have been less than what you've seen historically, not just because of where interest rates are.

So weighing all the factors, and we'll have a decision relatively soon I feel like.

BILLY KIPERSZTOK:

Also Kathryn, you mentioned that Wells Fargo is a Buy First, but it is no longer a Buy First; it has been placed on hold. So just kind of a semantics thing there, but it's important. It's not a Buy First; it is on hold.

JEFF FISCHER:

That hold was several weeks ago, I think, it was put on hold. We convey that every Monday in the Monday Memo, as well as on the discussion board.

Okay, great. So I can answer this one. Red44, thank you for posting, is asking, "What is the long-term plan for SVXY, which is an ETF vehicle that should grow in value over many years , as long as volatility is relatively stable or when it spikes, it regresses back down to the mean. And during periods of low volatility, ongoing low volatility, that's when SVXY should really shine and give us the kind of compounded 10% annualized we hope for at least, returns that we're seeking. So I view SVXY as a small, one-percent, very long-term holding that should compound, given the dynamics of the ETF, given that it shorts the futures of the VIX, of the Volatility Index.

Now for people who have more knowledge about those ETFs, such as VXX, which we've shorted in the past, we're considering adding a small short of VXX as well, because that short has, in the past year, two years really, outperformed along of SVXY, but shorting has other complications. You can get called out. You can't compound, so the position just shrinks over time, so we might do a combination approach. But my plan is to hold SVXY a long time.

Then we talked about this week, when SVXY falls sharply, since we now have more belief in its ability to come back and then reward us over time, we may add a small trading position to it when it falls very sharply, so why n ot use big spikes in volatility? This is something J.P. has argued for the past week. Use big spikes in volatility to add to SVXY, so I think we're all on board to potentially do that next time.

J.P. BENNETT:

Yeah, if you think in terms of tactical decisions, something like this that is go ing to move very sharply when the market is getting hit since the falls tend to be more volatile than the climbs up. It's a really easy way for us to kind of adjust our position in the portfolio with one decision, right? Given back earlier in the year when the market did get hit, it fell around 40% or so. Yes, it came back, but if there's something in the market that makes us want to adjust our exposure, it's an easy way to go about doing that.

JEFF FISCHER:

All right, so thank you for the question. I hope now you know, for now, we plan to keep SVXY for a long time and we may add little positions to it at times.

We have a question from Lon, hey Foolon, good to see you and thank you, as always, for all of your help on that discussion board. You are really incredible out there in helping so many members, and us too, in the work that you do, so thank you. Very Foolish. Lon is asking, "Any thoughts on Gentex as the shares fall a little today?" Billy, any thoughts on the Gentex puts or Gentex itself?

BILLY KIPERSZTOK:

Sure, since you prompted it, I'll start with the puts. Obviously it depends upon our assessment of the business what we want to do with those puts, but our puts expire, let's see, in December, so we still have two months until the expiration of those puts. They are currently right now in the money, so as it stands, if the stock price would stay the same until December, they would be assigned and turned into shares, which is something that we stated we were okay with in our initial put right alert. And anytime you write puts, you want to make sure that you're okay accepting the stock if it were to be assigned to you. But we may, as we have done with several other written put positions, roll that put out to a later month targeting further income, or we may decide to just accept more shares and buy more of Gentex.

And that kind of segues into the next part of the question which is, what did I think of the quarter? I thought that the quarter, at least based upon my cursory look at results, which I did this morning, it seemed to me to be an excellent earnings report. I wrote a little bit like my first-take thoughts on the Gentex board, so you can check that out . It was in response to CMF, who had posted about their earnings release and I wrote something there.

The company is doing well. They're increasing revenue. Revenue grew at greater than 10%. Earnings per share is growing near 20% year-over-year. Gross margins are as high as they've been in many years and seem to be continually increasing and the company just continues to execute really well and it's trading at a valuation that in my estimation is pretty cheap, and you can see that as a good deal below our fair value es timate.

So Gentex is a company; it's one of the companies that I cover that I have the most conviction in as far as at this price and at this valuation. The biggest risk to them being a migration of technology away from the mirror in cars, which is not something that we should discard, but I don't see that as a major risk anytime in the next three to five years, which is the period we are focused on with our long investments here at PRO.

So as for Lon's specific question as to why the shares fell a little bit today, I'm actually kind of surprised to see that because earlier today, after I looked at the release, Gentex was actually up about 2%, and that was earlier today, and now they're down about 2%. So I'm not sure if management said something in the conference call or an analyst asked a question that got a non-satisfactory response, but to my eyes, initially without having fully analyzed the quarter, seemed like it was a good quarter and Gentex continues to execute just as we expect, so things are looking good there.

JEFF FISCHER:

Sounds good, Billy. It could just be post-earnings volatility by selling and buying, who knows? But we'll look forward to your update on Gentex as you go through results.

J.P., I'll ask the next one from Kathryn again of you , and as we step to that question, first I'll say that Proport is up about 6.5% year-to-date, which is just a tad below the North Star at 7.2%. J.P. mentioned earlier, well we have the Santa Claus rally to look forward to, so maybe that'll help us.

J.P. BENNETT:

The North Star doesn't benefit from that, but we will.

JEFF FISCHER:

And I think we're a little above the indexes right now, so even though I personally feel that we've had kind of a challenging year with some challenging positions and some mistakes I've made, we're still doing pretty well on our returns, especially for veteran members. Then newer members, as always, as we always have said the past eight years , once you're with us a few years, your return should move in lock-step with us over time and hopefully you'll benefit every rolling three years with nicely positive returns , but so far this year, as with last year, a fairly up and down flat market, and we did well last year. I can't complain this year, although I'd like to be doing a bit better, but still not a bad year by any means so far. And hopefully we'll improve upon it going forward.

So J.P., I was going to ask you, and it just jumped down, but we'll still ask it anyway because you probably looked at it and are ready. Kathryn asks, "Percentages for stock buys resulted in fewer than a hundred shares for small accounts. How does that affect future options participation?"

J.P. BENNETT:

I think the way we've always talked about it is the core of your portfolio should be holding great stocks, right? And then you layer on top of that option strategies, if you can, and so even if you can't buy a hundred shares, you can't buy it in round lots, so maybe you'll have to miss out on future options strategies for a particular name. we would never recommend buying a stock if we didn't believe that it could beat the North Star on its own right, just with the stock going up in price. So I wouldn't be overly concerned with that. It's always a great benefit to kind of have that tool in your pocket for in the future if something doesn't work out like you want and you maybe want some extra income or something like that, but at the core, buy shares of great companies. That's what we strive to do and so do that, even if you can't buy in round lots.

JEFF FISCHER:

Sounds good. Which then leads into our next question. The one at the top now is from Anonymous. "Has PRO ever sold a stock? We've been riding Gilead downwards all year. Gilead has had a rough year . Starbucks; Starbucks, come on. Great stock over the years, but flat or down this year.

MALE:

It's only down around 13% or so since peaking last year. And I'll just quickly jump on that one; you can speak to the other ones. But that's a stock that I think since I took over coverage two or so years ago, I've always said, man, this valuation is pretty frothy or pretty full, right? Frothy, I don't think it's a bubble, but just speaking in terms of coffee-speak, right? But I actually like that it is kind of going nowhere because that gives it a chance to grown into its valuation, right? Because if you look at the business, it's still doing tremendously well and so the stock goes nowhere, but the fundamentals continue to improve, the stock just becomes cheaper over time and so it's down only 13%, like I said, since peaking last year. I'm not really all that worried, to be honest with you.

JEFF FISCHER:

And we have sold many stocks over the eight years. I don't know, more than a dozen easily, maybe 18, maybe 20. Because we're always trying to improve the portfolio and focus on companies that we believe in most strongly. Some stocks we've bought just opportunistically, like in energy and metals and things like that, and sold when our thesis played out.

BILLY KIPERSZTOK:

AIG as well.

JEFF FISCHER:

AIG as well. To speak to the other few that you mentioned here and then conclude with a point, I hope. Faxet we just started buying in May, we recommended first in May and a 2% position, and it's up from the day the alert went out; it's still up. It just ran up further than I would have expected and then gave those gains back, but that's all short-term stuff. We believe in the business and for the past 20 years it has grown earnings every single year, it's grown revenue for more than 30 years straight, 35 years. It's a good business with pricing power, strong recurring revenue, 95% retention rate on customers, so we believe in the long-term of that stock. We're actually looking at it to maybe add a little bit more, now that it's come back to our original purchase price.

Gilead Sciences , as we talked about earlier, even as it hits record free cash flow as a business, the stock is down I think 20, 25% this year. That said, biotech has had a rough year as well. Celgene is down quite a bit along with some other giants. But as shared earlier, we believe in the business. If that is not the case, if we don't believe in the business anymore or the stock price, then we will indeed sell.

We're always looking for things to put in the portfolio that are better than what we own, and since we're a limited cash portfolio, we don't add cash to the portfolio; we do need to sell to keep a cash balance and keep buying new things that we like more. So you will see sells the longer you're with PRO, definitely. But we're very particular and deliberate in our sells, in most cases, unless something really throws us for a surprise.

BILLY KIPERSZTOK:

And Jeff?

JEFF FISCHER:

Yes, Billy?

BILLY KIPERSZTOK:

I'm sorry if I didn't catch it or if you already went into this, but did we go over some of the stocks that we had recently sold?

JEFF FISCHER:

No, we just mentioned AIG and there's things like Cameco and L-3 and…

BILLY KIPERSZTOK:

Things that come to mind for me are Buckle and Tupperware as well. So we definitely do sell stocks, but it's not all that frequent.

MALE:

The Buckle is a great example of kind of a value shot that we got outright. It was really cheap. It remains cheap, but we just looked at it and we're like we don't really believe in management's direction, we don't believe in the fundamentals, so we're getting out even though it's cheap. It's had a pretty rough go of it since we sold it.

MALE:

We try really hard to differentiate between market volatility and shifts in sentiment towards the company is not unusual for stocks to move up and down 10, 15% for no reason versus shifts in fundamentals of the underlying business and the industry, which definitely needs work and we spend time trying to figure out if that changes the investment thesis.

JEFF FISCHER:

That's a great point, and over time so far, our turnover has been about 10%, so far below the average mutual fund, which I know is 40ish, 50% even, which means they're selling, they're churning half their holdings every year, which is not a way to generate good returns. We like our turnover to be low, 20% or lower, 10% is great, lower than that, fine, some years, because that's the way you compound. We're always looking to trade up into better companies that we can then keep for years and years. So my two cents.

GoodName is asking, "Most recent alerts have related to options. Do you see this as a favorable environment for using options? Why?" Ironically, you guys can add whatever you wish to this, but I would say no. Options aren't paying well right now. That said, the stock market is in some ways even trickier than options. Do you guys want to expound on that?

MALE:

I would say my stance right now is personally I place an even higher emphasis on making sure that the effective entry price is the price I'm willing to actually buy shares at, right? I'm willing to give up a little extra yield because let's be honest, most options don't pay very well, and so I'll give up a little bit extra if it means I get to write puts or do options on a company that I'm really comfortable with and effective entry price that I actually really want to buy shares at.

JEFF FISCHER:

I think as the year ends and we reassess the whole portfolio, it's fairly likely that we'll see some sells and some new buys, as well as new shorts. So it has been pretty option-centric in the past year. We've been targeting income, that's true, but it's also been challenging to find stocks that we're really excited to buy, that we like better than what we already own and so forth.

But as we manage the portfolio, we're likely to move ahead in baskets of sells of two or three and purchases of two or three and new things, and so we may not be quite so option-centric. I know we won't be all the time so options-centric, but it's a touch environment for both options because they don't pay well right now and stocks as well. There's a lot of risk out there.

MALE:

Valuations seeming a little stretched on a lot of companies and we have a number of holdings that seem to be moving sideways, at least in the short term, but no obvious catalysts for the next quarter or two. It's probably not surprising that you've seen a number of cover calls in income-type positions, and we'll probably continue to do that.

JEFF FISCHER:

That's a good point. We've done more covered calls this year than we have I think, perhaps since inception pretty much. So Heck Creek, hey Heck, hey Ben, is asking, "How much were we smiling after AXP announced earnings?" I'm glad the stock is up about 10%. It's just a good example of when you believe in a business, as Jeremy talked about a question prior, you give it time to play out. And as we've talked about here as well in the past, we don't want our whole portfolio to be doing well all at once, because that means it's likely all going to do poorly all at once. History and studies show that laggards in good companies, lagging stocks of good companies become leaders later on and vice versa. So to smooth out your returns a bit, it's good to have some good companies that have lagging stocks right now in your portfolio.

That said, AXP is only in Motley Fool Options, where we have the stock, but now that shares are up so much, maybe we'll look at covered calls there finally. But I still believe the brand and the business will prove itself out over the long run.

So now a question from Kathryn; we already answered that question from Kathryn. Stocks are the main show here; options when you can do them. Great. And a question from Mike, "Heads up on what we'll do with Nike, diagonal after tomorrow's expiration?" That's a Motley Fool Options position. I was writing something up on it today that may go out as soon as tomorrow as those calls expire, so watch your inbo x soon.

And Tim is asking, "What would be a good breakdown of our cash allocation, such as income and hedging and market correction purchases?" If any of you want to jump in on that, you certainly do. It's a tough question, so I'll thrown in that on average over time, we've averaged 72% long, about 20% short and 10 ish percent options/cash, very roughly speaking. And we'll go whichever way the market seems to tell us to go. We don't have a set allocation framework that we're always going to stick to. If we're bearish, we could be no more than 50% long or less, so we'll be flexible with the market opportunities.

I don't know if you guys have anything you'd like to add to that, to Tim's question?

BILLY KIPERSZTOK:

Yeah, I don't really think of our cash allocation as having different baskets of like using a portion of our cash for income or a portion for hedging or a portion for something else. I kind of just view the cash by itself. The amount of cash that we're holding relative to maybe the amount of short put exposure we have or the long exposure that we have, that kind of gives you a sense of how we feel about the market in general. If we're holding more cash than we normally do, maybe we're feeling a bit more defensive, and if we're holding a bit less cash than we normally do, maybe we're feeling like there are some opportunities in the market for us to pursue. So the way we treat our cash is a way for you guys also to gauge our sentiment.

JEFF FISCHER:

Jeremy just wrote about cash in this week's Monday Memo too.

JEREMY MYERS:

We get a lot of questions about that.

JEFF FISCHER:

But thanks, Billy. That was a better direct answer to Tim than I gave now, rereading his question.

Okay, we're going to go down to Leslie's question. Great to see you, Leslie. You can see she's welcoming J.P. back, questioning about Deere. Great to see the rest of us. Thank you, Leslie, for as always, your very kind comments. Billy does rock the tie. J.P., quick thoughts on Deere.

J.P. BENNETT:

Quick thoughts, or can I have the rest of this chat?

JEFF FISCHER:

We have 13 minutes and I'm hoping we can answer all these questions.

J.P. BENNETT:

Well don't count on it because I'm about to get started. Quick take, I posted some comments up on Deere's board. I know you guys hit on it while I was away and it continues to be the case in the months since they posted earnings. Results for the industry are pretty abysmal, right? If you look at it on a monthly basis, four-wheel drive tractors down 20, 30% month over month over month over month. And in many cases Deere is down more than the industry, so their fundamentals are not; it's just the industry is not doing very good.

You look at other people in the industry and they're saying you could see upwards of two, three planting cycles before you see any kind of changing sentiment for orders. If you just kind of look at that part of the thesis, it's playing out perfectly. The part where we kind of messed up a little bit on and it's really important if you're going to be good at shorting over the long run is being able to identify when sentiment is really going to break down.

So what we saw with say something like World Acceptance where that short worked out amazing because we identified A, when the fundamentals were really going to start to deteriorate even at a faster pace than they were previously and the second part is we also identified when sentiment was just going to get super bearish. We were able to turn that pretty good, and to be frank, we were wrong in terms of that part. If you look at kind of the industrial machinery index for the S&P since bottoming out when the market fell, it's upwards of over 30%, right?

So if you think in terms of just kind of sector rotation and kind of trends like that, there's just a lot of money that's flown into this industry because people are saying that the bottom is in and I fundamentally don't believe that is the case. When you look at heavy equipment, those cycles take years to play out, to kind of reverse course. And so we still think that eventually things are going to play out like we want, but at the same time, we need to kind of be humble and practice proper portfolio management and not just be like we're going to hang onto this thing until the very end, right? We need to be humble and recognize maybe people just are going to forever look two, three years down the road and kind of have that pie-in-the-sky analysis.

I think based on how the industry basically overextended itself due to the commodity super cycle, it's going to take years to play out, but right now the stock is not trading based on those expectations. People are saying that maybe the bottom is in this year and it's going to rebound sharply and so we're going to keep watching it, but it's not going to have a leash that extends for years and years. We're going to make what we believe is the best decision.

JEFF FISCHER:

Thank you, J.P. And now we have ten minutes left, and let's really see if….

J.P. BENNETT:

That wasn't too bad.

JEFF FISCHER:

That wasn't. that was good. It's a complicated question, and we're going, as J.P. said, we're reassessing it every week now.

Let's see if we can get through all these. It will be a miracle, but I'll start with Snide23 who says, "Why no call writing on DGS since the first one? What has changed in the thinking since then?" What's happened is emerging markets have been stronger. The ETF is now around 42 up from 38 where we wrote the first covered calls, so it's good those calls expired and we haven't covered it again. That's quite a move for an index since then. And the ETF is near a 52-week high , which would be a good thing if it can get to that. Just kind of confirmation that there's buying interest there and the valuation looks reasonable still. And the calls have not paid well, so that was part of the thinking too, so really it's good to seem some appreciation and we'll write calls again only if they pay well and we like the valuation pricing on it too.

Anonymous is asking, "The thinking on AmTrust? Keep holding for larger growth long term? We don't hear much from you on AmTrust from you lately it seems." It's true, AmTrust has had a quiet year. I'll just say, and J.P. if you want to add anything of course do, but it's a stock I've known 11, 12 years now and I still like how they're growing the business largely through acquisition over time and I think they've done something different in the industry and created value because of it and I think in the long run, as long as we believe in the thesis, we will be keeping it long term.

J.P. BENNETT:

I would say maybe just a little bit more pessimistic and we're a motley bunch, so we can always have different opinions, right? And just if you think about it in terms of where the insurance and reinsurance markets are, they're extremely competitive. There's a ton of money that has flown in from hedge funds and from other people and so you look at it, the returns these companies are able to generate going forward, are not as great as they once were and I do believe you are seeing people start to kind of move into segments where before AmTrust was one of the few players.

There's a lot more people playing. I think it's going to be a lot more competitive going forward, so I wouldn't expect the same type of growth going forward unless they are willing to kind of reduce how kind of strict they were with their acquisitions and kind of maybe play a little more fast and loose with the type of risks that they were accepting. And if you look at certain segments of the insurance market that they're playing in, the market looks like it's had some really great years and so it's probably going to start tightening up and conditions are going to start worsening and so I think that probably has some thing to do with why AmTrust stock has been a little bit troubled recently.

JEFF FISCHER:

It also ran up so far in prior years. But yeah, you're right. I would expect them to make acquisitions that are kind of complementary to what they do as well, to grow a bit more, grow their fee business some more potentially. As with any insurance provider, you have to believe in management, which we've talked about a lot because there's risk there too, but so far, we're with it. Good points though, J.P.

We have seven minutes to go; let's see how far we can get. We're in pretty good shape. Anonymous is asking, "We mentioned Oracle, but we haven't yet expanded. Jeremy, we just talked about it this week and Jeremy shared his thoughts with us, with the team on the thesis.

JEREMY MYERS:

Oracle is a stock we've owned for a long time now and I would say as a whole has probably underperformed our expectations and has been going through a transition over the last two years or so from an on-premise license business where they get all their cash upfront to a software-as-a-service subscription business and the economics of those two businesses are different, so there's been some distortion in the financials. What you're seeing is sales growth has slowed. The top line is about flat. They're not making a lot of new licensure sells and within that on premise business, they're making up for that by selling support and updates.

So my one concern there is a lot of open source software is becoming much better and much more competitive in the market and they need to be able to defend that part of their business while the cloud business is growing. At this point, the cloud business is only about 10% of sales. Now it's growing. Last quarter grew at 80% and is actually starting to grow faster as it gets bigger, which is pretty amazing for the size of the company. So this year it'll probably grow, [inaudible] just got in for 65+%, so that's impressive and there's a great reception for the product, but we need to look down the road three or four years and be convinced that Oracle's going to be able to also transition a lot of those legacy database customers into sort of a hybrid cloud model so that they'll continue to capture that cash and that profit is available in the industry.

I wouldn't say that I'm negative at this point; I'm just skeptical and just trying to think through what that's going to look like.

JEFF FISCHER:

We ended our last meeting with Jeremy saying some things are starting to go in the right direction, definitely, and they've maintained their core free cash flow well; they just haven't grown it for several years. So let's give them another quarter; we'll see results again in December and we're just going quarter by quarter, kind of…

MALE:

I want to see management deliver on the profitability expectations that they've promised for that cloud business, that they expect to get to 80% gross margins. They've grown from 40 to 60 over the last year, and they also claim that the business as a whole has hit a trough in profitability and it should improve from here on out. So if they're able to deliver and you start to see that trend reversing, I'd be much more positive.

JEFF FISCHER:

And we do believe that the risk should be reasonable while we wait to see it play out, at least quarter by quarter as we go.

MALE:

Sure, and I don't see a ton of downside at this point either. I wrote in my last update that I sort of look at it as ballast in the portfolio. If there's volatility, I don't expect it to get hit all that hard while we're waiting for some of those new initiatives and new investments to really start to pay off.

JEFF FISCHER:

Great, so Karen is asking, "Do we plan to write new puts on Celgene after ours expire tomorrow?" We did make good income, expiring tomorrow, and we'll see as we look at the portfolio as a whole, we'll make that decision fairly soon.

Any updates on Wells Fargo? We talked about that right at the outset at two o'clock, so this is a good reminder that this will be on the PRO website, archived indefinitely, so you can revisit and if you miss anything, you'll see it there.

I think this next question from Mitchell, I'll go through quickly too because I think it regards Motley Fool Options more than PRO. "A lot of trades cannot be filled at the strike prices indicated." We usually provide flexible guidance, even if it's a spy-put ratio spread that you may be talking about, you move your strikes up or down in accordance with how much the spy has moved in that case and/or no matter what you're talking about, PRO or Options, watch Strategies You Can Start on Friday for updates or with PRO Catch-up Trades on Monday.   So hopefully that will help you. Then really read the pricing guidance too, because we try to add flexibility and timely advice over the weeks, no matter when you show up to the trade, this yield per month, etc.

Current thinking on Deere short? J.P. just covered that. Anonymous, here's one for Billy, I think, "Covered pizza shares with calls expire tomorrow." So this is timely. "Shares are 80. What do you think you should do?" What should anonymous do, Billy?

BILLY KIPERSZOTK:

I think it depends on why you wrote those covered calls. If you did it as part of an alternative trade for when we shorted Domino's Pizza to hedge a portion of your portion, perhaps you could let those shares go because at this point for PRO, now that we've shorted 2% in Domino's Pizza, it basically effectively lowers our Papa John's exposure by 2%, so if you kind of did the covered calls to match us, when you sell, you're going to end up being at the same level of exposure in pizza that we are. Now if you sold those covered calls for income and you don't want to lose those shares, then you might want to roll them up and out. Really it depends on why you wrote those covered calls.

Now with respect to your specific question, is do we see pizza, Papa John's, making a move? I'm not sure whether you mean making a move down or up. If it does make a move down, we are hedged by our Domino's short, and if it makes a move up , it may or may not, I'm not sure. They report earnings in a couple of weeks, I think in early November, and if those earnings are strong, then the stock might rise, but whether you roll those calls is really up to you as far as why you wrote them in the fist place.

JEFF FISCHER:

All right, thank you, everybody. We do have to wrap up here, unfortunately.   Jayco, a final question on Skyworks? That's an Options position that expires next week. No need to take action as long as Skyworks stays above $72.50. Couldn't help myself there.

So the rest of the questions we'll just answer and put on the site along with this archive chat and video. So thank you, everyone. Jeremy, thank you.

JEREMY MYERS:

Good to be here.

J.P. BENNETT:

Glad to be back.

JEFF FISCHER:

J.P. good to have you back, and Billy, thank you for the snazzy tie and calling in.

BLLY KIPERSZTOK:

No problem, thank you. Pleasure to be here.

JEFF FISCHER:

Thank you, Motley Fool PRO members. We'll see you on the boards and we'll see you again in the Monday Memo as well and next month for a chat as well. Thank you. Fool On!

Close Your Short on Pier 1 Imports

Published Oct 5, 2016 at 1:52PM

How You Participate

- **Trade:** Buy to close your remaining short shares of **Pier 1** (NYSE: PIR).
- **Allocation:** We are currently short 3,700 shares, or 0.6% of the portfolio.
- **Price Guidance:** ***It is incredibly important that you use a limit order*** and aim to close at going prices. ***If we all set limit orders at no greater than the going price, we may be able to avoid causing the stock price to rise due to the collective action of our membership.***
- **Price (as of 1:38 p.m.):** $4.53

What We're Thinking

After placing the stock on Hold a few weeks ago (watch or read about that decision here, from our late-September Portfolio Positioning Event), today we're recommending that *Pro* members close their entire short positions on Pier 1.

Last week, the company reported second-quarter 2017 results. Those results had already been pre-announced, and they were not good. The company reported decelerating same-store sales or comps (-4.3%), declining net sales (-6.7% year-over-year), and negative operating and net margins. Management also guided to continued comps and sales contractions for the rest of the year. In a vacuum, our short thesis (that the company's brick-and-mortar business is in a serious long-term decline and that it doesn't have the resources to compete with big-pocketed competitors in the omni-channel market) is playing out just as we'd hoped.

However, we don't live in a vacuum. On Sept. 19, management disclosed that hedge fund Alden Global Capital had acquired a 9.5% stake in the company. Alden Global Capital is a secretive hedge fund that focuses on distressed equities. Recently, Alden Global has been known for buying up news media assets and making significant changes to the companies; Alden Global's principal investor, billionaire Randall Smith, has been described as a "pioneer of so-called vulture investing."

Following the Alden Global news, the company quietly disclosed on Sept. 27 that it was adopting a "Short-Term Shareholder Rights Protection Agreement." In Pier 1's words, the rights from the agreement "restrict any person or group from acquiring beneficial ownership of 10% or more of the Company's outstanding common stock (including, for these purposes, certain derivative securities) after the date of this announcement. The Rights will not prevent a takeover of the Company, but may cause substantial dilution to anyone acquiring 10% or more of the Company's common stock, which may block or render more difficult a merger, tender offer or other business combination involving the Company that is not supported by the Board of Directors."

Based on this agreement, our assessment is that management is likely expecting Alden Global to pursue a hostile takeover of Pier 1, either by buying up more shares in the public markets or by making a tender offer to current shareholders.

We have prior experience with an activist investor targeting one of our struggling shorts (see our position history with Boulder Brands). Combined with the above assessment, this makes us content to close our position now for an approximate 9% gain in the three months since we started it.

We still expect further decline in the company's business, and it would have been nice to be able to continue holding the short. But risk management dictates that the proper decision is to close our short now. Shorting is inherently much more tactical and timing-based than investing in core long positions, and we must be willing to act quickly and decisively when needed.

Once we've closed this position, we can then keep an eye on the company's situation and see whether an alternative strategy is possible later, which will depend on how our assessment of the investment thesis changes. And even if we don't reinitiate a strategy on Pier 1, we can be content with our 9% gain on this position in a short three months, while the market indexes increased to new highs.

Alternative Trades

- **If you set up a any other alternative position on Pier 1 (synthetic short, bearish spreads, etc.):** We recommend that members who followed us using an alternative trade close their position as well.

Pro Can Help

- Questions? Head over to the Short Pier 1 discussion board.

The Facts on FactSet Research

Published Oct 3, 2016 at 3:27PM

Dear *Pro* members,

October has begun, hearkening another month of earnings reports -- and the final quarter of the year. We like to use this quarter to reassess all of our positions with a *twice-as-critical* eye, making sure we don't want to close some by year-end (perhaps for a tax loss where we're losing faith, or to clear room for new positions we like better). Some of us, myself included, are slow to pull the selling trigger (I tell myself this is a much better fault to have than selling too quickly!), so I find the year-end gut-check helpful. Expect updates on this process in the *Pro* port from here through the end of December.

Meanwhile, data and analytics company **FactSet Research Systems** (NYSE: FDS) was ahead of the pack in announcing fourth-quarter 2016 results last week, but the stock has been kicked in response. Those results continued FactSet's long streak of steady growth, but were shy of average Wall Street estimates. That fact, plus fear of customer cancellations, plus analyst downgrades all combined to clock the stock. After going through results, we don't share Wall Street's concerns to nearly the same degree. FactSet remains a **Buy First** at our current 2% allocation. If you don't own shares yet, step up to the plate! (Or, at least, "sell to open" puts, considering any $155 or $160 puts today.)

The Facts on FactSet

In the quarter that just ended, FactSet's revenue increased by 9.7% to $287 million, while organic revenue was up 8.8% and diluted earnings per share (excluding one-time gains) rose 11.9%.

Client count was up 17 to nearly 3,100. User count grew by more than 2,100 (up 5.5%) to greater than 65,600. The company is paid on both metrics, and adding new clients is important because it leads to long-term cross-selling opportunities and typically a growing user count at those businesses. On this count, FactSet had record growth in new client acquisition last quarter and saw more competitive wins in the marketplace than it has before. In an industry that is largely about taking market share, FactSet is relatively small compared with competitors; it has an expanding product suite, and it's doing "exceptionally well" alongside larger peers. And revenue for all of FactSet's add-on products (those being sold to existing clients) was up at least 10% year-over-year. International revenue also advanced smartly, up 10% in Europe and nearly 17% in Asia-Pacific. Next quarter, management guides for 14.5% total EPS growth.

So why did the stock fall?

Funds Losing to the Market

In part, the answer relates to a problem you and I know very well in this industry: underperforming mutual funds and hedge funds. Yes, record highs in the stock market mean *tough* business for many active managers. If you can't keep up with the market, your business is at risk -- and that's what the industry is seeing, leading to employee firings or fund closures. As measured in *dollars*, FactSet's retention remained at 95%, so most of its revenue is renewing thanks to the staying power of large clients. But it is seeing more "market-related cancellations," when a smaller fund that's losing to the market goes out of business or lets employees go. Global director of sales Scott Miller said "it feels like the worst of [this] is over," but management admits it doesn't know what the market will do next.

Most of FactSet's largest customers are still in the game, but this was the second quarter in which management had to discuss higher-than-usual cancellation numbers. Investors were spooked and are selling the stock -- despite the fact that FactSet is adding healthy numbers of new clients and still growing. Management sees a healthy pipeline ahead, too, and is confident about its competitive position.

Moving With the Punches

Management's confidence is boosted by the belief that the company is among the best-positioned to help passive investing clients, the number of which is growing. Dollars that are moving out of active funds don't just vanish; these dollars move into passive investments, including ETFs. FactSet bought the data and analytics business run by ETF.com in 2015, and management believes it offers the highest-quality data and analytics solutions to passive fund managers. Keep in mind, most ETFs *are not* actually passive. Managers need to assess an ETF's holdings, potential, and risks before investing -- and the sheer number of ETFs (there are more funds than there are individual stocks) makes this a daunting task. CEO Frederick Snow said the company will "continue to capitalize on marketplace trends, including the movement from active to passive."

Overall, FactSet's offerings to every client are sticky -- whether that client is a global bank or a small hedge fund, and whether it's using portfolio analytics tools, risk assessment data, or multi-asset class analysis tools. A typical client might be using all of them, because FactSet's solutions are enterprisewide. As with *Pro* holding **Verisk Analytics** (NASDAQ: VRSK) in the insurance industry, FactSet is embedded into its clients' daily workflow, making the company essential to the process of doing business. When I've spoken with friends in money management who use FactSet, the universal response has been along these lines: "The data is indispensable. Once you use it, you can't work without it. And switching costs [in time and process disruption] are enormous." This speaks to FactSet's high retention rate.

I believe Wall Street fears a growth slowdown to a degree that won't likely materialize. If the stock market continues to hit new highs, putting lagging funds out of business, FactSet may lose some more small clients that can't compete -- but its large client list is growing, and its revenue dollars are, too. It's very well positioned to keep serving the growing horde of passive asset managers, and its young product suite promises healthy cross-selling to clients. On the flip side, if Wall Street declines, that's not an easy situation for fund managers either (the fund business is tough either way!). During downturns in the past, they've relied on FactSet's services even more. The company increased revenue and earnings handsomely right through 2008 and 2009.

Meanwhile, management bought back 258,000 shares last quarter at an average of $166 apiece, and they won't take on debt to buy back shares (a decision we're happy with!), keeping FactSet's powder dry to make major acquisitions. Trading at about $160 today, the stock fetches about 23 times expected earnings -- right in line with its 10-year average P/E, putting it near our fair-value estimate for North Star-type returns. It may take a while to see those returns (multiple compression is one risk today), but as with our other high-quality "compounding" businesses, we expect the stock to eventually deliver the long-term gains we seek.

Here's our original buy report (the stock is up 7% since then). Questions? Please ask on the FactSet board.

Fool on!

-- Jeff (TMFFischer)

Pro Performance

Performance as of 8/31/2016

	Annualized		Total Return	
	Since Inception	Rolling 3-Year	YTD	Inception
Pro Portfolio	**13.3%**	**16.2%**	**7.3%**	**167.9%**
North Star	**8.3%**	**8.0%**	**6.5%**	**88.0%**
S&P 500 Total Return	11.9%	12.3%	7.8%	144.2%
MSCI World	6.1%	5.3%	3.4%	60.3%

*Start close of 10/6/08.

Pro Guidance Changes and Completed Trades

- Please see our new weekly Monday article covering these topics.

More From Motley Fool *Pro*

- Charts of the Week
- Resist the Easy Explanation
- Short Stories on Four Short Ideas

Pro Catch-Up Trades and Upcoming Expirations: Oct. 3, 2016

Published Oct 3, 2016 at 3:27PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

- Just getting started? Our Portfolio Building Report No. 1 features details on all our Buy First stocks; Portfolio Building Reports No. 2 and No. 3 get you up to speed on all of our Buy stocks; and our Portfolio Positioning Report tackles our shorts, options, and hedges.

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Gentex** (NASDAQ: GNTX): Buy 2.9%.
- **FactSet Research Systems** (NYSE: FDS): Buy 2%.
- **MasterCard** (NYSE: MA): Buy up to 4.6% (or buy in halves over time).

Continue building your portfolio with our Buys, including these highlighted today:

- **AmTrust Financial Services** (NASDAQ: AFSI): Buy up to 5.2%, in halves if preferred. Or, see options below.
- **ProShares Short VIX Short-term Futures** (NYSEMKT: SVXY): Buy 1.1%.

Shorts:

- **John Deere** (NYSE: DE): Sell short 1.9%, along with *owning* 2% in **Valmont** (NYSE: VMI). This is a paired trade.

Pro options:

- **AmTrust Financial Services**: This is not an official recommendation, since the stock is a Buy. But if you don't want to buy all of your 5.2% stake yet, consider selling to open January 2017 $25 puts, lately about $1.05, to target potentially buying some of your shares around $24, if they're below your strike by expiration.
- **Gentex**: Sell to open Dec. 16, 2016, $17.50 puts, aiming for at least $0.70. Sell one put for every 100 shares you could buy at a net $16.80. Selling 23 puts, *Pro* is looking to add 1.5% to our stake, for 4.4% total in stock.
- **Skyworks Solutions** (NASDAQ: SWKS): Sell to open January 2017 $75 calls on your shares if you want income, selling one call per every 100 shares you want to cover.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY):
  - Set up the **December put ratio spread** as shared in this recent alert. Lately, today, it can be set up for no net cost ($0.00).

- If you haven't yet, you can set up something similar to our November put ratio spread by buying to open one November 18, 2016 $210 put and selling to open two November 18, 2016 $202 puts ($2 higher than our official trade). This can be set up today for a net debit of about $0.09 or $0.10. So, it's not a credit, but it's only a small debit.

Options expiring next:

- **Celgene** (NASDAQ: CELG): Our Oct. 21 $95 puts are on track to expire as income. We'll consider writing new ones as that happens.
- **Gilead Sciences** (NASDAQ: GILD): Our Oct. 21 $85 covered calls are currently on track to expire as income.
- **Wells Fargo** (NYSE: WFC): Our Oct. 14 $50.50 covered calls are on track to expire as income.

Pro Guidance Changes and Completed Trades: Oct. 3, 2016

Published Oct 3, 2016 at 3:27PM

Pro Guidance Changes (from the past two weeks)

- **Deere & Co.** (NYSE: DE): Moves back to Short, at a 1.9% allocation. We also assume you own a 2% stake in **Valmont** (NYSE: VMI).
- **Pier 1** (NYSE: PIR): Moves to Hold as we review recent news events. Hold means that if you have a position, keep it, but don't start a new one for now.
- **Wells Fargo** (NYSE: WFC): Moves to Hold as we assimilate and contemplate the unfolding scandal. We're as disappointed as you are -- perhaps even more so, given that it's our recommendation.

Pro Completed Trades (from the past two weeks)

- **Gentex** (NASDAQ: GNTX): As recommended, we sold to open 23 contracts of Dec. 16, 2016, $17.50 puts for $0.73, potentially increasing our stake of Gentex shares by 1.5%, to 4.4% if we get shares.
- **SPDR S&P 500** (NYSEMKT: SPY): We set up our December 2016 $180/$190 put ratio spread, as described in the alert, for a credit of $0.06.

You can see all of our guidance, positions, and transactions from the Recommendations page.

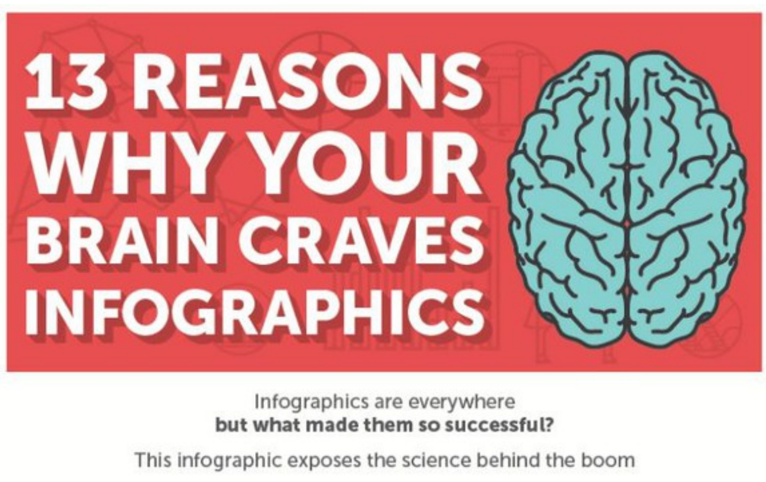
Charts of the Week: Infographics, Cognitive Biases, and the Gender Pay Gap

Published Sep 26, 2016 at 3:26PM

Dear *Pro* Fools,

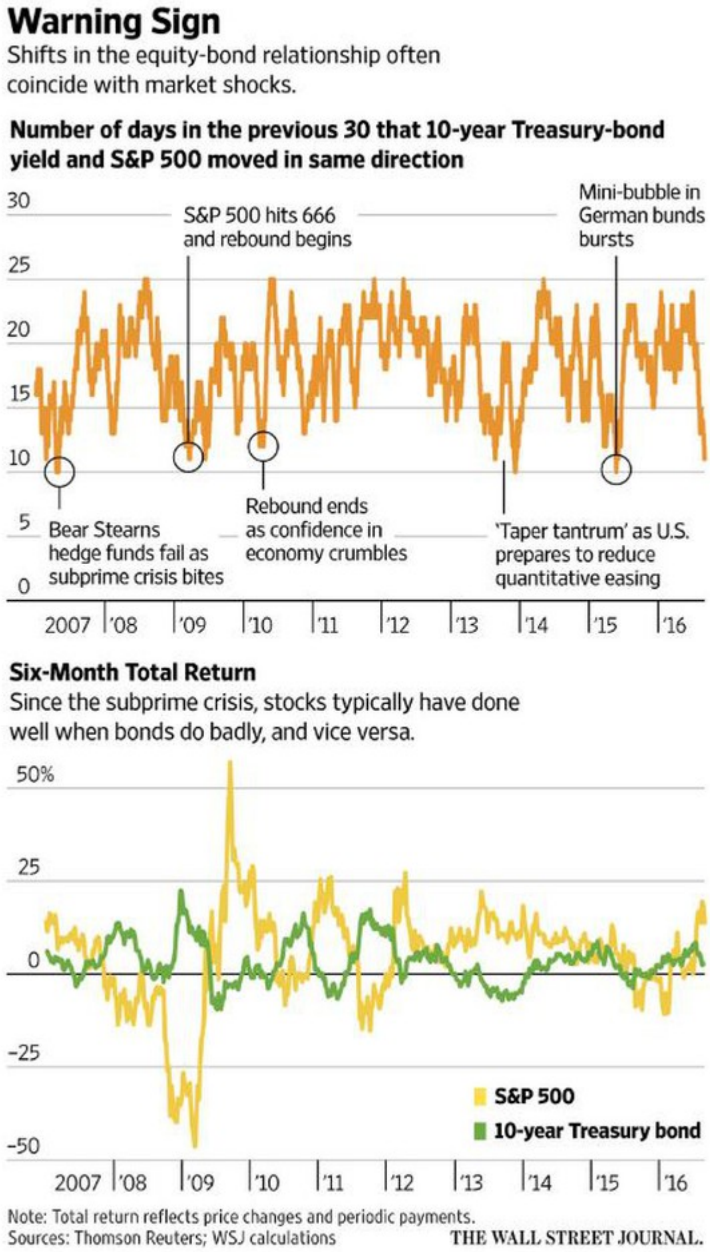
After a fantastic *Pro* Fool meetup in Chicago last weekend (thank you to all who organized and attended!), I'll kick off our Monday with the fourth edition of my "Charts of the Week" series. In this week's Memo, I'll share the five most interesting and/or market-relevant charts I came across this week while perusing the financial blogs and websites I frequent:

1. 13 Scientific Reasons Explaining Why You Crave Infographics



This meta-graphic from Visual Capitalist details 13 data-driven reasons behind the power of infographics (click on the photo for the full graphic), providing empirical evidence for my love of graphs, charts, and visual data!

2. Time to Worry? Stocks and Bonds Are Moving Together

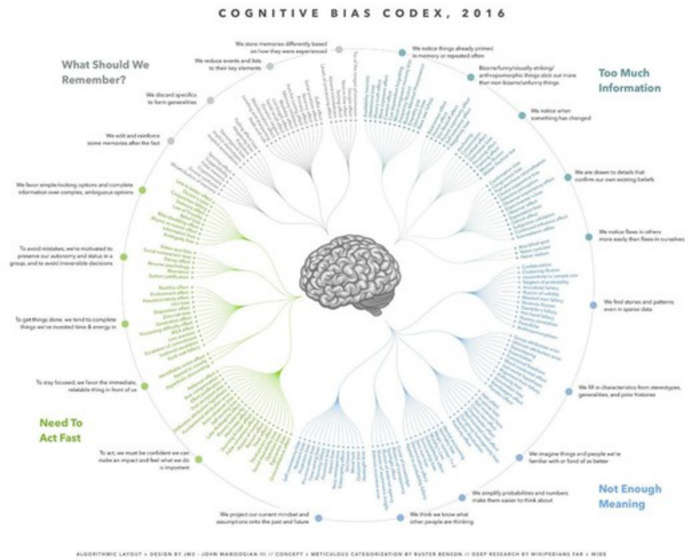


This graphic from *The Wall Street Journal* shows how shifts in the equity-bond relationship often coincide with market shocks. The top graph shows that as of Sept. 6, the date the graphic was published, the S&P 500 and the 10-year Treasury bond yield had moved in the same direction in just 11 of the prior 30 trading days, close to the lowest number since the start of 2007.

For context, the general relationship is that stock prices and bond yields tend to rise and fall together, as what is good for stocks is bad for bonds (pushing bond prices down and yields up), and vice versa. When bond yields and stock prices *don't* move together, it has often been a signal of marketwide volatility.

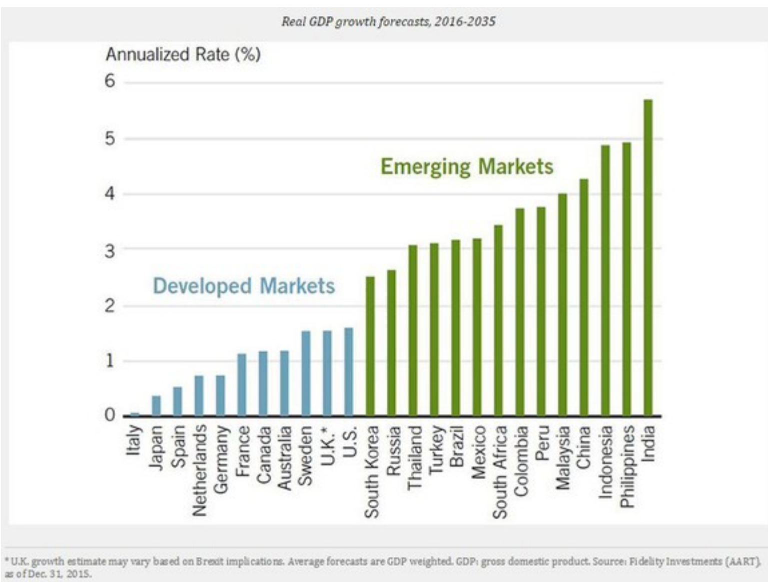
One possible explanation for this recent dynamic is the market's fixation on central bank policy and interest-rate expectations. Expectations of interest rates being lower for longer push the price of everything up and yields down, leading to a possible divergence between stock prices and bond yields, as seen in the graph above. For what it's worth, since this graphic was published Sept. 6, the S&P 500 and the 10-year bond yield have moved in the same direction on 7 of the 14 trading days.

3. Cognitive Bias Codex



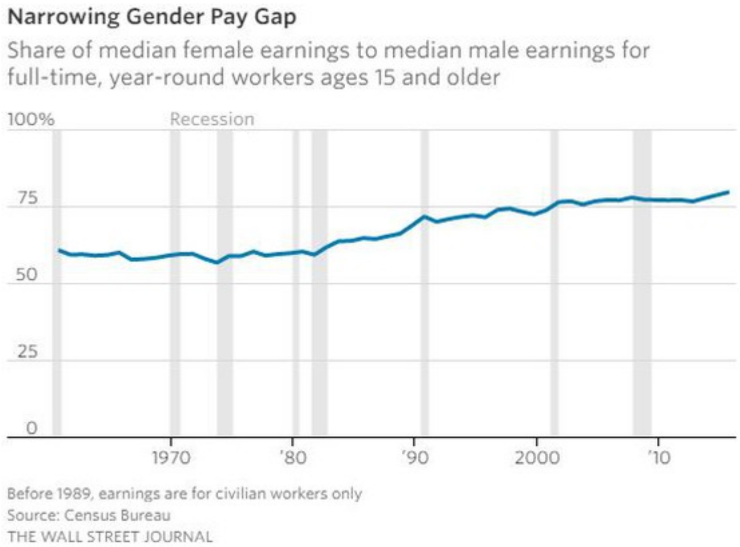
This fantastic graphic from [Better Humans](#) (click on the image for an enlarged graphic) breaks down cognitive biases (the bane of investors) into four main categories: too much information, not enough meaning, need to act fast, and what should we remember?

4. Emerging-Market Countries Are Likely to Grow Faster Than Developed Markets Over the Next 20 Years



This chart from [Fidelity](#) shows annualized real GDP growth forecasts for 2016-2035 for various countries. The graph clearly shows that emerging markets are expected to grow at a faster rate than developed economies over the next 20 years (at least according to Fidelity's research team). The expectation of faster growth is in large part because of faster labor-force growth, and several emerging markets with youthful demographics -- such as the Philippines, India, and Indonesia -- also have the potential to grow productivity rates off a relatively low base. According to Fidelity, the largest risk to this emerging-market outlook is the potential for financial instability, particularly in China.

5. Narrowing Gender Pay Gap (But Still a Ways to Go)



This graph from the U.S. Census Bureau and *The Wall Street Journal* shows how the gap in earnings between men and women was the narrowest on record in 2015. But women still earn just 80 cents for every dollar earned by a man working full time -- the ratio of female-to-male earnings last year came in at 79.6%, up one percentage point from 2014.

According to Cornell University economics researchers, about half of the gender wage gap stems from women being more heavily clustered in lower-paying jobs and industries -- not that they are paid less for identical work. Around one-sixth comes from men being on the job longer, and just over one-third of the gap comes from factors that can't easily be pinned down, including potential discrimination.

For more data and graphics on the gender pay gap, check out this graphic that shows the top 15 occupations with the largest gender wage gaps, and check out this interactive graphic that shows the pay gap across 446 different occupations. According to that interactive graphic, women earn more than men in just 7 of the 446 occupations (the seven are: wood sawing machine setters/operators, utility meter readers, highway maintenance workers, dietitians/nutritionists, telecommunications line installers/repairers, crane/tower operators, and transportation/storage/distribution managers).

The *Pro* Bottom Line

There you have it, Fools -- the fourth edition of my top five charts of the week. Hope you enjoyed it, and bring any questions or comments to the Memo Musings board!

Best,

-- Billy (TMFBillyTheKid)

Pro Guidance Changes

- **Deere & Co.** (NYSE: DE): Moves back to Short, at a 1.9% allocation. We also assume you own a 2% (currently) stake in **Valmont** (NYSE: VMI).
- **Pier 1** (NYSE: PIR): Moves to Hold as we review recent news events. Hold means that if you have a position, keep it, but don't start a new one for now.
- **Wells Fargo** (NYSE: WFC): Moves to Hold as we assimilate and contemplate the scandal unfolding. Boo to management!

Pro Completed Trades

- **Gentex** (Nasdaq: GNTX): We sold to open 23 contracts of Dec. 16, 2016, $17.50 puts for $0.73, potentially increasing our stake of Gentex shares by 1.5%, to 4.4% if we get shares.
- **Skyworks Solutions** (Nasdaq: SWKS): We bought back 1,000 shares to bring our allocation back to 3.4%, same as before, and we sold to open January 2017 $75 covered calls on all our shares, as earlier recommended. Those calls can still be sold today by those seeking income.

Pro Catch-Up Trades: Sept. 26, 2016

Published Sep 26, 2016 at 3:26PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

- Just getting started? Our Portfolio Building Report No. 1 features details on all our Buy First stocks; Portfolio Building Reports No. 2 and No. 3 get you up to speed on all of our Buy stocks; and our Portfolio Positioning Report tackles our shorts, options, and hedges.

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Broadridge Financial Services** (NYSE: BR): Buy up to 5.4%, in halves if preferred.
- **Gentex** (NASDAQ: GNTX): Buy 2.9%.

Continue building your portfolio with our Buys, including these highlighted today:

- **AmTrust Financial Services** (NASDAQ: AFSI): Buy up to 5%, in halves if preferred. Or, sell to open January 2017 $25 puts, lately about $1.10, to target potentially buying some of your shares at $24, if they're below your strike by expiration.
- **Oracle** (NYSE: ORCL): Buy 3.5%.

Shorts:

- **Domino's Pizza** (NYSE: DPZ): Sell short 2%, along with *owning* 3.6% in **Papa John's** (NASDAQ: PZZA). This is a paired trade.
- **John Deere** (NYSE: DE): Sell short 1.9%, along with *owning* 2% in **Valmont** (NYSE: VMI). This is a paired trade.

Pro options:

- **Gentex** (NASDAQ: GNTX): Sell to open Dec. 16, 2016, $17.50 puts, aiming for at least $0.70. Sell one put for every 100 shares you could buy. Selling 23 puts, *Pro* is looking to add 1.5% to our stake, for 4.4% total in stock.
- **Skyworks Solutions** (NASDAQ: SWKS): Sell to open January 2017 $75 calls on your shares if you want income, selling one call per every 100 shares you want to cover.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY): Set up a December put ratio spread as shared in this recent alert. It pays a lower credit today, of about $0.11, but it's still a credit.

Options expiring next (October):

- **Celgene** (NASDAQ: CELG): Our Oct. 21 $95 puts are on track to expire as income. We'll consider writing new ones if that happens.
- **Gilead Sciences** (NASDAQ: GILD): Our Oct. 21 $85 covered calls are currently on track to expire as income.
- **Wells Fargo** (NYSE: WFC): Our Oct. 14 $50.50 covered calls are on track to expire as income.

Oracle Is Gaining Momentum In The Cloud

Published Sep 22, 2016 at 3:07PM

Oracle's (NYSE: ORCL) fiscal first quarter earnings report disappointed the market, but the company's shift to the cloud continues to gain momentum. Overall sales increased 2% -- or 3% when adjusting for Brexit-related currency volatility. Similar to recent quarters, new license sales declined 10%, but thanks to a 3% increase in updates and product support, total on-premises revenue actually increased 1%. Though Oracle's legacy database system is in slow decline, the cloud-based software as a service (SaaS) and platform as a service business (PaaS) is gaining momentum.

SaaS and PaaS sales grew by 82%, which bested the 80% high end of management's guidance and management expects demand to continue growing through the end of the year. As a result, management raised cloud growth guidance from 65% to 67%. Further, cloud gross margins improved to 62% vs. 40% a year ago, making solid progress to management's eventual 80% gross margin target. As promised last quarter, the dollar growth in cloud revenue is finally exceeding the dollar decline in licensing revenue, which should help operating profitability gradually return to previous levels.

One of investors' biggest concerns is that the rapid growth in the cloud business is coming at the cost of the licensing businesses. To that effect, management confirmed that on-premises renewal remained at historical levels and 50% of new cloud customers are entirely new. Management attributes the accelerating growth in clouds sales to a more experience, and better trained sales force that finally has a full suite of products to sell and more geographies to sell into. They also have a large installed base to serve as referrals and promoters of the cloud products which makes adoption less risky for new clients. Down the road, Oracle intends to convert as many of its legacy database customers to the cloud as possible, but the company believes that most companies will use a hybrid combination of cloud-based and on-premises applications to meet the full range of their IT needs.

The company has cleared foreign antitrust reviews for the NetSuite acquisition, but it still awaits regulatory approval in the U.S. One of NetSuite's largest shareholders, T. Rowe Price, recently announced that it would vote against merger, citing a conflict of interest due to Ellison's ownership stake in both companies. That move makes it likely that Oracle will be required to raise its bid to close the deal. Though the interest on the debt that the company recently raised to fund the deal is a slight drag on earnings, management expect the NetSuite deal to become accretive quickly, strengthen Oracle's portfolio of cloud applications, and improve Oracle's exposure smaller companies.

Management has also begun to emphasize their strategy to grow the infrastructure as a service (IaaS) business, which puts them up against Amazon Web Services and Microsoft's Azure business. Ellison claims that Oracle's updated IaaS data centers have a technological advantage over AWS which makes them faster and more cost effective. Ellison also claims that Oracle's technology allows customers to shift their corporate infrastructure to the cloud in the most convenient way possible. This all sounds great, but the data center business is inherently a lower margin because of its capital intensity and the prospect of competing on cost against Amazon isn't encouraging. However, if this allows Oracle to sell a total end-to-end solution to a new cloud customer, it should make the relationship stickier over time.

Oracle continues to be reasonably priced at about 14.5x forward earnings and 8.5x enterprise value-to-EBITDA, both of which are just a hair above their five-year average. The balance sheet remains strong with $14.3 billion on net cash. Free cash flow over the past twelve months has grown 5% to $12.6 billion. Management spent about $2 billion during the quarter to repurchase an additional 49 million shares. There's little reason to expect Oracle to take off all of a sudden – in my mind this is more of a defensive position that serves as ballast in a volatile market – but over time the company should gradually get rerated at a higher multiple that is more in-line with it cloud-based peers. We're keeping our current "Buy" rating and $46 fair value estimate in place. We're also looking for an opportunity to write covered calls on the stock, but option premiums for Oracle are generally very small and usually not worth the effort.

Write Puts on Gentex

Published Sep 22, 2016 at 11:42AM

Is this for you? Since we're looking to add 1.5% to our stake in this company, this alert should be applicable (now or perhaps later) to all *Pro* members, whether you already own shares of **Gentex** (NASDAQ: GNTX) or not. If you don't yet own shares, check out the Alternative Trades section at the end of the report.

How You Participate

- **Trade:** Sell to open December 2016 $17.50 puts.
- **Allocation:** 1.5% — write one put for every $115,000 or so you manage; *Pro* will write 23 contracts. In addition to our current 2.9% stock holding, this would bring our total allocation to about 4.4%.
- **Price Guidance:**
  - **Now:** Use a **limit order** to target $0.75 or greater to start (for a 4.3% effective yield in 86 days). **If we all use limit orders** and the stock price cooperates, we may be able to achieve $0.75 today.
  - **Later:** As prices and time to expiration change, those approaching the position should aim to get paid a yield on time value of at least 1% or so ($0.175) per month to expiration.
- **Prices (10:45 a.m. 9/22):** Stock: $17.67; options: $0.70 bid / $0.85 ask. Guidance: $0.75.

- **Stock Rating:** Buy First, 2.9% allocation; we're now adding 1.5% in additional exposure through these new puts.

What We're Thinking

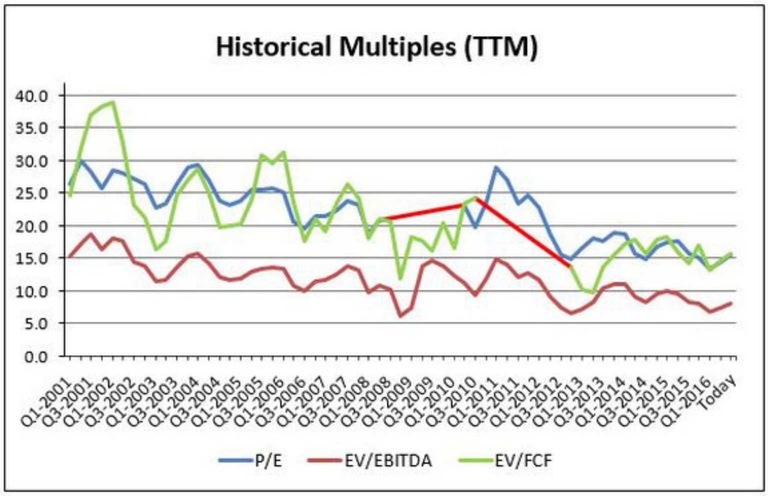
With the expiration of our September 2016 $15 puts last week, we've now run five successful rounds of put-writing for income on Gentex, with all five iterations expiring fully as income. This has taken place over about a year and 9 months, with our first round of written puts occurring in January 2015.

Since then, we've earned $6,370 in options income from our five rounds of written puts, and we've earned $2,596 from seven dividend payments in January, April, July, and October of 2015 and in January, April, and July of 2016. Based on our current ownership stake of 4,400 shares, that's income of $2.04 per share. That equates to an 11.5% yield on the current share price, which helps offset some of the stock-price weakness Gentex has experienced since the end of 2014 (as of today, the stock price is down about 2% compared with the closing price on Dec. 31, 2014).

Those who have followed this strategy from the beginning will notice that we've upped the strike price from $15 in the prior iteration of the strategy to $17.50 in this one. We're OK with increasing our strike price for a few reasons.

For one, when we initiated this strategy in January 2015, we started at the $17.50 strike. Since that first iteration of the strategy, Gentex has increased quarterly revenue by 21%, quarterly gross profit by 24%, operating profit by 30%, and earnings per share by 25%, and the company's EV/EBITDA ratio has decreased from 9.6 to 8.1.

With the income from this strategy at $0.75 per share, if assigned, we'd buy shares at $16.75 apiece. At that price, we'd be buying at 14.7 times trailing-12-month (TTM) earnings, 7.6 times TTM EBITDA, and 14.8 times TTM free cash flow.Given Gentex's recent business execution, we think those multiples are attractive.



Note: Red lines represent omitted outlier multiples that correspond to recession-depressed earnings and cash flow.

More That Matters

- **Maximum loss:** For this iteration of the put strategy alone, our risk is the same as share ownership starting at about $16.75, or 5.2% less than the recent price.
- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At a minimum of $0.75, that's a 4.3% effective yield in 86 days.
- **Follow-up:** For this iteration of the put strategy alone, we'll buy shares at a net $16.75 if the stock is below our $17.50 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 2.9% allocation first — Gentex's shares are a Buy First. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1.5% of your portfolio, then just buy 1.5% in stock directly *if and when Pro* does so through these puts (we'll alert you on the boards and in the subsequent Monday Memo if and when we do).
- **Want to write other puts?** Consider writing November 2016 $17.50 puts if the price on those options holds up better than the December puts after this alert is issued. Right now, the bid/ask on the November 2016 puts is $0.55/$0.70 (a 3.6% effective yield in about two months).

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Check your mirrors and switch lanes over to the Gentex discussion board.

Portfolio Positioning Report

Published Sep 21, 2016 at 11:22AM

Welcome | Shorting in Short | Hedging ... in Short | Your Exposure | This Stuff Is Optional
Options Are Optional, Too — but Advised! | About This Report
The Positions Themselves (Shorts, Hedges, Options, All the Rest)

November 2018 Note: This report needs a refresh! Please stay tuned -- we'll let you know when it's up-to-date again.

Dear *Pro* Member,

Our first three Portfolio Building Reports provided you guidance on all of *Pro*'s Buy First and Buy stocks. This final report will do the same for our active short and timely option positions, some of which we use as hedges. For reasons we'll explain, we don't expect that many of you will initiate all of the positions in this report right away, or perhaps at all. And that's perfectly fine!

Hedging is about lowering your exposure to the risks of the market; to a lesser extent, shorting is as well. These additional investment tools tweak or adjust the risk profile of your *invested* portfolio, so if you're still building your collection of long-term stocks, concentrate on that first. Stock investments are the core of the *Pro* portfolio, and by owning *Pro* stocks, you are positioned to compound your value over time. We know there's a learning curve for strategies that are new to you, so it's important that you know there's no rush with shorts, options, and hedges; you can incorporate the positions in this report, or our future updated ones, when you're ready. We're here for you in the meantime.

Before outlining the current positions you can take, let's review how each strategy works. We'll begin with shorts — a sort of "anti-investment" that we believe will decline in value, adding profits to our portfolio in the process.

Shorting in Short

When you sell a stock short, you borrow shares of a company or an ETF from your broker and immediately sell them, collecting the proceeds. At various brokers, this trade action is called "sell short," "sell to open," or just "sell." In the future, you'll need to buy the same number of shares back to replace the ones you borrowed and sold. This second step is called "cover," "buy to cover," or "buy to close." You hope to profit from buying the shares back at a *lower price* than when you opened, or sold, the position originally.

The difference between your original sell — or short — price and the price you later pay to buy back (and return) the borrowed shares is your profit or loss. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock rises to $30, you've lost $10 per share when you buy it back. We use shorts in *Pro* because they're one way to profit when the market or a targeted company falls, but they come with their own risks — shares can be hard to borrow, shorting fees are often involved, and a short can get closed on you (you're forced to buy it back) if the broker wants the shares back early. So, we need to size each of our short positions appropriately small.

Hedging ... in Short

A hedge is similar to a short because it gains value when prices fall, but it's different in intent; these positions are taken only to *offset* the risk we have in another position or in our market exposure as a whole. So, when we sell short (or use bearish options on) a market-index proxy like the **SPDR S&P 500** (NYSEMKT: SPY) ETF or **PowerShares QQQ** (NASDAQ: QQQ), we are hedging our exposure to the stock market or to a particular index as a whole. A hedge is a form of insurance; it only pays you when you need it, and it usually won't make any money. But we *know* a market-index hedge will increase in value whenever the market goes down — making it an effective hedge during bad times. We just always remember that if the market doesn't fall (or doesn't fall enough), our hedge will go unused.

For this reason, we try to spend very little to hedge, but sometimes costs can't be avoided. We have to reconcile this with the fact that hedging lets us stay *more* invested in stocks than we might otherwise be. In other words, one key way we profit from our hedges is by using them to help us keep our long stock exposure higher! We own more great companies because we soften our total risk by hedging. As with shorting, you should only hedge if you have stock market exposure you want to "hedge out." You don't need to hedge or short to succeed.

Your Exposure

To know whether hedging is for you, it's helpful to think about your stock market exposure. This is simply how much of your total portfolio is invested in long stocks. Excluding options and shorts, *Pro* is about 73% invested in long stocks as of this writing. That's high for a typical absolute-return portfolio like ours, which is part of why we want to short and hedge! Many hedge funds are market-neutral (net 0% long) or only 10% to 20% net long. Pro is much more invested, and has benefited. Like many members, you may own other stocks beyond *Pro*'s, so if you've also bought all of our stocks, you might be even more exposed to market risk than we are. Lately, we typically hedge the *Pro* portfolio down to about 60% market exposure with our index hedges and other shorts, and you could (but do not need to) follow along today. In other market situations, we'll likely hedge much more.

The bottom line is: As you consider adding hedges and shorts to your portfolio, first know how much of your assets are invested in stocks. That helps dictate how much shorting or hedging you want to initiate to reach the *net* market exposure you desire. *Pro* has averaged about 73% net long exposure since January 2012, but that number will move up and down as our opportunities change. Our exposure is always shown at the bottom right of the Recommendations page. For many years, I've found that about 72% market exposure, along with the use of options, can be enough to earn strong (market-topping) returns with less risk. This pleasing result rests on investing in superior long-term stocks, and the past is no promise of future returns, but we're aiming to continue that success.

This Stuff Is Optional

Not every *Pro* member is comfortable with shorting or hedging, and there are practical considerations to take into account as well. First, you need a margin account to sell short, so (unless you use options to go bearish) you can't sell short in an IRA. Second, you have to accept that shorts can run strongly against you, so you need cash to cover that risk. Third, you'll usually pay an annualized fee of anywhere from 1% to 7% of a particular short's daily value to short it. Fourth, in many cases it's hard to borrow shares to short, period. That is the situation with some of our shorts today. Finally, short shares can be bought away from you at the worst time, when they're up in price (called a "forced buy-in"). If brokers can no longer find shares to borrow, you can be forced to "buy in" at market prices to return your borrowed shares.

So what to do given all this? You can use options to short in some cases -- we do, and we explain how to do so wherever appropriate. You can also consider opening a brokerage account that is particularly friendly to shorting. Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does, and does not charge a fee for shorting. You could also wait and see whether shares become available in your existing, traditional brokerage account, though note that at many brokers, certain shares are basically never available for shorting. Or, if you're not drawn to it, you don't need to short.

Options Are Optional, Too — but Advised!

Our options positions are also ... optional, but we strongly advocate learning to use options and following along with ours over time. Options are powerful tools for income, hedging, greater upside, and more. We know from experience they're well worth the time it takes to learn them, and we're here to help. Options can make you a much more confident and versatile investor, and they can generate a whole new stream of income for you and your family. So, if you're new to using options, you're certainly in the best place! Use *Motley Fool Pro* and our sister service, *Motley Fool Options* (free for the life of your *Pro* membership), to learn how to use these great tools. On a personal note, if you're going to learn just one simple strategy, I suggest learning how to write puts (link goes to *Motley Fool Options*) for steady income or to buy a stock lower.

About This Report

The *Pro* service will (when you're ready!) help you short vehicles we believe could decline; teach you how to hedge your portfolio; and set you up to generate returns from options. To that end, keep in mind that today's report is just a start; we'll have many *brand-new* investment recommendations arriving to your inbox as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way!

On the other hand, if this looks overwhelming right now — or if you're still catching up with our core stock positions — that's perfectly fine. You don't need to start these positions now. As mentioned, long positions are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and often rewarding — aren't necessary to succeed with *Pro*. As you learn these strategies and progress with us, just keep your exposure to the stock market in mind.

In closing, I'll stress again that you shouldn't feel pressured to act right away. We will continue to make updated recommendations on our holdings for newcomers on an ongoing basis in our Monday Catch-Up Trades — and as brand-new opportunities emerge. That's part of the fun! Building over time is the most rewarding process. So take your time, and make an investment only when you're ready. Finally, please bring any questions to our live event on Friday, Dec. 16, or to our Making *Pro* Fit You discussion board.

Foolishly,

— Jeff Fischer, *Pro* advisor

The Positions Themselves

Shorts

- **CurrencyShares Euro Trust** (NYSEMKT: FXE): Sell short 1.7%, on our thesis that the U.S. dollar will appreciate against the euro as U.S. interest rates increase. If you can't borrow shares, skip this position rather than using options, because we may close this short soon (we've had it for years in anticipation of today's current situation), and the options have significant friction costs if you only use them a short while. So, short shares directly, or don't start a position.

- **Domino's Pizza** (NASDAQ: PZZA): Sell short 2.1% only if you own about 3.9% in **Papa John's** (NASDAQ: PZZA). The Domino's short is a partial hedge of our Papa John's investment.

- **Direxion Daily Financial Bear 3x Short** (NYSEMKT: FAZ): Sell short 0.2% as a long-term leveraged investment in financial stocks going higher. If you can't borrow shares, but you have options approval in a margin account, you can set up a January 2018 synthetic short instead by selling to open January 2018 $20 calls and buying to open an equal number of January 2018 $20 puts. Set up one synthetic short for every $2,000 in value you can short, but only up to a very small portion of your portfolio. If you can't set this up, simply invest 0.2% more in one of our financial stocks, such as **Visa** (NYSE: V).

- **Gogo** (NASDAQ: GOGO): Sell short 0.5% directly. If you can't sell short directly, the options are not attractive enough to use.

- **Shake Shack** (NYSE: SHAK): Sell short 0.6% directly. Again, the options are expensive to use. Be aware we're down 18% on this short ourselves, so we will reconsider it, per our policy, at about a 20% loss. We may close it, protect it, or add to at that point. We shall see.

Hedges

- A live, new alert for a sizable market index hedge is scheduled to hit everyone's inbox (and the *Pro* site) soon. So watch for our new hedge soon, and all who wish can get on board.

Options

- **American Tower** (NYSE: AMT): Assuming you first have established your 3.5% American Tower stock allocation (the stock is a Buy First), set up diagonal calls per our recent alert; however, instead of selling to open April 2017 $115 calls, sell to open $110 calls. Follow allocation guidance in the alert, and ask any questions on the AMT board linked at the end of the alert.

- **Parexel** (NASDAQ: PRXL): If you already own at least 100 shares of Parexel, "sell to open" one March 2017 $65 call for every 100 shares of the stock you own. We are selling these covered calls for income and to potentially exit our position at a higher price. If you don't yet own Parexel, **do not** buy the stock or write these covered calls; the stock is rated Hold.

- **Skyworks Solutions** (NASDAQ: SWKS): Assuming you own shares of Skyworks (a Buy on our scorecard), "sell to open" Jan. 20, 2017, $75 calls, selling one call for every 100 shares of stock you own. We are selling these covered calls as income, and will manage the position for members at each expiration. The recent price you'll get paid for the calls is adequate.

- **Verisign** (NASDAQ: VRSN): Buy 1.5% in shares and set up a covered strangle for income and another potential 1.5% in stock, per our recent alert.

The Rest: On Hold

Any position not shown as Buy First, Buy, or Short is on Hold. And any option not listed here but still on the Recommendations page is either ending soon, no longer timely, or no longer recommended. So if you have started positions in all of our Buy First, Buy, and Short stocks, and then followed along with the shorts and options in this report that you're able to, you will be caught up to *Pro!* Sit back, bask in your success, and simply follow our new trade alerts to keep up (as well as our Monday Catch-Up Trades for any positions you might still lack). If you are not yet caught up, continue to take your time, follow our Monday updates, and ask questions on the boards. There's no rush. Good things come to those who move gradually, including investors.

Welcome again to the esteemed *Pro* community! We'll talk with you again soon.

Hedge: Set Up Another Put Ratio Spread on the SPDR S&P 500

Published Sep 20, 2016 at 2:48PM

Is this for you? At *Pro*, we employ hedges to target returns during a market decline. You don't need to hedge to succeed with *Pro*, but if you are at least 80% invested in stocks and *want* to hedge some of your market exposure, then consider following along.

Our Other SPY Position: We currently have another 10% SPY hedge, which is due to expire in November and is near-the-money (we have a long $210 strike while SPY is $214). Today's new 10% hedge is designed to kick in if the market falls *below* the $190 break-even price of that November hedge. So this new hedge is a hedge on our previous hedge, since that previous hedge becomes an obligation if SPY falls below $190. Got it?

Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $190,000. We are leaving our current November 2016 SPY put ratio spread in place; you can set it up today if you haven't yet. (And if you're only setting up one SPY hedge, you should set up that November one, which will lately cost you a small $0.15 debit. Today's new one is supplementary to that one.)

This is a complex trade, so if it seems challenging at first read, don't fret. Simply tune in to our live **Portfolio Positioning Event** **at 1:30 p.m. Eastern tomorrow, Wednesday, Sept. 21.** During the event, we'll discuss this and our other options, hedges, and shorts. In the meantime, bring questions to the SPY discussion board -- but there's no need to hurry. A hedge like this is easier to set up once the market is declining, so it's not necessarily imperative to set it up now.

How You Participate

- **Action:** Use a spread order to set up a put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
- **Allocation:** About 10% of your total portfolio value, measured on the look-through value of the $190 puts you're buying (each $190 put represents $19,000 in hedge value). Set up one 2:1 put ratio spread for every $19,000-sized hedge you want. Hedging about 10% of our entire portfolio of $2.67 million, *Pro* will sell 28 $180 puts to finance this position and buy 14 higher-strike, $190 protective puts with the proceeds. (Fourteen puts representing 100 shares each at a $190 strike = $266,000 look-through put value = 10% of our $2.67 million portfolio value.)
- **Trade:**
  - **Use a combo or spread order to simultaneously ...**
    - Write ("sell to open") **two** Dec. 16, 2016, $180 puts, and
    - Buy ("buy to open") **one** Dec. 16, 2016, $190 put. Click "View All" on the option chain at your broker to see all strikes, and do not use the "NS" (or non-standard) option. Use the liquid option. Execute one set of the above options for every $19,000 hedge you want; or one for every $190,000 you manage (assuming you want another 10% hedge in addition to our November hedge).
- **Price Guidance (as of 2:40 ET):**
  - Sell to open **two** Dec. 16, 2016, $180 puts: Lately $0.92 x 2 = $1.84 credit.
  - Buy to open **one** Dec. 16 2016, $190 puts: Lately $1.66 debit.
  - **Net credit:** Lately about **$0.18** credit per spread -- but this price will change (it has fluctuated between **$0.18 and $0.20** today). As it does, simply aim for a credit, and later for close to no cost, using an appropriate limit order when you act.
  - **SPY price:** $214
  - **Potential adjustment:** If SPY moves much in price before you set up your trade, you may want to move one or both of your strike prices up or down accordingly -- as much as SPY has moved -- while still aiming for a net credit. After our mandatory 24-hour trade delay, we will make such an adjustment if need be, and tell you about it.

What We're Thinking

You've heard our philosophy and approach before. At *Pro*, we aim to have winning positions in down, flat, and positive markets. That means we need to address all three possibilities at once in our portfolio. At the same time, we remain oriented toward the long term and majority invested in healthy stocks. A hedge on a market index is a hedge against a lower stock market while the rest of our stocks remain free to appreciate. We generally don't try to manage for market declines of 5% or less (that's just volatility), but when *Pro* is functioning as desired, declines of about 7% or more should result in some of our positions, such as these spreads, becoming profitable. At the same time, the put ratio spreads we use:

- Are harmless if the market goes higher (they don't ding our returns)
- Are typically cash-free to set up (they often pay us a credit -- essentially income)
- Should have a low probability of long-term loss or even opportunity cost (since if we buy into SPY, odds are good it'll outperform many other stocks we could have bought instead)

What's the trade-off? As with any written put, we need to be ready to buy the underlying investment; for today's position, that means we're prepared to buy into the S&P 500 index (through SPY) if the price falls below $180, which is our breakeven point on this hedge. That's 15.8% lower than today's prices. If the S&P does fall that much, we would plan to buy *long-term call options* on SPY instead of the shares, saving most of our cash in the process; see below for details on that. We don't believe there's much probability of long-term loss, because we believe SPY will recover. And if the index does fall sharply, history suggests it's likely to do so in the range of 10% to 20%, so in most cases this hedge would help us.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2.67 million
- 10% of that value: $267,000
- Dec. 16, 2016, spread:
  - Buy to open $190 puts. Fourteen contracts representing 100 shares each = $266,000 in look-through exposure, or about a 10% hedge on our current portfolio value, cash included.
  - Sell to open $180 puts -- 28 contracts, half of which are *not* covered by long puts and thus become a potential obligation at a net $170, currently an 8.9% possible stake. (If the decline occurs, this would be a larger stake then, as our portfolio value would be lower).
  - At home, you would buy one $190 put and sell two $180 puts for every $190,000 in portfolio value you want to set up a 10% hedge against.

Return Details

SPY Price at Dec. 16, 2016, Expiration	Value of 1 Purchased Dec. 16, 2016, $190 Put	Value of 2 Written Dec. 16, 2016, $180 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Recent $214
$190 or higher	$0	$0	$0.18 or so gain per spread -- or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 11.2%
$185	$5 x 100 = $500	$0	$500	(13.5%)
$180	**$10 x 100 = $1000**	**$0**	**$1000 (max profit per spread)**	**(15.8%)**
$175	$15 x 100 = $1,500	($5) x 200 = ($1,000)	$500	(18.2%)
$170	**$20 x 100 = $2,000**	**($10) x 200 = ($2,000)**	**$0 (break-even)**	**(20.5%)**
$165	$25 x 100 = $2,500	($15) x 200 = ($3,000)	($500)	(22.9%)

If SPY declines more than 11.2% from recent levels, this hedge starts to come into play (and our November hedge, assuming we still have it, moves out of its maximum profit range). Our maximum profit on *this* hedge is earned if SPY declines 15.8% from its recent level of $214 by our December expiration date. The spread will help us a bit on an index decline of as much as about 20%, to $170; deeper than that, and our short (or "sold to open") $180 puts start to work against us. So this hedge is effective up to that point.

Follow-Up

Assuming we set this spread up for a credit, it will result in a small profit even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $180-strike-price put obligation (starting with a net buy price of $170) if SPY is below $180 by expiration. We should be happy to buy into the index at 15.8% lower. And up to that point, this hedge will have paid us as the market fell.

If the market *does* fall by more than 15.8%, our plan would be to close the short puts and buy long-term SPY calls (or something we like even better, whether calls or a stock) instead of buying the SPY ETF. We should be able to do so at a reasonable strike price for about 25% to 35% of the cost of buying SPY shares. So, our potential 9.2% stake in SPY shares will likely cost us only about 2% to 3% of our cash if we buy calls instead. We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases.

The bottom line is that any drop in SPY as far as 20% below recent prices will result in this hedge showing at least a small profit at expiration. And it costs us nothing to set up (it pays us) and will not hurt our returns if the market keeps rising.

How It Fits Into *Pro*

Pro hedges to lower our market exposure, or risk. We aim to achieve positive returns every rolling three years, and inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market can make a difference. We made $10,700 when our last put ratio spread closed in-the-money in February. Since then, we've also made more than $1,300 in income using put ratio spreads that expired unused this year. Even small gains add up over the years, and this hedge fits well with our goal of hedging in a cost-efficient way that doesn't drag on our returns in a rising market. These spreads do require regular upkeep, opening new positions as old ones expire, and they are time-sensitive, really only helping at or right near expiration.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $190,000:**
  - For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Assuming you already have our $210/$200 spread set up from a previous recommendation, and you want another spread, use a spread order to "Buy to open" Dec. 16, 2016, $190 puts and "sell to open" *an equal number* of Dec. 16, 2016, $180 puts. Recently, this will cost you about $0.73 ($73) per spread, and that is your maximum risk. Buy as many spreads as you care to risk $73 on. Paying a bit more is fine, too, if prices change. This strategy would be worth up to $10 ($1,000) per spread on an 15.8% market decline to $180 or any lower price, but you should be prepared to lose your whole $73 per spread if SPY doesn't decline at least below $190 by expiration, which is a large 11% drop. You have to assume a hedge like this will expire worthless. So, only risk what you are comfortable losing.
- **To lower your market exposure while following our full official trade (and making the position possible in some IRAs):**
  - Set up the official put ratio spread as recommended, but also "buy to open" puts (with the same day of expiration) at a strike price *well below* $180. Buy *half as many* as the number of $180 puts you wrote. When you do so, all of your $180 puts will be "covered" -- half by your $190 puts, and half by these other puts you choose to buy at a much lower strike. Choose how much you want to pay to select your lower strike price to purchase. To us, the $170 strikes or lower look good, recently costing $0.53 or less. You will only need cash in your account to cover the difference between your two lowest strike prices (if you buy $170 puts, that's $10 per share), and your risk is capped, making this potentially IRA-friendly. This makes the total cost of your hedge about a $0.33 debit, and it still has $10 in potential ending value.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Pro Catch-Up Trades: Sept. 19, 2016

Published Sep 19, 2016 at 3:22PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy (or Buy First); the portfolio is meant to work together as a whole.*

- Just getting started? Our Portfolio Building Report No. 1 features details on all our Buy First stocks, and Portfolio Building Reports No. 2 and No. 3 get you up to speed on all of our Buy stocks!

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Facebook** (NASDAQ: FB): Buy up to 6.8% (in halves if you prefer).
- **FactSet Research** (NYSE: FDS): Buy 2.2%.
- **Wells Fargo** (NYSE: WFC): Buy 4.1% (intending to write covered calls on one-third of that).

Continue building your portfolio with our Buys, including these highlighted today:

- **AmTrust Financial Services** (NASDAQ: AFSI): Buy up to 5.1%, in halves over time if preferred. Or, sell to open January 2017 $25 puts, lately about $1, to target potentially buying some of your shares at $24, if they're below your strike by expiration.
- **Gilead Sciences** (NASDAQ: GILD): Buy 2.7%.

Our shorts (if you're new to shorting, you can wait for our Portfolio Positioning Event this Wednesday, Sept. 21):

- **Domino's Pizza** (NYSE: DPZ): Sell short 2.1%, along with owning 3.5% in **Papa John's** (NASDAQ: PZZA). This is a paired trade.
- **Pier 1 Imports** (NYSE: PIR): Sell short 0.6% to start (see our trade alert).

Pro options (again, to be addressed during our Portfolio Positioning Event):

- **Skyworks Solutions** (NASDAQ: SWKS): If you lost your shares, buy them back up to 3.1% of your portfolio and sell to open January 2017 $75 calls on them, one call per every 100 shares you want to cover.

Hedges:

- To be discussed at our Positioning Event this week.

Options expiring next (October):

- **Celgene** (NASDAQ: CELG): Our Oct. 21 $95 puts are on track to expire as income. We'll consider writing new ones if that happens.
- **Gilead Sciences** (NASDAQ: GILD): Our Oct. 21 $85 covered calls are currently on track to expire as income.

- **Wells Fargo** (NYSE: WFC): Our October 14 $50.50 covered calls are on track to expire as income.

Resist the Easy Explanation

Published Sep 19, 2016 at 3:22PM

Fellow Fools,

Following two sleepy summer months during which the stock market rarely moved more than 0.5% on a given day, the S&P 500 fell by nearly 2.5% two Fridays ago, and the increased volatility continued through last week. As usual, there's been no shortage of market pundits offering their take on why the market suddenly took a dive, with most settling on an increased likelihood of rising interest rates in the near future.

The specter of rising rates has loomed for the better part of two years, so why did the market suddenly start paying attention over the past two weeks? Maybe it was hawkish comments by various Federal Reserve regional presidents favoring higher interest rates. Or maybe it was comments from the newly anointed "Bond King," Jeffrey Gundlach, who suggested that the decades-long bond rally is finally over. Or maybe it's just the result of a bunch of trigger-happy investors looking for any reason to lock in gains following the recent post-Brexit rally. These explanations make for good headlines and punchy sound bites, but figuring out the true cause is never that easy.

The Opposite of Simple

"It's not supposed to be easy. Anyone who finds it easy is stupid." – Charlie Munger

In reality, the sudden spike in market volatility was probably caused by a combination of all of those things, as well as a multitude of other small events that led a diverse group of investors to act in tandem, driving stock prices lower. This behavior is what scientists and economists have come to expect from complex adaptive systems. These are systems in which individual agents pursue their own interests, and through numerous interactions and constant adaptation, they create a self-organizing system such as an ecosystem -- or in this case, the stock market. Because there isn't a linear relationship between the individuals and the system, it's difficult to make direct connections between cause and effect, In other words, you can't just add up the behavior of all of the individuals to explain the behavior of the entire system. Instead, a series of events combine in seemingly random succession until a trend emerges from the chaos.

Michael Mauboussin is well-known for his popular investing books and the insightful white papers he continues to publish as the head of global financial strategies at Credit Suisse. What many of his fans don't know is that he is also chairman of the board of trustees of the Santa Fe Institute, a leading center for multidisciplinary research in complex systems theory. Over the years, Mauboussin has written extensively about why market efficiency is better explained by complex adaptive systems than by traditional financial theory, which assumes linear relationships, normal distributions, and rational market participants. I highly recommend his white paper, "Revisiting Market Efficiency: The Stock Market as a Complex Adaptive System," for members who would like a more thorough explanation of this framework for describing market activity.

The key aspect of this framework for investors is being able to identify the circumstances under which market efficiency starts to break down. This is most common when the decision rules being used by market participants, which can start out very different, begin to converge -- usually the result of fear or greed -- and the buying and selling begins to aggregate in the same direction. This loss of diversity explains the booms and busts the market experiences on a macro scale from time to time, but it also contributes to the occasional inefficient pricing we as investors try to exploit on individual securities.

The Theory in Practice

The rapid growth of the ETF industry has made it easier for investors to pick and choose classes of stocks on which they can make directional bets based on the theme of the day. One example over the past two years has been REIT indexes, which have bounced up and down amid speculation over the next interest-rate move by the Federal Reserve. To many investors, the decision to buy and sell this group of stocks is easy math. Real estate companies tend to have highly leveraged balance sheets, and higher rates will cause borrowing rates to increase, so sell REITs.

What's missed by this type of decision-rule investing is the second-order thinking that provides nuance to the markets. In this example, higher interest rates are usually accompanied by a strengthening economy, higher employment, and increased inflation -- all forces that tend to be good for the real estate industry. The approach also doesn't account for the relative fundamentals of the individual companies in the index. For example, in the *Pro* portfolio we've seen **American Tower**'s (NYSE: AMT) stock fall with no news about the company to justify the sell-off. Further, remember that higher interest rates aren't bad for all stocks. Goldman Sachs recently pointed out in a note to clients that even though rising interest rates are good for mmany financial institutions, the price the market is charging to hedge them is currently the same as for the rest of the market, suggesting that investors are treating all stocks the same and selling indiscriminately. In the *Pro* portfolio, financial companies including **Wells Fargo** (NYSE: WFC) and **TD Ameritrade** (NASDAQ: AMTD) should both benefit in a rising rate environment.

The *Pro* Bottom Line

Humans feel an intense desire to link cause and effect in our daily lives. When there are big swings in the market, it's easy to latch on to the narratives of stock-market commentators and think we need to take action. It's important to remember that these expert explanations of what's driving the market are usually oversimplified at best. Remember that when everyone is telling the same story, odds are that nuance is being missed and inefficiencies created. If we can keep our heads during these times and stay patient -- which our hedges, shorts, and cash position allow us to do -- we'll have the ability to be opportunistic and generate considerable value for our portfolio over time.

Thoughts? Bring them to our Memo Musings board. Have a great week, Fools!

Foolish Best,

-- Jeremy (TMFTank)

More From Motley Fool *Pro*

- Short Stories on 4 Short Ideas
- What Has *Pro* Taught Us?
- Getting Into the Flow of *Pro*

Position Update: Skyworks Solutions

Published Sep 19, 2016 at 2:04PM

Is this for you? This advice is only for members who lost some or all of their shares of **Skyworks Solutions** (NASDAQ: SWKS) through covered calls last week. We're taking the following steps to buy the position back and write the previously recommended covered calls. That said, this overview might be of interest to any members who use covered calls.

Foolish Summary: Of our 1,200 shares of Skyworks Solutions, 1,000 were called away from the *Pro* port late last week via our $70 September covered calls before we could roll them. We still have 200 shares of the stock, and we rolled our $70 calls on those shares to a January expiration and a $75 strike price, as we advised members. This situation is not a real problem, but we want to get back into the position as intended, so today's update sets us all up for that!

Buying Back Our Called Away Shares: To make our position whole again and align with members, tomorrow we will *buy back* the 1,000 shares sold from us and write the January 2017 $75 calls on them as planned. The end result should match our intentions all along: We'll have 3.1% in stock with January 2017 $75 calls written against it. If you lost your shares, some or all, you can take this same action to match us. This position still provides ample upside via the time value we're collecting.

Actions:

- Own 3.1% in Skyworks. It is rated a Buy.
- "Sell to open" January 2017 $75 calls, one call for every 100 shares owned.
- Use a limit order at the going price (it can change rapidly).
- If you own fewer than 100 shares as a 3.1% stake, simply keep owning shares.

Service Clarification: In *Pro*, we recommend owning 3.1% in shares. You can write calls on them or not. In *Options*, we have been writing puts on the stock for income.

What Happened

We already knew that when you write covered calls, you must be prepared to lose your shares. Situations can change quickly, and you may not be able to act in time to keep a stock. That is true for you in your busy life, and it's true for us in this service. It was definitely true for us last week, not least because behind the scenes, your *Pro* team must wait 24 hours after we issue an alert to act. In this case, during those 24 hours, most of our shares were called away.

In seeking other lessons can we take from these events, we found few new ones, but a couple of old ones worth repeating.

In any situation, prices can rise and fall rapidly. In this one, the stock swung 17% in the space of three days. Even so, if you were able to act when the alert went out with the stock at $74 (and the report was written mere minutes earlier, with the stock at $72!), then you rolled your calls up $5 per share for a credit, to $75, and you kept your shares. You're golden. So, there was not a strategy error to learn from here. The stock simply kept rising that day, suddenly evaporating the time value in the calls, until most of our shares were called away in after-hours trading Thursday night, with the stock above $77. When we went to roll first thing the next morning, after our 24-hour Fool delay, we saw we'd been assigned.

Prior to this large stock-price move, everything with this position was standard for a covered call. The stock was above our $70 strike price for most of the past month, but the calls carried so much time value that it didn't make sense to close or roll them early.

For instructive purposes, let's look at the closing price of Skyworks over the past month (from Google Finance):

Date	Open	High	Low	Close
Sep 16, 2016	77.15	77.24	75.00	76.07
Sep 15, 2016	73.00	77.25	72.98	77.02
Sep 14, 2016	69.73	72.43	69.51	72.40
Sep 13, 2016	68.50	70.45	68.25	69.36
Sep 12, 2016	66.00	68.58	65.76	68.34
Sep 9, 2016	70.51	70.69	66.06	66.76
Sep 8, 2016	71.93	71.94	70.84	71.43
Sep 7, 2016	73.18	73.76	71.57	72.05
Sep 6, 2016	74.29	74.52	72.25	73.01
Sep 2, 2016	75.25	75.43	74.21	74.62
Sep 1, 2016	74.79	75.19	74.21	75.09
Aug 31, 2016	74.13	75.24	73.90	74.86
Aug 30, 2016	74.40	75.79	73.84	74.20
Aug 29, 2016	74.79	75.65	74.50	75.22
Aug 26, 2016	74.35	75.00	73.74	74.84
Aug 25, 2016	73.16	74.75	73.11	74.33
Aug 24, 2016	73.95	74.31	72.98	73.29
Aug 23, 2016	73.13	73.90	72.88	73.78
Aug 22, 2016	72.34	72.89	71.94	72.62
Aug 19, 2016	71.56	73.40	71.56	72.29
Aug 18, 2016	70.48	72.06	70.29	71.80
Aug 17, 2016	69.70	70.42	69.20	70.19
Aug 16, 2016	69.35	69.81	68.60	69.60

Almost from the time we started the position, the stock rose above our $70 strike price and stayed there, and yet our $70 calls carried high time value, as you would expect on a volatile stock.

The Friday before last, Sept. 9, shares suddenly fell below that, to $66, and our patience looked to have been vindicated, with us potentially collecting full income soon. If we had wanted to for some reason, we basically had one day to close early in response; if we issued an alert on Monday, Sept. 12, we could have closed Tuesday for just a little time value. But seeing shares as low as $65 Monday (before closing higher) meant reasons to act looked minimal to none. Then the quick ascent began Wednesday (from Fool Quotes):

Late Wednesday, the stock jumped to $72 from less than $70 earlier in the day. Now I knew we had to act, because we didn't want to risk losing shares with only two days left. We issued our rolling alert at 10 a.m. Thursday morning. As I entered current pricing into the alert, the stock was still $72; suddenly that morning, it ran to $74, and then before long all the way to $77, leading to many early exercises on the $70 calls.

All this is hopefully instructive in demonstrating that circumstances can leave you less than a day-long window in which to avoid losing your covered shares on a sudden move in the underlying stock. It's important to always keep that in mind when writing covered calls. The standard procedure with covered calls is:

- Watch time value and roll or close once it's nearly gone.
- But if the call looks on track to expire as income, you typically let it be, knowing you can usually roll it for a credit if it later moves against you (so why pay to close it?).
  - **An exception we can add now -- one new lesson we can take home:** On an exceptionally volatile stock, close the calls early if you get a good chance to a few days before expiration and you have any concern about the stock rebounding.
- No matter what, be ready to lose your stock, because it can go out of your control.

We followed these standard steps, and will consider the exception next time in such a situation. Was it wrong to write calls in the first place? Not in my opinion, because we chose to turn this stock into an income position for now and the foreseeable future, and we'll keep doing that until the valuation situation changes. Trading at 15 times earnings while being a "chip" stock now growing earnings around 10% annually, Skyworks looks reasonably priced.

Soon we will buy our sold shares back again,and write the January $75 calls on them. We'll need to do so at today's higher price. We'll make our trade once 24 hours have passed after this update.

As ever, do not cover any shares you want to keep for certain! To talk about this, please visit the Skyworks board.

Roll Your Covered Calls on Skyworks Solutions

Published Sep 15, 2016 at 10:05AM

Is this for you? This recommendation is for *Pro* members who wrote September $16 $70 *calls* on Skyworks with us. Newcomers who want to write covered calls can follow along with today's recommendation; see the How You Participate box for more. *Pro* members not writing calls can continue to own this Buy-rated stock in a 3.1% allocation. (*Options* members who wrote $70 puts expiring tomorrow are on track to earn full income without needing to take any action. If the stock falls below $70 tomorrow, *Options* will issue an alert to roll or close.)

How You Participate

- **Trade:** Use a rolling order to on **Skyworks Solutions** (NASDAQ: SWKS) options to:
  - "Buy to close" all Sept. 16, 2016, $70 calls (click to see "All Strikes")
  - "Sell to open" the same number of Jan. 20, 2017, $75 calls
- **Allocation:** Write ("sell to open") one new call for every lot of 100 shares you are covering. *Pro* is covering all 1,200 shares owned, representing 3.1% of the portfolio.
- **Prices** (9:35 a.m.):
  - Skyworks Solutions: $74.10
  - Sept. 16, 2016, $70 call (splitting bid/ask): $4.20
  - January 20, 2017, $75 call: $5.50
  - Net credit to roll: Approximately $1.30 (plus we gain $5 in upside per share, $4 of which is currently already earned)
- **Option Price Guidance:** Prices will change rapidly, but use a limit order to roll for ideally about **$1.30 in net credit** or higher. You *must* roll for the credit you can get by Friday to avoid losing your shares.
- **Stock Guidance:** Buy, at 3.1% (you don't need to use options on it unless wished)
- **Newcomers:** Simply "sell to open" the January $75 calls, lately for around $5.50 or so (that price will fluctuate), selling one call for every 100 shares you own and want to cover for income. Against the current share price, aim for a minimum 1.5% option yield per month to expiration -- lately about 6%, or $4.45.

What We're Thinking

iPhone 7 pre-orders are reportedly blistering, and **Skyworks Solutions** (NASDAQ: SWKS) – with **Apple** (NASDAQ: AAPL) as its largest customer – is enjoying a higher share price as a result. That's interesting because Skyworks' *second-largest* customer is Samsung. Samsung, meanwhile, is in the hot seat, suffering an expensive phone recall over potentially explosive batteries. The company faces massive refunds and perhaps customer defaults. However, Skyworks shouldn't need to refund any of its revenue to Samsung, and many customers may default to another of the phones that Skyworks serves with its analog modules, amplifiers, antennae and so forth.

Anyway: On word of strong iPhone orders, yesterday Skyworks jumped well above the $70 strike price of our calls that expire tomorrow (Friday), so we're rolling our covered calls to a later month and a higher strike price. Waiting until now to act gave us a couple of benefits: it allowed time value to dissipate from the calls, and it let us see whether the stock really did rise above $70. A few days ago this looked less likely, but here we are, so we'll take action.

But please note that this stock can be volatile. If Skyworks is back *below* $70 by Friday and you can afford to watch it periodically that day, you won't need to buy to close your $70 calls if the stock ends the day below $70 and stays there after hours. In that case, you could let your calls simply expire as full income (do nothing), avoiding paying any time value, and then write the new calls next week.

But as long as Skyworks is still above $70 on Friday, we're buying to close the $70 calls as soon as we can to avoid being exercised; we're then selling new calls expiring later, and rolling our strike price up in case the Apple-infused rally continues. From a higher strike price, it should be easier to attractively roll our calls again down the road if Skyworks goes even higher.

For now, the plan is to continue to write covered calls on the belief that the stock will remain volatile and we'll generate extra income on it over time. The stock remains a Buy in *Pro*, and we have a 3.1% allocation. We're covering all of our shares at the moment. If you're not writing covered calls, or own fewer than 100 shares, you can just continue owning the stock. Cool? Stay cool.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium paid us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up**: We hope to see this covered call expire for income, and then write new calls if wished. If we need to roll higher to capture more upside in the stock, we will if we like the pricing.

Options Can Help

- **Want to know more about this strategy?** Our guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the SWKS board.

Pro Catch-Up Trades and Upcoming Expirations: Sept. 12, 2016

Published Sep 12, 2016 at 3:04PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

- Just getting started? Our Portfolio Building Report No. 1 features details on all our Buy First stocks, and Portfolio Building Reports No. 2 and No. 3 get you up to speed on all of our Buy stocks!

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights this week:

- **Facebook** (NASDAQ: FB): Buy up to 6.7% (in halves if you prefer).
- **FactSet Research** (NYSE: FDS): Buy 2.2%.
- **MasterCard** (NYSE: MA): Buy up to 4.4%.
- **Wells Fargo** (NYSE: WFC): Buy up to 4.4% (intending to write covered calls on one-third of that).

Continue building your portfolio with our Buys, including these highlighted today:

- **AmTrust Financial Services** (NASDAQ: AFSI): Buy up to 5.1%, in halves over time if preferred. Or, sell to open $25 puts expiring in later months.
- **Gilead Sciences** (NASDAQ: GILD): Buy 2.7%.
- **Medtronic** (NYSE: MDT): Buy 3.2%.
- **Oracle** (NYSE: ORCL): Buy 3.6%.

Our shorts (if you're new to shorting, you can wait for our Portfolio Positioning Event on Sept. 21, or move forward now and ask questions on the boards):

- **CurrencyShares EuroTrust** (NYSEMKT: FXE): Sell short 1.8%.
- **Domino's Pizza** (NYSE: DPZ): Sell short 2% along with owning 3.4% in **Papa John's** (NASDAQ: PZZA).
- **Pier 1 Imports** (NYSE: PIR): Sell short 0.5% to start (see our recent trade alert).

Pro options (again, to be addressed during our Portfolio Positioning Event):

- No catch-up options trades are currently recommended.

Hedges:

- **S&P 500 Depository Receipts** (NYSEMKT: SPY): Set up the November put ratio spread as per our latest alert. You can do so for a credit.

Options expiring next (on Sept. 16):

- **Gentex** (NASDAQ: GNTX): Our $15 puts are on track to expire as full income.
- **SPDR S&P 500** (NYSEMKT: SPY): Our September $200/$189 put ratio spread is on track to expire unused, earning us some income. No action should be needed unless the market falls 7% or more this week. We have the November hedge ongoing, and will look to set up a new complementary one after this one expires.
- **Skyworks Solutions** (NASDAQ: SWKS): Our $70 covered calls are on track to expire as full income. If the stock gets above $70 later this week, we'll issue an alert to close or roll the calls. If shares stay below $70, we'll do nothing and let the calls expire.
- **Valmont Industries** (NYSE: VMI): Our $135 covered calls are on track to expire as full income on Friday. We'll only take action if the stock price rises above $135 before then.

Short Stories on 4 Short Ideas

Published Sep 12, 2016 at 3:04PM

Dear *Pro* members,

I don't force decisions. I would rather have several months pass without a new idea in the *Pro* portfolio than rush, or force, a decision and end up seeing members lose money on it. Plus, after decades of investing, you come to recognize the difference between when you're compelled to act and when you're hesitant, and you learn to listen to your hesitancy. Many of the positions you *don't* take *could* have performed well for you, but if you force a decision at the start, you're teaching yourself the wrong lesson, and eventually you'll pay for that.

The stocks we'll outline next are just a few of the shorts I've been considering for a long time (months or even a year or more). They're all down over this time, but we don't anchor on that, because it's not relevant. We're still considering them as shorts, and our assessment of the business *today* is what's relevant. Often, we want to short companies that could potentially go bankrupt, but that's not likely with any of these anytime soon, so they make for interesting discussion.

4 Short Considerations

Cameco (NYSE: CCJ)

- Uranium miner
- Nuclear power industry struggling
- Considered shorting since $18, lately $9
- Risk of being acquired: Very low

Longtime *Pro* members may remember that we invested in the world's leading uranium miner back in 2009, and sold for a profit in 2010. Since the devastating 2011 tsunami in Japan, the nuclear power industry has been in a mini-meltdown. Japan shut down all of its reactors. Germany is doing the same. The U.S. is taking down plants more quickly than planned. Growth in nuclear energy has stalled, uranium supplies spiked, and spot prices are in the basement. Uranium providers have a tough time making money now, and there's no telling when the industry will turn.

Cameco was one of few uranium miners with the size and strength to stay in the green, at least until last quarter. To do so, management has had to close some mines, take charges, and reorganize, and now it spends about $40 million a year just to keep water pumping through inactive mines to keep them safe. Against such a challenging backdrop, we considered shorting Cameco in the high teens. A few things have stopped us so far: It is the industry leader with a fine balance sheet (only now are its shrinking cash and meaningful debt starting to look a bit threatening); until now, it still showed annual profits; and commodity prices are impossible to predict. We keep watching, because if the industry doesn't turn, even Cameco could end up largely washed out.

Gogo (NASDAQ: GOGO)

- Provider of in-flight Wi-Fi
- Competitive, expensive business
- Considered shorting since $18, lately $12
- Risk of being acquired: Very low

For several years, Gogo was the *de facto* in-flight Wi-Fi provider on planes progressive enough to offer that amenity. The connection was typically spotty, but many were willing to pay for it anyway. Now, competition has taken flight. Gogo needs to compete against heavyweights including **ViaSat** (NASDAQ: VSAT) and **Panasonic** (OTCMKT: PCRFY) as the skies get crowded with new satellite-powered Wi-Fi. Gogo recently lost some **American Airlines** (NASDAQ: AAL) business to ViaSat, and management will need to keep spending to maintain its customer relations, upgrade, and compete. In June, management sold $525 million in junk bonds at a steep 12.5% annual interest rate. The company isn't expected to make a profit for years, and its quarterly interest payment alone is now $17 million. Gogo has $509 million in cash and $791 million in long-term debt, along with negative $60 million in free cash flow over the past 12 months.

Why have we hesitated to short it in the past? A few times, we've been close to acting but then the stock price took a precipitous drop, causing us to cancel our attack. But we hesitated *initially* because Gogo was the first mover and industry leader, serving a few thousand planes and growing. As with Cameco, we'd usually rather bet against second-tier companies than leaders, even in a weak industry. But this year competition has heated up, and Gogo proved itself willing -- even eager -- to take on that 12.5% debt, so it appears the competitive risks are serious. Gogo may be a more *logical* short now than it was last year, before competitors arose and interest payments went up. Shares have always been difficult to borrow, but we could use options to set up a synthetic short if we decide to act. For more, check out this nice summary by fellow Fool Brian Stoffel.

GoPro (NASDAQ: GPRO)

- Maker of sport-action video cameras
- Electronics industry is notoriously cutthroat
- Considered shorting (*seriously*) since mid-teens, lately $13
- Risk of being acquired: Moderate

Occasionally, I've imagined issuing a combined "Short Gogo and Short GoPro" trade report here in *Pro*. It just *sounds* amusing -- and, to my ear, profitable. Maybe it'll happen.

You know GoPro for its Hero line of indestructible cameras, but its margins have not proven nearly so resilient. Profits plummeted this year, turning to losses, as demand cooled for cameras that are arguably a niche product. Your mom loves her iPhone, but she doesn't need a Hero camera to record her daily life (unless your mom is an uber-cool kite-surfing, sky-diving, shark-riding, cliff-jumping dynamo).

GoPro is banking on its new Hero 5 camera and Karma drone, both due this year, to restart its adrenaline. But even if these products make a splash, risks seem high that they won't have a long-term impact on revenue. The drone industry is already crowded with quality machines at low prices, and the high-end adventure camera market is still a niche. Plus, now that iPhones are waterproof and getting better cameras, many potential consumers may feel less need to try a GoPro.

We hesitated to short in the past because -- again -- GoPro is the leader in its space, has great brand recognition, and has been growing until recently. It's also recommended by smart Fools in other Motley Fool services. Today, I still believe risks favor GoPro's main business being "commoditized" toward minimal profits; the technology device industry is littered with innovative companies that became irrelevant. GoPro's recent acquisitions of video editing companies have been an attempt to avoid that. In addition, a disastrous attempt to sell low-end cameras may have taught management that maintaining premium prices is smarter. The company has no debt and ample cash, but it hasn't been profitable in a year. Its two new products will broadcast to the world whether that will change, and if so, for how long.

Shake Shack (NYSE: SHAK)

- Popular burger and shake joint
- Priced like a groundbreaking, high-moat company
- Considered shorting since $40s (wasn't really possible earlier), lately $34.50
- Risk of being acquired: Above average

Shake Shack's angus beef hamburgers are popular, but so is the stock, perhaps to a fault. It's trading at a $1 billion valuation despite only operating 51 owned stores as of June 29, which means each Shake Shack is valued at $19.6 million, compared with $6.1 million for each **Chipotle** (NYSE: CMG) location. The stock trades at 85 times earnings and 66 times forward estimates, while the bottom line is expected to grow about 24% in fiscal 2017. Any real disappointment in same-store sales could make the stock more soggy than a day-old cup of french fries.

Like GoPro, Shake Shack was a fairly recent IPO; the opportunity to take a reasonable short position only arrived six months after the IPO, at best, and as long-term options became listed. But we have some hesitancy about shorting shares of a brand leader with expanding profits. We usually won't short on valuation alone, preferring cracks in the foundation, which Shake Shack seemingly lacks (other than slowing growth). That said, we've been close to shorting it via a synthetic short because the price is so generous and we see few catalysts for it to go higher, other than years of earnings growth to lower the valuation multiple. Could the chain be acquired? That's possible ($1 billion is easy for, say, McDonald's), and is another reason why shorting a leader is more risky than a lower-quality business.

The Jury Is Still Out

Any of these positions could end up working or not; Cameco aside, these are young companies, and all have compelling factors alongside their risks. We've been watching them since prices were higher, but that doesn't tell the whole story; we were smart *not* to short two of them earlier this year, when Gogo and GoPro were both in the $8 range and left for dead. Both are up more than 50% since then. All of these stocks are difficult and expensive to borrow for shorting, so we might need to use options to short them. But they're all still possibilities, among the others we're considering (including more retailers). Share your thoughts on these! And do you have a short you like? Share it on the Shorting board, too!

Fool on!

-- Jeff (TMFFischer)

Sept. 23 Is Around the Corner! *Pro* Chicago Meetup

Pro and *Options* Fools are planning an unofficial meetup in Chicago this month. If you'd like to eat some pizza at Gino's East and chat with Jeff Fischer and Billy Kipersztok of *Pro*, Jim Gillies and Jim Mueller of *Options*, and awesome, Foolish *Pro* members, check out this discussion-board thread to get details -- and then RSVP!

Pro Performance

Performance as of 8/31/2016

	Annualized		*Total Return*	
	Since Inception	Rolling 3-Year	YTD	Inception
Pro Portfolio	**13.3%**	**16.2%**	**7.3%**	**167.9%**
North Star	**8.3%**	**8.0%**	**6.5%**	**88.0%**
S&P 500 Total Return	11.9%	12.3%	7.8%	144.2%
MSCI World	6.1%	5.3%	3.4%	60.3%

*Start close of 10/6/08.

Pro Guidance Changes

- None.

Pro Completed Trades

- **Wells Fargo** (NYSE: WFC): We sold to open Oct. 14, 2016, $50.50 calls on one-third of our stock position, for income.

More From Motley Fool *Pro*

- What Has Pro Taught Us?
- Getting Into the Flow of *Pro*
- *Pro* Quality Checklist: Pier 1 Imports

Pro Catch-Up Trades: Sept. 6, 2016

Published Sep 6, 2016 at 3:19PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

- Keep in mind our Portfolio Building Report No. 1, which features details on all our Buy First stocks, and Portfolio Building Reports No. 2 and No. 3 -- the latter, just released today, gets you up to speed on all of our Buy stocks!

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Broadridge Financial Services** (NYSE: BR): Buy up to 5.5%.
- **Facebook** (NASDAQ: FB): Buy up to 6.7% (in halves if you prefer).
- **FactSet Research** (NYSE: FDS): Buy 2.2%.
- **MasterCard** (NYSE: MA): Buy 4.4%.

Continue building your portfolio with our Buys, including these highlighted today:

- **American Tower** (NYSE: AMT): Buy 3.8%.
- **Gilead Sciences** (Nasdaq: GILD: Buy 2.6%.
- **OpenText** (NASDAQ: OTEX): Buy 3.3%.
- **Papa John's** (NASDAQ: PZZA): Buy 3.4% in conjunction with shorting 2% in Domino's (see below).
- **Verisk** (NASDAQ: VRSK): Buy 2.2%.
- **Visa** (NYSE: V): Buy 2.4%. (See our earnings update.)

Shorts -- if you're new to shorting, feel free to wait for our Portfolio Positioning Event on Sept. 21:

- **CurrencyShares EuroTrust** (NYSEMKT: FXE): Sell short 1.8%.
- **Domino's Pizza** (NYSE: DPZ): Sell short 2% along with owning 3.4% in Papa John's (see above) (see what we did there? We set up an infinite loop).
- **Pier 1 Imports** (NYSE: PIR): Sell short 0.6% to start (see our recent trade alert).

Pro options (again, to be addressed during our Portfolio Positioning Event):

- None currently recommended for newbies.

Hedges:

- **S&P 500 Depository Receipts** (NYSEMKT: SPY): Set up a new put ratio spread per our latest alert. You'll have to set it up now for a small debit of $0.05 per spread, but that's still not bad.

Options expiring next (on Sept. 16):

- **Gentex** (NASDAQ: GNTX): September 2016 puts. Gentex shares are trading at about $18, well above our $15 strike. These puts are on track to expire as full income. The stock remains a buy.
- **Skyworks Solutions** (NASDAQ: SWKS) and **Valmont Industries** (NYSE: VMI): September 2016 covered calls. These contracts have 11 days to go, so we'll issue updated guidance as we approach expiration. If Skyworks is still above $70, as appears likely right now (it's $72.50), we plan to roll our options to a later month ahead of expiration, as time value dissipates. Valmont is the same story -- we'll likely roll if the stock is above $135, but right now our calls are due to expire as full income.

What Has Pro Taught Us?

Published Sep 6, 2016 at 3:19PM

Dear *Pro* member:

This past week, *Pro* member and Ticker Guide Karen (CMF_KBecks) posted a question on the *Pro* discussion boards, asking fellow members what they've learned during their time with *Pro* and how it's changed them as investors. She also asked for Foolish stories from anyone willing to share one. This conversation is off to a great start, and you can read your fellow members' thoughts here.

And when you're done, if you haven't already, please share your answers! What are the key lessons you've learned so far as an investor, either with *Pro* or before you joined us? Do you have a funny, difficult, or inspiring investing or life story to share? Please do!

We always like to walk the walk, so today members of the *Pro* team are sharing the key things *we've* learned.

Billy:

We start with our most senior analyst. You know him from his great analysis, writing, and recommendations: Billy Kipersztok (TMFBillyTheKid). Billy joined *Pro* and *Options* in the spring of 2013 as a newcomer to options. Now he's a star. Enough said. Billy's takeaways:

- I'm now much more cognizant of the behavioral aspects of investing.

- I have a much greater understanding of sophisticated investing strategies such as options, shorting, hedging, and ETF investing.

- I've developed a better process for identifying great businesses (the *Pro* Quality Checklist), improving the efficiency of the idea-generation process.

Ellen:

Pro launched in 2008, and Ellen Bowman (TMFKabellen) joined the team in 2011, making her the second most senior Fool here. *Pro* and *Options* wouldn't be half what they are without Ellen's tireless creative work, including building pages, organizing live events, managing content, and making sure we're coherent (and polite!) when we write. [*Editor's note*: *Thanks, Jeff. :)*] Like us, Ellen is, of course, also an investor. Here are some things she's learned:

- Fair value is neither objective nor immutable. Working on *Pro* over these five (!) years, I've seen so many members fret about fair value and when to hop on board with various positions -- and the advice from Jeff and team has always stayed the same: If it's listed as a Buy or Buy First on our Recommendations page, we think it's poised for North Star-beating returns today. I recently moved half of my 401(k) into a self-directed account to mirror *Pro*'s long positions (which allows me to amuse myself by telling Jeff to do a good job because my kid's gotta eat!), and I followed my own advice: I chose a day to buy, followed the *Pro* allocation calculator, and bought without looking back.
- It's gonna be fine. So far, even the most shocking events I've seen while working at TMF, from the housing crash to terrorist attacks to Brexit, have passed without destroying the stock market, the country, or the world as we know it. Jeff's and the team's steady advice and perspective have been key for me as I learn to let things pass.
- Community matters. One of the most wonderful things about *Pro* and *Options* in particular is the involvement and expertise of our community members. It feels great to be part of the *Pro* team, but it feels even better to watch new members come into *Pro* and turn from students to teachers. The amount of knowledge we can all share this way is exponential.

Jeremy:

Jeremy Myers (TMFTank) is our newest analyst, having joined *Pro* last year, but he's nonetheless a senior analyst after having spent nearly seven years on *Motley Fool Hidden Gems*. He's already providing outstanding coverage on several *Pro* stocks, and working on new recommendations, too, in a tough market to find value. Jeremy says:

- I've learned that you don't have to make it back the same way you lost it. Too often, we hang on to losing positions hoping to get back to even, when it makes more sense to cut our losses and invest in a better opportunity going forward.
- I've found that the key edges we Fools have over the market are time frame and temperament. Stretching our time frame further into the future provides a greater margin of error for an investment thesis to play out, but we also need the temperament to ride out the bumps along the way.
- Since joining the *Pro* team a year ago, I've become more cognizant that stock picking and portfolio management are separate, complementary investing skills. You need to be reasonably good at both to be a successful investor over time, but I've gained a greater appreciation for the role that intelligent portfolio and risk management play in compounding your wealth over time.

Sept. 23 Is Coming Soon! *Pro* Chicago Meetup

Pro and *Options* Fools are planning an unofficial meetup in Chicago in September. If you'd like to eat some pizza at Gino's East and chat with Jeff and Billy Kipersztok of *Pro*, Jim Gillies and Jim Mueller of *Options*, and many of the finest *Pro* members around, check out [this discussion-board thread] to get details -- and then RSVP!

Jeff:

When I think of what I've learned since *Pro* launched in 2008, many of my thoughts center on the challenges we face as a service, and working to excel despite those, as well as some investment lessons:

- We will recommend fewer than 2% of the companies we look at, which means that out of every 100 companies we consider, we'll be fortunate to recommend a few of them, long or short. Almost all of them have something that holds us back. I consider this a *good* thing, as long as our high success rate on both longs and shorts continues. This does mean that many months can go by before we recommend something entirely new, but often, a business you already know and own is better than something novel with its unknown risks.
- By far, the biggest mistake I've ever made personally is selling a good company because of valuation concerns. This has cost me many thousand times more (in lost opportunity) than any bad stock I ever held on to. I sold **Amazon.com** (NASDAQ: AMZN) years ago on valuation worries, before buying it back mountains higher. Here in *Pro*, we have fixed funds, so if we lack cash and want to buy something new, we need to sell something. But the lesson still stands: We should rarely, if ever, sell our strong companies. We've made some good sells, including **3D Systems** (NYSE: DDD) and **InvenSense** (NYSE: INVN), but only when the companies were struggling and not living up to our hopes, which is different from selling a good company on valuation concerns.
- I've learned from hearing countless member experiences -- and from my own life -- that there is always adversity to overcome in life, and some of it is monumental. Despite this, you need to keep calm and focused when it comes to your investing, and stay on course (even if that means stepping back for periods of time, leaving your stocks alone). Investing is a privilege, and you remember this the moment there's a family emergency that needs your attention. I've learned that we're surrounded by resilient people here at the Fool, because all of us go through tough times. I hope you are usually content, because adversity never really ends. It's part of life and part of investing. How you approach and address it is *more* than half the battle, especially with investing. The great community here can be a giant help.

Thank you again to Karen for posting these key questions to the community! This is an excellent way for members (new and old alike) to get to know each other, and *Pro*, better. Please [visit the discussion] if you haven't already, and we'll see you there!

Fool on!

-- Jeff (TMFFischer)

Pro Performance

Performance as of 8/31/2016

	Annualized		*Total Return*	
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S&P 500 Total Return	11.9%	12.3%	7.8%	144.2%
MSCI World	6.1%	5.3%	3.4%	60.3%

*Start close of 10/6/08.

Pro Guidance Changes

- None.

Pro Completed Trades

- **Domino's Pizza** (NYSE: DPZ): We sold short a 2% stake in DPZ to hedge 2% of our 3.4% long exposure to **Papa John's International** (NASDAQ: PZZA). PZZA remains a Buy at 3.4%, but ideally off-set by this 2% short in DPZ.

More From Motley Fool *Pro*

- [Getting Into the Flow of *Pro*]
- [*Pro* Quality Checklist: Pier 1 Imports]
- [The Human Side of Investing]

Pro Portfolio Building Report No. 3: Our Buy Stocks, Continued

Published Sep 6, 2016 at 12:26PM

Welcome, Fools! As new members continue to learn more about *Pro*, we get a lot of questions about fair value. The most common one is this:

> **Q:** If a stock is rated Buy or Buy First, but its current price is higher than *Pro*'s stated fair value, is that stock still a Buy or Buy First right now? Should I really buy it today? At this price?

A: Yes. Yes, at least *start* to buy your allocation. Dip your toes in if you're not buying the whole stake yet (which is also fine!). Today's price should still provide the long-term annualized return we seek.

This may seem counterintuitive at first, but with some context, we think you'll see how this approach makes sense for our portfolio. Make sure you read Jeff's important Memo, "The Flaws of Fair Value," to understand how a great company has multiple extra ways to increase value that we can't bake into our long-term projections, partly because we don't know everything management is planning. (And to read more on fair value, click here.)

Moving on to today's report: Presented below are the rest of *Pro*'s Buy stocks; with these and our previous two reports, plus judicious application of the advice above, you should be ready to keep adding to your *Pro* portfolio as you're comfortable! Stay tuned for our next live chat, which we'll tell you about on the site and via email, and bring us your questions on the Getting Started & Help discussion board. We're glad to have you.

Best,

-- The *Motley Fool Pro* team

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Buy: Johnson & Johnson (NYSE: JNJ)

At eight out of eight of our Pro Quality Checklist criteria, Johnson & Johnson is a quintessential Pro-quality stock.

Suggested Allocation: About 3.1% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (2/22/17)
- Talk about Johnson & Johnson

The eighth largest company in the U.S. by market cap, J&J is one of the world's leading health-care companies, conducting business in virtually every nation of the globe.

The business is organized as a holding company, with more than 250 operating companies that are separated into three business segments: consumer (19% of 2016 sales), pharmaceutical (46%), and medical devices (35%). The consumer segment sells dozens of familiar brands (think Band-Aid and Listerine). The pharmaceutical business is the company's largest; in fact, J&J is the world's sixth largest pharmaceutical company by annual sales. And the medical devices segment includes a broad range of products used in the orthopedic, surgery, cardiovascular, diabetes-care, and vision-care fields.

For such a large company, J&J has an outstanding financial profile (which provides evidence for the company's competitive advantages). As a top-notch business, this is one we expect to hold for a long time. While its large size means we don't expect runaway growth and upside from J&J, we do expect to earn North Star-challenging returns with low downside risk from one of the safest stocks you are likely to find in the entire investment universe.

Buy: OpenText (NASDAQ: OTEX)

This company's information management software keeps the digital lives of businesses in order, and its exchange software platform drives business transactions and earns recurring revenue.

Suggested Allocation: About 3.2% (see Recommendations page for real-time allocation)

For More

- Most recent earnings coverage (5/15/17)
- *Pro*'s original recommendation (8/31/11)
- Talk about OpenText

Based in Canada, **OpenText** (NASDAQ: OTEX) provides Enterprise Information Management (EIM) software to governments, legal firms, financial institutions, and other corporations that need to manage growing reams of digital data. Its overall goal is to provide customers with a singular software platform for managing, analyzing, and exchanging enterprise information; it also wants those customers to conduct business transactions over OpenText's business commerce exchange.

To these ends, OpenText steadily acquires smaller companies to add their services to its wares. Management made four acquisitions in mid-2016 that should fuel about $300 million in new revenue over the coming year (adding to its current $1.9 billion in annual sales), along with strong earnings-per-share (EPS) growth. As these acquisitions are assimilated, margins should continue to improve and the company's market share should rise. About 85% of OpenText's revenue is of a naturally recurring nature, being subscription-based.

This cloud and license software seller is under the radar of many investors, but it's the largest independent EIM software provider after IBM. Recently $63, the stock has been a strong long-term performer, up about 1,200% since its 1996 market listing, compared with 255% for the S&P 500. Today, the stock trades at 15.3 times estimated earnings for the coming year, while non-GAAP earnings per share are expected to increase by 15.5%.

Buy: Paycom Software (NYSE: PAYC)

Pro is looking to add more high-growth positions to the portfolio, and this company can sign that check -- so to speak.

Suggested Allocation: About 3% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (11/30/16)
- Talk about Paycom

Paycom Software is a profitable, young, cloud-based provider of payroll and human capital management (HCM) software, which manages the employment life cycle for employers and employees. It's differentiated by its comprehensive, integrated Software-as-a-Service (SaaS) solution that saves customers money and makes HR systems more efficient.

Revenue has compounded at 46% annualized over the past three years, and profitability and free cash flow much more rapidly than that. The company sports more than 15,000 clients and stores data on 2.1 million employees, and its average three-year retention rate (recurring revenue) was 91% as of Dec. 31, 2015. In the most recent quarter, 98% of revenue was recurring. It notches $300 million in annual sales, meaning the company can grow for years before it takes significant market share in the immense payroll and HCM industries. And its comprehensive and growing HR solution is ahead of competitors', promising market-share gains for years. Finally, at the time of our rec, the stock traded at 31.8 times expected non-GAAP earnings for 2018, in line with the company's estimated growth rate.

Be sure you've got a long-term outlook of at least three to five years, some comfort with high price volatility, and comfort with the potential for at least a partial loss of capital, then welcome Paycom as a high-growth, North Star-friendly addition to your portfolio.

Buy: ProShares Short VIX Short-Term Futures ETF (NYSEMKT: SVXY)

Profit from the long-term nature of stock market volatility to revert to an average level after each spike.

Suggested Allocation: About 2% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (11/25/14)
- Talk about SVXY

Buying shares in — let's make it easy and use the ticker, shall we? — SVXY is a recommendation for *Pro* members who are comfortable owning a small stake in a volatile position that we *may* add to during market downturns. *Pro* is a portfolio service, so all positions are meant for everyone, to the extent you can invest in them and wish to. But this position is not core to what we do, and will be especially volatile, so only follow it if you're comfortable with high volatility in a holding.

This unusual vehicle should increase in value when stock market volatility — as measured by the CBOE Volatility Index (or the VIX) — goes down or is range-bound. This ETF *sells short* futures contracts on the VIX that have one month and two months to expiration. Unless expected volatility from the S&P 500, as measured by the VIX, increases above and beyond the premium already baked into the futures contracts being shorted, the positions turn a profit in the ETF and the ETF goes up in value. Helping further, VIX futures contracts are historically in a state of "contango" as much as 90% of the time. Contango means that future-month contracts are increasingly more expensive than earlier months' and than the current VIX itself (much like a call option has a premium above the current stock price). This is a tailwind for SVXY. As long as volatility is ultimately rangebound overall (as it is historically), then just holding this small stake over the years should reward us.

We recommend starting at 1.1% (or round to 1% if you want), and we may add more when the VIX soars — meaning when volatility in the market is high and SVXY is low. But even if we don't, we believe this small position should create compounded value for us over the long term thanks to the regressive nature of volatility in the market: It spikes, and then grinds back down, and is usually range-bound.

Buy: Skyworks Solutions (NASDAQ: SWKS)

This leading designer of analog modules for smartphones and connected Internet of Things devices is growing sharply.

Suggested Allocation: About 4.4% (see Recommendations page for real-time allocation)

For More

- Latest earnings coverage (5/15/17)
- *Pro*'s original recommendation (8/5/14)
- Talk about Skyworks

The loftily named **Skyworks Solutions** (NASDAQ: SWKS) supplies customized analog semiconductor modules and related products to major smartphone makers around the world. As Wi-Fi connectivity grows, Skyworks' complementary Internet of Things business is growing, too, recently representing about one-fourth of total revenue. Company profit margins continue to expand as Skyworks increases its market share as well as the amount of its components it sells into many devices.

We're now seeing a move to higher-speed LTE wireless coverage in China and in most emerging markets; this is a long-term opportunity unfolding for Skyworks, even as smartphone sales level off in mature markets and at the company's largest customer, **Apple** (NASDAQ: AAPL). On July 21, Skyworks guided for 10% to 11% sequential revenue growth next quarter -- a bump higher than the 8% guidance given for the same quarter a year ago, suggesting healthy if not mind-blowing expectations for the iPhone 7. Management expects sequential growth to continue for the quarter after that, too, clearing current inventory concerns. As a technology leader growing faster than its market and with improving margins (a rarity in the chip industry), Skyworks, at about $74, is trading at 12.6 times earnings expected for the next year. The stock looks to us like a reasonably priced way to invest in the long-term ascent of mobile connectivity and the Internet of Things through a strong niche leader.

Buy: Starbucks (NASDAQ: SBUX)

You only think you're there for the coffee — the ubiquitous java purveyor has big plans.

Suggested Allocation: About 3.5% (see Recommendations page for real-time allocation)

For More

- Most recent earnings update (3/27/17)
- *Pro*'s original recommendation (8/22/2012)
- Talk about Starbucks

In the global coffee giant's fiscal third quarter, **Starbucks** (NASDAQ: SBUX) achieved 4% same-store sales (SSS) growth in the United States. Before that quarter, the company had generated at least 5% U.S. SSS growth for 25 consecutive quarters, so the "miss" grabbed some headlines.

But following a small dip in growth, there's no reason to see this green-and-white cup as half-empty. Revenue was up 7% year-over-year, and Starbucks now has more than 12 million active Rewards loyalty members, representing 18% growth from the prior year. A net 474 new Starbucks locations opened across the globe over the quarter, and we still believe that Starbucks is one of the highest-quality growth companies in the world. Revenue has increased for 23 of the past 24 years (1991 through 2015), and the company's 5- and 10-year average returns on invested capital are higher than 20%. Management is guiding for revenue growth of 10% for the full year (down from 10%-plus), and we expect Starbucks to provide at least a 10% forward rate of return.

Also this past quarter, management announced an investment in "Italian artisan bakery" Princi; the press release notes that Princi is "known for its artisan breads created from traditional family recipes" and that its "five locations have become beloved experiences for customers across Milan and London." Princi will also provide the food at Starbucks Reserve stores, showing that management is focusing on expanding and improving the food business as one way to give its growth a jolt. (Yes, that pun was intended. We might be working too mocha.)

Buy: Verisk Analytics (NASDAQ: VRSK)

This prototypical Pro *holding provides us with exposure to powerful tailwinds within the financial, energy, and health-care industries, among others*.

Suggested Allocation: About 2% (see Recommendations page for real-time allocation)

For More

- Most recent earnings coverage (2/27/17)
- *Pro*'s original recommendation (6/23/15)
- Talk about Verisk

Founded in 1971 by insurance-industry giants, **Verisk Analytics** (NASDAQ: VRSK) provides decades-old proprietary data and contemporary analytics to risk managers, property and casualty insurers, and financial institutions -- and after an acquisition to expand its data offerings, to the global oil and gas, chemicals, energy, and mining industries, as well. Company-wide, more than 80% of annual revenue comes from subscriptions to its services, and customers renew at an outstanding 98% rate as of 2015.

Verisk has pricing power, allowing it to increase prices regularly, including during the mayhem of 2009. How so? The company offers data that its customers need and others don't have; it has deep domain expertise, allowing it to work closely in each industry it sells to; it invents new analytic methods and better algorithms; and it's deeply embedded in customer workflow, becoming part of a user's process. Without Verisk's analysis, an insurance giant might have a hard time pricing policies.

Public since 2009, Verisk counts every major insurance company as a customer, and became part of the S&P 500 index in 2015. Historically fetching a premium valuation, the $83 stock recently trades at 26 times expected earnings for the year ahead, and 22 times free cash flow. We like the thought of new members starting a position here.

Establish a Partial Allocation of Covered Calls on Wells Fargo

Published Sep 2, 2016 at 11:15AM

Is this for you? Yes, if you're a *Pro* member and have matched our 4.5% allocation to **Wells Fargo** (NYSE: WFC). If you're new to *Pro*, Wells Fargo is addressed in our Portfolio Building Report No. 1 from Aug. 16; it may be helpful to review that information as well. (If you own 2018 calls on Wells Fargo from *Motley Fool Options*, leave those alone. They have nothing to do with this alert.)

How You Participate

- **Action:**
  - Sell ("sell to open") Oct. 14, 2016, $50.50 calls on Wells Fargo. *Please note that these are **weekly** options*.
  - Stock Status: Buy First; own a 3.2% stake in WFC for the long term; and have an additional 1.3% WFC stake for today's option income generation.
- **Allocation:** Cover about 30% of the 4.5% portfolio stake in Wells Fargo that you own. *Pro* will be selling seven calls (we own 2,400 shares; 700/2,400 = 29.2% of our shares). Please note that if our 4.5% allocation is fewer than 200 shares for you, you can opt not to write covered calls and just keep your allocation as is for long-term upside -- unless you really want to cover 100 of the shares you own.
- **Prices (11:00 a.m. Sept. 2):**
  - **Stock:** $50.45
  - **Sell to open Oct. 14, 2016, $50.50 calls (bid/ask):** $1.14/$1.18
- **Price Guidance:** Using a **limit order**, split the bid/ask and aim to receive a net credit of at least $1.16. As prices change, realize that the price of the calls will change as well. Over time, aim to earn a premium of at least 1.5% (expressed as a percentage of the stock's market price) per month to expiration.
- **Important Earnings and Tax Note:** These calls expire at the end of the same day that Wells Fargo is scheduled to release third-quarter 2016 earnings before the market opens. We are choosing this date by design, taking advantage of the "earnings uncertainty premium" embedded into the option prices. Be aware that there may be volatility involved with this trade on the day of earnings/expiration, and we need to be -- and are -- ready to sell these income shares. With your broker, be sure to be set your account up for tax purposes as "Last In, First Out (LIFO)." We don't want to sell our long-term shares and have larger capital gains taxes to pay. We only want to sell the shares we acquired this year for income.

What We're Thinking

Wells Fargo has been an income workhorse for *Pro* for a few years now. Since 2014, *Pro* has written two covered strangles on the company and has written or rolled puts three times (not including this covered-call trade). The net result of all these income trades over the past two years has been a total of $3,259. When including the regular dividends we've received along the way, we've earned more than $9,000 in income from Wells Fargo in two years, a 7.5% return when expressed as a percentage of the current value of our Wells Fargo stake.

Since our last iteration of written puts ended with assignment of shares in early May, we've been patiently waiting for Wells Fargo's stock price to increase before reinitiating our long-running income strategy with covered calls.

Our intent with this strategy is to continue to monetize this small part of our Wells Fargo position for income. We are covering just the portion of our shares that was assigned to us via our written puts in May.

Considering the income we've earned on just the written-put portion of our Wells Fargo income strategy (i.e., ignoring the covered strangles), our net buy price on our shares that were assigned in May is $49.39. With these calls, assuming we earn $1.16 per call (the bid/ask midpoint), our net buy price on the portion of shares we are covering is reduced to $48.23. If Wells Fargo ends up above $50.50 at expiration, we intend to let our shares get called away for an effective 4.7% return earned in about five months (excluding dividends), and then immediately write puts again for more income. If those puts are assigned, we can follow up again with covered calls.

In this manner, we can run a continuing income strategy of near-the-money puts and/or calls as one portion of our Wells Fargo exposure, until we no longer feel that the income strategy is worthwhile. Meanwhile, we leave our long-term shares uncovered in order to capture full upside.

The fact that these covered calls will expire on the day of earnings means we can simplify our decision-making process. We won't have time to issue a rolling trade if the stock is above $50.50 on the day of expiration, so there are only two potential outcomes:

1. **Wells Fargo stock ends below $50.50 on Oct. 14:** Our calls will expire fully as income, and we will look to initiate another partial covered-call position so long as pricing is favorable.
2. **Wells Fargo stock ends above $50.50 on Oct. 14:** Our calls will be assigned and we will sell 700 shares (29.2% of our total WFC allocation) at $50.50 per share. We will look to write puts shortly thereafter to continue our income strategy, so long as pricing is favorable.

More That Matters

- **Maximum loss:** For the current iteration of the income strategy (which includes the January, March, and May recommendations), our risk is the same as share ownership starting at about $48.23, or about 4% below the current price.
- **Maximum gain:** On this covered-call trade alone, our maximum gain is the covered-call premium. At $1.16, that's a 2.3% yield on the current share price in 43 days.
- **Follow-up:** In October, we'll sell our shares at $50.50 if the stock is above our $50.50 strike price. We may then write new puts to continue our income strategy. If the calls expire as income, we will look to write new calls (or pursue a different strategy) for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 4.5% allocation first — Wells Fargo's shares are a Buy First. Then write these partial covered calls for income on about 29% of your shares, leaving a 3.2% allocation uncovered.
- **Don't like the idea of writing calls that expire on the day of earnings?** You can look at various other expirations and strike prices, depending on what you like best. If you choose this route, be aware that *Pro*'s course of action may diverge from yours, depending on what expiration and strike you choose, and depending on the stock-price movements of Wells Fargo.

Pro Can Help

- **Want more on this strategy?** See our guide to writing covered calls.
- **Questions?** Please ask, Fools! Drive your stagecoach over to the Wells Fargo discussion board.

Deere Cuts Costs to Kick the Can Down the Road

Published Sep 1, 2016 at 2:38PM

Deere (NYSE: DE) continues to struggle through a tough agricultural operating environment, but this quarter another large sales decline was overshadowed by management's cost cutting initiatives, delivering a surprise earnings beat. Rather than regurgitate the details of the quarter, I'd point members to the Press Release and the Conference Call Slide Deck for review of the nitty-gritty detail.

Overall, it was another rough quarter for Deere with net revenue and sales down 11% year over year. Agriculture & Turf sales declined 11% for the quarter though the segment's operating margin increased to 12.1%. Nearly two percentage points of that margin lift was the result of a one-time gain on a partial sale of Deere's equity stake in landscapes supply company SiteOne. Even worse, Construction & Forestry net sales decline 24% for the quarter and operating profit declined 58%. Financial Services net income declined by nearly 18% during the quarter as the result of "less favorable financing spreads, a higher provision for credit losses and higher losses on lease residual values".

The biggest news for the quarter came at the end of the conference call when the CFO shared that, on a mid-cycle volume basis, the company's operating margin should improve by three percentage points compared to where they were in 2010. As a result, management believes those savings should result in an additional $500 million in pre-tax income by the end of 2018, even if the ag downturn persists at current levels. Our short thesis is based on the expectation that the downturn will end up being worse than most investors expect -- but more on that in a minute.

With one quarter to go in the fiscal year, here is management's updated guidance for 2016:

- Worldwide Ag & Turf equipment are forecast to be down about 8%, including about 2 points of negative currency translation. This is unchanged from the previous forecast.
- U.S. and Canada expected to be down about 15% to 20%, with sales of large ag equipment down 25% to 30%.
- Europe remains flat to down 5%, due to lower crop prices and farm incomes as well as persistent pressure on the dairy sector.
- South America, expected to be down 15% to 20% in 2016.
- Construction & Forestry sales forecasedt to be down 18%.
- Field inventory to sales ratios for new large ag equipment are expected to end the year in line with 2015 year-end levels
- Full-year 2016 earnings forecast increased to $1.35 billion

Pro's Take

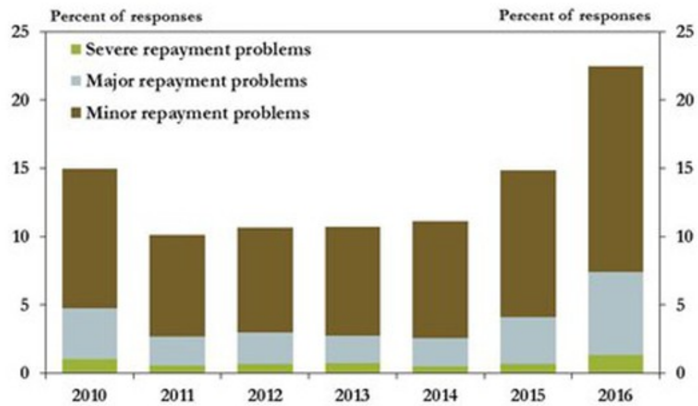
It would be fair to say that we were surprised by the market's reaction to Deere's third quarter earnings report. As we expected, industry fundamental remain weak as persistently low commodity food prices have resulted in falling farm profits, declining farmland values, and plummeting demand for new equipment. These developments were all in line with our original short thesis. We also knew that Deere was cutting costs and reducing its work force in response to industry conditions, but what caught us (and most other investors) off guard was the magnitude of the $500 million of cost savings that Deere guided for by fiscal 2018. Based on the current challenges of the business, it's obvious why management would like to point investors' eyes to the horizon, but we remain skeptical.

It also seems that investors are trying to call the bottom of the ag cycle, likely under the belief that 1) this is a normal cycle and 2) an improved cost structure will make it easier for the company to ride out the downturn, thus limiting the downside from here. It remains our view that the abnormally large volume of tractors sold near the top of the cycle will require an abnormally long (or deep) trough to clear out excess used equipment inventories.

Though some investors have become more optimistic, there are few reasons to believe that the fundamentals will improve in the next few quarters. For example, other agricultural-related businesses, like Pro's own **Valmont Industries** (NYSE: VMI), reported last quarter that it has yet to see a light at the end of the tunnel for its Valley irrigation segment. Also, the management team at **Titan International** (NYSE: TWI), which makes around 80% of Deere's tire and wheel sets under the Goodyear brand of farm tires, stated on its recent earning call there was little evidence of a turnaround in the U.S. for Deere through the end of the year. Titan only saw a modest improvement in the <100 horsepower tractor segment and one of the few bright spots for the company was the aftermarket business, which suggests that farmers are still directing their dollars to maintaining existing equipment.

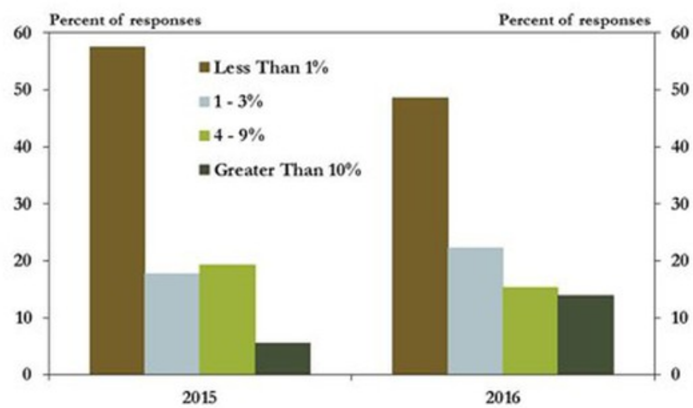
Additionally, earlier in the month the USDA announced that it expects a record harvest this fall which should keep commodity prices depressed through at least the end of the year and weigh further on farm profits. The Kansas City Fed reported that banks in its district are reporting more evidence of financial distress by farmers, noting an uptick in both the percentage of distressed loans and the number loans being denied. They're also reporting a continued slide in the value of farmland (see the charts below).

Chart 6: Loan Repayment Problems, Second Quarter



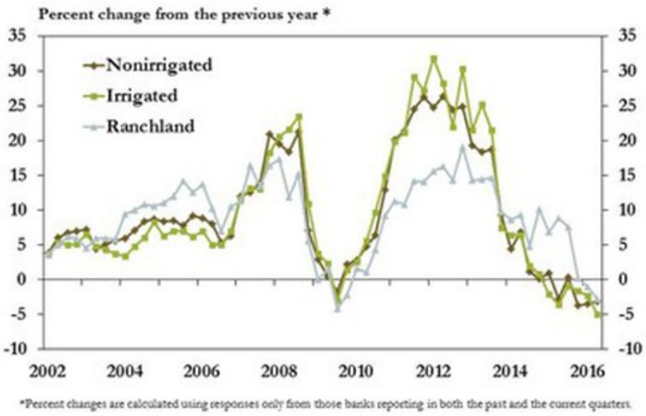
Source: Kansas City Federal Reserve

Chart 8: Percent of Farm Operating Loan Applications Denied, Second Quarter



Source: Kansas City Federal Reserve

Chart 9: Tenth District Farmland Values



Source: Kansas City Federal Reserve

These statistics suggests that farmers' financial distress is increasing which should reduce demand for new equipment in the coming quarters. The data also supports our suspicion that farmers are relying more on short-term leases to manage their balance sheets and lay off the risk of a decline in future residual value onto Deere. This should be a concern for Deere shareholders because even though management claims that they are trying to reduce the residual values for their new leases, in recent quarters the residual value of their leasing book sits at about 64% of initial cost compared to 40% to 42% of initial cost a decade ago. Considering that we're in a soft resale market for used equipment there's a high probability that Deere will have to take additional writedowns on the value of that equipment as those leases expire and also increase the depreciation charge being taken on the lease book as a whole. According to the last John Deere Capital Corp 10-K filing from nearly a year ago,

"*Estimates used in determining end of lease market values for equipment on operating leases significantly impact the amount and timing of depreciation expense.* ***Hypothetically, if future market values for this equipment were to decrease 10 percent from the Company's present estimates, the total impact would be to increase the Company's annual depreciation for equipment on operating leases by approximately $141 million.***"

$141 million isn't all that significant for a company that is projecting to earn $1.35 billion for the current fiscal year, but that lease portfolio has continued to grow rapidly over the past year and any significant impairments could certainly could put a dent in management's narrative. During the call management validated analysts concerns about the leases, stating,

"*As we look at future maturities, we continue to work hard to reduce the return rate on those maturities as well as finding more effective ways to dispose of those when they get returned so that the loss rates are not as significant. But as long as we stay at these lower levels, as long as used equipment prices continue to be at more depressed levels, I think that continues to bear watching and certainly has risks.*"

Further,

"*We'll hit some pretty strong maturities in the fourth quarter of this year and then certainly as you move into spring next year, I think another kind of wave of maturity.*"

This means that there will be a steady stream of used equipment hitting the market in the coming quarters, adding to the current glut. Deere has been very aggressive in growing its new and used equipment leasing business to make up for fewer retail sales. Over the past few quarters we've also seen a big jump in the size of the operating lease book while the proceeds from the sale of used equipment actually decreased. Part of the reason for the decline is arguably fewer trade-ins on new retail sales, but it's likely also the result of Deere releasing the used equipment and/or holding it on its balance sheet rather than selling it and further flooding a depressed market. Further evidence of this is that in the John Deere Credit Corp (JDCC) SEC filings you can find a line on the balance for "other assets" which has been growing steadily the past few quarters (the most recent quarter has yet to be filed). That's where Deere holds the leased equipment that it has yet to sell\. Combined with the fact that JDCC's profitability declined nearly 30% last quarter, it seems likely that the company is working hard to manage aftermarket prices for used inventory to delay additional impairments.

Foolish Bottom Line

No one ever said shorting is easy. In fact, a couple weeks ago I highlighted in the Monday Memo that it's among the toughest things we have to do, at least emotionally, as investors. Despite the challenge, we continue to think that finding strategic shorts is a worthwhile endeavor. In the case of Deere, shorting it kept us from selling Valmont, which generates about 25% of its sales from the Valley irrigation segment, over similar concerns about a prolonged downturn in the U.S. agriculture industry. We also expect that it will provide a hedge should the stock market, which has been marching steadily higher since the March post-Brexit low, ultimately reverse course in the coming months.

The key points of our original thesis appear to still be in place, but sentiment toward the stock has obviously shifted. Deere is aggressively cutting costs and doing a good job of managing through the down cycle. Even so, following the recent increase in the stock price shares are trading at 18-times The Street's estimate of **2018** earnings. If the company can continue to manage investor expectations long enough, eventually it will be rewarded by an upturn in the cycle. Thus far management has proven adept at that task, promising a 2016 recovery in 2015 that never materialized and now a huge cost savings over two year out. We think the next two quarters will be telling as the company deals with upcoming lease maturities and tries to continue rationalizing its cost structure in the face of tepid demand for new equipment. **Deere remains on Hold, while the team discusses whether the recent move in the stock price warrants an update to our guidance.** (For new members a "Hold" rating means that it's ok to keep the position open if you have already shorted the stock. Otherwise, we are not recommending that members start a new position at this time.)

Short Domino's Pizza

Published Aug 30, 2016 at 11:57AM

Is this for you? This trade is for all *Pro* members who are matching our allocation to **Papa John's** (Nasdaq: PZZA) and seek possible downside protection for that position.

How You Participate

- **Trade:** Sell short **Domino's Pizza** (NYSE: DPZ).

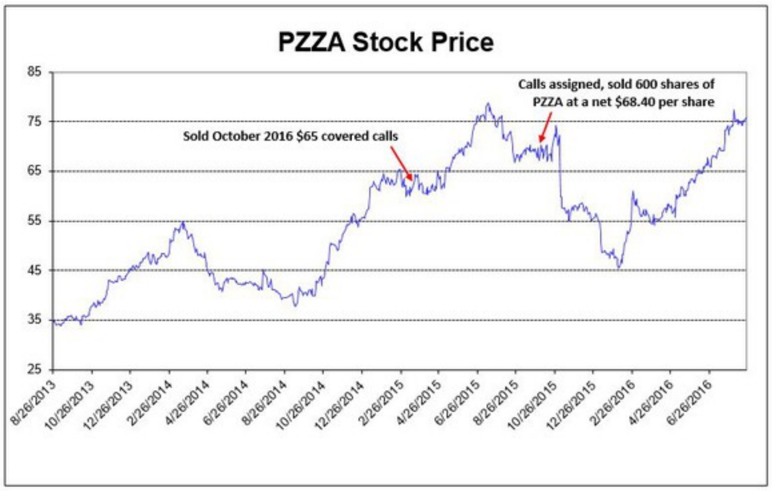
- **Allocation:** 2% (or short around 59% of your *long* allocation to **Papa John's** (NASDAQ: PZZA) in a new DPZ short -- read on).
- **Price guidance:** It is **critical that you *use a limit order*** to aim to short around current pricing.
- **Recent price:** $149.83
- **Availability at Interactive Brokers (Aug. 30):** 3.4 million shares
- **Current annualized shorting fee (Aug. 30):** 0.25%
- **Current dividend yield (Aug. 30):** 1%; we also need to pay this dividend while shorting shares.
- **Short interest (percentage of shares outstanding as of Aug. 30)**: 6% (per S&P Capital IQ)
- **Next earnings date**: Oct. 18

What We're Thinking

Why short Domino's? Doesn't *Pro* own competitor Papa John's? Exactly. In fact, as you'll read in this alert, this short is a *paired* position with Papa John's, meaning that we cannot consider this position without also considering the position it's paired with. The long position (Papa John's) and the short position (Domino's) combine to create one, single super-position that reflects our thesis. Further explanation of the paired thesis follows below, and reviewing the history of our Papa John's position will help provide further context.

In early 2015, *Pro* decided to establish a partial allocation of covered calls on our shares of Papa John's. The rationale for the covered calls was that the then-current price (about $61 per share) reflected rosy expectations, and we aimed to buffer a portion of potential downside volatility via the covered-call premiums. Our stake had also grown large enough that we were content to cut it.

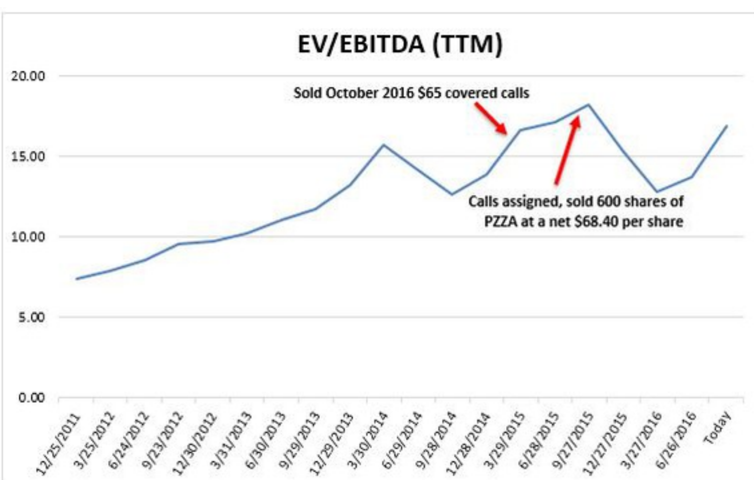
About seven months later, *Pro*'s calls were assigned, and we sold one-third of our Papa John's position at a net $68.40:



Source: S&P Global Market Intelligence

Over the following months, Papa John's stock experienced severe volatility, reaching as low as $44.47 in February of this year, a 44% decline from its peak of $79.40 in July 2015. Remember, small- and mid-cap stocks will tend to be more volatile than large companies. Since that roller-coaster ride, Papa John's stock has been on a tear, and it's back above the price levels at which our covered calls were exercised.

However, looking only at the stock price is somewhat misleading. An alternative way to look at our position management would be to examine Papa John's valuation multiples; doing so takes business performance into account as well as the stock-price changes. Here is the same graph, except instead of stock price, the metric in question is EV/EBITDA:



As you can see, the graphs generally follow the same trend, but a key difference is that in the EV/EBITDA chart, today's valuation multiple is roughly equivalent to the multiple that existed when we wrote our first set of covered calls. The stock price is higher, but the multiple is nearly the same; the only way for that to be the case is if the denominator of the equation (EBITDA) is higher. And as we see below, that is the case:

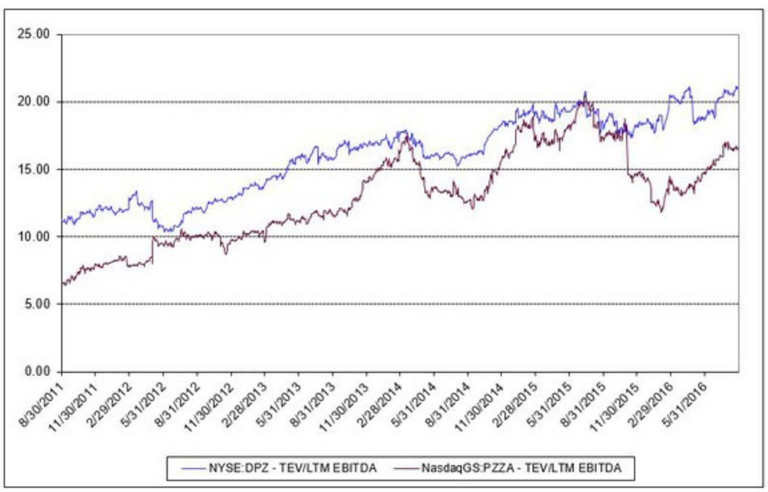
	Stock Price	TTM EBITDA (in thousands)	EV/EBITDA
3/10/2015	$60.90	$157,584	17.15
8/30/2016	$75.11	$187,300	16.69

Papa John's now sports an EV/EBITDA multiple similar to when we covered a portion of our shares last year -- and it's at an even higher premium (about 32%) to our admittedly conservative fair-value estimate. Since our assessment of the position hasn't meaningfully changed, we need to decide how we're going to manage our Papa John's exposure. We could write more covered calls, but instead, we believe that shorting Domino's is a superior way to buffer potential downside volatility for Papa John's. Consider the following:

- The correlation coefficient (the statistical variable *r*) of Domino's and Papa John's daily stock-price movements over the last five years is 0.977, an almost-perfect positive linear correlation. Put another way, 95.5% of the variation of Papa John's stock price can be explained by variation in Domino's stock price ($r^2 = 0.955$).
- Selling calls buffers only a very small portion of potential downside. Let's say we were to write the January 2017 $77.50 calls: We would earn a premium of about $3.65. That buffers against about a 4.9% decline in Papa John's stock before the covered-call position would enter negative-returns territory.
- For comparison, selling short a stock that historically moves in tandem with the stock we aim to protect would in theory buffer almost *all* of our downside. Assume Papa John's stock were to decline 44% from the current price, like it did during the last peak-to-trough decline mentioned above. In that instance, Papa John's stock would be at $42.06. At the same time, we could expect Domino's stock to decline almost exactly in the same proportion (at least as predicted by the stocks' historical correlations). The gain on our short position in Domino's could almost exactly offset the loss from a Papa John's price decline, providing much more complete downside protection than would a covered call.

The trade-off is that we won't receive any income from selling calls, and we also have to consider the costs of shorting (the modest 0.25% short fee, plus the cost of paying the 1% dividend). However, we think the prospect of much more complete downside protection is worth it.

Additionally, we may even stand to earn an absolute return from this position, thanks to the discrepancy in valuation multiples between the two companies. Domino's has consistently carried higher multiples than Papa John's over the past five years, with the average discrepancy between their EV/EBITDA multiples at about 3.07 over that time frame (the median is 3.33). Currently, the multiple discrepancy is 4.5, with Papa John's at 16.6 and Domino's at 21.1. Over the past five years, that figure has been lower than 4.5 nearly 84% of the time. With a higher multiple, Domino's has less room for error and is likely to experience more volatility after a poor quarter or if markets go south. If that happens, and the multiple discrepancy decreases, our paired position will benefit.



Source: S&P Global Market Intelligence

How This Fits Into *Pro*

All in all, this short of Domino's has almost nothing to do with Domino's business (which is performing well) and everything to do with managing our current Papa John's position. As a paired trade, it is a low-cost hedge that will ideally protect almost all of our downside for the portion of the long Papa John's allocation we are hedging.

By shorting Domino's at a 2% allocation, and with our current Papa John's exposure at 3.4%, we bring our effective allocation to Papa John's to about 1.4%. This short / hedge / paired position allows us to continue owning Papa John's indefinitely, preventing the potential tax consequences that would arise if we were to sell part or all of our stake through covered calls.

If Domino's and Papa John's stock prices decline to a valuation that is more in line with our estimates, we can cover our short; in doing so, we'll immediately increase our effective exposure to Papa John's back to its original allocation. And if the stocks keep rising in value, we still benefit from the 1.4% of our Papa John's position that we are choosing not to hedge.

Finally, we must discuss the worst-case scenario for this position: that Papa John's stock price falters while Domino's continues to rise. In that case, we lose out on both sides of the trade. If that scenario occurs, we'll assess the business performance of both companies and attempt to determine whether the stock-price action is warranted. If our assessment leads us to believe that we should adjust our paired position, we'll do so at that time. If not, we'll likely maintain it.

Alternative Trades

- **New to Pro and haven't established your Papa John's allocation yet?** We suggest that you simultaneously buy 3.4% in Papa John's and short 2% in Domino's, in the spirit of this alert. If you can't or don't want to short, then we suggest you buy only the *difference* between the Papa John's and Domino's allocations, purchasing 1.4% in Papa John's. If you take this course, if and/or when *Pro* closes its short to increase its allocation to Papa John's, you can buy more Papa John's stock to match our allocation.
- **In an IRA and can't short?** Consider:

- Reducing your stake in Papa John's by 2% (since tax consequences for those in IRAs are irrelevant), and increasing your allocation to Papa John's if and/or when *Pro* closes its Domino's short.
- Or you could sell covered calls (the January $77.50 or $80 calls look good to us, but feel free to explore other options if you like them better).

Pro Can Help

- **New to shorting?** Check out this Memo on the topic from Jeff for a look at how *Pro* approaches the strategy. If you're considering covered calls instead, this guide from *Motley Fool Options* should help answer your questions.
- **Further questions?** Head over to our brand-new, hot-from-the-oven Domino's discussion board.

Pro Portfolio Building Report No. 2: Our Buy Stocks

Published Aug 30, 2016 at 11:56AM

Welcome, *Pro* Fool! This report details our current thinking on nine of the Buy positions in our portfolio; the Buy stocks not listed here are included in our third report. Once you've read theses and the previous report detailing our Buy First positions, you're ready to start (or continue) building your *Pro* portfolio as swiftly or as slowly as you like.

We want our advice to be uncomplicated: Purchase our Buy Firsts first (again, taking your time according to your situation — there's no rush); purchase our Buys after that; match our allocations as closely as you can (but don't worry about needing to buy in 100-share lots — fewer is fine); and stay tuned for our next monthly live chat, during which we answer member questions in real time. Also, please read this note on fair value as you move toward matching your portfolio to *Pro*'s.

We're glad you're here, learning to become an investor who will come out on top in all markets. Bring any questions to the Getting Started & Help discussion board, and Fool on!

Best,

The *Motley Fool Pro* team

Table of Contents

Buy: Amazon (NASDAQ: AMZN)

You will be assimilated.

Suggested Allocation: About 3.4% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (1/26/17)
- Talk about Amazon

When *Pro* first bought Apple in 2012, it was already the most valuable company in the world, sporting a massive $127 billion in annual revenue. Less than five years later, revenue is up 69%, and our investment (to which we later added) is up 72% excluding dividends. Apple has outperformed a majority of our positions, despite its giant size. Enormous **Amazon.com** could follow the same path, and may even have superior avenues for sustained growth:

- According to the U.S. Census Bureau, only 8% of U.S. retail sales occur online, but the shift to the Internet continues -- Amazon's revenue rose by 29% last quarter.
- Gartner estimated in 2015 that Amazon Web Services (AWS) for the cloud had 10 times the utilized capacity of its next 14 competitors *combined*, and this lucrative business increased revenue by 70% in 2015.
- Alexa is a leading artificial-intelligence operating system in the home.
- Amazon Prime may have as many as 80 million global subscribers, each paying $99 a year for free shipping and streaming video.
- And more ...

Amazon has so many business arms that a more fitting name could have been Octopus. Consumer retail sales drive massive cash flow to the company daily, but today it's cloud services that generate most of the profits. Amazon's cloud is heavy in machine learning and AI; relatedly, Alexa's early success is driving Amazon Echo and Dot product sales, and manufacturers around the world are now building Alexa into new devices and cars. Amazon has hundreds of fulfillment centers, and investment bank Piper Jaffray says 44% of U.S. citizens now live within 20 miles of one -- that's a strong competitive advantage. Drone delivery is in the works, and Amazon is investing in more of its own delivery to save on costs. U.S. sales account for about two-thirds of retail revenue, but international is growing and largely untapped. In an unconventional surprise, the company is launching a physical bookstore in Manhattan, and Amazon Go grocery stores around the country. And then there's Amazon's award-winning original content.

Sometimes lost in the breathless coverage of all these initiatives is what helps drive the success of each: data. Founder and CEO Jeff Bezos, 53, is driven by the intelligent use of information and cutting-edge technology to do business better than others. As the world's largest online retailer, Amazon has a better understanding of consumer retail behavior than any internet competitor, allowing it to anticipate customer desires. Couple that with the relentless pursuit of improving the customer experience, and Amazon always seems two steps ahead. In its own words, Amazon is "guided by four principles: customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking." Management has a history of reinvesting cash flow for more growth, learning from mistakes, and pushing new boundaries. This bodes well for long-term growth, and for us as shareholders.

Buy: Apple (NASDAQ: AAPL)

The leader in mobile computing products should see more long-term growth than anyone expects.

Suggested Allocation: About 4.8% (see Recommendations page for real-time allocation)

For More

- Most recent earnings update (2/27/17)
- *Pro*'s original recommendation (2/14/12)
- Talk about Apple

Led by its iPhone, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the smooth Apple operating system, iOS, which centers on the iTunes and App Store marketplaces, as well as the new Apple Pay. iTunes alone earns more revenue each year than two-thirds of the companies in the Fortune 500, while Apple itself is the most valuable company in the world, with more than $220 billion in annual sales. The company's integrated hardware and software make for a sticky consumer experience that provides disincentives to switch to a competitor, and as more people use multiple computing devices, Apple makes it easy to transition seamlessly from one of its products to another.

The company regained some shine with third-quarter earnings on July 26; while sales and earnings declined as expected, revenue of $42.4 billion and gross margin of 38% were at the high end of expectations. The new, cheaper, 4-inch iPhone SE is seeing strong demand in emerging markets (India and China included), becoming the first smartphone many consumers buy. Meanwhile, the number of customers switching to Apple products from other phone models hit its highest level ever. Apple sold 40.4 million phones this quarter, and the active installed base of iPhone users rose by more than 10% year-over-year. This helped drive services revenue in the Apple ecosystem (iTunes, Apps) up 19%, to $6 billion, for a $24 billion annual run rate.

Though Mac sales were down following new product releases a year ago, iPad revenue was up 7%, for the best result in 10 quarters, on the roll-out of the 9.7-inch iPad Pro. Overall, product sales have been strong (especially for phones) and inventories are at good levels as Apple reportedly readies a new phone model for release this fall. At $106, the stock trades at 12 times earnings, while EPS is expected to grow again in 2017. We're not counting on a revolutionary product anytime soon, but we are counting on record numbers of phones being sold to both existing and new customers over the coming years.

Buy: Broadridge Financial Solutions (NYSE: BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: About 5.4% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (4/27/10)
- Most recent earnings update (2/15/17)
- Talk about Broadridge

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in its fiscal 2015, its platforms processed approximately 85% of all shares in the United States. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider for managing investor communications.

The company's smaller division, Global Technology and Operations (GTO), accounts for 26% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance this Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy: FactSet Research Systems (NYSE: FDS)

Stable, predictable, and meeting every one of Pro'*s quality criteria, this data and analysis provider is no myth.*

Suggested Allocation: About 2% (see Recommendations page for real-time allocation)

For More

- Buy More recommendation (4/28/17)
- *Pro*'s original recommendation (5/18/16)
- Talk about FactSet Research Systems

The ideal *Pro* company has predictable recurring revenue, pricing power, a dependent customer base, expanding opportunities, and smart management. FactSet Research scores eight out of eight on our company quality checklist, and while most companies are struggling to grow these days, FactSet increased its revenue 9% in 2015 to more than $1 billion, with earnings per share growing 16%. That made for 35 consecutive years of revenue growth, and 19 consecutive years of earnings growth -- every year since FactSet went public in 1996. Over the past 21 quarters, earnings per share have grown by more than 10% year-over-year each quarter. The business has the traits we look for most: stable, predictable results with the ability to reinvest healthy free cash flow for more growth.

Founded in 1978, FactSet's data and analysis platform has become integral to the daily operations of thousands of financial professionals, including investment bankers, institutional investors, hedge funds, and asset and risk managers. Serving more than 3,000 customers with a total of 63,500 users, FactSet prides itself on personalized attention, making its customized data a core part of its customers' daily workflow and decision-making. FactSet's consultants paid 46,000 visits to its 3,000-plus customers in 2015, making sure to meet individual needs. Clients in turn reported 97% satisfaction with FactSet's customer service.

Meanwhile, FactSet doesn't carry any of the risks inherent with most "financial"-related companies; it's a subscription business model, selling data. It doesn't have balance-sheet risk. Should competitors start to cut prices to win market share (not likely, but possible), we'll need to reassess. But as long as FactSet retains pricing power and can steadily add new clients, it should create North Star-challenging long-term returns. We're happy with our position of about 2.2% today, and may potentially build it higher (with new trade alerts) as opportunities dictate.

Buy First: Gentex (NASDAQ: GNTX)

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: About 2.9% (see Recommendations page for real-time allocation)

For More

- Most recent earnings update (3/8/17)
- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex

In 1982, a small company in Zeeland, Mich., called **Gentex** made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands more than 90% of that market.

Currently, about 26% of cars made worldwide have an auto-dimming rearview mirror, and only 8.5% have auto-dimming exterior mirrors. For context, prior to 1987, those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher usage; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror (including the newly launched full-display mirror), both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy First: Mastercard (NYSE: MA)

With approximately 85% of the world's commerce still happening in paper money, electronic payment leaders have a lot of room to grow.

Suggested Allocation: 5% (see Recommendations page for real-time allocation)

Mastercard (NYSE: MA) is among the most attractive businesses in the world. The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns running a largely fixed-cost transaction network that becomes more profitable the more people use it.

For More

- Latest earnings update (2/9/17)
- *Pro*'s original recommendation (9/8/11)
- Talk about MasterCard

The company "charged forward" again in 2015 despite slow international commerce and a strong U.S. dollar. For the year, net revenue in local currency advanced 8%, and EPS gained 18% before special items. But right now, an investment in MasterCard -- as with **Visa** (NYSE: V) -- is an investment in growth *beyond* this year, because 2016 looks tepid as emerging markets struggle and the dollar remains strong. Much of the company's growth potential is being coiled up like a spring. That spring should pop when more economies begin to expand again and the dollar weakens. The market knows this, so the stock maintains a premium valuation.

Buy: Medtronic (NYSE: MDT)

The medical-device industry is complex and regulated, and it provides entrenched leaders with a competitive moat; our leading company is growing in international markets.

Suggested Allocation: About 2.9% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (7/1/2009) ...
- ... and our second buy recommendation (11/9/10)
- Talk about Medtronic

In March of 2016, the CEO of Medtronic put it like this: "Our formula for long-term success is to deliver consistent mid-single-digit revenue growth, with 200 to 400 basis points of EPS leverage, [and to] return a minimum of 50% of our adjusted free cash flow to shareholders through dividend growth and share repurchases. The expected net result is creating enormous value, with sustainable double-digit [at least 10%] total shareholder returns."

As shareholders of Medtronic, this is exactly what we've seen over the years: Our annualized return on the position is above 11%, and we think something close to this can continue going forward. Medtronic is a market leader in vital medical devices, be they for the heart, spine, knee, or one of four other key categories. The stock yields nearly 2%, and the dividend has increased annually for the past 39 years, resulting in an 18% compounded annual growth rate (CAGR). Expect continued dividend increases, sales growth of about 4% to 6%, and earnings-per-share growth considerably higher than that. Medtronic has a sound strategy to deal with the more regulated and costlier health-care environment. We're confident the business remains competitively advantaged, operates in an attractive industry, and is well-positioned to grow, especially in emerging markets. With reasonably priced shares, we target North Star-type returns.

Buy: Oracle (NYSE: ORCL)

This old-guard tech giant at a low price has more room to grow.

Suggested Allocation: About 3.7% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (9/17/09)
- Talk about Oracle

Oracle (NYSE: ORCL) is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems** (NASDAQ: CSCO), **Dell**, and **Microsoft** (NASDAQ: MSFT) — Oracle's value has steadily risen as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe, and its own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

We've been waiting patiently for the company to turn the corner in its transition to a cloud-based software-as-a-service (SaaS) business model, and it looks like that corner is now safely behind us. New software license sales declined 10% in the fiscal fourth quarter as demand for cloud-based applications increased, but a 4% increase in software updates and product support mostly closed the gap, resulting in a 2% overall decline. Fortunately, the cloud business has finally reached the size where its sales growth will more than make up for the slow decay of the on-premise business.

In the quarter, the company blew past the high end of management's estimates for SaaS/platform-as-a-service (PaaS) sales growth, posting a 68% increase over the previous year and 17% sequential growth over the previous quarter. Cloud sales now account for 8% of Oracle's revenue, compared with 5% a year ago. Though the top line will likely continue to grow at a modest low-single-digit pace for the next several quarters, the company is increasing the lifetime value of its customer base and becoming more profitable. Oracle is currently trading at a free-cash-flow yield of about 7.5%, which is attractive considering the likelihood of improved profitability as the cloud business scales. The company is a full-service solution, one that's poised to enjoy long-term growth in free cash flow.

Buy: O'Reilly Automotive (NASDAQ: ORLY)

Auto-parts retailers are boring, right? Right! But an investment here is up 670% over the past 10 years, and we expect additional returns around the corner.

Suggested Allocation: About 4.4% (see Recommendations page for real-time allocation)

For More

- Latest earnings update (3/6/17)
- *Pro*'s original recommendation (4/15/14)
- Talk about oh, oh, O'Reilly

America's second-largest auto parts retailer, **O'Reilly Automotive** (NASDAQ: ORLY) operates more than 4,500 stores, about one-quarter of them in California and Texas. Auto parts are a big business, estimated at $231 billion, and O'Reilly is an exceptional competitor, with an addressable market size of about $131 billion. Running 24 regional distribution centers and 240 hub stores as part of a two-tiered distribution strategy, the company provides same-day or overnight availability on more than 142,000 items, including many its competitors don't usually stock. Basic auto parts, tools, and services complement those hard-to-find treasures. As a result, O'Reilly's sales are historically split between "do-it-yourself" retail customers and lucrative, repeat-sales professional-services customers (such as auto repair shops), a luxury many smaller competitors don't enjoy.

On July 28, the company reported its 30th consecutive quarter of 15% or greater earnings-per-share growth. The results also featured a 7% increase in revenue and same-store sales (SSS) growth of 4.3%, on top of 7.2% SSS gains a year earlier. Operating margins continue to trend higher, now at 19.5%.

O'Reilly has opened 89 new auto-parts stores so far in 2016, pushing it toward 4,700 locations in 44 states, with a goal of 200 new stores total before the year is out. Besides the advantages listed above, O'Reilly's tailwinds include cheaper gas prices, more people working, and cars staying on the road longer (which means more repairs). For the year, the company increased earnings-per-share guidance to $10.30 to $10.70, implying a P/E of 27.5 on the $288 stock. Given the consistent track record of strong value creation at O'Reilly, a P/E in the lower 20s seems justifiable; shares trade at about 25 times expected earnings one year from now. This stock has always appeared a bit expensive, yet has rewarded handsomely.

As one of our largest positions, O'Reilly remains a stock we own for the long haul. Shares remain rated a Buy even though they currently (and historically) trade a bit above our fair-value estimate. After earnings per share rose 25% in 2015, we expect at least 16% growth in 2016, with the chance for acquisitions to move that number higher.

Buy: WisdomTree Emerging Markets Small Cap Dividend Fund (NYSEMKT: DGS)

Diversification in emerging markets with some of the best small, high-yield companies you've never heard of.

Suggested Allocation: About xxx% (see Recommendations page for real-time allocation)

For More

- *Pro*'s most recent Buy recommendation (4/28/17)
- Talk about DGS

At *Pro*, we like the idea of investing in emerging-market small caps to diversify and target higher growth. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) (the longest ETF name in the world!*). This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index, and yields between 3% to 4% per year.

For *Pro*, owning shares of this well-managed ETF offers exposure to up to 600 of the most promising international business that we couldn't easily buy in any other way. Serving as direct exposure to emerging markets, this is an excellent way to invest in small companies in locations where we don't have a discernible edge but where growth exists — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The benefits of diversifying outside our home market are equally important over long periods. Emerging markets have badly lagged developed markets for the last several years, but eventually they should take the performance baton again, and we'll be in good stead with this position.

*Statement may not be 100% "true"

Getting Into the Flow of Pro

Published Aug 29, 2016 at 3:43PM

Dear *Pro* member:

The *Pro* service just closed to new members, so we're excited to welcome new investors to the service! We're also grateful to our veteran members who are helping newcomers get started. Remember when you were getting on your feet here, and how much you had to consider to make *Pro* work best for you? That's where many newer Fools are right now, and with every question we see in the community, we're heartened by the help the asker is getting from fellow members. A special shout-out to phooLon, TMFEpsilon, RockyTopBob, marksrjm, BigOil1, CMF_KBecks, JSPColorado, HeckCreek, SilverHawk27, and so many others we've seen! I wish I could name you all. Thank you.

Of course, the team wants to help as much as we can, too, both on the boards and in larger communications like this. I remember when *Pro* itself started in 2008, and how overwhelming it felt at times. But I knew we just needed to take one step at a time, make some progress each day (in our learning, in our teaching, in our process), and follow our core beliefs. That's true for members, too. One step at a time. *That* will get you invested in the types of companies that have served us well for years, and should looking ahead. Companies including **FactSet Research Systems** (NYSE: FDS), with its strong recurring revenue, and **Facebook** (NASDAQ: FB), with its clearly laid-out 10-year plan.

The qualities that we seek in our core investments are usually lacking in the companies we sell short. *Pro* combines long-term investments in "compounding machines" with selling *short* poor performers, an approach that should continue to generate healthy returns for members. And even if you don't sell short, you should do perform strongly over time invested in our long stocks.

Sept. 23 Chicago Meetup

Pro and *Options* Fools are planning an unofficial meetup in Chicago in September. If you'd like to eat some pizza at Gino's East and chat with Jeff and Billy Kipersztok of *Pro*, Jim Gillies and Jim Mueller of *Options*, and many of the finest *Pro* members around, check out this discussion-board thread to get details -- and then RSVP!

Portfolio Politics and New Ideas

All members should give themselves ample time to get into the flow of *Pro*. Most members take *months* or longer to get fully on board with the portfolio, and that's fine. You want to feel confident and knowledgeable about each step you're taking, and the portfolio is a living entity (at least, we see it that way) that's full of symbiotic relationships. It takes time to get fully aligned. This week is a case in point.

We plan to issue a new short recommendation on Tuesday. This position will be a *hedge* on a position we currently own and rate a Buy. You would *not* set up this new short unless you also own the long position -- but you might not realize this if you just skimmed the alert. So, each time *Pro* sends you a recommendation, please take the time to enjoy reading it carefully. Our portfolio holds more than 30 total positions, and most are meant to work together in one way or another, with some holdings offsetting others. Expect to take some time to get into the flow of this way of "complete investing," to whatever extent you think is right for you.

We simplify the initial process for you by offering Portfolio Building Reports on our Buy First and Buy stocks. Following these is as simple as buying stakes in allocations similar to our own, as shared in the reports. We have a new Portfolio Building Report coming out tomorrow (Tuesday), followed by a third on Sept. 6. On Sept. 21, we'll have a Portfolio Positioning Event to get you started in hedges and options (and other shorts), too, if you wish. Meanwhile, brand new recommendations may arrive in your inbox at any time. We're considering new long, short, and option ideas.

As a *Pro* member, you also receive all the content from *Motley Fool Options*. The ideas from that service are meant as stand-alone recommendations -- they may complement your *Pro* portfolio very well, but aren't part of the *Pro* portfolio.

Pro Portfolio Housekeeping and Guidance

Along with new ideas, we're of course always keeping current on our whole portfolio. Although we sometimes take months to make decisions (a good thing, in my mind), we're always thinking about them. Lately, our positions on Hold are all shorts. Here's our latest on some ongoing positions.

- **Caesars Entertainment** (NASDAQ: CZR): We closed half of this short for a 35% gain in July 2015, and we have a 47% gain on the other half. Are we smart to keep sitting on it in hopes that lawsuits unravel against Caesars? One concern is that the longer these cases go, the more chances Caesars management has to convince their adversaries to work with them (or just exhaust the opposition). That said, the company's legal expenses are mounting, and we still believe Caesars has illegally swindled its secured debtors out of assets. We'd like to see the whole company unravel. For now, we ponder the odds of this, clouded by the opaque prism of the legal system; as we do, the short is on Hold for newcomers. Even so, Friday's late news that protection from outside bondholder lawsuits for the parent company will *not* be renewed as they expire today is a step in the right direction for our short. In this case, the parent company we're selling short may be held liable for up to $11 billion in bondholder debts, enough to bring the whole thing down. But it's still a judge's decision. A ruling on Caesar's potential liability could arrive as soon as Tuesday after the market closes in New York.
- **CurrencyShares Euro Trust** (NYSEMKT: FXE): We're short the euro via this ETF, a position that's up 16% for us. That's a healthy gain in a currency. With the U.S. poised to increase interest rates, the U.S. dollar should stand to rise a bit more against the euro, so for now this short remains in place. It moves back to Short today from Hold. Just be mindful that we might close this short at any time (it's interest rate dependent), and thus newcomers may end with a short-term loss if FXE doesn't decline further before we do. Newcomers could also wait for Sept. 21 for more guidance, if wished.
- **Deere & Company** (NYSE: DE): Cyclical stocks are strange beasts. They often rally long before a recovery occurs because investors *anticipate* a recovery. That seems to have happened lately with Deere and with **Valmont Industries** (NYSE: VMI). Both businesses continue to struggle, lacking revenue growth, but both are regaining investor favor on cost-cutting and *prospects* of a distant recovery. Our Deere short serves as a hedge to our Valmont long, and so far the combination has made money overall since we shorted Deere. Shorting Deere let us keep Valmont. But what's the best move now for newcomers? And for us veterans, too? Deere is on Hold while we asses this, with our expected update coming to you this week.
- **Skyworks Solutions** (NASDAQ: SWKS): Targeting income, we're short September $70 covered calls on this Buy-rated stock. Shares have risen lately, perhaps in anticipation of **Apple**'s (NASDAQ: AAPL) iPhone 7, but the expected volatility for the stock is high enough that we should be able to roll our covered calls next month to a later date and collect another credit. (We will of course send a trade recommendation to all members when we do.) Writing lucrative options on Skyworks, just as we've done in *Motley Fool Options*, should ultimately result in income. This chipmaker is likely to remain volatile in both directions, even though

we believe its long-term direction will be up. Newcomers right now will be advised in a forthcoming Portfolio Building Report to just buy shares, at a 3.4% allocation, and wait for the Sept. 21 event to consider writing covered calls. You can also take a look at the Catch-Up Trades we publish each Monday.

Once again, welcome to new *Pro* members! We're grateful you're here as a *Pro* Fool, and we're here to help you succeed, ideally exceeding your investing goals. To *Pro* veterans, thank you again!

Please visit the Memo Musings board if you have any questions.

-- Jeff (TMFFischer)

Pro Guidance Changes

- **CurrencyShares Euro Trust** (NYSEMKT: FXE): Shares move back to a Short, at a 1.8% allocation. Just be sure to read the paragraph on this position above. Newcomers can wait for the Sept. 21 Portfolio Positioning event to act, if preferred. If you can't get shares to short at your broker, and you have options experience and persmission, you can set up a 2018 synthetic short.

Pro Completed Trades

- **S&P 500 Depository Receipts** (NYSEMKT: SPY): We set up a put ratio spread, as decribed in our recent recommendation. We sold 26 November 2016 $200 puts and bought 13 November 2016 $210 puts, getting a net credit of $0.27 each. This position hedges out 10% of our long exposure when SPY is between $210 and $200, and a sliding scale less than that amount when SPY is between $200 and $190.

More From Motley Fool *Pro*

- *Pro* Quality Checklist: Pier 1 Imports
- The Human Side of Investing
- Facebook's Future Spelled Out

Pro Catch-Up Trades: August 29, 2016

Published Aug 29, 2016 at 3:42PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

- Also keep in mind our Portfolio Building Report No. 1, which features details on all our Buy First stocks, and stay tuned for tomorrow's Report No. 2, which will detail nine of our Buys!

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Broadridge Financial Services** (NYSE: BR): Buy up to 5.4%.
- **Facebook** (NASDAQ: FB): Buy up to 6.6% (in halves if you prefer).
- **FactSet Research** (NYSE: FDS): Buy 2.2%.

Continue building your portfolio with our Buys (or wait for our Portfolio Building Report on Tuesday if you wish), including these highlighted today:

- **American Tower** (NYSE: AMT): Buy 3.8%.
- **Apple** (NASDAQ: AAPL): Buy 3.6%.
- **OpenText** (NASDAQ: OTEX): Buy 3.3%.
- **Medtronic** (NYSE: MDT): Buy 3.3%.
- **Visa** (NYSE: V): Buy 2.4%. (See our earnings update.)

Shorts -- if you're new to shorting, feel free to wait for our Portfolio Positioning Event on Sept. 21:

- **CurrencyShares EuroTrust** (NYSEMKT: FXE): Sell short 1.8%.
- **Pier 1 Imports** (NYSE: PIR): Sell short 0.6% to start (see our recent trade alert).

Pro's options (again, to be addressed during our Portfolio Positioning Event):

- None currently.

Hedges:

- **S&P 500 Depository Receipts** (NYSEMKT: SPY): Set up a new put ratio spread per our latest alert. You can still do so for a credit.

Options expiring next:

- **Gentex** (NASDAQ: GNTX): September 2016 puts. Gentex shares are trading at $18, well above our $15 strike. With 25 days remaining, these puts are on track to expire as income.
- **Skyworks Solutions** (NASDAQ: SWKS) and **Valmont Industries** (NYSE: VMI): September 2016 covered calls. These contracts have 18 days to go, so we'll issue updated guidance as we approach expiration. If Skyworks is still above $70, as appears likely right now, we plan to roll our options to a later month (and possibly higher strike) ahead of expiration, as time value dissipates.

Portfolio Positioning Event: Sept. 21, 2016

Published Aug 22, 2016 at 4:18PM

As you gradually build your *Pro* portfolio of stocks, it will become time to consider hedges, shorts, and options if you're following along with us in these versatile investment tools. Join us on this page at 1:30 p.m. ET today, Sept. 21, for our live video chat on these topics and anything else you'd like to know about *Pro*! In the meantime, please enjoy our final report for new members, released today. We'll be answering questions about the positions in this report during today's chat.

Click here for the Portfolio Positioning Report

- We use sli.do for the audience participation part of our live chats. For a general overview, click here. The *Pro*-event-specific chat room can be found here or by visiting slido.com and entering the code #ProPortReport. Please open Slido in a new tab or window -- that way, you can follow along with the video here and the questions there. We'll be answering questions in order of which get the most votes, so please vote on other members' questions as you ask your own!

Transcript

Jeff: Greetings Motley Fool Pro members, we are delighted that you are here for our September 21st 2016 Pro Portfolio Positioning event. I am flanked on both sides and through technological wonders up in the air as well by your fellow Pro team, analysts and advisers and content manager extraordinaire. We have Jeremy Myers to my right, senior analyst on Pro, we have Billy Kipersztok on Skype and saving the most of all for last, we have Ellen Bowman right here on my left.

Ellen: Thank you Jeff.

Jeff: Ellen, really I should introduce you first every time, it's not very gentlemanly of me not to.

Ellen: Yeah, I actually forgive you, I forgive you this time.

Jeff: Thank you. We were talking right before we went live how very little sleep we got last night.

Ellen: This will be ...

Jeff: I only got a few hours sleep and so it's going to be an interesting hour together but we are thinking clearly and focused and ready for a great hour with you.

Jeremy: Absolutely.

Jeff: The purpose of this hour is to give a quick overview of the positioning report we just issued which covers our active shorts, options and hedges. Also even more than that I would say, because you can read that report at you leisure, is to answer your live questions. On this page where you see the video right now, be sure to go down to the paragraph underneath the video and click into the slido.com for the chat room. You'll need to do that in a separate window and then hopefully you can size the two windows to have them on your screen at the same time, the chat, the video and the slido.com where you will enter the code Proportreport, it's Proportreport.

Inside there you can see all the questions from your fellow Pro members and ask your own questions and vote up the questions that you want to see answered most and we'll get to those first. Before we get to your questions which are already starting to be collected here, and we thank you for that, a lot of great question here already. Let's talk a little bit, Ellen, about the positioning report that you put together with the writing of all of us analysts here.

Ellen: This is a big Project, this is Probably the biggest report that we issue. It's so long in part because the introduction is so important. If you are not familiar with shorting or hedging or options or how to gauge your exposure against what we are doing here, please, please read the introduction. There is also an important part that says this stuff is optional. We know that not every member is going to be comfortable with shorting or hedging. We know that not everybody is going to want to use options or be able to. That doesn't mean there's not important information here for you but please don't feel pressured to follow every single piece of advice immediately. As Jeff notes in the intro, if you are still building your long portfolio, these positions are meant to be a compliment to that, so you are going to want to continue with that before you leap in here.

A lot of the stuff is, especially at first glance, can be really complicated and so we hope to have a live event that would be able to clear up any questions that you have at the start. After the intro we go into our shorts and then our hedges, and then at the end there is a list of the positions that we have on our score card but we are not recommending for new members now and some reasons for that. We are going to take your questions as they come in here and as the highest voted. The first one is from Jeff Thinking Man, he says, "In an IRA, do the put spreads require some reserve?"

Jeff: Yes Jeff, good to see you again, we saw you in the Motley Fool Options chat yesterday as well.

Ellen: Shout out.

Jeff: The answer is a spread in an IRA, the amount of reserve that you will need is the difference between your two strike prices. If you set up a $10 dollar spread in an IRA for say at one dollar cost, well let's see if I'm thinking about this right. You are buying the put, you are selling a put, well it depends on what type of spread that you have. I told you not much sleep and now we are talking options. In IRA, the beauty of an IRA is that it will only let you risk the cash that you put on the line to begin with. It really doesn't use margins so there should not be in a typical spread any need for additional funds set aside in the IRA other than what you initially put aside with most spreads. That is certainly true with what we are recommending which is a bear put spread as a hedge. That's why you are buying a put option at a higher strike for Protection and you are selling a put option at a lower strike to help fund that purchase of your higher strike put.

The lower strike option that you are selling is completely covered by the higher strike that you are buying, so there is no additional funds needed for that position. The most you can lose is your near cost at the outset which is around a dollar per share in most of the spreads we recommend. Jeff, short answer is that with the spreads you can use in an IRA usually just the cash you put up is all you need to put up.

Ellen: Okay, Headcreek, hello Headcreek? Says, "Wells Fargo gets a public park walk to the senate woodshed. The stock is down at Buck today in reaction and the Feds statement this afternoon will add volatility, should we write puts for income?"

Jeff: Billy.

Billy: As the, yeah I'll step up and answer this one, as the analyst who covers Wells Fargo. To answer your question, today we actually put Wells Fargo on hold for the portfolio due to the latest scandal involving sales quotas and fraudulent accounts which is still ongoing. Wells Fargo testified, management testified before Senator Congress yesterday and news and information is still rolling in on that. We want to make sure that we read that information and we check on the commentary for management to make sure that this scandal hasn't changed our investment thesis. If you go back and you read our original recommendation for Wells Fargo, one of the biggest parts of our thesis was a best in class management team and a difficult to replicate sales culture. Both of those things were implicated in the scandal that occurred.

This may represent a significant change to our thesis, so we are putting the stock on hold so that we can review all of the information and come to a determination on how we want to Proceed. For anybody with the covered calls if you have questions about our recent covered calls at the $50 dollar and 50 cent strike which expire October 14th, those call are not really viable anymore because the stock prices declined in response to the scandal. The stock is on hold, the calls are not really viable so for now just wait until you hear something from us. If you want to go off on your own and write puts, certainly feel free but Pro is not recommending that right now and we have the stock on hold.

Jeff: Good summary Billy, thank you. I would say within Probably a week to 10 days we'll have a formed opinion on everything that's going on. We of course as always want to take our time and go through all the information that we can. There is more information coming out each day including the hearing of course. The good news is we have to believe that 98% some of Wells Fargo's business at least is on the up and up and strong and creating value for shareholders. Even though we believe that we want to make certain that that thesis is true and only continue to recommend it if we believe that to be the case. Wells Fargo is one of our top 10 positions, it's about our 4% holding but as Billy said, it's on hold. What that means is just don't buy it now if you haven't yet but if you own it of course keep it and the covered calls are nice. I'm glad you wrote those Billy because they are expiring as income in a couple of weeks it looks like.

Ellen: Okay, Jeff Thinking Man is back again, he is the voice of the people, he gets applauded a lot. How would you change or modify the Pro Portfolio for people who are retired or would you?

Jeff: That's a great question, do you have thoughts Jeremy?

Jeremy: I would say, well I always start any retirement question on it depends on your personal situation if you have a pension, if you are trying to ... If you have a lump sum of money that you are trying to live off of. The Pro Portfolio really is a standalone portfolio that represents an equity position. Even though it is absolute returns and even though we are trying to achieve Northstar returns, it's still somewhat or mostly delivered to the stock market, even though it should be less volatile over time. Odds are that you Probably have a bond allocation or some the other asset allocations that a financial planner would suggest have a truly diversified portfolio. Also the opportunity to diversify internationally and some other ways that we don't necessarily directly address within the Pro Portfolio. As I said before it's I believe that we are pretty well setup for a standalone portfolio and with a lower volatility investor in mind, like someone who is in retirement.

Jeff: That's true, I agree with all of that and the longer you are at Pro or investing generally you might learn from us or from your experiences ways to generate more income if that's what you want. You can use more of our option strategies or add in more of the Motley Fool option ideas to your Pro Portfolio. Maybe like Jeremy said it really depends of the rest of your holdings whether you have bonds or pension might tell you how much you want in stock. If you want more or less stock exposure than we have, you can make that adjustment just as an allocation adjustment but still own everything we own just in smaller amounts so you have the portfolio balanced how we are trying to set it up. Great question, great answer Jeremy and we do have our retirement board on the Pro site itself. Check out in the community section the boards and you will see that there. There's periodically really great long discussions going on there on that board.

Ellen: Yeah, it's a lot of our boards are really educational but that one in particular is I've seen it be very helpful to a lot of people.

Jeff: Well a lot of our members use Pro in so many different ways and have a ... Are very willing to share in exactly what their strategy is and how they use it in their own portfolio.

Ellen: I know some of them better than we do, how they can ... They are living it, we are giving you theoretical advice. We have a question from Paul that says, "The strategy guide states that the portfolio's cash will be around five percent most of the time but cash extort which you can find on our recommendation's page at the bottom is 18.8%, can you explain the higher cash position?"

Jeff: Sure, part of it is that we have short puts out in the market that are of essentially long exposure of about 16% so really our free cash is around two or three percent. The way we manage those short puts we view our free cash as being higher than that because we don't plan to turn those put options into positions. I'll also say that this strategy guide is Probably that one part of it could be updated and that falls on me. Because I remember writing that believe it or not in 2008 when we started. Like the Fool will want to know what was your cash normally going to be at? I said, well around five percent net after everything is a pretty good ... It's likely to be there over the long, long term but we'll have periods where we have 20% cash, periods where we have no cash and sometimes we might have even more cash than that.

We were looking for an average there and I think that's still pretty accurate that we'd like to keep some free cash always. Then through our use of strategy, of option strategies and what not, really have much more free cash than five percent but five percent is the net after everything is accounted for. Again as you said Ellen that's on the recommendations page, the boxes at the bottom of that page showing all our exposure.

Ellen: Excellent. Yeah, okay, here is Jeff again. He says, "I am slowly transitioning from a stock adviser and NFO Portfolio to a Pro Portfolio. How do people balance new options recommendations with their Pro Portfolio?" As almost everyone watching this already knows I'm sure you got Motley Fool Options as part of your Pro subscriptions but they are separate services. Motley Fool Options recommendations are not tied into the Pro Portfolio as a whole. That's my disclaimer you guys take it away.

Jeff: Billy, do you have thoughts on this?

Billy: Sure, what I would say to you Jeff would be the best way Probably to answer this question would be to pause it, the question to the boards on Pro. I'm sure you'll get tons of great answers from people who are actively doing that Like how we mentioned the boards are a great place to get answers rather than from us because we are the ones that are giving you the information and not really the ones implementing it. I think more qualified to answer this question than we are would be members who are actually doing it but I'll offer my input as well. How do people balance new options recommendations with their Pro Portfolio? I think it depends on your personal preference, you might look at an options recommendation and you may not like the company or the strategy on one hand or on the other hand you may really like it. Depending on whether you like the idea, whether it fits in with your current portfolio, many other factors you might consider whether you want to implement a certain option.

For example your overall exposure to the market, do you have the cash available to secure a put? Are you in IRA? Et cetera. There are lots of different considerations that you'll need to take to decide whether you want to do an options recommendation but just make sure that especially with options and Pro because Pro is a portfolio, like we always say it's integrated. You don't want to just act on every options recommendation like you would with Pro. Every recommendation in Pro we intend you to act upon because it's a whole portfolio. With options it's more like stock adviser, it's you pick and choose and you figure out which one fits in best with your portfolio at a given time and go from there.

Jeff: That's exactly right and that's how I view the services. Once you join Pro and so many of you are new here and this event is for and directed at new members as well as existing members. You've joined to get the full portfolio as Billy said and so that's what you should focus on first. Once you have that built and you are comfortable with it and how we invest, you can follow Motley Fool Options ideas and see which ones you like personally to complement your Pro Portfolio. You do you use Pro first as a whole then tack on some of the options ideas that you particularly like.

Ellen: Sounds good, excuse me, Paul asks this similarly, "How does a new Pro investor choose between matching your cash allocation versus buying long positions? Which comes first?"

Jeremy: I think in this case my personal opinion is that you should always have some cash in your portfolio, so depending on if you are new to Pro as you are building the portfolio, you should buy our or buy first stocks first and gradually start matching our other trades. If you are following any of our options trades or puts specifically where you have to have some cash to secure those, you should always leave that cash available in your portfolio but over time I would expect there always would be some amount of cash in your portfolio. You can't really beat the optionality of having that and if you don't have hedges setup where if the market drops they are going to create cash, that you are going to be able to reinvest, you are Probably going to be sorry that you don't have any what we call dry powder to redeploy at lower prices.

Ellen: I'm going to put that in the next head report. You are going to be sorry, Jeremy says you are gong to be sorry.

Jeremy: Yeah. I have been there before, I have been sorry before.

Ellen: All right, Eugene Wilson asks, "I am new to Pro and four of my bigger gainers are not in the Pro Portfolio. What do you recommend?" I think this speaks to I'm already invested, I'm joining your service, how do I prioritize?

Jeff: It's a great question and it dovetails nicely with the one Jeremy just answered. We typically don't want you to sell your winners from the past if you can at all avoid it. Because unless it in an IRA you are taking a tax liability, a tax hit. Even beyond that if you have a low cost basis and it pays a dividend you are generating a great yield on that company, you Probably know it really well, you own it for a reason, you like owning it. You have a great return that could only if you've really bought into a compounding business, it could have much farther to run. We are always hesitant to sell winners in our lives and in Pro as well as long as the business is still performing. If you can avoid selling your big gainers do so is our recommendation as long as you still believe in them. That may mean you buy 20 of Pro stocks instead of 24, or you buy less of each one and still put the whole portfolio together.

Whatever you can do at this point anyway, meld your current portfolio that you like and want to keep with Pro. Because I think what will make you happiest in the long run. As you learn our strategies like our hedging and shorting strategies, you'll see that those work on your portfolio as a whole even if you have some different positions than we do. Because really you are just trying to lower you exposure with the hedge and that works whichever 24 stocks you own. I hope that helps, what we are doing is discouraging you from selling winners that you still like. If there are stocks that you no longer believe in or are just not comfortable owning that's an easy sell. Then over time you'll get more and more to the Pro Portfolio, many members take a few years or longer to get there but you will get there.

Because events will happen, companies you own will be bought out or you'll find a reason to sell something and you'll meld bond more with Pro but it's a long term Process and I say that all the time and it's a funny part of our business. Investing is a long term endeavor and you should maneuver very gradually and yet we know members are paying a subscription that's typically three years long or so. They want to make Progress quickly on what they are doing but that goes against investing well so to the best of your ability be patient, move gradually and hopefully be committed to Pro for the long term because that's where you'll get the most reward.

Ellen: It is a little bit of a paradox that members love actionable advice and often especially in Pro our actionable advise is we are good right now or you know. You read a memo recently about how you are not going to buy something unless you are sure of it and if that means six months go by and then six months go by because that's how the portfolio works. Okay, anonymous asks, "I see you added ..."

Billy: Yes. Hey, guys I wanted to ...

Ellen: Oh yeah, go for it.

Billy: Sorry, sorry Ellen.

Ellen: Sorry.

Billy: I wanted to add something to that one as well. One thing that members do if they have positions from outside of Pro that they want to integrate into Pro is check and see which industry or sector or part of the economy that those companies represent. See if Pro also owns any companies in those same industries or sectors and if there's an overlap, then that may be an area where you can use your company that you own that's outside of Pro to represent that portion of exposure within Pro. For example some people instead of owning MTrust, own maybe like Berkshire Hathaway Uninsured or a Markell Alston Uninsured. That's one way also that people can meld their current holdings that are outside of Pro with Pro.

Ellen: Thank you, that was very important and I'm glad you said it. Anonymous says, "You added another put ratio spread on the SPY yesterday. I didn't make the first one that expires in November, how best to catch up today?"

Jeff: A great question there, I love that it's on a recommendation that's in the positioning report that went out today. The answer, the short answer is in the SPY report itself that went out yesterday. It says that if you don't have the November hedge yet, then set that one up first. You can still do so as of yesterday night for a small, only a small debit, it was a small cost of 30 cents or so. Then also setup the December one which you can do still for a credit. The reason we want two is these spreads really only become handy at expiration and you never know when the market is going to be down. Of course the November one was partly setup in a response to well we always run these typically almost always because you never know what will happen. We also want one of these hedges in November because it's the election month.

If we have a rustic response to the elections outcome, at least we'll have, at least we'll have some hedges and there are others we're thinking about setting up too for that month right now. At least we'll have some hedges expiring in November that could help us but so set that one up first and then December afterwards. The guidance is in the SPY report both SPY reports at this point. I just realized the pricing has changed a bit but not bad.

Ellen: Yeah, everything is linked in the SPY section of the report that came out today. You will be able to find the previous two reports in there. We have another anonymous question about the SPY hedges, "They represent a fairly large obligation to purchase this stock, what do most brokers require for reserve?"

Jeff: Most brokers do require anywhere from 10 to 30% of the potential stock purchase price be set aside in cash. These SPY puts that we are writing will be a smaller amount, closer to the 10% side because they are pretty far out of the money. The market has to fall quite a bit before these become an obligation. As the market does fall the obligation will grow so no matter what you need to have a sizable amount of buying power in your account to set these up. We've recognized that of course we have the cash to buy SPY if it came to that but we don't plan to. If things really went south our plan would be to close the puts and buy call options on SPY instead for about a quarter of the cost of SPY itself or buy some other stock that we like better. No matter what we want to use this position as a trigger to put on some long positions if the market falls really sharply. We want the discipline and this to be the reminder of that discipline to make some good investments at that time in a recovery. Anyway, so fairly large obligation, typically 10 to 20% of the cash value.

Ellen: Bruce says, "I think a review of Wells Fargo is in order. Management is a concern given the lax oversight that has become public, update please." Then he mentions the position that he has, January 28th calls from 11:15. Before this started I know, Billy, we were talking a little bit about Wells Fargo, what did you have to say?

Billy: Yeah, I think we touched on this also a little bit earlier, is we are definitely going to review Wells Fargo. I agree that the scandal represents some mismanagement and we want to determine whether that's systemic or whether that's something that really affects our conviction in investing in this company for the long term. We are going to dig into management commentary, we are going to listen to the hearings, we are going to make sure we've heard and really digested what management has to say and make sure we are satisfied holding the position.

Jeff: Yeah and we really want to hear what solutions they are putting in place to stop this from happening again. This crisis could become an opportunity that makes Wells Fargo stronger and the stock has already reacted negatively which of course makes it cheaper. This maybe a time we might come out of what Billy just said and be more positive on the company. We can't know though until they really lay out, what happened, why and what they have done or are doing to fix it. This is a good moment to touch on the guidance changes that we had today in the report and on the site for all members. Which was again Wells Fargo moved to hold while we review it the coming week or so, however long it takes. It's on hold right now, hold your shares but if you haven't bought yet you can wait until you get our opinion, our updated opinion.

We also moved Pier 1 Imports short on hold for new members and Billy can maybe speak to that in a second. We moved Deere, John Deere back to short for all members so it was on hold while we reviewed results and it's back on short now at ... I have to look up the exact allocations because I don't want to give it incorrectly. It's at 1.9% allocation, so Billy if you want to take a minute to say why Pier 1 moved to hold for now and then Jeremy could speak a moment on us moving Deere back to short especially in relation to our Valmont long that will be great.

Billy: Sure, so Pier 1, a couple of weeks ago the company preannounced its Quarter Two 2017 earnings, which repertoire and below it's own guidance and below expectations. Simultaneous with that preannouncement, the company also announced that the current CEO will be resigning, a mutual agreement to step down with the company and in response to that news the stock dropped significantly, 10-15%. Right now we're sitting on I think about a 20 percent gain on our short, meaning the stock has declined about 20% since we shorted it which is great. Before some news that we heard a couple days ago, we had not put the position on hold, we were continuing to recommend a short and waiting for the full Quarter Two 2017 results to be released. Because of a portion, only just a few snippets of financials were released with a preannouncement. The full results will be announced September 28th so a week from today. Two days ago on the 19th we learned that a hedge fund, Alden Global Capital LLC, has acquired a nine and a half percent stake in the company.

To us especially given our experience with another one of our prior shorts which was older brands where a hedge fund investing firm came in, established a significant stake and then advocated for a sale of the company. Then the company ended up being bought out which was a negative for our short position. Any time we see a hedge fund come in and take a significant stake in one of our shorts that triggers a well, we should check this out, review it and make sure that our short is still good and we want to remain short. That the risks haven't changed measurably. Being as it happened two days ago, that this nine and a half percent stake was announced and the company is going to report earnings in one week. Right now we are going to put the position on hold, we are going to wait and see what the full financial results look like a week from now. We are also going to do some research on this hedge fund that has established a significant stake in Pier 1.

We can check out their history of value creation, how they tend to go about being an activist investor, taking significant stakes and maybe changing management or changing business strategy. Those are things that we can look into. For now the short is on hold, we don't recommend that new members who haven't already shorted it, short now but for those that are short you can continue to hold it and you should expect to hear pretty soon from us. Like Wells Fargo I would say, within a week or two max on what we plan to do.

Jeff: Great, thanks Billy. Jeremy, John Deere we shorted earlier this year, it's partly to hedge our position in Valmont Industries. The two positions are the same size and in similar cyclical large equipment, farming related industries and so far Valmont has risen more than Deere has risen. We put Deere on hold as the analyst who brought it to the portfolio took a few months to work in a different division and they are now coming back. Jeremy took over Deere, went through all the results and has now led us to this point.

Jeremy: The thing that is obvious is that the agricultural industry is still struggling, the forward string construction and for the smaller part of Deere's business but really agriculture is still struggling. What Deere was able to do this past quarter that caused a stock rise was surprise the market with good earnings that they have been cutting cost, which we were expecting them to do. The numbers that they announced were in their long term targets and this is looking out two years or Probably a little bit higher than what the market was expecting. The other thing is that there is some one time gains of solving equity stake in a subsidiary and other things that it helped the earnings look a little better than what the market was expecting. It was really that cost cutting which is what I think got people excited. Now, I think they've known for a while that this ... What these targets were and they've been holding that for an opportune time to release those. Which is going into a harvest season which is pretty bad and farm Profits are falling and used equipment are starting to pile up on lots. Being able to ... The way that they actually release the information at the end of the conference call was after the analysts' questions were finished and they said, "By the way at the end this is what our target is going out to 2018 I believe." Which is like half a million or half a billion dollar in cost savings and three full percentages points of extra margin mid-cycle earnings. That's based on previous mid-cycle earnings and our short thesis is really that that is going to be a lower level going forward because there is so much access inventory that's starting to build.

Jeff: It's so funny, it's unusual that they said that at the very end when usually you share that information at the start and you are able to take questions on it but not to be like a conspiracy theorist guy but it's funny how they did that at the end. We still believe in the short and as the short as a hedge as well against Valmont. I'm glad it's moved back to short now. If you haven't shorted it yet, you can short 1.9% that assumes you also own 1.9% in Valmont Industries.

Jeremy: Well that is just a partial hedge because in Valmont, about 25% of sales is based on as from agriculture, from irrigation. You are also just hedging the global economy and commodity prices and a number of other things in addition to Valmont.

Jeff: Great.

Ellen: We had a question down the list from Lean about the thesis on the Deere shorts so Lean hopefully that answered that for you.

Jeff: Yeah, we have a lot of questions and we are half way through so we'll Probably start ... I'll do my best to be a speed responder.

Ellen: We'll try lighting around, we'll try it. Another question about coming new to the portfolio from Dwayne. I was an MDP, how do I determine which socks I have the lowest conviction in so that I can sell them to raise funds to purchase Pro stocks?

Jeff: You joined Pro from Million Dollar Portfolio, we appreciate that, thank you very much for being a full member period. We hope whichever full service you are in brings you long term value. That's a tough question because each team works on their own and we don't know which stock in Million Dollar Portfolio are low conviction or lowest but I assume they all believed in. Because they are running a portfolio as well so they only want to be own things they believe in. Which are the least appealing to you which don't match your style or your method of investing perhaps? Which are the smallest positions or the newest ones is where I would start. I also want to say that you can Probably ... Lack of sleep may be saying this but you could Probably call customer service here at the full, get back into MDP and try to stay for 30 days and try to assess out which ones you might what to sell.

Because they'll be helpful on the boards to that extent but I bet they are going to tell you that they believe in all of them because it's a portfolio so it's really up to you which ones to sell. Go to the making Profit you board here on Pro and ask you fellow members how they have done it because so many members have joined while being members of other services and then meld over to a Pro Portfolio so it can certainly be done.

Ellen: Okay, anonymous says, "Can I get someone to walk me through the put ratio spread you on the SPY or will I have to go all through options U first? This is my main goal?" Options U is a lot and I don't blame you for having this as your main goal. This answer may be disappointing but hopefully fruitful please take this to the boards and someone there will walk you through. Go to the SPY board on the Pro site and one of us will or Lon Probably will before we get a chance to. We've got a couple of members who are amazing at explaining this stuff and that is where you'll get the one to one beck and forth that we can't do right now on this video. Yes, we don't expect you to read all of Options U before you take action and hopefully, well definitely you will find some knowledgeable people on the SPY board who can help you piece it together.

Jeremy: The thing that's great about that is that there are other members out there that have the exact same question who will be able to benefit because that's going to stay on the board and you will be able to go back and review it.

Ellen: Yeah, absolutely.

Jeremy: It will be a little more convenient to be able to do that.

Ellen: Absolutely. A new member post, it says anonymous suggests that marketing played up Pro is hedging. For newbies and old-timers both, can you briefly discuss the place of hedges in the whole portfolio? You do in the intro a little bit.

Jeff: Sure, I think what's really happening is the market's making new highs, there's a lot of uncertainly up there so hedging, a lot of people are thinking about hedging after years of rising prices. For all of us how do we hedge in the Pro Portfolio? As Ellen said, it's the intro to today's positioning report. It's one place where you will learn a bit about it but we try to hedge in most cases in a way that doesn't drag in our returns, it doesn't cost us a lot of money and that will reward us with a sizable amount of cash that we can then invest in new longs when the market falls. That said, we are not all that hedged right now, with two 10% hedges and SPY with about seven percent or so exposure and shorts which are also a form of a hedge and we have some covered calls, little ones. We could be much more hedged in the future, it just depends on the risk that we see out there.

The key is that we have tools and ways to hedge very inexpensively and in ways that can really limit our risk. Like we will buy put options when we have cause to, when we think that that's money well spent. Hedging is an always evolving but organic part of Pro and sometimes will be minorly hedged and sometimes much more hedged. The point is to try to have winners even when the market falls and then reinvest those funds into cheaper stocks.

Jeremy: Well just buying puts can become pretty expensive over time. You essentially buy insurance and paying that premium so using the put ratio spreads is much more cost effective and less of a drag on your returns over time.

Ellen: I liked what you said about the hedge being a trigger to act to. I don't know if I quite thought of it that way before but it makes good sense. I think so

Jeff: Sure.

Ellen: Anonymous says, "I'm new to shorting, when does margin interest get charged against a short position?"

Jeff: Well I think generally we are interactive brokers and it's the end of each month, the 20th, the third week of each month, I think it hits our account but it's a monthly cycle and it may differ by broker. I assume it's the same day each month, so check with your broker and see. Realize that if a position is, a short position has a three percent fee, it's the average of the value of that position and then it's three percent per year divided by 12. You'll pay one 12th of that in a given month. Hopefully the fees are pretty small mostly.

Ellen: We have another anonymous or maybe the same one who says, "Follow up, are there any plans for income securities like bonds in Pro?

Jeff: Yeah, we've talked about bonds since we started long ago but stocks have been more attractive. They are bond ETFs that we can consider certainly. I think in the long run, assuming we do this for 20 or 30 years, there will come to be a bond sleeve of the portfolio, a bond ETF at least sleeve of the portfolio. Because bonds and stocks cycle as far as attractiveness can go and lately it's been stocks almost all the way and that's been a good thing.

Ellen: Stick around.

Jeff: 20 or 30 years it's ...

Ellen: Yeah, it's just patience, we preach patience. Jeff says, "He doesn't own I assume any of VMI and doesn't have a six percent allocation of Facebook. Which is the higher priority by some Valmont or by more Facebook to get to the allocations?"

Jeff: My quick answer is that depends on how much Facebook you own, if you only own a few percent of Facebook, I'd bring it to four percent before I would buy VMI. If you are at four percent Facebook already then I'd Probably add some VMI instead but we still believe in Facebook as much as ...

Jeremy: If you have neither, Facebook is rated by personnel and Valmont's the buy so we put those ratings up because that's our conviction as far as the valuation or the timeliness of each individual position.

Ellen: Norman says, "I find your quick reference guides on corporate calls, buying calls, writing puts quite instructive and any plans to have guides on diagonals, ratios, et cetera." First of all, thank you, Norman. Second of all, yes, Billy and I work on those and Billy I'm going to call you out right here, can we make a new one for Norman pretty soon?

Billy: Let's do it.

Ellen: All right cool, where do you want to start? Maybe diagonals, we do a lot of those.

Billy: Yeah, diagonals sound good.

Ellen: Okay, we are always, theoretically, we are always working on them but this is a good trigger to get us to mix. Well, because we can do one for everything and we haven't done that yet. Anyway, yes, Norman we will do that for you, thank you.

Billy: Also put into the slido, the ones that you want to see the most and that way that might help us.

Ellen: Yeah, please do submit and then we can see them voted on and that will help us decide maybe more logically than we just did. Anonymous, Billy, wants to be reassured that you will be able to get your ironing done?

Billy: I think I should be able to. I have what I need here so hopefully, hopefully yes.
Jeremy: He hasn't learnt his lesson from last time when we talked about his bookshelves first.
Billy: Yeah, I'm going to start clearing up this whole back area so that we don't get any comments anymore, just nothing.
Ellen: I'm going to send you like a $50 yes certificate IKEA and that can buy some lovely bookshelves for you.
Billy: What's interesting actually is IKEA has a book case, its actually a bookcase system, it's called The Billy and you know how IKEA has some crazy names for all their furniture. There's this bookcase called Billy and so that's literally screaming my name.
Ellen: Don't be freaked out but we have a Billy in our house. Moving on, anonymous says, "Pro has lots of financials and yet no financials specific hedge, FSC seems like a complex train, any thoughts?"
Jeff: FSC is a short of a short of financials so it's another long and yet it's a flawed ETF because it uses leverage, three times leverage. Even when the financials were down for much of this year, this FSC short worked for us and it still went down in value. That's just an aside, it's a flawed ETF short that is basically a long financial. You're right, we have a lot of financial exposure overall and no specific hedge right now. In the past, we have done a little bit of financial hedging, and we've considered it but for the most part we still like prices there, and we still see upside. If the interest rate cycle finally starts to change, that should really help a lot of our financials. We haven't talked about hedging them lately.
Jeremy: I think if anything we looked at short specific companies but I don't think we've found anything that's specific really compelling on an individual stock level at this point.
Ellen: All right. I'm sorry, I just moved one that I shouldn't have moved. Let's see.
Jeff: Ellen's controlling the behind the scenes of the slides.
Ellen: Yes, I decide whether your question makes it through. I missed that one. I'm going to go back and find it in a second.
Jeff: Okay, I can jump to another one.
Ellen: Yeah. Why don't you do that while I look?
Jeff: Then we can click all these off. Another Pro member asks, will there be a transcript and yes, I believe there will be a transcript.
Ellen: Yes, there will.
Jeff: As always.
Ellen: It usually takes a day or two but yes we're getting a thumbs up from the studio that there will be a transcript.
Jeremy: Yes. Excellent.
Jeff: Excellent. The transcript will be on the site along with a video replay as well, and I think any questions that we don't get to during this live chat will publish a written response to as well.
Ellen: Yes, I'll collect them, and we'll follow up with them in another couple days as well. Probably by the end of this week or beginning of next. I found it. David A. asks respecting Pro philosophy and Northstar goals, should you consider other investments like Gold or Miners in these times of negative interest rates and high stock values?
Jeff: I was just reading another question so I missed. Okay.
Ellen: I'm sorry.
Jeff: We're on the top one now. Should you consider other investments? Well, Jeremy, do you have thoughts?
Jeremy: We generally avoid stocks that are specifically tied to moves in commodity prices that we don't have a lot of control or knowledge or insight into such as gold. In this example the gold miners and the miners tend to be more leverage plays on gold. If you wanted to do something like that, you could Probably take a smaller position in a miner, but I would say that if you look at our portfolio, we don't have a lot of exposure to energy to oil. Also other things that we just don't have a core competency in judging where the value of that commodity is going to go or have a very strong opinion on that in order to build a position.
Jeff: True. What we do have are companies that generate reliable free cash flow and something that we believe we can model continuing. We're looking for businesses with really strong recurring and a lot of cases subscription type revenue. That's exactly why Jeremy would say we don't go after commodity type businesses very much.
Billy: Now, I could see being as gold is unique in that it trades inline with investor fear and sentiment, I could see Pro maybe getting into gold at a small allocation as a hedge against market volatility or some crazy event that would cause the price of gold to increase. Like Jeremy and Jeff were saying, I don't see Pro going into individual stocks and individual miners in that sense. Yeah, gold is something that I've been thinking about more lately. I used to write it off but I can see within Pro especially with our absolute return goal, during times of volatility where having a small allocation of it might be beneficial, and I've been giving some more thought to that for what it's worth.
Jeff: Billy, I just saw your video stream and nice tie. I liked the tie.
Billy: Thank you.
Jeff: It looks good.
Ellen: Is it ironed? Did you iron it?
Billy: I did, I did.
Ellen: Good. Yeah, I know, all of us look like slabs next to this guy.
Jeff: It's true, Pro actually owned a Gold ETF back in 2009/2010 and we sold it for a Profit which was fortunate given what happened to Gold later. Remember how everyone was so positive on Gold, and that has proven anything but true in the last six to seven years.
Ellen: Len asks this one has moved up quickly. I'm retiring at the end of the year, congratulations, is Pro a logical portfolio for retirement or would Supernova or Rule Your Retirement be more suited? I will say at the outset that Rule Your Retirement is not a managed portfolio, it is a collection of advice. They do have sample portfolios that you can follow along with but it might not be the same integrated portfolio experience that you would get at a Pro or a Supernova.
Jeremy: It is a great complement to any of the other investment services.
Ellen: It's amazing, Rule Your Retirement is ...
Jeremy: I would recommend it as far as Bang for your Buck.
Ellen: Yeah, no kidding.
Jeremy: It's well worth it.
Ellen: The archives we have 10 years of really good stuff there.
Jeff: Maybe everyone should join Rule Your Retirement no matter what.
Ellen: We collaborate, book and happy.
Jeff: The service is always open. I think it's, I don't want to say, but I think it's $49 or some low amount like that. Pretty good.
Ellen: Yeah, we don't charge enough for it, for what's it worth. It's really good.
Jeff: Ellen's right. There's no real portfolio there, I think to have bond focused model portfolios.
Ellen: They do.
Jeff: Then Supernova is higher volatility, higher risk than if volatility is a risk to you, then Pro. As we talked about at the start of this event, we think Pro is a good portfolio for those in retirement or nearing retirement. Especially if you can tweak it a little bit for your specific needs. Whether that means targeting more income or having more cash or what have you. Overall as Jeremy said in his first answer to a question like this, we have stability in mind and we're hoping to have positive returns every role in three years no matter what. We're investing fairly conservatively I would say for the most part.
Jeremy: Well I was just going to add that as we're living longer also retirements becoming longer. That equity position is important so you also don't want to get too conservative. You want to make sure that money's going to last as long as you are. An equity position over a full market cycle it is valuable.
Ellen: I would say to Supernova does have some missions that are designed for people in retirement, those are their phoenix missions. What you might want to do is give member services a call and have them walk you through each if you haven't done that already. We definitely we have a lot of members in Pro who are retired and use it that way, and our retirement board would be a great place to ask, but member services can give you some more context about the other services and how they're used as well.
Jeff: That's a good point. I wonder if any members are using the Supernova Retirement Portfolios and if they are, could they post on the Pro Retirement Board about it?
Ellen: Yeah, we would love to. If you are, please do share with us, we would love to have ...

Jeff: Put a new thing there.
Ellen: We touched on this a little earlier but anonymous says, "I'd like to take advantage of more option recommendations, but I'm nervous about the elections further turning anything into chaos. What are your feelings?"
Jeff: Well, higher volatility like we've seen lately leads to better options prices if you're an option writer. That's a good thing for writing options right now. As we've talked about, we do have a hedge setup for November. We were just talking yesterday with the team and I about possibly putting more hedges on that expire right around the election, like short-term hedges. Because yeah it could be rocky depending on what happens in the election and the markets response to that. We're aware of that, but it's also a short-term concern hopefully.
Ellen: If it's not, it will be the least of our concerns.
Jeff: We'll just we'll be as well prepared going into November as we reasonably can be without being too reactionary.
Ellen: Paul says, would you consider periodically posting most recent one, three and five annualized for comparison? I assume es talking about one, three and five-year rolling returns versus rolling and inception.
Jeff: I think we have that.
Ellen: I think we do too, but I thought maybe I misunderstood.
Jeff: Its on the recommendations page and were one of the few services that does this. Go to the bottom of the recommendations page, we have a returns table that shows annualized since reception the rolling three years and then the year to date return and then our total absolute return since inception as well. Take a look at that and if you have other ideas, other returns you'd like to see we can try to get them from the full every month as they do our statements. Post on the what the Pro suggestion board if you have other numbers you'd like to see.
Ellen: Yeah, member suggestions and we will listen. Penny says the Fed leaves the rate unchanged, what are our thoughts?
Jeff: Oh, so we're getting that breaking news in this event. That's cool.
Ellen: Thank you, members.
Jeff: Breaking news everybody, the Fed is not acting. Thoughts are well let's see the odds were laying a rate hike in this fall as the higher odds, higher than well it's September now, I think it was October when a rate hike Every hike was really expected, but I'll have to see what their comments were to really share thoughts.
Jeremy: Yeah, I think the Bond Market was pricing in their raise but this time. I think not having a surprise is going to reduce volatility a little bit versus if the decision was different. I would imagine most people suspect nothing is going to change until after the election. That they don't want to influence the market immediately leading into the election.
Jeff: Yeah that's a good point.
Jeremy: December is probably the best bet I've made from what I've read.
Billy: I think, yeah, the market is pricing in rate hike in December so far is what I've been reading.
Ellen: Bruce says he would vote cheat sheets on spreads and diagonals. Thank you, Bruce. NMNM says, "Where is the commentary on the hold on the Pier 1 short? Why was it moved to hold? I have an alternative position using options what to do?" We did touch on that earlier in this conversation. Hopefully you NMNM were able to see that part, if not, the video they will be up shortly after and you'll be able to touch on it there. Do you want to recap real quick, Jeremy?
Jeremy: Billy or I could quickly say I did hear she did post this before we talked about PIR so hopefully they heard that, but it's on hold while we review it pending results that are coming and recent news of a hedge fund buying a greater than nine percent stake. We want to see what that hedge fund is about and what they're hoping to do with Pier 1.
Ellen: Okay, Jason says if options are available only in my non-IRA account approximately 20% waiting versus 80% IRA, can I identify which recommended positions I should purchase in this account?
Jeremy: Okay, so I guess I see what you mean. Which stocks should you put in the IRA on the argument that you might be using options on them? We can't know the future for certain but we can know right now that if you go to the recommendations page for certain we can't know the future at all but if you can, we can know some things.
Ellen: Speak for yourself.
Jeremy: Time will go by. If you go to the recommendations page, each stock that has an option on it will have a little O icon next to it. I would start with the safe bet is to buy the stocks that we currently use options on in your IRA. Then you'll be able to partake in those. Other than that, I can say that all of our core holdings it's rare that we use options. Our stocks that we own for the long term are usually just left alone as stocks. You shouldn't have much, it shouldn't be a real problem for you.
Ellen: Headcreek again. Hello Heck. Jeff said no incremental security for bare puts spreads in IRAs but primary hedges put ratio spread. One sold put must be cash secured I believe.
Jeff: That's certainly true in an IRA. The IRA alternative is a bear put spread that requires no extra cash. I don't know that most IRAs will allow a put ratio spread and if they do it'll be cash secured as you said. The ones they'll put will have to have all the cash put aside. I think in an IRA the bear put spread usually makes more sense rather than hold all that cash on the side, all the time. That's why it's there is an alternative trade in the report.
Ellen: Anonymous wants to know if they can consider preferred stock I guess as a way to hedge the market as well as provide fairly good income?
Jeff: Jeremy or Billy, of thoughts on preferred?
Billy: Yeah, I've looked at preferred stocks before. I've made some commentary on them in prior chats and on the board sometimes. Preferred stocks can be a good way to provide lower volatility than regular stocks. They're like a mix between equity and bonds. You have some upside depending on the structure of the preferred, and you also have protection on the downside being as they have a regular yield. Again it's all dependent upon the preferred, each preferred is different, and the terms are different which you'll find in the prospective. They generally tend to be correlated very highly with interest rates, right? When interest rates are low, the demand for a preferred and their higher income than regular stocks is higher. Then when interest rates are rising which is the current environment that we're in right as I just said the market is pricing in a rate hike in December when rates go up, preferred, the value of a preferred goes down. It may be a good way to hedge the market but for us and Pro as far as how we consider using them, we think now is not necessarily the best time to own preferred because as rates rise, the demand for a preferred should decrease.
Ellen: Okay, let's do ... We've got five minutes left so let's try to get three, maybe two or three more and then we will say our goodbyes. Katherine says the covered calls for Wells Fargo are on hold. Is the recommendation to buy first also on hold? Yes, give us a week to 10 days while we work through what's going on there. Anonymous says I just recently joined Pro, and I'm starting to build the portfolio. Since November is close, should I just wait till after the election to buy the portfolio recommendations?
Jeff: I'd say no. Usually elections don't result in that much change but either way, why not average and start to average in to the buyer first and move gradually. A lot of members buy in into the portfolio over many, many months. At least start so that you're starting to get on board.
Ellen: Sprinkles says on the Pro Open Positions page, I can't seem to find where hold would be written for options. One moment, let me look. There is a what to do column.
Jeff: Yeah, for options there isn't because options are timely, and so they're either you either have them or you don't but Wells Fargo, the stock has been put on hold and that should imply that the option that we wrote is also on hold.
Ellen: You can check there what we think now page two as well under recommendations because that will say short hold et cetera. That will give you some guidance.
Jeff: Maybe we should put some words above the options part that just says these were timely these, I don't know but ...
Ellen: Yeah, that might be revisiting. We might need to.
Jeff: Yeah, well make a note of that.
Ellen: Sure. Jeff says we heard discussion about volatility, any pending or thoughts on a VIX Trade.
Jeff: We have done positions on the VIX in the past.
Ellen: Yes we have.
Jeff: Given the curve of the price of those options and how much the VIX futures have to move to make them profitable, it's a tough, it's a tough proposition as I'm sure Jeff knows. That said we setup some creative options trades on the VIX and I look at the pricing every once in a while. We'll probably do more with the VIX in the long term at various times maybe November, we'll see.
Ellen: Maybe 20 years from now, you don't know. You just don't know. Sprinkle has a question about options and Pro. I was following the Skyworks trade in options, and I had my $70 puts expire for full income. Is writing $75 puts the best way to move into the Pro position?

Jeff: Well, that's one way to but we have the stock rated buy in Pro and then to have everyone on the same page for writing as we recommended the $75 calls that we rolled up to. If you're not in the position yet at all, you have the freedom to either buy the stock directly or keep writing put options at a strike of your choice. 75 and below is fair game because that's where we have the stock now as a buy so you can do what you prefer. Options will probably have another trade on Skyworks as well.

Ellen: It will probably.

Jeff: Yes.

Ellen: Kenny says, Pro members are posting Pro positions and strategies questions on the options boards, please keep those to the Pro boards. That's good board hygiene. Listen to Kenny. Thank you. Penny says for new Motley Fool 1 members, is there a place we can see a matrix of Pro everlasting et cetera to see if a stock is recommended by multiple Motley Fool services? Yes but I am not the one to walk you through that. Please call member services, they will be able to walk you through the screen on the one site and the way that those recommendations are organized so that someone who really knows what they're doing there will be able to get you the tools that you need.

Jeff: I think if you enter a ticker in the one site, it gives you a summary of everywhere it is, but it's not a matrix per say. It's more, it's a long list.

Ellen: Yeah, they do the stuff all day. They'll really know how to help.

Jeff: Sweet.

Ellen: Anonymous says I'm getting overloaded by email about Fool 1 right now. Is there a good way to compare the different Motley Fool Programs? This is going to sound familiar, but please call member services. It's a big part of what they do is walking individuals through what we offer and helping them figure out where they might best fit. They're really, really good people and they are good at it. Yes, please do give them a call. We'll do one more. Linda says as I'm trying to figure out the SPY recommendations. Assuming I went with August recommendation, could you walkthrough what will happen to them in November?

Jeff: Yeah, certainly. If Spy is below the price of those options, we'll close the options for the current value. If it's between our two strikes, we'll have a profit on the hedge. If Spy is above the strike prices that we had in November, the options expire on use. We don't have to do anything, they just disappear, and we keep the initial income that they paid us. As with almost any option if it's in the money at expiration we'll then take action, if it's all the money, we don't need to do anything.

Ellen: Okay and that brings us to one minute left. I think we should probably say our goodbyes. If we did not get to your question, I am collecting them, and we will answer them and send them to you via e-mail within by Monday. Because the memo will be out on Monday and we'll definitely want to have it done by then.

Jeff: Great.

Ellen: Yes, apologies if we didn't get to you.

Jeff: That's great that we will.

Ellen: Exactly.

Jeff: Thank you on behalf of all of us, the Pro team here, thank you for being here with us today. Thank you to new Pro members. Again as we've all said four different ways, among the four of us, take your time, move gradually. We believe you're in a great place. Hopefully, fellow members believe that as well for investing success over the coming year and years to come, I had a nice poetic.#

Ellen: You did. Lack of sleep is good for your wisdom.

Jeremy: Inhibitions.

Ellen: That's right.

Jeff: If you have any questions as always go to the Pro community boards. Jeremy?

Jeremy: Well thanks for being here. Enjoyed it and looking forward to interacting with everyone on the boards.

Jeff: Thank you and Billy, do you want to say your goodbye?

Jeremy: Sure, thanks for joining us guys. I've really enjoyed it and looking forward to hearing from you guys on the boards.

Ellen: We have one of these chats every month. Not a portfolio positioning one but a live video chat so we'll have a date for the October 1 up pretty soon and you'll be informed about it. Take care Fools.

How did we do?

If you rate this transcript 3 or below, this agent will not work on your future orders

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Pro Quality Checklist: Pier 1 Imports

Published Aug 22, 2016 at 4:00PM

Dear *Pro* Fools,

Our *Pro* quality checklist series looks at our stocks through the lens of the eight factors we identify in the "Finding Great Companies" section of our Strategy Guide. Today, we're continuing the series with our first look at one of the shorts on our scorecard: **Pier 1 Imports** (NYSE: PIR). We expect most of our long positions to check off a majority of our quality criteria, so it stands to reason that we should expect our short positions to *lack* most of those qualities. And as we'll see in this Memo, there are reasons why we chose Pier 1 as a direct short. Without further ado ...

1. Sustainable Competitive Advantage

No. The success of Pier 1's retail business depends on consumer retail traffic and on management's ability to identify trends and provide merchandise that satisfies consumer demands. Pier 1 has no structural characteristics (for example, scale, network effect, or switching costs) that allow it to draw customers and achieve success to a greater degree than competitors.

Pier 1's lack of competitive advantage (and deteriorating competitive positioning) is evidenced by its margin trends:

Quarter	TTM Gross Margin %	TTM Operating Margin %	TTM Net Margin %
Q1-2014	43.7%	11.8%	7.6%
Q2-2014	43.6%	11.4%	7.0%
Q3-2014	43.5%	11.4%	7.0%
Q4-2014	42.1%	9.9%	6.1%
Q1-2015	41.5%	9.4%	5.7%
Q2-2015	41.1%	8.6%	5.1%
Q3-2015	40.8%	7.8%	4.6%
Q4-2015	40.4%	6.8%	4.0%
Q1-2016	39.9%	6.1%	3.6%
Q2-2016	39.0%	5.6%	3.2%
Q3-2016	37.9%	5.0%	2.9%
Q4-2016	36.7%	4.0%	2.1%
Q1-2017	36.2%	2.9%	1.4%

2. Pricing Power

No. As a retailer that doesn't offer uniquely differentiated products, Pier 1 competes in a highly contested market. The emergence of online commerce over the past 15 years has spawned hundreds (if not thousands) of low-cost competitors that can offer similar products without the burden of Pier 1's legacy infrastructure, leading to intense price competition. Pier 1's margin trends also provide evidence of a lack of pricing power, which often goes hand in hand with a lack of competitive advantage.

3. Dependent Customer Base

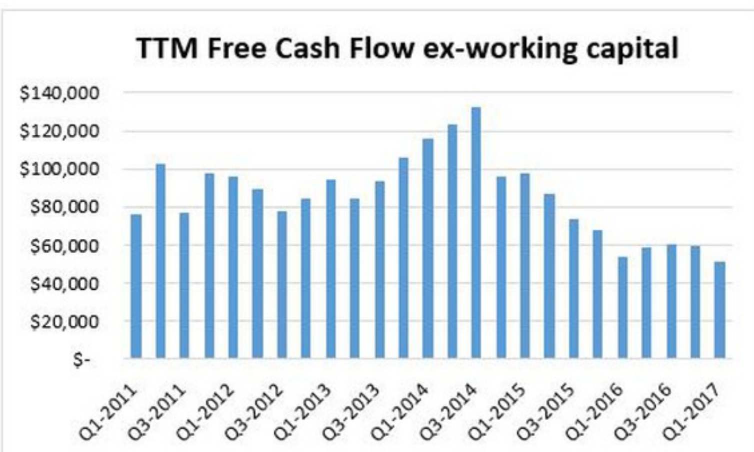
No. About 99% of Pier 1's business revolves around around individual retail consumers. These consumers are not dependent upon Pier 1 for home goods and furnishings, and there are myriad other sources for similar products.

4. Predictable Revenue

No. As a home goods and furnishings retailer based predominantly in the U.S., Pier 1's sales generally ebb and flow with the U.S. housing market. The housing market itself is unpredictable, which provides the first layer of unpredictability for the company's revenue. Additionally, Pier 1's weak competitive positioning is leading to loss of market share, and management has not been able to consistently predict the impact of slowing retail traffic and the pace of sales declines, often missing its own guidance.

5. Growing Free Cash Flow With Compounding Returns

No. As you might expect from the company's margins, Pier 1's free cash flows -- while still positive -- are declining. When excluding fluctuations in working capital such as inventory adjustments (which can significantly obscure underlying trends in reported cash flows), Pier 1's free cash flows look like this:



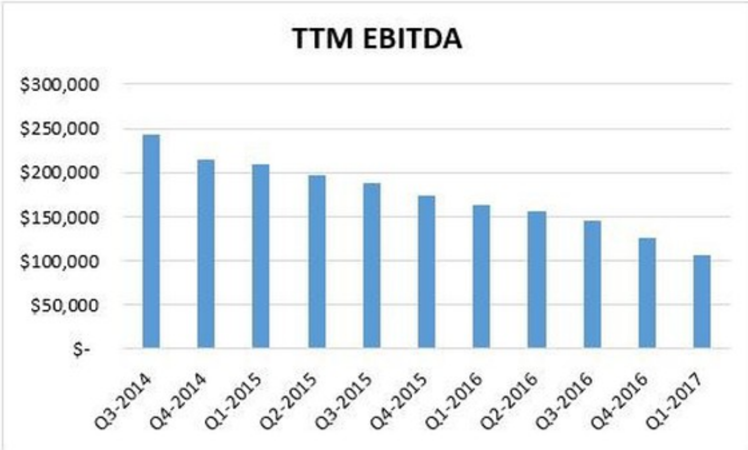
If the company's margins continue to deteriorate, further investment in the business (via capital expenditures or share repurchases) will have the effect of diminishing -- rather than compounding -- shareholder returns.

6. Financial Resilience

Sort of. The company has $128 million in cash on its balance sheet, compared with about $200 million in long-term debt. Despite falling margins, Pier 1 is cash flow-positive, and management is not in danger of defaulting on debt or being unable to pay for routine capital investment.

However, the company's financial resilience is certainly trending negative. Pier 1 is currently paying about $20 million to $25 million a year in cash dividends, and annual capital expenditures since 2011 have been in the range of $20 million to $80 million a year.

Meanwhile, trailing-12-month EBITDA was at $106 million as of the most recent quarter, and is falling quickly as margins decline.



Given this, management may eventually need to start making difficult decisions about whether to suppress capital spending or reduce the dividend if earnings continue their free-fall.

Additionally, Pier 1 took on most of its current debt in fiscal 2014 to use for continued share repurchases. Since December 2012, management has spent a total of $464 million on share repurchases at an average cost of $15.75 per share.

In retrospect, these repurchases have been a very poor capital allocation decision. With the stock currently trading at $4.62, those $464 million in repurchases are now worth just $136 million, good for a -71% return on investment. These repurchases have taken capital away from the business that could have been used for supply chain investments, investments in marketing and advertising, or to pay down debt.

7. Expanding Possibilities

No. Pier 1's possibilities are shrinking. The company's core business (in-store retail sales to consumers) is in decline as general U.S. retail traffic is fading, losing market share to online shopping.

Pier 1 did launch an e-commerce business in 2013, but that segment of the business is slowing rapidly; Pier 1 simply doesn't have the scale or the cash to compete with bigger players with deeper pockets.

Furthermore, with the reduced financial flexibility caused by falling margins and ill-timed share repurchases, the company doesn't have much excess cash to devote to exploring new growth opportunities.

8. The Three C's of Management (Clarity, Consistency, Capability)

No. Management has not shown the ability to properly forecast and anticipate business performance, and has consistently missed and/or revised its near-term and longer-term guidance and financial targets.

For example, here's how Pier 1 performed on certain metrics in fiscal 2015 and 2016, relative to its initial guidance announced in the fourth quarter of the prior year:

	Fiscal 2015 Initial Guidance	Fiscal 2015 Actual	Fiscal 2016 Initial Guidance	Fiscal 2016 Actual
Company comparable sales growth	"High single-digits"	4.7%	"Mid single-digits"	0.7%
EBITDA margin %	11%	9.3%	9.3%	6.7%
Earnings per share (EPS)	$1.16-$1.24	$0.82	$0.83-$0.87	$0.46
Operating margins by the end of Fiscal 2016	11%-11.5%			4.0%
eCommerce sales by the end of Fiscal 2016	"at least $400 million"			$305

Not only has Pier 1 missed its initial guidance, but management has continued to revise their estimates downward each quarter as the years have progressed, and they don't seem to have a good handle on the pace of the decline of the business.

In addition to the poor forecasting, the aforementioned strategy of taking on debt to increase share buybacks has so far been disastrous, increasing the company's debt load significantly while the stock's free-fall simultaneously incinerates shareholder capital.

Moreover, management has poured money into restructuring and new initiatives (such as the e-commerce platform) that so far just haven't paid off. In my opinion, the company would have been better off embracing the fact that its business is in terminal decline, slashing capital spending to the bone, suspending all share buybacks, and funneling as much cash flow as possible directly to investors in the form of dividends.

Finally, there is a lack of consistency in financial management (which provides context to the company's poor forecasting), as the current CFO joined in 2015 after the prior CEO "retired" under suspicious circumstances. Prior to joining Pier 1, the current CFO held the same role at **Tuesday Morning** (NASDAQ: TUES), a company that itself has recently been struggling to meet investor expectations.

The *Pro* Bottom Line

With just 0.5 out of the 8 *Pro* quality characteristics we look for, it's little surprise that we chose Pier 1 as a direct short. Although the stock price has declined more than 80% since its recent highs in 2013, we think the business is likely to suffer through further pain. Pier 1 is currently an active short on our scorecard at a 0.6% allocation, and if you've yet to establish a short position, hopefully this Memo helps provide some impetus to match our short allocation.

Here are links to additional *Pro* quality checklist articles:

- **FactSet Research Systems** (NYSE: FDS) -- 8/8
- **Gentex** (NASDAQ: GNTX) -- 5/8
- **American Tower** (NYSE: AMT) -- 7.5/8
- **Broadridge** (NYSE: BR) – 8/8

- **Oracle** (NYSE: ORCL) -- 8/8
- **O'Reilly Automotive** (NASDAQ: ORLY) -- 6/8
- **TD Ameritrade** (NASDAQ: AMTD) -- 5.5/8
- **Valmont Industries** (NYSE: VMI) -- 5.5/8
- **Mastercard** (NYSE: MA) – 7/8

Fool on!

-- Billy (TMFBillyTheKid)

Pro Guidance Updates

- **Broadridge Financial Services** (NYSE: BR): This quiet, typically non-volatile, strong-performing stock remains a **Buy First** for our long-term investors. With its high recurring revenue, strong retention rates, healthy business performance, and a few more quarters of growth under its belt, our fair value estimate increases to $65 from a previous $58.

Pro Catch-Up Trades: August 22, 2016

Published Aug 22, 2016 at 4:00PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Broadridge Financial Services** (NYSE: BR): Buy up to 5.4%.
- **Facebook** (NASDAQ: FB): Buy up to 6.5% (in halves if you prefer).
- **FactSet Research** (NYSE: FDS): Buy 2.2%.

Continue building your portfolio with our Buys (or, wait for our next Portfolio Building Report if you wish), including these highlighted today:

- **OpenText** (NASDAQ: OTEX): Buy 3.3%.
- **Oracle** (NYSE: ORCL): Buy 3.7%.
- **Visa** (NYSE: V): Buy 2.4%. (See our earnings update.)

Shorts:

- **Pier 1 Imports** (NYSE: PIR): Sell short 0.6% to start (see our recent trade alert).

Options (or, wait for our Portfolio Positioning Event):

- **Gilead Sciences** (NASDAQ: GILD): Sell to open October 2016 $85 calls, one for every 100 shares you would like to cover (as expiration gets closer, we accept what the market is willing to pay). See our recent trade alert.
- **Skyworks Solutions** (NASDAQ: SWKS): If you haven't covered your shares yet, and want to, sell to open September 2016 $75 calls, lately for $1.10 each, writing one call for every 100 shares you own and are OK covering. The stock is still rated Buy.

Hedges:

- **S&P 500 Depository Receipts** (NYSEMKT: SPY): Set up a new put ratio spread per our latest alert.

Options expiring next:

- **Gentex** (NASDAQ: GNTX): September 2016 puts. Gentex shares are trading at $18, well above our $15 strike. With 25 days remaining, these puts are on track to expire as income.
- **Skyworks Solutions** (NASDAQ: SWKS) and **Valmont Industries** (NYSE: VMI): September 2016 covered calls. These contracts still have 25 days to go, so we'll issue updated guidance as we approach expiration. If Skyworks is still above $70, we plan to roll our options to a later month (and possibly higher strike) ahead of expiration.

Hedge: Set Up Another Put Ratio Spread on the SPDR S&P 500

Published Aug 18, 2016 at 1:46PM

Is this for you? At *Pro*, we employ hedges to target returns during a market decline. You don't need to hedge to succeed with *Pro*, but if you are at least 80% invested in stocks and *want* to hedge some of your market exposure, then consider following along.

We currently have another 10% SPY hedge, which is due to expire in September (and is at prices where we wouldn't recommend it anew); today's additional 10% hedge will lower our market exposure -- if the market falls to our strike prices -- to a net 60% or so. Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $210,000. We are leaving our current September 2016 SPY put ratio spread in place for veteran members; today's new spread is at much higher strike prices, to account for the market's rise this summer, and it expires in November after the election.

This is a complex trade, so if it seems challenging at first glance, don't be alarmed. Simply wait until our live **Portfolio Positioning Event on Sept. 21**, when we'll discuss this and our other options, hedges, and shorts. In the meantime, bring questions to the Hedging discussion board -- but there's no need to hurry. A hedge like this is easier to set up once the market is declining, so it's not necessarily imperative to set it up now.

How You Participate

- **Action:** Use a spread order to set up a put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
- **Allocation:** About 10% of your total portfolio value, measured on the look-through value of the $210 puts you're buying (each $210 put represents $21,000 in hedge value). Set up one 2:1 put ratio spread for every $21,000-sized hedge you want. Hedging about 10.3% of our entire portfolio of $2.65 million, *Pro* will sell 26 $200

puts to finance this position and buy 13 higher-strike, $210 protective puts with the proceeds. (Thirteen puts representing 100 shares each at a $210 strike = $273,000 look-through put value = 10.3% of our $2.65 million portfolio value.)

- **Trade:**
  - **Use a combo or spread order to simultaneously ...**
    - Write ("sell to open") **two** November 2016 $200 puts, and
    - Buy ("buy to open") **one** November 2016 $210 put. Click "View All" on the option chain at your broker to see all strikes. Set up one set of the above options for every $21,000 hedge you want; or one for every $210,000 you manage, if you want a 10% hedge.
- **Price Guidance:**
  - Sell to open **two** November 2016, $200 puts: Lately $1.90 x 2 = $3.80 credit.
  - Buy to open **one** November 2016, $210 puts: Lately $3.45 debit.
  - **Net credit:** Lately about **$0.35** credit per spread -- but this price will change. As it does, simply aim for a credit, or close to no cost, using a limit order.
  - SPY price: $218
  - **Potential adjustment:** If SPY moves much in price before you set up your trade, you may want to move one or both of your strike prices up or down accordingly -- as much as SPY has moved -- while still aiming for a net credit. After our mandatory 24-hour trade delay, we will make such an adjustment if need be, and tell you about it.

What We're Thinking

At *Pro*, we aim to have winning positions in down, flat, and positive markets -- and that means we need to address all three possibilities at once in our portfolio. At the same time, we remain oriented toward the long term and majority invested in healthy stocks. A hedge on a market index is simply a hedge against a lower stock market while the rest of our stocks remain free to appreciate. We generally don't try to manage for market declines of 5% or less (that's standard volatility), but when *Pro* is functioning as desired, declines of about 7% or more should result in some of our positions, such as these spreads, becoming profitable. At the same time, the put ratio spreads we use:

- Are harmless to us if the market goes higher (they don't ding our returns)
- Are typically cash-free to set up (they often pay us a small credit -- essentially income)
- Have a low probability of long-term loss

What's the trade-off? As with any written put, we need to be ready to buy the underlying investment; for today's position, that means we're prepared to buy into the S&P 500 index (through SPY) if the price falls below $200 -- or really, below $190, which is our breakeven point on this hedge. That's 13% lower. If the S&P falls that much, we would plan to buy *long-term call options* on SPY instead of the shares, saving most of our cash in the process; see below for details on that. We don't believe there's much probability of long-term loss because we believe SPY will recover. And we think it's likely that if the index does fall by November, it's likely to be down in the range of 5% to 13%, in which case this hedge will help us.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2.65 million
- 10% of that value: $265,000
- Nov. 18, 2016, spread:
  - Buy to open $210 puts. Thirteen contracts representing 100 shares each = $273,000 in look-through exposure, or about a 10.3% hedge on our current portfolio value, cash included.
  - Sell to open $200 puts -- 26 contracts, half of which are *not* covered by long puts and thus become a potential obligation at a net $190, currently a 9.3% possible stake.
  - At home, you would buy one $210 put and sell two $200 puts for every $215,000 in portfolio value you want to set up a 10% hedge against.

Return Details

SPY Price at Nov. 18, 2016, Expiration	Value of 1 Purchased Nov. 18, 2016, $210 Put	Value of 2 Written Nov. 18, 2016, $200 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Recent $218.40
$210 or higher	$0	$0	$0.37 gain per spread -- or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 3.8%
$205	$5 x 100 = $500	$0	$500	(6.1%)
$200	**$10 x 100 = $1000**	**$0**	**$1000 (max profit per spread)**	**(8.4%)**
$195	$15 x 100 = $1,500	($5) x 200 = ($1,000)	$500	(10.7%)
$190	**$20 x 100 = $2,000**	**($10) x 200 = ($2,000)**	**$0 (break-even)**	**(13%)**
$185	$25 x 100 = $2,500	($15) x 200 = ($3,000)	($500)	(15.3%)

If SPY declines more than 3.8% from recent levels, this hedge starts to come into play. Our maximum profit on the hedge is earned if SPY declines 8.4% from its recent level of $218.40 by our November expiration date. The spread will help us a bit on an index decline of as much as about 13%; deeper than that, and our short (or "sold to open") $200 puts start to work against us, at least for now. Our breakeven on SPY is at $190 -- again, that's 13% below recent prices. So this hedge is effective up to that point.

Follow-Up

Assuming we set this spread up for a credit, it will result in a small profit even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $200-strike-price put obligation (starting with a net buy price of $190) if SPY is below $200 by expiration. We should be happy to buy into the index 13% lower. And up to that point, this hedge will have paid us as the market fell.

However, if the market *does* fall by more than 13%, our plan would be to close the short puts and buy long-term SPY calls (or something we like even better, whether calls or a stock) instead of buying the SPY ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY shares. So, our potential 10.3% stake in SPY shares will cost us only about 2.5% of our cash if we buy calls instead. We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases. We would likely ultimately diagonalize those new SPY calls for ongoing income.

The bottom line is that any drop in SPY as far as 13% below recent prices will result in this hedge showing a profit at expiration. And it costs us nothing to set up (it pays us) and will not hurt our returns even if the market keeps rising (in fact, we make a small profit on the hedge even then). If the market falls by more than 13%, we are obligated to buy into shares of SPY, but we'll be happy to do that -- and we'd likely buy call options instead of the ETF, committing only 2.5% of our portfolio value in this particular position as we look to leverage profits as the market recovers. After this hedge is set up, we rest easier knowing that it will start to help us if and when the market slides by between 4% and 13%.

How It Fits Into *Pro*

Pro hedges to lower our market exposure, or risk. We aim to achieve positive returns every rolling three years, and inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market can make a difference. We made $10,700 when our last put ratio spread closed in February. Even small gains add up over the years, especially after those gains on market declines are invested in good stocks. This hedge fits well with our goal of hedging in a cost-efficient way, one that doesn't work against us if the market rises. Plus, it offers us protection on a market drop greater than 3.8% or so. These spreads do require regular upkeep, opening new positions as old ones expire, and they are time-sensitive, really only helping at or right near expiration.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:**
  - For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Use a spread order to "Buy to open" Nov. 18, 2016, $210 puts and "sell to open" *an equal number* of Nov. 18, 2016, $200 puts. Recently, this will cost you about $1.55 ($155) per spread, and that is your maximum risk. Buy as many spreads as you care to risk $155 on. This strategy would be worth up to $10 ($1,000) per spread on an 8.4% market decline to $200 or any lower price, but you should be prepared to lose your whole $155 per spread if SPY doesn't decline to at least below $210 by expiration. You have to assume a hedge like this will expire worthless. So, only risk what you are comfortable losing.
- **To lower your market exposure while following our full official trade (and making the position possible in some IRAs):**
  - Set up the official put ratio spread as recommended, but also "buy to open" puts (with the same day of expiration) at a strike price *well below* $190. Buy *half as many* as the number of $200 puts you wrote. When you do so, all of your $200 puts will be "covered" -- half by your $210 puts, and half by the other puts you choose to buy at a much lower strike. Choose how much you want to pay to select your lower strike price to purchase. To us, the $189 strike or much lower looks good, recently costing $1 or much less. You will only need cash in your account to cover the difference between your two lowest strike prices (if you buy $189 puts, that's $11 per share), and your risk is capped, making this potentially IRA-friendly. This makes the total cost of your hedge about a $0.65 debit, and it still has $10 in potential ending value.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

AmTrust Financial Keeps Doing What It Does Best

Published Aug 16, 2016 at 10:10PM

AmTrust Financial Service (NASDAQ: AFSI) posted another solid quarter, though the stock is still out of favor with investors and is still trading about 25% below its 2015 peak. Even so, the company continues to perform well and management remains focused on growing the company's book value through opportunistic acquisitions and disciplined underwriting. Annualized return on equity for the quarter was 21.1% and despite issuing shares to help fund recent acquisitions, book value per share increased 26% compared to a year ago. The company recently closed on its acquisitions of Republic Companies and Nationale Borg and both contributed to results for the quarter. The pending acquisition of ANV Holdings, which gives the company access to the Lloyd's of London marketplace, is slated to close in the fourth quarter and according to management the acquisition pipeline "remains robust".

Gross written premium for the quarter grew by 23.5%, or 14.5% not counting the Republic Companies acquisition, and net earned premium grew by 21.9% to $1.18 billion. AmTrust's combined ratio came in at 91.7% versus 90.5% a year ago. The loss ratio ticked up slightly to 66.4% compared to 65.9% in the second quarter of last year. Management attributes a 70 basis point increase in the cost ratio (from 24.6% to 25.3%) to acquisition costs based on premium distribution. The company's invested assets have grown to a record of more than $9 billion which delivered $50.7 million of investment income for the quarter and the average yield on the portfolio was 3.47%

In late July the company announced that the Tower Group was being placed into conservatorship and the California Insurance Department shared its conservation plan to help resolve Tower Groups's legacy liabilities. The plan requires the Karfunkel Family Trust and members of the Karfunkel family to contribute $200 million to the Tower Group receivership to speed up the resolution process. This is positive news for AmTrust because it relieves the company of the $125 million stop loss reinsurance agreement that it signed when it acquired the Tower Group's commercial lines business. AmTrust management is pleased to have this contingent credit liability removed from the business. The conservation plan also includes a maintenance guarantee by the Karfunkel Family Trust that allows AmTrust to refinance the loan the company used to acquire Tower Group's assets to fixed rate of 3.7% from 7%. (A more detailed explanation of the conservation plan can be found here)

Pro's Take

AmTrust may be unloved by the market, but it's still a Buy in the Pro portfolio. The company's stock also appears to be on management's "buy first" list, as they repurchased over 3.5 million shares during the quarter at an average price of $24.82. That brings the total shares repurchased for the year to nearly 6 million. Management stated on the call that as long as AmTrust shares were trading at a discount to their assessment of the company's value, it makes more sense to buy back shares than to buy another business. I agree with that sentiment and over time management has proven to be prudent capital allocators. **With shares trading just below our $26 fair value estimate and not far above management's recent buyback range, we continue to think that members should allocate up to 5% of their portfolio to AmTrust Financial Services**.

Pro Portfolio Building Report No. 1: Our Buy First Stocks

Published Aug 15, 2016 at 8:29PM

Welcome, Fool! We're glad you're here. This first report is meant to get you up to speed on our Buy First stocks — the companies in your *Pro* portfolio that we believe you should start purchasing first. But before we get to that, a few words about how best to use *Pro* ...

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that aims to generate winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, hedges, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* fit you.** We know not all investors are in the same situation! We can help you figure out how to buy *Pro* investments given your personal situation, including investing in an IRA or coming to *Pro* already fully invested. Check out our advice for every approach to *Pro*: Invested Elsewhere | "Free-Range" | Whoever You Are

3. **Catch up with our portfolio at your own pace.** Start with the stocks in this report, and follow along with our subsequent reports. You can always see our Buy First, Buy, and Hold guidance (which is the most important -- more important than valuation estimates) on the Recommendations page, and you can get a succinct, up-to-date take on all of our stock positions on our What We Think Now page.
4. **Don't freak out about fair value.** Instead, read Jeff's explanation of how it's calculated and what it means.

Bring any questions to the Getting Started & Help discussion board, and Fool onward!

-- The *Motley Fool Pro* team

Table of Contents

Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: About 4.1% (see Recommendations page for real-time allocation)

For More

- *Pro* 's original recommendation (5/6/13)
- Most recent earnings update (4/28/17, from our sister service, *Motley Fool Options*)
- Talk about AMT

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Global mobile data traffic is expected to increase at a compounded annual growth rate (CAGR) of 53% between 2015 and 2020, and global mobile 4G connections are expected to grow from 1.1 billion in 2015 to 4.7 billion by 2020 (a 34% CAGR). Communications site operator **American Tower** is well-positioned to benefit from this trend.

AMT leases antenna space on more than 100,000 cell sites (towers, rooftops, and more) to wireless service providers across the globe. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, can't be canceled, and feature contractual annual price escalations. More than half of AMT's properties are located in 12 (soon to be 13) different countries outside the U.S., including India, Brazil, Colombia, Mexico, Nigeria, and South Africa, and management is intent on expanding the company's international portfolio as it continues to build and acquire more towers.

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE, or to increase coverage density. When they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; about 98% of AMT's customers up for renewal each year do so, and more than 60% of its current leases don't renew until 2021 or later.

The stock may experience volatility in the short term because of its tendency to trade alongside the interest-rate-sensitive REIT sector, but over the long term, the underlying strength in business fundamentals should shine through. We expect to earn modest income from a growing dividend and strong appreciation as AMT continues to build out its international tower portfolio.

Buy First: Coherent (NASDAQ: COHR)

Specific devices may come and go quickly, but we have our eyes on the lasers that help put them together.

Suggested Allocation: 2.5%

For More

- *Pro*'s original recommendation (5/17/17)
- Talk about Coherent

Microelectronics. Miniaturization. Mobile computing. Wearables. Artificial intelligence. The Internet of Things. Moore's Law. All of these help to fuel the business of **Coherent**, a leading producer of commercial and industrial lasers and laser services. Coherent was founded near the dawn of the laser, in 1966, and its recent acquisition of peer Rofin-Sinar for $942 million gives today's business a leading breadth of products and worldwide reach -- even as the utility of lasers continues to grow.

The company sells dozens of laser models to dozens of industries, and 26% of last quarter's revenue was recurring (parts, consumables, repairs, and related services). That's nice to have, but the real story here is an ever-greater need for lasers in the manufacturing of ever more electronic devices and other items. This is a volume story -- and a story of rapid change. As the components that companies use in technology products rapidly evolve, the lasers used to build the products and test them must evolve, too, resulting in new sales for Coherent. We see how quickly tech is evolving, so rather than investing in one particular technology, we're investing in a means for putting most any technology together.

Buy First: Facebook (NASDAQ: FB)

Although it's lately riding a wave of popularity, we believe the strong stock is justified, and the business should grow handsomely in coming years.

Suggested Allocation: About 7.3% (see Recommendations page for real-time allocation).
You can buy in thirds, or halves, over a few quarters. Experienced investors can write put options to target buying some of their shares cheaper; to do this, "sell to open" one put option for every 100 shares you could buy. Because you want to be assigned shares, sell "near-the-money" puts, with a strike price near the current share price, that expire in just a month or two.

For More

- Latest earnings update (5/15/17)

- *Pro's* original recommendation (9/18/12 – dated by now! But this shows how we thought about it back then when it was $20 and most were bearish)
- Talk about Facebook

Facebook remains a young story about monetizing the largest, most engaged online audience ever hosted by one company. The company's future is in strong hands; management is showing patience and care as it starts to monetize more of its properties, putting visitor experience first. So far, this approach has paid off, with user engagement up even as more ads appear. The billions of connections maintained on Facebook's properties are making the sites extremely sticky, offering the potential for increased value to advertisers (and thus Facebook shareholders) -- especially as the advertising gets smarter and more targeted.

It's our largest position at a recent 6.5%, and the size of our investment in Facebook feels appropriate given how much growth potential lies ahead and how well-managed the company is. Even from today's price, we estimate Facebook could return about 15% annualized for shareholders over the next five to seven years. Though shares are currently a bit above our fair-value estimate, the stock is rated Buy First on its long-term potential. Key risks include users moving away from Facebook, but so far the company has shown great skill in *increasing* user engagement and stickiness, rather than stunting it. It's also possible that management could spend more than Wall Street expects, though that should mainly be a short-term concern.

Buy First: Visa (NYSE: V)

With its mission to "accelerate the electrification of commerce," industry leader Visa has most of the world left to conquer.

Suggested Allocation: About 3.1% (see Recommendations page for real-time allocation)

For More

- Buy More recommendation (3/30/17)
- *Pro*'s original recommendation (4/28/15)
- Talk about Visa

The ubiquitous nature of credit and debit cards in America means that many of us can go through life rarely touching cash. Yet even in the U.S., cash still accounts for approximately 40% of transactions, followed by debit cards at 25% and credit cards at 17%. And globally, cash is truly king: MasterCard estimates that 85% of all consumer transactions still take place with old-school paper and coins. But all of that is slowly changing as economies modernize and middle-income families proliferate, bringing more converts to the benefits of electronic payment. With its mission to "accelerate the electrification of commerce," industry leader **Visa** (NYSE: V) has most of the world left to conquer.

We like Visa for many of the same reasons we like MasterCard. And with the recent acquisition of Visa Europe, the company will be adding 523 million card accounts that resulted in 38 billion transactions and $1.67 trillion in point-of-sale spending last year. For the fiscal third quarter, revenue was up 3% year-over-year, primarily because of foreign-exchange headwinds and slow global growth. Management is guiding for 7% to 8% revenue growth for the full year.

Having closed on its acquisition of Visa Europe, the company can start taking advantage of some of the deal's long-term benefits, such as greater scale, increased market share, and growth in free cash flow (FCF). Visa has also formed a key partnership with PayPal, under the terms of which PayPal will no longer steer users toward paying with a bank account (and not Visa), and in return Visa will allow users to pay with PayPal in any stores that have Visa contactless payment technology. We like this deal, which both shows Visa's entrenched position and negotiating leverage and also effectively turns a major competitor into a financial partner; with the bank-account obstacle removed, we think more customers will likely pay with a credit card in order to build up points. Management has repurchased $5.5 billion of stock so far this year, with an authorization to buy back an additional $7.3 billion. After taking on $16 billion of debt to fund the Visa Europe acquisition, the company has net debt of about $7.1 billion, which is equal to about one year of FCF.

Visa is valued at about $195 billion, and given its tiny market share, its ceiling should be much higher than that. It fits into *Pro* as a recurring-revenue business that invests its free cash flow in more growth at still higher rates of return, making it a compounding vehicle.

Pro Catch-Up Trades: August 15, 2016

Published Aug 15, 2016 at 3:48PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **MasterCard** (NYSE: MA): Buy 4.3%% if you haven't yet. (See our earnings update.)
- **Wells Fargo** (NYSE: WFC): Buy up to 4.3%.
- **FactSet Research** (NYSE: FDS): Buy 2.1%.

Continue building your portfolio with our Buys, including these highlighted today:

- **Visa** (NYSE: V): Buy 2.4%. (See our earnings update.)
- **Starbucks** (NASDAQ: SBUX): Buy up to 3.3%.

Shorts:

- **Pier 1 Imports** (NYSE: PIR): Sell short 0.7% to start (see our recent trade alert).

Options:

- **Gilead Sciences** (NASDAQ: GILD): Sell to open October 2016 $85 calls, one for every 100 shares you would like to cover (as expiration gets closer, we accept what the market is willing to pay). See our recent trade alert.
- **Skyworks Solutions** (NASDAQ: SWKS): Sell to open September 2016 $70 calls, one for every 100 shares you would like to cover. See our recent trade alert.

Hedges:

- No updates.

Options expiring next:

- **Gentex** (NASDAQ: GNTX): September 2016 puts. Gentex shares are trading at $18.28, well above our $15 strike. With 32 days remaining, these puts are on track to expire as income.
- **Skyworks Solutions** (NASDAQ: SWKS) and **Valmont Industries** (NYSE: VMI): September 2016 covered calls. These contracts still have 32 days to go, so we'll issue updated guidance as we approach expiration.

The Human Side of Investing

Published Aug 15, 2016 at 3:46PM

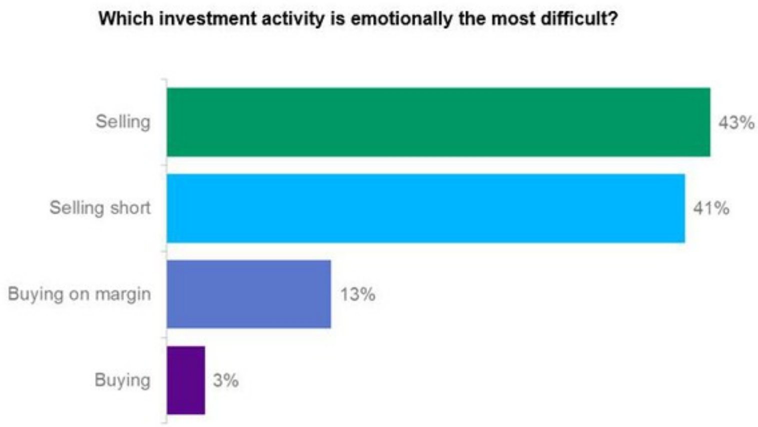
Fellow Fools,

We humans are complicated animals. That's becoming ever more apparent to me as the parent of two young children, for whom every emotion seems to be magnified to the *n*th degree. If you ask my five-year-old daughter about her day, a good day is often "the best day of her life" and a bad one quickly spirals into a tear-filled "worst day ever." It has taken me awhile to learn that it's much more effective to meet these emotional outbursts with validation rather than trying to insert my own rational perspective.

With the exception of their teenage years, I expect my kids' mood swings to moderate over time, but we adults know there's no escaping our emotional vicissitudes. Even for the most dispassionate among us, these whirlwinds of emotion remain into adulthood to some extent, adding color to our personal lives -- and heavily influencing our financial lives. In other words, our emotions are a feature, not a bug in the system. For that reason, I thought it might be worthwhile to provide some validation for those *Pro* Fools out there who find themselves caught on the occasional roller coaster of feelings when it comes to making investment decisions.

Don't Worry, It Isn't Just You

An article on the CFA Institute's blog, titled "Feeling Machines: The Emotional Cost of Buying and Selling," caught my attention recently. To be honest, the article itself isn't too exceptional, but what did turn my head were the following survey results from more than 700 readers of the CFA Institute's Financial NewsBrief who were asked to rank their investment activities based on the emotional difficulty they associate with them.



Source: CFA Institute blog, *Feeling Machines: The Emotional Cost of Buying and Selling*

These results shouldn't be surprising to anyone who's tried managing their own investments for any period of time. If anything, it should be reassuring that a large group of likely well-trained financial professionals (I doubt many others subscribe to the Financial NewsBrief) also fall victim to the same emotional biases as the rest of us.

At *Pro*, these less pleasurable investing activities are an everyday fact of life. With our mandate of managing a fixed amount of capital in pursuit of North Star-besting returns, selling existing positions or engaging in selective short-selling can be critical tools as we manage risk while trying to maximize returns. Most of us go out of our way to avoid negative emotions, so it's little surprise that the vast majority of the investing media spends a lot more time talking about which stocks to buy rather than which to sell or (gasp) sell short. At The Motley Fool's 2016 FoolFest, then-*Pro* analyst JP Bennett hosted a fantastic presentation highlighting the challenges investors face when deciding to sell a position.

Also, Jeff has written at length about the ins and outs of shorting, including this great Memo from a couple of years back. We currently only have a few short positions in the *Pro* portfolio, but those positions often cause a disproportionate amount of angst among our members -- whether or not they ultimately perform as expected. As you can see from the survey results above, that response to shorting is perfectly natural. Fortunately, there's also the *Pro* Community, which is a powerful tool in such circumstances, allowing you to share your feelings and get thoughtful responses from like-minded Foolish investors.

The *Pro* Bottom Line

First and foremost: Know thyself. We'd love for all of you to follow all of our trades if you'd like to match our returns over time, but every Fool should also draw a line in the sand if certain strategies keep them awake at night. After all, you can't win if you don't stay in the game. There are many ways to use your *Pro* service successfully. Many members pick and choose a combination of our long, short, and option trades that best suits their individual needs and investing temperament. Others follow every trade and match our allocations precisely.

And remember, it's good to be a little bit uncomfortable when investing. In the words of Warren Buffett, "you pay a very high price in the stock market for a cheery consensus." The fact that investing is difficult should be encouraging. If it were easy, then everyone would do it well, and any profits would be spread thin. Embrace those emotions. They are what create the cycles of fear and greed that drive the market and create pockets of opportunity for patient, rational investors to exploit over time.

Foolish best,

-- Jeremy (TMFTank)

Pro Guidance Changes

- None in the past week.

Pro Completed Trades

- **Gilead Sciences (Nasdaq: GILD):** We sold to open October 2016 $85 calls, collecting $1.15 each, writing nine contracts to cover all our shares.
- **Skyworks Solutions** (Nasdaq: SWKS): We sold to open September 2016 $70 calls, collecting $1.24 each, writing twelve contracts to cover all our shares.
- **Expeditors International** (Nasdaq: EXPD): We rolled our covered strangle, buying to close our August 2016 $46 put/$49 call strangle, and selling to open a November $48 put/$50 call strangle, for a net credit of $1.05.

Write Covered Calls on Skyworks Solutions

Published Aug 10, 2016 at 2:25PM

Is this for you? This recommendation is for *Pro* members who own at least 100 shares of Skyworks Solutions, and who wouldn't mind capping upside on the shares in return for near-term income.

How You Participate

- **Trade:**
  - Sell to open September 16, 2016 $70 calls on **Skyworks Solutions** (NASDAQ: SWKS)
- **Allocation:** Write ("sell to open") one call for every 100 shares of the stock you own and want to cover. *Pro* will cover all 1,200 shares we own, representing 3% of the portfolio.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a **limit order** to split the bid/ask price spread at going prices. Aim for as close to a 1% yield (that's option premium / current price of the stock) per month, accepting a bit less if need be.
- **Prices** (11 a.m.):
  - **Skyworks Solutions:** $66.30
  - September 16, 2016 $70 call (bid/ask): $1.05/$1.10.
  - So, $1.08 is a 1.6% yield on $66.35 in 37 days.

Skyworks Solutions (SWKS), 3% stock allocation, Buy rating

We have a 30% gain on Skyworks in about two years of ownership — more including the dividend — so it has been a strong performer for us. But it has also been volatile. It was above $100 for a while before falling back to the $60s. Most newer members are likely underwater on it so far. Now looking for another round of icome, it's still OK to write covered calls in that case, since you shouldn't anchor on your cost basis. These covered calls have a strike price that's lately 5.5% above the share price, and the option pays us another 1.6%.

We seek to make an optimal decision on the current condition, and writing short-term calls on this chipmaker (as we did this spring) may bring us some income and increase our return on it this year. Trading at 11.4 times one-year ahead estimates. Skyworks is priced like a typical chip company, even though its financials are far better than average. But until the uncertainty surrounding iPhone and smartphone sales subsides, the stock may be volatile and rangebound, a situation options can usually capitalize on. These options will expire well before the October earnings report.

The *Pro* Bottom Line

Given *Pro*'s goal of earning monthly income by writing options, our hope is that this position will result in additional income in September. If you don't own 100 shares, don't sweat it. The income is nice, but owning quality stocks, in any amount, is the first priority of a long-term investor.

There are no alternative trades today. If you can't write covered calls on your shares, simply continue to own the stock. Skyworks Solutions remains Buy rated.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium it pays us. The total combined gain is the call strike plus plus the premium received.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up**: We hope to see this covered call expire for income, and then decide our next course of action. If we need, we may roll it higher. We may also let the shares get sold (if it comes to that) and write puts if we want to maintain exposure to the company.

Options Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the SWKS board.

Write Covered Calls on Gilead Sciences

Published Aug 10, 2016 at 11:03AM

Is this for you? This recommendation is for *Pro* members who own at least 100 shares of Gilead Sciences, and who wouldn't mind capping upside on the shares in return for near-term income.

How You Participate

- **Trade:**
  - Sell to open October 21, 2016 $85 calls on **Gilead Sciences** (NASDAQ: GILD)
- **Allocation:** Write ("sell to open") one call for every lot of 100 shares of each stock you own. *Pro* will cover all the 900 shares of Gilead that we own, representing 2.7% of the portfolio.
- **Price Guidance:** Prices will change as the underlying stocks move, but use a **limit order** to split the bid/ask price spread at going prices. Aim for as close to a 1% yield (that's option premium / current price of the stock) per month, accepting a bit less if need be.

- **Prices** (11 a.m.):
  - **Gilead Sciences:** $79; October 21, 2016 calls (bid/ask): $1.25/$1.27. So, $1.26 pays 1.6% in 72 days. This is a bit lower than wished, but OK with the strike price 7.6% above the share price.

What We're Thinking

Writing covered calls in this case on a strong but struggling business, we're working to generate (or at least improve) returns on the position while we await a recovery, in the aftermath of this earnings season. Though we're risking missed upside on the shares if the stock rises far beyond our call stock price, we think the potential payoff is worth the risk.

Gilead Sciences (GILD), 2.7% stock allocation

Gilead's giant Hepatitis C sales have likely peaked; year over year, revenue from the franchise declined sharply last quarter, and management said peak sales may have been realized. The drugs should remain a cash cow franchise for years to come, though, with (by far) most Hepatitis C patients still untreated. Shares are extremely cheap at less than 7 times earnings, but the market is skeptical that Gilead can grow any year soon — and, barring a major acquisition, that's probably true.

In the past, management has grown through acquisition, and it likely will again. They may even make a purchase by the end of this year. But for now, we're comfortable targeting income on the stock. Our calls have a strike price that's lately 7.6% higher than the share price, and pay us 1.6% in 72 days. Lacking real gains on the stock, if we lose shares, there isn't a tax issue to consider. But if Gilead does increase for good reason, we'd likely aim to roll our calls higher, or close them.

The *Pro* Bottom Line

Given *Pro*'s goal of earning monthly income by writing options, our hope is that this position will result in additional income in October. If you don't own 100 shares, don't sweat it. The income is nice, but owning quality stocks, in any amount, is the first priority of a long-term investor.

There are no alternative trades today. If you can't write covered calls on your shares, simply continue to own the stock. Gilead Sciences remains Buy rated.

More That Matters

- **Maximum gain:** The stock's upside is capped at our call strike price, and the potential gain on the covered call is the premium it pays us. The total combined gain is the call strike plus plus the premium received.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up**: We hope to see this covered call expire for income, and then decide our next course of action. If we need, we may roll it higher. We may also let the shares get sold (if it comes to that) and write puts if we want to maintain exposure to the company.

Options Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions, please visit the GILD board.

Facebook's Future Spelled Out

Published Aug 8, 2016 at 4:00PM

Dear *Pro* member:

The *Pro* portfolio struck a new all-time high on Friday, up 6.9% on the year, in line with our North Star, and keeping our returns "index-topping" the last one, two, three, five, and eight years (or since inception). Looking ahead, our three-, five-, and 10-year goals aim for continued strong returns with (ideally) fewer mistakes and as little turnover as feasible.

Some of us are at a stage in life where the biggest long-term goal we have is to simply enjoy each day. That's fortunate! Others have three-, five- and 10-year plans laid out. Strong companies make long-term plans, too, and out of all the companies I follow, **Facebook** (NASDAQ: FB) is the best at revisiting the topic every quarter.

Our largest holding at 6.6%, Facebook has three-, five- and 10-year plans that have been consistent for years, and are all in motion at once. They are:

- **Three years:** Continue to build the community and help people share more of what matters to them.

- **Five years:** Build its products into full ecosystems with developers and business.

- **10 years:** Build new technologies to help everyone connect in new ways (4 billion people, more than half the planet, are not yet online).

Within these plans are several initiatives. For examples: Facebook believes that within five years, most online content-sharing will be video, so it's building for that. Artificial Intelligence and virtual reality are in the early stages of consumer use. Facebook's new DeepText learning-based engine can understand the context of several thousand posts per second in 20 different languages. About 1 million people a month are using Oculus Rift on mobile phones, and demand for the new VR headset is growing.

Helping fulfill its plans, Facebook has several growing product platforms:

- **Facebook:** 1.7 billion people use it monthly, and 1.1 billion daily (daily user numbers are up 17% compared to last year). Facebook added more than 200 million users the last 12 months, its best absolute growth in more than three years. Average time spent on the site per user increased by more than 10% this quarter (largely thanks to video).

- **Instagram:** The photo- and video-sharing site now has more than 500 million monthly active users, and more than 300 million daily.

- **Messenger:** For the first time, more than 1 billion people use Messenger every month. It isn't monetized yet.

- **WhatsApp:** More than 1 billion people use WhatsApp each month. Not yet monetized.

- **Search (mostly on Facebook so far):** 2 billion searches a day, and this "product" is also not being monetized.

Across these properties, Facebook has three phases. They are:

- **Phase 1:** Grow the user base and engagement.
- **Phase 2:** Grow organic interactions between businesses and consumers.
- **Phase 3:** Build the commercial opportunities.

To give you an idea of the scale Zuckerberg wants on each product line, Messenger now achieves 1 billion organic interactions between businesses and consumers each month. Despite that milestone, the company is still in the "incredibly early" stages of thinking about monetizing it. Messenger is really still in phase 2, building the organic interactions. Only Facebook and recently Instagram are in phase 3.

As Facebook builds its giant consumer-driven platforms, businesses flock to them like birds to the largest bird feeder on the planet. About 60 million businesses now have a page on Facebook. Yet fewer than 4 million are advertising so far. More than 30% of small and medium-sized businesses in the U.S. don't have a website at all. For them, Facebook has made launching one on its site easy.

On the commercial front, Facebook has still another framework in place, with three priorities:

- Capitalize on the shift to mobile.
- Grow the number of marketers using its ad products — offering a simple, quick ad interface (which more than 80% of new advertisers use at first) to detailed, targeted ads.
- Continually make the ads more relevant and effective.

For savvy advertisers, Facebook is a potential goldmine. The size and engagement of the community means that even an ad targeting a specific demographic can reach 300,000 or more people.

This sort of advertising power is driving record financial results. Last quarter, advertising revenue jumped 63% to $6.2 billion, with the strongest growth rates in the lucrative North America and Asia-Pacific regions. Some 84% of advertising revenue was on mobile. Profitability levels at Facebook grew more than expected, and CFO David Wehner was able to lower guidance for expected *spending* this year on the top end of the range.

At its current price around $125, Facebook trades at 50 times free cash flow and 28 times estimated earnings for the year ahead. Some near-term risks include more challenging year-over-year growth comparisons the rest of this year, and the likelihood that ad loads (the number of ads shown per user experience) will flatten out after mid-2017, taking away one recent growth driver. Presumably, new drivers across the business will be unfolding.

We're in the process of updating our fair-value estimate, but the stock remains a **Buy First** here. Newcomers may wish to buy in thirds or halves, since Facebook is our largest holding; or, you can consider selling to open put options to target a lower buy price on some shares.

In its conference calls, different members of the management team fluidly access the same frameworks outlined above in their comments and answers, showing a team on the same page. Another strong quality of Facebook: It can largely control its own fate as long as it can maintain traffic engagement (which draws in still more users and advertisers). Unlike many investments, Facebook won't be derailed by falling commodity costs, sudden competition at scale is unlikely, and technology improvements will likely work in its favor, not against it.

Please visit the Facebook board if you have any questions or comments, and thank you for being a *Pro* Fool!

-- Jeff (TMFFischer)

Pro Guidance Changes

- None in the past week.

Pro Completed Trades

- **Valmont Industries** (NYSE: VMI): We sold to open September 2016 $135 calls, collecting $1.40 each, writing four contracts to cover all our shares.

Pro Catch-Up Trades: August 8, 2016

Published Aug 8, 2016 at 4:00PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio. Some highlights:

- **Facebook** (NASDAQ: FB): Featured in today's Memo. Buy up to 6.6% if you haven't yet. If starting out, consider buying in portions over time.

Keep building your portfolio with our Buys, including these highlighted today:

- **Oracle** (NYSE: ORCL): Buy 3.7%.
- **Visa** (NYSE: V): Buy 2.4%.

Shorts:

- **Pier 1 Imports** (NYSE: PIR): Sell short 0.75% to start (see our recent trade alert).

Options:

- **Valmont Industries** (NYSE: VMI): Sell to open September 2016 $135 calls, one for every 100 shares you would cover (as expiration gets closer, we accept what we get paid). See our recent trade alert.

Hedges:

- No updates.

Options expiring next:

- **Expeditors International** (NASDAQ: EXPD): Our August $46/$49 covered strangle expires in 11 days. Time value is nearly gone, so we'll be rolling the strangle. See today's trade alert.

Roll Your Covered Strangle on Expeditors International

Published Aug 8, 2016 at 3:30PM

Is this for you? This is only for *Pro* members who have an existing income position on **Expeditors International** (NASDAQ: EXPD) and currently in-the-money call options expiring August 19. Those not yet in this position can check out Alternative Trades at the end of this report to start a partial position (writing puts) or wait and watch our future *Pro Catch-Up Trades* each Monday, where we'll guide you into the entire position if pricing improves for newcomers.

How You Participate

- **Actions:**
  - **Closing old position:** Buy to close all existing August 2016 $49 calls. You may also buy to close all existing August 2016 $46 puts for mere pennies, or leave them be to expire August 19 (if you do wait, do not write new puts until these expire). Leave your 2017 synthetic long alone.
  - **Opening new position:** Write a new covered strangle. Sell to open November 2016 $48 puts and sell to open November 2016 $50 calls. Sell one of each for every synthetic long you have already set up (or every 100 shares of stock you own).
  - **Allocation:** Approximately 1.9% look-through exposure on the synthetic long plus an additional 1.8% exposure through your short puts in the strangle for 3.7% total exposure to Expeditors International. Each synthetic covered strangle at today's price represents about $10,000 in exposure to the stock. So, for 3.7% exposure, set up one synthetic covered strangle (one each of all four options involved) for approximately every $270,000 you're managing. *Pro* has 10 contracts of each option in the synthetic long, and then in the written strangle, too.
- **Prices and Guidance (12:45 p.m.):**
  - **Stock:** $50.90
  - **Options:**
    - **Close old strangle (or you can roll your entire strangle, combining these two orders):**
      - Buy to close August 2016 $49 calls, lately about $2.10 (splitting the bid/ask). Aim to pay as little time value as possible to close these calls.
      - Buy to close August 2016 $46 puts, lately $0.05 (or leave these alone to expire August 19, and write your new puts then).
      - Combined: **About a $2.15 debit**
    - **Write new covered strangle:**
      - Sell to open November 2016 $48 puts (bid/ask): $1/$1.10.
      - Sell to open November 2016 $50 calls (bid/ask): $2.70/$2.75.
      - Combined splitting the bid/ask: **About a $3.75 credit**
  - **Total price to roll:** About **a $1.60 credit**
  - Close your old positions using a limit order at current pricing, paying as little time value as possible. Write the new strangle using a limit order of about $3.75 in credit. As prices change, ideally accept no less than $3, or about 6% on the current share price in just more than three months to expiration. Later, aim for a 2% yield on the current share price per month to expiration.
    - **Timing:** As as long as Expeditors International remains above $50, aim to close your August $49 calls soon, to avoid being exercised a bit early. Time value is nearly gone.

What We're Thinking

Shares of our overseas shipping facilitator, Expeditors International of Washington, remain an income position here in *Pro*. We are comfortable having exposure to the shares (currently through a synthetic long, which mirrors share ownership without requiring us to pay out capital) and writing put and call options to target income. Since *Pro*'s inception in 2008, Expeditors has had a recurring presence in the portfolio, generating returns.

After a record 2015, earnings at the Seattle-based operation have been flat so far in 2016, as expected. The stock has drifted higher and still fetches a reasonable valuation. We believe this well-run business will continue to deliver respectable results, even if world trade volume slows marginally. Meanwhile, the stock is as reasonably priced as it has been in years, now trading at 21.3 times earnings and 15.5 times free cash flow.

Asia trade accounts for about half of the company's revenue. But, of course, many of China's exports are shipped to North America and Europe. This gives the business some breathing room even when China's domestic economy (including imports) slows, as it's currently doing. Although this year could remain choppy, that uncertainty adds to the option premiums we collect, aiding our income strategy.

Why This Strategy?

Although it's a highly profitable, expertly managed niche business in an attractive service space, Expeditors is not on the radar of the average investor. Its valuation is reasonable, and its options pay well. Not expecting a surge in earnings, we're content to keep covering the position with calls, in this case, with in-the-money calls (our only other option right now would be to write $55 calls rather than $50, and those don't pay well).

Given the premiums on the options, we're able to roll our calls up $1 in the strike price, from $49 to $50, and still do so at a credit, even though we're rolling forward only a modest three months. We'll have one more potential roll in November, and by January 2017, we may turn our synthetic long into stock — or set up another synthetic long if we want to keep the position going. Time will tell.

More That Matters

- **Maximum loss:** The same as owning at least 200 shares of stock (100 now, and 100 at $48), minus the option premiums received.
- **Maximum gain:** This new strangle caps our upside at $50, plus the combined option premiums received. The most we can make on this strangle alone is the $3.75 or so in premium paid to us (ignoring that it was a roll, which is a sunk cost); that's earned if the stock is between $48 and $50 by expiration.
- **Follow-up:** In November, we'll weigh our options heading into our January 2017 expiration, likely writing one more round of options expiring January.

Alternative Trades

- **If you simply wrote covered calls last time and want to keep doing that:** Roll your August $49 calls to November $50 calls. Lately, this pays about a $0.60 credit.

- **If you simply wrote puts last time and want to do so again, or if you're new and simply want to write puts:** Your old puts are expiring as income. As they do, sell to open November 2016 $48 or $49 puts (newcomers can do so anytime), selling one for every 100 shares you would buy, up to a 3.7% potential allocation. Note: These puts pay less than our desired 1% per month right now, but they're the best options available.
- **If you're new and simply want to write covered calls (the IRA-friendly alternative!):** With the stock above $50 and $50 calls being the most viable ones to write, we don't recommend setting up this particular position right now.
- **If you're new to *Pro* and want to participate in the full new position:** We recommend waiting and watching *Pro Catch-Up Trades* every Monday. We'll include Expeditors if pricing improves a bit for newcomers.

Pro Can Help

- **Want more on this strategy?** See our guides to covered strangles and synthetic longs. We're combining the two into a synthetic covered strangle.
- **Questions?** Please ask, Fools! Ship yourself on over to our Expeditors board. We can all help you, especially if you're new!

Gentex's Results Reflect Healthy Growth

Published Aug 7, 2016 at 3:23PM

***Pro*'s Take: GNTX Q2-2016 Earnings**

Gentex (NASDAQ: GNTX)

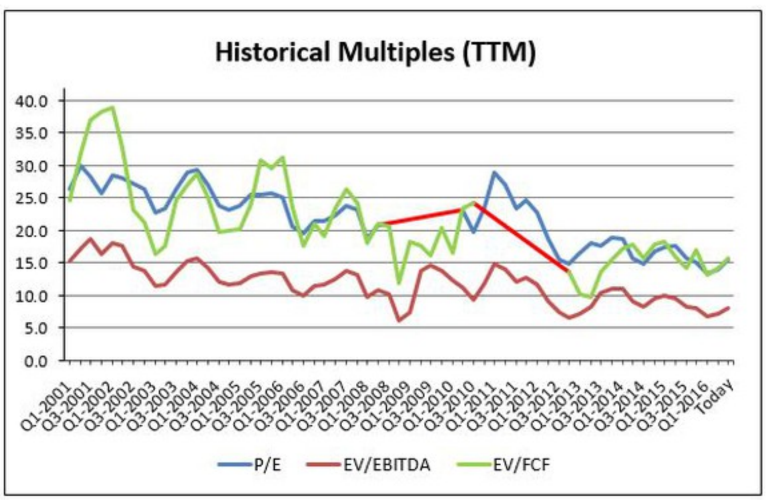
What Happened?

- Q2-2016 press release

Guidance Update

After incorporating this quarter's results into my model, **our Fair Value increases to $19 per share.** The market was pleased with this quarter's report, and the stock price is up almost 10% since the day before the report, nearing levels not seen since early 2015. The stock is about 7% below our newly updated fair-value estimate, and **Gentex remains a Buy First** on our scorecard.

At about 15.5 times trailing-12-month earnings and 8 times EV/EBITDA, despite the recent stock price increase, the stock is still trading near the low end of historical valuation multiple ranges despite a robust balance sheet, steady operating performance, and continued success in market penetration and organic growth. If you've yet to start a position or fill out your stock allocation in Gentex, now is a great time.



Note: Red lines represent omitted outlier multiples that correspond to recession-depressed earnings and free cash flow levels.

We also have a 1.4% look-through allocation in September 2016 $15 written puts. After the earnings bounce, those puts are on track to expire fully as income (as did our four prior iterations of Gentex puts), although we are still more than a month away from expiration. If you've yet to match our written put allocation, I would wait until the current round of puts expire in September to see if we reup our strategy. If we choose to write new puts, you can match us then.

Updated Guidance: Buy First (no change)

Recommended Allocation: 2.9% with a 1.4% look-through allocation in September 2016 $15 puts

Fair-Value Estimate: $19 (up from $18)

Current Price: $17.70

Our Thesis

Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1) Penetration: Unit growth vs. auto production. Over time, we want to see Gentex's auto-dimming mirrors to continue to gain market share. If the company is increasing units sold faster than auto production, it is moving in the right direction. Quarterly global interior mirror unit volumes grew strongly to +15.1% year-over-year growth (accelerating from +13.6% a quarter ago) vs. ~3% year-over-year growth in auto production in the company's primary markets, showing that Gentex continues to significantly outpace vehicle production growth and capture market share. Q2-2016 interior units sold in North America decelerated to +6% (from +11.6% last quarter) and Q2-2016 international interior units increased +20.6% (up from +14.7% last quarter).

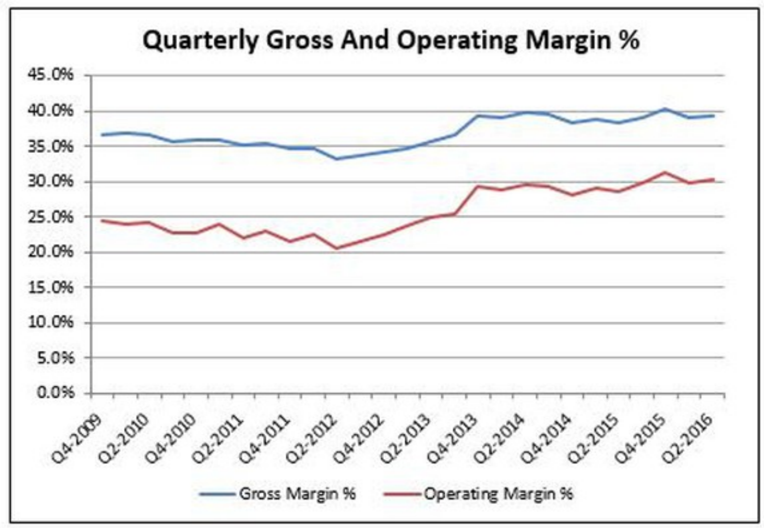
Exterior mirror unit shipments have taken a breather after a scorching 2015, with Q2-2016 exterior unit volumes up +9.2% in North America (vs. +16.8% last quarter) and +8.8% internationally (vs. +0.4% last quarter). Due to lower exterior unit growth relative to interior unit growth, the exterior mirror attach rate declined to 38.1% (i.e. 38.1% of cars equipped with interior units also were equipped with exterior units), compared with 40.3% a year ago. Exterior unit growth in 2016 will likely continue to lag 2015's growth rates as demand builds back up, but the overall trajectory of exterior unit growth is sound and market penetration continues.

2) Pricing and value: Unit growth vs. automotive segment sales. Powerful auto makers force annual price concessions on their suppliers, and Gentex isn't immune. Price reductions have recently been in the range of 2.5% to 3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices (ASPs) and gross margins.

In Q2-2016, total units (interior + exterior mirrors) increased +15.1% and automotive segment sales were up +11.9%. This dynamic suggests lower ARPU (average revenue per unit) and is consistent with the expectation of annual price concessions.

3) Margin performance. In Q2-2016, gross margin was 39.4%, up from 38.4% a year ago as annual price reductions were more than offset by purchasing cost reductions and favorable product mix. Management raised the low end of its gross margin guidance range for full year 2016 margins to 39%-39.5% (up from 38.5% at the low end previously), and the company has done a great job keeping margins up through the first half of 2016.

Q2-2016 operating margin performance was 30.4% (vs. 28.5% in Q2-2015). Selling, general, and administrative (SG&A) and research and development (R&D) expenses came in within normal ranges and are consistent with recent trends:



What We Think Now

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

If you have questions, drive on over to the Gentex discussion board.

TD Ameritrade's Steady Growth Continues

Published Aug 7, 2016 at 11:51AM

Pro's Take: AMTD Fiscal Q3-2016 Earnings

TD Ameritrade (NASDAQ: AMTD)

What Happened?

- Fiscal Q3-2016 press release
- Fiscal Q3-2016 earnings presentation
- Fiscal Q3-2016 earnings call transcript

Guidance Update

After incorporating this quarter's results into our model, **our Fair Value estimate remains unchanged at $35**. Positive operational momentum was offset by slightly lower expectations surrounding interest rates. The valuation does assume a slow increase in interest rates over the next several years, so in the absence of that occurrence, the company may be challenged to grow earnings and the stock price may stagnate. The stock has been quite volatile this year, swinging between extremes as market sentiment on financial stocks has fluctuated (exacerbated by Brexit).

Updated guidance: Buy (no change)

Recommended Allocation: 2.4%

Fair-value estimate: $35 (unchanged)

Current price: $31.36

The Numbers

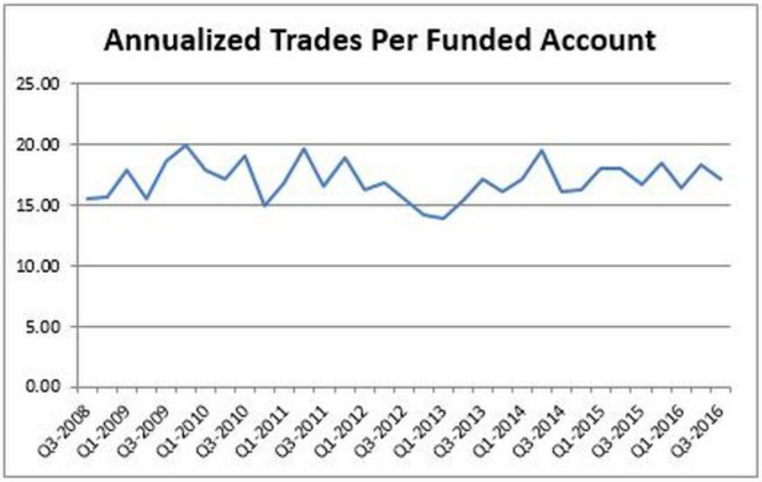
- Net revenue of $838 million (+5.5% year-over-year)
    - **Transaction-based**:
        - Funded accounts grew to 6.87 million (+4.9% year-over-year)
        - Trades per funded account of 4.31 (vs. 4.59 last quarter vs. 4.17 a year ago)
        - Average commissions and fees per trade of $11.72 (vs. $11.60 last quarter vs. $12.01 a year ago)
        - Totals up to:
            - 6,872,000 x 4.31 x $11.72 = **$347 million** in transaction-based revenue (+5.8% year-over-year)
    - **Spread-based**:
        - Total spread-based revenue of **$377 million** (+3.3% year-over-year)
        - Average spread-based balance of $106.1 billion (+11.3% year-over-year)
        - Thus, Net Interest Margin (NIM) =
            - $377 million / $106.1 billion = 0.355% (quarterly)
            - NIM (annualized) = 0.355% x 4 = 1.42% (vs. 1.44% last quarter vs. 1.53% a year ago)
    - **Fee-based**:
        - Fee-based revenue of $96 million (+12.9% year-over-year)
        - Average fee-based balance of $162.1 billion (+0.5% year-over-year)
        - Thus, Investment Product Fee Yield =
            - $96 million / $162.1 billion = 0.059% (quarterly)
            - Investment Product Fee Yield (annualized) = 0.059% x 4 = 0.237% (vs. 0.230% last quarter vs. 0.211% a year ago)
- Record client assets of $736 billion (+4.8% year-over-year)
- Record interest rate sensitive assets of $113 billion (+10% year-over-year)
- Net new client assets* of $13.6 billion (8% annualized growth rate)
- Record diluted EPS of $0.45 per share (+26% year-over-year)
- Trailing-12-month (TTM) average return on equity (ROE) of 17.5% (up from 16.7% a year ago)
- Capital management:
    - Paid $0.17 per share in cash dividends in the quarter (a 2.3% yield on the current share price)
    - Repurchased approximately 1.7 million shares of its common stock at an average share price of about $28.82 per share ($49 million)

*excludes changes in client assets due to market fluctuations

Analysis

TD Ameritrade continues to gather client assets at a steady pace despite a volatile market. In Fiscal Q3-2016, net new assets (NNAs) were up $13.6 billion, a 7.6% annualized growth rate relative to total client assets at the beginning of the quarter. The company's Fiscal 2016 and long-term goal is to grow net new assets at a rate between 7-11%, and this quarter is within that range.

Trading activity was more muted this quarter compared to last quarter, with just one day in the quarter where intraday volatility eclipsed 2%, compared to 16 such days last quarter. The company averaged 462,000 client trades per day this quarter, up 6% year-over-year:

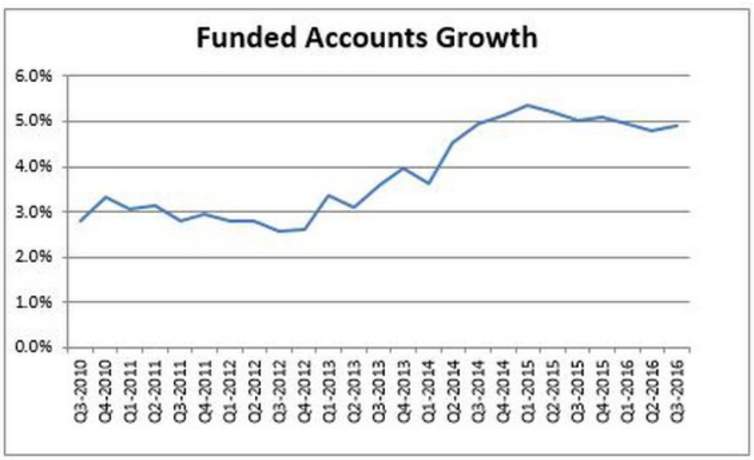


Average commissions and fees per trade came in at $11.73, which is up +1% sequentially and down -2.5% year-over-year:

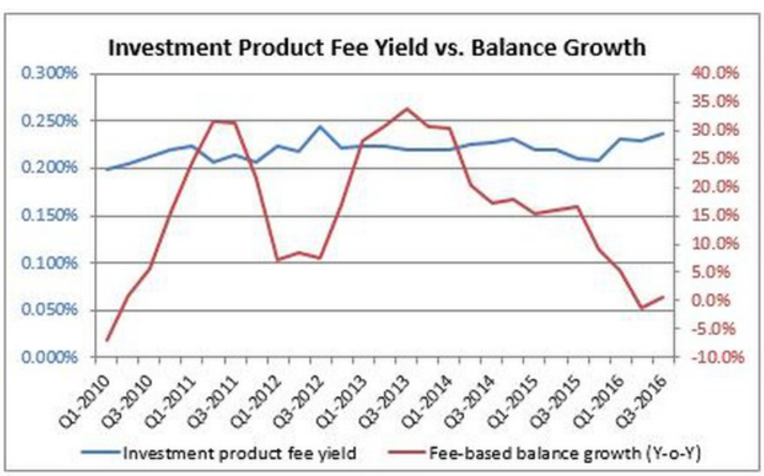
Notably, in the conference call, management finally conceded that "continued price competition" is playing a part in pressuring commission rates, as opposed to focusing on product mix to explain the trend. I wrote last quarter:

> *"I'm not convinced that mix is the predominant factor in reduced commission rates. The metric is probably also influenced by the emergence of very low-cost brokers (e.g. Robinhood, Interactive Brokers)."*

I am glad that management is now willing to admit that price competition is playing a part in the decline in commission rates. However, this is not too much of a concern in terms of our assessment of the business, as our valuation assumes a steady decline in commissions and fees per trade over the next ten years. In the short-term, the transaction-based revenue stream will likely continue to bounce around, varying based upon product mix, market volatility, and fluctuations in the commission rate. But over the long run, steady account growth (a 4.4% CAGR over the last 8+ years) has led to persistent upward pressure on transaction-based revenue, and that trend seems likely to continue:



The fee-based segment of the business had a good quarter, with fee-based revenue up +12.9% year-over-year. The company's average fee-based investment balance during the quarter was a record $162.1 billion. Higher investment balances and a higher investment product fee yield led to the strong growth seen in this segment:



What We Think Now

TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and as interest rates increase, the company is positioned to grow earnings sharply.

If you have questions, post them on our [TD Ameritrade discussion board].

Papa John's Continues to Deliver

Published Aug 4, 2016 at 11:26AM

Pro's Take: PZZA Q2 Earnings

Papa John's International (NASDAQ: PZZA)

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Q2-2016

Total revenue growth: +6% (vs. +4.8% in Q2-2015)

Operating profit margin: 8.7% (vs. 7.8% in Q2-2015)

EPS growth*: +24.8% (vs. +22.5% in Q2-2015)

Domestic comparable store sales: +4.8% (vs. +5.5% in Q2-2015)

International comparable store sales: +5.3% (vs. +6.8% in Q2-2015)

....

*EPS growth is adjusted for a non-recurring legal settlement expense recorded in Q2-2015

Quarter Quick Take

Papa John's turned in a strong Q2-2016, continuing its successful formula of sales growth, expanding margins, and share buybacks. The company delivered growth of 24.8% in earnings-per-share (when adjusted for a non-recurring legal settlement expense) due to higher global restaurant sales growth (+5.9%), expanding operating margins (8.7% in Q2-2016 vs. 7.8% in 2Q-2015) and continued share buybacks (the company has reduced its diluted share count by 6.7% since the same quarter last year).

It's been almost a year since *Pro* trimmed its Papa John's position by one-third via covered calls (selling at a net $68.40 per share), and the past year has been a typically volatile one for the stock. Papa John's stock is often subjected to extreme movements in the share price. After this earnings report, the company is now trading at all-time highs, and up 75% from the year-to-date low of $44.47 just 6 months ago on February 4th. The stock trades at the mercy of market sentiment, and right now sentiment is quite high. Restaurant traffic and sales trends has been sluggish lately, and Papa John's strong comps in the second quarter again show the continued resiliency of the pizza category.

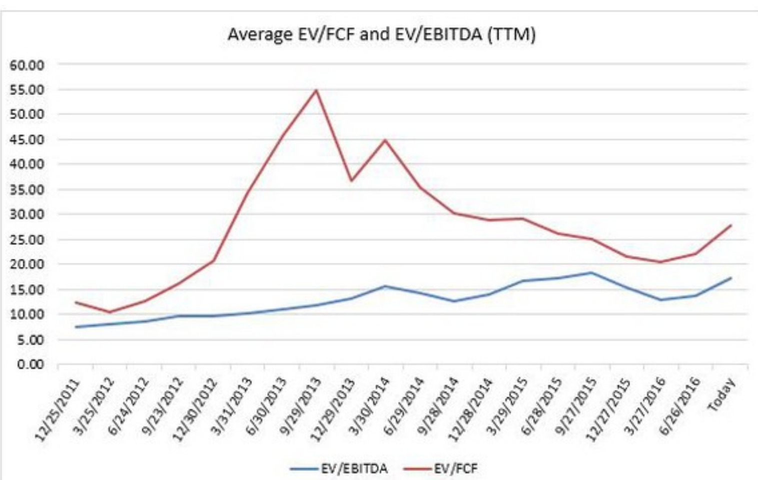
Guidance: Buy (no change)

Recommended Allocation: 3.5%

Fair Value estimate: $57 (up from $54)

Current Price: $77.80

The recent increase in the stock price has led to a corresponding increase in the stock's valuation multiples:



At $77.80 per share, Papa John's is trading at 17.2x EV/EBITDA, and 27.8x EV/FCF. For context, **Domino's** (NYSE: DPZ) trades at 20.7x EBITDA, **Dunkin' Brands** (NASDAQ: DNKN) trades at 14.5x, and **Starbucks** (NASDAQ: SBUX) trades at 16.9x:

After incorporating this quarter's results into our model and adjusting for the time value of money, **we're raising our fair-value estimate to $57 per share (from $54)**. At $77.80 per share, the stock is trading 36% above our fair value estimate. The stock remains a Buy, but those who have yet to establish a position can likely afford to be patient, as the market is building in quite rosy expectations for future growth. At this price, among all the companies I cover, Papa John's would be the one I'd be most careful about establishing a new position or increasing an under-allocation.

Our Thesis

Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main quick service restaurant (QSR) pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest market share gains in the mature QSR-pizza market.

We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only about 1,500 international restaurants the company has a long runway for growth (compare to Domino's which has over 7,300 international stores and Pizza Hut which has over 7,500 international stores). Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

1) Store Performance*:* During Q2-2015, systemwide restaurant sales increased +5.9% (+7.7% when excluding the impact of foreign currency). Domestic comps increased +4.8% while international comps increased +5.3%.

Domestic comps growth reversed course after five straight quarters of deceleration, a welcome sign. The prior deceleration was due to "extremely competitive pricing" within the category driven by a commodity environment that has been "very favorable" in terms of both cheese prices and beef prices. For a company that relies on a higher-quality brand message, lower commodity prices make it easier for competitors to undercut Papa John's on pricing.

However, this quarter, cheese pricing edged back up, easing some of the competitive pricing pressure that was seen in the first quarter. Additionally, Papa John's was much more active in Q2 with promotional offers, introducing another national sports partnership with Major League Baseball (in addition to the recently renewed partnership with the NFL and Super Bowl), new limited-time-offers, and a promotional bundle deal.

In part due to the strong performance in Q2, management raised its domestic comps guidance for full year 2016 from 2%-4% to 3%-5%. The midpoint of the new guidance range (4%) is roughly in line with what the company achieved in full year 2015.

As for international comps, the company continues to churn out mid-to-high single digit comps performance. At +5.3% for the quarter, this marks the 19th consecutive quarter of international comps above +5%:

**Shaded areas represent management's guidance ranges for full year 2016*

The company's measured expansion continued, adding 32 new restaurants (net) in the quarter and 42 so far this year -- of which 28 were international and 14 were in North America. The company now has over 1,530 international stores (up from 822 at the end of 2011, a 14.9% CAGR in units).

Management expects full year 2016 openings to come in at 180-210 restaurants, with 75% of the net unit growth in international markets. 195 restaurant openings for 2016 would represent +4% growth versus the existing store count as of the end of 2015. The company's pipeline remains healthy, with 200 domestic restaurants and 1100 international restaurants, the majority of which are scheduled to be opened over the next six years.

2) Brand: Brand strength is challenging to measure, but we need to monitor it because it is key to the company's brand-based advantages and higher price per pie. Based on recent data, which includes store growth, the domestic pizza market was about flat and the international pizza market grew about 3%-4%. So Papa John's comps (which *exclude* store growth) suggest continued market share gains at the expense of competitors. This is likely due to the company's competitive advantages related to scale (efficient advertising/distribution) and an early lead in technology (digital ordering and loyalty programs).

One way to monitor brand strength is to look at customer satisfaction. I track the yearly scores from the ACSI customer satisfaction survey, and this year's recently released results showed that Papa John's is continuing its winning ways. The company has scored the highest (or tied for highest) among its pizza chain competitors for the 16th year in the past 18, extending its streak at the top of the category to 5 straight years:

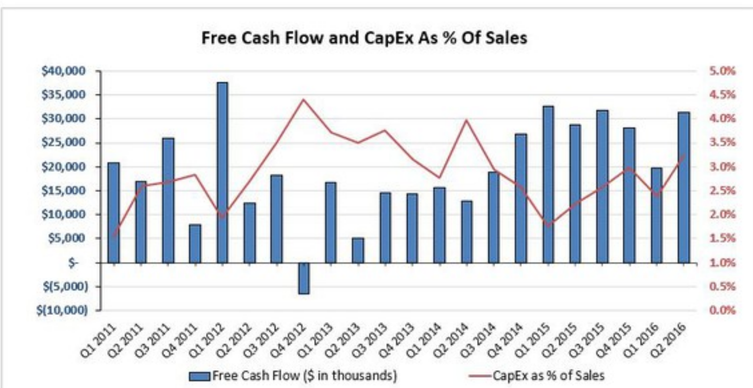
ACSI Customer Satisfaction Scores

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Papa John's	76.0	77.0	78.0	76.0	76.0	77.0	78.0	79.0	77.0	76.0	75.0	80.0	79.0	83.0	82.0	82.0	78.0	82.0
Little Caesar	70.0	69.0	70.0	74.0	75.0	74.5	74.0	77.0	75.0	75.0	75.0	78.0	80.0	82.0	82.0	80.0	74.0	81.0
Domino's Pizza	67.0	69.0	73.0	75.0	75.0	73.0	71.0	75.0	75.0	75.0	77.0	77.0	77.0	77.0	81.0	80.0	75.0	78.0
Pizza Hut	68.0	70.0	71.0	70.0	75.0	73.0	71.0	76.0	72.0	76.0	74.0	78.0	81.0	78.0	80.0	82.0	78.0	77.0
Limited-Service Rest. Avg.	69.0	70.0	71.0	71.0	74.0	75.0	76.0	77.0	77.0	78.0	78.0	75.0	79.0	80.0	80.0	80.0	77.0	79.0
Papa John's	**76.0**	**77.0**	**78.0**	**76.0**	**76.0**	**77.0**	**78.0**	**79.0**	**77.0**	**76.0**	**75.0**	**80.0**	**79.0**	**83.0**	**82.0**	**82.0**	**78.0**	**82.0**
Competitor average	68.3	69.3	71.3	73.0	75.0	73.5	72.0	76.0	74.0	75.3	75.3	77.7	79.3	79.0	81.0	80.7	75.7	78.7
Gap	7.7	7.7	6.7	3.0	1.0	3.5	6.0	3.0	3.0	0.7	(0.3)	2.3	(0.3)	4.0	1.0	1.3	2.3	3.3

When the ACSI results were released, I mentioned on the boards that there have been studies that link ACSI scores with financial and stock market performance, so it is good to see Papa John's widening its customer satisfaction edge over its competitors this year. Continued high marks in customer satisfaction are a nice plus to our investment thesis.

3) Margins: We expect Papa John's capital light business model to eventually result in higher operating margins that propels free cash flow generation. From 2014-2015, the company dealt with depressed margins and free cash flow due to the roll-out of the company's new proprietary POS system (FOCUS), which as of the end of 2015 is totally complete.

Now that the investment phase has passed, the company is enjoying higher margins and free cash flow generation, as lower capital expenditures have lifted free cash flow higher. In this graph, note the inverse relationship between capital expenditures and free cash flow; when capital expenditures are elevated, free cash flow is depressed, and vice versa:



Note that free cash flow will likely decrease a bit in 2016 as the company paid a $12.3 million legal settlement in January (in Q1-2016), and the company expects a year of somewhat elevated capital spending (guidance is for $55-$65 million in capital expenditures, up from $39 million in 2015) due to a new domestic commissary in the U.S., company-owned unit development in the U.S., investments in technology, and routine capital replacement.

The company's operating margin continues to expand as the company's sales growth (+6%) outpaced its expense growth (+4.9%). Quarterly operating margin in Q2-2015 came in at 8.7%, versus 7.8% in the same period a year ago. When we look at TTM operating margins to smooth out seasonality, the picture looks very nice:

The operating margin expansion is due in part to strong cost control, but also to a favorable commodity cost environment. Cost control gains should continue if the company continues to achieve healthy sales growth in excess of expense growth. But if commodity prices rise sharply, the current pace of margin expansion will likely slow.

What We Think Now

Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. Prior headwinds (commodity prices and technology investments) have proven to be temporary and Papa John's should continue to deliver improved financial performance.

Pro Can Help

- **Questions?** Stop by our delicious, savory [Papa John's discussion board].

Checking In on Visa and MasterCard

Published Aug 1, 2016 at 2:59PM

Fellow Fools,

It's earnings season at *Pro*, which means it's time to take a brief respite from searching for new opportunities and check in on the performance of a couple of our existing holdings. When combined, **Visa** (NYSE: V) and **MasterCard** (NYSE: MA) now account for a 6.7% allocation in the *Pro* portfolio -- about the same size as our largest holding, **Facebook** (NASDAQ: FB). Though the companies compete against each other, their future will largely be determined by similar economic forces, so it makes sense to think about them in tandem. For example:

- Both companies have announced new deals (Visa's partnership with PayPal and MasterCard's acquisition of VocaLink) that allow them access to payments and data being routed through the bank-operated Automated Clearinghouse (ACH) system, which completely bypasses the card companies' networks. These deals also give both companies exposure to the growing person-to-person transaction business led by companies like Venmo, as well as to a large number of business-to-business and government-related payments that tend to use the ACH system exclusively. According to MasterCard's management, ACH payments represent 50% of the total payments across the world's top 50 countries.
- Both companies are also experiencing legal uncertainty after the Second Circuit Court of Appeals decided to throw out a $5.7 billion class action settlement against MasterCard, Visa, and a number of large card-issuing banks. At this point, we're waiting to hear next steps from the court. It'll certainly be expensive to litigate and settle these claims, but such legal fees seems to be a regular cost of doing business. These lawsuits are evidence of the strong competitive advantage that our companies possess in the payment industry. At this point, I view these legal expenses to be an ongoing cost of doing business rather than an existential threat. I expect both card companies to gradually cede a bit of their profit margin in order to be allowed to keep the lion's share.
- Finally, both companies are working to expand their geographic footprint, most notably in China. In June, the People's Bank of China released the final regulations for foreign card networks that would like to enter the Chinese market. According to both Visa and MasterCard, the biggest challenge is navigating the cybersecurity and national security standards. While they slowly sort through the details, management at both companies is working to add new card issuers, increase acceptance by merchants, and develop the required local technology. China still represents a massive opportunity for both MasterCard and Visa, but it'll obviously be awhile before either is able to generate significant volume there.

Those are just a few of the common developments that the companies reported on this quarter. Now, let's move on to a quick review of individual results.

MasterCard (4.3% Allocation)

MasterCard beat expectations handily this quarter, posting a 14% increase in both net revenue and earnings per share. The company recently announced the acquisition of UK-based VocaLink, which expands MasterCard's presence in the UK market and, as mentioned above, also provides more exposure to payments routed through the ACH system. Management believes they have picked up a market-leading asset thanks to VocaLink's popular Fast ACH solution, and they are excited about the new transaction data they can now access to develop additional value-added services.

In addition to increasing payment volume, services like MasterPass -- which allows merchants and mobile wallet providers to use MasterCard's network to process online and mobile payments -- continue to grow in popularity. The addition of near field communication (NFC) capabilities will allow contactless payments for Android devices at more than 5 million locations spread across 77 countries beginning later this month. MasterPass is powering mobile wallets like Apple Pay and Android Pay, and MasterCard will be partnering with Microsoft for its mobile wallet solution on Widows 10 devices. All together, "Other Revenue," which also includes consulting, fraud prevention, and security services, grew by 25% for the quarter.

Despite a faster-than-expected start to the year, management still expects 2016 results to come in at the low end of their "low-double-digit" three-year revenue growth estimates. Also, as we've noted in the past few quarters, rebates and incentives are expected to increase by 20% this year, outpacing revenue growth and indicating a difficult bidding environment for both new deals and the retention of existing clients.

MasterCard remains a Buy First at a 4.3% allocation. The company is experiencing improved momentum across its business lines, and the stock should continue to perform well in the coming quarters. MasterCard remains one of our favorite investment ideas in the *Pro* portfolio. Following the strong second quarter, we're reviewing MasterCard's fair-value estimate for a possible update.

Visa (2.4% Allocation)

Visa's business continues to grow at a steady rate as the company works to integrate its large Visa Europe acquisition, which closed at the end of the quarter. Management is focused on rolling out a number of its value-added services (including Visa Checkout, Visa Token Service, and Visa Direct) to its European customers who are excited to have the added functionality. One of the analysts on the earnings call asked whether management planned to begin raising fee levels in Europe to match its competition in the region, but management tactfully avoided the question.

There's little doubt that the company will try to increase fees over time, but Visa needs to sell its new customers on the value of its ancillary services before increasing costs. Visa is also beginning to see U.S. transaction volume increase as the recently signed Costco and USAA deals ramp up. Incentives as a percentage of gross revenue increased to 19%, which shows that the company needed to offer attractive term to steal customers from the other card companies. That number is expected to grow further as the Costco program kicks in next quarter, but should settle at 18.5% for the year, at the high end of the guided range.

Visa's newly announced partnership with PayPal begins a new era of cooperation for these former competitors, and it also allows Visa access to the ACH payment world. The key benefit for Visa is that PayPal will no longer discourage users from linking their Visa cards to their PayPal accounts during the registration process. PayPal is also going to improve the quality of the data it provides to Visa to make it easier to identify fraud, track disputes, and apply loyalty rewards. In exchange, PayPal will receive incentive payments based on transaction volume; it will also have use of Visa's Digital Enablement Program (VDEP), which employs token encryption technology. This should improve the security of PayPal's mobile payment platform and increase the company's point-of-sale acceptance. PayPal's willingness to deal with Visa shows that consumers still value the ancillary services the card companies provide and demand to be able to use their Visa cards to fund payments.

There wasn't much discussion of this on the call, but as one of the corporate sponsors of the Rio Summer Olympics, Visa is about to start a large advertising campaign. Expect to see a lot of new Visa commercials and branding throughout the games, which should help to preserve the company's spot as one of the most valuable global brands.

Visa remains a Buy at a 2.4% allocation. The company is working through a number of complicated transitions with the Visa Europe acquisition and now the PayPal partnership. It may take a couple of quarters for the dust to clear, but members should feel comfortable buying shares at today's price if they don't already own the stock.

The *Pro* Bottom Line

It looks like both of our payment companies are performing well despite a number of economic and legal headwinds. Weak economies in Europe and Asia have weighed on transaction volumes, but the shift toward digital payments is continuing to gain momentum around the globe. Visa and MasterCard have been facing various lawsuits for years, and I don't expect that to change anytime soon. Over the past year, the companies have combined to generate nearly $15 billion in operating profits, which is more than sufficient to fund their legal defense. Additionally, the move to secure better access to ACH payment flows shows that management at both companies is not just resting on their laurels and cashing checks. They both continue to invest in technology and keep a close eye on where the industry is heading.

We are pleased with the progress that both companies are making in growing their business and the steps they're taking to defend their competitive position. The transition from cash to digital payments is still in its early innings across the globe, and we think Visa and MasterCard are well-positioned to capitalize on that trend.

If you have any questions or comments, please visit the Memo Musings board and/or the Visa and MasterCard boards to share your thoughts.

Foolish best,

--Jeremy (TMFTank)

Write Covered Calls on Valmont Industries

Published Jul 28, 2016 at 11:15AM

Is this for you? This recommendation is for all *Pro* members who own at least 100 shares of Valmont Industries and who wouldn't mind potentially capping upside on the shares in return for near-term income.

How You Participate

- **Trade:** Sell to open Sept. 16, 2016, $135 calls on **Valmont Industries** (NYSE: VMI).
- **Allocation:** Write ("sell to open") one call for every round lot of 100 shares of stock you own. *Pro* will cover all of its 400 shares; that represents 2% of the portfolio being covered for income. If you own fewer than 100 shares, just hold on to them for now. They remain a Buy.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a limit order to split the bid/ask price spread at the going price. Aim for about a 1.7% yield (that's option premium / current price of the stock) with a little more than 1.5 months to expiration. As expiration gets closer, always aim for our usual 1% per month in income to expiration. These options are relatively thinly traded, so **it is critical that you use a limit order**.
- **Prices** (10 a.m.): As prices change, just divide the going option premium -- splitting the bid/ask pricing -- into the current share price to target a yield of about 1.7%.
  - **Valmont Industries:** $131
  - **September $135 calls (bid/ask):** $2.00/$2.50 (as of 10:30am today)

    So, $2.25 is equal to about 1.7% in 50 days. This yield is sightly better than we achieved in our last round of covered calls on Valmont, assuming that current pricing holds up. We'll accept this income or close to it.

What We're Thinking

Following the recent post-Brexit run-up in the stock market and a couple of yawn-worthy earnings reports from our *Pro* companies, we're writing covered calls on **Valmont Industries** (NYSE: VMI) to generate income while we wait for results to improve. Many industrial and agriculture businesses have continued to struggle through what has become an extended cyclical downturn, and Valmont has not escaped the malaise. We don't anticipate any near-term catalysts to change the market's sentiment toward the company before the next earnings report, so we're writing covered calls on all 400 shares in the *Pro* portfolio, hoping to generate a 1.7% yield on the position in the next 50 days. If Valmont's stock price ends up higher than the $135 strike price at expiration, we'll plan to roll our calls to a higher strike. Should we ultimately lose our shares, we'll end up walking away just shy of breakeven on the position, including the dividends and the written call premiums we've collected.

Another Less-Bad Quarter for Valmont

Valmont's second-quarter earnings report was essentially a replay of the previous one. The company once again blew past earnings estimates, thanks mostly to management's cost-cutting initiatives, but sales continue to disappoint and management doesn't expect a near-term rebound in its key markets. Sales were flat in the engineered support structures division, thanks to weak U.S. wireless telecom spending and lower infrastructure investment by European governments. Improvements in the coatings division were mostly the result of the recent acquisition of American Galvanizing, and the irrigation business continues to be hurt by falling farm income. Despite the headwinds, management remains focused on improving operating efficiency, announcing an additional $4.7 million restructuring charge to consolidate the company's Australian manufacturing facilities. This move is expected to generate an additional $5 million in savings in 2017.

As a result of these initiatives, operating income margin for the quarter came in more than 3 percentage points higher than a year ago, and management expects year-end earnings per share to improve by 12% to 15% over last year (excluding the one-time Australian restructuring charges). This is good news, and a good reason to continue holding the stock, but the company is currently priced at just less than 20 times forward earnings -- which still is not categorically cheap. For that reason, we don't expect to see meaningful stock appreciation until sales growth rebounds and the company begins to realize significant operating leverage from its improved cost structure. In the meantime, Valmont has a strong balance sheet and continues to generate significant free cash flow, so we also think the downside is limited, barring another major leg down in the industrial and/or agriculture markets.

The *Pro* Bottom Line

Management's recent restructuring initiatives should serve Valmont well in the long run, as it will emerge as a more efficient organization when demand returns, but we don't expect any meaningful changes in the market's sentiment toward the stock between now and the end of the next quarter. As we mentioned in our last report, as long as Valmont's end markets remain stuck in the mud, we'll continue to write covered calls between earnings reports and generate income while we wait for the cycle to turn.

More That Matters

- **Maximum gain: T**he stock's upside is capped at our call's strike price, and the maximum gain on the covered call is the premium it pays us.
- **Maximum loss:** The full stock value, minus the call premium received.
- **Follow-up**: We hope to see these covered calls expire for income, and then decide our next course of action. If necessary, we may roll them higher. But if we lose our shares, we are comfortable with that prospect.

Options Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions about any of these, please visit the VMI board.

Seeing the Big Picture

Published Jul 25, 2016 at 3:26PM

Dear *Pro* member:

As of Friday, the *Pro* portfolio was up 5% year-to-date -- right near our North Star, and closer to the S&P 500's 6% year-to-date gain than the Nasdaq's mere 1.7%. Looking farther back, the portfolio gained 7.5% in 2015, while the S&P 500's total return was 1.4%. So, for the past 18 months, we've been able to grind out a return in a fairly tepid -- yet choppy -- environment.

I don't believe any Americans have seen an investing environment quite like today's before. We have ...

- extremely low interest rates and little cause to increase them
- a strong dollar because interest rates are even lower, and the picture weaker, overseas
- very slow (to no) GDP growth here and abroad

Yet we've never seen so many U.S. companies succeeding around the world, growing through geographic diversification as (in many cases) decades-old investments in fostering international expertise slowly reap growing dividends.

Demographics suggest that this low-interest rate environment may not lose hold anytime soon. Low interest rates are offered when businesses need to drive demand; they go up when demand is overheating. Temperatures are rising this summer, but why would demand anytime soon? An estimated 32% of the U.S. population is 50 years old and older, with nearly half of those being 65-plus. In other words, much of the population is closer to an age where they're likely to *downsize* their spending. The average American woman is having fewer than two children (not enough to replace herself and her mate), so immigration is the fuel for the modest population growth seen in the United States. (In fact, immigrants are expected to drive 88% of our population growth through 2065.)

Along with slow growth and an aging populace, it's inevitable that negative surprises will hit the economy, slowing GDP periodically. And it's hard to imagine rocket boosters that will suddenly increase economic growth. For example, cheaper energy is a net positive, but it drags down earnings for the energy sector, and thus the S&P 500. Pokemon Go may be the hottest new fad, but it's not going to push the economy higher (sorry!). And when interest rates tick up, if they do, not much of anything is likely to change.

Despite potential productivity improvements and innovation, today's demographic headwinds, the combative political landscape, troubles internationally, and the surprise problems that always pop up suggest that the emphatically rocky road we've seen since 2000 is likely to continue. And yet great companies continue to create record-breaking value, because the foundation of our economy -- entrepreneurial thinking and ownership -- remains strong. Average Americans' needs are being met better than at any point in history, people are living longer and healthier lives, and consumer choice is everywhere.

Our job as investors is to see the big picture *and* the small one. We need to recognize the most likely outcome for the big picture -- the economy and the world as a whole -- by seeing the trends in place today and trying to estimate what will change them or keep them going. And we need to see the smaller (but no less complete) picture whenever we analyze an individual company. What makes it special? Why are its earnings likely to grow? Why would investors give it a valuation that will grant us our desired return? How does it fit into the big picture of the world and the smaller picture of our portfolio?

These questions are part of what make investing an ongoing delight and challenge. And they help make me want to be a focused investor. If I owned 100 companies or more, I might do just as well, but by only owning about 30 (long and short), I can have strong opinions about each. Each one fits into a puzzle that should, ideally, help the portfolio perform as wished. It's my hope that by being focused, I'll have fewer losers. This is one way to invest. Another way is to buy many dozens of stocks and let time work its magic. Your winning value should exceed your losers, but you're likely to have plenty of fallen stocks, and you'll have less ability to react to situations with in-depth knowledge. Maybe you don't want to react, though; maybe that's your strategy.

Whatever your approach, our environment is likely to only reward exceptional companies and leave many others behind. We hope our *Pro* approach will continue to capitalize on this, because the coming years promise to be just as interesting -- and perhaps more challenging -- than recent years.

Skyworks Lights Up Some Hope

Earnings season always make us think big-picture, even as we're looking at a small snapshot of results. We'll see earnings from many *Pro* stocks this week, and the results we've seen so far have largely been satisfactory. **Skyworks Solutions** (NASDAQ: SWKS) is a case in point. Although the stock fell after its report last week, the company projected healthy guidance, with 10% to 11% sequential revenue growth expected in the current quarter, and another sequential bump in the quarter after.

At the same time, operating margins continue to trend upward, the company's products are in an increasing array of smartphone models, and its Internet of Things business is growing. Wall Street is leery of growing inventory, but management said it's "product in process" for new phones to come. The projected sales growth rate may also be less than some hoped for, given the new iPhone model expected this fall, but Skyworks typically guides conservatively. Assuming the new iPhone does even moderately well, Skyworks should be set up to keep growing nicely. And over time, ideally **Apple** (NASDAQ: AAPL) will become a smaller customer (on a relative basis) as the Internet of Things grows. For more on our initial summary of Skyworks, *Pro* members can look up the stock anywhere on the Fool.

For now, please visit the Memo Musings board if you have any questions or comments, and thank you for being a *Pro* Fool!

-- Jeff (TMFFischer)

More From *Pro*

Pro Guidance Changes

- None in the past week.

Pro Completed Trades

- None in the past week.

More From Motley Fool Pro:

- Pro's Third Annual Mid-Year Review
- Learning to Love Uncertainty
- Choppy Challenges Won't Stop Us

Pro Catch-Up Trades: July 25, 2016

Published Jul 25, 2016 at 3:25PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **FactSet Research** (NYSE: FDS): Buy 2.1% if you haven't yet.

Continue building your portfolio with our Buys, including these highlighted today:

- **Visa** (NYSE: V): Buy 2.4%.

Shorts:

- **Pier 1 Imports** (NYSE: PIR): Sell short 0.75% to start (see our recent trade alert).

Options:

- None today.

Hedges:

- No updates.

Options expiring next:

- **Expeditors International** (NASDAQ: EXPD): Our August $46/$49 covered strangle expires in 25 days. We'll have updated guidance closer to the expiration. Lately, shares are $49.90, and the options in our strangle have a combined $1.60 in value, so that's $0.70 in time value that we want to see dissipate before we roll the in-the-money option (currently the calls).

Business as Usual for Wells Fargo

Published Jul 19, 2016 at 12:13PM

Wells Fargo (NYSE: WFC)

Updated Guidance: Buy First (no change)

Recommended Allocation: 4.5%

Fair-Value estimate: $55 (**reduced from $58**)

Current Price: $48.42

What Happened?

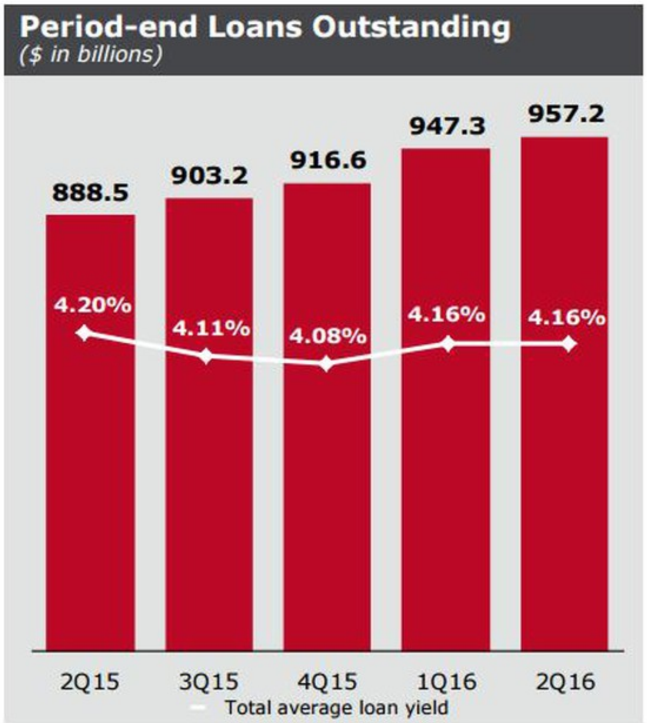
- Q2-2016 press release
- Q2-2016 financial supplement

So What?

The 3 key items that I watch for Wells Fargo:

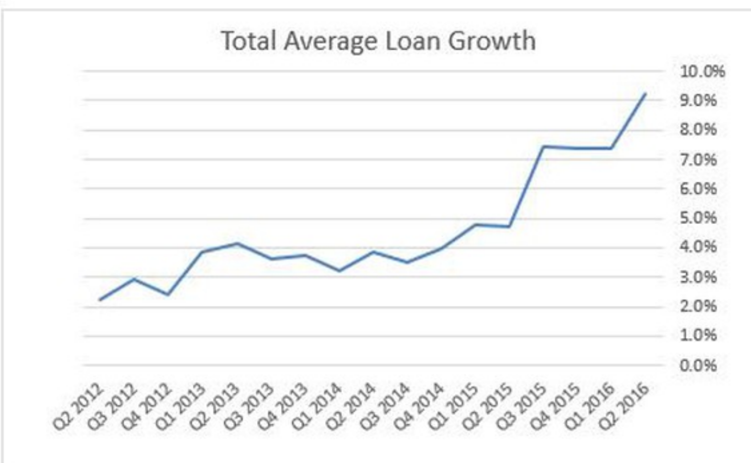
- Growth (or lack thereof) in loans and deposits
- Trends in credit quality (as monitored via net charge-offs and reserving policy)
- Trends in the efficiency ratio and expense reduction

1) Growth in loans and deposits



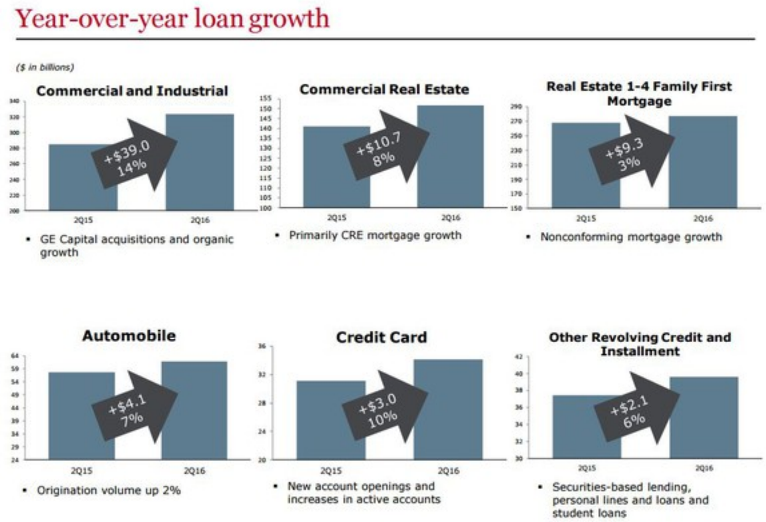
Source: WFC 2Q16 Quarterly Supplement

Total average loan growth for the quarter accelerated nicely compared to last quarter's +7.4% growth year-over-year, coming in at a strong +9.2%, though this figure was partially impacted by inorganic growth from recent GE Capital acquisitions:



Source: Company filings, analyst calculations.

There was particular strength in commercial & industrial loans, and credit card balances, and commercial real estate loans:

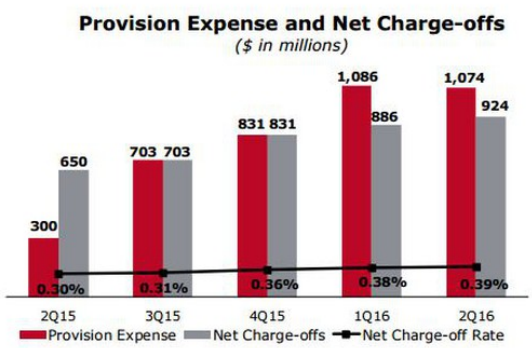


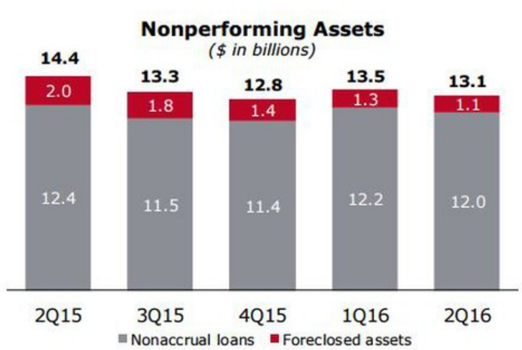
As for deposits, Wells continues to perform well. The company achieved 4.3% year-over-year growth in total average deposits, and 7.6% year-over-year growth in consumer and small business banking deposits. Consumer and small business banking deposits comprise about 59% of total deposits. Funding costs increased a bit to a still-low rate of 0.11%, up from 0.10% last quarter, driven by increased short-term interest rates and a corresponding increase in deposit pricing for certain wholesale banking customers.

The company's ability to grow deposits meaningfully at a very low cost is perhaps the company's biggest structural competitive advantage. Wells is able to do this by having a nationwide presence with significant geographic density in most markets, optimizing distribution via newer channels (mobile/technology), and strong customer relationship management and product cross-sell achieved via a consistent culture that has been a hallmark of the company for decades.

2) Trends in credit quality

Credit quality showed a fourth straight quarter of sequential decline, with net charge-offs as a percent of total average loans increasing slightly to 0.39% (from 0.38% last quarter, and 0.36% the quarter before). Lower is better. Despite the slight increase, this charge-off rate is still very low and below historical averages. High credit quality has been a consistent theme of the current credit cycle as banks have cut down on risk in response to the turmoil of the 2008-2009 financial crisis.





Source: WFC 2Q16 Quarterly Supplement

The reason for the continued declines in credit quality is the company's exposure to oil & gas loans. Credit quality in the oil & gas industry has decreased over the past year or so alongside the concurrent decline in the price of oil.

Wells charged off $263 million in its oil & gas loan portfolio in Q1 2016, up from $204 million last quarter and $118 million last quarter. Oil and gas nonaccrual loans (loans where the full and timely collection of interest or principal is uncertain) came in at $2.6 billion, up from $1.9 billion last quarter, working out to about 15% of the company's total outstanding energy loan portfolio.

The company has $1.6 billion of allowance for credit losses on oil & gas loans, which based on a $17.1 billion portfolio works out to a 9.3% reserve rate. The company's entire subset of outstanding oil & gas loans accounts for 1.8% of total loans outstanding. The company's declining credit quality in the oil & gas portfolio is not exactly welcome, but it is certainly not a dire threat to the company's business. Continued credit quality declines in the oil and gas portfolio are likely, but as the company continues to reduce its exposure to that industry and grow loans in other industries, the impact to the overall business becomes smaller and smaller.

3) Trends in the efficiency ratio

The efficiency ratio (a measure of the bank's overhead costs as a % of its revenue -- lower is better) came in at 58.1%, down from 58.7% last quarter and down from 58.5% a year ago. The efficiency ratio is at the high end of management's target range of 55-59% (blue shaded area in graph):

Source: Company filings.

Management has indicated that they expect the efficiency ratio in 2016 to come in at the high end of their target range, unless interest rates increase faster than expected. The company continues to invest in product development and compliance / risk management technology, including cyber-related spending.

Now What?

All in all, Wells Fargo continues to do what it does best -- steadily grow loans and deposits, and generate a lot of profit. The company's diverse operating model shields it from difficulties in any one particular segment, and this revenue and profit diversity (alongside the company's hallmark conservatism relative to peers) helps Wells Fargo produce consistent results even as the macroeconomic environment shifts and fluctuates.

From our long-term view, underlying business results remain strong, the core earnings power of the business remains intact and is poised for positive operating leverage if and when interest rates and lending spreads rise, and the company's capital return program continues to benefit shareholders. At $48.42 per share, the company yields 3.1% and trades at 1.37x a growing book value.

Guidance Update

Due to reduced return-on-equity targets shared at the company's 2016 Investor Day (management's ROE target range was reduced from 12-15% to 11-14%), **our Fair Value estimate is reduced to $55 per share** (representing a 1.55x P/B multiple), about 14% higher than the current price. Long-run ROE targets are a direct input into our WFC valuation model, and when ROE expectations decline, the fair value of the business declines as well. The fair value decrease is more a reflection of reduced expectations surrounding interest rates than it is a reflection of weakness in the business.

Wells Fargo remains a Buy First on our scorecard with a 4.5% allocation. Those who have yet to fill out their stock allocation in this long-term compounder should feel comfortable doing so at current price levels. At some point, we expect to run an income strategy (perhaps covered calls) on a portion of our allocation, but we are waiting for more advantageous prices before initiating an income strategy.

Fool on!

Billy

If you have questions, drive your stagecoach over to the Wells Fargo discussion board.

Pro's Third Annual Mid-Year Review

Published Jul 18, 2016 at 3:27PM

Dear *Pro* members,

It's time for our annual *Pro* portfolio mid-year review! In this installment of the series I started two years ago, we will discuss *Pro*'s performance halfway through the year. We will discuss market volatility, portfolio activity, and talk about major drivers of our performance. With the information from this review, we can determine how our results or approach have changed (if at all), and we can potentially use this new information to our benefit.

The Review

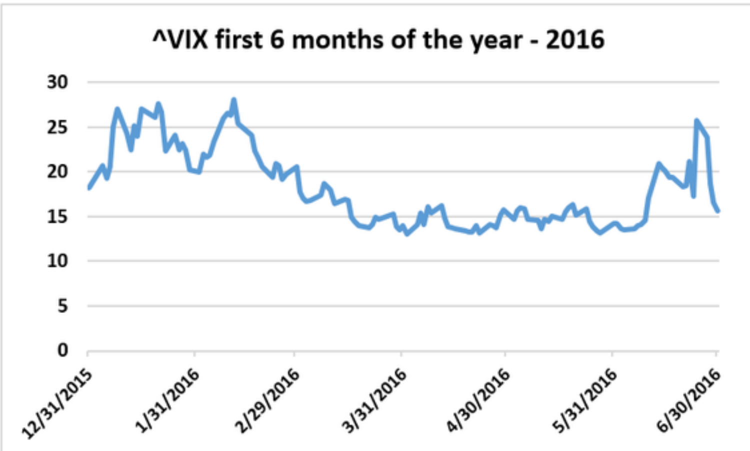
The *Pro* portfolio's performance has been below our goal over the first six months of 2016. Our year-to-date performance as of June 30, 2015, is about 1.4%, underperforming both the S&P 500 (up 3.8% during a very volatile six months, ranging between -11.4% and +3.7%) and our North Star (up about 5.1% in the same time frame). One thing to note is that the Nasdaq is lagging the S&P 500 considerably; it was actually in the red as of June 30, and has an influence on many of our positions. Adding returns since July 1, the portfolio is now up about 4% year-to-date, getting much closer to the North Star.

Our gross long exposure is about 83%, a bit less than our historical average of about 87%, indicating our slightly more cautious stance during this volatile market. Here's a comparison of the performances of *Pro*, the S&P 500, and our North Star over the first halves of 2013, 2014, and 2015:

Year	*Pro*	S&P 500	North Star*
2013	22.4%	12.6%	4.1%
2014	7.4%	7%	4.4%
2015	9.4%	1.2%	4.6%
2016	1.4%	3.8%	5.1%

Source: U.S. Bureau of Labor Statistics seasonally adjusted, indexed, monthly CPI-U data series.

Volatility (as measured by the ^VIX index) started the year at an elevated level, as fears of an economic slowdown in China led to a global sell-off in equities markets, including the worst 10-day start to a trading year in U.S. market history. From there, volatility declined as markets recovered, only to spike again after the UK voted to leave the European Union (i.e., "Brexit") in late June. Since then, markets have roared back strongly to new all-time highs, and volatility has declined to lower levels:



Source: S&P Capital IQ.

As far as our activity, the pace of our trades has been somewhat different when compared with the first halves of 2013, 2014, and 2015, mainly because of our increased emphasis on options for income:

	2013	2014	2015	2016
New Purchases	2	2	1	1
Allocation Increases	3	1	0	1
Options for Income	8	8	8	13
Options for Leverage	1	1	1	0
Shorting	1	0	2	2
Hedging	4	4	4	4
Sales (or short covering)	3	3	1	4

Note: 2016 activity includes trades made between June 30 and today.

Pro has been much more active in attempting to generate option income in 2016 so far; this has been an area of emphasis for us as we aim to buffer a volatile, seesaw market with consistent option income.

We have been similarly active in buying in 2016 compared with last year (though less active than in 2014 and 2013); we've established one new stock position (**FactSet Research Systems** (NYSE: FDS) -- up more than 10% since our buy recommendation) so far this year; and we have increased our allocation to just one of our core stocks (**Wells Fargo** (NYSE: WFC), thanks to the assignment of written puts.

We've been a bit more active in selling and/or closing positions this year compared with the past few, which -- alongside the muted buying activity and addition of two new shorts -- has led to the decrease in our gross long exposure as mentioned above. We closed leveraged options positions in **Coca-Cola** (NYSE: KO), **American Airlines** (NASDAQ: AAL), and **American Tower** (NYSE: AMT), and we covered our short on **World Acceptance** (NASDAQ: WRLD).

Our strongest-performing stocks so far this year have been **Valmont Industries** (NYSE: VMI) (31% return year-to-date), **OpenText** (NASDAQ: OTEX) (26%), **Broadridge** (NYSE: BR) (25%), **Papa John's** (NASDAQ: PZZA) (24%), and American Tower (22%).

Our worst (again, so far) have been **AmTrust** (NASDAQ: AFSI), down 16%; **TD Ameritrade** (NASDAQ: AMTD), down 15%; **Gilead Sciences** (NASDAQ: GILD), down 13%, **Skyworks** (NASDAQ: SWKS), down 12%, and Wells Fargo, down 11% -- as well as our American Airlines calls, which lost most of their value as the stock fell to a P/E of less than 4.

All in all, the first six months of 2016 have been volatile and perilous. We've used options for income to take advantage of a more volatile market, we've seen strong appreciation from a number of our core stocks, and we've added shorts and slowed down our purchase activity to take a slightly more defensive stance in this uneasy market environment.

Despite the weak performance of some of our larger positions (many of them financial stocks affected by a lack of interest-rate increases), the *Pro* portfolio as a whole is holding up well in a choppy market. Though we have trailed both the S&P 500 and our North Star over the first six months of the year, we think we're set up well to continue to achieve our goals over the long term, and we view the weakness in the Nasdaq and many of its stocks as future returns we're likely to enjoy. We are also glad for the many poor performers in the market we have avoided buying.

The *Pro* Bottom Line

Pro's low-turnover approach is patient, flexible, and focused on an absolute-return strategy. We try to keep our underlying philosophy in mind with every portfolio decision we make. Fittingly, the conclusion from the prior two mid-year review columns is still completely applicable today. Here it is, with edits in brackets only to change the reference to the year:

"While we aren't market prognosticators and we can't tell you what to expect from the market over the second half of [2016], we can tell you what our approach to portfolio management will be. We will continue to invest in core stock positions (i.e., compounding machines) when the balance of risk and reward looks favorable. We will continue to use options strategies either for income, to add to our positions at lower prices, or for leverage, depending on what opportunities present themselves. We will seek to short weak, disadvantaged companies that appear poised for a stock price decline, and we will manage our net long exposure via index hedges as market conditions dictate."

Fool on!

--Billy (TMFBillyTheKid)

Pro Guidance Changes

- **American Tower** (NYSE: AMT): Following sharp appreciation, shares move to Buy from Buy First. We have a 4% stock allocation.
- **Oracle** (NYSE: ORCL): Finally seeing some appreciation, shares move to Buy from Buy First. We have a 3.9% allocation.

Pro Completed Trades

- **American Tower:** We closed our long January 2017 $80, short July 2016 $111 diagonal call for about a $31 credit.

Pro Catch-Up Trades: July 18, 2016

Published Jul 18, 2016 at 3:20PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Gentex** (NASDAQ: GNTX): Buy 2.7% in stock if you lack it.
- **MasterCard** (NYSE: MA): Buy up to 4.2%.
- **Wells Fargo** (NYSE: WFC): Buy up to 4.4% in stock.

Continue building your portfolio with our Buys, including these highlighted today:

- **American Tower** (NYSE: AMT): Buy up to 4% in stock.
- **Oracle** (NYSE: ORCL): Buy up to 3.9% (see our earnings update).
- **Verisk** (NASDAQ: VRSK): Buy 2.4%.

Shorts:

- **Pier 1 Imports** (NYSE: PIR): Sell short 0.75% to start (see our recent trade alert).

Options:

- **American Tower**: Buy to close your July 22, 2016, $111 calls, and sell to close your January 2017 $80 calls, to end your diagonal call per our alert.

Hedges:

- Hedges? We don't need no stinkin' hedges! Just kidding. But no new "catch-ups" today.

Options expiring next:

- **Expeditors International** (NASDAQ: EXPD): Our August $46/$49 covered strangle expires in 32 days. We'll have updated guidance closer to the August expiration. Lately, shares are $49.95, and the options in our strangle have a combined $2.25 in value, so that's $1.30 in time value that we want to see dissipate before we roll.

Close Your Diagonal Calls on American Tower

Published Jul 14, 2016 at 2:00PM

Is this for you? This alert is for *Pro* members who, like us, own a diagonal call position on **American Tower** (NYSE: AMT). The diagonal call consists of both a long-dated owned call and a shorter-dated sold call. *Pro* owns the January 2017 $80 call and is short the July 22, 2016, $111 call. If your strike prices and expiration dates differ from ours, we still recommend that you close your position alongside us. **Please note: We are not touching our stock position, which remains a Buy First right now at a 4% allocation.**

How You Participate

- **Action:** Sell ("sell to close") your January 2017 $80 calls on American Tower (or whatever variant of these you have); simultaneously buy ("buy to close") your July 22, 2016, $111 calls (or other variant). *Please note that the short calls are **weekly** options.*
- **Allocation:** Sell all long calls you hold and buy back all short calls you have previously written. *Pro* will be selling its six long calls and buying back its six short calls.
- **Price Guidance:** Use a **limit order** to target a net credit of at least $31 per diagonal call spread (the difference between our $111 and $80 strike prices). With time value in our short calls at about $0.05, aim to close the position promptly to avoid being assigned. That said, you'll need to be very disciplined with your limit order, as our diagonal spread is worth at *at least* $31 so long as the stock price remains above our strike price. If you accept less than $31 to close your spread, you are

giving your counterparty free money. That's all to say: **Make sure you get this trade done promptly, but be cognizant of the value of what you're selling, and be disciplined with your limit orders.**
- **Prices** (as of 11:35 a.m. 7/14/16):
  - **Stock Price:** $116.60
  - **Sell to close January 2017 $80 calls (bid/ask split):** $36.65
  - **Buy to close July 22, 2016, $111 calls (bid/ask split):** $5.65
  - **Net credit:** $36.65-$5.65 = $31

What We're Thinking

Our long-running option position on American Tower, which began with a bought call in December 2014, has worked exactly as we might have hoped. In that initial alert, we mentioned that the goal of our call purchase was to benefit from leveraged upside. Having accomplished this, we now prefer to close the entire position. The alternative is to attempt to roll the calls out and/or up to target further returns, but this would expose us to leveraged losses if the stock price drops.

With the $31 or so per spread from closing our diagonal position, plus $1.39 from our first set of diagonal calls (at the $105 strike), plus $1.45 for the second set of diagonal calls (at the $108 strike), minus $1 for closing those calls, plus $1.16 for our most recent round of diagonal calls (the calls we are buying to close at the $111 strike), we will have received, or will be receiving as we close ...

$31 + $1.39 + $1.45 - $1.00 + $1.16 = $34

... over the life of the entire diagonal call position.

We established the bought calls in December 2014 for $23.35 per contract (with American Tower's stock price at about $96 per share). That means the total return on our diagonal call position is:

$34 / $23.35 = 46%

That's 46% in a little more than 18 months since initiating the position, compared with a 21% increase in the stock price (which we also captured with our unencumbered 4% stock position). That's the leveraged upside we're referring to.

This strategy has been a great example of how we can opportunistically use options to help enhance our returns. We've kept track of the position-level returns for American Tower since buying it in May 2013, and if we hadn't employed any options at all, our return on the stock alone (including dividends) would be 12.4% annualized. That's great on its own -- but including all the options we've done on American Tower (including written puts in late 2013 and early 2014, and then the call and diagonals), our position-level return increases to 14.5% annualized. Options have added 2 percentage points annually to this position's returns, an excellent result.

Now that American Tower is trading closer to our fair-value estimate than it ever has across the position's entire history, we are content to close our leveraged position, reducing our portfolio's risk profile slightly as we continue to capitalize on further upside with our simple 4% stock allocation. Again, we are keeping those shares.

This position has been a win-win on both sides, and we can chalk this strategy up as a success -- even with the stock now about 5% above our latest strike price. We aim to make good returns with smart risk, while knowing we can't be perfect. In the interest of risk management (and with expiration not that far away now, in January), we're happily closing our diagonal calls on American Tower.

Alternative Trades

- **Want to keep your diagonal call position going?** You can keep the position open if you really prefer, rolling out and/or up, and being careful to mind your allocation. If the stock continues to rise, rolling out and up over time will capture further upside in a leveraged manner. We're closing for the reasons explained in this report, but if you are comfortable with the risk of leveraged losses if the stock price drops, it's OK if you want to keep the strategy running on your own.
- **Other strikes and expirations?** As shared at the start, we would suggest simply closing those, too, as we're managing our total AMT exposure at this price.
- **Simply own the stock?** Do nothing. *Pro* will still own a 4% allocation in American Tower after closing our diagonal calls. We recommend that you match our allocation.

Pro Can Help

- **Questions about this trade?** Consume data and post your questions on our American Tower board.

Learning to Love Uncertainty

Published Jul 11, 2016 at 3:37PM

Fellow Fools,

Seemingly impossible events -- or, rather, low-probability happenings that have never happened before -- actually occur all the time. Sports provide some of the best instances of this phenomenon, because they feature a lot of historical statistical data as well as robust betting markets that collectively gauge the odds of future outcomes. For example, before the Cleveland Cavaliers recently claimed the NBA title, no team had come back from a 3-to-1 deficit to win the NBA championship -- and the feat occurred against a team with the best regular-season record in history, no less. A year ago, UK bookmakers placed 5,000-to-1 odds against Leicester City winning the English Premier League championship, only to watch the Foxes hoist the trophy this year for the first time in the club's 132 years.

Over the past few months, a lot of ink has been spilled about a few improbable geopolitical outcomes that have left experts scratching their heads and reexamining their prediction models. We'd be the first to tell you that no one can consistently guess the direction of the market (or politics), but like it or not, as investors, we're in the business of predicting. We are forced to become comfortable using incomplete information to make reasonable assessments regarding the likelihood of future outcomes, and a few of these events provide good examples of where we can go wrong.

Playing Favorites

A year ago, few people believed that Donald Trump had a realistic chance of becoming the Republican nominee for president. Even Nate Silver, the respected statistician who made his name by correctly predicting 99 of 100 states in the past two presidential elections, initially pegged Trump's chances of securing the nomination at about 2%. Since then, Silver has penned a *mea culpa* reflecting on how he got caught acting more like a pundit than an empirically minded analyst.

Similarly, when the stock market pundits were trying to divine the outcome of the Brexit vote, they overlooked the polls, instead relying on the bookmakers they believed had a better fix on the voters' sentiment thanks to the wisdom of crowds. Some of those bookmakers had odds of British citizens leaving the European Union as low as

10%; the 90% odds of a "Stay" vote were seductive to bettors and even seemed to lure the financial markets into a false sense of security.

My intention isn't to bash Silver, who is very good at what he does, or to dismiss the wisdom of the crowd. Rather, I think this gives us a few good examples of how groupthink can influence predictions, and how most humans are really bad at interpreting probabilities. On the whole, people tend to underestimate the odds of unlikely events -- unless they are particularly scary, like a plane crash or shark attack, in which case they severely overestimate the odds. Further, when we hear that something has a high probability of occurring, let's say an 80% to 99% chance, our brains often take a shortcut and label it a "sure thing." As a result, we don't spend enough time considering the possible ramifications of a highly unlikely, but still possible, negative outcome.

The longer you've been investing, the more likely it is that you've experienced the frustration that occurs when an improbable event rips a small hole in your portfolio. It's a humbling experience, and one that usually recalibrates your risk gauge to expect more randomness. It's important to remember that as investors, we are compensated for taking on risk and embracing uncertainty -- there's simply no way around it. If there were, investors would bid up the price of equity assets, accepting lower future returns and significantly reducing our ability to earn the North Star-matching returns we target at *Pro*.

The *Pro* Bottom Line

Though we have a number of high-conviction investments in the *Pro* portfolio with heavy combined weightings, like **Facebook** (NASDAQ: FB) and the credit card companies **MasterCard** (NYSE: MA) and **Visa** (NYSE: V), we are careful not to over-commit to any one idea. The fallout from the **Valeant Pharmaceuticals** (NYSE: VRX) saga has shown the pain that an overweighted, high-conviction pick can inflict on a portfolio. In that case, even investors with board seats and easy access to management learned too late they were also working with incomplete information. We know that we rarely have an information advantage, so we maintain a diversified portfolio to reduce idiosyncratic risk (that's the business risks associated with each company), and we use hedges and shorts strategically to limit market risk and hopefully reduce volatility over time. We also hedge against our own uncertainty -- it's our acknowledgement that there are simply things that we cannot know. It's critical that we don't allow any position to become so big that it would cause irreparable harm should it suddenly go to zero.

The *Pro* team is currently preparing for the next round of earnings, which will really start to pick up in the next two weeks. As much as we'd love to see every company perform exactly as planned, we fully expect a few surprises (positive and negative) along the way. In the meantime, please visit the Memo Musings board if you have any questions or comments.

Foolish best,

--Jeremy (TMFTank)

Pro Catch-Up Trades: July 11, 2016

Published Jul 11, 2016 at 3:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **American Tower** (NYSE: AMT): Buy up to 4% in stock.
- **Gentex** (NASDAQ: GNTX): Buy 2.6% in stock if you lack it.
- **MasterCard** (NYSE: MA): Buy up to 4.2%.
- **Oracle** (NYSE: ORCL): Buy up to 3.8% (see our earnings update).

Continue building your portfolio with our Buys, including this highlighted today:

- **Verisk** (NASDAQ: VRSK): Buy 2.4%.

Shorts:

- **Pier 1 Imports** (NYSE: PIR): Sell short 0.75% to start (see our recent trade alert).

Options:

- Not today.

Hedges:

- Not today.

Options expiring next:

- **Expeditors International** (NASDAQ: EXPD): Our August $46/$49 covered strangle expires in 39 days. We'll have updated guidance closer to the August expiration. Lately, shares are $49.95, and the options in our strangle have a combined $2.30 in value, so that's $1.35 in time value that we want to see dissipate before we roll.

Good Investing Hurts

Published Jul 11, 2016 at 1:16PM

Pro *Fools, we thought you might enjoy this Morgan Housel article from 2014, recently re-run in our* Motley Fool One *service.*

In his book on the Bin Laden raid, Navy SEAL Mark Owen writes that "one of the key lessons learned early on in a SEAL's career was the ability to be comfortable being uncomfortable."

Being cold, wet, hungry, and tired is a normal part of the process, Owen writes. Rather than trying to avoid it, they learn to deal with it.

That's probably a good lesson for most things in life, including investing.

Want to be a great investor over the long run? Get used to being uncomfortable.

Research Affiliates, one of the smartest market research firms around, just did a big study on 45 years of mutual fund returns.

The results were depressing. Of 350 mutual funds available to investors in 1970, only 100 survived through 2014. The other 250 closed, or were merged with other funds. Of the 100 that survived, 45 beat the market over the whole period; 42 of them beat it by less than two percentage points per year.

But that's old news. What's remarkable was a characteristic of the three "superstar" funds that beat the market by more than 2 percentage points a year for 45 years. They spent, on average, a third of the time underperforming the market on a rolling three-year basis:

	Excess return over S&P 500, 1970-2014	Percentage of quarters spent underperforming the market on a rolling 3-year basis	Longest consecutive number of quarters underperforming the market on a rolling 3-year basis
Franklin Temleton Mutual Share	3%	35%	18
Fidelity Magellan	2.9%	43%	23
Fidelity Contrafund	2.3%	31%	21

Source: Research Affiliates

You can imagine the ridicule these managers went through when, for years on end, they lagged the market. Clients surely pulled money out of their funds. Journalists stopped calling them. Their personal pay likely plunged. It was uncomfortable.

But they still beat 99% of their peers over the long run.

This is a good display of four of important rules.

History Doesn't Crawl; It Leaps

There are four types of investment returns:

- Consistently bad.
- Mostly bad and occasionally good.
- Mostly decent and occasionally good.
- Consistently good and fraudulent.

That's the complete list.

Look at the long-term history of great investors, and you'll find they occupy the third category. A disproportionate share of their overall gains come from a small number of investments. At last year's **Berkshire Hathaway** (NYSE:BRK-B) shareholders meeting, Warren Buffett noted that of the 400 to 500 stocks he's invested in during his life, he's made most of his money on 10 of them. Same with Ben Graham, whose entire career success as an investor is tied to one stock: GEICO. Incredible opportunities (or luck) don't happen frequently enough to show up in annual returns. It's often middling performance for years, and then ... wham. One event knocks it out of the park.

There's Nothing Special About a Year

Yale economist Robert Shiller once noted the absurdity of racing to meet one-year goals. "I don't know why people keep using one-year earnings," he said. "That is the time it takes the Earth to go around the sun. I don't see any other significance."

Say a manager underperforms the market for 12 months, but by month 19, they're beating it. Who cares? Why is 12 months the official limit on measuring success? What gets dangerous is when a manager feels he needs to perform on a 12-month -- or quarterly -- basis, and starts doing all kinds of insane trading maneuvers to window-dress year-end returns.

You Have to Act Differently if You Want Different Returns

This seems obvious, but there's safety in numbers, and for most managers, there is more job security being consistently mediocre than being occasionally bad and occasionally great. Too many fund managers effectively run a high-fee index fund and aren't really trying to outperform. As with SEALs, doing well over time means being comfortable being uncomfortable, straying from the crowd, and often lagging your benchmark.

Picking the Right Manager Is Insanely Hard

Out of 350 funds, three did well over the 45-year period. Three. 0.85%. And how many investors were brave enough to stick with them for a long period of time? Few, I bet. Sometimes a manager's poor performance is really a sign he's incompetent. Other times, a smart manager is just going through a bad stretch. How do you know which is which? If there was an easy way to answer that, we'd all be rich.

Pro Video Chat, July 2016

Published Jul 7, 2016 at 11:10AM

The *Pro* team held a video chat on this page at 3 p.m. Eastern on Monday, July 18, to answer your questions! Below are written answers to the questions we received via email ahead of time, and a transcript is pending.

Q: PRO has had a tough 18 months it looks like PRO has under performed both the S&P 500 and our North Star targets. Fortunately, I do measure success with a longer time frame(3-5 years) however it can be hard to make up for losses or lack of performance as we lose compounding power - if you know what I mean. I would rather have steady 7-8% yearly returns then 1% followed by 15%, right. How do does PRO avoid making mistakes or taking on more risk to make up for these lack luster returns. What do we need to do differently or are you happy with the current strategy?

A: Hi JPro: Pro has done well the past 18 months. From 12/31/14 to 6/30/16, the portfolio is up 9.1% vs. the S&P 500 total return at only 5.2%. The North Star was up 13.3% over that time, but add in our strong July so far, and we're closing in on the North Star, too -- which remember is our ultimate goal, but not a benchmark. We hope to be able to get close to the North Star over the years. If we do, it should be phenomenal compared to most anything else out there. Mainly we use the North Star to help guide our decisions and remind us of our absolute return goals. Anyway, our returns are tracking right along what you could hope for, if you want steady returns like that. -JF

Q: So svxy and shorting vxx are really not the same trade. Shorting vxx is a long term short, if you don't close your position any paper losses can be recovered with patience and time. Svxy is only shorting the next month or two, and then is rolling its short so svxy is not performing as i expected. In times of mild volatility it performed well, however in times of very high volatility it seems like svxy locks in some losses? Look at the volatility spike in august of last year. Vxx increased in price as expected but svxy dropped in price a lot more than i would expect. I am curious to see if pro is looking a svxy performance. Should we go back to shorting vxx. The way to start the short is to sell a naked call on the vxx. pro got burned by this in the past but the real lesson was not the short but Pro i think over allocated capital to the short and also thier broker at the time hurt them.Those who could hold on to it eventually did fine. Just because the horse bucks you off does not mean you give up on it, we learned a lesson and maybe its time to get back on?

A: There are multiple issues involved in shorting VXX in a service like ours, including: Not everyone will be able to short it, or will be able to stay short when VXX spikes. People are too often called out of VXX on very large spikes (someone always is, it seems) -- and if that happens to even one member, then we've failed that member. A synthetic short may work better for all of us, and that's being considered as a complement to our tiny SVXY position. We of course are keeping a close eye on SVXY. I posted recently that I believe it will still perform in the long run, and it offers benefits that include we can't get called out of it, and it can indeed compound over the years (unlike a short). I think utlimately it will again (again -- as it had its earliest years). It has just been a choppy 18 months or so. -JF

Q: Jeff has mentioned several times now how VXX seems to be performing better than SVXY as a volatility trade. VXX shorting via options seems to have less risk than direct shorts. What type of trade would PRO consider if they used options to short VXX? Regards, Bob

A: Hi Bob! Indeed, a synthetic short is being considered on VXX, especially the next time the VIX futures spike. It may be time to finally start a SMALL position again, since SVXY -- though I still believe in it -- may take a longer time to start to generate returns. VXX, meanwhile, has continued to work for those short it. -JF

Q: "That's a good impression" she said. "OK, can you do an impression of Mickey Mouse?" I asked. "No, I only do Dental Impressions and this upper mouth night-guard costs $650. Last week's emergency dental crown cost $900. Don't forget your regularly scheduled office cleaning is next Wed." the dental assistant said. I've heard from others that their crowns cost $1000 to $1300. Implants are more $. The machine that makes the crowns is akin to a reverse 3D printer. The machine takes a tiny block of porcelain and follows the computer generated pattern to produce the crown, using 2 diamond drill bit needles and 2 water jets. Took 15 mins. to make a perfectly fitted and color-correct crown. Assistant also stated that ALL Filings and Crowns wear out. What we BBBs (Beautiful Baby Boomers) have in common is expensive dental work. I'd like PRO to consider adding a dental stock. Can anyone there do some research into this please? I really would love to put a stock where my money is... Duwango

A: Thank you, Duwango! And thank you for the great postcard we just received! Very Foolish! I don't know this company, but we do know a bit about medical devices thanks to our MDT investment. We are also looking for other healthcare investments as GILD is a bit disappointing so far. We will consider many different aspects of health care, including dental now. Thank you! -Jeff

Q: How do I trade the recommended options when my account may have only 7, 8, or 10 shares of this stock? Jeff

A: Hi Jeff: In those cases, you can't write covered calls on the stock. You need 100 shares. But with more limited funds, you can buy options when we choose to, and leverage your capital. But writing options only works when 100 share exposure is a fair allocation for you. Best, Jeff

Q: The VIX is very low right now, and you have to believe that in time it will jump considerably higher. Isn't there a sumwhat conservative way to use this to generate cash?

A: Hi King2fish: The VIX has bounced around a lot this year, as Billy's Memo wrote about today. We have used options on the VIX before (you can't trade the VIX itself), but they're expensive and don't move as much as the index itself. It's tough to make money with them, to say the least. -Jeff

Q: I was writing weekly puts on ORCL about this time last year, partly for income and also to fill out my position. Then ORCL missed earnings and I was assigned on more puts than I had planned for. I continue to hold the excess shares but I am thinking about trimming my holdings now that ORCL is near a 52 week high. However ORCL has been a MF Pro buy first stock like forever. Should I trim now or wait for a while since ORCL just had a good earning report and I am potentially leaving profits on the table? I currently have 2000 shares and should sell about 800.

A: Hi there: If you are that over-allocated, trimming is typically a good idea at anytime. You don't want to own too many shares of any single stock such that the position makes you uncomfortable when it falls -- becuase then your discomfort will cause you to sell at the worst time. So, trimming -- or starting to trim now at least -- proably makes sense, since you have 2,000 shares and should only have about 800 to have a 4% allocation. Sounds like your allocation is around 10%. We believe in ORCL, and its price, but you'll probably want to trim that down for your own comfort level. -Jeff

Q: I think I know your answer to my question, but I am going to ask any way. I am a charter member, so I purchased initial partial positions in some stocks at a muck lower cost basis than I paid when I filled out the position. So when I calculate my position size, should I factor in the lower cost basis or just calculate on the current share price? For example, using BR at a 5.4% position size and assuming a portfolio size of 1 million, I should invest $54,000 to own about 800 shares using current pricing of about $67. I initially purchased 300 shares at $21.27 for $6381 in mid 2010 and filled out my position (correct total dollars invested) buying 700 additional shares at $52 for $36,405 in March 2015. I have $42,786 invested in BR and am overweight by 200 shares by today's pricing. AFSI is another example. With a price of $24.50 and 4.9% position size I should own about 2000 shares. My cost basis is $9.55 on my initial 1400 shares. I currently own 2800 shares and have slightly more invested than the $49,000. I guess I am asking if I should be looking at dollars invested on these older positions or number of shares I should own with current pricing? I am at or slightly over all positions, including shorts and hedges, except only half of ORLY, no short on PIR until after the dividend payment and for personal reasons I have chosen not to own PZZA. I also participate in many of the MF Options recommendations. Thanks for all you do. It's been an amazing education for me.

A: Hi again! The only value that matters today is the current value of the position, not what you invested in it. So, all of our allocations are based on the current value of the positoin -- **the money that is in that position today. I hope this helps! -Jeff**

Q: I have participated in this trade (AMT) and have a short call that is expiring next week. The current price is 116 and the short call strike is 111. Will you be recommending a buy to close or a roll up and out trade? When should we expect notification?

A: Hi Bruce: We did recommend closing the whole diagonal call on AMT. We've made our returns and we're happy to close at this price on AMT. So, close your diagonal call (both legs) if you're following us. Best, Jeff

Q: I wrote 2 covered call contracts on EXPD which was listed as an alternate trade for IRA purposes, instead of the strangle, if memory serves. The stock is trading at ~$50.50 at the time of this writing and the $49 strike is for the August 19 expiration. The stock is up 4.6% since I wrote the buy write order and I have a $1.32 in option premium. Would you recommend rolling up and out or simply let the shares be called next month and reestablish the trade? Thoughts? And thanks for your comments.

A: Hi again Bruce: We'll issue a recommendation when the $49 calls have very little time value remaining -- so probably in early August unless the stock falls back some (or sooner if the stock goes higher). We are watching it and plan to roll our options. You can follow along then, when we issue that trade. It'll be in your inbox! Best, Jeff

Q: I the recent Monday Memo of May 31 on "Targeting Annualized Returns", APPL and GILD were left unestimated. Is there any consideration to moving the capital currently allocated to these 2 investments to something where there is a higher conviction? Thanks for the great service, still new to the program but love the the multi faceted approach.

A: Thank you, Dan! We have plenty of capital to invest still, right now, so we're not planning on selling AAPL or GILD right now. We look forward to the next earnings reports. Both are listed as Buys, meanwhile. Both are really outstanding companies -- among the best, or the best, in their industries -- so we're glad to own them. Both are also very inexpensive. Our lack of an estimate on how much they may appreciate is more a reflection of not knowing where the market will want to value them over the long term. Will value multiples below 10 remain the case!? Maybe. Then appreciation will likely be around 6-7% a year, and unless we can get those returns higher with options, we may need to move that capital eventually. But will the market value them above 10x earnings again? Then the returns should be well above 10% annualized. So, that's where our uncertainty exists, but not in the quality of the businesses. Best, Jeff

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Short Pier 1 Imports

Published Jul 6, 2016 at 3:17PM

Is this for you? This trade is for Fools with a margin account who can locate shares with their broker. Before this alert was sent, TD Ameritrade, Interactive Brokers, Fidelity, and OptionsHouse had shares available to short. Check with your broker to locate shares and inquire about any fees involved. Also, this trade is only for Fools who don't mind volatility — the stock will likely bounce around depending on quarterly results, so be prepared for a potentially bumpy ride.

How You Participate

- **Trade:** Sell short **Pier 1 Imports** (NYSE: PIR)
- **Allocation:** 0.75%
- **Price guidance:** Because Pier 1 is not highly liquid, **it is critical to use a limit order.** Initially, **use a limit order** to short around recent prices, about $5.30 or higher. As time goes on and prices change, newcomers may need to short below that.
- **Recent price (2:48 p.m. 7/6/16):** $5.34
- **Availability at Interactive Brokers (7/5):** 2.7 million shares
- **Current annualized shorting fee (7/5):** 0.65%, plus the dividend below
- **Current dividend yield (7/5):** 5.2%; we also need to pay this dividend while shorting shares
- **Ex-dividend date:** July 18th
- **Short interest (percentage of shares outstanding as of 7/5):** 16.3% (per S&P Capital IQ)

What We're Thinking

Founded in 1962, Pier 1 Imports is a home-goods retailer specializing in decorative accessories, furniture, candles, housewares, gifts, and seasonal products. As of May 28, 2016, the company operated 1,027 stores in the U.S. and Canada.

The bull case for Pier 1 goes like this: The stock has been beaten down lately, and it's now trading at relatively cheap multiples -- 4.8 times EV/EBITDA, 4.4 times free cash flow, a P/E ratio of 17, and a price-to-book of 1.6. The company has a fast-growing e-commerce presence, and management is closing stores and taking steps to increase profitability. Inventory and working capital management are improving, and as a consequence, gross margins may expand in the near term after their prior weakness.

The bear case for Pier 1 goes like this: The company's long-term viability is questionable. Its industry is in the midst of disruption, and Pier 1 cannot easily compete on price with online retailers that don't have large store bases and utilize just-in-time inventory management. Margins are likely to continue to erode, and the fast-growing (until now) e-commerce business is experiencing a sharp slowdown that's likely to persist, harming comparable-store sales metrics and bringing attention to falling margins. Management is also plowing organic cash flow -- and debt -- into fruitless share repurchases, which demonstrates poor decision-making around capital allocation and detracts from shareholder value.

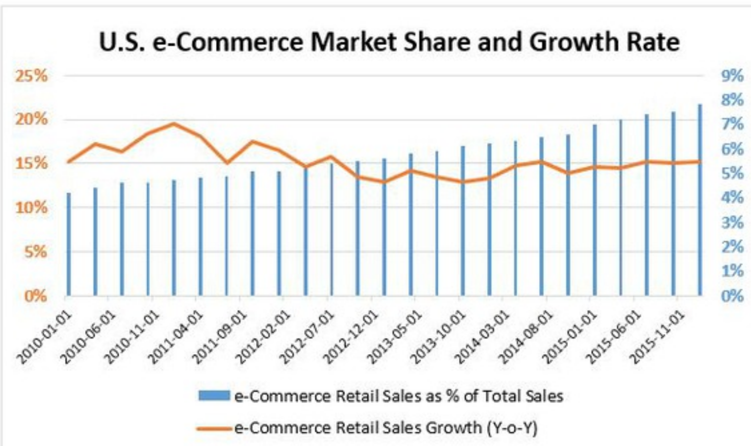
Given slowing growth and deteriorating margins, we think Pier 1's current price of $5.34 per share is higher the true intrinsic value of the business. We believe there is potential for outright downside from these price levels as Pier 1's e-commerce sales slow, total margins continue to deteriorate, and same-store sales decline. If these trends continue, the company will not be able to earn its cost of capital, leaving its worth equivalent to the book value of its assets -- if we're being generous. Book value per share (which has been declining) is currently $3.31, suggesting nearly 40% downside from current price levels.

Red Flags

- We don't believe the company has a sustainable competitive advantage. The success of Pier 1's retail business depends on consumer retail traffic and management's ability to identify trends and provide merchandise that satisfies consumer demands. Pier 1 doesn't have unique characteristics (that we see) to draw customers to stores to a greater degree than competitors. Additionally, overall U.S. physical retail traffic is in decline as e-commerce continues to grab a growing share of U.S. retail spending:

Month	U.S. Retail Traffic % Change (Y-o-Y)
May-16	-9.9%
Apr-16	-6.5%
Mar-16	-9.7%
Feb-16	-6.6%
Jan-16	-4.3%
Dec-15	-5.8%
Nov-15	-7.6%
Oct-15	-10.7%

Source: RetailNext

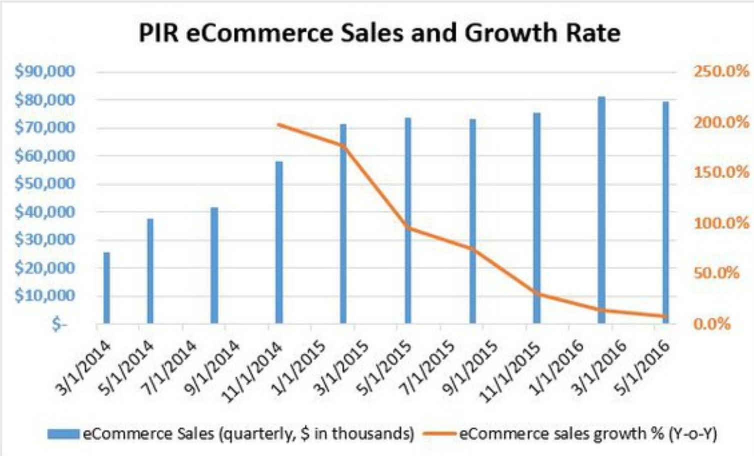


Source: FRED economic database

- We can see the effect of declining retail traffic and increased competition in Pier 1's financials, as same-store sales have been in a general decline over the last several years:

- Even in decline, same-store sales are artificially inflated because of the e-commerce business, which was launched in July 2013. The company includes orders placed online in its comparable-store sales calculations, which makes the metric look stronger than it really is, especially as the e-commerce business showed rapid growth during its first few years.

- However, after that initial burst, sales growth from the digital channel has sharply decelerated, and the trend looks likely to continue as organic growth starts to take the place of inorganic, start-up growth:



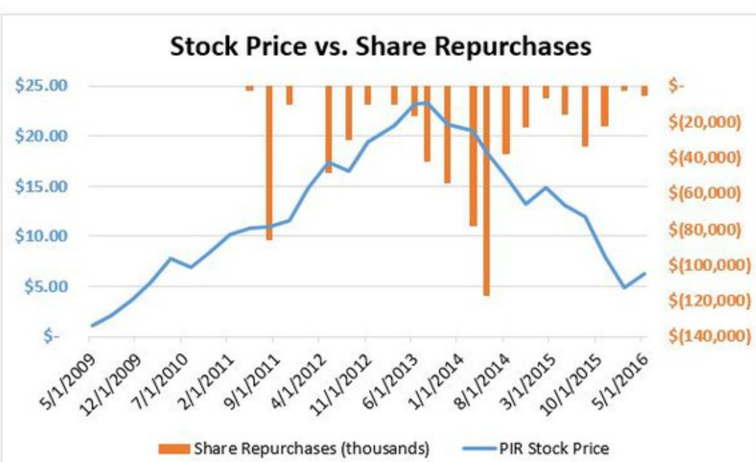
- Because of the confluence of declining traffic, increased promotional activity to drive sales, and increased competition from newer businesses with leaner cost structures, Pier 1's margins have been under significant pressure in the past few years. The company's trailing-12-month (TTM) gross, operating, and net margins have declined essentially every quarter since the beginning of fiscal 2014:

Quarter	TTM Gross Margin %	TTM Operating Margin %	TTM Net Margin %
Q1-2014	43.7%	11.8%	7.6%
Q2-2014	↓ 43.6%	↓ 11.4%	↓ 7.0%
Q3-2014	↓ 43.5%	→ 11.4%	→ 7.0%
Q4-2014	↓ 42.1%	↓ 9.9%	↓ 6.1%
Q1-2015	↓ 41.5%	↓ 9.4%	↓ 5.7%
Q2-2015	↓ 41.1%	↓ 8.6%	↓ 5.1%
Q3-2015	↓ 40.8%	↓ 7.8%	↓ 4.6%
Q4-2015	↓ 40.4%	↓ 6.8%	↓ 4.0%
Q1-2016	↓ 39.9%	↓ 6.1%	↓ 3.6%
Q2-2016	↓ 39.0%	↓ 5.6%	↓ 3.2%
Q3-2016	↓ 37.9%	↓ 5.0%	↓ 2.9%
Q4-2016	↓ 36.7%	↓ 4.0%	↓ 2.1%
Q1-2017	↓ 36.2%	↓ 2.9%	↓ 1.4%

- In fact, because of "internal and external pressures, including competitive pricing" and "the headwind of a challenging store traffic environment," Pier 1 reported a quarterly operating loss (-$7.8 million) in its most recent results on June 29. This was the first such loss since the summer of 2009, when the company was emerging from the U.S. housing crisis.

- We think Pier 1's e-commerce sales are likely to continue to slow, and category competition will continue to be fierce, pressuring the company's margins and bringing attention to the slow decline of its retail storefront operations. This decline has until now been partially obscured by the rapid growth of the nascent e-commerce business.

- Additionally, we are not fans of management's capital-allocation policies. Since fiscal 2014, Pier 1 has spent more than $450 million on share repurchases at much higher stock prices than today's. Management even took on about $200 million in debt in fiscal 2015 with the intent of ramping up share repurchases, yet as of Feb. 27, the company's average repurchase price since fiscal 2014 has been $16.39 per share -- 212% higher than today's price of $5.26. Based on the current stock price, these share repurchases have had the effect of incinerating more than $300 million in shareholder capital, quite notable for a company with a total enterprise value of about $500 million. If operations don't turn around, continued share repurchases will further erode shareholder value:



How It Fits Into *Pro*

Given Pier 1's weak competitive positioning, deteriorating financials, and questionable capital-allocation policies, we feel comfortable with a 0.75% short position. The intent is to start small with our allocation, retaining the flexibility to add to our short position over time. If the company's numbers exhibit further decline, we may look to increase our allocation to the short. On the other hand, if management manages to reignite growth and steady its margins, we'll re-examine our thesis.

This small position is an addition to our direct short basket, and it modestly lowers *Pro*'s net long exposure to the market. This short should fare well for us in a falling market, at which time U.S. consumer spending and retail sales will likely decline and the company's debt load should become a burden.

Be aware that we will need to pay the company's current 5.2% dividend yield as it is paid out on a quarterly basis. Despite that hurdle, we still believe that shorting this company offers us the ability to reduce our market exposure and potentially achieve an attractive position-level return going forward.

Alternative Trades

- **Prefer not to short or otherwise aren't able to locate shares?** If you're in a margin account, you can consider setting up a long-term synthetic short position, simultaneously buying January 2018 $5 puts and selling an equal number of January 2018 $5 calls. This strategy can currently be set up for almost no cost (at a start price of $5 per share). This differs from shorting in that you are not required to pay the dividend (although said dividend is factored into the start price), and you don't receive cash up front like you would if you were shorting outright. The value of the synthetic short will increase in a 1:1 ratio as the stock price declines and decrease in a 1:1 ratio as the stock price increases. Set up one synthetic short for every 100 shares (or $500 worth) you wish to short, up to a 0.75% allocation.

- **Investing in an IRA?** Consider setting up a shorter-term bear put spread, simultaneously buying January 2017 $6 puts and selling an equal number of January 2017 $4 puts. This trade can currently be set up for about $1 per spread (at a start price of $5 per share). This trade profits if the stock declines to less than $5, and its profit is capped once the stock price reaches $4, at which point the spread will be worth $2 -- a potential 100% return on your $1 cost to set it up. If Pier 1 stock ends at more than $6 by expiration, your spread will expire worthless, so be very mindful of position sizing. Only invest as much capital as you are willing to lose, and be aware of how the risk/reward payoff differs from that of shorting.

- **For advanced options investors:** If you're in a margin account, and you prefer to use options to target a cash inflow at the outset of your strategy, you can also consider selling short-term or long-term naked calls at various strike prices, whichever you like best. (Be wary of important dates like earnings reports.) If Pier 1's stock price ends up below the strike price of your calls at expiration, you keep the entire premium as income. On the flip side, naked calls (like shorting) have theoretically unlimited losses. If the stock price rises well above your strike price by expiration, you'll be obligated to buy shares at the market price in order to sell them at your strike price; the difference is your loss on the trade, minus the premiums received for selling the call in the first place. Selling naked calls is the bearish equivalent of writing puts: The most you can earn is the premium received, and you don't have upside below your strike price, but you receive a cash inflow up front that you are ideally less and less obligated to pay back over time, rather than paying up front to achieve future gains.

Pro Can Help

- Questions? Head over to the new Short Pier 1 discussion board.

Pro Catch-Up Trades: July 5, 2016

Published Jul 5, 2016 at 3:02PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **FactSet Research Systems** (NYSE: FDS): Buy 2% in this new position.
- **Gentex** (NASDAQ: GNTX): Buy 2.6% in stock if you lack it.
- **MasterCard** (NYSE: MA): Buy up to 4.2%.
- **Oracle** (NYSE: ORCL): Buy up to 3.8% (see our earnings update).

Continue building your portfolio with our Buys, including these highlighted today:

- **Gilead Sciences** (NASDAQ: GILD): Buy up to 3%.
- **Verisk** (NASDAQ: VRSK): Buy 2.4%.

Shorts:

- None currently.

Options:

- **Celgene** (NASDAQ: CELG): Sell to open October 2016 $95 puts, for a potential 3% stock allocation, lately getting paid $4.50 or more with the stock just above $100. Sell one put for every 100 shares you could buy at $95 (or a net $90.50).
- **Gentex** (NASDAQ: GNTX): Sell to open September 2016 $15 puts for a potential 1.5% additional allocation to the stock; lately, shares are $14.95, putting the puts in-the-money, but we still like this option, which nets a buy price of about $14.30.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY): You can set up our latest Sept. 16, 2016, $200/$189 put ratio spread for a small debit of about $0.06 lately; right now, it may be better to wait for a market drop to set this up for a credit.

Options expiring next:

- **Expeditors International** (NASDAQ: EXPD): August $46/$49 covered strangle. We'll have updated guidance close to the August expiration. Lately, shares are near $49, which would have both options expiring as nearly 100% income.

Choppy Challenges Won't Stop Us

Published Jul 5, 2016 at 3:02PM

Dear *Pro* member:

We have entered a newly challenging period for investors, but that doesn't mean we need to change the foundation of how we invest. With social unrest in Europe, tepid earnings growth in the U.S., China trying to support an over-leveraged economy, and South America largely suffering, only a mole couldn't see that headwinds exist for stocks. Add to this the belief that most U.S. stocks appear generously priced (because few other attractive investments exist!), and it may mean that the choppy, sideways market we've seen over the past 18 months will persist.

This doesn't mean we can't make money here, though. **FactSet Research Systems** (NYSE: FDS) is up about 7% since our recommendation was issued in May, and **Verisk** (NASDAQ: VRSK) and **Visa** (NYSE: V) are both up more than 11% since our recommendations to buy last year. We are buying new stocks carefully. And we've repeatedly made money writing options on the likes of **Gentex** (NASDAQ: GNTX) and others, with more in the works. So, we don't mind the choppy challenges of today's market. Large returns are more difficult to realize in such a situation (and avoiding large losses must remain a priority), but we believe we can continue to work our way toward positive results while biding our time for the next market upswing that should lift our strong stocks.

As we work on that path, let's revisit six foundations of investing.

Six Investing Foundations to Remember

1. Time is the biggest factor for success. Whatever you wish to master, it's the *time* devoted to it that will most determine your success. But investing is generous. You *don't* need to devote all of your waking hours to it to succeed. To the contrary: As the popular saying goes, it's time *in* the market, not timing the market, that matters. The longer you let your funds stay invested in good companies, the higher your odds of success.

2. A 52-week high doesn't matter. Many stocks are currently trading far below their past year's highs, but don't let that convince you they're all good buys. Many might still be better *shorts* than buys. A stock's past high may have zero relevance -- it may simply represent a mistake made by previous investors. So, don't assume a beaten-down stock is a bargain by anchoring on something (an old high) that may lack meaning.

3. Make the best decision for today. In the same vein, many investors anchor on their cost basis. "I'll sell when I get back to even on this position" is rarely a good way to approach your decisions, because your past buy price is *not* relevant today. All that's relevant is how you believe the stock will perform next. If you don't believe in a company any longer, take your lumps and sell.

4. Time could make your portfolio stronger and stronger. Over the years, your winners will become a greater portion of your portfolio, and your losers will shrink in relevance. So, even those who don't make any new decisions can benefit from an increasingly strong portfolio -- assuming enough positions in it are winners. Keep this in mind if you're reluctant to sell, or if you're a poor seller. Inaction is a perfectly acceptable response much of the time.

5. Know yourself. Along with time in the market, your temperament is key. Know your limits. When you make a poor decision, realize why you did it, and avoid that situation in future. Some industries will simply make you nervous, for example, so learn to avoid them. Or, putting too much money in one stock may cause you to panic and sell when it's down. Observe yourself and then protect yourself from future mistakes of temperament.

6. Even simple decisions can take weeks. I typically like to take weeks, sometimes months, to make a new decision, even if it's a relatively simple one (such as deciding to write covered calls on a holding for the first time). Don't feel rushed. By pondering the decision for a few weeks, you'll come to have a more rounded view of it, and feel more comfortable when you do decide.

Earnings Ahead

We hope you all enjoyed some fireworks the past weekend! We're due for more starting next week, as earnings season ramps up. **Oracle** (NYSE: ORCL) and FactSet have already kicked off our earnings season in *Pro*, and so far we're pleased -- although it may be a challenging quarter overall. We'll see.

On that note, please visit the Memo Musings board if you have any questions or comments, and thank you for being a *Pro* Fool! Let's get 'em.

-- Jeff (TMFFischer)

Pro Guidance Changes

- None in the past week.

Pro Completed Trades

- None in the past week.

Pro Catch-Up Trades: June 27, 2016

Published Jun 27, 2016 at 3:24PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **FactSet Research Systems** (NYSE: FDS): Buy 2% in this new position.
- **Gentex** (NASDAQ: GNTX): Buy 2.7% in stock if you lack it.
- **Oracle** (NYSE: ORCL): Buy up to 3.8% (see Jeremy's new earnings update).

Continue building your portfolio with our Buys, including these highlighted today:

- **Skyworks Solutions** (NASDAQ: SWKS): Buy 2.9%.
- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): Buy 0.7%.
- **TD Ameritrade** (NASDAQ: AMTD): Buy 2.2%. With new expectations that interest rates won't go up perhaps until 2017 thanks to Britain, financial stocks have been hit, and patience will be required.

Shorts:

- None currently.

Options:

- **Celgene** (NASDAQ: CELG): Sell to open October 2016 $95 puts, for a potential 3% stock allocation. These puts lately pay more than $7 each, with the stock right near $95.
- **Gentex** (NASDAQ: GNTX): Sell to open September 2016 $15 puts for a potential 1.5% additional allocation to the stock; lately, shares are $14.70, putting the puts in-the-money, but we still like this option, which nets a buy price around $14.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY): You can set up our latest Sept. 16, 2016, $200/$189 put ratio spread for about a $0.90 credit lately (but any credit is good), as higher volatility increases the bid on the lower-strike puts. So, follow the original alert to set up this position for September.

Options expiring next:

- **Expeditors International** (NASDAQ: EXPD): August $46/$49 covered strangle. We'll have updated guidance close to the August expiration. Lately, shares are $47, which would have both options expiring as income.

Pro's Updated Correlation Matrix

Published Jun 27, 2016 at 3:24PM

Dear *Pro* Fools,

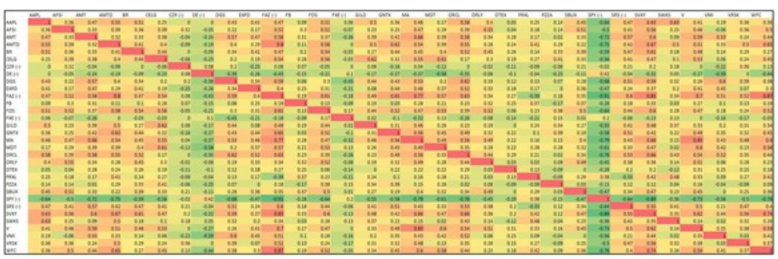
It's been a while since we've run a Memo that analyzes the stock-price correlations between our companies; this was the last one, from early last year. After the market shock of Brexit last week, it's all the more important to keep an eye on the *Pro* portfolio's exposure and other risk measures so we can accurately consider whether we're positioning ourselves properly to achieve our long-term North Star goal.

As such, in this Memo, I've run the correlation analysis we've run in the past on today's portfolio, re-creating our correlation matrix for *Pro*'s current holdings. I hope this Memo is useful not only to those members who have seen how our portfolio composition and correlations have changed over time, but also to those who've never considered our correlations before. Please be sure to reread former *Pro* analyst Nick Crow's original correlations Memo for background information on how to interpret the correlation matrix.

Step Into the Matrix

The graphic below shows all the possible correlations between each pair of stocks ("pairwise correlations") for our portfolio. The matrix includes our shorts and companies on which we only hold options positions. A (-) in the header indicates that we are short that security.

A note of consideration: Although I've included our SPY hedge, be careful in interpreting its output. Our SPY put ratio spread is a combination of several derivative positions, meaning that price correlations are difficult to analyze because the profit/loss curve is not linear (i.e., correlations change depending on which price we're talking about). The numbers in the matrix for SPY likely best represent only the prices in between our strike prices ($189 and $200); outside those strike prices, the correlations are likely to be very different. (Click the image for a larger version.)



Source; Portfolio Lab Pro and analyst calculations. Correlations are based on monthly price movements.

As we can see from their green shading, our direct shorts (CZR and DE) are negatively correlated with most of the rest of the portfolio, offering us diversification benefits. Our direct shorts zig when the rest of our portfolio zags, and it is partially for this reason that we are intent on continuing to build out a direct short "sleeve."

We refer to CZR and DE as "direct shorts" because they are short positions on individual company equities. Our other shorts (FAZ, FXE, and SRS, all three of which are ETFs) behave differently. FAZ and SRS are actually short vehicles themselves (short financials for FAZ and short real estate for SRS). When you short a short vehicle, the position behaves like a long. We can see that effect with the orange and red shading for FAZ and SRS, indicating their positive correlations with the rest of our portfolio. The FXE short, as a short of a currency, behaves somewhat independently from the rest of the portfolio, with neither a strong positive or a strong negative correlation with almost any position.

The matrix indicates that among our core long positions, the five with the lowest correlations to the rest of the portfolio are Papa John's (aggregate pairwise correlation score: 3.98), OpenText (4.49), Facebook (5.68), Parexel (6.00), and Valmont Industries (6.24). And the five positions with the highest correlations are MasterCard (12.27), Visa (12.22), TD Ameritrade (11.84), FactSet Research Systems (11.47), and Wells Fargo (11.27).

The *Pro* Bottom Line

Pro follows a flexible, absolute-return investing strategy that utilizes shorts, options, and ETFs alongside our core long stocks. Despite some areas of significant concentration (for example, our 25%-plus allocation to financials), we believe our portfolio is sufficiently diversified. Additionally, our current S&P 500 put ratio hedge offers significant negative correlation to our holdings once the index falls below a certain level, further reducing overall riskiness. And as options investors, we build strategies with non-normal return profiles — hedging and collecting premiums in exchange for the obligation to sell shares higher or buy shares cheaper. That means we can manage our risk *and* profit through a wide range of outcomes.

While some of the names of the companies have changed, and the correlation table looks a bit different than it did in its prior two iterations, our underlying philosophy and our goals are the same. We continue to aim for North-Star beating returns over every rolling three-year period, and correlation and diversification are important parts of achieving that goal.

Fool on!

— Billy (TMFBillyTheKid)

Oracle's Cloud Business Is Firing on All Cylinders

Published Jun 24, 2016 at 5:31PM

We've been waiting patiently for **Oracle** (NYSE: ORCL) to turn the corner in its transition to a cloud-based software as a service (SaaS) business and it now looks like that corner is safely in the rearview mirror. In the recently announce fiscal Q4 the company blew past the high-end of management's estimates for SaaS and platform as a service (PaaS) sales growth, posting a 68% increase over the previous year and 17% sequential growth over Q3. As management noted in the conference call, what's most encouraging is that Saas/PaaS growth is actually accelerating as the business gets bigger. In the last quarter the company added 1,640 new customers, bringing the total SaaS count to about 12,000, and cloud sales now account for 8% of Oracle's revenue versus 5% a year ago. For reference, the cloud business posted 20% growth in 2014, 34% growth in 2015, 52% growth in 2016, and management is guiding for better than 65% growth next year.

Though most of the talk is about the breakaway success of the cloud business, Oracle's on-premises business is still the primary contributor to company sales at 72% of total revenue. As expected, new software license sales declined 10% as demand increases for cloud-based applications, but a 4% increase in software updates and product support mostly closed the gap, resulting in a 2% overall decline. At best, we expect this business to tread water while the cloud business continues to grow. Management pointed out that the cloud business has finally reached the size where its sales growth was more than making up for the slow decay of the on-premise business. As a result we should begin to see a marked improvement in most operating metrics (operating margin, EPS, etc.) in the coming year.

For the year, total software and cloud sales totaled $29 billion which is a 3% increase in constant currency. Of that total, cloud increased 52% for the year while on-premises was about flat. In total, the company generated about $12.4 billion in free cash flow over the year which the company returned to shareholders through $10.4 billion in buybacks and $2.5 billion in dividends. That amounts to 105% of cash flow, which Oracle funded debt, though the company maintains a net cash position of $12.3 billion.

What's Driving Cloud Demand?

The main drivers of the faster SaaS growth are an improving suite of products, a better trained salesforce, new sales tools that shorten the sales cycle, and increasing cross-selling opportunities. In the past quarter Oracle had 917 current customers expand their relationship and over 270 customers who bought SaaS also bought PaaS. This success, in addition to the reported two percentage point increase in cloud renewal rates, suggests that Oracle's cloud applications are being well-received by customers. Also, Oracle is quickly becoming a force in cloud enterprise resource planning (ERP) software. That development has expanded the company's addressable market to include many middle-market businesses which were previously considered too small. This quarter Oracle added 800 ERP customers and about half of those had no previous Oracle relationship.

As always, Larry Ellison made sure to call out Oracle's cloud competition on the call, noting that Oracle's cloud business is now growing faster than both **Salesforce.com** (NYSE: CRM) and **Workday** (NYSE: WDAY). He also shared the company's two ambitious goals for 2017: growing the cloud business twice as fast as the closest competitor and becoming the first SaaS company to reach $10 billion in annual cloud sales. Infrastructure as a surface (IaaS) sales growth have been growing at a slower, but still respectable at a 11% clip, because of stiff competition from **Amazon's** (NASDAQ: AMZN) AWS and **Microsoft's** (NASDAQ: MSFT) Azure units. The company has recently reengineered its IaaS offering to improve its performance and reduce costs significantly, but I expect this business to remain a distant third for the foreseeable future.

Legal Matters

It's also worth noting the whistleblower suit that popped up earlier in the month that alleged that Oracle was using misleading accounting to inflate its cloud sales. During the call Safra Catz only shared a brief mention of the case stating, "Now in regard to our cloud revenue accounting, we have reviewed it carefully and are completely confident that it is 100% accurate, and if anything, slightly conservative." At this point there's little detail regarding the exact charges and the only other response from Oracle was from a spokesperson who stated, "This former employee worked at Oracle for less than a year and did not work in the accounting group. She was terminated for poor performance, and we intend to sue her for malicious prosecution." We'll be paying close attention to this as additional details emerge, but in the interim, I'm willing to give Catz (Oracle's former CFO) the benefit of the doubt.

Looking Forward

As the cloud business continues to scale, profitability should improve toward management's stated goal of an 80% gross margin. Management didn't nail down the timeline for that improvement other than to state that the expected Q4 FY '17's gross margin to be much higher than FY '16's 52% year-end margin. Sales growth guidance for next quarter has been increased to 75% to 80% suggesting that the cloud growth momentum we saw in the fourth quarter isn't just the result of management pulling sales forward to hit year-end bonus targets. If that pace continues then the company could once again blow past management's 65% baseline estimate for the coming year.

The *Pro* Bottom Line

Overall, Oracle posted a solid quarter and our investment thesis appear to be on track. The transition to a SaaS sales model is proving successful and we should begin to see those wins show up on the income and cash flow statement as a steady stream of recurring cash flow. Even though the topline will likely continue to grow at a modest low-single-digit pace for next several quarters, the company is increasing the lifetime value of its customer base and becoming more profitable as the cloud business scales. Oracle is currently trading at a free cash flow yield of about 7.5%, which is attractive considering the likelihood of improved profitability as the cloud business scales. Oracle remains a *Buy First* recommendation and we suggest that you buy shares to match *Pro's* 3.8% allocation if you haven't already.

Brexit: And Then There Were 27

Published Jun 24, 2016 at 12:15PM

Dear *Pro* member:

Along with the rest of the world, we at *Pro* have been watching the polls in the United Kingdom for weeks. As recently as yesterday, Wall Street put the odds of Britain staying in the European Union almost as high as 90%. Those odds turned out to be 100% wrong, with 52% of UK voters electing to leave the EU. With roots going back as far as the 1950s, this union of 28 countries officially began to form in 1993 as a way for European countries to share trade agreements, environmental and immigration laws, and eventually a common currency (for many countries, not the UK) -- in short, to lend more stability and growth to much of the continent. The union was greatly tested by the financial crisis of 2008, and the strains have grown since then.

I don't want to sound too dramatic, but the UK's referendum to leave the EU may just be the first splinter off the mantle. More indebted countries -- the likes of Portugal, Greece, Italy, or Spain -- have more to gain from leaving the EU, on the surface at least, than does the UK (for one, they could devalue their expensive debt). Plus, rumblings for liberation from the EU in France and the Nordic countries has already begun. But let's not get ahead of ourselves. Nothing is certain right now, not even the UK's fate, and that's why Wall Street is bound to be volatile for a time.

Now-former UK Prime Minister Cameron resigned today -- having promised a referendum to help win his own election, he played a game of chicken with the country and lost. So the first step for Britain is to establish new leadership. Then, assuming the UK honors the referendum, it needs to begin a lengthy, multi-year process to extricate itself from the many binds of the EU. Britain will need to draft new trade laws and pacts; new environmental regulations; new immigration policies; new, new, new. It's going to be messy and it will take time. But this is one instance in which we might be glad that most investors have a short attention span.

The shock of this news will wear off, replaced by the tedium of bureaucracy. Investors will return their focus to earnings results, beginning in a few weeks in the United States. Yes, headlines from Europe may lead the news for weeks, especially if more countries set up their own referendum votes, but before too long, financial results and reassurances from companies could go far to bring investors back to what matters most. The UK is the fifth-largest economy in the world (although it may have just ceded that spot to France), and it's in no one's interest to lose trade with it. Countries, and businesses, will work to keep commerce moving throughout this transition.

In the *Pro* portfolio, stocks most affected this morning include financials. Economic uncertainty tightens up lending, and banks depend on overnight lending to fund some operations. **AmTrust Financial Services** (NASDAQ: AFSI) has business in England, and the stock is lower this morning, but **Wells Fargo** (NYSE: WFC) is down nearly as much. This isn't because anyone knows something we don't know. It's because they don't know what the future holds, and that worries them. But we will argue that's always the case. We never know the future. We invest in probability. Our ability to be right more often than we're wrong is the result of close study of businesses and probabilities. Bumps aside, as long as we keep our minds healthy, I don't expect that to change. Adding probability to a long-term frame of mind, we should continue to generate pleasing returns over long periods.

The UK voted to leave the EU because 52% of its voters desire more control over immigration; over trade and employment; over how the country spends its money. Whether this was the right choice for the UK, only time will tell. In the meantime, we know we're invested in companies with strong leaders that we believe will grow value even when adversity is put directly in their path.

Right now, we have no plans to sell any of our stocks as a result of the UK's vote. However, we may now stay short the **CurrencyShares Euro Trust** (NYSEMKT: FXE) for a longer period of time, waiting to see if another shoe drops in Europe. We'll decide whether to take the short off Hold for newcomers soon. But if the euro falls much more, we may use the price to exit the short.

Elsewhere in the portfolio, **O'Reilly Automotive** (NASDAQ: ORLY) only operates in the U.S., and yet the stock is initially down sharply this morning. There's a chance to add to the position if you lack our 5.2% allocation. **Visa** (NYSE: V) just closed on its acquisition of Visa Europe, and is initially down sharply this morning, too -- an opportunity to buy shares if you lack them. We are especially careful when we buy financial stocks, so with our due diligence in hand, we still believe in them today for the long haul, including Wells Fargo and our others.

If you're looking to catch up on more recent *Pro* positions, you can also:

- Buy 2% in **FactSet Research Systems** (NYSE: FDS), per our report.
- Sell to open puts on **Celgene** (NASDAQ: CELG), per our recent recommendation, if you haven't yet.
- If you haven't, sell to open puts on **Gentex** (NASDAQ: GNTX), per our recent recommendation.
- Set up the **SPDR S&P 500** (NYSEMKT: SPY) put ratio spread per our recent recommendation. This morning, as I write this, the same hedge trade we did can be set up for a credit of about $0.35 per spread. That may change, but the point is, you can still get a credit.

Or, you can decide to do absolutely nothing today, and enjoy your weekend, same as always.

Whatever you do, if you maintain flexibility in your portfolio -- including cash -- you should not sweat volatility; instead, we hope you, like us, can see the opportunity in it. We are here hoping that expectations for volatility remain high on Wall Street, because that will lead to more options opportunities (including writing more covered calls at better prices), and we hope that actual volatility will lead to more stock opportunities, both long and short.

Overall, it's possible the rest of this year will be dominated by news from Europe, just as the Arab Spring was the big news years before, or the currency crisis in Asia in the 1990s, or any other number of historical upheavals. Britain is charting a new course for itself; it won't be easy; it will come with costs. Any benefits may only be seen many years ahead. The reverberations are only now beginning. But business goes on, and we'll be watching our companies to navigate the new environment well.

If you have questions, or want to talk, please visit the *Pro* Philosophy board!

Fool on!

-- Jeff (TMFFischer)
Advisor, *Motley Fool Pro* (U.S.!)

Brexit: What We Are (and Aren't) Doing

Published Jun 24, 2016 at 8:57AM

Market commentators are lining up to calmly forecast the likely outcome of the U.K.'s decision to leave the European Union. These are the same commentators who calmly forecast that the U.K. would not leave the European Union, so take them for what they're worth.

Winston Churchill fittingly said, "Democracy is the worst form of government, except for all the others." Thursday's vote may have been precisely what he spoke of. While the people have spoken, they have voted for pushing the pound to the lowest level since 1985, the nation's bank stocks down nearly 30%, and — at the risk of being one of those forecasters — almost certainly a weaker economy. Based on currency fluctuations, the U.K. gave up its title as the world's fifth-largest economy last night, ceding to France. And we're only a few hours after polls closed.

What's this mean for you as an investor?

An investor friend of mine, Tren Griffin, jokes whenever market-moving news occurs that he "cannot wait to get to my computer in the morning and proceed to do absolutely nothing."

The most important thing you can do right now is heed his advice. We're not selling or fleeing the market. We're genuinely shaking our heads in surprise, but we're not worried. If anything, huge declines become opportunities.

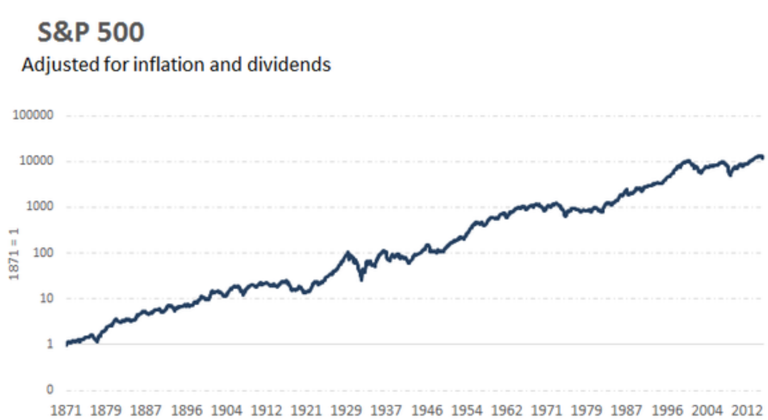
My litmus test for whether the world economy will create value over time is asking the question, "Did more people wake up this morning seeking to solve problems and make life better for others than do the opposite?" And the answer is still firmly "yes."

Whether it was after 9/11, or the 2008 financial crisis, or Greece's default, financial markets habitually have sharp, knee-jerk reactions to big news stories with lots of uncertainty. The attitude among investors becomes "sell now, ask questions later," as so many hedge funds and professional traders cannot afford the risk of *not knowing* what might happen to their investments over the next, say, 30 days.

We're not in that camp.

It's possible a big stock sell-off is justified. But it's probable that a downward dip is more indicative of people selling because they don't know what's going to happen, not because they know something you don't. That's why we stay the course.

Let me remind you of this chart. It's the U.S. stock market over the last 140 years, adjusted for inflation:



Do you know what happened during this period?

- 1.3 million Americans died while fighting nine major wars.
- Four U.S. presidents were assassinated.
- 675,000 Americans died in a single year from a flu pandemic.
- 30 separate natural disasters killed at least 400 Americans each
- 33 recessions lasted a cumulative 48 years.
- The stock market fell more than 10% from a recent high at least 97 times.
- Stocks lost a third of their value at least 12 times.
- Annual inflation exceeded 7% in 20 separate years.
- The words "economic pessimism" appeared in newspapers at least 29,000 times, according to Google.

And the market still increased 10,000-fold.

So, I suspect we'll be OK.

Patience will be constantly tested but ultimately rewarded — as it always has been.

Want to talk Brexit? Join us on the Philosophy & Strategy board!

Pro Live Chat, June 2016

Published Jun 22, 2016 at 4:29PM

6/22 Update: Fools, today's chat will be text-only, with no video component. See you at 2 p.m. in the space below!

Facebook: A Deeper Dive

Published Jun 22, 2016 at 3:29PM

Facebook, one of members' most widely held stocks, is worth a closer look. What will the company look like, a few years from now? Motley Fool analysts Simon Erickson and Aaron Bush go deep into Facebook, the stock, and the future.

{% video %}

Simon:

Welcome to the breakout session of a deep dive on **Facebook** (NASDAQ: FB), a small company you might have heard a thing or two about in the last couple of years. Quick show of hands, who is a Facebook shareholder in the room? Awesome. We know what we're getting into with this company. Hopefully, Aaron and I, over the next 30 minutes or so, will teach everybody something new about Facebook, especially from an investing perspective, that you didn't know already, and that we think is important to this company. This is a fantastic company in so many different ways.

Let's go ahead and look at what we're going to talk about today. We'll start with just an introduction of how Facebook got from where it was in Harvard in the year 2004, to what it looks like 12 years later today, and how this company has transitioned over the years. The second section's going to be really about the competitive advantages of Facebook. Social networking was not new when Facebook got into it. There were other companies that were also trying to do the same things, but we're going to look at why Facebook became Facebook, and then MySpace and Friendster became what they did as well.

We'll talk a little bit about [its] competitive advantages. What are the financials that have really become important for this company, and how does that transition into those? Then we'll step back and we'll look at the Mark Zuckerberg part of this equation. What [are] the culture and the people like in this space? How does that play a part for us as investors? We'll look forward from 2016 on.

Facebook's a $330 billion company today. What does it look like in the future, past 2016? What does that mean for us that raised our hands as investors in the room? We'll talk about some other opportunities and some of those risks that are associated as well. We'll even throw in what we think Facebook could potentially be worth going forward. On that note ... Oh also, I should say, if you do have questions, we should have index cards passed out on the table. Please fill out questions on that and pass them to the sides to Motley Fool staff, and we'll get to questions after we go through the presentation. All right, so [here] we are, deep dive into Facebook.

Aaron:

Great. Thanks, Simon. Before we go into talking about the current state of Facebook and what Facebook could be worth going forward and how it's going to get there, I think it's interesting to talk a little bit about how it came to where it is today. As Simon mentioned, the company was founded in 2004 by Mark Zuckerberg when he was 19. He was a sophomore at Harvard, and really right off the bat, Facebook took off. It became a phenomenon on the Harvard campus, and within two years, not only had it scaled to other college campuses, to high schools, but very rapidly opened up to anyone over the age of 13. Within six months of its initial founding, they already had moved their headquarters to Silicon Valley. Tremendous start from the very beginning.

Only two years later is when they made their first big change to the platform. Facebook in their early days, is really just a bunch of profile pages, where people had updates about themselves ever so often. In 2006, that's when Facebook rolled out its news feed, its timeline, which took all the changes that members on Facebook were making on the platform and put them into a stream for people to use. Two years after that, is when they launched chat, which now is Messenger as we know it today, and [it's] also when Sheryl Sandberg was brought onboard as Chief Operating Officer, and she has been incredibly instrumental in helping Facebook monetize its business.

The company IPO'd in 2012, which is about when us, as Foolish investors, started getting familiar with it. That same year it hit 1 billion active users, and after that it became a story of acquisitions. Acquiring first Instagram for a billion dollars, Oculus VR for $2 billion, and then later WhatsApp for about $19 billion, I believe. If we look now, where Facebook is today, this chart, our picture is a little bit outdated, so right now Facebook has 1.65 billion users. That's larger than any country's population around the world. It has actually now topped 1 billion WhatsApp users per month and 800 million Facebook Messenger users. Now, between WhatsApp and Facebook Messenger, they now send over three times as many messages per day as SMS or text messages did [at their] peak. It's a really tremendous growth. Instagram, now over 400 million active accounts, and Oculus is just getting started. That's where Facebook is today, and I'll hand it back over to Simon to talk a little bit about how all of this helps form the company's competitive advantages.

Simon:

Yeah, exactly. Like Aaron was saying, go back to 2004: Facebook was almost instantly a success, as soon as it was launched. On day four it had 650 users. On week three, it had over 6,000 users. We always talk about the power of the network effect, and that's just when more users join, more users want to join, and of course that attracts a lot of attention from advertisers. The basis of this business is, it's a very good business to be in. Mark Zuckerberg was able to very quickly scale this business in a quick way.

In addition to getting a lot of users early on, he really didn't have any costs required to do this business as well. He built the software off of freely open-sourced software, PHP for the programming language. He use MySQL for the database. It was freely available, it didn't cost him anything. Even at the point that Facebook had over a hundred thousand users, the only bills they were paying were for the servers to manage the traffic coming to the site. You put the combination of a company that's getting stronger and stronger with each new user that joins, with very, very few up-front costs, and you get a very powerful combination between the two of those.

I would argue the biggest competitive advantage that Facebook has, and the best thing they were getting for free, was information from their users. Because of the profiles, like Aaron talked about, all of Facebook's users were voluntarily giving them free information about their interests and what they liked out there. Advertising has always been a business of going where the traffic is. The billboards that are on the major highways cost more than the ones that are out in the middle of nowhere, so volume alone was not enough to justify competitive advantage. Facebook also had the ability to show a different billboard for every car that was driving along their highway. They knew what their users liked, they knew exactly what their interests were, and this was the gold mine was advertisers that they had.

In addition to that, Facebook took it the next step forward. Because it was an Internet company, there was back and forth, getting information in real time, all the time, from all of the traffic that was going to it. It could instantaneously tell an advertiser what the return on their investment was for any ads placed on Facebook. This was something that Friendster and Myspace did not have. They didn't have that wealth of information that Facebook did. As they got bigger, that information vault got stronger, and it really transformed the company into the strong competitive advantage it has. I'm going to pass it back over to Aaron to talk about what financial metrics flow from that competitive advantage.

Aaron:

Right. There are many different things to look at here, many different ways to look at the financials, but just to choose one thing to put on the slide, I decided to put this graph. The graph is of revenue growth. It's an important one, because the blue line represents just how far Facebook has come, scaling its revenue so quickly. The orange line represents the revenue growth rate. As you can see, if you can see the numbers, they still are growing above a 40% [annual rate]. It's been pretty steady and consistent for a good while now. That is incredibly powerful.

This growth really stems from two things. One, it stems from more users coming on board, onto the platform. That 1.6 billion users really adds up. Second, it shows the growth of average revenue per user. I think that is particularly interesting. In the fourth quarter of this past year, Facebook generated $13.50 per user in the US and Canada. That's a pretty good amount just for people scrolling through the Facebook feed. That number was up 50% year over year, so that really shows really strong, compelling growth. What is particularly interesting to me is the discrepancy between what's going on in North America and the rest of the world. $13.50 in US, but worldwide, where the vast majority of users are, the average revenue per user is only $3.70, which is [roughly] three and a half times lower than what it is domestically. That is a large opportunity that Facebook is able to chip away at every day until that gap closes.

Revenue growth is great, and seeing it [so] strong for so long is really impressive, but it only matters if it translates into earnings and cash flow. Unfortunately, as Simon partially discussed, they are a pretty low-cost business, so they have a tremendous margin profile. It's been a bit lumpy due to some certain expenses, like scaling employees and infrastructure ahead of the growth curve. All in all, it averages out. It really is a tremendous number.

Gross margins have been in the mid-80% range, which, if you don't sit around looking at financial statements all day, that's a very, very high number. More importantly than that, 30% of revenue turns into free cash flow, which is all of the cash that Facebook pulls in in a certain period of time, minus basically the cost of infrastructure. 30% of the revenue and growth turning into cash is a very high amount and that is what funds their acquisitions and future [purchases] and what have you that allows them to diversify and grow tremendously. Because of that, it's no surprise that the balance sheet is so strong, with over $20 billion of cash and absolutely no debt. It's a financial fortress on top of having great competitive advantages, stronger network effects, and people coming back every single day. Let's talk a little bit about the culture now.

Simon:

Right. If we step back ... By the way, this is the original thefacebook.com, in Harvard in 2004. You see at the bottom, "a Mark Zuckerberg production." I don't know if anyone remembers the old-school Facebook as it looks here, but in the original conversations that Mark Zuckerberg was able to have with his team, as this was just a concept in 2004, he used words like "connect" and "dominate." "Monetize" was never part of the conversation for him. He just wanted to build something that users really liked. He didn't have to worry about fundraising or the business of making any money. He didn't have any costs he had to worry about.

Because he had a team with Dustin Moskovitz doing a lot of the programming, [and] Sean Parker doing a lot of the business stuff, it allowed him to really just focus on what his vision for Facebook, "The Facebook" at the time, was going to be. I think it gave him a lot of flexibility, which is very powerful for a young leader like Mark Zuckerberg was. On top of that, he didn't have to spend any money to grow his business, either. Facebook selectively picked colleges that it wanted to launch at. Especially in the first year, they could basically control how they were expanding, based on much traffic they wanted to get and how many servers they had at the time. There really wasn't a whole lot of costs involved in marketing or advertising this business, either.

The combination of the two of those, of not having to raise any money because you don't have have very many costs, and selectively controlling your growth, means that he always had absolutely voting control. He had the vision of this company all the way. He didn't have to share his vision with anyone else, and he didn't have to rely on other financing, which so many other businesses have. It was a really great industry and a great time to be a part of.

Then this is the one that I really [like] the most of the culture of Facebook. They call it the hacker mentality. It's continually optimizing small things on the site, continually. It's very interesting to me because I came from a background in the energy industry. I'm from Texas, if there's any other Texans out there. In the industry that I worked in, the amount of time from the concept of a new idea to when you would actually have that in front of a customer was, if you were lucky, 18 to 24 months. A very long cycle time.

I got the chance to visit Facebook's headquarters a couple of years ago. I asked them the same question. I said, "What's the amount of time that goes, from when you guys come with a new idea in a discussion with management, to when it's actually in front of a customer or user on Facebook on the site?" I was kind of figuring maybe it was like a month, maybe it was six weeks, something like that. Their answer was, "It's 20 minutes." They immediately can launch something out there and get feedback about whether or not it's going to work, and they just pull the stuff off the site that doesn't. It's continually being optimized. It's that hacker mentality that's just so amazing to me, that culturally is still a part of this business. Aaron, what does the future of Facebook look like?

Aaron:

Yeah, this is the part that interests me the most. I think we can look at this in a few different steps. First of all, they're going to continue to grow in the same way that they have. They're going to continue to add new users across the entire platform. Between Facebook, Instagram, WhatsApp, they have now about 3 billion -- probably a little less than that because of some overlap -- but about 3 billion active users across all of that. They can still continue to grow. They're going to constantly improve the platform. They recently just launched live functionality. It's going to show live video. They just made a big partnership with eSports, with a big eSports company, to showcase just video games being played, which is a huge market now.

Then they're going to continue rolling things out, like recently, instant articles, which allows users to read articles on Facebook without using much bandwidth, so you don't have as high of Internet needs to use the service well. Just continuing what they've done is going to continue to help them. Also there's some other things out there that are more predictable that they're going to do, but that they're not necessarily doing in full force right now.

First of all, I think Facebook will absolutely continue to help people in developing countries go online. One, because Mark Zuckerberg thinks it's the right thing to do. Two, because doing so naturally just helps Facebook become a stronger business. Right now, they're doing it with these fancy Internet drones that fly in the air for a very long period of time. It's super impressive technology, but I have a feeling we'll continue to see more of that.

Second, I think we'll continue to see them scale products. Not just the Facebook core platform, but other ones, too -- Instagram being perhaps the most important one. A really interesting statistic about Instagram is that they have one-fourth the number of active users as Facebook, but they have one-fifteenth the number of active advertisers. That's a humongous discrepancy. I think even though the advertisers are less, even so, the average advertiser is probably spending less money on Instagram than they are on Facebook. Instagram has a tremendous runway.

Then WhatsApp and Messenger, they're two messaging apps will likely start integrating commerce capabilities at an accelerated pace over the next few years. We've seen them roll it out with Uber and make some minor tests here and there, but I have a feeling they're going to start pushing a lot harder, which opens up some really interesting opportunities.

Lastly, looking at what is more abstract. If you were to look at Facebook anytime in the past several years, trying to look for it and predict what was going to happen in the next five years, you always would have been blindsided by something. There just always would have been something big that would have happened that you wouldn't have been able to see before. I have a feeling that's going to happen again. I have a feeling they'll make some large acquisitions that we can't even predict now. Partially because those companies may not exist yet, partially because they might be getting started, or they could surprise us.

Virtual reality is also probably going to be a very huge deal, several years away. I think investors have learned to lower their expectations a little bit with virtual reality, looking more in the near term, but looking longer-term it still has tremendous opportunity. Then lastly, bots, which are basically little nuggets of artificial intelligence software that plug into Messenger or can even be plugged into the core of Facebook that help users solve tasks, get things done, or make the platform more addicting to use. Tons of room for them to think about how to move forward in a bunch of different ways. Of course, things could always go wrong. Simon, you want to talk a bit about the risks?

Simon:

Well, OK, Aaron, before we get too hooray about artificial intelligence and virtual reality and the bots taking over out there, let's take the other side of this coin, too, as objective investors and say, there's a lot of uncertainty in those future markets. A couple that we just talked about:

Virtual reality. We've seen forecasts of this being a $70 billion industry by the year 2020, but when you look at that today, it's still about a $7 billion market. That's a [tenfold] growth in the next four years. That sounds optimistic, and I can definitely see there being a case [for] that, but in reality today, most of it's still a hardware play. There's a lot of uncertainly in that forecast that we have to at least look at and objectively say, OK, is this really progressing as well as a lot of those forecasts would believe?

Artificial intelligence was another one that Mark Zuckerberg has recently talked about, about incorporating AI into Facebook's five- and 10-year plan. Still a very small industry today. Sub-$1 billion industry in the entire AI world. Big ambitions, big opportunities. We love this about Facebook, but we have to make sure that they're actually fulfilling their claims on these multibillion-dollar acquisitions.

The second thing that's a key risk that investors, I think, should be aware of, is that this is a great visionary leader. I mean, Mark Zuckerberg's got some noble things he's trying to accomplish over the next year. With his wife, [in] the Shannon Zuckerberg initiative, they're looking to cure diseases by the end of the century, they're looking to personalize education, they're looking to slow climate change. These are multibillion-dollar, noble but charitable goals, and to accomplish those, Mark Zuckerberg has committed 99% of his personal net wealth, which is mostly Facebook shares, to these charitable activities.

Now, because of that, he's recently created a third class of Facebook stock, that's non-voting, so he can actually offload shares without losing voting control of the company. It's going to be very interesting to see if there's any kind of disconnect in the next couple of years between Zuckerberg's noble initiatives, and then maybe a little bit of a clash with shareholders who still want to see profits on their investments as well. Two things I think we should keep an eye on as far as risks.

Aaron, the question I think as investors we're asking today is, like we said, Facebook is a $330 billion company today. You've seen a huge run-up in shares over the last several years.

Aaron:

Yeah.

Simon:

What is this company worth to an investor that's starting out at 2016?

Aaron:

That is a very good question. There are many ways to look at finding what that answer is. The answer itself is changing all the time, too. I decided to take a fairly simple approach and break down how we can see returns shape up in the next five years. Walking through my assumptions a little bit and thinking about this, I think it makes sense to expect 6%-8% annualized user growth on their core platforms. Historically, it's been double digits, but naturally, when they have to bring in people by the hundreds of millions, there's only so many more hundreds of millions of people out there, so that has to slow down a little bit, but 6%-8%.

Then I think we can expect 15%-20% growth in revenue per active user. That may sound very ambitious, but I really don't think it is, considering [that] a lot of advertisers are still moving money online, they're going to continue to up their ad spend. There's a tremendous amount of opportunity for Facebook to bridge the gap, lower the discrepancy between what they're making in advertisements domestically and the rest of the world. Then yeah, there's tons of room.

I was talking to Simon a little bit yesterday about this, but if you look at any Facebook news feed, about 3% of the content that you're looking at is paid for. If that were to go up to 5% or 6%, you probably wouldn't notice a huge change in your Facebook experience, but what that means for the advertising money that Facebook is pulling in would be enormous. Tons of room to grow with that.

I also think we should start to see messaging apps slowly monetize. Oculus might break even. Those are both a little bit iffy. Then 30% free cash flow margins, which is normal with what they've already been doing. Then if you put that together, look a little bit into the different growth that they could hit with those different ranges, you see these returns up here, which range from 9% to 96%. I've bolded the third one because I think that is probably closest to the most likely scenario, and that's a 62% return.

A couple of things about that. One, 62% is about 10% annualized. That's not fantastic. Part of that is because of just simply the massive run-up that Facebook has had. It's already up 50% over the past 12 months, just to give some perspective. When stocks go up that much, it does tend to take away a little bit from future returns. That said, I didn't really include any optionality in looking at how the valuation could play out in the future. What that means is that I really just looked at the core Facebook platform, how Instagram can plug into that, but if messaging really takes off monetizing with commerce, or if Oculus takes off, or if they acquire something else, it really could boost that up fairly significantly above that 60-ish percent growth and that would very likely be market-beating. Because they're such a great company, I would not count against that at all. All right.

Simon:

Aaron. Thanks very much. We're going to start the Q&A session. If you do have questions, please write them on that note card. If we can collect those. Do we have anyone from The Motley Fool here that can help us grab the questions? Thanks. Thanks, Matt. As we get started on the Q&A session, let me ask you, Aaron, to kick this off. As an investor, you've got a lot of metrics up here and a lot of assumptions, but what do you think the most important metric as an investor that I should be looking at when I'm looking at Facebook?

Aaron:

Sure. In the past I would have said, you would have to look at a combination of both user growth and average revenue per user, and those would give a very good idea of where the business is going and what it's capable of. As they're looking to lower out some expenses over time, I think it will start to make sense to look at free cash flow per user, so looking really at, "What is each user bringing down in terms of cash?" in whatever time period. I think we'll start to see that become more and more relevant in the years ahead. That could be very, very good indicator of the health of the business, but also how to value it.

Simon:

Great point. One other one I'd like to add to is, content is changing on Facebook. If you looked at Facebook during the last decade, early on it was mostly just text-based ads. Then it came picture-based ads, and now it's a lot of video-based ads. You kind of wonder, what is Oculus going to look like? Is it going to be a virtual reality-based ad in the future? A lot of the acquisitions Facebook's making right now [are] to get that price per advertising point up, which of course quickly falls to the bottom line. I would argue they've got the platform in place to handle all of that, and the capacity to handle the increased data associated with those. The price per ad of Facebook is now increasing concurrently with the volume of ads. I should say that again. The number of total advertisements is increasing [at] a positive rate, as is the price per advertisement, which is a very powerful one-two combination we've seen from Facebook. All right.

Aaron:

Questions.

Simon:

Here we go. Aaron, I'll spot you up with the first one. Question is, why does **Twitter** (NYSE: TWTR) not have the same competitive advantages as Facebook?

Aaron:

Sure. I think their history has been very different in terms of what they're used or. Facebook is more a biography of yourself over time. It's turned more and more into sharing videos and that kind of thing. Twitter has been more, "Oh, I'm thinking this in the moment. I'm going to say it," or something that is more sharing the news. Fundamentally two different purposes that don't butt heads too much. Second, and one thing that has really helped Facebook and has not helped Twitter at all, is that Facebook has been constantly iterating on its platform and its timeline -- basically, its news feed. Through being able to improve what people are seeing, that helps people stick around. Twitter has just kept it the same, chronological for a very long period of time. It's harder to get started with it as well, so that's part of what has made Twitter stagnant, and why Facebook has gotten so far ahead.

Now we're seeing Twitter start to try do some things to change their platform, and they're having a really hard time [doing] it. While Facebook does it all day, every day, with the hacker mentality that Simon was talking about. It's working very well for them. That's how I would look at Facebook versus Twitter a little bit. All right. Simon, do you think that the stock will reach a point where it will plunge dramatically?

Simon:

I don't think so. We get this question a lot. It's kind of a variation, I think, of, is Facebook at an all-time high, and have I missed the boat on this investment? Back to the comment you made, Aaron, about 3% ad load, only 3% of the news feed that we're currently seeing is sponsored and paid for by a company -- 3%. The other [part] of that, there's about 27% of that is trying to get you to come to another business's page. They're not paying for it, they're trying to redirect you to come see their Facebook page. The other 70% of that is cat videos, and videos of your baby doing whatever it's doing that you're sharing with your friends.

When you think about it, like the point Aaron made, when you've got a business that is making as much money as it is today, [still] only 3% of what you're seeing is being monetized. We're not even really monetizing Messenger. We're not even really monetizing Oculus. These are huge optionality plays that haven't made any money for Facebook yet. I don't see anything that, to me, says that this is the top of this business, and that we're going to decline after this. I think that Zuckerberg has done a great job of planning for the future, putting the right pieces in place for Facebook to be a lot larger than that.

Aaron:

Yeah, I would just say, I don't think there's any fundamental reason right now to think that something about the business would cause the stock to dramatically sell off. If I had to guess, it almost definitely will to a significant degree at some point, because of recessions, which cause ad spending to go down. There are many different reasons why it could happen, and I think with all great businesses, you do see that over time. It's nothing I would bet against.

Simon:

I like this question. How about the younger generation? Are they still as in to Facebook as far as competitive threats from things like Snapchat? What do you think Aaron?

Aaron:

That's a good question. I think to some degree, that they are missing out. I think that's only natural, but one important thing to realize is that people don't just use one social media platform. People can use multiple and juggle them very easily. I think with Facebook, we still are seeing a good amount of young people use it. What is turning into the Facebook of the youngest teenager generation right now, is Instagram, which is owned by Facebook. A lot of the user growth we're seeing there is that demographic jumping on board. That's part of why Facebook bought Instagram, [to] capture that younger demographic.

Snapchat, it definitely is a competitor, and it definitely is butting into market share, but in the growing market, there can be multiple winners. I'm not worried about that yet. All right. In the earlier session, Tim presented the case against M&A, mergers and acquisitions -- that they usually don't work out. With Facebook so active in M&A, should we be worried? Why or why not?

Simon:

Well, I mean, we definitely got that as a risk. That's one of the uncertainties of the bridge that leads into the clouds; you don't know what it's going to look like. Clayton Christensen -- any fans of disruption out there? -- would say that the innovators dilemma is [that] you can't know everything about a new market before you get into it.

You're not going to have perfect data for anything when you're jumping into something like virtual reality or artificial intelligence. It's just that Mark Zuckerberg has got a war chest of money that he can almost carve his own future into these new markets, in a more compelling way than a lot of competitors could. He's creating the future of Facebook because he's starting those markets. Oh yeah, there we go.

Aaron:

I can't believe we didn't show that picture earlier. It's epic.

Simon:

That was the best part of the presentation so far, I think. This guy is creating markets and he's jumping ahead of his competitors. Rather than saying, "Hey I'm going to wait for perfect data, he's saying, "Hey I'm going to put $19 billion down for WhatsApp. $2 billion down for Oculus, because I want to be a part of what those look like in the future." I think it's something we should be aware of, but I'm not sure it's a killer that they're spending a lot of money on acquisitions.

Aaron:

Yeah. I'd say a couple of things about that. One, there are two types of acquisitions that Facebook is probably going to do. One are the tools, and for a lot of start ups that make tools that help other companies grow or market better, that kind of thing, their goal is to be able to reach a scale of a billion users or so that they can assist. Naturally they can't do that without the help of someone like Facebook, or Google. Facebook is going to definitely be active in buying the smaller companies and bringing them to scale very quickly. I think that's pretty much a no-brainer for them to do, in terms of M&A. It's just [pennies] of change for them.

Then second, the type of acquisitions that they'll make are the kind that threaten their existence. I think we've seen this. They don't just go buy something because they think it'll be successful, or because they think it's cool. They really only buy big things if it potentially is a threat to taking them down. If you think about Instagram, capturing the younger generation. If you think about WhatsApp, it's a competitor to Messenger, and together they have almost 2 billion messaging users. Then Oculus, Zuckerberg has said, is the next-generation computing platform, and there are many ways for social to plug into that over time. Even if that's a very, long distance away, in terms of chess, it's making a move seeing 10 steps ahead. I think that's what they're thinking about there.

Even if something like Oculus doesn't pan out, it was a $2 billion dollar acquisition for now a company that's $330 billion. Even that, we talk about a lot, but that still, it's less than 1% of who they are.

Simon:

I read recently also that WhatsApp had the capacity to add 1 million users per day. Pretty phenomenal when you think about the terms of how big this platform is getting. Yes, it's not as defined today, but if you can get that kind of user base also plugged into Facebook ... They're buying these companies with stock. The new companies they acquire, they want to see Facebook succeed, too. This is an aligned interest of them as shareholders, too. I'm OK also with the acquisitions they're making.

Aaron:

Simon do you know what the average user does [in terms of] minutes per day?

Simon:

Do you have the number on that?

Aaron:

I don't, so this is a question we don't have the answer to, so I can find the answer and post it onto the one discussion board for Facebook, unless someone knows.

Speaker 3:

The last [reported figure] was fifty minutes.

Simon:

Fifty minutes. Five-Zero.

Aaron:

Fifty minutes. Okay.

Simon:

Fifty minutes per day.

Aaron:

Thank you. Fifty minutes per day. I think that is trending up. Then another question: Is there any risks or concerns with security and privacy?

Simon:

Oh sure, yeah. Any user community like this that has billions of users across the globe, you can't say that's not a risk.

Aaron:

Right.

Simon:

Two parts of that. One is the cybersecurity risk, which I think Facebook does its homework on making sure that's pretty much as secure as they can have it at all times. I think the privacy, the sharing of how much information that you're sharing is publicly available is a much bigger discussion maybe than we can even get into. People sometimes don't want to see Facebook get political. Maybe some users don't want to have all of their information immediately being mined by advertisers out there.

I expect we're going to see even more of a discussion, which Zuckerberg has done a good job of alerting anybody who is a Facebook user about, of [how to] control your privacy settings, and make sure you're comfortable with what you're putting on the site. That's not something the company should manage. I think that's an individual user's perspective on what you're comfortable with. I think that's a bigger discussion, don't you think, Aaron?

Aaron:

Yeah. I don't have too much to add. I would just say that hacking is probably just in its very beginning, so it's going to be a constant struggle between hackers getting smarter and businesses getting smarter to deal with them. Almost definitely there will be slip-ups over time, and privacy is just relative to people's opinions, basically.

Simon:

With regard to the gentleman that's on the screen to our right right now: What do you see happening if Zuckerberg follows the Bill Gates model and steps away from Facebook?

Aaron:

I wouldn't entirely count against it. I don't know if we're going to see that soon. He's still is in his younger thirties, but if that happens, I think that raises big questions. That is a potential risk that I don't know if we have perfect answers to. I would assume that someone like Sheryl Sandberg would become CEO. That's not something that terrifies me, just thinking about that for a moment, but I couldn't say whether anyone could perfectly replace the founder mentality and the visionary thinking that the Zuckerberg has put into Facebook. So, definitely a risk.

Simon:

Last time I checked, we look at Glassdoor a lot to judge employee satisfaction, and Facebook, amazingly, last I looked, has a 99% approval rating of Mark Zuckerberg from employees. Fantastic for a company that size. For Mark Zuckerberg, who's now the seventh-richest person in American at what? 30? 32? 31 years old?

Aaron:

Something like that.

Simon:

31 or 32 years old. Definitely a key part of our thesis for this. He also decentralizes a lot of control. Like the artificial intelligence stuff, he doesn't have to make all of the decisions on that department. He's able to hand off a lot of the stuff that's going on at Facebook right now, that you mentioned in the future-

Aaron:

That's an important. Instagram operates separately from the core of Facebook. Messenger operates in its own unit. WhatsApp operates on its own unit. All together, under the Facebook holding company so to speak. All right.

Simon:

Good? Two more questions. I'll give you one of these, and I'll take one too. Is there a correlation between the change in P/E, [the] price to earnings multiple, and the focus of Facebook on new areas, i.e Oculus, etc. Is there a correlation between the valuation metrics that the market's giving Facebook, and how much they're spending on new acquisitions?

Aaron:

I would say yes, a little bit in acquisitions as well as the core platform. I think the biggest boost in expenses has been just rapidly hiring employees over the past couple of years to get ahead of certain growth curves. That's nothing unnatural. Google went through that. Other companies in the past, like Cisco, went through that same thing. Yeah, definitely these more ambitious, newer projects, especially when they try to add tools to monetize them and scale them, that's definitely going to have a cost to it. I think we're starting to see those costs come into play. All right. Initially, all users were college students. How does the more diversified user base hurt the connections between users? Goals of the platform?

Simon:

Yeah so first of all, I don't think that it's hurting the connections of the platform. Having more people is actually, if anything, improving your connections. It's not just a subset of the population that goes to Harvard University this year. It's now [that] anybody can get on Facebook. Again, Zuckerberg, his intentions for this, is always to improve communication between people. He's adding tools like Oculus, where you can actually pretend that you're seeing your friend right in front of you at the same time, and talk to them. You haven't talked to them in maybe 10 years; you can use Facebook to better connect in doing stuff like that. Imagine how an advertiser can connect with a user if they can actually take them on a test drive of a car in virtual reality, or show them what they're trying to sell in what looks like real time. I think if anything, yes it's a larger pool, maybe it's not as exclusive as the original The Facebook was, but I'd argue that they're actually connecting better now than they were before.

Aaron:

I'd say there's a trade-off. I think they're getting more types of connections between different types of people, and that's definitely a plus for growing users and growing advertising dollars. I do think there has been an effect that has had on the users. If it's all college students, they're going to act like college students, but as soon as their mothers start coming onto the Facebook platform, they're probably going to start acting a little bit differently, so that's when they start heading over to a new platform. I think some of the popularity of Facebook, with everyone coming on board, has propelled competitors to rise and fill certain gaps that Facebook now has left behind.

Simon:

A niche that's opened up.

Aaron:

Yeah.

Simon:

Good point. All right, well, thanks again for attending our deep dive of Facebook. We'll stick around for a little while, if anyone has any other follow-up questions. Hope this was helpful for everyone, and Fool on!

Summer Solstice Solicits Sunshiny Sentiments

Published Jun 20, 2016 at 3:40PM

Dear *Pro* member:

I was once told by an editor [*editor's note: and I was once told by a managing editor*] that Rule No. 1 of writing a regular column is *not* to cite the weather or the season in your opening line. I'm not sure why that would be Rule No. 1 -- perhaps because it's so commonly done? -- but I must ignore it today as summer begins in the northern hemisphere. It feels downright disrespectful to ignore the importance of the seasons on this day, the longest day, the summer solstice. So, welcome, summer! We love you.

Here is the photo our excellent editor, Ellen, sent me to greet summer -- her daughter, Lola:

I can't get anywhere *near* topping that, so can we all sign off and go outside now?

Not yet? OK. But soon.

June 20, 2016: An Income Assessment (With Sunshine)

Another snapshot in time, today. A June Monday in 2016. With 172 days down, we have 194 days remaining in 2016, a leap year. *Pro* launched in October 2008, nearly eight years ago, or less than 2,900 days. We have healthy returns largely because we had been investing for years prior to 2008, so we know what we like; we know too much activity hurts returns; and we try to avoid big mistakes (although we still make them from time to time).

Most of our gains have been driven by capital appreciation in long-term stock holdings, and that should hold true for the next eight years, too. That said, it may be a bit *less true* between now and 2024, only because we are using (and plan to use) options more often for income now that most stocks don't look as attractively priced as they did in the recent past.

Even so, a few large stock winners the next eight years (and we certainly hope to have several!) will likely still produce the bulk of our future gains here in *Pro*, helped along by income and hedges. I also know that many members write many more options than we do, and produce considerable income doing so. Following our way of investing, you can amp up or down your income as you wish. We aim to amp it up for the rest of this year as long as it looks reasonable to do so.

We had several options expire last Friday for income, including covered calls on three stocks. We're looking to write more options on several positions soon. We're also due to set up new hedges, because our **SPDR S&P 500** (NYSEMKT: SPY) put ratio hedges expired Friday, too (for about $450 in gains, despite being unused).

So far this year, we've made $11,238 on our market index hedges, all of them on SPY. The bulk of that came from a February $200/$190 put ratio spread that ended in-the-money. SPY is at about $208 today, up about 3% this year. The Nasdaq is still down nearly 3% in 2016. Overall, it's generous to call 2016 a wash for most stocks so far. Many stocks have declined sharply.

The *Pro* portfolio is modestly in the green thus far this year, helped by our hedges and by $12,549 in realized option income year-to-date. A good part of the gain from options arrived with last Friday's expirations, but nearly half is still from **Coca-Cola** (NYSE: KO) puts that expired in January. All told, our closed hedges and options have added nearly 1% to the portfolio so far this year, which is notable in a pursuit where you sometimes battle to stay positive, and may need to fight for every point you make.

In 2015, we made about $800 on index hedges, and nearly $17,000 in option income; so we're well ahead of last year's pace, at our current $11,238 and $12,549, respectively.

Our stocks -- as is true for many investors -- have equally given and taken so far this year, resulting in not much change, excluding dividends. But most of our businesses are growing, so they're working their way toward future returns. Some results this year as of this morning:

- **AmTrust Financial** (NASDAQ: AFSI), down about 18%
- **Apple** (NASDAQ: AAPL), down 9%
- **Broadridge Financial Services** (NYSE: BR), up 19%
- **Facebook** (NASDAQ: FB), up 9%
- **Gilead Sciences** (NASDAQ: GILD), down 17%
- **O'Reilly Automotive** (NASDAQ: ORLY), up 4%
- **Papa John's International** (NASDAQ: PZZA), up 18%
- **Skyworks Solutions** (NASDAQ: SWKS), down 14%

Some stalwarts, including **Visa** (NYSE: V) and **MasterCard** (NYSE: MA), are about flat on the year so far, as their value multiples slowly contract; **Starbucks** (NASDAQ: SBUX) is down 7% since January.

It's during times like these that we're happy to own strong businesses that we greatly believe in; we're ready to potentially add to them on drops, while always scanning for more options opportunities. As long as our investing house is in order and we're up-to-date on all of our holdings, we'll also have time to work on other investing content. So it may be summer, but a Fool's work is never done. The key thing is that we enjoy it -- and keep in mind that no Fool should miss the summer for the screen.

On that note, get out and enjoy the longest North American evening of the year! Just visit the Memo Musings board if you have questions, and thank you for being a Fool with us!

-- Jeff (TMFFischer)

Pro Guidance Changes

- None this week.

***Pro* Completed Trades**

- **American Airlines** (NASDAQ: AAL): We sold to close all of our January 2017 $35 calls, getting $2.18 each.
- **Celgene** (NASDAQ: CELG): Per our recommendation, we sold to open eight October 2016 $95 puts, getting paid $5.30 each.
- **Gentex** (NASDAQ: GNTX): Per our alert, we sold to open 25 September 2016 $15 puts, getting paid $0.50 each.
- Our covered calls on **Valmont** (NYSE: VMI), **Skyworks Solutions**, and **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) all expired as income.
- **SPDR S&P 500** (NYSEMKT: SPY): Our two June hedges expired unused.

Pro Catch-Up Trades: June 20, 2016

Published Jun 20, 2016 at 3:38PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our Portfolio Building Reports will get you fully invested over the coming few weeks, as much as you want to be.

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **FactSet Research Systems** (NYSE: FDS): Buy 2% in this new position.

Continue building your portfolio with our Buys, including these highlighted today:

- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): Buy 1%.

Shorts:

- None currently.

Options:

- **American Airlines** (NASDAQ: AAL): Sell to close your January 2017 calls, per our alert.
- **American Tower** (NYSE: AMT): Sell to open July 22, 2016, $111 diagonal calls for income, per our recent alert. *Pro* is accepting a lower price in order to get this short-term trade done; today, we entered a $0.90 limit order. (Leave your long-term shares in AMT alone.)
- **Celgene** (NASDAQ: CELG): Sell to open October 2016 $95 puts, for a potential 3% stock allocation. With 123 days to expiration, that's 4.1 months. We're targeting at least 1.25% in yield on the strike price per month, so that equates to being paid at least $4.85 per put you write as of today.

Hedges:

- None currently.

Options expiring next:

- **Expeditors International** (NASDAQ: EXPD): August $46/$49 covered strangle. We'll have updated guidance close to the August expiration.

Get to Know the Pro Universe

Published Jun 16, 2016 at 2:55PM

The *Pro* Universe is a screening tool powered by *Motley Fool One*'s Fool IQ and the Fool's central research database to show you Foolish analysts' conviction level on each company. In the following video, TMF head of product Tim Hanson explains the tool from a *Million Dollar Portfolio* perspective.

{% video %}

Fool IQ is a powerful research tool that we have inside of *Motley Fool One* that makes sense of all the stocks that our 50-some-odd analysts around the world are following.

My name is Tim Hanson, and I'm the head of product here at The Motley Fool. You know, one thing about Fool IQ that I think — or that I hope — is fun is that it's appealing to investors who are novices or experts. So if you're a novice investor, we've made some buttons that you can literally just click once and they will make the universe drill down to retirement-type stocks, or small-cap stocks, and so on and so forth. If, on the other hand, you're an expert investor who really likes diving in, you can build your own filters ... your own complicated screens ... to find what you're looking for.

It's a database of all the ideas that our analysts are working on, or of all the ideas inside the service in which you are a member. The way it's like a screener is it allows you to find our favorite ideas tagged by asset class (like small cap or large cap), or industry (such as energy or consumer discretionary). Or by criteria you might be looking for in a stock (if you were looking for a dividend yield, or lower-than-average volatility). Or you'd like to combine several of those elements to find the stock that's really a good fit for your portfolio and what you're looking for.

So the reason it's a little bit unique is that while it does include financial information that you'd find in most screeners, what it also includes is our conviction, or our covering analyst's conviction in the ideas. So we keep track of everything our analysts are following and how they feel about one stock relative to another, and then we aggregate them all into what we call a leaderboard so we can identify someone's favorite idea over an idea that they don't feel quite as strongly about. It's a way for you to personalize our picks, rather than based on what our advisors decide is the best at any given month without knowing your circumstances.

The Fool IQ universe within *MDP* includes all the stocks that you have access to. Those are *MDP* recommendations as well as *Stock Advisor*, *Hidden Gems*, *Rule Breakers*, *Income Investor*, and *Inside Value*. For the first time ever, you're able to access all of those stock picks, all of that investing IP, without having to leave the *MDP* site. We also want to give members the opportunity to engage with the universe of front-end recommendations that they have access to in the same way that the *MDP* advisors do. They're looking for certain strategies. You can look for ideas in those same strategies using the Fool IQ experience inside of *MDP*.

You could use it to suggest potential ideas on the discussion boards, if you wanted to. You could use it to find stocks that would be complementary to what you own. Or if you think, for example, that you want to have more exposure or less exposure than the portfolio managers, you can do that. Or if you come into cash at a time when *MDP* doesn't have cash, or vice versa, you can still get actionable advice from the service without waiting for them to transact.

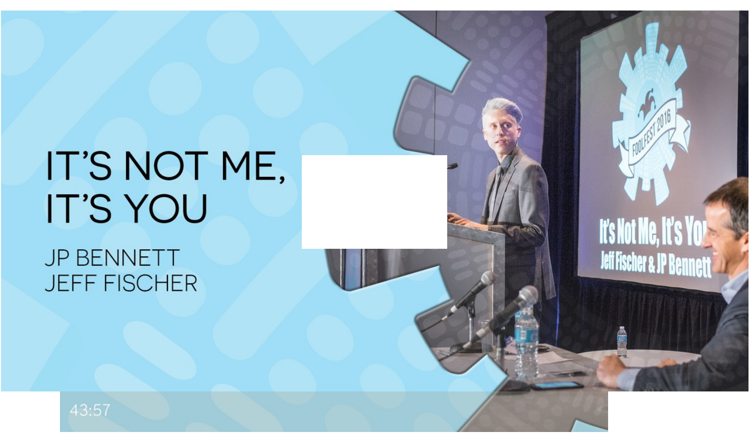
You know, no one's obligated to use it. We're not taking away the recommendations that come out every month in features such as Best Buys Now and Starter Stocks and Core Stocks and all the things that we've tried to do to help people better navigate the universe. We just want to give people another tool that they can use to really make sense of the stock recommendations that they have access to, find the ones that are right for them, and really help you and our company, The Motley Fool, achieve our mission of helping the world invest better. And that's building a portfolio of stocks that you feel great about, on your terms, that can last you a lifetime.

FoolFest 2016: It's Not Me, It's You

Published Jun 16, 2016 at 10:29AM

Our annual member event, FoolFest, took place last month in Alexandria, Va. This video shares some Pro*-related content from the event. Enjoy!*

We talk a lot at The Motley Fool about stocks we're buying, but we hear from members that when to sell is a much bigger challenge. Here, Jeff Fischer digs into how to make the difficult decision to part with a stock.



JP BENNETT:

For those of you who were here, yesterday, for Tom Gardner's opening remarks and Tim Hanson's presentation, you know that they both had some pretty strong things to say about selling, but for those of you who don't know me, I have a bit of a rebellious side to me, and so I'm going to stick my neck out, put my job on the line, and talk about selling.

Specifically, today we're going to talk about *Pro's* approach to identifying when it's not really working out between you and one of your stocks, and when it's time to break up; hence the title of the presentation.

If you think about it, at its core, investing is really all about buying low and selling high. Hopefully the selling takes place far down the road and at a much higher price; but we're really talking about two pieces of the puzzle here. Despite this, it seems like everywhere you look, 90%-95% of the attention is focused on the first half of that equation ... on buying ... and if you think about this from a psychology perspective, this does make a lot of sense.

There's a lot of appeal to finding a new idea — the thrill of the hunt — but there's actually a great quote from Terrance Odean, a professor at the University of California, where he says that buying tends to be more optimistic because it's about what a stock can do for you going forward; whereas selling tends to be more pessimistic, because it's about what a stock has done for you in the past, and this may or may not have been very pleasant, as we all can relate. Now, the side effect of this is that for many people, selling tends to be nothing more than an afterthought with really no deliberate process in place.

From our perspective here in *Pro*, this is really unfortunate, because although it would be great if we could always follow the Buffett maxim of "the best time to sell a stock is never," a lot of times that really isn't achievable for us. If you think about it, we're investing in order to meet financial objectives; whether it be retirement, a college education, or a fancy vacation. We need cash to pay for those things and oftentimes that comes in the form of closing positions. So we think it's really important to give selling its due.

Now, the first thing we want to impress upon you is that selling really isn't easy. It's just as hard as buying stocks, or finding great stocks to buy. One might be able to argue that from a psychological perspective, it's even more challenging. So let's say you bought a stock, here, at around $20 and over time it goes up to $30. That's great. You've got a really nice return, but what do you do now?

Perhaps you're the type of investor who's really concerned about giving back gains, so you sell prematurely, even though the company is essentially firing on all cylinders and odds are the stock's going to keep going up over time.

Or perhaps you're the type of investor who's overly optimistic, and you just think all of your stocks are going to keep going up and up and up and you're subject to what is referred to as the *endowment effect*, which refers to simply by owning something, you tend to think it's worth more.

Or perhaps you considered selling at $30, but you decided to hold off. Then the fundamentals turn and the stock starts to fall and it essentially becomes a dog. Yet you just can't bring yourself to sell because you're anchoring on that $30 price and you're just holding out saying, "That's when I wanted to sell originally. If it gets back there, I'll sell, but not until it gets there." You just leave this stock lingering in your portfolio and not really helping you achieve your financial objectives.

This, alone, would probably be more than enough to make selling quite difficult...

AUDIENCE:

[Laughter]

JP BENNETT:

...but it's just the tip of the iceberg, right? There are a lot of behavioral biases that are essentially working against you to prevent you from making a rational and optimal decision when it comes to closing your positions. And this is why we think it's so important to actually have a deliberate process in place for selling when you actually need to sell.

So moving on, the rest of this presentation is really going to be structured around the why and the when for why we sell in *Pro*. There are a lot of unique scenarios that you will probably encounter during your investment careers for why you need to sell. We really don't have time to cover all of those, so we're just going to focus on what we do here in *Pro*.

With respect to *why*, we're looking for three key things, and the first one is with respect to our thesis. We're looking to see whether it's played out like we had hoped, and so we no longer have our reason to invest in the stock. We're looking to see if our thesis has kind of drifted in an undesirable manner, or we're looking to see if our thesis is essentially straight up busted and the fundamentals have changed. Now this is a really big component of the *when*, so we're going to skip over that for the time being and talk about the latter two (risk management and opportunity cost).

With respect to risk management, there are a ton of things that we could talk about, but today we want to just touch on the whole notion of managing or trimming positions, and to a large extent, this really has to do with the debate between not wanting to punish your winners versus insuring that you don't have a single point of failure in your portfolio.

I'll be the first to admit that the notion of punishing your winners — that is, selling shares of a stock simply because it's done what you wanted it to do (and not only that, but it's done such a good job [that] it now represents an oversized percentage of your portfolio) — doesn't sound very smart. That's not what we want to happen.

But at the same time, I think it's important to realize that you can't let those positive possibilities cloud your judgment of potentially investing in the next **Amazon** (NASDAQ: AMZN) or **Apple** (NASDAQ: AAPL) in the early innings, and have that prevent you from making an appropriate portfolio-management decision and ensuring that your performance and your ability to achieve your financial objectives isn't overly reliant on the performance of one or two stocks.

A great example of this, from our perspective, is **Valeant Pharmaceuticals** (NYSE: VRX). For those of you who don't know, last year Valeant was essentially the epitome of a hedge-fund darling. In the second quarter of 2015, there was a ton of really large investors with really big stakes in the company and Bill Ackman of Pershing Square fame had, at one point, around 20% of his funds in this one stock. He referred to it as an "early stage **Berkshire Hathaway**." (NYSE: BRK-A) (NYSE: BRK-B)

Now, Valeant's fall from grace, as you can see by the stock, is really nothing short of amazing, but the point we want to focus on here, for the purposes of this discussion, is the notion that here you had a bunch of hedge funds, who had millions of millions of dollars to spend researching this one company [and] who had access that we couldn't even dream of here at the Fool. Who employed some of the brightest minds in the finance industry, and even they couldn't see what lay beneath the surface with Valeant.

So from our perspective, it forces us to realize that we need to have some humility, here, and understand that we Foolish investors, with far fewer resources at our disposal, can't understand a single stock well enough to the point where we can justify making it an oversized percentage of our portfolio and make our dependence overly reliant on that one stock.

As far as *Pro* is concerned, we tend to have 7% be the general point where we start to have those discussions, and 10% of our portfolio tends to [be] more of the hard line for us. But it's important to remember, first and foremost, we're Foolish investors, so we're not micromanaging our positions. We're not selling or adding every time a position changes by a couple of basis points. We really want to let our winners run as much as possible and then only seek to sell some shares — not all — just some if it gets to the point where diversification becomes an issue for us.

Moving on to opportunity cost, *Pro* was originally seeded with $1 million from The Motley Fool, and that's the only external funding we're ever going to receive. The only way our portfolio will grow over time is through performance, so basically, what we've got is what we've got. This means if we want to keep buying shares of new companies, at some point we're going to have to sell shares of other companies.

And if you drill this down even one step further, it's worth considering why you would want to keep just an average idea in your portfolio when you have something that you think is potentially a *great* idea. Once again, we're Foolish investors. We don't believe in high turnover. We want to find great companies that we can hold for extended periods of time, and reap the benefits of capital appreciation with minimal tax and trading consequences.

But at the same time, we don't necessarily think you should essentially just grandfather a position in your portfolio. That's to say that periodically, we think that your stock should essentially *earn* the right to be included in your portfolio. They should demonstrate it with their performance, and you shouldn't just keep them in there simply because they were in there the day previous.

A great example of that from *Pro's* past is **AIG** (NYSE: AIG), the insurer that got into just a tiny bit of trouble in the financial crisis.

AUDIENCE:

[Laughter]

JP BENNETT:

Now the team, back in 2012, took a look at it, and they found a reformed insurer that was much more simplified, trading at a really attractive valuation for what an average insurer should be trading for, so they bought shares. And basically over time, the company has stayed decidedly average, but that valuation discrepancy ran its course, and it was no longer trading for a deep discount to what an average insurer should be trading for.

We decided that, especially when you consider the alternatives we were thinking of investing in, it made sense to sell those shares, and we ultimately picked up **Visa** (NYSE: V) and **Verisk Analytics** (NASDAQ: VRSK). Now, both of these companies have outperformed the S&P since we bought shares, but really importantly, from an opportunity-cost perspective, both of those stocks have outperformed AIG by around 15% in the first year. We think that so far, it's playing out in terms of us making a smart move in terms of opportunity costs.

Now let's switch into the second part, the *when* part of the presentation. The first thing that we really want to impress upon you is the importance of having the proper mind-set. I'm a firm believer that you need to have the right mind-set straight from the get-go if you want to mitigate the impact of all those behavioral biases we referred to earlier.

And one of the keys to doing this is accepting the fact that reaching the point where you decide to buy shares means that in no way you're at the finish line. Now that you have capital on the table, you can't fall prey to the allure of just looking for confirming evidence to your thesis, and just root your stock sign higher. You need to maintain an objective mind-set, because now the risk of losing capital is real, and you need to be looking for *dis*confirming evidence for your thesis, even if it's uncomfortable. And in most cases, it is.

The reason for this is pretty straightforward. Last year, J.P. Morgan did a pretty good study where they looked at the Russell 3000 Index from 1980 to 2014. As to what they found, the first thing really isn't all that surprising, and I'm sure a lot of you know this ... that two-thirds of the stocks in this study underperformed the index.

But even more interesting, from my perspective, is they found that 40% of the stocks in the study, from their all-time high, had a permanent decline of 70%. A permanent decline. So there are a lot of duds out there in the public markets, and this means that like it or not, we try to avoid it, but some of these are going to make their way into our portfolio. So you need to maintain an objective mind-set and have some humility to be able to accept when you've made a mistake because as the famous saying goes, "It's OK to be wrong, but it's not OK to stay wrong."

Moving on to what we talked about earlier with respect to thesis tracking, we're looking for these three key things, and it's actually pretty straightforward in terms of tracking them and making sure that we can identify when one of these things are taking place. Specifically, what we're looking for is when you find a stock that you think you want to buy, what do you do?

You create a thesis for why you're doing it, and key to that is identifying the key drivers that will make your thesis play out, and [make] the stock a good investment. Once you've identified those key drivers, just track them over time to make sure things are progressing in an appropriate fashion.

Now, I'm not saying track them quarter to quarter, and if the company messes up in two quarters, pull the ripcord and get out. You want to give the company the ability to manage for the long run, but at the same time, just make sure that your thesis is working appropriately. Now let's move into some examples. We'll go in order here to flesh out this idea a little bit more.

The first one is when your thesis plays out like you had expected. Back in 2010, we had the [Deepwater] Horizon oil spill and in the aftermath of that, it seemed like every company that had even the slightest exposure to deepwater drilling really had their stocks take it on the chin, regardless of how much that would actually impact the business. The *Pro* team looked at Bristow Group.

For those of you who don't know, it's in the helicopter business, and essentially what they do is provide transportation for the crews, for supplies, for machines, and things like that. They felt like the haircut that the stock took really wasn't fair. The stock was now trading at a discount to the fair value of its helicopter fleet -- that they had recently upgraded -- that you really hadn't seen at all in the past five years.

Pro bought shares, and over time, the thesis proved itself as the market subsequently realized that the discount really wasn't warranted, and the business continued to perform pretty admirably. The stock recovered, and it was at this point the *Pro* team decided that basically the thesis had worked, and we don't have a reason to own shares anymore. Let's look for something else.

The next one is thesis drift, and David Einhorn from Greenlight Capital has a really good quote on this, where he basically says that he doesn't have a ton of rules, as far as investing is concerned; but one rule that has served his team really well is, whenever they find that they're wrong about why they did something, they get out of the position, period. End of story. They never invent new reasons to stay in a position when the original reason isn't there anymore.

So what you're really looking for is, say you invest in hypothetical Company X for a reason we call Thesis A. Over time, that thesis proves to not work out. It's a bust. But instead of recognizing that you were wrong, you dig in your heels, and you invent Thesis B and say, I'm going to stick with this one. Thesis B doesn't work out, but instead of recognizing that you were wrong and taking your capital and putting it in a more promising situation, you dig in your heels once again, and you come up with Thesis C. You continue to justify your actions instead of recognizing that you were wrong.

I'll be the first to admit that we're not perfect here in *Pro*, by any stretch of the imagination. We make a lot of mistakes, but one thing that I found by going back and reviewing *Pro's* history, even before I joined the team, was that the *Pro* team has a really good track record of acknowledging when they were wrong and not trying to come up with reasons to justify their reason for holding a particular stock. I actually don't have an example for this one, so we can move into the next one — the one that is probably the most prominent — and that's when your thesis is just busted.

Now, Scott Fearon is a money manager, and he's not really as well known as the other people I've quoted so far. He's got a really good book called *Dead Companies Walking*, where he talks about how he's been really successful at shorting over the years. This quote really struck a chord with me, because he acknowledges that he's not perfect, but he considers himself to be a really great quitter.

That's one of the things that has helped him succeed over the long run -- and actually do really well and vastly outperform the S&P 500. It's because he understands what the J.P. Morgan study found (that more companies are going to fail than are going to succeed), so if you can essentially identify when you are wrong early on in the process, you can actually put yourself at a huge advantage going forward.

The example we'll use, here, is **The Buckle** (NYSE: BKE), which is an apparel retailer who specializes in having a really good in-store experience, and they sell an awful lot of denim. Now, when we bought shares, there were three things that the *Pro* team really liked. They thought the management team really had a firm grasp on the industry and understood what it takes to create shareholder value. The store performance was really impressive, and it was actually getting more impressive over time. And then, of course, there was some type of valuation appeal to the thesis, as well.

But what we found as we tracked the stock over time — those first two points right there really started to come into question. Specifically with regard to the first point, what we found was there were two big things that the management team really whiffed on. The first one was the activewear trend — the trend that has been benefiting the likes of Nike and Under Armour for years now. I really hesitate in even calling it a trend, because it's not something that was hot in the spring and no longer fashionable in the summer.

This has been around for a couple of years now, and if you look at the chart on the left, you'll see that activewear, which is represented by the blue bars, has really accounted for the vast majority of growth in this industry. There have been many years where the bricks-and-mortar stores for ex-activewear has really done almost nothing. It's been flatline, and in some years even negative. The management team really was unable to deal with this shift that we saw within the industry.

The second point is the move to online retailing for apparel. We all know that online accounts for a really small percentage of total overall sales in the U.S., but within the apparel industry, it's a vastly different story. These are numbers from 2014, and I'm still waiting for 2015.

But at that point, online sales had already accounted for over 17% of total sales, here, in the U.S. and it's consistently growing in the high teens/low 20s. With bricks-and-mortar performance, in your good years you're getting low single digits, and in most years you're getting flat to potentially negative growth.

For the longest time, The Buckle really didn't prioritize having a good online presence, and that really started to eat into their store performance. A key metric that you should be looking at when you're considering buying bricks-and-mortar [retailers] is same-store sales or comparable-store sales, and this way, you can get a feel for how the stores are performing over time.

The thing that we saw with The Buckle was that there was a divergence that started to take place within The Buckle and the industry. Now, to be fair, the industry has definitely had some hard times over the past few years, and especially recently, it's been getting hit pretty hard, but the divergence was alarming for us because it seemed like The Buckle, more often than not, was doing worse.

We eventually got to the point where we essentially lost conviction in those first two parts of our thesis, and because of that, we decided that the thesis was busted and it was worth selling shares, even though we had given back a lot of the gains that we had. We still closed for a relatively modest gain, but we wanted to wait and make sure we saw that the performance really wasn't there and the thesis was truly busted, and so we decided to sell at this point.

It turns out it was a really good call because their performance since then...

AUDIENCE:

[Laughter]

JP BENNETT:

...has been really lackluster. They've had comparable-store sales growth of negative 10%-plus for the past few months, and they're just really struggling right now.

Now, if you want to talk a little bit about that valuation part of the thesis, as you can see, we actually sold the stock at a valuation that was quite attractive compared to historical norms. But one thing I'm sure every investor knows is that cheap stocks can get even cheaper...

AUDIENCE:

[Laughter]

JP BENNETT:

...and that's exactly what happened with The Buckle. We gave back a large chunk of our gains, like I said, but since we closed, it's down around 32%. I know it was down again, today, based on some pretty weak earnings. Overall, I would say we probably made a really good decision acknowledging that our thesis was no longer in play and it was time to move somewhere else.

Now one thing that a lot of people think about with selling and selling discipline is a valuation-based approach, and that's because a lot of people think about traditional value investing, where you've got a stock trading for, say, $30 and change. You think the intrinsic value is close to $40, and you want to benefit from that convergence, and once it hits $40, you're selling and you're out of the stock.

But once again, in *Pro* we're Foolish investors, so although we're looking for that difference, we consider that more the margin of safety, because we want great stocks that we can hold for long periods of time that can deliver those outsized returns. One of the things that really helps hit home here is the example of **Starbucks** (NASDAQ: SBUX).

We bought Starbucks in the second half of 2012 and it really took only a couple of months where we had a really strong earnings report and the stock moved above what we thought the fair value of the stock was. But for those of you who track Starbucks, you know that our decision to not sell just based on valuation was a great one, because the stock has been an absolute monster since then.

And if you want to take a step further to look at when we decide it's OK to sell based on valuation and when it isn't, it really gets to the point where there's different reasons for a stock to increase in value. So going back to that hypothetical example, let's say that that stock at the time, when it was trading for around $30 and change, was trading for around 18x earnings. Now here's two possibilities for when you fast forward and the stock has more than doubled.

In the top example, sure, the business has grown and earnings have increased, but the primary driver for that increase in stock price has been the market's willingness to pay a higher multiple. To pay more for those shares. And that's an example where we tend to be somewhat leery, because it's really hard to predict what the market's going to think about a given stock in the next couple of days, couple of months, couple of years. So that's an instance where we will more strongly consider valuation.

Starbucks, on the other hand, was a case of the lower example, where it was really strong store performance that was driving the increase in stock price. In this example, yes, the market's now paying slightly more for those earnings. It's primarily the company knocking it out of the park and firing on all cylinders, and that's what's forcing the stock price higher.

So in that case, because we recognize that valuation is more of an art than a science, and there's more of a fair value range of a stock than a specific point, that's a case where we'll be happy to sit back and say: "You know what? We may be wrong, here, on valuation. We may be undervaluing this company. We probably shouldn't sell just based on valuation alone."

Here's a great quote from Chuck Akre of Akre Capital Management on the situation, where he basically admits that selling for him is rarely about valuation, and just about valuation, because he understands that the great companies (the Starbucks, the Apples, the Amazons) are really hard to find, and once you find an attractive entry point to buy shares at, you really shouldn't part with them lightly.

He's had plenty of examples where you have a stock that you get out at $50 and tell yourself you'll get back in at $35. Well, it's going to fall down to $35 and a penny. You're not going to look at it again, and then the next time you do, it's going to turn into an Amazon and be trading for $300 or something like that, and that can really hurt. So if you've got a great stock, don't just be beholden to valuation-based principles for selling.

We'll leave you here with just a few more final thoughts, and the first one is, first and foremost, once again, we're not advocating for a trading mind-set. We're Foolish investors. We just think it's important to understand that this is a really important part of the process for a lot of people, in order to have the funds to pay for what they're investing for, and so it's important to develop a process and not just leave it to an afterthought and haphazardly decide when you're going to sell a given stock.

The second point is, just like with buying, you're never going to bat 1,000%. It's incredibly hard to call tops and bottoms. Some of the stocks you sell are going to go on and become the next Apple. Some of the stocks you don't are going to become duds. But what you need to focus on is your total portfolio performance, because ultimately, that's what's going to determine whether or not you're able to meet your financial objectives. You can't just focus in on one mistake and let that beat you up. You can learn from it, but don't let that mistake essentially defeat you.

And then the last one is just with respect to timing versus longs and shorts. In *Pro*, we actively short stocks, and there is definitely a different nuance with regards to timing. As our example with The Buckle showed, we really want, when we have a long position, to give the company its fair shake to prove us wrong. To turn the ship around. We don't want to, like I said, pull the ripcord after a bad quarter or two, because the company may turn around and recover, and it may just be a short blip in the radar.

With respect to shorting stocks, though, there are basically two things that you're essentially fighting against. The first is the cost to borrow shares. You essentially have to pay a fee to short stocks; and the second one is, the market tends to grind higher over time, so when you short something, you're essentially trying to fight that tide. You tend to want to have a shorter leash for our shorts.

An example of this, here, is **Five Below** (NASDAQ: FIVE), a retailer that sells five-dollar cheap-priced knickknacks. When we decided to short it, there were three things that we homed in on. As time progressed, the first and the latter point hadn't really run its course, yet. It can take quite a while for competitive dynamics to change within an industry, and the financial flags that we had identified — some were working out as we wanted them to. They were getting worse (like inventory management). Other things weren't really playing out like we had hoped. It was essentially a push, in my opinion.

But the one thing that really made us take a step back was the issue with respect to the management team. When we originally shorted it, it was run by their founders, who had a prior public company that they took into bankruptcy. There were some decisions that we saw them make that really made us question whether or not they could create shareholder value over the long run. So although we were short the company, we really liked the management team there, but we wanted them to stick around for a while.

AUDIENCE:

[Laughter]

JP BENNETT:

Shortly after we shorted the company, we started to see a bunch of management turnover. They got a new CEO from **Wal-Mart** (NYSE: WMT). They replaced a bunch of executives. That forced us to take a step back. We essentially decided that, "You know what? These guys aren't proven. We don't know whether or not they're going to be able to achieve their goal of opening 2,000 stores in the long run, but we've got a really nice thing, here." And especially given what the market has done (the market was up over that time frame), we decided that it was probably best for us to take those gains and go elsewhere.

The final point here for this presentation, before we get into the Q&A, is the ultimate litmus test, and that's reallyl whenever you're looking at your stocks, just ask yourself: "If I didn't already own it, would I want to buy it today?" If not, it might be worth at least having that discussion with someone else, or even with yourself, to think whether or not it's time to break up with this particular stock. And with that, let's go on the Q&A.

AUDIENCE:

[Applause]

JP BENNETT:

Thank you.

JEFF FISCHER:

Such a great, attentive audience. Do you have any questions for JP and myself?

JP BENNETT:

Or Jeff?

JEFF FISCHER:

Yes?

MALE:

[00:30:59]

JP BENNETT:

For that example, it's important to differentiate optionality from thesis drifts. In the case of an Apple or an Amazon, where you have one thesis, and originally they knock it out of the park, your thesis isn't drifting. They knock it out of the park, and then they have that optionality to develop another one. And then you see, "OK, now they're moving on to the iPod. Well, they killed it with the Mac. Maybe they're going to do well with the iPod. So it's worth sticking around for that." They kill it with the iPod, and then you see the iPhone coming down the line. "Well, maybe the third time's the charm and they're going to keep going on and on." So it's really important to differentiate between the two.

MALE:

[00:31:44]

JP BENNETT:

I don't follow **Chipotle** (NYSE: CMG) that closely, so Jeff, this is all you.

AUDIENCE:

[Laughter]

JEFF FISCHER:

I don't follow it, either, but I have an opinion. Or I'm about to have an opinion.

AUDIENCE:

[Laughter]

JEFF FISCHER:

But I'm happy to share. We know management has executed very well in the past, and what they sell has really connected with consumers on a broad basis. It's one of the most successful quick-serve restaurants ever, so far, in the short history of what they're doing.

I would give it more time to play out, still. Food-based illnesses have happened to probably a majority of restaurant chains at some point or another. They didn't deal with it as quickly or effectively, in my opinion, as I would have liked them to have, but I think they're learning very rapidly the cost of their actions, and I think they're going to make up for them in the long run.

So if I were an owner of Chipotle — and I'm not, but we've looked at the stock several times since this happened — I believe I would keep it. I don't think the thesis is broken. I think they've definitely hit one of those one or two-year speed bumps that JP mentioned. I don't think the thesis is broken yet, but they've hit a real challenge, and they dealt with it, in my opinion, maybe on a 6 out of a scale of 10. They scored a 6. Hopefully with the next challenge, they'll do better. Any other questions? Do you guys never sell stocks?

AUDIENCE:

[Laughter]

JEFF FISCHER:

That's OK.

MALE:

When things are busted and it's time to sell, is it also time to look at coming out of the short?

JP BENNETT:

We should have with The Buckle.

AUDIENCE:

[Laughter]

MALE:

Weren't you thinking about it?

JEFF FISCHER:

With The Buckle, no. With other positions, yes.

JP BENNETT:

Speak for yourself, Jeff.

JEFF FISCHER:

Oh, were you? So many sells we've looked at later and thought, "Why didn't we short it? We should think about shorting it." But in a lot of cases, hopefully the companies that we buy have enough qualities that it will keep us from shorting them even if we no longer want to own them. But it's always worth considering. If you're selling it, at least consider shorting it.

FEMALE:

[00:34:16]

JEFF FISCHER:

I bet we can each add some tips. Look at the 150 really sincerely, and any that don't really speak to you, that don't draw some sort of reaction from you, like "Oh, I like that." If it's just an "Eh, I don't know why I own that," then definitely put that on the list to potentially sell. If it's taxable accounts, of course, any that are "eh," and at losses, if you have gains to offset, that's a tax-friendly decision right there. That's two points. JP?

AUDIENCE:

[Laughter]

JP BENNETT:

But you stole my two points, Jeff.

AUDIENCE:

[Laughter]

JP BENNETT:

I would say...

JEFF FISCHER:

Got to go for it.

JP BENNETT:

The big thing is you're going to want to start to give yourself essentially hunting ground within your own portfolio. So like you said, do just a quick [review] of "like it, don't like it, like it, don't like it." And then once you compile a list of "I don't like" stocks, then it's time to maybe do a little bit more digging. And also, I would say one thing to pay attention to is essentially to make sure when you're selling stocks, you still remain properly diversified in terms of sectors and things like that.

I don't know your investing style, but maybe you have a penchant for biotechs and other things like that; and so all the stocks you don't like are just other stocks, and you just cut them out. Then what you're left with is an extremely volatile portfolio that may or may not achieve your objectives.

You have a very challenging task ahead of you. I commend you for undertaking it, because I think it's definitely important to take the first step, but I think the most important thing is to just develop a game plan and a point of attack.

JEFF FISCHER:

And if you don't have a thesis for any of the stocks as you go through them, you don't have to throw it out right away, necessarily, but take a look at it, as JP said, and then see if you can come up with a thesis. Well, that's kind of dangerous at this point.

AUDIENCE:

[Laughter]

JEFF FISCHER:

If you don't have a thesis, consider selling that one, too. You should know why you own it.

MALE:

[00:37:28]

JEFF FISCHER:

That's a great question. The question is, do we manage our own portfolios differently than the *Motley Fool Pro* service? Do we take a different approach? And over time, the answer is, "less and less." My portfolio and the *Pro* portfolio become more and more similar kind of naturally over time. And we try to manage the *Pro* portfolio as we would want our own portfolio managed. We don't want high turnover. We don't want to give you tax bills. We don't want to hang onto losers and just hope against hope that they'll work out.

It's one thing, I'm proud of, that we don't have much thesis drift. If a thesis isn't working out — like InvenSense was something *Pro* owned early, or 3D Systems — we'll hopefully sell. That's true of ourselves and it's what we'll do in the service, too. And some of those sells are hard, because they're recommended in other places.

But what we always think about in the end, and what the Fool is always thinking about, is the best choice for the member, and every service tries to do its best to make the best choice for the member. And that's typically the best choice for ourselves, too. We're invested right alongside you, and over time, I'd match the portfolio exactly, if I could, but my portfolio and *Pro* are becoming very similar over time.

JEFF FISCHER:

Did I make buys and not recommend them, or why is it different? The context is, *Pro* started in 2008, and I arrived with an existing portfolio myself. And a lot of *Pro's* early buys (Open Text, Amtrust, Oracle) were things I owned personally. So it started out where *Pro* was mirroring what I owned and then we started to get new things into *Pro* that I don't own and that I couldn't own first. If I know we're going to recommend it in *Pro* and I don't own it, I can't buy it.

So we'll recommend it in *Pro* and then eventually I hope to get a chance to buy it inside our trading restriction guidelines. So part of the reason I don't own everything is we have trading restrictions that keep us from easily owning everything. And anything I buy, I cannot sell before *Pro* does, no matter what. I have to keep that in mind, too.

JEFF FISCHER:

A sell watchlist? Should you have a sell watchlist? We talk about the positions that we would sell first if we wanted to raise cash, and I think anyone with a limited funds portfolio can benefit by doing that. So you have a short list of your favorites, I imagine. Why not have a short list of your least favorites?

And the way we work, especially, is very deliberate and very slow. It took us quarters and quarters to sell The Buckle. We were thinking about it for several quarters, but having that list initially helped. So right now, we have a list of things that we would sell first if we wanted to raise cash.

So yes, I think that's a good practice. It also makes you pinpoint and be aware of your so-called problem positions, or the ones that aren't working out as you hoped right now. Put them on the deck, so to speak, to be sold off if they don't get better. That's a good way to stay on top of your portfolio. We have time for one more question for JP.

AUDIENCE:

[Laughter]

MALE:

How do you separate emotion from this?

JP BENNETT:

That's definitely really tough, and one of the best things to do, obviously, is to try and not focus on the stock price, but in reality there are a lot of situations where you have to and it's almost essentially unavoidable. The key thing for me, as an investor, is I think it's important to know thyself. As an investor, you need to be able to identify what your triggers are and what gets you emotional.

The first thing is, whenever you get to a point where you think you want to make a decision, at least sleep on it. At least try and walk away for a little bit, because maybe the couple of percentage points that the stock moves in the interim isn't really worth worrying about in terms of making sure that you have a clear head.

And one thing that works a lot for me, and it might work for other people too, is whenever there's a position like that (a problem position) I always go back to the thesis. Go back to the key drivers that I've identified, and try to step away from what's going on in the market. Just bury my nose in the financial statements and try and step away from the activity.

It almost, to a large extent, helps me essentially calm my mind and refocus on what's really important, and there may be a case where it's like Chipotle, where the stock is getting hammered, but if you look at what the company's doing, you ultimately decide that this may be the first of three strikes, but it's not worth being all three strikes at once, and it's time to go elsewhere.

All right, thanks everyone.

FoolFest 2016: Advanced Options Strategies

Published Jun 16, 2016 at 10:24AM

Our annual member event, FoolFest, took place last month in Alexandria, Va. This video shares some Pro*-related content from the event. Enjoy!*

Motley Fool Options Co-Advisors Jeff Fischer and Jim Gillies led this in-depth seminar for experienced options investors interested in going deeper.

{% video %}

JIM GILLIES:

Thanks for coming. I am Jim Gillies, co-advisor of *Motley Fool Options* and lead advisor of *Pro Canada*. Jeff and I drew lots to see who was going to do the basic *Options* presentation and the advanced *Options*, and you can see who lost. Did anyone go to Jeff's session? Jeff had 40 slides for beginner options, and I have 10 slides for advanced options.

AUDIENCE:

[Laughter]

JIM GILLIES:

So there's a message in there somewhere. I'm also going to be squinting at my iPad, so if I'm not looking at you, it's because I'm trying to figure out what I'm going to say again.

Everyone's obviously spent a little bit of time in *Motley Fool Options*, I'm guessing, or at least you're interested through the [Everlasting Portfolio options] that we brought out. I think we started about a year ago on that. And Jeff would probably agree with this. We often feel that we're saying the same things over and over again, because we're generally saying the same things over and over again.

But it's true. It's like, we don't want you to overleverage. We don't want you to do things you're not comfortable with. So if you feel that you've heard a lot of this before, think how I feel.

AUDIENCE:

[Laughter]

JIM GILLIES:

But we'll try to get through this in hopefully about half the time allotted, and we'll have a bunch of time, there for Q&A.

Q&A this year is apparently a little different. You've all got index cards on the table. You'll be writing on those, and I believe Liz — wave at the back, Liz — will collect them, or if you have something you want to ask, Liz will collect them and bring them to me. I will weed out the bad questions and throw them away. Anything that's making fun of me, I will read, and then hopefully we'll get to a few and we'll go through the session.

Advanced options is a broad subject. I mean, the Bible on options for investing is McMillan's book [*Options as a Strategic Investment*, by Lawrence McMillan]. That thing is about 1,200 pages with appendices, and it's not light reading. So when you say, "Oh, you can do advanced options," I'm like, "OK. Let's try to narrow that down a little bit."

I was going to talk about three strategies — the diagonal call, the synthetic covered call, and the jade lizard. I know you're all disappointed, but I had to drop the jade lizard, so if you want to talk about jade lizards later, we can do that, but for the interest of expediency, we can come back to that.

Options, as a Foolish tool -- it's hard to believe they really didn't exist until about seven or eight years ago. In 2006, as a young eager Fool, I pitched an idea for a service that looked a lot like *Motley Fool Options* to Tom and Dave. They were very nice, and thanked me very pleasantly. "That's great, Jim. Thank you very much," and completely ignored the whole thing for the next couple of years. And it was probably right to do so. Tom has talked a lot about how he didn't think options were Foolish.

Jeff Fischer came back to the Fool after being gone for about four years. We launched *Pro* in late 2008. We launched *Options* together in 2009, and from that you can probably glean who the better salesperson is.

AUDIENCE:

[Laughter]

JIM GILLIES:

Today we've got options in multiple services. Obviously *Motley Fool Options*, *Pro*, *Pro Canada*, *Special Ops*. There's an *EP Options* and a couple of services that are no longer with us (*Alpha*, for example). There was options use there, and what we've done is encouraged options use, and we've gotten through the message that options are Foolish.

I think this is just personal speculation, but you're listening to me, so...

AUDIENCE:

[Laughter]

JIM GILLIES:

...I think what options do is they scratch an itch for the investor. Especially in the 21st century wire-connected world, we've got these two competing narratives coming out. On the one hand, long-term buy and hold, and "our favorite holding period is forever" with Warren Buffett. And Charlie Munger talked about, "buy good companies and sit on your ass while you're not doing anything." *Gee, I bought **MasterCard*** (NYSE: MA). OK, I'm done.

And on the other hand, you've got CNBC nattering at you 24/7. You've got Jim Cramer coming on every night. "Buy Apple. Sell Apple. Buy Apple. Don't trade Apple." Last night, did anyone see the headline on CNBC tied to Tesla? What did Tesla do yesterday? They're offering stock. Two billion dollars to bring you your Model 3 two years faster. Two billion dollars [in] stock. The worst kept secret. Everyone knew Tesla was going to have to do this. What was the headline on CNBC yesterday? Not "drop." *Plunged! Tesla plunges!* Did you happen to check what it did? It was up 3% during the day and it was down 0.5% after hours. That in a 24-hour, always-investing, do-something [television program], that qualifies as plunging. Sure.

And even Motley Fool, we've always got a stream of ideas coming at you, and there's always all kinds of things going on. You have these two competing narratives. You have the "do nothing" narrative and you have the "oh my goodness, I've got to do something," so call this the logical side of your brain and the emotional side. You guys are on the logical side. (Jim points to the left side of the audience).

AUDIENCE:

[Laughter]

JIM GILLIES:

Sorry! (Jim points to the right side of the audience). And I maintain that options and options use — Foolish options use — unless you scratch that itch, you can leave that side of the portfolio alone. It's just a theory. Worth what you paid for it. But we know long-term buy and hold works, so let's look at the stuff where we can scratch that itch. Get your trading fun in. Maybe make some income. Maybe make some capital gains, as well, and we move from there.

This is the 7 Rules. Does anyone not know what the 7 Rules are? Has anyone not seen the 7 Rules of Options Use? If you're a *Motley Fool Options* member or a *Motley Fool ONE* member, of course, in the service it's like the first thing you see over in the guidebook and Options U. This is how we run the service.

The most important is the first one — valuation first, options second. We spend 90% of our time with No. 1. That's the dirty little secret. That's where all the Foolish investing principles come in. That's where we're looking at the business's cash flow. That's where we're looking at the strategy and what's going on. And the options come — I'm going to let Rick take my picture — at a later date. Everything else is kind of a follow-on.

Second, we do think long term. Options, people tend to think, are short-term vehicles. The longest-dated, publicly traded option tends to be about 26 months if you happen to get it on day one in September, when the two-years-hence options come out. Yet we can run strategies for multiple years. We've been running a strategy on **Monsanto** (NYSE: MON) in the service for six-plus years now, and ideally we'll run it another six-plus years unless it gets bought. I'm still trying to wrap my head around if someone is going to buy Monsanto. Monsanto is hated so much! Who would buy them? Why do you want that headache?

We are more often writers than we are buyers, because we like to get paid. Options can have the somewhat negative effect of going to zero, which is less pleasant than you think it is (unless you've sold that option). So we do tend to like to write the options most of the time.

Diversification is not necessary. We can pick one strategy and run with it. Jeff is very famous for saying he likes to run one strategy. He likes to write puts, write puts, write puts, and for variety write puts.

AUDIENCE:

[Laughter]

JIM GILLIES:

Or you can pick a stock... This is payback. There he is! This is payback for 2010 in Miamim when he wrote a column wherein he said I was going to be standing in a disco bar wearing a glitter suit.

AUDIENCE:

[Laughter]

JIM GILLIES:

And that went out to how many umpteen *Options* members? So this is for Jeff, who I'm going to call up later.

So diversification. You can run multiple strategies on the same company. **GameStop** (NYSE: GME) has been in *Options* for years and we've been running variants of income strategies on it.

We stay focused. Again, we're focusing on the business. We're staying off CNBC is what we're doing most of the time.

We believe in making money most of the time. We're not looking for options strategies to individually beat markets at any given time. We prefer our portfolio to beat the market and we prefer accuracy. With most of them, at the end of the strategy you have more money than when you started. Pretty simple.

And then the last one. We like community, which should be glaringly apparent.

The next Jeff shot. Make sure he's not checking his phone. So this is Jeff's 40-slide presentation in one.

AUDIENCE:

[Laughter]

JIM GILLIES:

This is the two types of options. (He's going to shoot me later.) Two types of options — calls and puts. Four different positions for options. You can buy or sell each, so you can have long call, short call, long put, short put.

Options are Lego blocks. You put them together along with long stock or short stock and that is how you make the advanced option strategies we talk about. Everyone is familiar with the Lego block concept, I'm sure, with options. The simplest Lego block position would be... Anyone? Covered calls. A covered call is just you buy stock and then you write a call option against it. There's your Lego block concept. Two securities together that are working for a specific process outcome.

So our first diagonal call. Who does not know what a diagonal call is? Probably about 15%-20%. Who hates diagonal calls? It depends how they go. You can make a decent amount of money on diagonal calls. You're not going to shoot the lights out, but you're probably also not going to blow a big hole in your portfolio, so on balance, that's a good thing.

A diagonal call is like a covered call, except you are purchasing a deep-in-the-money call option instead of stock by as long-dated as you can. Right now in May 2016, the longest-dated options that are publicly traded and available are January 18, so that's where you look and you stop looking. You buy that. (If you are a member of Fidelity and your broker tells you to set up a diagonal buying of a six-month option, ignore them. That's true — Fidelity does that.)

And then you sell a short-term out-of-the-money call. So again, it's like a covered call, and it's going to let you scratch that trading itch I was talking about earlier, because you have to do something probably every three to six months. Maybe a little more frequently, maybe a little less frequently, but the general average is every three, four, or five months, you're going to being doing something. Some sort of a rolling trade or your written call will expire and so you'll do another one.

I believe these are IRA-friendly. Being a Canuck, we don't have IRAs and we're not allowed to do it in our registered accounts. But I believe it's IRA-friendly.

The reason you are buying deep in the money when you buy your call is go to the principle of option prices being the summation of intrinsic value and time value. Does anyone not know what intrinsic value and time value are? *This is the advanced class*.

AUDIENCE:

[Laughter]

JIM GILLIES:

So real difficult math, here. The intrinsic value of a call is simply the difference between the stock price and the strike price. If you have a $60 stock and you're looking at a $40 striking call, $60 minus $40 is $20. The intrinsic value of that call is $20. So that call better cost more than $20 when you see the price. If it doesn't, you should probably buy a lot of them and then sell them immediately to the next sucker. So that's intrinsic value.

Now intrinsic value is bounded at zero, so if you're looking at buying a $65 call and the stock is trading at $60, well $60 minus $65 is negative $5. It doesn't have an intrinsic value of negative $5. Intrinsic value is bounded by zero on the bottom, so it's either bounded by zero or the stock minus strike price.

Time value is just the market's trading price less the intrinsic value. So if, again, the stock is at $60, you're buying a $40 call, the intrinsic value should be $20. You see that option is trading for $25. The time value is? $5. Very simple.

So when you're doing a diagonal — the call you're buying — you want to buy as little time value as possible. Why? Because time value goes away. It is going to go to zero, and we don't want to buy something that goes to zero. We want to *sell* something that goes to zero. So we buy as deep in the money as possible. The farther down the strike price is away from the current stock price, the less time value you will have to pay.

My basic heuristic, here, when I'm setting up a diagonal is the short-term, out-of-the-money call has a zero intrinsic value. Why? Because the strike price is above the current stock price, so by definition it's going to have zero intrinsic value. It's going to all be time value. I want the short-term call that I sell — all that time value I sell — to fully cover the time value I'm going to pay for in the purchased option. I'm literally just walking away. I've got no money up for time value. I'm buying intrinsic value of the stock where it is less the strike price.

So the point of doing a diagonal is it leverages your return if things go your way, and your risk ... you can't lose more than you put into it. We'll get to an example in a minute, here, but anything you put into a diagonal, if the stock immediately and irrevocably goes to zero, you can't lose more than you put in. So there are some strategies where you can have a more negative outcome.

The good news is if you are trading this around — if you're satisfying your trading itch — what's going to happen over time, in most cases, if you pick a good diagonal candidate and it does what you think it's going to do, you're probably going to be bringing cash out over time, which lowers your investment capital. If it does go immediately and irrevocably to zero (which I've never seen happen, but I keep on saying it), your risk over times lessens in your diagonal.

You want to pick a good candidate. If you wanted to go out and willy nilly set these up on your favorite biotech company, or pre-revenue tech company... Thank you. Sorry. Finance jokes.

AUDIENCE:

[Laughter]

JIM GILLIES:

No, it's true. There's a company I follow in Canada that I was asked to look at by someone else, and I described it as the worst company I've ever seen, and it still refuses to go to zero. But they made an acquisition yesterday, and they announced their acquisition as they were buying a "pre-revenue" company.

AUDIENCE:

[Laughter]

JIM GILLIES:

The jokes write themselves, right? It's like, "Really? OK!" So you're not going to do this on those types of companies. You are going to do this on the big, bloated, and boring. You want a company that's in a big, profitable industry group. Biotechs — no. Consumer staples — sure. **Coca-Cola** (NYSE: KO). **Pepsi** (NYSE: PEP). Jeff has a Coca-Cola diagonal running right now. I had a Pepsi diagonal running in the past. I'm sure there's a joke in there somewhere.

You want big companies. $25 billion minimum is usually a pretty good rule of thumb. You want companies that don't have a lot of leverage. A diagonal strategy is leveraged in and of itself. Let's let the blowup happen in that leverage if it's going to happen, rather than having the company blow itself up ... **Valeant Pharmaceuticals** (NYSE: VRX).

Sorry. I'm a Canadian. You knew Valeant was doomed. You knew Valeant was doomed when the headlines started coming out. "Valeant Pharmaceutical surpasses Royal Bank as largest company in Canada by market cap." Because the other companies that have previously done that (**Potash Corporation** (NYSE: POT), Research In Motion [now BlackBerry], Nortel, Bre-X) most of those are bankrupt or close enough. Well, Research In Motion is still around. So I should have known Valeant, but that's another story.

So you want no leverage or fairly little leverage unless there's a good reason to break with that tradition. You want a strong history of returns on equity. 12% is a good hurdle. More if the company has been buying back a lot of stock, which depletes the equity account, which reduces your ROE. You want a good history of free cash flow. You want a company that's making lots of money and has been showing good earnings growth. And you want it trading at or slightly below fair value estimates.

What you see down there are some examples from our past and present in *Options*. **Microsoft** (NASDAQ: MSFT), **3M** (NYSE: MMM), **Costco** (NASDAQ: COST) (which screwed me), **Accenture** (NYSE: ACN), **Coca-Cola** (NYSE: KO), **Home Depot** (NYSE: HD). [These are] all good candidates for diagonalization. You heard this morning the companies that would be for the next 10 years (five or six companies).

None of them would be too good diagonal candidates — maybe **Marriott** (NASDAQ: MAR)— but the rest of them have LEAPs, so that fails because you can't directly set it up. **Illumina** (NASDAQ: ILMN) and **Amazon** (NASDAQ: AMZN), way too volatile. Might be great companies, but your diagonal would blow up within a couple of quarters. Markel has no LEAPs. Marriott — it's probably not bad.

But I'll let you in on a secret. A good diagonal candidate probably isn't the stock for the next 10 years, because it's already been the stock. Microsoft, over the next 10 years, will probably get roughly a market return, if you include the dividend. It's not going to be what Microsoft was in the '90s. That's OK. You don't need that for diagonals.

This is one we ran until earlier this year. It's **eBay** (NASDAQ: EBAY), everyone's favorite online auction house they don't go to anymore. We set up a diagonal on eBay in October, 2013. We set it up at about $15, so we can't lose any more than $15. If eBay went to zero, our loss is $15. The stock price was about $52 at the time, so it sucks to go to zero, and eBay wasn't going to zero, anyway. Lots of cash. No debt at the time. That sort of thing.

So you can see we set it up in October, 2013 and we started trading around it. And every one of those lines, there, is basically a trade when we would buy back a previously written call, or we would sell a new call, or we would see a previously written call expire worthless and we'd sit out, maybe a little bit, for an earnings report. And then you can see toward the end, in 2015, we rolled it a couple of times. Rolled it up and out.

But you can see the column here, we started putting $15 into it. We got basically half of our money back over time. So again, we started off that if eBay had gone to zero, we'd lose $15 a share. By July of 2015, if eBay had gone to zero, we would have lost $7.50. We'd already put a lot of cash out. eBay, of course, wasn't going to zero. eBay owned some little company called **PayPal** (NASDAQ: PYPL), which I'm still shocked wasn't listed as a stock for the next 10 years, and they were going to spin it out.

When they did spin it out, they adjusted the options, which isn't germane here, but what ended up happening is by the time we got to January of this year, the time to close, we closed the position for $18.40. Again, we only had about $7.65 left in the stock at that point. And so if you'd been an eBay buyer, you had stock that was up about 14%. A diagonal basically could triple that return. Actually, eBay is probably still a good diagonal candidate now that PayPal's out the door. PayPal is not a good candidate because there's some growth in there. You probably want to capture the growth for that.

And remember I said diagonals are like a covered call, so if we decided to run a covered call, here, just replacing the LEAP with purchased stock, eBay would have been a great covered call. It makes 31% in about two years, two and a third years. That's OK. Again, the diagonal call still looped it much better. So that's diagonals.

Now everyone who loves diagonals, do you love synthetic covered calls, as well? Good. What's your favorite synthetic covered call? **Gilead Sciences** (NASDAQ: GILD)?

AUDIENCE:

[Laughter]

JIM GILLIES:

IBM (NYSE: IBM). Ooh. Ix-nay on the IBM thing. Basically, a synthetic covered call is a three-legged strategy. You are selling to open a long-dated put. You are buying to open a long-dated call. Both at the money. If the stock is trading at $50, you're doing this at $50. Same expiration. Same strike price. And then like the diagonal, you're selling a short-term call.

This is not IRA-friendly, because IRAs require you to cash in to secure your written puts, which is just the same as buying the stock, so you don't do these in an IRA. Now, in many cases, the two options you sell (the long-dated put and the short-term out-of-the-money call) will more than cover the cost of the purchased call. So you are selling this for no money out the door.

You're basically taking a covered call and you're juicing with pure leverage, because who doesn't like pure leverage? Much like the diagonal, you're trading this every three to six months most likely, and again, you're scratching that itch, so you can leave your long-term holdings (not of IBM) alone.

You can earn with this a spectacular cash-on-cash return, because you're leveraging the value of your other assets. You're leveraging the value of your long-term buy-and-hold portfolio. I'm not sure why I always think you guys are the long-term buy and hold (points at left side of audience). You're the rogue traders over here (points at right side of audience). But you can get some absolutely spectacular cash-on-cash returns, and the neat thing about the first two (the at-the-money, long-dated written put and the at-the-money, long-dated purchase call) is that forms what's called a synthetic long.

Synthetic longs are a type of strategy that are almost infinitely rollable. I mentioned Monsanto, earlier, and how we've been running a strategy on Monsanto for six-plus years. We've been doing that even though their longest options are just barely over two years. You have the ability, as you approach expiration on one round, to buy back the written put you sold, sell the call as a purchase, write a new two-years-out put, purchase another long-dated call. You exit the exact same position.

You probably get paid to do it (the company is the dividend payer). With Monsanto, we've been paid every single time we've done it, and you keep going on your merry way. So synthetic covered calls can run basically as long as you want them to, unless Monsanto gets bought by the aspirin maker.

This is just a quick profit graph, here. This is a synthetic long. You can see the lower-dotted line that slopes up and to the right. That's what a profit-loss curve of a long call would be. The blue line is the profit-loss curve of a written put. You put those two lines together, and you get the big red line in the middle which looks a lot like the profit-loss curve if you own a stock. Forty-five degrees up and to the right. The stock goes up a dollar, you make a dollar. The stock goes down a dollar, you'll lose a dollar.

This is an $80 synthetic long that crosses the X-axis at about $2, ballpark, suggesting that you would have paid $2 to set up the synthetic long, but it's OK. You're going to write a call that's going to pay you $2 to take care of that. Probably the stock is about $80. I don't know what stock this was when I set this up. So it's to say that the first two options (the sold-to-open, long-dated, at-the-money put and the bought-to-open, long-dated at-the-money call) form this synthetic long. That's the underlying for your strategy, and then you write the written call on top of it, just like with the diagonal.

Again, in the spirit of always saying the same thing over and over again, the most important criteria, if you're going to do one of these, is the fair value of the stock. If you cannot estimate the fair value of the stock, you have no business doing probably any options strategy on it and certainly not one of these types.

And more importantly, saying that it's trading at a P/E of 20 and historically it's always traded between 22 and 23, so it must be undervalued ... that's not fair value, by the way. That's not a fair value assessment. It's part of a valuation analysis, but that's not a reason. You have to basically have an understanding of why Microsoft is trading at $50 today, but I think it's worth $172, and here's why.

And once you go through it, you should be checking your assumptions. I once graded a students thing at the local university on valuation. I sat down and there was this very nice, young group of kids. Very earnest. And **McDonald's** (NYSE: MCD) at the time was trading at about $90 a share and they said it was worth $240. The largest restaurant company in the world that everybody knows of, that has an army of analysts following every single thing it does, was undervalued by 70% because a group of young MBAs thought it was.

What are the assumptions in your model? How did you come to this? Do you really think the cost of capital for McDonald's is 3.5%, and so on and so forth? Once you realize maybe your model might be subject to some change, what I'm saying is, be skeptical of any value you come out with, and test why you think the company is worth what you think it's worth.

Also, don't forget certain expense items. There was once a company called Reddy Ice — it's still around, I guess — but it was the subject of a big activist/investor fight. These guys were buying their own stock back, and the activist investor (Roy Disney's hedge fund) was fighting with them. There was all kinds of stuff. Made mistakes. And they said, it's undervalued, and they said they were being taken out $25 a share. A big fight over it.

They finally got the merger kiboshed. Basically the stock went to zero, afterwards, because the guys who were fighting over it, who owned one-sixth of the stock, had forgotten to include basically three-quarters of the operating expenses in their model. I'm pretty sure the analyst that put that model together got fired, as he should have been.

Similar criteria, though, when you're doing a synthetic covered call. You want your big and profitable [companies]. You don't mind maybe going down a little bit in size, because you like [to see a little growth] in these types of strategies, so maybe a smaller company. You like, again, your debt-to-capital ratio a little bit lower. You want a strong history of cash generation and the ability to reinvest their cash in their own business at high rates, or at least reinvest in acquisitions at high rates if their business can be acquisitioned. Trading at or below fair value.

A couple of poster children for this type of thing are MasterCard and **Berkshire Hathaway** (NYSE: BRK-A) (NYSE: BRK-B). Anyone running a synthetic covered call on Berkshire Hathaway? Is it your first experience, or have you run the first two with this, as well? It's Berkshire Hathaway. I think that Warren Buffett kid is going to amount to something.

We've been doing this for a long time, but the added benefit for this being, an interesting strategy to run with Berkshire Hathaway is that Buffett has said they will be active buyers of their own stock below 1.2x book value. Well, Berkshire Hathaway, again, that whole strong history of cash generation and ability to reinvest itself at high rates ... I think Buffett's got that covered. Berkshire is currently trading at $140. What's that multiple-to-book? It's about 1.33x or 1.32x. Somewhere in there. And Buffett has said they were going to be a buyer in force with all that cash they make at 1.2x.

What are the chances of Berkshire Hathaway ever trading below 1.2x book value for any length of time ever again? Pretty close to zero. What is Berkshire Hathaway's book value doing over time? Going up. Its book value today is about $105, which would put the 1.2x — basically Buffett has given you an embedded put option. He will buy your stock from you at 1.2x book value. Today that's about $126. So Berkshire, unless there's a major dislocation, probably doesn't go below $126.

The book value is growing. By January of next year, book value, at say 7% growth by the next time the January 2017 LEAPs expire ... that floor, that strike place on the Buffett put, as I call it, will probably be $132 or $133. January 18, again, [7%] book value growth. By the way, Berkshire has compounded book value at about 19%, so I don't think 7% is a big hurdle over 50 years. It will be about $140, so it's a ratchet effect. You've got your synthetic long all set up, which you can push out ad infinitum, and you're constantly rolling and doing your maintenance trades on top of it.

Another chart you can't read. This is one of the examples. We've done this on Berkshire a number of times in this service, and we will probably continue doing it until they close the doors on either us or the coffins, whatever comes first. Basically this is a 2012 to 2014. We could do the 2014 to 2016 one. We could do the one prior to this one. Basically what you want to see on this one is, out of the gate, the stock was about $78.50. We set up our synthetic long at $80 going out as far as possible. We wrote the $85 call for about three months hence, so out of the gate, even though the stock was at $78 and change, we were paid $0.85.

Well, it's better than nothing. Better than a kick in the teeth. That gave us a capital-at-risk profile, which you can think of as what the effective price is. If we were assigned on our puts immediately, what is the effective price of Berkshire that we'd be paying? $79.15. So over time, again, much like with the eBay example, we trade around, we roll it up, roll around, and we start building cash.

Then what happens about midway through? We build about $3.00 a share in cash and the stock was slowly rising. Then Berkshire went *vroom*. The last half of this strategy shot to the roof. So we had to put cash back in a couple of times. By the time we got pretty much to the end of our trading activities on this — remember, we're scratching that itch we've all got — so we'll leave our long-term buying [alone]...

We've got our Berkshire Hathaway stock over here, and you guys are trading in Berkshire Hathaway options. By the time we got to where we were kind of done with the trading aspect of this service, we had invested a net $2 per share in Berkshire Hathaway. When we closed the position, we pulled out $17.50. We put in $2 net. That's a very hard thing to calculate return on investment for. Actually, not that hard. So the stock, alone, jumped 47% during this period. Now, that's OK. Berkshire did well. And the long-term buy and holders of Berkshire who owned it for years and are going to keep holding it for years were very happy with that return over that time.

The synthetic covered call folks beat it by about 20 percentage points. What ended up happening — remember, you're not doing this is in an IRA. You're not cash securing that because No. 1, you're an advanced optioneer, so that's fine. And No. 2, you're not doing this in an IRA so you're using the buying power. You're leveraging your other assets. You're leveraging, perhaps, the owned Berkshire Hathaway stock over here by generating option income and capital gains over here.

So you put $2 in and you pulled $17.50 out. That's nearly an 8x cash-on-cash return. In a year and a half to almost two years, that's pretty satisfactory. I think that's reasonable. And we can do that over and over. We are on our third iteration of this particular strategy on Berkshire. We will probably continue running it out again as long as we can. I think that's it for me.

AUDIENCE:

[Applause]

JIM GILLIES:

You had to give me this one on top? Really? From Jeff Fischer in the back.

AUDIENCE:

[Laughter]

JIM GILLIES:

Do you have a spare room if Trump wins?

AUDIENCE:

[Laughter]

JIM GILLIES:

Jeff, you are always welcome north of the border, where free healthcare flows like milk and honey and the top tax rate is 55%.

AUDIENCE:

[Laughter]

JIM GILLIES:

I'm looking to buying a bigger house, but it's my policy not to comment on the politics of others, but since you brought it up. Ellen is our wonder editor. Our cat herder. She's not here, today, I don't think. So whenever Ellen gets upset with me, which (a) is my fault most of the — all of the time...

AUDIENCE:

[Laughter]

JIM GILLIES:

...and (b) it happens an annoyingly number of times that I probably should learn better, so what I do is I soothe the savage beast. I did not call Ellen a savage beast. I love Ellen.

AUDIENCE:

[Laughter]

JIM GILLIES:

But what I'll do is I'll send her a reminder of how wonderful Canadians are because I'll send her a picture of Justin Trudeau, our prime minster, or as I like to call him, Prime Minster Centerfold.

AUDIENCE:

[Laughter]

JIM GILLIES:

He's a nice young man. "Would **Apple** (NASDAQ: AAPL) fit fair-value criteria today?" This gives me a great chance to invite my partner in crime up. Come here, Jeff. Let's turn this into an options Q&A if you don't mind. I know what I think about Apple. What do you think about Apple? We can sit down, too.

JEFF FISCHER:

That's funny. Sunny and I in the back were talking about Apple as a possible diagonal call candidate. As long as you believe that their smartphone units will hold up, the business should be fairly stable if their units hold up and their margins hold up. I happen to believe Apple has, believe it or not, more growth ahead. It may just be quite lumpy getting there, but the smartphone market is not actually saturated by any means. The question is, what sort of pricing will Apple be able to maintain when the market slowly lurches to a larger size in coming years.

I wouldn't make Apple my first diagonal call candidate today, because it is so dependent on smartphones. That said, all its early years, it was dependent on computers, so one product for another. But it's a possibility — not a terrible one, because the calls pay pretty well (the ones that you're writing). By the way, I didn't ask about Trump. I don't get into politics.

JIM GILLIES:

[Laughs]

JEFF FISCHER:

Who asked that question?

JIM GILLIES:

No one will admit it. John! I like Apple. In the interest of full disclosure, both *Motley Fool Options* (points at Jeff Fischer) and *Motley Fool Pro Canada* (points to himself) both have bull call spreads on Apple. A bull call spread is a starter drug for diagonals.

AUDIENCE:

[Laughter]

JIM GILLIES:

We kind of like it. Where is yours? I think yours is $85-$90 and mine is $90-$95?

JEFF FISCHER:

Yes. What we've done in *Options* when Apple declines quite a bit, which it does more frequently than you would think, is we've set up bullish positions ... mostly spreads. Bullish spreads. And we also own shares in *Pro*, of course. I think like most Fool services, for better or worse it's almost (not a mandatory stock to own) but it seems that way right now.

JIM GILLIES:

I'll be buying [an iPhone 7], because this thing is pretty much toast. (Holds up his cellphone). The next question. "Would you ever run strategies using futures and/or options on futures? Why or why not? On Forex, financials, commodities? Simple hedge S&P with futures instead of SPY options?" I'm going to say no, because I'm not that smart.

AUDIENCE:

[Laughter]

JEFF FISCHER:

I would say that the cost is greater, typically ...at least the platforms I'm aware of. The risk — the leverage is much higher...

JIM GILLIES:

The leverage is huge.

JEFF FISCHER:

...so I'm not sure that we would go down that route. It's so easy to blow yourself up. That said, I don't know if you guys have heard of the new binary options, which are all or nothing, and which make a lot of sense to me initially. You risk what you want. You either make all of that amount or you lose all of it.

But the advantage is you can't lose any more than that, so in a way, it's less risky than writing put options on a stock that can go to zero. In this case, you're either going to make the $1,000 or pay it out. Done. So if you're right 90% of the time, or even 60%, you'll make money in a binary way with much less capital at risk. Most brokers, including TD Ameritrade, don't trade binaries, yet, although they are out there. You can look it up and there's an app to look into them.

"Do you ever use tech analysis to help a timing RSI Bollinger bands?"

We don't, but we use fundamental analysis, which ties into valuation. Tech analysis sometimes matches valuation analysis. A stock reaches support at a certain price because its valuation is attractive to enough people at that price. So we don't use tech analysis, but our fundamental analysis, in a lot of regards, fills that role for us.

JIM GILLIES:

I'm all of a sudden having a Charlie Munger vibe, too, with Buffett over here.

JEFF FISCHER:

Shoot it down.

JIM GILLIES:

I don't use tech analysis at all, mainly because... What's the old Buffettism? I looked at the chart upside down and got the same answer.

AUDIENCE:

[Laughter]

JIM GILLIES:

I'll let you take the next one. "When do you roll in-the-money short calls, (a) early on before they get too far underwater, or (b) after all time value has expired?" The answer is (b)-ish. You do it when most of the time value has expired. There are rare circumstances when you might want to buy back time value.

One example would be the much-cited Monsanto. We currently have a written call, July, $97.50 against our synthetic long there. If Monsanto does get bought, or at least take an offer from Bayer, and we'll assume they can get through ... they'll never get through antitrust ... you might want to buy that one back, but the market knows that you're going to pay a pretty healthy time premium, there, so it's still probably worth holding your cards, and holding on, and hoping it doesn't happen yet. But why pay for something you don't need to pay for?

JEFF FISCHER:

The question is: "You begin with a thesis and set up a bullish position, a synthetic long. Now the underlying stock doubles or triples," which makes your synthetic long go up a great amount in value, "but your thesis has not been met. Discuss your thought process." I'm very happy.

AUDIENCE:

[Laughter]

JIM GILLIES:

I was going to say. I actually had that happen to me one time. I set up a synthetic long in a company (I put a couple of grand into it because I had to pay for the syn long) and the stock basically doubled in six weeks. I wish that would happen more often.

AUDIENCE:

[Laughter]

JIM GILLIES:

It was crazy. So me being a smart guy [pauses], I sold a higher-strike call for about $4,000 and bought back the written put and I netted myself $2,000 on that. Now I have no risk on the written put if the stock were to go back down. Now I have a big, fancy bull call spread. The stock proceeded to double again in the next six months, except now I've capped my upside.

JEFF FISCHER:

I think when this happens, try to assess why the stock moved so much. And then is there more to go if your thesis does play out? Is that going to be a rocket booster further, or has it already played out to such a degree that your thesis is now priced in? Also, has the price risk gone up enough that you should just close your position? Be happy with what you made and go? Those are a few things to think about.

JIM GILLIES:

I already mentioned Nortel, earlier. Nortel back in the day, for those who don't know, is a spinoff from the Canadian Telecom Company and it was, at one point, the largest company in Canada. But as all, it failed. It doubled, tripled, and quadrupled a number of times throughout the '90s, but it was pretty much always at the same valuation ratio. It was 2x earnings and so many times EBITDA.

And then in the last year, the tech bubble of '99 and into 2000, it went from something like 2x revenue where it had sat (between 1.5-2x revenue) forever, up and up and up. It went to, I believe, 8-10x revenue. If you were holding a syn long at that point, and that situation plays out, at that point you are running away screaming with your money. You're done. At least I would be.

JEFF FISCHER:

Here's a question. "Does it make sense to sell put options in an IRA? If you're in an IRA, is a buy-write covered call better? Why? What are the best options strategies for IRAs?"

Covered calls certainly work in IRAs. You can sell put options in many IRAs, as long as you have the cash. It has to be cash-secured, so you have the cash on the side to buy the stock should it fall. That's a requirement. You can't use your equity.

If you're making a strong enough yield on your cash, and you're happy to have it out of the market while you wait for a lower buy price, then sure, you can sell puts in an IRA. The great thing, obviously, is all the taxes are deferred on that income.

But probably some of the best strategies for IRAs, then, are income strategies, because those are always taxed very highly and they're taxed at your income level in a regular account. So if you can make income in an IRA — granted, you can't tap that income, yet — you'll save a lot on taxes doing it that way.

JIM GILLIES:

I have a question wanting me to put on a glitter suit. "Jim, how much of your personal portfolio is invested in options? Is this different than what you advise?"

That's a hard question to answer, because invested in options — I don't buy hardly any stand-alone calls or stand-alone puts where you're actually invested. If you do a diagonal, there's a certain amount there, but is a diagonal invested or is a covered call ... does that count as an options part of it? Plus options, there's no portfolio in options.

I'd probably say my exposure is probably about 35%-40% beyond my straight-up stock holdings, if that makes any sense.

JEFF FISCHER:

And how long are you invested in stocks?

JIM GILLIES:

Oh, forever.

JEFF FISCHER:

No, I mean exposure-wise. Is it 100%? Eighty percent?

JIM GILLIES:

I'm probably about 10%-15% cash [00:46:30].

JEFF FISCHER:

That math works out.

JIM GILLIES:

Yeah, ballpark. Do we have time for one or two more, Liz? One more.

JEFF FISCHER:

We have four more, so we have to choose.

JIM GILLIES:

How do we determine fair value? Oh, big question.

JEFF FISCHER:

It is. Visit the Option Philosophy Board and Jim will answer.

AUDIENCE:

[Laughter]

JIM GILLIES:

In excruciating detail.

JEFF FISCHER:

This is a good one. A sensitive one. "Why can't *Motley Fool Options* and *Motley Fool Pro* members use limit prices?"

JIM GILLIES:

I didn't know Rocky Top Bob was here.

AUDIENCE:

[Laughter]

JEFF FISCHER:

See the hat back there? There he is. It's a good question. We always say to use a limit price when trading an option. When investing in an option. I think part of what happens is some members do not. They want to get the position done, no matter what. They just put in a market order and that happens. But I think the market makers are also moving the price as soon as they see this flood of orders coming through. They see all these limit prices coming and they'll move the pricing to protect themselves. To take advantage.

JIM GILLIES:

To screw you.

JEFF FISCHER:

And then people lose patience and they start to change their orders to the market makers' prices. So if the market makers see a huge amount of volume coming in on a stock, they'll adjust the bid-ask accordingly. But that's really true in options where there's dedicated one or two market makers to each option and their job is to make that option liquid. They'll move prices when they see all of our orders coming in.

The good thing is we know that's going to happen. A lot of people don't believe me when I say it, but the price guidance is flexible and we spell that out. We say, "Here's the ideal price right now, but as prices change, accept no less than 'blank.'" And that usually gives you a wide range of pricing that you can accept that day or the coming days or weeks.

So we're always trying to improve on how we message pricing and limit orders, but because I don't think we can stop market makers from moving their pricing.

JIM GILLIES:

And I think the add-on I would give is you should ignore trade alerts. If you're sitting at your computer and it shows up, maybe you can get the recommended price thing. If you check your email two hours later and there's already been a lot of movement in the stock, and the options prices have moved, you should just ignore it and tune in on Friday to the trades you can make in the weekly where we'll give updated pricing, because on Friday at 2:00 ET when that comes out, you're not going to be fighting with however many other *Options* members who are chasing the price down.

JEFF FISCHER:

If we didn't get to your question, track us down. We'll be here. We can answer. Thank you, Jim. I'm glad that the U.S. let you in, again.

AUDIENCE:

[Laughter]

JIM GILLIES:

I'm shocked every time, actually.

JEFF FISCHER:

Thank you, all.

AUDIENCE:

[Applause]

JIM GILLIES:

Thank you, sir. [Jim and Jeff shake hands]

FoolFest 2016: Intro to Options

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Our annual member event, FoolFest, took place last month in Alexandria, Va. This video shares some Pro*-related content from the event. Enjoy!*

Motley Fool Options co-advisor Jeff Fischer and senior analyst Jim Mueller led this in-depth seminar on the nuts-and-bolts of options investing, designed for the options novice.

JEFF FISHER:

[This is a] beginning options class, more than a presentation. We are assuming that you don't know options very well or at all. We are going to introduce you to options -- what they are, some of the terms that you would want to know over time. We are going to talk about two strategies: buying call options for upside, and selling put options for income. I'm joined by Jim Mueller.

JIM MUELLER:

Thank you.

JEFF:

Core analyst on *Motley Fool Options*. Also on *Supernova* -- portfolio lead on *Supernova,* and -- Jim?

JIM:

And *Stock Advisor*. We are going to be throwing a whole bunch of information at you. There's going to be some terms that are familiar in one way, and totally unfamiliar in a way. We are going to be using them. If you feel overwhelmed, that's entirely normal. Everything that we talk about is available in the Options U course section of the Options service website.

I encourage you to go through that and review what we are talking about. Then go to the boards, and then ask questions about anything you might not understand. There are plenty of resources beyond this that will help you understand how to use options.

JEFF:

I've been using options about 16 years, since the year 2000. I've found pretty early on, too, that they can really change your life financially. They can add a little bit of extra income that just helps your life financially become easier, or they can add enough income to make a real difference. We've met over the years now many Motley Fool members who have retired earlier thanks to options. Who have built dream vacation homes thanks to options.

Mainly, what they are doing is writing options for repeated income month after month on their stock portfolio. The way we use options in general is, we have less risk typically than owning a stock outright. Everyone generally thinks options are risky, and use certain ways that would be [risky]. The way we always use them at the Motley Fool is a way that generally decreases our risk.

That's why at Motley Fool Options, more than 90% of our closed positions have made money. That goes back to some eight years now. Personally, it goes back even further. I've publicly been recommending options since 2005, 11 years, to members. Jim, how long have you been using the options?

JIM:

About six years, I guess. I agree with Jeff, the income is a nice boost to your portfolio. Also when times are flat or even down, it helps cushion the down as far as cash flow goes. What I use the income for is to invest in more stock positions I want to be in. I don't have to contribute as much cash to my portfolio as maybe I should.

JEFF:

They are also a lot of fun if you obviously have a great interest in investing. The addition of options to your stock portfolio lets you leave your stocks alone for the long term, but have some fun -- sometimes excitement -- in the short term, [using options] in a way that reflects what you believe about a stock to create some different outcome. [If] the stock is flat, you can make money on it. If it's down, you can make money on it . ...

There are different sets of tools that you'll have. You don't just have to rely on stocks going up. You have other ways to make money.

Let's get started with what an option is. I think we will have time for questions at the end. Please write down any questions you have [for] when we are done.

An option gives its owner -- you can be a buyer initially or a seller of the option; we'll talk about that later -- it gives the owner the rights to either buy or sell the underlying stock.

It's an option to make a transaction on the stock at a set price, called the strike price, and by an expiration date. All U.S. equity options have an expiration date. We'll talk about all these things a bit more as we go forward. An option just gives you the right to make a transaction in the stock at a price that you chose initially, before your expiration date.

An option has value, of course. It trades on the exchange all day long just like a stock. Typically at a small fraction of the stock price. The stock price may be $20; an option for it may trade at a dollar or less. Of course, the price of the option itself moves with the stock price up and down, but to a much greater degree, typically. It's leverage; you are going to see larger gains or losses as the stock moves in the option itself.

Options are very liquid. They are traded all day long. There's a market-maker behind every option. They are out there making sure there's liquidity. You can buy or sell an option pretty easily at any moment in the market. Granted, we tend not to -- we think long-term even as we use options -- but they are liquid. Liquid enough that Warren Buffet uses them. He used options, a strategy we'll talk about, to build up his **Coca-Cola** (NYSE: KO) stake, to build up his Burlington Northern stake, at lower prices.

Just an aside: When Warren Buffet said, "derivatives are weapons of mass destruction," he was not talking about stock options. Stock options are listed. They are transparent. You know the underlying value of a company. It's all in the clear on stock options. Here, he was talking about mortgages that were bundled, that had no clear liquid market, that you couldn't get pricing on -- anything that was unclear. Equity options, he has used for a long time.

Finally, an option can be turned into the stock at the strike price any time the option owner likes -- but it doesn't need to be. You can just buy yourself the option instead, if you prefer.

Why would you want to use options? What got us started, why do we now espouse options to Motley Fool members? I really started to use them around 2000 to generate income. I knew if I could generate some of my own cash flow from my portfolio beyond dividends, and beyond just waiting for capital appreciation, I would have that more flexibility in my life and in my investments.

Think about the cash that you are bringing into your portfolio, in this case by selling options for income. You can then reinvest in stock and grow your returns even further, or you can keep the cash and use it as you wish. I had some good vacations thanks to option income. You also use options to of course gain greater upside on your position, with less capital at risk. It's leverage.

A leverage has bad connotations to it, typically if you are using margin, which we do not recommend -- if you are borrowing money to buy a stock. That's leverage we don't recommend. Leverage with an option is a way to leverage returns while putting less money at risk than you would with a stock.

JIM:

That leverage is built into the option itself. You are not doing anything extra.

JEFF:

The third reason, or many reasons more to use options are, as we said, the upside: You can make returns in a flat market, a down market. A stock that goes nowhere can be your dream, because you can just make income on it again and again. Jim really has made income on **Wal-Mart** (NYSE: WMT) for [the] 10 years that it was flat. He just kept writing options on it. You can also use it to protect your positions, given that options can be set up bearishly or bullishly or neutral.

Keeping in with our intro to options, I have to touch on briefly that there are two types – luckily, there are only two types. There's the option called a call option. The call option goes up in value when the stock goes up. The call option is the right to buy that stock. As the stock goes higher, that call option, the rights to buy the stock, goes up as well.

JIM:

The reason it gets more valuable as the stock goes up is because that strike price is the transaction price. If the strike price is say $50, it becomes more valuable when the stock is trading at $60 compared to $55, because the option gives you the right to buy those shares at $50 when they are on the market at $60 or $70 or whatever.

JEFF:

Inversely, a put option will go up in price as the stock falls, because the put option gives you the right to sell that stock at your strike price. The value of that right of course rises as the stock falls.

JIM:

That's just the opposite of the situation I just described. You can sell at $50 when the shares are at $35.

JEFF:

There are some key ways that options differ from stock. We don't expect you to remember all these, or the terms we are about to talk about. We just want to plant the seed, so that when you come across them again, you will remember you heard them. You'll start to internalize them. The biggest thing to know and remember is [that] each option contract represents 100 shares of the stock.

There's no way around that. Every single option is 100 shares. That's partly or largely how you get the leverage that you do get.

Every option has time value. We'll talk about that in greater detail with some examples. It's extra value that the option has beyond what you would expect it to have, to count for the potential volatility of the stock and the time until expiration.

As we said, options have strong strike prices, but it's important to know that they're staggered. They won't be at every single level. Some options have strike prices that are $20, $25, $30, $35. Others will have dollar increments. You get to choose your strike price. When you go to your brokerage account, you will enter a stock ticker. Somewhere there, you'll see the option chain link. You click to see that link. You'll see all the strike prices that that option has available.

As we said, an option expires. They always expire. US options can expire anywhere from a week from now to up to two and a half years from now. Let's talk a little bit about each of these factors. [With] 100-to-1 leverage, you get to control more shares for much less money at risk. Therefore, you have greater upside or downside on a percentage basis, even though you have less money involved.

The strike price is your choice. You set it up on day one, and that determines the price at which you would later buy or sell the stock if you choose to do so. It's an important consideration. We look at the stock, and what we believe [about] what the stock price would do, to help us set up the strike price that we choose. A couple of terms that you'll hear again and again are "in the money," "out of the money," and there is "at the money."

An in-the-money option is an option that has a strike price that is beneficial compared to the current share price. A call option, for instance -- if a call option gives you the right to buy a stock at $5 per share, and the stock is trading at $10 per share, that strike price is more advantageous than the current share price. It's lower. It's a better buying price. That's in the money.

Inversely, if the strike price was $12 and the stock was $10, that's an out-of-the-money option, because you can buy the stock cheaper in that case for a call option. The strike price you choose -- it influences pretty much everything. The outcome of your trade. It will determine how much capital you put in, the amount of risk or speculation you have or do not have, how defensive you are. Strike price is important.

For an example of strike prices, we'll take a look at Disney, which recently traded at $100 per share. Just to demonstrate how this can be lined up. We wouldn't buy a June call option on Disney -- that's too short-term -- but we might buy a 2018 call option on **Disney** (NYSE: DIS). Here's an option that expires in one month. The right to buy Disney at the $85 strike [price] -- you would pay $16 for that call right now. That would cost you about $1,600 as opposed to $8,500 to buy the stock. That's how you risk less.

JIM:

No, $10,000. The share price is $100.

JEFF:

Oh, right, right. At $100, not $85. $10,000 to buy the stock, $1,600 compared to $10,000 to buy 100 shares. Much less money at risk.

The $100 strike price is at the money. The strike is the same as the share price. You would pay $2.75 for that right now. Yesterday, somebody asked, why would you pay -- great question -- $2.75 today for a call option that lets you buy the stock at the current price? The answer is, only if you want to risk much less money.

If you believe Disney could rise 5% or so in a month to $105 or $105.50, this call option would about double in value. If you are looking for leveraged returns, and you only want to put a few dollars in at this time, you might buy that call option. A much more speculative call option to buy would be the $105 for just $0.85. You would only buy that if you thought Disney could rise considerably in the next month.

Another example of pricing: [There's a] $55 stock, and there's a $50 strike price call option on it. That has $5 in intrinsic value. Which is simply the difference between the stock price and the call option strike price. This call option gives you the right to buy shares at $50. The shares are right now at $55. That alone is worth $5 right three. If the stock fell to $54, the intrinsic value would fall in kind [by] $1, to $4.

JIM:

The intrinsic value is how much in the money -- using the earlier term -- how much in the money the option is. For a call with a share price above the strike price, it's in the money. It's just $5 or $4 as Jeff just said. Suppose the share price drops to $49. Then it's out of the money, and the intrinsic value is equal to zero. Any out-of-the-money option has no intrinsic value.

JEFF:

Then above intrinsic value, you add time value, which we mentioned. It's the magic extra value than an option has to account for its super powers, or really, to account for the unknowns of the time until expiration and how much the stock may move. The more volatility expected from a stock, the greater time value its option has. In this case, it's not a very volatile stock, let's say. There's only $1 in time value. You add that to the intrinsic value, the real value, and that's what comes to what is called the option premium, or the complete cost of the option.

Again, this is a lot to take in if you are new to options or just starting. We just want you to start to know these terms. Intrinsic value is what the option is truly worth right now -- how much is in the money. The time value is the extra amount to account for the time until expiration. In this case, the total option premium is $6.

This, we just talked about -- we'll move quickly. Jim explained this really well.

Time value is anything outside of intrinsic value. The more time till expiration, the more time value you have. Here's a great example: **MasterCard** (NYSE: MA), recently $95 a share. It's a fairly volatile stock, even though it's such a stable business. The options have some premiums to them. The July call option costs about $2. It has a few months until expiration. If you were to buy the January 2018 option, you would pay $11.

In both cases, since this is an out-of-the-money call, that's all time value. You are paying this for a few reasons. You don't want to pay so much for the stock, but you are willing to pay a little bit of time value for the upside of the stock. You of course believe MasterCard is going to rise by -- above your strike price, and greater than your time value as well. [The] main point here is, the more time until expiration, the more time value you'll pay as the option buyer -- or you'll collect as the option seller, as we'll talk about.

If MasterCard doesn't get above the strike price in time, that time value evaporates, and the option ends without any value. MasterCard is $95 right now. If it doesn't rise above that strike in time, that option is worthless. All options have expirations. This is just a visual to show you how many expirations there are. There are now weekly options. There are options that expire every week on many stocks. On many stocks, there are options that go all the way up two years, to 2018 in this case. The 2019 options will roll out this fall incrementally.

When we are buying options, we are buying the long-term options almost exclusively. As far out as we can go -- 2018 right now. When we are selling options, as we'll talk about, we are selling short-term options. That's where we generate that regular monthly income that we'll talk about.

The first strategy -- before we talk about selling options for income -- is buying calls, which you do when you believe a stock is going to go up, and you want to participate in that upside, but with less money at risk, or you are looking for a greater return than the stock might give you, or you want to conserve your cash.

You might be in a rocky market. Stocks are falling. You want to start to dip your toes in, but you don't want to burn up a lot of your cash to buy shares. You can invest typically much less -- only 10% of the stock's cost, maybe less -- to get 100-share exposure to that stock, and then participate if the market does recover soon, or if it does in the next few years, too.

You can buy call options to increase a stake in something you believe in. You may own shares of something, and you like it enough that you want a bit more exposure. Again, you may not want to put in [as] much money that it would take to buy shares, but you put in a little bit of money that it would take to buy calls, and let that sit alongside your stock exposure.

Of course, you buy call options to potentially turn them into stock at a later date. Any call option that you own that's in the money, you can turn it into stock at any time at your strike price. You pay the strike price at that point, and the cost that you paid for the option initially is a sunk cost as well of course.

[Here are] some examples of the success we've seen buying call options.

JIM:

Here, you can see where the leverage starts to play in. Jeff had a bought call in **Coca-Cola** (NYSE: KO). When the stock rose only 60%, the value of the option itself rose 75%. That's an example of the leverage that [comes from] owning, controlling, or getting the benefit from the 100 shares without putting as much money into it.

JEFF:

It can really help on a large company like Coca-Cola that you don't expect to go up much. It's stable to own. It's OK, but it's much more fun if you can make a large return on a small gain in the stock. [Here's] **Disney** (NYSE: DIS), another example in Motley Fool Options, another recommendation, and how it did. In Pro we recommended Facebook calls, which did well when the stock went up. We turned a lot of those calls into stock that we still own. It's Pro's largest position.

It's great -- buy options for upside -- but how? What parameters should you follow? We buy the most distant expiration, as I said, almost exclusively. We tend to only buy calls on stocks that have long-term options listed on them. Not all stocks do. Right now, we look at the 2018 call options. We typically most times buy at a strike price that's below the current share price.

We are doing that because we want to minimize the time value that we have to pay, that we need to pay. We want to maximize the potential that the call option ends with the value, let alone goes up in value [by] the amount that we want.

JIM:

If you are buying a call that's out of the money, with the strike price above the share price, you are paying 100% time value. You are increasing the risk that the option is not going to be worth anything at the end, because the share price has to move further up in order for you to make money at the end than if you were buying options in the money with strikes below the share price.

JEFF:

We'll have some examples of that in a second, I believe. Next, [the] time value that we want to pay is 3% to 5% a year. When we buy call options, we are looking at 100% gain or better. The risk of a call option is that the stock falls below your strike price before expiration, or at expiration. If that happens at expiration, not before -- at expiration is what matters.

If the stock is below your strike price at expiration, the call ends without value. To take that risk of 100% loss, we want to target at least 100% gain, but again, without being speculative about it. By buying a call on Coca-Cola that's logical, that could double if the stock goes up 20%, say in two years.

[Here are] some examples, some real-time examples of call purchases. **Visa** (NYSE: V), as you can see. The stock is $77. You might, if you are bullish on Visa, buy a 2018 $70 call option.

Right now, you would just pay $13 per call. For 100 shares, you would put in $1,300 instead of $7,700, keeping cash for other ideas if you want. When you do the math of the share price minus the strike price ... Said more easily, when we do the strike price plus the cost of the call option, you could see what our net buying price on the stock would be if we were to turn these calls into stock much later down the road: $83 per share.

We are paying $6 in time value, which is reasonable. It's within the 3% to 5% per year maximum that we want to pay. Now, we want again the potential for a double. Since we are paying $13 for these call options, the way to get 100% return on them, the calls need to get to $26. Which means Visa needs to get to $96 per share. That's just the difference between the share price and our $70 strike price.

Visa needs to gain 24% in about two years for these calls to double in value. It could happen if you get close to that. If it could go up 18%, we would still be quite happy with our return, which would be 70%, 80% or so.

Some examples of these strikes that are available to you. You can see a deeper in-the-money strike, like a $50, will cost you more in intrinsic value, but less in time value. Gives you a lower net buying price on the stock.

If you want to go up to $60, you'll pay a bit less in intrinsic value, and a little more in time value, and so on. Which one do you choose? In this case, our favorite one is this one. It's a reasonable amount of time value. As shown earlier, we are paying less than 3% to 5% per year on time value. We have decent odds that Visa could gain 20% or so or more to make these calls about double in price.

We have a reasonable net start price on the stock of $83 versus the current $77. I view that as -- a price to use options is [that] you have to accept a little time value cost. If it's reasonable, it's fine, because of the leverage that you are getting and the less money that you are putting at risk -- much less, in this case. Just to reiterate before we go to the next example, [when] buying calls we look at the distant expiration, 2018.

We buy strike prices that are in the money. We minimize the time value that we are paying. We look for 100% gain on that call. The price that we pay for the call, we are hoping that it can double. We look at how far the stock has to go to get there. Typically, we are looking at stocks that need to go up 18% to 25% in two years for our calls to double.

Another example: Alphabet trades around $700 lately. The calls are pretty expensive, but you pay $16,000 for a call option as opposed to $70,000 for 100 shares of the stock. You can see you're paying $60 in time value there. It's not too bad, though; it's 8.5% in nearly two years. It's just within the parameters of what we might accept to pay. Here's where it's a little bit of a reach maybe to gain 100%. In this case Alphabet would need to reach $920, which is a 31% share gain.

It's possible, but I wouldn't necessarily say it's highly probable. This is a call option that we may pass on for now, or wait for Alphabet to slip some, unless you are happy with less than a 100% gain. If you are bullish on Google (**Alphabet** (NASDAQ: GOOGL) (NASDAQ: GOOG)), [and you] are happy with the 50% gain in the call, then you could earn that if Alphabet just went up 15%. You are buying call options on companies you believe in, stocks you believe are going up in the next few years.

What's the follow-up, what happens next? You can turn it into stock any time you like as the owner. You call your broker and you say you want to exercise these call options -- turn them into the stock. Then you buy the stock at the strike price. Then you can own it as long as you like. Or, if you wait until expiration and the call is in the money -- the strike price is better than the current share price -- the call automatically turns into stock.

If you don't want the stock, you can just sell the call on the market at the going price, and you have your gain or loss that way based on the price of the call at the time. Finally, you can close the calls and open new ones at a later date. We've done that in options, the service Motley Fool Options, where we've had positions going on for years and years -- six, seven years -- because every two years we'll just roll it to a new option.

Finally, the worst case is, the call ends without any value. Again, if the stock is at a lower price than your call option strike price at the end, then that option is out of the money. You can buy the stock cheaper on the market. The call doesn't have any value. You are out that money. The only good news [is] that maybe that you invested a small amount, much smaller than you would have to buy 100 shares of stock, one. Two, you can, if you want, buy the stock on the market at a lower price. By owning the call option, it's kept your eye on the stock as well.

JIM:

The last issue is, you get the leverage gains by a relatively small move in the stock, and get a large movement in the value of your options. This last point is the risk that you are putting up with to get that, and there's the risk that you will end up with nothing at the end.

JEFF:

That's why we typically buy call options on strong businesses with solid earnings, just as we do when we use strategy No. 2, where we are selling put options on strong businesses. This is the strategy I use most -- and Jim as well. I would say a majority of option members use selling puts most of all. And why? It's the steady short-term income. It sets you up to buy the stock that you like at a lower price. That time value that we talked about, that you have to pay when you buy a call option? You are paid the time value -- you collect it when you use this strategy.

Why do it? Income every month you can target. You just have to be ready to buy the stock that you are writing or selling puts on at a lower price, the price that you choose. The strike price that you choose. Aside from income and buying the stock lower, you can sell puts to potentially add to positions that you own or [are] building, and that you like. If you want to build a 5% allocation in the stock, you might start with buying 2% or 3% outright.

If you think you have time and want to target a lower buy price on the stock, you can sell puts instead of buying the rest of the shares outright. You get to add to the position lower potentially, but you get paid income while you wait either way. How you sell puts mechanically is different than buying a call option. You buy a call option or buy to open, just like a stock.

When you sell a put option, your beginning transaction is a sale, and you are paid money in. It's like you're selling insurance to someone. If the stock is $25, you could sell a put option that says, "If that stock falls to $20 or lower, I'll buy it from you." You are paid the option premium, also known as, in this case, an insurance premium. That's paid into your account on day one, and you get to keep that.

It's [a sell] transaction at the start. It's like selling short. You collect the option premium, all of it, and you are taking on this potential obligation to buy the stock lower. It's really like setting a limit order at a lower price, and then waiting to see if the stock hits that price -- but you are getting paid while you wait.

JIM:

That's the best part.

JEFF:

How to sell puts, again, it's quite different than how we buy calls. When we buy calls, long-term is all we do. Selling puts, you are selling near-term expirations, because you are maximizing the time value that you are being paid. We look at puts typically that expire in three months or less. They can be weekly for some people. Some people prefer six months, but we generally do three months or so or less.

JIM:

The philosophy here, as Jeff said, is different. In buying a call, we are trying to pay as little time value as we can, but we want to use a long time period for our thesis to turn out right. Time value will decay very, very slowly over that long time period. As expiration nears, the decay rate starts to pick up speed. We want to take advantage of that. In selling puts, we want to take advantage of that decaying time value. We can sell more and more time value over and over and over again.

JEFF:

That's exactly right, and especially because we are only selling time value -- meaning we are selling put options that are out of the money, with a strike price that's below the current share price. Then we are paid the time value. We aim for at least the 1% yield per month, and we'll show you how to calculate that in a moment. (All these slides will be on the website.)

We are selling puts when we are ready to buy shares if they decline. We always have to be ready to take on that potential obligation if it happens. As with buying call options, here's one way where they are similar. We target strong, growing companies. The reason being, you don't want the stock to fall sharply on you. From your strike price, your risk is the same as owning the stock, ultimately.

From your strike price, that's the risk you have. You want ... a strong company that has reliable earnings, generally speaking -- that's what we favor -- and that has a valuation that you are at least very comfortable with. We say this because speculative stocks have very high premiums. You can get paid a lot to sell a put option on a company that has no earnings. That may or may not work out.

The reason that those put options pay so much is there's a lot of risk in them. The stock could fall very sharply. We prefer to collect income on a regular basis, avoid blowups, and therefore we apply the strategy to reliable companies with reliable earnings.

JIM:

Slow and steady wins the race.

JEFF:

That speaks to again being happy to own these shares. It's a company that we believe in for the long haul. We are not interested in gambling here. [Here's] an example of selling to open puts on a stock that right now is at $117.50. I've been selling puts on **Facebook** (NASDAQ: FB), I think about three years now. I own shares. I've also, alongside that, sold puts to potentially get more shares if they fall by my expiration date.

Really, I've been targeting income on a company I know really well and believe in. Over these three years or so, as well as the shares have done, I've made more selling put options on the stock than I've done by owning the shares. One way to think about that is if you can make a few dollars per share per month selling puts over three years, that's $24 a year times three, would be $72. [In order to exceed that,] I must have gained more than $72 per share in the stock. I've made more writing puts the last three years, even though I'm happy to own the stock as well.

Right now, if you are happy to potentially buy Facebook lower, you would sell to open. In this case, we are doing a short-term example. We typically do the options that expire in one month. In this case, you're paid more than $200 per put option that you sell. Your outcomes are, you're potentially on the hook to buy shares about 4% lower. That's if the stock price is below your strike price at expiration. (What happens before [that] doesn't matter; generally speaking, it's only at expiration.) Or you are just paid this nearly 2% yield in less than a month.

That's your option premium. Measured against your strike price, which is the money you should set aside to potentially buy the shares, [that] gives you your yield. Nearly 2% a month. Again, we target at least 1% a month, 12% annualized. You can usually get considerably more than that, as you can see here. As long as Facebook remains or is above $115 on June 17 when this expires, we just collect that nearly 2% yield. It's done. Option disappears. We could do it again.

If Facebook is below $115, the strike price at expiration, we could buy the shares. We still keep that income we are paid. Our net buy price on the stock is actually below $113, or more than 4% lower.

[Here's] another example going a bit longer, which shows you that you can write puts at a lower strike price and still get paid well. The August options at $110 pay about $400 each per put. You are committing to buying the shares around 10% lower if the stock is below $110 at this August expiration.

In return for that commitment, that potential obligation, you are paid a nearly 4% yield in about three months. If you are at all bullish on Facebook, or even neutral -- you think the stock is going to hold its ground -- this position may make sense for you. You can make 3.7% in three months. You have a 10% cushion until you are at your potential buy price on Facebook. As long as the stock falls less than that, or doesn't fall at all, you'll make some money here. If it stays above $110, you make the whole premium and have no obligation.

We have a few other examples of put selling. **Skyworks Solutions** (NASDAQ: SWKS) is a holding in Pro. They supply technology, digital analog chips to smartphones and Internet of Things devices. They have very reliable earnings historically -- strong margins. Their margins are going up, which is unheard-of, for the most part, for a semiconductor company. (It's grouped into semiconductor stocks.) It's quite volatile, and the put options pay well. In this example, options expiring in a month will pay you nearly a dollar per share, even though they net you a buying price that's nearly 9% lower, just one month from now.

The stock would have to fall a fair amount for this option to become in the money. You are getting a 1.6% yield in 30 days. That's great. If you are looking for income in the next month, this is something that you could set up. We have recommended selling put options on Skyworks in Motley Fool Options a few times now. We have an active position there.

Here's for someone who wants to maybe go a bit longer. Some members prefer to not have to look every month. They would rather live their lives. Maybe they are taking a long summer vacation. You could then sell a put option that expires in November on Skyworks, with a much more distant strike price. Remember, there's more time to expiration now, [so] you are going to be paid much more time value in this case than you would on a June option at this strike price. You are paid more than $300, even though you set up a potential buy price on the stock 20% lower.

Skyworks would need to fall quite far for you to get all the way to your breakeven price. That's a nice cushion. Meanwhile, you are earning a 6% yield in six months, which as you know these days is very tough to get -- a 12% annualized yield, with this added cushion that your breakeven price on this position is 20% lower.

That's an intermediate-term income that members target as well -- those who want to write options expiring in six months instead of one month. You get the added benefit of a lower strike price. You still get a strong yield. You just have to wait longer to collect that value, because the time value, as Jim mentioned, will take a longer time to decay.

JIM:

To realize that value, you are paid on day one. You get to realize it when the option is over. When it expires or you close it.

JEFF:

All right. We have ...

JIM:

How much time?

JEFF:

About five minutes. Here's one more. This is a company in the Everlasting Portfolio, [a] Tom Gardner recommendation. It's operating in commercial real estate. As a financial company, the premiums are pretty good as well. Stock is $23. You can sell to open August puts, and you are paid about $145. What I found surprising about this -- and I recommended it in early May in Motley Fool One because of this --

You are setting up a much lower buy price in three months, and you are getting paid very well in three months. A 6% yield in just that short time frame, on a stock that is already down quite a bit this year, 20% or 30% this year. It looks like a good valuation. We issued this recommendation to Motley Fool One members a few weeks ago, as a way to make income or set up a buy price on the stock more than 8% lower.

Here's an example like we saw with call options. The different strikes that are available to you -- and that's one beautiful thing about options: You can choose how much risk you want to take, how defensive you want to be. Intel is $30. The at-the-money put option with the $30 strike price will pay you the most, of course, because the odds are highest that Intel could end below $30 in this scenario.

It pays you a dollar, expires in two months. If you wanted to instead sell to open at a $29 strike price, you will be paid a bit less, but you are setting up a more defensive position. The odds are perhaps better that you'll just get that income and won't have any obligation to buy the stock. If the stock does fall below 29 by expiration, you have a lower net buy price -- in this case, 28.30.

Even further, you could sell a $28 put instead, and have a more defensive position. ... In this case the one that we like best would be one that is 5% lower or so and still offers a greater-than-2% yield in two months. That's this one. That's the type of position that we've recommended at Motley Fool Options before. It pays pretty well. Gives you a nicely lower potential buy price on Intel, and a good yield.

As alternatives, we tell members, they can write a lower strike if they want to be more defensive. If you are more eager to get shares, you can write the $30 strike and get paid more income while you wait, and have a better chance of getting to buy the shares at $30. The outcomes when you sell put options, just to go over that again: As long as the stock price is above your strike price at expiration, you don't get the stock; you keep all the income you were paid. The option disappears, and you can sell another put option.

That's how people do this week after week or month after month. The stock holds steady or goes up until the put expires. They sell another one for more income. If the stock is below your strike price at expiration, then you get to buy the stock at your strike price, but you still keep the income you are paid, and that lowers your net start price even further. If you don't want to buy the stock, you can buy to close at any time the put option that you sold to open.

You pay the going market price, either a gain or a loss at that time, depending where the stock is trading. We use this strategy most -- I think most members do, too -- because it's probably the best repeatable strategy out there. Again, it's like setting a limit order to buy a stock at a lower price that you want to buy anyway, and getting paid while you wait for that price to come along, whether it does or not.

Why is this good as well? Of course, good stocks were turned up. You are increasing your discipline. You are committing to buying on dips. Many of us step away when stocks fall; we think, "Oh, we will wait longer, maybe it will go down further," and then miss the dip. How many missed January-February? When you sell put options, that locks you in and commits you to buying the stock. Whenever that happens, nine times out of 10, I'm happy down the road that I got the stock at that price. Of course, you are paid while you are waiting.

In summary, when we buy call options, we are doing [it] for these reasons: We want the upside. We want a leveraged return. When we sell put options, we are targeting short-term income and a really good yield of about 12% annualized or more. That's how a lot of members have made a lot of income to make a difference in their portfolio. The risks, as Jim and I talked about: [A] call option can end worthless if the stock price is below your strike price at expiration.

You only risk what you are comfortable risking, or can just end worthless if the stock price doesn't go up. [If it] just stays on a range. You'll lose that time value that you paid. With the put option, [if] the stock falls far below your strike price and your net start price on the stock, you are starting at a large loss. That said, you are probably buying the stock at a lower price than you would have if you bought on day one, without selling put options.

JIM:

There are strategies to deal with that situation.

JEFF:

Or another risk: If you sell puts without owning shares, the stock might soar. Like if I didn't buy any Facebook shares, I would regret that. We recommend in a lot of cases selling puts on a stock that you already own some shares of that, you really believe in. That way, you are getting all the upside of the stock as well, and then collecting income and potentially getting to add to your shares at a lower price.

The best thing about options, as we started out with, is they let you be long-term with your stocks. They are a complement to your stock. You don't have to touch your stocks. You can let them be to appreciate as you should. [Options] add all these extra tools to your portfolio: the income, the leverage, the gains whether the stock market is flat. As you get more experienced with options gains by hedging and protecting, you can put on positions that will make money when the market falls.

They are just a way to be a much more flexible investor, making money in various scenarios, different ways, while still being a long-term stock investor with your stocks. You can learn much more about options in Motley Fool Options, of course, where we have a whole full Options U suite of tutorials and guides. Motley Fool Pro, where we use options alongside a stock portfolio, combined, as they are meant to be complementary to each other. We target monthly income in Motley Fool Pro as well. In Motley Fool One, we have quarterly options recommendations on Tom's Everlasting Portfolio stock.

Thank you, everybody. Thank you, Jim.

JIM:

We are just about out of time. We are are going to try to squeeze in -- we've got a lot of questions, thank you very much. We are not going to be able to answer all of them. We'll try to squeeze in just a few.

JEFF:

Before we start, I'll say, we have lunch next. Then after lunch at 1:10 you can go to "The Four Stocks You Don't Want To Miss." That session is starting right now, but then repeats after our lunch. You won't miss it. It will run again after lunch. We'll have lunch and then go to that session.

JIM:

One member asked, though, "When can you exercise the option?" The options we deal with, you can exercise it anytime until expiration. From the moment you buy it until the expiration. You must be the owner of the option. You must buy it in order to exercise it. If you sell the option, like if you sell a put, that choice is not yours.

"What would happen when selling a put with a flash crash?" Basically nothing, because it happened so quickly. More importantly, there's still a lot of time value left in the option that the owner would be giving up if they exercised to take advantage of that.

Finally ... Those are the ones that we are not going to answer, sorry. You can pigeonhole us after this session if we didn't get to your question.

"Can you explain how buying options [fits] with a Motley Fool long-term holding stock philosophy?" I'll let Jeff speak to that.

JEFF:

We'll buy an option that expires in 2018, and then at 2018, we'll either turn it into stock, let it exercise into shares as we did with Facebook, or we can roll those options, if we are bullish, another two years ahead – two-and-a-half years. You can keep positions going indefinitely. We'll stay as long-term as we think we should be in that company. It's a great question.

We think long-term even as we use short-term put options. We know we might end up with shares that we then want to own for the long term. We think long-term when we buy call options, too -- at least in increments of two years or more. Someone else asked about allocation: "What size is the position similar to a stock size?" If that's 2% or 3% before you do the same thing here.

JIM:

[The percentage yield is relative to] the price it would cost you to buy the shares.

JEFF:

Yes.

JIM:

With that, we thank you for your attention. If your name is Bob, see the gentleman in the red shirt. That guy in the back. Thank you very much.

JEFF:

Thank you all.

JIM:

Or Rob.

Write Puts on Gentex

Published Jun 15, 2016 at 1:16PM

Is this for you? Since we're looking to add 1.5% to our stake in this company, this alert should be applicable (now or perhaps later) to all *Pro* members, whether you already own shares of **Gentex** (NASDAQ: GNTX) or not. If you don't yet own shares, check out the Alternative Trades section at the end of the report.

How You Participate

- **Trade:** Sell to open September 2016 $15 puts.
- **Allocation:** 1.5% — write one put for every $100,000 you manage; *Pro* will write 25 contracts. In addition to our current 2.8% stock holding, this would bring our total allocation to about 4.3%.
- **Price Guidance:**
  - **Now:** Use a **limit order** to target $0.50 or greater to start (for a 3.3% effective yield in 94 days). **If we all use limit orders** and the stock price cooperates, we may be able to achieve $0.50 today.
  - **Later:** As prices and time to expiration change, those approaching the position should aim to get paid a yield on time value of at least 1% or so ($0.15) per month to expiration.

- **Prices (1:05 p.m. 6/15):** Stock: $16.05; options: $0.45 bid / $0.55 ask. Guidance: $0.50.
- **Stock Rating:** Buy First, 2.8% allocation; we're now adding 1.5% in additional exposure through these new puts.

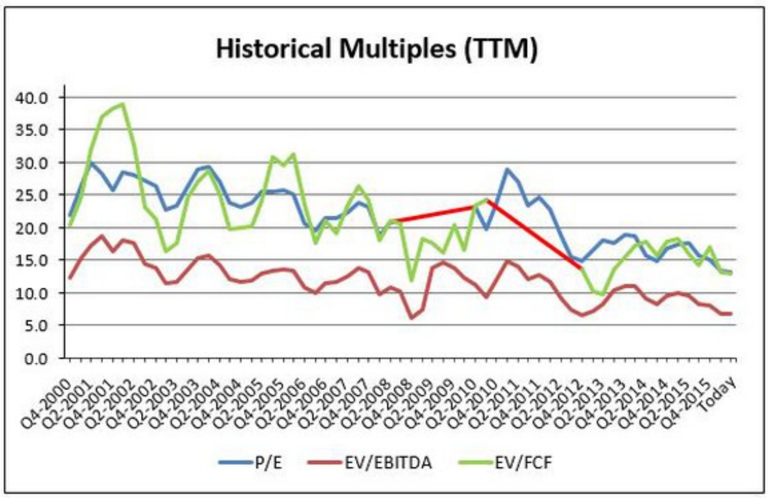
What We're Thinking

With the expiration of our May 2016 $15 puts last month, we've now run four successful rounds of written puts on Gentex, with all four iterations expiring fully as income. This has taken place over about a year and a half, with our first round of put-writing occurring in January 2015.

Since then, we've earned $5,139 in options income from our four rounds of written puts, and we've earned $2,200 from six dividend payments in January, April, July, and October of 2015 and in January and April of 2016. Based on our current ownership stake of 4,400 shares, that's income of $1.67 per share. That equates to an 10.4% yield on the current share price, which helps offset some of the stock-price weakness Gentex has experienced since the end of 2014 (as of today, the stock price is down about 11% compared with the closing price on Dec. 31, 2014).

Since our May puts expired, we've been waiting for a new opportunity to reinitiate our income strategy. Now that Gentex's stock price has declined a bit from its recent highs, we've decided to continue our approach by writing these new September 2016 $15 puts. While we like Gentex's long-term prospects, we prefer to target income on our position alongside the potential to add to our stake at a lower price. With the income for this iteration of the strategy at $0.50, we'll have collected a total of $2.56 per share with our series of five written puts on Gentex, giving us an effective start price on assigned shares of $12.44. (Your mileage may vary depending on how much you collected in the first several go-rounds and your tax situation.) This is about 22% lower than the current level, and 31% lower than our fair-value estimate; we'd happily buy shares for this price.

That said, we also need to evaluate the strategy on today's new decision alone — are we happy to potentially buy shares at $14.50? At that price, we'd be buying at 13.3 times trailing-12-month (TTM) earnings, 6.7 times TTM EBITDA, and 13 times TTM free cash flow, at the low end of historical ranges over the company's past 15 years. That includes the 2008-2009 period, when auto sales plunged and several automakers looked like they might go bankrupt. Given Gentex's recent business execution, we think those multiples are attractive.



Note: Red lines represent omitted outlier multiples that correspond to recession-depressed earnings and cash flow.

More That Matters

- **Maximum loss:** For this iteration of the put strategy alone, our risk is the same as share ownership starting at about $14.50, or 9.7% less than the recent price.
- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At a minimum of $0.50, that's a 3.3% effective yield in 94 days.
- **Follow-up:** For this iteration of the put strategy alone, we'll buy shares at a net $14.50 if the stock is below our $15 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 2.8% allocation first — Gentex's shares are a Buy First. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1.5% of your portfolio, then just buy 1.5% in stock directly *if and when Pro* does so through these puts (we'll alert you on the boards and in the subsequent Monday Memo if and when we do).
- **Want to write other puts?** Consider writing December 2016 $15 puts if the price on those options holds up better than the September puts after this alert is issued. Right now, the bid/ask on the December 2016 puts is $0.80/$1.00 (a 6% effective yield in about six months).

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Check your mirrors and switch lanes over to the Gentex discussion board.

Write Puts on Celgene

Published Jun 14, 2016 at 3:22PM

Is this for you? This is for all *Pro* members who can add another potential 3% position to their portfolio to match us. If you can't write puts or are managing less than $300,000, do nothing but wait and then buy 3% in shares directly if and when we do the same (we'll alert you if shares are put to us).

How You Participate

- **Trade:** Sell to open October 2016 $95 puts on **Celgene** (NASDAQ: CELG).

- **Allocation:** 3%. Write one put for every $300,000 you manage; *Pro* will write 8 contracts, potentially buying 800 shares worth $76,000 of our $2.5 million portfolio.
- **Price Guidance:**
  - **Now:** Use a **limit order to target $5.50** or greater to start, for a 5.8% effective yield in 129 days, or 4.3 months until expiration. Accept no less than $5.10.
  - **Later:** If the stock rises, you'll need to accept a lower yield. If it falls, the puts will pay more. As prices and time to expiration change, those approaching the position later should aim to get paid a yield of at least 1.25% per month to expiration, measured on the $95 strike price; that's $1.18 per month, or $5.10 in put proceeds, right now with 4.3 months to go.
- **Prices (2:55 p.m.):**
  - Stock: $100.50
  - Sell to open October 2016 $95 puts (bid/ask): $5.45/ $5.65
- **Stock Rating:** We don't yet own the stock, but we'd rank it a Buy at $95 or less, with a 3% allocation. If we get shares, we'll tell all members to buy.

What We're Thinking

A nearly $80 billion biotech behemoth, Celgene is a research and development success story, pioneering new drug discovery methods to become a leader in treating cancer and inflammatory diseases -- and it's growing strongly.

In the first quarter of 2016 reported in May, revenue was up 21% and earnings per share jumped 23%. And management expects to enjoy earnings growth at a clip of about 15% annualized through 2020; they project earnings per share of $13 that year, up from the estimated $6.75 to $7 per share they're calling for in 2017. That's on projected 2020 sales of $21 billion compared to 2016 estimates of $10.75 billion.

Celgene's success is being driven by a few blockbuster drugs, but one – REVLIMID – represents an estimated 62% of its sales, with $6.7 billion in revenue expected this year . REVLIMID sales were up 19% year-over-year last quarter, as more multiple myeloma patients were treated. Other sharply expanding drugs treat other versions of blood cancer; there's also ABRAXANE, a treatment for breast, lung, and pancreatic cancers with about $1 billion in sales expected this year despite a highly competitive landscape.

Not standing still, Celgene has one of the richest product pipelines in the industry. The company expects to see results from an whopping *18* phase III (or final-phase) clinical trials in the next two years, some of which could become blockbusters. The company can't rest. REVLIMID will start to lose U.S. patent protection in stages between 2022 and March 2025, and though management believes it can replace lost sales by then with new drugs (potentially including a new version of REVLIMID itself), Wall Street is likely to take a wait-and-see approach.

Patent cliffs on key drugs naturally make investors cautious (including Fools like us), so despite currently strong earnings growth at Celgene, odds seem low that Wall Street will sustainably reward the company with much higher value multiples right now -- until and unless Celgene appears able to keep growing in 2022 and beyond thanks to new drugs. That's how our strategy comes into play.

Why This Strategy?

At $101.61 as of Monday's close, the stock trades at 17.2 times expected earnings one year ahead. Assuming management can reach its $13-per-share earnings target for 2020 -- a target it deems conservative -- the stock trades at 7.8 times those distant estimates. That's obviously inexpensive, but we know that large biotech stocks -- such as **Gilead Sciences** (NASDAQ: GILD) lately -- can trade at that type of valuation if future growth is uncertain or lacking.

Rather than assume Celgene can maintain a P/E multiple in the teens and increase the share price nicely into 2020, we're taking a much more conservative stance and assuming the stock can just tread water around current prices, or not fall too much. That's all it needs to do for us to earn nearly 6% in yield over the next 4.3 months, and then presumably more after that assuming we can repeat the strategy. If we end up getting to buy shares, we'll consider using covered calls to improve returns.

The bottom line driving this investment is a belief that, at current prices, Celgene's downside risk should be reasonable, and we can earn a North-Star topping return writing options on it -- while remaining happy to buy this biotech if it comes to that. Longer-term, management's collaborative approach to drug discovery and its product pipeline suggest additional success for the business, but we don't need to bank on that yet.

More That Matters

- **Maximum loss:** The same as share ownership starting at about $90 per share.
- **Maximum gain:** The yield the puts pay us, or about 5.8% in 4.3 months. If we get shares, our upside is initially uncapped.
- **Break-even:** If the $95 puts pay us $5.50, our net start price per share is $89.50 if we get the stock.
- **Follow-up:** We may roll our puts if the stock is below $95 at expiration, or take shares and consider covered calls. If our puts expire as income, or are closed for partial income, we will consider writing new ones.

Alternative Trades

- **Can't write puts, or managing less than $300,000?** Simply wait and see whether we get "put" shares to our portfolio. If we do, at that time we'll alert you to buy 3% in stock directly to match us -- assuming we want to own the stock even without covered calls (because you won't be able to write covered calls, either, without 100-share exposure).
- **Want to write other puts?**
  - If you want a more defensive position, write ("sell to open") October 2016 $90 puts; lately they pay about $4 each.
  - If you want a more aggressive position, you can write October 2016 $100 puts. They lately pay about $7.50 each -- and our recommendation was nearly for writing $100 puts instead of $95, but we went a bit more defensive in the end.

Pro Can Help

- See our Options U guide to writing puts if you want more 411 on this strategy.
- Keep a healthy mind and healthy outlook on our new Celgene board.

Pro Catch-Up Trades: June 13, 2016

Published Jun 13, 2016 at 3:39PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our Portfolio Building Reports will get you fully invested over the coming few weeks, as much as you want to be.

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **FactSet Research Systems** (NYSE: FDS): Buy 2% in this new position.
- **MasterCard** (NYSE: MA): Buy up to 4.5%.

Continue building your portfolio with our Buys, including these highlighted today:

- **OpenText** (NASDAQ: OTEX): Buy up to 3.3%.
- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): Buy 1%.

Shorts:

- None currently.

Options:

- **American Airlines** (NASDAQ: AAL): Sell to close your January 2017 calls, per our recent alert.
- **American Tower** (NYSE: AMT): Sell to open new July 22, 2016 $111 diagonal calls, p today's alert.

Hedges:

- None currently.

Options expiring:

- Currently, all three of our June 2016 covered call positions -- on **Skyworks** (NASDAQ: SWKS), **Valmont** (NYSE: VMI), and **WisdomTree Emerging Markets SmallCap** (NYSEMKT: DGS) -- are on track to expire as full income this Friday, with no action needed. If that changes, we'll issue a trade alert.

Pro Quality Checklist: MasterCard

Published Jun 13, 2016 at 3:39PM

Fellow Fools,

With only a few quiet weeks remaining before earnings season picks back up, this seems like an opportune time to return to our *Pro* quality checklist series and review another portfolio holding. This week, we're taking a look at Buy First-rated **MasterCard** (NYSE: MA). The credit card behemoth is one of our largest holdings with a nearly 5% allocation, thanks to a gain of almost 200% since we added it to the portfolio. Based on those stats, it's safe to assume that MasterCard is one of our favorite long-term investing opportunities. It's always tempting to spend most of your time studying your losers to avoid future pain, but it's just as worthwhile to run a winner through the paces. To that end, and as a reminder of why the company earned a top spot in the *Pro* portfolio, here's MasterCard.

1. Sustainable Competitive Advantage

Yes. MasterCard has one of the widest competitive moats on the *Pro* scorecard. The company's global payment processing system provides massive network effects; the more merchants using the system, and the more consumers using MasterCard-branded cards, the more valuable the system is for everyone. The best part about companies with network effects is that they can sometimes offer a winner-take-all situation. In this case, there's a triumvirate of winners, which includes **American Express** (NYSE: AXP) and **Visa** (NYSE: V) as well as MasterCard, and it would be extremely difficult for a newcomer to capture meaningful market share. MasterCard also has a number of intangible assets, including a global brand that's taken decades to build and a treasure trove of data being collected -- and, increasingly, monetized -- every day. Finally, MasterCard's scale advantages allow it to operate efficiently across a global footprint spanning 210 countries with various currencies and ever-changing laws and regulations.

MasterCard's strong competitive advantage is evidenced by operating margins in excess of 50% and return on capital approaching 40%. These fat profit margins attract a constant stream of newcomers hoping to gain share, including PayPal and other new digital solutions. New innovations, like the blockchain distributed ledger technology that powers cryptocurrencies like bitcoin, are also threatening to disrupt the current payment ecosystem. For the most part, MasterCard has been quick to embrace these newcomers and find ways to form partnerships or develop similar capabilities rather than clinging to the status quo.

2. Pricing Power

No. This point is a close call because of MasterCard's dominant position in the industry. Growing regulatory scrutiny, which has reduced or capped some processing fees, and stiff competition from Visa, which has recently resulted in the loss of longtime accounts including USAA, have left MasterCard's pricing power limited at best. Also, recent increases in incentives and rebate costs suggest that the card brands feel the need to share a bigger portion of their take in order to sign new banks and merchants. It's unlikely this trend will reverse in the near term.

3. Dependent Customer Base

Yes. Merchants who want to offer customers the option to use a credit or debit card are almost certainly going to use the MasterCard and Visa payment platforms (and possibly American Express if they can stomach the higher fees). On occasion you'll find businesses that try to operate cash-only, like my local barbershop, but the reality is that consumers enjoy the convenience and benefits of using a credit card, and many merchants would forego sales if they failed to provide that service.

On the other side of the coin, if an issuing bank wants to get its card into consumers' wallets, there needs to be a MasterCard or Visa logo on the front. Consumers trust these global brands and value the cardholder benefits, including rewards and fraud protection, that they receive from MasterCard.

4. Predictable Revenue

Yes. MasterCard is essentially a toll-taker in the global consumer economy. The company pockets a tiny slice of every transaction that passes through its payment network. Unlike American Express, MasterCard does not issue credit itself; that means it doesn't have to worry about cardholder defaults, only their willingness to spend. Though economic turmoil can affect consumers' transaction volume, MasterCard's global footprint helps smooth some of the volatility, even with occasional currency fluctuations. Also, the company's growing suite of service offerings, including fraud prevention and loyalty programs, add a new revenue stream while making the company's relationship with card issuers stickier. Over the past two years, currency volatility and the rapid decline in gasoline prices have weighed on MasterCard's sales growth, but even so, that amounts to a small wiggle in a steady upward march.

5. Growing Free Cash Flow With Compounding Returns

Yes. Like many companies in the *Pro* portfolio, MasterCard sports an asset-light business model, meaning that management invests more in people and platform than plant, property and equipment (PP&E). With its processing platform built, MasterCard can leverage its existing network to service increasing purchase volume with little incremental spending required. That's why the company is able to generate operating margins in excess of 50% and copious free cash flow to reinvest in the business or return to shareholders. Over the past three years, management has returned $10.8 billion to shareholders through a combination of share repurchases and dividends, and we expect this to continue for the foreseeable future as the company's ability to reinvest at the same level of returns is limited.

6. Financial Resilience

Yes. MasterCard is a cash-printing machine with little need to invest in fixed assets, so the company boasts an ironclad balance sheet. Though management employs a bit of debt to boost the company's return on equity, the large cash reserve and steady free cash flow would allow them to pay down debt quickly if the need arose. MasterCard's business held up surprisingly well through the Great Recession, and it should do even better in your garden-variety business-cycle downturn. Also, because the company's fees are tied to total transaction volume, MasterCard is also well-positioned to deal with -- or even benefit from -- an inflationary environment, should one arise.

7. Expanding Possibilities

Yes. One of the linchpins of our investing thesis is MasterCard's ability to capitalize on the transition from cash to digital transactions -- a trend that should only accelerate over time with the addition of mobile payment technology. MasterCard has proven success expanding its network into international markets, and one of the largest developing economies, China, is just getting ready to open its doors to foreign payment processors. It will take a while for MasterCard to establish itself in the country, but growth in China and other emerging markets with a rising consumer class will certainly add to the company's processing volume over time. Also, MasterCard is developing a number of ancillary businesses that allow the company to profit from the huge amount of unique data it creates. These value-added services not only keep existing customers happy, they are additional channels for high-margin revenue growth.

8. The Three C's of Management (Clarity, Consistency, Capability)

Yes. With a company as large and globally diverse as MasterCard, it's impossible to pin its success on any one individual. Though there's no "visionary founder" -- MasterCard was previously controlled by an association of financial institutions -- CEO Ajay Banga and CFO Martina Hund-Mejean have a long track record of successfully running large, multinational businesses, and both have a significant portion of their wealth tied up in MasterCard shares. Management has done a good job of setting ambitious, though achievable, multi-year goals, executing on their plans and effectively communicating their progress to shareholders. The payment industry has experienced rapid innovation over the past decade, and MasterCard's management has been successful in recognizing important trends and responding, either by developing new technology in-house or by acquiring new capabilities as necessary to stay at the front of the pack. Overall, MasterCard has such a strong business model that management's biggest job is limiting the number of unforced errors and avoiding complacency.

The *Pro* Bottom Line

With 7 of the 8 *Pro* quality characteristics we look for, it's little surprise that MasterCard has been a top performer since we added it to the portfolio in 2011. Though competitive pressures have picked up recently, management has been investing heavily in defending MasterCard's competitive position and finding new opportunities for growth. We think MasterCard has a fantastic business model, and we're happy to have a 7% combined allocation to the industry through our 4.5% position here and our 2.5% position in Visa. MasterCard is currently rated as a Buy First, so we suggest members buy shares to match our allocation if they haven't already.

Here are links to additional *Pro* quality checklist articles:

- **FactSet Research Systems** (NYSE: FDS) -- 8/8
- **Gentex** (NYSE: GNTX) -- 5/8
- **American Tower** (NYSE: AMT) -- 7.5/8
- **Broadridge** (NYSE: BR) – 8/8
- **Oracle** (NYSE: ORCL) -- 8/8
- **O'Reilly Automotive** (NASDAQ: ORLY) -- 6/8
- **TD Ameritrade** (NASDAQ: AMTD) -- 5.5/8
- **Valmont Industries** (NYSE: VMI) -- 5.5/8

Have a great week, Fools!

Best,

-- Jeremy (TMFTank)

Pro Completed Trades

- **FactSet Research Systems** (NYSE: FDS): We bought 330 shares, for a 2% position, at $160.30. (edited)
- **American Tower** (NYSE: AMT): We bought to close our June 10, 2016, $108 diagonal calls for $1.

Re-Establish Your Diagonal Calls on American Tower

Published Jun 13, 2016 at 11:57AM

Is this for you? This recommendation is for all *Pro* members who have matched our 3.9% stock allocation in **American Tower** (NYSE: AMT) and **also** own January 2017 or 2018 calls, or are ready to buy them now. For new *Pro* members who do not yet own calls, please check out the guidance under "New *Pro* members" in the "How You Participate" section of this alert. Mind that we are only writing calls to cover our owned calls, **not** to cover our stock position. We recommend that you leave your stock allocation **uncovered** in order to capture further potential upside in American Tower.

How You Participate

- **Trade:** Sell to open July 22, 2016, $111 calls on American Tower. *Please note that these are **weekly** options*.
- **Allocation:** Sell one call for every January 2017 (or January 2018) $80 call you already own (or are buying now). *Pro* will cover its six long calls.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a limit order to split the bid/ask spread at going prices as long as you get at least a 3.5% yield on your long January 2017 or 2018 call value (see the math below). These weekly options are relatively thinly traded, so **it is critical that you use a limit order** to avoid collapsing the bid/ask spread.
- **Prices** (as of 11:35 a.m. 6/13/16):
    - **Stock price:** $109.50
    - **Sell to open July 22, 2016, $111 calls (bid/ask split):** $1.40
    - **January 2017 $80 calls we own (bid/ask split):** $29.85
    - **Diagonal call yield:** $1.40/$29.85 = 4.7% in 40 days.
- **New *Pro* members:** If you've yet to buy calls on American Tower, go ahead and set up the whole diagonal call trade today. Use a diagonal call order (sometimes referred to as a "calendar spread" order, depending on your broker), buying the **January 2018** $80 calls (rather than the 2017 calls *Pro* owns, in order to give your calls more time to expiration) and simultaneously selling the July 22, 2016, $111 calls to aim for a net debit of $30.05 or so. Invest about 0.7% of your funds in the long calls if you're matching our allocation.
- **Alternative Guidance:** If *Pro*'s volume results in a significant impact on the July 22, 2016, $111 call pricing, or if the stock price changes considerably from the price in this alert, consider looking at various other strikes or weekly expirations for your short call, depending on what you like best. Be sure to consider when American Tower is expected to report second-quarter 2016 earnings (last year, that date was July 29), as that may impact the option premiums and expected volatility of the stock around that date. If you choose this route, be aware that *Pro*'s course of action may diverge from yours, depending on what strike and expiration you choose, and depending on the stock-price movements of American Tower.

What We're Thinking

After closing our short calls last week to avoid assignment, we're content to keep our diagonal call position going, selling a new short-dated call to generate income and target further upside from our long-dated owned calls.

The rationale for this diagonal call is much the same as it was for the previous iteration. These new written calls could pay us 4.7% or so on our current long call's value in one month, and we have upside to the $111 strike price (about 1.4% higher than the current price), which if reached would increase the value of our owned calls by about 5%. This is an example of the leverage that owned calls provide! If the stock price shoots well above our written call's strike price prior to expiration, we can roll our calls for further income (if the rolling trade looks attractive) while still capturing the full upside of the stock with our uncovered 3.9% stock allocation, currently our seventh largest.

Even if we assume that we will have to sell our long calls in a little over a month when our written calls are assigned, the return on the long calls (including the income from the series of two diagonal calls) would be approximately 47%, well ahead of our North Star since our December 2014 purchase. And although we aren't explicitly planning to close or sell our diagonal call, preferring to roll if possible, our willingness to sell outright does increase as the stock price appreciates and grows closer to our fair value.

More That Matters

- **Maximum gain:** The 4.7% premium earned from writing the calls, plus upside in our owned calls to our short call strike price at $111, which is lately about 1.4% higher than the current price.
- **Maximum risk:** The full value of our long $80 calls, minus premiums received from short calls.
- **Follow-up**: We hope to see these short calls expire for income later this month, and then we will determine whether we want to write new calls. If we need to roll or close, we will.

Pro Can Help

- **Want to know more about this strategy?** Our Options U guide to writing diagonal calls can keep you on an even keel.
- **Questions about this trade?** Consume data and post your questions on our American Tower board.

The Best 2 Days in Fooldom

Published Jun 9, 2016 at 12:00PM

The best part of The Motley Fool's online community is bringing together hundreds of thousands of investors from all over the world. The worst part is that we rarely meet any of those people face to face.

We bridge that gap a few times a year by inviting hundreds of our investors, advisors, analysts, and guest speakers to talk investing, business, the economy, and more. The events are truly one of the highlights of being part of our community.

We just wrapped up FoolFest 2016, our largest event of the year near our headquarters in Alexandria, Virginia.

Here's a video of the highlights. Check it out, then keep reading for my top takeaways -- and how you can watch the full two-day event.

{% video %}

1. Dan Pink on Motivation

Best-selling author Dan Pink gave a great talk about motivation, including how making people's jobs more meaningful increases productivity:

> Let me very quickly give you one study that I think makes this case really well. It's a study out of Harvard Business School. They went to a cafeteria. Imagine people going through the line in a cafeteria. What the researchers did is they set up an iPad, and the iPad allowed the people in the kitchen, the back of the house, to see the people in line, the cafeteria customers.
>
> There were four conditions. In one case they could see each other. In one case, the cooks could see the customers. In another case, the customers could see the cooks. In one case they couldn't see each other.
>
> When the cooks could see the customers through this iPad camera, the quality of the food improved. The dependent variable in this study, what they were measuring, was the quality of the food. It wasn't whether the cooks were satisfied. It was, what do people think of the food? When the cooks could see the customers, the quality of the food improved.

> Now those cooks were not like, "We're standing up against Big Food. We are empowering local farmers," or anything like that. It's like, "I'm just making an awesome omelet, and I want it to be great, because this guy looks like a nice guy and I want the omelet to be good."

2. Nell Minow on Curfews and Cutoffs

Nell Minow, a corporate governance expert, told an amazing story about having to scold her dad for not attending enough board meetings:

> I was at the then very new Institutional Shareholder Services, which was the first large company set up to advise institutional shareholders on proxy votes, and it bugged me that nobody was paying attention to boards of directors. And I said, "Well, they have to tell us two things: do they have any stock and did they go to meetings. Let's not vote for them if they don't have any stock and they don't go to meetings."
>
> So the second name that came up was my dad, who had missed more than 25%, which is the cutoff. So I had to call him and tell him. I said, "Hi..."
>
> And he said, "Hi, how are the kids?" So I said, "Oh, they're fine. Listen, I have something to tell you. You've missed too many meetings on the board of AON, and we're going to recommend a vote against you. Our clients include the California Public Employees' Retirement System, and TIAA-CREF, and they're going to vote against you."
>
> He said, "How many meetings did I miss?" I said, "Well, the cutoff is 25% and you missed 27%." He said, "That's really close." I said, "When I came home at 12:15 and my curfew was 12:00, you told me that close didn't count."

3. David Gardner on the Pressure for Predictability

Motley Fool co-founder David Gardner talked about the importance of predictability in corporate results:

> I had that taught well to me by Howard Schultz of Starbucks, who was invested in [The Motley Fool] early on, and we had some good opportunities to learn from Howard. One of the things Howard said is, "If and when you ever go public, you need to know ahead of time that you have your next four quarters nailed." Howard was probably a little too hardcore on this, but he basically said, "If you come out of the gate, and you miss your first, second, or third earnings, Wall Street will walk away from you and they'll never come back."
>
> And while I think, again, that might be a little bit over the top, he was just talking about the importance of predictability in a business.

4. Bryan Hinmon on Finding Time to Focus

Motley Fool analyst Bryan Hinmon, CFA, shared uncommon ways to improve your performance as an analyst:

> How many of you are familiar with the circadian rhythm? The circadian rhythm is the biological process whereby very naturally our bodies are synced up to a 24-hour cycle. A guy named Nathaniel Kleitman studied sleep for a long time. Apparently he felt like he understood everything there was to know about sleep. Or got bored with it, and decided to study being awake.
>
> And what he found, when he dove into his study of wakefulness, was there are cycles within that circadian cycle. This is the ultradian rhythm, a product of Nathaniel Kleitman. He basically posited that we have natural, biological cycles of alertness and they happen to take a form. The bad news is we've got about 90 minutes of high-functioning activity before we need a 20-minute break.

5. Morgan Housel on the Risk Inside Our Heads

I gave a talk about risk, and how the biggest risk we face as investors is our own behavior:

> We, as investors, are constantly bombarded with mental ammunition for the fact that markets are risky and that we should take actions to avoid that risk. And we tell ourselves after the market decline that we learned our lessons, and we won't make the same mistakes [as in] the past, so we sell after stocks have declined, only to get lured back into them after they've risen again. We come up with all kinds of different trading strategies to get in and out of the market at opportune times. And we do these with good intentions to make ourselves safer. To reduce risk. And rarely do we take a step back and realize that we're doing just the opposite.
>
> Because the biggest risk that you face as an investor is not that you're going to experience volatility in the stock market. Volatility is a pretty normal and common thing in the stock market, even when the stock market's doing really well.
>
> The biggest risk, by far, that you face as an investor, is fooling yourself into believing that the way that you deal with this risk is to take actions and try to outsmart and outmaneuver the volatility. That's when you really end up in trouble.

6. Jason Moser on the Optimism of Chipotle

Fool analyst Jason Moser talked about Chipotle's recent stumbles, and how the company has capitalized on a lower share price:

> We go back to November 1, 2015, they've spent almost $1 billion since then on share repurchases, representing a reduction of almost 2 million shares in the total share count there. This, all the while, they still have a very flush, healthy balance sheet with $250 million in cash and equivalents at their disposal.
>
> There are a couple of things we can take from this. No. 1, the model is very cash-flow productive, right? These stores don't cost a lot to open. They realize the return on their investment very quickly, which allows them to really bring in a lot of cash, reinvest in the business, and build up a very healthy balance sheet. No. 2, I think management here even recognized that the shares, while they probably deserve to get hit pretty hard, I think management also seeing the forest for the trees, knows that this is not the end of the business. This is Steve Ells' legacy, I don't think he wants to go out on a sour note like this.

And that's just a small slice of what we covered at FoolFest. There's actually 21 videos available -- just click below to get more:

Watch the Full Event

Video transcript

Chris Hill: We're just wrapping up FoolFest 2016, two incredible days where we were talking about top stocks for the next decade, Morgan Housel doing an amazing session on risk and what it means for us as investors. We had CEO interviews; we had breakout sessions on retirement planning, dividend stocks, growth stocks, options — so much great content — we hope you check it out on this year's Digital Pass.

[↑ Back to the top](#)

Another Potential Trade on Your Diagonal Call on American Tower

Published Jun 9, 2016 at 10:34AM

Is this for you? This is for all *Pro* members who wrote June 10, 2016, $108 diagonal calls on **American Tower** (NYSE: AMT). If you're a new *Pro* member and you have yet to establish a diagonal call position on American Tower, please ignore this particular alert. If and/or when *Pro* decides to re-establish its diagonal call position, after we either buy to close our calls on Friday or let them expire, we'll issue a *new* trade alert instructing you how to do so. Remember that all members should already own an unencumbered 3.8% stock allocation to American Tower, so if you have yet to establish the diagonal call, you should still have exposure to the stock's upside.

How You Participate

- **Condition:** If American Tower's stock price is below $108 as Friday's market session nears its close, you need do nothing. If the stock price is above $108 at that time, buy to close your $108 calls. (Leave your owned 2017 or 2018 calls alone. We will keep owning those.)
  - **Trade:** Buy to close your June 10, 2016, $108 written calls.
- **Allocation:** Buy every June 10, 2016, $108 call you previously sold.
  - **Price Guidance:** Use a **limit order** and aim to pay as little time value as possible, but realize you need to close these calls on Friday if the stock is above $108, or you risk getting your owned *shares* (rather than calls, assuming both securities are owned in the same account) called away. **We want to avoid that scenario!** As of today, the calls still have $0.205-$0.30 in time value remaining, even though they are "out-of-the-money" and on track to expire if the stock price stays unchanged. As we approach expiration, time value will erode, so the longer you wait to make this conditional trade, the more advantageous it will be.
  - **Prices** (10:00 a.m. ET):
    - Stock: $107.67
    - June 10, 2016, $108 calls (bid/ask): $0.20/$0.30 (by tomorrow this value should be lower, unless of course the stock price rises above $108 by more than this amount).
- **Follow-Up:** We're not issuing a rolling trade alert today because rolling may not be possible (and we can't foresee future prices tomorrow -- sorry!). Instead, we're waiting until our existing calls are closed before we consider writing new calls on this stock. This will probably be next week or the following week.

What We're Thinking

We're back at it again -- another race to expiration with our American Tower diagonal calls. Since the stock price is flirting with our diagonal-call strike price, and we don't want our short calls to be assigned, we need to address what to do with our calls if the stock stays above our strike price on expiration day. Since *Pro* itself must wait a day before taking action on its recommendations, we have to issue this alert today if we want to act tomorrow. So here it is.

If luck shines on us, American Tower's stock will be modestly below $108 tomorrow, and our written diagonal calls will expire fully as income. If not, and the stock looks like it will end the day above $108, we'll need to take action as detailed above in order to maintain our desired position. We'll buy to close our $108 calls in that case tomorrow, then reassess the position for a few days, while keeping our 2017 long calls.

How This Trade Fits Into *Pro*

Unless American Tower's stock price declines significantly in the next week or so, we're likely to initiate another diagonal call before long, again targeting income in between earnings reports. We don't want to sell our long call just yet (the underlying stock is rated Buy First on our scorecard), because we see more long-term potential in the business.

Pro Can Help

- **Questions?** Consume data and ask your questions on the [American Tower board](#).

Pro Catch-Up Trades: June 6, 2016

Published Jun 6, 2016 at 2:08PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our [Portfolio Building Reports](#) will get you fully invested over the coming few weeks, as much as you want to be.

Pro's [Buy First stocks](#) are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Facebook** (NASDAQ: FB): Have close to our 6.5% exposure yet? Work toward 5% if 6.5% seems too large to you.
- **FactSet Research Systems** (NYSE: FDS): Buy 2% in this [new position](#). (*Pro* has 30 days from the report date, May 18, to buy our shares. We won't likely wait that long, but so far our limit orders have missed a buy.)
- **Wells Fargo** (NYSE: WFC): Match our newly larger 4.8% stock position with new shares (or short-term, near-the-money written puts, if you prefer).

Continue building your portfolio with [our Buys](#), including these highlighted today:

- **Gilead Sciences** (NASDAQ: GILD): Buy 3.1%.
- **Starbucks** (NASDAQ: SBUX): Buy up to 3.4%.
- **TD Ameritrade** (NASDAQ: AMTD): Buy 2.6%.
- **Visa** (NYSE: V): Buy 2.5%.
- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): Buy 1%.

Shorts:

- None currently.

Options:

- None currently.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY): The June 17, $177/$185 put ratio spread we announced on May 4 can be set up for a net cost of $0.01 (in a debit) at recent prices. Given the strong chance this spread won't get used in the next 10 market days, you can skip setting it up if you haven't yet and don't want to; or if you'd rather, you can set it up to match *Pro* and as "disaster" insurance.

Pro's June Options Race to a Finish

Published Jun 6, 2016 at 2:08PM

Dear *Pro* member:

We have eight options positions on track to expire this month, one this Friday, seven next Friday. As this year rolls on, we plan to continue to write more monthly options, often targeting income. To prepare you for our current pending expirations, let's run through our plans.

American Tower (NYSE: AMT) June 10 $108 diagonal calls: We closed our April 29 $105 diagonal calls for a 93% gain, then wrote these June 10 $108 diagonal calls for more income. With the stock lately at $107.50, we may need to close these calls by the time they expire this Friday, ideally for a partial gain. Watch for a conditional trade alert to hit your inbox by the middle of this week if American Tower's stock price is still flirting with $108 or higher. A conditional alert informs you what to do in case of either option: If the stock ends Friday *below* $108, we can do nothing and simply let our calls expire for the full gain, but if shares are bouncing around $108, we'll close them for a partial gain to be safe and avoid seeing them exercised. We'll then look to write new diagonal calls with a new alert in the near future. Right now, the $108 calls expiring this Friday still have $0.40 in value remaining (all time value), so we can wait for that to dissipate. Again, if shares stay below the $108 strike, we can just let them expire as full income. But we'll be ready to close on Friday if the stock price continues to dance around $108.

Skyworks Solutions (NASDAQ: SWKS) June 17 $70 covered calls: With shares lately at $66.50, our $70 calls are on track to expire as income, although we could be forced to close a bit early or roll if the share price challenges our strike price next week. Currently, we're up nearly $1,000 -- or 71% -- on these calls, which we wrote on May 5. If they expire, we'll consider writing new ones, perhaps at a higher strike price because the stock has recovered recently.

Valmont Industries (NYSE: VMI) June 17 $140 covered calls: With shares at about $135, these calls are also on track to expire as income a week from Friday. If so, we'll look at new calls to write. Although cyclical stocks like Valmont have enjoyed a rally lately, there's still enough reason to consider writing calls on income for them right now. Commodities and emerging markets remain depressed. But if Valmont's stock price rises above $140 by next week, watch your inbox for a rolling or closing trade alert.

WisdomTree Emerging Markets SmallCap Dividend Fund (NYSEMKT: DGS) June 17 $38 covered calls: Just to irk us, the ETF's price has run higher in recent days, touching $38 today. We'll keep watch, of course, and close or roll our calls next week if pricing dictates. As long as DGS is *below* $38, we can let the calls expire for full income on June 17. If it's near or above $38, we'll close a bit early, or we'll roll to a later month and slightly higher strike. But there's no reason to act right now. The June 17 $38 calls still cost $0.45, which is all time value that we can wait to see dissipate.

SPDR S&P 500 (NYSEMKT: SPY) June 17 $200/$190 spread: This defensive bear put spread hedge paid *Pro* $451 when we set it up, and will earn us *additional* profit if the index trades between $200 and $180 by expiration. The S&P 500 is lately above $211, or 5.2% higher than our $200 strike. So, unless the index falls by more than 5% by June 17, we will do nothing but let the full spread expire for our initial credit. If SPY is *below* $200 by a week from Friday, we can close our $200 puts for an additional gain. If SPY is below *$190*, we'll need to close those, too. But right now, it appears likely we needn't do anything but let it all expire. That's likely true even if you have spreads set up at modestly different strikes.

SPDR S&P 500 (NYSEMKT: SPY) June 17 $185/$177 spread: This spread is even further out-of-the-money, and it will most likely expire unused and untouched. It's disaster insurance at this point, clicking into play only if SPY declines by more than 12.3% to $185. You could buy to close the $177 puts for pennies right now if you wanted to remove that remote potential obligation to buy SPY at $177, but we plan to do nothing but wait for it all to expire.

In Summary

So, to sum up: Watch your inbox for a conditional trade alert on American Tower this week. We may send similar conditional alerts next week on our three covered-call positions expiring June 17, if the stocks trade high enough to merit it. Right now, though, American Tower, Skyworks, Valmont, and DGS are all on track to expire as full income, with no action needed. As for our two SPY hedges, we likely won't need to do anything at all, but we will look to set up new index hedges as these expire.

Overall, *Pro* is up a bit this year (see our updated results below), slogging it out for returns while the Nasdaq is down slightly in 2016 and the S&P 500 is up somewhat. We'll continue to own stocks we feel strongly about (the core of the portfolio); we always have new stocks in consideration; we're considering new shorts; and we plan to target steady option income and hedges.

Questions on this month's expirations? Please visit the *Pro* Options Strategies board. And thank you for being a Fool with us!

-- Jeff (TMFFischer)

Pro Guidance Changes

- **American Airlines** (NASDAQ: AAL) call options move to "Sell to Close" per last week's trade alert.
- **Deere & Company** (NYSE: DE) short sale moves to "Hold" as we reassess the position.

Pro Completed Trades

- **SPDR S&P 500** (NYSEMKT: SPY): We set up our June 17 $177/$185 bear put spread for a $0.01 debit, to complete the trade in our 30-day window.

Pro Performance

Performance as of 5/31/2016

	Annualized		Total Return	
	Since Inception	Rolling 3-Year	YTD	Inception
Pro Portfolio	**13.0%**	**16.0%**	**2.4%**	**155.7%**
North Star	**8.3%**	**8.0%**	**4.1%**	**83.8%**
S&P 500 Total Return	11.8%	11.1%	3.6%	134.6%
MSCI World	6.0%	4.4%	0.7%	56.1%

*Start close of 10/6/08.

Sell to Close Your Calls on American Airlines

Published Jun 3, 2016 at 3:03PM

Is this for you? This is only for *Pro* members who own January 2017 calls on **American Airlines** (NASDAQ: AAL). But you should consider selling if you own 2018 calls, too.

How You Participate

- **Action:** Sell to close your January 2017 $35 (or other strike price and/or expiration date) calls on American Airlines
- **Allocation:** Sell to close all calls
- **Recent Price of Jan. 2017 $35 calls (bid/ask):** $1.91/1.95
- **Price Guidance:** At prices as we publish, you would use a **limit order** to get the going price of about $1.93 or higher. As the price changes, use an appropriate limit order between the bid and ask price.

What We're Thinking

Without failures, it's difficult to recognize success. Our 16-month investment in call options on American Airlines has been a spectacular failure. Off by about 90%, our $35 calls are on track to expire without value unless American's baggage-heavy stock can take flight again before January.

Lately trading at about $31, the stock is down about 44% since we started our position, having slid from an average of 15 times earnings over 2015 (with a low P/E that year of 6, at about the time we bought) to today's mere 2.8. Most investors don't believe that American can retain anywhere near its current level of profitability. In part, Wall Street is disheartened by a steady decline in passenger revenue per average seat mile (PRASM), down 7.5% last quarter and expected by management to decline 6% to 8% in the current quarter.

American Airlines now believes this PRASM downtrend could continue into 2017. Overall, growth in airline seat capacity and competitive pricing are keeping a lid on investor enthusiasm, to say the least, even as American posts record profits aided by low fuel costs. In fact, much of our (and I should really say "my") original thesis came true: American's profits soared after its restructuring and its merger with US Airways, also thanks to low oil prices (which fell even more than we could have hoped!). But other key parts of my thesis are under attack.

Last year, key competitors vowed to hold the line on pricing, but it appears that fares keep slipping. Competitors have also used cash windfalls to invest in more capacity, rather than saving it for a rainy day. In short, the industry appears to be slipping toward irrational "boom time" behavior again, investing in capacity when oil is cheap, and risking flying too many empty seats when oil is more expensive again.

Looking ahead, I'm not very optimistic about American for a few reasons:

- Oil prices have recently rebounded to more than $50 per barrel, up from less than $30 back in January. American Airlines doesn't hedge its fuel costs (a boon for us -- or it should have been -- as oil fell), so the jump in costs will almost certainly crimp American's future earnings power compared to the past year.
- As mentioned, the airline industry (though not American) has been adding seat capacity throughout the oil price downturn. Rather than taking new capacity offline if fuel costs take flight or passenger demand declines, some airlines may cut fares to fill seats.
- American is investing in a "differentiated" economy-class experience as a way to win more customers -- but will this expensive endeavor really drive more traffic, when many view domestic air travel as a commodity? I don't think differently priced economy seats will drive demand the way American hopes.

But there are other main reasons we're selling our calls. We're selling to close because:

1. We're running low on time, with only about seven months (two quarters) until expiration.
2. As mentioned, American expects PRASM to fall over the rest of this year -- not just incrementally, but by as much as 8% year-over-year this current quarter. Even though the second half of 2016 is expected to be "less bad," it's hard to imagine investors bidding the stock much higher under this cloud.
3. Our calls are out-of-the-money by about 11% (a $35 strike on a $31 stock) and carry 5.5% time value on the strike price (about $1.93 on the $35 strike) -- this time value will steadily dissipate.
4. With the calls still worth $1.93 in time value, the stock needs to increase by about 19% (to $36.93 from $31) by expiration in January *just* for our calls to end with the same value they have today. Playing the odds, we'll take the bird in the hand today. So we'll sell. Even what little capital we can get back today is still capital that we value, and wouldn't want to simply let vanish.

Lessons Learned?

Here are some big, recurring lessons:

A cheap stock can get even cheaper. We all know this, but American flies the idea home. Although earnings have increased in the time we've owned our calls, the stock has only gone down, sending its valuation multiples much lower. Shares traded for about 7 times EBITDA early last year; that multiple is lately 3.7. The stock's P/E multiple has more than halved, to 2.8. It's important to remember that a cheap stock valuation *does not* remove the underlying risk or speculation that may exist in a stock or a business. Wall Street will sell a stock into the ground, down to a P/E of 2, if investors don't believe in it.

Not all stocks in an improving industry will be treated well. Often, winners continue to win, and past losers are ignored. As of Thursday, **Southwest Airlines**' (NYSE: LUV) stock is up 13% over the past year, while American is down 24%. Despite record profits in the industry and at most carriers, not all stocks are benefiting. Wall Street still believes in long-term historical winners like Southwest, but hasn't bought into the idea that legacy carriers like American can really continue to succeed.

Investors might ignore industry improvements they deem temporary. As mentioned, it seems Wall Street doesn't believe that past "losers" like American can positively change their ways for good, especially if investors don't believe the industry will stay as strong as it is today. Wall Street may also believe that the savviest companies, like Southwest, will maintain an evolving edge that will ultimately harm secondary competitors.

Wall Street can be skeptical for a long time. I thought a year to 18 months was ample time for Wall Street to see, quarter after quarter, how American is *different* and *better* this time. Instead, Wall Street has focused on concerns that have bubbled up -- from lower PRASM to competing fares to increased investments in new planes and economy classes. Wall Street's sour mood on American could last for years. The stock may trade cheaply for a long time, and if fuel costs increase much, that could be another headwind.

Choose your option appropriately! High volatility is expected from American's shares, so its options are expensive. To minimize the amount of *time value* we paid, I ended up recommending $35 calls on a $55 stock. This meant we had to invest a significant amount of our capital (we chose 1% total) in intrinsic value.

Usually, this is logical -- if you believe that intrinsic value will hold steady. But in this case, it wasn't smart. We would have been better served buying *at-the-money* or even out-of-the-money call options, risking much less capital per call. Would we still have risked 1% of our total portfolio in those higher-strike calls? Almost surely not. We probably would have trimmed the investment to 0.5%, given the leverage we would have, and spent half as much for a more speculative position.

American's cheap valuation and the near-certainty of its near-term earnings growth (which has indeed played out!) made me mark down the risks in the industry and thus in the stock. I was wrong to do that.

When buying call options, one always estimates the valuation and business risk. But one must also estimate the risk of how Wall Street may treat the shares, and buy calls that appropriately limit your own capital at risk when merited. For instance, be careful buying deep in-the-money calls on a cyclical stock like a semiconductor company; it can fall sharply on its cycles. You're better off risking less and buying a call with a higher strike price. With American, even though the business was priced cheaply and earnings were increasing, the situation was more speculative than I acknowledged, and buying deep in-the-money calls was questionable in hindsight. We could have risked 0.5% total and bought $55 calls for $7 (or something like that) at the start, rather than putting 1% into $35 calls for $25 each. Sure, this is some hindsight, but also a lesson to remember with positions like these.

The Foolish Bottom Line

Even after a lifetime of investing (or nearly 30 years), and even during the past year when *Pro*'s account value is up, there are still times when I feel like most of my decisions are wrong. I've come to realize that those times -- like today -- are important chances to step back, take stock (so to speak) and realize that most of what we're doing together is indeed creating long-term value. That said, at times it's hard not to place a lot of weight and focus on positions that are losing. That's good, to an extent -- we benefit from the reminders and the lessons learned. But it's also important to then move forward with a healthy outlook. Mistakes can make us better, more humble, and smarter investors, if we learn from them.

Will we invest in something like this position again? Surely! But will we do it better? I certainly think so. We'll risk less capital, for one thing, and use different options in cases like this. I've also been looking at shorts in this industry, so we may ultimately make money from the knowledge gained over the past 16 months.

As you invest, it's important to ensure that everything you do is a stepping stone toward more knowledge to feed future decisions. If you do that, most of the choices you make should ultimately lead to better long-term results -- even if they offer short-term setbacks some of the time. Thank you for bearing with us as we learn another lesson.

Alternative Trades

- **Want to keep your calls?** You can keep them if you prefer, if you have so little invested in them that selling them isn't worth it to you. The stock could always rebound, of course; you never know. We're closing for the reasons explained in this report. You could also write diagonal calls against them if you wish, to monetize them a bit while still giving them some room to recover.
- **Other strikes and expirations?** As shared at the start, we would suggest simply closing those, too. They have ample time value to capture.
- **Simply own the stock?** This is a tougher call. We said on day one you could hold on to the stock for the long, long term if you like as an alternative. If we owned shares today, rather than expiring call options, we would *not* likely be selling them yet, with the market so down on the shares right now. We would likely wait and see what happens next. (Our calls simply don't give us the luxury of time.)

Pro Can Help

As we said in our original report, "Tell us we're crazy — er, we mean, ask us questions — on the American Airlines Group board." As we also wrote on day one, "Seat belts on? We're ready for departure (in more ways than one)." So, we departed from our normal course of business. Now we return with more knowledge and, overall, more capital (but no thanks to this position).

Targeting Annualized Returns

Published May 31, 2016 at 2:14PM

Dear *Pro* member:

A few months ago, before new members joined, I wrote a column explaining how we target returns for the *Pro* portfolio. If you haven't seen that, it may be worth visiting. Following first-quarter earnings and updated annual guidance from many of our companies, today I'm updating our return hopes for each company-based stock we own and recommend.

As a reminder, we generally seek at least 10% annualized total returns (dividends included, arriving as cash to the portfolio) from our holdings *and* for the portfolio as a whole. To get there, we believe we need to own several stocks capable of *more* than 10% annualized returns, to help balance the laggards we'll inevitably have. Currently, some of our recent higher-growth stocks, including **AmTrust Financial** (NASDAQ: AFSI) and **Facebook** (NASDAQ: FB), are "growing more mature," lowering our return expectations from here. That's not an awful thing. Keep in mind that **Alphabet** (NASDAQ: GOOG), for example, has generally experienced maturing growth for years, yet has been a leading stock.

Also keep in mind that we don't expect any of these returns to arrive in a steady fashion -- instead, we seek them by the end of a time period measured in years. Stocks could be flat for a few years, and then make up for it with a strong 30% gain. (That simple fact helps explain why market timers usually do much worse than long-term wealth builders who stay in the market.) So, where do our hopes for our positions stand now?

10% Compound Annualized Returns

Obviously we won't always be right, but we always target companies we believe can return at least 10% annualized from our purchase price over the long haul. If a good company falls after we buy it, we may buy more, expecting that new investment to earn more than 10% annualized. Today, 13 of our 22 companies slot into the 10%-desired-return bucket (listed by allocation size):

- **AmTrust Financial Services** (NASDAQ: AFSI), 5.3%
- **Broadridge Financial Services** (NYSE: BR), 5.3%
- **O'Reilly Automotive** (NASDAQ: ORLY), 5.2%
- **Wells Fargo** (NYSE: WFC), 4.8%
- **Oracle** (NYSE: ORCL), 3.8%
- **American Tower** (NYSE: AMT), 3.7% (excluding calls at 0.5%)
- **Parexel** (NASDAQ: PRXL), 3.2%
- **Medtronic** (NYSE: MDT), 3.1%
- **Gentex** (NASDAQ: GNTX), 2.8%
- **TD Ameritrade** (NASDAQ: AMTD), 2.6%
- **Verisk** (NASDAQ: VRSK), 2.2%
- **Valmont** (NYSE: VMI), 2.2%
- **FactSet Research Systems** (NYSE: FDS), 2% once we buy it

Total allocation: 46.2%

Our allocation to investments we believe can return 10% annualized with reasonable risk has grown from nearly 39% a few months ago to 46% today, mainly because AmTrust and O'Reilly were added to this list, as well as FactSet. AmTrust is being cautious as pricing in its core business softens, and though O'Reilly continues to grow quickly -- lately, earnings per share are growing above 20% year-over-year -- we're conservatively moving it to the 10% expectation bucket because of its valuation and a logical assumption that business will periodically slow. We still like all of these investments, of course, and the portfolio is well positioned should financial companies start to benefit from higher interest rates.

15% Compound Annualized Returns

- **Facebook** (NASDAQ: FB), 6.5%
- **MasterCard** (NYSE: MA), 4.5%
- **Starbucks** (NASDAQ: SBUX), 3.4%
- **OpenText** (NASDAQ: OTEX), 3.2%
- **Skyworks Solutions** (NASDAQ: SWKS), 3.1%
- **Papa John's International** (NASDAQ: PZZA), 3%
- **Visa** (NYSE: V), 2.5%

Total allocation: 26.2%; return multiplier in relation to 10% goal is 1.5x = 39.3% influence

With these seven stocks, we hope and aim for at least 15% annualized returns; all have blown by that number in recent years, but we still believe there's enough growth on tap to support similar results in the years to come. If these seven stocks can return 50% more, annualized, than the stocks above, then while they add up to only a 26.2% allocation, their strength in the portfolio is more like a 39.3% weighting or exposure when it comes to reaching our current 10% annualized total portfolio goal. With 10% being our North Star, we could just buy all presumed 10% growers. But buying companies we believe will return more than that in essence leverages us on our way toward our goal, and can let us keep some cash out of the market for future opportunities.

New to this list since last time are Facebook and Skyworks -- they were in the 20% annualized returns bucket last time. Those stronger returns could still happen, but we have to expect less given Facebook's past appreciation and current headwinds from Apple at Skyworks. Keep in mind that we don't expect these returns all at once, or even in a steady fashion. But over a rolling three-year time period, we see a case for even giants like MasterCard and Visa returning 15% annualized.

20% Annualized Returns

- **None at the moment.**

Total allocation: 0%; return multiplier in relation to 10% goal is 2x = 0% influence

Removing AmTrust, Facebook, and Skyworks from this bucket, we're left without any right now. That doesn't mean some of our positions won't return 20% annualized the next three years. Heck, some of our out-of-favor stocks in the 10% bucket (Wells Fargo, Valmont, etc.) could return that much annualized by 2019. But at the moment, we aren't modeling or expecting that sort of annualized return from holdings.

Un-estimated at This Time

- **Apple** (NASDAQ: AAPL), 3.5%
- **Gilead Sciences** (NASDAQ: GILD), 3.1%

Finally, two stocks are currently in a place where we're not estimating how much they may return, although we believe they could return at least 10% annualized from today's price. Both are very inexpensive, but both have large, similar questions hanging over them: Can each find another road to higher growth even though they've already climbed to the top of Mount Everest? And what sort of valuation multiple is Wall Street willing to pay for an extremely successful company that may not grow very much for... years? Right now, Wall Street won't pay much. But if sentiment changes, or growth avenues are found, these two stocks could return much more from here. Given uncertainties at the moment, though, we prefer to be patient and not make too many presumptions; as long we believe 10% annualized returns remain possible (and we do), we can wait and keep analyzing.

Keeping in Balance

Now, when you add up our total allocation toward meeting our 10% return goal, you get, from the top bucket on down: 46.2% + 39.3% + 0% = 85.5%. We may be 85.5% of the way toward our goal. Adding Apple and Gilead with our minimum 10% return assumption, we're at 92.1%, even though we have about 19% in cash (after buying FactSet). But however you slice it, the outcome is the same: We're seeking to invest in more strong *growth* businesses for the portfolio. We want to add more exposure to faster growth leaders.

If we also continue to add low-cost hedges and successful shorts, as well as steady option strategies, we should remain on track.

Questions? Please visit the Memo Musings board. Thank you for being a Fool with us!

-- Jeff (TMFFischer)

P.S. If you want to read more about this construct, and haven't yet, please visit our April 4 Memo on the topic.

Pro Catch-Up Trades: May 31, 2016

Published May 31, 2016 at 1:56PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our Portfolio Building Reports will get you fully invested over the coming few weeks, as much as you want to be.

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **FactSet Research Systems** (NYSE: FDS): Buy 2% in this new position. (*Pro* has 30 days from the report date, May 18, to buy our shares. We won't likely wait that long.)
- **Wells Fargo** (NYSE: WFC): Match our newly larger 4.8% stock position (with shares or short-term, near-the-money put writing if you prefer).

Continue building your portfolio with our Buys, including these highlighted today:

- **Gilead Sciences** (NASDAQ: GILD): Buy 3.1%.
- **O'Reilly Automotive** (NASDAQ: ORLY): Buy 5.2% in halves, over time.
- **Parexel** (NASDAQ: PRXL): Buy 3.2%.
- **Starbucks** (NASDAQ: SBUX): Buy up to 3.4%.
- **TD Ameritrade** (NASDAQ: AMTD): Buy 2.6%.

Shorts:

- **Deere & Co.** (NYSE: DE): Sell short 1.9% in stock.

Options:

- None currently.

Hedges:

- **SPDR S&P 500** (NYSEMKT: SPY): The June 17 put ratio spread we announced on May 4 can be set up for a net cost of $0.00 (yup, zero) at recent prices. On a market drop, the price to set this up may become a bit more favorable for newcomers. As this is far out-of-the-money (SPY trades much higher than our $185 upper strike), we at *Pro* are currently waiting for a market drop to set it up, although we need to make the trade by June 4 to meet our 30-day trade window. So, expect that this week.

Celebrate Our Community: Polaris Award 2016

Published May 26, 2016 at 3:36PM

Pro Polaris Award 2016

The votes are in! Please join us in congratulating phooLon and honoring his invaluable contributions to our community.

As proposed by ADrumlinDaisy (now BrokeInDaBurgh) in 2013, the Polaris Award is "a *Pro* community analogue of the Feste Award, an annual award given to the member who provides the most value to his or her fellow members." Criteria include a regular, frequent, Foolish presence on the *Pro* discussion boards; helpful, expert-level advice; creativity; and efforts to foster a sense of community.

Previous winners include the esteemed and deserving **aleax**, **RockyTopBob**, and **fullofcarp.** This year's winner, **phooLon**, will receive a shiny new discussion-board charm but has declined the monetary prize of $250 to use at Apple or Starbucks. See the full rules here. More to say? Bring it to the Member Suggestions board, and Fool on!

Polaris Award 2016 Contest Rules

Published May 26, 2016 at 11:22AM

OFFICIAL POLARIS AWARD 2016 CONTEST RULES

1. ENTRY: No purchase necessary to enter or win. The contest will begin on 5/26/2016 and end on 6/17/2016. The entry deadline for the contest is 6/10/2016.

2. ELIGIBILITY: This contest is open only to legal U.S. residents, over the age of 18.

Employees and contractors (and their families) of The Motley Fool or any of its affiliates are not eligible. Void where prohibited by law. Contestants residing in those areas where the contest is void may participate in the contest but may not win any prizes.

3. WINNER SELECTION: The member who has the most votes from other members of the Pro community will be declared the winner. Votes will be collected in a manner as stated by TMF with these rules, and each individual in the Pro community can only vote once. Motley Fool employees and contractors may vote, but are not eligible to win.

4. PRIZES: The winner will receive a $250 gift card from their choice of either Apple or Starbucks. [Value: $250]

5. WINNER NOTIFICATION: The winner will be notified within 5 days after the determination date. Inability to contact a winner may result in disqualification and selection of an alternate winner.

6. GENERAL CONDITIONS: The winner will be required to execute and return a Certificate of Eligibility, Consent and General Release form within 14 days of notification. The winner may also be required to complete and return a W-9 for tax purposes. Non-compliance within this time period may result in disqualification and selection of an alternate winner. Any income tax liability is the sole responsibility of the winner. By acceptance of the prize, the winner consent to the use of his or her name and/or likeness for purposes of advertising or trade without further compensation, unless prohibited by law.

7. USE OF CONTEST INFORMATION: All entries become the property of The Motley Fool. The Motley Fool reserves the right to use any and all information related to the contest, including submissions provided by the contestants, for editorial, marketing and any other purpose, unless prohibited by law.

8. CONDUCT: All contest participants agree to be bound by these Official Rules. The Motley Fool in its sole discretion, reserves the right to disqualify any person it finds to be tampering with the entry process, the operation of this website or is otherwise in violation of these rules.

9. LIMITATIONS OF LIABILITY: The Motley Fool is not responsible for late, lost or misdirected email or for any computer, online, telephone or technical malfunctions that may occur. If for any reason, the contest is not capable of running as planned, including infection by computer virus, bugs, tampering, unauthorized intervention or technical failures of any sort, The Motley Fool may cancel, terminate, modify or suspend the contest. Entrants further agree to release The Motley Fool from any liability resulting from, or related to participation in the contest.

10. WINNERS LIST: The names of the winner may be obtained by sending a self-addressed stamped envelope to Pro Member Contest 2016, The Motley Fool, LLC, 2000 Duke Street, Alexandria, Virginia 22314.

Pro Catch-Up Trades: May 23, 2016

Published May 23, 2016 at 2:43PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our Portfolio Building Reports will get you fully invested over the coming few weeks, as much as you want to be.

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **FactSet Research Systems** (NYSE: FDS): Buy 2% in this new position. (*Pro* has not had a chance to buy its shares yet, because we were engrossed in last week's FoolFest event. We have 30 days from the report date, May 18, to buy our shares. We won't likely wait that long.)
- **MasterCard** (NYSE: MA): Buy up to our 4.6% allocation.
- **Wells Fargo** (NYSE: WFC): Match our newly larger 4.7% stock position.

Continue building your portfolio with our Buys, including these highlighted today:

- **Apple** (NASDAQ: AAPL): Buy 3.5% in stock.
- **Gilead Sciences** (NASDAQ: GILD): Buy 3%.
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- **Parexel** (NASDAQ: PRXL): Buy 3.1%.
- **Starbucks** (NASDAQ: SBUX): Buy up to 3.5%.

Shorts:

- **Deere & Co.** (NYSE: DE): Sell short 1.9% in stock.

Options:

- **Expeditors International** (NASDAQ: EXPD): Set up a synthetic covered strangle if you haven't, following the Alternative Trade guidance at the end of the May 16 report. Right now, set up the synthetic long using options with a $48 strike price. Buy to open January 2017 $48 calls and sell to open an equal number of $48 puts for a net debit that's lately about $0.10. Then sell to open the August $46 puts and $49 calls for about a $2.60 credit.
- **Skyworks Solutions** (NASDAQ: SWKS): "Sell to open" June 17, 2016, $70 covered calls, one for every 100 shares you own and want to cover, per our May 4 alert. With shares lately near $67, these pay $0.95 to $1 again.

Hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): With patience, the put ratio spread we announced on May 4 can be set up for a net debit of $0.01 to $0.02 at recent prices (though as you'll recall, we sought no cost or a credit on Day One). On a market drop, the price to set this up may become more favorable for newcomers. As this is far out of the money (SPY trades much higher than our $185 upper strike), we at *Pro* are currently waiting for a market drop to set it up, although we personally need to do so before June 4 to meet our 30-day trade window.

Earnings Updates From AmTrust to Visa

Published May 23, 2016 at 12:12PM

Fellow Fools,

With earnings season wrapping up for us here in *Pro*, we're beginning to shift our focus toward finding even more ideas for the portfolio. But before we do, some housekeeping is in order, so let's take a look at how four of our current holdings here in *Pro* fared this past quarter.

AmTrust Financial Services (Nasdaq: AFSI)

The company continues to push forward with its grow-by-acquisition strategy; its $233 million deal to acquire property and casualty insurer Republic Companies is its largest to date. This move will immediately make AmTrust a much more prominent player in Texas, the second-largest insurance market in the U.S. and a market that AmTrust had not previously targeted very heavily. (Within the company's small commercial business division, Texas was the seventh largest state at 2.9% of gross written premiums in 2015.) With $762 million in gross written premiums in 2015, this acquisition will likely increase AmTrust's gross written premiums by about 10% on a full-year run-rate basis.

Despite pricing pressure in many of its markets, AmTrust continues to deliver solid growth. This increase in competition has slightly hurt underwriting profitability, and the company's loss ratios have slowly ticked higher over the past few quarters. However, management has repeatedly stressed a willingness to remain disciplined throughout the underwriting cycle and forgo short-term profits in favor of long-term success, which is critical for success in underwriting.

Deere & Company (NYSE: DE)

If you just skimmed the headlines on Friday, you may have thought the market got Deere wrong -- the stock finished 5.5% lower even though the company "beat" its estimates. But from our vantage point, this wasn't a mistake (and I'm not just saying that because we're short the stock!). Sales continue to be weak, and operational deleveraging is taking its toll on Deere's bottom line. Moreover, the positive surprise in sales was really nothing more than a difference in the timing of shipments between quarters, and the company actually lowered its 2016 net income guidance once again.

This quarter, management also increased its provision for credit losses and took an impairment on both construction and agricultural equipment operating leases. Management noted during the earnings call that the company is taking steps to mitigate the risk on its operating lease portfolio, but we still think the provision the company is reporting is too low.

From our perspective, management's goal of $50 billion in sales by mid-cycle in 2018 is increasingly starting to look like a pipe dream. If you use the company's own guidance for full-year 2016, revenue will need to grow at an annualized rate in 2017 and 2018 that the company hasn't even come close to achieving in the past 25 years. In fact, even if you assume that John Deere will somehow miraculously finish 2016 with 2013's peak-year revenue figure (which is more than 40% higher than the company is expecting to report), management would likely *still* have a difficult time hitting this target, as they've only been able to achieve this type of growth 20% of the time over the past 25 years. The first mention of this 2018 goal that I can find was made back in 2011, before the commodity cycle turned over, and if you ask us it looks like it's about time management updated their expectations.

Verisk Analytics (Nasdaq: VRSK)

Over the past few quarters, we've been watching two things closely with respect to Verisk Analytics — when will the company sell its health-care business, and how will WoodMac continue to weather the storm in the energy sector?

We finally got a definitive answer to the first question this past quarter as Verisk agreed to sell its health-related business to Veritas Capital for $820 million, or a pre-tax internal rate of return (IRR) of about 12%. Although this return is solid, it is below the company's average IRR of 19% for prior deals, probably in part because the news had leaked that the company was beginning to shop the business. But we still like this move, because it enables the company to focus its time and energy on what it does best. After the sale, the overall company will have higher margins, more stable revenue growth, less seasonality, a higher mix of subscription revenue, and stronger free-cash-flow conversion. In a day and age where many companies seem to be interested in empire-building, or simply getting bigger for the sake of getting bigger, this type of discipline is refreshing.

With respect to WoodMac: The business continues to weather the storm in the energy sector better than most, with revenue up slightly on a constant currency basis when you remove the effects of purchase accounting. However, because we want the company to focus on positioning itself to generate strong returns over the next couple of years (as opposed to the next few quarters), we're more concerned with seeing what is happening to WoodMac's client renewal rates and its ability to expand its customer base. We didn't get any specific numbers this quarter, but reading between the lines, it sounds as though things continue to progress in a satisfactory manner.

Total revenue and EBITDA growth for the quarter at WoodMac were 28% and 24%, respectively. May 19 will mark the one-year anniversary of the completion of the WoodMac acquisition, so we shouldn't expect mid- to high-20% growth going forward; however, we remain confident in the company's ability to continue to deliver high-single-digit organic revenue growth and total revenue growth in the low teens, with enviable margins (EIBTDA margins were 50.4% this quarter) going forward.

Visa (NYSE: V)

Though results beat estimates at Visa as well, shares also traded lower after the company followed through with its previous warning that it would have to lower its full-year revenue guidance if economic activity didn't pick up. But this is no John Deere; while we believe the cyclical issues currently afflicting Deere will remain for far longer than the stock's bulls are expecting, we believe the current weakness afflicting Visa is more of a bump in the road. The company is still on pace to generate about $7 billion in free cash flow, not to mention constant-currency EPS growth in the low teens. And despite a possible delay in the closing of the deal to purchase Visa Europe, as well as a change in its terms (in favor of a larger up-front payment), we still think the deal will be accretive to shareholders over the long run. Shares remain a Buy and we're increasing our fair-value estimate a tick, to $82 from $80.

The *Pro* Bottom Line

There wasn't much in the way of surprises with these four companies this earnings season, despite the market's initial reaction to the results. While there are always challenges for any business, generally speaking, our thesis for each is tracking as we would expect.

Want to discuss any of these businesses? Take your thoughts to the AmTrust, Deere, Verisk, or Visa discussion boards!

Enjoy your week,

-- JP (TMFYossarian)

Pro Completed Trades

- **Expeditors International** (Nasdaq: EXPD): We rolled our covered strangle, buying to close our May 2016 $40 put/$45 call strangle, and selling to open an August $46 put/$49 call strangle, for a net credit of $0.10.
- **Gentex** (Nasdaq: GNTX): Our May $15 puts expired as income again. We're watching for new opportunities.
- **Wells Fargo** (NYSE: WFC): Our $52.50 puts were turned into shares, buying us 700 more shares, and bringing our total stake in Wells stock to 4.7%. Match us if you wish, or keep writing puts. Our current thinking (which may change!) is to turn part of this position into an income position with covered calls. Stay tuned.

Fool Community

- Fools discuss last week's great annual FoolFest event in Alexandria, Va. -- see Oliver's popular post and others on the Social Banter board.
- BrokeInDaBurgh at his Foolish best stokes another conversation.
- RockyTopBob asks, "Is your port in a funk?"

Buy FactSet Research Systems

Published May 18, 2016 at 10:16AM

Is this for you? This is for all *Pro* members.

How You Participate

- **Action:** Buy **FactSet Research Systems** (NYSE: FDS)
- **Allocation:** 2% to start (*Pro* will buy about 330 shares)
- **Scorecard Status:** Buy First
- **Fair-Value Estimate:** $163 (8.1% higher, and targeting 10% annualized returns)
- **Recent Price:** $150.75
- **Market Value:** $6.2 billion (mid-cap)
- **Dividend Yield:** 1.3% ($2 per year)
- **Price Guidance:** This is thinly traded. Use a **limit order** and initially aim to pay less than $151.50. As prices change over time, this starting guidance will quickly lose relevance; as that happens, **our guidance will remain "Buy First"** until we officially notify you otherwise. Whenever you buy, use a limit order.

What We're Thinking

The ideal *Pro* company has predictable recurring revenue, pricing power, a dependent customer base, expanding opportunities, and smart management. FactSet Research scores eight out of eight on our company quality checklist, and while most companies are struggling to grow these days, FactSet increased its revenue 9% last year to more than $1 billion, with earnings per share growing 16%. That made for 35 consecutive years of revenue growth, and 19 consecutive years of earnings growth -- every year since FactSet went public in 1996. Over the past 21 quarters, earnings per share have grown by more than 10% year-over-year each quarter. The business has the traits we look for most: stable, predictable results with the ability to reinvest healthy free cash flow for more growth.

The Business

Founded in 1978, FactSet's data and analysis platform has become integral to the daily operations of thousands of financial professionals, including investment bankers, institutional investors, hedge funds, and asset and risk managers. Serving more than 3,000 customers with a total 63,500 users, FactSet prides itself on personalized attention, making its customized data a core part of its customers' daily workflow and decision-making. FactSet's consultants paid 46,000 visits to its 3,000-plus customers in 2015, making sure to meet individual needs. Clients in turn reported 97% satisfaction with FactSet's customer service.

For data-hungry clients, FactSet's platform combines news and information from more than 220 third-party data suppliers, 100 news sources, and 80 market exchanges, and it ties in portfolio and risk management analysis and tools as well. Drill-down data can include detailed geographic revenue insights for a company, historical financials going back decades, fine-toothed company and industry comparison, portfolio simulation, predictive risk, alpha testing, and more. Approximately 83% of FactSet's monthly subscription revenue comes from the likes of investment portfolio managers. The rest is from investment banking firms that support mergers and acquisitions, capital market services, and equity research.

Pro's 8-Point Quality Checklist

Let's run FactSet through *Pro's* company criteria.

Sustainable Competitive Advantage

FactSet's extensive historic and contemporary global database, along with its proprietary financial modeling and analysis, provides a high barrier to entry despite the competitiveness of the industry. The company's dedicated focus on customer service further sets it apart. Its customized service offerings are entrenched in clients' workflows, central to their analysis and decision-making. Other than pricing power, perhaps the best sign of a competitive advantage is switching costs. When your work depends on a steady stream of data that you can quickly interpret and incorporate, and your staff of dozens to hundreds is trained to use this custom platform, changing providers carries real switching costs and the risk of disruption.

Pricing Power

Historically, every February, FactSet has increased the price for all customers. It still does, but now price increases are inherent in each contract renewal, and those renewals hit every day, so price increases are spread over the year. Despite contracts that can run into tens of thousands of dollars a year, FactSet has ingrained annual price increases into the client relationship.

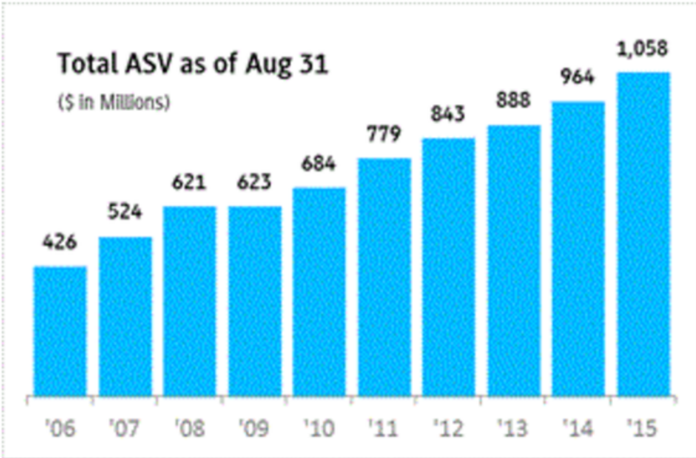
Dependent Customer Base

As of last quarter, FactSet enjoyed a greater than 95% customer retention rate, up from 93% a year ago. This leads to recurring subscription revenue, making for a stable revenue base, especially when coupled with price increases. Client retention rates have been above 90% since 2010, and even then, retention of annual subscription value (FactSet's measure of revenue) ran higher than 95%. Even during the financial crisis of 2008-2009, FactSet was able to increase revenue modestly as most large clients became more reliant on its data.

Predictable Revenue

FactSet's revenue has increased by a 9.5% annualized clip over the past five years, and it was up by 9.5% organically last quarter, too. Recall that revenue has grown for 35 consecutive years. A 95% customer retention rate and annual price increases, along with the addition of new clients (183 new clients in fiscal 2015, for a 6.7% addition), leads to predictable revenue.

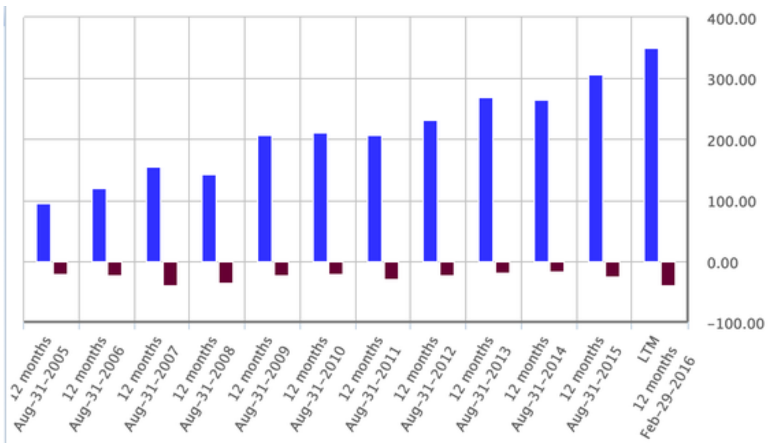
Here's a snapshot of annual subscription value (ASV) from 2006 to last year, starting at less than half a billion dollars and reaching more than a billion in fiscal 2015 (which ended last August).



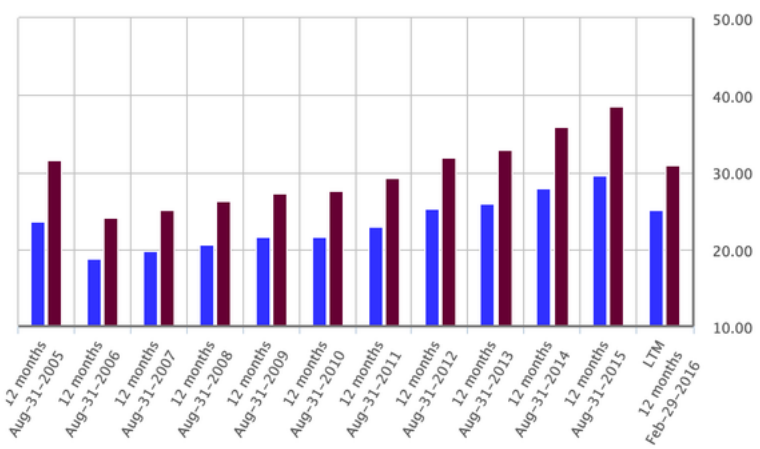
Source: FactSet 2015 10-K filing.

Growing Free Cash Flow with Compounding Returns

Even after recent investments in new servers, a revamped software interface, and more consultants to expand customer service, FactSet is not a capital-intensive business. Free cash flow has consistently hit records, including last quarter. Below is cash from operations (in blue) minus capital expenditures (purple), going back to 2005. Recently, free cash flow topped $300 million. It grew 13.5% in fiscal 2015.



Importantly, FactSet is able to earn strong returns by *reinvesting* its free cash flow. Investing in more third-party data feeds, more customer service, and software and tool development, the company is able to up-sell more offerings to existing customers, raise prices, and keep clients. Return on capital (in purple) and return on assets (blue) have both topped a stellar 20% (for the former in recent years, 30%) since 2008.

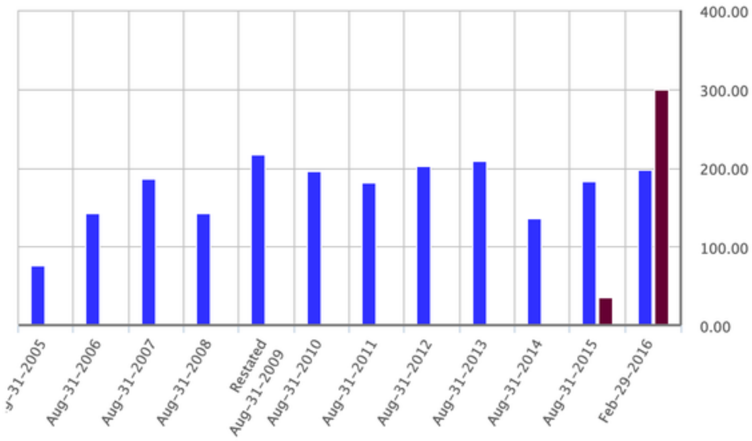


Charts source: Amusingly, competitor S&P Capital IQ

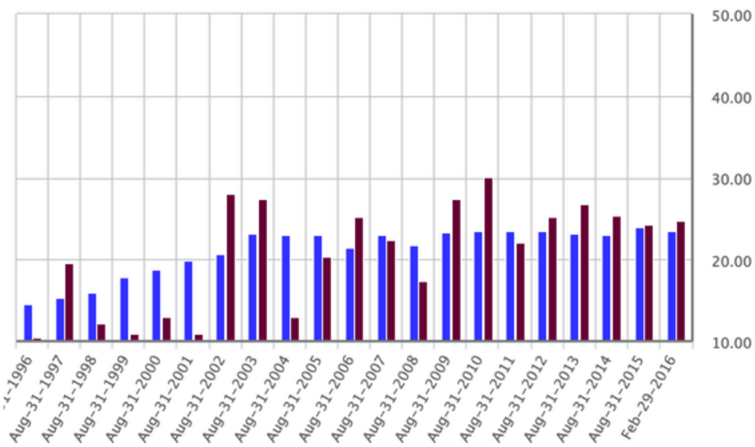
Financial Resilience and Value in Hand

The company has historically been debt-free and cash-rich, it earns free cash flow yearly, and it has increased its dividend every year since 2005. (FactSet has paid a dividend since 1999.)

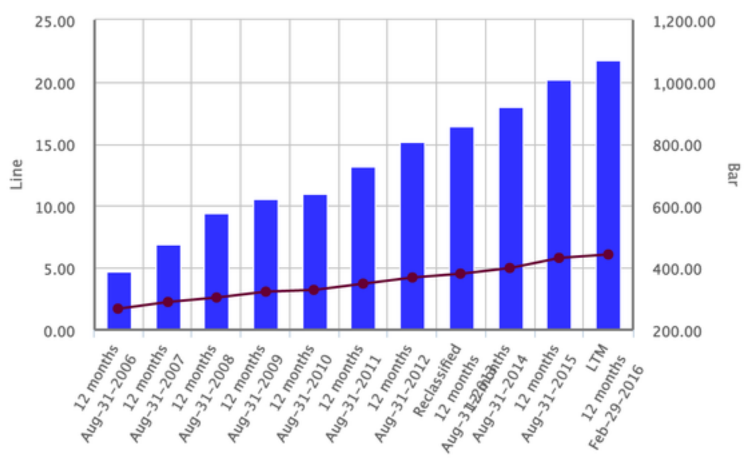
In what we view as smart leverage during a time of low interest rates -- especially given its historically strong returns on investment -- FactSet recently acquired $300 million in debt to fund two acquisitions. FactSet can pay this off from free cash flow over a few years. Below, see cash and short-term investments (blue) and long-term debt ("Prince purple") in millions of dollars.



Today, FactSet enters the *Pro* portfolio as one of our highest-margin businesses, among the likes of **MasterCard** (NYSE: MA) and **Verisk** (NASDAQ: VRSK). Its earnings-from-continuing-operations margin (in blue, shown as a percentage) has been higher than 20% since 2002, and its free cash flow margin (in purple) averages 24% since then.



The company is willing to forgo gross margin percentage points (which decline as management invests in its product) as long as it can keep operating margins steady, making up for it on the bottom line. This has led to years of steady earnings-per-share growth (the purple, with EPS shown on the left side) in line with, or greater than, revenue growth (in blue, with millions in sales on the right).



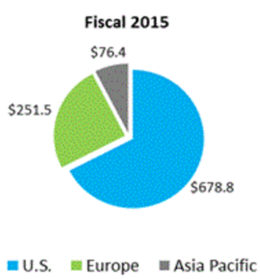
All this consistency comes at a price. We're paying 20 to 24 times free cash flow (depending how you measure it) and about 25 times earnings, and a bit less than 22 times forward EPS estimates. But this is no different from -- actually, it's cheaper than -- most anyone has ever paid for shares of FactSet. The long-term average P/E has been 30.3, and the price-to-free-cash-flow average is 32. Growth has slowed since the early days, but not enough to suggest we're overpaying (even if we can expect some multiple contraction over time). The business is stronger than ever. And today's price represents the valuation multiples this steady business has been able to command, almost continually, since going public in the 1990s. The stock, meanwhile, has appreciated as the business has grown. Here's the P/E and price-to-free-cash-flow history:

Charts: S&P Capital IQ.

Expanding Possibilities

According to industry reports, global spend on market data and analysis was up 4.1%, to $26.5 billion, in 2015. FactSet estimates it has 3% to 5% market share, giving it plenty of room to grow by offering more personalized services. Its largest competitors are Bloomberg, Thomson Reuters, and Standard & Poor's Capital IQ. According to FactSet's 2015 annual SEC filing, Bloomberg's market share was up a tad to 32% last year, while Thomson Reuters' share was down a bit to 25.9%. Standard & Poor's Capital IQ market share is estimated at 3% to 5%, comparable to FactSet's.

With FactSet reporting 9.5% organic revenue growth last quarter, the industry continues to expand in North America and Europe, the core of the business. And there's a great deal of extra room to grow internationally. Here's FactSet's geographic revenue by millions last year, with the U.S. accounting for about 67%:



Broadly speaking, FactSet's data products can be customized to serve professionals in corporate, legal, government, marketing, and academic fields -- anything that may benefit from market, company, and investment-related data, and any entity that invests. Data is compounding daily and needs to be managed and analyzed, leading to steady (if at times low) long-term growth in an industry like FactSet's. The primary driver of growth, though, remains the investment industry. If value in that industry grows (as we believe it will long-term), FactSet's market should continue to grow. For instance, last year, strong demand for fixed income data helped drive results.

The Three C's of Management

We seek clarity, capability, and consistency from management -- and we prefer tenure. We have all that here. Reading conference calls back to 2008, management has been clear and consistent in its message and purpose. The results speak to managers' abilities. Just as importantly, the company traditionally has a greater than 90% retention rate with employees, and has won multiple "best places to work" awards.

CEO Philip Snow, 51, started his career at FactSet in 1996. The CFO is 47 and also started in 1996. The COO is 42 and started in 1995. The global director of sales is 47 and joined FactSet in 2015, after leaving Bloomberg. This young management team is helping keep the company on the cutting edge, and the CEO earns a strong 85% approval rating from employees on Glassdoor.com.

The Foolish Bottom Line

With recurring revenue, a 95% retention rate, pricing power, switching costs, and an expanding market as the need for reliable data and analysis grows, FactSet checks the boxes we seek in a long-term *Pro* investment targeting compounding. A further slowdown in IPOs or mergers and acquisitions, or a fall in the stock market in general, could become a headwind to growth, but historically most customers stay with the company, and better growth resumes during better markets.

Meanwhile, FactSet doesn't carry any of the risks inherent with most "financial"-related companies; it's a subscription business model, selling data. It doesn't have balance sheet risk. Should competitors start to cut prices to win market share (not likely, but possible), we'll need to reassess. But as long as FactSet retains pricing power and can steadily add new clients, it should create North Star-challenging long-term returns. We're glad to start a 2% position today, and may potentially build it higher (with new trade alerts) as opportunities dictate. We may or may not use options on it eventually. Being near our allocation guidance is more important than buying in 100-share blocks.

Fool on!

Alternative Trades

- **Only want to target lower buy prices?** You can "sell to open" puts, one for every 100 shares you would buy at lower prices. Take your pick of June to December puts, choosing ones with strike prices around $150 or a bit lower, but realize this is a Buy First stock and we're starting with a direct 2% stake in shares.

Pro Can Help

- **Want to talk about the reams of data shared here?** Ask questions or comment on *Pro*'s new FactSet Research Systems discussion board.

The Market Takes a Bite out of Apple

Published May 16, 2016 at 4:47PM

As widely predicted, **Apple** (NASDAQ: AAPL) reported the first quarterly revenue decline since 2003, helping to further an apparent crisis in confidence redux for the company. It was only three short years ago that slowing iPhone 5s sales pulled the stock down by almost 45%, with investors proclaiming that Apple was a dead company walking. This time around, it's slowing sales for the iPhone 6s/6s Plus that have the market worried, and the stock was recently trading 30% below its 52-week high.

Updated Guidance and Valuation

Updated guidance: Buy (no change)

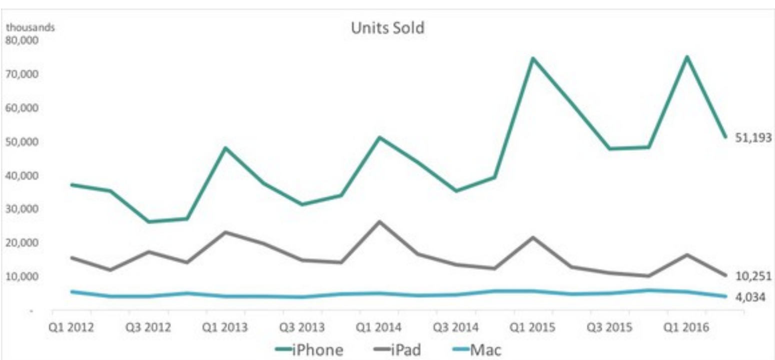
Recommended allocation: 3.3%

Fair-value estimate: $122

Metric	Apple		S&P 500	
	Trailing	Forward	Trailing	Forward
EV/Revenue	2.28	2.39	2.13	--
EV/EBITDA	6.62	7.39	11.04	--
P/E	10.08	10.74	23.21	17.16
P/FCF	8.93		18.47	--

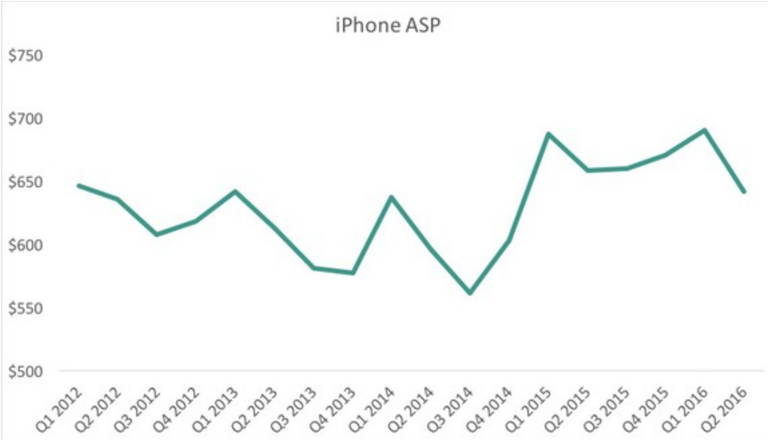
Source: S&P Global Market Intelligence

Results



Source: Company filings

Revenue for the quarter was down 13% (9% in constant currency) as iPhone unit sales and revenues fell 16% and 18%, respectively. A reported $50.6 billion in revenue was within last quarter's guidance, but as is often the case with the stock market, just meeting expectations wasn't good enough; the stock finished the day after earnings more than 6% lower. iPhone average selling price (ASP) also fell this quarter, but it's worth keeping in mind that ASP is still much higher than it was before the introduction of the iPhone 6 Plus, the higher cost of which raised ASP. This metric also continues to be negatively affected by foreign currency fluctuations; although management didn't provide the specific number this quarter, CFO Luca Maestri did note that iPhone ASP would have been $49 higher last quarter with the effects of foreign currency removed.



Source: Company filings

iPad and Mac sales also declined this quarter, but the Services and "Other" divisions were up 20% and 30%, respectively, thanks to strong App Store and Apple Music sales and the Apple Watch continuing to outpace the introduction of most of Apple's prior product launches. .

Pro's Take

I think it's fair to say that with Apple, this time is different. The key here is in determining what exactly we mean by "this time." Either:

- We're referring to the industry as a whole and this time is different because Apple isn't destined to become next Nokia, Blackberry, Sony, etc.

or:

- We're referring to Apple's history and this time is different because Apple will be unable to overcome its reliance on a single product as it's done with the Mac, iPod, etc.

The implications for the company, and subsequently for Apple's stock, are vastly different, so it's important to figure out which side you agree with. Both are appealing from an intuitive standpoint, but this alone isn't enough. Saying that Apple has to go the way of its predecessors simply because of its size is, in my eyes, akin to saying that a stock is a great buy simply because it's trading at a low P/E. Given a large enough sample size, both statements are likely to hold true, but there are always outliers. And to date, Apple has been a huge outlier. As Michael Mauboussin noted in *The Base Rate Book -- Sales Growth*, "Apple's growth in the last dozen years has ... been truly amazing. Out of the 1,251 companies in Apple's size cohort ($6-13 billion), there were only 2 instances of sales growth of 35-40 percent compounded annually over 10 years. Both were Apple." But giving the company a free pass based on its prior successes isn't any better, given that the industry landscape has changed so much and Apple is a vastly different company now.

As of right now, we're not in any rush to lump Apple in with the other fallen titans of the tech industry. Prior to the iPhone 6 upgrade cycle, we had already seen sales slowing as the company started running out of easy wins (moving into new markets, adding new carriers). But with the iPhone 6/6 Plus launch, Apple resumed growing at a pace that we hadn't seen since 2012.

We tempered our expectations for 2016 in response to this, believing that the company had essentially pulled sales forward thanks to the strong demand for the new form factor of the 6 and 6 Plus. That's exactly what appears to be taking place. Its two-year growth rates are commendable for a company of Apple's size, and we still think growth will resume once the iPhone 7 rolls around, albeit at a slower pace than we're seeing now. By then, the primary avenues for iPhone unit growth will likely have shifted toward converting users of other operating systems and shortening the upgrade cycle for existing iPhone users.

Going forward, I also think it's important to consider more than just unit sales and ASP when trying to gauge the success of the iPhone in a given quarter. This is because, as noted by Benedict Evans of Andreessen Horowitz in a recent presentation, the smartphone has essentially become a sun, or the center of a new ecosystem. Mobile is no longer a subsection of the Internet -- it is quickly becoming the Internet, as more and more people begin to access the Internet via mobile devices exclusively. (More than half of Facebook's users only use it on mobile.) So although smartphone sales themselves may be slowing, there are an increasing number of ways for Apple to monetize its position in mobile.

I believe a better way to gauge the health of the iPhone business is by looking at iPhone sales in combination with everything else the iPhone enables, like Services revenue or Apple Watch sales. Speaking of which, services revenue overtook that of both the iPad and the Mac for the first time ever; it's now the company's second-largest division. App Store revenue was up 35% this past quarter, and the purchase value of services tied to the company's total install base rose 27% to $9.9 billion in the March quarter. Apple Music had more than 13 million subscribers as of April 26, meaning it continues to add about 1 million new subscribers per month, a pace similar to what we've seen from market leader Spotify (with 30 million paying subscribers). And although it isn't directly contributing to Apple's financial statements in a meaningful way just yet, Apple Pay continues to exhibit strong growth -- CEO Tim Cook reported that transaction volume was 5 times higher than last year, and the company is adding about 1 million new users per week. And although the company doesn't provide much color on the state of Apple Watch, by most estimates the Apple Watch launch continues to pace ahead of the iPhone in terms of sales.

There is always a fear that people will shift away from iOS to Android, but I think it's important to keep in mind that Android may have won the market in terms of market share, but as of right now Apple has actually won in terms of capturing the most desirable customers.

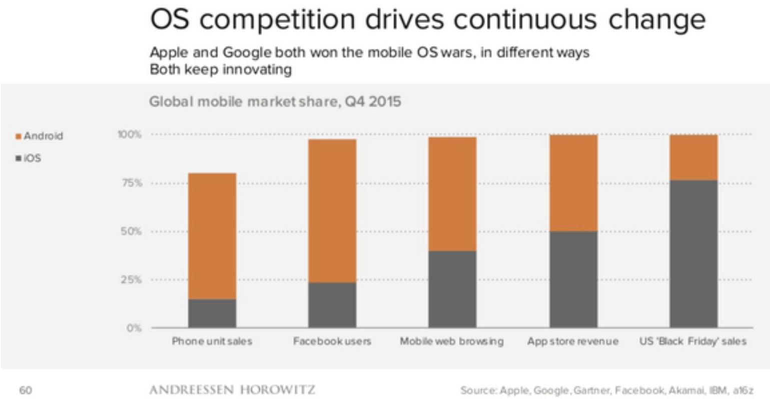


Image source: Benedict Evans, *Mobile is Eating the World*

Maestri also noted on the conference call that, according to business intelligence provider App Annie, the App Store generated 90% more global revenue than Google Play in the March quarter, up from a 75% lead in 2015. In a sense, this is a positive feedback loop: Having the most valuable users on iOS ensures that developers and content creators prioritize putting their apps and content on the iPhone, which keeps the most desirable customers around (and draws in more), which in turn draws in more app and content creators (who doesn't want to go where the money is?), and so on.

I'd be hard-pressed to find another company anywhere close to Apple's size that's so frequently subjected to market manias and panics about its individual stock. As an investor, watching this play out so frequently is equally fascinating and frustrating. We still believe the stock is meaningfully undervalued here, but it's anyone's guess when (or even if) market sentiment will reverse course.

Pro Catch-Up Trades: May 16, 2016

Published May 16, 2016 at 2:55PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our Portfolio Building Reports will get you fully invested over the coming few weeks, as much as you want to be.

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Broadridge Financial Services** (NYSE: BR): Buy our 5.2% allocation, at once or in halves if you like.
- **MasterCard** (NYSE: MA): Buy up to our 4.6% allocation.

Continue building your portfolio with our Buys, including these highlighted today:

- **Apple** (NASDAQ: AAPL): Buy 3.3% in stock.
- **Gilead Sciences** (NASDAQ: GILD): Buy 3.1% in stock.
- **O'Reilly Automotive** (NASDAQ: ORLY): Buy 5.2% in halves, over time.
- **Parexel** (NASDAQ: PRXL): Buy 3.1%.

Options:

- None currently, other than today's **Expeditors** (NASDAQ: EXPD) trade.

Hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): With patience, the put ratio spread we announced two weeks ago can be set up for a cost of $0.04 at recent prices (though as you'll recall, we sought no cost or even a credit on Day One). On a market drop, the price to set it up should get more favorable for newcomers. As this is far out-of-the money, we at *Pro* are currently waiting for a market drop to set it up.

Charts of the Week: Lobbying, an Internet Minute, and the History of Life

Published May 16, 2016 at 1:27PM

Fellow Fools: The Motley Fool would not be named The Motley Fool if it weren't for David Gardner -- and his love of Shakespeare and tomfoolery. Today, David celebrates a milestone birthday, and as we share our gratitude and congratulations with him, the *Pro* team wants to include you! To convey your well wishes to David (as well as any reflective thoughts!), just drop a note to DavidsBirthday@fool.com. And then Fool on! -- The *Pro* team

Dear *Pro* Fools,

My charts series is back this week for its third edition. In this week's Memo, I'll share the five (plus one bonus!) most interesting and/or market-relevant charts I came across this week while perusing the financial blogs and websites I frequent:

1. The American Middle Class: U.S. Metropolitan Areas

EMBED </> REPORT DATA

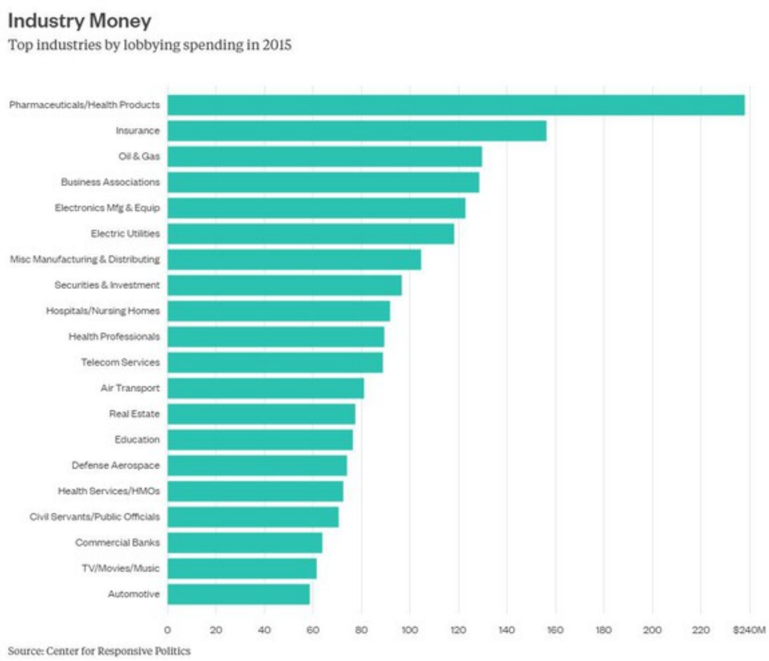
Source: Pew Research

This interactive graphic from Pew Research details the geographic distribution of three tiers of American households -- Upper Income (income greater than or equal to $124,925 per year), Middle Income (between $41,641 and $124,924 per year), and Lower Income (less than or equal to 41,640 per year).

2. History of Life

This fun graphic from Visually (see a larger version here) shows the history of life as we know it, detailing mass extinction events, continental drift, and milestones achieved during various geologic eras.

3. Top Industries By Lobbying Spending (2015)



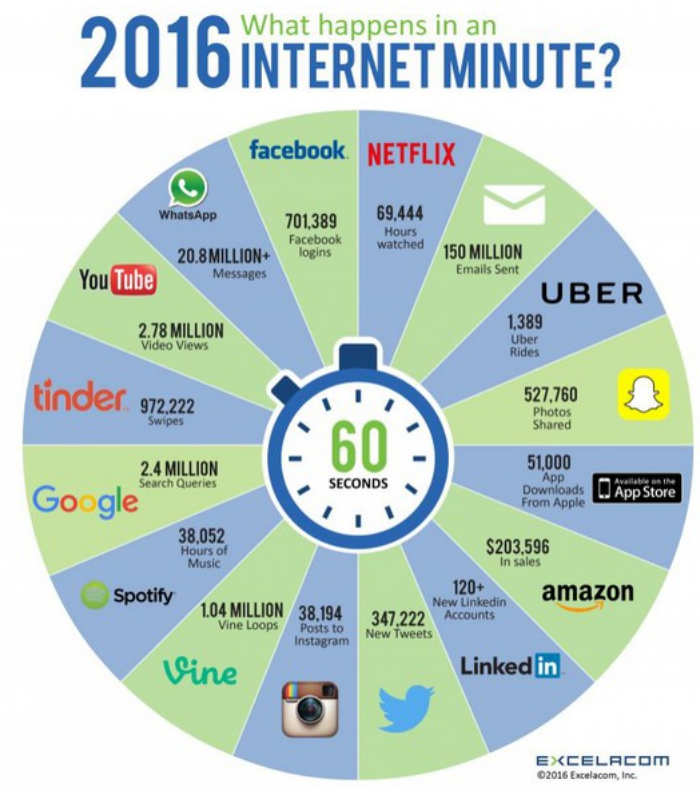
This chart shows the industries with the largest lobbying spending in 2015. Perhaps not surprisingly, the pharmaceutical and health-product industry tops the list by a wide margin. Check out the source article from Bloomberg Gadfly for more charts detailing the industries with the greatest *increase* in lobbying spending over the past five years, as well as the most-reported issues for the industries with the greatest growth in lobbying expenses.

4. U.S. Consumption In Real Time

Source: Couponbox.com

This real-time counter shows U.S. consumption of a variety of categories, and you can watch the stats climb by the second.

5. What Happens In An Internet Minute? (2016)

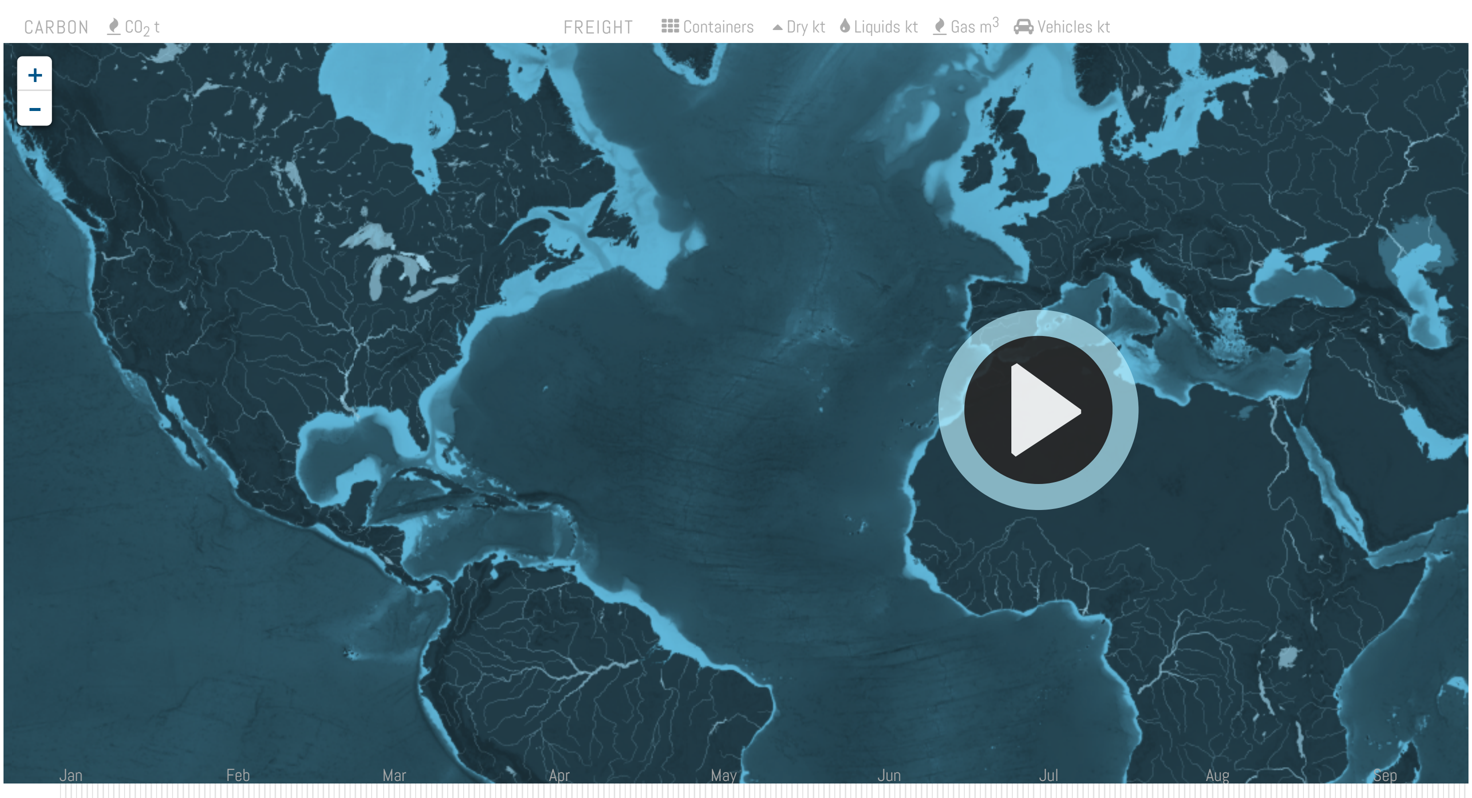


This similar (though static) chart from Excelacom details the activity that occurs across various web/media services every minute in 2016. The numbers are staggering. Compared with 2015, the majority of these numbers have significantly increased. For example:

- **Uber** – 695 more rides per minute (100% increase)
- **Amazon** – $83,836 more in sales per minute (70% increase)
- **Spotify** – 24,752 more hours of music uploaded per minute (186% increase)

This goes to show how consumers are continuously using the Internet more and more each day, pressuring Internet speeds to increase as well (which is a boon for our wireless infrastructure provider, **American Tower** (NYSE: AMT)).

6. Bonus Chart: Global Shipping Routes (2012)



Created by London-based data visualisation studio Kiln and the UCL Energy Institute

I've included a bonus chart this week, just because I think this one is particularly cool. This interactive map from [Kiln] details the movements of the global merchant fleet over the course of 2012, overlaid on a bathymetric map. You can also see some statistics, including a counter for emitted carbon dioxide (CO_2) and info on maximum freight carried by represented vessels, among other functionalities.

The *Pro* Bottom Line

There you have it, Fools -- the third edition of my top five (plus one!) charts of the week. Hope you enjoyed it, and bring any questions or comments to the Memo Musings board!

Best,

-- Billy (TMFBillyTheKid)

Roll Your Covered Strangle on Expeditors International

Published May 16, 2016 at 1:21PM

Is this for you? This is for all *Pro* members with an existing income position on **Expeditors International** (NASDAQ: EXPD) expiring this Friday, May 20, and for all new *Pro* members who want to start this position now. Those who want to own stock instead of a synthetic long, or who are investing in an IRA, should see the alternative trades at the end of this report. And if you're new to options and this is overwhelming, take your time and ask questions on the EXPD board to learn about it; you could also simplify it into a covered-call position, just buying at least 100 shares of stock and writing covered calls on it. Again, see the end of the report.

How You Participate

- **Actions:**
  - **Old position:** Buy to close all existing May 2016 $45 calls. You may also buy to close all existing May 2016 $40 puts for mere pennies, or let them be to expire on Friday (if you do this, don't write new puts until these expire). Leave your 2017 synthetic long alone.
  - **New position:** Write a new covered strangle. Sell to open August 2016 $46 puts and sell to open August 2016 $49 calls. Sell one of each for every synthetic long you have already set up (or every 100 shares of stock you own).
- **Allocation:** Approximately 1.9% look-through exposure on the synthetic long, and another 1.8% exposure through your short puts in the strangle, for 3.7% total exposure to EXPD. Each synthetic covered strangle at today's price represents about $9,300 in exposure to the stock. So, for 3.7% exposure, set up one synthetic covered strangle (one each of all four options involved) for approximately every $250,000 you're managing. *Pro* has 10 contracts of each option in the synthetic long, and then in the written strangle, too.
- **Prices (11:40 a.m.):**
  - **Stock:** $47.50
  - **Options:**
    - **Close old strangle (you can roll your entire strangle, combining these two orders):**
      - Buy to close May 2016 $45 calls, lately about $2.55 (splitting the bid/ask). Aim to pay as little time value as possible to close these calls.
      - Buy to close May 2016 $40 puts, lately $0.05 (or let these alone to expire Friday, and write your new puts then).
      - Combined: **About a $2.60 debit.**
    - **Write new covered strangle:**
      - Sell to open August 2016 $46 puts (bid/ask): $1.60/$1.65.
      - Sell to open August 2016 $49 calls (bid/ask): $1.25/$1.35.
      - Combined splitting the bid/ask: **About a $2.92 credit.**
      - Total price to roll: About a $0.32 credit.
- **Price Guidance:** Close your old positions using limit orders at current pricing, and do so by Friday. Write the new strangle using a limit order of about $2.92 in credit. As prices change, ideally accept no less than $2.80, or 6% on the current share price in just more than three months to expiration. Later, aim for a 2% yield on the current share price per month to expiration.

What We're Thinking

Shares of our favorite overseas shipping facilitator, Expeditors International of Washington, remain a long-term income target for us. We are comfortable having exposure to shares (currently through a synthetic long, which mirrors share ownership without requiring us to pay out capital), and writing put and call options on them to target higher income than usual. Almost since *Pro*'s inception in 2008, Expeditors has had a fairly steady presence in the portfolio, generating returns.

After a record 2015, earnings are expected to flatten in 2016, but that should be enough to keep our option income strategy going and, ideally, to keep the stock in a friendly price range. Overall, we believe this well-run business will continue to deliver respectable results, even if world trade volume slows marginally. Meanwhile, the stock is less expensive than it has been in years, now trading at less than 20 times earnings and 13 times free cash flow.

Asia trade accounts for about 50% of the company's revenue. But of course, many of China's exports are shipped to countries with stronger economies (and cleaner air), including North America and Europe. This gives Expeditors' business some breathing room even when China's domestic economy (including imports) slows, as it's currently doing. Although this year could remain choppy, that uncertainty adds to the option premiums we'll collect, aiding our income strategy, while we ultimately believe Expeditors will keep sailing in a price range, or drift higher.

Why This Strategy?

Although it's a highly profitable, expertly managed niche business in an attractive service space, Expeditors is not on the radar of the average investor. Its valuation is reasonable, and its options pay well. Not expecting a surge in earnings, we're content to keep covering the position with calls. As we're also not expecting a great, *lasting* drop in the share price, we're also comfortable writing puts. Why not just buy the stock to strangle instead of setting up a synthetic long? You may if you prefer! We are opting to keep our cash free, and use the leverage of a synthetic long to make the income we earn on this position more meaningful compared to the modest capital (or non-capital) we invest.

More That Matters

- **Maximum loss:** The same as owning at least 200 shares of stock (100 now, and 100 at $46), minus the option premiums received.
- **Maximum gain:** This new strangle caps our upside at $49, plus the combined option premiums received. The most we can make on this strangle alone is the $2.90 or so in premium paid to us (ignoring that it was a roll, which is a sunk cost), earned if the stock stays anywhere between $46 and $49 by expiration.
- **Follow-up:** By our expiration, we'll manage our covered strangle for more income, writing a new one as this one ends, or rolling if we need to. You'll hear via a trade alert!

Alternative Trades

- **If you're new to *Pro* and want to participate in the full new position:** In a margin account, set up a new synthetic long with the allocation guided at the top of this report (one syn long for every $250,000 managed) by selling to open January 2017 $47 puts, and buying to open an equal number of January 2017 $47 calls. This can lately be done for about a $0.10-$0.20 debit. Then write the August $46/$49 covered strangle as guided at the top of this report.
- **If you just wrote covered calls last time and want to keep doing that:** The May 2016 $45 calls need to be rolled to keep the position going. You can lately close the May $45 calls for about $2.55, and then sell to open new August 2016 $47 calls for about $2.20. We're working to keep the debit low while getting $2 more upside.
- **If you just wrote puts last time and want to do so again, or if you're new and just want to write puts:** Your old puts are expiring as income. As they do, sell to open August 2016 $45 or $46 puts (newcomers can do so anytime), selling one for every 100 shares you would buy, up to a 3.7% potential allocation.
- **If you're new and just want to write covered calls (the IRA-friendly alternative!):** Use a buy/write order to buy at least 100 shares of stock and sell to open the August 2016 $49 calls with us. Lately, this can be set up for a net debit of about $46.25 per share. You can do this with up to a 3.7% allocation.
- **Want to just strangle shares of stock instead?** You may! Rather than set up the syn long, just buy stock in 100-share increments, and then sell to open the August 2016 covered strangle on the stock, writing one strangle for every 100 shares you buy, up to a 3.7% total allocation (shares and short put exposure).
- **Whew!**

Pro Can Help

- **Want more on this strategy?** See our guides to covered strangles and synthetic longs. We're combining the two into a synthetic covered strangle.
- **Questions?** Please ask, Fools! Ship yourself on over to our Expeditors board. We can all help you, especially if you're new!

Wonderful Worlds (That Never Existed)

Published May 16, 2016 at 11:19AM

"Nostalgia is a seductive liar," George Ball once said.

The easiest way to rationalize today's problems is to recall a time when they didn't exist. It gives the impression that our frustrations are temporary and fixable, rather than an ongoing reality of life.

But a lot of the "good old days" we look back on never actually happened. My biggest takeaway from economics is that the past wasn't as good as you remember, the present isn't as bad as you think, and the future will be better than you anticipate. Realizing the good old days weren't as great as we remember goes a long way to becoming thankful for what we have and being optimistic about our future — key traits for investors.

Here are three worlds we nostalgically remember that only occurred in our heads.

1. A Time When Most Workers Had a Pension

The median retirement account balance for workers age 55-64 is $76,381, according to Vanguard. This is perhaps a third of what a typical couple will need for medical expenses alone during retirement.

The first response to something this serious is indignation. The second is nostalgia. "People haven't gotten worse at preparing. Workers used to have pensions," a commenter on a retirement forum recently said. One article remembers a time when pensions were "universally accepted and expected." Another says sharply, "Twenty-five years ago, everyone had a pension."

Well, no.

Pension coverage peaked in 1979, when 38% of private workers participated in a defined-benefit plan, according to the Employee Benefits Retirement Institute. Which is to say, 62% did not.

Compare that to 401(k) participation today: "Nearly 80 percent of full-time workers have access to employer-sponsored retirement plans, and more than 80 percent of these workers participate in a plan," writes the American Benefits Council. The percentage of all workers (full and part-time) participating in some form of retirement plan has been pretty stable over the last 40 years, at around 45%.

There was a time when pensions were standard at large, deep-pocketed companies. But there was never a time when large, deep-pocketed companies employed most Americans. A big share of employment comes from the Eddie's Car Repairs and Sue's Bakeries of the world, which were as unlikely to offer a pension 40 years ago as they are today.

And even as pension coverage has plunged, what remains are so much more generous that total pension income has gone up over time. Nevin Adams of EBRI writes: "Pension income ... represented 20 percent of all the income received by those 65 and older in 2010. In 1975, it was less than 15 percent."

It can't be repeated enough that the only reason we have a retirement crisis today is because, for the first time in history, everyone *expects* to retire rather than working until they die.

2. A Time When the Government Lived Within Its Means

A vocal group of voters and politicians are pushing for a balanced-budget amendment that prevents the federal government from running a deficit. It's based on logic that "American families live within their means. It's time for the American government to follow suit," as one supporter put it.

This idea that deficits must be stopped harkens back to a time when the government spent less than it took in.

Which is a world that has never existed.

The government has run a deficit in 84 of the last 115 years, according to the Office of Management and Budget. That's 73% of the time. The few periods of surplus came during times we now call bubbles: the 1920s and the late 1990s. The only non-bubble period in which the government ran multiple surpluses were the three years after World War II, as military spending fell but war-time taxes remained. It was accompanied by a deep recession. Government debt has increased in 49 of the last 50 years. I suspect the next 50 years will be similar.

People intuitively think the government must have lived within its means in the past because no person could spend more than they make forever and remain viable. But governments aren't people. Governments have indefinite lifespans, with no final date when all debt needs to be repaid. Rather than paying debt off, old debt is replaced with new debt, and life carries on as normal. As long as debt-to-GDP has some level of stability over time — a big *if*, mind you — a government can run a deficit every year, forever. Our government will spend $600 billion more than it takes in from taxes this year. But with a growing $18 trillion economy, the debt-to-GDP ratio should *decline*. In that context, a half-trillion-dollar deficit is rather conservative.

A government *does* have to live within its means. It's just hard to wrap your head around the idea of a perpetual deficit being well within a government's means.

3. A Time When the Market was Calmer and More Orderly

There are more than 34,000 references to "today's volatile market" on Google.

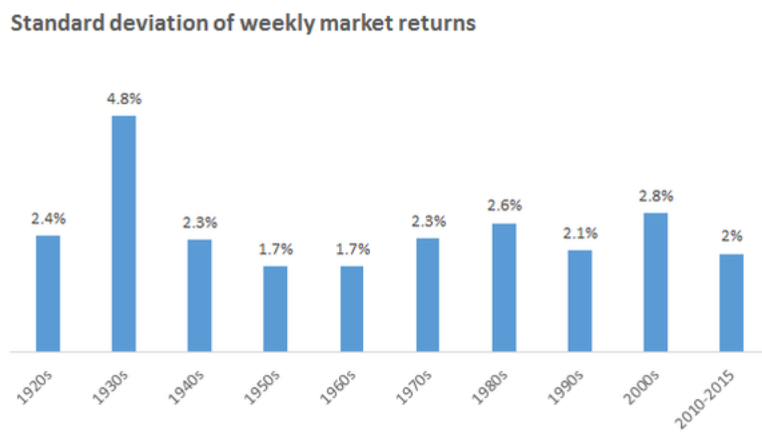
You hear it all the time. An example from this week: "In today's volatile market environment, managing risk and building the 'right' portfolio is harder than ever."

"Today's volatile market" implies that yesterday's market was less volatile — which is a testable assumption. And it's mostly wrong.

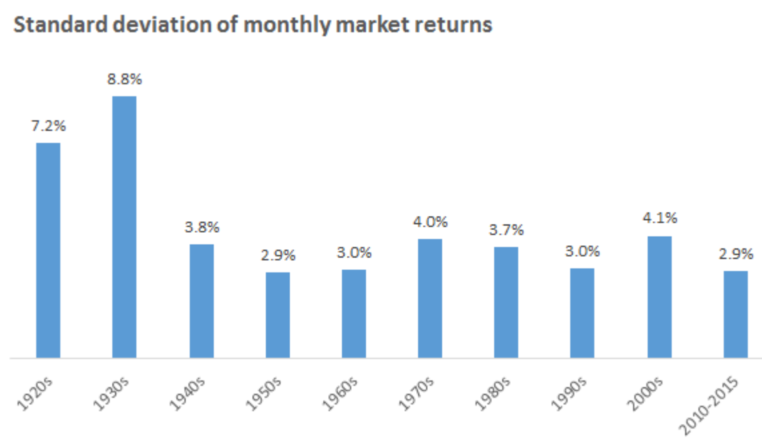
Yesterday's market was, by and large, just as volatile as today's.

I recently calculated market volatility for daily, weekly, monthly, and annual market periods over the last 90 years. At every length of time, recently volatility is nearly equal, if not below, its long-term average.

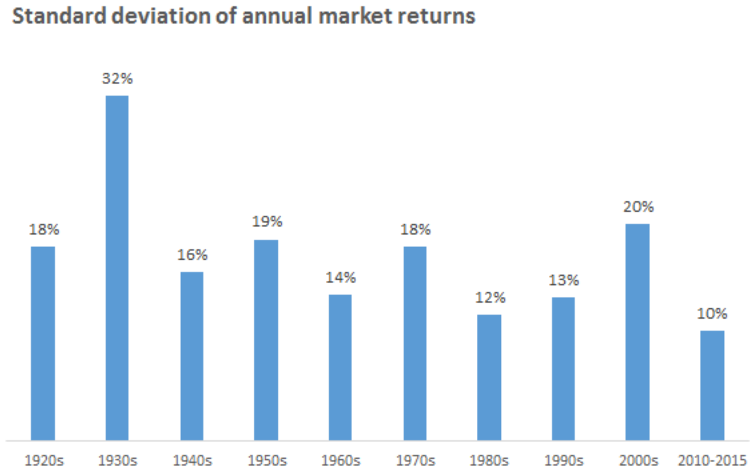
Take weekly volatility of the S&P 500. Recent years are hardly an outlier:



And monthly volatility:



And annual:



I suspect people think today's market must be more volatile than the past because it's been really volatile lately, and they assume no society in its right mind could put up with chaos for ninety years straight.

But we have. The idea that markets used to be more orderly is a lie; that world has never existed.

Falsely imagining today as more volatile than yesterday also explains why so many investors are prone to sell, fidget, rotate, and worry when the market dips. Not understanding the historical context of volatility make declines appear abnormal, like something is broke and needs to be avoided. In reality, volatility is exactly *why* markets have generated good returns over time. If markets were calm, there would be no risk. And if there's no risk, there's no reason for returns above bonds. Why would there be? It has always been that way, and it always will be.

Same as it ever was.

Parexel Reports Growing Margins

Published May 15, 2016 at 1:44PM

Pro's Take: PRXL Fiscal Q3-2016 Earnings

Parexel International (NASDAQ: PRXL)

What Happened?

- Q3-2016 press release
- Q3-2016 10-Q
- Q3-2016 presentation

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Q3-2016

Sales growth: +5% Y-o-Y (+5.4% in constant currency)

Backlog growth: +9.1% Y-o-Y

Gross profit margin: +323 bps Y-o-Y to 35.9%

Operating profit margin: +242 bps Y-o-Y to 13.2%

GAAP EPS growth: +32.2% Y-o-Y

non-GAAP EPS growth: +34.8% Y-o-Y

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Guidance Update

The business continues to track well against our thesis despite a competitive operating environment and changing marketplace dynamics. Parexel's largest business segment, Clinical Research Services (CRS), continues to win new business and prove that the biopharma industry is moving toward a strategic outsourcing partnership model. The company's Consulting and Informatics segments are growing as well, and longer-term margin expansion in these smaller segments is helping companywide results.

Updated guidance: Buy (no change)

Recommended Allocation: 3.1%

Fair Value estimate: $65 (no change)

Current Price: $58.52

There is no change to our recently updated $65 Fair Value estimate, which implies a TTM P/E ratio of 24.3x (GAAP) and 19.8x (non-GAAP) and a TTM EV/EBITDA ratio of 13.1x. It also implies a forward P/E ratio of 21.9x (GAAP) and 18.6x (non-GAAP) based on expected Fiscal 2016 earnings. We believe these multiples to be reasonable given the company's growing industry, strong competitive position, ongoing margin expansion, strong ROICs (lately ~20% and increasing), and expected medium-term earnings-per-share growth of 15-20%. Members lacking a (full) position should feel comfortable initiating or adding to their position at current pricing (with shares 10% below our Fair Value estimate), given recent stock price volatility.

Our Thesis

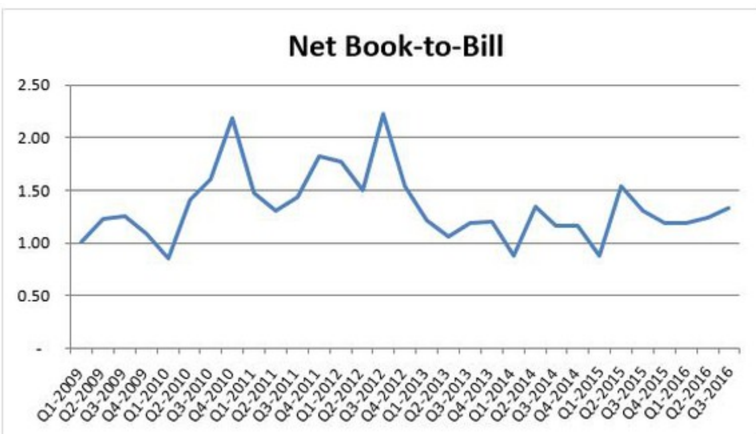
Because of its reputation, global reach, and technology prowess, Parexel International will win its fair share of the growing pharmaceutical development market. In addition, we expect the proportion of R&D dollars outsourced to contract research organizations to grow as large biopharma companies adopt the strategic partnership model and smaller biotechs become responsible for more drug discovery. Finally, as new business wins mature, the true earnings power and margin potential of the company's business will shine through.

The Most Important Things

1) ***Penetration and Backlog*****:** Penetration refers to the proportion of biopharma R&D dollars that go to CROs versus being used in-house for development and increased penetration provides evidence that the biopharma/CRO partnership model is proving out. We can compare the growth of the biopharma industry R&D spend to the growth in Parexel's backlog to determine whether the CRO industry is experiencing continued outsourcing penetration. We also monitor backlog trends to ensure Parexel is sufficiently adding future business – backlog that converts to sales usually represents ~80% of the sales in any given quarter, so strong backlog growth suggests strong future sales growth.

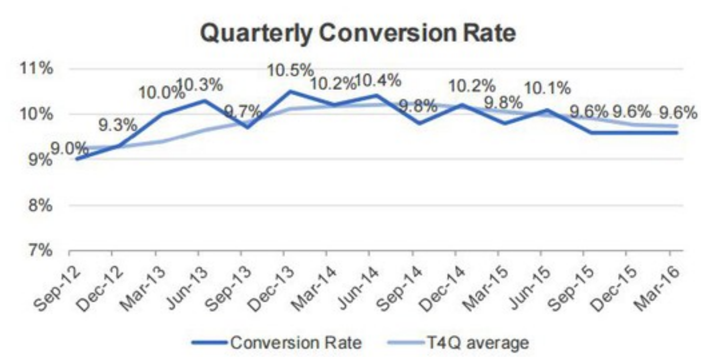
According to recently released industry data, biopharma R&D spend was roughly flat from 2014 to 2015, and it is expected to grow at a 2-3% CAGR from 2015 to 2020. For comparison, Parexel's year-over-year backlog growth in Fiscal Q3-2016 was 9.1% (and 3.3% sequentially), so we can see that Parexel's backlog is growing at a rate higher than that of biopharma R&D spending. This indicates that the CRO industry -- and Parexel in particular -- is continuing to experience increased penetration of biopharma R&D spending.

The company's net book-to-bill ratio increased sequentially to 1.33 due to solid increases in net new business (+7.2% Y-o-Y). A net book-to-bill ratio above 1 indicates that the company is booking more business than they are recognizing, suggesting that future sales growth should increase:



However, revenue growth is affected not just by backlog growth, but also by backlog conversion (percentage of backlog recognized as revenue for a given quarter) and backlog cancellation (percentage of backlog that was cancelled in a given quarter). The cancellation rate in the quarter came in at 5.5%, slightly higher than historical norms of about 3.5%-5% (the cancellation rate fluctuates depending on the type of drugs and the type of studies being conducted). The main reason for cancellations in the quarter was client portfolio reprioritization (rather than performance-related issues).

Lately, the company's conversion ratio has been lower than historical averages and it is trending lower (higher is better):



Management notes that this is due to increasingly stringent regulatory requirements and increasingly complex clinical trials, leading to longer-duration projects that remain in the start-up stage longer than in the past. It is also due to a shift in focus from biopharma companies into more complicated therapeutic areas (such as oncology, immune-mediated disorders, and rare diseases). More than half of Parexel's current projects in backlog relate to innovative compounds in these complex therapeutic areas, which are areas of expertise and competitive advantage for Parexel. Parexel benefits from global scale, a data advantage, and expertise relative to smaller CRO peers, specifically in late-stage (Phase III and IV) studies. This should help Parexel (and the other "top tier", publicly traded CROs) win an increasing share of biopharma R&D outsourcing relative to smaller, less capable peers.

As a result, backlog conversion has declined and the company is seeing a shift in the revenue conversion curve. This decline in the conversion rate will likely persist in the near term as project mix normalizes, and management expects that the prolongation of trials will reach a steady-state sometime in Fiscal 2017 (next year). At that point, revenue growth may begin to become more in line with recent backlog growth. The long-term driver of Parexel's revenue growth remains new business wins and backlog growth.

In any event, as the CRO industry picks up a higher percentage of biopharma R&D spending, we should see revenue and backlog growth outpace the expected 2-3% growth in R&D spending. With 5% growth in service revenue, 7% growth in net new business, and 9% growth in backlog, that's what we're seeing, which provides evidence that our thesis continues to progress.

2) ***Margin Performance***: Companywide gross margin was flat sequentially and increased +323 bps year-over-year. The company's largest segment (representing 79% of total revenue), Parexel Clinical Research Services (CRS) increased gross margins to 32.7% from 29.1% a year ago, the highest it's been since 2011. The gross margin improvements were driven by savings from the company's previously announced Margin Acceleration Program, and a distribution of labor to low-cost locations. The restructuring charges due to this program will be complete by the end of the year and the company's gross margin should continue to improve.

As for the other two business segments, Parexel Consulting (PC) gross margins increased to 47.1% (up from 46.3% a year ago). The PC segment represents 8% of companywide revenue. Parexel Informatics (PI) gross margins increased to 48.3% (up from 47.5% a year ago). The PI segment represents 13% of companywide revenue.

3) ***PI Business Trends:***

Technology is a core competence for Parexel. The company's PI segment is the lifeblood of innovation for transforming the traditional clinical trials process into a more efficient, more effective, technology-driven one. We want to see this business perform well to ensure it remains a competitive differentiator for Parexel and helps it win business in its CRS and PC segments. Now reaching scale, we also expect PI to exhibit operating leverage and become a more meaningful portion of profits.

Revenue growth in this segment was solid at +10.7% year-over-year, coming in at $74 million in revenue for the quarter, the highest quarterly figure for this segment in the company's history. Recently, I'd been disappointed by the trajectory of this segment of the business, as average revenue growth over the past 7 quarters has been just +2.8% compared to 17.5% average growth between 2011-2014.

The last two quarters have been good for the PI segment, and it appears that the company may be on the verge of continuing the momentum in this segment. I've mentioned in the past that our valuation expects PI to grow revenue by 10% annually and achieve 55% gross margins by 2020. These expectations were a significant aspect to our initial thesis, so I'll be watching this segment closely over the next few quarters to see if we need to ratchet down our expectations.

What We Think Now

Helping pharmaceutical companies get drug candidates to market, Parexel is poised to benefit as those companies gradually outsource more of this process to select CRO partners who can perform the work better, faster, and cheaper. We also expect margin expansion as recent investments and restructuring pay off and continued growth of the Parexel Informatics technology segment.

Pro Can Help

- Post your questions on our Parexel International discussion board.

Earnings News From 5 Pro Companies

Published May 9, 2016 at 3:02PM

Dear *Pro* Fools,

Earnings season arrives like a monsoon in *Pro* land, with half a dozen companies announcing results on some weeks. The storm has mostly passed this spring, and we're nearly done reviewing results. Our companies on the whole appear on track, and we're already looking at *new* ideas.

Before we get to anything new, though, we spend time learning more about our current companies each quarter, so these earnings reports matter to us — even though *Pro* looks ahead three years as we seek to build real returns over time.

For now, let's cut to the chase on recent results from five *Pro* stocks.

The Results

American Airlines

American Airlines (NASDAQ: AAL) has not been friendly to us. Although it's now one of the cheapest companies on the market, trading at about 4 times earnings, our hopes for a much higher share price this year are coming down to earth. The main culprit: Passenger revenue per available seat mile, or PRASM, continues to decline at American, down 7.5% last quarter. Next quarter, American expects an additional 6% to 8% year-over-year decline. Supply at other airlines has grown, challenging fare prices. At the same time, American is spending more on employees, including a new profit-sharing plan.

Management previously guided for rising PRASM this year, but last month, American pushed that guidance to 2017. And how will the company grow it again? The plan includes offering different service levels in coach class (to differentiate itself), charging varying prices, and serving different customer wishes. Given how airline tickets are commonly shopped for as a commodity sought out on fare-screening sites, I question how well American will be able to market its new tiered services in coach, let alone sell them. This makes me concerned about the costs associated with this new initiative.

Our January 2017 $35 calls still have time value, and we may soon sell to capture that value and then reassess for 31 days. Do we want to keep believing that Wall Street will reprice American to, say, at least 8 times earnings — a potential double? Or are we being stubborn? Are the skeptics right to think that American's profits will diminish on higher costs, more competition, and eventually higher fuel costs? Thankfully (in a way) our January expiration date forces us to reassess now and make our next decision. We'll share our conclusion with you when we're ready. And we'll certainly have valuable lessons to share.

Our American Airlines 2017 calls remain on Hold. New members are not advised to buy. Those with 2018 calls can act when we act.

Expeditors International (NASDAQ: EXPD) announced results late last week. Once I'm finished looking through them, we'll be rolling our May covered strangle on the stock, moving our strike prices higher. At that point, newcomers can join along, too. Watch your inbox for this update and alert.

Gilead Sciences (NASDAQ: GILD), like **Apple** (NASDAQ: AAPL), is a victim of its past success. The biotech's results were so strong in recent years that it can't grow year-over-year right now, and Wall Street (which loves growth most of all today) has sold the stock lower. Gilead is going for about 8 times earnings, making it even cheaper than Apple. Its Hepatitis C treatments account for the majority of the company's revenue, and even though Gilead is serving more patients, drug prices have come down, so revenue on the drugs slipped 6% from last year to $4.3 billion. This competitive pressure won't go away, so we may have seen peak profit on Hep C, even as Gilead reaffirmed its revenue guidance for 2016.

That said, revenue, cash flow, *and* profit should remain blockbuster-sized, and the stock will get cheaper as management continues to buy back shares — Gilead bought back 17% of shares since 2012. The new CEO is intent on making game-changing acquisitions, too, and the company has the size and cash to do it. An enhanced pipeline via acquisitions could make investors interested again and rerate the stock to a more reasonable valuation. For now, we have a world-class business — like Apple — priced at a discount because it isn't growing today. Management has been able to grow the business incredibly well so far, and we have faith it will be able to again from here.

Gilead remains a Buy at a 3.1% allocation. If you can stay close to that allocation while doing so, consider buying in 100-share blocks. We may seek to make option income on Gilead while we wait.

O'Reilly Automotive (NASDAQ: ORLY) remained a picture of consistency, with same-store sales up a strong 6.1% last quarter on top of giant 7.2% and 6.3% gains the two previous years. That's customer loyalty combined with new customer acquisition skills right there. O'Reilly opened 52 net new stores in the quarter and increased total revenue 10.2%. The results were remarkable for being unremarkable. The industry drivers remain in place: More complex car parts; more miles being driven; more old cars on the road. As these tailwinds continue, O'Reilly should add an additional 150 or so new stores this year. **O'Reilly remains a Buy.** Given our 5.3% stake, members may wish to buy in halves over a few quarters.

Skyworks Solutions (NASDAQ: SWKS) is selling more product for each new generation of smartphone (and to just about all smartphone makers), and grew its Internet of Things sales 18% to represent 23% of revenue. The second half of 2016 should bring the business back to quarter-over-quarter growth, particularly as the new iPhone launches. In 2017, the company sees year-over-year growth continuing. At the same time, fewer competitors can meet the needs of customers, Skyworks is winning new business earlier in the product cycle, and profit margins are headed higher. In other words, Skyworks is on track and trades at 11.5 times earnings estimates one-year forward. The company remains a compelling way to invest in the digital mobile revolution and Internet of Things.

We own a 3.1% allocation, and last week, we sold to open June 17, 2016 $70 covered calls, targeting short-term income. **Skyworks remains a Buy.** Members who have yet to fill their stock allocation should feel comfortable purchasing shares at current prices and writing our new covered calls if wished**.** If you're writing puts on Skyworks with us in *Motley Fool Options*, that's another way to target exposure, but we suggest picking up enough shares to match us in *Pro*, now or later.

The *Pro* Bottom Line

In summary:

- **American Airlines:** Our calls remain on hold. Wall Street may not be willing to apply a respectable valuation to the airline, even though it does to others. American still has to prove that it can compete effectively over the long haul, despite steady pressures. We'll share our guidance on our 2017 calls with you as soon as we've made our decision.
- **Expeditors:** The business looks healthy, and our May covered strangle coupled with a synthetic long has made us money so far this year. We'll be rolling our options to higher strike prices very soon, and we'll welcome newcomers then.
- **Gilead Sciences:** Is Gilead done growing? Ultimately, we don't think so, and once it proves its a savvy biotech operator (and acquirer!) again, Wall Street's returning faith should price the stock well above its current level. The stock remains a buy at a 3.1% allocation. We may need patience and could consider writing options.
- **O'Reilly:** Shares remain a buy at a 5.3% stake (average in over time). The long-term story remains in place.
- **Skyworks:** Shares are a buy at a 3.1% stake. Everything is going well at the business except for the current slowdown in iPhone sales. Keep in mind that we also own Apple, which is Skyworks's largest customer. Combined, we have ample exposure to the mobile revolution.

We're happy to have all of these positions except, naturally, American Airlines right now. We wandered from our usual type of buy, and it hasn't worked out yet. The company could always surprise us, but right now, our time for American is starting to run low as the lessons we're learning are running high. As for the other four companies highlighted here, we believe they will continue to reward us in the long run. If you have any questions, please visit the respective company board or our [Memo Musings board](#).

Fool on!

— Jeff (TMFFischer)

***Pro* Guidance Changes**

- **Broadridge Financial** (NYSE: BR): Fair value estimate goes $2 higher, to $58. The stock remains a Buy First with a 5.1% allocation.
- **Facebook** (NASDAQ: FB): Fair value estimate increases $5, to $107. The stock remains a Buy First with a 6.7% allocation.

***Pro* Completed Trades**

- **American Tower** (NYSE: AMT): We sold to open June 10, 2016 $108 diagonal call on our long AMT calls for $1.46 each.
- **Skyworks Solutions** (NASDAQ: SWKS): We sold to open June 17, 2016 $70 covered calls on all our shares for $1.05 each.
- **Valmont** (NYSE: VMI): We sold to open June 17, 2016 $140 covered calls for $1.50 each.
- **WisdomTree Emerging Markets SmallCap** (NYSEMKT: DGS): We sold to open June 17, 2016 $38 calls for $0.55 each.

Returns

	Annualized Return Since Inception	Annualized Return, Rolling 3 Years	Year-to-Date Return	Return Since Inception
Pro	12.9%	16.1%	0.8%	151.5%
North Star	8.2%	7.9%	3.0%	81.9%
S&P 500	11.6%	11.3%	1.7%	130.4%
MSCI World	6.0%	4.2%	0.5%	55.7%

Pro Catch-Up Trades: May 9, 2016

Published May 9, 2016 at 2:14PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our Portfolio Building Reports will get you fully invested over the coming few weeks, as much as you want to be.

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Broadridge Financial Services** (NYSE: BR): Buy our 5.1% allocation, at once or in halves if you like.
- **MasterCard** (NYSE: MA): Buy up to our 4.6% allocation.

Continue building your portfolio with our Buys, including these highlighted today:

- **Apple** (NASDAQ: AAPL): Buy 3.3% in stock.
- **Gilead Sciences** (NASDAQ: GILD): Buy 3.1% in stock.

Options:

- **Skyworks Solutions** (NASDAQ: SWKS): Sell to open June 17, 2016 $70 calls, aiming for $0.95 or higher. That's about a 1.4% yield on the recent share price, in 39 days. Sell one call for every 100 shares you own and want to cover. We covered all our shares.
- Our other covered calls, announced last week, no longer pay an attractive yield at the moment.

Hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): With patience, the put ratio spread we announced last week can be set up for $0.00 net cost at recent prices.

Broadridge Remains on Track

Published May 9, 2016 at 12:40PM

Pro's Take: BR Q3-2016 Earnings

Broadridge Financial Solutions (NYSE: BR)

Q3-2016

Quarterly recurring fee revenue growth (Y-o-Y): +12% to $399 million

TTM Operating profit margin*: +159 bps Y-o-Y to 24%

Closed Sales growth (Y-o-Y): +7% to $29 million

Quarterly EPS growth (Y-o-Y): +21% to $0.52

**Operating profit / Fee revenue. This removes the impact of distribution revenue, which is a pass-through cost and distorts the true economics of the business.*

Quarter Quick Take

The company has produced a solid start to Fiscal 2016, and it looks like management's guidance for the full year is going to be achievable: recurring fee revenue growth of 10%-12% (YTD +9.9%), Closed Sales of $120-$160 million (YTD $94 million), earnings-per-share growth of 7-12% (YTD +16%), and free cash flows of $350 million-$400 million (YTD $105 million, though typically the vast majority of the company's free cash flow is produced in the seasonally strong Fiscal Q4).

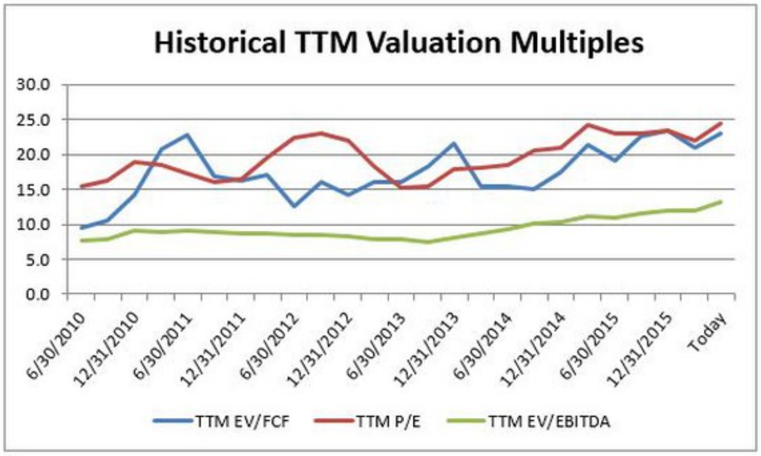
Updated guidance: Buy First (no change)

Recommended Allocation: 5.1%

Fair Value estimate: $58 (up from $56)

Current Price: $60.51

Based on management's guidance, at $60.51 per share, the stock is priced at about 21x projected 2016 cash flow and 24x projected 2016 GAAP EPS. Both of those valuation metrics have increased a bit since the beginning of the year (and relative to the company's history), meaning that the stock is less of a bargain:



However, Broadridge still features stable cash flows, a steady growth profile, an increasingly strong competitive positioning, and expanding margins to show for it. **Our Fair Value estimate increases to $58 per share (from $56), and Broadridge remains a Buy First on our scorecard.** Members who have yet to start or fill out their position can feel comfortable doing so at current prices, or you can write puts if you prefer to target a lower entry price (at current pricing, the $60 puts are a reasonable choice).

Our Thesis

Broadridge has a near monopoly in proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record and sound capital allocation policies make Broadridge a sturdy rock to build the Pro portfolio upon. We expect modest growth in fee revenue, slight operating leverage, plenty of free cash flow and a growing stream of dividends to help achieve North Star-like returns.

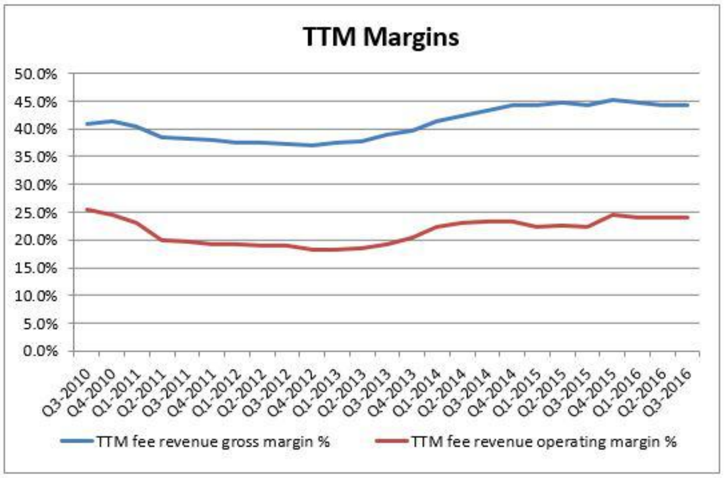
The Most Important Things

1) ***Closed Sales:*** This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%+). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

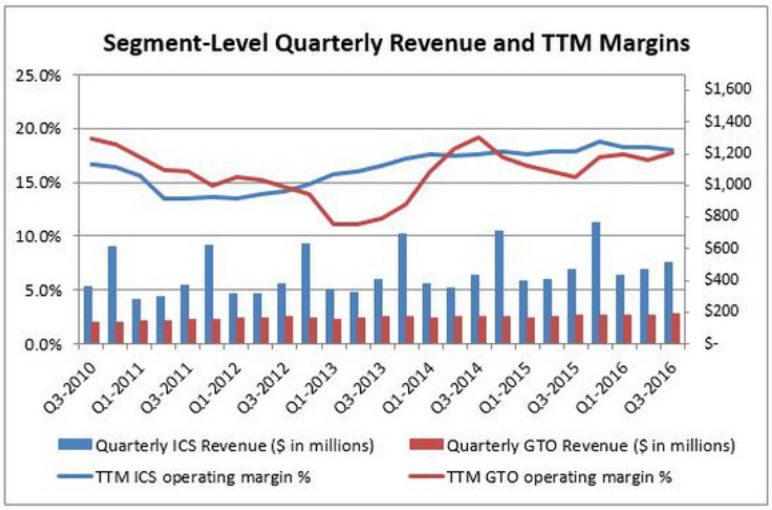
Lately, closed sales have taken a bit of a breather compared to Fiscal 2015, but that's in part because 2015 was an extraordinary year for closed sales. For year-to-date Fiscal 2016 (Q1, Q2, and Q3), the company has reported $94 million in closed sales, which is down about -13% compared to the first half of Fiscal 2015 ($108 million). But when we account for the difficult year-over-year comparison by comparing to the first three quarters of Fiscal 2014 (a 2-year "stack"), the two-year absolute growth comes in at 52% (a 23% CAGR). The three-year growth rate (comparing to Fiscal 2013) is similarly strong at 62% growth (a 17% CAGR).

The run-rate for closed sales for Fiscal 2016 implies full-year closed sales of $125 million, which is within the company's guidance range of $120-$160 million. Additionally, Fiscal Q4 is historically the strongest sales quarter of the year, so the company may have room to reach the high end of its guidance for closed sales by the end of the fiscal year (next quarter).

2) ***Fee Revenue Margin Performance:*** In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers) we prefer to look at trailing twelve months (TTM) margins to smooth out quarterly fluctuations. TTM fee revenue gross margins came in at 44.3% (up slightly from 44.2% a year ago), and TTM fee revenue operating margins came in at 24% (up from from 22.5% a year ago):



When looking at each individual segment - Investor Communications Solutions (ICS) and Global Technology Operations (GTO) - margins show a similar, albeit lumpier trend. This graph does a good job showing Broadridge's seasonality and historically strong Fiscal Q4s (note that it shows *quarterly* revenue compared to *TTM* margins):



We'll get a much better sense of how margins are trending after next quarter, historically the company's most important quarter from a sales and cash flow perspective. If the company can continue its performance in closed sales, generate healthy sales growth, and control costs (especially acquisition-related costs), then there may be room for continued margin expansion (especially in the ICS segment) as we finish Fiscal 2016 and enter Fiscal 2017.

3) ***Capital Allocation:*** Although Broadridge is a slow grower, it generates a lot of cash and has low reinvestment needs. Management has a very clear plan to put that cash to work: it targets a 45% payout ratio, and it plans on using incremental debt capacity to pick up the pace of acquisitions (targeting $400-$600 million between FY2015-FY2017) and share repurchases.

On the dividend front, the company has paid out $1.17 per share on a TTM basis, good for a 47% payout ratio and about a 2% yield on the current price. On the acquisition front, the company is making good progress -- the company has spent $218 million on five acquisitions (Direxxis, Wilmington Trust, Thomson Reuters Fiduciary Services and Competitive Intelligence unit, TwoFour Systems, and most recently QED Financial Systems) since its capital stewardship priority update in December 2014. The company has an excellent acquisition track record (a 20%-plus IRR since Fiscal 2007), and they expect acquisitions to account for about 2% of growth in recurring fee revenue out to Fiscal 2017. In the first three quarters of Fiscal 2016, the company has exceeded that goal -- acquisitions have accounted for 4% year-over-year growth in recurring fee revenue so far this year.

As for share repurchases, the company has bought back $97 million in shares at an average price of about $54 per share in the first three quarters of Fiscal 2016. As for debt, the company has added $131 million in debt during the first three quarters of Fiscal 2016 via its revolving credit facility, which has a variable interest rate of LIBOR plus 112.5 basis points (currently about 1.3%). This is consistent with the company's longer-term strategy to run the business at a debt-EBITDAR ratio of 2:1 (based on my calculations the company is currently at about 1.85:1).

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Pro Can Help

- **Questions?** Bring them over to the Broadridge discussion board.

Re-Establish Your Diagonal Calls on American Tower

Published May 5, 2016 at 12:10PM

Is this for you? This recommendation is for all *Pro* members who have matched our 3.8% stock allocation in **American Tower** (NYSE: AMT) and **also** own January 2017 or 2018 calls, or are ready to buy them now. For new *Pro* members who do not yet own calls, please check out the guidance under "New *Pro* members" in the "How You Participate" section of this alert. Mind that we are only writing calls to cover our owned calls, **not** to cover our stock position. We recommend that you leave your stock allocation **uncovered** in order to capture further potential upside in American Tower.

How You Participate

- **Trade:** Sell to open June 10, 2016, $108 calls on American Tower. *Please note that these are **weekly** options.*
- **Allocation:** Sell one call for every January 2017 (or January 2018) $80 call you already own (or are buying now). *Pro* will cover its six long calls.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a limit order to split the bid/ask spread at going prices as long as you get at least a 4% yield on your long January 2017 or 2018 call value (see the math below). These weekly options are relatively thinly traded, so **it is critical that you use a limit order** to avoid collapsing the bid/ask spread.
- **Prices** (May 5):
  - **Stock price:** $106.50 (as of 12:00 p.m. 5/5/16)
  - **Sell to open June 10, 2016, $108 calls (bid/ask split):** $1.60
  - **January 2017 $80 calls we own (bid/ask split):** $27.25
  - **Diagonal call yield:** $1.60/$27.25 = 5.9% in 37 days.
- **New *Pro* members:** If you've yet to buy calls on American Tower, go ahead and set up the whole diagonal call trade today. Use a diagonal call order (sometimes referred to as a "calendar spread" order, depending on your broker), buying the **January 2018** $80 calls (rather than the 2017 calls *Pro* owns, in order to give your calls more time to expiration) and simultaneously selling the June 10, 2016, $108 calls to aim for a net debit of $27.25 or so. Invest about 0.6% of your funds in the long calls if you're matching our allocation.
- **Alternative Guidance:** If *Pro*'s volume results in a significant impact on the June 10, 2016, $108 call pricing, or if the stock price changes considerably from the price in this alert, consider looking at various other strikes or weekly expirations for your short call, depending on what you like best. If you choose this route, be aware that *Pro*'s course of action may diverge from yours, depending on what strike and expiration you choose, and depending on the stock-price movements of American Tower.

What We're Thinking

Since last Friday's thrilling conclusion to our first iteration of diagonal calls, we've analyzed American Tower's first-quarter 2016 results and have **updated our fair-value estimate to $120 per share** (from $115). Based on our updated evaluation of the business, we're content to keep our diagonal call position going, selling a new short-dated call to generate income and target further upside from our long-dated owned calls.

The rationale for this diagonal call is much the same as it was for the previous iteration. These new written calls could pay us 5.9% or so on our current long call's value in one month, and we have upside to the $108 strike price -- about 1.5% higher than the current price, which if reached would increase the value of our owned calls by about 5.5%. (This is an example of the leverage that owned calls provide!) If the stock price shoots well above our written call's strike price prior to expiration, we can roll our calls for further income (if the rolling trade looks attractive) while still capturing the full upside of the stock with our uncovered 3.8% stock allocation (currently our sixth largest).

Even if we assume that we will have to sell our long calls in a month when our written calls are assigned, the return on the long calls (including the income from the series of two diagonal calls) would be approximately 33%, well ahead of our North Star since our December 2014 purchase. Of course, we don't plan to close or sell unless we're forced to, so we'd look to roll our calls if we can, targeting further upside on our growing Buy First stock.

More That Matters

- **Maximum gain:** The 5.9% premium earned from writing the calls, plus upside in our owned calls to our short call strike price at $108, which is lately about 1.5% higher than the current price.
- **Maximum risk:** The full value of our long $80 calls, minus premiums received from short calls.
- **Follow-up**: We hope to see these short calls expire for income later this month, and then we will determine whether we want to write new calls. If we need to roll or close, we will.

Pro Can Help

- **Want to know more about this strategy?** Our Options U guide to writing diagonal calls can keep you on an even keel.
- **Questions about this trade?** Consume data and post your questions on our American Tower board.

American Tower Adds More Towers

Published May 5, 2016 at 12:10PM

What Happened?

- Q1 2016 press release
- Q1 2016 supplemental materials
- Q1 2016 earnings presentation

CEO Jim Taiclet:

> "The global proliferation of smartphones is driving significant growth in subscriber demand for higher-bandwidth applications. As a result, during the first quarter, we continued to experience solid leasing demand across our served markets as mobile operators invest in their networks to manage key performance factors, including coverage, capacity and peak network speed.
>
> "Additionally, in India, we recently closed our Viom transaction, the latest step in our strategic initiative to diversify our operations and further establish the Company as a leading global provider of communications real estate in key free-market democracies around the globe. We remain focused on pursuing disciplined investments like Viom as we aim to simultaneously increase return on invested capital and generate double-digit growth in both our AFFO per Share and dividend. We believe this strategy will drive compelling returns for stockholders over the long term."

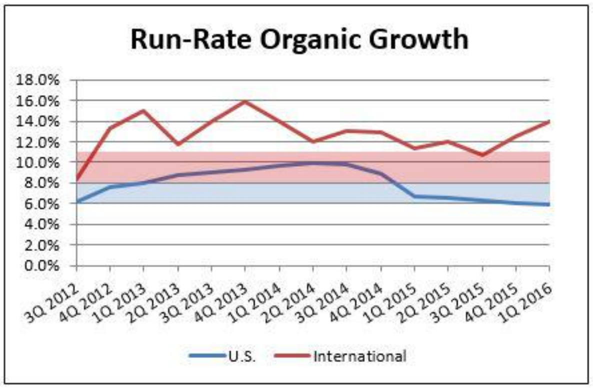
So What?

American Tower (NYSE: AMT) reported a very good first quarter for 2016, with solid organic core growth in revenue and good margin performance across the entire global asset base.

Organic core growth accelerated in both the U.S. and internationally, coming in at 7.1% and 13.2%, respectively (vs. 5.2% and 12.5% last quarter). Organic core growth in the U.S. was partially bolstered by the positive impact of $31 million of decommissioning revenue, compared with $17 million in the first quarter of last year.

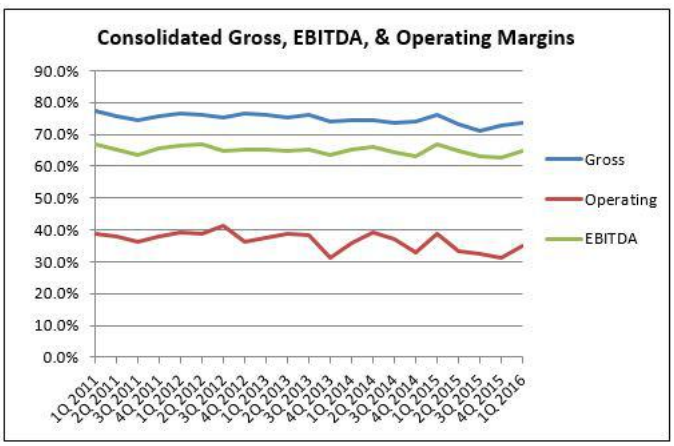
Because of the effects of these non-recurring decommissioning agreements, American Tower has started to disclose a new metric called **run-rate revenue**, which strips out timing-, currency-, and accounting-related effects and is the company's best guess on recurring revenue tied to long-term tenant lease agreements that should continue in the future. This new disclosure should help investors more accurately assess the key drivers of the company's revenue model. In the future, I'll be referring most often to run-rate revenue rather than "core" revenue.

On a run-rate basis, organic growth was 5.9% in the U.S. and 14% internationally. International run-rate organic growth was broad-based across all regions, up 12.7% in Asia (i.e., India); 16.1% in Europe, the Middle East, and Africa (EMEA, which includes Germany, Ghana, Nigeria, South Africa, and Uganda); and 13.6% in Latin America (which includes Brazil, Chile, Colombia, Costa Rica, Mexico, and Peru).



Note: Because this is a new disclosure, the data set is not complete. Where run-rate organic growth data was not available, I used organic core growth as a proxy. Shaded areas are management's target ranges.

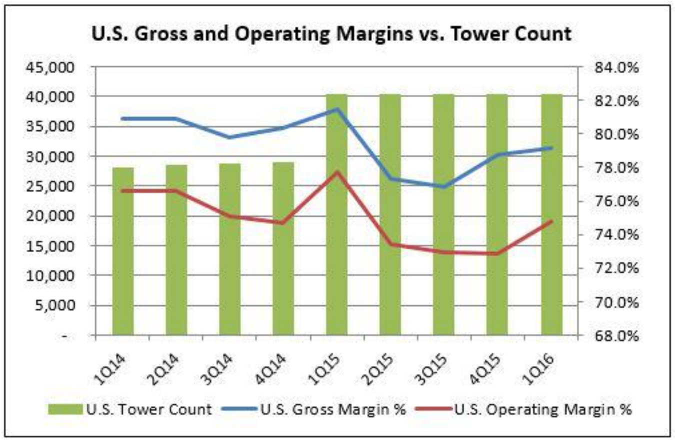
Margins increased sequentially in the quarter thanks to the strong organic growth, cost controls, and the continued integration and leasing of more than 25,000 low-tenancy sites built, leased, or acquired since the beginning of last year. These include newly acquired towers in the U.S. (acquired from Verizon), Nigeria (acquired from Airtel), and Brazil (acquired from TIM).



[Two quarters ago](), I mentioned that "we should see margins start to increase over the next six to 12 months and beyond as American Tower begins to work its way through its application pipeline for the under-utilized Verizon towers," and that's exactly what we're seeing. Management commentary on the call suggests the Verizon portfolio is tracking as expected:

> **CEO Taiclet:** "As to Verizon ... we have a 9% to 10% long-term sort of cumulative average growth rate expectation over 10 years for that portfolio and we still do. So every month or 2, it's not going to change, I can't imagine, materially. We're seeing new business on the sites. They're in really great shape as far as the carrier portfolio for capacity, ground space, the documentation I referred to earlier. So we're progressing through our plan and expect to be able to deliver what we've stated in the past."

U.S. gross margins increased sequentially to 79.1% (from 78.8% last quarter) and U.S. operating margins increased sequentially to 74.8% (from 72.8% last quarter), reflecting those trends:



Internationally, margins declined a bit sequentially as higher margins in EMEA and Latin America were offset by declining margins in Asia, related to the company's recent acquisition of the Viom portfolio in India:

According to management, the new assets in Asia will likely take about 12 to 18 months to become fully integrated. However, since the U.S. segment accounts for about 73% of companywide gross profit and 75% of companywide operating profit, the margin trajectory of the U.S. business will have a far greater impact on the company's near-term performance than the margin trajectory of the international business.

As for debt, the company's net leverage ratio came in at 5, in line with management's expectation of ending 2016 at 5 times leverage or below. The company has plenty of liquidity (more than $3 billion), and no significant debt maturations until 2018.

Yearly distribution growth continues to track ahead of management's 20% long-term growth target, coming in at 21% ($0.51 per share, a 1.9% forward yield on the current share price). Twenty-percent annual distribution growth continues to look like a more than reasonable target for 2016 and beyond.

Now What?

This quarter's report confirms that our investment thesis -- that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time -- is continuing to play out. The company's impressive operating history, excellent management, and strong competitive position in a growing industry give me confidence that American Tower will continue to increase revenue and cash flow at high rates for a long time, providing strong returns on capital (ROIC). Given the effects of the recently closed Viom acquisition in India, the company expects to end the year with nearly 150,000 sites worldwide (compared to just more than 100,000 sites as of this quarter's report), and acquisitions and incremental leasing activity should continue to drive revenue, cash flow, and ROIC higher over the long term:

Source: AMT Q1 2016 earnings presentation. 2016E reflects midpoint of 2016 outlook.

Data and Guidance

- Current Price: $105.43

- Fair-value estimate (**updated**): $120
- Allocation: 3.8% plus a 0.6% diagonal call allocation
- Market Cap: $45.1 billion
- EV/EBITDA (TTM): 19.5

AMT remains a Buy First, with an updated fair-value estimate of $120 per share and an allocation of 3.8% plus a 0.6% diagonal call allocation (see today's alert here for more details). If you've yet to start a position or haven't yet bought calls, now is as good a time as any to match us. The stock may experience volatility in the short term because of its tendency to trade alongside the interest rate-sensitive REIT sector, but over the long term, the underlying strength in business fundamentals should shine through.

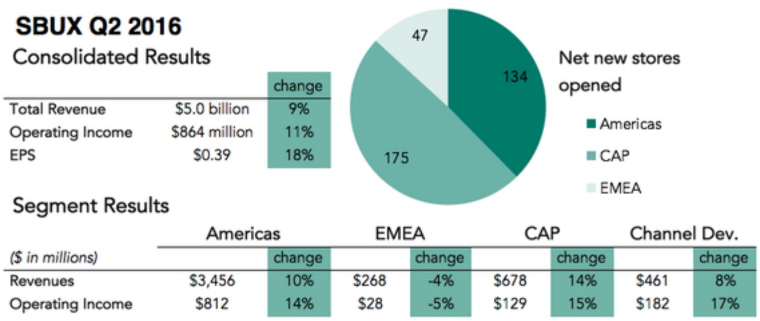
Fool on!

-- Billy (TMFBillyTheKid)

Starbucks Brews Up Strong Results

Published May 5, 2016 at 9:49AM

They say that variety is the spice of life, but it's hard to be unhappy with **Starbucks**' (NASDAQ: SBUX) consistency when it comes to reporting impressive quarterly results.



Source: Company filings

Updated Guidance and Valuation

Updated guidance: Buy (no change)

Recommended allocation: 3.6%

Fair-value estimate: $50 (up from $49)

Current Multiples

Multiple	Trailing	Next 12 Months
P/S	4.2	3.7
P/E	34	28
EV/EBITDA	17.68	15.29
P/FCF	33	--

Source: S&P Global Market Intelligence

Investment Thesis

Starbucks offers a unique blend of sales drivers (domestic and international growth, food and beverage innovation, and channel development, just to name a few) and cost-reduction opportunities (payment innovation, European restructuring, expansion of consumer product margins). We believe the coffee is just a gateway for the company to repeatedly sell customers an experience rooted in comfort, quality, health, community, and conscience. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand into new products, new platforms, new times of day, and new brands. We expect new store openings across the globe to strengthen the company's brand and cost-based competitive advantages and improve profitability over time.

With a company as large as Starbucks, you might think there isn't much more room for growth. But you'd be wrong. As laid out during the company's 2015 Investor Day presentation, management believes that by the end of 2019, Starbucks will increase its store base to more than 30,000 global locations (up from more than 24,000 today), achieve $30 billion in annual revenue (up from $20.2 billion TTM), and double its annual operating income. Given the global strength of the Starbucks brand, we believe that this is definitely possible.

Results

Comparable-Store Sales

	Q2 2016			Q2 2015			
	Sales Growth	Change in Transactions	Change in Ticket	Sales Growth	Change in Transactions	Change in Ticket	Percentage of total revenue
Consolidated	6%	2%	4%	7%	3%	4%	100%

	Q2 2016			Q2 2015			
Americas	7%	3%	5%	7%	2%	5%	69.2%
CAP	3%	2%	2%	12%	10%	2%	13.6%
EMEA	1%	0%	1%	2%	2%	1%	5.4%
Channel Development							9.2%
Other							2.6%

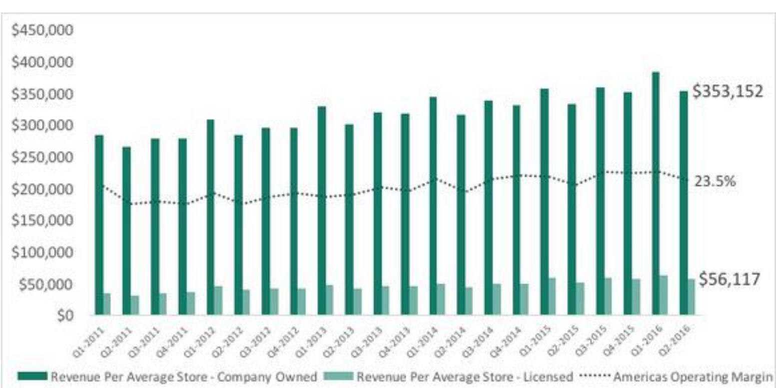
Source: Company filings

Americas

Here in the U.S., it appears as though the company is attempting to do two things: continue to solidify itself as a "third place" (as in "not home or work," not as in "coming in third") destination of choice for many, while also catering to those in search of convenience. We see both ventures as critical to the company's domestic success going forward, and as of right now, financial results would suggest that Starbucks is on the right track. Comparable-store sales growth was flat year over year and decelerated sequentially, but Starbucks remains a standout performer in the industry.

Source: Company filings

Food continues to be a big driver for the company, contributing two points to U.S. comparable-store sales and accounting for 20% of segment revenue for the first time ever. And both company-owned and licensed stores continue to perform well as the company exhibits operating leverage as it scales.



Source: Company filings, analyst estimates

China/Asia-Pacific

The headline numbers for this division may no longer look quite as impressive now that Starbucks Japan is fully included in the base figures for revenue and comparable-store sales, but the results were actually in line with our estimates. China revenue was up 18%, with the company's latest stores -- opening at a pace of about 10 per week -- continuing to set records for profitability and volume. The company is also hoping to roll out additional digital and loyalty features in China, and its partnership with Tingyi, which will provide more than 1 million points of ready-to-drink Frappuccino distribution in China, will begin in in the third quarter. John Culver, who is the group president of Starbucks Coffee China/Asia Pacific, Channel Development and Emerging Brands (that's a mouthful!), spoke to the size of the opportunity of the latter during the Q&A portion of the earnings call:

And the only thing I would add, Howard, to that is the fact that the single-serve business is really -- does not exist in China nor in Asia at any significant degree. So this is all white space. And as Howard said, we are truly the only global premium coffee brand, both in Japan, Korea, China or the rest of Asia, that's going to be able to leverage a retail footprint and an awareness and a trust level with our consumers on educating them about in-home consumption of single-serve coffee.

Europe, the Middle East, and Africa

Licensing income now accounts for more than 60% of total income for Starbucks' smallest operating segment. After adjusting for a continued shift from company-owned to licensed stores, as well as some foreign-exchange headwinds, the division recorded 7% adjusted revenue growth and system comp growth of 4%.

Channel Development/Consumer Packaged Goods

There's a lot to like about what Starbucks is doing with its second most profitable business segment. Revenue and operating income were up 8% and 17%, respectively, as the company continues to expand its lead in the U.S. market in both premium single-serve offerings and premium roasting grounds. Starbucks is also the leading brand on the K-Cup platform, with 16.3% market share that grew by 3 times the category average this quarter; it will likely post 20% annual growth this year. In this past quarter, the company also reworked and extended its relationship with Keurig. Starbucks now has greater flexibility in adding additional SKUs, as well as the opportunity to sell K-Cups directly into offices, food-service operations, colleges and universities, hotels, and convenience stores. Better yet, Starbucks also announced last month that it has entered into a relationship to bring its single-serve offerings to Nestle's Nespresso unit -- the leader in premium single-serve outside North America -- later this year. The rollout will start in Europe, where Starbucks estimates that single-serve represents more than 40% of all coffee consumed and that 50% of its "best" customers own a Nespresso machine at home.

Digital and Loyalty

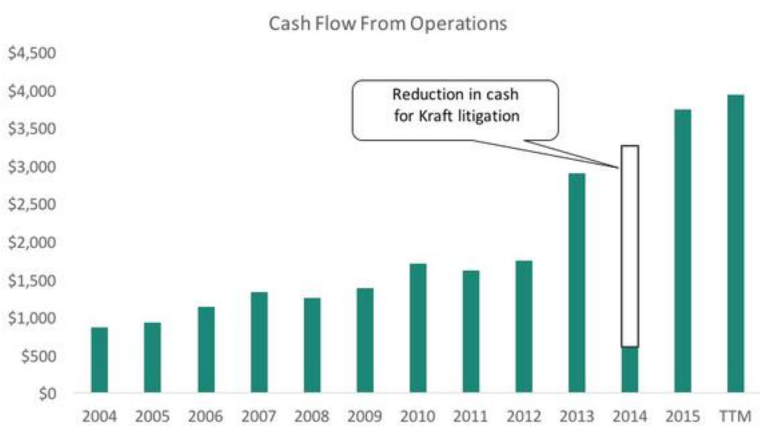
Coming out of the holiday quarter, My Starbucks Rewards (MSR) additions and money loaded to Starbucks cards didn't keep up with the impressive pace set in the second quarter of 2015, when these metrics were surpassingly even better than in the holiday quarter preceding them. This quarter, the company added approximately 1 million new MSR members here in the U.S.; that brings the total to more than 12 million, representing 50% growth over the past two years. And the company now has almost 19 million app users (a 90% increase over the past two years), with these users now accounting for 24% of all transactions here in the United States. The continued adoption of Starbucks mobile payment options, especially Mobile Order & Pay, will be key if the company hopes to continue to deliver strong U.S. comparable-store sales.

There was some initial pushback after the company modified its rewards program to favor its most loyal (read: highest-spending) customers, and certain media outlets reported that the company's customers were "rebelling." But so far, it seems like it was much ado about nothing. Management noted on the call that that rewards membership has accelerated recently, with an impressive 280,000 people signing up in the week prior to the report. We can see how the modification might discourage the frugal customer who was solely buying $1.85 cups of coffee to earn a free drink as cheaply as possible, but we believe the move will be a net positive for the company, as it ultimately rewards Starbucks' best customers and incentivizes spending more with the company. Management also recently announced that it will be partnering with JPMorgan Chase and Visa to create a Starbucks general-purpose prepaid debit card.

Individually, moves like this may not move the needle, but one shouldn't underestimate the company's push to make it possible for customers to earn "Stars Everywhere." The most successful consumer-facing companies are frequently those that are able to develop consumer behaviors that revolve around the company's offerings, and making it possible to earn stars for things other than visiting a Starbucks location does exactly that. Another example of this would be the company's move to introduce the MSR program in the grocery aisle. The company saw an 18% increase in the number of codes that were redeemed in this past quarter, and more than 2 million MSR members to date have redeemed more than 20 million codes from CPGs.

Valuation

From an operational standpoint, Starbucks has been doing extremely well. But, and I'm sorry to sound like a broken record yet again here, that performance doesn't come cheap. In order for the current share price to be justified, the company will likely need to expand its free cash flow at a mid-teens or higher rate over the next 10-plus years. Over the preceding 10, the company has easily eclipsed this, increasing cash flow from operations by 18%.



It'll be hard for Starbucks to maintain this type of growth going forward, but that's not to say that I don't believe it's possible. It's all about execution. We know that management is targeting 30,000 stores by 2020, which would require an increase in store count of about 1,500 per year at a minimum. Total stores increased by 1,677 in 2015, and management expects to open up around 1,800 stores this year. When it comes to rapidly growing companies, there's always a risk of expanding too quickly, but given the performance of Starbucks' recent new locations, this pace seems reasonable and puts that 30,000 number firmly in the company's sights. This means that if Starbucks is able to continue to find new locations that deliver cash-flow returns similar to those at its existing stores, keep capital expenditures in line with historical norms, and achieve global comps in the range of 5% or so, we should see the company report a free-cash-flow growth rate in the low teens over the next four years. These aren't easy targets, to be sure, but with the way Starbucks has excelled from an operational standpoint over the past few years, this is one of the last public companies I'd want to bet against.

Starbucks remains a Buy on our scorecard, and I'm increasing our fair-value estimate slightly, to $50, which would value the stock at 27 times 2016 earnings and 14.3 times EBITDA.

Hedge: Set Up a Second Put Ratio Spread on the SPDR SP 500

Published May 4, 2016 at 12:09PM

Is this for you? At *Pro*, we use hedges to target returns during a market decline. You don't need to hedge to succeed with *Pro*, but if you are at least 80% invested in stocks and *want* to hedge your market exposure, then consider following along. In addition to our other 10% SPY hedge, this additional 10% hedge will lower our market exposure -- if the market falls to our strike prices -- to about a net 55%. Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $185,000. We are leaving our current June 2016 SPY put ratio spread in place; this new spread is a *complement* to that, at lower strike prices in case the market falls further. Some new members have a slight variation of our first June spread from Catch-Up Trades; these members should keep that spread in place, as we are. Again, we want *two* June spreads in place after this alert is fulfilled, the original one with a $200 bought strike price, and this one with a $185 bought strike price. See our recommendations page to see these holdings listed in action.

How You Participate

- **Action:** Use a spread order to set up a put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
- **Allocation:** About 10% of your total portfolio value, measured on the look-through value of the $185 puts you're buying (each put represents $18,500 in hedge value). Set up one 2:1 put ratio spread for every $18,500-sized hedge you want; hedging about 9.7% of our entire portfolio of $2.48 million, *Pro* will sell 26 puts and buy 13 (because 13 puts at a $185 strike = $2,405 x 100 shares per contract = $240,500 look-through put value = 9.7% of our $2.48 million portfolio value).
- **Trade:**
  - **Use a ratio spread order to simultaneously ...**
    - Write ("sell to open") **two** June 17, 2016, $177 puts, and:
    - Buy ("buy to open") **one** June 17, 2016, $185 put. Click "view all" at your broker to see all strikes.
- **Price Guidance (prices as of 9:45 a.m.):**
  - Sell to open **two** June 17, 2016, $177 puts: Lately $0.37 x 2 = $0.74 credit
  - Buy to open **one** June 17, 2016, $185 puts: Lately $0.74 debit
  - **Net debit or credit:** Lately about **$0.00** per spread -- but this price will change. As it does, simply aim for no cost, a small credit, or a tiny debit, always using a limit order.
  - **SPY price:** $204.95
  - **Potential adjustment:** If SPY moves in price before you set up your trade, you may want to move one or both of your strike prices up or down accordingly -- as much as SPY has moved -- while still aiming for a net credit. After our mandatory 24-hour trade delay, we will make such an adjustment if need be, and tell you about it.

What We're Thinking

At *Pro*, we aim to have winners in down, flat, and positive markets -- and that means we need to address all three possibilities at once in our portfolio. Yet our portfolio remains oriented toward the long term and is majority invested in healthy stocks. A hedge on a market index is simply a hedge against a lower market while the rest of our stocks remain free to appreciate. We generally don't try to manage for market declines of 5% or less (that's standard volatility), but when *Pro* is functioning as desired, declines of about 7% or more should result in some of our positions, such as these spreads, becoming nicely profitable. At the same time, the put ratio spreads we use:

- Are harmless to us if the market goes higher (they don't ding our return)
- Are typically cash-free to set up (they often pay us a small credit -- essentially income!)
- Have a low probability of long-term loss

What's the trade-off? As with any written put, we need to be ready to buy the underlying investment; for today's position, that means we're prepared to buy into the S&P 500 index (through SPY) if the price falls below $177, or about 13.6%. If the index declines by more than 17.5%, this hedge becomes a liability, with SPY falling below our breakeven point. If that happens, we would plan to buy *long-term call options* on SPY instead of shares, saving most of our cash in the process. See below for details on that. We don't believe there's much probability of long-term loss because we believe SPY will recover.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2,484,000
- Ten percent of that value: $248,000
- June 17, 2016, spread:
  - Buy to open $185 puts. Thirteen contracts representing 100 shares each = $240,500 in look-through exposure, or about a 9.7% hedge on our current portfolio value, cash included.
  - Sell to open $177 puts -- 26 contracts, half of which are *not* covered by long puts and thus become a potential obligation at a net $169, currently an 8.9% possible stake.
  - At home, you would buy one $185 put and sell two $177 puts for every $18,500 in portfolio value you want to hedge.

Return Details

SPY Price at June 17, 2016, Expiration	Value of 1 Purchased June 17, 2016, $185 Put	Value of 2 Written June 17, 2016, $177 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Recent $204.95
$185 or higher	$0	$0	$0.00 gain per spread -- or any credit or debit for setting up the trade	No gain or loss on any increase in price, or any decline of less than 9.7% (because, remember, we have a spread that kicks in at $200, or only 2.3% lower; like a ladder trade, this one starts well below that first spread)
$182	$3 x 100 = $300	$0	$300	(11.2%)
$180	$5 x 100 = $500	$0	$500	(12.2%)
$177	**$8 x 100 = $800**	**$0**	**$800 (max profit per spread)**	**(13.6%)**
$172	$13 x 100 = $1,300	($5) x 200 = ($1,000)	$300	(16.1%)
$170	$15 x 100 = $1,500	($7) x 200 = ($1,400)	$100	(17.1%)
$169	**$16 x 100 = $1,600**	**($8) x 200 = ($1,600)**	**$0 (break-even)**	**(17.5%)**
$167	$18 x 100 = $1,800	($10) x 200 = ($2,000)	($200)	(18.5%)

SPY Price at June 17, 2016, Expiration	Value of 1 Purchased June 17, 2016, $185 Put	Value of 2 Written June 17, 2016, $177 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Recent $204.95
$165	$20 x 100 = $2,000	($12) x 200 = ($2,400)	($400)	(19.5%)

If SPY declines more than 9.7% from recent levels, making our other hedge profitable (albeit with a declining profit at that point), then this hedge starts to come into play. Our maximum profit is earned on the spread if SPY declines 13.6% from its recent level of $204.95 by our June expiration. The spread will help us a little on an index decline of as much as about 17%; deeper than that, and our short puts turn into an obligation that's in the red.

Follow-Up

Assuming we set this spread up for no cost, it costs us nothing even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $177 put obligation (starting with a net buy price of $169) if SPY is below $177 by expiration.

However, if that does happen, our plan would be to close our puts and buy long-term SPY calls (or something we like even better, whether calls or a stock) instead of buying the ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY shares. So, our potential 8.9% stake in SPY shares will only cost us about 2.2% of our cash if we buy calls instead. This is important, because we would also have an obligation at about $180 to buy more shares, thanks to our previously set up spread expiring the same day. We'll be happy to buy calls on the index at these depressed prices and still keep most of our cash available for other stock or call purchases. We would likely diagonalize those calls, after a rebound, for income.

How It Fits Into *Pro*

Pro hedges to lower our invested market exposure, or risk. As you know, we aim to achieve positive returns every rolling three years, and inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market can make a difference. We made $10,700 when our last put ratio spread closed in February. Even small gains add up over the years, especially after those gains on market declines are invested in good stocks. This hedge fits well with our goal of hedging in a cost-efficient way, one that doesn't work against us if the market rises. Plus, if offers us protection on a market drop greater than 10% or so. Our current spread loses its value around there (achieving its maximum profit on a smaller drop). These spreads do require regular upkeep, opening new positions as old ones expire, and they are time-sensitive, really only helping at or right near expiration.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:**
  - For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Assuming you already have our higher-strike ($200/$190) bear put spread set up from our Positioning Report, now use a spread order to set up a second one if you like. "Buy to open" June 17, 2016, $190 puts and "sell to open" *an equal number* of June 17, 2016, $180 puts. Recently, this will cost you about $0.63 ($63) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $10 ($1,000) per spread on a decline to $180 or any lower price, but you should be prepared to lose your whole $63 per spread if SPY doesn't decline enough by expiration. This is so far out-of-the money, you have to assume it will expire worthless. It's risk insurance.
- **To lower your market exposure while following our full official trade (and making the position possible in some IRAs):**
  - Set up the official put ratio spread as recommended, but also "buy to open" puts (with the same day of expiration) at a strike price *well below* $177. Buy *half as many* as the number of $177 puts you wrote. When you do so, all of your $177 puts will be "covered" -- half by your $185 puts, and half by the other puts you choose to buy at a much lower strike. Choose how much you want to pay to select your lower strike price to purchase. To us, the $169 strike or lower looks good, recently costing $0.20 or less. You will only need cash in your account to cover the difference between your two lowest strike prices (if you buy $169 puts, that's $8 per share), and your risk is capped, making this potentially IRA-friendly. This makes the total cost of your hedge about a $0.20 debit or less, with no risk beyond that, and it still has $8 in potential ending value.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Write Covered Calls on 3 Pro Stocks

Published May 4, 2016 at 11:42AM

Is this for you? This recommendation is for all *Pro* members who own at least 100 shares of the following stocks and who wouldn't mind potentially capping upside on the shares in return for near-term income.

How You Participate

- **Trade:** Sell to open June 17, 2016, covered calls on:
  - **WisdomTree Emerging Markets** (NYSEMKT: DGS) -- $38 calls
  - **Skyworks Solutions** (NASDAQ: SWKS) -- $70 calls
  - **Valmont Industries** (NYSE: VMI) -- $140 calls
- **Allocation:** Write ("sell to open") one call for every round lot of 100 shares of each stock you own. *Pro* will cover all the shares we can, leaving only an odd lot of 50 shares of DGS uncovered; combined, this represents another 7.5% of the portfolio being covered for income.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a limit order to split the bid/ask price spread on each option at going prices. This week, aim for about a 1.5% yield (that's option premium / current price of the stock) given about 1.5 months to expiration. As expiration gets closer, always aim for our usual 1% per month in income to expiration. These options are relatively thinly traded, so i**t is critical that you use a limit order**.
- **Prices** (11:15 a.m.)(as prices change, just divide the going option premium -- splitting the bid/ask pricing -- into the current share price to target around a 1.5% yield; you'll have to accept a bit less lately on VMI):
  - **WisdomTree Emerging Markets:** $37.30; June $38 call (bid/ask): $0.65/$0.85. So, $0.75 is a 2% yield on $37.30 in 44 days. You can accept a bit less if needed. Keep in mind, as the stock falls, the option can pay less and still yield what we wish on the stock price.

- **Skyworks Solutions:** $66; June 17 $70 call (bid/ask): $1.50/$1.65. So, $1.55 is a 2.3% yield on $66 in 44 days. Can accept a bit less if needed.
- **Valmont Industries:** $134; June $140 calls (bid/ask): $1.60/$2.00. So, $1.80 pays 1.3% in 44 days. This is a bit lower than wished, but necessary now as the stock has fallen this morning. We'll accept this income or close to it.

What We're Thinking

After a flat 2015, the S&P 500 is essentially flat so far this year, too, meaning an investor needs to work harder to make returns. That's especially true when you consider the Nasdaq Composite is down more than 5% this year; who among us doesn't own many Nasdaq-listed stocks? The *Pro* portfolio is about flat so far this year, too, so we're considering various reasonable ways to increase our gains, including new longs and shorts. One other great possible way to increase returns is to write, and manage, more options. With these three covered-call options expiring in 44 days, we're targeting about 1.5% in income on each position (and more than that combined, right now). After our June expiration, we may keep income trades going much longer on these targets and others, and roll these options higher if need be.

WisdomTree Emerging Markets (DGS), 1.7% stock allocation

We're writing covered calls on 1,100 of our 1,150 shares, looking to generate more income returns on this index-based ETF from here forward -- unless we have reason to believe emerging markets are about to soar. The options have $1-increment strike prices, which helps make it easier to roll them, and the near-the-money options pay more than our desired 1%-per-month yield. We do need to be ready to roll higher in case the ETF rises in price, but that should not be too difficult. Also, if we lose our shares, we're not that concerned. Assuming we still want exposure to emerging markets, we can turn around and write puts or simply buy new shares. An index should not rise too much, too fast. We have a loss so far, so tax consequences are minimal.

Emerging-market stocks have recovered a bit this year, up about 6% year-to-date. But catalysts for additional gains appear muted in the near term, with relatively tepid economic data coming from China and oil and other commodity prices depressed. Rather than sell our emerging-market exposure, we're hoping we can earn a North Star-like return using options on it for now.

Skyworks Solutions (SWKS), 3.2% stock allocation

Among these three, Skyworks is the one I'm least enthusiastic to cover, but the scales still tip toward covering it for the next six weeks. Along with **Apple** (NASDAQ: AAPL), analog semiconductor producer Skyworks is in its trough quarter for the year, and it's unlikely that catalysts exist for rapid price appreciation over the coming weeks (famous last words!). If Skyworks *does* shoot skyward, we should be able to roll our covered calls higher fairly easily, given strike-price increments of $2.50 per share and decent premiums. It's a great company and business, but Wall Street still relegates Skyworks to the semiconductor industry, so its stock is likely to remain volatile; we should be able to monetize it further by managing options on it periodically. The business remains healthy and profitable. The only big headwind right now is the iPhone sales slowdown at Apple, its largest customer.

Valmont Industries (VMI), 2.2% stock allocation

Our irrigation-system and steel engineering product company has enjoyed a resurgence in price after its recent quarter showed higher profits on cost-cutting. But management doesn't expect real improvement in its business lines in the foreseeable future. As expertly managed as Valmont is, we might be able to write calls on it consistently, especially between earnings reports, to derive a better return from our investment in these slow-growth (right now) industrial industries (no, that is not redundant!). The stock trades at about 21 times expected earnings for 2016.

Summary

Given *Pro*'s goal of earning monthly income by writing options, our hope is that these three in aggregate will result in additional income in June, and then we'll go from there. If you don't own 100 shares of each, don't sweat it. The income is nice, but owning good, dividend-paying stocks like these should benefit you well over the years, even if you can't write options on them to target near-term gains, too.

More That Matters

- **Maximum gain:** In each case, the stock's upside is capped at our call strike price, and the maximum gain on the covered call is the premium it pays us.
- **Maximum risk:** The full stock value, minus the call premium received.
- **Follow-up**: We hope to see these covered calls expire for income, and then decide our next course of action. If we need, we may roll them higher. Anticipating new buys elsehwere, or the abillity to write puts on these three stocks, we are also content to let our shares get sold if it comes to that.

Options Can Help

- **Want to know more about this strategy?** Our Options U guides to writing covered calls and rolling covered calls can help.
- **Questions about this trade?** To ask particular questions about any of these, please visit either the DGS board, or SWKS board, or VMI board.

What Markets May Come

Published May 2, 2016 at 3:24PM

Fellow Fools,

Positive returns over every rolling three-year period, with the aim of doubling our real purchasing power every 10 years: With such a lofty objective, no one can ever accuse us here at *Pro* of choosing a low hurdle to make our lives easier. Regardless of what the market is doing, our North Star will continue to inch higher, which means that if we want to stand any chance of achieving our objective, it's critical that we post a high batting average (accuracy is our first *Pro* Principle, after all).

There is also a psychological appeal to having a high investing batting average, given that it's all too easy to spend too much time worrying about your losers. Why? Well, as Shawn Anchor notes in his book *Before Happiness*, research has found that our brains are essentially hard-wired to devote more attention to the negative aspects of our lives and respond faster to threats than to good news. If you think about it from an evolutionary standpoint, this makes perfect sense. For most of our species' history, being paranoid was an advantage; it increased your odds of living to see another day. We may no longer have to worry about being a tiger's next meal, but we can still see the effects of this tendency on a daily basis — it's the reason we remember our losers more vividly than our winners, and why we often feel the urge to do something whenever a position starts to go against us.

But despite this psychological appeal and our *Pro* principle of accuracy, there are actually positions in our portfolio that we don't mind seeing in the red. In fact, you could even say there are times we outright *enjoy* seeing certain positions move down. Confused? The key here is the need to look at your portfolio as a, well, portfolio. There are a select few investors in the world who will be able to achieve their financial objectives with the performance of one or two stocks. For the rest of us, it's the performance of our entire portfolio that will determine whether our time spent investing is ultimately a success.

Nobody knows what the future will hold, in the market or elsewhere. In fact, University of Pennsylvania researcher Phil Tetlock found an inverse relationship between the accuracy of an expert's predictions and his or her self-confidence -- keep that in mind the next time you hear or read a pundit weaving a compelling narrative about the actions you need to take because of what the market will do over the next month or two! But as I mentioned, there is one thing we do know here in *Pro*: Our North Star benchmark will continue to push higher over time. This means that if we want to stand a chance of meeting our mandate, we need to construct a *Pro* portfolio that takes into account the wide range of potential outcomes for the market. We can't just sit around and hope the market cooperates over the next three years. This is where our hedges and shorts come into play.

Hedges are designed to deliver profits when the markets are falling, helping soften the blow of lost value in our long positions and providing us with cash we can then use to pick up additional shares of any favorite stocks that might have been unfairly punished during the selloff. That said, though we may feel smart whenever our hedges work out, we're actually better served when they don't, because our long positions vastly outweigh our hedges and shorts. We've recently tried to limit the amount of drag hedges can have on our portfolio by using low-cost option spreads, but the fact remains that it's almost always a good thing when our hedges don't work out, because it means the market (and our long positions) are moving higher.

But what about shorts, you say? To be sure, we aim to only short stocks that we expect to deliver absolute returns during the life of our position. But shorts do serve multiple purposes in our portfolio. As Jeff noted in a Memo from last April:

> 1. Our company shorts also serve as market hedges, as a majority of stocks move together. In a down market, our basket of shorts should benefit the portfolio in most cases. While we wait, ideally our short basket is less costly than shorting the market index would have been. And if we're really good, our shorts in aggregate will fall even in a rising market.
>
> 2. Having a basket of carefully chosen shorts increases our short exposure, which allows us to increase our long exposure. This way we can own more great companies for the long haul while staying true to our absolute-returns goal.

Just as is the case with our hedges, it's hard for us to be too upset when a short position is in the red because the overall market is moving higher. For example, our latest direct short, **Deere** (NYSE: DE), is currently down 13%. But over the same time frame, the S&P 500 is up 9.3%, meaning that our position has currently delivered a negative alpha of just 3.7% -- a percentage that really isn't worth losing sleep over, given that the stock fell 4.2% the last time it reported earnings. We also mentioned in our write-up that shorting Deere made us far more likely to keep our position in **Valmont Industries** (NYSE: VMI), a move that has worked out even better than we expected: Valmont's stock has risen by more than 37% since we published our trade alert on Deere.

Every time we reopen our doors, we find that many of our newest members are eager to jump straight into our hedging and short recommendations after signing up. Before you do so, it's imperative that you establish the proper mindset with these positions. To quote Jeff once again (this time from a conversation between us):

> Anyone hedging -- but also shorting -- has to expect the positions to usually work against them when the market rises. That's why they're called hedges and shorts. They're expected to help you when the market falls. Shorting is difficult even in a flat market, let alone a rising one. That's why most of our future is riding on our longs, and our shorts and hedges are just a small form of insurance against larger-than-average market declines. We want our shorts to all work out, but a strong market can overwhelm a strong short thesis -- a rising tide even lifts the boats with small leaks. So keep your shorts and hedges in context. Don't expect gains from them, usually, during a rebounding market.

It's only natural to want to win when it comes to investing. But when you're managing a portfolio like a *Pro*, it's important that you never forget there are actually instances where not only is it OK to lose -- it's actually beneficial.

Best,

JP

***Pro* Completed Trades**

- **American Tower** (NYSE: AMT): We bought to close our April 29, 2016, $105 diagonal calls for $0.10 on Friday, keeping most of the premium as income. We of course still own our long-term calls on AMT.

Pro Catch-Up Trades: May 2, 2016

Published May 2, 2016 at 3:08PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our Portfolio Building Reports will get you fully invested over the coming few weeks, as much as you want to be.

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Broadridge Financial Services** (NYSE: BR): Buy our 5.1% allocation, at once or in halves if you like.
- **Facebook** (NASDAQ: FB): Buy our 6.6% allocation, in halves if you prefer.
- **MasterCard** (NYSE: MA): Buy up to our 4.7% allocation.

Continue building your portfolio with our Buys, including these highlighted today:

- **Apple** (NASDAQ: AAPL): Buy 3.3% in stock.
- **Gilead Sciences** (NASDAQ: GILD): Buy 3.2% in stock.
- **Medtronic** (NYSE: MDT): Buy 3.2% in stock.
- **Skyworks Solutions** (NASDAQ: SWKS): Buy 3.2% in stock. Keep in mind that Apple is Skyworks' largest customer, and the stocks move together much of the time. We're comfortable with a 6.5% combined allocation to these two mobile computing leaders.
- **Parexel International** (NASDAQ: PRXL): Buy 3.2% in stock.

Options:

- No existing ones right now to jump on. Expect new trade alerts for all members soon.

Hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): We plan to issue a new hedge alert soon. Meanwhile, our June put ratio spread can be set up for no cost if you move your lower strike price up. So, you would sell to open two June 17, 2016, $193 puts for every one June 17, 2016, $200 put you buy. Each $200 put represents a $20,000 short of SPY. Use the trade alert for allocation guidance (again, simply adjusting your lower strike to $193, and still paying nothing to set up each spread). We expect a new, second hedge trade to be issued to all members soon, to complement this existing hedge.

The Extraordinary Power of Compound Returns

Published May 2, 2016 at 10:25AM

A few years ago, Warren Buffett went on CNBC to talk about the stock market. An interviewer asked about the market hitting new milestones — the Dow had just crossed 15,000, and currently trades at about 18,000 — to which Buffett offered a memorable response: "I can remember when the Dow crossed 100."

The CNBC crew sat in stunned disbelief. I remember doing the same. As I write this, the Dow is down about 100 points, which is an unmentionable blip. But the entire index was worth 100 points within Buffett's lifetime. And he's not Methuselah. The Dow traded last below 100 on May 26, 1942. Buffett was 11. A not-insignificant number of Motley Fool members were around to see it as well.

The thought of the Dow trading at 100 blows our minds because, as physicist Albert Bartlett put it, "the greatest shortcoming of the human race is our inability to understand the exponential function." The power of compound returns is so strong it's almost too hard to comprehend.

The Dow rising from 100 to 18,000 in 74 years equates to 7.2% average annual growth, which is in fact below the market's historic average. Growing by 7.2% for another 74 years would leave the Dow just north of 3,000,000 — yes, three million — which astounds me more than the thought of it at 100. A 9% annual growth rate, which is closer to average, means the Dow could be closing in on 10,000,000 by the time my son retires. Plus dividends.

These aren't forecasts, and 75-year extrapolations would only be relevant to pre-kindergartners. But our difficulty comprehending the power of compound growth means realistic calculations lead to mind-bending conclusions.

Apple (NASDAQ: AAPL) is the largest public company in the world, with a market cap of $579 billion. The idea of a company worth half a trillion dollars would have seemed preposterous 20 or 30 years ago; the entire country's GDP didn't surpass $500 billion until 1958, and the largest company in 1980 was **IBM** (NYSE: IBM), worth $39 billion. The largest company growing from $39 billion to $579 billion over 36 years is a 7.8% annual growth rate, which seems quite reasonable. Repeating the performance would mean that 36 years from now, the world's largest company will be worth something close to $9 trillion.This sounds absurd, but so did the idea of a $579 billion company 36 years ago.

Wal-Mart (NYSE: WMT) does $480 billion a year in revenue. A conservative growth rate of 5% a year would mean it (or perhaps an upcoming competitor) will do something like $2 trillion a year in sales within 30 years. That's equal to the current GDP of Russia.
The median American household earns $52,000 a year. For the last century, Americans have increased their productivity (the main driver of economic growth) by an average of 1.8% a year. Similar growth over the next 30 years would lead to median household income of more than $85,000 a year, adjusted for inflation, which is an amount that today would put you in the 94th percentile. Not all productivity growth may accrue to the median household — most economic growth goes to a small number of people, which explains income inequality — but real growth of just 1% a year would allow a median household to earn $70,000 in 30 years, and $82,000 in 50 years, adjusted for inflation. Put differently, the median household when my son is an adult will likely be richer than the top 2% of households were when his grandparents entered the workforce.

U.S. GDP is currently $18 trillion. If the economy grows at the same rate over the next 50 years as it did in the previous 50 — no sure thing, but hardly unreasonable — GDP will rise to half a quadrillion dollars a year within my own life expectancy, and $10 quadrillion within a century.

Again, these aren't forecasts, particularly on the timing. The power of compounding returns means tiny differences in annual gains grow into extraordinary differences over time, which makes predictions all the more difficult.

But in the context of reasonable future goals, compound returns can make your current fears seem minuscule, even irrelevant. A few days after the Dow crossed 100 in 1942, it fell 2.9%, from 106 to 103. This three-point move was a big deal at the time. It's the kind of stuff we'd have special reports for on the nightly news. But three points is 0.01% of today's market — utterly negligible.

To take a more recent example, the Crash of 1987 was one of the biggest market events in history. Every finance textbook talks about it. The Dow fell 508 points during the crash, which was extraordinary back then. But it's roughly the same amount the Dow has gained ... in the past nine days.

To discuss this column, please visit the Philosophy & Strategy discussion board. Fool on!

A Potential Trade on Your Diagonal Call on American Tower

Published Apr 28, 2016 at 1:19PM

Is this for you? This is for all *Pro* members who wrote April 29, 2016, $105 diagonal calls on **American Tower** (NYSE: AMT). If you're a new *Pro* member and you have yet to establish a diagonal call position on American Tower, please ignore this particular alert. If and/or when *Pro* decides to re-establish its diagonal call position after the company reports earnings tomorrow (Friday), new members can join in at that time, when we issue a *new* trade alert instructing you how to do so (likely next week, if we're going to). Remember that all members should already own an unencumbered 3.7% stock allocation to American Tower, so if you have yet to establish the diagonal call, you should still have exposure to the stock's upside.

How You Participate

- **Condition:** If American Tower's stock price is above $105 as Friday's market session nears its close, buy to close your $105 calls. (Leave your owned 2017 or 2018 calls alone. We will keep owning those.)
  - **Trade:** Buy to close your April 29, 2016, $105 written calls.
- **Allocation:** Buy every April 29, 2016, $105 call you previously sold.
  - **Price Guidance:** Use a **limit order** and aim to pay as little time value as possible, but realize you need to close these calls on Friday if the stock is above $105. As of today, since American Tower reports earnings tomorrow, the calls still have about $1 or so in time value that you'll have to pay if you wish to close them. It's more logical to wait until after earnings tomorrow morning, and see where things stand. If the stock is below $105 by the end of Friday, we can let the calls expire as income, doing nothing with them.

- **Prices** (12:30 p.m. ET):
  - Stock: $105.15
  - April 29, 2016, $105 calls (bid/ask): $1.15/$1.30 (by tomorrow this value should be lower, unless of course the stock goes above $105 by more than this amount).
- **Follow-Up:** We're not issuing a rolling trade alert today because rolling may not be possible (and we can't foresee future prices tomorrow -- sorry!); instead, we're waiting until our existing calls are closed before we consider writing new calls on this stock. This will probably be next week or the following week, after we've analyzed Friday's earnings.

What We're Thinking

Since our April 29, 2016, $105 written diagonal calls on American Tower expire on the same day that the company releases earnings, we need to address what to do with our calls if the stock stays above our strike price on expiration day. Since *Pro* itself must wait a day before taking action on its recommendations, we have to issue this alert today if we want to act tomorrow. So here it is.

If luck shines on us, American Tower's stock will be modestly below $105 tomorrow and our written diagonal calls will expire fully as income. If not, and the stock looks like it will end the day above $105, we'll need to take action as detailed above in order to maintain our desired position. We'll buy to close our $105 calls in that case tomorrow, and then reassess the position for a few days, while keeping our 2017 long calls.

How This Trade Fits Into *Pro*

Unless American Tower's stock price declines significantly after the company's earnings report, we're likely to initiate another diagonal call for income before long, again targeting income in between earnings reports (that didn't pan out perfectly this time because AMT chose to announce earnings on Friday rather than in early May, as it often has in years past). We don't want to sell our long call just yet (the underlying stock is rated Buy First on our scorecard), because we see more long-term potential in the business.

Pro Can Help

- **Questions?** Consume data and ask your questions on the American Tower board.

Portfolio Positioning Report: April 27, 2016

Published Apr 27, 2016 at 12:06PM

Welcome | Shorting in Short | Hedging ... in Short | Your Exposure | This Stuff Is Optional
Options Are Optional, Too — but Advised! | About This Report
The Positions Themselves (Shorts, Hedge, Options, All the Rest)

Join our live event at 2 p.m. May 4

Dear *Pro* Member,

Our first three Portfolio Building Reports provided you guidance on all of *Pro*'s Buy First and Buy stocks. This final report will do the same for our active short and option positions, many of which we use as hedges. For reasons we'll explain, we don't expect that many of you will initiate all of the positions in this report right away, or perhaps at all. And that's perfectly fine!

Hedging is about lowering your exposure to the risks of the market; to a lesser extent, shorting is as well. These additional investment tools tweak or adjust the risk profile of your *existing* portfolio, so if you're still building your collection of long-term stocks, concentrate on that for now. Stock investments are the core of the *Pro* portfolio, and by owning *Pro* stocks, you are positioned to compound your value over time. We know there's a learning curve for strategies that are new to you, so it's important you know there's no rush; you can incorporate the positions in this report when you're ready. We're here for you in the meantime.

Before explaining these positions, let's review how each strategy works. We'll begin with shorts — a sort of "anti-investment" that we believe will decline in value, adding profits to our portfolio in the process.

Shorting in Short

When you sell something short, you borrow shares of a company or an ETF from your broker and immediately sell them, collecting the proceeds. At various brokers, this trade action is called "sell short," "sell to open," or just "sell." In the future, you'll need to buy the same number of shares back to replace the ones you borrowed and sold. This second step is called "cover," "buy to cover," or "buy to close." You hope to buy the shares back at a *lower price* than when you opened the position. You profit directly on the position if you are able to close it at a price that's advantageous to you.

The difference between your original sell — or short — price and the price you later pay to buy back (and return) the borrowed shares is your profit. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock rises to $30, you've lost $10 per share when you buy it back. We use shorts in *Pro* because they're one way to profit when the market or a company falls, but they come with their own risks — shares can be hard to borrow, fees are often involved, and a short can get closed on you (you're forced to buy it back) if the broker wants the shares back early. So, we need to size our short positions appropriately small.

Hedging ... in Short

A hedge is similar to a short because it gains value when prices fall, but it's different in intent; these positions are taken to *offset* the risk we have in another position or in our market exposure as a whole. So, when we sell short (or use bearish options on) a market-index proxy like the **SPDR S&P 500** (NYSEMKT: SPY) ETF, we are hedging our exposure to the stock market as a whole. A hedge is a form of insurance; it only pays out when you need it, and usually it won't make money. We *know* a market-index hedge will go up in value whenever the market goes down — and that's nice to know. But most times, the market won't fall (or won't fall enough), and our hedge will go unused.

For this reason, we try to spend very little to hedge, but there are sometimes still costs. We have to reconcile this with the fact that hedging lets us stay *more* invested than we otherwise would, given our goal of absolute positive returns. In other words, one key way we profit from our hedges is by using them to help us keep our long stock exposure higher! As with shorting, you should only hedge if you have specific stock market exposure you want to "hedge out." Recently, *Pro* issued a new market hedge using options on the SPDR S&P 500. Tweaked a bit for today (see below!), that is our current market-hedge recommendation for anyone who wants to hedge out 10% of their long exposure, as we are doing (bringing *Pro* right now to about 65% net long).

Your Exposure

To know whether hedging is for you, it's helpful to think about your stock market exposure. This is simply how much of your total portfolio is invested in long stocks. Excluding options and shorts, *Pro* is about 80% invested in long stocks as we work through quarter one earnings. That's high for an absolute-return portfolio (which is part of why we want to short and hedge!). And like many members, you may own other stocks beyond *Pro*'s, so if you've bought all of our stocks, you might be even more exposed to market risk than we are. We're hedging the *Pro* portfolio down to about 70% market exposure with our SPY hedge (other shorts make up the other 5%, bringing us to the aforementioned 65%), and you could (but do not need to) do the same.

The bottom line is: As you consider adding hedges and shorts to your portfolio, first know how much of your portfolio's assets are invested in stocks. That helps dictate how much shorting or hedging you want to initiate to reach the *net* market exposure you desire. *Pro* has averaged about 73% net long exposure since January 2012, but that number will move up and down as our opportunities change. Our exposure is always shown at the bottom right of the Recommendations page. For many years, I've found that about 72% market exposure, along with the use of options, can be enough to earn strong returns with less risk. The past is no promise of future returns, but we're aiming to continue that success.

This Stuff Is Optional

Not every *Pro* member is comfortable with shorting or hedging, and there are practical considerations to take into account as well. First, you need a margin account to sell short, so (unless you use options to go bearish) you can't do it in an IRA. Second, you have to accept that shorts can run strongly against you, so you need cash to cover that risk. Third, you'll usually pay an annualized fee of anywhere from 1% to 5% of the short's daily value to short something. Fourth, in many cases it's hard to borrow shares to short, period. That is the situation with some of our shorts today. Finally, short shares can be bought away from you at the worst time, when they're up in price (a "forced buy-in"). If brokers can no longer find shares to borrow, you're forced to "buy in" at market prices to return your borrowed shares.

So what to do? You can use options to short in some cases -- we do, and we explain how to do so wherever appropriate. You can also consider opening a brokerage account that is particularly friendly to shorting. Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does, and does not charge a fee for shorting. You could also wait and see whether shares become available in your existing, traditional brokerage account, though note that at many brokers, certain shares are basically never available for shorting. Or, if you're not drawn to it, you don't need to short at all.

Options Are Optional, Too — but Advised!

Our options positions are also ... optional, but we strongly advocate learning to use options and following along with ours over time. Options are powerful tools for income, hedging, greater upside, and more. We know from experience they're well worth the time it takes to learn them, and we're here to help you. Options can make you a much more confident and versatile investor, and they can generate a whole new stream of income for you and your family. So, if you're new to using options, you're in a great place! Use *Motley Fool Pro* and our sister service, *Motley Fool Options* (free for the life of your *Pro* membership!), to learn how to use these great tools. On a personal note, if you're going to learn just one simple strategy, I suggest learning how to write puts (link goes to *Motley Fool Options*) for income or to buy a stock lower.

About This Report

Let's return to the main show. This Portfolio Positioning Report and the special live event and Q&A following it on May 4, will (when you're ready!) help you short vehicles we believe will decline; teach you how to hedge your portfolio; and start to generate returns from options. But keep in mind that this is just a start; we'll have many *brand-new* investment recommendations arriving to your inbox as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way!

On the other hand, if this looks overwhelming right now — or if you're still catching up with our core stock positions — that's perfectly fine. You don't need to start these positions now. As mentioned, long positions are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and often rewarding — aren't necessary to succeed with *Pro* in the long term, let alone immediately. As you learn these strategies and progress with us, just keep your exposure to the stock market in mind.

In closing, I'll stress again that you shouldn't feel pressured to act immediately. We will continue to make recommendations on an ongoing basis, including in our Monday Catch-Up Trades — and as brand-new opportunities emerge. That's part of the fun! So take your time, and make an investment only when you're ready. Finally, please bring any questions to our Making *Pro* Fit You discussion board.

Foolishly,

— Jeff Fischer, *Pro* advisor

The Positions Themselves

Shorts

- Deere & Company (NYSE: DE)
- Direxion Daily Financial Bear 3X Shares ETF (NYSEMKT: FAZ)

Hedge

- SPDR S&P 500 (NYSEMKT: SPY)

Options

- American Tower (NYSE: AMT)

All the Rest (On Hold)

- Caesars Entertainment (NASDAQ: CZR) short
- CurrencyShares Euro Trust (NYSEMKT: FXE) short
- American Airlines (NASDAQ: AAL) calls
- Expeditors International (NASDAQ: EXPD) strangle
- Gentex (NASDAQ: GNTX) short puts
- ProShares UltraShort Real Estate (NYSEMKT: SRS) short
- Wells Fargo (NYSE: WFC) short puts

Shorts

Deere & Company (NYSE: DE): Sell Short

The farm equipment giant just ended a cycle of tremendous sales growth, and now we believe air is coming out of the tires.

Suggested Short Allocation: 2% to match us
(and this assumes you own about 2% in *Pro* stock **Valmont Industries** (NYSE: VMI)

How It Fits Into *Pro*

For More

- *Pro*'s recommendation history
- Talk about DE on our discussion board

We recently sold short shares of Deere & Company because we believe investors are currently overestimating the true normalized earnings power for this farm equipment manufacturer. As JP writes in our recent report, the latest agricultural "super cycle" gave rise to what we believe was an unsustainable increase in farm equipment sales. If we're right, this has positioned John Deere, the world's leading manufacturer of agricultural and forestry equipment, to report disappointing results going forward as the industry works its way back toward equilibrium.

But this short also serves another purpose – it's a low-cost macro hedge that reduces the impact on our portfolio of potential adverse developments in commodities, the U.S. economy, the global economy (both developed and emerging markets), and currency exchange rates. And given Deere's large book of financing receivables (debt owed to it), the stock also serves as a small counterbalance to our sizable exposure to the financial industry. Finally, it directly hedges our 2% long position in Valmont Industries, which also sells farm equipment, namely irrigation machines.

Availability

Interactive Brokers has 6.4 million shares available for shorting as of April 26 – so that should be enough for anyone here, wink wink. The annual fee to short is about 0.5%. Most all brokers should have Deere shares readily available for shorting. Just be ready to lose money on this short/hedge hybrid if Deere runs against us. It's far from a fly-by-night operation. As long as Valmont goes up more than Deere (and so far it has), then this "paired trade" is making us money.

Direxion Daily Financial Bear 3X Shares ETF (NYSEMKT: FAZ): Sell Short

Daily leverage keeps steady downward pressure on this bearish ETF that we're short.

Suggested Short Allocation: 0.3% to 0.6% (we are currently short only 0.3%,
as the position has shrunk nicely, but we may add to it opportunistically)

How It Fits Into *Pro*

For More

- *Pro*'s recommendation history
- Talk about FAZ on our discussion board

This bearish ETF is meant to provide 3 times (300%) the daily *inverse* results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. By shorting this ETF, we're effectively 3 times long, on a daily basis, the U.S. large-cap financial sector, which includes the likes of *Pro* holdings **Wells Fargo** (NYSE: WFC) and **Visa** (NYSE: V).

Leveraged, inverse ETFs like this one are flawed because they rebalance their derivative positions daily in order to maintain a constant exposure. Over long holding periods, the costs involved with rebalancing eat away at returns, keeping downward pressure on the vehicle as a whole. Also, returns are compounded daily, which adds to tracking errors. As our original buy report details, we continue to believe that large-cap U.S. financials are inexpensively priced — and we own several of them as a result. That belief makes shorting this flawed bearish financial ETF all the more attractive.

That said, shorting FAZ has become difficult over the years, and our position size has dwindled severely. We lately have a 78% profit on our short! But similar profits should keep coming over the long haul -- like us, any newcomer to a short can make up to 100% on the short, and no more. So, new short sellers like you are in a fine position as this inverse, short, leveraged ETF can keep going down. That said, new members can skip this position if shorting it proves difficult, or use options instead (see the Alternative Trade below) if you have a six-figure account. We own plenty of strong financial companies serving a similar purpose in the portfolio. You have plenty of exposure to the upside we see in financial leaders if you own our stocks.

Availability

This ETF is hard to borrow. Lately, only 80,000 shares of FAZ were available for shorting at Interactive Brokers at a 6.1% annual fee. Periodically, TD Ameritrade has shares available with no fee. Members have sometimes been "bought in" on their shares at Interactive Brokers, for a forced closing of the short.

Alternative Trade

If you can't short shares directly, then you can set up a synthetic short in a margin account. "Sell to open" January 2018 $40 calls on FAZ, and "buy to open" an equal number of January 2018 $40 puts. Lately you will collect a net credit of about $2 to set this up. This makes you short FAZ with a start price of about $38, and sets you up to profit if FAZ declines in price. Only sell one call for every $3,800 in FAZ you are able to comfortably short. On a $380,000 account, one contract of each option would be a 1% allocation. That's about as much as we recommend.

Eagle-eyed members will notice that *Pro*'s short position on FAZ is 0.3% of our portfolio. We're recommending 0.6% to newcomers because we know you'll be unable to short at least one other position in the *Pro* portfolio, namely SRS (more on that later). There are no IRA-friendly alternatives for this short. If you can't short it at all, you could add between 0.3% and 0.6% to one of our three financial companies — Wells Fargo, MasterCard, or Visa — instead.

Hedge

SPDR S&P 500 (NYSEMKT: SPY): Set Up a Put Ratio Spread

Set up for no cost, this market hedge lowers our exposure to stocks and will pay us if the S&P falls about 4% to 10%.

Suggested Allocation: 10% or so; you would set up one spread for every $200,000 you manage

For More

- *Pro*'s original recommendation (please note, we recommend a higher strike price on the lower of the two put options now -- $192 instead of $190. You'd set up a trade as described, but using $192/$200 strike prices.
- Talk about the SPY hedge on our discussion board

Requiring a margin account, this June put ratio spread we set up last month can still be set up for no cost if you move your lower strike price up a bit. So, "sell to open" two June 17, 2016, $192 puts for every one June 17, 2016, $200 put you "buy to open." Again, this can be set up lately for no cost. Each $200 put represents a $20,000 short of SPY, so you would buy one for every $200,000 you manage, to set up a 10% position. Use the trade alert for more allocation guidance (again, simply adjusting your lower strike to $192, and still paying nothing to set up each spread).

Be aware that we plan to issue a second hedge to all members in future, one that profits if the S&P 500 falls further than this June hedge allows for. The two hedges will work together if the market falls more, the new one picking up where this one leaves off.

Alternative Trade

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:** For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, "buy to open" June 17, 2016, $200 puts and "sell to open" *an equal number* of June 17, 2016, $190 puts. Recently, this will cost you about $1.15 ($115) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $10 ($1,000) per spread on a decline to $190 or any lower price, but you should be prepared to lose your whole $115 per spread if SPY doesn't decline below $200 by expiration.

Options

American Tower (NYSE: AMT): Buy to Open January 2018 $80 Calls

Suggested Allocation: 0.6%

These calls target long-term upside on American Tower, adding to our existing stock holding.

For More

- *Pro*'s original recommendation
- Talk about American Tower on our discussion board

We're recommending 2018 calls on American Tower today, but you may notice that *Pro* owns January 2017 $80 calls instead. We bought them before the 2018 calls were listed, and newcomers should consider buying January *2018* $80 calls, to give the investment thesis more time to play out. *Pro* will likely roll its calls out to 2018 (or potentially 2019 later this year) before they expire in 2017, as long as the investment thesis doesn't change. We're seeking leveraged returns if American Tower stock appreciates by 2017 (or 2018 or 2019).

Because we recently established a diagonal call position (our owned long-dated call, plus an overlaid short-dated written call for income) that expires this week, **our guidance for this position is conditional.** We recommend that you **do not** establish this full position immediately, instead waiting until Friday, April 26, when American Tower reports first-quarter 2016 earnings before the market opens.

- **Condition 1:** On Friday after earnings, American Tower's stock price is above $105 and it looks like *Pro* will need to take action to either close the diagonal call position or roll our written call up and/or out.
  - **Action:** New *Pro* members should wait until *Pro* sends out our official rolling or closing alert on Friday and heed the guidance for new *Pro* members in the "Alternative Trades" section of the alert.
- **Condition 2:** On Friday after earnings, American Tower's stock price is below $105 and it looks like our $105 written calls will expire worthless.
  - **Action:** New *Pro* members can go ahead and buy a 0.6% allocation to American Tower January 2018 $80 calls, using a limit order and aiming for a price near the midpoint of the bid/ask spread.

A 0.6% allocation at current prices most closely equates to buying one call for every $450,000 or so you manage. This is a small position by design, so be careful not to over-allocate to the calls; you already own the stock, after all! We may seek to add more to our position later, though, if volatility provides us with lower prices. Members for whom one contract would over-allocate their portfolios can consider buying 0.6% more in stock, bringing your stake to approximately 4.3%. Realize you won't benefit from the leverage the calls will provide, although you will have a better breakeven price and no expiration.

All the Rest of *Pro*'s Positions

As a *Pro* member with an especially keen eye (and great memory!), you will note that we haven't updated you on *every* position in the portfolio yet. Pricing opportunities being what they are and with expirations right around the corner, not all of our positions are primed for new action right now, and not all options positions are timely. Worry not. We will publish Catch-Up Trades when we see new *Pro* opportunities on existing positions, and many of our positions will require upkeep in the form of a whole new alert emailed to everyone, so you can get on board then! One by one, it won't take us long to get there. Here's the status on our remaining positions that are currently "on pause for newcomers" — either on hold or not timely.

American Airlines (NASDAQ: AAL)

Long January $35 2017 calls on hold

Last year, we bought call options to profit on a rising, very inexpensive airline stock. Instead, our first foray into an industry fraught with a legacy of failure is, so far, failing. Our calls are down about 74%, and we're not sure how much longer we'll give them. American Airlines just reported earnings this week that came with lackluster guidance on key metrics, and with our expiration about eight months away, we may soon take our remaining money and go home, tail between our legs. Airlines are not a typical *Pro* investment, which is why we used low-cost call options to dip our toe in the water. So far, color us burned. If the winds change and we believe new members should get on board, we'll alert you. But for now, steer clear.

Caesars Entertainment (NASDAQ: CZR)

Short on hold

Pro is short shares of America's largest casino operator, **Caesars Entertaiment** (NASDAQ: CZR), which has put one of its units into bankruptcy proceedings. The stock is volatile -- we booked a 35% profit on half of our short last year, and our remaining short shares show a 40% profit of late. The outcome of this short position is partly dependent on the courts; lawsuits from large investors are being weighed, but operationally the business (shed temporarily of some debt on the books, and split into new units) is looking better. The court is dragging its heels on proceedings, so we're deciding whether we want to stay short or take our gains and move on. This makes us comfortable telling new members to hold off – wait and see what we decide. If we stay short, we'll tell you, and you can short shares then.

CurrencyShares Euro Trust (NYSEMKT: FXE)

Short on hold

We've been short the euro against the dollar since late 2011. We view this position as a quiet anti-investment; the risk to us is relatively known (and reasonable), and the profit potential remains worth pursuing. As the euro has declined from about $1.30 to a recent $1.10 to the dollar, we currently have a 15% profit on the position. But we pay fees to keep this short, and with interest rates now unlikely to rise quickly in the U.S., the dollar may not strengthen much more against the euro anytime soon. So we are considering closing this short position. Earnings results (taking place right now) may help us to consider how the Fed may act next regarding interest rates, which may help us decide what to do with this currency short. We should have a decision in May and will let you know! If we move from Hold back to Short, you can get on board.

Expeditors International (NASDAQ: EXPD)

Synthetic covered strangle on hold

Shares of shipper Expeditors International have run up sharply the past few months. Our synthetic long expires next January, but we'll have to address our May covered strangle before then. These options were written for income and will need to be rolled to higher strike prices. When we do that by the May expiration, we'll guide newcomers on exactly how to set this income position up.

Gentex

Puts on track to expire

Pro has written May 2016 $15 puts that, if exercised, would have us add about 1.5% in stock to our **Gentex** (NASDAQ: GNTX) position. The goal with these puts is to earn income and potentially add to our existing stock position at lower prices. Since this position is just a few weeks from expiration, we don't recommend that new members join us now. We'll aim to write puts again whenever we see good pricing after these expire -- and at that point all members can join in.

ProShares UltraShort Real Estate

Short on hold

We have a small (0.3%) short remaining in the **ProShares UltraShort Real Estate ETF** (NYSEMKT: SRS). We enjoy watching its slow descent in price, but the ETF only has $36 million in assets now, making it too small to recommend to new members. Plus, outside of our broker (Interactive Brokers), it appears impossible to borrow shares to sell short now — and if you do find them, the annual percentage fee to short is high (recently 5% at IB). Instead, as shared above, we recommend that you sell short 0.6% in FAZ as a long-term alternate. Or just sit this small position out.

Wells Fargo

Puts on track to be assigned

Our $52.50 written puts on **Wells Fargo** (NYSE: WFC) expire in May, and with the stock currently trading slightly below $51 per share, our puts are in-the-money. If current pricing stands and we do not take action, *Pro* will be assigned on its written puts, adding about 1.5% to our Wells Fargo stock allocation. New members are advised not to set up this position yet and to wait for an official follow-up alert from *Pro*.

Within the next few weeks (and dependent upon the price action of Wells Fargo stock), *Pro* will either roll our puts out to a later month -- targeting further income -- or we will let the puts expire and accept shares to increase our stock allocation. If we roll our puts out to a later month, new *Pro* members can write the new puts alongside us (there will be specific guidance for new members in the "Alternative Trades" section of the alert). If we accept new shares of Wells Fargo, new *Pro* members can add 1.5% to their stock allocation **if and when *Pro* does so via assignment of its written puts.**

In Conclusion

We'll likely recommend some of these positions (except the SRS short) to new members once we reaffirm that there's sufficient opportunity still afoot, when pricing improves, or after our options expire. Just watch your inbox for official trade alerts! Also, Monday's Catch-Up Trades could pertain to a few of these.

At the same time, we're not standing still. In this and our three previous Portfolio Building Reports, you have many great *Pro* investments -- all rated Buy First or Buy -- to move into. And of course, we'll continue to send brand-new investment recommendations to all members.

It's not vital that your portfolio be 100% identical to ours (many members deviate considerably), but by becoming familiar with how we invest, learning the strategies we use that you can also employ, and owning many of our core stocks, you should be positioned to succeed well with *Pro* over the time frame that matters. Meanwhile, if you're new to shorts, hedges, and options, start to dip your toes in as your comfort allows. We're here to help, and we believe you'll see many, many great benefits as the years unfold.

Fool on!

The *Pro* team:

— Jeff (TMFFischer), Ellen (TMFKabellen), Billy (TMFBillytheKid), JP (TMFYossarian)

Pro Catch-Up Trades: April 25, 2016

Published Apr 25, 2016 at 2:56PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and all of our stocks are rated Buy; the portfolio is meant to work together as a whole.*

New members: Keep in mind, our Portfolio Building Reports will get you fully invested over the coming few weeks, as much as you want to be.

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Broadridge Financial Services** (NYSE: BR): Buy our 5% allocation, at once or in halves if you like. Earnings are due May 5, but with high recurring revenue, results don't often shock.
- **Facebook** (NASDAQ: FB): Start to buy our 6.1% allocation in thirds -- but note that Facebook reports earnings Wednesday, so time your first purchase with whatever makes you comfortable.
- **Gentex** (NASDAQ: GNTX): Buy up to 2.8% in stock. Earnings were last week.
- **Oracle** (NYSE: ORCL): Buy up to 3.8%, or buy in halves. Earnings were last month (here's our review).
- **Wells Fargo** (NYSE: WFC): Buy 3.4% in stock. Earnings are already out.

Continue building your portfolio with our Buys, including these highlighted today:

- **Papa John's International** (NASDAQ: PZZA), buy 2.7% in stock.
- **Skyworks Solutions** (NASDAQ: SWKS), buy 3.3% in stock. Earnings from Apple (a major customer) are due this week. Expect choppiness, as ever.
- **TD Ameritrade** (NASDAQ: AMTD), buy 2.5% in stock.
- **Visa** (NYSE: V), buy 2.5% in stock.

Options:

- No existing ones right now to jump on. Our upcoming Positioning Report may have some, and new ones will be issued as Trade Alerts.

Hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): We plan to issue a new hedge alert soon. Meanwhile, our June put ratio spread can still be set up for no cost if you move your lower strike price up. So, you would sell to open two June 17, 2016, $192 puts for every one June 17, 2016, $200 put you buy. Each $200 put represents a $20,000 short of SPY. Use the trade alert for allocation guidance (again, simply adjusting your lower strike to $192, and still paying nothing to set up each spread). New members, keep in mind our Positioning Report and Event to come in the next week or so. You could wait for those if you wish. These hedges actually pay you more to set them up if the market initially falls, and they won't help us until expiration anyway.

Our most recent short:

- **Deere & Company** (NYSE: DE): Sell short (sell to open) 1.9% worth of shares per our recommendation. Keep in mind, this is also a hedge on our **Valmont Industries** (NYSE: VMI) stock position, which recently jumped on earnings.

Wells Fargo Chugs Along Despite Higher Oil and Gas Losses

Published Apr 25, 2016 at 2:52PM

Wells Fargo (NYSE: WFC)

Updated Guidance: Buy First (no change)

Recommended Allocation: 3.4% with a 1.4% look-through allocation in May 2016 $52.50 puts

Fair-Value estimate: $58 (no change)

Current Price: $50.34

What Happened?

- Q1-2016 press release
- Q1-2016 financial supplement

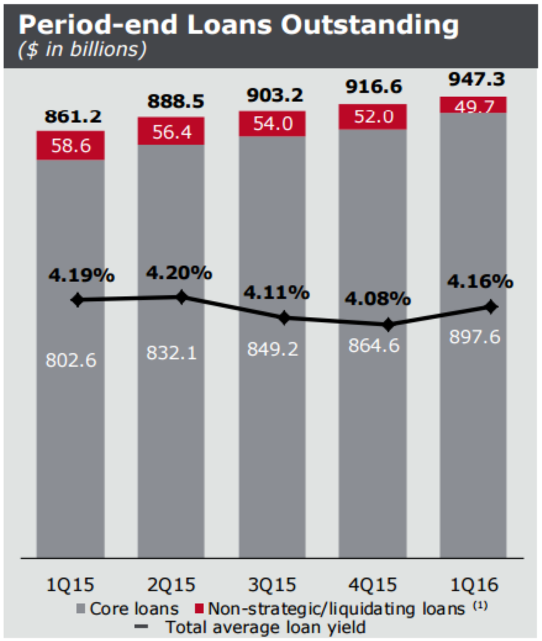
So What?

The 3 key items that I watch for Wells Fargo:

- Growth (or lack thereof) in core loans and deposits
- Trends in credit quality (as monitored via net charge-offs and reserving policy)
- Trends in the efficiency ratio and expense reduction

1) Growth in loans and deposits

I track core loan growth rather than total loan growth because this metric excludes the distortion from the small and shrinking non-strategic/liquidating loan portfolio (which is mostly a vestige from the Wachovia acquisition made during the 2007-2008 financial crisis):

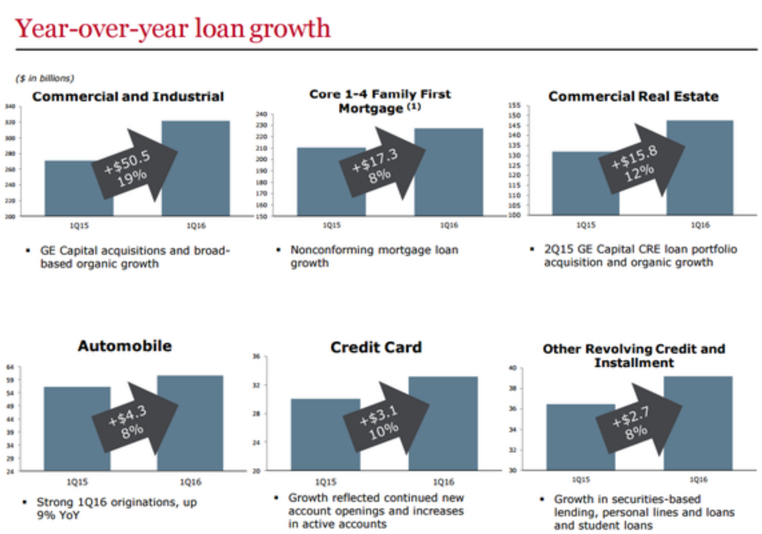


Source: WFC 1Q16 Quarterly Supplement

Organic core loan growth for the quarter accelerated slightly compared to last quarter's 7.8% growth year-over-year, coming in at a solid +8%. When including the $30.8 billion in loans and leases acquired from GE Capital, core loan growth came in at 11.8%:

Source: Company filings, analyst calculations. Dashed line shows growth including the loans acquired from GE Capital (i.e. "inorganic" growth).

There was particular strength in commercial & industrial loans, commercial real estate loans, and credit card balances:



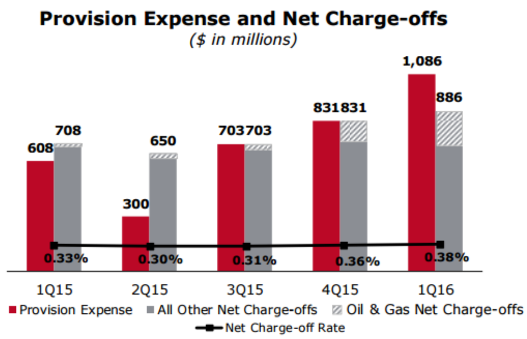
As for deposits, Wells continues to perform well. The company achieved 3.8% year-over-year growth in total average deposits, and 7.3% year-over-year growth in consumer and small business banking deposits. Consumer and small business banking deposits comprise about 59% of total deposits. Funding costs increased a bit to a still-low rate of 0.10%, up from 0.08% last quarter, driven by increased short-term interest rates and commercial deposits.

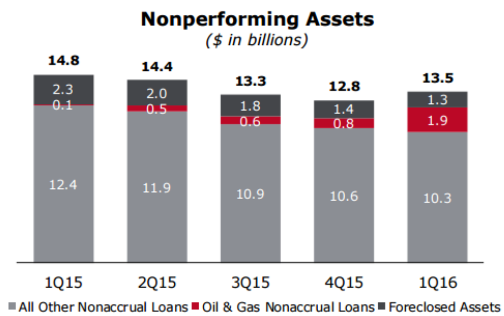
The company's ability to grow deposits meaningfully at a very low cost is perhaps the company's biggest structural competitive advantage. Wells is able to do this by having a nationwide presence with significant geographic density in most markets, optimizing distribution via newer channels (mobile/technology), and strong customer relationship management and product cross-sell achieved via a consistent culture that has been a hallmark of the company for decades.

Net interest margin declined slightly, coming in at 2.90% vs 2.92% last quarter and 2.95% a year ago. The net interest margin is unlikely to meaningfully increase until long-term interest rates rise (who knows when that will happen).

2) Trends in credit quality

Credit quality showed a third straight quarter of sequential decline, with net charge-offs as a percent of total average loans increasing to 0.38% (from 0.36% last quarter, and 0.31% the quarter before). Lower is better. Despite the slight increase, this charge-off rate is still very low and below historical averages. High credit quality has been a consistent theme of the current credit cycle as banks have cut down on risk in response to the turmoil of the 2008-2009 financial crisis.



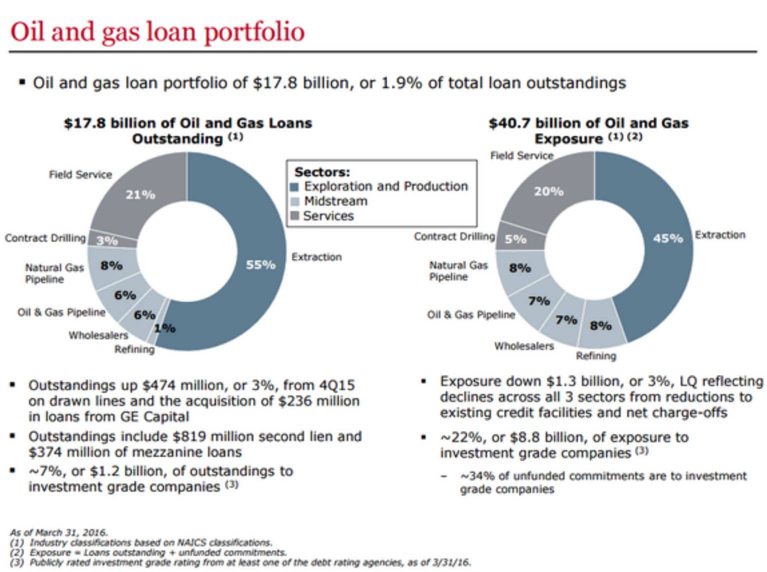


Source: WFC 1Q16 Quarterly Supplement

The reason for the sequential declines in credit quality is the company's exposure to oil & gas loans. Credit quality in the oil & gas industry has decreased over the past year alongside the concurrent decline in the price of oil.

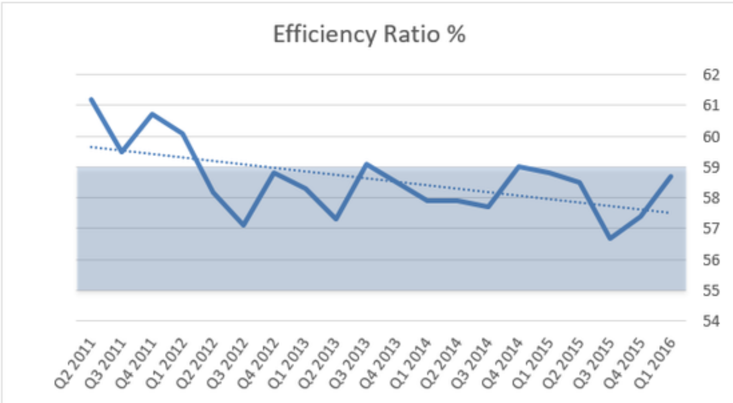
Wells charged off $204 million in its oil & gas loan portfolio in Q1 2016, up from $118 million last quarter. Oil and gas nonaccrual loans (loans where the full and timely collection of interest or principal is uncertain) came in at $1.9 billion, up from $843 million last quarter, working out to about 10.7% of the company's total energy loan portfolio.

However, over 90% of the company's nonaccrual oil and gas loans were current on interest payment, and "substantially all" of the company's oil & gas nonaccruals are senior secured loans. The company has $1.7 billion in reserves on oil & gas loans, which based on a $17.8 billion portfolio works out to a 9.3% reserve rate. The company's entire subset of outstanding oil & gas loans accounts for 1.9% of total loans outstanding. The company's declining credit quality in the oil & gas portfolio is not exactly welcome, but it is certainly not a dire threat to the company's business:



3) Trends in the efficiency ratio

The efficiency ratio (a measure of the bank's overhead costs as a % of its revenue -- lower is better) came in at 58.7%, up from 57.4% last quarter but down from 58.8% a year ago. The efficiency ratio is at the high end of management's target range of 55-59% (blue shaded area in graph):



Source: Company filings.

Management has indicated that they expect the efficiency ratio in 2016 to come in at the high end of their target range, unless interest rates increase faster than expected. The company continues to invest in product development and compliance / risk management technology, including cyber-related spending.

Now What?

All in all, Wells Fargo continues to do what it does best -- steadily grow loans and deposits, and generate a lot of profit. The company's diverse operating model shields it from difficulties in any one particular segment, and this revenue and profit diversity (alongside the company's hallmark conservatism relative to peers) helps Wells Fargo produce consistent results even as the macroeconomic environment shifts and fluctuates.

From our long-term view, underlying business results remain strong, the core earnings power of the business remains intact and is poised for positive operating leverage if and when interest rates and lending spreads rise, and the company's capital return program continues to benefit shareholders. At $50.62 per share, the company yields 3% and trades at 1.46x a growing book value.

Guidance Update

After incorporating this quarter's results into our model, **our Fair Value estimate remains unchanged at $58 per share** (representing a 1.68x P/B multiple), about 15% higher than the current price. Wells Fargo remains a Buy First on our scorecard with a 3.4% allocation and a 1.4% look-through allocation to May 2016 $52.50 written puts. Those who have yet to fill out their stock allocation in this long-term compounder should feel comfortable doing so at current price levels. And if you've yet to match our written put allocation, I'd wait for our Portfolio Positioning Report set to be released on April 27th, which will detail our shorts/options/hedges, and will be available here.

Fool on!

Billy

If you have questions, drive your stagecoach over to the Wells Fargo discussion board.

TD Ameritrade Experiences Record Trading Activity During a Volatile Quarter

Published Apr 25, 2016 at 2:52PM

Pro's Take: AMTD Fiscal Q2-2016 Earnings

TD Ameritrade (NASDAQ: AMTD)

What Happened?

- Fiscal Q2-2016 press release
- Fiscal Q2-2016 earnings presentation
- Fiscal Q2-2016 earnings call transcript

President and CEO Fred Tomczyk:

> "We continue to execute well, resulting in solid quarterly performances for each of our major revenue streams. Over what was a volatile quarter for the markets, we gathered $14 billion in net new client assets and helped our clients place a record 509,000 trades per day, on average."

Guidance Update

After incorporating this quarter's results into our model, **our Fair Value estimate remains unchanged at $35 per share**. This valuation does assume a slow increase in interest rates over the next several years, so in the absence of that occurrence, the company may be challenged to grow earnings and the stock price may stagnate. The stock has bounced back strongly since February -- up almost 30% from its 52-week low of $24.88 just a few months ago during a time of increased market volatility and investor speculation about the timing of future interest rate increases. The stock may experience further volatility this week as the Federal Reserve is set to release a statement on Wednesday.

Updated guidance: Buy (no change)

Recommended Allocation: 2.5%

Fair-value estimate: $35 (no change)

Current price: $31.62

The Numbers

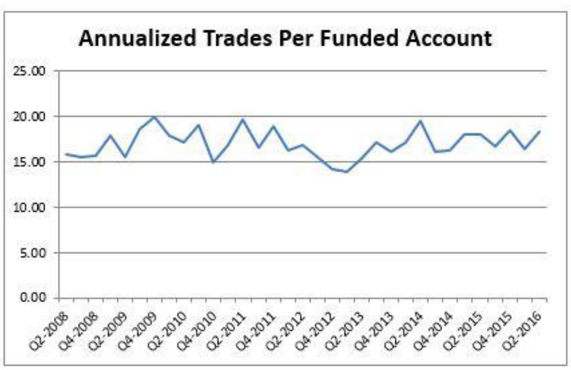
- Record net revenue of $846 million (+5.4% year-over-year)
  - **Transaction-based**:
    - Funded accounts grew to 6.77 million (+4.8% year-over-year)
    - Trades per funded account of 4.59 (vs. 4.13 last quarter vs. 4.50 a year ago)
    - Average commissions and fees per trade of $11.60 (vs. $11.90 last quarter vs. $12.03 a year ago)
    - Totals up to:
      - 6,777,000 x 4.59 x $11.60 = **$361 million** in transaction-based revenue (+2.9% year-over-year)
  - **Spread-based**:
    - Total spread-based revenue of **$382 million** (+7.9% year-over-year)
    - Average spread-based balance of $105.8 billion (+12.2% year-over-year)
    - Thus, Net Interest Margin (NIM) =
      - $382 million / $105.8 billion = 0.361% (quarterly)
      - NIM (annualized) = 0.361% x 4 = 1.44% (vs. 1.49% last quarter vs. 1.50% a year ago)
  - **Fee-based**:
    - Fee-based revenue of $88 million (+3.5% year-over-year)
    - Average fee-based balance of $153.1 billion (-1.3% year-over-year)
    - Thus, Investment Product Fee Yield =
      - $88million / $153.1 billion = 0.057% (quarterly)
      - Investment Product Fee Yield (annualized) = 0.057% x 4 = 0.230% (vs. 0.232% last quarter vs. 0.219% a year ago)
- Record client assets of $711 billion (+2% year-over-year)
- Record interest rate sensitive assets of $112 billion (+11% year-over-year)
- Net new client assets* of $14.1 billion (8% annualized growth rate)
- Diluted EPS of $0.38 per share (+10.9% year-over-year)
- Trailing-12-month (TTM) average return on equity (ROE) of 17% (up from 16.8% a year ago)
- Capital management:
  - Paid $0.17 per share in cash dividends in the quarter (a 2.1% yield on the current share price)
  - Repurchased approximately 8 million shares of its common stock at an average share price of about $28.78 per share ($231 million)
  - Declared a $0.17-per-share quarterly cash dividend (an increase of 13% year-over-year), payable on May 17 to all holders of record of common stock as of May 3.

*excludes changes in client assets due to market fluctuations

Analysis

TD Ameritrade posted a decent quarter for asset gathering in its fiscal Q2-2016, with net new assets (NNAs) up $14.1 billion billion, an 8% annualized growth rate relative to total client assets at the beginning of the quarter. The company's Fiscal 2016 and long-term goal is to grow net new assets at a rate between 7-11%, and this quarter is within that range, but below the 10%+ NNA growth we've seen over the last several years.

The company saw record trading activity during Fiscal Q2-2016, with a record average client trades per day of 509,000 up 7% year-over-year. Trading activity was particularly high in the volatile month of January. During the quarter, there were 16 days with intraday volatility of at least 2%, and 42 days with intraday volatility of at least 1%. This volatility drives increased trades per account:



Source: Company filings and analyst calculations.

Average commissions and fees per trade came in at $11.60, which is down -2.5% sequentially and down -3.6% year-over-year. Management continues to focus on product mix to explain this pressure on commission rates, noting that a higher mix of institutional trades (which is a lower revenue per trade product) and fewer contracts per option trade (due to a higher VIX) are to blame.

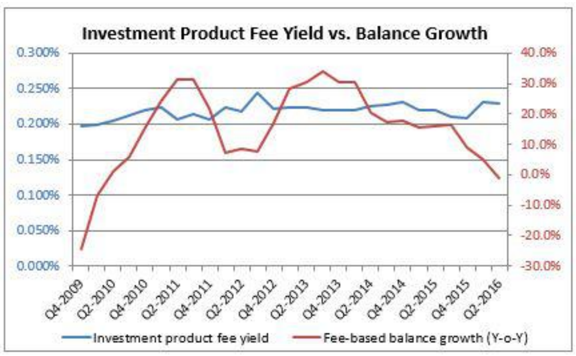
I'm not convinced that mix is the predominant factor in reduced commission rates. The metric is probably also influenced by the emergence of very low-cost brokers (e.g. Robinhood, Interactive Brokers). The commission rate has begun to decline below the low end of the company's recent historical range, but this is not too much of a concern in terms of our assessment of the business, as our valuation assumes a steady decline in commissions and fees per trade over the next ten years:

Source: Company filings and analyst calculations.

The company's record trading activity was partially offset by the lower commissions and fees per trade, and as a result transaction-based revenue increased +2.9% year-over-year. In the short-term, the transaction-based revenue stream will likely continue to bounce around, varying based upon product mix, market volatility, and fluctuations in the commission rate. But over the long run, steady account growth (a 4.4% CAGR over the last 8 years) has led to persistent upward pressure on transaction-based revenue, and that trend seems likely to continue.

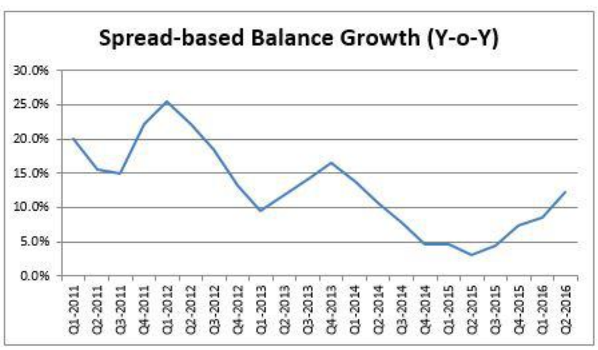
The fee-based segment of the business had a decent quarter, with fee-based revenue up +3.5% year-over-year. The company's fee-based investment balances ended the quarter at a record $161 billion, but the average balance during the quarter was significantly lower, reflecting the market pullback in January and Feburary that later recovered in March.

I wrote last quarter that "the average fee-based balance should decline alongside declines in the market" and that's exactly what we saw. But on the flip side, for next quarter, if the market doesn't experience another pullback, we should see an increase in the fee-based revenue stream as higher market levels support a higher average fee-based balance throughout the quarter:



Source: Company filings and analyst calculations.

As for the spread-based portion of the business, the rate of growth in the spread-based balance accelerated yet again this quarter:



Source: Company filings and analyst calculations

This portion of the business is the one that's sensitive to interest rate changes, so it's nice to see continued acceleration of growth in one of the company's key value drivers. We'll continue to watch this metric over time to make sure it's staying on track, especially now that the first Federal Reserve rate hike has occurred and future additional rate hikes are expected. Spread-based revenue will likely increase throughout 2016 compared to 2015 due to higher spread-based balances and higher yields on earning assets. However, IDA yield growth will be dampened slightly by an increase to the FDIC deposit insurance fund which will begin in July, increasing the FDIC fee TD Ameritrade pays on its insured deposit account agreement with TD Bank.

What We Think Now

TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and as interest rates increase, the company is positioned to grow earnings sharply.

If you have questions, post them on our TD Ameritrade discussion board.

Gentex's Market Penetration Continues

Published Apr 25, 2016 at 2:52PM

***Pro*'s Take: GNTX Q1-2016 Earnings**

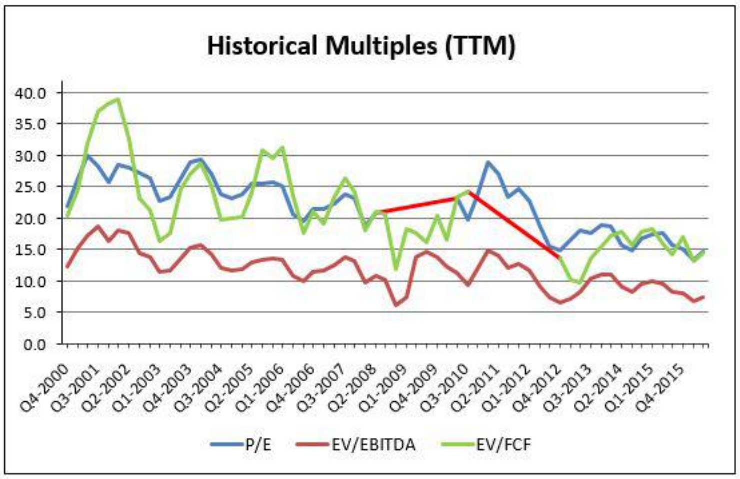
Gentex (NASDAQ: GNTX)

What Happened?

- Q1-2016 press release

Guidance Update

After incorporating this quarter's results into my model, **our Fair Value estimate remains unchanged at $18 per share.** With the stock trading more than 10% below our FV estimate, **Gentex remains a Buy First** on our scorecard. At about 14.5 times trailing-12-month earnings and 7.5 times EV/EBITDA, the company is trading at valuation levels that are about as low as they've been throughout its history despite a robust balance sheet, steady operating performance, and continued success in market penetration and organic growth. If you've yet to start a position or fill out your stock allocation in Gentex, now is a great time.



We also have a 1.5% look-through allocation in May 2016 $15 written puts. Those puts are on track to expire fully as income (as did our two prior iterations of Gentex puts we wrote in August and December 2015), although we are still a few weeks away from expiration. If you've yet to match our written put allocation, I'd wait for our Portfolio Positioning Report set to be released on April 27th, which will detail our shorts/options/hedges, and will be available here.

Updated Guidance: Buy First (no change)

Recommended Allocation: 2.8% with a 1.5% look-through allocation in May 2016 $15 puts

Fair-Value Estimate: $18 (unchanged)

Current Price: $15.95

Our Thesis

Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1) Penetration: Unit growth vs. auto production. Over time, we want to see Gentex's auto-dimming mirrors to continue to gain market share. If the company is increasing units sold faster than auto production, it is moving in the right direction. Quarterly global interior mirror unit volumes grew strongly to +13.6% year-over-year growth (decelerating a bit from +16.2% a quarter ago) vs. ~1% year-over-year growth in auto production in the company's primary markets, showing that Gentex continues to significantly outpace vehicle production growth and capture market share. Q1-2016 interior units sold in North America accelerated to +11.6% (up from +7% last quarter) and Q1-2016 international interior units increased +14.7% (down from +22.1% last quarter).

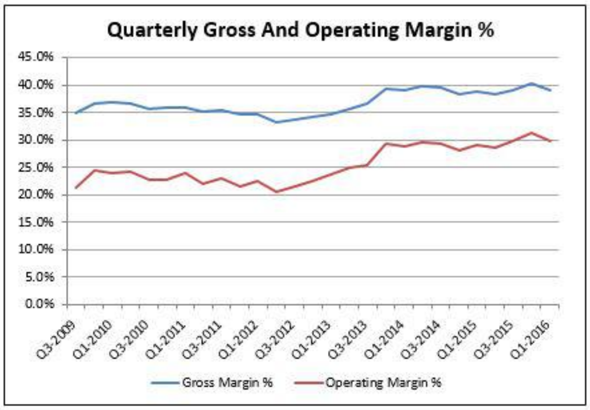
Exterior mirror unit shipments have taken a bit of a breather after a scorching 2015, with Q1-2016 exterior unit volumes up +16.8% in North America (vs. 33.7% last quarter) and +0.4% internationally (vs. 12.8% last quarter). Due to lower exterior unit growth relative to interior unit growth, the exterior mirror attach rate declined to 38.3% (i.e. 38.3% of cars equipped with interior units also were equipped with exterior units), compared with 41.2% a year ago. The deceleration of growth in exterior units can be explained by a difficult comparison to the year-ago period, as exterior unit volumes are still growing nicely and are a key growth driver for Gentex. Compared to Q1-2014 (2 years ago), global exterior unit volumes are up 29.7% (a 14% 2-year compound annual growth rate). Exterior unit growth in 2016 will likely continue to lag 2015's growth rates as demand builds back up, but the overall trajectory of exterior unit growth is sound and market penetration continues.

2) Pricing and value: Unit growth vs. automotive segment sales. Powerful auto makers force annual price concessions on their suppliers, and Gentex isn't immune. Price reductions have recently been in the range of 2.5% to 3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices (ASPs) and gross margins.

In Q1-2016, total units (interior + exterior mirrors) increased +11.3% and automotive segment sales were up +9.2%. This dynamic suggests lower ARPU (average revenue per unit) and is consistent with the expectation of annual price concessions.

3) Margin performance. In Q1-2016, gross margin was 39.1%, up from 38.8% a year ago as annual price reductions were more than offset by purchasing cost reductions and fixed overhead cost leverage. The company expects full year 2016 margins to come in between 38.5%-39.5%, so this quarter's result was right in the middle of that range. Now that annual price reductions have lapped (about 70-80% of annual customer price reductions take effect on January 1), gross margin may have some upside in the latter half of the year since the company experienced elevated expenses in 2015 due to launch costs and worker overtime.

Q1-2016 operating margin performance was 29.8% (vs. 29.2% in Q1-2015). Selling, general, and administrative (SG&A) and research and development (R&D) expenses cam in within normal ranges and are consistent with recent trends:



What We Think Now

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

If you have questions, drive on over to the Gentex discussion board.

Earnings News From 3 Pro Companies

Published Apr 25, 2016 at 2:35PM

Dear *Pro* Fools,

It's that time again -- earnings season! Your *Pro* team has been working hard to analyze our companies' recent earnings reports, and in this Memo I'll take the opportunity to update you on three of the companies I cover for the portfolio: **Gentex** (NASDAQ: GNTX), **TD Ameritrade** (NASDAQ: AMTD), and **Wells Fargo** (NYSE: WFC).

I'll give a quick overview of each company, summarizing results and recapping our investment theses now that I've had a chance to dig into the numbers and monitor business progress. **All three positions remain active holdings on our scorecard for new and veteran members alike.**

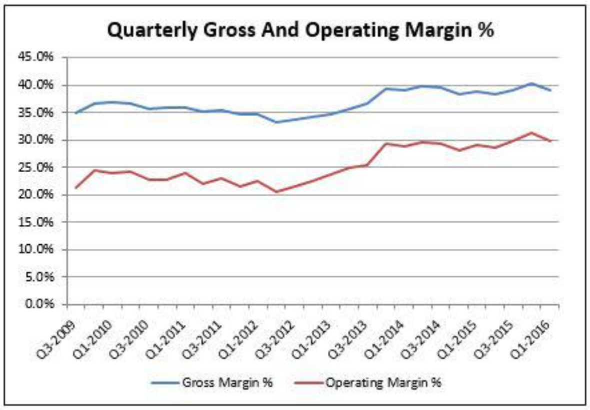
The Results

Gentex

GENTEX
CORPORATION

After a strong close to 2015, our mirror maker followed up with an excellent first-quarter 2016. The company posted 10% year-over-year net revenue growth, 7% EPS growth, and total mirror unit growth (interior and exterior) of 11%. The strong unit growth was achieved despite just a 1% increase in worldwide light vehicle production, so we know Gentex continues to gain market share.

The company's margin performance is sound, with slight year-over-year increases in gross and operating margins relative to last year's first quarter:



Gentex's strong profitability and cash generation have led to a rising cash balance. The company now has $2.39 per share in net cash and investments on the balance sheet (about 15% of the current share price). In addition to the $0.085 regular dividend in the quarter (a 2.1% forward yield on the current share price), management continued its recent string of share repurchases, buying back about $44 million worth of shares in the quarter at an average price of $14.27. This marks seven straight quarters of share buybacks for the company, and as cash piles up on the balance sheet, management appears to be more willing to pursue buybacks as a capital allocation strategy. I view these continued buybacks as a signal of confidence from management, and with Gentex shares trading at historically low multiples and below our estimate of fair value, I think the buybacks are a strong capital allocation decision.

As for *Pro*'s position, we own a 2.8% allocation and have a 1.5% look-through allocation to $15 puts that expire in a few weeks. **Gentex remains a Buy First, and members who have yet to fill out their stock allocation should feel comfortable purchasing shares at current prices.** As for the written put allocation, if you've yet to match us, I'd wait for an update in our Portfolio Positioning Report, which will be released on April 27. There, we will cover our outstanding shorts, options, and hedges. See a full write-up on the quarter here.

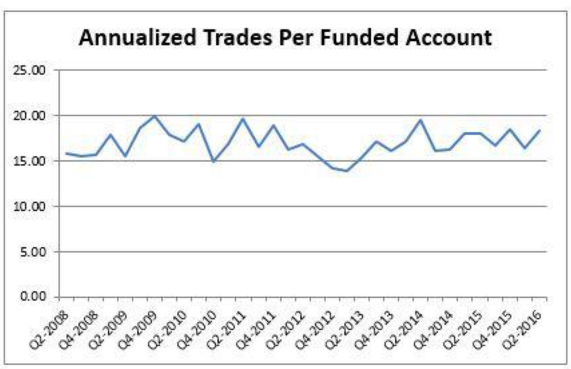
TD Ameritrade

TD Ameritrade

TD Ameritrade delivered a solid second quarter (its fiscal year begins in September of the previous year), boasting record client assets of $711 billion and record quarter-end fee-based investment balances of $161 billion. The company upped net revenue by 5% year-over-year and increased earnings per share (EPS) by 11% year-over-year as operating margins increased relative to the year-ago period.

Underlying business trends at TD Ameritrade are solid. This business is doing what it's done for a long time – gathering assets at a healthy pace, stimulating higher trading activity through its award-winning platforms, and augmenting its transaction- and spread-based revenue with a growing fee-based business.

The company saw a record quarter for trading activity, with annualized trades per account at the higher end of its historical range ...



... but falling commissions and fees per trade led to modest growth (+3%) in transaction-based revenue as higher activity was offset slightly by lower pricing:

Overall, despite lumpy quarter-to-quarter results, TD Ameritrade continues to steadily increase its earnings power while maintaining strong upside to rising interest rates. Meanwhile, we benefit from a stable (and growing) regular dividend, occasional special dividends, and share buybacks. There's no change to our $35 fair-value estimate, and the stock **remains a Buy on our scorecard with a 2.5% allocation**. **Members who have yet to match our allocation can feel comfortable doing so at current prices.** See a full write-up on the quarter here.

Wells Fargo

In the first quarter of 2016, Wells Fargo continues to do what it does best -- steadily increase loans and deposits, and generate a lot of profit. The company reported organic core loan growth of 8% (11.8% if we include acquired loans and leases from GE Capital), and deposit growth was 3.8% (7.3% for consumer and small business banking deposits). Wells Fargo generated $5.5 billion in net earnings, the 14th consecutive quarter of quarterly earnings higher than $5 billion; it's one of only two companies in the country to have achieved this, with the other being fellow *Pro* holding **Apple** (NASDAQ: AAPL).

Credit quality declined slightly as the performance of the company's oil and gas loan portfolio continues to decrease. However, the company has increased reserves to account for worsening performance, and oil and gas loans account for just 1.9% of total loans outstanding. The company's declining credit quality in the oil and gas portfolio is not exactly welcome, but it is certainly not a dire threat to Wells Fargo's business.

In our long-term view:

- Underlying business results remain strong.
- The core earnings power of the business remains intact and is poised for positive operating leverage if and when interest rates and lending spreads rise.
- The company's capital return program continues to benefit shareholders.

At recent prices, the company yields 3% and trades at about 1.46 times book value, which is growing. Our fair-value estimate remains unchanged at $58, and **shares remain a Buy First with a 3.4% stock allocation** and a 1.4% look-through allocation to $52.50 puts that expire in a few weeks. As for the written put allocation: As with Gentex, if you're not yet caught up here, I'd wait for an update in our Portfolio Positioning Report on April 27. There, we will cover our outstanding shorts, options, and hedges. See a full write-up on Wells Fargo's quarter here.

The *Pro* Bottom Line

In summary, after going through results and updating our valuation models, the status of these three companies remains unchanged:

- **Gentex:** No change to fair-value estimate; shares remain a Buy First, with a 2.8% allocation.
- **TD Ameritrade:** No change to fair-value estimate; shares remain a Buy, with a 2.5% allocation.
- **Wells Fargo:** No change to fair-value estimate; shares remain a Buy First, with a 3.4% allocation.

Each of these three companies continues to progress well against our investment theses, and we continue to believe that each will deliver North Star-beating returns (lately around 7.5% to 9% annualized) over the next rolling three-year period.

If you have any questions about this Memo, feel free to stop by the appropriate company's discussion board:

- Gentex
- TD Ameritrade
- Wells Fargo

Fool on!

— Billy (TMFBillyTheKid)

Performance vs. Outcomes

Published Apr 25, 2016 at 11:33AM

Fellow Pro *Fools: Morgan regularly writes about one of the most important aspects of investing well: mindset. And your mindset is largely influenced by your knowledge of stock market history, another topic Morgan covers better than anyone. Morgan writes every week for* Motley Fool One*, and we're fortunate to be able to share some of his columns with you in* Pro*. Today's article suggests that stock outcomes are often unexpected when looked at "logically" (Coca-Cola shares are at a high as soda sales fall?), but when you consider how profits grow at strong companies over the years, good stocks should ultimately keep making new highs in years to come. Enjoy! -- Jeff*

Coca-Cola (NYSE: KO) is fighting 12 consecutive years of soda consumption decline. Its stock is at an all-time high.

Tesla (NASDAQ: TSLA) is changing the world, and orders for its new car are off the charts. Its stock is lower than it was 18 months ago.

Cigarette consumption [has dropped]44% since 1981. **Altria** (NYSE: MO) stock is up 71,000% since 1981.

Walmart (NYSE: WMT) net income has tripled since 2000. Its stock has lost 1.5% since 2000.

Apple (NASDAQ: AAPL) has earned almost a quarter trillion dollars of profit since 2012. Its stock has barely budged.

Profits for **Amazon** (NASDAQ: AMZN) round to zero since 2012. Its stock has tripled.

2009 was one of the worst years for the economy in a century. The market rose 27%.

2015 was a good year for the economy. The market rose 1%.

Brazil's economy is a disaster. Its stock market is flat over the last two years.

America is enjoying the longest streak of [low unemployment]claims in four decades. Its stock market is also flat over the past two years.

And so on.

I'm fascinated with the problem of why really smart people have such a hard time predicting the future. It's mostly because the future is more random than we think. But it's also because future performance (like earnings and economic growth) doesn't tell you half of what you need to know to predict future outcomes — especially to predict precise outcomes. Outcomes are determined by performance within the context of expectations, with importance heavily weighted toward the latter. And if predicting future performance is hard, calibrating them against expectations often borders on sorcery.

Even if you accurately forecast future performance, predicting the outcome from that performance requires answering two questions:

- Are current expectations reasonable?
- What will future expectations be?

The first is possible to answer, but pretty hard. We can look at sentiment and valuations to gauge, based on past trends, whether the current mood seems reasonable. But disagreeing with popular sentiment is easier said than done. Few things feel better than fitting in, and having a viewpoint that goes against everyone around you is a mental battle not one person in 10 can maintain for long. Rather than identifying extremes in current sentiment, it's easier to justify the market's mood no matter what it is. Billionaire investor Howard Marks once wrote:

> The problem is that extraordinary performance comes only from correct nonconsensual forecasts, but nonconsensual forecasts are hard to make, hard to make correctly, and hard to act on.

The second — predicting future expectations — is even harder. To know where stock prices will be in five years, I have to know what mood people will be in, five years from now. Which is as ambitious as it sounds. Ask yourself what kind of mood you yourself will be in in April 2021, and you'll shake your head in laughter. Ask what kind of mood seven billion strangers will be in in April 2021 — that mood, of course, will determine stock prices in five years — and it's hard to keep a straight face. This is where the disconnect between performance and outcomes occurs: Accurately predicting five years of economic growth might not do much for the stock market if, five years from now, people are worried about the future five years from then.

As legendary investor Ben Graham said, "In the short run, the market is a voting machine. But in the long run, it is a weighing machine." Even if future markets are gloomier than they are now, rising profits and compounding business assets can leave investors with a positive return. This "weighing" is why true long-term investing isn't gambling. Real, reliable value is created, even if we don't know exactly when it will flow to shareholders' pockets. It's why we invest in quality businesses for the long run, and have high confidence in doing so.

But the more precisely that people try to forecast, the more they rely on predicting emotions and expectations. In a world where Wall Street analysts focus most of their time analyzing performance — what earnings will do, or what the economy will do — it's no wonder they struggle to predict outcomes.

It's yet another reason we take the long view, without tying our expectations to specific dates, and are open to a range of short-term possibilities.

Thoughts? Bring them to the *Pro* [Philosophy & Strategy board]!

Pro Portfolio Building Report No. 3: April 22, 2016

Published Apr 22, 2016 at 12:14AM

Welcome, Fools! As new members continue to learn more about *Pro*, we get a lot of questions about fair value. The most common one is this:

> **Q:** If a stock is rated Buy or Buy First, but its current price is higher than *Pro*'s stated fair value, is that stock still a Buy or Buy First right now?
>
> - Should I buy it today?
>   - At this price?
>
> **A:** Yes.
>
> - Yes, at least *start* to buy your allocation. Dip your toes in if you're not buying the whole stake yet.
>   - Yes, today's price should still provide the return we seek.

This may seem counterintuitive at first, but with some context, we think you'll see how this approach makes sense for our portfolio. As Jeff writes in a recent Memo called "[The Flaws of Fair Value]" (also linked on our [Guidebook page]):

- A fair-value estimate is the approximate price from which we expect a stock to earn our desired long-term rate of return.
- If a stock is rated Buy on the [Recommendations page], we believe it can deliver a [North Star]-worthy return or better over the coming three years (lately, that's about 10% annualized).

- A fair-value estimate is a snapshot in time; it represents *today's* fair value, usually using the last 12 months as your base.
- A growing company increases its fair value daily, just as you do if you're saving some money each day. All else equal, a stock's fair value ticks up steadily as the company grows.
- We update our fair-value estimates quarterly at most, and usually only bi-annually or annually, given that our estimates (like all estimates) are approximate and model out yearly results.
- We lean conservative, rather than aggressive, with our fair-value estimates.

A great company has multiple extra ways to increase value that we can't bake into our long-term projections, partly because we don't know everything management is planning.

To read more on fair value, click here and here.

Moving on to today's report: Presented below are the rest of *Pro*'s Buy stocks; with these and our previous two reports, plus judicious application of the advice above, you should be ready to keep adding to your *Pro* portfolio as you're comfortable! Stay tuned for our Portfolio Positioning Report on April 27 and our live chat event on May 4, and bring us your questions on the Getting Started & Help discussion board! We're glad to have you.

Best,

-- The *Motley Fool Pro* team

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Buy: Gilead Sciences (NASDAQ: GILD)

Dominant in treating HIV and Hepatitis C, Gilead is a powerhouse biotech company positioned to keep rewarding owners.

Suggested Allocation: 3.6%

For More

- *Pro*'s original recommendation (4/30/14)
- Latest Earnings Update (2/29/16)
- Talk about Gilead

Gilead Sciences (NASDAQ: GILD) helps millions of people fight life-threatening diseases. Its HIV drugs are prescribed to 8 out of 10 new HIV patients and are already helping millions of others enjoy much better lives. HIV treatment represented the majority of Gilead's revenue until its Hepatitis C cures, Sovaldi and Harvoni, were approved in 2014 and 2015, respectively. The most successful drug launches in history, Sovaldi topped $10 billion in first-year revenue, and Harvoni reached megablockbuster status quickly as well.

An estimated 2.7 million to 3.2 million hepatitis C patients reside in the United States, with an estimated 200,000 more joining those ranks per year; a whole 2.8% of the *world* (almost 200 million people) is thought to have this common blood-borne infection. That means millions could conceivably benefit from treatment by Gilead products, while still leaving plenty of room for competing drugs to do well, too. So far, though, Gilead has dominant market share for hepatitis C, just as it does for HIV. The company enjoys first-mover advantage to the hepatitis C market, and its drugs are said to lead in effectiveness with fewer side effects.

Though earnings-per-share growth isn't expected this year following blowout revenue gains last year, stability is predicted, and Gilead shares look inexpensive at around 8 to 9 times earnings, especially as management vows to keep buying back meaningful shares. Gilead has more than 200 compounds in clinical trials, including a focus on oncology, and it's in the market to make acquisitions that would add to earnings. Gilead is one of the most profitable biotechnology companies in the world, and we believe this inexpensive behemoth should be in your *Pro* portfolio.

Buy: O'Reilly Automotive (NASDAQ: ORLY)

Auto-parts retailers are boring, right? Right! But an investment here is up 670% over the past 10 years, and we expect additional returns around the corner.

Suggested Allocation: 5.3% (given this position size, buy in halves over two to four months if you prefer)

For More

- *Pro*'s original recommendation (4/15/14)
- Latest Earnings Update (3/24/16)
- Talk about oh, oh, O'Reilly

America's second-largest auto parts retailer, O'Reilly operates more than 4,500 stores, about one-quarter of them in California and Texas. Auto parts are a big business, estimated at $231 billion, and O'Reilly is an exceptional competitor, with an addressable market size of about $131 billion. Running 24 regional distribution centers and 240 hub stores as part of a two-tiered distribution strategy, the company provides same-day or overnight availability on more than 142,000 items, including many its competitors don't usually stock. Basic auto parts, tools, and services complement those hard-to-find treasures. As a result, O'Reilly's sales are historically split between "do it yourself" retail customers and lucrative, repeat-sales professional services customers (such as auto repair shops), a luxury many smaller competitors don't enjoy.

An extremely well-run company, O'Reilly has seen earnings per share increase by more than 20% every quarter for seven years straight, and same-store sales and margins have been climbing consistently for years. And O'Reilly sees more opportunity ahead: Management plans for 210 new stores in 2016, for margins to tick higher again, and for same-store sales growth of between 3% and 5% in the quarter ended in March. Many tailwinds are helping this U.S.-only company: More people are working, so miles driven are headed higher; the average car is staying on the road longer, needing more repairs; and new cars have more complex parts that are costlier to repair. In the last recession, O'Reilly performed fairly, too, because more people keep their cars longer during hard times, and invest in keeping them running well (though fewer people are driving as unemployment increases).

As one of our largest positions, O'Reilly remains a stock we own for the long haul. Shares remain rated a Buy even though they currently (and historically) trade a bit above our fair-value estimate. After earnings per share rose 25% in 2015, we expect at least 16% growth in 2016, with the chance for acquisitions to move that number higher.

Buy: Parexel International (NASDAQ: PRXL)

Parexel is poised to benefit as pharmaceutical companies gradually outsource more drug development work to select CRO partners who can perform the work better, faster, and cheaper.

Suggested Allocation: 3.4%

For More

- *Pro*'s original recommendation(12/23/13)
- Most recent earnings update (2/2/16)
- Talk about Parexel on our discussion board

Parexel (NASDAQ: PRXL) is one of the world's largest and most respected contract research organizations (CROs). Over more than 30 years, it has built a stellar reputation on helping drug makers navigate complex clinical trial processes quickly, which has enabled it to cement important relationships and have a role in developing more than 95% of the 200 top-selling drugs.

Based on industry data, from 2004 to 2015, outsourcing penetration — the number of development dollars outsourced to CROs — has increased by nearly 70%. Outsourcing is a cheaper alternative to the traditional high-fixed-cost model of staffing lots of white coats across various therapeutic specialties all around the globe. For large drug developers, letting CROs handle the development work — and those massive staffing needs — can boost profits and time to market, and for smaller drug developers who can't afford a huge staff, there is no other choice. As regulators require more efficacy data, larger patient participation, and increasingly global results, navigating the challenges of the 110,000-plus trials being conducted globally has become frustratingly complex, turning large, proven CROs with expertise and global capabilities into value-adding partners rather than transactional customers. We think Parexel will continue to benefit.

Buy: Papa John's International (NASDAQ: PZZA)

Deliver a slice of the profit pie right to your doorstep.

Suggested Allocation: 2.7%

For More

- PZZA position review (5/23/14)
- Most recent earnings update (3/8/16)
- Talk about Papa John's

Papa John's International (NASDAQ: PZZA) operates and franchises close to 4,900 pick-up and carry-out pizza joints in 40 countries and territories. For the past 30-plus years, Papa John's has been making pizza and building its brand around the "Better ingredients, better pizza" tag line. Bringing that unwavering focus to each pie has resulted in the company's perceived quality advantage over its big-chain pizza competitors, which allows it to consistently price a dollar or two higher and attract high-quality franchisees. Now that its brand advantage is sufficiently established in North America, Papa John's is turning its sights abroad, believing that delicious American pizza is a language every taste bud speaks.

As sure as a fresh pizza will be gobbled up by hungry kids, Papa John's delivers results. For 12 consecutive years, the company has recorded flat or positive North American same-store sales growth. Over the last four years, international comps have been in the 5% to 8% range (and consistently higher than comps in North America), offering strong evidence that Papa John's flavors travel well. The company opened 230 restaurants in 2015 and expects about 200 more this year, and because Papa John's is primarily a franchisor, it doesn't have to bear the cost of that expansion (it's taken on by the franchisees). Competing for a share of the global appetite is tough business, but Papa John's has been able to increase sales and profits at commendable rates over the past decade, which has resulted in plenty of cash generation. Management initiated a dividend in 2013 and has consistently bought back stock over the years.

We believe the company will maintain its brand positioning, modestly improve underperforming franchise locations, and continue to be an attractive entrepreneurial outlet for new franchisees abroad. Papa John's should also be able to take modest market share from mom-and-pop pizza shops in established markets as digital ordering continues to gain adoption; it's a tough hurdle for smaller players to overcome. With a little bit of menu innovation and new markets maturing, we believe 3% same-store growth is sustainable over the next five to 10 years. We rate shares a Buy and encourage members to do plenty of field research on this one.

Buy: ProShares Short VIX Short-Term Futures ETF (NYSEMKT: SVXY)

Profit from the long-term nature of stock-market volatility to revert to an average level after each spike.

Suggested Allocation: 0.9%

For More

- *Pro*'s original recommendation (11/25/14)
- Talk about SVXY

Buying shares in — let's make it easy and use the ticker, shall we? — SVXY is a recommendation for *Pro* members who are comfortable owning a small stake in a volatile position that we *may* add to during market downturns. *Pro* is a portfolio service, so all positions are meant for everyone, to the extent you can invest in them and wish to. But this position is not core to what we do, and will be especially volatile, so only follow it if you're comfortable with high volatility in a holding.

This unusual vehicle should increase in value when stock market volatility — as measured by the CBOE Volatility Index (or VIX) — goes down or is range-bound. This ETF *sells short* futures contracts on the VIX that have one month and two months to expiration. Unless expected volatility from the S&P 500, as measured by the VIX, increases above and beyond the premium already baked into the futures contracts being shorted, the positions turn a profit and the ETF goes up in value. Helping further, VIX futures contracts are historically in a state of "contango" as much as 90% of the time. Contango means that future-month contracts are increasingly more expensive than earlier months' and than the current VIX itself (much like a call option has a premium above the current stock price). This is a tailwind for SVXY. As long as volatility stays rangebound overall, then just holding this small stake over the years should reward us. We recommend starting at 0.9% (or round to 1% if you want), and we may add more when the VIX soars — meaning when volatility in the market is high and SVXY is low. We're ready for it! But even if we don't, we believe this small position should create value for us over the long term thanks to the regressive nature of volatility in the market: It spikes, and then grinds back down.

Buy: TD Ameritrade (NYSE: AMTD)

Assets and investment fees are rising; earnings should surge when interest rates head higher.

Suggested Allocation: 2.4%

For More

- *Pro*'s original recommendation (7/11/13)
- Monday Memo on TD Ameritrade's business model (9/15/14)
- Latest earnings update (1/21/16 -- this quarter's update is on the way)
- Talk about TD Ameritrade

Entrusted with more than $700 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NASDAQ: AMTD) hosts about 450,000 stock, options, and futures trades on an average day, collects investment fees, and earns interest on billions in cash and interest-earning assets. Its partnership with **TD Bank** (NYSE: TD) (which owns 42% of the company) also gives it a unique position in its industry, allowing TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank; when the current record-low Federal Funds interest rate increases, TD Ameritrade will earn much higher interest income, virtually all of it pure profit.

In the meantime, the company retains its focus on increasing client assets, providing top-notch customer service, and launching more investment products and features. The company has increased net new client assets by at least 10% annualized for the last seven years and counting. We expect management to continue to be excellent stewards of capital, returning profits to shareholders and increasing investor value. All the while, we know higher interest rates will someday lead to much higher net income. But even as we look forward to that, we can admire the company's current results, accept a growing dividend stream, and be ready to enjoy healthy returns.

Buy: Valmont Industries (NYSE: VMI)

Providing irrigation systems, electrical tower support structures, road barriers and more, this industrial company benefits as agriculture needs increase and countries build infrastructure.

Suggested Allocation: 1.9%

For More

- *Pro*'s original recommendation (11/5/13)
- Earnings update: next available in late April
- Talk about Valmont

Founded in 1946, Valmont supplies steel and aluminum poles to infrastructure projects worldwide, including road and traffic lights, stadium and parking lights, and wireless communications poles and support towers, as well as electrical towers. The company also sells highway safety products including barriers and road grating. Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot irrigation systems are the world's leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient irrigation, so there's lots of room to run. Suffering lately, the company also has an energy and mining division. Results here -- and in its irrigation business -- will improve if (or when) commodity prices increase. That may be starting to happen now, and management just projected 12% to 15% EPS growth in 2016.

Operating in more than 80 countries, Valmont is a long-term investment in an exceptionally run, cyclical business that's currently in a downturn (which is when you usually want to buy!) from which it may be starting to emerge. Valmont has been an outstanding long-term performer for other, earlier investors, and we believe we could benefit smartly in the long run, too.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund (NYSEMKT: DGS)

Diversification in emerging markets with small, promising, high-yield companies you've never heard of.

Suggested Allocation: 1.8%

For More

- *Pro*'s original recommendation (11/22/10)
- Talk about DGS

At *Pro*, we like the idea of investing in emerging-market small caps to diversify and target strong long-term earnings growth, along with a dividend kicker.
Enter WisdomTree Emerging Markets SmallCap Dividend Fund (the longest ETF name in the world!*). This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields around 3% in dividends).

For *Pro*, owning shares of this well-managed ETF offers exposure to up to 600 of the most promising international business that we couldn't easily buy in any other way. Serving as direct exposure to emerging markets, this is a way to invest in small companies in locations where we don't have a discernible edge but where growth exists — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The benefits of diversifying outside our home market should come home to roost given time -- we've been patient so far. Emerging markets have badly lagged developed markets for the last several years, but eventually they should take the performance baton again, and we should be well served by this position. Meanwhile, we don't mind waiting, because we know that's how diversification works. That's *why* you diversify: so not everything performs or falls at the same time.

*Statement is not true. We own or are short others with equally long names.

Pro Portfolio Building Report No. 2: April 20, 2016

Published Apr 19, 2016 at 7:49PM

Welcome, *Pro* Fool! This report details our current thinking on eight of the Buy stocks in our portfolio. The rest of our Buys will be featured in our third report, coming Friday. Once you've read these and the previous report detailing our Buy First positions, you're ready to start (or continue) building your *Pro* portfolio as swiftly or as slowly as you like.

We want our advice to be uncomplicated: Purchase our Buy Firsts first (again, taking your time according to your situation — there's no rush); purchase our Buys after that; match our allocations as closely as you can (but don't worry about needing to buy in 100-share lots — fewer is fine); and stay tuned for our Portfolio Positioning Event on May 4, when the team will be answering your questions in real time.

We're glad you're here, learning to become an investor who will come out on top in all markets. Bring any questions to the Getting Started & Help discussion board, and Fool on!

Best,

The *Motley Fool Pro* team

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A Note on Fair Value >>

Buy: AmTrust Financial Services (NASDAQ: AFSI)

This shrewd insurer looks to enter markets optimistically, when pricing is favorable because others are struggling.

Suggested Allocation: 5.1%, perhaps bought in two to three blocks over the next two or three months

For More

- *Pro*'s original recommendation (4/3/2009)
- Most recent earnings update (3/7/2016)
- Talk about AFSI

AmTrust Financial Services (NASDAQ: AFSI) was founded in 1998, making it one of the new kids on the block in an industry where many of its competitors have been around for 100 years or more . But this newbie insurer has some serious street smarts. AmTrust likes to compete in niche markets (for example, small, low-hazard workers' compensation policies), waiting until a rough patch demonstrates that the incumbents in a space have loosened their underwriting standards. It's then able to grab market share in an environment favorable to itself, as rivals attempt to cope with prior losses by raising prices.

Over the past 12 months, AmTrust has written $2.8 billion of workers' comp premiums, making it highly likely to finish the year as one of the top five workers' comp underwriters in the United States. But we don't think that means it's doomed to the glacial pace of growth common to many of the larger insurers. The company is moving into the commercial package insurance business (which includes workers' comp); SNL Financial estimated this as a $241.3 billion market in net written premiums as of 2014. AmTrust management believes its commercial package business can become its next billion-dollar platform, and we believe management will continue to find markets ripe for disruption.

Buy: Apple (NASDAQ: AAPL)

The leader in mobile computing products should see more long-term growth than anyone expects.

Suggested Allocation: 3.8%

For More

- Pro's original recommendation (2/14/12)
- Most recent earnings update (2/4/16)
- Talk about Apple

Led by its iPhone, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the smooth Apple ecosystem, which centers on the iTunes and App Store marketplaces, as well as the new Apple Pay. Apple services (iTunes, App Store, Apple Music, etc.) generated more revenue last year than more than 70% of the companies in the Fortune 500, while Apple itself is the most valuable company in the world, with more than $230 billion in annual sales. Despite this massive size, the company continues to grow and generate increasing profits for shareholders -- earnings per share were up 27% this past year. The company's integrated hardware and software make for a sticky consumer experience that provides disincentives to switch to a competitor, and as more people use multiple computing devices, Apple makes it easy to transition seamlessly from one of its products to another.

We expect the recently launched Apple Watch and Apple TV to help further entrench the Apple ecosystem into people's daily lives, all while Apple continues to work on developing its next major product and returning massive amounts of capital to shareholders through dividends and buybacks (almost $50 billion in fiscal 2015!). We're not counting on a revolutionary product anytime soon, but we are counting on record numbers of phones being sold to both new and existing customers over the coming years. We want to be in on that conference call.

Buy: Medtronic (NYSE: MDT)

The medical-device industry is complex and regulated, and it provides entrenched leaders with a competitive moat; our leading company is growing in international markets.

Suggested Allocation: 3.1%

For More

- *Pro*'s original recommendation (7/1/2009) ...
- ... and our second buy recommendation (11/9/10)
- The next earnings update is coming in May.
- Talk about Medtronic

In March, the CEO of Medtronic put it like this: "Our formula for long-term success is to deliver consistent mid-single-digit revenue growth, with 200 to 400 basis points of EPS leverage, [and to] return a minimum of 50% of our adjusted free cash flow to shareholders through dividend growth and share repurchases. The expected net result is creating enormous value, with sustainable double-digit [at least 10%] total shareholder returns."

As shareholders of Medtronic, this is exactly what we've seen over the years: Our annualized return on the position is 11.25%, and we think something close to this can continue going forward. Medtronic is a market leader in vital medical devices, be they for the heart, spine, knee, or one of four other key categories. The stock yields 2%, and the dividend has increased annually for the past 38 years, resulting in an 18% compounded annual growth rate (CAGR). Expect continued dividend increases, sales growth of about 4% to 6%, and earnings-per-share growth considerably higher than that — all of which should combine for North Star-challenging returns. While Medtronic has touted itself as a play on international markets, growth in the U.S. has lately regained traction, too. International markets still account for a small minority of revenue, and are growing smartly.

Buy: OpenText (NASDAQ: OTEX)

This company's information management software keeps the digital lives of businesses in order, and its exchange software platform drives business transactions and earns recurring revenue.

Suggested Allocation: 3%

For More

- *Pro* 's original recommendation (8/31/11)
- Most recent earnings coverage (3/10/16)
- Talk about OpenText

A leader in Enterprise Information Management (EIM), OpenText offers customers (governments, universities, corporations) a full suite of software solutions to manage growing reams of digital data. Its three areas of focus are data and information management; information exchange platforms within and across organizations; and analytics, where "big data" is used to gain insights and better run a business. Said differently, OpenText helps customers go digital with their data, or manage what is already digital, including transactions.

The leading independent provider of EIM software, Canada-based OpenText is enjoying strong cloud sales as well as steady license contracts. Its EIM market should increase sales by least 10% annualized (our estimate) over the next four years. In turn, we're looking for at least 10% annualized returns from our ownership of OpenText shares. The year 2016 is an important and exciting one for the company; its new software, called Release 16, is rolling out after its fall 2015 debut. It's designed to integrate nearly everything OpenText software can do, and success should bring many more cross-selling opportunities, as well as new clients. At the same time, deep data analytics is embedded throughout the software for the first time, adding upsell opportunities. OpenText enjoys strong recurring revenue (which represented 84% of its sales in fiscal 2015). We may sometimes recommend options on the stock, as we've done several times in our sister service, *Motley Fool Options*.

Buy: Skyworks Solutions (NASDAQ: SWKS)

This leading designer of analog modules for smartphones and connected Internet of Things devices is growing sharply.

Suggested Allocation: 3.4%

For More

- *Pro* 's original recommendation (8/5/14)
- Latest earnings coverage (3/2/16)
- Talk about Skyworks

Beyond having one of the coolest names in our portfolio, Skyworks Solutions makes technology that powers wireless connectivity in a wide variety of products: Apple and Samsung smartphones, **Medtronic** (NYSE: MDT) medical devices, **Alphabet** (NASDAQ: GOOGL) and **General Electric** (NYSE: GE) products. In the "Internet of Things," millions of physical objects are going online, and Skyworks is uniquely positioned to benefit. Not only does it serve *all* smartphone makers, but the company is diversified across industries to total more than 2,000 customers. How so?

Skyworks sells more than 2,500 high-performance analog semiconductors and related products, supported by more than 2,200 patents. The product list includes amplifiers, attenuators, receivers, switches, diodes, modulators, GPS power and voltage regulators, and more, often sold together as a module for a phone or connected device. Skyworks earns industry-beating operating margins of more than 30% (and they're headed higher) by selling specialized solutions to giant customers with growing connectivity needs. Plus, as wireless complexity increases, fewer companies can deliver the integrated modules customers need, putting Skyworks in an even stronger position. The China opportunity is large as well.

This can be a volatile "chip" stock, but its long-term outlook (which is the time frame we care about!) remains compelling. The company expects its long-term total addressable market to increase by about 15% a year, and Skyworks is increasing its profits more quickly than that.

Buy: Starbucks (NASDAQ: SBUX)

You only think you're there for the coffee — the ubiquitous java purveyor has big plans.

Suggested Allocation: 3.8%

For More

- [*Pro*'s original recommendation] (8/22/2012)
- [Most recent earnings update] (2/5/2016)
- [Talk about Starbucks]

You may not realize it, but "**Starbucks**" (NASDAQ: SBUX) is no longer just a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense, it's just a front. We *think* we go to Starbucks for the coffee, but those green-and-white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

Starbucks began opening America's eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 24,000 stores in 70-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences in more than 80 million transactions each week This company is continually finding new ways to reach customers; we're grabbing a latte and a cake pop and coming along for the ride.

Buy: Verisk Analytics (NASDAQ: VRSK)

This prototypical Pro *holding provides us with exposure to powerful tailwinds within the financial, energy, and health-care industries, among others*.

Suggested Allocation: 2.2%

For More

- [*Pro*'s original recommendation] (6/23/15)
- [Most recent earnings coverage] (3/1/2016)
- [Talk about Verisk]

Verisk Analytics (NASDAQ: VRSK) may not be a familiar name, but with a strong competitive advantage, high customer retention, robust and contract-based cash flows, a scalable business model, and large (and growing) markets, the company is in many ways a prototypical *Pro* holding. Verisk started as an information utility for the insurance industry, but nowadays it's is a data and analytics powerhouse that provides customers with solutions in all sorts of arenas: raw data, tailored analytics, enterprise reporting systems, policy fraud detection solutions, competitive benchmarking, and legally tested policy language, just to name a few.

One way to invest successfully is to buy out-of-favor industries, and three to five years from now, we may look back and realize that Verisk did exactly that by entering into the energy industry (via its May 2015 acquisition of Wood Mackenzie) in the midst of the current energy slide. We tend to shun commodity-based businesses here at *Pro*, but we believe Verisk's purchase of WoodMac was a good one: The latter is pretty much a copy of the former, but with a different end market. WoodMac is a leading provider of data analytics to the global energy, chemicals, metals, and mining markets, and it actually has higher margins and a greater percentage of subscription-based revenue than Verisk's other business units. We don't profess to have the ultimate insight into what the next six months have in store for WoodMac and Verisk, but we believe shareholders will be very happy with the results over the next three years.

Buy: Visa (NYSE: V)

With its mission to "accelerate the electrification of commerce," industry leader Visa has most of the world left to conquer.

Suggested Allocation: 2.5%

For More

- [*Pro*'s original recommendation] (4/28/15)
- [Most recent earnings coverage] (11/25/2015 — this quarter's update is on the way)
- [Talk about Visa]

The ubiquitous nature of credit and debit cards in America means that many of us can go through life rarely touching cash. Yet even in the U.S., cash still accounts for approximately 40% of transactions, followed by debit cards at 25% and credit cards at 17%. And globally, cash is truly king: MasterCard estimates that 85% of all consumer transactions still take place with old-school paper and coins. But all of that is slowly changing as economies modernize and middle-income families proliferate, bringing more converts to the benefits of electronic payment. With its mission to "accelerate the electrification of commerce," industry leader **Visa** (NYSE: V) has most of the world left to conquer.

We like Visa for many of the same reasons we like MasterCard. And with the recent acquisition of Visa Europe, the company will be adding 523 million card accounts that resulted in 38 billion transactions and $1.67 trillion in point-of-sale spending last year

. Visa is valued at $195 billion, and given its tiny market share, its ceiling should be much higher than that. It fits into *Pro* as a recurring-revenue business that invests its free cash flow in more growth at still higher rates of return, making it a compounding vehicle.

Pro Catch-Up Trades: April 18, 2016

Published Apr 18, 2016 at 2:29PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

New members: Keep in mind, our [Portfolio Building Reports] will get you fully invested over the coming few weeks, as much as you want to be.

Pro's [Buy First stocks] are recommended for your long-term portfolio; buy into them gradually. Some highlights:

- **Broadridge Financial Services** (NYSE: BR): Buy our 5% allocation, at once or in halves if you like.

- **Facebook** (NASDAQ: FB): Buy our 6% allocation in thirds or halves over time (or sell to open May 20, 2016, $106 puts, lately for around $3 each, if you'd like to target buying 100 shares or more at about a net $103 or so).
- **Gentex** (NASDAQ: GNTX): Buy up to 2.7% in stock.
- **Oracle** (NYSE: ORCL): Buy up to 3.9%, or buy in halves.

Continue building your portfolio with our Buys, including these highlighted today:

- **OpenText** (NASDAQ: OTEX): Buy up to 3% in stock.
- **Papa John's International** (NASDAQ: PZZA), buy up to 2.7% in stock.
- **TD Ameritrade** (NASDAQ: AMTD), buy 2.5% in stock.
- **Verisk Analytics** (NASDAQ: VRSK), buy 2.2% in stock.

Options:

- **Gentex** (NASDAQ: GNTX): Opportunistically, when they pay enough per our guidance, sell to open May 20, 2016, $15 puts as detailed in our recent recommendation, to potentially add to your stock.

Hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): Our April hedge expired Friday. We plan to set up a new one soon. Our June put ratio spread can still be set up for a credit if you move your lower strike price up. So, you would sell to open two June 17, 2016, $192 puts for every one June 17, 2016, $200 put you buy. Each $200 put represents a $20,000 short of SPY. Use the trade alert for allocation guidance (again, simply adjusting your lower strike to $192, and still getting a small credit to set up each spread).

Our most recent short:

- **Deere & Company** (NYSE: DE), as a hedge against the market and our investment in **Valmont** (NYSE: VMI): Sell short (sell to open) 1.8% of Deere as per our recommendation.

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6 Key Things to Learn From Pro

Published Apr 18, 2016 at 12:49PM

Welcome, new Pro *Fools! We're glad you're here. In the following column, first published in November 2015, Jeff shares the key aspects of* Pro *that will help your investing most now and in coming years. As you find your way around, keep an eye on the Guidebook page and your email for the series of Portfolio Building Reports that will get you caught up with us, and please bring any questions to the Getting Started & Help board. Thank you again for being here -- and a special thanks to our veteran members for their Foolish assistance on the discussion boards! -- The* Pro *Team*

Dear *Pro* members:

It's great to see new *Pro* members on our discussion boards, asking questions, engaging in conversation with other members, and making investment decisions suitable to them as they move forward – whether that's mirroring the *Pro* portfolio exactly, or modifying it to suit individual needs.

When we launched *Pro* nearly eight years ago, this type of community discourse between members wasn't possible. Today, those questions are much easier for our veteran members to answer, so they can help new members get up to speed (thank you!). That said, we're still early in this endeavor to grow great value together over many years. We're still just starting.

Today, we'll highlight some of the most important things for all members to learn from *Pro*. But first, let's get some of the most common new-member questions out of the way:

- **Should I invest in an IRA or not?** That's up to you; many members do. Just remember you can't sell short or do all options trades in an IRA.
- **Should I only buy stock in 100-round lots?** That's not important unless we say so; don't buy 100-round lots if it takes you far from allocation guidance.
- **Should I buy all of *Pro*'s Buy-rated stocks, or only the ones below our fair-value estimate?** Yes, buy all the ones that are rated Buy; that's why we rate them Buy! Fair value is a conservative estimate that goes up over time. Your Portfolio Building Reports will get you up to speed on all of our investments, including our shorts and options in early May.
- **Should I sell all of my old stocks or not?** Sell your least favorites if you need to raise funds for *Pro*, but don't be shy about keeping stocks you love.
- **How important is it to match your allocations?** It's fairly important, but not an exact science. If we have 2.7% in a stock and you invest 3%, or vice versa, it's probably just fine. Just be fairly close.
- **Can I buy *Pro* stocks in increments?** Yes. We often recommend that, especially on our larger positions. Buy up to our allocation in halves or thirds over a number of months that makes you comfortable. Some members go all in at once. It depends on your preference.

Those are important initial questions. Now let's look at the bigger picture: What will help your investing *most* over the coming years? Here, in order of importance, we have ...

6 Key Things to Learn From Pro

1. The types of companies we buy.

If you only come away with one thing, it should be this: We buy companies with eight specific qualities (we spell them out in your Guidebook) that will ideally lead to long-term compounding. We aim to buy companies that will steadily grow, reinvest their cash flow in more growth, and compound further as a result. We target businesses with pricing power, predictable revenue, high returns on capital, and other specific traits. Learning to spot these types of winners could change your long-term investment success in a large way.

2. Our preferred time frame -- and patience.

If you're a Foolish investor, this one is easy. You already know that small gains are made in the short term and by trading (if you're lucky), but fortunes are made by holding great businesses for years. We don't sell our favorite businesses on short-term blips or minor valuation concerns. We're investing to compound. You should only buy a stock when you have a rolling three-year outlook, to start.

3. Portfolio construction.

If you internalize those first two factors alone, you should do very well over the rest of your investing life, and (sadly) be miles ahead of most others. But *how* you build and manage your portfolio will help determine the magnitude of your success, and the bumpiness you experience in getting there.

What we hope you'll learn from your *Pro* service about portfolio construction and management is best gathered from at least a few years of following what we do. One constant you'll see is that we want flexibility in our portfolio. We want to be confident and have room to make new investments even when the market is in chaos. So, we seek to construct a portfolio that only holds businesses we believe in (that match our criteria), keeps cash for opportunities, and delivers steady returns despite market volatility -- with at least some positions winning no matter what the market is doing.

For some stats: Since January 2012, our portfolio has averaged 87% long and 15% short, meaning we've averaged 72% net long (or net invested in the market). Yet with less volatility and only 72% market exposure, we've outperformed our always-positive North Star and the S&P 500 -- thanks in part to the strong types of companies we own. Learning portfolio construction is a great endeavor here.

4. Using options for income.

If you're interested in going beyond stocks into options, arguably the single most valuable lesson you can learn here (and in our sister service, *Motley Fool Options*) is how to generate income by selling options. We talk about this so much across both services that I won't go into it more here (see Options U if you want to dive deeper), but suffice to say countless members have changed their investing lives -- and made retirement possible or better -- by learning how to generate income in their portfolios (while still holding stocks for upside!). Among our favorite strategies are written puts, diagonal calls, and covered strangles (and simply buying calls for leveraged upside), and we've made option income almost every month over the past year in *Pro*. Monthly option income on top of our stock investments remains our goal.

5. How and why we hedge.

Carrying some cash is one way to soften the blow of falling markets; another is by learning to hedge the *Pro* way. We typically set up low-cost option hedges on major market indexes, such as the S&P 500 or Russell 2000. Many of our hedges don't cost us money out of pocket (instead, they often carry an obligation to buy shares of the index if it falls sharply, something we're fine with). Most hedge funds pay a large percentage of assets to hedge, but we usually don't. Not doing so has been important to our returns since inception. If you want to learn to hedge, follow our hedging trade alerts (most of which are very low-cost) and attend (or review) our Portfolio Positioning Event on May 4. This event will also address our shorts and current options.

6. Shorting losers.

Finally, selling companies short isn't for everyone, but you can learn how to employ this "expert only" investing style in a way that won't put your portfolio at unreasonable risk – and should help in bad and sometimes even good markets. We seek to short companies that should struggle *whatever* the environment. Position sizing and risk management (including knowing when to close the position) are important, as is having a broker that allows you to stay short (we've had the best luck with TD Ameritrade and Interactive Brokers). Shorts are the final piece of the puzzle to learn here in *Pro*, and we'll have more about on our existing shorts on May 4. (If you can't make the May 4 event, no worries; video and text will both be archived on the event page when it's over.)

It's All a Fun Process

Overall, enjoy the process! Like anything good, it takes time. But if you enjoy it, before you know it you'll own great stocks, and be happy owning them; you'll be calm, because you always think in terms of rolling-three-year time periods for your stocks; you'll have a portfolio that is flexible; you'll be generating regular income from options if you want; and you will be hedging and shorting as much or little as you wish, with confidence. All the while, you'll remain invested for long-term upside. These are the key things we hope you'll learn with us at *Pro* to make you a better investor for life. Just realize that it takes time to make real money in the stock market. In the short term, prices are likely to move in either direction, by varying degrees.

Thank you for being here and for putting your trust in us. And to our great veteran members, thank you for welcoming new members so thoughtfully and thoroughly!

-- Jeff (TMFFischer)

Pro Portfolio Building Report No. 1: April 13, 2016

Published Apr 12, 2016 at 8:51PM

Welcome, Fool! We're glad you're here. This first report is meant to get you up to speed on our Buy First stocks — the companies in your *Pro* portfolio that we believe you should start purchasing first. But before we get to that, a few words about how best to use *Pro* ...

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that aims to generate winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, hedges, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* fit you.** We know not all investors are in the same situation! We can help you figure out how to buy *Pro* investments given your personal situation, including investing in an IRA or coming to *Pro* already fully invested. Check out our advice for every approach to *Pro*: Invested Elsewhere | "Free-Range" | Whoever You Are
3. **Catch up with our portfolio at your own pace.** Start with the stocks in this report, and follow along with our subsequent reports between now and our live event on May 4. You can always see our Buy First, Buy, and Hold guidance (which is the most important -- more important than valuation estimates) on the Recommendations page, and you can get a succinct, up-to-date take on all of our stock positions on our What We Think Now page.

Bring any questions to the Getting Started & Help discussion board, and Fool onward!

-- The *Motley Fool Pro* team

A Note on Fair Value >>

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Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 3.8%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Global mobile data traffic is expected to increase at a compounded annual growth rate (CAGR) of 53% between last year and 2020, and global mobile 4G connections are expected to grow from 1.1 billion in 2015 to 4.7 billion by 2020 (a 34% CAGR). Communications site operator **American Tower** is well-positioned to benefit from this trend.

For More

- *Pro*'s original recommendation (5/6/13)
- *Pro*'s "Buy More" recommendation (3/17/14)
- *Pro's* "Buy Calls" recommendation (12/17/14)
- Most recent earnings update (2/27/16)
- Talk about AMT

AMT leases antenna space on more than 100,000 cell sites (towers, rooftops, and more) to wireless service providers across the globe. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, non-cancellable, and feature contractual annual price escalations. More than half of AMT's properties are located in 12 (soon to be 13) different countries outside the U.S., including India, Brazil, Colombia, Mexico, Nigeria, and South Africa, and management is intent on expanding the company's international portfolio as it continues to build and acquire more towers.

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE, or to increase coverage density. When they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; about 98% of AMT's customers up for renewal each year do so, and more than 60% of its current leases don't renew until 2021 or later.

The stock may experience volatility in the short term because of its tendency to trade alongside the interest rate-sensitive REIT sector, but over the long term, the underlying strength in business fundamentals should shine through. We expect to earn modest income from a growing dividend and strong appreciation as AMT continues to build out its international tower portfolio.

Buy First: Broadridge Financial Solutions (NYSE: BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 4.9%

For More

- *Pro*'s original recommendation (4/27/10)
- Most recent earnings update (2/5/16)
- Talk about Broadridge

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in its fiscal 2015, its platforms processed approximately 85% of all shares in the United States. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider for managing investor communications.

The company's smaller segment, Global Technology and Operations (GTO), accounts for 26% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance this Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy First: Facebook (NASDAQ: FB)

Although it's lately riding a wave of popularity, we believe the strong stock is justified, and the business should grow handsomely in coming years.

Suggested Allocation: 6.2% (buy in thirds, or halves, over a few quarters; or, experienced investors can write put options to target buying some of their shares cheaper; "sell to open" one put option for every 100 shares you could buy; since you want shares, sell "near-the-money" puts, with a strike price near the current share price, and that expire in just a month or two)

For More

- Latest earnings update (3/2/16)
- *Pro's* original recommendation (9/18/12 – dated by now! But this shows how we thought about it back then when it was $20 and most were bearish)
- Talk about Facebook

Facebook remains a young story about monetizing the largest, most engaged online audience ever hosted by one company. The company's future is in strong hands; management is showing patience and care as it starts to monetize more of its properties, putting visitor experience first. So far, this approach has paid off, with user engagement up even as more ads appear. The billions of connections maintained on Facebook's properties are making the sites extremely sticky, offering the potential for increased value to advertisers (and thus Facebook shareholders) -- especially as the advertising gets smarter and more targeted.

It's our largest position at a recent 6.2%, and the size of our investment in Facebook feels appropriate given how much growth potential lies ahead and how well-managed the company is. Even from today's price, we estimate Facebook could return about 15% annualized for shareholders over the next five to seven years. Though shares are currently a bit above our fair-value estimate, the stock is rated Buy First on its long-term potential. Key risks include users moving away from Facebook, but so far the company has shown great skill in *increasing* user engagement and stickiness, rather than stunting it. It's also possible that management could spend more than Wall Street expects, though that should mainly be a short-term concern.

Buy First: Gentex (NASDAQ: GNTX)

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 2.6%

For More

- Most recent earnings update (3/3/16)
- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex

In 1982, a small company in Zeeland, Mich., called **Gentex** made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands more than 90% of that market.

Currently, about 26% of cars made worldwide have an auto-dimming rearview mirror, and only 8.5% have auto-dimming exterior mirrors. For context, prior to 1987, those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher usage; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror (including the newly launched full display mirror), both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy First: MasterCard (NYSE: MA)

With approximately 85% of the world's commerce still happening in paper money, electronic payment leaders have a lot of room to grow.

Suggested Allocation: 4.5%

MasterCard (NYSE: MA) is among the most attractive businesses in the world. The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns running a largely fixed-cost transaction network that becomes more profitable the more people use it.

For More

- *Pro*'s original recommendation (9/8/11)
- Latest earnings update (3/14/16)
- Talk about MasterCard

The company "charged forward" again in 2015 despite slow international commerce and a strong U.S. dollar. For the year, net revenue in local currency advanced 8%, and EPS gained 18% before special items. But right now, an investment in MasterCard -- as with **Visa** (NYSE: V) -- is an investment in growth *beyond* this year, because 2016 looks tepid as emerging markets struggle and the dollar remains strong. Much of the company's growth potential is being coiled up like a spring. That spring should pop when more economies begin to expand again and the dollar weakens. The market knows this, so the stock maintains a premium valuation.

Even so, we recently moved MasterCard back to Buy First and increased its fair-value estimate. The stock trades a bit above that price, but that's been the case for as long as we've been following it. From this price, we target about 11% annualized returns over the long haul.

Buy First: Oracle (NYSE: ORCL)

This old-guard tech giant has reinvented itself into a cloud software leader, with expanding margins and fast-growing cloud revenue.

Suggested Allocation: 3.9%

Oracle is the largest business software provider in the world, with more than 420,000 customers and $37 billion in annual revenue. The giant built its legacy by selling database management software licenses and related hardware, but in recent years it's begun transitioning customers to its new cloud software offerings, in the process hosting customer data on its own premises.

For More

- Latest earnings update (4/1/16)
- *Pro*'s original recommendation (9/17/09)
- Talk about Oracle

This transition has cost it money in recent years. First, Oracle had to invest in hardware, software development, and sales staff. Second, cloud customers bring in less up-front revenue compared with traditional software license sales, creating a strong revenue headwind in the short term. Over the long term, however, cloud customers are more lucrative than old-timey license customers, with the benefits generally starting about three years after making the switch. Oracle is in early stages of this transition, but enough customers are moving to its cloud that Oracle's revenue has not been growing lately.

The good news: Now that investments and other transition costs are slowing, gross margins for the cloud business are going higher, and Oracle expects profit growth to result, especially as cloud revenue increases. We believe Oracle's comprehensive software solutions will help it keep most of its giant installed base and continue to win it new customers, ultimately leading to a larger, more profitable business. After several years of patience, we should start to see this healthy scenario unfold soon and for the coming many years. This Buy First stock looks undervalued today, and we model for at least 10% annualized total returns with relatively low risk.

Buy First: Wells Fargo (NYSE: WFC)

At heart, banks are simple businesses, and Wells Fargo is one of the best of the breed.

Suggested Allocation: 3.2%

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** (NYSE: WFC) is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 8,600 branches and 12,900 ATMs. It's the third-largest bank in America by total deposits, it has a reputation for high customer loyalty and satisfaction, and it's the U.S. leader in residential mortgage and small-business lending.

For More

- *Pro*'s original recommendation (12/10/10)
- *Pro*'s "Buy More" recommendation (7/29/14)
- Most recent earnings update (1/20/16)
- Talk about Wells Fargo on our discussion board

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up roughly half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During low-interest lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

Wells Fargo's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. In a world of continued low interest rates, we should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But if and when long-term interest rates rise and loan demand accelerates, Wells Fargo's earnings power — bolstered by growth in fee-based revenue — will hit its full stride.

Shares are trading at less than our estimate of fair value, and at recent prices they yield a growing 3.2% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. With its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

Portfolio Positioning Event: May 4, 2016

Published Apr 12, 2016 at 8:16PM

The *Pro* team held our Portfolio Positioning live chat on this page on Wednesday, May 4, with video streaming below and a text chat under that. Watch the replay and read the text-chat transcript below, and bring any questions to the discussion boards for answers from the team and your fellow Fools alike!

Video Transcript

JEFF FISCHER:

Greetings, Fools, and welcome to the *Motley Fool Pro* Portfolio Positioning event. I'm joined today by J.P. Bennett in this video chat. J.P., how are you today?

J.P. BENNETT:

Pretty good. How about you, Jeff?

JEFF FISCHER:

Doing well, thank you. And we are joined in a text portion of the chat — text only, no sound — by Ellen Bowman at TMFKabellen and Billy Kipersztok at TMFBillyTheKid. They will both be answering questions that you enter into the text portion of the chat. J.P. and I can also see those questions, here, and we will answer some, as well. So we'll chat with you, here, in the video for maybe a half hour, or so, and see how it goes. Then we'll be in the text portion of the chat the full hour, (either two of us or all four of us).

Thank you for being here. We're glad you're here. To veteran *Pro* members, hello again. To brand new *Pro* members, welcome. We are delighted that you're here and that we are here with you. We think you've made a great choice to invest in a Foolish way — let alone a *Motley Fool Pro* way — which is to view your portfolio as a bedrock, as strong companies that we believe will grow over the years and compound your money.

Now, if most of our investments do well, we should do very well. We'll always have some that are laggards. Some that are losers. We will patiently assess those and close them or work on them with options — whatever we feel is best over time — but overall, we're patient as we seek our North-Star-type returns, which right now are running around 10% annualized.

What else is different in *Pro*, though, from owning great stocks, is we use options for income, for leverage, and for protection. A case in point is today's hedge. We also short. We are always looking for more shorts.

J.P. BENNETT:

Always.

JEFF FISCHER:

We probably go through, J.P., 25 or 30 short candidates before we find two or three that we could possibly do, partly because it's very difficult to short many of the stocks that you want to short.

J.P. BENNETT:

It's a hard game to be successful in. That's for sure.

JEFF FISCHER:

It's true, but when you are, it's great. And so far we've had good success shorting. We've had, to my memory, almost all winners.

J.P. BENNETT:

[crosstalk 00:02:28]

JEFF FISCHER:

Exactly. Welcome, again. Here's a little overview of what we'll do. We'll run through the Portfolio Positioning Report and summarize that for you. Hopefully you've all read it by now (it came out last week). And then we'll talk about today's new recommendations, and then we'll tease. We'll name all the companies we're about to buy — no, we won't do that. We'll talk a little bit about looking ahead and what we hope to do, and we'll answer your questions. So very simple, and it should be a fun time together.

A final point is that this will be recorded and archived on the site, along with a transcript, so it will be there for the record.

Let's get started. *How is the live chat going?* Well, it's not our concern right now as long as this video chat is running.

J.P. BENNETT:

We've got some questions in there, now.

JEFF FISCHER:

Oh, good. Questions are starting to come in. Let's go through the Portfolio Positioning Report. If you want to find it yourself, on your Pro site go to the Guidebook tab. Click that and you'll see all of our catch-up reports. And the final one, April 27, about a week ago, was the Positioning Report. In this report we assume that you're starting to build your portfolio. You've bought many of our companies or you're at least on the path to doing that. And now you can start to at least consider the hedges, the shorts, and the options that we recommend, as well.

In most cases, we won't have many active options that you can do right away. We'll step you up to those with new trade alerts, because options are typically timely. And that's true, in some cases, with our hedges and shorts, as well. It's a long way of saying that in this report there were only four trades that we recommended you could do, and the rest (seven of them) are on hold, but we'll get you up to speed on those later.

We'll talk through the four, starting with the shorts, J.P. The first is Deere & Company. We have a recommended short of a 2% allocation. What's the thinking here?

J.P. BENNETT:

Basically we're betting against Buffett.

JEFF FISCHER:

We should have done it on IBM. We thought about it and it would have worked out very well.

J.P. BENNETT:

The thesis, here, is pretty simple. For the past couple of years, we went through what was an agricultural super cycle. Farmers made a ton of money. They saw their land values increase, and in some places exponentially. What did they do with all this excess cash? One of the things they did is buy a ton of new farm equipment. And as far as tractors are concerned, if you look at the historical data, the increase that we saw in the midst of the super cycle, as far as new tractor sales are concerned, was really unprecedented.

So what we expect is now that farm income is starting to drop (and it's been hit pretty hard), there really doesn't look to be any recovery for farmers on the immediate horizon. Land values are also starting to take a bit of a hit and so what we expect is it's going to take some time for the downside of this cycle to play out.

And if you look at the stock, we think that the bulls in the stock are betting that maybe in a year this company is going to be right back to producing cash flows and earnings like they were previously, where we think the normalized run rate is an awful lot lower as they've got all these new tractors and there's really no rush to go out and start replacing them.

So there's an alpha in terms of we think this is going to generate absolute returns, but then there's another aspect of this short in that it does provide a low-cost macro hedge that really helps the portfolio if the economy or just the markets, overall, are getting hit given that this is a cyclical company.

JEFF FISCHER:

If you look at J.P.'s original report here on the *Pro* site, it really details what he just touched on, which is a record number of equipment sales, record prices on farmland, and actually record crop output, as well, which leads ultimately to lower crop prices. All these factors are like a stretched rubber band. It's coming back and we think it will come back further than the market thinks.

J.P. BENNETT:

Exactly. With shorts it's often the case that you need to find a catalyst (a company that's going to struggle) but then it also needs to be a case where the market's expectations are misaligned with reality. Then we think as they continue to produce subpar results, and people start to wake up to the idea that this isn't going to be a quick snapback, then you're going to see a lot of selling pressure and then the stock is going to start to get hit.

JEFF FISCHER:

They also have a large financing department where, if things really went south on them, they could see a lot of defaults and a lot more downside risk there.

J.P. BENNETT:

And they're really trying to push the financing part of the business, as farmers aren't nearly as interested in just straight up buying tractors. They're trying to do everything they can as far as trade-ins, so you're seeing [an increase in the number] of tractors that they finance through their financing arm.

The increase that you've seen in terms of the number of tractors and the absolute value of equipment that they're now helping farms buy is increasing at a very steady clip, and that's helping stabilize their sales to a certain extent. They've already fallen quite a bit, but they'd be down even more if they weren't trying to offer such lucrative terms for farmers to finance new purchases.

JEFF FISCHER:

Then you have depressed commodity prices. Weak emerging markets. Do you know offhand, J.P., the percentage of sales that are outside the U.S.?

J.P. BENNETT:

Offhand, I can't tell you.

JEFF FISCHER:

I know we talked about it a few weeks ago, and it's substantial, suffice it to say. It's maybe one-third, or three-sevenths, or something like that.

J.P. BENNETT:

A fraction. Just keep going on fractions and eventually we'll be right.

JEFF FISCHER:

We'll hit it. It was substantial enough that we liked the short even more because of that.

J.P. BENNETT:

There are a bunch of different ways we think this can play out, and with investing you want to stack the odds in your favor. We feel like we have a lot of potential catalyst, here, for this to work out. But you've got to be patient. You can't predict exactly when the market's going to "wake up," if it does wake up, and start to align its thinking with what we're currently thinking. So sit tight. Currently we're in the red about 10-12%.

JEFF FISCHER:

I think we're around the worst of it and members shorted at higher prices than it fell, and we could put our short on.

J.P. BENNETT:

Yes, we shorted it…

JEFF FISCHER:

Right around the bottom…

J.P. BENNETT:

…and then it just started to take off. So we're down around 10%, and in the grand scheme of things, that really isn't something worth losing sleep over, given that it's only a 2% short. So you need to keep everything in perspective. If you buy a stock and it pops 10%, you immediately don't conclude that this is going to be a winning investment forever. It's the same thing with a short. If you're down 10%, don't conclude that it's game over. The thesis is still intact.

JEFF FISCHER:

That's a good point and good perspective. And speaking to patience, we're glad that while we wait, Deere is a very inexpensive company to short. The annual fee is very low. That said, we do pay approximately a 3% dividend that we'll pay quarterly as short sellers, so that will come out of your account as long as you're short Deere.

J.P. BENNETT:

It's best to think of that as part of the cost…

JEFF FISCHER:

Part of the fee.

J.P. BENNETT:

We've had some other shorts where we've paid an awful lot more than that. Things like World Acceptance.

JEFF FISCHER:

And keep in mind Deere is partly a hedge on Valmont Industries, because the two are both tied to agriculture, emerging markets, and, in some sense, industrial cyclical industries. Valmont has done very well since we shorted Deere and Valmont…

J.P. BENNETT:

It's up like 37%. I'd say that's pretty well.

JEFF FISCHER:

And they're equally weighted. They're both about 2% allocations, and Valmont pays a dividend that's about half of Deere's dividend. So that's a short. Keep perspective, as J.P. said. It's just a 2% position. We don't recommend adding more right now, partly because if Deere runs up quite a bit without merit, in our opinion, we could potentially short more shares.

It's very liquid. Very easy to add to our short lower or, in this case, increase our average short cost and maybe come out with a gain, that way. But we'll see. As a hedge or as a short, even if we don't gain, but the loss is small and it's served other hedging purposes, that helps us.

J.P. BENNETT:

Like I said in the memo, so far we're really down to the market only a couple of percentage points given that the market has done so well. In the grand scheme of things, it really hasn't dragged down our overall portfolio too much, given that a lot of our other stocks have rallied quite nicely as the market's recovered after the past couple of months where there was a lot of fear and uncertainty in what's going to happen.

JEFF FISCHER:

Speaking to rallies and long-term returns, the next short we'll talk about is ticker (FAZ). It's the Daily Financial Bear 3X short. This is an ETF that's been around since the financial crisis, more or less. It did really well during the crisis, but it's done horribly since then because financial stocks were so cheap and they have slowly recovered lost ground. We shorted the short of financials, so we're long. We're 3X long financials by shorting this flawed ETF. It's flawed because of the way it compounds returns. It stacks the odds against it doing extremely well.

So we're up 65-70% on this short, but we still believe in it the same as ever because financial stocks are still inexpensive. The most you can ever make on a short, of course, is 100%, so new members shouldn't look at it as if we've already made 60% so there's not much more to make.

No, anyone who shorts today can make the same 60-70% we've made or more. It just may take time. So we suggested a 0.3-0.6% to short in FAZ. FAZ is difficult to short with most brokers. TD Ameritrade sometimes has shares. Interactive Brokers does have shares, but it's a 4-5% annual fee to short. That isn't that bad, really, and so that's why we're still short shares and still recommend it.

That said, if you're not shorting (and many members do not short), you can, instead, pick up an extra 0.5% in the likes of Wells Fargo or Visa. We have plenty of financial exposure and this ETF was another way (and still is) to increase our financial exposure without putting money out by collecting money into the portfolio instead of by shorting. We like this short for the long term. If you can put it on, great. If you don't, then know that you have plenty of financial exposure by following the *Pro* portfolio.

Those were two of the shorts that you could take on right now. J.P., if you have it pulled up there, do you want to talk about the existing (the earlier June) put ratio spread on SPY?

J.P. BENNETT:

I don't have it up here, but the thinking was very similar to what we have in the report that we just put out. We're going to set up a ratio spread. We don't want it to be where the market falls a little bit and the hedge kicks in. Right now the market has retreated to a point where we are pretty close to our upper put strike being in the money, but if the market falls by a decent amount — a $200-190 spread — then our puts will start to show value and we'll have a gain there.

But if it falls enough, then it flips over and turns into a liability. It was basically around a 10% look-through value, so if you do that one combined with our other ratio spread about 19%, it's important to keep in mind that they do kick in at different levels, so it's not like as soon as the stock falls below $200, both of them immediately kick in. It falls, the first one kicks in. If it keeps falling, then the second one kicks in but the first one turns into a liability.

But like we've said in prior reports where we set up ratio spreads, if that happens, the odds are we'd probably just close the position, turn around, and then buy calls on the market as a much more effective use of our cash to participate in that upside should the market recover. And odds are if the market falls, it ultimately will recover. That's a bet we wouldn't mind making if the market falls a lot.

JEFF FISCHER:

Well said. So the put ratio spreads are a way to hedge, if you want to, without the way we set them up. Without usually putting any money out. Usually we get paid some money, some income, per se, to set these up.

Why is that? Because we are taking on an obligation to buy, in this case, shares of SPY if the market falls sharply. So with the one in the Positioning Report, it was a $200 put we were buying, and in this case we adjusted it a little higher to $192 puts that we are selling. You can still set that up today and do so for very little cost or no cost.

Then the trade we issued today was a $185 put that we're buying and selling $177 puts. And, as J.P. said, those were just to, when the one starts to fall out of use, if the market falls too much, the second one kicks into exposure for us. So it's a way to hedge if the market falls. It expires on June 17, which is only 44 days away, now, and as it reaches expiration, we plan to, as usual, issue new ones for a few months ahead so that we're consistently hedged whenever we want to be.

And right now we do want to be for a few reasons. The market is near the upper end of its historical price range. It's still within the average, but upper end. There's a lot of uncertainty, especially in emerging markets, and earnings aren't really growing, right now.

Ultimately I think this sets us up. This year and a half of flat returns will set us up for a better future — better returns and more earnings growth — because we have easier comparisons that we're putting into place right now. Ultimately it will be a good thing for patient people.

J.P. BENNETT:

I know there's a couple of our stocks where we're looking at the valuation. We still love the prospects for the company, but the valuation maybe seemed a little bit stretched. Flat markets are pretty good because if our companies continue to execute, then they essentially grow into the valuation.

Take, for example, Starbucks. If the stock doesn't go anywhere and just treads water, and Starbucks continues to execute like they have been for the past couple of years, the valuation becomes cheaper over time as their cash flows and their earnings grow. I wouldn't mind a flat market for a little bit.

JEFF FISCHER:

A little bit — especially because we can do things like we did today — write covered calls and find opportunities for things that get beaten down with earnings. We're looking at a handful right now after earnings.

So that's the hedge that we had set up before new members joined and then today we issued a second one. If you have questions on that, hopefully you're asking them in the live text chat right now, which we'll jump to in a minute, or go the SPY board and we can answer your individual questions there, as well. On the S&P 500 SPDR board on *Pro*.

With the Positioning Report, we just had you buy 2018 call options on American Tower, which we are bullish on for the long term. The more people using cell phones, data, and whatnot, the more valuable these towers become around the world. The space that American Tower leases on them, the more valuable that is, more or less. They have long-term contracts with escalator clauses throughout.

Billy is almost done with his earnings review of American Tower and has teased us that the fair value price might go up a fair amount, so our fair value estimate is about to go up on that stock, it sounds like. And now that you bought your long-term call option on American Tower for upside, we will probably have another diagonal call recommendation, soon, for income on that call. Meanwhile, we have almost a 4% allocation in shares for the long term, too.

Those were the four positions that you could take right now as of this Positioning Report. I'll quickly run through all the rest that are on here and why we wouldn't have you do them right now, because you'll visit the recommendation page, see these, not have them yourself, and wonder why that is. *How do I get started on these? Why am I not getting started?* J.P., jump in anywhere you want. A lot of these are my mistakes or successes, in some cases.

J.P. BENNETT:

I was going to say. They're not all mistakes, yet. Some of these turned out pretty good.

JEFF FISCHER:

The first one — and I'm just running through the Positioning Report if you want to look at that alongside us — is American Airlines. We own $35 call options that expire in January, 2017. Right now the stock is about $33. When we bought these, the stock was about $50, so it's been one of our worst positions in my memory in our whole lifetime here in *Pro*. Luckily it was just a call option and we didn't risk more than 1%, but we're on track to lose that 1% right now and we take that very seriously.

American Airlines stock trades at about 3-4x earnings. It started at around 6-7x earnings and we thought the market would reward it as it kept growing profits to about a 10x earnings multiple, which would drive the stock a good 50% and our calls up 100%. Lo and behold, the opposite has happened. The company has grown and the market is rewarding it at about half the earnings multiple that it used to — down to a 3 P/E.

Why is that? Even though American is growing earnings, it isn't growing revenue per average passenger mile and it doesn't expect to until at least next year. Earlier it said it would this year, so it keeps pushing that back. That metric really matters to the market, because if it isn't growing revenue per average passenger mile flown, ultimately the margins are going lower and the prospects for greater profits are diminished, especially if oil prices go up.

So the market is really bearish on American. The stock has gotten hit. We're down to seven months until expiration. Our calls have time value of $3-4 per share, and we might just take that soon, so veteran members are perking up. We might just take what we can get out of the calls and move on, because we could wait a long time for Wall Street to change its opinion on the airline. It was a one-off speculative, as we noted in the first report. The position for us — we wish it were working out differently, but I may be about to wave the white flag on it.

Caesars Entertainment, meanwhile, is the opposite. We've made about 40% shorting Caesars. We closed half of it for that gain and we still have the other half. It's in bankruptcy proceedings, and we're waiting to hear more from judges. We're debating whether we want new members to short the company now that it's down 40% or not. So if we want you to, you'll hear from us on that.

Currency Shares Euro Trust we're also seriously debating closing. We've made about 15%. The euro has fallen a lot if you look at a 5-year chart of the euro versus the dollar. The 5-year chart shows exactly what we're looking for, which is a big drop in the euro. For a currency, a very big drop. And it has since flattened out. We have to decide if we believe there's another leg down for the euro, or not, and act accordingly, so we might be closing this euro short soon. Certainly after three or four years of waiting, we don't want to lose that gain.

Expeditors International — you'll hear from us soon. We're going to roll our covered strangle and we'll get newcomers into that position at that time. That's this month and as soon as next week, probably. There's a little time value still left, but soon.

Gentex — those puts are expiring as income and then we'll probably write new ones.

And then we have a few things on hold, like the Wells Fargo put that we'll roll. We'll get newcomers into that one, as well. And the short of the real estate ETF. It's just become too small in the ETF to short anymore. It's a tiny ETF — about $30 million in assets — so we're having you just sit that one out.

Generally, if you own *Pro* stocks and you do the positions that we said you could (so far those four) and then step into the new ones as we issue them, you'll be caught up probably within a few months as completely as you want to be. Again, you don't need to hedge or short if you don't want to (or use options), but we do recommend definitely options if you have any interest at all. Shorting and hedging, if you have some interest, is definitely worth it in the long run.

J.P., let's briefly run over today's trade alert. I want to see what the questions are about in the live chat, as I haven't seen that yet. We're seeing some come in.

J.P. BENNETT:

It looks like Billy and Ellen are doing a pretty bang-up job in answering most of them.

JEFF FISCHER:

That's great. If there's any big themes, here, in the text chat we can speak to those, as well. I'll ask Ellen if there are any themes and then we'll run through the new trades.

And we hope new members are starting to navigate the discussion boards and asking questions there. We are out there as frequently as we can be. Even more important, in most regards fellow members are out there and they're just being phenomenally helpful. Thank you for that. Almost any question you ask gets an answer and usually pretty quickly.

J.P. BENNETT:

Often quicker than I can get to it. There's already a couple of members that have chimed in…

JEFF FISCHER:

That is true.

J.P. BENNETT:

…which is great.

JEFF FISCHER:

And right now we're going through earnings reports and looking at new ideas, so we may be on the boards a bit less than usual, but we'll be back. These things ebb and flow and we really appreciate the membership out there who is helping.

Ellen says some questions being asked frequently — what about Expeditors today? Yes, that strangle is working out well for us. The synthetic long is up. We've made money so far, and I think the strangle is making a little money, too, even though the shares are $47 and we wrote $45 calls. The put-and-call combo paid us more than $3, as I recall, so we have some money there. But there's still a little time value in the calls. We'll close and roll those as soon as next week.

Someone else is asking why cover DGS. Frankly, it's because we can. Seriously, it's because the options pay decently. This one paid about 2% in 45 days. This year emerging markets have had a good run — up 6% so far. We don't see big reasons why that will continue. In fact, there are more reasons to be concerned that it won't. But either way, we can manage these covered calls.

You really should fault us for not writing calls in the past. We've been waiting patiently several years for emerging markets to do something and they haven't. We've only collected a dividend on this ETF, and we arguably could have been monetizing it a little bit more.

So we'll see how these calls go and we'll manage them. I think we'll make money, ultimately, on DGS whether we keep writing and rolling calls, or let our shares go and write puts to get back in. The bottom line is with emerging markets, it may be another year where they move mainly sideways, but we'll try to set this up so we make money either way.

How do you do options and hedges in IRAs? J.P., do you want talk a little to that? We do have alternative trades in the SPY Reports.

J.P. BENNETT:

That's what I would say. Always look for the alternative trades and see whether or not there's one that you can participate in. As far as shorting and hedging is concerned, we've said it before and we'll say it again. These aren't things that are 100% necessary to be successful in the long run. They are tools that we implement in order to help meet our mandate. For those members who want to strive to achieve similar results, it makes sense for them to do those, but they're not absolutely necessary.

Sometimes the alternative trades just don't make sense for you, or there aren't attractive ones, and we're not going to try and force an IRA alternative if there isn't something we believe in. Some cases maybe you'll have to deviate slightly from *Pro*, but for the most part, if you stick with as many of the positions as you can (and also that you believe in), your results should mirror ours in the long run. But first things first. Always check the alternative trades.

JEFF FISCHER:

Exactly. We'll do our best with every option — short and hedged — to provide an IRA-friendly alternative trade. In the cases where we can't, we'll make a point of saying that so that you're not left wondering about IRAs. We'll just say there are no attractive alternative trades, there.

And by the way, that is what we said with Deere. We didn't want members buying puts on John Deere — they're pretty expensive — or using options, period. We just wanted to short it directly, so if you're in an IRA, unfortunately you can't short Deere. But, as J.P. just said, that's okay. It isn't vital to your success.

J.P. BENNETT:

I know some member who ultimately decided to go with puts. If that's what they wanted to go with, and they understand the risks and rewards, that's perfectly acceptable. The reason we didn't at the outset was we didn't know exactly when this thesis was going to play out.

I think it's important to keep in mind that previously we had really great luck with Caesars and World (we put out a short report) and it seemed like the next day, the catalyst played out. So people who bought puts that expired relatively soon made out very handsomely, but that's not always going to be the case. We didn't know exactly when this thesis was going to play out, so we didn't want members having to constantly re-up and basically continue to buy puts.

Then subsequently when the hammer drops (if it does drop), you're in a situation where it's basically a wash because the stock's fallen a lot. You've made a lot of money with one put that you purchased, but because you had to buy a string of puts, it really didn't work out for you. We weren't comfortable with it, so it's just something that members had to weigh the options, themselves, and see what they believed in, and how soon they thought the thesis was going to play out.

JEFF FISCHER:

Exactly. And like with the FAZ short, there was an alternative trade and there is in the Positioning Report, but it's a synthetic short, and that's if you can't get shares to short, you can set up a synthetic short using options. But, of course, you can't do that in an IRA. FAZ is just another case where there's no IRA-friendly alternative because the put options, by themselves, cost so much.

The hedges that we set up, though, as J.P. said, certainly have IRA-friendly alternatives in each report, so check that out either in the Positioning Report (we give you an alternative trade for the higher strike SPY hedge) and in today's report on SPY, there are alternative trades for this lower-strike hedge. So down at the bottom of the report, see the alternative trades and that should let you set this up in an IRA.

That said, make sure you want to hedge in your IRA. If you have 10 to 20 years to retirement, hedging these funds that you will not touch for 10 or 20 years may not be worth the trouble. That said, if the market falls, it will give you some proceeds that you can then invest in lower-priced stocks, and that's always very nice.

You're partly here to hedge, and we're here to help make it happen if you have any interest in doing that. So we will keep working on IRA-friendly alternatives because we know close to half of *Pro* members, according to surveys, use at least some *Pro* investments in IRAs, so we know it's important to you all.

Let's go back to the live chat. Any other questions there?

J.P. BENNETT:

Billy pointed out the general theme of following Pro exactly versus modifying it for your own circumstances. That's something that's always worth considering. The first thing that you need to keep in mind is that *Pro* is different from the likes of *Stock Advisor* or *Rule Breakers*. Those are just idea-generation services. You pick your own allocation. You pick and choose what you want to do with it. They're not making recommendations based on the [00:32:59] of a portfolio. They're just coming up with they think the best idea is for them every month.

On the other hand, all of *Pro's* recommendations and actions are taking into consideration the portfolio as a whole and how we think those actions will impact that portfolio. So the side effects of deviating from what the recommendations are, are definitely different as opposed to something like *Stock Advisor* and *Rule Breakers*.

That's not to say that you can't do it if you have something that you just don't believe in, or you have something outside of *Pro*. You read a recommendation from someplace else, like *Supernova*, and you love the idea. That's fine. I know plenty of our members allocate some of their portfolio to *Pro* and maybe they allocate a different percentage to *Rule Breakers* and one to *Income Investor*. That's fine if that's the way you think you're best suited to achieve your financial objectives. It's always worth keeping in mind, however, that should you deviate from *Pro*, your returns could be materially different from what we achieve.

JEFF FISCHER:

And they might be materially better, or they might not. But Billy said that exactly right. The main things we hope you'll learn here (and I wrote this in a memo recently) are how we invest, and if you follow us exactly, then you'll definitely learn how we invest and see how our returns are. You'll mirror them.

But if you model how we invest and do it with other stocks, as well, I think it will still benefit you if you target the types of companies that we target, which are generally speaking really strong companies with a lot of qualities that make them that. So study what we look for in a company, and then seek that in other companies, as well, that you're buying.

Then you also learn how to use options and hedge and short. You can put it together in a way where your positions may differ a bit, but you still have the overall approach and philosophy, and that should really benefit you over the long term.

Ellen is saying that someone asked why we chose DGS itself, specifically, and not just the covered calls on it. Because it's kind of a dog. That was a helpful question. I'm happy to answer this. We bought DGS along with Vanguard Emerging Markets way back when…

J.P. BENNETT:

Before my time. Just wanted to throw that out there.

JEFF FISCHER:

In 2009 or 2010. Vanguard Emerging Markets did pretty well and we sold it right near the peak of emerging markets, so bravo. That was good. And DGS has actually done well compared to the other emerging market indexes (VWO and EEM) that we follow — other emerging market index ETFs. We chose it because it's small companies that we couldn't find ourselves in these foreign countries. It pays a decent dividend. The companies are growing, on average, nicely.

But emerging markets, as a whole, have gone nowhere or been hit for the last four or five years. They've seen valuation contraction. They've seen earnings contraction in a lot of cases. So in a bad environment, DGS has done okay compared to a lot of its peers, and for a bad environment we're pretty happy with how it's been managed and how it has, overall, held up all right.

But that's why we chose it, and thankfully we haven't added to it much. I'm glad we did sell our other emerging market exposure. But we kept the small cap exposure because we wanted some small cap exposure around the world with dividend yields, as well, for reasons explained in the original report.

Any other questions? Here's one I'll just read from Mikey: Hello, Jeff and J.P. In order to hedge my IRA, I sold another put at $180 S&P. Since that gives me coverage down that low, would it make sense for me to add the recent SPY hedge there? Thank you guys, and keep up the great work.

That's very kind and thank you. So to hedge the IRA, Mikey sold a put at $180 and they have coverage down that low. Would it make sense to add the recent SPY hedge there? I need more details on that before answering.

J.P. BENNETT:

I'm wondering if he means that he basically converted the ratio of the spread to a more traditional spread. Some of the alternatives that we recommend where he basically caps the losses…

JEFF FISCHER:

In an IRA.

J.P. BENNETT:

Yeah.

JEFF FISCHER:

I bet you're right.

J.P. BENNETT:

But I'd want to know his other strikes. I'm not sure if he's referring to using the $180 in the original report.

JEFF FISCHER:

Mikey, if you can ask that question on the SPY board, we'll be sure to check it and answer it for you. Another question from a member: I have puts on Skyworks. I imagine many members might have put options on Skyworks from Options, itself, or as they build their portfolio. I do not have any stocks, so what does today's covered call recommendation on Skyworks mean from my situation?

It means you don't have to do anything. Luckily covered calls and put options are equivalent in the sense of what they can pay you return-wise. J.P., any other thoughts?

J.P. BENNETT:

I was just going to add there are instances where recommendations will overlap. Like we have Apple in *Pro*, and then we have a bull call spread over in *Options*. Whenever that's the case, you always need to keep in mind your overall allocation. If you have what you believe is a full allocation to Apple in your regular stock portfolio, and then you see a bull call spread recommendation come out in *Options*, you don't have to do that spread. Just make sure you always stay properly diversified. That's one of the tenets to good investing.

JEFF FISCHER:

Definitely. Perfect. As to Skyworks, I feel good about the company. Management is great. Their business is very strong. The stock is volatile and that's okay. That can play in our favor. I think over the long run, we'll continue to earn returns from the stock.

It's been unfortunate to see it give back so many returns, lately, but I think we can also add options into the mix periodically, if not frequently, because they pay well. We know the business well. We can manage the options as best as we can and overall make money in a couple of ways on Skyworks. So I feel good about that position, and whether you're writing puts or own shares and write covered calls, or just own shares, I think in the long run all three will make money.

J.P. BENNETT:

And I think there's something that's always worth keeping in mind with covered calls. One of the biggest fears is you set up a covered call on a stock and then it just zooms away. It goes on an absolute tear. Sometimes that can lead to people really regretting their decisions and so they're somewhat hesitant to write covered calls on those stocks.

My mindset, and I think probably the better mindset to have, is regardless of a position (if it's a long position, or if you're buying stock, if you're setting up covered calls or if you're writing puts) you only want to do those on the best of the best. You don't want to be [doing these if you think] it is a marginal company that probably isn't going to do very well.You don't think the stock is going to go anywhere, so you write a covered call on that.

I would much rather write covered calls on a stock that I believe strongly in, but I want to generate income, as well, so I think it's important to keep in mind that when we're writing covered calls on individual stocks, we're still probably doing that on really strong companies that we have a high conviction in, that may ultimately run away from us.

But to me that is a far preferable alternative than the opposite, where we set up a covered call on a stock we don't strongly believe in. It falls out of bed and then we're stuck with a stock that's down meaningfully, and all we collected was a tiny bit of income which didn't do anything to offset the losses because we have such a large loss from a capital gains perspective.

JEFF FISCHER:

It's a good point. Let's talk a little bit about the trade alert we put out today. We're already

well into this chat and it's flying by.

J.P. BENNETT:

Time flies when you're having fun, right Jeff?

JEFF FISCHER:

It does. We are having fun, now. It's great to be covering earnings. Looking at new companies. Doing research. I'm excited about the next couple of weeks, months, and the next year for new ideas. It seems like some things are getting shaken up.

J.P. BENNETT:

The market isn't just moving straight up. It makes it more interesting as far as active investing is concerned. There's a lot of opportunities on both the long and short sides. Now that we're getting time to devote to that research to find them, I think we'll have plenty of things to recommend in the coming months.

JEFF FISCHER:

And as you said earlier, J.P., after six quarters of the stock market going nowhere, or a lot of stocks going down, as long as those companies have been growing earnings over time, they've become much cheaper. Even if they were just flat, they've become cheaper because their earnings are growing. So as we shake through the giving tree of the stock market, we're starting to see more possibilities and it's fun.

It's also fun to go through newer companies (recent IPOs from the last two, three, or four years). Some of them have really been forgotten and become compelling, so we should add some new names into *Pro* this year, and more than we did last year, I'm betting.

Speaking of today's trades, I think we already covered the SPY put ratio spread quite well. If you are hedging in an IRA, go down to the bottom of that trade and see the alternatives and then right below that, if you have questions, go down to the SPY discussion board and we can answer your questions there, for you, and help you set this up.

One good thing to know is you don't need to rush to set up these hedges. They pay you more when the market's falling than they do right now. So if the market falls and you don't set it up for the next several days or weeks, that's okay. You'll end up getting a better price. Now if the market rises, it's less attractive to set it up. You might get paid less or nothing to set it up. But meanwhile, you haven't needed it, so there's usually not a big rush to set up put ratio spreads for that reason.

And then we said to write covered calls on three *Pro* stocks. Historically we have never written that many covered calls in *Pro*.

J.P. BENNETT:

I can't remember doing something like that.

JEFF FISCHER:

Part of the reason was valuations were all more attractive. We didn't want to cover stocks that we thought would go up imminently. But right now there are more positions that apparently may not go up in the near term as much as we would like. That said, even if they do go up, we're writing covered calls on positions and we believe we can manage the calls effectively because the strike prices are reasonable, the pricing is decent, and so forth.

I don't know what else to say about these three that we issued today (DGS, Skyworks, and Valmont), except to say on the pricing guidance, aim for about 1.5% yield as of right now, because there's a month and a half to expiration and we always target 1% yield per month, more or less. We target more if we can.

If the stock is falling (like Skyworks is lower than when the alert went out), divide what the call option currently pays into the current stock price, and you might still get that 1% or 1.5% or higher yield anyway. So it could be okay to accept a lower premium on this call. You're still getting the yield on the current share price that we're seeking. I think they do all still work out right now and they're all viable to write at the moment.

Again, these will expire in 44 days and before then, or at that time, we'll have updated guidance as needed. If the stocks are lower, the calls all just expire as income. If any of these shares are above our strike price, we'll issue you an alert if we want to roll the calls higher or close them. And if we roll the calls higher, obviously we'll keep the position going with income. If we close the calls, that means we just want to keep the stock uncapped.

We could let some of these shares go. I wouldn't mind selling a few of these positions if it came to that. For reasons cited in the report, I think we can turn around and write puts if we want to get back into these positions, but more than that, we're looking at other ideas. I'm confident we'll have new ideas coming into the portfolio that we may like better than some of these, so that's why we started to write covered calls. If we lose positions, we'll be okay with that.

We have 15 minutes left in the live portion of this, so back to the live chat and we can answer some questions there that Ellen is forwarding to us and then we'll have to wrap this up, for now anyway, and get back to writing reports.

J.P. BENNETT:

Fun, fun.

JEFF FISCHER:

Roger G says: As a previous Options member, I have chosen to translate your Deere short into a long put option to reduce capital at risk. Your take? Well, I'll let J.P. speak to that.

J.P. BENNETT:

We already touched on it a little. We didn't include something like that in the original report for reasons we've already mentioned, but if you're [not] concerned about the capital at risk, and you understand the risk and reward of setting up a position like that, there is no reason you can't do it. It was just our call on what the ideal situation was. It's not that we think that you definitively should not do it. It's just a lot of things in investing are making judgment calls, and we felt like that was the prudent thing for us to do at the time.

JEFF FISCHER:

The good thing about buying puts, instead of shorting, is that you have much less capital at risk. If the shares soar, you're just out what you paid. But, as J.P. said, if you have to do it again and again, those costs add up. But do what you're comfortable with, definitely, and congratulations on using options knowledge to approach the position in a different way. That's great.

Overall, the most important thing, whatever you do, is that you're comfortable with it, because you, alone, have to live with it day in and day out, and when things get volatile, if you're nervous at home or uncertain, you're more likely to make a mistake. To close a position exactly when you shouldn't.

So the key is to be comfortable with it. We're around as much as we can be. We'll send emails. Assurance. Be on the boards when things get really rocky. We'll talk you through positions that we still believe in or get us out of positions if we don't believe in them.

So our finger is always on the pulse and we're always there to help. But even so, only you know what you think about at night, and if something worries you so much that you get out of it on your own at a bad time, then that's unfortunate. So be comfortable, yourself, with each position you take on.

J.P. BENNETT:

I would say one of the biggest things that differentiates good short sellers from bad short sellers is the mindset. To be able to put everything in perspective and to not overreact, because when you're shorting something, in essence you're going against the upward pull of the market over time, so you have to be comfortable with a position momentarily working against you. To just stay calm and levelheaded and think things through before making a decision.

JEFF FISCHER:

That is true. Always take a step back. If you're feeling nervous or emotional, that should trigger in you, *I need to step back, get grounded, and make a rational decision*. Go back to your investing notebook, if you keep one, and look at why you started a position and see where it stands now. Come to the boards, post, and get feedback from others. It's a really good way to help.

Here's a question from RecklessMike. He says: Hello, I'm new to Pro. (Welcome, Mike.) I'm investing $30,000 based on the allocation suggested. Then in July I'll have another $5,000. (That's great.) How do I allocate that $5,000? I trade on Fidelity and I would like to minimize my trading fees. Thanks. PS: Love your cool haircuts. (I love the plural there. I am sure you meant haircut — J.P.'s.)

J.P. BENNETT:

Come on, Jeff. Don't sell yourself short, there.

JEFF FISCHER:

I'm just glad I have some hair. Or maybe not. If I didn't, I'd have more free time. I wouldn't have to shower every day.

J.P. BENNETT:

I think we all appreciate that you shower every day before coming into the office, Jeff.

JEFF FISCHER:

That's a great question, Mike. You're investing $30,000 right now at today's allocations with $5,000 to invest later. And then the follow-up question to that is whether you are adding $5,000, or whatever amount, periodically whenever you can. I would assume so. So to the best of your ability, try to foresee what you're going to add and allocate with that in mind, but also realize we'll have new positions and you'll want some capital to put to those.

It isn't easy — there's no easy answer — but overall, the better you can be close to our allocation advice without being far overweight in any one position, that's the best outcome. Maybe you only own 20 positions that are 5% each, because you want to minimize trading costs, you say. Or even for now 10 positions that are 10% each, maybe, at the max. And knowing that you're adding more cash, that will work those allocations down as you add new positions and new cash.

So focus on the positions you like best. We like all of them — they're all buys — and we don't have a crystal ball to say which will do best, but we think all will meet our goals over the long term. That's why we keep them. That's our hope. And as you add money, move into new positions while keeping your others in check (like 5-7% each hopefully at the most). I said 10% earlier, but I'm backing away from that now.

I hope that helps. I don't know if it does. RecklessMike, if you have a follow-up question, go to the Making Pro Fit You board and we'll check that out and try to answer there.

Robert says: Jeff, J.P., Billy, and Ellen, thank you for your continued emphasis on taking your time. (That's certainly true.) If the market falls, the put ratio spread gets more attractive, initially. (That's true, as well.)

It is all about taking your time. You can't change your financial position immediately. It typically will take at least a number of years to build to that, so try to enjoy the process. J.P., you've been investing how many years, now?

J.P. BENNETT:

Not as many as you?

JEFF FISCHER:

Well, that's easy, but…

J.P. BENNETT:

I can't tell you, offhand. I started when I was a freshman in college.

JEFF FISCHER:

I don't want to give away your age.

J.P. BENNETT:

A couple of years, at least.

JEFF FISCHER:

Five, or six, or seven.

J.P. BENNETT:

Mm-hmm.

JEFF FISCHER:

And he has a great portfolio, from what I've seen and what we've talked about, but like all of us, he's still building it. It's a lifelong endeavor and that's what makes it fun. So do take your time. As we always say, average into positions if you prefer that and we'll be there to keep helping you down that path.

J.P. BENNETT:

It is a marathon — not a sprint.

JEFF FISCHER:

That is true. We have five more minutes. Here's a question from Rich: All three of today's call writing recs are bidding far below the targets. Are we well off simply hoping for a market pop this week to hit better strikes?

No, Rich. Let me look at current pricing [to see] if the market has fallen sharply all of a sudden. It's down a little bit. Skyworks is down a little bit. What I will say is what we said earlier. We're looking for a 1.5% yield on the current share price. So as the share price goes down, even if the option pays a bit less, the yield may still be about 1.5%. So I'm betting that is still the case and that you can still write these options.

There wasn't a dollar-per-share target given in the trade alert because of that. We just listed the current price, but said that that price will change and just aim for a yield on the current share price. Don't anchor on the option price that is in the alert. So read the alert, again. Read the price guidance closely, and you'll see that these should still be viable today as long as they pay about 1.4-1.5% of the current share price.

With that, we only have two more minutes to wrap up, here. J.P., any closing thoughts?

J.P. BENNETT:

I think we covered everything we set out to do at the beginning, which is a bit of a surprise for us. We've been known to go off on tangents and not always meet our objective, but we did a pretty good job staying on track.

JEFF FISCHER:

Good job, J.P. Good answers. I had a good time. And members, we appreciate that you were here. We'll answer one more question. JRF asked:Would you write a covered call on Gentex?We'll have to get back to that. So far we haven't. We believe the stock has more upside, and the calls generally haven't paid that well. We instead have been writing puts on Gentex to potentially add to our position, and that has generated good income in the past year or so and maybe longer. So we're more likely to keep writing puts on Gentex right now, than write covered calls, but down the road we might.

Then a member says they're bewildered that Berkshire and Microsoft are not on the Pro buy list. I think that's partly because we try to find positions that a lot of members don't already have or know about, and instead of Berkshire we've owned Amtrust Financial, which is a small insurance company. Kind of the opposite of Berkshire.

J.P. BENNETT:

You could say that.

JEFF FISCHER:

The returns have been very good. We also owned AIG in the past because it was deeply undervalued, and we own some Berkshire positions, like MasterCard, and we own a lot of financials. Berkshire does, as well.

J.P. BENNETT:

Coca-Cola…

JEFF FISCHER:

Wells Fargo is their biggest position. That's one of our positions, as well. So we certainly keep track of what Warren Buffett is doing. I think why I haven't recommended the position, aside from the fact that it's recommended in most places around the Fool, is Buffett's age, frankly, and the size of the company, now. I think we can get better returns than Berkshire because Berkshire is so big, and so far that's proven true with many of our positions.

And then Microsoft is simply not in our wheelhouse. We have Oracle and we have a lot of other tech exposure. Maybe we should have bought Microsoft, as well, but we haven't. So as we wrap up, we can look at it again. We have had positions on Microsoft in *Motley Fool Options* and Berkshire, as well, in *Motley Fool Options*.

So thank you members, for being here. We appreciate it very much. We hope you are gradually getting started with *Pro* and will ask any questions that you have on the discussion boards. Keep in mind it's a long-term endeavor. We are right now enjoying going through earnings and doing research on new companies. We look forward to adding new things to the portfolio, both long and short, and new options, as well.

As each trade alert arrives, take your time. Read the whole thing. Make sure it suits you and that you're comfortable with it. And then ask any questions that you have on the discussion board.

Overall, if you are majority invested in good companies that we recommend, we think you'll meet your goals in the long run. If you're adding shorts, hedges, and options, it adds more possibility and more potential returns, and we find it a lot of fun, too. That's why we hope you're here. We look forward to seeing you on the boards, and with more trade alerts, and the weekly memo, as well. Thank you again. J.P.?

J.P. BENNETT:

Just enjoy the rest of the week, everyone, and we'll see you on the message boards.

JEFF FISCHER:

Thank you to Ellen and Billy, as well, and we'll see you soon. Fool on!

[End]

The Professional Investor's Pursuit of Something for Nothing

Published Apr 12, 2016 at 10:23AM

Fellow Pro *Fools: Morgan regularly writes about one of the most important aspects of investing well: mindset. And your mindset is largely influenced by your knowledge of stock market history, another topic Morgan covers better than anyone. Morgan writes every week for* Motley Fool One*, and we're fortunate to be able to share some of his columns with you in* Pro*. Today's article speaks eloquently to having realistic expectations for your investments. Enjoy! -- Jeff*

Motley Fool Mindset: Behavior
To know success, know yourself.

It never ceases to amaze me that simple financial difficulties can affect the smartest and most well-connected investors in the world.

Andrew Caspersen, a partner at a prestigious private equity firm, was charged last week with running a $95 million Ponzi scheme. That's news itself, but it's not what first caught my attention.

What made me shake my head was the offering document — basically a marketing pitch — that Caspersen used to lure money into his scheme. One document claimed Caspersen's fund "offers private equity returns (15%) but without the risk."

Huge fifteen-percent annual returns *without risk*. No risk!

Big returns with no risk are what everyone wants in investing. It's the equivalent of saying, "I want a beautiful four-bedroom apartment overlooking Central Park for less than $800 a month," or a weight-loss program that lets you eat donuts on your couch while burning fat. It's preposterous on its face, but the siren song is so beautiful that people can't help but line up to hear more.

Caspersen's alleged victims weren't inexperienced youngsters. They were deep-pocketed, well-connected professional investors, which makes the story all the more intriguing. The dream of getting something for nothing isn't just ae problem afflicting uninformed amateur investors. It runs right up to the top of Wall Street's most seasoned elite.

A friend of mine recently gathered a list of expectations that institutional investors demand from hedge funds before they'd consider investing. These are direct quotes from institutional investors (note, here: "drawdown" means "temporary loss"):

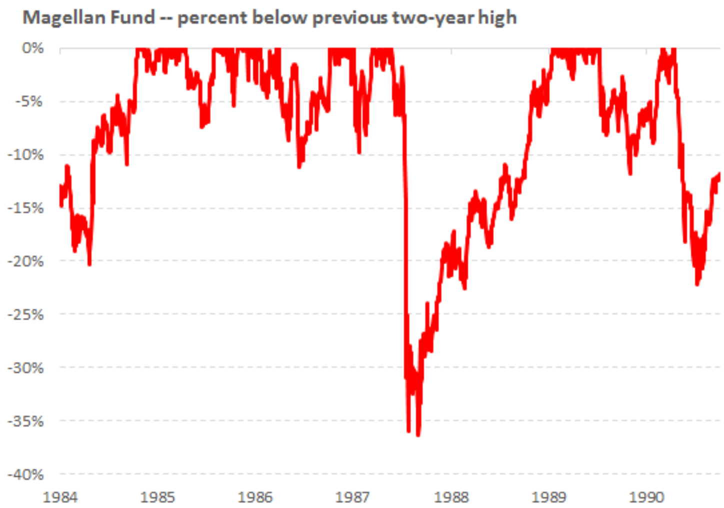
> "*Expects a return of 10% to 15% and drawdowns of no more than 5% to 10%.*"
>
> "*The expected return of the manager is typically between 12% to 15% on a five year annualized basis. Managers with a maximum drawdown of 20% or more will be not considered.*"
>
> "*We target returns of 15% and [maximum drawdowns] should be 7%.*"
>
> "*A strict requirement is that funds must have at least three years of 15% returns. The ratio of annual returns to maximum drawdown must be at least 1.5.*"
>
> "*Currently looking for energy hedge fund managers with net returns greater than 20%. Managers should have the 'right pedigree' and not have a drawdown of greater than 15%.*"

People want a big upside, and little downside.

When you are on this pursuit of something for nothing, as many professionals are, you are more likely to end up getting nothing for something. So it's no wonder that the average hedge fund has underperformed the S&P 500 by more than 100 percentage points since 2009.

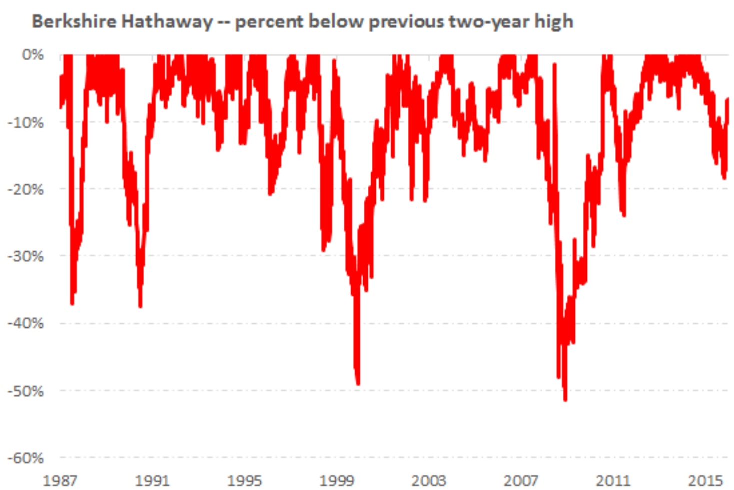
Think about this. Famed investor Peter Lynch made his name running Fidelity's Magellan Fund. Almost all of his gains came in the mid-to-late 1980s, when the fund returned an astounding 19.9% per year, one of the best investing performances in history.

I wondered what percentage of the time during that period Magellan was in a 7% drawdown — the kind of negative performance institutional investors demand on avoiding. It turns out Lynch's fund was 7% below its previous or more about 41% of the time during his miraculous run:



Dig into the data on this chart, and I count eleven separate times Magellan fell into a 7% drawdown during this period. But, remember, suffering just *one* of those drawdowns would have taken the fund off institutional investors' lists of funds worth investing in.

Now consider Warren Buffett's Berkshire Hathaway. Over the last 30 years, Berkshire has gained about 16% a year, which is outstanding. But it's been in a 7% drawdown or worse 48% of the time, including no fewer than 29 separate 10% declines. The average professional investor, seeing this much volatility, would have plugged its nose and walked away, unwilling to accept a bad month in exchange for three decades of sensational returns.



I often think amateur investing may be easier and more fruitful than professional investing. The career pressure to perform, the inability to accept loss, and the incentives for winning in the short run may make professionals more vulnerable to inflated expectations than individuals.

Understanding this reality, calling it out, and realizing that our edge lies in rejecting the pursuit of something for nothing is a lot of what Foolish investing is all about.

Pro Catch-Up Trades: April 11, 2016

Published Apr 11, 2016 at 3:26PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **Facebook** (NASDAQ: FB): Buy our 6.1% allocation in thirds or halves over time (write near-the-money puts if you don't mind potentially missing upside).
- **Gentex** (NASDAQ: GNTX): Buy up to 2.6% in stock.
- **Wells Fargo** (NYSE: WFC): Buy up to 3.2%, or buy in halves.
- **Oracle** (NYSE: ORCL): After our recent update, the stock remains a Buy First. Buy up to 3.9%, or buy in halves.

Continue building your portfolio with our Buys, including these highlighted today:

- **Papa John's International** (NASDAQ: PZZA), buy up 2.7% in stock.

- **TD Ameritrade** (NASDAQ: AMTD), buy 2.4% in stock.
- **Valmont Industries** (NYSE: VMI), buy 1.9% in stock for the long-term upside potential.

Options:

- **Gentex** (NASDAQ: GNTX): Write May 2016 $15 puts as per our recent recommendation, to potentially add to your stock.

Our most recent short:

- **Deere & Company** (NYSE: DE), as a hedge against the market and our investment in **Valmont** (NYSE: VMI): Sell short (sell to open) 2% of Deere per our recent recommendation.

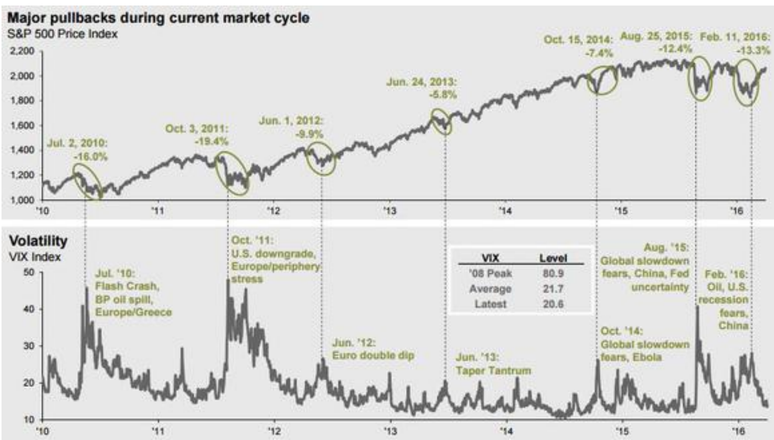
Charts of the Week (Second Edition)

Published Apr 11, 2016 at 12:18PM

Dear *Pro* Fools,

Your self-professed "charts guy" is back at it again. In this week's Memo, "Charts of the Week (Second Edition)," I'll share the five most interesting and market-relevant charts I came across this week while perusing the financial blogs and websites I frequent:

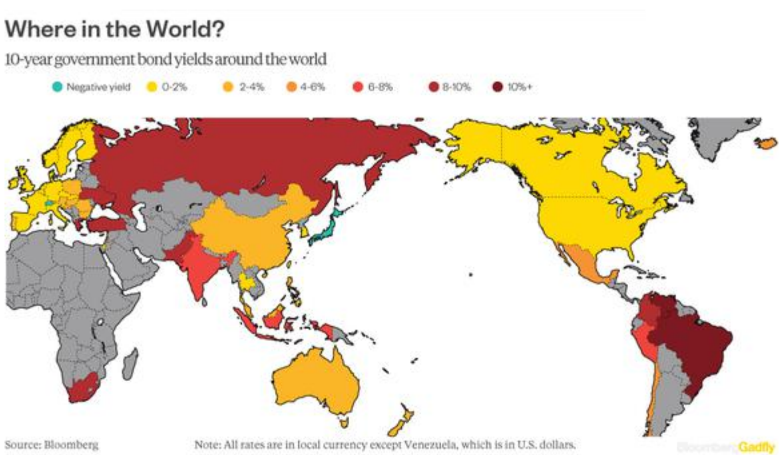
1. Market Pullbacks and Volatility During Current Market Cycle (2010-2016)



Sources: FactSet, Standard & Poor's, J.P. Morgan Asset Management. (Bottom) CBOE.

From one of my favorite quarterly chart books (the JP Morgan Asset Management Guide to the Markets, updated as of the second quarter of 2016), this chart highlights seven major market pullbacks since 2010 (top half), overlaid with the concurrent spikes in the VIX index (bottom half).

2. Dude, Where's My Yield?



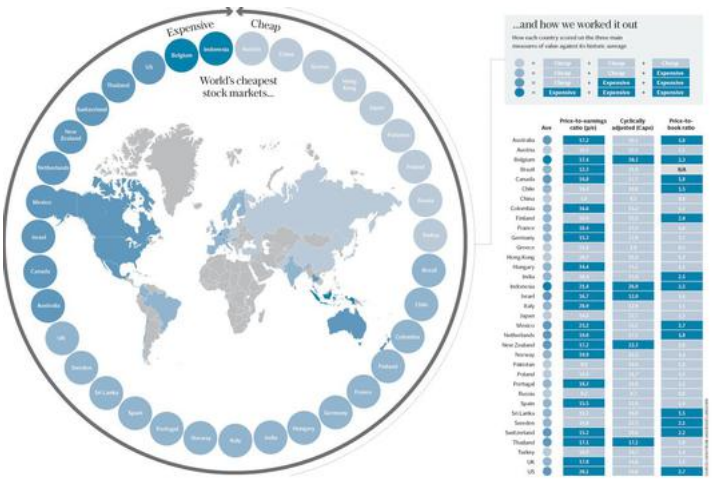
This chart from Bloomberg shows a geographical representation of 10-year government bond yields around the world. With some countries (India, Brazil, Russia) offering yields of 7% to 10% or more, why aren't investors racing to lend to these nations? Because efficient currency markets act to offset that yield for foreign investors when they cash out and have to convert back to their own currencies.

3. Decoupling of Economic Growth and Greenhouse Gas Emissions

This one is probably my favorite graphic this week. This fascinating chart, based on data from the BP Statistical Review of World Energy 2015 and corroborated by recent data from the International Energy Agency, shows how 21 countries (including the United States) have reduced annual greenhouse gas (GHG) emissions since the year 2000 while expanding their economies. Amidst the increased activism and media attention paid to the impact of global climate change, I had been unaware that this positive global trend was unfolding until I saw this.

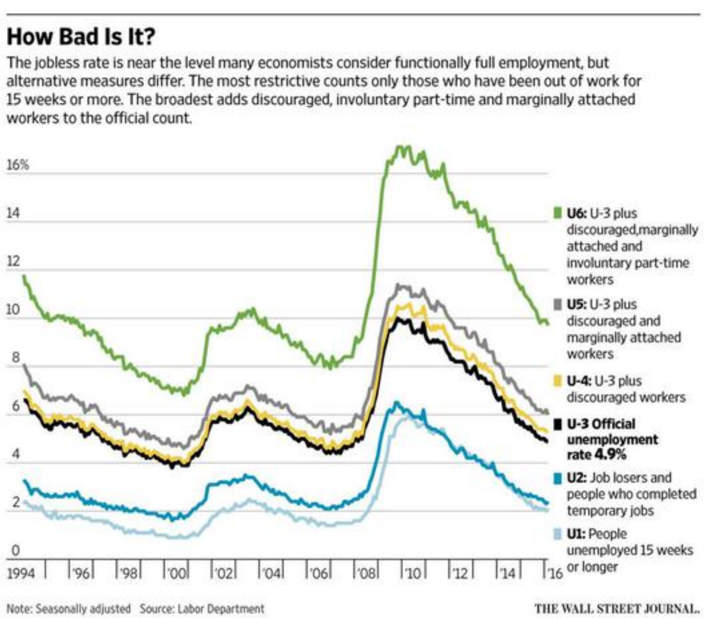
In the United States, an energy consultant recently opined that the primary reason carbon emissions are falling is because of hydraulic fracturing ("fracking"), which has led to a large switch from coal to relatively cleaner-burning natural gas in electricity generation. However, declines in U.S. emissions were offset by increasing emissions in most other Asian developing economies and the Middle East, and a moderate increase in Europe. The next challenge for reduced global GHG emissions is to prevent carbon leakage to other countries as nations move their industries overseas.

4. The World's Cheapest Stock Markets



This excellent graphic from *[The Telegraph]* (view a larger version [here]) shows three valuation measures for each country: the price-to-earnings ratio (P/E); the cyclically adjusted price-to-earnings ratio (CAPE); and the price-to-book ratio (P/B). Each market is then compared to its own historical average to determine its relative "cheapness."

5. Alternative Measures of Unemployment



This graph from *The Wall Street Journal* breaks out different measures of the U.S. Bureau of Labor Statistics' official unemployment rate, known as U-3. It shows the history and trajectory of the five other alternative measures of labor underutilization, which provides a more detailed picture of U.S. unemployment than the single, "official" data point. For more detailed descriptions of U-1 through U-6, see here (under "NOTE").

The *Pro* Bottom Line

There you have it, Fools -- the second edition of my top five charts of the week. Hope you enjoyed it, and bring any questions or comments to the Memo Musings board!

Best,

-- Billy (TMFBillyTheKid)

Write Diagonal Calls on American Tower

Published Apr 5, 2016 at 1:44PM

Is this for you? This recommendation is for all *Pro* members who have matched our 3.7% stock allocation in **American Tower** (NYSE: AMT) and **also** own January 2017 or 2018 calls or are ready to buy them now. We are only writing calls to cover our owned calls, **not** to cover our stock position. We recommend that you leave your stock allocation **uncovered** in order to capture further potential upside in American Tower. If you bought calls on American Tower during the *Pro* on-boarding process, you can follow along with this trade.

How You Participate

- **Trade:** Sell to open April 29, 2016, $105 calls on American Tower. *Please note that these are **weekly** options*.
- **Allocation:** Sell one call for every January 2017 (or January 2018) $80 call you already own (or are buying now). *Pro* will cover its 6 long calls.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a limit order to split the bid/ask spread at going prices as long as you get at least a 3.5% yield on your long January 2017 or 2018 call value (see the math below). These weekly options are relatively thinly traded, so i**t is critical that you use a limit order** to avoid collapsing the bid/ask spread.
- **Prices** (April 6):
  - **Stock price:** $104 (as of 9:35 a.m. 4/6/16)
  - **Sell to open April 29, 2016, $105 calls (bid/ask split):** $1.20
  - **January 2017 $80 calls we own (bid/ask split):** $24.65
  - **Diagonal call yield:** $1.20/$24.55 = 4.9% in 24 days.
- **Catch-Up Trade:** If you're setting up the whole trade today, use a diagonal call order, buying the January **2018** $80 calls (rather than the 2017 calls *Pro* owns, in order to give your calls more time to expiration) and selling the April 29, 2016, $105 calls to aim for a net debit of $25.10 or so. Invest about 0.6% of your funds in the long calls if you're matching our allocation.

What We're Thinking

Since we bought our American Tower calls in late 2014, the position has been somewhat of a laggard. Our original intent was to target leveraged upside as American Tower continued to increase its tower portfolio via acquisitions and steadily increase its cash flow and earnings power.

While American Tower, the business, has continued to execute wonderfully on its growth strategy, until recently, the stock price wasn't playing along. It reached a 52-week low of $83.07 in February:

	December 17, 2014	February 11 2016	% change
# of Towers	69,912	100,131	43%
TTM Total Property Revenue	$3.9 billion	$4.7 billion	20%
TTM Adjusted EBITDA	$2.6 billion	$3.1 billion	18%
Stock Price	$97.14	$83.07	-14%

But since those lows, the market and the REIT sector have roared back strongly, reacting positively to information from the Federal Reserve that further rate hikes will be implemented more slowly than previously expected. American Tower now trades near $104 per share, up 25% from its recent lows and hovering around a 52-week high as we approach first-quarter 2016 earnings, which are expected sometime in early May (the exact date is not yet available)

Given the stock's strong recent appreciation, and *Pro*'s goal of targeting regular income in 2016 to capitalize on a volatile market, we have decided to cover our owned calls with a diagonal call in order to capture some income (and slightly higher upside) prior to the company's earnings report.

Although the original intent of our long call was not income, we are comfortable with the trade-offs we are making with this diagonal call. These written calls could pay us 5% or so on our current long call value in less than one month, and we have upside to the $105 strike price, a little less than 1% above the current price. If the stock price shoots well above our written call's strike price prior to expiration, we can roll our calls for further income (if the rolling trade looks attractive) while still capturing the full upside of the stock with our uncovered 3.7% stock allocation (currently our ninth largest).

Even if we assume that we will have to sell our long calls in a month when our written calls are assigned, the return on our long calls (including the income from these diagonal calls) would be approximately 12%, besting our North Star since our December 2014 purchase. Of course, we don't plan to close or sell unless we're forced to, so we'd look to roll our calls if we can, targeting further upside on our growing Buy First stock.

More That Matters

- **Maximum gain:** The 4.9% premium earned from writing the calls, plus upside in our owned calls to our short call strike price at $105, which is lately around 1% higher than the current price.
- **Maximum risk:** The full value of our long $80 calls, minus premiums received from short calls.
- **Follow-up**: We hope to see these short calls expire for income later this month, and then wait to see earnings results. If we need to roll or close, we will.

Options Can Help

- **Want to know more about this strategy?** Our Options U guide to writing diagonal calls can keep you on an even keel.
- **Questions about this trade?** Consume data and post your questions on our American Tower board.

Pro Catch-Up Trades: April 4, 2016

Published Apr 4, 2016 at 3:56PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **Facebook** (NASDAQ: FB): Buy our 6.4% allocation in thirds or halves over time (write near-the-money puts if you don't mind potentially missing upside).
- **Wells Fargo** (NYSE: WFC): Buy up to 3.3%, or buy in halves.
- **Oracle** (NYSE: ORCL): After our recent update, the stock remains a Buy First. Buy up to 3.9%, or buy in halves.

Continue building your portfolio with our Buys, including these highlighted today:

- **Papa John's International** (NASDAQ: PZZA), buy up 2.6% in stock.
- **TD Ameritrade** (NASDAQ: AMTD), buy 2.5% in stock.

Options:

- **Gentex** (NASDAQ: GNTX): Write May 2016 $15 puts as per our recent recommendation, keeping in mind our "Later" guidance.

Our most recent short:

- **Deere & Company** (NYSE: DE), as a hedge against the market and our investment in **Valmont** (NYSE: VMI): Sell short (sell to open) 2% of DE per our recent recommendation.

How We Target Pro's Returns

Published Apr 4, 2016 at 2:13PM

Dear *Pro* member:

Pro is commonly thought to be a lower-risk portfolio, set up to have lower volatility than the market. But to the extent that we do achieve lower volatility (and so far we've done pretty well), it's thanks to the quality of the companies we buy, the prices at which we invest, and the allocation framework we set up. We are *not* set up to be wallflowers, and we do not lack conviction. In fact, being on average only 72% net invested for many years means that the only way we can achieve a higher return than the S&P 500 -- and come close to our North Star -- is by taking some sort of risk. What kind? Our 10 largest positions make up 45.6% of our portfolio as of this morning -- close to half. Being this concentrated also concentrates your risk, but sets you up to outperform if your largest positions remain handy winners. And there's more.

Aside from our top 10 holdings, we currently have 15 other long investments (two of which are shorts of short ETFs), three shorts, and a handful of options strategies -- a few are longs, one is a hedge, and others are income-oriented. Again, this isn't a portfolio built to hug an index by purchasing many dozens of stocks. We only have 25 longs, and as mentioned, 10 of them make up almost half of the portfolio. We certainly hope and aim for the portfolio to do better than the index to the upside (we basically have to, if we want to stay near our North Star over the years) despite not being fully invested, and we want it to do better in downturns despite being concentrated in a handful of stocks. This strategy can only work if you:

- choose the right companies -- growing businesses that are less likely to suffer much in economic downturns (we use our *Pro* quality criteria to screen for this)
- use hedges that don't drag much on returns during a bull market
- don't run into disasters with open-ended short positions, let alone with your largest stock holdings

But that *still* isn't enough to target the returns you want. You need to get more specific.

Of course, there will be time periods where we don't meet our goals, but so far the ride has been fairly steady for several years. What's driving it? And how *do* we generate healthy returns while only being about three-quarters invested? A lot of the answer has to do with our allocations to companies that we expect to compound at above-average rates. We place our stocks into buckets based on simple but specific minimum expectations, and this helps us manage allocations. Let's look at our happy *Pro* bucket list!

10% Annualized Compound Returns

Obviously we won't always be right, but we always target companies that we believe can return at least 10% annualized from our purchase price over the long haul. If a good company falls after we buy it, we may buy more, expecting that new investment to earn more than 10% annualized. Today, our companies that fall into the 10% desired return bucket are (by allocation size):

- **Broadridge Financial Services** (NYSE: BR), 4.9%
- **Apple** (NASDAQ: AAPL), 3.9%
- **Oracle** (NYSE: ORCL), 3.9%
- **American Tower** (NYSE: AMT), 3.7% (excluding calls at 0.5%)
- **Gilead Sciences** (NASDAQ: GILD), 3.4%
- **Parexel** (NASDAQ: PRXL), 3.3%
- **Wells Fargo** (NYSE: WFC), 3.3% (excluding short puts)
- **Medtronic** (NYSE: MDT), 3%
- **Gentex** (NASDAQ: GNTX), 2.7% (excluding short puts at 1.5% look-through)
- **TD Ameritrade** (NASDAQ: AMTD), 2.5%
- **Verisk** (NASDAQ: VRSK), 2.2%
- **Valmont** (NYSE: VMI), 1.9%

Total allocation: 38.7%

We believe these investments face lower-than-average business and valuation risk, and yet all 12 could return at least 10% annualized the coming years, including dividends. We have more than one-third of the portfolio invested in these bedrocks. Of course, ideally many of these stocks will top that bogey, and we know some won't. Note that some of the companies listed, including Apple, started with expectations for higher than 10% annualized growth -- and delivered -- but have grown to such a size that we expect only about 10% from them now. Verisk, meanwhile, could return more, but we bought at a valuation that has us hoping for a 10% annualized gain.

15% Annualized Returns

- **O'Reilly Automotive** (NASDAQ: ORLY), 5.4%
- **MasterCard** (NYSE: MA), 4.5%
- **Starbucks** (NASDAQ: SBUX), 3.8%
- **OpenText** (NASDAQ: OTEX), 2.9%
- **Papa John's International** (NASDAQ: PZZA), 2.6%
- **Visa** (NYSE: V), 2.5%

Total allocation: 21.7%; return multiplier in relation to 10% goal is 1.5x = 32.5% influence

With these six stocks, we hope and aim for at least a 15% annualized return; all have blown by that number in recent years, but we still believe there's enough growth on tap to support similar results in the years to come. So what? If these six stocks can return 50% more, annualized, than the dozen stocks above, then while they add up to a 21.7% allocation, their strength in the portfolio is more like 32.5% exposure when it comes to reaching our current 10% annualized total portfolio goal. With 10% being our North Star, we could just buy a bunch of presumed 10% growers. But buying companies that we believe will return more than that in essence leverages us on our way toward our goal, and lets us keep some money out of the market.

20% Annualized Returns

- **Facebook** (NASDAQ: FB), 6.3%

- **AmTrust Financial Services (**Nasdaq: AFSI), 5.2%
- **Skyworks Solutions** (NASDAQ: SWKS), 3.7%

Total allocation: 15.2%; return multiplier in relation to 10% goal is 2x = 30.4% influence

These three higher-growth businesses make up 15% of our portfolio -- and if they can return at least 20% annualized, they alone could drive about 30% of our 10% annualized portfolio return goal. Said another way, if each of these stocks returns 20% annualized, it's as good as *twice as much cash* invested but growing by only 10% annualized. Don't believe me? $150,000 going up 20% in a year gives you a $30,000 gain. $300,000 going up 10% gives you... a $30,000 gain.

Now, when you add up our total allocation toward meeting our 10% return goal, you get, from the top bucket on down: 38.7% + 32.5% + 30.4% = 101.6%.

Even though these 21 stocks only represent 75.6% invested capital, if our returns from each are as desired, they'll get us 101.6% of the way to our 10% annualized return goal for the whole portfolio. That has largely been the case so far.

Next, if we add low-cost hedges and successful shorts, as well as option strategies, we should have even stronger returns -- and some winners when the market declines, too.

Keeping the Portfolio Aligned

If I've learned one thing in life, it's that change is constant. Perhaps it's the only constant. But change in a portfolio's construction should not occur frenetically; rather, it should take place gradually, over many years. After several years of rising prices, some of the stocks from which we expect 20% and in some cases 15% annualized returns are looking long in the tooth. This year, Facebook may need to be marked down to a presumed 15% grower, as will AmTrust as the workers' comp business slows. We may not expect OpenText and Starbucks to return 15% annualized much longer, so they could potentially move to the 10% bucket. And some positions, like Valmont, haven't grown at all yet. The point is: To keep the portfolio aligned with our goals using this construct, we gradually need to add more high-growth companies, or we need to invest more of our cash in 10% growers -- whichever we see in the market.

Meanwhile, our shorts of leveraged, short ETFs were made with the aim of returning at least 10% annualized, and they have. We essentially view them as longs. But most of our other company shorts are viewed as "extra" returns achieved beyond our goals (our long stocks alone should lead to our desired returns), and our income is essential but largely "extra" to our returns, too. Finally, hedges -- when they pay off -- pad downturns and add more cash to our coffers, which we can then reinvest, hoping to compound it.

I hope this column helps explain some of the thinking that goes into the *Pro* portfolio and shows why allocation, and where you allocate, matters. We're about 75% invested in core stocks, but if our return projections are right, this should get us to more than 100% of our return goal, while still keeping cash on the side for opportunities. So far, it has. But as with all things, as time goes by we need to make changes and add new positions, working to keep a semblance of this balance. Our hunt for growth companies that entice us to buy them is lengthy. Questions? Please visit the Memo Musings board.

-- Jeff (TMFFischer)

Pro Completed Trades

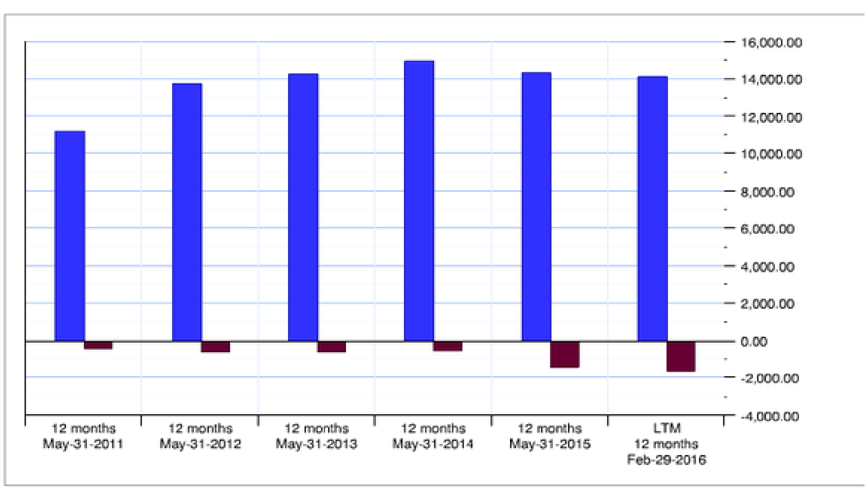
- **Gentex** (NASDAQ: GNTX): We sold to open 25 contracts of the May 2016 $15 puts, collecting an average of $0.36 each, within our guided range for at least a 1.5% yield per month. This could add 1.5% more exposure to the stock.

Oracle Foresees a Brighter Future

Published Apr 1, 2016 at 10:37AM

Oracle (NYSE: ORCL) is the largest business software provider in the world, with approximately 400,000 customers and $37 billion in annual revenue. The giant built its legacy by selling database management software licenses and related hardware, but in recent years it's begun transitioning interested customers to its newer cloud software offerings, as well as hosting customer data on its own premises. This transition doesn't come cheap. First, Oracle had to invest in hardware, software development, and sales staff. Second, cloud customers bring in less up-front revenue compared with traditional software license sales, a strong headwind in the short term. Over the long term, however, cloud customers are more lucrative than license customers, with the switch generally starting after three years. Oracle is in early stages of this transition, but enough customers are moving to the cloud that Oracle's revenue and cash from operations is treading water during the transition.

Cash from Operations (blue) and Capital Expenditures (red)



Source: S&P Capital IQ. Numbers in millions.

But now that investments and other transition costs are slowing, margins are going higher, and Oracle expects this profit growth to expand, especially as cloud revenue increases. Meanwhile, it has to keep battling large competitors including **Microsoft** (NASDAQ: MSFT), **IBM** (NYSE: IBM) and **Amazon.com** (NASDAQ: AMZN), not to mention **Salesforce** (NYSE: CRM) and **Workday** (NYSE: WDAY), in order to retain customers who might use a transition to the cloud as a reason to jump to another provider. We believe Oracle's comprehensive software solutions will help it keep most of its installed base, and continue to win new customers, ultimately leading to a larger, more profitable business. After several years of patience, we should start to see this unfold soon and over the next many years. The stock remains a Buy First, with a 3.9% allocation.

Status	**Buy First**
Fair-Value Estimate	$46 (no change)
Recent Price	$40.95
Current Allocation	3.9%
Dividend Yield	1.5%

Key Long-Term Thoughts

- Several years ago, Oracle began to rewrite all of its software to enable cloud usage. In its March conference call, the company called the move to cloud "a generational shift in technology that is the biggest and most important opportunity" in Oracle's history. Oracle now has more than 11,000 customers using its cloud services, but it's still early in the shift.
- Oracle said it's "not quite at the end of the beginning" of its own business transition to serve the cloud; it's making progress, and we are starting to see results. "We are far enough along that our financial statements will begin to show our success with accelerating revenue growth [and] operating margin expansion over time," according to management -- this should lead to healthy earnings-per-share growth.
- Oracle sells customers a complete enterprise software solution on premises or in the cloud (or both, as many prefer). It needs to convince customers it's nimble, contemporary, and effective, so they don't move to newer competitors. So far, large customer wins are encouraging. In SaaS (Software as a Service) cloud sales, Oracle won 942 new customers last quarter; it now has more than 11,000 customers in SaaS and PaaS (Platform as a Service). Increasing customer counts more quickly than competitors, it's likely taking market share, and its giant installed base of customers combines with the reality of switching costs to put it in a position of strength.
- To simplify: If you sell a traditional software license for $1, after a year you only get a portion of that $1 again in the form of support revenue. But if you sell $1 in cloud services, then the next year, you get $1 again with a renewal. So, cloud is a net revenue win over time.

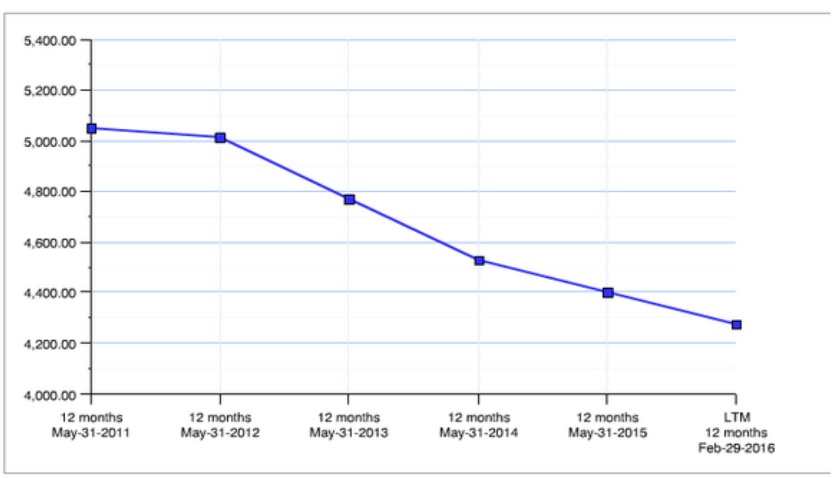
Secondary Thoughts

- Tackling the competitive question head-on, Oracle said, "We're very comfortable that we can defend our leading position in the database market."
- The earliest cloud renewal rates are coming in strong, and they should get materially better -- the customers who joined a bit later obtained the stickiest cloud applications from the start, and that should drive "very, very high" renewal rates. (Plus, the earliest customers came in on promotions.)
- Oracle's performance in the Asia-Pacific region improved considerably. Business in most of the world now seems fairly stable, with the notable exception of Brazil and its macro problems. Overall, Oracle expects relative stability in legacy businesses and growth in cloud.

The Numbers

- **Outlook:** For Q4 now in progress, SaaS and PaaS revenue should be up 57% to 61%. Cloud Infrastructure as a Service (IaaS) revenue should be -1% to +3%. Total cloud and on-premise software sales should rise 1% to 2%, with total revenue growth being -2% to +1% with currencies. Non-GAAP EPS should be $0.82 to $0.85, compared with $0.78 last year. Looking further ahead to Q1 2017, SaaS and PaaS revenue should be up more than 59%, and margins should be higher. For the full fiscal year 2016, constant-currency on-premise software revenue should be positive, with growth in software support making up for a decline in new license sales. Cloud-related capital expenditures for the full year will be much lower than last year, helping cash flow and margins.
- **Q3 2016 just ended:** SaaS and PaaS revenue were up 57% in dollars. As the transition to cloud continues, much of the rest of the business was flat to down. See the press release for those details.
- The company has lowered its diluted shares outstanding by more than 16% over the past four years.

Weighted Diluted Shares Outstanding (millions)



Source: S&P Capital IQ.

Market Cap	$170.9B
Cash	$50.7B
LT Debt	$40.1B
EV/EBITDA	10.7
EV/EBITDA NTM est.	9.1
P/FCF	13.8

P/E	20.1
P/E NTM Est.	14.8

Position Summary

Valued at less than 14 times free cash flow and 14.8 times forward earnings estimates despite currency headwinds, the business is not expensive; it remains about 12% below our fair-value estimate. As long as we continue to believe Oracle can win enough of the enterprise race into the cloud, the stock remains a long-term buy for your diversified *Pro* portfolio, where it's rated Buy First today at a 3.9% allocation. Experienced members may also write near-the-money put options to try to get shares cheaper and earn income while waiting.

Oracle EV/EBITDA Multiple (10-Year)

Source: S&P Capital IQ

- Float over to *Motley Fool Pro*'s Oracle board to ask your questions!

Pro Catch-Up Trades: March 28, 2016

Published Mar 28, 2016 at 3:15PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **Broadridge Financial Services** (NYSE: BR): Following our recent update, the stock moves to Buy First. Buy up to 4.9%, or buy in halves.
- **Facebook** (NASDAQ: FB), buy our 6.4% allocation in thirds or halves over time (write near-the-money puts if you don't mind potentially missing upside).

Continue building your portfolio with our Buys, including these highlighted today:

- **Apple** (NASDAQ: AAPL), buy up to 3.8% in stock.
- **O'Reilly Automotive** (NASDAQ: ORLY): Our fair-value estimate moves up; shares are a long-term buy, up to a 5.5% allocation. Buy in halves if preferred, or write puts on a sizable account.
- **Papa John's International** (NASDAQ: PZZA), buy up to 2.6% in stock.
- **TD Ameritrade** (NASDAQ: AMTD), buy 2.5% in stock.

Options:

- **American Airlines** (NASDAQ: AAL): Buy to open January 2017 $35 calls, lately for about $8.80 each (buy one call for every $880 you are comfortable risking, up to 0.5%). We don't know yet whether we'll extend this strategy beyond 2017, but it's possible.
- **SPDR S&P 500** (NYSEMKT: SPY): Set up the new put ratio spread per our recent recommendation. It can lately be set up for a net credit above $0.20.

Our most recent short:

- **Deere & Company** (NYSE: DE), as a hedge against the market and our investment in **Valmont** (NYSE: VMI): Sell short (sell to open) 2% of DE per our recent recommendation.

Pro Quality Checklist: Gentex

Published Mar 28, 2016 at 1:18PM

Dear *Pro* Fools,

We've now run six of the companies in our portfolio through our *Pro* quality checklist:

- **American Tower** (NYSE: AMT) -- 7.5/8
- **Broadridge** (NYSE: BR) – 8/8
- **Oracle** (NYSE: ORCL) -- 8/8
- **O'Reilly Automotive** (NASDAQ: ORLY) -- 6/8
- **TD Ameritrade** (NASDAQ: AMTD) -- 5.5/8
- **Valmont Industries** (NYSE: VMI) -- 5.5/8

Today, we will continue our checklist series with **Gentex** (NASDAQ: GNTX), our auto-dimming mirror maker. The company is our 16th largest position, with a 2.7% allocation, and we recently wrote puts on it to either bring in income or increase our allocation at a lower price. Here's how it stacks up against our eight criteria.

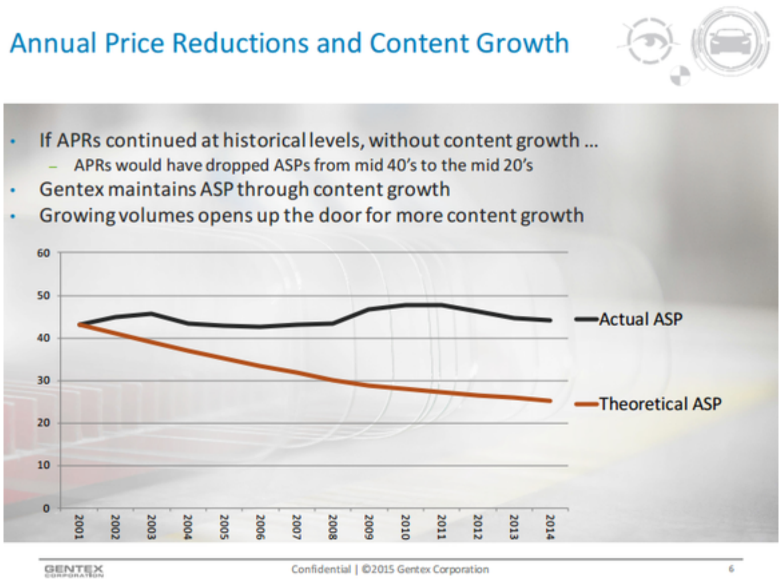
1. A Sustainable Competitive Advantage

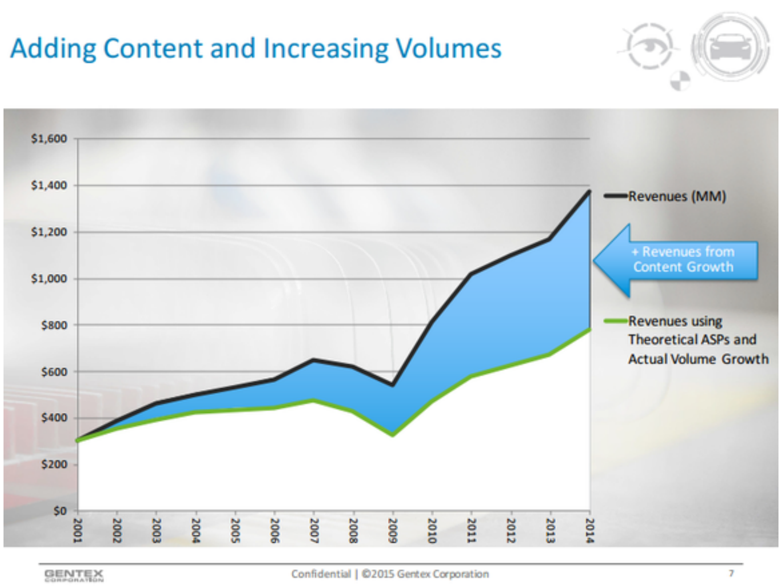
Yes. Gentex's most significant competitive advantage is efficient scale. The company dominates its niche, with 91% market share of the global auto-dimming rearview mirror market in 2015. This market is large enough to reward Gentex with strong returns, but small enough not to attract significant competition. Gentex's strong engineering and R&D functions (R&D is typically 6%-8% of sales) act as an additional deterrent to competitors. As evidence of Gentex's market dominance and competitive advantages, the company's market share in rearview mirrors is up from 83% in 2000.

2. Pricing Power

No. Gentex's customers are large multinational automakers. Like much of the rest of the automotive supply industry, Gentex experiences pricing *pressure* more than pricing power. Gentex's powerful customers subject the company to demands of annual price *reductions* (APRs), which historically are in the range of 2%-3%.

Notably, though, Gentex has been able to combat the annual price reductions by adding new features and additional content to its mirrors. As seen in the graphs below, despite the annual price reductions, the company has actually been able to maintain average selling prices (ASPs) via growth in content (i.e., addition of new features):





3. Dependent Customer Base

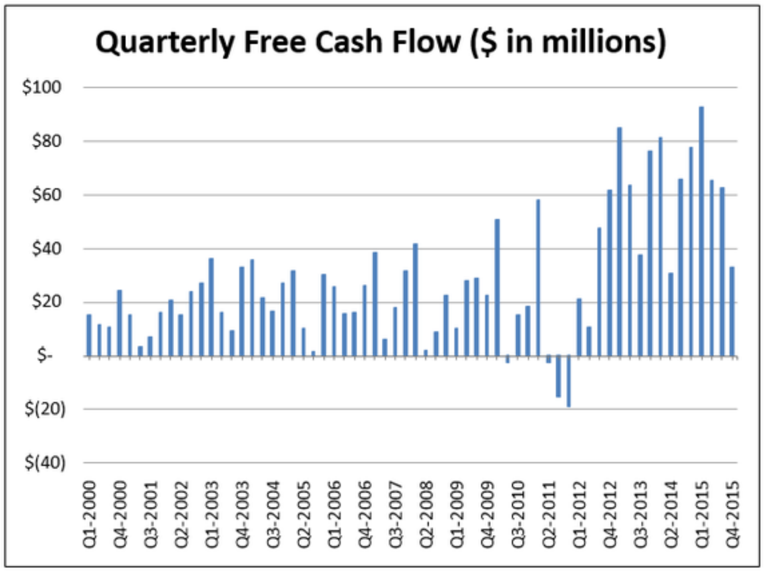
No. Gentex's products are not mission-critical for the company's automaker customers. Its mirrors are typically made available as an option (most often as a part of an options "package") on premium models within an automaker's product line. As the selection rates for the options on premium models increase, they generally become available on more and more models.

4. Predictable Revenue

No. Gentex operates in the automotive industry, which is cyclical and is highly influenced by global levels of economic activity. Automotive production levels and customer orders can be volatile. For example, in the first quarter of 2009, the company reported $94 million in quarterly sales, a 47% yearly decrease from the pre-recession high set just one year prior. If an economic recession shrinks global consumer demand for vehicles, Gentex's sales will suffer.

5. Growing Free Cash Flow With Compounding Returns

Yes. Gentex's dominant market position and competitive advantages lead to strong margins and plenty of free cash flow. Its free cash flow margins since the end of 2000 have averaged 15.7%, and the company's increased market penetration, revenue growth, and expanding margins have led to expanding free cash flow:



Gentex also has the opportunity to reinvest its cash flow at high rates of return. The company has spent more than $800 million since 2000 on engineering, research, and development -- activities that have spurred the content growth mentioned above, which helps the company maintain selling prices and keep margins high.

Additionally, Gentex has shown that it is not averse to making significant acquisitions. In 2013, the company spent about $700 million to acquire HomeLink, a wireless vehicle/home communications product that enables drivers to remotely activate a variety of radio-frequency convenience products for automotive applications (garage doors, home lighting, entry gates, etc). HomeLink has proven to be a strong acquisition already, helping Gentex increase gross margins from the 33%-36% range pre-acquisition to the 38.5%-40% range post-acquisition. In 2015, HomeLink modules (excluding revenue from HomeLink integrated into mirrors) accounted for roughly 11.6% of Gentex's automotive-division revenue.

6. Financial Resilience

Yes. Gentex has a very resilient balance sheet, with strong free cash flow (about 15% of sales, as mentioned above) and a net cash balance of $425 million.

7. Expanding Possibilities

Yes. Gentex has consistently shown the ability to innovate via its engineering, research, and development functions. The company continually seeks to develop new products and is currently working to introduce additional advanced-feature auto-dimming mirrors (for example, the recently introduced full display mirror). Acquisitions into adjacent markets are a possibility as well.

8. The Three C's of Management (Clarity, Consistency, Capability)

Yes. Gentex is led by Chairman and CEO Fred Bauer (age 73), one of the original founders of the business. Bauer has more than 35 years of experience with Gentex, and he has been integrally involved in the operational, engineering, administrative, and financial aspects of the company for his entire tenure. Bauer is also the named inventor on a number of the company's patents and owns more than $100 million in company stock (2.3% of shares outstanding).

The company has a strong bench of managerial talent. The other five executive officers (excluding Bauer) average 43 years of age, and the young executives participate heavily on earnings calls and within the company's operations. Executive compensation is modest (no executive earns more than $2 million in total compensation), and the company's incentive system is sound.

Perhaps the only knock I have on management is the level of disclosure. Gentex doesn't provide a high level of granular detail in its filings, but that's likely just a consequence of being a smaller company that doesn't attract much analyst attention. As the company's Wall Street coverage has grown, management's disclosures and communication to investors have improved.

The *Pro* Bottom Line

In sum, Gentex scores a 5/8 on our *Pro* quality checklist. While it's not the most exemplary *Pro* stock, Gentex's strong competitive advantages and qualitative attributes make it a welcome complement to the rest of our portfolio. Because of the company's exposure to cyclicality, we have to be more careful about position sizing and valuation. That explains our relatively small 2.7% allocation, and our preference for writing puts in order to potentially increase our allocation with a margin of safety. But given the company's low valuation, its increasing market acceptance and penetration, and a technology tailwind in the automotive industry, Gentex should be able to sustain margins and earn North Star-like returns from here.

Fool on!

-- Billy (TMFBillyTheKid)

Guidance Changes

- **Broadridge Financial Services** (NYSE: BR): On the heels of **Facebook** (Nasdaq: FB) and **MasterCard** (NYSE: MA) before it, now this stock moved to Buy First, too. We have a 4.9% allocation.

- **Gilead Sciences** (NYSE: GILD): Although it looks inexpensive, the stock moves down to Buy (from Buy First) given the the lack of growth prospects in the intermediate future. We still believe a North Star return is possible, though. We have a 3.4% allocation.
- **O'Reilly Automotive** (Nasdaq: ORLY): Our fair value estimate increases to $255. The stock remains a Buy, with a 5.5% allocation.
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS) Fund: The ETF Returns to Buy, with a 1.7% allocation. So far, putting it on Hold, rather than selling it, was the better, with shares up about 15% since then. Given that we already have cash, we're willing to give this emerging markets ETF a bit more time to show improving performance before assuming that cash would be a better place for this money.

Completed Trades

- **SPDR S&P 500** (NYSEMKT: SPY): We set up our new June 2017 put ratio spread, per our alert. We obtained a credit of $0.37.

O'Reilly's Fair-Value Estimate Revs Up

Published Mar 24, 2016 at 10:39AM

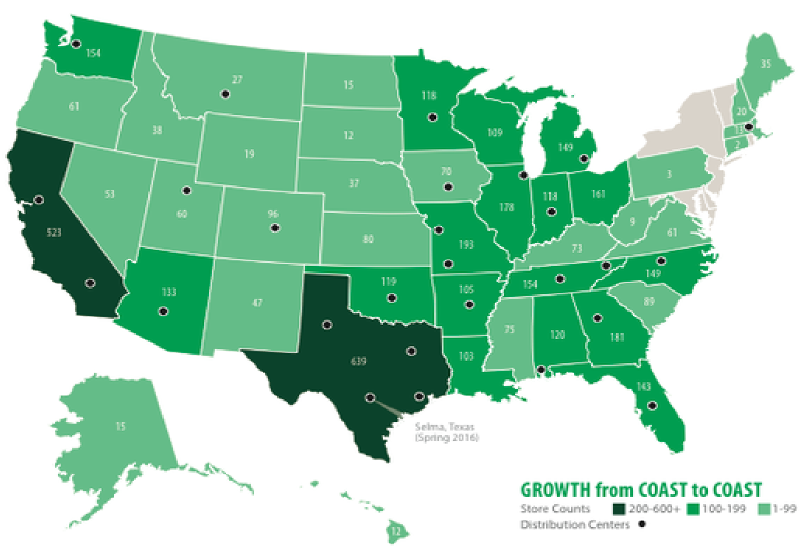
O'Reilly Automotive (NASDAQ: ORLY) owns more than 4,500 retail auto parts stores in the United States, and is lately adding more than 200 new stores per year. An extremely well-run company that has increased same-store sales and margins consistently for years, O'Reilly sees more opportunity ahead. And as one of our largest positions, O'Reilly remains a stock we want to own for the long haul. Shares are rated Buy even though they lately trade about 9% higher than our fair-value estimate (which is, again, an estimate).

Status	Buy
Fair-Value Estimate	$255 (up from $220)
Recent Price	$276
Current Allocation	5.6%
Dividend Yield	0%

Key Long-Term Thoughts

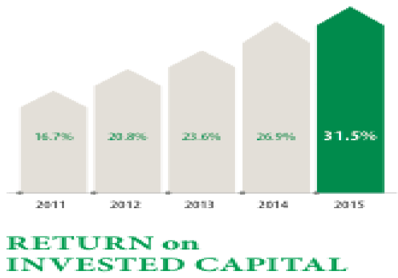
- This story remains all about growth. Little is exciting about selling auto parts unless you're consistently expanding. O'Reilly increased same-store sales 7.7% in the last quarter, and more than 7% in each quarter of 2015, grabbing market share along the way. The last quarter represented the 28th consecutive quarter of EPS growth greater than 20% -- that's seven years running.
- After opening 205 net new stores in 2015 (right on target), the company has sights on opening a net 210 in 2016. In most states, exposure is low enough that growth is on tap.
- Both the professional customer and the do-it-yourself customer contributed strongly to same-store sales growth. Increases in comparable transaction count and average ticket size contributed equally, too. The company credits knowledgable customer service and wide availability of parts (at competitive prices) for driving repeat traffic. Its new loyalty program is helping, too.
- Management continues to consider acquisition targets, including in the Northeast. Many candidates are chains that are not publicly traded and operate 100 to 400 stores.

Store Count by State (source: O'Reilly 10-K)



Secondary Thoughts

- Last year through November, miles driven were up 3.5% year-to-date. They should increase again this year, to a lesser degree. Miles driven, employment rates, severe weather, and gas prices are all drivers of this business.
- The company has an adjusted debt-to-EBITDA ratio of 1.52, well below its targeted 2 to 2.25. Management is using today's low interest rates to add leverage, given the stability of its cash flow. Since the quarter closed, O'Reilly has begun raising $500 million more through a secondary note expiring in 2026, with 3.55% interest rates.
- Management is purposely working its cash level down because of the strong returns it earns on invested capital.



(source: O'Reilly)

- O'Reilly performed well in the last recession, and expects to in the next one; people keep their cars longer during tough times, requiring more repairs to keep them in running order, and this can help offset lower employment and fewer miles driven.
- Lower fuel costs help lower the company's own distribution costs, as well as leading to more customer miles driven. If fuel prices rise meaningfully this year, that could become a headwind compared with a strong 2015.
- The company expects new car sales to remain healthy as more jobs form.

The Numbers

- **Outlook:** With management expecting tailwinds from modest improvements in employment and low gas prices, same-store sales guidance for the first quarter and 2016 is a positive 3% to 5%. First-quarter EPS guidance is $2.41 to $2.51, and full-year EPS guidance is $10.10 to $10.50. On average, analysts expect 16% EPS growth this year, to $10.66. Revenue should be $8.4 billion to $8.6 billion, and gross margin 52.3% to 52.7%. Free cash flow should be $750 million to $800 million, after capex of $460 million to $490 million. Selling, general, and administrative (SG&A) expenses should be up about 2% this year, more than the 1.5% standard, on higher medical costs, a bit more advertising, and more investment in data systems.
- **Q4 2015 and FY2015:** Q4 sales were up 10.5%, EPS rose 24%. For the full year, operating profits hit a record 19%, up 140 basis points over 2014. Full-year 2015 EPS was up 25% to $9.17.
- Gross margins will not keep expanding as rapidly as they have recently; that growth rate isn't sustainable. But ongoing incremental improvements are foreseen.

Market Cap	$27.1B
Cash	$116M
LT Debt	$1.39B
EV/EBITDA	15.9
EV/EBITDA NTM est.	14.4
P/FCF	29.8
P/E	29.7
P/E NTM Est.	25.5

Position Summary

At 5.6%, O'Reilly is our second-largest position. We are always cautious with retail investments, but when you find an exceptional company leading a profitable retail sector, the returns can be rewarding for a long time. With smart distribution of a vast array of parts, helpful customer service, and strong financial returns, O'Reilly continues to look like a standout company. The stock remains a long-term buy for your diversified *Pro* portfolio.

- Vroom on over to *Motley Fool Pro*'s O'Reilly Automotive discussion board and ask your questions!

Write Puts on Gentex

Published Mar 24, 2016 at 10:02AM

Is this for you? Since we're looking to add 1.5% to our stake in this company, this alert should be applicable (now or perhaps later) to all *Pro* members, whether you already own shares of **Gentex** (NASDAQ: GNTX) or not. If you don't yet own shares, check out the Alternative Trades section at the end of the report.

How You Participate

- **Trade:** Sell to open May 2016 $15 puts.
- **Allocation:** 1.5% — write one put for every $100,000 you manage; *Pro* will write 25 contracts. In addition to our current 2.7% stock holding, this would bring our total allocation to about 4.2%.
- **Price Guidance:**
  - **Now:** Use a **limit order** to target $0.50 or greater to start (for a 3.3% effective yield in 58 days). **If we all use limit orders** and the stock price cooperates, we may be able to achieve $0.50 today.
  - **Later:** As prices and time to expiration change, those approaching the position should aim to get paid a yield on time value of at least 1% or so per month to expiration. (That means at least $0.15 per month remaining.)
- **Prices (9:50 a.m. March 24):** Stock: $15.31. Options: $0.50 bid / $0.55 ask. Guidance: $0.50.
- **Stock Rating:** Buy First, 2.7% allocation; we're now adding 1.5% in additional exposure through these new puts.

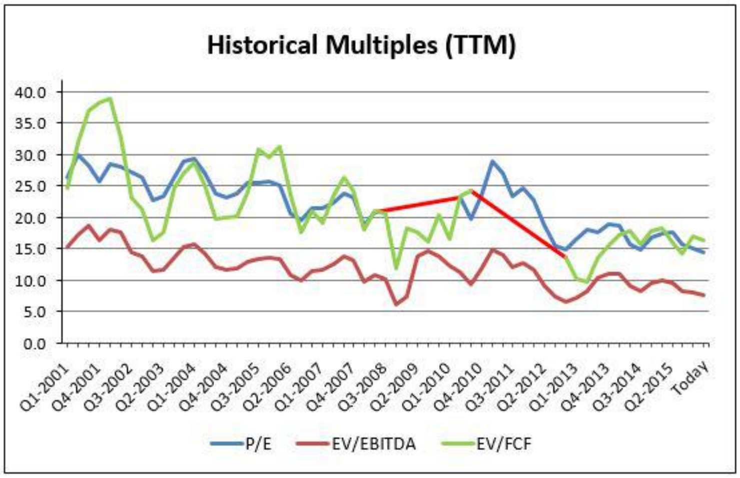
What We're Thinking

After the expiration of our March 2016 $15 puts last week, we've now run three successful rounds of written puts on Gentex, with all three iterations expiring fully as income. We've been running an income strategy on our Gentex position for more than a year, having begun our first round of put-writing in January 2015.

Since then, we've earned $4,259 in options income from our three rounds of written puts, and we've earned $1,826 from five dividend payments in January 2015, April 2015, July 2015, October 2015, and January 2016. Based on our current ownership stake of 4,400 shares, that's income of $1.38 per share. That equates to an 8.9% yield on the current share price, which helps offset some of the stock-price weakness that Gentex has experienced since the end of 2014 (as of today, the stock price is down 15% compared with the closing price on Dec. 31, 2014).

For many of the same reasons I've shared in previous alerts, we've decided to continue our income strategy by writing these new March 2016 $15 puts, targeting both income and the opportunity to buy shares at a lower price. Though we like Gentex's long-term prospects, we prefer to target income on our position alongside the potential to add to our stake at a lower price. With the income for this iteration of the strategy at $0.50, we'll have brought in a total of $2.20 per share with our series of four written puts on Gentex, giving us an effective start price on assigned shares of $12.80. (Your mileage may vary depending on how much you collected in the first two go-rounds and your tax situation.) This is about 16% lower than the current level, and 29% lower than our fair-value estimate; we'd happily buy shares for this price.

That said, we also need to evaluate the strategy on today's new decision alone — are we happy to potentially buy shares at $14.50? At $14.50 per share, we'd be buying shares at 13.5 times trailing-12-month (TTM) earnings, 7.1 times TTM EBITDA, and 15.2 times TTM free cash flow, at the low end of historical ranges over the company's past 15 years. That includes the 2008-2009 period, when auto sales plunged and several automakers looked like they might go bankrupt:



Note: Red lines represent omitted outlier multiples that correspond to recession-depressed earnings and cash flow.

Given that Gentex has executed well this year and that the auto market has continued to demonstrate strength — with seasonally adjusted annual sales of 17.4 million units in February 2016, 6.8% higher than the 16.3 million in February 2015 — we think those multiples are attractive.

More That Matters

- **Maximum loss:** For this iteration of the put strategy alone, our risk is the same as share ownership starting at about $14.50, or 5.3% less than the recent price.
- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At a minimum of $0.50, that's a 3.3% effective yield in 58 days.
- **Follow-up:** For this iteration of the put strategy alone, we'll buy shares at a net $14.50 if the stock is below our $15 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 2.7% allocation first — Gentex's shares are a Buy First. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1.5% of your portfolio, then just buy 1.5% in stock directly *if and when Pro* does so through these puts (we'll alert you if and when we do).
- **Want to write other puts?** Consider writing June 2016 or September 2016 $15 puts if the price on those options holds up better than the March puts after this alert is issued. Right now, the bid/ask on the June 2016 puts is $0.55/$0.65 (a 4% effective yield in about three months) and the bid/ask on the September 2016 puts is $0.90/$1.20 (a 7% effective yield in about 6 months).

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Check your mirrors and switch lanes over to the Gentex discussion board.

Hedge: Set Up Another Put Ratio Spread on the SPDR S&P 500

Published Mar 23, 2016 at 3:18PM

Is this for you? At *Pro*, we use hedges to earn returns during a market decline. You don't need to hedge to succeed with *Pro*, but if you are at least 80% invested in stocks and want to hedge your market exposure, then consider following along. This 10% hedge will lower our immediate market exposure to about a net 70%. Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $200,000. We are leaving our April 2016 SPY put ratio spread alone, as it's far out-of-the-money, so we'll have two going at once.

How You Participate

- **Action:** Use a spread or ratio spread order to set up a put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
- **Allocation:** About 10% of your total portfolio value, measured on the look-through value of the $200 puts you're buying (each put represents $20,000 in hedge value). Set up one 2:1 put ratio spread for every $200,000 you manage and want to hedge; hedging just over 10% of our entire portfolio of nearly $2.5 million, *Pro* will sell 26 puts and buy 13 (because 13 puts at a $200 strike = $2,600 x 100 shares per contract = $260,000 look-through put value = 10.4% of our $2.5 million portfolio value).
- **Trade:**
    - **Use a ratio spread order to simultaneously ...**
        - Write ("sell to open") **two** June 17, 2016, $190 puts, and:

    - Buy ("buy to open") **one** June 17, 2016, $200 put. Click "view all" at your broker to see all strikes.
- **Price Guidance:**
    - Sell to open **two** June 17, 2016 $190 puts: Lately $2.60 x 2 = $5.20 credit
    - Buy to open **one** June 17, 2016 $200 puts: Lately $4.88 debit
    - **Net credit:** Lately about **$0.32** credit per spread -- but this price will change. As it does, simply aim for a credit, or close to no cost, using a limit order.
    - SPY price: $203.90
    - **Potential adjustment:** If SPY moves in price before you set up your trade, you may want to move both of your strike prices down or up accordingly, as much as SPY has moved, while still aiming for a net credit. After our mandatory trade delay, we will make such an adjustment if need be, and tell you about it.

What We're Thinking

At *Pro*, we aim to have winners in down, flat, and positive markets -- and that means we need to address all three possibilities at once in our portfolio. Yet our portfolio remains oriented toward the long term and majority invested in strong stocks. A hedge on a market index is simply a hedge against a lower market while the rest of our stocks are free to appreciate. We generally don't care about declines of 5% or less, but when *Pro* is functioning as desired, declines of about 7% or more should result in some of our positions, like these spreads, becoming nicely profitable. At the same time, the put ratio spreads we use:

- Are harmless to us if the market goes higher (they don't harm our return)
- Are typically cash-free to set up (they often even pay us a small credit -- essentially income!)
- Have a low probability of long-term loss

What's the trade-off? As with any written put, we need to be ready to buy the underlying investment; for today's position, that means being prepared to buy into the S&P 500 index (through SPY) if the price falls below $190. In this case, if the index declines by more than about 11.7%, this hedge becomes a liability, with SPY falling below our breakeven point. If that happens, we would plan to buy long-term call options on SPY instead of shares, saving most of our cash in the process. See below for details on that.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2,492,000
- Ten percent of that value: $249,000
- June 2016 spread:
    - Buy to open $200 puts. Thirteen contracts representing 100 shares each = $260,000 in look-through exposure, or about a 10.4% hedge on our current portfolio value, cash included (you could also round down to 12, but that gets us only a 9.6% hedge; we'd rather round up).
    - Sell to open $190 puts -- 26 contracts, half of which are *not* covered by long puts and thus become a potential obligation at a net $180, currently a 9.4% possible stake.
    - At home, you would buy one $200 put and sell two $190 puts for every $200,000 in portfolio value you want to hedge ($20,000 look-through value per $200 put divided by $200,000 = a 10% hedge).

Return Details

SPY Price at June 17, 2016, Expiration	Value of 1 Purchased June 17, 2016, $200 Put	Value of 2 Written June 17, 2016, $190 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Recent $203.90
$200 or higher	$0	$0	$0.32 gain per spread -- or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 1.9%
$195	$5 x 100 = $500	$0	$500	(4.4%)
$190	**$10 x 100 = $1,000**	**$0**	**$1,000 (max profit per spread)**	**(6.8%)**
$185	$15 x 100 = $1,500	($5) x 200 = ($1,000)	$500	(9.3%)
$180	**$20 x 100 = $2,000**	**($10) x 200 = ($2,000)**	**$0 (break-even)**	**(11.7%)**
$175	$25 x 100 = $2,500	($15) x 200 = ($3,000)	($500)	(14.2%)

If SPY declines more than 1.9% from recent levels, this hedge starts to come into play. Our maximum profit is earned on the spread if SPY declines nearly 7% from its recent level of $203.90 by our June expiration. The spread will help us a little on an index decline of as much as about 11%; deeper than that, and our short puts turn into an obligation that's in the red. Our break-even at $180 matches where our April put ratio spread on SPY starts -- we own those puts at $180. So, that's nice overlap. We plan to roll those April options as they near expiration (or set up a new second put ratio spread).

Follow-Up

Assuming we set this spread up for a credit, it will result in a small profit even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $190 put obligation (starting with a net buy price of $180) if SPY is below $190 by expiration.

However, if that does happen, our plan would be to close our puts and buy long-term SPY calls (or something we like even better, whether calls or a stock) instead of buying the ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY shares. So, our potential 9.4% stake in SPY shares will only cost us about 2.3% of our cash if we buy calls instead. We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases. We would likely ultimately diagonalize those calls for ongoing income.

How It Fits Into *Pro*

Pro consistently hedges to lower our invested market exposure, or risk. As you know, we aim to achieve positive returns every rolling three years, and inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market can make a difference. We made about $10,700 when our last put ratio spread closed in February. Even small gains add up over the years, especially after those gains on market declines are invested in good stocks. This hedge fits well with our goal of hedging in a cost-efficient way, one that doesn't work against us if the market rises. It does require regular upkeep, though, opening new positions as old ones expire, and these spreads are time-sensitive, really only helping at or right near expiration.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:**

    - For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, "buy to open" June 17, 2016, $200 puts and "sell to open" *an equal number* of June 17, 2016, $190 puts. Recently, this will cost you about $2.30 ($230) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $10 ($1,000) per spread on a decline to $190 or any lower price, but you should be prepared to lose your whole $230 per spread if SPY doesn't decline enough by expiration.

- **To lower your market exposure while following our full official trade (and make the position possible in some IRAs):**
  - Set up the official put ratio spread as recommended, but also "buy to open" puts (with the same month of expiration) at a strike price *well below* $190. Buy *half as many* as the number of $190 puts you wrote. When you do so, all of your $190 puts will be "covered" (half by your $200 puts, and half by the other puts you choose to buy at a much lower strike). Choose how much you want to pay to select your lower strike price to purchase. To us, the $180 strike or lower looks good, recently costing $1.40 or less. You will only need cash in your account to cover the difference between your two lowest strike prices (if you buy $180 puts, that's $10 per share), and your risk is capped, making this potentially IRA-friendly. This makes the total cost of your hedge about a $1.08 debit, with no risk beyond that, and it still has $10 in potential ending value.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Pro Catch-Up Trades: March 21, 2016

Published Mar 21, 2016 at 3:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **Broadridge Financial Services** (NYSE: BR): Following last week's update, the stock moves to Buy First. Buy up to 4.9%, or buy in halves.
- **Facebook** (NASDAQ: FB), buy our 6.3% allocation in thirds or halves over time (write near-the-money puts if you don't mind potentially missing upside).

Continue building your portfolio with our Buys, including these highlighted today:

- **Apple** (NASDAQ: AAPL), buy up to 3.8% in stock.
- **Papa John's International** (NASDAQ: PZZA), buy up to 2.7% in stock.
- **TD Ameritrade** (NASDAQ: AMTD), buy 2.5% in stock.

Options:

- **American Airlines** (NASDAQ: AAL): If you've haven't bought calls on AAL, we still believe there is value to be had. But the market needs to start to agree with us. Buy to open January 2017 $35 calls, lately for about $10.30 each (buy one call for every $1,030 you are comfortable risking, up to 0.5%). We don't know yet whether we'll extend this strategy beyond 2017, but it's possible.

Our most recent short:

- **Deere & Company** (NYSE: DE), as a hedge against the market and our investment in **Valmont** (NYSE: VMI): Sell short (sell to open) 2% of DE per our recent recommendation.

Being Wrong vs. Staying Wrong

Published Mar 21, 2016 at 2:40PM

Dear Fools,

Earlier this year, fellow Fool Morgan Housel published an article that I found to be especially relevant for *Pro* investors. In it, he talked about the need to be able to distinguish between when you're being patient and when you're being outright stubborn. Investing and stubbornness make for a dangerous cocktail (especially in the context of a short position). But the prevalence of such a mixture is unsurprising when you consider the concept of cognitive dissonance, not to mention our human tendency to focus on the negatives.

Why is it that we frequently see investors spending so much time focusing on the positions that aren't working out as they had hoped, even if their overall portfolio is trouncing its benchmark? Odds are it's because our brains appear to have a negativity bias. As Ray Williams from *Psychology Today* noted:

> In our brains, there are two different systems for negative and positive stimuli. The amygdala uses approximately two-thirds of its neurons to detect negative experiences, and once the brain starts looking for bad news, it is stored into long-term memory quickly. Positive experiences have to be held in our awareness for more than 12 seconds in order for the transfer from short-term to long-term memory. Rick Hanson describes it in this way: "The brain is like Velcro for negative experiences but Teflon for positive ones."

From my perspective, the issue isn't so much that people focus on finding the duds in their portfolio -- it's what they do after they've identified them. I believe that one of the common threads among all great investors is that they actually embrace their failures, harnessing them to become better investors. They welcome failure with open arms because they view it as a learning experience that will help them with future investing decisions. Unfortunately, this appears to be a bit of an uncommon practice in our field.

Stubbornness -- or refusing to relinquish the "I'm right and the market is wrong" mind-set despite meaningful contradictory evidence -- tends to be a more common reaction to failure. This is likely the result of our brains' attempts to reduce cognitive dissonance, defined as the mental stress or discomfort associated with holding multiple contradictory beliefs or opinions simultaneously. In this case, the dissonance occurs when we're presented with new information (a position we own is in the red) that directly contradicts a prior, strongly held belief (we're above-average investors who don't need to resort to passive investing and spent a lot of time and energy researching that particular position).

The average batting average for players in Major League Baseball's Hall of Fame is around .300, meaning even the all-time greats only got a hit 30 percent of the time. Sports analogies are commonplace in investing, and this particular one is often used to highlight how it is possible to be successful without being perfect. To be sure, not every type of investing strategy will deliver satisfying results if you're right only 30 percent of the time — odds are that venture capitalists will be far more satisfied with those results than value investors. But the value of this saying isn't in the percentage; it's in the idea that you need to refrain from being a prisoner of the moment and look at how your overall results stack up over a more relevant time period. You can still get into the Hall of Fame if you strike out -- and you can still be a good investor even if all of your positions don't pan out.

"It's OK to be wrong, but it isn't OK to stay wrong" is a popular saying among traders, but I believe it is just as important to adopt this mind-set as a long-term investor. As Morgan noted, however, this becomes increasingly difficult the more time, energy, and money we invest into a particular position. The more we invest, the more we want to believe we're right, and the more we want to believe we're right, the more prone we become to confirmation bias, which further reinforces the mistaken belief that we're right.

Our brains may appear to be hard-wired for us to achieve suboptimal investing results, but with deliberate practice, you can overcome this. The key is to be able to identify how your brain works and create a process that forces you to replace destructive tendencies with beneficial ones. For example, whenever you find yourself dwelling on a position that's in the red, force yourself to refocus by think about what it is that really matters -- being right all the time, or meeting your financial objectives? Every investor, even the greats, will take a swing and a miss (or several) now and again. High accuracy is great insofar as it keeps you from losing money, but it doesn't guarantee that you'll meet your financial objectives. If that were the case, there'd be no reason for us to invest in anything other than Treasuries and hold them to maturity. This seemingly subtle change in your mindset can actually have a sizable impact on the way you think about your positions, helping to free you from the urge to dwell on losing positions and recognize when it's time to move on.

Foolish best,

-- JP (TMFYossarian)

Pro Catch-Up Trades: March 14, 2016

Published Mar 14, 2016 at 3:49PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **American Tower** (NYSE: AMT), buy up to 3.5% in stock
- **Facebook** (NASDAQ: FB), buy our 6.3% allocation in halves over time (write near-the-money puts if you don't mind potentially missing upside)
- **Gentex** (NASDAQ: GNTX), buy up to 2.7% in stock
- **MasterCard** (NYSE: MA), buy up to 4.3% in stock

Continue building your portfolio with our Buys, including these highlighted today:

- **Apple** (NASDAQ: AAPL), buy up to 3.7% in stock
- **Papa John's International** (NASDAQ: PZZA), buy up to 2.7% in stock
- **Parexel** (NASDAQ: PRXL), buy up to 3.2% in stock
- **TD Ameritrade** (NASDAQ: AMTD), buy 2.6% in stock

Options:

- **American Airlines** (NASDAQ: AAL): If you've never bought calls on AAL, we still believe there is value to be had. The market just has to start to agree with us. Buy to open January 2017 $35 calls, lately for about $9.90 each (buy one call for every $990 you are comfortable risking). We don't know yet whether we'll extend this strategy beyond 2017.

Our most recent hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): If you haven't set up this put ratio spread yet, the index is much higher now, but if you want to mirror the original alert, you can get close. Lately, you can set up the April 15, 2016, hedge by buying to open $180 puts and selling to open two $173 puts for breakeven. The spread is smaller than the $12 one we initially recommended, but with the market going up, lower-strike puts don't pay as well.

And our most recent short:

- **Deere & Company** (NYSE: DE), as a hedge against the market and our investment in **Valmont** (NYSE: VMI): Sell short (sell to open) 2% of DE per our recent recommendation

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Pro Quality Checklist: Broadridge

Published Mar 14, 2016 at 1:30PM

Dear *Pro* Fools,

So far, we've run five of the companies in our portfolio through our *Pro* quality checklist:

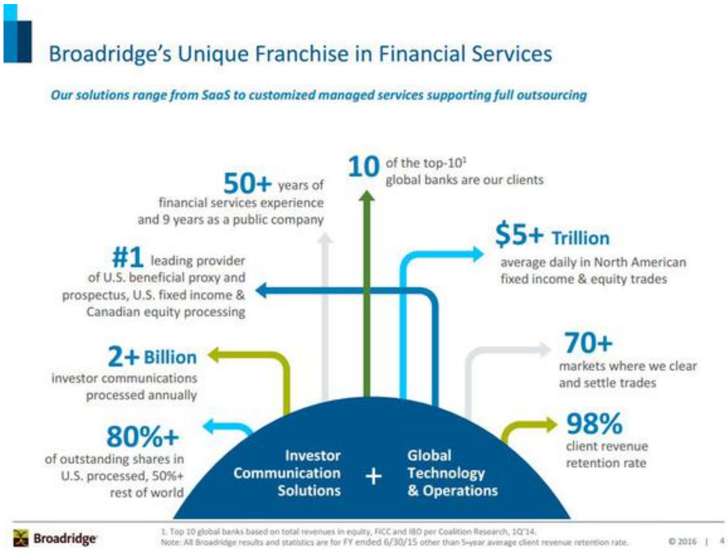
- **American Tower** (NYSE: AMT) -- 7.5/8
- **Oracle** (NYSE: ORCL) -- 8/8
- **O'Reilly Automotive** (NASDAQ: ORLY) -- 6/8
- **TD Ameritrade** (NASDAQ: AMTD) -- 5.5/8
- **Valmont Industries** (NYSE: VMI) -- 5.5/8

Today, we resume our checklist series with a look at **Broadridge** (NYSE: BR), our provider of investor communications and securities processing. The company is our fourth-largest position, with a 4.8% allocation. Here's how it stacks up against our eight criteria.

1. A Sustainable Competitive Advantage

Yes. Broadridge benefits from strong competitive advantages, the most predominant of which is scale. The company dominates its markets, processing approximately 85% of outstanding shares in the U.S. (and about 72% globally) with its proxy services solutions, as well as more than $5 trillion in equity and fixed-income trades per day of

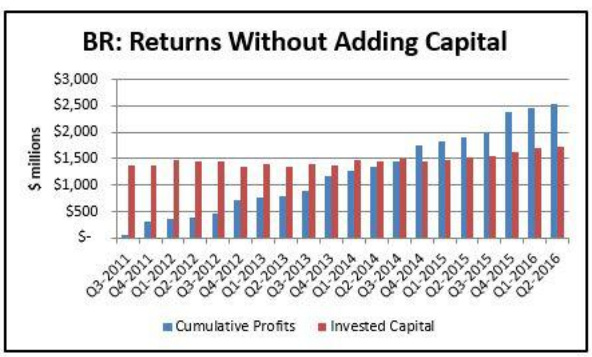
U.S. and Canadian securities, and approximately 60% of U.S. fixed-income trades.



The company's scale, successful acquisitions, and low capital intensity (capital expenditures average 2.2% of sales since 2010) have led to rising returns on capital and strong free cash flow, quantifiable evidence of competitive advantage:

	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
Fee Revenue Growth %	1.0%	9.4%	5.1%	7.9%	6.5%
Fee Revenue Gross Margin %	37.9%	37.1%	39.8%	44.3%	45.3%
Fee Revenue Operating Margin %	19.3%	18.2%	20.4%	23.4%	24.5%
After-tax ROIC % (average)	15.2%	13.1%	16.3%	19.7%	19.8%
Free Cash Flow ($ in millions)	$ 143	$ 244	$ 220	$ 334	$ 365
Acquisitions ($ in millions)	$ 294	$ 72	$ -	$ 97	$ 203
% Revenue Growth From Acquisitions	4%	3%	0%	1%	2%

Broadridge is an excellent business because it generates highly predictable recurring revenue and requires very little reinvestment, meaning it enjoys copious, low-risk free cash flow. The chart below shows that Broadridge's growing earnings (blue bars) have come without much additional capital investment (red bars):



Broadridge's mission-critical back- and middle-office solutions also lead to strong client retention, with a stellar 98% five-year average client revenue retention rate. We see that Broadridge benefits from high switching costs, which is typical for companies that deal with administrative solutions. Its products are deeply integrated into its clients' processes, so moving to another provider entails a major business disruption.

2. Pricing Power

Yes. Broadridge's dominant market position and limited competition afford it the luxury of largely controlling its pricing. The company's core business is subscription-based, and more than 91% of total fee revenue is recurring. (The rest is event-driven, meaning it depends on the number of special events and corporate transactions processed.) The recurring-revenue clients essentially *have* to renew their contracts with Broadridge, given that the alternative would be setting up their own in-house processing and record-keeping units. That would not make sense from a cost perspective, because Broadridge can perform these tasks cheaper and better thanks to its dominant scale, robust and growing product suite, and expertise.

It's interesting to note that Broadridge benefits from an inverse form of pricing power. Though the company doesn't flex its muscles via outright price increases (internal revenue growth has averaged just 1.4% since 2011, pacing about in line with inflation), the scalability of its tech-based automation platforms allows processing costs to decrease over time. As costs decrease, simply maintaining the same pricing is a de facto increase.

3. Dependent Customer Base

Yes. Broadridge is by far the market leader in helping financial firms untangle non-core but mission-critical tasks such as proxies, prospectuses, trade confirmations, and account statements — the kind of administrative work nobody else wants to do. Its diverse customer base includes retail and institutional brokers, global banks, mutual funds, annuity companies, institutional investors, and corporate issuers. The company counts all of the top 10 global banks as clients, clears and settles trades in 70-plus markets, and processes more than 2 billion investor communications annually. Broadridge's systems help reduce the need for clients to make significant capital investments in operations infrastructure, thereby allowing them to increase their focus on core business activities.

4. Predictable Revenue

Yes. Broadridge benefits from a 98% client revenue retention rate thanks to its reputation for quality and strong client relationships, themselves stemming from 50-plus years of financial services experience. The company earns revenue based on long-term contracts, and as mentioned, more than 90% of total revenue is recurring. Its diverse revenue distribution (more than 1,100 broker-dealers, about 10,000 corporate issuers, and about 800 mutual fund families) leads to predictable (though slow-growing) revenue as stock listings expand, new client contracts are signed, acquisitions increase the company's addressable market, and new ways to manage client data are implemented.

5. Growing Free Cash Flow With Compounding Returns

Yes. Broadridge's low capital intensity and strong competitive advantages lead to plentiful free cash flow. Its free cash flow margins since the beginning of fiscal 2011 have averaged 15.2%, and FCF has increased from $144 millon in fiscal 2011 to $365 million at the end of fiscal 2015 (a 26% CAGR).

Broadridge has a long runway for growth in adjacent products and markets, and management routinely spends a good portion of cash flow on acquisitions -- 51% of cash flow since the beginning of fiscal 2011. The company has an outstanding acquisition track record, spending $777 million in 15 key acquisitions since becoming a public company in 2007. The internal rate of return (IRR) of the acquisition portfolio is tracking to 20%-plus as of the end of fiscal 2015.

The company's size and scale, distribution channel, and client base make acquisitions more successful, as complementary businesses are worth more and are more efficient under the Broadridge umbrella than they are standing alone.

6. Financial Resilience

Yes. Broadridge has a very resilient balance sheet, with strong free cash flow (15% of sales, as mentioned above) and a net debt-to-EBITDAR* ratio of about 1.7. The company's operating income covers interest expense 18 times over. Broadridge produces steady and consistent cash flow, and it has incremental debt capacity to run the business at a debt-EBITDAR ratio of 2:1.

**Debt/EBITDAR ratio is calculated as (Debt + 8x Rent Expense) / (EBITDA + Rent Expense)*

7. Expanding Possibilities

Yes. Broadridge has the ability to grow into adjacent markets via targeted acquisitions. During the past two fiscal years, the company has acquired six different businesses, all complementary to the core business. These include a provider of cloud-based marketing solutions and services for financial advisors, the trade processing business of the Wilmington Trust unit of M&T Bank, the fiduciary services and competitive intelligence unit of Thomson Reuters' Lipper division, a provider of real-time foreign exchange solutions, a provider of fee calculation, billing, and revenue/expense management solutions for asset managers, and a provider of websites and related communications solutions for financial advisors. Broadridge will likely continue to expand globally and into new asset classes and win some more new outsourcing deals, driving growth through new products and tuck-in acquisitions.

8. The Three C's of Management (Clarity, Consistency, Capability)

Yes. Broadridge is led by CEO Richard Daly, an industry veteran for more than 35 years. Daly got his start in the proxy business in 1979 with the Independent Election Corp. of America (IECA), then one of the biggest proxy firms in the business, and founded what is now Broadridge in 1987 to capitalize on the increasing prevalence of electronic record-keeping in the financial services industry. Daly sold his fledgling business to payroll giant **Automatic Data Processing** (NASDAQ: ADP) in 1989, launching the proxy-services group within ADP's Brokerage Services division.

In 2007, Broadrige was spun off from ADP and began trading as an independent public company. Daly has been CEO of Broadridge since the spinoff in 2007, and his deep industry experience and connections benefit the company. Daly owns more than $71 million in Broadridge stock (1.1% of outstanding shares), aligning his interests with those of common shareholders, and management compensation structure (including long-term equity-based incentives) promotes long-term growth in value per share.

Management's communication with the investment community is exemplary (as would be expected from a company whose core product is an investor communications solution), and its capital stewardship strategy is clearly outlined within each investor presentation (see slide 13 here for an example).

The *Pro* Bottom Line

In sum, Broadridge scores a perfect 8/8 on our *Pro* quality checklist. There's a reason this company is our fourth-largest position: It is a model of a *Pro*-type investment. Broadridge's business lies at the nexus of *Pro's* largest sector bets, technology and financials, and it benefits from key trends in the financial services industry including mutualization (i.e. standardization of non-differentiating industry capabilities), digitization, and data/analytics. Broadridge looks set to continue to challenge North Star-like returns from the current price, and the company's capital-light and scalable business, promising new product pipeline, excellent acquisition track record, and sound capital allocation policies make it a sturdy rock to build the *Pro* portfolio upon.

Fool on!

-- Billy (TMFBillyTheKid)

Pro Completed Trades

- **SPDR S&P 500** (NYSEMKT: SPY): On Friday, the *Pro* service's 30-day window to make this trade closed, so we placed our latest hedge on SPY. We bought to open twelve April 15, 2016, $180 puts, and sold to open twenty-four April 15, 2016, $173 puts. The latter, the ones we sold, have a strike price five dollars above the $168 strike in the original alert; that's because we tweaked them so we could still place the trade at breakeven. (To be 100% honest, actually, it cost us one penny.) The index has increased sharply in the last month, so the hedge has been unnecessary, though it initially paid members a credit. We wanted to place a trade as close to the original one as possible, so we're all on the same page. We are now considering hedges at much higher strikes given the market's increase. If you still lack this lower-strike April hedge and want it, see today's Catch-Up Trades. You can do as we did and set up this low-probability hedge for about breakeven.

Pro Guidance Updates

- **Facebook** (Nasdaq: FB) moved to Buy First, and our fair-value estimate increased to $100. We have a 6.3% allocation.
- **MasterCard** (NYSE: MA) moves to Buy First, and our fair-value estimate increases to $84. We have a 4.3% allocation.

MasterCard Is Still a Master of Growth

Published Mar 14, 2016 at 12:10PM

MasterCard (NYSE: MA) "charged forward" in 2015 despite slow international commerce and a strong U.S. dollar. For the year, net revenue in local currency advanced 8%, and EPS gained 18% before special items.

But right now, an investment in MasterCard -- as with **Visa** (NYSE: V) -- is an investment in growth *beyond* this year, because 2016 looks tepid as emerging markets struggle and the dollar remains strong. Much of the company's growth potential is being coiled up like a spring. That spring should pop when more economies begin to expand again and the dollar weakens. The market knows this, so the stock maintains a premium valuation. Even so, we're moving MasterCard's fair-value estimate higher today, and given the predictable nature of this strong business, moving it back to Buy First.

Status:	**Buy First**
Fair-Value Estimate:	$84 (up 6%)
Recent Price:	$88
Current Allocation:	4.3%
Dividend Yield:	0.9%

Key Long-Term Thoughts

- MasterCard is moving smartly in digital payments, security, and new international markets; outside of Visa, a single strong international competitor still doesn't exist, which means much more long-term growth ahead as cash still accounts for 85% of transactions. There's room for all current leaders to grow nicely.
- Operating expenses were up 1%, or 4% on a currency-adjusted basis, again showing the leverage in the business model.
- Rebates and incentives (given to promote use of the cards) were up 20%, or more than revenue. This line should be up a bit less this year, but it remains something we watch in relation to competitive pressures. The industry is only extremely attractive if its competitors don't need to offer too many rebates just to maintain market share.
- MasterCard's services business (immune to rebates, made up as it is of recurring fee revenue) is now about 25% of the company's revenue, with the core business accounting for the other 75%. Margins should tick up over time, with more scale.

Secondary Thoughts

- MasterCard continues to do the legwork for eventual approval to conduct transactions in China.
- Eighty percent of its card issuers are now using SafetyNet, MasterCard's security service, for a fee.
- The service business -- advisors, consulting, information services (analytics) -- remains an important, growing business at MasterCard (and Visa).
- MasterCard is investing considerably this year in China, in MasterPass (now in 29 countries), and in security and the services businesses.
- Europe remains a relatively under-penetrated market when it comes to electronic payments.

The Numbers

4th Quarter Selected Financial Performance
($ in millions, except per share data)

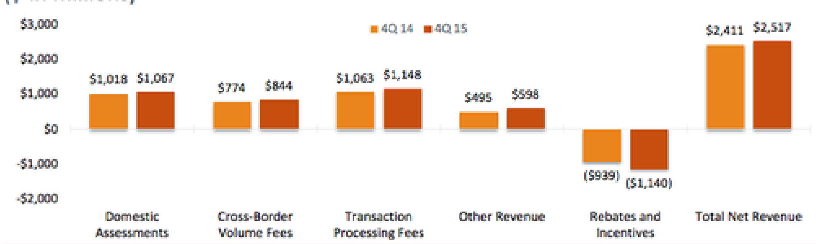
	4Q 15	4Q 14	YOY Growth As Reported	YOY Growth FX Adjusted
Net revenue	$ 2,517	$ 2,411	4%	9%
Total operating expenses	1,410	1,393	1%	4%
Operating income	1,107	1,018	9%	17%
Operating margin	*44.0%*	*42.2%*	*1.8 ppts*	*2.7 ppts*
Net income	$ 890	$ 801	11%	18%
Diluted EPS	$ 0.79	$ 0.69	14%	22%
Effective tax rate	13.1%	20.3%		

Note: Figures may not sum due to rounding.

3 January 29, 2016 ©2016 MasterCard. Proprietary MasterCard

The fourth quarter saw healthy 14% growth in earnings per share as reported, but note the much lower tax rate (13% vs. 20%) thanks to favorable settlements with tax authorities following an audit. Still, adjusted for currencies, EPS growth was very strong at 22%, meaning it was healthy outside of the lower tax rate.

4th Quarter Revenue
($ in millions)



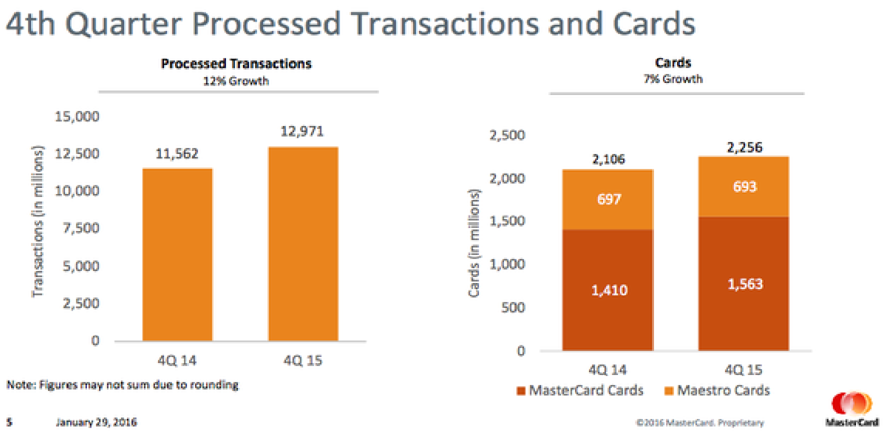
Growth	Domestic Assessments	Cross-Border Volume Fees	Transaction Processing Fees	Other Revenue	Rebates and Incentives	Total Net Revenue
As-reported	5%	9%	8%	21%	21%	4%
FX-adjusted	10%	13%	13%	26%	27%	9%

Note: Figures may not sum due to rounding.

6 January 29, 2016 ©2016 MasterCard. Proprietary MasterCard

Shown above, "other revenue" -- fee income -- is important because of the growth of rebates and incentives in relation to the core transaction business. That growth in recent years has suggested that the industry remains particularly competitive among the top two players -- it's an ongoing land grab.

Transactions were up 12% year-over-year, and the number of cards issued rose by 7% (though keep in mind that many old cards do become inactive):



Outlook

- Management sees challenges persisting in most parts of the world, with the United States likely being the most resilient economy. Europe's economy is expected to grow at its fastest pace since 2011 this year, but from a depressed base. Large emerging-market economies -- including China and Brazil -- look weak. The company's total growth rate in 2016 should be well below its long-term average.
- MasterCard maintains its 2016 to 2018 performance objectives as follows: Net revenue CAGR of low double digits (10% to 12%), operating margin of at least 50%, and EPS CAGR in the mid-teens.
- Its three-year projected growth starts from 2015's $3.12 EPS. This suggests about $4.74 per share in earnings by 2018, putting the $88 stock at 18.5 times those estimates. This may look expensive so far ahead, but there is considerable upside potential to these estimates, and low probability that results will come in much below them.

Market Cap	$98B
Cash	$6.7B
LT Debt	$3.2B
EV/EBITDA	17.0
EV/EBITDA NTM est.	15.8
P/FCF	20.5
P/E	26
P/E NTM Est.	25

Position Summary

Our fair-value estimate of $84 puts MasterCard stock at 20 times expected earnings for next year, a minimum multiple merited by this premium, strongly growing business in an average stock market. When growth one day uncoils, the bottom line could grow in the 20% range again. We're happy to have 4.3% in MasterCard (and 2.3% in Visa) for the long haul, while watching the competitive moat for leaks. MasterCard remains a buy -- namely now, a Buy First.

- *Motley Fool Pro*'s MasterCard board. Ask your questions!
- MasterCard Investor Relations

An Open-Book Update on OpenText

Published Mar 10, 2016 at 10:10AM

OpenText (NASDAQ: OTEX) sells enterprise information management (EIM) software. Meeting its customers where they are, the company's offerings are available by license or in the cloud. The past few years have been marked by choppy license results and (as for most companies) a challenging environment in international markets, worsened by a strong dollar. OpenText has managed through this situation while keeping market share (it appears) and increasing its margins. As it releases new software, called version 16, this fall, success will mean adding more clients and cross-selling.

Status	**Buy**
Fair-Value Estimate	$55 (no change)
Recent Price	$49
Current Allocation	2.8%
Dividend Yield	1.6%

Key Long-Term Thoughts

- The company's most significant new product release, version 16, occurs in the second half of this year.
- The goal is to provide a singular platform for managing, analyzing, and exchanging enterprise information.
- A new opportunity present in version 16 is selling embedded analytics to existing customers, thanks to last year's Acuate acquisition. The new software has analytics embedded everywhere, in the Content Suite, Process Suite, and Experience Suite.
- The CEO has also assumed the role of CTO. No word on how long this is planned to last, but we'd rather see the roles separated.

Secondary Thoughts

- The company is considering acquisitions, and views a choppy, difficult market as an opportunity. It expects to do "multiple and meaningful" transactions this year.

- OpenText is focused on generating more cross-selling opportunities, especially starting in 2017.
- Americas were 56% of sales, Europe/Middle East/Africa 35%, and Asia-Pacific Japan 9%.
- See this outstanding presentation.

The Numbers

- **Outlook:** The current third quarter should have traditional seasonality. OpenText doesn't provide guidance.
- **Q2 2016:** In constant currency, revenue rose 6%, recurring revenue was up 4%, maintenance revenue gained 9%, cloud revenue was up 1% and license revenue jumped 19% (9% in local currencies). Adjusted operating income rose 12% to $172 million. Margins are higher and on track with plans, with adjusted operating margin at 37%.

Market Cap	$5.9B
Cash	$742M
LT Debt	$1.57B
EV/EBITDA	12.8
EV/EBITDA NTM est.	10.0
P/FCF	14
P/E	26.7
P/E NTM Est.	13.5

Position Summary

At 2.8%, OpenText is our 15th largest position, putting it in the bottom two-thirds of our stock holdings. Yet it's reasonably valued, and the EIM industry in general should increase sales by at least 10% annualized over the coming several years. I have suggested writing puts on OpenText for years in *Motley Fool Options*, and we may do a bit of that in *Pro*, too, should we decide to potentially add to our stake. But keep in mind, we also own **Oracle** (NYSE: ORCL) in *Pro*. Both have been slow performers the past two years. Long-term analysis suggests that eventually they'll reward us more strongly again, but we still want to keep our exposure to software reasonable, while considering adding young, higher-growth companies, too.

- *Motley Fool Pro*'s OpenText discussion board. Ask your questions!
- OpenText Investor Relations

Papa John's Delivers Consistent Earnings Growth

Published Mar 8, 2016 at 2:32PM

Pro's Take: PZZA Q4 and FY-2015 Earnings

Papa John's International (NASDAQ: PZZA)

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Q4-2015

Total revenue growth: -2% (vs. +9.7% in Q4-2014)

Operating profit margin: 9.7% (vs. 7.9% in Q4-2014)

EPS growth: +20.1% (vs. +26.1% in Q4-2014)

Domestic comparable store sales: +1.9% (vs. +4.1% in Q4-2014)

International comparable store sales: +5.3% (vs. +8.9% in Q4-2014)

FY-2015

Total revenue growth: -2.5% (vs. +11.1% in FY-2014)

Operating profit margin: 8.3% (vs. 7.4% in FY-2014)

EPS growth: +13.6% (vs. +13.4% in FY-2014)

Net new restaurant unit growth: +230 (+4.9%, vs. +235 and 5.3% in FY-2014)

Domestic comparable store sales: +4.2% (vs. +6.7% in FY-2014)

International comparable store sales: +6.9% (vs. +7.4% in FY-2014)

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Quarter Quick Take

Papa John's turned in a solid Q4-2014 and wrapped up a strong fiscal year in 2015. Despite pressure on total revenue growth (+2.5% in 2015) due predominantly to lower cheese prices (which impacts Commissary sales to restaurants but has no effect on margins as the company passes on the costs with a fixed markup), Papa John's delivered reported growth of 13.6% in earnings-per-share (EPS) due to higher global restaurant sales growth (+5.3%), expanding operating margins (8.3% in FY-2015 vs. 7.4% in FY-2014) and continued share buybacks (the company reduced its diluted share count by 6.2% in 2015). If not for the $12.3 million legal settlement expense that the company recorded in Q2-2015 to settle a class action lawsuit, Papa John's would have reported +19.4% EPS growth.

2015 was another example of the formula that Papa John's has successfully used to grow its earnings-per-share at a 5-year compound annual growth rate (CAGR) of +16.3% since the end of 2010:

	FY-2011	FY-2012	FY-2013	FY-2014	FY-2015
Net Revenue Growth	8.1%	10.2%	7.2%	11.1%	2.5%
Global Restaurant Sales Growth*	7.7%	10.6%	6.2%	9.8%	5.3%
Operating Margin %	7.1%	7.4%	7.4%	7.4%	8.3%
Yearly Reduction in Share Count	4.3%	5.2%	7.1%	5.8%	6.2%
EPS Growth**	12.2%	17.9%	18.8%	13.4%	19.4%

*This metric includes both comparable store sales growth and net restaurant unit growth

**FY-2015 EPS growth is adjusted for legal settlement expense

It's now been two quarters since *Pro* trimmed its position by one-third via covered calls (selling at a net $68.40 per share). As I write this, at around $57 per share, the stock is currently ~16-17% below those levels, and is now much closer to our fair-value estimate, which prior to this update was $57.50 (last updated in August 2015 here).

But after accounting for 2015 results and rebuilding my valuation model for Papa John's, **we're lowering our fair-value estimate to $54 per share.** The reduction in fair value is more a function of changes in long-term valuation driver assumptions (franchise royalty rates, franchise productivity, net unit growth, and cheese pricing) than it is a reflection of the momentum of the business. It is a good example of one of "The Flaws of Fair Value".

As my familiarity with the business has grown and business results have provided clarity on trajectory, I've altered some important assumptions to more accurately reflect my expectations of the future. While this doesn't mean I think the company is actively destroying value, it does mean that my estimate of fair value has decreased. Despite the valuation decrease, **Papa John's should be able to earn North Star-like returns over the next three years due to a combination of low-to-mid single digit comps growth, modest store unit growth, operating margin expansion, and continued share buybacks.**

Guidance: Buy (no change)

Recommended Allocation: 2.8%

Fair Value estimate: $54 (down from $57.50)

Current Price: $57.25

Given the recent decline in the company's share price, Papa John's is more reasonably valued than it was over much of the last two to three years, despite far less uncertainty regarding the trajectory and sustainability of the company's international expansion. On a TTM basis, at $57 per share, the company trades for 28.7x P/E (27.3x if we exclude the non-recurring legal expense), 20x EV/FCF, and 14x EV/EBITDA.

For context, **Domino's** (NYSE: DPZ) trades at 20.5x EBITDA, **Dunkin' Brands** (NASDAQ: DNKN) trades at 15.5x, and **Starbucks** (NASDAQ: SBUX) trades at 18x. As financial performance has improved (and the share price has declined), Papa John's trailing multiples have contracted as we expected. For those without a position, now is as good a time as any in the last few years to establish a position in this strong business with good operational momentum and a long international growth runway.

Our Thesis

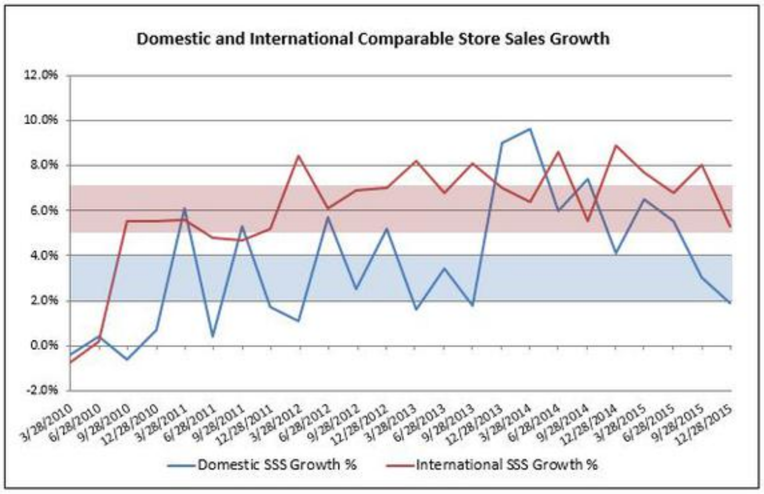
Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main quick service restaurant (QSR) pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only about 1,500 international restaurants the company has a long runway for growth (compare to Domino's which has over 7,300 international stores and Pizza Hut which has over 7,000 international stores). Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

1) Store Performance*:* During Q4-2015, systemwide restaurant sales increased +3.4% (+5.7% when excluding the impact of foreign currency). Domestic comps increased +1.9% while international comps increased +5.3%.

Domestic comps growth continued its deceleration this quarter (down from 6.5%, 5.5%, and 3% in Q1-2015, Q2-2015, and Q3-2015, respectively) due to "extremely competitive pricing" within the category driven by a commodity environment that has been "very favorable" in terms of both cheese prices and beef prices. For a company that relies on a higher-quality brand message, lower commodity prices make it easier for competitors to undercut Papa John's on pricing. For full year 2015, the company achieved 4.2% domestic comps growth, at the high end of the company's initial guidance of 2%-4% that was set out in Q4-2014. Management's guidance for 2016 is for 2%-4% domestic comps growth, in line with last year's guidance, though slightly below what the company achieved in full year 2015.

As for international comps, the company continues to churn out mid-to-high single digit comps performance. At +5.3% for the quarter, this marks the 17th consecutive quarter of international comps above +5%:



**Shaded areas represent management's guidance ranges for full year 2016*

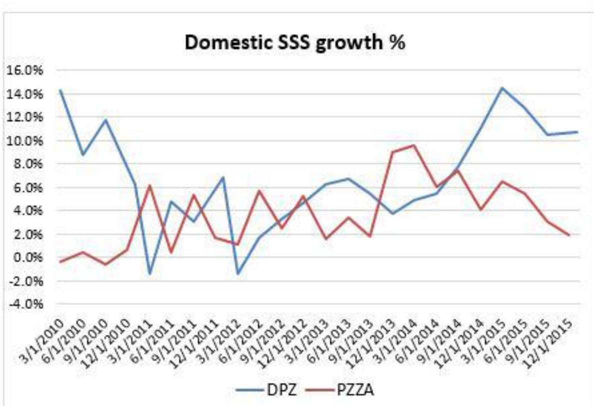
The company's measured expansion continued, adding 107 new restaurants (net) in the quarter and 230 for the full year -- of which 182 were international and 48 were in North America. The company recently opened in its 41st country in Israel and will be opening soon in Spain. The company now has over 1,500 international stores (up from 822 at the end of 2011, a 16.2% CAGR in units).

Management expects full year 2016 openings to come in at 180-210 restaurants, with 75% of the net unit growth in international markets. 195 restaurant openings for 2016 would represent +4% growth versus the existing store count as of the end of 2015. The company's pipeline remains healthy, with 200 domestic restaurants and 940 international restaurants, the majority of which are scheduled to be opened over the next six years.

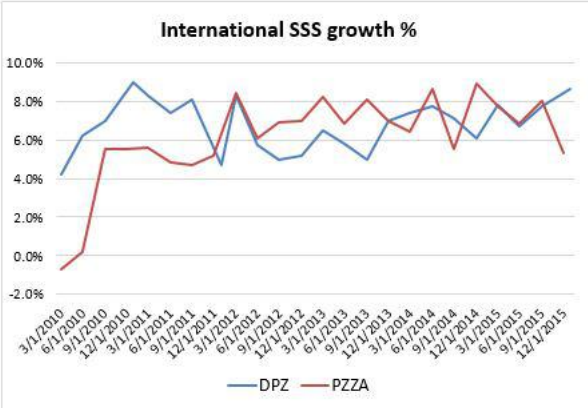
2) Brand: Brand strength is challenging to measure, but we need to monitor it because it is key to the company's brand-based advantages and higher price per pie. Based on recent data, which includes store growth, the domestic pizza market was about flat and the international pizza market grew about 3%-4%. So Papa John's comps (which *exclude* store growth) suggest continued market share gains at the expense of competitors. This is likely due to the company's competitive advantages related to scale (efficient advertising/distribution) and an early lead in technology (digital ordering and loyalty programs).

As for PJ's strongest peer, Domino's domestic comps came in at an excellent +10.7% in the quarter, outperforming Papa John's meaningfully. This past quarter was the fifth consecutive quarter of double-digit domestic comps growth for Domino's, demonstrating excellent momentum. Domino's is much more willing to compete on price than Papa John's which likely helped it earn share during the past year of lower commodity prices and aggressive pricing. The company's strong comps over the past year likely have had some impact from failed product launches in the previous year, which helps year-over-year comparisons. Comps have some cyclicality to them, and Domino's itself doesn't expect the double-digit comps to continue, mentioning that their long-term guidance is 2%-5% domestically, similar to Papa John's guidance range of 2%-4% (an example of how Papa John's tends to err on the conservative side).

But there's no denying that Domino's is on a roll domestically as they continue their marketing initiatives (including reimaging the existing store base), invest in technology, and add a new loyalty program. Domino's gained more U.S. market share than competitors as of the most recently available data (May 2015), increasing in share from 17.7% to 18.8%. Papa John's also increased its market share but to a lesser degree, from 11.7% to 12.2%. Little Caesar's market share increased from 14.4% to 14.7%, and Pizza Hut's market share declined by -1.7%, although they still have the largest market share at 25.1% of the segment. Domino's is more aggressive strategically than Papa John's, which can lead to higher growth when the company executes well. But it also exposes the company to more potential operational missteps and volatility, which is something that Papa John's has largely avoided over the last several years:

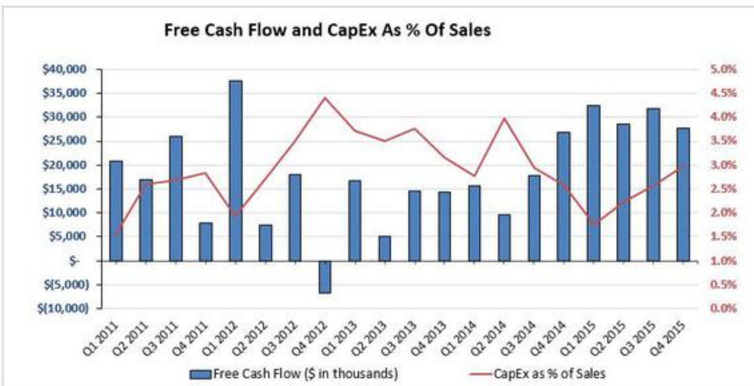


The competition is much more closer internationally, where most of future growth will occur. Both Papa John's and Domino's international comps performance suggest that the pizza concept and the two companies' technology advantages and expansion strategies are translating in the higher-growth overseas markets:



3) Margins: We expect Papa John's capital light business model to eventually result in higher operating margins that propels free cash flow generation. From 2014-2015, the company dealt with depressed margins and free cash flow due to the roll-out of the company's new new proprietary POS system (FOCUS), which as of last quarter is now totally complete.

Now that the investment phase has passed, the company is enjoying higher margins and free cash flow generation, as favorable changes in working capital (related to FOCUS inventory levels) and lower capital expenditures have lifted free cash flow much higher. In this graph, note the inverse relationship between capital expenditures and free cash flow-when capital expenditures are elevated, free cash flow is depressed, and vice versa:



Trailing twelve month (TTM) free cash flow is $120.4 million, the highest in the company's history, and up 73% compared to the year-ago period. Note that free cash flow will likely decrease a bit in 2016 as the company paid the legal settlement in January (in Q1-2016), and the company expects a year of somewhat elevated capital spending (guidance is for $55-$60 million in capital expenditures, up from $39 million in 2015) due to a new domestic commissary in the U.S., company-owned unit development in the U.S., investments in technology, and routine capital replacement. At the current price of about $57 per share, the company is trading at about 18.6x P/FCF, the lowest this metric has been since Q3 2012, and a far cry from the 50x multiple we saw a few times in 2013 amid elevated capital spending.

What We Think Now

Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. Near term headwinds (commodity prices and technology investments) have proven to be temporary and Papa John's should continue to deliver improved financial performance.

Pro Can Help

- **Questions?** Stop by our delicious, savory Papa John's discussion board.

AmTrust's Results Reflect Reality

Published Mar 7, 2016 at 3:58PM

With **AmTrust Financial Services** (NASDAQ: AFSI) down 29% from its 52-week high ($35.94, in August) and 17% year-to-date, you might be inclined to think there's something seriously wrong with the company. To be sure, its financial results for the past few quarters weren't as impressive as we've seen in years past, but they're still very solid given the current industry landscape.

AmTrust Financial Services Fiscal 2015 Results

Consolidated Results

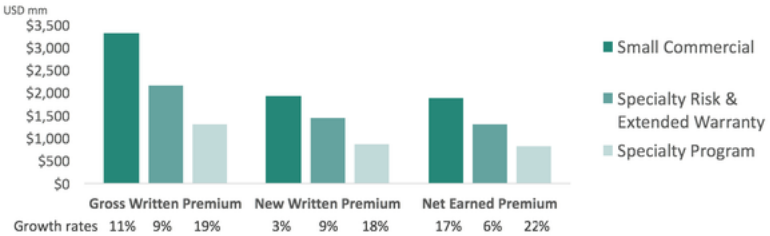
Premiums		Change
Gross Written	$6.8 Billion	12%
New Written	$4.3 Billion	8%
Net Earned	$3.5 Billion	14%

Insurance Ratios	
Loss Ratio	66.7%
Expense Ratio	24.3%
Combined Ratio	91.0%

Rolling Returns	
ROCE	22.70%
ROA	2.40%

Serivce & Fee Income	
Total	$478 Million
Growth	17%

Segment Results



Source: Company Filings

Updated Guidance and Valuation

Updated guidance: Buy (no change)

Recommended allocation: Veterans have 5.4%; for newcomers, start with 3% or so, then look to opportunistically increase your position size over time.

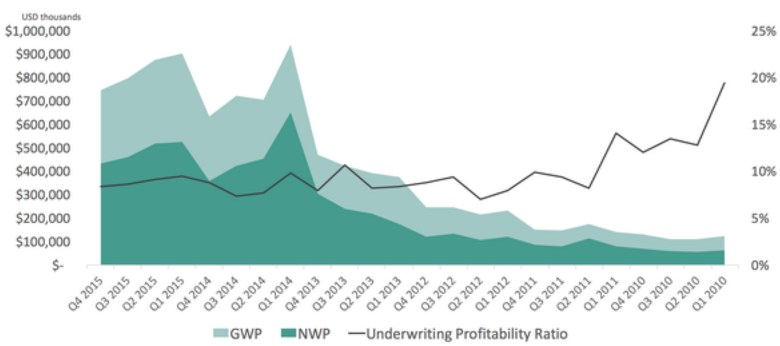
Fair-value estimate: $26 (no change)

The Results

Small Commercial Business

Pricing weakness in 2015 (more on that in a bit) meant that policy count was the primary driver of growth for AmTrust's largest segment. AmTrust's largest states (California, Florida, and New York) were once again the biggest contributors, accounting for 74% of the $321 million increase in gross written premium. The reported growth rates were the slowest we've seen in some time, but if you remove the impact of non-recurring premium from the Tower Group acquisition, gross written premium for this division actually increased 17.4%. Similarly, if you remove this impact from net written premium, growth this year was 13.1%. Though the business is still very profitable, we are seeing margins slowly contract over time. This is likely because of two factors:

- Cherry-picking policies through acquisitions becomes increasingly difficult as the company grows, as you need to assume an ever-increasing number of policies to move the needle.
- The markets in which AmTrust competes are currently becoming more competitive.



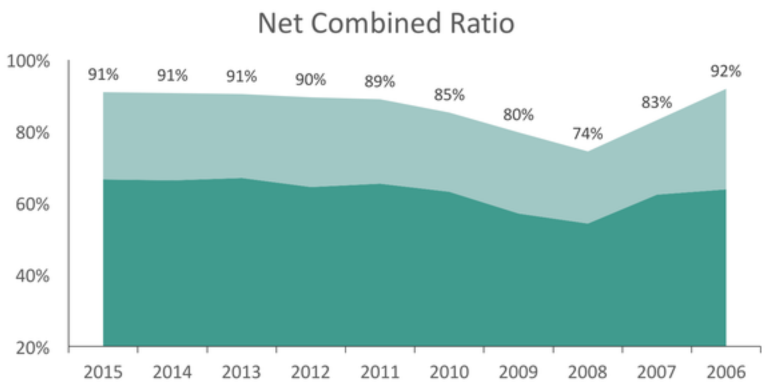
Specialty Risk and Extended Warranty

The division of AmTrust with the most international exposure was once again hit hard by the strengthening U.S. dollar. Negative currency fluctuations of approximately $156 million more than completely offset this segment's European operations in 2015. Absent this effect, growth continues to be healthy and profitability is also solid -- although, once again, not as good as what the company reported in the prior years.

Specialty Program

This division saw some of the most favorable pricing trends, which -- when combined with an increase in policy count -- helped drive the strongest reported growth. Although it's technically defined as a different segment, the specialty program division shares many traits with AmTrust's small commercial business division. This means that much of what we said about the latter holds true here as well.

Combined Ratios and Reserves



For the year, AmTrust's combined ratio ticked up ever so slightly -- just 30 basis points, to 91.0 -- as the specialty risk and extended warranty division and the specialty program division pushed the net loss ratio slightly higher.

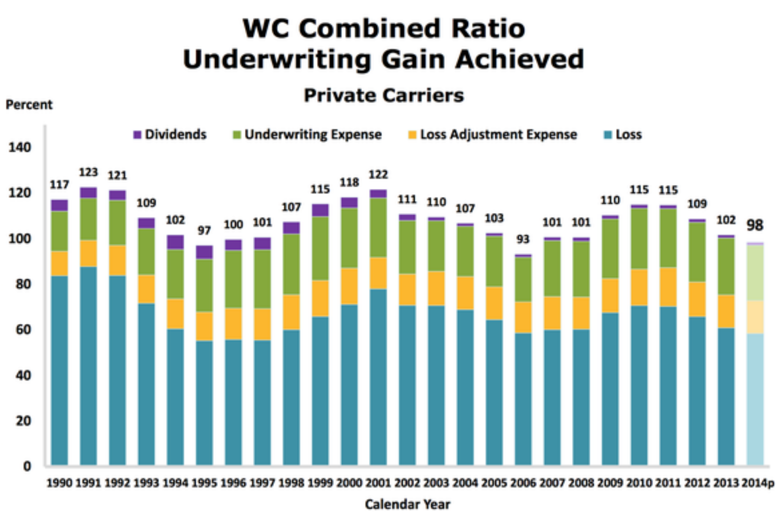
	2015	2014	2013
Loss Ratio			
Small Commercial Business	65.4%	65.7%	65.8%
Specialty Risk and Extended Warranty	67.6%	66.4%	67.2%
Specialty Program	68.2%	67.3%	68.2%
Total	66.7%	66.4%	67.0%
Expense Ratio			
Small Commercial Business	25.8%	25.9%	25.5%
Specialty Risk and Extended Warranty	20.3%	20.6%	18.6%
Specialty Program	27.5%	27.0%	26.6%
Total	24.3%	24.3%	23.5%
Combined Ratio			
Small Commercial Business	91.2%	91.6%	91.3%
Specialty Risk and Extended Warranty	87.9%	87.0%	85.8%
Specialty Program	95.7%	94.3%	94.8%
Total	91.0%	90.7%	90.5%

Reserves appear to be adequate based on accident-year loss developments over the past 10 years. However, given that long-tail policies (those with a sizable gap between between the incident that results in a claim and the settlement of said claim) account for a sizable portion of AmTrust's business, there is always the risk that policies from prior years will come back to haunt the company. This lag between underwriting and paying out claims can make it hard to evaluate long-tail insurers, because you may not see the impact of the soft part of the insurance cycle -- during which completion is more intense and pricing becomes favorable for the consumer -- until years after the policies were written. This is why we've repeatedly noted that we want to see AmTrust actually pull back some when the cycle softens; it's a more timely indicator of management's discipline and willingness to prioritize the long-term health of the business over short-term results.

Pro's Take

The past few years were definitely kind to AmTrust as it aggressively entered into markets in which prices were rising as competitors attempted to cope with prior losses. This enabled the company to rapidly gain market share, and it's now one of the largest workers' compensation underwriters here in the United States. But this growth also means that the company has reached the point where its financial results will more closely resemble what is taking place within the industry.

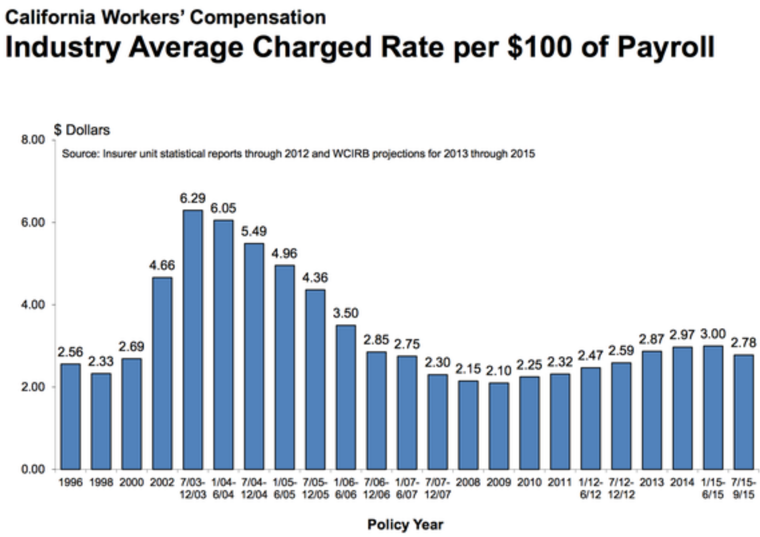
The current state of the industry isn't as favorable for AmTrust, and its results are starting to reflect this. We've seen continued improvement in the industry's combined ratio since its peak a few years back:



Source: NCCI, [State of the Workers Compensation Line 2015]

To a large extent, this move mirrors what is taking place within AmTrust's largest markets, though the levels aren't necessarily the same. For example, California's combined ratio has yet to fall below 100 (signifying underwriting profitability) according to the latest figures from the Workers' Compensation Insurance Rating Bureau of California (WCIRB).

Loss trends and policy count for both the industry and AmTrust continue to be favorable, but unsurprisingly, we've seen this improvement in the industry result in pricing pressure.



Source: WCIRB, Report on September 30, 2015 Insurer Experience

Rates will likely fall further in places like California, putting a damper on AmTrust's results. However, management still likes the way the company is positioned in these markets, and relatively speaking, AmTrust's pricing held up quite well in 2015:

Workers' compensation	+1%
Small Commercial Risk ex-workers' comp	+4.5%
Specialty Program ex-workers' comp	+5.6%

Management has stressed that they're more than willing to pull back on expanding if need be, and to a certain extent it looks like this is already starting to play out. Although this may result in some near-term disappointment, it's exactly what we'd like to see, because undisciplined underwriting has a nasty habit of catching up with companies exactly when they can't afford it. Policy count continues to increase, though we'll be keeping an eye on renewal rates -- the small commercial business division's results were still very solid at 84%, but that's down 300 basis points from the 87% it posted in 2013.

There's no denying that AmTrust has fallen prey to the stealth bear market that's claimed many a Foolish favorite over the past few months. And insurance-industry developments may be partially responsible for the decline, as well. AmTrust's stock has spent the majority of its time above our fair-value estimate over the past few years, something we were comfortable with given that its business model makes it one of the harder stocks in the *Pro* portfolio to value. But it's now declined to the point where the two have essentially converged. This isn't the way we would have liked to see things play out over the past few months -- the price dip doesn't help us much if we currently don't plan on increasing our position, which we don't, because it's already our third-largest. That said, given that we've always attempted to err on the side of caution when valuing AmTrust, our confidence in the stock's ability to deliver satisfactory returns over the next three years has increased with the recent decline in the stock.

The Flaws of Fair Value

Published Mar 7, 2016 at 2:19PM

Dear *Pro* member:

We frequently hear from members who question whether they should buy *Pro* stocks that trade above our fair-value estimate. Our answer is that if a stock is rated Buy on the Recommendations page, we believe it can deliver a North Star-worthy return or better over the coming three years (lately, that's about 10% annualized). However, there are pitfalls in publishing a fair-value estimate, and so we return to the topic periodically to see if we can improve our practices for members.

I could argue for eliminating the published number entirely (as most Fool newsletters do), largely because we all anchor to it, but members do expect to see a fair value here. We could provide a fair-value *range*, which is how we create our fair-value estimates internally. Or we could move to a fair-value *target*, sharing our expectations for where we believe a stock could trade in three years. We're already doing that exercise with our current fair-value estimate, of course: With a 10% discount rate, we expect at least 10% annualized growth on a stock from today's fair-value estimate, making it simple to project where the stock might trade in three years.

Before we go further, let's define fair value, and then talk about its flaws.

A fair-value estimate is the approximate price *from which we expect a stock to earn our desired long-term rate of return*.

So, if we believe a stock is fairly valued at $100 today, and we hope to earn at least 10% annualized on it, we project that it could trade at around $133.10 in three years. This means if the stock is 10% above our fair-value estimate today, it could still appreciate strongly in the coming years, especially if our estimate continues to prove modest.

When it comes to fair-value estimates, many factors are commonly overlooked by investors:

- A fair-value estimate is a snapshot in time; it represents *today's* fair value, usually using the last 12 months as your base.
- A growing company increases its fair value daily, just as you do if you're saving some money each day. All else equal, a stock's fair value ticks up daily as the company grows.
- We update our fair-value estimates quarterly at most, and usually only bi-annually or annually, given that our estimates (like all of them) are approximate and model out yearly results.
- We lean conservative, rather than aggressive, with our fair-value estimates. A great company has multiple extra ways to increase value that we can't bake into our long-term projections, partly because we don't know everything management is planning. We need to base most of our estimates on what we know now, not on new products, services, markets, or acquisitions a company may add.

That last bullet point only touches on the many other factors that will continually change a fair value but that aren't, or can't be, accurately guessed at in a fair-value estimate. Will tax rates change? What will currencies do? When will interest rates go up, and by how much? What if a company decides to buy back 10%, 15%, or 20% of its shares (as some have done in recent years)? What if a company finds a way to increase sales by just 1% more per year than you expected? Extrapolated out 10 years, that leads to a very large difference in today's fair-value estimate.

And that brings us to the biggest flaw of a fair-value estimate: Too often, they're wrong by a great magnitude -- and I mean billions, even tens of billions of dollars. Even hundreds of billions. Nobody predicted in 2002 that the iPod would lead to the iPhone and iPad, and that Apple would go from a relatively tiny company to one worth $572 billion with more than $200 billion in cash and investments. Discounted cash flow models generally model results 10 years forward, and then slap on a tiny terminal growth rate. No one guessed what Apple's 10 years had in store. And how many mature companies grow at a terminal 2% rate per year? It seems a company either withers away, gets bought out, or grows much more quickly than that, reinventing itself, finding new markets, and moving ahead with new life. Think **Apple** (NASDAQ: AAPL), **Disney** (NYSE: DIS), and **Nike** (NYSE: NKE).

Fair-value models from a decade ago couldn't factor in Disney buying Marvel, Pixar, and Star Wars, or Nike selling billions of dollars' worth of product overseas as prosperity spreads in emerging markets.

So, if a fair-value estimate based on what you know *today* causes you to sell a stock (or not buy it), you're missing all the future upside from progress you can't predict.

A discounted cash flow model takes what is known, adds reasonable assumptions, and projects forward. It doesn't take into account the countless events that can -- and will -- change the world, and often valuations, the *most* over the next 5, 10 and 20 years.

That said, fair-value estimates do serve as a better guidepost for buy and sell decisions on lesser companies. If one of our second-tier companies -- one lacking pricing power, or short on growth avenues -- trades above its fair-value estimate, we'll strongly consider parting with it. But when an outstanding business the likes of **Starbucks** (NASDAQ: SBUX) trades reasonably above our fair-value estimate, we want to give it the benefit of the doubt and let it be (or even buy more!), as long as we believe in its future. Anyone who sold Starbucks in the past because it looked expensive has come to regret that decision, at least from a returns perspective. Anyone who hasn't bought Starbucks on valuation concerns underestimated the business, too.

It can't be proven, but it's probable that more wealth has been missed in the stock market because of these three factors than any others:

1. Selling good companies (or selling out entirely!) when the market swoons.
2. Selling great companies after making 100% or so ... only for the stocks to then turn small investors into millionaires over the many years to come, going up 1,000% or more.
3. Not buying great companies because they looked expensive.

The influence of fair-value estimates has probably cost investors as much wealth as any other factor. It's impossible to truly imagine a decade or two ahead, and how much more valuable strong companies can be. Not all will work out, but the winners will dwarf the losers -- and dwarf a 10-year old fair-value estimate.

Foolishly,

-- Jeff (TMFFischer)

Gentex Shines Bright In 2015

Published Mar 3, 2016 at 12:52PM

***Pro*'s Take: GNTX Q4- and FY-2015 Earnings**

Quarter Quick Take

Gentex (NASDAQ: GNTX) reported an outstanding close to 2015, delivering Q4 net revenue growth of 15.7% and total mirror unit growth of 16.2% despite modest auto production growth (1-2%) in the company's primary markets over the same period. With full year 2015 unit growth of 13.6% vs. 2015 auto production growth of 1.6%, Gentex's mirror sales continue to handily outpace global auto production, which suggests that the core element of our thesis (higher auto-dimming mirror penetration rates) is playing out.

In 2015, the company sold 10.8% more interior mirrors (5.5% in North America and +14.1% internationally) and 21.2% more exterior mirrors (+36.5% in North America and +14.3% internationally) than it did in 2014. The company has announced and launched several new products that look to drive growth throughout 2016 and beyond, and as cars become more technology-rich than ever before, Gentex is well positioned to meet that demand.

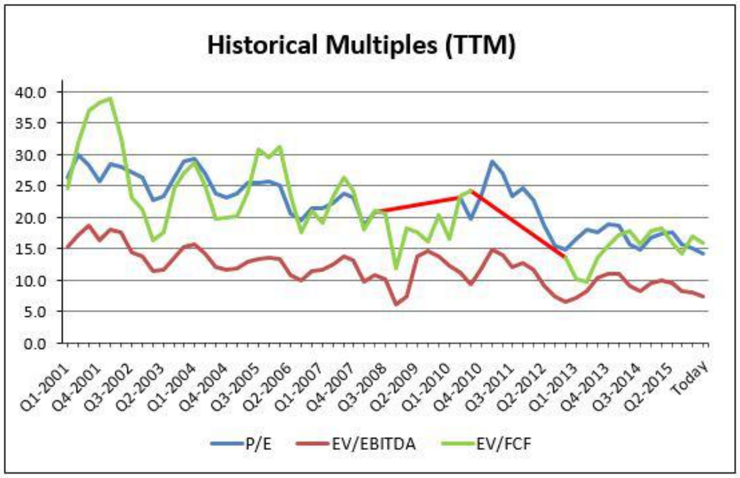
As evidence, consider that in 2013, the company had 37 new launches of its inside and outside electrochromic (EC) mirrors. In 2014, there were 43 new launches of inside and outside EC mirrors. And in 2015, the company has had 63 new vehicle launches. This increased rate of adoption is why Gentex has been able to consistently grow sales often at a rate of 10% or more than global auto production.

Management continues to buy back stock, repurchasing $28 million of stock during Q4 at an average price of about $15.30. Management is historically stingy with repurchases, but as cash piles up on the balance sheet (cash + short term investments are up 12% year-over-year, and cash + investments represent 14.5% of the current share price once you net out debt), management appears to be more willing to pursue buybacks as a capital allocation strategy. I view these continued buybacks as a signal of confidence from management, and with Gentex shares trading at historically low multiples and below our estimate of fair value, I think the buybacks are a strong capital allocation decision.

Guidance Update

In 2015, Gentex continued to do what it does best -- sell its products at a pace well above the rate of auto production growth, and invest in manufacturing and product development initiatives in order to raise average selling prices and reduce manufacturing costs to offset annual price reductions expected by its powerful automaker customers. As global auto production picks up and as more and more automakers integrate technology into their models, Gentex should benefit over the long-term.

After updating my valuation model, **our fair value estimate remains unchanged at $18 per share.** The company's recent outperformance and improvements in penetration and margins were offset by lower expectations for global auto production amid a weaker global macro environment. Yet with the stock trading more than 15% below our FV estimate, **Gentex remains a Buy First** on our scorecard. At just over 14 times trailing-12-month earnings and at 7.5 times EV/EBITDA, the company is trading at valuation levels that are about as low as they've been throughout its history despite a robust balance sheet, steady operating performance, and continued success in market penetration and organic growth. If you've yet to start a position or fill out your allocation in Gentex, now is a great time.



We also have a 1.5% look-through allocation in March 2016 $15 written puts. Those puts are on track to expire fully as income (as did our prior iteration of Gentex puts we wrote in August 2015), although we are still a few weeks away from expiration and the stock is very close to our strike price. If you haven't matched us you can still write the puts, although with just a few weeks to expiration, the absolute amount of income is quite low despite a decent yield.

Updated Guidance: Buy First (no change)

Recommended Allocation: 2.8% with 1.5% in written puts

Fair-Value Estimate: $18 (unchanged)

Current Price: $15.21

Our Thesis

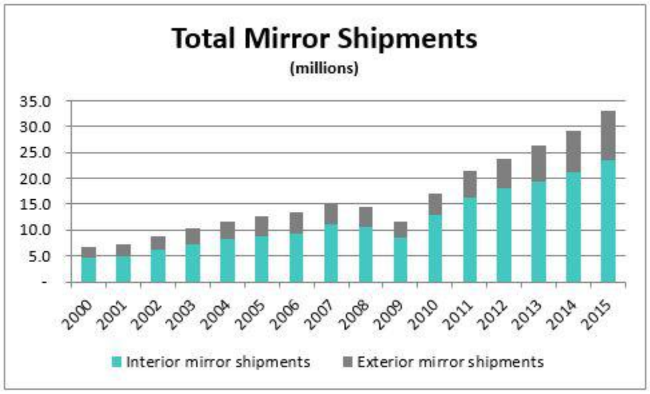
Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1) Penetration: Unit growth vs. auto production. Over time, we want to see Gentex's auto-dimming mirrors to continue to gain market share. If the company is increasing units sold faster than auto production, it is moving in the right direction. Quarterly global interior mirror unit volumes accelerated nicely to +16.2% year-over-year growth (up from +12.4% a quarter ago). Full year 2015 global interior mirror unit volumes increased 10.7% (up from 9.3% in full year 2014) vs. 1.6% yearly growth in auto production in the company's primary markets, showing that Gentex continues to significantly outpace vehicle production growth and capture market share. Full year 2015 interior units sold in North America accelerated to +12.6% (up from +4.4% in 2014) and full year 2015 international interior units increased +14.1% (up from +13.4% in 2014).

Exterior mirror unit shipments continue to grow even faster, with full year 2015 unit volumes up +36.4% in North America (vs. 12.2% in 2014) and +14.3% internationally (vs. 14.9% in 2014). Full year 2015's exterior mirror attach rate was 40.3% (i.e. 40.3% of cars equipped with interior units also were equipped with exterior units), compared with 36.8% in 2014. Exterior mirrors currently only have about 7% to 8% market penetration relative to global auto production, but that penetration rate is clearly increasing, as evidenced by strong unit growth metrics.

The company continues to do an excellent job growing its units sold at a rate higher than that of auto production, demonstrating strong growth and increasing market penetration:



2) Pricing and value: Unit growth vs. automotive segment sales. Powerful auto makers force annual price concessions on their suppliers, and Gentex isn't immune. Price reductions have recently been in the range of 2% to 3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices (ASPs) and gross margins.

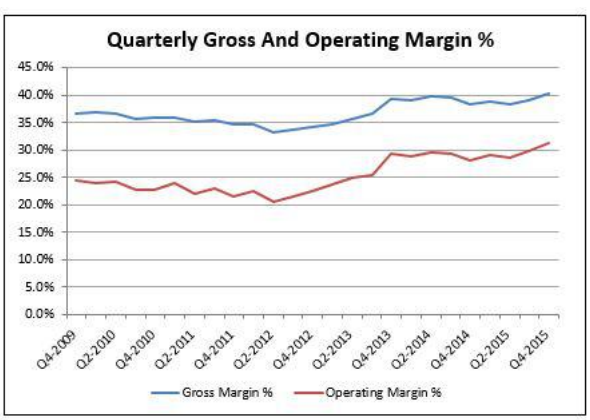
In full year 2015, total units (interior + exterior mirrors) increased +13.6% and automotive segment sales were up +12.4%. This dynamic suggests lower ARPU (average revenue per unit) and is consistent with the expectation of annual price concessions. However, some of the lower ARPU can be explained away by the continued success of exterior mirrors, which have lower ARPU but higher margins relative to interior mirrors. Despite the lower ARPU, the more exterior mirrors Gentex sells, the better it is for the business. They lift the overall margin profile of the business and since exterior mirrors are sold alongside interior mirrors, they are increasing the total dollar value of their products in cars. Here is a relevant question from an analyst regarding ASPs and the response from management:

> **Daniel Lemont Drawbaugh (Analyst):**
>
> *"Okay, great. Also, I guess, looking ahead to that 2017 time frame, can you talk a little bit about where you sort of see ASPs going, not just in 2017, but in 2016 as well? You guys have been pretty good at sustaining those with the additional content. Can you talk a little bit about where you think they'll go by that 2017 time line?"*
>
> **Chief Financial Officer and Senior Vice President Steven R. Downing:**
>
> *"Sure. I mean, if you take out the APRs that we've always talked about kind of being in the 2% to 3% range from an annual price reduction, so that's kind of the headwind. So on average, if you're looking at anywhere from a $40 to $45 price point, you're talking about $1, $1.30 headwind at the beginning of every year. And so we have to find content that helps offset that. Really if you look at '13 and '14, most of what drove that ASP downtrend was the loss of RCD mirrors. So they are a significantly higher-priced product than our average. We had those losses in the North American markets. That negatively affected the last few years. If you take that out, what you would have seen was an overall growth trajectory of our ASPs. That's driven primarily by increasing penetration of electronic content. It is naturally offset a little bit by introduction on lower segment vehicles that we're just introducing on at low -- below corporate ASPs. And then ultimately for us, what we're excited about is when you talk about the advent of Full Display Mirror and its launch over the next several years. We expect that, especially in '18 and beyond, to have a positive impact on ASPs. Now the other deterrent to ASP has always been our outside mirrors. They're below-average ASP. And so as that business grows faster than the inside mirror business, you will see another a negative factor on the ASP mix. If you look at what we're -- the trajectory looks like for next couple of years, we really see those kind of growth rates kind of moving in parallel with each other. So we wouldn't expect a whole lot of negative ASP headwind from the outside mirror business, at least in the next 2-year period."*

3) Margin performance. In full year 2015, gross margin was 39.1%, down from 39.2% in 2014, due largely to foreign currency fluctuations and annual customer price reductions. However, for Q4-2015, the company reported a gross profit margin of 40.2% (vs. 38.4% in Q4-2014), the highest gross profit margin reported by the company on a quarterly basis since the second quarter of 2004.

I mentioned last quarter that as the company works through new product launch inefficiencies and as higher-margin new products make their way through the sales pipeline, gross margin should see a boost. That's what we continued to see this quarter with a sequential increase in gross margin from 39% to 40.2% (the second straight quarter of sequential gross margin improvements), as launch inefficiencies were no longer a headwind and improved product mix, purchasing cost reductions, and fixed overhead cost leverage gave margins a sequential boost.

Full year 2015 operating margin performance was very strong, coming in at 29.7% (vs. 29% in 2014). On a quarterly basis, Q4-2015's operating margin of 31.2% was the highest operating margin reported by the company on a quarterly basis since the first quarter of 2004. The strong operating margin performance is due primarily to SG&A expenses-while revenue increased 12.2% (+$168 million in absolute terms) in 2015, SG&A expenses actually decreased by 8.1% (-$5 million in absolute terms). Management mentioned however that the majority of the decline was due to foreign currency fluctuations (namely the Euro).



Management's 2016 gross margin guidance range is 38.5%-39.5%, indicating flat gross margins compared to 2015. Management's 2016 SG&A and R&D expense guidance indicates slight operating margin expansion, as SG&A and R&D expenses grow more slowly than sales.

What We Think Now

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

If you have questions, drive on over to the Gentex discussion board.

Facebook's Future Gets a Like From Us

Published Mar 2, 2016 at 3:31PM

Facebook (NASDAQ: FB) remains a young story about monetizing the largest, most engaged online audience ever hosted by one company. The company's future is in strong hands; management is showing patience and care as it starts to monetize more of its properties, putting visitor experience first. So far, this approach has paid off, with user engagement up even as more ads appear. The billions of connections maintained on Facebook's properties are making the sites extremely sticky, offering the potential for increased value to advertisers (and thus Facebook owners) for years to come -- especially as the advertising gets smarter and more targeted. Again, this business is in early innings.

Status:	**Buy First** (up from Buy)
Fair-Value Estimate:	$100 (up from $90)
Recent Price:	$109
Current Allocation:	6.3% (our largest)
Dividend Yield:	N/A

Key Thoughts

- Almost all Facebook users use the service on their mobile devices each month. Customers are ahead of businesses in this shift, with the latter only now migrating to mobile and mobile advertising because that's where the eyes are. The migration is still unfolding, promising many more ad dollars headed Facebook's way.
- Instagram's 400 million active users make it and Facebook the company's two largest mobile advertising platforms. Early advertising success on Instagram is excellent; the picture format of the site is perfect for integrated, related advertising. Ninety-eight of Facebook's top 100 advertisers are now advertising on Instagram.
- Facebook will monetize Messenger, WhatsApp, and other properties carefully, putting user experience first and continuing to learn from and improve advertiser results.
- Facebook's advertising growth is broad-based, going beyond e-commerce, consumer products, and retail.

Secondary Thoughts

- More than 800 million people use Messenger monthly; nearly 1 billion use WhatsApp monthly; more than 1 billion used Facebook Groups in a single month last quarter; and more than 500 million use Events each month.
- Facebook Lite and Free Basics is bringing Facebook and the Internet to millions of people (19 million in 33 countries so far) with no or slow connections.
- Facebook's Oculus Rift Virtual Reality device will begin shipping to more than 20 countries by the end of this month, initially targeting gamers (hundreds of games are rolling out already).
- Every member of Congress now uses Facebook to communicate, and political advertising can target specific districts, demographics, etc.
- Sports Stadium is Facebook's early test of real-time sharing around events, including sports (650 million sports fans populate Facebook). Real-time sharing is an important focus for Facebook now.
- The company is testing a new site/service for Facebook users who just want to view videos.

The Numbers

- **Outlook:** We'll see another year of heavy investment in 2016; total GAAP expenses should rise 30% to 40%, and non-GAAP 45% to 55%. Capital expenditures should be between $4 billion and $4.5 billion, up from $2.5 billion last year. And 2016 will be the first year in which Facebook pays significant income taxes in the U.S. on a cash basis. All of this pitted against strong 2015 growth rates will obviously make 2016 EPS growth slower, but it should remain robust at an estimated 35%.
- **Q4 2015:** Ad revenue was up 57% (66% in constant currency) last quarter, while mobile ad revenue rose 81% to $4.5 billion, now making up 80% of total ad revenue. Monthly users reached 1.59 billion, with more than 1 billion visiting every day and almost all users (1.44 billion) using mobile devices. Fourth-quarter average ad prices increased 21%, while ad impressions increased 29%.

Market Cap	$311B
Cash	$18.4B
LT Debt	$0
EV/EBITDA	36.9
EV/EBITDA NTM est.	19.5
P/FCF	53
P/E	84
P/E NTM Est.	35

Position Summary

It's our largest position at 6.3%, and the size of our investment in Facebook feels appropriate given how much growth potential lies ahead and how well-managed the company is. Even from today's price, we estimate Facebook could return about 20% annualized for shareholders over the next five years. Though shares are currently above our fair-value estimate, the stock moves to Buy First on its long-term potential. Key risks include users moving away from Facebook, but so far the company has shown great skill in *increasing* user engagement and stickiness, rather than stunting it. It's also possible that management could spend more than Wall Street expects, though that should mainly be a short-term concern.

- Facebook investor relations
- *Motley Fool Pro*'sFacebook discussion board. Ask your questions!

Skyworks Stays Strong

Published Mar 2, 2016 at 2:44PM

Skyworks Solutions (NASDAQ: SWKS) is positioned to keep increasing its profits at a healthy clip as more smartphones are sold and connected devices (the Internet of Things) proliferate. Few competitors can match the complex, customized analog semiconductor and related products Skyworks sells to manufacturers, leading to higher profit margins for the company, more long-term product wins, and increased revenue visibility.

After a relatively soft first half of 2016 thanks to **Apple** (NASDAQ: AAPL) clearing out inventory, Skyworks expects to finish the year strong. Apple is its largest customer; Samsung is second. The broad Internet of Things industry, which is currently being led by connected homes, makes up 20% of revenue and growing, with even higher margins than smartphones. Long-term growth rates overall could remain above 10% for many years.

Status:	**Buy** (down from Buy First as we look to decrease the volatility of our Buy First stocks)
Fair-Value Estimate:	$85 (no change)
Recent Price:	$69
Current Allocation:	3.4%
Dividend Yield:	1.5%

Key Thoughts

- Demand for wireless data continues to surge, requiring dramatically higher levels of analog performance from semiconductors, which in turn results in Skyworks being able to sell more product per computing device, at higher profits.
- As a technology integration leader, Skyworks is consolidating market share, and as it does so, its visibility into new product wins and future product architectures is "very strong." Future products being designed now are extremely complex, and well ahead of competing solutions.
- The Internet of Things is happening now, but just getting started, offering many long-term growth avenues. Sales in this division grew about 12% for Skyworks in the first quarter.
- The Skyworks business model is focused on high-value-added integrated solutions to customers at unrivaled scale, with plenty of room to add capacity as needed.
- Profit margins should keep trending higher.

Secondary Thoughts

- The first-quarter product mix was 64% integrated mobile systems (smartphones), 16% power amplifiers, and 20% broad markets (Internet of Things).
- China is a growth driver as the country's phone networks move to 4G; Skyworks sales were up 20% in China in the past quarter, and the country represents 20% of revenue.
- Sales in smartphones should increase by the mid-single digits overall, but the growth rate for Skyworks' addressable market in the phone space should be at least double that.
- Samsung, Skyworks' No. 2 customer, is using ever more complex solutions, as are all China customers. Even value-tier customers are moving into more complex solutions.
- Skyworks plans to return about 40% of cash flow to investors through dividends and buybacks.
- Skyworks has worked with TDK and Qualcomm a long time, and isn't very concerned about their new partnership.
- While connected homes are driving the growth of the Internet of Things right now, it's starting to be seen in automobiles and other important industries, too.

The Numbers

- **Outlook:** Management is targeting a 53% long-term gross margin and a mid-term goal of $8 per share in annualized EPS. For the second quarter of 2016, EPS could rise 8% to $1.24, with gross margins of about 50.5%. For all of 2016, EPS should increase by around 10% or more, followed by higher growth in 2017.
- **Q1 2016:** Revenue was up 15%, operating income 30%, and EPS 27% to $1.26.

Market Cap	$13.98B
Cash	$1.2B
LT Debt	$0
EV/EBITDA	9.2
EV/EBITDA NTM est.	8.0
P/FCF	26.0
P/E	14.4
P/E NTM Est.	12.0

Position Summary

Skyworks' shares may have gotten ahead of themselves when they topped $100 last year; with perfect hindsight, we could have sold then and then bought back lower. Indeed, we might have done just that on a lesser business (where conservative valuation models are the primary driver of decisions). But despite being a semiconductor business, Skyworks does *not* fit that description. It is strong in every way that matters, including growing margins, strong growth rates, more product wins, and so on. The stock is likely to remain volatile, though. We are happy to be long-term owners of shares, which remain a Buy, and we may consider options as another way to monetize the position opportunistically. Our fair-value estimate of $85 is 14.6 times our expected earnings per share for the year ending in September 2016. Having Apple as its largest customer is one key risk, but we know that Skyworks' product is in the next generation of iPhones, and the company is likely already working on the next iPhone after that.

- Skyworks Investor Relations
- *Motley Fool Pro*'s Skyworks discussion board. Ask your questions!

Roll Your Written Puts on Wells Fargo

Published Mar 2, 2016 at 1:15PM

Is this for you? Yes, if you're a *Pro* member following our option writing for income on **Wells Fargo** (NYSE: WFC), and if you (like us) have an in-the-money March option reaching expiration in about two weeks. If your March puts have already been assigned, take a look at the Alternative Trades section at the end of this alert. (If you own 2018 calls on Wells Fargo from *Motley Fool Options*, leave those alone. They have nothing to do with this alert.)

How You Participate

- **Action:**
  - Buy ("buy to close") your previously written March 2016 $52.50 puts.
  - Write ("sell to open") May 2016 $52.50 puts.
- **Allocation:** Write the number of May puts equal to the number of March puts you buy to close. *Pro* will be rolling its seven contracts. The look-through allocation on the puts is about 1.5%.
- **Prices (11:45 a.m. March 2):**
  - **Stock:** $49.32
  - **Options:**
    - Buy to close March 2016 $52.50 puts (bid/ask): $3.05/$3.50
    - Sell to open May 2016 $52.50 puts (bid/ask): $4.00/$4.15
    - Combined rolling bid/ask: $0.50/$1.10 ($0.80 at the midpoint)
- **Price Guidance:** Using a **limit order**, split the bid/ask and aim to receive a net credit of at least $0.80. As prices change, realize that you should complete the roll by March expiration; if you don't, you will be assigned shares of Wells Fargo stock. You have some time to complete this rolling trade, so don't feel that you need to rush, but keep an eye on the time value of the March $52.50 puts – the closer it gets to zero, the more likely you are to be assigned.

What We're Thinking

Since our last recommendation to roll our written puts on Wells Fargo, the company has reported fourth-quarter 2015 earnings, recent U.S. economic data has increased the likelihood of further Federal Reserve rate increases, and the stock has experienced some more volatility, reaching as low as $44.50 per share (almost 10% less than the current price) on Feb. 11.

Nonetheless, with our puts in-the-money by about 6%, and with some members already seeing assignment on their written puts, we're forced to either roll our puts or accept assignment on new shares of Wells Fargo.

Our take is similar to last time: While we're OK with the idea of being assigned new shares of Wells Fargo, we're more content to simply roll our puts out to May, collecting some additional income as we wait for more clarity on the interest rates and business momentum. Wells will report first-quarter 2016 earnings sometime in April, and we will receive the "earnings uncertainty premium" for rolling to a date that's beyond the earnings report.

We wrote January puts for $1.10 per contract (your mileage may vary depending on when you wrote yours), and our roll out to March provided us with a credit of $1.16 per contract. So with the additional $0.80 from rolling our March puts out to May, our new effective buy price on additional shares of Wells Fargo would be $49.44, slightly above the current price and 14.8% below our $58 fair-value estimate.

We'll reevaluate our written put position in May. If our puts are still in-the-money, we'll decide whether to accept shares of stock or roll further; if they're not, we could let our position expire and look to reinitiate our income strategy on Wells Fargo shortly thereafter, depending on market conditions.

More That Matters

- **Maximum loss:** For the current iteration of the put strategy (which includes the January and March recommendations), our risk is the same as share ownership starting at about $49.44, or about 0.2% above the current price.
- **Maximum gain:** On this rolling trade alone, our maximum gain is the rolling credit. At $0.80, that's a 1.6% yield on the current share price in 80 days.
- **Follow-up:** In May, we'll buy shares at a net $49.44 (about 1.46 times current book value) if the stock is below our $52.50 strike price, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts (or pursue a different strategy) for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 3.6% allocation first — Wells Fargo's shares are a Buy First. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1.5% of your portfolio, then just buy 1.5% in stock directly *if and when Pro* does so through these puts (we'll alert you).
- **Were your March puts assigned?** You could:
  - Write May 2016 $52.50 covered calls on your assigned shares, which is a functionally equivalent trade to our May 2016 $52.50 written put position.
  - Sell the shares that you bought via assignment and write May 2016 $52.50 puts alongside us, aligning you precisely with *Pro*'s official position. Both choices are functionally equivalent, although writing May covered calls may mean you'll take a different course of action than *Pro* does, depending on what happens with the share price as we approach May expiration.
- **New to the position and didn't write puts last time?** You can:
  - **Match *Pro*** by writing May 2016 $52.50 puts at a 1.5% look-through allocation. Recognize that these puts are in-the-money and have a higher risk of assignment than puts that are at-the-money or out-of-the-money.
  - **Be slightly more conservative, if you prefer, and reduce your risk of assignment** by writing May 2016 $50 puts. Recognize that your effective yield will be higher than that of *Pro*'s rolling trade and your potential buy price will be lower, but you will not be aligned with *Pro*'s official position. You can also look at weekly puts at various other strikes, depending on what you like best. If you choose this route, be aware that *Pro*'s course of action may diverge from yours, depending on what expiration and strike you choose, and depending on the stock-price movements of Wells Fargo.

Pro Can Help

- **Want more on this strategy?** See our guide to writing puts.
- **Questions?** Please ask, Fools! Drive your stagecoach over to the Wells Fargo discussion board.

Pro Video Chat, March 2016

Published Mar 1, 2016 at 12:09PM

Fellow Fools,

We've gathered your questions, and today we're ready to answer as many as we can in an hour! **Our live video chat will be streamed on this page from 3 to 4 p.m. Eastern today.** We're also trying out a new way for members to get involved:

1. Visit this link, or go to slido.com (https://www.sli.do/home) and enter code #ProChatMarch.
2. Ask a short question or post a quick comment (there's a 160-character limit). Once it's approved, you and everyone else in the sli.do chat will see it and can vote it up the list if they like it; that will help us know which topics will be most useful to address.
3. Note that **there is a limit** to the number of participants in the sli.do chat. That limit is 1,000; our chat participation is generally less than that, but as this is our first time trying this format, we of course can't know for sure. If we do go over the limit, we will decide whether and how to increase it for next time.

Want to practice? Go to the sli.do chat page and ask a question or submit a comment. Ellen, as the moderator, will approve a few before 3 p.m. so members can practice voting and get used to the interface. **The majority of questions and comments will not be approved except during the hour of the chat, 3 p.m. to 4 p.m. Eastern** -- otherwise we could end up with so many questions that they're impossible to address.

If you didn't get your question in before the deadline last Friday, it will be included in next month's list. And if your question isn't answered in today's chat, please be patient -- we had a great many submissions this time! Thanks, Fools.

Transcript

JEFF FISCHER:

…*Motley Fool PRO* live chat. Here we are in real time. J.P. Bennett joins me along with Billy Kipersztok who is on Skype. Billy, how are you doing?

BILLY KIPERSZTOK:

Doing well, Jeff. How about yourself?

JEFF FISCHER:

Great. Great to have you, here. J.P., it's good to see you.

J.P. BENNETT:

Glad to be here.

JEFF FISCHER:

So as PRO members know, we collected questions. Ellen Bowman, our editor-in-chief of *Motley Fool PRO* and *Motley Fool Options,* is behind the scenes helping us. We collected questions in the last week from you — we have about 60 questions — and we're hoping to answer as many of them as we can.

And because we are gluttons for punishment, we have a live sli.do page open. You should have received the email about it today telling you to go to the slido.com site and there you can enter ProChatMarch2016 (I believe it was something like that) and it gets you into our sli.do page. There we'll be taking your questions, as well, assuming we have time. I've seen a list of them there already, J.P., that we can jump on quickly and answer.

I'm going to screen through the sli.do chats, first, and then we'll get to the questions from this past week. And if I answer quickly, it's because I'm trying to get to as many as possible. It's not because it's a curt answer. It's just there are a lot of questions and we want to get to them.

And again, we're experimenting. We'll see how this works, J.P. Taking your questions in, we were then writing answers out, ourselves, one by one. We thought maybe we should take written questions and then publish written answers, rather than making people wait an hour to hear them through a chat, that we'd then transcribe. So there may be a combination in the future — we take your questions, we write out answers, and we have a live sli.do tied-in chat for real-time questions.

I'm going to fly through some of these sli.do questions. One comes from Paul S. who writes: *It seems like the latest correction came and went. Do we have any strategies to deploy cash more quickly when something like this happens in the future?*

Maybe a so-called correction came or went. We don't know. What we focus on are valuations at the time, and we didn't see anything that we wanted to buy quite yet. We were getting close, but we didn't see anything that we wanted to buy already. We're pretty fully invested, minus our hedges and shorts. We have about 20% cash, which is about the minimum we want given where valuations are right now. But when we see things we want to buy, we'll act on them no matter where the market is.

J.P. BENNETT:

I would say there's no rush. It's not like we pull back from fair valuations to extremely cheap. It was more like maybe we're getting a little bit ahead of ourselves. I know J.P. Morgan published some research not too long ago noting that the market's back to average on a forward-valuation basis. It's not like it was the time to just go in and buy whatever you could find. We're still at a point where it pays to be disciplined.

JEFF FISCHER:

I agree. If you look at the past year (and even the past 18 months to two years) it's difficult to find stocks that have gone up. Maybe one or two out of 10 have done well. So as we said at the start of the year (and all of last year) we want to be careful and only buy something when we have very strong conviction in it.

BILLY KIPERSZTOK:

And I'll add something there, too. Remember that anything we add to the portfolio has to be more compelling to us than what we already have. If that's not the case, then we'll just add to our existing holdings. Something to keep in mind is that we have active written put positions on Wells Fargo and Gentex, both of which were established or rolled during the market correction. Those are still outstanding and may be exercised just to stock.

JEFF FISCHER:

That's true. We also had earnings happening — a few of them we're still going through — and we considered adding to Skyworks, but we own Apple and Skyworks. We looked at Gilead to add to that, possibly, but the lack of growth, there, makes us comfortable with our current allocation. We did add some positions to *Motley Fool Options*, of course, but we'll act when we are really compelled to for PRO.

The second question. Lon is asking: *Updates for those of us who still own Tupperware*. I posted on the Tupperware board today, in fact, that it's still a sell. The stock is around the price where we sold it. Earnings looked tepid this last quarter. They weren't well-received, either. We have stronger companies that we're considering, so Tupperware is still a sell.

Some kind thoughts that you can see if you're in sli.do, as well. Thank you for those thoughts. Gary says: *You have a lot of representation of tech in Pro (Apple, Skyworks, Facebook, Oracle). What's our current take on these holdings given current events?* J.P., do you have any thoughts?

J.P. BENNETT:

I would say we still like where we stand. If you look at it on a case-by-case basis, we all cover different stocks. I cover Apple. You cover Skyworks. My opinion on Apple is that it's still undervalued and that the market doesn't appreciate the competitive position. Yes, it's not going to grow as fast as it did back when the iPhone came out, but it's because we're talking about a much bigger business in the order of billions. It can't grow that fast unless it's going to become bigger than the U.S. economy. I still think that Apple is attractive and meets what we're looking for in PRO.

JEFF FISCHER:

It's funny how during the last two phone cycles the stock seemed to have a quiet year in between new models, and then the new model excitement (as the iPhone 7 comes out later this year) will probably kick in. I would also say Facebook is more of a social network than a tech stock — an advertising-based business. But we are still heavily weighted in technology and financials, and we still find them attractive.

One more question from sli.do. Adrian asks: *My option account limits me to covered call writing only, yet most of the options in PRO are writing puts. Can you have more calls, please?*

I'll say unabashedly go to *Motley Fool Options* where we'll have more covered call writing. In PRO we're trying to own compounding-machine companies. We really believe we'll do well in the next three to five years and longer. We don't typically want to cap their upside in most cases. We'll write some covered calls in PRO, but not as many as you'll see in Options and not as many as we will write puts in Options.

Let's move on to the questions that we collected earlier from all of you, and thank you for sending these in.

J.P. BENNETT:

We got a lot more than we got last time.

JEFF FISCHER:

We did and I'll go to Billy, first. From SavingForHiking: *I'm curious about under what conditions PRO extends exposure to long positions. There's a decent cash position* — we touched on this a little bit, already — *in the PRO portfolio and we saw a recent dip, yet PRO didn't go longer on any positions. In fact, it added a short. I'm curious what the rationale is and when the right time is.*

BILLY KIPERSZTOK:

That is a good question. Knowing the right time to extend long exposure is a difficult decision. I don't think that PRO is going to try to anticipate short-term market movements, but what we are going to do is keep an eye on valuations and we're going to keep looking at the opportunity set that we have from new stocks. Then when the market comes down and we see a correction, that opportunity set gets bigger.

Then similar to what I was saying earlier, anything that we add to the portfolio has to be more compelling to us than our existing holdings. We're always looking at new opportunities, but then we always have to compare opportunity costs to what we already have. I don't think we ever feel compelled to make decisions quickly. This means that sometimes we lose out on opportunities when they come and go really quickly, but we prefer to focus on having high conviction in our ideas rather than acting quickly and maybe making a mistake.

JEFF FISCHER:

I agree. I think two times out of three, at least, we're going to be kind of boring, but I hope our results will play out in the way that a very considerate investor would hope them to play out over the long term. J.P., let's get to our newest short.

J.P. BENNETT:

[00:09:18]

JEFF FISCHER:

We have two or three questions about shorting John Deere. Various Fools said we were betting against Warren Buffett. Does that makes sense? The stock had already fallen a fair amount and we have to pay a dividend. These things were all addressed in the short report. Was that okay with us? How will low fuel costs affect farm income and thus John Deere's income?

J.P. BENNETT:

Where do we start? Let's start with the fuel costs first. Yes, that was something that we did consider. I think some studies estimate it's around 15% of total costs for farmers, but it's important to realize it's not a case where suddenly they're not being hurt as much on the cost side of things. Just because their fuel is cheaper doesn't mean they're going to go out and buy more tractors. That's not how it works.

Something you need to keep in mind with a short is that how the industry is currently doing is playing into our thesis, but our thesis is, in many ways, a byproduct of what has taken place … that kind of bubble … in that people went out and purchased new tractors or replaced their old tractors at what is essentially a rate that was unprecedented.

Go back as far as you want — we had never seen anything like that — so now we're at a point where the average age of the fleet is extremely young. Farms are becoming more productive and so naturally you're going to see the need for new equipment go down.

What we're saying here is that yes, farmers are in a tough spot. That's part of it. But at the same time the side effect — the way that the equipment industry is going to have to find a more normalized level going forward — is going to lead to a situation where people think Deere is going to have one or two rough years and then they're going to bounce straight back. Our opinion is materially different. We're trying to find the "new normal" level and the new normal level is probably where we are right now.

I know there were some questions about how we feel about the short. I can't speak for you guys, but I'm not losing any sleep over it. You need to have the right mindset when shorting. It's not a huge position. We're only down a little. I know we addressed some of these issues with some posts on the message board.

If you have a long position and it pops 10% soon after you buy it, do you immediately think, "Oh, that's money in the bank. The position's going to work out for the rest of time. I don't have to think about it anymore." Of course not. That's not the way you think.

But with shorting, it can be very tempting. It seems to elicit a strong response if it moves against you right away and you start questioning yourselves. If you look at Five Below, that thing popped against us. I forget the exact percentage. We were down pretty big, but we continued to look at the thesis. The thesis was on track as far as the business performance was concerned, and we were able to close it for a 20% profit. That's how I think about Deere right now.

JEFF FISCHER:

And keep in mind that Deere is also a hedge against Valmont Industries. It made it much easier for me to keep that stock. I was really on the fence about potentially selling it for something better or just to raise cash, actually, for the time being. But once J.P. formulated his short of John Deere, we talked about it, and the whole team liked the analysis. It made it easy to say, "If we're shorting John Deere, we can keep Valmont and keep DGS or emerging markets exposure, because these two really hedge each other out pretty well." So far, Valmont is up more than John Deere, and they're both equally sized positions, so that's a net win.

Warren Buffett — he's not always right. In fact, he's wrong a lot, and he's the first to admit that it's a handful of stocks that have made him the vast majority of his wealth over the many years. He's been wrong just as frequently on airline stocks. On IBM, lately. On American Express, lately.

J.P. BENNETT:

There's one other point that we haven't touched on. Someone mentioned: *It's already taken a tumble. Why now?* I think this is a reflection of our process where we're not trying to call bottoms with longs. We're not trying to call tops with shorts. You can do a lot of damage if you try and time those and get it wrong. We'd much rather see a great business that's doing great and then just continue to ride along those coattails, or find a business that's already currently struggling and then just ride it down as it continues to struggle. That's what we think we have, here, with Deere.

I think it was Chanos — it was one of the most famous short sellers — where in one of his first analyses he put out a short recommendation (he was just an analyst at the time) for Baldwin Pianos. What happened? The stock tripled in his face after he put out that recommendation. It ultimately went bankrupt, but I personally don't have the nerves of steel to stay short something when it moves up 300% against me, so why try and call the top? Let's just sit back and wait until we see it struggling and we think times are going to get worse. We thought that it was a good time to continue pursuing this as a potential short for us.

JEFF FISCHER:

And the S&P is up nearly 10% since that short, so the market was at a point where it seemed like it was going to make a big move one way or the other. It did, but that's as temporary as any move. So again, especially in the context of our whole portfolio, the short is perfectly fine and we believe in the thesis as much as we did a couple of weeks ago. It's all good.

What I'm going to do, now, is fly through five questions or so that I have earmarked, and while I'm doing that, if each of you would get a couple of your own questions ready, then you can go through those. That will be more efficient.

J.P. BENNETT:

We're already off track with the time, aren't we Jeff?

JEFF FISCHER:

We are. We're a little off our one-question-per-minute goal — we're not hitting that — but I think I can make up for some lost time right now. Alex wrote: *Love you guys. Thanks for doing the video answers format. I like it a lot.* That's good to hear.

Some options are done to hedge risk. Others are to generate income. Some are to gain an entry point into a stock. What I want to know is have you done an analysis of how much the PRO portfolio is dependent on options for performance? How much difference would a portfolio like PRO have if it didn't use options over the long term?

In the last two years we've made about $24,000 extra from option income, so not that much. That's about 1% of the current portfolio in two years. We haven't targeted that much option income yet, though. We're mainly focused on stocks and stock appreciation.

The past year, or so (and I'm pretty slow-moving) it's looked like stocks were less likely to keep going up so much, so we stated we do want to make option income every month and we're pretty close to that goal. So over subsequent years, when the market is not really going anywhere, we should be making more option income, but so far, options have added a small amount to the portfolio.

If we do have a greater focus on option income, we'll try to put in there more alternative trades. Spreads. Covered calls that you can do in IRAs. There are at least alternatives that you can consider.

Bob asks: *As a new Fool, I have entered the Starter positions (*the Buy First, I guess*). How do I do the next moves?*

Bob, I would just focus on the Buy stocks and buy them incrementally. You can just go right down the list and buy in full or half-allocations and then a quarter or two later buy the other half. Just keep moving gradually. Almost everything in the portfolio is ready to buy, except for one position, so you can gradually move into those.

I can do two more. Bruce asked about the *SPY* put ratio spread with the April strikes. He has an IRA, so he can't do it, so he would like more IRA attention. In that report at the bottom are two alternative trades that are IRA friendly. So do check out the SPY report. You'll see the IRA-friendly alternative trades in there. As for us, we haven't placed our trade yet. We have to by Friday. As the report says, we will adjust our strikes to the current conditions and then place the trade. That way we can let you know Monday what we did.

If you set up the initial trade, you can roll that up, at that point, or keep it and set up a new hedge at these higher strikes, if you want. The market is up about 9% since that alert went out, and it went up really quickly, which is why we couldn't do our trade. And no harm, no foul. Not a big deal, so far.

You can keep your existing hedge, if you want, and set up a new one at higher strikes or you can roll your existing one for a profit up to higher strikes, but we'll have details of what we set up this Friday, which is the 30-day mark where we have to set it up. Frankly, I would wait for the market to fall before setting it up, but we don't have the choice of 30 days and it's fine. Billy or J.P., as you ready to answer?

BILLY KIPERSZTOK:

I've got a question from Patrick. He says: *I've been building up my retirement portfolio with Stock Advisor recommendations for about 15 years and now I'm ready to start withdrawing. But after all of these years of letting my runners run, I'm great at buying but it kills me to sell. What do you think of an options strategy that forces me to sell; that is, I set up covered calls on a selection of my holdings, focusing on the ones with good upside, perhaps looking for a strike price about 10% or above. Not all trades will be executed. It may kill me when one is, but the ones that are executed will give me cash for withdrawals.*

A good question, Patrick. Congratulations, first of all, on the success of your portfolio and transition to withdrawals. I think covered calls are a great way to force yourself to sell. I use options, all the time, as a decision-making tool, because they force you to make decisions in advance of when the action will actually occur. So definitely consider setting up covered calls on some of your positions.

One thing you say is focusing on the ones with good upside. Maybe not focus on the ones with good upside, because with a covered call you're selling the upside. Perhaps think about focusing on the stocks that have limited upside, or that you see maybe don't have large appreciation potential.

To use examples from PRO, maybe consider writing covered calls on a company like Broadridge and avoid writing covered calls on a company like Facebook, which is a high-growth company that could experience a lot of appreciation. That's question one.

Another question from Bill: *Has anyone ever done a statistical study of how options affect the market either positively or negatively?* That is an interesting question. Yes, people have done studies. There are lots of studies available. If you just Google search the effect of derivatives on markets, that will give you several research studies to take a look at.

Also CBOE (the Chicago Board Options Exchange) — part of their website is called "3rd Party Research." It's under the Institutional heading on their website, and there's a ton of different research reports about the effect of derivatives on markets. As far as the conclusions from those studies, as you might expect, they're somewhat inconclusive. It depends on what you mean by "whether they affect the market positively or negatively."

I've seen studies that show that derivatives or futures either increase volatility of the underlying asset, or they decrease volatility of the underlying asset, or they have no effect on the volatility whatsoever. I've also seen that derivatives use has increased U.S. real GDP by permitting greater extension of credit to the private sector and by improving firms' ability to undertake capital investment.

Check out those studies. There's lots of studies and you'll learn a lot from reading them, so good question. Another question from Jim: *What is your view of the chances that the U.S. would enter a recession in the next 10 to 12 months?*

A timely question. I wrote a memo a couple of weeks ago about the likelihood of a recession, taking a look at a couple of indicators, and my assessment was that the likelihood of a recession in the near term is quite low based upon job growth, based upon wage growth, based upon a pickup in retail sales.

But, again, there's a caveat. A recession can happen at any time. The data you have available to you is only looking backwards in time, and whatever is happening right now, and whatever is happening in the near future we don't have data for. We'll have to keep an eye on it and we'll see what happens as it comes in. It's hard to say, but as of what we know right now, the likelihood of a near-term recession is somewhat low.

JEFF FISCHER:

Thanks, Billy. J.P.?

J.P. BENNETT:

Jpro asked: *I heard or read rumors that AmTrust is going to have a hard time covering workers compensation issues coming up. In fact, there may be some shorts on AmTrust regarding this. Any concerns? Are the rumors unfounded?*

Part of the issue when you're dealing with workers comp insurers is that workers compensation is a long-tail policy. It's not like auto or something for your house where the incident happens, you put in a claim, and you're paid out right away.

Workers compensation can take years to play out, so you can study the business and feel like you have a good grasp of what's going on, but then four years down the road, you find out that what you thought were adequate reserves were nowhere close to what was really needed because of some development that you really couldn't have seen coming.

It's hard to say with 100% certainty that there's nothing wrong with AmTrust, but you can't really say that about any company. We've done our homework. We still feel comfortable with the position, but time will tell. You have to see how those markets develop. AmTrust is a big player in California, and California has run into issues in the past as far as workers compensation is concerned. It's one to keep a close eye on, but as of right now we're comfortable with our position.

JEFF FISCHER:

What I like about AmTrust, too, is they've telegraphed over the last couple of years that the workers comp business is slowing down. It's getting more competitive, right now. It does cycle, and because of that (and because it's part of their company ethos) they have been searching for other growth opportunities elsewhere.

As with any insurance company or any financial stock, you have to believe in management and you have to watch how they run the business over many years, which we have done with AmTrust. So long term I still believe in it. It's still a small company. I think there's plenty of long-term potential ahead of it, so we're keeping it, right now, as our second-largest position.

J.P. BENNETT:

You first started following it as soon as it IPO'd, right?

JEFF FISCHER:

Yup. It was 2005 or 2006.

J.P. BENNETT:

Another company-specific question. *What keeps Apple from being valued at its true worth?* Well, it's pretty hard to tell what the market is thinking at times. The market isn't always efficient. Like Jeff said, there seems to be a bit of a cycle that goes on in terms of thinking the company is going to do great and continue to grow. Then it's like, "Oh, boy. This phone isn't all that we thought it was going to be, so this company is going to be liquidated within two years." Then they see something they like again, and so the stock starts to ebb back up.

At the current valuation, I feel pretty comfortable with it. I think there's an attractive risk-reward ratio for the company because I do believe it is more than just a going concern. I think it's going to continue to do well. I think the market definitely underappreciates the staying power and really what the company's trying to achieve.

Yes, the hardware industry has been littered with companies that were kings and then two years later something came out, completely dethroned them, and they could never recover. But Apple is definitely trying to do something a little bit different in terms of their services businesses — keeping people hooked into their hardware — and almost using their hardware as a platform to develop other businesses and keep people interested in their products over time. I can't tell you exactly why the market doesn't seem to like Apple, right now, but I know that we still do.

JEFF FISCHER:

And now as we wrap up earnings, we're going to talk about all of our positions, what we see ahead for the next year or so, and probably reconfigure many of our Buy Firsts and Buy Stocks. Apple's one that may move to Buy First. We shall see.

I can jump on a couple of questions. Several PRO Fools asked about our shorts, namely the FAZ and SRS shorts, which are small. Combined, they're 0.7% of the portfolio. Then the [Euro 00:26:37] which is 2%. So that's 2.7% of the portfolio as a whole. Members asked: *What is the plan? Why do we still short these? Is it worth it after fees?* Yes, if you short in Interactive Brokers, there are fees. If you short at TD Ameritrade, there are no fees, which is really nice.

But we, of course, want to make sure that these positions are making money after fees, as we pay the fees. We're at Interactive Brokers. SRS is down 11% the past year, and it's down 39% the past two years. FAZ — even with the recent market hit to financials — is down 7% the past year and 39% the past two years. The [Euro 00:27:19] short is down 21% the past two years. It's up a bit the past year and that one's cheap to short.

The first two are more expensive to short, and they're returning much more than the fee, if the fee is 4-6% a year and they've returned almost 20% annualized the past two years. So we're making money on them, and they're small enough (but not so small) that they're still worth keeping in our opinion. As long as we believe they can fall more than the fees, then we'll stay short.

One concern I have is that they're so difficult to short now that yes, new members are not getting into them, and if the market really runs against us, we may get called out at the worst time. We didn't see that happen in January, so that's reassuring, but that's on the front of our minds when we look at these shorts.

I would say in the life of these shorts we're much closer to closing them and moving on to something else than we are to keeping them twice as long as we already have. We've had them two to three years, already, so we're getting toward the tail end of these, I would think, although you never know. If they get easier to short, we might short more FAZ.

BILLY KIPERSZTOK:

Jeff, a quick question for you. Are there alternative trades that people can do utilizing options for those shorts?

JEFF FISCHER:

There is. There have been in the past on FAZ. There are LEAPS, so I know many members have a synthetic short set up on FAZ, and that's fine. You can keep that going. We could consider that next time, too. Even though the cost of shorting is factored into the options, still, that's one way to approach it. And SRS really has no options worth trading. That little ETF is almost small enough to be delisted, practically. A good question, Billy.

These shorts worked out so well that we'll continue to look at ETFs that are leveraged, because that creates the chance for compounding disintegration of their value. That's what we've seen here. Even with the market down, where you think these inverse shorts should be up (like FAZ), it isn't, because the compounding works against it. That's part of the reason why we've kept the shorts as we have so far. J.P., do you have another question?

J.P. BENNETT:

Max asks: *What's the best risky investment for a five-year time horizon? (And the best way to play oil?)*

That's a loaded question. I would say for starters that as most people know, we are generally not interested in dealing specifically with commodities. We don't want direct exposure. We don't want to try and find the drillers and things like that. So right off the bat I would say you can toss that back-end part of the question out of the way, because we're not looking at those types of companies.

The first part of the question — the best risky investment for a five-year time horizon — there's two thoughts I have for that. The first is that approach, to me, seems more suited for *Rule Breakers*. I think in investing it is very important that you know what you do well and what you're good at, and what you don't do well and you're not good at.

Our approach is not the *Rule Breakers* approach. We don't adopt that venture capitalist philosophy, where you're going to find some companies. Some of they may go bust, but some of them are going to turn out amazing and that's how you're going to make your money. That's really not what we do in PRO. I think we need to be true to ourselves and not try and stretch ourselves to adopt that mentality.

The second one just gets to a little bit of a rub I have with traditional finance theories where the general notion is you need to take more risk to make more money — that the only way is if you increase your risk, the potential return increases, as well. I don't think that's necessarily the best way to look at it, especially for what we're doing (we're not specifically finding a company that's a risky bet, but we're going to make a lot of money, here, so let's put our chips on the table).

Yes, we look at risk. We analyze the businesses. We consider the downside, but we don't specifically say that our portfolio needs more risk, so let's go find a risky company and hope that it works out for us.

JEFF FISCHER:

We've got Skyworks, which is nicely volatile. And Gilead Sciences is surprisingly volatile and concentrated on one drug, right now. But that's a good point, J.P.

I can jump on sort of a related question. Steve says: *Alphabet or Google is recommended by many other Motley Fool services, yet not in PRO or Options. I want to buy it, but with the down market I have no cash. Would a syn long be the best method to hold a position, and why haven't PRO or Options made the recommendation?*

A syn long mirrors stock ownership. If you don't have any cash, though, you're taking a risk. You're basically buying the stock on margin or future margin, at the very least. You're using leverage — you're leveraging your equity — so be careful before you do that. But a syn long is one way to have stock exposure without putting cash out on day one.

Why haven't we recommended it? It's funny. We've been talking about Google or Alphabet for quite a while — several months, now. We all generally like it, but we do feel like we have the better company in the space, right now, which is Facebook, which is taking more mobile ad dollars and growing much more quickly. And I think it really has more traction with its user base, too, as far as engagement (time spent on the site) and the data that they're collecting from those users. As great as Google is at collecting data, Facebook is, I think, even a step above them.

Facebook is our largest position, and it makes almost all of its money from online advertising, just like Google, so they're similar in that way. We have considered Alphabet, and we may add it to the portfolio at some point if we're really compelled to. What has stopped us, so far, is the valuation. Since it went above $700, the valuation is not that compelling for us in this environment right now.

Someone asked if we could walk through the exposure calculations on the Recommendations page on the website. Rather than try to do that right now vocally, I would say go the Recommendations page and under the exposure table there's a little link that says what these terms mean. Click that link and it will define each term for you. Hopefully that will help. Then we can circle back to that question. It's time for a memo that explains those, again, to members who have joined since November or so.

J.P. BENNETT:

And to piggyback off of that, I also saw a question that was asking about our performance versus the North Star. That information is also contained in that little part of our page, there, at the bottom. That's the best place to go to see how we've done. What is it? Annualized since inception, past three years, and then year-to-date return for the PRO and North Star. We also have the S&P 500 and the MSCI World Index.

JEFF FISCHER:

That's all on the Recommendations page.

BILLY KIPERSZTOK:

I've got a question about Papa John's.

JEFF FISCHER:

Great.

BILLY KIPERSZTOK:

Coming from sli.do. *Papa John's has been stuck in the doldrums, if not dropping lower in price. Do you see it as a candidate for writing puts?*

I don't know about writing puts on Papa John's, because for much of the stock's history, it has been a little bit overvalued relative to our fair value estimate. Right now with the recent drop in price, (which was related to not this most recent earnings, but the earnings report beforehand, where the stock dropped about 12% on the day of the release) that contributed to a decline in the stock price and then the recent market volatility contributed even more to a decline in the stock price. That brought Papa John's stock price back closer to where our fair value is.

If you look on the home page of our website, I recently posted an update of Papa John's Q4 and full year 2015 earnings, and I updated the fair value, there. If you read that report, you'll get a sense of what we think about Papa John's and what we expect from it moving forward.

The upshot, there, is that we do think Papa John's is going to be able to provide North Star-like returns over at least the next three years moving forward from this price, but it's still just a bit above our newly updated fair value estimate and I would be a little careful increasing your allocation to that position.

Now, if you don't have a full allocation to the position and you haven't matched us yet, then sure, writing puts may be a good way to increase your allocation and bring it up closer to where we are. But if you're already at a full allocation, I may not be too enthusiastic about writing puts.

JEFF FISCHER:

Just looking at it right now, it's worth pointing out that Papa John's is down 8% the past one year, while the Russell 2000 is down 12.5%. So it's been a rocky road for small-cap stocks, in general, and Papa John's has done better than the average stock. It's up this year a little bit year to date. The past five years, of course, it's up 280%.

I think the story of Papa John's, as with Domino's, as Billy writes so well in his reviews, is still one about growth, and really international growth, as well. Those are both well-run businesses with growing profits so, as Billy said, we still like the next three years.

And it's expected that stocks will take a year, or even two, and really tread water as the valuation catches up. This is exactly what you could expect to see, at some point, after a long run in the market. You never know where the market's going to finally stop expanding value multiples, but at some point it will and the stocks will take a few years to catch up and for their valuation multiples to come down as the business grows and then resume appreciating.

And that's how it looks with some of our stocks. Papa John's may be one of them. It comes with investing. Hopefully you always have some positions that perform, while others are catching up.

I have a question about the SPY hedge, again, from RickN336. He says: *Hey, guys. Really enjoy the PRO service*. Thank you. We really appreciate that.

My question is in regard to the SPY hedges you set up. Most pay a small credit. They don't create a drag on the portfolio. Why are you only hedging 10% of the portfolio instead of your whole 70% long exposure? From what I can see, things really only break down if the market trades far under our sold puts. Even in that case, we get assigned or buy new options in the market at an attractive price.

This is all true, but it's all about the downside exposure and our desire to not be too volatile and still achieve steady returns over the long term. If we were to hedge 70% of the portfolio with puts — and say SPY did fall 20-30% — our hands would be tied. There wouldn't be much else we could do at all, even if we were to buy calls in SPY instead of the stock itself. We'd feel so exposed, but that's all we could do.

So we're keeping it to a hedge amount that we're comfortable with if the market really does fall. There's a Warren Buffett saying that I like quite a bit. He's seen a lot of people blow up by risking money that they needed to make money they didn't need. We don't want to take big risks for money that we don't necessarily need and risk the money that we have and do need. We want to sensibly grow the money that we have and need.

It's a good question, though. We've hedged up to 20%, or so, through put ratio spreads and we probably will again. Lately we've just been doing 10% because we like our positions, and we have about 20% cash, as it is.

J.P. BENNETT:

I've got a question, here, from RockyTopBob.

JEFF FISCHER:

RockyTopBob in Illinois.

J.P. BENNETT:

His question is: *Since PRO and other no-new-money portfolios must sell, at times, to generate capital for especially good opportunities to buy, what methods do you use, and what can you teach members about the art of selling? Just holding a lot of cash loses to inflation in the current cash investment market. Regards, Bob.*

This is something we can't hope to answer in the limited amount of time that we have, here, so I think it's probably something we should spend a memo talking about. I know that there have been some criticisms against The Motley Fool as being a company that really doesn't teach about selling or doesn't stress selling enough. It's always been the approach of find great companies, buy those companies, and then over time the winners will outweigh the losers. But we need to be cognizant that not everyone has that luxury, especially the people that might be attracted to PRO. So just a couple of things to keep in mind.

Obviously, the first one is rebalancing. You need to know where your comfort zone is with that. We want to let our winners run, but it gets to a point where I think it's prudent capital management to consider trimming them. We all have different triggers. For me, it's around 7% or so. I think for Jeff — you said it's like 10%?

JEFF FISCHER:

It depends on the business.

J.P. BENNETT:

If you really like the business. So when it gets to 7%, I feel almost a strong need to at least bring up the conversation. That doesn't necessarily mean that we're going to trim it, but I think you need to have a point that you consider like a starting point where you at least have to consider it so you just don't let it run mindlessly forever.

BILLY KIPERSZTOK:

J.P., what was the allocation of AmTrust when we trimmed it?

J.P. BENNETT:

I feel like it was around 7%. It was bouncing up above that. It was below it. I'm pretty sure right around that was the trigger for the discussion to begin as far as writing covered calls on it are concerned.

Some of the other things to consider, obviously, are if you've got a huge winner and you sell it, there's obviously big tax implications, there, if it's held in a taxable account. You need to consider that. When you're looking at a position to sell and replace it with something else, you should also keep in mind and make sure that your conviction in that new idea is such that it will not only outperform the position that you're selling, but it will do so by a magnitude that will more than offset the taxes that you will need to pay, because there's some opportunity costs there.

And I would say the one thing to keep in mind — and you touched on it in your memo, too, Jeff — is the idea of how conviction plays into how lenient you are with how the stock trades in comparison to what you think the stock is worth. If you look at something like Starbucks, where it moves well above our fair value estimate (and you look at the business and it's firing on all cylinders and all unanimously agree that it's got a bright future if they continue to execute), then we're going to be a little bit more lenient.

We don't want to risk potentially selling and paying taxes for those who hold it in a taxable account and then sitting on the sidelines and praying that it gets hit so we can get back in it before it runs up again. So we're going to be a little bit more lenient, there. Where if you take something more like The Buckle or Tupperware, even if it's trading below our estimate, and we look at the business and the conviction isn't there anymore, it might be time to consider replacing it with something else.

JEFF FISCHER:

That's true and well said. Unless you're like an opportunistic trader (or trying to be) — someone who's active (and I would say maybe overly active at trading) — you're going to find that over the years you sell less, especially outright of an entire position. PRO will probably sell less frequently over the years than it has, so far, because hopefully you get better at what you do. You buy better.

J.P. BENNETT:

Hopefully.

JEFF FISCHER:

If you buy smart, you rarely need to sell is the hope. But it's a great question. We've done a fair amount of selling and I think it's instructive to see that we sell The Buckle for these reasons, or Tupperware for these reasons. We sold the Vanguard Energy Fund several years ago for various reasons that we should revisit — one of which was we don't know where commodity prices are going next. Oil was I think around $80-90 a barrel back then. There are certain positions that are more readily smart to sell, but we're trying to buy positions that will compound over many years.

J.P. BENNETT:

I'm not sure what The Buckle is trading for, right now, but I've paid attention to some of the same-store comps since we've sold it and they've been really ugly, down into high-single digits/double digits. And that's the type of business where even if you have a loss, don't just get in the mindset where you're going to wait until it gets back to even and sell it. If you really have lost conviction in it, put that money elsewhere (at least that's my opinion) and try and harvest those losses to offset some of your gains going forward.

JEFF FISCHER:

I'll answer a few more questions that are on sli.do, because I love that members have embraced sli.do. This is our first chat that uses sli.do, as well. It's kind of fun because if you're watching a tape of this, or not in sli.do right now, you can go in there, ask any question you want and then other people on the site can thumb up your question. Then the most popular questions rise to the top — and that's what we'll jump on first. Bob asks: *How do we find out about Fool events that PRO and Options members can attend?*

The answer is you should hear about that from The Motley Fool. They should email all members ahead of time telling you when this event is, where it is, and how you can get there. The next one that I know about is the annual FoolFest and that's in mid-May. I don't want to give the wrong dates.

J.P. BENNETT:

Don't look at me. I don't know.

JEFF FISCHER:

May 19 and 20?

BILLY KIPERSZTOK:

May 19 and 20.

J.P. BENNETT:

Thank you, Billy, for saving us.

JEFF FISCHER:

Here in Alexandria, Virginia. You should be getting a notice about that soon from The Motley Fool.

The next question. Larry asks: *Do you think Ford is a good stock for a dividend player?* Larry, I would say yes. Ford yields more than 4% and I think the dividend is safe. I think the business is on stable footing. I don't know that you'll see that much appreciation with it for long periods of time. At points you will see some appreciation. But yes, I think it's a good dividend stock most likely. It's difficult to use options on it, although we have tried, because the options don't pay that much.

You hear all this talk, right now, about peak sales of autos and I think that's kind of silly. I don't think cars are anywhere near peak sales. They might be near a short-term peak, but five years from now I'd be shocked if auto sales were not much higher than they are right now.

BILLY KIPERSZTOK:

I'll go ahead and jump on another question that was sent in earlier from [M. Stick 00:47:27]. *Do you think that the U.S. will see negative interest rates (as is occurring in Japan and Europe), the possibility of Canada adopting negative rates in the next couple of years, and what of deflation becoming an issue for the U.S. economy as it is for Europe?* I decided to pick up this question because I am the PRO macro guy, as J.C. likes to call me.

As far as the U.S. seeing negative interest rates anytime soon, I highly doubt that. I think U.S. policy is trending toward increased rates, the reason being (which ties into the end of your question) because core inflation, which is inflation excluding food and energy, is actually rising and is getting closer to the Fed's target of 2% inflation.

There's common rhetoric around deflation concerns, and whatnot, but a lot of that is related to the decline in the price of energy, which has a disproportionate impact on the inflation number as it's recorded without any adjustments. But when you look at what we call "core inflation," which is obviously the more [fundamental] item, it is actually going up.

In the United States, I think the trend is more towards slight inflation, and with that happening, I don't think that the United States is going to change course, change its policy, and go towards negative interest rates. I think we're more likely to see interest rate increases slowly in the future (the pace of which is to be determined). Anytime you try to speculate what's going to happen with the Federal Reserve and central bankers, you find out that you're going to be wrong more often than not. So it's one of those things where you may have an idea as to what you think might happen, but let it unfold and then you go from there.

As far as Canada adopting negative rates, I really have no idea. I don't follow Canada as much as I follow the United States or other global markets, so I don't have much to add there.

J.P. BENNETT:

Get Gillies on the phone.

BILLY KIPERSZTOK:

Yeah, that's a good point. Let's get Jim in here.

JEFF FISCHER:

Thank you, Billy. I can fly through a couple of more questions in the time we have left. One from BBDOC. You guys get any ready, too, and we might actually get most of these, at least in one form or another. We're not reading all the questions out, but we've grouped together ones that are similar.

BBDOC says: *You make many recs and the net debit or credit many times is not near the price that you first recommended. I'd like more of a plus or minus range I can work with and then at least a follow-up a few days after your rec.*

I think you're thinking mainly of *Motley Fool Options* lately, but also some positions in PRO. We almost always give an initial limit order guidance. That's updated at the last moment that we possibly can before we send the trade, which is usually about an hour before the trade goes out given the time it takes to publish. Then alongside that we give a minimum. We do give a range, in most cases, of first try to get this and, if not, then try to aim for this, so there's usually some flexible guidance in there. And we know the prices will change, so we usually work that into the trade, too.

Then every Friday in *Motley Fool Options*, there's Trades You Can Make, which provides updated price guidance, especially on new trades. So every Friday that's there. And then every Monday in *Motley Fool PRO* there's Catch-Up Trades, which will also update price guidance on recent recommendations.

So we are trying to cover all these bases and maybe you just weren't aware of where that was happening. That's happening in those Catch-Up Trades and Trades You Can Make, but also in the alerts, themselves, there's price flexibility.

From Bruce: *I have a mental block. I cannot tell if I'm making money on my calls. If I sell a put and it expires, I'm in the money?* Yeah, you made money, but the put is out of the money. *If my calls show up negative on my TD Ameritrade am I losing money?*

Whenever you sell a call or a put, it shows up as a negative in your account, and if it goes to zero, or some amount smaller than the amount that it initially started at, then you're making money. One way to maybe understand this better is to look at your gain-loss ledger in your TD Ameritrade account at your past trades, and that will show you how those gains and losses add up.

One more, and then Billy, I'll give it to you. We still have four minutes, so we're doing okay. A member asks: *In the last interview, one of the speakers said that the stocks chosen for a put-sell strategy aren't stocks that should be in a portfolio. Why recommend such a strategy using such a stock?*

They're talking about Nile, which is a *Motley Fool Options* position. I want to address this one, because it's incorrect. Anytime we do recommend selling a put option, we would be happy to take the stock in the portfolio, and I know that's the case with Jim, as well, and with Blue Nile, which he has taken shares of in *Motley Fool Options*. So it remains true. Anytime we recommend selling put options on a stock, even if it is for income, you still need to be ready to buy the stock and own it for the longer term.

BILLY KIPERSZTOK:

I'll add, also, that with Nile, I think a lot of Jim's thesis, there, was that the stock has a tendency to just trade flat. The company is using all its free cash flow to buy back shares, so there's somewhat of a floor underneath the stock price and the volatility premiums are good on that stock, so Jim likes to write puts.

And remember. When you're writing puts, it's actually a neutral strategy. It doesn't necessarily imply that the stock has to go up. So if the stock treads water, which is what his thesis is for Nile, then writing puts is actually a good strategy.

JEFF FISCHER:

Good point, Billy. J.P., do you have any others?

J.P. BENNETT:

Here's a question on silver. From RSS: *Do we buy a miner/producer, a large consumer of silver that will have increased profits from low prices and raw coin?* That gets back to what we said previously about our natural aversion to commodity-based companies, so I can say that we're not actively looking at miners or producers right now.

It looks like he's got another question here. I think he's talking about Flint, Michigan and the water scare and he's asking: *Do we consider buying companies that produce bottled water, filtration systems, chemicals, etc.? Many think Michigan is just the beginning.*

It's something we've considered in the past — just looking in that space — because obviously water is something that a lot of people need and it's really not available in a consumable form in many places in the world. One of the first companies I looked at when I joined PRO was A.O. Smith. We obviously never ended up going with it and we should have because it was in the mid-$40s and now it's in the $70s.

It's an interesting space that we may revisit at some point, but my ultimate conclusion, after looking at some of those companies, is that it's hard to find a PRO-type company in that space. There were some things that I really liked about A.O. Smith, but there were also some things that gave me some pause.

What I will say to this question, though, is we're not going to overreact to a scare or something like that. I know when we had the Ebola scare, some companies went on a monster tear because it was like, "Oh, my gosh. This is the new reality." Then the new reality wasn't the new reality and the stocks got slashed back down to earth. Obviously it's really unfortunate what happened there, but we're not going to overreact to that and make a really big decision that materially impacts our portfolio just based on one event like that.

BILLY KIPERSZTOK:

I'm going to add something, there. The company that J.P. is referring to with the Ebola crisis is Lakeland Industries. Go ahead and look up their stock chart. They had a huge size increase in September of 2015 due to the Ebola crisis and now the stock has hit the floor. Just an example.

JEFF FISCHER:

It's a good one and I like the perspective of thinking long term despite even short-term concerns like that or shocks to the system. It reminds me a little of the '70s or '80s, where there were all these cries that there were going to be giant food shortages for the whole world, and then, of course, oil was going to run out. Of course, those things didn't prove true. Now there are a lot of concerns — and I think they're legitimate — that water will become a scarce and fought-over commodity. It's possible, but is it probable? I don't know yet. It's too early to say.

What we have to do is analyze companies. We have looked at the water space and continue to go back to it periodically, as J.P. said, and find a really strong company. And I think it's so early in the world of monetizing water — Pepsi and Coca-Cola aside — that it's early to say. But this country also has a giant infrastructure problem, and needs to update its water systems severely, so that's a place we've been looking at, too. That's such a giant project, though. It touches so many different companies.

J.P. BENNETT:

Plus a lot of the direct exposure to water, here in the U.S., are regulated entities, so they're not going to be huge home-run-type hits because the returns that they can earn are capped by the government.

JEFF FISCHER:

One more question in sli.do and then we'll wrap up. Someone asked: *Given that PRO has been a portfolio for years, do you think that the current allocations are valid for a new PRO member, given the past gains in the positions?*

The answer is yes. Every day we look at the portfolio and make sure that we're comfortable and happy with the allocations we have, because we know that's our reality. That's what we own today and that's what new members are going to buy, as well.

So in a way, as Billy likes to say (and J.P. has said it, too), every day you're either choosing to buy a stock or not at your current allocation. If you don't take an action on it, you're choosing that current allocation again right now.

And that's what we're doing. We're happy with Facebook as our largest position. And O'Reilly is up there. And AmTrust. So yes, we like our allocations and we do think about them regularly. Thinking about adding to positions or trimming, but the allocations that you see, right now, are comfortable to us.

And with that, we're past our time, but I think we answered most questions. When you get a chance, let us know on the boards how you like this format. We appreciate you being here and sending in your questions ahead of time. Sending in questions on sli.do, as well. We appreciate that, as it helps us a lot. Sli.do was fun to try, too.

We'll be back next month with another format — maybe this one or maybe we can improve upon this one. Meanwhile, we'll see you on the boards, in new trade alerts, and in our weekly column, of course.

Thank you, Billy, for being here.

BILLY KIPERSZTOK:

Thank you, Jeff.

JEFF FISCHER:

Thank you everyone behind the scenes. Thank you, Ellen. Thank you, J.P., and thank you, most of all, to members who make this possible. Thank you, Fools. Have a great afternoon and thanks for joining us.

J.P. BENNETT:

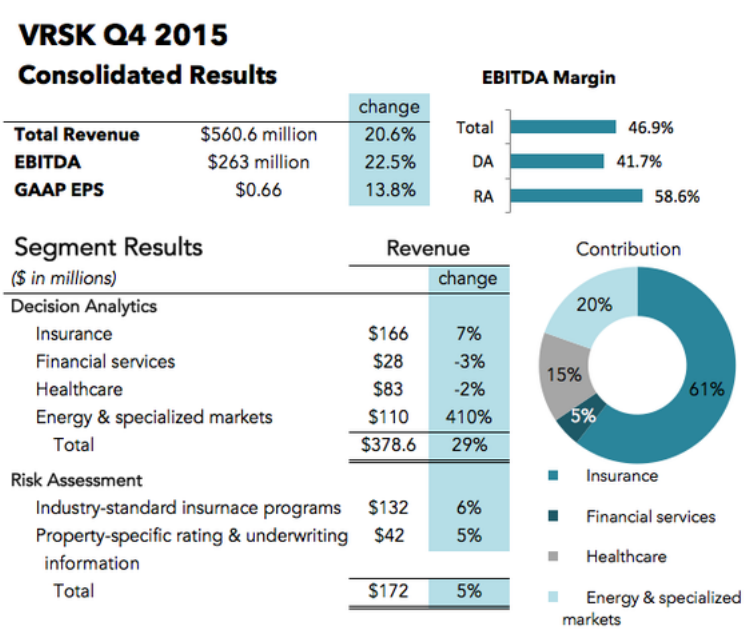
See you next time.

[End]

Verisk's Numbers Look Solid

Published Mar 1, 2016 at 11:28AM

Fourth-quarter results at our data-analysis expert, **Verisk Analytics** (NASDAQ: VRSK), weren't all that different from what we saw in the third quarter, but the market's subsequent reaction most certainly was. The stock took a meaningful haircut after last quarter's earnings call disappointed investors, but things went a lot smoother this time around. The stock price reacted positively to results that were respectable given what's currently taking place in the energy and health-care spaces.



Updated Guidance and Valuation

- **Updated guidance**: Buy (no change)
- **Recommended allocation**: 2.1%
- **Fair-value estimate**: $80 (no change)

Current Multiples

StartFragment EndFragment

Multiple	Trailing	Forward

EV/EBITDA	16.2x	13.9x
P/E	24x	22x
P/FCF	27x	23x

Source: S&P Global Market Intelligence, analyst calculations

Health Care

Verisk continues to find itself in a sticky situation with its health-care division. On the one hand, management has acknowledged that changes in the industry landscape since it first entered have made health care less attractive. Verisk loves proprietary data and processes, but as CEO Scott Stephenson noted during the earnings call:

> ... when you look at the vast majority of the data that we've got inside of the insurance vertical; the financial services, retail banking vertical; and the oil and gas, metals and mining vertical, a lot of what we've got is very, very unique. The nature of regulation and industry structure in the healthcare world in the United States makes it relatively harder to have distinct data assets ... So it's not that we don't have data. We actually have a lot of data, but we very much want Verisk to be a highly distinctive, very differentiated partner to our customers.

This means Verisk likely won't hesitate to sell the business if the price is right. But everybody now knows this, and that fact in and of itself makes it harder for Verisk to extract a favorable price.

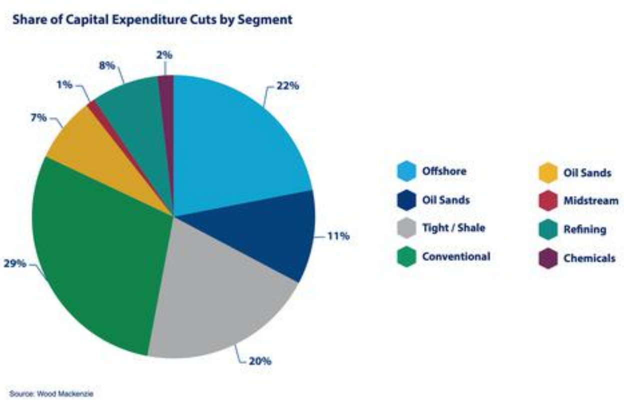
On the other hand, just because management is contemplating whether to sell the business doesn't mean it's in terminal decline. After removing the temporary impact of accounting changes, health-care revenue increased by 6.2% this year; management expects faster growth and improved margins in 2016 as the commercial side of the business starts to ramp up, offsetting some of the seasonality of the Medicare Advantage business.

So what do we think Verisk should do? Our hope is that management remains disciplined, because the appropriate course of action all depends on what offers they get for Verisk Health. As of right now, a dollar invested into the health-care division likely generates a lower return than a dollar invested in say, the insurance section of the decision analytics business. So if someone offers Verisk a fair price for this business, it makes sense to sell it and reinvest those proceeds into areas that will generate higher returns. But that's only if the company is offered a fair price.

This brings us the question of what, exactly, a fair price would be. I could just throw out some random revenue or EBITDA multiple, but given the lack of granularity surrounding the business, my honest answer is that I'm not exactly sure right now. I would, however, expect the multiple to be less than what Verisk as a whole is trading for, given that the prospects for its other segments currently appear brighter. It's also worth noting that the recent market turbulence likely didn't do management any favors as they explored selling the business. Regardless, this is something we continue to monitor closely, and management should have more to say next quarter.

Energy

The rest of 2016 will likely be more telling with respect to how 2015 acquisition Wood Mackenzie and the rest of Verisk's energy division will hold up during the contraction and (hopefully) trough of an energy cycle. But it's hard not to be pleased with what we've seen thus far. Organic growth for the quarter and full year was 4.3% and 5.1%, respectively, with WoodMac up 5% for the year (in British pounds) despite a slight 1% decline this quarter. Verisk also reported that the annual contract value of signings was up in 2015, impressive considering that the oil and gas industry was simultaneously slashing capital spending by $145 billion across all parts of the industry and deferring more than $200 billion worth of future projects.



With the current price of oil, another round of sizable reductions in industry capex seems like a foregone conclusion for 2016. This means that Verisk's new growth initiatives for WoodMac will likely be the primary reason the company meets management's 2016 forecast of positive growth (if it's able to do so). WoodMac recently entered into a commercial alliance with Thomson Reuters to give its Eikon platform subscribers access to some of WoodMac's data. Now, this deal in and of itself doesn't really move the needle, but it is one of the first big signs that Verisk has begun delivering on its strategy to increase the number of WoodMac clients, which is one of management's biggest priorities right now.

During the Q&A session, management all but confirmed my prior suspicion that WoodMac is offering some pricing concessions in order to retain customers. At first this might sound like a bad sign, but I actually think *slight* pricing concessions are a smart business decision. The company could conceivably hold the line or even slightly raise prices without much near-term customer attrition, thanks to the contractual nature of its offerings. But in managing the business for the long term, it makes sense for WoodMac to try to work with its customers in order to strengthen those relationships, which could position the company to win a disproportionate amount of any increases in capex once the energy industry begins to turn. This is why we think it's a great sign to hear Verisk reporting that through the first six weeks of 2016, it continues to see strong year-over-year growth in research subscription clients and data portal usage.

Financial Services

The inherent lumpiness in the Argus (financial services) division, the result of the relatively young age of the business, was the culprit behind the 2.6% decline in revenue this quarter. We'll likely see below-average growth and margins in the first quarter as well as we lap additional one-off projects that had above-average margins, but this is very much still a secular growth story. Argus posted 20.5% growth for the full year in 2015, and we expect to see similarly strong full-year growth in 2016 as well.

Insurance

Verisk's insurance business was similarly uneventful (in a good way). The risk assessment division continues to deliver revenue growth in the mid-single digits with extremely strong margins, while the decision analytics insurance business is growing faster but with lower margins. Given the pricing power of Verisk's insurance offerings and the fact that the company is constantly developing new solutions (often by finding ways to repurpose existing data), we expect to see similar results going forward.

The *Pro* Bottom Line

After seven months in this position, we're currently hovering around breakeven. This may be lagging the North Star, but we're content with this performance given that the S&P 500 is down 8% since we first recommended buying shares and down 6% since our followup recommendation. Meeting our absolute-return objective definitely becomes much more difficult when the overall market stops cooperating, but we still have confidence that Verisk will be able to help our portfolio do exactly that going forward. That said, we're opting to keep our fair-value estimate unchanged until we receive additional color next quarter on the likely outcome for Verisk Health.

Pro Catch-Up Trades: Bonus Leap Day Edition, Feb. 29, 2016

Published Feb 29, 2016 at 3:30PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **American Tower** (NYSE: AMT), buy up to 3.5% in stock
- **Gentex** (NASDAQ: GNTX), buy up to 2.7% in stock
- **Gilead Sciences** (NASDAQ: GILD), buy up to 3.3% in stock

Continue building your portfolio with our Buys, including these highlighted today:

- **AmTrust Financial** (NASDAQ: AFSI), buy at least half of our 5.3% stake to start
- **Apple** (NASDAQ: AAPL), buy up to 3.7% in stock
- **Parexel** (NASDAQ: PRXL), buy up to 3.2% in stock
- **Visa** (NYSE: V), buy up to 2.5% in stock

Our most recent hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): If you haven't set up the new put ratio spread yet, the index is much higher now. Lately, you can set up the April 15, 2016, hedge by buying to open $190 puts and selling to open two $182 puts for a credit. The spread is smaller than the $12 one we initially recommended, but with the market going up, lower-strike puts don't pay as well; we need to move our strikes higher and decrease our spread. *Pro* will set up its new hedge using **these modified strikes** as soon as this week -- unless prices change again, in which case we'll adjust accordingly. If you're already in the April SPY hedge position, you can stick with it (let it be), or close it for a small gain now and set up this new one, at these higher strikes, instead.

And our most recent short:

- **Deere & Company** (NYSE: DE), as a hedge against the market and our investment in **Valmont** (NYSE: VMI): Short 2% of DE per our recent recommendation

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Gilead Sciences, Cash-Flow Machine

Published Feb 29, 2016 at 1:08PM

Gilead Sciences (NASDAQ: GILD) achieved a record 2015 with revenue up 31%, to $32.6 billion, and income of $11.91 per share, up from $7.35 the year prior. Non-GAAP diluted earnings per share (EPS) were up 56% to $12.61. After two years of strong growth, the company is guiding for slightly lower results in 2016.

Up 54% year-over-year, Gilead's Hepatitis C (HCV) drugs accounted for 58.5% of sales last year ($19.1 billion), while everything else achieved $13 billion in revenue (up 8%). As the early surge in HCV sales tapers off, the company needs to find new growth avenues. However, much like Apple, Gilead could still create North Star-topping value based on the stable free cash flow it uses to buy back shares, increase the dividend, and ideally acquire other companies (or drugs). Still, the challenge of continuing to expand after such strong growth is large. Hence, the stock trades inexpensively.

Status:	**Buy First**
Fair-Value Est. (no change):	$120
Recent Price:	$88
Current Allocation:	3.3%
Dividend Yield:	2%

Key Thoughts

- More than 770,000 people have been treated with Gilead's HCV drugs since their launch, and in November the FDA approved Harvoni for expanded use in patients with genotype 4, 5, and 6 chronic HCV.
- Gilead is maintaining dominant market share in Hep C treatment, with more than a 90% share of 2015's 250,000 patients. Its drug is safer and more effective than competing medication, and providers are increasingly considering that as they prescribe for patients.
- Even with nearly 400,000 Americans treated so far, more than 3 million people in the U.S. are estimated to be infected with HCV, only about half of whom have been diagnosed.
- Gilead is "confident in the long-term sustainability of HCV markets worldwide." This year, shorter durations of treatment, price volume deals in Europe, and payer contracts in the U.S. may keep revenue flat even as more patients are treated.
- An estimated 360,000 U.S. patients are being diagnosed with HCV and coming into treatment each year, and treatment levels are lower than that at around 250,000.
- As noted, the most recent data suggests about 1.5 million HCV patients diagnosed in the U.S.; that's compared with 1.6 million when Sovaldi was launched in 2013. So, despite Gilead's having treated nearly 400,000 Americans, the number of patients out there is nearly flat: Meaning, there are nearly as many newly-diagnosed patients as ones who've been through treatment, so the pool of patients remains large.
- Gilead has 70% to 80% market share in HCV in Europe. Management anticipates patient growth in 2016, but lower revenue per patient because of pricing deals and shorter treatment periods. The company is doing what's right for the patient while still being paid fairly.

- Gilead's HIV sales reached $3 billion last quarter, up 5% year-over-year, with two-thirds of that in the United States. Seven of 10 U.S. HIV patients use Gilead treatments, but that has been whittled down a little by competition.

The Numbers

Market Cap	$118.5B
Cash	$14.6B
LT Investments	$11.6B
LT Debt	$21.2B
EV/EBITDA	5.5
P/FCF	8.2
P/E	7.4
P/E NTM Est.	7.2
TTM OCF	$20.3B
TTM Cap Ex	$747M
TTM FCF	$19.5B

Summary

Gilead's shares look inexpensive trading at just more than 7 times earnings -- even if earnings are only flat over the coming few years. The challenge for Gilead is in finding new growth avenues, because HCV pricing will likely continue to drift lower in 2017 and beyond, even if the patient base remains stable in numbers. Its pipeline is healthy -- including 30 clinical studies in oncology, with 10 in phase III, and the deepest number of candidates ever in its total pipeline -- but even so, acquisitions are likely key to meaningful future growth. Gilead has a history of making smart acquisitions.

This year, management projects $30 billion to $31 billion in revenue, down a bit from last year. Management has authorized, or is in the process of authorizing, $20 billion total in share buybacks (16.8% of the current market value). The company is increasing the dividend by 9.3% this year.

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What We Think Now: *Gilead Sciences has seen surging free cash flow thanks to its market-leading Hepatitis C treatments, which accounted for nearly 60% of 2015 revenue. As sales growth tapers, the stock is cheap, and we believe management can find future growth opportunities through acquisitions. Meanwhile, Gilead has a large pipeline of drug candidates targeting deadly diseases including oncology, but for the coming few years, it's our belief in a stable Hepatitis C market and good use of its growing capital that makes the stock worth owning in Pro.*

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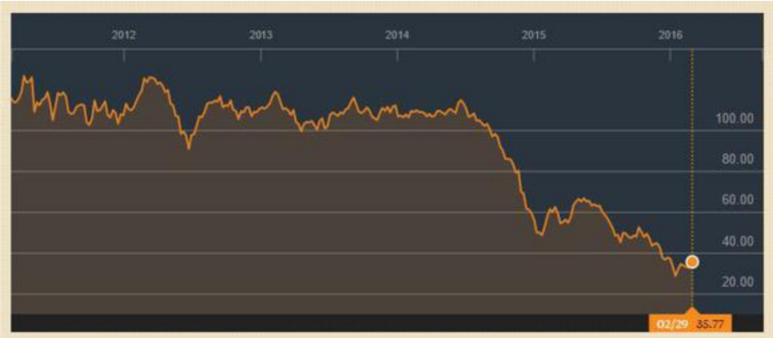
- Gilead's investor relations
- The earnings release page
- *Motley Fool Pro's* Gilead discussion board. As your questions!

Is the U.S. Headed for an Economic Recession?

Published Feb 29, 2016 at 12:44PM

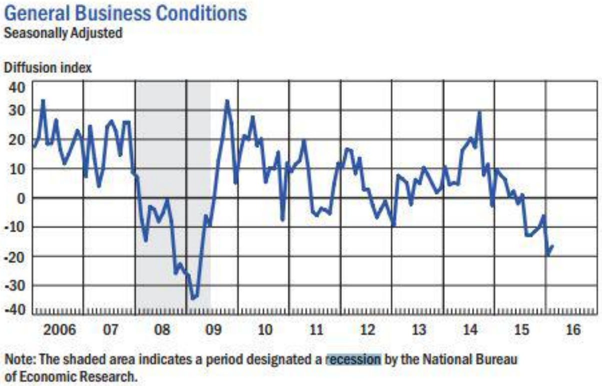
Dear *Pro* Fools,

It's no secret that the stock market has suffered in 2016; its first 10 trading days were the worst of any year. Crude prices continue to hover near their lows, with oil currently at $35.77 per barrel, down nearly 70% from 2014 highs:



Source: Bloomberg

The U.S. manufacturing sector isn't doing well, with the New York Fed's Empire State Manufacturing Survey index in negative territory. The January figure is as low as the index has been since the 2007-2009 recession:



Source: Federal Reserve Bank of New York

All of this negative sentiment has led to a growing concern among investors and financial media that a U.S. recession may be on the horizon. However, after looking at some important data points, it's my opinion that the likelihood of a near-term U.S. economic recession is low. In this Memo, I'll present three data series that support my view.

1. Job Growth Is Solid

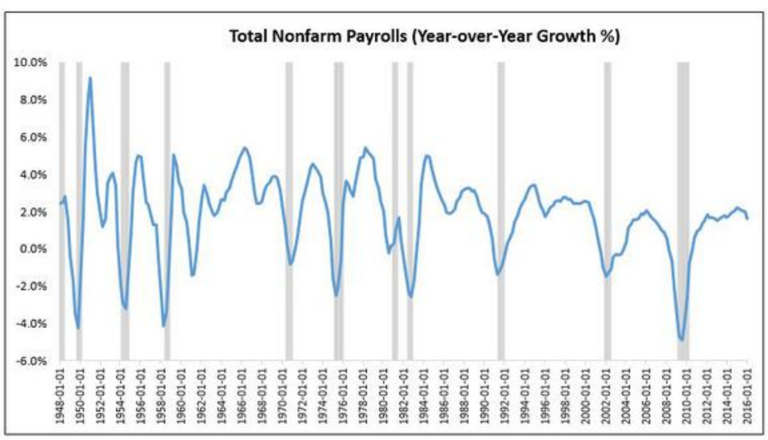
Higher unemployment rates are one of the most widely recognized indicators of a recession. For example, in December 2007, the national unemployment rate was 5%, and it had been at or below that rate for the previous 30 months. At the end of the recession, in June 2009, it was 9.5%.

As of the most recent reading, the U.S. unemployment rate is 4.9%, the lowest it's been since the end of the recession:

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2006	4.7	4.8	4.7	4.7	4.6	4.6	4.7	4.7	4.5	4.4	4.5	4.4
2007	4.6	4.5	4.4	4.5	4.4	4.6	4.7	4.6	4.7	4.7	4.7	5.0
2008	5.0	4.9	5.1	5.0	5.4	5.6	5.8	6.1	6.1	6.5	6.8	7.3
2009	7.8	8.3	8.7	9.0	9.4	9.5	9.5	9.6	9.8	10.0	9.9	9.9
2010	9.8	9.8	9.9	9.9	9.6	9.4	9.4	9.5	9.5	9.4	9.8	9.3
2011	9.1	9.0	9.0	9.1	9.0	9.1	9.0	9.0	9.0	8.8	8.6	8.5
2012	8.3	8.3	8.2	8.2	8.2	8.2	8.2	8.1	7.8	7.8	7.7	7.9
2013	8.0	7.7	7.5	7.6	7.5	7.5	7.3	7.3	7.3	7.2	6.9	6.7
2014	6.6	6.7	6.7	6.2	6.2	6.1	6.2	6.2	6.0	5.7	5.8	5.6
2015	5.7	5.5	5.5	5.4	5.5	5.3	5.3	5.1	5.1	5.0	5.0	5.0
2016	4.9											

Source: Bureau of Labor Statistics

Not only is the unemployment rate low, but job growth continues to be strong, averaging about 1% to 2% growth year-over-year since 2011:



Source: Bureau of Labor Statistics

As seen by the shading in the graph, recessions are strongly correlated with declining job growth. You'll note that the January job-growth reading shows a slight decline, perhaps a reason for concern. But January's jobs report is often noisy, with the largest seasonal adjustment factor of all months, and this month's report included some one-off categories that are not indicative of economic problems (including a significant decline in jobs in the private-education market). All in all, job growth continues to look strong, and we've never seen a recession when the job market is growing at a healthy rate.

2. Wage Growth Is Accelerating

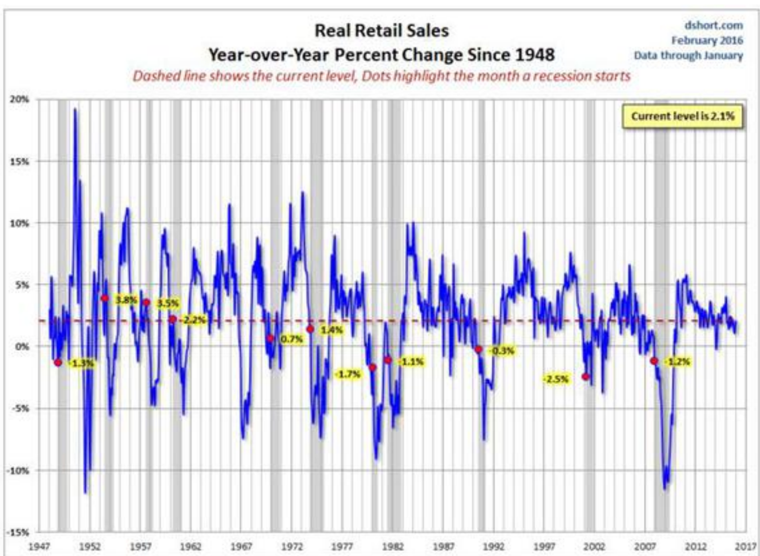
Decelerating or falling wages are another strong indicator of a recession. (Note that this graph shows *nominal* wages, not adjusted for inflation.)

Source: Federal Reserve Bank of Atlanta

Again by looking at the shaded areas, we can see that wage growth often declines in a recession. However, lately wage growth has been accelerating, at a three-month moving average of about 3.1% in December. In 2015, inflation was between -0.20% and 0.73%; as of January 2016, it was 1.37%, , making this real wage growth all the more encouraging.

3. Retail Sales Have Picked Back Up Lately

Yet another sign of a recession is slowing retail sales:



Source: advisorperspectives.com

As you can see in the graph above, retail sales have been in a downtrend for a couple of years. However, as of data compiled through Feb. 20, the year-over-year change in weekly shopping center retail sales has bounced back up to about 3%, suggesting an improvement for overall retail sales in the months ahead.

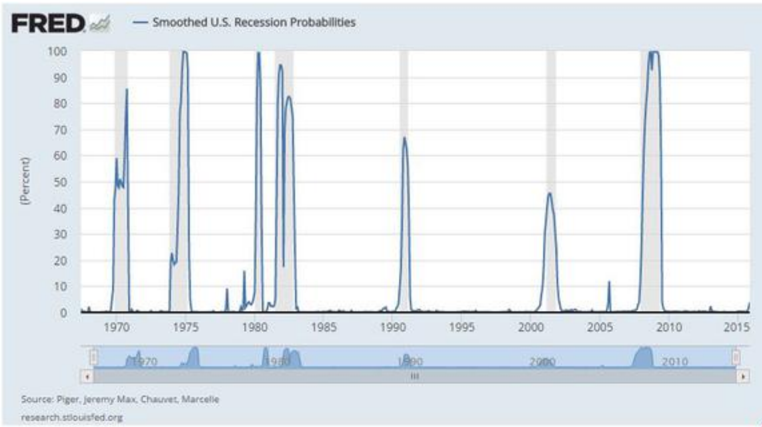
Source: Morningstar

The *Pro* Bottom Line

The turbulent market so far in 2016 has many investors worried about the likelihood of a U.S. economic recession. In this Memo, I've explained three reasons why the economy seems to be on solid footing. While the current economic situation is not high-octane, it's not bleak, either. Given low unemployment, solid job growth, growth in real wages, and an uptick in retail sales, there is reason to be optimistic about the state of the U.S. economy as we continue further into 2016.

Of course, this data is a look back at what recently happened, and although trends look healthy, what's happening now -- or about to happen -- could change that. But if there's a recession ahead, recent data doesn't suggest that it's starting to unfold yet.

I'll conclude this Memo with a final graph that uses a technical model* to show the probability of a U.S. recession, with the vertical axis scaled between 0% and 100%. The most recent reading in November showed a probability of 3.84%.



Fool on!

-- Billy (TMFBillyTheKid)

*The model utilizes a dynamic-factor markov-switching model applied to four monthly coincident variables: non-farm payroll employment, the index of industrial production, real personal income excluding transfer payments, and real manufacturing and trade sales. This model was originally developed in Chauvet, M., "An Economic Characterization of Business Cycle Dynamics with Factor Structure and Regime Switching."

A Day in the Foolish Life: Investing, the Market, and Beyond

Published Feb 26, 2016 at 8:00AM

Several hundred *Motley Fool One* members met in San Diego a few weeks ago to talk about investing, our finances, and life.

We hold these gatherings for *One* members several times a year. They're truly one of the highlights of being part of our Foolish community.

The event included talks from Tom Gardner, Jeff Fischer, Andy Cross, Google executive Suzanne Frey, longtime Fool LouAnn Lofton, myself, and many others.

We learned lessons that day that can help every Foolish investor, so I want to share with you a video of the highlights. Watch below, then keep reading for a few of my favorite takeaways from the event — and how you can watch the full event.

{% video %}

In his opening remarks, Tom listed four traits of successful investing. This one struck a chord with me:

> Now, **rule of the road No. 1 is I believe that everyone should buy 15 to 30 Motley Fool recommendations at a minimum.** I know it can be tempting to dip in and buy one or two and see if they work, or three or four, but really if you want to replicate the kinds of market-beating returns that we've gotten at The Motley Fool for more than 20 years, you need to own 15 to 30 business that we've recommended.

This is so important, because we meet members who have most of their portfolio in a handful — sometimes just one or two — stocks. Remember that we know and expect that a percentage of our picks won't work out over time. That's normal. Extreme concentration in just a few stocks increases the odds of massive disappointment if your holding ends up being an inevitable loser.

Next, *Pro* and *Options* advisor Jeff Fisher talked about setting your expectations *before* the market declines:

> The only anchoring I do — and we all anchor — I anchor to the high-water mark, whatever it was of my portfolio, and I assume it's 20% lower, because I know at some point it's going to be at least 20% lower.
>
> So if you're going to anchor, anchor in that way, and **then the volatility is part of your expectation,** or you try to internalize that it's going to happen.

Inside Value advisor Rich Griefner gave a good talk on the power of business moats — the most important trait Warren Buffett looks for. Here are his thoughts on Moody's:

> Do you guys know Moody's? They're one of the largest credit-rating organizations. They rate debt and the companies that issue that debt. Moody's did a really bad job of rating debt in the 2007-2009 time frame, and it nearly caused the destruction of the global economy.
>
> But even so, Moody's is still strong today. Still earns 30% return on capital and they still have a 40% market share. How did that happen? Why has nobody come in to compete with Moody's? The answer is to become a nationally recognized statistical ratings organization, you have to jump through all kinds of hoops. It's really hard to become qualified to compete with Moody's. **So even though they almost destroyed the entire global economy, Moody's is still earning 30% return on capital and are converting 30% of their revenue to free cash flow.** That's what it means by "30/30 club."

Finally, Google executive Suzanne Frey talked about the power apps play in our life. By saving everyone time, they have become the great equalizer:

> I'm going to talk about an unusual commodity today. Most people may not call it a commodity, but when you think about **the most precious commodity we all have... well, of course, it's time. It can't be traded. It can't be bought and sold.** Whether you're Elon Musk, you're Warren Buffett, or you're someone just trying to make ends meet, we all have exactly the same amount of time ... 24 hours a day, seven days a week. It is the grand equalizer and it's something that we take quite seriously in everything we do.

If you're interested in checking out more from these presentations and 15 sessions from the all-day event, you can now tune in with a digital pass — the first time we're making this exclusive access available to members across The Motley Fool. Simply click the button below to learn more:

Watch the Full Event

Video transcript:

Morgan Housel: The stock market's down 10% since last summer and it makes a lot of people nervous. It's so important to realize, though, the reason ... the specific reason ... that stocks do well over long periods of time is because they're risky in the short term.

Jeff Fischer: I'll add that one way that I think a lot of us measure volatility is we think of the high-water mark of our portfolio, or our assets, on the absolute best day that it ever had. It was worth this much and now it's worth this much. That's how we see volatility. But that's asking for perfection. Life isn't perfect. A relationship isn't perfect.

The market — you don't expect it to be perfect. The only anchoring I do (and we all anchor) I anchor to the high-water mark, whatever it was of my portfolio, and I assume it's 20% lower, because I know at some point it's going to be at least 20% lower. So if you're going to anchor, anchor in that way.

Tim Hanson: I think people should be focused on just being self-aware. If the recent market movements have stressed you out in a very meaningful way, odds are that you should be looking for something in your portfolio that would be diversifying ... that is to say different from what you already own.

Sara Hov: Under Armour has no qualms about selling athleisurewear, so this trend of people dressing up as if they're going to run or do yoga and they end up just sitting around all day or shopping...

Alex Scherer: Or going to Whole Foods...

Sara Hov: ... or going to Whole Foods or Starbucks...

Alex Scherer: It's my contention that Kinder Morgan is really a port in the storm and is trading at rock-bottom prices.

Rich Greifner: MercadoLibre is the eBay of Latin America. It's also the PayPal of Latin America and in some ways it's the Amazon.com of Latin America, as well.

Tim Hanson: Limit orders are an example of a tool that's been created to give you the opportunity to get really cute about some aspect of your investing — which is to say, "Hey, I'm willing to buy this at $11.99, but I am not willing to buy it at $12.00."

Robert Brokamp: The way I describe asset location is basically which eggs should go in which baskets, because some investments are more tax efficient than others. Some accounts have built-in tax benefits.

Suzanne Frey: We think about time very, very differently. We are, frankly, obsessed with it. And once you understand this, you're going to understand everything we do at Google.

Morgan Housel: If you can't outsmart other people, then the way that you get ahead is by doing something that they're not willing to do, which for investors (we repeat this a lot) is to have a longer time horizon than them. That's how you can find your edge in today's market.

LouAnn Lofton: So I go up to Buffett and I just tapped him on the shoulder and said, "Mr. Buffett, my name is LouAnn Lofton and I said you invest like a girl." And he immediately stood up and gave me a big hug and big guffaws. And that is not an act. He really is that guy that you see and that you hear about. He is that down-home. And he was telling everyone around us, "Oh, she wrote this book that says I invest like a girl."

And so, of course, I had to get a couple of pictures, which I'll share. So this is the first one. Now this is funny to me because this is something that Buffett apparently likes to do. He likes to do the photo where you act like you're stealing his wallet. He literally said to me, "I'm going to hold it and you act like you're taking it."

↑ Back to the top

Pro Catch-Up Trades: Feb. 22, 2016

Published Feb 22, 2016 at 3:37PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **American Tower** (NYSE: AMT), buy up to 3.4% in stock
- **Gilead Sciences** (NASDAQ: GILD), buy up to 3.4% in stock
- **Wells Fargo** (NYSE: WFC), buy up to 3.5% in stock

Continue building your portfolio with our Buys, including these highlighted today:

- **AmTrust Financial** (NASDAQ: AFSI), buy at least half of our 5.5% stake to start
- **TD Ameritrade** (NASDAQ: AMTD), buy 2.4% in stock
- **Visa** (NYSE: V), buy up to 2.5% in stock

Our new hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): If you haven't set up the new put ratio spread yet, the index is much higher now. Lately, you can set up the April 15, 2016, hedge by buying to open $190 puts and selling to open two $182 puts for a credit. The spread is smaller than the $12 one we initially recommended, but with the market going up, lower-strike puts don't pay as well. We will set up our new hedge using modified strikes (like these) as soon as this week, and let you know what we set up. If you're already in the April position, you can stick with it (let it be). We might recommend a second hedge later.

And our most recent short:

- **Deere & Company** (NYSE: DE), short 2% per our recent recommendation

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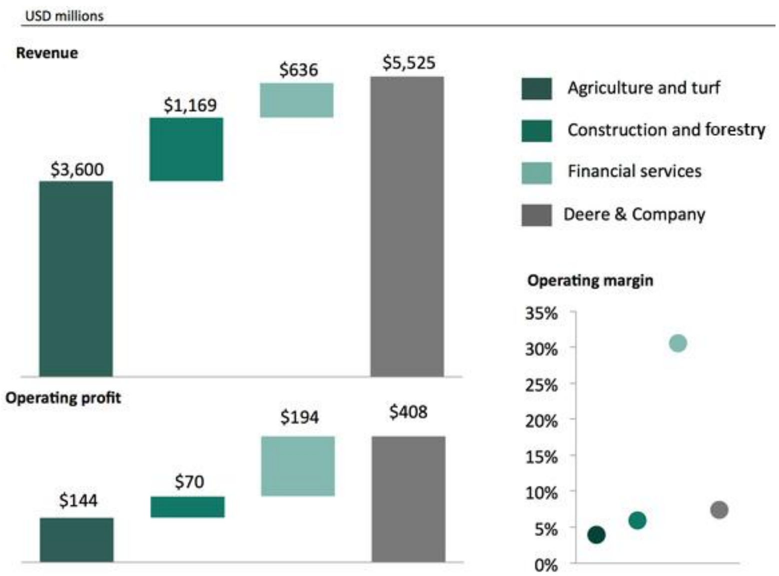
Deere in the Headlights

Published Feb 22, 2016 at 1:40PM

Fellow Fools,

After **Deere & Company** (NYSE: DE) released its first-quarter 2016 results this past Friday, one of the first headlines I saw was that the company beat bottom-line estimates. This may technically be true, but the results themselves and subsequent management commentary revealed that the situation is far less rosy than this headline would suggest.



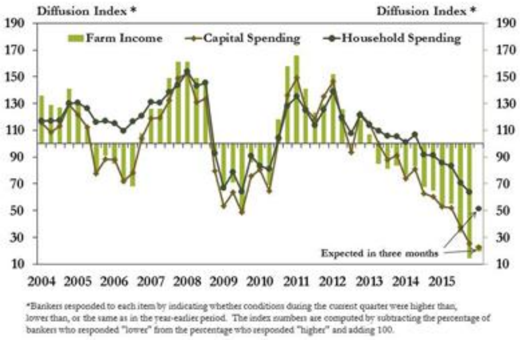
Source: Company filings.

Equipment sales fell 15% in the first quarter of fiscal 2016, 18% in the U.S. and Canada. Lower shipment volumes were the primary culprit, but adverse currency movements also hurt the company to the tune of 4 percentage points. Helping offset some of this weakness was a 2-percentage-point rise in realized prices as Deere continues to charge more for its products despite the current state of the industry and increased competition. Lower volumes also meant that the duality of operating leverage was once again on display despite the company's efforts to control costs. Equipment operating margins contracted once again as the decline in operating profits outpaced the decline in revenue growth. The agriculture and turf and the construction and forestry divisions saw operating profits fall by 46% and 52%, respectively.

	Revenue	Operating Profit	Net Income
Agriculture and turf	-12%	-46%	
Construction and forestry	-23%	-52%	
Financial services	-2%	-17%	
Deere & Company	-13%	-37%	-34%

Source: Company filings

One of the bright spots for Deere this quarter, relatively speaking, was its financial-services division. Revenue and operating income there fell by just 2% and 17%, respectively, and the company continues to manage its reserves based on a belief that credit losses will remain in line with its historical averages. But given the continued weak industry outlook — the latest update from the Kansas City Fed saw spending continue to decline, credit conditions continue to deteriorate, and farmland values fall in the fourth quarter — we're somewhat skeptical of this assumption. We wouldn't be surprised if future results for this division start to mirror the declines seen in Deere's equipment business.



Source: Kansas City Fed

With much of the writing already on the wall for this quarter, focus turned to Deere's outlook for the rest of 2016. Lowering your full-year guidance after just one quarter is never a good thing (except for those who are short the stock), but that's exactly what Deere did. The reason for the sudden change of heart, according to management, is that their prior estimates contained some embedded optimism about improvement in the back half of the year. Management has a recent history of jumping the gun when calling the bottom of the cycle, so this didn't come as much of a surprise to us.

	2016 Guidance	
	New	**Previous**
Net Sales	-10%	-7%
Agriculture and turf	-10%	-8%
Construction and forestry	-11%	-5%
Net Income	$1.3 billion	$1.4 billion

Source: Company filings

The company also tapered its rate of share repurchases this quarter, reducing the outstanding share count by just 0.4% (the smallest sequential decline since the second quarter of 2013). When asked during the earnings call about the pace of repurchases going forward, management noted that buybacks are more of a residual use of cash -- higher priorities include ensuring Deere maintains its current debt rating, investing in organic and inorganic growth, and maintaining the dividend. Chief Financial Officer Rajesh Kalathur also noted that Deere will only repurchase shares if the stock trades at a discount to management's estimate of intrinsic value, but if we're perfectly honest, this came across to us as nothing more than lip service. The best time for cyclical companies to repurchase their stock is on the downswing of the cycle, when the stock is getting hit. But this is when most companies (including Deere) taper their repurchases, because their operating cash flow becomes strained.

Pro's Take

Since peaking in the third quarter of 2013, quarterly revenue and net income have fallen by 49% and 77%, respectively. But in and of itself, this doesn't mean that the bottom of the cycle is just around the corner or that Deere's financial results will soon skyrocket back up. Rather, these numbers are a byproduct of what is happening within the industry, not the other way around -- it's the industry, not the numbers, that determines when the real bottom is found. We believe conditions will remain muted in the agricultural sector and that farmers will postpone the purchase of new equipment because they've already made recent upgrades, so there's no reason to expect a rapid recovery in sales anytime soon.

Management continues to stress the fact that all of Deere's operations currently remain profitable, something the company struggled to achieve during prior downswings in its industry. While negative earnings would certainly be a boon to our thesis, we don't believe that the success of our position is dependent upon them. Cyclical companies like Deere are often valued based on mid-cycle earnings, to avoid the dangers of valuing a business at either extreme. We continue to believe that most Deere investors have unrealistic expectations about what the company's mid-cycle earnings power truly is, as well as about the speed with which the industry will bounce back after the unprecedented growth in tractor sales that took place this past cycle. Simply put, 19 times forward earnings is only cheap if the company will be able to return to pre-2015 levels in a reasonable time frame.

We can't afford to get complacent with any of our positions, but right now Deere appears to be exhibiting a favorable risk-reward trade-off. Given the current state of the industry, our primary risk appears to be a change in investor sentiment. But moods are fickle, and we believe that continued poor financial results will ultimately drive the stock price lower.

Why Does Pessimism Sound So Smart?

Published Feb 17, 2016 at 11:15AM

Morgan Housel is Motley Fool One's expert on the intersection of investing, economics, and human nature. He studies the impact of big-picture issues on individual investors' lives — making us better Fools along the way.

Context: *No investor is an island, and Morgan sets out to help you understand how things outside your control that can affect your financial future.*

"For reasons I have never understood, people like to hear that the world is going to hell," historian Deirdre N. McCloskey told the *New York Times* recently.

It's hard to argue. Despite the record of things getting better for most people most of the time, pessimism isn't just more common than optimism, it also sounds smarter. It's intellectually captivating; pessimists are given more attention than optimists, who are often viewed as oblivious suckers.

It's always been this way. John Stuart Mill wrote 150 years ago: "I have observed that not the man who hopes when others despair, but the man who despairs when others hope, is admired by a large class of persons as a sage." Matt Ridley wrote in his book *The Rational Optimist:*

> If you say the world has been getting better you may get away with being called naïve and insensitive. If you say the world is going to go on getting better, you are considered embarrassingly mad. If, on the other hand, you say catastrophe is imminent, you may expect a McArthur genius award or even the Nobel Peace Prize.

In investing, a bull sounds like a reckless cheerleader, while a bear sounds like a sharp mind who has dug past the headlines — despite the record of the S&P 500 rising 18,000-fold over the last century. Wharton Professor Jeremy Siegel is often chided as a perma-stock-bull, blindly cheering for a higher market every time he goes on TV. But he's done it since the early 1980s, a period in which the market increased in value 40 times over. Alas, few care about past results when someone else is warning about The Next Great Depression.

This goes beyond investing. Harvard professor Teresa Amabile shows that those publishing negative book reviews are seen as smarter and more competent than those giving positive reviews of the same book. "Only pessimism sounds profound. Optimism sounds superficial," she wrote.

Why?

There's clearly more at stake with pessimism. Daniel Kahneman won the Nobel Prize for showing that people respond stronger to loss than gain. It's an evolutionary shield: "Organisms that treat threats as more urgent than opportunities have a better chance to survive and reproduce," Kahneman once wrote.

Here are a few other reasons I've observed for why pessimism gets so much attention.

1. Optimism appears oblivious to risks, so by default pessimism looks more intelligent.

But that's a wrong way to view optimists. Most optimists will tell you that things will get ugly, that we'll have recessions, bear markets, wars, panics, and pandemics. But they remain optimistic because they set themselves up in portfolio, career, and disposition to endure those downsides. To the pessimist a bad event is the end of the story. To the optimist it's a slow chapter in an otherwise excellent book. The difference between an optimist and a pessimist often comes down to endurance and time frame.

2. Pessimism shows that not everything is moving in the right direction, which helps you rationalize the personal shortcomings we all have.

Misery loves company, as they say. Realizing that things outside your control could be the cause of your own problems is a comforting feeling, so we're attracted to it.

3. Pessimism requires action, whereas optimism means staying the course.

Pessimism is "SELL, GET OUT, RUN," which grabs your attention because it's an action you need to take right now. You don't want to read the article later or skim over the details, because you might get hurt. Optimism is mostly, "Don't worry, stay the course, we'll be alright," which is easy to ignore since it doesn't require doing anything.

4. Optimism sounds like a sales pitch, while pessimism sounds like someone trying to help you.

And that's often the truth. But in general, most of the time, optimism is the correct default setting, and pessimism can be as big a sales pitch as anything — especially if it's around emotional topics like money and politics.

5. Pessimists extrapolate present trends without accounting for how reliably markets adapt.

That's important, because pessimistic views often start with a foundation of rational analysis, so the warning appears as reasonable as it is scary.

In 2008, environmentalist Lester Brown wrote: "By 2030 China would need 98 million barrels of oil a day. The world is currently producing 85 million barrels a day and may never produce much more than that. There go the world's oil reserves."

He's right: We'll run out of oil in that scenario. But that's not how markets work. A shortage pushed up oil prices, high prices incentivized producers to come up with new drilling techniques, and now we have more oil than we know what to do with. World oil production last year was 96 million barrels — already way above what he thought was the high mark. Failing to account for markets' ability to adapt is the cause of death of most pessimist forecasts.

Should you ever listen to pessimists? Of course. They're the best indication of what's unsustainable, and thus probably about to change, and thus the soil of what's to be optimistic about.

Pro Catch-Up Trades: Feb. 16, 2016

Published Feb 16, 2016 at 3:00PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **American Tower** (NYSE: AMT), buy up to 3.4% in stock

Continue building your portfolio with our Buys, including these highlighted today:

- **Facebook** (NASDAQ: FB), buy half of our 6.1% allocation to start
- **TD Ameritrade** (NASDAQ: AMTD), buy 2.3% in stock
- **Visa** (NYSE: V), buy to 2.4% in stock

Our new hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): If you haven't set up the new put ratio spread yet, as ever, do so only after you close your Feb. 19, 2016, put ratio spread sometime this week. Then set up the new one near the current SPY price. Currently, with SPY at $188, you would "sell to open" two April 15, 2016, $174 puts, and "buy to open" one April 15, 2016, $186 put. Lately, you can do this for a debit of about $0.50 (the rebounding market actually makes these hedges harder to set up for a credit). Follow last week's rolling trade alert for allocation guidance.

And our most recent short:

- **Deere & Company** (NYSE: DE), short 2% per our recent recommendation

Why Most Investors Fail, and How We Avoid That

Published Feb 16, 2016 at 2:06PM

Today, we're revisiting one of our very favorite Memos, this one first published in 2011. For many here, this will be new, and it remains as true as ever! We hope the fact that these words are still just as relevant five years on helps underline our message of steadiness and persistence.

Dear *Pro* Member:

Reliability and steadiness are essential to any successful career, whether you're a teacher, a doctor, an engineer, or a barber. That's because these qualities are directly tied to long-term performance. You won't achieve success over the years if you don't stick to your principles, if you fail to learn from your mistakes, or if you regularly change your approach without good reason. We know this to be the case in our working lives, but when it comes to investing, studies show that a majority of individual investors are just the opposite: They unreliably change course all the time, and not surprisingly, the results are dismal.

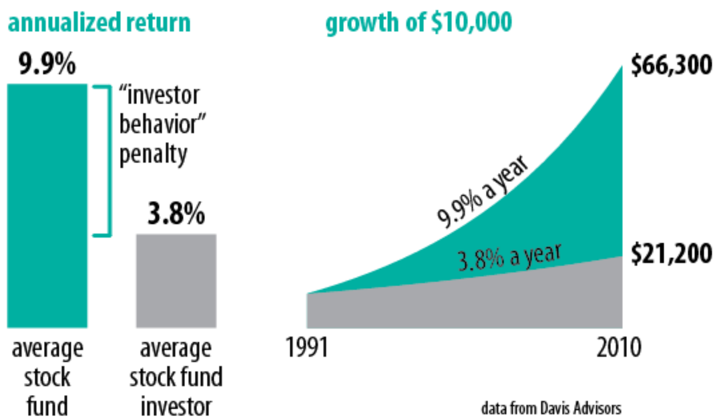
Missing Most of the Upside

The best-performing mutual fund from 2000 to 2010 was the CGM Focus Fund (CGMFX), which returned more than 18% annualized despite a flat S&P 500. The fund's outstanding track record would have turned $100,000 into more than $500,000 over those 10 years. The only problem? According to Morningstar, the average investor in the fund actually *lost* 11% annually over those same very successful 10 years. That is not a typo: The fund gained 18% annualized, but its average investor lost 11% annualized. You're not crazy to ask how that is even possible.

The answer is that many fund holders tried to time the market. For example, the fund soared 80% in 2007, so hordes of investors poured money into it in 2008 — only to see it fall 48% that year. That decline led investors to pull money out in 2009, taking losses soon before the market doubled from its low. Investors were making emotional decisions based on recent events, changing their stance repeatedly, and as emotion would have it, at the most inopportune times. Could this be happening with some investors now, too?

Not Just One Fund; It's Universal

According to an investing study from Davis Advisors, the average stock-holding mutual fund returned 9.9% annualized from 1991 to 2010, but the average fund owner earned only 3.8% on average per year.



Not pretty, especially when we translate this performance into dollars. By trading in and out of funds, the average fund owner increased a $10,000 investment to just $21,200 over nearly two decades — while the average *fund* turned that $10,000 into $66,300. Now imagine the continuing effects of compound returns on both of those amounts and the growing difference between them over a lifetime. Feel the pain. Remember it next time you're tempted to make a rash trade. Davis also finds that the less trading a fund itself does, the better the fund's results tend to be. What's true for individuals is true for funds.

Successful Investing Includes Many Bad Years

All great investors suffer years of poor results, bar none. It's just how the market is. Warren Buffett's partner, Charlie Munger, has an outstanding lifelong record, but his annual results lagged the S&P 500 index 29% of the time. An impatient investor would have left Munger during some of his down years and missed riches later.

And Munger is far from alone. According to Davis Advisors, investors who achieve the strongest records aren't always at the top of the performance list. Not even close. Over a 10-year period, Davis studied 192 large-cap money managers who had previously ranked in the top 25% for performance. They found that:

- A full 93% of them spent **at least one three-year period in the bottom half** of all performers.
- Sixty-two percent of them spent at least one three-year period among the **lowest 25%** of all performers.
- And 31% of the best money managers spent at least three of 10 years among the **very worst 10%** of all performers!

In other words, over this 10-year period, you could expect most of the best investors to be ranked among the *very* worst about one-third of the time.

This data clearly illustrates why impatient investors lose out: They go from vehicle to vehicle seeking results based on recent performance. They sell when one asset is down, only to buy another asset that may be up recently, but is just as likely to go down next — because nearly *all* investments and *all* investors have weak periods. As we showed above, chasing performance by looking in the rearview mirror can turn a 9.9% annualized return into 3.8%. Sitting tight would be so much better.

Stay the Course

Steadiness and persistence are necessary for successful investing. But don't take that to mean you'll always do well. There will be years in which your results disappoint you, and years in which your successes are far greater than you thought possible. That's why it's vital to invest in ways that make you comfortable, so you don't lose faith during rocky periods.

Even now (especially now!), investing is a lifelong pursuit. At *Pro*, we own companies we believe will increase in value over the next three years and beyond. We hedge and short, too, because volatility is a given. But we continue to believe that good companies will drive most of the profits we generate in the coming years, and we look forward to the value we'll generate together by staying the course.

Thoughts or questions on this Memo? Please bring them to our [Memo Musings discussion board].

Foolishly,

— Jeff Fischer (TMFFischer)

Roll Your Put Ratio Spread on the SPDR S&P 500

Published Feb 11, 2016 at 1:43PM

Is this for you? Please read the full alert to see if and how it applies to you, and take action sometime before market close on Feb. 19 if it does. Anyone who has a Feb. 19, 2016, put ratio spread on SPY (as we do) or who wants to set up a new hedge should follow this alert. Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $180,000.

How You Participate

- **Action:** First, if you have our Feb. 19, 2016, put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY), that spread is in-the-money, and should be closed before expiration a week from Friday. When you're ready, "Sell to close" all of your Feb. 19, 2016, $200 puts, and "buy to close" all of your Feb. 19, 2016, $190 puts. We have a partial profit on this spread; that profit currently grows when SPY goes up (up to $190, our maximum profit point) and shrinks when SPY declines (below $180, the spread becomes a loss). Nobody knows what the index will do over the coming five market days, but higher prices would at this point increase the profit in our spread, and lower prices could eliminate our profit. Either way, we want to close the spread by expiration.
- **Second action (or newcomers' only action):** Once you have closed your Feb. 19 spread, set up a new one. Buy to open April 15, 2016, $180 puts, and sell to open twice as many April 15, 2016 $168 puts.
- **Allocation:** About 10% of your total portfolio value, measured on the look-through value of the $180 puts you're buying (each put represents $18,000 in hedge value). Set up one 2:1 put ratio spread for every $180,000 or so you manage and want to hedge; hedging 10% of its entire portfolio (9.7% to be precise), *Pro* will sell 24 puts and buy 12.
- **Trade:**
  - **Use a spread order to simultaneously ...**
  - Write ("sell to open") **two** April 15, 2016, $168 puts, and
  - Buy ("buy to open") **one** April 15, 2016, $180 put. Click "view all" at your broker to see all strikes.
- **Price Guidance (Noon ET):**
  - Sell to open **two** April 15, 2016 $168 puts: Lately $3.57 x 2 = $7.14 credit
  - Buy to open **one** April 15, 2016, $180 put: Lately $7.07 debit
  - **Net credit:** Lately about **$0.07** credit (or higher) per spread, but this price will change; as that happens, just aim to set this up for virtually no cost using a limit order.
  - **Potential adjustment:** If SPY's price has changed much by the time you set up your trade, you may want to move your two strike prices down or up accordingly (as much as SPY has moved), while still aiming for a credit or no cost. We will make just such an adjustment ourselves if need be, and tell you about it.
  - **SPY price:** $182.30

What We're Thinking

A hedge on a market index is simply a hedge against a lower market. We generally don't care about declines of 5% or less, but when *Pro* is functioning as desired, declines of about 10% or more should result in some of our positions, like bear spreads, becoming profitable. In today's volatile market, our February spread on the SPDR S&P 500 has lately bounced around its full profit level ($190 on SPY); as of now, it has fallen below it, giving us only partial profits. (To see how profits on the February spread will work out in the end, reference our table from the [old trade alert].)

As with any near-the-money option, there's nothing we can do to control the outcome as expiration nears; we're at the mercy of the short-term market gods. As we go to close our February spread sometime in the next five market days (noting that Monday is a holiday), we hope we can do so on a day SPY is running up, the closer to $190 the better. But if we need to close while SPY is lower, we will, missing out on some or much (or all) of the spread's profit. Setting up put ratio spreads that don't cost us anything -- they pay us a credit -- but come with the risk of missing gains, and having downside exposure, if the market falls too much. We're on that cusp now. Those who merely set up bear put spreads, the alternative trade, have achieved the full profit (you can close the whole spread for close to $10 each, or five times your cost of $2).

But we're far from upset with our put ratio spread. We're in the ballpark of our desired results -- as of this writing, we've earned about one-fourth of the full potential profit -- and we're now in a good position to roll it, setting up a new spread at lower strikes, in case the market keeps falling. Once again, this new put ratio spread will:

- Be harmless to us if the market goes higher (it won't harm our returns)
- Be cash-free to set up (it will even pay us a small credit)
- Have a relatively low probability of loss

What's the trade-off? As with any written put, we need to be ready to buy the underlying investment; for today's trade, that means being prepared to buy shares of SPY via this hedge if the market falls too sharply. In this case, if the index falls more than 14.4% from today's price, this new hedge becomes a liability, with SPY falling below our breakeven point. If that happens, we would roll, close, or plan to buy long-term call options on SPY instead of shares, saving most of our cash in the process. See below for details on that.

To help you grasp how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2,233,000
- 10% of that value: $223,300
- April 15, 2016, spread:
  - Buy to open $180 puts. Twelve contracts representing 100 shares each = $18,000 x 12 = $216,000 in look-through exposure, or a 9.7% hedge on our current portfolio value, cash included.
  - Sell to open $168 puts, 24 contracts, half of which become a potential obligation, currently a 9% possible stake.
  - Following along, you would buy one $180 put and sell two $168 puts for approximately every $180,000 in portfolio value you want to hedge ($18,000 look-through put value divided by $180,000 = 10%).

Return Details

SPY Price at April 15 Expiration	Value of 1 Purchased April 15, 2015, $180 Put	Value of 2 Written April 15, 2016, $168 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Recent $182.30
$180 or higher	$0	$0	$0.07 gain per spread, or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 1.3%
$178	$2 x 100 = $200	$0	$200	(2.4%)
$176	$4 x 100 = $400	$0	$400 (max profit per spread)	(3.5%)
$174	$6 x 100 = $600	$0	$600	(4.6%)
$172	$8 x 100 = $800	$0	$800	(5.7%)
$170	$10 x 100 = $1,000	$0	$1,000	(6.7%)
$168	**$12 x 100 = $1,200**	**$0**	**$1,200 (maximum profit per spread)**	**(7.8%)**
$166	$14 x 100 = $1,400	($2) x 200 = ($400)	$1,000	(8.9%)
$164	$16 x 100 = $1,600	($4) x 200 = ($800)	$800	(10%)
$162	$18 x 100 = $1,800	($6) x 200 = ($1,200)	$600	(11.1%)
$160	$20 x 100 = $2,000	($8) x 200 = ($1,600)	$400	(12.2%)
$158	$22 x 100 = $2,200	($10) x 200 = ($2,000)	$200	(13.3%)
$156	**$24 x 100 = $2,400**	**($12) x 200 = ($2,400)**	**$0 (breakeven)**	**(14.4%)**
$154	$26 x 100 = $2,600	($14) x 200 = ($2,800)	($200)	(15.5%)

Our maximum profit is earned on this April spread if SPY declines another 7.8% from its current level of $182.30 (noting that it's already down 12.7% since our last spread was set up in November). From there, the spread will help us a little on a decline all the way to about 14.4% lower than today's price; beyond that, our short puts turn into an obligation that's in the red.

Follow-Up

Assuming we set this spread up for a credit, it will result in a small profit even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $168 put obligation if SPY is below that price by expiration.

If that does happen, our action may be to close our puts and buy long-term SPY calls (or something we like even better, whether calls or stock) instead of buying the ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY itself. So, our potential 9% or so stake in SPY shares will only cost us about 2.5% of our cash if we buy calls instead (though keep in mind, our portfolio value will be lower, too). We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases.

How It Fits Into *Pro*

Pro hedges in attempts to lower our market exposure, or risk. As you know, we aim to achieve positive returns every rolling three years, and inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market will make a difference. Even small gains add up over the years, especially if those gains are reinvested in depressed stocks. This hedge fits well with our goal of hedging in a cost-efficient way. It does require regular upkeep, though, opening new positions as old ones expire.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $180,000:**
  - For a cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, as we are, "buy to open" April 15, 2016, $180 puts and "sell to open" *an equal number* of April 15, 2016, $170 puts. Recently, this will cost you about $3 ($300) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $10 ($1,000) per spread on a decline to $170 or any lower price, but you should be prepared to lose your $3 per spread if SPY doesn't decline below $180 by expiration.
  - Have the alternative bear put spread from last time? Great! You can close it for close to $10 per spread, or nearly a 5x profit.
- **To lower your market exposure while following our official trade (and make the position possible in some IRAs):**
  - Set up the original put ratio spreads as recommended, but also "buy to open" puts (with the same months of expiration as our two spreads) at strike prices *well below* $168. Buy *half as many* as the number of $168 puts you wrote. When you do so, all of your $168 puts will be "covered" (half by your $180 puts, and half by the other puts you choose to buy at a much lower strike; choose how much you want to pay to select your lower strike price). You will only need cash in your account to cover the difference between your two lowest strike prices, and your risk is capped, making this potentially IRA-friendly. Lately, you can buy the April 15, 2016, $148 puts for about $1.05, meaning your only risk (and necessary cash reserve) is now $20 per share on half of your $168 puts. And this makes the total cost of your hedge about a $1 debit.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Pro's First Video Chat

Published Feb 11, 2016 at 11:42AM

Fellow Fools,

We love our monthly check-ins with members, but as previously announced, we wanted to try something new this time around. Members submitted questions ahead of time via email and we answered them on camera; check it out below! It's also vital for us to know whether this new format works for you, so please bring your thoughts on that to the Member Suggestions board.

Topics include: *Pro*'s options recommendations; corruption on Wall Street; our financial companies in this interest-rate environment; TD Ameritrade vs. Interactive Brokers; sizing your hedges; health insurance stocks; how *Pro* protects its capital; and more. To download an mp3 of the audio from the chat, click here.

{% video %}

Run time: 28 minutes 8 seconds.

Transcript

Ellen Bowman: Hello, Fools. I am Ellen Bowman. I'm the editor of Motley Fool Pro and this is our inaugural video live chat. This is JP Bennett over here and Jeff Fischer, as you know, over here. We collected some questions from you all. I'm just going to get started. The first one is: Pro talks a lot more options. Education, weekly trade ideas, et cetera, than it actually does. I know timing can be tricky, but it seems a good many opportunities go begging in this very important value adding element of Pro. Can we expect more trade recommendations in this area?

Jeff Fischer: More options trades in pro?

Ellen Bowman: Yes.

Jeff Fischer: We can certainly expect them. It's true, although we had about the same number of trades last year as we've-

Ellen Bowman: We did?

Jeff Fischer: -had in prior years. It's felt a little less active the last, I don't know, 6 to 12 months maybe even. That's partly because we haven't found compelling things. Now, the market has fallen quite a bit as of this taping. The SMP is down, I think, 12, 13%. Nasdaq's down 15% this year. Anyway, as we see more opportunities, we'll have more trade ideas, definitely, including options. Do keep in mind that you get the option service as a compliment. A good amount of our time goes into that service and extra options ideas over there that compliment Pro ideas, especially on my side of the scorecard. Because I'm thinking of the 2 together.

Ellen Bowman: Simultaneously. Yeah. I know people don't always, necessarily, realize that, but options ... The service is an idea service, whereas Pro is, obviously, a portfolio service. If there are things that look appealing in options, they're, by no means, off-limits if you're following Pro.

Jeff Fischer: That's a good point.

Ellen Bowman: JP, I'll ask you this one. How do you get your hair so awesome? This is an actual member question.

Jeff Fischer: Who asked that question?

Ellen Bowman: We're not going to sell them out.

Jeff Fischer: We're not telling names.

JP Bennett: Lots of bleach.

Ellen Bowman: Do you do it yourself?

JP Bennett: No, because I wouldn't have any hair left if I did.

Ellen Bowman: You pay somebody to do it?

JP Bennett: Of course.

Ellen Bowman: Okay. Good to know. That's all you get to know today anonymous.

JP Bennett: I'm done now? I need a little bit more.

Ellen Bowman: You can go. Next up, what are Pro's opinions, or reactions, to the increase talk of corruption on Wall Street, corporate boardrooms, the largest banks? This seems to be picking up interest by the average American, witness the Sander's phenomena, and many books on the subject. I believe in equity investments, but it worries me that some kind of fix is in that places the retail investor at an extreme disadvantage.

JP Bennett: Oh, boy. That's a big one. I would say there's probably two things you'll want to take into consideration when you're thinking about this. The first is, yes, high-frequency trading, front running, things like that, they are an issue. Hopefully, over the long run, people can actually make changes that would mean this type of stuff doesn't really go on as much as it used to. The second thing is, all right, that's not going to change overnight. How can we deal with the situation that we're currently presented?

To me, I think the biggest advantage we have as retail investors is that we have a much longer time horizon than high-frequency traders and hedge funds and things like that. That time arbitrage, even though Pro in comparison to other foolish services, we, by necessity, have a shorter time horizon, but always making sure that even within that confined 3 year investing horizon, you have the ability to extend it, if circumstances arise that necessitate that, without a meaningful change to how you live and how you invest. I think it's important to take that perspective and then be okay with, maybe, losing a couple percentage points right off the bat, or something like that, and riding through it. Because if our thesis is valid, over a much longer time horizon, it will play out exactly like we want it to.

Jeff Fischer: I don't think I have anything to add to that except, probably, in many ways, the markets more regulated and companies are much more regulated since the 1970's, even. Let alone 1934. For the most part, as JP said, our one advantage is our time frame, and second, our ability to find really good companies. Then, ideally, keep them as long as they deserve to be held. We always watch for signs of management wrongdoing, or mistruths, or things that are really serious in nature so we can avoid those.

JP Bennett: Yeah. It's, basically, taking control of what we can actually control and worrying about high-frequency traders front running us to scout a couple basis points, or factions of pennies. That's not something that's in our control right now.

Ellen Bowman: Okay. That follows. I am going to identify our questioner here because it's Caron, and we all love Caron. Some of our stock BC's involve rising interest rates and there seems to be a lot of uncertainty. How much does our Pro success depend on the Fed and how can we stay smart about the positions effected by it?

Jeff Fischer: That's another great question. One thing to know about Pro is any position we buy has its own merits. We buy on its own merits, and extra things like interest rates, or if we were to buy commodities, commodity prices. That would be an extra thesis on top of it. We like Wells Fargo, the business, even if rates don't go up and the price right now. We like TD Ameritrade the same way, even if rates don't go up.

We still believe in them. The returns may not be nearly as strong as we had hoped, until rates do go up, but the return should still be respectable. I think that's true of almost any Pro stock that we buy.

Ellen Bowman: Yeah. I've never edited a thesis by you where you're like, "This will work out if this one thing happens." You're usually a little bit more-

Jeff Fischer: There's more to edit.

Ellen Bowman: A little bit yeah. JP, anything?

JP Bennett: To the extent that the Fed controls the market, all of our stocks are somewhat dependent upon what they do. Like Jeff said, all of our financial exposure, financial companies, they will benefit from an eventual increase in rates if we finally do get one, but we're not banking solely on that.

Ellen Bowman: That's not the whole thesis.

JP Bennett: We are, in many respects, entering into an unprecedented era where we had such influence by the Fed, and now we're trying to get back to a normalized rate environment. What is normal now? Given slower growth and things like that. They're trying to increase rates when inflation, half of the mandate, is nowhere near the 2% they want to target.

It's a very interesting time to be investing and it'll be really interesting to see how that develops. Because we really have no historical perspective, we can't rely, exclusively, on the interest rate argument for TD Ameritrade or Wells Fargo or something like that.

Jeff Fischer: I think, like many people, we are resetting our expectations right now to be even more conservative than before. I wouldn't expect rates to go up 3 or 4 times this year, as was previously anticipated. It may be a long time before rates go up meaningfully, given the deflation and commodities and lack of demand, especially overseas, apparently. It may be a long time.

We have to invest accordingly. That may make us much more hesitant to add to our financial exposure. We've been cautiously waiting to see how things would go, anyway, there. Anyway, we are always adjusting our expectations. Right now, we're dovish on interest rates going up. We don't really expect to see much this year.

Ellen Bowman: Okay. You both mentioned Ameritrade. We have a question here about it. Just curious if you considered interactive brokers when you recommended Ameritrade that has outperformed Ameritrade over Pro's ownership period. All without including diffidence, do you track Ameritrade against other companies in the same room?

JP Bennett: Billy covers that one. I will say that, yes, we've given consideration to it. We added it in options. Wasn't the best of timing, given how the market has behaved since we added it. Yeah. Whenever we follow a specific company, we're always looking at the industry, the competitors. Because it's core that we do that to make sure that when we pick one, and we are foolish on the industry in general. It's like, "Well, why is, one company that we're picking, why is it going to do better than everyone else?" Good question.

Ellen Bowman: Well said. All right. We have somebody who says "I set aside a portion of my portfolio to follow Pro and to build my long positions, according to the recommended allegation. For the short positions and options, especially the SPY Hedge, I feel that I could use, more or less, the size of the money I manage as the basis for the allocation. I want to hedge my entire portfolio, not just my Pro portfolio. Is this approach reasonable?"

JP Bennett: Yes. That makes good sense. You size any hedge to hedge the amount of assets that you would like to hedge, and not just the Pro portfolio. That said, when you're buying positions, you might be thinking the same way, too. If we, say, buy 2 1/2% Visa, if you have a Pro portfolio that, if you bought 2 1/2% in that portfolio, but it was only 0.5% of your total assets, you might want to rethink that to make it more meaningful.

Ellen Bowman: Our allegation is a reflection of how much we believe in the stock, right? You can assume that we're slightly more bullish on something, that we have a higher allegation to, and that you can probably take from that you could be, too.

JP Bennett: That's right. Especially at the start. When we issue the trade, it's how much we want to move into it right away. Overtime, as positions grow, we might believe in our largest positions as much as a position that is smaller. We're happy to have appreciation. Yep.

Jeff Fischer: I would just add to move it to more of a theory perspective. A lot of people, now, are advocating that you should think of your wealth in 2 buckets. There is the financial capital and then there's your human capital. Which, your human capital refers to the amount that you will earn over your lifetime. Whereas your financial capital is the things that you've already accumulated, like your stocks, your cash, things like that.

In that particular bucket, like Jeff said, you should think of it all in one bucket. Don't strip it out into certain things. From that perspective, if you wanted to hedge a larger chunk of that particular bucket, yes. You don't have to necessarily just think about, "All right. I have this Pro portfolio and I'm only going to hedge that." You should think about buying, selling, hedging, in terms of that kind of entire portfolio. Just make sure that when you do that, you're making sure you're still staying properly diversified.

If you're doing it in terms of shorts, don't rely on 1 or 2 shorts. As far as whatever portfolio, wherever you're holding those, make sure that you can stomach that volatility. You don't want to be getting margin calls because you basically just have a portfolio and you don't have a ton of excess cash in there. It's just almost exclusively used for shorting, and then all of your shorts start running against you really aggressively. That won't be a fun time.

Ellen Bowman: That's suboptimal. We avoid that. Okay. We have a long question here about healthcare. I'm going to try to shorten it a little bit. Some drug firms are saying they have minimized price hikes in recent months to avoid attracting attention. Bernie Sander's single-parent plan would, of course, decimate health insurance companies. Big pharma is, apparently, responding by being frightened of what a Clinton or Sanders presidency might do. What would be a good position on pharma, specifically health insurance stocks, that would take advantage of an unlikely, but potentially, devastating drop?

JP Bennett: That's all you Jeff.

Jeff Fischer: I haven't thought through that, yet. I don't believe it's going to happen. I wouldn't take a position out of political concerns. We'll continue to focus on businesses that we really believe will be strong, almost no matter what. If Capitol Hill, or the White House, changes drastically in that undercuts a whole industry, then-

Ellen Bowman: Then ...

Jeff Fischer: -there will be a lot of pain across that industry. Partly for that reason, we keep our exposure limited to every industry. We have, I think, 6% or so in healthcare, directly.

JP Bennett: I'd have to look.

Jeff Fischer: Even companies we believe in strongly, like MasterCard and Visa, that exposure is around 7% or so. Because we know regulations could always change, rules could always change. It's a good question. I don't want to dismiss it out of hand, but I think it's early to have that concern, or at least, it's early for me to be researching in relation to that concern. I don't have an answer.

Ellen Bowman: Makes sense.

Jeff Fischer: I like what we own, though. I like Medtronic and Gilead Sciences. Good question. These are all good questions.

Ellen Bowman: They are. Okay. Jeff said something about this being a year where we're working not to lose money. What is Pro's best strategy for protecting capital during bearish markets?

JP Bennett: I said that, I think on a post or in a memo, that there are times to make money in the market and times not to lose money. At least, as a focus right now, anyway. It may not last the whole year, but it seems more of a time to be cautious and try to minimize your losses. Obvious ways to do that are to hedge or short. Right now, we could use more of those, and we continue to research them.

Prices have changed so quickly over this year that a lot of ideas have fallen away from us. The opposite of rising away from us. We have some hedges. We have cash. The clearest way not to lose money in a falling market is to not make new investments, and we've been very slow to do that, thankfully. We're ready with a list of things to buy. Meanwhile, we've been minimizing our losses by not putting on more long exposure.

Ellen Bowman: Okay. You were talking about industries a minute ago, and this question comes from that, I think. What industries could we take positions in to defend our gains? Is our dividends more important now?

Jeff Fischer: To defend our gains, which industries should we buy into? Are dividends more important? I think where this question is going is should we look to add to the yield of the portfolio, increase dividends.

Ellen Bowman: Yeah. I think so.

Jeff Fischer: Unfortunately, the past year or so, high yield stocks have gotten crushed. You can see that in Motley Fool income investor, which just focuses on dividends stocks. The reason for that was people were expecting interest rates to go up. At which point, bonds and other instruments would compete more favorably with dividends, and so dividends stocks go down a little bit, at least. There's no overall, at all. A lot of it evens out in the end when rates are rising.

Dividends stocks are not as attractive when rates fall. They're more attractive. Over the long run, I think, just having a good mix of capital appreciation-type stocks and dividends stocks is the way to go. We try to have balance. We've generated about a 2% yield, dividend yield, on our invested assets, each of the past several years. Which in Pro is pretty good while we're not targeting dividends. If we can add at least a few more percent with option income, as we did last year, then you're getting a pretty good deal.

JP Bennett: I think another thing to add to that, too, is, I'm pretty sure I wrote about this in a memo at some point in the past.

Jeff Fischer: You write so much. You can't forget.

JP Bennett: Yeah.

Ellen Bowman: Maybe I'll remember it.

JP Bennett: Yes. That's the reason I forget, because I write too much. Anyways. Overtime, you're seeing the coloration of more assets move towards, one, when things are getting hit. The time that you want diversification, and even if you dive into equities and you just look at different sectors and things like that, we've seen ... If you go back 20, 30 years, the idea of basically cutting up your portfolio and making decisions based on industries and trying to create diversification that way, was a lot more beneficial than it is in 2 days market where, when you just look at the markets down. Pretty much everything is getting cut with varying degrees.

I would say that we don't specifically manage a portfolio, saying that we need to have a specific exposure to a give industry. I think, in 2 days kind of environment, that's the wrong way to go about it. You need to find awesome companies. Then after you've found a company you really like, make sure that, in terms of industry exposure, it makes sense in your portfolio. That will exclude us from going too heavily into a given industry. We may say that, "Hey. A sector and industry looks attractive right now. Let's see if we can find a company we want to invest in that we really like," but we won't go into it with this specific mandate saying "Oh, energy has been cut really bad, so we're going to find one." I think when you take that mindset, it leads you to come up with a investment that it's, primarily, based on the fact that you think you need to find something. Not that it's actually a good opportunity.

Ellen Bowman: You pick the stock first and build the thesis afterward?

JP Bennett: Exactly.

Jeff Fischer: I can piggyback on that comment by saying I think we've invested fairly defensively from the start in the type of companies that we seek, which is what JP just spoke to. One's with pricing power, one's with competitive advantages that are real, and that should be sustained. One's with growing market opportunities.

All the Pro criteria that we look for in a company, that has kept us defensive, in that, it's kept us out of commodity-based businesses, or out of loan margin, cutthroat-type of businesses. To companies that are doing well, even now, when things are a little challenged. Hopefully, if we keep that mindset, we'll stay defensive while still investing for returns.

Ellen Bowman: Not just preservation.

Jeff Fischer: Yeah. Where we've taken the most risk, probably, is in financials. Even in Wells Fargo and AmTrust and things of that nature. AIG in the past that we sold. We did that after the crisis when the dust had settled. We had strong businesses at really attractive prices. The good news is the those companies have stayed reasonably priced, so we still like them. We still like Wells Fargo. Then Technology, we bought Technology when it's inexpensive. We're trying to be defensive even as we invest to grow.

Ellen Bowman: Okay. On an even more defensive note from the same member, who says that he has lots of portfolio management questions. How much cash, in percentage terms, should we have on-hand?

JP Bennett: I guess it would all depend on the given person and how closely you want to mirror Pro, right?

Ellen Bowman: Right. You can go to our recommendations page, see how much cash we have, and go with that.

JP Bennett: Yeah. There's obviously an opportunity cost. This is one thing I know I did write about in a prior memo. There was an opportunity cost associated with holding cash. Yes, it is a huge benefit that it gives you flexibility when the market falls. You can invest and benefit from that bounce back to a disproportionate amount. At the same time, the benefit depends on where in your investing horizon that cut falls. If the market's going rally for 15 years before falling, a meaningful amount, then the benefit associated with holding cash isn't nearly as strong as a opposed to, right now I have 30% cash. The market falls by 50% tomorrow. I put it to work. Then the benefit is huge. That gets more towards portfolio theory and where you are in what's your time horizon and letting that, to a certain extent, dictate the type of investor that you are.

Someone younger, they probably shouldn't be sitting on a huge chunk of cash unless they are a very nervous individual. Whereas, and being fully invested, would lead them to make sub-optimal decisions at the exact wrong time, like selling at the bottom. Whereas, the closer you get to retirement, I know Jeff spoke about it previously, but cash is a great asset to retirement.

Jeff Fischer: Retirement? I spoke about retirement?

JP Bennett: No.

Jeff Fischer: Did I announce that?

JP Bennett: No. The importance of cash and diversification and hedging and things like that. It's not as sexy as shorts and hedges, right? It can be very helpful, as far as managing volatility and making sure you don't lose during the periods when you're focus should be on not losing.

Ellen Bowman: All right. We have somebody who would like to know about your thoughts related to energy socks, but I think we have shared them, so I will not as about that. Similar question about materials markets. Okay. I think it is important that-

Jeff Fischer: I like that. Ellen's like ... she's learning what is on the chopping block. Those guys are not going to buy materials or anything.

JP Bennett: No.

Jeff Fischer: Energy? We will look, in all seriousness. There are good businesses out there. I'm not speaking to Ellen now, I'm speaking to ourselves. We do look. If we find something we like enough, we'll go there, but it needs to have pricing power. It needs to have all kinds of catalysts.

JP Bennett: I think the one thing to think about those are naturally cyclical businesses. The key is what is the normalized environment going forward? This builds off of what we talked about with deer when we shorted it, right? It was basically, we think that byproduct of that boom in the agricultural industry lead to an unsustainable increase in tractor sales. The more normalized rate going forward, isn't nearly as high as what people think.

In the energy sector, yes, oil has gotten gutted. What's the normalized rate going forward? Obviously, supply and demand need to come back and balance. What we've seen is that Woodmack recently, actually, put out a study, I don't know if you've seen it yet, Jeff, where it's basically, despite this huge gutting of prices, actual production has been cut by .1%. The big difference is that people are pushing out expenditures to open new wells and things like that. That's where the big shift has been.

It's not like all right, oil has fallen so hard, people have just all of a sudden turned of the spigots, and so productions going to come down really fast. The rebound is going to be just as steep and we're going to get back to $100 a barrel. The key is, if you're going to invest in those businesses, what is the normalized rate and what type of multiples should those stocks get? I can't speak for Jeff, but I haven't done enough work to find some company where I'm comfortable enough to make that bet right now.

Jeff Fischer: You have to keep in mind, technology keeps improving, too. There are now oil shell ... what's the word? Oil shell.

Ellen Bowman: Drills?

JP Bennett: Wells?

Jeff Fischer: Wells, I guess. Wells in Texas where they can produce oil, profitably, at $20 a barrel. If it gets cheaper and cheaper to produce it ...

JP Bennett: Even the more expensive wells, they still aren't cutting production. Some companies are literally just going, "Please rise, oil. Please rise." The cost associated with turning off the well, or stopping production, and then bringing it back online, they're not really wanting to play that game.

Ellen Bowman: More like buckle down and wait a little bit and see.

Jeff Fischer: My bet is eventually Alpek will cry uncle and lower production and that'll help everybody. You can't invest on that thesis.

Ellen Bowman: Don't invest on that thesis anyone. All right. You guys are awesome. You answered a question I tried to skip over. You wouldn't let me. I think it is important that Jeff discuss balancing ones portfolio, even in the face of significant gains. The importance of diversification and of locking in profits. That's a big one. Do you want to just take the first part? Balancing in the face of gains.

Jeff Fischer: Yeah. I think, if you're winning positions get to become 10% or more of your portfolio, and that's just my arbitrary number, it can be 7% percent, it could be ... Then you have to really think about balancing, or selling it down a little bit just to spread your risk a little bit. It's a tough question because you don't want to cutoff your biggest winners. From my perspective, and I think David Gardner's too, anyone who started investing in the 1990's, their biggest winners became Amazon and Starbucks. If you had sold them early, now you're biased towards not selling at all.

Ellen Bowman: Oh, yeah.

Jeff Fischer: Actually, that's true over the history of the market, too. If you bought J&J in the 50's or Coca-Cola in the 80s up to this point, it's best that you've just held it. Selling your best performers, it should be done reluctantly, carefully. Only when you have far too much to make yourself comfortable and, or, you see something you like as much, or more, to put some of that money into-

Ellen Bowman: I was going to say what would be the stimulus that would make you decide? Is it just arbitrarily it crosses this number? I guess it is for some people, but otherwise, is there a reason-

Jeff Fischer: It is for some people, but it really depends on the business. We always are more likely to sell a less strong business, like the Buckhold, than we would be Starbucks or Visa. Even if Starbucks or Visa or O'Reilly, look overpriced for a while, we'll give it time. We know it may dip and we may have to wait it out, but in the long run, we expect more compounding. Where as cyclical business, or a retailer or something, that's not nearly as strong, that compounder, as much, we'll sell if it gets near fair value-

Ellen Bowman: That makes sense.

Jeff Fischer: -generally speaking.

Ellen Bowman: Okay.

JP Bennett: I think that's pretty much on the market. It's like, look at the business first. That should be the primary driver, but then you just always need to have it in the back of your head, this is the maximum threshold. Because it can be a great business, it can do great things, but at some point, if you think about it in terms of portfolio management, you're going to want to cap your maximum exposure to a company. Being a bit of a bear and putting a counterpoint to people who've started in the 90s or whatever, and those businesses became such great things.

What you're now seeing, if you look at the unicrans and stuff like that, businesses are going public at a much later time. It's, in theory, going to be, pretty much, impossible for Facebook, say, to deliver the returns of Microsoft just because of the evaluation that was currently attached to the business. That's just something of trying to keep your mindset in check in terms of, yes, you've seen these businesses go public and the returns are just astronomical. I wish I was investing in those companies at that point in my life, but I would say, for the most part, we're unlikely to see those type of mind-boggling return numbers going forward.

Don't just hold on to a company because you're just super infatuated with the business and you remember in historical context that something went public and just went absolutely gangbusters in the next 20 years. It's a balancing act.

Jeff Fischer: That's a great point. It is a balancing act. Time-frame becomes such a big part of it, too.

JP Bennett: Oh, yeah.

Jeff Fischer: If you need any money within 3 years, then you want a more balanced portfolio and you can't depend so much on just a few large positions., the closer you are to retirement, say.

Ellen Bowman: You guys are reminding me in 1997, when he graduated from high school, my father-in-law offered my husband, either, a new computer or $1,000 in Apple stock and he took the computer. That's why I did not marry a rich man.

Jeff Fischer: I think 95% of 18 year olds would take-

Ellen Bowman: Would have taken ... I know.

JP Bennett: I don't know. I was in to stocks at that point in my life. I may ...

Ellen Bowman: Yeah, JP is maybe a different one. I think that's going to wrap it up for Pro, for our Pro questions. Thank you to everybody who submitted one. We hope this new format has been good for you. We will let you know how it goes and stay tuned. Thanks.

JP Bennett: Thank you.

Jeff Fischer: Thank you.

Ellen Bowman: Cool.

Pro Catch-Up Trades: Feb. 8, 2016

Published Feb 8, 2016 at 4:10PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually. Lately worth highlighting:

- **Skyworks Solutions** (NASDAQ: SWKS), buy up to 3.2% in stock; or "sell to open" March 11, 2016, puts or later (at your choosing), if you wish to target a lower buy price

Continue building your portfolio with our Buys, including these highlighted today:

- **O'Reilly Automotive** (NASDAQ: ORLY), start by buying half of our 5.1% position (earnings are out Feb. 10)
- **Verisk** (NASDAQ: VRSK), buy up to 2% in stock
- **Visa** (NYSE: V), buy up to 2.4% in stock

And our most recent short:

- **Deere & Company** (NYSE: DE), short 2% per our recent recommendation

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How Fellow Fools Approach This Market

Published Feb 8, 2016 at 12:03PM

Pro Completed Trades

- **World Acceptance** (Nasdaq: WRLD): We closed all of our remaining short shares, booking a 48.7% gain.
- **Deere & Co.** (NYSE: DE): We sold short a 2% position (600 shares for us).

Dear *Pro* member:

A few hundred Fools gathered in San Diego last week for a *Motley Fool One* member event. We shared two evenings and one full day together, meeting one another, talking about investing, hearing from speakers, panels, and fellow Fools, and enjoying food and drink outdoors in the kind, temperate climate. Much of the city around us was new, built in the last 10 years, and the buildings seemed to reflect the promise this young country still has.

However, the main event took place on Friday, when the stock market offered anything but promise. Technology shares were hit especially hard last week (and so far this morning, too), with **LinkedIn** (NYSE: LNKD) tumbling a hard-to-believe 44% Friday during our member event. The stock is popular across the Fool, a substantial holding in a few services, so many members felt the hit, but nobody seemed excessively downbeat about it, or about the market as a whole. Sure, many questions from the audience centered on volatility, macro concerns, and the market's near-term future, but panic or unhappiness were not a part of the day.

That must be because Fools know to only invest in stocks using cash that isn't needed for at least three years. We didn't plan to sell anything on Friday (or today), so the current prices are -- technically speaking -- not even relevant to us. Plus, we know investing returns are finite. A rising stock market steals from future returns, and a falling market promises higher future returns. This is inevitable math.

Still, it's never fun to watch the value of your portfolio decline sharply. We pointed out in last week's Memo that the average stock entered a bear market last year, falling more than 20% (that's the amount someone decided to define as a bear market). For many stocks, last year's drop is starting to look like a walk through the park, with declines pushing 40% or more this year. As for the indexes, the bear lurks there, too. As of 10:15 a.m. ET this morning, the Nasdaq was down 18.7% from its June 2015 high; the S&P 500 was off 13.6% from its May 2015 high; and -- representing small caps -- the **iShares Russell 2000** (NYSEMKT: IWM) is down a big 25.9% from its high. The vast majority of these losses happened since January 1. *Pro*, meanwhile, is down 10% this year (as of this morning). We're now at a point where we're considering significant new hedges to keep that number from getting worse, if we think that's likely. We don't want to decline so much that earning a net profit over the next year or eighteen months would seem unlikely.

So, what's going on?

The stock market follows a story, and the narrative has changed. For several years, the narrative was a recovering economy, growing employment, and higher earnings -- all supported by federal stimulus. Today's narrative is slowing growth in China; struggling emerging markets; tumbling commodity prices; stressed energy-company debt, with defaults growing; zero Fed stimulus in the U.S.; and new doubts that interest rates will increase much this year. (They probably won't. That would mean banks including **Wells Fargo** (NYSE: WFC) and brokerage houses including **TD Ameritrade** (NASDAQ: AMTD) will need to wait longer for the benefit of higher rates.) Today's edgy narrative points to the possibility of a recession, which is when GDP shrinks compared to the previous year. Should we fear a recession? In many cases, they're so shallow that they're ending just as we begin to realize they've started.

Meanwhile, stocks will ultimately trade on future earnings expectations. Once the narrative of fear begins to calm, and people have more faith in earnings estimates, stock valuation should become a focus again. If stocks get cheap enough, valuation *becomes* the new narrative. We've seen that happen how many times in a sharply falling market? Most of them (2001 and 2009 were exceptions, because earnings were so miserable). Trading at 1,847 this morning, the S&P 500 is valued at 14.4 times "normalized" 2016 earnings estimates of about $128 per share. That's right at the long-term median, according to Multpl.com. Half the time stocks trade lower, half the time they trade higher. So, if earnings hug that estimate, we're in historically neutral pricing territory. That should come as a small relief. (If everyone wanted to suddenly focus on earnings as reported, or GAAP rather than non-GAAP, then the index is at a 20 P/E multiple. So, accounting is one of the bigger risks we may face. But I don't believe Wall Street will move to ignore non-GAAP anytime soon.)

What are members doing in this environment? Rather than worrying too much about the unknowable (the big macro, for example), many in San Diego said they're buying more shares, targeting companies they know and love. Those who aren't adding more cash are simply riding it out, with no plans to sell in the near future anyway. Some are reassessing and selling positions they don't feel strongly enough about (falling markets often bring out the critic in us, which is not a bad thing when done rationally). One kind member didn't care to speak about today's market at all. He only wanted to share that writing options has allowed him and his wife to give to charity every year -- they give the options proceeds away. This was a touching conversation.

The bottom line for *you* is as personal as it was for every person in San Diego: What are you investing toward? What makes you comfortable? Is your portfolio behaving the way you hoped during yet another 20% market decline? (They happen roughly every four years on average.) Here in *Pro*, we've always said that having portfolio flexibility is key. If your portfolio is stuck now and your hands are completely tied because stocks fell, then you might grow more anxious than you otherwise would be. If you have portfolio flexibility to take positive actions in this negative market, then you can look at the current situation constructively and act accordingly.

That's where we are in *Pro* today. We have cash to consider new long investments at much lower prices, either stocks or calls. We can also consider offsetting new buys with more shorts. And we've been waiting for acceleration in the decline to set up a new hedge, because -- assuming we're using a put ratio spread -- pricing initially gets better, not worse, when setting up certain option spreads on a price decline. Or we could just keep waiting: Cash affords us that, too. But given our goals, that's not going to be our only action.

The point is to maintain portfolio flexibility. Assuming you care at all about near-term volatility, and taking action during it, you must keep some flexibility in your portfolio construction. Our long-term stock holdings have a rolling three-year outlook; but almost all of our other work (hedges, writing options, shorting) is about generating returns over much shorter periods of time. That's what we have the flexibility to do right now, whenever compelled. And that puts us in a better place. Please visit the Memo Musings board to share any thoughts or questions.

We'll be in touch soon!

-- Jeff (TMFFischer)

Broadridge Continues to Produce Steady Growth

Published Feb 5, 2016 at 4:40PM

Pro's Take: BR Q2-2016 Earnings

Broadridge Financial Solutions (NYSE: BR)

Q2-2016

Quarterly recurring fee revenue growth (Y-o-Y): +7.8% to $399 million

TTM Operating profit margin*: +158 bps Y-o-Y to 22.5%

Closed Sales** growth (Y-o-Y): -1% to $48.5 million

Quarterly EPS growth (Y-o-Y): +18.4% to $0.33

**Operating profit / Fee revenue. This removes the impact of distribution revenue, which is a pass-through cost and distorts the true economics of the business.*

***Closed sales were previously described by the Company as recurring revenue closed sales.*

Quarter Quick Take

Broadridge continued its solid sales momentum in Fiscal Q2-2016, posting reported revenue growth of 11% in the quarter. The company disclosed sales activity with some key clients in Fiscal Q2 2016 (including Barclays and Societe Generale) and generated $48.5 million in closed sales in the period, down 1% compared to last year's record quarter during Q2-2015. Margin pressure has started to alleviate, and the company reported lower SG&A expenses and higher operating margins as a result. The company continues to pursue its tuck-in acquisition strategy, acquiring QED Financial Systems for about $15 million in November, and acquisitions contributed 5% to growth in recurring fee revenue in the quarter.

The company has produced a solid start to Fiscal 2016, but they have a bit of work to do to meet or exceed management's guidance for the full year: recurring fee revenue growth of 10%-12% (YTD +8.8%), Closed Sales of $120-$160 million (YTD $66.5 million), earnings-per-share growth of 7-12% (YTD +13%), and free cash flows of $350 million-$400 million (YTD $5.7 million, though typically the vast majority of the company's free cash flow is produced in the seasonally strong Fiscal Q4).

Updated guidance: Buy (no change)

Recommended Allocation: 4.7%

Fair Value estimate: $56 (up from $54)

Current Price: $51.49

Based on management's guidance, at $51.49 per share, the stock is priced at about 18x projected 2016 cash flow and 20x projected 2016 GAAP EPS. Both of those metrics have declined a bit compared to the the past few quarters, providing investors an opportunity to buy shares at a bit of a better value compared to before the recent market correction. Broadridge still features stable cash flows, a steady growth profile, an increasingly strong competitive positioning, and higher margins to show for it. **Our Fair Value estimate increases to $56 per share (from $54), and Broadridge remains a Buy on our scorecard.** Now is as good a time as any to establish a position or fill out your allocation.

Our Thesis

Broadridge has a near monopoly in proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record and sound capital allocation policies make Broadridge a sturdy rock to build the Pro portfolio upon. We expect modest growth in fee revenue, slight operating leverage, plenty of free cash flow and a growing stream of dividends to help achieve North Star-like returns.

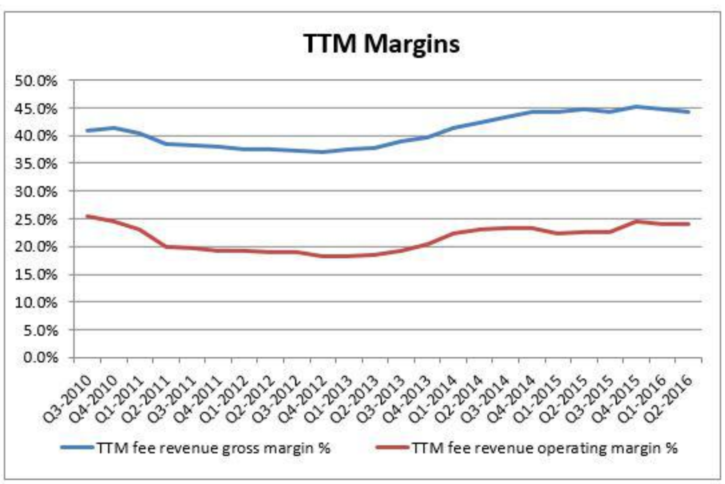
The Most Important Things

1) ***Closed Sales:*** This metric (previously disclosed as "recurring revenue closed sales") represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%+). Tracking closed sales gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

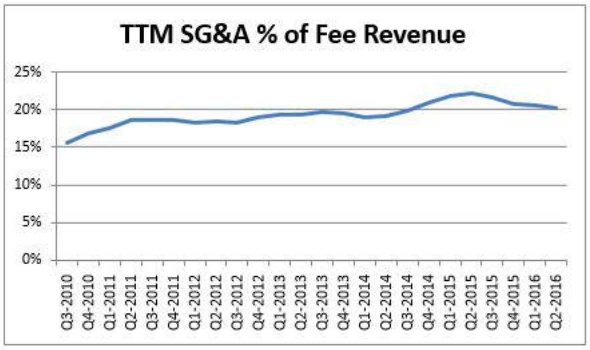
Lately, closed sales have taken a bit of a breather compared to Fiscal 2015, but that's because 2015 was an extraordinary year for closed sales. For the first half of Fiscal 2016 (Q1 and Q2), the company reported $66.5 million in closed sales, which is down about -19% compared to the first half of Fiscal 2015 ($81 million). But when we account for the difficult year-over-year comparison by comparing to the first half of Fiscal 2014, the two-year absolute growth comes in at 75% (a 32% CAGR). The three-year growth rate is similarly strong at 95% growth (a 25% CAGR).

The run-rate for closed sales for Fiscal 2016 implies full-year closed sales of $133 million, which is well within the company's guidance range of $120-$160 million. Additionally, Fiscal Q4 is historically the strongest sales quarter of the year, so the company may have room to reach the high end of its guidance for closed sales by the end of the year.

2) ***Fee Revenue Margin Performance:*** In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers) we prefer to look at trailing twelve months (TTM) margins to smooth out quarterly fluctuations. TTM fee revenue gross margins came in at 44.4% (down slightly from 44.7% a year ago), and TTM fee revenue operating margins came in at 24.1% (up from from 22.5% a year ago):



TTM gross margins declined slightly due to foreign currency fluctuations and revenue mix, and TTM operating margins expanded due to SG&A expense leverage as the company's SG&A expenses as a percent of revenue declined, offsetting the smaller impact of the gross margin decline. SG&A expenses have started to moderate after a year of increased spending (i.e. investments in the sales force to generate higher sales):



If the company can continue its outstanding performance in closed sales and healthy sales growth, then there may be room for continued margin expansion.

3) ***Capital Allocation:*** Although Broadridge is a slow grower, it generates a lot of cash and has low reinvestment needs. Management has a very clear plan to put that cash to work: it targets a 45% payout ratio, and it plans on using incremental debt capacity to pick up the pace of acquisitions (targeting $400-$600 million between FY2015-FY2017) and share repurchases.

On the dividend front, the company has paid out $1.14 per share on a TTM basis, good for a 48% payout ratio and about a 2.2% yield on the current price. On the acquisition front, the company is making good progress -- the company has spent $216 million on five acquisitions (Direxxis, Wilmington Trust, Thomson Reuters Fiduciary Services and Competitive Intelligence unit, TwoFour Systems, and most recently QED Financial Systems) since its capital stewardship priority update in December 2014. The company has an excellent acquisition track record (a 20%-plus IRR since Fiscal 2007), and they expect acquisitions to account for about 2% of growth in recurring fee revenue out to Fiscal 2017. In the first half of Fiscal 2016, the company has exceeded that goal -- acquisitions accounted for 4% growth in recurring fee revenue in Q1 and 5% growth in Q2.

As for share repurchases, the company has bought back $10.6 million in shares at an average price of about $53 per share in the first half of Fiscal 2016. As for debt, the company has added $66 million in debt during the first half of Fiscal 2016 via their revolving credit facility, which has a variable interest rate of LIBOR plus 112.5 basis points (and may be refinanced into a longer-term instrument at some point in the future). This is consistent with the company's longer-term strategy to run the business at a debt-EBITDAR ratio of 2:1 (based on my calculations the company is currently at about 1.7:1).

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

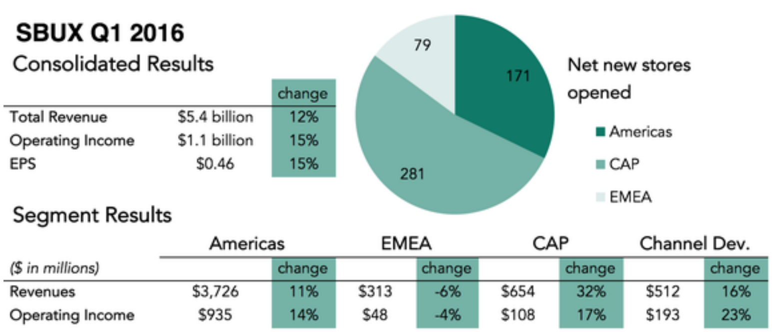
Pro Can Help

- **Questions?** Bring them over to the Broadridge discussion board.

Starbucks Roasts the Competition

Published Feb 5, 2016 at 4:40PM

It's good to be the king -- or, in this case, the siren. **Starbucks**' (NASDAQ: SBUX) dominance was on full display once again this past quarter, as the company reported impressive comparable-store sales (comps) and saw its loyalty program gain further steam.



Source: Company filings

Updated Guidance and Valuation

Updated guidance: Buy (no change)

Recommended allocation: 3.8%

Fair-value estimate: $49 (up from $47)

Current Multiples

Multiple	Trailing	NTM

P/S	4.1x	3.7x
P/E	34x	28x
EV/EBITDA	17.1x	14.8x
P/FCF	31x	

Source: S&P Capital IQ

Investment Thesis

Starbucks offers a unique blend of sales drivers (domestic and international growth, food and beverage innovation, and channel development, just to name a few) and cost-reduction opportunities (payment innovation, European restructuring, expansion of consumer product margins). We believe the coffee is just a gateway for the company to repeatedly sell customers an experience rooted in comfort, quality, health, community, and conscience. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand into new products, new platforms, new times of day, and new brands. We expect new store openings across the globe to strengthen the company's brand and cost-based competitive advantages and improve profitability over time.

With a company as large as Starbucks, you might think there isn't much more room for growth. But you'd be wrong. As laid out during the company's most recent Biennial Investor Day presentation, management believes that within five years, Starbucks will increase its store base to more than 30,000 global locations (up from 23,571 today), achieve $30 billion in annual revenue (up from $19.7 billion TTM), and double its annual operating income. Given the global strength of the Starbucks brand, we believe that this is definitely possible.

Results

Comparable-Store Sales

	Q1 2016			**Q1 2015**		
	Sales Growth	Change in Transactions	Change in Ticket	Sales Growth	Change in Transactions	Change in Ticket
Consolidated	8%	4%	4%	5%	2%	3%
Americas	9%	4%	5%	5%	2%	3%
CAP	5%	4%	2%	8%	8%	0%
EMEA	1%	1%	0%	4%	3%	1%

Source: Company filings

Americas

Starbucks has never been stronger here in the United States. Its Americas segment — which consists of the U.S. (81% of stores), Canada, and Latin America — delivered 11% revenue growth for the quarter and 14% operating income growth as margins expanded despite greater investment in partnerships and digital products. And Starbucks' comps continue to be some of the best in the industry. In fact, in the following chart you can see how Dunkin' Donuts U.S. comp has failed to eclipse either component of Starbucks Americas comp over the past few quarters.

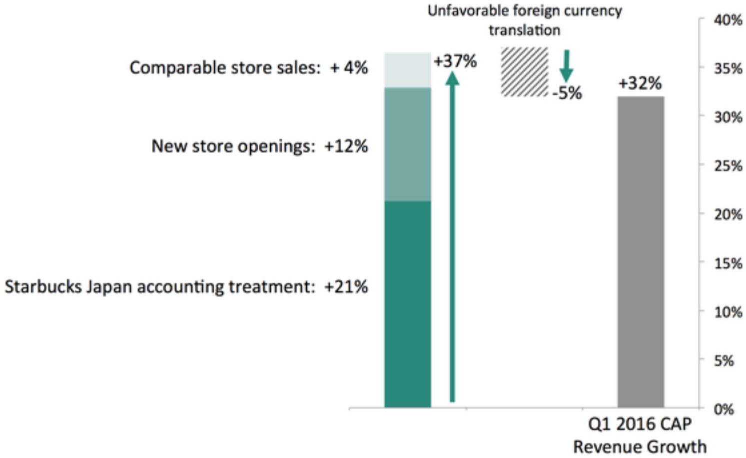
Source: Company filings, Bloomberg; calendar year quarters

The company's aggressive push into food initially elected a lukewarm reception from many, and while the world may not be making its dinner dates at Starbucks just yet, it's hard to argue with the results from an investing perspective. Food revenue was responsible for a third of the 9% U.S. comp as revenue rose 20% this quarter. Beverage innovation and Teavana handcrafted tea beverages also contributed 1 point each to the U.S. comp figure. And while it may seem that Starbucks is ubiquitous, new stores here in the Americas continue to deliver record profitability and return on investment.

With respect to the company's growing digital initiative, over 21% of all transaction in the U.S. were paid using the company's mobile apps, up from 13% last year. And more than 1 million customers in the U.S. used Mobile Order & Pay in December. Just as My Starbucks Rewards (MSR) members are more valuable to the company because they spend more, we expect that Mobile Order & Pay users will become increasingly valuable as the increased speed and convenience ultimately brings about more transactions. Not only that, but as the company perfects the app, we will likely see an increased rate in upselling ("do I want an extra shot in my Americano? Eh, why not?") and food attach ("How did the app know I love chocolate chip cookies? Heck yeah, I could go for one right now!"). At the end of the quarter, Starbucks was enjoying a run rate of 6 million Mobile Order & Pay transactions per month, a number we expect to continue to grow at an impressive clip.

China/Asia Pacific

Revenue for China and the Asia Pacific region, or CAP, was up 32% thanks to strong performance in the region and the change in ownership structure of Starbucks Japan. (Starbucks reported results for these stores using the equity method for five out of the 13 weeks in first-quarter 2015.) Here's what the breakdown of CAP's revenue growth looks like:



Source: Company filings

Also noteworthy: This quarter was the first to include the 1,009 recently acquired Starbucks Japan stores in its comps. This was likely at least partially responsible for the slowdown, as historical filings prior to the acquisition reveal that the transaction growth for this store base was well below what the CAP segment as a whole has historically achieved.

Similar to Apple CEO Tim Cook, Starbucks' CEO Howard Schultz has historically been dismissive when questioned about the impact of a China slowdown. This quarter was no different as Schultz affirmed once again that China is a huge opportunity for Starbucks, and while we share his long-term optimism to a large extent, this is something we'll continue to keep an eye on.

Europe, the Middle East, and Africa

The results this quarter for Starbucks' European, Middle Eastern, and African (EMEA) operations were very much in line with what we've come to expect, save for the negative impact of the tragic Paris terrorist attacks. The shift toward licensing stores continues to pay dividends, as the company reported that the licensed stores delivered comparable-store sales growth in the high single digits. As of the end of this quarter, 71% of EMEA stores are licensed.

Channel Development

Despite posting strong results last year, revenue and operating income for Starbucks' channel development division increased by 16% and 23%, respectively. With upwards of 80% of coffee occasions taking place outside of coffee shops, Starbucks' emphasis on expanding this business is well placed. It's the category leader in premium coffee and K-Cups, but Starbucks nonetheless continues to grow faster than these two markets and take additional share. In fact, the company recently surpassed Kraft to occupy the No. 2 spot in all coffee.

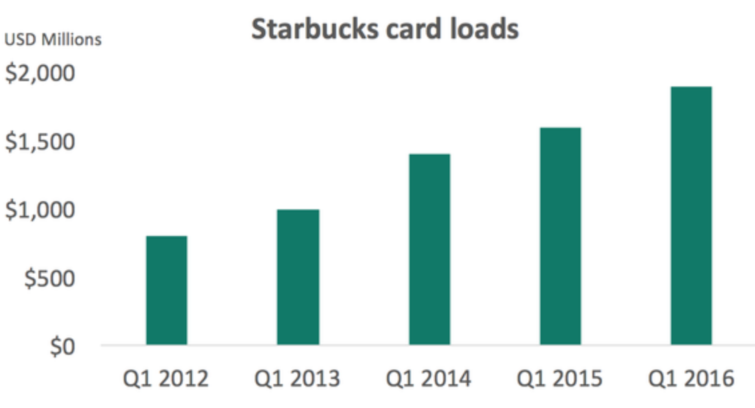
Product	Q1 Sales Growth	U.S. Market Share	Change
Premium Roast & Ground	10%	17.2%	+ 160 basis points
K-Cups	20%	27.3%	+ 100 basis points

Source: Company Q1 2016 earning call

This is primarily a U.S. growth story for now, but this won't be the case for too much longer. Starbucks reaffirmed once again that it is on track to begin distributing ready-to-drink beverages in China and Latin America later this year.

Loyalty

It's become an annual tradition in its own right for interested parties to respond in awe at the number of gift cards Starbucks manages to sell each holiday season. Clearly, I must have done something wrong in 2015, as I wasn't a recipient of the gift of choice for many Americans -- 1 in 6 U.S. adults received a Starbucks gift card, up from 1 in 7 last year. But as we all know, the true value of these cards to Starbucks far exceeds the amount loaded on them (which was up 19% this year to $1.9 billion). These gift cards are often the gateway drug, so to speak, that pulls consumers into the MSR ecosystem. MSR members were up 23% this holiday quarter to 11.1 million members.



Source: Company earnings calls

***Pro*'s Take**

Our cautious stance with Starbucks over the past year was almost exclusively because of concerns regarding the stock's valuation. The company continues to fire on all cylinders, and over the past few years, the market has justifiably responded by attaching a premium valuation to the stock. And when concerns over a stock's valuation turn out to be warranted, there are only two ways for the issue to be resolved -- either the stock price treads water until the company can grow into the valuation (i.e., valuation multiples drop if the stock price remains unchanged while the company continues to grow), or the stock price drops.

Prior to today's sell-off, the stock's decline since the October highs pretty much mirrored the decline in the S&P 500. So one could argue that the decline in the stock was more the result of luck than a reflection of our concerns over valuation. Either way, you won't hear us complaining. Before the decline, we were of the opinion that despite the generous valuation, Starbucks still had the potential to deliver North Star-matching returns. And with each percentage point decline in the stock price, our confidence only grows. Today makes for an attractive entry point for any member who has yet to mirror *Pro*'s 3.8% allocation.

Facebook's Cash Flow Surges, Driven by Richer Content

Published Feb 4, 2016 at 4:48PM

This earnings analysis comes to us courtesy of our friends at Motley Fool Million Dollar Portfolio.

Once again, **Facebook** (NASDAQ: FB) is crushing it, and the world's largest social network has plenty of reasons to celebrate the 12 candles on its birthday cake.

Revenue increased 52% year-over-year to an incredible $5.8 billion, driven largely by mobile advertising. Mobile now accounts for 80% of Facebook's total ad revenue, up significantly from 23% just three years ago.

	4Q 2012	**4Q 2013**	**4Q 2014**	**4Q 2015**
Total Advertising Revenue ($billion)	$1.3	$2.3	$3.6	$5.6
Ad Revenue from Mobile (%)	23%	53%	69%	80%

Alongside the revenue growth, Facebook reported its user base has now reached 1.59 billion (which is approaching the combined population of North America, South America, and Europe).

One of the most exciting metrics for investors was that Facebook's operating margin shot up to 44% — which is significantly higher than it was last quarter (32%) or a year ago (29%).

Facebook's rising margins are representative of their ability to simultaneously offer richer content and place additional ad impressions. Let's dig deeper into each of those.

Content Is King ... and Richer

Facebook's foundation has always been to get the world connected, which CEO Mark Zuckerberg took a chance to reemphasize on the conference call:

> *Our strategy here is to deliver better, more engaging experiences for our community, and to give people better tools for sharing different types of content with the different groups of people that they care about.*

Those engaging experiences and better tools are rapidly evolving. In its earliest days, Facebook offered advertisers the ability to place text-based, sponsored links. But the social network king now offers richer forms of content, such as pictures and videos. Richer content increases user engagement — which could improve conversion rates.

Examples of Text, Picture, and Video-based advertisements from The Motley Fool on Facebook.

Many companies are now building entire ad campaigns on Facebook. COO Sheryl Sandberg shared an example of how **Microsoft** (NASDAQ: MSFT) is offering richer content to a new audience:

> *To reach a large mobile audience for the launch of Halo 5, Microsoft Xbox used video optimized for Facebook and Instagram. They understood that people watch video differently and mobile News Feed than on TV. So they created videos to capture audience attention in the first 3 seconds even without sound. They drove over 380 million impressions and 49 million video views in key markets and increased purchase intent by 10 points in the U.S.*

Of course, Facebook doesn't give away that higher engagement for free. Richer content advertisements command higher prices, which has helped (along with the shift from PC to mobile) to drive Facebook's effective price per advertisement steadily higher.

	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Total Revenue ($b)	$ 2.0	$ 2.6	$ 2.5	$ 2.9	$ 3.2	$ 3.9	$ 3.5	$ 4.0	$ 4.5	$ 5.8
Revenue Annual Growth Rate (%)	60%	63%	72%	61%	60%	49%	42%	39%	41%	52%
Effective Price per Advertisement (% increase/decrease)	42%	92%	118%	123%	274%	335%	285%	220%	61%	21%
Total ad impressions (% increase/decrease)	16%	-8%	-17%	-25%	-56%	-65%	-62%	-55%	-10%	29%

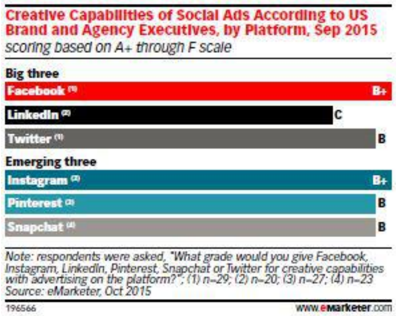
Numbers are as reported in Facebook's quarterly results.

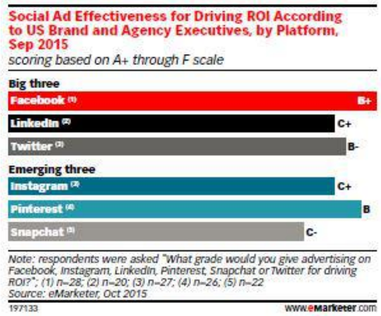
As content continues to evolve along the awesomeness continuum (from text-based to virtual reality, and all points in-between), Facebook will capture higher prices per ad impression.

Total Impressions ... Now More Impressive

The improvement in advertising content also brings another benefit to Facebook. In addition to carrying higher prices, cooler ads also improve the user experience. No one likes unrelated, annoying pop-up ads (which perhaps is what led to the demise of MySpace). But users have welcome the unobtrusive, creative ads offered on Facebook.

Senior ad buyers in the US consider Facebook industry-leading in its creative capabilities and its ability to drive return-on-investment (ROI). This gives companies the ability to craft marketing messages that are creative and effective, but also profitable.





Source: eMarketer

Having the largest pool of users and giving advertisers a plethora of options to choose from makes Facebook hard to displace by competitors.

But let's look a little closer at that chart, which shows the trade-off between quality and volume:

	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15
Total Revenue ($b)	$ 2.0	$ 2.6	$ 2.5	$ 2.9	$ 3.2	$ 3.9	$ 3.5	$ 4.0	$ 4.5	$ 5.8
Revenue Annual Growth Rate (%)	60%	63%	72%	61%	60%	49%	42%	39%	41%	52%
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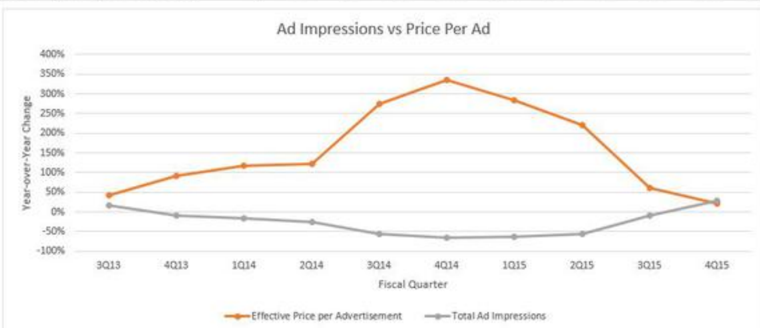


As we alluded to above, Facebook has spent most of the past two years transitioning to targeted mobile advertising. That meant fewer ads that could fit on a smaller screen, but they were the right ads at the right time. The total number of advertisements decreased (the gray line), but the price per ad skyrocketed (the orange).

But now, Facebook gets to have its cake and eat it too.

For the first time in more than two years, the number of ad impressions and the price per ad *both increased* over the previous year. Facebook isn't opening the floodgates and overwhelming users with too many advertisements (i.e. impressions shoot up while the prices falls). Instead, they're offering richer advertising content, which its 1.59 billion users is accepting without negatively impacting their experience.

In other words, Facebook is breaking down the long-established advertising trade-off of price vs volume. They're now getting both.

The impact of this is the rocketing cash flow. If the company can continue to incorporate its products like Instagram and Oculus into the daily routine of billions of people, we should expect operating margins to continue to march even higher.

The Bigger Picture ... Keeps Getting Bigger

With respect to that last line, it seems that every quarter, I find myself asking the same question: *How big can Facebook really get?* Said another way, how much advertising can we handle before it starts getting annoying?

The short answer appears to be that Facebook still has a zillion different ways it can monetize its platform (note that 'zillion' is not a technical term, and is purposely imprecise).

Ad load refers to the amounts of content that is sponsored by other parties. It's essentially the percentage of paid advertisements that appear on your site.

According to a study conducted in October, the ad load on Facebook's News Feed is only 3%. 27% comes from organic page posts (small businesses trying to link you to their Facebook pages), and 70% comes from your friends posting about politics, sharing pictures of their toddlers, or linking to cat videos (your mileage may vary).

Facebook is still only monetizing a fraction of what it could. The company has 2.5 million active advertisers and 50 million small business pages, but this is just a sliver of its users. Messenger now has more than 800 millon people. WhatsApp has more than a billion. Neither of those services is effectively being monetized today. We're just getting started.

Facebook also seems to always keep the bigger picture in mind. In their forward guidance, CFO David Wehner mentioned the company will be tripling its investment in its long-term areas of focus — including global connectivity, Oculus, and artificial intelligence. We expect each of those will translate into additional ad impressions and higher associated prices in the future.

The Foolish Bottom Line

Facebook still has plenty of room left to run. Even with 1.5 billion users and a $300 billion valuation, their global focus and highly scalable business model offer significant potential upside for investors.

Get all our updates on Facebook:

[Send me updates on FB]

Don't Fear the Great iPhone Slowdown

Published Feb 4, 2016 at 4:22PM

Revenue growth at **Apple** (NASDAQ: AAPL) for the first quarter of its fiscal 2016 was its slowest since the third quarter of 2013, a result of currency headwinds and a slowdown in iPhone unit sales. Perhaps in anticipation of this, Apple saw its market cap fall by about $227 billion over the past six and a half months. To put this in perspective, that's greater than the existing market capitalization of every position in *Pro* save for Facebook and Wells Fargo. We don't profess to have any insight into if or when the market's opinion on Apple will reverse course, but we do believe that Apple remains meaningfully undervalued at today's price.

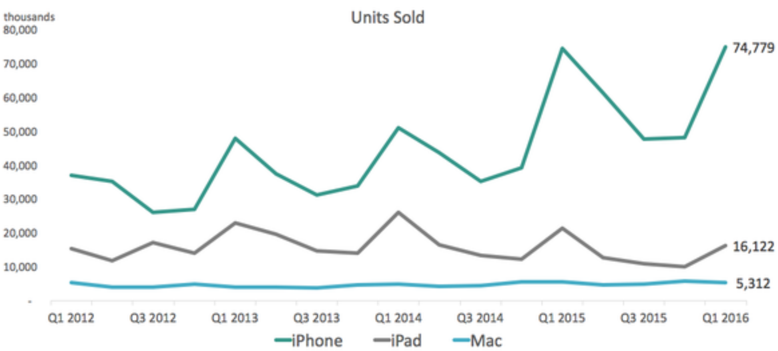
Updated Guidance

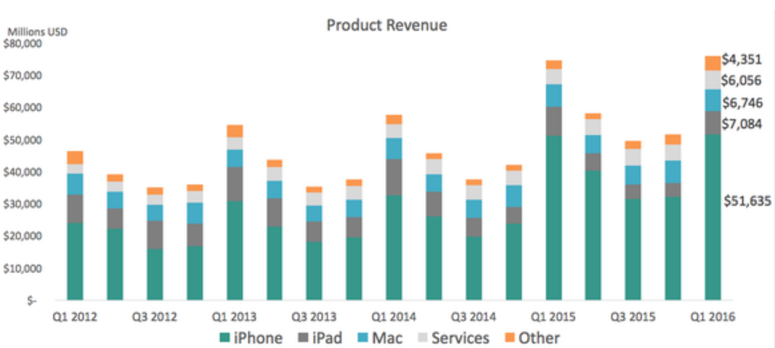
Updated guidance: Buy (no change)

Recommended allocation: 3.7%

Fair-value estimate: $122

The Results

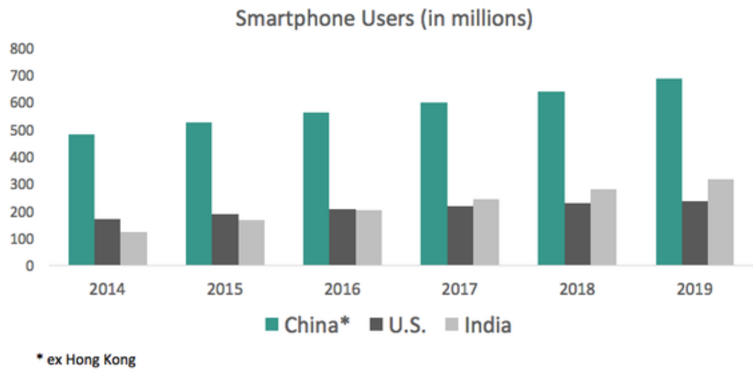




Source: Company filings

The great iPhone slowdown of 2016 has begun, with unit sales increasing by just 0.4 percent. But when you consider that the 46 percent growth Apple reported this time last year was its largest in quite some time, these results are far from the abject disaster that some media outlets have made them out to be. Our expectations for the rest of 2016 remain muted, but the market opportunities [we discussed last quarter] didn't just disappear into thin air. The company should have plenty of opportunities to increase its iPhone user base as long as management continues to execute.

When talking about iPhone sales in emerging markets, most of the time we like to focus on China -- deservedly so, given that it's quickly become one of Apple's largest end markets. But there are plenty of other opportunities. iPhone sales increased 76 percent this past quarter in India, a market that will soon become the second largest in the world for smartphones despite penetration that lags both the U.S. and China by a significant margin.



Source: eMarketer, 2015

And as Cook noted during the earnings call, the demographics appear favorable for a company like Apple:

> The population in India is incredibly young. The median age there is 27. I think of the China age being young at 36, 37. And so 27 is unbelievable. Almost half the people in India are below 25. And so I see the sort of the demographics there also being incredibly great for a consumer brand and for people that really want the best products. And as you know, we've been putting increasingly more energy in India. India revenue for us in Q1 was up 38%. We also had currency issues in India as everybody else did. Constant currency growth was 48%. And so it's a very rapidly expanding country. And I think the government there is very interested in economic reforms and so forth that I think all speak to a really good business environment for the future.

Moving on to the iPad: With 85 percent of tablets in the U.S. priced higher than $200, it wasn't all that surprising that the iPad continued to suffer from the same malaise that has befallen the entire industry. IDC estimated that the worldwide tablet market contracted yet again for the quarter, and even though the research firm referred to the iPad Pro as "the clear winner this season," overall iPad unit sales fell 25 percent (versus an estimated 13.7 percent decline for the worldwide market).

With the Mac, the situation is essentially reversed. Compared with the iPad, the Mac has a much smaller share of its market, meaning it has consistently been able to outperform the overall market for PCs. This quarter proved no different, but though unit sales outpaced the market as a whole, sales fell for the first time in nine quarters.

With respect to services, the usually secretive Apple actually decided to increase the amount of information it made available to investors. Management said this move was in response to investor demand, but from our perspective it seems likely that the company was at least partially motivated by a desire to change the market's habit of myopically focusing on iPhone unit sales. The added color was certainly appreciated, given the sheer size of the business. Excluding the gain from a patent infringement dispute, services revenue rose 15 percent this quarter to $5.5 billion, which is only $300 million less than fellow *Pro* constituent Facebook reported this earnings season. App Store revenue was up 27 percent thanks in part to a 18 percent increase in the number of customers, while Apple Pay continues to gain traction — the company saw a significant acceleration in usage in the second half of 2015, with a growth rate 10 times that of the first half of the year.

Pro's Take

In many ways, Apple will likely end up a victim of its own success in 2016. This is because we are now lapping the monstrous results delivered by the iPhone 6 and 6 Plus. Prior to 2015, the growth rate for iPhone unit sales had fallen for five consecutive years, but strong demand for the newly introduced larger version in 2015 resulted in an almost tripling of unit sales growth, to 37 percent. We're left to speculate on what type of products Ive & Co are currently dreaming up out in Cupertino, but we believe Apple's CapEx is currently being put to good use. And with an active installed base of more than 1 billion devices, Apple's services business appears poised to continue to deliver impressive results going forward despite muted iPhone sales in 2016.

Today's price makes for an attractive entry point by our estimate, as there appears to be a lot of pessimism currently baked into the stock price. We're lowering our fair-value estimate slightly to $122; that decision is based on foreign currency headwinds and potential struggles in certain end markets because of challenging macroeconomic conditions. However, shares firmly **remain a Buy** with a 3.7 percent allocation.

Close Your Short on World Acceptance

Published Feb 3, 2016 at 10:26AM

How You Participate

- **Trade:** Buy to close your remaining short **World Acceptance Corp.** (NASDAQ: WRLD) shares.
- **Allocation:** After previously closing half of our position, we are currently short 350 shares, or 0.4% of the portfolio.
- **Price Guidance:** ***Use a limit order*** and today aim to pay less than $28.50.
- **Price (as of 10:18 a.m.):** $27.02

What We're Thinking

Today, we're recommending that *Pro* members take advantage of World Acceptance's weak third-quarter results (and the stock's subsequent 23% haircut) to close out any remaining positions in the stock. After taking some time to re-survey the landscape, we believe the risk/reward ratio now favors ending this position.

Next month will mark the two-year anniversary of the Civil Investigative Demand (CID) that World received from the Consumer Financial Protection Bureau, or CFPB. When we opened our position in World last July after a long time on the sidelines, it was because we believed the CFPB was likely to reach a decision by the end of 2015. Most aspects of our thesis are playing out as planned, but it appears the CFPB is being even more cautious than we expected. This has been a headwind for our short case for sure, but we can't say that we disagree with the CFPB's measured approach; the outcome of this investigation could very well set a precedent for the entire industry, so it's critical for the agency to bring its A game right from the get-go.

At this point, though, even if the CFPB does try to bring the hammer down, it looks increasingly likely that this will turn into a long, drawn-out slugfest. World's financial results have been weak since we opened our position, in part because management has been making changes to its business practices over the past few quarters. For example, in the most recent quarter, the company disclosed that it has ceased all field calls to its customers' residences and workplaces, as well as stopping all phone calls to the latter. This move was likely in response to a compliance bulletin released by the CFPB this past December, but we can't tell for certain whether management is responding to direct requests from the CFPB or just taking preemptive measures in an attempt to reduce the odds of a death sentence. Either way, it appears as though World is making a more concerted effort to comply with the letter of the law, though not necessarily the spirit.

Neither of those factors would necessarily mean much if not for the high cost of borrowing shares to short. We've been fortunate that the fee for shorting World has come down some since we closed half of our position back in October, but it is still a meaningful headwind at 11.5 percent. The longer it takes for the CFPB to reach a decision, and the longer World drags out the process, the more these fees eat away at our returns.

It's all too easy to focus on how a stock will respond if your thesis plays out perfectly, but as investors, it's critical we remain cognizant of what might happen if things *don't* go our way. Let's consider a scenario in which the CFPB's actions bring World's earnings down by 75%, but World doesn't end up defaulting on its bonds. In this scenario, which is still quite bearish, the company would be trading for a little over 9 times earnings at today's price. That valuation is near the low end of the range of the past 15 years, if you exclude the financial crisis and the past eight months. With a current market cap of $245 million and a valuation of 2.3 times earnings and 0.68 times book value, it appears as though the market is currently betting that the CFPB will go for World's jugular.

We may agree with this sentiment, but we also believe the math simply doesn't favor maintaining our short as is. At 0.4 percent of our portfolio, our remaining position won't have much of an impact even if our thesis continues to play out as planned. The stock could fall by another 50% tomorrow, and it would affect our portfolio by just 21 basis points -- the same as if Facebook rose by 3.1%. We'd need to short additional shares to make this a meaningful contribution to the portfolio, and while we may be comfortable doing so at some point in the future, that time is not now.

How It Fits Into *Pro*

Shorting World has definitely been a wild ride, but our position has delivered from both a market-hedging and an absolute-return perspective. The stock has fallen 55% since we first issued the trade alert, and it's underperformed the market since the very beginning. Given World's small market cap and low trading volume, *Pro* was unable to get the same pricing as most members, but our position was nonetheless a resounding success. Closing it will increase our portfolio's long exposure, but this will be more than offset by our latest short. And, as always, we are constantly on the lookout for additional shorts to add to the portfolio.

Alternative Trades

- **If you set up a synthetic short, or simply bought puts:** We recommend that members who followed us using an alternative trade close their position as well.

Pro Can Help

- Want to talk about World? Join us on the discussion board, where easy payments are available.

Parexel Continues to Penetrate the Growing Pharmaceutical Development Market

Published Feb 2, 2016 at 3:21PM

Pro's Take: PRXL Q2-2016 Earnings

Parexel International (NASDAQ: PRXL)

Quarter Quick Take

Parexel reported a solid quarter in Fiscal Q2-2016. The company continued to win its fair share of new business, with a net book-to-bill ratio (an indicator of future business) of 1.24. Reported revenue growth came in at 3.9%, though it was affected by currency headwinds (revenue growth was 5.6% on a constant currency basis) and slower backlog conversion due to project mix. This slower backlog conversion may continue to pressure reported revenue growth in the near-term (and backlog growth should continue to outpace reported revenue growth), but as projects mature and milestones are met, revenue growth should eventually return to our 8-12% longer-term expectations.

In the meanwhile, the company's Margin Acceleration Program is beginning to show its benefits as improved labor productivity and cost management led to improved gross and operating margins. This margin expansion will likely continue as restructuring costs roll off and should be sustainable as the the company continues to improve its reported revenue growth over time. Margin expansion and share buybacks led to 4.9% GAAP EPS growth and 30.4% non-GAAP EPS growth (which excludes acquisition- and restructuring-related costs). The company's Fiscal Q3-2016 guidance implies 4% reported revenue growth and 29% EPS growth at the mid-point, and Q3 GAAP and non-GAAP earnings are projected to converge as one-time costs roll off.

....

Q2-2016

Sales growth: +3.8% (+5.6% in constant currency)

Gross profit margin: +143 bps Y-o-Y to 35.9%

Operating profit margin: -42 bps Y-o-Y to 10.5%, (+196 bps Y-o-Y to 12.5% excluding non-recurring restructuring costs)

GAAP EPS growth: +4.9% Y-o-Y

non-GAAP EPS growth: +30.4% Y-o-Y

....

Guidance Update

The business continues to track well against our thesis despite a competitive operating environment and currency headwinds. Parexel's largest business segment, Clinical Research Services (CRS), continues to win new business and prove that the biopharma industry is moving toward a strategic outsourcing partnership model. The company's Consulting and Informatics segments are growing more modestly, but longer-term margin expansion in these smaller segments is helping companywide results. **Our Fair Value estimate increases to $65 per share** (from $63) due to an update of biopharma R&D spending data and rolling forward our model. However, we may need to reexamine our assumptions for the company's Parexel Informatics (PI) segment if growth continues to remain below our expectations.

Updated guidance: Buy (no change)

Recommended Allocation: 3.4%

Fair Value estimate: $65 (up from $63)

Current Price: $62.78

Our Fair Value estimate implies a TTM P/E ratio of 26.4x (GAAP) and 21.2x (non-GAAP) and a TTM EV/EBITDA ratio of 13.9x. It also implies a forward P/E ratio of 21.2x (GAAP) and 18.6x (non-GAAP) based on expected Fiscal 2016 earnings. We believe these multiples to be reasonable given the company's growing industry, strong competitive position, ongoing margin expansion, strong ROICs (lately ~20% and increasing), and expected long-term earnings-per-share growth of 15-20%.

Members lacking a (full) position can feel comfortable initiating or adding to their position at current pricing (with shares about 3% below our Fair Value estimate). However, it may be wise to be patient in establishing a full allocation; Parexel shares have been volatile-customer concentration, lumpy quarterly results, and a high multiple make this likely to continue-so we may look to be opportunistic with options to generate current income.

Our Thesis

Because of its reputation, global reach, and technology prowess, Parexel International will win its fair share of the growing pharmaceutical development market. In addition, we expect the proportion of R&D dollars outsourced to contract research organizations to grow as large biopharma companies adopt the strategic partnership model and smaller biotechs become responsible for more drug discovery. Finally, as new business wins mature, the true earnings power and margin potential of the company's business will shine through.

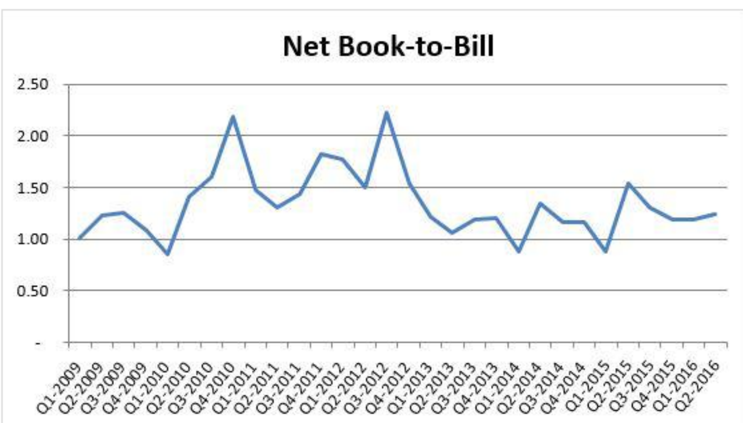
The Most Important Things

1) ***Penetration and Backlog*****:** Penetration refers to the proportion of biopharma R&D dollars that go to CROs versus being used in-house for development and increased penetration provides evidence that the biopharma/CRO partnership model is proving out. We can compare the growth of the biopharma industry R&D spend to the growth in Parexel's backlog to determine whether the CRO industry is experiencing continued outsourcing penetration.

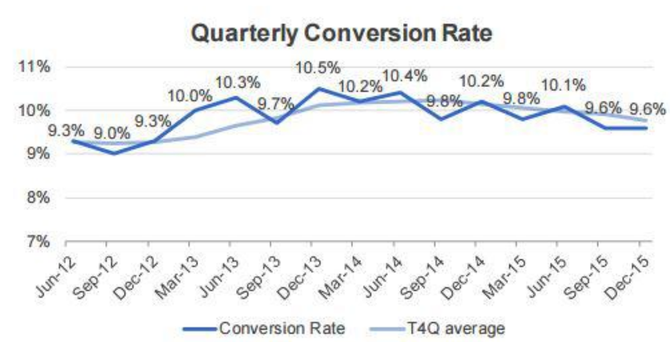
According to the most recently released industry data, biopharma R&D spend is expected to be flat from 2014 to 2015, and it is expected to grow at a 2-3% CAGR from 2014 to 2020. For comparison, Parexel's backlog growth in calendar year 2015 was 7.5% (9.6% in constant currency), so we can see that Parexel's backlog is growing at a rate higher than that of biopharma R&D spending. This indicates that the CRO industry -- and Parexel in particular -- is continuing to experience increased penetration of biopharma R&D spending.

We also monitor backlog trends to ensure Parexel is sufficiently adding future business – backlog that converts to sales usually represents ~80% of the sales in any given quarter, so strong backlog growth suggests strong future sales growth. In Fiscal Q2-2016, backlog grew 0.9% sequentially and 7.4% year over year (2.3% and 8.9% in constant currency).

The company's net book-to-bill ratio increased sequentially to a decent 1.24 due to solid increases in net new business. A net book-to-bill ratio above 1 indicates that the company is booking more business than they are recognizing, suggesting that future sales growth should increase:



However, revenue growth is affected not just by backlog growth, but also by backlog conversion (percentage of backlog recognized as revenue for a given quarter) and backlog cancellation (percentage of backlog that was cancelled in a given quarter). The cancellation rate in the quarter came in at 4.1%, well within historical norms of about 2.5%-7% (the cancellation rate fluctuates depending on the type of drugs and the type of studies being conducted). But lately, the company's conversion ratio has been lower than historical norms and it is trending lower (higher is better):



Management noted that this is due to increasingly stringent regulatory requirements and increasingly complex clinical trials, leading to projects that remain in the start-up stage longer than in the past. This may also be due to a shift in focus from biopharma companies into more complicated therapeutic areas (such as oncology, immune-mediated disorders, and rare diseases).

This decline in the conversion rate may persist in the near term, and it led Parexel to reduce its 2016 revenue guidance, but it may also actually bode well for Parexel in the future due to their global scale, data advantage (an example of which includes this recent data-sharing partnership with Optum), and expertise relative to smaller CRO peers, specifically in late-stage (Phase III and IV) studies. This should help Parexel (and the other "top tier", publicly traded CROs) win an increasing share of biopharma R&D outsourcing relative to smaller, less capable peers.

In any event, as the CRO industry picks up a higher percentage of biopharma R&D spending, we should see revenue and backlog growth outpace the expected 2-3% growth in R&D spending. With 5.6% growth in constant-currency service revenue and 8.9% growth in constant-currency backlog, that's what we're seeing, which provides evidence that our thesis continues to progress.

2) ***Margin Performance***: Company gross margin increased +289 bps sequentially and increased +143 bps year-over-year. The company's largest segment (representing 79% of total revenue), Parexel Clinical Research Services (CRS) increased gross margins to 32.6% from 30.4% a year ago, the highest it's been since 2011. The gross margin improvements were driven by strong cost management and savings from the company's previously announced Margin Acceleration Program. While the company is continuing to book restructuring charges due to this program, those charges should roll off by the end of the year and the company's gross margin should continue to improve.

As for the other two business segments, Parexel Consulting (PC) gross margins increased to 49.8% (up from 48.2% a year ago). The PC segment represents 8% of companywide revenue. Parexel Informatics (PI) gross margins declined to 46.7% (down from 50.5% a year ago). The PI segment represents 14% of companywide revenue.

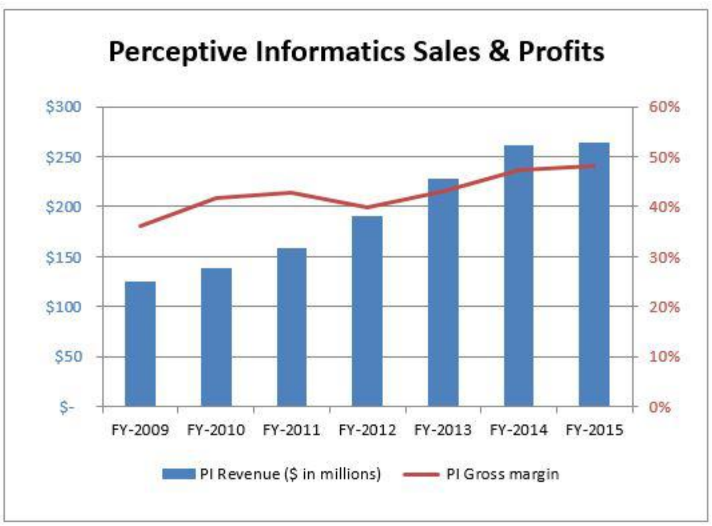
The main contributors to the gross margin expansion in the PC segment were favorable business mix and improved utilization. PI's gross margin declined primarily due to project mix.

3) ***PI Business Trends:***

Technology is a core competence for Parexel. The company's PI segment is the lifeblood of innovation for transforming the traditional clinical trials process into a more efficient, more effective, technology-driven one. We want to see this business perform well to ensure it remains a competitive differentiator for Parexel and helps it win business in its CRS and PC segments. Now reaching scale, we also expect PI to exhibit operating leverage and become a more meaningful portion of profits.

Revenue growth in this segment was solid at +7.8% year-over-year in constant currency, coming in at $70 million in revenue for the quarter. However, I've been disappointed by the trajectory of this segment of the business, as average revenue growth over the past 6 quarters has been just +1.5% compared to 17.5% average growth between 2011-2014.

Gross margins have declined since peaking at 50.5% in Fiscal Q2-2015 a year ago, and our expectations have been that this segment would continue to grow strongly and continue to improve its gross margins over time. Over the past year and a half, that hasn't happened (as you can see in the graph below):



I've mentioned in the past that our valuation expects PI to grow revenue by 10% annually and achieve 55% gross margins by 2020. These expectations were a significant aspect to our initial thesis, so I'll be watching this segment closely over the next few quarters to see if we need to ratchet down our expectations.

What We Think Now

Helping pharmaceutical companies get drug candidates to market, Parexel is poised to benefit as those companies gradually outsource more of this process to select CRO partners who can perform the work better, faster, and cheaper. We also expect margin expansion as recent investments and restructuring pay off and continued growth of the Parexel Informatics technology segment.

Pro Can Help

- Post your questions on our Parexel International discussion board.

Pro Catch-Up Trades: Feb. 1, 2016

Published Feb 1, 2016 at 3:55PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually over time. Lately worth highlighting:

- **Gentex** (NASDAQ: GNTX), buy up to 2.5% in stock
- **Gilead Sciences** (NASDAQ: GILD), buy up to 3.2% in stock
- **Oracle** (NYSE: ORCL), buy up to 3.6% in stock
- **Skyworks Solutions** (NASDAQ: SWKS), buy up to 3.4% in stock, or "sell to open" May 2016 $62.50 puts (or others of your choosing) if you wish to target a lower buy price. These lately pay you $4.30 each, or 6.9% in 109 days. Sell one put for every 100 shares you would buy.

Build out your portfolio with our Buys, including:

- **AmTrust Financial** (NASDAQ: AFSI), buy up to 6.1% in stock; we usually suggest buying larger positions in halves or thirds over time.
- **Medtronic** (NYSE: MDT), buy up to 3.2% in stock
- **Papa John's International** (NASDAQ: PZZA), buy up to 2.4% in stock
- **TD Ameritrade** (NASDAQ: AMTD), buy up to 2.3% in stock
- **Verisk** (NASDAQ: VRSK), buy up to 2.1% in stock
- **Visa** (NYSE: V), buy up to 2.5% in stock

Members who still lack a stake in this more speculative call option can take note of this recommendation:

- **American Airlines** (NASDAQ: AAL): Buy to open 0.4% in January 2017 $35 calls

And finally, our recent short:

- **Deere** (NYSE: DE): Short 2% per our recent recommendation.

Pro's 2015 Results

Published Feb 1, 2016 at 11:38AM

Dear *Pro* Fools,

I hope you've started 2016 with a healthy heart, mind, body, and spirit -- and that you haven't let short-term market volatility ruin your day. True, the market had its worst start to a year *ever* -- but it declined more than this last summer, and last summer is already largely forgotten. Sharp declines are opportunities, so we're on the lookout for ways to capitalize while staying true to *Pro*'s approach and goals.

Before we leave 2015 entirely, let's review it. Reviews offer insights regarding how you invest, mistakes you make, and what you should do more of. Armed with information, you can adjust to keep improving your process.

2015 Redux: $178,000 Appreciation

Pro had a healthy 2015, helping maintain a strong three-year annualized return, per our goal. The *Pro* portfolio started 2015 worth $2.32 million, and ended up 7.5% at $2.49 million. On average, we were 67.7% net invested over the year, using cash, shorts and hedges to lower our exposure. Our returns were pleasing in a flat market, despite the last week of December knocking us below 10% and just beneath our North Star. We still succeeded overall while making very few new buys and avoiding new risks:

Investment	2015 Return	3-Year Annualized Return
Pro	7.5%	19.5%
North Star	8.2%	8.2%
S&P 500	1.4%	15.1%
MSCI World	(2.7%)	7.5%

Our gains were propelled by the likes of **Facebook** (NASDAQ: FB), up 34% last year on top of 2014's 43% gain; **O'Reilly Automotive** (NASDAQ: ORLY), up 32% on top of 2014's 50% jump; and **Broadridge Financial** (NYSE: BR), up a North-Star topping 16.3% before dividends.

Let's not forget our shorts. **Caesars Entertainment** (NASDAQ: CZR) started 2015 at $15.69 and ended the year at $7.89, losing almost 50%. Our trade alert to close half your position went out with the stock at less than $7. We issued a short on **World Acceptance** (NASDAQ: WRLD) on July 16 when the stock was above $60 and moved to close half last October for around a 43% gain, at $34. We still have half the short; lately, the stock is about $28. Our **CurrencyShares Euro Trust** (NYSEMKT: FXE) short fell 11% as the euro weakened sharply (as a reward, I went to Italy!). Finally, **Five Below** (NASDAQ: FIVE) started 2015 at $40.58, and we closed in December at $27.15, or 34% lower on the year. So, our shorts definitely helped.

Laggards for the year included our emerging-market ETF (I won't even name it here, but you know who you are, *DGS*) and **Tupperware** (NYSE: TUP), which started the year at $63; we sold for $55 at year-end. Meanwhile, **Valmont** (NYSE: VMI) started 2015 at $127 and closed at $106.02, down 16.5%; and **Oracle** (NYSE: ORCL) declined from $44.97 to $36.53, or 19%. Our small **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY) position also fell sharply as the market became choppy. Looking ahead, we continue to think in terms of rolling three-year periods as we assess the potential of our holdings.

Net Realized Gains: $94,751

We booked $94,751 in net realized gains last year, 71% of it long-term. This total gain is nearly identical to the realized gain we booked in 2014. Last year, just more than half of our realized profit came from selling a small partial stake in **AmTrust Financial** (NASDAQ: AFSI) and about half of our position in **Papa John's International** (NASDAQ: PZZA); selling **American International Group** (NYSE: AIG) and covering part of Caesars and World Acceptance also added sizable gains. Our biggest realized loss last year was Tupperware.

Adding Stocks in a Bear Market?

It's worth pausing to highlight that 2015 was a bear market for most stocks. Consider that 70% of stocks in the Russell 2000 fell 20% or more last year; 49% of stocks in the S&P 500 and 68% of Nasdaq Composite stocks did the same. That's a bear market. In fact, the median stock in the S&P 500 fell 22% in 2015. Lest you think it was only *suspect* stocks that fell, the reality is that most new stocks recommended by the Fool's monthly newsletters were down, because most stocks were falling, period. The numbers below reflect results through today.

Service	2015 Picks Up	2015 Picks Down
Stock Advisor	8	17
Rule Breakers	2	22
Hidden Gems	3	20
Income Investor	2	10

Nobody knew the year would unfold this way, but we have the luxury in *Pro* of *not* acting unless greatly compelled to. Seeing little to jump on, we only issued two new stock buys last year -- **Visa** (NYSE: V) and **Verisk** (NASDAQ: VRSK), both in the green today. Meanwhile, last year's one new call purchase on **American Airlines** (NASDAQ: AAL) is down sharply, with leverage making it really ugly. The point is: In some years, making money on new stock buys is nearly impossible. Some years, *most everything goes down*. If we continue to buy carefully, we might avoid buying too many new stocks during those years. We'll ideally buy after prices look more attractive.

But as a long/short portfolio, we never get a free pass! Why weren't we *shorting* more stocks last year? We should have. We definitely tried, but passed on many companies for various reasons, to the detriment of our returns.

Hedges: +$811 (up from a $34,673 loss in 2014)

Last year, we set up three put ratio spread hedges on the **SPDR S&P 500 ETF** (NYSEMKT: SPY). With a flat market overall, none paid off big, but we kept $811 in credits in the end. Getting paid to hedge is nice. The reason we collect that cash is that we agreed to buy SPY at a much lower price if it falls.

At the start of 2015, I said we wanted to greatly lower our costs for and losses from hedging, and we sure did. We had an $800 gain, compared with a $34,673 loss on our hedges in 2014, when we directly shorted SPY and other indexes. We continue to use put ratio spreads to hedge cheaply; if the underlying index falls enough that we're obligated to buy shares, we plan to buy calls instead, and keep most of our cash for other positions.

Dividends: $32,304 (up from $25,387 in 2014)

We received more than $32,000 in dividends last year, up 27% from 2014 and adding to our cash to the tune of 18% of our yearly gains. Our largest absolute payers included **The Buckle** (NYSE: BKE), **AmTrust** (NASDAQ: AFSI), Tupperware, Broadridge, and **Wells Fargo** (NYSE: WFC). With two of those now sold, our dividends are on pace to be a bit lower this year -- we'll see if new buys rectify that. Dividends added 1.4% to the portfolio's 2015 starting value.

Option Income: $16,774 (up from $7,581 in 2014)

We earned more than $16,774 in net income writing options in 2015, which was 121% more than the $7,491 earned in 2014. We wanted to improve upon 2014, and we did, but we would still prefer to earn *greater* annual option income. These net option proceeds amounted to 0.72% of the portfolio's 2015 starting value. Add this to the 1.4% in dividend yield we received, and our income hit a respectable 2.12% of the portfolio while we averaged 68% net long.

Most of our option income was earned by writing strangles on **Expeditors International** (NASDAQ: EXPD) and puts on **Gentex** (NASDAQ: GNTX), **Live Nation** (NYSE: LYV), and **Wells Fargo** (NYSE: WFC). We didn't buy any new shares via puts last year. (This income excludes the $800 or so we made writing put ratio spreads on SPY.)

Active, But With Low Turnover

We issued 43 trade alerts in *Pro* last year, or 3.6 per month. That's right in the middle of our usual trade volume: We had 34 trade alerts in 2014, 42 in 2013, and 55 in 2012. It's key that we don't sacrifice returns for activity.

We want to keep stock turnover low, so as in years prior, much of last year's activity was related to options and hedges. Still, we closed a handful of stock positions, namely The Buckle, Tupperware, AIG, and the two partial sales already mentioned. We ended the year with 21 core stock investments, and among those, our top 10 positions make up 42.3% of the portfolio.

Improving Further

So, Fools, we start 2016 hoping to again improve how we think and act when it comes to our investing, and thus improve our long-term results. Expecting a choppy market, this year we want to keep earning income, continue to add shorts and hedges, and jump on favorite stocks (or long call options) when we see buying opportunities. Many of you customize your Foolish portfolios; consider studying your results from 2015 to see where you did well and what can be improved. Post comments or questions on the Memo Musings board -- and thank you for being a *Pro* Fool with us! We enjoyed last year, and we look forward to another memorable year with you in 2016.

— Jeff (TMFFischer)

MasterCard Finishes Strong in 2015

Published Jan 29, 2016 at 6:19PM

MasterCard (NYSE: MA) finished a challenging 2015 with a solid quarter fourth quarter. The company managed to blow past analysts' earnings estimates by $0.10, thanks in part to disciplined cost controls and a lower than expected effective tax rate for the quarter. Currency headwinds and low gasoline prices remain a drag on gross dollar volume growth, but those effects should dissipate once we get into the second half of the year and begin to anniversary some of the largest FX and commodity price swings of 2015. Globally, the U.S. and European markets have maintained the strongest transaction volume and outlook going forward, while Brazil and China are both seeing slowing growth.

For the full year, MasterCard posted an 8% increase in net revenue and 18% EPS growth, ending management's 2013 to 2015 forecast period at a 19.2% compound annual growth (CAGR) rate for EPS. That result is just shy of the company's 20% EPS CAGR goal, but it's not bad considering the number would have been two percentage points higher without the recent currency fluctuations.

Growth Initiatives

MasterCard continues to gain acceptance of its MasterPass mobile wallet solution, adding 13 new markets this quarter and bringing the total to 29 new markets for the year. The company is also investing heavily in security and fraud prevention analytics to create additional value for customers. Merchants are moving ahead with the mandated transition to EMV (PIN and chip) card terminals, which means that future fraudster will begin focusing more on Internet transactions – similar to what happened in Europe when it made the same EMV transition a few years back. As a result, MasterCard has seen growing demand for Safety Net, its real-time fraud monitoring and cyberattack prevention solution.

MasterCard is also making progress with the roll out of its network in China, though everyone is still waiting for final regulations to be issued by the central government. At this point, the company is working with both Bank of China and ICBM (two of the five state-sponsored banks) to launch a mobile payment solution using MasterCard's tokenization technology and other cloud-based solutions. In the past year, MasterCard has also partnered with a number of other Chinese institutions to create a total of 32 single-branded programs.

Outlook For 2016

Management reiterated their recently announced 2016 to 2018 goals for low double-digit net revenue growth, mid-teens EPS growth, and a 50% annual operating margin --but they also acknowledged that the first quarter would start off at the low end of that range. After spending heavily on acquisitions in 2015, the company expects to focus its investment in the coming year on expanding in China, capturing a bigger share of the global digital wallet, and improving its portfolio of service solutions. The company also has $4.2 billion remaining under the current authorization which amounts to about 4% of MasterCard's current market capitalization.

Foolish Bottom Line

Overall, we're happy with how MasterCard has navigated a tough operating environment in 2015 and we remain confident in the company's competitive position and the long-term growth prospects of the business. However, MasterCard's shares are still richly valued, trading at over 26-times trailing free cash flow (FCF). Considering management's soft guidance for the upcoming quarter, continued uncertainty in China, and a volatile U.S. stock market, I'm leaving the current fair value estimate of $78 in place for the time being, which reflects a trailing FCF multiple of about 23-times. (For more detail on our thought process regarding MasterCard's valuation refer to my recent post on the MasterCard discussion board.)

Though shares are now trading considerably higher than our fair value following today's 6.4% jump, MasterCard retains a Buy rating because we believe long-term investors can still earn solid returns from this level.

Short Deere & Company

Published Jan 28, 2016 at 11:55AM

How You Participate

- **Trade:** Sell short **Deere & Company** (NYSE: DE)
- **Allocation:** 2%
- **Price guidance:** Use a limit order and initially aim to short above $75.50. As time goes on and prices change, newcomers may need to short below that.
- **Recent price:** $76.41
- **Availability at Interactive Brokers (Jan. 28):** 6 million shares
- **Current annualized shorting fee (Jan. 28):** 0.66%
- **Current dividend yield (Jan. 27):** 3.2% (we also need to pay this dividend while shorting shares)
- **Short interest (percentage of shares outstanding as of Jan. 29)**: 12.8% (per S&P Capital IQ)
- **Next earnings date**: Feb. 19

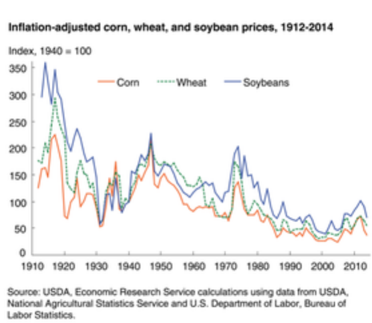
What We're Thinking

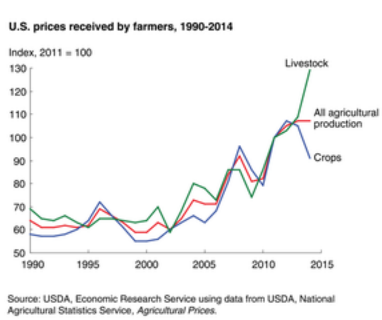
At its core, investing is about buying low and selling high. And perhaps nowhere is this more important than when investing in cyclical industries, including agriculture. Here in the U.S., the agricultural industry has seen spikes in demand thanks to wars, exports, and new uses such as biofuels, all of which have given rise to agricultural booms that eventually went bust.

We believe that the current cycle, which began in the early 2000s, resulted in an unsustainable increase in farm equipment sales. We also believe that this has positioned Deere & Company (henceforth John Deere), the world's leading manufacturer of agricultural and forestry equipment, to report disappointing results going forward as the industry works its way back toward equilibrium. We're shorting the stock, then, because we believe this gives us favorable odds of generating a North Star-like return. But this position is equally important to us as a macro hedge to reduce our portfolio's sensitivity to the strength of the global economy. We'd be less likely to short it without this added benefit.

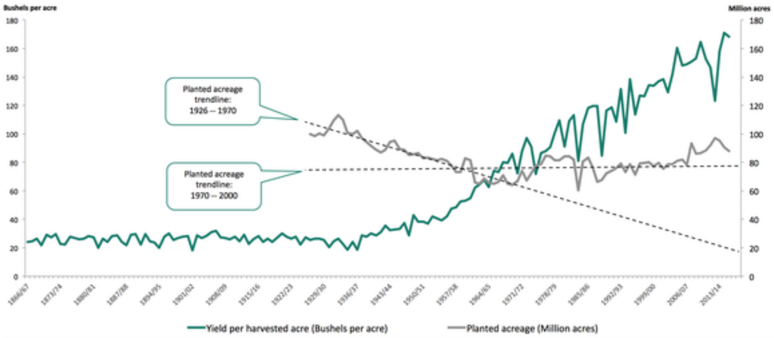
The Landscape

Things really started looking bright for U.S. farmers as a new agricultural cycle began in the early 2000s. An increase in crop demand, for human consumption as well as for biofuels, resulted in the longest sustained price rally since 1930. Farmers were also able to reap larger harvests thanks to productivity gains and (surprisingly) a greater number of planted acres for certain crops; before this, ever-better tech had long meant fewer necessary acres, a situation only somewhat stymied by agricultural exports (notice the difference in trendlines in the corn statistic chart).





U.S. Commodity Statistics: Corn (1966 -- 2015)



Source: United States Department of Agriculture

And as farm income rose, so did land values -- at a rates not seen since the 1970s in some places. For example, Iowa farmland saw double-digit growth every year from 2004 to 2012, save for a measly 2.2 percent decline in 2009. But it's called a cycle for a reason, and as the commodity adage goes, the best cure for high prices is high prices. The current landscape for farmers isn't nearly as rosy; it appears that prices will likely remain muted for the near future. The Federal Reserve Bank of Kansas City recently noted that production in the U.S. has expanded faster than consumption in the past few years. For example, U.S. inventories of corn, soybeans, and wheat have increased more than 100 percent since 2013, while use has increased just 7 percent over the same period. Globally, softening demand and growing competition (in part because of the strength of the U.S. dollar) are hurting U.S. farmers -- on average, exports decreased approximately 10 percent each month in 2015 compared with 2014.

With 10 consecutive quarters of farm-income and capital-spending declines in the Federal Reserve's 10th district, it appears as though we're firmly on the downswing of the latest cycle. So why have we decided to short John Deere now that the top has clearly passed? The key here is that our thesis isn't based upon commodity cycles in general, but rather a side effect of this one.

The Company

Unsurprisingly, the upswing of the most recent cycle was a great time to be a supplier to the industry. After falling 15% in fiscal 1999, John Deere's equipment sales rose 261% over the next 14 years. Net income bottomed out two years after revenue at -$64 million before rebounding to $3,537 million by the end of fiscal 2013. But since that peak, total revenue and net income are down 23.7 and 45.1%, respectively. In fourth-quarter 2014, management forecasted that its agricultural segment would bottom out in 2015, but ultimately had to backtrack as the weakness continued. In fact, the company now expects agricultural machinery sales in the U.S. and Canada to decline another 15 percent to 20 percent in 2016.

It's hard to say for certain whether 2016 will mark the bottom; we won't be surprised if it doesn't. But we do believe that the recent cycle has left investors with an artificially inflated perception of John Deere's true mid-cycle earnings power, as well as of the speed with which the agricultural machinery manufacturing industry will recover. That's because one of the things farmers did with their newfound wealth during this past cycle was, unsurprisingly, go out and spend it on farming equipment -- too much, we believe, at least based on farm productivity, planted acreage, and the lifespan of the active fleet.

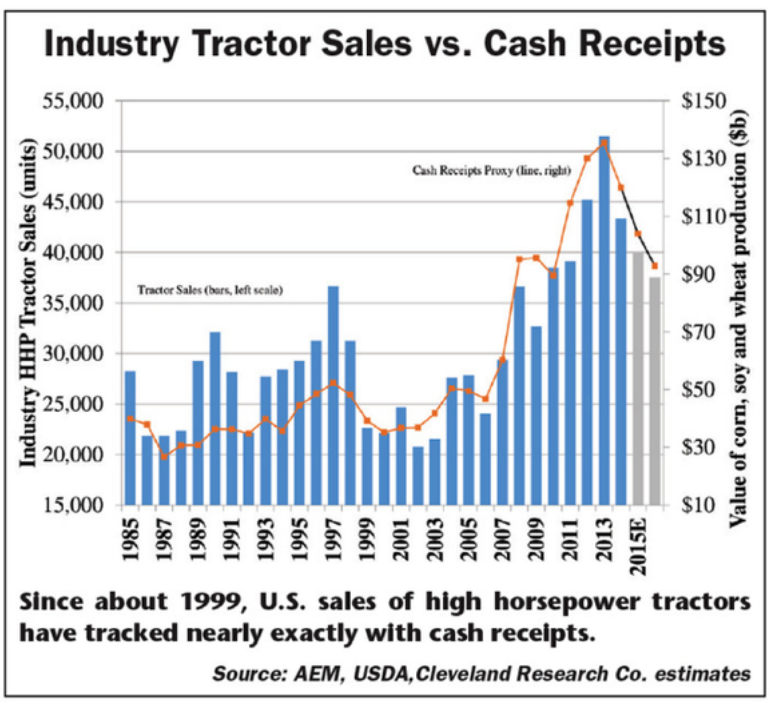
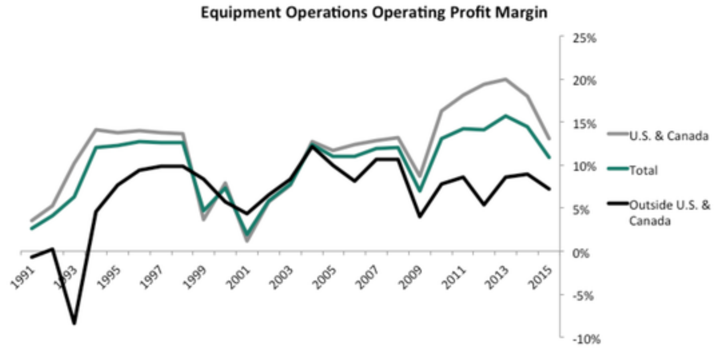


Image source: Farm Equipment Magazine, 2015

John Deere may have been able to snap right back after posting disappointing results in 2009, but this was likely thanks to an industrywide sales rebound. We believe the current environment more closely resembles what took place around the turn of the century, when industry sales stalled out for five years and compressed John Deere's equipment operating margins in the U.S. and Canada -- except results could be even worse this time around, because the rate of purchases near the end of the current cycle was unprecedented.



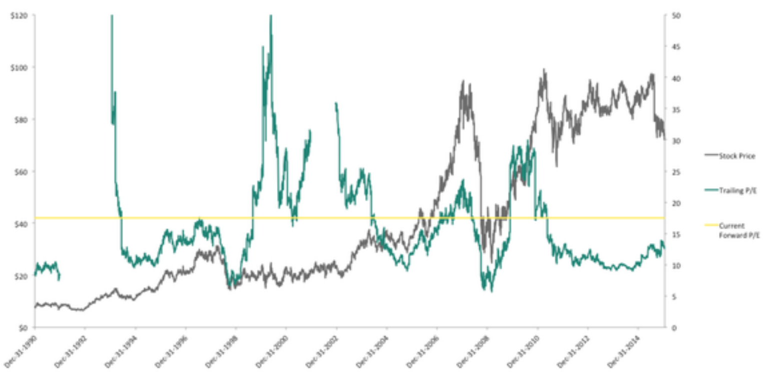
Source: Company filings

Margins are much higher than during prior weak points in the cycle, and the company has made additional investments to expand production capabilities in recent years. We believe margins are likely to compress further going forward, even though John Deere is admittedly a better-run business today. Operational leverage is a two-way street; it's a boon when times are good, but it increases the pain when times are bad.

You might think of John Deere as a manufacturer, and it is -- but it's a bank, too. Like houses, tractors are big-ticket items, often purchased using some type of loan. John Deere's loan book has steadily grown to its current level of almost $31 billion worth of financing receivables, of which agriculture and turf products account for 66 percent. This has been an excellent business for the company over the past 15 years, with operating margins steadily expanding to an all-time high of 37 percent in fiscal 2015. But there could be struggles going forward if conditions continue to worsen. The Federal Reserve Bank of Kansas City noted in its latest agricultural credit survey that repayment rates continue to decline as demand for renewals and extensions rises, but John Deere's provisions for credit losses as a percentage of the average owned portfolio are still well below the company's historical average.

The Valuation

As sell-side analysts on Wall Street have begun dialing in their expectations for the year, we calculate that John Deere currently trades for around 17.7 times 2016 earnings estimates.



Source: S&P Capital IQ

There's an old maxim that the time to buy stocks in cyclical companies is when they're expensive, because that's when they're actually cheap (because earnings are getting ready to bottom). You'd have to go back to 2011 to find the last time John Deere traded for today's trailing P/E multiple, but we don't think this is the bottom for the company's operating results or for its stock price. Moreover, that saying isn't an absolute; John Deere's stock looked "expensive" in 1998 and in the mid-'00s -- and this proved true both times, as the price was subsequently cut in half.

The stock has held up so well in spite of such poor results in part thanks to the massive buyback program begun in 2011, which has shrunk share count by nearly 15% over just the past two years. This has made for a frustrating short in recent years. But management's forecast for equipment operating cash flow to fall by 16% in 2016 will, by our estimates, result in an even larger decline in the company's previously stagnant free cash flow. Add in the fact that John Deere will need to pay upward of $800 million in order to maintain its dividend, and we believe management will likely taper the rate of repurchases in 2016. One adage that we do expect to play out: Massive buybacks are often the sign of a top in a cyclical industry, because that's when companies are flush with cash.

How This Fits Into *Pro*

The purpose of this position is distinctly twofold. It's intended to serve as:

1. a short with a favorable chance of generating profits and with company-specific headwinds to limit the likelihood of its moving sharply against us;
2. a low-cost macro hedge.

With respect to the latter, shorting John Deere will help reduce the impact on our portfolio of potential adverse developments in commodities, the U.S. economy, the global economy (both developed and emerging markets), and currency exchange rates. And with its large book of financing receivables, the stock also serves as a small counterbalance to our sizable exposure to the financial industry. John Deere certainly isn't buzzard-bait material, but we believe it fits our portfolio well given its current valuation and outsized exposure to the North American agricultural machinery manufacturing industry. Finally, shorting John Deere also helps partially hedge our long exposure in **Valmont Industries** (NYSE: VMI), a company that depends on farmers to drive sales in its irrigation business. That company is on Hold for review. With this hedge, we may be more likely to keep owning Valmont. But even if we ultimately sell it, we like the Deere short on its own merits for the portfolio and as a macro hedge.

Pro Can Help

- Having problems with the hydraulics on your 6175M row-crop tractor? Head over to the new Deere & Company message board.

Live Chat Update: We Want Your Questions

Published Jan 27, 2016 at 1:31PM

Fellow Fools,

We're doing something new with our live chats to kick off 2016. As longtime members know, we've held a live text chat every month for quite some time now. We've enjoyed these very much, finding them educational, funny, interesting, and a great way to get to know our fellow *Pro* Fools -- and we hope members have, too. But the format of those text chats was, shall we say, suboptimal, with many members finding it difficult to participate. So, to kick off 2016, we'd like to try an experiment: video chats.

Here's the idea: You send us the questions you'd like answered, addressing your emails to ProChatQuestions@fool.com. *Pro* team members answer them in a video a few days later; because we're able to see ahead of time which topics have a lot of interest, we know what's top of mind with our members and will be able to give one thorough answer for those topics instead of potentially seeing them repeated several times. More efficient all around!

Please send your questions -- either for or about the video chat -- to ProChatQuestions@fool.com. Any that arrive after midnight ET on Wednesday, Feb. 3, will be out of the running for this round. We'll film our answers soon after and will have the video available by the end of the next week.

And finally: This is a one-time trial to gauge interest in and the efficiency and usefulness of this format. If it works out, great! We look forward to this new way of connecting with members. If not, then we will figure out what comes next. No matter what, we value these regular check-ins with *Pro* Fools and will work to ensure they continue.

Best,

The *Motley Fool Pro* team

Pro Catch-Up Trades: Jan. 25, 2016

Published Jan 25, 2016 at 2:46PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are recommended for your long-term portfolio; buy into them gradually over time:

- **American Tower** (NYSE: AMT), buy 3.4% in stock
- **Gentex** (NASDAQ: GNTX), 2.5% in stock
- **Gilead Sciences** (NASDAQ: GILD), 3.6% in stock
- **Oracle** (NYSE: ORCL), 3.6% in stock
- **Wells Fargo** (NYSE: WFC), 3.5% in stock
- **Skyworks Solutions** (NASDAQ: SWKS), 3.4% in stock, or "sell to open" May 2016 $60 puts (or others of your choosing) if you wish to target a lower price. Sell one put for every 100 shares you would buy. Skyworks reports earnings this week.

Build out your portfolio with our Buys, including:

- **AmTrust Financial** (NASDAQ: AFSI), buy up to 6.1% in stock; we usually suggest buying larger positions in halves or thirds over time.
- **Apple** (NASDAQ: AAPL), up to 3.9% in stock. Note: Apple reports earnings Tuesday night.
- **Medtronic** (NYSE: MDT), 3.3% in stock
- **Papa John's International** (NASDAQ: PZZA), up to 2.5% in stock
- **Parexel International** (NASDAQ: PRXL), up to 3.5% in stock
- **TD Ameritrade** (NASDAQ: AMTD), 2.4% in stock
- **Verisk** (NASDAQ: VRSK), 2.1% in stock

And then there's our airline investment, down even though oil (its main cost) is plummeting. Members who lack a stake can take note of this recommendation:

- **American Airlines** (NASDAQ: AAL): Buy to open 0.4% in January 2017 $35 calls

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Pro Quality Checklist: TD Ameritrade

Published Jan 25, 2016 at 10:55AM

Dear *Pro* Fools,

So far, we've run four of the companies in our portfolio through our *Pro* quality checklist:

- **American Tower** (NYSE: AMT) – 7.5/8
- **Oracle** (NYSE: ORCL) – 8/8
- **O'Reilly Automotive** (NASDAQ: ORLY) – 6/8
- **Valmont Industries** (NYSE: VMI) – 5.5/8

Today, we resume our checklist series with a look at **TD Ameritrade** (NASDAQ: AMTD), our online discount broker and one of our smaller allocations at 2.5% (the 19th largest position in the port). TD Ameritrade reported its fiscal first-quarter 2016 earnings last week, and now we check out how the company stacks up against our eight criteria.

1. A Sustainable Competitive Advantage

Yes. TD Ameritrade benefits from competitive advantages in two areas – brand and switching costs. The company's brand advantage stems from its strong reputation in the industry, achieved via award-winning platforms and a focus on quality in customer service. TD Ameritrade has consistently been recognized by industry commentators for the excellence of its products and services for several years running.

Additionally, all brokers benefit from switching costs. The logistical difficulty of switching brokers (paperwork, cost-basis tracking, tax tracking, etc.) deters clients from switching to other brokers. Once you sign up and bring your assets to TD Ameritrade, you're more likely to stay on as a customer than you are to leave.

2. Pricing Power

Yes. At $9.99 per trade, TD Ameritrade has the highest nominal commission rate among the largest online discount brokers. On an average-commission-per-trade basis, TD Ameritrade is also consistently higher than its peers. The company has positioned itself competitively in such a way that it's able to charge premium prices thanks to its value-added offerings (multiple trading platforms, commission-free ETFs, educational/research tools, and high-quality customer service). Despite the highest commission rates in the industry, TD's new-account growth (lately around 5% annually) is higher than the industry average (1.7% to 2.2%).

3. Dependent Customer Base

Sort of. Investors need a brokerage firm in order to match buyers and sellers in an efficient manner. However, any brokerage firm would suffice (they don't *need* to use TD Ameritrade). Then again, switching costs prevent customers from changing to another broker quickly and easily. So I'll give TD Ameritrade half credit for this one.

4. Predictable Revenue

No. This one is cut-and-dried – TD Ameritrade's revenue sources are volatile and unpredictable. The company derives revenue from three main sources: transaction-based revenue (trading activity), spread-based revenue (interest revenue), and fee-based revenue (fees on investment products).

All three revenue sources vary widely depending on market conditions. Trading activity is dependent on market volatility, interest revenue varies with interest rates, and fee-based revenue fluctuates alongside the market. For this category, TD Ameritrade gets a definitive "no."

5. Growing Free Cash Flow With Compounding Returns

Sort of. TD Ameritrade generates outstanding cash flow thanks to its asset-light model. Since the fourth quarter of 2007, the company has generated $0.24 of free cash flow for every $1 of sales, a 24% free-cash-flow margin. Free cash flow is also growing nicely as the company attracts more assets and is set to increase further in the coming years as interest rates rise per the Federal Reserve's projections.

However, TD Ameritrade doesn't have a lot of places to reinvest that cash. The company spends relatively little on capital expenditures (an average of 4.4% of sales since fourth-quarter 2007) and hasn't made a significant acquisition since thinkorswim in 2009. As such, TD Ameritrade has shown a willingness to pay a special dividend with its excess cash – it did so in December of 2012 and 2013. While we're OK with this shareholder-friendly management practice, we ideally prefer businesses that have ample opportunities to reinvest their cash in new projects with high rates of return. TD Ameritrade does not fit that category, so it gets half credit for this one.

6. Financial Resilience

Yes. TD Ameritrade has a very resilient balance sheet, with strong free cash flow (24% of sales, as mentioned above) and a net cash position (more cash and investments than debt). Additionally, its unique relationship with TD Bank allows the company to earn a satisfactory return on its float (client cash) without taking undue risk. The company has high credit ratings with "low default risk" and "excellent debt service capacity."

7. Expanding Possibilities

Sort of. In the 1990s, the rise of the Internet led to a rapid growth of online brokerages that were able to drastically reduce the cost of executing trades. This had the effect of lowering commission rates across the industry and led to a wave of consolidation. TD Ameritrade was one of the prime beneficiaries of this trend.

However, this growth avenue has slowed and the industry has reached a level of maturity in terms of its technological disruption of traditional full-service stockbrokers. The next frontier for brokerage firms is to provide new services with an asset-based fee structure. TD Ameritrade has done this via its fee-based revenue stream, which includes company programs like Amerivest.

Fee-based revenue has grown strongly since 2009 as the company has significantly increased the amount of fee-based assets under management. This area continues to grow at a faster rate than the rest of the company, and management expects ongoing strong growth from this segment.

8. The Three C's of Management (Clarity, Consistency, Capability)

Yes. TD Ameritrade's management team has done an excellent job navigating the changing landscape of the brokerage industry. The company was an early leader in the shift to low-cost online brokers, and management anticipated the importance of derivatives and futures trading for the retail investor, as seen with the well-timed acquisition of thinkorswim in 2009. Management also communicates well with the investment community, providing satisfactory clarity, detail, and data granularity in their presentations. I view management's history of capital allocation favorably, as evidenced by its successful acquisition strategy in the 1990s and 2000s followed by a period of lesser investment and special dividends when there were fewer investment opportunities.

The *Pro* Bottom Line

In sum, TD Ameritrade scores a 5.5/8 on our *Pro* quality checklist. The company is somewhat of an odd duck compared with our ideal of a predictable compounding machine. But despite TD's relatively low score, there is only one category in which it scores an outright "no" (Predictable Revenue).

The reasons TD Ameritrade doesn't score more highly on our list include its revenue volatility and the fact that it's more mature than our typical company, with less opportunity to reinvest its strong cash flow. However, in owning TD Ameritrade, we gain exposure to a profitable, shareholder-friendly company that will benefit strongly in a rising rate environment. The company's relatively low allocation of 2.5% is an indicator of its niche role in our portfolio.

Fool on!

-- Billy (TMFBillyTheKid)

TD Ameritrade Is Set to Benefit From Higher Interest Rates

Published Jan 21, 2016 at 4:09PM

Pro's Take: AMTD Q1-2016 Earnings

TD Ameritrade (NASDAQ: AMTD)

Quarter Quick Take

In fiscal Q1-2016, TD Ameritrade demonstrated solid earnings despite muted trading activity. This company does a great job of focusing on what it is able to control and preparing for what it can not, a testament to the company's defensible competitive position and strong management. Net revenue was down -0.9% (due to lower trading activity), client assets grew by +3.4% (and net new assets by +10.5%), and earnings per share grew by +2%. The company has been able to pay a well-funded dividend and steadily increase its core earnings power, and the company's interest-sensitive earnings are set to grow this year now that the Federal Reserve implemented a 0.25% rate hike in December. If volatility remains high, asset gathering momentum continues, and the Federal Reserve implements additional rate hikes this year, we could see strong earnings growth -- the high end of management's 2016 earnings guidance represents 17% growth relative to full year 2015 earnings. And even if the most optimistic scenario doesn't unfold, the company continues to produce steady cash flow and strong profit margins and should grow steadily as it continues to gather client assets.

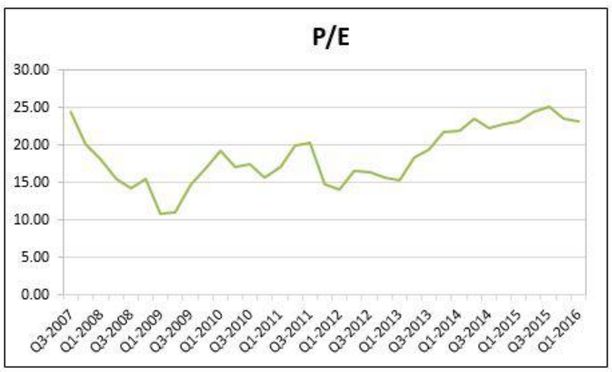
President and CEO Fred Tomczyk:

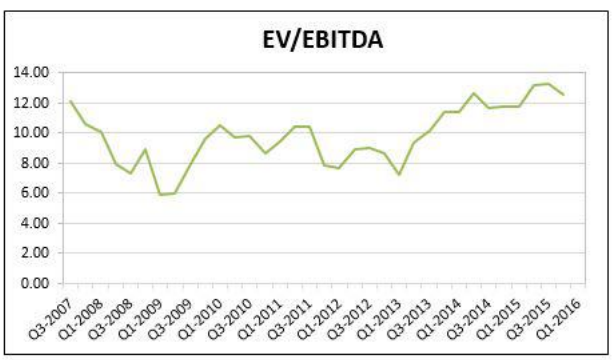
> "Our first quarter of fiscal 2016 was strong. Asset gathering is going particularly well, as we delivered our second best quarter ever – and a double-digit annualized growth rate. With the Federal Reserve raising interest rates for the first time in nine years and continued execution on our growth strategy going well, we are well-positioned for the current environment. We will continue along our path, investing thoughtfully in growth and building our long-term earnings power for the benefit of our clients, shareholders and associates."

Guidance Update

After incorporating this quarter's results into our model, our fair-value estimate remains unchanged at $35 per share. This valuation does assume a slow increase in interest rates over the next several years, so in the absence of that occurrence, the company may be challenged to grow earnings and the stock price may stagnate. Currently, the stock is about 28% below its 52-week highs as market volatility and investor speculation about the timing of future interest rate increases has led to increased volatility for companies that are interest rate-sensitive.

Given the recent market sell-off, TD Ameritrade's trailing twelve month (TTM) valuation multiples are lower than they've been in quite some time even as the company should finally start to realize some benefits from higher interest rates this year. At $27.95 per share, the company trades for 18.7x P/E and 9.9x EV/EBITDA. Here's what those multiples have looked like since 2007 (based on the quarterly average of the share price):





Updated guidance: Buy (no change)

Recommended Allocation: 2.5%

Fair-value estimate: $35 (no change)

Current price: $27.95

The Numbers

- Net revenue of $812 million (-0.9% year-over-year)
  - **Transaction-based**:
    - Funded accounts grew to 6.69 million (+4.9% year-over-year)
    - Trades per funded account of 4.13 (vs. 4.62 last quarter vs. 4.52 a year ago)
    - Average commissions and fees per trade of $11.90 (vs. $11.89 last quarter vs. $12.47 a year ago)
    - Totals up to:
      - 6,686,000 x 4.13 x $11.90 = **$328 million** in transaction-based revenue (-8.6% year-over-year)
  - **Spread-based**:

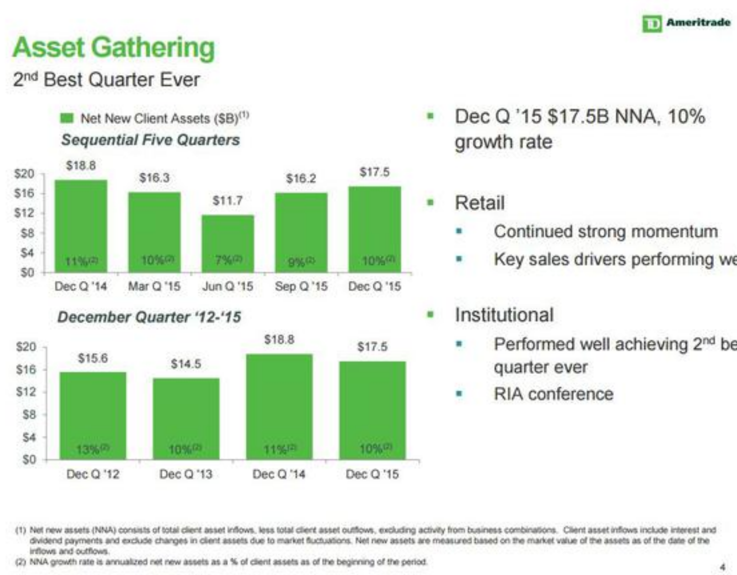
- Total spread-based revenue of **$381 million** (+3.5% year-over-year)
        - Average spread-based balance of $102.5 billion (+8.5% year-over-year)
        - Thus, Net Interest Margin (NIM) =
            - $381 million / $102.5 billion = 0.372% (quarterly)
            - NIM (annualized) = 0.372% x 4 = 1.49% (vs. 1.49% last quarter vs. 1.56% a year ago)
    - **Fee-based**:
        - Fee-based revenue of $92 million (+10.8% year-over-year)
        - Average fee-based balance of $152.9 billion (+1.5% year-over-year)
        - Thus, Investment Product Fee Yield =
            - $92 million / $152.9 billion = 0.062% (quarterly)
            - Investment Product Fee Yield (annualized) = 0.062% x 4 = 0.241% (vs. 0.209% last quarter vs. 0.220% a year ago)
- Total client assets of $695.3 billion (+3.4% year-over-year)
- Record interest rate sensitive assets of $110 billion (+9% year-over-year)
- Net new client assets* of $17.5 billion (10.5% annualized growth rate)
- Diluted EPS of $0.39 per share (+2% year-over-year)
- Trailing-12-month (TTM) average return on equity (ROE) of 16.7% (down from 17.4% a year ago)
- Capital management:
    - Paid $0.17 per share in cash dividends in the quarter (a 2.4% yield on the current share price)
    - Repurchased approximately 1 million shares of its common stock at an average share price of about $38 per share
    - Declared a $0.17-per-share quarterly cash dividend (an increase of 13% year-over-year), payable on Feb. 17 to all holders of record of common stock as of Feb. 3.

*excludes changes in client assets due to market fluctuations

Analysis

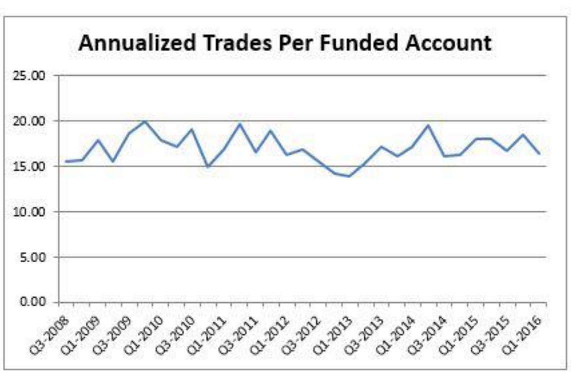
TD Ameritrade posted a strong quarter for asset gathering in its fiscal Q1-2016, with net new assets up $17.5 billion, a 10.5% annualized growth rate relative to total client assets at the beginning of the quarter. The company touted this quarter as its second best quarter ever for asset gathering, which is true if we're talking about the absolute amount of net new assets -- the only higher quarter on record is Q1-2015, when the company brought in $18.8 billion in net new assets.

But focusing on absolute amounts is misleading, since as the company continues to grow, it will need to generate higher and higher absolute amounts in order to achieve the same growth rate. Looking specifically at growth rates, there have been 9 quarterly periods since fiscal 2010 where the annualized growth rate of net new assets was higher than the 10.5% posted this quarter (but only one in the last two years -- the record Q1-2015 quarter). Nonetheless, it is still impressive that the company can maintain healthy growth rates even as it grows larger. The company's Fiscal 2016 and long-term goal is to grow net new assets at a rate between 7-11%, and this quarter is at the high end of that range, which is a very satisfactory result:



Source: TD Ameritrade December Quarter Fiscal 2016 Earnings Presentation

Trading activity declined in the quarter toward the lower end of the company's historical range as a more cautious investor sentiment took hold after a very volatile quarter in the prior period (which included the August 2015 market correction):



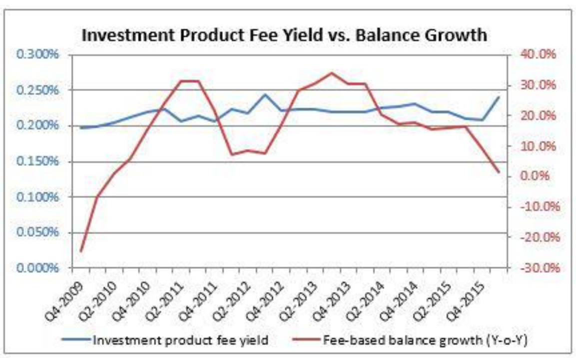
Source: Company filings and analyst calculations.

Average commissions and fees per trade came in at $11.90, which is flat sequentially and down -4.5% year-over-year. This metric remains at the lower end of the company's recent historical range, but this is not too much of a concern in terms of our assessment of the business, as my valuation assumes a steady decline in commissions and fees per trade. Management continues to focus on product mix to explain this pressure on commission rates, noting that a higher mix of futures (which is a lower revenue per trade product) and few contracts per option trade (due to a higher VIX) are to blame:

Source: Company filings and analyst calculations.

Due to the lower trading activity and lower commissions and fees per trade, transaction-based revenue declined -8.6% year-over-year, which explains why TD Ameritrade experienced flat companywide net revenue growth. We can likely expect to see growth in transaction-based revenue next quarter due to the significant volatility we've seen in markets to begin 2016 -- management mentioned that for January month-to-date, the company is averaging 579,000 trades per day, which is the highest on record, and even significantly higher than the previous record month of August last year (which came in at 537,000 trades per day).

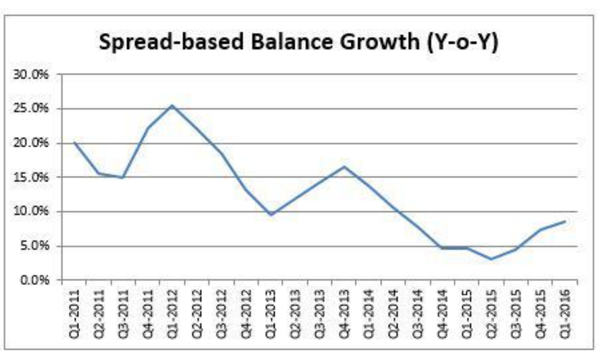
The fee-based segment of the business grew nicely in the quarter, with fee-based revenue up +10.7% year-over-year (compared to -1.2% growth last quarter and 15.3% growth a year ago). The increase in this segment is due to a sharp increase in the investment product fee yield, which increased measurably from 0.209% last quarter to 0.241% this quarter as there was a recognition of previously deferred revenue related to the company's Amerivest fee rebate promotion (which kicks in for clients if their Amerivest portfolios have two consecutive quarters of negative performance).



Source: Company filings and analyst calculations.

However, assuming the stock market doesn't rally strongly to close out the quarter, we should expect to see fee-based revenue decline next quarter since the average fee-based balance should decline alongside declines in the market.

As for the spread-based portion of the business, the rate of growth in the spread-based balance accelerated again this quarter:



Source: Company filings and analyst calculations

This portion of the business is the one that's sensitive to interest rate changes, so it's nice to see continued acceleration of growth in one of the company's key value drivers. We'll continue to watch this metric over time to make sure it's staying on track, especially now that the first Federal Reserve rate hike has occurred and future additional rate hikes are expected.

Management expects that the 25 basis point rate hike will result in a lift to 2016 revenues of $50 million to $80 million (1.5%-2.5% growth relative to 2015 full year revenue) and a lift to 2016 earnings per share of $0.06-$0.09 (4%-6% growth relative to 2016 full year EPS).

What We Think Now

TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and as interest rates increase, the company is positioned to grow earnings sharply.

If you have questions, post them on our TD Ameritrade discussion board.

Wells Fargo Has the Resiliency to Weather a Storm

Published Jan 20, 2016 at 11:47AM

Wells Fargo (NYSE: WFC)

Updated Guidance: Buy First (no change)

Recommended Allocation: 3.6% with a 1.6% look-through allocation in March 2016 $52.50 puts

Fair-Value estimate: $58 (no change)

Current Price: $47.25

What Happened?

- Diluted EPS of $1.03 per share (up 1% from Q4 2014)
- Revenue of $21.6 billion (up 0.9% from Q4 2014)
- Efficiency ratio of 57.4% (vs. 56.5% in Q3 2015 vs. 59% in Q4 2014)
- ROA of 1.27% (vs. 1.32% in Q3 2015 vs. 1.36% in Q4 2014)
- ROE of 12.23% (vs. 12.62% in Q3 2015 vs. 12.84% in Q4 2014)

Loan/deposit growth and credit quality:

- Core* loans of $864.6 billion (up 7.8% from Q4 2014)
- Average total deposits of $1.22 trillion (up 5.8% from Q4 2014)
- Net charge-offs as a % of total loans up to 0.36% (vs. 0.36% in Q4 2014)
- No reserve release** (vs. $250 million Q4 2014)

Capital allocation:

- Share buyback activity continued (diluted share count declined 15.9 million, or 0.3% of total shares outstanding, from last quarter)
- Quarterly common stock dividend of $0.375 per share (3.2% yield on the current share price)

Operating segments:

- Community Banking: Net income of $3.30 billion (down 3.8% from Q4 2014)
- Wholesale Banking: Net income of $2.10 billion (up 6.8% from Q4 2014)
- Wealth, Brokerage, and Retirement: Net income of $595 million (up 15.8% from Q4 2014)

*"Core" loans excludes the impact of the non-strategic/liquidating loan portfolio

**Reserve release represents the amount by which net charge-offs exceed the provision for credit losses

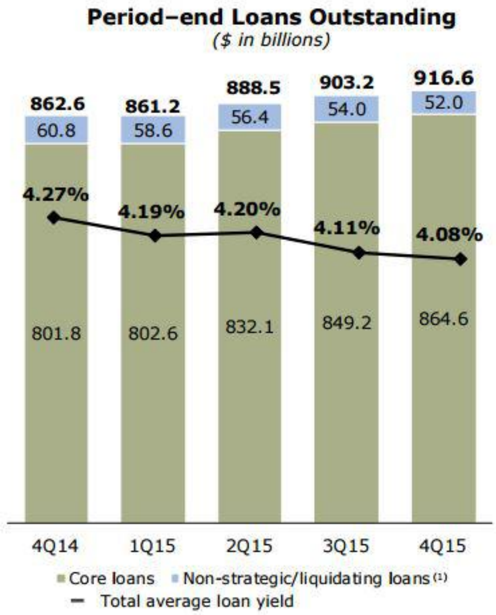
So What?

The 3 key items that I watch for Wells Fargo:

- Growth (or lack thereof) in core loans and deposits
- Trends in credit quality (as monitored via net charge-offs and reserving policy)
- Trends in the efficiency ratio and expense reduction

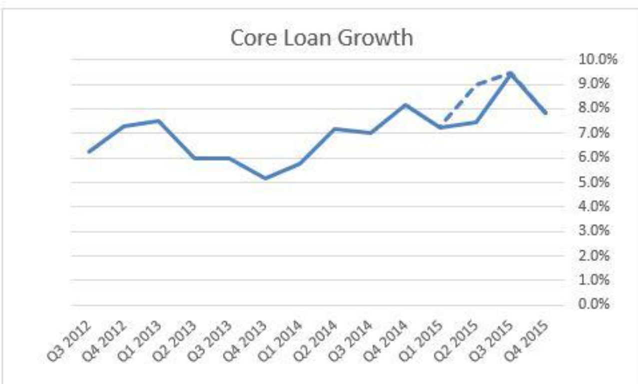
1) Growth in loans and deposits

I track core loan growth rather than total loan growth because this metric excludes the distortion from the small and shrinking non-strategic/liquidating loan portfolio (which is mostly a vestige from the Wachovia acquisition made during the 2007-2008 financial crisis):



Source: WFC 4Q15 Quarterly Supplement

Core loan growth for the quarter decelerated a bit compared to last quarter's excellent showing of +9.5% year-over-year, coming in at a still-healthy +7.8%, which is higher than the U.S. banking industry's average (recently in the 5.3%-5.9% range).



Source: Company filings, analyst calculations. Dashed line shows growth including the loans acquired from GE Capital (i.e. "inorganic" growth).

Since Wells Fargo is so large and so involved in many facets of the U.S. economy, the company's financial performance can provide some good information about general U.S. economic conditions.

Wells Fargo is the United States' largest commercial real estate and residential mortgage originator, and we can see that the real estate market continued to be an area of strength for the U.S. economy in the fourth quarter, with Wells' commercial real estate loan portfolio up 10% and core 1-4 family first mortgages up 8%. Additionally, the American consumer seems to be doing well, which is not surprising given higher employment, higher wages, and lower gas prices. In addition to strength in Wells' consumer housing portfolio, credit card balances were up 9% and automobile loans were up 8%.

Commercial and industrial loans have continued to increase at a healthy rate, even as industrial markets are struggling in the current environment due to low energy prices and a slowing of demand from China for goods and many commodities. Wells Fargo is continuing to loan to these markets (+10%), though at a decelerating pace.

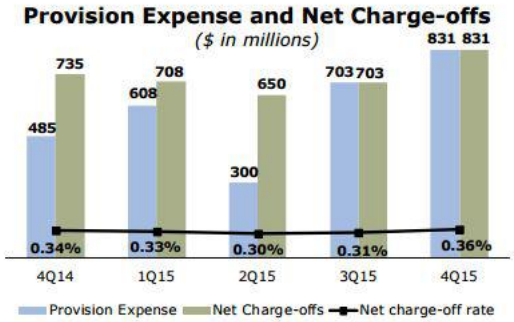
As for deposits, Wells continues to perform well. The company achieved 5.8% year-over-year growth in total average deposits, and 7.4% year-over-year growth in average consumer and small business banking deposits. Consumer and small business banking deposits comprise about 57% of total deposits. Funding costs remained stable at an ultra-low rate of 0.08%. Total average deposit growth decelerated a bit from last quarter's 6% growth, but deposit growth remains very healthy and nicely above the U.S. banking industry average of about +4.7% as per the latest FDIC summary of deposits survey.

The company's ability to grow deposits meaningfully at a very low cost is perhaps the company's biggest structural competitive advantage. Wells is able to do this by having a nationwide presence with significant geographic density in most markets, optimizing distribution via newer channels (mobile/technology), and strong customer relationship management and product cross-sell achieved via a consistent culture that has been a hallmark of the company for decades.

Net interest margin declined slightly, coming in at 2.92% vs 2.96% last quarter and 3.04% a year ago. The net interest margin is unlikely to meaningfully increase until long-term interest rates rise (who knows when that will happen).

2) Trends in credit quality

Credit quality showed a second straight quarter of sequential decline, with net charge-offs as a percent of total average loans increasing to 0.36% (from 0.31% last quarter and 0.30% the quarter before). Lower is better. Despite the slight increase, this charge-off rate is still very low, below the recent industry average of about 0.40% (which is quite low itself). Higher credit quality has been a consistent theme of the current credit cycle as banks have cut down on risk in response to the turmoil of the 2008-2009 financial crisis.



Source: WFC 4Q15 Quarterly Supplement

The reason for the sequential decline in credit quality is the company's exposure to the energy industry, which has been experiencing turbulence lately as the price of crude oil has declined to below $30 per barrel. Regarding Wells Fargo's exposure to potential defaults in the energy industry, the company provided excellent detail on its oil and gas portfolio.

First off, management mentioned that they have about $17 billion outstanding in energy loans (down about 6% vs. a year ago), and "most" of that portfolio is not investment-grade and in a senior loan position. Compared to $912.3 billion in total average loans, we can see that energy loans represent just 1.9% of the company's total loan portfolio. This is an important point, as it demonstrates the relatively small impact that prospective energy loan defaults would have on the company's overall loan portfolio.

Wells charged off $118 million in its oil and gas portfolio in Q4 2015, up $90 million from last quarter. Oil and gas nonaccrual loans (loans where the full and timely collection of interest or principal is uncertain) were $843 million, up $277 million from the third quarter, working out to about 5% of the company's total energy loan portfolio. However, as of year-end 2015, over 90% of the company's nonaccrual oil and gas loans were current on interest payments. The company has $1.2 billion of reserves on oil and gas loans, which based on a $17 billion portfolio works out to a 7% reserve rate. Management expects that if oil stays at or near $30 per barrel for the next year, then oil and gas losses will be higher, but they also believe that their $1.2 billion in reserves will be sufficient.

There was also an interesting exchange between an analyst and WFC's management regarding a potential economic "spillover effect" from the decline in the oil and gas sector:

Analyst Michael Mayo:

"Okay. And now let's just pull the lens back a little bit. John, you've been through many cycles. And I'm just wondering, is the decline in the oil and gas sector similar to other industry-specific declines that then spill over on the broader economy? In other words, what comes to my mind is 2002 TMT [ph], there you had Enron, WorldCom, you had a spillover effect, you had some market concerns, you had some losses. Or what other period does this seem similar to? Or is this stretching too much? This oil and gas thing, it's fine, it's going to blow over. Where do you stand?"

CEO John Stumpf

"Actually, Mike, it's a great question. I go back to 1985 or the early '80s when I ran the workout group and so I got to see our Denver-based energy business up close at that time. So I've -- and then we saw, of course, the one in -- there's been a couple of cycles since that time. And this one's different in a couple of respects. First of all, the economy in the U.S. is more diversified. So the communities in which energy plays a role is more diversified. Not true in every community, but -- and we look at that. Secondly, companies this time around reacted much more quickly. I think in past corrections, there was more hope and prayer going on for higher prices or a rebound. And so they reacted quickly. And I'd also say, this time around, the way companies financed themselves, there was -- there is more private equity and other debt that would be subordinate to the bank debt. So there has been -- there are differences. And I'd say the final thing is this is the mismatch between supply and demand at the world level is fairly narrow. So there's about 93 million barrels produced a day and about 92 million consumed. So it's a very narrow mismatch, and demand seems to still be increasing. So I'm not suggesting that's going to make this problem go away anytime soon. The Saudis are pumping like crazy, so are the Russians. And of course, with what's happened with tight oil here in the U.S., but -- so there are differences. And our people who run this portfolio for us have seen many or most of those cycles. So every one is different."

CFO John Richard Shrewsberry

"One thing I'd add is while there's certainly a plenty of give opportunity for market-related contagion when one industry is suffering and other industries are starting to -- or trying to borrow. But in this instance, the cheap oil has a net stimulative impact on U.S. growth. A WorldCom fraud is not beneficial for everybody else in the U.S. Telecom didn't get cheaper, but fuel is getting -- has gotten cheaper, which is good for consumers and good for other..."

CEO John G. Stumpf

"And Mike, I'll give you one other example. I was with a large builder in the Texas market not long ago, and they were talking about the fact that some of what's happening in oil and gas and the field services is making cement more available and workers and so forth that are important to housing. So I'm not suggesting it happens everywhere, but it's -- every one's different."

Regarding Wells Fargo's exposure to the energy industry, all in all I'm not too concerned about a significant impact to the business, based upon the data and commentary provided by management.

3) Trends in the efficiency ratio

The efficiency ratio (a measure of the bank's overhead costs as a % of its revenue -- lower is better) came in at 57.4%, up from 56.7% last quarter and down from 59% a year ago. The efficiency ratio is in the middle of management's target range of 55-59% (blue shaded area in graph).

Source: Company filings.

The company's expense ratio for the full year in 2015 was 57.8%, and management mentioned that they expect the efficiency ratio in 2016 to come in at the high end of their target range, unless interest rates increase faster than expected. The company continues to invest in compliance and risk management technology, including cyber-related spending. Additionally, they continue to spend on product development.

Now What?

All in all, Wells Fargo continues to perform well despite a fluctuating and uncertain macroeconomic environment. The company's diverse operating model shields it from difficulties in any one particular segment, and this revenue and profit diversity (alongside the company's hallmark conservatism relative to peers) helps Wells Fargo produce remarkably consistent results. Although revenue growth remains tepid, the company continues to steadily grow loans and deposits, and the company should benefit if interest rates continue to rise. In the meanwhile, if the economy worsens, the company has enough capital and resiliency to weather a downturn.

From our long-term view, underlying business results remain strong, the core earnings power of the business remains intact and is poised for positive operating leverage if and when interest rates and lending spreads rise, and the company's capital return program continues to benefit shareholders. After the recent market decline, at $47.25 per share, the company yields 3.2% and trades at 1.40x book value, as low as it's been since mid-2013.

Data and Guidance

- Current Price: $47.25
- Fair Value: $58 (no change)
- Market Cap: $241 B
- P/B 1.40

After incorporating this quarter's results into our model, our Fair Value estimate remains unchanged at $58 per share (representing a 1.72x P/B multiple), about 23% higher than the current price. Wells Fargo remains a Buy First on our scorecard with a 3.6% allocation and a 1.6% look-through allocation to March 2016 $52.50 written puts. Those who have yet to fill out their position in this long-term compounder should feel comfortable doing so at current price levels.

A note on our written puts: if you haven't yet written puts alongside us, you could also write the March 2016 $52.50 puts to match *Pro*'s position, although those puts are largely intrinsic value since the stock price is well below our strike price. If you want to generate a higher yield, you could lower your strike price to $50 (or look at various other weekly strikes, depending on what you like best). If you choose this route, be aware that *Pro*'s course of action may diverge from yours, depending on what expiration and strike you choose, and depending on the stock-price movements of Wells Fargo.

Fool on!

Billy

If you have questions, drive your stagecoach over to the Wells Fargo discussion board.

Assessing Pro's Landscape

Published Jan 19, 2016 at 2:46PM

Pro Guidance Changes

- **Skyworks Solutions** (NASDAQ: SWKS): The stock moves to Buy First on valuation.
- **Valmont Industries** (NYSE: VMI) and **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS) move to Hold as we make sure we want to keep our exposure to them (more details below).

Pro Completed Trades

- **Coca-Cola** (NYSE: KO): We sold to close our January 2016 $37 calls profitably, and let our $43 written calls and $37 written puts expire as full income. *Pro* is out of Coca-Cola now, while *Motley Fool Options* maintains a diagonal call position.
- **Expeditors International** (NASDAQ: EXPD): We set up a January 2017 $42 synthetic long, and sold to open a May 2016 $40 put, $45 call covered strangle, for a 3.5% total allocation.
- **Wells Fargo** (NYSE: WFC): We rolled our January $52.50 puts to March.

Foolish Summary: If you aren't investing yet in our Buy-rated stocks, now is a good time to get started. Read on for details!

Dear *Pro* Member:

After having yesterday off for the Martin Luther King, Jr., holiday, we didn't plan to run a Monday Memo today. But given recent volatility in the stock market, we wanted to touch base with you -- especially with members who have yet to invest, or have only invested a little bit.

Almost all of our stocks are cheaper than they were a few weeks ago, so if you're ready to buy, it's a good time to start. As always, we espouse the idea of moving gradually as you build your portfolio. Don't think you need to invest all your cash at once. Instead, master the art of gradual investing. If you plan to save and invest more money each year, you want to foster a steady approach, a strategy where you're always adding to great businesses over time. Each decision should be incremental, rather than monumental. If you're retired and not adding new cash, then having a steady disposition is still just as priceless, so you don't derail your portfolio at the worst time. You want to stay the course and make small adjustments as opportunities and risks change. Again, your moves should be incremental rather than monumental.

The Latest Market Flu

We're fortunate in that we don't own many stocks in *Pro* that are in the direct crosshairs of this downturn. Unprofitable technology companies, energy companies, and many recent IPOs have been cut down severely. But we're not here reassessing whether we should keep holding our debt-laden oil and natural gas drillers, for example, because we don't own any. And we're not rushing to buy into energy, either -- even now. If you can name an industry that has a more competition-filled worldwide landscape, less pricing power, and more emerging technologies challenging it, please share! We'd like to short that industry, just as we (arguably) should be short energy -- at least old energy.

On Hold

Our two stocks nearest to the devastating energy fire are **Valmont Industries** (NYSE: VMI), which has exposure to commodity prices and energy, and our **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS) fund. Valmont started a restructuring program last April, and management has an acquisition strategy for growth (and the balance sheet to support it), but low crop prices promise to dampen its irrigation-system sales, and infrastructure and utility spending is limping along both domestically and overseas.

Meanwhile, many emerging-market governments depend on oil proceeds, so when oil falls, those economies are threatened. If China's demand for commodities is slowing (and it surely is), that compounds the problem. Both Valmont and DGS are threatened by these factors; both moved to Hold last week as we reassess whether we want to keep the positions. Our exposure to each is small, at 1.7% and 1.6% respectively, but adds up to 3.3% of the portfolio -- far from meaningless. If we did sell, we would put the money somewhere we like better; we don't really want to lower our total long exposure right now (it's at 80%) except with hedges and shorts.

Why are we comfortable with this long exposure? Because overall U.S. companies appear healthy, we like what we own, and we have exactly the right time frame to grow our money in good stocks: three years and longer.

Buys

Some of our positions demand special mention, so they'll command much the rest of this Memo. **Skyworks Solutions** (NASDAQ: SWKS) moved to Buy First last week after it tumbled on concerns that **Qualcomm** (NASDAQ: QCOM) is partnering with an analog competitor, TDK, in a $3 billion deal to compete in radio frequency front-end (RFFE) modules and filters, a Skyworks speciality. This industry is expected to grow 80% by 2020, to $18 billion, and even if Qualcomm takes some market share, Skyworks is best positioned to benefit.

But Qualcomm's news, and fears that **Apple** (NASDAQ: AAPL) iPhone sales may be "light," have sent Skyworks shares much lower. Despite growing profit margins and bold earnings predictions from management, the stock trades at 8.6 times EBTIDA, down from 19 about a year ago, and at 10 times earnings expectations. Multiples like this are usually nothing to get excited about with most small chip companies, but Skyworks has the margins, balance sheet, growth rate, and market opportunity to merit our investment. The stock is a Buy First with a 3.1% allocation. The share price will likely remain volatile -- chip stocks often are -- but our three-year outlook softens that concern.

Other stocks worth a special mention include:

- **Apple;** it's a 3.7% position rated Buy. Earnings this month may help calm recent concerns or they may stoke the fire, but we believe that in the long run, Apple has more room to grow. Only an estimated 15% of the world has high-speed Internet access, and cash-heavy Apple is dreaming up the future behind closed doors.
- **Wells Fargo** (NYSE: WFC), **TD Ameritrade** (NASDAQ: AMTD), **Broadridge Financial** (NYSE: BR) -- our financial-related stocks are on the market's bad side on investors' hunch that the Federal Reserve won't raise interest rates as much or as quickly as previously thought, not with China slowing and oil falling; in addition, many smaller oil and gas companies are going to default on debt, hitting bank reserves (we'll have an update on this situation at Wells Fargo with our upcoming earnings coverage this week). These events present a price opportunity for dedicated owners; look at the allocations we have to these stocks and at least slowly start to average into them if you haven't.
- **American Airlines** (NASDAQ: AAL) doesn't hedge its fuel costs, and now oil is below $30 a barrel, but nothing suggests that airline ticket prices are going lower. The company should continue to rake in billions in profits, and its stock trades at just 4.1 times EBITDA and 5.5 times earnings. You can "buy to open" the same January 2017 $35 calls we own for about $8.20 each now. Only invest what you can afford to lose, since the stock only need slip below $35 by expiration for the calls to end worthless. On the flipside, if the market finally reprices American at something closer to industry average, the shares could about double, sending our calls up much more. If we have to play this out to 2018 or beyond, we will, rolling our calls if we can; it will wholly depend on how the business is doing.
- **Oracle** (NYSE: ORCL): The software giant has been thrown out with the bathwater. We've written plenty about it, and even though it only trades at 12.7 times expected earnings, it's going to require more patience as cloud revenue builds. For newcomers, though, now you can buy in at prices not seen since 2014 (and before then, 2011, though that's not a happy thought for us; this is definitely an investment that proves we have patience when the business seems to be tracking correctly).
- **Gentex** (NASDAQ: GNTX) is a 2.6% position. Despite automobile makers posting record sales, their shares are down, and Gentex with them, on concern we're nearing a top in car sales. We have faith in Gentex's ability to grow. If you don't own some shares, pick them up. Writing puts doesn't make great sense now because the $15 puts just generate mostly intrinsic value for you; but you could write June $12.50 puts for $0.60, or a 4.8% yield in about five months.
- **Gilead Sciences** (NASDAQ: GILD) is now at 8.4 times earnings and 7.8 times estimated earnings. The market is pricing in a steady decline in Gilead's Hepatitis C drugs; we believe that's less than likely, and management is not suggesting it. Plus, the business is worth more even with a slowdown. We have a 3.5% position; don't over-allocate, because even the best-looking investment can turn out wrong.

Upcoming Monday Memos

- A review of our 2015 results
- Our thoughts on "the macro" -- can you invest well for it?
- An analysis of our sell history

Overall, dear *Pro* member, look at our recommendations. As always, we'll be delighted to roll out new ideas this year (longs, shorts, options, and hedges), but we of course believe in our Buy-rated stocks as well, and we hope you're building positions across all of them as we manage them as a portfolio.

You're living very much in the moment as you read this; it's *right now*. But you're not investing for right now. You're investing for at least three years ahead. Odds are strong that when we revisit this column three years from now, most prices will be higher, if not considerably so. Even though energy prices are falling and China's economy reportedly grew "only" 6.9% last year, the world economy on the whole isn't shrinking, and most good businesses will increase value over time -- especially when starting from very reasonable valuations, as we see across many of our positions. This thesis may look incorrect for many months, or even a year, but eventually it should prove right. Meanwhile, I hope our decisions will continue to improve upon the past. Move incrementally and enjoy yourself.

See you on the boards!

-- Jeff (TMFFischer)

Sell Your January 2016 Calls on Coca-Cola

Published Jan 14, 2016 at 10:25AM

Is this for you? This is for *Pro* members with a 2016 synthetic long on Coca-Cola. *Options* members running a diagonal call on the company should continue to follow the advice in our sister service.

How You Participate

- **Trade:** Sell to close all January 2016 $37 calls (or other January 2016 calls) owned on **Coca-Cola** (NYSE: KO). Leave your January $37 puts and January $43 short calls alone to expire, assuming they stay out-of-the money on Friday, or just close them for pennies now.
- **January 2016 $37 call price (bid/ask):** $4.80/$5.10
- **Stock Price:** $41.85
- **Price Guidance:** Use a limit order that nets you intrinsic value (i.e., strike price + option price = current share price) plus a little time value (about a nickel), selling by Friday. Lately, this means targeting a sell price of about $4.90 or so. Realize the price will change with every change in the stock price.

In March 2014, **Coca-Cola** (NYSE: KO) shares dipped to $38, and *Pro* stepped in and recommended a bullish synthetic long. The shares are 9% higher since then -- not earth-shattering, and not North Star-topping, but a decent return on a low-risk position. Our own return is especially good considering our leverage. We were *paid* $200 to set up the synthetic long position (we paid no cash out), and it's worth $8,300 as of yesterday. We're also earning $1,522 by writing a $43 diagonal call that expires Friday. That brings our total gain to nearly $10,000, while we didn't use any cash to open or maintain the position.

We're selling to close our $37 calls on Friday, rather than letting them be exercised into stock. Coca-Cola isn't in a strong enough position to enter the *Pro* portfolio as a standalone stock today; earnings growth at this international giant is still slight, and soda sales continue to suffer. The stock will likely stay range-bound, so we prefer to continue an income position on Coca-Cola in *Motley Fool Options*, and focus *Pro* on more *Pro*-like companies that meet our company criteria, including healthy growth prospects.

Here's our current position snapshot:

Coca-Cola (KO)	Write (Sell) Synthetic Covered Calls	1/15/16	$43.00	-17	$41.72	-$1,522.00	-$68.00	+95.5%
Coca-Cola (KO)	Synthetic Long (Sell Puts)	1/15/16	$37.00	-17	$41.72	-$6,221.00	-$51.00	+99.2%
Coca-Cola (KO)	Synthetic Long (Buy Calls)	1/15/16	$37.00	17	$41.72	$6,016.00	$8,160.00	+35.6%

Alternative Trades

- **Would you rather exercise your calls into a long-term stock position?** That's your choice! Do nothing, and your calls will turn into stock over the weekend; you'll own 100 shares for every call you currently own. Your new stock will get purchased at your $37 strike price. Turning the calls to stock avoids a tax bill for now, until you sell the shares.
- **Own 2017 or 2018 calls?** You can go on owning those for the long haul if you like, independently.
- **Own 2017 or 2018 calls and writing diagonal calls on them?** So are we, over in *Motley Fool Options*. Keep following that advice there.

Pro Can Help

- **Have a question?** Pour it out on Pro's Coca-Cola board.

Close Your Covered Strangle on Expeditors International and Set Up a New One

Published Jan 13, 2016 at 10:46AM

Is this for you? This is for all *Pro* members with an existing income position on **Expeditors International** (NASDAQ: EXPD) expiring in January, and for all those who want to start this position now. (Those who want to own stock instead of a synthetic long, or use an IRA, should see the alternative trades at the end of this report.)

How You Participate

- **Actions:**
  - **Old position:** "Sell to close" your long January 2016 $40 calls, and "buy to close" your short January 2016 $46 puts. Your other options -- January 2016 $40 puts and $48 calls -- are set to expire Friday. You can let them be or, more safely, close them for pennies.
  - **New position:**
    - **Trade 1:** Set up a new synthetic long: Buy to open January 2017 $42 calls, and sell to open an equal number of January 2017 $42 puts.
    - **Trade 2:** Then write a new covered strangle: Sell to open May 2016 $40 puts and May 2016 $45 calls. Do this once for each synthetic long you set up.
- **Allocation:** Approximately 1.8% exposure on the synthetic long, and another 1.7% exposure through your short puts in the strangle, for 3.5% total exposure. Each synthetic covered strangle represents about $8,300 in exposure to the stock. So, for 3.5% exposure, set up one synthetic covered strangle (one each of all four options listed above) for every $235,000, approximately, that you manage. *Pro* will use 10 contracts of each option in the synthetic long, and then in the written strangle.
- **Prices (10 a.m.):**
  - **Stock:** $43.40
  - **Options:**
    - **Old position:** Sell to close January 2016 $40 calls at the going price, lately $3.50. Buy to close January 2016 $46 puts, lately $2.60. These prices will change. Using current prices to complete the trades by Friday.
    - **New synthetic long:** Sell to open January 2017 $42 puts (bid/ask): $3.70/$3.90. Buy to open January 2017 $42 calls (bid/ask): $4.90/$5.20. Combined splitting the bid/ask: **About a $1.25 debit.**

- New covered strangle: Sell to open May 2016 $40 puts (bid/ask): $1.25/$1.40. Sell to open May 2016 $45 calls (bid/ask): $1.85/$2. Combined splitting the bid/ask: **About a $3.10 credit.**

- **Price Guidance:** Close your old positions using limit orders at current pricing, and do so by Friday. For the new synthetic long, the price will change as the stock price changes. Just aim to pay almost no time value. Lately, there isn't any (the stock is $43.40 and the $42 synthetic long costs less than $1.40). Write the new strangle using a limit order of about $3.10 in credit. As prices change, ideally accept no less than $2.80, or 6.5% on the current share price in about four months to expiration.

What We're Thinking

Shares of our favorite overseas shipping facilitator, Expeditors International of Washington, have fallen on concerns that world trade volume will follow China down a path to economic malaise. Its stock is now trading at 9.5 times EBITDA, with lower value multiples on many measures than it's seen in years, even though the company is on track to increase earnings per share by more than 20% in 2015 and profit margins are trending higher as management prudently cuts costs.

Earnings are expected to moderate in 2016 -- the average analyst estimate has them ticking just 5% higher -- but that should be enough to keep our option income strategy going and, ideally, to keep the stock in a friendly price range. Overall, we believe this well-run business will continue to deliver respectful results, even if world trade volume slows marginally.

Asia accounts for about 50% of the company's revenue. In the nine months ended last September, air freight net revenue in North Asia was up 35%; the same revenue in South Asia increased 29%, both on higher tonnage and favorable spot-market buying opportunities. Ocean freight revenue was also up in Asia. Many of China's exports are of course shipped to countries with stronger economies (and cleaner air), including North America and Europe. This gives Expeditors' business some breathing room even when China's domestic economy (including imports) slows, as it's currently doing. Although this year could be choppy, that uncertainty adds to the option premiums we'll collect, aiding our income strategy, while we ultimately believe Expeditors will come through fine, too.

Why This Strategy?

Since starting this income position in August 2014, we have earned about a net $2,000 in profits (all option income) on the less than $600 in cash we originally deployed. Although this gain is much less than it was a few months ago, it still amounts to more than triple the value of the cash we invested, and it has brought us a healthy yield on the equity we set aside to hold puts open, too -- equity we wouldn't have invested elsewhere anyway, given the cash we have in the portfolio. Since August 2014, the S&P 500 is flat to down (depending on the day you measure from), so this income strategy has outperformed a poor market and still seems logical (we haven't missed great upside in Expeditors or in the S&P 500).

Meanwhile, although it's a highly profitable, expertly managed niche business in an attractive service space, Expeditors is not on the radar of the average investor. Its valuation is reasonable to us, and its options pay well. Not expecting a surge in revenue or earnings, we're content to keep covering the position with calls. Not expecting a great drop in the price, we're also comfortable writing puts. Why not just buy the stock to strangle instead of setting up a synthetic long? You may if you prefer. We are opting to keep our cash free to invest elsewhere as wished, and to use the leverage of a synthetic long to make the income we earn on this position much more meaningful compared to the modest capital we invest.

More That Matters

- **Maximum loss:** The same as owning at least 200 shares of stock (100 now, and 100 at $40), minus the option premiums received.
- **Maximum gain:** This new strangle caps our upside at $45, plus the option premiums received, so about $48. The most we can make on this strangle alone is the $3.10 or so in premium paid to us, which is earned if the stock stays anywhere between $40 and $45 by expiration.
- **Breakeven**: Our new synthetic long mirrors stock ownership that started at about $43, while this new short strangle in isolation has breakeven points at about $37 and $48.
- **Follow-up:** By our May expiration, we'll manage our covered strangle for more income, writing a new one as this one ends, or rolling if we need to. You'll hear via a trade alert!

Alternative Trades

- **If you're new to *Pro* and want to participate in the full new position:** Just follow the New Trades outlined at the top of this report.
- **If you just wrote covered calls last time and want to keep doing that:** The January 2016 $48 calls you wrote are expiring as income. Now you can write the May 2016 $45 calls with us, writing one for every 100 shares of stock you own and want to cover. They lately pay around $1.90 each.
- **If you just wrote puts last time and want to do so again rather than take shares:** The January 2016 $48 puts can be rolled to May 2016 $48 puts for about a $0.75 credit. They're deep in-the-money, so you're waiting for a recovery. This lets you keep more upside than we anticipate, but you never know how fast a stock can recover. That said, if you'd rather roll to a lower strike, roll down to the May $45 puts. That requires about a $1.10 debit.
- **If you're new and just want to write covered calls (the IRA-friendly alternative!):** Use a buy/write order to buy at least 100 shares of stock and sell to open the May 2016 $45 calls with us. Lately, this can be set up for a net debit of about $41.50 per share. You can do this with up to a 3.5% allocation.
- **If you're new and just want to write puts:** Write May 2016 $40 puts with us, selling one for every 100 shares you could buy, up to a 3.5% allocation. These currnetly pay $1.30, or roughly 3.3%, with just more than three months to expiration.
- **Want to strangle shares of stock instead?** Rather than set up the syn long, just buy stock in 100-share increments, and then sell to open the covered strangle on the stock.
- **Already been "put" some extra shares via Jan. 2016 $48 puts?** Keep them to strangle (rather than setting up a new syn long), while still closing your 2016 syn long. Or, sell the new shares to set up the 2017 syn long instead, and then strangle that syn long.
- **Already have a syn long that expires in 2017?** Set up this new strangle on it.

Pro Can Help

- **Want more on this strategy?** See our guides to covered strangles and synthetic longs. We're combining the two into a synthetic covered strangle.
- **Questions?** Please ask, Fools! Ship yourself on over to our Expeditors board. We can all help you, especially if you're new!

Roll Your Written Puts on Wells Fargo

Published Jan 12, 2016 at 11:36AM

Is this for you? Yes, if you're a *Pro* member following our option writing for income on **Wells Fargo** (NYSE: WFC), and if you (like us) have an in-the-money January option reaching expiration this Friday. You should roll before Friday's close. Note that Wells Fargo is scheduled to report fourth-quarter 2015 earnings on Friday morning. We don't know whether the stock will go up or down afterward, but we're choosing to roll beforehand in order to capture the "earnings uncertainty premium." (If you own 2018 calls on Wells Fargo from *Motley Fool Options*, leave those alone. They have nothing to do with this alert.)

How You Participate

- **Action:**
  - Buy ("buy to close") your previously written January 2016 $52.50 puts.
  - Write ("sell to open") March 2016 $52.50 puts.
- **Allocation:** Write the number of March puts equal to the number of January puts you buy to close. *Pro* will be rolling its seven contracts. The look-through allocation on the puts is about 1.6%.
- **Prices (11 a.m. Jan. 12):**
  - **Stock:** $50.80
  - **Options:**
    - Buy to close January 2016 $52.50 puts (bid/ask): $1.76/$1.84
    - Sell to open March 2016 $52.50 puts (bid/ask): $3.00/$3.15
    - Combined rolling bid/ask: $1.16/$1.39 ($1.27 at the midpoint)
- **Price Guidance:** Using a **limit order**, split the bid/ask and aim to receive a net credit of at least $1.20. As prices change, realize that you should complete the roll by Friday's close; if you don't, you will be assigned shares of Wells Fargo stock.

What We're Thinking

Not too much has changed with Wells Fargo's business since we wrote our puts in October, but some recent turmoil in the markets has knocked a few dollars off the stock price, forcing us to either roll our in-the-money January puts or accept new shares of stock.

While we're OK with the idea of accepting assignment on new shares of Wells Fargo, we've decided that we're more content to simply roll our puts out to March, collecting some additional income as we wait for more clarity on the business. Wells is scheduled to report fourth-quarter 2015 earnings this Friday, and we will receive the "earnings uncertainty premium" for rolling prior to the report.

We wrote our January puts for $1.10 per contract (your mileage may vary depending on when you wrote yours), so with the additional $1.20 from rolling the puts, our new effective buy price on additional shares of Wells Fargo would be $50.20, slightly lower than the current price and 13.4% below our $58 fair-value estimate.

We'll reevaluate our written put position in March. If our puts are still in-the-money, we'll decide whether to accept shares of stock or roll our puts out to a later month; if they're not, we could let our position expire and look to reinitiate our income strategy on Wells Fargo shortly thereafter, depending on market conditions.

More That Matters

- **Maximum loss:** For the current iteration of the put strategy (which includes the January puts), our risk is the same as share ownership starting at about $50.20, or about 1.2% below the current price.
- **Maximum gain:** On this rolling trade alone, our maximum gain is the rolling credit. At $1.20, that's a 2.3% yield on the current share price in 67 days.
- **Follow-up:** In March, we'll buy shares at a net $50.20 (about 1.5 times current book value) if the stock is below our $52.50 strike price, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts (or pursue a different strategy) for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 3.6% allocation first — Wells Fargo's shares are a Buy First. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1.6% of your portfolio, then just buy 1.6% in stock directly *if and when Pro* does so through these puts (we'll alert you).
- **New to the position and didn't write puts last time?** You can either:
  - **Match *Pro*** by writing March 2016 $52.50 puts at a 1.6% look-through allocation. Recognize that these puts are in-the-money and have a higher risk of assignment than puts that are at-the-money or out-of-the-money.
  - **If you prefer to be slightly more conservative and reduce your risk of assignment,** consider writing March 2016 $50 puts. Recognize that your effective yield will be higher than that of *Pro*'s rolling trade and your potential buy price will be lower, but you will not be aligned with *Pro*'s official position. You can also look at weekly puts at various other strikes, depending on what you like best. If you choose this route, be aware that *Pro*'s course of action may diverge from yours, depending on what expiration and strike you choose, and depending on the stock-price movements of Wells Fargo.

Pro Can Help

- **Want more on this strategy?** See our guide to writing puts.
- **Questions?** Please ask, Fools! Drive your stagecoach over to the Wells Fargo discussion board.

Don't Forget the Low-Hanging Fruit

Published Jan 11, 2016 at 12:40PM

This Week's *Pro* Expirations

- **Coca-Cola** (NYSE: KO): We plan to end this position with a trade alert this week, selling to close our January $37 calls and letting our short $43 calls (and short $37 puts) expire. We earned a positive return on Coke, but don't care to extend the position in *Pro* right now. (A diagonal call on Coca-Cola continues in *Motley Fool Options*.)
- **Expeditors International** (NASDAQ: EXPD): We will issue a trade alert in the next few days. We plan to simply roll our January 2016 synthetic long to 2017, and close our January $46 puts and then write a new covered strangle on our new synthetic long. Those with stock will get guidance, too.
- **Wells Fargo** (NYSE: WFC): We are rolling our January $52.50 puts to a later month. The trade alert will arrive to you soon!

Fellow Fools,

Investing is a tough business, and this is the time of year when we're reminded just how tough. Though 2015 was a solid year for the *Pro* portfolio, most professional fund managers didn't fare quite as well. Research firm HFR reported that hedge funds lost an average of more than 3% this year, while the market (including dividends) returned 1.4%. And according to Lipper, only 46% of actively managed mutual funds bested their benchmarks. The *Pro* portfolio posted a 7.4% gain for the year, but the purpose of this Memo isn't to gloat. Instead, I'd like to take a step back and try to put these gains into perspective.

Investing is a zero-sum game. There are a lot of incredibly talented, highly motivated investors in those funds mentioned above, all of whom are competing to generate alpha for their investors. It's important to remember that none of us is entitled to market-beating returns, regardless of our relative intelligence or success in other facets of life. The *Pro* team works hard to deliver consistent positive returns for our members, but even so, we know it's impossible to guarantee the same level of success from year to year. What we *can* guarantee is that there are a number of easier and higher-probability ways to increase your wealth than by relying entirely on your investing returns to do the heavy lifting.

Get a Plan

An investment portfolio is not the same as a detailed financial plan. Separate studies from [Morningstar] and [Vanguard] suggest that using financial-planning best practices can improve your portfolio's return by a (conservative) average of 1.5 percentage points. Examples of the strategies highlighted include diversified asset allocation, tax-efficient [asset location] and withdrawal strategies, annuity allocations, rebalancing, and lowering expense ratios and fees.

The authors of Morningstar's study labeled the added returns from these stategies as "gamma," pointing out that "unlike traditional alpha, which can be hard to predict and is a zero-sum game, we find that Gamma (and Gamma equivalent alpha) can be achieved by anyone following an efficient financial planning strategy." In other words, generating abnormal returns by investing is uncertain at best, but the added returns from smart financial-planning decisions are as close to a sure thing as you'll find. In a world where few investment managers consistently deliver any alpha at all, it would be foolish to overlook the opportunity to improve your portfolio's returns by a percentage point and a half with a high probability of success.

It's worth pointing out that neither study mentions tax-loss harvesting, which is considered a best practice by many but is, according to financial planning expert and blogosphere all-star Michael Kitces, [less of a no-brainer] than most people believe. The studies also don't account for a wide range of other financial decisions, including estate planning, evaluating insurance needs, [optimizing Social Security benefits], choosing the right college savings accounts, and Roth IRA conversions with the potential for added value creation.

Finally, a few caveats. When coming up with their estimates, both Morningstar and Vanguard compared their optimized returns to the returns of the average investor. The *Pro* community is likely already above average in this area, so the opportunity to add value may be smaller than advertised. And of course, not everyone can take advantage of all of these strategies. Even so, each of us could probably identify a few topics mentioned here that could use more attention; if you're not inclined to get into the nitty-gritty details, it might be worth hiring a fee-only financial planner or a good CPA to review your finances to make sure you're collecting as many of these easy wins as possible.

The Business of You

The easiest way to increase your financial wealth is to save more money. You can do this by cutting back on spending or by making more money while keeping your spending in check. Though the first option is certainly viable, I'd wager that the latter is more palatable to most people.

In many cases, investing in your own human capital is the highest-return prospect available, though the returns are less certain than those promised by financial-planning strategies. For most young adults, [the most valuable asset they possess] is their ability to earn. Sadly, though, human capital is a depreciating asset; it decreases in value with every year that passes, and the only way to maintain or boost its value is to increase your future stream of cash flow by working more and/or earning more money each year. Earning more usually requires learning new skills and finding ways to generate additional value for your employer or customers. Also, it's important to remember that this asset could be suddenly devalued by a layoff or a forced retirement, so in many cases your human capital will require constant reinvestment just to maintain the status quo.

Another way to invest in yourself is by taking care of your health. Since your body is more or less just a vehicle to carry around your brain, it would be a shame to waste all of the effort you put into improving your knowledge by neglecting its chariot. Studies suggest that regular exercise, good sleep habits, and maintaining a healthy weight are all associated with earning higher wages. Though most of these studies can't differentiate between correlation and causation, there's a fair amount of research to support the idea that these behaviors also result in improved brain function. Considering that a few side benefits of a healthier lifestyle include lower stress, a longer life span, a higher quality of life, and ultimately lower health-care costs, this is an investment opportunity that too many of us neglect.

What's a Relationship Worth?

It's easy to overlook things that are difficult to quantify, but I think most of us agree that social/emotional capital can be invaluable, especially in the event you ever need to spend it. I'm listing this investment opportunity separately because maintaining your social network often distracts from increasing the other sources of wealth mentioned above. Developing and nurturing relationships with friends, family, and business associates takes time, effort, and often money, but most people would agree that those relationships lead to a richer, more fulfilling life.

Too often, people forgo this investment while their trying to build their stores of financial and human capital, often missing out on the benefits that social and emotional capital can deliver along the way. There's no market that prices these connections in real time to let you know how much value you've accumulated. I think a reflection on the people you can call on during challenging times, whether in your personal or professional life, can give a good idea of where you stand and what areas could use some focus.

The *Pro* Bottom Line

If this Memo seems a little off-topic, know that there's some precedent for holistic financial thinking in *Pro*'s weekly communications. A couple of years back, Jeff penned a Memo called "[Are You Optimizing Your Life?]," which inspired the creation of the aptly named [Optimize Your Life discussion board]. I hope members out there who are concerned with anything I've mentioned above -- financial planning, emotional capital, investing in their own earning potential, and so forth -- will [use that board] to share a few tips for success.

Our ultimate goal at *Pro* is to help out members generate wealth, but that means different things to different people. We're all targeting a different combination of financial, human, and social capital to satisfy our goals. Before you devote the majority of your time (another crucial asset) to pursuing investment alpha, please consider whether you're picking off all of the low-hanging fruit that could help you reach these goals in a more efficient manner.

Best,

-- Jeremy (TMFTank)

***Pro*'s Returns**

	Annualized Return Since Inception	Annualized Return, Rolling 3 Years	Year-to-Date Return
Pro	13.6%	19.5%	7.5%
North Star	8.3%	8.2%	8.2%
S&P 500	12.1%	15.1%	1.4%
MSCI World	6.3%	7.5%	(2.7%)

Through Dec. 31, 2015; always visible on our Recommendations page

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Papa John's: A Steady Business but a Volatile Stock

Published Jan 7, 2016 at 12:30PM

Pro's Take: PZZA Q3-2015 Earnings

Papa John's International (NASDAQ: PZZA)

....

Q3-2015

Total revenue growth: -0.3% (vs. +12.7% in Q3-2014)

Operating profit margin: 7% (vs. 6.5% in Q3-2014)

EPS growth: +16.7% (vs. +19.3% in Q3-2014)

....

Quarter Quick Take

In Q3-2015, Papa John's continued to focus on what it does best -- "Better Ingredients, Better Pizza". In the first quarter of results since Pro trimmed its position by one-third via covered calls (selling at a net $68.40 per share), the company delivered another solid quarter, with North American restaurants increasing comps by +3% and international restaurants increasing comps by +8%. These growth rates suggest continued market-share gains at the expense of pizza industry rivals. Earnings per share grew 16.7% year-over-year, increasing due to higher operating margins and ongoing debt-fueled stock buybacks (the company's share count has reduced by 3.6% vs. a year ago). Free cash flow generation is starting to really kick into gear now that commodity costs have moderated and the company's point-of-sale system roll-out is complete. Papa John's generated $119.5 million in free cash flow over the trailing-12-month (TTM) period, up 109% compared to the year-ago period. Papa John's continues to focus on quality, consistency, and measured international expansion, and the company looks set to finish up a strong 2015 that exceeded management's initial guidance at the beginning of the year.

Guidance: Buy (no change)

Recommended Allocation: 2.6%

Fair Value estimate: $57.50 (no change)

Current Price: $51.37

But despite the strong operating results, the company's stock has been in a bit of a slump lately, declining 12.1% on the day of the earnings release, and down 35.6% compared to its 52-week high of $79.40 in July of 2015. Papa John's is a steady business but a volatile stock, and in Pro's history we've presided over other significant swings in the stock price (the stock declined more than 30% between March to September in 2014).

To take advantage of that share price volatility and the company's then-expensive valuation, we sold October 2015 covered calls that were assigned at expiration at a net $68.40, which so far has been a positive decision for us given where the stock price is today. Despite selling a part of our position in order to mitigate some valuation risk, we still believe in the business over the long term, and we think Papa John's should best the North Star over the next 3-5 years from the current share price (which is now about 11% below our Fair Value estimate). Low-to-mid single digit comps growth, modest store unit growth, operating margin expansion, and share repurchases should all combine to help the business grow earnings at a rate that at least challenges our North Star.

Given the recent decline in the company's share price, Papa John's is now more reasonably valued than at any point over the last two to three years, despite far less uncertainty regarding the trajectory and sustainability of the company's international expansion. On a TTM basis, at $51 per share, the company trades for 27x P/E (23x if we exclude the non-recurring legal expense recorded last quarter), 13.2x EV/EBITDA, and 18.4x EV/FCF. For context, **Domino's** (NYSE: DPZ) trades at 18.4x EBITDA and **Dunkin' Brands** (NASDAQ: DNKN) at 14.3x. As financial performance has improved (and the share price has declined), Papa John's trailing multiples have contracted as we expected. For those without a position, now is as good a time as any in the last few years to establish a position in this strong business with good operational momentum and a long international growth runway.

Our Thesis

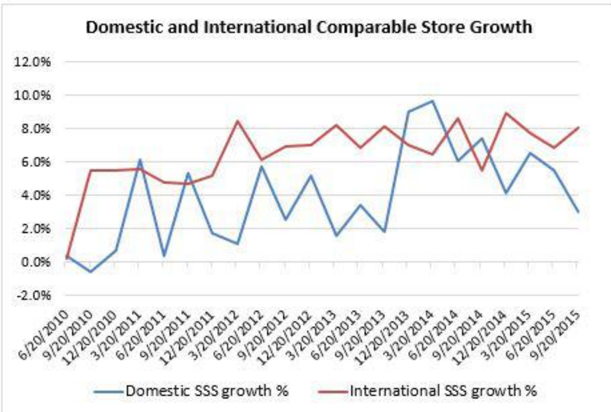
Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main quick service restaurant (QSR) pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only about 1,400 international restaurants the company has a long runway for growth (compare to Domino's which has over 7,000 international stores). Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

1) Store Performance*:* During Q3-2015, systemwide restaurant sales increased +3.9% (7% when excluding the impact of foreign currency). Domestic comps increased +3% while international comps increased +8%.

Domestic comps growth slowed this quarter (down from 6.5% and 5.5% in Q1-2015 and Q2-2015, respectively) as a result of "unpredicted, very aggressive pricing activity" within the category. For year-to-date 2015, the company is sitting at 5% domestic comps growth, at the high end of the company's recently raised 3%-5% domestic comps guidance for full year 2015. Given that Papa John's is the official pizza partner of the National Football League (NFL), management expects domestic comps to come in at the high end of guidance for the fourth quarter as we head toward the end of the NFL season.

As for international comps, the company continues to churn out mid-to-high single digit comps performance. At +8% for the quarter, this marks the 16th consecutive quarter of international comps above +5%. There was particular strength this quarter in the U.K. market with "double-digit" comps in that region, its third consecutive quarter of double-digit comps growth.

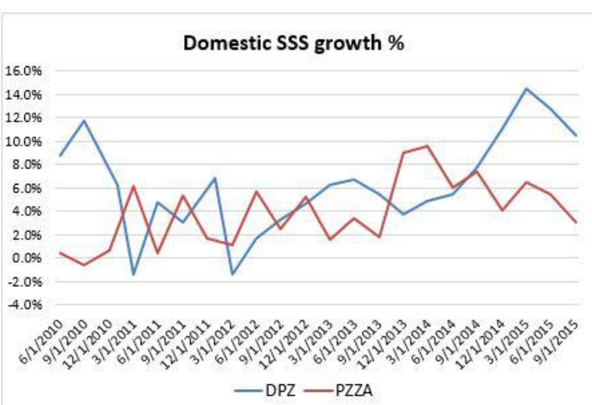


The company's measured expansion continued, adding 52 new restaurants (net) in the quarter -- 37 internationally and 15 in North America. The company successfully opened its 40th country in Bolivia and is fast approaching 1,500 international stores. Management recently updated its net unit opening guidance, indicating that it expects full year 2015 openings to come in at the low end of the 2015 guidance range of 220-250 restaurants. 220 restaurant openings for 2015 would represent +4.7% growth versus the existing store count as of the end of 2014. The company's pipeline remains healthy, with 250 domestic restaurants and 970 international restaurants, the majority of which are scheduled to be opened over the next six years.

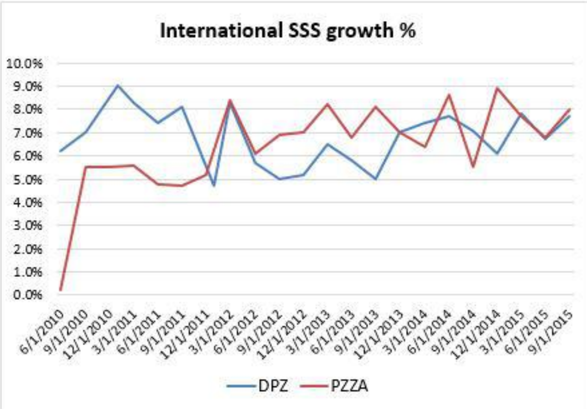
2) Brand: Brand strength is challenging to measure, but we need to monitor it because it is key to the company's brand-based advantages and higher price per pie. Based on recent data, which includes store growth, the domestic pizza market was about flat and the international pizza market grew about 3%-4%. So Papa John's comps (which *exclude* store growth) suggest continued market share gains at the expense of competitors. This is likely due to the company's competitive advantages related to scale (efficient advertising/distribution) and an early lead in technology (digital ordering and loyalty programs).

As for PJ's strongest peer, Domino's domestic comps came in at an excellent +11.5% in the quarter, outperforming Papa John's meaningfully. This past quarter was the fourth consecutive quarter of double-digit domestic comps growth for Domino's, demonstrating excellent momentum. Domino's menu has a much wider assortment of items outside of pizza (pasta, sandwiches, chicken, and breads), and new menu initiatives at Domino's (including the new marbled cookie brownie) helps to explain some of the difference in comps. Additionally, Domino's is much more willing to compete on price than Papa John's which likely helped it earn share during a quarter of aggressive pricing.

But there's no denying that Domino's is on a roll domestically as they continue their marketing initiatives (including reimaging the existing store base), invest in technology, and add a new loyalty program. Domino's gained more U.S. market share than competitors as of the most recently available data (May 2015), increasing in share from 17.7% to 18.8%. Papa John's also increased its market share but to a lesser degree, from 11.7% to 12.2%. Little Caesar's market share increased from 14.4% to 14.7%, and Pizza Hut's market share declined by -1.7%, although they still have the largest market share at 25.1% of the segment. Domino's is more aggressive strategically than Papa John's, which can lead to higher growth when the company executes well. But it also exposes the company to more potential operational missteps and volatility, which is something that Papa John's has largely avoided over the last several years:

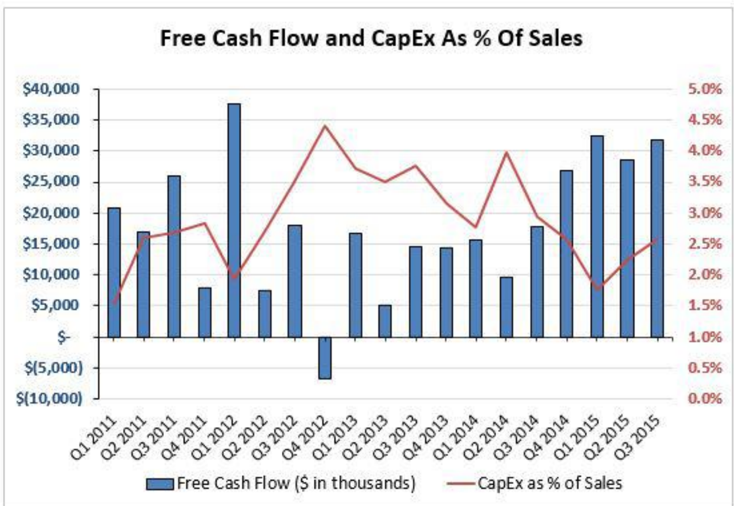


Papa John's and Domino's are neck and neck internationally, where most of future growth will occur. The strong international comps performance continues to suggest that the Papa John's brand and expansion strategy are translating in the higher-growth overseas markets:



3) Margins: We expect Papa John's capital light business model to eventually result in higher operating margins that propels free cash flow generation. From 2014-2015, the company dealt with depressed margins and free cash flow due to the roll-out of the company's new new proprietary POS system (FOCUS), which as of this quarter is now totally complete.

Now that the investment phase has passed, the company is enjoying higher margins and free cash flow generation, as favorable changes in working capital (related to FOCUS inventory levels) and lower capital expenditures have lifted free cash flow much higher. In this graph, note the inverse relationship between capital expenditures and free cash flow-when capital expenditures are elevated, free cash flow is depressed, and vice versa:



Trailing twelve month (TTM) free cash flow is $119.5 million, the highest in the company's history, and up 109% compared to the year-ago period. Note that free cash flow will likely decrease a bit in 2016 as the company has not yet paid the $12.3 million legal expense that it recorded on the financial statements last quarter. At the current price of about $51 per share, the company is trading at about 17.1x P/FCF, the lowest this metric has been since Q3 2012, and a far cry from the 50x multiple we saw a few times in 2013 amid elevated capital spending.

What We Think Now

Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. Near term headwinds (commodity prices and technology investments) have proven to be temporary and Papa John's should continue to deliver improved financial performance.

Pro Can Help

- **Questions?** Stop by our delicious, savory Papa John's discussion board.

Get the Latest on Skyworks Solutions From CES in Las Vegas!

Published Jan 5, 2016 at 9:00AM

Here's all the latest on Fool-recommended companies, straight from the 2016 Consumer Electronics Show in Las Vegas

(This up-to-the-minute reporting is part of *Supernova 2016* — the FREE celebration leading up to the new-member opening of *Motley Fool Supernova* and the launch of the brand-new Odyssey 2 mission! Scroll down for a full schedule of events.)

Supernova only opens to new members once or twice a year. And it's set to open for a short time on Wednesday morning, January 13th...

And here's another reason your timing couldn't be better: Right now we're in the final stages of launching a brand-new real-money portfolio mission inside *Supernova* — you can get all of the details by clicking here.

Or you can simply bookmark this page and check back for all the latest from *Supernova* analysts scouring CES in Las Vegas for what they think will be the most meaningful investments and trends of 2016 and beyond ...

Tuesday, Jan. 5

Noon ET to 3 p.m.

- CES 2016 Trends to Watch
- Multi-Screen Strategies for Connected TV Technology and Content
- Fiber on Fire: Illuminating the IoT
- Smart Home Commerce: The Home Replenishment Revolution

4 p.m. ET to 7:30 p.m.

- Connected Health: Doctors without Wires
- Enterprise Technology: Today and Tomorrow
- YouTube: Unlocking the Power of Programming

Wednesday, Jan. 6

11:30 a.m. ET to 1 p.m.

- Keynote speech: Netflix CEO Reed Hastings

Noon ET to 3 p.m.

- VR/AR Think Tank: The Next Generation
- Future of TV: From Primetime to Multi-Platforms
- Cord-Cutting Brings New Content Opportunities
- Wearables: Healthcare, IoT, and Smart Home Use Cases
- Automated Driving

4 p.m. ET to 7:30 p.m.

- Virtual Reality: Hollywood Does Cutting Edge
- Disruptive Technology's Pervasive Impact on Enterprise
- What's Next for Augmented Reality
- Interview with Skyworks Solutions CEO David Aldrich

Thursday, Jan. 7

Noon ET to 3 p.m.

- The Business of Virtual Reality
- Reinventing the Phone-Car Connection
- Running Through Virtual Reality

3 p.m. ET to 8:30 p.m.

- Oculus Rift: The Family Friend
- The State of OTT Entertainment
- Robots in the Real World
- Keynote: YouTube Chief Business Officer Robert Kyncl

Imagine starting 2016 by seeing what's "next." And knowing exactly which David Gardner-recommended stocks should be in your portfolio and how much you should allocate to each position.

Supernova members who've followed the Odyssey 1 mission have started each of the past four years with this tremendous advantage, scooping up:

- Tesla in 2013 for 344% gains
- Sierra Wireless in 2014 for 96% gains
- Netflix in 2015 for 143% gains

Now here's the upshot in all this for you...

Right now you have the opportunity to climb aboard Odyssey 2 from the very beginning – all the details are a click away!

Pinpointing Your Meaning Markers

Published Jan 4, 2016 at 1:26PM

Pro Completed Trades

- **Tupperware** (NYSE: TUP): We closed our position, selling 1,000 shares at an average price of $55.54.

Fellow Fools,

It's been estimated that approximately 45 percent of Americans make a New Year's resolution each year. Setting goals is a commendable thing to do, but the stark reality is that only about 8 percent of those who come up with resolutions actually end up reaching their goal. There are multiple reasons for this, but chief among them is that these well-intentioned people never lay the appropriate foundation — something that's critical not just for houses, but for life in general. And, of course, for investing, too.

A key part of the foundation-laying process — in terms of setting goals, at least — is being able to identify the right motivational factors. Or as Shawn Achor says in a book called *Before Happiness,* you need to make sure your mental map is populated with the appropriate "meaning markers" — mental signposts that can be anything you consider important or valuable, any aspect of life you feel a deep emotional connection with. (Side note: Shawn's funny, fast-paced TED Talk is one of my favorites.) Obviously, this can be easier with some tasks than others, but the payoff is clear: Research has found that those who are able to identify their meaning markers, and make sure their mental maps are oriented around them, tend to be more engaged and productive, have higher levels of motivation, report greater job and life satisfaction, and the list goes on and on.

Being able to identify and remain cognizant of your investing meaning markers — the real reasons you invest — can also pay big dividends. And this process is not just important for what it contributes (e.g., motivation); it can also help you to avoid some of the pitfalls of investing.

For example, the financial industry is chock-full of extremely smart and talented individuals, yours truly notwithstanding. But many of these individuals also share another trait, one that's often the driving force behind their academic and initial career success: Many are extremely competitive. At first blush, you might think this is a desirable trait for successful portfolio managers. After all, investing is extremely difficult, and managers are in a sense competing with one another to attract funds and deliver the best results. But how beneficial is this trait, really, in the world of stock investing?

In his book *Dead Companies Walking*, portfolio manager Scott Fearon noted that he believes being ultra-competitive is actually the last trait you want to see from someone managing your money. And though it might initially sound somewhat heretical, given that one of the core values here at The Motley Fool is "competitive," I actually think he's on to something. The key, at least in my opinion, is moderation. What he's referring to is the danger of adopting an investment approach that's solely focused on winning. Looking into some of the more notable recent calamities in the world of finance, we find one thread that connects many of the culpable individuals: They really didn't need to (break the law, speculate baselessly, lie to investors) for monetary gains, at least not when they started out. What started them down the path was an intense desire to win.

In his book, Scott notes one trait he's most proud of, one that has played a big role in allowing him to deliver an annualized return of 11.4% after fees since 1991 with only one down year (at least as of the book's printing earlier this year): He's a great quitter.

> The fact that more companies fail than succeed means, as an investor, you're going to have to deal with losing investments. Excessively competitive people have a hard time accepting this reality. They overestimate their own abilities and own chances of success. Worst of all, they are reluctant to give up when things turn bad. That's the real danger of competitiveness. Remember the old saying: "It's OK to be wrong; it's not OK to *stay* wrong" ... They think that they can will their stocks to victory somehow, that things will come out well in the end if they just try hard enough. But that's just not how it works.

Loss aversion is a very real problem in investing, and those investors who are consumed by the notion of winning all the time tend to compound their mistakes by exhibiting confirmation bias and doubling down on their mistakes instead of accepting them and moving on. Unfortunately, it's far too easy to focus too much on winning nowadays, given that we have scorecards (stock prices, return metrics) everywhere we look. This is why I believe it is so important to identify your investing meaning markers and review them on a regular basis. Why is it that you invest? Is it for your kids' education, a comfortable retirement, because it's a lot of fun, or perhaps to donate to worthy causes? When making investment decisions, you should first and foremost be thinking about how those choices might affect your ability to reach those goals.

Our decisions to sell Tupperware and **The Buckle** (NYSE: BKE) are recent examples of this type of mindfulness in action. As Jeff said in the Tupperware sell recommendation, "we don't want neutral positions in the portfolio for years on end — we want to strongly believe in each company we own." Selling a position that's in the red by about 30 percent (Tupperware) or one that has struggled mightily over the past year (The Buckle) is neither fun nor easy, but reaching this decision was a lot simpler when we thought about in terms of how confident we were that these two stocks would help us achieve our North Star objective going forward.

Practicing mindfulness, in life or in investing, can seem like a waste of time when so many other matters need attention. But the busier we are, the more important it becomes to take a few minutes every now and then to slow down, take a few deep breaths, and focus on the "why" behind our actions.

Here's to a Foolish (and mindful) New Year.

— JP (TMFYossarian)

Write Puts on Gentex

Published Dec 22, 2015 at 10:01AM

Is this for you? Since we're looking to add 1.5% to our stake in this company, this alert should be applicable (now or perhaps later) to all *Pro* members, whether you already own shares of **Gentex** (NASDAQ: GNTX) or not. If you don't yet own shares, check out the Alternative Trades section at the end of the report.

How You Participate

- **Trade:** Sell to open March 2016 $15 puts.
- **Allocation:** 1.5% — write one put for every $100,000 you manage; *Pro* will write 25 contracts. In addition to our current 2.8% stock holding, this would bring our total allocation to about 4.3%.
- **Price Guidance:**
  - **Now:** Use a **limit order** to target $0.55 or greater to start (for a 3.7% effective yield in 87 days). **If we all use limit orders** and the stock price cooperates, we may be able to achieve $0.55 today.
  - **Later:** As prices and time to expiration change, those approaching the position should aim to get paid a yield on time value of at least 1% or so per month to expiration.
- **Prices (as of market open Dec. 22):** Stock: $15.72. Options: $0.50 bid / $0.60 ask. Guidance: $0.55. See current prices.
- **Stock Rating:** Buy First, 2.8% allocation; we're now adding 1.5% in additional exposure through these new puts.

What We're Thinking

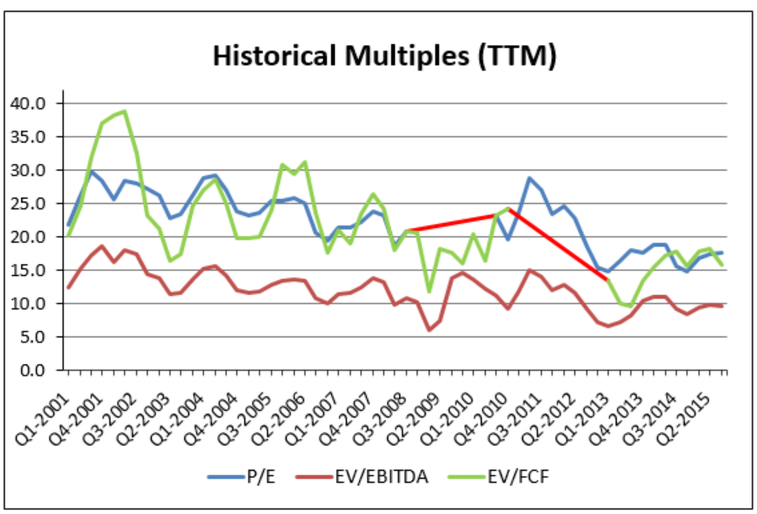
After the expiration of our December 2015 $15 puts last week, we've now run two successful rounds of written puts on Gentex, with both iterations expiring fully as income. We've essentially been running an income strategy on our Gentex position all year, having begun our first round of put-writing in January 2015.

In 2015 alone, we've earned nearly $3,300 in options income from these two written puts, and we've earned $1,452 from four dividend payments in January, April, July, and October. Based on our current ownership stake of 4,400 shares, that's income of $1.08 per share. That equates to a 7% yield on the current share price, which helps offset some of the stock-price weakness that Gentex has experienced throughout the year (as of today, the stock price is down 13% compared with the closing price on Dec. 31, 2014).

For many of the same reasons I've shared in previous alerts (and as we've hinted on the boards), we've decided to continue our income strategy by writing these new March 2016 $15 puts, targeting both income and the opportunity to buy shares at a lower price.

The company is historically cheap right now, and though we like its long-term prospects, we prefer to target income on our position alongside the potential to add to our stake at a lower price. With the income for this iteration of the strategy at $0.55, we'll have brought in a total of $1.86 per share (on a look-through basis) with our series of three written puts on Gentex, giving us an effective start price on assigned shares of $13.14. (Your mileage may vary depending on how much you collected in the first two go-rounds and your tax situation.) This is about 16% lower than the current level, and 27% lower than our fair-value estimate; we'd happily buy shares for this price.

At $13.14 per share, we'd be buying shares at 13 times trailing-12-month (TTM) earnings, 6.7 times TTM EBITDA, and 11.6 times TTM free cash flow, at the low end of historical ranges over the company's past 15 years. That includes the 2008-2009 period, when auto sales plunged and several automakers looked like they might go bankrupt:



Note: Red lines represent omitted outlier multiples that correspond to recession-depressed earnings and cash flow.

Given that Gentex has executed well this year and that the auto market has continued to demonstrate strength -- with seasonally adjusted annual sales of 18.1 million units in November, higher than the 17.5 million data point from July -- , we think those multiples are very attractive.

More That Matters

- **Maximum loss:** For this iteration of the put strategy alone, our risk is the same as share ownership starting at about $14.45, or 8.1% less than the recent price.

- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At a minimum of $0.55, that's a 3.7% effective yield in 87 days.
- **Follow-up:** Including the premiums from our previous put write, we'll buy shares at a net $13.14 if the stock is below our $15 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 2.7% allocation first — Gentex's shares are a Buy First. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1.5% of your portfolio, then just buy 1.5% in stock directly *if and when Pro* does so through these puts (we'll alert you if and when we do).
- **Want to write other puts?** Consider writing June 2016 $15 puts if the price on those options holds up better than the March puts after this alert is issued. Right now, the bid/ask on the June 2016 puts is $0.90/$1.00, good for a 6.3% effective yield in about six months.

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Check your mirrors and switch lanes over to the Gentex discussion board.

O'Reilly Automotive Shifts Back to Buy

Published Dec 21, 2015 at 3:34PM

Pro Guidance Changes

- **O'Reilly Automotive** (NASDAQ: ORLY) returns to Buy, and its fair value increases to $220. We have a 5.1% allocation, but we suggest newcomers move in at only about 1.7% at a time over several quarters.
- **Tupperware** (NYSE: TUP) moved to Sell, as we exit our position by year-end.

Pro Completed Trades

- **Expeditors International** (NASDAQ: EXPD): Per our trade alert, we bought to close our December 2015 $48 puts and sold to open new January 2016 $46 puts, rolling down. We did not write the January 2016 $48 calls yet, because the stock fell sharply before we could. We hope to write them on a rebound.
- See all of our Buys on our Recommendations page.

Programming Note: The *Pro* Memo will be taking next week off. Happy holidays, and we'll see you again on Jan. 4, 2016!

Dear *Pro* member:

This year has been challenging for many investors. As of Friday, the Russell 2000 is down nearly 7% year-to-date; the S&P 500 is down 2.5%, off 6% from its May high. That may not sound so bad at first, but it masks how many stocks have been clobbered harder than Yosemite Sam in a battle with Bugs Bunny. The energy sector has been a killing field, commodities have been pillaged, and big names have fallen: **3D Systems** (NYSE: DDD) has lost 70%, **Yelp** (NYSE: YELP) is down 50%, **GoPro** (NASDAQ: GPRO) is also down 70%, and our own **Oracle** (NYSE: ORCL) is almost 20% lower. There has been a bear market for many if not most stocks this year, except for a handful of leaders.

Future *Pro* Content

On a side note, *Pro* sold 3D Systems in 2013 for a 134% gain at prices three times higher than today's -- but why didn't we short it afterward?

We'll review our sell history and performance in an early 2016 Memo. We'll also review our 2015 results in early 2016.

And we'll have other new features rolling out, as well. Stay tuned!

O'Reilly Automotive (NASDAQ: ORLY) has been one such market leader; it's up more than 30% this year, helping the *Pro* portfolio gain 6.2% in 2015 as of Friday. We know we're performing considerably better than most long/short portfolios or hedge funds -- perhaps most portfolios, period -- but we're not content. We always know we could do better, and our North Star is now a bit ahead of us this year. That said, it's an inevitability that we'll have worse years, too, as we invest to win over a rolling three-year period.

This year, we've seen a gush of benefits (sorry) thanks to our lack of energy exposure. **Valmont Industries** (NYSE: VMI) is our main, if indirect, participant in the sector, and we've sidestepped the disasters befalling so many oil and gas stocks. How? We try to avoid buying companies that don't have pricing power or other incredible competitive advantages. Our guidelines help keep us away from most commodity producers.

Take It Slow With O'Reilly

Many past investing lessons helped to shape our *Pro* quality checklist for the companies we consider. As we move O'Reilly Automotive back to Buy after its recent price decline, let's run it through our gauntlet. First, we have a 5.1% allocation to the stock, making it our third-largest holding. We suggest new members begin to build a position by thirds, buying about 1.7% at a time over the coming quarters. You *could* buy a full allocation at once if you prefer, but the stock of the auto-parts retailer isn't cheap and is likely to be volatile, even though it's a boring business.

Competitive Advantage

With more than 4,500 retail locations in 46 states and more than 200 new stores being added per year, O'Reilly is there when you need auto parts and expertise. The industry is competitive, but O'Reilly is taking market share as customers become loyal. Same-store sales have grown by more than 7% each quarter this year, surpassing industry growth. O'Reilly credits much of its advantage to its customer service and the diversity of parts it has available. The former sounds trite, but as cars become more complex, so do repairs, and O'Reilly has the know-how to serve its customers and the parts they need. Of course, don't discount the value of store locations. With a large footprint of stores, wide parts availability, and reliable service, O'Reilly has built a name -- and an advantage -- for itself.

Pricing Power

O'Reilly can't continually raise prices and expect to keep customers, but it has steadily grown profit margins by focusing on improving its technology and distribution network, its administrative costs, and its offering of value-add services for customers (such as oil changes). Lately, it's begun selling store-branded parts. Since 2010, the company's EBITDA margin has grown from 16.6% to 21.7%, and margins are expected to continue to tick higher. So, although O'Reilly lacks pricing power in the traditional sense (auto parts prices typically go up with inflation, and hard-to-find parts have higher margins), like many strong businesses, it has been able to consistently increase profits at a greater clip than sales growth through several other means.

Dependent Customer Base

Customers can switch auto parts retailers easily. O'Reilly succeeds by offering top-notch customer service, wide availability of parts, and nearby locations. Still, most customers don't depend on this company alone. On this one, it misses the mark.

Predictable Revenue

Over the past five years, revenue has grown 8.1% annualized, while normalized net income was up by 16.7% annualized. In the third quarter that just ended, sales jumped 10.8%, and it was the 27th consecutive quarter of earnings-per-share growth greater than 15%. Same-store sales have increased consistently for years. O'Reilly doesn't have subscription revenue or naturally recurring revenue, but it has been able to demonstrate predictable revenue better than most any physical retailer we've seen. Even better, when inevitable bumps in the road do occur, we have faith they will prove temporary.

Growing Free Cash Flow, Compounding Returns

Even as it opens new stores, the company generated more than $800 million in free cash flow over the past 12 months -- and it's plowing some of that cash into opening new, highly profitable stores. O'Reilly has the economics of a compounding machine: Over the past five years, unlevered free cash flow has compounded at a rate of 37.4% annualized.

Financial Resilience

The company targets a debt-to-EBITDA ratio of 2 to 2.25; the current level is well below that, at 1.6. Smart leverage helps O'Reilly grow more quickly and profitably. Although O'Reilly carries low-cost long-term debt of $1.3 billion, financially it's strong, and we agree with using debt to grow more quickly rather than ceding markets to competitors. Free cash flow is robust, and use of capital has been smart.

Expanding Possibilities

After opening 205 stores this year, O' Reilly plans to open 210 in 2016, and plenty of acquisition opportunities remain. The company still has a modest presence in many parts of the country, and although competitors do lurk there, it can take market share as it enters new markets. O'Reilly also expands through higher same-store sales -- new customers arrive through word of mouth and steady marketing. As the job market improves, more commuters hit the road, and O'Reilly derives further benefit. Old cars staying on the road longer, and the fact that new cars are ever more complex, also play to O'Reilly's hands.

Three C's of Management: Clarity, Consistency, Capability

We've been following them since 2007, and management has an impeccable track record. They share a clear plan, execute on it, and appear capable of taking the business to the next level. Management respects employees, pays well, and drives higher results through bonus compensation. At the same time, executives are not excessively paid.

In Sum

O'Reilly scores well on six of our eight criteria, missing on pricing power and a dependent customer base, but it makes up for those misses through related qualities. All that said, the stock is trading at higher valuation multiples than it has in the past. Some of that is merited by greater business performance, but its price still makes us more conservative in our short-term expectations. We suggest newcomers move in slowly: Instead of buying our 5.1% allocation right off, buy about 1.7% up to three times over the coming quarters. Members with large accounts can consider writing near-the-money puts, too. The company's sales are helped by extreme hot or cold weather, which wears on cars, and so far this winter has been mild to say the least. We may also consider covered calls again for income; if so, we'll aggressively manage them. Over the long term, we believe O'Reilly has the team and business in place to keep compounding value, and that's what we seek.

Questions? Please visit our Memo Musings board. And have an excellent holiday!

- Jeff (TMFFischer)

Cash In on Community

Enjoy some holiday reading in our great community! And share your thoughts!

- **American Airlines** (NASDAQ: AAL) employee and *Pro* member bob111 shares his positive thoughts on his company.
- Longtime member nevercontent shares why he loves his **Apple** (NASDAQ: AAPL) Watch.
- We discuss poor performance from **Oracle** (NYSE: ORCL), and how we want to keep a focused, high-performing portfolio.
- Winners are made possible in the market by losers.

Oracle Keeps On Keepin' On

Published Dec 18, 2015 at 9:04PM

This quarter's earnings release was mostly a non-event for **Oracle** (NYSE: ORCL) as management had already primed investors for a slow quarter before the momentum starts to pick up in the second half of the fiscal year. The company met earnings estimates, partially thanks to a lower tax rate for the quarter, and management's outlook for the year remains positive. As expected, currency volatility was a drag on the top line and the company is still transitioning to a cloud-centric business model, which continues to obscure the outlook for sales growth and profitability. Even so, Oracle's business remains on track and it looks to be strengthening as we move into the second half of the year.

Cloud Segment

Cloud (SaaS and PaaS) revenue was up 38% to $487 million for the quarter and management expects that growth rate to accelerate to 50% in the third quarter and then move even higher through the end the year. Infrastructure as a service (IaaS) growth slowed to 11% during quarter and management expect the growth to continue to moderate into the single digits through the end of the year. The IaaS hosting business is struggling to gain traction against stiff competition, but management claims that the company developed a next-generation data center which it believes will allow Oracle to become the lowest cost provider of IaaS.

Billings (a combination of new sales and the sequential change in deferred revenue) for the quarter grew by 68%. As always, management was sure to compare Oracle's success to its pure play cloud competitors, **Salesforce.com** (NYSE: CRM) and **Workday** (NYSE: WDAY), which grew billings at 21% and 41%, respectively.

Gross margin for the cloud business only improved modestly this quarter, growing to 43% compared to 40% last quarter, but margin expansion is just beginning to kick in for the young business. As the cloud business continues to scale, management expects gross margin to increase to 55% to 60% by the end of the year and then hit 80% by the end of fiscal 2017.

Oracle has spent heavily over the past few year to develop a full suite of SaaS applications and build the infrastructure and sales force necessary to support its cloud business. As growth accelerates there should be improved productivity and the ability to leverage many of those fixed costs. Management already dialed back on some of the capital expenditures this quarter, and margins are expected to increase from 43% to 80% over the next year and a half.

Licensing Segment

Though seems to be getting relegated to the back seat during the quarterly reports, Oracle's cash cow on-premises business continues to hold its ground. Despite all of the attention on cloud sales, this legacy business still generates 71% of the company's sales. New license sales dropped 18% this quarter on the back of a 16% decline last quarter, but software updates and product support revenue still increased 5%.

Management expects on-premises revenue to grow modestly for the year, showing that this business probably won't decline as quickly as many have feared. Though the business is no longer growing, it remains extremely profitable and generates a ton of cash that can redeployed into faster growing areas of the business.

Capital Allocation

As I mentioned above, management has begun to dial back on cloud infrastructure spending causing capital expenditures to declined by more than half for the quarter. The company has also significantly reduced its acquisition activity while it focuses on executing its cloud strategy resulting in a nice increase in free cash flow.

Over the past year, Oracle has generated over $11 billion in free cash flow and the company closed the quarter with a $10.4 billion net cash position on the balance sheet. During the quarter the company repurchased $3.25 billion worth of shares at an average price of just under $38 a share and paid dividends of $2.5 billion.

The *Pro* Bottom Line

There remains a divergence between how Oracle's business is performing and how the company's stock is performing – mostly because of uncertainty about the shifting business model. Oracle remains hugely profitable, generates enviable returns on capital, and creates a ton of free cash flow. At the same time sales growth has slowed for strategic reasons -- the company is emphasizing cloud sales which are recognized ratably over the life of a subscription instead of perpetual license sales where the majority of the sale is recognized upfront. As I highlighted two quarters ago, SaaS sales are expected to have lifetime economic value three-times larger than a traditional license sale. When combined with rapidly growing margins, these contracts give Oracle the potential to grow it profits at a much faster clip than with its legacy model.

In very short order, Oracle has built a cloud business that is expected to finish the year at about a $3.2 billion annual run rate. Still, that figure is less than 10% of the company's sales over the past year which is why the market values Oracle at just 3.9-times enterprise value-to-sales compared to pure play cloud competitors Salesforce and Workday which are assigned multiples of 8.4-times and 13.4-times, respectively. Keep in mind that those competitors are growing their top line much faster, but they also generate no profits and see less free cash flow in a year, combined, than Oracle often does in a single quarter.

As the cloud business scales and margins expands, I think we're getting close to an inflection point business where investors will begin to better understand the economics of the cloud business. When combined with more data regarding revenue per user and churn rates, analysts will become more confident gauging the business's value and the discount built into the stock price from uncertainty should dissipate. At some point I believe the market will start to value Oracle's cloud and legacy business as separate entities, and patient shareholders will be rewarded.

Sell Tupperware

Published Dec 17, 2015 at 11:46AM

Foolish Summary: For all *Pro* members who own **Tupperware** (NYSE: TUP), the stock moves from Hold to Sell as we harvest some losses for tax purposes. Another benefit: We can step away from this lagging position for a time, to analyze with fresh eyes whether we want to buy it back after 31-plus days or not. The stock went ex-dividend yesterday, so we will still receive the current $0.68-per-share dividend payment on Jan. 4, 2016. Sell all of your shares with a limit order at current pricing, ideally above $56.50.

How You Follow Along

- **Trade:** Sell Tupperware (NYSE: TUP)
- **Allocation:** Sell all shares. *Pro* is selling its 1,000 shares, representing 2.2% of the portfolio, and bringing our cash (excluding shorts) up to 20.1%.
- **Price Guidance:** Use a **limit order**, please, to sell at the going price, lately above $56.50.
- **Our Return:** On this batch of stock, obtained through options written in 2013, we have a 30.6% loss (excluding dividends and earlier option gains), the largest stock loss in the portfolio. Our original stock stakes in Tupperware, bought in 2010, were sold in 2013 for 42% and 80% gains; we've also made considerable income with options and dividends over all these years. So, overall, veteran *Pro* members have a win with Tupperware. More recent buyers have a loss.

What We're Thinking

The first thought to share is: ***Don't rush for the exits.*** Sell -- *calmly* -- if you agree with our thinking. We haven't suddenly turned tail on Tupperware; the long-term story remains intact, and the stock's valuation is more depressed than it has been in several years. However, the low valuation is taking its lead from subpar business performance, and that may not improve soon. We're selling to take some tax losses and reassess whether Tupperware deserves a spot in the *Pro* portfolio; to that end, let's talk through how well the business fits with the qualities we seek from *Pro* stocks.

Competitive Advantage

Tupperware's main advantage is its giant sales force (about 3 million strong) around the world. These devotees arrange sales parties that drive nearly all of the company's revenue, but this setup is also a potential weakness. Much of the sales force is not active at any given time, and when an economy improves, it can be more difficult for Tupperware to recruit and keep strong performers. Management often touts weak economies as a boon to its sales force, but we haven't seen that play out consistently in Europe and other affected areas in recent years. There is also considerable churn in the sales force. That said, local sales staff help Tupperware create new market-specific products that become big hits. Overall, we rank this business quality as a slightly positive to neutral factor at Tupperware.

Pricing Power

The majority of Tupperware's revenue gains (in constant currency) have come from price increases, so the company does command pricing power, and has done so for the years we've been following it. Many of its more popular items now are higher-priced kitchen tools, rather than simple storage containers. Tupperware wins on this quality.

Dependent Customer Base

The end customer is not dependent on Tupperware products; there are many ways to buy containers and kitchen tools. Members of the sales force, however, are dependent on selling Tupperware products for their income. Net-net, this quality ranks neutral.

Predictable Revenue

We have to say no. Sales vary widely by country each quarter, dependent on how many parties the sales force throws and how many incentives Tupperware offers. Revenue is not highly predictable and is dependent on a steady stream of parties from an engaged sales force.

Growing Free Cash Flow With Compounding Returns

Trailing-12-month free cash flow is flat with results in 2009, when Tupperware first cracked $200 million for this metric. Since then, the number has bounced around the $200 million to $250 million range, lately slipping to the low end as the strong dollar weighs on results. As for compounding: Rather than reinvesting great sums in growing the business, Tupperware aggressively bought back shares and increased its dividend in recent years. Both practices are in a holding pattern now, as is meaningful reinvestment in growth. Tupperware currently fails on this measure.

Financial Resilience

Though we don't have any immediate concerns, there are chinks in the armor. Tupperware's dividend payout ratio now rides a bit higher than the company's 50% target, at 64.8%. Should net income fall sharply, the nearly 5% dividend yield could come into question. Long-term debt stands at $609 million, climbing in recent years as Tupperware used low interest rates to raise debt and buy back shares. That decision (which we didn't like at the time) was ill-fated, as the stock has fallen considerably, and now Tupperware pays about $45 million in annual interest expense, up from $27 million in 2010. Tupperware's cash stands at $93 million. With long-term debt-to-capital at 59.7%, the company is not in danger of financial hardship around the corner as long as free cash remains steady, and it should. But financially, it's one of the weaker companies in the *Pro* port. We rank this quality neutral to lacking.

Expanding Possibilities

Tupperware cites billions of people in India, China, and the developing world as still mostly untapped markets for its products, and that's true. But recruiting and retaining its sales force is how the company turns possibilities of expansion into reality, and management concentrates far less on these initiatives than we'd like. The long-term growth story remains in place, but management does not seem to be executing efficiently to get there -- hence, results are choppy from market to market. Right now, we rate this quality at Tupperware as neutral (given lack of execution) to a slight positive (given massive populations in emerging markets).

Three C's of Management: Clarity, Consistency, Capability

Everyone makes mistakes, so we don't expect perfection. But management's use of debt to buy back shares, and its policy of jacking up the dividend whenever net income increased -- without leaving a cushion in case of a subsequent decline -- shook our confidence in their thinking. Management also passively backed away from its earlier sales-growth goals last quarter, unofficially knocking them down by a percentage point or two by saying, paraphrased, "That would still be a good result." We believe the management team does have long-term capability, but every quarter, they have excuses for why some markets dragged down results. It's rare that every market performs adequately at once, which eventually calls into question the worldwide management structure. We rate this quality neutral to a slight negative.

In Sum: Neutral

On our eight *Pro* qualities, we currently have one strong positive (pricing power), two strong negatives (predictable revenue and increasing free cash flow), and five neutral-to-modest leanings in either direction. Contrast this with an inexpensive stock yielding nearly 5%, and with the potential to provide fireworks when sales pop in some quarters, and you can see why it's a bit of a confounding position, and where our neutral rating comes from. But we don't want neutral positions in the portfolio for years on end -- we want to strongly believe in each company we own. So we are calmly selling our Tupperware shares with a limit order, and we'll see in the coming month and beyond whether we are drawn back to the position.

Alternative Trades

- If you wrote puts or covered calls, you can buy to close them en route to closing all Tupperware positions. If you'd rather let them go to expiration, you can consider that, depending on your strike and expiration date.

Pro Can Help

- Please visit our Tupperware discussion board if you have questions or comments!

Roll Your Covered Strangle on Expeditors International

Published Dec 16, 2015 at 11:48AM

Is this for you? Yes, if you're a *Pro* member following our option writing for income on **Expeditors International** (NASDAQ: EXPD), and if you (like us) have an in-the-money December option reaching expiration this Friday. You should roll before Friday's close.

How You Participate

- **Action:**
    - **Old position:** Buy to close your December 2015 $48 puts, and either simultaneously buy to close your December 2015 $50 calls, or wait for those calls to expire on Friday, Dec. 18.

    - **New position:** As you close your December strangle, or as you reach Friday afternoon and can be certain your calls will expire: Sell to open January 2016 $46 puts and January 2016 $48 calls to complete your new strangle.
- **Allocation:** Sell one January strangle (one of each option) for every 100 shares of exposure you already have to the company, and for every additional 100 shares you could add. *Pro* has exposure to 1,000 shares through 10 contracts of a synthetic long, so we're selling 10 puts and 10 calls -- this potentially doubles our exposure, to a full 3.5% allocation.
- **Prices (11 a.m.):**
    - **Stock:** $46.95
    - **Options:**
        - Buy to close December 2015 $48 puts (bid/ask): $1.10/$1.30. Buy to close December 2015 $50 calls (bid/ask): $0.00/$0.10.
        - Sell to open January 2016 $46 puts (bid/ask): $0.80/$0.90. Sell to open January 2016 $48 calls (bid/ask): $0.75/$0.85.
        - Combined split of bid/ask: $1.25 to close, $1.65 to open.
- **Price Guidance:** Split the bid/ask and aim for a **combined credit of $0.40** to roll (if you're rolling all at once). As prices change, realize that you should complete the roll by Friday's close -- or, at least, buy to close your December $48 puts by then, unless you personally want to buy more shares or EXPD stock jumps above $48 by expiration.

What We're Thinking

Nothing at the business has changed in the last month, but Expeditors' stock has dropped a few dollars, forcing us to roll our in-the-money December puts. Targeting short-term income in December hasn't panned out (it's our first strangle on Expeditors in 16 months that didn't bring us income!), but we can roll to January for a credit. In January, we'll decide what to do with our profitable synthetic long on Expeditors and the position as a whole. Right now, this strangle remains an income position for another month. In brief: We are short puts and long calls to mirror stock ownership in Expeditors; we're writing these new puts and calls (a covered strangle) on that position for income.

Why This Strategy?

Since starting this position in August 2014, we have earned about $8,000 in income, and we have unrealized gains of about $7,000 on our synthetic long. That amounts to more than $15,000 in realized and unrealized gains on the less than $600 cash we deployed to start the position 16 months ago.

Our "income with upside" objective, which leverages our capital, is playing out nicely, but it's also nearing expiration! Our synthetic long on Expeditors expires in January, on the same day as the new strangle we're setting up on it today. Before that time, we'll decide what to do with our in-the-money $40 calls. We can either let them be exercised into stock and then continue to write strangles on the stock, or we can sell our long calls to either exit Expeditors entirely or next set up new options on it. (The former is our likely decision, as we have plenty of cash and we like this income position.) If we sell the calls, though, we'll generate a taxable gain in January for anyone in a taxable account. At any rate, we have some time before making this second decision by early 2016.

To potentially help your own planning, my current preference is to let our $40 calls turn to stock next month (for new members, we'd recommend just buying stock) and then continue writing strangles on the stock for income. This could change if the situation or portfolio changes much, but right now, this approach looks logical for an income position that delays taxes.

More That Matters

- **Maximum loss:** The same as owning at least 200 shares of stock (100 now, and 100 at $46), minus the option premiums received.
- **Maximum gain:** This new strangle caps our upside at $48, plus all the options premiums received. The most we can make on this strangle alone is the $1.65 in premium, which is earned if the stock stays anywhere between $46 and $48 by expiration.
- **Breakeven**: Our existing synthetic long mirrors stock ownership that started at about $40.60, while this new short strangle in isolation has breakeven points at $44.35 and $49.65.
- **Follow-up:** In January 2016, we'll decide whether to turn our synthetic long into stock, roll it forward, or close the position. You'll hear via a trade alert!

Alternative Trades

- **If you're new here and want to participate in the full position:** We suggest waiting less than one month to see what we decide to do with our whole Expeditors position as it nears its January expiration.
- **If you just wrote covered calls last time:** The January 2016 $50 calls we recommended last month are on track to expire as income; you can leave them alone to expire. Or, you can close them early if you want to write the new January 2016 $48 calls with us (rolling down for a larger credit of about $0.75).
- **If you just wrote puts last time:** The January 2016 $48 puts we recommended paid you around $1.15 last month. They're at about $1.80 lately, still sporting plenty of time value. You can continue to wait until expiration to see what we'll do in January.
- **If you're a veteran member doing the IRA-friendly/covered-calls-only trade:** If you simply bought shares of stock earlier and wrote the December 2015 $50 calls, they're on track to expire, and as they do, you can write the January 2016 $48 calls with us.

Pro Can Help

- **Want more on this strategy?** See our guides to covered strangles and synthetic longs. We're combining the two into a synthetic covered strangle.
- **Questions?** Please ask, Fools! Ship yourself on over to our Expeditors board. We can all help you, especially if you're new!

Pro Catch-Up Trades: Dec. 14, 2015

Published Dec 14, 2015 at 3:20PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking. Remember that we're a full portfolio service, and most all of our stocks are rated Buy already.*

Pro's Buy First stocks are worth adding to your long-term portfolio:

- **American Tower** (NYSE: AMT), 3.4% in stock and 0.4% in January 2017 $80 calls
- **Gentex** (NASDAQ: GNTX), 2.8% in stock
- **Gilead Sciences** (NASDAQ: GILD), 3.6% in stock
- **Oracle** (NYSE: ORCL), 3.6% in stock
- **Wells Fargo** (NYSE: WFC), 3.7% in stock

There's also our Buys, including:

- **Skyworks Solutions** (NASDAQ: SWKS), buy up to 3.7%
- **Parexel International** (NASDAQ: PRXL), buy up to 3.3%
- **Medtronic** (NYSE: MDT), buy up to 3.1%
- **Papa John's International** (NASDAQ: PZZA), buy up to 2.8%
- **Pro Shares Short VIX ST Futures** (NYSEMKT: SVXY): Buy up to 0.8%

And then there's our airline investment, down lately even though oil (its main cost) is plummeting. We don't believe this incongruent situation will last. Members who lack a stake can take note of this recommendation:

- **American Airlines** (NASDAQ: AAL): Buy to open 0.5% in January 2017 $30 calls.

And our latest hedge can still be set up, now for an even larger credit.

- **SPDR S&P 500** (NYSEMKT: SPY): See our official late-November trade alert guidance.

Pro Quality Checklist: Oracle

Published Dec 14, 2015 at 11:30AM

Fellow Fools,

We've taken a few weeks off from our *Pro* quality checklist series while the team has been busy digesting earnings reports and welcoming new members to the *Pro* family. After reviewing **Valmont Industries** (NYSE: VMI) -- a position that was on Hold at the time -- in the most recent round, I thought I'd move to the other end of the spectrum for this week's Memo and feature one of our Buy First stocks. **Oracle** (NYSE: ORCL), in the *Pro* portfolio since 2009, has been a consistent performer until this year, when the company hit a rough patch as a shift to a cloud-based subscription model has weighed on the stock. Given all this, it's helpful to review why we still believe Oracle has one of the widest moats in the *Pro* universe and will likely continue to deliver North Star-like returns (or better) going forward.

1. A Sustainable Competitive Advantage

Yes. Oracle has long been the dominant player in the enterprise software market, offering one of the most comprehensive product suites in the industry. The company has considerable scale advantages over competitors, allowing it to invest heavily in research and development and fund a vast sales force that benefits from multiple cross-selling opportunities. Once Oracle makes a sale and moves a company onto one of its database management systems, there are significant switching costs (data migration, down time, and retraining) if that company wants to change platforms later. By locking customers into its platform, Oracle has also been able to sign long-term maintenance contracts that provide a steady stream of recurring income.

Oracle was slow to shift from its legacy perpetual-license business model to a cloud-centric strategy, but once it finally did change direction, the company has shown itself able to take advantage of its scale to rapidly expand its software as a service (SaaS) business. In a short period of time, Oracle has been able to leapfrog many of its pure-play cloud competitors despite their multi-year head start, proving that the company remains capable of defending its competitive moat.

2. Pricing Power

Yes, for now. The enterprise software industry is extremely competitive, and Oracle has been able to increase its gross margin for most of the past decade thanks to its reputation for leading technology and quality service. Its margin profile has changed slightly in the past year as sales of its cloud-based services ramp up; though the cloud portion of the business is currently a drag on margins, management believes it will ultimately drive higher margins than the legacy business.

Though I'm awarding Oracle a point based on past performance and management's predictions about the future, there's a risk that strong competition in the cloud business could erode some of the company's pricing power over time.

3. A Dependent Customer Base

Yes. Oracle provides software that is mission-critical for its corporate customers. Once Oracle installs its hardware and software, and a business migrates its proprietary data to Oracle's database, that customer isn't likely to change vendors for quite some time. And in its perpetual license business, clients not only make an up-front purchase but also pay Oracle to provide ongoing software updates and technical support.

By comparison, Oracle's cloud-based services have fewer frictional costs when it comes to to switching providers. That said, changing systems still results in lost productivity and retraining costs, neither of which most businesses want to deal with. To combat those who might, Oracle will have to shift its focus from customer acquisition to customer retention and invest more in continuously improving its applications and delighting its customers.

4. Predictable Revenue

Yes. It's a mature software business, so nearly half of Oracle's revenue is recurring. For most of its history, Oracle focused on a razor-and-blade business model in which a company would buy a software license up front for a set price and then sign a multi-year maintenance contract, which provided Oracle with high-margin recurring revenue.

The timing of the revenue recognition will shift as Oracle transitions to a cloud-centric business model, with more revenue coming in later years. That means less cash up front from a new sale, but it also means that the proportion of high-margin recurring revenue will continue to increase over time, and if retention rates stay high, each of those customers will have a greater lifetime value.

5. Growing Free Cash Flow With Compounding Returns

Yes. Over the past decade, Oracle has matured from a young growth company into a slower-growing yet incredibly profitable cash-printing machine. Over the past five years, an astounding 22% of Oracle's sales have converted to free cash flow (including acquisition expenses), and the company has increased that figure at an annualized rate of nearly 19%.

Today, Oracle has run into the high-class problem of generating more cash than it can reinvest in the business at similar rates of return. As a result, management has engaged in a steady stream of acquisitions and has also returned excess capital to shareholders via buybacks and a small but growing dividend .

6. Financial Resilience

Yes. Oracle has a fortress of a balance sheet, with almost $14 billion of net cash. The company makes smart use of low-rate debt to fund acquisitions and boost return on equity. Thanks to Oracle's predictable cash flow and growing base of recurring revenue, its interest coverage ratio sits at a healthy 11 times annual interest expense.

Even during the Great Recession, Oracle continued to increase sales and maintained a profit margin well in excess of 20%, showing that companies considered spending on the company's software a mandatory expense.

7. Expanding Possibilities

Yes. Though Oracle has the biggest piece of the pie in the enterprise software market, that pie continues to grow at a steady clip, and the company's global presence allows it to take advantage of faster-growing international markets that are quickly adopting technology. Oracle continues to develop new applications that it can cross-sell to existing customers, and the company's move into the cloud-based SaaS market allows it to sell to a more diverse client base. Importantly, Oracle has been able to maintain modest growth in its legacy perpetual-license business while it rapidly expands its cloud business, which suggests that the company isn't just cannibalizing its existing customer base.

8. The Three C's of Management (Clarity, Consistency, Capability)

Yes. Say what you will about eccentric company founder Larry Ellison and his exorbitant pay packages over the years, but it's hard to argue with his track record of creating value for long-term shareholders. Ellison remains the driving force behind Oracle's competitive business culture, which has allowed it to stay at the top of the corporate-software heap despite a constantly shifting technological landscape. Though Ellison relinquished the top leadership role in late 2014, he still serves as chairman and chief technology officer and has a heavy hand in charting the company's course. Based on his behavior during quarterly conference calls, when he consistently calls out competitors by name, he also remains as intensely competitive as ever.

Oracle's day-to-day operations are now led by co-CEOs Safra Catz and Mark Hurd, who are both experienced executives intent on maintaining the company's competitive edge and continuing to grow the business. Though some would argue that Oracle was slow to embrace the shift to the cloud, management has sent a clear message in recent quarters that expanding the SaaS business is now a top priority. It's still early in this pair's tenure, so it's difficult to award a check on all three Cs, but I'm confident investing alongside this management team as a whole.

The *Pro* Bottom Line

Altogether, I score Oracle an 8 out of 8 on our *Pro* quality checklist -- but as I mention in No. 2 above, we're going to keep a close eye on the company's pricing power in the cloud business. It's often difficult to get excited about a mature software company; most investors prefer the new, faster-growing start-ups. But then, it's often difficult to get excited about many *Pro* companies. We value predictability over next-new-thing sex appeal, and we're not willing to pay a premium for unproven businesses -- especially in the technology industry, where change is so rapid.

We view Oracle as a high-quality business with a deep moat, and though the company's stock has underperformed our expectations year-to-date, the business continues to quietly compound capital over time. Best of all, thanks to investor uncertainty surrounding its shifting revenue model, Oracle trades at an attractive price, earning it a spot as one of *Pro*'s Buy Firsts.

Thoughts? Questions? Bring them to the Memo Musings discussion board, and Fool on!

-- Jeremy (TMFTank)

Verisk: Investor Day, Pro's Takeaways

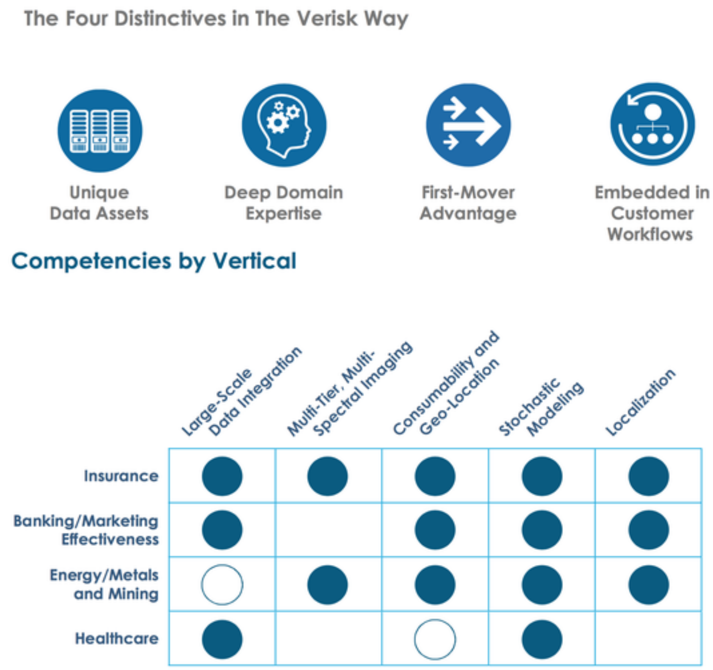
Published Dec 9, 2015 at 10:48AM

Verisk Analytics' (NASDAQ: VRSK) Dec. 1 investor day was definitely an important one, given the uncertainty surrounding the company's health-care and energy businesses in the aftermath of its third-quarter earnings call. It didn't take long for us to realize that management brought its A game this time, and while some questions still remain, the proceedings did reinforce our belief that we made the right decision to pick up additional shares after the stock sold off.

Verisk Health

Minutes before hosting its earnings call this past October, Verisk management publicly acknowledged for the first time that it's considering divesting its health-care business; further info was promised in the future. While there was no specific presentation about healthcare on investor day, if we view the company's opening presentation through the lens of potential reasons to sell Verisk Health, it's much easier to see why Verisk might opt to divest what's objectively a promising business. Management was also forthcoming on this topic during the investor day Q&A session.

To put it simply: The landscape has changed since the company entered the space back in 2003. Nowadays it seems as though countless companies are looking to grow simply for growth's sake, but Verisk is refreshingly disciplined. It has identified what it considers to be its four key "distinctives" -- categories that set it apart -- and five core competencies, and it's constantly reevaluating whether its current businesses and potential acquisition targets help it pursue the former and leverage the latter.



source: Verisk Analytics December 2015 Investor Day, slides 4 & 10

Management noted during the Q&A session that as time went on and the landscape changed (via the Affordable Care Act, for example), it became increasingly apparent that while Verisk Health was progressing nicely, it was ultimately unlikely to become "Verisk-like" enough. This isn't to say that the business is a bad one; it's simply that management is now questioning whether the health-care division will be able to take full advantage of what Verisk does best.

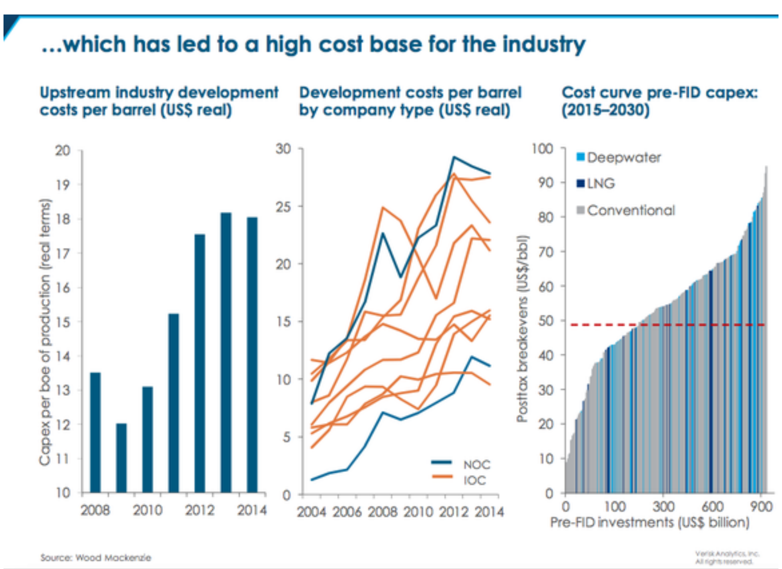
It also appears as though Verisk Health might not be fully aligned with the company's operational priorities for the future -- though, once again, this has more to do with changes in the business landscape than anything else. For example, international expansion will be a big priority for the company going forward, but Verisk Health will never be a global business because, as CEO Scott Stephenson cheekily put it, "the rest of the world does not want to do healthcare the way that we do it in the United States for all the obvious reasons."

Stephenson and the rest of the team frequently noted that there's no rush to divest the business, given that they still consider it a strong one. However, it struck me that this might have been to avoid coming across as forced sellers, in an attempt to get the best price possible. We believe that the odds are the business will be sold at some point and the proceeds will be used to fund additional acquisitions in the company's other three verticals: insurance, financial services, and energy.

Wood Mackenzie

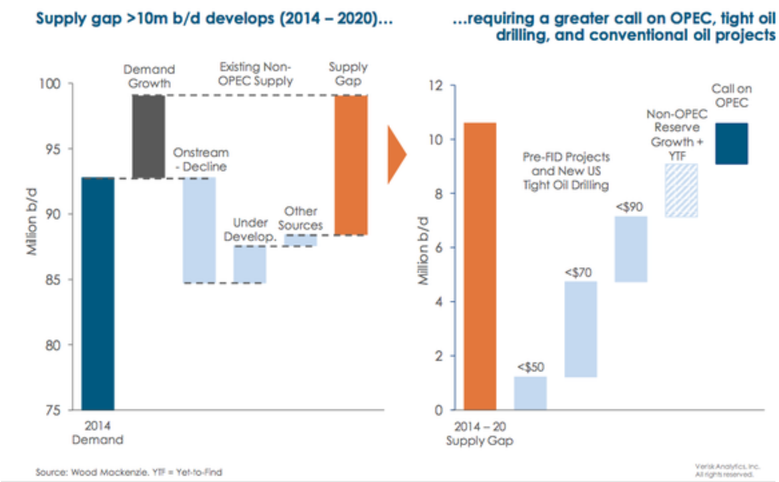
Verisk also delivered on its promise to provide investors with plenty of color on its recent acquisition of Wood Mackenzie, a global energy research and consultancy group providing data, analysis, and advice to clients worldwide. Almost half of the slide deck was devoted to WoodMac and the energy sector, and it was by far the topic management spent the most time on.

As with Verisk's other business divisions, much of what WoodMac offers becomes increasingly important to its clients when the industry it serves is under stress -- and it's hard to deny that's currently the case for oil and gas. Currently, projects that have yet to achieve the final investment decision (FID) needed for execution make up about $1 trillion worth of new investments, but half of those projects simply don't make sense right now given the current price of oil and the rise in development costs. (See the chart on the far right; the red line denotes the price of oil at the time the presentation was assembled.)



source: Verisk Analytics December 2015 Investor Day, slide 45

WoodMac recently estimated that close to $200 billion of spending on new oil and gas projects has been shelved across the industry for the time being, but it's important to note that the company expects a supply gap to open up over time thanks to continued demand growth and production declines from existing projects.



source: Verisk Analytics December 2015 Investor Day, slide 49

This drop in oil prices has put pressure on WoodMac's customers, but rather than obsessing about the near-term effects on top-line growth, WoodMac has been using the events of the past two years as an opportunity to deepen its relationships with current customers. It's also developing new solutions in order to benefit disproportionately during the future recovery (as far as capex spending is concerned). Things look very encouraging so far; the company has seen a 25% year-to-date increase in the number of clients using its online portal and a 34% increase in the number of "super users" (those who consume WoodMac's offerings constantly and are the critical drivers of renewal rates). WoodMac has also seen a 24% increase in the number of client-facing interactions, such as calls, meetings, and the like. Ultimately, we expect these investments to result in strong top-line growth, and we're already seeing promising signs. Client subscription renewal rates for 2014 and so far in 2015 are coming in at 98%, which is a great sign -- subscriptions have consistently accounted for 80%-plus of WoodMac's business over the past few years.

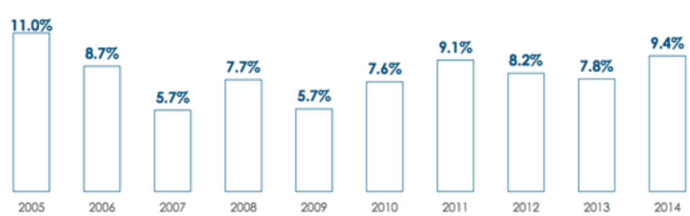
One of the things we like to look for when analyzing businesses is what I like to refer to as "easy wins": attractive opportunities for growth or improvement that don't really require a company to go above and beyond what it's currently doing. And I've become even more convinced that we have exactly that with WoodMac. Specifically, it looks as though the company's solutions were vastly undersold while private equity was in control of the business. As WoodMac CEO Stephen Halliday noted during the Q&A session, all you really have to do is ask yourself whether you believe there are only 900 entities (the number of WoodMac clients before its recent acquisition of The PCI Group) in the world who are interested in some aspect of energy, metals and mining, and/or chemicals. That number seems awfully low to me, and WoodMac agrees; management believes its client base could ultimately quadruple.

There are multiple reasons I believe we should see rapid growth in WoodMac's user base as long as the company is able to execute. For one, the amount a client spends on WoodMac's solutions is quite low as a percentage of overall spending. So the purchase decision depends more on the value WoodMac adds, not the price it charges. Relatedly, client account growth doesn't need to come at the expense of WoodMac's competitors; clients often initially work with multiple companies in WoodMac's line of work before ultimately paring down to just one or two. So, once again, it ultimately comes down to the quality of WoodMac's offerings. And since we believe WoodMac is one of the best in this space, we're quite comfortable with that. Moreover, though Halliday spoke positively of the company's previous private equity backers, he did note that WoodMac is able to think longer-term and make more investments in the business now that it's owned by Verisk.

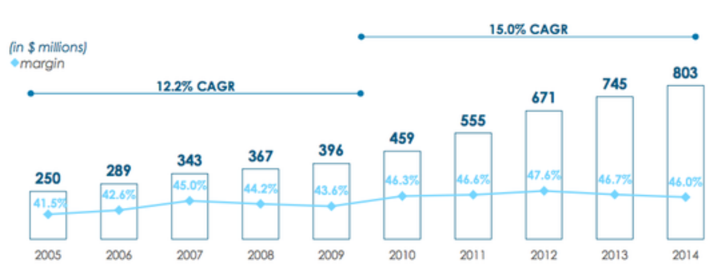
Verisk's Future

The work Verisk does may be complex, but its business model is attractively simple. The company looks to identify and create strong, steadily growing businesses with great (and defensible) margins, which then spin off a bunch of cash Verisk can use to acquire additional business units with similar characteristics. We appreciate this model not just because it's essentially what we're trying to do here in *Pro*, but also because it results in consistently impressive results.

Organic Revenue Growth



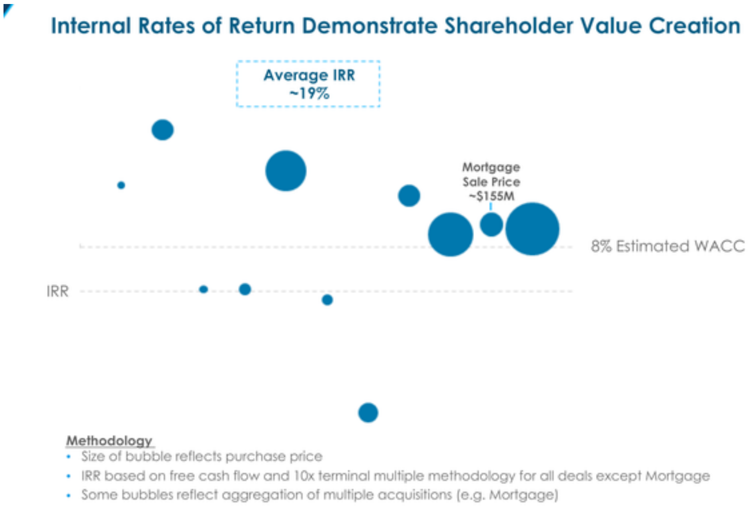
EBITDA



source: Verisk Analytics December 2015 Investor Day, slides 80 & 81

The fact that Verisk is consistently able to grow faster than the markets in which its clients operate speaks to the value customers place on its offerings. And because these end markets are becoming increasingly complex and more reliant upon data and analytics, we believe Verisk is poised to continue to deliver results like these for the foreseeable future. Management estimates that the company's addressable market is currently about $21 billion, of which Verisk still has less than 10%. This percentage is already quite impressive, but we expect it to grow over time.

Acquisitions are what drive overall revenue growth into the teens and higher, and management spent more time than normal discussing the company's track record -- likely because of questions last quarter about whether the WoodMac deal made sense. In the most informative slide from this part of the presentation, Chief Knowledge Officer Eva Houston noted that all of the company's large deals currently have an internal rate of return that's higher than the company's estimated cost of capital.



source: Verisk Analytics December 2015 Investor Day, slide 106

The *Pro* Bottom Line

Verisk's management team is clearly managing and investing in the business for the long term, and the company's board of directors recently authorized an incremental $300 million for its share repurchase program. As we noted in our original write-up, we fully expected the company to resume repurchasing shares before achieving its target post-WoodMac leverage; we believe the fact that it's done so is a signal that the underlying business is strong, not that Verisk Health will be sold off in the near future. Verisk's investor day presentation didn't completely dismiss the questions we had as a result of last quarter's earnings call, but it did reinforce our belief that we made the right decision to pick up additional shares after the stock sold off.

Questions? Comments? Bring them to the Verisk discussion board!

Digging Up Investment Treasure

Published Dec 7, 2015 at 3:00PM

Pro Completed Trades

- **Five Below** (NASDAQ: FIVE): We bought to cover all of our short shares, paying $27.15 to end the position with a 23.1% profit.
- **SPDR S&P 500** (NYSEMKT: SPY): We set up our hedge in the form of a put ratio spread, selling to open 26 February 2016 $190 puts and buying to open 13 $200 puts. We received a $0.31 credit. This can still be set up for a credit as of this morning.
- See all of our Buys on our Recommendations page.

Dear *Pro* member:

Simplification provides clarity, and that unlocks potential.

One of the greatest businesses in recent history, now worth more than half a trillion dollars, launched with one Web page hosting a single search box and one word: "Google." Now called **Alphabet** (NASDAQ: GOOG), the company's reputation still rests on sites and services that are clean and easy.

An investment thesis can – and perhaps should – be just as simple. In many cases, at its core, it is. We own **Visa** (NYSE: V) and **MasterCard** (NYSE: MA) on the belief that electronic payments will continue to replace cash and that these two payment networks are the strongest.

During quarterly earnings conference calls, I enjoy discovering snippets that help make the case for an investment all over again. Any investment argument must be supported by the financials, our knowledge of competitors and management, the business landscape, and so forth. But to boil the current situation down to a few key words, we're looking for something very simple: an insight that makes it all click.

Three Cases Stated

Skyworks Fireworks

One of the strongest investment cases I've seen lately comes from *Pro* holding **Skyworks Solutions** (NASDAQ: SWKS). Creating micro-processing technology that runs in smartphones, tablets, and Internet of Things devices, the chipmaker is riding the mobile revolution. But the key part that originally caught my attention was this: It has rising profit margins while capturing market share.

This was reiterated in the November conference call. As CFO Donald Palette said, "We continue to see our served market opportunity growing at a mid-teens pace for the foreseeable future, based on our ability to address more systems-level functionality and expand our footprint. Second, we are targeting continued gross margin expansion

..." As Skyworks takes market share, it increased revenue by 42% in the year that ended in October, to $3.26 billion, and management expects gross margins to move to 53% within two years, up from today's 50% -- and then to 55% over the longer term.

CEO David Aldrich added confirmation: "We are seeing fewer competitors, a definite consolidation of share, as we address each customer. ... [So] we continue to see increased content with each successive generation of design." Said another way: We are integrating more functionality as these devices get more complex, and we notice that fewer competitors are able to do it. As its technology becomes more complex, Skyworks is selling more of that technology for use in each phone or device, because fewer competitors can provide a complete solution the way Skyworks can. As a result, Skyworks is involved in the design process ever earlier, leading to more revenue visibility. And the more content it sells for a product, the more profit.

Skyworks now targets organic annualized earnings of $8 per share within six to eight quarters, which would put this Buy-rated stock at less than 11 times future earnings. And in the last few years, Skyworks has topped its own guidance.

Tupperware Capped

With two-thirds of its kitchen product sales occurring overseas, **Tupperware** (NYSE: TUP) has struggled for several quarters. The stock is currently on Hold while we decide our next move. Sometimes when a company struggles, you seek clarification in a conference call. You're already skeptical of the business, so you want to see reasons to give it more of a chance.

The best I found in Tupperware's recent conference call came from CEO Rick Goings: "The loss from FX [Foreign Exchange] of actually – over these last three years, [it's] almost 50% of our profit. It went from $5.43 [in earnings per share] then to $2.22. We were able to claw our way back ... almost up to $4.44. And if FX had been even, our EPS would be around $7.50 per share [right now]." So, currency exchange rates have kept Tupperware's net earnings about 50% lower than they would have otherwise been. The business is growing, but currency rates are eating it all.

We knew this was happening, but the magnitude can get lost until it's stated. Tupperware's results should trend much higher when the dollar weakens. The question is: When will that happen? With U.S. interest rates likely to increase, the dollar may strengthen further.

While we wait, Tupperware is increasing its base. As CFO Michael Poteshman said, "We've been growing over the last eight, nine, 10 years in the 5% to 9% increase range in local currency sales." That's a healthy organic growth rate for this business. With earnings growth traditionally higher than that, and a strong dividend, we would typically see a North Star return under this scenario (as we did on our first Tupperware stock position, which we profitably closed). But we need currencies to cooperate a bit. We'll have an update soon on our next decision.

A Changed American

Sometimes, conference calls lend perspective you may not otherwise have. Wall Street remains skeptical that airlines will stay profitable; one fear is that competing with discount airlines will harm the giants, which is keeping big airline stocks cheap. **American Airlines** (NASDAQ: AAL) CEO William Parker had a mouthful to say in the last conference call:

> The reality is Brent oil prices this year are going to average something around $55 a barrel. In 2005, Brent averaged $55 a barrel. The economic cycle for 2005, you guys decide, but it was a pretty good year in the economic cycle. So the two things that we, as airlines, that really affect our profitability that are outside our control, the economic cycle and fuel prices, were the same in 2005 or very similar in 2005 as they are in 2015. In 2005, this industry lost $28 billion. In 2015, we're going to make something close to $20 billion. This business is not the same. It's dramatically different. People that are worried that, oh my gosh, here, now that fuel prices are falling, here goes fares falling and... it's the old business again... [They] are missing the point and are missing what has happened. This business has dramatically transformed. Fuel prices fall, indeed it does make sense for some capacity to come in that does result in prices falling. But if you think this is the old business, you're just not paying attention.

Though we lack corroborating financial data (it isn't broken out), American challenged concerns related to competing with discount airlines. As president Scott Kirby said, "In these markets, once we've gone to matching prices, we've actually had performance that's been either in line or better than the rest of the system. And so we feel really good about it. Every single market that we are matching any low-cost carrier is profitable. They're nicely profitable. They're some of the most profitable markets in our system."

As shared in our Portfolio Positioning Report last week, you can "buy to open" January 2017 $35 call options on American, at about a 0.5% allocation.

Summed Up

Whether it's **Gilead Sciences** (NASDAQ: GILD) offering data to support our assertion that its key Hepatitis C drug sales should stay strong, or **Apple** (NASDAQ: AAPL) sharing that a minority of customers have upgraded to iPhone 6 (leaving plenty of potential), sometimes just one or two revelations shared per quarter can reinforce your investment case, add confidence to the financial estimates you're targeting, or debunk a common criticism. Those are some of the reasons we love digging through conference calls and quarterly SEC filings from our businesses.

Questions? Comments? Please visit our Memo Musings board! We'll see you out there. For now, have a great week!

-Jeff (TMFFischer)

Returns

Investment Vehicle	Annualized Return Since Inception	Annualized Return, Rolling 3 Years	Year-to-Date Return
Pro	14%	20.8%	10.3%
North Star	8.2%	8.2%	7.8%
S&P 500	12.3%	16.1%	3%
MSCI World	6.6%	8.8%	(0.9%)

Table returns are as of Nov. 30, 2015. Information is updated the end of every month. Start date for annualized inception return is the close of Oct. 6, 2008. *Pro* opened the morning of Oct. 7, 2008. The S&P 500 Total Return Index includes reinvested dividends and has zero fees (it is not investable). *Pro's* returns include all commissions and do not reinvest dividends.

Pro Live Chat, December 2015

Published Dec 7, 2015 at 10:16AM

Join the *Pro* team at 3 p.m. Eastern on Tuesday, Dec. 15, for a text-only live chat! Set a reminder below.

Close Your Short on Five Below

Published Dec 2, 2015 at 2:35PM

Is this for you? This trade is **only** relevant for *Pro* members who are participating in our short on **Five Below** (NASDAQ: FIVE). New members lacking any Five Below exposure can ignore this trade alert.

How You Participate

- **Trade:** Buy to close (or cover) all of your existing short shares of Five Below.
- **Allocation:** Close your entire Five Below position. *Pro* will close its 900 short shares.
- **Price Guidance:** Use a **limit order**, please, to buy at the going price, lately around $28. Really. We mean it. *Use a limit order*. Please.
- **Price (as of 2:30 p.m. ET):** $27.64

Special Note! Take Heed! Five Below is scheduled to report earnings after the market closes tomorrow, Dec. 3. *We are looking to close our position **before** this happens.*

What We're Thinking

It may have taken more than a year, but it looks as though Wall Street is finally coming around to seeing our side of the story on Five Below. The stock is now flirting with a 52-week low after multiple downgrades over the past few weeks, and we find ourselves with a solid 20%-plus gain -- even though the S&P 500 rose by more than 6 percent during the life of our short. The prior quarter was one of the weakest we've seen since we first started covering the stock, and the initial reads for Five Below's all-important holiday quarter are mixed, so one could argue that we should continue to remain short. But given the current valuation, we believe the risk/reward dynamics of this position have shifted enough to warrant closing our position ahead of earnings tomorrow.

From the outset, we thought the market was being overly optimistic with its valuation of this particular discount retailer. Over the long run, we believe the industry's competitive dynamics will prohibit Five Below from reaching management's ambitious target of 2,000 stores and will ultimately compress margins. We also questioned whether the right management team was steering the ship, given that the founders' prior public company filed for bankruptcy. This latter point turned out to be prescient, as the senior management team experienced meaningful turnover (including a new CEO) after we initiated our position, but it's anyone's guess how long management will continue to claim that 2,000 stores are possible.

The company' current footprint (417 locations as of the end of last quarter) and geographic concentration suggest that, barring a major misstep, it will be able to continue to open stores at an impressive clip in the near term, which should drive above-average revenue and earnings growth. The nature of Five Below's offerings leads us to believe that comparable-store sales will remain muted going forward, but that's unlikely to deter management from opening new stores, given their target average payback period of just one year.

To be perfectly honest, we won't be all that surprised if Five Below posts disappointing results for the rest of the fiscal year. But with market sentiment having shifted somewhat, we believe the potential payoff for remaining short no longer outweighs the risks. When we began this position, management's blue-sky scenario was being accepted as the base case; now, both the short- and long-term prospects for the company have been called into question. Multiple reports have suggested that the holiday quarter could be weak for Five Below, and Goldman Sachs recently reduced its store-count estimates for the company. In the report downgrading Five Below to a sell, the authors stated that they now believe the company can achieve only 1,700 stores without competition or 1,400 stores with a new competitor. The latter is closer to what we initially envisioned as the base case for Five Below.

This newfound pessimism appears to be baked into the stock somewhat, given that it is now trading for less than 12 times EBITDA estimates (the lowest valuation it's had since going public). So if the company does end up positing disappointing results this quarter, the reaction may not be as violent as last quarter, when we saw a 9 percent sell-off in aftermarket trading after the earnings release. On the other hand, if Five Below *does* post solid results this quarter, we may get hit with a double whammy -- our investment thesis would take a hit, and market sentiment could shift back just as quickly. After considering these, and other, scenarios -- as well as the fact that we recently reduced our retail exposure with our sell of The Buckle -- we have ultimately decided to close our position in Five Below before the company reports earnings tomorrow, and we suggest you do the same.

To discuss this, please head on over to the Five Below message board.

Portfolio Positioning Report: Dec. 1, 2015

Published Dec 1, 2015 at 10:00AM

Welcome | Shorting in Short | Hedging ... in Short | Your Exposure | This Stuff Is Optional
Options Are Optional, Too — but Advised! | About This Report | The Positions Themselves (Shorts, Hedges, Options, All the Rest)

Join our live event at 1 p.m. Dec. 1

Dear *Pro* member,

Our first two Portfolio Building Reports gave you guidance on all of *Pro*'s Buy First and Buy stocks. This final report will do the same for our active short and option positions, many of which we use as hedges. For reasons we'll explain, we don't expect that many of you will initiate all of the positions in this report right away, or perhaps at all. And that's perfectly fine!

Hedging is about lowering your exposure to the risks of the market; to a lesser extent, shorting is as well. These additional investment tools tweak or adjust the risk profile of your *existing* portfolio, so if you're still building your collection of long-term stocks, concentrate on that for now. Stock investments are the core of the *Pro* portfolio, and by owning *Pro* stocks, you are positioned to compound your value over time. We know there's a learning curve for strategies that are new to you, so it's important you know there's no rush; you can incorporate the positions in this report when you're ready. We're here for you in the meantime.

Before explaining these positions, let's review how each strategy works. We'll begin with shorts — a sort of "anti-investment" that we believe will decline in value, adding profits to our portfolio in the process.

Shorting in Short

When you sell something short, you borrow shares from your broker and immediately sell them, collecting the proceeds. At various brokers, this trade action is called "sell short," "sell to open," or just "sell." In the future, you'll need to buy the same number of shares back to replace the ones you borrowed and sold. This second step is called "cover," "buy to cover," or "buy to close." You hope to buy the shares back at a *lower price* than when you opened the position.

The difference between your original sell — or short — price and the price you pay to buy back (and return) the borrowed shares is your profit. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock soars to $30, you've lost $10 per share when you buy it back. We use shorts in *Pro* because they're one good way to profit when the market or a company falls, but they come with their own risks — shares can be hard to borrow, fees are often involved, and a short can get closed on you (you're forced to buy it back) if the broker wants the shares back early. So, we need to size our short positions appropriately small.

Hedging ... in Short

A hedge is similar to a short because it gains value when prices fall, but it's different in intent; these positions are taken to *offset* the risk we have in another position or in our market exposure as a whole. So, when we sell short a market-index proxy like the **SPDR S&P 500** (NYSEMKT: SPY) ETF, we are hedging our exposure to the stock market as a whole. A hedge is a form of insurance — it only pays out when you need it, and usually it won't make money. We know a market-index hedge will go up in value whenever the market goes down. But most times, the market won't fall (or won't fall enough), and our hedge will go unused.

For this reason, we try to spend little to hedge, but there are sometimes still costs. We have to reconcile this with the fact that hedging lets us stay *more* invested than we otherwise would, give our goal of absolute returns. In other words, one key way we profit from our hedges is by using them to help us keep our long stock exposure higher! As with shorting, you should only hedge if you have specific market exposure you want to "hedge out." Recently, *Pro* issued a [brand-new hedge] using options on the SPDR S&P 500. That is our current market-hedge recommendation for anyone who wants to hedge out 10% of their long exposure, as we are doing (bringing *Pro* right now to about 70% net long).

Your Exposure

To know whether hedging is for you, it's helpful to think about your stock market exposure. This is simply how much of your total portfolio is invested in long stocks. Excluding options and shorts, *Pro* is about 83% invested in long stocks as we kick off December. That's high for an absolute-return portfolio (which is part of why we want to short and hedge!). But for new *Pro* members, two stocks — accounting for 7.4% of our exposure — are on hold. So if you bought all of our current Buys and Buy Firsts, you are only 75.6% invested in stocks. You have less reason to hedge and/or short right now; however, like many members, you may own other stocks beyond *Pro*'s. We're hedging the *Pro* portfolio down to about 70% market exposure, and you could (but do not need to) do the same.

The bottom line is: As you consider adding hedges and shorts to your portfolio, first know how much of your portfolio's assets are invested in stocks. That helps dictate how much shorting or hedging exposure you want to initiate to reach the *net* market exposure you desire. *Pro* has averaged around 72% net long exposure since January 2012, but that number will move up and down as our opportunities change. Our exposure is always shown at the bottom right of the Recommendations page.

This Stuff Is Optional

Not every *Pro* member is comfortable with shorting or hedging, and there are practical considerations to take into account as well. First, you need a margin account to sell short, so (unless you use options) you can't do it in an IRA. Second, you have to accept that shorts can run strongly against you, so you need cash to cover that risk. (See Billy's recent Monday Memo for a rundown on what happened to our short position on Boulder Brands.) Third, you'll usually pay an annualized fee of anywhere from 1% to 5% of the short's daily value to short something. Fourth, in many cases it's hard to borrow shares to short, period. That is the situation with some of our current shorts today. Finally, short shares can be bought away from you at the worst time, when they're up in price (a "forced buy-in"). If brokers can no longer find shares to borrow, you're forced to "buy in" at market prices to return your borrowed shares.

So what to do? You can use options to short in some cases -- we do, and we explain how to do so wherever appropriate. You can also consider opening a brokerage account that is particularly friendly to shorting. Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does, and does not charge a fee for shorting. You could also wait and see whether shares become available in your existing, traditional brokerage account, though note that at many brokers, certain shares are basically never available for shorting. Or, if you're not drawn to it, you don't need to short at all.

Options Are Optional, Too — but Advised!

Our options positions are also ... optional, but we strongly advocate learning to use options and following along with ours over time. Options are powerful tools for income, hedging, upside, and more. We know from experience they're well worth the time it takes to learn them, and we're here to help you. Options can make you a much more confident and versatile investor, and they can generate a whole new stream of income for you and your family. So, if you're new to options, you're in a great place! Use *Motley Fool Pro* and our sister service, *Motley Fool Options* (free for the life of your *Pro* membership!), to learn how to use these great tools. On a personal note, if you're going to learn just one simple strategy, I suggest learning how to write puts (link goes to *Motley Fool Options*) for income or to buy a stock lower.

About This Report

Let's return to the main show. This Portfolio Positioning Report and the special live text chat accompanying it today, December 1, at 1 p.m. ET, will (when you're ready!) help you short vehicles we believe will decline, hedge your portfolio, and generate returns from options. But keep in mind that this is just a start; we'll have many brand-new investment recommendations arriving to your inbox as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way!

On the other hand, if this looks overwhelming right now — or if you're still catching up with our core stock positions — that's perfectly fine. You don't need to start these positions now. As mentioned, long positions are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and often rewarding — aren't necessary to succeed with *Pro* in the long term, let alone immediately. As you learn these strategies and progress with us, just keep your exposure to the stock market in mind.

In closing, I'll stress again that you shouldn't feel pressured to act immediately. We will continue to make recommendations on an ongoing basis, including in our Monday Catch-Up Trades when we — and brand-new possibilities emerge regularly. That's part of the fun! So take your time, and make an investment only when you're ready. Finally, please bring any questions to our Making *Pro* Fit You discussion board.

Foolishly,

— Jeff Fischer, *Pro* advisor

The Positions Themselves

Shorts

- Caesars Entertainment (NASDAQ: CZR)
- CurrencyShares Euro Trust (NYSEMKT: FXE)
- Direxion Daily Financial Bear 3X Shares ETF (NYSEMKT: FAZ)

Hedge

- SPDR S&P 500 (NYSEMKT: SPY)

Options

- American Airlines (NASDAQ: AAL)
- American Tower (NYSE: AMT)

All the Rest

- Coca-Cola (NYSE: KO)
- Expeditors International (NASDAQ: EXPD)
- Five Below (NASDAQ: FIVE)
- Gentex (NASDAQ: GNTX)
- O'Reilly Automotive (NASDAQ: ORLY)
- Tupperware (NYSE: TUP)
- Wells Fargo (NYSE: WFC)
- World Acceptance (NASDAQ: WRLD)

Shorts

Caesars Entertainment (NASDAQ: CZR): Sell Short

The casino giant remains crippled by debt as it tries to shake free by placing a subsidiary in bankruptcy court.

Suggested Short Allocation: 0.6% to match us

How It Fits Into *Pro*

Pro is short shares of America's largest casino operator, **Caesars Entertaiment** (NASDAQ: CZR), which has put one of its units into bankruptcy proceedings. The stock is volatile -- we booked a 35% profit on half of our short this year, and our remaining short shares show a 32% profit of late. The outcome of this short position is partly dependent on the courts, but in the meantime, the business continues to suffer, lawsuits from large investors are weighing further on the balance sheet, and the parent company ultimately may need to file for financial protection, too. All of this makes us comfortable staying short and recommending that new members get on board with a small position.

For More

- *Pro*'s recommendation history (see Trade Alerts, bottom right)
- Talk about CZR on our discussion board

Availability

Shares of CZR are often available for shorting at various brokers; the annual fee is lately 1.6% at Interactive Brokers (with 700,000 shares lately available for shorting), and there is no fee at TD Ameritrade, when it has shares available.

Alternative Trade

If your broker does not have shares available for shorting, and you're trading in a margin account, you can instead set up a synthetic short. "Sell to open" January 2018 $10 call options on CZR, and to buy to open an equal number of January 2018 $10 put options. Lately, you can aim for a net credit of about $1.50 to set this up, but realize that will change as the share price moves. Each synthetic short represents about $850 in exposure, so don't allocate above our 0.6% or so.

CurrencyShares Euro Trust (NYSEMKT: FXE): Sell Short

Shorting the euro against the dollar is relatively low-risk insurance against disaster in Europe.

Suggested Short Allocation: 1.8% to match us

How It Fits Into *Pro*

We've been short the euro against the dollar since late 2011. We view this position as a quiet anti-investment; the risk to us is relatively known (and reasonable), and the profit potential remains worth pursuing. As the euro has declined to a recent $1.06 to the dollar from about $1.30, we currently have a 20% profit on the position.
But parity to the dollar is still a possibility, and it needn't stop there. With interest rates ready to increase in the U.S., and with Europe in the midst of a giant bond-buying program, the dollar may be preferred to the euro for at least a few more years, perhaps bringing the euro down to 0.90 to the dollar. And if Greece or other euro nations default, the euro could be badly punished. The vehicle we're shorting (it's called a trust, but trades like a stock) only holds physical euros, so it's a pure way to short the euro against the dollar in our U.S.-based brokerage account.

For More

- *Pro*'s recommendation history
- Talk about FXE on our discussion board

Availability

Shares of FXE are often available for shorting at various brokers; the annual fee is lately 1.8% at Interactive Brokers (with 1.6 million shares available for shorting), and there is no fee at TD Ameritrade.

Alternative Trade

If your broker does not have shares available for shorting, and you're trading in a margin account, you can instead set up a synthetic short. "Sell to open" January 2018 $104 call options on FXE, and to buy to open an equal number of January 2018 $104 put options (lately for about a $1.60 net debit, but that price will change). Just realize that you, like us, are short the vehicle at today's price, and you will see losses if FXE's price goes up. Also, only sell to open one call option for every $10,400 in FXE you can afford to be short, remembering that each option represents 100 shares. We have nearly a 2% short allocation, so to set up one synthetic short and keep it at just 2%, you would need an account value of about $500,000. If 100 shares via options is too large an allocation for you and you can't short fewer shares directly, then just sit this one out! There are no IRA alternatives at this time that are attractive enough to merit your retirement-account dollars, and it's unlikely the euro will plummet enough to make this a short you really lament missing.

Direxion Daily Financial Bear 3X Shares ETF (NYSEMKT: FAZ): Sell Short

Daily leverage keeps steady downward pressure on this bearish ETF.

Suggested Short Allocation: 0.3% to 1% (we are currently short only 0.3%,
as the position has shrunk nicely, but we may add to it opportunistically)

How It Fits Into *Pro*

This bearish ETF is meant to provide 3 times (300%) the daily inverse results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. By shorting this ETF, we're effectively 3 times long, on a daily basis, the U.S. large-cap financial sector, which includes the likes of **Wells Fargo** (NYSE: WFC) and **Visa** (NYSE: V), *Pro* holdings.

Leveraged, inverse ETFs like this one are flawed because they rebalance their derivative positions daily in order to maintain a constant leverage. Over longer holding periods, the costs involved with rebalancing eat away at returns, keeping downward pressure on the vehicle as a whole. Also, returns are compounded daily, which adds to tracking errors. As our original buy report details, we continue to believe that large-cap U.S. financials are cheaply priced — and we own several of them as a result. That belief makes shorting this flawed bearish financial ETF all the more attractive.

That said, shorting FAZ has become difficult over the years, and our position size has dwindled severely. We lately have a 77% profit on our short! But those profits should keep coming, and new short sellers like you are in a fine position as this inverse, short, leveraged ETF can keep going down. That said, new members can skip this position if shorting it proves difficult (or use options if you have a six-figure account). We own plenty of strong financial companies serving a similar purpose in the portfolio.

For More

- *Pro*'s recommendation history
- Talk about FAZ on our discussion board

Availability

This ETF is hard to borrow. Lately, only 50,000 shares of FAZ were available for shorting at Interactive Brokers at a 4.9% annual fee. Periodically, TD Ameritrade has shares available with no fee. Members have sometimes been "bought in" on their shares at Interactive Brokers, closing the short.

Alternative Trade

If you can't short shares directly, then you can set up a synthetic short in a margin account. "Sell to open" January 2017 $40 calls on FAZ, and "buy to open" an equal number of January 2017 $40 puts. Lately you will pay a net debit of about $1.50 to $2 to set this up. This makes you short FAZ with a start price of about $38, and sets you up to profit if FAZ declines in price. Only sell one call for every $4,000 in FAZ you are able to comfortably short. On a $400,000 account, one contract would be a 1% allocation. That's about as much as we recommend to start.

Eagle-eyed members will notice that *Pro*'s short position on FAZ is 0.3% of our portfolio. We're recommending 1% to newcomers because we know you'll be unable to short another position in the *Pro* portfolio, SRS (more on that later). There are no IRA-friendly alternatives for this short. If you can't short it at all, you could add 0.3% to 1% to one of our two financial companies — Wells Fargo or Visa — instead.

Hedges

SPDR S&P 500 (NYSEMKT: SPY): Set Up a Put Ratio Spread

With yesterday's trade alert on the SPDR S&P 500, *Pro* recommended a new put ratio spread to hedge market risk. Please revisit that report to learn how to set up a 10% portfolio hedge if your market exposure is high enough to merit it, as *Pro* has done. (We want net market exposure of around 70%.) The trade alert has IRA-friendly alternatives, as well as a low-cost spread for those lacking the equity required to hold open the official trades.

Options

American Airlines (NASDAQ: AAL): Buy to Open January 2017 $35 Calls

Allocation: 0.4% or so

These calls target long-term upside on what we believe is a resurgent, disciplined airline that will continue to enjoy profitable operations.

For More

- *Pro*'s original recommendation
- Talk about American Airlines on our discussion board

Early this year, we recommended *Pro* members buy to open January 2017 $35 calls on American Airlines. Now is a much better time to join this slightly speculative position. Although the stock trades at less than 10 times earnings, it's still speculative because Wall Street may not give the company a much higher valuation multiple anytime soon -- although we believe investors should. Following major consolidation in the U.S. airline industry, I believe the Big Three airline leaders are going to stay profitable. Persistently low oil prices would only help, and we don't believe energy is going to resurge in price anytime soon. Today, you can buy these call options for around $11, or less than half the price we paid almost a year ago. We still believe there is eventual upside in our position, and newcomers have much better odds for success at today's price. Realize we may write diagonal calls against these calls for income while we wait. But for now, get started with our original report. Note, again, that prices are lower now. Only invest what you can afford to lose in these calls!

American Tower (NYSE: AMT): Buy to Open January 2018 $80 Calls

Allocation: 0.5%

These calls target long-term upside on American Tower, adding to our existing stock holding.

For More

- *Pro*'s original recommendation
- Talk about American Tower on our discussion board

Pro owns January 2017 $80 calls because we bought them before the 2018 calls were listed. Newcomers should consider buying January 2018 calls (rather than the 2017 calls that *Pro* owns) in order to give the investment thesis more time to play out. *Pro* will likely roll its calls out to 2018 prior to 2017 expiration so long as the investment thesis doesn't change.

We're seeking leveraged returns if American Tower stock appreciates by 2017. To follow along, **use a limit order** to buy to open January 2018 $80 calls. Aim for a price near the midpoint of the current bid/ask spread. A 0.5% allocation at current prices most closely equates to buying one call for every $500,000 you manage. This is a small position by design, so be careful not to over-allocate to the calls; we may seek to add more to our position later if volatility provides us with lower prices. Members for whom one contract would over-allocate their portfolios can consider buying 0.5% more in stock, bringing your stake to 4%. Realize you won't benefit from the leverage the calls will provide, although you will have a better breakeven price and no expiration.

All the Rest of *Pro*'s Positions

As a *Pro* member with an especially keen eye (and great memory!), you will note that we haven't updated you on every position in the portfolio yet. Pricing opportunities being what they are and with expirations right around the corner, not all of our positions are primed for new action right now, and not all options positions are timely. Worry not. We will publish Catch-Up Trades when we see new *Pro* opportunities on existing positions. One by one, it won't take us long to get there. Here's the status on our remaining positions that are currently "on pause for newcomers" — either on hold or not timely.

Coca-Cola

Synthetic Long Ending Soon

Pro holds a synthetic long option position, with synthetic covered calls, on **Coca-Cola** (NYSE: KO), but it expires in January 2016 -- not far away. By then we'll have an updated strategy decision and advice for all members. We advise new members to wait. (Some of you started an option position on Coca-Cola with *Motley Fool Options* — that's a fine substitute for now and perhaps indefinitely, unless we get a great new opportunity.)

Expeditors International

Synthetic Covered Strangle

Shares of shipper **Expeditors International** (NASDAQ: EXPD) have run up sharply and provided a lot of income for *Pro* over the past 15 months. Our synthetic long expires in January, and we're not sure yet whether we'll turn it into stock. We advised newcomers looking for a short-term income trade to buy stock (in 100-share lots) and then write the new December 2015 $48 put/$50 call strangle with us. That's still viable. You can see that Alternative Trade guidance at the end of our recent EXPD report.

Five Below

Short on Hold

Discount retailer **Five Below** (NASDAQ: FIVE) is down 18% since we first recommended selling it short, so we're happy; but we'll see a new earnings report on Dec. 3, so volatility may be directly ahead. We want to see those results before deciding our next move,not to mention what we want new members to do with this short. Stay tuned!

Gentex

Puts on Track to Expire

Pro has written December 2015 $15 puts that, if exercised, would have us add about 1% in stock to our **Gentex** (NASDAQ: GNTX) position. The goal with these puts is to earn income and potentially add to our existing stock position at lower prices. Since this position is just a few weeks from expiration, we don't recommend that new members join us now. We'll likely write puts again whenever we see good pricing after these expire -- and at that point all members can join in.

O'Reilly Automotive

On Hold

We have a 5.2% stock position in **O'Reilly Automotive** (NASDAQ: ORLY), but it's on hold for new members as we review the valuation. We'll have an update with guidance this month!

Tupperware Brands

On Hold

Tupperware (NYSE: TUP) derives most of its revenue overseas, but the strong dollar has hit results, and called into question management's aggressive share buyback plans over the past few years. We're reassessing if we want to keep this admittedly cheap-looking stock or not. We'll have guidance for all members this month! Right now, we have a 2.2% allocation, but new members are advised to wait.

ProShares UltraShort Real Estate

Short on Hold

We have a small (0.3%) short remaining in the **ProShares UltraShort Real Estate ETF** (NYSEMKT: SRS). We enjoy watching its slow descent in price, but the ETF only has $32 million in assets now, making it too small to recommend to new members. Plus, outside of our broker (Interactive Brokers), it appears impossible to borrow shares to sell short now — and if you do find them, the annual percentage fee to short is high (recently 5.2% at IB). Instead, as shared above, we recommend that you sell short up to 1% in FAZ as a long-term alternate, or buy up to 1% in shares of the **iShares Dow Jones US Real Estate** (NYSEMKT: IYR) as a long-term hold instead. Or just sit this small position out.

Wells Fargo

Puts on Track to Expire

Our $52.50 written puts on **Wells Fargo** (NYSE: WFC) expire in January, and we've earned much of the income already. New members are advised to wait for a new put-writing trade to make with us after January expiration.

World Acceptance

Short on Hold

We shorted **World Acceptance** (NASDAQ: WRLD) this year and quickly booked a large 37% gain, closing half our short. Now shares of this questionable consumer lender are hard to find for shorting, and Interactive Brokers charges more than 21% a year for the honor. That's too expensive, so we're considering closing the rest of this position. New members can steer clear for now.

In Conclusion

We'll likely recommend many of these positions (except the SRS short) to new members once we reaffirm that there's sufficient opportunity to make up for the current risk, and/or when pricing improves or after expiration on our options. Just watch your inbox for trade alerts!

At the same time, we're not standing still. In this and our two previous Portfolio Building Reports, you have many great *Pro* investments -- all rated Buy First or Buy -- to move into. And of course, we'll continue to send brand-new investment recommendations to all members.

It's not vital that your portfolio be 100% identical to ours, but being closely attuned to it, especially with our core stocks, should position you to succeed well with *Pro* over the time frame that matters. Meanwhile, if you're new to shorts, hedges, and options, start to dip your toes in as your comfort allows. We're here to help, and we believe you'll see many, many great benefits as the years unfold.

Fool on!

— Jeff (TMFFischer) and the *Pro* team (Billy, JP, Jeremy and Ellen)

Boulder Brands: Process vs. Outcome

Published Nov 30, 2015 at 2:38PM

Pro Guidance Changes

- **Five Below** (Nasdaq: FIVE): This short moves to Hold as we await Dec. 3 earnings and contemplate our next move. Newcomers should wait.

Pro Completed Trades

- **Boulder Brands** (Nasdaq: BDBD): We covered (or bought to close) all of our 6,200 short shares at $10.93, ending the position.
- **Expeditors International** (Nasdaq: EXPD): We wrote a December 2015 $48 put/$50 call short strangle, collecting $1.25 per share combined.
- **Verisk Analytics** (Nasdaq: VRSK): We bought 100 additional shares at $73.90, bringing our allocation to 2%. The stock is a Buy.

Dear *Pro* Fools,

Last week, just a few days after we recommended writing covered puts intended to close our position, we found out that our largest short holding, **Boulder Brands** (NASDAQ: BDBD), had agreed to a buyout from **Pinnacle Foods** (NYSE: PF). Pinnacle intends to launch a tender offer to acquire all outstanding shares of Boulder Brands at $11 per share, valuing the entire company (including $265 million of net debt) at $975 million.

To avoid another, potentially higher bid, we recommended closing all outstanding positions on Boulder Brands after we saw the news, locking in our total return on the position. Our short position has an effective start price (including fees) of $8.89; this excludes the $1.10 we guided to in our covered put recommendation, since we weren't able to execute our trade before the buyout. Our total return on the position is a 23.2% loss; if we had been able to achieve guidance on our written put recommendation, our total loss would have been a 9.6% loss.

With the buyout announcement, the biggest risk to our thesis came to fruition. We knew a buyout was possible, but we underestimated its likelihood -- or more so, the price the acquirer was willing to pay.

While it's never fun to see an investment (long or short) go against you, investing mistakes have benefits. This is especially the case for shorts, which are more tactical in nature and tend to run their course much more quickly than longs. So with this as with any mistake, let's analyze what went wrong and attempt to benefit from this knowledge in the future.

Process vs. Outcome

I think this Boulder Brands position is an excellent example of the process-vs.-outcome dichotomy. Several years ago, before my time with *Pro*, I read a *Stock Advisor* article by none other than Jim (the Other) Mueller, TMFTortoise. The title was "Use Outcomes to Improve Your Process, Not to Judge It," and the crux of the article really stuck with me.

Jim's main point was that we tend to judge our performance based on outcomes, despite the fact that outcomes are totally outside our control. Instead, we should judge our performance based on *process*, which is completely within our control, to determine whether we could have done a better job preparing for the eventual, unknowable outcome. Jim presented this matrix from J. Edward Russo and Paul J.H. Shoemaker's book, *Winning Decisions*:

	Good outcome	Bad outcome
Good process	Deserved Success	Bad Break
Bad process	Dumb Luck	Poetic Justice

In this Memo, I'll run through each branch point in *Pro*'s position history with Boulder Brands and attempt to classify each decision into one of the four displayed in the matrix above.

March 23, 2015: Short Boulder Brands

Our initial action ("Decision 1") on Boulder Brands was a simple short of the company's stock. Our short thesis revolved around troubling management and governance, questionable earnings quality, and a poor balance sheet.

June 10, 2015: Boulder Brands Co-Founder and CEO Resigns

Less than three months later, Boulder announced in a press release that the co-founder and CEO had resigned, and the company provided updated guidance that disappointed the market. The stock fell more than 20% that day, closing at $6.91 per share, down 28% from our effective short price of $9.60 per share.

If we'd closed our position after the CEO resignation, then Decision 1 would have fallen squarely into the "Deserved Success" quadrant of the process vs. outcome matrix. The short thesis was spot on, with poor earnings quality leading to poor revenue growth, and troubling governance leading to a management departure. The outcome justified our good process.

However, ultimately, we decided *not* to close the position, eventually settling on:

June 22, 2015: Short More Boulder Brands and Buy Protective Calls

After further research, deliberation, and discussions among the team, we decided to press our (at that point) successful short, deciding to short more stock and buy protective calls at the same time in order to cap our risk. We'll call this second portfolio action "Decision 2."

We believed that the company's negative business momentum was likely to continue, and that all of the troubles leading to the CEO's resignation were still apparent and likely to persist. We felt that more downside was likely, and we even acknowledged the possibility of a takeout offer or merger in our write-up.

Aug. 14, 2015: Boulder Brands Stock Spikes on Buyout Hopes

On Aug. 6, Boulder Brands reported terrible second-quarter 2015 earnings, but it did announce "a range of strategic alternatives to enhance shareholder value." On the heels of the July 29 disclosure of a significant stake by activist investing fund Engaged Capital, this was enough to bring the stock up 17% on the day of the report.

If we'd closed our position here, Decision 2 would have fallen into the "Bad Break" category of the matrix. Our process was sound, and we were correct about the negative trajectory of the company's financials. We anticipated the possibility of an adverse outcome leading to a spike in the stock price, and we properly positioned ourselves to protect against it. If we had exited the position then, our overall position would have resulted in a 9.7% gain.

But again, we ultimately decided not to close the position, continuing to:

Sept. 2, 2015: Sell Your Protective Calls on Boulder Brands

After more continued discussion, we decided to sell our protective calls to reset our uncapped short position ("Decision 3").

In my evaluation, Decision 3 was the first in which our *process* was unsound. Our initial short thesis had been fulfilled, and the investment case for the company at that point was much different than the case that existed when we established our short. The presence of an activist investor and management's statements about "strategic alternatives" combined to create a higher likelihood of a negative outcome for our short position. Uncapping the short at that point was probably unwise.

Our reasoning was too simplistic -- we believed upside above $10 per share to be unlikely, and we thought that was enough justification to maintain exposure to continued operational miscues and negative financial performance. In the end, our estimation of likelihood was incorrect, and we didn't give enough credence to just how often management teams (like the one at Pinnacle) pay up for acquisitive growth with hopes of "synergy" and "cost savings." The tendency for managers to overpay for mergers and acquisitions is even something we've discussed before (see "Uses of Capital" in this prior Memo), so we shouldn't have discounted this possibility as much as we did.

Decision 3 certainly falls into the "Poetic Justice" quadrant of the matrix. Our process and reasoning weren't sound, and our position-level returns suffered because of it.

Nov. 20, 2015: Write Covered Puts on Boulder Brands

Eventually, Boulder Brands reported third-quarter earnings, and the results showed signs of financial and managerial improvement. After reviewing the quarter, we decided that maintaining our short was too risky (we were right!), and we recommended writing covered puts on the stock with the intent of closing our position entirely at expiration ("Decision 4"). However, just a few days later, Boulder was acquired, and the premium received for the puts was incinerated by the rise in the stock price.

This is where the judgment of process can get a bit murky. Conditionally, based on our reasoning from Decision 3 (i.e., that upside much above $10 was unlikely), Decision 4 would fit into the "Bad Break" quadrant. But on an absolute basis, Decision 4 was "Poetic Justice," as we probably should have closed our short before Decision 3.

This is an example of how errors can compound – a mistake in one part of a process can cause a ripple effect. Even if each subsequent decision is conditionally sound, if the decisions are based on faulty assumptions, the whole process falters.

When we decided to write puts rather than close immediately, we were also keeping in mind the fact that we run a portfolio service; we wanted to avoid significantly affecting the market price. But those concerns were dwarfed by the magnitude of the premium paid by Pinnacle to acquire all outstanding shares of Boulder. The correct decision here would have been to directly close the position.

Nov. 24, 2015: Close Your Positions on Boulder Brands

In response to Pinnacle's takeout offer, we recommended that members close all outstanding short shares or option contracts ("Decision 5").

Obviously, we haven't seen the outcome of this one yet. It's always possible that the acquisition could fall through, which would probably result in a significant stock-price decline, but there's no way of assessing the likelihood of that. Also, it's possible that another, potentially higher bid could come through to Boulder shareholders, adding additional risk to those with short positions. While we won't know what quadrant Decision 5 will fit into until the deal closes or other news is announced, in my estimation it is an example of good process.

The *Pro* Bottom Line

There is much to be learned from unsuccessful investments, both on the long side and on the short side. The fact that shorts tend to be more action-packed and short-term in nature helps us in our ability to analyze our mistakes. In this Memo, we talked about the difference between process and outcome, and how it's much more important to judge ourselves on our process (which is in our control) rather than by outcomes (which are not).

In conclusion, we probably suffered from thesis drift with this position. When our original thesis came to fruition, we should have marked the position a success and moved on cleanly. Instead, despite changes to the situation that affected the likelihood of bad outcomes, we continued to pursue further returns. Our assumptions and estimations of likelihood were wrong, and we ended up with a losing position.

In the future, we should be more careful in examining our assessment of probabilities, and we should lend more credence to the fact that managers often pay rich prices to achieve acquisitive growth. With this acquisition, Pinnacle Foods assumes that it will be able to increase Boulder's adjusted EBITDA by 50% over the next two years via "a combination of synergies and previously identified cost savings," resulting in a 2017 price multiple of 10 times EV/EBITDA when combined with $47 million in tax benefits. (For context, the current and unadjusted TTM EV/EBITDA for Boulder at $11 per share is 25.5.)

Those are some aggressive assumptions, and we won't know whether they're realistic or not until the future unfolds. But what we do know is that the valuation process in mergers and acquisitions is flawed. We should have been more aware that a premium price in this acquisition was possible, especially given that the possibility of being acquired was explicitly mentioned by management.

Thoughts? Bring them to the Boulder Brands discussion board. Fool on!

-- Billy (TMFBillyTheKid)

Hedge: Set Up a Put Ratio Spread on the SPDR S&P 500

Published Nov 30, 2015 at 1:01PM

Is this for you? At *Pro*, we use hedges to earn returns during a meaningful market decline. You don't need to hedge to succeed with *Pro*, but if you are at least 80% invested in stocks and want to hedge against a market decline, then consider following along. This 10% hedge will lower our market exposure to about a net 70%. Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $200,000.

How You Participate

- **Action:** Ideally, use a spread order or a ratio spread order to set up a put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF, as detailed below.
- **Allocation:** Ten percent of your total portfolio value, measured on the look-through value of the $200 puts you're buying (each put represents $20,000 in hedge value). Set up one 2:1 put ratio spread for every $200,000 you manage and want to hedge; hedging 10% of our entire portfolio of nearly $2.6 million, *Pro* will sell 26 puts and buy 13 (because 13 puts at a $200 strike = $2,600 x 100 shares per contract = $260,000 look-through put value = 10% of our portfolio value).
- **Trade:**
  - **Use a ratio spread order to simultaneously ...**
    - Write ("sell to open") **two** February 2016 $190 puts, and:
    - Buy ("buy to open") **one** February 2016 $200 put. Click "view all" at your broker to see all strikes.
- **Price Guidance:**
  - Sell to open **two** February 2016 $190 puts: Lately $1.85 x 2 = $3.70 credit
  - Buy to open **one** February 2016 $200 puts: Lately $3.45 debit
  - **Net credit:** Lately about **$0.25** credit per spread -- but this price will change. As it does, simply aim for a credit, or close to no cost, using a limit order.
  - SPY price: $209.50
  - **Potential adjustment:** If SPY moves in price before you set up your trade, you may want to move both of your strike prices down or up accordingly, as much as SPY has moved, while still aiming for a net credit. After our mandatory trade delay, we will make such an adjustment if need be, and tell you about it.

What We're Thinking

At *Pro*, we aim to have winners in down, flat, and positive markets -- and that means we need to address all three possibilities at once in our portfolio. A hedge on a market index is simply a hedge against a lower market. We generally don't care about declines of 5% or less, but when *Pro* is functioning as desired, declines of about 7% or more should result in some of our positions, like these spreads, becoming nicely profitable. At the same time, the put ratio spreads we use:

- Are harmless to us if the market goes higher (they don't harm our return)
- Are typically cash-free to set up (they can even pay us a small credit -- essentially income!)
- Have a relatively low probability of loss

What's the trade-off? As with any written put, we need to be ready to buy the underlying investment; for today's position, that means being prepared to buy into the S&P 500 index (through SPY) if the market falls too sharply. In this case, if the index falls more than 14%, this hedge becomes a liability, with SPY falling below our breakeven point. If that happens, we would plan to buy long-term call options on SPY instead of shares, saving most of our cash in the process. See below for details on that.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2,570,000
- Ten percent of that value: $257,000
- February 2016 spread:
  - Buy to open $200 puts. Thirteen contracts representing 100 shares each = $260,000 in look-through exposure, or about a 10% hedge on our current portfolio value, cash included.
  - Sell to open $190 puts -- 26 contracts, half of which are uncovered by long puts and thus become a potential obligation at a net $180, currently a 9.1% possible stake.
  - At home, you would buy one $200 put and sell two $190 puts for every $200,000 in portfolio value you want to hedge ($20,000 look-through value per $200 put divided by $200,000 = a 10% hedge).

Return Details

SPY Price at February 2016 Expiration	Value of 1 Purchased February 2016 $200 Put	Value of 2 Written February 2016 $190 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Recent $209.50
$200 or higher	$0	$0	$0.25 gain per spread -- or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 4.5%
$195	$5 x 100 = $500	$0	$500	(6.9%)
$190	**$10 x 100 = $1,000**	**$0**	**$1,000 (max profit per spread)**	**(9.3%)**
$185	$15 x 100 = $1,500	($5) x 200 = ($1,000)	$500	(11.7%)
$180	**$20 x 100 = $2,000**	**($10) x 200 = ($2,000)**	**$0 (break-even)**	**(14.1%)**
$175	$25 x 100 = $2,500	($15) x 200 = ($3,000)	($500)	(16.5%)

If SPY declines more than 4.5% from recent levels, this hedge starts to come into play. Our maximum profit is earned on the spread if SPY declines 9.3% from its recent level of $209.50 by our February expiration. The spread will help us a little on an index decline of as much as 14%; deeper than that, and our short puts turn into an obligation that's in the red.

Follow-Up

Assuming we set this spread up for a credit, it will result in a small profit even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $190 put obligation (starting with a net buy price of $180) if SPY is below $190 by expiration.

However, if that does happen, our plan would be to close our puts and buy long-term SPY calls (or something we like even better, whether calls or a stock) instead of buying the ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY shares. So, our potential 9% or so stake in SPY shares will only cost us about 2.25% of our cash if we buy calls instead. We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases.

How It Fits Into *Pro*

Pro consistently hedges to lower our invested market exposure, or risk. As you know, we aim to achieve positive returns every rolling three years, and inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market will make a difference. Even small gains add up over the years, especially if those gains on market declines are then reinvested in depressed stocks. This hedge fits well with our goal of hedging in a cost-efficient way, one that doesn't work against us if the market rises. It does require regular upkeep, though, opening new positions as old ones expire, and these spreads are time-sensitive, really only helping at or near expiration.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:**
    - For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, as we are, "buy to open" February 2016 $200 puts and "sell to open" *an equal number* of February 2016 $190 puts. Recently, this will cost you less than $1.70 ($170) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $10 ($1,000) per spread on a decline to $190 or any lower price, but you should be prepared to lose your whole $1.70 per spread if SPY doesn't decline to somewhere below $200 by expiration.
- **To lower your market exposure while following our full official trade (and make the position possible in some IRAs):**
    - Set up the original put ratio spreads as recommended, but also "buy to open" puts (with the same month of expiration) at a strike prices *well below* $190. Buy *half as many* as the number of $190 puts you wrote. When you do so, all of your $190 puts will be "covered" (half by your $200 puts, and half by the other puts you choose to buy at a much lower strike). Choose how much you want to pay to select your lower strike price. To us, the $180 strike or lower looks good, recently costing $1 or less. You will only need cash in your account to cover the difference between your two lowest strike prices (if you buy $180 puts, then $10 per share), and your risk is capped, making this potentially IRA-friendly. This makes the total cost of your hedge about a $1 debit, with no risk beyond that, and still $10 in potential ending value.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Visa Announces a Solid Fourth Quarter and a Monster Acquisition

Published Nov 25, 2015 at 11:58AM

Visa (NYSE: V) finished its fiscal year with a strong fourth quarter despite persistent headwinds from currency volatility, sputtering international economies, and plummeting gasoline prices. Global payment volumes grew 12% in constant currency and net operating revenue increased 13% in constant dollars to $3.6 billion. Lower gasoline prices remain a 2% drag on U.S. payment volume, but that should moderate later in the year as we lap the early 2015 drop in oil prices.

The strengthening dollar has been a drag on profits thanks to both currency translation and decreased cross-border spending growth. Increased currency volatility has partially offset this headwind thanks to Visa's ability to profit from wider bid-ask spreads. Global cross-border volume growth, which tends to carry the highest margins, declined to 5% in constant currency from 8% growth the three preceding quarters. Management also shared that cross-border growth has slowed further to 3% through the first month of the current quarter.

Visa also announced another big customer win this quarter, stealing USAA from **MasterCard** (NYSE: MA) and ending a 30-year relationship between the financial service provider and the other payment processor on the *Pro* scorecard. The company also renewed it's it partnership with **Wells Fargo** (NYSE: WFC) which locks in 5 or the top 6 accounts through 2020.

In the fourth quarter client incentives were up significantly to 18.4% of gross revenue as the company signed several new renewals and announce a couple big wins. Though this will drive continued volume growth in 2016, management expects client incentives to remain at 18.5% through 2016, compared to the 17.1% run rate the company achieved in 2015. This is evidence that competition remains fierce, though management emphasized that the vast majority of the company's growth comes from the shift from cash to digital transactions rather than taking market share.

On the capital allocation front, Visa continued to return cash to shareholders, repurchasing nearly $3 billion of shares at an average price of just under $66 a share. The company now has $7.8 billion of repurchase authorization for fiscal 2016.

Visa Acquisition

The biggest announcement for the quarter is the planned acquisition of Visa Europe for $16.5 billion of cash and stock. Including the proposed $4.7 billion of earnout provisions, total consideration for the deal could hit $21.2 billion if the Visa Europe business achieves certain performance hurdles. The company plans to raise $15 billion to $16 billion in debt to fund the acquisition and to repurchase enough shares over the next year to offset the dilution from the convertible preferred shares issued to Visa Europe shareholders. These buybacks will be in addition to the company's normal repurchase activity.

Management also claims that they are attempting to create "a more efficient long-term capital structure". In other words, they're taking advantage of historically low interest rates (3% to 3.5%) to reposition the balance sheet and benefit from the tax shield provided by interest payments on debt. Visa's business model generates a ton of free cash flow, which can easily support additional debt without risking financial distress or the company's investment grade credit rating. Management is targeting a leverage ratio of 1.0 to 1.5-times EBITDA, which the company can reduce quickly if necessary.

Overall, this transaction isn't much of a surprise. The payment processing business is all about scale and this acquisition allows Visa to make a big jump in that regard. Europe will now represent 26% of Visa's combined transaction volume. Visa previously made the transition from the member-owned model to the commercial model before its 2008 IPO and these companies have been working closely for a long time, so the cultural transition shouldn't be too painful. Still, management expect the total integration process to take 3 to 4 years and cost $450 million to $500 million in addition to $150 million of one-time transactional closing costs. The technology integration will likely be the biggest cost savings, as the two companies merge platforms and eliminate redundancies. All-in-all management expect to generate $200 million in cost savings which amounts to a 30% reduction from Visa Europe's annual run rate.

2016 Outlook

Looking forward into next year, management expects payment volumes to grow faster than the 11% clip they've grown over the past two years. That increase should begin in the second quarter when we anniversary the big drop in gas prices and then accelerate in the second half as the USAA (a recent steal from MasterCard) and **Costco** (NASDAQ: COST) deals come online. Management expects currency to be a three percentage point drag on net revenue in 2016 – up from the 2.5 percentage point drag the company experienced this past year. As a result of a strengthening dollar, management also does not expect any meaningful improvement in cross-border transactions growth in the coming year.

Visa is also spending heavily in China to be ready to launch services once the government finalizes its new regulations later in the year. It's nearly impossible to make any estimates about how quickly that market will ramp, but it's a massive opportunity that's mostly being served by a single provider, UnionPay, so even a small market share win will move the needle.

The *Pro* Takeaway

Visa continue to perform well in a tough operating environment. The acquisition of Visa Europe seems a bit pricey, but it's a smart strategic decision and there's likely significant upside to current transaction volumes as the European economy improves and currency valuations mean revert over time. There's also room to improve yields through pricing, but management didn't want to share those plans for competitive reason.

Both of the payment processors in the *Pro* portfolio continue to benefit from the same tailwind and we think they have strong competitive advantages (brand, scale, network effect, etc.) that will allow them to continue creating value for shareholders. Even though Visa doesn't look cheap (it rarely does) at 27.8-times forward earnings and 17.7 times enterprise value-to-forward EBITDA we still think it will continue to generate North Star besting returns for the foreseeable future.

Close Your Positions on Boulder Brands

Published Nov 24, 2015 at 12:49PM

Is this for you? This trade is **only** relevant for *Pro* members who are participating in our short and any related positions we have on **Boulder Brands** (NASDAQ: BDBD). We are closing all Boulder positions with this alert -- new members lacking any Boulder positions can ignore this trade alert.

How You Participate

- **Trades:**
    - Buy to close (or cover) all of your existing short shares of Boulder Brands.
    - Buy to close all January 2016 $10 puts.
- **Allocation:** Close all existing Boulder short shares or option contracts. *Pro* will close its 6,200 short shares. (Unfortunately, we did not get to write the covered puts suggested last week, but we're glad many members did!)
- **Price Guidance:**
    - Use a limit order to close short shares for the going price, lately around $10.93 -- give or take pennies when you make the trade.
    - With a limit order, buy to close the January $10 puts for $0.05.
- **Prices (as of 10 a.m. ET):** Stock, $10.93; options, bid/ask: $0.00/$0.05

What We're Thinking

This morning, news broke that **Pinnacle Foods** (NYSE: PF) sees value in one of our short holdings, Boulder Brands, offering a buyout price of $11 per share, or $975 million including Boulder's debt. Just a few days ago, we took action to exit our short at a price near $9 by recommending $10 covered puts, but today that option is gone (literally and figuratively). Members who wrote those puts earned income, offsetting some of the stock's gain, and you can close the puts for a nickel to end that exposure.

It's now time to buy to cover, or close, our short shares of Boulder Brands. The stock is a bit below the $11 buyout price, and we don't want to wait for another, potentially higher bid. Instead, it's time we cry uncle (again, as we did a few days ago with our puts!) and leave this short. We're down 27% today, a loss made tenable by our small position sizing, now about 2.6%.

But the loss still smarts, we were still wrong, and we can learn lessons from this. At one point, we had a large gain on our short. We smartly (in hindsight) bought calls to protect that gain, even as we shorted more shares to bank on continued sales declines. But we later closed our calls for a profit and opened ourselves up to upside risk again.

Billy and I spoke about this position last week, along with our covered put recommendation, and (again, with hindsight) we now believe we should have covered the short when the CEO resigned and the stock was in a tailspin. However, sometimes a company continues to unravel after the CEO leaves. In this case, though, it turned out that a strong hand took the helm. And as we reported this month, the story started to get better -- leading to our choice to move to close our short.

Any way you look at it, we learned some lessons here that we can talk about together in future. Perhaps the next time a CEO resigns and a short is falling, we may close half or all of it. Each case is different, but we now have this experience to recall and add to our decision-making process. As we close our Boulder short, *Pro*'s short exposure decreases by 2.6%. We're seeking new shorts and hedges that should roll out in trade alerts in coming days and weeks.

Have a great Thanksgiving. With this short closing, now you can even enjoy some Boulder Brands foods at the table! (Provided it doesn't leave a bitter taste in your mouth.)

Alternative Trades

- **Did you set up a synthetic short instead of shorting shares directly?** Close that as well.
- **Did you buy puts instead of shorting?** You can "sell to close" your puts if they still have any value, dependent on the strike. Or you can simply keep them (they're probably near worthless) in case the buyout falls through and the stock falls.
- **Did you write different covered puts?** Whether December or February, buy to close those as well, both for $0.05. Why? Just in case the stock falls. We don't want you to be on the hook to buy shares.

Pro Can Help

- If you have questions, please visit our Boulder Brands discussion board.

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6 Key Things to Learn From Pro

Published Nov 23, 2015 at 2:56PM

Pro Completed Trades

- **Boulder Brands** (NASDAQ: BDBD): We wrote 62 December 2015 $10 puts, covering all of our short shares. We were paid $0.55 each. [**Correction:** This trade did NOT get filled. We'll try again on Tuesday, at a lower limit if needed. The next two did.]
- **Expeditors International** (NASDAQ: EXPD): We sold to open December 2015 $48 puts and $50 calls, collecting $1.25 in premium (a 2.55% yield on the share price) with expiration in 25 days.
- **Verisk Analytics** (NASDAQ: VRSK): We bought 100 more shares at $73.90, bringing our total allocation up to 2%.

Please note: On these trades, we're receiving considerably poorer pricing than was listed in the Trade Alert in question (this usually happens!). But after our 24-hour waiting period, we have to make the trade if we reasonably can; we wanted to get these done, and we still believe in each even as pricing changes.

Dear *Pro* members:

It's great to see so many new *Pro* members on our discussion boards, asking questions, engaging in conversation with other members, and making investment decisions suitable to them as they move forward – whether that's mirroring the *Pro* portfolio exactly, or modifying it to suit individual needs.

When we launched *Pro* more than seven years ago, this type of robust community discourse between members wasn't possible. New members didn't know for certain what we were about. What was our style? How would we invest? Today, those questions are much easier for our veteran members to answer, so they can easily help new members get up to speed (thank you!). That said, we're still early in this endeavor to grow great value together over many years.

Today, we'll highlight some of the most important things for all members to learn from *Pro*. But before we do that, let's get some of the most common new-member questions out of the way:

- **Should I invest in an IRA or not?** That's up to you; many members do.
- **Should I only buy stock in 100-round lots?** That's not very important, especially if it takes you further from our allocation guidance.
- **Should I buy all of *Pro*'s Buy-rated stocks, or only the ones below our fair-value estimate?** Yes, buy all the ones that are rated Buy; that's why we rate them Buy! Fair value is a conservative estimate that goes up over time.
- **Should I sell all of my old stocks or not?** Sell your least favorites if you need to raise funds for *Pro*, but don't be shy about keeping stocks you love.

Those are important initial questions. But now that they've been answered, let's look at the bigger picture: What will help your investing *most* over the coming years? Here, in order of importance, we have ...

6 Key Things to Learn From Pro

1. The types of companies we buy.

If you only come away with one thing, it should be this: We buy companies with eight specific qualities (we spell them out in your Guidebook) that will ideally lead to long-term compounding. Rather than seeking small gains that don't really make a difference, we aim to buy companies that will steadily grow, reinvest their cash flow in more growth, and compound further for us as a result. To describe these businesses, we borrowed the term "compounding machines" from fund manager Chuck Akre; it fits so well, we didn't need to change it.

If you learn to target businesses with pricing power, predictable revenue, high returns on investment, and our other qualities, it should change your long-term investment success in a large way. This year hasn't been friendly to most stocks; energy, new tech, and a lot of retail stocks are down 40%, 50%, or more. Since inception, *Pro* has had very few losers because we work hard to target companies that are resilient in most any scenario. When we stray from our own criteria, we're more prone to lose. Take heed!

2. Our preferred time frame -- and patience.

If you're a Foolish investor, this one is easy. You already know that small gains are made in the short term and by trading (if you're lucky), but fortunes are made by holding great businesses for years. We don't sell our favorite businesses on short-term blips or minor valuation concerns. We're investing to compound. You should only buy a stock when you have a rolling three-year outlook, to start.

3. Portfolio construction.

If you internalize those first two factors, you should do very well over the rest of your investing life. But *how* you build and manage your portfolio will help determine the magnitude of your success, and the bumpiness you experience in getting there. How do you allocate your positions? Do you let winners run or keep trimming them?

What we hope you'll learn from your *Pro* service about portfolio construction and management is best gathered from at least a few years of following what we do. One constant you'll see is that we want flexibility in our portfolio. We want to be confident and have room to make new investments even when the market is in chaos. So, we seek to construct a portfolio that only holds businesses we believe in (that match our criteria), has cash for opportunities, and delivers steady returns despite market volatility -- with at least some positions winning no matter what the market is doing.

For some stats: Since January 2012, our portfolio has averaged 87% long and 15% short, meaning we've averaged 72% net long (or net invested in the market). Yet with less volatility and only 72% market exposure, we've outperformed the North Star and the S&P 500 -- thanks in part to the strong types of companies we own.

4. Using options for income.

If you're interested in going beyond stocks into options, arguably the single most valuable lesson you can learn here (and in our sister service, *Motley Fool Options*) is how to generate income by selling options. We talk about this so much across both services that I won't go into it more here (see [Options U] if you want to dive deeper), but suffice it to say that countless members have changed their investing lives -- and made retirement possible or better -- by learning how to generate income in their portfolios (while still holding stocks for upside!). Among our favorite strategies are written puts and covered calls, and we've made option income almost every month this year here in *Pro*. That remains our goal: Monthly option income on top of our stock investments.

5. How and why we hedge.

Carrying some cash is one way to soften the blow of falling markets; another way to do this is by learning to hedge the *Pro* way. We typically set up low-cost option hedges on major market indexes, such as the S&P 500 or Russell 2000. Many of our hedges don't cost us money out of pocket (instead, they often carry an obligation to buy shares of the index if it falls sharply, something we're fine with). Most hedge funds pay a large percentage of assets to hedge, but we usually don't. Not doing so has been important to our returns since inception. If you want to learn to hedge, follow our hedging trade alerts (most of which are very low-cost) and attend (or review) our Portfolio Positioning event on Dec. 1, which will address a new hedge or two we hope to issue by then, along with our options and shorts.

6. Shorting losers.

Finally, selling short companies isn't for everyone, but you can learn how to employ this "expert only" investing style in a way that won't put your portfolio at unreasonable risk – and should help in bad and even good markets. We seek to short companies that should struggle *whatever* the environment. Position sizing and risk management (including knowing when to close the position) are important, as is having a broker that allows you to stay short (we've had the best luck with TD Ameritrade and Interactive Brokers). Shorts are the final piece of the puzzle to learn here in *Pro*; we'll have more info on our existing shorts on Dec. 1, along with interesting, promising new shorts in the weeks to come. (If you can't make the Dec. 1 event, no worries; video and text will both be archived on the event page when it's over.)

It's All a Fun Process

Enjoy the process. Like anything good, it takes time. But if you enjoy it, before you know it you'll own great stocks, and enjoy owning them; you'll be calm, because you always think in rolling-three-year terms; you'll have a portfolio that is flexible and strong; you'll be generating regular income from options if you want; and you will be hedging and shorting as much or little as you wish, with confidence. These are the key things we hope you'll learn with us at *Pro* to make you a better investor for life.

Thank you for being here and for putting your trust in us. And to our American members, have a wonderful Thanksgiving holiday!

-- Jeff (TMFFischer)

Write Covered Puts on Boulder Brands

Published Nov 20, 2015 at 11:14AM

Is this for you? This trade is **only** relevant for members who are participating in our short of **Boulder Brands** (NASDAQ: BDBD), which is currently on Hold. If you've yet to establish a position on Boulder Brands, you can simply ignore this alert. The position is now on track to leave the portfolio.

How You Participate

- **Trade:** Sell to open January 2016 $10 puts.
- **Allocation:** 2.3%. Write one put for every 100 shares of Boulder Brands you are short; *Pro* will write 62 contracts. These in-the-money puts, if exercised, would see us close out our short position completely around a net $8.90.
- **Price Guidance:**
  - Based on the pricing in this alert, because the bid/ask spread is wide, **it is extremely critical that you use a limit order** to target $1.10 or greater to start (for an effective buy-in price of $8.90, and a 6.6% yield on time value in just less than two months). **If we all use limit orders** and the stock price cooperates, we can hopefully achieve $1.10 today. Be aware that as the stock price bounces around, the premiums will change, and the guidance in this alert may quickly become stale. If you can get a higher premium, go for it, **using a limit order** (are you sensing a pattern?) to at least split the bid/ask spread. As time goes on, it is more critical for you to execute this trade than to hold out for the guided price. We intend to use these puts to close our short, and with just two months to expiration, time value will drain from the puts relatively quickly, reducing their attractiveness. If *Pro*'s alert impacts market liquidity and guidance is immediately unachievable, see the Alternative Trades below. (But this won't happen, of course, because **everyone is going to use a limit order**. Right?)
- **Prices (as of 9:45 a.m. Nov. 20):** Stock, $9.53; options, $0.85 bid / $1.50 ask.
- **Scorecard Status:** Short (Hold), 2.3% allocation; we're now writing in-the-money puts with the goal of completely closing our position.

What We're Thinking

Shorting is a difficult business. Despite deteriorating financial results that are tracking almost perfectly with our short thesis, **Boulder Brands** (NASDAQ: BDBD) is trading right around the price it was enjoying when we established our initial short position in March of this year. Why? For one, the stock has become the target of an activist investor, and Boulder has announced that it is exploring "a range of strategic and financial alternatives to enhance shareholder value" -- corporate-speak for "we are looking to divest a portion of our business or be acquired." For another, Boulder's most recent earnings report showed signs of improvement in the company's operations (see our review of the quarter here for more). Additionally, the stock rose in value this week after **ConAgra Foods** (NYSE: CAG) announced that it will split into two companies. This has fueled further speculation about the prospects for corporate action from Boulder (will it split into two companies too? Or perhaps something else?).

All in all, after thoroughly analyzing the business and tying it back to our initial short thesis, we've decided that despite the stock's ugly valuation (146 times TTM GAAP earnings, 42 times TTM free cash flow), there's simply too much risk involved with keeping an active short position. Our initial short thesis relied upon poor management, a flawed business, *and* a pricey valuation. Now, with the change in management and an improvement in fundamentals, the short thesis would rely increasingly on valuation as the main pillar. With the potential for continued operational improvement and a possible corporate action (a spinoff, divestment, or buyout), this short has become much more risky than it was when we established it.

As such, we've decided that the proper course of action is to write in-the-money puts that, if exercised, would see us "buy to close" our short shares at prices that are more favorable than simply closing the short on the open market. Additionally, writing puts will likely put less pressure on the stock price than issuing a simple close. Since this is a small business with less liquidity than a typical *Pro* stock, we have to be careful about how our actions affect the stock price.

So we'll be pursuing a strategy we use often (written puts), but in a much different manner than is typical for us. Writing in-the-money covered puts will lower the effective closing price on our short and will result in less pressure on the share price than issuing a simple close.

Given the net start price on our two slices of short shares, plus the profit on our protective calls, less the drag of short fees, our effective start price on the position is $8.89 per share. If we can achieve the $1.10 guidance and our puts are assigned, then we'd be closing our short at a net $8.90, resulting in an essentially breakeven result on the total Boulder Brands position. If our puts are assigned in January, we'd have maintained a small amount of short exposure and reduced our correlation to long stocks for 10 months essentially for free, although we weren't able to earn an absolute profit on the position. And we've also earned some experience that shows just how difficult it is to be a successful short seller.

More That Matters

- **Maximum loss:** Our maximum loss on our overall covered put position (short shares + short puts) is theoretically unlimited if the stock continues to rise. This is the same as a regular short.
- **Maximum gain:** On these written puts alone, our maximum gain is the put premium. At $1.10, that's a 6.6% effective yield on time value in just less than two months.
- **Follow-up:** If our puts are assigned, we'll be buying back our short shares at a net price of $8.90 per share, about breakeven on our Boulder Brands position. If the stock price rises above $10 before expiration, we will likely write new puts at a higher strike, maintaining our intent to close the position.

Alternative Trades

- **Did you write a synthetic short instead of shorting shares directly?** You could either write covered puts that expire the same month as your synthetic short, or you could just close your synthetic short immediately.
- **Did you buy puts instead of shorting?** You can "sell to close" your puts if they still have worthwhile value.
- **Want to write other covered puts?** Consider writing December or February puts if the price on those options holds up better than those of the January puts after this alert is issued, aiming to at least split the bid/ask spread. Be aware that with a December expiration, your net buy-in price will be higher than the January puts, although you will have to wait less time to close your short. With the February expiration, your premium will be higher and your net buy-in price will be lower, but you'll have to wait more time to close your short, increasing the risk of adverse news.

Pro Can Help

- If you have questions, please visit our Boulder Brands discussion board.

Boulder Brands Shows Signs of Improvement

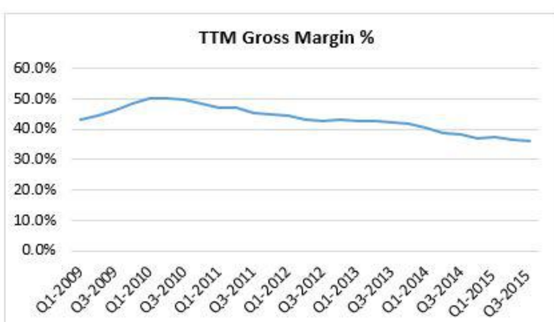
Published Nov 20, 2015 at 10:40AM

After uncapping our short position on **Boulder Brands** (NASDAQ: BDBD) back in early September by selling our protective calls, we've been waiting for the company to report its most recent round of earnings before making any decision on what to do with our position. Since we started the short in March, our short thesis has been complicated by a CEO resignation and subsequent reshuffling of management, speculation about a divestment or buyout, and the involvement of an activist investor. Let's dig into this quarter's numbers to see how the results stack up against our short thesis.

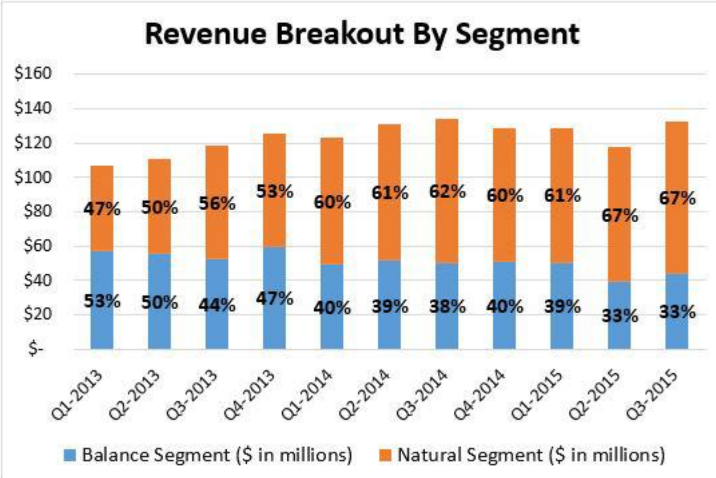
What Happened?

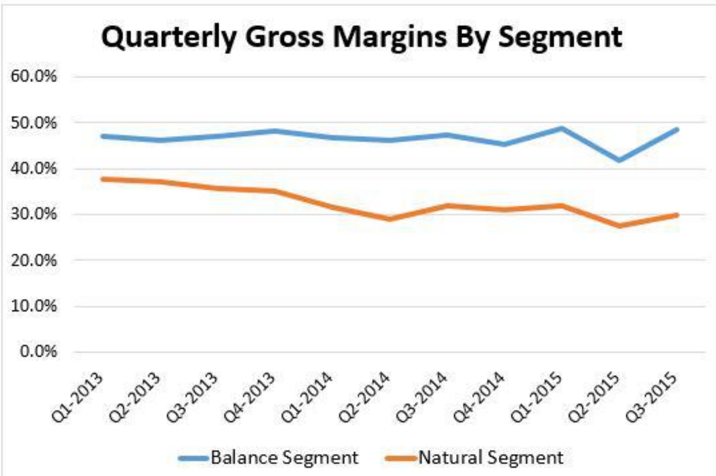
Boulder Brands reported a decent quarter that actually beat consensus estimates on quarterly revenue and adjusted EBITDA, reporting net sales of $132.9 million (a 0.7% decline compared to Q3 2014) and adjusted EBITDA of $19.6 million (a 6.2% decline compared to Q3 2014). Side note: As long-term investors, we generally don't place too much emphasis on Wall Street estimates, but they do have a tendency to affect short-term stock price movements. Given that short positions are more tactical and timing-dependent in nature, in this case it's useful to take note of how the business performed relative to near-term expectations.

The company experienced a significant sequential (quarter-over-quarter) increase in gross margin, reporting 36.1% compared with 32.4%last quarter. Despite this, companywide TTM gross margin (the rolling four-quarter average, which smooths out seasonality and provides a longer-term perspective) continued its decline, as this quarter's TTM gross margin was down compared with a year ago:



The primary reason for the year-over-year decline in gross margins is a higher proportion of sales from the company's faster-growing and lower-margin Natural division. Margins are also declining across this division because of yield losses at Udi's as the company focused on removing bread items with air pockets or holes from its production line:

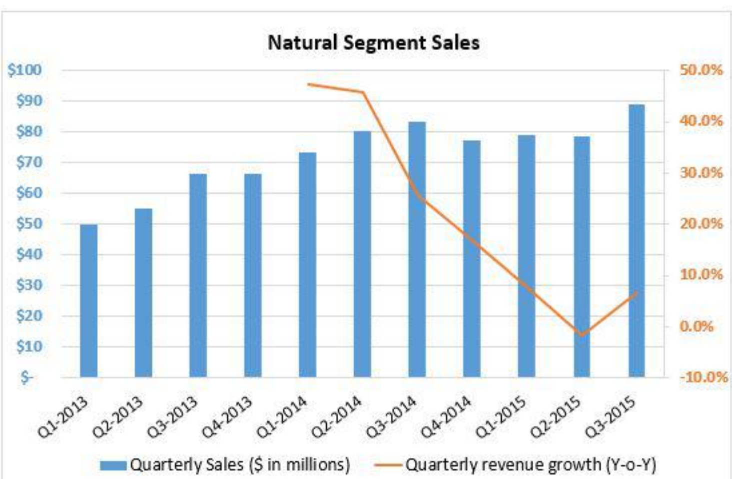




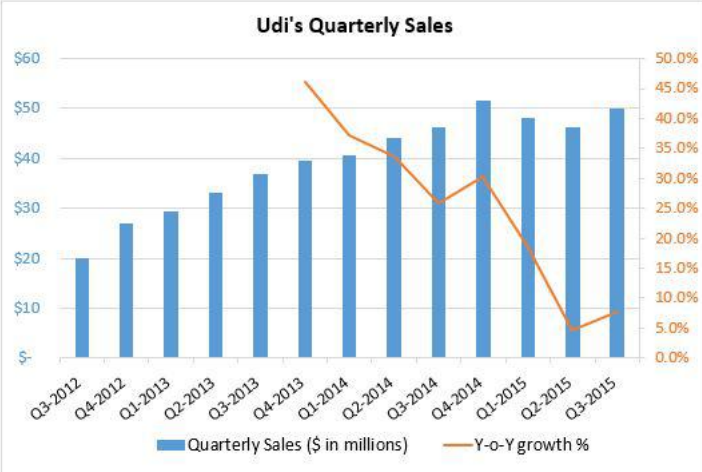
The day of the earnings release, the company's stock price bounced around as investors digested the report, swinging from a low of -5.9% to a high of +4.9%, eventually closing at $8.98 (up 3.3% that day).

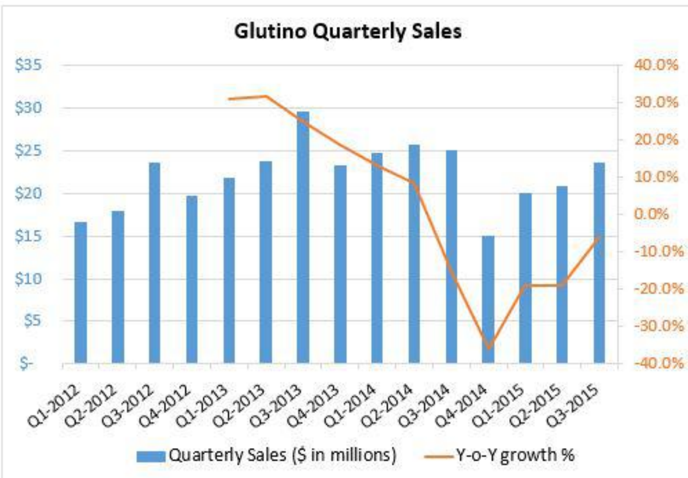
So What?

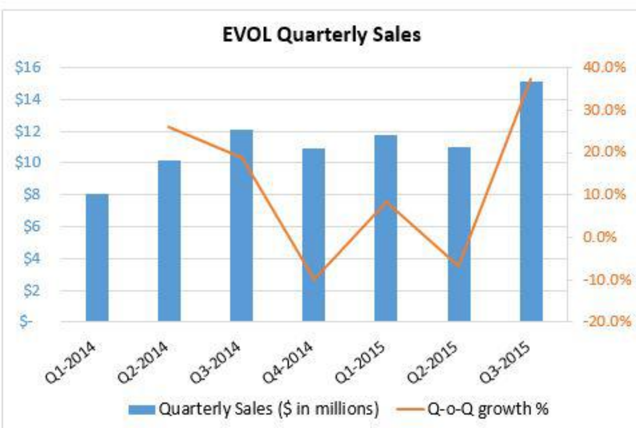
The key element to our short thesis is that the prior sales growth trajectory of the company's Natural business (composed of the newly acquired Udi's, Glutino, and EVOL brands) was misleading and was likely to slow. We can dig into the quarterly sales trends to figure out how that element of the thesis is tracking. In Q3 2015, the company was able to reverse the trend of declining sales in the Natural division, posting an acceleration of sales growth for the first time since year-over-year trends were available:



The Natural division posted year-over-year quarterly sales growth of 6.6%, vs. a decline of 1.9% last quarter. Breaking it down even further by looking at each individual brand, we can see which brands are responsible for the increases in sales:







We can see from the graphs that the declining growth trends for the company's key brands in the Natural division have turned around, with Udi's sales accelerating to 7.7% growth year-over-year (up sequentially from 4.6% last quarter), Glutino's sales posting a smaller decline of 5.9% year-over-year (vs -18.9% last quarter), and EVOL sales accelerating to nearly 40% quarter-over-quarter growth (from -6.7% last quarter).

Management noted that the increases in sales were dependent on different factors, with volume increases (via distribution and velocity gains) most strongly impacting the EVOL brand, and price increases most strongly impacting Udi's. The wording in the 10-Q on the composition of growth was devoid of numerical specifics, perhaps intentionally so.

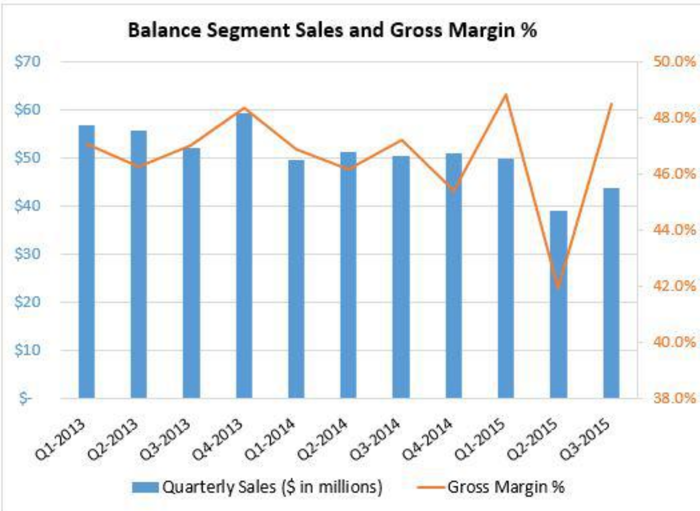
The composition of growth (distribution vs. velocity) is an important distinction, since our short thesis relies on our belief that initial distribution growth will eventually have to give way to end-user consumption (velocity) growth. Since EVOL is a younger and smaller brand (acquired two years ago, vs. three years ago for Udi's and four for Glutino), it's not surprising that it's showing higher distribution and velocity growth than the older, more mature brands. For example, in this quarter, the company launched EVOL cups in Target (NYSE: TGT), with 12 new SKUs. Sales of newly launched SKUs will obviously boost sequential sales figures compared to quarters when those SKUs didn't yet exist.

Additionally, EVOL targets a different market than Udi's and Glutino, focusing on consumers who desire simple ingredient lists without artificial ingredients or preservatives (vs. a focus on the gluten-free market for the other two brands). In my estimation, EVOL is probably the company's most strategically positioned brand, but since it is small (comprising just 17% of the company's Natural division sales and 11% of companywide net sales), it doesn't affect earnings as much as the other brands, although that may change if EVOL continues to grow.

Udi's makes up more than 56% of the company's Natural division sales, so trends for Udi's are disproportionately important to Natural's trajectory. This quarter, the company was able to generate growth in Udi's sales via price increases, but in a competitive industry, price increases are likely unsustainable, since they negatively impact demand as consumers can trade down to a lower-priced product. But if the company's brand strength is stronger than I anticipate, further price increases could continue to fuel growth. It'll be interesting to pay attention to management commentary regarding the growth trajectory (and growth composition) of Udi's sales over the next few quarters.

At Glutino, the pace of sales declines slowed significantly, although sales growth is still negative at -5.9% vs. the same quarter a year ago. Management noted that excluding co-pack sales and foreign exchange rates for the Canadian dollar, Glutino sales actually increased 3.7%. It appears that Glutino sales are starting to stabilize, and management stated on the conference call that it's because "we're focused on it."

As for the company's legacy Balance division, results were relatively strong compared to last quarter, which was the worst quarter for this segment in the company's history:



I wrote last quarter that "this segment may bounce back a bit next quarter as the Easter-related seasonal factor rolls off," and that's what happened, with the segment posting a year-over-year sales decline of -12.9% (vs. -23.7% last quarter) and a corresponding uptick in gross margins due to a favorable product mix within the Smart Balance portfolio. I was a bit surprised to see such a significant increase in gross margins, and it may be related to the company's focus on product renovation and reformulation to reduce costs.

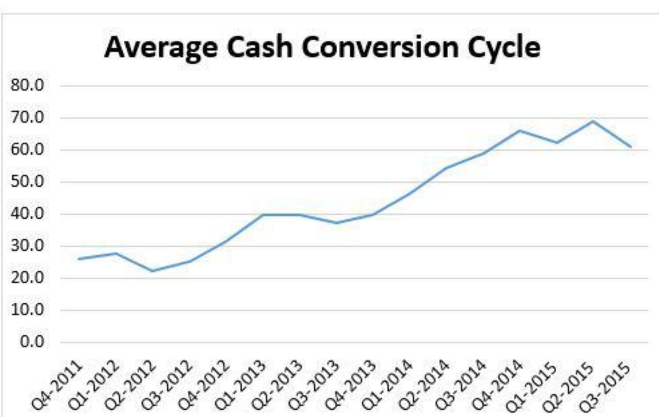
Now What?

All in all, based on the results from this quarter and the corresponding management commentary, it seems as though the new management team has a much better handle on competently and properly managing the company's supply chain, cost structure, and product portfolio. Management has already implemented a restructuring initiative by reducing salaried headcount by 15%, and they mentioned that the resultant G&A savings would be deployed into reinvigorating the company's marketing.

Low and ineffective marketing spend was another key element of our initial short thesis, so the company's turnaround in sales alongside new marketing initiatives provides another dent to the ongoing viability of our short thesis. Management made many comments on the conference call about how they plan to realign the marketing function, and the comments were well-reasoned and thoughtful.

Management also commented on their "fanatic discipline" on controlling costs. This is a sharp contrast from the previous management team, which seemed to be loose with corporate controls and spending. The company mentioned several initiatives focused on reducing costs, including the aforementioned headcount reduction (which helped provide a favorable impact to G&A expense of $1.8 million in the quarter), increased outsourcing to co-packers where it can create cost savings, improvements in supply chain efficiency, product renovation and reformulation to improve gross margins, and a SKU rationalization program to cut underperforming products from the company's portfolio.

We can already see some effects of the new team's strategies in the company's sequential gross margin improvement, reduced G&A expense, and improved sales trends alongside new marketing initiatives, as well as in an improvement in the cash conversion cycle, another key metric we have focused on with our short thesis:



The cash conversion cycle (the length of time it takes for the company to convert inputs into cash flows) declined this quarter, suggesting better working-capital and cash-flow management. The drivers behind the decline were a reduction in how long it took the company to collect on sales (Days Sales Outstanding) and an increase in how long it took the company to pay its creditors (Days Payable Outstanding). The company's Days Inventory Outstanding (how long the company takes to turn its inventory into sales, which for Boulder is probably the most important metric of the three) actually increased in the quarter to the highest level I have on record, which is a positive for our short thesis. But the magnitude of that increase was smaller than the magnitude of the effects of the other two metrics.

While the improvement in the cash conversion cycle is indicative of better management, the company needs to be careful in how it deals with customers and creditors. Boulder Brands generally has less bargaining power compared to its bigger and more powerful grocery, club, and mass-merchandise customers, so cracking down on receivables collection and extending payments to creditors may strain business relationships. The company's short-term need for higher cash flow should be balanced with a longer-term focus on strong relationships with its business partners.

Speaking of cash flow, the company's operating cash flow in the quarter was $400,000; management invested $4.6 million in capital expenditures, resulting in negative free cash flow of $4.2 million. We can see how short-term cash flow management is a concern for Boulder, as the company has only $23.8 million in cash on the balance sheet, struggles to generate free cash flow, and carries a significant long-term debt load of $287.7 million, which creates an annual interest expense of nearly $17 million.

Declining sales growth, significant interest expense, and consistent restructuring, acquisition, and integration costs (which have averaged $1.7 million per quarter since Q3 2011) have made increasing earnings a struggle. This will likely continue as management tries to balance the competing needs for its cash: to pay for capital expenditures, to spend on marketing and selling initiatives, to pay down principal on debt, and to pay its significant restructuring expenses. The cash crunch hampers management's ability to funnel resources where they are most needed.

For example, consider that over the past four quarters, Boulder has generated total operating earnings (defined as revenue less cost of goods sold less marketing, selling, and G&A expenses) of $21.6 million. In those same four quarters, the company has paid interest expense on its debt of $16.7 million, as well as $19 million toward the principal and $16.5 million in net capital expenditures. That's a net $30.6 million lost over the last four quarters for just those categories alone, which exclude the company's significant restructuring expenses.

While the new management team seems to have a better handle on how to optimize the company's product portfolio, they really have their hands full and will need to see continued sales and earnings growth if they want to dig themselves out of their significant debt load. Working capital management and other short-term investing gains (such as the company's sale of 35% of its stake in juice start-up Suja) are not a sustainable way to grow free cash flow, and Boulder needs its brands to produce sustainable long-term growth to justify its valuation multiples.

At $9 per share, the stock trades for 1.6 times TTM sales, 146 times TTM GAAP earnings, 26 times TTM operating income, 22 times TTM EBITDA (17.6 if adjusted for "non-recurring" goodwill / trade name impairments and restructuring/acquisition/integration-related costs), and 43 times TTM free cash flow (defined as operating cash flow less capital expenditures less acquisitions). While I recognize the improvements to operations this management team has made, I struggle to understand how this weak business can be worth those lofty multiples. The market must be expecting significant, continued growth in sales from the company's brands. That, or the market is valuing the company on a sum-of-the-parts basis as if it will be acquired.

With 33% of companywide sales coming from the Balance division (which is experiencing 10%-15% declines in sales), 18% from Glutino (which is experiencing 6%-20% declines in sales), and 37.5% from Udi's (which has seen a significant slowdown in sales growth until this quarter, when growth resumed thanks to price increases), I find it difficult to envision a scenario in which Boulder is able to meaningfully reignite companywide sales growth. This is especially true when considering the company's balance-sheet problems, which force it to choose between reinvesting into the brands via marketing and manufacturing efficiency initiatives, or paying interest and principal on debt.

Nonetheless, the involvement of Engaged Capital as an activist investor and the potential for a buyout has led to higher risk now than when we initiated our short. The new management team seems much more focused and capable than the previous managers, and given this fact plus signs of a turnaround in the company's financial metrics, we believe keeping our short active would be an example of thesis drift. Although the stock's valuation looks bad, if the business is going to steadily improve, the market may look past the price and keep bidding the stock higher -- and that's not to mention the potential for corporate action, such as a spin-off, divestment, or buyout. That's why we've decided to write near-the-money puts with the intent of closing our short. See this corresponding alert for more details.

Pro Can Help

- **Questions?** Visit our Boulder Brands discussion board.

Pro Portfolio Building Report No. 2: Nov. 19, 2015

Published Nov 19, 2015 at 10:00AM

Welcome, *Pro* Fool! This report details our current thinking on all of the Buy stocks in our portfolio. Once you've read this and the previous report detailing our Buy First positions, you're ready to start (or continue) building your *Pro* portfolio as swiftly or as slowly as you like.

We want our advice to be uncomplicated: Purchase our Buy Firsts first (again, taking your time according to your situation — there's no rush); purchase our Buys after that; match our allocations as closely as you can (but don't worry about needing to buy in 100-share lots — fewer is fine); and stay tuned for our Portfolio Positioning Event on Dec. 1, which will address our shorts, hedges, and options.

We're glad you're here, learning to become an investor who will come out on top in all markets. Bring any questions to the Getting Started & Help discussion board, and Fool on!

Best,

The *Motley Fool Pro* team

Table of Contents

Buy: AmTrust Financial Services (NASDAQ: AFSI)

This shrewd insurer looks to enter markets optimistically, when pricing is favorable because others are struggling.

Suggested Allocation: 6%, perhaps bought in two to three blocks over the next two or three months

For More

- [*Pro*'s original recommendation] (4/3/2009)
- [Most recent earnings update] (8/20/2015 — this quarter's update is on the way)
- [Talk about AFSI]

AmTrust Financial Services (NASDAQ: AFSI) was founded in 1998, making it one of the new kids on the block in an industry where many of its competitors have been around for 100 years or more. But this newbie insurer has some serious street smarts. AmTrust likes to compete in niche markets (for example, small, low-hazard workers' compensation policies), waiting until a rough patch demonstrates that the incumbents in a space have loosened their underwriting standards. It's then able to grab market share in an environment favorable to itself, as rivals attempt to cope with prior losses by raising prices.

Over the past 12 months, AmTrust has written $2.7 billion of workers' comp premiums, making it highly likely to finish the year as one of the top five workers' comp underwriters in the United States. But we don't think that means it's doomed to the glacial pace of growth common to many of the larger insurers. The company is moving into the commercial package insurance business (which includes workers' comp); SNL Financial estimated this as a $233.6 billion market in net written premiums as of 2013. AmTrust management believes its commercial package business can become its next billion-dollar platform, and we believe management will continue to find markets ripe for disruption.

Buy: Apple (NASDAQ: AAPL)

The leader in mobile computing products should see more long-term growth than anyone expects.

Suggested Allocation: 4.1%

For More

- [Pro's original recommendation] (2/14/12)
- [Most recent earnings update] (11/16/15)
- [Talk about Apple]

Led by its iPhone, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the smooth Apple operating system, iOS, which centers on the iTunes and App Store marketplaces, as well as the new Apple Pay. iTunes alone earns more revenue each year than two-thirds of the companies in the Fortune 500, while Apple itself is the most valuable company in the world, with more than $230 billion in annual sales. Yet it's still growing strongly, with earnings per share up 43% this past year. The company's integrated hardware and software make for a sticky consumer experience that provides disincentives to switch to a competitor, and as more people use multiple computing devices, Apple makes it easy to transition seamlessly from one of its products to another.

We expect the recently launched Apple Watch and Apple TV to help further entrench the Apple ecosystem into people's daily lives, all while Apple continues to work on developing its next major product and returning massive amounts of capital to shareholders through dividends and buybacks (almost $50 billion in fiscal 2015!). We're not counting on a revolutionary product anytime soon, but we are counting on record numbers of phones being sold to both existing and new customers over the coming years. We want to be in on that conference call.

Buy: Broadridge Financial Solutions (NYSE: BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 4.5%

For More

- [*Pro*'s original recommendation] (4/27/10)
- [Most recent earnings update] (8/17/15 — this quarter's update is on the way)
- [Talk about Broadridge]

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in its fiscal 2014, its platforms processed more than 80% of all shares in the United States. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider for managing investor communications.

The company's smaller segment, Global Technology and Operations (GTO), accounts for 26% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance this Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy: Facebook (NASDAQ: FB)

The world's leading social network — and most trafficked website — is managed for long-term growth.

Suggested Allocation: 5.8%

For More

- [*Pro*'s original recommendation] (9/18/12)

- Jeff on CNBC with "Four Minutes on Facebook" (11/5/15)
- Talk about Facebook

More than 1.5 billion people use **Facebook** (NASDAQ: FB) to connect with friends, families, companies, marketers, and celebrities each month. Incredibly, more than 1 billion people visit daily. Most traffic arrives through mobile devices, and with a strategic focus on mobile advertising platforms, the company is on track to earn more than $16 billion in annual revenue.

Meanwhile, Facebook also seeks to remain the leader in social media and its offshoots, including virtual reality. The company has the equity to acquire competing platforms and to build traffic while treating each channel (Facebook, Instagram, Messenger, WhatsApp) separately.

Facebook is spending aggressively on technology, but today's spending should be rewarded down the road, and the company's free cash flow remains strong. The long-term potential is bright. The Internet still only grabs a minority of the ad dollars spent around the world each day, but online marketing continues to grow rapidly, and social media is finally finding its way into the spotlight — largely thanks to Facebook. That said, of the 45 million businesses with Facebook pages, only about 2.5 million advertise so far, meaning this friend network has plenty of room to spread.

Buy: MasterCard (NYSE: MA)

Plastic — and digital — is pushing paper out as the world's way to pay, and MasterCard leads the charge.

Suggested Allocation: 4.6%

For More

- *Pro*'s original recommendation (9/8/11)
- Most recent earnings update (11/18/15)
- Talk about MasterCard

MasterCard (NYSE: MA) is among the most attractive businesses in the world. The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders, who are actually exposed to the card users' finances; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

Though MasterCard competes with a large number of well-heeled and (in some cases) innovative businesses, the company's profitability is growing nicely even though the global economy isn't. And that makes perfect sense, because when it comes to paying for stuff, the global market leader isn't **Visa** (NYSE: V), or PayPal, or banks ... it's cash. Cash is used for a still-astounding 85% market share of transactions, but it's slow and inefficient, and with no one managing its brand, it's quickly losing out to better alternatives — like MasterCard. We continue to believe in the stock for the long haul (*especially* for the long haul, in fact). With earnings out recently, expect a valuation and earnings update soon.

Buy: Medtronic (NYSE: MDT)

Operating in a complex, regulated industry that provides entrenched leaders a competitive moat, our medical-devices leader is moving into international markets.

Suggested Allocation: 3%

For More

- *Pro*'s original recommendation (7/1/2009) ...
- ... and our second buy recommendation (11/9/10)
- Most recent earnings coverage (8/10/15)
- Talk about Medtronic

A leading medical-device maker, massive Medtronic should reach $6.5 billion free cash flow this year — and management plans to continue to return about 50% of cash flow to shareholders through increased dividends and buybacks. The recent Covidien merger should lead to at least $850 million in cost synergies by the end of fiscal 2018, as well.

While Medtronic has touted itself as a play on international markets, growth in the U.S. has regained traction, too. This year, U.S. revenue is up 7% to represent 56% of sales. Emerging-market sales are up 11%, representing just 13% of sales. Management sees strong long-term potential in emerging markets.

Whether it's cardiac issues, spine injuries, knee problems, or one of four other key categories, Medtronic is a market leader in vital medical devices. The stock yields 2%, and the dividend has increased annually over the past 38 years, resulting in an 18% compounded annual growth rate (CAGR). Expect continued dividend increases, sales growth of about 4% to 6%, and earnings-per-share growth even higher than that — all of which should combine for North Star-challenging returns.

Buy: OpenText (NASDAQ: OTEX)

This company's information management software keeps the digital lives of businesses in order, and its exchange platform drives business transactions.

Suggested Allocation: 2.6%

For More

- *Pro*'s original recommendation (8/31/11)
- Most recent earnings coverage (8/10/15)
- Talk about OpenText

With about 65,000 cloud software customers, renewals in that space running at about 95%, and the cloud making up 33% of its sales, **OpenText** (NASDAQ: OTEX) is officially a cloud software company. But as with **Oracle** (NYSE: ORCL), it's not *just* a software company; it's really a hybrid. OpenText also sells software the old-school way — on-premises, on a license basis — and renewal rates on those sales are in the low 90% range. OpenText is not looking to replace license sales entirely with cloud sales, instead letting customers choose their preference.

A leader in Enterprise Information Management (EIM), OpenText offers customers (governments, universities, corporations) a full suite of data-related software solutions. The three areas of focus are data and information management; information exchange platforms within and across organizations; and analytics, where "big data" is used to gain insights and better run a business. OpenText helps customers go digital with their data, a market that should grow smartly (we estimate at least 10% annualized) for a long time. Last year, OpenText increased adjusted operating cash flow by 25%, and margins are expected to trend higher next year. The $45 stock trades at about 13 times expected non-GAAP earnings for the year ending June 2016.

Buy: Papa John's International (NASDAQ: PZZA)

Deliver a slice of the profit pie right to your doorstep.

Suggested Allocation: 2.6%

For More

- PZZA position review (5/23/14)
- Most recent earnings update (8/17/15 — this quarter's update is on the way)
- Talk about Papa John's

Papa John's International (NASDAQ: PZZA) operates and franchises more than 4,700 pick-up and carry-out pizza joints in more than 38 countries. For the past 30-plus years, Papa John's has been making pizza and building its brand around the "Better ingredients, better pizza" tag line. Bringing that unwavering focus to each pie has resulted in the company's perceived quality advantage over its big-chain pizza competitors, which allows it to consistently price a dollar or two higher and attract the best franchisees. Now that its brand advantage is sufficiently established in North America, Papa John's is turning its sights abroad, believing that delicious American pizza is a language every taste bud speaks.

As sure as a fresh pizza will be gobbled up by hungry kids, Papa John's delivers results. For 11 consecutive years, the company has recorded flat or positive North American comparable-store sales growth. Recently, international comps have been in the 5% to 8% range, offering lip-smacking evidence that Papa John's flavors travel well. The company has opened more than 200 restaurants over the past two years and expects 220 more this year, and because Papa John's is primarily a franchisor, it doesn't have to bear the cost of that expansion (it's taken on by the franchisees). Competing for a share of the global appetite is tough business, but Papa John's has been able to increase sales and profits at commendable rates over the past decade, which has resulted in plenty of cash generation. Management recently initiated a dividend in 2013 and has consistently bought back stock over the years.

We believe the company will maintain its brand positioning, modestly improve underperforming franchise locations, and continue to be an attractive entrepreneurial outlet for new franchisees abroad. Papa John's should also be able to take modest market share from mom-and-pop pizza shops in established markets as digital ordering continues to gain adoption; it's a tough hurdle for smaller players to overcome. With a little bit of menu innovation and new markets maturing, we believe 3% same-store growth is sustainable over the next five to 10 years. We rate shares a Buy and encourage members to do plenty of field research on this one.

Buy: Parexel International (NASDAQ: PRXL)

Parexel is poised to benefit as pharmaceutical companies gradually outsource more drug development work to select CRO partners who can perform the work better, faster, and cheaper.

Suggested Allocation: 3.5%

For More

- *Pro*'s original recommendation (12/23/13)
- Most recent earnings update (8/17/15 — this quarter's update is on the way)
- Talk about Parexel on our discussion board

Parexel (NASDAQ: PRXL) is one of the world's largest and most respected contract research organizations (CROs). Over more than 30 years, it has built a stellar reputation on helping drug makers navigate complex clinical trial processes quickly, which has enabled it to cement important relationships and have a role in developing more than 95% of the 200 top-selling drugs.

Based on industry data, from 2004 to 2015, outsourcing penetration — the number of development dollars outsourced to CROs — has increased by nearly 70%. Outsourcing is a cheaper alternative to the traditional high-fixed-cost model of staffing lots of white coats across various therapeutic specialties all around the globe. For large drug developers, letting CROs handle the development work — and those massive staffing needs — can boost profits and time to market, and for smaller drug developers who can't afford a huge staff, there is no other choice. As regulators require more efficacy data, larger patient participation, and increasingly global results, navigating the challenges of the 110,000-plus trials being conducted globally has become frustratingly complex, turning large, proven CROs with expertise and global capabilities into value-adding partners rather than transactional customers. We think Parexel will continue to benefit.

Buy: ProShares Short VIX Short-Term Futures ETF (NYSEMKT: SVXY)

Profit from the long-term nature of stock market volatility to revert to an average level after each spike.

Suggested Allocation: 1%

For More

- *Pro*'s original recommendation (11/25/14)
- Talk about SVXY

Buying shares in — let's make it easy and use the ticker, shall we? — SVXY is a recommendation for *Pro* members who are comfortable owning a small stake in a volatile position that we *may* add to during market downturns. *Pro* is a portfolio service, so all positions are meant for everyone, to the extent you can do them and wish to. But this position will be especially volatile, so only follow it if you're comfortable with high volatility in a holding.

This vehicle increases in value when stock market volatility — as measured by the CBOE Volatility Index (or VIX) — goes down or is range-bound. This ETF *sells short* futures contracts on the VIX that have one month and two months to expiration. Unless volatility in the S&P 500, as measured by the VIX, increases above and beyond the premium already baked into the futures contracts being shorted, the positions turn a profit and the ETF goes up in value. Helping further, VIX futures contracts are historically in a state of "contango" as much as 90% of the time. Contango means that future-month contracts are increasingly more expensive than earlier months' and than the current VIX itself (much like a call option has a premium above the current stock price). This is a tailwind for SVXY, and it exists most of the time. As long as volatility stays near its average overall, then just holding this small stake over the years should reward us very well. We recommend starting at 1%, and we may add more when the VIX soars — meaning when volatility in the market is high. We're ready for it! But even if we don't, our position should create value for us over the long term.

Buy: Skyworks Solutions (NASDAQ: SWKS)

This leading designer of semiconductors, antennae, and more for smartphones and connected devices is growing sharply.

Suggested Allocation: 3.6%

For More

- *Pro*'s original recommendation (8/5/14)
- Latest earnings coverage (8/10/15)
- Talk about Skyworks

Skyworks Solutions (NASDAQ: SWKS) makes technology that powers wireless connectivity in a wide variety of products: Apple and Samsung smartphones and tablets, **Medtronic** (NYSE: MDT) medical devices, **Google** (NASDAQ: GOOG) and **General Electric** (NYSE: GE) products, and the list goes on. In the "Internet of Things," billions of physical objects are going online, and Skyworks is uniquely positioned to benefit. Not only does it serve *all* of the top-tier mobile device makers, but the company is diversified across industries to total more than 2,000 customers.

Skyworks sells more than 2,500 high-performance analog semiconductors and related products, supported by nearly 1,000 patents. The product list includes amplifiers, attenuators, receivers, switches, diodes, modulators, GPS power and voltage regulators, and more, often sold together as components of a phone or connected device. Skyworks earns industry-beating operating margins of more than 30% by selling specialized solutions to giant customers with growing connectivity needs. Plus, as wireless complexity increases, fewer companies can deliver the integrated modules customers need, putting Skyworks in an even stronger position. The China opportunity is large as well. This can be a volatile stock, but its long-term outlook (which is the time frame we care about!) remains very compelling.

By 2016, the company is targeting $8 in earnings per share on a run-rate basis (the most recent quarter x 4). The $75 stock trades at only 9.3 times that projected result. The company expects its long-term total addressable market to increase by about 15% a year, and Skyworks is growing much more quickly than that.

Buy: Starbucks (NASDAQ: SBUX)

You only think you're there for the coffee — the ubiquitous java purveyor has big plans.

Suggested Allocation: 3.8%

For More

- *Pro*'s original recommendation (8/22/2012)
- Most recent earnings update (7/30/2015 — this quarter's update is on the way)
- Talk about Starbucks

You may not realize it, but "**Starbucks**" (NASDAQ: SBUX) is no longer a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense it's just a front. We *think* we go to Starbucks for the coffee, but those seasonal red cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

Starbucks began opening America's eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 23,800 stores in 65-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences to fill more than 70 million mouths and hearts each week. This company is continually finding new ways to reach customers; we're grabbing a latte and a cake pop and coming along for the ride.

Buy: TD Ameritrade (NYSE: AMTD)

Assets and investment fees are rising; earnings should surge when interest rates head higher.

Suggested Allocation: 2.9%

For More

- *Pro*'s original recommendation (7/11/13)
- Monday Memo on TD Ameritrade's business model (9/15/14)
- Talk about TD Ameritrade

Entrusted with about $670 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NYSE: AMTD) hosts around 460,000 stock, options, and futures trades on an average day, collects investment fees, and earns interest on billions in cash and interest-earning assets. Its partnership with **TD Bank** (NYSE: TD) (which owns 41% of the company) also gives it a unique position in its industry, allowing TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank; when the current record-low Federal Funds interest rate increases, TD Ameritrade will earn much higher interest income, all of it pure profit.

In the meantime, the company retains its focus on increasing client assets, providing top-notch customer service, and launching more investment products and features. The company has increased new client assets by at least 10% annualized for the last seven years and counting. For context, the S&P 500 (including dividends) has delivered about a 43% total return since 2008; client assets held at TD Ameritrade are up by 240% over the same period. Operating margins are strong, too, lately in the low-40% range.

We expect management to continue to be excellent stewards of capital, returning profits to shareholders and increasing investor value. All the while, we know higher interest rates will someday lead to much higher net income. But even as we look forward to that, we can admire the company's current results and be ready to enjoy healthy returns.

Buy: Valmont Industries (NYSE: VMI)

Providing irrigation systems and support structures, this industrial company benefits as agriculture needs increase and countries build infrastructure.

Suggested Allocation: 1.8%

For More

- *Pro*'s original recommendation (11/5/13)
- Most recent earnings coverage (11/1/2015)
- Talk about Valmont

Valmont Industries (NYSE: VMI) features four business divisions, each serving a growing need around the world. Founded in 1946, Valmont's engineered products division supplies steel and aluminum poles to infrastructure projects worldwide, including road and traffic lights, stadium and parking lights, and wireless communications poles and support towers. This division also sells highway safety products including barriers and road grating. In addition, because it sells steel and concrete support structures, Valmont profits as electrical grids are renovated or built out.

Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot irrigation systems are the world's leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient mechanized irrigation, so there's lots of room to run.

To top it all off, the company provides hot-dip galvanizing (just like Mom used to make), anodizing, and other coatings to protect aluminum and steel from corrosion. One of the largest custom galvanizers in the world, Valmont expects continued growth because it still captures a small percentage of the total market. Overall, Valmont operates in more than 80 countries. This is a long-term investment in an exceptionally run, cyclical business that's currently in a downturn (which is when you usually want to buy!). We've started with a small position and will considering adding to it over time.

Buy: Verisk Analytics (NASDAQ: VRSK)

This prototypical Pro *holding provides us with exposure to powerful tailwinds within the financial, energy, and health-care industries, among others.*

Suggested Allocation: 2%

For More

- *Pro*'s original recommendation (6/23/15)
- Most recent earnings coverage (11/11/2015)
- Talk about Verisk

Verisk Analytics (NASDAQ: VRSK) may not be a familiar name, but with a strong competitive advantage, high customer retention, robust and contract-based cash flows, a scalable business model, and large (and growing) markets, Verisk is in many ways a prototypical *Pro* holding. Verisk started as an information utility for the insurance industry, but nowadays, the company is a data and analytics powerhouse that provides customers with solutions in all sorts of arenas: raw data, tailored analytics, enterprise reporting systems, policy fraud detection solutions, competitive benchmarking, and legally tested policy language, just to name a few.

One way to invest successfully is to buy out-of-favor industries, and three to five years from now, we may look back and realize that Verisk did exactly that by entering into the energy industry (via its acquisition of Wood Mackenzie) in the midst of the current energy slide. We tend to shun commodity-based businesses here at *Pro*, but we believe Verisk's purchase of WoodMac was a good one — the latter is pretty much a copy of the former, but with a different end market. WoodMac is a leading provider of data analytics to the global energy, chemicals, metals, and mining markets, and it actually has higher margins and a greater percentage of subscription-based revenue than Verisk's other business units. We don't profess to have any insight into what the next six months have in store for WoodMac and Verisk, but we believe shareholders will be very happy with the results over the next three years.

Buy: Visa (NYSE: V)

With its mission to "accelerate the electrification of commerce," industry leader Visa has most of the world left to conquer.

Suggested Allocation: 2.5%

For More

- *Pro*'s original recommendation (4/28/15)
- Most recent earnings coverage (8/5/2015 — this quarter's update is on the way)
- Talk about Visa

The ubiquitous nature of credit and debit cards in America means that many of us can go through life rarely touching cash. Yet in the U.S., cash still accounts for approximately 40% of transactions, followed by debit cards at 25% and credit cards at 17%. And globally, cash is truly king: MasterCard estimates that 85% of all consumer transactions still take place with old-school paper and coins. But all of that is slowly changing as economies modernize and middle-income families proliferate, bringing more converts to the benefits of electronic payment. With its mission to "accelerate the electrification of commerce," industry leader **Visa** (NYSE: V) has most of the world left to conquer.

We like Visa for many of the same reasons we like MasterCard. And with the recent acquisition of Visa Europe, the company will be adding 500 million card accounts that resulted in 18 billion transactions totaling $1.6 trillion last year. Visa is valued at $190 billion, and given its tiny market share, its ceiling should be much higher than that. It fits into *Pro* as a recurring-revenue business that invests its free cash flow in more growth at still higher rates of return, making it a compounding vehicle.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund (NYSEMKT: DGS)

Diversification in emerging markets with some of the best small, high-yield companies you've never heard of.

Suggested Allocation: 1.7%

For More

- *Pro*'s original recommendation (11/22/10)
- Talk about DGS

At *Pro*, we like the idea of investing in emerging-market small caps to diversify and target higher growth. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) (the longest ETF name in the world!*). This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields around 3%).

For *Pro*, owning shares of this well-managed ETF offers exposure to up to 600 of the most promising international business that we couldn't easily buy in any other way! Serving as direct exposure to emerging markets, this is an excellent way to invest in small companies in locations where we don't have a discernible edge but where growth exists — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The benefits of diversifying outside our home market are equally important over long periods. Emerging markets have badly lagged developed markets for the last several years, but eventually they should take the performance baton again, and we'll be in good stead with this position.

*Statement may not be 100% "true"

Write a New Covered Strangle on Expeditors International

Published Nov 19, 2015 at 9:44AM

If you are new to *Pro* and new to this position: This trade alert shows you the type of detailed, timely guidance you can always expect from us as our time together grows. Today, though, new members don't need to start this position unless they're highly motivated to do so. This is an advanced strategy. At the bottom of the report, our Alternative Trades for new members suggest modified approaches to this income position if you want to join in now. If you want to use options as part of your *Pro* portfolio, but you're not quite ready yet, you can wait for our Dec. 1 Portfolio Positioning Report and live event for more guidance.

Is this for you? Yes, if you're a *Pro* member following our option writing for income on **Expeditors International** (NASDAQ: EXPD), and if you (like us) have November options reaching expiration tomorrow, Nov. 20. **But please read the Conditional Note below,** as there are some timely conditions to be aware of.

How You Participate

Conditional Note: With the stock lately at $49.45, our November 2015 $46 puts and $50 calls are due to expire as full income Friday, Nov. 20. This is a good thing, and it means we don't need to touch these options *unless* the stock rises above $50 on Friday. You have two choices in managing this position now; we're sending this alert today so you're prepared no matter which you choose.

1. You can buy to close your November $50 calls today for a small sum (currently $0.15) and write the new strangle detailed below. You would do this if you wanted to remove any chance that the stock could drift above $50 tomorrow and surprise you. Only write the new strangle after you're certain your November $50 calls are closed.
2. You can do what we're doing: Wait and see whether Expeditors stock stays below $50 tomorrow, letting your whole strangle expire for full income if it does. (You'll save some money by not buying back your calls!) Then, write the new strangle very late tomorrow or Monday after expiration becomes certain. Alternatively, if EXPD is above $50 tomorrow, you can buy to close the November $50 calls and then write the new strangle (again, only after you're certain they previous one is closed).

Pro must wait 24 hours, so we'll be acting as necessary on Friday afternoon.

- **Action:** As the circumstances above play out, use a strangle order to simultaneously sell to open December 2015 $48 puts, and sell to open December 2015 $50 calls.
- **Allocation:** Sell one strangle (one of each option) for every 100 shares of exposure you have to the company. We have 1,000-share exposure through 10 contracts of a synthetic long, so we're selling 10 puts and 10 calls, as we've done before -- this potentially doubles our exposure, to a full 3.5% allocation.
- **Prices:**
  - **Stock:** $49.45
  - **Options:**
    - December 2015 $48 puts (bid/ask): $0.70/$0.80
    - December 2015 $50 calls (bid/ask): $0.75/$0.90
    - Combined bid/ask: $1.55/$1.70
- **Price Guidance:** Split the bid/ask as best you can, aiming for a **combined credit of $1.60 or higher** to sell the strangle. If we all use **limit orders**, then $1.60 should hold for Day One. As prices change, aim to get paid at least 3% of the current share price to write the strangle, lately about $1.50, targeting 3% in yield on share price in one month to expiration.

What We're Thinking

Our global logistics buddy reported healthy earnings last quarter, with air freight volume up 3%, net revenue increasing 11%, and a 17% gain in adjusted earnings per share. With a tight focus on cost control and organic growth, Expeditors is a well-run company with a stock that has slowly grown less expensive as earnings have increased. Our strategy -- writing both puts and covered calls on our long position in the stock, which was set up as a synthetic long -- has led to strong income, as planned, while allowing for steady upside for the shares over the past year or so, too. We just kept writing strangles at higher strike prices.

While we don't yet know whether we'll need to close our November $50 calls tomorrow, we do know that either way, we're sitting pretty and about to earn most of our November income. And because this is an income position, we're ready to write new options right away again. We're looking to sneak in one more income trade in December, then one more in January, before deciding what to do with our synthetic long position at January expiration. We'll either turn it into stock or roll it a few years forward; in either case, our goal is to keep this position going as long exposure to this stable company, along with steady option income. That means newcomers can feel comfortable about joining in, too.

Why This Strategy?

Since since starting this position in August 2014 (and assuming our options expire tomorrow), we will have earned about $8,000 in income on it so far, and we have unrealized gains of about $8,600 on our synthetic long. That amounts to more than $16,600 in realized and unrealized gains on the less than $600 in cash we deployed to start this position last August.

So our "income with upside" objective that leverages our capital is playing out well. In fact, it's worth pointing out today that we would use a higher strike price than $50 for our December covered calls if possible, *but* the next strike price available is $55 and it pays little, so we're all but forced to write calls with a strike near the current share price to continue our income objective. (And that's the case even though Expeditors is doing well.)

More That Matters

- **Maximum loss:** The same as owning at least 200 shares of stock (100 now, and 100 at $48), minus the option premiums received.
- **Maximum gain:** This new strangle still caps our upside at $50, plus all the options premiums received. The most we can make on this strangle alone is the $1.60 in premium, which is earned if the stock stays anywhere between $48 and $50 by expiration.
- **Breakeven**: Our existing synthetic long mirrors stock ownership that started at about $40.60, while this new short strangle in isolation has breakeven points at $46.40 and $51.60, giving us a decent range.
- **Follow-up:** The current plan is to continue writing strangles to earn income and to roll our existing strangle up or down if need be. By January 2016, we'll decide whether to turn our synthetic long into stock or roll it forward.

Alternative Trades

- **If you're new here and want to participate in the full position right away:** A written covered strangle (especially on a synthetic long) is a complex trade. If you're feeling at all intimidated, it's OK to wait for our Portfolio Positioning Report and live event on Dec. 1 instead! But if you're rarin' to go, here's what we suggest:
    - Buy about 1.7% in stock itself, in 100-share round lots (with the stock near $50 per share, 100 shares is about $5000. So, buy $5000 in stock for every $290,000 in *Pro* money you manage), then sell to open the January 2016 covered strangle. To do this, sell to open one January 2016 $48 put and one January 2016 $50 call for every 100 shares of stock you buy, and every 100 additional shares you could buy at a lower price. This gives you a total 3.5% exposure to Expeditors. The January 2016 $48 put / $50 call strangle pays you about $2.40 combined, or $240 per strangle. In exchange, you are agreeing to buy more shares of stock at $48, or sell your existing shares at $50, if the stock hits either price by expiration and you don't roll the option first. We'll have guidance as the January expiration approaches; we chose January to avoid a sudden taxable event this December and give you more time to see how this works before you have to take action again.
- **If you're new to *Pro* and just want to write covered calls:** Just buy at least 100 shares and simultaneously sell to open January 2016 $50 calls, lately paying you about $1.25 each. Write one call for every 100 shares you buy, ideally using a buy/write covered call order to do it all at once. Make sure your shares are less than a 3.5% allocation. This is an IRA-friendly trade.
- **If you're new to *Pro* and just want to write puts:** Sell to open January 2016 $48 puts, lately being paid about $1.15 each. Sell one put for every 100 shares of the stock you'd be happy to buy if it falls below $48 by expiration.
- **If you're a veteran member doing the IRA-friendly/covered-calls-only trade:** If you simply bought shares of stock earlier and wrote November 2015 $50 calls, you can follow the same guidance in this alert, closing the calls if necessary tomorrow and writing the new December 2015 $50 calls (ideally for at least $0.85, although that price will change if the stock moves). Accept the going price in that case. Finally, if the stock rises above $50 by Friday, we believe you should roll your calls, rather than lose your shares -- hence today's report. Those wanting to avoid any excitement tomorrow can simply close the November $50 calls today, lately for about $0.15 -- or use a rolling order to close them and write the new December $50 calls, resulting in a net credit of about $0.70.

Pro Can Help

- **Want more on this strategy?** See our guides to covered strangles and synthetic longs. We're combining the two into a synthetic covered strangle.
- **Questions?** Please ask, Fools! Ship yourself on over to our Expeditors board.

Plenty To Like About MasterCard's Boring Quarter

Published Nov 18, 2015 at 12:27PM

MasterCard (NYSE: MA) posted another strong quarter, growing its global card count 8% to 2.2 billion and processing 13% more gross dollar volume (GDV), on a constant currency basis. The U.S. economy continues to be one of the few bright spots in the world, as emerging markets struggle and Europe tries to stage a recovery. In the U.S., GDV was up 8% for the quarter, a sequential increase of one percentage point. That's more impressive considering that there remains a two percentage point headwind from lower gasoline prices. Cross-border transaction volume increased by 16%, but cross-border fees only grew 11% as the result of higher intra-Europe travel and fewer international travelers to the U.S.

Security and the Digital Wallet

Other (non-processing) revenues grew by 15%, driven by MasterCard's growing suite of security products and recent acquisitions. The payment industry continues to evolve toward more digital options, like mobile wallets, and security remains a central focus for all parties. The U.S. is slowly shifting to chip-based EMV terminals, and management expects 60% of cards and 40% of terminals to be upgraded by the end 2016. Though the upgrade PIN and chip technology is "voluntary", starting in October the liability for fraudulent activities has shifted to whoever is using the least advanced security technology. If the merchant has a swipe terminal, but the customer is using a chip enabled card, then the liability rests on the merchant. The opposite is true of banks who have yet to issue new smartcards despite the availability of EMV terminals. If both the merchant and the bank have upgraded to EMV technology, the liability for any fraud rests with the credit card companies. MasterCard expect that all cards in the U.S. will be converted by 2017.

The latest generation of EMV enabled terminals also allow for near field communication (NFC) which should drive increased adoption of contactless payments. To address this, MasterCard continues to roll out its MasterPass technology which provides EMV-level security for shopping online and making in-app purchases. This tokenized service, which employees MasterCard's MDES technology, is also being used by Android Pay and Samsung Pay. (Tokenization is a security measure that uses an alphanumeric identifier in place of card numbers which can only be used for limited purposes and can't be copied and used at another merchant. It also allows merchant to store your card data in an encrypted form to prevent identify theft from intrusions.)

Other Developments

- As reported last quarter, MasterCard will be technically ready to process transactions in mainland China by the end of 2016, but they're still working on card issuance, vendor acceptance and other regulatory hurdles.
- During the quarter, MasterCard also announced that USAA was moving to Visa (NYSE: V), ending a 30-year relationship. This loss of a major client was certainly painful, but management stated that the terms of the deal became too onerous for them to match. Though we should be happy that management is maintaining pricing discipline, this is another indication that competition remain fierce. Combined with the recent **Costco** (NASDAQ: COST), Visa has shown that it is willing to cut margin to the bone to obtain high quality card holders.
- Further confirmation of the increasingly competitive environment is the slowly increasing cost of rebates and incentives. That trend is something we will definitely be keeping an eye on in coming quarters.

- Visa's recently announced acquisition of Visa Europe was also a hot topic on the conference call. In the short term, management believes that the integration of the two companies with different cultures will could serve as a distraction. Longer term, since Visa Europe was previously owned by its more than 3,000 member banks, it seems that MasterCard will end up with a more rational competitor in the European market once Visa and Visa Europe are reunited under one corporate umbrella.

Capital Allocation

MasterCard continues to generate a ton of cash, adding an additional $1.3 billion of cash flow from operations during the quarter. The company ended with $5.1 billion of cash and equivalents on the balance sheet and $1.2 billion remaining in its current repurchase authorization. During the third quarter MasterCard repurchased about 10 million shares for approximately $930 million and added another 1.5 million shares for $144 million so far in the fourth quarter. Between buybacks and dividends, the company is on pace to return about $4.2 billion to shareholders in 2015. That amounts to a 3.8% combined shareholder yield at today's market capitalization, which isn't bad for a company that has the ability to continue growing at a double digit clip for the foreseeable future.

Updated Outlook

During MasterCard's recent Investment Community Meeting in September, management updated their three-year performance targets which are set to expire at the end of this year. Though management's targets for low double-digit net revenue CAGR, Mid-teens EPS and 50% annual operating margin were projecting slightly lower growth, those are still exceptional numbers for a company MasterCard's size. The company will continue to benefit from the transition to digital payments and huge parts of the world, including China and India, remain largely untapped.

The Pro Bottom Line

Despite the recent pullback in the stock, MasterCard continues to trounce the market, delivering a 13.8% gain versus a market that is now slightly down for the year. With shares still trading at 26.5-times forward earnings and 17.5 times enterprise value-to-forward EBITDA, MasterCard hardly looks cheap. Still, we think this is one of the highest quality businesses in the *Pro* portfolio and it deserves a premium to the market. As we enter the fourth quarter and look forward into the next year, MasterCard should see easier quarterly comps as it laps the headwinds from currency volatility and falling gas prices. That should provide an opportunity for more positive surprises and continued outperformance in 2016.

If You're Gonna Learn, Learn From the Best

Published Nov 16, 2015 at 2:39PM

Fellow Fools,

Sometimes, smart people make incredibly stupid mistakes. If you decide to manage your own investment portfolio, odds are that at some point one of those mistakes will be your own. Though most of these mistakes are small and easily corrected, others can be costly and painful. I've always referred to that second variety of mistakes as "paying tuition," because they're usually lessons that you remember vividly and don't want to experience twice.

Though it's critical to learn from your own mistakes, I've found that the best way to keep your "tuition" bill to a minimum is learning from the mistakes of others. The recent drama surrounding **Valeant Pharmaceuticals International** (NYSE: VRX) looks like it provides one of those rare opportunities. I have no thoughts on whether Valeant will rebound quickly from its problems. I don't know the business well enough have an informed opinion. I also have no feeling of *schadenfreude* toward those investors, including a lot of Fools, who have lost money on their Valeant investments. Instead, I see a situation where some very smart people made some questionable decisions regarding portfolio and risk management, and the rest of us would do well to take note of those follies.

A Teachable Moment

In the weeks since Valeant began its precipitous decent, we've learned that several high-profile investors were burned by heavy allocations to the company's stock. As a media darling, Bill Ackman of Pershing Square Capital Management has probably received the most attention, but the example I think we can learn the most from is that of the esteemed Sequoia Fund.

Over the past four and a half decades, Sequoia has compiled an enviable track record, and it's long been considered the *crème de la crème* of the value investing world. When Warren Buffett closed his early investing partnership in 1969, he directed investors to this fund, which was started by William Ruane, a friend from Buffett's Columbia MBA program, and his associate Richard Cunniff. Though Ruane and Cunniff are no longer with us, their investment philosophy remains tightly engrained within the company's culture.

For that reason, I was fascinated by a *New York Times* article published last week that profiled the internal turmoil at the Sequoia Fund after its largest holding, Valeant, lost more than 70% of its value since the beginning of August.

Sequoia has been known to take concentrated positions in its highest-conviction picks, and earlier in the year, the fund's managers allowed its position in Valeant to balloon to nearly one-third of the fund's assets . When Sequoia's portfolio managers revealed that they'd added more to the position at a late-October board meeting, two of the company's independent directors, Vinod "Vinny" Ahooja and Sharon Osberg, resigned within five minutes of each other. Mind you, these were not folks who didn't understand the balance between risk and reward in the markets. Ahooja is a former partner at Goldman Sachs, and Osberg is a former Wells Fargo executive, a world-class bridge player, and one of Warren Buffett's closest friends.

This sort of public dissent is unusual for a mutual fund board, and it draws attention to Sequoia's risk-management strategy gone awry. In a portfolio, it makes sense to overweight your highest-conviction ideas, but it rarely makes sense to put yourself in a situation where an unforeseen or unimaginable event could have such a devastating effect on your portfolio -- and possibly limit your options at the worst possible time. In this case, the fund's managers have submitted to the remaining three board members and have agreed not to add any more to the existing position, even though this may end up being the best possible time to invest.

Manage Your Portfolio Like a *Pro*

Whether the drawdown in Valeant's stock ends up being a temporary situation or a permanent loss of capital remains to be seen. Either way, I think most people would agree that the Sequoia Fund's portfolio managers exposed their clients to an incredible amount of risk, and I doubt they would want a repeat of this situation.

The *Pro* team spends a lot of time thinking about how our portfolio is constructed, and how all of the pieces play together to help us achieve our goal of North Star-beating returns. Though we're big believers in letting our winners continue to compound over time, we're also very conscious of risk and the volatility that can arise from a highly concentrated portfolio. For that reason, we avoid allowing a position to grow too large, which is why we recently trimmed our position in **AmTrust Financial** (NASDAQ: AFSI) allocation by selling covered calls on part of it.

I know we've got a lot of new members who are still figuring out the lay of the land, so I thought I'd point everyone toward a few excellent resources to help understand *Pro*'s portfolio management strategy. If you'd like a comprehensive review of how Jeff thinks about building the *Pro* portfolio -- and why you're not likely to see a third of our portfolio invested in any one stock – you can't beat Jeff's Portfolio Construction presentation from FoolFest 2014. And for the overachievers in the crowd, here are a few other articles that are also worth your time:

- At FoolFest 2015, Jeff outlined four portfolio pitfalls – and how to avoid them
- Former *Pro* analyst Bryan Hinmon detailed how and why we manage volatility and risk.
- Billy looked at how our companies play together with an updated correlation matrix

The *Pro* Bottom Line

Things that have never happened before happen all the time. It's impossible to predict what those events will be, but it's not difficult to predict that at some point, something will likely happen to influence your investment in ways you didn't anticipate. Most investors will find that a surprising number of our successes and failures are the result of extraneous events we didn't consider when we originally began investing in the business. But that's the whole point of investing: If the future were easy to divine, then it would already be discounted by the stock price. The best we can do to moderate risk is to invest in a diverse group of high-quality, resilient businesses, and be sure not to put ourselves in a position where a surprise could limit our options or cause irreparable harm.

Again, welcome to all of the new Fools who are joining us in *Pro*. We're excited to have you here, and we look forward to hearing from you! Be sure to check out our first Portfolio Building Report published last week, and if you have any questions, please join the *Pro* community on our discussion boards.

Fool on!

-- Jeremy (TMFTank)

Pro Guidance Changes

- We're moving **Valmont Industries** (NYSE: VMI) from Hold to Buy. Valmont's end markets remain weak and we considered selling to harvest the tax losses, but recent news that Congress is making progress on a new highway funding bill leads us to believe it's worth holding onto this solid business for a bit longer.

Buy More Verisk Analytics

Published Nov 16, 2015 at 1:51PM

***Editor's note*:** A glitch in our CMS has this article displaying Nov. 5 as its publish date. It was first published Nov. 16, we promise.

Is this for you? *Pro* is increasing its allocation to **Verisk Analytics** (NASDAQ: VRSK) up to 2%. If you're following our portfolio closely, you will do the same. New members can buy up to 2% in Verisk today. Veteran members can add incremental shares to get to 2%.

How You Participate

- **Action:** Buy **Verisk Analytics**.
- **Allocation:** Buy shares to bring your allocation to 2% (up from 1.7%). *Pro* will be buying another 125 or so shares.
- **New *Pro* Members:** Buy up to 2% in VRSK now, to match us.
- **Scorecard Status:** Buy (click here to see our original buy report)
- **Fair-Value Estimate:** $80
- **Recent Price:** $72
- **Price Guidance:** Use a limit order and initially aim to pay less than $72.50. As prices change over time, this starting guidance will quickly lose relevance; as that happens, **our guidance will remain "Buy"** until we officially notify you otherwise.

The Business

With new members in mind, let's first review this company, which we bought for the first time in July. In our original report, we noted that Verisk is similar to current *Pro* holdings **Visa** (NYSE: V) and **MasterCard** (NYSE: MA), as well as prior holding **CME Group** (NASDAQ: CME), in that it was actually created by its customers. Major players in the insurance industry set up an "information utility" called ISO (now a Verisk subsidiary) in 1971 to help make the industry more efficient.

Nowadays, Verisk is a vertically focused data and analytics powerhouse that provides customers with solutions in all sorts of arenas: raw data, tailored analytics, enterprise reporting systems, policy fraud detection solutions, competitive benchmarking, and legally tested policy language, just to name a few. Verisk leverages its mass of proprietary data, industry expertise, and predictive analytics to serve hundreds of customers in all sorts of industries: financial services, including the top 100 U.S. property and casualty (P&C) insurers and 29 of the top 30 credit card issuers in North America, the U.K., and Australia; healthcare, including nine out of the top 10 health-plan providers; government entities; and professionals in the supply chain management and risk management businesses. And as of May 19 of this year, Verisk's clientele includes entities in the energy, chemicals, and metals and mining industries as well.

A strong competitive advantage, high customer retention, robust and contract-based cash flows, a scalable business model, large (and growing) markets -- all these traits make Verisk a prototypical *Pro* holding.

What We're Thinking

It's not very often that a mature, highly profitable company like this reports free cash flow growth of 50%, only for the stock to sell off meaningfully the following day. But that's what happened with Verisk two weeks ago.

The 50,000-foot view on earnings looked pretty decent, but the stock price declined after an uninspiring earnings call, uncertainty surrounding a potential divestiture of the health-care division, and a larger-than-expected decline in non-subscription revenue from recently acquired data-analysis business WoodMac. (We previously looked at the quarter in greater detail.) The idea of waiting until December before getting additional details on the performance and outlook of these two business divisions isn't appealing to those who have a small-f foolish short-term investing mind-set, so they sold shares. But we believe the situation isn't so dire.

At its core, investing is all about buying low and selling high. Three to five years from now, we may look back and realize that Verisk did exactly that by entering into the energy industry (via WoodMac) in the midst of the current energy slide, and potentially exiting the soaring health-care industry now while valuations are favorable. Incidentally, since reporting earnings, Verisk has actually acquired another company in the oil and gas space. One way to invest successfully is to buy out-of-favor industries, and this latest acquisition is yet another sign that management believes now is an opportune time to enter the industry. With respect to healthcare, M&A activity in this space has been robust of late; a company with characteristics similar to Verisk's health-care division finished its first day as a public company trading for a lofty 35 times EBITDA, which is, in our opinion, a very attractive valuation from a seller's standpoint.

Overall, core operations at Verisk remain strong, growing, and highly attractive. Whether they're insurance providers or energy leaders, customers rely on Verisk's data to make smart decisions. This gives Verisk pricing power, predictable revenue, growing free cash flow -- indeed, all the attributes we want to see from a long-term holding. As a little-known Warren Buffett investment, Verisk fits the bill for more of our money.

How This Decision Fits Into *Pro*

We've decided to increase our position size back up to 2%. Members should view this as both a portfolio management decision and an indication of our belief in the company. Following the post-earnings sell-off, we're continuing with our plan to methodically increase our position size over time. But with our original stake (from July) about flat with our original start price, we don't believe this is the time to be overly aggressive. By increasing our allocation by only a little, we leave ourselves positioned to take advantage of any additional sell-offs, yet we have enough invested in Verisk today to make a difference long-term.

Alternative Trades

- **Want to write puts instead?** Unfortunately, Verisk puts don't pay very well. But with the stock currently not far from the $70 strike price, members can capture about a 4% yield by writing the March $70 puts for about $2.80. Please do not over-allocate. Write one put for every 100 shares you're happy to potentially buy.

Pro Can Help

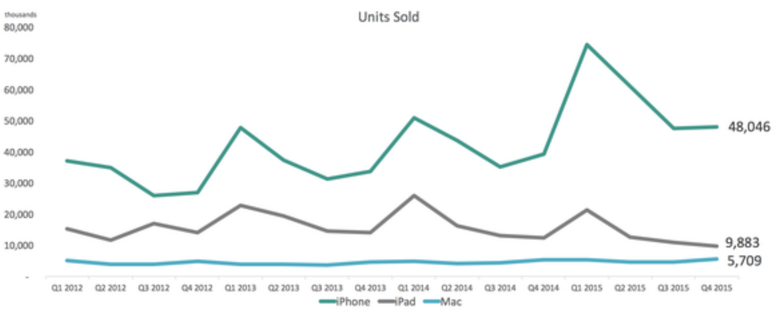
- Got some data you need analyzed? Head over to the Verisk Analytics discussion board.

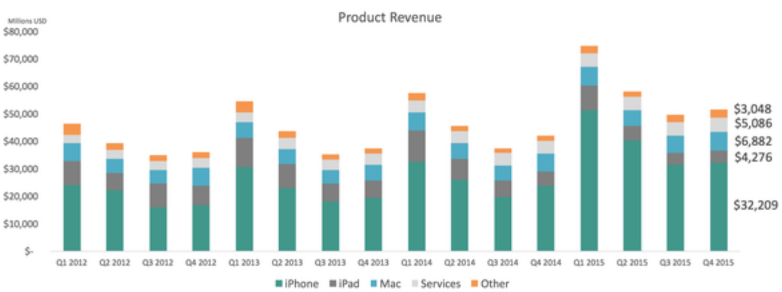
That's One Shiny Apple

Published Nov 16, 2015 at 12:47PM

Apple (NASDAQ: AAPL) once again posted strong results this quarter. Or as CEO Tim Cook noted on the call, Apple's growth this year was greater than the full-year revenue of about 90% of the companies in the Fortune 500.

The Results





Strong growth in multiple divisions resulted in fourth-quarter revenue growth of 22%, while an increase in company margins and the repurchasing of $14 billion worth of shares drove a 38% increase in EPS. Over the past year, it's become very evident that not all publicly traded companies' emerging-market operations are created equal, with multiple companies struggling in this market as well as being hurt by the U.S. dollar's gain versus the Chinese yuan. Apple's overall growth this quarter would have been 800 basis points higher if it weren't for unfavorable currency movements, but even so, it still posted an impressive 63% growth rate in emerging markets.

The company is also making strong roads in the enterprise market. The common perception is that Apple makes products for you and me, but its partnerships with IBM and Cisco are clear indications that management foresees this market as a meaningful source of growth in the years to come. Enterprise markets accounted for close to $25 billion in revenue (11%) this past year, which represents 40% growth over 2014.

Updated Guidance

Updated guidance: Buy (no change)

Recommended allocation: 4.1%

Fair-value estimate: $128

Pro's Take

The iPhone is still the cornerstone of Apple's business, so it's always worth asking just how big (in terms of sales) it can become. comScore's latest U.S. results peg smartphone penetration at around 78%. If you think about this in terms of the diffusions of innovations theory (sometimes referred to as a technology adoption curve in this context), this means that we are well into the late majority. (Below, the blue line is the adoption curve and the brown line is cumulative adoption.)

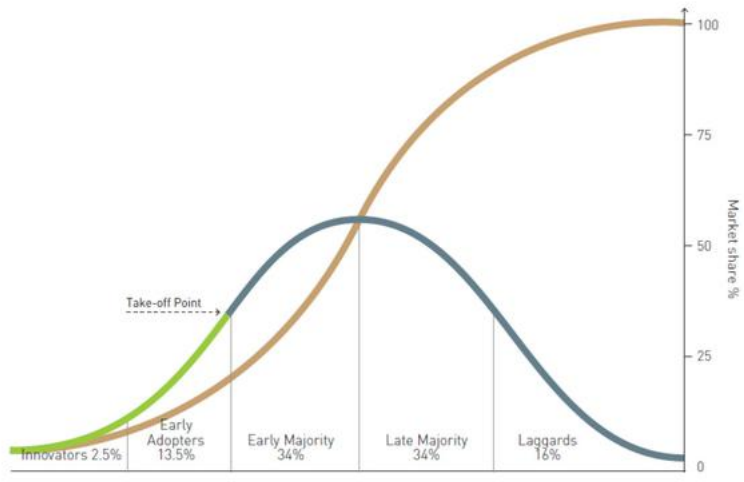
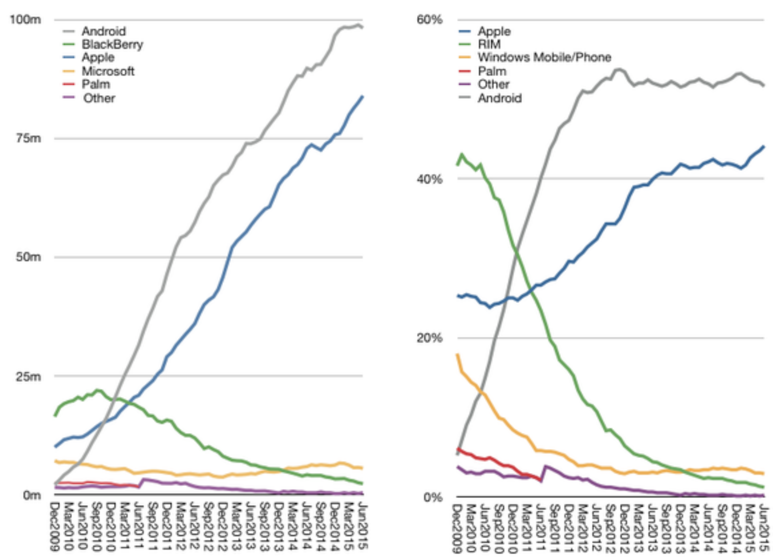


image source: http://slickercity.net blog

So a slowdown in U.S. unit sales growth shouldn't be cause for alarm; rather, we should expect it. But there are two important questions for this and every other market: "When will the market truly become saturated?" and "What type of market share will Apple ultimately command?" With regard to the first question, some experts believe that saturation might not start to occur until 90% penetration or beyond. Given how the smartphone appears to be weaseling its way into every part of our daily lives, this seems entirely possible. And it stands to reason that Apple will continue to capture a meaningful percentage of new users, meaning such sales should continue to be a source of growth for the company (albeit at a much slower rate than in many international markets, where the iPhone has just recently become available). For reference, comScore estimates that the U.S. user base increased by approximately 8.4 million from January to September 2015.

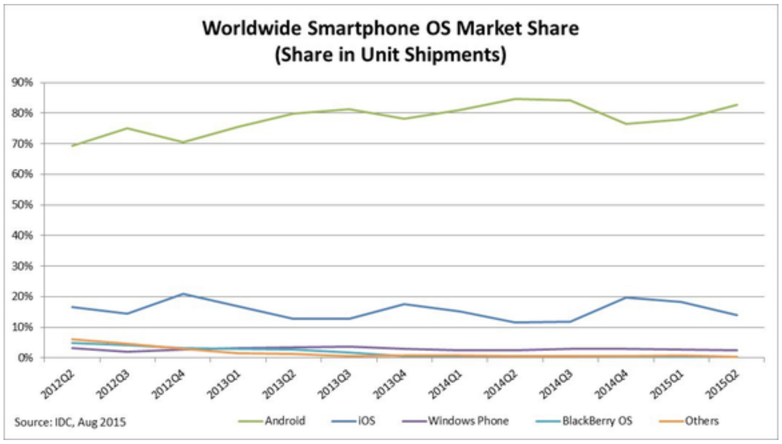
With respect to the market share Apple will ultimately be able to command, Cook noted on the call that the company saw the most people ever switching from Android to Apple this quarter (30% of new activations). To be sure, the company is losing some customers in the other direction, but it seems unlikely that Apple could increase its market share (up 230 basis points, to 43.6%, between January 2015 and September 2015, according to comScore) without being able to covert more customers than it lost.

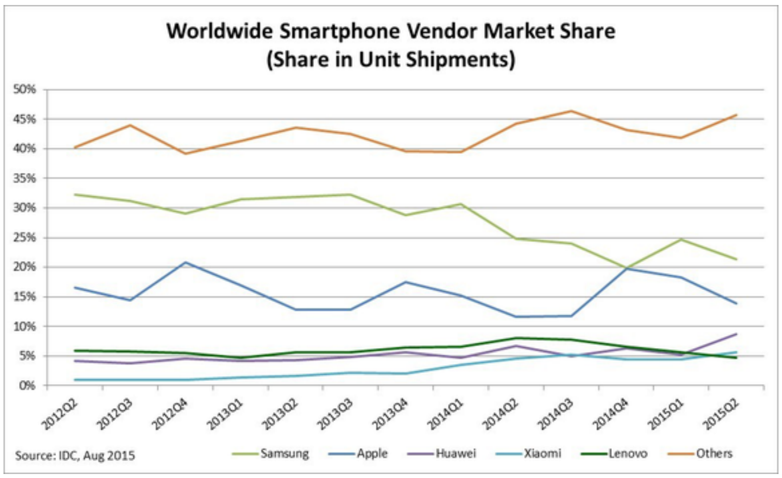


source: image-Horace Dediu, Asymco; data-comScore

One new dimension worth considering is the potential change in the upgrade cycle as carriers and Apple push customers toward upgrade programs. Given that these plans often allow customers to upgrade their phones annually for "zero cost," it stands to reason that we might see an uptick in the number of customers who upgrade each year. This would result in a slight, temporary bump in the unit growth rate here in the United States. Management also noted during the earnings call that only about a third of customers with phones older than an iPhone 6 have upgraded to a newer phone, which means Apple still has a sizable U.S. opportunity in terms of getting customers on a more regular upgrade cycle. When you take all this into consideration, we believe the U.S. will continue to be an attractive market for Apple, even as the company's growth rate continues to slow.

Globally, smartphone usage is, unsurprisingly, far less common. Estimates for global smartphone penetration tend to fall at about 28% to 30% , with the low-cost Android operating system still dominating the market.





Given the higher price point and the reasons people choose an iPhone (to get certain features, as a status symbol, etc.), it shouldn't be much of a surprise to see such a large disparity between Apple's U.S. and worldwide market share. Emerging-market growth continues to be very strong, but we believe it's hard to get a good feel for how Apple will land in a given market until it begins to mature; as cellular coverage in that market improves and more features become available, the iPhone becomes a more viable, attractive alternative. Apple's growth in China is a perfect example of this: iPhone sales were up 120% in mainland China this quarter, even though IDC has noted that China has started to exhibit a more mature growth pattern (like what we see in North America and Western Europe). China's smartphone market contracted for the first time in six years in the first quarter of 2015, and if you back out iPhone growth from the China numbers this quarter, you'll notice that the rest of the market actually contracted slightly this quarter as well.

Of course, the iPhone isn't just about how many units Apple can sell; it's also about the ecosystem, and the ancillary revenue that ecosystem can generate. Performance at the App Store was once again quite strong, growing 20%-plus per year while the number of transacting customers is up 18%. This last metric is one to pay attention to, as it's an important sign of healthy growth. (For some mobile gaming companies and others, growth can be solely dependent on generating additional revenue from the same subset of paying customers.) And Apple Pay's ability to achieve double-digit growth in transactions month after month is another great sign.

With respect to Apple's other sources of revenue, Mac sales continue to be commendable in a market that shrunk by about 11% (based on IDC's latest numbers). Apple Watch sales also appear to be quite strong, with revenue from "other products" increasing by 61% this quarter. The laggard of the group continues to be the iPad, even though it commands 73% of the U.S. market for tablets priced above $200 and appears to be bringing Chinese residents into the Apple ecosystem. (For 68% of the people who purchased an iPad in China, it was the first tablet they've owned, with 40% of those customers making this their first Apple purchase.) Nonetheless, both revenue and unit sales declined 20% this quarter.

From a valuation standpoint, Apple continues to trade like a slow-moving hardware company, at around 9 times free cash flow and 13 times earnings. In our opinion, that's too cheap for a company we believe will be able to remain dominant in technology for quite some time. Granted, it's still somewhat of a one-trick pony, with the iPhone accounting for more than 66% of total sales this year. But we believe Apple's ability to reinvest its robust free cash flow in projects to drive future future growth, while also maintaining a generous dividend and share repurchase program *and* growing its massive cash hoard (cash and short-term investments totaled $42 billion this past quarter!), leave Apple poised to deliver North Star-like returns over the next three years.

Lackluster Results at World Acceptance Corp.

Published Nov 12, 2015 at 1:10PM

Second-quarter results were very much in line with what we've come to expect from payday lender **World Acceptance Corp**. (NASDAQ: WRLD). Revenue and net income fell 7.9% and 9.8%, respectively. Interest and fee income, which accounted for 91% of revenue, fell 6.2% this quarter; this was thanks in large part to a decrease in the company's average earnings loans, as well as unfavorable movement in the dollars-to-pesos exchange rate.

Insurance commissions and other income fell by 22.6% as volume in the division dropped. The company also ended up needing to to repurchase some charged-off accounts it sold just two quarters ago, in the fourth quarter of fiscal 2015. We'd questioned the recovery potential for these accounts in the past, and we believe this move provides yet another reason for us to call the true value of the company's loan portfolio into question.

As followers of this position know, the Consumer Financial Protection Bureau (CPFB) is investigating World. In the 10-Q, we learned that the company submitted its response to the CPFB's Notice and Opportunity to Respond and Advise (NORA) letter on Aug. 28. At first glance, this submission appears to have come one week after the deadline, though it's more likely that the deadline was pushed back as the two entities engaged in discussion. Unsurprisingly, we didn't get any update on when we're likely to hear the outcome of the CFPB's investigation.

Perhaps this had something to do with the short squeeze we saw in the aftermath of the earnings release -- though admittedly, if that's the case, it doesn't make much sense to us. Odds are it will be the CFPB, not World, that will disclose the outcome of the investigation. And the CFPB doesn't owe it to World to try to time that disclosure favorably with the company's earnings reports. There's only one way we can see World announcing the conclusion to the saga, and that's if the CFPB finds nothing wrong with World's business practices. We don't expect this to happen, and we believe the possibility becomes even more remote as time goes on. But if we had to guess the reason for the post-earnings rally, we'd put our money on some shorts covering (specifically, those speculating that the hammer was about to come down), followed by a bit of a short squeeze.

The company's results weren't very pretty, but these results alone don't justify shorting the stock of a company trading for around 3.5 times earnings. The reason there are plenty of folks besides us Fools who are short World Acceptance is because everyone's thesis revolves around the same exact thing: a belief that the CFPB has World in its crosshairs. Our original expectation was that we'd hear something from the CFPB before the year is out. We may still, but the recent spike in the cost to short this stock has us rethinking our willingness to sit around (this was also a big factor in our decision to close half of our position with around a 40% gain).

This is also why we have decided to place the stock on hold for the time being. The risk-reward dynamic has admittedly shifted somewhat since we first shorted World, and because of this, we're not as keen for new members to jump right in and short the stock along with us at this time. But we are content to remain short our 0.5% exposure and suggest that those Fools who have been following along from the start do the same.

Invest Like a Pro: If You're Invested Elsewhere

Published Nov 12, 2015 at 10:00AM

How to build a *Pro* portfolio — investing gradually as you sell other holdings or accumulate funds.

If you're already fully invested, you may need to sell existing positions to add *Pro* picks. We recommend that you do this gradually and deliberately, and we've offered advice on how to approach this task.

Freeing Up Cash

List your existing positions in order from your highest-conviction holding to your lowest-conviction holding. If you own stocks from another Motley Fool service, you can use that service's guidance on those stocks in building your list. If you don't know why you own a stock, that's a good reason to sell it. When you're ready, incrementally sell your lowest-conviction stocks and use the proceeds to build your *Pro* portfolio.

Be mindful of your sector and geographic allocations. You don't want to unintentionally end up owning nothing but oil or European stocks just because they were your favorites. If you're struggling with what to sell, post to our discussion boards — the *Pro* team can't give you individual advice, but our community members can and frequently do weigh in with helpful guidance.

Building Your *Pro* Portfolio

Start Here: Portfolio Building Reports

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new *Pro* portfolio.

Part 1: Our Buy First Stocks
Part 2: Our Buy Stocks
Part 3: Our Buy Stocks, Continued
Portfolio Positioning Report
Important: A note on fair value

What's Next?

As you're building your *Pro* portfolio, participate alongside us with new trades if possible. If you don't have cash available, make the new trades the first ones you buy when the time is right. Each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want.

You may decide to modify the strategy we choose for a trade; for example, writing puts instead of buying a stock outright. If you choose to deviate from our recommendation, though, make sure you:

Uniquely *Pro*

If you're joining us from another Motley Fool service, it is critical that you understand what makes *Pro* so powerful. At *Pro*, we are building a portfolio, not simply offering investment recommendations. *Stock Advisor* and *Rule Breakers*, for example, offer stock recommendations from which members can pick and choose.

In contrast, *Pro*'s trades are intended to be integrated building blocks of an overall portfolio. We cannot emphasize this enough: Anytime you decide to deviate from the *Pro* portfolio, make sure you understand how the trade in question is intended to fit with our portfolio — and how the modified trade will fit with yours. With every trade, keep the portfolio context in mind.

1. Understand why we chose the strategy we did
2. Have a reason that the modified strategy better fits your portfolio
3. Exercise caution by sizing the position a bit smaller than you would otherwise

If you have any questions about our trades or making a strategy fit your investing goals, drop by our Making Pro Fit You discussion board, where the *Pro* team and community are happy to help.

You'll also receive the team's Monday Memo email every Monday afternoon, with commentary, news, and any updates to our guidance.

If You're Investing in an IRA

IRAs are tax-deferred accounts that usually don't allow shorting and allow only simple options strategies. If you're building your *Pro* portfolio in an IRA, you can follow our stock-buying trade alerts directly. Most IRAs allow you to write covered calls, so you can also follow those trade alerts (check with your broker to see if you have permission). For trades that go further afield, here are several points to consider:

Writing Puts: Some IRAs don't allow put writing (although many do, if they are cash-secured), so you should simply buy shares in these positions over time. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Other Options Trades: If you can't make a trade in your IRA, check our trade alert for a list of alternative trades. For example, when we write puts to try to buy shares of Stock X more cheaply, you might be able to simply buy shares of Stock X. (If there are no alternate trades, we'll say so.)

Shorting: Some inverse ETFs can be purchased in IRAs (purchasing an inverse of something is similar to shorting that thing). As with options, we'll mention suitable alternatives in the trade alerts.

As tax-deferred accounts, IRAs are well suited for income-generating strategies like covered calls, high-yield dividend stocks, and ETFs with large taxable distributions. If being unable to follow all our recommendations leaves a hole in your portfolio, you may be able to fill the gap with additional income-generating strategies — for example, by writing covered calls on *Pro* stocks you'd be willing to sell at your strike price.

Because IRAs do not allow the use of margin or shorting, you will likely find it difficult to follow along with most of our hedging strategies. If that's the case, we recommend keeping an eye on both your cash balance and *Pro*'s hedging strategies. When the *Pro* portfolio adds hedges, increase your cash balance; when we pull hedges off, reduce your cash balance by investing more in our Buy and Buy First stocks.

Finally, you may want to consider opening a separate, non-IRA account if possible. You can then manage both your IRA and non-IRA accounts as a single portfolio, with income-focused and shorter-term strategies in the IRA and more complex, speculative, and short trades in the second account.

If You Can't Trade Complex Options

You can still follow most of our trade alerts directly — except, obviously, those involving complex options strategies. In those cases, we offer simpler alternatives whenever possible, such as writing puts, writing covered calls, or buying or shorting a stock or ETF directly. If we issue a trade alert using an income-generating strategy you're unable to employ and there are no workable alternatives, consider using the strategies you do have at your disposal to generate income elsewhere in your portfolio.

If you want to expand your repertoire, you should continue to request higher options permissions from your broker every couple of months until they are granted. Account size is one factor brokers consider when making this decision, so to up your odds of success, consider consolidating accounts or moving funds to the account in which you wish to trade options.

In the meantime, don't lose sight of the big picture; remember that we're building a portfolio. If you can't make a particular options trade, you may be able to make an alternate trade or you may need to sit that trade out — either way, it's no big deal. That said, you'll want to pay particular attention to any trade alert in which we use options for hedging purposes (for example, a synthetic short or a ratio put spread on an ETF or an index). Trades like these are important to our integrated portfolio, so don't ignore them. If alternatives are available, we'll outline them. If not, you may want to take action elsewhere in your portfolio to meet similar goals. For example, one way to accomplish this would be to raise your cash position by trimming a few holdings. As always, we're available on the Making Pro Fit You discussion board to field your questions.

Hungry for more *Pro* goodness? Check out our strategy guide!

Go to the Strategy Guide

Pro Portfolio Building Report No. 1: Nov. 12, 2015

Published Nov 12, 2015 at 10:00AM

Welcome, Fool! We're glad you're here. This first report is meant to get you up to speed on our Buy First stocks — the companies in your *Pro* portfolio that we believe you should start purchasing first. But before we get to that, a few words about how best to use *Pro* ...

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that aims to generate winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, hedges, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* fit you.** We know not all investors are in the same situation! We can help you figure out how to buy *Pro* investments given your personal situation, including investing in an IRA or coming to *Pro* already fully invested. Check out our advice for every approach to *Pro*: Invested Elsewhere | "Free-Range" | Whoever You Are
3. **Catch up with our portfolio at your own pace.** Start with the stocks in this report, and follow along with our subsequent reports between now and Dec. 1. You can always see our Buy First, Buy, and Hold guidance (which is the most important -- more important than valuation estimates) on the Recommendations page, and you can get a succinct, up-to-date take on all of our stock positions on our What We Think Now page.

Bring any questions to the Getting Started & Help discussion board, and Fool onward!

-- The *Motley Fool Pro* team

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Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 3.4%, plus 0.5% in bought calls

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Global mobile data traffic is expected to increase at a compounded annual growth rate (CAGR) of 57% between last year and 2019, and global mobile 4G connections are expected to grow from 459 million in 2014 to 3 billion by 2019 (a 46% CAGR). Communications site operator **American Tower** is well-positioned to benefit from this trend.

What It Does

AMT leases antenna space on more than 99,000 cell sites (towers, rooftops, and more) to wireless service providers across the globe. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, non-cancellable, and feature contractual annual price escalations. About 60% of AMT's properties are located in 12 different countries outside the U.S., including India, Brazil, Colombia, Mexico, Nigeria, and South Africa, and management is intent on expanding the company's international portfolio as it continues to build and acquire more towers.

How It's Working

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE (or, in Africa, from voice to data), or to increase coverage density. When they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; about 98% of AMT's customers up for renewal each year do so, and more than 70% of its current leases don't renew until 2020 or later.

What We Expect

Rental and management revenue is up 14.3% year-over-year in the most recent trailing-12-month (TTM) period, with the domestic division up 16.6%, outpacing the international side primarily because of the company's recent acquisition of about 11,500 towers from Verizon. We expect revenue to roughly double over the next five years through a combination of price escalations, new towers, and upgrades, and year-to-date 2015 results suggest that the company is well on its way.

After its 2011 conversion into a real estate investment trust (REIT), AMT is required to pay out 90% of taxable income from its qualified REIT subsidiaries to shareholders. It currently distributes $1.84 annually, a 1.9% yield, and management expects to increase the dividend by about 20% annually over the next five years. (Importantly, only the U.S. business and a small portion of the international business is organized as an REIT. For more, see *Pro*'s original recommendation.)

For More

- *Pro*'s original recommendation (5/6/13)
- *Pro*'s "Buy More" recommendation (3/17/14)
- *Pro's* "Buy Calls" recommendation (12/17/14)
- Talk about AMT

Management reduces taxable income though the use of net operating losses. And because the useful life of its tower properties in all likelihood exceeds the depreciation schedule, AMT also uses a depreciation shield, which reduces taxable income and understates the value of some assets on the balance sheet. Thus, typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

The *Pro* Bottom Line

We value AMT at about $115 a share. Today's price provides an acceptable margin of safety for a business of this caliber. The stock may experience volatility in the short term because of its tendency to trade alongside the interest-rate-sensitive REIT sector, but over the long term, the underlying strength in business fundamentals should shine through. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network. *Pro* owns January 2017 $80 calls because we bought them before the 2018 calls were listed. Newcomers should consider buying January 2018 calls (rather than the 2017 calls that *Pro* owns) in order to give the investment thesis more time to play out.

Buy First: Gentex (NASDAQ: GNTX)

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 2.8%

What It Does

For More

- *Pro's* most recent update (10/26/15)
- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex

In 1982, a small company in Zeeland, Mich., called **Gentex** made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands almost 90% of that market, and it sells eight times more units than its closest competitor.

How It's Working

In 2000, the company sold 6.8 million units; in 2014, it sold 29 million. That growth has been driven by an increased focus on safety, higher car sales, and greater market penetration (more car makers offering Gentex mirrors as a trim option). Gentex has turned these market dynamics into wonderful financial performance. Revenue has risen by nearly 20% annually since 1990, and over the past decade, the company's net margins have bounced around the mid- to high teens, recently increasing into the low-20% range. Those numbers are shockingly good for an auto-parts supplier, showing that its fancy mirrors are showing up in more and more new cars.

What We Expect

Currently, about one in every four cars made worldwide has an auto-dimming rearview mirror, and only 7% have auto-dimming exterior mirrors. For context, prior to 1987, those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher usage; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror (including the soon-to-be launched full display mirror), both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy First: Gilead Sciences (NASDAQ: GILD)

One of the strongest biotech companies on earth, Gilead is positioned to keep rewarding owners.

Suggested Allocation: 3.7%

What It Does

For More

- *Pro*'s original recommendation (4/30/14)
- Talk about Gilead

Gilead Sciences (NASDAQ: GILD) helps millions of people fight life-threatening diseases. Its HIV drugs are prescribed to 8 out of 10 new HIV patients and are already helping millions enjoy much better lives. Its HIV products represented the majority of Gilead's revenue until its Hepatitis C cures, Sovaldi and Harvoni, were approved last year. The most successful drug launch in history, Sovaldi topped $10 billion in first-year revenue, and Harvoni reached megablockbuster status this year as well.

An estimated 2.7 million to 3.2 million hepatitis C patients reside in the United States, and a whole 2.8% of the world (almost 200 million people) is thought to have this common blood-borne infection. That means tens of millions could conceivably benefit from Sovaldi or the newer single-pill version, Harvoni, and this would still leave plenty of room for competing drugs to do well, too.

How It's Working

Gilead is on track to increase earnings per share more than 50% this year on the strength of its new hepatitis C franchise, yet the $108 stock trades at less than 9 times expected 2015 earnings. The company's products have a healthy lead over competitors' hepatitis C drugs both in the U.S. and in other countries, and a key competing drug from **AbbVie** (Nasdaq: ABBV) has come under scrutiny for side effects. Gilead's Harvoni drug, approved in October 2014, is the first single-pill regimen for curing Hepatitis C, and competitors aren't likely to match it anytime soon. Meanwhile, the company's HIV franchise remains unparalleled, and Gilead has more than 200 compounds in clinical trials.

What We Expect

Following big growth in 2015, we expect robust sales in 2016 as Harvoni is prescribed to tens of thousands of new patients around the world. Beyond next year, countries will slowly approve the drug and its reimbursement over many years; Gilead expects the European market, for example, to expand for quite some time. Overall, it's estimated that Gilead will increase earnings by more than 15% annualized over the next five years. Meanwhile, we expect Gilead's refreshed HIV franchise and growing oncology franchise to help increase shareholder value. It's important to realize that the stock can be volatile at times; nonetheless, Gilead is one of the best biotechnology companies in the world, and we believe this inexpensive behemoth should be in your *Pro* portfolio.

Buy First: Oracle (NYSE: ORCL)

This old-guard tech giant at a low price has more room to grow.

Suggested Allocation: 3.7%

What It Does

Oracle (NYSE: ORCL) is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems** (NASDAQ: CSCO), **Dell**, and **Microsoft** (NASDAQ: MSFT) — Oracle's value has steadily risen (up 220% in 10 years) as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe. And when it comes to hardware, Oracle's own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

Combining hardware with boxed software and new, sprawling cloud services, Oracle is a full-service solution, one that's poised to enjoy long-term growth in free cash flow. The business is incredibly sticky — companies don't trust their data to just anyone, and it's risky to make a switch. To add to its massive recurring revenue base, Oracle cross-sells new products to existing clients and continues to rope in new customers with its comprehensive software and hardware solutions, whether on site or in the cloud. The company has also been known to make some (read: *many*) acquisitions to propel growth.

For More

- *Pro*'s original recommendation (9/17/09)
- Latest earnings coverage (9/18/15)
- Talk about Oracle

How It's Working

Leading software sellers can write a program once and sell millions of copies, then provide small but critical updates on a regular basis. These updates drive a subscription business model, which leads to recurring revenue. Most of Oracle's customers renew annual software contracts that represent more than 40% of its revenue. This is stability upon which Oracle grows. Even better, as more customers move to a cloud-based relationship (rather than licensing on-premise software), Oracle enjoys increasing monthly recurring revenue, even as customers save money because they no longer need to host their own software. For Oracle, economies of scale make hosting inexpensive.

What We Expect

At about $40, Oracle trades at about 14 times free cash flow, below the S&P 500's average, and management expects more operating leverage ahead and greater overall profits as cloud revenue steadily increases. We model about a 10% annualized return, which would pace our current North Star with relatively low risk. This is a good buying opportunity for a proven business that still has plenty of room to grow.

Buy First: Wells Fargo (NYSE: WFC)

At heart, banks are simple businesses, and Wells Fargo is one of the best of the breed.

Suggested Allocation: 3.7%

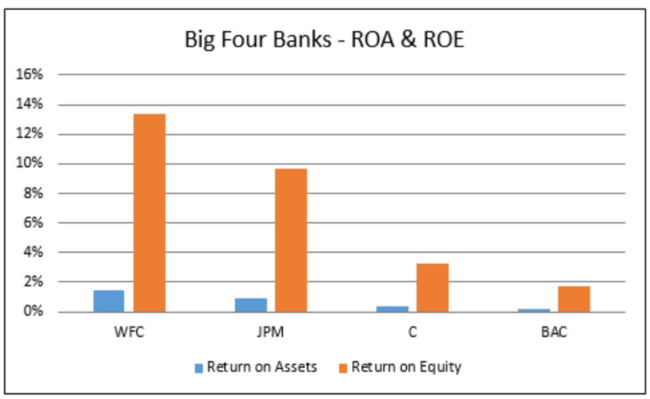
What It Does

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** (NYSE: WFC) is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 8,700 branches and 12,800 ATMs. It's the fourth-largest bank in America by total assets, it has a reputation for high customer loyalty and satisfaction, and it's the U.S. leader in mortgage and small-business lending.

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up roughly half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During tough lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

How It's Doing

CEO John Stumpf and team are truly the best of the breed. Return on assets and equity for fiscal year 2014 were rock-solid, at 1.45% and 13.4% respectively — great results given the low-interest rate environment and new regulations that require higher liquidity levels (i.e., less leverage) than before the financial crisis. A look at ROE figures for the other three big banks shows Wells Fargo's comparative excellence:



Source: Wells Fargo February 2015 Credit Suisse Financial Services Forum Presentation

Total revenue growth has been elusive, but expense reductions and improvements in credit quality have driven quarter after quarter of earnings growth, leading to higher earnings than before the financial crisis. Deposit growth has been tremendous (coming in at 8.1% in the third quarter of 2015), and as Wells Fargo grabs additional "wallet share," fee income increases as well. The credit quality of the loan portfolio is very strong, with net charge-offs at just 0.31% of total loans as of third-quarter 2015. All of this has contributed to a very well-capitalized balance sheet, allowing Wells Fargo to comply with the aforementioned capital regulation requirements well ahead of schedule.

More Resources

- *Pro*'s original recommendation (12/10/10)
- *Pro*'s "Buy More" recommendation (7/29/14)
- Talk about Wells Fargo on our discussion board

What We Expect

Wells Fargo's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. In a world of continued low interest rates, we should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But when the U.S. economy picks up steam, interest rates rise, and loan demand accelerates, Wells Fargo's real earnings power — bolstered by growth in fee-based revenue — will hit its full stride.

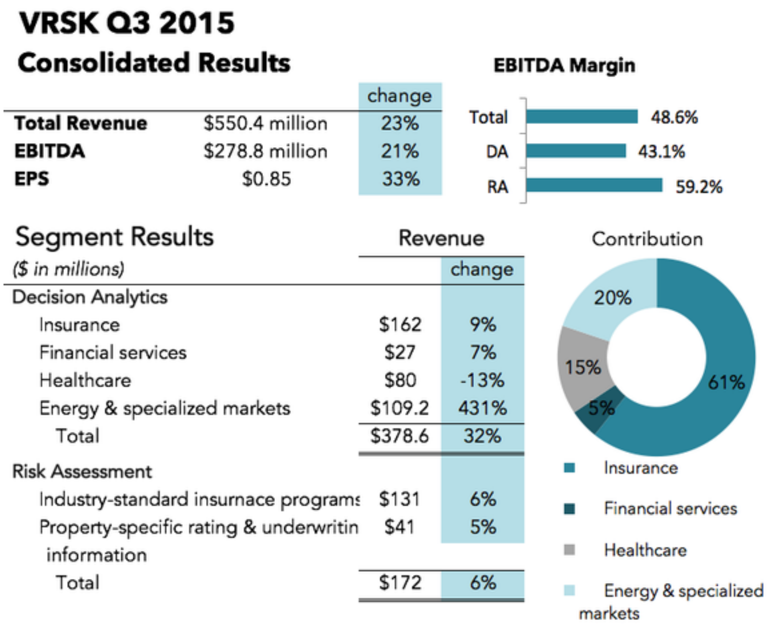
Shares are trading at less than our estimate of fair value, and they yield a growing 2.7% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. *Pro* has also used options in the past to generate even more income from this position, so try to invest using round, 100-share lots if it keeps you within half a percent (plus or minus) of our 3.7% allocation. If that's not feasible for you, share ownership alone is fine, too; with its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

- **Coming up:** Our next two Portfolio Building Reports will come your way Nov. 19 and Dec. 1! We'll email you when each is ready, and you'll find the links under the Guidebook tab.

Strong Results but New Questions at Verisk Analytics

Published Nov 11, 2015 at 4:13PM

This was an interesting quarter for **Verisk Analytics** (NASDAQ: VRSK). The 50,000-foot view looked pretty decent, but the stock sold off thanks to an uninspired earnings call, uncertainty surrounding the future of Verisk's health-care division, and a faster-than-anticipated decline in non-subscription revenue at recently acquired WoodMac.



VRSK Q3 2015
Consolidated Results

		change
Total Revenue	$550.4 million	23%
EBITDA	$278.8 million	21%
EPS	$0.85	33%

Segment Results
($ in millions)

	Revenue	change
Decision Analytics		
Insurance	$162	9%
Financial services	$27	7%
Healthcare	$80	-13%
Energy & specialized markets	$109.2	431%
Total	$378.6	32%
Risk Assessment		
Industry-standard insurnace programs	$131	6%
Property-specific rating & underwritin information	$41	5%
Total	$172	6%

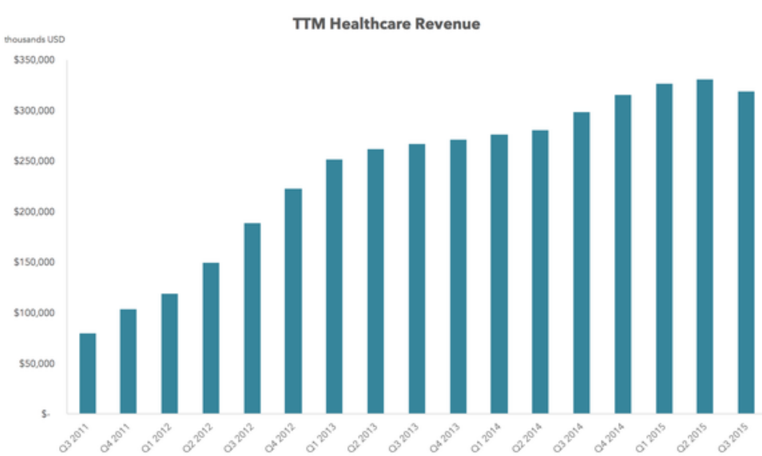
Updated Guidance and Valuation

- **Updated guidance**: Buy (no change)
- **Recommended allocation**: 1.7%
- **Fair-value estimate**: $80

Both the insurance and the financial-services divisions continue to be business as usual, so let's just jump straight to the two businesses that justifiably attracted the most attention during the earnings call.

Health Care

The big news here was that Verisk is exploring the possibility of divesting its health-care operations -- but let's start with the results first. Management has always noted that whenever it enters a new market, growth there tends to be somewhat lumpy as new clients start by putting one or two of Verisk's solutions through an isolated trial phase before scaling across the whole business and adding additional solutions. Even so, up until this past quarter, the health-care segment had been a steady performer for Verisk since it entered the space a few years back.



Now, management did hint during the first-quarter earnings call that the back half of this year could be challenging for the company, but given Verisk's track record, I don't think anyone was expecting a 13% decline this quarter. It's a scary headline number to be sure, but it's also somewhat misleading because of some changes in revenue accounting. Net of pass-through revenue (the revenue metric that really matters to us, since it excludes revenue that will be passed through to Verisk's clients) declined only 2% this quarter. Even so, we find these results to be a bit troublesome given that this business is still somewhat seasonal (most of the company's Medicare Advantage work takes place in the second half of the year).

These results may have raised some doubts about what we should expect from Verisk Health in the fourth quarter, but the biggest question is this: Why would management look to sell a business that has such a long runway, as long as the company is able to execute on its plans? The press release confirming the rumors that Verisk is exploring a possible divestiture seemed somewhat rushed, and management didn't give us a ton of color on the call (though they did note that additional details will be provided during their investor day in December). Here are some of the things management did allude to:

- International expansion opportunities, or lack thereof: In the aftermath of the WoodMac deal, the company has been very forthcoming about its desire to expand internationally. Since Verisk Health is destined to remain a domestic operation for the foreseeable future, management might view redeploying capital into this segment as a suboptimal use of shareholder funds.
- Striking while the iron is hot: M&A activity in this sector has been robust, with many businesses receiving attractive valuations.
- Doesn't fit as well with the other three verticals (insurance, energy, financial services): These other three can benefit from what is currently being done in other parts of the business more easily than the health-care division can.

It's hard to say right now whether selling Verisk Health is the right move; the answer will ultimately depend on how the company spends the proceeds. Management hinted that additional acquisitions and share buybacks will both be on the table, but without knowing for certain how this will play out, we'll reserve judgement for the time being. The company does have an impressive history of making smart deals, but our preference here in *Pro* is to evaluate each acquisition and divestiture on its own merits instead of simply giving management teams free passes because of their track record.

Energy

Verisk's newest business also received plenty of negative attention this quarter. Management reduced their expectations for this year's revenue from the recently acquired WoodMac (which does data analysis in the energy sector) by $15 million as the anticipated 2016 decline in non-subscription business was pulled forward into this quarter. Given that management had previously sounded confident in their 2015 projections for WoodMac, this was not something we were expecting to hear. As with Verisk Health, management noted that shareholders will receive an in-depth update on this division come December. Unsurprisingly, this was met with the same unenthused response from the analysts on the call.

It's never good when a company revises its revenue estimate downward not long after completing an acquisition, but it's important to keep things in perspective. Organic growth for Verisk's energy and specialized market was 5.6%, with WoodMac up 1% in British pounds this quarter and 7% year to date. This is quite impressive when you consider the severe pullback in capital spending in the oil and gas industry. Some experts have predicted that total capital spending in the U.S. energy industry will decline by more than 25% this year, and WoodMac recently estimated that close to $200 billion of spending on new oil and gas projects has been shelved for the time being.

The *Pro* Bottom Line

It's not very often you see a mature, highly profitable company report free cash flow growth of 50% only for the stock to sell off meaningfully the following day. But that's what we got with Verisk. The idea of waiting until December before getting additional details on the health-care and energy divisions isn't appealing to those who have short-term mind-sets, but we believe the situation isn't so dire. Investing is all about buying low and selling high, and three to five years from now, we may look back and realize that this is exactly what Verisk did by entering into the energy industry in the midst of some carnage and potentially exiting the health-care industry while valuations are favorable.

Questions? Comments? Bring them to the Verisk discussion board!

Pro Catch-Up Trades: Nov. 9, 2015

Published Nov 9, 2015 at 2:39PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

Pro's Buy First stocks for your core, long-term stock portfolio:

- **American Tower** (NYSE: AMT), buy up to 3.4% in stock
- **Gentex** (NASDAQ: GNTX), buy up to 2.8% in stock
- **Gilead Sciences** (NASDAQ: GILD), buy up to 3.7% in stock
- **Oracle** (NYSE: ORCL), buy up to 3.7% in stock
- **Wells Fargo** (NYSE: WFC), buy up to 3.7% in stock

There are also *Pro*'s Buy stocks, including:

- **Apple** (NASDAQ: AAPL), buy up to 4.2% in stock
- **Verisk Analytics** (NASDAQ: VRSK), buy up to 1.6% in stock

New members can start to buy now, or wait for our Portfolio Building Reports, which start to roll out Nov. 12. Welcome to *Pro*!

Prepping Pro Members for 2016

Published Nov 9, 2015 at 1:33PM

Greetings, *Pro* members!

Did you know that only 52 days remain in 2015? Excluding holidays, that means only about 35 business days left. Over that short time, we're going to conclude our current-quarter earnings coverage, welcome new members and start getting them up to speed with the *Pro* portfolio, and make more decisions to ideally position the portfolio well for 2016 and beyond.

We've had a very good 2015, with *Pro* up 11.7% as of October 31. That's ahead of our North Star at 7.2% and the S&P 500 at 2.7%. We want to continue doing what we're doing right, and get better at what we've done wrong.

As for what we do right, I'd say we find strong businesses that compound our wealth, and then hold our shares; use options sensibly for income, extra returns, and hedging; and "sell short" struggling companies to profit on falling stocks. We aren't overactive investors, though we're always engaged because we love what we do.

We've gone wrong -- and thankfully, they've been small mistakes -- when we've bought companies (or used options) in situations that didn't live up to *Pro* standards. We aim to learn from our mistakes and keep improving.

The good news: We've been investing in a *Pro* fashion for 15 years, and this service has been doing so for members since 2008. So we know it works, and we know *how* it works. Plus, we've learned more good lessons at this point than at any other, so it's a good time to be here.

We're going to keep plowing through earnings to get updates out to you, and then we expect new trade alerts in *Pro* and in *Motley Fool Options*. But first, we want to welcome new members to *Pro* this week, and help them get started.

Welcome, New Members!

New *Pro* members are advised to steadily build a *Pro* portfolio by following our Portfolio Building Reports. The first report, highlighting Buy First stocks, rolls out Thursday (we'll email you every time there's a new one). Our subsequent reports will outline the rest of the *Pro* stocks we believe you should invest in; after that, since you'll be largely invested, we'll have a Portfolio Positioning Report (and accompanying live chat) on Dec. 1, for those who want to short, hedge, and use options. With these tools, you can manage your market exposure or risk level.

We're so glad to see so many new members using the Pro community! Common questions include:

- **How do I meld *Pro* stocks with my existing stocks?** One approach is to treat *Pro* as a sleeve of your total assets; within that sleeve, follow the portfolio as closely as possible. If this is you, we still recommend that you eventually own as many *Pro* stocks as you are happy to own. Our portfolio is meant to *work as a whole*. If you're selling some stocks to get there, start with your least favorites -- the ones you believe in least -- to add *Pro* stocks. Take your time. We don't want you racking up giant tax bills by selling winning stocks you love. You can follow our portfolio and apply our hedging strategies to your own portfolio, too, while gradually moving into more *Pro* stocks over time. Ask related questions on our "Making *Pro* Fit You" discussion board.
- **Should I buy a full allocation of each stock today?** We're advising that you mirror our current allocation as shown on the Recommendations page. We make certain we like how our portfolio is constructed, and to guide you over the years, we can only know what your allocations are if you follow our own. That said, many members average into positions over time. If we recommend 4% in a stock, some of you may buy 2% to start, and 2% later. That's fine, and would be beneficial if prices slip -- as long as you finish the job later. Experienced options users sometimes "sell to open" puts to target lower buy prices on some of their shares.
- **Some stocks are above your estimate of fair value. Should I buy anyway?** If a stock is rated a Buy or Buy First, we believe it will still perform well over our time frame, meeting or beating our goals. Fair value is an estimate, and it's the price *from which* we expect our desired rate of return. If a stock is a bit above our estimate, that doesn't mean its promise is gone, by any means. Plus, keep in mind that a fair-value estimate steadily goes up as a business grows. We update them around twice a year.
- **How long will I own these stocks?** The Motley Fool has always said that you shouldn't invest money in stocks for anything less than three years. That's smart advice. We view all of our core stocks with a rolling three-year time frame.
- **Do I need to hedge, short, and use options?** The short answer is no. Many investors do great just owning stocks, and in *Pro*, our stocks alone should lead to success. But for those who want to use these dynamic tools for income, leverage and more, we'll help you incorporate them into your *Pro* portfolio starting with our Portfolio Positioning Report on Dec. 1.
- **How do I use *Motley Fool Options* alongside *Pro*?** *Pro* members receive *Motley Fool Options* free for the life of their *Pro* membership! *Options* provides individual options ideas and education; for members who want *additional* options positions in their portfolio, these are a perfect complement and return enhancer.

For other common questions, see our welcome note. (We've welcomed plenty of new members over the years, so much so that veteran members may have seen the note a time or two before.) And as you go through our Guidebook, enjoy the process! Investing is a marathon, never a sprint. If you make a little progress each week, you're headed toward the long-term magic of compounding, which can only happen over many years.

To our existing members, thank you for so kindly welcoming new *Pro* members to the service, and for all your help on the discussion boards!

To everyone, we expect a series of recommendations (in both services) as we go through the rest of the year. In *Pro*, we like to use the end of the calendar year to reassess and make adjustments. We have this in mind already as we guide new members.

But always think "marathon," never "sprint." Steady income from options aside, any money you can make in a day or week won't be enough to matter. The money you make over many years of being invested is what makes the biggest difference. We're glad you're here in *Pro*. Let's keep the conversation going on our discussion boards.

Fool on!

— Jeff (TMFFischer)

American Tower Keeps On Integrating Its New Assets

Published Nov 4, 2015 at 3:25PM

What Happened?

- Total rental and management (R&M) revenue of $1.24 billion (year-over-year core* growth of 27.4%)
- Domestic R&M segment revenue of $808 million (year-over-year core growth of 21%)
- International R&M segment revenue of $405 million (year-over-year core growth of 44%)
- Adjusted EBITDA of $779 million (year-over-year core growth of 26%)
- Adjusted funds from operations (AFFO) of $558 million (year-over-year core growth of 33%)

*Core growth reflects adjustments for foreign currency exchange rate fluctuations, pass-through revenue, straight-line revenue and expense recognition, and material one-time items

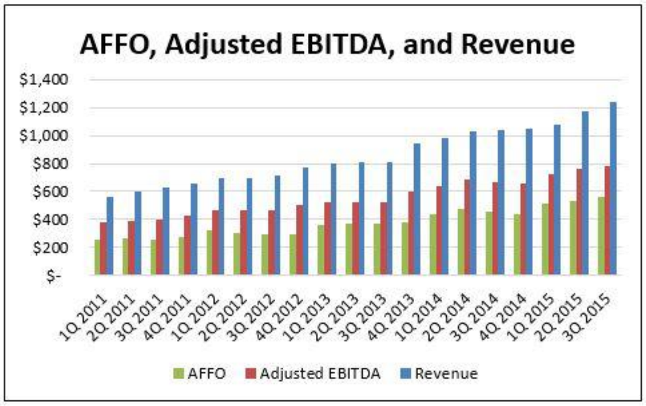
CEO Jim Taiclet:

> "Our nearly 14% growth in AFFO per Share in the third quarter was fueled by continuing exponential growth in mobile data demand in both the U.S. and in our international markets. We believe that this growth in demand will go on for many years to come, driven by a combination of lower cost smartphones proliferating around the world, additional spectrum being deployed for mobile data and the competitive imperative for mobile operators to steadily invest in their networks.
>
> Our strategic objective is to capture this long-term growth opportunity by building strong positions in the world's largest free market economies with attractive wireless industry structures. So far in 2015, we have made tremendous progress on expanding American Tower's global growth platform through our acquisitions of rights to the Verizon towers in the U.S., Telecom Italia's towers in Brazil, Airtel's portfolio in Nigeria and our recently announced Viom transaction in India. We expect that these strategically located assets will further lengthen and strengthen our AFFO per Share growth trajectory well into the future."

So What?

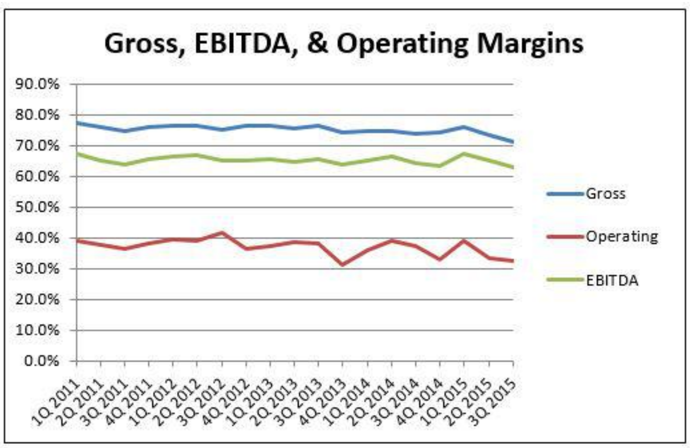
American Tower (NYSE: AMT) reported a bit of a noisy quarter in Q3 2015 as the company continues to experience significant foreign currency headwinds and work toward integrating a variety of newly acquired assets, including the Verizon assets in the U.S., nearly 4,700 towers in Nigeria, and over 1,000 additional sites in Brazil from the TIM acquisition that had yet to close as of the previous earnings report. Foreign currency fluctuations knocked off 8% from reported revenue, 9% from Adjusted EBITDA, and 11% from AFFO, which is the highest-magnitude impact I've seen since covering the company.

Nonetheless, the company continues to build on its strong business performance and compounding dynamics. The company continues to execute on its strategy of using cheap debt to consolidate a critical industry with growing end-markets and secure, recurring revenue characteristics. This has resulted in strong and consistent growth in revenue, EBITDA, and AFFO as growth in end-markets continues and new assets are integrated and leased up:



Two quarters ago, I noted that "we may see slower revenue growth and stagnant or declining margins in the coming quarters as [timing-related] factors dissipate and new acquisition-related assets (and their lower margin profiles) make up a larger portion of the company's revenue. But over time, we should see margins tick up as scale and incremental leasing activity on new assets take hold." That's what happened again this quarter, with margins continuing to decline sequentially, primarily due to the significant and immediate effect that the lower-margin Verizon assets have on domestic margins.

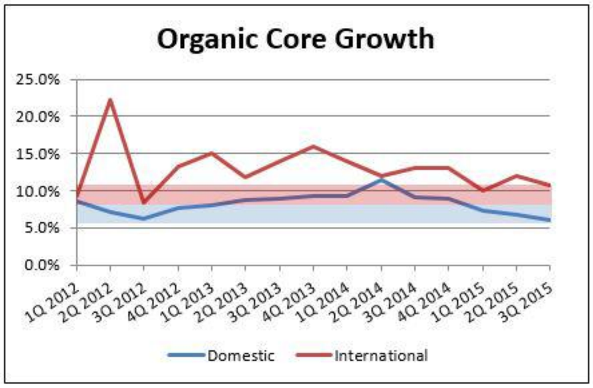
International margins actually increased on a year-over-year basis (international operating margins increased from 69.3% in Q3 2014 to 70.5% in Q3 2015) due to strong international organic growth, even despite the addition of new lower-tenancy towers in Brazil and Nigeria. But due to the disproportionate effect of the domestic portfolio on the overall company's financial results, margins continued to decline, exacerbated by the aforementioned foreign currency fluctuations:



Despite this, we should see margins start to increase over the next 6-12 months and beyond as American Tower begins to work its way through its application pipeline for the under-utilized Verizon towers. Management made some comments on the call regarding the progress of integrating the significant Verizon acquisition:

> **CEO Taiclet:** "*So on the Verizon towers, we've actually got almost 5,000 third-party applications on 11,500 sites. Now it's going to take months, and in some cases, a number of quarters to get those applications through. It's a mix of co-locations and amendments. It's all kinds of activity there. It will play out over literally the next 6 to 12 months as far as real revenue opportunities that flow from those many applications. But we already have commenced new business in process where we think we'll end the year with about $800,000 a month of incremental monthly revenue based on the new applications we will have processed by then. So that's a really great start. It's in line with our business plan, and we've got a huge pipeline of applications as we've kind of opened up these towers for business, so to speak.*"

Organic core growth (growth excluding revenue associated with new properties) continued to track well, with international organic core growth coming in at +10.7% (decelerating a bit from +12.7% last quarter) and domestic core growth continuing to slow (coming in at +6% vs +6.8% last quarter) as AT&T and Sprint maintain reduced levels of U.S. network investment activity relative to the same periods in 2014. AT&T and Sprint are expected to pick up their investment activity into 2016 and beyond as they launch their next-generation network plans, which should support higher domestic organic core growth. Organic core growth continues to track within management's target ranges (the shaded area on the graph below):



As for debt, the company's net leverage ratio came in at 5.4x, and management expects to reach 5x leverage or below by the end of 2016. The company has plenty of liquidity (nearly $2 billion), no significant debt maturations until 2018, and a weighted average debt tenor of nearly 6 years.

Yearly distribution growth continues to track ahead of management's 20% long-term growth target, coming in at 28% growth ($0.46 per share, a 1.8% yield on the current share price). 20% annual distribution growth continues to look like a more than reasonable target for 2016 and beyond.

American Tower's management team does a great job of trying to present new and compelling information on each conference call rather than delivering canned, stale information. This call provided some excellent information, specifically related to (1) the company's capital allocation process and priorities, and (2) the effect of technological developments on American Tower's future prospects. Here are my favorite excerpts:

> **On capital allocation between U.S. and international markets:** "*We have said a number of times in the past, we don't have a specific revenue split target for U.S. versus our international markets. But just as a reference, because of the size, the pricing structures, the strength of the contracts that Tom already mentioned, the U.S. still delivers 75% of the operating income of the company, right? So that's going to be a very big flywheel that itself grows over a long period of time and there's a smaller flywheel of international operating income that's going to grow faster for a longer period of time. And so those 2 things actually complement each other and we don't have a specific target of how the math ought to work in, say, year 5 or year 10. But what we will continue to do is look both in the U.S. and outside for investment opportunities that meet our investment criteria, right, which is meaningful AFFO per share, growth opportunity at asset prices that give us a good opportunity to also keep ROIC stable and rising over time as well, OK? That's how we make those investment decisions. The benefit of having the global aperture as we look at those investment decisions are, it gives us a lot more things to look at. Many of those things will meet our investment criteria. We'll go through them. A couple of those have happened already this year in the case of TIM, Airtel and now Viom. We also had that aperture open in the domestic side and we made a very significant agreement with Verizon, as everybody knows, earlier this year. And then there's a lot of things we don't have to do because we have the wide aperture. There's a couple of other carrier deals that didn't meet our asset pricing objective, and you didn't see us win those. There's many international deals because we have again both sides of the street to play on that we don't take because we don't think we have to take them to grow inorganically. So I think those are the benefits of having the global team in place, the track record, these multinational customer relationships. The diversification will naturally happen, because as you know, 60% of the sites and it will be greater next year, contingent on our Viom closing are outside of the U.S. and they're going to grow faster and longer. So this is naturally going to evolve over time, but there aren't any targets.*"
>
> **On technological developments and their effects on AMT (long, but worth reading for those concerned about technological disruption, important lines bolded for emphasis):** "*There are 2 facets of mobile network investment, which are depicted on the next slide. The first is known as the core side of the network. The fixed-line portion of the system, which consists of the switches, servers and related electronics; the fiberoptic cable and copper that connects all these major components together; and the software that makes it all work. The other side of the network is known as the RAN, or radio access network, and is made up of the widely distributed transmission or cell sites. Each cell then utilizes an airlink over radio spectrum to reach your device over the air. At American Tower, we play only on the RAN side of the network, and demand for our real estate goes up directly whenever more transmission equipment, such as antennas, is required for capacity or when new cell locations are needed for coverage. Moreover, our demand goes up indirectly when improvements in the core network reduce its cost of operation, potentially freeing up more capital and/or OpEx resources for the RAN and its many cell sites. Therefore, **it's crucial to view technology and industry developments as they relate to American Tower by asking 3 simple questions about each. First, does this particular technology significantly improve airlink capacity, and thus reduce the need for equipment on towers? Second, does this technology significantly increase the distance a high-quality wireless signal can travel, allowing sites to be positioned further apart? And third, conversely, does this technology reduce core network costs, which then would enable more resources to be deployed back into the RAN?***
>
> *So now I'll spend a few minutes on several emerging technologies which we believe are or will be incorporated into future mobile network deployments and address those 3 critical questions for each.*
>
> *First, let's start with self-optimizing networks or SONs and software-defined networks or SDNs. SONs allow networks to be more intelligent by dynamically managing traffic. This helps carriers reduce expensive truck rolls to make physical network equipment adjustments in the field. Meanwhile, SDNs provide carriers with a tool to add new network functionality and services through simple software upgrades, dramatically reducing time and cost. Both the SON and SDN therefore primarily enhance the efficiency of the core side of carrier networks and help operators reduce OpEx and CapEx there. So we view both of these technologies as neutral to positive for tower demand.*
>
> *Next, let's address cloud RAN or C-RAN technology, which enables carriers to centralize the base stations of several cell sites at a data center, instead of having dedicated ground-based equipment at each tower site. As a result, the carriers are able to reduce their base station costs and enhance the processing efficiency of the mobile core portion of their networks. While their ground space requirements at the base of towers can decrease with C-RAN in use, the amount of equipment on the towers themselves is unaffected, or in some cases, actually increases, as remote radio heads are installed on the tower. So for a tower operator, we also expect C-RAN to be typically neutral to net positive.*
>
> *As you can see on Slide 19, **it is our understanding that none of the technologies I just mentioned materially enhance airlink capacity or extend effective signal ratings. Conversely, when it comes to whether or not these innovations have the capability to decrease carrier operating expense on the core side of the network, the answer is yes. Over the long term, they should be a positive for the tower industry.***
>
> *Turning to the airlink side of the network. There have been technological improvements which over time have improved network capacity. For example, carrier aggregation has enabled mobile operators to deploy unpaired spectrum usually with high and low bands together all on one site. This adds network capacity in the short term as spectrum assets are more effectively utilized. But in the long term, we believe this will actually lead to increased cell site densification as the design requirements of the highest frequency band spectrum will dictate ultimate network density and overall design requirements. Our estimate is that over the last few years, capacity gains from new spectrum and higher spectral efficiency of LTE has absorbed roughly 20% to 30% of incremental network usage, leaving the 70% to 80% being solved through additional cell sites and equipment on our towers. As I have highlighted in past calls, the laws of physics govern the properties of RF signal propagation and thereby limit the impact that many changes in technology can have to the airlink*

portion of a mobile network. For example, in the largely suburban and rural areas served by our U.S. towers, antenna elevations of at least 75 feet above ground level are usually needed for effective signal transmission. And antennas that are upwards of 10-feet tall also continue to be required for the specific spectrum bands being used and the cell radius being served in these topologies. In addition, higher bandwidth data traffic requires more signal propagation locations to ensure sufficient signal strength and more equipment at those locations to process that signal as well. And these trends drive solid core organic growth that you've seen in our business year after year. ***Given the topographic and demographic characteristics of the United States and our international markets, we continue to expect the macro tower to be the predominant siting solution for carrier network deployments now and in the future.***

Additionally, the improvement of technology in the mobile core should enable the carriers to deploy relatively more capital on their radio access network build-outs to keep up with the demand. This may be especially relevant with the much higher throughput expected on future 5G networks and beyond. Moreover, our international operations continue to benefit from the increasing availability of cheaper, more advanced smartphones and the greater ability of many more people around the world to afford them. Mobile connectivity is revolutionizing communications, commerce and entertainment in the developing world, and we think that in many of our served markets, the modernization cycle is actually accelerating."

Now What?

This quarter's report yet again provides confirming evidence that our investment thesis (that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time) continues to play out. Despite short-term margin pressure related to acquisitions, the company's strong operating history, excellent management, and strong competitive position in a growing industry give me confidence that American Tower will continue to grow revenue and cash flow at high rates for a long time, providing strong returns on capital.

Data and Guidance

- Current Price: $102.44
- Fair Value estimate (unchanged): $115
- Allocation: 3.5% plus 0.6% in bought calls
- Market Cap: $43.8 billion
- EV/EBITDA (TTM): 20.7
- EV/EBITDA (2015 projections): 19.9

AMT remains a Buy First, with no change to our fair value estimate of $115 per share and an allocation of 3.5% plus 0.6% in January 2017 $80 calls. If you've yet to start a position or haven't yet bought calls, now is as good a time as any to match us. The stock may experience volatility in the short-term due to its tendency to trade alongside the interest rate-sensitive REIT sector, but over the long-term the underlying strength in business fundamentals should shine through.

Fool on!

-- Billy

Pro Quality Checklist: Valmont Industries

Published Nov 4, 2015 at 2:29PM

Programming note: *Our weekly Memo is two days late this week because of the annual TMF company meeting, which took place Monday and Tuesday.*

Fellow Fools,

In this second edition of our *Pro* quality checklist series, I've decided to dig into one of the companies that we recently placed on Hold, **Valmont Industries** (NYSE: VMI). Valmont has underperformed our expectations since we added it to the portfolio two years ago, but that's not reason enough to discard it immediately. And because most of Valmont's woes are related to a wide-ranging slowdown across the industrial sector, rather than any operational missteps by the company, this seems like a great time to review the qualities that drew us to Valmont in the first place.

1. A Sustainable Competitive Advantage

Yes. As the No. 1 or No. 2 manufacturer in the markets it serves (irrigation equipment, telephone poles), Valmont has the advantages of scale to reduce costs and create a barrier to entry for new competitors. The company's size relative to suppliers likely grants it negotiating power, and Valmont's intangible assets -- including brand recognition and a reputation for both quality and execution on large, complex projects -- have resulted in a long list of loyal customers. The company boasts extensive engineering expertise, and management invests heavily in research and development to create new, innovative products. Valmont's competitive advantage is evidenced by its ability to consistently earn returns on capital well in excess of its cost of capital, and its ability to generate healthy margins and maintain them over the business cycle.

2. Pricing Power

No. Though Valmont is an industry leader, the pricing of its products is largely driven by commodity input costs and the margin that competing bidders are willing to accept on their contracts. Valmont can usually pass through changes in material costs, and customers are often willing to pay a premium for Valmont's expertise and high-quality products. However, if the company *truly* had pricing power, management wouldn't need to spend time on earnings conference calls discussing the pricing discipline of its competitors. By comparison, **Apple** (NASDAQ: AAPL) pays little concern to how much competitors are discounting their phones when it comes time to launch a new iPhone.

3. A Dependent Customer Base

Sort of. The world contains a limited number of companies that are able to complete large-scale irrigation, infrastructure, and utility projects. For customers that require those services, maintaining a tight schedule and avoiding cost overruns is often more important than obtaining the lowest possible bid, so they prefer to work with a company like Valmont. Also, once a customer makes a large investment in installing Valmont's products, they aren't likely to switch to a competitor -- the convenience of using a single vendor for parts and maintenance often outweighs saving a couple of bucks on the initial purchase price.

Despite these positive attributes, I can't give Valmont full credit on this point, because the degree of customer dependency varies significantly across its businesses. Also, small-scale or less specialized projects usually come with tougher competition and smaller margins. For this type of business to earn a full point, I'd also like to see a higher proportion of recurring parts-and-services revenue.

4. Predictable Revenue

No. Valmont's business is about as predictable as you'll find for a cyclical manufacturing company, but it's still cyclical. Thanks to the company's exposure to multiple end markets (agriculture, energy, infrastructure, and mining), the peaks and valleys of the separate cycles usually combine to smooth out sales and profit growth. Unfortunately, over the past few quarters, we've seen what happens when all of Valmont's end markets enter a down cycle in tandem.

Over a longer time frame, we know that global economic growth will require infrastructure spending to support it, and Valmont provides a wide range of products to make that happen. We've been seeing reports for years now that our own country's roads, bridges, and electric grids are in dire need of upgrade and repair, which should provide a solid backlog of business in the U.S. over the next few decades. We are confident that Valmont will benefit from those trends, but the timing of those contracts isn't as certain as it is at our other recurring-revenue businesses.

5. Growing Free Cash Flow With Compounding Returns

Yes. Valmont has an impressive history of upping its free cash flow at a healthy clip, and even during the Great Recession, the company still managed to remain cash-flow positive. Though Valmont has paid a dividend for years, the company still retains around 85% of earnings to reinvest in the business. Management uses an economic value added (EVA) framework to inform capital allocation decisions, which focuses investment dollars on projects and acquisitions with the largest spread between the expected return on capital and the company's cost of capital. Over the past year and a half, the company has also repurchased shares when management thought they were undervalued, resulting in a 14% reduction in the diluted share count.

6. Financial Resilience

Yes. Like most industrial businesses that require heavy investments in plant, property and equipment, Valmont carries a significant amount of debt on its balance sheet. Though $767 million in total debt seems like a large number, it's only twice the company's annual EBITDA production, and even in a terrible year, the company brings in enough operating profit to cover its interest payments a comfortable six times over. This intelligent use of debt has allowed the company to leverage its assets and generate an average return on equity of nearly 18% for the decade ending in 2014.

In late 2014, Valmont's management took advantage of the company's investment-grade credit rating and the low-interest rate environment to refinance a portion of its higher-rate debt and raise additional capital. The company issued $500 million in 30-year and 40-year bonds, locking in interest rates at 5% and 5.25%, respectively. That was a serious vote of confidence in Valmont's long-term prospects from the capital markets.

7. Expanding Possibilities

Yes. Global population growth and the expansion of emerging-market economies are the key trends that will drive Valmont's future growth opportunities. As countries around the world become wealthier, they will need to invest heavily in infrastructure to keep their economies competitive and their populations happy. Valmont's irrigation division will also play an important role in improving farm productivity to feed a growing global population.

Valmont's global network of sales offices and production facilities positions the company to be a key beneficiary of international growth. Recently, a strong dollar and weak economic conditions in Europe, South America, and Australia have been a drag on Valmont's performance, but that volatility will also serve as a tailwind when those markets recover. Valmont will also continue to take advantage of its strong cash flow production to make opportunistic acquisitions and gain access to complementary products, unique capabilities, and/or new geographic regions.

8. The Three C's of Management

Yes. Over the years, Valmont has been a textbook example of operating efficiency -- maintaining profitability and healthy returns on equity even during economic slowdowns. The company is run by Mogens Bay, who has been CEO since 1993 and took over the chairman's seat on the board in 1997. Over the past two decades, Bay and his team have created an exceptional amount of value for shareholders, and their performance during the current industrial down cycle has proven that the team knows this business well. Valmont refinanced debt and shored up the balance sheet last year when the market first started to soften, and management has been surgical about cutting costs and streamlining the business since then.

So far, management has underpromised and overdelivered on its restructuring plan, recently increasing the annual savings expected from their efforts from $19 million to $30 million. Management also announced in its most recent earnings call that it intends to improve its communication with investors, and to hold its first investor day early next year. I believe management scores points on all three criteria, and thanks to their efforts, we'll be looking at a much stronger business when the cycle eventually turns.

The *Pro* Bottom Line

Altogether, I score Valmont Industries a 5.5/8 on our *Pro* quality checklist. It should be obvious from this checklist that Valmont's biggest weakness is the cyclical nature of its target industries, followed closely by tough competition for smaller-scale projects. Though the company's diversification across multiple industries usually reduces sales volatility, we should expect periods, like this one, during which the entire group moves in tandem and growth stalls. Valmont remains a high-quality business run by a strong management team, but we need to spend some additional time thinking about how this business's cyclicality works with the rest of the portfolio to help us achieve our North Star mandate.

Following our recent decision to move Valmont to Hold, we plan to have an update on our guidance in next couple of weeks, so stay posted. In the meantime, we'd love to hear your thoughts on the Valmont Industries discussion board.

Fool on!

-- Jeremy (TMFTank)

Valmont Industries Lays the Groundwork for a Recovery

Published Nov 1, 2015 at 4:36PM

As one of the few losing positions on the Pro scorecard, there's been a fair amount of hand-wringing about what we should do with **Valmont Industries** (NYSE: VMI) – and even more so as we head into the year-end tax-loss harvesting season. The market reacted positively to a "not-as-bad-as-it-coulda-been" quarter and management continues to deliver on their plans to streamline the business.

As we expected, sales and profits continued to decline, down 17% and 43% respectively thanks to a combination of soft demand, currency headwinds, and restructuring costs. These results are consistent with what many other industrial companies have been reporting. The energy, agriculture, mining, and construction industries are all in down cycles and there's little indication that demand will increase any time soon and recent reports of plummeting steel demand in China suggests that things could get worse before they get better.

In **Fastenal's** (NASDAQ: FAST) most recent earnings call, the company'sCEO declared that he believes were in an industrial recession. Considering that the company services 250,000 industrial customers a month, he probably has above average insight into market conditions. In previous cycles it was unusual for so many markets to slow all at once. As a result diversified industrials like Valmont didn't seem as volatile as what we're seeing today, but when combined with headwinds from a strong dollar, these market conditions are probably about as bad as it get for Valmont-short of a full-blown global recession.

Eyes On The Horizon

Despite this tough operating environment, one thing is clear: Valmont's management is playing the game like they've been here before. We've been impressed with their no-nonsense approach to managing the business during this down cycle. So far this year management has consolidated production into fewer, lower-cost facilities, centralized the production planning process across segments, and cut about 700 positions. Management claims that they have been able to achieve this reduction without limiting production capacity. The company has the same number of machines running and can add shifts as necessary to match an uptick in demand.

As a result of those and other actions, management now expects to generate $30 million in annual cost reductions beginning next year – well above their initial target of $19 million. Though the company has cut SG&A from around $13 million a quarter to $9 million, management emphasized that they intend to continue investing research and development to maintain their position as a market leader in each segment.

Segment Updates

- **Engineered Infrastructure Products** (41% of sales) –

There's still no sign that public infrastructure spending is picking up and with 25% of sales coming from the distressed energy and mining industries, the EIP segment continues to languish. Congress passed a three-week extension for the long awaited hihway bill, but we're still waiting for a multi-year extension which will hopefully come before the end of the year. Also, U.S. wireless carriers have pulled back on the infrastructure spending since the beginning of the year. This segment continues to suffer from the deleveraging effects of lower volume and currency headwinds.

- **Utility Support Structures** (26% of sales) –

The utility segment remains ultra-competitive and management intends to continue their disciplined strategy of not bidding on unprofitable business. Utilities have focused their capex on transitioning from coal fired plants to meet federal mandates and as a result they are investing less in large transmission projects. As a result the project mix this quarter was generally smaller in scale which was a drag on margins. Management has been focused on cutting costs in this segment and expect to generate two percentage points of operating cost improvement starting next year.

- **Irrigation Systems** (18% of sales) –

Irrigation spending is closely correlated to farm profits, which are expected to decline by 30% to 40% this year. There was significantly less storm damage this year which made for a tough quarterly comparison to a year ago. Management claims that competitors have remained fairly rationale about pricing which has allowed the segment to remain profitable despite falling production volume. It's nearly impossible to predict movement in crop prices into the future, but there's been some indication that a strong El Niño should disrupt global weather patterns, especially in the southern hemisphere, and influence the commodity food markets.

- **Coatings** (12% of sales)–

The coating segment remained strong in North America, but continued challenges in the Australia market has led to plant closures and impairment charges. Zinc prices have dropped significantly this year, but the industry has maintained pricing discipline.

Smart Capital Allocation

Valmont continues to generate a lot of cash-$54 million in basic FCF during the quarter – so, as you might expect after the decline in the stock this year, analysts are very interested in management's capital allocation strategy. According to management, their hierarchy remains, 1) reinvest in the business, 2) acquisitions, 3) pay out 15% of net income as a dividend 4) buyback stock. In the last quarter management cut back on #1, but checked off the other three boxes with the acquisition of American Galvanizing and a continuation of the share buyback program, repurchasing 247,000 shares for an average price of about $109.50 a share.

One encouraging point that management made about their acquisition strategy is that they claim Valmont is "an EVA-type company". The economic value-added (EVA) framework (which focuses on maximizing the return on capital that can earned over a company's cost of capital) establishes a companywide process that makes it more likely that capital will flow to its best use and that management will remain disciplined in their bidding strategy. When combine with Lean manufacturing processes, this can be a great value creator for capital intensive industrial businesses, like Valmont.

The *Pro* Bottom Line

With the cycle moving against them, all that Valmont's management team can do is ride out the storm and try to build a leaner business for the next recovery. When that eventually happens, Valmont should see an incredible amount of operating leverage from the restructuring initiatives completed this year and earnings per share should get a boost from the steadily shrinking share count. That combination leads me to believe that a five-year double from these levels isn't an unreasonable assumption. However, considering our goal of generating North Star returns over rolling three-year periods, we also need to consider the opportunity cost of keeping our capital tied up while we wait for the cycle to turn.

Valmont remains on Hold as we carefully consider how we'd like to manage this positions. Keep an eye out for the upcoming Memo where we'll run Valmont Industries through Jeff's updated checklist of what makes for an ideal *Pro* company.

Pro Welcome Video Transcript

Published Oct 29, 2015 at 7:50PM

Greetings, and welcome to *Motley Fool Pro*!

I'm Jeff Fischer, your lead advisor, and I want to briefly introduce you to everything this one-of-a-kind investing service has to offer. Plus, I want to show you how to get the most out of your experience with *Pro*.

As you know, our goal is to generate steady returns – in any market climate – with a sleek array of investment tools alongside tailored, step-by-step guidance. Used together, we believe our strategic deployment of shorts, hedges, ETFs, options, and long-term stock purchases can help consistently elevate your portfolio in ways few services can.

So how – and where – should you start?

Well, we know that every investor is different. And because of that, we've arranged an introductory set of investments – the first *Pro* trades -- you can make to suit your personal style and level of comfort.

On November 6th, you'll see the first part of this introductory series in the form of our first "Portfolio Building" Report. These are the stock purchases we recommend you to make first... as soon as you're ready.

But if you'd like a little more time to get your feet wet, hold off until November 13th when we release a second report that details our latest thinking on several of the other active recommendations in the *Pro* portfolio. There's also a third report coming November 20 that will include the rest of *Pro*'s stocks. So, you can start with us right away on Nov. 6, or you can wait until you've read all three reports – we're in this for the long haul, so there's no hurry. And, we're a full portfolio service. Ultimately, we want you to have a fail-safe portfolio, just like *Pro*'s. Some members copy our portfolio exactly, others partially. You'll find what suits you.

In the meantime, I highly recommend getting acquainted with how we do things in *Pro*. On our "Strategy Guide" page, you'll find critical information about our investment philosophy, as well as a specific list of traits we look for in a buying opportunity.

What's more, you'll learn about the *Pro* "North Star," our portfolio's target performance metric. We define our North Star as the inflation rate plus 7% annually. Multiplied out, a decade of reaching the North Star target would double your money – even after inflation!

Following the always-positive North Star with minimal volatility is what we're after here at *Pro*... and it's that mind-set that goes into every single recommendation we make.

That last point is particularly important. Because although some of our trades may be short-term in nature, the goal of the *Pro* portfolio as a whole is to achieve real, long-term gains. And that's why sticking tight to the North Star – and not jumping on risky short-term plays – is so important.

Another feature of *Pro* that we're proud to offer is full-access to our Motley Fool Options service, free for the life of your *Pro* membership. Of course, using options in your portfolio is completely your choice. In *Pro* and in *Options*, we give you all the tools you'll need, and vetted recommendations with a great track record – more than 92% of our options have ended profitably. Just click on the *Options* link, and you'll find ready-made trades (and guidance!) for all experience levels.

Everything you need to get started in *Pro* is available here in the Guidebook... including when you can expect updates, how to track your performance, help determine which trades are right for you, and much more. So take some time to look around. I'm sure it will make your experience in *Pro* much more enjoyable – and your portfolio will certainly thank you for it.

As always, if you ever need help or have questions about our service, our investments, or our strategies, please feel free to post on the message boards. There, you'll find the entire *Pro* team – myself included – as well as a friendly and knowledgeable community of fellow *Pro* members.

Once again, welcome aboard *Motley Fool Pro*. I'm excited to start profiting with you soon... and well into the future.

TD Ameritrade Continues to Grow Client Assets

Published Oct 29, 2015 at 10:54AM

Pro's Take: AMTD Q4-2015 and FY-2015 Earnings

TD Ameritrade (NYSE: AMTD)

Quarter Quick Take

In Q4 2015, TD Ameritrade yet again demonstrated its ability to deliver strong profits despite unpredictable value drivers. This company does a great job of focusing on what it is able to control and preparing for what it can not, a testament to the company's defensible competitive position and strong management. For Fiscal 2015, the company grew net revenues by 3.7%, client assets by 2.2% (and net new assets by 10%), and earnings per share by 4.7%. The company has been able to pay a well-funded dividend and steadily increase its core earnings power, and the company's interest-sensitive earnings are set to grow sharply during periods of rising interest rates (who knows when that will happen).

Nonetheless, despite the company's consistency, certain metrics (namely commission rates and growth in the fee-based portion of the business) seem to imply that competitive pressures have been heating up lately, so that's something we'll want to keep an eye on. In the absence of higher interest rates, if competitive pressures start to take a significant toll on the business, then the company may be challenged to continue to grow. Despite this, the company continues to produce steady cash flow and strong profit margins. We'll see over time how management is able to respond to the current competitive environment.

President and CEO Fred Tomczyk:

> "The story of 2015 is one of continued momentum and strength in nearly every area of our business. Strong trading and asset gathering have again helped us deliver growth in earnings, despite the continued low interest rate environment. We finished the year strong in trading, averaging a record 462,000 trades per day, as volatility returned to the markets in the fourth quarter. And, we gathered a record $63 billion in net new client assets, a double-digit growth rate for the seventh consecutive year. We will carry that momentum with us into fiscal 2016. We have a strong competitive position, an unrelenting client focus, and we remain well-aligned with the secular growth trends – which will serve to help us continue delivering strong organic growth and earnings."

Guidance Update

After incorporating this quarter's results into our model, our fair-value estimate remains unchanged at $35 per share. This valuation does assume a slow increase in interest rates over the next several years, so in the absence of that occurrence, the company may be challenged to grow earnings and the stock price may stagnate. Currently, the stock is about 10% below its 52-week highs as investor speculation about the timing of an interest rate increase has led to increased volatility for companies that are interest rate-sensitive. This volatility may continue depending upon market conditions.

Updated guidance: Buy (no change)

Recommended Allocation: 2.7%

Fair-value estimate: $35 (no change)

Current price: $35

The Numbers (for Q4-2015)

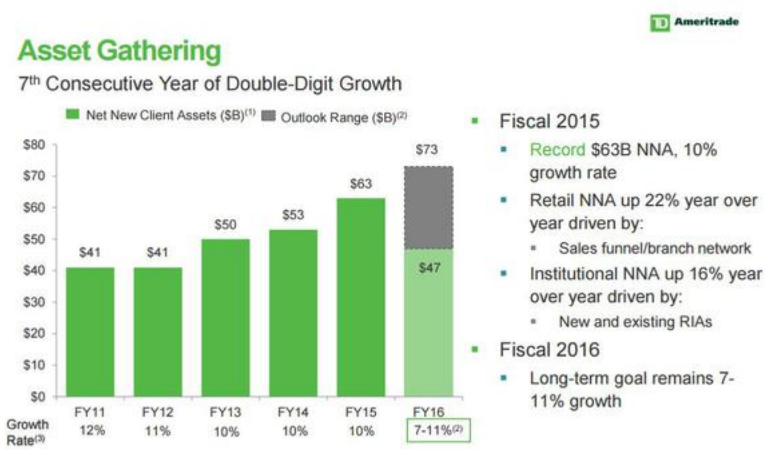
- Record net revenue of $831 million (up 4.5% year-over-year)
  - **Transaction-based**:
    - Funded accounts grew to 6.62 million (up 5.1% year-over-year)
    - Trades per funded account of 4.62 (vs. 4.17 last quarter vs. 4.06 a year ago)
    - Average commissions and fees per trade of $11.90 (vs. $12.01 last quarter vs. $12.97 a year ago)
    - Totals up to:
      - 6,620,000 x 4.62 x $11.90 = **$364 million** in transaction-based revenue (up 9.6% year-over-year)
  - **Spread-based**:
    - Total spread-based revenue of **$373 million** (up 1.6% year-over-year)
    - Average spread-based balance of $99.8 billion (up 7.4% year-over-year)
    - Thus, Net Interest Margin (NIM) =
      - $373 million / $99.8 billion = 0.374% (quarterly)
      - NIM (annualized) = 0.374% x 4 = 1.49% (vs. 1.53% last quarter vs. 1.58% a year ago)
  - **Fee-based**:
    - Fee-based revenue of $82 million (down 1.2% year-over-year)
    - Average fee-based balance of $157.1 billion (up 9.1% year-over-year)
    - Thus, Investment Product Fee Yield =
      - $82 million / $157.1 billion = 0.052% (quarterly)
      - Investment Product Fee Yield (annualized) = 0.052% x 4 = 0.209% (vs. 0.211% last quarter vs. 0.231% a year ago)
- Total client assets of $667 billion (up 2.2% year-over-year)
- Record interest rate sensitive assets of $108 billion (up 8% year-over-year)
- Net new client assets* of $16.2 billion (9.2% annualized growth rate, up 20.9% year-over-year)
- Diluted EPS of $0.40 per share (up 3.5% year-over-year)
- Trailing-12-month (TTM) average return on equity (ROE) of 16.9% (up from 16.7% a year ago)
- Capital management:
  - Paid $0.15 per share in cash dividends in the quarter (a 1.8% yield on the current share price)
  - Repurchased 7.1 million shares of its common stock at an average share price of $33.52 per share
  - Declared a $0.17-per-share quarterly cash dividend (an increase of 13% year-over-year), payable on Nov. 24 to all holders of record of common stock as of Nov. 10.

*excludes changes in client assets due to market fluctuations

Analysis

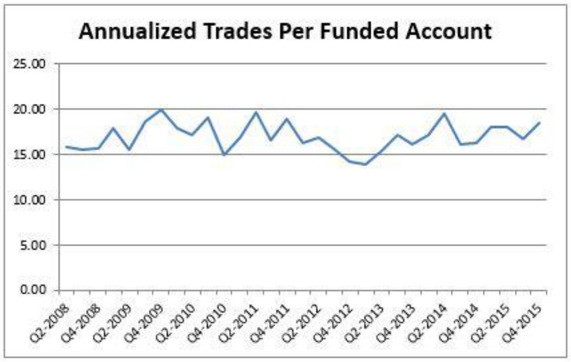
After a bit of a slowdown last quarter, the rate of growth in asset gathering picked back up in Q4, with net new assets up $16.2 billion, or 9.2% year-over-year. This was despite a decline of over 6% in the S&P 500 index during the quarter, showing how TD Ameritrade is able to grow its asset base even when equity prices are declining.

For the fiscal year ended this quarter, the company brought in a record $63 billion in net new assets, a 10% annualized growth rate. This was the 7th consecutive fiscal year of double-digit net new asset growth. The company's Fiscal 2016 and long-term goal is to grow net new assets at a rate between 7-11%, which based on current trends seems reasonable:



Source: TD Ameritrade September Quarter Earnings Presentation

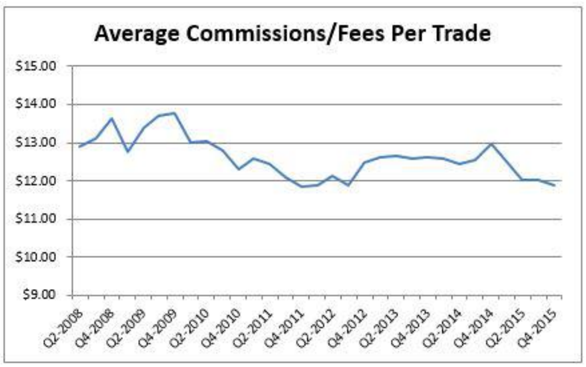
Trading activity ticked up in the quarter with particularly high trading metrics during the volatile month of August. In August, TD Ameritrade posted a record 537 thousand daily average revenue trades (DARTs), the highest figure I have on record.



Source: Company filings and analyst calculations.

The company continues to execute on penetrating derivatives (a record 43% of DARTs during Fiscal 2015, up from 41% in Fiscal 2014) and mobile trades (a record 16% of DARTs during Fiscal 2015, up from 13% in Fiscal 2014). Trading activity seems to be trending upwards as higher-activity derivatives traders are comprising more and more of the company's customer base. This bodes well for transaction-based revenue if the trends continue into the future.

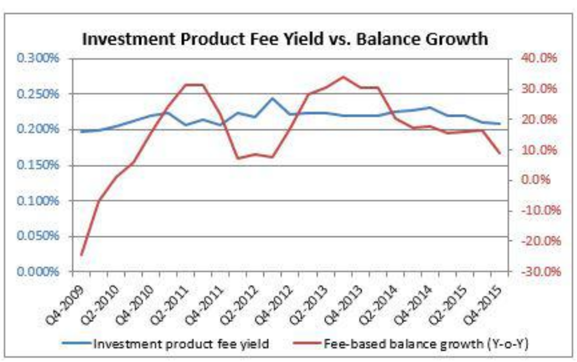
Despite the higher activity, average commissions and fees per trade declined quite significantly to $11.90 (down 8.3% year-over-year) to stay at the low end of the company's recent historical range. This is not too much of a concern in terms of our assessment of the business, as my valuation assumes a steady decline in commissions and fees per trade. Management focused on product mix to explain this pressure on commission rates, noting that a higher mix of futures (which is a lower revenue per trade product) is to blame:



Source: Company filings and analyst calculations.

However, TD Ameritrade generally has the highest commission rates among online discount brokers, and it's possible that promotional activity and price competition across the industry are affecting the company's pricing. I'll be watching this metric and the growth in funded accounts more closely over the coming quarters to make sure that TD Ameritrade is able to support its premium pricing while still bringing in a healthy amount of new accounts.

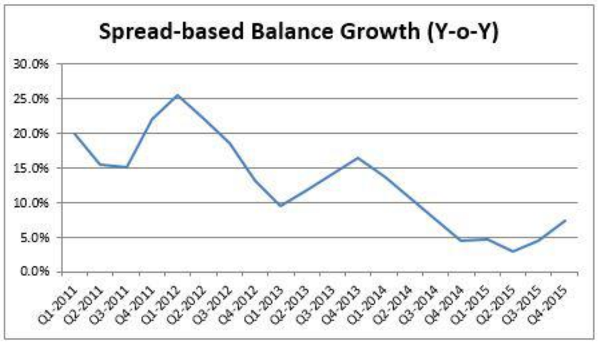
Speaking of competition, growth in the fee-based segment of the business has actually turned negative, down 1.2% year-over-year (compared to 7.6% growth last quarter and 23.9% growth a year ago). The decline in this segment was caused by several factors, including a lower fee-based balance due to asset price declines, lower net new asset growth, and lower fee yields (which is partially affected by the company's performance-based Amerivest fee rebate promotion).



Source: Company filings and analyst calculations.

As I suspected last quarter, increased competition in the investment guidance industry is certainly slowing the pace of growth in this segment of the business. This is more of a concern than the decline in commissions, as my valuation assumes continued healthy growth from this segment of the business (although it's still not a huge value driver at about 10% of companywide net revenues). Based on the last few quarters, I'm going to ratchet down my longer-term expectations for this portion of the business. Management expects to return the segment to growth in Fiscal 2016, guiding to 14% year-over-year growth in fee-based revenue for 2016 based on the midpoint of guidance. I'm curious to see how this segment fares over the next several quarters.

As for the spread-based portion of the business, the rate of growth in the spread-based balance accelerated again this quarter:



Source: Company filings and analyst calculations

This portion of the business is the one that's sensitive to interest rate changes, so it's great to see an acceleration of growth in one of the company's key value drivers. We'll continue to watch this metric over time to make sure it's staying on track, especially as we inch ever closer to the Federal Reserve's interest rate increase.

The company released full year 2016 guidance, implying (at the midpoint of guidance) no growth in transaction-based revenue, 11% growth in spread-based revenue, 14% growth in fee-based revenue, and 8% growth in earnings per share. Guidance seems reasonable if not somewhat conservative.

What We Think Now

TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and when interest rates increase, the company is positioned to grow earnings sharply.

If you have questions, post them on our TD Ameritrade discussion board.

Pro Quality Checklist: American Tower

Published Oct 26, 2015 at 3:58PM

Dear *Pro* Fools,

Last week, we introduced you to our newly updated checklist of the eight qualities we look for in an ideal *Pro* company. And as Jeff mentioned on the boards, we plan on publicly sharing our thoughts on each of our stocks in relation to the eight criteria. With this Memo, I'll kick it off by running one of the companies I cover, **American Tower** (NYSE: AMT), through the *Pro* quality gauntlet. Let's get started!

1. A Sustainable Competitive Advantage

Yes. American Tower leases space on more than 40,000 towers in the U.S. and almost 60,000 internationally, American Tower owns the largest portfolio of towers in the world. Especially in the U.S., where tower infrastructure is essentially saturated, American Tower has a geographic and regulatory advantage in terms of owning a large portfolio of well-placed assets. For wireless carriers looking to upgrade their networks, it often makes more financial sense to lease space on a well-located American Tower property than to obtain the necessary permits and spend the money to build towers from scratch.

Additionally, American Tower benefits from switching costs. The company has long-term, non-cancellable contracts with customers, meaning those customers can only switch providers at the end of a lease term. Furthermore, switching equipment from one tower to another introduces the risk of disruption of network quality, and it costs the carrier significantly in both time and money. As evidence, churn rates for leases are very low, typically in the 1%-2% range.

2. Pricing Power

Yes. This one is simple – American Tower has the pricing power to include annual escalators in its contracts. In the U.S., the escalators are approximately 3% annually (which is higher than the current U.S. inflation rate); internationally, the escalators are typically based on local inflation indices.

3. Dependent Customer Base

Yes. In the past, wireless carriers used to own and operate many of their own towers. However, thanks to the economics of co-location (the ability to support more than one carrier on each tower), companies like American Tower are able to own and operate towers more cheaply and efficiently than the carriers themselves.

This explains why, in the past several years, we've seen all of the major U.S. wireless carriers offload their tower assets to tower companies:

- 2008: Sprint sells about 3,000 towers to TowerCo (later acquired in 2012 by SBA Communications)
- 2012: T-Mobile USA sells about 7,200 towers to Crown Castle
- 2013: AT&T sells about 9,700 towers to Crown Castle
- 2015: Verizon sells about 11,300 towers to American Tower

The rationale behind the sales is easy to understand – it's simply more cost-effective for the wireless carriers to sell and lease the assets than it is to own, operate, and maintain them themselves. Now, since the tower companies own almost all of the prime tower infrastructure, the carriers need the tower companies in order to run their networks, and the tower companies need the carriers as tenants on their towers. It's a symbiotic relationship.

4. Predictable Revenue

Yes. This one is easy – American Tower has long-term, locked-in contracts. As of June 30, 2015, the company has approximately $32 billion of non-cancellable, contracted revenue in its backlog. Based on approximately $4 billion in revenue in fiscal 2014, that's about eight years of locked-in revenue. Additionally, thanks to the contracts, American Tower also knows the timing of the revenue. Not many companies have such strong revenue visibility in terms of both amount *and* timing.

5. Growing Free Cash Flow With Compounding Returns

Yes. American Tower has outstanding compounding dynamics. Not only does the company generate strong (and growing) free cash flow, but management is also continually reinvesting that cash flow into new projects (predominantly acquisitions – see a recent example here) with high returns on invested capital.

For example, since the fourth quarter of 2011, American Tower has increased its trailing-12-month adjusted funds from operations (REIT-speak for "free cash flow") from $1.06 billion to $1.95 billion as of the most recent quarter. That's a 19% compound annual growth rate in 3.5 years.

American Tower's strategy is to use its cash flow to acquire underutilized new assets, increase cash flow from those new assets, and then reinvest its now-higher cash flow into more new assets, which will then fuel further growth in cash flow. It's a virtuous cycle and a perfect example of how compounding works.

6. Financial Resilience

Sort of. I'm giving American Tower half credit on this one. The company has a significant debt load, with net debt of nearly $16 billion compared with an adjusted EBITDA (earnings before interest, taxes, depreciation, and amortization) run rate of about $3.05 billion, giving it a net leverage ratio (net debt/adjusted EBITDA) of 5.2.

Management has stated that it strives to run its business with a net leverage ratio between 3 and 5, so this figure is a bit higher than ideal. The ratio is a bit elevated because management has been flexible with leverage in order to make some significant acquisitions over the past few years, raising debt (and in some cases issuing equity) to do so. This has led to a slight deterioration in the company's credit rating, which makes borrowing a bit more expensive. All else equal, that's a bad thing.

Nonetheless, despite the debt load, the company generates heaps of operating cash flow (more than $2 billion per year and growing), which is more than enough to service the debt *and* keep growing. Additionally, the company has more than $2 billion in additional liquidity from cash on hand and unused drawings from its credit facilities.

It remains to be seen how the recent acquisition of Viom Networks will impact the company's financial position; we'll likely hear more when the company reports earnings this week. But if American Tower wants to improve its credit rating and get back into the target leverage range, it'll need a few quarters to increase cash flow and to pay down debt. At the current juncture, American Tower's financials are resilient, but not bulletproof.

7. Expanding Possibilities

Yes. American Tower is one of the prime beneficiaries of one of the largest secular trends on our planet today: the exponential growth of mobile data consumption. As per the most recent Cisco Visual Networking Index (VNI) forecast, global mobile data traffic will grow tenfold between 2014 and 2019, a compound annual growth rate of 57%. And as this traffic grows, wireless carriers will have to race to upgrade their networks with the capacity to meet this exploding demand. Additional and upgraded equipment will have to be placed on towers, and global tower operators will benefit.

This is where American Tower differentiates itself from its U.S.-based competitors – not only will our company benefit from the growth of mobile data traffic in the U.S., but with its significant and expanding international presence, it will also benefit from growth in other markets, some of which are growing even faster than the global average. Geographic diversification and experience give American Tower the benefit of being able to study its portfolio and optimize its incremental investments into the geographies that are growing the fastest and have the most potential.

8. The Three C's of Management

Clarity: Yes. Management does an excellent job outlining its investment process, goals, and priorities, on both a long-term and a short-term basis. Each earnings presentation contains a slide titled "Capital Allocation Priorities," generally in reference to the current year. Additionally, in the fourth quarter of 2012, CEO Jim Taiclet outlined an "aspirational goal" to double the company's tower count and generate "mid-teens" growth in adjusted funds from operations per share over the next five years.

Consistency: Yes. Management not only outlines its goals but refers to them often, and these priorities seem to be very important in driving business decisions. Management answers questions honestly and consistently, and often repeats its principles or strategies on conference calls to drive them home.

Capability: Yes. CEO Jim Taiclet has been in his role since 2003, and has shepherded the company through its current growth strategy. When he first took the job, American Tower operated 15,000 towers and had $715 million in annual revenue and $156 million in annual operating cash flow (a 21.8% margin). Today, the company operates nearly 100,000 towers, and in the most recent fiscal year, it generated $4.1 billion in annual revenue and more than $2.1 billion in operating cash flow (a 52% margin). In November 2014, the *Harvard Business Review* ranked Taiclet No. 18 on its list of the 100 best-performing CEOs in the world over the previous decade. I am consistently impressed with Taiclet's understanding of capital allocation priorities and his ability to communicate with the investment community.

The *Pro* Bottom Line

All in all, American Tower scores a 7.5/8 on our *Pro* quality checklist, with the only question mark being financial resilience, where I gave the company half credit. That's a strong showing, and it's evidence (along with the stock's discount to our fair-value estimate) as to why we rate this company a Buy First and why we own long-term calls in order to leverage upside. We think American Tower is a great example of a *Pro*-like business. And keep an eye out for further Memos like this one, in which we run more of our companies through our checklist to see how they score.

Fool on!

-- Billy (TMFBillyTheKid)

Gentex Mirror Sales Accelerate

Published Oct 26, 2015 at 2:23PM

***Pro*'s Take: GNTX Q3 2015 Earnings**

Quarter Quick Take

Gentex (NASDAQ: GNTX) turned in an excellent quarter in the Q3 2015, delivering 11.1% net revenue growth and 16.1% total mirror unit growth despite flat auto production in the company's primary markets over the same period. Unit growth continues to handily outpace global auto production, which suggests that the core element of our thesis (higher auto-dimming mirror penetration rates) is playing out.

The company sold 12.4% more interior mirrors (+9.2% in North America and +14.4% internationally) and 22.2% more exterior mirrors (+38.9% in North America and +14.4% internationally) than it did in Q3 2014. The company has announced and launched several new products that look to drive growth throughout 2015 and beyond, and there are more new product launches coming in Q4 2015 (namely the full display mirror on the 2016 Cadillac CT6). As cars become more technology-rich than ever before, Gentex is well positioned to meet that demand.

As evidence, consider that in 2013, the company had 37 new launches of its inside and outside electrochromic (EC) mirrors. In 2014, there were 43 new launches of inside and outside EC mirrors. And in 2015, through nine months, the company has had 54 new vehicle launches. This increased rate of adoption is why Gentex has been able to consistently grow sales often at a rate of 10% or more than global auto production.

Management continues to buy back stock at an increasing pace, repurchasing $34 million of stock during the quarter at an average price of $15.99 (below the current price). Management is historically stingy with repurchases, but as cash piles up on the balance sheet (cash + cash equivalents are up 22% year-over-year, representing 9% of the current share price once you net out debt), management appears to be more willing to pursue buybacks as a capital allocation strategy. I view these continued and increasing buybacks as a signal of confidence from management, and with Gentex shares trading below our estimate of fair value, I think the buybacks are a strong capital allocation decision.

Guidance Update

Despite slight declines in margins related to foreign currency fluctuations, Gentex is continuing to do what it does best -- sell its products at a pace well above the rate of auto production growth, and invest in manufacturing and product development initiatives in order to raise average selling prices and reduce manufacturing costs to offset annual price reductions expected by its powerful automaker customers. As global auto production picks up and as more and more automakers integrate technology into their models, Gentex should benefit over the long-term.

Our fair-value estimate remains unchanged at $18, and with the stock trading almost 10% below our FV estimate, **Gentex remains a Buy First** on our scorecard. At just over 16 times trailing-12-month earnings and at 8.6 times EV/EBITDA, the company is trading at valuation levels that are about as low as they've been throughout its history despite a robust balance sheet, steady operating performance, and continued success in market penetration and organic growth. If you've yet to start a position or fill out your allocation in Gentex, now is a great time.

We also have a 1.5% look-through allocation in December 2015 $15 written puts, which we wrote at attractive prices during the late August market volatility. Those puts are on track to expire fully as income, although we are still nearly 2 months away from expiration. If you haven't matched us you can still write the puts, although with a higher stock price and lower marketwide volatility, the yield is much lower than when we wrote them.

Updated Guidance: Buy First (no change)

Recommended Allocation: 2.8% with 1.5% in written puts

Fair-Value Estimate: $18 (unchanged)

Current Price: $16.37

Our Thesis

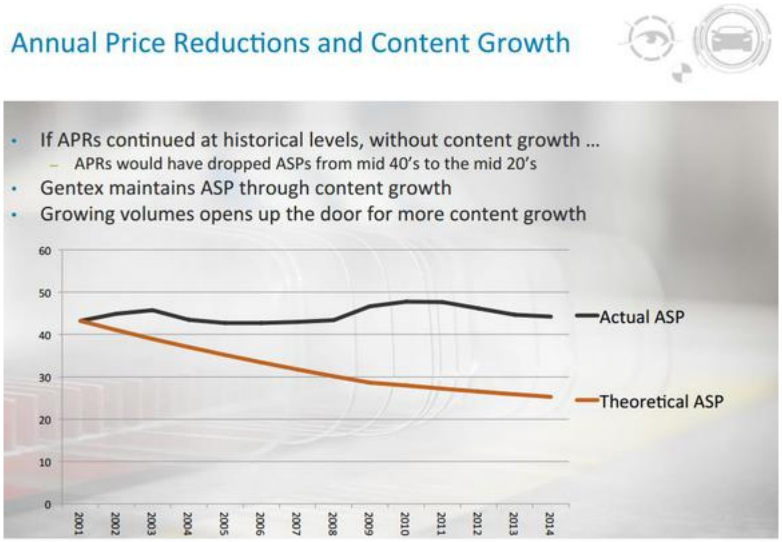
Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

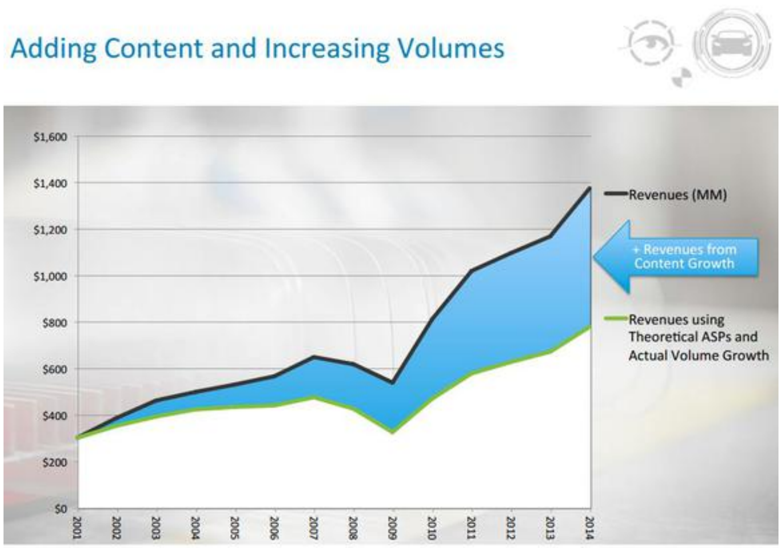
The Most Important Things

1) Penetration: Unit growth vs. auto production. Over time, we want to see Gentex's auto-dimming mirrors to continue to gain market share. If the company is increasing units sold faster than auto production, it is moving in the right direction. Global interior mirror unit volumes accelerated nicely to +12.4% year-over-year growth (up from +7.3% a quarter ago), despite flat auto production in the company's primary markets, showing that Gentex continues to significantly outpace vehicle production growth and capture market share. Interior units sold in North America accelerated to +9.2% (up from +3.1% a quarter ago) and international increased +14.4% (up from +10% a quarter ago), for +12.4% interior unit growth overall.

Exterior mirror unit volumes continue to grow even faster, up a blazing +38.9% in North America and +14.4% internationally. The exterior mirror attach rate was 40.8% (i.e. 40.8% of cars equipped with interior units also were equipped with exterior units), compared with 37.5% a year ago. The attach rate resumed its upward trend after a slight dip last quarter. Exterior mirrors currently only have about 7% to 8% market penetration relative to global auto production, but that penetration rate is clearly increasing, as evidenced by strong unit growth metrics.

2) Pricing and value: Unit growth vs. automotive segment sales. Powerful auto makers force annual price concessions on their suppliers, and Gentex isn't immune. Price reductions have recently been in the range of 2% to 3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices (ASPs) and gross margins. Here's are two slides from a recent management presentation that shows how Gentex has been able to execute on this strategy over the last 15 years:





During the quarter, total units (interior + exterior mirrors) increased +15.1% and automotive segment sales were up +11.2%. This dynamic suggests lower ARPU (average revenue per unit) and is consistent with the expectation of annual price concessions. However, some of the lower ARPU can be explained away by the continued success of exterior mirrors, which have lower ARPU but higher margins relative to interior mirrors. Despite the lower ARPU, the more exterior mirrors Gentex sells, the better it is for the business. They lift the overall margin profile of the business and since exterior mirrors are sold alongside interior mirrors, they are increasing the total dollar value of their products in cars. Here are some relevant comments from management:

> **Vice President and Chief Accounting Officer Kevin Nash:** "*...if you look at the orders, you'll see that outside mirrors outpace inside mirrors in terms of growth rate, almost double. And so when you look at the price points of those, outside mirrors are always going to be far less than inside mirrors. And so it's great business. It's a great margin profile product. However, it is well below the ASP of the company, currently. And so that is really what's creating the negative on the ASP side. It's not a negative for the business, in fact, quite the opposite and that's why we try to look at more of a content type equation than an ASP conversation, because it's not really indicative of the success or health of the business.*"

3) Margin performance. During the quarter, gross margin was 39%, down from 39.5% a year ago in Q3 2014, due largely to foreign currency fluctuations. I mentioned last quarter that as the company works through new product launch inefficiencies and as higher-margin new products make their way through the sales pipeline, gross margin should see a boost. That's what we saw this quarter with a sequential increase in gross margin from 38.4% to 39%, as launch inefficiencies were no longer a headwind and improved product mix and purchasing cost reductions gave margins a sequential boost. Management reiterated its 2015 full-year gross margin guidance range of 38.5%-39%. SG&A and R&D expenses are in line with historical norms, perhaps even slightly lower than normal due to the benefit of foreign currency fluctuations on R&D and SG&A expenses. Operating margins followed gross margins lower, coming in at 28.9% vs. 29.3% in Q3 2014. However, if we adjust for FX fluctuations, operating margins would have increased compared with the year-ago period, despite the decline in gross margins (due to fixed overhead cost leveraging related to production facilities running at high capacity levels).

What We Think Now

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

If you have questions, drive on over to the Gentex discussion board.

Close Half of Your Short Position on World Acceptance

Published Oct 23, 2015 at 1:19PM

How You Participate

- **Action:** Buy to close *one-half* of your short **World Acceptance Corp.** (NASDAQ: WRLD) shares.
- **Allocation:** We are currently short 0.90%, and we will reduce that to about 0.45%, closing approximately half of the 700 shares we're short.
- **Scorecard Status:** Sell Short (unchanged). (If someone new to the position wanted to match us at 0.45%, they could.)
- **Recent Price:** $33.75
- **Price Guidance:** ***Use a limit order*** **and today aim to pay less than $34**
- **Special note:** The company is scheduled to report earnings Oct. 29.

What We're Thinking

We're in a strange position with World Acceptance Corp.: Our thesis is playing out exactly as we hoped, but it's also the reason we need to close part of our position.

The stock is down more than 40% since we sold shares short in *Pro*, with many members having even larger gains than us thanks to a more advantageous start price. And things are playing out as we anticipated, though if we're being perfectly honest, we didn't expect it to happen this quickly!

The business continues to struggle here in the U.S., and we finally got confirmation that the Consumer Financial Protection Bureau will in all likelihood take legal action against the company. But shares have recently become harder to come by, and the cost to borrow shares to sell them short has spiked to more than 20% a year (with only 15,000 shares available today at Interactive Brokers). We still believe the odds are in our favor that the stock will ultimately head lower as the CFPB continues to clamp down on the business, but the longer it takes for this to play out, the more the fees to short World Acceptance will eat into our returns -- and the longer we sit on the risk of being called out of our short on any large spike in price.

What we are *not* doing is recommending that members close half their position in response to the stock gradually drifting higher over the past few weeks on below-average volume. We do not believe that this movement in the stock provides any insight into what is to befall the company at some point in the future. There have been days where the stock spiked dramatically based on rumors that the CFPB will go easy on World Acceptance on a specific date. But these dates have always come and gone without a peep from the CFPB, and at face value these rumors appear to be nothing more than attempts to manipulate the stock price. For example, look at the trading on Oct. 1: This was one of the days when the rumor mill was in full force, driving the stock up 15.7% at one point. It finished the day up only 0.7% once it became clear that the CFPB was not planning on releasing a statement. But we would hate for our entire short to be called out during such a move.

How This Decision Fits Into *Pro*

Similar to our move with **Caesars** (NASDAQ: CZR), by closing half of our position in World Acceptance of our own free will today, we are able to lock in an extremely attractive return. And because we recently closed our position in **The Buckle** (NYSE: BKE), we can do so without increasing our net long exposure compared with a week ago. This is in line with our desire to maintain steady market exposure overall right now.

Once again, **please use a limit order** to close half of your short! This stock is thinly traded, and our activity will move the stock up considerably if we do not *all* use limit orders.

Alternative Trades

- **If you set up a synthetic short, or simply bought puts:** You can close half of your contracts. If you only set up only one contract, you have a choice on your hands; keep it or close it based on what seems best for your portfolio.

- Want to talk about World? Join us on the discussion board, where easy payments are available.

Write Puts on Wells Fargo

Published Oct 23, 2015 at 11:46AM

Is this for you? Since we're looking to add 1.5% to our stake in this company, this alert should be applicable (now or perhaps later) to all *Pro* members, whether you already own shares of **Wells Fargo** (NYSE: WFC) or not.

How You Participate

- **Trade:** Sell to open January 2016 $52.50 puts.
- **Allocation:** 1.5% — write one put for every $350,000 you manage; *Pro* will write seven contracts. In addition to our current 3.6% stock holding, this would bring our total allocation to about 5.1%.
- **Price Guidance:**
  - **Now:** Based on the pricing in this alert, use a **limit order** to target $1.10 or greater to start (for a 2.1% effective yield in 85 days). **If we all use limit orders** and the stock price cooperates, we should be able to achieve at least $1.10 today. Be aware that as the stock price bounces around, the premiums will change, and the guidance in this alert may quickly become stale. If you can get a higher premium, go for it, using a limit order to split the bid/ask spread.
  - **Later:** As prices and time to expiration change, those approaching the position should aim to get paid a yield of at least 0.75% or so per month to expiration (Wells Fargo's volatility is below average, so we are willing to accept a slightly lower yield than what we typically target).
- **Prices (as of 10:20 a.m. Oct. 23):** Stock, $54.50; options, $1.08 bid / $1.13 ask. Guidance: $1.10. Current prices.
- **Scorecard Status:** Buy First, 3.6% allocation; now we're adding 1.5% in additional look-through exposure via these new puts.

What We're Thinking

After two successful rounds of covered strangle writing on Wells Fargo, the last of which expired fully as income back in April, we've been patiently monitoring the company's earnings reports (check out our coverage of Q3 2015 here) and the general macroeconomic environment, waiting for a good opportunity to revisit the position. A covered strangle has been a good strategy to pursue on Wells Fargo thanks to the company's low volatility (and thus low premiums) and the low-interest rate environment, which has meant a sluggish growth environment for lenders and a relatively low likelihood of runaway upside for the stock.

Recently, however, we've taken a more cautious stance on selling the upside of Wells Fargo (the short-call leg of a strangle) in light of the potential for an interest rate increase from the Federal Open Market Committee (FOMC). Speculation about an increase -- let alone the increase itself -- has the potential to cause a bounce in the stock prices of financial companies that rely on lending spreads for profits.

As such, given the potential for nearer-term upside, and given a somewhat higher-volatility environment that allows us to collect higher premiums, we no longer think it's the best course of action to cover the upside of Wells Fargo as part of our income strategy. Especially in light of our recent sales (AmTrust, Papa John's, and The Buckle), we've decided that we're happy to target a lower buy price on another slug of shares of one of our favorite companies, earning some decent income in the meantime.

More That Matters

- **Maximum loss:** For this iteration of the put strategy alone, our risk is the same as share ownership starting at about $51.40, or 5.7% less than the recent price.
- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At $1.10, that's a 2.1% effective yield in 85 days.
- **Follow-up:** On just this iteration of the put strategy, we'll buy shares at a net $51.40 (about 1.5 times current book value) if the stock is below our $52.50 strike price at January expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 3.6% allocation first — Wells Fargo's shares are a Buy First. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1.5% of your portfolio, then just buy 1.5% in stock directly *if and when Pro* does so through these puts (we'll alert you).
- **Write other puts?** Consider writing December 2015 $52.50 puts if the price on those options holds up better than the January puts after this alert is issued. You could also consider a shorter time period or an alternative strike price by using the weekly options. Be aware of how this would change your yield and effective buy price.

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- If you have questions, drive your stagecoach over to the Wells Fargo discussion board.

Another Steady Quarter From Wells Fargo

Published Oct 21, 2015 at 11:10AM

Wells Fargo (NYSE: WFC)

Updated Guidance: Buy First (no change)

Recommended Allocation: 3.6%

Fair-Value estimate: $58 (no change)

Current Price: $53.25

What Happened?

- Diluted EPS of $1.05 per share (up 3% from Q3 2014)
- Revenue of $21.9 billion (up 3.3% from Q3 2014)
- Efficiency ratio of 56.7% (vs. 58.5% in Q2 2015 vs. 57.7% in Q3 2014)
- ROA of 1.32% (vs. 1.33% in Q2 2015 vs. 1.40% in Q3 2014)
- ROE of 12.62% (vs. 12.71% Q2 2015 vs. 13.10% in Q3 2014)

Continued increases in loan/deposit growth and credit quality:

- Core* loans of $849.2 billion (up 9.5% from Q3 2014)
- Average core deposits of $1.09 trillion (up 8.1% from Q3 2014)
- Net charge-offs as a % of total loans of to 0.31% (vs. 0.32% in Q3 2014)
- No reserve release** (vs. $300 million Q3 2014)

Capital allocation:

- Share buyback activity continued (diluted share count declined 26.7 million, or 0.5% of total shares outstanding, from last quarter)
- Quarterly common stock dividend of $0.375 per share (2.8% yield on the current share price)

Operating segments:

- Community Banking: Net income of $3.69 billion (up 6.2% from Q3 2014)
- Wholesale Banking: Net income of $1.77 billion (down 7.7% from Q3 2014)
- Wealth, Brokerage, and Retirement: Net income of $606 million (up 10% from Q3 2014)

*"Core" loans excludes the impact of the non-strategic/liquidating loan portfolio

**Reserve release represents the amount by which net charge-offs exceed the provision for credit losses

Chairman and CEO John Stumpf:

> "Wells Fargo's strong third quarter results reflected the ability of our diversified business model to generate consistent financial performance in an uneven economic environment while continuing to meet our customers' financial needs. Compared with a year ago, we grew loans, deposits and capital, and returned more capital to shareholders through dividends and share buybacks. Our balance sheet and credit results remained strong and our 265,000 team members continue to focus on helping our customers succeed financially."

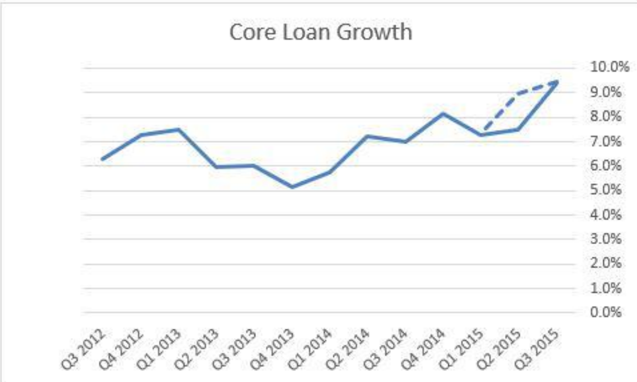
So What?

The 3 key items that I watch for Wells Fargo:

- Growth (or lack thereof) in core loans and deposits
- Trends in credit quality (as monitored via net charge-offs and reserving policy)
- Trends in the efficiency ratio and expense reduction

1) Growth in loans and deposits

Core loan growth for the quarter came in at a very healthy 9.5% year-over-year. This figure includes the impact of $354 million in loans acquired from GE Capital, but even *without* the GE loans, at 9.4%, loan growth was the highest it's been since I've been covering the company. Similar to last quarter, there was particular strength in commercial and industrial loans (which includes the GE Capital loans, up 15% year-over-year) and credit card balances (up 14% year-over-year).



Source: Company filings, analyst calculations. Dashed line shows growth including the loans acquired from GE Capital.

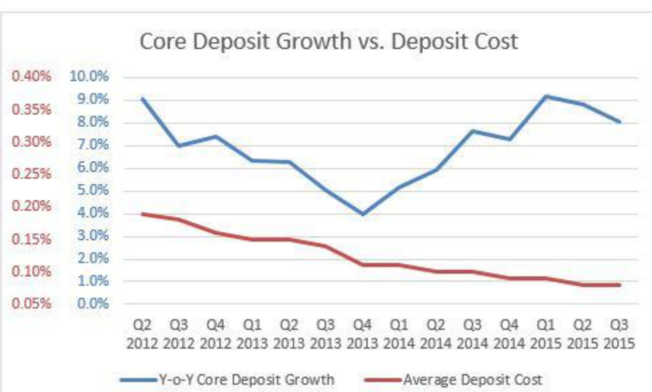
Since Wells Fargo is so large and so involved in many facets of the U.S. economy, the company's financial performance can provide some good information about general U.S. economic conditions. I've been mentioning that I hadn't expected loan growth to increase meaningfully (i.e. to 9-10% growth) unless U.S. economic growth starts to sustainably accelerate (say to the 3-3.5% growth level) and long-term interest rates rise. Despite that sentiment, both including and excluding the acquired loans from GE, loan growth came in above 9%, so this was an excellent result for the quarter.

Although the acceleration of loan growth may be partially explained by the decline in loan *yields* (down to 4.11% vs. 4.29% a year ago), it may also be indicative of a few other trends. For one, we can see that the real estate market continues to be an area of strength for the U.S. economy, with Wells' commercial real estate loan portfolio up 10% and 1-4 family first mortgages up 7%. Additionally, the American consumer seems to be doing well, which is not surprising given higher employment, higher wages, and lower gas prices. In addition to strength in Wells' consumer housing portfolio, credit card balances were up 14% and automobile loans were up 7%. Based on this data, I wouldn't be surprised if U.S. economic growth in the third quarter comes in perhaps slightly higher than expectations.

Finally, commercial and industrial loans have continued to increase at a very healthy rate, although this may be less indicative of strength in those markets and more a function of stress and need for short-term financing from companies in those industries. Industrial markets are struggling right now due to low energy prices and a slowing of demand from China for goods and many commodities. Strong increases in loans in these markets (+15%) may be reflective of an increase in risk taking from Wells, as loanees in those markets are experiencing tough times.

Not surprisingly, as growth in loans in the commercial and industrial segment have increased, improvements in credit quality have leveled off and reserve releases have gotten smaller. In fact, the reserve release for this quarter was zero, with net charge-offs equaling the provision for credit losses -- the first time since Q1 2013 that Wells did not report a reserve release. Nonetheless, I'm confident in Wells' risk management practices and I trust that management will continue to maintain a prudent balance between loan growth and credit quality. This is an area I'll continue to monitor over time.

As for deposits, Wells continues to shine. The company achieved 8.1% year-over-year growth in core deposits. Funding costs remained stable at an ultra-low rate of 0.08%. Deposit growth decelerated a bit from last quarter's 8.8% growth, but deposit growth remains very healthy and well above the U.S. banking industry average as per the latest FDIC summary of deposits survey:



Source: Company filings, analyst calculations

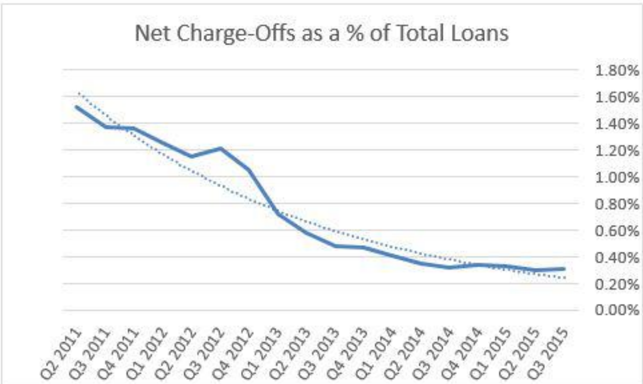
The company's ability to grow deposits meaningfully at a very low cost is perhaps the company's biggest structural competitive advantage. Wells is able to do this by having a nationwide presence with significant geographic density in most markets, optimizing distribution via newer channels (mobile/technology), and strong customer relationship management and product cross-sell achieved via a consistent culture that has been a hallmark of the company for decades.

Net interest margin declined slightly, coming in at 2.96% vs 2.97% last quarter. The net interest margin is unlikely to meaningfully increase until long-term interest rates rise (who knows when that will happen).

2) Trends in credit quality

Credit quality showed a slight sequential decline quarter, with net charge-offs as a percent of total average loans increasing to 0.31% (from 0.30% last quarter). Despite the increase, this charge-off rate is still very low, well below the industry average of 0.42% (which is quite low itself). Improvements in credit quality have been a consistent theme of the current credit cycle as banks have cut down on risk in response to the turmoil of the 2008-2009 financial crisis.

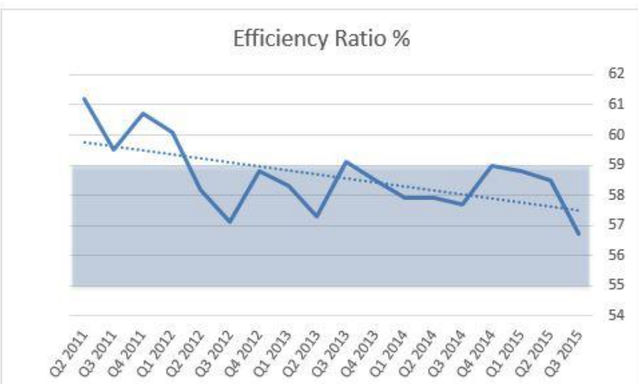
It will likely be difficult to keep improving credit quality from these very low levels. But since Wells Fargo is known for underwriting discipline, I anticipate continued strong performance from this metric. Slight deterioration in credit quality from these levels will not worry me (and may actually be beneficial in terms of generating higher loan growth), but we want to watch the trend to make sure that the company's discipline is staying on track.



Source: Company filings.

3) Trends in the efficiency ratio

The efficiency ratio (a measure of the bank's overhead costs as a % of its revenue -- lower is better) decreased meaningfully this quarter, coming in at 56.7% vs. 58.5% last quarter and 57.7% in the same quarter a year ago. The efficiency ratio is in the middle of management's target range of 55-59% (blue shaded area in graph).



Source: Company filings.

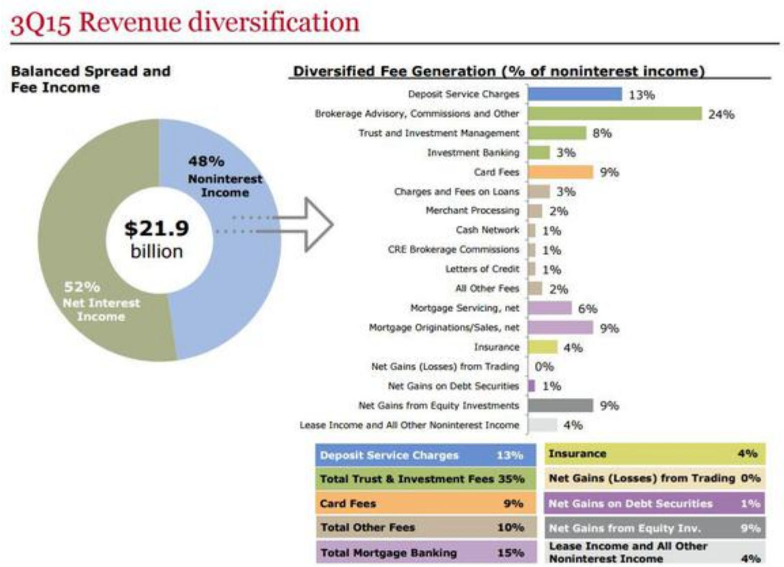
Wells' focus on expense control yielded positive results in the quarter, although management mentioned that in the absence of higher revenue growth, they expect to operate at the high end of their target range for the rest of the year as they invest their savings from expense control into other areas of improvement such as compliance, risk management, and technology. Interestingly, this commentary from management aligns well with our thesis for another Pro company, **Broadridge** (NYSE: BR), which benefits as financial institutions increasingly invest in and outsource those functions.

Now What?

Yet again, Wells Fargo is so consistent that I can simply quote prior write-ups for my conclusion:

> "Not much different from last quarter (or the quarters before for that matter). Wells Fargo continues to execute its strategy and boast admirable consistency despite a fluctuating and uncertain macroeconomic environment. The company's performance is a testament to its diverse operating model. The company has so many levers to pull that if one segment falls others pick up the slack."

For additional clarity, here's what I mean when I mention the company's diverse operating model:



The company's income is split about 50/50 between interest income (lending spreads) and noninterest income (fees and other services). And the noninterest income is very well diversified, with no category in the quarter accounting for more than 24% of the total. The company does a great job of managing these both of these profit streams better and more consistently than peers, and we expect that to continue.

From our long-term view, underlying business results remain strong, the core earnings power of the business remains intact and is poised for positive operating leverage when interest rates and lending spreads rise, and the company's capital return program continues to benefit shareholders.

Data and Guidance

- Current Price: $53.25
- Fair Value: $58 (no change)
- Market Cap: $272 B
- P/B 1.58

After incorporating this quarter's results into our model, our Fair Value estimate remains unchanged at $58 per share (representing a 1.72x P/B multiple). Wells Fargo remains a Buy First on our scorecard with a 3.6% allocation, and those who have yet to fill out their position in this long-term compounder can feel comfortable doing so at current price levels.

Fool on!

Billy

If you have questions, drive your stagecoach over to the Wells Fargo discussion board.

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8 Qualities of an Ideal Pro Company

Published Oct 19, 2015 at 12:58PM

Pro Completed Trades

- **AmTrust Financial Services** (NASDAQ: AFSI): We sold about 20% of our shares via October $60 calls. Our allocation is now 6.9% and the stock remains a buy.
- **O' Reilly Automotive** (NASDAQ: ORLY): We bought to close our October $250 calls, keeping our shares and leaving them uncovered for now. The stock is a buy. We have a 5% allocation.
- **Papa John's International** (NASDAQ: PZZA): We sold one-third of our shares via October $65 calls. Our allocation is now 3.2% and the stock remains a buy.
- **SPDR S&P 500** (NYSEMKT: SPY): Our October put ratio spread expired unused. We're looking at new hedges to set up, including an update to our November SPY hedge for those not yet in it (including us!) because of price changes.

Pro Guidance Changes

- **Tupperware** (NYSE: TUP)**:** The stock moves to Hold as we review its attributes for up to 30 days.
- **Valmont Industries** (NYSE: VMI)**:** The stock moves to Hold for the same reason.

Dear *Pro* member:

At *Pro*'s inception in 2008, we shared with you seven qualities we believe make for a great company and ideally an excellent investment. Today, we've updated the list and added an additional quality. As we updated, it was was pleasing to see we didn't need to change much (what we're doing is working!) -- but we do believe we've made meaningful improvements, and the eighth quality we added is important. Let's walk through it all below. As we proceed, just note that these qualities aren't necessarily listed in order of importance; many of them feed into one another. And remember to invert: If we want these qualities in our investments, we also want to avoid or consider shorting companies that lack most of them.

8 Qualities We Want in Pro

1: A Sustainable Competitive Advantage

You'll often hear investors and analysts tout the importance of a "protective moat" around a business that protects its profits, but we want to pin that cliche down. What protects profits at **Procter & Gamble** (NYSE: PG), for a random example? In the case of any *Pro* stock, we want to know. How is **Gentex** (NASDAQ: GNTX) keeping competitors at bay? What assures us **Broadridge** (NYSE: BR) will continue to keep most public companies as customers of its proxy services? We study to make sure our companies have advantages that won't slip away.

2. Pricing Power

Along with a lasting competitive edge, Warren Buffett says pricing power is the biggest indicator of a company's long-term success. The ideal *Pro* company will be able to increase prices systematically or as necessary and not lose customers. **Verisk Analytics** (NASDAQ: VRSK) is an ideal example, as it increased prices throughout the financial crisis. **Starbucks** (NASDAQ: SBUX) has been able to charge more for coffee and keep growing. We want to avoid companies that can't increase prices without harming the business. They're just not as powerful.

3. Dependent Customer Base

This is the first quality we tweaked in our update. It used to read "Diverse Customer Base," but we think "dependent" more accurately sums up what we seek. Company X may have many customers, but if they're not dependent on Company X in particular, they can easily go elsewhere. A *dependent* customer base suggests a competitive moat and should afford the business pricing power. Think **Apple** (NASDAQ: AAPL): Many customers feel dependent on the Apple operating system and pay up for the company's products. Or consider **Skyworks Solutions** (NASDAQ: SWKS), which is providing modular solutions that customers can't easily get elsewhere, so its margins are going higher. **Visa** (NYSE: V) and **MasterCard** (NYSE: MA) serve millions of merchants that need to offer the convenience of credit cards to their customers.

4. Predictable Revenue

We used to call this one "Naturally Recurring Revenue." Better and more broadly said, we want highly *predictable* revenue. The previous phrase encompassed strong contract renewal rates at **Oracle** (NYSE: ORCL), **OpenText** (NASDAQ: OTEX), or **AmTrust** (NASDAQ: AFSI), for example, and the recurring transaction-based revenue at MasterCard. But we've broadened the wording such that we can now include something like **Amazon.com**'s (NASDAQ: AMZN) predictable revenue, which occurs thanks to the lack of an equally strong competitor. (What type of business lacks predictable levels of revenue, let alone pricing power? Most commodity-based businesses.)

5, Growing Free Cash Flow With Compounding Returns

It's a mouthful, but in our update, we added three words at the end here. We want our companies to steadily increase their free cash flow, yes -- but we also want them to then *reinvest that cash* in new opportunities for strong returns. This is how our businesses become compounding machines. We still favor long-term growth rates of at least 10%, in order to challenge our North Star.

6. Financial Resilience

This quality was formerly called "A Strong Balance Sheet." But on update, we think that's subjective and narrow in scope; plus, sometimes debt is smart. Overall, what's much more important is a company that runs its financials so it survives in all environments and thrives in most. Our businesses stayed profitable in the Great Recession and didn't have to worry about debt loads. We don't want to own companies that are just a few bad years away from financial trouble.

7. Expanding Possibilities

This used to be "Expanding Product Possibilities," but we realized it should include geographic expansion, acquisitive possibilities, new customer growth, and more. Basically any way a company could grow, we want to make sure our investments are situated to do so. This also relates to increasing free cash flow with compounding reinvestment possibilities.

8. The Three C's of Management

This is our new category. We wanted to add several important management qualities, and JP came up with these "three C's" to encompass them.

- **Clarity:** We need to keep our money with management teams that lay out a clear long-term strategy for success.
- **Consistency:** Members of management need to do what they say they will, and when they need to pivot, they should admit it rather than rewriting the past. We want a consistent narrative of events and consistent execution on a clearly outlined plan, even if that plan has to evolve.
- **Capability:** Is this management team the right one for the job? We need to believe they're highly capable and trustworthy.

An 8-Point Gauntlet

We encourage you to run all your companies through this checklist. It isn't easy to clear. Our recent sell, **The Buckle** (NYSE: BKE), lacked all but No. 6, and on No. 7, even as it adds stores, it's struggling to grow results. In fact, poor communication and planning from The Buckle management inspired us to add the eighth quality above. We're learning from our losers and, we hope, improving our future investments as a result.

Currently, we're running recent laggards **Tupperware** (NYSE: TUP) and **Valmont Industries** (NYSE: VMI) through the gauntlet to make sure they should remain in the portfolio. Both have been moved to Hold as we review them for up to 30 days. Overall, we want a portfolio of steady compounders, not companies that struggle to grow or depend on luck to soar. If each of our investments fits most or all of the eight *Pro* qualities, we should have strong long-term results.

To discuss this Memo and these attributes, please visit our Memo Musings board.

Fool on!

-- Jeff (TMFFischer)

The Motley Fool Pro Guidebook

Published Oct 16, 2015 at 10:28AM

Start Here: Portfolio Building Reports

To get started with the funds you have available to invest, we'll be providing a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new *Pro* portfolio. **The reports will be linked below on the dates noted.** All dates are subject to change depending on market activity.

Part 1: Our Buy First Stocks Part 2: Our Buy Stocks Part 3: Our Buy Stocks, Continued

Portfolio Positioning Report and Live Chat: Sept. 21

Important: A note on fair value

What should I expect
from *Pro*?

• Guidance on a winning portfolio
• A weekly Memo with commentary and market analysis
• Trade Alerts whenever we see an opportunity worth acting on
• A monthly live chat with the *Pro* team
• A ton of help on our discussion boards

Strategy Guide

Follow these features, and you'll be investing like a Pro in no time:

- How We Invest
- Inside the Portfolio

- Our North Star
- Finding Great Stocks

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I want to learn more

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  - Invested Elsewhere
  - "Free-Range"
  - Whoever You Are
- See guidance on every active position in What We Think Now
- Get a breakdown of how much you might want to invest in each *Pro* position with our allocation calculator

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Meet the Team

Motley Fool Options

Your *Pro* membership also includes full access to *Motley Fool Options*, an options-only service led by Jeff Fischer, the rest of the *Pro* team, and options guru Jim Gillies. *Options* scours the Foolish universe of stocks to provide a steady stream of actionable options ideas to complement your stock portfolio. The vibrant *Options* community is a great place to cut your teeth, talk shop, and learn new strategies in Options U.

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Resources

- Allocation calculator
- Our sister service, *Motley Fool Options*
- What to know if you're investing in an IRA
- Getting Started discussion board
- *Pro*'s options guides
- Some thoughts from Jeff on fair value

- A guide to our North Star
- Finding Great Companies: *Pro*'s 8 Qualities
- Manage your email settings
- FAQ
- The *Motley Fool Options* brokerage discussion board
- Contact member services

Potential Trades on O'Reilly Automotive and SPDR

Published Oct 15, 2015 at 1:20PM

Is this for you? This is for all *Pro* members who wrote October $250 covered calls on **O'Reilly Automotive** (NASDAQ: ORLY) and/or those who set up the Oct. 16, 2015, put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY), which includes owning $200 puts.

How You Participate: O'Reilly Automotive

- **Condition:** If the stock is above $250 on Friday (or today if you prefer), buy to close your $250 calls.
  - **Trade:** Buy to close your October 2015 $250 covered calls.
- **Allocation:** Buy every call you previously sold.
  - **Price Guidance:** Use a **limit order** and aim to pay as little time value as possible, but realize you need to close these calls on Friday if the stock is above $250. As of today, the calls still have more than $1 in time value that you'll have to pay if you wish to close them.
  - **Prices** (11 a.m. ET):
    - Stock: $249.50
    - October 2015 $250 calls (bid/ask): $1.30/$1.55 (by Friday this value should be lower, unless of course the stock goes above $250 by more than this amount).
- **Follow-Up:** We're not issuing a rolling trade alert today because rolling may not be possible; instead, we're waiting until our existing calls are closed before we consider writing new calls on this stock. This will probably be after earnings, which are due Oct. 28.

How You Participate: SPDR S&P 500 ETF

- **Condition:** No matter what, by the end of Friday, sell to close your Oct. 16, 2016, $200 puts on SPY. You could close them today if you prefer, but if you do, close the other half of your put ratio spread (your short puts) as well. That way you won't be exposed to a potential crash in SPY's price.
  - **Trade:** Sell to close Oct. 16, 2015, $200 puts on SPY.
- **Allocation:** Sell to close each $200 put you currently own.
  - **Price Guidance:** Accept what the market will pay you.
  - **Prices** (11 a.m. ET):
    - ETF: $200.50
    - Oct. 16, 2015, $200 puts (bid/ask): $0.57/$0.58. On Friday, this will be higher or lower depending on where SPY trades.
- **Follow-Up:** We want to reinitiate hedges on the index and we aim to do so very soon, providing new guidance for those not yet in the November hedge (because of pricing changes, this includes us!). We may initiate a brand-new hedge, too, if we like the pricing.

What We're Thinking

As shared in yesterday's email update, we have some options expiring tomorrow that kindly request our attention. If luck were to shine on us, O'Reilly's stock would be below $250 at expiration and our covered calls on it would end fully as income, while the S&P 500 would somehow tank below $200 so we could sell our puts for a good profit (and then watch the S&P rebound next week). However, the market doesn't fulfill our short-term dreams very well at all. Thankfully, though, it's excellent at doing so over the long term, so we won't complain.

You can act on both of these options today or Friday. If O'Reilly's stock price is above $250, you can buy to close your $250 calls, ideally keeping some income (right now, that is the case). You can do that anytime -- now if you don't mind paying time value, or Friday late afternoon to pay less time value (while taking a chance the stock goes higher still). We plan to target new covered calls on the stock a bit later.

Meanwhile, with the SPDR S&P 500 ETF, we can sell our $200 puts expiring tomorrow for some cash -- a small gain on the hedge. Just be aware that if you sell before late Friday afternoon, you'll need to buy to close your short puts as well (assuming you wrote $187 to $191 puts with us as part of the overall hedge). If you don't, you'll be sitting on an unlikely but large potential loss. It'll cost you a penny to close out that risk and buy to close those short puts, if you sell your $200 puts much before Friday's close. Why play with fire for a penny or so? Or, you can wait until the end of Friday and then close your $200 puts and let your lower-strike puts simply expire. Just realize that of course the $200 puts may not have any value at all left (they're all time value right now) by Friday afternoon unless SPY is lower than $200. Right now, it's at $200.50.

How These Trades Fit in With *Pro*

We're likely to initiate another defensive income position on O'Reilly later this month, given the valuation on the shares, but only between earnings reports. We don't want to sell these shares yet (they're rated Buy on our scorecard), because we see more long-term potential in the business and we are doing some selling elsewhere in the portfolio to raise cash.

And SPY put ratio spreads continue to be a hedge of choice in the portfolio. We'd like our long puts to end in-the-money sometime! But when they don't, the hedge doesn't set us back. In this case, we may be able to make some dough with SPY right around $200 or lower, by closing those puts by Friday. And then we hope to have new hedges announced soon.

Pro Can Help

- **Questions?** Rev on over to the O' Reilly and SPDR S&P 500 boards to fire off any questions.

Sell The Buckle

Published Oct 14, 2015 at 7:47PM

Is this for you? This sell recommendation is for any *Pro* member who owns shares of **The Buckle** (NYSE: BKE) and won't mind selling. Read our reasons for selling below.

How You Follow Along

- **Trade:** Sell **The Buckle** (NYSE: BKE).

- **Allocation:** Sell all shares. *Pro* is selling its 1,100 shares, representing 1.6% of the portfolio.
- **Price Guidance:** Use a **limit order**, please, to sell at the going price, lately above $35.
- **Our Return:** From Day One, we've earned about 7% annualized holding this position, all thanks to dividends. Newer members have a loss.

Deciding when to sell a stock is never easy. In the case of The Buckle, we've decided to do so because of our North Star -- specifically, because we believe the only near-term catalyst that could enable the stock to deliver North-Star-like returns over the next three years would be a change in market sentiment about The Buckle. And we don't foresee any catalysts that would make that likely.

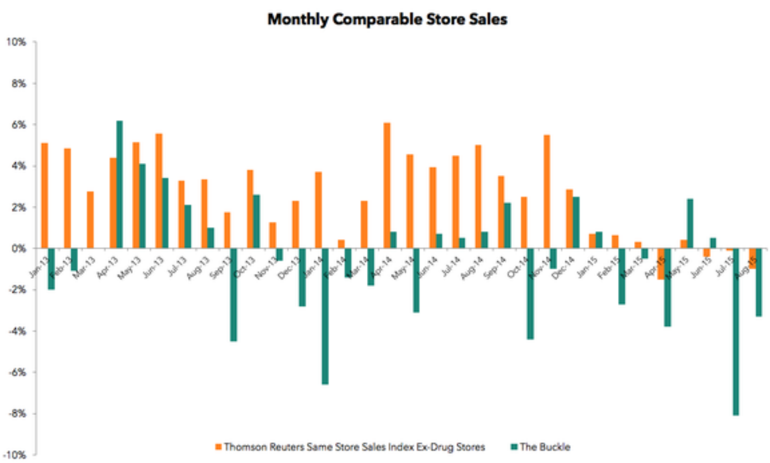
What's Changed?

When we first recommended buying The Buckle back in June 2012, we highlighted a few key metrics we like to keep an eye on when looking at retailers, and we noted how impressive the company's performance had been over the previous 10 years (2002 to 2012). Unfortunately, these trends didn't continue after we first purchased shares.

($ figures in thousands)	2002	2011	Annual Growth Rate	2014	2011 - 2014 change
Stores	304	431	4.0%	460	6.7%
Sales per store	$ 1,339	$ 2,498	7.2%	$ 2,321	-7.1%
FCF per store	$ 57	$ 406	24.3%	$ 330	-18.7%
Sales per square foot	$ 274	$ 462	6%	$ 459	-0.6%
Inventory turnover	4.7x	6.2x	3%	4.5x	-25%

Source: SEC Filings, S&P Capital IQ, and analyst estimates
Per store calculations are based on average stores open during the period

And if you take a look at comparable-store sales, you'll see that The Buckle's results over the past few years have disappointed on both an absolute and a relative (to the industry) basis.



Source: Thomson Reuters Corporation and company filings

So what's to blame? For starters, the company missed out on the activewear trend that has been such a huge tailwind for **Nike** (NYSE: NKE), **Lululemon** (NASDAQ: LULU), **Under Armour** (Nasdaq: UA), and others. (For some context, here is an article on how Levi's is trying to adapt to this new reality.)

Apparel and Activewear (Dollar % Change)

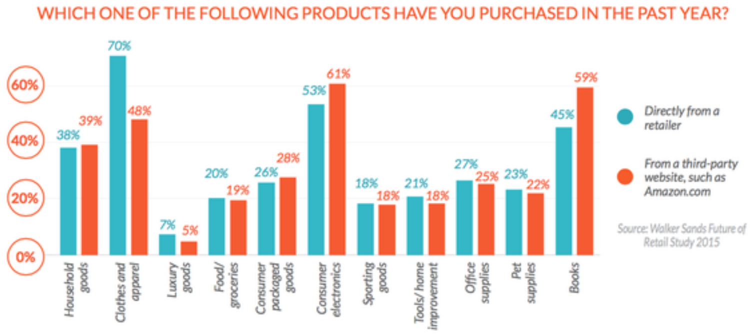
	Total Apparel (w/ Activewear)	Total Apparel (w/o Activewear)	Activewear
12 months Jul'11-Jun'12	+4 percent	+3 percent	+8 percent
12 months Jul'12-Jun'13	+4 percent	+3 percent	+10 percent
12 months Jul'13-Jun'14	+1 percent	-1 percent	+7 percent

Source: The NPD Group, Inc. / Consumer Tracking Service 2011-2014

This has been a huge headwind for The Buckle, but we don't believe it's the only issue. Management may be disciplined when it comes to capital allocation, but they were slow to react to the shifts in the industry brought about by the rise of online shopping and social media. For years, one of The Buckle's greatest strengths has been its in-store experience and great sales staff. This greatly reduced the need for the company to participate in the pricing warfare many competitors waged, and it also fostered customer loyalty. Unfortunately, this strength starts losing its relevance once a customer starts researching and purchasing clothes online.

Now, stories of online shopping killing brick-and-mortar shops are often exaggerated -- e-commerce sales accounted for only 7.2% of total U.S. retail sales in the second quarter of 2015, after adjusting for seasonal variation. But the threat is more serious in the apparel industry, where consumers are far more willing to purchase items online.

Most Common Types of Products Purchased Online in the Past Year



According to The NPD Group, online transactions *already* account for 17% of total apparel sales. And while in-store apparel sales were down 2 percent for the 12 months ending in February 2015, online purchases continue to strengthen, with many of the largest markets in the U.S. increasing by at least 10% over that time (total online purchases increased by 19 percent). And the online space is arguably even more cutthroat than the malls The Buckle operates in, with new competitors showing up overnight and most companies now regularly offering sales, free shipping and returns, and other incentives to win customers. These are practices that The Buckle has been slow to adopt (and which management still seems somewhat hesitant to use), and unfortunately, research has found that they are also some of the most important factors that influence whether someone purchases an item online.

Relatedly, we also believe that The Buckle is losing mindshare to its competitors as it struggles to play catch-up with its social-media presence.

Followers on various forms of social media

	Facebook	Twitter	Pinterest
The Buckle	387,626	21,400	29,100
American Eagle	10,622,904	705,000	80,700
Urban Outfitters	2,068,613	1,020,000	275,100
Gap	7,180,058	639,000	101,000
J. Crew	1,445,781	360,000	208,100
H&M	24,131,687	6,950,000	172,200
Topshop	4,052,563	1,190,000	118,100
Madewell	452,916	63,900	116,600

last updated October 12, 2015

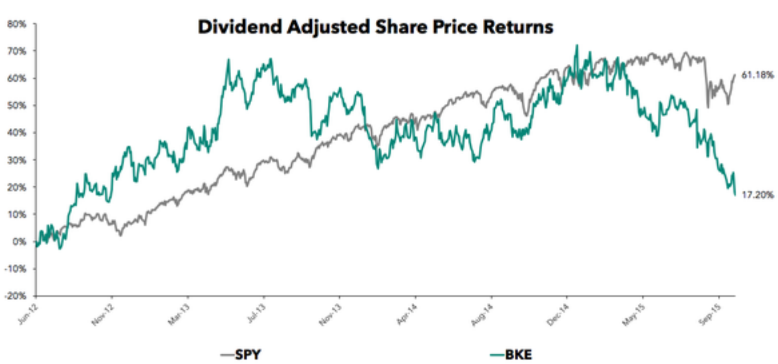
These admittedly aren't prefect comparisons for The Buckle; there are differences in store count, target audience range, and sales strategies, to name a few. But we believe it does give some insight into the type of competition The Buckle is facing. For example, Madewell -- a division of J. Crew tailored to "denim lovers" -- plans to finish this year with around 105 stores, less than a quarter of The Buckle's current store base, but it already has 17%, 199%, and 301% more followers on Facebook, Twitter, and Pinterest, respectively.

The company also doesn't fare very well when you look at it through the prism of our recently updated checklist (we'll detail this checklist in Monday's upcoming Memo):

Sustainable Competitive Advantage	✗	The company's ROE and margins over the past 10 years have been quite impressive, but given the changing landscape, we believe the likelihood of repeating these results over the next 10 is anything but a sure thing.
Pricing Power	✗	With troubling trends in mall traffic and pricing wars online, the company will likely need to compete more on price than it has in the past.
Dependent Customer Base	✗	Tastes change and customers are fickle.
Predictable Revenue	✗	It is a certainty that people will purchase clothes, but the styles they will gravitate toward are anything but certain.
Growing Free Cash Flow	✗	Free cash flow growth has stagnated over the past few years.
Financial Resilience	✓	The company is conservative and has a healthy balance sheet.
Expanding Possibilities	✓	The company should be able to open additional stores at a slow pace over the next few years.
The Three C's of Management	✗	Management is notoriously close-mouthed.

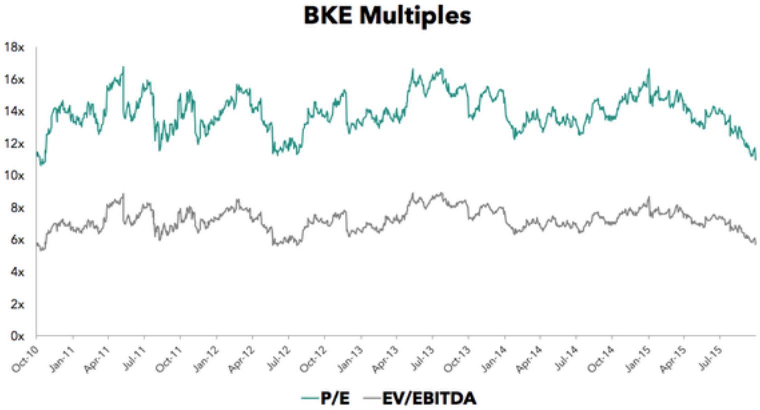
The Stock

Our position started off extremely strong, absolutely crushing the North Star by returning more than 60% through July of 2013. But it's been distressed denim since then as the S&P 500 continued to grind higher while The Buckle stalled out.



Source: S&P Capital IQ

Despite being a dividend all-star for *Pro* (we've collected more than $12,000 in dividends on our $42,000 initial investment!), the company's stock has been a disappointment from a capital-gains perspective after the one-two punch of troubling financial results and a high dividend payout ratio. Regarding the latter point, we actually applaud management's decision to return such a large amount of capital to shareholders, especially when you consider the alternatives (letting the cash sit on the company's books earning almost nothing, or aggressively redeploying it toward projects that ultimately destroy shareholder value). Nonetheless, a stock normally drops by about the amount of the dividend once it goes ex-dividend.



	P/E	Standard Deviation	EV/EBITDA	Standard Deviation
Since IPO average	15.24x	4.44x	6.96x	2.34x
10-year average	14.55x	2.55x	7.25x	1.22x
5-year average	13.91x	1.15x	7.22x	0.69x
3-year average	14.09x	1.06x	7.34x	0.63x
1-year average	13.96x	1.13x	7.28x	0.57x
Current	10.9x		5.6x	

Source: S&P Capital IQ, author's calculations.

As you can see, the sentiment surrounding The Buckle's stock is bearish, with the lowest multiples we've seen in recent memory. As an additional data point to support this notion, short interest now stands at 25% of the float, which is pushing near the upper bounds of the range it's held to since the start of 2015. The stock has always carried a high short interest, partly because of the belief that in the apparel industry, reversion to the mean is an unescapable gravitational force. And some are claiming that now is the time to short the company, since The Buckle's metrics have started to turn over.

It's true that this industry is littered with casualties. We've seen founder-led companies run into the ground (American Apparel, Abercrombie & Fitch); industry darlings turned into pariahs (Aeropostale); failed turnarounds (Wet Seal); dominant companies that fell from grace only to recover and then fall again (The Gap); companies that dominated a niche, but fell from grace and never stopped falling (dELiA*s) ... Even some luxury wares (Coach), thought to be more resilient thanks to brand and pricing power, have seen their stock, and products, thrown in the discount bin. Selling clothes is not for the faint of heart, and when things take a turn for the worse, it can be hard for a company to reverse course. Today's valuation may prove to be a value trap if fundamentals continue to weaken at The Buckle.

The *Pro* Bottom Line

We've stressed in the past that we would never short a stock based solely on valuation, and the inverse is just as true: We won't refrain from selling a stock on valuation alone. An expensive stock can become even more expensive, and a cheap stock can get even cheaper. We can't predict if or when the market will assign higher value to The Buckle. The hope of this happening is one of the few things the stock has going for it. But that alone is certainly not worth keeping it in our portfolio; we believe we can invest in a much more *Pro*-worthy company instead. Following slowly degrading results capped by the recently released dismal sales data for the month of September (a 5.6% decline in net sales and a 6.7% decline in comparable-store sales), we simply no longer believe The Buckle is likely to generate North Star-beating returns over the next three and five years. **We will use a limit order to sell our position sometime in the next 30 days.**

To discuss this, please visit [The Buckle board](#).

A Foolish Update: Pro's October Options Expirations

Published Oct 14, 2015 at 3:20PM

Dear *Pro* member,

Five options positions in *Pro* will expire on Friday, so today we want to give you the essential updates on our plans for each. And even if you don't use options, our plans this week may affect you on two positions: **AmTrust Financial** (NASDAQ: AFSI) and **Papa John's International** (NASDAQ: PZZA). We wrote covered calls on some of our shares of these companies, and as planned, we're ready to sell off those partial positions to raise some cash.

So, if you didn't write covered calls, you should consider your tax and portfolio situation and consider selling some of these shares directly to match us. Details follow, so let's do the rundown.

AmTrust Financial Services (NASDAQ: AFSI)

In short: Do nothing with our October 2015 $60 calls. Those calls are set to sell about 20% of our shares for us. Members who don't use options would trim the position to 6.8% to match us.

Our October $60 covered calls paid us about $2, and if the stock stays above $60 by Friday, the calls will sell 700 of our 3,267 shares at $62. That's about 20% of our AmTrust holding, so our allocation to the stock will decline from 8.7% of the portfolio to 6.8%, remaining our largest holding by 1.5%. If you own more than 6.8% and didn't write covered calls, consider trimming your stake down to that level, while keeping your taxes and portfolio situation in mind.

We sell a leader like this in order to raise cash for new positions while still keeping this position sizable. Because it's an insurer, we also view AmTrust as a higher-risk position, so we have limitations on how large a portion of the portfolio we'll let it become. But so far, we're grateful for its performance. In fact, we probably would not need to sell any if we were adding money to the portfolio regularly, since that would make this allocation smaller automatically. But given our mandate, we're ready to sell some shares via covered calls to trim it. If you own less than 6.8% already, you needn't sell any.

Live Nation (NYSE: LYV)

In short: Do nothing; our written $24 puts are on track to expire as income.

For the second time, our written puts on the live-music leader are set to expire as income as long as the stock remains above $24 on Friday. We're watching for new opportunities with Live Nation. We don't yet own shares.

O'Reilly Automotive (NASDAQ: ORLY)

In short: The stock is near the $250 strike price of our covered call; we'll roll or close by Friday if need be, so watch for a conditional trade alert on Thursday.

If O'Reilly stock remains near our $250 strike price, we'll issue an alert tomorrow, to be acted on by Friday if needed. If the shares remain below $250, our covered calls will expire as income and no action will be required. If shares tick above $250, on Friday we'll either close our calls for a partial profit, or roll them to a higher strike. Thursday's conditional trade alert will provide parameters. For now, we don't need to act quite yet.

Papa John's International (NASDAQ: PZZA)

In short: Do nothing with your October 2015 $65 calls. Our calls are set to automatically sell about one-third of our stock position. Members who don't use options would trim the stock to 3.3% to match us.

If the pizza purveyor's stock stays above $65 by Friday, we'll see 600 shares get sold, or about one-third of our position, for around a net $68. This will lower our allocation from 5% to about 3.3%. So if you own more than 3.3% in the stock and didn't write calls, consider your portfolio needs, cash, and taxes, and then consider trimming. To match us, you would reduce to 3.3%. We still like Papa John's – it remains a buy – but as one of our largest positions trading at assertive value multiples, we're content to trim from it again. It's been an outstanding performer and the long term is still promising.

SPDR S&P 500 (NYSEMKT: SPY) ETF

In short: We aim to sell to close our $200 puts by Friday for the value we can get. Our short puts at a much lower strike price can be left alone to expire.

Right now, we're rooting for SPY to go lower! We capture more value in our $200 puts, which expire Friday, the further below that price SPY falls. Assuming they hold any value, we'll "sell to close" the $200 puts by the end of Friday (following a Thursday trade alert). As a hedge, we'll keep these puts until right toward the end, and then close. Our short puts (at strikes of $187 to $191) are set to expire, but you might want to keep your long $200 puts open until you're certain the short puts will expire – in other words, until the end of Friday – so that you're not nakedly exposed to SPY's downside via all your short puts.

In Summary

That's it for our scary October options! Turns out that up close, there's nothing scary about them. We're ready to let some shares of AmTrust and Papa John's be sold via covered calls, raising 3.6% more in cash for the portfolio, bringing *Pro* to about 15.7% cash. Our Live Nation puts can be left alone to expire; our O'Reilly covered calls are set to expire as income, too, but we'll act by Friday if the stock rises above $250; and our SPY hedge may earn us a little return if we can close the $200 puts for any value Friday. Any questions, please visit the *Pro* options board!

Thank you for being a Fool with us. Fool on!

-- Jeff (TMFFischer)

Analyze Backward, but Invest Forward

Published Oct 12, 2015 at 9:49AM

Note: Jeff is traveling back from the Fool member event in Miami today; we'll address this week's options as soon as possible after he returns!

Fellow Fools,

I love the Internet, and not just because it allows my 4-year-old daughter to watch cake-decorating videos to her heart's content and my 6-year-old son to learn about the latest Minecraft "mod" (whatever that is) before his friends do. I'm constantly amazed at how the Internet allows for the proliferation of information and enables us to dig deeply into topics of interest. Thanks to the magic of the Web, I recently spent an hour listening to a lecture by John Burbank of Passport Capital in which he shared his investing process -- a privilege that, pre-Internet, would have only been enjoyed by the MBA students at UC Berkley's Haas School of Business.

Burbank is well known in the hedge-fund community for his prescient call about the housing market collapse in 2007, and he's one of the top-performing hedge-fund managers so far this year. He continues to manage $4.2 billion across three equity-focused funds that combine top-down macro thinking with bottom-up fundamental analysis. I found his talk particularly interesting because it focused almost exclusively on the "art" of investing: using incomplete information to make educated guesses about the future. Burbank distilled his investment process into these three points:

- Invest in things that never happened before.
- Hedge against reversion to the mean.
- Depend on the unimaginable.

A quick glance at that list should make it obvious that this isn't your normal paint-by-numbers recipe for investing success. Rather, it's a way to frame your thinking about the future. Looking out five years from now, it's nearly impossible to make those guesses with any amount of precision -- but in many cases, you only need to be vaguely right to find profitable investments. Many experts agreethat thanks to the demographic headwinds from an aging population across the world, we'll likely see slower global economic growth in the coming decades. Even so, it's important to realize that some companies will be able to capture a disproportionate share of that value creation, and it's our job as investors to try to imagine which ones they'll be.

Tuning Your Crystal Ball

At the end of his lecture, Burbank also provided a valuable framework for thinking about technological change . He spoke of how the Internet bubble was really an Internet *infrastructure* bubble, and though many of the companies that laid the fiber-optic cable no longer exist, the rest of the economy is only just beginning to reap the benefit from that massive investment in new technology.

This line of thinking reminds me of a book by Daniel Gross called *Pop!: Why Bubbles are Good for the Economy.* The book, which was published just after the housing bubble imploded, also examined booms and busts like the telegraph, the railroads, the Internet, and alternative energy. Gross concluded that the early investors who build the infrastructure to support a new technology often lose out when enthusiasm results in overcapacity, but the businesses that find novel ways to use that cheap capacity end up capturing the most value.

For example: Overbuilding of the railroads led to numerous bankruptcies, but it also made possible mail-order catalogues, like Sears Roebuck, and allowed for the creation of a modernized food distribution system and national consumer brands. Likewise, the Internet continues to lower costs and make it easier to share ideas. Media streaming companies including **Netflix** (NASDAQ: NFLX) and **Pandora** (NYSE: P) continue to benefit from the miles of "dark fiber" that were dormant for years before the desire for on-demand entertainment became a mass-market phenomenon.

Many of these benefits seem obvious in retrospect, but they're much more difficult to recognize in real time. Access to cheap capital in recent years has likely led to overinvestment in many industries and the creation of excess capacity, which will fuel future innovation. One area where I expect to see this is the energy industry. The improving efficiency of hydraulic fracking has led to a glut of fossil fuels, and alternative energy sources are becoming more competitive than ever, driving down energy costs for a wide range of industries.

The *Pro* Bottom Line

My wife and I recently spent two weeks in Europe celebrating our 10th wedding anniversary with two of our closest friends. For a few days, we stayed with our friends' family in Italy. They own part of a large paper manufacturing company, and for multiple generations, the business has provided the family with significant wealth and a comfortable lifestyle -- but it's obvious that the next generation won't be so lucky. In addition to being excellent hosts, the family was also gracious enough to entertain my questions about the state of the business. The one thing they said that struck a nerve (and partially inspired this Memo!) was, "We knew this was going to happen – it's not a surprise -- but we didn't think it would happen so fast."

It's easy to dismiss conversations about technology and innovation as the domain of speculative growth investors, but it's risky to ignore the ways your investments might be disrupted by the next new thing. Though at *Pro*, we search for businesses with strong competitive advantages, all companies fight the winds of change. As we enter another earnings season, it's just as important to try to imagine the trends that will drive a company's next three years as it is to focus on how it performed over the past three months. I'm looking forward to an update on how our collection of businesses is performing, but I'm just as excited to hear from the *Pro* community about where you see the groundwork being laid for the next boom -- and who you imagine those winners and losers could be.

Thoughts? Bring them to our Memo Musings board. Have a great week, Fools!

Best,

-- Jeremy (TMFTank)

Portfolio Positioning Event: Dec. 1, 2015

Published Oct 8, 2015 at 1:26PM

The *Pro* team held a Portfolio Positioning Event on this page at 1 p.m. Eastern on Tuesday, Dec. 1. The video and text chat are archived below!

Video Transcript

CHRIS HILL:

Hi, I'm Chris Hill joined by *Motley Fool PRO* and *Options* Lead Advisor Jeff Fischer. Thanks for being here.

JEFF FISCHER

Hey, Chris. Thank you.

CHRIS HILL:

Welcome to the *Motley Fool PRO* Positioning live event. Off camera we've got some of our fellow Fools in the text chat room (Ellen Bowman, Billy Kipersztok, Jeremy Myers, and the whole crew). We wanted to first talk through the new hedge trade that members have gotten.

JEFF FISCHER

Right, Chris.

CHRIS HILL:

A brave new world, I think, for new *PRO* members who have been with the service for three or four weeks or so.

JEFF FISCHER

That's right.

CHRIS HILL:

If you're an experienced investor, you're probably experienced in going long on stocks, but as we've talked about before, and as *PRO* members know, the *PRO* portfolio is a lot of going long on stocks, but it's also shorting and hedging.

JEFF FISCHER

So true, Chris. For the past few weeks new members have been getting up to speed. Buying *PRO* Buy stocks and Buy First stocks. Now these are our core positions — the great companies that we plan to own and hope to own for years to really compound our money.

If you only buy our stocks — our long portfolio — you should do well over the years. You should do really well, hopefully. But for those many *PRO* members who want to short and hedge, now is where we start to get into that.

Why do we do all the buys, first? Well, because you need something to hedge, so we assume now if you're going to hedge that you're at least 80% invested with us. That you're mostly invested long and that's why you may now want to learn how to hedge and short, so we issued a new hedge position just yesterday.

CHRIS HILL:

Let's talk about it. We'll get right to it. It's the "set up a put ratio spread on the SPDR S&P 500."

JEFF FISCHER

That's right. Now what we love about this, and what we try to do in *PRO* when we hedge, Chris, is have a low cost and a low drag position. We don't want to pay much to set it up and we don't want it to hit our returns when the market goes up, but when the market falls, we want it to help us. It sounds like we want the best of all worlds…

CHRIS HILL:

You want your cake and eat it, too. That's what it is.

JEFF FISCHER

We do and we always have, and that's largely what this does for us. This is no cost to set up. It actually can pay us a credit to set it up. And if the market goes up, this hedge doesn't hurt us. It just disappears. We get the credit. We can make some income, actually. If the market falls, this hedge comes into play and will buffer the market downturn.

Now how is this possible? It's because there is a small catch to it. We are agreeing to buy into the S&P 500 Index ETF if it falls, in this case, more than 15% or so. So that agreement — selling that insurance out into the market — is what's paying for our hedge at a higher price and that's how we get the best of both worlds. We profit if the market falls anywhere from about 5-15%, but we're agreeing to buy into the index if the market falls more than 15% and we're comfortable with that.

CHRIS HILL:

It seems like for some people there's a little bit of a mental barrier to get over with this type of hedge, because part of it is saying "I'm essentially betting on the U.S. stock market to drop, and just at a gut level I don't want to do that."

But in some ways this is really not all that different than just simply having some cash (which is something I think a lot of investors are used to). Just saying, "Well, I want a little cash on the sidelines." This is essentially the same thing, only putting it to work for you.

JEFF FISCHER

That's true, Chris, and this will result in returns if the market falls. Your cash will essentially grow. Then what we like to do is cash that in, take our gain, and put that money to work in stocks that are now cheaper.

That said, if members do not want to hedge, they don't need to. They can just carry cash. *PRO* right now has about 16% cash and that's a good cash cushion that we'll also look to put to work when prices fall on anything that we want to buy.

So you don't need to hedge, but if you want to, this is a great way to hedge without money out of pocket and without a position that works against you when the market rises. So many hedge funds short the market directly and sometimes we do that. The problem, then, is as the market rises, they're paying more and more for that short. It's a drag on their returns. And the other even trickier thing is when you close that short. When you know to take your hedge off.

This one expires in February and, like I said, it has set parameters where if the market falls 5-15% it pays us. If it falls more than that, we get to buy into the market…

CHRIS HILL:

At a discount.

JEFF FISCHER

At a good discount. And if the market goes up it doesn't matter. We make some income. This expires in February (we set up another one) so it's a great hedge. What you're doing is selling two puts at a lower price — in this case in the report we said $190 — and then you're buying one put at the $200 strike price. So as you see, the proceeds you get from selling the puts at $190 pay for the protective puts. You're short, in essence, so you buy at $200, and that's all spelled out in the report.

CHRIS HILL:

Where is the *PRO* portfolio right now in terms of percentage that is long and percentage that is hedges and shorts?

JEFF FISCHER

A great question. We're about 85% long and with this short we'll be about 15% short, so we'll be about 70% net long. And Chris, since 2012 (going on four years now) we've been about 72% net long on average, yet it's been our strongest four years compared to the market and on absolute terms. So you can be 72% net long and still do much better than the S&P 500. You're doing better with less risk and we love that combination.

CHRIS HILL:

We'll get to some of the questions from members in just a second, but back to the percentages. I'm curious. When you're looking at managing the *PRO* portfolio, do you have a basic number you're trying to hit or at least stay within range of? That 72% you talk of? I'm curious if in four years the portfolio is at a point where you think to yourself, "Uh, you know what? We're a little too long. I've got to focus my attention on finding some hedges and shorts."

JEFF FISCHER

Definitely, Chris, and that's a great question. There are times where we've been 90% net long for a period of months and during that time we really did look for shorts and hedges. But to your first question, I've found that over the last 15 years or so that 70-80% net long should, given the types of companies we're buying, still let you do better than the market. So you have less risk and less exposure, but you're keeping up with or doing better than the market. That's kind of our sweet spot — 70-80% net long.

Now when prices get really attractive, we may be 90-95% long, and when we want to be more defensive, we could be 50% long only. Or we could even be market neutral. With one quick trade we could short an 80% SPY, be market neutral, and just wait it out if we think things are really risky. But about 70% is our long-term average.

CHRIS HILL:

Let's get to some of the questions from members. From Bill who writes, "I'm only about 50% invested so far. Should I set up the hedge anyway?"

JEFF FISCHER

Great question, Bill. Do read the SPY report. That spells out our guidance there, as well. But our thought is if you're at least about 80% long, then set this up, because it will take you 10% lower long down to about 70% and that's where we want you to be if you're following *PRO*. But if you're already less than 70% long, you don't need to set up this hedge. You can wait until you buy more stocks and until you're more exposed to the market.

The hedge is really about your market exposure and managing it on a whole.

CHRIS HILL:

A question from Cheryl. Should I do the December and January options you have in the portfolio?

JEFF FISCHER

A great question. Today we issued the *PRO* Portfolio Positioning Report — just recently issued it — and there's a lot there. It spells out all of our current options, all of our current shorts, and our hedges, as well. We're saying to now hold off on the December and January options on Gentex and Wells Fargo, because here we are at December. December will expire very soon and January, as well. We've made most of the income on those puts. When they expire we'll have new ones. We expect to issue brand new ones for everybody, including new members, so that's when you can jump on board.

There are a few options that are currently recommended and that's in the Portfolio Positioning Report. You can buy calls on American Airlines and buy calls on American Tower to start.

CHRIS HILL:

You can also short Caesars Entertainment.

JEFF FISCHER

So the Portfolio Positioning Report also spells out three shorts that you can short to join with us. One is Caesars Entertainment, the country's largest casino operator. They are, unfortunately, basically insolvent. They tried to rejigger their whole business and put all the debt into a new subsidiary that they then put into bankruptcy hoping to keep the parent company safe from all that. Right now the courts are deciding whether all the maneuvers they did were legal. To us they don't appear to be legal. It appeared to be a calculated maneuver to shove all the debt off to somebody else and keep the owners safe in their parent company.

We don't know that it will work out. If it doesn't work out, the stock could basically go to zero. Caesar's parent could claim bankruptcy. If it does work out, then the stock will probably stick around to where it is or go up a little bit and we would close our short. So far we've made about 30% on the short. We still think it's a good short for about a 0.6% position.

CHRIS HILL:

Is that always the goal with a short? We're looking for this thing to go to zero? Or are there times in the *PRO* portfolio where you've shorted a company simply because you and your team have looked at it and said, "You know what? This is way too overvalued. This is going to come down. It might not go to zero, but this is absolutely going to come down from where it is."

JEFF FISCHER

We try to do a combination of both. That said, shorting on valuation is much more difficult. We could be missing something. We could be wrong. But sometimes we'll short something hoping to make 20-25% on a value and fundamental space argument. But frequently we're looking for really flawed or greatly under-fire companies like Caesars or World Acceptance (which is now on hold as a short). Or Five Below, which was more a valuation short. But generally we're looking for companies that have flawed businesses at prices that shouldn't be sustained.

CHRIS HILL:

A couple of questions from members about the portfolio itself. From Ed who asks, "How long should I take to buy all the *PRO* stocks?"

JEFF FISCHER

A good question, Ed. You can take your time. We always advise patience. Gradually move into them. Or some members have joined and bought them all at once — just buying all the Buys and Buy Firsts in our allocations to get up to speed and then get on with their lives. That's fine, as well. But if you want to take your time and space it out over several months, or a few earnings reports, you can do that, as well.

CHRIS HILL:

From Dennis, who writes, "I own stocks from *Stock Advisor* and with some *PRO* stocks I'm now 100% invested. How do I buy more *PRO* stocks?"

JEFF FISCHER

A good question. A lot of members have asked this on the discussion boards, too. Go to the Making Pro Fit You board and ask any question. But right now our answer to that is do as you've done. Sell your least favorite holdings from previous services. You don't need to sell things you love. Why would you want to? But sell things you really don't like and then move into the *PRO* stocks that you like better.

And again, you can take your time. If it takes a year to do this or longer, that's fine. If you end up with a hybrid *Stock Advisor*/*PRO* portfolio, that's also fine. The key is that you like everything that you own. And then with the strategies that you're learning in *PRO* (ways to hedge and short, and options) you can overlay that onto any long stock portfolio that you like. That's the great thing.

So you can be 100% long in *Stock Advisor*, *Million Dollar Portfolio*, and *PRO* combined stocks, and then use *PRO* strategies to put on a 20% hedge and get yourself to 80%, say. So you don't have to only own *PRO* stock investments for the long term. You can own some other stocks, as well.

CHRIS HILL:

And that's something that can be difficult to do initially looking at your portfolio, particularly if there are holdings that you've had in your portfolio for a while. But if you can get over that mental hurdle — just look at them and ask yourself from this point forward which ones you feel the best about over the next five years — if you can do that and push aside when you bought them, and how much money you might have made with them, and you just start from today looking out over the next five years, then it's a little bit easier to say to yourself that one in particular has had a good run but you don't feel as good about it for the next five years.

JEFF FISCHER

That's true, Chris. And also keep in mind your tax situation. Taxes are a real cost. If you're in a taxable account and you have some large gains in Disney or Netflix or something, be careful about selling those and incurring a large tax bill.

CHRIS HILL:

A question from Linda. "Can I set up the new SPY hedge in a few weeks?"

JEFF FISCHER

You can. The good thing about this hedge — there's guidance in the report that tells you how to adjust it. If the S&P goes up a few dollars per share or down a few dollars per share, when you go to set up the hedge, adjust your strike prices by a similar amount. By a dollar or two lower or higher. The key is to keep a spread of about $10 between your upper and lower strike price, and to try to get a credit when you set this up. So even if SPY is higher or lower, you can approach the trade later. Just adjust by the same amount up or down on your strike prices.

CHRIS HILL:

And you just mentioned a moment ago the discussion boards for *Motley Fool PRO* members and the idea of making *PRO* fit for you. This is so important because there are all of these recommendations from you and the team, but it is important for members to make it their own.

And particularly at the end of the year when I think about Linda's question. Every year like clockwork, once we get into December, then you have the mainstream business media talking about, "Wow. Historically this is what happens in December." Or, "This is what happens the week between Christmas and New Year's." And even more than usual as investors we're bombarded with the stats on what happens to the S&P 500…

JEFF FISCHER

That's so true.

CHRIS HILL:

…and that's where the discussion boards become this safe haven where you can go to shut out the noise from the mainstream financial media and just focus on what's going to work for you.

JEFF FISCHER

It's a great point, Chris, and you'll also hear a lot, at this time of year, about rebalancing. *Sell your winners and move into energy* or whatever was beaten down this year. We don't do that in *PRO*. We use December as an opportunity to make sure we love everything we own. To maybe take some losses on things we don't like anymore to offset the gains we've had this year (or partially offset them).

We've had a good year, but we don't rebalance just as a matter of course. We don't believe in that. We like to let our winners run. That's a Fool-wide belief. Let your winners run to the extent that you're comfortable doing so. Don't move into losing industries just because they're losing. They may lose for a long time.

I don't have great confidence in energy now, any more than I did before. We don't own it in *PRO* — energy as a whole. I don't know that we'll move into it. I think there are so many energy sources coming online that energy pricing may stay down for quite a long time, for one example, anyway.

So use the boards to make sure you're comfortable with your portfolio at the end of this year and going forward, but don't rush. You don't have to rush. You need to make *PRO* fit you exactly [00:16:25].

CHRIS HILL:

A question from John. "How do I use ideas from *Motley Fool Options* alongside *Motley Fool PRO*?"

JEFF FISCHER

A good question. *Motley Fool Options* is *PRO's* sister service and for the life of your *PRO* membership you get *Options* free. It's a great complement. A great community over there, as well. All *PRO* members have access to *Options* and then you have a large *Options* community, as well, that is only in *Options*.

So use that community, as well. Use the ideas as a complement to your *PRO* portfolio. The *Options* ideas are all vetted by the team, myself, and Jim Gillies. They're all from us. We like them just as I like *PRO*. That means those ideas make good sense next to *PRO*. If you're looking for extra income, extra leverage, or things like that you can add those options onto your *PRO* portfolio.

CHRIS HILL:

We've talked about this before and a couple of the members have indicated this with their questions about timing. With *Options*, as with *PRO*, you don't need to rush. That's another thing that we have to fight against — the popular concept that options is this frenetic trading vehicle when really, the way you and the team use options, it's much more, dare I say, boring.

JEFF FISCHER:

Yes, it's true. And especially new members, and people new to *Options* think they have to rush in and get a certain price. Get the price that's in our published report. But that's not true, and as you learn how options work over time, you'll see that you can just adjust the trade a few weeks or even a few months later. Use a different expiration or use a different strike. You can still express the same belief about a position and get equally good pricing, even down the road, so take your time.

CHRIS HILL:

Can we go through some of the positioning that's been communicated to me so far? I mean, we talked about Caesar's…

JEFF FISCHER

Yup…

CHRIS HILL:

…but I'm wondering if we can spend just a couple of minutes going through some of the other Positioning Report.

JEFF FISCHER

Yes, it's a large report, Chris, and it was just sent today so take your time. Read it and get to know it and let's talk through some of it today. We have three active shorts. Caesar's is something you can short now. The euro — the CurrencyShares Euro Trust. We've been short that since 2011.

CHRIS HILL:

I was just going to say. For a good few years.

JEFF FISCHER

A long time. We're up about 20%, but the euro could still fall further to the dollar as our interest rates go up and Europe keeps its stimulus on. That should lead to a stronger dollar and the euro could, dare I say, get down to $0.90 to a $1.00, from $1.04 right now. That should be a great time to go to Europe.

CHRIS HILL:

And we talk about ways to use hedging. This trade is essentially a hedge against all of the U.S. companies, and it appears to be a growing list. Over the last six to 12 months as they've done their quarterly earnings reports, one of the things we've heard over and over is "These results would have been better, but the dollar is so strong." It's like if you want a way to play against the strong U.S. dollar, here's one of them.

JEFF FISCHER

That's so true, Chris. That's a great point and this position has helped a bit in that regard. But you saying that makes me realize we probably could have made this position larger a year or two ago as more and more companies complained about the weak euro. But it's been a good short and it may still be a good short. We think it still is. Your rewards may not be as large as we've had so far, but they're still worthwhile potentially.

And the other good thing about this short is it's very unlikely the euro is going to soar against the dollar, so it's a relatively low-risk short.

CHRIS HILL:

In terms of the options — I think you mentioned this earlier — American Airlines and American Tower.

JEFF FISCHER:

Those are two simple call options you can buy — 2017 to target upside in these two positions. They're small — they're about half a percentage point each — and we believe in them. You're getting a good price on American Airlines. The stock is down since we started this position about a year ago, so you get a better price than us. And American Tower — you get about the same price we paid and you're then positioned for extra upside in those shares. We also own shares of American Tower and recommend, of course, that you buy shares, as well.

CHRIS HILL:

And then in terms of the rest, there's some pretty big names out there, and two of Warren Buffett's favorites in Coca-Cola and Wells Fargo.

JEFF FISCHER

That's right. Right now they're on hold. All the rest are just on hold. Coca-Cola — our options expire in January of 2016. We're not sure if we'll turn that to stock or not, yet, here in *PRO*, and so we're asking you to hold off on that for the moment. That said, if you set up the Coca-Cola position in *Motley Fool Options*, that's a fine complement to *PRO* and you can keep following that service.

Wells Fargo — we recommend the stock here in *PRO*. We hope you've bought shares. And we also, as we talked about at the outset briefly, wrote put options for income on Wells Fargo. Those expire very soon, so hold off on that. We've made most of that money already. We'll write new ones, soon, and invite you in with a brand new trade alert at that time.

CHRIS HILL:

Again, I love seeing the complex, in-the-weeds business right up against the everyday, everybody-knows-it business and in this case it's Tupperware.

JEFF FISCHER

Tupperware. A stock that's on hold right now. We first bought those shares in 2009 or 2010. Made good money on them. Sold them, because they looked inflated. Then the stock started to fall and we bought back in, but we bought back in too early, and now we're down about 20% on those shares.

But the more worrisome thing — the market does that sometimes — is the way management is spending money. They borrowed a lot of money to buy back shares, so we're making sure we want to stick with this management team. The stock is on hold. We'll have an update in December for all members, and if we believe we want to keep it then we'll tell you to buy shares. They do look cheap. But if not, then we'll use that as a tax loss and sell it this month. But we'll know very soon.

CHRIS HILL:

Management is something that I think members who have been with The Motley Fool for a long time have come to expect out of you and the other analysts and advisors. We do look at management. It does matter. At the end of the day, it is human beings that are running these businesses. I'm curious to what extent you and the *PRO* team look at management — if management becomes a bigger X factor when you're thinking about shorting a stock or if it's the same consideration whether it's *we're going long on this. We're shorting*. Whatever.

JEFF FISCHER

That's a great question. It does become a bigger factor. It can, naturally, when you're shorting something, because you're really looking for management that seems to be off balance or doesn't have a good strategy. May be outright failing at what they're doing. And that, when you spot it, is unfortunate to see, but also kind of fun to see as a short seller. *We have these guys by the tail. Let's short this company.*

But it's equally important with the companies we buy. We have "8 Qualities of a *PRO* Company." Chris, you know of that list. And one of the qualities is management. We want management that has a clear vision and consistently executes on that vision. So, yes, management is important whether we're going long or short.

CHRIS HILL:

Before we wrap up, I'm curious. What can members expect from *PRO* in 2016?

JEFF FISCHER

It's a great time of year because new options are coming out for 2018 and we're looking at those. We're looking at new shorts to replace some of these that we're closing just recently that members saw. And we have this new hedge that we're setting up now. We'll probably set up another one to complement this hedge that expires a different month. And we have 16% cash, so we're looking at new buys.

So we have a wide array — a wide docket — of things that we're really interested in and excited about that we'll roll out soon. It should be a good end of the year. It's one of my favorite times of year — the end of the year — to really reassess everything you have (which we've already done with all of our Buys and Buy Firsts) and then prepare yourself for the next year, and get yourself where you want to be. It's a good time to be building your portfolio with us, because that's what we're doing, and it's a fun time to look at new shorts and new longs.

CHRIS HILL:

In terms of the stocks that you're thinking about going long on, are there particular industries that you're looking at? It sounds like energy is not on the list. And if you think back that was one of the big narratives one year ago this week — looking at how the price of oil had fallen so much…

JEFF FISCHER

Yeah. It did collapse.

CHRIS HILL:

…and what we were going to see in 2015, et cetera.

JEFF FISCHER

A lot of people thought, "Here's a buying opportunity," and now those energy stocks are much, much lower than they were a year ago. We are, though, looking at energy. We won't write anything off and we may, very well, find something we like that makes money in a tangential way from energy. We bought energy after the BP oil spill and made a good return on that, so we'll see. Our sweet spot is financials, technology, and now healthcare, as well. Those are three areas we're really looking as well as consumer-oriented businesses.

The other thing we're always looking at, Chris, is monthly income. Our goal in *PRO* is also to generate income every month. So we'll be busy, as ever, and yet hopefully in our own calm, steady, no-rush, no-stress way.

CHRIS HILL:

Before we wrap up this event — and we will keep the text chat going, by all means — any concluding thoughts for the members who have been on board for about a month or so?

JEFF FISCHER

Yes. Welcome. We hope you're enjoying your time with us. Please read the Portfolio Positioning Report. Post any questions you have. If you're feeling like you're not yet on your feet, or you haven't yet started, go to your *PRO* home page and fill out the survey there. Use the tracker to help you get on track — on your own track.

Then ask any questions you have on the boards. We're there to help. Especially with this new hedge, I know it's an intimidating-looking trade, but once you get it, it's a really potent tool to have in your toolbox and it's pretty easy once you do it a few times.

So whether it's shorting, options, or hedging, we're here to help. Take your time. The key is that you'll be about 80% invested in stocks now or soon. That's where you'll really compound money over the long term and that gives you time to learn to hedge, to short, and to use options with us. So thank you for being here.

CHRIS HILL:

Thanks everyone for being here. As Jeff mentioned, check out the discussion boards. We'll keep the text chat going for a little while longer, but we're here 24/7, particularly on the discussion boards. On behalf of Jeff Fischer and the entire *PRO* team, I'm Chris Hill. Thanks for watching. Fool on!

[End]

Pro Catch-Up Trades: Oct. 5, 2015

Published Oct 5, 2015 at 3:13PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

Pro's Buy First stocks are worth adding to your long-term portfolio:

- **American Tower** (NYSE: AMT), 3.4% in stock and 0.5% in January 2017 $80 calls
- **Gentex** (NASDAQ: GNTX), 2.8% in stock and 1.5% by writing ("sell to open") December 2015 $15 puts
- **Gilead Sciences** (NASDAQ: GILD), 3.6% in stock
- **Oracle** (NYSE: ORCL), 3.7% in stock
- **Wells Fargo** (NYSE: WFC), 3.6% in stock

There's also:

- **Apple** (NASDAQ: AAPL), buy up to 4%
- **Skyworks Solutions** (NASDAQ: SWKS), buy up to 4%
- **Parexel International** (NASDAQ: PRXL), buy up to 3.2%
- **Medtronic** (NYSE: MDT), buy up to 2.9%
- **Tupperware** (NYSE: TUP), buy up to 2.1%

And then there's our airline investment, characteristically (of airlines in the past) deep in the red. But we're still believers in the value here. Members who lack a stake can take note of this recommendation:

- **American Airlines** (NASDAQ: AAL): Buy to open 0.5% to 1% in January 2017 $30 calls.

And our new hedge:

- **SPDR S&P 500** (NYSEMKT: SPY): To adjust the put ratio spread for the jump in the index if you haven't made the trade yet, now sell to open two Nov. 20, 2015, $179 puts and buy to open one Nov. 20, 2015, $187 put. You can do so for a small credit, lately. This is only an $8 spread, and at higher strikes, but still complements our October hedge well. For more details on allocation, see our recent trade alert.

Pro Live Chat, October 2015

Published Oct 5, 2015 at 1:34PM

Join us at 1 p.m. Eastern on Wednesday, Oct. 21, for our monthly live chat!

A Fireside Chat With Member fullofcarp

Published Oct 5, 2015 at 9:36AM

Dear *Pro* member:

When we asked you, our community, to name your favorite community member for *Pro*'s 2015 Polaris Award, you gave the victory to Bill (fullofcarp). Bill has been a *Pro* member since the beginning and is an institution on the *Pro* boards, helping others and sharing his investing thoughts. As when RockyTopBob won the inaugural Polaris Award and aleax won the second, we were delighted to see fullofcarp take the honor this year. Thank you, members! And congratulations, Bill!

Today, we have the pleasure of spending some time talking with Bill about his life, his investing, and his passions. We hope you enjoy the interview! -- Jeff

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Q: Bill, please tell us about where you grew up. What about your younger years influences you most today?

I grew up in a redwood forest in California where my dad was the head ranger. When my humor falls flat, I blame it on the fact that I grew up mostly talking with raccoons and squirrels and deer (and occasionally with rattlesnakes and scorpions) and not with people!

I learned from very early on to take care of the forest. Because some percentage of visitors were either incapable of or unwilling to pick up after themselves, it was the responsibility of the rest of us to do more than our "fair share" (e.g., picking up trash) to ensure it didn't deteriorate over time. Today, I view my role in society/on the planet in the same way, especially as somebody blessed to have grown up and lived in such a wealthy, privileged country. I feel a deep sense of responsibility to pull more than just "my own" weight on a regular basis.

Q: Why did you start to invest in the stock market? What was your dream? And do you remember your first purchase?

During the dot-com bubble, I invested in some high-flying tech companies. I temporarily made some huge paper profits, then eventually lost it all (and then some, since I added during the descent) during the bursting of the bubble. Then eight years went by when I didn't think about investing very much. I think back on those years and wish that I'd done much, much more. Unfortunately, at that time I didn't have any money available for investing. Since then, I've tried to make up for lost time. I'm hoping to be able to retire "early" (within one to three years, having just turned 60), and what I've learned from *Pro* is a major reason that I believe I can do it.

As to the first purchase, I honestly don't remember which was the first one; all of those original ones were disasters. My memories of *Pro* purchases are much stronger.

Q: How has your investing approach changed over the years?

Before I started to follow TMF about eight years ago, I really had no plan. I understood that I should have one, but did not. Then I spent a few years following TMF recommendations, but relied solely on my first impressions with a particular recommendation without spending any serious time thinking about it. Finally, for the past five years or so, I've been giving enough thought to each recommendation so that I'm comfortable with it, including thinking about how a particular idea fits in with the rest of my existing portfolio.

Not including hedges and tactical trades (e.g., volatility trades), I've had between about 20 and 80 different positions open over the past five years. Currently, I have what I consider to be 28 core positions, plus three hedges and 12 speculative positions. For me, this is a manageable number, and the mix suits me very well. I have *Pro* to thank for my willingness to make those hedges and for the inspiration and confidence to take suitable risks using options with my speculative positions.

Bill with his girlfriend, Maria Susana, in [Tayrona National Park](), Colombia.

Q: Bill, what first drew you to the Fool, and what keeps you here?

After the dot-com bust, I joined TMF as part of a New Year's resolution on Jan. 1, 1999, but didn't really do anything with it. It wasn't until I had some investable money eight years later that I started to rethink the mistakes that I'd made during the dot-com era and started doing some reading. I realized that I needed some guidance, and the overall Fool philosophy made sense. Even so, until recently, I hadn't actually dug very deeply into comparisons of different approaches. Now, after trying out a few different Fool services and understanding the sometimes significant differences between them (part of the "Motley" part of TMF), I've now found a mix of things that work for me. My current mix of *Pro* as a solid foundation plus more risky positions that have been recommended by Tom and/or David Gardner is something that I can't imagine doing without.

Q: You've been a member of *Pro* since 2008. Why, Bill, why?!

I was one of the original members of *Pro* when it first started in the fall of 2008 — I confess that I fell victim to the Fool marketing menace. [Ed. note: We're glad it worked, as long as it rewards you!] Maybe I'm still the victim of mind control and that's why I'm still here.

I had been a member of another Fool service that had fared quite badly during the 2008 market collapse. *Pro*'s goals of steady returns with a balanced portfolio suited my perspective at that time, and the idea of using options in particular appealed to me. One of my Ph.D. minors is in finance (including option pricing theory), but I had never done anything with finance in the years since. However, the combination of those old memories and my math abilities (I am a self-described "recovering mathematician") has meant that the technical details of what *Pro* does with options and shorting come easy to me.

I don't, however, have any desire to do deep fundamental analysis, and so I rely on that work by *Pro*. I often apply my own different options strategies to the ideas of particular stocks and ETFs that *Pro* provides. I guess that to some degree it's simply the case that I have a deep sense of loyalty to Jeff and his teams of advisors over the years because they have truly changed my life for the better.

Q: The community voted you as the most valuable community member. What has the community given to you over the years?

The *Pro* discussion boards are a very enjoyable hobby for me, and the *Pro* community feels like a part of my family. Even though I've spent a meaningful amount of time in person with only a small number of Pro members, it feels like home.

As [fellow *Pro* Fool] phooLon has written, I think the boards provide an outlet for the itch that remains from my former days as a college professor. And as with the more traditional forms of teaching, I believe that this has greatly helped me, and that I've gained at least as much as I have helped others. Staying active on the boards is not only my hobby, but it keeps me engaged and educated with my investments. As is probably obvious to anybody who has read very many of my posts, I often stray from the formal *Pro* recommendations, adapting the basic idea but using different strategies (usually involving options) that fit my own situation. Since that includes frequent adjustments to the option positions (which is sort of equivalent to trading stock shares around a base position), staying emotionally active is important. *Pro*'s community energizes me on a regular basis.

But I'm also keenly aware that what I do is probably inappropriate for most members, and in keeping with "the Motley," I trust my handle and signature to remind readers to not take me — or any other poster for that matter — too seriously. We must all choose our own path and accept personal responsibility for our actions.

Q: If you could give one sentence of advice to your fellow investors (and you can right now!), what would it be?

Patience: This is a marathon, not a sprint.

The longer version: If there's anything that you don't understand, you should consider two options — take your time and learn the topic better before making any investment in anything related to it, or else skip it entirely if you don't have the time or inclination to learn more.

There is no one investment that is so magical that you absolutely MUST make it, certainly not immediately. If you aren't comfortable with an investment position and it (inevitably, eventually) turns against you for a while, you will have a very high risk of doing the wrong thing in reaction to it. Emotions often trump logic in times of stress. And even if you make the right decision, you'll likely be very emotionally stressed, and that's not a good thing. Only if you are comfortable with a position will you remain calm and take the time to do things right. This does *not* mean that you have to do deep fundamental analysis. Personally, I leave that to the *Pro* experts. But I always try to understand the fundamentals at least enough so that I'm comfortable with a particular recommendation before making a trade.

Very well said, Bill. Thank you so much for your time today, for your thoughtful responses, and for being a Fool with us! We'll see you on the boards!

Updated *Pro* Performance

Performance as of 9/30/2015

	Annualized		
	Since Inception	Rolling 3-Year	YTD
Pro Portfolio	**13.5%**	**19.6%**	**4.8%**
North Star	**8.3%**	**8.1%**	**6.8%**
S&P 500 Total Return	11.3%	12.4%	-5.3%
MSCI World	5.7%	6.4%	-7.5%

*Start close of 10/6/08.

Put Ratio Spread Trades on the SPDR S&P 500

Published Sep 29, 2015 at 3:32PM

Is this for you? At *Pro*, we use hedges to earn returns during a meaningful market decline. You don't need to hedge to succeed with *Pro*, but if you are at least 80% invested in stocks and want to hedge against a market decline, then consider following along. Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $200,000. **If, like us, you have the Sept. 30 put ratio spread, you could potentially "sell to close" your Sept. 30 $185 puts by expiration to capture some value. Leave your October put ratio spread alone.**

How You Participate

- **Action:** First, if you have our Sept. 30, 2015 put ratio spread in place, you can "sell to close" your Sept. 30 $185 puts by the close of business on Wednesday to capture any value. Wait until the last minute if you believe the index could keep falling. Then, set up this new put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF once you're certain the Sept. 30 one is expiring.
- **Allocation:** Nine percent of your total portfolio value, measured on the look-through value of the $181 puts you're buying (each put represents $18,100 in hedge value). Set up one 2:1 put ratio spread for every $200,000 or so you manage and want to hedge; hedging 9% of its entire portfolio, *Pro* will sell 24 puts and buy 12.
- **Trade:**
  - **Use a ratio spread order to simultaneously ...**
  - Write ("sell to open") **two** Nov. 20, 2015, $171 puts, and:
  - Buy ("buy to open") **one** Nov. 20, 2015, $181 put. Click "view all" at your broker to see all strikes.
- **Price Guidance (3:15pm ET):**
  - Sell to open **two** Nov. 20, 2015, $171 puts: Lately $2.32 x2 = $4.64 credit
  - Buy to open **one** Nov. 20, 2015, $181 put: Lately $4.45 debit
  - **Net credit:** Lately about **$0.21** credit per spread -- but this price will change; as prices change, just aim for a credit, or close to no cost, using a limit order.
  - SPY price: $187.50
  - **Potential Adjustment:** If SPY moves much in price before you set up your trade, you may want to move your strikes down or up accordingly, as much as SPY has moved, while still aiming for a credit. We will make just such an adjustment if need be, and tell you about it.

Note on our existing spreads: Our Sept. 30 spread is on track to expire, but lately you can sell to close the $185 puts by expiration to capture some value. Our October spread should be left alone for now. We'll address it near expiration.

What We're Thinking

At *Pro*, you know that we aim to have winners in down, flat, and positive markets -- and that means we need to address all three possibilities at once in the portfolio. A hedge on a market index is simply a hedge against a lower market. We generally don't care about declines of 5% or less, but when *Pro* is functioning as desired, declines of about 10% or more should result in some of our positions, like these spreads, becoming profitable. At the same time, the put ratio spreads we use are:

- Harmless to us if the market goes higher (they don't harm our return)
- Typically cash-free to set up (they can even pay us a small credit)
- Relatively low probability of loss

What's the trade-off? As with any written put, we need to be ready to buy the underlying investment; for today's trade, that means being prepared to buy shares of SPY via these hedges if the market falls too sharply, generally more than 15%. In this case, if the index falls more than 14.3%, this November hedge becomes a liability, with SPY falling below our breakeven point. If that happens, we would plan to buy long-term call options on SPY instead of shares, saving most of our cash in the process. See below for details on that.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2,394,000

- Nine percent of that value: $215,460
- Nov. 20, 2015, spread:
  - Buy to open $181 puts. Twelve contracts representing 100 shares each = $217,200 in look-through exposure, or a 9% hedge on our current portfolio value, cash included.
  - Sell to open $171 puts (24 contracts, half of which become a potential obligation, currently a 8.6% possible stake).
  - At home, you would buy one $181 put and sell two $171 puts for approximately every $200,000 in portfolio value you want to hedge ($18,100 look-through put value divided by $200,000 = 9%).

Return Details

SPY Price at Nov. 20 Expiration	Value of 1 Purchased Nov. 20, 2015, $181 Put	Value of 2 Written Nov. 20, 2015, $171 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Recent $189 (the SPY price has changed by 0.7% prior to publishing, to $187.50, but this table reflects $189)
$181 or higher	$0	$0	$0.21 gain per spread, or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 4.2%
$176	$5 x 100 = $500	$0	$500	(6.9%)
$171	**$10 x 100 = $1,000**	**$0**	**$1,000 (max profit per spread)**	**(9.5%)**
$168	$13 x 100 = $1,300	($3) x 200 = ($600)	$700	(11.1%)
$165	$16 x 100 = $1,600	($6) x 200 = ($1,200)	$400	(12.7%)
$161	**$20 x 100 = $2,000**	**($10) x 200 = ($2,000)**	**$0 (breakeven)**	**(14.8%)**
$155	$26 x 100 = $2,600	($16) x 200 = ($3,200)	($600)	(18%)
$150	$31 x 100 = $3,100	($21) x 200 = ($4,200)	($1,100)	(20.6%)

Our maximum profit is earned on this November spread if SPY declines 9.5% from its current level of $189. The spread will help us a little on a decline all the way to about 14.8%; beyond that, our short puts turn into an obligation that's in the red.

Follow-Up

Assuming we set this spread up for a credit, it will result in a small profit even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $171 put obligation if SPY is below that price by expiration.

However, if that does happen, our plan would be to close our puts and buy long-term SPY calls (or something we like even better, whether calls or stock) instead of buying the ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY itself. So, our potential 8% or so stake in SPY shares will only cost us about 2% of our cash if we buy calls instead. We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases.

How It Fits Into *Pro*

Pro consistently hedges to lower our market exposure, or risk. As you know, we aim to achieve positive returns every rolling three years, and inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market will make a difference. Even small gains add up over the years, especially if those gains are reinvested in depressed stocks. This hedge fits well with our goal of hedging in a cost-efficient way, one that doesn't work against us if the market rises. It does require regular upkeep, though, opening new positions as old ones expire, and staggering our months because these spreads really only help at or near expiration.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:**
  - For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, as we are, "buy to open" Nov. 20, 2015, $181 puts and "sell to open" *an equal number* of Nov. 20, 2015, $171 puts. Recently, this will cost you less than $2 ($200) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $10 ($1,000) per spread on a decline to $171 or any lower price, but you should be prepared to lose your $2 per spread if SPY doesn't decline below $181 by expiration.
- **To lower your market exposure while following our official trade (and make the position possible in some IRAs):**
  - Set up the original put ratio spreads as recommended, but also "buy to open" puts (with the same months of expiration as our two spreads) at strike prices *well below* $171. Buy *half as many* as the number of $171 puts you wrote. When you do so, all of your $171 puts will be "covered" (half by your $181 puts, and half by the other puts you choose to buy at a much lower strike; choose how much you want to pay to select your lower strike price). You will only need cash in your account to cover the difference between your two lowest strike prices, and your risk is capped, making this potentially IRA-friendly. Lately, you can buy the Nov. 20, 2015, $160 puts for about $1, meaning your only risk (and necessary cash reserve) is now $11 per share on half of your $171 puts. And this makes the total cost of your hedge about a $1 debit.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Our Cautious 2015, and What's Ahead

Published Sep 28, 2015 at 3:05PM

Dear *Pro* member:

When it comes to new buy recommendations, 2015 has so far been the quietest year in the history of *Pro* (and *Motley Fool Options*, too!). Today, I'll explain why.

First, to review, we've only issued three brand-new buy recommendations in *Pro* this year:

- Buy calls on **American Airlines** (NASDAQ: AAL), January
- Buy **Visa** (NYSE: V), April
- Buy **Verisk Analytics** (NASDAQ: VRSK), July

Flying Low?

The first new position, buying calls on an airline stock, was an intentionally "contrary" investment; we took on higher risk hoping for higher returns. We invested 1% in call options on a stock trading at about 7 times expected earnings for the 18 months ahead. I argued that once investors begin to believe the airline's profits are sustainable, the stock should be awarded a much higher valuation.

Though oil prices have fallen since our January buy, the thesis hasn't played out yet. Shares are down around 31% since we started our position, and our call options are down twice that. However, I'm not discouraged on the longer-term prospects. Our 2017 calls on American Airlines provide plenty of time for a change in sentiment. And volatility in these shares is actually our friend -- it helps on the way up as much as it hurts on the way down. So, I hope shares remain volatile.

For those lacking a position, today you can invest up to 1% in the January 2017 $30 calls.

Charged Up and Skirting Risk

Issued in April and July, our next two new buys were much more risk-averse. Credit-card giant Visa has opportunities to grow in China and Europe (should it acquire its European namesake), while its core business is enjoying big tailwinds from new account wins with **Costco** (NASDAQ: COST) and **JP MorganChase** (NYSE: JPM). Our thesis also suggested that currency exchange rates would grow more volatile, helping the company's cross-border business. This currency volatility has started to play out. Underpinning all this is one of the most enviable businesses in the world, with a strong competitive moat, inflation-friendly dynamics, revenue growth as the world's wealth grows, and great room to expand as electronic payments replace cash. Visa fetches a premium valuation, but we believe it's merited, and so far the stock is up a bit since our buy despite a much lower S&P 500.

Our purchase of Verisk runs much in the same vein as Visa: We're buying the best business we could find at a price that seems merited. Providing deep data and analytical tools to insurance providers that have come to rely on the information, Verisk enjoys strong recurring revenue and a peerless competitive moat, and it has new growth markets on tap, including the health-care and energy sectors. Adding to our faith in the business, Verisk was able to increase prices and grow sales even during the Great Recession. We started with a 1.7% stake that we'll happily add to over time, believing that Verisk can ride through most any storm and keep growing.

As with Visa, Verisk's share price has held up despite a weak market. With both purchases, we were hoping to buy stability in a weak market and strength in a good market. Both stocks can be bought today at up to 2.3% and 1.8% stakes, respectively.

Why Not More New Buys?

You've probably already divined the reason we haven't been buying anything else this year: We've sought to avoid risk -- or, at least, to keep from increasing our portfolio's risk profile. Why? Because valuations on the stocks we've considered have suggested patience . We're content with our portfolio, and we only want to spend cash on new buys when we're strongly compelled. So far, the above is all that's compelled us! Valuations on most of the new stocks we've considered are at the higher end of an historical range, and today's growth rates are moderate or under pressure. Rather than force a new purchase, we're happy to wait. And we're not just waiting; we're also able to spend more of our time researching short sales and considering options trades.

Pro has issued 12 options trades this year, all of which mainly had a focus on income, including repeat strangles on **Expeditors International** (NASDAQ: EXPD) and written puts on **Live Nation** (NYSE: LYV) (another new name in the portfolio) and **Gentex** (NASDAQ: GNTX), among others. We've also issued shorts on **Boulder Brands** (NASDAQ: BDBD) and **World Acceptance** (NASDAQ: WRLD), as well as writing covered calls on **Coca-Cola** (NYSE: KO), **O'Reilly Automotive** (NASDAQ: ORLY) and others. Covered calls are a low-risk form of shorting, and while in a sense the rewards are also low, they do offer good yields.

We've considered many other new shorts, but our bar is high. We don't want open-ended business risk; the cost to short can't be too steep; shares need to be available in sufficient quantity; and so forth. Beginning a new short position takes us considerable time, though we continue to work on it. Meanwhile, as share prices go down,* the valuations on our list of favorite possible new *long* investments get more attractive, too, so we're watching for opportunities there that we like.

The Big Lesson: Always Be Patient

One of the most important investing lessons I've learned over many years is simply to be patient. Don't act until -- and unless -- you're truly compelled to act. If you don't have strong feelings regarding what to do at any given time, don't feel forced to do anything (assuming you like what you already own and how your portfolio is set up). Because we do like our portfolio, waiting for sweet pitches this year has been relatively easy, and this patience has saved us all money. Even though we're a "newsletter," we're not going to create activity for you unless we're genuinely excited about the positions we recommend for your money. We are willing to wait a long time for that. For another example, not buying into energy has been a good decision so far.

Meanwhile, I know newer *Pro* members are waiting for returns to begin with most of our long positions. Our specific losers aside (for which we take full responsibility!), negative market periods like this are an unavoidable part of investing. Sometimes, the market is stuck in neutral or reverse. As a *Pro* member in these circumstances, ideally you're saving more money and adding to our Buys over time. After all, most of our businesses keep increasing their profits, and eventually the stocks will follow suit.

Other Volatile Positions and What's Next

We're also seeing volatile moves from **Gilead Sciences** (NASDAQ: GILD), **Skyworks Solutions** (NASDAQ: SWKS), and our **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS) ETF. I'm not concerned about any of these. In fact, I'm glad the stocks remain volatile, because that cuts both ways. Biotech and chip stocks have swung wildly on headlines, but both of our businesses in those spaces are performing well. Meanwhile, emerging markets have been in a downtrend that requires patience. I'm glad we haven't bought more lately, although we might eventually.

Overall, this has been a year to move deliberately rather than quickly. The S&P 500 is currently (as of 1:30 p.m. Eastern) down more than 8% for the year. We would have liked to have had more shorts by now, but we're glad we've stayed modest with our new buys this year, and it's best that we remain careful in what we choose to short, too. As we enter the last three months of the year, we hope to add a few more shorts, we'll continue to write options whenever we see a good window, and if prices provide, we're ready to add more buys. We may also trim or cut some losers in a year-end cleanup, if the stocks aren't too cheap to do so.

Update: Our SPY Hedge

Our $170/$185 put ratio spread on **SPDR S&P 500** (NYSEMKT: SPY) is set to expire on Wednesday, Sept. 30. Lately, SPY is $188.60, so our $185 puts expiring in two days suddenly sport a little time value that we could capture (value that will balloon if SPY declines below our strike price). But this value won't last if SPY gains ground in the next 48 hours. We'll have a trade alert out soon to close the $185 puts and, ideally, set up a new put ratio spread in a similar vein expiring some months later.

Meanwhile, our October put ratio spread, which had us buy October $200 puts, is deep in-the-money on those puts, which is nice. Our October $187 short puts (later adjusted to $191 for those who missed the trade) are not yet an obligation (or are only a small obligation that we could just close) if this position were to end today. But we'll keep an eye on that.

Overall, realize that we welcome volatility. It should shake out some good opportunities. But we're not just waiting on that. We'll issue new shorts, options, or -- yes -- longs when we're strongly compelled to. We like how we're invested, and we like that we have optionality ahead of us.

Foolishly,

-- Jeff (TMFFischer)

**Editor's note: Jeff and I both ended up with [this earworm](), so we decided to share it with you, too. Happy Monday!*

Pro Catch-Up Trades: Sept. 28, 2015

Published Sep 28, 2015 at 3:02PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking.*

Pro's Buy First stocks are worth adding to your long-term portfolio:

- **American Tower** (NYSE: AMT), 3.3% in stock and 0.5% in January 2017 $80 calls
- **Gentex** (NASDAQ: GNTX), 2.7% in stock and 1.5% by writing ("sell to open") December 2015 $15 puts
- **Gilead Sciences** (NASDAQ: GILD), 3.6% in stock
- **Oracle** (NYSE: ORCL), 3.6% in stock
- **Wells Fargo** (NYSE: WFC), 3.6% in stock

There's also:

- **Skyworks Solutions** (NASDAQ: SWKS), buy up to 4.2%
- **Parexel International** (NASDAQ: PRXL), buy up to 3.4%
- **Medtronic** (NYSE: MDT), buy up to 2.7%

And then there's our airline investment, characteristically (of airlines in the past) deep in the red. But we're still believers in the value here. Members who lack a stake can take note of this recommendation:

- **American Airlines** (NASDAQ: AAL): Buy to open 0.5% to 1% in January 2017 $30 calls.

Charts of the Week

Published Sep 21, 2015 at 3:29PM

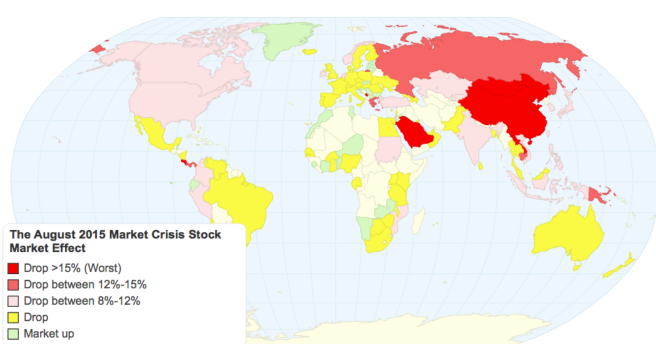
Dear *Pro* Fools,

If you haven't noticed yet, I'm a charts guy. And I don't mean stock charts -- the visual form of stock price and volume data that technical analysts use to try to forecast future price movements. I'm talking about charts in the most general sense: "information in the form of a table, diagram, etc.," as defined by Merriam-Webster.

In almost all of the content I contribute to the Fool, I try to include at least one chart. I love how charts can take large amounts of disparate data and distill it down into something that's visually appealing and easy to understand. In fact, I'm so into charts that on my resume, under Hobbies and Interests, you'll find a bullet point that mentions how I am "interested in [the] development of novel data visualization designs."

For this week's Memo, I thought I'd share my love of charts with you all by showcasing five of the most interesting and market-relevant charts I came across this week while perusing the financial blogs and websites I frequent. Without further ado:

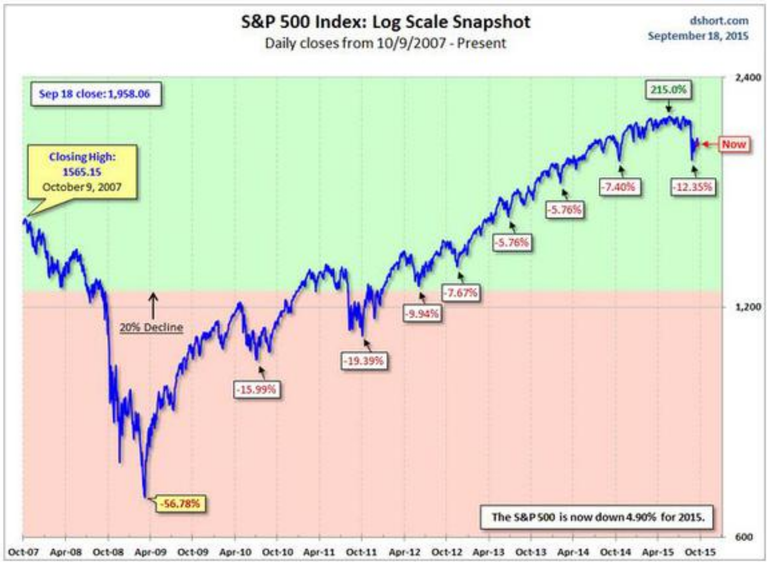
1. The August 2015 Market Crisis Stock Market Effect



via chartsbin.com

This chart shows the percentage change in market capitalizations between Aug. 14, 2015, and Aug. 24, 2015 for countries across the world, in U.S. dollars. The chart is interactive, so if you scroll over it with your mouse you can compare the P/E ratios from before the crisis to after the crisis for each country.

2. S&P 500 Index: Log Scale Snapshot



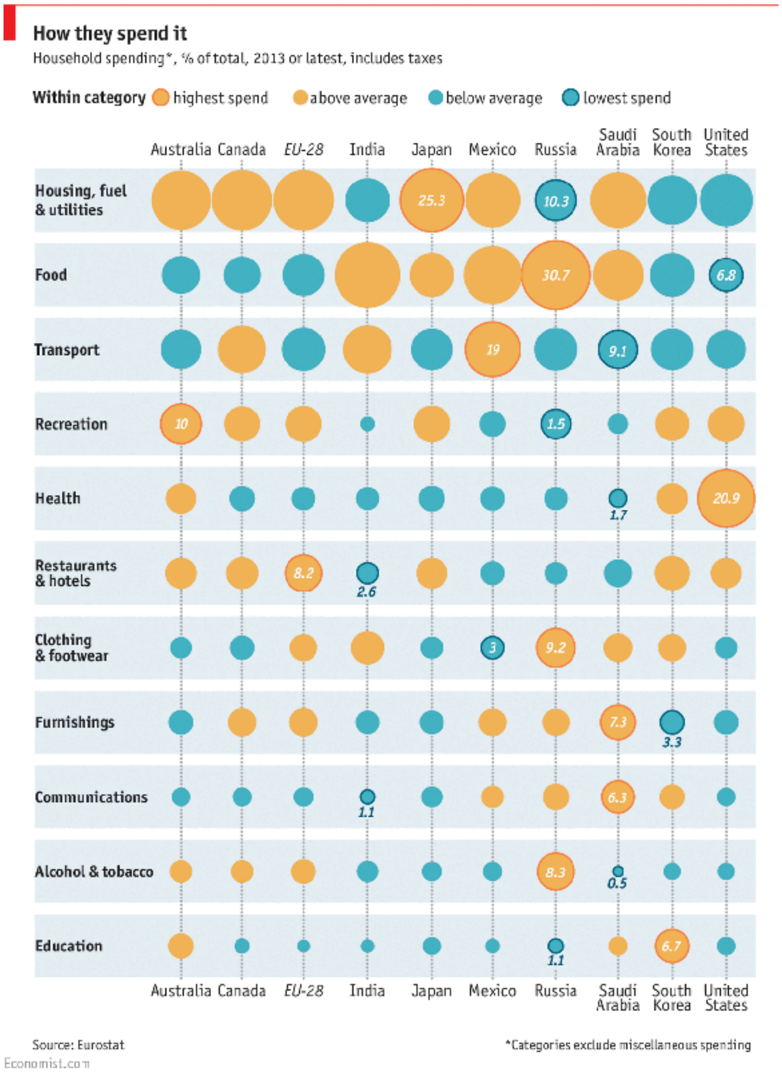
This chart, from Doug Short at Advisor Perspectives, shows the daily S&P 500 closing value, starting with the all-time high prior to the Great Recession. The chart shows major peak-to-trough declines since the lows of the financial crisis, including the most recent -12.35% movement detailed in the interactive chart above. This chart helps provide some longer-term perspective on the recent stock market "crisis."

3. New Home Sales and Recessions

Source: [Calculated Risk]

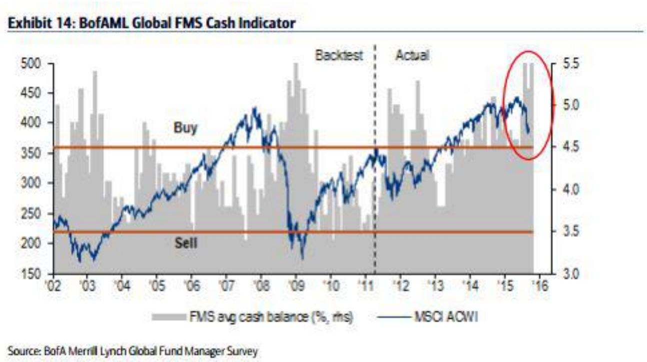
This chart from the blog Calculated Risk compares the Census Bureau's new residential sales data (since 1963) to U.S. economic recessions (shaded in blue). The dashed line represents the July 2015 sales rate. We can see from this graph that while the housing market has recovered from its post-recession lows and is in an uptrend, we are still very far from pre-recession highs. The Census Bureau is set to report August new-home sales data on Thursday, Sept. 24; when the data is released, you'll find it [here].

4. How Countries Spend Their Money



This chart from *The Economist* shows household spending by category for certain countries (or groups of countries, with respect to the 28 European Union nations). For each category, in terms of percent of total spending, you can see which country spent the most (denoted by a large orange circle) and which country spent the least (denoted by a small blue circle). For me, as a United States citizen, the most interesting takeaway from this chart is how much we spend on healthcare relative to the other countries in the chart.

5. Bank of America Merrill Lynch Global Fund Manager Survey Cash Indicator



This chart from the September 2015 Bank of America Merrill Lynch Global Fund Manager Survey (FMS) shows the average cash balance of the funds it contains as a percent of total assets (denoted by gray bars in the chart), compared with the MSCI All Country World Index (ACWI). The FMS contains information from 214 panelists with $593 billion in assets under management. In September 2015, the average cash balance for the managers in the survey increased to 5.5%, which is the highest since the 2008-2009 financial crisis. The chart notes (via the orange-brown lines) that when the balance rises above 4.5%, it's a contrarian buy indicator, and when it declines below 3.5%, it's a contrarian sell indicator.

The *Pro* Bottom Line

There you have it, Fools -- the top five charts of the week from your self-professed "charts guy." Even if you don't share my enthusiasm for the visualization of data, I hope you've at least learned something new from these charts. Have a wonderful week, and Fool on!

Best,

Oracle's Cloud Biz Is Gaining Momentum

Published Sep 18, 2015 at 11:03AM

For long-term **Oracle** (NYSE: ORCL) shareholders, the company's gradual transition to a cloud-based SaaS business has been painfully slow. We keep waiting for that big, breakout quarter to prove that the business has turned the corner-and it looks like we'll be waiting at least another three months. Oracle continues to grow cloud sales at a rapid pace, analysts continue to prod management for more details about the economics of the cloud business, and the stock continues to trickle down as investors gradually lose patience with their investment. Currency swings are once again a significant headwind for the business, resulting in a 9% drag on total sales and $0.06 knock on earnings for the quarter. Thankfully, at least in this instance, Oracle doesn't have a very big presence in China, so the recent turmoil there had a negligible effect on the company's performance. Though Oracle's stock sold off modestly following the earnings report, we still think there's a lot to like about this business.

The strong growth of the cloud-based SaaS and PaaS business continues to be the key to our long-term thesis, and that part of the story is very much intact. Though on-premises revenue was only up 4%, with most of the gain coming from software updates and product support, cloud revenue grew by 34% and cloud bookings increased by 165%. Management attributed the growing momentum in cloud sales to a number of factors, including the completion of a full product suite to offer customers, better trained sales staff, and most recently, the translation of the software into more languages allowing for sales across to more regions.

Based on contracts already in place, management expects revenue growth to accelerate in the second half of the year and for annual cloud sales to grow 50% year-over-year. A portion of this growth will come from existing customers that signed up a year or two ago with promotional pricing that is beginning roll off. By comparison, on-premises is expected to only grow modestly at 0% to 2%. Though we'd like to see this cash cow part of the business growing at a faster pace, the fact that the licensing business is holding steady means that Oracle isn't cannibalizing its installed base to drive growth, nor are cloud competitors making significant inroads with existing customers.

Also, capital expenditures are expected to decline significantly in the second half of the year following the massive spending needed to to launch the full suite of cloud products and fund the infrastructure build-out (a 90x increase in data capacity over the past three years) which needed to be in place before the company could grow it's cloud business. Also, for the first time management shared that the cloud gross margin is expected to hit 60% by end of the year and 80% within two years as the business rapidly scales.

As Competitive As Usual

As always, Ellison and Hurd made sure to draw comparisons between how the company is performing versus competitors **Salesforce.com** (NYSE: CRM) and **Workday** (NYSE: WDAY). In human capital management (HCM), Oracle doubled the new customer count at 166 and 200 new enterprise resource planning (ERP) customers added is more than Workday's lifetime sales. For the year, management expect to book between $1.5 billion and $2 billion of SaaS and PaaS business, between 50% higher and double what Salesforce.com expects to sell this year.

Oracle's key competitive advantage is its unique ability to allow customers to have both on-premises and cloud-based running at the same time and allow companies to move their data seamlessly between the platforms. According to co-CEO Mark Hurd,

"The major differentiation for Oracle that nobody else can do is we can actually do this on-premises for you and do it for you in the cloud. And we can do it at the exact same time. We can deliver to you a capability in the cloud and we can deliver the exact same capability to you on-premises and move those workloads back and forth, whether that's Database as a Service, some dev tests, dev testing our cloud into your data center to run your production applications. It's important to understand, this is a huge differentiator that only this company can deliver."

Oracle is also encouraging customers to run their development test in that cloud instead of on-premises because they believe it lowers the customer's costs while generating more total revenue for Oracle. Additionally, many of Oracle's competitors, including SAP, NetSuite, and Salesforce run Oracle's database software, and they've rapidly adopted the company's multi-tenancy and in-memory solutions which allows them to use less hardware and run their software more efficiently.

The Pro Bottom Line

The big idea driving the shift to the cloud is that it allows Oracle to capture more of the overall tech spends and allow clients save on their overall IT costs. Of course, this sounds too good to be true because someone has to be losing. In this case that "someone" is a combination of the IT employees that maintained on-premises databases and server stacks, the vendors that sold non-Oracle branded equipment, and the data centers that hosted corporate servers. Now Oracle employees cover those functions using Oracle servers,which are running Oracle software and are located in Oracle data centers, allowing Oracle to capture the majority of the profit in that value chain.

Even following the poor performance of the stock so far this year, Oracle still doesn't look especially cheap at a 9.4-times EV/EBITDA, which is just below the company's 3-year average. Looking forward, analysts on the conference call seemed skeptical about management's growth and margin guidance, which suggests The Street may be overly conservative in their future profit estimates-especially once the cloud business starts to scale. Not surprisingly, management is bullish on the cloud business and backed it up last quarter by increasing share buybacks during the quarter to $3 billion versus last year's quarterly run-rate of $2 billion. Further, they claim they will increase the buybacks even more if recent markets conditions persist.

We continue to think that Oracle has done a great job of defending its core installed base while its cloud business gets up to speed. Now that the company has completed its portfolio of cloud-based applications, we expect growth to accelerate in the coming year. Oracle continues to be a Buy First and we would consider adding to the position opportunistically if this pullback continues.

SVXY: Past, Present, and Future

Published Sep 14, 2015 at 3:28PM

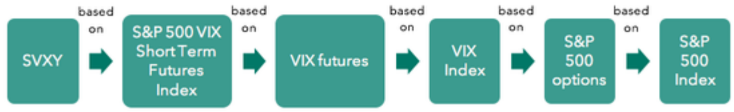
Fellow Fools,

As you know, *Pro* has had a small stake in the **ProShares Short VIX Short-Term Futures ETF** (NYSEMKT: SVXY) since November of last year. The SVXY has been a source of confusion lately, so today we're going to take a deeper dive into the instrument itself as well as our future plans for the position. This is going to be a lengthy memo, so let's get started!

What Is This Thing, Anyway?

Though the value of the SVXY is ultimately derived from movements in the stock market, purchasing shares doesn't make you a partial owner of a company like it would with, say, Apple. And the SVXY's relationship to the market is a lot more convoluted than those of the other ETFs in our portfolio (FAZ, for example). The goal of the

SVXY is to deliver daily returns that are the inverse of the S&P 500 VIX Short Term Futures Index. That index, in turn, attempts to replicate a position that rolls futures contracts on a daily basis to deliver a constant one-month rolling long position in VIX futures contracts. The relationship looks a little like this:

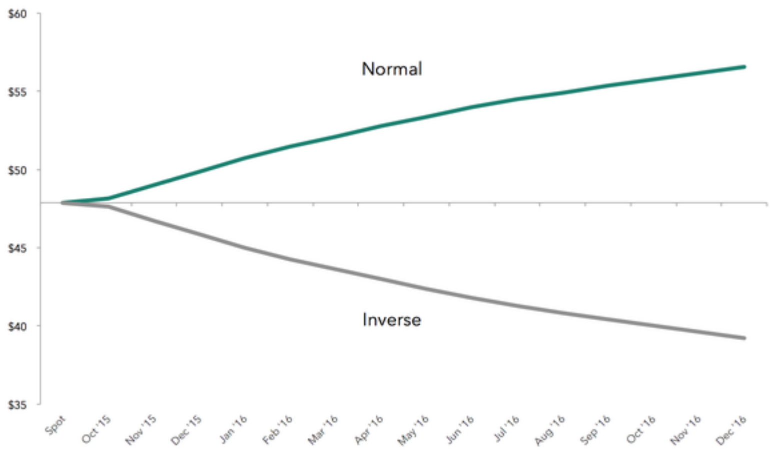


The CBOE created the VIX to provide a measure of the market's expectation for volatility over the next 30 days, using option prices for the S&P 500 Index. Because it is an estimate of an expectation, the VIX isn't always right. Even so, it has become widely known as the "fear index," and it's often used to gauge market sentiment. This name isn't 100% appropriate, though, as the VIX is measuring option premiums, not movements in the market. Most of the time the VIX works as expected (since downward moves have historically been more volatile and associated with higher premiums than upward moves), but Vance Harwood found that 20% of the time, the VIX actually moved in the same direction as the S&P 500.

For those who want to create securities to trade volatility, there's a complication: You cannot buy or sell the VIX. In order to get around this, market participants have instead created instruments that derive their value from VIX futures contracts. In order to better understand what is taking place with the SVXY, we actually need to devote some time to talking about the instrument from which it derives its value — futures.

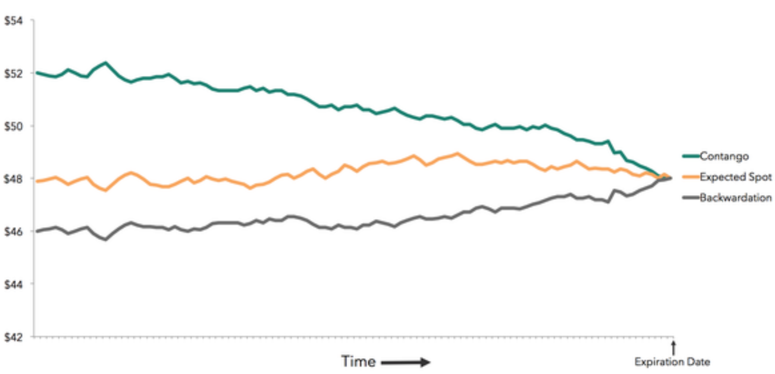
Under the Hood

Futures are standardized contracts that represent the obligation to buy or sell a specific asset at a future date for a predetermined price. They are similar to the options we're used to dealing with here in *Pro*, but there are some key differences (including the fact that they represent an obligation, not a right). There are multiple expiration dates for each asset, and you can plot the prices for each date on what is known as a futures curve. A normal futures curve is one where the prices tend to rise over time, while an inverse curve is where prices tend to fall as you move further along the curve.



Over time, the spot (current) price and the futures price must converge. The spot price can rise up to meet the futures price, the futures price can fall to meet the spot price, or they can meet somewhere in the middle. It doesn't really matter as long as they converge by expiration. (If they didn't, an arbitrage opportunity would be available.) This is where contango and backwardation come into play.

Contango, the buzzword we all like to use when talking about VIX futures, refers to a state in which the futures price is above the expected futures spot price (*not* simply when the curve is upward-sloping). This distinction is important because it is entirely possible for there to be no contango in a normal curve, and therefore no roll yield (see further explanation below). . Backwardation is simply the opposite of contango. When contango occurs, the futures price will roll down to converge with the spot price over time. When backwardation occurs, the futures price will roll up to converge with the spot price.



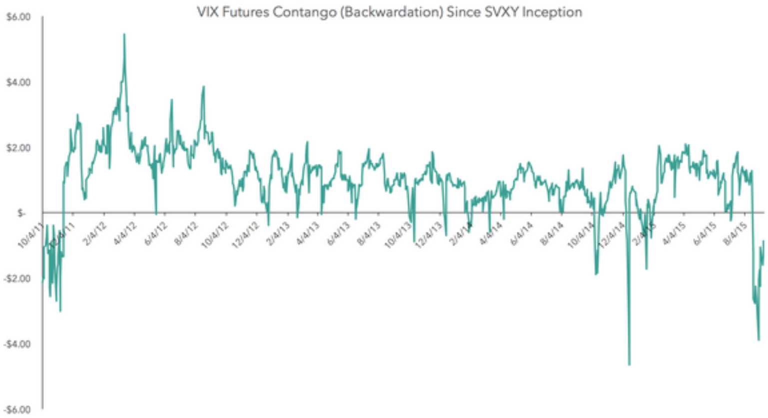
Roll yield refers to the return you can capture depending on the shape of the curve:

Type of Position	Contango	Backwardation
Long	negative	positive
Short	positive	negative

It is calculated as the change in the futures price minus the change in the spot price. As a simplified example, suppose you bought a futures contract at $10 with the underlying asset trading for $13. By expiration, the asset is trading for $15; to prevent an arbitrage situation, your futures contract must be worth $15 as well. The roll return you captured is ($15-$10)-($15-$13), or $2. You achieved this return because you were long a futures contract when the curve was in backwardation. If that remained the case, you could once again purchase a futures contract price at a discount to the spot price, so in this instance you would continue to maintain the same exposure while pocketing the extra $3.

Gazing Into the Future

So what determines the prices on a given futures curve? Well, it depends on the underlying commodity. In the case of the VIX futures, we're dealing with a non-storable commodity, and those tend to offer a better prediction of futures expectations. Going long the SVXY has been a pretty smart move over the years, because the the VIX futures curve is normally in a state of contango -- that is to say, the VIX consistently overestimates realized volatility.

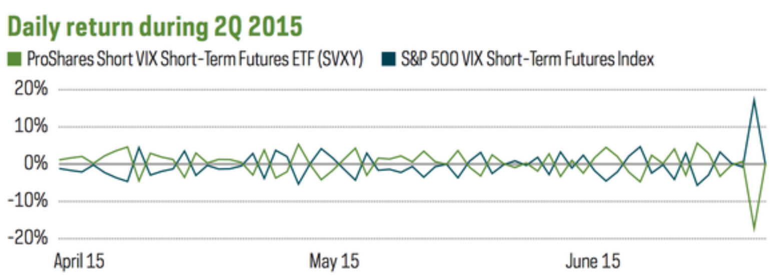


Data source: Bloomberg, calculated using constant one- and two-month VIX futures

And it is this factor that brings the SVXY its positive roll yield, not the act of actually rolling the contracts (so yes, the name "roll yield" can be a bit misleading). This is because a notional amount -- not a fixed number -- of first-month futures contracts (specifically: a contract multiplier, $1,000 in this case, multiplied by the spot price) are rolled into second-month VIX futures. This has to be the case; otherwise, the net asset value would actually increase every time contracts were rolled and they would not be able to achieve their target weight. The roll yield is actually achieved over the life of the contracts as they are held in the portfolio as the futures prices decline toward the spot price (since contango is far more prevalent than backwardation).

A Broken Mirror

Another common question: Why are the SVXY's results so different from what you'd expect after looking at the VXX, which attempts to achieve the opposite of the SVXY (it aims to *mirror*, not invert, the daily returns of the S&P 500 VIX Short Term Futures Index). The VXX is down 17% year to date, so shouldn't the SVXY be up 17% instead of down 20%? Unfortunately for us, the answer to this question is no. It's just the way the math works out (or if you want to use academic-speak, it's because of volatility drag). You see, the SVXY only attempts to deliver (before fees, of course) the inverse of the daily performance of the S&P 500 VIX Short Term Futures on a daily basis. And it does a pretty good job of doing just that:

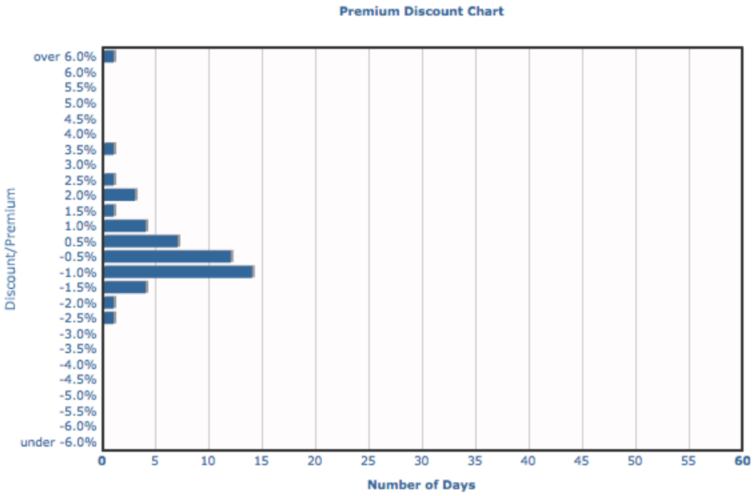


Source: ProShares Short VIX Short-Term Futures ETF fact sheet

But this does not mean that the compounded returns over time will result in a similar chart, as you can see from the hypothetical example below. Also, spikes in volatility can actually exacerbate the problem -- hence the term "volatility drag."

daily return	t0	t1	t2	t3	t4	t5	t6	t7	t8	t9	t10
Index X	--	5%	7%	3%	5%	-3%	10%	15%	2%	4%	4%
Index Y	--	-5%	-7%	-3%	-5%	3%	-10%	-15%	-2%	-4%	-4%
cumulative return											
Index X		5.00%	12.35%	15.72%	21.51%	17.86%	29.65%	49.09%	52.08%	58.16%	64.49%
Index Y		-5.00%	-11.65%	-14.30%	-18.59%	-16.14%	-24.53%	-35.85%	-37.13%	-39.65%	-42.06%

Also note that buying and selling pressure can force the SVXY stock price to deviate from what it should be based on its NAV.



Source: ProShares

That said, the SVXY's prospectus provides for what are referred to as "authorized participants." Whenever the stock price falls too much, they step in and buy blocks of shares, and whenever it rises too much, they can sell shares back into the market.

So Now What?

We've spent a good amount of time talking about contango, but with the recent spike in volatility, we currently find ourselves in a state of backwardation. Remembering our roll yield chart above, this is a tailwind for instruments that are currently long VIX futures, and a ball and chain for the SVXY. The sharper the decline, the more the SVXY suffers. Here's a look at how the SVXY and VXX have done since the SVXY started trading in late 2011:

30-day returns since SVXY inception

	VXX	SVXY
mean	-9.9%	7.8%
median	-11.2%	7.4%
std. deviation	14.6%	17.6%

When in backwardation

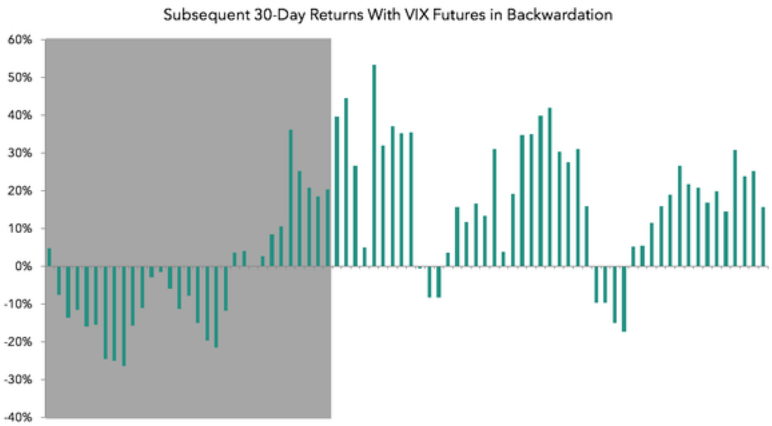
	VXX	SVXY
mean	-13.6%	9.9%
median	-16.1%	11.5%
std. deviation	13.4%	19.6%

When in contango

	VXX	SVXY
mean	-9.6%	7.6%
median	-10.9%	7.3%
std. deviation	14.7%	17.5%

Data source: Bloomberg, author's calculations

At first glance, buying the SVXY whenever the futures curve moves into backwardation looks like a pretty smart move. But VIX futures have spent less than 6% of total trading days in backwardation since the SVXY started trading, and if you take a look at the contango/backwardation chart above, you'll see that except for the first 31 days after the SVXY hit the market, there was never an extended period in which the VIX futures curve was in backwardation. So the backwardation data directly above is misleading, because it also includes periods during which the SVXY had the one-two punch of a falling VIX and a curve rapidly moving back into contango. But if you look at that 31-day period (the gray portion of the chart below), you'll see that an extended stay in backwardation is no fun for the SVXY.



Data source: Bloomberg, author's calculations

This is why we haven't rushed in to buy more of the SVXY during its recent decline. We don't know how long the futures curve will stay in backwardation, and because of that, we don't know how the SVXY will behave in the coming weeks. Despite all this talk about the future and futures, the behavior of the VIX futures going forward is unknown to us -- and until Nostradamus accepts our multiple generous offers to join the *Pro* team, that will remain the case. . But we'll likely look to add to our stake (through either buying additional shares or writing puts) as backwardation lessens, because one of the surest ways to make sure the position ultimately works out in our favor is to systematically add to it whenever it gets beaten down.

Foolishly yours,

-- JP (TMFYossarian)

Congratulations to all members who made it through today's lesson! Grab a glass of wine (or tea, or moonshine -- we won't judge) and come mingle with us on the Philosophy & Strategy discussion board.

Write Covered Calls on O'Reilly Automotive and Part of Your AmTrust Financial Services Position

Published Sep 4, 2015 at 12:45PM

Is this for you? This is for *Pro* members who own more than 6% in **AmTrust Financial Services** (NASDAQ: AFSI) in lots of 100+ shares, and who wouldn't mind selling some shares through covered calls. And for members who are comfortable targeting short-term income on **O'Reilly Automotive** (NASDAQ: ORLY), with the possible risk that we might lose our shares if a big enough resurgence in price makes rolling our covered calls impractical.

How You Participate: AmTrust Financial Services

- **Trade:** Sell to open October 2015 $60 calls on AFSI
- **Allocation:** To potentially decrease your allocation from 7.9% to around 6%, cover about 21% of your stake. But ultimately, only sell one call for every 100 shares you own and want to cover (**do not cover shares you wish to keep!**). *Pro* will cover 700 of its 3,267 shares, writing 7 calls.
  - **Price Guidance:** Use a limit order and ideally aim to be paid at least $1.50. As prices change over the coming days, aim to be paid at least 2% of the current share price (lately that's $1.16). After that, watch for our Catch-Up Trades on Mondays.
  - **Prices** (11 a.m. ET):
    - Stock: $57.80
    - October 2015 $60 calls (bid/ask): $1.25/$2 ($1.625 splitting the bid/ask, but we said $1.50 above to give better odds for success at today's price)

How You Participate: O'Reilly Automotive

- **Trade:** Sell to open October 2015 $250 calls on ORLY
- **Allocation:** Sell one call for every 100 shares you own and want to cover (**do not cover shares you wish to keep!**). We have a 4.9% stake in the stock, and will cover it all. So, *Pro* will cover all of its 500 shares, writing 5 calls.
  - **Price Guidance:** Use a limit order and ideally aim to be paid at least $3.20. As prices change over the coming days, aim to be paid at least 1% of the current share price (lately that's $2.35). After that, watch for our Catch-Up Trades on Mondays.
  - **Prices** (11 a.m. ET):
    - Stock: $235
    - October 2015 $250 calls (bid/ask): $2.85/$3.80 ($3.325 splitting the bid/ask)

What We're Thinking

You might have noticed that volatility has increased in the stock market, with the Chicago Board Options Exchange VIX index (or "fear index") jumping from 12 in mid-August to a recent 28, well above its long-term average of around 19. The VIX usually rises when the S&P 500 declines, and true to form, that's been the case. One advantage of a higher VIX is inflated options prices, amid expectations for increased volatility. We now get paid more for writing options, including short-term contracts that are decently out-of-the-money. We're going to start capitalizing on this opportunity with two new covered call positions for possible stock sales and income.

AmTrust

Shares of this plucky insurer are up 34% in the past 12 months, and our position has grown to our largest by a greater than 50% margin, at 7.9%. This is a good problem to have, but as more opportunities shake out in the marketplace, we will be content to sell this position down a bit, to around 6%, looking to invest the proceeds in other ideas. We like other financial stocks as much as we like AmTrust, and by moving some funds out of it, we lower our concentration risk. Although our *modus operandi* is to let our high-quality winners run as long as merited, as a small insurance company, AmTrust always harbors more potential risk. The company has a much greater chance of unpleasantly surprising us than does something like **Visa** (NYSE: V) or **Verisk Analytics** (NASDAQ: VRSK), both of which are contenders for a greater allocation in the portfolio.

Perhaps the only thing I don't like about potentially selling some AmTrust is the tax bill. It's a long-term capital gain for us, but it's still a tax bill. Consider your own situation. Also, some members may not have a gain in AmTrust if they recently bought above $60. Keeping your full stake is not out of the question — we're only potentially trimming 1.9% of our total portfolio exposure to it and around 21% of the position, after all, and we intend to remain long-term investors in the business. But for us, trimming down our holdings would be fine (AmTrust would remain our largest stake). If you own less than 6% already, you can sit tight. AmTrust is modestly above our $52 fair value estimate, and these calls will reach expiration before the next earnings report.

O'Reilly

O'Reilly's a stock that perpetually looks expensive. But these days, its price premium is more accentuated than usual, thanks to consistently strong business results. We've been wise not to write calls on O'Reilly yet, and we take some risk of losing our shares by covering for the next 40 days, but these income-targeted covered calls are more than 6% out-of-the money, and are set to expire before O'Reilly's next earnings report. The calls will pay us about 12% annualized, thanks to a higher VIX, and we'll take that given O'Reilly's current valuation.

The stock trades at 15 times trailing EBITDA (earnings before interest, taxes, depreciation, and amortization), although its 10-year average EBITDA multiple is closer to 11. Indeed, the stock is about 24% above our $190 fair value estimate. It trades at 29 times trailing earnings, and 25 times expected earnings for the next 12 months.

So why not sell outright? Because O'Reilly has been growing diluted earnings per share by 23.5% annualized the past three years. That type of consistent growth, coupled with growing margins and a long runway for future growth, deserves a premium. So we're not *eager* to sell — indeed, the stock is still rated a Buy. But we finally believe the stock may be at a point where we can carefully write covered calls for income and either not lose our shares, or actually not regret losing them if we do — and eventually get a better chance to buy back lower.

We'll cover our shares at $250 and either let the stock go if it rises more than 6% in about a month, or roll the calls higher if we decide that's our preferred course of action. Currently, I would lean toward rolling to keep our shares and avoid another tax bill. Given that stance, we *are* bending our covered call rules here (as we occasionally do), since we're not 100% ready to let the stock go. But the odds of just earning income in 40 days, in a choppy market, seem to outweigh the risk of the stock jumping too much. Time will reveal us to be fools or Fools on this thought.

How This Fits in With Pro

These two trades will bring a small amount of extra income to *Pro*, and potentially position us to trim our largest position and perhaps sell our 4.9% stake in our auto-parts retailer (if the stock rises and we don't roll the calls), raising cash for new positions. Both moves are in line with our mandate to manage the portfolio with reasonable risk in terms of allocations and valuations. To be clear, though, I don't believe that O'Reilly has more risk than the average stock, but its *future returns* rely on greater business outperformance than many of our stocks need to achieve.

So let's see whether we can use the higher VIX to help us earn some income in October.

Alternative Trades

If you don't own enough AmTrust or O'Reilly to write covered calls, do nothing, but be ready to sell your allocation in AmTrust down to 6% if we do so via covered calls (we'll alert you with a new email if that turns out the case). And, be ready to potentially sell your O'Reilly shares if we let ours get called away next month (again, we'll alert you).

Pro Can Help

- **Covered Calls.** Want to learn more about them? See our guide to the strategy, and to rolling covered calls.
- **Questions?** Rev on over to the *Pro* Philosophy board to ask general questions, and see the company-specific boards — AmTrust and O' Reilly — to pose questions on those.

Sell Your Protective Calls on Boulder Brands

Published Sep 2, 2015 at 12:19PM

Is this for you? This trade is only for members who are following along with our **Boulder Brands** (NASDAQ: BDBD) short position and bought protective calls alongside us. All others should ignore this recommendation. Bring your questions to the Boulder Brands board.

How You Participate

- **Trade:** Sell to close your September 2015 $7.50 calls.
- **Allocation:** Sell all of your protective calls; *Pro* will sell 62 calls.
- **Price Guidance:** Based on today's pricing, **it is critical that you use a limit order** to try to sell at $1 or higher (with the stock at about $8.25, this implies $0.25 of time value). With increased volume from this alert, this guidance may not hold. But with three weeks to September expiration, we should be able to sell some time value. For this week, as the stock price changes, try to sell your calls for at least $0.10 to $0.15 above intrinsic value. As we get closer to expiration, you may need to sell for closer to intrinsic value. Realize that if the stock declines from current prices, you'll ultimately need to accept less to sell your calls, but you should still use limit orders and still aim to get time value!
- **Recent Prices (as of 10:40 am Sept. 2):** Stock, $8.25; September $7.50 calls (bid/ask), $0.80/$1.20

What We're Thinking

Boulder Brands has been a great case study on why shorting is difficult. Since we established our initial position in March, our short thesis is tracking almost perfectly: Competitive pressure and poor earnings quality are taking a toll on revenue growth and margins, and the company's governance issues have led to the resignation of the co-founder and CEO.

Nonetheless, because of the timing of when we increased our short position, and because the stock has risen alongside rumors of a buyout (exactly the sort of news we were protecting against with our bought calls), we're currently sitting on a nearly 10% gain on our overall short position, which includes two tranches of short shares and our protective calls:

	# of Shares/Contracts	Start Price	Cost Basis	Current (Sold) Price	Market Value	Profit (Loss)
Original Short (3/23/15)	-3900	$9.60	($37,432)	$8.25	($32,175)	$5,257
Add More To Short (6/22/15)	-2300	$6.98	($16,050)	$8.25	($18,975)	($2,925)
Sept 2015 $7.50 Protective Calls (6/22/15)	62	$0.60	$3,726	$1.00	$6,200	$2,474
TOTAL			($49,757)		($44,950)	$4,807

After analyzing second-quarter earnings and evaluating the possibility of a buyout offer, we've decided to cash in the profit on our protective calls and reset our uncapped short position with this alert today.

While it's always possible that the company could be acquired at a premium, the acquiring company would be paying rich acquisition multiples, and it would have to be making some quite optimistic assumptions about synergy and the ability to reignite growth. We think it's unlikely that Boulder would be acquired for much more than $10 per share (which represents more than a 20% premium over the current price), and we also believe that Boulder is likely to report more poor results with third-quarter earnings (set to be released in early November).

Because we think upside above $10 per share is unlikely, and because we'd have to pay at least $0.50 per call to roll out to December, we think the proper decision from here is to sell our calls and leave our short position uncapped. Including the profit from our calls, our net short price (and thus our breakeven on the position) becomes $9.03 (9.5% above the current price). Once we sell our calls, we'll once again profit (or lose) one-to-one with Boulder's stock price.

Alternative Trades

- If you're more cautious, you can consider rolling your September $7.50 calls out to December, paying a net debit of about $0.50 (about 6% of the current share price) to do so. This caps your risk at $7.50 or higher, but reduces your profit if Boulder's stock declines from here.

Pro Can Help

- Questions? Visit our Boulder Brands discussion board.

A Perspective on Perspectives

Published Aug 31, 2015 at 3:27PM

Fellow Fools,

It seems that an essential part of being a kid is maintaining a list of favorites. In addition to a favorite color (blue), a favorite number (1,000), and a favorite food (cheeseburgers), my son also has a favorite animal. He's had a soft spot for lions ever since he was a toddler, and even though he's almost seven now, every time we go to the zoo we still make a beeline to the lion exhibit in hope of catching one of the beasts doing something other than napping. After spending years admiring these impressive creatures from a safe distance, I could see why so many Americans were outraged when they learned that a dentist from Minnesota had killed one of these majestic animals while hunting in Zimbabwe.

No Memo Next Week

Fools, next Monday is Labor Day, so we will not be publishing a Memo. Enjoy the day!

Shortly after the story trickled down to the local media outlets, *The New York Times* published an op-ed from a Zimbabwean-born doctoral student in molecular and cellular biosciences (say that three times fast): "In Zimbabwe, We Don't Cry for Lions." Though many Americans were quick to persecute the hunter for slaughtering a defenseless animal, it appears that you may interpret this news differently if you grew up in a place where lions roamed free and were known to occasionally enter your village and attack a relative or two. Go figure.

I've always found it interesting that two people can look at an event or a piece of information and come to vastly different conclusions, both convinced they are right beyond any doubt. This is true for investing, too: Individual perspectives aggregate to form a market, but each is framed by a unique life experience, and our biases are largely influenced by individual self-interest. That explains how every transaction involves a buyer and seller who are deriving a vastly different conclusion about the future prospects of a business from the same pool of information. These opposing forces are essential for price discovery, and a prerequisite for a properly functioning stock market.

The example of Cecil the lion may be a bit extreme, because it's so obviously influenced by geography and culture. But after the market turmoil we've experienced over the past few weeks, we're reminded that investors' behavior can be just as dramatically polarized. Here a few examples of hot topics -- including a few from our own *Pro* community -- where I've noticed varying perspectives determining how events are being interpreted.

On Oil Prices

When probed by analysts on where they think energy prices will be a year from now, **Core Laboratories** (NYSE: CLB) management likes to defer to "the law of physics and thermodynamics" when predicting a V-shaped recovery. To them, it's all about energy produced versus energy consumed when estimating future supply. But trying to determine how markets will interpret those variables to set prices is a bit more complicated.

Most people agree that an extended period of depressed oil prices is generally bad for highly leveraged oil exploration and production companies, deepwater drillers, and oil sands producers. In the longer term, this downturn will likely reward the conservative companies that didn't overextend during the boom and will thus be able to acquire distressed assets on the cheap. It will also force both the petroleum industry and the alternative energy providers to innovate and find novel ways to reduce production costs to remain economically viable.

The decline is also a drag on small towns in remote drilling areas, like North Dakota and West Texas, which benefited from the influx of petrodollars but have few economic alternatives to fall back on. By contrast, in Hawaii, electricity costs are normally more than three times the national average because about two-thirds of the state's energy comes from oil-fueled power plants. Thanks to the decline in oil, Hawaiians benefited from a 23% decrease in their electricity bills in June 2015 versus the previous year.

Cheaper gas prices result in more disposable income for consumers. They're also a boon for transportation companies and airlines including *Pro* holding **American Airlines** (NASDAQ: AAL), which count fuel among their highest costs. Though the U.S. is consuming less gasoline than in the past, a strengthening U.S. economy will likely take up more of the slack over time.

On Market Volatility

One of my favorite financial bloggers, Josh Brown, posted an insightful and timely missive on why the stock market has to go down the day before the market tanked last Monday.

> "The only reason stocks can go up is because they can also go down. It is this risk that keeps investors in check and that keeps people from paying an infinite amount of money for shares in a business. The reintroduction of risk, in the context of this summer's sell-off, is the best thing that could have possibly happened."

A steadily climbing market lulls investors into a false sense of security, convincing them to take more risk than they could otherwise stomach. Weeks like the one we just experienced are an important reminder of exactly how much risk you accepted when designing your portfolio. Volatility is scary. It's even scarier when you are in or near retirement, or you have under-saved, and you *need* the market to keep climbing to hit your number. On the other hand, investors who are still in the asset-accumulation phase are probably frustrated that the market bounced back before they could invest more capital.

On Managing Our Laggards

I've noticed a number of comments on the *Pro* discussion boards and during our live chats regarding what we should do to manage some of our underperforming positions. We spend a lot of time thinking about the construction of our portfolio and the correlation between individual assets. It would be difficult to say we had a diversified portfolio if everything were performing well at the same time. Back in May, Jeff turned a critical eye toward several of our "problem positions," but we're generally just as deliberate in making a decision to remove a position as we are when we decide to include it in the first place.

If I look at a portfolio and see no underperforming positions, I get worried. That usually means that either all of the holdings are benefiting from the same tailwind, or the portfolio isn't taking enough risk. Losing money on some positions is a necessary evil when trying to build a portfolio of uncorrelated assets.

The *Pro* Bottom Line

When I started penning this memo, I had hoped to simply point out some interesting contradictions without taking a side. But it was impossible not to allow my own biases to creep in – and I guess that's the point. The most difficult thing we can do as investors is to try to put our own biases aside and learn to appreciate the other side of the trade, whether we agree with it or not.

When discussing the challenges of successful investing, Charlie Munger once told Howard Marks, "It's not supposed to be easy. Anyone who finds it easy is stupid." The best we can do is to constantly test our assumptions, try to keep an open mind when new information presents itself, and do our best not to be "stupid."

Questions? Comments? Bring them to the Memo Musings board.

Yours in intelligence,

-- Jeremy (TMFTank)

Pro Catch-Up Trades: Aug. 31, 2015

Published Aug 31, 2015 at 3:18PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

Pro's Buy First stocks are worth adding to your long-term portfolio:

- **American Tower** (NYSE: AMT), 3.4% in stock and 0.5% in January 2017 $80 calls
- **Gentex** (NASDAQ: GNTX), 2.8% in stock and 1.5% by writing ("sell to open") December 2015 $15 puts
- **Gilead Sciences** (NASDAQ: GILD), 3.9% in stock
- **Oracle** (NYSE: ORCL), 3.7% in stock
- **Wells Fargo** (NYSE: WFC), 3.7% in stock

And then there's our airline investment, characteristically (of airlines in the past) deep in the red. But we're still believers in the value here. Members who lack a stake can take note of this recommendation:

- **American Airlines** (NASDAQ: AAL): Buy to open 0.5% in January 2017 $30, $32.50, or $35 calls, depending on how much you want to spend per call, and how much time value you want to pay.

Pro Live Chat, August 2015

Published Aug 25, 2015 at 1:36PM

Join us at 1 p.m. Eastern on Thursday, Aug. 27, for our monthly live chat!

China, Oil, Interest Rates -- and Calm

Published Aug 24, 2015 at 3:38PM

***Pro* Completed Trades**

- **Expeditors International** (NASDAQ: EXPD): We sold to open a November 2015 strangle, selling 10 November $46 puts and 10 November $50 calls for a $3 credit. Today you can get more! See our trade alert for details.

Dear *Pro* members:

It's days like this that show you what type of investor you are. Are you calm in the face of adversity? Do you remember why you invested in the first place, and does that help you stay the course? We certainly hope so. It does us. But let's survey the landscape.

What's Up?

Stocks were battered and fried last week, with the S&P 500 falling 5.8% and the Nasdaq sliding 6.8%. All major U.S. indexes are now down for the year, with the S&P down 4.3% year-to-date as of Friday. For several minutes this morning, panic selling ensued; the S&P 500 was down more than 5% at the market open, bringing it 12% below its recent peak. Soon, however, it began to claw back.

The prices we saw briefly after 9:30 a.m. point to the danger of using stop-loss orders or market orders (as many apparently did) to sell *any* of your stocks. Consider the horrible prices panic sellers obtained this morning compared with where these stocks are trading just hours later:

Company	**Low of the day**	**Recent Price (1:30pm)**
Apple (NASDAQ: AAPL)	$92	$107.35
Facebook (NASDAQ: FB)	$72	$85.35
Gilead (NASDAQ: GILD)	$86	$104.70
MasterCard (NYSE: MA)	$74.61	$90.47
Skyworks (NASDAQ: SWKS)	$70.87	$83.40
Visa (NYSE: V)	$60	$70.30

Note that four of these stocks had a low today that was an even number: $60, $72, $86, $92. Why? Very likely because people had stop-loss orders at those levels. In a panicked market, when buyers are few and far between, prices can slide so fast that your outrageously low stop-loss order can suddenly be hit -- and get filled. Ouch.

This morning's indiscriminate selling also suggests a lot of "hot money" and stocks bought on margin. Speculators wanted to get out, *or had to*, and prices reflect that. Now, don't lament that you didn't buy. Volatility may return, these prices lasted mere minutes, and some brokers weren't working anyway; many investors' hands were frozen by unresponsive websites.

But what does this volatility mean? What's happening?

First, some context to keep in mind: Stocks have gained so much ground over the past several years that some giveback is to be expected, just as we've been saying for years. That's no consolation to those starting to invest right now, though. The more important factor for them – and us – is the valuations we're paying today.

I don't know where the market will close today, but as of Friday, the S&P 500 traded at 16.7 times expected 2015 earnings; for the Dow Jones Industrial Average, that number was 14.9. Both valuations are in the middle of long-term historical averages. Further, as of Friday, the S&P 500 paid a 2.2% dividend -- more than the 10-year Treasury bond. Better, the earnings yield on stocks (which is the inverse of the P/E ratio) is a healthy 6%.

Looking across the investment landscape, stocks still appear to be the most attractive place for money you won't need in the coming three years or longer.

So why all the selling?

The truest answer is: Because it's natural. On average, the stock market falls at least 10% once every 11 months. Stocks may be the best-performing asset you can hold for the long term, but the price of that performance is volatility. If your head doesn't know that, or your stomach can't take it, then you'll likely miss the long-term benefits of ownership, because you'll sell at the worst time.

Recent selling may be random, but the media is offering us reasons if we want them, including the fall of stocks in China, lower oil prices, and the likelihood of an interest rate hike from the Fed. Let's talk about each.

China

The slide in China's Shanghai index has grabbed headlines, but its ascent from January to June went relatively unnoticed in the United States. Beginning the year around 3,200, the index hit 5,178 in June, and has since declined back to 3,200. Speculators have created this volatility. Now the concern is how the falling stock market will affect China's economy -- and we don't think it will do so with any real magnitude.

About 55% of U.S. households own stock, but only about 10% to 12% of households in China do. China is still a nation of savers with cash in the bank, so the decline in the stock market is not likely to affect consumer spending much. China's economy as a whole is a black box (how much is it really growing? Can we trust the government?), but it has enough tailwinds that odds favor continued GDP expansion, albeit at a slower pace.

A second point to keep in mind is that the Shanghai market is filled with speculators and new investors. Valuations on shares listed in Hong Kong, where institutional investors have long been ensconced, are much more reasonable than the prices seen on the Shanghai market. So, we shouldn't assume the volatile Shanghai market is an accurate reflection of the strength of China's economy. It isn't. Unfortunately, though, its volatility has spooked investors around the world.

Oil

Texas crude spilled below $40 per barrel last week, causing concern among investors who believe this suggests soft demand because of weakening economies. But it's unlikely that's the case. Demand for oil is still expected to grow to a record level in 2015 as economies expand. The imbalance is with supply. Thanks largely to U.S. innovation, the world is producing more oil than it needs, and the glut will likely persist well into next year. That reality – along with selling fueled by levered investment funds that *need* to unwind bullish oil positions – is likely to blame for driving oil prices lower, rather than much weaker economies. By the way, the market seems even more irrational when I see **American Airlines** (NASDAQ: AAL) stock getting clobbered even though oil, its chief cost, is tumbling.

Interest Rates

This is the bogeyman we imagine under the bed. Interest rates are currently so low that if the Fed increases them slowly by quarter-points, which seems likely, it could take *years* to get back to a historically healthy level of 3% to 4% (ideally a bit above inflation). A tiny increase in rates this year won't suddenly make stocks unattractive, and it won't derail the economy.

Once rates begin to increase and investors see that stocks are still the most attractive option out there, this bogeyman may start to fade. Higher rates are not likely to derail our slow-moving economy, either. Rates will go up so gradually that companies and consumers will have time to adjust and plan for them. If anything, the knowledge that rates are going up could drive more economic activity, driving people to buy homes or companies to finance investments before rates go higher still.

In Sum

This isn't to say all is rosy. Risk is ever-present in stocks if you view price volatility as risk (we typically don't). China could slow down enough to hit the whole world. Perhaps oil's fall *is* a precursor to much slower economic growth. And even a small rate hike might slow the U.S. economy. But I believe odds strongly favor the opposite in each case. China will grow over the next three years. Cheaper energy will help many other economies grow, too. And rate hikes will be slow and modest enough to keep the U.S. on a path of recovery. Against this backdrop, U.S. stocks are reasonably priced. They're not cheap, but they're not too dear, either, especially compared to alternatives. We expect price volatility. But we also expect to come out ahead on the other side of it.

We were preparing to buy some of the deals we saw this morning, but those prices disappeared in a flash. We're not concerned. Opportunities will reoccur. We're patient. We're also considering whether we want to short some indexes as additional hedges. But overall, we're happy with what we own. We don't use margin, and we always have a three-year outlook. Given those facts, today is like any other -- we're just more watchful for opportunities amid the volatility. To discuss, please visit the Memo Musings board.

Foolishly,

-- Jeff (TMFFischer)

Pro Catch-Up Trades: Aug. 24, 2015

Published Aug 24, 2015 at 3:30PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **American Tower** (NYSE: AMT)**:** If you've yet to match our allocation, invest up to 0.5% of your *Pro* funds in January 2017 $80 calls.
- **Medtronic** (NYSE: MDT): Buy up to 3% in stock if you lack exposure.
- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): Buy up to 1% in shares if you lack exposure.
- **TD Ameritrade** (NYSE: AMTD): Buy up to 2.7% in shares if you lack exposure.

What Happens Next?

Published Aug 24, 2015 at 11:00AM

Morgan Housel is Motley Fool One's expert on the intersection of investing, economics, and human nature. He studies the impact of big-picture issues on individual investors' lives — making us better Fools along the way.

There have been 4,559 weeks since 1928. Last week was the 434th worst for the stock market.

And there have been 22,793 trading days since 1928. Friday was the 249th worst.

As I write this Monday morning, stocks are about to open down big time.

It's not fun. I know so many investors who, during bull markets, say they can't wait for a pullback so they can buy cheaper shares. Then the pullback comes and they say, "You know what, this actually isn't fun. It hurts to see your net worth go down." In psychology, "prospect theory" is the idea that a loss hurts multiple times worse than a gain. It's real, and it's powerful. Investor Ben Carlson put it this way last night: "Stocks rose more than 400% in the 1980s, but all anyone remembers is the crash of 1987."

But if you look at those stats I provided above, you can only come to one conclusion: **This stuff happens.**

As bad as last week was, it didn't even crack the top 10% of weeks since 1928. And keep in mind, the market has risen 3,500-fold since 1928, or the equivalent of turning a $20 bill into a BMW.

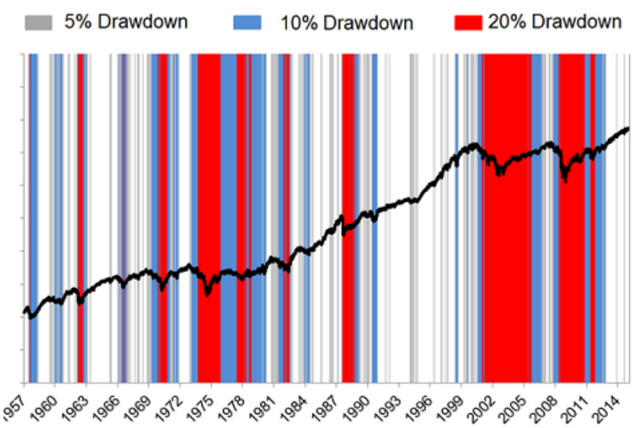
You've heard the standard advice: Don't panic. This is normal. Stick to your plan. Think long term. Maybe start looking for bargains, as a lot of us are.

But when this stuff happens I also wonder: What happens next?

Statistically, I mean. On average. Because no one knows exactly what happens next.

Here's What History Says

This chart, made by my friend Michael Batnick, shows when the S&P 500 has been down 5% from its all-time high (gray), down 10% from the high (blue) and down 20% from the high (red):



Crunch all the data in this chart, and you'll see that the market is at an all-time high just 7% of the time. And ...

- It's between **0% and 5%** below its all-time high **36%** of the time.
- **5% to 10%** below its all-time high **15%** of the time. This is where we are now
- **10% to 20%** below the all-time high **22%** of the time.
- **20%** or more below the high **21%** of the time.

In other words, the market is where we are today or lower from its previous all-time high about half the time. And again, that's during a period when the market made millionaires out of modest savers.

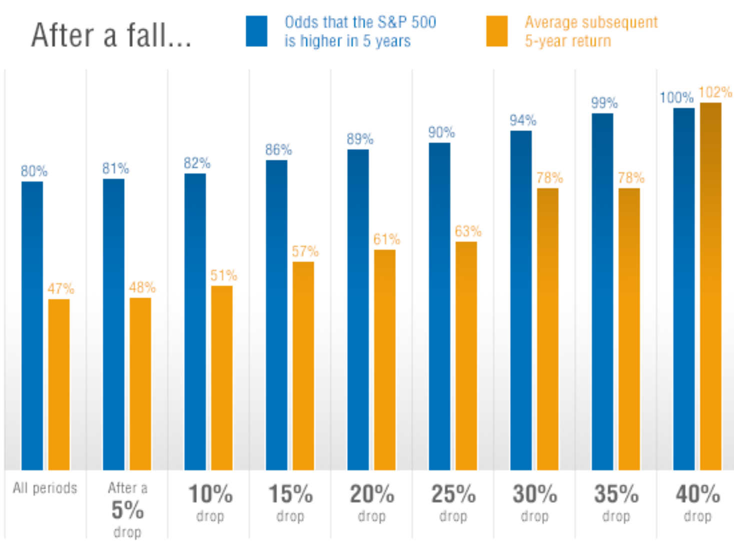
Some more numbers for you: Historically, about one-third of 5% declines go on to become 10% declines. And about half of 10% declines go on to become 20%+ declines.

So, think about that. **Stocks are down about 10% from their all-time high. Historically, half the time this happens they fall another 10% or more.**

Now for the Good News

Everything about successful investing comes back to one thing: The long run.

Earlier this year, I looked at the five years *after* the market drops by a lot. Here's what I found:



After a 10% drop, stocks are higher five years later 86% of the time. The average return during that period is 51%, which is great. If the market were to fall 20% from its all-time high, historically it's been higher five years later 89% of the time. There are no sure things in investing, but that is darn close.

I heard a smart person on TV last week say something along the lines of, "With markets falling, it's time to be careful."

Really? That kind of thinking is exactly why most people fail at investing. The time to be careful is when everything is going well. That's when you create a long-term plan that helps you endure through volatility.

The most important thing to remember right now is that today's pain plants the seeds for tomorrow's gains. That's always the case in investing. The reason the market has done so well over the last six years is specifically because we had a terrible bear market in 2008. The pain of last week sets us up for higher, and more probable, future returns. It could easily get worst from here. But the worse it gets, the higher the odds of future success. That's why I shake my head at comments like that on TV. The last thing you want to be is be ambitious last Monday and careful today.

The lines outside Chipotle are still long. The willingness to pay $5 for Starbucks coffee is still strong. The engineers at Tesla are still geniuses. When I think about "what next?" that's what I think about. It's what ultimately matters most, and what you'll remember most when looking back at your investments years from now.

Nick Murray, one of my favorite investment writers, once wrote:

> $6,200,000,000
>
> Yes, that's right, it's six billion two hundred million dollars. A very large sum of money, wouldn't you say? Now what, you ask, does it represent?
>
> It is roughly how much Warren Buffett's personal shareholdings in his Berkshire Hathaway, declined in value between July 17 and August 31, 1998. And now for the six billion dollar question. During those forty-five days, *how much money did Warren Buffett lose in the stock market?* The answer is, of course, that he didn't lose anything.
>
> Why? That's simple: he didn't sell.

Write Puts on Gentex

Published Aug 21, 2015 at 12:02PM

Is this for you? Since we're looking to add 1.5% to our stake in this company, this alert should be applicable (now or perhaps later) to all *Pro* members, whether you already own shares of **Gentex** (NASDAQ: GNTX) or not.

How You Participate

- **Trade:** Sell to open December 2015 $15 puts.
- **Allocation:** 1.5% — write one put for every $100,000 you manage; *Pro* will write 25 contracts. In addition to our current 2.7% stock holding, this would bring our total allocation to about 4.2%.
- **Price Guidance:**
  - **Now:** Use a **limit order** to target $0.85 or greater to start (for a 5.7% effective yield in 120 days). **If we all use limit orders** and the stock price cooperates, we should be able to achieve $0.85 today. Due to the wide bid/ask spread, if our volume starts to affect pricing, accept no less than $0.80 per put today, **but start with a limit order of $0.85 at first**.
  - **Later:** As prices and time to expiration change, those approaching the position should aim to get paid a yield on time value of at least 1% or so per month to expiration.
- **Prices (as of market open Aug. 21):** Stock, $15.14; options, $0.65 bid / $1.15 ask. Guidance: $0.85. Current prices.
- **Stock Rating:** Buy First, 2.7% allocation; now we're adding 1.5% in additional exposure through these new puts.

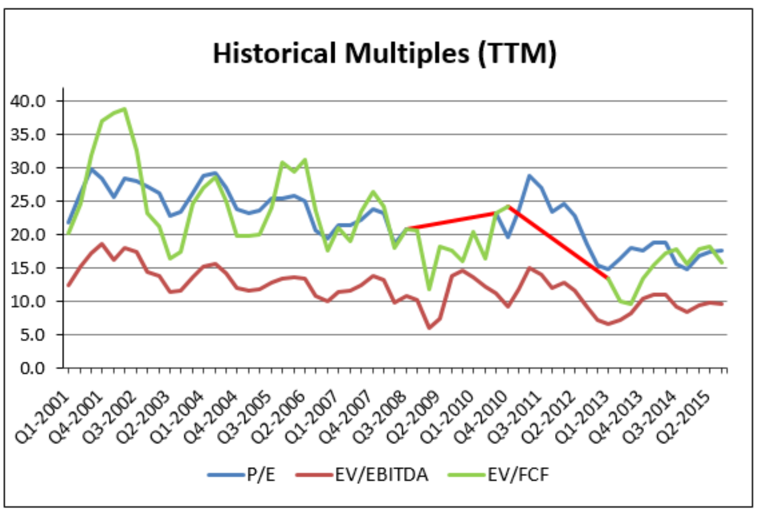
What We're Thinking

After our first round of put writing on Gentex expired fully as income in March, we've been patiently assessing the company's earnings reports and waiting for a good opportunity to revisit the strategy. Given the recent market volatility (which increases option premiums) and the fact that Gentex stock is down 19% from its year-to-date high of $18.80 on March 23, we think now is a favorable time to reestablish our written put position, targeting both income and the opportunity to buy shares at a lower price.

Since our first puts in January (just more than two quarters ago), Gentex's quarterly revenue has increased by 8.3%, its operating income has increased by 9.1%, and it has raised its dividend by 6.3%. And yet, because of valuation-multiple compression since then, we're now able to target an effective buy price on this particular iteration of written puts of $14.15, 15% below the effective buy price targeted in our first round of puts, and 21% below our recently updated fair-value estimate of $18 per share.

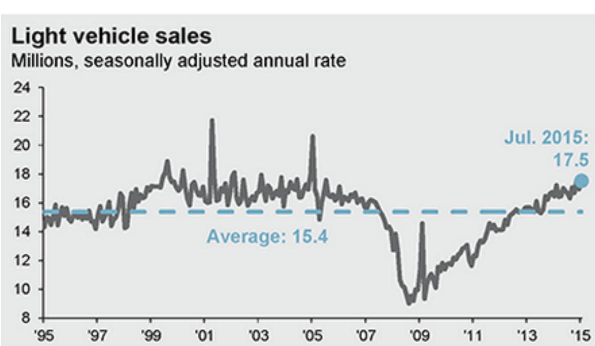
Although the company is historically cheap right now, and though we like its long-term prospects, as we mentioned in our **Live Nation** (NYSE: LYV) write-up, our current long exposure leaves us wanting to be a bit more defensive with our income-generating positions. With the income for this iteration of the strategy at $0.85, we'll have brought in a total of $1.49 per share with our two written puts on Gentex this year, giving us an effective start price of $13.51. (Your mileage may vary depending on how much you collected in the first go-round and your tax situation.) This is about 11% lower than the current level, and 25% lower than our fair-value estimate; we'd happily buy shares for this price.

With an effective buy price on the overall strategy of $13.51, we'd be buying shares at 13.6 times trailing-12-month (TTM) earnings, 7.3 times TTM EBITDA, and 13.1 times TTM FCF, at the low end of historical ranges in the company's past 15 years, including the 2008-2009 period when auto sales plunged and several automakers looked like they might go bankrupt:



Note: Red lines represent omitted outlier multiples that correspond to recession-depressed earnings and cash flow.

And when we compare today's auto market environment to the recessionary environment, it makes those multiples all the more attractive:



Source: JP Morgan Market Insights-3Q 2015 Guide to the Markets®

More That Matters

- **Maximum loss:** For this iteration of the put strategy alone, our risk is the same as share ownership starting at about $14.15, or 6.5% less than the recent price.

- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At a minimum of $0.80 (but again, use a limit of $0.85 to start!), that's a 5.3% effective yield in 120 days.
- **Follow-up:** Including the premiums from our previous put write, we'll buy shares at a net $13.51 if the stock is below our $15 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 2.7% allocation first — Gentex's shares are a Buy First. Then you can consider writing these puts for income or to add more shares. If one put option exceeds 1.5% of your portfolio, then just buy 1.5% in stock directly *if and when Pro* does so through these puts (we'll alert you if and when we do).
- **Write other puts?** Consider writing March 2016 $15 puts if the price on those options holds up better than the December puts after this alert is issued. Right now, the bid/ask on the March 2016 puts is $1.10/$1.60, good for a 8.7% effective yield in just more than seven months.

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Check your mirrors and switch lanes over to the Gentex discussion board.

Write a New Covered Strangle on Expeditors International

Published Aug 20, 2015 at 2:45PM

Is this for you? This is for *Pro* members who are following our option writing for income on **Expeditors International** (NASDAQ: EXPD), and, like us, have August options reaching expiration tomorrow (Friday). But please read the note below, as there are timely and, uh, "conditional" conditions.

How You Participate

Conditional Note: With the stock lately at $49.80, our August 2015 $46 puts and $50 calls are due to expire as full income after Friday. This is a good thing, and it means we don't need to touch these options *unless* the stock rises above $50 on Friday. You have two potential approaches, and we're sending this alert today so you're prepared no matter which you choose.

1. You can buy to close your August $50 calls today for a small sum (currently $0.15), and write the new strangle detailed below. You'd do this if you wanted to remove any chance that the stock could drift above $50 tomorrow and surprise you. Only write the new strangle after you're certain your August $50 calls are closed.
2. You can wait and see whether Expeditors stock stays below $50 tomorrow, letting your whole strangle expire for full income if it does. (You'll save some money by not buying back your calls!) Then, write the new strangle late tomorrow or Monday after expiration becomes certain. Alternately, if EXPD is above $50 tomorrow, you can close the August $50 calls and then write the new strangle (again, only after you're certain they've been closed).

Pro must wait 24 hours, so we'll be acting as necessary on Friday afternoon.

- **Action:** As the circumstances play out, use a strangle order to simultaneously sell to open November 2015 $46 puts, and sell to open November 2015 $50 calls.
- **Allocation:** Sell one strangle (one of each option) for every 100 shares of exposure you have to the company. We have 1,000-share exposure through 10 contracts of a synthetic long, so we're selling 10 puts and 10 calls, as we've done before -- this potentially doubles our exposure to a full 3.5% allocation.
- **Prices:**
  - **Stock:** $49.80
  - **Options:**
    - November 2015 $46 puts (bid/ask): $0.90/$1.00
    - November 2015 $50 calls (bid/ask): $2.15/$2.25
    - Combined bid/ask: $3.05/$3.25
- **Price Guidance:** Split the bid/ask, aiming for a **combined credit of $3.10** or higher to sell the strangle. If we all use **limit orders**, then $3.10 should hold for Day One. As prices change, aim to get paid at least 4.5% of the current share price to write the strangle, lately about $2.25, targeting at least 1.5% in yield on share price per month to expiration.

What We're Thinking

Our global logistics buddy Expeditors International reported healthy earnings last quarter, with ocean and air freight volume up 5% and 9% respectively, leading to a 6% increase in revenue. Further, the company was able to contain costs, so operating income rose 28%, its strongest year-over-year gain in years. Share repurchases helped earnings per share to rise 33%.

Fortunately, our August strangle provided enough headroom for upside in the stock following these results; shares hit a new high early today even as the market faces headwinds, necessitating this potential "roll trade" before our options expire. Whether or not we'll need to close our August $50 calls tomorrow, though, we're sitting pretty and about to earn most of our August income. And because this is an income position, we're ready to write new options again.

Why This Strategy?

Since since starting this position in August 2014 (assuming our options expire tomorrow), we will have earned about $5,000 in income so far, and we have unrealized gains of more than $8,600 on our synthetic long. That amounts to more than $13,600 in realized and unrealized gains on the less than $600 in capital we deployed to start this position last Aug. 15.

So, our "income with upside" objective that leverages our capital is playing out well. In fact, it's worth pointing out today that we would use a higher strike than $50 for our November covered calls if possible, *but* the next strike price available is $55 and pays little, so we're all but forced to write calls with a strike near the current share price to continue our income objective. (And that's the case even though Expeditors is doing well.) This is fine -- we're content to be more defensive with $50 covered calls.

More That Matters

- **Maximum loss:** The same as owning at least 200 shares of stock (100 now, and 100 at $46), minus the option premiums received.

- **Maximum gain:** This new strangle caps our upside at $50, plus the premium received, which means $53.10 per share. The most we can make on this strangle alone is the $3.10 in premium, which is earned if the stock stays anywhere between $46 and $50 by expiration.
- **Breakeven**: Our existing synthetic long mirrors stock ownership that started at about $40.60, while this new short strangle in isolation has breakeven points at $42.90 and $53.10, giving us a nice range.
- **Follow-up:** The current plan is to continue writing strangles to earn income, and roll our existing strangle up or down if need be. By January 2016, we'll decide whether to turn our synthetic long into stock or roll it forward, too.

Alternative Trades

- **IRA-friendly/covered calls:** If you simply bought shares of stock earlier and wrote August 2015 $50 calls, you can follow the same guidance in this alert, closing the calls if necessary tomorrow and writing the new November 2015 $50 calls (ideally for at least $2.15, although that price will change if the stock moves). Accept the going price in that case. Finally, if the stock rises above $50 by Friday, we believe you should roll your calls, rather than lose your shares -- hence today's report. Those wanting to avoid any excitement tomorrow can simply close the August $50 calls today, lately for about $0.15 -- or use a rolling order to close them and write the new November $50 calls, resulting in a net credit of about $2.

Pro Can Help

- **Want more on this strategy?** See our guides to covered strangles and synthetic longs. We're combining the two into a synthetic covered strangle.
- **Questions?** Please ask, Fools! Ship yourself on over to our Expeditors board.

Another Pleasant Quarter at AmTrust

Published Aug 20, 2015 at 1:32PM

Pro's favorite insurance provider, **AmTrust** (NASDAQ: AFSI), showed us yet another strong quarter earlier this month. AmTrust continues to acquire business lines that management believes are mispriced, and until the market starts to harden, we can continue to expect full steam ahead. As an added bonus, shareholders also learned that the company will be increasing its quarterly common stock dividend by 20%.

AmTrust Financial Services Q2 2015

Consolidated Results

		change
Gross written premium	$1.68 billion	16%
Percetnage retained	60.1%	-390 bps
Net earned premium	$969 million	11%
Operating diluted EPS	$0.84	-37%

Insurance ratios	
Loss ratio	65.9%
Expense ratio	24.6%
Combined ratio	90.5%

GAAP rolling returns	
ROE	21.6%
ROA	2.5%

Segment Results

- **Guidance**: Buy
- **Recommended allocation**: Veterans have 8%; for newcomers, start with 3.5%, then look to opportunistically increase your position size over time.
- **Fair-value estimate**: $52

Segment Results

Segment Insurance Ratios

		Second Quarter 2015	Second Quarter 2014
Small commercial	Loss ratio	65.1%	66.7%
	Expense ratio	25.8%	25.6%
	Combined ratio	90.9%	92.3%
Specialty risk and extended warranty	Loss ratio	65.3%	67.1%
	Expense ratio	20.2%	19.8%
	Combined ratio	85.5%	86.9%
Specialty program	Loss ratio	68.7%	68.1%
	Expense ratio	28.1%	27.2%
	Combined ratio	96.8%	95.3%

Small Commercial Business (SCB)

Gross written premium for AmTrust's biggest segment increased by 24.3%, or $171.2 million, to $875.8 million this quarter. Workers' compensation accounted for the majority of this growth as the company's policy count increased by 45.1%. And AmTrust continues to target the states where it has the largest presence -- workers' comp policies in California, Florida, New Jersey, and New York made up 63% of the growth in this division. Pricing still supports expansion given that it remains somewhat favorable (prices are up 7.4% in California and 3.7% in New York year-to-date), but competition is heating up in some spaces. This was the reason the company's average policy size decreased by 16.1% this quarter. Call us crazy, but we were actually happy to see this happen. One of the most important things we look for when analyzing an insurer is discipline, and it appears AmTrust is exhibiting exactly that with its refusal to engage in a pricing war for its larger accounts -- even if that means they go to a competitor.

Net written and earned premiums increased by 14.2% and 24.9%, respectively. Net written premiums were lower than gross primarily because the company passed on a greater percentage of the latter to reinsurers during the quarter. But because the premiums are earned (recognized on the income statement) over the life of the policy, net earned premium growth still hit the mid-20-percent range. Net earned premiums also got a bump thanks to the cut-through reinsurance agreement with Tower Group International, because it was not subject to the company's quota share agreement with **Maiden Holdings** (Nasdaq: MHLD). (In this agreement, AmTrust passes through a percentage of the the premium written by its U.S., Irish, and U.K. insurance companies, as well as the corresponding losses.)

Specialty Risk and Extended Warranty (SREW)

Gross written premium actually decreased 4.7% ($23.7 million) this quarter, to $479.9 million, as a strong dollar continues to hurt this segment -- 68.8% of gross written premium was generated outside the U.S. this quarter. Net written and net earned premiums decreased by 4.3% and 11.7%, respectively. Overall retention was essentially unchanged this quarter, but net earned premiums fell by a greater percentage because the company is now writing policies with longer tails.

Specialty Program (SP)

Gross written premium for this division was up 37.1% ($87.3 million) this quarter, to $322.7 million. Workers' comp tends to account for about 30% of the SP segment's business, so many of the catalysts behind the strong growth in the SCB division were in play here as well. Also similar to SCB: The premium retention ratio decreased by 650 basis points, as a greater percentage of SP's business is now covered by the quota share agreement with Maiden. So net written and net earned premium growth, both with growth of 23%, trailed gross written premium this quarter. The company is continuing to push for rate increases in this segment, and it's restricting its underwriting guidelines in an attempt to improve the quality of the business even more.

Services and Fees; Investments

Service and fee income growth continues to be steady. The segment was up by 8.2% ($8.2 million) this quarter, as recent acquisitions and increased fees from certain customers helped to offset a $2.7 million decline in fees from business associated with SREW. The company's investment portfolio has grown by more than 330% since 2010, as it's gone from a small insurer to a behemoth that has underwritten $6.4 billion over the past 12 months. Underwriting still accounts for the majority of AmTrust's profits, but as with most large insurers, the bigger the company gets, the more important the fees-and-investments side becomes. Investment income was up 11.3% ($3.7 million) this quarter to $36.3 million, primarily because of an increase in fixed-income investments; this came about in part because the company invested a portion of the proceeds from its recent stock offerings (both common and preferred), as well as from recent acquisitions.

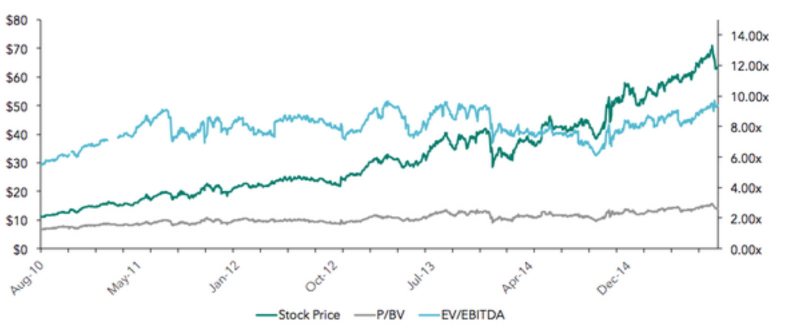
Pro's Take

AmTrust's low tax rate for the quarter (effectively 5.2%) ensured a strong beat on the bottom line, but there were plenty of other things to like. Currency exchange losses were the primary culprit behind the decline in net income (a $47.3 million loss this quarter versus a $1.1 million gain in Q2 of 2014), but loss trends continue to be encouraging while growth and profitability remain robust. But given the cyclicality of AmTrust's market, these results don't come as a complete surprise. This cyclicality is why we were pleased to hear that the company is willingly shedding some of its larger accounts rather than slash prices. Competition is clearly heating up, but who knows when the market will finally harden. So it's nice to see the company taking pre-emptive measures instead of trying to play the market-timing game. In particular, I liked this comment from CEO Barry Zyskind:

> And the other phenomenon is when the market is a rising market and there are not a lot of players in there, besides us writing our small workers' comp, we'll see bigger workers' comp. So let's say we have a real expertise in restaurants. We'll see big chains, restaurant chains, and so we'll have bigger premiums. When the market becomes more competitive ... we're seeing very good growth in policy counts, but actually those bigger accounts [are] what the market's chasing.
>
> So what we tend to do in this market is ... just hunker down and really focus on the small, low-hazard [policies] , and we don't worry about the big chains. We let everyone else ... fight it out on the bigger stuff. So, for example, two years ago there was an opportunity to do workers' comp, which we've done for many years, in auto dealerships, and we had a nice book of business. And came January 1, some markets came in and became very, very aggressive about pricing. We basically got rid of all that business -- not on purpose, we put our price out, but the market was way below [it]. And instead we're making it up with what we do very well, the smaller stuff.

But even though AmTrust is deliberately letting some business go, it has issued both equity (common and preferred stock) and debt in the past year. So we expect that the company will make multiple new acquisitions before the year is out, out even though it's already made nine year-to-date.

Over the past year, the S&P 500 is up about 4.5%. But AmTrust's stock has been on an absolute tear, having risen almost 50%. Though operational performance has been a big driver, the stock is not immune to the multiple expansion that has permeated the market.



Going forward, we'll continue to watch AmTrust's insurance ratios closely -- the loss ratio to see how underwriting is going, and the expense ratio to get insight into the integration of acquisitions as well as organic expansion efforts. But we continue to believe that the future is bright for this opportunistic niche investor, and that shareholders with an appropriate long-term mind-set will be rewarded with North Star-challenging returns, even at the current price.

Catching Up With 3 More Pro Companies

Published Aug 17, 2015 at 2:55PM

Dear *Pro* Fools,

After a deluge of company updates from Jeff last week, I've got another earnings recap Memo for you on three companies that reported within the last two weeks: **Broadridge** (NYSE: BR), **Parexel** (NASDAQ: PRXL), and **Papa John's** (NASDAQ: PZZA). If you're not in the mood to dive deep into the nitty-gritty details, check out the **bolded information** in each company's write-up — or skip to the end of the Memo!

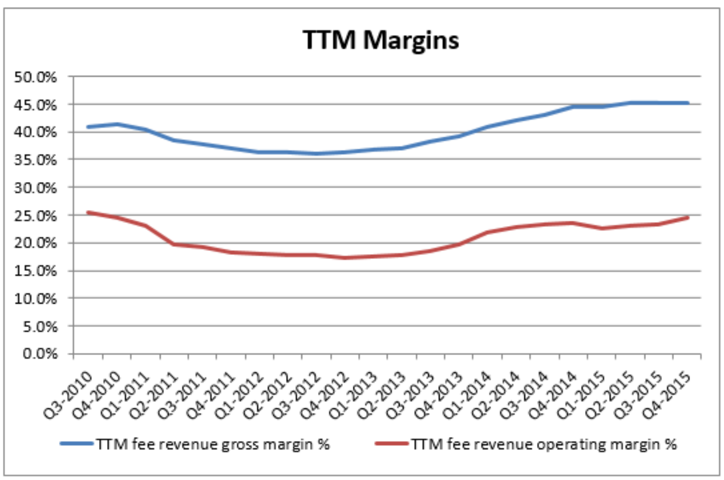
Broadridge®

Our leading provider of investor communications and financial industry technology solutions closed fiscal 2015 in its usual steady manner, posting record full-year recurring revenue closed sales (RRCS) of $146 million (up 15% year-over-year). RRCS represents anticipated annual revenue for new client contracts signed during the period, and that revenue must be recognized over time, rather than all at once right away. As such, Broadridge's reported revenue grew at a slower pace, up 5% year over year.

Once Broadridge's customers are on board, high switching costs discourage them from changing providers; revenue recurs at stratospheric rates of about 98%. Thus, RRCS is one of Broadridge's most important metrics, and tracking it gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings.

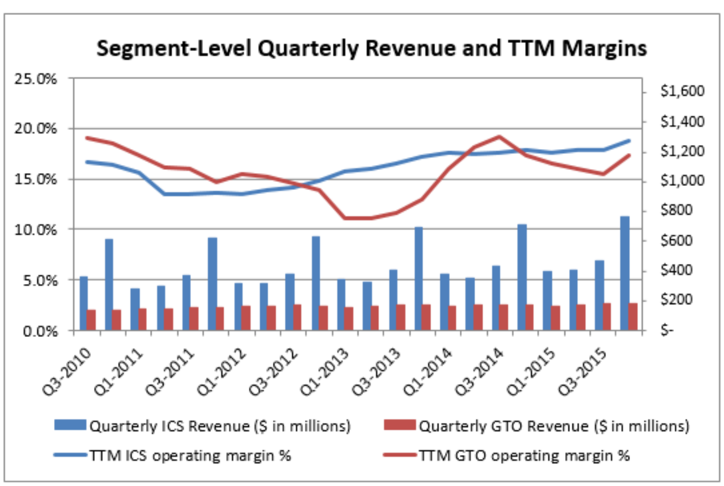
RRCS showed strong growth in fiscal 2015, demonstrating Broadridge's strong value proposition for its financial-industry clients, which include banks, broker-dealers, mutual funds, and corporate issuers. Additionally, RRCS was atypically stable this year, with no quarter accounting for more than 33% of the total for this year, and fiscal Q2 (calendar Q4) was the strongest sales quarter of the year. This is in contrast to the past three years, where fiscal Q4 (calendar Q2) accounted for an average of 46% of full-year RRCS. At the beginning of the year, management guided to $110 million-$150 million in RRCS, and the company was able to tip the scales at the very high end of that range.

Despite foreign currency headwinds, gross margin for trailing-12-month (TTM) fee revenue was up 70 basis points to 45.3%, and operating margin rose 89 basis points to 24.5% compared with the year-ago TTM period. Because Broadridge is a seasonal business — activity spikes in the company's fiscal fourth quarter as clients file proxy materials and annual reports — we prefer to look at TTM margins to smooth out quarterly fluctuations. These margins are the highest in the company's history, demonstrating the scalability of the company's capital-light business model:



Note: These figures exclude pass-through distribution revenue and costs, providing a clearer picture of the true profitability of the business. As such they are different than the margins reported in the press releases.

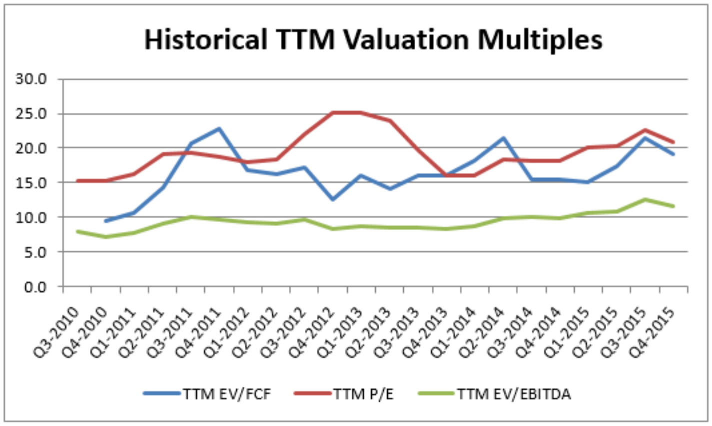
When looking at each individual segment — Investor Communications Solutions (ICS) and Global Technology Operations (GTO) — margins show a similar, albeit lumpier trend. This graph does a good job showing Broadridge's seasonality (note that it shows *quarterly* revenue compared to *TTM* margins):

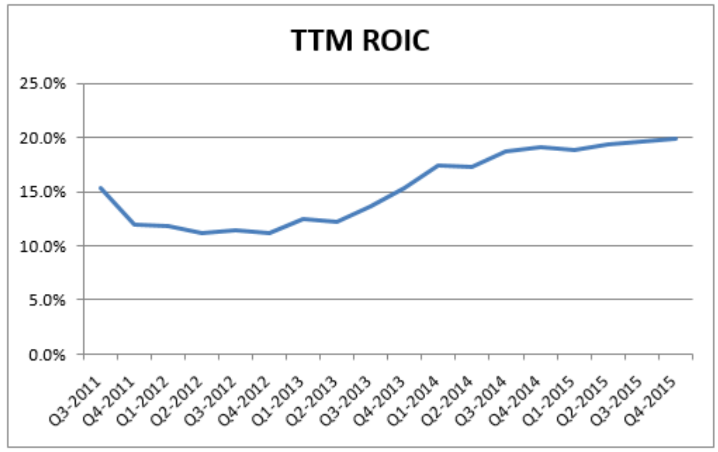


After incorporating fiscal 2015 results and the company's newly updated forward three-year objectives into my model, **we're increasing Broadridge's fair value estimate from $49 to $54**. Broadridge continues to benefit from a trend toward increased regulatory compliance and digital communication, and management's capital-allocation skills and investments in growth should lead to stronger sales performance and reinforced competitive advantages over time. The company has an excellent acquisition track record (a 20%-plus IRR) and in fiscal 2015 alone, the company spent over $200 million on four acquisitions (Direxxis, Wilmington Trust, Lipper's Fiduciary

Services and Competitive Intelligence Unit, and TwoFour Systems), which helps to augment the company's current product and service offerings. With more growth levers and cross-selling opportunities than ever before, Broadridge is very well positioned to meet the goals it outlined in its December 2014 Investor and Analyst Day presentation (see slide 87), which, if achieved, would lead to North Star-like stock price returns.

Although the company is trading at the mid-to-high end of historical valuation ranges at 24 times P/E, 12 times EV/EBITDA, and 20 times EV/FCF, the company boasts a historically high ROIC to show for it:



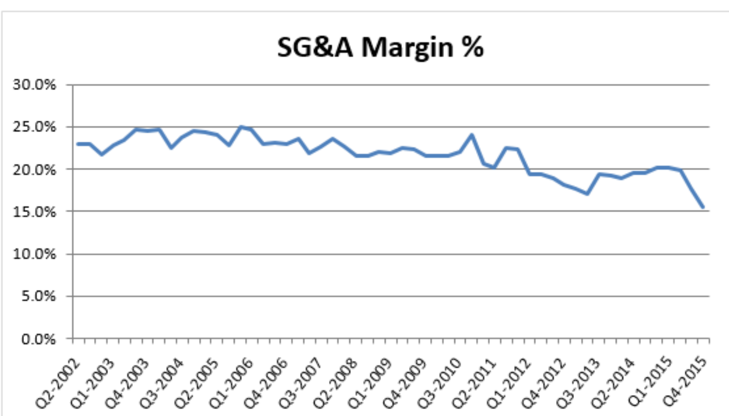


2016 guidance implies a forward multiple range in the vicinity of 20 times on a P/E basis and 17.6 times to 20 times on an EV/FCF basis. This high-quality business deserves to trade at premium multiples, and **Broadridge remains a high-conviction Buy on our scorecard. Now is as good a time as any to establish a position or fill out your allocation**.

PAREXEL

After pre-announcing a restructuring program and reduced guidance a little over a month ago, Parexel reported a typically lumpy quarter in fiscal Q4 2015. For the quarter, the company reported slowing growth in service revenue (2.4% vs. 10.2% in the same period a year ago), declining gross and operating margins (31.2% and 7.5%, respectively, vs. 35.7% and 11.5% a year ago), and a 12.8% decline in EPS.

But despite the ugly headline numbers, the underlying trends in the business are actually pretty healthy. The decline in operating margin has a lot to do with the $20 million of restructuring charges related to the company's "Margin Acceleration Program," and we got a sense of the type of cost savings we might expect once those charges (mostly employee separation benefits) are off the books. Thanks to a more streamlined organizational structure, SG&A expenses as a percent of service revenue (lower is better) declined sharply to 15.5%, the lowest it's been since as far back as I have data on the company. This ongoing expense reduction should ultimately result in higher margins over the long term:



As for gross margin, it's mostly mix- and timing-related, as the company continues to grow its headcount ahead of an expected ramp-up in revenue starting in fiscal 2016. Much like Broadridge, Parexel often books more revenue than it recognizes in a given quarter due to revenue recognition requirements. For example, in each quarter in fiscal 2015, Parexel reported higher growth in net new business wins (gross bookings minus cancellations) than growth in reported revenue:

	Q1-2015	Q2-2015	Q3-2015	Q4-2015
Reported service revenue growth (Y-o-Y)	9.4%	2.5%	2.0%	2.4%
Net new business growth (Y-o-Y)	9.7%	17.2%	13.9%	5.4%

As such, the company's net book-to-bill ratio remains at a healthy 1.19, suggesting that reported revenue should ultimately start to converge with new-business win growth as project revenue recognition milestones are met throughout fiscal 2016.

All indications suggest that we should see improved revenue growth and expanded margins in fiscal 2016 and beyond. But we may need to be patient; the company expects to pay further restructuring charges, and new employee productivity continues to ramp up. Still, underlying sales data and a biopharma industry tailwind toward increased clinical research and development outsourcing seem to point toward a brighter future for Parexel. We'll be watching to make sure that the company achieves its revenue ramp-up as expected in fiscal 2016.

We're increasing Parexel's fair value estimate from $61 to $63. Based on Friday's closing price around $68 per share, recent prices are a reasonable entry point for new investors or those who wish to fill out their allocation (or you could consider writing puts to buy shares a bit cheaper). The stock should continue to challenge the North Star, so long as Parexel can deliver on our expectations for 7% to 12% revenue growth and moderate margin expansion over the next three to five years.

PIZZA PAPA JOHN'S

Papa John's delivered yet another strong quarter in Q2 2015, with North American restaurants increasing comps by 5.5% and international restaurants increasing comps 6.8% (in constant currency). Global restaurant sales growth (which includes new restaurant units) came in at a solid 8.8%, although total revenue growth was a bit weaker (at 4.8%) in part because of a sharp drop in cheese block prices compared to a year ago (PJ's sells cheese to its franchisees — when cheese prices decline, the fixed-markup franchisee cheese sales decline in proportion). Due to strong international comps performance over the first six months of the year, management raised international comps guidance from a midpoint of 6% to 7% for full year 2015, on top of raising the midpoint of its domestic comps guidance from 3% to 4% last quarter.

Despite the strong comps and sales performance, earnings per share fell 33% year over year predominantly due to a $12.3 million legal settlement expense relating to the collective and class action lawsuit, *Perrin v. Papa John's International, and Papa John's USA*, which alleged delivery drivers were not reimbursed in accordance with the Fair Labor Standards Act. Adjusting for the non-recurring legal settlement expense, EPS grew 22.5% year over year.

Limited-time offers (including new menu additions Garlic Knots, Cinnamon Knots, and Papa's Lighter Choices), effective marketing, and continued migration to digital ordering (which garners higher average tickets and now makes up more than 50% of total sales) helped drive comps higher. These growth rates continue to suggest market-share gains at the expense of pizza industry rivals as Papa John's strong digital offerings and laser focus on quality continue to resonate with consumers.

The American Customer Satisfaction Index recently released its 2015 rankings for pizza chains, and for the 14th time in 16 years, Papa John's was awarded the top spot (tying with Pizza Hut):

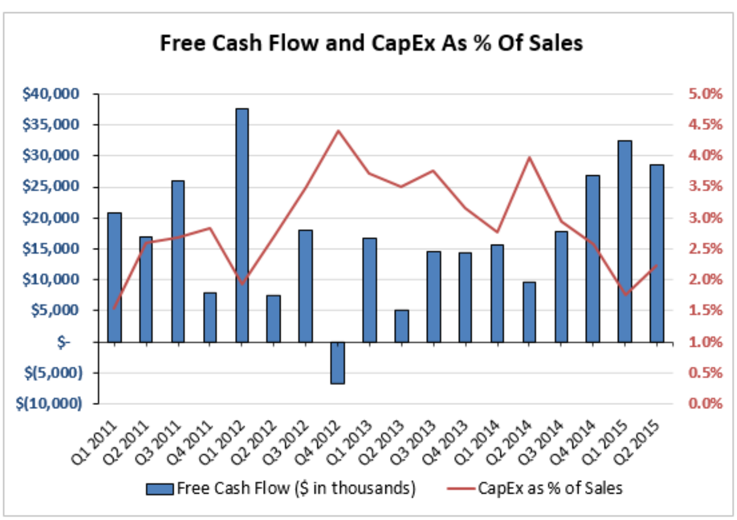
ACSI Customer Satisfaction Scores

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Papa John's	76.0	77.0	78.0	76.0	76.0	77.0	78.0	79.0	77.0	76.0	75.0	80.0	79.0	83.0	82.0	82.0	78.0
Little Caesar	70.0	69.0	70.0	74.0	75.0	74.5	74.0	77.0	75.0	75.0	75.0	78.0	80.0	82.0	82.0	80.0	74.0
Domino's Pizza	67.0	69.0	73.0	75.0	75.0	73.0	71.0	75.0	75.0	75.0	77.0	77.0	77.0	77.0	81.0	80.0	75.0
Pizza Hut	68.0	70.0	71.0	70.0	75.0	73.0	71.0	76.0	72.0	76.0	74.0	78.0	81.0	78.0	80.0	82.0	78.0
Limited-Service Rest. Avg.	69.0	70.0	71.0	71.0	74.0	75.0	76.0	77.0	77.0	78.0	78.0	75.0	79.0	80.0	80.0	80.0	77.0
Papa John's	76.0	77.0	78.0	76.0	76.0	77.0	78.0	79.0	77.0	76.0	75.0	80.0	79.0	83.0	82.0	82.0	78.0
Competitor average	68.3	69.3	71.3	73.0	75.0	73.5	72.0	76.0	74.0	75.3	75.3	77.7	79.3	79.0	81.0	80.7	75.7
Gap	7.7	7.7	6.7	3.0	1.0	3.5	6.0	3.0	3.0	0.7	(0.3)	2.3	(0.3)	4.0	1.0	1.3	2.3

Note: 2004 wasn't reported due to a change in measurement, so for continuity, the years 2003 and 2005 are averaged to obtain a 2004 data point.

Additionally, now that the company's FOCUS point-of-sale system rollout is essentially complete and cheese and meat prices have moderated, the company's margins are starting to improve, as we anticipated. The company's operating margin came in at 7.8% (vs. 7.1% in the same period a year ago), and free cash flow margin came in at 7.2% (vs. 3.5% a year ago), even despite unusually high G&A expenses in the period. Margins are likely to continue to increase as we approach the back half of 2015.

Trailing-12-month (TTM) free cash flow came in at $105 million, the highest since I've been covering the company, although this figure is bound to decrease a bit over the next year due to the legal settlement payment (despite recording the hit to earnings, the company hasn't paid the settlement yet and expects to do so within the next 12 months). As we can see, elevated capital spending (visualized as "CapEx as % of Sales") has moderated and free cash flow is higher because of it (note: this graph shows *quarterly* free cash flow rather than *trailing 12 months*):



Due to the higher free cash flow, the company now trades at about 30 times EV/FCF, which is lower relative to 2013 and early 2014 when it was often trading in the 40 to 50 range amid its FOCUS rollout and elevated spending. On an EV/EBITDA basis, the company is trading around 18.6, at the high end of historical ranges (which, alongside increased profits, helps explain why PJ's stock has appreciated over 80% in the past year). Neither EV/FCF nor EV/EBITDA are affected by the legal settlement expense, and as such the P/E ratio jumped higher to 36, due to depressed earnings because of that settlement expense. For context, fellow international franchisors **Domino's** (NYSE: DPZ) and **Dunkin' Brands** (NASDAQ: DNKN) trade around 40 times EV/FCF and 19.4 times EV/EBITDA, and 38 times EV/FCF and 17.7 times EV/EBITDA, respectively.

As the company has continued to trade higher, expectations have remained high, and that alongside the substantial legal settlement expense probably contributed to the stock declining more 5% on the day of its earnings release. After incorporating this quarter's results into my model, **we're increasing Papa John's fair value estimate from $54 to $57.50**, but at over $72 per share as of this writing, the stock is more than 25% above our conservative point estimate. Papa John's continues to post comps performance well in excess of what I've modeled (my base case assumes 3.5% annually over the next 10 years), and even as I've accounted for a higher likelihood of the bull case, the stock price continues to race ahead of my valuation estimates.

Nonetheless, if PJ's can continue to consistently churn out mid-to-high single digit comps growth, paying up for (and holding) the stock may be justified. **Papa John's remains a Buy at current prices, with a partial allocation of October 2015 $65 covered calls** that would see us sell one-third of our stake at a net $68.40 if the share price is above $65 at expiration. As expiration approaches, depending on the share price at the time, we'll consider either rolling our calls or letting them be assigned. Members who have yet to sell calls can still match us with $65 calls if they desire (achieving a higher net sell price), or they can sell higher-strike calls if they want to give their position more breathing room for upside. Of course, don't sell calls if you're not comfortable selling the shares you cover.

The *Pro* Bottom Line

Each of these three companies remains a Buy on our scorecard, with fair value estimates and allocations as follows:

- **Broadridge:** FV estimate increases to $54 (from $49), 4.6% allocation
- **Parexel:** FV estimate increases to $63 (from $61), 3.4% allocation
- **Papa John's:** FV estimate increases to $57.50 (from $54), 5% allocation plus a one-third allocation of October 2015 $65 covered calls

Despite the currently volatile market environment, we maintain our long-term view and believe that each company will be able to deliver North Star-beating returns (lately around 8% to 9% annualized) over the next rolling three-year period.

If you have any questions, feel free to stop by the discussion boards:

- Broadridge
- Parexel
- Papa John's

Fool on!

— Billy (TMFBillyTheKid)

Boulder Brands Stock Spikes on Buyout Hopes

Published Aug 14, 2015 at 10:28AM

What Happened?

After announcing the resignation of its CEO and preannouncing lowered guidance, **Boulder Brands** (NASDAQ: BDBD) reported an awful quarter that even underperformed its own recently lowered estimates. Despite guiding to net sales in the quarter of $122-$124 million and adjusted EBITDA of $12-$14 million less than two months ago, the company reported sales of $118 million (-10.4% year-over-year) and adjusted EBITDA of $11.7 million (-33.5% year-over-year). The company guided to a 0%-2% year-over-year increase in sales in the Natural segment and 16%-18% year-over-year decrease in sales in the Balance segment, but delivered a decline of -2% in the Natural segment and a decline of -24% in the Balance segment.

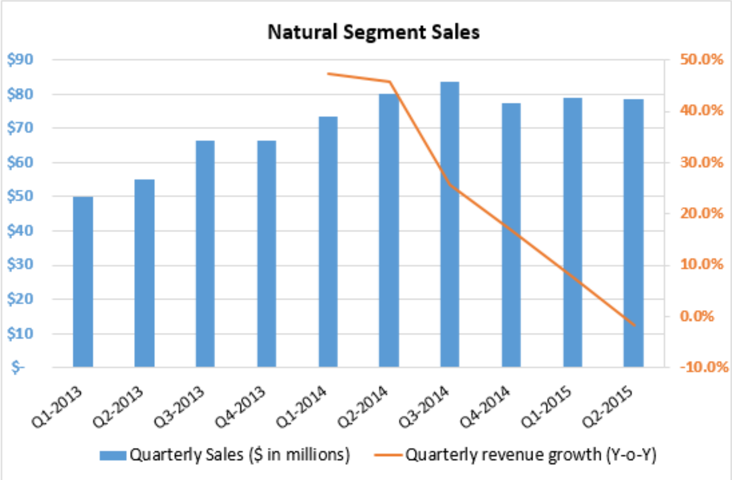
But yet, the stock rose over 17% on the day of the report, and it was up almost 5% the day after. Though it has given back some of those gains, given where the price is as I write this, the stock is up 40% from it's year-to-date low of $6.28 on July 8th, just over one month ago. The stock is trading close to where it was when we established our initial short position in March, despite the aforementioned resignation of CEO and co-founder Stephen Hughes and sharply deteriorating financials since then.

Why? Alongside earnings, the company announced that it is exploring "a range of strategic and financial alternatives to enhance shareholder value" -- corporate-speak for "we are looking to divest a portion of our business or be acquired". The company mentioned in the announcement that they have "recently received inquiries from a number of qualified parties that expressed interest in discussing a potential transaction with Boulder Brands."

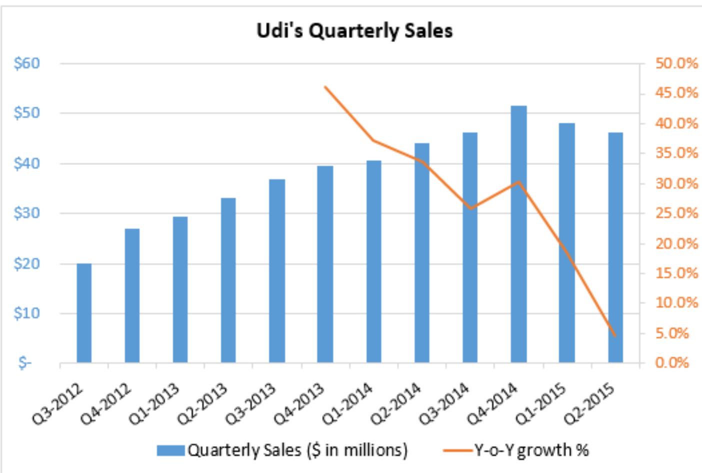
This announcement, alongside the disclosure of a 9.6% position by activist investing fund Engaged Capital, seems to have sparked renewed interest in Boulder Brands from special situations investors hoping to make a quick profit on a merger or acquisition candidate. It also doesn't help that Bill Ackman recently disclosed a multi-billion dollar stake in consumer packaged goods (CPG) giant Mondelez International (NASDAQ: MDLZ), drawing market attention to the possibility of further waves of food industry consolidation.

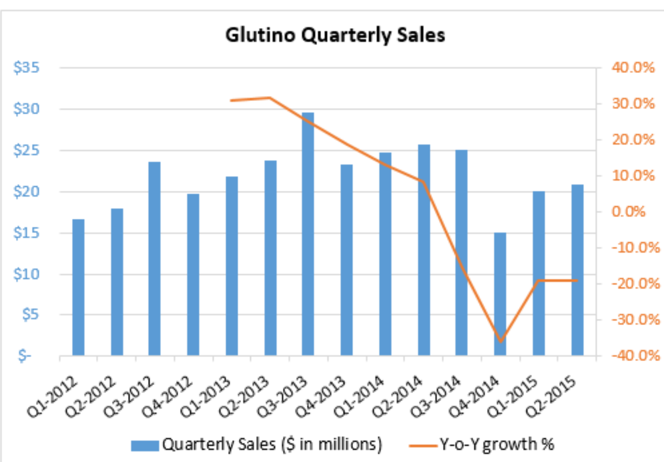
So What?

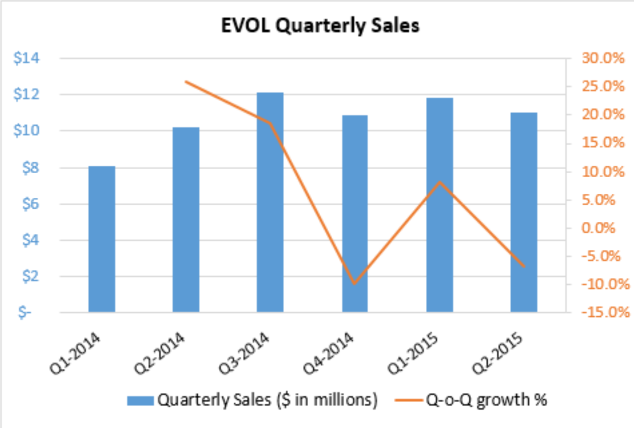
Based on the numbers from the Q2 report, our short thesis is tracking wonderfully -- perhaps even better than we expected. The key element to our short thesis was that the prior sales growth trajectory of the company's Natural segment (composed predominantly of the newly acquired Udi's, Glutino, and EVOL brands) was misleading and was likely to slow. That's exactly what happened. As of the most recent quarter, the Natural segment is now experiencing *declining* sales, down -1.9% vs. the same quarter a year ago:



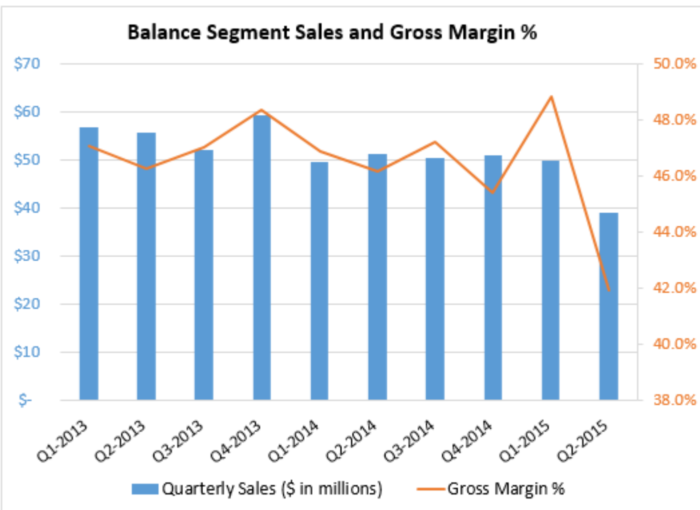
Breaking it down even further by looking at each individual brand, we can get an even more granular picture of how sales growth in the Natural segment has deteriorated now that initial distribution gains have been fully lapped. Given that the company continues to change its disclosures on brand-level sales (perhaps in order to obscure the data), note that these sales figures are educated guesses derived from piecing together disparate yet corroborating data points:





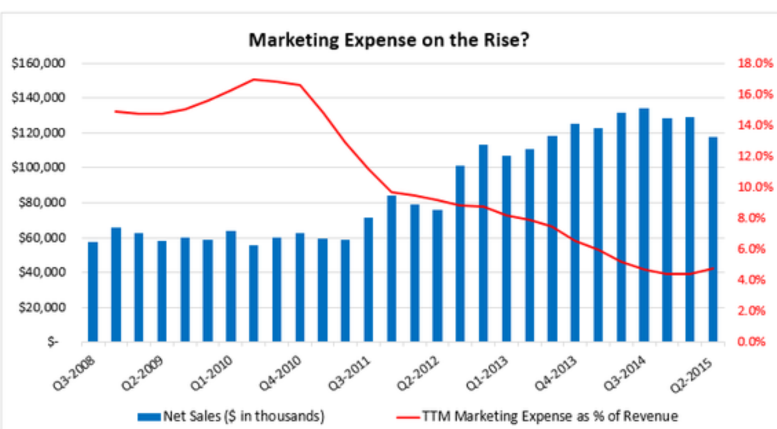


All three of the company's key brands in the Natural segment are experiencing declining growth trends, with some brands (notably Glutino) posting strongly negative growth. In addition to weakness in the company's previously high-growth Natural segment, the company's legacy Balance segment experienced severe weakness as well, posting the worst quarter for this segment in the company's history:

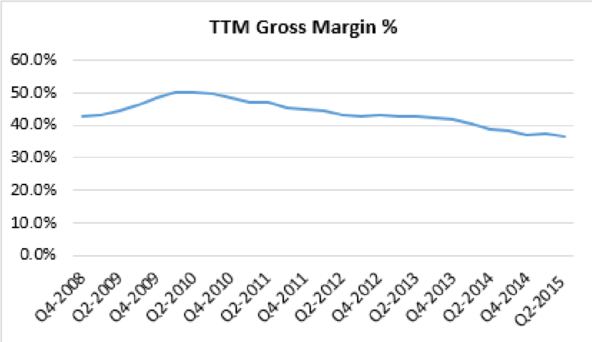


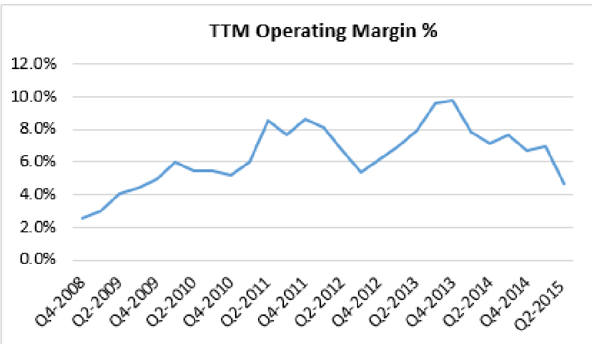
I wrote last quarter that I expected the Balance segment to post weak results due to an early Easter date in Q1, but I didn't expect the deterioration to be as severe as it was, especially in light of increased marketing spend from the company as the new management team shifted strategy following the resignation of the previous CEO. Nonetheless, this segment may bounce back a bit next quarter as the Easter-related seasonal factor rolls off.

Interim CEO Jim Leighton spent quite a bit of time on the call talking about the company's marketing strategy, mentioning that one of the company's critical issues is to become "more balanced and effective in marketing". In Q2, the increased marketing spend didn't seem to pay off, and due to increased competition, a weak financial position, and diminished brand positioning/awareness, the company may have a difficult time translating the increased spend into proportionally higher sales. The company may have entered a vicious cycle where higher marketing spend lowers margins, which diminishes the ability to reinvest in the brands, which reduces sales, and so on and so forth:

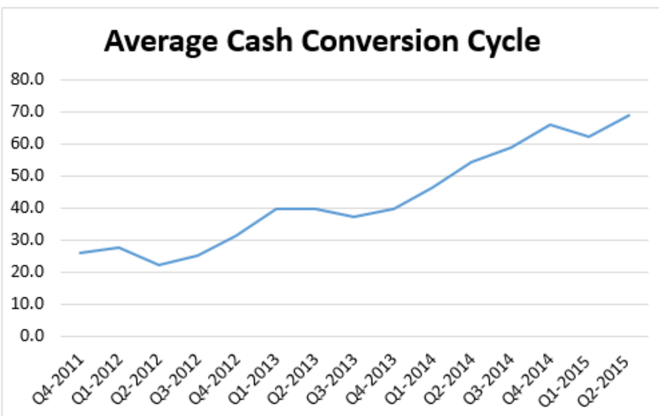


Due to increases in operating expenses across the board, margins really took a hit in Q2, with gross margin coming in at 32.4% (vs. 35.7% a year ago) and operating margin coming in at -3.6% (vs. 6.6% a year ago), and net margin coming in at -3.1% (vs. 2.1% a year ago). On a segment-level basis, the Natural segment posted a 27.6% gross profit margin (vs. 29.1% a year ago) and the Balance segment posted a 41.9% gross profit margin (vs. 46.2% a year ago).





Other financial metrics aren't faring well either, with the company's cash conversion cycle continuing to rise (lower is better) even as the company reported negative sales growth. The company continues to take longer to move its inventory and to collect on sales, suggesting that even these lower sales levels may have further to fall:



Now What?

Despite the rise in the stock price, because we capped our risk with protective calls in late June, here's how Pro's profit on the overall strategy looks so far:

	# of Shares/Contracts	Start Price	Cost Basis	Current Price	Market Value	Profit (Loss)
Original Short (3/23/15)	-3900	$9.60	($37,432)	$8.79	($34,281)	$3,151
Add More To Short (6/22/15)	-2300	$6.98	($16,050)	$8.79	($20,217)	($4,167)
Buy Protective Calls (6/22/15)	62	$0.60	$3,726	$1.40	$8,680	$4,954
TOTAL			($49,757)		($45,818)	$3,939

Based on our total cost basis of -$49,757 (our cost basis is negative since this is a short), our profit of $3,939 leaves us with nearly an 8% profit so far on the overall strategy. Capping our risk with protective calls just over a month ago turned out to be a prudent move -- without the calls, we'd be looking at about a 2% loss on our overall short.

Due to the profit/loss curve on our position, the profit on our position is essentially locked in -- we can't lose money on the strategy if the stock keeps going up (with the exception of a small amount of erosion from the time value still embedded in our calls), and we can still earn a higher profit if Boulder Brands' stock price ends up below $7.50 per share by September expiration.

Given the company's continued deterioration in financial metrics, negative business momentum, and still-high valuation (a negative GAAP P/E ratio, 125x trailing adjusted earnings, 17.2x adjusted EBITDA, and 547x trailing free cash flow), we think maintaining exposure to downside at these levels is still a prudent decision.

Although it's always possible that the company is acquired at a premium to the current share price, we're doubtful that an acquiring company would want to pay the current (let alone higher) multiples for a business that's struggling as mightily as Boulder Brands. We think that the announcement of "strategic and financial alternatives" was a strong public relations move that was able to draw attention away from the company's deteriorating financials without giving any real insight into the actual likelihood of a sale. And even if the company is acquired, our profit is locked in by our protective calls, which we can exercise at any time to close our short. **Boulder Brands remains an active 2.1% short on our scorecard, fully hedged by in-the-money September $7.50 owned calls.** If the company is yet to be acquired by September expiration, we'll consider rolling our calls out to December or March in order to maintain exposure to further downside.

For those who have yet to start a position or who have not yet bought protective calls, I'd suggest that they do one of three things:

- **For those who want to match *Pro*:** mirror *Pro's* position with a 2.1% short allocation and one bought (buy to open) September 2015 $7.50 call for each 100 shares shorted, or establish the functionally equivalent trade of buying (buy to open) September 2015 $7.50 puts, targeting a 2.1% allocation (with the latter you must may cash up front as opposed to receiving a cash inflow).
- **For those who wish to be more aggressive:** establish a 2.1% short allocation and buy (buy to open) one September 2015 $10 call for every 100 shares shorted, or establish the functionally equivalent trade of buying (buy to open) September 2015 $10 puts, targeting a 2.1% allocation. Note that this would be off-reservation from *Pro* and you will not receive official guidance on this position moving forward.
- **For those who wish to be even *more* aggressive:** establish a 2.1% short (or synthetic short) allocation, leaving it uncovered. You could establish this position if you are confident that the share price is likely to decline from here and are willing to accept the risk of the stock rising (for example if the company is bought out at a premium to the current price). Note that this would be off-reservation from *Pro* and you will not receive official guidance on this position moving forward.

Note that with the three strategies mentioned above, your profit/loss curve will be different than that of *Pro's* position which has been established over time. For those with $7.50 calls, if you establish the position today, because of the protective hedge, you won't begin to profit until the stock declines below about $7.50. For those who choose to buy $10 calls, you won't begin to profit until the stock declines below about $8.50, and you can lose money up until the stock rises just above $10 per share, at which point you would be hedged by your bought calls. For those who choose not to hedge their short, you will profit inversely at a 1:1 ratio as BDBD's stock price changes (for each share you short: for every one dollar the stock price goes down, you gain one dollar, and vice versa), and your maximum risk is uncapped.

Pro Can Help

- **Questions?** Visit our Boulder Brands discussion board.

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7 Pro Company Updates; Plus, Medtronic Is a Buy

Published Aug 10, 2015 at 3:11PM

***Pro* Completed Trades**

- **Coca-Cola** (NYSE: KO): We set up synthetic covered calls per last week's trade alert, selling to open January 2016 $43 calls for $0.90 each. We wrote one call for every January 2016 $35 call we own.
- **Live Nation** (NYSE: LYV): We wrote puts per last week's trade alert, selling 21 contracts for $0.65, a 2.7% yield in 2.2 months.

***Pro* Guidance Changes (details in the Memo)**

- **Medtronic** (NYSE: MDT): The stock moves to **Buy**, with a new, higher fair-value estimate of $74, and a 3% allocation. Earnings are due around Aug. 17.
- **Skyworks Solutions** (NASDAQ: SWKS): Fair-value estimate increases to $85. Shares remain a Buy with a recent 4.1% allocation.
- **Tupperware** (NYSE: TUP): Fair-value estimate decreases to $72. Shares remain a buy with a 2.2% allocation.

We Welcome *Pro*'s New "Home Fool!" We're delighted to announce that Toby Bordelon (you may know him as TMFEpsilon) has joined *Pro* and *Options* as our "Home Fool." You'll find Toby answering questions and pointing members in the right direction on our discussion boards -- now in an official capacity for us, though he's been doing just that at TMF since 1998. At the same time, we want to thank Lon Levy (phooLon) for his work as our previous Home Fool. Lon did an outstanding job helping hundreds of members in *Pro* and *Options*. We're very grateful, and we're excited that Lon remains as active as ever in our community. Thank you to Toby and Lon! Be sure to check out Toby's great introductory post.

Dear Fools,

Earnings season has blown through like a summer storm, and *Pro* sailed through it. Our portfolio has appreciated, most positions are higher, and -- most importantly -- most of our companies are excelling, while none (except our shorts) are on shaky foundations. Let's review several... with guidance updates!

American Airlines (NASDAQ: AAL)

- Buy January 2017 $35 calls
- About a 0.5% allocation

Last quarter, our favorite airline (or our favorite airline *investment*, anyway) reported a record second-quarter net profit of $1.7 billion, or $2.41 per share. That was compared with $864 million in profits, or $1.17 per share, the year prior. The financials are flying high as fuel prices keep doing the limbo. More important, the consolidated U.S. airline industry is by most signs being managed for profits rather than market share. This is good. Reflecting confidence in its position, and dubbing its share price undervalued, management bought back $753 million in stock at $43.53 per share last quarter, and announced a new $2 billion buyback.

But Wall Street remains focused on passenger revenue per average seat mile, or PRASM, and this number fell 6.9% to $0.1357. PRASM was down 5% domestically; the rest of the decline was because of a strong dollar and and results from international markets, mainly Latin America. Given much lower operating costs, airlines are spending some money to grow capacity. More seats mean lower prices in some markets -- or more empty seats, decreasing PRASM. American Airlines management says this may be the new norm, and advises Wall Street to focus on total profitability instead. American has $4.2 billion in trailing net income, and management expects record profits to continue even though PRASM may decline another 6% to 8% in the third quarter. Because of the aforementioned capacity increases and the strong dollar, PRASM may not turn positive again until the second half of 2016 (which would be fine for our 2017 calls). Either Wall Street will learn to look beyond PRASM to operating results, or we'll be waiting a while before enthusiasm returns to the shares.

We're in no hurry to write diagonal calls on our beaten-down calls, though. The stock only fetches about 6.6 times expected 2016 earnings. Oil has recently slipped again, and American (which doesn't hedge fuel prices) should benefit further. The company is bullish on its future, and we know how quickly Wall Street's emotions can change toward a stock, especially an industry leader that looks cheap. If investors become comfortable with current PRASM dynamics and start to believe that profits overall are here to stay, American shares should benefit greatly. We're content to sit on our calls, which are a small position.

Gilead Sciences (NASDAQ: GILD)

- Buy First
- 4.1% allocation
- Fair-value estimate stays at $120 (but is due for an update, likely trending higher, next quarter)

Our biotech giant exceeded expectations and raised guidance for the year yet again. Revenue climbed 26% to $8.2 billion, nearly 10% higher than estimates, and earnings per share were up 33.5%. The company's new (as of last year) Hepatitis C drugs accounted for more than half of revenue, and the increase there was more than was expected. Once again, management said it's "still early days" for the drugs: Many patients haven't yet been given access to this potential cure, new patients are diagnosed every day, and international markets are still opening up. In the U.S. alone, Gilead has only treated about 300,000 patients out of 1.6 million diagnoses.

From the start of our position, we've argued that Gilead's Hepatitis C franchise would bring in strong revenue for a much longer period than Wall Street was estimating, and we continue to believe that's the case (though sales will eventually level out). Currently, Gilead is grabbing about 90% of the market share in treating the disease, showing that health-care providers recognize Gilead's superior cure and side-effect profile. As of last quarter, about 470,000 patients globally had started treatment with Gilead's hepatitis drugs, a tiny sliver of the potential audience.

At a recent $118, the stock trades at only 10.1 times expected earnings for this year, and it remains a Buy First. Looking out longer than a few years, we'll have to see how Gilead can fill in the eventual large sales gap that slowing Hepatitis C revenue will bring. I suspect a large acquisition may come into play.

Medtronic (NYSE: MDT)

- Returns to **Buy**
- 3% allocation
- Fair-value estimate increases to $74

A leading medical-device maker, massive Medtronic increased sales by 7% in its April quarter after adjusting for currency effects. After our early assessment of its merger with Covidien, we're returning the company to Buy status, and members without shares can purchase up to 3%. Keep in mind that an earnings report is due again mid-month. We view that as a non-event; it's just a chance to learn more, given that nobody knows how the stock will react in the short term.

Zeroing in on value creation, the company delivered $1.7 billion in free cash flow in its last quarter and should reach $6.5 billion free cash flow for the year. Management plans to continue to return about 50% of cash flow to shareholders through increased dividends and buybacks, and expects the Covidien merger to lead to at least $850 million in cost synergies by the end of fiscal 2018.

While Medtronic has long touted itself as a play on international markets, growth in the U.S. has regained traction, too. Last quarter (ended April 24), U.S. revenue was up 8% to represent 56% of sales. Emerging-market sales rose 11%, representing just 13% of sales. Management sees strong long-term potential in emerging markets, but our sense is that this nut is proving harder to crack than expected, and it's going to take longer than hoped to reach scale in places like China. But it's still possible over time.

Whether it's cardiac issues, spine injuries, knee problems or something else, Medtronic is a steady innovator and market leader in vital medical devices. The stock yields nearly 2%, and over the past 38 years the dividend has increased every year -- resulting in an 18% compounded annual growth rate (CAGR). Expect continued dividend increases, sales growth of about 4% to 6%, and earnings-per-share growth even higher than that, all of which should combine for North Star-challenging returns. The stock moves back to Buy as our confidence in the Covidien merger grows.

OpenText (NASDAQ: OTEX)

- Buy
- 2.5% allocation
- Fair-value estimate stays at $55

With about 65,000 cloud software customers and renewals in that space running at about 95%, OpenText is now a cloud software company -- the cloud accounts for fully 33% of sales. But as with **Oracle** (NYSE: ORCL), it's really a hybrid. OpenText also sells software on-premises on a license basis (the old-school way!), and renewal rates on those are in the low-90% range. To be clear, OpenText is not looking to replace license sales entirely with cloud sales. Instead, some customers have a preference for one over the other, and many customers order a combination of both. This is fine with OpenText; offering and supporting both is the long-term plan.

A leader in Enterprise Information Management (EIM), OpenText offers customers a full array of related software solutions. The three areas of focus are data and information management; information exchange platforms within and across organizations; and analytics, where "big data" is used to gain insights and run the business better. OpenText helps customers go digital with their data, a market that should grow smartly for a long time. Last year, OpenText increased adjusted operating cash flow by 25%, and margins are expected to trend higher going forward. The $46 stock trades at 13.2 times expected non-GAAP earnings for the year ending June 2016.

So where we do stand now? We're considering moving OpenText to Buy First status based on valuation, and if we do, we may add a tad more to our position as well. That would be an easier decision if we didn't already own a decent stake in Oracle, but since we do, we have to be certain we want more software exposure before acting. If not, we're content with our current stake. Either way, we're inclined to wait in part because the IRS is seeking $550 million in taxes and penalties relating to a 2010 restructuring. OpenText strongly disagrees with the request, and is fighting it. Resolution would be welcome. OpenText has the cash, but it would be a giant amount to pay out. Management is confident right now that they won't have to, but ... you never know.

O'Reilly Automotive (NASDAQ: ORLY)

- Buy
- 4.8% allocation
- Fair-value estimate stays at $190

Auto-parts retailer O'Reilly presented another outstanding quarter, with revenue up 10.2%, same-store sales up 7.2%, higher margins, and earnings per share up 20%. Growing complexity in car parts is helping the business, as are other tailwinds: People are driving more; cars are lasting longer and thus being repaired more often; fuel prices are lower; employment is going up. Plus, O'Reilly is excelling with both professional and retail customers, while steadily adding close to 50 stores per quarter (99 in the first half of the year).

Though the $240 shares trade a premium (26 times forward earnings estimates), we're happy to keep owning our stake in O'Reilly. We will likely see a flat few years, though, in a weaker stock market. That's something we're willing to wait through rather than selling, paying taxes, and hoping to get back in at a lower price. We will consider covered calls, meanwhile, but so far *not* writing any has been a very good choice. We have also considered moving the stock to Hold, but haven't yet; in the past, doing so proved to be a mistake.

Skyworks Solutions (NASDAQ: SWKS)

- Buy
- 4.1% allocation
- Fair-value estimate increases to $85

Increasing complexity in Internet-connected devices is driving higher profit margins at analog semiconductor leader Skyworks. From the horse's mouth, the company "sells the smallest, most efficient, and most integrated products in the market today, incorporating all amplification, switching, logic and filtering. And this is both in transmit and receive functions." Like music to our ears, Skyworks is winning customers across multiple industries, from home to auto to smartphones to appliances to routers, as competitors can't deliver these complex, integrated solutions. As complexity increases, the lead time on design cycles with customers is growing to as many as two to three years. This gives the company better visibility on revenue than it has ever had, and Wall Street loves that.

At the same time, gross margins are heading higher, and management says that should be the case for years ahead. By calendar 2016, the company is targeting $7 in earnings per share on a run-rate basis (most recent quarter times four). The $89 stock trades at only 12.9 times that projected result. Last quarter, sales grew 38% to $810 million, and earnings per share jumped more than 60%. The company expects its long-term total addressable market to grow around 15% annualized, and hopes for a rate even faster than that.

Tupperware (NYSE: TUP)

- Buy
- 2.2% allocation
- Fair value estimate decreases to $72

Although Tupperware's stock has had a rough ride in recent years, the business has been stable. Free cash flow is steady, sales were up 4% last quarter in local currencies, and the company expects $4.42 to $4.52 in earnings per share this year. That values the $59 stock at about 13 times earnings (at the midpoint of guidance), and the shares yield a generous 4.6%.

However, Tupperware hasn't increased its free cash flow (or revenue) for many years, and management decisions over the past few years have us starting to question how long the business belongs in the portfolio. Specifically, the company took on debt to buy back shares at much higher prices, and management hiked the dividend to a level that allows no room to reasonably increase it unless the business grows much more. To put it simply, they were too aggressive.

Meanwhile, Tupperware's 3-million-strong global sales force produces sporadic results by region. Sometimes European countries are hot, other quarters they're cold. Weakness has occurred lately in emerging markets, too, which was never the case in earlier years (to my memory). Emerging markets make up two-thirds of sales, and revenue there should increase by at least 10% annualized, but some markets hit air pockets, and the strong dollar dings every sale when it gets converted to U.S. currency.

This leaves us with less than a compounding machine. Right now, we're giving Tupperware the benefit of the doubt, hoping it can unlock the secret to securing steady growth for a number of years, driving shares much higher. But if growth doesn't start to materialize, our patience will wear thin, and we'll strongly consider ditching Tupperware at that point for something better. Let's hope it doesn't come to that, but if it does, we'll be ready.

Foolishly,

-- Jeff (TMFFischer)

MasterCard Rings Up Another Solid Quarter

Published Aug 6, 2015 at 5:16PM

Though MasterCard (NYSE: MA) posted disappointing sales growth for the quarter, shares have continued to perform well as investors remain optimistic about the business's long-term potential. A combination of currency headwinds, soft economic conditions in Asia and Latin America, and falling gas prices all weighed on results, but the company is still on track to hit management's long term goals of 11% to 14% net revenue CAGR, 20% earnings CAGR and 50% annual operating margin.

Globally, the number of cards grew 8% to 2.2 billion and processed transactions grew by 13% in the quarter to over 12 billion. An important indication that the business is strengthening is that processed volume has increased by two percentage points sequentially in both the U.S. and internationally, and every region grew at a double-digit rate except the U.S. which grew in the high single digits.

Adjusted for currency, net revenue increased 7% and earnings per share grew 15% despite higher expenses from integrating acquisitions. G&A increased 14% for the quarter, but that growth would have only been 3% excluding acquisitions. The company is also still digesting the loss of the Chase portfolio, which will result in tough comps through the end of the year.

What About China?

Management remains cautiously optimistic about their planned entry into China. The company confirmed that it will be technically ready to process payments in China by the end of 2016, but it expects there to be numerous restrictions and complicating factors as the market slow opens to foreign competition. As a result, management is being very deliberate with their near term investment plans for the country and have yet to include any China spending in the 2015 cost guidance.

What? Another Law Suit?

Regulatory issues will continue to be a problem as a new antitrust suit was filed in Europe, but these allegations also confirm the strength of the card company's competitive advantage. In July, the EU announced that it was filing an antitrust suit against MasterCard regarding the difference in interchange fees charged on cross-border transactions. For context, this suit covers less than 1% of the company's total volume and similar charges were levied against Visa over three years ago without a resolution. I expect a similar drawn-out process to take place with MasterCard and though the company may need to pay fines and reduce some fees, based on the outcome of similar suits over the past several years it shouldn't impair the long term prospects of the business.

How 'Bout Those Acquistions?

MasterCard's recent acquisitions also continue to show positive results. The company's SafetyNet technology that not only detects fraud events but also reacts in real-time is quickly growing in popularity. Only two years after its initial launch 80% of MasterCard's issuers are using the service. Cybersecurity is a critical differentiator for processors and it will continue to be an increasing cost of doing business for the entire payment industry.

Also, by combining the company's existing Asia-Pacific gateway with the recent DataCash and TNS acquisitions, MasterCard has created one of the few global e-commerce gateway solutions which allows for more cross-selling opportunities across the company's existing customer base. As a result, we're also seeing early success in expansion to adjacent offerings like loyal programs that will likely become even more important as we transition to mobile payments.

Where From Here?

Despite lukewarm economic conditions across most of the world, MasterCard continues to execute well and consistently grow its global market share. Shares are up about 12% year-to-date, easily besting the market and contributing positively to our North Star return goal. Thanks to a growing global presence and consumers' transition from cash to digital payments driving demand, we're looking forward to many years of value creation. MasterCard remains a Buy and we'll be reevaluating our fair value estimate in the coming weeks.

Write Puts on Live Nation

Published Aug 6, 2015 at 9:54AM

Is this for you? This is for *Pro* members who are looking to generate income and lack at least 2% exposure to this company.

How You Participate

- **Trade:** Sell to open Oct. 16, 2015, $24 puts on **Live Nation** (NYSE: LYV).
- **Allocation:** If we get shares, 2% in stock. Sell one put for every $120,000 in your portfolio. *Pro* will sell 21 contracts.
- **Price Guidance**
  - Now: Initially, aim to get paid at least $0.90 per put. This is a 3.8% yield in a little less than three months.
  - Future: As prices and time to expiration change, those approaching the position should aim to get paid a yield of around 1% or so per month to expiration. Also, make sure the strike price you choose is at least 2.5% below the current stock price.
- **Prices** (as of 1:56 p.m. ET):
  - **Stock price:** $25.12
  - **Option Price (bid/ask):** $0.85/$0.95 (splitting the bid/ask = $0.90)
- **Note**: The company reports earnings Aug. 10.

What We're Thinking

It's been business as usual with LiveNation since our initial trade alert on March 31; the only point of note came after first-quarter earnings July 30, when the stock briefly popped almost 7%. But that doesn't mean it's been a snoozefest – in the past few months, Live Nation has announced multiple new sponsorship partnerships, not to mention a few meaningful acquisitions.

- April 30: Bonnaroo, one of the largest music festivals in the United States
- June 9: Front Gate Tickets and Universe -- the former helps strengthen Ticketmaster's position in the festival space, and the latter does the same for DIY ticketing.
- August 3: Marek Lieberg, the fifth-largest concert promoter in the world

Since peaking at $29.21 on June 11, the stock has fallen around 14% for reasons unbeknownst to us. But we're not complaining -- we find writing puts to be a lot more attractive at this level. We estimate that the stock is worth somewhere between 12.5 and 13 times EV/EBTIDA (the level it reached after first-quarter earnings), compared with its current multiple of 11.7.

We're once again targeting a $24 strike price because, though we like the company's long-term prospects, our current long exposure leaves us wanting to be a bit more defensive with our income-generating positions. With the income for this position at $0.90, we'll have brought in a total of $1.60 per share with our two written puts on Live Nation, giving us an effective start price of $22.40. (Your mileage may vary depending on how much you collected in the first go-round and your tax situation.) This is almost 11% lower than the current level, and we'd happily buy shares for this price.

More That Matters

Maximum loss: Our risk is the same as share ownership starting at about $23.10, or 8% less than recent prices.

Maximum gain: On this put write alone, our maximum gain is the put premium. At $0.90, that's a 3.8% yield in 71 days.

Follow-up: We'll buy shares at a net $23.10 if the stock is below our $24 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **Not using options?** In that case, wait to see if the stock declines to about $23.50 or so and then start a 2% stake.
- **Want to be even more defensive?** The January $24 puts pay about $1.50, which is a 6.4% yield and reduces your net start price even further to $22.50.

Pro Can Help

- **Need a refresher on writing puts?** Check out our guide.
- **Questions?** Crowd-surf on over to our Live Nation discussion board.

Visa Charges Ahead

Published Aug 5, 2015 at 1:17PM

The world's largest payment processor, **Visa** (NYSE: V), rolled with the punches as usual this quarter, once again reporting solid results.

Visa Q3 2015

Consolidated Results

		change
Revenue	$3.5 Billion	12%
Free cash flow	$2 Billion	11%
EPS*	$0.74	29%

Total Cards
2.4 billion
7% increase

Segment Results

(USD Billions)

		change
Service revenues	$1,550	9%
Data processing revenues	1,400	6%
International transaction revenues	1,039	21%
Other revenues	199	2%
Client incentives	(670)	5%
Total operating revenues	$3,518	12%

Updated guidance: Buy (no change)

Recommended allocation: 2.3%

Fair-value estimate: $74 (up from $72)

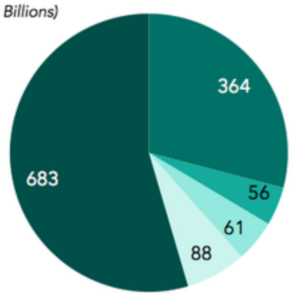
Current Multiples

Multiple	Trailing	Forward
P/S	13.5	13.5
P/E	31	27
EV/EBITDA	19.7	17

Revenue growth came in above management's expectations for the quarter, despite sizable foreign-exchange headwinds and other challenges (including high currency volatility and lower client incentive levels, which came about because of lower payment volumes and performance adjustments). Moving down the income statement, the company also recognized a $280 million tax benefit this quarter that had the effect of pulling forward $0.12 of EPS from Q4 (when it was originally expected to occur).

Global Payments Volume

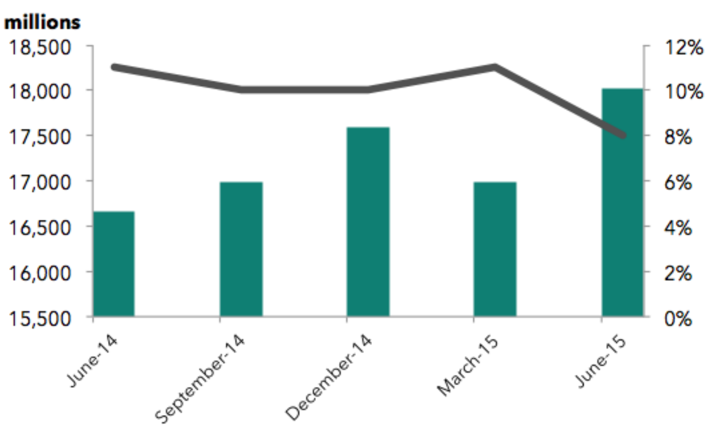
(USD Billions)



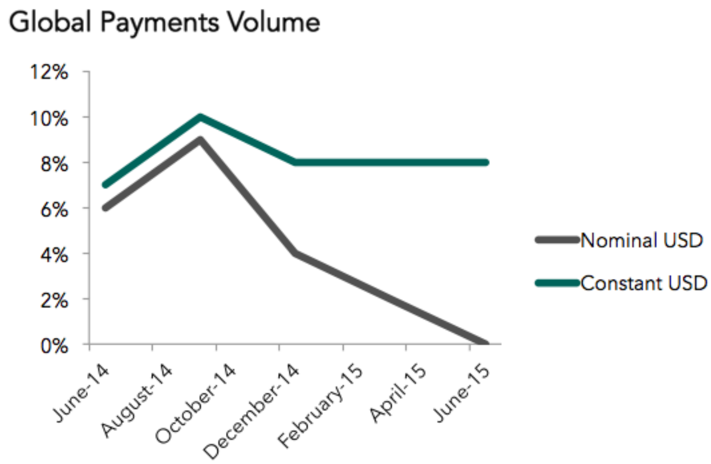
	Growth	
	Nominal	Constant USD
Asia Pacific	8%	15%
Canada	-6%	5%
CEMEA	-6%	15%
LAC	-13%	12%
US	9%	9%

Global payments volume, which is the primary driver of service revenue, increased by 5.1% this quarter, or 11% based on constant dollars. Cheap gas prices continue to have a sizable negative impact on Visa's results here in the U.S.; consumers are using most of the savings to pay down debts or improve their household balance sheets, rather than charging new purchases. Another contributor to the deceleration in growth was the continued moderation of the Chase conversion, though winning this account should ultimately prove to be a tailwind for the company for a long time.

Processes Transactions & Growth



Transactions processed over Visa's network, the primary driver of data-processing revenue, were up 8% year over year to a little more than 18 billion. Sequentially, however, this was a decline of 3% from the March quarter. This is primarily because the company transferred domestic processing in Russia to a national card payment system known as NSPK, which was created in response to the actions of Visa and MasterCard during U.S. sanctions against the Crimea last year. Given that this transition just finished up, we should expect this type of negative hit to the growth rate for the next three quarters as well.



Global cross-border volume was once again up 8% on a constant dollar basis, continuing the trend we've seen for the past few quarters. Cross-border transaction processing and currency conversion activities are the drivers of international transaction revenue, which was up 21% this quarter. That's thanks to pricing changes on certain U.S. acquirer fees that took hold in April, as well as higher currency volatility (which increases the fees Visa earns when it converts payments from one currency to another for customers).

Management was hush about the possibility of acquiring Visa Europe, but if you ask us, it seems like the odds of this deal increase with each passing day. Management noted that Visa is unlikely to repurchase any additional stock this quarter because of regulations regarding material non-public information (the SEC wouldn't look too kindly on the company repurchasing a ton of Visa stock and then announcing the terms of a Europe deal).

Speaking of Visa Europe, one of the biggest hits to the company this quarter was the $110 million increase in the Visa Europe put option. Currently, Visa Europe has a perpetual put option that will require Visa to purchase all outstanding shares of Visa Europe if exercised. The option must be valued periodically and is recorded as a liability on the company's balance sheet. But it is neither a cash expense nor an accurate representation of how much it will cost Visa to acquire Visa Europe – under the terms of the option, the purchase price will likely be in excess of $15 billion, even though the put option is currently valued at $255 million.

One of the more interesting comments from CEO Charles Scharf during the Q&A session came in response to a question about how Visa's strategy against PayPal will adapt now that the mobile payments leader has completed its separation from eBay. Visa's strategy won't change all that much in the immediate future, but Scharf did acknowledge that the current relationship is not sustainable for the long term. Right now, Visa cards are used in roughly 25% of transactions that go through eBay wallets, but PayPal uses the data from these transactions to try and disintermediate Visa from the transaction.

In our original write-up, we noted that we're more comfortable paying up for a high-quality business like this one than buying a lesser company simply because it looks cheap. Given the secular (the shift toward electronic payments) and company-specific (Chase, Costco, etc.) tailwinds behind Visa, I don't anticipate our stance to change anytime soon.

Write Synthetic Covered Calls on Coca-Cola

Published Aug 5, 2015 at 10:02AM

Is this for you? This is for *Pro* members who have a **Coca-Cola** (NYSE: KO) synthetic long (or just own calls or at least 100 shares of stock), and who want to write covered calls for income. We are doing so as our position approaches its natural expiration in January.

How You Participate

- **Trade:** Sell to open January 2016 $43 calls on Coca-Cola
- **Allocation:** Sell one call for every Coca-Cola call you own (or every 100 shares you own) and want to cover (**do not cover shares you wish to keep!**). *Pro* will cover all of its contracts, writing 17 calls.
  - **Price Guidance:** Ideally, aim to be paid at least $0.90 to $0.93. As prices change over the coming week, aim to be paid at least 2% of the current share price (lately, that's $0.84).
  - **Prices** (Aug. 5):
    - Stock: $42.05
    - January 2016 $43 calls (bid/ask): $0.90/$0.96 ($0.93 splitting the bid/ask)

What We're Thinking

In March 2014, we recommended setting up a synthetic long option position on Coca-Cola when its stock price was $38.33. The stock is 9.7% higher today, and owners (not us) have also been paid more than a 3% annual yield, resulting in a respectable 17-month return. But that's largely because we set the position up during a drop in price. The stock is actually down since its April 2013 high, so our March 2014 buy was a fortuitous price.. Our synthetic long has made money, turning unused equity in our portfolio into about $8,600 in unrealized profits so far.

As our position's January 2016 expiration nears, we're looking to squeeze a bit more income out of it by writing synthetic covered calls. This also turns our long 2016 calls into a bull call spread, as a way to end the position. Doing so caps our upside at $43, but in return we're guaranteed a bit more income.

Management performed admirably in the last year, taking market share yet again, increasing beverage sales and volume, and reducing costs -- but that doesn't change the fact that 46% of sales in 2014 were Coca-Cola soda products which are under fire, meaning there will be challenges to growth. I believe that in the long run Coca-Cola will create more value, and shareholders will continue to be rewarded, but it will likely be a slow rise.

We're still considering what (if anything) we will choose to do next with Coca-Cola in *Pro*. Buying shares, thereby committing some of *Pro's* capital to the company, seems an unlikely next choice from where we stand today (although if we did so, we could use the shares for covered calls). So does setting up another synthetic long. If we continue our involvement with Coca-Cola, we're likely to go on viewing it as a reasonably priced, but slow-growing, income-oriented position. For now, however, we just need to focus on bringing our synthetic long to a conclusion, and writing some calls on it makes sense to us.

More That Matters

- **Maximum gain:** Our net sell price is $43.93, or about 4.5% higher than the recent share price, in about five months.
- **Maximum risk:** The full value of our January 2016 $37 calls, minus premiums received from the new short calls, plus the stock exposure of our January 2016 $37 puts.
- **Follow-up:** We currently plan to bring the synthetic long to conclusion at expiration in January. Any new recommendation on Coca-Cola would be a new, fresh position.

Alternative Trades

Given the short-term nature of this trade, and our stated intention to move toward closing the position, we don't have alternative trades to offer today. However, you could follow the new trade in *Motley Fool Options* if you lack exposure to Coca-Cola and want to set up an income-oriented position.

Pro Can Help

- **Questions?** Spill on over to our Coca-Cola board.

American Tower Transmits a Strong Quarter

Published Aug 3, 2015 at 3:26PM

What Happened?

- Total rental and management (R&M) revenue of $1.17 billion (year-over-year core* growth of 23%)
- Domestic R&M segment revenue of $803 million (year-over-year core growth of 21%)
- International R&M segment revenue of $351 million (year-over-year core growth of 28%)
- Adjusted EBITDA of $762 million (year-over-year core growth of 21%)
- Adjusted funds from operations (AFFO) of $537 million (year-over-year core growth of 25%)

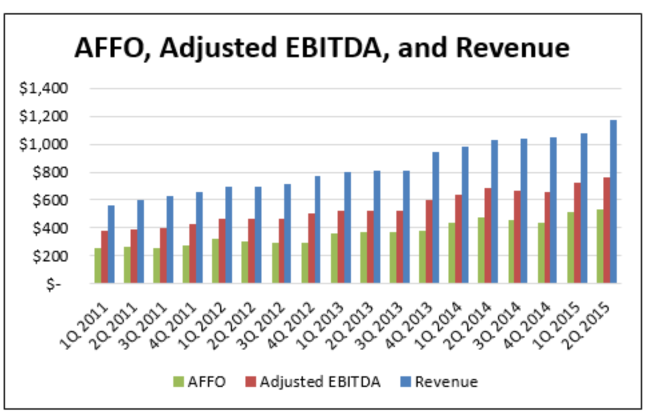
*Core growth reflects adjustments for foreign currency exchange rate fluctuations, pass-through revenue, straight-line revenue and expense recognition, and material one-time items

CEO Jim Taiclet:

> "Our second quarter 2015 results reflected yet another quarter of strong demand for our tower space both domestically and abroad. In the U.S., we are rapidly integrating our Verizon portfolio, which already has more than 900 lease applications in its pipeline. Internationally, leasing activity from our top customers, including Telefónica, América Móvil and Airtel, drove Organic Core Growth in revenue of nearly 12%.
>
> In addition, we are confident that the customer network investment trends developing in markets like Mexico, India and Brazil position us well to not only deliver 2015 Core Growth of over 20% in rental and management revenue, Adjusted EBITDA and AFFO, but also to drive compelling growth in all three of these metrics well into the future."

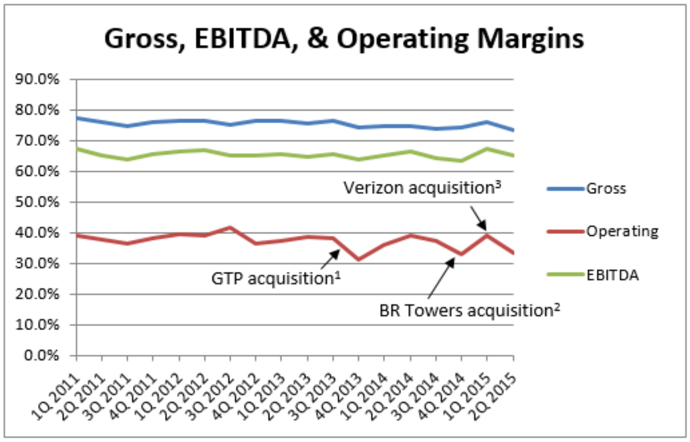
So What?

American Tower (NYSE: AMT) reported a typical quarter that provides further evidence that the company continues to build on its strong business performance and compounding dynamics. The company continues to steadily march ahead with its strategy of using cheap debt to consolidate a critical industry with growing end-markets and secure, recurring revenue characteristics. This has resulted in strong and consistent growth in revenue, EBITDA, and AFFO as growth in end-markets continues and new assets are integrated and leased up:



The company has closed on and is in the process of integrating several new acquisitions, including 11,500 towers from the Verizon acquisition, 4,200 sites in Brazil from Telecom Italia, and 4,700 towers in Nigeria from Bharti Airtel. The company also has ~2,300 sites in Brazil and up to 200 sites in Nigeria that have yet to close and are expected to do so over the next 12 months or so. The company is already getting strong initial trends on the Verizon portfolio, with 900 lease applications in pipeline, and the Airtel Nigeria sites are already expected to contribute ~$30 million in cash EBITDA in full year 2015. Given the performance of the business, management raised full year 2015 guidance to reflect international outperformance, cost controls, the impact of the Nigeria Airtel portfolio, and savings on cash interest from significant refinancing activity on the company's debt portfolio (see example here) during the quarter. Guidance does not include the 2,300 sites in Brazil or the 200 sites in Nigeria yet to be closed or demand catalysts in Mexico related to expected investments from AT&T and America Movil. As I noted last quarter, initial 2015 guidance was somewhat "sandbagged" and I've noticed that management has a tendency to provide low initial guidance and then raise it over the course of the year in order to influence and manage market expectations, which I appreciate.

I noted last quarter that "we may see slower revenue growth and stagnant or declining margins in the coming quarters as [timing-related] factors dissipate and new acquisition-related assets (and their lower margin profiles) make up a larger portion of the company's revenue. But over time, we should see margins tick up as scale and incremental leasing activity on new assets take hold." That's exactly what happened this quarter, with margins declining across the board. But as I wrote previously, the margin impact is very typical of American Tower's acquisition strategy, and we've seen it happen before:



1) GTP acquisition closed on 10/1/13, adding over 5,000 domestic sites (22% growth from the then-previous domestic base)

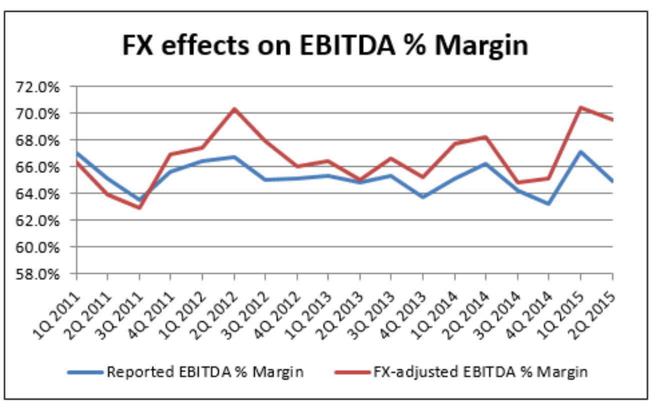
2) BR Towers acquisition closed on 11/19/14, adding over 4,600 international sites (11% growth from the then-previous international base)

3) Verizon acquisition closed on 3/30/15, adding over 11,000 domestic sites (40% growth from the then-previous domestic base)

In each case, a big acquisition resulted in a temporary hit to margins as the lower-tenancy, lower-margin assets were added to the existing asset base. And again in each case, margins consequently ticked up in the following quarters. American Tower has demonstrated that they are very efficient operators and they are able to quickly meet or exceed their integration targets with regular consistency. Management provided detail on the conference call about their ability to integrate assets, providing data showing that the longer American Tower has managed an asset, the higher the tenancy rate (and thus the higher the margin profile).

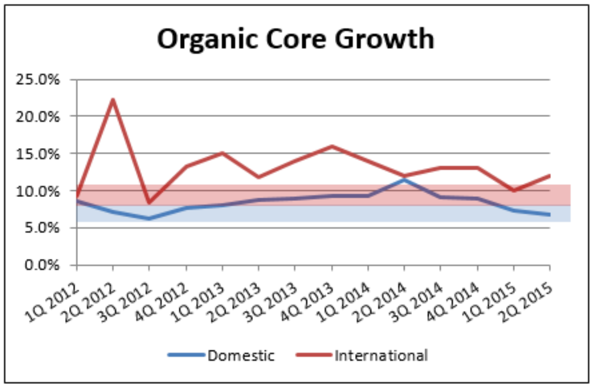
For example, on Brazilian sites that they've constructed or acquired between 2000 and 2005, the sites average nearly 3 tenants per tower and a local currency net operating income (NOI) yield of 50%. And for sites in Brazil constructed or acquired between 2005 and 2010, the sites average nearly 2 tenants per tower and an NOI yield of almost 30%. Management mentioned that this dynamic is repeatable in all of their markets. In Mexico (AMT's longest-tenured international market), 2000 to 2005 "vintage" towers generate NOI yields of more than 30% with average tenancy of over 2.0, and 2005 to 2010 "vintage" towers generate NOI yields of about 30% with average tenancy of over 2.0. The company also mentioned strong organic core growth trends in South Africa (almost 15% since 2011) and India (3-year average of about 9%).

Additionally, the company has been able to increase margins after acquisitions despite significant foreign currency effects. Take a look at how foreign currency fluctuations have affected American Tower's adjusted EBITDA margins:



American Tower's significant exposure to international markets and international currencies provide a potential future catalyst if foreign currencies eventually turn around and increase in value relative to the dollar. This will provide a boost to U.S. dollar-denominated revenue and cash flow if and when that occurs.

Finally, organic core growth (growth excluding revenue associated with new properties) continued to track well, with international organic core growth showing acceleration (coming in at 12% vs. 10% last quarter) and domestic core growth slowing a bit (coming in at 6.8% once adjusted for non-recurring timing effects vs. a comparably adjusted 7.4% last quarter) as AT&T and Sprint have reduced their U.S. network investment activity relative to the same periods in 2014. AT&T and Sprint are expected to pick up their investment activity into 2016 and beyond as they launch their next-generation network plans, which should support higher domestic organic core growth. Organic core growth continues to track within management's target ranges (the shaded area on the graph below) and ahead of my longer-term estimates:



As for debt, the company's net leverage ratio came in at 5.2x, and management expects to reach 5x leverage or below by the end of 2016. The company has plenty of liquidity (nearly $3 billion), no significant debt maturations until 2018, and a weighted average debt tenor of over 5 years.

Yearly distribution growth continues to track ahead of management's 20% long-term growth target, coming in at 29% growth ($0.44 per share, a 1.9% yield on the current share price). 20% annual distribution growth continues to look like a more than reasonable target for 2015 and beyond.

Now What?

This quarter's report yet again provides confirming evidence that our investment thesis (that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time) continues to play out. Despite short-term margin pressure related to acquisitions, the company's strong operating history, excellent management, and enviable competitive position in a growing industry give me confidence that American Tower will continue to grow revenue and cash flow at high rates for a long time, providing strong returns on capital.

Data and Guidance

- Current Price: $95.11
- Fair Value estimate (unchanged): $115
- Allocation: 3.3% plus 0.4% in bought calls
- Market Cap: $40.3 billion
- EV/EBITDA (TTM): 20.1
- EV/EBITDA (2015 projections): 18.6

AMT remains a Buy First, with no change to our recently updated fair value estimate of $115 per share and an allocation of 3.3% plus 0.4% in January 2017 $80 calls. If you've yet to start a position or haven't yet bought calls, now is as good a time as any to match us. The stock may continue to stagnate in the short-term due to its tendency to trade alongside the interest rate-sensitive REIT sector, but over the long-term the underlying strength in business fundamentals should shine through.

Fool on!

--Billy

Analyzing Verisk Analytics

Published Aug 3, 2015 at 12:40PM

***Pro* Completed Trades**

- **SPDR S&P 500** (NYSEMKT: SPY): We set up our 11% look-through allocation in October put ratio spreads, buying 14 October 2015 $200 puts, and selling 28 October 2015 $191 puts (adjusted from $187 for those who had not made the original trade yet, including us). We paid a $0.03 debit to make the trade. (This was and is a catch-up trade for those lacking this hedge.)
- **Verisk Analytics** (Nasdaq: VRSK): We bought a 1.7% stake, or 600 shares, at $72.76.

***Pro* Guidance Changes**

- **Facebook** (Nasdaq: FB): Our fair-value estimate increases to $84. The stock remains a buy at a 5.1% allocation.
- **Starbucks** (Nasdaq: SBUX): Our fair-value estimate increases to $47, and we have a 3.6% allocation. As with many strong stocks lately, our guidance comes with a caveat that we could see a flat year or two if the market weakens, as our fair-value estimate suggests.

Fellow Fools,

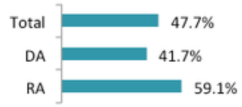
When we recommended our latest position, **Verisk Analytics** (Nasdaq: VRSK), on July 23, second-quarter 2015 earnings were still pending. We were obviously optimistic enough about the long term to recommend buying before the numbers came in, but it's always nice to see the short term looking rosy as well. The quarter got us off to a great start, with revenue up 18% (including acquisitions), adjusted EBITDA (which excludes nonrecurring transaction costs associated with the recent acquisition of Wood Mackenzie, as well a sizable hedge gain) up 22%, and free cash flow jumping 40%.

VRSK Q2 2015

Consolidated Results

		change
Total Revenue	$498 million	18%
EBITDA	$238 million	22%
EPS	$0.77	29%

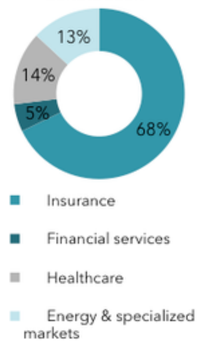
EBITDA Margin



Segment Results

($ in millions)	Revenue	change
Decision Analytics		
Insurance	$165	8%
Financial services	$26	21%
Healthcare	$69	6%
Energy & specialized markets	$65	199%
Total	$326	25%
Risk Assessment		
Industry-standard insurnace programs	$131	6%
Property-specific rating & underwriting information	$41	6%
Total	$172	6%

Contribution



In today's Memo, I'm going to analyze our analytics business to see how they like it when the tables are tur- I mean, to give some insight into why we are so excited to welcome this one to the *Pro* portfolio. For earnings details (guidance, valuation, multiples), scroll to the very bottom.

In our buy recommendation, we said Verisk is in the business of "finding truths buried in data and using them to help others make better decisions about risk and opportunities." Here's how that worked out for each division in the second quarter.

Insurance

The May acquisition of Wood Mackenzie, which provides data analytics to the global energy, chemicals, metals, and mining markets, will help accelerate management's plans to further diversify Verisk's business and become a global data powerhouse. For now, though, it's insurance that still brings in most of the business. And business is good.

- **Risk assessment:** Revenue growth here was 6% this quarter, right in line with what we were expecting, and we think Verisk's solutions will continue to dominate their respective markets. The outlook for the division is slow and steady: growth at the rate of the markets it serves, plus a little extra from annual price increases. This should result in 5% to 6% annual growth for this segment for the foreseeable future. That's far from a bad thing when you've got the best margins in the space, not to mention dependable cash flows that can be reinvested back into the business or returned to shareholders through buybacks. Management calls risk assessment its "heritage business," but we think of it as the company's personal cash cow.
- **Decision analytics:** No surprises here, either. Revenue was up a little more than 8% this quarter, below a few analyst estimates, but we're more than happy with this number considering that the segment grew 14% last year. Over the past three years or so, this division has consistently reported quarterly revenue growth in the range of 8% to 12% or so, and we expect similar results going forward. There are new markets to be found and existing markets to be further served, especially as the company increases its focus on international expansion in the aftermath of the WoodMac deal.

Financial Services

The company that accounts for almost all of this division's revenue is named Argus, and it provides competitive benchmarking, scoring solutions, analytics, and customized services to the financial industry. It's a subscription-oriented business, but it's still relatively young (and so are many of its markets), meaning it also brings in project-based revenue. Until the latter customers transition to the subscription model (which we think is highly likely), revenue here will likely be somewhat lumpy. That said, management predicts growth in the high teens going forward, with this quarter actually coming in at 21%.

Health Care

Revenue growth for this division was recorded as 6%, but that number is misleading. Long story short, Verisk changed the language in some of its contracts regarding Medicare Advantage to avoid having to become a "licensed medical provider"; this means the company records less revenue on the income statement, but that's all that it means. This move has no impact on the actual business, nor does it impact segment EBITDA or net income. On a comparable basis, then, revenue actually increased by 19.6%. That's a great sign considering that this division tends to ramp up in the third and fourth quarter each year. We have high hopes for Verisk's health-care business, and so far things are progressing nicely.

Energy and Specialized Markets

As mentioned above, Verisk recently acquired Wood Mackenzie, and thanks to that plus the acquisition of a company called Maplecroft, revenue growth in this division nearly tipped 200% for the quarter. About 62% ($40 million) of that came from WoodMac, though the deal didn't even close until halfway through the quarter.

Impressively, organic growth for WoodMac came in at 10% when measured in British pounds (WoodMac's headquarters are in Edinburgh), despite the turmoil in the commodity markets. That's because most -- 80%-plus! -- of WoodMac's revenue is subscription-based (Verisk knows great minds think alike), with long-term contracts and high renewal rates that hit 98% in 2014. It also doesn't hurt that WoodMac's services actually become more valuable to the customer when times are tough. Asked why WoodMac's growth was so strong given the current environment, Verisk CEO Scott Stephenson said:

> WoodMac content is must-have for their customers. It's absolutely indispensable. ... When an end market gets perturbed the way that it has, there are puts and takes. And everybody likes to talk about the takes ... which is capex temporarily moving down. But the put is that people need to understand this dynamic marketplace even more than before. And as a result ... some of the customer segments, some geographies in the world ... have actually grown quite strongly. ... When you have must-have information, it's going to find its market, and that's what WoodMac is doing right now.

Purchase accounting rules will artificially deflate margins this year, but WoodMac should return to its historical 45% to 47% EBITDA margin starting next year.

Pro's Take

Verisk broke with tradition earlier this year when it issued 10.6 million shares to help finance the WoodMac acquisition. And as we noted in the [trade alert](), while management's goal is a debt-to-EBITDA ratio of 2.5 by the end of next year, we believe that will leave plenty of cash to finance additional acquisitions and/or buy back even more shares. (Happily, Stephenson confirmed our expectations on the call by noting that buyback program should be resumed before the close of 2016.) In fact, the company has already offset some of this dilution -- outstanding share count only increased by 10 million this quarter thanks to the completion of an accelerated share repurchase program.

Verisk is a premium company trading for a premium valuation, but if you compare the stock's current forward multiple to what it's fetched in the past, you'll see why we believe we got a very fair price for our first (and likely not last) purchase. Since its 2009 IPO, Verisk's EV/EBITDA ratio has averaged 14.6. That's less than half of one standard deviation below the company's current forward multiple of 15.1. (Because of the recent acquisitions, trailing-12-month multiples are misleading right now.) In the chart that follows, you can see how the current forward multiple compares to the multiple the stock has fetched since its IPO (blue line).

If Verisk's stock is still trading for the same trailing-12-month multiple (19) next year, it will likely be one of the best, if not *the* best, performers in our portfolio. But we don't need all-time EV/EBITDA highs to ensure our success; in fact, we fully expect that multiple to fall, not because we think the stock price is going down, but because we think year-over-year EBITDA growth will be strong over the next few quarters and the company will be paying down some of its debt using its operating cash flows (which, *ceteris paribus*, reduces enterprise value).

Even if Verisk's multiple falls all the way back in line with its historical average -- which we think is highly unlikely with its prospects so bright -- we estimate we'll still be able to hit our North Star target over the next three years. That said, if it does go on sale, you won't hear us complain. We'd be more than happy to buy additional shares at that price.

Foolishly yours,

-- JP (TMFYossarian)

Verisk Earnings Details

Updated Guidance and Valuation

- **Updated guidance**: Buy (no change)
- **Recommended allocation**: 1.8%
- **Fair-value estimate**: $81

Current Multiples

Multiple	Trailing 12 Months	Next 12 Months
P/S	6.9	5.7
P/E	28	25
EV/EBITDA	19	15

What's a Bubble?

Published Aug 3, 2015 at 11:00AM


Morgan Housel is Motley Fool One's expert on the intersection of investing, economics, and human nature. He studies the impact of big-picture issues on individual investors' lives — making us better Fools along the way.

The Shanghai Composite stock index doubled from last June to this April. As of a few weeks ago, it was up roughly 60% this year alone.

Then someone turned the lights off.

The index has lost a third of its value since mid-June. Chinese regulators set up a bailout fund to stem the bleeding, which has already erased $3.2 trillion of wealth.

So, let me ask you: Is this a bubble?

The obvious answer is "yes." But no other topic can be as misleading, controversial, or important as whether or not a market is in a bubble. Before we get too excited about this bubble, let's take a minute to appreciate how hard it is to spot one in real time.

On top of a China bubble, smart people say we now have a U.S. stock bubble, a bond bubble, a new housing bubble, a debt bubble, a profits bubble, a Fed bubble, a dividend bubble, a social media stock bubble, and a healthcare bubble.

The word "bubble" didn't exist in economic textbooks 20 years ago, according to Yale economist Robert Shiller. How can a concept that's not even old enough to drink suddenly be everywhere we look?

The fact that no one talked about bubbles two decades ago is why we seem to have so many bubbles today. Since there's no objective definition, anyone can anoint anything they want as a bubble and make a convincing argument that they're right.

Shiller, who won the Nobel Prize for his research on bubbles, took this problem into his own hands.

"It wasn't carefully defined, so I wrote my own definition," he once told NPR.

A bubble is "like a mental illness," he said. "The American Psychiatric Association's diagnostic and statistical manual, which defines mental illness, consists of a checklist of symptoms." For Shiller, the checklist symptoms of a financial bubble are:

- Rapid price increases.
- Investors tell stories to justify the reasons for the bubble.
- People share stories about how much money they're making.
- People feel envy and regret that they didn't participate.
- The media gets excited.

But just as mental illness can be overdiagnosed, a lot of investments could fit this checklist without being a bubble.

Take **Microsoft** (NASDAQ: MSFT) stock in the early 1990s.

A time of rapidly increasing prices? Check. The stock price increased eightfold from 1985 to 1990.

Stories to justify the reason for the bubble? Check. "Superchips Herald a Revolution," *The New York Times* wrote in 1984.

Stories about how much money insiders made? Check. "THE DEAL THAT MADE BILL GATES $350,000,000," *Fortune* wrote in 1990.

Envy for not participating? Check. About 1 in 5 Microsoft employees were millionaires in 1992, "many under the age of 30," one news article pointed out. You can imagine how that made new employees feel.

Buoyant media? Check. The personal computer was *Time* 's Person of the Year in 1982.

It fit Shiller's bubble criteria to a T.

But Microsoft stock in the early 1990s wasn't a bubble. It was an amazing bargain. Anyone who bought Microsoft stock in 1990 has since earned a 5,900% return, versus the S&P 500's 740% gain. What looked like a textbook bubble was *literally the opposite* of a bubble.

Think about **Amazon.com** (NASDAQ: AMZN) in 1998, **Google** (NASDAQ: GOOGL) in 2004, **Netflix** (NASDAQ: NFLX) in 2005, or **Apple** (NASDAQ: AAPL) in 2007. The list of things we erroneously thought were bubbles dwarfs the list of actual bubbles by tenfold, at least. Which is why looking at something like Chinese stocks today, or even U.S. stocks, is always more complicated than it seems.

Everyone knows bubbles exist. We know tech stocks in 2000 and housing in 2006 were swamps of irrationality.

But that's hindsight. And hindsight is a misleading jerk. I promise you, 9 out of 10 people who say the housing bubble was obvious would have given you a different answer in 2006.

Eugene Fama, an economist who shared the Nobel Prize with Shiller, says he knows why this is. He doesn't think bubbles can be predicted. And since they can't be predicted, he doesn't think we can say they even exist.

"The word 'bubble' drives me nuts, frankly," Fama told NPR. He thinks markets are efficient at pricing in all available information, even if in hindsight we know that information was wrong.

"If I can predict that housing prices will go down, if the market is working properly, then they should go down now," Fama said. "Because what you're saying is, 'I have information that prices will go down,' and that information is not in the prices. But if the market is working properly, the information should be in prices."

Sure. But do markets work properly?

On a chalkboard, yes. In reality, of course not. In textbooks, the average consumer spends her day calmly calculating ways to maximize her odds of success. In reality, we're tricked by marketing, terrible at math, fooled by randomness, plagued by bad policy, blind to history, and drunk on courage.

NPR asked Fama, in a sarcastic tone, if he really believed bubbles can't exist.

"I don't think there's any evidence that says anyone can reliably predict when prices go down," Fama said. "So if you interpret the world 'bubble' to mean, 'I can predict when prices are going to go down,' you can't do it."

Shiller rebuts that calling something a bubble doesn't mean you know when it's going to burst, just that it will eventually.

"You can have a fairly high degree of confidence," he said. "That's what I felt in the stock market in the late 1990s. And then again I felt that in the 2000s, with the housing bubble." Anyone familiar with Shiller's work knows he doesn't call timing. He'll be the first to admit predicting what markets will do next is impossible.

Fama is still skeptical. "What happens each time [a bubble bursts] is the media goes in and finds someone who predicted it, and that person gets anointed," he said. "You don't go back and look at past predictions and see if it's just luck."

But doesn't Shiller calling the last two bubbles prove they can be predicted? "Statistical reliability means more than two," Fama said. "Predicting the next 10 would be really convincing. Then I'd be convinced."

Shiller laughed. "Yeah, but I don't live that long."

That's the problem.

Economics isn't like chemistry, where we can conduct thousands of controlled experiments in a lab to prove something exists. So few bubbles have occurred that we don't have enough data to be 100% sure of much of anything. By the time we have enough data to prove a concept, the economist who came up with the original idea is often dead, misquoted, or forgotten. We're left dealing with theories, often shaped by political beliefs.

The biggest problem is that even if a bubble is spotted, it's hard to know what to do about it. It's like a dog chasing a deer who finally catches up to it and has no idea how to respond. Bite? Run? Bark? He didn't think he'd ever get this far. Most bubble spotters aren't content just avoiding them; they try to bet against them. But that can be more dangerous than falling for them. A lot of smart people lost fortunes shorting tech stocks in the 1990s. Even if someone is smart enough to spot an actual bubble, their advice on what to do about it can be disastrous .

If the history of bubbles teaches us anything, it's to be humble.

Many were shocked when Shiller and Fama shared the Nobel Prize, since the two hold what look like opposite beliefs. But they have a common denominator: They both advocate humility. Fama doesn't think we can predict bubbles. Shiller thinks we can, but doesn't think we can ever know when they'll collapse.

What we need, but I know we'll never get, is more of this type of thinking. I'm holding out for a humility bubble. And I have no idea what Chinese stocks will do next.

Facebook's Dominance Is Still Just Beginning

Published Jul 31, 2015 at 4:39PM

> *If you go back 10 years, most of how people communicated and shared was text. We are going through a period where now it's mostly visual and photos. We are entering into a period where that's going to increasingly be primarily video, and we're seeing huge growth there.*
>
> *But that's not the end of the line. There's always a richer way that people want to share and consume thoughts and ideas, and I think that immersive 3-D content is the obvious next thing.*
>
> *— Facebook CEO Mark Zuckerberg*

Social network king **Facebook** (NASDAQ: FB) reported second-quarter results on Wednesday that demonstrated its continued dominance in online advertising. The results were good, and we think the opportunity to expand its core business looks even better.

But the company is also investing heavily into richer forms of content and a few initiatives that could change the world of online advertising as we know it. This is the stuff to keep in mind as you look at Facebook's expenses for the quarter. In contrast to Wall Street's initial disappointment over short-term margin contraction, we're satisfied that Facebook is doing what it takes to beef up its hefty competitive advantage today and lay the groundwork for potentially revolutionary ways of reaching its users tomorrow.

We'll get back to those world-changing initiatives in a minute. Let's first take a look at this quarter's results, which you can also review in this company presentation.

The Numbers

Revenue increased 39% to $4 billion, with $3.8 billion of that still coming from the company's core advertising business. Mobile accounted for 76% of total ad revenue, yet another increase.

Facebook's pace of growth during the past decade has been incredible. But perhaps even more impressive is the growth potential for its core business. Nearly half of the company's ad revenue — some $1.8 billion — currently comes from the U.S. and Canada. There are 213 million active users in this region, and the average ad revenue per user is $8.63. Compare those numbers to Asia-Pacific, where there are more than twice as many users (496 million) but the total ad revenue is only $600 million and the average ARPU is only $1.25. There are still *plenty* of future profits to be had as Facebook optimizes its advertising platform internationally.

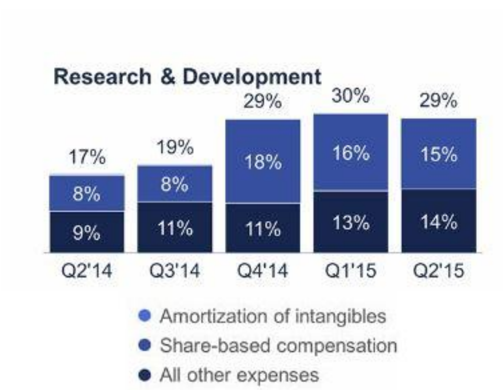
Monthly active users have reached 1.49 billion, and daily active users have reached 968 million. The percentage of users who sign on daily is increasing, indicating that engagement remains high and Facebook is still highly relevant.

DAUs / MAUs

Q2'13	Q3'13	Q4'13	Q1'14	Q2'14	Q3'14	Q4'14	Q1'15	Q2'15
61%	61%	62%	63%	63%	64%	64%	65%	65%

Rounding out revenue, the "Payments and Other" segment clocked in at about $215 million. Those who use the site regularly may have noticed that Facebook is now promoting its Payments feature, which allows users to send money directly to one another — while storing users' bank account information, which would make future purchases that much easier for them. The company is also beta-testing a Buy button on certain pages that would let users purchase directly from advertisers.

Expenses, meanwhile, *significantly* outpaced revenue this quarter. On a GAAP basis, total expenses increased 82%, causing operating margin to fall from 48% to 31%! A good chunk of those expenses come in the form of stock-based compensation ($763 million) and the amortization of intangibles ($180 million), largely related to Facebook's $22 billion acquisition of WhatsApp last fall.



Components of Facebook's R&D expense. Source: Facebook investor presentation.

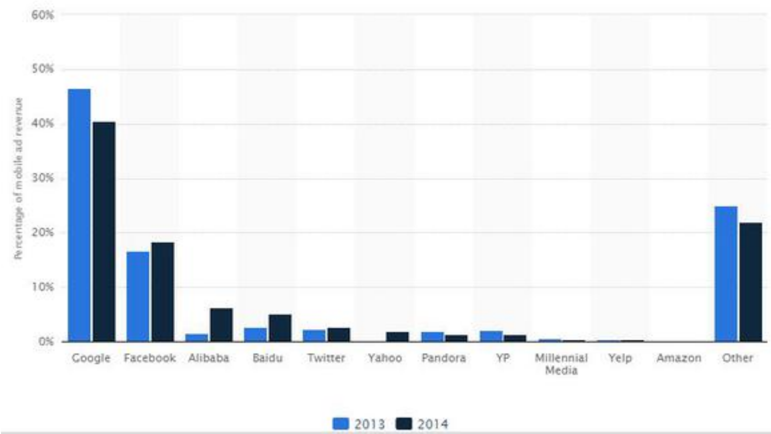
But even excluding those non-cash costs, expenses still rose 57% on a non-GAAP basis, which tightened the operating margin from 60% to 55%. In the grander scheme of things, having an operating margin of *only 55%* is hardly a problem. Facebook's core business is an absolute cash cow, churning out a steady stream of profits that the company can use to expand into other endeavors.

The Priorities

COO Sheryl Sandberg outlined the company's top three priorities for investing that profit stream: capitalizing on mobile, growing the number of advertisers, and making ads more relevant. Note that each of these programs would make Facebook's core platform even stronger.

1. Capitalizing on Mobile

In the conference call, Sandberg said Facebook now gets one out of every five smartphone minutes used in the U.S., as its video advertisements have been a huge hit with mobile. At last glance, Facebook has been aggressively winning share, pulling in 18.4% of the $40 billion total mobile Internet advertising market last year. Facebook's gains have come largely at the expense of **Google** (NASDAQ: GOOGL) and a fragmented collection of competitors.



Source: Statistica.

Not only is Facebook winning, but mobile is a lucrative market that is growing extremely quickly. The global mobile ad spend is already expected to nearly quadruple between 2014 and 2019, reaching almost $200 billion (if this statistic didn't blow your mind at first glance, read it again).

Mobile Internet Ad Spending Worldwide, 2013-2019

	2013	2014	2015	2016	2017	2018	2019
Mobile internet ad spending (billions)	$19.20	$42.63	$68.69	$101.37	$133.74	$166.63	$195.55
—% change	117.9%	122.1%	61.1%	47.6%	31.9%	24.6%	17.4%
—% of digital ad spending	16.0%	29.4%	40.2%	51.1%	59.4%	65.9%	70.1%
—% of total media ad spending	3.7%	7.8%	11.9%	16.5%	20.5%	24.1%	26.8%

Note: includes display (banners, video and rich media) and search; excludes SMS, MMS and P2P messaging-based advertising; ad spending on tablets is included
Source: eMarketer, March 2015

186887 www.eMarketer.com

Source: eMarketer.com

By the end of next year, mobile will account for the majority of all digital advertising. Facebook is rightly taking notice, continuing to invest in and improve its mobile user experience.

2. Increasing the Number of Advertisers

Not surprisingly, businesses have identified the power of Facebook's network effect. More than 40 million small and medium-sized businesses now have their own Facebook pages. Sandberg explained that setting up a page is now easier and cheaper than even launching a small-business website, while still capturing a wider audience and building brand recognition:

> *"If we look at even in the United States, which is a very advanced market, I think it's something like 35% of SMBs don't have a Web presence of any kind. But a great majority of those do have a Facebook page, and that's because setting up a Web presence for an SMB is complicated and expensive. You can't just start a Web page. But it is easier and free to start a Facebook page until you see broad adoption."*

Facebook today is focusing on getting businesses and advertisers to build a presence on their site. As I alluded to above, its next step will be building out the Buy button.

3. Making Advertisements More Relevant

Once again, we saw a sharp increase in the price Facebook charged per advertisement, complemented by a decrease in the total number of clicks. Cost per click (whose definition the company recently changed) increased 220% year over year, while the total number of clicks decreased 55%. The company is getting more targeted in its advertising, showing "the right ad to the right person at the right time."

	Q2 2015	Q1 2015	Q4 2014	Q3 2014	Q2 2014
Price Per Ad (Y/Y % Change)	220%	285%	335%	274%	123%
Total Ad Impressions (Y/Y % Change)	(55%)	(62%)	(65%)	(56%)	(25%)

New advertising products, such as carousel ads (multiple images in one ad unit), dynamic product ads (upload a full catalog, then match products with users), and lead ads (allow users to connect with companies) are unlocking additional value and boosting prices.

We'll expect to see Facebook continue to focus on targeting advertising in future quarters.

The Bigger Picture

Facebook's user base is not only growing, but it's also discovering the platform in different ways. About 300 million people use Instagram, 700 million use Messenger, and 800 million use WhatsApp on at least a monthly basis. The company recently celebrated the first anniversary of Internet.org, which has provided free basic Internet service to more than 1 billion people across 17 countries. Facebook's user base of 1.5 billion people will likely be going nowhere but up.

So we have a company that has established itself as a global phenomenon, with a dominant competitive advantage that is only getting stronger.

Where does Facebook go from here?

The first step appears to be making a fundamental change in the way potential customers communicate online with advertising businesses. Today's methods are fairly simple: We research products we're interested in and read reviews from others who have already purchased. But Zuckerberg sees Facebook strengthening the relationship between buyers and sellers — similar to what customers experience when walking into a bricks-and-mortar location today:

> "Right now, some people in WhatsApp use the service in order to message businesses, [where] Messenger is more people-to-people today. We're working on a lot of different things that make it so that people can get value from interacting with businesses. The long-term bet is that by enabling people to have good organic interactions with businesses, that will end up being a massive multiplier on the value of the monetization down the road when we work on that and really focus on that in a bigger way."

At first glance, this sounds like the live chat features already available on several e-commerce sites. But let's not forget that we're talking about Mark Zuckerberg here. This is the same visionary leader who spent $24 billion over the past two years acquiring Oculus and WhatsApp to bring richer content to a larger audience.

The Oculus Rift will begin shipping to consumers in the first quarter of 2016, which is only six months away. Zuckerberg is already promoting it as the world's best available virtual-reality experience. I expect the number of headsets sold will be in the millions, and they'll be incredibly well-received -- especially by gaming enthusiasts.

Since Facebook's primary business is still in advertising, I suspect that Oculus will complement Facebook's core competencies by allowing advertisers to interact directly with users over the site. This essentially breaks down the "window-shopping" that customers have done, to the chagrin of electronics retailers such as **Best Buy** (NYSE: BBY), for years. No more looking at and test-driving products in the store, then buying them online for a better price. With Facebook, retailers wouldn't need the physical locations at all — they could just demonstrate products directly to customers in virtual reality.

We're still very early in the transition. But Zuckerberg has dropped enough hints to suggest that Oculus and WhatsApp will have a much bigger impact than many who scoffed at their initial acquisition cost are currently giving them credit for.

The Foolish Bottom Line

Facebook remains a Buy in *Pro*, with a current 5.1% allocation. Our fair-value estimate increases to $84. To discuss this *Pro* recommendation, please visit our Facebook board. -- *Jeff Fischer*

Starbucks' Quarter Gives Investors a Jolt

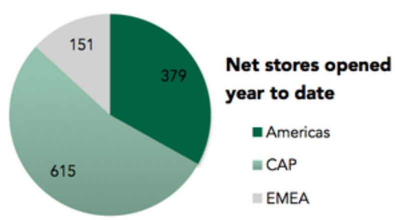
Published Jul 30, 2015 at 1:48PM

Despite meaningful foreign currency headwinds and the challenges of taking full ownership of Starbucks Japan, the coffee giant has once again posted results that more than lived up to our expectations. Starbucks served an additional 23 million more customers at locations that have been open for at least 13 months, and its latest class of stores is shaping up to be one of its best in recent memory.

SBUX Q3 2015

Consolidated Results

		change
Total Revenue	$4.9 billion	18%
Operating Income	$939 million	22%
EPS	$0.41	21%



Segment Results

($ in millions)	Americas	change	EMEA	change	CAP	change	CPG	change
Revenues	$3,415	12%	$295	-9%	$653	237%	$404	8%
Operating Income	$855	17%	$36	23%	$150	49%	$143	3%

Updated Guidance and Valuation

Updated guidance: Buy (no change)

Recommended allocation: 3.6%

Fair-value estimate: $47 (up from $43)

Current Multiples

Multiple	Trailing	Forward
P/S	4.6x	4.1x
P/E	32x	31x

EV/EBITDA 19.6x 17.2x

Investment Thesis

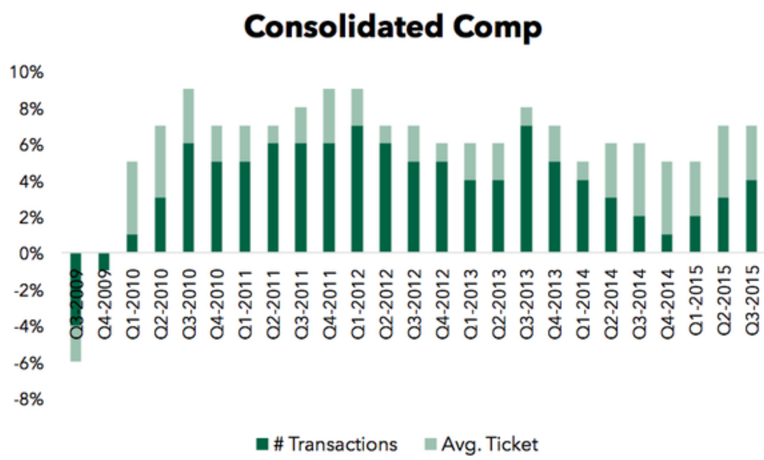
Starbucks (NASDAQ: SBUX) offers a unique blend of sales drivers (domestic and international growth, food and beverage innovation, and channel development, just to name a few) and cost-reduction opportunities (payment innovation, European restructuring, expansion of consumer product margins). We believe the coffee is just a gateway for the company to repeatedly sell customers an experience rooted in comfort, quality, health, community, and conscience. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand into new products, new platforms, new times of day, and new brands. We expect new store openings across the globe to strengthen the company's brand and cost-based competitive advantages and improve profitability over time.

With a company as large as Starbucks, you might think there isn't much more room for growth. But you'd be wrong. As laid out during the company's most recent Biennial Investor Day presentation, management believes that within five years, Starbucks will increase its store base to more than 30,000 global locations (up from 22,088 today), achieve $30 billion in annual revenue (up from $17.7 billion TTM), and double its annual operating income. Given the global strength of the Starbucks brand, we believe that this is definitely possible.

Results

Comparable-Store Sales

	Q3 2015			Q3 2014		
	Sales growth	Change in transactions	Change in ticket	Sales growth	Change in transactions	Change in ticket
Consolidated	7%	4%	3%	6%	2%	4%
Americas	8%	4%	4%	6%	2%	4%
China, Asia, Pacific	11%	10%	1%	7%	6%	1%
Europe, Middle East, Africa	3%	2%	1%	3%	2%	2%



Americas

This quarter proved once again that Starbucks still has legs here in the States. Transaction volume was up an impressive 4%, along with a 4% increase in average ticket size. Starbucks has demonstrated an ability to continually raise prices without seeing much in the way of customer attrition, but the largest contributor to the 4% increase in average ticket was not price hikes -- it was customers voluntarily trading up to more expensive items as well as adding additional items to their order. Growth in ticket size is extremely important because there are limits to the number of people a given store can serve, not to mention the number of people who are interested in going to Starbucks in the first place. So we shouldn't expect this type of transaction growth to continue indefinitely. In fact, management made a point of trying to temper expectations about the future somewhat and noted that analysts should be modeling for an overall comp number in the mid-single digits with a "modest" increase in traffic.

One of the key contributors to the growth in the average ticket size this quarter was the continued increase in the number of people purchasing food from Starbucks. Food contributed more than two points to the U.S. comp this quarter, with breakfast sandwiches doing particularly well. Management noted that only half of the 30% growth in breakfast sandwiches came from an increase in attach (customers adding food to their order), suggesting that we're actually seeing meaningful growth in the number of people who are only looking for something to eat swinging by their local Starbucks on their way to work in the morning.

Member growth in the My Starbucks Rewards program was an impressive 28% this quarter, and the increase in gold members was even better (32%). Management also gave more color on its latest MSR initiative -- partnering with other businesses to let them to purchase Stars from Starbucks and distribute how they see fit. It's a win for these businesses because they can use these Stars to acquire and retain customers, and it's a win for Starbucks because it provides a new source of revenue and because it helps further integrate Starbucks into its customers' daily lives, which we always love to see. So far, Starbucks has partnered with Spotify, The New York Times, and Lyft, and as usual, the company has ambitious plans for this latest initiative.

Starbucks hit another milestone this past quarter -- 20% of its in-store transactions took place using mobile payments. And the tests of Mobile Order & Pay came in above expectations, with the service helping to improve store performance even in the busiest of Starbucks locations (a great stress test). The company is accelerating the rollout, with the goal of offering it at every store in time for the holidays.

China, Asia, Pacific (CAP)

Excluding the $309 million of incremental revenue from the acquisition of Starbucks Japan, revenue growth for the CAP region was a robust 20%. The company has opened 615 stores so far this year in the region, and management noted on the call that the latest class of stores is tracking to be even more profitable than those that came before. Apple isn't the only company in our portfolio that can stir up excitement when it opens a new store overseas -- there was around 1,000 people (and 50-plus reporters) waiting in line when Starbucks opened up its first store in the Tottori Prefecture.

Since Starbucks didn't complete the acquisition of Starbucks Japan until late 2014, stores in this country won't be included in the CAP comp until the beginning of next year. COO Kevin Johnson mentioned that the Japanese quarterly comp numbers were among the strongest in the past few years, but I'll be interested to see how they look once the stores are included in the comp base. (And since we have a pretty good handle on what the rest of the region is doing, we'll be able to get a rough estimate of how the Japanese stores are doing even if management doesn't provide us with actual numbers.)

Europe, Middle East, Africa (EMEA)

Despite significant foreign-currency headwinds and other challenges, Starbucks was able to report a 3% comp in EMEA. This was the ninth consecutive quarter of positive growth, and while this pales in comparison to the 22 straight quarters of 5% or greater comp growth for the overall company, I do believe it's a sign that the shift in EMEA business strategy is paying off. Excluding the $44 million in currency headwinds, sales for the quarter actually increased 5%.

Channel Development

It was business as usual in channel development, with revenue for the division up 8% as the company continues to take market share in the K-Cup category. And this is in spite of the fact that competition continues to heat up in this space. Starbucks also announced that it will be partnering with PepsiCo to bring the Bucks' ready-to-drink coffee and energy-drink portfolio to Latin America, where the company estimates a market of about $4 billion. The plan, which is similar to the deal the company stuck with Tingyl to expand its ready-to-drink offerings in Asia, is to start distributing beverages next year.

Pro's Take

A lot of factors come into play when deciding where to buy your next cup of coffee, hamburger, milkshake, etc. One of those factors helps explain the immense popularity of restaurant chains: familiarity. When you go into an Applebee's, for example, you generally know what the food will taste like, how long it will take to arrive, and so forth. There's something to be said for that knowledge. And in some ways, this is how we felt after going over Starbucks' latest results. The results felt somewhat familiar because the company has been firing on all cylinders for awhile now.

We think the market agrees with us on that: Even after factoring in the acquisition of Starbucks Japan, the multiples at Starbucks stocks continue to inflate (some are a sip or two away from 10-year highs). In isolation, this data point doesn't scare us; we believe the outlook for the company is extremely bright. But because the market is far more mercurial, we could see a meaningful sell-off should Starbucks not live up to the market's lofty expectations at some point in the future. Something like this wouldn't decaffeinate our confidence in the business, but it doesn't hurt to be prepared for such a move ahead of time.

As far as the business is concerned, we continue to be impressed with the rate of MSR adoption, growth in food sales, and Starbucks' international expansion opportunities. We expect more great things on the horizon for the company, which is why it remains a Buy on our scorecard even though the current price is still meaningfully above our revised estimate of fair value.

No V-Shaped Recovery for Valmont Industries

Published Jul 30, 2015 at 10:43AM

What's a management team to do when everything that can go wrong, does go wrong? In **Valmont Industries'** (NYSE: VMI) case, they put their heads down and keep doing what's made the company successful for the past few decades.

Between currency headwinds, weak public spending on infrastructure, depressed crop prices hurting farm profits, falling commodity prices crushing miners, and a double dip in oil prices crimping productions, nearly all of Valmont's end markets are suffering – and if that's not enough, why don't we throw in currency headwinds for good measure. At this point it should be little surprise that Valmont reported its third earnings miss in a row as profitability continues to suffer from declining sales and increased restructuring costs.

It's amazing, though, that a high fixed-cost manufacturing business like Valmont has been able to remain profitable through this malaise. Though sales declined 19% over last year's quarter, the company still managed to deliver a 9% operating margin. I think that speaks to both the resiliency of the business and quality of the management team that is navigating this unusual confluence of cyclical soft spots across the business.

Turning to the business segment updates -

- **Engineered Infrastructure Products** (37% of sales) – Currency headwinds and order delays for both wind turbine structures and offshore drilling equipment hurt sales again this quarter. The highway bill remains stuck in Congress, which continues to restrict states' willingness to move forward on many transportation projects. As a result the company remains focused on growing its commercial customer base.

- **Utility Support Structures** (23% of sales) – Quoting activity for large projects has recently increased. Pricing on small projects remains competitive and management decided to raise prices on bids for these projects rather than writing unprofitable business. I respect management's decision even though it will hurt sales volume in the near term. It makes more sense to figure out how to cut costs and run a profitable business rather than accepting thin margins just to keep the plants running. It'll be interesting to see how competitors respond

- **Irrigation Systems** (22% of sales) – Management reported that even though sales volume has dropped significantly, the industry is maintaining a surprising amount of pricing discipline and market share is remaining fairly consistent. Valmont and Lindsay are so dominant in this industry that this statement feels a bit like management is signaling. Last year's second and third quarter were boosted $15 million both quarters by an unusually high amount of storm damage. Also, currency weakness in Brazil and changes to the government's subsidized loan program hurt demand.

- **Coatings** (11% of sales)– Weak demand for custom projects in the U.S. and fewer internal orders from the Irrigation and Utility segments. The company idled its Australian coatings plant and recorded an impairment charger

Restructuring Progress

In the quarterly conference call, management was clear that it doesn't expect any near term catalysts for the business, but they're focused on streamlining the business and managing those variables they can control. Management is focused on cutting costs and restructuring the business's global footprint, a move which will result in $30 million of cash and non-cash charges and is expected will deliver $20 million of incremental operating income by 2016. So far this year they have closed, consolidated, or repurposed several plants and they expect to have the majority of the restructuring completed by the end of the year.

Though management claims that despite the facility rationalization, they are maintaining excess capacity to be able to respond quickly to a rebound in demand, I'm a bit concerned about underinvestment. Management believes that maintenance capex is $40 million and they are planning to spend $55m over the next two years, but D&A is expected to be $95 million this year. When the cycle turns, the company should see significant operating leverage as it spreads growing revenue over a smaller fixed cost base, BUT (and that's intentionally a big "but") at some point they'll have to increase capex to meet demand which could be a disproportionate drag on future free cash flow. This is something we'll need to watch closely when the cycle eventually turns.

Where From Here?

Big picture, Valmont's balance sheet remains strong with $317 million and no debt and the company generated $61 million of cash flow from operations this quarter. That means management has the ability to make opportunistic investments if the downturn worsens, rather than only playing defense. Over the past year the company has reduced its diluted share count by 13% and is has $234 million remaining in its repurchase authorization which, at today's market prices, could knock out an additional 9% of the share count. When the cycle eventually turns, this reduction should provide additional leverage on per share metrics.

Based on today's tough operating environment it's difficult to imagine where Valmont's business is going to be a year from now, but looking out 3 to 5 years it's not a stretch to believe that this company will be substantially more valuable. Most investors maintain a watch list of high quality business that they'd love to buy on a pullback, but Valmont is a great case study to show why that strategy is always more difficult in practice. Though it's difficult to see a losing position on the scorecard, I think the potential upside from this point significantly outweighs our risk of a permanent capital impairment. This remains a high quality, well-managed business that still deserves a spot in the Pro portfolio.

Catch-Up Trade: Put Ratio Spread on the SPDR S&P 500

Published Jul 29, 2015 at 12:03PM

Is this for you? This is only for *Pro* members who (like *Pro*) have **not yet** set up the October 2015 put ratio spread recommended last month on the **SPDR S&P 500** (NYSEMKT: SPY) ETF. We're adjusting our lower strike price so we can make the trade at a credit, and this is a good catch-up point for anyone who's not yet in the trade. Members already in the trade should sit tight -- you're good!

How You Participate

- **Action:** Set up a put ratio spread on the SPDR S&P 500 ETF.
- **Allocation:** 11% of total portfolio value. Set up one 2:1 put ratio spread for every $200,000 you manage and want to hedge. *Pro* will sell 28 puts and buy 14, hedging 11% of our entire portfolio value (our cash included).
- **Trade:** Write ("sell to open") **two** October 2015 $191 puts. (Our price was $187 originally, and members who already sold those puts don't need to change.) Simultaneously, buy ("buy to open") **one** October 2015 $200 put for every $200,000 you're hedging. Click "view all" at your broker to see all strike prices.
- **Price Guidance:**
  - Sell to open *two* October 2015 $191 puts: Lately $1.35 x 2 = $2.70 credit
  - Buy to open *one* October 2015 $200 put: Lately $2.67 debit
  - **Net credit:** Lately about **$0.03** per spread (but this price will change; ideally just aim for a credit, or no cost, using a limit order)
  - SPY price (10 a.m. ET): $209.50

Our existing spreads: We continue to keep our Sept. 30 spread in place. No action is needed on that one. This October 2015 spread will complement that one.

What We're Thinking

Within hours, if not minutes, after we issued our new put ratio spread recommendation on SPY last month, it became impossible to achieve the trade for a net credit. This appears to be because too many members failed to use limit orders to set up the trade. Even on an ETF as gargantuan as SPY, groups such as ours can influence options prices if we don't use limit orders. Why? Because professional market makers (who provide liquidity and are usually the ones on the other side of your option trade) can see every order out there, and if they suddenly see hundreds of retail orders like ours coming into the marketplace, especially ones without limit orders, they'll take advantage. They make more money on sloppy investing. So: ***Please use limit orders on any order you place.***

Although this hedge should help us if the market falls by our expiration, I have not been eager to set it up for a debit, so I've waited. We'll now aim to set it up tomorrow (after our 24-hour wait period), ideally for a small net credit again (or, at least, no cost). That's only possible now if we change one of our strike prices. We're moving our lower strike price up $4 to $191, from $187. This lowers the potential profit on the trade, and exposes us to a possible SPY purchase at a higher price, but we're still comfortable with the trade. The break-even on this hedge is $182 -- is close to the maximum profit on our September hedge, which is at $185.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value (10 a.m.): $2,576,000
- 11% of that value: $283,360
- October 2015 spread:
  - Buy to open $200 puts. Fourteen contracts representing 100 shares each = $280,000 in look-through exposure, or an 11% hedge on our current portfolio value, cash included.
  - Sell to open $191 puts. That's 28 contracts, half of which become a potential $267,400 obligation, currently a 10.4% possible stake.
  - At home, you would buy one $200 put and sell two $191 puts for approximately every $200,000 in portfolio value you want to hedge.

Return Details

SPY Price at October Expiration	Value of 1 Purchased $200 Put	Value of 2 Written $191 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Current $209.50
$200 or higher	$0	$0	$0.03 gain per spread, or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 4.5%
$195	$5 x $100 = $500	$0	$500	(6.9%)
$191	**$9 x $100 = $900**	**$0**	**$900**	**(8.8%)**
$185	$15 x 100 = $1,500	($6) x 200 = ($1,200)	$300	(11.7%)
$182	$18 x 100 = $1,800	($9) x 200 = ($1,800)	$0 (breakeven)	(13.1%)
$180	$20 x 100 = $2,000	($11) x 200 = $2,200	($200)	(14.1%)
$175	$25 x 100 = $2,500	($16) x 200 = ($3,200)	($700)	(16.5%)
$170	$30 x 100 = $3,000	($21) x 200 = ($4,200)	($1,200)	(18.9%)

Our maximum profit is earned on this October spread if SPY declines 8.8% from its current perch above $209. The spread will help us a little on a decline all the way to about 13%; beyond that, our short puts turn into an obligation that's in the red.

Follow-Up

Assuming we set this spread up for a credit, it will result in a small profit even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $191 put obligation if SPY is below that price by expiration.

However, if that does happen, our plan would likely be to close our puts and buy long-term SPY calls (or perhaps something we like even better, whether calls or stock) instead of buying the ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY itself. We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases.

How It Fits Into *Pro*

Pro consistently hedges to lower our market exposure, or risk. As you know, we aim to achieve positive returns every rolling three years, and our guide is inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market makes a difference. Even small gains add up over the years, especially if those gains are reinvested in depressed stocks. This hedge fits well with our goal of hedging in a cost-efficient way, one that doesn't work against us if the market rises.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:**
  For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, as we are, "buy to open" October 2015 $200 puts and "sell to open" *an equal number* of October 2015 $191 puts. Recently, this will cost you around $1.32 ($132) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $9 ($900) per spread on a decline to $191 or any lower price, but you should be prepared to lose your $1.32 per spread if SPY doesn't decline to at least $198.68 by expiration.
- **To lower your market exposure while following our official trade (and make the position possible in some IRAs):**
  Set up the original put ratio spreads as recommended, but also "buy to open" puts (with the same months of expiration as our two spreads) at strike prices *well below* $191. Buy *half as many* as the number of $191 puts you wrote. When you do so, all of your $191 puts will be "covered" (half by your $200 puts, and half by the other puts you choose to buy at a much lower strike; choose how much you want to pay to select your lower strike price). You will only need cash in your account to cover the difference between your two lowest strike prices, and your risk is capped, making this potentially IRA-friendly.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Product Over Profit

Published Jul 28, 2015 at 10:00AM


Morgan Housel is Motley Fool One's expert on the intersection of investing, economics, and human nature. He studies the impact of big-picture issues on individual investors' lives — making us better Fools along the way.

Which of these two (real) companies would you invest in?

The first boasts in its annual report that it has a single goal: "Maximizing shareholder value."

A few lines later, it promises: "We are deeply committed to building the value of the Firm ... in everything we do, we are constantly identifying and evaluating ways to add value."

After discussing ways to boost the company's share price in a conference call, the CEO emphasizes that "our goal is simple; that's to create value for our shareholders."

The other company takes a different approach.

Its annual report states that the business "was not originally created to be a company." Customers who are key to its future "believe in something beyond simply maximizing profits," it reads.

Its CEO once stated bluntly, "We're definitely not in it for the money," and admitted to a friend that "I don't know business stuff."

One analyst wrote that management simply "doesn't care that much about making money."

What are these companies?

The first is Lehman Brothers, just before it went bankrupt in 2008.

The second is **Facebook** (NASDAQ: FB), just before it went public in 2012 and started generating billions in profit.

I cherry-picked this example. But if you look closely you will find something similar across most businesses.

Companies that focus on profits often lose customers, while companies that focus on customers often find profits.

This is a key theory we think a lot about at The Motley Fool.

Many of us are, for the most part, more interested in companies that focus on customers, employees, and shareholders (usually in that order) rather than companies whose sole priority is maximizing shareholder value.

This isn't because we don't care about making money. It's just the opposite.

Amazon has consistently sacrificed short-term profit in the name of creating the best products in the industry. Far from hurting investors, shares surged 1,100% in the last decade.

Before **Google** (NASDAQ: GOOGL) (NASDAQ: GOOG) went public in 2004, it warned investors that it would do "good things for the world even if we forgo some short term gains." That ethos allowed it to build one of the most profitable businesses in the world, earning a cumulative $91 billion in profit since going public and sending shares up 895%.

Biographies of Steve Jobs portray a man largely indifferent to money, frustrated by corporate cultures that worshiped short-term profits. Instead, 100% of his focus went toward building phenomenal products. This has, of course, turned Apple into the most profitable company the world has ever known.

Start with a relentless drive toward serving customers, and profits will find their way.

Lehman Brothers, on the other hand, went bankrupt because a singular drive for profits led management to bury the company's balance sheet with $30 of debt for every $1 of net worth, which scared away enough customers in late 2008 to bankrupt the whole firm.

General Motors also lost its way when the "car guys" were overrun by the "bean counters" and profits took precedence over products, as former vice chairman Bob Lutz put it. He elaborated:

> Leaders who are predominately motivated by financial reward, who bake that reward into the business plan and then manipulate all other variables in order to "hit that number," will usually *not* hit the number, or, if they do, then only once. But the enterprise that is focused on excellence and on providing superior value will see revenue materialize and grow, and will be *rewarded* with good profit.

These are enormously complicated topics prone to generalization and confusing of correlation with causation. All businesses need a balance between customers and shareholders.

But the broader message, I think, is important. Lehman Brothers obsessed over profits and failed miserably. Facebook obsessed over products and flourished -- with incredible profits and shareholder wealth as a result. Neither is a coincidence, and the comparison says a lot about what it takes to become a profitable company.

Pro Catch-Up Trades: July 27, 2015

Published Jul 27, 2015 at 2:15PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **WisdomTree Emerging Markets Small-Cap Dividend Fund** (NYSEMKT: DGS): Feeling bold? Feeling Foolishly contrarian? As emerging markets fall, you can buy into our emerging markets ETF if you lack current exposure. We have a 1.8% stake in this top-rated international dividend ETF. We simply have to have a long-term perspective. We may add to our stake if prices get really juicy.
- **Oracle** (NYSE: ORCL): Software is in the doghouse, but Oracle is built to last. If you lack exposure, you can buy shares up to our 3.6% allocation.

Apple Beats Estimates but Investors Want More

Published Jul 27, 2015 at 2:02PM

Despite exceeding expectations, **Apple**'s (NASDAQ: AAPL) third-quarter results didn't seem to please investors. The iEverything giant crushed Wall Street estimates: Earnings per share increased 45% over the prior year; revenue, 33%. However, the report included a few items that left analysts wanting, which led to the stock's decline.

Let's take a look at the key takeaways from the conference call.

iPhone

The company's key product sold 47.5 million units during the quarter, which was up 35% year over year. iPhone revenue outpaced volume growth and was up 59% owing to a $99 increase in average selling price. Compared to the previous quarter, unit volumes were down 22%, which seemed to surprise some of the analysts on the call. This decrease is normal for a relatively new product, but the drop was slightly greater than what we've seen in the past, which added pressure to Apple's stock price.

The popularity of the phone and its importance to Apple is staggering. For the consolidated quarter, the iPhone accounted for 63% of total sales. An interesting statistic mentioned by CEO Tim Cook was that roughly "27% of the installed base of customers prior to the launch of the 6 and 6 Plus have now upgraded." He went on to say that the company views this "as a very bullish sign on the future that there's a lot of headroom left for upgraders. We also are incredibly happy to see the highest Android switch rate that we've observed."

iPad and Mac

The iPad continues to struggle as unit volumes declined 18% and revenue dropped 23%. Management boasted about very positive customer satisfaction metrics for the iPad, but we aren't seeing that reflected in the financials. The enterprise segment continues to be a focus, and **United Airlines** (NYSE: UAL) has renewed its contract to provide iPads for pilots. There's certainly some overlap now given the iPhone 6 Plus isn't much smaller than the iPad Mini, so consumers are opting to use their phones more, lessening the need for a tablet. That said, the positive customer satisfaction metrics provide evidence that iPad sales could tick up as replacement cycles — which are longer than the phone — come due.

Mac units sold increased 9% over last year as the company continues to grow its share of the PC market. Revenue growth matched volume growth for the product.

Services, Other Products, and Capital Return Program

Service revenue was up 12%, reaching a record $5 billion in sales. Management mentioned particular strength in China, where sales doubled over last year. As of the end of the quarter, the China App Store has 250,000 apps that customers can download.

Apple Music is less than a month old. The service has been launched in over 100 countries. Apple Pay was launched in the U.K., and **American Express** (NYSE: AXP) will now support the service for its corporate clients. Neither of these services will likely have a huge impact on cash flow; however, they both add to the premium ecosystem the company has developed, which keeps people coming back to its products.

It's pretty clear given the questions on the conference call that analysts were hoping to hear unit volumes for the Apple Watch. Management isn't disclosing those figures so as to not hand over valuable information to competitors. That said, they did shed some light on the popularity of the newest gadget. The overall category grew sales by

49%, and the Apple Watch accounted for more than 100% of this growth. That might sound odd to you — more than 100% of the growth — but that's because the Watch's growth more than offset the decline in iPod and sales of accessories.

Finally, Apple's sticking to its commitment to reward shareholders. The company paid out $3.1 billion in dividends and bought back $4 billion worth of stock in the open market. As of the quarter's close, the company has executed on $126 billion of its $200 billion capital return initiative.

The *Pro* Bottom Line

Apple remains a Buy in *Pro*, with a 4.3% allocation and a fair-value estimate of $126. We'll be updating our valuation this quarter, and it will likely move higher. We continue to believe the mobile computing industry is in relative infancy, and Apple is the most innovative company in the space — and is by far the most profitable. Our company also has more cash than most *countries*, and is able to acquire disruptive companies and technologies, as well as return funds to shareholders. Although its enormous size (relative to the size of companies historically, but not necessarily in the future) brings unique challenges, we continue to believe the investment can challenge, or top, the North Star on a rolling three-year basis. -- *Jeff Fischer*

A World of Hurt?

Published Jul 27, 2015 at 1:03PM

In our trade alert for **World Acceptance** (NASDAQ: WRLD), we focused largely on the ominous Consumer Financial Protection Board investigation and on the changing moods of World's creditors. But as we noted in our follow-up Monday Memo, World's core U.S. business isn't exactly firing on all cylinders. So we weren't surprised when we saw that the company's first-quarter fiscal 2016 results had very few bright spots. That said, we *were* surprised to see the stock finish 11% lower on the day (at one point it was down almost 19%!).

The Results

Net income rose 4.8% and EPS rose 16.7% because of cost-cutting (including provisions for loan losses, which fell 15.1%) and because the company has reduced the weighted average of its diluted shares outstanding by 10.2% since Q1 of fiscal 2015. One of the main reasons we decided to establish our position was that we believed World's creditors were unlikely to permit the company to repurchase any shares until the CFPB investigation was completed, and this hunch proved to be correct -- the company did not repurchase any shares this past quarter.

Net income also benefited from the sale of accounts that we previously charged off, to the tune of $1.1 million (the company recognized $1.8 million in revenue, and management has previously commented that the margin on these sales is around 63%). This move also helped the company's ratio of net charge-offs to average net loans improve to 11.9% from 12.7% last year. At first glance, this looks like a sizable jump in the right direction, but if you want to make an apples-to-apples comparison, you need to include those accounts that were sold. When you do this, you'll see the ratio was essentially unchanged at 12.8%. Interestingly, the buyer of these accounts has already contacted World because the accounts' early performance has been worse than expected. The sale was expected to generate about $1 million per month for World for a year and a half, but if performance doesn't improve, the timing and/or amount World ultimately receives will come into question.

Revenue fell 6% on a 5.5% decline in interest and fee income and a 9.5% decline in insurance and other income. Gross loans decreased 1.2% to $1.15 billion, a theme as of late, though a weak Mexican peso helped contribute to this decline. On a currency-neutral basis, management attributed the weakness to lower volumes and a higher number of accounts 60-plus days past due (the company stops accruing revenue on an account once this happens). Obviously, neither factor is desirable for the company. New customer volume continues to highlight the difficulty World is having in attracting new customers – it was down about 4.8% quarter-over-quarter.

Other Notes From the Call

- Management no longer believes the earnings-per-share target of $16 per share is achievable by March 31, 2017 and has stopped providing guidance.
- The company has finally started to embrace technology and is working on updating its website (which is sorely needed -- you couldn't access a branch locator online until last year!).
- Management doesn't plan on asking for approval to repurchase shares until they get more clarity surrounding the CPFB investigation. But they do believe they have more than enough capital to continue with their growth strategy.
- Based on World's counsel and CFPB guidelines, management expects they'll hear back from the CFPB in the next six months.

Pro's Take

It's true that we initiated this short position just before earnings, but that's not because we expected the stock to be hit so hard. We're not complaining; we're just not really sure what Mr. Market was reacting to. These results were very much in line with what we were expecting -- strong bottom-line results because of the (now suspended) buyback and cost-cutting, with most other metrics indicating that the company's core business is under pressure because of increased competition and scrutiny. Given that this is what has been playing out for the past few quarters, we don't think it should have come as a surprise. Maybe Mr. Market was holding out hope that World had already received approval from its creditors to continue repurchasing shares, or perhaps investors didn't like that the company withdrew its 2017 guidance without providing any update. Regardless, our short position is off to a good start, with the stock currently trading around 15% lower than our original limit guidance.

We're still waiting on the CFPB to reach a decision regarding World's business practices, but it's worth pointing out that the agency did fine Citibank and Discover last week. We think there is a lot of similarity between some of the justifications for those fines and World's current business practices. So while there is no way to know for certain what the CFPB will do to World (if anything), we do believe these are positive signs.

We can't tell what the future will hold; however, our plan is to hold our position until the CFPB investigation comes to a close. If the stock continues to fall in the interim, we may look to close part of our position or establish a hedge, as we recently did with fellow shorts **Caesars** (NASDAQ: CZR) and **Boulder Brands** (NASDAQ: BDBD). If you haven't established a short position in World yet and are considering it, please remember to size your position accordingly. This stock is likely to be volatile over the next six months, at least.

A Cloudy Future for Oracle and OpenText

Published Jul 27, 2015 at 12:08PM

Pro Guidance Changes

- **Gentex** (Nasdaq: GNTX): The company moves to Buy First from Buy. We have a 2.7% allocation, and our fair-value estimate has increased to $18 per share. See our latest earnings coverage.

Pro Completed Trades

- **Caesars Entertainment** (Nasdaq: CZR): In a move to help ensure profits on our short no matter what, we closed 48.5% of this position last week (1,700 of 3,500 shares) at a price of $7.75. We kept a 0.5% position active, which is now worth 0.3% of the portfolio after the stock fell sharply on a court ruling that Caesars' parent company can be sued while its subsidiary is in bankruptcy. This ruling increases the risk that the parent company may need to file for bankruptcy protection, too, eventually. We're happy to sit on the rest of our short, monitor news, and manage the position accordingly, either adding, subtracting, or doing nothing. See our trade alert.
- **World Acceptance** (Nasdaq: WRLD): We sold short 1.5% exposure, or 700 shares for *Pro*, last week at $58.14 per share. World Acceptance is still a short at today's 1.4% exposure. See our trade alert.

Fellow Fools,

"Thesis creep" can be a costly mistake for investors. It's easy to explain away a stock's short-term problems when its industry is experiencing rapid change, and it becomes even easier when the position in question is a profitable one and the company has a management team you've grown to respect. Since the *Pro* team is running our portfolio with the goal of generating North Star-beating returns, it's crucial that we constantly reexamine our assumptions when companies begin to struggle.

As you might remember, Billy's recent semi-annual review of the *Pro* portfolio called out **Oracle** (NYSE: ORCL) and **OpenText** (NASDAQ: OTEX) as two of our portfolio's biggest laggards year-to-date; I thought that warranted some special attention. Though both picks are still in the green overall, we need to stay focused on where these companies are going, not where they've been.

These businesses are both suffering from the same affliction: a shift in the software industry, which is moving away from a perpetual-license, on-premises pricing model and toward a cloud-based, monthly subscription model. This has resulted in near-term accounting messiness (for lack of a better word) that we think is obscuring a more profitable future. Though both Oracle and OpenText are competing with a wide range of scrappy start-ups along with established cloud players, it's encouraging that both companies have loyal customer bases and the resources necessary to make the required jump.

Over the past few quarters, it seems that both companies have finally committed to growing their cloud business. In May, OpenText management announced in a special meeting that it's restructuring its business and refocusing its sales force on cloud-based products. Oracle's latest quarterly conference call was practically a pep rally for the cloud, and rumors are that Oracle sales reps are being paid more to push cloud products. In the meantime, analysts and investors are worried that the companies will cannibalize their cash-cow legacy businesses in favor of an untested business model. Let me explain why I think these concerns are overblown.

So What's the Confusion?

To fully understand why this transition has been so disruptive, we need to start with a quick primer on how this shift in business models affects a company's short-term profitability. (If you would like a more detailed explanation of software as a service, or SaaS, economics, I highly recommend this post by venture capital firm Andreessen Horowitz.)

The biggest difference between the perpetual-license and SaaS models has to do with how revenue is recognized under GAAP accounting standards. When a perpetual-license sale is made, both the revenue from the sale and the costs of acquiring that customer are both recognized immediately on the income statement. This provides a fairly clear picture of the profitability of each transaction. By contrast, cloud-based subscription revenue can only be recognized as it's periodically billed, even if there's a multi-year contract. The remaining value of the commitment sits on the balance sheet as a liability called "unearned revenue," which is reduced over time as the service is delivered.

So with cloud subscriptions, while the customer-acquisition cost hits the balance sheet immediately, the revenue is spread out equally over the term of the contract. This mismatch is a huge drag on early profitability, especially when a company is growing quickly and incurring a lot of sales and marketing costs, and it doesn't account for the lifetime economic value of that revenue stream. As the client base matures and growth slows, the recurring subscription revenue begins to exceed the new-customer acquisition costs, and the business can become incredibly profitable.

The SaaS-ier, The Better

According to Oracle management, the typical SaaS customer is worth about three times as much as a perpetual-license client over a 10-year term , even when accounting for the time value of money. OpenText leadership has confirmed similar economics for its cloud offerings, noting that it takes about three years to break even, after which the cloud customer could be worth considerably more.

I'm always skeptical when management throws around numbers like these, but OpenText's assertion has been confirmed in a blog post from IT industry consulting company Gartner discussing the pros and cons of SaaS pricing. According to Gartner, "The rule of thumb for web analytics is that three or four years of annual SaaS payments matches the cost of buying a comparable software license." That's consistent with other industry blogs claiming the rule of thumb for SaaS is that a one year of a cloud subscription usually costs two-thirds of the value of a perpetual license, plus one year's maintenance cost. So, it looks like we're all on the same page.

That raises a question: If cloud products are significantly more expensive over time, why are customers so happy to sign up for them? For many businesses, the answer is in the flexibility they provide. There's no big cash outlay up front; the software can usually be deployed faster than a licensed version; it's upgraded automatically by the service provider; and the recurring costs of maintaining an in-house server stack can be eliminated. Instead, these costs are all wrapped neatly into a predictable recurring monthly subscription cost, which gives warm fuzzies to cash-flow-conscious CFOs.

The *Pro* Bottom Line

Though Oracle and OpenText built their business on the traditional software licensing model, there's a SaaS land grab under way. We're encouraged that both companies are taking the threat seriously. Investors who had become accustomed to consistent, predictable cash flow won't be happy while the transition takes place, but this seems like a necessary evil if both companies want to secure their market position going forward.

To complicate matters, analysts now have two vastly different business models to try to value -- and one is likely siphoning customers from the other. That doesn't exactly make for a nice, tidy DCF model and/or a high-conviction price estimate. What it does make for is uncertainty, and the Street *hates* uncertainty. It's no surprise that many investors have decided that it's better to sell now and reinvest later, once there are signs of improvement. The problem with waiting for the "all clear" signal is that, as Warren Buffett has noted, you pay a steep price in the stock market for a cheery consensus.

Though both companies came late to the fight, Oracle and OpenText have strong customer relationships and deep pockets, allowing them to close the gap quickly. These nascent cloud businesses haven't been around long enough to provide credible estimates of customer churn and acquisition cost, but over time we expect the relationships to be just as sticky as they were under the traditional model, and margins should steadily improve. More importantly, both companies' success in rapidly growing their cloud businesses suggests that their competitive advantages are in fact sustainable, so we're happy to sit on our hands for a few more quarters and (optimistically) wait out the transition.

Battle Your Brain to Become a Less-Biased Investor

Published Jul 27, 2015 at 11:00AM


Morgan Housel is Motley Fool One's expert on the intersection of investing, economics, and human nature. He studies the impact of big-picture issues on individual investors' lives — making us better Fools along the way.

You've probably never heard of Mohnish Pabrai. And there's a reason for that.

Pabrai is one of the most successful investors of the last 20 years. One dollar invested in his hedge fund in 2000 would be worth more than $7 today, versus $1.78 in the S&P 500. And that's "after my ridiculous fees," as Pabrai jokes.

Why have you never heard of him?

I first learned of Pabrai from a friend in 2007. There was almost nothing written about him at the time. He wrote a book in 2006, but no publisher was interested, so he self-published a handful of copies.

I discovered that Pabrai lived near me, gave him a call, and asked if I could interview him. He graciously agreed.

I came to his office expecting to see a normal hedge fund arrangement: dozens of well-dressed analysts, rows of Bloomberg terminals, TVs tuned to CNBC.

But I found something completely different.

Pabrai manages more than half a billion dollars entirely by himself. He became one of the world's best investors with a desk, a filing cabinet, and a nap room. "I have a hard time getting past the day without the nap, so the nap is a must," he says.

Pabrai was the antithesis of most hedge fund managers. This made me even more fascinated in his success. So I asked him what his secret was.

"Control over my emotions," he said.

"That's it?" I asked.

"It's huge," he said. "It's all you need. You'd be surprised."

Pabrai isn't a successful investor because he has more information than everyone else, or because he's better at math than everyone else, or because he knows more about business than everyone else. He's successful because he has won the battle with his brain.

The reason you probably haven't heard of Pabrai is because he has such control over his emotions that he has little desire for fame. I don't think he feels the need to be on CNBC or have his face on the pages of *The Wall Street Journal*. He's emotionally grounded enough to be perfectly content reading at his desk.

Successful investing has little to do with what you know and almost everything to do with how you act. This report will attempt to be instructive. How, exactly, do you overcome these flaws? How do you become more like Pabrai?

A year ago, I interviewed Daniel Kahneman, a Princeton psychology who won the Nobel Prize in economics. I asked him if humans can overcome biases or if they are deeply ingrained flaws that we're stuck with — whether Pabrai is a freak of nature, essentially.

"They can be partially overcome, yes," he said. "There are ways people can become better thinkers."

He elaborated on how this applies to investors:

> I think it is very important not to encourage people to do things that are likely to expose them to regret. The potential for regret is something that investors should know about themselves.
>
> "How much am I going to suffer if this decision of mine doesn't work out?" "How easily am I going to think, 'Oh, I made a mistake'? How prone am I to think that I made a mistake?" It's a big variable, and really worth discussing, I think, with clients because part of the inability to stay the course ... you have to inoculate yourself against regret.
>
> At its core, overcoming cognitive biases is about inoculating yourself against regretful decisions.

This is, of course, easier said than done. And tackling this subject for every personality would be impossible.

I see three areas that consistently cause investors huge amounts of regret:

1. **Where you get your information.**
2. **ho you talk to about your investments.**
3. **How you keep yourself accountable to your own goals.**

Let's go through each one.

1. Where You Get Your Information

Twenty years ago, only a few media outlets dominated the dissemination of financial information: *The Wall Street Journal*, *New York Times*, an early version of CNBC, and Louis Rukeyser.

Today, those outlets make up a minuscule fraction of what's published (and Rukeyser is no longer with us). Financial media has exploded, with hundreds of outlets providing thousands of opinions each day.

Though that's mostly a good development, it can also be dangerous if you don't know how to use it.

The truth is that, while news coverage has grown exponentially in the last two decades, the amount of news has not. Today's financial media offers copious amounts of drivel, gossip, rumor, innuendo, and nonsense. As author Nassim Taleb once wrote, "The calamity of the information age is that the toxicity of data increases much faster than its benefits."

To avoid bias, therefore, it is vital that you as an investor know how to navigate this world.

Finding reasonable information is about more than using reputable sources. Consider this quote from a December 2008 front-page *Wall Street Journal* article:

> Igor Panarin posits, in brief, that mass immigration, economic decline, and moral degradation will trigger a civil war next fall and the collapse of the dollar. Around the end of June 2010 or early July, he says, the U.S. will break into six pieces — with Alaska reverting to Russian control. California will form the nucleus of what he calls "The Californian Republic," and will be part of China or under Chinese influence. Texas will be the heart of "The Texas Republic," a cluster of states that will go to Mexico or fall under Mexican influence. Washington, D.C., and New York will be part of an "Atlantic America" that may join the European Union.

Keep in mind, the economy was falling apart in December 2008. And this was *The Wall Street Journal*, America's most prestigious financial news source, so people took this seriously. You may have yourself.

After years of trudging through the financial media, here's how I would dissect a story like this today to ensure it doesn't bias my behavior.

Who is Igor Panarin?

A quick search would have shown that Panarin, a Russian political scientist, has a history of making outlandish predictions. He first presaged the same six-part American disintegration in 1998. In previous years, he augured what he called the "New British Empire," the "New Eurasia," the "Eurasia Union," and a new global currency — none with any success.

This is vital to know, because you instantly realize that this prediction tells you more about Panarin's personality than his objective analysis of the economy. Predicting collapse is just what he does. It's who he is.

If you get to know enough financial pundits, you'll find this is a recurring theme. People who are currently bearish on stocks — Peter Schiff, Marc Faber, John Hussman — have by and large been bearish for *decades*. Bulls like Jeremey Siegel have been bullish for most of their careers as well. It's a reflection of their personalities.

After you learn the background of pundits and analysts, you are less likely to take them as seriously as you did before. You will learn that most analyst are athletes in a full-contact sport called punditry. Realizing this helps prevent you from being biased by their views.

If Panarin is right, what should I do about it?

Let's say America is about to break apart into six pieces. Or let's say the analyst predicting a market crash is right. Or the guy who says **Chipotle** (NYSE: CMG) is going to beat earnings is right.

What should you do about it?

For most long-term investors, the answer is almost always *nothing*.

If you need to sell stocks next week to cover your mortgage, knowing if the market is going to crash next week is vital. If you're investing for the next 15 years, what the market does next week is irrelevant. If you are a day trader or hold short-term options, Chipotle beating earnings is really important to you. If you're a long-term shareholder, it shouldn't be at all.

The worst trait of the financial media is its inability to recognize that investors have different time horizons, which makes it impossible to offer blanket advice. Yet it does all day long. Very few sources of information come with a warning that says "This advice is intended for a 62-year-old investor with at least 10 years to invest." Instead, it's given as "The market is going to crash and *you* should sell." The truth is that the person writing this information has no idea who you are, what your goals are, or how long you have to invest. Even if their prediction turns out to be accurate, you should not assume it is applicable to you and your goals. Because it rarely is.

To prevent media from biasing your financial decisions, my sincere advice is: Consume less of it. It does not have to be more difficult than this.

In his book *The Information Diet*, Clay Johnson writes:

> It's not information overload, it's information overconsumption that's the problem. Information overload means somehow managing the intake of vast quantities of information in new and more efficient ways. Information overconsumption means we need to find new ways to be selective about our intake. It is very difficult, for example, to overconsume vegetables.

We also have to distinguish between *information* and *analysis*. Company annual reports, economic data, and conference call transcripts have information. Pundits and analysts provide analysis. In my research, successful long-term investors favor information over analysis by at least a 10-to-1 margin. Most people are good thinkers, but are gullible to being persuaded by pundits who are trying to grab attention. If you go for the information and ignore the pundits, you will have a better time coming to smart, unbiased decisions.

Stock picks, board posts, and articles within the Motley Fool community are a great resource because they are the closest bet you have to reading material that aligns with your goals, strategy, and investment philosophies. They are as close as you will get to vegetables.

Outside of the Fool, I would advise favoring books over articles. There are lots of bad books and lots of great articles. But books are more likely to be thought out, thorough, fact-checked, and edited than most articles. They are also more likely to make you think, rather than act, which is exactly what you want information to make you do.

For those of you with a voracious appetite for more, you will find a list of my favorite authors, journalists and resources for solid, reliable investment information at the bottom of this report.

2. Who You Talk to About Your Investments

New York Times columnist Carl Richards has a great saying. A financial advisor, Richards says, is someone who puts a gap between you and stupid.

Even brilliant investors are tempted to fall for biases and do dumb things with their money. An advisor's job is to look you in the eye, shake his head, and walk you back from the ledge.

One of the leading causes of biased financial decisions is confirmation bias. It's the tendency for investors to seek out advice from people who already agree with their views.

I attend a lot of financial conferences, many of which are theme-based — macro conferences, gold conferences, dividend conferences, and so on.

What astounds me at these conferences is how closed off they are to differing opinions. If you attend a gold conference and say anything negative about gold, you will be treated as an ignorant outsider and avoided. People think they attend conferences to learn something new, but I've learned that's not really the case. They attend to have their views confirmed by other people. It is pure confirmation bias. And it's dangerous.

Kathryn Schulz, author of the book *Being Wrong: Adventures in the Margin of Error*, once explained:

> The first thing we usually do when someone disagrees with us is we just assume they're ignorant. They don't have access to the same information that we do, and when we generously share that information with them, they're going to see the light and come on over to our team. When that doesn't work, then we move on to a second assumption, which is that they're idiots. They have all the right pieces of the puzzle, and they are too moronic to put them together correctly. And when that doesn't work, we move on to a third assumption: they know the truth, and they are deliberately distorting it for their own malevolent purposes. So this is a catastrophe.

If you don't surround yourself with people who disagree with your views, you'll never realize that you can be just as biased — and wrong — as everyone else. And you'll keep making the same mistakes.

Part of The Motley Fool's investing ethos is a culture of encouraged debate. We not only accept dissent when making stock picks but encourage it. Junior analysts can — and do — tell their bosses why they're wrong. This is how we fight confirmation bias.

But there's something we can't do for you, our members: prevent you from buying more stocks when the market is bubbly and selling out when it crashes.

One of Kahneman's pieces of advice to avoid biases is to have an advisor who is in a different emotional state than you are. This is how individual investors can avoid confirmation bias.

You should have a trusted person in your life — a friend, a relative, a co-worker — who you run financial decisions by.

This person should know you well. They should know your goals and your flaws. But they can't be emotionally attached to your financial decisions. Their goal is to provide a trusted, yet unbiased, opinion of your decisions. They put a gap between you and stupid.

For the last seven years, I have shared my personal financial plan with fellow Fool Matt Koppenheffer. I trust Matt, but he thinks differently than I do. He's not nearly as emotional as I am in some areas, sees risks that I don't, and offers a point of view that I could never come up with on my own. It is a perfect arrangement for avoiding biases, because while I trust Matt, I don't agree with everything he says and he doesn't always agree with me. That is exactly what you want. Rather than confirm my views, Matt makes me think and puts a gap between me and stupid. Every investor should have someone like this.

3. How You Keep Yourself Accountable to Your Own Goals

One of the most important lessons I've learned about investment biases is that people are terrible at predicting their future emotions.

Every investor I know says they'll be greedy when others are fearful. They never assume that they themselves will be the fearful ones. But someone has to be, by definition.

No investor wants to think they'll panic and sell if stocks fall 20%. They're more likely to say that a 20% decline would be a buying opportunity. This is the right attitude, but the reason there will be a 20% crash is specifically because some investors choose panic selling over opportunistic buying.

My experience is that most investors who say they'll be greedy when others are fearful soon realize that they are the "others." It has to be this way: When everyone thinks they're a contrarian, at least half will be wrong.

When investors are bad at predicting their emotions, sticking to their financial goals becomes difficult. I can say I plan on investing $500 a month each month for the next 30 years. Or I can assume that I won't sell when the next market crash comes. But those goals rely on the assumption that I can behave the way I'd like to in the future. And that's a dicey assumption to make.

I have found that the best way to get a realistic picture of my future emotions is to document my past emotions. You can do this by keeping an investing journal.

Every investor, no matter how active or passive, should have an investing journal. It doesn't have to be elaborate. Just document how you're feeling when you make investment decisions.

If you keep a detailed journal of your feelings and emotions when making investment decisions and review it over time, I think you will notice that how you expected to feel when the market falls, or surges, is far different from how you actually feel.

This is easy for me, because I'm an investment writer. All of my thoughts and feelings are documented on Fool.com.

I'd like to think of myself as a contrarian investor. I'd like to think a market crash is a wonderful thing to take advantage of. I want to be Mohnish Pabrai.

But when I look back at articles I wrote in 2008 and 2009, as the market was crashing, I have to admit: I was more scared and pessimistic than I thought. If I'm honest, they show that I have a lower risk tolerance than I think I do.

And I never would have known this unless these past feelings were in writing.

Admitting this is part of the reason I choose to hold quite a bit of cash in my portfolio, as I wrote about in a previous report. I don't want to pretend that I have a high risk tolerance that, objectively, is probably a fantasy. Right now, with the market near an all-time high, that would be easy to do. To prevent bias, I want to look at my past behavior and realize that it's probably a good indication of what my future behavior will be.

I would recommend every investor write down their feelings. A few sentences a few times per year. Keep this journal active for years, throughout different market conditions, and be honest with yourself about what you find. It could be the best tool you have to avoid future regret.

Further Reading

If you are interested in behavioral finance, I would highly recommend the following books:

- Your Money and Your Brain, By Jason Zweig
- The Science of Fear, by Daniel Gardner
- Mistakes Were Made (But Not By Me), by Carol Tavris and Elliot Aronson
- The Behavior Gap, by Carl Richards
- The Little Book of Behavioral Investing, by James Montier

And if you're looking for great financial columnists around the web, I'd recommend:

- Michael Batnick
- Ben Carlson
- Jason Zweig
- Patrick O'Shaughnessy
- Tadas Viskanta
- Tren Griffin
- Jesse Livermore
- Sam Lee

Gentex Looks Forward as Mirror Sales Increase

Published Jul 24, 2015 at 4:33PM

***Pro*'s Take: GNTX Q2 2015 Earnings**

Quarter Quick Take

Gentex (Nasdaq: GNTX) turned in a stout quarter in the second quarter of 2015, delivering 12.4% net revenue growth and 10.7% total mirror unit growth despite a decline in auto production in the company's primary markets over the same period. Unit growth continues to handily outpace global auto production, which suggests that the core element of our thesis (higher auto-dimming mirror penetration rates) is playing out.

Gross margins took a bit of a hit this quarter (down to 38.4% vs 39.7% a year ago) as annual customer price reductions, manufacturing inefficiencies, unfavorable product mix, and currency rate fluctuations affected that figure. Operating margins were also down this quarter (28.5% vs 29.5% a year ago), but were affected by one-time severance charges and foreign currency fluctuations and should pick up a bit in the next few quarters. Margin performance and a narrowing of gross margin guidance is a potential culprit for why the stock sold off a bit after reporting, but the business is doing just fine.

The company sold 7.3% more interior mirrors (+3.1% in North America and +10% internationally) and 20.2% more exterior mirrors (+35.3% in North America and +13.1% internationally) than it did in Q2 2014. The company has announced and launched several new products that look to drive growth throughout 2015 and beyond. As cars become more technology-rich than ever before, Gentex is well positioned to meet that demand.

Management continues to buy back stock, repurchasing $25.1 million worth at an average price of about $17.93 (almost 11% above the current price). Management is historically stingy with stock repurchases, but as cash piles up on the balance sheet (cash + investments are up 37% year-over-year, representing 9% of the current share price once you net out debt), management appears to be more willing to pursue buybacks as a capital allocation strategy. The company has repurchased shares at an increasing pace the last four quarters, with $10 million in buybacks in Q3 2014, $20 million in Q4 2014, $25 million in Q1 2015, and now $25.1 million this past quarter. I view these continued and increasing buybacks as a signal of confidence from management. Management also made some comments on their acquisition strategy on the call, and their comments were intelligent and reasoned, reaffirming my favorable view of their merit:

> "We're constantly evaluating acquisition targets. One of the things we do talk openly about, however, is from a strategy perspective, Gentex is very careful about making sure we find acquisition targets or anything that we would buy. It has to keep with our current corporate profile in terms of the what that business looks like, how unique is it in the marketplace, does it fit well with our existing business from a technology and a roadmap standpoint, and then does it have the type of margin profile that we look for and have the longevity that we think we need in order to justify the investment. And so from a strategic perspective, those are all factors we take into consideration.
>
> On the finance side, things are going pretty high premiums right now, and so it's one of the other factors we look at. We're not too interested in overpaying for a technology, if it's something that we believe we could either development in house or if it doesn't meet that strategic objective. That -- all that being said is we're very interested in looking for opportunities like the HomeLink one, but it's got to be the right fit, and we're not going to over-pursue any opportunity or overpay. Our strike zone is probably a little smaller than a lot of suppliers as it relates to acquisition, but we are constantly evaluating opportunities there."

Guidance Update

Despite slight declines in margins related to price reductions from its powerful customers (the big automakers), Gentex is continuing to do what it does best -- sell its products at a pace above the rate of auto production growth, and invest in manufacturing and product development initiatives in order to raise average selling prices and reduce manufacturing costs. As global auto production picks up and as more and more automakers integrate technology into their models, Gentex should benefit. After incorporating this quarter's results into our model and updating our forward projections, **we've increased our fair-value estimate from $17.50 to $18**, and with the stock trading more than 10% below our updated FV estimate, **we're moving Gentex from Buy to Buy First** on our scorecard. At just over 16 times trailing-12-month earnings, the company is trading at valuation levels that are about as low as they've been throughout its history despite a robust balance sheet, steady operating performance, and strong industry tailwinds. If you've yet to start a position or fill out your allocation in Gentex, now is a great time.

Updated Guidance: Buy First (changed from Buy)

Recommended Allocation: 2.8%

Fair-Value Estimate: $18 (up from $17.50)

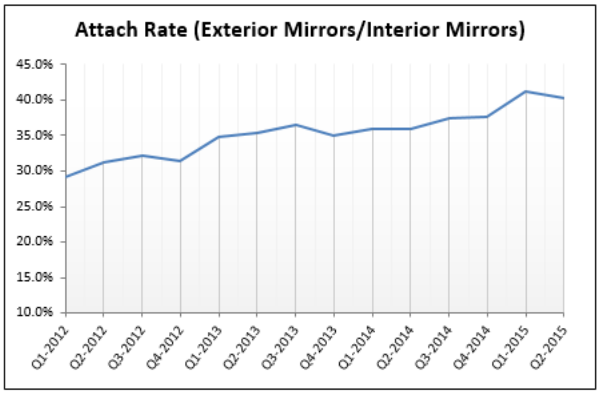
Current Price: $16.13

Our Thesis

Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1) Penetration: Unit growth vs. auto production. Over time, we want to see Gentex's auto-dimming mirrors to continue to gain market share. If the company is increasing units sold faster than auto production, it is moving in the right direction. Global interior mirror unit volumes were up +7.3% and auto production in the company's primary markets was actually down about 1%, showing that Gentex continues to significantly outpace vehicle production growth. Interior units sold in North America increased +3.1% and international increased +10%, for +7.3% interior unit growth overall. Exterior mirror unit volumes grew even faster, up a blazing +35.3% in North America and +13.1% internationally. The exterior mirror attach rate was 40.3% (i.e. 40.3% of cars equipped with interior units also were equipped with exterior units), compared with 36% a year ago. The attach rate dipped a bit compared to last quarter's record 41.2%, but this quarter's attach rate is the second highest in the company's history. Exterior mirrors currently only have about 7% to 8% market penetration relative to global auto production, but that penetration rate is certainly increasing.



2) Pricing and value: Unit growth vs. automotive segment sales. Powerful auto makers force annual price concessions on their suppliers, and Gentex isn't immune. Price reductions have been in the range of 2% to 3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices and gross margins. The company has been experiencing inefficiencies around new product launches recently, which affected gross margins by about 30 basis points this quarter (down from about 50 to 75 basis points last quarter). As the company works through these inefficiencies and as the higher-margin new products (such as the full display mirror scheduled to be launched in Q4 2015 on the Cadillac CT6) make their way through the sales pipeline, gross margin should see a boost. During the quarter, total units (interior + exterior mirrors) increased +10.7% and automotive segment sales were up +12.4%. This dynamic suggests lower ARPU (average revenue per unit) and is consistent with the expectation of annual price concessions.

3) Margin performance. During the quarter, gross margin was 38.4%, down from 39.7% a year ago in Q2 2014. For the trailing 12 months, gross margin was flat at 38.8% compared with 38.8% in the year-ago TTM period. Management narrowed its 2015 full-year gross margin guidance range by 0.5% at the top end (to 38.5%-39%) because of the aforementioned manufacturing issues. If the company can generate strong unit growth (especially in higher-margin products), it may be able to beat guidance, but that will likely be a difficult achievement. SG&A and R&D expenses are in line with historical norms, and operating margins followed gross margins lower, coming in at 28.5% vs. 29.5% in Q2 2014. However, if we adjust for FX fluctuations and one-time severance-related charges, operating margins would have been flat compared with the year-ago period, despite the decline in gross margins (due to SG&A leverage related to production facilities running at high capacity levels).

What We Think Now

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

If you have questions, drive on over to the Gentex discussion board.

Buy Verisk Analytics

Published Jul 23, 2015 at 3:31PM

How You Participate

- **Action:** Buy **Verisk Analytics** (NASDAQ: VRSK).
- **Allocation:** 1.7% (*Pro* will buy about 600 shares).
- **Scorecard Status:** Buy
- **Fair-Value Estimate:** $80
- **Recent Price:** $74.25
- **Dividend Yield:** 0%
- **Price Guidance:** Use a limit order and initially aim to pay less than $74.75. As prices change over time, this starting guidance will quickly lose relevance; as that happens, **our guidance will remain "Buy"** until we officially notify you otherwise.
- **Next Earnings Date:** July 28

What's in a name? In the case of Verisk Analytics, more than you might think. Verisk's name is a combination of the Latin word for truth, "veritas," with the English word "risk." And that's exactly what the company is all about – finding truths buried in data and using them to help others make better decisions about risk and opportunities.

The Business

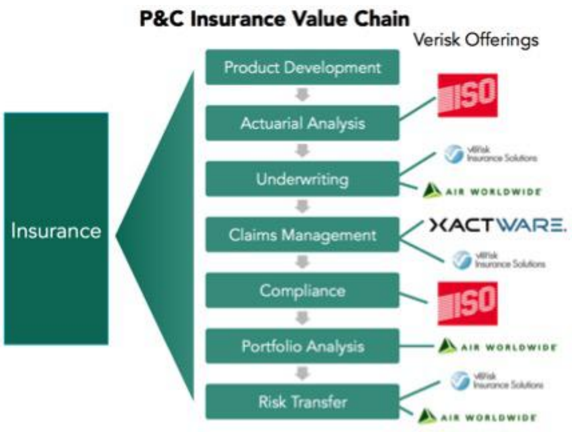
Similar to current *Pro* holdings **Visa** (NYSE: V) and **MasterCard** (NYSE: MA), as well as prior holding **CME Group** (NASDAQ: CME), Verisk was actually created by its customers. Major players in the insurance industry set up an "information utility" called ISO (now a Verisk subsidiary) in 1971 to help make the industry more efficient.

Nowadays, Verisk is a vertically focused data and analytics powerhouse that provides customers with solutions in all sorts of arenas: raw data, tailored analytics, enterprise reporting systems, policy fraud detection solutions, competitive benchmarking, and legally tested policy language, just to name a few. Verisk leverages its mass of proprietary data, industry expertise, and predictive analytics to serve hundreds of customers in all sorts of industries: financial services, including the top 100 U.S. property and casualty (P&C) insurers and 29 of the top 30 credit card issuers in North America, the U.K., and Australia; health care, including nine out of the top 10 health-plan providers; government entities; and professionals in the supply-chain management and risk management businesses. And as of May 19, Verisk's clientele now includes entities in the energy, chemicals, and metals and mining industries as well -- we'll talk more about that below.

What We're Thinking

A strong competitive advantage, high customer retention, robust and contract-based cash flows, a scalable business model, large (and growing) markets -- all these traits make Verisk a prototypical *Pro* holding. In fact, the company actually scores 7 of 7 when using our quality checklist.

As mentioned, Verisk is "vertically focused." This means the company is primarily concerned with creating solutions that help customers with a variety of tasks throughout the value chain of a particular industry (see image below), as opposed to creating one product that it tries to sell to customers across different industries ("horizontally focused"). This means that Verisk's solutions are more likely to be tailored to the needs of its customers and highly integrated into those customers' workflow, which results in high customer retention and pricing power for Verisk.



Source: Company filings

Verisk's solutions become even stickier when you realize the company is more than just a one-trick pony -- its offerings help customers boost their top line as well as control costs. And in the industries Verisk serves, there is a *lot* of demand to control costs.

In 2014, around 68% ($380 billion) of the earned premiums in the U.S. P&C insurance market had to be used for claims and claims settlement expenses. And in 2011, *The Journal of the American Medical Association* estimated wasteful spending in the U.S. health-care system of at least $558 billion (the midpoint of the estimate was actually $910 billion). Because Verisk's solutions help control costs, customers actually end up valuing them even more when times get tough. For example, not only did the company's insurance segment expand between 2007 and 2010 -- during what management referred to as one of the worst P&C insurance markets since the Great Depression -- but Verisk was actually able to push through price increases without a negative effect on customer retention.

The insurance industry makes up the bulk of Verisk's clientele (72% of 2014 revenue), and as you can probably imagine, being a company created by its customers comes with certain advantages. Verisk has been able to leverage its long-standing relationships with insurers to create multiple products that occupy the top spot in their respective categories; in fact, some have a market share higher than than 90%.

Sizable opportunities also exist in both health care (18% of 2014 revenue) and financial services (5.5%). Verisk recently entered the health-care space with the goal of removing inefficiencies from the market while helping drive the shift from volume-based to value-based health care. Management is only targeting a $4.8 billion market at the moment, but they've already captured 6.6% of that, and they expect that market to almost double by 2019.

Management estimates the current addressable market for its financial-services division at $500 million. That means Verisk has captured slightly less than 20% of this market since it entered the space with its 2012 acquisition of Argus. Five hundred million may sound small (in this context, anyway), but this market is a part of a much larger whole that's riding secular, not cyclical, trends. For example, Verisk's market share of global business analytics spending, reporting, and modeling for the financial services industry (a $15 billion market) is around 25 basis points (bps), and its market share of the $9 billion that financial services companies spend annually on media targeting and optimization is around 33 bps.

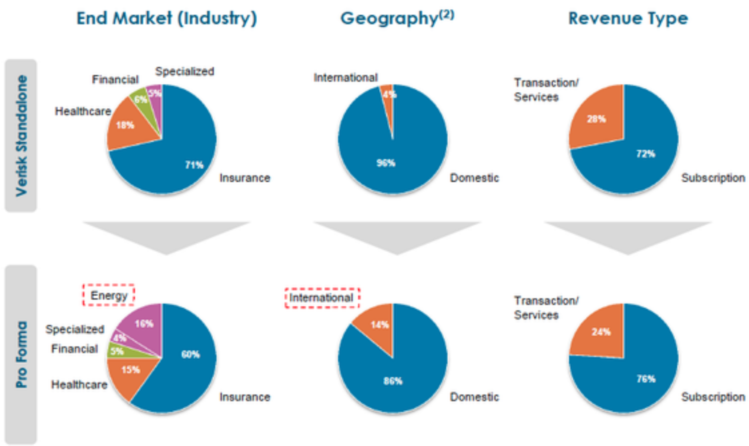
Organic growth in these two newer divisions has been impressive so far, but we believe we're still in the early innings. As management has been known to mention, this business doesn't have many iPod or iPhone-like opportunities. Also, new customers don't immediately sign up for everything Verisk has to offer; Verisk will frequently work with them to create a customized solution, which the customer will then put through proof-of-concept and an isolated trial phase before deciding to scale up. That said, that first solution often acts like a gateway drug –- Verisk's health-care division signed on 35 new clients in 2014, but it was able to make 115 upsells. And the company is constantly developing new solutions to make its customers' lives simpler and more profitable.

The Financials

As you might imagine, this type of business can be very attractive from a cash-flow perspective. After the necessary investments to get everything set up, the incremental costs of selling additional solutions to a customer are very low, as are maintenance capital-expenditure requirements. This results in strong margins (2014 EBITDA and net income margins were 45% and 23%, respectively) and returns (ROC and ROE were 24% and 98%, respectively), as well as plenty of cash for Verisk management to do with as they please.

Too much cash can actually destroy shareholder value if it entices a company to make ill-fated acquisitions. But Verisk's capital-allocation track record is extremely impressive. Using a conservative EBITDA multiple of 10, management estimates an annualized return on its acquisitions of around 20%. Additionally, between its 2009 IPO and May of this year, Verisk had already shrunk its share count by almost 12%.

Now back to that May 19 expansion of its client base I mentioned. On that date, Verisk acquired Wood Mackenzie, a leading provider of data analytics to the global energy, chemicals, metals and mining markets. The cost was sizable -- $2.8 billion, with $722 million coming from a secondary share offering. The market wasn't sure how to react to the deal given the high price, but we think it makes a lot of sense: Verisk has bought a company that's essentially a copy of itself, but in different end markets (WoodMac actually has higher margins and a greater percentage of subscription-based revenue). This means Verisk gets access to additional data it can use to develop new products and further diversify its revenue sources. Management has also hinted in the past that they see sizable opportunities for the company outside of the U.S., and this deal is a big step in that direction.



Source: Verisk's WoodMac acquisition presentation

We like the current mix of organic and acquisition-based growth, but as long as Verisk management continues to look for businesses to bring into the fold (which they've said is their plan), the risk remains that the company could ultimately end up overpaying, or that a venture into a new line of business could destroy shareholder value. As a counterpoint, though, management has previously demonstrated a willingness to cut ties with a business if it isn't performing or is no longer "Verisk-like." In February of 2014, the company sold its mortgage analytics business, Interthinx; though the mortgage industry has come under pressure since originations peaked years ago, the company was still able to generate an internal rate of return (IRR) on Interthinx of around 20%.

How It Fits Into *Pro*

By adding Verisk to our portfolio next to **Visa** (NYSE: V), we're returning our exposure to the financial services industry to a level close to what we had before we sold **American International Group** (NYSE: AIG). But with Verisk, we also get exposure to powerful tailwinds within the energy and health-care industries, among others.

Verisk has something in common with Visa when it comes to valuation, too; both are above-average companies trading at above-average multiples. Verisk currently trades at 32 times earnings and 16.5 times EV/EBITDA. But it's important to note that only the numerator in those equations factors in the acquisition of WoodMac, since the company has already issued the additional 10.6 million shares. Pro forma, Verisk is currently trading for around 15.3 times our estimate of fiscal 2015 EBTIDA, a price we're willing to pay for such a high-quality company that we expect to hold for many years. We're taking a measured approach, starting our position at 1.7%, and we'll be prepared to add to it (either by writing puts or buying shares) if the stock experiences a rough patch at some point.

The company borrowed $1.9 billion to acquire WoodMac, and the plan is to use free cash flow to rapidly reduce debt to 2.5 times EBITDA by the end of 2016. By our estimates, Verisk should be able to do this easily, with around $500 million in free cash flow to spare. That's cash that could be used to opportunistically acquire another business or start repurchasing shares once again. Either way, we believe the company is poised to deliver North-Star like returns over the years, with the potential for considerably stronger performance thanks to its business model and broad market opportunities.

Questions? Bring them to our brand-new, veritably veracious Verisk board!

TD Ameritrade Posts Solid Results

Published Jul 22, 2015 at 11:19AM

Pro's Take: AMTD Q3-2015 Earnings

TD Ameritrade (NYSE: AMTD)

Quarter Quick Take

In Q3 2015, TD Ameritrade yet again demonstrated its ability to deliver consistent results even though the company's value drivers (trading activity and interest rates) are mostly unpredictable. This consistency is a testament to the company's competitive advantages and strong management. Despite a difficult operating environment (low volatility and trading, low interest rates, and increased competition), net revenue was up 4.1% year-over-year and EPS grew 5.2% year-over-year. This well-managed company is able to pay a well-funded dividend and steadily increase its core earnings power, and the company's interest-sensitive earnings are set to grow sharply during periods of rising interest rates (who knows when that will happen).

President and CEO Fred Tomczyk:

> "As we complete our third quarter and look back on the last nine months, we remain upbeat about our growth and prospects for another strong year"..."We continue to execute well against our growth strategy, with $47 billion in net new client assets gathered year-to-date, an organic growth rate of 10 percent and up 17 percent over last year. Likewise, average client trades per day, year-to-date, are 456,000, up 5 percent over last year. This leaves us with good momentum, and we will continue to invest in organic growth initiatives."

Guidance Update

After incorporating this quarter's results into our model, our fair-value estimate remains unchanged at $35 per share. At just more than $37 per share, the company is trading nearly 6% above that estimate, so members without a (full) position may want to consider spacing out new purchases or selling puts to buy shares at a lower price. After a rough start to 2015, the stock has experienced strong appreciation (up 15.7% from its year-to-date low of $32.07 per share on Feb. 2) as investors have bid up shares in anticipation of the Federal Reserve's upcoming interest rate decision.

Updated guidance: Buy (no change)

Recommended Allocation: 2.9%

Fair-value estimate: $35 (no change)

Current price: $37.12

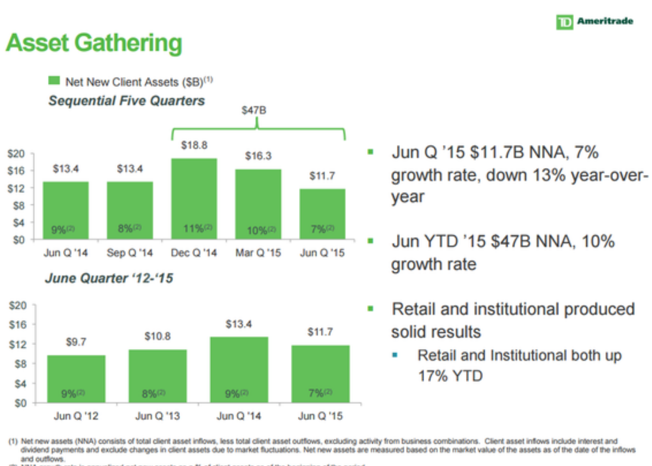
The Numbers

- Net revenue of $794 million (up 4% year-over-year)
  - **Transaction-based**:
    - Funded accounts grew to 6.55 million (up 5% year-over-year)
    - Trades per funded account of 4.17 (vs. 4.50 last quarter vs. 4.05 a year ago)
    - Average commissions and fees per trade of $12.01 (vs. $12.03 last quarter vs. $12.55 a year ago)
    - Totals up to:
      - 6,551,000 x 4.17 x $12.01 = **$328 million** in transaction-based revenue (up 3.5% year-over-year)
  - **Spread-based**:
    - Total spread-based revenue of **$365 million** (up 4% year-over-year)
    - Average spread-based balance of $95.3 billion (up 4.5% year-over-year)
    - Thus, Net Interest Margin (NIM) =
      - $365 million / $95.3 billion = 0.383% (quarterly)
      - NIM (annualized) = 0.383% x 4 = 1.53% (vs. 1.50% last quarter vs. 1.54% a year ago)
  - **Fee-based**:
    - Fee-based revenue of $85 million (up 7.6% year-over-year)
    - Record average fee-based balance of $161 billion (up 16.5% year-over-year)
    - Thus, Investment Product Fee Yield =
      - $85 million / $161 billion = 0.053% (quarterly)
      - Investment Product Fee Yield (annualized) = 0.053% x 4 = 0.211% (vs. 0.219% last quarter vs. 0.228% a year ago)
- Record total client assets of $702 billion (up 8% year-over-year)
- Record interest rate sensitive assets of $102 billion (up 6% year-over-year)
- Net new client assets* of $11.7 billion (6.7% annualized growth rate, down 13% year-over-year)
- Diluted EPS of $0.36 per share (up 5.2% year-over-year)
- Trailing-12-month (TTM) average return on equity (ROE) of 16.4% (down from 16.6% a year ago)
- Capital management:
  - Paid $0.15 per share in cash dividends in the quarter (a 1.6% yield on the current share price)
  - Repurchased 125,000 shares of its common stock at an average share price of $36.75 per share
  - Declared a $0.15-per-share quarterly cash dividend payable on Aug. 18 to all holders of record of common stock as of Aug. 4.

*excludes changes in client assets due to market fluctuations

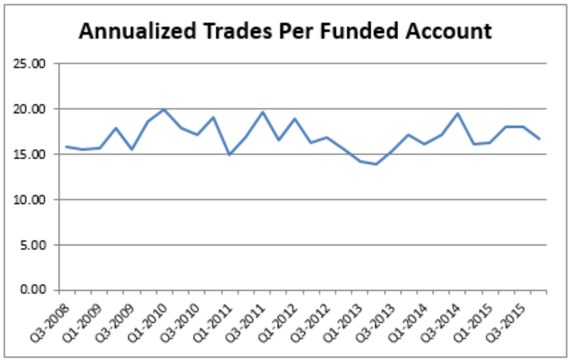
Analysis

In this quarter, the rate of growth in asset gathering slowed a bit, with net new assets down 13% year-over-year (the first time in five quarters that the company gathered fewer net new assets than the same period a year ago):



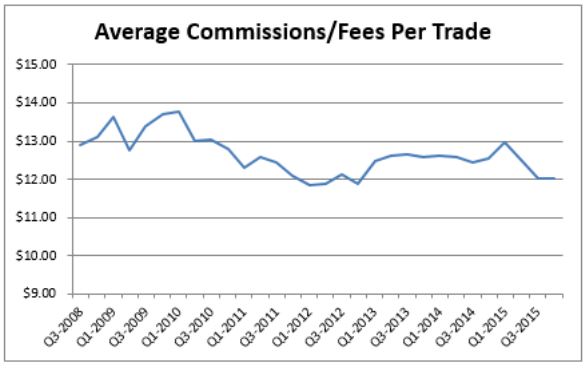
Source: TD Ameritrade June Quarter Earnings Presentation

Trading activity was a bit muted relative to the previous two quarters, but the company continues to execute on penetrating derivatives (comprising a record 44% of trades per day in the quarter) and mobile trades (comprising a record 17% of trades per day, up from 13% a year ago). Management called out low intra-day volatility in the quarter (it had the fewest days in a quarter with intra-day volatility higher than 1% since the December quarter of 2006) as a reason for muted trading activity:



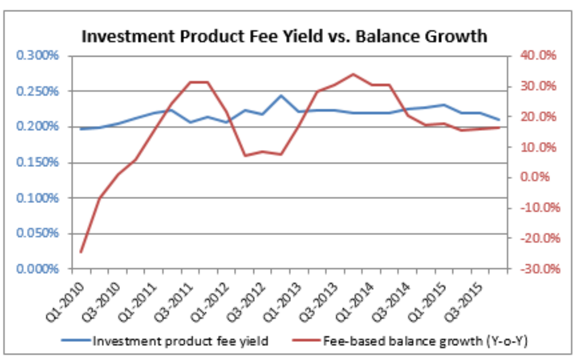
Source: Company filings and analyst calculations.

Average commissions and fees continued to stay at the low end of the company's recent historical range. The commission rate was essentially flat sequentially as low retail investor trading and a historically high mix of futures as a percentage of derivatives trading (about 10%) continue to negatively impact commissions per trade:



Source: Company filings and analyst calculations.

Growth in the fee-based segment of the business is slowing down, with revenue growth decelerating to 7.6% year-over-year (from 13.3% last quarter and 21.5% a year ago). The revenue growth in this segment was most strongly affected by a decline in the average investment product fee yield because of the [Amerivest performance-based rebate offer] that is currently on the market.

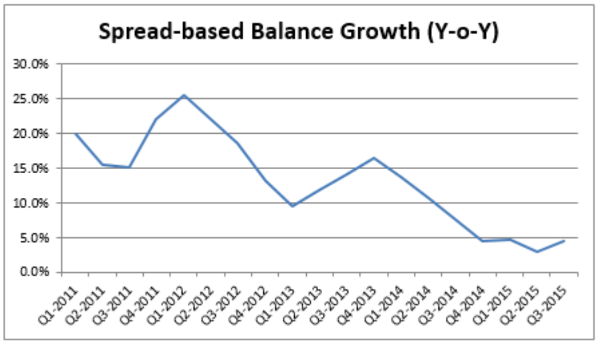


Source: Company filings and analyst calculations.

After capitalizing on rapid growth in this segment during the nascent stage of the robo-advisor industry, TD Ameritrade is seeing increased competition from the likes of companies such as Betterment, Acorns, and Wealthfront affecting its growth in this arena, as the company's growth in fee-based investment balances is not accelerating despite lower yields. Although fee-based revenue represents only 11% of the company's revenue, it's also been the company's fastest-growing segment. I'm interested to see how this part of the business performs over the next several quarters.

As for the spread-based portion of the business, it is very sensitive to changes in interest rates, and it will provide a big boost to profitability if and when interest rates rise. The company has guided that a 100-basis-point increase in the Fed Funds Rate will increase annual earnings by $0.38 per share in year 1, $0.44 in year 2, and $0.51 in year 3. Given that trailing-12-month EPS was $1.47 per share, that's some pretty healthy upside (26%, 30%, and 35%, respectively).

Given that information, we want to see that spread-based balance continue to grow at a healthy clip. When interest rates eventually do rise, we want TD Ameritrade to have as many interest rate-sensitive assets as possible. The rate of growth in the spread-based balance accelerated a bit this quarter:



Source: Company filings and analyst calculations

Our valuation assumes slowing growth in the spread-based balance, so an acceleration of growth in one of the company's key value drivers is a welcome sign. We'll continue to watch this metric over time to make sure it's staying on track, especially as we inch ever closer to the Federal Reserve's interest rate increase.

What We Think Now

TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and when interest rates increase, the company is positioned to grow earnings sharply.

If you have questions, post them on our TD Ameritrade discussion board.

Where's the Inflation?

Published Jul 20, 2015 at 12:29PM


Morgan Housel is Motley Fool One's expert on the intersection of investing, economics, and human nature. He studies the impact of big-picture issues on individual investors' lives — making us better Fools along the way.

A *Motley Fool One* member emailed me recently asking: "The Federal Reserve has printed trillions of dollars of money since 2008. How is it possible that this hasn't brought hyperinflation?"

It's a good question. With the disclaimer that economists have written entire books on this subject, here's a 500-word answer.

Inflation goes up when there's too much money chasing too few goods. Simple supply and demand.

Virtually every historical bout of hyperinflation has been caused by the *latter half* of that equation.

History will show that it's hard to get hyperinflation just by increasing the money supply — you also need to decrease the amount of goods in the economy. This can happen after wars, when factories have been bombed out (Japan, 1940s); when neighbor countries take your assets to pay reparations (Germany, 1920s); or when governments confiscate productive assets like farms (Zimbabwe, 2007).

One reason America hasn't experienced high inflation since 2008 is because our biggest problem after the crisis was *too many* goods. Too many vacant homes. Too many office buildings. Too many cars. This wasn't true just in America, but most of the developed world.

Contrary to popular belief, the Federal Reserve doesn't actually control the money supply. All money creation in our economy occurs when private banks make loans. When **Citigroup** (NYSE: C) lends you $1,000, it essentially creates about $900 out of thin air (they keep the rest on reserve). That's how money is made. The Fed lends money to banks and tweaks the amount of reserves they hold. But without banks making new loans, the amount of money sloshing around the economy won't rise, no matter how much is printed.

That's important, because since 2008 our glut of too much stuff — too many homes, too many toys, too much oil, etc. — has caused banks to be reluctant to ramp up lending.

Mortgage issuance plunged after 2008. Lines of credit were cut. The federal government ran massive budget deficits after the financial crisis, but even that wasn't enough to offset the decline in private-sector lending. Total debt — government and private — as a share of GDP declined from 2009 to 2013.

So what happened to the trillions of dollars the Fed printed, a practice known as quantitative easing?

QE doesn't necessarily increase the amount of money floating around the economy. The Fed buys Treasury bonds from a group of private banks called primary dealers. After they agree on a price, banks give the Fed Treasury bonds, the Fed gives banks newly printed cash.

As far as the economy is concerned, no new assets are really created. The Fed printed $3 trillion of new cash, but it also removed $3 trillion of Treasuries from the private banking system. (This is different from other economies which have, for example, printed money and injected it directly into the economy, often to pay soldiers during wars.) The new cash in the banking system provides liquidity and can help banks make new loans. But if those banks aren't willing to make new loans because the economy already has too much stuff, the Fed can print a tremendous amount of money without doing much to inflation.

Which is exactly what's happened since 2008.

None of this is a forecast of what might happen next. I have no idea what the future rate of inflation will be, nor does anyone else. Things could change quickly — lending could ramp up, the Fed could hike interest rates, there could be an oil shock based on political disputes.

But the headlines of how much money the Fed printed over the past seven years made it way too easy to conclude hyperinflation was right around the corner. In reality, these kinds of events are always more complicated than they seem on the surface.

Investing great Peter Lynch was once asked about how to invest given high inflation in the 1980s.

"I don't worry about any of that stuff," he said. "I've always said if you spend 13 minutes a year on economics, you've wasted 10 minutes."

The lesson: Buy good businesses. Hold them for a long time. The rest is commentary.

What's the Word on World?

Published Jul 20, 2015 at 10:39AM

Fellow Fools,

We always try our best to give you the full scoop in each of our trade alerts, but it's unavoidable that some of our work gets left on the cutting-room floor. Our recent short of **World Acceptance Corp.** (NASDAQ: WRLD) was no different. So for today's Memo, we thought you might enjoy a Q&A session with some more detail about what we found while looking into World. Let's do this!

Q: Aside from the Consumer Financial Protection Bureau's civil investigative demand (referenced in the alert), how's the business doing?

A: Return metrics are still impressive, but it looks as though World's business is slowing down. Interest and fee income (which accounts for 86% of overall revenue) and total revenue increased by only 0.1% and 1.8%, respectively, in fiscal 2015, even though the company opened 69 new branches. (That said, that number is somewhat misleading -- the net increase in branches was only 3.9%, because World actually merged 22 unprofitable branches with others.) World's loan portfolio remained relatively unchanged in size on a constant currency basis, while loan origination volume has actually fallen for two straight years. And by the company's own admission, it's getting increasingly difficult to attract new customers to its stores. Ironically, we suspect this is because competition in the installment-loan industry is heating up, with payday lenders and their ilk moving to installment loans in hopes of staying one step ahead of regulators.

Q: Management turnover appears to be a theme with many of your shorts (whether before or after the position is initiated). Does this continue with World?

A: Yes. Current CEO and Director Sandy McLean III will be leaving in two months. Preceding him out the door were the prior CFO and senior vice president at the end of 2013, the COO and president in late 2013, and the former senior vice president of the company's southern division in June of this year. It's also worth noting that World's former auditor, KPMG, resigned in August of last year as well. It's hard to know ahead of time whether these moves are a sign of worse things to come, but the amount of turnover we've seen as things have started to get tougher for the company is noteworthy.

Q: Do you think the company's creditors will prevent World from repurchasing any of its stock, and if so, how long will the moratorium last?

A: For context, and as noted in the trade alert, the most recent amendment to World's credit agreement states that World can't buy back its own shares unless lenders who hold at least 66 2/3% of the company's aggregate commitments approve of the buyback.) We're not mind-readers, but we believe it's unlikely that World's creditors will let it continue to repurchase stock at the pace it has in the past. There are a couple of related reasons for this. First: For years, amendments to World's credit agreements have proven ever more favorable for the company -- but in the past four amendments, creditors have become increasingly stringent. And the pace is increasing, too; the prior four years averaged around one to two amendments per year, but we've already seen three in calendar 2015. It looks like the balance of power has shifted in favor of the creditors.

The second reason is that World has traditionally preferred to leave some headroom between the maximum amount it can withdraw under its revolving credit agreement and the amount it actually borrows. It's currently on the hook for about $500 million, so seeing the limit reduced to $600 million isn't that troublesome -- yet. But the most recent amendment also states that World's borrowing limit will be reduced again, to $500 million, by March of next year. The chart below illustrates World's historical headroom, and if management wants to maintain these levels, World will likely want to reduce the amount it's borrowing (unless it expects its creditors to reverse course).

Source: Company filings

The third reason is the seasonality of World's business. The company's fiscal year ends in March, which as we've noted is when its revolving credit limit is expected to drop again. The fourth quarter also accounts for the highest percentage of World's free cash flow, and we expect that the company will have a hard time reducing its debt in earnest (as we assume will be necessary) while simultaneously repurchasing stock. One possible lever would be to pull back on its lending practices, but this would have a negative impact on future growth. World has a bit more than $38 million in cash on its books, which it could conceivably use to buy back shares -- but we have a hard time seeing the creditors let World use that cash to buy back stock instead of paying down its debt.

Q: What is it about the latest amendment to World's credit agreement that spooked the market so much?

A: In addition to the new stipulation about buybacks, the new provision included a clause that said if a governing body hands down any type of ruling (other than the imposition of a monetary fine) that is likely to have a material impact on World's business, and it's not bonded or otherwise stayed within 60 days, the company will be considered as having defaulted on its loan. Shortly after the amendment was filed, financial services firm Sterne Agee suspended its price target, saying that this will "essentially eliminate" any buyback World had planned and prevent the company from expanding its loan portfolio. Meanwhile, investment bank FBR downgraded the stock based on similar concerns.

Q: How risky is this position?

A: We view this position as similar to our **Caesars Entertainment** (NASDAQ: CZR) short. Specifically, we think it will likely be somewhat binary in nature – if the CFPB ultimately decides to come down against World, the shorts (like us) will make out handsomely, but if the punishment isn't as harsh as many are expecting, the market will need to establish a new equilibrium for how much it's willing to pay for a business like World. That's hard to estimate with certainty, but it's safe to say it would be meaningfully higher than today's price. If things don't play out like we anticipate, we're unlikely to wait around for that new equilibrium, since we'll have a clear indicator that our thesis isn't working out.

Finally, World is a great example of why we pay such close attention to position size. With an initial allocation of 1.5%, we believe this position can meaningfully help our portfolio if our thesis does work out, but if it doesn't, the position is still small enough that our portfolio will be able to overcome it.

If you've got a different question you'd like us to answer, make sure you head on over to the discussion boards.

Foolishly yours,

-- JP (TMFYossarian)

Close Half of Your Short Position on Caesars Entertainment

Published Jul 17, 2015 at 10:39AM

How You Participate

- **Action:** Buy to close *one-half* of your short **Caesars Entertainment** (NASDAQ: CZR) shares.
- **Allocation:** We are currently short 0.90%, and we will reduce that to about 0.45%, closing approximately half of the 3,500 shares we're short. (We'll round to 100-share lots, though, in case we ever want to use options.)
- **Scorecard Status:** Sell Short (unchanged). (If someone new to the position wanted to match us at 0.45%, they could.)
- **Recent Price:** $6.81
- **Price Guidance:** ***Use a limit order* and today aim to pay less than $6.90.**
- **Special note:** A July 22 court ruling may have significant influence on the stock, up or down.

What We're Thinking

On Oct. 1, 2014, *Pro* issued a recommendation to open a 2% short position in Caesars Entertainment. Ten months later -- and happily for us -- the shares are down 42%. Why? The company sought voluntary bankruptcy protection for one of its new subsidiaries in January, and the parent company is now bogged down by lawsuits from debt holders who claim that management illegally sheltered billions of dollars in assets during its restructuring. We side with the bondholders; although we're not lawyers, our belief is that Caesars did illegally move assets to keep them from creditors. Should the court agree, it's likely the stock price will fall to zero, because not just the subsidiary but Caesars itself would likely be forced to file for bankruptcy in that case.

Based on my read of the law and history, I believe the odds of this happening are better than 60%.

However, I know I could be wrong. Courts are anything but predictable, and the law is much more complex and nuanced than any of us would care to admit. Laws and how they're interpreted evolve over time, so you never know how a judge is going to rule in a particular case until the gavel comes down. The next gavel to fall is on Wednesday, July 22, when a Chicago judge will rule whether lawsuits against the parent company (Caesars itself) can go forward while one of its subsidiaries is in bankruptcy. There is no clear precedent; in some historical cases, lawsuits against the parent were allowed to continue, while in others, they've been "stayed" to give the parent stability while getting its subsidiary through bankruptcy. The latter ruling seems especially possible when the new lawsuits could bring the parent to its knees, derailing all chances of organized resolution, as could be the case here.

So what's the upshot? If the ruling on Wednesday allows lawsuits against the parent company to proceed, Caesars itself may soon need to file for bankruptcy, and the stock will crater again. But if the ruling gives Caesars a reprieve from lawsuits, the stock will likely enjoy a relief rally, regaining some lost ground. If the ruling coincides with a new debt settlement among creditors, there could be an even bigger rebound; rumor is that hedge fund giants John Paulson and George Soros are close to reaching such an agreement with Caesars, although we can't confirm this.

With this short, we have bet against some of the biggest giants in the private equity world -- including Apollo Global Management and TPG -- and we have won. We've made money while they're losing, and we've made money while countless giant hedge funds (including Paulson's and Soros's) invested in Caesars have lost so far. We should be happy. But we should not underestimate our competition. They will fight until Caesars' last breath. To greatly increase the odds that we make money on this short whatever comes next, we're closing half of our position and taking a partial victory lap with our 42% gain.

How This Decision Fits Into *Pro*

We don't know how the court will rule on Wednesday, let alone what might happen in bigger, future rulings, and we've already earned a very attractive return as of today. Locking in a large gain on half of our position means that even if the stock returns to $11, we'll still have a nice overall gain of about 20% net. Meanwhile, we're adding a new 1.5% short to the portfolio -- **World Acceptance** (NASDAQ: WRLD) -- and we recently increased the allocation to our existing short of **Boulder Brands** (NASDAQ: BDBD). So, even as we cut our Caesars short in half, our overall short exposure in the portfolio is increasing. This is in line with our desire to decrease our direct market-exposure risk.

We considered buying protective call options instead, but they're expensive on Caesars, and the cost would have hit our returns meaningfully while only protecting us at a considerably higher net price. Today's decision isn't easy -- we do believe the stock could go much lower, and we believe the only way the parent company can treat creditors fairly is to file bankruptcy and give up its assets. But closing some of our short is the "reasoned" approach, nearly guaranteeing that we can end this entire short position with a healthy profit later -- even if the stock rises again. And if the stock keeps falling, possibly to $0, our portfolio still benefits from our remaining 0.45% position.

We will use a **limit order** and carefully close half our position. Please be smart and use limit orders with us. Paying any price just to get your trade done will only make this less profitable for everyone.

Alternative Trades

- **If you set up a January 2016 synthetic short, or simply bought puts:** You can close half your contracts. If you only set up only one contract, you have a choice on your hands; keep it or close it based on what seems best for your portfolio.
- **If you set up a bear put spread:** Your decision on whether to close should depend on your strike prices and how much profit you've earned. If you've earned most of the profit you can possibly make on the spread (say 75%, 80%, or more), it may be logical to close it, but that again depends on your strike prices. Ask us

questions on the board below.

Pro Can Help

- **Want to roll the dice on our discussion board and chat?** Visit our run-down, gaudy, gold-plated but outdated Caesars board.

Wells Fargo Reports Consistent Results as Usual

Published Jul 16, 2015 at 3:17PM

Wells Fargo (NYSE: WFC)

Updated Guidance: Buy First (no change)

Recommended Allocation: 3.8%

Fair-Value estimate: $58 (no change)

Current Price: $58.15

What Happened?

- Diluted EPS of $1.03 per share (up 2% from Q2 2014)
- Revenue of $21.3 billion (up 1.1% from Q2 2014)
- Efficiency ratio of 58.5% (vs. 58.8% in Q1 2015 vs. 57.9% in Q3 2014)
- ROA of 1.33% (vs. 1.38% in Q1 2015 vs. 1.47% in Q2 2014)
- ROE of 12.71% (vs. 13.17% Q1 2015 vs. 13.40% in Q2 2014)

Continued increases in loan/deposit growth and credit quality:

- Core* loans of $832.1 billion (up 9% from Q2 2014)
- Average core deposits of $1.08 trillion (up 8.8% from Q2 2014)
- Net charge-offs as a % of total loans down to 0.30% (vs. 0.35% in Q2 2014)
- $350 million reserve release** (vs. $510 million Q2 2014)

Capital allocation:

- Share buyback activity continued (diluted share count declined 23.1 million, or 0.4% of total shares outstanding, from last quarter)
- Increased quarterly common stock dividend to $0.375 per share from $0.35

Operating segments:

- Community Banking: Net income of $3.36 billion (down 2.1% from Q2 2014)
- Wholesale Banking: Net income of $2.01 billion (up 3% from Q2 2014)
- Wealth, Brokerage, and Retirement: Net income of $600 million (up 11% from Q2 2014)

*"Core" loans excludes the impact of the non-strategic/liquidating loan portfolio

**Reserve release represents the amount by which net charge-offs exceed the provision for credit losses

CFO John Shrewsberry:

> "Wells Fargo's second quarter results once again reflected the benefit of our balanced business model. Compared with the first quarter, revenue increased on net interest income growth and expenses declined. Our balance sheet remained strong, as evidenced by solid asset quality, liquidity and capital, and we were within our targeted ranges for ROA, ROE and efficiency."

So What?

The 3 key items that I watch for Wells Fargo:

- Growth (or lack thereof) in core loans and deposits
- Trends in credit quality (as monitored via net charge-offs and reserving policy)
- Trends in the efficiency ratio and expense reduction

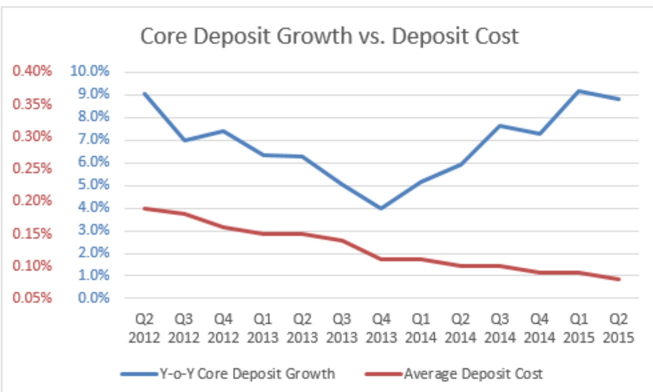
1) Growth in loans and deposits

Core loan growth for the quarter came in at 9% year-over-year. This figure includes the impact of $11.5 billion in loans acquired from GE Capital. *Excluding* the GE capital acquisition, core growth came in at 7.5%, accelerating a bit from last quarter's 7.3% growth.There was particular strength in commercial and industrial loans (which includes the GE capital loans, up 15% year-over-year) and credit card balances (up 14% year-over-year).

Source: Company filings, analyst calculations. Dashed line shows growth including the $11.5 billion in loans acquired from GE Capital.

I wrote last quarter: "I don't expect loan growth to increase meaningfully (i.e. to 9-10% growth) unless U.S. economic growth starts to sustainably accelerate (say to the 3-3.5% growth level) and long-term interest rates rise. In the meantime, if the company can keep its loan growth in the same general range as it's been recently, I'll be happy." Both including and excluding the acquired loans from GE, loan growth accelerated from last quarter, so no qualms here.

As for deposits, Wells continues to shine. The company achieved 1.5% quarter-over-quarter growth and 8.8% year-over-year growth in core deposits. Funding costs dropped one basis point from last quarter to an ultra-low rate of 0.08%. If they're only paying 0.08% on deposits, they should be gathering as many deposits as they can, and that's what they're doing. Deposit growth decelerated a bit from last quarter's outstanding 9.2% growth, but deposit growth remains very healthy:



Source: Company filings, analyst calculations

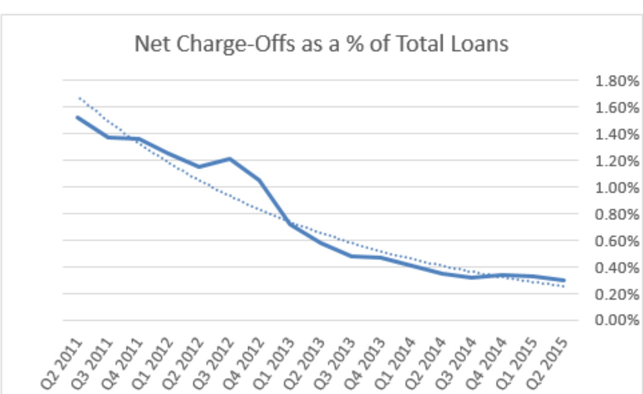
The company's ability to grow deposits meaningfully at a very low cost is perhaps the company's biggest structural competitive advantage. Wells is able to do this by having a nationwide presence with significant geographic density in most markets, optimizing distribution via newer channels (mobile/technology), and strong customer relationship management and successful product cross-sell achieved via a consistent culture that has been a hallmark of the company for decades.

For the first quarter since 2012, the net interest margin increased, coming in at 2.97% vs 2.95% last quarter. The net interest margin is unlikely to meaningfully increase until long-term interest rates rise (who knows when that will happen).

2) Trends in credit quality

Credit quality improved this quarter, with net charge-offs as a percent of total average loans declining to 0.30% (from 0.32% last quarter). This is the lowest charge-off rate I've seen from Wells Fargo since I've covered the company, and management continues to impress me with their ability to maintain healthy loan growth while still managing to wring out improvements in credit quality.

It will likely be difficult to keep improving credit quality from these very low levels. But since Wells Fargo is known for underwriting discipline, I anticipate continued strong performance from this metric. Slight deterioration in credit quality from these levels will not worry me (and may actually be beneficial in terms of generating higher loan growth), but we want to watch the trend to make sure that the company's discipline is staying on track.

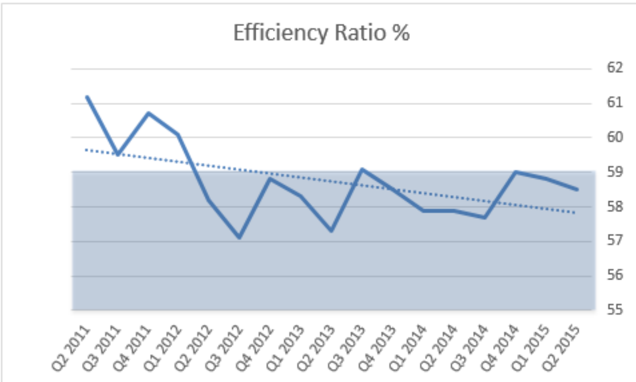


Source: Company filings.

The reserve release this quarter was $350 million (vs. $100 million a quarter ago and $510 million in the same period a year ago).

3) Trends in the efficiency ratio

The efficiency ratio (a measure of the bank's overhead costs as a % of its revenue -- lower is better) ticked down a bit this quarter, coming in at 58.5% vs. 58.8% last quarter. The efficiency ratio remains at the high end of management's target range of 55-59% (blue shaded area in graph). Management has stated that their goal is to ultimately get the efficiency ratio down to 55%, but in the absence of higher economic growth or higher long-term interest rates, the efficiency ratio is likely to stay near the high end of management's range.



Source: Company filings.

Now What?

Wells Fargo is so consistent that I can simply quote prior write-ups for my conclusion:

> "Not much different from last quarter (or the quarters before for that matter). Wells Fargo continues to execute its strategy and boast admirable consistency despite a fluctuating and uncertain macroeconomic environment. The company's performance is a testament to its diverse operating model. The company has so many levers to pull that if one segment falls others pick up the slack."
>
> "From our long-term view, underlying business results remain strong, the core earnings power of the business remains intact and is poised for positive operating leverage when interest rates and lending spreads rise, and the company's capital return program continues to benefit shareholders."

Data and Guidance

- Current Price: $58.15
- Fair Value: $58 (no change)
- Market Cap: $299.4 B
- P/B 1.76

After incorporating this quarter's results into our model, our Fair Value estimate remains unchanged at $58 per share (representing a 1.76x P/B multiple). Wells Fargo remains a Buy First on our scorecard with a 3.8% allocation, and those who have yet to fill out their position in this long-term compounder can feel comfortable doing so at current price levels.

Fool on!

Billy

If you have questions, drive your stagecoach over to the [Wells Fargo discussion board](#).

Short World Acceptance

Published Jul 16, 2015 at 3:11PM

Is this for you? This is for Fools with a margin account who can locate shares to short with their broker. Before our release of this alert, Interactive Brokers had shares available to short. Check with your broker to locate shares and inquire about fees involved. Additionally, this trade is only for Fools who don't mind volatility and the special stresses of shorting — this could be a bumpy ride. Remember, shorting isn't necessary to succeed as an investor.

How You Participate

- **Trade:** Sell short **World Acceptance Corporation** (NASDAQ: WRLD)
- **Allocation:** 1.5%
- **Price guidance:** Use a limit order and initially aim to short above $59.25. As time goes on and prices change, newcomers may need to short below that.
- **Recent price:** $60.25
- **Availability at Interactive Brokers (July 16):** 350,000 shares
- **Current annualized shorting fee (July 16):** 2.75%
- **Short interest (percentage of shares outstanding as of July 16)**: 44.37% (per S&P Capital IQ)
- **Next earnings date**: July 23

Short sellers have been circling World Acceptance Corporation (henceforth known as World), one of the nation's largest installment lenders, for a few years now. To date, things have not played out like those observers have hoped, but we believe the tide is finally starting to turn against the lender.

The Business

World positions itself as a lender for those who have limited access to capital and have been spurned by banks and other lenders. Technically this is true, but the business is a lot less altruistic than this description might lead you to believe.

Fifty percent of the company's loans come with an interest rate (as defined by the Truth in Lending Act) that exceeds 50%.

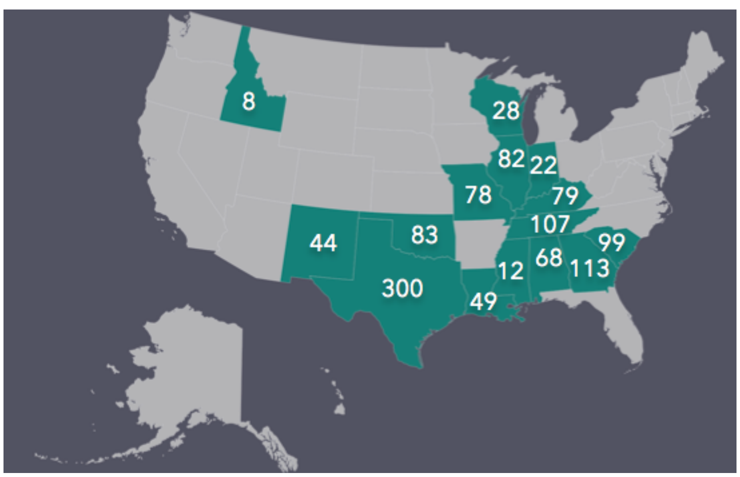
APR Low	APR High	Percentage of Gross Loans Receivable
25%	36%	23.4%
37%	50%	23.5%
51%	60%	10.9%
61%	70%	8.6%
71%	80%	3.7%
81%	90%	14.1%
91%	100%	6.2%
101%	150%	8.8%
151%	199%	0.7%

U.S. Portfolio Loan Size	Percentage of Total Portfolio
$0 - $250	1.3%
$251 - $500	14.9%
$501 - $750	10.0%
$751 - $1,00	11.9%
$1,001 - $1,500	18.9%
$1,501 - $2,00	12.9%
$2,001 - $5,000	26.5%

Source: Company filings and investor presentation

And this rate actually understates the true cost of the loan, thanks to other fees and insurance products the company actively markets to borrowers. (This was detailed in Pulitzer Prize-winning organization ProPublica's piece on World, called "The 182 Percent Loan.") In fiscal 2015, the average length of a smaller loan from World was 10 months; for a larger loan, it was 23 months. But these numbers understate how long the average borrower remains with World. The high interest rates often leave borrowers unable to repay their loans, after which they're essentially forced to accept World's offer to refinance. In fact, refinancing activity accounted for a shocking 71.5% of the loans World originated over the past fiscal year. Unfortunately, refinancing often leaves a borrower in an even worse position. It requires even more fees, and early payments consist primarily of interest (similar to a home mortgage), so it can be hard to make progress on principal. Also, World's predetermined lending amounts can mean that customers who were already struggling to repay a loan are refinanced into an even bigger one.

As of March 31, World operates in 1,172 U.S. locations plus 148 in Mexico. Branch location is important to every business, given considerations like brand awareness, specialized product offerings, knowledge of the customer, etc. But it's especially important to World because there are states where World's practices have essentially been banned. A 2012 study by the Corporation for Enterprise Development found that 22 states capped the APR for installment loans of $500 or less at 36%. (Both the cap rate and the size of the loan covered vary by state.) That particular number is important because the company admits in its 10-K filing that a nationwide 36% cap rate would "certainly eliminate our ability to continue our current operations" should it ever be implemented.



Branch location source: Company presentation

Why Short Now?

This is without question an unsavory (and un-Foolish) business; if we were ever going to root for a company to go under, this would be the one. But we won't short (or buy!) any company based on emotion. We need supporting facts. Short sellers and other organizations have been calling for World's downfall for years, and we've been watching it for some time as well; we even considered shorting it last fall, though we ultimately decided against it. However, a few recent developments have left us believing that now is the right time to act.

The first piece of the puzzle has to do with the Consumer Financial Protection Bureau (CFPB), which has released a proposal for additional regulations for certain payday, vehicle-title, and similar predatory loans. To be clear, World is not a payday lender. Only the 20% of its gross loan volume that's secured by borrowers' vehicles would be regulated under the new rules. But it's very much like one. And the CFPB doesn't look kindly on lenders whose loans end up being refinanced repeatedly, so it should come as no surprise that the agency issued a Civil Investigative Demand to World in 2014 and has asked for additional information since then.

We believe that the CFPB has World in its crosshairs, and we think its recent proposal indicates what it will likely try to accomplish with World and other installment lenders in the future. If that's the case, the outlook isn't bright. The CFPB proposal is not without flaws and is likely to undergo revisions, but many have noted that the requirements would come close to eliminating the loans it targets. And the CFPB isn't hiding what it's trying to accomplish — the following table shows the results of agency simulations under different versions of the proposals, with different assumptions about the behavior of the borrowers:

	Assuming Consumers Do Not Return After Cooling-Off Period		Assuming Consumers Return After Cooling-Off Period	
	Amortization	Off-Ramp	Amortization	Off-Ramp
Number of Loans	-62.2%	-62.2%	-54.8%	-56.5%
Loan Principal	-76.2%	-67.1%	-71.2%	-61.7%
Loan Fees	-74.5%	-65.4%	-69.5%	-60.3%

Source: CFPB (2015): *Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans*

It's not unheard of for a government agency to move on to installment lenders after initially pursuing other types of predatory lenders. The Department of Defense did exactly that when it amended the Military Lending Act to cap interest rates for covered borrowers at 36%. (Management says those borrowers only account for a fraction of World's business.) At a minimum, the CFPB expects to issue an additional ruling to identify and supervise major participants in the installment lending market, but we believe a harsher punishment is more likely.

Also, after multiple amendments to the company's revolving credit line that were increasingly favorable to World (and left us scratching our heads), the lenders are finally starting to reverse course. The most recent amendment had it all: a decrease in the company's credit line, an increased interest rate, a reduced allowable-debt ratio, and a provision saying the company can't repurchase stock without the approval lenders holding at least 66 2/3% of the aggregate commitments. There are other provisions that could threaten World's business in there too, and it's perhaps not surprising that this harsh amendment was followed by a downgrade from one analyst and a price-target suspension from another; all that was itself followed by a 20%-plus decline in World's stock price.

Take note of the news about buybacks above. Short sellers have had to endure a massive buyback over the past few years – the share count has nearly been halved since the start of 2010, helping prop up the price. One of the reasons we didn't act when we considered shorting World previously was that we didn't want to short a company that was in the midst of a massive buyback binge, so this new amendment made a real difference for us. Plus, if World's creditors are starting to get spooked, one can't help but wonder what's on the horizon for the company.

In terms of its earnings multiple, World actually looks like a bargain. The company has always traded at a discount to the market (and deservedly so, if you ask us), but it's currently trading near the low end of its historical range at 5.03 times TTM earnings. However, this is a case where we need to look to where the business is headed, not where it's been.

Depending on the severity of the CFPB's ruling, we believe there are multiple ways this position can work out in our favor. For example, it might go after World's aggressive selling of credit insurance (Discover Bank and Capital One Bank have been fined for similar deceptive practices). Insurance commissions account for around 14% of World's revenue — but as other short sellers have pointed out, if you examine customer receipts, you'll see that World often lends borrowers money to purchase the insurance. Since this amount gets bundled into the loan, World is actually able to collect interest on the insurance cost as well. So a nontrivial amount of the company's interest and fee income is also tied to credit insurance. And margins are likely to be extremely high for this division since World just sells the insurance. This means the percentage of net income attributable to the company's questionable insurance operations is likely shockingly high.

As with other financial companies, we also think it's important to look at World in terms of its price-to-book-value ratio. The stock currently trades for 1.7 times book value, which is rather generous in our opinion given the quality of the loans on its book. With such a large percentage of loan volume coming from refinancing, it's hard to accurately estimate what the ultimate recovery rate would be if the CFPB did limit World's ability to continually refinance its loans. Charge-offs as a percentage of average loans receivable are an already lofty 13% to 17% ; we believe that number would shoot higher with CFPB limitations. And given World's poor recovery rate, we might see a double whammy — a decline in book value per share, and a decline in the amount the market is willing to pay for shares.

How It Fits Into *Pro*

As the latest addition to our growing basket of short positions, this short of World Acceptance will lower both our overall net long exposure and our exposure to the financial sector (the largest sector in our portfolio). Given the potential moratorium on buybacks that could last for the foreseeable future, we believe the stock is likely to serve as a good market hedge over the near term while we wait for more details on the CFPB's plans. Once this happens, we expect the position to generate alpha regardless of what the market is doing. And make sure you stay tuned -- we'll have even more to say about World in next week's Monday Memo.

Alternative Trades

- **January 2016 synthetic short:** Experienced investors who cannot locate shares to short can consider setting up a January 2016 $60 synthetic short. Please note that while we expect an update from the CFPB before then, there is no definitive timetable for that investigation. So you may have to roll your position (for either a loss or gain). Keep your look-through allocation to 1.5%.
- **IRA Friendly:** There are no IRA-friendly trades to be had here. Apologies!

Want to talk about World? Join us on the brand-new discussion board! Easy payments available!

My Cash Strategy for Beating the Market

Published Jul 15, 2015 at 2:00PM

Morgan Housel is Motley Fool One's expert on the intersection of investing, economics, and human nature. He studies the impact of big-picture issues on individual investors' lives — making us better Fools along the way.

You may have never heard of Arnold Van Den Berg, but he's among the greatest investors of our time.

Van Den Berg was born in Holland in 1939 and survived Nazi occupation when he and his brother were smuggled into an orphanage. He moved to America after the war, finding a job as a mutual fund salesman after high school. In 1974, he set out on his own, opening an investment management company called Century Management, aiming to invest based on the value principles of Benjamin Graham.

The rest is history. Since 1974, Van Den Berg's fund has returned 14.5% a year, versus 11.9% a year for the S&P 500. That 40-year track record puts him in the upper echelon of investors. $1,000 invested in his fund in 1974 would be worth $196,000 today, versus $80,000 for the S&P.

But what's fascinating about Van Den Berg isn't his returns. It's how he achieved them.

During the 40 years he's been managing money, cash has made up more than 20% of his assets, on average. The typical mutual fund holds closer to 5% cash over time.

To me, that is remarkable. As investors, we constantly hear about how much a drag cash can be. That's been especially true over the past five years, as interest rates have hovered close to zero percent, or negative after inflation.

"Cash is trash," one recent headline read.

"Money market funds are the stupid investment of the week," another warns.

It's enough to make you mad. How do we reconcile the idea that "cash is trash" when one of the world's most successful investors held more than one-fifth of his assets in cash for four decades?

The answer is more complicated than it seems.

The 3 Main Strategies for Your Cash

Most investors, especially the young and working, are constantly saving, with new cash ready to invest each month or year.

But that poses a dilemma. Maybe it's a dilemma you face, too: How, and when, should investors invest their extra cash back into the market?

Index giant Vanguard did a study last year asking a simple question: If you inherit some money today, should you invest it all at once, or spread it out in even amounts over time, known as dollar-cost averaging?

Most financial advisors I know would recommend dollar-cost averaging, investing evenly over, say, a one-year period.

But Vanguard's data doesn't support that idea. The firm looked at market data going back to 1926, and what it found was clear as day: The majority of the time, you are better off investing all of your cash at once, in a lump sum.

The reason is simple. Stocks tend to go up over time. Holding cash means you'll possibly — even probably — miss out on the market's returns. And since no one can know when stocks might slip into another bear market, it makes sense for long-term investors to remain fully invested rather than tip-toeing in over time. Over 10-year periods, the investor who invested her cash in a lump sum outperformed the investor who practiced dollar-cost averaging by an average of 2.3% per year. The results were pretty much the same when Vanguard looked at U.K. and Australian markets. "It's logical," Vanguard wrote, "to implement a strategic asset allocation as soon as possible because it should offer a higher long-run expected return than cash."

But there's another side to this story. And it's where Van Den Berg comes back in.

Vanguard's report assumes there are only two ways to deploy cash: in a lump sum, or an even dollar-cost average.

But there's obviously a third way: investing strategically, deploying cash only when you think the market offers the best opportunities.

Know Your Optionality

When most investors think about the return they're getting on cash, they take the yield in their savings account, maybe strip out inflation, and come to some abysmally low number.

But if you're a strategic investor, cash earns another type of return that often goes overlooked. It's called optionality.

I've been thinking a lot about optionality since having breakfast with a seasoned financial advisor earlier this year. I asked him, what the biggest mistake investors make is. "Not having enough cash, ever," was his answer.

"What do you mean?" I asked.

"Interest rates have been low for 10 years. So no one wanted to hold cash," he said. "But think about 2008. There were two types of people: those with secure jobs and those without. Then the economy crashed. Those with secure jobs didn't have enough cash to take advantage of once-in-a-lifetime investing opportunities. Those without secure jobs didn't have enough cash to keep their heads above water."

This reminded me of something Nassim Taleb, author of the popular book The Black Swan, once wrote: "Optionality is the property of asymmetric upside (preferably unlimited) with correspondingly limited downside (preferably tiny)."

That's what cash is.

Cash gives you options other assets don't. It lets you take advantage of some situations and protects you from others. For investors, the optionality value of cash comes from the fact that it possibly lets you buy stocks at cheaper prices in the future.

And here's what's important: The value of that optionality can more than offset the abysmal interest rate you're earning on your cash.

Van Den Berg was once asked why his fund holds so much cash. "Think of it this way," he said. "If we sit in cash and wait for a $15 stock to get down to our $10 buy point, then when it eventually goes back up to $15, we get a 50% return on our investment. We think this more than makes up for the few months or quarters we might have to wait in cash, even if cash paid no yield at all."

When you think of it this way, cash in the bank yields a lot more than the advertised fraction of 1% most people earn these days. The "real" yield is the pitifully low interest rate plus the value of the optionality.

Take two hypothetical investors. Each has saved $100 per month, every month, since 1929 (bless them).

The first practices dollar-cost averaging. He invests his $100 every month into the S&P 500 come rain or shine.

The second puts her $100-a-month savings in cash when stocks are rising and deploys the entire amount only after stocks have declined 20%.

How have these two investors fared since 1929?

The investor who's hoarded her monthly savings, and only deployed it when the market crashed, has nearly 14% more money today than her friend who practiced dollar-cost averaging.

That extra return, which can add up to a lot of money over a lifetime of savings, is the optionality value of the cash she held in the bank all those years, waiting for the market to fall. It's a very real return she earned on top of her savings account's interest rate. For years, her friends chided her for earning a puny 1% or 2% yield on her savings account, when in reality she was earning substantially more once the value of the cash's optionality is factored in. Now she's richer than her snickering friends.

This kind of thinking is why smart investors like Van Den Berg outperform the market over time despite holding a lot of cash. Their cash hoards aren't anchors earning low returns; they are opportunities awaiting a large return. "Cash combined with courage in a crisis is priceless," Warren Buffet once said.

All this is fine, you're probably saying, but everything I've discussed is backward-looking theory. How can you implement an actual cash strategy in your portfolio today?

My "Crazy" Cash Strategy

I can't provide individual advice — investors of different ages, incomes, and risk tolerances have different priorities. But I can tell you how I think about cash with my personal money.

Bill Gates was once asked why Microsoft kept so much cash on its balance sheet. "I wanted to have enough money in the bank to pay a year's worth of payroll even if we didn't get any payments coming in," he said.

That may seem extreme, but Gates understood something most Americans overlook: Things change fast. You can go from on top of the world one day to fighting for scraps the next. The best way to protect yourself from life's vicissitudes is to ensure you aren't forced to sacrifice long-term gains to deal with short-term pain. If Gates hadn't kept so much cash in the bank, he might have had to sell strategic assets, or even the entire company, if Microsoft had a bad quarter. I will even suggest that a main reason Microsoft has been so successful for 30 years is because it's kept enough cash in the bank to remain flexible and focused on the long run while its competitors have had to sell out to remain solvent in the short run.

I take a similar approach with my own money. I keep as much as 40% of my assets in cash, which is inordinately high for my age.

Most financial advisors will tell me this is crazy. But I disagree. I want to make sure I never have to sell my holdings to generate cash to cover a short-term problem, such as illness or unemployment. It's being forced to sell stocks before you're ready that will clobber your long-term wealth — not earning a low interest rate on your cash. That's especially true when you think about the fact that you're more likely to need emergency cash when the economy is in poor shape, triggering layoffs and friends and family in need. And that's exactly when stocks are likely to be cheap.

For most of you, how long you stay invested is the single biggest determinate for how well you'll do at investing. And the best way to remain invested for the long run is to keep enough cash around to ensure you're never forced to sell out.

I want to stress that everyone's finances are different, and this is not personal advice. But some people think they are maximizing long-run potential by remaining fully invested in the market, when in reality they are putting themselves at the mercy of short-term wobbles. As Buffett put it, "When forced to choose, I will not trade even a night's sleep for the chance of extra profits."

A Simple Plan for Taking Advantage

The other reason I keep a large chunk of cash around is the same reason Van Den Berg does: I want to be ready and able to invest when the market presents opportunities to buy cheap stocks.

But that's easier said than done. How do you know when to deploy your cash? And how much of it should you invest when the market tanks?

I have a simple method that provides what I think is a good framework for cash management.

Throughout history, the harder the market drops, the more opportunity there's been for bold investors to make their moves. The problem, of course, is that the deepest market drops — where stocks fall 30% or more — occur less often than shallower drops of, say, 10%. I needed to figure out how to deploy enough cash to take advantage of decent opportunities while still keeping enough cash on hand for big opportunities.

So I looked back at 140 years of market data and came up with a plan.

Say I have $1,000 cash set aside to invest (in addition to emergency funds so I sleep well at night). It's opportunistic investment money. Here's my roadmap for deploying it:

Market falls by	I invest	Historical frequency
10%	$100	Every 11 months
15%	$220	Every 24 months
20%	$300	Every 4 years
30%	$130	Every decade
40%	$125	Every few decades
50%	$125	2-3 times a century

I deploy the most cash when the market falls by 20% because that's both a big decline and one that, historically, occurs pretty frequently. A 50% or greater crash represents the biggest opportunity, but it occurs rarely enough that I don't want to set aside too much cash waiting for it to happen.

As for which companies I'll invest in when the market crashes ... I'm comfortable not knowing that beforehand. Every crash affects different industries in different ways, creating opportunities that simply can't be predicted in advance. How much I'm comfortable investing can also fluctuate alongside valuations. I might not buy stocks after a 10% drop if we're coming off a bubble, such as tech stocks in 2000.

What my roadmap does help with is thinking about how much value my cash has when the market drops. Investors have a natural tendency to freeze and panic when stocks fall. Being armed with a plan to deploy my cash based on historical evidence is the best way I know of to combat the emotions that prevent most investors from taking advantage of market opportunities. It's how I prepare to actually realize the optionality value of my cash.

As Van Den Berg once put it, "That cash you're holding today is the raw material of tomorrow's superior returns." Wise words to consider as investors fret over minuscule returns earned in their savings accounts.

Quick Take: Morgan Housel on the Inevitable Crash

Published Jul 13, 2015 at 12:00PM

At the recent *Motley Fool One* member event in Seattle, Motley Fool One senior analyst Morgan Housel spoke about the eventual end of this bull market — and how Fools can tune out predictions and thrive over the long run. Watch these clips for some of Morgan's top advice on how to think about investing in stocks:

- Assume the market may crash at any moment
- The cost of admission for long-term success

Assume the Market May Crash at Any Moment

Even if we know the history of market crashes — how frequent they are, how inevitable they are, and even how good they can be for future returns — one of the worst things you can do is think that you know when it's going to come. ...

So we know that market crashes occur pretty regularly, but we have no idea when the next crash will occur, and this cognitive dissonance between these two I think really trips up a lot of investors. ...

So I think the most important thing you can do right now is prepare for a market crash without trying to predict it. And I think that's not only true right now — it's true for your entire life as an investor. No matter what the market's doing, I think a good default position is to assume that the market is going to crash pretty much at any moment. You just have to be prepared for it in your investing without trying to predict it. ...

Whether that means you need to keep a certain percentage of your assets in cash or bonds — or even if you have a tremendous amount of money and you can afford a 50% decline in your assets — do you have the mental fortitude to be able to handle that, too? Or when 2009 rolls around, will you go out and sell your assets, even if you have plenty of money?

So it's really important to know yourself and know your own behavior..

The Cost of Admission for Long-Term Success

What's so true for all investors is that how you're going to perform over the long run is not necessarily how you did when the market was surging. It's how you react when the market is falling. If you can keep your head on straight during those brief periods the market is falling and just not screw up during those periods, it's hard not to do well in stocks over the long run. That's the good news. ...

The reason you can make a lot of money in stocks over time is specifically because they go down a lot in the short run. You have to be willing to accept that cost of admission and if you're not, there are other assets that are stable that will give you no returns.

Pro's Second Annual Mid-Year Review

Published Jul 13, 2015 at 10:41AM

Dear *Pro* members,

Last week, while rereading *Pro*'s historical archive (as I sometimes do for fun and to check in on our past thinking), I came across a Memo I wrote almost exactly a year ago discussing *Pro*'s performance halfway through 2014. I had been planning to make today's Memo an earnings preview for the companies I cover (Wells Fargo reports Q2 earnings tomorrow),* but after rereading that past column, I decided that reviewing *Pro's* performance on a semi-annual basis is actually a pretty good idea. Doing so provides us with information on how our results or approach have changed (if at all), and we can potentially use this new information to our benefit.

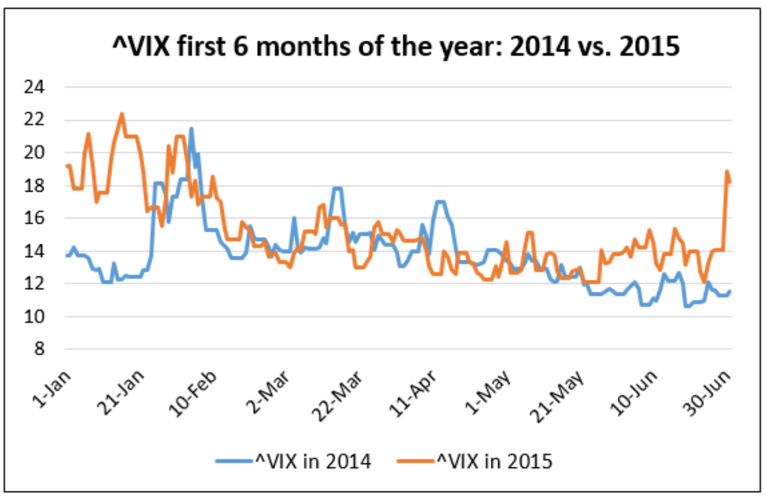
The Review

The *Pro* portfolio has performed well over the first six months of 2015. Our year-to-date performance as of June 25, 2015, is about 9.4%, outpacing both the S&P 500 (which whipsawed to a volatile 1.2% gain through June 25 after roaming between -3.2% and 3.5%) and our North Star (up about 4.7% in the same time frame). Our gross long exposure is about 88%, almost exactly in line with our historical averages. Here's a comparison of the performances of *Pro*, the S&P 500, and our North Star over the first halves of 2013, 2014, and 2015:

Year	***Pro***	**S&P 500**	**North Star***
2013	22.4%	12.6%	4.1%
2014	7.4%	7%	4.4%
2015	9.4%	1.2%	4.4%

**Source: US Bureau of Labor Statistics seasonally adjusted, indexed, monthly CPI-U data series. 2015 figure is as of June 1, 2015 (the most recent data point as of this report).*

Volatility (as measured by the ^VIX index) started the year at an elevated level amid falling oil prices and developments in foreign exchange markets. It steadily declined from there before spiking again at the end of June during renewed concerns over the Greek debt crisis:



Source: S&P Capital IQ.

As far as our activity, the pace of our trades is similar to the first halves of 2013, 2014, and 2015:

Metric	**2013**	**2014**	**2015**
New Purchases	2	2	1
Allocation Increases	3	1	0
Options for Income	8	8	8
Options for Leverage	1	1	1
Shorting	1	0	2
Hedging	4	4	4
Sales (or short covering)	3	3	1

Pro has been a bit less active in buying in 2015 compared with 2014 and 2013; we've established one new stock position (**Visa** (NYSE: V)) so far this year, and we haven't increased our allocation to any of our core stocks. Part of the reason is that we haven't outright sold much of anything, either; *Pro* is a fixed-money portfolio, meaning that if we want to keep our exposure the same while adding new stocks, we must first sell something we already own. In addition to adding a new stock in Visa, we've introduced two other new companies to the portfolio via options -- a bought call on **American Airlines** (NASDAQ: AAL) and written puts on **Live Nation** (NYSE: LYV).

When it comes to generating income, we've been just as active as in the past, with eight income trades so far this year. Those include written puts on **Gentex** (NASDAQ: GNTX)), a covered strangle on **Wells Fargo** (NYSE: WFC), and two covered strangles overlaid atop our **Expeditors International** (NASDAQ: EXPD) synthetic long.

Some of our income trades didn't work out exactly as we expected, including an ill-timed diagonal call on our American Airlines position. We ended up committing additional capital to that position to roll up to a higher strike about a week after we initiated it, only to see that additional capital incinerated when American's stock price retreated back below our *original* call strike price before expiration. From that experience, we learned to be more careful with income strategies on positions that aren't explicitly intended for income from the outset.

Our partial covered calls on **Papa John's** (NASDAQ: PZZA) are now well in-the-money, and unless the stock price retreats measurably before October expiration or an attractive rolling opportunity is available, we'll let them be exercised to sell one-third of our position. If that comes to pass, it's an outcome we anticipated and are prepared for; we'll be divesting a portion of our shares at a price well above our estimate of fair value while still benefiting from share-price appreciation on two-thirds of our position.

We also introduced a new short this year, this one on **Boulder Brands** (NASDAQ: BDBD). Later, we increased our allocation and bought protective calls after the stock fell more than 20% following the resignation of co-founder and former CEO Stephen Hughes.

Our strongest-performing stocks so far this year have been Papa John's (40% return YTD), **Skyworks Solutions** (NASDAQ: SWKS) (38%), and **Starbucks** (33%). Our worst (again, so far) have been **OpenText** (NASDAQ: OTEX), down 33%; **Oracle** (NYSE: ORCL), down 10%; and Gentex, down 9.5%.

All in all, while the first six months of 2015 have been choppy -- the S&P 500 is just barely into positive territory -- the *Pro* portfolio is performing well. We've used options for income to take advantage of a more volatile market, we've seen strong appreciation from a number of our core stocks, and we've added shorts and slowed down our purchase activity to take a slightly more defensive stance in this uneasy market environment.

The *Pro* Bottom Line

Pro's low-turnover approach is patient, flexible, and focused on an absolute-return strategy. We try to keep our underlying philosophy in mind with every portfolio decision we make. So fittingly, the conclusion from last year's mid-year review column is still completely applicable today. Here it is, with edits in brackets only to change the reference to the year:

> "While we aren't market prognosticators and we can't tell you what to expect from the market over the second half of [2015], we can tell you what our approach to portfolio management will be. We will continue to invest in core stock positions (i.e., compounding machines) when the balance of risk and reward looks favorable. We will continue to use options strategies either for income, to add to our positions at lower prices, or for leverage, depending on what opportunities present themselves. We will seek to short weak, disadvantaged companies that appear poised for a stock price decline, and we will manage our net long exposure via index hedges as market conditions dictate. Here's to a successful first half of [2015], and hopefully to a successful second half as well."

Fool on!

— Billy (TMFTailwind, aka TMF________)**

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*Bonus Content: Earnings Preview!

Three of the companies I cover are set to report earnings within the next two weeks. Here are a few things I'll be looking for when each company reports:

Wells Fargo (reports July 14)

1. Growth in loans and deposits
2. Trends in credit quality
3. Trends in the efficiency ratio
4. Management commentary on the overall economy and interest rates

TD Ameritrade (NYSE: AMTD) (reports July 21)

1. Trading activity, mobile and derivatives penetration, and pricing
2. Net new asset growth (and specifically fee-based balance growth)
3. Net interest margin and management commentary on a changing rate environment

Gentex (reports July 23)

1. Gross and operating margin performance
2. Mirror unit growth (both exterior and interior) relative to auto production growth
3. Share buyback activity and management commentary on capital allocation priorities

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** I've decided to change my TMF handle, and I'm giving the *Pro* community an opportunity to determine the outcome! Check out my TMF handle renaming contest and submit your entry here.

The Hierarchy of Investor Needs

Published Jul 6, 2015 at 1:41PM


Morgan Housel is Motley Fool One's expert on the intersection of investing, economics, and human nature. He studies the impact of big-picture issues on individual investors' lives — making us better Fools along the way.

One summer in college, I interned at an investment bank. It was the worst job I ever had – more on that another time.

A co-worker and I survived our days by bonding over a mutual interest in the stock market.

My co-worker was brilliant. S*cary* brilliant. The kind of guy you felt bad hanging out with because he made you realize how dumb you are. He could dissect a company's balance sheet and analyze business strategies like no one else I knew or have met since. He was the smartest investor I ever met.

He went to an Ivy League school, breezed through an advanced financial course load, and after college landed a high-paying gig at an investment firm. He went on to produce some of the worst investment results you can imagine. Not just bad, but shockingly, disastrously bad.

Didn't see that coming, did you?

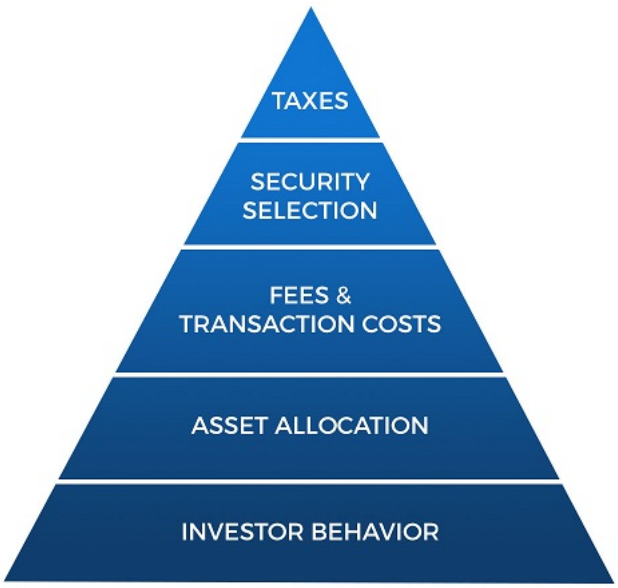
My co-worker is a genius on paper, but he didn't have the mental disposition to be a successful investor. He was too emotional, had too much of a gambling mentality, and never grasped that his book intelligence didn't necessarily translate into investing intelligence, which made him massively overconfident in his ideas. His textbook investing brilliance didn't matter. His emotional faults led him to be a terrible investor.

He's a great example of a powerful investing truth: You can be a brilliant investor on one hand, but fail miserably because of what you lack on the other.

There is, in other words, a hierarchy of investor needs. There are skills that matter more than others and, until they're mastered, render all other skills useless.

Here's what I came up with.

The most important investing topic is at the bottom. Each topic has to be mastered before the one above it can matter:



Every one of these topics is incredibly important. None should be belittled.

But you can be the best stock-picker in the world, yet if you buy high and sell low – the epitome of bad investing behavior – none of it will matter. You will fail as an investor.

You can be a great stock-picker, but if you only have 10% of your assets invested in stocks – a poor asset allocation for most investors – you're not going to move the needle.

You can be a super-tax-efficient investor. But if your stock selection is poor, you're not going to have many capital gains to pay taxes on in the first place. And if you're paying too much for advice, your tax savings can be irrelevant.

This graphic will mean different things to different people. Some investors have already mastered most of these topics. Others will find a few of them meaningful.

But no matter what level we've reached, a common problem any investor can encounter is the temptation to try to solve one problem without first mastering a more fundamental one. It can cause severe frustration, because if you've gotten the hang of a more advanced topic, you might think you should be on the road to riches -- but a more basic issue, like investor behavior or asset allocation, could still put you on a road to ruin. Just like my old co-worker.

Pro Live Chat, July 2015

Published Jul 6, 2015 at 12:47PM

Join us at 1 p.m. Eastern on Wednesday, July 22, for our monthly live chat!

The GDP and the Stock Market

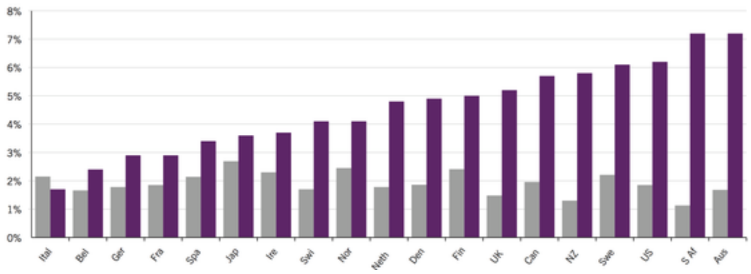
Published Jul 6, 2015 at 11:24AM

Fellow Fools,

Ignoring for a second the effects of buybacks, stock splits, and multiple expansion, why is it that the price of a successful company's stock increases over time? Generally, it's because the company gets bigger. Consider the fictional but excellent company Foolish Diamonds Inc., which sells diamond rings. As those rings grow more popular, the company's revenue increases each year, which results in the earnings per share of its common stock doing the same. If the stock price doesn't also increase, the P/E ratio will fall over time, indicating that the company is actually getting cheaper. It'd be akin to buying a diamond ring, then returning to the store at a later date to pay the same amount for another ring that's identical except for a bigger diamond. Opportunities like this are rare, but the market does occasionally offer them up.

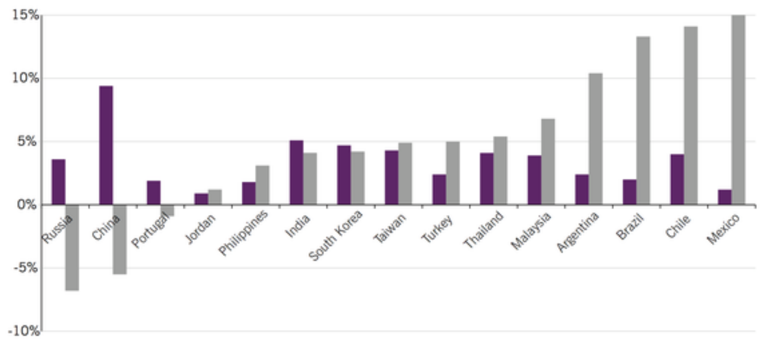
So it would stand to reason that robust growth in gross domestic product should result in impressive equity returns, right? This statement is often used as a selling point for investing in emerging markets, and it sounds logical: Strong real GDP growth should drive strong growth in corporate profits, which in turn should help deliver impressive equity returns. Reality, though, is not quite as simple (shocking, I know). In fact, evidence suggests the opposite is actually true.

Jay Ritter from the University of Florida found that from 1900 to 2011, the correlation between per-capita income growth and real equity returns was actually negative.



Source: Ritter, J.R. (2012). Is economic growth good for investors? *Journal of Applied Corporate Finance, 24(3)*, 8-17. Real per capita GDP growth rate per annum (on left in gray) and real equity return per annum (on right, in purple), 1900-2011. The real return data (dividends plus capital gains, adjusted for inflation, in local currency units) are from Dimson, Marsh and Staunton (2012). Real per capita GDP growth rates are from the World Bank, Dimson, Marsh and Stanton (2012), and Maddison (2010).

The countries included in this original analysis were selected because they have stock markets that have been in continuous operation since 1900. But what about emerging-market countries? In this case, the analysis was run from 1988 (1993 or 1995 for the BRIC countries) through 2011, but the results were the same – the correlation was negative.

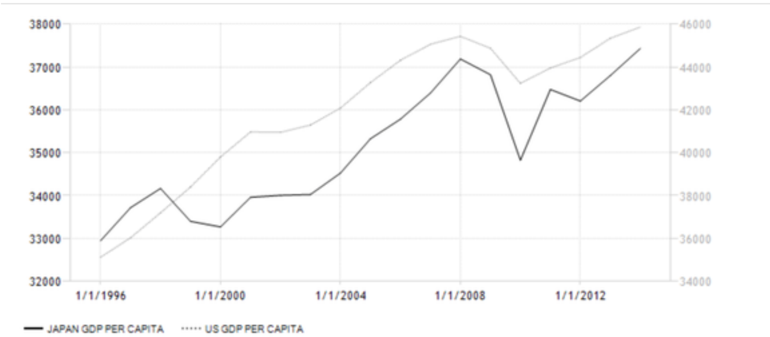


Source: Ritter, J.R. (2012). Is economic growth good for investors? *Journal of Applied Corporate Finance, 24(3)*, 8-17.

So what's going on here? Is this just data mining, or have we found a spurious relationship? To start, it's important to note that the above is an attempt to simplify an incredibly complex relationship. A long sample period was chosen in an attempt to avoid the effects of monetary policy, business cycles, international revenues, expectations for future GDP growth, and a myriad of other variables that can and do impact market returns over the shorter term. These factors might very well come into play for you as an individual investor, depending on the length of your investing horizon.

But on the other hand (and as Ritter notes), these findings are actually consistent with what Warren Buffett and University of Pennsylvania professor Jeremy Siegel have said: In a competitive economy, consumers -- not the owners of capital -- are often the primary beneficiary of technological advancement, because it leads to a higher standard of living. And if an economy grows because of investments in new or existing companies through equity or debt offerings, returns do not accrue to existing shareholders unless they're greater than what was already being achieved – and unfortunately, the opposite is true more often than not.

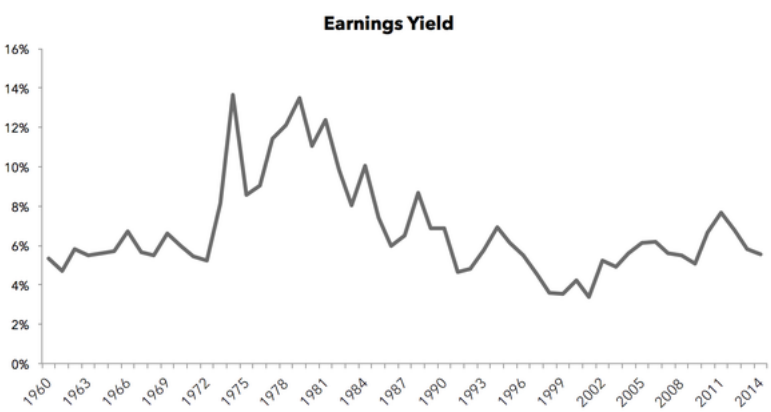
If you wanted to see this play out in real time over the past 20 years, all you needed to do was keep an eye on Japan. The country has done its best to keep up with the U.S. when it comes to growth in per-capita GDP, but the discrepancy between stock market returns is vast. (They may end up in a relatively similar position, but note the discrepancy in starting points.)



Source: tradingeconomics.com

And consider China, where the equity market has grown from "almost nothing" in 1993 to $3 trillion in 2011 (the end date of Ritter's analysis). You'd expect annual returns to be impressive over that time horizon, but as the emerging-markets chart above illustrates, they've been anything but. That's because much of this growth in the aggregate market cap has come from the increase in the number of listed companies, including China's four largest state-owned banks.

Of course, here at *Pro*, we evaluate our performance over rolling three-year periods, not multiple decades, so it's necessary for us to take a different stance than Ritter in that respect. These results don't give us a free pass to ignore what our economy is doing right now. But they do give us insight into future market returns over time, or at least Ritter's beliefs about them. He posits that the most important factor is the market's earnings yield, which is simply the inverse of the P/E ratio (so high = cheap). For reference, here's where the S&P 500 earnings yield finished at the end of 2014:



Data source: Aswath Damodaran

We do pay attention to the price of the overall market, but we're really sticklers when it comes to the price we're paying for individual companies. That's because Ritter is right: A great company can be a bad investment if you pay too much. This doesn't mean we're dyed-in-the-wool value investors, however. Our focus is the price we're paying relative to the value we're receiving, not the price we're paying compared with historical prices or the current price of competitors' stocks.

Our latest recommendation, **Visa** (NYSE: V), is a perfect example of this. Visa was trading for 22 times projected 2016 earnings and 23.8 times trailing free cash flow when we sent out our trade alert. This certainly doesn't sound like a bargain, but we're more than happy to pay up for such a strong company with a huge runway. We want companies with competitive advantages we believe will last for the foreseeable future, because they are the ones best positioned to deliver excess returns to shareholders – regardless of the macroeconomic picture.

Foolishly yours,

-- JP (TMFYossarian)

Despite Trimming Guidance, Parexel Remains on Track

Published Jul 2, 2015 at 10:34AM

Dear *Pro* Fools,

Last week, **Parexel** (NASDAQ: PRXL) held its annual Investor Day presentation, providing updated 2015 guidance and outlining a "Margin Acceleration Program" designed to improve the efficiency of the organization. The market reaction to the announcements was negative, and the stock declined almost 8% on the day of the presentation.

We don't always feel the need to comment on a large price swing (especially on a volatile stock like Parexel), but since the stock has traded consistently above our fair-value estimate so far in 2015, we decided to take a closer look at the presentation and management commentary to ensure that the recent price decline represents a more attractive entry point for members who have a partial position or no position.

After reading through the press release, the presentation slides, management comments, and reviewing industry resources, we have **increased our fair-value estimate to $61 (from $59).** So long as our thesis continues to track, we believe Parexel should continue to challenge the North Star over at least the next three years.

What Happened?

In the press release accompanying the Investor Day presentation, Parexel trimmed fourth-quarter revenue and earnings guidance because of currency headwinds and restructuring expenses associated with the margin acceleration program. The company plans to record $35 million to $45 million in pre-tax charges, primarily separation benefits related to the elimination of up to 850 positions. As a result of the restructuring, the company expects to achieve $20 million to $30 million in pre-tax savings in FY 2016, and annual pre-tax savings of $50 million to $60 million once the restructuring is fully completed.

In addition to the restructuring program, the company offered full-year 2016 revenue guidance slightly below consensus expectations, implying 7% to 9.5% revenue growth from the midpoint of 2015 guidance. These implied growth rates are slightly less than our longer-term expectations of low-double-digit growth in revenue over the next five years.

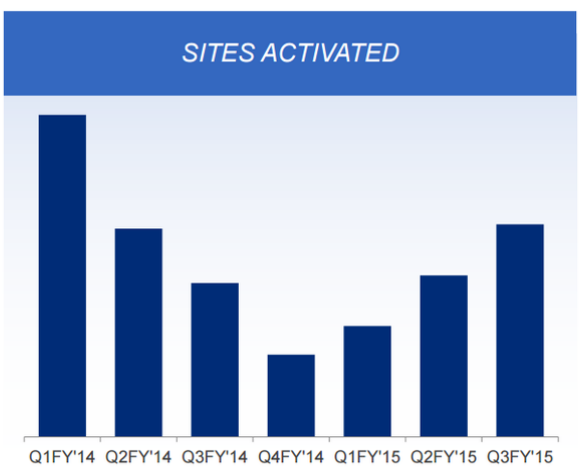
What Does It Mean?

When I read that Parexel was planning on eliminating up to 850 positions in a restructuring, my first reaction was concern. Was this an abrupt change from the company's recent strategy? Over the past several quarters, the company had been aggressively hiring employees in anticipation of a ramp-up in projects and revenue, with accelerating growth in headcount since Q4 2014. As I wrote last quarter:

> "The company continues to hire employees in anticipation of a ramp-up in revenue as multiple projects mature through the next quarter and beyond. Headcount increased 14% year over year, and those new hires mean the company's revenue per employee is historically low; it's likely to bounce back over time as projects progress, new-employee productivity improves, and revenue growth resumes at a higher pace."

But after reading through management commentary on the restructuring, I believe the eliminated positions are unrelated to the ramp-up in hiring in the clinical research and partnership functions of the business. The positions targeted for elimination are in support functions, and the company is seeking to more efficiently integrate its service offerings and eliminate overlap and unnecessary layers in the organizational structure.

Management is still confident in their active projects and partnerships over the next several quarters, and they've been hiring ahead of the demand curve, meaning they expect revenue growth will occur without the need for incremental labor -- that means cost leverage and higher margins. The company's healthy 1.30 book-to-bill ratio, 12% TTM growth in net new business, and recent increases in sites activated all support management's view of accelerating revenue growth:



Guidance Update

All in all, the business continues to track well against our thesis despite a competitive operating environment and currency headwinds. I also appreciate a management team that's willing to take a short-term hit on profits in order to optimize the longer-term efficiency of the organization. With that said, we'll want to make sure that the restructuring plan leads to the cost savings as anticipated. Additionally, we want to keep a close eye on quarterly results to make sure the company continues to win new business as the partnership model continues to gain traction, the backlog conversion rate stays healthy (management expects it to range between 10% and 11%, most recently it was 9.8% last quarter), and cancellation rates stay reasonable (the historical range is between 2.5% and 7%; it was 5.7% in the most recent quarter).

The 7%-plus stock-price decline on the day of the company's Investor Day presentation is ultimately not too worrisome. In the two weeks prior, the stock had risen almost 10%, so the market knocked it back down to a level similar to that seen after the company reported lukewarm Q3 earnings in late April. Parexel is a volatile stock, prone to sudden lurches in the share price based on lumpy results, but despite the volatility, we believe the company should continue to reward us with solid returns over the long run. Since its addition to the *Pro* portfolio in late 2013 (and including one set of written puts), the stock has provided about a 26% annualized return.

The increase to our fair-value estimate is due to an increase in longer-term expectations for clinical development outsourcing penetration. The most recent industry data continues to support the notion that contract research organizations (CROs) like Parexel will continue to win an increasing share of the increasing global clinical development market.

Updated guidance: Buy (no change)

Recommended Allocation: 3.3%

Fair Value estimate: $61 (up from $59)

Current price: $64.50

At current prices, members who have yet to match our allocation can feel comfortable either buying shares outright or writing puts to target a buy price closer to our fair-value estimate.

Pro Can Help

- Post your questions on our Parexel International discussion board.

Set Up a Put Ratio Spread on the SPDR S&P 500

Published Jun 30, 2015 at 2:22PM

Is this for you? At *Pro*, we use hedges to earn returns during a meaningful market decline. You don't need to hedge to succeed with *Pro*, but if you are at least 80% invested in stocks and want to hedge against a market decline, then consider following along. Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $200,000 or so.

How You Participate

- **Action:** Set up a put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
- **Allocation:** 11% of total portfolio value. Set up one 2:1 put ratio spread for every $200,000 you manage and want to hedge, *Pro* will sell 28 puts and buy 14, hedging 11% of our entire portfolio value (our cash included).
- **Trade:** Write ("sell to open") **two** October 2015 $187 puts, and buy ("buy to open") **one** October 2015 $200 put for every $200,000 you're hedging. Click "view all" at your broker to see all strikes.
- **Price Guidance:**
  - Sell to open *two* October 2015 $187 puts: Lately $2.68 x2 = $5.36 credit
  - Buy to open *one* October 2015 $200 put: Lately $5.32 debit
  - **Net credit:** Lately about **$0.04** per spread (but this price will change; ideally just aim for a credit or close to no cost using a limit order)
  - SPY price: $206

Our existing spreads: We are letting our existing June 30 spread expire today, and we'll continue to keep our Sept. 30 spread in place. No action is needed on either one. If you lack the September spread, see Alternative Trade guidance at the end of this report.

What We're Thinking

At *Pro*, we aim to have winners in down, flat, and positive markets -- and that means we need to address all three possibilities at once in our portfolio. A hedge on a market index is simply a hedge against a lower market. We don't know if or when a meaningful decline will occur, of course, but if it does, a hedge can help us get through it more easily. We generally don't care about declines of 5% or less (those are just part of the market), but when *Pro* is functioning as desired, declines of about 10% or more should result in some of our positions, like these spreads, becoming profitable. At the same time, the put ratio spreads we use are:

- Harmless to us if the market goes higher (they don't harm our return)
- Typically cash-free to set up (they can even pay us a small credit)

What's the trade-off? We've had to be ready to buy shares of SPY via these hedges if the market falls too sharply. So with today's trade (as with any written put), we need to be ready to buy the underlying investment -- in this case, the SPY ETF -- if it falls below our lower strike price. If the index falls more than 15.5%, our new October hedge becomes a liability. However, if that happened, we would plan to buy long-term call options on SPY instead of shares, saving most of our cash in the process. See below for details on that.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro*'s allocation and our collective possible returns.

- *Pro* portfolio value: $2,535,000
- 11% of that value: $278,850
- October 2015 spread:
  - Buy to open $200 puts. Fourteen contracts representing 100 shares each = $280,000 in look-through exposure, or an 11% hedge on our current portfolio value, cash included.
  - Sell to open $187 puts (28 contracts, half of which become a potential obligation, currently a 10.3% possible stake).
  - At home, you would buy one $200 put and sell two $187 puts for approximately every $200,000 in portfolio value you want to hedge.

Return Details

SPY Price at Oct. Expiration	Value of 1 Purchased $200 Put	Value of 2 Written $187 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Current $206
$200 or higher	$0	$0	$0.04 gain per spread, or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 2.9%
$195	$5 x $100 = $500	$0	$500	(5.3%)
$190	$10 x 100 = $1,000	$0	$1,000	(7.8%)
$187	**$13 x 100 = $1,300**	**$0**	**$1,300 (max profit per spread)**	**(9.2%)**
$185	$15 x 100 = $1,500	($2) x 200 = ($400)	$1,100	(10.2%)
$180	$20 x 100 = $2,000	($7) x 200 = ($1,400)	$600	(12.6%)
$175	$25 x 100 = $2,500	($12) x 200 = ($2,400)	$100	(15%)
$174	**$26 x 100 = $2,600**	**($13) x 200 = ($2,600)**	**$0 (breakeven)**	**(15.5%)**
$170	$30 x 100 = $3,000	($17) x 200 = ($3,400)	($400)	(17.5%)

SPY Price at Oct. Expiration	Value of 1 Purchased $200 Put	Value of 2 Written $187 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Current $206
$165	$35 x 100 = $3,500	($22) x 200 = ($4,400)	($900)	(19.9%)
$160	$40 x 100 = $4,000	($27) x 200 = ($5,400)	($1,400)	(22.3%)

Our maximum profit is earned on this October spread if SPY declines 9.3% from its current perch at $206. The spread will help us a little on a decline all the way to about 15%; beyond that, our short puts turn into an obligation that's in the red.

Follow-Up

Assuming we set this spread up for a credit, it will result in a small profit even if the market rises or treads water. On the flip side, we need to be ready to fulfill the $187 put obligation if SPY is below that price by expiration.

However, if that does happen, our plan would be to close our puts and buy long-term SPY calls (or perhaps something we like even better, whether calls or stock) instead of buying the ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY itself. So, our potential 20% or so stake in SPY shares will only cost us about 5% of our cash if we buy calls instead. We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases.

How It Fits Into *Pro*

Pro consistently hedges to lower our market exposure, or risk. As you know, we aim to achieve positive returns every rolling three years, and inflation plus 7% annualized (our North Star) over longer periods. With these challenging goals, any small advantage we gain in a falling market will make a difference. Even small gains add up over the years, especially if those gains are reinvested in depressed stocks. This hedge fits well with our goal of hedging in a cost-efficient way, one that doesn't work against us if the market rises.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:**
  - For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, as we are, "buy to open" October 2015 $200 puts and "sell to open" *an equal number* of October 2015 $187 puts. Recently, this will cost you around $2.64 ($264) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $13 ($1,300) per spread on a decline to $187 or any lower price, but you should be prepared to lose your $2.64 per spread if SPY doesn't decline to at least $197.36 by expiration.
  - **To lower your market exposure while following our official trade (and make the position possible in some IRAs):**
    - Set up the original put ratio spreads as recommended, but also "buy to open" puts (with the same months of expiration as our two spreads) at strike prices *well below* $187. Buy *half as many* as the number of $187 puts you wrote. When you do so, all of your $187 puts will be "covered" (half by your $200 puts, and half by the other puts you choose to buy at a much lower strike; choose how much you want to pay to select your lower strike price). You will only need cash in your account to cover the difference between your two lowest strike prices, and your risk is capped, making this potentially IRA-friendly.
  - **Haven't yet gotten into our September 2015 $185/$170 put ratio spread?** The *Pro* portfolio also has a put ratio spread on the above options, in a 9% allocation (set up in March). If you lack this complementary hedge and want to add it, you can set the same one up today for a net debit of about $0.25 per spread. So, you do need to pay a bit to set this up today. If you prefer, you could sell to open two $175 puts (instead of $170) and buy one $185 put, and do so for a credit of about $0.25 per spread. Just realize you'll have a higher breakeven price.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Of Gyro Sandwiches and Feta Cheese

Published Jun 29, 2015 at 12:15PM

Dear *Pro* members:

As the price to buy into American companies declined this morning, a headline in my inbox said, "Greek Drama Makes New Investments Risky."

The media tells it like this: As prices fall, stocks get more risky (rather than less); on the other hand, as prices *rise*, the coast is clear to pay more for your shares than you would have the day before, because there's less risk. We've heard this counterintuitive sentiment before, and I don't doubt we will again.

It's completely illogical, but that's how many on Wall Street still think. Thankfully, this gives us an opportunity to benefit from thinking differently. Lower prices, not higher, are better for buyers. Higher prices simply steal from future returns. We'd rather have slow and steady returns than an overexcited market, and given my druthers, I'd much rather have cheap stocks than expensive ones, because the odds would favor above-average long-term returns. So bring on the cheap.

Further, as Morgan Housel has pointed out, every market crash was an opportunity in hindsight. So why do we view future market declines as a risk?

Sure, we dislike downturns partly because we're already largely invested, and nobody likes to see the value of their holdings dwindle. But at *Pro*, we know prices don't always go up, so we keep some cash on the sidelines (we have 13.7% right now), and we maintain shorts and hedges. That way, a portion of our portfolio benefits from lower prices. If some of our short stocks were to fall sharply, we might close them and put at least some of that cash to work in cheaper stocks.

When it comes to Greece, the country has lived beyond its means and doesn't have the resources to sustainably support its debt. This has seemed obvious for five years (see Morgan Housel's explainer for more). Had we avoided stocks because of it, we would have missed years of gains. And why? Greece's economy is small, and most of its debt is carried by other European countries (rather than public companies), so any default should do relatively little to no harm to the companies we own. Meanwhile, we've been short the **CurrencyShares Euro Trust** (NYSEMKT: FXE) ETF since 2011. We'll close that short if we believe the euro has suffered enough.

Sadly, though, our bullish long-term investments can't avoid the way investor emotion affects the stock market, leading to price volatility like today's. We also can't avoid the unknown -- there may be risks in Greece that nobody has realized yet, and that's why some are selling stocks indiscriminately. But emotions and as-yet-unknown risks are both temporary factors. Emotions calm eventually, and emergent risks are attacked. The long-term earnings power of our companies is still what matters most, even if emotions rule the day for a short time.

And right now, they do. That's obvious when even a company like **O'Reilly Automotive** (NASDAQ: ORLY), which only operates in North America, is down ostensibly because of "Greece." Maybe someone thought the issue was "grease."

A Snapshot of Select *Pro* Holdings

American Airlines (NASDAQ: AAL): It seems that airlines remain a tough investment, and this one hasn't helped our portfolio yet. But the stock is inexpensive, and risk-tolerant newcomers to the position can "buy to open" January 2017 $35 calls for about $10.50 each, investing up to 0.5% of their funds to match our current portfolio.

Boulder Brands (NASDAQ: BDBD): We increased our short last week to 1.7%, and bought September 2015 $7.50 calls to cap the risk on our entire short position. Now we can comfortably cheer for much lower prices.

Five Below (NASDAQ: FIVE): The teen retailer has run up on us, becoming the only short position that's currently losing us money. We're sticking with it for now, keeping it partly as a hedge against a weak market. Should stocks remain weak, Five Below may break down again. The business still looks expensive, even though its prospects are looking a bit better than one quarter ago. Those who want to mirror our 1.4% short can do so.

Oracle (NYSE: ORCL) and **OpenText** (NASDAQ: OTEX): Large, legacy software companies are facing headwinds right now, including a strong dollar hurting results overseas (a dilemma many U.S. companies face) and a steady move to cloud software subscriptions rather than software license sales. The latter is leading to lower revenue bookings initially, but should bring much higher total revenue over many years. So, we believe it's worth waiting through this business transition. Both stocks have suffered, though. Newcomers can buy up to 3.8% in Oracle and 2.2% in OpenText to match us today.

SPDR S&P 500 (NYSEMKT: SPY): Our June put ratio spread, which we used to hedge against downside in the general market, expires at market close tomorrow, June 30. We expect to issue a new alert as that happens, replacing the first of our two current index hedges with a position with a later expiration date. (Our second existing SPY hedge expires Sept. 30, but kicks in at much lower index prices.) So, watch for that new alert. It's important that we let the June hedge die before setting up a replacement, because put ratio spreads carry an obligation if the market falls very sharply, and we don't want to double up on that obligation. We haven't needed the hedge so far (the market is about flat this year), but we didn't pay to set it up. Our last two put ratio spreads paid us a small credit in total.

In closing for today, I hope you're enjoying summer! It's a great time of year for tomatoes, olives, olive oil ... and you know, hummus sounds good right about now, and pita bread, and feta cheese, and ...

Foolishly,

-- Jeff (TMFFischer)

Greece vs. the Euro

Published Jun 29, 2015 at 10:51AM

For a broader perspective on the news from Greece, we bring you this update from Motley Fool One *senior analyst Morgan Housel, explaining how we got here — and what's next.*

Greece's economy may have peaked in 450 B.C., but it's the most influential economy in the world this morning, wreaking havoc on global markets as the country inches toward defaulting on its national debt.

What's going on? To explain, we have to go back to the 1990s ...

- **Doing business in Europe was a pain in the neck** when all countries had their own currency. An Italian buying a French bicycle had to convert lire to francs, and the French bicycle company had to convert francs to Deutsche Marks when importing parts from Germany. Everyone involved took a risk that someone else's currency would fluctuate during the process, leaving them with a loss.
- **To make things easier for everyone,** a group of European countries adopted the euro as currency on Jan. 1, 1999. This made it simpler to do business with neighbor countries, increasing trade and making everyone better off (in theory).
- **The setup is similar to that of the United States:** We have 50 individual states that share a single currency (the dollar).
- **But there's a key difference:** Our 50 states have a central government that collects taxes, pays social insurance, runs the military, and so forth. It's important that all 50 states share a central government budget because some states are richer and more productive than others. Connecticut residents paid an average of $13,163 in federal taxes in 2012; Mississippi residents paid an average of $3,503. But no matter what state you live in, the same federal government has your back. Residents in states that don't pull their weight in federal tax revenue still get Social Security, Medicare, protection from a national army, and so on. Rich states subsidize poor states, creating cohesion and semblance of order under a single currency.
- **But Europe doesn't have a central government.** Each country collects its own taxes, creates its own social insurance program, pays for its own roads, and funds its own national healthcare, all with varying degrees of largesse.
- **This is a problem with a single currency,** because low-debt countries prosper with a strong currency that encourages investment, while unproductive high-debt countries actually need a currency that loses value to help boost inflation (inflation makes it easier to repay debt) and make exports cheaper for other countries to buy.
- **Knowing this could be a problem,** the original euro pact set guidelines banning big budget deficits among member countries. It was an attempt to keep every country on the same fiscal page.
- **Alas, these rules were not enforced.** Greece spent the 2000s running up huge deficits, fueled by large pension benefits and a cultural indifference to tax cheats.
- **In 2010, the world wised up** to the extent of Greece's debts and stopped lending it money. Normally in a situation like this, Greece's currency would plunge in value, and surging inflation would devalue its old debts. This would cause a deep recession, but ultimately put its economy back on track.
- **But Greece doesn't have its own currency. It has the euro.** Which meant it couldn't inflate its debt away with a cheap currency, and more importantly, other countries with the euro didn't want to let one of their brethren fail, because the whole idea of the euro is that everyone is in this together.
- **So other countries and the International Monetary Fund** have been bailing Greece out for the last five years. Debt terms were renegotiated and aid was provided. In return, Greece was ordered to slash government spending, raise taxes, and get its national finances under control.
- **Those budget cuts sent Greece's economy into utter agony.** Unemployment hit 28% in 2013, worse than the U.S. ever experienced during the Great Depression. In 2012, 77-year-old Dimitris Christoulas shot himself after his government pension was cut. His suicide note summed up the situation: "The government has annihilated all traces for my survival, which was based on a very dignified pension. And since my advanced age does not allow me a way of dynamically reacting. I see no other solution than this dignified end to my life, so I don't find myself fishing through garbage cans for my sustenance."
- **People don't put up with that kind of misery for long,** so a new government was elected in January. The new government – the Syriza party – promised to stand up to foreign creditors and end economy-crippling budget cuts. "The verdict is clear: We will bring an end to the vicious circle of austerity," newly elected prime

minster Alexis Tsipras said on election night.

- **This began six months of Greece and its lenders** calling each other's bluff. Greece said there would be no more budget cuts. Lenders said there would be no more bailouts.
- **Greece lost this showdown last week** when finance ministers from 18 countries rejected pleas for a bailout extension.
- **This sets Greece up to default on its debt,** which will likely occur on Tuesday when it's due to pay the International Monetary Fund 1.55 billion euros that it doesn't have.

Greece is holding a national referendum next Sunday, asking its people whether it wants to keep negotiating with creditors or go its own way.

The latter would mean Greece will leave the euro and return to its old currency, the drachma. A new drachma would be worth a lot less than the euro, meaning all savings held in Greek banks would instantly be worth much less than before.

In response, Greeks spent the last week draining their bank accounts as fast as they could, attempting to hoard paper euros before they might be converted into new drachma.

This is a classic run on the banks – as of Saturday, one-third of Greek ATMs were out of cash, and on Sunday the Greek government shut down the banking system altogether. Banks across the country will not reopen until July 7. The Greek stock market will be closed for at least as long.

What a mess. I'll have more later this week.

Oracle Earnings: It’s All About That Cloud

Published Jun 22, 2015 at 9:35PM

One thing has become obvious from **Oracle**'s (NYSE: ORCL) fiscal fourth quarter report; it's becoming increasingly difficult for Wall Street analysts to predict the company's quarterly results. It may seem that Oracle has become a chronic underperformer after missing earnings expectation in four of the past six quarters, but the reality this quarter is that the company is a victim of its own success. Oracle's focus on selling its cloud-based Software-as-a-Service (SaaS) and Platform-as-a-Service (PaaS) applications resulted in the company blowing away its own internal estimates, posting $428 million in sales versus management's $300 million expectation. This was a 34% increase (on a constant currency basis) over last year and management expects growth to be as high as 60% next year.

Though this seems like this would be great news, the market reacted negatively over worries that the cloud success may have come at the expense of the company's cash cow licensing business, which declined by 10% (also in constant currency) during the quarter. This is a cause for concern because software licenses, along with the accompanying updates and support, still represent over 70% of the company's revenue. The change in GAAP revenue recognition rules caused by the transition from the pay-upfront licensing model to the ratable revenue of cloud services is going to wreak havoc on the financial statements, making it nearly impossible for investors to build a high-conviction valuation model.

Short-term Pain, Long-term Gain

Companies generally avoid sharing the specifics of their contract terms for competitive reasons, but to assuage investors' concerns, management spent a large portion of the conference call explaining the economics of the two contract types. According to management, when comparing the cash flow from a software license versus a cloud contract over a 10-year term, management expect the cloud deal to generate about 3-times more revenue. For this reason management is adamant that they prefer to sell cloud services even if it will be a short-term drag on sales and profitability. According to co-CEO Safra Catz,

"While we believe our overachievement in cloud bookings will be much more valuable in both revenue and earnings over time, cloud revenue is recognized ratably unlike new license, which is recognized upfront. This shift has the effect of lowering near-term earnings per share but, over time, will increase it significantly

So for example, a $1 million license deal, which would be recognized upfront drop right to the bottom line, would ultimately result in about $3 million in revenue over 10 years. A $1 million SaaS, PaaS booking -of SaaS booking results in $10 million over that same time period. I would not trade the cloud revenue for the license revenue, as cloud revenues and cloud bookings mean significantly more in revenues and earnings over time"

Now that Oracle has filled out its portfolio of cloud applications, management is ready to hit the accelerator. Of the $858 million of new SaaS and PaaS sales during the year, about half occurred in the fourth quarter. It should be noted that the fourth quarter is seasonally strong because sales reps try to close deals to hit year-end quotas, but even so, Oracle is demonstrating that it has an extremely competitive cloud product offering. During the quarter cloud billings-defined as total cloud revenue plus the sequential change in gross deferred revenue-increased by 78% compared to 21% at **Salesforce.com** (NYSE: CRM) and 31% at **Workday** (NYSE: WDAY). In FY 2016, management expects to sell between $1.5 billion and $2 billion of new cloud business. That's 50% more than Salesforce.com expects to sell this year.

One of the biggest concerns that many investors have is that the rapid increase in cloud sales is cannibalizing the core license business. Management was sure to point out that the majority of the SaaS deals are not existing Oracle customers. According to co-CEO Mark Hurd,

"Last quarter, I think I said that 82% of our cloud SaaS deals were actually not Oracle customers of an application when they acquired or contracted for a SaaS application. This quarter, it was over 60%. So these are -- this is not just a conversion of Oracle customers -- Oracle application customers to SaaS. This is a lot of greenfield new market share for Oracle as well"

This means that the SaaS model is more desirable for global midsized companies that can't afford the added expense of a large on-premises deployment, which should significantly expand Oracle's market opportunity.

Looking Forward

For the past few years, Oracle's management has remained focused on becoming the market leader in SaaS and PaaS and they will likely achieve that goal in the coming year. Though the license business slowed during the quarter, management insists that the on-premise installed base still has room to grow. Following the recent sell off, Oracle's stock is trading for about 10-times EV-to-EBIDTA and 14-times trailing free cash flow, which seems reasonable for an industry leader that is executing well and doing all of the right things to maintain its competitive position. Though this transition to the cloud is likely to result in volatility over the next few quarters, Pro members should be pleased that the company is well ahead of plan in establishing a fast growing stream of recurring revenue.

Of Unicorns and Bubbles

Published Jun 22, 2015 at 4:43PM

Guidance Changes

- **The Buckle** (NYSE: BKE): Our fair-value estimate decreases to $48 from $51. Shares remain a buy at a 2% allocation.

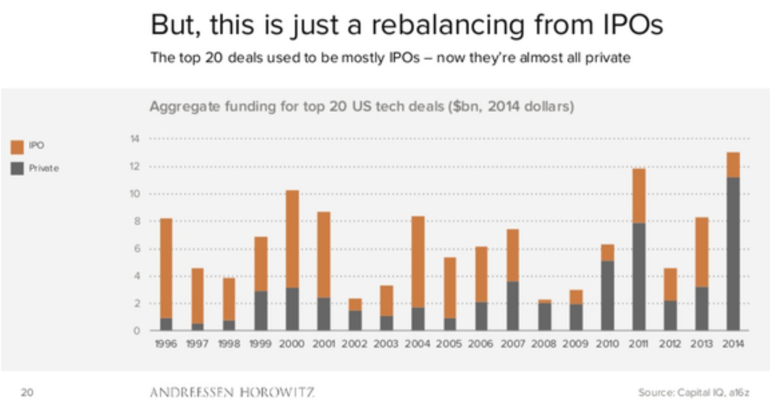
Fellow Fools,

In a recent coverage update for our sleepy clothing retailer The Buckle, I mentioned my belief that there are three truths in life: death, taxes, and changes in what's fashionable. But because I prefer even numbers, I'd like to add one more to that list today: talks of bubbles whenever our market starts hitting new "all-time highs."

In a discussion about bubbles, the tech sector is almost always mentioned, of course. And one of the biggest reasons for the chatter this time around is the number of unicorns currently inhabiting Silicon Valley. Private-company unicorns, a term that was coined by Cowboy Ventures founder Aileen Lee, were once the stuff of legend, but in recent years it's become far less rare for a company to achieve a $1 billion valuation based on fund-raising. When Lee published the initial "unicorn club" article in 2013, there were 39 unicorns here in the United States. Morgan Bender, Benedict Evans, and Scott Kupor of Andressen Horowitz noted in a recent presentation that there are now 61 of these mythical beasts stateside -- and that 75% of the largest venture-capital investments ever have been raised in the last five years. Meanwhile, Fortune's list of unicorns now pegs the global count in excess of 100.

I've read some pretty convincing articles on both sides of the bubble talk. And I've got to admit that some of the more recent valuations have left me scratching my head. It's certainly possible that the proliferation of unicorns could create a bubble that spills over into the public markets, and there are other ways you and I could be affected as investors, too.

Ever heard someone say something like "I'm investing in Company XYZ because it's going to be the next [Microsoft, Apple, Oracle, Amazon ...]"? Often, the implication is that the speaker expects the returns on XYZ's stock to mirror those of [Microsoft, Apple ...] to a certain degree. Spotting a company that is destined to join that select group is hard enough, but even if you're able to achieve such an impressive feat, you might not end up with similar returns in your portfolio going forward. You see, one of the main reasons there are so many unicorns around all of a sudden is simply that tech companies are now staying private for longer. Bender, Evans, and Kupor referred to the late-stage financing rounds that result in these generous valuations as "quasi-IPOs" and noted how the median time to IPO has expanded from four years in 1999 to 11 years in 2014.

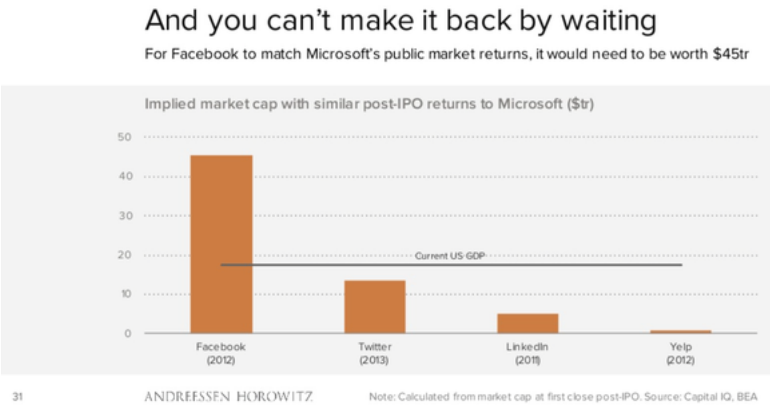


Source: Andressen Horowitz

IPOs that take place later in a company's life should be a net positive for our public markets, since we won't have as many companies like pets.com and flooz.com going public and then failing spectacularly. (Come to think of it, perhaps this is a negative for us at *Pro*, since we won't be able to short them.) But this is a drawback for the best public-market tech investors, since it also means there's increasingly less meat on the bones when a company does go public. Private investors are capturing more of the value that these companies are creating than ever before:

Source: Andressen Horowitz

Your *Pro* team can't boast that we were early adopters of Facebook (we weren't cool enough), but the *Pro* service was an early adopter of the stock, having purchased call options on the company around six months after it went public. We believe that the future is very bright for Facebook, but even so, we're not expecting Microsoft-like returns, and it took a significant decline in the stock for us to become interested. Why? Simply put, because Facebook's valuation doesn't allow it:



Source: Andressen Horowitz

I'll leave it to someone far smarter than me to figure out if and when the next tech bubble will burst, but I do think it's clear that what's taking place out in Silicon Valley is affecting us regardless. You already know that in *Pro*, we're here for the long haul. We know bubbles (and unicorns!) will come and go. Keeping an eye on this activity is just one way we can position ourselves nimbly and opportunistically, without trying to time the market.

Foolishly Yours,

-- JP (TMFYossarian)

Short More Boulder Brands and Buy Protective Calls

Published Jun 22, 2015 at 3:13PM

Is this for you? This trade is for members who have an active direct short position on shares of **Boulder Brands** (NASDAQ: BDBD). All others should read the "Alternative Trades" section of this recommendation, or bring your questions to the Boulder Brands discussion board.

How You Participate

- **Trade:** This recommendation has two components:

1. Sell short more Boulder Brands
2. Buy September 2015 $7.50 calls on Boulder Brands

- **Allocation:** Bring your short allocation on Boulder Brands up to 1.7%. *Pro* is currently short 3,900 shares for a 1.1% allocation -- we will be adding 0.6% more to our short, or shorting 2,300 additional shares. Then, purchase (buy to open) one September 2015 $7.50 call for every 100 shares of BDBD that you're short. *Pro* will be buying 62 calls. Depending on your broker, you may be able to save on commission costs by completing this trade in one transaction.
- **Price Guidance:**
  - For adding to the short: Initially, **use a limit order** to short at current prices when you make your trade, lately around $7.18; as time goes by, ideally add to your short at no less than $7 per share.
  - For the September 2015 $7.50 calls: **It is critical that you use a limit order**, initially aiming to split the current bid/ask spread. At current prices, **pay no more than $0.55 per call.** As the stock price changes, the cost of the call will change.
- **Recent Prices:** Stock: $7.18; September 2015 $7.50 calls (bid/ask): $0.45/$0.60

What We're Thinking

Last week, Boulder Brands partially vindicated our short thesis by announcing the resignation of co-founder and CEO Stephen Hughes alongside a slumping sales outlook that suggests a slowing growth trajectory. The stock price declined by more than 20% on the day of the announcement, and as I type this, our short is up about 26% since we established our position in late March.

However, unlike our long positions, which we try to ensure are great businesses that compound slowly over time, short positions require much more incremental thought and activity. The success of our initial position precipitates a new question – what do we do next? In our write-up of the resignation announcement, we noted that there was an argument to be made for "all three choices: 1) add to our short, 2) hold, or 3) cover." In fact, with this alert, we've decided to take a *fourth* choice – adding to our short while buying protective calls to buffer our downside. Here's why.

As outlined in the aforementioned write-up, we think there's a strong argument to be made for continued downside from current stock-price levels. We believe our short case is now stronger than ever for several reasons:

- The declining sales outlook lends credence to our thesis of unsustainable inventory-management and cash-conversion trends, weakening interest in the company's newly acquired brands, and increased competition.
- Boulder's debt picture is troubling, with $291 million outstanding under its term loan versus just $9 million of trailing-12-month (TTM) free cash flow. Declining sales will make it very difficult for the company to increase the latter number. Additionally, the company's debt bears interest at a variable rate, meaning Boulder will owe more in interest when short-term rates rise.
- Recent board reshuffling and management turnover suggest discontinuity and negative business momentum. Management can't fully focus on fixing the current troubles until there's a new CEO and a new business strategy in place. Boulder will have to spend resources that could be used elsewhere to find and compensate a new CEO, and employee morale may be affected.
- At about $7 per share, the company's valuation is still quite high. Boulder trades at about 40 times TTM impairment-adjusted earnings and 26 times original 2015 non-GAAP earnings guidance (which will clearly end up being too generous -- and non-GAAP excludes "one-time" costs that have been ongoing since 2011). If the company can't reignite growth, the stock price may experience further multiple compression.

For all the above reasons, we think maintaining exposure to Boulder's downside (or upside for our short) remains an attractive proposition. As for the upside for Boulder (the *downside* to our short), the success of our initial short position has afforded us a compelling risk/reward opportunity. By buying protective calls, we ensure a worst-case scenario of a small profit on our overall position if the stock price rises above $7.50 between now and September expiration.

The math works as follows. With 3,900 shares shorted at $9.60 and 2,300 shares shorted at $7.10, our net start price on our 1.7% short allocation is $8.67 per share. Assuming we pay $0.55 per September 2015 $7.50 call, the cost to buy calls to protect our entire short position would be $3,410 (6,200 shares times $0.55 per contract). The table below details the profit potential on our overall strategy:

BDBD ends at:	Net Profit on BDBD short:	Net Profit % w/o Protective Calls:	$7.50 Call Value at Sept. Expiration	$7.50 Call Net Profit at Sept Expiration	Total Strategy Net Profit at Sept. Expiration	Total Strategy Net Profit % at Sept. Expiration
$ -	$53,770	100%	$0	-$3,410	$50,360	94%
$ 3.50	$32,070	60%	$0	-$3,410	$28,660	53%
$ 4.00	$28,970	54%	$0	-$3,410	$25,560	48%
$ 4.50	$25,870	48%	$0	-$3,410	$22,460	42%
$ 5.00	$22,770	42%	$0	-$3,410	$19,360	36%
$ 5.50	$19,670	37%	$0	-$3,410	$16,260	30%
$ 6.00	$16,570	31%	$0	-$3,410	$13,160	24%
$ 6.50	$13,470	25%	$0	-$3,410	$10,060	19%
$ 7.00	$10,370	19%	$0	-$3,410	$6,960	13%
$ 7.50	$7,270	14%	$0	-$3,410	$3,860	7%
$ 8.00	$4,170	8%	$0.50	-$310	$3,860	7%
$ 8.50	$1,070	2%	$1.00	$2,790	$3,860	7%
$ 9.00	-$2,030	-4%	$1.50	$5,890	$3,860	7%
$ 9.50	-$5,130	-10%	$2.00	$8,990	$3,860	7%
$ 10.00	-$8,230	-15%	$2.50	$12,090	$3,860	7%

The highlighted columns show why we believe this strategy to be compelling. By buying protective calls, we eliminate all downside on our overall Boulder Brands short and lock in a minimum 7% gain on our effective start price of $8.67 per share. At the same time, we maintain most of the upside should the stock continue to fall. Buying calls protects us from several otherwise adverse potential outcomes, such as a takeout offer or merger, a surprisingly strong quarterly report in August, or the hiring of a star manager that lifts the spirits of the investor base.

The *Pro* Bottom Line

While we are happy to see evidence in favor of our short thesis so soon after establishing our position, we believe more trouble may be on the horizon for this struggling business, so we think adding to our short is prudent. The downside to buying protective calls is that we spend 0.1% of the portfolio's value to cap our risk, but there are multiple benefits. With this strategy, we lock in a profit no matter what happens with the stock, and we maintain plenty of upside should the stock continue to fall. And in addition to its merits as a stand-alone position, this risk-capped short presents a compelling hedge to our longs. If the market experiences weakness, Boulder Brands will likely be susceptible because of its economic sensitivity and high multiples. We'll continue to monitor the business to make sure the thesis stays on track, starting with Q2 2015 earnings, set to be reported in early August. And if we haven't taken action by the time September expiration comes around, we'll look to make our next incremental decision – either closing the position, leaving it as is, or buying December or further-dated calls to continue to cap our risk.

More That Matters

- **Maximum Loss:** On our overall short strategy, we risk what we pay to buy the protective calls, which will end without value if Boulder remains below $7.50 per share by September expiration. We also risk further losses in our Boulder short, up to $7.50. Maximum loss from here forward would result in about a 7% profit on our overall short strategy (including the shares we originally shorted in March).

- **Maximum Gain:** On our overall short strategy, our maximum gain is 94% should Boulder's stock end up worth $0 (note: we believe a $0 outcome to be unlikely).

- **Follow-Up:** After second-quarter earnings in early August, we'll decide whether to use our calls to cover our short if Boulder is above $7.50, or if we want to keep our short (and perhaps hedge it again) if shares remain below $7.50.

Alternative Trades

- **Haven't yet established a short position on BDBD?** While the risk/reward is less compelling than it was in March, you can still follow the spirit of this recommendation by establishing a 1.7% short position and buying one September 2015 $7.50 call for every 100 shares of BDBD you're short. Note that your profit/loss potential will be different than what is outlined in the table in this alert, and your breakeven on the short will be $6.63 per share, or 8% less than the current price. That 8% is the cost of buying calls as insurance against upside. While the profit potential on this more recently established trade is lower, it still serves as an attractive hedge to our longs.
- **Cant or don't want to short?** You can establish a functionally equivalent trade and match our profit/loss curve by simply buying September 2015 $7.50 puts, targeting a 1.7% allocation on a look-through basis. This trade provides identical exposure to our trade with one fewer trade command, although you must pay cash up front as opposed to receiving a cash inflow.
- **Working with a synthetic short based on our previous recommendation?** You can match our strategy by setting up additional synthetic short contracts to align with our 1.7% allocation, and buy one September 2015 $7.50 call per set of synthetic short contracts to cap your risk.

Pro Can Help

- Questions? Visit our [Boulder Brands discussion board].

Nothing New at Five Below

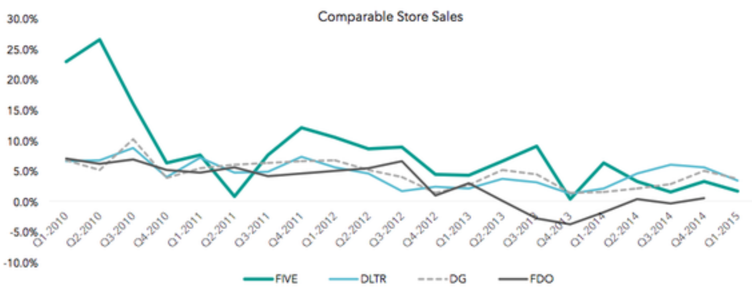
Published Jun 17, 2015 at 9:46AM

The first quarter of fiscal 2016 marked the first full quarter with new CEO Joel Anderson at the helm, but the results were very much in line with what we've come to expect at **Five Below** (NASDAQ: FIVE).

The Results

Headline numbers continue to impress, thanks to strong store unit growth (up 19% year over year). Revenue, EBITDA, and net income increased by 22%, 28.8%, and 38.9%, respectively, as the company opened up 19 stores this quarter. New-store performance was the reason the results exceeded management's previous guidance;

comparable-store sales, for those that have been open for at least 15 months, came in at 1.7% because of a 2.6% increase in average dollar value and a 0.9% decline in transaction volume.



Comparable-store sales have been weak for the past few quarters, I'm but I'm actually OK with giving the company a pass this quarter, since it was up against a 6.2% comp from Q1 of last year. And as for what the rest of the year may hold, management expects comps to be 4% to 5% next quarter and around 3% for the crucial holiday quarter.

The Valuation

Five Below continues to trade at a premium valuation, one that suggests the market does believe the company will ultimately end up hitting its 2,000-store target while holding comps somewhat steady. Valuation isn't a cornerstone of our thesis, which is a good thing given that Five Below's multiples have actually contracted over the past year -- the company continues to open up stores at a blistering pace, while the stock is up less than 10% over the same time. Even so, the stock still currently trades for around 2.5 times forward sales and 37 times forward earnings.

Pro's Take

Results for the quarter came in above management's expectations, but we think this has more to do with management under-promising and over-delivering than anything else. While there are some companies out there who shoot straight from the hip, this is more the exception than the rule and investors should always be wary about blindly following management's words.

The company also raised its full-year guidance with just one quarter in the books. Sales are now expected to end within the range of $820 million to $828 million this year, up from $816 million to $824 million. This really isn't all that surprising, though; as I said last quarter, using management's own store-opening and comparable-store sales guidance gets you closer to $830 million in sales.

At the end of the day, this quarter was more of the same – both bears and bulls were able to look at the results and believe the numbers supported their thesis. The continued slowdown in traffic leaves us wondering if customers are losing interest in Five Below, but the company continues to push forward with its rapid expansion plan. The key to shorting is doing so right before the catalyst that drives the stock lower materializes. Unfortunately, this is also the hardest thing about shorting, because it does involve a bit of market timing. We're a little bit more than a month away from the one-year anniversary of this short, and currently we're about 12% in the red. So our timing wasn't the best. But the impact on the overall portfolio has been minimal, and we still believe this position deserves a spot in our long/short portfolio as a bear-market hedge as well as an individual position. We also have plans to visit a few more stores in the near future and will report back with our findings, so stay tuned.

The Buckle Gets Thrown Into the Clearance Bin

Published Jun 15, 2015 at 3:31PM

The Buckle's (NYSE: BKE) first-quarter results for 2015 continued to follow its usual pattern for this year. Unfortunately for shareholders, that pattern means somewhat uninspiring results and uncertainty about when things will change for the better.

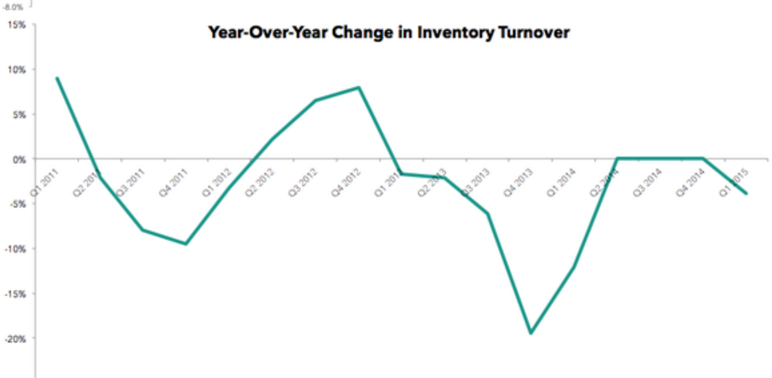
	Q1 2015	Q1 2014
Net Sales	$271.3 million	$271.7 million
Operating Margin	19.5%	21.8%
Net Income	$33.6 million	$37.3 million
EPS	$0.70	$0.78
Comparable Store Sales	-2.2%	-0.9%
Retail Stores	463	450
Sales per Square Foot	$105.82	$110.41
Change	-4.2%	-1.4%
Inventory Turnover	4.9x	5.1x
Ending Inventory per Store	$280 thousand	$265 thousand
Change	5.7%	10.8%

Note: Comparable-store sales for Q1 2014 do not include online sales, while Q1 2015 comps do.

Updated Guidance: Buy (no change)

Recommended Allocation: 1.9%

Fair-Value Estimate: $48 (down from $51)



The Buckle has increased its store count by 13 stores since this point last year, but stores open at least a year continue to struggle. Comparable-store sales (comps) fell 2.2% for the quarter thanks to a 6% decline in the number of transactions and a 0.4% decline in the number of items sold per transaction. These declines were partially offset by a 4.5% increase in prices. Online sales continue to be a bright spot (with 12.9% growth this quarter), but because those still only account for around 9% of net sales, their ability to offset the weak in-store performance continues to be minimal. We did see a nice boost in comps for May that helped the stock rise by about 5% the day the numbers were released, but we need to remember that this 2.4% growth came on the back of a -3.1% comp for May '14.

The growth in men's merchandise sales continues to outpace women's merchandise (6% versus -4%), but women's merchandise sales still account for the majority of sales (46.5% versus 43.5% for men's merchandise). Accessory and footwear sales were up 2% and 1.5%, respectively, and continue to grow in importance as they now account for 8% and 6.5% of all sales.

Weak comparable-store sales also hurt the company's margins this quarter. As management has said in the past, The Buckle needs an annualized comp number somewhere in the mid-single digits to provide operating leverage at the gross margin level. In the first half of the year, the necessary comp number is a little bit higher, since the company's sales tend to be greater in the back half. But either way, we will likely see deleveraging for the first half of the year, as The Buckle actually reported a negative comp for the first quarter.

Pro's Take

Online sales continue to be a bright spot for The Buckle; however, the competition in this space is fierce and getting more intense by the day. As I noted in last quarter's earnings coverage, even though online sales still account for less than 7% of total retail sales, the apparel industry is converting at a much faster clip. And The Buckle now finds itself going up against both its brick-and-mortar competitors and a new army of flash-sale sites, both of which are happy to offer free shipping as well as frequent sales to win your business. The Buckle is doing its best to try and carve out its own niche in the cutthroat world that is fashion retail, but I believe its approach is better suited to the brick-and-mortar world, because one of the cornerstones of that approach (having a great in-store experience) matters very little when your customers are shopping online.

After selling off mildly after releasing results, the company now finds its stock priced more like something you'd find at The Gap than the latest collection from Comme des Garçons. The Buckle might be against discounting its merchandise, but historically the market has not shared the same sentiment when it comes to The Buckle's stock:

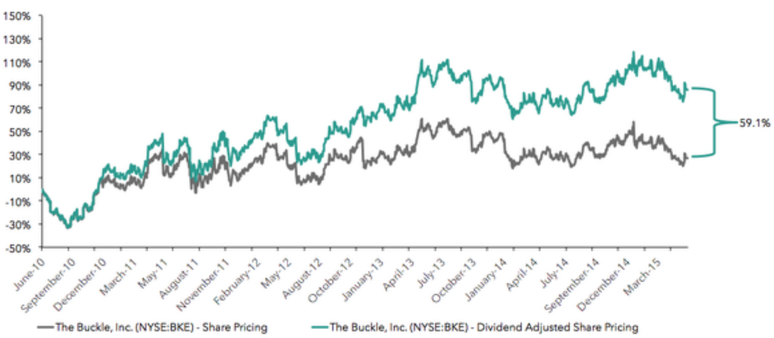
Average mulitple	10 year	5 year	3 year	1 year
EV/EBITDA	7.21x	6.96x	7.29x	7.37x
P/E	14.78x	13.72x	10.67x	14.20x

Current multiple	
EV/EBITDA	7.18x
P/E	13.64x

Standard deviation above (below)	10 year	5 year	3 year	1 year
EV/EBITDA	(0.02)	0.16	(0.16)	(0.44)
P/E	(0.43)	(0.02)	2.65	(0.68)

Given the company's recent performance, it's hard to argue that trading at a discount to the retail apparel industry average (EV/EITDA: 12.4, P/E: 24.8) is unwarranted. We're lowering our fair-value estimate to $48 today, or 14.5 times trailing earnings, to account for this continued weakness in the brick-and-mortar stores. We still expect the company to continue to methodically expand its presence across the lower 48, but the profitability of those stores has become increasingly uncertain over the past year.

The Buckle continues to be *Pro*'s dividend all-star. So far in 2015, we've collected $3.23 in dividends, a 6.2% yield on the stock's closing price for 2014. And if we assume that management will keep with tradition and wait until the start of 2016 before increasing the quarterly dividend again, we'll finish the year with a 7.03% yield. Our focus is on total returns for each of our positions, but the discrepancy between capital gains and total returns for The Buckle is perhaps the biggest of any in our portfolio.



Data source for dividend adjusted returns: S&P Capital IQ

This is why our position in The Buckle has been able to produce North Star-beating numbers even though the stock has remained somewhat range-bound since we first bought it in 2012. If the stock recovers, we may consider writing calls against our position to extract even more income, but for the time being, we're content to just sit back and collect our dividends.

Capitalize on the Whims of the Crowd

Published Jun 15, 2015 at 10:37AM

Dear *Pro* members: Today, we're delighted to welcome Jeremy Myers (TMFTank) as the newest analyst on the *Pro* team! Joining Billy, JP, Ellen (our editor extraordinaire), and me, Jeremy brings to *Pro* an acute knowledge of investing in small to medium-sized companies. Many of you already know Jeremy from his role as senior analyst on *Motley Fool Hidden Gems* over the past six years. He still holds that position, and as part of *Pro*, he'll be working to add more smaller companies to our portfolio. He'll also help us find shorting opportunities and exceptional large companies that fit into the portfolio. Jeremy jumps right in today with a great column on investing diversity. Enjoy! And then please welcome Jeremy on the Meet & Greet board. -- Jeff Fischer

Dear fellow Fools,

As we all know, diversity is a good thing. Genetic diversity is essential to the survival of life on our planet. Cognitive diversity is critical to building and maintaining a successful business. Relationships tend to be more rewarding when the parties have complementary rather than competing traits. Even portfolio diversification is referred to as "the only free lunch" – and what Fool doesn't like free food?

But although it's a blessing in many areas of life, variance is actually the enemy of an enterprising investor who's searching for mispriced assets. Research shows that when it comes to making estimates of an unknown value, the collective is almost always a more accurate guesser than even the most skilled member of the group. That's a humbling prospect for professional investors who dedicate their lives to trying to outwit the competition, but the good news is that this research also points to where some of the best investment opportunities hide.

That Crowd Is Smarter Than You – Until It's Not

One of the best descriptions I've read of what drives the machinations of the stock market is Michael Mauboussin's article, *The Wisdom and Whims of the Collective*. In this essay, Mauboussin proposes the "diversity prediction theorem" -- first described by Scott Page in *The Difference* -- as a key driver to maintaining market efficiency.

The basic tenets of the diversity prediction theorem are:

1. The collective is smarter than the average person in that collective. Not sometimes, but always.
2. Collective error is determined in part by ability and in part by diversity.
3. The collective is usually better at predicting results than the best of the individuals.

And in order for these tenets to hold true, certain conditions must also be met:

1. There must be diversity within the underlying agents.
2. There must be an aggregation mechanism that brings the information together.
3. There must be rewards for being right and penalties for being wrong.

Of that list of prerequisites, the condition most likely to be missing in financial markets is cognitive and/or emotional diversity. At one extreme, Mauboussin believes these breakdowns lead to asset bubbles; at the other end of the spectrum, you find a more subtle condition called "time arbitrage," which is when the short-term prices reflect more noise than signal. This second type of diversity breakdown is much more common, and it can be prime hunting ground for new investment opportunities if you can recognize it as it happens.

The Theory in Practice

As humans, our fundamental biases make it difficult to recognize when our sentiments have diverged from reality. For that reason alone, it's worth stepping back occasionally and reflecting on whether there are any investing narratives you see repeated a bit too often? For example, here are three areas I've been watching:

- **FOMO stocks:** The astronomical valuations being assigned to both biotech stocks and a host of privately held tech start-ups is likely being driven by both greed and FOMO (fear of missing out). Last week, **Axovant Sciences** (NYSE: AXON), a recently founded biotechnology company, raised $315 million in an IPO that valued the company at nearly $3 billion. Axovant is run by a 29-year-old former hedge fund manager. It generates no revenue, and its only asset is a developmental drug for Alzheimer's disease that it bought from **GlaxoSmithKline** (NYSE: GSK) for $5 million. Is it a coincidence that this is happening only a month after specialty ETF shop Direxion launched the first triple-levered biotech ETF? I doubt it.

  The climate is just as euphoric over in Venture Capital Land, where Uber raised financing at a $50 billion valuation, placing its worth at nearly equal to that of **FedEx** (NYSE: FDX). Even **Men's Wearhouse** (NYSE: MW) founder and former executive chairman George Zimmer recently announced the launch of zTailors, an "Uber for the tailoring world." Since we don't have ability to invest in (or short) these names, I'll leave that discussion for later, but paint me skeptical.

- **The oil patch:** The carnage we've witnessed across a wide range of energy-sector stocks suggests that investors are taking a "sell now and ask questions later" mentality -- even toward companies only tangentially related to oil production. I won't pretend to have any insight into where oil and prices will be a year from now (or five), but we can be certain that fossil fuels will continue to power a large portion of the global economic engine. There are a number of high-quality businesses with strong balance sheets that should be able to ride out the current storm and end up in a stronger position if and when oil prices recover.

- **Dividend stocks:** The recent sell-off of many dividend-paying stocks looks like a great example of indiscriminate selling. Many investors are using basic decision rules and selling entire industries without considering how their individual constituents may perform. For example, this *Wall Street Journal* article quotes two unrelated financial planners who have both nearly eliminated REITs and utilities from their clients' portfolios.

  Though interest rates could cause short-term volatility in these stocks, if rates are rising in response to an improving economy, that should be a net positive for most of these businesses. I expect that the volatility in many of these dividend payers will only increase as we get closer to a Federal Reserve rate hike and speculation intensifies.

The Foolish Bottom Line

Over my six-year career at The Motley Fool, I've been focused exclusively on finding situations in which overly negative sentiment has caused a breakdown in cognitive diversity. In *Pro*, I'm excited to use a wider range of tools to capitalize on the other end of the sentiment spectrum as well. As the new, old kid on the *Pro* block, I'd like to say how thrilled I am to be working with the *Pro* team and the community of like-minded Fools who've gravitated toward Jeff's investment philosophy. I've loved searching for small, undiscovered investment opportunities at *Hidden Gems* (and I'll continue to do just that), but I'm looking forward to developing a more holistic view of portfolio construction and risk management here at *Pro*. I've already seen a lot of familiar names from the *Hidden Gems* community, and I look forward to meeting the rest of the *Pro* family on the boards.

Foolish best,

-- Jeremy (TMFTank)

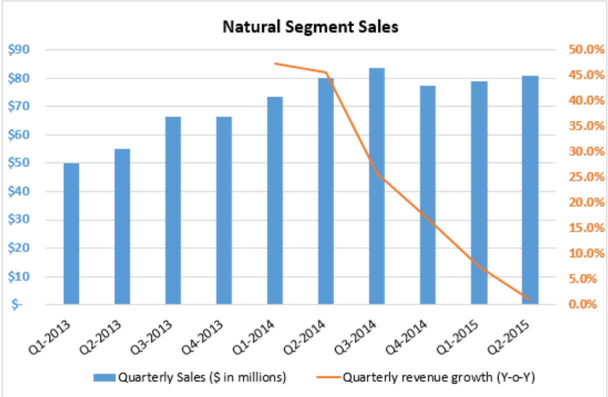
Boulder Brands Co-Founder and CEO Resigns

Published Jun 10, 2015 at 2:28PM

In a surprise move, **Boulder Brands** (NASDAQ: BDBD) today announced that co-founder and CEO Stephen Hughes has resigned, effective immediately. The company also provided an outlook for Q2 2015 that was less than inspiring, expecting sales between $122 million and $124 million during the period, a year-over-year decline of 5% to 7% compared with the second quarter of 2014. The market was not pleased with the announcement (rightfully so), and as I type this, the stock is down more than 20% as all the major U.S. market indices are up almost 1.5% ... a nice result for short sellers like us!

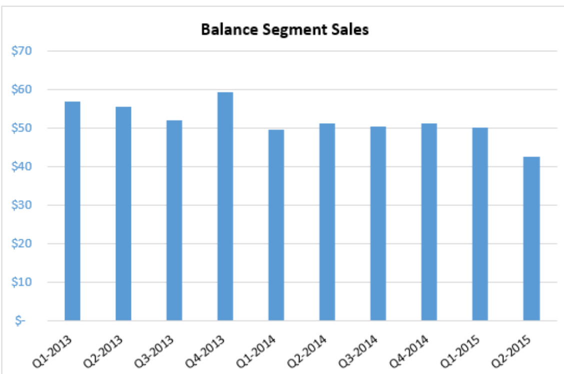
For now, **there's no change to our guidance**, and we will continue to hold our short position (currently an active 1.1% allocation) until we come to a decision on how best to proceed from here. For some more color, here are some excerpts (slightly edited for clarity) from an email I sent to the team earlier today:

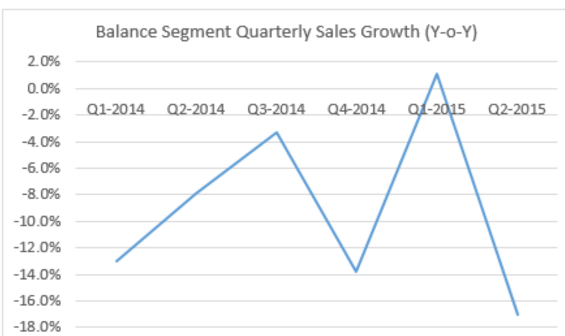
> "Just fully read through the press release. I'm very happy with the way the thesis is playing out and I'm glad we were in when the wheels started to fall off. This quarter looks to be the one where [the numbers start to really deteriorate] after the company has worked for so long to delay the inevitable.
>
> "I'm most pleased with the updated sales growth estimates that the company gave. I've long stated that the key element to this short would be the sales growth trajectory (or lack thereof) of the company's Natural segment (its newly acquired brands). Well... check out what the updated estimates imply:



"The under-investment in marketing, the roll-off of acquisition-fueled growth, the ramp-up of well-funded competitors, channel stuffing, and ultimately the lack of value proposition for its grocery store customers is finally leading the stagnating growth that we hypothesized.

FWIW, the legacy Balance segment is getting crushed, too:





"After an early Easter date made the Balance segment's last quarter look good (1.1% growth), I expected poor performance this quarter as that seasonal factor rolled off, and that's what we got. But I think this segment will revert a bit next quarter, since if you adjust for the timing effects, the true trajectory of the business is likely the average [of] what we got for last quarter and this quarter (somewhere in the negative 8% to negative 12% range... still pretty awful). So we will likely see relative 'improvement' from the Balance segment in Q3.

"The question now becomes -- what do we do next? I think there's an argument to be made for all three choices: 1) add to our short, 2) hold, or 3) cover. [I don't want to make a hasty decision, but initially I'm leaning toward perhaps adding more to our short, for a few reasons:]

" • I now have more confidence in the viability of the short thesis than ever before, since we finally have numerical evidence that the sales-growth trajectory of the newly acquired brands (and thus the shiny growth prospects for the business) have fallen off the table.

" • I think the company is in a dire situation, with a lot of debt and not a lot of growth with which to earn a satisfactory return on that debt. If current trajectories hold, the company will struggle to simply earn enough cash flow for working capital needs, maintenance capital expenditures, and interest payments. And since the company's debt is variable-rate, rising rates will hurt them even more. More goodwill impairments may be likely.

" • The management change will likely hurt the business. The board and the executives will spend valuable time looking for a replacement, and will likely have to spend heavily to attract a decent manager (what manager would want to jump into this mess unless there's a financially compelling compensation package?). There will be likely be more "one-time" earnings charges related to the management change, and there might be more organizational restructuring that adds even more "one-time" costs. Employee morale will be affected (especially for the employees that were "acquired" from Glutino or Udi's, etc.), and the negative momentum of the business may fuel a negative feedback loop, especially in the sales/marketing teams.

" • The valuation is still quite high. At $7 per share, the company still trades at 40 times TTM impairment-adjusted earnings, and at 26 times original 2015 non-GAAP earnings guidance (which clearly will end up being too generous, not to mention that non-GAAP excludes "one-time" costs which really aren't one-time at all). The company trades at about 1.9 times book value, and for a company that is now struggling to earn a positive rate of return on investment, let alone its cost of capital or excess returns, I argue it should probably trade closer to book value. Maybe 1.5 times book value is an optimistic estimate of fair value. That would place FV in the $5.50 range, with downside (upside for our short) to 1 times book value, or about $3.50 per share (another 50% gain from here)."

The *Pro* Bottom Line

All in all, we're happy with the way this position has worked out so far, but we want to work to make the proper decision from here forward. I in fact do not see this 20%+ decline as a knee-jerk reaction -- rather, I see the CEO's resignation as a catalytic event that helped the market come to a more realistic assessment of the true intrinsic value of the business. And the stock may have further to fall, or it may not. The team and I will discuss the position, and any action to be taken will be communicated to you all with a trade alert. For now, we'll hold on to our active short position at about a 1.1% allocation.

Fool on!

--Billy

Pro Can Help

- **Questions?** Visit our Boulder Brands discussion board.

Have We Reached the Top?

Published Jun 8, 2015 at 3:02PM

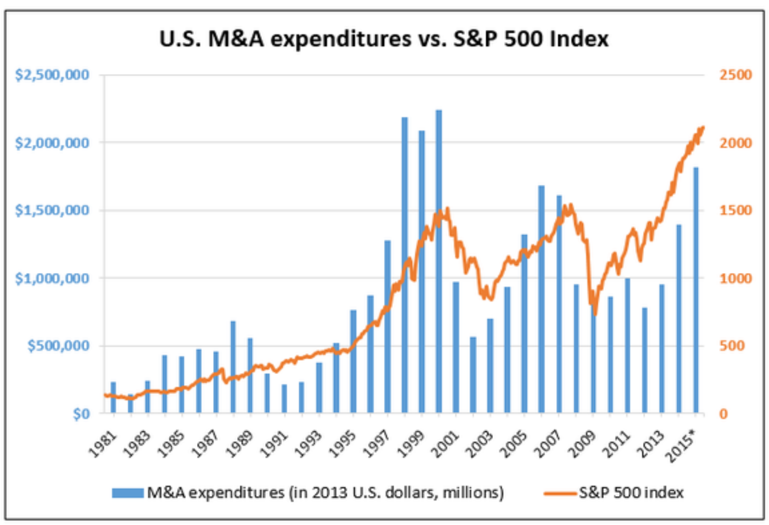
Dear *Pro* Fools,

If you've been paying attention to U.S. financial news, you've probably noticed a lot of mergers and acquisitions (M&A) from American companies lately. Some notable M&A activity this year has been:

- **Charter Communications**' (NASDAQ: CHTR) complex three-way megamerger/acquisition with **Time Warner Cable** (NYSE: TWC) and Bright House Networks
- **Avago Technologies**' (NASDAQ: AVGO) cash-and-stock deal for fellow chipmaker **Broadcom** (NASDAQ: BRCM)
- **Intel**'s (NASDAQ: INTC) all-cash acquisition of **Altera** (NASDAQ: ALTR)
- **AbbVie**'s (NYSE: ABBV) acquisition of **Pharmacyclics** (NASDAQ: PCYC)

In fact, U.S. M&A activity hit an all-time monthly record in May 2015, totaling $243 billion. Before that, the previous two monthly peaks were $226 billion in May 2007 and $213 billion in January 2000.

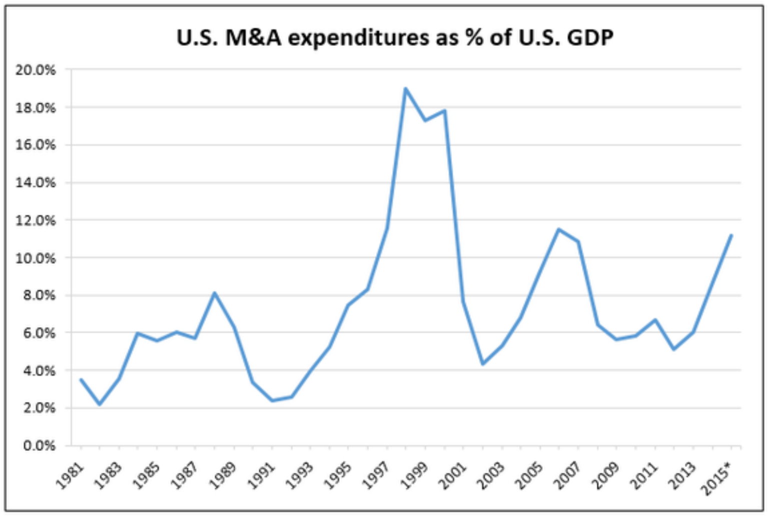
If that timing jumps out at you, no, it's not a coincidence: M&A activity tends to peak near market tops. Check out this graph of U.S. M&A expenditures compared with the S&P 500 index:



Sources: Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, Michael J. Mauboussin and Dan Callahan, CFA (2014), S&P Capital IQ, FactSet. 2015 figure for M&A expenditures is an annualized run rate based on data as of May 2015.

As I noted in a previous Memo ("On Capital Allocation"), M&A expenditures tend to reach their apex when stock market values are high (i.e. managers can use inflated equity as currency) and capital is cheap and easily accessible. If that sounds similar to the financial environment we're in right now, that's because it is (see: near-zero interest rates and record year-to-date U.S. corporate bond sales).

So should we be concerned? Does record M&A activity mean that we've finally reached the top of this six-year-plus bull market? Well, when we take a closer look at the data, there's reason to believe that this *isn't* the peak. For example, if we compare total M&A expenditures to GDP to normalize for the growth of the economy, the graph looks like this:



Sources: Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, Michael J. Mauboussin and Dan Callahan, CFA (2014), Federal Reserve FRED economic database. 2015 figure is Q1 2015 seasonally adjusted annual rate. GDP data in chained 2009 dollars.

After adjusting for the growth of the economy, we haven't yet reached the height of the tech-bubble M&A peak. Additionally, during previous peaks, interest rates were much higher. In January 2000, the 10-year Treasury rate was 6.66%, and in May 2007 it was 4.75%. Capital is much cheaper today, with the 10-year Treasury rate hovering around 2.4%, meaning that companies can justify even higher purchase prices relative to 2000 and 2007. Given those extra data points, there may be room for even higher levels of M&A expenditures.

Despite the data above, the truth is, there's only one way to know whether this is a market peak: *hindsight*. We could be sitting right at the top of a market cycle, or this monthly M&A activity record could just be the middle innings of an even bigger game. The only way to know is to let the future unfold.

At *Pro*, we don't try to divine short-term market movements. While it's interesting to observe the data, whether M&A activity portends a market peak is ultimately of no matter to us. We are focused squarely on our underlying philosophy and goal, which is to maintain a diverse, flexible portfolio that aims to generate North-Star beating returns over every rolling three-year period. And we work every day to position our portfolio to achieve that goal.

Fool on!

-- Billy

Valmont Is Still in a Valley

Published Jun 1, 2015 at 2:05PM

Guidance Updates

- **Valmont Industries** (NYSE: VMI): Shares remain a Buy at a 1.9% allocation, but our fair-value estimate decreases to $140. For our current take, read on!

Returns to Date

- We're having a good year so far. The returns table on our Recommendations page was just updated through the end of May -- click here to see how we're doing.

Dear Fools,

In November 2013, *Pro* suggested investing in shares of diversified manufacturer Valmont Industries. Shares are down 12% from the recommendation price; include dividends, and as of last week we've lost around 10.5% in 18 months. Why? All four of Valmont's business lines entered a weak cycle. This isn't a complete surprise. Following a record 2013, nearly everyone expected the company's irrigation sales to soften. In fact, we were buying the stock *after* it had declined some on that very premise. But we didn't expect the other business lines to follow suit. The red dot shows when our our trade alert was issued, at about $142.

For six months or so, the business did well enough to reward us; then, one year ago, the company's utility division began to disappoint as competitors drove prices lower. Next, commodity prices declined, affecting Valmont's mining-related sales in Australia, and irrigation sales weakened as expected. With all business lines soft, Valmont is now initiating a restructuring plan to lower costs, effectively going on the defensive. We want the typical *Pro* business to smartly be on the *offensive*, so let's break down what's behind this current disappointment.

The Lowdown

Valmont reports results in four operating divisions.

Engineered Infrastructure Products (34% of Q1 sales)

In this division, Valmont uses its steel expertise to build traffic and light poles, communications towers, grates, offshore structures and more. Sales ticked up 4% this quarter, to $238 million, thanks to an acquisition and better results in Europe and Asia. However, mining-dependent Australia remains weak, and governments are not readily funding infrastructure projects in North America and Europe. Operating income declined 13% to $11.9 million -- representing 5% margins, compared with 6% a year ago -- because of lower profitability in Australia and currency translations. We know much of the infrastructure in the U.S. is in need of repair; when will the government green-light it?

Utility Support Structures (25% of Q1 sales)

Sales dropped 18% last quarter, to $176 million, in the division that provides steel poles and support towers for utilities. This was partly because of competitors driving prices lower (leading Valmont to bid on fewer projects), and partly because those projects tended to be on the smaller side. The larger the project, the fewer the number of companies that can potentially fulfill it; Valmont is hoping for large projects to resume, because competitive pricing on those should be more rational. Operating income dropped 53% to just $15 million, showing how modest profits are on small projects that suffer pricing wars. Another challenge here: Revenue is tied to steel costs, and steel has declined 35% in the last six months.

Irrigation (22% of Q1 sales)

Farm irrigation equipment revenue declined 27% to $154 million as volume dried up around the world, compared with a healthy 2014. In the United States, farm income is declining with crop prices, and around the world, lower commodity prices dampen demand -- as could changes to a government financing program for farmers in Brazil this year (that's a large Valmont market). Operating income declined 44% to $24 million because of lower volume on fixed costs. Pricing in the industry stayed "somewhat stable," as the CEO put it, and historically that has been the case. Were that to change, our thesis would come into question.

Coatings (11% of Q1 sales)

Revenue in the coatings division -- which includes galvanizing to prevent corrosion or rust, painting, and anodizing -- fell 10%, mostly due to a weak Australian market. Operating income declined 21% to $11 million. Valmont is a world leader in galvanizing, and it's a strong-cash-flow business when demand is high.

The Restructuring

In response to these challenges, which management does not expect to dissipate soon, Valmont just initiated a $30 million (cash and non-cash) restructuring plan. Targeting aspects of the business they *can* control, they're making sure they're operating as efficiently as possible by cutting unnecessary spending and closing some redundant facilities. The cash expenses of $19 million should be recovered through lower operating costs in 12 to 18 months.

The Big Picture

Should we continue to own shares? I believe the answer lies in another question: Does Valmont still have competitive advantages? If so, we should be rewarded, as planned, by owning shares over the long haul. The stock has returned 15.4% annualized since 1993, more than doubling the S&P 500's 7.3% (measured by Valmont to Jan. 7 of this year). But double-digit annualized returns will only resume if Valmont still has competitive advantages, *and* governments increase spending on infrastructure, *and* irrigation demand keeps growing. Those are some "ifs" and "ands" to overcome. Plus, if steel prices and the competitive landscape in the utility sector do not improve, those will be headwinds.

It's encouraging that during past downturns, Valmont has remained profitable and generated healthy free cash flow (we wouldn't have invested in it otherwise!). And it has steadily grown in the process. Here's a history of the key numbers:

Valmont	2005	2006	2007	2008	2009	2010	2011	2012	November 2013 Buy Report
Sales ($B)	1.11	1.28	1.50	1.91	1.79	1.98	2.66	3.03	3.29
Oper. ($M)	83	111	156	229	238	192	266	381	485
EV/EBITDA	8.6	11.3	13.9	7.3	7.4	11.2	8.0	8.6	**6.8**
P/E	21.5	25.1	26.5	12.7	13.8	26.2	16.2	12.8	13.3
P/FCF	13.9	23.9	91.6	41.1	10.9	44.2	32.7	29.5	17.6
ROE (%)	12.5	16.9	20.8	23.3	21.4	11.1	22.1	18.7	20.2

And here's where we stand since our buy report:

Valmont	2013	2014	Now
Sales ($B)	3.3	3.1	3.0
Oper. ($M)	485	358	317
EV/EBITDA	7.1	7.1	8.3
P/E	13.8	16.9	19.7
P/FCF	18.2	16.2	13.2
ROE (%)	19.0	13.5	11.9

Numbers source: S&P Capital IQ.

Sales are down about 10% since we bought, and operating income is down nearly 35% because of fixed costs in this industrial business. The company's EV/EBITDA value multiple was only 6.8 when we bought it, well below the 13-year average of 8.7. I believed that would limit our downside risk even at a peak cycle. It certainly hasn't hurt. Today, on lower results, the business is at 8.3 times EBITDA, still below its average. We can't forget the leverage in this business: On an upturn in revenue, profits are traditionally magnified as sales are spread over the steady, fixed costs of doing business, so the valuation (and thus the stock) should respond nicely.

The Conclusion

Valmont's revenue, income, free cash flow, and dividend have been steadily increasing for years, and if the business maintains competitive advantages, we believe management will continue to deliver, meaning we should be hitched to a North Star-challenging stock here, eventually. However, if at any point we want to be more defensive and raise cash, want capital for a stock we like better, or feel Valmont's edge is blunted, we will at that time sell shares to likely offset gains elsewhere.

Right now, though, we still believe in this long-term thesis: All these business lines should see growing demand in the long term, and reasonably-priced Valmont is positioned to profit. In the near term, we have hopes that within months we'll see some light on the other side of this valley. Will we buy more stock or at least write puts if we see a recovery coming? We're not ready to commit yet, but that's certainly on the table. On the flip side, if new competitive pressures make a recovery seem unlikely, we'll be ready to sell and move on. Like most investments in any business, the long-term attraction of this one comes down to its competitive advantages. We will keep assessing those.

For more on Valmont, check out its recent investor presentation. See *Pro*'s latest Valmont numbers, and post any questions on the Memo Musings board or the Valmont board. Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking.*

- **American Airlines** (NASDAQ: AAL): If you don't own calls yet, you can buy January 2017 $30 calls for about $15.50 each. Invest up to 0.5% of your funds in the calls.
- Obviously, most of our other stocks remain Buys.

Pro Live Chat, June 2015

Published May 29, 2015 at 2:29PM

Join us at 1 p.m. Eastern on Thursday, June 25, for our monthly live chat!

Pro Catch-Up Trades: May 26, 2015

Published May 26, 2015 at 3:05PM

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- **American Airlines** (NASDAQ: AAL): The stock was battered last week. If you don't own calls yet, you can buy January 2017 $30 calls for about $15 each. Invest up to 0.5% of your funds in the calls.
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- **OpenText** (NASDAQ: OTEX): This company also got battered last week. You can buy up to 2.4% in the stock if you don't own shares yet.
- Obviously, most of our other stocks remain Buys.

Our 'Problem' Positions

Published May 26, 2015 at 2:04PM

Guidance Updates

- **AmTrust Financial Services** (NASDAQ: AFSI): Shares return to a Buy, with a suggested 3.5% allocation to start (and gradually grow to match us over time). Fair value estimate increases to $50.
- **Apple** (NASDAQ: AAPL): Fair value estimate increases to $126 from $118. Shares remain a Buy at a 4.6% allocation.

Dear fellow Fools,

Here at *Pro*, we don't invest much money in the retail or energy sectors, and volatility in recent months may remind you why. Consumer retail is a tough nut to crack if your goal, like ours, is steady growth for decades: Consumer tastes change, competition is omnipresent, and even how and where we shop is changing. Energy, meanwhile, is a sprawling, largely commoditized industry that's spawning more competitors as solar and alternative sources expand.

There are, of course, countless interesting investments in both sectors, but in our quest for compounding machines, we usually prefer to buy subscription- or transaction-based businesses with recurring fee revenue, such as you find in software or financials. Where we *have* ventured into retail or energy, volatility has resulted, but we've kept the positions small so the portfolio as a whole is mostly insulated.

For today's column, I'll call the following volatile positions our "problem positions," and by that I only mean they're in the red lately. Not all are energy- or retail- related, but not surprisingly, four of the six are.

Problems ... With Solutions

"*You fix what you can fix and you let the rest go. If there ain't nothin to be done about it it ain't even a problem.*" -Cormac McCarthy

American Airlines (NASDAQ: AAL), **0.5% exposure.** Our recent foray into an airline investment is (perhaps not surprisingly?) our worst performer this year. We invested a small amount in call options, and as calls will do, they've been cut in half while the stock is down about 16%. Wall Street is spooked that airline capacity is growing and revenue per average seat mile is lately declining across the industry, but these and pricing concerns appear overblown. I believe once management teams reiterate a commitment to maintaining strong profits, the stocks in this volatile sector should start to recover -- and American Airlines is among the cheapest of the bunch.

That said, I actually consider the airline a leveraged investment in energy. If oil prices languish, American continues to benefit. If oil rebounds too much, American's profits will decrease. So we've kept the position small, even though I believe airline profits will persist and this company is cheap. If it gets much cheaper, we just may be compelled to add a tad more.

The Buckle (NYSE: BKE), **1.9% exposure:** *Pro* is in the green on the clothing retailer -- and don't forget the large, special dividends -- but I know many newer members are not. The Buckle has declined lately on lower same-store sales. JP is waiting for an SEC filing to finish his review of the recent quarter, but we're in agreement that the stock looks inexpensive. We believe jeans will stay in fashion (we make bold bets here!), so as long as this well-managed jeans purveyor can continue to increase store count and find ways to increase foot traffic, it's positioned to create long-term value. But as with much of retail, the stock has been down this year on lighter spending from customers. Gas is cheaper than before, but it turns out folks aren't spending the difference -- they're saving the money instead. Eventually, though, they'll have enough saved to do some spending. Plus, jeans wear out. We would like to see The Buckle make its brand more resonant and relevant with more people, though.

OpenText (NASDAQ: OTEX), **2.4% exposure:** New members have a loss on this enterprise information management (EIM) software leader. The stock is down smartly following third-quarter results and last week's news that the fourth quarter is tracking much lower than Wall Street estimated. Most of the difference, though, is attributed to the strong dollar. When the currency situation eventually changes, OpenText's results should be amplified to the positive. OpenText is also transitioning more customers to cloud contracts, which lowers up-front revenue, but adds long-term subscriptions. About 86% of the company's revenue is recurring. I'm willing to wait for better results, as OpenText continues to generate strong free cash flow in a growing industry, and looks inexpensive.

Tupperware (NYSE: TUP), **2.6% exposure:** I'm working to maintain patience with this direct retailer. About 67% of sales are overseas, and the strong dollar is hitting results here, too, but Tupperware has also bungled past share buybacks using debt. We're down 19% on Tupperware excluding dividends we receive (which pay more than 4% annually now), making it our largest stock loser. Our total loss is relatively modest, but it's still not helping our portfolio climb toward its North Star. Free cash flow growth has been lacking for several years at Tupperware, and we'll only hold the stock as long as we believe it will resume. For now, that remains the premise.

WisdomTree Emerging Markets Small-Cap Dividend Fund (NYSEMKT: DGS), **2.1% exposure:** Emerging-market stocks haven't done well for several years, period. The U.S. stock market has handily outperformed them. But we know eventually they will have their day in the sun; in the meantime, they're inexpensive, and this fund is well run. It's sensible diversification to keep some emerging markets in our portfolio. This keeps us in tune with these markets and may see us better prepared to add to the position when we finally feel the time is right. Including dividends, we've made some money on this ETF, but it has lagged developed markets. Eventually it should do very well comparatively.

Valmont Industries (NYSE: VMI), **2% exposure:** Another energy-related business, Valmont suffers as commodity prices decline, governments spend little on infrastructure projects, and the utility sector becomes extremely competitive. This has historically been an outstanding long-term investment, so we're assessing to make sure that Valmont maintains enough of its competitive advantages to merit continued strong performance. I should have my next earnings review this week. For now, we certainly still believe in management and in the potential of this long-term investment.

These six investments add up to 11.5% of the portfolio. Exclude OpenText, which is still a winner for us since inception, and these losers are just 8.9% of the portfolio. Of course, we frown on any movement into the red, but knowing that some losses are inevitable with stocks, your measure of success is how small you keep them. Meanwhile, we continue to believe in the merits of these investments over the longer haul. Remember, studies show that losers eventually become winners, and vice versa. It stands to reason then that having some losers helps diversify your portfolio; they could become winners when other positions start to struggle.

Elsewhere, we've seen weakness lately in **American Tower** (NYSE: AMT); the stock trades with REITS, which are sensitive to any hints about future interest rates. But we can celebrate strength in most of our large positions, including AmTrust Financial, **Apple** (NASDAQ: AAPL), **Skyworks Solutions** (NASDAQ: SWKS), **Gilead Sciences** (NASDAQ: GILD) and others, while all of our shorts are making money since we started the positions. Portfolios will always have gainers and laggards. We seek to minimize our losers, of course, and have winners that do well enough to make the losers less and less significant.

Finally, let's all keep this in mind: This market has been nothing if not friendly (unless you're selling short), and still lingers near all-time highs. It will get much, much more volatile at times. We'll do our best to add shorts, hedges, and options to navigate it, while knowing time is on the side of great businesses -- those we own, and those we will be looking to add.

Questions on our current losers? Post on the Memo Musings board. Thanks, and Fool on!

— Jeff (TMFFischer)

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- Obviously, most of our other stocks remain Buys.

OpenText Reads the Coming Cloud

Published May 22, 2015 at 10:37AM

Guidance: Shares remain a Buy at today's 2.3% allocation.

OpenText (NASDAQ: OTEX) CEO Mark Barrenechea regained the helm of the company this week, having returned from treatment for leukemia. His illness apparently gave him pause to reflect, because his first move is bold: He's restructuring the company to prepare for a larger cloud-based future. Restructuring in this case means losing about 5% of the workforce, and shedding some facilities, in order to save about $50 million per year in operating costs. The one-time charge to get there will be $25 million.

The plan takes shape as more and more customers are signing cloud subscription agreements for their software needs, rather than paying the up-front cost of a license and putting the software on their own servers. That means OpenText is hosting more software on its servers for customers, and charging each a monthly fee. Revenue and margins are initially lower with cloud software (and that's why many cloud competitors are not yet profitable), but over the long haul, total revenue received should be higher. Also, as more customers are added to the cloud, margins should improve as the cost of hardware is spread over more customers. This is why, as with **Oracle** (NYSE: ORCL), OpenText is happy to embrace the cloud.

Currently, about 30% of OpenText's revenue is already cloud-based, and that number is increasing rapidly. In fact, the company's transition to the cloud is already half finished. Management suspects that in a year -- two years, tops -- a majority of revenue will come from the cloud. ("Majority" here means perhaps as much as 60%.) The company continues to support license sales, too (in which the customer buys a license and takes the software to their premises), and many customers in highly regulated industries, such as financials, will continue to buy a license.

Overall, OpenText's business has not changed. The company is selling the same products. But as more customers request cloud contracts, it realized the need to streamline costs a bit more to maintain its margins. It wants to optimize its sales and customer support structure for more cloud sales. OpenText is also seeking more cloud acquisitions, looking for attractively priced, complementary software businesses with strong recurring revenue. Currently, 86% of its own business is recurring revenue, and its maintenance contract renewals top 90%.

Lower Guidance

Though it adds uncertainty, the company's restructuring seems logical for the changing times. So it was probably management's fourth-quarter 2015 guidance that sent shares 13% lower Thursday. Usually, OpenText does not provide sales or earnings guidance, but it used this opportunity to say that Wall Street's expectations for the coming quarter were too high. Its internal expectations are on track, but Wall Street was expecting too much. Management says most all of the reason for the shortfall is currency-related, with the weak euro knocking about $44 million off quarterly revenue. Currency-neutral revenue could reach nearly $500 million in the quarter (higher than Wall Street's model, and on par with last year), but after adjustments, revenue will likely land around $440 million to $455 million. This means earnings per share next quarter of between $0.64 and $0.72, lower than Wall Street expected.

Also dinging quarterly results by a small amount (no more than $10 million) is the customer shift to the cloud from license contracts. Again, these cloud contracts cost much less up front, but result in a long-term (three-year minimum) monthly fee that adds up to compete with license revenue. Finally, a tough selling environment is dampening results, which we've seen across many software companies. OpenText is holding its own (it increased revenue 8%, excluding currencies, in the quarter that just ended), so we don't believe it's losing market share. Assuming the bulk of today's issues are currency- and macro-related, both pain points should eventually ease. In the long term, cloud sales represent exactly the type of stable, recurring revenue and sticky business model we want to see. It just takes time to get there.

Valuation

Lately $42.50, the stock trades at about 11.5 times free cash flow. Our fair-value estimate remains at $55, although given the restructuring and more cloud revenue around the corner, we may need to be patient to see that price again; ideally it'll be followed by long-term appreciation as long as OpenText keeps executing. As our world continues to go digital, the Enterprise Information Management software industry OpenText leads should keep growing at North Star-challenging rates over the long haul.

To post questions, visit our OpenText board.

Apple Still Has No Equal

Published May 20, 2015 at 3:33PM

Apple (NASDAQ: AAPL) had its biggest second quarter ever, with $58 billion in sales, $19 billion in cash from operations, and $13.6 billion in net profit. A giant 69% of revenue came from overseas, where growth is strongest. iPhone revenue was up 55% year-over-year, and Apple estimated that only about 20% of active iPhone owners have upgraded to a model 6. Margins improved again, and the company expanded its capital return program to $200 billion (on a $750 billion market cap) through March 2017. Apple Watch is off to a great start. The stock remains a Buy and our conservative fair value estimate increases to $126 -- that's 14 times EPS estimates for the year ending September 2015.

```
=========================
    Pro Guidance
=========================
Status:        Buy (No change)
Fair Value Est:   $126 (up from $118)
Current Allocation:  4.6%
=========================

    Q2 Key Stats

Revenue:      +27% to $58 billion
Net Income:     +33% to $13.6 billion
Earnings Per Share: +40% to $3.06


     Overview
=========================
Recent Price:    $130 (up from $118 last Q)
Yield:        1.6%
=========================
    Valuation
=========================
Market Cap:    $749.6 billion
Cash & Equiv.:   $33.4 b
LT Investment:   $160.4 b
LT Debt:      $40.0 b
Enterprise Value: $595.8 b
=========================
Metric      Multiple
=========================
EV/EBITDA      10.4
EV/EBITDA NTM     9.4
P/E         16.1
P/E NTM       14.1
P/FCF        11.6
=========================
    TTM Cash Flow
=========================
OCF:    $76.3 billion
Cap EX:   $11.7 billion
FCF:    $64.6 billion
=========================
    TTM Margins
=========================
```

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Gross Margin    39.7% (all up)
EBITDA Margin    34.4%
Oper. Margin    22.5%
Lev. FCF Margin   21.8%
ROE         38.4%
=========================

=========================
 Historical EV/EBITDA
=========================
  Dec. 31  Ann. Avg.
2002  6.2   12.2
2003  26.6   21.1
2004  41.8   25.0
2005  28.6   25.1
2006  23.6   21.7
2007  33.5   24.8
2008  7.6   17.8
2009  20.0   14.2
2010  13.9   13.3
2011  9.8   11.0
2012  8.0   9.9
2013  8.5   7.0
2014  10.8   9.3

Avg.  18.3      (13 years)
Now  10.2
NTM est.9.4
========================
========================
```

Looking Ahead: Apple predicts a healthy Q3, with sales up about 27% YOY to $46 to $48 billion on continued strong iPhone demand. Currency headwinds are decreasing sales growth considerably, but it's still strong. Gross margins should be stable YOY around 38.5% to 39.5%.

============

What We Think Now: Apple is the leader in mobile computing products, and the number of people buying into its ecosystem continues to grow. Apple capitalizes on this by making its operating system work seamlessly across devices, increasing stickiness. The mobile computing revolution is still in early stages, and Apple still has no equal.

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[Apple investor relations]

The Prognosis Is Good for Gilead Sciences

Published May 20, 2015 at 2:02PM

Gilead Sciences (NASDAQ: GILD) reported a strong first quarter in all product categories, including continued momentum for its Hepatitis C franchise. The company increased revenue guidance for the year, to $28-$29 billion (up from earlier guidance of $26-$27B). That's growth of 14% to 18% over last year. The stock remains a Buy First in *Pro*, with a 3.9% allocation. Our fair value estimate remains conservative as long as strong Hep C sales are sustainable a number of years.

```
=========================
    Pro Guidance
=========================
Status:     Buy First
Fair Value Est:   $120
Current Allocation:  3.9%
=========================

    Q1 Key Stats

Revenue:      +52% to $7.6 billion
Net Income:     +85% to $4.6 billion
Earnings Per Share: +99% to $2.94

Hep C Sales:    +19% sequentially to $4.6 billion
HIV product sales: +15% YOY to $1.4 billion
```

Key Thoughts

- Gilead is maintaining dominant market share in Hep C treatment, with an estimated 90% share of genotype 1 patients beginning treatment in Q1 using Gilead.
- Harvoni use is growing faster than Sovaldi did, as more markets open.
- From a competitor's conference call that I went though (to be clear, GILD won't say these things), competitor **AbbVie** (NYSE: ABBV) projects $750 million of its own quarterly Hep C sales by the fourth quarter 2015 -- that's 16% of the size of GILD's Hep C sales this quarter, or still modest. It had $231 million in Hep C sales this quarter.
- GILD shares look reasonably to cheaply priced given that Gilead and AbbVie project the Hep C market to remain large for years to come, as patients are gradually treated around the world. These two are likely to remain #1 and #2 in the market. The largest risk to year-over-year results may be lower drug prices as contracts come to renewal in years ahead and more competitors reach the market.

```
    Overview
=========================
Recent Price:    $110
Yield:        1.6% (dividend starts in June)
```

```
=========================
    Valuation
=========================
Market Cap:     $161 billion
Cash & Equiv.:   $11.2 b
LT Investments:   $3.2 b
LT Debt:      $11.9 b
=========================
Metric      Multiple
=========================
EV/EBITDA       8.6
EV/EBITDA NTM est.  7.8 (among Pro's cheapest, other than AAL)
P/FCF         9.8
P/E         12.6
P/E NTM est.     10.2
=========================
    TTM Cash Flow
=========================
OCF:    $16.9 billion
Cap EX:   $517 million
FCF:    $16.4 billion
=========================
     Ratios
=========================
Gross Margin     86% (all much higher)
EBITDA Margin    69.3%
FCF Margin      45.6%
ROE         90.4%
ROC         42%
=========================
=========================
Historical Avg. EV/EBITDA
=========================
   2004  29.4
   2005  22.4
   2006  20.2
   2007  19.3
   2008  19.1
   2009  13.8
   2010   8.1
   2011   7.6
   2012  11.3
   2013  19.8
   2014  18.3
   Average 17.2 (11 years)
   Now   8.6
   NTM Est 7.8
=========================
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Looking Ahead

As we said from the start, what matters most the coming handful of years is Hep C sales -- how strong will they be? Since the drugs cure patients, revenue will not be linear. Sales will subside, leaving a sizable headwind for year-over-year growth in years to come. But for now, we expect sales will be healthy at least through 2018, as patients are slowly reached. In recent calls, management shared the same long-term view, with long-term marketing plans -- though none of us can predict what competitive pricing pressures may eventually challenge this assertion.

Conference Call Notes

Sovaldi & Harvoni (HEP C):

- $4.6 billion in revenue (60% of total) in Q1, with $3.4 billion in the U.S, the rest in Europe. It's up 19% over Q4 and doubling year-over-year. Approximately 90,000 patients started in the quarter.
- In the U.S., Hep C revenue grew 8% sequentially to $3.4 billion, with approximately 70,000 patients starting, up more than 50% since the last quarter.
- About 21,000 Hep C patients started in Europe, with $1 billion in revenue, and more markets coming online.
- About 90% of people with health insurance in the U.S. are now under insurance plans that have contracts with GILD on Hep C, and 83% of those have direct access to Harvoni. (Of course, not all of these contracts are exclusive. Many plans may also offer competing drugs.)
- Remember COO Milligan said last quarter, Harvoni has "proven to be useful in a far greater range of patients than we thought. I look at our next generation opportunities, and I think we have by far the most competitive portfolio out there. And that gives me great confidence that we will be able to continue to have good product pricing throughout our segments. So I'm not at all concerned about future competition that people seem to be concerned about."
- But that said, this quarter for competitive reasons GILD said it will no longer share its gross to net adjustments. It in fact didn't mean to last quarter, but remember how we zeroed on it? It helped. We wrote here: "Gilead expects its 2015 gross to net adjustment for HCV products in the U.S. to be about 46%, compared to 22% at the end of 2014. In other words, they're more than doubling the discount on the drug, but this is done with the requirement that it is offered to many more patients (rather than just the primarily severe patients that have been treated so far). (So, simple math suggests about a $51K price tag for Harvoni, compared to the $95K list price, and compared to a $74K price at last month's 22% discount. This suggests that growth in patients will keep revenue growing this year even as the price is much lower.)" So far this is proving out, especially as GILD just increased revenue guidance.
- GILD estimates capacity to treat at least 250,000 Hep C patients in the U.S. this year, or about 78% more than started last year. Though prescriptions are currently flattening off in the U.S., it does not expect that to remain the case. The company still expects 250,000 patients or more being treated in the U.S. this year, and around 100,000 patients likely in Europe this year.
- Sovaldi's list price in Europe is $41-$45K, and Harvoni will be about 15% higher.
- Japan is a giant market where Sovaldi was approved March 25, and Harvoni should see approval by mid-year.
- GILD has drugs in phase II studies to help patients wipe out chronic Hepatitis B, which is a lifelong infection for most patients.

HIV

- Sales up 15% to $1.4 billion.
- Three new HIV regimens could be approved between Nov. 2015 and mid-2016.

- Eight out of 10 new HIV patients started on a GILD drug this quarter, as competition from **GlaxoSmithKline** (NYSE: GSK) takes some market share (it used to be that 9 of 10 started with GILD). But GILD remains in a "very, very strong position" as its single-tablet regimens grow sharply, with Stribild up 75% YOY, Complera 33% YOY, and still new treatments in late-stage trial.

OTHER

- The oncology pipeline is now 30 clinical studies strong, with 10 being Phase III studies.
- The company has the widest, deepest number of candidates in its pipeline than it ever has (how much revenue it amounts to is too early to say).
- The company bought back $3 billion in stock, or 29.6 million shares at an average $101.38, and in April it started buying shares as part of its new $15 billion buyback (9.3% of the current market cap).
- The company is always considering acquisitions, staying in therapeutic areas. It likes acquisitions of phase III products where it can speed up the process and expand the product use.

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What We Think Now: Gilead Sciences offers a great investing trifecta: size, growth and value, all in one. Its blockbuster Hep C treatment has the early lead around the world; its HIV franchise is stronger than ever; and its balance sheet has never been stronger. Its strong pipeline targets deadly diseases with novel treatments as Gilead works to improve lives.

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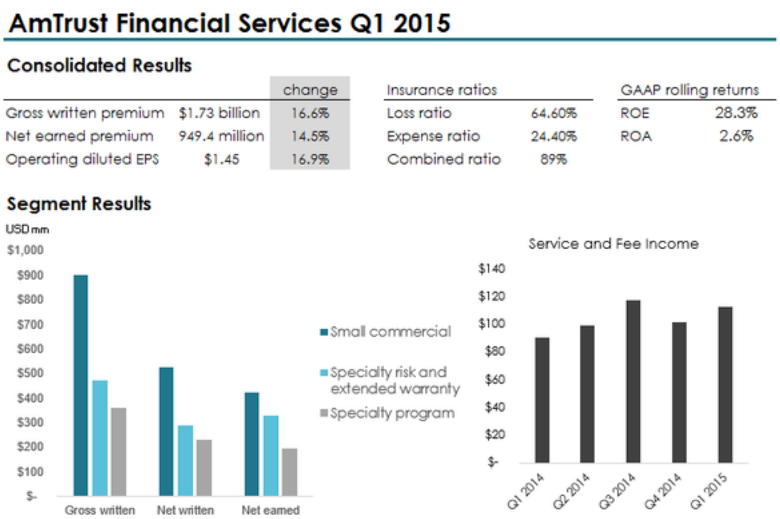
- Gilead's investor relations
- The earnings release page
- A great, long PowerPoint presentation on results (you don't need me!)

AmTrust Moves Back to a Buy

Published May 19, 2015 at 11:45AM

AmTrust (NASDAQ: AFSI) started the year off on the right foot. Book value per share growth continues to be strong (up 7.7% this quarter and almost 24% year over year) even though shares outstanding have increased by almost 6% since this point last year.



Updated guidance: Buy (change from Hold)

Recommended allocation: Veterans have 7.7%; 3.5% to start for newcomers

Fair-value estimate: $50 (up from $43)

Segment Results

Segment Insurance Ratios

		First quarter 2015	First quarter 2014
Small commercial	Loss ratio	64.7%	67.1%
	Expense ratio	25.9%	23.1%
	Combined ratio	90.6%	90.2%
Specialty risk and extended warranty	Loss ratio	66.4%	68.0%
	Expense ratio	26.4%	25.7%
	Combined ratio	92.8%	93.7%
Specialty program	Loss ratio	66.4%	68.0%
	Expense ratio	26.4%	25.7%
	Combined ratio	92.8%	93.7%

Net Earned Premium by line

(thousands USD)	Small Commerical Business	Specialty Risk and Extended Warranty	Specialty Program	Total
Workers' compensation	$ 247,302		$ 52,648	$299,950
Warranty		$115,502	$ 114	$115,616
Other liability	$ 8,257	$ 47,215	$ 72,268	$127,740
Commercial auto and liab.	$ 29,481	$ 4,466	$ 27,677	$ 62,712
Medical malpractice		$ 24,244		$ 24,244
Other	$ 95,364	$ 80,088	$ 18,133	$198,789
Total NEP	$ 380,404	$271,515	$170,840	$829,051

Year Over Year Change

	Small Commerical Business	Specialty Risk and Extended Warranty	Specialty Program	Total
Workers' compensation	18.1%		47.4%	23.2%
Warranty		31.2%		31.1%
Other liability	27.4%	-30.5%	-43.9%	-34.4%
Commercial auto and liab.	76.1%	-23.0%	27.3%	44.5%
Medical malpractice		49.8%		49.8%
Other	-27.1%	31.2%	136.6%	9.4%
Total NEP	11.5%	21.2%	14.9%	14.5%

Small Commercial Business

Gross written premiums (GWP) decreased 4% for the quarter because of $174 million in non-recurring premiums AmTrust assumed as a part of the Tower Group deal last year. Excluding the $174 million in premiums, GWP actually grew by 21.9%. California, Florida, New York, and New Jersey continue to be areas of strength for the company, as these states accounted for approximately 55% of the GWP growth. Workers' compensation GWP increased by 30.3% for the company as a whole this quarter, and even though AmTrust has big plans for other lines of business, workers' comp continues to be the primary driver for this segment -- it accounted for $140 million of the increase in GWP, which accounts for more than 100% of the segment growth after removing the non-recurring premiums. This means that the other lines in this segment must have seen a net decrease in GWP.

One of the lines in which GWP declined year over year was the commercial line, which AmTrust acquired in the Tower Group deal. At first glance, this might sound alarming -- management has been vocal about believing this could be AmTrust's next billion-dollar line -- but this decline wasn't entirely unexpected; it had always seemed unlikely that all of the business AmTrust received through the agreement would renew. Losing $20 million out of the $90 million that was included in the original cut-through agreement isn't great, but it gives us a firmer baseline against which to measure performance going forward. Management still believes that they are on a pace to write between $400 million and $500 million in premiums this year, and I expect that this amount will quickly grow as the company continues to acquire related businesses such as ARI Mutual.

Net written premium (NWP) -- the gross written premiums that the company does not cede to a reinsurer -- also declined for the quarter, again because of the Tower Group premiums (which were not subject to AmTrust's quota share where it cedes around 40% of written premiums and corresponding losses to Maiden Holdings (NASDAQ: MHLD)).

Net earned premiums (NEP) -- the premiums that are actually earned by the company in a given quarter -- increased by 11.5% for the segment this quarter. Because premiums are recognized on a pro-rata basis over the life of a policy, and the average policy for this segment tends to have a term of one year, the large increase in NWP over the past year (23%) was able to largely offset the loss in NEP from the non-recurring Tower Group premiums.

Specialty Risk and Extended Warranty

Over the past year or so, around 60% of this business has been generated internationally. We knew that, so we knew this segment was going to have a significant headwind this quarter – the strength of the U.S. dollar. Good results stateside were the sole reason for the 5.3% growth in GWP in this segment, as the adverse currency movements completely offset international premium growth in local currencies. Using the exchange rates that prevailed during the first quarter of 2014, gross written premium growth would have been closer to 14%.

NWP for the quarter increased by an even smaller 2.3% because the company ceded a larger percentage of segment GWP this quarter, but NEP actually jumped 21.2%. This discrepancy can be attributed to segment growth, as well as the assumption of $33 million of unearned premiums during the quarter. It's worth noting that CEO Barry Zyskind specifically called out how they are preparing to devote even more time to building out this segment as the small commercial segment becomes more competitive.

Specialty Program

Strong expansion of existing programs (commercial automotive and general liability) resulted in an increase in GWP of 28.2%. But similar to the specialty risk and extended warranty segments, NEP increased by a smaller percentage this quarter (14.9%) as AmTrust ceded a higher percentage of GWP (35.3% versus 29.1% in Q1 2014).

Services and Fees; Investments

Results for both segments were strong. Income from the service and fee business increased 24.1% to $112.9 million, while investment income and realized gains tallied $50.3 million this quarter. Dividends and interest on fixed-income securities accounted for $34.6 of the $50.3 million, while $15.7 million came from gains on investments. AmTrust's investment portfolio is now worth more than $5.8 billion, and -- similar to most insurers -- is primarily composed of cash equivalents and fixed income.

Pro's Take

Pricing wasn't as favorable in AmTrust's largest markets this quarter, but the company is still positioned to remain competitive going forward thanks to its strategy of opportunistically entering into markets. California is a perfect example of this -- AmTrust has benefited from pricing increases to the tune of 55% since its first foray in the state in 2011, even though the company was not around to take part in the losses that resulted in such aggressive pricing increases. Going forward, AmTrust has one of two options in its larger markets as competition ramps up – it can continue to compete on price and gain market share, or it can position itself to be more defensive by being less competitive on pricing and relying primarily on renewals until pricing becomes more favorable.

Over the past 12 months, the company has written $2.5 billion of workers' compensation premiums, making it likely that AmTrust will count itself as one of the top five underwriters in the U.S. by the end of the year. As we've mentioned in the past, the company will soon have to make a more deliberate choice between strong growth and high profitability in its workers' compensation business. When you're small, it's easy to grow at a fast clip while remaining highly profitable by cherry-picking your customers. But this is not a luxury afforded to the big dogs of the industry. Given that we would strongly prefer management choose the latter (profitability), it has been reassuring to hear the team repeatedly talk about how they aren't afraid to pull in the reins if need be. Wells Fargo is expecting the competition to continue heating up this year since three plus years of above average rate increases have resulted in premium growth that is now outpacing incurred losses and a recent decline in the frequency of losses. AmTrust's largest markets will likely be some of the last states to see all out pricing wars, but this is something we'll definitely be keeping an eye on.

But -- and this is a big "but" -- this doesn't mean that AmTrust will soon be relegated to "GDP plus a few hundred basis points"-type growth. With the Tower acquisition, the company has just started moving into the commercial package business in a meaningful way. In 2013, SNL Financial estimated that the size of the commercial insurance market (which includes workers' comp) was $233.6 billion in net written premiums, and AmTrust believes that its commercial package business can become its next billion-dollar platform.

So far in 2015, the company has made four acquisitions that were large enough to require disclosure, and based on recent comments by the management team -- as well as the fact that the company recently raised capital through a secondary equity offering -- I suspect that management will continue to grow through acquisitions throughout the rest of the year.

Just like we did with **O'Reilly Automotive** (NASDAQ: ORLY) yesterday, we're moving AmTrust back to a Buy. Actually, the situations are quite similar in that we're making this move even though shares of both companies are trading noticeably higher than our newest fair-value estimates. What gives? At the risk of sounding like a broken record, I'll paraphrase what I talked about during the most recent FoolFest. Fair-value estimates are exactly that: estimates. It is more accurate to think of a fair-value estimate as a range. And given the quality of the business and size of the opportunities that we believe AmTrust has (even as it becomes one of the big dogs in the workers' comp market), the range for AmTrust is wider than it is for some of *Pro*'s other holdings -- for example, **The Buckle** (NYSE: BKE) or **Valmont Industries** (NYSE: VMI). Even at this price, we still think AmTrust can underwrite North Star-beating returns over the next three years.

But that doesn't mean that you need to immediately increase your allocation to match our 7.7%, especially if you currently do not own any AmTrust shares. Pick an allocation that you feel comfortable starting out with (perhaps around 4% or so) and then look to opportunistically buy shares when the opportunity presents itself. Though put options don't pay as well as they once did, writing puts is another viable alternative if you prefer to get paid while you wait. As I currently type up this report the September $57.50 puts pay around a 4.7% yield in 122 days and give you a net start price that is around 9.5% below the stock's current price.

Questions? Bring them to our AmTrust board!

Pro Catch-Up Trades: May 18, 2015

Published May 18, 2015 at 2:18PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **American Tower** (NYSE: AMT): Down lately, shares remain a Buy First at a 3.4% position, and we own about 0.5% in January 2017 $80 calls.
- **Boulder Brands** (NASDAQ: BDBD) and **Five Below** (NASDAQ: FIVE): These shorts are priced around where we originally sold short. We have 1.5% and 1.2% short allocations, respectively. If you have yet to join us, now might be a good time.
- **O'Reilly Automotive** (NASDAQ: ORLY): Buy up to 2.5% in stock if you don't have a position.

O'Reilly Automotive Revs to a Buy

Published May 18, 2015 at 1:37PM

Guidance Updates

- **O'Reilly Automotive** (NASDAQ: ORLY) moves to Buy, with a 2.5% starting allocation recommended. Its fair-value estimate increases to $190.
- **Skyworks Solutions**' (NASDAQ: SWKS) fair-value estimate increases to $80. The stock remains a Buy with a 4.7% allocation.
- **Tupperware**'s (NYSE: TUP) fair-value estimate ticks down to $74. The stock remains a Buy at a 2.7% allocation.

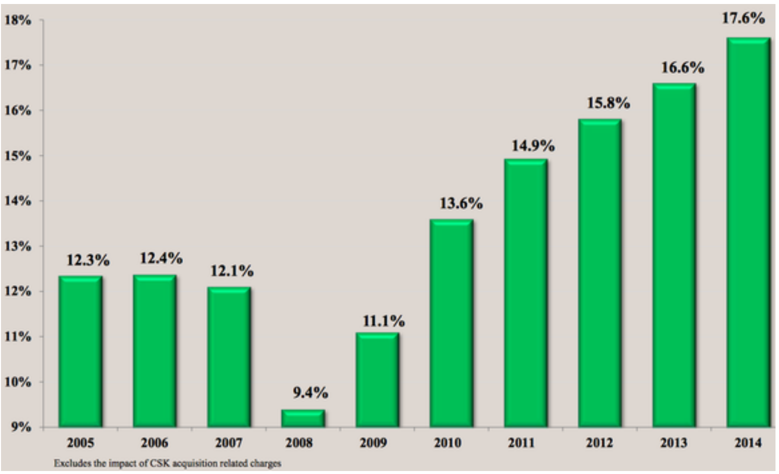
Dear *Pro* members,

The United States grew up on the automobile, leading to a motor-centric life that today supports more than 250 million registered cars in a population of 320 million people. But when we recommended buying shares of a leading auto-parts retailer, **O'Reilly Automotive** (NASDAQ: ORLY), in April 2013, the trade alert was largely met with a yawn. And why not? It's an auto-parts company. I was honestly a little bored myself while writing the report, but I had no hesitation in buying the stock for *Pro*. Behind the dull facade, this is an incredible business and long-term performer, with shares up 23% annualized since the 1993 IPO. For us, the stock is up 124% in just more than two years, with plenty more road ahead.

I placed the stock on hold last November as new members joined *Pro*. I was being cautious on the valuation, and it seemed prudent not to ask new members to buy *all* of our stocks at once -- averaging in over time usually leads to some opportunities. O'Reilly has continued to gain ground since then with exceptional growth in its business. In the first quarter of 2014 (so, last year), the company achieved same-store sales growth of 6.3%. That was a challenging result to lap this year, so I thought we might see some selling on first-quarter results. Instead, the company blew past the prior year. Same-store sales were up 7.2% last quarter *on top of* last year's 6.3%. And this was the sixth quarter in a row of same-store sales growth higher than 5%. What's the secret here? Let's look under the hood.

The Luck of the Irish

With more than 4,400 locations, O'Reilly is the third-largest auto-parts retailer in the country, behind only **AutoZone** (NYSE: AZO) and **Advance Auto Parts** (NYSE: AAP). However, it has considerably higher profit margins than Advance, and it's neck and neck with AutoZone. O'Reilly boasts an impressive 11% net profit margin, and profitability is still rising. Here are operating margins:

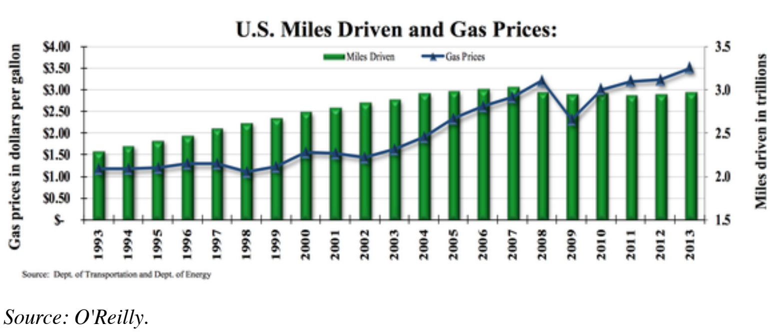


Source: O' Reilly investor relations.

How is this happening? Pricing on auto parts is rational rather than cutthroat, because pricing isn't what drives a sale. Availability of parts and helpful service drives a sale. O'Reilly caters equally to do-it-yourselfers and the professional market, but whoever the customer is, the key is that O'Reilly has knowledge to share about the customer's problem and has the parts available to solve it. The average O'Reilly store manager has been with the company from 12 to 18 years, and the clear message to new employees is that this is a service business. Since pricing remains stable, the company can drive higher margins as it builds out its distribution network, bringing greater efficiencies.

In O'Reilly's April conference call, management talked about taking market share as it becomes the *first* place more customers go for parts, rather than a second or third choice. Why? Because when someone goes to O'Reilly, even if it wasn't their first choice, they take note of the employees' helpful answers and the wide selection of parts available quickly. O'Reilly opens giant distribution centers in key markets, surrounded by larger hub stores, both serving hundreds of surrounding smaller stores with more than 146,000 parts -- fast. Most customers have questions they need answered, and they want the parts immediately, so online orders are less of a threat to this industry than to many others. Many people making repairs also need follow-up help, so a local store with technicians they trust is key.

Even so, management says the No. 1 driver of O'Reilly's business is miles driven. The more miles America drives, the better for O'Reilly. Yet much like **MasterCard** (NYSE: MA) and **Visa** (NYSE: V), which are doing well despite a tepid economy, O'Reilly has shone through the lower-mileage years from 2008 to 2013.

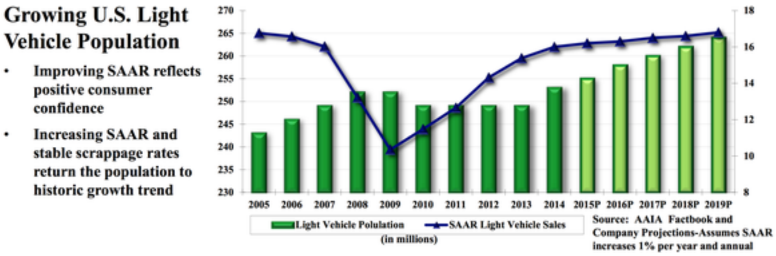


Source: O'Reilly.

With gas prices down sharply over the past six months and U.S. unemployment continuing to improve, O'Reilly should enjoy tailwinds. More people working means more people driving, and lower fuel prices make everyone more willing to drive further.

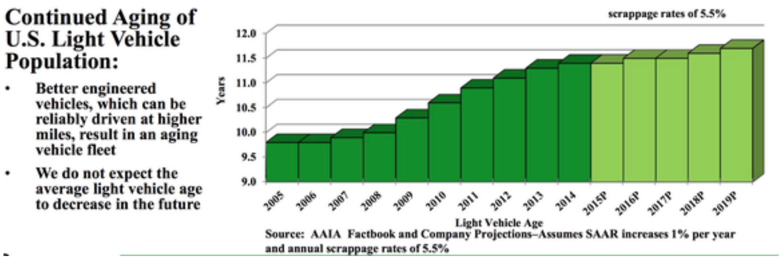
Also propelling O'Reilly is a growing *and* aging vehicle population. Cars are more reliable than ever, so they're staying on the road longer. But older cars need more maintenance, and older parts often cost more. Plus, the repairs on older cars are usually larger jobs (for example, brakes or suspensions). Meanwhile, parts on *newer* cars are getting more complex, so they're also getting more expensive to replace and repair. Both facts help the business.

Finally, after weak performance during the recession, light vehicle sales are expected to increase annually at least through 2019 ("SAAR" stands for Seasonally Adjusted Annual Rate).



Source: O'Reilly.

At the same time (like all of us!), the average car on the road is getting older (and wiser and better-looking, right?).



Source: O'Reilly.

These tailwinds coincide with O'Reilly adding 200 new stores a year (or about 4.5%) to its base, which is larger unit growth than it has ever seen. Management maps out plenty of opportunity ahead, too, including untapped markets. Of the more than 36,000 auto-parts stores in the U.S., fewer than half are owned by large chains.So acquiring of small players and grabbing market share by adding new locations are two additional growth avenues. As it did last year, O'Reilly expects to add 200 stores again in 2015 (this chart is from a year ago).

Source: O'Reilly.

Large, lucrative markets in Florida and the Northeast remain largely untouched by O'Reilly as yet. Meanwhile, the company boasts more than 600 stores in Texas and more than 400 in California, demonstrating how many stores some states can hold.

Now we come to price. The stock has looked expensive ever since I started following it in 2006, when it traded at around 25 times earnings. It's up more than 700% over the past 10 years, so its pricey appearance has led to dramatic results. Today at around $223, shares trade at 28.6 times earnings and 22.6 times consensus forward EPS estimates, while earnings per share were up 28% in the quarter just ended. We should expect this growth rate to slow soon (barring acquisitions), but a long-term earnings growth rate in the upper teens is possible, and since margins are expected to tick higher, a premium price is likely to remain. Equally important, O'Reilly has a history of generating more free cash flow than expected -- more than $800 million over the past 12 months, feeding its $23 billion market value -- even as it opens a new store on average every 1.8 days.

Our fair-value estimate of $190 prices shares at 21.8 times our estimated earnings for the year ending in December. The stock is about 17% above our fair-value estimate (about a year ahead of itself, you could say), but we know there's plenty of room for error with estimates. Shares are a Buy with our standard three-year rolling outlook. We recommend newcomers buy around 2.5% (up to 3%), and build up to 4.5% or so on meaningful price declines. You could also sell to open puts -- such as August or November $200 puts, for example -- to potentially buy 100 or more shares at lower prices.

For more on the business, steer to the company's annual presentation from May 5, or last year's Analyst Day presentation. And cruise on over to our O'Reilly discussion board if you have any questions!

Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **American Tower** (NYSE: AMT): Down lately, shares remain a Buy First at a 3.4% position, and we own about 0.5% in January 2017 $80 calls.
- **Boulder Brands** (NASDAQ: BDBD) and **Five Below** (NASDAQ: FIVE): These shorts are priced around where we originally sold short. We have 1.5% and 1.2% short allocations, respectively.
- **O'Reilly Automotive** (NASDAQ: ORLY): Buy up to 2.5% in stock if you don't have a position.

The Sky's the Limit for Skyworks

Published May 15, 2015 at 11:58AM

As the demand for and the complexity of wireless connectivity both continued to incease, **Skyworks Solutions** (NASDAQ: SWKS) again topped expectations, reporting a record second quarter that nearly doubled profits. The stock remains a Buy, and our estimated fair value increases to $80. That's 15.5 times our non-GAAP EPS estimate for the year ending this September (four months away). I view this fair-value estimate as being fairly conservative; I harbor a belief that growth is likely to outstrip current expectations in 2016, too.

```
    Overview
========================
   Pro Guidance
========================
Status:       Buy (no change)
Fair Value Est.:   $80 (up from $75)
Current Allocation: 4.7%(up from 4% last Q, due to appreciation)
========================


   Q2 2015 Key Stats

Revenue:      +58% to $762 million
Oper. Income:    +99% to $259 m
Net Income:    +114% to $220 m
Earnings Per Share: +85% to $1.15 (non-GAAP)

   Q3 2015 Outlook

Revenue:      +36% to $800 million
Gross Margin:    48% (up 130bps)
EPS:        +54% to $1.28

   Longer-Term Outlook

Gross Margin:    50%+
Earnings:      $7 annualized EPS, for a start
```

Key Thoughts (Mostly the Same!)

- Skyworks is growing more rapidly than expected; last year, $5 in annualized EPS was an intermediate-term objective; now they're already targeting $7 per share in annualized earnings.
- Multiple factors are converging to drive strong growth. An overlying theme is growing demand for wireless connectivity, and not just in phones, but multiple devices outside mobile (cars, homes, medical, etc). Along with this, wireless needs are becoming more complex, narrowing the number of competitors who can deliver as solutions become modular, meaning you need wide expertise in various components. This increases the value-add of a company like Skyworks, as it leads to more content sold into each unit at higher margins. This also leads to longer-term roadmaps with customers, even 2-3 years out.
- Expect volatility from a semiconductor stock, especially one that has gained 91% since we bought in August. But also recognize Skyworks' unique position in the industry (including healthy margins that appear protected by a moat), and surging demand for its products across vertical markets and in the China mobile market. Apple represents concentrated risk as a very large customer, but hints of roadmap discussions suggest they will remain a customer for at least a few more years, and then ideally of course longer (while the rest of Skyworks' business grows, too).

```
    Overview
=========================
Recent Price:   $98.45 (up from $81.85 last Q)
Yield:        0.50%
=========================
    Valuation
=========================
Market Cap:     $18.8 billion
Cash & Equiv.:    $1.0 b
LT Debt:        $0
Enterprise Value:  $17.8 b
=========================
=========================
Metric      Multiple
=========================
EV/EBITDA      17.7
EV/EBITDA NTM est.  12.4 (comfortingly "reasonable")
P/E         28.8
P/E NTM est.     17.5
P/FCF        30.5 (second half of the year drives this lower)
=========================
   TTM Cash Flow
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=========================
OCF:    $938 million
Cap EX:  $322 m
FCF:    $616 m
=========================
    TTM Margins
=========================
Gross Margin    45.7% (all up but FCF)
EBITDA Margin    34.2%
Oper. Margin    22.6%
FCF Margin     14.3%
ROE         25.1%
=========================
=========================
 Historical EV/EBITDA
=========================
     Avg.
2002   27.8
2003   33.1
2004   26.8
2005   10.4
2006   14.9
2007   15.5
2008   11.0
2009   11.1
2010   15.0
2011   13.4
2012   11.6
2013    9.9
2014   14.7
Avg.   16.5 (over 13 years)
Now    17.7
NTM est. 12.4
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Conference-Call Key Quotes and Points

- Some of the company's out-performance has come from gaining more content in each device it's selling into -- so, a higher dollar share of each product. This deepens the customer relationship. But SWKS is also expanding rapidly in vertical markets, with 27% growth YTD in Internet Of Things markets like automobiles (with multiple design wins with GM's OnStar telematics), connected homes, machine-to-machine modules for industrial applications, and others such as Google's video monitoring solutions (whatever those are! sounds evil).
- Sales are denominated in dollars, so SWKS is the first company I've covered this quarter that hasn't had to complain about currency exchange rates.
- CEO David Aldrich: "...We are reaping the benefits of our dual H strategy of providing leadership and custom integrated solutions, while continuing to diversify into high-margin verticals. And as a measure of our progress, in 2011, around 60% of our revenue came from single-function devices for mobile applications. Today, more than 2/3 of our revenue is comprised of integrated mobile systems and broad markets, which are our fastest growth areas, driving improved financial returns, and putting us on a clear path toward 50% gross margins and above. And as the leader in complex RF and analog integration, we're the primary beneficiary of the ongoing industry shift toward systems solutions. And as the communications architectures continue to advance in complexity, we're becoming an integral part of our customers' development roadmaps, providing more value in the overall supply chain. This is creating a fundamental shift in our business model; simply put, more complex systems drive increased profitability."
- Power amplifiers were 31% of revenue; integrated mobile systems 47%; broad markets 22%. Integrated mobile systems grew 139%, but the broad market portfolio (mentioned above as IOT) grew 27%.
- SWKS sells to every smartphone manufacturer, and almost every smartphone platform (some manufacturers have multiple platforms).
- SWKS continues to grow its production capacity substantially, but customers are lined up to consume that capacity. It maintains a flexible base of in-house and outsourced manufacturing.
- "By all measures, wireless connectivity is exploding as an enabling technology... Much of the excitement [is] around innovations in the connected car, the automated home, wearable technologies and previously unimagined new categories like drones, all utilizing enabling technologies like 4G, like GPS, local area networking, and near field protocols like ZigBee and Bluetooth. Our overarching mission is to make it effortless for customers to embrace these forms of connectivity, leveraging our decades of experience in mobile to enable more and more devices in adjacent markets to become seamlessly connected. Powering these will be a combination of sensors, microcontrollers and most importantly for Skyworks, connectivity and power management solutions. With a high proportion of analog content and comparatively low digital processing needs. These products require a high level of integration and will need customized solutions produced in massive scale at attractive cost points. All of these attributes play directly into Skyworks' core strengths. In this way, Skyworks is a conduit into the Internet of things. This is an exciting opportunity, but just one of many tailwinds we're capitalizing on today."
- Four major trends are driving growth: 1) A surging need for high-performance integrated systems for connectivity. 2) Bringing connectivity to emerging markets. 3) Internet of Things. Machine-to-Machine connections are estimated to grow fourfold through 2020. Connected Homes and Wearables could drive tens of millions of new units. 4) New vertical markets, ones with longer product life cycles, fewer competitors, and higher margins, including automotive, medical and industrial.
- CEO Aldrich:

> "I would like to provide some added perspective on the underlying trends that we see fueling our growth in the coming years. At the highest level, the world is rapidly becoming more interconnected, fueling an explosion of network devices along with massive growth in wireless data traffic. According to recent report, mobile data usage grew by 69% last year, driven by proliferation of smartphones and other interconnected devices within the Internet of Things, along with the adoption of high data rate services like 4G, LTE and 802.11ac. Now for service providers, this growing ecosystem of connected devices provides a vital gateway for new revenue streams, linking millions of subscribers with lucrative services like on-demand music and video content, over-the-top programming, security and cloud-based enterprise services.
> "At the same time, consumers are recognizing that the quality of the connectivity pipe is a key factor in their overall user experience and are upgrading to more powerful devices, bigger data plans and faster connections. The end result is a raise by OEMs across our served markets to provide leading-edge performance, creating a market opportunity that is growing at a mid-teens pace for the foreseeable future. And an addressable market for Skyworks, it's growing even faster. I'd like to highlight 3 key trends that fuel this: First, there's an explosion in RF and analog complexity, and it's driving robust growth in our served markets and a consolidation of market share. Skyworks' mission is to simplify this increasingly more challenging technical environment for our customers. Across the board, we see more content opportunities in each successive generation of device and integrated solutions displacing conventional discrete components. As this happens, a host of component providers, who lack our technology brand, our integration capabilities and system expertise, are simply unable to keep pace."Second, we are rapidly expanding our footprint within existing customers and existing markets, increasing our serviceable opportunity. Our systems solutions enable us to sweep in an unprecedented amount of new Skyworks content, like filtering, like tuning and power management. And a prime example is our high-performance filter portfolio, where our unique technology edge is enabling higher levels of system performance through tighter band spacing, less interference and a more efficient signal path.
>
> "On top of this, we're launching entirely new product categories like we serve -- like we see diversity modules, which support enhance download speeds

and represent a substantial expansion of our addressable opportunities."Third and finally, we're leveraging our decades of experience in mobile. We are enabling a growing array of devices in adjacent markets to become seamlessly interconnected, like wearable technologies, home automation and the connected car, utilizing enabling technologies like 4G, like GPS, local area networking standards and low-energy near-field protocols like ZigBee and Bluetooth."So in closing, we remain quite optimistic about our prospects for the remainder of 2015 and beyond. And we created a unique business model, tether to the global wave of connectivity and combining consistent above-market top line growth, with the financial returns of a best-in-class, diversified analog company."

- SWKS is well positioned in China where 3G is a 2x multiplier (if not more) on its profits per phone, and now 4G LTE is rolling out and moves profits up even further.
- China is a both volume opportunity *and* content gains (selling more into each device) that "will be around for many, many years."
- The company's recent SkyOne module is becoming a core product.
- Relationships with **Qualcomm** (NASDAQ: QCOM) and MediaTek remain strong.
- A question came in regarding SWKS' largest customer. The answer: "Obviously, we can't comment on that specific customer. But in general, the architectures are getting much more complex. And we're very fortunate to have visibility out, 2, in some cases 3 years in terms of the overall architectures that are being deployed to deal with all this complexity. We see nothing slowing that down, so it's obviously a tailwind for us. We're seeing more addressable content in those kinds of functions you typically think about for us, power amplifiers, duplexers, Wi-Fi, switching and control. But we're seeing awful lot now in what we're able to produce in terms of complex, antenna tuning, devices on the receive path, lighting, power management. And I will say that, as an incumbent, we've been very successful and quite proud of it in maintaining and growing our footprint with each successive design with all our major customers."
- CEO David Aldrich: "I don't see anything turning the tables on this natural tendency toward complexity for the next five years."
- Filters and modules are two rapidly growing areas for SWKS.
- The second half of the year is usually the strongest, financially, but seasonality is waning as they sell into more markets, so I'm guessing the second half may be a bit less pronounced.
- Pricing remains stable (strong, in other words) and they don't see anything changing that dynamic soon given the modules they're selling. Again, margins should head higher over time.
- Autos are slowly becoming a meaningful part of revenue (no longer trivial) as "smart auto" designs proliferate (a connected hub environment in the car). It's obviously the future (who in the U.S. to start will want a dumb car in a few years, five years, time?). Connected homes and energy management systems may follow.

Pro Summary

All of the attractive reasons that led to recommending SWKS for the Pro Portfolio remain in place, and are stronger than before. In the original buy report, I suggested a conservative 25% growth rate early on, and SWKS has more than doubled that. As a "chip" industry company, expect volatility in the shares. We're hoping to be invested for several years, and hope to see its markets grow much larger over that time. The company will need to maintain its technology edge and combat lower pricing that always plagues tech, but today Skyworks is excelling, and the outlook looks promising. The stock isn't inexpensive as it was before, but longer term it still holds ample promise. We may need to wait through some periods where it looks pricey, as we'll likely only sell if it becomes much more expensive-looking.

- Pro's original Buy Report
- Skyworks' Investor Relations

Papa John's Delivers An Excellent Quarter

Published May 14, 2015 at 12:48PM

Pro's Take: PZZA Q1-2015 Earnings

Papa John's International (NASDAQ: PZZA)

....

Q1-2015

Total revenue growth: +7.7% (vs. +12.9% in Q1-2014)

Operating profit margin: 8.7% (vs. 8% in Q1-2014)

EPS growth: +22.1% (vs. +6.1% in Q1-2014)

....

Quarter Quick Take

Papa John's delivered an excellent start to 2015 in Q1, with North American restaurants increasing comps by 6.5% and international restaurants increasing comps 7.7% (in constant currency). Earnings per share grew 22% year-over-year, increasing due to higher operating margins and ongoing debt-fueled buybacks, even despite a $(0.03) per-share impact from POS system roll-out costs. Limited-time offers, effective marketing, and continued migration to digital ordering (which garners higher average tickets and now makes up more than 50% of total sales) helped drive comps higher. These growth rates suggest continued market-share gains at the expense of pizza industry rivals. Free cash flow generation is starting to turn the corner after several quarters of elevated spending and high commodity costs, which began to moderate in the last quarter of 2014. Papa John's continues to focus on quality, consistency, and measured international expansion, and the company looks set for a strong 2015 despite conservative full-year guidance that has already been increased and may have more room for increases.

Guidance: Buy (no change)

Recommended Allocation: 4.7% plus partial covered calls.

Fair Value estimate: $54 (no change)

Papa John's trailing twelve month (TTM) valuation multiples remain near their historical highs at 36x P/E (32x expected 2015 earnings), 17x EV/EBITDA, and 33x EV/FCF, but we think recent operational performance, improving margins, and a long growth runway support those high multiples. For context, **Domino's** (NYSE: DPZ) trades at 19x EBITDA and **Dunkin' Brands** (NASDAQ: DNKN) at 18x. Papa John's is finally beginning to benefit from its recent investments in technology, and as those costs roll off throughout the rest of the year, financial performance should improve and trailing multiples should contract.

Our partial covered call position expires in October and will see us sell one third of our stake at a net $68.40 if the share price is above $65 at expiration. If the company continues to perform as well as it did in this quarter, our calls are likely to be in the money at expiration and we will either have to roll our calls or let them be assigned. As we get closer to October expiration, depending on how the business performs and how the stock price moves, we'll decide which course of action to take (if any is needed). Members who have yet to sell calls can now sell them at a higher price than *Pro* achieved, or they can sell October $67.50s or $70s if they want to give their position more breathing room. Of course, don't sell calls if you're not comfortable selling the shares you cover.

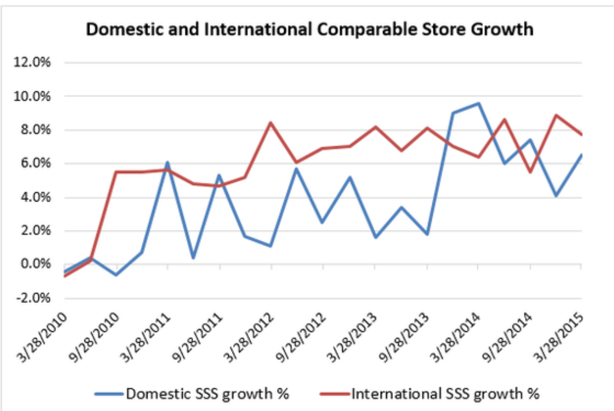
Our Thesis

Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main quick service restaurant (QSR) pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only about 1,350 international restaurants the company has a long runway for growth (compare to Domino's which has over 6,600 international stores). Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

1) Store *Performance:* During Q1-2015, systemwide restaurant sales increased +7.4% (9.6% when excluding the impact of foreign currency). Domestic comps increased +6.5% while international comps increased +7.7%. As I noted last quarter, management's initial full year 2015 domestic comps guidance (2%-4%) seemed quite conservative given the recent momentum in the pizza market, and accordingly this quarter management raised 2015 domestic comps guidance to 3%-5% (which is still below the current trend). Management kept international comps guidance at 5%-7% despite exceeding the high end of that range in Q1.

The company just continues to churn out amazing comparable store sales performance-this quarter marked the 18th straight quarter of positive domestic comps and the 20th straight quarter of positive international comps:

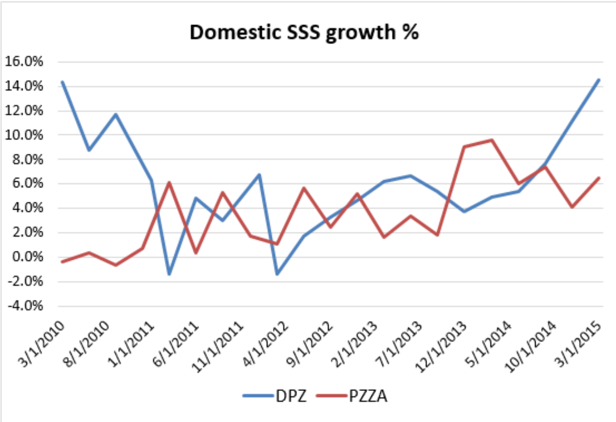


The company's measured expansion continued, adding 36 new restaurants (net) in the quarter, almost all of which were international. The company expects to open 220-250 net new restaurants in 2015 (representing 5% unit growth year-over-year), with most of the unit growth weighted toward the end of the year. The company's pipeline remains healthy, with 200 domestic restaurants and 1,000 international restaurants scheduled to be opened over the next six years.

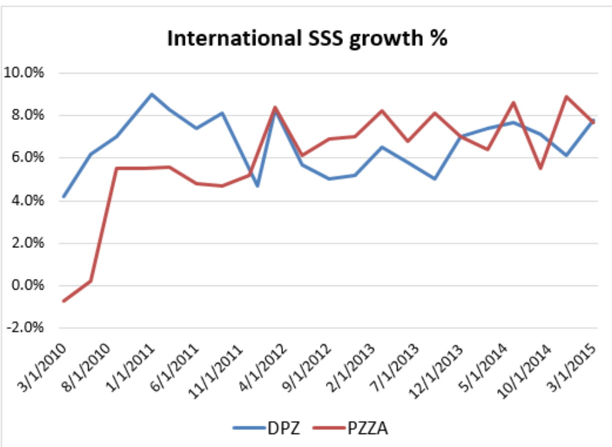
2) Brand: Brand strength is challenging to measure, but we need to monitor it because it is key to the company's brand-based advantages and higher price per pie. Based on recent data, which includes store growth, the domestic pizza market is growing at about 2%-3% and the international market at about 5%-6%. So Papa John's comps (which *exclude* store growth) suggest continued market share gains at the expense of competitors. This is likely due to the company's competitive advantages related to scale (efficient advertising/distribution) and an early lead in technology (digital ordering).

As for PJ's strongest peer, Domino's domestic comps came in at an outstanding 14.5% in the quarter, outperforming Papa John's meaningfully. Domino's menu has a much wider assortment of items outside of pizza (pasta, sandwiches, chicken, and breads), and new menu initiatives at Domino's helps to explain some of the difference in comps. Papa John's is committed to a much more pizza-focused menu, and although it may lead to lower comps in some periods where competitors' new menu item launches are successful, it reduces complexity and prevents missteps, and it allows the company to continue to focus on what it does best: Better Ingredients, Better Pizza. Papa John's mentioned on the call that they don't expect to generate meaningful comps growth from menu expansion:

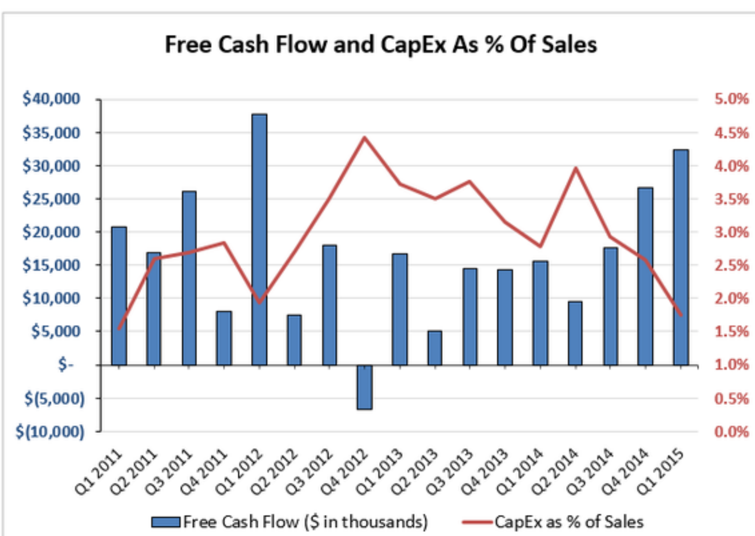
> "*...we've said this before, our brand and our model is one of quality, consistency and simplicity. We'll continue to play that play. Pizza will be our focus*."..."*I would not expect ever to see at Papa John's an extensive development of sandwiches and an array of side items that would create any kind of complexity within our operations model*." **-COO Steve Ritchie**



Papa John's and Domino's are neck and neck internationally, where most of future growth will occur. The strong international comps performance continues to suggest that the company's brand and expansion strategy are translating overseas:



3) Margins: Ultimately, we expect the capital light business model to result in higher operating margins that propel free cash flow generation. Since the beginning of 2014, the company has dealt with depressed margins and free cash flow due to the roll-out of the company's new new proprietary POS system (FOCUS), which as of this quarter is now substantially complete. The company has been financially affected by franchise royalty incentives, higher levels of working capital investment (equipment inventory), and higher depreciation and capital expenditures. Now that the investment in FOCUS is complete, capital expenditures have moderated, and margins and free cash flow should see a nice boost throughout the rest of the year, especially as cheese prices (which historically represent 35%-40% of food cost) have moderated from a peak of nearly $2.30 per 40-pound block last year to the low $1.50s this year. In this graph, note the inverse relationship between capital expenditures and free cash flow- when capital expenditures are elevated, free cash flow is depressed, and vice versa:



What We Think Now

Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. Near term headwinds (commodity prices and technology investments) should prove temporary and Papa John's should deliver improved financial performance.

Pro Can Help

- **Questions?** Stop by our delicious, savory Papa John's discussion board.

Write a New Covered Strangle on Expeditors International

Published May 14, 2015 at 12:37PM

Is this for you? This is for *Pro* members who are following our option writing for income on **Expeditors International** (NASDAQ: EXPD), but please read the note below, as there are timely conditions. If you are new to the trade, you can buy shares in 100-round lots, or set up a January 2017 "at-the-money" synthetic long, and write the strangle. The minimum commitment is about $9,300, or 200 potential shares. *Pro* has a 3.8% allocation, half through a synthetic long and half through short puts.

How You Participate

Conditional Note: With the stock lately at $47.20, our May 2015 $43 puts and $48 calls are due to expire as full income after Friday. This is a good thing. We don't need to touch these two options *unless* the stock rises above $48 on Friday, in which case you'll need to buy to close the $48 calls as you write today's new strangle. Speaking of today's strangle, you will be best off writing it Friday at the *end of the day* (once you're certain the old strangle is expiring), or closing your May options first for $0.05 each, or just waiting until Monday to write the new strangle. We're sending the alert today so you're prepared, mainly in case the stock rises above $48 Friday.

- **Action:** After the circumstances above have played out, use a strangle order to simultaneously sell to open August 2015 $46 puts, and sell to open August 2015 $50 calls.
- **Allocation:** Sell one strangle (one of each option) for every 100 shares of exposure you have to the company. We have 1,000-share exposure through 10 contracts of a synthetic long, so we're selling 10 puts and 10 calls, as we've done before -- this potentially doubles our exposure.
- **Prices:**
  - **Stock:** $47.20
  - **Options:**
    - August 2015 $46 puts (bid/ask): $1.35/$1.45
    - August 2015 $50 calls (bid/ask): $0.75/$0.85
    - Combined bid/ask: $2.10/$2.30
- **Price Guidance:** Split the bid/ask, aiming for a **combined credit of $2.20** to sell the strangle. If we all use **limit orders**, then $2.20 should hold for Day One. As prices change, initially aim to get paid at least 4.5% of the current share price, lately about $2.10 combined; longer-term, target at least 1.2% per month to expiration.

What We're Thinking

Expeditors International reported healthy earnings last week, with ocean and air freight volume up 12% and 13% respectively, boosting revenue by 14%. Further, the company was able to contain costs, so its operating income grew 25%, its strongest year-over-year gain since 2011. Share repurchases helped earnings per share to rise 31%. Fortunately, our strangle has provided enough headroom for upside, with the stock up a market-beating 5.5% year-to-date. Our synthetic long is benefiting, and we're booking income, too. As an income position, we're ready to write options again, and we're again moving our strangle to higher strike prices to account for the 15%-or-so earnings growth Expeditors expects this year.

Why This Strategy?

So far since last August, assuming our May options expire tomorrow, we will have earned $3,206 in total income, and we have unrealized gains of $7,428 on our synthetic long. That's more than $10,600 in realized and unrealized gains on the less than $600 in capital we deployed to start the position last August 15. So far, our "income with upside" objective is playing out well.

More That Matters

- **Maximum loss:** The same as owning at least 200 shares of stock (100 now, and 100 at $46), minus the option premiums received.
- **Maximum gain:** This new strangle caps our upside at $50, plus the premium received, which means about $52.20 per share. The most we can make on this strangle alone is about $2.20 in premium, which is earned if the stock stays anywhere between $46 and $50 by expiration.
- **Breakeven**: Our existing synthetic long mirrors stock ownership that started at about $40.60, while this new short strangle in isolation has breakeven points at $43.80 and $52.20, giving us a nice range.
- **Follow-up:** The current plan is to continue writing strangles to earn income, and roll our existing strangle up or down if need be.

Alternative Trades

- **IRA-friendly/covered calls:** If you simply bought shares earlier and wrote May 2015 $48 covered calls, you're on track to let them expire tomorrow, and then you can sell to open August 2015 $50 calls just as we are, ideally for at least $0.80. If you want a higher credit, consider writing August 2015 $49 calls instead, lately $1.10; just realize that you have a lower ceiling for upside if you do. Finally, if the stock rises above $48 by Friday, you'll want to roll your calls tomorrow, rather than lose your shares -- hence, this report today.

Pro Can Help

- **Want more on this strategy?** See our guides to covered strangles and synthetic longs. We're combining the two into a synthetic covered strangle.
- **Questions?** Ship yourself on over to our Expeditors board.

Tupperware Is Still Good

Published May 13, 2015 at 2:27PM

We're keeping **Tupperware** (NYSE: TUP) as a Buy, but we're content with our 2.7% allocation, rather than compelled to add to it for now.

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    Pro Guidance:
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• Buy (no change) at a 2.7% allocation
• Fair Value Est.: $74 (down from $76)
• Members lacking a 2.7% allocation can buy, or write June-Sept $65 puts to target a still lower price

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Tupperware is seeing a large relative decrease in reported sales and earnings due to the strong dollar, with revenue down 12% in dollars but up 3% in local currency. The company's leverage remains a bit high, but management believes revenue, cash flow, and earnings will increase over the coming 12 months, putting them in a position to buy back shares again. Currently, about $130 million of the company's $180M-$190M in FCF is going to the dividend -- which is getting a bit close for comfort. They do not plan to change the dividend, though, and should be able to steer through this with room to spare.

History

Our relationship with Tupperware dates back nearly six years, to June 2009, when the stock was $26. After writing a series of puts, we ended up owning shares at about $40, and enjoyed something around 100% appreciation to about $80 (plus dividends). After we sold via calls due to valuation, we saw a strong quarter or two and started writing puts again, getting new shares in the $80s, and adding more in the low $70s. More patience would have paid off instead (I had some concerns on the company's capital allocation as they kept buying shares in the $90s). But in the next three years, the stock still has good potential to challenge our North Star. Tupperware is far from our strongest business, though, so our small allocation today seems merited.

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  Q1 2015 Results
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• Revenue:    +3 local currency, down 12% in dollars
• Diluted EPS:  +4% local currency
• Emerging mkts: +8% local currency (66% of sales)
• Estab. markets: -6% (mainly Europe)
• Sales force:  -1% active sales force, up 2% total sales force
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Projections

Q2

• Q2 2015 sales growth of 5% to 7% constant currency
• Q2 2015 EPS of $1.14 to $1.19, up 11% in local currency, down 19% in dollars after $0.40 negative foreign exchange

2015

• 2015 FCF of $180 million to $190 million (down from earlier $200M guidance due to the dollar)
• 2015 sales in local currency up 4% to 6%
• 2015 EPS of $4.50 to $4.70, down from up to $5 est. due to currency, and down from $5.38 last year; shares have a 14.4x P/E at the mid-point of guidance

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========================
   Overview
========================
Recent Price:   $66.3
Dividend Yield:   4.1%
Payout Ratio:     71% (they want to keep it at 50% tops)
Market value:    $3.3 billion
========================

========================
   Pro Guidance
========================
Status:       Buy
Est. Fair Value:   $74
Allocation:     2.7%
========================

  Valuation@$66.30
   =============
Metric     Multiple
========================
EV/EBITDA      9.8
EV/EBITDA NTM est  9.5
P/E         17.5
P/E NTM       13.8
P/FCF        15.0
========================

========================
     Cash
========================
OCF         $289 million
Cap Ex        $69 million
FCF         $220 million

Cash & Equiv.    $84 million
LT Debt       $610 million
========================

========================
    Ratios
========================
Gross Margin    66.2% (up)
Cont. Op Earnings  7.6% (down on currencies)
FCF         9.9% (down on currencies)
ROA         12.3%
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ROC          20%
Debt/Equity     531%
Debt/Capital     84%
Debt/EBITDA      2.1 (targets 1.75)
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  Avg. EV/EBITDA
=========================
2003   9.4
2004   9.4
2005   8.9
2006  10.5
2007  10.7
2008   6.6
2009  11.1
2010   8.9
2011   8.6
2012   9.4
2013  12.0
2014   9.0
Avg.   9.5
Now   9.8
NTM Est 9.5
========================
```

• TUP has increased its operating margin from single digits in 2005 to the low teens lately, and believes it can improve further. Keep this in mind when considering historical valuation multiples above -- they should trend upward from 2005.

• TUP has addressed 25% to 30% of emerging market possibilities at the most, so there's much more room for growth. They should keep growing in China around 20% a year even if GPD there slips.

• Brazil, U.S. and Canada were strong, with U.S. and Canada sales up 7%. This was the third quarter in a row of sales growth there after refocusing efforts.

• Asia-Pacific was surprisingly weak, down 6%, but believed to be an anomaly.

• China was up 19%.

• Europe was overall weak, led by France, which suffered mightily under terrorist attacks. Parties were cancelled and mistrust remains in society. Germany, meanwhile, was strong, and Russia was also up.

• More scale will improve operating margins more than anything else; they're already very cost-aware; they need to efficiently drive growth (and productivity from the 2.9M sales staff) to get more scale.

• TUP expects better cash flow in 2016, leading to a stronger balance sheet and more possible share buybacks; they won't take on debt now to buy stock "cheap," since that additional debt is too risky. (I agree with them. Unfortunately, they took on debt earlier to buy stock when it was higher, which we didn't love at the time, and which ties their hands now. Lesson learned on their new share buyback strategy? Let's hope so. For all of us.)

How It Fits Into Pro

We appreciate that TUP provides non-tech exposure and profitable, growing consumer exposure in emerging markets. It trades at a reasonable price with a strong yield. We want to see management improve how it uses capital, though, and how it motivates and retains the sales force. The stock still merits a spot in Pro today, but even as we give the business leeway for a few soft years, we need to see signs that FCF will grow nicely over rolling-three-year periods. At this point, our stake in TUP doesn't need to be any larger than it is. We would rather add to it upon seeing signs of lasting structural and financial improvement than add now and risk not seeing improvement.

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For more details, please see the press release, presentation, and 10-Q. Post on our Tupperware discussion board with any questions!

American Airlines Sees Clear Skies Ahead

Published May 13, 2015 at 1:26PM

American Airlines (NASDAQ: AAL) CEO William Parker said during the recent first-quarter conference call, "... Anybody that really takes the time to study the industry and where it is now versus where it's been in the past knows it's different. I certainly know it's different, therefore I'm confident doing what I've done."

What has he done?

He decided to take all of his compensation in equity instead of cash. He believes, "My compensation should be paid in the same currency as we ask our shareholders to accept, because we should have interests that are highly aligned."

He's also willing to do this because he strongly believes it "really is different this time... I wouldn't be doing this if I thought it was still the same old airline business, because it's not. We're not suggesting there's not still risk in airline stocks, but we're really bullish on what the outlook is for years to come. So I'm more than happy to be compensated the same way you are."

He went on to clarify that it's still a cyclical business, but "the peaks are much, much higher than they were before, and the troughs are going to be much, much higher. And I think the swings are going to be much less." He believes this will prove out in the next downturn.

His view supports our investment thesis, wherein we argue that airline consolidation has led to more rational pricing and fuller planes. After decades where losses in the name of competition were accepted, the consolidated industry appears much smarter about money, and wants to fly profitably. Maybe the players are finally learning the lessons that Southwest Airlines (LUV) has been teaching for decades?

However, it's still not easy. The key themes in AAL's Q1 were:

- The company is tamping down its own capacity in many international markets, partly by delaying new planes. Demand is still growing, but capacity is growing more in some markets.
- Passenger Revenue per Available Seat Mile (PRASM) at AAL dipped again, partly due to the dollar, and due to competition.
- Lower fuel costs drove record profits, and lower-than-usual fuel costs are expected to last this year at least.
- With nearly $10 billion in cash, the company will continue to invest in its gates, planes, employees and share buybacks, and pay down debt.

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   Pro Guidance
=========================
Status:         Buy LEAPS (Jan. 17 $35 calls)
Stock price:      $49
Stock Fair Value Est: $70-78
Current Allocation:  0.9% in the calls
=========================
```

Q1 2015 Numbers:

- Pretax margin of 12.4%, with net profit of $932 million, or $1.30 per share (up from $480 million last year Q1).
- Operating revenues of $9.8 billion, down 1.7%, as mainline capacity at AAL declined 1.7%.
- PRASM down 1.7% with 1 percentage point being the stronger dollar; normalized, it was down 0.7% to $0.1565. (Rev per seat mile is priced like an option!) :)
- Avg. mainline fuel cost of $1.83 per gallon, down 41%
- Mainline CASM (cost per avg. seat mile) was $0.0949, up 5.8% primarily due to higher salaries
- $2.5 billion in cash from operations and $1.1 billion in Free Cash Flow this quarter

See the full press release

Notable Changes

This is a new position, so changes are few. However, the dip in PRASM and delaying of capacity is worth noting. It's not enough to change the thesis today, though.

Overriding Thoughts After My Review

- AAL continues to look like a deep value trading at 6 times 2016's post-tax estimated earnings, when it should merit about 10x assuming profits are here to stay.
- But it's not a slam dunk investment by any means. Risks are above average, because costs are steep, passenger demand could dip, and oil prices could surge.
- We are also dependent on competitors acting rationally. If they keep adding more capacity than is needed, that could lead to some trouble. This appears to be more of a problem internationally.

Outlook

- Strong results in Q2 last year, lower capacity today, and a 2-point currency headwind will lead to a 4% to 6% drop in PRASM in Q2.
- Beyond Q2, the outlook should improve.
- In 2016, the benefits of a single reservation system (after merging with US Airways) will start to show.
- AAL domestic capacity should still grow 2% to 3% this year, and international about 1%.

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    Overview
=========================
Recent Price:     $49
Yield (for owners):  0.8%
=========================
    Valuation
=========================
Market Cap:      $34 billion
Cash & Equiv.:    $9.9 b
LT Debt:      $17.6 b
Enterprise Value: $41.7 b
=========================
Metric      Multiple
=========================
EV/EBITDA       5.8
EV/EBITDA NTM     4.3 (our least expensive stock by far)
P/E         10.7
P/E NTM        5.1
P/FCF         NM
=========================
    TTM Cash Flow
=========================
OCF:    $4.3 billion
Cap EX:   $5.6 million (new planes and gate investments)
FCF:    -$1.3 billion
=========================
     Ratios
=========================
Gross Margin     30.4%
EBITDA Margin    17.8%
FCF Margin      -1.5%
ROA          8.3%
ROC         18.7%
=========================
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Owning calls on AAL is a way to own upside should the business continue to operate well enough to draw in more investors, and should oil remain lower than it has in recent years. If oil rises, or AAL mis-steps, our risk is reasonable and we're ready (worst case) to lose what we invested in the calls.

Whether or not we want to write diagonal calls on our LEAPS is currently a tough choice, but if we're going to, we may want to between earnings announcements. It's tough because the stock is viewed as a value play, and could run up on us, and if we're covered we ruin the reason we bought the calls. But, the calls pay well, and AAL shares could continue to languish for months since many believe oil prices will go up, and Q2 will likely be soft either way.

We are content to own the calls with 2017 in mind, but will continue to watch diagonal calls for possible income. If we move to write diagonal calls, that has to become part of the strategy of this position, rather than a conflicted "one-off" trade. So, if we start writing diagonal calls, it may be as a formal income strategy on this position between earnings reports.

Best,

Jeff

Opportunity Still Beckons for MasterCard

Published May 12, 2015 at 1:15PM

MasterCard (NYSE: MA) continued decent year-over-year growth in a difficult environment, and shares ascended to a new high. Our fair-value estimate increases a bit after two quarters, but the stock's valuation still does appear to be about 18 months ahead of its financial results (I attribute a small part of this to lost business, such as Chase, that is moving over to Visa). I imagine the market is giving MasterCard the benefit of the doubt and believes struggling economies will improve eventually, driving higher growth. Unrelated, the strong dollar is a large headwind that will someday reverse to become a tailwind, and China is a new, large long-term opportunity.

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=========================
   Pro Guidance
=========================
Status:        Buy (no change)(long-term outlook)
Fair Value Est:    $78 (up from $75)
Current Allocation:  4.5% (our fifth largest)
=========================

Key Q1 2015 Stats

Net Revenue:     +3% to $2.2 billion (+8% adjusted for currency)
Operating Expense:  -1% (+3% adjusted for currency)
Operating Income:  +5% (+12% adjusted)
Net Income:     +17% to $1 billion (+24% adjusted for currency)
Earnings Per Share: +22% to $0.89 (+29% adjusted)
WW Gross $Volume:  +12% (local currency)
U.S. GDV:       +7%
Volume Growth X-US: +14% (local currency)
Cross-border Volume: +19% (")
Processed Trnsactns: +12% to 11 billion
```

Notable Changes: The company still sees a struggling worldwide economy, and the strong dollar further weakens its results. But great cost management, continued transaction growth, share buybacks, and a lower tax rate all drove strong earnings-per-share growth. Is it sustainable? Perhaps for a few quarters, but we need to see economic improvements for MasterCard to maintain growth near today's levels for the long term. The opening of China's market starting in June is a giant potential opportunity, but it will take years to develop. Meanwhile, lower gas prices decreased U.S. gross dollar volume by 2 percentage points -- it's meaningful. Finally, MasterCard acquired Applied Predictive Technologies, a cloud-based analytics company. This will allow its customers to use their own data to measure the profit impact of marketing, merchandising, operations and spending. MasterCard wants to offer differentiating services to customers.

Overriding Thoughts After My Review

- Most of the world remains a large, long-term opportunity
- Cost management (and leverage) in the business remains impressive
- The Chase credit card roll-off (to Visa) remains a headwind to 2015 results
- The dollar is a large headwind that will one day change
- Much of the world is limping (Russia, Asia-Pacific, Latin America); how long will that last?
- Will Europe continue to slowly recover thanks to stimulus? It holds some logic
- Lower gas prices are a drag on U.S. results so far; consumers are saving rather than spending that money
- If this is MasterCard during weak times, we can look forward to strong times

2015 Outlook

- Currency-adjusted high-single-digit revenue growth, after a few slower quarters as Chase rolls off to Visa; low-single-digit revenue growth before currencies.
- Operating expenses should grow by mid-single digits on a currency-adjusted basis, but primarily due to a 7-point hit from acquisitions. Leverage remains in the business.
- MasterCard will provide a new long-term objective in September at Investor Day. The overall growth prospects in the industry have not changed. For now, it expects to meet its old long-term objectives on the low end (11% to 14% CAGR revenue growth and at least 20% CAGR EPS growth from 2012-2015, with at least 50% operating margins). But that's mostly history now.

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    Overview
=========================
Recent Price:     $92 (up from $74 one year ago)
Dividend Yield:    0.7%
=========================
    Valuation
=========================
Market Cap:    $104.8 billion
Cash & Equiv.:    $5.7 b
LT Debt:       $1.5 b
Enterprise Value: $100.6 b
=========================
Metric      Multiple
=========================
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```
EV/EBITDA      18.2
EV/EBITDA NTM    16.8
P/E         28.3
P/E NTM       26.2
P/FCF        29.3
=========================
    TTM Cash Flow
=========================
OCF:    $3.75 billion
Cap EX:   $181 million
FCF:    $3.57 billion
=========================
     Ratios
=========================
EBITDA Margin    57.8%
FCF Margin      35.7%
ROE         58.5%
ROC         40.7%
=========================
  Past 3-Year CAGR
=========================
Revenue       11%
EBITDA        12.6%
Net Income      23%
Diluted EPS     27.1%
Oper. Cash Flow   10.8%
=========================
=========================
 Historical EV/EBITDA
=========================
     Avg.
2006   12.2
2007   18.4
2008   17.9
2009    9.9
2010    9.9
2011   10.8
2012   12.8
2013   15.8
2014   16.9
Now    18.3
Avg.   14.2
NTM est. 16.9
========================
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Remaining Conference-Call Notes

- U.S. retail sales (ex-automobiles and gas) grew 5.1% in Q1, up from 4.1% last Q. (Side-note: Will this help FIVE?)
- Some improvements seen in U.S. and European economies, but much of Latin America and Asia-Pacific remain slow.
- China will require an initial capital commitment of about $160 million, but the long-term opportunity is large. MasterCard estimates that it'll be ready for business there before the end of 2016. China and India (the world's two most populous countries) are still 95% to 99% cash transactions, but already China is an enormous credit market (remember the stats in our Visa report? China rivals the rest of the world already; the question is, how much will the government let MA and V profit on it?).
- Reminder: Europe remains "an enormous opportunity" given that, outside of the Nordic countries, a vast majority of transactions are done in cash. Europe grew strongly last quarter with transaction growth in the low-20% range.
- MasterPass is live in 16 countries, and MasterCard is working with Samsung Pay, which will soon launch in the United States. (Of course, it's also on Apple Pay.) The company is technology-agnostic; it just wants to work with any secure payment system around the world.
- The company bought back 11 million shares at an average cost of about $86, for a generous $947 million. Clearly they believe the stock is worth more than we do, which is a good thing. We choose to be more conservative.
- We should think of rebate incentives as a good thing; they're front-end-loaded costs that lead to larger revenue growth later.
- Reiterated this point: MasterCard is growing rapidly in emerging markets, but there are different yield structures in many of them. You have to align your pricing structure with the local scenario. First, newcomers to cards use ATMs (withdrawing cash to go make purchases); those are much lower-yield transactions for MA. These users migrate later toward debit card and then credit card use, with higher yields for MA. Right now, MA is still in the lower-yield phase of many emerging markets. It's a long-term growth story.

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What We Think Now (unchanged): MasterCard's global network is a financial toll road that takes a small slice of each transaction. Though there are many established and upstart competitors, the world leader is cash with 85% market share, representing plenty of room for MasterCard to grow by offering a more convenient alternative.

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- MasterCard investor relations
- *Pro*'s MasterCard discussion board

Steady Growth From Broadridge

Published May 11, 2015 at 3:00PM

Pro's Take: BR Q3-2015 Earnings

Broadridge Financial Solutions (NYSE: BR)

Q3-2015

Quarterly recurring fee revenue growth: +4.7%

TTM Operating profit margin*: -84 bps to 22.5%

Quarterly EPS growth (Y-o-Y): +5.1%

*Operating profit / Fee revenue

This removes the impact of distribution revenue, which is a pass-through, and distorts the true economics of the business

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Quarter Quick Take

Broadridge's recent investments in its sales force are paying off-the company continues to generate excellent sales momentum, with a record $108 million in recurring revenue closed sales (RRCS) for the year-to-date period, up 74% compared to the same period a year ago. Although margins are facing near-term pressure due to those investments, the company has begun to lap the periods of elevated spending, and margin pressure should alleviate over the next several quarters. The company continues to pursue its tuck-in acquisition strategy, acquiring Direxxis LLC for $33 million in March, and acquisitions contributed 2% to growth in recurring fee revenue in the quarter. The company has now entered the strongest seasonal sales quarter of the year, and the business is well on track to meet or exceed management's guidance for FY-2015: recurring fee revenue growth of 5%-7% (YTD +5.2%), RRCS of $110-$150 million (YTD $108 million), and free cash flows of $320 million-$370 million (YTD $126 million).

Updated guidance: Buy (no change)

Recommended Allocation: 4.3%

Fair Value estimate: $49 (no change)

Based on management's guidance, at $51.50 per share, the stock is priced at about 20x projected 2015 cash flow and 22x projected 2015 GAAP EPS. Both of those metrics are near Broadridge's historical highs, but relative to its history, the company now has more stable cash flows, a steadier growth profile, strengthened competitive positioning, and higher margins to show for it. **There's no change to our recently updated fair-value estimate, and Broadridge remains a Buy.**

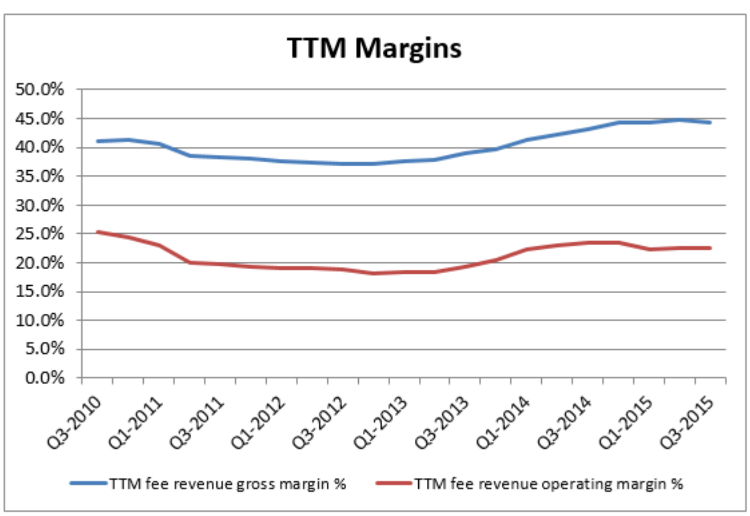
Our Thesis

Broadridge has a near monopoly in proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record and sound capital allocation policies make Broadridge a sturdy rock to build the Pro portfolio upon. We expect modest growth in fee revenue, slight operating leverage, plenty of free cash flow and a growing stream of dividends to help achieve North Star-like returns.

The Most Important Things

1) ***Recurring Revenue Closed Sales:*** This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (97%+). Tracking RRCS gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings. The company has been on fire with respect to RRCS, reporting record quarterly sales in Q1 and Q2. The strong performance continued into this quarter, with the company reporting $27 million in RRCS in Q3, up 13% from $24 million in the same period a year ago. Year-to-date RRCS are at a record $108 million, up 75% compared to $62 million over the same period a year ago. As such, the company has already essentially met the low end of its full year RRCS guidance ($110-$150 million). Seeing as Broadridge's fiscal fourth quarter is historically the strongest sales quarter of the year (over the least three fiscal years, Q4 has represented an average of 46% of full year RRCS), I'd be pretty surprised if the company doesn't meet or even exceed the high end of guidance for the year. Management mentioned that the sales pipeline remains strong, so I'm interested to see if the strong sales momentum continues into next quarter.

2) ***Fee Revenue Margin Performance:*** In order to track the true economics of the business, we look at gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue. And because of Broadridge's seasonality (related to annual filing deadlines for its customers) we prefer to look at trailing twelve months (TTM) margins to smooth out quarterly fluctuations. TTM fee revenue gross margins came in at 44.3% (up from 43.1% a year ago), and TTM fee revenue operating margins came in at 22.5% (down from 23.4% a year ago):



TTM operating margins are slightly depressed as the company has been investing in additional SG&A spend (i.e. commissions) to boost sales performance over the last four quarters. Given the company's outstanding performance in RRCS, I think this additional spending is justified. In part due to these investments, I expected margins to hold steady or decline slightly, and that's what we continue to see. However, as the year progresses, the elevated spending should roll off (for example, quarterly SG&A spend was down 4% y-o-y, while TTM SG&A spend was up 16%), and we should see some margin expansion if the company can continue its healthy sales growth.

3) ***Capital Allocation:*** Although Broadridge is a slow grower, it generates a lot of cash and has low reinvestment needs. Management recently updated its capital stewardship priorities for the next three years (through FY 2017), and management has a very clear plan to put that cash to work: it targets a 45% payout ratio, and it plans on using incremental debt capacity to pick up the pace of acquisitions (targeting $400-$600 million through FY2017) and share repurchases. On the dividend front, the company has paid out $1.02 per share on a TTM basis, good for a 49% payout ratio and about a 2% yield on the current price. On the acquisition front, the company is making good progress-they've closed three acquisitions this fiscal year (TwoFour, Direxxis, and Wilmington) for an aggregate amount of about $125 million. The company expects acquisitions to account for about 2% of growth in recurring fee revenue over the next three years, and the company is on track with that goal-they achieved 2% growth in recurring fee revenue in Q3 2015 due to acquisitions. As for share repurchases, the company bought back a net $109 million in shares at an average price of $52.90 per share in the quarter. As for debt, the company added $105 million in debt via their revolving credit facility, which has a variable interest rate between 1% and 2% (and may be refinanced into a longer-term instrument at some point in the future). This is consistent with the company's longer-term strategy to run the business at a debt-EBITDA ratio of 2:1 (based on my calculations the company is currently at about 1.2:1).

What We Think Now

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Pro Can Help

- **Questions?** Bring them over to the Broadridge discussion board.

Discipline or Dropping Anchors?

Published May 11, 2015 at 2:41PM

Fellow Fools,

Imagine it. You spend countless hours researching company XYZ, trying to figure out what its stock is worth. After many late nights, you finally come up with your estimate of fair value, but unfortunately, the current price doesn't afford you a large enough margin of safety. So, being the disciplined investor that you are, you decide to simply add it to your watch list.

A few months go by, and you decide to check back in on XYZ. Much to your surprise, the stock is now 25% higher! You spend the afternoon getting up to speed with what has taken place since you did your valuation work, but you don't find anything worthy of such a large move. Stumped, you decide to seek out two fellow investors you respect (I'm feeling imaginative today, so let's call them investors A and B).

After hearing you describe the situation, investor A replies that "investing is about waiting for fat pitches. It sounds like you're doing the right thing and remaining disciplined." But before investor A has finished, investor B interjects: "Wait a second, investor A. Can't you see that our friend here is engaging in anchoring? He's helplessly basing his belief about what the stock is worth on his original estimate, which might actually have been wrong! The market is subject to the occasional bout of irrationality, but it is also frequently right."

Compounding Biases

In the scenario above and its real-life counterparts, a fascinating question arises: Is the investor who passes on the stock remaining disciplined, or is she engaging in the cognitive error of anchoring and adjustment? On the one hand, we know that discipline is a must if we want to be successful investors. But on the other hand, our estimates of a stock's fair value are just that: estimates. And we know that anchoring around these estimates is a very real phenomenon, one that often causes investors to sell too soon or miss out entirely.

One of the biggest problems with behavioral biases is that they often end up combining with one another. This can make it rather difficult to peel away the layers and figure out what is really going on inside your mind. For example, whether you end up anchoring on a specific price can depend on another information-processing bias — the availability bias.

That is to say, whether you ultimately decide to stay on the sidelines or buy in after a large move can be heavily influenced by your most salient memories. Did you decide to pass on multiple stocks right before the financial crisis hit? Do you remember passing on stocks that ultimately went on to become multi-baggers? If you have memories of the former, you'll be more inclined to conclude you're being justifiably disciplined, while if you have strong memories of the latter, you'll likely start to question your original decision and whether you're now engaging in anchoring.

Not only that, but regret aversion, loss aversion, conservatism bias, and overconfidence bias also play a role (just to name a few). This really shouldn't come as a surprise, since as Roger Penrose once quipped, "compared to the complexity of a brain, a galaxy is just an inert lump."

My Investing Sextant

Whenever I find myself questioning whether I'm unjustifiably anchoring to a certain price, I like to look at three things to try and clear things up:

- **Measuring stick:** What am I using to determine whether I made the right decision? Ultimately, an investor's measuring stick needs to be the price of a stock, but prices can be an unreliable indicator over short time periods. So, instead of measuring my success based on the stock's behavior over weeks or months, I revisit my original thesis and expectations for the company. If I realize that the company in question actually has a far bigger end market than I originally estimated and I refuse to change my original estimate of the stock's fair value then I'm not just anchoring, I'm being stupid.
- **Time period:** The investment management industry was in large part built around a fundamental mismatch between performance and compensation. Ultimately, we should be graded based on how we were able to do over long stretches of time, but compensation is paid out on performance over much shorter periods. A 10% move in the wrong direction in the aftermath of one earnings release doesn't automatically mean that I made the wrong call. If the stock price is the only thing signaling a potential error, then I'm usually content to wait and see how things progress over the coming quarters.
- **Sample size:** Batting 1.000 is pretty much impossible when it comes to investing in stocks, so rather than spend all my time focusing on one decision, I prefer to look at multiple situations in which the key variables were somewhat similar. If the overall results suggest that my process works for me in a given situation, I don't spend time thinking about the one stock that got away.

Though our **Live Nation** (NYSE: LYV) position was not the inspiration for today's Memo, it does provide a great example of why it's so important to have a system for evaluating your investing process. Since we recommended writing puts at the end of March, the stock is up more than 7% thanks to an almost 11% jump after earnings earlier this month. Does that mean we made the wrong decision to write puts instead of simply buying shares? I'll have no problems issuing a mea culpa if our decision ultimately ends up being a subpar one, but at this point I believe it's too soon to tell. Using the actual numbers the company reported as our measuring stick (as opposed to the stock's reaction), the quarter was decent and the summer concert season appears to be shaping up in line with our expectations. And looking at the other two factors, our time period is still far too short and our sample size too small if we just consider the one put-writing position in isolation.

Skepticism, in Moderation

I originally chose my TMF name because I believe it's healthy for investors to have a little bit of skepticism and paranoia in them. The rationale behind our decisions might not always be obvious to us, so I always like to pause before acting to think about (a) what I want to buy/sell, (b) how I came to this conclusion, and (c) why I decided to act. But as with most things in life, there are diminishing marginal returns to this activity. Spending too much time thinking about your biases can lead to paralysis by analysis if you're not careful. We all have our own reasons for investing, but I don't think anyone does it because they like spending their days second-guessing themselves. Make what you believe is the best decision at the time and then learn from your mistakes and successes. That's what Foolish investing is all about.

Enjoy your week, Fools.

-- JP (TMFYossarian)

Pro Catch-Up Trades

- **Gentex** (NASDAQ: GNTX): If you lack a 3.1% position, shares have dipped lately, and remain a buy, as reported last week. Or, you can consider writing $17.50 puts.
- **OpenText** (NASDAQ: OTEX): If you lack a 2.7% position, the stock is down after earnings, and remains a buy.

Pro Catch-Up Trades: May 11, 2015

Published May 11, 2015 at 2:15PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking.*

- **Gentex** (NASDAQ: GNTX): If you lack a 3.1% position, shares have dipped lately, and remain a buy. Or, you could consider writing $17.50 puts.
- **OpenText** (NASDAQ: OTEX): If you lack a 2.7% position, the stock is down after earnings, and remains a buy.

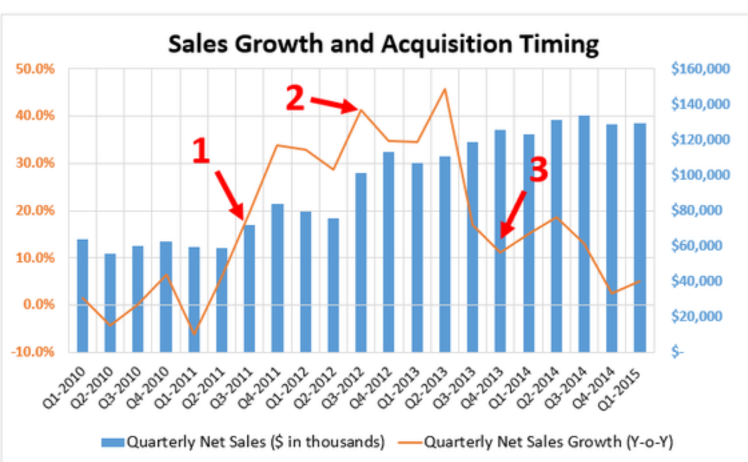
Boulder Brands: Discount Quality at a Premium Price

Published May 11, 2015 at 10:18AM

In its first quarter since *Pro* opened our short position in late March, **Boulder Brands** (NASDAQ: BDBD) reported modest results that met Wall Street's consensus expectations on revenue and adjusted EPS. The market reacted favorably to the report on the day of the release, bidding shares up almost 10% by the end of the day on strong volume. But the next day, on a day when all three major market indices were up over 1%, the stock traded down nearly 5% on lighter-than-average volume. It seems the market doesn't really know how it wants to interpret this earnings report. In any event, we're not too concerned with market movements or consensus Wall Street expectations, and after digging into the results we're content with how the business is progressing against our short thesis.

What Happened?

The company reported quarterly net sales of $129 million, up just 5% year-over-year. After fully lapping its most recent acquisition (EVOL) last quarter, the company's revenue growth now is fully comparable on a year-over-year basis and it's clear that growth is slowing now that acquisition-fueled gains have rolled off the books:

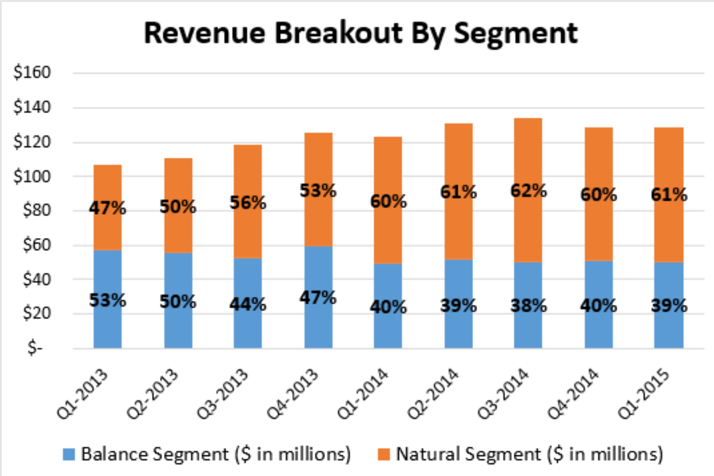


1) Glutino acquired on 8/3/11 for $66.3 million.

2) Udi's acquired on 7/2/12 for $126.9 million.

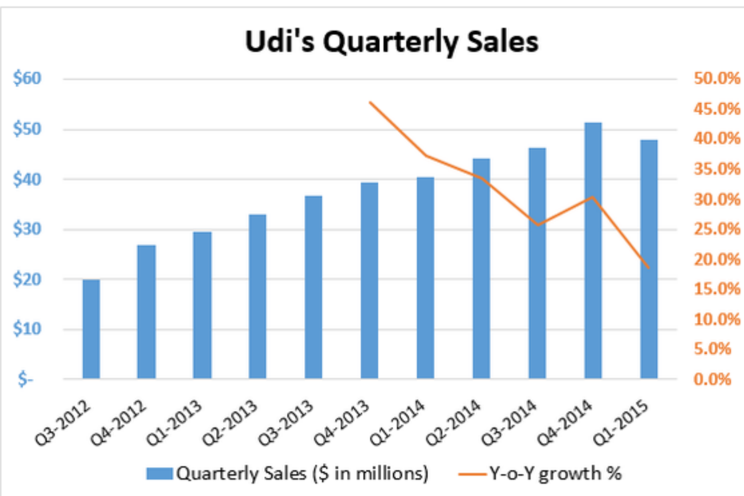
3) EVOL acquired on 12/23/13 for $48.9 million.

We can look at the company's two main reporting segments - "Natural" (i.e. the company's newly acquired brands: predominantly Udi's, Glutino, and EVOL) and "Balance" (i.e. the legacy Smart Balance brand and the newer Earth Balance brand) - to get a more granular sense of the trends in revenue. For context, here's how revenue between the two segments has broken out since Q1 2013 (the earliest date since the company reshuffled its reporting segments):

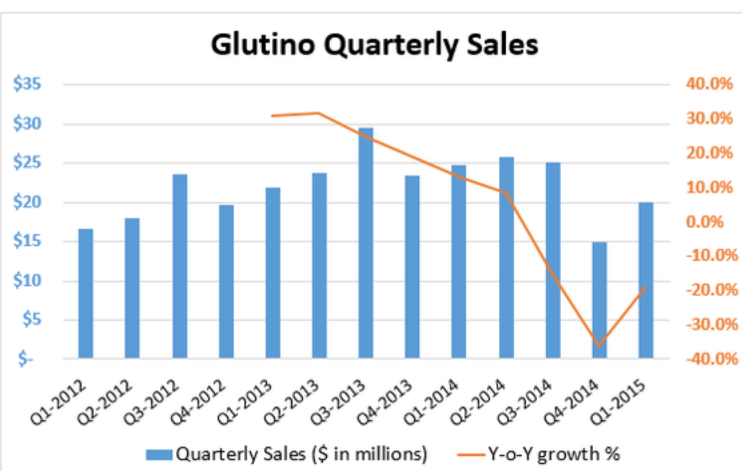


The Natural Segment:

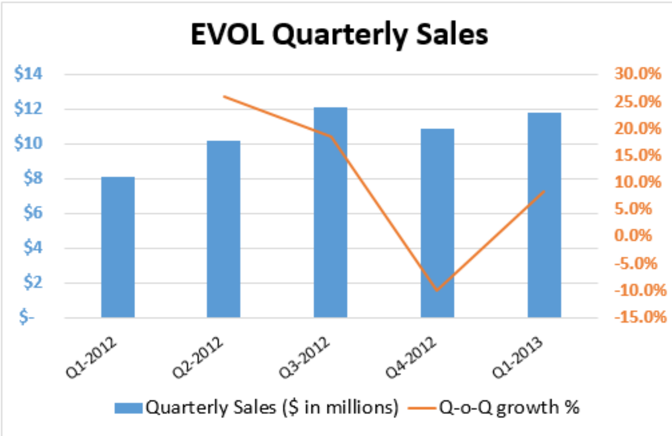
Despite guiding to 13% year-over-year revenue growth for the Natural segment for full year 2015, the company reported growth of just 7.6% in the first quarter. One of the most important facets to our short thesis is that growth from acquired brands is already slowing and may not be sustainable, so based on this quarter's data, that element of our thesis is tracking nicely. Because the company doesn't break out sales by brand in its reports (which obscures the ability to track growth), I have to back into the figures by using the limited data provided in the company's filings and information from company presentations. But based on my best estimates for quarterly sales, growth in the acquired brands continues to be less than inspiring:



It's encouraging to see growth slowing at Udi's as it has been the brand with the most momentum and I believe it has the highest potential to disrupt our short thesis. CEO Stephen Hughes mentioned on the call that they are "in the heart of the selling season", and the company's sales and marketing strategy is centered around Udi's, so we'll want to keep an eye on sales trends as the year progresses.



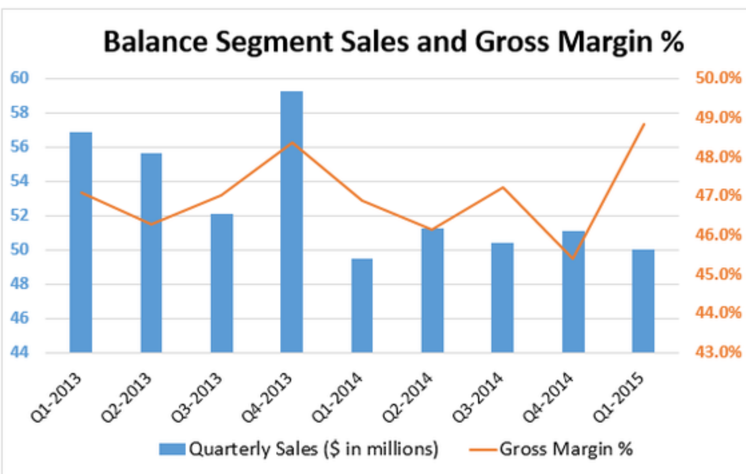
As for Glutino, despite a sequential uptick, year-over-year sales growth is still sharply negative. This brand is really struggling, and the company is working on revitalizing the brand by improving taste and quality. Part of the sales decline (about 4%) was due to discontinued items, which should continue until Q3 when the company will no longer be comparing to periods when discontinued items were still in distribution.



For EVOL, the acquisition is still pretty new and it's difficult to make conclusions about future growth. Year-over-year growth rates are strong (45%) as the company continues to build out distribution of the brand, and sequential (quarter-over-quarter) growth ticked up a bit after three straight quarters of deceleration. Along with Udi's, EVOL is an important part of the company's "Frozen Forward" sales and marketing strategy, so we'll continue to monitor sales trends as the year progresses.

The Balance Segment:

The Balance segment performed surprisingly well this quarter, achieving year-over-year growth in sales (of 1.1%) for the first time in four quarters. Gross margins increased substantially, up nearly 200 basis points:



However, the performance was affected by a few important items of note. For one, the segment benefited from an early Easter date (April 5th this year compared to April 20th last year), and sales in baking spreads tends to peak during that seasonal time period. This had the effect of pulling forward some sales, and will make year-over-year comparisons look good in this quarter and look bad next quarter. The Easter pull-forward had a $1.5 million positive impact on sales in the quarter, indicating that absent the timing factors, sales growth would be down about 2% year-over-year.

As for gross margin, it was likely somewhat affected by the Easter sales gains, but the company mentioned that the gross margin increase was "primarily driven by our strategic decision to reduce trade and couponing for Smart Balance". As mentioned in our original write-up, reduced spend in marketing may boost margins in the short term, but it impacts long-term brand positioning and sales growth and sustainability. I'm expecting pretty poor performance from this segment throughout the rest of the year as reduced trade spend should negatively impact future sales and the difficult Easter comparison period lies ahead next quarter.

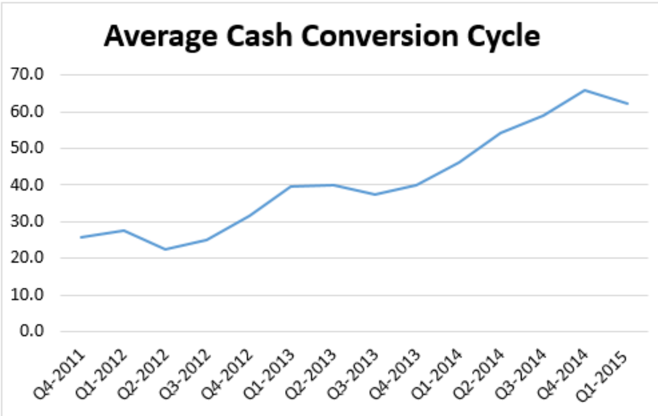
So What?

Overall, I don't really understand why the market viewed this earnings report so favorably. The trading patterns of this stock are a bit confusing. I think the 10% gain on the day of the release was in part due to heavy selling ahead of the earnings report - the stock declined 12% between April 27th and May 6th (the day before earnings). So the stock is more or less trading around the same price as it was before the sharp decline leading up to the report.

Perhaps the market was impressed with the strong uptick in gross margins, but if that's the case then I think the market is misguided, since it was mostly due to the seasonal factors and reduced trade spend which should negatively impact future sales and margins in the company's stagnating Balance segment. Additionally, sales growth trajectories are pacing below guidance (on pace for $516 million in sales vs. guidance midpoint of $555 million), although the company may be able to achieve guidance if sales and marketing efforts pay off in the upcoming quarters.

However, the company is limited in its ability to spend on marketing due to strained financial flexibility. The company produces enough operating earnings to cover its debt maturities, capital expenditures, working capital needs, and interest expense, but there's not very much left over to reinvest back into the business to reinvigorate growth. If sales slow further due to limited investment in marketing, the company's financial picture might get even worse. They really need sales growth to pick up in order to give themselves some breathing room, and so far it's not happening.

Finally, the company's earnings quality did not meaningfully improve in the quarter. Accounts receivable (up 17.4% y-o-y) and inventory (up 14.9% y-o-y) yet again grew faster than sales (up 5% y-o-y). And although the company's cash conversion cycle improved a bit (i.e. decreased) this quarter, it's still quite elevated compared to recent history, indicating relative difficulty in converting inputs to cash:



Note: Figures in this graph differ from the graph in the original report due to a change in the calculation of days payable outstanding-I'm now excluding "other accrued expenses" from the days payable calculation.

Now What?

After reviewing the quarter, I don't feel much different about the company or our investment thesis. As I've mentioned before (bottom paragraph in that link), the primary driver of whether this short will be successful or not will be the growth trajectory of the company's recently acquired brands and the stagnation (or turnaround) of the company's spread business. In this quarter, we saw what looked like the start of a turnaround from the spread business, but in fact the numbers were inflated by a timing-related benefit and reduced trade spend, which will likely hurt results throughout the rest of the year. The growth trajectories of Udi's, Glutino, and EVOL continue to show signs of weakness as earnings quality did not meaningfully improve and future growth will be dependent upon the company's effectiveness with its sales and marketing campaigns. Due to limited ability to invest in sales and marketing, I think the company will face meaningful hurdles in generating healthy, accelerating growth, especially as bigger competitors with stronger financial positions continue to angle for their share of the natural and specialty foods market.

After adding back the $150 million goodwill impairment incurred in Q3 2014 and using a normalized tax rate of 40% (management's guidance for full year 2015), at $9.50 per share the stock trades at 54x trailing adjusted earnings. Even using management's non-GAAP earnings (which exclude a variety of "non-recurring" costs despite these costs having been ongoing since Q3 2011), the company trades at 42x trailing non-GAAP earnings. On a forward basis, the company trades at 35x management's 2015 guidance for non-GAAP earnings. And based on my optimistic estimates (the company meets sales guidance, improves operating margins to 7.5% for the year from 6.8% this quarter, and does not incur any "one-time" costs) the company is trading at 41x expected 2015 earnings.

Based on a simple discounted cash flow model, the current market price implies strong, sustained revenue growth and margin expansion over at least a decade. Given the company's meaningful issues related to operational momentum, earnings quality, financial flexibility, and governance, we frankly don't think that's likely to occur, and we think the intrinsic value of the stock is much lower than the current market price. **Boulder Brands remains an active, though volatile, short on the *Pro* scorecard with a 1.5% allocation, and members who have yet to initiate their short can feel comfortable shorting at or near current prices.**

Fool on!

--Billy

Pro Can Help

- **Questions?** Visit our Boulder Brands discussion board.

Earnings News From 4 Pro Companies

Published May 4, 2015 at 11:48AM

Dear *Pro* Fools,

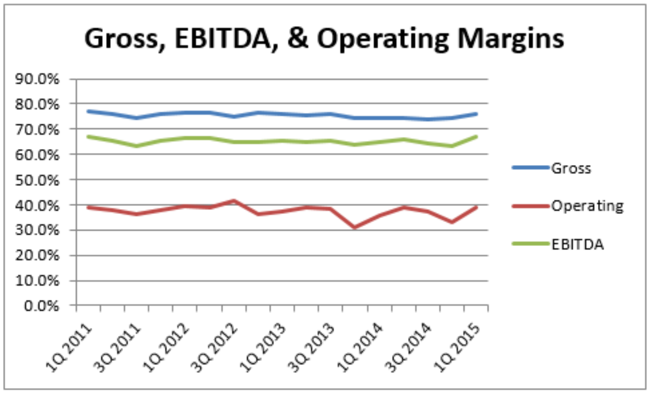
It's that time again -- earnings season! Your *Pro* team has been working hard to analyze our companies' recent earnings reports, and in this Memo I'll take the opportunity to update you on four of the companies I cover for the portfolio: **American Tower** (NYSE: AMT), **Gentex** (NASDAQ: GNTX), **Parexel** (NASDAQ: PRXL), and **TD Ameritrade** (NYSE: AMTD). I'll give a quick overview of each company, summarizing results and recapping our investment theses now that I've had a chance to dig into the numbers and monitor business progress. **All four positions remain active holdings on our scorecard for new and veteran members alike.**

The Results

American Tower

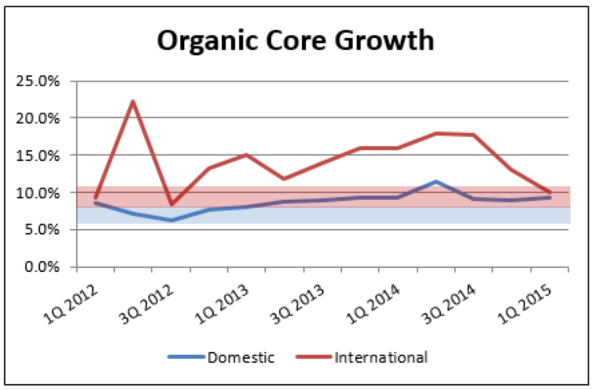
AMERICAN TOWER®

American Tower had a very solid first-quarter 2015, reporting healthy core growth in revenue (16%), adjusted EBITDA (18%), and adjusted funds from operations, or AFFO (22%), the three headline metrics I watch closely. This strong growth was in spite of continued foreign-exchange headwinds that knocked about 4% off reported revenue. Adjusted EBITDA and AFFO growth outpaced revenue growth, indicating rising margins.



Part of the margin performance is because AMT is better able to leverage operating expenses as the business grows, but timing factors also played a role. Expenses related to maintenance and preferred stock distributions were lower than expected, and revenue -- thanks to a $17 million decommissioning agreement with one of AMT's major tenants -- was higher than expected. So we may see slower revenue growth and stagnant or declining margins in the coming quarters as these factors dissipate and new acquisition-related assets (and their lower margin profiles) make up a larger portion of the company's revenue. But over time, we should see margins tick up as scale and incremental leasing activity on new assets take hold.

Organic core growth slowed a bit this quarter, coming in at 9.3% domestically (7.4% excluding the decommissioning agreement) and 10% internationally, reflecting the slowdown in carrier spending and lease activity seen in late 2014. But management stated on the call that their application pipeline showed a significant increase in the quarter from three of their four top customers, supporting the expectation that new leasing activity (and thus organic core growth) should pick up in the second half of the year. Organic growth in the quarter was still on target with management's expectations (shaded areas reflect management's guided ranges):



Source: Company filings and conference calls.

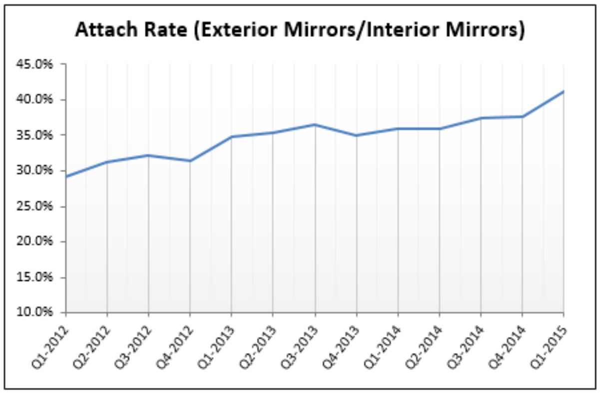
Overall, the company's business performance and compounding dynamics continue to impress me. American Tower steadily reports strong revenue and profit growth despite a difficult currency environment, and it's able to reinvest its copious cash flow at high rates of return. We continue to believe this company is extremely well-positioned to benefit from the continued growth of technological innovation in the global telecom industry. After incorporating the company's recent performance and increased guidance (which now includes the impact of the Verizon transaction), **we've increased our fair-value estimate to $115 per share**. This includes a dilutive impact of about 8% from the stock offering that was used to help fund the Verizon transaction.

Though it's more of a tech/telecom company than a real estate company, American Tower tends to trade alongside the REIT sector, so its stock price has stagnated as market speculation around interest rates has whipsawed REITs. The stock's near-term weakness makes our call purchase in December look a bit poorly timed, but the short-term volatility is exactly what we were looking to capitalize on with that purchase. In fact, if the share-price weakness continues, we may even consider increasing our allocation to the calls (as we hinted in the original report). The business is as strong as ever, but shares are trading at the lower end of recent historical ranges. At current prices, based on sandbagged 2015 EBITDA guidance (which hasn't yet incorporated the acquisitions yet to close), the company trades at about 18.6 times EV/EBITDA. The last two times the company traded at such a low multiple were in the third quarter of 2013, when it was the subject of a short attack by Muddy Waters, and in the third quarter of 2011, in the midst of a market correction attributable to the European sovereign debt crisis. **We think shares are significantly undervalued, and the stock is a Buy First, with a 3.4% stock position and 0.4% in January 2017 $80 calls. With shares currently about 18% below our fair-value estimate, members who have yet to fill out their allocation should consider doing so.**

Gentex

GENTEX CORPORATION

After missing guidance on sales and profits last quarter, our mirror maker rebounded with an excellent first-quarter 2015. The company posted 10% year-over-year net revenue growth, 11% EPS growth, and total mirror unit growth (interior and exterior) of 11%. The strong unit growth was achieved despite a 2% decline in worldwide light vehicle production, so we know Gentex continues to gain market share. Results were especially strong for exterior mirrors, with 23% year-over-year unit growth and a record exterior attach rate of 41.2%.



The exterior attach rate shows how many of Gentex's interior mirror systems come with exterior mirrors "attached" as well, and because exterior mirrors are both more complex and more profitable, higher is better. The success in exterior mirrors played a part in increasing margins, with gross profit margin coming in at 38.8% vs. 38.4% a quarter ago:

Gross profit margins are an important metric for Gentex, as powerful automakers force annual price concessions on their suppliers and the company must reduce production costs and add new features to hold the line on average selling prices and gross margins. The company performed well on that front during the quarter -- total units sold (interior and exterior mirrors) increased by 11.4% and automotive segment sales were up by 10.5%. These figures suggest slightly lower ARPU (average revenue per unit), with price per unit declining less than the typically cited range of 2.5% to 3%.

Because of operating-expense leverage and currency fluctuations reducing staffing costs in overseas markets, operating margins increased as well, up to 29.2% from 28.1% a quarter ago. Additionally, margins are slightly depressed in the short term because of increased costs associated with new product launches. As those costs roll off by the end of the fiscal year, management hopes to see continued improvement in gross and operating margins. Accordingly, and in part because of current foreign exchange rates, management lowered its operating expense guidance for fiscal 2015 (implying higher profits).

Gentex's strong profitability and cash generation has led to a rising cash balance. The company now has $1.37 per share in net cash and investments on the balance sheet (about 8% of the current share price). In addition to the $0.08 regular dividend in the quarter (a 1.8% forward yield on the current share price), management continued the recent string of share repurchases, buying back $25 million worth of shares in the quarter at an average price of $17.86. This marks three straight quarters of share buybacks for the company, each bigger than the quarter before (they spent $10 million two quarters ago, and $20 million last quarter). Management is typically very selective with buybacks, so I view this as a signal that they foresee continued strong performance in the quarters and years ahead.

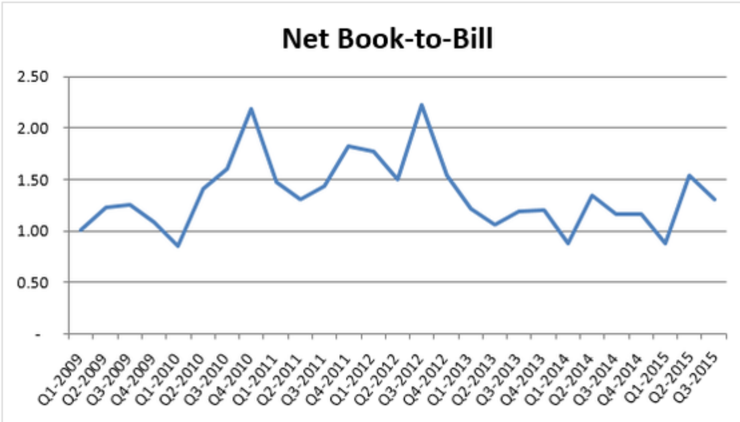
As for *Pro's* position, we own a 3.1% allocation and wrote $17.50 puts that expired as income in March. Since then, we've been waiting to see a quarter of results before deciding whether to write new puts. Once we update our valuation (likely after Gentex files its 10-Q), we'll decide whether to continue our written put strategy. **Gentex remains a Buy, and members who have yet to fill out their allocation should feel comfortable purchasing shares at current prices.**

Parexel

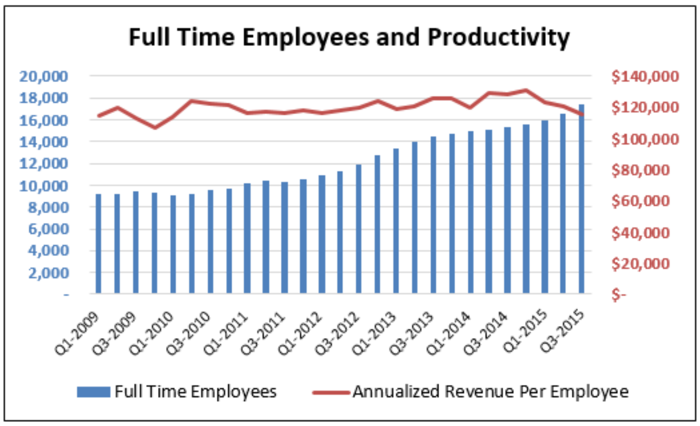
PAREXEL®

As is typical for our biopharma contract research organization (CRO), Parexel reported a lumpy fiscal third quarter, which ended March 31, 2015. The company missed its own guidance on revenue because of foreign exchange effects and client delays on projects in the consulting division. Consolidated service revenue came in at $502 million, up just 2% year over year (5.1% when excluding the $15.4 million negative impact of foreign exchanges). Gross margins in the company's largest division (clinical research services, or CRS, which accounts for almost 80% of consolidated revenue) declined 126 basis points sequentially and 283 basis points year-over-year, landing at 28.8% and contributing to a year-over-year decline in companywide gross profit for the first time since the first quarter of 2012. Accordingly, the stock sold off almost 7% on the day of the earnings release as the market digested the company's results.

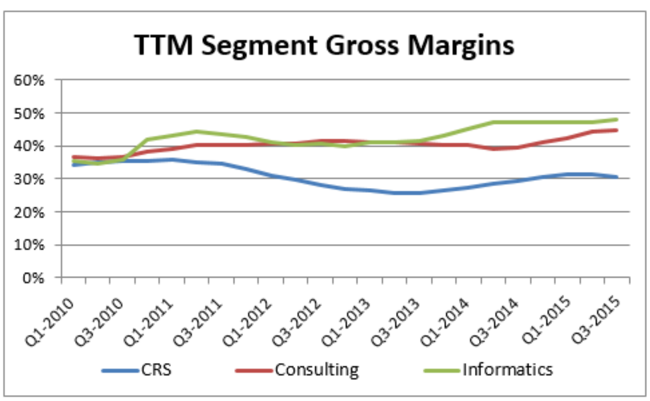
But if we dig deeper than the seemingly negative headline numbers, Parexel is progressing just as we expect. We wrote last quarter that currency headwinds and a sales mix weighted toward younger projects in the start-up phase "should continue to pressure reported revenue in the near term (and backlog growth should outpace reported revenue growth)." And that's exactly what we saw this quarter, with backlog growth of 5.3% year over year and net new business wins up 14% year over year. The net book-to-bill ratio came in at 1.3 this quarter, suggesting healthy demand:



The decline in gross profit was expected and is also not worrisome -- I wrote last quarter that "we should expect to see project mix continue to pressure gross margins in the CRS division into the rest of 2015." The company continues to hire employees in anticipation of a ramp-up in revenue as multiple projects mature through the next quarter and beyond. Headcount increased 14% year over year, and those new hires mean the company's revenue per employee is historically low; it's likely to bounce back over time as projects progress, new-employee productivity improves, and revenue growth resumes at a higher pace.



The margin expansion story for the rest of the business is intact. Gross margins in the company's other two divisions (consulting and informatics) continue to tick up on a year-over-year basis, driven by cost controls and a favorable business mix, and we expect this trend to continue.



Despite a volatile share price, the company continues to track well against our investment thesis (that Parexel should benefit as the CRO industry picks up a higher percentage of biopharma R&D spending). Management comments suggest that revenue growth should begin to pick up on a sequential basis as the company's project pipeline begins to mature, and we'll be watching to make sure revenue growth and margin expansion stay on track as the year progresses. **After incorporating recent results into our model, we're increasing our fair-value estimate from $57 to $59. Shares remain a Buy with a 3.4% allocation.**

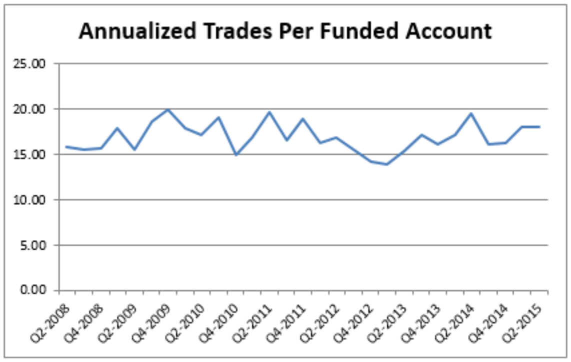
TD Ameritrade

TD Ameritrade

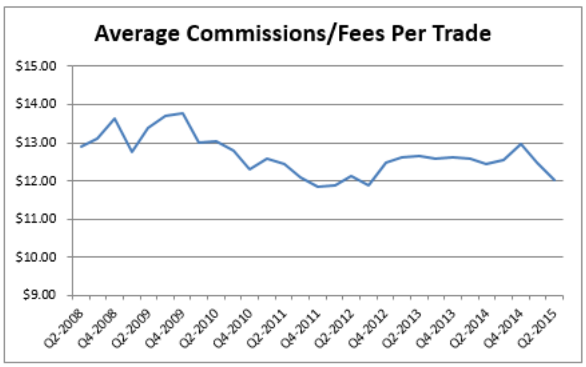
TD Ameritrade delivered a solid second quarter (its fiscal year begins in September of the previous year), boasting record client assets of $695 billion and record fee-based investment balances of $155 billion. But the market wasn't particularly pleased with the results, with shares trading down nearly 3% on the day of the release despite a flat day for the S&P 500. TD Ameritrade met earnings expectations with $0.35 per share (flat year over year) but missed consensus revenue expectations, posting quarterly net revenue of $803 million vs. an expected $820 million, a 1.1% year-over-year decline. Additionally, higher operating expenses pushed operating margins down to 36.9% from 42% a quarter ago.

Despite the lackluster headline results, the underlying business trends remain strong. TD Ameritrade is still doing what it's done for a long time – gathering assets at a healthy pace, stimulating higher trading activity through its award-winning platforms, and generating impressive results from its fast-growing fee-based business.

The main culprit for the revenue miss was lower average commissions per trade. Despite healthy trading activity, with annualized trades per account at the higher end of the company's historical range ...



... average commissions and fees per trade saw a significant sequential decline, coming in at $12.03, at the lower end of the recent historical range:



Management explained this on the conference call by noting that volatility in the energy sector increased investors' appetite for commodity futures, which rose to a record 10% of trades, up from 7% last year. Futures have lower commissions per trade than almost anything else TD Ameritrade offers, and increased volume was the primary contributor to the drop. We're not concerned about the drop in transaction-based revenue, as trading activity will vary from quarter to quarter based on market developments, and the company continues to increase its derivatives activity (now a record 42% of trades per day) and mobile activity (now a record 15% of trades) at a consistent clip.

TD Ameritrade continues to excel at adding net new assets, adding $16.3 billion in the quarter (excluding changes due to market fluctuations), a 10% annualized growth rate. Specifically, the fee-based portion of the business continues to grow rapidly and gain market share. Fee-based balances were up 16.1% year over year (accelerating from 15.5% growth a quarter ago), and investment-product fee revenue was up 13% from a year ago. Fee-based revenue now accounts for an 11% (and growing) share of net revenue, and we expect continued strong performance from this part of the business.

Overall, despite lumpy quarter-to-quarter results, TD Ameritrade continues to steadily increase its earnings power while maintaining strong upside to rising interest rates. Meanwhile, we benefit from a stable (and growing) regular dividend, occasional special dividends, and share buybacks. There's no change to our recently updated $35 fair-value estimate, but after reviewing earnings, **we're moving shares to Buy from Buy First on valuation**. The stock is trading above our fair-value estimate, and results are volatile enough to make its downside profile more in line with our Buys than with our Buy Firsts. **Despite the guidance change, members who have yet to match our allocation can feel comfortable doing so at current prices.**

The *Pro* Bottom Line

In summary, after going through results and updating our valuations, we've made the following changes:

- **American Tower:** Fair-value estimate increases from $110 to $115; shares remain a Buy First, with a 3.4% stake in stock and about 0.4% in calls.
- **Gentex:** No change to fair-value estimate; shares remain a Buy, with a 3.1% allocation.
- **Parexel:** Fair-value estimate increases from $57 to $59; shares remain a Buy, with a 3.4% allocation.
- **TD Ameritrade:** No change to fair-value estimate; shares move from Buy First to Buy on valuation, with a 2.9% allocation.

Each of these four companies continues to progress well against our investment theses, and we continue to believe that each will deliver North Star-beating returns (lately around 8% to 9% annualized) over the next rolling three-year period.

If you have any questions about this Memo, feel free to stop by the appropriate company's discussion board:

- American Tower
- Gentex
- Parexel
- TD Ameritrade

Fool on!

— Billy (TMFTailwind)

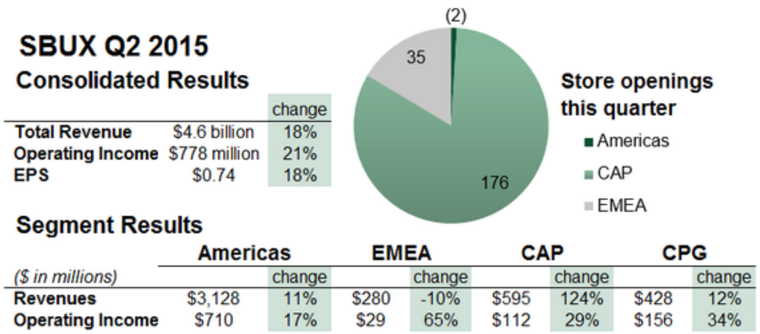
***Pro* Completed Trades**

- **AIG** (NYSE: AIG): Our shares were sold at $56.74, and our calls at $26.74.
- **Visa** (NYSE: V): We bought 800 shares (2.1%) at $66.67.

Delicious, Hand-Crafted Results at Starbucks

Published May 4, 2015 at 9:12AM

There was no post-holiday caffeine crash for **Starbucks** (NASDAQ: SBUX) during the second quarter, as the company once again posted excellent results.



Updated Guidance and Valuation

Updated guidance: Buy (no change)

Recommended allocation: 3.2%

Fair-value estimate: $43 (up from a split-adjusted $41)

Current Multiples

Multiple	trailing	forward
P/S	4.3x	3.7x
P/E	30x	29x
EV/EBITDA	18.5x	16x
P/FCF	29x	

Investment Thesis

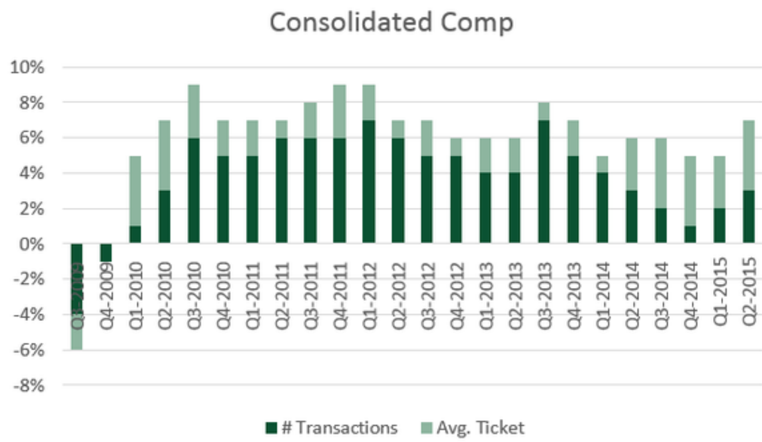
Starbucks offers a unique blend of sales drivers (domestic and international growth, food and beverage innovation, and channel development, just to name a few) and cost-reduction opportunities (payment innovation, European restructuring, expansion of consumer product margins). We believe the coffee is just a gateway for the company to repeatedly sell customers an experience rooted in comfort, quality, health, community, and conscience. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand into new products, new platforms, new times of day, and new brands. We expect new store openings across the globe to strengthen the company's brand and cost-based competitive advantages and improve profitability over time.

With a company as large as Starbucks, you might think there isn't much more room for growth. But you'd be wrong. As laid out during the company's most recent Biennial Investor Day presentation, management believes that within five years, Starbucks will increase its store base to more than 30,000 global locations (up from 22,088 today), achieve $30 billion in annual revenue (up from $17.7 billion TTM), and double its annual operating income. Given the global strength of the Starbucks brand, we believe that this is definitely possible.

Results

Comparable-Store Sales

	Q2 2015			Q2 2014		
	Sales growth	Change in transactions	Change in ticket	Sales growth	Change in transactions	Change in ticket
Consolidated	7%	3%	4%	6%	3%	3%
Americas	7%	2%	5%	6%	2%	3%
China, Asia, Pacific	12%	10%	2%	7%	7%	0%
Europe, Middle East, Africa	2%	2%	1%	6%	5%	1%



Americas

The closure of 132 licensed locations at Target stores in Canada (sorry, Jim!) meant a year-over-year decline of 130 net stores in Starbucks' largest segment, the Americas, but revenue was still up 11% YOY while 110 basis points (bps) of operating margin expansion resulted in even better operating income growth (17%). A 7% Americas comp was particularly impressive on the back of a strong 6% comp in 2014. Results for both food and tea offerings were robust (sales up 16% and 15%, respectively) and we continue to see food sales meaningfully contribute to the Americas comp. Food attach rates were higher in every region and time of day, and contributed 2 percentage points to the Americas comp.

China, Asia, Pacific (CAP)

CAP had an equally impressive quarter, with revenue and operating income up 124% and 29% respectively. At first glance, the divergence of these two growth rates might sound alarming, but it's important to remember that the change in accounting treatment for the remaining Starbucks Japan stores is the primary culprit. Starbucks' acquisition of those stores had a negative impact of 1,470 bps on CAP operating margin, even though they're actually some of Starbucks' most profitable locations. I believe investors should pay close attention to the fact that the net decline was actually only 1,390 bps because the company achieved a positive 80 bps of sales leverage. As of the end of fiscal 2014, Starbucks' EMEA segment (see below) was still its second-largest geographically, but I wouldn't expect that to last for too much longer. The company opened 176 stores this past quarter in CAP and has opened 769 net new stores in the region in the last 12 months. With 5,034 stores in this region, Starbucks is now more than halfway toward its goal of 10,000 CAP stores within five years.

Europe, Middle East, Africa (EMEA)

The turnaround story for this region continues. The 2% comp isn't the best in an absolute sense (especially when compared to the results in CAP and the Americas), but I believe that the move to shift this segment more toward licensed stores in order to help improve profitability is the right one. The opening of 35 net new stores helped the company report record results in this region even though foreign-currency headwinds reduced overall company revenue by two percentage points.

Channel Development

Net revenue for this division increased by 16% for the quarter, while operating leverage helped drive margins higher and increase operating income by 23%. As we've mentioned in the past, there is a tremendous opportunity here for Starbucks as it continues to reach consumers in more than 1 million places that *aren't* retail stores. This is important because when Americans drink coffee, they do so in a coffee shop only 20% of the time.

***Pro*'s Take**

During the company's most recent investor day, the management team laid out their seven strategies for growth:

Source: 2015 Annual Meeting of Shareholders

And while it will take multiple quarters, if not years, before the final verdict is in on whether the company is hitting its goals, I believe the early signs suggest it's headed in the right direction.

In particular, I was very impressed with the continued strength in gift card amounts, mobile adoption, and My Starbucks Rewards (MSR) membership growth. Historically, the company hasn't broken out the dollar amount loaded on to gift cards each quarter, but management did mention that number was $1.6 billion last quarter. This quarter's $1.1 billion was pretty impressive, too. Deferred revenue has grown at a compound annual growth rate of almost 20% since 2010, and while this isn't a completely clean look at gift card use (only the remaining unused balance is captured on the balance sheet at the end of each quarter, and deferred revenue also includes other items including the value of unredeemed items MSR members have earned), I do think it gives a strong directional indication.

MSR members growth also continues to be robust. The company added around 1.3 million members this quarter and now has more than 10.3 million in total, which is 14% higher than at the end of last quarter (and 27% higher than at this point last year). We know that MSR members are more valuable to the company (they tend to spend up to four times as much) and that growth in gift-card usage begets MSR membership growth, so these metrics are great signs.

App usage was also up 23% quarter over quarter and now accounts for 19% of transactions. And while we're still in the early innings of the Mobile Order & Pay rollout, management noted that it's driving an increase in the daily transactions attach rates in the 600 stores where the service is currently offered.

Even though we're increasing our fair-value estimate by almost 5% to $43, the stock remains higher than that as the market has recently increased the multiple it's willing to pay for Starbucks shares. But we're keeping our Buy rating because I believe that, as it stands right now, Starbucks is currently in a position where its operational execution can still leave members with North Star-like returns even if multiples contract somewhat. History doesn't always repeat itself, but for some context, consider that back in October of 2013 the EV/EBITDA multiple for the stock was the highest it's been in the past five years (more than 20). The stock was trading for around $40.45 then, so even though the multiple has contracted somewhat over the subsequent months, the CAGR for the stock over this time frame was more than 14% excluding dividends.

Questions? Comments? We snagged you a table on the Starbucks board.

OpenText's Long-Term Story Looks Unchanged

Published Apr 30, 2015 at 1:22PM

Greetings, Fools!

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==================================================
Guidance Unchanged

• Fair Value Estimate remains $55 (No Change)
• Remains a Buy at our 2.8% allocation (or write puts)

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OpenText (NASDAQ: OTEX) CEO Mark Barrenechea was on the conference call, spoke a lot, and said he's on track with his 100-day treatment for Leukemia. So, that's great news. The company is going full steam ahead, as it's of course bigger than any one person, as he put it. He's still working, too, just traveling less.

To the third quarter: A confluence of factors sent earnings much lower. The culprits: Foreign currency exchange rates hitting sales, more customer transitions from pricier upfront license deals to subscription cloud deals, weakness in Europe, Middle East, Africa -- basically everywhere but the U.S. -- a higher tax rate for OTEX, higher interest expense following acquisitions with debt, and bad debt write-offs at GXS, which OpenText acquired more than a year ago (GXS had debts on the books that passed one-year-old, so OTEX took the full charge, even though it plans to recover as much of the funds as possible). Macro-economic issues aside, many of these financial factors are one-time.

Now OpenText is in its fourth quarter, traditionally a stronger quarter. Nearing the end of its 2015, year-to-date on a constant currency basis the company has grown revenue 30% and adjusted EPS 15%, and even its license software growth rate is 6%, while cloud is growing much more. OpenText is agnostic about what customers sign on for -- cloud, license, or otherwise. They just want to form the relationship and earn the revenue over the years. Just as **Oracle** (NYSE: ORCL) says, cloud revenue becomes beneficial compared to license revenue after 3 years. It just takes time for the cloud subscription revenue to add up to the upfront license cost.

It was definitely a surprisingly weak quarter when it came to income, with a lot of factors I'm still going through in detail, but the long-term story looks unchanged and remains promising. We will consider writing puts to potentially add to the position over time, or buying shares directly, especially if the price goes lower. Time will tell. We have to be cautious and patient because the expected growth rate for OTEX (and many companies) is coming down quickly to account for currency rates and a slower-than-expected world economy. It seems we're currently on shakier ground, when it comes to near-term growth potential, than we've been in a long time. And that seems largely universal, at least for international companies. Of course, that could change as soon as a quarter from now, too. Nobody knows. That's why we invest for the longer haul.

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  Q3 2015 Results
=========================
• Revenue:    +1% to $447 million (+8.1% constant currency)
• Adj. Net Inc: -20% to $81 million (-13% constant currency)
• Diluted EPS:  -21% to $0.66 (-13% constant currency)
• Oper cash flow: Up slightly, new record at $144M
• Recurring rev: +3.8% to $384M, 86% of revenue (+10% constant currency)
• License Rev:  -12% to $64M (down 4% constant currency)
• Cloud Rev:   +12% to $144M (+17% constant currency)
• Dividend:   +16% to $0.80 per share/year
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Background

OpenText sells enterprise information management (EIM) software via cloud, license, or managed services contracts to help customers organize and run electronic content, business processes, regulatory and other data.It also conducts, invoices, and manages business transactions through GXS. Through a recent acquisition (Actuate), it's now offering data analytics, too, which can fold into its software over time. The company's sales are spread across industries, governments, and geographies, but the Americas were 58% of sales, EMEA 33% and Asia only 9% last quarter.

Pro's thesis: The enterprise information management (EIM) software industry will grow by about 10% annualized over the long haul, and OpenText will grow stronger than the industry every rolling three years. In addition, OpenText will be a leader in business exchange transactions, and recurring, fee-based revenue will grow. As long as shares are reasonably valued and OTEX continues to serve its markets well, we should enjoy healthy long-term returns.

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    Overview
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    Guidance
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Fair Value Est:   $55 (no change)(15.3x NTM EPS est.)
Current Allocation: 2.8%
Status:       Buy (and/or write puts)
Yield:        1.5%
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   Valuation @$51.85
 $6.3 billion market cap
========================
Metric     Multiple
========================
EV/Sales       3.9
EV/EBITDA      13.6
EV/EBITDA NTM est. 11.6
P/FCF             13.9
P/E GAAP      25.0
P/E NTM est.    14.2

NTM = Next Twelve Months
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   TTM Cash Flow
========================
OCF         $526 million
Cap Ex        $74 million
FCF         $452 million

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   Balance Sheet

Cash & Equiv.    $632 million
LT Debt      $1.58 billion (due to recent acquisitions)
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    Ratios
========================
Gross Margin    71.7% (all good numbers trending up YOY)
Cont. Op Earnings  13.6%
FCF         23.5%
ROE         15.2%
Debt/Equity     89.8% (we want to see this trend down
and successful acquisitions!)

Debt/Capital    47.3%
=========================
Historical Avg. EV/EBITDA
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2005  10.2
2006  10.0
2007  11.8
2008   9.6
2009   9.9
2010  10.0
2011  11.3
2012  11.0
2013  13.8
2014  17.2
Now   13.6
NTM Est 11.6
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Recent License Growth
========================
Q3 2014 6%
Q4 2014 27%
Q1 2015 6%
Q2 2015 (7%)
Q3 2015 (12)

License is becoming less relevant as cloud sales grow
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Key Conference Call Notes

• Operating margins should remain at 28% to 32% this year

• Cloud services revenue should continue to grow most rapidly; the industry continues to move toward cloud, as more customers what more flexibility; OTEX has been selling cloud for going on three years now, and it's becoming a substantial part of the business

• OTEX remains focused on recurring revenue (now 86% of sales), adjusted net income, and cash flow.

• Along with currency rates, revenue was affected by customers taking longer to ponder license vs. cloud deals. And macro weakness especially in EMEA (Europe, Middle East, Africa).

• The Blue Carbon software release is on track for the end of this calendar year.

• The company continues to seek more acquisitions; prices are up a bit.

• Renewal rates on maintenance revenue are very strong, in the low-90% range.

• Cloud revenue was up 17% constant currency.

• The headlines for Q3, the CEO said, were foreign exchange hits, cloud transitions (which slow revenue recognition), EMEA macro weakness, "some unique expense items, strong cash flows, and a strong product lineup."

Review Material

• OTEX's large cloud operation: 25 core data centers around the world; 1,500 production racks; 150,000 square feet of raised floor space, 900 managed customers, 60,000 cloud customers, 600,000 trading grid partners, nearly 2,000 staff (of 8,000 total at OTEX)

• The Actuate acquisition allows OTEX to bring analytics everywhere within the OTEX ecosystem -- on-premise, in cloud, and to the development community. Actuate has been providing analytics for 20 years. OTEX closed on Acuate on January 16. The enterprise value was $272 million, or 2.5x revenue. They have 500 employees in San Mateo, with 72% of revenue in N. Amer and 28% the rest of the world. There's an opportunity to grow it around the world. Some customers include The Royal Air Force, Shell, Johnson Controls. Partners include Cisco and Dell, NetApp and NCR. They'll stay in San Mateo. Initially, Actuate is hitting OTEX's margins.

• I like this quote from CEO Mark Barrenechea last quarter: "Fifteen years ago you could be Amazon-ed. Today, you could be Uber-ed, which is a reflection of digitalization. OpenText is well-positioned, as our vision is a digital-first world, and our key platforms allow customers to begin digitalization of their enterprise processes today, such as the customer journey, supply chains, risk and governance, innovation and employee functions."

• SAP relationship remains strong.

Bottom Line

In summary, it was not an attractive quarter on the bottom line! We dislike seeing any of our investments earn less income. But cash flow remains strong, and revenue is growing in constant currency. Currency is a big headwind with the euro down 18% against the dollar since last fall, but eventually currency will be neutral, and then it will be a tailwind. Eventually. We have to get through that (with all of our international companies) and make sure OTEX stays focused on growing the underlying business with strong profits. Today, the overall business remains on track and the shares, reasonably valued, remain a buy. When currency is a tailwind and the business is still growing (against lower comparisons a year ago, too), it should result in very attractive looking growth rates down the road, for OTEX and others.

This was a quick review of yesterday's results and conference call; when and if I have more, I'll share it.

(For more from OpenText, including full investor presentations, please see the company's IR site:http://investors.opentext.com)

Please post questions ...

Best,

Jeff

Impressive iPhone Sales Give Apple Another Stellar Quarter

Published Apr 28, 2015 at 4:12PM

See for Yourself

- Check out Apple's earnings release.

Apple's (NASDAQ: AAPL) second-quarter earnings are out, and it should come as no surprise that the numbers are impressive. Sales grew 27%, to $58 billion, and earnings per share rose 40%, to $2.66, for the quarter. Below are a few points to note from the earnings release and conference call:

- Gross margin ticked up 150 basis points for the quarter to 40.8%.
- International sales made up 69% of overall revenue for the quarter.
- China sales were up 71% for the quarter to a record $16.8 billion.
- Revenue for the third quarter is projected to be $46 billion to $48 billion.
- Third-quarter gross margin is projected to be 38.5% to 39.5%.

iPhone

iPhone sales were solid again in the second quarter, with 61.2 million units sold and very strong performance in emerging markets. The average selling price for iPhones jumped $62 compared with the same quarter last year, to $659, thanks to a strong mix of 6 and 6 Plus units. Management noted that it continues to see a stronger rate of consumers switching to iPhones from rival devices compared with previous cycles. Executives also said that they estimate that about only 20% of users have upgraded to iPhone 6 or 6 Plus, indicating robust demand to come.

iPad

Tablet sales continue to decline; Apple sold sold 12.6 million iPads compared with 16.4 million a year ago. This isn't really news — the replacement cycle for iPad simply isn't like that of the iPhone. However, strong performance in Japan and China, as well as ongoing opportunities in enterprise, demonstrate that there are still plenty of opportunities to enlarge the iPad consumer base.

Macs and Services

Apple sold 4.6 million Macs in the quarter for 10% year-over-year growth. Management was particularly encouraged that this happened while the global PC market contracted 7%. The company's services revenue grew 9%, to $5 billion, thanks to strong performance in the App Store. According to market data firm App Annie, the App Store generated 70% more global revenue in the March quarter than did Google Play, up from a 60% lead in the September quarter.

Apple Pay, the Watch, and a Dividend Raise

Not long ago, management referred to 2015 as the year of Apple Pay, and executives continue to be encouraged at the progress they're making. **Discover** (NYSE: DFS) has signed on as a partner, **Best Buy** (NYSE: BBY) offers Apple Pay in-app and will roll out in stores later this year, and a leading health-care payment network will bring

Apple Pay to more than 50 major hospitals around the country.

The reception of Apple Watch has been positive. Those sales don't affect the second quarter, but we will start to see those sales in the third-quarter. Although Apple didn't provide any information about how many watches have been sold, CEO Tim Cook noted that Apple Watch margins will be lower than the company average for the foreseeable future.

Management increased the size of Apple's capital return program from $130 billion to a whopping $200 billion. (I guess when you have $193.5 billion in cash and equivalents on the balance sheet you can do things like this.) But it's worth noting that more than $171 billion of this is held offshore. For the quarter, Apple spent $7 billion to repurchase 56.4 million shares and paid out $2.7 billion in dividends. The company also announced an 11% bump in the dividend, from $0.47 to $0.52 per quarter.

The *Pro* Bottom Line

At a 4.6% position that has been rated "Buy" for a long time (and "Buy First" before that), Apple remains one of the largest holdings in *Pro*. Pro needs to run a valuation update following these strong results, but the expectation today is the stock will remain in the portfolio. Although this is a bit of a different story today than it was a few years ago, the business is still innovating and growing — it's just growing a little more slowly than before. And that's OK by us ... Fools are patient.

Buy Visa

Published Apr 28, 2015 at 3:09PM

How You Participate

- **Action:** Buy **Visa** (NYSE: V).
- **Allocation:** 2% (*Pro* will buy about 760 shares).
- **Scorecard Status:** Buy
- **Fair-Value Estimate:** $72
- **Recent Price:** $66.70
- **Dividend Yield:** 0.7%
- **Price Guidance:** Use a limit order and initially aim to pay less than $67. As prices change over time, this starting guidance will quickly lose relevance; as that happens, **our guidance will remain "Buy"** until we officially notify you otherwise.
- **Special note:** Visa announces earnings the evening of Thursday, April 30. We have no idea how the stock will react, but it shouldn't affect our rolling three-year outlook as we start to buy shares. That said, if you don't like buying into volatility, you can wait a day.

What We're Thinking

The ubiquitous nature of credit and debit cards in America means that many of us can go through life rarely touching cash. Yet in the U.S., cash still accounts for approximately 40% of transactions, followed by debit cards at 25% and credit cards at 17%. And globally, cash is truly still king: **MasterCard** (NYSE: MA) estimates that 85% of consumer transactions take place with old-school paper and coins. But all of that is slowly changing as economies modernize and middle-income families proliferate, bringing more converts to the benefits of electronic payment. With its mission to "accelerate the electrification of commerce," industry leader **Visa** (NYSE: V) has most of the world left to conquer.

The Business

Created by a group of banks when Gerald Ford was in the White House, Visa has been building its competitive moat and powerful brand for 40 years,but it only went public in 2008, in the fog of the financial industry meltdown. After that came a downpour of new regulations, and though the dust is still settling, we can see Visa for what it is: an extremely profitable, well-run organization with plenty of long-term potential. Even during the world's economic malaise, Visa has been able to increase revenue by 10.8% annualized the last three years, and cash from operations 21.4% annually. As economies expand and *more* money changes hands, Visa will benefit further. Inflation helps, too, because much of Visa's revenue is based on transaction value.

As with *Pro* holding MasterCard, Visa doesn't issue credit cards or carry consumer loans. Instead, it licenses its brand to issuing banks and operates the largest electronic payments network in the world, VisaNet. Set up in 200 countries and territories, VisaNet handled $4.5 trillion in payment volume in the year ended March 2014. That's greater than the nominal GDP level of every country or region except the E.U, U.S., China, and Japan (according to IMF estimates), but it still represents less than 6% of the world's estimated $77 trillion in 2014 GDP ... and GDP keeps growing.

Keeping it simple, Visa's business has one reportable operating segment, "Payment Services." Encompassing Visa-branded debit, prepaid and credit cards, its business makes money from:

- **Service Revenue** (38% of $15.3 billion in gross 2014 sales): Primarily a toll collected on the *dollar volume* transacted on Visa cards.
- **Data Processing Revenue** (34%): Fees for network access, including authorization, clearing, and settlement. These fees are based on the *number* of transactions.
- **International Transaction Revenue** (23%): Transactions conducted across country borders, resulting in international transaction fees and currency fees. Volatile currency exchange rates help Visa make more money.

Other client services account for the rest of revenue (5%). Overall, all revenue is offset by a cost called "client incentives," which are long-term payment contracts with banks and partners to promote the use of Visa. Client incentives were about 17% of revenue in 2014, and are expected to remain in the high teens for now. These incentives may in part have helped Visa recently wrestle the giant **JP Morgan Chase** (NYSE: JPM) portfolio of business away from MasterCard and win the **Costco Wholesale** (NASDAQ: COST) account from **American Express** (NYSE: AXP). (Costco represented nearly 8% of Amex's annual dollar volume.)

These new clients will add significantly to Visa's business (in relation to Costco, starting in 2016). And Visa already dwarfs its competitors on the electronic commerce stage, likely lending it more negotiating power with customers, whether they're banks, merchants, or partners. Here's how 2013's $8.6 trillion in payment volume was dispersed.

Company	Payment Volume ($billions)	Transactions (billions)	Cards (millions)
Visa	$4,383	89.7	2,219
MasterCard	$2,991	52.7	1,281
American Express	$940	6.4	107
Discover (NYSE: DFS)	$127	2.2	64
JCB	$176	1.9	83

Diners Club	$26	0.2	6

Source: Visa 10-K filing, 2014.

As large as Visa appears, these numbers exclude Visa Europe, which is a separate business that Visa may purchase someday. They also exclude China, where foreign companies have not been allowed to compete. Estimated at another $6.8 trillion in size and growing 33% last year, the Chinese debit and credit card market is slated to open to Visa, MasterCard, and other competitors starting in June. Until now, the market has been run by Chinese monopoly UnionPay. Visa is already on the ground in China with limited operations and long-term partnerships. Details of the new Chinese laws are pending, and growing a business there will be a long process, but it brings access to another 20% of the world's population in a country with ever-increasing affluence. Fun factoid: China now accounts for more iPhone sales than North America.

With the world's income growing, electronic commerce spreading, and new markets opening across the globe, if we had to choose one word to describe Visa's business, it would be "tailwinds." But we could just as easily choose "leadership," "moat," "growth," or "leverage."

Financials

Measured by the profitability and scalability of the business, Visa has one of the strongest business models of any in the *Pro* portfolio. Costs to run its payment network are largely fixed, so increases in revenue – through any combination of new card users, more transactions, or greater dollar volume – largely fall to the bottom line, bringing larger percentage gains in income. With a net income margin of 43% (up from 34% in 2009) and return on equity above 20%, Visa is turning more than 50 cents of every sales dollar into free cash flow. That cash can be reinvested to drive more card usage at higher returns, turning the business into a compounding machine.

You don't often get to buy this type of company on the cheap, especially in a bull market. We're paying a premium price of 23.8 times trailing free cash flow and 22 times expected earnings per share for the year ending September 2016. Annual revenue growth is expected to be about 10% over the next two years, but annualized earnings-per-share growth over the next five years is estimated at more than 18%. Given leverage in the business, today's slothful economy, and Visa's abundant free cash flow, odds favor additional positive catalysts that we're not counting on today.

Whether we're correct about that or not, we're still comfortable starting a position in Visa today. As the common axiom has it, history shows it's better to pay up for an outstanding business than to buy a mediocre one at a discount. It would likely take incredible technological evolution or devastating regulation to derail Visa's trajectory. So far, Visa has its finger on the pulse of new ways to pay, including **Apple** (NASDAQ: AAPL) Pay, and although regulatory battles in the U.S and Europe are far from over, the worst of the storm may have subsided along with the financial crisis.

How It Fits Into *Pro*

For too long, we've allowed our 4.3% stake in MasterCard to be the sole representative of our belief in the long-term promise of electronic payments. Visa deserves a spot alongside it. We're starting Visa at only a 2% allocation, so our combined direct exposure to the industry will be 6.3%. Obviously, we still like MasterCard as well -- and notably, that stock has always looked expensive, too, but it has been one of our best performers. With that combined exposure, we still have room to add a bit more to either position, or to another company in the financial industry, partly because we're removing more than 4% exposure to financials by selling **American International Group** (NYSE: AIG).

Adding Visa to our portfolio now may remind some members of when we added **Apple** (NASDAQ: AAPL) in 2012. Some believed it was too late to buy such a giant company at a nearly $500 billion market value. Our return on Apple is 88% (excluding dividends) in less than three years, and now its market value is $773 billion even following giant share buybacks. Visa is valued at $165 billion, and given its tiny market share, its ceiling should be much higher than that. It fits into *Pro* as a recurring-revenue business that invests its free cash flow in more growth at still higher rates of return, making it a compounding vehicle.

Visa is everywhere you want to be -- except in our portfolio. It's high time we change that.

Alternative Trades

- **Only want to target lower buy prices?** You can sell to open puts, one for every 100 shares you would buy at lower prices. Take your pick of options, but realize this is a Buy stock and we're starting with a direct 2% stake.

Pro Can Help

- **Feeling charged up to chat?** Ask questions and comment on the new Visa board, where we're ready to network with you via our own "FoolNet."

Sell AIG Stock and Warrants

Published Apr 27, 2015 at 1:21PM

Is this for you? This trade is for Fools who own shares, warrants, or calls of **AIG** (NYSE: AIG).

How You Participate

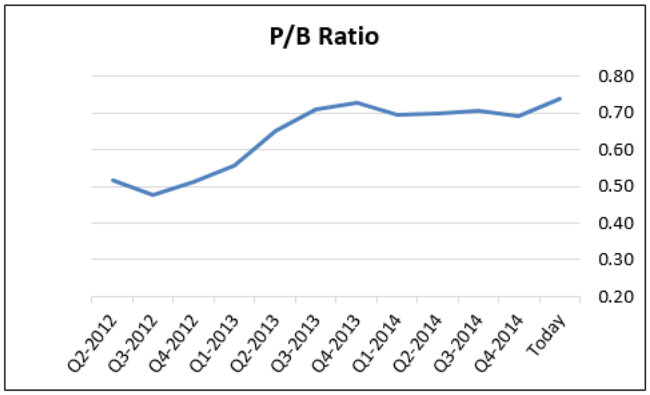
- **Trade:** Sell AIG stock and warrants.
- **Allocation:** We recommend selling the entire position -- both shares and warrants (or calls if you have them in lieu of warrants, as we do). For *Pro*, that is 1,500 shares (3.4% of our portfolio) and six calls (0.6% of our portfolio).
- **Price Guidance:** For the stock, **use a limit order** to aim to sell as close to the going market prices as possible. For the warrants (or calls), **it is imperative that you use a limit order to aim to sell as close to the midpoint of the bid-ask spread as possible**. These are thinly traded and **will** be affected by a spike in volume.
- **Recent Prices:** Stock, $56.90; warrants (bid/ask), $23.79 / $24.00
- **Scorecard Status:** Sell
- **Note:** AIG reports 2015 first-quarter earnings on Thursday, April 30, so if you want to avoid price volatility associated with earnings, aim to close your position before then. This is especially important for members with calls (rather than warrants) that expire soon, as leveraged option gains can be ephemeral. Those with longer-dated positions can likely afford to be more patient if increased volume results in lower pricing. As always, consider your own portfolio, your cash, and your tax situation before undertaking any stock sale. Finally: As we've said in the past, most of the stocks we sell will probably continue to do well once we're out of them. But when our thesis has been met for a non-core holding, we are apt to sell and move the funds into a position that promises greater long-term compounding.

What We're Thinking

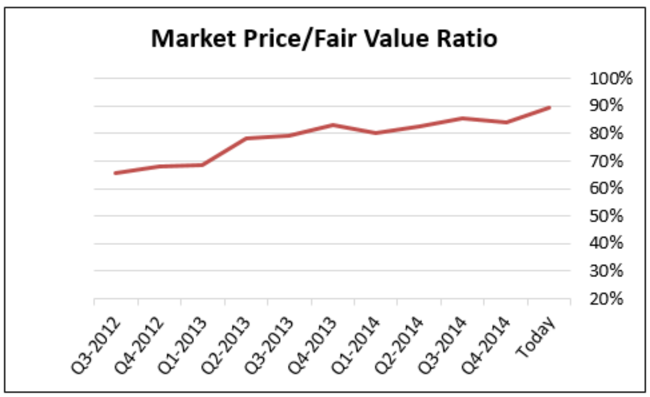
Today, we're recommending that you sell your entire stake in AIG – both stock (*Pro* holds a 3.4% allocation) and warrants (because we can't track warrants on our scorecard, *Pro* owns a 0.6% allocation in January 2016 calls). Here's why:

- **The market has rewarded AIG with a higher price-to-book ratio as the company's operations have improved.** When we first recommended buying AIG stock and warrants in [August 2012](), the company was still disentangling itself from a near-collapse that had almost brought down the world's financial system. The Federal Reserve and the U.S. Treasury had provided billions of dollars in bailout funds to AIG, and the company was a black sheep among investors and to the public – hardly anyone wanted to touch it (except us!). The valuation at the time reflected that sentiment, with the stock trading at 0.56 times book value.

  Since then, the company has done an admirable job cleaning up its operations – paying back the government in full, divesting non-core assets, and improving its core insurance operations to the point where it is now solidly profitable and able to pay out a regular dividend. As the market has recognized this improvement, it



  has rewarded the company with a higher valuation:
- **It's neither dirt cheap nor a core *Pro* holding.** For our core long holdings, *Pro* aims to buy outstanding businesses that will ideally compound our capital for many years to come. These outstanding businesses tend to share certain characteristics (for example, sustainable competitive advantages, pricing power, and expanding product possibilities). We've long stated our belief that AIG is just a so-so business, deficient in many of those characteristics, and that we own it because it is cheap. AIG's discount to our fair-value estimate is currently at its narrowest since we initiated the position, so we believe now is as good a time as any to say farewell to a so-so business that has turned out to be an excellent investment.



The *Pro* Bottom Line

Any asset can be a good investment at the right price, and AIG is a great example. We bought undervalued shares when market sentiment was almost universally negative. Since then, we've achieved a 62% cumulative return (23% annualized), earned via modest dividends and strong stock and option price appreciation. We've long stated that we'd be happy to part with our position if the stock nears our fair-value estimate, and we think now is an opportune time to cash in our chips.

Again, bear in mind that AIG is set to report earnings after market close on Thursday, April 30. No matter whether the stock goes up or down after the report, we'll be happy with our decision, and we look forward to putting our capital to work elsewhere.

Pro Can Help

- Questions? File your claim on the AIG discussion board.

Deep Cuts From the Pro Vault

Published Apr 27, 2015 at 11:51AM

Pro Guidance Changes

- **American International Group** (NYSE: AIG): Shares move to Sell as we exit this non-core position as it nears our fair-value estimate. Please read the sell report and consider your own situation before selling.
- **Facebook** (NASDAQ: FB): Fair value moves up to $80 (from $72). The stock remains a Buy with a 4.5% allocation. See our earnings review.
- **Earnings Reviews:** Just a friendly note that we're going through earnings on many of our companies right now, and updates will be issued as ready. So far, none of our Buy guidance has changed; our many Buys remains Buys, and our few positions on hold are being evaluated for new buyers. And of course, we work for you, so you'll be the first to know when this guidance changes!

Dear *Pro* members:

George Santayana once famously said that "progress, far from consisting in change, depends on retentiveness. When change is absolute there remains no being to improve and no direction is set for possible improvement: and when experience is not retained, as among savages, infancy is perpetual. Those who cannot remember the past are condemned to repeat it." So in the ongoing quest to avoid perpetual infancy, I've recently taken up the task of learning more about *Pro*'s history -- much to the chagrin of Jeff and Ellen, as this has resulted in me asking them even *more* questions. [Editor's note: We actually don't mind this, but we do act annoyed to keep him on his toes. You have to *earn* your way onto this team.]

Polaris Award 2015

Now in its third year, our Polaris Award honors the *Pro* members who contribute so much to our thriving community -- and we need your help to choose the nominees. Tell us who you love >>

Given this new hobby of mine, it was only natural that I decided to comb through the archive of *Pro* Monday Memos. It was, perhaps, even more natural that I should choose to do so in search of inspiration when I found myself with a severe case of writer's block and the deadline for *this* Memo fast approaching. I came away with a much better understanding of how the portfolio evolved over time, what Jeff & Co. were thinking about in years past, and how our style has evolved -- so much so that I decided to create a time capsule, if you will, of some of *Pro*'s earliest memos.

Do be aware that this isn't a collection of the best of the best per se; rather, it's simply a collection of Memos I enjoyed reading. For those of you who, like me, are relatively new to the service and are interested in learning more about *Pro*'s history, I'd encourage you not to stop with just the few below -- take it from me that combing through the Memo archives in their entirety is a great way to spend a lazy afternoon or Sunday morning. And for those of you who have been here since the beginning, get ready to take a trip down memory lane!

- It only seems right to start with Jeff's first Monday Memo.
- And here's the first Memo that talks about shorting. Out of curiosity, I decided to check how many of the stocks mentioned in this Memo have underperformed the S&P 500 since it was published on Nov. 10, 2008. (Disclaimer: I know it's unlikely that someone would keep a short position on a particular stock on for this long in the real world.) As it turns out, Jeff and former *Pro* analyst Todd Wenning got three out of five correct: **Citigroup** (NYSE: C), **Weyerhaeuser** (NYSE: WY), and **Zions Bancorp** (NASDAQ: ZION) have all underperformed on a capital-gains basis, while **Brinker International** (NYSE: EAT) and **Trina Solar** (NYSE: TSL) have beaten the S&P 500 over the subsequent years.
- *Pros* vs. Joes: In this December 2008 Memo, Todd and Jeff noted that TMF's CAPS All-Stars were displaying more bearish behavior while the rest of the CAPS community was getting more bullish. It's interesting to note that the market hit a bottom only a few short months after this Memo was published.
- What did the *Pro* portfolio look like in early 2009? Take a peek.
- Three days after the aforementioned market bottom, what was *Pro* talking about? South Park, tractors, and Europe, naturally.
- *Pro*'s Buy Firsts, the July 2009 edition.
- And here's an interesting 2009 Q&A session with Jeff and Todd.
- Thinking long and hard about short positions: Jeff chimes in with another great memo on shorting.
- Here's what *Pro* was up to in early 2010 with what Jeff dubbed "*Pro*'s biggest update ever."
- How do you get started analyzing a company? Todd gives his take in this memo.
- What would Ben Graham think of *Pro*? Former *Pro* analyst Bryan Hinmon offers his thoughts.
- I have a dog named Hobbes. The title of this Memo is a reference to the *Calvin and Hobbes* comic strip. Of course I'm going to include Nick's memo discussing the three investing lessons of Calvinball.
- Jeff chimes in on four traits he believes every great investor should have.
- It may seem like a distant memory, but it wasn't all that long ago when volatility was par for the course.

Do you have any favorite Memos from previous days? Share them with us on the Memo Musings board!

Foolishly yours,

-- JP (TMFYossarian)

Celebrate Our Community: Polaris Award 2015

Published Apr 23, 2015 at 10:58AM

Pro Polaris Award 2015

And the winner is ...

fullofcarp!

Want to offer your congratulations and adulation? Do so on this discussion-board thread -- but note that fullofcarp let us know he's traveling through tomorrow, May 19, so he may not respond immediately.

As proposed by ADrumlinDaisy in 2013, the Polaris Award is "a *Pro* community analogue of the Feste Award, an annual award given to the member who provides the most value to his or her fellow members." Criteria include a regular, frequent, Foolish presence on the *Pro* discussion boards; helpful, expert-level advice; creativity; and efforts to foster a sense of community.

As you can see above, our winner this year is the esteemed and deserving **fullofcarp**! He will receive a shiny new discussion-board charm and $250 to use at Apple or Starbucks — winner's choice. See the full rules here.

Best,

The *Motley Fool Pro* Team

Polaris Award 2015 Contest Rules

Published Apr 23, 2015 at 10:42AM

OFFICIAL CONTEST RULES

1. ENTRY: No purchase necessary to enter or win. The contest will begin on 4/23/2015 and end on 5/15/2015. The entry deadline for the contest is 5/15/2015.

2. ELIGIBILITY: This contest is open only to legal U.S. residents, over the age of 18.

Employees and contractors (and their families) of The Motley Fool or any of its affiliates are not eligible. Void where prohibited by law. Contestants residing in those areas where the contest is void may participate in the contest but may not win any prizes.

3. WINNER SELECTION: The member who has the most votes from other members of the Pro community will be declared the winner. Votes will be collected in a manner as stated by TMF with these rules, and each individual in the Pro community can only vote once. Motley Fool employees and contractors may vote, but are not eligible to win.

4. PRIZES: The winner will receive a $250 gift card from their choice of either Apple or Starbucks. [Value: $250]

5. WINNER NOTIFICATION: The winner will be notified within 5 days after the determination date. Inability to contact a winner may result in disqualification and selection of an alternate winner.

6. GENERAL CONDITIONS: The winner will be required to execute and return a Certificate of Eligibility, Consent and General Release form within 14 days of notification. The winner may also be required to complete and return a W-9 for tax purposes. Non-compliance within this time period may result in disqualification and selection of an alternate winner. Any income tax liability is the sole responsibility of the winner. By acceptance of the prize, the winner consent to the use of his or her name and/or likeness for purposes of advertising or trade without further compensation, unless prohibited by law.

7. USE OF CONTEST INFORMATION: All entries become the property of The Motley Fool. The Motley Fool reserves the right to use any and all information related to the contest, including submissions provided by the contestants, for editorial, marketing and any other purpose, unless prohibited by law.

8. CONDUCT: All contest participants agree to be bound by these Official Rules. The Motley Fool in its sole discretion, reserves the right to disqualify any person it finds to be tampering with the entry process, the operation of this website or is otherwise in violation of these rules.

9. LIMITATIONS OF LIABILITY: The Motley Fool is not responsible for late, lost or misdirected email or for any computer, online, telephone or technical malfunctions that may occur. If for any reason, the contest is not capable of running as planned, including infection by computer virus, bugs, tampering, unauthorized intervention or technical failures of any sort, The Motley Fool may cancel, terminate, modify or suspend the contest. Entrants further agree to release The Motley Fool from any liability resulting from, or related to participation in the contest.

10. WINNERS LIST: The names of the winner may be obtained by sending a self-addressed stamped envelope to Pro Member Contest 2014, The Motley Fool, LLC, 2000 Duke Street, Alexandria, Virginia 22314.

Pro Live Chat, May 2015

Published Apr 20, 2015 at 3:50PM

Join us at 1 p.m. Eastern on Thursday, May 21, for our monthly text-only live chat!

The Shortfalls of Shorting

Published Apr 20, 2015 at 3:19PM

Greetings, *Pro* members,

All of us invest (at least in part) to reach or maintain financial freedom. And part of that freedom means not being tied down by our portfolios every day. As much as we enjoy investing, we all have days when we say to ourselves, "OK, I got it. Own great companies for the long haul. It doesn't matter what prices do today" -- and we unplug and go about our lives. When you sell a stock short, though, you have less leeway to go sail around the world and leave your investments alone. Shorts require more attention, even if they're small positions.

Why is that?

For one, a short is a margin investment -- in reverse. You're paid the proceeds from the sale on the day you sell something short, and the stock you sold could theoretically double or rise tenfold (or even a hundredfold); if it did, you would be on the hook to buy it back at that devastating price. It's no surprise that short selling has destroyed countless hedge funds, let alone small investors.

And for what? The risk-and-reward trade-off of shorting is unfavorable. The most you can earn on a short sale is 100%, and that's if the stock delists. And 100% of *what*? Of the amount you're willing to risk on day one, which is usually a modest sum (because as a savvy investor, you want to contain your risk). So, even if you reach a perfect 100% gain on a short, it's usually not going to benefit your portfolio by more than a few percentage points -- the allocation of your initial short.

Sure, every percentage point matters, but 100% gains on a short are rare enough that in practice they're almost nonexistent. A successful short is much more likely to net you 20%, or perhaps 40% (a very good short), or sometimes even 60%, before you close. On a 1% or 2% allocation, that won't move the needle on your portfolio much, especially if you have other shorts that are working against you because of shorting fees, dividends you have to pay, appreciation, or all three. You're fortunate if your short positions are a wash at best in a half-decent stock market, even though shorting consumes a lot of time and subjects you to oversized risks.

All told, it's difficult to make meaningful money selling short unless you happen to have many good shorts open when the market falls sharply, taking those positions with it. Consistently making money by shorting is close to impossible, given the market's preference for rising over the years and the fact that the system is stacked against short sellers. Business owners, employees, investment banks, inflation, and capitalism are all aligned to generate growing value for even half-successful companies.

Plus, barring bad news, it's easier to steadily attract new buyers to a stock, lifting shares higher, than it is to make existing owners sell, pushing the stock down. Shares of even a mediocre company may rise for years until a bear market finally pushes more people to sell than buy.

Given all these negatives, why short at all? How do we justify it in *Pro*?

I'm glad you asked.

Of Shorts and Hedges

As much as we would like our short stocks (as opposed to our index hedges) to earn value for us *no matter what* the stock market does, we know that isn't always a realistic assumption. It's a bold assumption. Market correlation means that, historically, a majority of stocks will move up when the market goes up. That also means a majority of stocks *fall* in a market downturn, so shorts are likely to reward us when the market declines.

We like having shorts in place for market declines, but ultimately this only adds value if we're shorting stocks that *don't go up much* while we wait, even if we wait years for a 20% market fall. That's a difficult goal to obtain, and it's why we spend so much time considering any short before recommending it.

Not much time has passed, but so far our "direct" shorts have fared well for us despite the positive market. Here are the returns of *Pro*'s past and present shorts as of 11 a.m. this morning, compared with the performance of a short of market indexes. (Note that our shorts of inverse and volatility ETFs are not included, since those behave as longs.)

Short	Rec Date	Rec Day Closing Price	Price Today (11:20 a.m.)	Our Short Return	Short S&P 500 Return	Short Nasdaq Composite Return
Boulder Brands (NASDAQ: BDBD)	3/23/15	$9.42	$10.29	(9.2%)	0.1%	0.3%
CurrencyShares Euro Trust (NYSEMKT: FXE)	12/12/11	$131.39	$105.79	19.5%	(70.1%)	(91%)
Caesars Entertainment (NASDAQ: CZR)	10/1/14	$12.32	$10.44	15.3%	(8.1%)	(12.8%)
Five Below (NASDAQ: FIVE)	7/16/14	$35.27	$35.64	(1%)	(6.2%)	(12.8%)
Sony (NYSE: SNE)	4/18/12	$16.89	$13.32*	21.1%	(7.8%)**	(3.7%)**

*All returns exclude dividends and fees. Returns are from recommendation date shown to today (or to closing day in the case of Sony). *We recommended closing our Sony short on Jan. 22, 2014, and the price shown is our higher closing price the next day. **From April 18, 2012, to Jan. 22, 2014.*

You can see that three of our shorts enjoy (in Sony's case, enjoyed) double-digit returns despite market indexes that went up over the same period; shorting the market indexes would have resulted in the losses shown above. Our shorting returns against a positive market suggest we're doing some things right. Hedge funds would tout these results. Elsewhere, our Five Below short is nearly a wash, despite the market being substantially higher -- the Nasdaq is up about 13%. Our Boulder Brands short is new, but this volatile stock has a losing start for us on absolute and relative terms. The market is down a tick since the short started, but small-cap Boulder (should we call it Pebble?) is up 9%.

Overall, our modest "short book" has added some value to the *Pro* portfolio despite the bull market. Shorting requires a lot of time and attention and increases our risks, so if it can add value even when going against the market trend, that's one way to justify it. Also, our shorts help us to comfortably be more invested than we otherwise would (including owning **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY), which is a counterbalance to our shorts). And our shorts have not cost us big the way some of our market hedges have, such as shorting the **SPDR S&P 500** (NYSEMKT: SPY) ETF over the past years.

Finally, providing a lesson about taking gains when you have them, we closed Sony at a 21% gain when shares were about $13. Today, the stock is above $30. Even a struggling company can generate confidence with turnaround plans that begin to show up in the financials. Shorting requires more of some skills we're not trying to master: market timing and short-term thinking.

Shorts in the Short Term

Shorts are usually short-term in nature, requiring all of us to flip our thinking, which is not easy. As Foolish investors, we've internalized the need to hold good companies for years to see compounding, but often a short should be closed within mere months if it's earned a good return. Why? Because it's rare that a company will continually get weaker over the years, unless it's truly dying. Companies will do anything to improve and survive. Plus, you pay to short -- so in other words, the clock is ticking.

The Short Take on Shorts

So, what is our takeaway on all this?

- Shorting is difficult. Even full-time short experts fight an uphill battle to make money. *Pro* is doing admirably with its direct shorts so far, and to us, that means that -- unless we want a quick market hedge -- we should *not* return to shorting market indexes directly as long as we can build a short book that does better than that. (That said, using options to hedge indexes still makes sense.)

- Shorting is expensive and has unusual risks, including being called out of the position, new company initiatives that change your thesis (reorg plans, being acquired, share buybacks), and losses that *compound* against you. A falling stock you own becomes less and less meaningful to your portfolio, but a short becomes more and more costly and risky as it works against you.

- Short selling cannot compound your money. You need to short again and again, typically making small gains each time, and be correct to a magnitude that exceeds your losses. This means that shorting requires a lot of your time and attention. (Plus, it results in short-term taxes no matter what.)

So Why Short at All?

1. We believe we can identify weak companies with stocks that should not do well, and ideally fall. If there's a bull market, we can usually wait it out as long as that particular company's business doesn't improve.
2. Our company shorts also serve as market hedges, since a majority of stocks move together. In a down market, our basket of shorts should benefit the portfolio in most cases. While we wait, ideally our short basket is less costly than shorting the market index would have been. And if we're really good, our shorts in aggregate will fall even in a rising market.
3. Having a basket of carefully chosen shorts increases our short exposure, which allows us to increase our long exposure. This way we can own more great companies for the long haul while staying true to our absolute-returns goal.

In summary, building a short book here in *Pro* is worth it as long as we continue to do it in a way that adds value in various ways. But you don't need to short to succeed. Many investors never become comfortable with shorting, and thus they (wisely) choose not to do it. If you are happy to short, though, then you can sleep easier knowing you have some positions that should help in a bear market -- and perhaps even in a good market, too.

To discuss this column, visit the Memo Musings board. Thanks for reading, and Fool on!

— Jeff (TMFFischer)

Pro Completed Trades

- **None**

Pro Catch-Up Trades

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- Got the short bug now? Both **Boulder Brands** (NASDAQ: BDBD) and **Five Below** (NASDAQ: FIVE) are at or above prices where we originally shorted. We have a 1.6% and 1.3% short allocation, respectively.
- Waiting for April earnings to buy more of our stocks? That's your choice, but you don't need to wait on Buy First stock, **Oracle** (NYSE: ORCL). It already reported results last month, and remains a Buy First. We have a 4.2% allocation.

Pro Catch-Up Trades: April 20, 2015

Published Apr 20, 2015 at 1:23PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

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Keeping an Eye on Five Below

Published Apr 17, 2015 at 7:30PM

The holiday quarter is ultra-important for discount teen retailer **Five Below** (NASDAQ: FIVE), and our intention has always been to use 2014's holiday quarter as a guidepost as to whether our short thesis for the company remained valid. That quarter is in the books, so let's take a look at what Five Below reported as well as what the future might hold. **I want to note right up front first that we're continuing to stay the course.**

The Past

Fourth-quarter and fiscal-2014 results for Five Below came in at the high end of management's guidance, but only after the company lowered the top end of its guidance range nine weeks into the fourth quarter. Sales and adjusted net income increased by 27% and 31% for the year respectively on the back of 62 new stores. For the quarter, sales and adjusted net income were up by 24% and 29% respectively.

A 20% increase in the overall store count helped to drive the impressive top- and bottom-line growth metrics, but the performance of seasoned stores wasn't nearly as strong. The company had a very favorable setup going into the 2014 holiday quarter, given that 2013's Q4 comparable-store sales (comp) number was a lackluster 0.3% (management blamed the weather). But Five Below could only muster a 3.2% comp for the quarter and 3.4% for the year. Interestingly, Five Below's comps have basically fallen in line with general deep-discounters, even though the company markets itself (and we tend to see it) as more of a preteen/teen retailer.

Note: X-axis refers to calendar quarters

The comp number gets even more interesting when you divide it into its two components: sales growth that's driven by an increase in the number of transactions, and sales growth that's driven by an increase in the average dollar value of each transaction.

	2011	2012	2013	2014
Transaction volume	6.1%	6.9%	4.8%	1.4%
Average dollar value	1.8%	0.2%	-0.8%	2.0%
Comp	7.9%	7.1%	4.0%	3.4%

You'll see that average dollar value (i.e. ticket size) rebounded in 2014, and if you're a parent you'll know why: Remember those rubber band looms every kid was playing with for awhile? Those were great for Five Below's traffic, but they had a downward pressure on transaction size in 2013. Now that purchases have shifted away from rubber bands, ticket size has returned to a more normalized level. Such are the vagaries of preteen retail.

As we've noted before, the company has admitted in the past that the primary long-term driver of its comp growth will have to be volume, and given Five Below's young target demographic (as well as the self-imposed ceiling on prices), we agree. So we need to be cautious about extrapolating the 2014 results for this metric into the future. However, the 240-basis-point decline in transaction volume is certainly worth our attention, and as you can see, this is the second straight year in which that metric declined significantly. This is a cornerstone of most short theses for Five Below, including our own.

First-Year Metrics

Historically, the company has been able to post impressive first-year metrics for its new stores. Let's dig a little deeper: In the most recent 10-K, management notes that its new-store model assumes "approximately $1.6 million in the first full year of operation and an average new store cash investment of approximately $0.3 million." That's actually a slight increase from prior filings, which referenced "$1.5 million to $1.6 million."

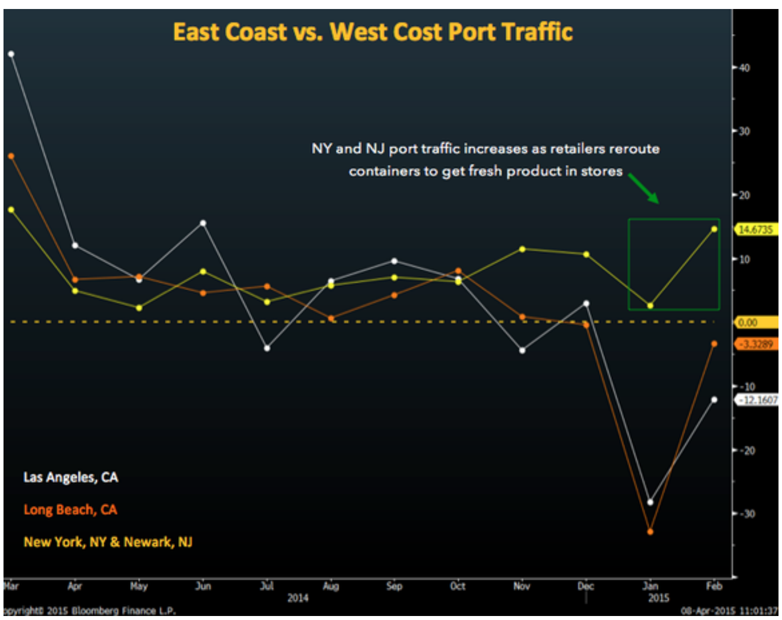
Subtle changes in regulatory filings can provide big clues into how the business is actually doing, but in this case I believe what CEO Joel Anderson said was actually even more important. In the past, management had always pointed out that Five Below's newest stores were performing "above expectations," but I believe this was the first earnings call during which someone actually provided us with figures to help put those words into context. Anderson noted that 2014 marked the fourth year that first-year sales came in at approximately $1.9 million per store. I had always assumed that figure was higher than the $1.5 million or so the company reported -- the latter would put the average yearly sales for mature stores at perhaps 25% higher than at the new ones, and that seemed unlikely. This means that new stores are performing similar to their seasoned brethren right out of the gate.

So why the disconnect between new and seasoned stores? In *Pro*'s original write-up, current Fool and former *Pro* analyst Bryan Hinmon noted competitive pressures nipping at Five Below's heels; nothing the company does is proprietary. But I actually don't think this is what we're seeing here. At least not yet. I suspect that this may just be customer fatigue. In a way, Five Below is a cooler version of the dollar store, one that's initially able to attract customers from all walks of life. But I can't help but wonder if over time, the novelty of Five Below's store experience and product offerings starts to wear thin. Because the company doesn't sell consumer staples (unless you count candy), there's no reason for customers to visit unless the company gets them excited to.

The Stuff They Sell

Inventory continued to rise on a per-store basis, up 7.5% year over year as the company tried to mitigate the impact of port labor conflicts on the West Coast. Congestion is still an issue as the ports try to work through the backlog, according to Bloomberg, and data from Datamyne suggests that container inflows are still down 12% compared to last year.

According to CEO Levi Strauss & Co. Chip Bergh, the situation has gone from "manageable to bad." A recent article in *The Wall Street Journal* noted that some companies are beginning to worry about receiving some of their spring products in time as four-day delays stretch into two weeks. Some companies have attempted to combat this issue by rerouting their shipments to the East Coast, where February port inflows were 14.7% higher than last year.



Source: Bloomberg L.P.

The Future

In our original short thesis for Five Below, some of the most compelling arguments had to do with red flags around management. The co-founders' prior public company had gone bankrupt, turnover in the executive suite was picking up, and insiders were selling large blocks of shares. Since then, the co-founders have continued to sell shares and the company has taken on a new CEO, a new EVP of Merchandising, and two new board members.

So what should we make of this? Taken in isolation, it's hard to view all this as anything other than a sign that the short case for Five Below is still valid. But the turnover in management could end up being a positive thing. Previously, Five Below's business model exhibited extremely impressive store-unit economics but was managed by people whose ability to steer the ship was more than questionable. Neither the new CEO nor the EVP of Merchandising have track records to suggest they'll shoot the lights out during their time at Five Below, but maybe they don't need to. Maybe all they need is to be slightly better than the people they've replaced.

It's still far to early to tell whether we'll actually see any changes and whether they're be a net positive or negative, but I found two comments from the new CEO to be interesting on this front:

> And lastly, but perhaps most importantly, is priority No. 5, marketing. Although our stores generate strong sales, recent market surveys we have conducted indicate that we have an exciting opportunity to expand our brand awareness and attract more customers to the Five Below experience in both new as well as existing markets. We simply need to do more to make people aware of this great concept. Our marketing strategy has been predominantly circular-driven, but in 2015, we will begin to optimize our media mix as we aim to be more effective with our marketing message by speaking to our core customers in the channels that are most relevant to them. What this means is a steady transition away from heavy circular dependence and a move to more digital and social media messaging.

Five Below's advertising budget had been primarily focused on print -- and remember, this is a retailer with a teen and pre-teen focus. Intuition tells me that audience is heavily skewed toward electronic entertainment as opposed to the Sunday circulars. This is low-hanging fruit, if you ask me, and it's something the co-founders should have done years ago.

Moving on:

> Our revenue forecast for 2015 assumes another strong class of new stores coupled with a same-store sales increase of approximately 3%. This reflects a slow start to Q1, given unfavorable weather in late February and early March. It also reflects the conservative approach to Q4, particularly in early December. While we have marketing and merchandising plans that we are excited about, we would rather see them drive results than assume associated upside in our outlook at this juncture.

The last sentence piqued my interest. Does this new team plan to under-promise and over-deliver instead of the other way around? That would be dangerous for those who are short the stock, because it would demonstrate that the company has become aware of two major cognitive errors, anchoring and adjustment and framing. A management team that is aware of these errors and trying to use them to its benefit (as most companies do nowadays) could make for a difficult short in the near to intermediate term.

Valuation

Five Below expects fiscal 2015 sales to be in the range of $816 million to $824 million, which would be top-line growth of 20 percent or so, and net income between $55.9 million and $57.7 million, growth of maybe 17 or 18 percent. (Management says the reason for the divergence is that this will be an "investment year.") For 2015, management expects diluted EPS of $1.02 to $1.05, which places the current price at around 35 to 36 times forward earnings.

Management expects to open 70 new stores this year -- 60% of those in the first half, with 18 coming in the first quarter. If we assume that these stores will ultimately end up generating around $1.9 million in sales during their first full year of operation, we could end up seeing the 2015 vintage contribute between $80 and $90 million to the bottom line this year (adjusting for the amount of time these stores will be open in fiscal 2015 and the seasonality of Five Below's sales). If we assume that the rest of Five Below's stores will achieve an annualized sales growth rate of around 3%, then the company could end up reporting closer to $830 million in sales.

You'll notice that this is above the top end of the guidance management provided to investors -- again, I wonder if management is planning to under-promise and over-deliver. If they can report revenue "above expectations," they'll gain flexibility in reporting bottom-line results that are at least in line with expectations. So I wouldn't be surprised if the company does end up reporting 2015 net income within guidance. But by my calculations, the current stock price implies that Five Below will be able to increase its free cash flow by 20%-plus for at least the next ten years, which seems doubtful unless management can keep up rolling out new stores fast -- and profitably.

What now?

In our opinion, 41 times 2014 earnings and 35 times forward earnings is rather generous for Five Below, but shorting a stock based solely on valuation frequently ends badly. So it's good to see that some parts of our thesis are playing out just like we had hoped. But we've also been thrown some curveballs, and I think that warrants shortening our leash at least a little.

The issue is not whether the thesis will ultimately play out; we still have a hard time envisioning this company profitably scaling to more than 2,000 stores. The issue is how quickly it will play out. We've seen enough to suggest that it could play out sooner rather than later, and we want to keep our short position open if it does. But we will be sensitive to any improvements we see in the business. Meanwhile, as we wait, we need to view this position as not only a short of Five Below specifically, but as a hedge against a bear market. A weak market would likely benefit most shorts, including this one. Along with our business thesis, then, this short continues to make sense in our long/short portfolio as a bear-market hedge as well as an individual position.

Want to talk about Five Below? C'mon over to our rad discussion board.
(That's something preteens say, right?)

Wells Fargo's Admirable Consistency

Published Apr 16, 2015 at 2:18PM

Wells Fargo (NYSE: WFC)

Updated Guidance: Buy First (no change)

Recommended Allocation: 3.7%

Fair Value estimate: $58 (up from $56)

What Happened?

- Diluted EPS of $1.04 per share (down 1% from Q1 2014)
- Revenue of $21.3 billion (up 3.3% from Q1 2014)
- Efficiency ratio of 58.8% (vs. 59% in Q4 2014 vs. 57.9% in Q1 2014)
- ROA of 1.38% (vs. 1.36% in Q4 2014 vs. 1.57% in Q1 2014)
- ROE of 13.17% (vs. 12.84% Q4 2014 vs. 14.35% in Q1 2014)

Continued increases in loan/deposit growth and credit quality:

- Core* loans of $802.7 billion (up 7.3% from Q1 2014)
- Total average deposits of $1.2 trillion (up 9% from Q1 2014)
- Net charge-offs as a % of total loans down to 0.33% (vs. 0.41% in Q1 2014)
- $100 million reserve release** (vs. $500 million Q1 2014)

Capital allocation:

- Share buyback activity continued (diluted share count declined 35.6 million, or 0.7% of total shares outstanding, from last quarter)
- No objection from the Federal Reserve to the 2015 Capital Plan, which included a proposed dividend rate of $0.375 per share for Q2 2015, up from $0.35 per share in Q1 2015

Operating segments:

- Community Banking: Net income of $3.67 billion (down 4.7% from Q1 2014)
- Wholesale Banking: Net income of $1.8 billion (up 3.2% from Q1 2014)
- Wealth, Brokerage, and Retirement: Net income of $560 million (up 18.1% from Q1 2014)

*"Core" loans excludes the impact of the non-strategic/liquidating loan portfolio

**Reserve release represents the amount by which net charge-offs exceed the provision for credit losses

CFO John Shrewsberry:

> "Wells Fargo earned $5.8 billion in first quarter 2015, an increase of $95 million from the prior quarter, including the benefit from lower income tax expense in the first quarter. Credit quality remained strong, as net charge-offs continued to decline. Expenses also decreased from the prior quarter and our efficiency ratio improved. We remained within our targeted ranges for ROA, ROE, efficiency ratio and net payout ratio, while maintaining record liquidity and capital levels."

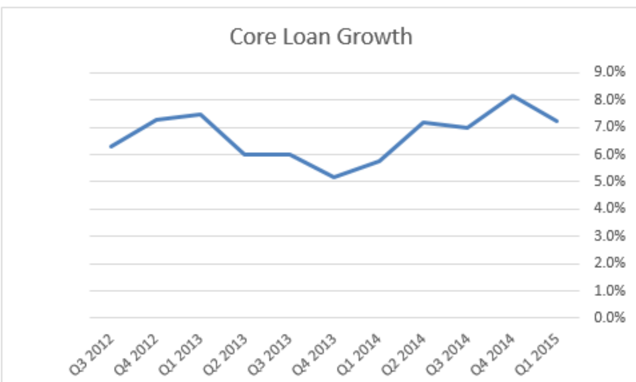
So What?

The 3 key items that I watch for Wells Fargo:

- Growth (or lack thereof) in core loans and deposits
- Trends in credit quality (as monitored via net charge-offs and reserving policy)
- Trends in the efficiency ratio and expense reduction

1) Growth in loans and deposits

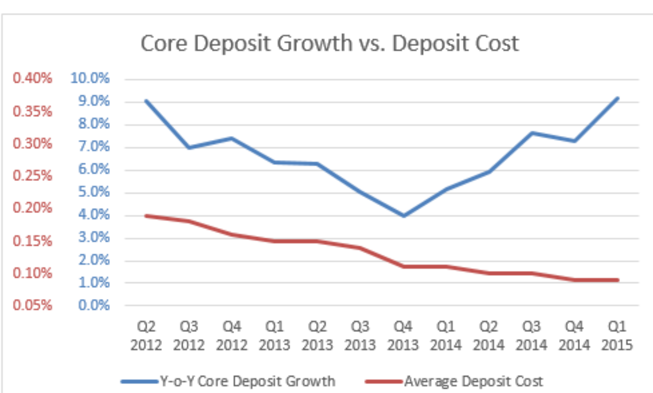
Core loan growth for the quarter came in at 7.3% year-over-year. The growth rate decelerated a bit from last quarter's excellent 8.1% growth level, but remains at a strong level. There was particular strength in commercial and industrial loans (up 13% year-over-year) and credit card balances (up 15% year-over-year). In the current U.S. economic environment of 2-2.5% GDP growth, I am very happy with loan growth in the range of 6-8%.



Source: Company filings, analyst calculations

Given the fluctuating economic environment (for example, declining oil prices and the concurrent effect on the energy and manufacturing industries), continued low interest rates, and Wells' laser focus on risk management and credit quality, recent loan growth trends have been excellent. I don't expect loan growth to increase meaningfully (i.e. to 9-10% growth) unless U.S. economic growth starts to sustainably accelerate (say to the 3-3.5% growth level) and long-term interest rates rise. In the meantime, if the company can keep its loan growth in the same general range as it's been recently, I'll be happy.

As for deposits, Wells continues to shine. The company achieved 2.6% quarter-over-quarter growth and 9.2% year-over-year growth in core deposits. Funding costs were stable at a rock-bottom rate of 0.09%. If they're only paying 0.09% on deposits, they should be gathering as many deposits as they can, and that's what they're doing. Deposit growth continues to accelerate in recent quarters:



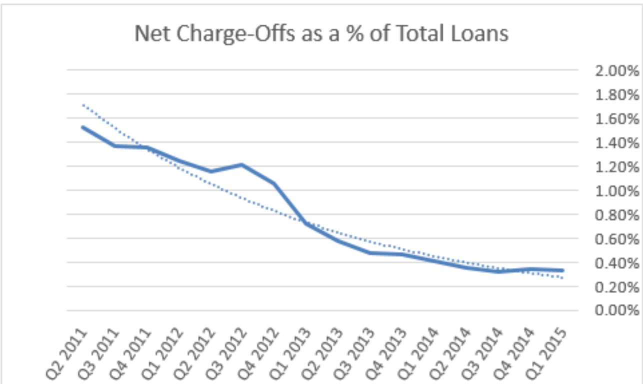
Source: Company filings, analyst calculations

The company's ability to grow deposits meaningfully at a very low cost is perhaps the company's biggest structural competitive advantage. Wells is able to do this by having a nationwide presence with significant geographic density in most markets, optimizing distribution via newer channels (mobile/technology), and strong customer relationship management and successful product cross-sell achieved via a consistent culture that has been a hallmark of the company for decades. CEO John Stumpf stated on the earnings call that "this is some of the strongest deposit growth years I've seen in my 30-some years with the company", and given the company's industry-low cost of deposits, deposit growth trends suggest that the company's competitive advantages may be strengthening.

Since deposit growth again exceeded loan growth, compression of the net interest margin (NIM) continued, coming in at 2.95% (down from 3.04% last quarter and 3.2% a year ago). I've written about net interest margin compression here. Quick summary is, it's not a big deal and so long as Wells continues to proficiently collect deposits, we will likely see NIM compress until rates rise and loan growth picks up.

2) Trends in credit quality

After a slight uptick in net charge-offs last quarter (a reversal from the unbroken trend of improvement that began in Q3 2012), credit quality improved slightly, with net charge-offs as a percent of total average loans declining to 0.33% (from 0.34% last quarter). Improvements in credit quality have leveled off, as we've long expected they would, and it will be difficult to wring out future improvements from these very low levels. But since Wells Fargo is known for underwriting discipline, I anticipate continued strong performance from this metric. Slight deterioration in credit quality from these levels will not worry me (and may actually be beneficial in terms of generating higher loan growth), but we want to watch the trend to make sure that the company's discipline is staying on track.

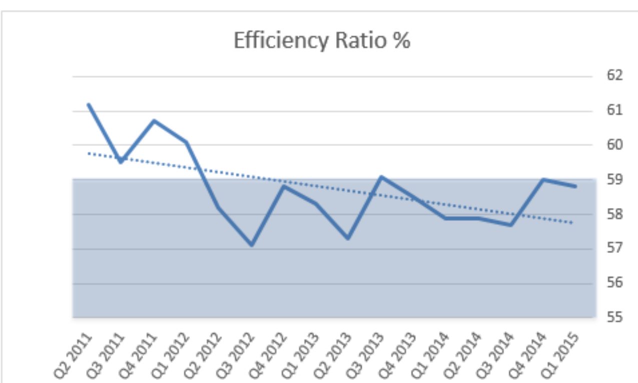


Source: Company filings.

The company is relying less and less on improved credit quality to generate earnings growth, which is good to see, although it creates some challenging comparisons to year-ago periods. For example, the reserve release in the year-ago period was $500 million compared to $100 million in this quarter. All else equal, if the reserve release in this quarter was the same as it was a year ago, the company would have reported 6.7% growth in earnings per share rather than a 1% decline.

3) Trends in the efficiency ratio

After a poor showing last quarter, this quarter showed sequential improvement in efficiency, with the efficiency ratio (a measure of the bank's overhead costs as a % of its revenue) declining to 58.8% from 59% last quarter, and within management's target range of 55-59% (blue shaded area in graph). Management has stated that their goal is to ultimately get the efficiency ratio down to 55%. For now, the company is investing in demands related to information security, compliance, and risk management (areas where another of our *Pro* holdings, **Broadridge** (NYSE: BR) stands to benefit), and that is likely to keep Wells at the higher end of their target range in the current economic and interest rate environment. But management is laser-focused on expense control, and I'm confident in their ability to steadily drive this figure lower, although the improvement won't be linear and will take time:



Source: Company filings.

Now What?

Quoting prior write-ups:

> "Not much different from last quarter (or the quarters before for that matter). Wells Fargo continues to execute its strategy and boast admirable consistency despite a fluctuating and uncertain macroeconomic environment. The company's performance is a testament to its diverse operating model. The company has so many levers to pull that if one segment falls others pick up the slack."

The market wasn't particularly pleased with this quarter's results, with shares at one point trading down nearly 2% during intra-day trading on the day of the earnings release (4/14). A rare year-over-year earnings decline, a sub-3% net interest margin, and a year-over-year decline in profit in the company's Community Banking segment (the largest segment) are likely contributors to the lukewarm investor reception to the report. But from our long-term view, underlying business results remain strong, the core earnings power of the business remains intact and is poised for positive operating leverage when interest rates and lending spreads rise, and the company's capital return program continues to benefit shareholders.

Data and Guidance

- Current Price: $54.65
- Fair Value **(updated)**: $58
- Market Cap: $281.6 B
- P/B 1.54

After incorporating this quarter's results into our model, we've increased our Fair Value estimate from $56 to $58 (representing a 1.77x P/B multiple). Wells Fargo remains a Buy First on our scorecard with a 3.7% allocation, and those who have yet to fill out their position should feel comfortable doing so at current price levels. We've been running a covered strangle strategy on Wells Fargo off and on over the past year, with our most recent iteration of the strategy ending with a fully profitable expiration on April 2nd. In light of the Fair Value update and the most recent quarter's results, the team may consider reinitiating the strangle strategy on Wells Fargo, and if we do, you'll receive an alert.

Fool on!

Billy

If you have questions, drive your stagecoach over to the Wells Fargo discussion board.

List of Pro Ticker Guides

Published Apr 15, 2015 at 2:14PM

This is a list of all the Ticker Guides in the *Pro* universe and the companies they're following.

What are Ticker Guides? They're members who help facilitate discussions on their respective boards, offering thoughts and helpful information regarding their company as well as stimulating Foolish conversation. You'll know them by the lamplight charm next to their name. This program is one way we've tried to harness the energy of our greatest asset -- our community.

Company	Ticker Guide	Link
American Tower (AMT)	CMF_bru5ce	Go to the board
Apple (AAPL)	CMF_muji	Go to the board
Broadridge Financial Solutions (BR)	CMFTurningItBlue	Go to the board
Celgene (CELG)	TMFTypeOh	Go to the board
Facebook (FB)	CMF-mazske	Go to the board
FactSet Research Systems (FDS)	CMFKBecks	Go to the board
Gentex (GNTX)	CMFSwift	Go to the board
Gilead Sciences (GILD)	CMFMLove	Go to the board
MasterCard (MA)	CMFCochrane	Go to the board
Medtronic (MDT)	CMF_AMDG4	Go to the board
Open Text (OTEX)	CMFSoloFool	Go to the board
Oracle (ORCL)	CMF_bru5ce	Go to the board
O'Reilly Automotive (ORLY)	CMF_bru5ce	Go to the board
Papa John's International (PZZA)	CMFKBecks	Go to the board
Skyworks Solutions (SWKS)	CMFbuyn2hold	Go to the board
Starbucks (SBUX)	TMFPoinkie	Go to the board
TD Ameritrade (AMTD)	CMFKBecks	Go to the board
Visa (V)	CMFPeterB	Go to the board
Wells Fargo (WFC)	CMFBLSH	Go to the board

Pro Catch-Up Trades: April 13, 2015

Published Apr 15, 2015 at 9:28AM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

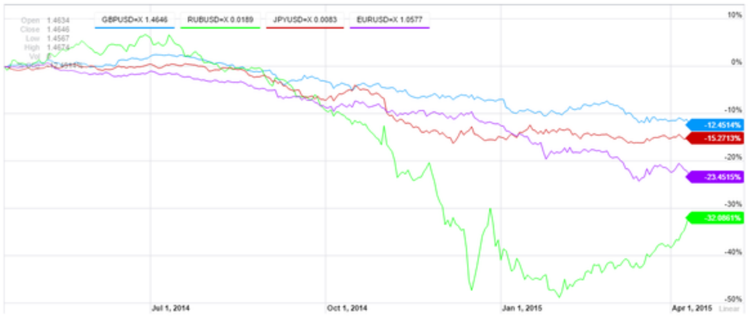
- **Expeditors International** (NASDAQ: EXPD): If you lack a position, target 3.5% total long exposure. Either buy about 1.8% in stock, or set up a January 2017 $45 synthetic long for the same allocation. Sell to open January 2017 $45 puts, and buy to open the same number of January 2017 $45 calls, lately for about a $2 debit with the stock at $47. Each synthetic long represents $4,500 in stock exposure. To then target another 1.7% in potential stock exposure, write a covered strangle. Sell to open May 2015 $46 puts and May 2015 $49 calls, one each for every 100 shares of Expeditors you have current exposure to, and every 100 more you could buy. Lately, you can get a credit on the covered strangle of about $1.50. (Keep in mind, *Pro* may convert to shares as our 2016 synthetic long comes to completion.)
- **SPDR S&P 500** (NYSEMKT: SPY) June hedge: If you haven't yet set up a put ratio spread to hedge, today you may using the same June 30, 2015, puts we used but adjusting the lower strike. Sell to open two June 30, 2015, $190 puts for every one June 30, 2015, $200 put you're buying. Lately, you'll pay about a $0.10 debit per spread. Each put you buy represents $20,000 in look-through short value, and each uncovered put you write represents $19,000 in a potential SPY purchase obligation. Set up one put ratio spread for every $200,000 you want to hedge. With SPY lately at $210, this put ratio spread has a maximum profit when the market falls 9.5% and a break-even price on a potential SPY purchase at 14.2% lower. See our past trade alert for more on the mechanics of this trade.
- **SPDR S&P 500** (NYSEMKT: SPY) September hedge: If you haven't yet set up our *second*put ratio spread to hedge, today you can using the same September 30, 2015, puts we used. Sell to open two September 30, 2015, $170 puts for every one September 30, 2015, $185 put you're buying. Each put you buy represents $18,500 in look-through short value, and each uncovered put you write represents $17,000 in a potential SPY purchase obligation. Lately, you can set this up for about zero cost (zero debit or credit). Set up one put ratio spread for every $185,000 you want to hedge. With SPY lately at $210, this put ratio spread has a maximum profit when the market falls 19% and a break-even price on a potential SPY purchase at 26% lower. See our past trade alert for more on the mechanics of this trade.

Pro's International Exposure

Published Apr 13, 2015 at 4:22PM

Dear *Pro* Fools,

Over the past year, investors have had money on the brain — more so than usual, as international currencies seem to have earned a greater portion of mindshare. As the United States continues its slow economic recovery and other major world economies have experienced relative weakness, the U.S dollar has become a safe haven for global investors, driving up its value relative to the other major world currencies. Here's the one-year performance of the pound sterling/dollar (blue), ruble/dollar (green), yen/dollar (red), euro/dollar (purple):



Source: Yahoo Finance

Multiple events over the past year have affected global financial markets and foreign currency exchange rates, for example:

- Japan's surprise expansion of its fiscal stimulus policy
- Russia's interest rate hike from 10.5% to 17%
- The Swiss central bank's decision to abandon its ceiling vs. the euro
- The European Central Bank's announcement of a 60 billion-euro-per-month stimulus program

International Exposure and *Pro*

Although international exposure is not a primary consideration for us here at *Pro*, it certainly affects the finances of our companies. Because our companies report their financials in dollars, weakening foreign currencies can have a significant impact on reported revenue. **American Tower** (NYSE: AMT), for example, reported a -4% effect on reported revenue core growth because of currency fluctuations in the most recent quarter.

I've also noticed more questions and board posts from *Pro* Fools related to currencies, international exposure, and investment opportunities outside the United States. For example, during our most recent live chat, I received a great question from VelobiciOptions:

> "*Was wondering about Pro's (our) exposure to US vs International economy. Many Pro companies obtain revenues in a variety of regions. Was wondering if the holding size weighted per region revenues or profits are tracked so that we can assess our International exposure...*"

To answer VelobiciOptions's question, I decided to look at our long positions. I pulled the most recent annual filing from each one and scoured the footnotes for a breakout of domestic (U.S.-based) vs. international (any other country) revenue for each company. I then used each position's allocation (total position value as a percentage of our long exposure, excluding long options) to calculate the total weighted average international revenue exposure.

Here are the results:

FY 2014 Revenue	Domestic Revenue %	International Revenue %
Pro's Total Weighted Average	60%	40%

Source: Company annual filings, analyst calculations.

Adjusting for position size, 40% of *Pro's* companies' revenue in their respective fiscal 2014s came from customers outside the United States. The degree to which our companies are exposed to international revenue varied widely. The three positions with the highest percentage of international revenue are, in order, **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) (100% international), **Skyworks Solutions** (NASDAQ: SWKS) (97.9% international), and **Tupperware Brands** (NYSE: TUP) (92% international). The three companies with the least are **O'Reilly Automotive** (NASDAQ: ORLY), **TD Ameritrade** (NYSE: AMTD), and **The Buckle** (NYSE: BKE) — all of which actually get 100% of their revenue from customers in the United States.

The companies with a relatively higher percentage of exposure to Europe include **Parexel International** (NASDAQ: PRXL), **Oracle** (NYSE: ORCL), **Gilead Sciences** (NASDAQ: GILD), **Open Text** (NASDAQ: OTEX), and **Gentex** (NASDAQ: GNTX). And companies with a relatively higher percentage of exposure to the Asia-Pacific region include Skyworks, Tupperware, and **Apple** (NASDAQ: AAPL).

The *Pro* Bottom Line

A few caveats: Because there's no standard format for reporting international revenue, the data aren't perfect. Each company has slightly different categorizations for various regions, which made it difficult to obtain anything more granular than a simple U.S. vs. international breakdown. Additionally, not all revenue reported as international is denominated in foreign currency; companies can still bill foreign customers in U.S. dollars. Despite these caveats, I hope the information gives you a better, though rough, understanding of how much exposure *Pro* has to international economic and currency developments.

Fool on!
Billy (TMFTailwind)

Pro Completed Trades

- **American Airlines** (NASDAQ: AAL): The April 10, 2015, $57 calls expired, as did our earlier $52 calls. We only own our original January 2017 $35 calls, uncovered for now.
- **Boulder Brands** (NASDAQ: BDBD): *Pro* sold short 3,900 shares at a net price of $9.60 per share, establishing 1.5% exposure.
- **Live Nation** (NYSE: LYV): *Pro* sold to open 21 July 2015 $24 puts at a net price of $0.71 per contract, establishing 2% exposure.

Pro Catch-Up Trades

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The Buckle Doesn't Change the World

Published Apr 8, 2015 at 4:16PM

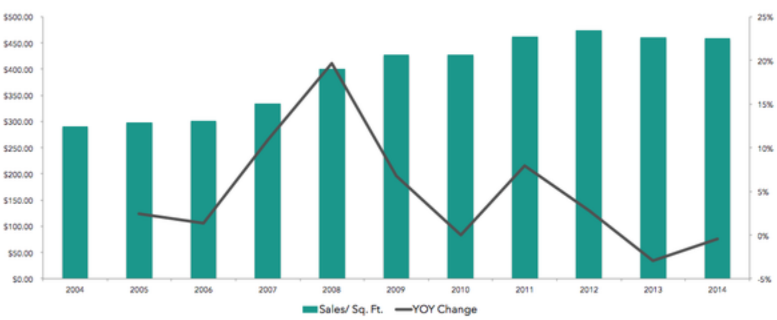
As has been the case since I took over covering the company, **The Buckle**'s (NYSE: BKE) fourth-quarter and fiscal 2014 results were muted. Top-line growth for the quarter came in at 4.3%, while net income remained essentially stagnant ($60.1 million vs. $59.3 million). The bright spot for the company continues to be online sales, which were up 12.6% for the quarter (6% for the year) and accounted for around 8% of sales for the year.

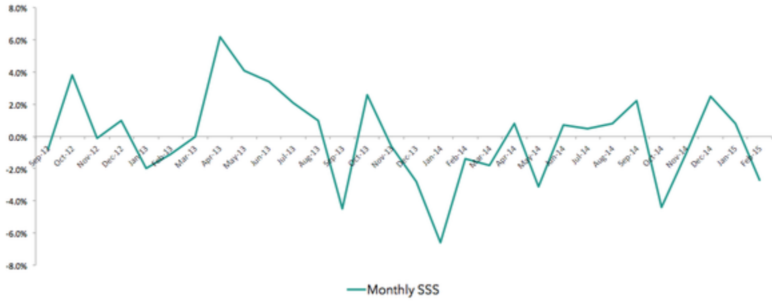
Updated Guidance: Buy (no change)

Recommended Allocation: 2.2%

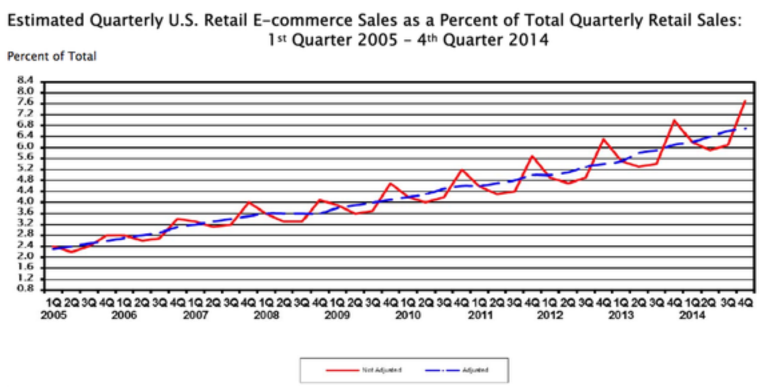
Fair-Value Estimate: $51 (no change)

The company increased its store count by 10 net new stores in 2014 to end the year with 460. Average sales per store were essentially flat (0.13%), as were comparable-store sales (comps), while sales per square foot fell slightly (down 0.4%). Forty basis points of decline isn't the end of the world, but it's worth noting that this metric was down last year, too -- and that prior to 2013, you'd have to go all the way back to 2003 to find the last time it declined.





The combination of muted in-store metrics and strong online growth suggests that some of The Buckle's customers are shifting their purchases online. That said, the impending demise of brick-and-mortar stores has been greatly exaggerated in the past. Even though e-commerce sales were up by more than 15% in 2014, they still only accounted for about 6.5% of the total.



Source: U.S. Department of Commerce

But it's important to note that the transition to online is further along in some industries. NPD Group estimated that online sales accounted for 14% and 15% of men's and women's apparel sales in 2013 (2014 numbers should be out sometime this month), with growth in online apparel sales far outpacing growth in store. This speaks to the importance of The Buckle getting its online experience right, and we'll be watching this closely going forward.

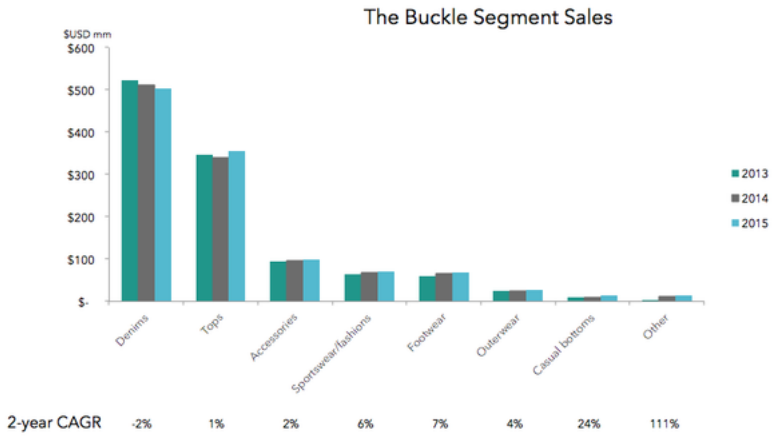
Store traffic also continues to be a struggle for The Buckle. We saw a 3.5% increase in units sold per transaction and a 1.3% increase in the average retail price of merchandise sold in 2014, but comps were flat, meaning in-store traffic must have fallen by 4.8%. Signs point to some of this volume shifting online, which is probably why the company will start incorporating online sales into its comparable store-sales results. The Buckle was essentially able to push through price increases across the board.

Even though The Buckle does offer activewear, the current trend away from more traditional attire has likely been a net negative for the company. Activewear is booming -- sales accounted for around $33.7 billion, or 16% of total U.S. apparel sales, for the 12 months ending in June 2014, and The NPD Group reports that the segment has been one of the primary drivers behind overall market growth. We believe that this trend has played a large role in the recent weakness in The Buckle's largest offering -- denim. Sales are down more than 3% in the past two years in this segment.

Apparel and Activewear (Dollar % Change)

	Total Apparel (w/ Activewear)	Total Apparel (w/o Activewear)	Activewear
12 months Jul'11-Jun'12	+4 percent	+3 percent	+8 percent
12 months Jul'12-Jun'13	+4 percent	+3 percent	+10 percent
12 months Jul'13-Jun'14	+1 percent	-1 percent	+7 percent

Source: The NPD Group, Inc. / Consumer Tracking Service 2011-2014



Source: Company filings

So given all this lukewarm news, why are we still holding The Buckle? In short, because we think our original thesis continues to have merit. When we recommended the company, we noted that it offers retail exposure with low fashion risk (jeans and tops); that its management team is properly incentivized, has meaningful ownership, and runs the business well; and that measured growth from store openings, online expansion, and a wider assortment of merchandise (footwear and children's clothes) would drive consistent earnings growth and dividends both regular and special. The thesis has been right on the money so far (our annualized total return including dividends is 17.6%), but of course, if we're going to keep this company in the *Pro* port, we need to believe that can continue.

The Buckle currently trades for around 7.9 times EV/EBITDA and 15.1 times earnings, which doesn't sound unreasonable on an absolute level. From a historical perspective, both multiples are above their 5-, 10-, and 15-year averages, but not outrageously so.

	EV/EBITDA		P/E	
	multiple	% of time above current	multiple	% of time above current
15-year average	6.59x	20%	14.32x	37%
10-year average	7.20x	29%	14.83x	40%
5-year average	6.96x	17%	13.72x	18%
current	7.93x		15.08x	

Source: S&P Capital IQ, analyst calculations

This was very much a ho-hum quarter for The Buckle, but such are the vagaries of fashion. Recent fashion trends haven't been helpful for the company, but as far as I'm concerned, there are three truths in life: death, taxes, and changes in what's fashionable. For now, we're content to watch and wait.

The Devil's in the Details

Published Apr 6, 2015 at 4:25PM

Fellow Fools,

Time for a quick pop quiz: In aggregate, which basket of stocks tends to outperform over time: large caps or small caps?

Most of us are taught early on in our investing careers that for time periods measured in years (which is what Foolish investors care about), the answer is small caps. And those who initially reject this conclusion usually convert after being presented with mounds of academic research from the '80s and '90s to reinforce it. In fact, there's an extension for the ubiquitous (for better or worse) capital asset pricing model (CAPM), the Fama-French three-factor asset pricing model, that includes a size beta because “small caps are riskier than large caps, therefore small-cap investors should be rewarded with a higher expected return.” So imagine my surprise this weekend when I came across a brief passage buried within the 2,200 or so pages of the CFA level III curriculum that questioned the validity of the size premium.

The authors seemed perfectly willing to quickly move on to another topic after making a statement that some might consider heresy, but I was not (especially because the Fama-French model was part of the curriculum for levels I and II). I immediately stopped studying and took to the Internet, ready to devote the rest of the day to discovering the truth about something I had previously accepted as gospel. I ended up needing less than an hour. As with so many things in life, it turns out that the devil is indeed in the details.

This table from an article by Vitali Kalesnik and Noah Beck over at Research Affiliates essentially sums up the debate in eight bullet points:

Summary of Findings on the Size Premium

Arguments in Favor:

1. Over the period July 1926 to July 2014, there was a size premium of 3.4% per annum in the United States.
2. The U.S. size premium is statistically significant (with a p-value of 1.7%), *assuming the returns are normally distributed.*
3. In the 30+ years since the publication of Banz's (1981) article , there has been an average size premium of 1.0% per annum across 18 developed markets including the United States.

Arguments Against:

1. There is an upward bias in size premium estimates due to inaccurate returns on delisted stocks in major databases.
2. Indices and hypothetical portfolios ignore trading costs.
3. The statistical significance of the size premium estimates is likely overstated due to data-mining and reporting bias.
4. Even with the biases that favor small stocks, there is no unquestionably significant evidence in support of the size factor.
   - The estimate of the U.S. size premium is dominated by extreme outliers from the 1930s.
   - The assumption of normality used to obtain statistical significance in the U.S. sample is extremely dubious.
   - There is no statistical significance outside the United States.
5. Even with the biases that favor small stocks, there is no risk-adjusted performance advantage attributable to the size factor.

Source: Research Affiliates (2014)

Ken Fisher noted in a *Financial Times* piece that small-cap stocks are a leveraged play off the bottom of a bear market. Exclude the first two years of the bull markets that began in 1932, 1942, 1974, and 2002 from the 1926 data and large caps actually outperform small caps on an annualized basis – 7.9% to 7.6%. Kalesnik and Beck also noted how a few data points can skew the overall results for monthly data when discussing the plausibility of returns being normally distributed. Here, "premium" refers to the difference between small- and large-cap stocks:

> The 23.6% premium registered in January 1934 is a 6-sigma event. If it were drawn from normal distribution, this would be a one-in-67-million-year event, like the one that wiped out the dinosaurs. The 27.2% difference in returns in September 1939 is a 6.9-sigma event; in a normal distribution, it would have about a one-in-five chance of occurring in the 4.5 billion years since the planet earth came into existence. The 33.8% premium in August 1932 is an 8.6-sigma event, and the 51.6% premium in May 1933 is a 13.1-sigma event. If these last two outliers were drawn from a normal distribution, each would have much less than a one-in-a-hundred chance of occurring in the entire 13.8 billion years the universe has existed.
>
> To add to the problem, all four outliers occurred in the 1930s. If they were removed, the estimated size premium in Table 1 would drop from 3.4% to 1.9% and lose statistical significance.

You frequently hear financial pundits question what's wrong with the market when small caps stocks start lagging large caps for any meaningful period of time. Perhaps the answer to that question is "nothing." The empirical evidence to support the notion that small caps stocks are rewarded with a size premium is nowhere near as bulletproof as many were taught to believe and, as Mr. Fisher noted, a few phenomenal years doesn't automatically equate to permanent brilliance.

Now before the Fools over at *Hidden Gems* get here with their pitchforks and torches, let me just say that I didn't bring this up to take a shot at those who prefer to invest in small caps. There are definitely opportunities to be had among smaller stocks; the results of the *HG* team are a testament to this. Rather, I'm writing about this topic because I think this is yet another great reminder that we could all probably stand to hold our beliefs a little less firmly, myself included. Most of the knowledge we accumulate is circumstantial in nature, yet our minds are quick to categorize it as absolute and unworthy of further scrutiny. I've lost track of how many "scientifically proven" diets we've seen over the past 15 years, how many things I've learned in school that turn out to be wrong. Morgan Housel recently wrote about how important it is for investors to be willing to change over time, because the market is constantly evolving and what worked in the past isn't always guaranteed to work going forward. But sometimes we need to update our approach and beliefs because we were wrong to begin with. It's happened to me before, and it'll happen to me again. That is one thing I do believe to be absolute.

Foolishly yours,

– JP (TMFYossarian)

Returns

Pro'*s returns as of March 31. This information is always available on the* *Recommendations page*.

Returns

	Annualized Return Since Inception	Annualized Return, Rolling 3 Years	Year-to-Date Return
Pro	15.0%	20.6%	6.7%
North Star	8.2%	7.8%	1.7%
S&P 500	13.3%	16.1%	1.0%
MSCI World	7.7%	9.9%	1.8%

Pro Completed Trades

- **Boulder Brands** (NASDAQ: BDBD): We sold short 3,900 shares at $9.60, initiating our 1.5% short position. See our recent trade alert for why!
- **Live Nation** (NYSE: LYV): We sold to open one July 2015 $24 put, getting paid $0.85 ($0.84 after commissions). The rest of our order didn't fill, so we still have 20 more puts to write, per our recent trade alert.

Write Puts on Live Nation

Published Mar 31, 2015 at 1:30PM

Is this for you? This is for *Pro* members who are looking to generate income and lack at least 2% exposure to this company.

How You Participate

- **Trade:** Sell to open July 17, 2015, $24 puts on **Live Nation** (NYSE: LYV).
- **Allocation:** 2% in stock if we get shares. Sell one put for every $120,000 in your portfolio. *Pro* will sell 21 contracts.

- **Price Guidance:** Initially, aim to get paid at least $1.00 per put. This is a 4.2% yield in about 3.5 months.
- **Future Guidance:** As prices and time to expiration change, those approaching the position later should aim to get paid at least a 1% yield per month to expiration. That's $0.24 per put, per month, remaining to expiration in mid-July. So, today that means get paid a minimum of $0.84 or so per put.
- **Prices** (as of 12:15 p.m. ET):
  - **Stock price:** $25.25
  - **Option Price (bid/ask):** $0.90/$1.15 (splitting the bid/ask = $1.03)

What We're Thinking

It may be cliché of us to say this, but there really is something magical about live music. Yes, 99.5% of the time the audio fidelity doesn't come anywhere close to what we have on our smartphones, but attending a live show is about much more than just sound quality. These events are about the people you go with, the electricity in the air, the memories you create. This is why the global concert market has proven to be so resilient over the years — the annual growth rate for the past 15 years is around 10% — even as other parts of the music industry seem to get disrupted on a monthly basis.

But what makes this industry even more attractive is the fact that a fundamental shift that has taken place within the music industry. You see, artists used to go on tour to promote their albums. Now they release albums to create buzz for their tours. Major acts generate upwards of 95% of their revenue from live events. At the center of this shift stands Live Nation, the world's largest concert promoter and our latest put-writing target.

The Business

Scale: It Matters

The best way to think about Live Nation's business is a flywheel, an analogy even the company has adopted. At the core is the absolutely massive concert promotion and live music event business, which accounts for close to 68% of revenue. Surrounding the core are ticketing (22% of revenue, primarily from Ticketmaster), its artist management business (6%), and sponsorship and advertising (4%).

The analogy works because management's focus on scaling the core business on a global level has, in many ways, become self-reinforcing. The larger the company gets, the more fans attend its events. More fans equals more money for artists, venues, and sponsors, which means more artists, venues, and sponsors want to work with Live Nation. And while concert promotion is a very low-margin business, the size and reach of Live Nation make it possible for the company to create additional business units with great margin profiles. For example, its on-site ancillary business has 50% adjusted operating margins while the sponsorship and advertising business' margins are north of 70%. This size also means that small investments can pay big dividends. Each time Live Nation figures out how to sell an additional 10 tickets to *all* of their shows, millions of dollars flow straight to the bottom line.

So how big is Live Nation? Well, the company estimates that it controls around 35% and 20% of the North American and global concert markets, respectively. Some estimate that its share of the concert promotion industry exceeds 60%; every 20 minutes a Live Nation event starts somewhere around the world. Last year it was responsible for almost 23,000 shows that were attended by 519 million fans in 33 countries, all while selling 154 million primary tickets. The company operates 158 venues (like The House of Blues), has sponsorships with 750-plus brands, and manages more than 280 artists (U2, Madonna, Maroon 5, and Pharrell, just to name a few). In terms of annual attendance, Live Nation is bigger than the NFL, NBA, and NHL *combined*.

GAAP, Schmaap!

On the surface, Live Nation's financial statements are anything but impressive. Since being spun out of Clear Channel Communications in late 2005, Live Nation has been unprofitable each year according to its generally accepted accounting principles (GAAP) financial statements. But if you dig a little deeper, you'll see that management's current focus is on continually reinvesting its capital into the business in order to gain market share and increase free cash flow. This is why so many doubted CEO Michael Rapino when he said in 2012 that the company would grow free cash flow by 40% to 45% over the next three years. Right now, the odds seem quite good that the company will hit the high end of its target range by the end of this year.

Creating shareholder value while at the same time reporting GAAP net income losses is not unheard of. **Liberty Media** (NASDAQ: LMCA), whose largest shareholder is John Malone, increased its stake in Live Nation by $38.5 million dollars last year and now owns 27% of the company. This is the same John Malone who was able to build a cable empire by focusing on minimizing reported profits in order to minimize taxes and increase free cash flow. His original masterpiece, Tele-Communications, outperformed the S&P by over 40-fold while he was at the helm even though the company never paid significant taxes. While comparing the two isn't apples to apples, it should provide some reassurance to investors that Live Nation has the people in place to skillfully allocate capital and create shareholder value.

Why This Strategy?

If we're bullish on the long-term prospects of the company, why write puts? While we believe the stock is currently slightly undervalued (current EV/EBITDA multiple is 11.8 times; our estimate of fair value pegs it closer to 13 times), we believe a patient approach is justified in today's choppy market, and we don't expect shares to soar away on us (although it's a risk we accept). We've been watching Live Nation all year and an effective entry price of $23.00 gets us to our most recently updated entry price target. As it happens, $23.00 is $0.25 more than the average price Liberty Media paid to increase its stake last March. So we'd be in good company should we end up buying shares. Selling puts also helps us with our goal of trying to generate more income this year.

More That Matters

- **Maximum loss:** Our risk is the same as share ownership starting around $23.00, or 9% less than recent prices.
- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At $1.00, that's a 4.2% yield in 108 days, or about 15% annualized.
- **Follow-up:** We'll buy shares at a net $23.00 if the stock is below our $24.00 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **Not using options?** In that case, wait to see if the stock declines to around $23.00 and then start a 2% stake.

Pro Can Help

- **Need a refresher on put writing?** Check out our guide.
- **Questions?** Plug in and amp it up on our new Live Nation discussion board.

Pro Catch-Up Trades: March 30, 2015

Published Mar 30, 2015 at 3:17PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **American Airlines** (NASDAQ: AAL): If you haven't invested 1% in calls yet, you can buy to open January 2017 $30 calls now (rather than $35, to keep time value lower), lately at around $26 each. That price will change as the stock moves. Click "see all" to see all strike prices with your broker.
- **OpenText** (NASDAQ: OTEX): If you don't own 3% in this stock yet, it's down lately on unfortunate news that CEO Mark Barrenechea is being treated for leukemia. We wish him a full recovery! The business should remain stable, and the stock can be bought up to 3%, or you can write $50 put options expiring in May or August to target a still-lower buy price.

Options, Earnings, and ... Europe?

Published Mar 30, 2015 at 2:21PM

Greetings, *Pro* members!

Today we have a "housekeeping" Memo, putting things in order and updating you on what's going on around *Pro*. So roll up your sleeves and put your kerchief on (or something like that!). We'll start with our upcoming options expirations, in chronological order.

Upcoming Options Expirations

- **SPDR S&P 500** (NYSEMKT: SPY) put ratio spread: Our March 31 put ratio spread is set to expire at the end of the day tomorrow. With SPY recently at $207 and our strike prices at $195 and $182, we don't need to take any action. The options will disappear after the 31st, leaving us with nearly $500 income even though the hedge didn't come into play. And just how did we earn this? In essence, we were paid for our agreement to buy SPY if it declined below $182. We already set up two new put ratio spreads, expiring June 30 and September 30. If you haven't initiated those yet, visit the trade report and ask questions on the SPY board. Positions very similar to ours can be set up for a credit with some minor strike-price tweaks.

- **Wells Fargo** (NYSE: WFC) **covered strangle:** Our April 2 covered strangle has strikes at $52.50 and $57.50, and the stock is lately $55. We're on track to earn about $1,200 on this short-term income position. Assuming no major price move on the stock, we can do nothing and let both options expire. We'll look to write a new strangle after Wells Fargo's earnings, which are due April 14.

- **American Airlines** (NASDAQ: AAL) **diagonal calls**: Our short $57 calls expire on April 10, and lately the shares are about $53. Members who already rolled from $52 to $57 are currently in the clear (though we have a debit to earn back later!). Those who haven't rolled yet (including us, because of price changes) are waiting for time value in our short $52 calls to dissipate or for the stock to rise again, at which point we would roll to avoid an onerous cost. We recommended rolling from $52 to $57 because we knew that if the stock rose much more at that point, rolling would be especially costly. But shares are volatile, and a price decline soon after made the roll less pressing — for now. Still, as long as shares are above $52, those who haven't rolled yet will need to take action before April 10.

  We bought our 2017 AAL calls for long-term upside, and we knew that writing short-term calls for income was a risk. Still, some setbacks like this included, we expect to make good returns on AAL overall. And it's true that new positions sometimes have a "breaking-in" period, during which you're more likely to make mistakes (or less than optimal decisions) until you find your groove. Those who only own the long 2017 calls can sit tight for now. We ourselves may keep those calls alone after our diagonal calls expire, and we may consider setting up a *separate* income position on AAL if we want — staying true to our own advice for options writers!

- **Expeditors International** (NASDAQ: EXPD) **synthetic covered strangle:** Our synthetic covered strangle on the shipping logistics provider is set to expire in more than a month, on May 15. The $48 calls in our short strangle are in-the-money, and I check daily to see if there's a roll we should make. So far, no need; right now, we can wait to see the time value in the $48 calls dissipate. Since we set it up last August, when the stock was out of favor, this "income with upside" position has been playing out well.

Earnings on Tap; Europe Up to Bat

We look forward to a new round of earnings reports starting in April. I posted last week that many stocks look generously valued; we have some on hold here in *Pro* in cases where the valuation is about 20% or more above the stock's long-term average. We want to ascertain if that premium is merited before telling newer members to buy, even if we're content to hold. (Keep in mind, the cost of selling is 20% or more in taxes in a regular account.) We like what we own, of course, and we only keep stocks that we believe will challenge our North Star over the coming three years; but we're also content to put some positions on hold and wait a quarter or two to better determine whether their valuations are merited.

Some stocks (not necessarily ours) are reaching prices where selling becomes an easier choice. Successful investing is largely about buying good companies and sitting on your hands for years, and we've done that, watching valuation multiples expand year by year. But we'll take action — sell, protect, or cover — if any stocks don't look priced to reward us over the next rolling three years. To that end, we're looking forward to earnings next month. In related news, we just saw results from short **Five Below** (NASDAQ: FIVE), and JP is taking a close look to see if we want to stay short or not.

Out in the world, I find Europe's depressed economy (and markets) and new 60-billion-euro-a-month stimulus program (up to 1 trillion euro by September 2016) an interesting combination. We've seen something like this in the U.S. before; is this an investment opportunity with a tailwind? Meanwhile, additional stimulus in Europe has aided our euro short, as has the U.S. preparing to raise interest rates — which was one key catalyst we expected.

Now it's back to the quiet realm of reading, thinking, and planning investments (which we know many of you enjoy doing as much as we do!). Until we talk again, thank you for being a *Pro* Fool with us. Fool on!

— Jeff (TMFFischer)

Pro Completed Trades

- **None.** Our 1.5% short of **Boulder Brands** (NASDAQ: BDBD) and diagonal call roll on **American Airlines** (NASDAQ: AAL) are both in process waiting on price.

Pro Catch-Up Trades

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **American Airlines** (NASDAQ: AAL): If you haven't invested 1% in calls yet, you can buy to open January 2017 $30 calls now (rather than $35, to keep time value lower), lately at around $26 each. That price will change as the stock moves. Click "see all" to see all strike prices with your broker.
- **OpenText** (NASDAQ: OTEX): If you don't own 3% in this stock yet, it's down lately on unfortunate news that CEO Mark Barrenechea is being treated for leukemia. We wish him a full recovery! The business should remain stable, and the stock can be bought up to 3%, or you can write $50 put options expiring in May or August to target a still-lower buy price.

In Investing, Nothing Is Always True

Published Mar 23, 2015 at 2:48PM

Fellow Fools,

Your brain is truly amazing. Just let it think about itself for a second: Eighty-six billion neurons, 100,000 miles of axons, neural impulses traveling at speeds upwards of 250 miles per hour — what's going on behind your eyes is mind-boggling. Given that level of activity, perhaps it should come as no surprise that our brains are constantly on the lookout to find shortcuts or create mental cheat sheets whenever possible.

Generally speaking, I'd say automation like that is a net positive; after all, as Jeff mentioned in a recent *Options* Weekly, we don't have an unlimited store of cognitive energy. Think about the number of tasks you complete within the first hour of waking up: getting out of bed, exercising, taking a shower, walking down the stairs, making your breakfast, reading the paper (or the screen), brushing your teeth ... When you first learned to do all of these things, they took a ton of energy and concentration, but as an adult you can do them almost without thinking. Now imagine what it'd be like each morning if you had to relearn each skill all over again! You'd be mentally spent before you even walked out your front door to go to work.

So mental automation can make many things easier. But there's a flip side: Your brain is also on the lookout for new shortcuts during activities were you actually *don't* want to cut corners, like when making financial decisions. The majority of cognitive errors and emotional biases associated with investing are connected by one common thread — they're in some way less mentally taxing than their alternatives. They're simply easier. This also has something to do with the proliferation of investing maxims ("Bulls and bears can make money, but pigs get slaughtered!") that traders and investors alike use to justify their actions.

The reason many of these maxims initially gain traction is that someone, somewhere, at some point in time, was able to achieve desirable results by following the action(s) the maxim prescribes. That means you can't dismiss it entirely as being factually incorrect. When you combine this with the fact that most of these maxims sound logical at first, it's easy to see why they gain so many adherents. And of course, there's an investing maxim for almost every situation and possible action, so that many contradict one another — and give investors a way to justify almost any suboptimal decision.

But unfortunately, whenever you base a decision solely on an investing maxim, you're making a fatal mistake: attempting to grossly oversimplify a complex system, like how some investors try to use stock charts to predict the future. Sure, a stock may have fallen 35%, but what is the underlying reason behind it? A technical analyst who sees a "death cross" (where a short-term moving average, say the 50-day SMA, crosses over a long-term, say the 200-day SMA) might respond that it doesn't matter, the chart tells you all you need to know. I beg to differ. A death cross that forms because Wall Street didn't like **Whole Foods**' (NASDAQ: WFM) quarterly results is very, very different from a death cross that shows up because a company's product is quickly being displaced by its competitors, à la **BlackBerry** (NASDAQ: BBRY) a few years back. The former could be a great buying opportunity; the latter not so much.

"Buy best-of-breed companies, regardless of price." "Buy the rumor and sell the news." "Invest in what you know." "Always let your winners run." "Always use stop-loss orders." "Never catch a falling knife." "The trend is your friend." There are countless maxims I could talk about. Some of them I disagree with entirely; with others, I agree with the premise but take issue with those who decide to use the maxim as a brush with which to paint every situation. One of the most popular investing maxims — "Be greedy when others are fearful" — is a great example of the latter.

As many of you already know, that quote comes from Warren Buffett's 2008 *New York Times* op-ed. It's hard to fault Buffett's logic that the best time to buy is when Mr. Market is acting highly irrational. Time has proven that this is a strategy for long-term investors. The issue I have in this situation is not in the maxim itself; it's that some investors misinterpret Buffett's comments to mean that any stock that falls off a cliff is a great buy. But take a look at the quote in context:

> A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. **To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions.** But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now. (emphasis added)

Options' Jim Gillies was channeling his inner Buffett (or was Warren channeling his inner Jim?) when he noted during his excellent FoolFest presentation that a large decline after an earnings miss is not always a signal to start buying. Sometimes the decline is simply a precursor of what's to come; in those cases, the market actually needs to fall more before the deterioration of a company's fundamentals has been appropriately incorporated into the stock price. Understand the business, the industry it operates in, its competitive advantage. There is no easy alternative. Or to invoke another investing maxim, don't fall prey to the "dead-cat bounce."

One of my favorite tools for combating the urge to rely on maxims is to simply talk to someone else about a stock I'm interested in. Articulating your thesis to someone else is a great way to catch yourself in the act, as I often do. But even if I don't, the person I'm talking to usually only needs about five minutes to find the error in my ways. It's humbling for sure, but I'd rather make a good decision after eating a slice of humble pie than make a bad decision while living with my head in the clouds.

Have a great week, Fools.

— JP (TMFYossarian)

Short Boulder Brands

Published Mar 23, 2015 at 12:03PM

Is this for you? This trade is for Fools with a margin account who can locate shares with their broker. Before this alert was sent, TD Ameritrade, Interactive Brokers, Fidelity, and OptionsHouse had shares available to short. Check with your broker to locate shares and inquire about any fees involved. Also, this trade is only for Fools who don't mind volatility — the stock will likely bounce around depending on quarterly results, so be prepared for a potentially bumpy ride.

How You Participate

- **Trade:** Sell Short **Boulder Brands** (NASDAQ: BDBD)
- **Allocation:** 1.5% (sell short $1,500 worth of shares for every $100,000 you manage)

- **Price Guidance:** Initially, aim to short around current prices, around $9.60 or higher.
- **Recent Price:** $9.70

What We're Thinking

Boulder Brands (formerly Smart Balance) is a young consumer-packaged-goods (CPG) company that provides food solutions to people with unique nutritional needs. It owns brands that play in several health-focused niche categories, including heart-healthy spreads (Smart Balance); vegan grocery items (Earth Balance); gluten-free grocery, frozen foods, and bakery items (Glutino and Udi's); frozen foods with a focus on simple ingredients (EVOL); and diabetic nutrition (Level Life).

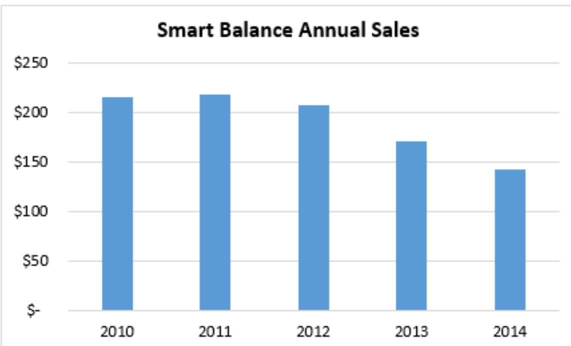
The bull case for Boulder Brands goes like this: The company owns established brands in nutritional niches that are gaining mainstream momentum and growing quickly. Boulder will increase distribution, increase items per store, innovate with new products within its brands, and make smart acquisitions to add brands that cater to other needs. Its small size, fast growth, and "healthful" food association also make it an attractive acquisition candidate for a larger, lumbering CPG food company.

The bear case for Boulder Brands goes like this: The company has troubling management and governance issues; an intensely competitive industry environment and limited financial flexibility may keep profits low; earnings are of questionable quality; and its business strategy is unlikely to succeed in commanding a premium valuation.

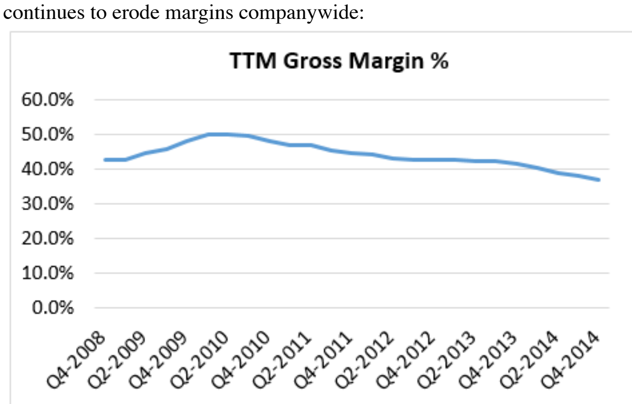
Given the company's slowing growth, financial strain, and management issues, we think the current price of $9.70 per share is well above the true intrinsic value of the business. We think there is potential for outright downside from these price levels as competition and limited market acceptance may lead to continued deterioration in business fundamentals. The stock is priced at 44 times trailing adjusted earnings, 36 times forward earnings, 16 times trailing operating income, and 16 times trailing adjusted EBITDA. In our opinion, these metrics are too high for a company that shows signs of trouble in each of the three key areas we focus on for short candidates: competition, people, and finances.

Competitive Flags

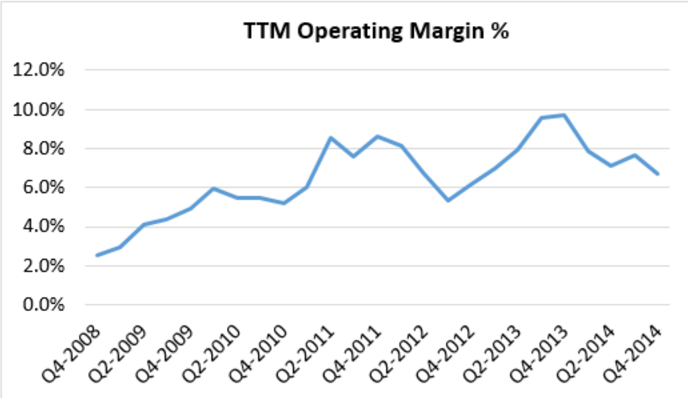
- We don't believe the company has a sustainable competitive advantage. Smart Balance has historically been the company's cash cow, as it's protected by patents allowing the company to make heart-friendly health claims on the package (no other spread can do so). This patent protection has led to high gross margins (40% to 50%) and strong cash flow. However, the patents that protect Smart Balance will expire in April, and once it comes off-patent, company gross margins — which are already weakening — will likely be under even more pressure.
- In addition to the loss of patent protection, competitors have been finding ways to compete more effectively with the health claims made by Smart Balance, hindering its sales growth. When it comes to spreads, the company competes with big companies with far greater operational resources (**Unilever** (NYSE: UL) and **ConAgra** (NYSE: CAG)), and their scale offers them advantages over Boulder Brands in marketing and distribution.

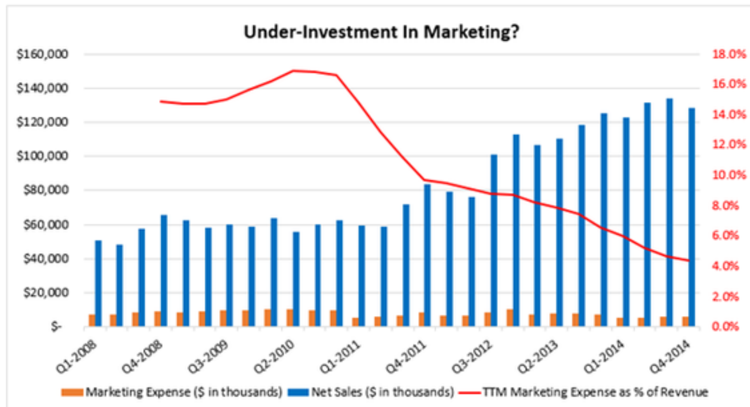


- The company foresaw this threat to sales and profits and began making acquisitions (Glutino in 2011, Udi's in 2012, and EVOL in 2013) to boost sales growth, enter shiny new markets, and attempt to mute the impact. But Boulder Brands doesn't benefit from patent protection in these new categories, which also bring it into competition with even more CPG heavyweights including **General Mills** (NYSE: GIS) (which owns Annie's) and **Hain Celestial** (NASDAQ: HAIN). Competition continues to erode margins companywide:



- Despite these declining gross margins, operating margins have been on the rise. What's going on? The answer is that the company has consistently under-spent on marketing to give the illusion of improving operating profitability. While operating margins have gone up (until recent quarters) ...





... the percent of revenue dedicated to marketing has dropped off sharply:

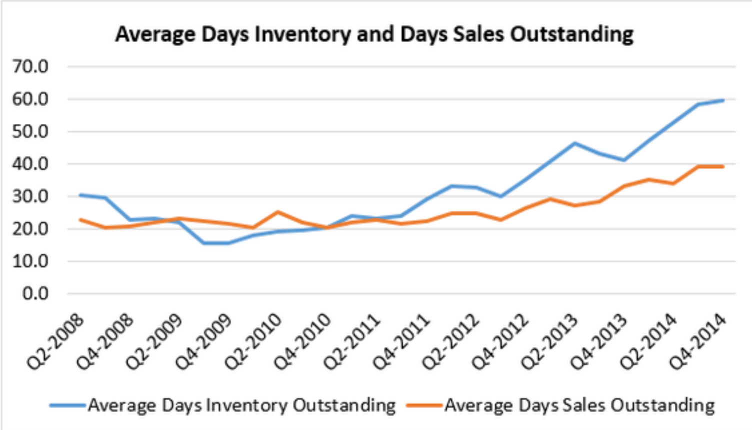
- We believe this is an example of brand mismanagement. This is a brand-driven company with incredible competition — if Boulder doesn't build its brand loyalty, it will not be able to charge premium prices. While under-investing in marketing helps short-term profits, it sacrifices long-term brand positioning and sales sustainability. Ultimately, under-investment in the brands through marketing will hurt profitability, and once sales slow a bit, the lack of profitability will return to the forefront.

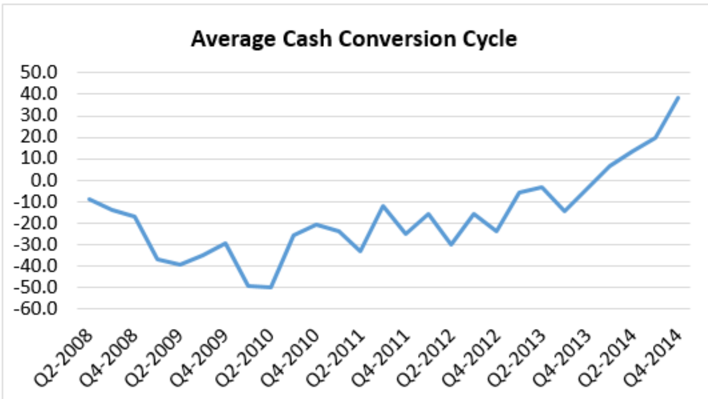
People Flags

- In our opinion, CEO Steve Hughes has a history of chasing trends under the guise of being a "health food guy," not building enduring companies. The time he spent at ConAgra (Healthy Choice), Tropicana, Celestial Seasonings, and Dean Foods (White Wave/Silk) all reveal similar stories: Find a trend, rapidly expand product lines, and focus on building sales while neglecting profitability and the logistical problems related to rapid product-line extensions.
- In September 2011, three board members (Robert Gillespie, Michael O'Brien, and lead director Robert McCarthy) abruptly resigned. The resignation letters were short but damning. Reading between the lines, these three independent directors clearly didn't like the direction of the company (Glutino was acquired in August 2011) or the July 2011 expansion of the board to make room for two more directors, both of whom had historical ties to CEO Steve Hughes.
- We believe the board is compromised and governance issues will persist. As alluded to above, CEO Steve Hughes has built a board of close friends or colleagues. Some digging uncovers that much of the board has historical ties to Hughes.
- In December 2011 ,the company's CFO, Alan Gever, stepped down. This move was also abrupt, and is notable coming on the tail of the director departures three months previous and the decent-sized acquisition of Glutino just before that. Gever received a $752k payout over 22 months and the immediate vesting of his otherwise at-risk bonus for his final year. The severance agreement notably included a non-disparagement clause where Gever was restricted from issuing any communication that "reflects adversely on" the company. Evidence suggests that Gever's resignation was not amicable.
- Hughes and management have a history of aggressive forecasting and missing guidance. In 2009, Hughes suggested that the Smart Balance brand could reach $1 billion in sales by 2014. As we can see from the graph above, 2014 Smart Balance sales were less than $150 million. And in 2014, the company missed guidance on revenue, earnings, and gross profit margin.
- We think the company's acquisition strategy is poorly chosen. Boulder's aim was to acquire new products in a healthy niche, but we think the gluten-free specialty food market is small and not likely to attract a large proportion of the population. Less than 1% of Americans have celiac disease — they *must* eat gluten-free or they suffer health consequences. Demand for gluten-free products from the rest of the market is reliant upon the perception that they're healthier and more desirable than traditional products. We're not sure that perception is likely to persist.

Financial Flags

- An analysis of earnings quality reveals some troubling red flags. Inventory growth has exceeded sales growth in 18 straight quarters, and as the company has striven to show short-term sales growth from its acquisitions, it has sacrificed cash collection for reported sales. Boulder's average days sales outstanding (how long a company takes to collect revenue after a sale has been made) has risen from the low 20s to nearly 40 days over the last few years, and days inventory outstanding (how long the company takes to turn its inventory into sales) has also increased at a similar pace:



- Taken together, this has not boded well for the company's cash conversion cycle, which is the length of time it takes for a company to convert inputs into cash flows. Boulder has quickly pivoted from a negative cash conversion cycle (it received payments from customers before it paid its suppliers) to a quickly rising positive cash conversion cycle: 

  These figures are indicative of potential channel-stuffing, where a company inflates sales figures by pushing more products through a distribution channel than the channel is capable of selling. In the most recent quarterly earnings release, the company experienced an "inventory rebalancing with [its] largest distributor", further supporting this possibility. While the initial buildout of shelf space can explain some of this behavior, it's also very likely that sales growth could experience even more pressure down the road as "fill"-related growth transitions to pure consumption growth, which is likely to be much slower.

- The company's recent acquisitions and the reshuffling of its reporting segments have two effects: masking the slowing sales growth in the company's Smart Balance cash cow, and making future growth look more promising than it actually is. The initial distribution of these new brands made it look like sales were growing quickly and sustainably, but in reality, Boulder is more than likely benefiting from the initial stocking of new shelf space. Boulder doesn't break out its sales by brand in its quarterly reports and has adjusted reporting segments several times over the last few years (another red flag), but my best estimates for quarterly sales for Glutino, Udi's, and EVOL suggest that growth from the acquired brands is already slowing and may not be sustainable.

- Boulder has limited financial flexibility because of its heavy debt load. It has $301 million of long-term debt outstanding, a debt-to-equity ratio of 126%. In 2014, the company had to increase its maximum debt/EBITDA ceilings from 4.75 to 6.5 (and 6 for quarters ending Dec. 31, 2015, and beyond) as declining margins and slowing sales have hampered EBITDA growth. I estimate that debt/EBITDA for 2014 was about 5.3. If EBITDA doesn't increase meaningfully, financial flexibility will be even more limited.

- The asset side of Boulder's balance sheet doesn't look strong enough to support more debt, either. Goodwill and other intangibles make up 66% of total assets — primarily consisting of brand value and trademarks/tradenames. For those asset values to be relied upon, we have to believe Hughes was a good acquirer — it's worth noting he paid $491 million to acquire the rights to Smart Balance in 2007, then took a $130 million goodwill impairment on that asset in 2010 and another $151 million impairment in the third quarter of 2014.

How It Fits Into *Pro*

Given Boulder's questionable earnings quality, management and governance issues, and limited financial flexibility, we feel comfortable with a 1.5% short position to start. If financials exhibit further deterioration, we may look to increase our allocation to the short. On the other hand, if the company manages to reignite growth and the stock price rises, we'll reexamine our thesis.

This small position is an addition to our direct short basket, and it modestly lowers *Pro*'s net long exposure to the market. This short should fare well for us in a falling market as the company's debt load, limited financial flexibility, and premium pricing and brands expose it to outsized risk if the overall economy takes a turn for the worse.

Alternative Trades

- None

Pro Can Help

- Questions? Visit our new [Boulder Brands discussion board](#).

Pro Live Chat, April 2015

Published Mar 20, 2015 at 2:53PM

Join us at 1 p.m. Eastern on Wednesday, April 8, for a text-only live chat!

Roll Your Diagonal Calls on American Airlines

Published Mar 19, 2015 at 1:50PM

Is this for you? This recommendation is for all *Motley Fool Pro* members who own calls on **American Airlines** (NASDAQ: AAL) and who wrote April 10 calls with us last week.

How You Participate

- **Trade:** Use a rolling order to buy to close your April 10, 2015, $52 calls on American Airlines, and sell to open an equal number of April 10, 2015 $57 calls. *Please note that these are **weekly** options*. And please read the full alert first.
- **Allocation:** Roll all of your short calls. *Pro* will roll its 10 calls.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a limit order and initially aim to roll for a net debit of $2.70 or less. If AAL is lower than the quoted price below, then the roll should cost less. If it's higher, the roll will cost more.
- **Prices** (11:30 a.m.):
  - **Stock price:** $54.75
  - **Buy to close April 10, 2015 $52 calls (bid/ask split):** $3.65
  - **Sell to open April 10, 2015 $57 calls (bid/ask split):** $0.95
  - **Rolling cost:** $2.70 net debit

What We're Thinking

There's an old joke among options geeks like us: If you want to make sure a stock's price will jump on you, just write calls on it. That's exactly what American Airlines stock has done since we wrote diagonal calls last week. Most of the recent surge was driven by the March 17 news of its inclusion in the S&P 500 index. The country's largest airline is surprisingly being added back to the venerable index not long after its bankruptcy -- most expected this could occur in 2016 or so, but it's happening on Friday. Ahead of that day, funds that mirror the index are buying shares, leading to heavy trading volume and price gains.

Same as ever, we can't know what the stock will do in the days and weeks following Friday, but we still believe the shares represent value, and we want to own our 2017 calls as long as that remains the case. Our attempt to earn short-term income prior to earnings (due around April 22) is costing us today, but we can't begrudge that outcome. We talked about this risk just last week in the trade alert. We knew the chance we were taking.

Given the looming expiration and the strike price on our short calls, we simply need to react to recent events. The situation has changed in the near term, so we want to adjust, too.

Source: Fool.com.

Why This Strategy?

We're rolling our calls to a higher strike price to avoid being short shares. We're willing to pay a debit to roll today, knowing that we have nearly two years to write more calls and likely earn back this debit and more. For now, we're keeping our April 10 expiration because we want these calls to expire before earnings. Plus, if the stock continues to rise after this roll, we can try rolling to April 17 if need be, which should also expire before earnings.

However, we should all realize that if the stock continues to gain altitude, we may need to pay another debit to close these new short calls before earnings. We don't want to miss the forest for the trees: We believe our 2017 calls could be worth much more over the next few years, and we don't want to miss that opportunity. But since we risked writing short-term calls for income, we need to manage that position as seems best until it plays out. We're not ready to simply close our calls today given that the extra buying from the S&P 500 news should slacken and subside in coming days. But we also want to roll higher to avoid getting "pinned" to our strike price and losing more and more upside in the process should shares keep rising. So, we take the middle road today, paying to roll and seeing what happens next.

If we roll our $52 calls to $57 at a $2.70 net debit, given that our first calls paid us $0.81 originally, we're $1.90 in the hole on our income strategy. We have a long time to work to make that back, assuming we see good ways to do so. But also note that we're gaining $5 in upside ($57 vs. $52) for a $2.70 cost, so the roll makes sense from that perspective, as long as we believe shares will hold up.

That said, if you wish to wait and hope for a few down days before rolling, you could. The $52 calls have about $0.90 in time value remaining, which should slowly dissipate, lowering your cost to close (at least in terms of time value). And rolling to $57 isn't exactly urgent. Given the recent Deltas on each, the $57 calls will move by about $0.33 for every dollar move in the stock right now, while the $52 calls will move by about $0.73 for every dollar change in the stock. So, if the stock keeps going up, this roll gets more costly. But if the stock goes down, the roll becomes cheaper. Either way, we want to get this trade alert out to share the intention, and then act on it soon.

More That Matters

- **Maximum gain:** After the roll, the credit on our new $57 calls is the most we can earn on the diagonal calls, and that strike price caps our long $35 call potential, too.
- **Maximum risk:** The full value of our long $35 calls, minus any net premiums received from short calls. So far, we'll have added to our cost basis with short calls -- not the desired outcome.
- **Follow-up**: We hope to see these short calls expire next month, then wait to see earnings results around April 22 before potentially writing new calls. If we need to roll or close, we will, paying to do so if need be, because we believe the long-term value of the stock is higher.

Alternative Trades

- **Own stock?** If you wrote April 10 $52 covered calls on shares of stock, roll those the same as we are, to April 10 $57.

Options Can Help

- **Want to know more about this strategy?** Our Options U guide to [writing diagonal calls] is available -- and unlike luggage, there's no additional charge.
- **Questions about this trade?** Fly on over to our [American Airlines board], where the soda and snacks are on us. Well, actually they're not. Sorry!

On Capital Allocation

Published Mar 16, 2015 at 3:31PM

Dear *Pro* members,

Investors talk about capital allocation a lot. When I was first learning about investing, capital allocation was something I was taught to focus on. I heard phrases like "make sure management is good at capital allocation" and "successful capital allocation is the key to long-term wealth creation." You may have heard of the book *The Outsiders*, which — in the words of Warren Buffett (a pretty good capital allocator himself) — is "an outstanding book about CEOs who excelled at capital allocation."

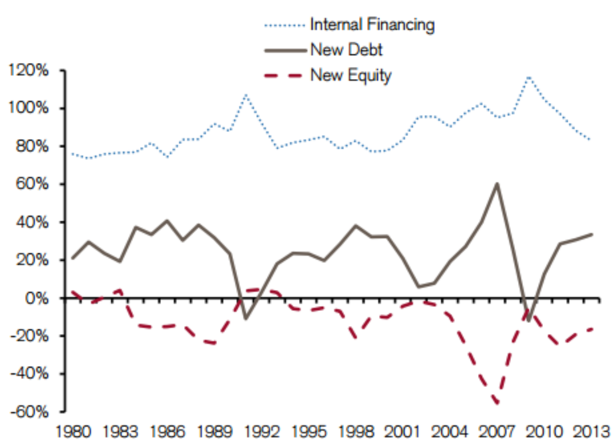
So it's clear that capital allocation is important, but it's all too easy to throw around the phrase without knowing what it really means. Here, we'll take a deeper look at capital allocation and give you a few examples of how to know whether management is doing its job right.

What Is Capital Allocation?

In its most simple form, capital allocation is the process of converting financial and other operational resources into something more valuable than they would be otherwise. If a manager invests $1 into a project that ultimately generates $2, then he or she has done a masterful job of capital allocation.

Sources of Capital

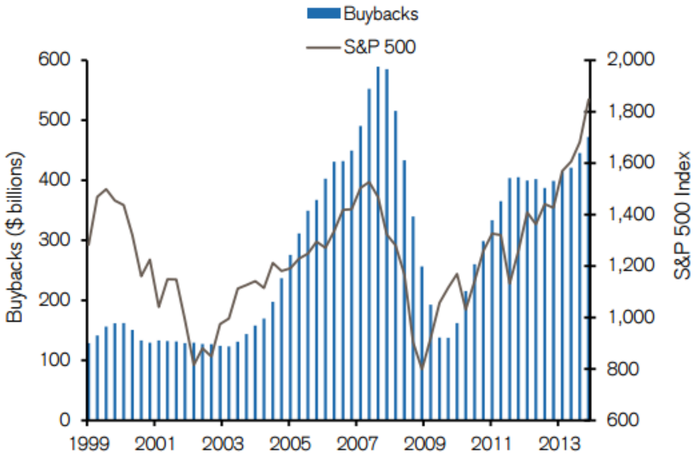
Capital comes from three main sources: internal financing (cash generated by the business from operational cash flow or asset sales), new debt issuances, and new equity issuances. Here's a chart that shows the breakdown of sources of capital for U.S. companies from 1980 to 2013:



Source: Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, Michael J. Mauboussin and Dan Callahan, CFA (2014)

You can see that internal financing is by far the predominant source of capital for U.S. companies, representing about 80% to 100% of total capital during this period. It's interesting that equity has predominantly been a negative source of capital, meaning that companies have spent more on buybacks than they received by issuing new equity.

Also interestingly, a closer look at share buybacks reveals that managers have generally not optimized their buyback timing with respect to capital allocation. Buybacks can add significant long-term value if they're done when shares are undervalued: If a stock worth $1 is selling on the market for $0.50, that's a no-brainer capital-allocation decision. On the flip side, buybacks can detract significantly from long-term value if they're done when shares are overvalued: If a manager spends $1.50 for a share that's worth $1, he is incinerating capital. Buybacks of shares at fair value add no incremental long-term value and in fact may detract from value when considering opportunity costs. Here's a chart of companies in the S&P 500 index that compares their total buyback volume to the level of the S&P 500 index from 1999 to 2013:

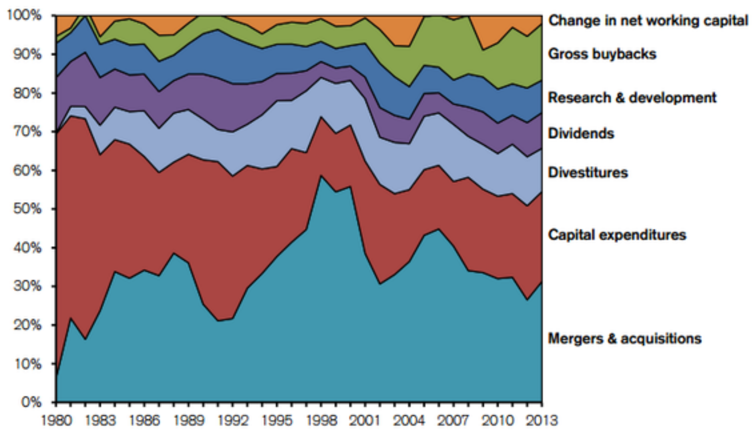


Source: Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, Michael J. Mauboussin and Dan Callahan, CFA (2014)

If companies were maximizing their use of buybacks, we'd see the highest volume of buybacks during market troughs and correspondingly less volume at market peaks. But in fact, we see the opposite — that management teams have a tendency to buy high and sell low. Bad!

Uses of Capital

Share buybacks are just one way management can spend capital. The chart below shows a breakdown of spending by source for the top 1,500 U.S. companies from 1980 to 2013:



Source: Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance, Michael J. Mauboussin and Dan Callahan, CFA (2014). *Note: Data for R&D, capital expenditures, buybacks, and dividends exclude financial companies and regulated utilities; data for mergers & acquisitions and divestitures include all industries*.

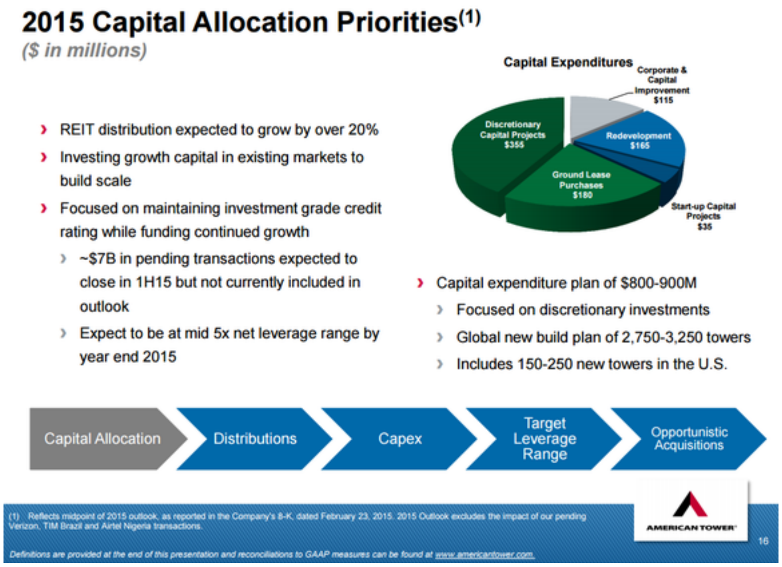
We can see that buybacks represent only about 1% to 15% of total capital spending. The largest source of capital spending is mergers and acquisitions. This chart again provides evidence that managers have a tendency to buy high — M&A expenditures are cyclical, tending to peak when the stock market is high and access to capital is easy (see: late 1990s and 2005 to 2006). If managers were focused on growth in long-term value, peak M&A activity would take place when stock market values (and thus whole-company values) are low.

Evaluating Capital Allocation

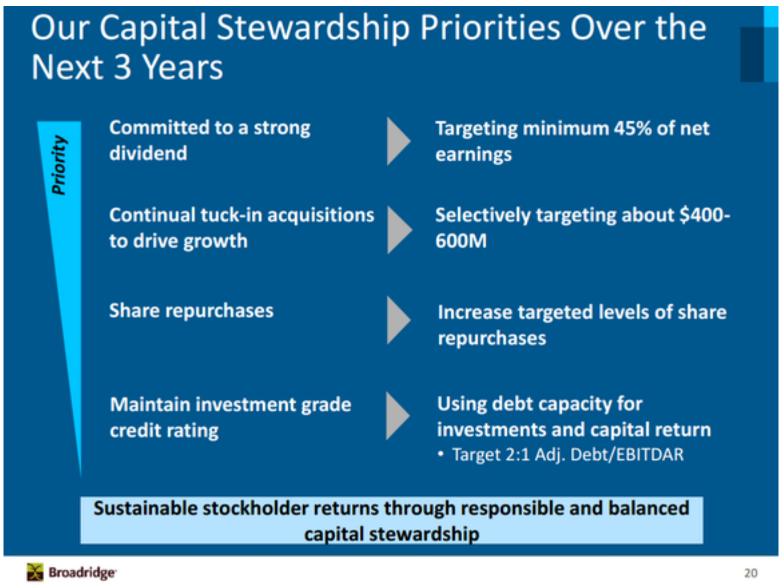
So, how do we know if management is good at allocating capital? Here are three ways to know whether your management team prioritizes effective capital allocation, with some examples from the *Pro* portfolio:

1) They talk about capital allocation.

It's surprising how many companies fail to appropriately communicate their capital-spending priorities. Managers should have a clearly articulated strategy for capital allocation. For example, **American Tower** (NYSE: AMT) and **Broadridge** (NYSE: BR) are very clear about their priorities, often including slides like these in their investor presentations:



Source: American Tower Q4 2014 earnings presentation



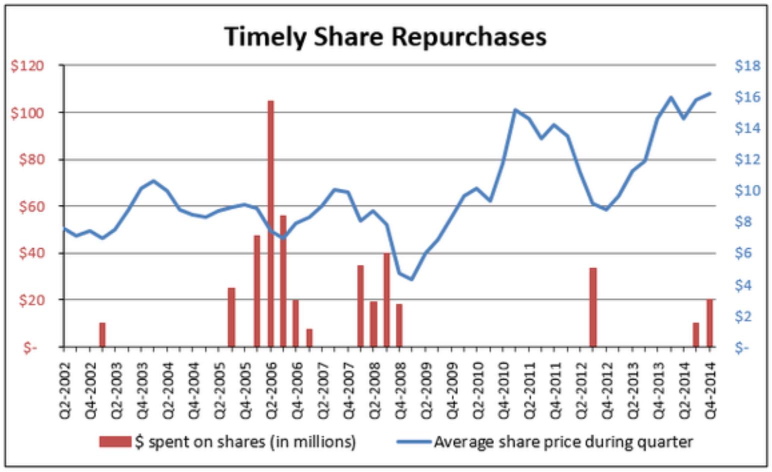
Source: Broadridge Investor Presentation at Credit Suisse Annual Global Services Conference (3/10/15)

2) They are appropriately incentivized.

If managers are incentivized to prioritize the short term over the long term, they may sacrifice proper capital allocation to try to juice short-term profits to hit their bonuses. We want to see incentive structures that clearly affect growth in long-term value per share. This may take a variety of forms (short-term vs. long-term goals, equity-based vs. cash-based, etc.), but the metrics used should focus on value (that is, metrics focused on capital efficiency such as ROE, ROIC, or EVA) rather than volume (growth in sales). For example, **Wells Fargo** (NYSE: WFC) executives receive a small, fixed base salary (14% to 20% of compensation), a small annual incentive award based on EPS and ROE (18% to 21%), and the rest in long-term equity-based incentives based on average three-year absolute and relative performance in ROE (62% to 65%). These types of incentive structures align management with growth in long-term value per share.

3) They display good timing with buybacks or acquisitions.

As I mentioned, managers have a tendency to spend more money on buybacks and acquisitions when stock market values are high. Optimal capital allocation principles suggest that managers should do the opposite — buy back shares and make acquisitions when stock market values are low. **Gentex** (NASDAQ: GNTX) is historically very good at this; it has a history of selectively buying back shares at or near local lows in the stock price, suggesting that it uses buybacks as a capital-allocation tool rather than as a use for residual cash:



Source: Company filings

Another good example is **TD Ameritrade**'s (NYSE: AMTD) $600 million acquisition of Thinkorswim Group during the depths of the credit crisis in January 2009, when the stock was trading at its lowest price in three years:

Source: S&P Capital IQ historical price chart of Thinkorswim Group (red arrow indicates timing of acquisition)

The Foolish Bottom Line

To summarize, capital allocation is perhaps a management team's most important function, and proper capital allocation is the key to maximizing long-term growth in value per share. Capital comes from three main sources — internal financing, debt, and equity — and can be spent on a variety of sources, including working capital, buybacks, dividends, divestitures, research and development, and mergers/acquisitions. We want to see management teams that clearly articulate their capital-allocation priorities, are properly incentivized, and are prudent in the timing of their capital spending.

Fool on!
Billy (TMFTailwind)

Pro Completed Trades

- **American Airlines** (NASDAQ: AAL): We sold to open 10 April 10, 2015, $52 calls at $0.81 per contract. The stock has risen since the alert, so if you've yet to complete this trade, it may make sense to increase the strike price on the sold calls to give yourself more room for upside. Make sure to target at least a 3.5% yield on your long January 2017 call value. See the alert for more details on yield math.
- **Papa John's** (NASDAQ: PZZA): We established a partial covered call position on Papa John's, selling 6 October 2015 $65 calls at $3.40 per contract to cover one-third of our 1,800 shares. That price will change as the stock moves.

FoolFest 2015: A Pro Panel

Published Mar 13, 2015 at 9:05PM

The Pro team, with special guest TMFPhooLon, takes member questions on the portfolio and what they expect from it. Recorded at FoolFest 2015 in Alexandria, Va.

{% video %}

Transcript to come!

FoolFest 2015: JP Bennett on Valuation

Published Mar 13, 2015 at 9:01PM

Analyst JP Bennett explains *Pro*'s methods of valuing a stock. Recorded at FoolFest 2015 in Alexandria, Va.

{% video %}

Transcript to come!

FoolFest 2015: Using Options in Pro

Published Mar 13, 2015 at 8:52PM

Jim Gillies, co-advisor of *Pro*'s sister service *Motley Fool Options*, explains how *Pro* uses options strategies to enhance the portfolio. Recorded at FoolFest 2015 in Alexandria, Va.

{% video %}

Transcript to come!

FoolFest 2015: Pro Welcome Q&A

Published Mar 13, 2015 at 8:46PM

Jeff Fischer and the *Pro* team, with special guest Jim Gillies, welcome members and take a few questions at the kickoff of FoolFest. Recorded at FoolFest 2015 in Alexandria, Va.

{% video %}

Jeff Fischer: Good morning, everybody.

Audience members: Good morning, Jeff.

Fischer: It's great to see you all here. Thank you for being here. We know that you could be anywhere in the world right now, and you chose to be here with us, and we greatly, we appreciate that.

Audience member: We love you, Jeff.

(laughter)

Fischer: We love you, as well. It's really great to see so many Fools here again or for the first time. We have Fools from Mexico, from Alaska again, Kendall. From Spain, Pablo is here again. Mitchell came from Mexico, Fools from the West Coast, of course, California. Canada.

Audience member: Canada.

Fischer: Canada.

(laughter)

Audience member: Who's this guy?

Fischer: All over, so we're really honored that you're here. Now that said, we are not naïve. We know Alexandria and Washington, DC, are a winter haven that people are flocking to. And in fact, the balmy Potomac, if you have seen it, it's teeming with red snapper and goliath grouper and other tropical fish, so if you're looking to charter a boat tonight and go fishing, I recommend the night time, that's when the temperature cools down a little bit out on that water or ice, it's great fishing.

So thank you for being here. Let me introduce Jim Gillies' Motley Fool Options.

(applause)

And Special Ops. Billy Kipersztok. Fool Pro and Options. J.P. Bennett. Motley Fool Pro and Options. And the star behind the scenes, Ellen Bowman. Motley Fool Pro and Options. She makes everything work, and when we arrive at nine in the morning and say, Ellen, we have a trade that we need to get out by 10, 10:30, she's all smiles, like, no problem. I can edit in five minutes. She does great work.

So we're going to start because we only have 30 minutes before lunch break, so we thought we'd start, just hit the ground running with questions that you all have about Pro, about Options, about investing in general, about Jim's fashion choices and where he shops in Canada. Anything you want to ask, that's how we're going to start this first half hour, and then after lunch, when you're all sleepy, we will lift you up with our presentations. So there's a microphone right there, and you can also yell out any question and I will repeat it for everybody because this is being recorded. But don't let that intimidate you, so. Who wants to ask the first question?

Audience member: Hi, I'm Susan. I'm from Denver.

Fischer: Hey, Susan.

Audience member: Last night, Jeff, I asked you where you're going to be moving the portfolio and you had mentioned more shorts. Do you think in the next couple of years, you'll be moving the portfolio at all into any international companies?

Fischer: It's a great question, Susan. And thank you. Susan did ask that last night and my, my intuition, my feeling, and it's the feeling of the team, as well, is that we want to add more shorts to the portfolio. We're actively looking at all times. We want to increase our short, what you can fancifully call a short book or just our short, our direct shorts of companies. Weak companies, we hope, struggling companies, kind of the opposite of what we try to buy. Now the reason we want to do that is valuations on a lot of companies do look generous, especially some companies that don't have a track record or recent IPOs, and it's slightly, I wouldn't call it an irrationally exuberant market, but it's a slightly happy market.

(laughter)

And but either way, we believe we can find weak companies that we want to be short, whether the market goes up or down. Hopefully, those shorts will perform whatever the market does. And if a short does west, less well than a strong market, even that is a win, but really, for us, the ideal of course is a short like **Five Below** or **Caesars** or **Sony** in the past, that goes down even when the market's going up. That's a really nice result to have.

Audience member: RadioShack!

Fischer: RadioShack. It was--

Audience member: That was done.

Fischer: We looked at that and it's, it's pretty hard to short most of the time, but we probably missed a window there. So I think we want to keep the companies that we really believe in even if they look slightly overvalued or modestly overvalued. We want to keep them to compound over time and one way to do that is to add more shorts and more hedges and I think that's the direction we will be moving in the coming months and year or two.

Billy Kipersztok: And you asked specially about international stocks, as well? Right? Do you have any thoughts on that?

Fischer: I thought you were going to answer, Billy.

Kipersztok: I'd be happy to.

Fischer: So international stocks, we, we own some shares. It's only a 2% position in the Wisdom Tree small and emerging markets small cap dividend fund. DGS is the ticker, and we are thinking about all the time adding to that a bit, and we've also looked at European companies to possibly add. So far, we haven't, but I would be surprised if we don't add some more international exposure because those stocks, especially emerging markets right now look historically inexpensive and they're much less expensive than U.S. stocks.

Kipersztok: But we are limited to those that trade on U.S. exchanges. Right, so you know, the foreign company ADRs or their ETFs.

Audience member: Would there be any overlap between some of the companies that you looked at and some of the stuff that (unclear 05:53) is doing? Like the international fund I heard about last night. Would that what you would be drawing from or would you be going out on your own (unclear 06:02)

Fischer: That's a good question. We would go out on our own, but there's nothing that stops us from looking at the filings of Tim's fund, and what would be a good starting point. Each quarter, when they file their holdings, we can look at those if we wish, and we know that's been vetted by at least one team already, so.

Audience member: (unclear 06:21) within the universe.

Fischer: As long as it's in, as long as it's in this solar system, we can do it.

(laughter)

Yeah, I do. Pro's universe is anywhere. We can go anywhere. Options is, are the full newsletters, the five newsletters and special reports. But so Pro can wander.

(laughter)

Ellen Bowman: Hey, so this is being recorded for later viewing, so anybody who doesn't want to ask a question in the microphone we're just going to need to repeat it up here so that it is audible later.

Fischer: Great. See, Ellen keeps us organized and tells us what's important.

Audience member: Are you ready for another question?

Fischer: Mm-hmm.

Kipersztok: Sure.

Audience member: My name's Ellen and I'm from Crozet, Virginia, outside of Charlottesville. I'd love to hear about your team's internal process for asset allocation. Not just kind of from a quantitative point of view, but from a deliberative, people, kind of discussion point of view.

Fischer: So how we talk about asset allocation?

Audience member: Mm-hmm.

Fischer: It's an evolving process. The portfolio's nearly seven years old. And good question, by the way. Thank you. And over that time, of course, you have some positions grow and become more of the portfolio and others shrink. And our, our overriding philosophy is we want to let our winners go on winning as long as merited. As long as we believe in them. We're not, at this stage, and maybe we will be later. We're not, we don't really favor the idea of rebalancing excessively. We've sold little parts of large winners in the past to put them into ideas that we like better and we'll keep doing that. But we're not going to chop something off just because it's grown to a larger part of the portfolio than other positions.

So it is an evolving thing, though, and right now, we're 80-ish% long, speaking of broad asset allocation, and I could see us being 60% or 50% net long in the coming year or two if that's what we believe is best. So allocation can change in that way, as well, by adding shorts and hedges. But on a position by position basis, we look at each one individually, and we should be comfortable with everything we own that if it grows and grows, we're okay with that. There may reach a point where we want to sell some because we are a fixed funds portfolio. We don't have new money coming in, and when we see something we like better, we'll need to trim from somewhere. But overall, we like to let our winners go as long as we believe in them.

And as far as how we talk about it as a team, basically, twice a month we talk about our positions overall, in any, and at any moment we'll talk about any that are concerning us that's, there's always an open conversation. If anything's concerning us, we start talking about it.

Audience member: Hi, I'm Morris. I'm a member from New York. I've seen the, I've been a member for about a year or so, and I've seen the portfolio do very well over that time, but it seems to be tracking the broad market indexes much more than it tracks he North Star, and I'm wondering why or how you're planning to make it track the North Star more than the market indexes during the inevitable downturn.

Fischer: Great question. The North Star, over the long term, and if you guys want to--Billy, you want to start?

Kipersztok: Sure, why not?

Fischer: Otherwise, I'd keep going, but…

Kipersztok: Yeah, I think you know, our portfolio falling the broader market indexes recently I think is just a function of our allocation. You know, we're predominantly in equities, obviously, so with the equity indexes as they go, we will go. But the decision to be allocated in a specific manner is something that we talk about and we discuss as a team all the time. And so you know, our thought process is, you know, as market conditions change, we expect to continually have our conversations and then hope to position ourselves in such a way that we can react to market conditions quickly. So if that might take the form of putting on a direct short where we can reduce our exposure by x %, you know, shorting a specific index or something like that.

So I think we try to take kind of a reactive approach to managing our portfolio and you know, and also we want to recognize that the North Star isn't necessarily something that we try to achieve over a short term period. It's something that we're looking to achieve over a long-term period. So with that said, it's not going to be a steady 8% return every single year. To achieve the North Star, we might have some periods where we have, you know, very strong returns and then some periods where we have less strong returns but over the average, it comes out to something closer to the North Star. So I think it's a combination of various things.

Audience member: (unclear 11:37) successful?

Fischer: No, I think Billy has a great answer, I think. A reactive, we'll be reactive to the market conditions. And the thing to keep in mind in a downturn of, we don't real, we don't, were not so concerned about downturns of 5 to 7 or 8%, those happen, they come and go very quickly. But the downturn of 10%, 20%, that's something we hope to be positioned for, whether we get positioned after a 7 or 8% decline or we happen to be positioned ahead of time. A lasting downturn can last up to a year, 18 months. And we'll have time during then to short things on the way down, to use some options, ideally. Things like that.

So it's, it's a reactive rather than predictive approach to a large degree. That said, when we look at valuations right now, we're looking for more shorts, and we'll put those on any time. We're continually hedging and I think we're going to hedge more in the near future as, not as a reactive function just because we want to, and we want to do it while things are rising. So it's, just as we've slowly increased our long exposure over time as we grew more confident in the recovery, in a downturn, we'll have less time to react but still time to react and try to capture returns during a slide, as well, as it occurs.

The other--one more thought is the North Star over time does better than the S&P 500, so when the S&P 500 is rising, we really want to be rising with it and hopefully making up some ground on North Star because when the S&P is falling, and the North Star is still going up 10% a year, it's going to be a beast to try to--we just want to keep close to it in that case.

Bowman: And the follow-up question was about whether this is market timing and how it might differ.

Fischer: Thank you Ellen. I'll answer it again now for the recording.

Bowman: I think you should, yeah. Backwards this time.

Audience member: Gene from Virginia, semi-local Fool. Hi.

Fischer: Hey, Gene. Good to see you.

Audience member: Thank you, thank you. My question, three years ago, four years ago, maybe as recent as two, my memory's a little hazy, a Pro sort of aspirational goal was to reduce if not the number of positions, at least the number of underlying instruments. To around 20, the reasoning back then being less things for you all to study and make sure that each sort of meaningfully contributed. I haven't heard that in the last year or 18 months. Why has your thinking on that changed or has your thinking on that changed?

Fischer: It has changed a little bit, Gene. We have 24 core positions now. We were at one point, we were up to 28 or 29 and we slowly whittled it down, and we feel comfortable with two dozen at this point. And we like having some smaller positions that are lagging, frankly, and I'll talk about that a bit later why we like that. And so we haven't felt compelled to whittle things down further. I guess the answer is, we're at 28, 29. We thought 20 may be better and we slowly decreased, but once we got to around two dozen, we were happy with that.

The other reality of what we do is we're trying to serve all of you with a portfolio that does really well over every rolling three years. But at the same time, we're trying to scratch that itch for new ideas when we see them and like them. If we're doing our job, we should always be finding, I don't care what he market is. We should always be finding at least a handful of really compelling ideas every year, whether that's three or four or whatever. And so then we need to add them into the portfolio and that's, we may not have as many positions that we're selling at the same time.

So we do realize, we're probably going to bounce around in the mid-20, low to high 20s as far as main positions go. And as we add more shorts, right now, we only have two direct company shorts. Three if you count the Euro, which you can't count. But Caesars and the Five Below, if we had say, our ideal is to add six, seven, eight more and have 10 shorts that are each 1-2% apiece. And then we'll have many more companies to follow, but I think too, when we were saying we're going to get down to 20 companies, we're trying to get rid of some work. Shed some work, but we decided, we were told we can't do that.

(laughter)

I kid on that one.

Kipersztok: Just to add a little bit of color to that, as well, so maybe it's not something that we have kind of publicized or talked about in our communications, but it's definitely something that we talk about as a team. Making sure that, you know, if we're going to be adding a new position to the portfolio, we want to make sure we start at a specific allocation. We want it to be meaningful to our returns, so we're trying not to introduce a bunch of small positions. We want to have relatively fewer, more meaningful positions. And that's something that we definitely try to emphasize.

Fischer: These are great questions. You guys are coming out swinging. Hello.

Audience member: Hi. I'm John from Arlington.

Fischer: John.

Audience member: I just joined the Motley Fool One in October, and so this is my first real involvement with the Pro service. I was just wondering is there any way to use the two, Everlasting portfolio and the Pro approach. Is there any sort of integration that's possible or if there is, what would be your suggestions to start doing that.

Fischer: That's a great question. J.P., do you have thoughts on that? And then I would also ask any member who is doing that to maybe share their thoughts.

J.P. Bennett: Yeah, I think there can definitely be some integration. I know a lot of members have talked about in the past so they may not dedicate their entire portfolio to Pro so it's really kind of looking at your personal portfolio and really what you want to try to achieve. If you're more concerned with achieving a return similar to like what we're trying to do as far as tracking the North Star, maybe dedicate a little bit more towards Pro. And on the other hand, maybe if you like Tom's idea of building an Everlasting portfolio of really buying stocks and holding them for the long term, maybe you can allocate a little bit more towards that.

So in many ways, we're looking for very similar type companies. We want high-quality companies that we can hopefully own for an extended period of time but our approaches are definitely different in what we're trying to achieve and of course, we take shorts into consideration and looking at actively hedging if we think there is a chance that the market might experience a correction and we would be put in a place where it would be harder for us to achieve North Star like returns unless we hedge out.

Fischer: Yeah, and I'll add that there is some overlap. Naturally, they both the portfolios have off the top of my head, **Starbucks** and **Facebook** and **MasterCard**. Tom took that one. And …

(laughs)

And so there is some overlap and what I do in watching Tom's Everlasting portfolio, he invests quarterly. When he buys something two times, three times, four times, that should get your attention. It means he really likes it and consider adding that to your portfolio as a complement to whatever Pro holdings you do have.

Kipersztok: And then also, as a Pro member, well, as a One member, you have access to all of the services, right? So you have access to Pro and to Options, which we're a little bit different in that we utilize some different strategies than some of the rest of the newsletters. So what a lot of Fool One members have done and have been successful doing in integrating the services is to use some of those tools that they've learned from Pro and Options, um, you know, things like Option strategies, various strategies, and applying it to the recommendations from other services. So that's one way that a lot of people have been able to integrate them.

Fischer: Are there any members who would like to share how they use Everlasting and Pro together, Pablo? Thank you, Pablo. Pablo from Spain.

(applause)

Audience member: Yeah, what, what I can share with you isn't exactly what he was saying now about using options. I'm starting to jump into the Everlasting portfolio. I joined first Pro, which is my favorite service still. And then I jumped into a bunch of others (unclear 20:22) portfolio and finally, I'm a One member now. I follow today four different services and I keep four different portfolios in the world. I buy every month Stock Advisor Tom recommendations. I buy every quarter the five recommendations by Tim in Everlasting. And I keep a mirror portfolio of Pro and a medium, a mirror portfolio of Million Dollar Portfolio.

And the way I use now Everlasting portfolio, but also Stock Advisor. Thanks to Jeff and Jim teaching on options is that they both portfolios at Stock Advisor and Everlasting are long-term ones. Stock Advisor is not really determined to be a long-term thing, but it is. If you look at the track history of Stock Advisor, they rarely sell anything. They mostly buy and then buy again and then buy the same company two years later, and then rarely, they put something on hold or even sell. And Everlasting portfolio is the same, for five years, they don't sell.

So what I do is when there's a new recommendation on either Stock Advisor or Everlasting portfolio, I first check if the company is giving dividends. If the company is not giving dividends, then I consider buying LEAPS. (unclear 21:46) if they are available. If they are not, which sometimes they are not, and you can only by calls like for three months period, then I just buy the stock, but if you can buy LEAPS which are deep in the money, let's say that the company's price at 100, I will buy with a strike of 70. Or around. Then I will buy LEAPS for one or two years long and then I will pay a really small premium. I will be low rate and then I will be using the cash that I'm not deploying on that in something different. So that's a way of combining both.

Fischer: That's great, Pablo.

Audience member: And sorry, on the other hand, if you join One as I did and some positions were already there and they look like really overpriced now, let's say **Zillow**, okay? When I joined One, they already had Zillow in the portfolio and I didn't buy Zillow. What I have been doing with some success is to write puts. To sell, make puts on that. Because if Tom thinks that this position will grow over time, and my interest is to buy it at a lower price than it is today. Then if I make it great, then it will match that position with Everlasting, if I cannot make it, great, as well. Because I will be compounding around 1% per month which is about 13% per year on that position.

Fischer: That sounds great, and I'm going to guess that it took you several months or even a few years to figure out how you're making all of these things work together, so that's I think a reality here, as almost everybody has found a way that's almost unique to themselves and what they are seeking to accomplish to make things work together., whether they end up using just one service or four or however many. That was great. Thank you, Pablo.

We have about--so at 11:45, we're breaking for lunch. But we're going to break at 11:43 so you guys can get to lunch before the others. No, I'm not, but I know the crowd out there.

Audience member: Hi guys, it's Mark. De Moines, Iowa.

Fischer: Hi, Mark.

Audience member: Second time. Love it.

Fischer: Great to see you.

Audience member: Hey, I wondered if you could speak a little bit to, you seem like you're taking a little bit more a deep dive approach on holds. **Papa John's**, **Medtronic**, and I know some of your recent comments, talking about you know, we're willing to take three, four months sometimes now to take a harder look at where we're at and make a more permanent decision. I've struggled with Papa John's personally. I just--I don't get pizza for some reason. That's my problem. I like to eat it, but I don't invest in it. I'm wondering if you could speak a little bit to the--what's going on in a team and what you're looking at as you take that deeper dive into holds and how you ultimately make your decision.

Fischer: Great. Great question, mark. So Papa John's did go on hold recently, and before that, **O'Reilly Automotive** in November, December. And right now **AmTrust** and Medtronic are both on hold as we go through earnings there. One thing that is in our mind is we're six, seven years old, and we only open a couple times a year, typically. And we had everything on buy up until last November. So we believe or we assume that everyone who wants to has bought these stocks and owns them already, and that gives us some leeway to then put them on hold for a quarter, even, or longer, to make sure that we want to keep recommending it, let alone keep owning it.

And why some things have gone on hold lately is we're looking at their valuation compared to past valuation, typically. And if it looks stretched by a significant measure, then we want to try to determine why, what has changed. Is this new price merited? Should we then continue to hold it or should we indeed get rid of it or at least write calls on it if we're comfortable that it's not going to fall much at all. So yeah, as the market has changed so much, pricing has changed so much, we're finding that we want more time, and some cases, to see a whole quarter and see how things are going before we move something back to buy.

That's been the case with O'Reilly, which was put on hold in late November to go through earnings as the valuation has, it's more than doubled for us, I think, less than two years. And it's a great business, but every business has its price where you may not want to own it. So it was put on hold in November and then oil prices, of course, cratered in December and it helped the stock even further. And what we're trying to determine is how much this lower fuel price is going to help O'Reilly. Management has said it will help. It will make a notable difference, but we want to know how much before we make a decision on whether to move it back to buy or not. So yeah, it's taking a little bit longer, but we only have four companies out of 24 on hold and our goal is to get that either to, back to buy or to a sell, whatever we decide looks best for everyone here and then for anyone who's new to the service, too.

Kipersztok: Yeah, and I think in the past, we kind of had an informal process where if we put a stock on hold, we would kind of do a 30-day review, and I think like what Jeff was mentioning, in some cases, it makes more sense to wait for a quarter or results, as opposed to an arbitrary 30-day window, so the whole process, just to give maybe a little bit of insight into it, because Papa John's is a company that I cover, so I'm responsible for conducting the review.

The team has a lot of conversations about it. On a given day, we might see something and just fire an email or the rest of the team, start a chain of discussion. So the process is kind of dynamic in some cases, you know, we're kind of monitoring day to day, seeing what the prices are and trying to look at valuation multiples; and then in other cases, we're waiting for earnings results and trying to incorporate those results into our model and seeing like Jeff said, if this new price is warranted. So yeah.

Fischer: Yeah, Billy has done a lot of research on Papa John's as we look it over again. He's sending us cheese industry facts and cheese pricing history and dairy pricing. It's very interesting. Because cheese prices stay low for a long time, that'll help Papa John's a lot; cheese prices, as you may or may not know, have fallen a lot lately.

(laughter)

Nice thing. So yeah.

Audience member: So based on this morning's talk, that doesn't portend bad things for the market.

Fischer: It may help pizza purveyors. So a lot of that research will go out when Billy issues an update. You'll get to see how we came to that conclusion. So.

Bowman: I think this will have to be our last question if we really want to break at 11:43.

Fischer: It's 11:40.

Audience member: Bill, I'm a local from Herndon just about a 45-mintue drive away. Speaking of valuation, do you do a relative valuation in the Tom Engle sense where you track the history of at various points in time along the way and make your decisions based on that sort of thing as opposed to any point in time in isolation. So for example, the share price may have gone up, but the earnings went up even higher or other fundamentals, so that relatively you could argue that it's an even better deal now than it was when the price was 20% less.

Kipersztok: Absolutely. The …

(laughter)

You may have seen or may not have seen, this is supposed to be more of a Pro panel but I'll co-opt for a second on Options. There was a, there was a position in **Costco** recently that I thought we were going to run for years, to be honest with you. And based solely on exactly what you were talking about. Costco, they announced a $5 special dividend and the efficient market promptly bid it up $12. To a literally, to an all-time high on any relative valuation basis you wanted, and so we killed the position.

And I know I personally do for anything, anything that's going out, we're always looking at what is the relative point. And also you want to start to take into account, you know, what is the, you know, can you come up with a justified, certainly more of like a price to book multiple. Sometimes you can come up with the so-called justified multiple. What's good for a company like **AIG**, for example, which I know is a Pro holding. But yeah, I mean, I think that has to be part of your valuation work. So, my two cents.

Fischer: Five dollars. Canadian. And I do love when that happens, when a company's earnings have grown so much that a stock at 100 has a lower valuation multiple than it did at 50, and that's what makes investing work. That's how compounding works. Any other? It is 11:42. If there are no more, we'll break for lunch, and we'll be back here at what time?

Audience members: 12:30.

Fischer: 12:30. We have a great afternoon planned. We look forward to seeing you. Thank you.

FoolFest 2015: Pro Stock Talk With Billy Kipersztok

Published Mar 13, 2015 at 8:33PM

Pro analyst Billy Kipersztok explains why the service has such an affinity for **TD Ameritrade** (NYSE: AMTD). Recorded at FoolFest 2015 in Alexandria, Va.

[Billy's PowerPoint slides in PDF format]

{% video %}

Billy Kipersztok: All right, well, I'm going to go ahead and get started here, guys. I just want to start again by thanking you all for joining us again. I'm Billy Kipersztok, as I was mentioned before. I'm going to be doing a little session with you guys called Pro Stock Talk. I'm going to go in-depth and talk a little bit more about why we like a specific company that we invest in for Pro, and that company is **TD Ameritrade**, which is a holding in our portfolio. I did a similar session last year on **American Tower**, and if you guys are interested, if you weren't here last year, you can go back into our extras section on the website, and you can see all the presentations from last year. Just go to February or March 2014. You can see those presentations, but yeah, so I'm just going to go into a little bit more detail about this specific company and why we like it as an investment for Pro.

So let me start off by asking you guys a question. So how many of you guys use TD Ameritrade as your broker? Show your hands. Okay. Pretty good. And of those people, how many of you guys use **Think or Swim**, which is their kind of more advanced platform? So fewer. Okay. Interesting. So yeah, a lot of you guys are probably familiar with them as a consumer. And I think it would be interesting to kind of drill down into the business. And I've talked a lot about this company in the service, so if you've read that and you're familiar with the business, hopefully this is a good refresher. And then also I've included some new information data in there, so even if you are familiar, hopefully, there's something new in here for everybody.

So why Pro likes TD Ameritrade as a Pro investment. I structured this presentation as with four main categories here, why we like the company. I'm going to go into detail of each one. The four categories are: competitive advantages, low financial risk, positive exposure to rising interest rates, and strong management and capital allocation. So let's get started.

So competitive advantages, brand and switching cost. So TD Ameritrade, one of their advantages, one of their competitive advantages that we believe that they hold, is that they have a strong brand. They have a good reputation in the industry, and they're known for their service quality, as well. So with that comes awards, so they have been recognized by various websites and other things for the excellence of their products. So they were the number one overall broker in 2015 by Stockbrokers.com, fourth straight year. Number one tablet app in the trader community. How many of you guys have used their tablet app for TD Ameritrade? A few? It's pretty good yeah. And then number one ranking best in class recognition in nine other categories, all of these things for multiple years in a row. So they're very well recognized, very well-awarded in the industry.

And then of course, this is true across the entire industry, is that all brokers have and benefit from switching cost. So anybody who's tried to switch brokers, I was just talking to Keith about it myself, thinking about switching brokers, but it's such a hassle because you have to fill out all the paperwork, worry about tracking your cost basis information, all of these other logistical issues that go into switching brokers. So what happens when you have a strong brand and switching costs, competitive advantages, it leads to pricing power.

So here this graph shows the average commissions and fees per trade for these four brokers. The green line is TD Ameritrade, the blue line is **Charles Schwab**, the purple is **E*TRADE** and then the orange-ish kind of brownish is **Interactive Brokers**. So you can see that TD Ameritrade has the highest average commissions and fees per trade, which is great if you're an investor in the company, not so great if you are a consumer of the company, obviously. And it's also interesting to note, you can see interactive broker is way below all of these other brokers. They kind of compete on a different strategy, so this is what's interesting about looking at various metrics across competitors, you can get a sense of where they're trying to position themselves strategically relative to the rest of the industry, so TD Ameritrade, Schwab, and E*TRADE tend to focus more on the retail investor, a little bit less trading and higher commissions, whereas Interactive Brokers tends to focus more on the much more active institutional client. So they get much more active traders trading for a lower cost per trade.

And those competitive advantages, so getting to quantifying competitive advantages, lead to stronger financial returns. So TD Ameritrade's average return on equity since 2009 is 16.3% compared to all these other brokers, which is better than them. And any time you see a return on equity in the mid-teens, that's a very strong performance. E*TRADE, I just want you guys to note so that you can see they have had negative return on equity since 2009. That is predominantly due to very big writedowns that they took on their loan book in 2009 when the financial crisis occurred. So that kind of goes hand in hand with my next point, which is why we like TD Ameritrade, is low financial risk, clarity and simplicity of financials.

So TD Ameritrade, unlike Schwab or E*TRADE, doesn't take on you know, undue risk with the assets that they earn interest on. So TD Ameritrade didn't experience any of those big writedowns on loans that E*TRADE or Schwab experienced in 2008, 2009. So TD Ameritrade has three main revenue drivers. The first is transaction-based revenue, which is revenue that they generate on commissions on trade execution. The second is spread-based revenue, which is revenue generated from interest earning assets, which are predominantly client-margin balances, which are margin loans, interests that they earn on loans, margin loans to clients. And securities lending.

So if you do shorting and you incur fees on any of the shorts that you have, that is included in spread base revenue. This portion of revenue is what we refer to when we are talking about TD Ameritrade has exposure to rising interest rates. So we'll talk about that a little bit more later. But TD Ameritrade does not engage in risky practices with its spread-based revenue, like say an E*TRADE or a Schwab, which exposes them to less financial risk.

And then the third revenue driver is fee-based revenue, which is revenue generated on company programs such as Amerivest or Advisor Direct, which is registered investment advisor referrals. So those are the three main revenue drivers for TD Ameritrade. Here's what it looks like versus the rest of the competition, so for TD Ameritrade, transaction-based is 44% of revenue, spread-based is 44% of revenue, and fee-based is 10% of revenue. You can see how it works out for the industry, you can see E*TRADE has a much larger portion in the spread-based revenue, which is why they were hurt much more disproportionately when the spread based assets faced a decline in value. I also want to point your attention to Interactive Brokers. You can see they have that purple segment that none of the other brokers have, and that's trading gains and currency exposure. So Interactive Brokers is more of a global operator; TD Ameritrade is only based in the United States. So that was fiscal year 2013, which contributed about 25% of revenue.

In 2014, which was actually a pretty bad year for currency, some of you may be familiar with that. This portion of revenue actually detracted about 12% from revenue. So we like that TD Ameritrade is not exposed to some of these more volatile sources of revenue. And then capital structure versus competition; TD Ameritrade has a very simple 80% equity, 20% debt structure. Less debt than some of their competitors such as E*TRADE with 60% debt to equity, and then Interactive Brokers is actually pretty interesting, they have a unique capital structure, where the public equity is actually only a very small portion of the overall equity in the firm. The rest is owned by a minority interest owned by the founder of the business. So low financial risk, clarity and simplicity of financials gets a check mark.

So the third reason why we like TD Ameritrade is positive exposure to rising interest rates, and this is probably the most important reason why we like them. Provide some optionality, in the case of interest rates rising from their current lows. So talking about how TD Ameritrade earns spread-based revenue, mention it's the yield on interest-earning assets plus the yield on insured deposit accounts. Now insured deposit accounts, this is a relationship that TD Ameritrade has with **TD Bank**. TD Bank owns 41% of the company, and client cash from TD Ameritrade, so cash that's held in brokerage accounts, is funneled to TD Bank and then TD Bank earns a spread on that client cash, and then TD Ameritrade receives that spread minus a servicing fee in various, the FDIC insurance premiums.

So anyway, in 2014, they earned $1.4 billion in spread-based revenue. Okay, interest-earning assets, like I said, client-margin balances, generate about 65 to 75% of interest-earning asset revenue and then securities lending balances, which is again fees on shorting, generates 20 to 35%. Recent yields on these assets of 2.8 to 3.3% and that's going to fluctuate with interest rates. So if interest rates are rising, we would expect the yield on these assets to rise, as well.

One interesting thing that I track from TD Ameritrade, this is kind of a footnote to the presentation, but I think it's pretty interesting, is client-margin balances as a percent of total client assets. And I think this is interesting to track, because it gives you a sense of kind of the friskiness of retail investors. So if investors are feeling very strong about markets, they might take on a higher percentage of their assets in margin loans. So you can see in 2006, 2007, client margin as a percent of total client assets was up near 3%. Took a sharp decline when the financial crisis hit, and then it rose up a little bit and then it came back down. So it's just interesting to note that even despite the stock market reaching, you know, new highs and having a very strong past five years, client-margin balances as a percent of total client assets is actually not that high, so that's just an interesting data point that I track with TD Ameritrade.

IDAs, again, yield on insured deposit accounts, it's an agreement to sweep client cash to FDI insured money market funds held at TD Bank. Again, this is how they are able to not have exposure to those riskier assets that could cause big writedowns on their books, and then instead of achieving a spread on the interest rate, they collect a marketing fee from what TD Bank is able to achieve.

This is a slide from TD Ameritrade's most recent presentation. It explains the impact to earnings per share, I'll point your attention to the bottom right hand side, of a 100 basis point increase in the federal funds rate, or 1% increase. A 1% increase in the federal funds rate, we would expect to increase earnings in year 1 by 38 cents, which based on last year's earnings, is about 27%. And what is great about this exposure to rising rates you can see it has a big impact on earnings. Not just on revenue, because the revenue, the extra revenue generated from higher interest rates comes with virtually no incremental cost. So it drops basically all down to the bottom line. So we're not saying that interest rates will rise, but if and when they do, TD Ameritrade stands to benefit.

All right, and then the final reason why we like TD Ameritrade is strong management and capital allocation. This is something that we kind of seek for across all of our investments at Pro. We want to have strong managers and people that know what they're doing with allocating their capital.

So this is the CEO, his name is Fred Tomczyk, he's been CEO since 2008. COO from 2007-2008 and before that, he was working with TD Bank, which obviously has a relationship with the company and now owns 41% of the company. Tomczyk owns $78 million in stock. So he's definitely financially incentivized to increase the value of this company, which is great. 86% of his pay is performance-based, which is good to see as well, and his incentives are earnings per share, net new client assets, and market share of trades. That's also something that we really try to focus on is how is management incentivized, and are the incentives something that will drive value to the investment? And in this case, I think they definitely are and TD Ameritrade has excelled in all three of these areas where the CEO's incentivized.

As far as capital allocation, the company has a history of rational acquisitions and expansion. In the early 2000s, they were involved in consolidating the overall online brokerage industry. And then in 2009, pretty much near stock market lows, they acquired Think or Swim, which has turned out to be a really great acquisition for them, so that was very well-timed. Smart acquisition by management. And then also they returned cash to shareholders, they initiated a regular dividend in quarter 1 2011.

And then another hallmark, I think, of a strong management team is the ability to issue special dividends. So when you have cash on your balance sheet and you have nowhere to invest it, why not return it to your shareholders instead of just letting it sit there on the balance sheet, so that's something that they've done in the past and may continue to do in the future. So overall smart, strategic decisions and operational priorities, strong management, capital allocation gets check mark.

So those are the four reasons why we like TD Ameritrade. And that's our investment there, and oh, one more thing. So yeah, TD Ameritrade has been very successful for us since we brought it into the portfolio July of 2013. Since then, it has returned over 50%, including dividends, which includes also the special dividends, versus the

North Star, which has returned about 14%. So hopefully, we expect this performance to continue and that's that. Any questions?

(laughter)

And use the microphone, as well, to ask your questions, if you have them.

Audience member: Just could you give us some insight into how you estimate the, that it will meet the required rate of return for the North Star, whatever, sort of with your valuation metrics? How that fits in?

Kipersztok: Yeah. So our evaluation process, at least personally, for me, I mean, all of our analysts use, you know, their own ways to do it. But for me, you know, I'll go out and I'll do a discounted cash flow valuation, projecting revenue out for a various amount of years, projecting expenses and then projecting cash flow, discounting it back at a given rate of return. For us, I typically discount equity at our North Star rate of return or maybe a little bit higher, and that's basically the answer to your question.

Audience member: So I have a question. I own both Interactive Brokers and TD Ameritrade.

Kipersztok: Sure.

Audience member: I understand that they probably target different segments. Is that changing, is Interactive Brokers, is it going after more retail investors like myself, and I guess the other question I have is they have a more bigger global operation?

Kipersztok: Yes.

Audience member: And is that a plus or a minus in your perspective?

Kipersztok: Yeah. Good questions.

Audience member: I think also, one of the other metrics, I don't know if you guys consider this, is the net revenue per employee.

Kipersztok: Revenue per employee?

Audience member: Yeah.

Kipersztok: Yeah.

Audience member: I think it's higher margin, good extent for Interactive Brokers compared to Ameritrade.

Kipersztok: Yeah, so, okay, three part question there, so yeah. First was are they targeting retail clients. Right, more. I think so, I mean, it seems to be that way anecdotally. I haven't specifically looked at the numbers, breaking it out institutional versus retail, but just from having conversations from people around Fooldom, it seems like Interactive Brokers is a pretty popular broker. I'm considering switching some of my assets over to Interactive Brokers as well. And I think the low commissions are just a compelling draw to people who are sensitive to price. So yeah, I mean, I think that they're targeting retail investors, but not necessarily on purpose; it just seems to be that they're drawn to their low commissions and their good trade execution.

The next part of the question, they have more global operations. Yes, so is that a good thing or is that a bad thing? So you can see, so in some cases it's a bad thing. So they had more currency exposure in 2014, which actually detracted from their revenue. So in that case, it's a bad thing, but in some ways, it's a good thing, as well, because it provides them with some more diversity in terms of growth rates and markets. And whatnot. So I think it's a mix of both good and bad.

And what was the third question again? Ah, revenue per employee. Yeah, so Interactive Brokers is kind of known for being very technologically focused and automating things very well. I would expect their revenue per employee to be very high. I don't know the numbers off the top of my head versus the competition, but I think, I mean TD Ameritrade is, any online broker really will be very efficient in terms of revenue per employee, because a lot of trade execution and revenue generation is automated. So that's an interesting point to look at and I'll research that. Thank you.

Any other questions? All right, well, thank you very much.

(Applause)

Jeff Fischer: Thank you, Billy, that was excellent overview and it shows clearly how we are working hard to know our companies really well so you don't have to. But if you want to, we are ready to convey that information on discussion boards through the updates that we do provide every quarter, and occasionally, we talk about them in the Monday memos, as well. And also at these events through Q&A. We spend the bulk of our time knowing our companies and learning more about them, and I'm going to talk about some of the resources we use to do that, as I start here.

Okay. It's already here, great. I can kind of read that. I hope you all had a good lunch. This is going to be fun; this is like, every year we do brand new presentations, because we're fortunate to have many members return repeatedly.

(laughter)

So I get to work on, we get to work on these and do them once and then off they go. This year, I want to talk about portfolio pitfalls for the first time. And I'll start by saying that we are all on a lifelong pursuit together and individually, and that pursuit is really about financial security and freedom for ourselves and our families. And how, in my opinion, how do you achieve that along the way and also have it when you are hitting your milestones, your goal points, your, your ultimate end of retirement. And I think the way, one great way to do that, the way I view it, is to have a great portfolio, a portfolio that has certain attributes that help you succeed from the beginning all the way to your goals.

And let's just talk about what a great portfolio is in the mind of Motley Fool Pro. It's a living, breathing, and flexible thing. It's not static. It will change to the environment that changes around it. It will adapt without you having to do anything. We'll talk about how that occurs. It allows for easy adjustments though, so if you do want to tweak it along the way, there are ways that you know of and ways that you can just tweak your portfolio to adjust it. And as we've talked about and Tom mentioned this morning, and I've expanded it a little bit, you have positive outcomes and you can have positive actions whether the market is down, flat, or up. So even if the market is going nowhere, you're having positive outcomes in your portfolio at that time. When the market's going down, your portfolio has positive results occurring within it. You may be not going up in value overall, but you have at least some positions that are making money for you as the market falls, and then it helps a lot with your approach to the market and what you choose to do next.

So in Pro, how do we achieve this, just in a nutshell? We have stocks for the long, term, long-term compounding in a strong market. We have options for income, let's call that a neutral market. Market's going nowhere, we're still making money with options. Ideally, month after month, and you've seen this year, we're really trying to have options expire every month. So far, so good two months in. It's just two months.

(laughter)

Then you have shorts for bear markets, and that's something we haven't had much of since we started in 2008 and that's a good thing in hindsight, but we do want to add more shorts as we talked about this morning to the portfolio and build out the short positions that we have. And that requires a bit more activity because shorts are usually a shorter-term holding, maybe six months, maybe a couple of years; whereas the longs, of course, we hope to own for many, many years. So we cover there with stocks: bull market, options, neutral, shorts, bear market, and then we add hedges for the unknown.

You want all four of these working together at once. And of course, you can always alter your allocations as you go. Right now, were 75%, 80% long. Next week, we could be 50% net long. We could put on a hedge that really lowers our exposure like that, and we can rest easy, if that's what we need. So this does look easy enough, and I think once you've been with Pro a while or even in your own experience, you see how this can work. So what gets in the way? How come so many of us don't have portfolios that fit in to all these attributes and succeed in good and bad markets to at least some degree? What derails our plan? What are the pitfalls, in other words, to portfolio greatness? And I open the floor up to throw a few examples out there, who would like to name one pitfall to having a great portfolio?

Audience member: Emotion.

Fischer: Emotion. That's a great one. Inertia. I like that one, especially.

(laughter)

Overconfidence. Fear. Lack of cash. Lack of cash.

Audience member: Not listening to you.

(laughter)

Fischer: Take your picture. Those are all great. Those are all great. We have fear, emotion, lack of cash, not listening to somebody. And a few other, those are all accurate. I'm happy to say I tried to find ones that may not, that we may not think about but that are always there. So pitfall number one: I have four pitfalls that we're going to talk about today. Pitfall number one is forecasting, or believing that you know the future, and that's in any way. So let's just, let's get this out early now. You don't know the future.

(laughter)

None of us know the future. We don't know what's going to happen in 20 minutes. I really don't know. So I want you to leave this event when you do in a couple days, or whenever you have to leave, liberated from the idea that you know the future or anything about it. Just take that weight off your shoulder because we don't know. Nobody knows what the future will hold.

When was the last time you saw a really outstanding investors, Warren Buffett being one of them, talk about a forecast for the economy or the market? He speaks in very general terms that he wouldn't bet against America in the long-run, that he would only want to be in stocks for ten years or longer. That's the kind of forecast that has some history behind it. But anything nearer-term, one or two years, nobody has any idea what will happen. So none of us should think that we can predict what's going to happen, and we have no reason to believe that we can. So why do we always look to forecasts? Why are we so dependent on forecasts? We'll have an answer for that.

But first, let's look at the pros. And this is from Davis Funds*, these are Wall Street's top strategists and it's their average prediction for the S&P. And what actually happened? And you can see, they completely missed, and most people did, 2008, 2009. Just it wasn't even on their radar that stocks may go down a little bit, they're predicting the market to continue to go up in 2008. I will say the one good thing I can say about this is they're hovering around a 10% annualized prediction and that's pretty smart, because that's about what the market does over the long term.

(laughter)

But let's take a different look and go back a bit further. So this is back to 1991. And it looks pretty darn good, doesn't it? The experts, their forecast is tracking the market extremely well. There's the actual S&P and there's the, well, the forecast. The only problem is this is about a year or two years behind what actually happened. So what they're actually doing is just retelling what has just occurred.

Their forecast is always lagging and the chart kind of shows it, but as the market finally did go up in mid '93, they started to predict that in mid '94. And then as the market started to fall in 2000, which, come on, 2000? You knew it was going to fall a little bit. That was craziness. They didn't start to predict a decline until almost into 2001, after the market had already fallen quite a bit. In fact, they were almost two years behind there.

Let's go back even further. Well, first let's look at operating earnings. Now, it stands to reason they're not any better at predicting operating earnings, Wall Street analysts. And they're not, their forecasts lag in much the same way the S&P index itself. They're always about a year behind. And these are the S&P 500 companies, large companies that can be fairly predictable in their operations, especially given the way management works to manage earnings, and yet the experts are still far off the mark and well behind the times. And this is going back to 1986.

Let's go back even further. And this is from the Wall Street Journal recently. Since 1929, the average market forecast by the experts on Wall Street has missed the mark more frequently and by a greater degree than darts just thrown at a range of random numbers. So 80, 90 years now, we've seen nobody can predict the market where it's going to go next. And yet over that time, if you had just said, ah, about 10% annually, you were right. But nobody does that, nobody wants to know that you can double your money every 7.2 years on average in the market if you just buy and wait with the index, with the index or let alone with good companies. People want to know the next couple of years. Why is that? Why do we forecast at all when we obviously cannot do it? And the answer might surprise you.

It's because forecasting is anchoring. We, and it's a survival instinct, too, we want to think that we know the future or know what's going to happen. And so we grasp at anything when we don't know the future. We make plans, obviously. We hope for the best, but when it comes with investing, when it comes to investing, we grasp at anything and what Wall Street learned everyone can grab on to, and so it has become ingrained on Wall Street, our forecasts. But a forecast is a form of anchoring. You're putting numbers and dates and price targets and earnings targets out there that we then take as not a forecast, our mind kind of turns it into knowledge and we anchor on that and believe that's what's going to happen. And when it doesn't, we're badly surprised.

So we forecast because we want to feel a sense of control. We forecast and then we anchor on what that forecast is, whether it's GDP growth, unemployment, and the funny thing is, so many of those numbers are then adjusted a month or two later, they're adjusted greatly, unemployment or GDP. And no one pays any attention. It really didn't matter, it turns out.

But why is forecasting a pitfall to having a great portfolio? One reason is we investors act on forecasts, either published or of our own making. One obvious example is to sell to avoid a predicted market decline. If the forecasts are saying, oh, this market's overheated, it's going to fall. And people have been saying that really, since 2011, 2012, easily. You may sell to avoid that. But that takes you off-track. You've been derailed from your portfolio plans.

We all know families, unfortunately, who sold in 2009. I know a few families who sold in March 2009. Really successful families doing very well. Their portfolios had been cut in half. They believed what they heard and what they read, what the market would keep falling, and so they sold, they sold on a forecast. And it was very hard to get back in years later. So a forecast can decimate your returns. If you're acting on what you believe is going to happen to the market, it can really destroy your results.

Forecasting is a pitfall in the other direction, too, though. You can take on too much risk if you are forecasting, you have a feeling things are going to be great. And that's whether it's the market as a whole and so as Billy talked about, you may margin up because you think the market's going to do really well; 2007, what a horrible time to ad margin, and yet people were. They were forecasting better returns ahead. That derailed them, without question.

You can also do it with stocks. We know Fools, unfortunately, and all of us have done it at some point possibly, who bet too much on a stock. Some Fools have lost a lot of money on **Apple** because they put too much into that single company at the wrong time and couldn't keep the position when it had that decline a couple of years ago. 35% decline. So a bullish forecast can lead you astray and destroy value as much as forecast of a falling market. Whether you act on fear or greed, you are forecasting an outcome that you do not actually know.

Another pitfall is investors trade more frequently due to forecasts of all kinds, whether they change from commodities to different sectors or company to company. They're again, just acting on a forecast. And that has disastrous results. As we heard this morning, here's another look at that, what was it called, it was a behavior gap. 8.7% the average stock mutual fund is returned from 94 to 2013, 5% is the return of the average fund investor. And that's not even counting the fees and the churn and taxes. That's just because people are selling and buying based on forecasts. They get in their own way.

So a forecast becomes an anchor that distracts you from the things that actually matter. It throws a balanced portfolio out the window because you've put your portfolio out of balance because you're believing something's going to happen based not on reality, but on a feeling or someone's prediction. And once you derail your portfolio, it may take a long time to get back on track. Once you sell out, it's very hard to get back in the market, because you want to prove yourself right. You want to wait and see prices actually fall.

But we do, okay, so forecasting. We don't want to rely on forecasting. It's a pitfall. But we want something. We want something to gauge the market, and what is the solution? The one I'll offer today is to use history, actual real history, versus now, which is an actual reality. And take forecasting out of the picture. So let's look at our reality right now compared to history. We have an S&P 500 on a trailing basis at about 17 times trailing earnings. So it's about 13% above its long-term average, which if you can see the red bar, is 15.3, and that's the red bar all the way across and this goes back to 1929, conveniently. And then we have a 25-year average, the green bar, of 18.9, and the little blue bar past ten year average of 16.9. So we have a market, on this measure, anyway, that is right in its average valuation range. It's 13% above the long-term average and I wouldn't argue with that. We could easily see stocks flat for a year or two. I wouldn't complain about that. We would do what we could to make money in that situation.

But let's use this; instead of a forecast, let's use reality. Let's look at where we're at right now, and this is whether it's an individual company or the market as a whole or to the extent that you can and want to, the economy as a whole. Look at it right now and look at history. Let's not try to guess what's going to happen next. We do this for all of our Pro stocks. We look at their current situation, their current valuation, and compare it to their historical valuation. Then we look at what's changed in the business to merit any change in the valuation, and if there's a great discrepancy, we need to ask why. Is it lower interest rates, that could be a reason why. That's a factor that plays a lot into stock valuation. Is it growth rates? Is it alternative investments? That's certainly a case now. Bonds are not attractive, emerging markets are weak. All these things play into the current valuation and yet, we're still within a historic range. And that's where we stand right now. We're not going to guess what's happening next.

But let's look at this. S&P 500 forward P/E. So based on this year's estimates and 2016 estimates, 16.4, 15.5, it's right in that average range and goes back down to the average range. And for a minute, you probably thought that was great. I know we all looked at those numbers and I know we had some comfort from that. Like, oh, that's good. The market's earnings are still predicted to go up, the market will be priced really reasonably. But no, this doesn't matter at all. Doesn't matter at all, what those numbers, the forward P doesn't matter at all, but I know we all looked at them, I did, and thought, all right, that's good, I can live with that. Doesn't matter, that could be a complete fiction and so now, the hard part for you is going to not, is going to be to not anchor on these. Don't leave here thinking 16 times, 15 times. Doesn't matter, we're at 17. 17.7 as of now, 17.3 as of last week.

But look how quickly, if you're anything like me, that you grasped on to those numbers. They become an instant anchor. Even though we can't bank on them. Proof of that is, here are the S&P 500's earnings per share going back to the 1870s. Look how choppy they are. They're anything but smooth, they're all over the place, so nobody predicted this; nobody could have. But again, if you took the super long term, and I'm sure somebody did 100 years ago, and they just don't get any credit for it, you could just draw a diagonal line upward, and that's how earnings have gone over the long term. That's the irony, it's much easier to forecast 10 or 20 years but you cannot forecast six months, and by forecast, we're not really forecasting, we're just looking at history and believing it will continue.

So if pitfall number one is forecasting and relying on forecasts to make your decisions, and we're going to avoid that by looking at the current situation, the reality compared to history. Pitfall number two … is the illusion of knowledge. And with this, I'm really trying to make your life easier, because now, you're leaving here saying I don't know the future, I'm not going to try. I'll look at the current present. I'll look at the past. That's the best I can do. So don't worry about the future anymore. Make plans, but don't plan on it.

And now, I want you to rely less on knowledge. You don't need excessive knowledge. Beyond some key factors, additional information is not only irrelevant, but it's even detrimental to your decision making. And here are some of the reasons why: more knowledge leads to overconfidence, which then, predictably, I imagine, leads to poorer results. You're taking oversize bets, you have too much belief in what you think is going to happen because you've done all this research, and so you bet too much on it. I'm betting we've probably all done that at some point.

Having more information makes you less efficient at processing. And so I've put very little on these slides in particular. Studies also show that we make better decisions with fewer data points. We'll show that in a moment. Because after all, all information that you gather is not good. And then I had to throw this in there, that forecasts are frequently mistaken for knowledge. So not only is there an illusion of knowledge that more knowledge is better, but things that you read are predicting things, you will assimilate and believe that it's become knowledge in your mind, even though it was a forecast, it was a prediction. There's no, it's not based on a fact whatsoever. Look how we all did that, I believe, with the forward S&P numbers I just put up there. We anchored on them and believed in them for whatever brief moment.

Back to having too much knowledge, period, overall, though. Keep in mind also that not all information is good. There's a lot of noise out there that clutters and just clouds your mind and makes it harder to make decisions. There is a lot, we're awash in bad information right now, inaccurate information or misleading information. Everyone has an agenda. And then there's what I call dramatic data. It's the 24-hour news cycle, which is now more than ever, a part of our lives if we don't unplug from it. And that, the news is driven to connect with you in some way to get an emotional response from you. That's the whole purpose and hope is that you'll stay glued to the TV. That's a disaster, of course, when you tie news with your investing decisions. It leads to emotional results.

So let's get some stats behind this. This is fun because it's looking at bookies, book makers, and it goes back to '73. And the more data that you gave a bookie for horse races, the more confident he became. His confidence, his or her confidence grew. And yet their accuracy actually went down. So with five data points, they had an accuracy level that was as good as or better than what they had with 40 data points. They didn't improve at all with more data and yet their confidence grew, so they were more likely to make bigger bets, make bad decisions. And take on too much risk.

Here's another example, which is a little troubling because these are, this is a study of judges. And stage one, two, three, four, at each stage, they were given more information about a certain subject or case. And the more information they had, you can see the dark line is their confidence level. The more information they had, the greater their confidence and yet the gray line, their accuracy did not go up. It stayed pretty flat. It went up a little bit, at stage two for reason, it went way down, so be careful of stopping at stage two. Stage three and four, really no market benefit compared to stage one information. So they spent a lot more time learning, they have a lot greater confidence, and yet the results don't show for it.

This is true in investing, as well. These are, again, Wall Street pros are the dotted line at the bottom. And this is measuring their confidence on a stock selection, and this is pretty striking. The more confident a pro, a Wall Street pro, anyway, is in a stock selection, the less accurate they're going to be. When they have 100% confidence, they have 15% accuracy. So when they're on TV, pounding the table, saying this is what you've got to buy right now, this is what I believe in most, it's gold, whatever it is.

That desperation, which is also a form of overconfidence, in these studies, anyway, results in very low, very low accuracy results. They're usually wrong. The top line shows how perfect calibration would look if as your confidence grew, your accuracy grew in line, that's how it should look. The typical Fool, you and me, does better than a pro. At least we kind of hold our own on our accuracy.

So one more look. And with more information, you get worse earnings forecasts from Wall Street. With a baseline amount of information only, which is on the far left, the margin for error on the forecast is smallest. When you add more information, add redundant information, the margin for error goes up tremendously. And that's true even when you add the baseline plus non-redundant, so plus extra information. You haven't gotten any benefit. It's the baseline that has, that is the most accurate and that matters most.

And yet at the same time, again, to tie back to our other two examples, as they had more information, their confidence went up each time. Yet we know their accuracy actually went down. So they were more confident and they were making more mistakes.

So what is suspect knowledge? There's too much information. And what else is suspect information or suspect knowledge? I would offer these as some examples. Brokerage houses, still, even though it was hoped to take away some conflict of interest after '99, 2000, it really hasn't happened. To this day, is **Merrill Lynch** wants to get **Twitter**'s secondary business, they need to write positively about Twitter. So broker reports still have a conflict of interest and are overwhelmingly positive because that's how they get business. If you write negatively about a business as a broker, you typically are not working with them again.

I'll throw in there all secondary sources for the sole reason, I mean, there are plenty of great secondary sources, but for the sole reason that you have to then double-check it. If you're going to a secondary source, you can't take it at face value. You need to make certain that what they're telling you and sharing with you is accurate and true, and then also dig in to see what conflicts of interest they may have. You'll spend a lot of time on that.

Smaller news websites, I've noticed this in the last couple of years, especially, should be avoided because they're desperate to get eyeballs. It's become much harder to generate traffic through various means at Yahoo Finance, other sites. And so you're mainly paying for traffic and you want to make your advertisement or however you're doing it pay off, so you're desperate. You're writing dramatic headlines, you're writing dramatic pieces, either about companies you're being extremely bullish on companies or extremely bearish, anything to get attention.

Blogs, of course, goes without saying. Get to know the person. Know their history, conflicts of interest, avoid anonymous blogs. That said, when our companies get attacked anonymously, we do, as you've seen from Bryan Hinmon last year and J.P. in December of last year, as well, we dig into it and we try to debunk in everything that they're saying because we want to believe in what we own. But as a whole, it's suspect knowledge. It's probably not worth your time. Talking heads, as well.

But you need a solution. There's so much noise out there and so many things that you want to avoid that will just clutter your mind and lead to bad decisions. This is what we rely on, and this by far, the majority of it. I'd say 90% of what we rely on is right here. It's the company SEC filings, which are quarterly and then the annual is outstanding for the amount of information you get from there. The company conference calls that we go over every quarter, and summarize for you, as well. You can learn a lot about management over the years by following these calls and seeing how consistent they are, how they react in adverse situations, how they approach opportunities and risk. And the conference calls are live and the questions range from bad to good, but you still get a rounded view of the management team.

Some long-term analysts that you trust, if you can find them. I find so many analysts move around from job to job, house to house. It's hard to find ones that are in one place for a long time, covering just a certain thing. But then independent industry reports, as well, are well-worth considering. And of course, yourself. So this is 90% or more of what I used to make decisions is right here. And that's true with the team, as well. But what do you focus on? You still need a focus as you go through this. And as you could predict, we focus on the business. There's a lot on this slide, so take a second.

Billy went over many of these points in his talk about TD Ameritrade, which I did want to say before I started is still rated a buy. It's about a 3.4% allocation. It's around our fair value, which means we expect to earn North Star better over time. So yeah, we still like that company clearly. So this is what we look for. Using those sources on the previous page, the key things we've always focused on in Pro are among these five to six and couple others, but these are the key ones.

Competitive advantage, only if a company has a competitive advantage can it have pricing power, which Warren Buffett has called the most important thing to investment success. If a company has pricing power, that tells you a lot of what you need to know about their competitive advantage, about how sustainable that might be, about where their margins might go, and about their growth opportunities. If you can raise your price and keep your customers or grow your customer base, you're really serving a need out there that is being unmet.

Of course we want a growing market. **Skyworks** is one of our most recent examples with the internet of things is just taking off. And Skyworks is really well-positioned and it's not a Johnny-come-lately, they've been planning for this since about 2002. So they're in a great position for what's probably going to go on for much longer than anyone believes, which are connected devices I think, just like the smartphone revolution. We're still in the very early innings worldwide of connectivity, mobile connectivity.

Of course we want a strong capital structure with healthy free cash flow. Goes without saying. And we prefer recurring revenue. 80% of revenue at **Open Text** recurs naturally through contracts or transactions. It's largely true of **MasterCard**, too. **Oracle**, as well. A lot of contract revenue, 45%. Why? Why do we love it? It's stability, clearly, it's recurring stability, so even in financial downturn and the crisis, companies like that we follow and own have a stable base of revenue. **AmTrust** is another one where renewal rates are very strong.

Of course, the fluffiest one, the hardest one to really know is the honest, competent management. We want companies that as the saying goes, that a monkey could run, because we want them to be that strong. But bottom line is, you need competent management and you need honest management. And it's hard to judge, but by knowing a company a long time, and the average Pro company we've known about seven to eight years now, some we've known twice that long, knowing the company a long time, following the conference calls, and just how they convey themselves, that's how we get a sense of that. Also when we're researching new companies, we look at the executives and their history, of course. Again, looking at history, not trying to forecast what's going to happen.

So pitfall number two was the illusion of information. So I like to review, because that's the only way I remember everything, or anything. So now we're not going to make decisions based on forecasting, but on reality versus history. And we know we don't need mountains of information. We just need good information about a business from a few sources that we trust. The rest you can do if you enjoy, but you're probably wasting your time.

Pitfall number three … is false diversification. I have tried to simplify this by saying, you're not really diversified if all of your positions are moving together. It doesn't matter how many you have. If they're all moving the same way, it's almost moving like one position. You're also not diversified if you only keep positions that are currently winning. If you're selling something that's lagging, because you don't have patience for it, and you only want green in your portfolio, you're decreasing your diversification, and increasing your forward risk as a result.

You're also arguably not diversified if you own all high or all low P/E stocks. So in other words, if you call yourself a growth investor, period, and so you just go after growth companies all the time, or you're a value guy and you only want to own value stocks, we'll talk about all these. Finally, if you mistake many holdings for diverse holdings, truly again, it's not if they're all moving together. Let's review the great Pro portfolio goal, we want positive outcomes and we want to be able to take positive actions, whatever the market is doing. If everything's moving together, we certainly can't do that.

Last year, I talked about one of the largest risks to a portfolio manager, in my view, is being hamstrung at the worst time. So in a moment of crisis, everything conspires to tie your hands, you can't do a thing. A lot of people were in that situation in 2008, 2009, of course, and it's a horrible feeling. And so your instinctual reaction is going to be to try to run away from it. To sell at the worst time. So if we can keep ourselves from having our hands tied, we're in much better shape. And the only way we can do that that I know of is to have a portfolio that reacts, that has sections of it that react differently to different markets. How are we doing so far on that?

My favorite. The colors kind of come through. Last month, Billy put this in a Monday memo. It's a correlation of all the Pro core holdings. And you can kind of see, I think, the green shades are our shorts, the **Caesars** and **Five Below**, and the Euro. And then we have a little bit of green also with a **Facebook**, Open Text, **PAREXEL, Papa John's**, those are all shades of green. This is a month ago because they were doing well in when the market was kind of down in January. But the only point I wanted to make here is we still, we don't have that much green on the portfolio. We don't have, and the green shows things that move inversely to everything else. And we want more green, as we talked about earlier today, so we're looking to add more shorts. Definitely.

But we also want some laggards in the portfolio, and thankfully, we have some. Why do we want that? Okay, the problem. The problem again, all positions moving together? Well, stocks that did well the past three years tend to reverse and then lag the other market, the other stocks the next three years, and the opposite of that. In other words, it's a see-saw. And other studies show that positive or negative moves for a stock on average last about 18 months. A stock will go down for about 18 months and slowly reverse or it'll go up for 18 months.

Now that's spread out over a very long time, but the point is just that stocks cycle, different stocks cycle. The baton is passed from one type, whether it's growth, to value and back and forth, and you want smoother returns in your portfolio, this is why you want some losers in your portfolio. Because eventually, they will take the lead while your winners take a rest. And this shows how that happens. Year one, you have the winners beating the losers. Year two, and this was a study, a 25-year study, the losers, on average, gained 8% on last year's winners in the second year. And by year three, they made up all the difference. Now they could both be winning overall if it's a good market. But the point is, if you sold your losers, you sold what were going to become your better investments in the next couple of years. You didn't have patience.

As we heard earlier this morning, the average mutual fund is held for around three years now. The average stock in this country is held for around 11 months. So people have no patience. If something moves on average 18 months before it turns around and you're selling around 11 months because you lost patience, you have missed out when it recovers.

So this tells you two simple things: don't just chase current market winners as tempting, as that is, and then don't give up on the laggards in your portfolio that you still believe in. This is a key point. If something's busted and your thesis is gone, of course, move on. Get away from it. But if you still believe in it, keep it because that laggard is likely to become a winner down the road. We have some in Pro, of course. We have **Valmont** and **Tupperware**, lately, and the **WisdomTree**, emerging markets ETF. Those are all in the red for us.

And in the case of emerging markets, that thing has been lagging for going on three years now. So its comparative return has been horrible compared to U.S. stocks. But we're happy to go on owning it because we believe in the ETF. We believe n the broad thesis that emerging markets will do well, will create value over time, and the cherry on top, I strongly believe emerging markets will have a long period again of outperformance and we'll be very glad when we still own emerging markets and maybe we own more by that point. We'll be very glad we held on to it when it's going up year after year and U.S. stocks are flat. So let's keep those losers in there, as long as we believe in them.

The other thing to keep in mind is top investors frequently lose. This is again a study from Davis Funds that you all may know of. We wrote about it in the memo a few times. What this is showing, the top quartile of large cap investors, fund managers over a ten-year period of study, so they were top quartile over a ten-year period prior, so over 20 years altogether, 95% of them fall into the bottom half of all investors for a period of time. And 73% of these investors fall into the bottom quarter, so they become among the 25% of the worst fund managers of all over at least one three-year period over this period of time. So just as stocks trade the baton back and forth between winners and losers, top investors do, too, which stands to reason they invest in a certain way that works sometimes and doesn't work other times.

But you know very well, if someone's lagging for three years, most people would sell that mutual fund and that's why I think we have a three-year average holding period on a fund. People lose patience. Studies show that you can hold it out for a year and a half, two years, but at some point, the average person hits a breaking point and they get out. It just happens to be the time when things will start to turn around. And there's some kismet to that.

So bottom line, though, not all of your positions should be winning all the time, and keep in mind, not all investors will be, either. Whether it's Billy, J.P., myself, anyone at the Fool, we'll have bad years. So let's look now at P/E stocks. What if you only owned growth stocks? Kind of an amazing study that I found and I need to dig into it further because I want to find more information on it, is that low-growth companies over the long haul rival high-growth companies when it comes to long-term EPS. Earnings per share growth. There's actually very little difference. They're nearly the same.

Now, partly that's because large low-growth companies are typically consistently profitable, and small companies are not. But, sorry about that. Small. Okay. The small stocks, as you know, over time, outperform large companies. And the reason is they're given a higher multiple to earnings because they're growing more quickly in the short-term. But if you take away, if you risk-adjust the returns, they're pretty much identical. You lose the advantage that small caps historically give you because they're generating the same amount of earnings as a large cap. They're just given a higher price. So risk adjusted, there's not much advantage. But still, you want to own, you want to own both.

Here's a study that goes back so far, it predates the digital age. This was made, I don't know, by a pencil and this is from 1933 to 1980. And it shows how low P/E stocks, which were the previous losers, then went on to become the winners compared to the high P/E stocks, the growth stocks that were winning beforehand.

So it just reinforces the idea that losers become winners again, as well. And here, I don't know if you can see this, but jumping into the modern age, this is a Morningstar chart that shows **Coca-Cola** returns. I thought we would all be surprised to see that the past 10 years, which is on the far right side, Coca-Cola has outperformed the Russell 2000. The Russell 2000 is up 8% annualized, Coca-Cola is up 9% annualized. And that's with soda sales falling every year.

So large companies have advantages. They buy back shares, they pay dividends, and dividends are factored in to this total return. So if you're only looking at growth, you should diversify and have value, as well. For both reasons, that the growth companies pay a higher price, but the earnings growth will actually about mirror that of value companies in the long run. And at some points, value will do well. Some points, growth.

So you want to diversify, in other words, by the price to earnings ratios. And we've done that in Pro. We have everything from the emerging markets, which right now is 11 times earnings. To, you can read right down the list, stocks trading everywhere from 11 times to 70 time earnings. It's P/E diversification. It should, over the long run, smooth out your returns. It should help. And it again argues why you want to be a value and growth investor, and that's what Pro has done and does do. We have everything from relatively slower growth, **Broadridge** or Gentex, to Facebook. Very fast growing.

So let's move to the next point in this pitfall number three, which was your number of holdings. Mistaking many for diversification. Now we could get into a great fun debate about how many stocks you should own. But I don't think it's a worthwhile debate and I don't think that anyone has the answer. I did a lot of research and found convincing evidence that seven stocks is enough, but other evidence that says today you really need 12 or 24 or 30 and new stats are saying you need 60 to 100 if you really want to diversify around the world and across different sectors and commodities and whatnot if you want to.

So I simplified this down to, you should own the number of stocks that you are comfortable owning and that works for you. It's different for all of us. Pro has about 24 core holdings but about 30, 33 altogether with shorts and options. But just realize that if everything that you own is moving together, you are not really diversified, so that's what you want to look at, rather than number of stocks that you own, how are they moving?

So these are the solutions that we have and that we aim to offer in Pro to false diversification. Keep in mind always that all positions should not be moving together. If they are, think about how you want to change that, and that's something we're actively thinking about in Pro right now, because most of our positions are moving together, and we want to, we've enjoyed a great market. We still believe that most companies are within reasonable valuations. But we want to decrease our diversification risk a bit. We want to put in more shorts.

At the same time, a solution is to own value and growth stocks. And keep winners and losers. As long as you believe in a loser, keep it.

All right. So on to pitfall number four. Let's review. We're no longer going to act on forecasts or let them sway our opinion. We're going to look at reality versus history. We don't need mountains of information, we don't want excessive information. It clouds our minds. It makes us make worse decisions. We lose our focus. And you're not diversified if everything is moving together or nearly everything is moving together. Now if you don't mind riding out a market downturn, that's okay, but if you want to do better in a market downturn, all of your portfolio should not be winning right now. You should have some losers. You should have some red in there, and things that will do well in a market downturn.

Pitfall number four, though, might be the most important. It may have the largest impact on your portfolio, even larger than the first three. It's mismanaging your winners. Losers take care of themselves, ultimately. They become ever smaller. If you're like many Fools who don't care to sell and do not sell or like Stock Advisor, you just not quick to sell, that loser becomes a smaller and smaller, it becomes insignificant. But winners have a potential to change your whole financial future. Winners, a winner or two alone can make a world of difference, as many of you know. But what do many of us do with our winners, even today? Many of the people I meet and talk with do this, if you can read that.

These are a couple of examples of something that I'm sure almost all of us have done at some point. The stock doubles, and they sell. They sell half to get their money back, or in the case below, which is, this is 2009, **Netflix** hitting 50 and so a Fool had made, they had doubled their money, and so they sold. And said, well, if it gets to 40, I'll maybe start another position. And we've all done this, I'm not calling it out to be cruel. I don't own Netflix, so I can't say I did better. But instead of owning a number, owning something that's doubled, oh, it's doubled, I'm taking my gain and going, we have to think that we're owning a business. We own part of a business. Don't even look at the number.

But here's what happened with Netflix. It doubled, so they sold, and they sold around that red dot. It never really went down again, and it's up 10x from that cell. So they had a double, which was well-earned. It looks like they could've waited a few years to get that double and when you get a double on a stock, it does feel pretty monumental. For some reason, we anchor on that number, and it feels like a milestone, even though it's completely random to everyone and anyone except us. And we take action, which is, I guarantee you, nine times out of ten, among Fool stocks, a giant mistake to sell because we doubled. It's up 10x since then.

So now imagine, instead of selling it, instead of selling your winners, imagine when a stock doubles, I want your first thought to be, maybe I should add to it. Maybe this is one, I really believe in the company, the thesis is going right, its' working out. Maybe I should add to it. Through sheer luck and stupidity, that's what I did in the '90s with **AOL** and **Amazon** and **Iomega**, I added to them as they went on because I was just starting out and I had savings from work and I put it into the stocks I knew already and owned even though they were up a lot. And that makes a world of difference. If you're adding to **Starbucks** as it goes up in the '90s instead of selling it because you doubled.

It's kind of funny, too, when you think about it, that we make stock decisions differently than we do life decisions. My wife and I went to a mediocre restaurant a couple of months ago and we have no desire to go back. But if you, I know more people, and I've done it, too, who add to their losing stocks instead of to their winning stocks. It's like finding a really great restaurant and then never going back again. So consider adding to your winners.

That's something David has done in Stock Advisor to great effect. He's added to Netflix six times. Recommended it six times, and he still beats himself up for having sold it once.

(laughter)

He also did the same with **Disney**, added six times through **Marvel** and through other things that Disney acquired, but it's mainly Disney. And David is very keen on adding again and again to his winners. And he does it sometimes where it doesn't work out. **Electronic Arts** and Schwab, he added three times, or added two times, bought them two times. Didn't work out and he ended up selling. But the point is though, even when you add to something repeatedly and it doesn't work out, the times where you do when it does work out with your winners makes a very large difference. And I think that's largely to thank in these results. I mean, Tom and David are both equally smart guys.

(laughter)

But the one thing that I see that David does differently, one of the main things, is that he buys his winners again and again. And Tom in Stock Advisor has, it seems, preferred to add new ideas to deliver the novel idea more frequently than not. So Tom has more diversity among his company names, but David, who has more concentration, has these great returns partly because he's added several times to his favorites, to his best winners. And as we know, both of them have let their losers largely be and fade into obscurity.

So as we think about building a portfolio, let's also think about building winners the way David does and the way very visibly Warren Buffett has. It's extremely rare that Buffett has ever bought something just once. Even when he was a much smaller fund, he would build up a stake over many, many years. Coca-Cola as you can see, he was buying it for seven years. **Geico**, he bought for about a decade, and then he finally decided, what the heck, I'll buy the whole thing. **Procter & Gamble**, he bought, started buying in 1989, he bought a bit more afterwards, and then he bought a lot more, it's interesting to note, in 2005, when the **Gillette** deal came through. He liked that deal, even though it was pricey and he even said so. It was an expensive deal, but he bought a lot more in 2005 on that news. I think part of the reason why is he had confidence because he had known P&G for six years. And then **Wells Fargo**, his largest holding, he's been buying it ever since he started in 1989. He almost every year, he buys more. So he is building winners. He's adding to them. And even now, his equity portfolio is very concentrated. Most of his holdings are in about eight positions.

This I don't know if you can see it, but just want to throw out there how consistent Buffett is in buying Wells Fargo every year and even in 2008, 2009, he might have been a little miffed. His percentage of company ownership went down due to dilution. But he kept putting in more money and grew his stake in Wells Fargo.

So pitfall number four, the solution to mismanaging winners, is to flip your thinking and at least consider, when you have a double or a triple or any magnitude of size winner, consider adding to it, consider building much further rather than selling it. This is something I have not done enough of myself in life. Or in Pro. We've pretty rarely added to winners and had we have, so far, we would have better results. Now we have a challenge that many of us have, which is we have limited funds, so if we're adding to a winner, we need to take that money from somewhere else so that's part of the reason we don't add that much so far.

But there are no promises that we won't add to winners in the future much more than we have in the past. We have bought more **AIG** and more AMT, one way we like to do it and you can consider too is to buy calls. So you can add to your winner, but invest much less in doing so by the long-term call, and every two and a half years, you just roll it and so you've added to your winner effectively but not had to put in a lot of capital to do it.

So I do need to thank James Montier, who's a primary source for the first two pitfalls on forecasting. And the illusion of knowledge. Some of those charts came from him and the data. All of the solutions come from us, so I hope they work. And now to wrap up, we're going to have a little pitfall avoidance session.

So I hope you're all ready, because we're going to do this together. So pitfall number one avoidance session. We're going to say together, I can't predict the future. That was good. It's fun, let's do it again, on three. One, two, three.

Audience: I can't predict the future.

Fischer: Excellent. Instead, we'll look at today's reality, and we'll compare to history. And … instead of forecasting. At the same time, though, we're going to update our look at the reality today for the things that are a little different. Interest rates, growth rates, things like that. Things we do for you. So you don't have to unless you want to.

Pitfall avoidance session number two: I don't heed analysts …

Audience: … analyst information.

Fischer: Nice job. Instead, we'll focus on a few good sources, and we'll use those sources to know the business, to focus on the business. Turn off the TV and get to know the business, and we'll do our best to help you along the way. Our quarterly reports, we want to make them better all the time and more of an ongoing research report that you can have at your fingertips, so that's a goal that we have this year.

Pitfall avoidance session number three. All right, we'll do this on three. One, two, three.

Audience: Not all my positions should be wining at the same time.

Fischer: Nice, and we almost said that at the same time, so that was good. This is true, not if you want true price diversity. Instead, own stocks that are running a different strides, hedge and short with Pro strategies or following Pro, right options. In other words, just address the bull, bear, and flat market all at once with your portfolio today.

And finally, session number four. Pitfall avoidance. One, two, three.

Audience: I can invest more in my winners.

Fischer: Nicely said, you guys are good. So in this case, whether that means more money or more time, let your winners go for more time as long as you believe in them if you can and you're confident to put more money into them. Think of them as building the long-term position, building your stake in that company. And with that, our four portfolio pitfalls to avoid. Thank you.

(applause)

Thank you all, we all have six minutes until our break, so we can take a few questions. Yeah.

Audience member: Hi, my name is Bob.

Fischer: Hi, Bob.

Audience member: From the great state of Virginia. Or Commonwealth. One of the things that I was wondering is, when you were talking about things, research that you trust, and SEC filings, I find them rather voluminous.

Fischer: Mm-hmm.

(laughter)

Audience member: And I was wondering if there was something like an outline or a read this and skip a lot of the other stuff that you all might have or could put out that would allow the novice in us to access that information without being overwhelmed.

Fischer: That's a great idea. This whole presentation will be on the Pro site, and we'll use it as a framework to provide the solutions that are in here, and that's a great idea and not just say here are our SEC filings for our companies, but here's what you should look at.

Off the cuff, I could say, of course, we look at the business overview, how they view their business, their industry, their competitors, and then a lot of times, especially if you've done it before, you can just zip through the risk factors, 'cause they're the legal boilerplate type of things. It's good to read them, the headlines and try to pick up any risk that you wouldn't know already or intuitively, but a lot of them you can skim right through and then get to the financials. So looking at a company, looking at its business, it's market, its competitors, and then its financials, those four things can usually tell us in a couple of hours whether we want to pursue it or in some cases, if it doesn't pass the test. Like a company, for instance, that relies on one or two customers, we'll usually move on. It's too risky.

Audience member: The letter to shareholders, as well.

Fischer: Yeah. The letter to shareholders every year summarizes the year well, too. So the 10K for those core business factors is great and then the quarterly's for the financials. Yeah. Yeah.

Audience member: And I'm Gerald* from, member from New York. Thank you very much for your session on diversification and these. My question is if you did on your last of the four pitfalls, if you did say have the good fortune to buy Netflix at 25, and it's a 20-bagger, and it's now 50% of your portfolio, given that you start with like a 3 or 4% position, at some point do you decide, I just am not going to own something bigger than a certain amount or that in itself is too much risk? I'm not sure what, I'm not sure what the answer is, but I don't know.

Fischer: It's such a great question. I don't want to give a cop-out answer. I do think it's personal risk tolerance, to a large degree. But you do reach a point where for anybody, if something is half of your net worth, you have to seriously consider decreasing that. I am comfortable personally with 10% even 15% in one position that I know really well. If it grows beyond that, I have to really consider whether I want to keep it that size, and depending on where you are in your life, you're either possibly adding more funds and that'll shrink its size a little bit, but in the case of a Netflix multi-bagger like that, that won't be the case. You may have to trim some. You could use options to protect it, but that'll be expensive to some degree.

But yeah, I think everyone has their own point where the risk is too high and that's largely up to your situation, I think. But 10%, 15% is a good baseline for me to start to really think about what to do.

Audience member: This is a great presentation. One question I have about predicting and forecasting. Is when you're doing, say, cash flow analysis and valuation, and you're predicting revenues and trying to discount that back. How do you balance that?

Fischer: It's a great question. How do you avoid forecasting, which is what we want to avoid? There, too, we are looking at history, and we're looking at how the business, it's not a static history, the business has typically grown over time, and so you have the history of as it grows at this rate, how do things change? How do margins change, how do expenses change? And you can factor that into you look at the reality right now where it is and it's almost as easy as extrapolating. Assuming certain key factors are the same, that their cash flow will remain a certain margin or trend higher. Your discount rate is what it is and whatnot, but it's, there's obviously some forecasting involved, but we're doing it as much as we can on the current reality versus history, interpreting history and projecting that forward, just as we would do with the S&P's earnings overall, as well.

But it's much more nuanced with a company, of course, especially when the company is changing, like Papa John's is a good example. They're just recently growing in international markets and they're one of the few chains that have, that is making it work really well. So Billy's had to work really hard to try to estimate how large that market could be, what the margins will be compared to the U.S. market, and growth rates and all those factors and it goes into a range, J.P.'s going to talk about valuation. Goes into a range of possible valuation scenarios that again, kind of look at the past and broaden it to look at the possible futures. But yeah, we try to avoid making predictions. We instead try to kind of extrapolate what we know, if that makes sense. Good question.

Audience member: Larry Quinn from Maryland. Probably a dumb question, but I've had shorts with you for several years, and they've always grown. But now--

Fischer: In a bad way?

Audience member: No, in a good way. I mean, it gets smaller and smaller, but they're a greater percentage. Now, in a down market, I would assume they would go the other way.

Fischer: So with shorts, are they index shorts or?

Audience member: No, I'm thinking, you know, like Caesars.

Fischer: Ah. Five Below.

Audience member: Fin Bear Real Estate.

Fischer: Oh, yup, yup. Yup.

Audience member: And (unclear 1:28:12) and real estate. I mean, they've always been going good, but now in a down market, I thought I'd have to get rid of them.

Fischer: So there's a two-part answer to your question. Two of our shorts, the FAZ and the SRS are inverse ETFs so they're bearish ETFs that were short and so that's a bullish position.

(laughter)

And so in the bull market or a rising market, it's done well. But you're right, in a falling market, those two ETFs will work against us. But we still believe that financial stocks are a reasonably priced and that real estate is reasonably priced, so we plan to keep those shorts. They've become very small now, which is a nice thing when a short works out, even if it runs up a bit against us it won't affect the portfolio much, and there are so many things working against those ETFs, including their leverage, over the long-term that we think the good shorts should just keep riding toward nothing as long as we can. So those two shorts, we'll probably keep 'cause they're so small. As long as we believe the valuation are reasonable on banks and real estate. 'Cause again, in essence, these are bullish bets on those two sectors.

And then our other shorts, Caesars and Five Below, have gone down despite a healthy market. Will they revert back in a bear market? We hope not. We don't believe so at the moment because Caesars, anyway, is a very weak and crippled business. We'll see how the lawsuit bankruptcy comes through. And Five Below we just think is overpriced and in a bear market, people will, we hope, believe that with us even to a greater degree. So our ideal is to find shorts, company shorts that do well whatever the market does, like those two have so far. But if we believe they have lived up to their potential and we should get out because some shorts, some bad companies will do well in a bear market. The money will go to what's already beaten down. Then we'll get out if we feel we should. It's a good question.

Audience member: In the handling of the 10-Qs 10Ks, gap versus non-gap is what kind of like to hear addressed.

Fischer: It's a real problem, a real issue. And I struggle with it, I think we all do. Because gap results, a handful of our companies, especially Facebook stands out, are very different compared to non-gap. So if you value Facebook just on gap, it looks a lot more expensive than it does on non-gap. The struggle that we have is the market tends to, now more than ever, value things on non-gap. That's what's cited, that what leads in press releases and research from analysts. And it seems to be what's driving stocks. All these so-called one-time charges whether they're currency related or stock grants, there's this delusion or this suspended belief that that's a one-time charge, even though they keep recurring. But people are forgiving of these charges. So we kind of take the middle ground and hope that on both the gap and non-gap basis that the companies look reasonable for the cash flow they're creating and what we, you know, model for them. How we model for them to grow over time.

Audience member: Going through your discussions, do you represent both the gap and non-gap and publish it to us?

Fischer: You know, we should more than we do. I don't think we have that much. Because most of our companies, thankfully, are very close. Oracle, for example, its gap results are better than its non-gap results. The only one that really stands out that I can think of is Facebook because it pays so much money in stock compensation. Its non-gap results are much stronger than its gap results. And right now we're seeing on a lot of our companies, Coca-Cola included, the currency exchange gap versus non-gap. Or even Tupperware, that grew sales 7% excluding currency last quarter. But negative growth, including currency. With currency, though, we cut a break because we know currencies will fluctuate typically within a couple years, and eventually it'll be a tailwind. But on other charges that are recurring, Facebook included, we can call that out more frequently. But we try to see that it's reasonably priced on gap and non-gap. Good question.

Audience member: Hi, Brent from Kentucky and I want to thank you for a wonderful presentation. And you were talking about anchoring on data and that there's some useful data and a lot of irrelevant data. And also, talking about maybe buying more winners and selling losers. And I just wanted to focus for a second on the purchase price, and what you purchase at really only has one consequence, which is in a taxable account, whether you pay capital gains or capital loss. But other than that, it has no effect on what a stock will do in the future.

And so I know in my own stock research, I like to periodically review the stocks. But I never look at what they've done, if they've gone up, if they've gone down, 'cause it has really no effect on what the company will do in the future. So I'll look at it for a capital gains or capital loss maybe, but as far as evaluating what I think the stock will do from here, whether I've gotten a double or a quadruple, or my position's been cut in half, the stock doesn't know that and it does care, so that sort of goes in my book into that irrelevant data.

Fischer: That's a great way to look at it and a really healthy way to look at it. I think you're in very rare company.

(laughter)

I think most of us have a really hard time not anchoring. Do we have a win or a loss here? Do we, how much have we gained or lost? But it's interesting. On TD Ameritrade, you can remove your prices if you want. You can show prices or not, turn them on or off. If you turn them off, try turning them off for a week or two, and your perspective is very different. You're not as, as, you know, what's the word? You're not as thrown or you don't lose your calm when prices are changing as much as you might otherwise if you're watching, and you're right, you don't look and see, here are my big winners. You just see all the companies you own with no numbers next to them. And it is a different feeling and approach; so that you can do that automatically is great. I know many of us struggle with anchoring on the price we paid. But you're right, it's not relevant, aside from taxes.

Great point. And we have to cut for a break, so thank you all again very much.

Papa John's Moves Back to Buy

Published Mar 10, 2015 at 2:33PM

Pro's Take: PZZA Q4-2014 Earnings and FY-2014

Papa John's International (NASDAQ: PZZA)

Quarter Quick Take

Papa John's delivered strong results for full-year 2014, as North American restaurants increased comps by 6.7% and international restaurants increased comps 7.4%. EPS grew 13.4% for the year, juiced by ongoing debt-fueled buybacks. Limited-time offers, effective marketing, and continued migration to digital ordering (which garners higher average tickets and now makes up more than 50% of total sales) helped drive comps higher. These growth rates suggest continued market-share gains at the expense of smaller rivals and other large pizza chains. Financial results are finally starting to turn the corner after several quarters of elevated spending and high commodity costs, which began to moderate in the last quarter of 2014. Papa John's continues to focus on quality and measured international expansion, and the company looks set for a solid 2015 despite conservative full-year guidance from management that may have room to increase as the year progresses.

....

Q4-2014 | FY-2014

Total revenue growth: +9.7% (vs. +5.6% in Q4-2013) | +11.1% (vs. +7.2% in FY-2013)

Operating profit margin: 7.9% (vs. 7.3% in Q4-2013) | 7.4% (vs. 7.4% in FY-2013)

EPS growth: +26.1% (vs. +10.1% in Q4-2013) | +13.4% (vs. +18.8% in FY-2013)

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Guidance Update

After reviewing Q4 and full year 2014 results, **we are moving Papa John's back to Buy**. Accelerating comparable-store sales, continued success overseas, moderating commodity costs, and the roll-off of recent business investments have led to strong performance for 2014, and the outlook remains promising for 2015 and beyond. Papa John's is doing what it's done for a long time: supporting franchisees during times of rising commodity costs, expanding overseas at a measured pace, and maintaining its focus on quality. The future is far from certain and results may be lumpy, but the long-term economics of the business remain very sound.

Updated Guidance: Buy (from Hold)

Recommended Allocation: 4.5% plus partial covered calls. See concurrent trade alert here for more details.

Fair Value estimate: $54 (up from $46)

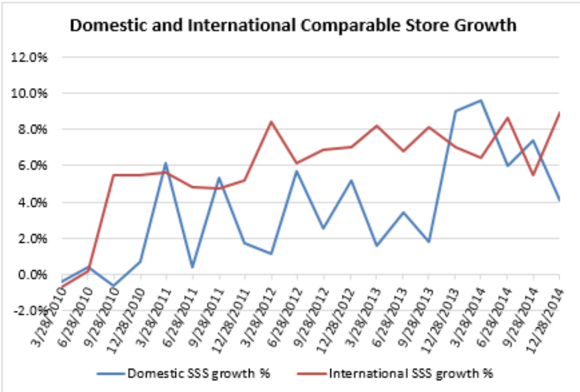
PZZA's valuation multiples are near their historical highs at 35x TTM P/E (32x 2015 earnings), 17x EV/EBITDA, and 39X EV/FCF, but recent performance and operating trends support those expanded multiples. For context, **Domino's** (NYSE: DPZ) trades at 19x EBITDA and **Dunkin' Brands** (NASDAQ: DNKN) at 16x. Papa John's is finally beginning to benefit from its recent investments, and 2015 looks to be a year of continued financial success.

Our Thesis

Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main QSR-pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only about 1,300 international restaurants the company has a long runway for growth (compare to Domino's which has over 6,000 international stores). Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

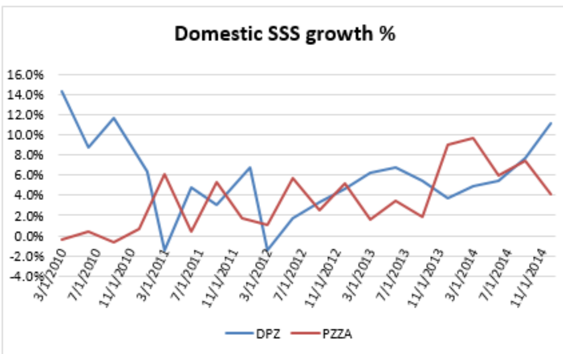
The Most Important Things

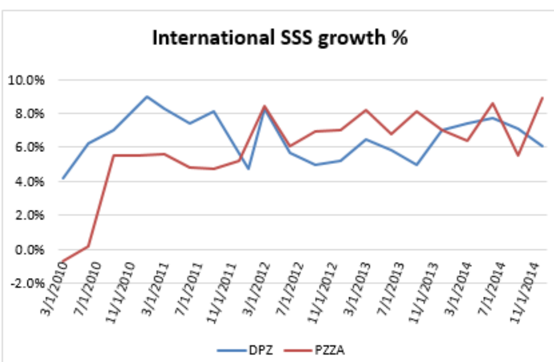
1) Store *Performance:* During Q4-2014, systemwide restaurant sales increased +6.6%. Domestic comps increased +4.1% while international comps increased +8.9%. Management offered full year 2015 guidance of +3% domestically and +6% internationally. This was a bit of a disappointment given that 2014 domestic and international comps were +6.7% and +7.4% respectively in full year 2014. Analysts probed into the comps guidance, and management signaled that perhaps they're sandbagging a bit. PJ does have a history of setting relatively conservative guidance and then raising it later in the year as they did in 2014, and CEO John Schnatter stated on the call that "I'd rather underpromise then overdeliver". Hopefully performance in 2015 will prove to be better than guidance, but our valuation doesn't count on it (our base case assumes low-to-mid 4% comp growth systemwide). But overall, performance in 2014 was very good as comps (particularly internationally) accelerated, and the solid restaurant performance keeps franchisees signing up: PJ opened 235 restaurants (net) in 2014 and expects to open 220-250 (net) in 2015. Its pipeline consists of 200 domestic commitments and 1,000 international commitments (the majority of which are scheduled to be opened over the next six years).



Source: Company filings.

2) Brand: Brand strength is challenging to measure, but we need to monitor it because it is key to the company's brand-based advantages and higher price per pie. As the U.S. pizza market grew at about 3% in 2014, Papa John's domestic full year comps of 6.7% show that the company continues to gain share versus the industry and its brand positioning remains strong. Relative to its strongest peer, Domino's modestly outperformed Papa John's domestically, but Papa John's has a slight lead over Domino's internationally, which is where most of future growth will occur:

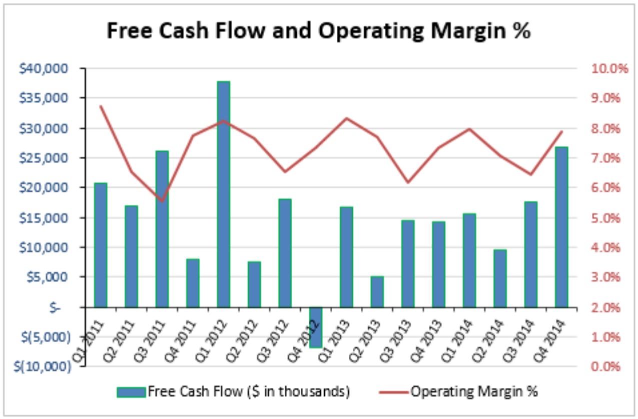




Source: Company filings.

It's interesting to track the international comps performance of Domino's vs. Papa John's since they take different strategies on international expansion-Domino's has focused on expanding quickly in its top 10 markets, while Papa John's expands more slowly across a variety of markets. Papa John's recent success in generating strong international sales growth provides evidence that its brand and expansion strategy are translating overseas.

3) Margins: Ultimately, we expect the capital light business model to result in higher operating margins that propel free cash flow generation. In the near term, we expect Papa John's to continue to spend heavily to support the build-out of its new POS system (FOCUS), and international infrastructure and development. This trend continued in Q4-2014 and full year 2014, with the FOCUS rollout alone impacting EPS by $0.02 and $0.06, respectively. But cheese prices have finally moderated (currently hovering around $1.50 per pound vs. a high of $2.50 per pound in mid-2014), and that along with lower gas prices provided a boost to free cash flow and margins (as we expected):



Source: Company filings and analyst calculations.

Comments from management suggest that margin performance should continue to strengthen (Schnatter about Q1-2015: "margins are just good as they ever have been") and as FOCUS costs should mitigate after the first half of 2015, I'd expect to see free cash flow continue to rise from 2014 levels.

WWTN

Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. Near term headwinds (commodity prices and technology investments) should prove temporary and Papa John's should deliver improved financial performance.

Establish a Partial Allocation of Covered Calls on Papa John's

Published Mar 10, 2015 at 2:19PM

Is this for you? This is only for *Pro* members who own a full allocation (currently 4.5%) in **Papa John**'s (NASDAQ: PZZA), for the equivalent of at least 300 shares of stock. For those with smaller portfolios, or for those who have yet to establish a position or who own a partial allocation, see the Alternative Trades section below.

How You Participate

- **Trade:** Sell to open October 2015 $65 calls.

- **Allocation:** Cover one-third of your shares. Pro owns 1,800 shares, so we will be selling six calls to cover 600 shares.

- **Price Guidance:** Papa John's options are thinly traded, so **it is critical that you use a limit order.** For now, aim for a credit of at least $3.25, but realize that the value of the calls will fluctuate with the stock. These calls expire in seven months, so there is no rush to set them up. Those who are patient may be rewarded with a higher premium if volatility leads to a higher stock price between now and October expiration.
- **Recent Prices:**
  - Papa John's: $60.90
  - October 2015 $65 calls (bid/ask): $3.10/$3.50

What We're Thinking

Shares of pizza purveyor Papa John's have been volatile over the past year, reaching a high of $55 in March 2014 and dropping more than 30% to a low of $38 in September, then soaring again by 70%-plus to a recent high of $66 per share just a few weeks ago. That has led *Pro* to a cycle of guidance updates, with the stock moving from Hold to Buy and back.

Now, after analyzing the most recent quarter and reviewing our longer-term expectations, we have decided to move Papa John's back to Buy. We believe in the long-term upside of the stock, but we also recognize that the current price reflects rosy (but we think achievable) expectations and that there may be short-term volatility if the company's recent momentum slows.

With this trade, we aim to take advantage of that volatility by selling a partial position of covered calls. This trade will help us manage our Papa John's position as we move forward by giving us a predetermined sell price on a portion of our shares, reducing our allocation (and thus our position-level risk) when the share price reaches a level where we are happy to sell. In the meanwhile, we also benefit by earning some income and by buffering a portion of the potential downside of the stock.

With a net sell price of about $68.25 per share (26% higher than our fair-value estimate) for these covered calls, we maintain 12% upside from the current price on one-third of our Papa John's position, and we maintain full upside for the remaining two-thirds. If the stock price stays below $65 per share by October expiration, we'll have earned a small premium that in effect reduces our cost basis in the stock and eases a portion of its downside volatility.

In other words, this partial allocation of covered calls serves as a position management tool. Because we believe in the company's long-term upside but recognize the potential for downside volatility, we are aiming to achieve a positive outcome in either scenario. If the stock continues to rise, we still own most of the upside and we stand to benefit. And if the stock price falls, we earn some income and mitigate a small portion of the downside. These partial covered calls are in line with our belief in holding excellent businesses even if they seem slightly overpriced.

More That Matters

- **Maximum Loss:** The same as stock ownership, minus the credits we received for selling the calls.
- **Maximum Gain:** Our upside is capped at $68.25 for the shares we cover with calls, or about 12% higher than today's price.
- **Breakeven:** The breakeven point on the covered shares is $57.65.
- **Follow-Up:** If shares are above $65 at expiration, we'll likely sell the shares that are covered, leaving us with about a 3% allocation.

Alternative Trades

- **Working with a smaller portfolio and own a full 4.5% allocation?** If you can't easily cover one-third of your position, leave your shares alone — we believe in the long-term upside of this stock. If you are more cautious, you can sell enough to achieve a 3% allocation and then look to reestablish a full allocation if the stock price retreats closer to our fair-value estimate.
- **Own a partial position or don't yet own shares?** If you don't yet own a full allocation in Papa John's stock, then aim to match our partial covered call position with a buy/write covered call on the first 1.5% of your allocation, then buy 3% more in unencumbered stock. If you are more cautious, you can build up the remaining 3% of your allocation gradually.
    - **Working with a smaller portfolio?** If you own a partial position or don't yet own shares and can't easily match our one-third covered-call position, then aim to patiently match our *stock* allocation of 4.5%. Shares are volatile, so it may make sense to build a full allocation over time. If you want to use written puts to help you build a position, the July $55 or $57.50 puts currently offer an effective buy price (if exercised) near our fair-value estimate. Be aware that with written puts, you forgo the upside of the stock.
- **Prefer a shorter time to expiration?** You can look at the July $65 calls instead of the October $65 calls. The absolute dollar value of the July calls is lower than the October calls, but the yield per day is higher.

Pro Can Help

- **Want to learn more?** See our guide to covered calls in our sister service, *Motley Fool Options*.
- **Questions?** Stop by our delicious, savory Papa John's discussion board.

Write Diagonal Calls on American Airlines

Published Mar 10, 2015 at 1:58PM

Is this for you? This recommendation is for all *Motley Fool Pro* members who own calls on **American Airlines** (NASDAQ: AAL), or are ready to buy them now, and who don't mind the potential hassle of managing diagonal calls with us to target periodic income.

How You Participate

- **Trade:** Sell to open April 10, 2015, $52 calls on American Airlines. *Please note that these are **weekly** options*.
- **Allocation:** Sell one call for every January 2017 $35 call you already own (or are buying now). *Pro* will cover its 10 long calls.
- **Price Guidance:** Prices will change as the underlying stock moves, but use a limit order at going prices as long as you get at least a 3.5% yield on your long January 2017 call value (see the math below).
- **Prices** (March 9):
    - **Stock price:** $46.78 (as of 1:40 p.m. 3/10/15)
    - **Sell to open April 10, 2015, $52 calls (bid/ask split):** $0.68
    - **January 2017 $35 calls we own (bid/ask split):** $17.50
    - **Diagonal call yield:** $0.68/$17.50 = 3.9% in 31 days.
- **Catch-Up Trade:** If you're setting up the whole trade today, use a diagonal call order to aim for a net debit of $16.85 or so. Invest about 1% of your funds in the long calls if you're matching our allocation.

What We're Thinking

What *are* we thinking? We only bought our long calls on this resurgent airline about six weeks ago, but even in our original report we said we might follow up by writing diagonal calls. Frankly, we're doing so because these calls pay so well -- but of course, that very fact could be a warning sign to call writers like us. High premiums suggest the market expects volatility, and it's true that shares could rebound and fly high, leaving us unpleasantly required to roll these short calls to catch up. That said, the country's largest airline looks undervalued, and we think the stock could indeed soar much higher by 2017 — but 2017 won't be here in 31 days, when today's calls are set to expire. We see this as a chance to earn some income before the company reports earnings in late April.

These written calls could pay us as much as 3.9% on our current long call value in just one month, and they'll expire before earnings on or around April 22. Plus, our $52 strike price is 11% above the recent share price, and our net "sell" price of $52.68 is 12.6% higher. Of course, we don't plan to close or sell, so we'd have to roll and potentially pay a credit if the stock increases that much in a month.

Why This Strategy?

American Airlines stock is down since its January earnings for several reasons. Management is intent on spending its copious cash flow on employee raises, airplane seats, check-in counters, and airport lounge improvements. They're also seeing more competition in some markets, and they expect lower revenue per seat mile in the current quarter than Wall Street hoped. None of that deters us on our longer-term thesis, but it's all put a damper on the stock lately, and it's hard to imagine the fog will lift completely in a month.

Wall Street will probably need to see earnings in late April before seriously reassessing the stock, likely giving us a chance to earn some income now that we've waited several weeks after January earnings for a price recovery that hasn't come. We seek to make one cup of lemonade out of this current lemon, and then leave it uncovered for upside again (we hope) with April's earnings. That's the plan. It's possible some folly will result. But sometimes we're OK with accepting a low risk of missed upside in the name of current income.

More That Matters

- **Maximum gain:** The 3.9% premium earned from writing the calls, plus upside in our owned calls to our short call strike price at $52, which is lately 11% higher.
- **Maximum risk:** The full value of our long $35 calls, minus premiums received from short calls.
- **Follow-up**: We hope to see these short calls expire for income next month, and then wait to see earnings results. If we need to roll or close, we will.

Alternative Trades

- **Own stock?** If you bought 0.5% to 1% in stock instead, and that equates to 100 shares or more, you can write covered calls if you wish -- sell to open the same April 10, 2015, $52 calls we're writing.

Options Can Help

- **Want to know more about this strategy?** Our Options U guide to writing diagonal calls can keep you on an even keel.
- **Questions about this trade?** Fly on over to our American Airlines board, now with extra leg room.

FoolFest Folly: Four Portfolio Pitfalls

Published Mar 9, 2015 at 4:13PM

Dear *Pro* members,

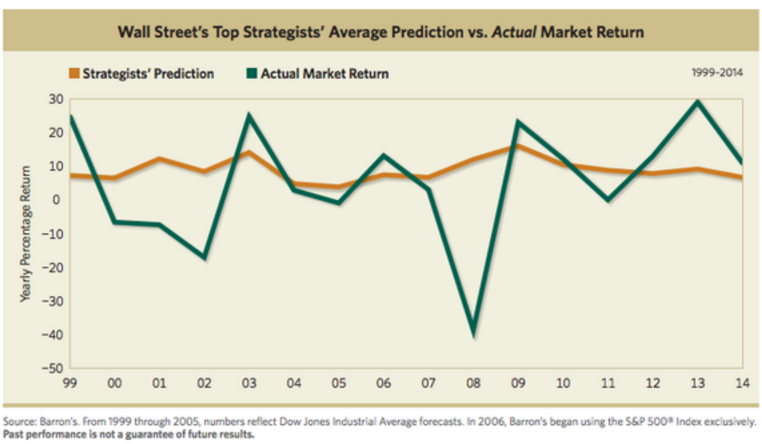
We greatly enjoyed hosting nearly 200 *Pro* members last week in Alexandria, Va., for TMF's annual FoolFest event. We hope to see even more of you next year! The Westin conference room was packed with about 700 Fool members in total. Many of them were *Motley Fool One* members, and many of those started with *Pro* and *Options*. It's always a pleasure to put a face and a life story to a name. At Fool events, there's also a third dimension: The mention of a screen name can make you realize you've known the person online for years. It's exciting to finally meet them in "real life"! Fools flew in from all around the world: Spain, Mexico, Venezuela, Alaska (yes, I know it's part of the United States ... sort of), you name it.

In the four-hour *Pro* breakout group, we enjoyed long Q&A sessions with members alongside four presentations (all of which will be available on the site shortly). Billy offered an educational deep dive on **TD Ameritrade** (NYSE: AMTD), explaining the drivers of the business and why we rate it a Buy First, as well as predicting new highs for the stock by last Friday — which it did achieve (or maybe he didn't bother to predict it; he just knew it). JP spoke about how we value companies, using **AmTrust Financial** (NASDAQ: AFSI) as an excellent example. Jim Gillies represented *Options* with a chat on how he buys LEAPS on beaten-down blue chips. I had to be the downer in the group and talk about portfolio pitfalls, though at least I was able to offer some solutions.

Let's run through those four pitfalls and solutions today, as reinforcement for those who attended and to share them with those who did not.

Portfolio Pitfall No. 1: Forecasting

Forecasting is a pitfall for your portfolio for a few reasons. For one, nobody can consistently forecast earnings, GDP growth, the S&P 500, or anything else for that matter. Yet we're too often prone to changing our portfolios because of forecasts — loading up on certain stocks, selling others, or even getting out entirely. Those are certain ways to derail your goal of a balanced portfolio. From Davis Advisors, look at how well experts were able to forecast the largest S&P 500 decline in decades:



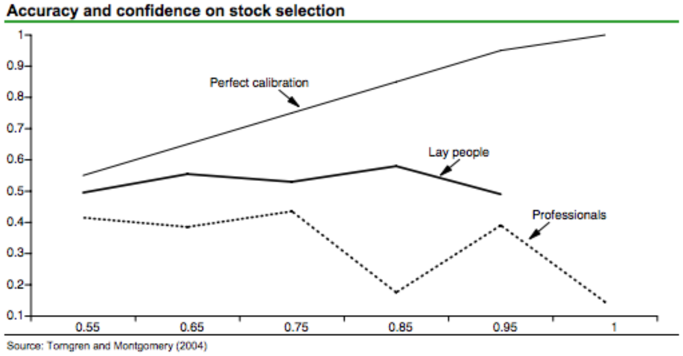
They completely whiffed. So why listen to them for anything else? Indeed, *The Wall Street Journal* has reported that throwing darts would have resulted in more accurate market predictions than the professionals gave, all the way back to 1929.

Solution: Instead of using forecasting to make decisions, we look at the current reality and compare it to history. Lately, the S&P 500 trades at around 17.7 times earnings — within its historical average, albeit at the higher end. We then take into account record-low interest rates, high margins, and so on to reach a take on the market. We do the same for our individual companies, looking at the current reality, comparing it to history, and adjusting our thesis for where the business stands today. That's right: We have theses, rather than forecasts. A thesis has vulnerabilities by definition, while a forecast welcomes overconfidence, leading to poor choices.

Portfolio Pitfall No. 2: The Illusion of Knowledge

Studies show that beyond a certain point, more information *does not* lead to better decisions — in fact, it makes for worse outcomes. Having mountains of data sloshing around in your head can lead to overconfidence, clouded judgment, and suboptimal results. What you need instead is the appropriate *core* information needed to make a decision. Much of the rest is noise.

This is important to us, because at *Pro* we seek high accuracy. We want as many of our positions to make money as possible. Studies show that the more data you gather, the higher your confidence but the lower your accuracy. Take a look at the below, from James Montier's paper, "Seven Sins of Fund Management." Accuracy percentile is shown on the left (Y) axis, and confidence percentile on the bottom (X) axis:



The more confident a professional investor becomes, in most cases, the more their accuracy declines. In fact, accuracy plummets down to just 15% at the 100% confidence level (the bottom-right of the chart). That table-pounding analyst is dead wrong. On the left side, when the pro investor is only 55% confident, accuracy is around 40%. Which begs the question: Who are these pros? They're not strong in either case. The lay person does much better — that's you, Fools.

Solution: We discount or ignore secondary sources (the constant news cycle, talking heads, conflicted brokers, opinionated bloggers) and focus on primary sources instead: SEC filings, company conference calls, and audited financials; our own heads to synthesize it all; and independent research to show us the big picture. When it comes to our companies, we use this information to affirm competitive advantages, pricing power, growing margins, strong financials, and proven management. We want enough information to have a strong thesis, but not so much that we're overconfident or clouded.

Portfolio Pitfall No. 3: False Diversification

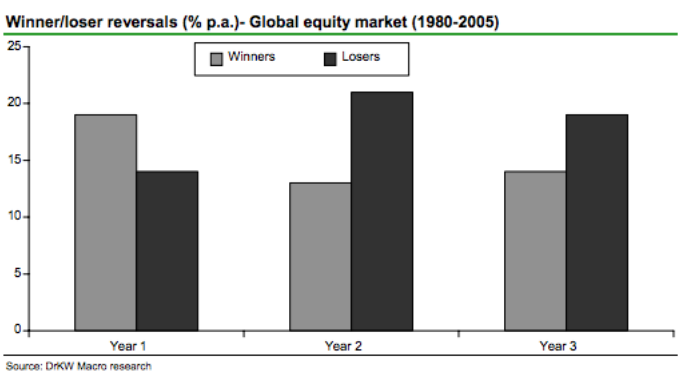
The number of positions you need to be diversified is debatable, with some research claiming seven companies is enough, and other data suggesting you need 12, 30, or even 100 stocks from around the world. Given *Pro*'s goal of having winners in up, down *and* flat markets, we can simplify the idea of diversification to this: *If all of our positions are moving together, we are not diversified*.

We want some positions winning when nothing else is, we want some laggards when everything else is winning, and we want some gains when the market is not going anywhere. We want to address all types of markets at the same time in our portfolio. So we have, all at once:

- Stocks for long-term compounding in bull markets
- Shorts for bear markets
- Options for flat markets (among other uses)
- Hedges for the unknown

We want our portfolio to have some positive outcomes whatever the market is doing, and we want to be able to take positive actions in all markets, too. If every position is moving together all the time, the portfolio is too binary for our goals. In addition to multiple strategies, we want some losers like our **WisdomTree Emerging Markets SmallCap Dividend Fund ETF** (NYSEMKT: DGS). Why?

Because losers eventually take the lead from winners. Many investors make the mistake of chasing winners (and selling their losers), ignoring studies that show that within three years, losers often catch up to — or even surpass — past winners. With the average stock held only 11 months, most investors don't have enough patience to see their losers turn green. If you still believe in your losers, keep them. From Montier again, here's how previous losers (presumably with good fundamentals) catch up:



Interestingly, studies also show that value stocks rival growth stocks for total long-term EPS growth. But growth is granted a higher multiple to earnings (meaning higher risk). So you want to own both, especially since sometimes growth is in favor, and sometimes value.

Solution: All of our positions should *not* be moving together. We use diverse strategies with inverse correlation. We also want to continue to own high-P/E stocks (growth) and low P/E stocks (value) — as well as winners *and* losers we still believe in.

Portfolio Pitfall No. 4: Mismanaging Winners

Too many investors sell winners when they have a double (or some other arbitrary number) or to "lock in gains." Instead, you should consider *adding* to your proven winners. Imagine if we had added a bit more to some of our stocks on their first double — **Papa John's** (NASDAQ: PZZA) or AmTrust, for example — rather than trimming.

We all need to be mindful of our total risk in any position, of course, but selling winners has almost surely left more wealth on the table for investors in aggregate — hundreds of billions of dollars, if not trillions — than any other mistake. Warren Buffett has it right: He *builds* on winners, adding for years on end. He bought shares of Geico through the 1970s and into the 1980s, before buying the whole company in 1996. He bought **Coca-Cola** (NYSE: KO) shares for years. He has been buying more **Wells Fargo** (NYSE: WFC) stock almost yearly since 1989. He is "building mountains" with his favorite companies.

Solution: Flip the notion of how you manage winners on its head. Rather than selling winners, consider adding a bit more to them. Consider building up your winners over many years.

Say it with us: You can't predict the future. You don't need endless amounts of information. Not all of your positions should be moving together. And you can give more — more time and/or more money — to your winners.

FoolFest 2015 in the History Books

Thank you to everyone who make the trek to D.C. for a wintry get-together! We enjoyed seeing many of you again and meeting others for the first time. By the way, for next year's FoolFest, we're hoping to have at least one *Pro* company executive visit to give a speech. This year, the CEO of **Skyworks Solutions** (NASDAQ: SWKS) was interested, as were AmTrust officials, but the dates didn't line up. Next year? We hope to see you there, too.

— Jeff (TMFFischer)

Pro Performance

Performance as of 2/28/2015

	Annualized		
	Since Inception	Rolling 3-Year	YTD
Charter Portfolio	**15.1%**	**20.8%**	**6.0%**
North Star	**8.1%**	**7.9%**	**0.7%**
S&P 500 Total Return	13.8%	17.8%	2.6%
MSCI World	8.1%	10.8%	3.7%

*Start close of 10/6/08.

Pro Completed Trades

- **SPDR S&P 500 ETF** (NYSEMKT: SPY): Per Friday's trade alert, we set up two put ratio spreads, setting up the June 30 spread for a cost of $0, and the September 30 spread for a $0.40 net credit.

Pro Catch-Up Trades

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- Please see our Portfolio Positioning Report, which was issued today. It has five trades (shorts and options) for those not yet partaking in those positions, and a brief update on all of our positions on Hold or that are not currently timely for newcomers.

Portfolio Positioning Report: March 9, 2015

Published Mar 8, 2015 at 1:29PM

Welcome | Shorting in Short | Hedging ... in Short | Your Exposure | This Stuff Is Optional
Options Are Optional, Too — but Advised! | About This Report | The Positions Themselves (Shorts, Hedges, Options, All the Rest)

See the replay of our March 9 live event

Dear *Pro* member,

Our first two Portfolio Building Reports gave you guidance on all of *Pro*'s Buy First and Buy stocks. This final report will do the same for our shorts and options positions, many of which we use as hedges. For reasons I explain below, we don't expect that many of you will initiate all of the positions in this report right away, or perhaps at all. And that's perfectly fine!

Hedging is about lowering portfolio exposure, and to a lesser extent, shorting is as well. They're tools to tweak and adjust your *existing* portfolio, so if you're still building your collection of long stocks, concentrate on that for now. Stock investments are the core of the *Pro* portfolio, and by owning *Pro* stocks, you are positioned to compound your value over time. We know there's a learning curve for some of these strategies, as well, so it's important you know there's no rush; you can incorporate the positions in this report when you're ready. We're here for you in the meantime.

Before explaining the positions themselves, I'll discuss how each strategy works. Let's start with shorts — a sort of "anti-investment" that we believe will decline in value, adding profits to our portfolio in the process.

Shorting in Short

When you sell something short, you borrow shares from your broker and immediately sell them, collecting the proceeds. At various brokers, this trade action is called "sell short," "sell to open," or just "sell." In the future, you'll need to buy shares back to replace the ones you borrowed and sold. This second step is called "cover," "buy to cover," or "buy to close." You hope to buy the shares back at a lower price than when you opened the position.

The difference between your original sell — or short — price and the price you pay to buy back (and return) the borrowed shares is your profit. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock soars to $30, you've lost $10 per share when you buy it back. We use shorts in *Pro* because they're one good way to profit when the market or a weak company falls, but they do come with their own risks — shares can be hard to borrow, fees are often involved, and a short can get closed on you (you're forced to buy it back) if the broker wants the shares back early. So, we need to size our short positions appropriately small.

Finally, a special note related to *Pro*: We do short individual companies, but we really like to short flawed investment vehicles, typically ETFs that use leverage. Because of the way they're constructed, these ETFs are all but destined to lose value over the long haul. This makes them expensive to short, but as we've shown, it can be worth it.

Hedging ... in Short

Similar to a short but different in intent, a hedge is a position taken to *offset* the risk we have in another position or in our market exposure as a whole. So, when we sell short a market-index proxy like the **SPDR S&P 500** (NYSEMKT: SPY) ETF, we are hedging our exposure to the stock market as a whole. A hedge is a form of insurance — it only pays out when you need it. We know a market-index hedge will go up in value whenever the market goes down, because like insurance, it's there to protect us in that very situation. But most times, the market won't fall, and our hedge will go unused.

For this reason, we try to spend relatively little to hedge, but the costs can still add up. We have to reconcile this with the fact that hedging lets us stay *more* invested than we otherwise would, given our absolute-return goals. In other words, one key way we profit from our hedges is by using them to help us keep our long stock exposure higher. As with shorting, you should only hedge if you have specific stock or stock market exposure you want to "hedge out." Recently, *Pro* issued two hedges — put ratio spreads — using the SPDR S&P 500. Those are our current market-hedge recommendations for anyone who wants to hedge up to 20% of their long exposure.

Your Exposure

Let's talk about your market exposure. This is simply how much of your total portfolio is invested in long stocks. Excluding options and shorts, Pro is 86.4% invested in long stocks as of March 6. That's high for an absolute-return portfolio (which is part of why we want to short and hedge!). But for new *Pro* members, four stocks — accounting for 18.8% of our exposure — are on Hold. So if you bought all of our current buys, you are only 67.6% invested in stocks. You have less reason to hedge and short right now (unless, like many members, you own other stocks beyond *Pro*'s). The bottom line is: As you consider adding hedges and shorts to your portfolio, first know how much of your portfolio assets are invested in stocks. That helps dictate how much shorting or hedging exposure you want to initiate to reach the *net* market exposure you desire. Pro has averaged around 70% net long exposure over its lifetime, but that number will move up and down as our opportunities do. Our exposure is shown at the bottom right of the Recommendations page.

This Stuff Is Optional

Not every *Pro* member is comfortable with shorting or hedging, and there are practical considerations to take into account as well. First, you need a margin account to sell short, so you can't do it in an IRA. Second, you have to accept that shorts can run strongly against you, so you need cash to cover that risk. Third, you'll usually pay an annual fee of anywhere from 1% to 5% of the daily short value to short something. Fourth, in many cases it's hard to borrow shares to short, period. That is the situation with some of our current shorts today. Finally, short shares can bought away from you at the worst time, when they're up in price (a "forced buy-in"). If brokers can no longer find shares to borrow, you're forced to "buy in" at market prices to return your borrowed shares.

So what to do? You can use options to short in some cases; we do, and we explain how to do so wherever appropriate. You can also consider opening a brokerage account that is particularly friendly to shorting. Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does, and does not charge a fee for shorting. Or, you can wait and see whether shares become available in your existing, traditional brokerage account (be aware that at many brokers, certain shares are basically never available for shorting). Or, if you're not drawn to it, you don't need to short at all.

Options Are Optional, Too — but Advised!

Our options positions are also ... optional, but we strongly advocate learning to use options and following along with ours over time. Options are powerful tools for income, hedging, upside, and more. We know from experience that they're worth the time it takes to learn them, and we're here to help you do that. Options can make you a much more confident and versatile investor, and they can free up whole new streams of income for you and your family. So, if you're new to options, you're in a great place! Use *Motley Fool Pro* and our sister service, *Motley Fool Options* (free for the life of your *Pro* membership!), to learn how to use these great tools. On a personal note, if you're going to learn just one simple strategy, I suggest learning how to write puts (link goes to *Motley Fool Options*) for income or to buy a stock lower.

About This Report

Let's return to the main show. This Portfolio Positioning Report and the special live chat accompanying it today, March 9, at 3 p.m. ET, will (when you're ready!) help you short vehicles we believe will decline, hedge your portfolio, and generate returns from options. Do keep in mind that this is just a start; we'll have many brand-new investment recommendations arriving to your inbox as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way!

On the other hand, if this looks overwhelming right now — or if you're still catching up with our core stock positions — that's perfectly fine, too. You don't need to start these positions now. As mentioned, long positions are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and often rewarding — aren't necessary to succeed with *Pro* in the long term, let alone immediately. As you learn these strategies and progress with us, just keep your exposure to the stock market in mind.

In closing, I'll stress again that you shouldn't feel pressured to act immediately. We will continue to make recommendations on an ongoing basis, including in our Monday Catch-Up Trades — and brand-new opportunities emerge regularly. That's part of the fun! So, take your time, and make an investment only when you're ready. Finally, please bring any questions to our Making *Pro* Fit You discussion board.

Foolishly,

— Jeff Fischer, *Pro* advisor

The Positions Themselves

Shorts

- Currency Shares EuroTrust(NYSEMKT: FXE)
- Direxion Daily Financial Bear 3X Shares ETF (NYSEMKT: FAZ)
- Five Below (NASDAQ: FIVE)

Hedge

- SPDR S&P 500 (NYSEMKT: SPY)

Options

- American Airlines (NASDAQ: AAL)
- American Tower (NYSE: AMT)

All the Rest

- AmTrust Financial Services (NASDAQ: AFSI)
- Caesars Entertainment (NASDAQ: CZR)

- Coca-Cola (NYSE: KO)
- Expeditors International (NASDAQ: EXPD)
- Gentex (NASDAQ: GNTX)
- Medtronic (NYSE: MDT)
- O'Reilly Automotive (NASDAQ: ORLY)
- Papa John's (NASDAQ: PZZA)
- Wells Fargo (NYSE: WFC)

Shorts

CurrencyShares Euro Trust (NYSEMKT: FXE): Sell Short

Shorting the euro against the dollar is relatively low-risk disaster insurance.

Suggested Short Allocation: 1.9% to match us

How It Fits Into *Pro*

We've been short the euro against the dollar since late 2011. We view this position as a quiet anti-investment in which the risk to us is relatively known (and reasonable) and the profit potential, while less clear, is worth pursuing. Although we are up 18% on the position as the euro has declined to a recent $1.07 to the dollar from about $1.30, parity to the dollar is still a possibility, and it needn't stop there. With interest rates ready to increase in the U.S., and with Europe starting a massive bond buying program, the dollar may be preferred to the euro for at least a few more years. And if Greece or other euro members default, the euro could be badly punished. The vehicle we're shorting (it's called a trust, but trades like a stock) only holds physical euros, so it's a pure way to short the euro against the dollar in our U.S.-based brokerage account.

For More

- *Pro*'s recommendation history
- Talk about FXE on our discussion board

Availability

Shares of FXE are often available for shorting at various brokers; the annual fee is lately 1.8% at Interactive Brokers, and there is no fee at TD Ameritrade.

Alternative Trade

If your broker does not have shares available for shorting, and you're trading in a margin account, you can instead set up a synthetic short. "Sell to open" January 2017 $107 call options on FXE, and to buy to open an equal number of January 2017 $107 put options (lately for about a $1 credit, but that price will change). Just realize that you, just like us, are short the vehicle at today's price, and you will see losses if FXE's price goes up. Also, only sell to open one call option for every $10,700 in FXE you can afford to be short, remembering that each option represents 100 shares. We have about a 2% allocation, so to set up one synthetic short and keep it at just 2%, you would need an account value of about $500,000. If 100 shares via options is too large an allocation for you and you can't short fewer shares directly, then just sit this one out! There are no IRA alternatives at this time that are attractive enough to merit your IRA dollars.

Direxion Daily Financial Bear 3X (NYSEMKT: FAZ): Sell Short

Daily leverage keeps steady downward pressure on this bearish ETF.

Suggested Short Allocation: 0.4% to 1% (we are currently short only 0.4%,
as the position has shrunk nicely, but we may add to it opportunistically)

How It Fits Into *Pro*

This bearish ETF is meant to provide 3 times (300%) the daily inverse results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. By shorting this ETF, we're effectively 3 times long, on a daily basis, the U.S. large-cap financial sector.

As we touched on in the introduction, leveraged ETFs like this one are flawed because they rebalance their derivative positions daily in order to maintain a constant leverage. Over longer holding periods, the costs involved with rebalancing eat away at returns, keeping downward pressure on the vehicle as a whole. Also, returns are compounded daily, which adds to tracking errors. As our original buy report details, we continue to believe that large-cap U.S. financials are cheaply priced — and we own several of them as a result. That belief makes shorting this flawed bearish financial ETF all the more attractive.

That said, shorting it has become difficult over the years, and our position size has dwindled severely. New members can skip this position if shorting it proves difficult (or use options if you have a six-figure account). We own plenty of strong financial companies instead.

For More

- *Pro*'s recommendation history
- Talk about FAZ on our discussion board

Availability

This is hard to borrow! Lately, only 85,000 shares of FAZ were available for shorting at Interactive Brokers at a 6.3% annual fee. Periodically, TD Ameritrade has shares available with no fee.

Alternative Trade

If you can't short shares directly, then you can set up a synthetic short in a margin account. "Sell to open" January 2017 $12 calls on FAZ, and "buy to open" an equal number of January 2017 $12 puts. Lately you will pay about $0.50 per contract, net. This makes you short FAZ with a start price of $12.50, and sets you up to profit if FAZ declines in price. Only sell one call for every $1,200 in FAZ you are able to comfortably short. On a $120,000 account, one contract would be a 1% allocation. That's as much as we recommend. (Eagle-eyed members will notice that *Pro*'s short position on FAZ is 0.4% of your portfolio. We're recommending 1% to newcomers because we know you'll be unable to short another position we have in our portfolio, SRS (more on that later). There are no IRA-friendly alternatives for this short. If you can't short it at all, you could add 0.5% to one of our financial companies — **Wells Fargo** (NYSE: WFC) or **MasterCard** (NYSE: MA) — instead.

Five Below (NASDAQ: FIVE): Sell Short

This young retail chain targets pre-teens and teens with $5-and-under items, but its stock has been caught up in IPO hype and still looks expensive.

Suggested Short Allocation: 1.1% to match us

How It Fits Into *Pro*

Five Below management would like investors to believe that the company can increase its current store count of around 350 stores to 2,000-plus in the coming years. But a ruthless competitive landscape and notoriously fickle target audience (pre-teens and teens) for this price-capped ($5 max) retailer make us skeptical of notion that the company will continue to achieve above-average growth and profitability. Management turnover and disappointing same-store sales growth for Five Below's all-important holiday quarter suggest that chinks in its armor may already be forming.

The stock is down 17.6% since we first recommended selling it short, but we believe more downside is possible given that it still trades for more than 31 times forward earnings. We'll see a new earnings report at the end of this month.

For More

- *Pro*'s original recommendation
- Talk about FIVE on our discussion board

Availability

Shares are readily available for shorting. Interactive Brokers charges a 0.75% annual fee.

Alternative Trades

The options on Five Below aren't long-term or attractive enough to consider.

Hedges

SPDR S&P 500 (NYSEMKT: SPY): Set Up Put Ratio Spreads

Pro currently has two actively recommended hedges on our portfolio, detailed in our March 6 trade alert on the SPDR S&P 500. Please see that report to see how to set up a 20% portfolio hedge if your market exposure is high (80% or above), as *Pro* has done. (We want net exposure of around 70% or lower.) The trade alert has IRA-friendly alternatives, as well as low-cost spreads for those lacking the cash required to hold open the official trades.

Options

American Airlines (NASDAQ: AAL): Buy Calls

Allocation: 1%

These calls target long-term upside on what we believe is a resurgent, disciplined airline that will enjoy profitable operations.

This trade alert, to buy January 2017 $35 calls on American Airlines was issued Jan. 23 to all members, so you may already own this position. But if you don't, now is a good time to join in. Call prices are lower, and we still believe in the long-term valuation upside on offer. Realize that we may write diagonal calls against these calls for income while we wait. Get started with our original report. Note, again, that prices are lower now.

American Tower (NYSE: AMT): Buy Calls

Allocation: 0.5%

These calls target long-term upside on American Tower, adding to our existing stock holding.

For More

- *Pro*'s original recommendation
- Talk about American Tower on our discussion board

We're seeking leveraged returns if American Tower stock appreciates by 2017. To follow along, **use a limit order** to buy to open January 2017 $80 calls. Aim for a price near the midpoint of the current bid/ask spread. A 0.5% allocation at current prices most closely equates to buying one call for every $450,000 you manage. This is a small position by design, so be careful not to over-allocate to the calls; we may seek to add more to our position later if volatility provides us with lower prices. Members for whom one contract would over-allocate their portfolios can consider these choices:

- Buy 0.5% more in stock, bringing your stake to 4.1%. Realize you won't benefit from the leverage the calls will provide, although you will have a better breakeven price and no expiration.
- Consider allocating 0.5% to a bull call spread at small strike increments. The in-the-money $90/$92.50, $92.50/$95, and $95/$97.50 spreads all offer attractive annualized returns if the stock price is above the higher strike price at expiration. Out-of-the-money spreads offer higher returns but an increased chance of total capital loss. (Our sister service, *Motley Fool Options*, offers what we think is an excellent overview of bull call spreads here. Please post subsequent questions on Pro's AMT board.) — Billy Kipersztok

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All the Rest of *Pro*'s Positions!

As a *Pro* member with an especially keen eye (and great memory!), you will note that we haven't updated you on every position in the portfolio yet. Pricing opportunities being what they are, not all of our positions are primed for new action right now, and not all options positions are timely. Worry not. We will publish Catch-Up Trades when we see new *Pro* opportunities on existing positions. One by one, it won't take us long to get there. Here's the status on our remaining positions that are currently "on pause for newcomers" — either on hold or not timely.

AmTrust Financial Services: Hold

Shares are simply on hold as we review recent earnings at **AmTrust** (NYSE: AMT). We expect them to return to Buy status soon. But as this is our largest position at 7.1%, we may advise newcomers to buy less than that. We'll alert you when we're ready with a decision. Please watch for Catch-Up Trades on Mondays.

Caesars Entertainment: Short

Pro is currently short shares of casino operator **Caesars Entertaiment** (NASDAQ: CZR), which has put one of its units into bankruptcy proceedings. The stock is volatile and has fallen nearly 20% since we shorted it. We would rather new members short during one of its fairly frequent surges, so we suggest waiting for now. If we see shares jump from a current $9.63 back to around $12, we may recommend newcomers short the stock then. That said, we are also debating closing our short and taking our 20% profit. The outcome on this short is partly dependent on the courts now, and we don't have an edge in analyzing that. However, the business continues to suffer.

Coca-Cola: Synthetic Long

Pro holds a 2016 synthetic long option position on **Coca-Cola** (NYSE: KO), but 2016 is not that far away, and a synthetic long may not be what we choose to do next. Within a few months, we'll have an updated strategy decision. We advise new members to wait. (Some of you started an option position on Coca-Cola with *Motley Fool Options* — that's a fine substitute for now and perhaps indefinitely, unless we get a great new opportunity.)

Expeditors International: Synthetic Covered Strangle

Shares of shipper **Expeditors International** (NASDAQ: EXPD) have run up sharply since last August, making us hesitant to suggest newcomers set up this predominately income-oriented position now. If and when it dips into the mid-$40s, we can get you started with it. Watch Monday's Catch-Up Trades, especially after any good market declines!

Gentex: Written Puts

Pro has written March 2015 $17.50 puts that, if exercised, would have us add about 1% in stock to our **Gentex** (NASDAQ: GNTX) position. The goal with these puts is to earn income and potentially add to our existing stock position at lower prices. Since this position is just two weeks from expiration, we don't recommend that new members join us now. The stock is hovering near the strike price, so as we approach expiration, we will decide whether we want to accept shares, roll the puts out to a later month to target more income, or (if the stock price ends above the strike price) write new puts. We advise that you wait a few weeks for us to send a new alert on Gentex before you act on this position. Meanwhile, as noted in Portfolio Report No. 2, we recommend you own 3.2% in this buy-rated stock. — Billy Kipersztok

Medtronic: Hold

We have a 3.1% position in medical devices giant **Medtronic** (NYSE: MDT). The position is on hold as we analyze the company's latest earnings in light of a much higher share price over the last year. We may write covered calls on the position, and could get newcomers into it then. Stay tuned.

O'Reilly Automotive: Hold

We have a 4.2% stock position in **O'Reilly Automotive** (NASDAQ: ORLY), but it's on hold for new members. Given that this auto parts retailer trades at record valuation multiples (partly justified by record results), we're considering our next move. We'll let everyone know.

Papa John's International: Hold

As we wrap up our earnings analysis, expect an update soon on the currently on-hold **Papa John's** (NASDAQ: PZZA).

ProShares UltraShort Real Estate: Short

We have a small (0.3%) short remaining in the **ProShares UltraShort Real Estate ETF** (NYSEMKT: SRS). We enjoy watching its slow descent in price, but the ETF only has $33 million in assets now, making it too small to recommend to new members. Plus, outside of our broker (Interactive Brokers), it appears impossible to borrow shares to sell short now — and if you do find them, the annual percentage fee to short is high (recently 6.7% at IB). Instead, as shared above, we recommend that you sell short up to 1% in FAZ as a long-term alternate, or buy up to 1% in shares of the **iShares Dow Jones US Real Estate** (NYSEMKT: IYR) as a long-term hold instead. Or just sit this small position out.

Wells Fargo: Short Strangle

Pro has written an April 2, 2015, $52.50/$57.50 covered strangle on Wells Fargo (note that these are *weekly* options). A strangle consists of two legs — a written put and a covered call — with different strike prices but the same expiration date. The goal of this strangle is to opportunistically target income on a stable stock. This strangle is playing out well so far, but a lot of time value has already dissipated since the alert, so we don't recommend new members join us just yet. Wells Fargo is set to report earnings in mid-April, and after our review of the quarter, we'll decide whether we want to pursue another income-generating strangle. If we do, you can join in with us then. — Billy Kipersztok

In Conclusion

We'll likely recommend many of these positions (except the SRS short) to new members once we reaffirm that there's sufficient opportunity to make up for the current risk, and/or when pricing improves. Just watch for *Pro* Catch-Up Trades, issued Monday or whenever an especially timely opportunity crops up.

At the same time, we're not standing still. In this and our two previous Portfolio Building Reports, you have many great *Pro* investments to move into gradually. And of course, we'll continue to send brand-new investment recommendations to all members. It's not vital that your portfolio be 100% identical to ours, but being closely attuned to it, especially with our core stocks, should position you to succeed well with *Pro* over the time frame that matters. Meanwhile, if you're new to shorts, hedges, and options, start to dip your toes in as your comfort allows. We're here to help, and we believe you'll see the many great benefits as the years unfold.

Fool on!

— Jeff (TMFFischer) and the *Pro* team (Billy, JP, and Ellen)

Set Up Put Ratio Spreads on the SPDR S&P 500

Published Mar 6, 2015 at 11:38AM

- **Is this for you?** Greetings, Fools! Go slow and read this full report carefully. **There is no need to rush.** If there's anything you don't quite understand, you can wait for our Monday [Portfolio Positioning Event] for more details and to ask questions.

  At *Pro*, we use hedges to protect against the unknown and to earn returns during a meaningful market decline. This report recommends two hedges. It's important to realize that you don't need to hedge to succeed with *Pro*, but if you are at least 80% invested in stocks and want to hedge against a market decline, then consider following along. Those without a margin account should consider the IRA-friendly Alternative Trades at the end of this report, as should those managing less than $200,000 or so.

How You Participate

- **Action:** Set up two put ratio spreads on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.

First Spread: June 30, 2015, $187/$200

- **Allocation:** 11% of total portfolio value. Set up one 2:1 put ratio spread for every $200,000 you manage and want to hedge; hedging 11% of its entire portfolio value, *Pro* will sell 28 puts and buy 14.
- **Price Guidance (March 6):** Lately, you can set up this trade for around no cost or a small credit.
  - Write ("sell to open") **two** June 30, 2015, $187 puts, and buy ("buy to open") **one** June 30, 2015, $200 put for every $200,000 you're hedging. Note that these are quarterly options that expire the end of June. Click "view all" to see all strikes.
    - Sell to open two June 30, 2015, $187 puts: $2.15 x2 = $4.30 credit
    - Buy to open one June 30, 2015, $200 put: $4.25 debit
    - Net credit: About $0.05 per spread (these prices will change, but ideally aim for a credit or close to no cost using a limit order)
    - SPY price: $210

Second Spread: Sept. 30, 2015, $170/$185

- **Allocation:** Another 9% of total portfolio value. Set up one 2:1 put ratio spread for every $185,000 you manage and want to hedge; hedging 9% of its entire portfolio, *Pro* will sell another 24 puts and buy 12.
- **Price Guidance (March 6):** Today, you can receive a healthy credit to set up the trade.
  - Write ("sell to open") **two** Sept. 30, 2015, $170 puts, and simultaneously buy ("buy to open") **one** Sept. 30, 2015, $185 put for every $185,000 you're hedging. Note that these are quarterly options that expire the end of September. Click "view all" to see all strikes.
    - Sell to open two Sept. 30, 2015, $170 puts: $2.20 x2 = $4.40 credit
    - Buy to open one Sept. 30, 2015, $185 put: $3.90 debit
    - Net credit: About $0.50 per spread (these prices will change, but aim for a credit using a limit order)
    - SPY price: $210

Our existing March 31 spread: We are currently letting our existing position run to expiration. It continues to be a hedge between now and then should SPY fall below $200. If we decide to close it, we'll send a trade alert. Newcomers don't need to worry about this one.

What We're Thinking

At *Pro*, we aim to have winners in down, flat, and positive markets -- and that means we need to address all three possibilities at once in our portfolio. A hedge on a market index is simply a hedge against a shock. We don't know if or when one is coming, of course, but if it does, a hedge can help us get through it more easily. We generally don't care about declines of 5% or less (that just comes with the market), but when *Pro* is functioning as desired, declines of around 10% or more should result in some of our positions, like these spreads, becoming profitable. At the same time, these put ratio spreads are:

- Free to us if the market keeps going higher (they don't harm our return)
- Cash-free to set up (they even pay us a small credit)

As our March 31 put ratio spread nears expiration, we're due to earn a small credit -- $488 -- for a hedge that never came into play. We'll take that. What's the trade-off? We have been ready to buy shares of SPY via that hedge if the market fell too sharply. So with these spreads, as with any put-writing trade, we need to be ready to buy the underlying investment (in this case, the SPY ETF) if it falls severely. If the index falls more than 17.1%, our new June hedge becomes a liability; if it falls 26%, the September hedge does, too.

To help you grasp this strategy and how many spreads to set up, let's run through details on *Pro's* allocation and our collective possible returns.

- *Pro* portfolio value: $2,470,000
- 11% of that value: $271,700
- 9% of that value: $222,300
- **June 30, 2015 spread:**
  - Buy to open $200 puts (14 contracts representing 100 shares each) = $280,000 in look-through exposure, or an 11.3% hedge on our current portfolio value
  - Sell to open $187 puts (28 contracts, half of which become a potential obligation, currently a 10.6% possible stake)
  - At home, you would buy one $200 put and sell two $187 puts for every $200,000 in portfolio value you want to hedge.
- **Sept. 30, 2015 spread:**
  - Buy to open $185 puts (12 contracts representing 100 shares each) = $222,000 in look-through exposure, or nearly a 9% hedge on our current portfolio value
  - Sell to open $170 puts (24 contracts, half of which become a potential obligation, currently a 8.2% possible stake)
  - At home, you would buy one $185 put and sell two $170 puts for every $185,000 in portfolio exposure you want to hedge.

Return Details: June 30, 2015 Spread

SPY Price at June 30 Expiration	Value of 1 Purchased $200 Put	Value of 2 Written $187 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Current $210
$200 or higher	$0	$0	$0.05 gain per spread, or any credit or debit for setting up the trade	Any increase in price, or any decline of less than 4.7%
$195	$5 x $100 = $500	$0	$500	(7.1%)

SPY Price at June 30 Expiration	Value of 1 Purchased $200 Put	Value of 2 Written $187 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Current $210
$190	$10 x $100 = $1000	$0	$1000	(9.5%)
$187	**$13 x $100 = $1300**	**$0**	**$1300 (max profit per spread)**	**(11%)**
$185	$15 x $100 = $1500	($2) x 200 = ($400)	$1100	(11.9%)
$180	$20 x $100 = $2000	($7) x 200 = ($1400)	$600	(14.3%)
$175	$25 x $100 = $2500	($12) x 200 = ($2400)	$100	(16.7%)
$174	**$26 x $100 = $2600**	**($13) x 200 = ($2600)**	**$0 (break-even)**	**(17.1%)**
$170	$30 x $100 = $3000	($17) x 200 = ($3400)	($400)	(19%)
$165	$35 x $100 = $3500	($22) x 200 = ($4400)	($900)	(21.4%)
$160	$40 x $100 = $40000	($27) x 200 = ($5400)	($1400)	(23.8%)

Our maximum profit is earned on the June spread if SPY declines 11% from its current perch. The spread helps us a little on a decline all the way to about a 17% drop. Beyond that, our short puts turn into an obligation that's in the red. We'll talk about our plan in that case in a moment.

Return Details: Sept. 30, 2015 Spread

SPY Price at Sept. 30 Expiration	Value of 1 Purchased $185 Put	Value of 2 Written $170 Puts	Our Total Return (or Loss) on 1 Ratio Spread	SPY Price Change (%) From Current $210
$185 or higher	$0	$0	$0.50 gain per spread or any credit or for setting up the trade	Any increase in price, or any decline of less than 11.9%
$180	$5 x $100 = $500	$0	$500	(14.3%)
$175	$10 x $100 = $1000	$0	$1000	(16.7%)
$170	**$15 x $100 = $1500**	**$0**	**$1500 (max profit per spread)**	**(19%)**
$165	$20 x $100 = $2000	($5) x 200 = ($1000)	$1000	(21.4%)
$160	$25 x $100 = $2500	($10) x 200 = ($2000)	$500	(23.8%)
$155	**$30 x $100 = $3000**	**($15) x 200 = ($3000)**	**$0 (break-even)**	**(26.2%)**
$150	$35 x $100 = $3500	($20) x 200 = ($4000)	($500)	(28.6%)
$145	$40 x $100 = $4000	($25) x 200 = ($5000)	($1000)	(31%)
$140	$45 x $100 = $4500	($30) x 200 = ($6000)	($1500)	(33.3%)
$135	$50 x $100 = $5000	($35) x 200 = ($7000)	($2000)	(35.7%)

The September spread comes into play if SPY declines more than 11.9%, with our maximum profit earned on a 19% decline. On a drop larger than that, our put obligation starts to eat into our profits until hitting our breakeven at expiration if SPY is 26.2% lower than today. A larger decline than that starts to turn this hedge into a loss. Market declines larger than 30% are rare, occurring about once a decade.

Follow-Up

Assuming we set these two spreads up for credits overall, they will result in small profits even if the market rises or treads water, let alone falls. But we need to be ready to fulfill the $187 and $170 put obligations if SPY is below those prices by our respective expirations.

However, our presumed plan in that case is to close our puts and buy long-term SPY calls instead of buying the ETF. We should be able to do so at a reasonable strike price for about 25% of the cost of buying SPY itself. So, our potential 20% or so stake in SPY shares will only cost us about 5% of our cash if we buy calls on SPY instead. We'll be happy to buy calls on the index at a depressed price and still keep most of our cash available for other stock or call purchases. In fact, we like the potential obligation of purchasing the index (in one form or another) at much lower prices. Though that's not the initial purpose of our hedge, history says it's a good move.

How It Fits Into *Pro*

Pro consistently hedges to lower its market exposure, or risk, in part because we have a goal of achieving positive returns every rolling three years and inflation plus 7% annualized (our North Star) over 10 years. With these challenging goals, any small advantage we gain in a falling market will make a difference. Even small gains add up over the years, but especially if the gains are reinvested in depressed stocks. This hedge fits well with our goal of hedging in a cost-efficient way, and in a way that doesn't work against us if the market keeps rising.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts:**
    - For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, like us, "buy to open" June 30, 2015, $200 puts, and "sell to open" *an equal number* of June 30, 2015 $187 puts. Recently, this will cost you around $2 ($200) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $13 ($1300) per spread on a decline to $187 or any lower price, but you should be prepared to lose your $2 per spread if the market doesn't decline enough.

      Next, if you want to set up the September hedge, too, use a spread order again to "buy to open" Sept. 30, 2015 $185 puts and "sell to open" *an equal number of* Sept. 30, 2015 $170 puts. Recently, this spread will cost you around $1.60 each ($160), and that is your maximum risk. This spread would be worth up to $15 ($1500) per spread on a decline to $170 or lower, but you should be *very prepared* to lose your $160 per spread if the market doesn't decline enough. Odds are it won't! As with any market hedge that you pay to set up, you have to *expect to lose* your investment most of the time, especially on a hedge that only kicks in during a large, lasting market decline. So only spend what you're ready to lose. (On your option chain, click "See All" to see these strikes. If prices change modestly, that's fine.)
    - **To lower your market exposure while following our official trade (and make the position possible in some IRAs):**
        - Set up the original put ratio spreads as recommended, but also "buy to open" puts (same months of expiration as our two spreads) at strike prices *well below* $187 and $170, respectively. Buy *half as many* as the number of $187 and $170 puts you wrote. When you do so, all of your $187 and $170 puts will be "covered" (half by your $200 and $185 puts, and half by the other puts you choose to buy at a much lower strike; choose how much you want to pay to select your lower strikes). You will only need cash in your account to cover the difference between your two lowest strike prices, and your risk is capped, making this potentially IRA friendly.

- **Managing less than $200,000?**
  - Use mini-options. If you want to use the non-standard (NS) mini-options, which represent just 10 shares of SPY instead of 100, then use the **June 19, 2015, mini-options (there are no June 30 minis)** to set up one 2:1 put ratio spread for every $20,000 you want to hedge. Use the same strike prices as our official recommendation, and use a limit order on the options, ideally for no cost or a small credit. There are no viable minis right now for the September hedge. We can wait to see if some list. They may.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a discussion board for that.

Pro on the Go With AmTrust

Published Mar 2, 2015 at 1:23PM

Dear fellow Fools,

Two Fridays ago, Jeff and I braved acrtic temperatures and the occasional woolly mammoth to venture up to New York City to meet with Barry Zyskind and Beth Malone, **AmTrust Financial Services**' (NASDAQ: AFSI) CEO and head of investor relations. Train delays and the aforementioned mammoths may have cut into our time at the headquarters of *Pro*'s largest holding, but the experience was still very insightful.

During earnings-call Q&As for most companies, Wall Street analysts usually hone in on short-term guidance and specific details. While these things are undoubtedly important, here at *Pro* we also like to take a step back and look at the bigger picture, and to focus on some of the more qualitative aspects of a company. And visits with management teams are a great chance to do just that. Without further ado, here is a collection of Zyskind and Malone's responses to our questions.

Q: What impact have the short attacks had on your business? How did they affect your time?

A: Prior to the December onslaught, we didn't spend much time on it. We just defended ourselves whenever something trickled to the surface because we never wanted this to become our focus. We didn't want to go down to their level and thought that the best way to deal with everything was to continue to execute. But from December until February earnings, we did spend a lot of time on it.

It never materially affected the business. This gave some an easy out if they wanted to use it as an excuse to do business with someone else, but ultimately very few did. I never once lost sleep about what they were saying; we beat it because the truth was on our side.

Q: Did it have an impact on morale?

A: It actually boosted morale. Sometimes you need something like that to bring everyone together; something everyone can rally behind.

Q: How about your relationship with regulators?

A: Tower Group was a huge win. [For JP's explanation of the Tower Group acquisition, see this post.] We had multiple regulators go over every part of our business with a fine-toothed comb — the short-seller even made a presentation to regulators outlining why the deal shouldn't go through — but they still approved the deal.

Q: Can you kind of walk us through your process for doing deals using Tower as an example? How long did it take for you to get comfortable with the deal? What were the sticking points?

A: When looking at a business, we ask, "Is there a piece of the business here that is profitable? Can we get just to the good part?" With Tower, after doing our due diligence, we realized that the problem wasn't that it was a bad book of business. The loss ratio was in the 60s — so, not a bad book of business. The issue was that Tower was booking a 50% loss ratio when it was really in the 60s. So adverse developments turned it into an 80% loss business and nobody wanted to touch it. But we saw that it wasn't a bad business. We didn't want to take the bad stuff, so we started looking into how we could isolate the part of the business we wanted. Since we don't want to bet the balance sheet, we often have to offload parts of a business to other entities. That's what we did here with ACP Re. We should easily be able to get the book to a 90% combined ratio, and this will end up being one of our most creative deals ever.

Q: On your last conference call, you mentioned how you've done over 30 deals. It's probably safe to say that not every deal has worked out like you had hoped. What have you learned from failed deals?

A: We protect against making big mistakes by refusing to bet the balance sheet and paying a price where we can still do well even if [things don't turn out like we had hoped and we end up paying a higher multiple]. Most of our acquisition mistakes in the past have had to do with joint ventures. Often, we find that we ultimately have different goals — they're focused on the short term while we focus on the long term — and this can create problems and we ultimately have to buy out our partner. We tend to do better when we can control the entire thing. So for example, if we like a particular fee business, it might make sense to take both sides (underwriting and fee) of the business so we don't have to worry about someone coming in and using the underwriting side to take the fee business out from underneath us.

Q: Currently you have a huge advantage as far as technology is concerned. Are others catching on?

A: You'd think so, but the industry still isn't waking up to technology. It's just really hard to change the wheel of a bus while it's moving. As we get bigger, we have to do bigger deals to move the needle, but sometimes the bigger companies are even more inefficient. We're still finding good deals where it's just the expense ratio that is the major problem.

Q: How has your management style changed as you've grown? What type of culture do you want to build?

A: The same core group has been together for 13 years. Our focus remains on hiring good people and letting them take control of their own destiny. We want to build an entrepreneurial culture. One where people do the right thing, but aren't afraid to take risks to try and get ahead. We want to find people who realize there is more than one way to do things.

The *Pro* Bottom Line

I had long suspected that Barry Zyskind and the other members of AmTrust's management team were "in it to win it" type of individuals, and our meeting only reinforced this notion. Whether it's going after a niche segment of the insurance industry or dealing with a short seller, I have a hard time believing this team does anything halfheartedly. The company's results over the past few years, and its reviews at Glassdoor, suggest that this mind-set permeates the culture at AmTrust.

Given Barry's comments on recent earnings calls with what we were able to learn during our meeting, I think it's reasonable to conclude that regulators left no stone unturned before approving the Tower Group deal. I also suspect that we will hear very little in the future from the vocal short-seller who made the end of last year so interesting.

Foolishly yours,

— JP Bennett (TMFYossarian)

Pro Portfolio Building Report No. 2: Feb. 25, 2015

Published Feb 24, 2015 at 4:11PM

Welcome, Fool! This report details our current thinking on all of the Buy stocks in our portfolio. Once you've read this and the previous report detailing our Buy First positions, you're ready to start building your *Pro* portfolio as swiftly or as slowly as you like. We want our advice to be uncomplicated: Buy our Buy Firsts first (again, taking your time according to your situation -- there's no rush); buy our Buys after that; match our allocations as closely as you can; and stay tuned for our Portfolio Positioning Event on March 9, which will address our shorts, hedges, and options.

We're glad you're here. Bring any questions to the Getting Started & Help discussion board, and Fool on!

Best,

The *Motley Fool Pro* team

Table of Contents

Buy: American International Group (NYSE: AIG)

Time and even average performance should lead to solid returns from this undervalued insurer.

Suggested Allocation: 3.3% stock, 0.6% warrants

For More

- *Pro*'s original recommendation (8/24/12)
- Most recent earnings update (11/5/14)
- Talk about AIG

At Your Broker

- eTrade: AIG.WS
- Fidelity: AIG/WS (paste CUSPID 026874156 into the quote page)
- Interactive Brokers: Find AIG; select "warrants" from the drop-down menu
- optionsXpress: AIGwS
- Schwab: AIG/WS
- TD Ameritrade: AIG+
- Vanguard: AIG_t
- OptionsHouse: AIG.WS

Helpful Links

- AIG's explanation of the warrants
- AIG's warrant registration statement filed with the SEC

What It Does / How It's Doing

Today's **American International Group** (NYSE: AIG) is not the same company that disgraced itself so profoundly in 2008. AIG has divested itself of whole business units since the financial crisis, managing to eliminate almost all of its previous exposure to the nasty derivatives that nearly brought down the economy. Left behind is a streamlined, disciplined company selling for cheap.

The company's insurance operations are better than they've been in years and are poised for continued, albeit lumpy, improvement. Structurally, those operations now consist of two main divisions, commercial and consumer; across both, AIG is writing fewer premiums at better prices than in past years, a great indication of improved underwriting discipline.

We recommend buying 3.3% of AIG stock and 0.6% of AIG warrants (see below for more on those). AIG has cleaned up its business, and it's currently cheap at about 0.7 times book value. Investors who buy AIG now are positioning themselves for outsized future returns with less risk -- contrarian investing at its best.

A Note on Warrants

Warrants are similar to call options, except that they are issued by the underlying company. They offer the purchaser the right (but not the obligation) to buy the stock in question at the specified price. The warrants we're recommending on AIG are valid for 10 years from the date of issue (Jan. 19, 2011), and they can be exercised at any point before they expire on Jan. 19, 2021. When exercised, they allow the holder of the warrant to buy shares of AIG at $45 per share, regardless of the market price. That

$45 strike price adjusts favorably in the event of dilution or annual cash dividends greater than $0.675 per share (which would also lower the share price). Warrants are illiquid, and Goldman Sachs is the designated market maker for them; when you buy them, be sure to use a limit order so Goldman doesn't get more than a fair price.

Be aware that if our investment in AIG works out, those who own warrants will earn leveraged returns on them. But it's possible that the warrants could end up as a total loss if AIG's stock price is below the $45 strike price at expiration (even though they're currently in-the-money by a few bucks).

Buy: Apple (NASDAQ: AAPL)

The leader in mobile computing products should see more long-term growth than anyone expects.

Suggested Allocation: 4.8%

What It Does / How It's Doing

For More

- Pro's original recommendation (2/14/12)
- Most recent earnings update (2/4/15)
- Talk about Apple

Led by its iPhone, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the smooth Apple operating system, iOS, which centers on the iTunes and App Store marketplaces, as well as the new Apple Pay. iTunes alone earns more revenue each year than two-thirds of the companies in the Fortune 500, while Apple itself is the most valuable company in the world, with $200 billion in annual sales. Yet it's still growing strongly, with 38% earnings-per-share growth last quarter. The company's integrated hardware and software make for a sticky consumer experience that provides disincentives to switch to a competitor, and as more people use multiple computing devices, Apple makes it easy to transition seamlessly from one of its products to another.

Apple Watch will launch this spring, while rumors still swirl about an Apple TV and even the possibility for an Apple Car. We're not counting on that last one! But we are counting on record numbers of phones being sold to both existing customers and new ones over the coming years, and we want to be along for the ride.

Buy: Broadridge Financial Solutions (NYSE: BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 4.5%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation (4/27/10)
- Talk about Broadridge on our discussion board

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in its fiscal 2014 (ended June 30, 2014), its platforms processed more than 80% of all shares in the U.S. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider to manage investor communications.

The company's smaller segment, Global Technology and Operations (GTO), accounts for 26% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy: The Buckle (NYSE: BKE)

We don't know fashion, but we can read financial statements — and this retailer has some style.

Suggested Allocation: 2.2%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation (6/20/12)
- Most recent earnings coverage (11/25/14)
- Talk about The Buckle

Your *Pro* team doesn't know much about fashion, but we can read financial statements. And if the next decade of business performance by **The Buckle** (NYSE: BKE) looks anything like the last one, we'd be willing to wear whatever getup the company suggests. The Buckle sells jeans, other apparel, and accessories at 463 retail locations across the United States, and we think the fantastic management team has figured out a formula that works: measured growth, middle-of-the-road merchandising, and great service. The store concept is in the middle of its life cycle, and the company's financial prudence and operational acumen should lead to a growing stream of free cash flow, dividends, and extra payouts — all of which can help the *Pro* portfolio in our pursuit of our North Star.

Buy: Facebook (NASDAQ: FB)

The world's leading social network — and most-trafficked website — is managed for long-term growth.

Suggested Allocation: 4.5%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation (9/18/12)
- Most recent earnings coverage (2/4/15)
- Talk about Facebook

More than 1.3 billion people use **Facebook** (NASDAQ: FB) to connect with friends, families, companies, marketers, and celebrities each month. Incredibly, more than 850 million people visit daily. Most traffic arrives through mobile devices, and the company has shown early success monetizing that traffic. Over the long term, management seeks to make the ads on the site as targeted and relevant to users as are the updates from their friends and family.

Meanwhile, Facebook keeps working to stay on the edge of social technology. The company has the equity to acquire competing platforms and to build traffic before monetizing the sites once they hit critical mass — which in Facebook's opinion is 1 billion users. Even now, CEO Zuckerberg is waiting to monetize Facebook's massive WhatsApp, Messenger, and Instagram audiences. Facebook is spending aggressively to grow its technology and platforms, but that spending should be rewarded down the road. The potential remains very large, as social sites currently draw just a tiny slice of the world's advertising pie.

Buy: Gentex (NASDAQ: GNTX)

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 3.2% stock; 1% in written puts (March 20, 2015 $17.50 puts)*
**If you're not ready to use options, you can simply buy stock and omit the written puts.*

What It Does / How It's Doing

For More

- Pro's most recent update (1/30/15)
- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex on our discussion board

In 1982, a small company in Zeeland, Mich., called **Gentex** (NASDAQ: GNTX) made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands almost 90% of that market, and it sells eight times more units than its closest competitor. We think there's a bright future here.

Buy: MasterCard (NYSE: MA)

Plastic — and digital — is pushing paper out as the world's way to pay, and MasterCard leads the charge.

Suggested Allocation: 4.4%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation (9/8/11)
- Most recent earnings update (11/22/14 — this quarter's update is on the way)
- Talk about MasterCard

MasterCard (NYSE: MA) is among the most attractive businesses in the world. Here's why: The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders, who are actually exposed to the card users' finances; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

Though MasterCard competes with a large number of well-heeled and (in some cases) innovative businesses, the company's profitability is growing nicely even though the global economy isn't. And that makes perfect sense, because when it comes to paying for stuff, the global market leader isn't **Visa** (NYSE: V), or PayPal, or banks ... it's cash. Cash is used for a still-astounding 85% market share of transactions, but it's slow and inefficient, and with no one managing its brand, it's quickly losing out to better alternatives -- like MasterCard. We continue to believe in the stock for the long haul (*especially* for the long-term potential!). With earnings out recently, expect a valuation and earnings update soon.

Buy: OpenText (NASDAQ: OTEX)

This company's information management software keeps the digital lives of businesses in order, and its exchange platform drives business transactions.

Suggested Allocation: 3.3%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation (8/31/11)
- Most recent earnings coverage(1/29/15)
- Talk about OpenText

OpenText (NASDAQ: OTEX) is a leading provider of enterprise information management (EIM). It sells software that lets companies organize their electronic content, and it offers a leading business exchange platform for enterprise commerce. A majority of its revenue recurs "naturally" each year as OpenText's products help companies, governments, and universities operate more efficiently and effectively, meet compliance requirements, communicate with colleagues, customers, and partners, and make transactions. OpenText has increased sales and cash from operations by more than 14% annualized over the past three years, and the goal is to continue to grow by at least 10% annualized as its various industries expand. Margins have grown with sales, and its cloud software revenue is increasing rapidly.

On Feb. 23, we heard that CEO Mark Barrenechea is being treated for leukemia. He's been a great CEO, and we wish him the best. He plans to return to OpenText after treatment.

Buy: Parexel International (NASDAQ: PRXL)

Parexel is poised to benefit as pharmaceutical companies gradually outsource more drug development work to select CRO partners who can perform the work better, faster, and cheaper.

Suggested Allocation: 3.4%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation (12/23/13)
- Most recent earnings update (2/3/14)
- Talk about Parexel on our discussion board

Parexel (NASDAQ: PRXL) is one of the world's largest and most respected contract research organizations (CROs). Over more than 30 years, it has built a stellar reputation on helping drug makers navigate complex clinical trial processes quickly, which has enabled it to cement important relationships and have a role in developing more than 90% of the 200 top-selling drugs.

From 2004 to 2013, the number of development dollars outsourced to CROs (outsourcing penetration) has increased by almost 50%. Outsourcing is a cheaper alternative to the traditional high-fixed-cost model of staffing lots of white coats across various therapeutic specialties all around the globe. For large drug developers, letting CROs handle the development work -- and those massive staffing needs -- can boost profits and time to market, and for smaller drug developers who can't afford a huge staff, there is no other choice. As regulators require more efficacy data, larger patient participation, and increasingly global results, navigating the challenges of the 110,000-plus trials being conducted globally has become frustratingly complex, turning large, proven CROs with expertise and global capabilities into value-adding partners rather than transactional customers. We think Parexel is poised to benefit.

Buy: ProShares Short VIX Short-Term Futures ETF (NYSEMKT: SVXY)

Profit from the long-term nature of stock market volatility to revert to an average level after each spike.

Suggested Allocation: 1%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation(11/25/14)
- Talk about SVXY

Buying shares in — let's make it easy and use the ticker, shall we? — SVXY is a recommendation for *Pro* members who are comfortable owning a small stake in a volatile position that we plan to add to during market downturns. *Pro* is a portfolio service, so all positions are meant for everyone, to the extent you can do them and wish to. But this position will be especially volatile, so only follow it if you're comfortable with high volatility in a holding.

This vehicle increases in value when stock market volatility, as measured by the CBOE Volatility Index (or VIX), goes down or is range-bound. How so? This ETF *sells short* futures contracts on the VIX that have one month and two months to expiration. Unless volatility in the S&P 500, as measured by the VIX, increases above and beyond the premium already baked into the futures contracts being shorted, the positions turn a profit and the ETF goes up in value. Helping further, VIX futures contracts are historically in a state of "contango" up to 90% of the time. Contango means future-month contracts are increasingly more expensive than earlier months and than the current VIX level itself (much like a call option has a premium above the current stock price). This is a tailwind for SVXY, and it exists most of the time. As long as volatility stays near its average overall, then just holding this small stake over the years should reward us very well. We recommend starting at 1%, and we may add to it when the VIX soars — meaning when volatility in the market is high. We're ready for it!

Buy: Skyworks Solutions (NASDAQ: SWKS)

This leading designer of semiconductors, antennae, and more for smartphones and connected devices is growing sharply.

Suggested Allocation: 4.2%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation (8/5/14)
- Latest earnings coverage (2/14/15)

Skyworks Solutions (NASDAQ: SWKS) makes technology that powers wireless connectivity in a wide variety of products: Apple and Samsung smartphones and tablets, **Medtronic** (NYSE: MDT) medical devices, **Google** (NASDAQ: GOOG) and **General Electric** (NYSE: GE) products, and the list goes on. In the "Internet of Things," billions of physical objects are being connected to the Internet, and Skyworks is uniquely positioned to benefit. Not only does it serve *all* of the top-tier mobile device makers, but the company is diversified across industries to serve more than 2,000 customers.

Skyworks sells more than 2,500 high-performance analog semiconductors and related products, supported by nearly 1,000 patents. The product list includes amplifiers, attenuators, receivers, switches, diodes, modulators, GPS power and voltage regulators, and more, often sold together as components of a phone or connected device. Skyworks earns industry-beating operating margins of more than 30% by selling specialized solutions to giant customers with growing connectivity needs. Plus, as wireless complexity increases, fewer companies can deliver the integrated modules customers need, putting Skyworks in an even stronger position. The China opportunity is large as well. This can be a volatile stock, but its long-term outlook (which is the time frame we care about!) remains very compelling.

Buy: Starbucks (NASDAQ: SBUX)

You only think you're there for the coffee — the ubiquitous java purveyor has big plans.

Suggested Allocation: 3%

What It Does / How It's Doing

For More

- Most recent earnings update (2/2/2015)
- *Pro*'s original recommendation (8/22/2012)
- Talk about Starbucks

You may not realize it, but "**Starbucks**" (NASDAQ: SBUX) is no longer a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense it's just a front. We *think* we go to Starbucks for the coffee, but those little white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

Starbucks began opening America's eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 21,800 stores in 65-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences to fill more than 70 million mouths and hearts each week. This company is continually finding new ways to reach customers; we're grabbing a latte and a cake pop and coming along for the ride.

Buy: Tupperware (NYSE: TUP)

This is not your mother's Tupperware.

Suggested Allocation: 2.9% (round to 3% if you wish)

What It Does / How It's Doing

For More

- *Pro*'s latest buy recommendation(7/30/14)
- Latest earnings coverage (2/3/15)
- Talk about Tupperware

Tupperware Brands (NYSE: TUP) earns nearly 70% of its revenue from immense emerging markets, including China and India, where it's been increasing sales by more than 10% annually. But the company is still only scratching the surface in the world's most dense, emerging urban population centers. As these countries, Brazil, Malaysia, and others begin to enjoy disposable income, citizens are able to store food for the first time, and many more can afford inexpensive kitchen products offered by Tupperware. In addition, Tupperware offers women in these regions a way to earn reliable income, something that's still tragically hard for women to find in many emerging markets.

Elsewhere in the developed world, "Tupperware parties" thrive in places as erudite as France and as prosperous as Germany, as well as in the good ole U.S.A. Cutting out retailers to focus on direct sales sets Tupperware apart, and with a sales force of 3 million and new products every year, the company has plenty of potential ahead. Meanwhile, we enjoy its 3.8% dividend and a reasonable valuation.

Buy: Valmont Industries (NYSE: VMI)

Providing irrigation systems and support structures, this industrial company benefits as agriculture needs increase and countries build infrastructure.

Suggested Allocation: 2%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation(11/5/13)
- Most recent earnings coverage (11/2/2014 — this quarter's update is on the way)
- Talk about Valmont

Valmont Industries (NYSE: VMI) offers four business divisions, each serving a growing need around the world. Founded in 1946, Valmont's engineered products division supplies steel and aluminum poles to infrastructure projects worldwide, including road and traffic lights, stadium and parking lights, and wireless communications poles and support towers. This division also sells highway safety products including barriers and road grating. In addition, because it sells steel and concrete support structures, Valmont profits as electrical grids are renovated or built out.

Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot irrigation systems are the world's leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient mechanized irrigation, so there's lots of room to run.

To top it all off, the company provides hot-dip galvanizing (just like Mom used to make), anodizing, and other coatings to protect aluminum and steel from corrosion. One of the largest custom galvanizers in the world, Valmont expects continued growth because it still captures a small percentage of the total market. Overall, Valmont operates in more than 80 countries. This is a long-term investment in an exceptionally run business, even though the business is cyclical and is currently in a downturn (which is when you want to start to buy). We've started with a small position.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund (NYSEMKT: DGS)

Diversification in emerging markets with some of the best small, high-yield companies you've never heard of.

Suggested Allocation: 2.1%

What It Does / How It's Doing

For More

- *Pro*'s original recommendation (11/22/10)
- Talk about DGS

At *Pro*, we like the idea of investing in emerging-market small caps to diversify and target higher growth. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) (the longest ETF name in the world!*). This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields around 3%).

For *Pro*, owning shares of this well-managed ETF offers exposure to up to 600 of the most promising international business that we couldn't easily buy in any other way! Serving as direct exposure to emerging markets, this is an excellent way to invest in small companies in locations where we don't have a discernible edge but where growth exists — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The benefits of diversifying outside our home market are equally important over long periods. Emerging markets have badly lagged developed markets for the last several years, but eventually emerging markets will take the performance baton for a number of years again, and we'll be in good stead with this position. In the meantime, we just wait for emerging markets to return to favor.

*Statement may not be true

Think Big!

Published Feb 23, 2015 at 2:21PM

Dear *Pro* members,

As of this morning, the *Pro* portfolio is up 6.2% this year. We're off to a strong start; meanwhile, our North Star is gaining less than 1% a month (although that adds up fast!), and the S&P 500 is up 2.2% year-to-date. All of our shorts are making money. Most of our long investments are, too. And we're making some income already this year.

But aside from short-term satisfaction and a continued belief in the companies we own (most of which we've known and owned for years), the first seven weeks of the year mean very little.

We need to think bigger than that — much bigger.

Think Big!

Many of us go into each January wondering what we can accomplish that year, and in a way that's good, but in another way it keeps us on a fast treadmill and shortens our outlook a bit too much. Just as *Pro* is always thinking in terms of three years — how can we generate positive returns every rolling three years? — there's great value in having intermediate-term goals in life, too, and focusing on those.

What do you hope to accomplish in three years?

In terms of investing, you know that *Pro* is aiming for positive returns every rolling three years, and we seek to earn at least 7% plus inflation (our North Star) annualized over longer periods. That would double our real purchasing power every 10 years. Those results would obviously clobber inflation, and would historically clobber the S&P 500 index, too — though the latter is not our goal.

Bigger!

It's always fun to hear stories from people about the stock they owned that made 300%, or how they made 75% in a few months on a call option they bought. But truly, that's just small talk. One-off victories don't add up to much unless you have a *long-term system* that produces victories *consistently over time*.

In *Pro*, we invest most of our money in compounding machines: businesses that are increasing free cash flow and reinvesting it for *more* growth at attractive returns. These companies enjoy competitive advantages and, often, pricing power. Owning a business with great attributes at a reasonable price should compound your dollars over the years, if you only let it.

Biggest!

What do we hope to accomplish in 10 years? Nothing short of extremely strong returns by most any measure, while taking less risk than many others because we use hedges and options and keep cash for opportunities.

Any results along the way are incidental. We need to think big, and then bigger, keeping our eyes on the horizon. It's not that far off anyway.

Three years is only 1,095 days, or 26,280 hours.

Ten years is fewer than 88,000 hours, not even 3,700 days. That people choose to think in terms much shorter than that, in mere weeks, or even a few days or hours, is a giant obstacle to their returns, and it's downright surprising given how quickly time goes by if you just let it.

Only in quiet waters things mirror themselves undistorted.
Only in a quiet mind is adequate perception of the world. — Margolius

Your Chance to Think Big

The world's opportunities are large for investors. The media likes to portray stocks as risky (ignoring market history), but putting your money with a business that has thousands of employees, mounds of cash, and great opportunities puts a lot of positives on your side. Where better could you put it? But time is the essential ingredient to success.

You would think after coming through 2009, and seeing markets recover, investors would internalize the fact that sharp declines are passing opportunities and no longer obsess about when the next decline will occur. If you made it through the last one, there shouldn't be much left that will faze you. Yet, the fear of waves in our calm investing waters continues to distract many investors. Why? The waves are opportunities that pass. We hope to capitalize on them even as we keep looking to the horizon.

In *Pro*, we work to dampen volatility, manage risk, and generate short-term income, but we also keep thinking big. Not of what's around the next corner, or even what this year can do for us — but what the next three years, and then five years, and then 10 years can do for us. That's where there's true victory to be had.

We're seven years into our first 10, but we look forward to the next decade even more. In that spirit, welcome to new *Pro* members! We look forward to helping you get started!

— Jeff (TMFFischer)

Pro Completed Trades

- **Expeditors International** (NASDAQ: EXPD): We bought to close our February 2015 $45 calls for a small gain, while our February $43 puts expired as full income. We sold to open a new May 2015 $43 put, $48 call strangle for a new $1.85 credit -- continuing to generate income on this income position with upside.
- **Wells Fargo** (NYSE: WFC): We sold to open an April 2, 2015 covered strangle, selling the April 2 $52.50 puts and $57.50 calls for a credit of $0.72 -- targeting income if the stock stays in this price range.

Pro Catch-Up Trades

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **American Airlines** (NASDAQ: AAL): If you haven't invested 1% in calls yet, you can buy to open January 2017 $30 calls now (rather than $35, to keep time value lower), lately at around $24 each. That price will change as the stock moves. Click "see all" to see all strike prices with your broker.
- **American Tower** (NYSE: AMT): If you haven't invested 0.5% in calls yet, you can buy to open January 2017 $80 calls, lately for around $22. That price will change as the stock moves. We also own 3.6% in the stock, which is rated Buy First.

Pro Catch-Up Trades: Feb. 23, 2015

Published Feb 23, 2015 at 2:17PM

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **American Airlines** (NASDAQ: AAL): If you haven't invested 1% in calls yet, you can buy to open January 2017 $30 calls now (rather than $35, to keep time value lower), lately at around $24 each. That price will change as the stock moves. Click "see all" to see all strike prices with your broker.
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Portfolio Positioning Event: March 9, 2015

Published Feb 20, 2015 at 4:18PM

Read the Portfolio Positioning Report

Join us at 3 p.m. Eastern on March 9 to talk stocks, shorts, hedges, and more with the *Pro* team!

Write a Covered Strangle on Expeditors International

Published Feb 20, 2015 at 11:51AM

Is this for you? This is for *Pro* members who are **already following along** with our option writing on **Expeditors International** (NASDAQ: EXPD) for income. Those brand-new to *Pro*, or brand-new to using options, can safely sit this one out. Instead, we recommend that you wait for our Portfolio Positioning event on March 6, when we'll advise on options positions for new members -- and, of course, please do read and ask questions in the meantime!

How You Participate

- **Action:** Use a strangle order to simultaneously "sell to open" May 2015 $43 puts, and "sell to open" May 2015 $48 calls, to create a covered strangle on **Expeditors International** (NASDAQ: EXPD).
- **Allocation:** Sell one strangle (one of each option) for every 100 shares of exposure you already have to the company. We have 1,000-share exposure through a synthetic long, so we're selling 10 puts and 10 calls, as we've done before.
- **Prices:**
  - **Stock:** $45.60.
  - **Options:** Sell to open May 2015 $43 puts (bid/ask): $0.95/$1.05. Sell to open May 2015 $48 calls (bid/ask): $1/$1.10. Combined bid/ask: $1.95/$2.15 credit.
- **Price Guidance:** Split the bid/ask and aim for a combined credit of $2.05 to sell the strangle. If we all use **limit orders**, then $2.05, or at least $2, should hold for Day One. We want to get the trade completed before Feb. 24.
- **Previous Position:** We closed our February $45 calls this week, and our February $43 puts are expiring as income today -- just make sure that remains the case in the final hours today if you go to write these new puts. *Pro* will transact next week.

What We're Thinking

Shipping logistics and freight consolidator Expeditors is estimated to be reporting earnings on Feb. 24. Our latest strangle written on the stock is ending today, so we had a choice: Wait and write the next strangle *after* earnings; or sneak it in right before earnings.

We chose the latter because this position was set up for income, and option premiums are currently inflated in anticipation of earnings. We have no reason to believe the stock price will irrecoverably fall, and we don't mind if it rises, because that will add a price gain to our income. So we're taking advantage of today's higher premiums. Writing options soon before earnings makes sense given that this is an income position we've known and followed since 2009. So, let's maximize our income.

If we waited until after earnings to write our next strangle, it's true that we would have another quarter's worth of knowledge under our belts; and we might have adjusted our strike prices by a few pegs depending on where the stock is after earnings. But we would very likely be paid considerably less than we can get today, and income is the main objective with this position.

Why This Strategy?

Expeditors is expected to report a year-over-year earnings-per-share gain of nearly 20% early next week. Its freight business likely remains healthy as trade between China and the U.S. slowly grows in both directions, whatever you hear about China's economy. A stable, profitable, well-run business trading at a reasonable valuation, Expeditors is a company we're comfortable using for income. Even during 2008-2009, when revenue dropped sharply, the company remained nicely profitable. We made money on it from 2009 to 2012, and rejoined it last August on a dip in price.

So far since last August, including today's expiration, we will have earned about $1,400 in new income and unrealized gains of about $4,600 on our synthetic long. That's approximately $6,000 in total on the less than $600 in capital we had to deploy to start the position (instead of cash, our equity makes holding the position possible). Expeditors is a strong company, but worldwide trade is not growing rapidly, so it has offered a good range-bound stock on which to earn income. We'll continue to write options on it (and roll to higher strike prices for upside if merited) as long as this remains the case.

More That Matters

- **Maximum loss:** The same as owning at least 200 shares of stock (100 now, and 100 at $43), minus the option premiums received.
- **Maximum gain:** This new strangle caps our upside at $48, plus the premium received, which means about $50 per share. The most we can make on this strangle alone is about $2.05 in premium, which is earned if the stock stays anywhere between $43 and $48 by expiration.
- **Breakeven**: Our existing synthetic long mirrors stock ownership that started around $40.60, while this new short strangle has breakeven points at $41 and $50 -- a nice wide range. Above $50, our gains are just capped. Below $41, we start to lose on 200 shares of stock.
- **Follow-up:** The current plan is to keep writing strangles to earn income.

Alternative Trades

- **IRA-friendly/covered calls:** If you simply bought shares earlier and wrote February 2015 $45 covered calls, you'll need to roll those calls if you haven't closed them already. You can sell to open May 2015 $48 calls as we are.

Pro Can Help

- **Want more on this strategy?** See our guides to covered strangles and synthetic longs. We're combining the two into a synthetic covered strangle.
- **Questions?** Ship yourself on over to our Expeditors board.

Pro Portfolio Building Report No. 1: Feb. 18, 2015

Published Feb 18, 2015 at 1:07PM

Welcome, Fool! We're glad you're here. This report is meant to get you up to speed on our Buy First stocks — the companies on our scorecard that we think are the best bets for new money now. But first, a few words about *Pro*:

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that aims to generate winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* fit you.** We know not all investors are in the same situation! We can help you figure out how to buy the *Pro* investments given your personal situation, including investing in an IRA or coming to *Pro* already fully invested. Check out our advice for every approach to *Pro*: Invested Elsewhere | "Free-Range" | Whoever You Are
3. **Catch up with our portfolio at your own pace.** Start with the stocks in this report, and wait for our next two reports to come. You can always see our latest take on all of our positions on our What We Think Now page. As you explore our recommendations, it's important to remember that a stock's "scorecard status" (Buy First, Buy, or Hold) is the best indicator of how we feel about it. If a stock is listed as a Buy or Buy First on the What We Think Now page, that means we think you can buy it today.

Bring any questions to the Getting Started & Help discussion board, and Fool on!

Best,

The *Motley Fool Pro* team

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Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 3.6%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Total U.S. mobile data traffic is expected to increase by more than 2,000% between 2012 and 2018, and U.S. mobile lines in service (including smartphones, computing devices, and machine-to-machine applications) are expected to increase from 360 million in 2012 to 648 million in 2018. Communications site operator **American Tower** (NYSE: AMT) is well-positioned to benefit from this trend.

What It Does

AMT leases antenna space on more than 69,000 cell sites (towers, rooftops, and more) to wireless service providers across the globe. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, non-cancellable, and feature contractual annual price escalations. About 60% of AMT's properties are located in 11 different countries outside the U.S., including India, Brazil, Germany, and South Africa, and AMT is intent on growing its international portfolio as it continues to build and acquire more towers.

How It's Working

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE (or, in Africa, from voice to data), or to increase coverage density. When they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; 98% to 99% of AMT's customers up for renewal each year do so, and more than 85% of its current leases don't renew until 2019 or later.

What We Expect

Revenue is up 25.3% year-over-year in the most recent trailing-12-month (TTM) period, with the international division up 27.2%, outpacing the domestic side. We expect revenue to roughly double over the next five years through a combination of price escalations, new towers, and upgrades, and year-to-date 2014 results suggest that the company is well on its way.

After its 2011 conversion into a real estate investment trust (REIT), AMT is required to pay out 90% of taxable income to shareholders. It currently distributes $1.52 annually, a 1.6% yield, and management expects to increase the dividend by 20% annually over the next five years. (Importantly, only the U.S. business and a small portion of the international business is organized as an REIT. For more, see our original write-up, linked in the sidebar.)

For More

- *Pro*'s original recommendation (5/6/13)
- *Pro*'s "Buy More" recommendation (3/17/14)
- Talk about AMT

Management reduces taxable income though the use of net operating losses. And because the useful life of its tower properties exceeds the depreciation schedule, AMT also uses a depreciation shield, which reduces taxable income and understates the value of some assets on the balance sheet. Thus, typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

The *Pro* Bottom Line

We value AMT at about $110 a share. Today's price provides an acceptable margin of safety for a business of this caliber. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network.

Buy First: Gilead Sciences (NASDAQ: GILD)

One of the strongest biotech companies on earth, Gilead is positioned to keep rewarding owners.

Suggested Allocation: 3.8%

What It Does

For More

- *Pro*'s original recommendation (4/30/14)
- Most recent earnings update (2/6/15)
- Talk about Gilead

Gilead Sciences (NASDAQ: GILD) helps millions of people fight life-threatening diseases. Its HIV drugs are prescribed to 8 out of 10 new HIV patients, and are already helping millions enjoy much better lives. The company's HIV products represented the majority of Gilead's revenue until its Hepatitis C cures, Sovaldi and Harvoni, were approved last year. The most successful drug launch in history, Sovaldi topped $10 billion in first-year revenue, and Harvoni is headed to megablockbuster status as well.

An estimated 2.7 million to 3.2 million hepatitis C patients reside in the United States, and a whole 2.8% of the world (almost 200 million people) is thought to have this common blood-borne infection. That means tens of millions could conceivably benefit from Sovaldi or the newer single-pill version, Harvoni, and this would still leave plenty of room for competing drugs to do well, too.

How It's Working

Gilead's revenue rose 137% in the quarter just reported, sending earnings per share up more than 340%, yet the $103 stock trades at less than 11 times expected 2015 earnings. The company's products have a healthy lead over competitors' hepatitis C drugs both in the U.S. and in other countries. The new Harvoni drug, approved in October, is the first single-pill regimen for curing Hepatitis C, and competitors aren't likely to match it anytime soon. Meanwhile, the company's HIV franchise remains unparalleled, and Gilead has more than 200 compounds in clinical trials.

What We Expect

In 2015, we expect healthy sales growth as Harvoni is prescribed to tens of thousands of new patients around the world. Beyond this year, countries will slowly approve the drug and its reimbursement over many years; Gilead expects the European market, for example, to grow for many, many years. Even as drug prices come down as more competitors arrive, profits will remain substantial. Meanwhile, we expect Gilead's refreshed HIV franchise and growing oncology franchise to help increase shareholder value in the coming years. It's important to realize that the stock can be volatile at times; nonetheless, Gilead is one of the best biotechnology companies in the world.

Buy First: Oracle (NYSE: ORCL)

This old-guard tech giant at a low price has more room to grow.

Suggested Allocation: 4.3%

What It Does

Oracle (NYSE: ORCL) is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems** (NASDAQ: CSCO), **Dell**, and **Microsoft** (NASDAQ: MSFT) — Oracle's value has steadily risen as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe. And when it comes to hardware, Oracle's own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

Combining hardware with boxed software and cloud services, Oracle is a full-service solution, one that's poised to enjoy long-term growth in free cash flow. The business is incredibly sticky — companies don't trust their data to just anyone, and it's tricky and even risky to make a switch. To add to its massive recurring revenue base, Oracle cross-sells new products to existing clients and continues to rope in new customers with its comprehensive software and hardware solutions, whether on site or in the cloud. The company has also been known to make some (read: *many*) acquisitions to propel growth.

For More

- *Pro*'s original recommendation (9/17/09)
- Latest earnings coverage (12/29/14)
- Talk about Oracle

How It's Working

Leading software sellers can write a program once and sell millions of copies, then provide small but critical updates on a regular basis. These updates drive a subscription business model, which leads to recurring revenue. Most of Oracle's customers renew annual software contracts that represent more than 40% of its revenue. This is stability upon which Oracle grows. Even better, as more customers move to a cloud-based relationship (rather than licensing on-premise software), Oracle enjoys increasing, monthly, recurring cloud revenue, even as customers save money because they no longer need to host their own software. For Oracle, economies of scale make hosting inexpensive.

What We Expect

At about $43, Oracle trades at about 14 times free cash flow, below the S&P 500's average, and management expects more operating leverage ahead and greater overall profits as cloud revenue steadily increases. We model about an 11% annualized return, topping our North Star with relatively low risk. This is a good buying opportunity for a proven business that still has plenty of room to grow.

Buy First: TD Ameritrade (NYSE: AMTD)

Assets and investment fees are rising; earnings should surge when interest rates head higher.

Suggested Allocation: 2.9%

Entrusted with about $670 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NYSE: AMTD) hosts around 440,000 stock, options, and futures trades on an average day, collects investment fees, and earns interest on billions in cash.

What It Does

Aside from being a leading discount broker, TD Ameritrade has a partnership with **TD Bank** (NYSE: TD) (which owns 41% of the company), giving it a unique position in its industry. The partnership allows TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank, and with cross-selling opportunities and below-average risk to boot. So, when the current record-low Federal Funds interest rate increases, TD Ameritrade will earn much higher interest income, all of it pure profit. Meanwhile, it continues to focus on job No. 1: increasing client assets and launching more investment products.

But about that Fed Funds rate: In 2007, it was 4.75%, up from 1% in 2003 during the last recession. Today, it's hovering between zero and 0.25%. The first year that it increases by 100 basis points (to 1.1% from today's 0.1%), management estimates TD Ameritrade's earnings per share will rise by an extra 26% compared with the prior year, on top of any other growth. And as history shows, interest rates could rise by much more than 100 basis points over the next three, five, and seven years.

How It's Working

TD Ameritrade has increased new client assets by at least 10% annualized for the last six years and counting. Management says this rate of growth has been about double that of its nearest competitor. For context, the S&P 500 (including dividends) has delivered about a 48% total return since 2007; client assets held at TD Ameritrade are up by 240% over the same period. Operating margins are strong, too, lately in the low-40% range.

For More

- *Pro*'s original recommendation (7/11/13)
- Monday Memo on TD Ameritrade's business model (9/15/14)
- Talk about TD Ameritrade

Diligent capital management led Standard & Poor's to upgrade the business to an "A" credit rating in 2012 (and reaffirm that rating in July 2014), which has helped fuel recent dividend increases; the quarterly dividend has grown 44% annualized since Q1 2011. With steady gains in customer accounts, decreasing shares outstanding, and a commitment to paying out roughly two-thirds of earnings to shareholders, the business should continue to reward owners — with the added benefit of much higher profits when interest rates increase. Meanwhile, the stock is trading right around its 10-year average price-to-book value of 4, although the company is more diverse and stronger now than over the past decade.

What We Expect

Management will continue to be excellent stewards of capital, returning profits to shareholders and increasing additional investor value. All the while, we know higher interest rates will someday lead to much higher net income. But even as we look forward to that, we can admire the company's current results and should enjoy healthy returns.

The *Pro* Bottom Line

Our current fair-value estimate on TD Ameritrade is $35. The company's earnings are likely at a cyclical low. Believing as we do that TD Ameritrade's profit potential is much greater than recent results suggest, we think the stock is a compelling buy in anticipation of higher interest rates. TD Ameritrade's business model is powerful when rates are headed upward. Most investors have probably forgotten that power since 2007, but will remember it when earnings start to jump.

Buy First: Wells Fargo (NYSE: WFC)

At heart, banks are simple businesses, and Wells Fargo is one of the best of the breed.

Suggested Allocation: 3.8%

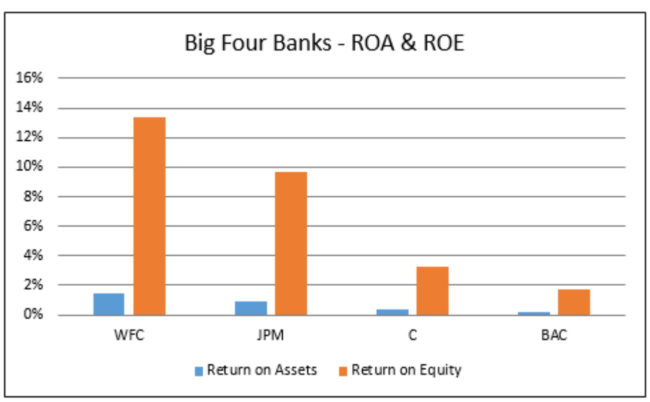
What It Does

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** (NYSE: WFC) is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 8,700 branches and 12,800 ATMs. It's the fourth-largest bank in America, it has a reputation for high customer loyalty and satisfaction, and it's the leader in mortgage and small-business lending.

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During tough lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

How It's Doing

CEO John Stumpf and team are truly the best of the breed. Return on assets and equity for fiscal year 2014 were rock-solid, at 1.45% and 13.4% respectively — great results given the low-interest rate environment and new regulations that require higher liquidity levels (i.e., less leverage) than before the financial crisis. A look at ROE figures for the other three big banks shows Wells Fargo's excellence:



Source: Wells Fargo February 2015 Credit Suisse Financial Services Forum Presentation

Total revenue growth has been elusive, but expense reductions and improvements in credit quality have driven quarter after quarter of earnings growth, leading to higher earnings than before the financial crisis. Deposit growth has been tremendous (coming in at 8.4% in the fourth quarter of 2014), and as Wells Fargo grabs additional "wallet share," fee income increases as well. The credit quality of the loan portfolio is very strong, with net charge-offs at just 0.34% of total loans as of fourth-quarter 2014. All of this has contributed to a very well-capitalized balance sheet, allowing Wells Fargo to comply with the aforementioned capital regulation requirements well ahead of schedule.

More Resources

- *Pro*'s original recommendation (12/10/10)

- *Pro*'s recent "Buy More" recommendation (7/29/14)
- Talk about Wells Fargo on our discussion board

What We Expect

Wells Fargo's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. In the current low-interest rate environment, we should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But when the U.S. economy picks up, interest rates rise, and loan demand resumes, Wells Fargo's real earnings power — bolstered by growth in fee-based revenue — will hit its full stride. And many customers who start a deposit account or mortgage with Wells Fargo will explore the company's offerings in other areas, too.

Shares are trading at less than fair value, and they yield a growing 2.5% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. *Pro* has also used options in the past to generate even more income from this position, so try to invest using round, 100-share lots if it keeps you within half a percent (plus or minus) of our 3.8% allocation. If that's not feasible for you, share ownership alone is fine, too; with its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

Close Your Short Calls on Expeditors International

Published Feb 18, 2015 at 12:00PM

Is this for you? This is for all members who wrote February $45 calls on **Expeditors International** (NASDAQ: EXPD). As long as the stock remains above $45 by Friday, we need to buy to close our calls — **members can do so now or wait and see if the stock is still above $45 by Friday**. By closing these calls, we're capturing extra income from our strangle; we plan to take a new position soon, which will be detailed in a separate trade alert.

How You Participate

- **Trade:** Assuming shares remain above $45, buy to close all of your February 2015 $45 calls on Expeditors International between now and Friday. (Leave your February 2015 $43 puts alone to expire as income.)
- **Price guidance:** You must **use a limit order** to pay as little time value as possible. Lately, with shares $0.35 above the strike price, you would realistically hope to pay no more than $0.50 to close. That will change as prices change, but the time value you pay should continue to be $0.15 or less.
  - **Recent prices (10:30 a.m. ET):**
    - Stock: $45.35
    - February 2015 $45 calls (bid/ask): $0.45/$0.70

What We're Thinking

Since last August, we've set up two covered strangles on freight consolidator Expeditors International, making income on both. But we had to close our short calls in the first trade to avoid exercise, and as it stands today, it looks like the same is true for our current short calls as well. We also have a synthetic long on the company, which is in the green. The second strangle we're ending today will result in income, too, and we plan to set up a new covered strangle soon.

Expeditors is due to announce earnings on Feb. 24, with 20% year-over-year EPS growth expected. The company's focus on U.S. and China trade drives growth as commerce increases between the two countries, while margins have benefited from cost controls.

If the premiums are inflated enough, we will recommend writing a new strangle right before earnings; otherwise, we'll wait and see how the stock responds to earnings before acting again. Either way, this remains primarily an income position (unless something in the results tells us it should be otherwise!), so we're going to keep targeting more income. Watch your inbox for the future trade alert.

More That Matters

- **Maximum gain:** These particular calls paid us $0.99 per share to start; that's the most we can earn on them if the stock ends Friday below $45. We plan to "buy to close" early if need be, though, and our maximum gain will be $0.99 minus what we pay to buy to close. On our whole strangle, the $43 puts paid us $1.04 per share and they're set to expire as income.
- **Follow-up:** The plan is to keep writing strangles at various strikes to earn income. Ideally, we would also like our synthetic long to continue to tick up in value as well, though that's of secondary importance.

Alternative Trades

- **Only wrote covered calls?** You can "buy to close" those just as described here.
- **Only wrote puts?** Those are set to expire as income. You won't need to do anything if the stock stays above your strike price.

Pro Can Help

- **Want more on this strategy?** Dust off our guide to covered strangles, and synthetic longs while you're at it. We're just combining the two into a synthetic covered strangle.
- **Questions?** Visit our revitalized Expeditors board.

Write a Covered Strangle on Wells Fargo

Published Feb 17, 2015 at 2:52PM

Is this for you? This is for *Pro* members who own shares of **Wells Fargo** (NYSE: WFC) and can write options for income.

How You Participate

- **Trade:** Use a combo order to write a covered strangle on your owned Wells Fargo stock. A strangle consists of two legs — a written put and a covered call — with different strike prices but the same expiration date:

- Write ("sell to open") April 2, 2015, $52.50 puts
    - Write ("sell to open") April 2, 2015, $57.50 covered calls
    - **Note** that these are **weekly** options (click "view all strikes" if you don't see these dates or strike prices)
- **Allocation:** Write one strangle (one written put *and* one covered call) per 100 shares of Wells Fargo you own. For *Pro*, that's 17 puts and 17 calls.
- **Price Guidance Now:** Because these are thinly traded weekly options, **it is critical that you use a limit order**. Aim for a credit near the midpoint of the combined bid/ask spreads of the put and call options (around $0.78 as of the day we issue this trade; realize that it will change).
    - **Later:** As the bid/ask spread compresses, aim for a credit slightly higher than the combined bids of the put and call options.
- **Recent Prices:**
    - Wells Fargo: $55.30
    - April 2, 2015, $52.50 puts (bid/ask): $0.40/$0.45
    - April 2, 2015, $57.50 calls (bid/ask): $0.33/$0.39

Why a Covered Strangle?

Today, *Pro* is going back to the well (pun intended) with a covered strangle on Wells Fargo. We've used this income-generating strategy on the company before, and we are again targeting income and potential profit within a certain range of stock prices. The thought process and execution behind this strategy are almost identical to those behind our previous strangle, but the strike prices and return math are slightly different. Specifically, at expiration (using the combined bid prices as the reference point), if the stock price is ...

- Less than $52.50: We'll be assigned to buy new shares at a net price of $51.77 (7.6% less than our fair-value estimate)
- Between $52.50 and $57.50: Our covered strangle will earn us the equivalent of a 1.3% yield on the current share price in 45 days.
- Higher than $57.50: Our covered calls could be exercised, forcing us to sell our shares at a net $58.23 if we don't take action.

Note that the third bullet point above violates Rule No. 1 of writing covered calls: Don't write calls on shares you don't intend to sell. We want to continue to hold Wells Fargo, and we intend to roll this strangle as needed, but if we are forced to sell our shares, we'll do so at 104% of our $56 fair-value estimate — not a terrible outcome.

We should also consider that Wells is already at a 3.9% allocation in *Pro*, and the written-put legs of this strangle could potentially increase that to about 7.5% if all of them are exercised. We wouldn't be comfortable with such a heavy allocation to most stocks, but Wells Fargo is an exception thanks to its operational excellence, consistency, and stability. Although we don't anticipate accepting more shares, it's comforting to know that we can if we need to. If we do increase our position by that much, we might write covered calls on some shares to ultimately trim it again.

Choosing an expiration in the first few days of April means we will sidestep any potential earnings surprises (and associated stock-price volatility) coincident with first-quarter 2015 earnings, to be announced April 14. Our $52.50 and $57.50 strike-price choices provide us with acceptable outcomes on either end of the strangle, as well as flexibility to roll up or down if necessary.

More That Matters

- **Maximum loss:** The same as stock ownership, minus the credits we received for setting up the strangle.
- **Maximum gain:** Our upside is capped at $58.23, or 5.3% higher than today's price.
- **Breakeven:** There are two breakeven points for strangles -- in this case, $51.77 at the low end and $58.23 at the high end.
- **Follow-up:** We'll consider writing a new strangle if this position expires fully as income. If it doesn't, we plan to roll the strangle to avoid accepting new shares (for the written-put leg) or selling our owned shares (for the covered-call leg).

Alternative Trades

- None. Neither individual leg (the written put or the covered call) pays well enough on its own, so we only suggest pursuing a strangle.

Pro Can Help

- Want to learn more? See our guide to strangles in our sister service, *Motley Fool Options*.
- Step up to the tellers at the Wells Fargo discussion board with questions!

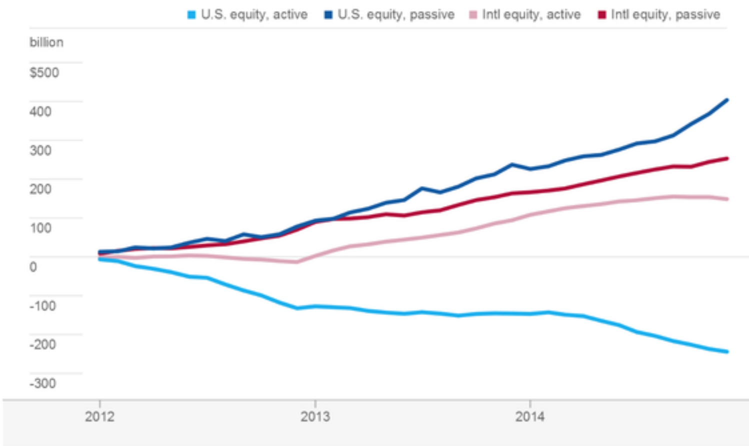
Passive vs. Active: The Final Reckoning

Published Feb 17, 2015 at 1:21PM

Fellow Fools,

The title of this Memo may be a bit melodramatic, I admit. That's especially true given the current battle between active and passive funds for U.S. investor dollars, where the results are a bit one-sided, to say the least. According to Morningstar, active U.S. equity funds lost $98.4 billion in 2014 versus $166.6 billion in inflows for passive funds, continuing the trend of the past few years.

Cumulative Flows for U.S. and International Equity Funds Since 2012, Active Vs. Passive



Source: Morningstar Direct Asset Flows, 2015

Clearly, Jeff, Billy, Ellen, and I work on a service that's swimming against the current. But does this mean it's time to start dusting off our resumes and finally embrace the cult of indexing? Au contraire, *mes amis*. And this isn't because I'm simply being stubborn.

An Active Investor, a Passive Investor, and Two Economists Walk Into a Bar ...

In their subtly titled paper *On the Impossibility of Informationally Efficient Markets*, Sanford Grossman and Joseph Stiglitz argue that, while an equilibrium degree of disequilibrium is possible, markets simply cannot remain in constant equilibrium. Their body of work eventually led to what has become known as the Grossman-Stiglitz paradox, which can be summed up like this:

- If markets are in constant equilibrium and asset prices reflect all information, then there is no reason for anyone to collect information and trade assets. Active investing will get you nowhere.
- But if everyone passively invests, then nobody will be watching to ensure that asset prices actually reflect all available information. Over time, the number of mispriced assets and the size of the deviations will both increase.

Imagine that everyone wakes up tomorrow and concedes that markets are 100% efficient. Even Bill Ackman and Carl Icahn decide to simply invest in an index fund and get on with their lives. In this new world, stock-price movements no longer reflect changes in the fundamentals of the underlying businesses. Instead, they're determined by fund flows and index compositions. For example, each time the Fool deposits some of my paycheck into my 401(k), the constituents of the index funds I invest in all get a little (and I mean a very, very, very, very little) bump as the inflow of capital forces them to buy more shares. And each time you liquidate some of your portfolio because it's time for your biannual six-week vacation, that decision will lead the funds you hold to sell shares, putting a downward pressure on prices.

In this brave new world of ours, nobody is monitoring prices. Companies who knock the ball out of the park, operationally speaking, are not rewarded with a higher stock price, while those who stink up the joint continually get a free pass. Given enough time, almost every asset will become mispriced.

So what does the endgame look like for this hypothetical market? Most of the outcomes I can envision are less than ideal; manipulation seems highly likely. Regardless of the outcome you predict, it should be clear by now why passive investors need the likes of you and me. In order for indexing to be successful, there must be price watchmen and watchwomen to exploit mispricing and keep everything in line. Without us, passive investing wouldn't work nearly as well as it does.

Passive Investing, *Pro*, and You

By now I'm sure many of you have realized that Grossman-Stiglitz cuts both ways: Active investors also benefit from passive investors. In fact, the more individuals who decide to simply mirror an index and call it a day, the better off *Pro* is. That's because the greater the percentage of investor funds dedicated to active approaches, the fiercer the competition to find mispriced assets. I might not go so far as to say finding mispriced assets would be impossible if 100% of investor funds were dedicated to the active approach, but it sure would be awfully hard.

Just Call Me Nostradamus

So what does the future hold for the active-passive battle over investor funds? My divination skills aren't the best, and markets are notoriously good at making soothsayers look like small-f fools, but I wouldn't be shocked if we see a reversing of investor preferences somewhere down the line.

Darwinism isn't restricted to just biology, and I think the pace of natural selection in the active-investing arena has begun to accelerate. 2014 was the worst year for hedge-fund closures since the financial crisis, and many are speculating that 2015 will be even worse. The active managers left standing will likely be some of the best at generating alpha, and if the growth in passive investing does lead to more opportunities for active investors, they may well end up with consistently enviable returns. And as subpar managers fall by the wayside, the best will take up a larger percentage of the active industry, resulting in higher average returns for the industry. This will make active investing look more enticing, because if there is one thing retail investors are good at, it's chasing performance.

The *Pro* Bottom Line

When you hear pundits talk about data similar to what I referenced at the beginning of this Memo, it can be tempting to start questioning whether you're making the right decision. Going against the grain can be hard. But I hope you decide to stay with us -- because our odds for success actually increase as more individuals throw in the active towel. And if you want to make our odds of success even better, make sure you tell everyone you know that indexing is the best way to invest. Just kidding ... but seriously, if you can't get them on board with *Pro*, that might not be bad advice.

Foolishly yours,

– JP (TMFYossarian)

Pro Guidance Changes

- **Skyworks Solutions** (NASDAQ: SWKS): The company's fair-value estimate increases to $75 on stronger growth. Shares remain a buy at a 4% allocation.
- **AmTrust Financial Services** (NASDAQ: AFSI) and **Medtronic** (NYSE: MDT) move to Hold as we review recent earnings results. With new members joining *Pro* this week, we want to be through earnings before recommending buys here at specific allocations.

Pro Catch-Up Trades

Catch-Up Trades are timely ideas to help you catch up with Pro *portfolio positions you may be lacking*.

- **American Airlines** (NASDAQ: AAL): If you haven't invested 1% in calls yet, you can buy to open January 2017 $30 calls now (rather than $35, to keep time value lower), lately at around $22 each. That price will change as the stock moves.
- **American Tower** (NYSE: AMT): If you haven't invested 0.5% in calls yet, you can buy to open January 2017 $80 calls, lately for around $22. That price will change as the stock moves. We also own 3.6% in the stock, which is rated Buy First.

Pro Guidance Changes: Feb. 17, 2015

Published Feb 17, 2015 at 12:37PM

- **Skyworks Solutions** (NASDAQ: SWKS): The company's fair value estimate increases to $75 on stronger growth. Shares remain a Buy at a 4% allocation.
- **AmTrust Financial Services** (NASDAQ: AFSI) and **Medtronic** (NYSE: MDT) move to Hold as we review recent earnings results. With new members joining *Pro* this week, we want to be through earnings before recommending buys here at specific allocations.

Pro Catch-Up Trades: Feb. 17, 2015

Published Feb 17, 2015 at 12:28PM

Catch-Up Trades are timely ideas to help you catch up with a Pro *portfolio position you may be lacking, or where price guidance was due for an update*.

- **American Airlines** (NASDAQ: AAL): If you haven't invested 1% in calls yet, you can buy to open January 2017 $30 calls now (rather than $35, to keep time value lower), lately at around $22 each. That price will change as the stock moves.
- **American Tower** (NYSE: AMT): If you haven't invested 0.5% in calls yet, you can buy to open January 2017 $80 calls, lately for around $22. That price will change as the stock moves. We also own 3.6% in the stock, which is rated Buy First.

Coca-Cola Shows Some Fizz

Published Feb 17, 2015 at 11:36AM

Coca-Cola (NYSE: KO) is in a transitional period, reorganizing how it addresses its myriad markets, changing bottling relationships, investing in brands, and cutting costs. During all this, revenue will likely be flat this year, while earnings should grow around 5%, same as last year. In *Pro* we have a profitable 2016 synthetic long option position that we *may* start to write synthetic covered calls on for income. It appears logical during this transitional year, assuming they pay well enough. Our estimated fair value remains $44, though this is a little challenged by lower growth than hoped for so far.

```
  Overview
========================
   Pro Guidance
========================
Status: Jan. 16 $35 syn long (newcomers would set up 2017)
Fair Value Est.:  $44  (no change)
Current Allocation: 3%  (look-through)
========================

  Q4 2014 Key Stats

Unit case volume: +1%
Revenue:    +4% currency neutral
Oper. Income:  +7% currency neutral
Cash from Ops:  +1% to $10.6 billion
EPS:      +5% currency neutral

   2015 Outlook

Revenue:   Slight growth
EPS:     +mid single-digits (5%-ish)
```

Key Thoughts

o The story is little changed from the past several quarters, as 2014, 2015 and perhaps even 2016 remain transitional years for Coca-Cola. The company is working to overcome a long-term decline in America's soda sales, filling the gap with new (and often non-sparkling) beverages. It is doing a commendable job, and now houses twenty billion-dollar+ brands, fourteen of which are not sparkling.

o There is probably much more value in Coca-Cola than the current business throws off -- which is why rumors persist that it would be an excellent (though giant) business to acquire and "rationalize." We don't bank on that, but I believe that management is trying to take action to realize long-term value in much the same way a buyer would.

o The macro-environment remains challenging, especially in Europe, and Coca-Cola is a giant freighter on the world's ocean. It can't change direction quickly. We should expect only slow improvements. However, expectations are modest, so even small positives quarter-by-quarter could grow the profit in our synthetic long. Meanwhile, downside should be limited to around $40 or the high-$30s in a poor market.

For now, we stay the course. For more on the quarter, please see our thoughts on the Coca-Cola board.

Skyworks Solutions Soars Higher

Published Feb 17, 2015 at 11:28AM

As demand for wireless connectivity grows, **Skyworks Solutions**(NASDAQ: SWKS) stormed past expectations, reporting a record first-quarter 2015 that nearly doubled profits. The company also provided strong guidance for the second quarter, side-stepping much of the seasonality it once faced. Margins are also growing. The stock remains a Buy in *Pro* and our estimated fair value increases to $75 -- that's 15x our EPS estimate for the year ending this September.

```
    Overview
========================
   Pro Guidance
========================
Status:         Buy (no change)
Fair Value Est.:   $75 (up 13% as growth greatly exceeds estimates)
Current Allocation:  4%
========================


   Q1 2015 Key Stats

Revenue:        +59% to $806 million
Oper. Income:    +114% to $282 m
Net Income:      +106% to $245 m
Earnings Per Share: +88% to $1.26 (non-GAAP)

   Q2 2015 Outlook

Revenue:      +56% to around $750 million
Gross Margin:    46% to 46.5% (up)
EPS:          +80% to $1.12

   Longer-Term Outlook

Gross Margin:    50% goal
Earnings:       $7 annualized EPS
```

Key Thoughts

o Skyworks is growing more rapidly than expected; last year, $5 in annualized EPS was an intermediate-term objective; now $7 per share in annualized earnings is already the target.

o An overlying theme is growing demand for wireless connectivity across broad product categories (phones, tablets, cars, medical, home, etc). Along with this, wireless needs are becoming more complex, narrowing the number of competitors who can deliver as solutions become modular. This increases the value-add of a company like Skyworks, and leads to more content sold into each unit at higher margins.

o Expect volatility from any semiconductor stock, especially one that has gained 50% since we bought in August. But given Skyworks' high-margin, industry-topping growth, the company is well-positioned to create additional value over our rolling 3-year time-frame.

For more, please see our coverage on its discussion board.

Guidebook

Published Feb 15, 2015 at 7:39PM

guidebook

Pro Portfolio Analytics

Published Feb 9, 2015 at 3:21PM

Dear *Pro* Fools,

In my Memo from a month ago titled "Correlations Redux," I hinted at "a future Memo with more risk measures such as beta, Sharpe ratio, and style categorizations." What was once the future is now the present (wait, that's confusing ... does time really exist?): In today's Memo, I'll take a closer look at the *Pro* portfolio and analyze its historical performance.

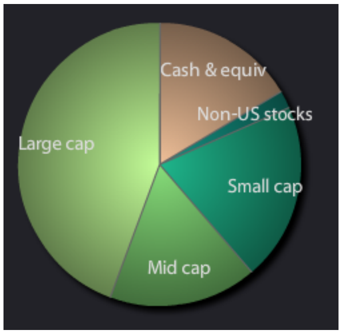
I will begin with a few disclaimers:

1. This analysis only considers *Pro*'s core long stock positions and our cash balance, excluding from consideration all shorts, ETFs, and options. If our shorts, ETFs, and options were included in the analysis, the metrics would of course be different; that said, this approach gives us a much cleaner look at the results of our long-term holdings, which are the main driver of our results.
2. Because of the methods and software used to perform the analysis, the metrics in the analysis represent only the historical performance of the **current *Pro* portfolio as it stands today, extrapolated backward.** Positions that we have owned and subsequently sold and any historical portfolio adjustments (allocation increases) are NOT factored into this analysis. What that means is that the analysis does not accurately represent the true history/performance of the real *Pro* portfolio.

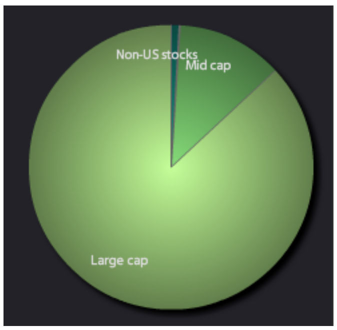
But we've had remarkably low turnover (our core positions have a weighted average holding period of 2.8 years), and our core longs plus our cash balance together historically represent about 85% to 105% of our total portfolio value (this number can be higher than 100% thanks to shorts!). Given those facts, the metrics below should be a decent proxy for the true performance of the *Pro* portfolio.

Finally, you'll notice that I chose both the S&P 500 Index and the Russell 1000 Growth Index (rather than our North Star) as the benchmarks for comparison. While the North Star is our guidepost for long-term (rolling-three-year) returns, it doesn't make much sense to compare the short-term risk and volatility measures of an equity portfolio to a metric that is not investable and doesn't trade on an open market. The S&P 500 is the most widely used benchmark, and the Russell 1000 Growth Index is a more comparable index to *Pro*'s portfolio in terms of mid-cap exposure and a bias toward growth stocks. I chose to include performance data only up to three years, as it corresponds with our average holding period.

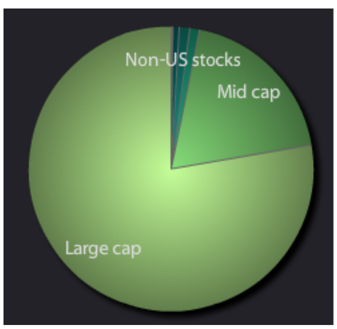
***Pro* Portfolio:**



S&P 500:



Russell 1000 Growth Index:



Source: Portfolio Lab Pro

Defining the Metrics

The metrics used in this analysis are often used in measuring the performance of hedge funds, and they are listed and defined as follows:

- **Annualized Total Return:** the total return of the portfolio over the period (including dividends).
- **Volatility (Standard Deviation):** the annualized standard deviations of the monthly returns (for a period of one year or more) or weekly returns (for a period of less than one year)
- **Alpha:** the excess return of the portfolio over a benchmark (in this case the S&P 500), after adjusting for risk (beta). A positive value of alpha implies that the portfolio has performed better than expected, relative to its risk. The higher the alpha, the better. This measure is annualized if the backtest period is more than one year.
- **Beta:** the volatility of the portfolio with respect to the benchmark. A value lower than 1 indicates that the portfolio is less volatile than the market. A value greater than 1 indicates that the portfolio is more volatile than the market.
- **Sharpe ratio:** compares the portfolio return against a risk-free return (i.e., a U.S. treasury bill), adjusted for risk. The greater the Sharpe ratio, the better the portfolio's risk-adjusted performance. For example, if two portfolios have achieved the same returns but with different levels of volatility, the portfolio with less volatility will have a better (higher) Sharpe ratio.
- **Sortino ratio:** a modification of the Sharpe ratio, using downside deviation for the risk adjustment instead of standard deviation. The downside deviation only considers the periods of negative returns. The greater the Sortino ratio, the better a portfolio's risk-adjusted performance.
- **Up/down capture ratio:** represents how much the portfolio participated in the moves, up or down, of the benchmark. An up capture ratio greater than 1 is desirable; it means that on average, the portfolio manager had higher returns than the benchmark in months when the benchmark had positive returns. Conversely, a down capture ratio lower than 1 is desirable, because it means the manager captured less of the market downside. To calculate the up capture ratio, you first identify the months in which the benchmark had a positive return, then divide the average monthly return for the portfolio during those months by the average monthly return of the *benchmark* during those months. Similarly, the down capture ratio is calculated using the months in which the benchmark had negative returns.
- **Maximum drawdown:** the largest peak-to-trough decline observed during the period.

Source: Portfolio Lab Pro

The Results

	6 months	1 year	2 years	3 years
Annualized Total Return				
Pro Portfolio	**26.5%**	**23.2%**	**22.6%**	**19.1%**
S&P 500 Index	16.7%	18.1%	18.8%	17.6%
Russell 1000 Growth Index	20.1%	18.4%	20.3%	17.4%
Volatility (Standard Deviation)				
Pro Portfolio	**10.0%**	**7.1%**	**7.8%**	**8.3%**
S&P 500 Index	13.9%	7.3%	9.0%	9.3%
Russell 1000 Growth Index	13.8%	8.0%	9.1%	9.5%
Alpha				
Pro Portfolio	**7.2%**	**8.0%**	**8.8%**	**5.7%**
S&P 500 Index	0.0%	0.0%	0.0%	0.0%
Russell 1000 Growth Index	1.7%	-0.2%	1.8%	0.1%
Beta				
Pro Portfolio	**0.62**	**0.74**	**0.76**	**0.75**
S&P 500 Index	1.00	1.00	1.00	1.00
Russell 1000 Growth Index	0.97	1.00	0.98	0.98
Sharpe Ratio				
Pro Portfolio	**2.35**	**2.22**	**2.73**	**2.08**
S&P 500 Index	1.10	1.34	1.89	1.68
Russell 1000 Growth Index	1.32	1.21	2.00	1.62
Sortino Ratio				
Pro Portfolio	**5.56**	**7.92**	**10.92**	**5.20**
S&P 500 Index	2.07	2.91	4.40	3.35
Russell 1000 Growth Index	2.54	3.96	6.17	3.36
Up Capture Ratio				
Pro Portfolio	0.82	**1.00**	0.98	0.88
S&P 500 Index	**1.00**	**1.00**	**1.00**	**1.00**
Russell 1000 Growth Index	0.98	0.88	0.97	0.92
Down Capture Ratio				
Pro Portfolio	**0.49**	**0.13**	**0.33**	**0.43**
S&P 500 Index	1.00	1.00	1.00	1.00
Russell 1000 Growth Index	0.93	0.98	0.93	1.02
Maximum drawdown				
Pro Portfolio	**-5.0%**	**-5.0%**	**-5.0%**	**-8.1%**
S&P 500 Index	-7.3%	-7.3%	-7.3%	-9.6%
Russell 1000 Growth Index	-7.3%	-7.3%	-7.3%	-9.8%

Source: Portfolio Lab Pro

In looking at the results, the backtest of the *Pro* portfolio is pretty amazing. For each data point, the bolded green font represents the best performance between the *Pro* portfolio, the S&P 500 Index, and the Russell 1000 Growth Index. *Pro* sweeps every category except the up capture ratio, which is to be expected for a portfolio that's 16%-plus in cash.

Pro's annualized returns are higher in every period, our volatility is lower in every period, our portfolio was a risk-adjusted outperformer in every period, and we captured 88% of the upside and just 43% of the downside of the S&P 500 over the past three years.

That downside capture ratio is something we strive for at *Pro*: We want to lose less than the market when the market goes down. We aim to achieve that goal by picking high-quality businesses with stable, recurring cash flows and strong balance sheets, and these numbers help to show that our approach is working, at least over the past three years. And mathematically, the downside capture ratio is a main contributor to the outperformance of the *Pro* portfolio. Even though we don't capture all of the upside of the market, by losing less when the market goes down, we have a larger base of capital from which to appreciate when the market starts to go up again.

Astoundingly, in searching Morningstar's database of almost 30,000 funds, I didn't find a single mutual fund that came close to achieving the trailing three-year absolute (let-alone risk-adjusted) returns of the *Pro* portfolio backtest. The only one in the ballpark was the Biotechnology UltraSector ProFund (ticker: BIPIX). And as of Barron's May 2014 hedge fund review (which analyzed performance through year-end 2013), only 25 hedge funds that qualified for the list had achieved a three-year annualized return greater than that of the *Pro* portfolio backtest.

The *Pro* Bottom Line

I'll again emphasize the limitations of this analysis: It excludes options, ETFs, and shorts; the impact of relatively new positions (like **Skyworks** (NASDAQ: SWKS) and **Gilead Sciences** (NASDAQ: GILD)) is overstated; and sold positions (such as **Intel** (NASDAQ: INTC) and **GrafTech** (NYSE: GTI)) are not considered. But this analysis of *Pro*'s historical performance gives us numerical evidence that our core approach works.

Because we focus on companies with high-quality franchises, strong balance sheets, and sustainable competitive advantages, *Pro* stocks tend to gain as much or more than the market when it rises, and lose less value than the market when it declines. This has led to some pretty heady results over the last three years.

Bringing us back to reality, the market doesn't typically return 17%-plus annualized over a three-year period ... and we know these results won't continue forever. The market of the last three years has been one of spectacular stock returns, and that played a significant part in explaining our own excellent returns. Nonetheless, the core *Pro* portfolio has been a risk-adjusted outperformer, and we hope to continue that performance into the future.

Fool on!

-- Billy (TMFTailwind)

Pro Guidance Changes

- **Apple** (NASDAQ: AAPL) Our fair-value estimate increases to $118. Shares remain a Buy with a 4.5% allocation.
- **Broadridge Financial Services** (NYSE: BR): Our fair-value estimate grows to $49. Shares remain a Buy with a 4.5% allocation.

- **Facebook** (NASDAQ: FB): Our fair-value estimate gets a "Like," increasing to $72. Shares are still a Buy with a 4.4% allocation.
- **Tupperware** (NYSE: TUP): Our fair-value estimate drops to $75. Shares remain a Buy with a 3% allocation.

Pro Guidance Changes

Published Feb 9, 2015 at 2:47PM

- **Apple** (NASDAQ: AAPL): Our fair-value estimate increases to $118. Shares remain a Buy with a 4.5% allocation.
- **Broadridge Financial Services** (NYSE: BR): Our fair-value estimate grows to $49. Shares remain a Buy with a 4.5% allocation.
- **Facebook** (NASDAQ: FB): Our fair-value estimate gets a "Like," increasing to $72. Shares are still a Buy with a 4.4% allocation.
- **Tupperware** (NYSE: TUP): Our fair-value estimate drops to $75. Shares remain a Buy with a 3% allocation.

Pro Catch-Up Trades: Feb. 9, 2015

Published Feb 9, 2015 at 1:30PM

Catch-Up Trades are timely ideas to help you catch up with a Pro *portfolio position you may be lacking, or where price guidance was due for an update*.

- **American Tower** (NYSE: AMT): If you haven't invested in its calls yet, you can buy 0.5% in January 2017 $80 calls, lately for around $21.50. That price will change as the stock moves. We also own 3.7% in the stock, which is rated Buy First.
- **Broadridge Financial Services** (NYSE: BR) remains a Buy at a 4.5% allocation. Our recent earnings coverage is linked in today's Monday Memo email.
- **Gilead Sciences** (NASDAQ: GILD) remains a Buy First at a 3.7% allocation. Our recent earnings coverage is linked in today's Monday Memo email.
- **Tupperware** (NYSE: TUP) remains a Buy at a 3% allocation. See our earnings review.

Broadridge Shows Strong Sales Momentum

Published Feb 9, 2015 at 12:48PM

Pro's Take: BR Q2-2015 Earnings

Broadridge Financial Solutions (NYSE: BR)

Quarter Quick Take

Broadridge continues to execute its business strategy, booking record recurring revenue sales in Q1 and Q2, setting the company up for a strong end to Fiscal 2015. Broadridge registered 7% growth in recurring fee revenue, 25.4% year-over-year growth in EPS, and announced two small, complementary acquisitions over the quarter. The company outlined its three-year plan at its investor day in December, and Broadridge should continue to challenge the North Star through 2017 with 7-10% recurring fee revenue growth, margin expansion due to increased scale, dividends/share buybacks, and tuck-in acquisitions to complement its existing product portfolio. Broadridge is a well-managed business with steady upside, low downside risk, and shareholder-friendly management.

....

Q2-2015

Total recurring fee revenue growth: +7%

TTM Operating profit margin*: +26 bps to 23%

EPS growth (Y-o-Y): +25.4

*Operating profit / Fee revenue

This removes the impact of distribution revenue, which is a pass-through, and distorts the true economics of the business

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Guidance Update

After two record quarters of sales in what are historically seasonally weak quarters, management's reaffirmed FY-2015 guidance looks pretty conservative: recurring revenue growth of +5% to +7%, EPS growth of +8% to +13%, recurring revenue closed sales of $110-$150 million, and FCF of $320-$370 million. I'd be surprised if Broadridge doesn't manage to outperform its guidance once results from the historically strong back half of the year are tallied.

Updated guidance: Buy (no change)

Recommended Allocation: 4.5%

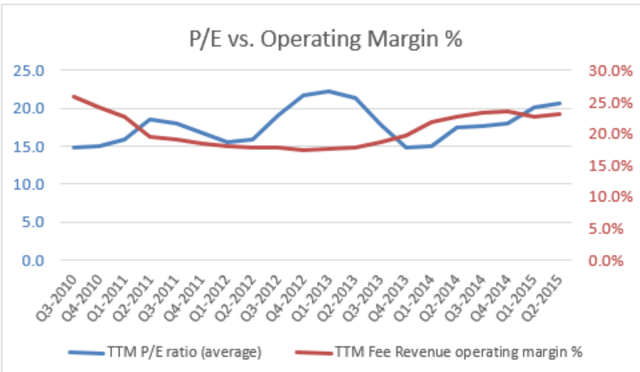
Fair Value estimate: $49 (up from $43)

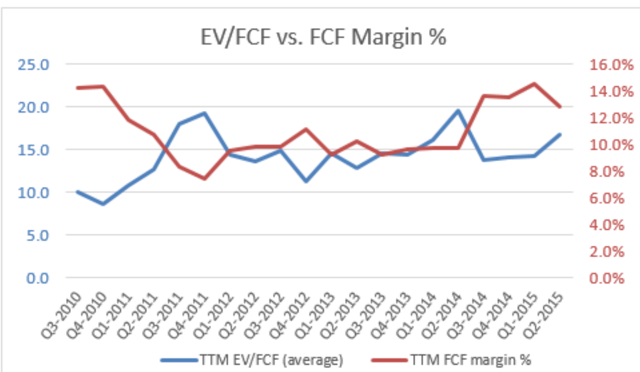
After adjusting my model and accounting for recent business performance, I've updated our Fair Value estimate to $49 per share (from $43). You'll notice that's a 14% increase since the last update-a pretty large increase for a steady business like Broadridge. The reason for the large increase this quarter is because after reviewing my valuation model, I determined that the discount rate I was using was too high (I was assuming a 5.5% cost of debt rather than the more accurate 4.5%):

	Outstanding Borrowings	Fixed Interest Rate
Senior notes due June 2017	$124.6	6.125%
Senior notes due September 2020	$399.5	3.95%
Total	$524.1	
Weighted average cost of debt		4.47%

Source: Broadridge Q2 2015 10-Q, Notes to Condensed Consolidated Financial Statements, Note 9

Since debt makes up 35% of the company's capital structure, that had a significant effect on the overall discount rate (i.e weighted average cost of capital, or WACC) I was using to discount projected cash flows.This change in discount rate contributed about $4 of the FV increase, and the balance of the increase was made up with cash generated since the last FV update and stronger near-term growth expectations due to the excellent start to Fiscal 2015. The stock's not a screaming bargain, especially after gaining over 3% on the day of earnings; the business is priced at 19x projected 2015 cash flow and 21-22x projected 2015 EPS. Both of those metrics are near Broadridge's historical highs, but relative to its history, the company now has more stable cash flows, a steadier growth profile, strengthened competitive positioning, and higher margins to show for it:





Sources: Company filings and analyst calculations.

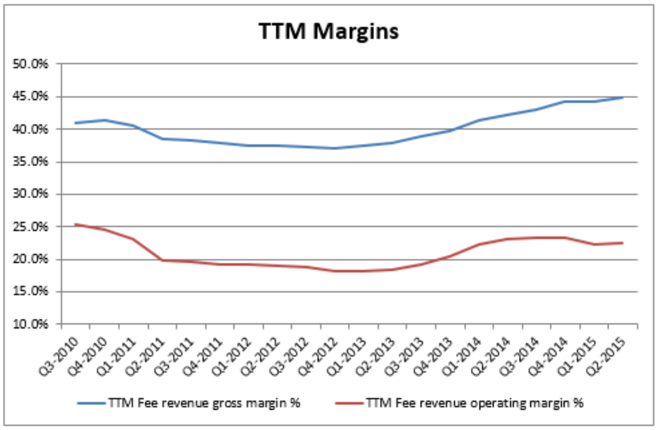
Our Thesis

Broadridge has a near monopoly in proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record and sound capital allocation policies make Broadridge a sturdy rock to build the Pro portfolio upon. We expect modest growth in fee revenue, slight operating leverage, plenty of free cash flow and a growing stream of dividends to help achieve North Star-like returns.

The Most Important Things

1) ***Recurring Revenue Closed Sales:*** This metric represents anticipated annual revenue for new client contracts signed during the period, and this revenue recurs at extremely high rates (98%+). Tracking RRCS gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings. After posting a Q1-record RRCS of $32 milllion last quarter, Broadridge yet again delivered stellar results with a Q2-record $49 million in RRCS. Although RRCS are lumpy, Broadridge's business is historically seasonally stronger in the second half of the fiscal year (due to regulatory filing deadlines imposed on its public reporting company and mutual fund clients). Due to the record RRCS performances in Q1 and Q2, the company should be able to easily meet its full year 2015 guidance of $110-$150 million in RRCS. Comments from a "very enthusiastic" management suggest the sales pipeline continues to be "robust with very good momentum". I'd be pretty surprised if the company doesn't challenge the upper end of guidance by the end of Fiscal 2015.

2) ***Fee Revenue Margin Performance:*** Broadridge maintains a technology platform upon which its business operates. As it brings more business (volumes) on board, it should benefit from low variable costs and increasing margins. We track gross and operating profits as a percentage of fee revenue, which ignores pass-through distribution revenue, and because of Broadridge's seasonality we prefer to look at TTM margins to smooth out quarterly fluctuations. TTM fee revenue gross margins came in at 45.3% (up from 41.9% a year ago), and TTM fee revenue operating margins came in at 23% (up from 22.8% a year ago). I wrote last quarter that I expected margins to hold steady or decline slightly in coming quarters as the company plans strategic growth investments to be executed in the second half of the fiscal year, and that's what we got. We should see these investments fully bear fruit in FY 2016 as the elevated spending rolls off, but if sales growth continues its strength we could see further margin expansion this year.



3) ***Capital Allocation:*** Although BR is a slow grower, it generates a lot of cash and has low reinvestment needs. Management has a very clear plan to put that cash to work: it targets a 45% payout ratio, then looks for bolt-on acquisitions that can achieve a 20% IRR, or it looks to repurchase shares. The company announced two acquisitions this quarter-a) acquiring the trade processing business of M&T Bank Corporation's (NYSE: MTB) Wilmington Trust Retirement and Institutional Services unit for an undisclosed amount and b) closing the acquisition of TwoFour Systems for about $32 million. The company plans to step up the pace of its acquisition spending over the next three years, targeting about $400-$600 million of tuck-in acquisitions to drive faster growth. Both of these new acquisitions tie in nicely with Broadridge's existing product lines, and management has historically been a good acquirer, so I view these transactions favorably. Broadridge also paid $32 million in dividends and bought back about $10 million in shares at an average price of $45.40 in the quarter. Broadridge gets a solid check mark for capital allocation in Q2 2015.

WWTN

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Gilead Sciences Has a Record 2014

Published Feb 9, 2015 at 10:12AM

Gilead Sciences (NASDAQ: GILD) reported record results and suggested that the market for Hepatitis C will remain large for many years to come. Wall Street is focused on price cuts, but those only come with increased patient access, so volume should benefit. The pricing concessions are larger than we hoped, though; even so, our fair value estimate is able to stay at $120, or 12.5x 2015 EPS estimates, and the stock remains a Buy First. Starting its first dividend, the stock will yield about 1.6%.

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Pro Guidance
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Status: Buy First
Fair Value Est: $120
Current Allocation: 3.7%

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Q4 Key Stats

Revenue: +137% to $7.2 billion
Net Income: +340% to $3.4 billion
Earnings Per Share: +341% to $2.43

Key Thoughts

o Concerns about Hepatitis C pricing have proven more legitimate than we assumed they would this early on, but this does not change the positive trajectory of the valuation, even if the magnitude is dampened a bit in the near term.

o Discounts in pricing on Harvoni and Sovaldi are given on the condition that access to patients is increased, meaning many more patients should qualify for treatment than have been so far.

o Gilead's Hepatitis drugs have the best outcome profile, and that is likely to remain the case, meaning Gilead should keep a healthy majority of market share. Gilead is not much concerned about future market entrants.

o Gilead's HIV franchise remains a growing powerhouse, and its pipeline is strong.

Looking Ahead

As we said before, what matters most the coming few years are Hep C sales -- how strong will they be? Since the drugs cure patients, revenue will not be linear. Sales will subside, leaving a sizable headwind for year-over-year growth in years to come. But for now it's a giant cash generator, adding value, and we expect sales will be healthy well past 2018. In this conference call, management voiced the same thought (and it's interesting it isn't being reported anywhere I read):

COO, John Milligan: "*...the number that's pretty strong is the 1.6 million people who are currently diagnosed and have been under care at least at some point in the past, and we see there's great opportunity for Gilead in future years to drive those patients into care. And so there are a number of programs that we'll be embarking upon this year, educational campaigns with things like primary care, not with the intent of them treating [right now], but with referring and identifying the disease, all the way through advertising campaigns that in 2016, 2017 and 2018 and beyond -- can go to the number of years beyond that -- will continue to drive those patients into care. I* *think additionally, as these therapies have gotten both more affordable for the system and better because of the simplicity of use, we will see those other patients, that roughly 3 million to 4 million people who are out there, the additional 2-plus million who are out there above the 1.6 million, will also have an opportunity to seek care. And we do see a great opportunity to drive those patients. So we do see this as a long-term sustainable business based on what we've seen today despite the rapid influx that we saw in 2014 and the continued influx that we anticipate in 2015."*

And in Europe:

"In Europe, the situation is actually quite sustainable, I think, for a number of years here. What we're seeing are commitments from the public sectors to treat a certain number of patients. And in most of those cases, it's a considerably higher number of patients than have historically been treated. But when we look at the denominator, the total number of patients who could be treated, this is something that plays out roughly 10 to 15 years or, in the case of some of the high prevalence countries like Italy, even beyond that. So we do think it is quite a sustainable market through Europe."

Should the market size remain robust (similar to 2015) for years, and pricing not decline meaningfully year-to-year as contracts roll over, then the value creation at Gilead the next 5-10 years is being sold very cheaply at today's stock price. Those are a few big "ifs," though, so some discount to the potential cash flow is merited. The discount looks a bit large right now, though. Shares remain a Buy First.

For all the numbers, outlook, and conference call notes, please visit our Gilead board.

Facebook's Value Increases Even as Spending Jumps

Published Feb 9, 2015 at 9:18AM

Greetings, Fools,

Facebook (NASDAQ: FB) had a "big" year, growing headcount 45% to 9,200, and investing in its future, yet achieving $3.6 billion in free cash flow on $12.4 billion in revenue. The stock remains a Buy and our estimated fair value increases to $72 -- that's about 36.5x EPS estimates (non-GAAP) for this year.

***Pro* Guidance**

- **Status:** Buy (no change)
- **Fair-Value Estimate:** $72 (up from $67)
- **Current Allocation:** 4.5%

Q4 Key Stats

- **Revenue:** +49% to $3.9 billion
- **Non-GAAP Operating Income:** +48% to $2.2 billion
- **Non-GAAP Net Income:** +86% to $1.5 billion
- **Non-GAAP EPS:** +69% to $0.54
- **FCF:** $1.07 billion

Key Thoughts

- Facebook is a fast-growing company that doesn't necessarily care if it grows quickly. The company is focused on the very long term, and has a primary goal of "connecting everyone." If it comes close to its goal, it will also "figure out" ways to keep earning growing revenue on its engaged audience.
- Wall Street is focused on Facebook's growing expenses, but I believe similar to Google last decade, higher expenses will eventually look reasonable in relation to how large revenue grows.
- The stock appears reasonably valued as long as site engagement remains as strong as it is now, and continues to grow (even slowly), while Facebook takes more advertising spend year by year. Social advertising is still a tiny slice of the total ad pie, and Facebook is intent on showing how well it works, and has early success.

Overview

- **Recent Price:** $75.40
- **Yield:** 0%

Valuation

- **Market Cap:** $211 billion
- **Cash & Equiv.:** $11.1 b
- **LT Debt:** $0 b
- **Enterprise Value:** $199.9 b

Metric	Multiple
EV/EBITDA	32.9
EV/EBITDA NTM est.	19.2
P/E	67.8
P/E NTM est.	38.2
P/FCF	55.2

TTM Cash Flow

- **CFO:** $5.45 billion
- **Cap EX:** $1.83 billion
- **FCF:** $3.62 billion

TTM Margins

- **Gross Margin:** 83.5% (all up lately)
- **EBITDA Margin:** 49.6%
- **Operating Margin:** 23.6%

- **FCF Margin:** 31.4%
- **ROE:** 11.3%

Historical EV/EBITDA

Year	Dec. 31	Annual Average
2012	44.1	33.8
2013	39.8	41.2
2014	33.6	35.1
Now	32.2	32.9

(Next-Twelve-Month estimate 19.2)

Note the historical value multiples. As you would expect, the EBITDA multiple is slowly declining as the business grows, even as the stock appreciates. It again reminds one of Google's early years. For the "Next Twelve Month estimate," the multiple would contract mightily unless the stock appreciates. This has been the case each year, though.

Looking Ahead

Facebook doesn't provide guidance, but expects currency exchange rates to decrease total revenue (from what it would otherwise be) by about 5%-point in 2015. Non-GAAP expenses should increase 50% to 65%, and GAAP expenses will grow a robust 55% to 70%. They're investing in people, product, and infrastructure (servers, Internet.org, etc). 2015 capital expenditures will be $2.7 to $3.2 billion, up from $1.8 billion last year. A year of investment, we don't expect fireworks on the bottom line or in free cash flow this year, but expect better growth later to make up for it.

Conference Call Notes

The Focus

- **3 years:** The main focus is to continue to serve and grow the community by providing better services for people and businesses worldwide.
- **5 years:** Build the next generation of Facebook services. Messenger is at 500 million monthly actives, WhatsApp at 700 million. Instagram has more than 300 million actives, more than 70% outside the U.S. Facebook Search is a work in progress with early promise. Facebook's Audience Network allows it to work with developers, forming an App model similar to Apple.
- **10 years:** Connect everyone to the Internet through Internet.org and develop the next generation of computing platforms, including Oculus.

The Audience

- The number of people using FB on an average day increased 18% in December, year-over-year.
- 1.39 billion people now use Facebook each month; 890 million visit daily, an increase of 165 million monthly actives and 133 million daily actives in 2014.
- Time spent per person per day across FB continued to rise, growing in Q4 by more than 10% compared to last year (and that excludes WhatsApp).
- WhatsApp, Messenger, Instagram still far from being monetized

2014 and More Q4 Numbers

- 2014 revenue +58% to $12.5 billion; $3.6 billion in FCF
- Q4 ad revenue +53% to $3.6 billion; mobile was 69% of total ad revenue, doubling to $2.5 billion.
- Q4 GAAP expenses up 87% to $2.7 billion; Non-GAAP expenses up 50% to $1.6 billion; Non-GAAP is not out-of-line with growth. Stock-based compensation and amortization were key drivers of the non-GAAP jump; headcount was key in the GAAP increase.
- Full-year, GAAP costs up 47%, non-GAAP up 34%. Again, reasonable for the growth. But there's bigger spending ahead (so large there's a chance FB won't be able to spend as quickly as it projects).

Ads

- The average price per ad increased 335%; total ad impressions declined 65% (due to a redesign of the right-hand column).
- The company's strategy is not to serve more and more ads the more content a user consumes, but simply to serve better ads to everyone.
- Instagram ads started to roll out (in a small way) in Q4 in Australia and Canada.
- Video views are soaring, to more than 3 billion views per day hosted by FB.
- Custom Audiences — FB's proprietary targeting products — are doing well for clients. (Example: Thomas Cook reached 30% of the Belgian population in one day and achieved a 3.85x return on investment.)
- Audience Network (ads off of Facebook) still new, but promising.
- Overall, clients are excited by the ability to be creative and tell stories with their ads on FB — and measure results quickly. Now the challenge is to scale. "Even for our largest clients globally, we still represent a really small part of what they do."
- The ultimate goal in the ad division is to be "a critical business partner to clients, providing people-based marketing at scale" to build brands and earn clients a good return.
- In the U.S., "mobile gets 25% of consumer media time, but only 10% of the ad budgets. ... that means that for every consumer hour spent on print, marketers spend $1, and they spend $0.07 per hour on mobile."

What We Think Now: The social-networking leader is building and always improving its services, aiming to be integral to life, with a goal of retaining and growing its audience. That will provide a lucrative platform to host relevant ads at greater profits for shareholders. By three years from 2014, Facebook's revenue could potentially double.

Facebook investor relations: http://investor.fb.com

To ask questions or comment, please visit *Pro's* Facebook board.

Why Kickstarter Is Off to a Great Start

Published Feb 6, 2015 at 10:14AM

JP recently contributed to a series in Motley Fool Rule Breakers *profiling private companies with disruptive potential. We thought you'd like to see his entry here! Read on to learn more about a disruptive company whose mission is helping out other potential disruptors.*

If you have a hankering to make some potato salad, but find yourself low on funds, there's a place on the Internet where strangers might contribute $55,000 toward your carb-loaded concoction. Sound like a joke? The same site can help your game-changing business idea or research project get financial support when you need it most — and it's disrupting the financial industry.

Kickstarter, a private crowdfunding company, is helping redefine how creators raise funds for business ventures, films, video games, music, art, technology, you name it. It's an extension of a model that once was the primary method for funding art — soliciting money from patrons in exchange for something like an early copy of a novel — only, as the company puts it, "turbocharged by the Web." In a world where traditional gatekeepers like banks, venture capitalists, or entertainment companies have the final say on what ideas see the light of day, Kickstarter places that power in the hands of you and me. See something you like? Support the project by pledging a donation. If the project meets its funding goal before the deadline, backers receive various perks, and the creator receives the total amount pledged — minus Kickstarter's cut.

Last year, 22,252 projects were successfully funded on Kickstarter, and 7.7 million people have pledged more than $1 billion for projects in the past six years. Oculus VR, which was later acquired by **Facebook** (NASDAQ: FB), raised almost 10 times its original goal back in 2012. A campaign to bring back the educational TV show *Reading Rainbow* raised $5.4 million, and an idea for a portable cooler was able to raise over $13 million!

Even though Kickstarter still has a start-up-type mentality and is heavily investing in its business (Kickstart Norway just launched this past September), the company has been profitable since mid-2010. Just as **eBay** (NASDAQ: EBAY) makes money by collecting a fee for sales that occur in its marketplace, Kickstarter collects a 5% fee from each project that is successfully funded.

Chairman Perry Chen came up with the idea for Kickstarter in 2002 when he tried unsuccessfully to raise funds to throw a concert. Not your typical tech company founder, Chen held a variety of jobs prior to starting Kickstarter, including artist, day trader, recording engineer, gallerist, waiter, and preschool teacher. A writer and rock critic (current CEO Yancey Strickler) and a designer (Charles Adler) later joined Chen to help found the company. Along the way, Kickstarter has received funding from prominent investors like **Twitter** (NYSE: TWTR) co-founder Jack Dorsey, but management has always insisted on doing things its own way.

Chen and company believe that creative projects make for a better world — and that their company is a tool to bring creative projects to life. Kickstarter is doing more than just changing the way people go about raising funds: It's helping fund disruptors all over the world.

Tupperware Pops

Published Feb 4, 2015 at 10:38AM

Tupperware (NYSE: TUP) has choppy results quarter-to-quarter, but its growth trajectory in emerging markets remains on track, with 10% year-over-year revenue growth. The inexpensive stock yields nearly 4%. Get our full update on its *Pro* board.

Apple Shines Bright

Published Feb 4, 2015 at 10:33AM

As *Pro* increases its fair value estimate on **Apple** (NASDAQ: AAPL), see our community board for the full report. And, keep in mind that ideally a stock appreciates by your desired rate of return starting *from* its fair value price.

Parexel's Backlog Is Back on Track

Published Feb 3, 2015 at 12:36PM

Pro's Take: PRXL Q2-2015 Earnings

Parexel International (NASDAQ: PRXL)

Quarter Quick Take

After last quarter's poor sales performance, new business wins picked up in Q2 2015. The net book-to-bill ratio, an indicator of future business, jumped to 1.54 from 0.88 last quarter as strategic partnership sales (a key element of our thesis) came back strongly. Revenue growth slowed a bit (2.5% year-over-year) due to currency headwinds and a sales mix that was weighted toward younger projects in the start-up phase. Both of these factors should continue to pressure reported revenue in the near-term (and backlog growth should outpace reported revenue growth), but as the projects mature and milestone are met, we expect revenue growth to return to our 8-12% expectations. Margin expansion and non-operating items led to 41% growth in EPS.

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Q2-2015

Sales growth: +2.5%

Operating profit margin: +99 bps to 10.6%

EPS growth: +41%

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Guidance Update

The business continues to track well against our thesis despite a competitive operating environment and currency headwinds. Parexel's largest business segment, Clinical Research Services (CRS), bounced back after a weak Q1, and it continues to win new business and earn strategic partnerships. The company's Consulting and Informatics segments are growing more modestly, but margin expansion in these smaller segments is helping companywide results. Longer term, these businesses should be meaningful contributors to economic value. There's no change to our $57 Fair Value estimate, as near-term revenue headwinds offset recent cash generation in our valuation model.

Updated guidance: Buy (no change)

Recommended Allocation: 3.4%

Fair Value estimate: $57 (no change)

Members lacking a (full) position should be patient in initiating or adding to their position with the stock about 7% ahead of our Fair Value estimate. Parexel shares have been volatile - customer concentration, lumpy quarterly results, and a high multiple make this likely to continue - so we may look to be opportunistic with options to generate current income.

Our Thesis

Because of its reputation, global reach, and technology prowess, Parexel International will win its fair share of the growing pharmaceutical development market. In addition, we expect the proportion of R&D dollars outsourced to contract research organizations to grow as large biopharma companies adopt the strategic partnership model and smaller biotechs become responsible for more drug discovery. Finally, as new business wins mature, the true earnings power and margin potential of the company's business will shine through.

The Most Important Things

1) ***Penetration and Backlog*****:** Penetration refers to the proportion of biopharma R&D dollars that go to CROs versus being used in-house for development and provides evidence that the biopharma/CRO partnership model is winning. As we wait for industrywide 2014 data to be tabulated, we can monitor backlog trends to ensure Parexel is sufficiently adding future business – backlog that converts to sales usually represents ~80% of the sales in any given quarter, so strong backlog growth suggests strong future sales growth.

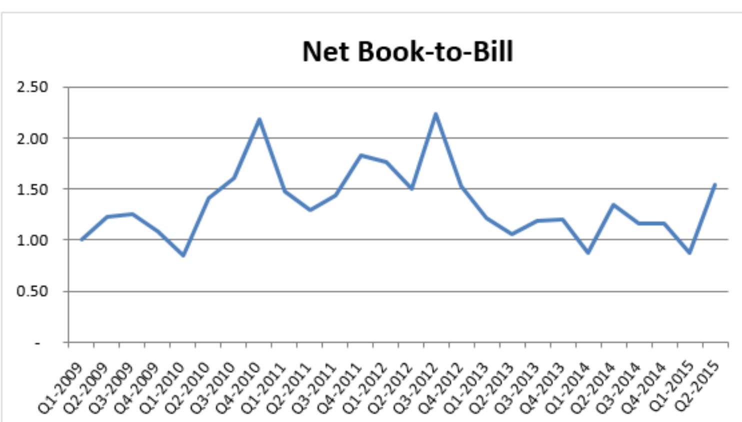
Backlog grew 4.5% sequentially and 6% year over year (5.5% and 6.9% if adjusted for unfavorable currency fluctuations). Because of Parexel's global presence, currency fluctuations (specifically the weak euro) should continue to have an effect, so that may dampen reported revenue growth figures as we approach the back half of the fiscal year. Additionally, management comments on the conference call suggest that revenue growth may lag backlog growth in the coming quarters due to project mix:

> "We still have a large number of projects that are in the start-up stages that typically generate lower revenue for labor effort expended. In addition, we have other studies that are winding down and, therefore, there is not as much backlog in the higher revenue generating enrollment stages at this point in time. As a result, we anticipate that revenue growth will lag new business success somewhat in the short term." -Josef von Rickenbach, Chairman / CEO

Part of that increase in backlog was due to a renewed and expanded partnership with GlaxoSmithKline (NYSE: GSK) which was referenced in the Q4 2014 call but not disclosed. Here are some comments from von Rickenbach regarding the GSK partnership:

> "...it is a multiyear agreement and it involves certain future new business commitments. In accordance with our policy, we have included in backlog only the elements that we expect will start to convert into revenue within the next 6 months.
>
> Part of the agreement includes the transfer of approximately 450 GSK employees to Parexel. These employees will transfer with work, including ongoing clinical trials. We look forward to welcoming these employees and to bringing them onboard. Our agreement with GSK is a prime example of how our partnerships with big pharma are deepening, it highlights our innovative thinking and demonstrates how we work strategically with clients to jointly evolve the business model. We have a close relationship with GSK and are very happy that they have trusted us in this new and expanded manner."

After last quarter's poor showing, the book-to-bill ratio bounced back to a healthy 1.54 due to the GSK partnership and solid increases in net new business. As we suspected, the poor book-to-bill last quarter seemed to be related to non-recurring timing issues, and those lost sales partially found their way into this quarter's results:



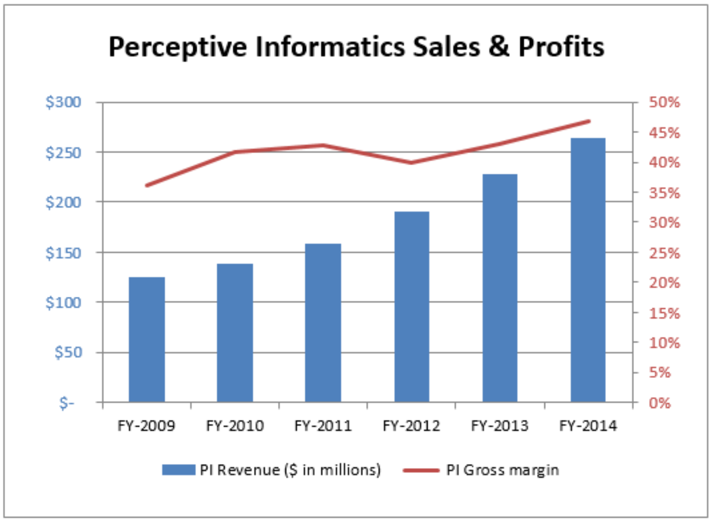
Source: Company filings and analyst calculations.

As the CRO industry picks up a higher percentage of biopharma R&D spending, we should see revenue and backlog growth outpace the expected 2-3% growth in R&D spending. With 8% growth in TTM service revenue and 6% growth in backlog, that's what we're seeing, which-along with new partnership announcements-provides evidence that our thesis continues to progress.

2) ***Margin Performance***: Company gross margin declined 72 bps sequentially and increased 105 bps year-over-year. Gross margin improvements have slowed a bit mostly due to the project mix and new hiring in the company's largest segment-Clinical Research Services (CRS)-as mentioned in the above section. We should expect to see project mix continue to pressure gross margins in the CRS segment into the rest of 2015. But as start-up projects mature and newly hired staff becomes more productive, over time we should see gross margins continue to tick up.

As for the other two business segments, Parexel Consulting and Medical Communications (PCMS) gross margins increased to 45.2% (up from 40.2% a year ago) and Parexel Informatics (PI) gross margins increased to a record 50.5% (up from 46.8% a year ago). The main contributors to the gross margin expansion in the two smaller segments (PCMS and PI are 11% and 13% of revenue, respectively) were favorable product mix and productivity improvements. Our model assumed more modest margin improvements, but we aren't complaining. If the company can keep up its margin performance in these segments, we may need to revise our long-run estimates upward.

3) ***PI Business Trends:*** Technology is a core competence for Parexel. The company's PI segment is the lifeblood of innovation for transforming the traditional clinical trials process into a more efficient, more effective, technology-driven one. We want to see this business perform well to ensure it remains a competitive differentiator for Parexel and helps it win business in its CRS and PC segments. Now reaching scale, we also expect PI to exhibit operating leverage and become a more meaningful portion of profits. Revenue stagnated a bit (down about 3% year-over-year) but as mentioned above the gross margin hit a record quarterly high of 50.5% (sooner than we expected). We expect PI to achieve 55% gross margins by 2020 – and performance is tracking nicely. Of note, PI's Randomization and Trial Supply Management system, ClinPhone RTSM, was recently ranked as the industry leader of interactive response technology, as reported in a new global survey of pharmaceutical and biotechnology companies conducted by Industry Standard Research. PI's success has synergistic benefits with its other segments-Parexel can integrate PI's technology into Research Services' projects and partnerships.



Source: Company filings and analyst calculations.

What We Think Now

Helping pharmaceutical companies get drug candidates to market, Parexel is poised to benefit as those companies gradually outsource more of this process to select CRO partners who can perform the work better, faster, and cheaper. We also expect margin expansion as recent investments pay off and continued growth of the Parexel Informatics technology segment.

Pro Can Help

- Post your questions on our Parexel International discussion board.

Pro Live Chat, February 2015

Published Feb 3, 2015 at 11:52AM

Our February live chat took place at 1 p.m. Eastern on Tuesday, Feb. 24. Relive the magic below!

What's Up With What's Down?

Published Feb 2, 2015 at 1:37PM

Pro Guidance Updates

- **Starbucks** (NASDAQ: SBUX): Our fair-value estimate increases to $82. The stock remains a Buy at a 3% allocation. Read JP's full report on earnings.
- **TD Ameritrade** (NYSE: AMTD): Our fair-value estimate increases to $35. Shares remain a Buy First with a 2.8% allocation. Get Billy's take on earnings.
- Many of our companies will receive a valuation update -- typically higher -- as we review January earnings. Stay tuned!

Dear *Pro* Fools,

Like many of us, the S&P 500 is apparently not a fan of winter -- the total returns index was down 3% in January. Over the same period, the *Pro* portfolio gained 0.0008%, leaving us basically flat, while our North Star gained 0.6%. Though we held our ground overall, some positions did slip-slide downhill. Today, I want to touch on our thinking on those.

For context, the stock market has declined over the past two months on world events that are more *Jaws* than Mickey Mouse. Oil is down 40% in two months, and although that should be a net positive for Western economies, it initially brings sharply lower prices for energy stocks and thus the market in general. Russia, the Ukraine, Syria all remain in conflict; China's growth is slowing; Europe and Japan flirt coyly with recession; the strong dollar is dinging earnings at home; and today it was reported that U.S. consumer spending was negative in December. To many, the glass is starting to look half-empty.

Against this backdrop, S&P Capital IQ prices the S&P 500 (at 1,995 on Friday) at 16.8 times expected normalized earnings for 2014. With an aggressive 8.5% in earnings growth estimated for 2015, the index fetches 15.4 times normalized 2015 estimates. That would price the index right at its historical norm. On a GAAP basis, the index is more expensive, and either way any threats to earnings could cause the market to have a subpar year. On the flip side, positive events could justify a move higher.

This either-or environment is rewarding companies that continue to thrive -- **Apple** (NASDAQ: AAPL) comes to mind -- and making it an "investors' market," if you will. We like that. But some of our positions have declined lately, too.

The A's Don't Have It

In case you haven't noticed, we've been showing our patriotic stripes: We've bought calls on **American Airlines** (NASDAQ: AAL), **American International Group** (NYSE: AIG), and **American Tower** (NYSE: AMT). (What's next? **American Express** (NYSE: AXP)? Maybe!) But right now, all of our American-named call options are in the red a tad.

AIG stock has been weak for reasons that remain unspecified to us; earnings on Feb. 12 will hopefully start to alleviate the situation. American Tower's stock has dipped a few dollars as well, and call options like ours can easily move 10% or more on a small move like that. Leverage works both ways. When it works against you on something you believe in, you wait it out with long-term calls, which is what we're doing with both positions.

Third up (or down) is American Airlines. The position has descended since earnings last week, even though results were fine. Management's focus on spending -- for better customer service and more growth, to increase pay for all employees, and because of more competition in some markets -- is weighing on the stock afresh at the moment. But the business is priced at around 5 times expected earnings for 2016, well below industry averages -- so if management delivers, investors could be well rewarded by our 2017 expiration.

The stock is volatile (as are all airline stocks), so our calls will be even *more* volatile. Don't let that spook you. We have a small 1% position. If we get an additional price opportunity we can't pass up, we may add a bit more. Other than that, we know our risk is small and limited, and we'll consider writing diagonal calls on our position, too, if that makes sense while we wait for appreciation. So, we have options with our options. And we're content to wait.

Volatility Returns

Historically, volatility is tame between Thanksgiving and February, but this year choppiness returned to the market even over the holidays. If it's getting to you, turn down your sensitivity to it. Be sensitive to others, and to good food, fresh flowers, and the like -- but don't be sensitive to market moves that are less than a few percentage points a day.

Volatility has sunk our small stake in the **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY) ETF. It stands at 0.9% of the portfolio, down from 1.3%. We will almost certainly add to this position when we see an especially attractive opportunity. I would like to see the CBOE VIX two-month futures at a minimum 25 -- and ideally 30 or higher -- before investing a bit more into this ETF for the long haul. Lately, the futures are just above 20.

We need to move *slow* and think *small* with this position, because even if the market's volatility stays the same (just grinding back and forth), SVXY's value could continue to decline if volatility remains choppy. We will only invest a small stake overall in this ETF, adding very small amounts judiciously. Over the long haul, the pricing structure of volatility futures should lead to slow but sure appreciation here, as it has for years, perhaps even making this a sizable position through appreciation someday. We just happen to be experiencing increasing volatility right now.

The Big Picture

Overall, we can't repeat it enough. We need to:

- Manage the portfolio as a whole, aiming for healthy rolling three-year annualized returns while taking reasonable risks.
- At the same time, we aim to manage each position in a way that seems best for it, including position sizing and strategy.
- We need to change positions thoughtfully and deliberately -- *if* and as the situation changes.
- We need to keep small positions and modest market volatility in context. The S&P 500 is 5.1% below its all-time high as of this morning.

It's also always worth repeating that we're seeking new shorts, considering additional hedges, income positions, and learning more about new possible investments every week. We always know we could do better, and we know we can't take our eyes off the ball. Right now, in addition to the above, we're going through earnings analysis.

Questions or comments? As always, please visit the Memo Musings board.

Have a great afternoon, and Fool on!

— Jeff (TMFFischer)

Pro Completed Trades

- **Gentex** (NASDAQ: GNTX): We sold to open fourteen March 2015 $17.50 puts for $0.65 each. The puts are in-the-money now, and we'll either happily accept more shares by expiration, or roll the puts before then if we want to target more credit. If your puts are exercised, keep your shares. See our earnings analysis.

Pro Catch-Up Trades

- **American Airlines** (NASDAQ: AAL): If you haven't invested 1% in January 2017 $35 calls, you can do so today at a lower price, lately around $18.50 each.
- **American Tower** (NYSE: AMT): If you haven't invested in these calls yet, you can buy 0.5% in January 2017 $80 calls, lately for around $22. That price will change as the stock moves. We also own 3.7% in this Buy First stock.
- **Gentex** (NASDAQ: GNTX): We have a 4.1% allocation total, with 3.1% in this Buy stock and 1% in extra stock exposure through short puts. If you haven't matched this allocation yet, you can do so by buying 3.1% in shares to start. Writing $17.50 puts makes less sense at the moment because you're mostly writing intrinsic value.

Pro Updated Returns

Updated as of Jan. 31. These are always available on the Recommendations page.

	Annualized Return Since Inception	Annualized Return, Rolling 3 Years	Year-to-Date Return
Pro	14.2%	19.5%	0%
North Star	8.2%	8.3%	0.6%
S&P 500	13%	17.5%	(3%)
MSCI World	7.3%	10.6%	(1.9%)

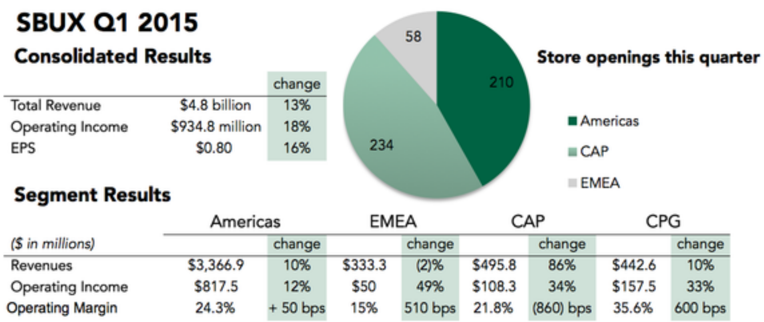
Pro Community

- **Chicago Party:** Member marksrjm (Bob) plans a **Caesars Entertainment** (NASDAQ: CZR) bankruptcy party in Chicago as a judge lets the case take place in the Windy City later this year. Can you attend?!
- **A Fool Recognized:** PhooLon becomes TMFPhooLon -- we're grateful to be able to knight Lon as an official "Home Fool" helping on the *Pro* and *Options* boards!
- **Abysmal Returns:** A hedge fund turns $100 million into $200,000. How? What are the lessons?

Starbucks Serves Up Another Winner

Published Feb 2, 2015 at 12:28PM

The strength of **Starbucks**' (NASDAQ: SBUX) results last quarter may have been open to interpretation (for the record, I thought they were quite strong), but the first-quarter results for fiscal 2015 left no doubt. Q1 2015 was the most successful holiday quarter in the company's history, highlighting the coffee chain's ability to thrive in a world where consumers increasingly favor shopping online over brick-and-mortar locations.



Consolidated Results

		change
Total Revenue	$4.8 billion	13%
Operating Income	$934.8 million	18%
EPS	$0.80	16%

Segment Results

	Americas		EMEA		CAP		CPG	
($ in millions)		change		change		change		change
Revenues	$3,366.9	10%	$333.3	(2)%	$495.8	86%	$442.6	10%
Operating Income	$817.5	12%	$50	49%	$108.3	34%	$157.5	33%
Operating Margin	24.3%	+ 50 bps	15%	510 bps	21.8%	(860) bps	35.6%	600 bps

Updated Guidance and Valuation

Updated guidance: Buy (no change)

Recommended allocation: 3%

Fair-value estimate: $82 (up from $79)

Current Multiples

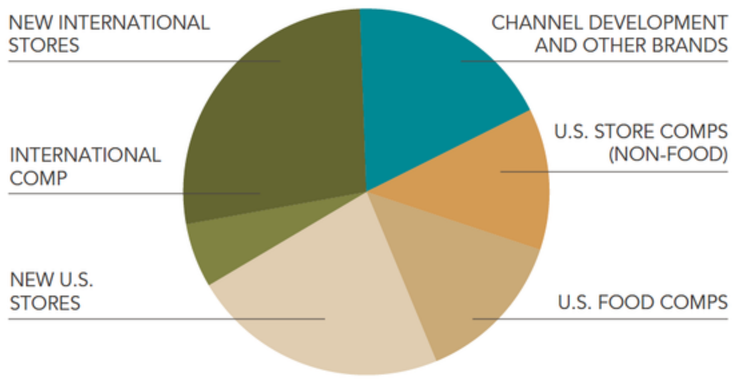
Multiple	trailing	forward
P/S	3.9x	3.1x
P/E	27x	24x
EV/EBITDA	16.6x	14.6x
P/FCF	29x	

Investment Thesis

Starbucks offers a unique blend of sales drivers (domestic and international growth, food and beverage innovation, and channel development, just to name a few) and cost-reduction opportunities (payment innovation, European restructuring, expansion of consumer product margins). We believe the coffee is just a gateway for the company to repeatedly sell customers an experience rooted in comfort, quality, health, community, and conscience. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand into new products, new platforms, new times of day, and new brands. We expect new store openings across the globe to strengthen the company's brand and cost-based competitive advantages and improve profitability over time.

With a company as large as Starbucks, you might think there isn't much more room for growth. But you'd be wrong. As laid out during the company's most recent Biennial Investor Day presentation, management believes that within five years, Starbucks will increase its store base to more than 30,000 global locations (up from 14,401 today), achieve $30 billion in annual revenue (up from $17 billion TTM), and double its annual operating income. The largest driver of growth will be new store openings, both domestic and international, but a slide from Chief Strategy Officer Matt Ryan's presentation highlighted how the company is planning on achieving strong growth in all facets of its business:

Diversified revenue growth



Source: Starbucks 2014 Biennial Investor Day presentation

Segment Results

Comparable-Store Sales

	Q1 2015			Q1 2014		
	Sales growth	Change in transactions	Change in ticket	Sales growth	Change in transactions	Change in ticket
Consolidated	5%	2%	3%	5%	4%	1%
Americas	5%	2%	3%	5%	4%	1%
China, Asia, Pacific	8%	8%	0%	8%	7%	1%
Europe, Middle East, Africa	4%	3%	1%	5%	3%	1%

Americas

Nearly 9 million more customers made their way through U.S. Starbucks stores in Q1, reversing a six-quarter trend of declining transaction volume. Food sales were up 29% and contributed 2% to the overall comp growth of 5%. Teavana results were essentially flat for the quarter, but total tea sales were up 17% as the company leveraged its other methods of distribution, like selling shaken iced tea and Teavana tea lattes in Starbucks retail stores. The company's goal is to double both its food and tea businesses over the next five years, and given the size of these two markets and Starbucks's current market share, we believe this is definitely achievable as long as the company continues to execute.

Europe, Middle East, Africa (EMEA)

The smallest geographic segment for the company (6.9% of sales), EMEA continues to be a turnaround story. Segment revenue would have been 3% higher if not for unfavorable changes in currency exchange rates; instead, it fell by 2%. Even so, this was the most profitable quarter for EMEA in the company's history as sales leverage, cost management, and a continued shift toward higher-margin licensed stores combined to expand operating margins by an impressive 520 basis points (bps). Comps for licensed stores continue to come in higher than the segment totals, suggesting the move toward licensed stores is paying off. For the quarter, EMEA licensed-store comps were in the high single digits, with Middle East stores serving up even higher growth in the mid-teens.

China, Asia, Pacific (CAP)

Excluding the impact of the Starbucks Japan acquisition, revenue was up 28% for this segment on the back of strong comps and 767 net new store openings in the past 12 months. This marks the 18th straight quarter in which revenue growth has met or exceeded 28%. As expected, the acquisition had a sizable, negative impact on CAP operating margins (a whopping (1,050) bps impact, to be specific), but this is simply a reflection of the change in accounting treatment for the division, not operational performance. Excluding the impact of the change in ownership structure, operating margins for Starbucks Japan actually increased by 200 bps and continue to be some of the highest in the company's portfolio. China continues to be one of the main drivers of Starbucks's growth; the company opened its 1,500th store in China last month and is targeting 3,400 by fiscal 2019.

Consumer Product Goods (CPG)

Overall revenue growth for the CPG division came in at 10 percent. Starbucks is now No. 1 in the business for coffee K-Cups; close to 100 million of them were shipped this past December, a 20% year-over-year increase. CPG currently accounts for 9.2% of sales, and management believes it can increase segment sales by 60% over the next five years. Currently, this division enables Starbucks to reach consumers in more than 1 million places that *aren't* retail stores. This is important because when Americans drink coffee, they do so in a coffee shop only 20% of the time.

Holiday 2014

If you received a Starbucks gift card from someone this past holiday season, you're not alone — in fact, one out of every seven American adults did. The company sold 2.6 million Starbucks cards on Dec. 23 alone! For the quarter, $1.6 billion was loaded on cards in just the U.S. and Canada, a 17%-plus increase over last year. That sure is a lot of lattes.

This will obviously be a boon for the company in the coming quarters as customers begin spending all that money, but the total benefit to Starbucks is far greater than the $1.6 billion already loaded on the cards. Gift cards help drive My Starbucks Rewards membership, and MSR members are far more valuable to the company than their non-member counterparts — in an average year, they visit three times more often and spend three times as much per visit. This past quarter, total MSR membership eclipsed 9 million (a 23% increase) as the company added 900,000 new members. And more than 60% of those 9 million MSR members are gold members, who spend four times as much as non-members!

The eagerly anticipated test results for the company's Mobile Order & Pay service also exceeded management's expectations. The company is now in the process of launching it in more than 600 stores in the Pacific Northwest over the next couple of months and plans a national launch by the end of 2015.

Investing in Employees

Management also announced that Starbucks will be making "the single-largest new investment we have ever made in our partners." The company will be increasing barista and shift supervisor pay rates, creating enhanced recognition programs, offering new food benefits, and investing in technologies to make their employees' lives easier and more productive. This investment will affect more than 135,000 employees here in the U.S., and we believe it's a great move — the customer-employee relationship as a key ingredient in Starbucks' success. True, there are up-front costs, but we're willing to bet that in the long run, happier employees = happier customers = happier shareholders.

Foolish Bottom Line

Starbucks serves up good coffee, great experiences, and ever-increasing variety for passersby and brand loyalists alike. Given its strong competitive position, excellent growth prospects, and a top-notch management team in place, we believe the company is poised to continue brewing returns that make Foolish shareholders very happy.

Pro Catch-Up Trades: Feb. 2, 2015

Published Feb 2, 2015 at 11:00AM

Catch-Up Trades are timely ideas to help you catch up with a Pro *portfolio position you may be lacking, or with trades where price guidance was due for an update.*

- **American Airlines** (NASDAQ: AAL): If you haven't invested 1% in January 2017 $35 calls yet, you can do so today at a lower price, lately around $18.50 each. That price will change as the stock moves.
- **American Tower** (NYSE: AMT): If you haven't invested in these calls yet, you can buy 0.5% in January 2017 $80 calls, lately for around $22. That price will change as the stock moves. We also own 3.7% in the stock, which is rated Buy First.
- **Gentex** (NASDAQ: GNTX): We have a 4.1% allocation total, with 3.1% in stock and 1% in extra stock exposure through short puts. If you haven't matched this allocation yet, you can do so by buying 3.1% in shares to start. (Writing $17.50 puts makes less sense at the moment because you're mostly writing intrinsic value.)

TD Ameritrade Stays the Course

Published Jan 30, 2015 at 1:19PM

Pro's Take: AMTD Q1-2015 Earnings

TD Ameritrade (NYSE: AMTD)

Quarter Quick Take

Overall, TD Ameritrade delivered a strong start to Fiscal 2015-net revenue grew 9% year-over-year and EPS grew 11% year-over-year. This well-managed company benefited from higher trading activity, continued to excel at gathering client assets, and continues to gain market share in its fee-based portion of the business. TD Ameritrade is still very well-positioned for rising interest rates (who knows when that will happen), and they are doing well at managing the parts of the business that are under their control.

President and CEO Fred Tomczyk:

> "We're off to a great start for 2015 as we delivered our best asset-gathering quarter in company history adding $18.8 billion in net new assets, up 30 percent year-over-year. We continue to see strong asset gathering in both the retail and institutional channels. Trading was at strong levels due to market volatility and investors continue to increase their usage of options, futures and mobile technology."

Guidance Update

After incorporating this quarter's results into our model, we've upped our Fair Value estimate to $35 (from $34). This business is poised to earn North Star-like returns from this price, and members lacking a full allocation can feel comfortable initiating or filling out their stake at today's prices.

Updated guidance: Buy First (no change)

Recommended Allocation: 2.8%

Fair Value estimate: $35.00 (up from $34)

The Numbers

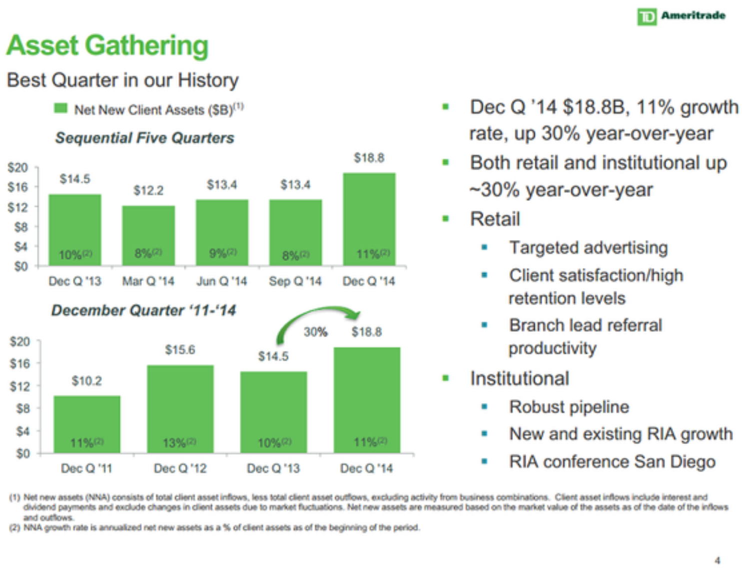
- Record Net Revenues of $819 million (up 9% year-over-year)
  - **Transaction-based**:
    - Funded accounts grew to 6.37 million (up 5.3% Y-o-Y)
    - Trades per funded account of 4.52 (vs. 4.06 last quarter vs. 4.31 a year ago)
    - Average commissions and fees per trade of $12.47 (vs. $12.97 last quarter vs. $12.58 a year ago)
    - Totals up to:
      - 6,370,000 x 4.52 x $12.47 = **$359 million** in transaction-based revenue (up 9.5% Y-o-Y)
  - **Spread-based**:
    - Total spread-based revenue of **$368 million** (up 10% Y-o-Y)
    - Average spread-based balance of $94.5 billion (up 4.7% Y-o-Y)
    - Thus, Net Interest Margin (NIM) =
      - $368 million / $94.5 billion = 0.389% (quarterly)
      - NIM (annualized) = 0.389% x 4 = 1.56% (vs. 1.58% last quarter vs. 1.48% a year ago)
  - **Fee-based**:
    - Fee-based revenue of $83 million (up 15% Y-o-Y)
    - Record average fee-based balance of $151 billion (up 16% Y-o-Y)
    - Thus, Investment Product Fee Yield =

- $83 million / $151 billion = 0.055% (quarterly)
- Investment Product Fee Yield (annualized) = 0.055% x 4 = 0.220% (vs. 0.231% last quarter vs. 0.221% a year ago)
- Record total client assets of $672 billion (up 13% Y-o-Y)
- Record net new assets* of $18.8 billion (11.5% annualized growth rate, up 30% Y-o-Y)
- EPS of $0.39 per share (up 3.2% Y-o-Y)
- Trailing twelve months (TTM) average return on equity (ROE) of 17% (up from 16% a year ago)
- Capital management:
  - Paid $0.15 per share in cash dividends in the quarter (a 1.9% yield on the current share price)
  - Repurchased 3.7 million shares of its common stock at a weighted average share price of $32.39 per share
  - Declared a $0.15 per share quarterly cash dividend (up 25% Y-o-Y), payable on Feb. 18, 2015 to all holders of record of common stock as of Feb. 4, 2015.

*excludes changes in client assets due to market fluctuations

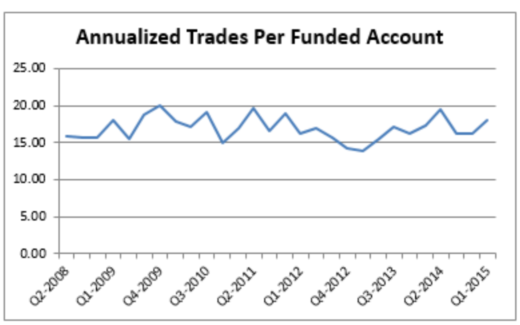
Analysis

The company continues to excel at gathering client assets. The more assets it gathers, the more it stands to benefit when the positive exposure to rising interest rates kicks in:



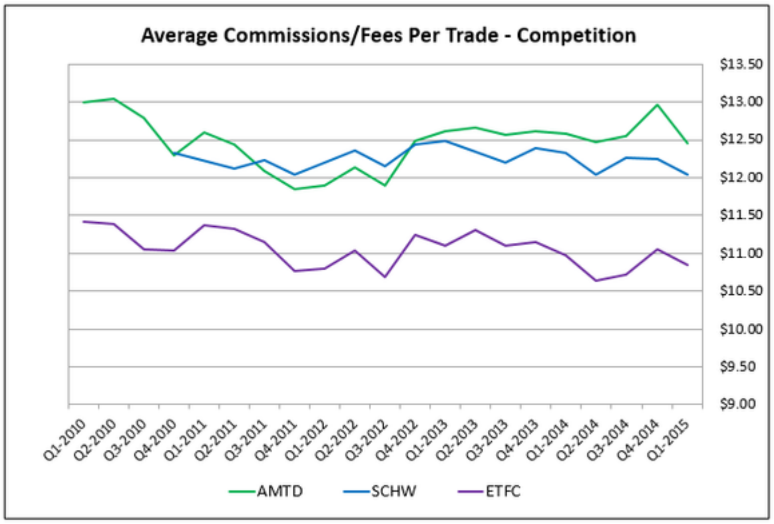
Source: TD Ameritrade December Quarter Earnings Presentation

The company continues to benefit from higher trading activity (posting the second best quarter for trading in company history), with higher-margin derivatives comprising 41% of trades per day, and mobile trades (mobile users are typically higher-activity traders) comprising a record 14% of trades per day (up from 12% a year ago, with daily mobile logins up 32% from last year). Management called out high intra-day volatility in the quarter (29 days where the S&P 500 moved greater than 1%!) as a reason for higher trading activity:



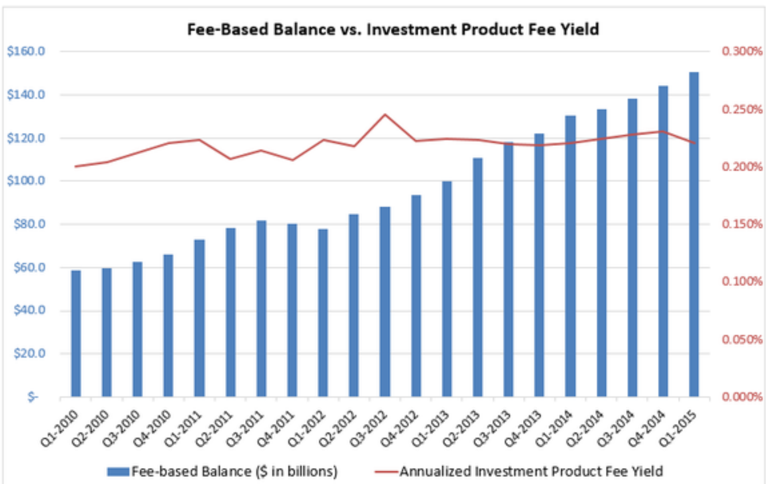
Source: Company filings and analyst calculations.

Average commissions and fees per trade normalized a bit after a strong increase last quarter (to $12.45 per trade from $12.97). Management mentioned that the commission rate was down primarily due to "the mix of derivatives trading as futures, which is a lower revenue per trade product, was a record 9%" (typically 6-7%) of average daily trades (driven by crude oil and the E-mini S&P 500 index). But TD Ameritrade continues to outperform its major discount-broker peers when it comes to pricing, as they've done a good job producing the technology and platforms needed to attract and retain higher-revenue derivatives traders:



Source: Company filings and analyst calculations.

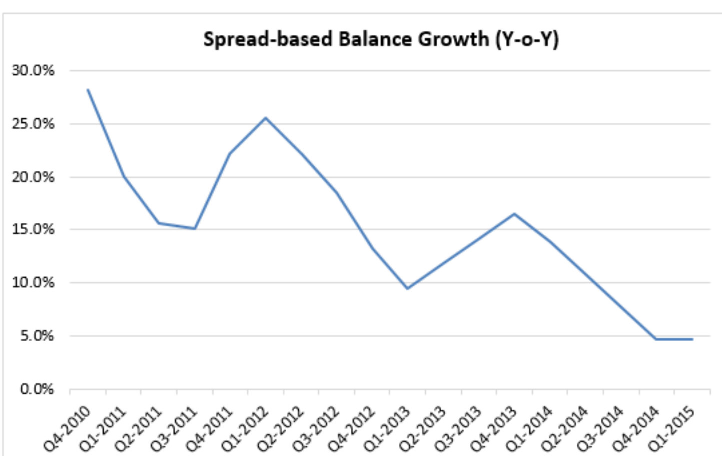
The fee-based segment of the business continues to impress, although revenue growth slowed a bit down to 15% Y-o-Y after 20%+ growth every quarter for the previous 10 quarters. The fee yield also declined a bit, affected likely by incentives and product mix. But management is "very bullish" on this particular part of the business, and it continues to grow rapidly and gain market share. We'll watch to make sure growth trends here stay on track.



Source: Company filings and analyst calculations

As for the spread-based portion of the business, it is very sensitive to changes in interest rates, and it will provide a big boost to profitability if and when interest rates rise. The company has guided that a 100 basis point increase in the Fed Funds Rate will increase annual earnings by $0.38 per share in year 1, $0.44 in year 2, and $0.51 in year 3. Given that trailing-twelve-months EPS was $1.46 per share, that's some pretty healthy upside (26%, 30%, and 35%, respectively).

Given that information, we want to see that spread-based balance continue to grow at a healthy clip. When interest rates eventually do rise, we want TD Ameritrade to have as many interest rate-sensitive assets as possible. After four straight quarters of decelerating growth, the rate of growth stabilized this quarter.



Source: Company filings and analyst calculations

Our valuation assumes slowing growth, so it's not super concerning, but we want to watch this metric over time to make sure it's staying on track.

What We Think Now

TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and when interest rates increase, the company is positioned to grow earnings sharply.

Gentex Misses Guidance but Still Posts a Decent Quarter

Published Jan 30, 2015 at 9:50AM

Pro's Take: GNTX Q4-2014 Earnings

Gentex (NASDAQ: GNTX)

Quarter Quick Take

Despite guiding to 10-15% revenue growth and a 39.5-40% gross profit margin after Q3 results, Gentex disappointed Wall Street with 7% revenue growth and a 38.4% gross profit margin in the fourth quarter. Accordingly, the stock sold off almost 6% the day of the earnings release. Management cited customer end of year inventory adjustments as a notable reason for the sales miss, and higher than expected manufacturing costs contributed 50-100 basis points to the gross profit margin miss.

While missing guidance is never good, when we drill down into results, operations are sound and poised for future growth. Gentex sold 9.4% more interior and exterior mirrors than it did in Q4-2013 (+7.9% in North America and +10.3% internationally). Certain product lines (HomeLink and SmartBeam) are growing faster than the overall corporate growth rate of 7-12%, and show promise for continued strong growth throughout 2015 and beyond. The company has also announced and launched several new products that look to drive growth throughout 2015. Unit growth continues to handily outpace global auto production, which suggests that the core element of our thesis (higher auto-dimming mirror penetration rates) is playing out.

....

Q4-2014

Sales growth: +7.2%

Operating profit margin: -112 bps to 28.1%

EPS growth: -1%

....

Guidance Update

The sales and gross profit miss this quarter seem to be due to temporary issues relating to timing and new product launches. Gentex is historically good at improving manufacturing efficiency, so I'm expecting the cost headwind to mitigate as we move toward the back half of the year. Management guidance for full year 2015 implies 9-10% revenue growth, about in line with our expectations. If the sales and manufacturing issues are indeed temporary, our recently updated $17.50 Fair Value estimate looks reasonable.

Updated guidance: Buy (no change)

Recommended Allocation: 3.1%, with 1% in written puts.

Fair Value estimate: $17.50 (no change)

Pro has a 3.1% allocation to Gentex, with March $17.50 written puts that if exercised will bring us to a 4.1% allocation. If current prices hold, as of today we are leaning toward adding more shares via our puts (in other words, simply letting our puts get exercised), but depending on market conditions, we may decide to roll our puts to a later month and target another credit. If your puts are exercised early (members report some have already been exercised), then we recommend you keep the new shares. That was our original intent and still is. Members lacking a (full) position should feel comfortable purchasing shares today – they're priced to achieve North Star-like returns over the long-run.

Our Thesis

Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1. ***Penetration: Unit growth vs. auto production.*** Over time, we want to see Gentex's auto-dimming mirrors to continue to gain market share. If the company is growing units sold faster than auto production, it is moving in the right direction. Interior mirror unit volumes were up +7.2% and global auto production was actually down about 2% (suggesting continued market penetration). Interior units sold in North America increased +4.7% and international increased +8.8%, for 7.2% interior unit growth overall. Exterior mirror unit volumes grew even faster, up +19% in North America and +14.2% internationally. The exterior mirror attach rate was 38% (i.e. 38% of cars equipped with interior units also were equipped with exterior units), compared to 35% a year ago.
2. ***Pricing and value: Unit growth vs. automotive segment sales.*** Auto makers force annual price concessions on their suppliers and Gentex isn't immune. Price reductions recently are expected to be in the range of 2.5%-3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices and gross margins. When manufacturing costs rise unexpectedly, we can see pressure on gross margins, which is what

happened this quarter. During the quarter, total units (interior + exterior mirrors) increased +9.4% and automotive segment sales were up +6.9%. This dynamic suggests lower ARPU (average revenue per unit) and is consistent with the expectation of annual price concessions.

3. ***Margin performance.*** During the quarter gross margin was 38.4%, down from 39.4% in Q4-2013. For the trailing twelve months, gross margin was 39.2% compared to 36.8% in the year-ago TTM. Management guided to gross margins of about 39% for fiscal year 2015, so as manufacturing efficiency improves, we should see this figure rise a bit. If the company can generate strong unit growth, it may be able to eke out further improvements, but they will be hard to come by. SG&A and R&D expenses are in-line with historical norms, and operating margins followed gross margins lower, coming in at 28.1% vs. 29.3% in Q4-2013.

What We Think Now

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

OpenText Stays on Course

Published Jan 29, 2015 at 2:53PM

OpenText (NASDAQ: OTEX) reported second-quarter 2015 results, and we have the scoop on the *Pro* community boards. The stock remains a "Buy" in *Pro* with a 3.3% allocation.

Pro's 2014 Results in Foolish Detail

Published Jan 26, 2015 at 3:48PM

Dear *Pro* Fools,

Reviewing the details of your investments each year shows where you can improve. You might be surprised to find that you traded more often than you planned, for example, or didn't receive as much dividend income as you thought. Armed with information, you can adjust for the future.

As we wrote recently, *Pro* had a good 2014, with relatively few stock sales. Let's dig into the details.

2014 Redux: $345,000 Appreciation

The *Pro* portfolio started 2014 worth $1,975,000, and was up 17.5% by year's end to $2,320,000. On average, we were 71% net invested over the year, using shorts on market indexes to lower our exposure. Yet our returns were pleasing by most any measure:

Investment	2014	3-Year Annualized Return
Pro	17.5%	22%
North Star	8.5%	8.7%
S&P 500	13.7%	20.4%
MSCI World	2.9%	13.1%

A tailwind for stocks has helped us generate a strong lead over our North Star, but years when stocks are negative will likely lessen this gap. The S&P 500 Total Returns index above assume all dividends reinvested and no fees. Our dividends are added to cash, and our commissions are deducted from results. Of note is how poorly the MSCI World index has performed comparatively; U.S. stocks crushed the world index in 2014, and continue to draw worldwide interest from investors.

Our gains were propelled by the likes of **AmTrust Financial** (NASDAQ: AFSI), up 73%; **Apple** (NASDAQ: AAPL), up 38%; **Facebook** (NASDAQ: FB), 41%; **Medtronic** (NYSE: MDT), 26%; **OpenText** (NASDAQ: OTEX), 28%; **Oracle** (NYSE: ORCL), 18%; **O'Reilly Automotive** (NASDAQ: ORLY), revving 49% higher; **Papa John's** (NASDAQ: PZZA), baking up 24%; and **Skyworks Solutions** (NASDAQ: SWKS), which shot up 41% from our August purchase. Several other gainers and a lack of big losers — **Tupperware** (NYSE: TUP), down 25% on us, was the largest — helped us earn strong results despite maintaining cash, hedges, and shorts. (Please note that these stock returns *exclude* dividends.)

Looking ahead, we continue to think in terms of rolling three-year annualized returns as we assess the potential of our holdings.

Hedges: ($34,673)

Last year, we used direct shorts and options on the **iShares Russell 2000 ETF** (NYSEMKT: IWM) and **SPDR S&P 500 ETF** (NYSEMKT: SPY) to hedge. Keep in mind that hedging allowed us to comfortably stay *more* invested in longs than we otherwise might have — in other words, hedging did help us achieve our returns, while lowering our risk and staying true to our mission.

That said, hedging has a real dollar cost. We booked $34,673 in losses on hedges last year, or about 1.8% of the portfolio's 2014 starting value. That's more of the portfolio than we would like to spend for positions that were typically hedging only 10% to 15% of our exposure. More than half of this loss ($18,985) came in November on $200 puts on SPY that we bought when the index was around $189. The mighty S&P 500 soared above $200 in a few weeks, erasing the entire value of that hedge. That was a case where spending much less to buy $190 or $185 puts would have been a welcome choice. That's hindsight, but I'll think three times before buying deep in-the-money puts to hedge again.

The $34,673 in losses on hedges still helped the portfolio to grow by $345,000 last year, though mostly in unbooked gains. Still, if we hadn't hedged, we might have sold more winners instead, cutting off long-term compounding.

Rolling Calls: ($10,037)

We spent $10,037 last year to roll calls higher, namely on **Intel** (NASDAQ: INTC). It was money well spent, because the stock kept climbing, and we sold at a higher price as a result of rolling. But it's still a notable sum, and a reminder to cover stocks carefully if you're going to. We would have been better off letting Intel be, although its sale resulted in buying Skyworks, which so far has been a great silver lining.

Realized Long-Term Gains and Losses: $96,343 and ($4,369)

We booked $96,343 in realized gains last year, all of it long-term, from four profitable sales. Much of it came from selling half of our Facebook calls (letting the rest turn into the stock position we hold today). We also booked a profit through our covered-call-induced sale of Intel. Pacer was nicely acquired away from us, and we sold our shares of the struggling **Graftech International** (NYSE: GTI). Finally, we sold **StoneMor Partners** (NYSE: STON) for a $4,369 long-term capital loss, *excluding* distributions it paid us. Including the company's 9% annual distribution, we earned a North Star-challenging return.

Dividends: $25,387

We received $25,387 in dividends last year, adding to our cash. That added 1.3% to our 2014 return, or just 7.4% of the year's total gain. Our largest absolute payers included **The Buckle** (NYSE: BKE), AmTrust, Tupperware, **Broadridge Financial** (NYSE: BR), and **Wells Fargo** (NYSE: WFC). Offsetting this income a bit, we *paid* a $513 dividend for being short shares of the iShares Russell 2000 ETF.

Option Income: $7,581

Implied volatility was low during most of 2014, resulting in modest option premiums. We saw few worth writing, so we mainly focused on new stock recommendations and making sure we wanted to keep our other holdings. We earned just $7,581 in option-writing income last year, adding 0.4% to the portfolio. Still, that effectively brought our "income yield" (including dividends) to nearly 1.7% on the whole portfolio value last year, while we were only about 71% net long. We are hoping to target considerably more option income this year.

Sitting Still: Priceless

We issued 34 trade alerts in *Pro* last year, or nearly three per month (that would explain a lot to my wife!). Still, it was one of our quietest years — we issued 42 trade alerts in 2013, and 55 in 2012. But 34 is still plenty of activity. The key is that we don't sacrifice returns for activity.

We want to keep stock turnover low, and we did a better job last year than in some earlier years, when team turnover helped drive more stock turnover. Much of last year's activity was related to options and hedges. So what we did that created the most value last year (other than some new buys) was decide to leave most of our stocks alone, whatever storms appeared to brew around some of them. Having a three-year minimum outlook helps. Sitting still will look very expensive some years, but over our time frame, it's necessary for compounding.

Building Further: Also Valuable

With 2015 under way, we're focused on more of the same (if something works for decades, keep doing it!). We're seeking more shorts, we want to maintain steady hedges (but at lower costs than last year), we always make sure we like our current positions and allocations, and we're looking at new buys and options for income and more. If you have questions about our returns or anything else, please visit the Memo Musings board.

I know many of you customize your Foolish portfolio. Look over your results last year to see what you did well and what can be improved. Thank you for being a *Pro* Fool with us! Fool on!

— Jeff (TMFFischer)

Pro Completed Trades

- **American Airlines** (NYSE: AAL): We bought ("buy to open") 10 January 2017 $35 call options, setting up a 1% allocation in absolute terms. See our transaction list (it may take 24 hours to appear there). Our order filled at $24.55.

Pro Catch-Up Trades

- **Gentex** (Nasdaq: GNTX): We're ready to accept a lower price to sell to open March 2015 $17.50 puts, if need be. As posted, we'll accept as low as $0.65-$0.60 now to get the trade done, and advise the same to members.

Buy Calls on American Airlines Group

Published Jan 23, 2015 at 1:52PM

Is this for you? *Pro* is targeting long-term upside by buying LEAPS, seeking leveraged returns if the stock appreciates by 2017. All members lacking any exposure to this industry or company could do the same.

How You Participate

- **Action:** Buy ("buy to open") January 2017 $35 calls on **American Airlines Group** (NASDAQ: AAL). (As a reminder, these calls will move up or down with the stock, and they give you the right to buy the shares for $35 any time before expiration if you so choose. We don't plan to. Need a refresher on when and why we buy calls? Click here.)
- **Allocation:** Invest approximately 1% of your *Pro* funds in the call premium. At recent prices, this most closely equates to buying one call for about every $237,500 you manage; for *Pro*, that's about 10 contracts. This is a small position by design, so be careful not to over-allocate. *Pro* members with smaller portfolios should see the Alternative Trades section below.
- **Price Guidance:** To split the wide bid/ask, **use a limit order**. At current prices, ideally you would pay $23.75 or less per contract — but if the stock price rises, you'll need to pay more.
- **Recent Option Price (bid/ask):** $23/$24.50 (split: $23.75)
- **Recent Share Price:** $55
- **Timing Note:** American Airlines reports earnings the morning of Tuesday, Jan. 27. We will likely buy our calls before then simply because our decision has been made. We expect upbeat guidance for 2015, but we know a stock can do anything immediately after earnings. If you prefer to wait until after Tuesday, please do. We're eyeing 2017 with this anyway.

What We're Thinking

It's still a tough business, but the airline industry has changed considerably in recent years. Steady consolidation means the four largest U.S. airlines now control roughly 90% of the nation's flights, down from a dozen airlines in that position last decade. This concentrated power supports rational ticket prices, because multiple competitors aren't swooping in with empty seats and dreams of market share. Indeed, as the industry benefits from much lower fuel costs, there has been no indication that leading airlines intend to lower fares in response. Demand should drive fare prices, and demand is healthy. At the same time, airlines today are better at limiting supply than in years past. Finally, most major airlines hedged some of their 2015 fuel costs, so they won't fully benefit from cheaper fuel.

The company we're buying calls on — American Airlines Group — is the only major airline that has *not* hedged its 2015 fuel costs, so it's positioned to enjoy the full benefit of lower prices. Fuel and related taxes are American Airline's largest operating cost, at 25% of recent revenue. With the price of jet fuel cut in half since last summer, savings in the industry — and for American alone — should amount to several billion dollars this year. In American's case, if fuel prices remain near current levels, 2015 fuel savings could exceed $5 billion. That's greater than the company's $4.3 billion in operating income the past 12 months.

Although investors dread the potential for fare wars, it appears that airlines are planning to use increased cash flow to pay down debt and reward shareholders, rather than pass savings onto customers. After all, fares are already low in historical terms. Yesterday, the leading discounter and one of the nation's four largest carriers, **Southwest Airlines** (NYSE: LUV), suggested in its guidance that it will hold fares steady, and **Alaska Airlines** (NYSE: ALK) flatly said "no," it won't lower prices in response to lower fuel costs.

The world's largest carrier, American Airlines entered bankruptcy in 2011, and merged with U.S. Airlines in 2013 after emerging from Chapter 11. Being leery of airline stocks is sensible. I am. (I never believed I would invest in an airline — ever.) But having flexible thoughts has merit. The recently consolidated industry knows it needs to run profitably, and the airlines have become smarter operators. They're filling seats at sensible revenue per mile, keeping capacity in line, charging for everything from baggage to food, and keeping costs in control. Plus, Southwest Airlines has shown steady profits are possible, with a 41-year profit streak.

American Airlines expects to have the industry's leading profit margins as it completes its consolidation with US Airways. The business could earn around $10 per share this year, and close to that again in 2016 (it should start to pay around a 25% tax rate that year, having burned off its past losses). Those results would put the stock at around 6 times 2016 earnings. If Wall Street's skepticism relaxes, shares could enjoy an earnings multiple closer to 10, giving flight to healthy appreciation.

How It Fits Into *Pro*

Many things need to go right for us to enjoy a higher altitude, so we're keeping our risk fairly modest at 1% of our capital. Perhaps foremost, if oil prices rebound too much, enthusiasm will likely wane for airline stocks, and earnings may disappoint. Second, American still needs to finish integrating US Airways and serve its sprawling customer base profitably. Airlines are incredibly expensive to run. Southwest aside, history shows how difficult it is to maintain profits. Finally, airlines are sensitive to the economy. Greater job creation helps sell more tickets, but another economic slowdown would likely hit hard.

The *Pro* portfolio has benefited handsomely from a lack of energy investments. We've sailed through a time when most energy stocks fell. Today, we can afford to add a small stake in a riskier (though cheap-looking) business that may benefit from the new energy landscape. At the worst, we'll lose 1% if American Airlines declines below $35 by expiration. Our stake in call options, as opposed to buying stock, lets us control 100 shares for about $2,375 rather than $5,500. Here's how returns at expiration could stack up from a starting price of $23.75 for the calls versus $55 for the stock:

American Airlines Share Price	Call Gain (Loss) on $2,375 Invested	Call % Return	Stock Gain (Loss) on $5,500 Invested	Stock % Return
$30	($2375)	(100%)	($2500)	(45%)
$35	($2375)(max loss)	(100%)	($2000)	(36%)
$40	($1875)	(79%)	($1500)	(27%)
$45	($1375)	(58%	($1000)	(18%)
$50	($875)	(37%)	($500)	(9%)
$55	($375)	(16%)	$0	0%
$60	$125	5%	$500	9%
$65	$625	26%	$1000	18%
$70	$1125	47%	$1500	27%
$75	$1625	68%	$2000	36%
$80	$2125	89%	$2500	45%
$85	$2625	111%	$3000	55%
$90	$3125	132%	$3500	64%

More That Matters

- **Maximum loss:** Our entire 1% investment if the stock is less than $35 at expiration.
- **Maximum gain:** Unlimited as the shares ascend.
- **Breakeven:** Around $58.75 on the stock at expiration.
- **Follow-up:** We may write calls on our long calls, turning it into a diagonal call income position, or a bull call spread, but we hope to see appreciation first. If our thesis plays out early or is failing, we may simply sell to close our calls. We don't foresee taking shares or having a long-term relationship beyond a few years, but that could change.

Buying calls, we don't view American Airlines as a core, long-term holding. We may write diagonal calls on our calls for income, or sell outright if our thesis plays out or falls into danger. Bottom line: We aren't ready to call an airline business a compounding machine that we want to own for years on end. That still seems far-fetched. But as the industry looks to stay rational on pricing and restrain seat supply, profits the next few years should draw the attention of more investors, lifting valuations on leading airline stocks. At the same time, persistently low fuel costs represent a giant potential tailwind. Wheels up!

Alternative Trades

Members for whom one contract would over-allocate their portfolios can consider the following:

- Buy 0.5% to 1% in stock if you'd rather not buy 1% in calls. You won't get the benefit of leverage, but you get the dividend, voting rights, and can go on owning shares as long as you like.

Pro Can Help

- Tell us we're crazy — er, we mean, ask us questions — on the American Airlines Group board. Seat belts on? We're ready for departure (in more ways than one).

Write Puts on Gentex

Published Jan 21, 2015 at 1:51PM

Is this for you? Since we're looking to add 1% to our stake in this company, this alert should be applicable (now or perhaps later) to all *Pro* members, whether you already own shares of **Gentex** (NASDAQ: GNTX) or not.

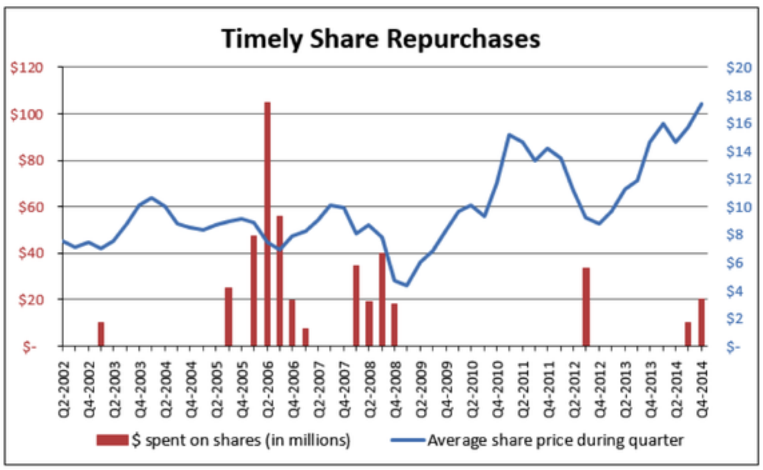
How You Participate

- **Trade:** Sell to open March 2015 $17.50 puts.
- **Allocation:** 1% — write one put for every $166,000 you manage; *Pro* will write 14 contracts. In addition to our current 3.3% stock holding, this would bring our total allocation to 4.3%. If you're devoting less than $166,000 to *Pro*, see our Alternative Trades at the end.
- **Price Guidance Now:** Use a limit order of $0.85 or higher to start (for a 4.8% yield in 58 days.)
  - **Later:** Gentex reports Q4 2014 earnings on the morning of Jan. 28. After investors' uncertainty about the earnings report has passed, we expect the yield on these puts (at least measured by time value) to decline significantly . So we suggest you write this put before Jan. 28 and target $0.70 (at the very least) for each put, a 4% yield. You will not likely be able to achieve this price after the earnings report (unless the stock falls).
- **Prices (1/21/15):** Stock, $17.50; options, $0.75 bid / $0.95 ask. Guidance: $0.85. Current prices.

What We're Thinking

Back in October, Gentex reported an excellent third quarter (scroll down to see the Gentex section). The company, which primarily sells advanced automotive mirror systems, turned 22% net revenue growth into 29% earnings-per-share growth, and management expects another strong report in the fourth quarter. Despite a forecast of declining auto production, management expects organic sales growth of 10% to 15%, suggesting strong market-share gains.

Additionally, over the past several months, management has sent us a strong signal that they believe shares are undervalued by buying them back: $10 million worth at an average split-adjusted price of $14.22 in the quarter ended Sept. 30, and $20 million worth at an average split-adjusted price of $18.28 in the current quarter. In the past, Gentex has displayed excellent capital allocation skills with its share buybacks, buying at prices corresponding to local lows in the stock price ...



... so when management buys back stock, we pay attention.

Additionally, after spending time analyzing last quarter's results, researching updated auto production forecasts, and incorporating management's forward guidance into our valuation model, we've **upped our fair-value estimate** from $16.50 to $17.50 per share. All of these factors played into our decision to recommend this written put, as we will be happy with either potential outcome: earning at least a 4%-4.8% yield on capital at risk in just less than two months, or accepting shares at March expiration at an effective buy price of (ideally) $16.65 per share or lower.

How It Fits Into *Pro*

Pro's exposure to the automotive industry is about 7.3% of our overall portfolio, via Gentex and **O'Reilly Automotive** (NASDAQ: ORLY). We're comfortable with the possibility of more exposure to this industry, but are mindful of our current positions. We are opting to generate income with written puts rather than purchasing more shares directly because we'd like to achieve a lower net purchase price (and thus a higher margin of safety) should we end up taking more shares.

Should these puts remain at-the-money (as they currently are) at March expiration, meaning the stock price remains at or less than our $17.50 strike price, we would get shares at about 4.8% less than our estimate of their worth and 8% less than what the notoriously stringent Gentex paid in its most recent round of buybacks. If we are assigned at expiration, we'll end up increasing our allocation in this well-managed compounder from a relatively small 3.3% to a more meaningful 4.3%, although we may roll our puts to avoid taking shares if we decide that is the proper course of action. We believe in management's acumen and capital allocation skills, the company's dominant competitive niche and strong financial position, and recent positive trends in the cyclical auto industry. So we are ready to own more Gentex close to today's prices.

More That Matters

- **Maximum loss:** Our risk is the same as share ownership starting around $16.65, or 4.8% less than the recent price and 15.7 times this year's earnings estimate.
- **Maximum gain:** On this put write alone, our maximum gain is the put premium. At a minimum of $0.70 (but again, use a limit of $0.85 to start!), that's a 4% yield in 58 days, or about 25% annualized.
- **Follow-up:** We'll buy shares at a net $16.65 if the stock is below our $17.50 strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire as income, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 3.3% allocation first — Gentex's shares are a Buy. Then you can consider writing these puts for income or to add more shares. If one put exceeds 1% of your portfolio, then just buy 1% in stock directly *if and when Pro* does so through these puts.
- **Write other puts?** Consider writing February 2015 $17.50 puts if the price on those options holds up better than March after this alert is issued. You could also consider writing June 2015 $17.50 instead, for at least $1.25, or a 7.1% yield in less than five months.

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Check your mirrors and switch lanes over to the Gentex discussion board.

Can You Really Have Too Much Cash?

Published Jan 20, 2015 at 1:55PM

Fellow Fools,

Investors frequently underestimate the effectiveness of cash as a hedge. The more cash you have, the less a market decline will affect your portfolio, and when fear (or outright panic) dislodges prices from reality, you're that much more equipped to take advantage. Cash is also easy to use and very cost-effective. In fact, James Montier, a member of GMO's asset allocation team and a prior co-head of global strategy at Société Générale, found that using cash as a hedge was preferable to tail-risk hedging (hedging for extreme market movements like we saw during 2008) from 2005 through 2011. A 75% equity, 25% cash portfolio soundly outperformed tail-risk hedging over this time period, and it also reduced the maximum drawdown (the difference between peak and trough portfolio values) compared with a portfolio that was 100% in equities.

What a Drag

So more cash = better, right? Not necessarily; believe it or not, holding too much cash can be a bad thing. As you know, equities have historically outperformed cash. This means that if your portfolio is too heavily weighted in cash, that weight will drag down your overall returns. This is what professionals have so intuitively decided to call "cash drag."

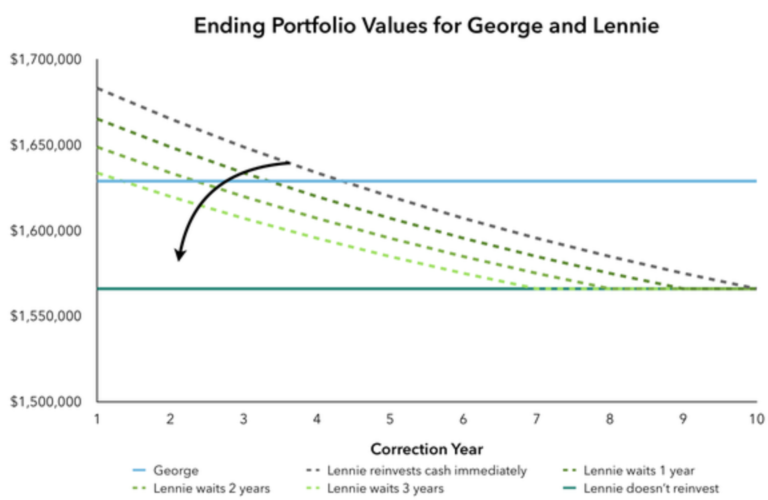
To better illustrate, let's work through an example. Imagine we have two investors, George and Lennie. In this hypothetical scenario, both investors have:

- Equity portfolios worth $1 million
- No plans to contribute additional funds
- Ten-year investment horizons
- The same equity returns each year

The big difference between the two is that at the beginning of our example, Lennie decides to sell some of his stocks to raise cash, fearing that a correction is right around the corner. He sells 10% of his equity portfolio, or $100,000. For the sake of this discussion, we'll define a correction as an annual return of -25%. In any year that *doesn't* feature a correction, we'll assume both investors achieve 9% returns on their equity investments. It's also important to realize that we're dealing with just their equity portfolios, so Lennie's additional $100,000 can be seen as a tactical investment decision — it's above and beyond the cash he already has, and it's independent of his liquidity requirements.

Now let's assume Lennie nails his prediction. By the end of the first year, George's portfolio is worth $750,000 while Lennie's is worth $775,000 ($675,000 ending equity value + $100,000 in cash). So Lennie is better off in year one. But remember, we're dealing with a 10-year investment horizon, so there's still nine more years to go.

If Lennie's ability to call the bottom is just as good as his ability to call the top, it won't be a fair fight. Lennie will easily outperform George. But who will come out ahead after 10 years is not set in stone. The following chart illustrates the range of potential outcomes for George and Lennie depending on when the correction comes (X-axis) and when Lennie decides to reinvest his spare cash (various green lines).



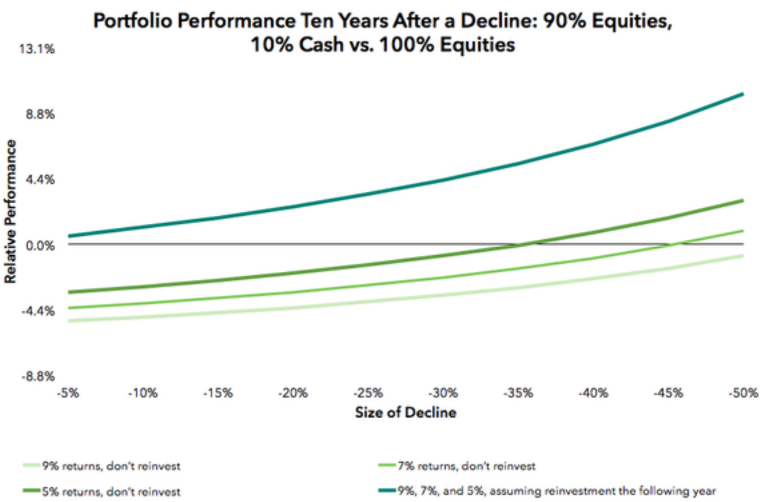
A couple of takeaways from this chart:

- The length of time it takes for the correction to come and Lennie's ability to take advantage of the decline are negatively related. This can be seen as you work from left to right on the chart. By year five, George's static portfolio is destined to outperform Lennie's, regardless of how quickly Lennie reinvests his cash.
- The longer Lennie waits to reinvest the $100,000, the more his returns will start to mimic the performance of a portfolio that doesn't reinvest the cash. This is indicated by the dashed lines' shift toward the solid "*Pro* green" line. Unfortunately, a large percentage of individual investors did something similar after the finical crisis, waiting to reinvest until they were sure it was "safe" to start investing in equities again. In real life, though, the outcome is often worse because markets tend to rebound sharply after a big drawdown (e.g., the S&P rebounded by more than 65% in 2009 after bottoming out in March) and most investors sell closer to the bottom than the top.

- If Lennie decides after the correction to just keep the $100,000 in cash because he likes how it reduces the volatility of his portfolio, then he must also accept that it will act as a drag on his returns over time (the difference between the two solid lines).

But Wait, There's More

The following chart may look complicated at first glance, but it's not so bad. It simply shows the ending value of a portfolio that started out 90% in equities and 10% in cash, divided by the ending value of a portfolio that started out 100% in equities, 10 years after a market decline. The x-axis shows the relative performance for declines of various size, and the y-axis indicates which portfolio outperformed – a positive value indicates that the 10% cash portfolio outperformed; a negative value indicates the opposite, meaning an investor would have been better off 10 years later if they just remained 100% in equities.



Some takeaways from this chart:

- The lower the equity returns, the greater the benefit of holding cash (e.g., it's harder for subsequent returns to overcome what was lost during the market decline).
- The larger the correction, the greater the benefits of holding cash.
- After a decline, the optimal decision is to put the cash to work, regardless of the size of the market drawdown and future equity returns.

Remember Why That Cash Is There

If you read all the way to the end of this Memo in hopes that I'd tell you exactly how much you need to keep in cash, I'm afraid you're going to be disappointed. Mimicking *Pro* is a great place to start (12.6% in cash ex-shorts), but your optimal allocation will likely differ based on your individual preferences and constraints. What I *do* hope you take away from this memo is this: The benefit you can derive from tactically increasing your cash position depends on a variety of factors. Perhaps the most important determinant is what you do with your cash when the opportunity arises. If you want to get the most out of your dollars, you need to put them to work at some point.

Foolishly yours,

– JP (TMFYossarian)

Pro Guidance Changes

- **Papa John's International** (NASDAQ: PZZA): We're moving the pizza purveyor to Hold (down from Buy) pending our review of its new valuation. Shares are up nearly 50% since we last moved them to Buy several months ago. (Incidentally, the company is expected to report earnings around Feb. 24.)
- **Skyworks Solutions** (NASDAQ: SWKS): The stock is up 45% since we recommended it last summer. Today, it's moving to Buy from Buy First on price.
- **Tupperware** (NYSE: TUP): Although shares still appear inexpensive, the stock is moving down to Buy from Buy First because of increasing uncertainty in many of its international markets, including Russia, China and South America.
- With these changes, see all *Pro*'s current Buy Firsts and ratings on the Recommendations page.

Pro Guidance Changes: Jan. 20, 2015

Published Jan 20, 2015 at 1:52PM

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Correlations Redux

Published Jan 12, 2015 at 1:16PM

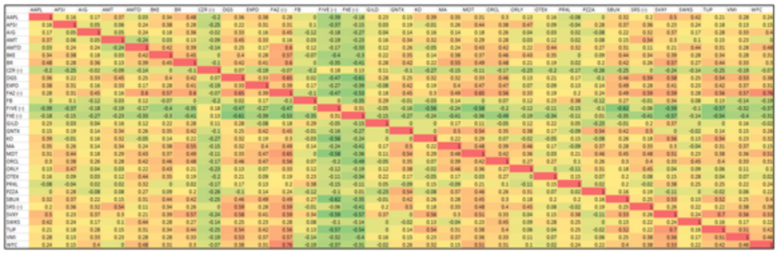
Dear *Pro* Fools,

A few weeks ago, Jeff started a discussion on the boards about removing the "Consider Adding More" (CAM) price from our Recommendations page and ceasing its use within *Pro*. As a team, and with the help of member input, we have in fact decided to get rid of CAM, and you can expect to see us phase it out in the coming days. In that same thread, Jeff also asked members what they'd like to see as a replacement for CAM on the recs page. We received several great ideas that we're still actively discussing, and when we've decided on a functional, useful alternate data point, we'll update the recs page to reflect that.

Some member suggestions we received centered around the correlations between stocks in our portfolio (and, more broadly, around risk measures in general). This reminded me of the Memo written by former *Pro* analyst Nick Crow back in 2012 in which he discussed the *Pro* portfolio's correlations for every position we held then. In that spirit, I decided to rerun the analysis and recreate the correlation matrix for *Pro*'s current holdings. It's my hope that this Memo will be useful not only to those members who were already interested, but to those who've never considered our correlation before. Do be sure to reread Nick's Memo for background information on how to interpret the correlation matrix.

Pro's Correlation Matrix

The graphic below shows all the possible correlations between each pair of stocks (pairwise correlations) for our portfolio. Note that — unlike in Nick's original matrix — I decided to include our shorts and companies on which we only hold options positions. A (-) in the header indicates that we are short that security. I did exclude our SPY hedge; since it's a derivative position, price correlations are meaningless because the profit/loss curve is not linear (i.e., correlations change depending on what price we're talking about). (Click to make the table larger.)



Source: Portfolio Lab Pro and analyst calculations. Correlations are based on monthly price movements.

As we can see from their green shading, our direct shorts (**Caesars Entertainment** (NASDAQ: CZR) and **Five Below** (NASDAQ: FIVE)) are negatively correlated with most of the rest of the portfolio, offering us diversification benefits. Our shorts zig when the rest of our portfolio zags, and it is partially for this reason that we are intent on continuing to build out a direct short "sleeve."

There are other interesting insights to be found here, too. As the lead analyst on both of these positions, I wasn't surprised to note that **American Tower** (NYSE: AMT) and **TD Ameritrade** (NYSE: AMTD) are negatively correlated. A savvy investor might expect this to be the case — American Tower is a REIT, and the REIT sector generally declines when interest rates are expected to go up (because REITs' debt therefore costs more). Conversely, TD Ameritrade would be expected to increase in value when interest rates rise, thanks to the interest rate sensitivity of its spread-based revenue.

Another intriguing insight is that among our core long positions, the three with the lowest correlations to the rest of the portfolio are Facebook, Gilead, and Parexel (in that order). And the three positions with the highest correlations are Medtronic, Broadridge, and Oracle (also in that order).

Index Correlations

Along with determining the correlations of our positions to each other, we can also calculate the correlation of our overall portfolio to various indexes. This analysis includes only our long positions, and excludes shorts and options.

Index	Correlation to Portfolio
Dow Jones U.S. Consumer Services Index	0.91
Russell 1000 Growth Index TR	0.89
Russell 3000 Index TR	0.87
S&P 500 Index TR	0.86
Dow Jones U.S. Industrials Index	0.83
S&P 400 MidCap Index	0.82
MSCI All Country World Index TR	0.8
Dow Jones U.S. Technology Index	0.79
Russell 1000 Value Index TR	0.78
Dow Jones U.S. Consumer Goods Index	0.78
Dow Jones U.S. Health Care Index	0.77
Dow Jones U.S. Financials Index	0.77
Russell 2000 Growth Index TR	0.71
Russell 2000 Index TR	0.71
S&P 600 SmallCap Index	0.69
MSCI EAFE Index TR	0.68
Russell 2000 Value Index TR	0.68
MSCI Eurozone Index TR	0.67
Dow Jones U.S. Basic Materials Index	0.66
MSCI Emerging markets Index TR	0.56
Euro currency	0.52
Dow Jones Composite REIT Index TR	0.46
Barclays US 1-3 Year Treasury Bond Index	0.43
MSCI Japan Index TR	0.33
Dow Jones-UBS Commodity Index	0.27
Dow Jones U.S. Oil & Gas Index	0.26
Gold spot	0.24
Dow Jones U.S. Utilities Index	0.24
Barclays US Aggregate Bond Index	0.22
Barclays US 7-10 Year Treasury Bond Index	0.16
Dow Jones U.S. Telecommunications Index	0.11
MSCI China A Index TR	0
Barclays US 20+ Year Treasury Bond Index	-0.08
Japanese Yen	-0.22
Dollar Index	-0.46

Source: Portfolio Lab Pro. Correlations are based on monthly price movements.

Perhaps unsurprisingly thanks to our heavy exposure to tech and financials, we are most highly correlated to the Dow Jones U.S. Consumer Services Index. We are also more highly correlated to the Russell 1000 Growth Index than we are to the S&P 500 index (but only slightly so), primarily because of our focus on growth companies and the fact that we own a higher proportion of mid- and small-caps than the S&P 500 index. This index correlation table may be useful to us (or to enterprising *Pro* members!) as we contemplate future hedges.

The *Pro* Bottom Line

The conclusion from Nick's 2012 Memo is still completely applicable today. So rather than restate it, I'll reproduce it here in full (with a slight edit in brackets to account for our SPY hedge):

> "Fortunately, we follow a flexible, absolute-return investing strategy that allows shorts and options. Our portfolio is well diversified, and our current S&P 500 [put ratio hedge] offers significant negative correlation to our holdings [once the index falls below a certain level], further reducing overall riskiness. Moreover, as options investors, we build strategies with non-normal return profiles — in plain English, we hedge and collect premiums in exchange for the obligation to sell shares higher or buy shares cheaper. That means we can manage our risk *and* profit through a wide range of outcomes."

While some of the names of the companies have changed, and the correlation table looks a bit different than it did in 2012, our underlying philosophy and our goals are the same. We continue to aim for North-Star beating returns over every rolling three-year period, and correlation and diversification are important parts of achieving that goal.

To discuss this Memo or ask questions, please post on the Memo Musings board. And keep an eye out for a future Memo with more risk measures such as beta, Sharpe ratio, and style categorizations.

Fool on!

— Billy (TMFTailwind)

Pro Live Chat, January 2015

Published Jan 12, 2015 at 10:02AM

Members joined the *Pro* team at 2 p.m. Wednesday, Jan. 28, for our first live chat of 2015. If you missed the chat or just want to read it again, the transcript is below!

A plain-text version of the transcript appears below in reverse chronological order.

Jeff (TMFFischer)

Indeed, Billy. Fool on!

JP Bennett

thanks for spending the afternoon with us, everyone! Hope to see most of you in person at FoolFest and during next month's chat!

Jeff (TMFFischer)

(Big movers first, usually.)

Billy Kipersztok

Thanks for joining us - Fool on! Now back to earnings :)

Jeff (TMFFischer)

We'll see you on the boards. I'm going through earnings with an initial focus on OTEX, TUP, SWKS...

TMFKabellen

Thank you so much for joining us! Jeff is right, it always goes by so fast. If you've got questions before our next monthly chat, of course, please bring them to the boards! Pleasure spending time with you all today. :) -Ellen

Jeff (TMFFischer)

Thank you all for being here today! This is always the quickest hour of the week/month. It flies by! We look forward to seeing you next month in both the Options and Pro live chats. Hope you enjoy the time before then...

Comment From Ray

How are your insights on BBT , mid regional banks?

Billy Kipersztok:

I've looked at a few regional banks (for example M&T). But I haven't looked at BB&T. For regional banks, I want to see a strong underwriting culture and excellent credit performance, disciplined management / capital allocation, and I'd also want to get a sense what types of loans are on their books to see whether there is undue risk (concentration in a specific industry, for example).

Banks that fit those criteria, have 10 % ROE's and trade at a low P/B multiple might interest me.

-Billy

Comment From Karen (KBecks)

Here's to a wonderful 2015, Pro members and team! Great chat today. Thank you for this forum!

Comment From IDavid

I'll be at Foolfest.

TMFKabellen:

Yay! Don't be a stranger. I know Lon will be there and some of our other superFools ...

Comment From jagilford

Hi all, I'm new to pro and have a question about taxes when selling old stocks to free up cash. Should that be a consideration when deciding to sell a stock that has done extremely well? I'm nervous to sell it as I've had it many years and it has gone way up.

Jeff (TMFFischer):

@jasilford, I'd say definitely. I dislike selling and paying taxes, of course, if you can avoid it. You need to like the new places for your money more than enough to compensate for the tax bill. With Pro, we try to walk a balance between caring and not, because about 40% of members invest via an IRA. But at any rate, do take taxes into mind -- they're a real part of managing your taxable account. But don't sit in poor stocks just to avoid a tax bill. Love what you own (in an objective way). :)

Comment From Scott

last post

TMFKabellen:

Nice try

Comment From bru5ce

An hour has gone by already? Wow! Thanks, folks, for everything you do!

TMFKabellen

OK, gents, answer the questions you're working on now and then I'm afraid we'll have to shut this down.

(Anyone here coming to FoolFest, by the way?)

Comment From Scott

Much thanks to Jeff, Billy, JP, and Ellen....I'm glad to have made the decision to Join PRO late in 2013 and to gain from your experience throughout 2014. I'm already recommending to my other MBA buddies your approach and perhaps I can persuade some to join

TMFKabellen:

That's so great to hear! Thank you :)

Comment From terrapin

Jeff, if yu get an idea from Jim for MSFT, do I just have to wait to see if a recommendation comes out? I'm against MSFT, but I like their Surface laptop surprisingly well.

Jeff (TMFFischer):

@terrapin: I'd probably say to Jim, "You run with that one," because he knows MSFT better than I do. If he wanted to do something with it, yup, it would come out as a MF Options trade alert.

Comment From RTichy

What else would be considered a "core" position for people just starting?

Billy Kipersztok:

Hi RTichy -

Of course any of our Buy Firsts, and virtually all of our Buys (with the exception of DGS and SVXY, and perhaps AIG) can be considered "core" holdings.

-Billy

TMFKabellen

Twoooooooooooo miiiiiiiiiiiiiiiiiiiiiiiiiiiinutes!

Comment From Ray

Are you still long on wear able tech stocks?

Jeff (TMFFischer):

@Ray: In that we own Apple and Skyworks, yes. But we're really just long on personal computing. Who knows if wearable will REALLY take off. That remains to be seen, even if it seems logical and likely. With these companies, we should earn returns either way.

Comment From silverFox

I'm new to Pro, but I thought I saw SWKS as Buy First and now is is Buy. Was it "downgraded"? If so when and why?

TMFKabellen:

silverFox, yes, it was -- see "Pro Guidance Changes" at the bottom of this Memo for details. We always report guidance changes in the next Memo after they happen. http://newsletters.fool.com...-E

Comment From phox

Dear Pros, I'm fully allocated in MA but don't have any shares in my IRA partition. I like American Express better from a consumer stand point and I like to own companies that I like. Would AXP, at its current price, be a reasonable proxy?

Jeff (TMFFischer):

@phox: Greetings! They're very different businesses (AXP takes on consumer debt), but I own both, so that makes it easier to say, yes, you could IMO spread your dollars into both. I respect AXP a lot, too. They are facing more competition from high-end Visa and MasterCard cards, and digital money requires investment to stay at the forefront, but I think they'll continue to do well over the long haul right now. And the valuation is lower.

Comment From VelobiciOptions

Good to you and the whole team. Congratulations on a wonderful year as shown in the 2014 report. Pro is doing very well indeed. Among the best in returns AND doing it year over year, which is very rare!

JP Bennett:

Thanks, Velobici! And thank you for your contributions to our boards!

Comment From BandCJ55

The pause by scrolling up slightly works on Chrome as well. It moves rapidly when you start moving down.

TMFKabellen:

Verified here, too (in Chrome) -- thank you!

Comment From Scott

How does the PRO team feel about the upcoming GILD earnings? Any concerns for a stock correction in the near term?

Jeff (TMFFischer):

@Scott: Another fun one! I think results should be decent given Harvoni's strength out of the gate. But guidance will tell the tale, and until we see how the new PBM relationships are shaping up, no point trying to guess. But I like the valuation of the business vs. reasonable expectations, so I'm glad to own it going forward.

TMFKabellen

Five-minute warning, Fools! Get your questions in now ...

Comment From devinder

are Skywork solution and Invensense similar businesses

Jeff (TMFFischer):

@devinder: Not really. Only in that they make small components for computing devices. But SWKS is much more diversified and has strong margins and cash flow.

Comment From terrapin

With a fairly vlatile stock, i.e., GoPro, but even Google as well, does it make sense to assume you can go in an out of Options as it varies?

JP Bennett:

We're not traders, so we don't recommend trying to jump in and out of stocks just to make a quick buck or two.

Comment From JSPColorado

You can effectively "pause" just by scrolling slightly up from the most recent message. Then scroll down slowly. On Safari, at least, that works to pause the feed.

Comment From Old Hippie Nerd

Any thoughts on the Chicago selection for the CZR circus as it relates to our position?

Jeff (TMFFischer):

@Old Hippie Nerd: It seems unfortunate! Yet, you never know. If we keep the short long enough to see, Chicago may rule against CZR where Delaware wouldn't have. Meaning: You just never know. I don't love that about this short -- that much of it comes down to a legal battle. So, we'll see if we want to keep it through the duration. Meanwhile, the weak business should help us. But on the surface, Delaware would appear to be the better court for us. In reality, only fate will show what Chicago does.

Comment From Karen (KBecks)

Did you plan this month's chat specially for Apple earnings day? :)

TMFKabellen:

Karen -- happy coincidence! :)

Comment From BandCJ55

Thanks. Very helpful comments on DGS.

Comment From Hemanth

Is there a way to track the options in the Pro Scorecard?

TMFKabellen:

Sorry, Hemanth, this is one of the most requested features we're not likely to provide anytime soon. :(I wish I had a better answer! -E

TMFKabellen

@terrapin: I also promote them on the homepage starting a week or two before the event itself, and there'll be a link in at least one Monday Memo email before the chat. I should add them to our coverage calendars, too -- note to self.

Comment From BandCJ55

Still feeling strong about Wisdom Tree (DGS) and if so why?

Jeff (TMFFischer):

@BandC: Haven't felt strong about DGS in a long time! But do believe emerging markets will have there day, and this is a very good ETF for that. Keep in mind, we're not well diversified if everything moves together at once. DGS has diverged greatly from our U.S. stocks. Eventually it should do well and U.S. stocks may not. And that's fine with us -- and makes it worth keeping because we do believe in the fund. But I think waiting for results in DGS could require still more patience. When it does finally have a good several years, that'll be nice. These things to cycle, and emerging markets have been weak a long time.

Comment From terrapin

Do you have these chats on a redoctable interlude, e g, every two weeks? How do we know when you'll do it again? Often on Wed.s?

JP Bennett:

They're monthly and we send out an email reminder, terrapin :)

TMFKabellen

^ Thank you!

Comment From I certainly second...

Something for we slow readers: in Safari there's an menu option under the debug menu (activate in prefs) to *pause web process.* Also in all the browsers at the bottom right of the chat window there is a well icon for settings. There you can click on the sound icon and mute or unmet the sound.

Comment From Jim

I noticed Jeff updated recommendations on the AAL calls and GNTX puts recently on the boards. I just happened to run across the comments, but am not on the boards routinely. I would have expected an email when a pricing recommendation is changed. Did I miss one? Other than looking frequently, will we be notified if you make comments on the boards regarding active trade recommendations (not follow-up comments)? Thx

Jeff (TMFFischer):

@Jim: We didn't update pricing guidance on AAL in any way -- that recommendation stands as is. We happened to buy our calls higher than they traded on day one, but there was no guidance to stick to the price on day one. On GNTX, the guidance was updated to everyone first in the Monday Memo. It wasn't a new trade alert, just a Pro Catch-Up Trade -- catch-up, in this case, to the latest pricing. Those are in any Monday Memo. Does this answer your question?

Comment From devinder

where is jim gilles TMF kanuck

JP Bennett:

Jim is not a part of Pro. He's on Options and Special Ops, devinder.

Comment From Susan

Scott, Consider the tax implications on syn longs. The short puts are taxed at ordinary income rates in taxable accounts. The long calls are at long term capital gain/loss rates.

Billy Kipersztok:

Thanks Susan! Yes, an important consideration.

Comment From foolinsd

FYI for those that don't like the alert sound, click on the gear icon on the bottom of this live chat to turn it off. You do have a choice :)

Comment From terrapin

Where are you with fallen hero INVN now--about my biggest loss that I clung to stubbornly.

Jeff (TMFFischer):

@terrapin: We sold more than a year ago, because, like DDD, the financials weren't shaping up as hoped. We wrote calls when the CEO was booted, and sold around $11. So, we've been out for a long time, and the stock is higher since. Right now, I look at the financials and still don't like them. But I know many at the Fool believe strongly in the CEO and the business. I like SWKS much better -- when I view it as a financial analyst and business analyst.

Comment From Scott

Is there some general rubric Pro uses to determine whether an investment thesis should be a syn long, Buy a LEAPS call, or go long the stock? Now that I'm fill out my portfolio, I would like to know how one generally starts in execution options (pun intended :)

JP Bennett:

I believe Billy answered a similar question somewhere up above, Scott.

Comment From Susan

Thanks Jeff. Not rambling at all. It helps to read/reread your thinking even though I have been with PRO for a while.

Comment From smides

For me, I was able to re-enable the typewriter sound by clicking the gear icon at the bottom of the chat window and clicking the speaker icon with the red slash through it. When the red slash is gone, you'll hear the dulcet clickity-clack once again.

Billy Kipersztok:

Thanks for sharing smides!

Comment From VelobiciOptions

Looks like a good day to sell puts on OTEX

Jeff (TMFFischer):

Hey VO! We shall see! Maybe a strangle again? I have to go through results. Since we're about 3.1% in OTEX, we have flexibility. Good to see you!

Comment From Scott

Hello Pro Team, I'm curious about syn longs. If one were to find a stock with Jan 17 LEAPS, and the investment thesis is for appreciation over the next 3 years, how would this make less sense than going long on the stock or simply buying a LEAPS call? From a novice standpoint, I see the syn long as a way to use margin in my margin account to keep a cash balance as a hedge. Moreover, why is KO a syn long and not other core PRO holdings?

Billy Kipersztok:

Hi Scott -

Deciding between a syn long vs. bought stock vs. a bought LEAP should take quite a few variables into consideration.

For one, the type of account matters. In IRA accounts, margin is not allowed, so the leverage benefit of a syn long is wiped out. It's better off in that case either buying stock or buying a call.

Secondly, for the Pro portfolio, we take into consideration our current allocations. A bought call only risks the capital we invested, whereas a syn-long commits us to buying more stock if the price ends up below the written put leg strike at expiration. For positions where we already have an allocation, we may not want to increase our allocation by that much.

In KO's case, we had no position in the stock, and we could benefit from the leverage of the syn-long since Pro is in a margin account.

There are other considerations as well (upside potential vs. downside risk, etc.) but that's a start.

-Billy

Comment From Dave

Any thoughts or suggestions on Facebook for today?

Jeff (TMFFischer):

@Dave: It remains one of my favorite "growth" businesses right now. I think FB is still reasonably priced. I compare it to Google early on, all the time, and it looks good. That said, this year they expect to spend a lot to grow. That's fine. But we'll see how Wall Street takes it. Of course, they share results in a few hours. So, we'll get a new look at the business soon. I like the idea of owning it for years as long as they continue to be THE place for social activity online. And they do, with their various properties. In a mammoth way. And the audience is remaining very engaged. Will that change? I don't know if that follows logic. People are very social creatures. FB just needs to remain the social hub of choice. And buy any threats. :)

Comment From Parshooter

Did not get in on the CZR trade originally, does the team feel that there is still time? Thank You!

JP Bennett:

This one will definitely take some time to play out, so I'd suggest checking the boards and reading the original rec. No need to rush :)

Comment From bru5ce

Maybe the people who don't like the click could mute their speakers?

Comment From RTichy

So tell me about Amtrust (AFSI). I haven't started a position at all, yet. It's way past the Fair Value and it's the largest holding. The portfolio recommendations screen has very mixed signals about whether or not one should immediately jump into 7.1-7.3% of one's money. If I read the WWTN page, I'd say it seems like a "core" position for Pro. Any disagreement with that?

Jeff (TMFFischer):

@RTichy: It is a core holding, I'd agree with that. But it is a large position lately (a good problem to have) at 7.1%. We suggested new members last fall average in over time, and perhaps only allocate up to 5% for now. Because we do consider trimming it from time to time. But at the same time, I lean to letting winners be. Letting them continue on. At any rate, if I were starting now, I'd start with a more modest position and plan to add later. Just to be a little more careful. That said, many people average into every position over time, not just AFSI. We'll have a value update before long, as we see results in February. We're also slated to visit the CEO and CFO in NYC on Feb. 20th.

Comment From Karen (KBecks)

Hey should we talk about Five Below (FIVE) during this chat??? :) I closed a little bit of my short position and I'm much less nervous now. Anything interesting with this one or has it become a little sleepy?

JP Bennett:

My opinion on the company has not change one bit. It's likely to remain sleepy until they report in March. I was not impressed with their holiday numbers at all. - JP

Comment From terrapin

Alright, Ellen, how can Old Hippy hear your clicking, and I can avoid it? No setting on our own computers?

TMFKabellen:

Nope. That would be too easy.

Comment From RTichy

How come the icon for "catch up trades" on the WWTN page links to a memo from April 21st, 2014?!

TMFKabellen:

Goodness! It shouldn't do that. I'll go examine/fix in 17 minutes. Thanks for the heads-up! -E

Comment From DL

I liked it too, for the same reason

TMFKabellen:

Duly noted! It's our usual practice to turn it off, but today the setting didn't "stick" -- maybe it's more popular than we ever realized! -E

Comment From DUWANGO

Any chance of investing in a snow shovel manufacturing company? Hope you are all warm and dry. Love this service. Extra congrats to PhooLon

TMFKabellen:

Leslie! I hope you're warm and dry out West as well. We dodged most of the blizzard, but it's times like this I miss living in Houston. Good to see you here! -E

Comment From AMG

I have a position in UBNT with a basis in the 40s... Hit prettty hard in 4th quarter and continues to decline... Do you have a recommendation on this stock?

Billy Kipersztok:

Hi AMG -

I personally haven't looked at UBNT. It's not a Pro recommendation, but I think it is for Rule Breakers?

In any event, I don't have much to say about it since I don't follow it. Your best bet is to ask on the company boards for the service in which it is an active rec.

-Billy

Comment From Karen (KBecks)

Good question about call buying, Susan! Good stuff.

Comment From terrapin

Think Microsoft is as bad as it appers? Candidate for a LEAP or a long put?

Jeff (TMFFischer):

@terrapin: I'm going to talk to Jim G about it for a start. He has followed MSFT in the past. Perhaps there's an opportunity there, was my thought, mainly for MF Options.

Comment From bru5ce

LOL, I kind of like the typing sound, because I can hide the window and then go back to it when there's something new! Ya can't please everyone... :-)

TMFKabellen:

Great minds! See above :)

Comment From Old Hippie Nerd

Hey... I liked the new clickety clacking.... :-))

TMFKabellen:

Goes to show, you can't please everyone. :) -E (who is now singing John Fogerty to herself)

Jeff (TMFFischer)

@devinder, On CZR, as of right now the position is about flat for us, while the market is up over the same period, so as a short, it hasn't scored us a win, but has done okay... so far. But it's an unusual short at this case. We have to make sure we remain comfortable shorting through a lawsuit. Luckily, the business is weak -- or has been -- while we wait.

Comment From mainmike

Any thoughts about offering alternate strike prices on recommendations to reduce the pile on effect that prevents many of us from executing the trade?

Billy Kipersztok:

Hi mainmike -

Sometimes we do that, as with the GNTX put write (at the bottom under "Alternative Trades"):

http://newsletters.fool.com...

Other times, we specifically mention that we don't recommend alternatives, and other times you can use your knowledge and comfort with options to make an educated "off-reservation" decision on your own.

-Billy

Comment From Tracy

That's it! Exactly! Thank you.

Comment From Susan

Jeff, When you buy LEAP calls, how do you decide on the strike and amount of TV you are willing to pay (other than as little as possible). Are you using back-of the envelope calculations on how much the leveraged position is likely to gain and then decide on the strike price?

Jeff (TMFFischer):

@Susan: One of the key levers is I want the potential to earn 100% on the calls I buy, since I am risking the whole capital amount (a 100% loss). So, that was true with the FB call purchase, with DIS, with the original KO purchase, and AAL -- you need to be able to make the case that your particular calls could reasonably double in value if your thesis plays out. Otherwise, I don't want to risk it. I don't want to risk a 100% loss for, say, a 50% gain... Second, the call is usually 20% or more in the money, because we're not trying to speculate. We're just trying to capitalize on a higher stock price over time. Buying in the money lowers time value and increases the odds we end with some value, of course. I dislike paying more than 10% time value over two years (5% a year), as an arbitrary round number, but on something as volatile as AAL, it was okay. So, the time value you'll pay really depends on the volatility of the stock. Hope the helps a bit. Long winded and rambling. Our guides to Buying Calls help, too.

Comment From terrapin

When you have long puts going further against yu than yu expect, what can you do to reduce losses?

JP Bennett:

If you bought puts you can just look to sell them to close your position. You could also consider rolling them to another date and possibly another strike, but you'll probably have to invest even more capital to do so. - JP

Comment From Tracy

I now this sounds lame...! It often seems like I have to stumble about on the website to find the list of positions and allocations for Pro. Most of the time - I go to nevercontent's weekly posting on the philosophy board to find what I need. What's the easiest way to access this information?

Billy Kipersztok:

Tracy -

Is this what you're looking for?

http://newsletters.fool.com...

To access that page, you just have to click on the "Recommendations" tab at the top of the site.

-Billy

Comment From devinder

CZR short should have shot up with bankruptcy filing but seems like PRO is still losing money on it. Any thoughts

JP Bennett:

This is going to take some time to play out. There are some folks on the long side who are going to do everything they can to try and isolate the damage and unlock value for the equity holders (i.e. themselves). We don't think they'll be successful, but it isn't going to play out over night, nor is it an open and shut case.

Comment From terrapin

How can I get rid of the typing sound on the message board just now?

TMFKabellen:

terrapin, I turned that setting off. Apologies for the clackity-clack! -E

Comment From Pixal

I also have had great difficulty matching the alerts with my trades. How many PRO members are there? I don't want to blindly trade, so it takes a little time to analyze the trades I want to match.

TMFKabellen:

Pixal, we can't tell you how many members there are, but it's good that you're not trading blindly, of course. As members have noted, by 4 or 5 days after the trade alert, pricing has usually settled down. -Ellen

Comment From No rate hike near ...

Oil crashing!

Jeff (TMFFischer):

Is it again today? That should of course ultimately be good for AAL.

Comment From RTichy

@JP to follow up on my short positions question: Are the short positions designed to relate to a particular long position, though? Yes I want to follow Pro very closely, but I am not sure on how to allocate my money into the portfolio effectively. Some of the longs are already well past Fair Value, and so I am holding off on those because I don't want to put money into a position Jeff is just waiting to drop, and if a short position is part of a tandem trade position, I don't see that on the portfolio screen, either...

JP Bennett:

I see, RTichy. You should look at our shorts in the context of our entire portfolio. They're not an attempt to hedge a specific stock/sector exposure on the long side of our holdings, but rather to help hedge the entire portfolio (though ideally we will make money on our shorts regardless of where the market goes).

Comment From Snapback

What are thoughts on buying BHI as way to play oil going back up at some point and also to profit from merger with HAL?

Comment From Snapback

any thoughts on buying BHI as way to play oil going up some day. hopefully benefiting from merger with HAL along the way.

Jeff (TMFFischer):

@Snapback: Oil isn't my forte. Energy in general I believe is a tricky industry because more and more energy keeps coming online. Many people allocate to energy as a rule because it's so integral to life. But I think you can do fine without energy investments, too. But really it's just not my area... That said, we are batting around possible ideas between us on the team, and reading suggestions from members. If something really looks good, like BRS did before, and VDE when oil was down -- like it is now -- then maybe. But what has changed since the last time we bought VDE is US oil production has soared, of course.

Comment From Kevin H

As a follow-up to Tracy's comment above concerning option trades -- it takes patience as preached by Jeff & Jim in MF Options. I also have found it can take 4-5 days before the recommended trade executes. (And always use limit orders.)

TMFKabellen:

Wise words.

Comment From M

Are you considering directly shorting any companies? like the sony short from couple of years ago.

Billy Kipersztok:

Hi M -

Yes, all the time :)

That's definitely a focus for Jeff, JP, and I. But good, high-conviction shorts are few and far between.

-Billy

Jeff (TMFFischer)

Hi All: We're still answering questions from 10-15 minutes ago. We'll get there!

Comment From SteveH

Hi, thanks for the chat. I have moved assets from a financial adviser into my MF sphere. Any suggestion on the best way to evaluate the mutual funds they had selected in order to sell intelligently in order to invest in MF recommendations. Is Morningstar a good option?

Billy Kipersztok:

I have used Morningstar personally in the past to evaluate mutual funds. They are generally well-regarded in the industry for their evaluation criteria. If you are a premium M* member and can read the analyst commentary, that's even better.

Additionally, you can check the funds' websites to see what their holdings are. That can also help in making determinations.

-Billy

Comment From M

I had synthetic short on FAZ that I allowed to exercise couple of weeks ago. My broker TDA forced me to cover the short saying that the stock is hard to borrow. Therefore I don't have any position in FAZ now. Any suggestions on how I can re-enter the short position?

Jeff (TMFFischer):

@M: A 2017 syn short should do the trick...

Comment From mfdravid

Any thoughts on the FXE short> Is it still a valid rec?

Jeff (TMFFischer):

@mfdravid: It still is an active recommendation. That said, of course the risk/reward is less attractive now, and it's much harder to short now than it was a few years ago. But it's active as a rec. We have no "hold" rec for Shorts because that's a risky way to view a short, IMO. We either say Short or Close it. We are still short.

Comment From phox

Hi Pro Team ... sitting here munching on a bowl of OTEX ... bought back a few more shares today. I love you guys!

TMFKabellen:

The feeling is mutual! Enjoy :)

Comment From Norman

I started Pro a yr ago. I'm ready to double up but things look a bit extended. Any suggestions

JP Bennett:

I'm not going to sit here and say I know for certain where the market is going to finish this year, but I do know a healthy amount of skepticism never hurt anyone. Just move at a pace you're comfortable with. I know we are with our new recommendations. - JP

Comment From Guest

any comments on svxy, it dropped a lot since recommended

Billy Kipersztok:

Hi Guest -

See this thread:

http://boards.fool.com/1228...

-Billy

Comment From Tracy

Thanks for feedback on O'Reilly and Papa Johns!

Comment From Tracy

American Airlines alert was surprising...in a good way! What triggered the possibility?

Jeff (TMFFischer):

@Tracy, As you know, it's not easy to find "value" (or deep value) type stocks right now that also have strong growth on tap. AAL showed up. Add that with a changed industry (or so we hope it'll stay changed, with fewer players) and strong consumer demand, alongside a very skeptical Wall Street, and it's an interesting situation. Now, it's still an airline investment, so we kept it small. :)

Comment From Tracy

@uwman - I find that it takes 4-5 days before the MFPro Options trade happen. I try every day until it finally happens.

Comment From Wisemann

I must admit that mat portfolio is a mix of PRO and other FOOLS recommendation, but PRO of late preformed much better than mine. PRO loses less on down days/weeks and rise more no good ones.

Billy Kipersztok:

One of Pro's primary goals is to lose less than the market when it falls. So that's good to see. And that we have been rising more than the market on good days is not a specific goal, but it sure is great when it happens. Here's to working towards and hoping that it continues :)

Comment From tbkurz

Any comments about considering doing short term options, ie weeklies?

JP Bennett:

They can definitely be lucrative, but they are also very dangerous. Make sure you're constantly aware of (and ok with) the risk you're taking on when using them - JP

Comment From JSPColorado

PRO CEO of the Year? Jeff Fischer, of course.

TMFKabellen:

Right? Like it's even a contest. -Ellen

Comment From DL

who did MDT merge with?

Jeff (TMFFischer):

@DL: Did they merge? No, no, I kid. I fool. I Fool. They merged with Covidien. Here's a good overview: http://www.bizjournals.com/...

Comment From Tracy

I'm slowly building my Pro Portfolio, and I'm skipping Papa John and O'Reilly Automotive for now. Should they be the last ones to add? Not add for now? Thoughts?

JP Bennett:

Hi Tracy, I'd wait until they are no long on "hold." They may go back to being a buy, but we could also decide to sell them. It'd be a bummer if you made a move only to see us put out a trade alert recommending you do the opposite shortly after. No harm in waiting. - JP

Comment From Karen (KBecks)

2014 Pro CEO of the Year…. who would you pick and why?

Billy Kipersztok:

Hi Karen -

Being as Morningstar singled out O'Reilly and Gilead's CEOs as finalist for their CEO of the year (I believe GILD's CEO ended up winning), those are the easy choices :)

Both companies had outstanding 2014s.

Other candidates might be AMT's James Taiclet, due to strong execution and deal-making in 2014, setting the company with an excellent competitive position both in the US and internationally over the next several years.

Papa John's and Starbucks also continue to perform well, with remarkably strong and consistent comparable store sales.

-Billy

Comment From BandCJ55

Any thoughts on a position in TSLA?

Comment From BandCJ55

Thanks. I belong to both Pro and Options. Thanks for the comment on WFM. What is your take on DDD and or TSLA?

Jeff (TMFFischer):

@BandC: We sold DDD because the financials weren't shaping up as hoped. TSLA is a one-of-a-kind business with a valuation that may price in a lot of the upside at this point for quite a while. They don't expect profits until 2020 I believe now...

TMFKabellen

@uwman: For Pro, Jeff means Catch-Up Trades -- TYCM are in Options. Pretty much the same thing though :) -Ellen

Comment From uwman

I have a lot of trouble getting options at your recommended pricing. Is my problem Vanguard, which seems to actively discourage options trading?

Jeff (TMFFischer):

@uwman: It depends on the position and the direction of the market. We're making our guidance flexible, though, and we provide follow-up guidance in Trades You Can Make -- we'll get better at this, I'm confident. And the market will cooperate much more when it's not so strong.

Comment From Old Hippie Nerd

A bigger window would be nice so that long comments and answers don't require scrolling back and then forward to see all of it.

TMFKabellen:

That I might be able to help with, though not in this session. Duly noted! -Ellen

Comment From erkaye

TUP is a very slow grower that shot up over night. Any options plays come to mind?

Jeff (TMFFischer):

@erkaye, It has actually been a fast-grower over our history (we started with it around $27, with various positions, and sold around $80, then got back in and it has declined since)... But right now, yes, sales are growing slowly and we will consider writing strangles on it again as we have in the past. For income. I was looking at the premiums this morning. :) But I need to go through earnings first. And then we'll decide.

Comment From RTichy

If one is just starting to develop a Pro portfolio, when should we start initiating the short positions? Relative to investing in the long positions, I mean.

JP Bennett:

I think it depends on what you want to get out of Pro. If you want to mirror us 1 for 1, then it would make sense to consider following on the short side of our book as well. But you don't have to if it isn't something you're comfortable with. Shorting can be volatile and isn't for everyone :) Personally, if I were in your shoes I'd probably wait until I was comfortable with the long side of my "Pro portfolio" - JP

Comment From No rate hike near ...

Where can I see the 2014 portfolio review memo?

TMFKabellen:

It was sent out this Monday and is still linked on the homepage -- URL is here:http://newsletters.fool.com... -Ellen

Comment From mrrobertinBangkok

i may have missed this, i just joined the chat. But any thoughts on Gentex earnings today? other than you are glad you didn't get in?

Billy Kipersztok:

Hi Mr. Robert -

Here's what I posted in response to a similar question earlier:

"We recommended GNTX for a combination of reasons. After reviewing Q3 (last quarter's) results, we updated our valuation to $17.50 per share. We saw management buying back stock, which historically was a strong indicator of improved performance. Management's forward guidance for Q4 implied strong performance. And we were ready to own more shares, if it came to that.

In light of management's guidance of 10-15% growth in net sales, yes, we expected a stronger quarter than 7% growth. But yet, it wasn't a *bad* quarter, just not up to par with expectations.

In my opinion, GNTX is still relatively cheap, and the effective buy price from the put write is an attractive entry point for a new slug of shares. In that sense, our opinion is unchanged.

I expect better performance next quarter, given management's comments on the call and their forward guidance. But results and time will tell. As we can see from this quarter, sometimes guidance is wrong :)

But there is enough margin of safety with this stock (for example, >12% of the share price is cash) to feel comfortable moving forward."

I also posted my preliminary thoughts on the results on the Gentex board.

-Billy

Comment From terrapin

It wuld be nice if we could attached a question as a reply to a previously asked question-- so all the info is right there.

TMFKabellen:

It would. Right now I'd settle for a pause button! -E

Comment From bbdoc1

you talked about writing Tesla puts on Motley fool 1 what dates were you thinking of and the price you would consider

Jeff (TMFFischer):

@bbdoc1: That was a question just put to me on the spot, so I don't have dates or even any thoughts in mind about telling someone what to do. But if someone wanted to buy TSLA lower, potentially, they could sell to open puts at various strikes and expirations -- choose your desired buy price....

Comment From terrapin

What are some simple ways utilize options for an earnings report that you think isiikely to be a win?

Billy Kipersztok:

The simplest way might be to buy a near-the-money call expiring soon after earnings. If you're right, you could see big gains. But if you're wrong, you can incinerate your capital.

Comment From Ralph

Interested in your thoughts on selling calls (diagonalizing) on our AAL LEAPS. Too volatile?

Jeff (TMFFischer):

@Ralph: That's certainly on the table. It's being considered and will be considered. We'll want to be careful to not miss the bulk of our thesis though, which is that the stock could rise strongly over time...

Comment From mfdravid

Hi Pro Team

TMFKabellen:

Hallo!

Comment From Karen (KBecks)

Just wanted to offer a big thumbs up for the 2014 portfolio review memo. It was a good read! Thanks for summarizing the history and for sharing your thoughts on what was learned in the past year. (Maybe I'll get to work on the math calculating my own 2014 portfolio performance too.)

TMFKabellen:

Jeff deserves the congrats, but I'll be the messenger: thanks, Karen! :) -E

Comment From No rate hike near ...

TUP?

Jeff (TMFFischer):

Question? I can't see it in this format. TUP had better results last quarter but sees a so-so 2015 shaping up. $5 in EPS puts it at 13x, though, along with a strong yield. So... still looks like a fine long-term holding for us. But I have to go through results.

Comment From RTichy

Why is the "recommended Allocation" in the portfolio based on the moment instead of an actual fixed point, and then report the amount the portfolio is above/below the allocation? Then you'd have to reset the allocation guidance say quarterly, but the way it is now, I fell like allocation is dependent solely upon performance since the position began...

JP Bennett:

Hi RTichy, You are correct that the way it is reported right now is dependent upon performance of our holdings, but I don't see this as an issue. These are our target allocations for members because these are the allocations that we are happy with -- if they weren't we would adjust the positions.

Comment From terrapin

I can't see that "rolling a call" is any dofferent than buying a new one--what's the dofference?

Billy Kipersztok:

Rolling a call means selling a previously bought call while simultaneously buying a new call.

Buying a new call is just that - establishing a brand new position with a bought call.

Comment From David

How close to expiration might you plan to cash in on your KO position?

Jeff (TMFFischer):

@David: We'll cross that bridge later this year, starting to seriously consider it this summer (unless earnings suggest doing so earlier). The bigger question may be to simply continue it -- roll it forward two years. And to possibly diagonalize it (which could happen anytime, IMO, but now we may as well wait for earnings).

TMFKabellen

Bob! Hey, Bob! :)

Comment From Wisemann

AIG is near its one year low. Any comment why the stock is not performing in the last few months? interest rates, new CEO, financial sector...

Billy Kipersztok:

Hi Wisemann -

I'm not sure :)

Perhaps interest rates - which have generally brought down the financial sector as expectations for rising rates have seemingly been pushed back.

See this comparison of AIG with the Financial Sector index:

http://finance.yahoo.com/ec...

Comment From Bob

RTB: Just hello to all and congratulations to Jeff and the team for a great performance in 2014 (and since inception. Did I hear we were going to beat the S&P by 20% this year? Extra hello to Mad Dog (Billy), see the boards ;-) Bob

Jeff (TMFFischer):

Great to see you, Bob! Thank you for stopping by. Yes, perhaps you heard that right, but it was someone else saying it, not us. :) I guess last year was 29%. I'll take any positive return at all, though. :)

Comment From bru5ce

Is this where LON jumps in and says it's LEAPS calls, not "leap calls"? :-)

Comment From terrapin

Best option setups fpr F, TWTR, BABA????

Jeff (TMFFischer):

@Terrain: In MF Options we have a syn lon on F. We may write calls on it, too, but the calls pay so little. It's a boring long-term holding. Boring but inexpensive. No thoughts on TWTR or BABA currently. Not enough to give advice. :)

Comment From Scott

Is buying $35 calls on AAL still recommended?

Jeff (TMFFischer):

@Scott: No change. The business looks inexpensive enough that even some less than stellar comments yesterday (about more competition in some markets) don't dampen the two-year outlook. The position is still recommended in our small allocation.

Comment From tbkurz

Curious as to whether you would advise buying more leap calls on American Airlines given that the price has softened a bit if we hadn't met our suggested fractional investment in it.

JP Bennett:

If you're still below a 1% allocation I don't see why not :)

Comment From foolinsd

Happy New Years everyone!

TMFKabellen:

Party hats! Noisemakers! Streamers! :)

Comment From jojorunner

what is your take on Euro/$ and how to best take advantage of that? thanks,

Billy Kipersztok:

Pro is short the Euro via FXE at a 2.1% allocation. That is perhaps a good place to start :)

Comment From Geoff Nordloh

Hope you don't mind a joint Pro/Options query: Often options recs seem to move out of recommended price range -- even within minutes of a rec -- and many of these seem never to look back. Difficult question to answer in general, but are you able to provide some guidance on how far to chase these? I feel I miss out on a lot of the good options trades as a result.

Jeff (TMFFischer):

@Geoff: Good question! Though this has been a long struggle, we do aim to make the guidance flexible in the original alert, and then provide updates in Trades You Can Make (or Catch-Up Trades in Pro). So, these positions do remain actively possible more often than not, for a long time, off and on...Some never come again, but I'd say a majority do. But we keep working on making the alert guidance as helpful as possible and flexible. Maybe this year we'll crack that nut for good!? Advice welcome, of course....

Comment From DL

DDD was a buy on the Stock Advisor report I first received from MF about 2 months ago

TMFKabellen:

Hey DL, are you an SA member? They cover that stock like it's on fire over there ... -Ellen (who also owns it)

Comment From Jim A

American Airlines is down since we bought calls. I'm thinking about selling the matching puts to create a synthetic long. Is this logical?

JP Bennett:

I wouldn't worry about a small loss this early in the lifespan of our position. There is still a long way to go here. We like calls because of our ability to risk only a small percentage of our total capital. Personally I wouldn't be looking to create a synth long just yet.

- JP

Comment From Daya

Jeff, any thoughts on covered calls on our AAPL holdings..?

Jeff (TMFFischer):

@Daya: Not at the moment. We have an aversion to writing calls on "core" (apple core -- ha -- sorry) holdings. In many cases, we'd eventually regret it. But I do have to go through the latest valuation and see where we stand on AAPL. If the possibilities are still looking attractive, we probably won't cover it. If we have questions about it, we may take various action. Good question!

Comment From Old Hippie Nerd

Are there any plans to use the results for the correlation in diversifying the Pro port?

Billy Kipersztok:

Hey there Michael -

I don't think we'll use the results in and of themselves to diversify just for the sake of diversification. But for any portfolio adjustments, we can consider the output from the correlation table in terms of making the best marginal decision. For example, if we have two stocks we want to sell, all else equal, we'd sell the one with the highest correlation to the rest of the portfolio.

In addition, as mentioned in the Memo, the index correlation table may be useful in contemplating future hedges.

-Billy

Jeff (TMFFischer)

You can get advice on DDD in Rule Breakers... And we still have a "sold DDD" board here in Pro where some members post.

Comment From John S

I was hoping to have MF Pro/ MF Options as part of a SMA account under MF One, but it requires a 300K initial investment to include MP Pro. Which is the initial outlay so high?

TMFKabellen:

I'm sorry, John, we can't answer questions about the SMAs -- legally, not because we don't want to. I'd recommend calling Member Services and asking for someone who is legally allowed. Apologies! -Ellen

Comment From sockpirate

very concerned about DDD

Jeff (TMFFischer):

@sockpirate: Which services are you in? Pro sold DDD more than a year ago. We don't have it any longer. I think Pro was first to buy it and first to sell it. :)

Comment From Any Info whyGNTX i...

Any Info why GNTX is down today?

Billy Kipersztok:

They reported earnings and missed guidance. Check out my preliminary comments on the Gentex board.

Comment From is tis suppose to ...

Is this suppose to be a video chat?

TMFKabellen:

No, it's text-only. Our regular monthly chats are almost always text-only because the guys can answer a lot more questions when they aren't also appearing on camera! -Ellen

Comment From Jane

I have a question about Ocwen Financial. I bought it right after it was recommended and it is down 2/3 to 3/4. I know there is the problem in CA. Should I sell at this low point or hold it with the expectation that it will increase. This is the third stock recommendation that has done this in the last few months. I just sold LeapFrog at a huge loss also. Please advise re Ocwen. Thanks!

Jeff (TMFFischer):

@Jane: Hi, Jane. I don't know Ocwen at all. I'm told that was a recent recommendation in Inside Value, so please visit that service, and post on the Ocwen board there. I know they will help you! LeapFrog is also not in this service -- that was in Million Dollar Portfolio and maybe Hidden Gems? This chat -- and the analysts here -- only work on Pro and Options. Apologies!

Comment From Karen (KBecks)

I will admit to only skimming Billy's awesome article about correlation. So let me ask while I have got you here… Are AAPL and SWKS very intertwined? I'm off allocation with Pro's recommendations and they are currently #1 (AAPL) and thanks to growth #2 (SWKS) in my port at present.

Billy Kipersztok:

Hi Karen!

AAPL and SWKS are intertwined, perhaps enough so to describe it as "very". Jeff might be able to provide more info as far as how much of Skywork's revenue is related to Apple products. When Apple products sell well, that means more demand for Skyworks' chips.

From the correlation table, only TD Ameridtrade (interestingly) is more highly correlated to SWKS (at 0.44) in terms of price movements than Apple (0.42).

But generally, yes, we should expect to see Skyworks' fortunes move alongside Apple's. While there are a lot of new applications for SKWS's technology outside of Apple products, and over time we'd hope to see the reliance on Apple decrease - for now Apple product sales are one of the biggest contributors to SWKS's results.

-Billy

Comment From Tony

Yeah AAPL

JP Bennett:

Yep, that was a doozie :)

Comment From M

Considering how low the oil prices are I suspect some time in future they are going to go back up. It might take several months or year or two. But the oil prices are going up some day. Any thoughts on how we can benefit from that? Is pro considering any stock or ETF for that?

JP Bennett:

We're always looking for opportunities, regardless of the sector. My advice would be to look for companies that can create value even at these levels. NOV, SLB, and HAL are possibilities as long as you're willing to be patient.

Comment From No rate hike near ...

Anyone else underwater on TUP?

Comment From When will we roll ...

did you get my question on KO?

TMFKabellen:

Yes! You should see Jeff's answer above :) -Ellen

Comment From bru5ce

Okay, it's an iPad thing. Firefox on Linux works great.

Comment From When will we roll ...

When will we roll the Feb diagonal over?

Jeff (TMFFischer):

I bet you're talking about the KO diagonal? That's a MF Options position, rather than Pro. We'll address it as expiration approaches next month. It may not need to be rolled at all. The $44 calls may just expire (the desired outcome) and we'll write a new call.

Comment From BandCJ55

Sending in comments, but I do not see any responses to questions.

TMFKabellen:

Hey BandCJ55, we publish them as we answer them, so that doesn't necessarily mean they haven't come through -- more likely someone is working on a response! That said, I don't see any Qs in the queue with BandCJ55 as the author, so maybe try to submit once more and I'll keep an eye out? -Ellen

Comment From BandCJ55

Any comments on WFM and a covered call option price to go with today?

Jeff (TMFFischer):

@BandC: WFM is an income position in MF Options, rather than Pro. We haven't recommended a brand new position there for a while, though, just rolling calls. You would only cover a position you were okay selling and had bought for income.. If that's the case, you can write near-the-money calls -- typically a few strikes higher than the price.

Comment From Bluerose113

okay, thanks.

TMFKabellen:

Sorry I couldn't be more helpful. -Ellen

Comment From Tony

I see the names

Jeff (TMFFischer)

@Dwight: I'll add that One provides access to all Fool services -- including Pro and Options. As well as Tom G's Everlasting Portfolio which is only in One. One also has access to financial advisors and wealth management tools including funds. So, it has other services, too. I say this because I know One opens this week for a short while, so for members who want those services, now is a possibility.

Comment From Bluerose113

i am curious in how big a portfolio makes it worthwhile to look into the new SMA service?

TMFKabellen:

Hey Bluerose, I'm pretty sure that legally we're not allowed to answer that, innocuous though it seems. I'd call Member Services and demand to speak to someone who is allowed. :)

Comment From mark

why did you recommend gntx and what went wrong with earnings- did you expect better earnings and are you still optimistic moving forward

Billy Kipersztok:

Hi Mark -

We recommended GNTX for a combination of reasons. After reviewing Q3 (last quarter's) results, we updated our valuation to $17.50 per share. We saw management buying back stock, which historically was a strong indicator of improved performance. Management's forward guidance for Q4 implied strong performance. And we were ready to own more shares, if it came to that.

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I expect better performance next quarter, given management's comments on the call and their forward guidance. But results and time will tell. As we can see from this quarter, sometimes guidance is wrong :)

But there is enough margin of safety with this stock (for example, >12% of the share price is cash) to feel comfortable moving forward.

-Billy

Comment From Jim

FYI using safari and can readily see comments.

JP Bennett:

Yep! I'm using safari and it looks good to me :)

- JP

Comment From bru5ce

Reno, and it's 46. We'll take all your snow - we're entering our fourth year of drought.

TMFKabellen:

I've never been to Reno, but my husband's grandmother got divorced there one day and married the next. So it sounds like a fun town to me! Anyway, welcome. :) -Ellen

Jeff (TMFFischer)

Maybe it's Explorer?

Comment From Dwight

Hi Guys. I am a recent Pro member and have invested in most all of the securities you have recommended, excluding options to this point. Can you tell me the difference between Pro and One?

JP Bennett:

Pro is a complete portfolio management service. Like One we're looking for great stocks to hold for the long run, but our approach to portfolio construction is different. Check this out for more info on how we operate here in Pro: http://newsletters.fool.com...

- JP

Comment From Old Hippie Nerd

The names are coming through fine on my Chrome browser.

TMFKabellen:

Excellent.

Jeff (TMFFischer)

I'm using Safari and it's working fine. Others using Chrome are fine...

Comment From Lon

Thanks to everyone who is congratulating me. As I have been writing on the boards, this is a fantastic community and I am honored to be a part of it. Delighted to be your Home Fool. phooL on! Lon.

Comment From Jazzmaven

Hello Pro Fools! Hope everybody's having a good day.

TMFKabellen:

Hey jazzmaven! Jeff got some bad news about his windshield today (he needs a whole new one), but other than that I think we're muddling along :)

Comment From Bluerose113

i'm using Firefox and it is working fine.

TMFKabellen:

Good to know. -Ellen

Comment From Chris

Working fine Chrome here and all names displaying -- on a Mac.

TMFKabellen:

Well no wonder they can't replicate it! :) It looks good in Chrome on my end, too. -Ellen

Comment From Daya

Three cheers to Lon!

Comment From Wisemann

I am under allocated in OTEX should buy more today? Do you think you would move TUP to buy first after the current earning?

Jeff (TMFFischer):

@Wisemann, You probably know I need more time to go through both results. From what I've seen so far this today, as I posted, I'm not concerned about OTEX, and matching our allocation is a good first step. We may look to add more. We'll see. On TUP, I don't think it's likely to move to Buy First, but that'll depend on a valuation update. They still see a tough 2015. But Buy First and Buy for us isn't a critical distinction. It's a whole portfolio , of course, and all stocks rated buy are rated buy. :)

Comment From kathy

When will sound click in?

TMFKabellen:

Hey kathy, there's no video or audio component on today's chat, just text.

Comment From marksrjm (Bob)

I see names on the responses

TMFKabellen:

Bob, I think it differs by browser, which is one reason the provider can't replicate it. IE seems to work, Chrome less so. -Ellen

TMFKabellen

Also, Fools, I asked after our last chat, and our provider doesn't have a way to pause comments while the chat is live. I know people were hoping for a different answer, and I'm sorry.

Comment From Gary

Refresh didn't help me. I'll try IE rather than Google Chrome

TMFKabellen:

Gary, I'm sorry. That will almost certainly help. -Ellen

Comment From Lon

Hi Ellen or whomever should know, names are not appearing on responses ... just on the initial comment which is being responded to. Thanks. phooL on! Lon.

TMFKabellen:

Thanks, Lon. That's frustrating because our provider hasn't been able to replicate the problem, so obviously they can't fix it. We'll sign our names. -Ellen

Comment From No rate hike near ...

No rate hike near term

Jeff (TMFFischer)

-Jeff

Comment From bru5ce

Responses aren't signed, again....

Jeff (TMFFischer):

We'll be sure to put our names down, then...

Comment From John B

Happy to be here for one! Thanks for the opportunity!

TMFKabellen:

Woo hoo! -Ellen

Jeff (TMFFischer)

Big welcome and round of applause for Lon! He's incredible in the Foolish community, especially in Pro and Options, and we're all very fortunate to have him here! Thank you, Lon!

Comment From Tracy

Yay, Lon! I also call him - Zen Master

Comment From Karen (KBecks)

Congrats Lon -- Woo Woo!

Comment From erkaye

Want to say anything about AAPL and TUP. Yikes, nice moves. Does TUP seem over extended. The numbers I saw didn't seem to be that good.

JP Bennett:

I'll leave TUP for Jeff, but Apple... that was... a very, very good quarter :)

Comment From bru5ce

Good morning (here, anyway) Fools!

TMFKabellen:

Greetings, bru5ce! Where are you? Is it warmer than 25 degrees there? :)

Comment From kevio

HI Everyone

TMFKabellen:

Hey kevio!

Jeff (TMFFischer)

I hope you were able to see our 2014 review in Monday's Memo... That sums up last year pretty well, for a start anyway. So far this year, the market has been choppy (some options opportunities may be forthcoming, among others). The portfolio has overall gone up a bit. So far, it's not eventful to total returns, even though many positions have moved meaningfully in either direction. That's nice. It could bring opportunities in positions.

Comment From Old Hippie Nerd

Huge round of applause for Lon!

Comment From Karen (KBecks)

I refreshed and now I can see… huzzah!

TMFKabellen:

Oh thank goodness :)

Comment From Gary

Still can't see the screen.

TMFKabellen:

Hey Gary, Karen said she refreshed and that fixed it -- can you try that?

Comment From Bluerose113

hi

TMFKabellen:

Hey!

Comment From JSPColorado

I have a comment, not a question. Three cheers for phooLon!

TMFKabellen:

Agreed! I don't throw the word "invaluable" around lightly, but Lon is one I'll use it for. :)

Comment From Chris

As long as Jeff and Billy go south and our stocks do not...

TMFKabellen

LON! Everyone give Lon a round of applause on his recent transition to Pro Home Fool :)

Comment From Karen (KBecks)

You are invisible on my screen! No color in the type.

TMFKabellen:

Oh for heaven's sake I am getting a little exasperated with this service provider. (This is an understatement.) Can you see this?

Also, hey, Karen :)

Comment From Lon

Hi Pro Fools, extra delighted to be here and looking forward to learning from you. phooL on! Lon.

Billy Kipersztok:

Great to see you on the chat, TMFPhooLon ;)

JP Bennett

Hi everyone! Glad you could join us once again!

Jeff (TMFFischer)

Greetings, Pro members! We're glad you're here and look forward to this chat with you... Of course, the chat will be recorded and Ellen will lovingly put it on the site when it's ready. :)

Billy Kipersztok

Hello Pro Fools! Billy Kipersztok (TMFTailwind) here, looking forward to this next hour with you all.

TMFKabellen

We're happy to have you here today. Jeff and Billy are both back from their tropical vacations and ready to answer your questions!

TMFKabellen

Welcome, Fools!

Learning From 2014 — the Good, the Bad, and the Glad

Published Jan 5, 2015 at 2:28PM

Dear *Pro* members,

Welcome to 2015! *Pro* enjoyed a strong 2014, and more importantly for our service goals, we also capped off a good three-year stretch. Now we look forward to the next rolling three years. We'll review our 2014 returns later this month (once we have final numbers from our broker and the Fool), but we're starting today with a look back on what we did well last year, and areas we need to improve.

To the Positive!

We had low turnover.

Countless studies show that investors who trade less end up with more wealth. As Charlie Munger more colorfully says, the best thing he and Warren Buffett ever did was sit on their hands. Contrast that with the dismal performance of hedge funds since 2009, and you see how less "flash" can add more value. In 2014, *Pro* sold just three full positions — **GrafTech International** (NYSE: GTI), **StoneMor Partners** (NYSE: STON), and **Intel** (NASDAQ: INTC) — and one partial position, closing half of our **Facebook** (NASDAQ: FB) calls (the rest turned to stock, becoming one of our largest positions).

Clearing out just three positions from an average of 30, including shorts and core options, gave us low turnover of 10% last year (and notably, we didn't initially intend to sell Intel). Some years our turnover will be higher, but last year was indicative of how much we want to sit on our hands. It's commonly cited that the average mutual fund has a turnover ratio of 100% or more, meaning it holds its average stock less than one year. At *Pro*'s recent turnover rate, we would hold our average stock 10 years.

Two of our sells in 2014 were reasonable for *Pro* (we'll get to the third later). GrafTech is a struggling commodity business that lacks pricing power (the stock is down more than 50% since we sold), and StoneMor, although it yields about 10% a year, has been diluting owners' holdings about that much by issuing new units (or shares). We owned GrafTech longer than we should have, believing in a rebound in steel and needle coke pricing as the world economy grew stronger. That didn't happen, and while *Pro* members who bought at the outset still earned a decent return, many others unfortunately did not.

We let our winners be.

This dovetails with low turnover, but there's nuance. It's tempting to sell, reduce, or at least write covered calls on your best-performing stocks. To calm this temptation, we remind ourselves we're invested for at least the next three years, so as long as a valuation offers strong upside over that time period and our allocation is still reasonable, we want to sit tight. Not writing covered calls on, or selling the likes of, **O'Reilly Automotive** (NASDAQ: ORLY), **Medtronic** (NYSE: MDT), **Papa John's International** (NASDAQ: PZZA), **AmTrust Financial** (NASDAQ: AFSI), and many others rewarded us greatly this year. Of course, we'll keep watching valuations, and we will lower our exposure if that seems best.

We added quality businesses.

Last year, we started some investments in strong companies that typically have pricing power, and those positions have already added to our returns. Specifically, we began stakes in **Coca-Cola** (NYSE: KO), **Gilead Sciences** (NASDAQ: GILD), **Skyworks Solutions** (NASDAQ: SWKS), and **Expeditors International** (NASDAQ: EXPD). We also added more shares of **Wells Fargo** (NYSE: WFC), **American Tower** (NYSE: AMT) and **Tupperware** (NYSE: TUP). So far, all but Tupperware have added to our returns. In 2015, we will start new investment relationships with more outstanding businesses.

To the Negative (Boo!)

Our hedges were inconsistent.

We use hedges to lower our market exposure and let us stay more invested in the process; in that way, hedges help us earn our total return. But last year, the timing of our hedges was (inadvertently!) borderline awful. Part of it was bad luck, but we need to improve our process this year.

As some hedges expired last year, we took too much time to set up new ones; by the time we did, the pricing had changed considerably. Then, late in the year, we set up a very responsive hedge, buying in-the-money puts at $200 when the underlying index was $189. The hedge did respond. Sharply. And when the underlying index made one of its fastest ascents ever, to more than $200 in a few weeks, our puts expired worthless. We spent more on that hedge than we would have liked. The egg is on my face for too casually believing the **SPDR S&P 500** (NYSEMKT: SPY) would not soar over those few weeks, and being absolutely wrong. We need to keep hedging in ways that limit our expense.

Though they let us keep more funds invested, our hedges were (as is typical) a drag on our returns last year, and that's expected. I'll have the math on how much of a drag when we look at our returns later this month; it's likely larger than we model (or would like) just because of the in-the-money puts we bought. We seek to lower this expense in 2015.

We covered Intel.

After waiting years for the PC market to rebound, we wrote covered calls on our Intel shares last February after management said it expected another flat year. We basically lost patience with the stock. A few months later, Intel raised guidance, and the stock price began to rise strongly as PCs rebounded after all. Because of our covered calls, we missed much of that upside. This shows some of the folly that's possible with covered calls: We were content to sell our shares at $26 when we wrote the calls — *assuming the status quo*. But as Intel's business suddenly spiked, our sell price looked bad, and we were stuck. So, even when you're ready to sell a stock, covered calls may come back to haunt you. There's a silver lining, though: We invested in Skyworks Solutions as a replacement, and we're considering other investments in the industry, too.

We didn't always short/invest incrementally.

We started our short in **Caesars Entertainment** (NASDAQ: CZR) at a fairly full 2% allocation. Had we started at 1%, we could have shorted more when the stock price shot higher. Likewise, we could have started **Five Below** (NASDAQ: FIVE) with a smaller position than the 1.5% we began with, and shorted more when it spiked, too. The take-away: When starting shorts in volatile stocks, we may make our initial positions smaller (about 1%) so we can easily add more. We did start smaller in our purchase of **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY), and we'll almost certainly get good chances to add to that position this year when volatility spikes.

Execution.

This one falls squarely on me (and a bit on the team). We saw opportunities that we didn't act on in time: great shorts, some longs, and even hedges. This is about process and execution: We can't possibly take every opportunity we see — we need to assess and choose our favorites — but we shouldn't miss moves we want to make. We missed a few this past year due to distraction or delay. We're content to miss ideas if we have lingering concerns, but once we've decided on a recommendation, we need to bring it home — get it out the door — whatever obstacles are thrown in our path.

Income?

Finally, we didn't target much option income in 2014, but that was mainly because we saw stock upside instead. This isn't so much a mistake (stocks did rise nicely) as an admission. In future years, we'll target more option income. Perhaps this year.

To Be Glad Is Foolish

In closing, 2014 was *Pro*'s sixth full year in operation (and my 20th year publicly managing money). Despite our mistakes and shortcomings, we're pleased with our results. You could say we did more right than wrong; I also think we did well largely thanks to the decisions made in years prior that we didn't undo last year. We hope to continue to improve in many ways in each coming year and beyond. And with our ongoing desire to learn from the past, we'll continue our review of 2014 as we roll into 2015.

Comments? Questions? Visit the Memo Musings board. Thank you for being a Fool with us, and happy 2015!

— Jeff (TMFFischer)

Pro Community

- ADrumlinDaisy shares his cautionary feelings on the Caesars short; great conversation ensues, including a visit from Fool CEO Tom Gardner.
- Earnings are coming — already! TMFMoosie has the calendar.
- Member Mike thanks *Pro* for the many happy returns. Here's to 2015!

Gentex's Stock Splits 2 for 1

Published Jan 2, 2015 at 12:39PM

Gentex (NASDAQ: GNTX) split its stock 2 for 1 on Dec. 31, 2014. If you own shares, the split doesn't affect your proportional ownership in the business — it simply means you now own twice the number of shares of the auto-parts supplier at half the price.

If you own Gentex and have entered it in your Fool scorecard, keep in mind that it will take up to 24 hours for the change to go into effect. If you track Gentex in your own system, make sure to double the number of shares you own and halve the price of each share in your records to keep your accounts accurate.

As usual with stock splits, remember that this move doesn't change the value of the company or your investment — it's all about the bookkeeping.

Bring any questions to our discussion boards, and Fool on!

Oil Prices and the Risk of Financial Contagion

Published Dec 29, 2014 at 12:56PM

Dear *Pro* Fools,

As 2014 comes to a close, we can look back on what will be the sixth straight year of positive returns from U.S. equities:

2009	26%
2010	15%
2011	2%
2012	16%
2013	32%
2014	13%

Almost six years after the current bull market began on March 9, 2009, we're still enjoying its presence. But it hasn't been completely smooth sailing — short-term fears have caused several market sell-offs along the way. Some examples include the Greek debt crisis in 2010, the U.S. credit-rating downgrade in 2011, continued Eurozone fears in 2012, and the Ebola- and geopolitical risk-fueled sell-off in October of this year.

With the 2008-2009 global financial crisis fresh in investors' minds, each of these sell-offs was accompanied by temporary panic and media rhetoric that the markets might be in for a major crash, but in each case, the market quickly bounced back and resumed its persistent upward trajectory.

As I read through financial news and headlines, the most recent short-term fear seems to be related to the sharp decline in the price of oil. After trading between $85 and $110 per barrel between 2012 and July of this year, oil prices have taken a rapid nosedive toward $50 per barrel over the past six months.

In parallel with the other market sell-offs of the past few years, the decline in oil prices has led to more media rhetoric and headlines speculating that the oil-price collapse may be the shock that leads to another global financial crisis. (Want examples? See here, here, and here.)

While I won't go so far as to say that the oil-price decline poses no threat to the global economy, I do believe that the linked articles and others like them might be overstating the potential risks, particularly in relation to the U.S. economy. Here are two key arguments behind "oil-price shock" claims, and why I think they are overstated:

1. Oil and gas junk bond defaults might cause a contagion effect.

The argument here is that highly leveraged oil and gas producers will be unable to service or roll over their debt, leading to defaults, asset sales, and a ripple effect throughout the oil and gas industry and the banks that underwrote the loans. Here's an example referring to the impact of oil loan exposure on **Wells Fargo** (NYSE: WFC).

After examining the data, I believe this fear is overstated. For example, referring to the Wells Fargo article above, the author neglects to compare Wells Fargo's oil and gas loan exposure to the size of its total loan portfolio. The author states that "Wells Fargo currently has very large exposure to the O&G industry relative to its peers." But as of the most recent 10-Q, Wells Fargo carried a total average loan balance of $833 billion, of which only 1.9%, or $15.4 billion, is related to the oil and gas industry. Even if default rates on oil and gas loans quintuple, there will be minimal impact on Wells Fargo's overall loan portfolio and credit quality.

On a more macro basis, I recently read a blog post comparing the size of the high-yield energy debt market to the total value of the U.S. bond and equities market, using data from the Bank of America Merrill Lynch bond database. The data show that even if the entire high-yield energy debt market defaults (an outlandishly unlikely scenario), it would only wipe out 0.6% of the value of the total U.S. bond market. Although this analysis is simple and neglects the impact on related equities and non-U.S. debt, it illustrates the fact that high-yield energy debt is a very small part of the total financial market, meaning that a contagion effect isn't highly likely.

2. Lower oil prices will hamper U.S. job growth.

After peaking at 10% in October 2009, the U.S. unemployment rate has been on a steady decline, and it now sits at a multi-year low of 5.8%. Low unemployment is good for an economy because it leads to higher production capacity, which in turn leads (along with increased labor productivity) to higher growth and economic development.

The fear here is that layoffs in the oil and gas industry might increase the unemployment rate and reverse favorable economic trends. While there will undoubtedly be layoffs in the energy sector, the effects are not likely to be severe.

According to the most recent data from the Bureau of Labor Statistics, all jobs directly related to the oil and gas industry represent just 0.7% of total U.S. non-farm employees. Even if job growth decelerates because of a retrenchment of investment in oil and gas exploration, the effect on the overall U.S. labor market will likely be small.

The *Pro* Bottom Line

As humans, our fear of loss often trumps the desire for gain. So it's only natural for us to jump to fearful conclusions when a new risk comes to light, such as the risk that the collapse in oil prices will lead to a financial crisis. But after examining the data, it appears that the fear of "oil-price shock" is less substantiated than the headlines suggest.

In addition to the two counterpoints I noted above, another intriguing aspect to the decline in oil prices is its potential to boost consumer spending — less money spent on gas means more disposable income for other things. And because personal consumer expenditures account for about 70% of U.S. GDP, if oil prices stay low, we may see newfound strength in consumer spending, stimulating higher GDP growth.

Fool on!

— Billy (TMFTailwind)

Pro Guidance Update

- **Oracle** (NYSE: ORCL): Our fair value estimate increases to $46 from $42. Shares remain a Buy First, with a recent 4.7% allocation. You can read our new update on recent earnings here.

Oracle Shines Again

Published Dec 29, 2014 at 11:28AM

Oracle (NYSE: ORCL) reported stronger-than-expected results on December 17 as its cloud software pipeline continues to turn into revenue. The company now has a $2-billion annual run-rate on cloud software, and that's "annually recurring revenue." It will continue to build on that. On-premise software and hardware also sold well.

Overall, Oracle is benefiting from its comprehensive software and platform suites, and from its highly focused, larger sales staff. Our fair value estimate increases to $46, targeting 10% annualized returns from there, and the stock remains a Buy First, at a current 4.7% allocation. See our full review on *Pro's* Oracle discussion board.

Stocks to Watch in 2015

Published Dec 29, 2014 at 9:00AM

Discover the three stocks Fools are watching in the new year.

{%video%}

Matt Argersinger: My stock to watch in 2015, it's got to be **SolarCity** (NASDAQ: SCTY), a company we've bought a couple times for our Odyssey 1 mission in *Supernova*. I just think they're at a point where they're seeing massive growth, but they're going to hit a million customers in a few years. With solar power now competitive, in most places, with traditional forms of electricity, it's going to be a huge ramp up for them.

Buck Hartzell: Stock to watch 2015 is **BofI** (NASDAQ: BOFI), Bank of the Internet. It's taking share from all of the big traditional bricks and mortar banks with retail branches, doing it online. They've had a phenomenal year, and the stock hasn't moved that much so I think it's going to have a good year next year.

Rana Pritanjali: I'll be watching energy sector, and the stock in particular would be **Seadrill** (NYSE: SDRL). Last year, because of the falling oil prices, energy sector has been just hammered. I think it has underperformed S&P 500 by 15%, and Seadrill is down more than 50% this year.

There's a lot of speculation going on whether they'll continue their current dividend payment. Right now, as you see, at the current price the yield is very high, so that's a stock I'm going to watch. *(Editor's note: Seadrill canceled its dividend after this video was filmed.)*

The company keeps on buying new rigs, and they are taking debt, and the CEO is pretty bullish on how the oil is going to go from here on out. I think the price of oil, the current price is not sustainable, so it's going to change. That's a company I'm going to watch for.

Outrageous Predictions for 2015

Published Dec 29, 2014 at 9:00AM

Four Foolish analysts take a stab at anticipating the investing stories that would surprise us in 2015.

{%video%}

Transcript

David Kretzmann: I'm going to say that **Apple** (NASDAQ: AAPL) is going to acquire **GoPro** (NASDAQ: GPRO) for $20 billion or more in 2015.

Buck Hartzell: My outrageous prediction for next year, 2015, is that **Berkshire Hathaway** (NYSE: BRK-B) and Warren Buffett will reload his elephant gun and actually acquire **Coca-Cola** (NYSE: KO). It would be about a $200 billion purchase, largest ever — probably in history — and he's got the cash and the capability and the borrowing power to do it, and I don't think he likes incumbent management. Untapped brand, and that will be his coup de grâce in his whole career, if he can acquire that venerable brand.

Brendan Matthews: This is a completely outrageous prediction. We've seen a big bubble in marijuana penny stocks, fraudulent companies that are capitalizing on the hype. I think that's actually going to continue, because I think President Obama is going to be the most prominent politician that's ever spoken out in favor of legalized marijuana. He is in his lame-duck years. He just lost the Senate. I think he's thinking about his legacy, and he wants to be on the right side of this issue.

Jason Moser: I think that this is the year that Warren Buffett will actually give us full clarity into his succession plans for Berkshire Hathaway, when he decides to step down. We have a lot of clarity thus far on the investing side, with Ted Weschler and Todd Combs, but we don't know as much about the executive positions and who's going to be the CEO of the company. He keeps that under wraps for now. I think that 2015 is the year where we get total clarity, and I don't think the market will freak out about it.

Gilead and Caesars Shake It Up

Published Dec 22, 2014 at 3:44PM

Dear *Pro* member:

The stock market rarely takes a holiday. I was going to use today's Memo to remind everyone that we should expect more volatility in coming years than we've seen the past few years — and that's not a bad thing. You just need to remain calm through it, and view sudden shifts as moments of opportunity. We didn't need to wait long, though, as today presented large moves in two of our positions.

For those rushing to wrap gifts and get to family gatherings, my takeaway is that our reasonable allocations helped the portfolio glide through today, and we need to keep managing our position sizing in 2015, too. That's half the battle. Meanwhile, our guidance on the two companies in the spotlight today remains unchanged. Now, let's discuss the stock-specific news.

Gilead Gets the Cold Shoulder

The landscape for pharmaceutical sellers may have begun to change today — and that includes Buy First stock **Gilead Sciences** (NASDAQ: GILD). **Express Scripts** (NASDAQ: ESRX), the country's largest pharmacy-benefits manager, will offer **AbbVie**'s (NYSE: ABBV) new hepatitis C drug for patients with the most common form of the illness — but not Gilead's drug nor other competing drugs. Why? Express Scripts signed an exclusive deal because AbbVie gave it pricing concessions.

This controversial move by Express Scripts blocks customers from accessing Gilead's arguably better treatment (it has fewer side effects, and requires only one pill a day instead of four to five). Express Scripts handled approximately 30% of all drug prescriptions across the U.S. last year, and now in a bid to lower costs, its CEO is promising to push drugmakers into pricing concessions — or be locked out. Even AbbVie fell on today's news, because it suggests that drugmakers are losing some of their power.

The takeaway for Gilead: There's no doubt that being largely shut out of the largest pharmacy-benefits manager in the country will affect Gilead's hepatitis C earnings. The question is to what magnitude. The AbbVie deal pertains only to the type 1 genotype of hepatitis C, which accounts for about two-thirds of cases. Express Scripts will still offer Gilead's drugs to cover other genotypes. So, that's two-thirds of Express Script's hepatitis C cases not being offered to Gilead, on approximately one-third of the U.S. population that's under Express Scripts.

That's obviously large, but more concerning is whether other benefits managers will try to go the same route as Express Scripts, forcing Gilead to lower prices in the process, or lose market share. Our valuation on Gilead is conservative enough that we believe it will fulfill our return objective over the coming years even now. But the odds of the stock nicely *exceeding* our goals are lower now, and risks are higher than before. If Gilead loses favor with other major pharmacy-benefit managers, our thesis will be challenged. For now, though, we believe it can weather this setback and still offer us handsome returns.

But it's not the last word: Controversy may also cause Express Scripts to backtrack eventually. Not allowing patients a better drug just due to (perhaps small) cost differences may not be good business. AbbVie's hepatitis C treatment costs $83,300 for 12 weeks, before the undisclosed concession that it granted Express Scripts (which we estimate could be as low as $60,000). But let's remember what Gilead said last quarter:

> We [Gilead] received FDA approval for Harvoni, a simple, safe and highly effective oral single-tablet regimen for hepatitis C. The 12-week regimen price for Harvoni is $94,500, which is in line with the regimen cost of the previous standard of care... We expect over time that up to half of genotype 1 patients may benefit from just eight weeks of therapy, meaning that the cost will be reduced by one-third for many patients.

That would bring Gilead's Harvoni treatment down to $62,370 for many patients, or perhaps about the same as AbbVie's, but with a better, easier treatment.

Express Scripts' CEO has long stated his anger about drug costs, and vows to take his fight to other major drug categories, too. But is he losing sight of patients and the big picture?

Still, in the immediate future, the U.S. is Gilead's most important market, and today's news could reduce by nearly a third its new hepatitis C sales in this country. The stock's reasonable valuation should limit our downside risk and still leave us with good profits over the coming years, but shares will face headwinds until there's more clarity regarding how much sales are affected by today's deal, and the possibility that other battles ensue.

Gilead lately trades at 9.2 times expected earnings in 2015, and consensus earnings growth was estimated at a relatively modest (for Gilead right now) 27%. We ourselves were modeling much closer to 20%. The company's growth could still be in that ballpark as its hepatitis C sales expand in Europe, Japan, and of course keep taking root in America. It remains a Buy First, although it's suffering a setback today, and has more uncertainty now in 2015.

Caesars Keeps Shuffling

Making today doubly interesting, **Caesars Entertainment** (NASDAQ: CZR) announced it would merge with **Caesars Acquisition Company** (NASDAQ: CACQ) in an all-stock deal. Caesars Acquisition was created in 2013, but already it's being acquired by its original parent company, which apparently has more arms than an octopus. CACQ has equity and debt investments in the gaming industry, including four casino properties that used to be held by the parent company, as well as online gaming ventures. It's those final two parts that interest Wall Street, who cheered the acquisition because it brings online gaming back to the fold at the parent company, along with four stronger casinos.

The excitement seems overstated, though, given the lack of financial strength at CACQ. At the same time, Caesars itself is technically in default, and has reportedly only reached a voluntary restructuring agreement with a few of its many debt holders. As long as the others stand firm and continue to sue, the company may face an involuntary bankruptcy in 2015 — depending on how courts rule.

One media source describes today's news as the company continuing to shuffle chairs on the deck of the *Titanic*. We won't be so bold as to say that. We know Caesars could still avoid the iceberg and roll over our short position instead. But our position is small enough that we'll be able to ride through that outcome, should it occur. We'll close the position if Caesars can pull off a restructuring that greatly lowers it debt, but we believe the odds still favor an outcome that gives control to those who actually deserve it: The first-lien bond holders (not the equity owners). An outcome should arrive in 2015. The stock remains a Sell Short right now for brave investors who keep the position small.

In Other News ...

Elsewhere in the portfolio, our largest position, **AmTrust Financial Services** (NASDAQ: AFSI), remains under fire from a small hedge fund that has a giant bearish spread on the stock. Alistar Capital needs the stock to fall very sharply to avoid a 100% loss on its massive option position. As you've seen, we take Alistar's attacks seriously, address them as they appear, and hope to meet with AmTrust early in the New Year. AmTrust is suing Alistar for defamation, among other things.

Our Portfolio Should Thrive Over the Years

Overall, today was an inauspicious day in *Pro*. One of our core investments was among the biggest losers on Wall Street, and one of our shorts was among the biggest winners. But we've had a good year, and over the past six years, *Pro*'s portfolio has outperformed the vast majority of all hedge funds and mutual funds. Days like this just happen. They're a reminder that nobody is infallible, and that we have to always work to keep our portfolio in the shape we want it. Only a sensible portfolio allows us to take days like this in relative stride.

Enjoy the holidays! We look forward to a Foolish 2015 investing with you!

— Jeff (TMFFischer)

Pro Catch-Up Trades

- **American Tower** (NYSE: AMT): Buy to open January 2017 $80 calls, in a 0.5% cash allocation, per last week's recommendation. Lately, you would use a limit order at $24.85 to split the bid/ask spread. Our total stock and option position in this business is now 4.3%.
- **Gilead Sciences** (NASDAQ: GILD): Shares remain a Buy First at a 3.7% allocation, even as competitive news rocks the price today. Through risks are higher now, we believe that over our time frame (a rolling three years) owners will still be rewarded.
- **SPDR S&P 500 ETF** (NYSEMKT: SPY): As a hedge, set up a put ratio spread as recommended. With SPY higher today, now the original spread can be set up for about a $0.05 or so debit (rather than a small credit), but it is still a menial cost. Please see the trade alert for allocation and other details, and for a link to the board for questions.

Pro Completed Trades

- **American Tower** (NYSE: AMT): We bought six January 2017 $80 calls at $23.35 each, for a 0.5% (cash basis) allocation, bringing our total exposure to this company (on a cash basis) up to 4.3%, per our recommendation.
- **SPDR S&P 500** (NYSEMKT: SPY) **ETF:** We sold to open twenty-four March 31, 2015 $182 puts, and bought to open twelve March 31, 2015 $195 puts, setting up a put ratio spread as a 10% look-through allocation hedge, per our recommendation. We received a $0.43 net credit to set this up.

Pro Catch-Up Trades: Dec. 22, 2014

Published Dec 22, 2014 at 2:12PM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking, or on trades where price guidance was due for an update.*

- **American Tower** (NYSE: AMT): Buy to open January 2017 $80 calls, in a 0.5% cash allocation, per last week's recommendation. Lately, you would use a limit order at $24.85 to split the bid/ask spread. Our total stock and option position in this business is now 4.3%.
- **Gilead Sciences** (NASDAQ: GILD): Shares remain a Buy First at a 3.7% allocation, even as competitive news rocks the price today. Through risks are higher now, we believe that over our time frame (a rolling three years) owners will still be rewarded.
- **SPDR S&P 500 ETF** (NYSEMKT: SPY): As a hedge, set up a put ratio spread as recommended. With SPY higher today, now the original spread can be set up for about a $0.05 or so debit (rather than a small credit), but it is still a menial cost. Please see the trade alert for allocation and other details, and for a link to the board for questions.

Pro Completed Trades: Dec. 22, 2014

Published Dec 22, 2014 at 1:36PM

Pro's recent completed trades:

- **American Tower** (NYSE: AMT): We bought six January 2017 $80 calls at $23.35 each, for a 0.5% (cash basis) allocation, bringing our total exposure to this company (on a cash basis) up to 4.3%, per our recommendation.
- **SPDR S&P 500** (NYSEMKT: SPY) **ETF:** We sold to open twenty-four March 31, 2015 $182 puts, and bought to open twelve March 31, 2015 $195 puts, setting up a put ratio spread as a 10% look-through allocation hedge, per our recommendation. We received a $0.43 net credit to set this up.

The Best CEOs of 2014

Published Dec 22, 2014 at 9:00AM

Watch this video and discover which CEOs rank among the best for 2014.

{%video%}

Jason Moser: We go back to February, with the Olympics and Sochi speed skate suitgate. You remember that, the big issue with the U.S. speed skate team? There were some problems, I guess, with the way the suits ... there was a perception there that the suits were not working very well. It turned out really it wasn't the suits, it was their training regimen. Kevin Plank is getting my call for CEO of the year, the way he handled that with total equanimity. He was not pointing fingers or making accusations, but being very proactive to the solution. It all ended up with the U.S. speed skate team renewing their deal with **Under Armour** (NYSE: UA) to supply uniforms for future events.

John Rotonti: The best CEO of 2014 was Warren Buffett. I think three different times in 2014 he acquired businesses by swapping stock from **Berkshire**'s (NYSE: BRK-A) (NYSE: BRK-B) portfolio that had huge unrealized gains, which saved Berkshire shareholders billions of dollars in taxes, and he's giving more and more responsibilities to Todd and Ted, to help plan for his eventual retirement.

Sara Hov: In 2014, **Williams-Sonoma** (NYSE: WSM) has just had really great success, even though the overall retail landscape has been extremely hard. I think CEO Laura Albert is a big part of that. She's kept the company focused on doing the right things to not only increase overall sales, but also just really kill it in the direct-to-consumer sales, which are now 51% of total revenue.

The Biggest Winners of 2014

Published Dec 22, 2014 at 9:00AM

Watch the video and discover which companies had an excellent year.

{%video%}

Brendan Matthews: The company I think had the best year in 2014 was **GoPro** (NASDAQ: GPRO). The stock is up 129%, successful IPO, $9 billion valuation — but really, the product is amazing. I've owned 20 cameras in my life, and this is the best one I've ever had. It's not even the camera, it's the stuff that people have done with it. You can go on YouTube and watch a fireman saving a kitten. It's amazing, and it's a company that's sold over a million units in the last quarter alone. I'm very impressed by GoPro.

Matt Argersinger: I'm going to go with **Keurig Green Mountain** (NASDAQ: GMCR). I think it's still, at this point, the No. 1 performer in the S&P 500 this year, totally surprised everyone. Everyone left the whole Keurig single-serve coffee machine for dead a few years ago, but it's actually become now, I think, the huge platform for single-serve coffee and potentially other drinks, so Keurig Green Mountain — awesome 2014.

John Rotonti: I think the company that had the best year in 2014 was **Apple** (NASDAQ: AAPL). I think the stock was up 48% for the year, and I think the market is giving the company credit for being more than just a hardware company now, but also an aspirational brand, which gives them pricing power, and a great software company as well. Then Apple also has a ton of optionality because of the $150 billion of cash on the balance sheet.

Sophia Lee: I think the company that had a great year in 2014 was **Ambarella**, AMBA (NASDAQ: AMBA). They supply camera chips for tech products like GoPro, security cameras, and wearable technologies. I think going forward they are riding this enormous trend in robotics and wearable technologies. Their competitive positioning is also helping their 120% growth this past year.

Sara Hov: Activision Blizzard (NASDAQ: ATVI) killed it this year. Their traditional games that they're known for are continuing to gain members, like *World of Warcraft*, and their new releases have just blown expectations out of the water. It's been a great year for them.

The Best Way to Invest in America's Future

Published Dec 17, 2014 at 3:55PM

Baby Aiden

Andrea was just 22, and had only been dating Eric for a few months when she learned she was pregnant. Andrea and Eric felt overwhelmed by the news. They desperately needed help.

Fortunately, Andrea enrolled in the national Nurse-Family Partnership® program, which provides nurse home-visits to low-income, first-time mothers. Andrea's nurse was able to answer questions about her pregnancy, and later, after her son Aiden was born, offered guidance on the baby's health and development.

Despite being young and woefully unprepared, Andrea and Eric eventually became successful parents. Andrea notes that "there isn't a class in school that tells you how to raise a kid" and believes that Nurse-Family Partnership is "like an instruction book that gives you the knowledge and positive encouragement to raise a baby." Aiden is now a thriving 11-year-old, and a big brother to his baby sister Briella, sister Autumn, and brother Cody.

By working with young, first-time moms, Nurse-Family Partnership is able to truly change lives – for generations to come. That's why The Motley Fool is proud to announce its collaboration with Nurse-Family Partnership for our 2014 Foolanthropy campaign. Click here to invest your tax-deductible contribution before 2014 ends, or keep reading to learn more about this outstanding evidence-based community health program.

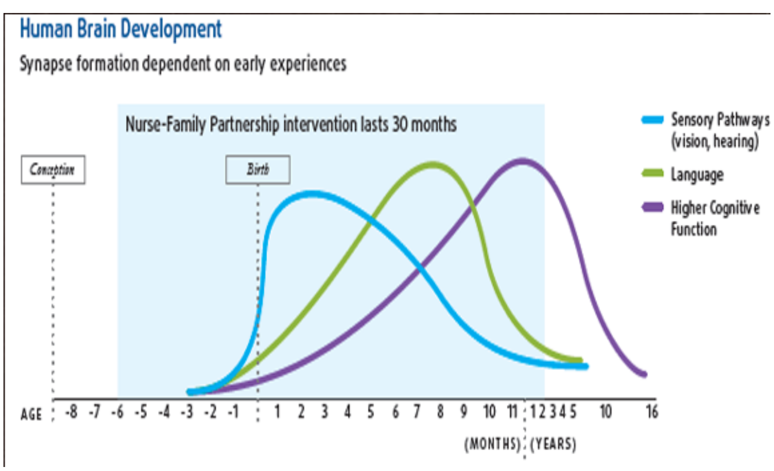
How Nurse-Family Partnership Changes Lives

The Nurse-Family Partnership program provides nurse home visits to first-time, low-income expecting mothers, most of whom are teenagers and unmarried. Beginning in pregnancy, the young woman is supported by a registered nurse who provides her with home visits to help her have a healthy pregnancy. After birth, the home visits continue until her child's second birthday. The organization focuses on new moms because a first pregnancy provides the best opportunity to promote and teach positive health and development behaviors between a mother and her baby.

Since the program began in 1996, 206,412 families have been served. Currently, 30,309 families are enrolled in the Nurse-Family Partnership in 43 states, the U.S. Virgin Islands, and six Tribal communities.

The program is based on the innovative work of David Olds, Ph.D., professor of pediatrics, psychiatry, and preventive medicine at the University of Colorado Denver. Olds passionately believes that early childhood development is crucial to success later in life. This belief led him to create a nurse home visitation program for vulnerable moms and their children.

Infancy is a critical time for child development. The level of support an infant receives early on has a major lasting impact on the child's emotional, educational, and social progress throughout life. According to Olds, "Terrible things can be prevented and good things can be made to happen with the involvement of nurses with these families early in their lives."



Source: Nelson, C.A., In Neurons to Neighborhoods (2000). Shankoff, J. & Phillips, D. (Eds.)

Nurse-Family Partnership helps poor first-time mothers during that critical first two-year window of opportunity for babies by sending nurses to teach mothers good health practices, and how to provide responsible child care, plan their economic future, and find work.

The evidence is clear that providing mothers with high-quality medical and emotional support from experienced nurses is an effective way to promote positive results during a critical phase in children's lives.

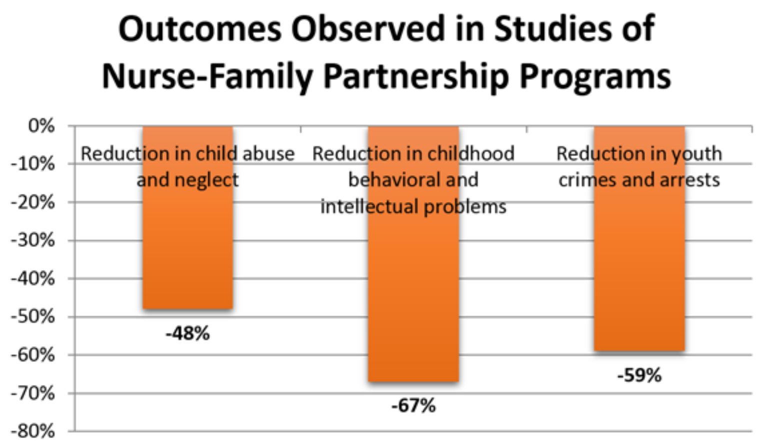
Investing in early childhood development could be the best investment we can make in America's future, and Nurse-Family Partnership is one of the best programs out there.

The remarkable story of Dr. Olds and his innovative idea is featured in the best-seller *A Path Appears: Transforming Lives, Creating Opportunities*, written by Pulitzer Prize winners Nicholas Kristof and Sheryl WuDunn. The authors write that Nurse-Family Partnership is "one of the most vigorously backed antipoverty programs in America, one that pays for itself several times over in reduced costs later on." Indeed, the RAND Corporation found that local communities can see up to a $5.70 return for every dollar they invest in the program.

One of the Best Antipoverty Programs in America

Here are just a few of the impressive benefits that have been observed in randomized, controlled trials among families participating in Nurse-Family Partnership:

- **48% reduction in child abuse and neglect:** The support and knowledge of nurses help mothers and children avoid the worst outcomes.
- **67% reduction in childhood behavioral and intellectual problems at age 6:** Better parenting leads to improved behavioral, emotional, and educational development for children.
- **59% reduction in youth crimes and arrests at age 15:** A healthy foundation in childhood helps to set children on the right path for later in life.



In addition, a study by Ted Miller, Ph.D., with the Pacific Institute for Research and Evaluation predicts that when Nurse-Family Partnership is brought to scale, it can achieve a 60% reduction in infant mortality and a 53% reduction in alcohol, tobacco and marijuana use for children ages 12 through 15.

Studies also indicate the program has other positive benefits for families and even saves more money than it costs by reducing the government's welfare, juvenile crime, and other expenses.

- **82% increase in months employed for mothers:** In addition to teaching parenting skills, nurses help poor mothers plan their economic future and find work so they can get on their own feet.
- **20% reduction in months on welfare**
- **68% increase in father's presence in household:** Families that have access to Nurse-Family Partnership show greater stability in other areas, as well.

It's Up to Us, Fools

We couldn't be more impressed with the program's effectiveness at helping mothers who want to raise their babies well and just need knowledge and support.

Right now, there's a huge opportunity to help Nurse-Family Partnership expand. Currently, Nurse-Family Partnership only reaches 2%-3% of eligible families.

During last year's Foolanthropy drive, our members raised $113,000 to build schools in Guatemala, absolutely shattering our $50,000 goal.

This year, we're aiming to raise $75,000 for the 2014 Nurse-Family Partnership Foolanthropy campaign with the help of the Fool community. This investment will help expand nurse visits to even more communities around America.

The Fool has made a $5,000 initial contribution, will match up to $5,000 in employee contributions, and will donate an additional $2,500 if we as a Foolish community reach our stretch goal of $100,000.

So now's your chance to chip in with us alongside the many Fools who are helping to make sure that every child gets the very best possible start in life. (Remember to claim your 2014 tax deduction if you contribute before the year-end deadline.)

Click here to find out more on how you can help, too.

Buy Calls on American Tower

Published Dec 17, 2014 at 1:26PM

Is this for you? *Pro* is targeting long-term upside by buying LEAPS on **American Tower** (NYSE: AMT), seeking leveraged returns if the stock appreciates by 2017. If you're following our portfolio closely, you should do the same.

How You Participate

- **Action:** Buy ("buy to open") January 2017 $80 calls on American Tower. (As a reminder, these calls will appreciate with the stock; they give you the right to buy the shares for $80 any time before expiration if you so choose. Need a refresher on when and why we buy calls? Click here.)
- **Allocation:** Invest approximately 0.5% of your *Pro* funds. At recent prices, this most closely equates to buying one call for about every $400,000 you manage; for *Pro*, that's about 6 contracts. This is a small position by design, so be careful not to over-allocate. We already own 3.8% in the stock. *Pro* members with smaller portfolios should see the Alternative Trades section below.
- **Price Guidance:** This option is not very liquid, so **it is critical that you use a limit order**, aiming to split the bid/ask spread. At current prices, ideally you'd pay about $20.50 or less per contract, but if the stock price rises, you'll need to pay more.
- **Recent Option Price (bid/ask):** $19.40/$21.10
- **Recent Share Price:** $96

What We're Thinking

Stock Info

- **Fair-Value Estimate:** $110
- **Scorecard Status:** Buy First

Pro members who have been following our American Tower position since the original buy report know that we view the stock — and the investment — favorably. Since our purchase at about $84 per share in May 2013, we've written and rolled a series of puts to try to add to our position, earning income along the way. Earlier this year, we added to our position outright, raising its allocation and making the company a more meaningful contributor to our results. Now, with the stock hovering near $96 per share at a 3.8% allocation, we've earned a North Star-beating annualized return of more than 13% when including all dividends and put proceeds. With today's call purchase, we're hoping to capitalize on additional upside.

The company has progressed against our investment thesis wonderfully since we first recommended purchasing the stock. In our original recommendation, we expected exponential growth in worldwide mobile data consumption to lead to strong revenue growth over the subsequent five years through a combination of price escalations, acquisitions, upgrades, and international investment. The company is ahead of pace to achieve our expectations; here's how some of American Tower's key metrics have changed since May 2013:

	May 2013	Now	% change
# of Towers	55,966	69,912	25%
TTM Rental Revenue	$2.9 billion	$3.9 billion	35%
Revenue Per Tower	$51,781	$55,813	8%

What's impressive about American Tower's growth is that newly acquired assets typically have a lower tenancy ratio (and thus lower revenue and margins) than assets that have been in the portfolio for several years. Yet even as the company has expanded its tower portfolio by 25%, revenue per tower has still gone up by 8%, demonstrating strong organic growth from increasing mobile data consumption and significant network investments from wireless carriers.

And the company is certainly not done growing – American Tower has made three large-scale acquisitions since June of this year, all international, and one of them in a brand-new country (Nigeria). These acquisitions will add about 16,000 towers to American Tower's portfolio, none of which are accounted for in the above table.

Because these acquisitions will likely stretch American Tower beyond its target leverage range of 3 to 5 times net debt/EBITDA, I suspect management will dial back on big acquisition spending over the next few quarters and will focus mostly on integrating the new assets and using cash flow from the business to pay down debt.

These acquisitions should add significant value if the company can perform like it has in the past, and I believe that the market is currently underappreciating American Tower's demonstrated ability to integrate new assets, increase tenancy ratios, and ultimately increase returns on capital as it acquires new towers. And I believe the company has a lot more room to grow as the global wireless market consolidates and matures. We hope to hold our shares and maintain exposure via calls for at least three to five years, and hopefully longer than that.

How It Fits Into *Pro*

Now that American Tower has been in our portfolio for almost 18 months, we feel comfortable enough with our investment thesis and with management's strategy and execution to target leveraged upside with a LEAPS call purchase. We aim to start with a small 0.5% allocation, knowing that American Tower may see some volatility along with the rest of the REIT sector when the Fed decides to change course on its interest rate policy. If American Tower suffers along with the REIT sector like it did in mid-to-late 2013 when "tapering" was the risk *du jour*, we may have an opportunity to add to our stake at lower prices. If not, we still benefit from leveraged upside.

This call purchase will increase our total look-through exposure (including both owned shares and calls) to 6.3%, making it in effect our second-largest position (our dollar exposure is 4.3%, making it tied for our sixth-largest position). Between American Tower's demonstrated operational execution, excellent management, strong industry tailwinds, and attractive economics, we think buying calls will turn out to be a smart decision.

More That Matters

- **Maximum loss:** Our entire 0.5% investment if American Tower stock is less than $80 at January 2017 expiration.
- **Maximum gain:** Unlimited as American Tower rises.
- **Breakeven:** $100.50 at expiration.
- **Follow-up:** We aim to start with a small 0.5% allocation, and will look to add more calls if the stock falls. And come expiration, we may roll our 2017 calls out for another year or two if we want to stay invested. Finally, if our call purchase is nicely profitable, we may eventually write diagonal calls against it or turn it into a bull call spread.

Alternative Trades

Members for whom one contract would over-allocate their portfolios can consider a few choices:

- Buy 0.5% more in stock, bringing your stake to 4.3%. Realize you won't benefit from the leverage calls provide, although you will have a better breakeven price and no expiration.
- Consider allocating 0.5% to a bull call spread at small strike increments. The in-the-money $90/$92.5, $92.5/$95, and $95/$97.50 spreads all offer attractive annualized returns (lately, 30%, 37%, and 42%, respectively) if the stock price is above the higher strike price at expiration. Out-of-the-money spreads offer higher

returns but an increased chance of total capital loss. (Our sister service, *Motley Fool Options*, offers what we think is an excellent overview of bull call spreads here.)

Pro Can Help

- Consume mobile bandwidth and post questions to the American Tower discussion board.

The Perilous Pitfalls of Multiples-Based Valuation

Published Dec 15, 2014 at 2:39PM

Fellow Fools,

How much is a company's stock truly worth? The question may be straightforward, but the process of answering it is anything but. This is why valuing companies using multiples — price-to-earnings, price-to-sales, price-to-book-value, etc. — has garnered so many adherents. Human beings are, to a large extent, lazy. And using multiples is quick and easy.

That's not to say that using multiples is bad, per se. People who rely on them almost always have the right intentions. They want to buy the cheap stocks and sell (or short) the most expensive. The problem is that they're taking a tool and using it as a solution. Price multiples may convey useful information, but they never tell the whole story. So it should come as no surprise that when we rely too heavily on them, the outcome is usually less than desirable. Let's take a look at some of the reasons why.

Apples to Apples, or Apples to Apple Pie?

One tech company is trading at 30 times earnings. Another is trading at 34 times. Which stock is a better value and worthy of a spot in your portfolio? If you decide based solely on their P/E multiples, then you are implicitly accepting that these two companies are equal with respect to everything except how much you're paying for shares — if they weren't, a difference in price would be warranted.

Flash back to May 2001. George W. Bush was just four months into his first term as president, and the animated film *Shrek* was the No. 1 movie in America. Two computer hardware companies by the name of **Apple** (NASDAQ: AAPL) and Dell were trading for similar multiples — 34 and 30, respectively — even though Dell was larger and more profitable. Their growth rates were as follows:

Company	1997	1999	1999	2000	2001
Apple	(28%)	(16.1%)	3.2%	30.1%	(32.8%)
Dell	46.5%	58.9%	48%	38.5%	26.2%

Apple staged somewhat of an operational recovery in 2000, but it was well on its way to another stinker in 2001, and the invite for the unveiling of the first-generation iPod was still five months away. For those who compared the two using multiples, choosing to invest in Dell over Apple probably looked like a no-brainer at the time. Since then, Apple has returned more than 8,000%, while Dell returned (43%) until it was taken private earlier this year. Peel back the first layer, and you'll often find that an apples-to-apples comparison is actually anything but.

The Best House in a Bad Neighborhood

This bullet point is simple, but it's imperative that you never forget it:

- It's possible that all of your comparables are overvalued.

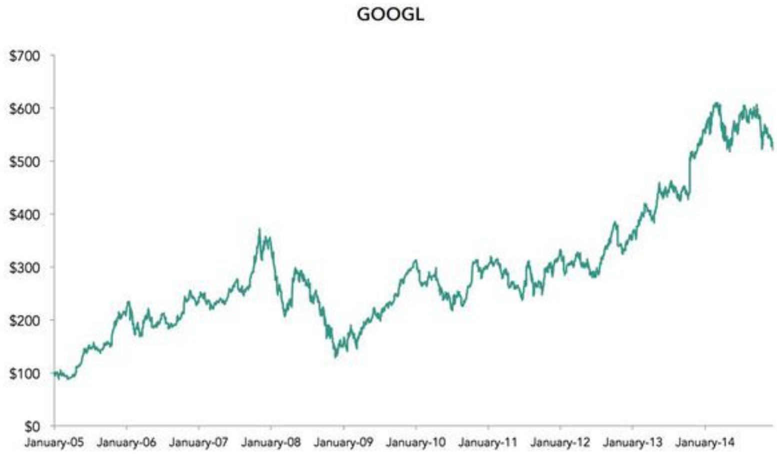
If that's the case, a particular stock may be widely overvalued even though it looks dirt cheap when compared to its peers, *à la* the dot-com bubble. There is little solace to be found when a peer group falls 45% but your stock only falls 40%.

Results May Vary

Did you know there's a mountain of academic research to support the claim that "value" stocks tend to outperform their more expensive "growth" brethren? I feel like I'm reminded of this fact on a weekly basis. Unfortunately, I think a crucial aspect of these studies is lost on most people (or outright ignored): Those studies were done using *large baskets* of value and growth stocks. The results hold on the whole, but individual results *will* vary wildly. Just because a stock looks cheap on the basis of its multiples doesn't mean it's a surefire market-beater. The next time someone cites this research to support their method of investing, ask them how many value stocks they hold in their portfolio. If their value portfolio is highly concentrated, politely remind them that individual results may vary.

Grow, Baby, Grow!

Over-reliance on multiples can also cause investors to pass on huge winners. Why? Because some companies really do grow into their valuation. Let's take another trip back in time, only this time to the start of 2005. Brent Crude oil had just broken $50 for the first time two months prior, and the Robert De Niro and Ben Stiller comedy *Meet the Fockers* was No. 1 in theaters. Imagine I approached you back then and told you to buy the stock of a company that was trading at about 250 times earnings and 20 times revenues, even though I knew the P/E multiple was going to contract by some 89% by the end of 2014. Would you have listened? I wish I had. The stock in question is **Google** (NASDAQ: GOOGL), and it's outperformed the S&P 500 by more than 360% since then:



Will *Pro*'s second-largest position, **Facebook** (NASDAQ: FB), follow a similar route? I don't know. But what I *do* know is that if you think we should sell, you're going to need to come up with a far better rationale than "it's trading at too high a multiple."

Foolishy yours,

— JP (TMFYossarian)

Set Up a Put Ratio Spread on the SPDR S&P 500

Published Dec 15, 2014 at 1:59PM

- **Is this for you?** Please take a deep breath, read this report carefully, and move slowly. This is a hedge, which we employ to reduce volatility and earn returns during a meaningful market decline. You don't need to hedge to succeed with *Pro*, but if you want to — and you have cash available, as we do, and can write naked put options and set up spreads (a high level of permission) — then you should follow along. Those without a margin account can't write naked puts, so they should consider the Alternative Trades at the end of this report, as should those managing less than $182,000.

How You Participate

- **Action:** Set up a put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
- **Allocation:** 10%. Set up one 2:1 put ratio spread for every $182,000 you manage and want to hedge; *Pro* will sell 24 puts and buy 12.
- **Price Guidance:** You receive a small net credit to set up the trade.
  - Write ("sell to open") two March 31, 2015, $182 puts, and simultaneously buy ("buy to open") one March 31, 2015, $195 put for every $182,000 you're hedging. Note that these are quarterly options that expire at the end of March.
    - Sell to open two March 31, 2015, $182 puts: $3.35 (x2 = $6.70 credit)
    - Buy to open one March 31, 2015, $195 put: $6.50
    - Net credit: About $0.20 per spread (prices will change, but aim for a credit or no cost)
    - SPY price: $200

What We're Thinking

First off, today's recommendation is not a reaction to the recently declining stock market, and it's not done with any new concerns in mind — lower energy prices, for example, should ultimately help the economy grow. Rather, we've been planning a hedge for several weeks. The market's decline of 4% from its high doesn't play a role, nor are we suggesting the market will continue to decline. If pressed, I'd guess it'll be higher a few months from now, but obviously nobody knows. That's why we insure against declines. This is just what we do. And in *Pro*, we aim to hedge in attractive ways.

This hedge costs nothing out of pocket, and it won't work against us if the market increases in price — it will simply expire unused, paying us some income to boot. Income aside, this hedge generates a positive return for us if the index declines between about 2.5% and 15% by our March expiration, a wide range that represents the typical magnitude of a near-term market decline.

The only catch of this "credit" hedge is that — as with any put-writing trade — you need to be ready to buy the underlying investment (in this case, the SPY ETF) if it falls enough. If the index falls more than 15%, the hedge becomes a liability, one that starts at a loss for us if SPY is below $169 at expiration.

So, our breakeven on the position is about 15% lower than the current SPY price — a healthy cushion on a large index, but not outside the realm of possibility. It's also worth noting that this hedge doesn't benefit us at expiration unless SPY is at least 2.5% lower than its recent $200. That's by design; as we often say, there's little to be done about small market declines (typically we say 7% or less), but we want to hedge against larger falls. This hedge will reach its maximum profit if the index declines another 9%, and will provide some profit all the way up to a 15% or so market decline. Some details on allocation and returns:

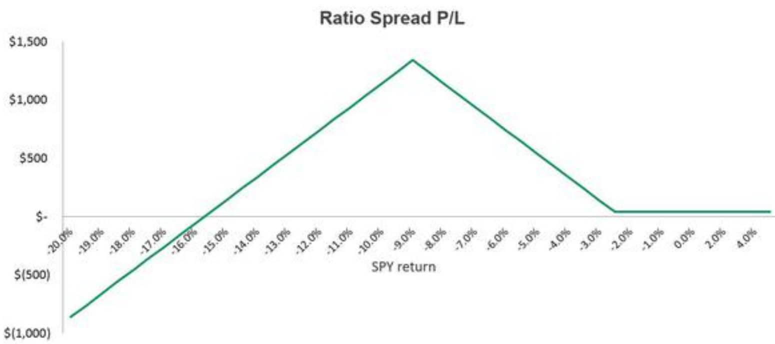
- Recent portfolio value: $2,300,000
- 10% of that value: $230,000
- Buy to open $195 puts (12 contracts, representing 100 shares each) = $234,400 in look-through exposure, or a 10%+ hedge on our current portfolio value
- Sell to open 24 $182 puts (half of which become a potential obligation, also about a 10% possible stake)
- Make sure you only write two puts and buy one for every $18,200 in SPY you could afford if you were forced to buy shares. (That number is $1,820 if you use the March 20, 2015, Mini options in our alternative trade below. These minis are denoted by a "NS.")

Return Details

SPY Price at Expiration	Value of 1 Purchased $195 Put	Value of 2 Written $182 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%) From $200

SPY Price at Expiration	Value of 1 Purchased $195 Put	Value of 2 Written $182 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%) From $200
$195 or higher	$0	$0	$0.20 per spread (or the credit received from initiating the trade)	Any increase in price, or any decline of less than about 2.5%
$193	$2 x $100 = $200	$0	$200	3.5%
$191	$4 x $100 = $400	$0	$400	4.5%
$189	$6 x $100 = $600	$0	$600	5.5%
$187	$8 x $100 = $800	$0	$800	6.5%
$182	**$13 x $100 = $1,300**	**$0**	**$1300** (max profit per spread)	**9%**
$181	$14 x $100 = $1,400	($1) x 200 = ($200)	$1,200	9.5%
$179	$16 x $100 = $1,600	($3) x 200 = ($600)	$1,000	10.5%
$177	$18 x $100 = $1,800	($5) x 200 = ($1,000)	$800	11.5%
$175	$20 x $100 = $2,000	($7) x 200 = ($1,400)	$600	12.5%
$173	$22 x $100 = $2200	($9) x 200 = ($1800)	$400	13.5%
$169	**$26 x $100 = $2,600**	**($13) x 200 = ($2,600)**	**$0** (break-even)	**15.5%**
$165	$30 x $100 = $3,000	($17) x 200 = ($3,400)	($400)	17.5%

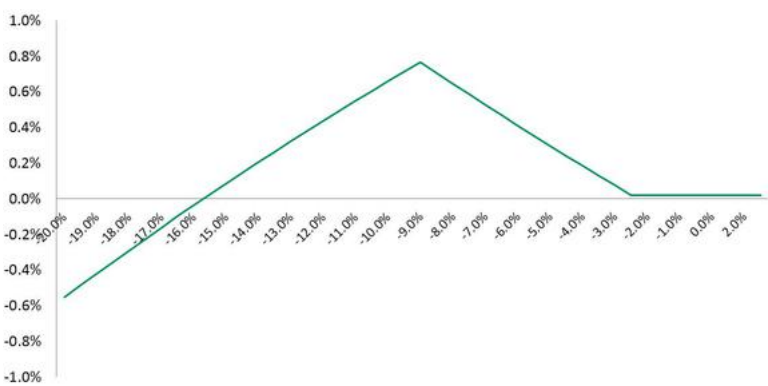
The first bold line above shows that our maximum profit will be earned if SPY declines 9% from its recent price, to $182, by our March 31, 2015, option expiration. Our breakeven on the strategy is $169 per share. If you're more of a visual learner, it breaks down like this:



Assuming we set this up for a credit, the trade will result in a small profit even if the market rises or treads water. But you need to be ready to fulfill the $182 put obligation if the index ETF declines below that price. Depending on the situation, we could start a 10%-or-so allocation in the S&P 500 index then. Or, we'll look at rolling our strategy to future months if we wish to avoid buying shares. Or, we may consider buying calls on SPY instead — to get the discounted price but use less cash. Or we may close the SPY puts to invest in stocks that we like more than SPY and that have declined more.

How It Fits Into *Pro*

Pro has consistently used hedges to lower its market exposure, or risk, in part because we have a North Star goal that calls for positive returns every rolling three years. Given this, any small advantage we can gain in a falling market will make a difference. In this case, if the market declines about 10%, this hedge will add about 0.68 of a percentage point in returns to the portfolio. It doesn't sound like much, but every half-point counts over the years, and even small annual differences end up as large amounts. That's compounding in action. Here's how this hedge can help the portfolio as SPY's price changes.



Alternative Trades

- **If you're hedging in an IRA or can't write naked puts:**
  - For a cost, you can set up a **bear put spread**, a strategy with capped risk that most IRAs allow. Using a spread order, "buy to open" March 31, 2015, $195 puts, and "sell to open" *an equal number* of March 31, 2015, $188 puts. Recently, this will cost you around $2 ($200) per spread, and that is your maximum risk. This strategy would be worth up to $7 ($700) per spread on a decline to $188 or lower, but you should be prepared to lose your $2 per spread if the market doesn't decline enough. As with any market hedge that you pay to set up, you have to *expect* to lose your investment most of the time, especially on a hedge that only kicks in during a lasting market decline.
  - **To lower your market exposure while following our official trade (and make the position possible in some IRAs):**
    - Set up the original put ratio spread as recommended, but also "buy to open" puts at a strike price well below $169. Buy half as many as the number of $182 puts you wrote. When you do so, all of your $182 puts will be "covered" (half by your $195 puts, and half by the other puts you buy at a much lower strike). You will only need cash in your account to cover the difference between your two lowest strike prices.

- **Managing less than $182,000?**
  - Use Mini options.If you want to use the non-standard (NS) Mini-options, which represent just 10 shares of SPY instead of 100, then use the **March 20, 2015 Mini options (there are no March 31 Minis)** to set up one 2:1 put ratio spread for every $18,200 you want to hedge. Use the same strike prices as our official recommendation, and use a limit order on the options.

Pro Can Help

- **Need a refresher on ratio spreads?** Our guide can help.
- **Want to talk about SPY?** We have a board for that.

A Second Look at Warren Buffett's Favorite Market Indicator

Published Dec 8, 2014 at 12:24PM

Dear *Pro* Fools,

There's no denying it: By many conventional metrics, the stock market is overvalued. Here are some data points to help illustrate that point:

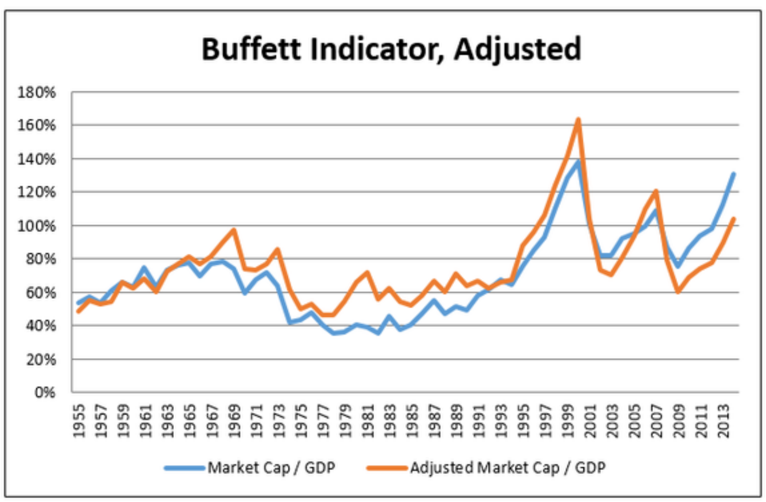
- Market indices are at all-time highs, with the S&P 500 and the Dow Jones Industrial Average closing at record highs last Friday, Dec. 5.
- Since the lowest point of the 2008-2009 financial crisis (March 9, 2009), the S&P 500 is up 207% (22% annualized) over a span of almost six years.
- The S&P 500's valuation metrics are higher than their historical norms:
  - P/E ratio: 20.1 (historical mean = 15.5)
  - P/S ratio: 1.8 (historical mean = 1.4)
  - P/B ratio: 2.8 (historical mean = 2.7)
  - Shiller Cyclically Adjusted P/E Ratio (CAPE): 27.3 (historical mean = 16.6)

Warren Buffett's favorite market indicator, the total U.S. market cap-to-gross-national-product ratio, also suggests the stock market is overvalued. In a *Fortune* article in 2001, Buffet mentioned the market cap-to-GNP ratio and explained that it has "certain limitations in telling you what you need to know.[1] Still, it is probably the best single measure of where valuations stand at any given moment."

Because I am familiar with the perils of single-variable analysis, I decided to take a different look at the Buffett indicator by adjusting for another variable – interest rates.

The effect of interest rates on stock valuations is complex, but it can be boiled down to a simple concept: supply and demand. When rates decrease, demand for safer investment vehicles like bonds decreases as well (thanks to the lower yields), and money flows to stocks in search of a higher return on investment. Conversely, when rates increase, demand for bonds increases, and money flows out of stocks into bonds.

Since 1955, a linear regression model shows that changes in the Fed Funds Rate have been able to explain 22% of the variability in the total U.S. market cap. As such, we can adjust the data to correct for the valuation-boosting effect of low interest rates. When we do that, this is what the Buffett indicator [2] looks like:



Sources: U.S. Bureau of Economic Analysis, Federal Reserve, analyst adjustments

When explaining his indicator, Buffett said, "If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200% — as it did in 1999 and a part of 2000 — you are playing with fire."

As you can see, the unadjusted Buffett indicator (the blue line) is quite high, above 120% and approaching levels last seen at the peak of the late-'90s / early 2000s dot-com bubble. However, once the valuation effects of interest rates are taken into account, the adjusted Buffett Indicator is just over 100%, and the market looks less expensive relative to its own history.

To this exercise you might say, "Billy, you're arguing that the stock market isn't as overvalued as we think because rates are low. But if the Fed expects to raise the federal funds rate in 2015, then by the same token, shouldn't we expect market valuations to fall when that happens?"

Statistically speaking, the answer is yes. If I use the same adjustment techniques and account for an expected 2015 federal funds rate of around 1.5%,[3] the simple model predicts a 1.7% drop in the total U.S. market cap. Not too bad.

Am I saying that's what's going to happen? Absolutely not. For a reflexive system like the stock market, we cannot expect that what happened in the past will happen in the future. So if someone asked me what will happen when rates rise, my answer would be "we'll see."

To discuss this Memo, visit the Memo Musings board.

Fool on!

— Billy (TMFTailwind)

1. This article discusses some of the limitations of the Buffett indicator.

2. I used GDP instead of Buffett's quoted GNP because the data was easier to find. The difference between GDP and GNP in the United States is trivial.

3. 1.5% comes from the most recent FOMC economic projections (see "Appropriate pace of policy firming" in Figure 2).

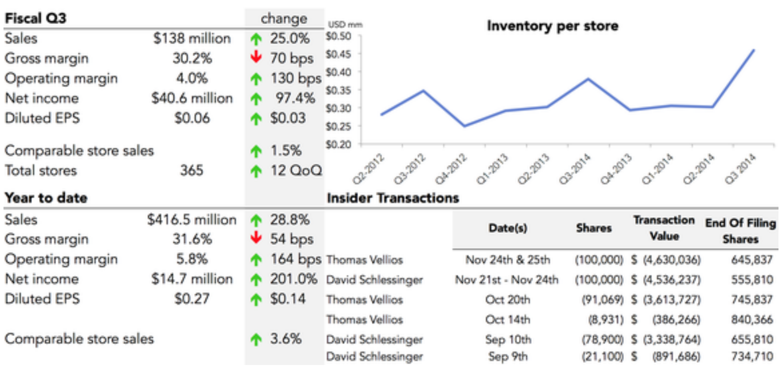
Pro Catch-Up Trade

- **Five Below** (NASDAQ: FIVE): Results for the Thanksgiving weekend shopping extravaganza from this price-capped retailer came in below expectations, and the early read from other tween retailers suggests that the weakness is likely to persist. The volatile stock remains a short at a 1.5% allocation.

Five Below's Third Quarter Was a Mixed Bag

Published Dec 8, 2014 at 11:49AM

Five Below's (NASDAQ: FIVE) third-quarter results and earnings call had a bit of everything.



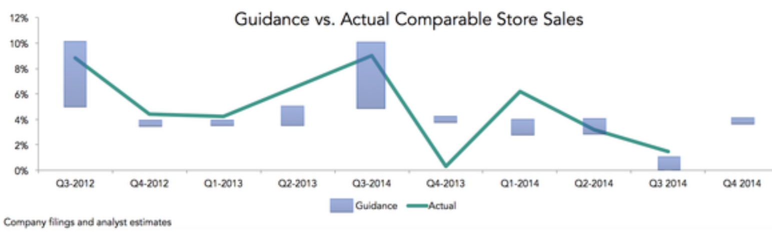
Fiscal Q3		change
Sales	$138 million	↑ 25.0%
Gross margin	30.2%	↓ 70 bps
Operating margin	4.0%	↑ 130 bps
Net income	$40.6 million	↑ 97.4%
Diluted EPS	$0.06	↑ $0.03
Comparable store sales		↑ 1.5%
Total stores	365	↑ 12 QoQ
Year to date		
Sales	$416.5 million	↑ 28.8%
Gross margin	31.6%	↓ 54 bps
Operating margin	5.8%	↑ 164 bps
Net income	$14.7 million	↑ 201.0%
Diluted EPS	$0.27	↑ $0.14
Comparable store sales		↑ 3.6%

Insider Transactions

	Date(s)	Shares	Transaction Value	End Of Filing Shares
Thomas Vellios	Nov 24th & 25th	(100,000)	$ (4,630,036)	645,837
David Schlessinger	Nov 21st - Nov 24th	(100,000)	$ (4,536,237)	555,810
Thomas Vellios	Oct 20th	(91,069)	$ (3,613,727)	745,837
Thomas Vellios	Oct 14th	(8,931)	$ (386,266)	840,366
David Schlessinger	Sep 10th	(78,900)	$ (3,338,764)	655,810
David Schlessinger	Sep 9th	(21,100)	$ (891,686)	734,710

The Good

Starting out with the good (which is bad for folks like us who are short the stock), top- and bottom-line growth came in at a respectable 25% and 97.4%. This strength was driven primarily by a store count increase of 20%, but comparable-store sales did contribute with a positive 1.5% comp for the quarter. This actually exceeded my expectations, given that the company was going up against the 9% rubber band loom comp from last year. Breaking the trend that has been in place since going public, comp growth was driven primarily by ticket size in Q3.



Company filings and analyst estimates

Gross margins continued to come under pressure, largely because of disruption at the West Coast ports. As alluded to last quarter, management decided to incur higher costs and shift receipts from November into October in order to mitigate the risk of not having enough inventory in Q4. Given the company's reliance on Q4 sales, this was prudent.

The Bad

But this move to accelerate import deliveries resulted in inventory on a per-store basis jumping 51% quarter over quarter and 20.6% year over year. This particular metric had been trending higher as the company filled up its new distribution facility in Mississippi, but that kind of growth is unprecedented for the company. For reference, inventory per store grew 26% QOQ and 9.4% YOY last year even though management's forecasts for Q4 2013 were more optimistic. Although prudent, this move could end up backfiring if traffic and sales come in below what management is hoping for. It also means that we should expect the downward pressure on gross margins to continue.

Speaking of traffic, results for this past holiday weekend shopping extravaganza came in below estimates. As a company with no e-commerce strategy in place, Five Below isn't exactly well positioned for the move toward online shopping. These preliminary results, combined with guidance for the all-important holiday quarter that was below expectations, sent the stock down more than 12%. The company expects sales to come in at $262 million to $266 million (implying top-line growth of 23% to 25%) based on one more new store and a 4% increase in comparable-store sales. Taken at face value, these expectations might sound fine, but it is crucial that you view them in light of (1) the fact that FIVE's results last holiday were quite poor, giving them a favorable benchmark, and (2) the expectations embedded in the current stock price.

The Ugly

The two co-founders, Thomas Vellios and David Schlessinger, continue to liquidate their holdings. Interestingly, they took advantage of SEC rule 10B5-1 to sell during quiet periods and sold 119,000 shares one week before earnings. These may be listed as "automatic dispositions," but color me skeptical. In the past three months, the two have liquidated 400,000 shares – good for almost 27% of their holdings at the beginning of the quarter. And this isn't a new development, either. I have a time viewing this as anything other than a negative. If management's forecast of 2,000-plus stores is realistic, why would they be selling when they're not even 20% of the way there? Having received $3,700,000 and $3,600,000, respectively, in cash compensation in 2013, it probably isn't because they need cash.

The Puzzle

In a move that few saw coming, CEO and co-founder Vellios announced his plans to pass the reins over to current COO Joel Anderson. Joel joined the company a little less than six months ago after leaving his position as the CEO of Walmart.com. The speed of with which this all happened leads me to believe that this was part of the reason Anderson decided to join Five Below, though there are rumors that the writing was on the wall for Anderson at Wal-Mart.

Current Valuation

Historical	
EV/EBITDA	25.3
P/E	51.9
P/S	3.25
P/CFO	45
P/FCF	128
Forward	
EV/EBITDA	19
P/E	38
P/S	2.6

The Bottom Line

Q3 results may have beat expectations, but the guidance for the holiday quarter was underwhelming. Given that Q4 traditionally accounts for around 40% of the company's yearly sales, I think this is a trade-off that short sellers should be happy to take every time. I currently view Five Below as a combination of two of the worst places to be in retail – non-discretionary low-priced retail (low barriers to entry, product mix that doesn't support an online presence, etc.) and tween retail (extremely fickle customer base). The true test for our short thesis will come this holiday, but as it stands right now, I struggle to see how Five Below's current business model will support 2,000-plus stores.

Our Favorite Time of Year

Published Dec 5, 2014 at 4:24PM

Greetings, *Pro* members!

We hope you're enjoying the approach of the coming holidays — and to our new members, we hope you're enjoying setting up your *Pro* investment portfolio, too! In our Portfolio Building Reports, we've recommended that new members start to purchase shares in nearly two dozen *Pro* companies that grace our portfolio, and that veteran members already own. These are companies that we have known well, in most cases for many years, and that we of course believe in enough to own ourselves. We see bright futures for our investments. At the same time, we look forward to inevitable market volatility, too, whenever it occurs, as an additional opportunity.

As you saw in last week's *Pro* Portfolio Positioning report (and live event), we're currently working on new portfolio hedges, and dissecting more companies as short-sale candidates. We want *Pro* to handle market downturns with relative grace, if not outright ease. And as always, we have new possible buys (either stocks or call options) and income ideas in the works. In 2015, we're going to continue to target at least 12 new option income recommendations.

It's my favorite time of year. Like many of us, I enjoy using the quiet time at the end of December to reflect and set key goals for the year ahead. When it comes to *Pro*, one goal will be to continue to have a portfolio that we feel 100% great about. This means steady reassessment and adjustments, but our overarching approach is time-tested, and we feel very good about the years to come. We feel confident we will continue to grow strong value over the time frame that matters: the coming years. We're grateful that you're a *Pro* member with us, and we're here to help you however we're able.

Another Live Chat Coming Up

Whether you joined us for our Dec. 3 chat or not, we'd love to see you in our regular monthly live text chat at 4 p.m. Monday. Please bring your questions — and your own goals to share.

Foolishly,
— Jeff (TMFFischer), *Pro* Advisor

Motley Fool Pro Live Chat, Dec. 8, 2014

Published Dec 5, 2014 at 3:45PM

Welcome, Fools! Our live text chat took place on this page at 4 p.m. Monday, Dec. 8. Relive it below!

Pro Portfolio Points

Published Dec 5, 2014 at 10:58AM

Greetings, *Pro* members! I look forward to reflection over the coming holidays, and to being well-positioned for the coming years, as well.

It's late 2014 ... here's where we are:

- We're hoping to have at least 33% more value in our portfolio by 2017, three years from now (that's 10% a year).
- The S&P 500 trades at 19.6 times trailing-12-month EPS, and 16.1 times 2015 estimates (re: Cap IQ). It's on the high side but still within historical averages. Lower oil prices could increase GDP growth overall more than lately expected.
- Many of our stocks trade at lower forward valuations, such as Gilead at 10 times, Skyworks at 13, and Oracle at 12.7.
- As late as mid-November, 73% of large-company value managers were "underperforming" the S&P 500 Value Index, and 94% of large-cap fund managers were trailing the S&P 500 Growth Index, Stovall says. This generally means they'll be reaching for returns this month and to do better in 2015.

Pro

- *Pro* is about 83% net long; new members are around 79% invested once they follow all five of our Building/Positioning reports from the past month.
- We have about 13% cash excluding shorts; new members have 17% or so.
- The *Pro* Port as of today is up 16.7% this year, ahead of the North Star (S&P is up 12% re: Cap IQ).
- Compounding is something: We're up 16% this year, but that means we added $330K in value, or a whole 33% on our original assets this year alone (33% would be one of the market's best yearly returns, and we're earning it in stealth fashion this year on our starting base). That's why long-term stock investors win out: even a 7% annual market gain can be a huge return on the money they invested 10 years ago.
- We've averaged 74% net long this year, and earned 139% of the market's return.
- Members should take their time to continue to get invested following our Building/Positioning Reports, and of course add our new recommendations following new trade alerts as we have them.
- You absolutely don't need to short or hedge or even use options if you're not ready.
- We're here to use a better long-term investing approach (a three-year outlook) in good and weak markets. The market is likely going to be more challenging the coming few years than the last few. We want to be ready.
- We're comfortable with our current exposure, but we're working on new market hedge positions.
- We'll likely lower our exposure to 70% or less as we bring out some hedge ideas, but we're comfortable for the moment.
- We are also working on new company shorts and potential buys (with calls or straight stock)
- All of our stocks are rated Buy First or Buy except **O'Reilly Automotive** (NASDAQ: ORLY), which is on hold for now. We'll have updated thoughts soon.
- All of our shorts can be shorted today except **Five Below** (NASDAQ: FIVE), which we recommend waiting on because it reports earnings tomorrow — in other words, hold off if you're new. Also, you can't really short **UltraShort Real Estate ProShares** (NYSEMKT: SRS) anymore because it is too small. Short more **Direxion Daily Financial Bear 3X Shares ETF** (NYSEMKT: FAZ) in place of starting a SRS short.
- Our synthetic long on **Coca-Cola** (NYSE: KO) is not recommended for newcomers at the moment. A price dip could change that. The diagonal on Coke from *Motley Fool Options*, in which many members participated, was a good alternative anyway. We'll almost surely have more opportunities in Coke for everyone.
- Our position on **Expeditors International of Washington** (Nasdaq: EXPD) was updated for newcomers in [a recent trade alert](). If you didn't do it then, you should wait for a *Pro* Catch-Up Trade to get on board with it.
- If you can't short FXE or FAZ directly, consider the synthetic shorts in the [Positioning Report]() today. But watch your allocations; each syn short is 100 shares. Instead of shorting FAZ or SRS, you can also simply add 1% more to one of our long financials or "real estate" holdings (**MasterCard** (NYSE: MA), **Wells Fargo** (NYSE: WFC), **American Tower** (NYSE: AMT), etc), rather than short FAZ.

Now that [our five reports are out](), as new members slowly take those in, we can spend more time focused on new recommendations that are in the works.

Best,

Jeff

The Pro Portfolio

Published Dec 5, 2014 at 10:07AM

What Is Exposure?

The "Exposure" table at the bottom of our Recommendations page shows how exposed we are to the market's upside and downside. We're simply measuring the amount of the *Pro* portfolio that's invested long versus short as a percentage of total portfolio value.

- "Long" includes all the stocks, bullish ETFs, and options we own – and positions expected to increase in price as the market increases, and decline when the market declines, including our shorts of bearish ETFs.
- "Short" includes all the short stocks, owned shares in bearish ETFs, and options we've written in the portfolio. This excludes our shorts of inverse or bearish ETFs, because those behave like longs.
- Our long exposure *plus* our short exposure equals our gross exposure (or total exposure to the market, long and short).
- Our long exposure minus our short exposure equals our net exposure (or total long exposure to the market). A net number higher than 50% means we're more than 50% long. A number of 70% means we're net 70% long. And so forth.
- "Hedged Out": The percentage of our long portfolio that is currently hedged by in-the-money options (typically covered calls). Once in-the-money, these positions do not offer us more upside, so they're tracked as "hedged out" unless and until they decline below the hedging strike price.
- "True Long": The amount of our assets that is invested long and unencumbered by shorts or hedges. This provides us a clear view of the amount of capital that currently has uncapped upside potential.
- "Cash Ex-Shorts" is the cash we have left *after* the current cost to close all of our short stock, ETF, and option positions, so it's our true cash balance.
- "Short Put Exposure" shows how much cash we would need to spend if all our written (or short) puts were exercised. Keep in mind, we can roll or close our written puts, so we don't often plan to turn all our written puts into cash-based positions. This means this number can be larger than our cash balance for long periods, even though we're not borrowing any funds.

Portfolio Building Report No. 4

Published Dec 1, 2014 at 4:19PM

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new Pro *portfolio.*

[Part 1]() [Part 2]() [Part 3]() [Part 4]() [Portfolio Positioning Event]()

Dear *Pro* member,

The stocks in your fourth Portfolio Building Report range from one of the strongest and fastest-growing biotech companies in the world, to the company earning by far the most profit on the young mobile computing revolution. Once you've read this report, you'll have our updated thinking on the rest of the *Pro* stocks that are rated Buy or Buy First, and our recommendation that you buy them. As always, though, take your time, ask questions on the discussion boards, and only invest as you're comfortable doing so. Average in over time if you prefer, or as you have cash available. We are investing to win over the long haul — that's the only time frame that ultimately matters. Nobody knows what the stock market will do over the coming months (so take your time), but we feel strongly that our companies will create great value over the coming years.

Next up is our Portfolio Positioning Report and live event with you on Dec. 3. We can't wait to see you there! During that event, we'll talk about shorting, hedging, and options, and the accompanying report will provide recommendations on those positions. As you gradually build your *Pro* portfolio of stocks, it becomes time to consider hedges, shorts, and options if you're following along with us in these versatile and promising investment tools. We look forward to the event and then to helping you every step of the way to long-term investing success.

Have a great Thanksgiving! Be Foolish!

— Jeff and the *Pro* Team

Table of Contents

Download this report as a PDF

Buy: Apple (NASDAQ: AAPL)

The leader in mobile computing products could see more growth than anyone expects.

Suggested Allocation: 4.6%

What It Does

Led by its iPhone and iPad, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the smooth Apple operating system, iOS, which centers on the iTunes and App Store marketplaces. iTunes alone earns more revenue each year ($18 billion) than two-thirds of the companies in the Fortune 500, while Apple itself is the most valuable company in the world, approaching $200 billion in annual sales — and still growing strongly, with 20% earnings-per-share growth last quarter. The company's uniquely integrated hardware and software have made for a sticky consumer experience that provides disincentives to switch to a competitor, and as more people use multiple computing devices, only Apple makes it easy to transition from one to the other seamlessly.

For More

- *Pro*'s original recommendation (2/14/12)
- Talk about Apple
- Most recent earnings update (11/22/14)

How It's Working

Over the past year, Apple refreshed all of its product lines and announced Apple Pay and Apple Watch. The Watch rolls out in early 2015, while the new iPhone 6 is already achieving record sales with demand far outstripping ready supply. Tim Cook teases that Apple has more product ideas in the works. Meanwhile, Apple has maintained its magic touch and is not chasing the lower-priced phone market, instead protecting profit margins. We like this choice. Apple earns by far the highest profits in the mobile computing industry, making it the most cash-rich company on earth, with $50 billion in free cash flow last year.

What We Expect

In the longer term, we expect more great innovations from Apple, including other new product categories. We believe customer loyalty will drive healthy recurring sales of phones, tablets and Macs, and new customers and market expansion will add more growth. The stock is priced to produce North-Star type returns as long as Apple maintains its healthy glow, as we believe it will.

Buy: The Buckle (NYSE: BKE)

This well-managed retailer has fit into its jeans admirably over the past decade.

Suggested Allocation: 2.5%

What It Does

Your *Pro* team doesn't know much about fashion, but we can read financial statements. And if the next decade of business performance by **The Buckle** (NYSE: BKE) looks anything like the last one, we'd be willing to wear whatever getup the company suggests. The Buckle sells jeans, other apparel, and accessories at 463 retail locations across the United States, and we think the fantastic management team has figured out a formula that works: measured growth, middle-of-the-road merchandising, and great service. The store concept is in the middle of its life cycle, and the company's financial prudence and operational acumen should lead to a growing stream of free cash flow, dividends, and extra payouts — all of which can help the *Pro* portfolio in our pursuit of our North Star.

How It's Working

The Buckle is a surprisingly steady operator in the notoriously fickle specialty retail space. The company's same-store sales are down 0.5% year to date, while online sales are up 2.8%. We accept a degree of lumpiness here and don't get too bent out of shape when these numbers bop around — The Buckle's target demographic is fickle teens and twentysomethings, after all. We simply monitor these figures for clues about the overall shopping experience and brand relevance. Management's stellar performance has earned the benefit of the doubt:

Metric	2003	2013	Annual Growth
Stores	316	450	3.6%
Sales per Store	$1,354	$2,335	5.6%

Metric	2003	2013	Annual Growth
FCF per Store	$121	$326	10.4%
Sales per Square Foot	$274	$461	5.3%
Inventory Turnover	4.1 times	4.9 times	1.8%

Dollars in thousands. Per-store calculations based on average stores open during the period. Sources: SEC filings, S&P Capital IQ, analyst estimates.

What We Expect

For More

- *Pro*'s original recommendation (6/20/12)
- Most recent earnings coverage (11/25/14)
- Talk about The Buckle

With 463 stores located in 43 states as of the end of the most recent quarter, we believe The Buckle has plenty of room to grow as it expands from the middle of the country to both coasts; it should be able to achieve wonderful store economics with the 650 to 850 locations we ultimately expect. Recent expansion into footwear, accessories, and children's offerings should provide enough fuel to keep same-store sales healthy, while a commitment to customer service entices repeat visits.

The Buckle also has a history of paying special dividends with its excess cash; since 2008, it's paid out almost $15 worth. This past January, *Pro* members holding the stock received a $1.42-per-share payout from the company (after a 1:16 stock split) in addition to the regular $0.22 dividend. While we can't count on special dividends, the average yield over the past six years, including special dividend payouts, has approached North Star-level returns. We're typically leery of the risks of investing in retail, especially fashion, but the proof is in the numbers for The Buckle.

Buy First: Gilead Sciences (NASDAQ: GILD)

One of the strongest biotech companies on earth, Gilead is positioned to keep rewarding owners.

Suggested Allocation: 4%

What It Does

Gilead Sciences (NASDAQ: GILD) helps millions of people fight life-threatening diseases. Its HIV drugs are prescribed to 9 out of 10 new HIV patients, and are already helping millions enjoy much better lives. The company's HIV products represented the majority of Gilead's revenue until its Hepatitis C cure, Sovaldi, was approved this year. The most successful drug launch in history, Sovaldi topped $8.5 billion in sales in three quarters, though it has only been prescribed to about 117,000 patients so far (as of Sept. 30).

An estimated 2.7 million to 3.2 million hepatitis C patients reside in the United States, and a whole 2.8% of the world (almost 200 million people) is thought to have this common blood-borne infection. That means tens of millions could conceivably benefit from Sovaldi or its newer single-pill version, Harvoni, and this would still leave plenty of room for upcoming competing drugs to do well, too.

How It's Working

Gilead's revenue rose 117% in the quarter just reported, sending earnings per share up 255%. The company's products have a healthy lead over competitors' Hepatitis C drugs still awaiting approval, first in the U.S. and then in other countries where it will take even longer. And because Gilead's Hep C drugs look as or more effective than competing products, doctors have few reasons to wait or switch. Gilead's new Harvoni drug, approved in October, is the first single-pill regimen for curing Hepatitis C, and competitors aren't likely to match it anytime soon. Meanwhile, the company's HIV franchise remains unparalleled, and Gilead has more than 200 compounds in clinical trials.

For More

- *Pro*'s original recommendation(4/30/14)
- Talk about Gilead
- Most recent earnings update (11/22/14)

What We Expect

Going into 2015, we expect more growth as Harvoni is prescribed to tens of thousands of new patients around the world. And that won't stop next year; countries will slowly approve the drug and its reimbursement over many years, and we expect Gilead to be the leader in the cure of Hepatitis C. Even if new competitors bring about a slip in pricing, the profits should remain substantial. And by signing generic drug agreements, Gilead is poised to lead the industry in providing a Hep C cure to 90 emerging-market countries. Meanwhile, we expect Gilead's refreshed HIV franchise and growing oncology franchise to keep increasing shareholder value even beyond the Hepatitis C market.

Buy: MasterCard (NYSE: MA)

Plastic — and digital — is overtaking paper as the world's way to pay, and MasterCard leads the charge.

Suggested Allocation: 4.5%

What It Does

MasterCard (NYSE: MA) is among the most attractive businesses in the world. Here's why: The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders, who are actually exposed to the card users' finances; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

Though MasterCard competes with a large number of well-heeled and (in some cases) innovative businesses, the company's profitability is growing quickly even though the global economy isn't. And that makes perfect sense, because when it comes to paying for stuff, the global market leader isn't **Visa** (NYSE: V), or PayPal, or banks ...

it's still cash. Cash has a still-astounding 85% market share of transactions, but it's slow and inefficient, and with no one managing its brand, it's quickly losing out to better alternatives -- like MasterCard.

How It's Working

For More

- *Pro*'s original recommendation (9/8/11)
- Talk about MasterCard
- Most recent earnings update (11/22/14)

This trend has already taken hold in the U.S., where we use cards for a third of our personal expenditures, so Americans often underestimate the opportunities — especially in developing nations. In the first nine months of 2014, MasterCard processed $3 trillion in purchase volume, $2 trillion of which came from outside the United States. Growth in its U.S. business was 8.3%, strongly outpacing our economy (as measured by GDP). And worldwide growth, excluding the U.S., clocked in at a tremendous 14.8% in local currencies. Cash is losing, and fast, but there's a long way to go — and a lot of opportunity for MasterCard. In its October conference call, MasterCard called out India, Japan, Europe, Australia and China as being some of its largest opportunities. Cash is by far the leading means of transaction in each place.

What We Expect

Management recently confirmed guidance for continued 11% to 14% compounded annual revenue growth and 20% earnings-per-share growth through 2015. We think this is possible under current (difficult) conditions, and we expect even better if economies around the world can turn the corner in 2015 and beyond. CEO Ajay Banga and team are doing a tremendous job moving the company forward, and keeping it at the vanguard in new ways to pay, too. Digital payments are another avenue for growth as MasterCard's invaluable connections to banks and millions of merchants make it a leading choice, along with Visa, for digital payment platforms such as **Apple**'s (NASDAQ: AAPL) Apple Pay. Though we value it conservatively, we expect MasterCard will continue to surprise the world with strong growth for years to come.

Buy: Medtronic (NYSE: MDT)

For once, maybe we can all profit from growing older.

Suggested Allocation: 3.2%

What It Does

No matter how good Grandma and Grandpa look at Thanksgiving, the honest truth is that ever more people in developed nations are advanced in age — and getting more advanced (that's the nicest way we can say it!). Global health care is a growth market we'd be silly to miss. Since 2009, *Pro* has stood by **Medtronic** (NYSE: MDT) because of its global reach, unrivaled commitment to research and development, and attractive financial profile. In that time, shares have risen 90%, but only now does the business finally looked poised to consistently grow, offering more upside to long-term owners like us.

Medtronic is in business to "alleviate pain, restore health, and extend life" for the chronically ill. The company has grown from a garage operation into one of the world's largest medical technology companies by keeping its patient-centric mission front and center. Today, Medtronic has a vast suite of high-tech products; it boasts market-leading share in key technologies; and it has successfully defended that position over time by keeping the pedal to the metal regarding research and development. And with approximately 9% of sales directed back into R&D, there are research dollars left over to keep the company's new product pipeline humming. Finally, Medtronic has made selective acquisitions to target higher-growth areas and fill product holes, and it now racks up nearly half of its annual sales in international markets. That trend will only grow stronger: Revenue was up 12% in emerging markets last quarter and only 5% in the U.S. Meanwhile, Medtronic prepares to acquire European-based Covidien, which should drive more growth.

How It's Working

Over the past few years, some of Medtronic's core markets have come under duress; in some cases, competition has picked up, while in others, product efficacy and sales practices have been questioned. As of late, though, all that has been stabilizing — and the company's other businesses, and its growth in emerging markets, were busy picking up the slack. Product diversification has been a big help in maintaining sales levels, and management's deft execution of its goals and impressive expense management have turned modest sales performance into admirable bottom-line results and cash generation.

Although sales have only advanced 3% annually over the past five years, earnings, dividends, and free cash flow have grown faster as management has cut costs, consistently rewarded shareholders, and maintained discipline with its reinvestments.

For More

- *Pro*'s original recommendation (7/1/09)
- Talk about Medtronic on our discussion board
- Most recent earnings update (11/22/14)

What We Expect

Under CEO Omar Ishrak (who came aboard in 2011), we expect Medtronic to continue its clinical excellence and focus on chronic diseases. We are also witnessing disciplined execution, a strong focus on building the infrastructure for ongoing emerging-market growth, and a healthy balance between the clinical benefits of the company's products and their economic value. Management expects the company to generate $25 billion worth of free cash flow over the next five years, and half of that is likely to be returned to shareholders in the form of dividends and share buybacks. The diagnosis is healthy for Medtronic to continue its North-Star topping returns.

Buy: Parexel International (NASDAQ: PRXL)

Outsourced drug development benefits this respected contract research organization.

Suggested Allocation: 3.3%

What It Does

Parexel (NASDAQ: PRXL) is one of the world's largest and most respected contract research organizations (CROs). Over more than 30 years, it has built a stellar reputation on helping drug makers navigate complex clinical trial processes quickly, which has enabled it to cement important relationships and have a role in developing more than 90% of the top 200 selling drugs.

For More

- [*Pro*'s original recommendation] (12/23/13)
- Most recent earnings update (11/10/14)
- Talk about Parexel

How It's Working

From 2004 to 2013, outsourcing penetration -- the number of development dollars outsourced to CROs -- has increased by almost 50%. Outsourcing is a cheaper alternative to the traditional high-fixed-cost model of staffing lots of white coats across various therapeutic specialties all around the globe. For large drug developers, letting CROs handle the development work (and those massive staffing needs) can boost profits and time to market, and for smaller drug developers who can't afford a huge staff, there is no other choice. As regulators require more efficacy data, larger patient participation, and increasingly global results, navigating the challenges of the 110,000-plus trials being conducted globally has become frustratingly complex. That makes a large, proven CRO with expertise and global capabilities more of a value-adding partner than a transactional customer.

Although Parexel's revenue and backlog growth have been lumpy recently as it competes for new partnerships, margins have already expanded as the company uses its assets more often and more efficiently. Since the first quarter of 2014, which ended Sept. 30, 2013, the company has increased gross margins from 32.5% to 35.2% and operating margins from 9.3% to 10.9%, leading to 34% earnings-per-share growth on a trailing-12-month basis.

What We Expect

From today's price, we believe the company's business performance will drive its stock to out-earn our North Star over the next decade. A continued industry shift from transactional, project-based relationships to integrated partnerships should ultimately make revenue more reliable. The company's operating leverage should lead to margin expansion over time as the company uses its assets ever more efficiently and revenue growth outpaces expense growth. And if our forecasts of the company's core business and industry tailwinds prove too optimistic, we could still see a nice return from its rapidly growing technology division, PAREXEL Informatics (PI) -- whether that's in the form of a possible spinoff, or just the market's acknowledgement of PI's hidden value.

Time Out!

Published Dec 1, 2014 at 11:55AM

Dear Fools,

Like many folks, I often find myself in a reflective mood during the holidays. This past Thanksgiving was my first opportunity to return to my hometown since relocating to work at Fool HQ, so there was plenty to think about. I always make sure to spend time reflecting on what I'm thankful for, but I also find myself eschewing some holiday traditions in order to spend my downtime thinking about where I need to improve — or to steal a fellow Fool's "motley value," trying to figure out how I can get "better every day."

Upon arriving at my parents' house this year, I was eager to resume one of my favorite activities — spending time in the woods with my best friend and fellow lover of nature, my dog Hobbes. Before I moved to Alexandria, I always made sure to do this as often as possible, not just because it's fun but because research suggests this activity actually makes me better at my job.

I only take two items with me during these adventures, a water bottle and a leash, because I want to give my brain a chance to unplug and do exactly what Hobbes does — wander. We live in a society that often praises those who work around the clock, but downtime is extremely important. It is during this downtime, referred to as random episodic silent thought (REST), that our brains enter the optimal state to achieve creative insight.

Investing is very much a mathematical exercise, but it is also a creative one. The best investors are those who can synthesize information and form connections that others can't. The result is that things appear to be obvious to these individuals at the time, but to everyone else only after the fact. Think about the impact of the iPhone back in 2007 or the recovery of AIG after the financial crisis. The arrival of your own "Eureka!" moments may seem random, but the process is anything but. As noted by Nancy C. Andreasen, psychiatrist and director of the Neuroimaging Research Center and the Mental Health Clinical Research Center at The University of Iowa, this process tends to move through stages:

> *It begins with **preparation**, a time when the basic information or skills are assembled. It continues on to **incubation**, a relaxed time during which the person does not work consciously to solve the problem, but when connections are unconsciously being made. This then leads eventually to **inspiration**, the eureka experience when the person suddenly sees the solution. It ends with **production**, a time when the insights are put into a useful form. The specifics of this basic process will vary depending on the type of creativity; writing a novel is different from identifying a new chemical synthesis. But the basic process and principles are the same across many different types of creativity.*

During REST, our brains engage in free-ranging and uncensored thought. Andreasen has found that our association cortices tend to be "wildly active" during REST and that this suggests our brains are spontaneously reorganizing and acting as self-organizing systems during this crucial state. This is why it is often so effective to take a break when you hit a mental roadblock — the word "break" and acronym "REST" are irony at its finest (with the latter being intentional).

Unfortunately, I got away from structuring REST into my daily routine after moving to Alexandria. I wanted to jump headfirst into my new role and take on any opportunity that came my way. It my seem counterintuitive, but I firmly believe that as I was working more, the quality of my output suffered. This became readily apparent to me last week. Shortly after returning to the woods and turning off my brain, I was greeted with a flood of new ideas — ideas that were unable to make their way to the surface of my consciousness while I was constantly seeking out new tasks to occupy my thoughts. Now, I'm not saying that all these ideas will turn out to be good. In fact, most probably won't. But that's another great thing about incorporating REST into your day: You actually have time to process your ideas and figure out if they are truly any good.

Now if you'll excuse me, Hobbes and I have some more exploring to do before I return to Alexandria.

Foolishly yours,

— JP (TMFYossarian)

Pro Completed Trades

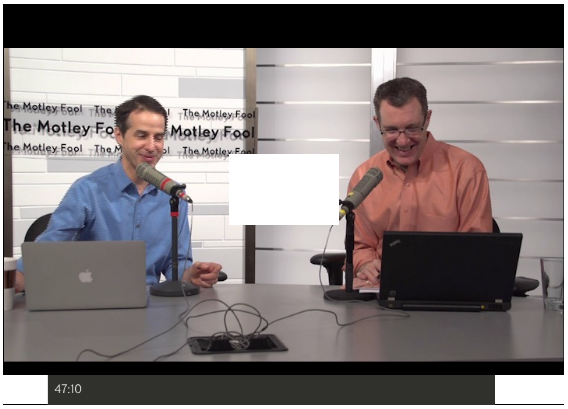
- **ProShares Short VIX Short-Term Futures** (NYSEMKT: SVXY): Pro bought 400 shares at $72.04, making for a 1.3% allocation (to best match members who bought earlier).

Portfolio Positioning Event

Published Nov 25, 2014 at 12:14PM

As you gradually build your *Pro* portfolio of stocks, it becomes time to consider hedges, shorts, and options if you're following along with us in these versatile and promising investment tools. Enjoy our final report in this series, and join us on this page at 1 p.m. Dec. 3 for our live chat with video!

Jump to the full report below **Download an mp3 of the video chat** **Jump to the video transcript below**



Portfolio

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Positioning Report

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Dear *Pro* Member,

The majority of the recommendations in this report are "shorts" — they're investments that we believe will decline in value, adding profits to a portion of our portfolio in the process. But let's take the pressure off right away: For reasons I explain below, we don't expect that many of you will initiate many of the positions in this report right away, or perhaps at all. And that's perfectly fine! Owning *Pro* stocks, you will still be positioned to compound your value over time.

Shorting in Short

For those new to shorting, let's step back for a quick overview. When you sell something short, you borrow shares from a broker and immediately sell them, collecting the proceeds. In the future, you'll need to buy shares back to replace the shares you borrowed. This is called "cover" or "buy to cover" or even "buy to close." You hope to buy the shares back at a lower price than when you opened the position. The difference between your original sell — or short — price and the price you pay to buy back (and return) the borrowed shares is your profit. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock soars to $30, you've lost $10 per share when you buy it back. Why do we short in *Pro*? It's one good way to profit when the market (or a weak company) falls. We also like to short flawed investment vehicles that, because of the way they're constructed, are destined to lose value over the long haul.

Hedging ... in Short

Similar to shorting, but different in intent, hedging is used to describe when we sell short a market index to simply hedge our long exposure to the market. A hedge is like insurance. We know our hedge will go up in value whenever the market goes down. But we don't expect to have to need this "insurance." It's there in case the market falls a lot. Most times, the market won't fall, and our hedge will go unused, usually being a small drag on our portfolio. As with shorting, you should only hedge if you want to. Currently, *Pro* is deciding on a new hedge and will issue a trade alert once it's finalized.

Shorting and Hedging Are Optional

Not every *Pro* member is comfortable with shorting or hedging. Practical considerations can have an impact as well. First, you cannot sell short in an IRA — you need a margin account. Second, you have to accept that shorts can run strongly against you. Third, you'll usually pay an annual fee of anywhere from 1% to 5% (of the short value) to short something. Finally, in many cases it's hard to borrow shares to short, period. That is the unfortunate situation with a few of our current shorts today. Fourth, short shares have the risk of being "called away" on you at the worst time, when they're up in price. If brokers can no longer borrow shares, you're forced to "buy in" at market prices to return your borrowed shares.

So, what do you do? You can use options to short in some cases; we explain how to do so wherever appropriate. You can also consider opening a new brokerage account that is more friendly to shorting (Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does, and does not charge a fee for shorting); or you can wait and see if shares become available in your existing, traditional brokerage account. Or, if you're not drawn to it, you don't have to short at all.

Options Are Optional, Too — but Advised!

Our options positions are also … optional. But we do strongly advocate learning to use options and following along over time. Options are powerful tools for income, hedging, upside and more. We know from experience that they're worth the time it takes to learn them. Options can make you a much more confident and versatile investor. So, if you're new to options, you're in a great place! Use *Motley Fool Pro* and our sister service, *Motley Fool Options* (free for the life of your *Pro* membership!), to learn how to use these great tools.

This Positioning Report

Returning to the main show, this Portfolio Positioning Report, and the special live chat accompanying it Dec. 3 at 1 p.m. ET, will (when you're ready!) help you short vehicles we believe will decline, and generate returns from options as prices dictate — either now, when we go to press, or later, in which case we'll guide you with future

Catch-Up Trades in *Pro*. Keep in mind that this is just a start; we'll have many brand-new investment recommendations arriving to your inbox as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way!

On the other hand, if this looks overwhelming at first — or if you're still catching up with our core stock positions — that's perfectly fine, too. You don't need to start all these positions now. Stock investments are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and often rewarding — aren't necessary to succeed with *Pro* in the long term, let alone immediately.

As you progress with us, just keep your exposure to the stock market in mind; hedging is about portfolio exposure. If you've bought all of our stock recommendations to date, your *Pro* portfolio is about 84% invested, meaning you have enough cash that you don't need to hedge quite yet unless you want to! If you want to, then adding the shorts in this report will bring your portfolio exposure down to a bit less than 80% net long. We are working on a hedge that would bring our exposure down even further, to 70% net long or less, while still leaving you more than 80% invested in great stocks. Neat trick, hey? We think so.

In closing, I'll stress again that you shouldn't feel pressured to act. We will continue to make recommendations on an ongoing basis, including in Catch-Up Trades — and brand-new opportunities emerge regularly. That's part of the fun! So, take your time, and make an investment only when you're ready. Finally, please bring any questions to our Making *Pro* Fit You discussion board.

Foolishly,
— Jeff Fischer, *Pro* advisor

Sell Short: Caesars Entertainment (NASDAQ: CZR)

The indebted casino operator is trying to escape a messy bankruptcy. Expect volatility!

Suggested Short Allocation: 2%

How It Fits Into *Pro*

The modern saga of U.S.-based casino operator Caesars Entertainment begins during the Age of the Mega-Buyout. In December 2006, private equity firms TPG Capital and **Apollo Management** (NYSE: APO) agreed to take Caesars (then known as Harrah's) private in one of the largest leveraged buyouts (LBOs) in stock market history, for a total consideration of almost $30 billion. At the time, Harrah's was the world's largest gaming company by revenue, and business was booming.

Shortly before the deal closed in January 2008, the financial system started its epic freefall and nearly collapsed, and the economy sank into the Great Recession. What looked like a brilliant idea in 2006 became a fight to pay off creditors and stay afloat.

The same casinos that were once rolling in cash and experiencing never-ending increases in demand were suddenly no longer profitable. When revenue began to drop precipitously, Caesars' significant fixed costs remained and the company began to burn cash. Today, Caesars is trying to avoid an involuntary default on debt by organizing a restructuring with agreeing debt holders. But it has moved valuable assets into a new subsidiary to try to protect them from debtors, some of which are now suing.

What happens next is anyone's guess, making this a highly volatile situation. The stock could be close to worthless next year, or could go higher if Caesars can pull off a restructuring. But we are betting against its crippling debt load and sagging operations.

For More

- *Pro*'s original recommendation (10/1/14)
- Talk about CZR on our discussion board

Availability

Some brokers have shares available for shorting. Interactive Brokers recently had 450,000 shares available and charged 3.25% a year.

Alternative Trade

If you only want to risk $3 per 100 shares, or $300 minimum, you can lately buy March 2015 $15 puts. Just realize that if the stock remains above $15 by then, your puts end without value. If the stock falls below $12 by expiration, your puts have value. Caesars also has 2017 options for those who want to set up a synthetic short using a strike price at the current share price, selling to open one call, and buying to open one put, for every 100 shares you want to short. Do not over-allocate! Each short call at $16 is $1,600 in short stock exposure.

Sell Short: CurrencyShares Euro Trust (NYSEMKT: FXE)

Shorting the euro against the dollar is relatively low-risk disaster insurance.

Suggested Short Allocation: 2.4%

How It Fits Into *Pro*

We've been shorting the euro against the dollar for a few years. We view this position as a quiet investment where the risk to us is relatively known (and reasonable) and the profit potential, while less known, is worth pursuing. For this position to work against us, the euro would strengthen against the dollar, but likely only by so much (assuming the U.S. doesn't go belly-up). Even if the euro returns to its all-time high against the dollar ($1.60 — currently one euro is worth $1.24) our losses will be tolerable. Meanwhile, the euro would have to decline to about $0.80 to a dollar to touch its all-time low. So, it's right in the middle of its historical range. If the worst happens in Europe, the euro could fall apart. The vehicle we're shorting (it's called a trust, but trades like a stock) only holds physical euros, so it's a pure way to short the euro against the dollar in our U.S.-based brokerage account.

For More

- *Pro*'s recommendation history
- Talk about FXE on our discussion board

Availability

Shares of FXE are often available for shorting at various brokers; the annual fee is 1.7% at Interactive Brokers, and there is no fee at TD Ameritrade.

Alternative Trade

If your broker does not have shares available for shorting, and you're trading in a margin account, you can instead set up a synthetic short. "Sell to open" January 2017 $123 call options on FXE, and to buy to open an equal number of January 2017 $123 put options. Just realize that you are, just like us, short the vehicle at today's price, and you will have paper losses if FXE's price goes up. Also, only sell to open one call option for every $12,300 in FXE you can afford to be short, remembering that each option represents 100 shares. If 100 shares is too large an allocation for you and you can't short fewer shares directly, then just sit this one out! There are no IRA alternatives at this time that are attractive enough to merit your IRA dollars.

Sell Short: Direxion Daily Financial Bear 3x (NYSEMKT: FAZ)

Daily leverage keeps steady downward pressure on this bearish ETF.

Suggested Short Allocation: 0.5% to 1%

How It Fits Into *Pro*

This bearish ETF is meant to provide 3 times (300%) the daily inverse results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. By shorting this ETF, we're effectively 3 times long, on a daily basis, the U.S. large-cap financial sector.

Leveraged ETFs like this one are flawed vehicles because they rebalance their derivative positions daily in order to maintain a constant leverage. Over longer holding periods, the costs involved with rebalancing eat away at returns, keeping downward pressure on the vehicle as a whole. As our original buy report details, we continue to believe that large-cap U.S. financials are cheaply priced — and we own several of them as a result. That belief makes shorting this flawed bearish financial ETF all the more attractive.

That said, shorting it has become difficult over the years, and our position size has dwindled. New members can skip this position if shorting it proves difficult (or use options if you have a six-figure account). We own plenty of strong financial companies instead.

For More

- *Pro*'s recommendation history
- Talk about FAZ on our discussion board

Availability

This is hard to borrow! Lately, only 90,000 shares of FAZ were available for shorting at Interactive Brokers at a 5.7% annual fee.

Alternative Trade

If you can't short shares directly, then in a margin account you can set up a synthetic short. "Sell to open" January 2017 $13 calls on FAZ, and "buy to open" an equal number of January 2017 $13 puts. You will pay less than $1 per contract, net. This makes you short FAZ with a start price a bit above $12, and sets you up to profit if and as FAZ declines in price. Only sell one call for every $1,300 in FAZ you are able to comfortably short. On a $130,000 account, one contract would be a 1% allocation. That's as much as we recommend (our own FAZ short is 0.5%, but newcomers are unable to short another similar position we have in our portfolio, so you can make FAZ about 1% instead). Never over-allocate to a short.
There are no IRA-friendly alternatives for this short. If you can't short it, you could add 0.5% to one of our financial companies instead, including **Wells Fargo** (NYSE: WFC) or **MasterCard** (NYSE: MA).

The Rest of *Pro*'s Positions!

As a *Pro* member with an especially keen eye (and great memory!), you will note that we haven't updated you on every position in the portfolio yet — even with this, our fifth report in the last month. Here, one by one, is the status on those few remaining positions:

Coca-Cola

Pro holds a 2016 synthetic long option position on **Coca-Cola** (NYSE: KO), but the stock has run up sharply (for Coke), from $38 to $44.50, since we started it this year. We advise new members to wait for a downdraft, at which point we may issue a *Pro* Catch-Up Trade. (Some of you started an option position on Coca-Cola with *Motley Fool Options* — that's a fine substitute for now and perhaps indefinitely, unless we get a good new opportunity.)

Five Below

We are short shares of pre-teen retailer **Five Below** (NASDAQ: FIVE) at a 1.7% allocation, but … drum roll … the company announces earnings tomorrow, Dec. 4. Since we have no idea how the stock will respond to earnings (it could crash, it could soar, it could do nothing), we think it best that new would-be short sellers wait until we see Thursday's news and assess it. We'll let you know soon after with a *Pro* Catch-Up Trade if we believe newcomers should short the shares.

O'Reilly Automotive

We have a 4% stock position in **O'Reilly Automotive** (NASDAQ: ORLY), but it's on hold for new members. Don't buy yet. We'll provide an update to all members early this month, moving the stock back to Buy if that appears to be the best decision.

ProShares UltraShort Real Estate

We have a small (0.4%) short remaining in the **ProShares UltraShort Real Estate ETF** (NYSEMKT: SRS). We enjoy its slow descent in price, but the ETF itself only has $38 million in assets now, making it too small to recommend to new members. Plus, it's nearly impossible to borrow shares to sell short now, and if you're able to, the annual percentage fee to short is high. Instead, as shared in this report above, we recommended that you sell short up to 1% in FAZ as an alternate. We're short 0.5% of FAZ ourselves.

In Conclusion

We may recommend all of these positions (except the SRS short) to new members once we reaffirm sufficient opportunity compared to current risk for newcomers in each, or when pricing improves. Just watch for *Pro* Catch-Up Trades.

At the same time, we're not standing still. From our reports, you have many great *Pro* investments to move into gradually, and we will continue to send brand-new investment recommendations to all members. It's not vital that your portfolio be 100% attuned to ours. But being closely attuned to it, especially with our core stocks, will position you to succeed well with *Pro* over the time frame that matters.

Fool on!
— Jeff (TMFFischer) and the *Pro* team

Transcript

JEFF FISCHER:

…just for comparison. Even though the market isn't our benchmark, it's very nice to do better than it, while being defensive, as well, especially in a year where 80-90% of fund managers are trailing the market [and] mutual funds continue to underperform. Anyways, that's where we're at. Pro is in a good position.

The market itself — the S&P 500, Chris — trades at 19.6x trailing earnings, which is the high end of its historical average range, which is about 15-20x. But it trades at 16.7x next year's estimates, so that's right in the middle of its historical average. And now you have lower oil prices which historically does, and now could, increase GDP growth, because for almost everybody, lower energy prices is a net benefit.

Next year could be a decent year, as well. Where we stand in Pro is we hope that in the next three years, our portfolio will be at least 33% higher, more valuable, in 2017 than it is right now. If we can make 10% a year, we'll end up 33% more valuable in three years. And think about that for compounding purposes, too. And that's our minimum hope, our goal, and that's whatever the market does. We know there will be rough spots in those three years, but we hope, overall.

And the reason we can say that is a lot of our companies are priced inexpensively, still. Gilead is at 10x forward earnings. Skyworks at 13x expected. Oracle at 12x expected. We have a lot of great, Class A names at good valuations, and we hope to compound with them and I'll stop right there for now.

CHRIS HILL:

Just one more question regarding 2014. Are you at all surprised by how the market has done this year? Because go back one year and 2013, [the] market was up somewhere in the neighborhood of 30%. It was one of the best years we had, had in decades. I don't know about you. I'm quite pleased with how the market has done, generally, this year. I don't want to say I was fearing for the worst, but I had sort of steeled myself for having the dreaded correction.

JEFF FISCHER:

Yes, or at least a rocky year back and forth. I am surprised too, Chris, and I think many veteran Pro members are, as well. We've given up about 2-3 percentage points this year to hedges and generally that's our charter. We want to be hedged and smooth out downside volatility and we know we're going to pay for that hedging when the market goes up. So, we're a little surprised, but we're happily surprised because we're still doing well, anyway. But yes, given the recent strength of the market, it's human nature to expect [that] it's time to give some back.

But, that's not how the market works. And if companies continue — lately their revenue growth has been healthy and earnings growth has been even better — next year could pleasantly surprise, as well. We would take a 5-6% gain in the market happily, because we will probably do considerably better than that.

CHRIS HILL:

Let's talk a little bit about what has led us to this positioning event, and that is over the past month, Pro has been advising members to buy Pro stocks.

JEFF FISCHER:

Exactly. New members who joined about a month ago — we've advised them through the course of four portfolio-building reports to buy all of our core stocks — and that's where you start. And Chris, we'll make this discussion a little about portfolio construction.

It makes sense that first you want to put your money in positions that should compound over time. We don't want to mess around with little positions or games on the side. You want most of your money in the direction, in the investments that it should be for the long haul, and we think in terms of at least three years forward — three rolling years. It's not that long of a time, sadly. That goes very fast, but happily that means returns grow quickly.

CHRIS HILL:

It's not that long of a time, but it is, when you look at all the research data. That is longer than the average holding period for the average investor.

JEFF FISCHER:

Oh, man, it's so much longer. It's so much longer, Chris, and that's part of the Fool's advantage and our advantage. I think you know this better than I may. The average stock is now held for weeks…

CHRIS HILL:

Yes.

JEFF FISCHER:

…and that's it.

CHRIS HILL:

Basically upside of five or six months.

JEFF FISCHER:

Yes. And I don't understand that at all. Like I'm really happy to be able to say [that] I bought Google and MasterCard the years they came public and I still own them. And some day I hope to hand that to my child and say, "Here. Here's a stock from 2005."

CHRIS HILL:

Right.

JEFF FISCHER:

"You better not sell it!"

CHRIS HILL:

Don't blow it.

JEFF FISCHER:

But we use options to make money on stocks so that we can keep owning stocks for the long haul, and that's how you really compound. These portfolio-building reports — the first four — are to get you in these stocks that we believe will compound your money over the only time that compounding works, which is the coming years. Remember why you're here — it's to make money. I like to think of it, because you can digest it, [that] every rolling three years you're here to make good money.

CHRIS HILL:

So, we've got the core holdings that you talked about. Could you spend just a couple of minutes talking a little bit about the shorts involved in Pro's service?

JEFF FISCHER:

Once you have your core holdings, it makes sense to consider shorts, if you want to, and then hedges and options, as well, so we're getting there gradually. The shorts — by most measures, so far, it's a good thing that we're not very short. The portfolio is about 84% net long. New members, now, who buy all of our core stocks will be a little less than 80% net long. It still means you have 20% to play with, so you don't really need to hedge.

We're looking for more shorts of companies to add to the portfolio — stocks that are overvalued and don't look promising, and we'll build that out over time. We have a couple right now. One is Caesars, which is still a recommended short at about 2%. One is Five Below, which is a recommended short around 1.5%. But, in this report, we say wait on that one because they announce earnings tomorrow, so we would hate to say to new members, "Hey, short that company today," when we just don't know what tomorrow will bring. We'll assess those earnings and then let you know.

CHRIS HILL:

One more question and then we'll get questions from members who are participating. When you think about the Pro portfolio [and] building a portfolio, how should members think about timing? And we've talked about this before specifically with options — that there is a tendency, almost an institutional tendency, to add urgency to think, "Gosh. I have to make this trade immediately." How should members think about the timing of these trades when it comes to building a Pro portfolio?

JEFF FISCHER:

It's a great question, Chris. You have to have the right time frame if you're going to succeed, and you shouldn't rush on anything. I sound like a broken record saying that to members on the boards and in these events when I can — that the only time that matters is going to be the coming years. You're not going to change your financial status in a few weeks or a few months. I don't understand the trading mentality. I tried it in my early twenties. I think most of us start that way and then…

CHRIS HILL:

How'd that work out for you?

JEFF FISCHER:

Not well. Not well. But that's what so many people think when they start to invest. You need to have action to invest. I met someone yesterday who was getting interested in investing. He's in his thirties and saved some money. I mentioned Warren Buffett, and he thought Buffett had made his money by trading, and so he thought he would really have to work hard to do it. And I had to point out [that] no, he's owned stocks since the seventies. American Express — he just buys it and sits on it. That's how it works.

So, there's no urgency for the options or the shorts. Arguably, I would say, there's more urgency to buy your core stocks and start to let them work for you. But even there, gradually go into it. A lot of members are adding money every month from their paychecks. Some members have a fixed amount. And especially those of you with a fixed amount — invest gradually. Average into our core stocks. Even though we put out all these reports in a month, we don't expect you to make all the trades or all the investments in that month if you're not ready to. Take your time, because time is on your side.

CHRIS HILL:

All right, let's get to some of the questions that have been coming in. From one of our members. How are the percent allocations determined in Pro?

JEFF FISCHER:

Good question. Managing the portfolio, we're trying to set up something that will do well in a strong market and do better than a falling market. So, the allocation percentages play a role in that. We are comfortable putting 4% into something like Oracle, but only, say, 1.5% into a short that's a small cap like Five Below. So, that will be our starting point.

Over time, as the allocations change, which they naturally do, we look at them every day. We literally, every day, start with a review of where we are at and make sure we like the allocations, because we know new members coming in are going to be told to match our current allocations. [We know] that's the only way we can get you onboard and then manage one portfolio together. So, the allocations will naturally fluctuate, and we make sure we're always comfortable recommending the allocation we currently have.

And the great thing about not adjusting them too much is we don't want to create unnecessary turnover, costs, taxes … but even better than that, our winners become a stronger part of the portfolio and the losers become less and less significant over time. So, I'm not big on balancing, per se, until you're reliant on your portfolio for retirement income. And if you are, then you usually keep three years out in fixed income investments.

So, we let the allocations go, over time, as long as we're comfortable with them, and we start them to begin with, in an allocation that we think serves the portfolio's goals over all. And that's a key thing everyone has to remember. We're a full-portfolio service. We're managing the portfolio to make money. There are some positions in there that we don't think will make money — hedges, for example — but they're in there as insurance or to balance a portfolio out during adverse events, so it's the whole thing that we want to make money.

CHRIS HILL:

A question from B.J. Can I buy puts to implement the short sales?

JEFF FISCHER:

B.J., a good question. In today's positioning report, we talk about synthetic shorts. On the currency shares short — FXE, the Euro — and the Financial [Bear 3x] ETF. On those you can set up long-term, 2017, synthetic shorts which is the equivalent to shorting the shares themselves. So, watch your allocation. Each synthetic short you set up is 100 shares.

I imagine if you're trying to do this in an IRA, you can't do a synthetic short. I imagine that might be your question — where it comes from — and that is just buy puts. We didn't recommend that because the puts are so expensive. The cost to get into that is so high that we think you can just pass on that. It just wouldn't do it.

CHRIS HILL:

A question from M. Facebook has been a big winner for me — both stock and options positions. Thank you for recommending it. Which new stock do you foresee being a big winner, like that one, for the next couple of years? Yes, Jeff, what will be the next big winner?

JEFF FISCHER:

I think it's the couple that we're working on that we may issue by the end of the year or early January. We're looking at some that are promising. In the portfolio, actually, I think Facebook is going to continue to be a good performer the next three years. It trades at 39x expected earnings for the next year and I bet it's going to grow like 45-50% year over year.

And they're doing what Google did early on, which was spending a lot to then propel future growth, so the next year or two may look a little light, free cash flow wise, because they're investing so much. But they'll get that back a couple of years down the road and the multiple on the stock will really contract in a good way. The value multiple on the shares should keep appreciating if everything goes as planned. So, I like Facebook a lot. I like Gilead a lot. Skyworks Solutions. All these companies, for the next couple of years, I think are, and then beyond, ideally promising.

CHRIS HILL:

A question from one of our members. What's the best way to judge the latest buy recommendations when the price of today is already much higher than the fair price value?

JEFF FISCHER:

A good question. When our fair value estimate is a bit lower than the current share price, that's okay. The fair value estimate is really a range that we have, and we publish to the conservative side of that range for obvious reasons. And you have to remember, too, that a fair value estimate is fair for a buyer as well as a seller. It's a fair price. From that price, we expect to earn our desired return, which typically is 10-11% annualized.

So, if a stock is 5% above that, it still should earn that return, more or less, over the next rolling three years because there's a lot of room for error in that estimate, and as long as we believe in the business and what they're doing, we're very comfortable keeping it as a buy, even when it's a bit above our fair value estimate.

The other thing to keep in mind is that fair value estimate goes up quarterly as the company grows, assuming the company does grow. But we only update it, typically, every six months to sometimes even once a year, although we try to do it every six months. So, the fair value estimate will go up, in kind, with the stock and members who have been around have seen that happen very much like clockwork, so far.

CHRIS HILL:

That's one of those risks that I think when you're starting investing nobody really focuses on because I suppose there are more important risk factors to consider. But the idea that you look at a price at which you're willing to buy a stock and you, in some ways, almost fall in love with that price and you say [that] if it's a little bit higher, then I'm not going to buy. I'm just going to wait for it to come down. And this has happened to me a couple of times, early in my investing days, where I just wanted it to fall a little bit further and it never did.

JEFF FISCHER:

Yes, that's true. We had that happen early on with a company called Tractor Supply, which many people had never heard of, and now is becoming a household retailer. But the stock was mid $30s. We wanted to buy in the low $30s. We passed on it. It ran up to $120 and split and it's still going up. So, anchoring is a dangerous thing, of course.

I would prefer to not even have our fair value estimate published, because it is a range and it's an estimate. And our cost basis or our return as well, I would rather not show people, because they anchor on that. They look and see [that] they're up 200% on Papa John's. I shouldn't buy it now. Whereas, that's really irrelevant. It may be cheaper now compared to what it's earning in cash flow than it was 200% ago. So, anchoring is a very prevalent and yet somewhat dangerous thing in investing that we all work to try to avoid.

CHRIS HILL:

A question from Paul. I'm new and not sure how to set up my core portfolio when I have multiple accounts — one SEP, two IRA accounts, my kids' 529 account, and a general account. Is there information on the site than can help me figure this out? I have $250,000 to invest now. Any suggestions?

JEFF FISCHER:

Let's go the Making Pro Fit You discussion board. Post your question there and we will help all we can. I know members will help, too, if they can. That's a very specific question and we'd want to get it right and have it in writing for you. So, good question.

CHRIS HILL:

A lot of moving parts to that question.

JEFF FISCHER:

Exactly.

CHRIS HILL:

A question from Karen. I did the last hedge. It was a bought put in an IRA account. Now I'm realizing that was probably a mistake. If I had put it in a taxable account, I would have been able to write off the loss value. Do I have that correct? Lesson learned for next time.

JEFF FISCHER:

Karen, yes, that's a great lesson. A great lesson for everyone and a great segue, too, into hedging. A hedge will lose money any time the market stays flat or goes up, generally speaking. A hedge is like you're buying insurance for your portfolio. So, if the market goes down, that insurance will pay you and your hedge will have become used. You collected on it. But in most cases, the hedge will expire unused and as a loss, so for that reason, putting the hedge in a taxable account is a great idea because in most cases, it will become a tax loss.

And hedging — we don't have a hedge in this portfolio-positioning report, even though we're working on one. We're working on two things — a market hedge, to bring our exposure down from [approximately] 80% back to [around] 70%, which is where we've averaged over time. We're working on that, and we probably will have it soon. And we're working on direct company shorts, as well, to lower our exposure, too. So, we're comfortable with where we are right now, but we are working on a new hedge, as that one expired a couple of weeks ago, now, in November.

CHRIS HILL:

A question from screen name FlyInTheWest. When Jeff says options are "expensive" or not, how is the relative expense of an option determined? When would we know they're reasonably priced or inexpensive?

JEFF FISCHER:

That's a great question. Mostly you want to look at how much you think the stock will move compared to how much of that is already priced into the option. Unfortunately, there's no formula that you can apply across all companies, of course, but you have to look at individual volatility. Intel, for example, [is] not in the Pro portfolio right now, but is historically a fairly nonvolatile stock, so its options should be fairly inexpensive.

If the options were priced much more than you thought Intel would move over that given time to expiration, then you would say the option looks expensive and we might sell it to collect the premium. There's interest rate that goes into it. The higher interest rates are, the higher option premiums usually are.

But discounting that, it's how much do you think the stock will move in a given time period and that should tell you where you think the option should be priced. And at times, options are priced far more than the stock will ultimately move, and that's a good thing. And when that happens, the VIX is higher and we'll be looking to sell those options to collect the premium. But lately it's been a low VIX environment and most options are not that expensive.

What's interesting is as we work on this hedge right now, we're looking at the S&P 500 to use those as a natural hedge again, and SPY options right now — S&P 500 options — are inflated. It's part of what we're considering and looking at. They really spiked as oil fell and fell. People are trying to assess what this big drop in oil means and while they're assessing it, they're buying put options, I imagine. But I don't want to rush and do that and pay a big price for a SPY put option. So, we'll see how that plays out a bit more.

CHRIS HILL:

You're definitely rooting for more volatility, though.

JEFF FISCHER:

More volatility would be good. It'd be nice if we could get our hedge going first, but either way, we'll be set up to do something about it that we like. Whenever that volatility comes, there are things we want to do to take advantage of it. So, if we're hedged beforehand or not, it won't matter. We'll just adjust what we do next.

CHRIS HILL:

A question from Tom. I have a smaller portfolio and smaller investment sizes. Is it better to reduce my diversity so that I can buy shares in hundred-share blocks and then use them for other investments, like options?

JEFF FISCHER:

Generally speaking, Tom, to a moderate degree you could do that. Buying in 100-share blocks is not that important. We don't use options on our core stocks in Pro that much because we're buying the stocks to own them for years to come and we want you diversified enough to be diversified, which means in Pro probably 15 to 20 of our stocks we want you to own, at least.

So, I wouldn't whittle that down much more than that and I would focus more on owning most of our positions at allocations that are close to us rather than trying to focus on 100 shares. The odds are if you have a smaller portfolio [and] you're adding money to it regularly, too, and over time, it will grow and you'll have more 100-share blocks. But, it's important to get there in a kind of organic, natural way and run the portfolio as close as you can to how we have it and not worry about 100-share increments right yet.

CHRIS HILL:

A question from Sandor. Are you trying to diversify the portfolio stocks? If not, are you just picking stocks individually or have some considerations, based on the other stocks in the portfolio … What are those?

JEFF FISCHER:

Yes, they do play together. We have a whole portfolio that we want to work as a whole and deliver a return as a whole. And we purposely have some things that are higher growth and some that are lower growth, and we actually don't even mind having some positions that are not going anywhere right now. [Two that come to mind are] Wisdom Tree Emerging Markets.

Emerging markets have gone nowhere for a couple of years — and that's perfectly fine, the way we view it, because we know that they cycle. We bought emerging markets and U.S. markets not knowing which would do better, but obviously we thought U.S. would do better. That's mainly where we are invested. And there will come a time when U.S. markets don't do as well and emerging markets do, and that's when that investment will perform for us.

So, we view the whole portfolio as something that will work together over time, but not all of it will work at once. And then what we bring into the portfolio and get out of it — they're all moving parts. They're all pieces of a puzzle, and that's sometimes why it takes us longer to issue a new buy or a new hedge, because it can change other things in the portfolio. It can mean reducing a position or selling something. So, yes, the short answer is it is really, truly a portfolio that we see working as a piece [and] as a whole, and so when anything new comes in or anything goes out of it, that can have reverberations across the portfolio.

CHRIS HILL:

A question from — I love this screen name — JohnnyLovesBeaches.

JEFF FISCHER:

Johnny! He's been a Fool for a long time.

CHRIS HILL:

I recall a comment you made about short S&P 500 ProShares a while back — about not holding it for too long. I've held a position for quite some time. My question is how do you think about exit strategies for short positions, or is it okay to accept the poor performance since the equity positions have been running very nicely?

JEFF FISCHER:

That's a great question and the answer is different depending on what you're short. If you're short an ETF, like that is, and it's an inverse ETF, there may be tracking issues. I haven't looked at the ticker, [which] is SH for members who don't know. It's an inverse S&P 500 ETF, so it's a way to hedge your portfolio by buying this ETF that is short the S&P.

The problem is it won't track directly to how the S&P does. There's some error there, so the short may even perform worse than the S&P, itself, going up does. We have traditionally shorted flawed ETFs like FAZ and SRS, which is now too small to short, and we wouldn't want to own a flawed ETF, for the long haul, for that tracking reason.

With other shorts, we do try to limit the loss to a reasonable amount of say a percent or two of the portfolio, at the most. If something's running against you that far and it's eating into your portfolio, you may be wrong. Something may be wrong with your thesis or your allocation and you may just want to cut it off at the knees because it's doing the opposite of what you want. It's compounding against you, and you definitely want to avoid that.

A rough rule on shorts is to close a direct short when it's 20% against us and our confidence is gone or waning, or if we are losing 1% or more of the portfolio value, we really have to reassess whether we want to stay in that short.

CHRIS HILL:

A question from David. Speaking of options, might they be expensive for a reason, such as insider types know something that we don't?

JEFF FISCHER:

Sometimes they are, especially put options or call options. Some possible news or rumors can inflate the prices. People are speculating on a buyout, say, or on a bad earnings report. If you watch them long enough, you'll notice that that option is out of line. Something's not right. And that can be reason sometimes. But it doesn't play into our long-term investing decisions or performance.

CHRIS HILL:

A question from Suneel. You just mentioned that you expect volatility to increase. Your latest recommendation to buy SVXY, I understand, will go down if volatility increases. Can you explain the logic behind the recommendation of SVXY?

JEFF FISCHER:

Yes, definitely. Volatility — I don't know that I said I expect it to increase, although the odds are…

CHRIS HILL:

You'd like it to.

JEFF FISCHER:

Yes, we'd like it to. We did say we'd like it to. And the odds that the market will be more challenging in the next couple of years than it has been makes sense. That said, none of us know for certain. But this position we started very small last week at 1.35% and we want to put a stake in the ground and have it in the portfolio and be ready to buy more when and if it does decline.

That said, we also know it may keep going up. Volatility in the market may increase a little bit, but the futures on this ETF that we're buying are still a headwind to the ETF. But lately, when we recommended this, the VIX was [approximately] 14 and the futures two months out were 16, so that's a pretty big premium. So, unless volatility increases more than that, this ETF will work in our favor. So, what we're really shorting, with this ETF, are volatility futures even more than volatility itself, and we're confident that the futures will continue to be higher-priced than the current volatility. Let's start small.

CHRIS HILL:

Let's stick with the future, for a second, because we don't make market calls at The Motley Fool, but I want to build on something you just alluded to which is that the last couple of years have really been great for investors. The next couple — I don't want to say they're going to be bad — but you used the word "challenging." I think that's probably spot-on. I do think the next couple of years — even if we have rising markets in 2015, 2016, and beyond — I think it's reasonable to expect they'll be more challenging.

JEFF FISCHER:

All of the stats, all of the odds say so. To go this long without a 20% decline is very unusual. So, yes, when you look at the numbers, we're bound to see more declines in the next couple of years than we have in the last five years. But, that said, will the market rebound as quickly as it has now?

We still remain, ultimately in a bull market, and there are a lot of things that suggest we could, because interest rates are bound to remain low. The economy is just starting to really pick up, and Europe and now China are trying to stimulate their own economies, as well. And companies have underinvested for years, and started to, the last couple of years, finally invest in the business a bit more, and I think we're starting to see the results as revenue starts to grow now at the same time that unemployment is declining.

Odds are it will be a more challenging couple of years ahead, but we would welcome that because that just mean opportunities. Volatility does lead to opportunities if you're ready for it.

CHRIS HILL:

A question from Sergio. Hello from the Canary Islands in Spain.

JEFF FISCHER:

Nice.

CHRIS HILL:

Boy. He just had to rub that in.

JEFF FISCHER:

Yes, no kidding. It's cool there.

CHRIS HILL:

Since I'm living in the Eurozone, is it necessary for me to sell short the Currency Shares Euro Trust? Once I gradually build my Pro portfolio of stocks, hedges, shorts, and options, when would it be time to hedge a weakening dollar if it comes in the future? Thanks, that was a great question.

JEFF FISCHER:

That is a great question. So, you live in Europe and I imagine a lot of your assets are in Euros, so it may, indeed, make sense to short the Euro as a hedge to many of your assets. And I don't know that you'd want to short the dollar, in the future, because you're already shorting the dollar by having so many assets in Euros. [That is] my assumption on your situation.

That said, our short Euro position is very small [at] 2.4%, so it's almost optional, because as a short of currency, we're not going to make a huge amount on that trade unless something went horribly wrong in Europe and it's not core to the portfolio. So, I would manage your currency exposure to the Euro and the dollar in whatever way makes you most comfortable given your particular situation.

CHRIS HILL:

At least we're past the debate that was rising a few years ago of whether or not the Euro would last as a currency.

JEFF FISCHER:

Yes. That was a very real debate and part of our reason for shorting the Euro was [we thought about] how much can we possibly lose shorting the Euro? Not much. But how much can we gain if something goes really badly? It hasn't gone badly, and that's good, but we still think the Euro can fall to the dollar, and so that's why we're keeping that short for now.

CHRIS HILL:

A question from Dave. Since you are looking at volatility, are you considering using the VIX for a hedge?

JEFF FISCHER:

We have used the VIX as a hedge in the past, and we do look at it regularly as a possible hedge, because when the VIX is so low, (at 12 right now), and it averages 19 over the long term, we could buy call options on the VIX to gain if the VIX spikes. That said, you're buying call options on the VIX futures. It's pricey, and the odds are still stacked against you. But now that we are short VIX futures, the odds of going long VIX futures, as a hedge increase, because the two positions can weigh each other out, and in the long run, the short VIX futures should produce a very good gain for us over the long haul. It gives us more room to buy VIX contracts, as a hedge, as well. So, it's a good situation.

CHRIS HILL:

I'm not suggesting that you have the hard data on this, but I am curious just anecdotally. As you go to member events, you meet Pro members. Do people share how long it takes them to build up to shorting and hedging? Obviously, everyone is different, but I would think that the average Pro member, once they get started, it takes at least a little while before they're executing shorts and hedges.

JEFF FISCHER:

That's a great question, Chris, and a great comment. And [with] many people, we do talk about it. For many members, it takes a year until they're comfortable using options on their own or even with us. And many don't short. They just haven't shorted. It's not in their comfort zone. So, some have been with Pro five years and haven't shorted anything or even hedged anything and that's fine. The portfolio is built to perform as a traditional long-only portfolio over time very well, we believe. It has so far, and that's without hedging or shorting or options.

But for those who want to use these strategies, it's usually within a few months that they're ready to start. Dip their toe in the water and then over six months to a year, they really start to grasp it and enjoy it. Especially the options part. Like we write in today's positioning report, options are such a great tool, Chris, as you know from our many conversations and especially for income, but also for hedging. So, to not use those, I feel, you're missing out in the long run because all of us, ultimately, will want steady income to complement our stocks.

CHRIS HILL:

Question from Mr. Bill. I'm in the process of constructing the Pro portfolio core stocks over the next month or two by converting an existing portfolio of stocks and bonds. I've already bought the five stocks in your first report and a couple more whose prices were near fair value. In what order should I buy the remaining? Shall I buy them in the order in which they appear in your reports, or should I buy those first whose price or fair value is lowest?

JEFF FISCHER:

Good question, and it speaks to the portfolio, as a whole. We don't know, of course, which companies will do best in the next several months as you're building up your portfolio. So, all our stocks are rated Buy or Buy First right now, except for one which we'll have a decision on within days. I would buy the Buy First first, if you haven't yet, and then just go through the Buys, in order, and quite honestly, go with the ones that you're most comfortable with buying first … the one that makes the most sense to you given your existing positions and your comfort level with that business and its price and average in that way.

But the overall point is that it is a whole portfolio. We don't know which ones will be the best ones the next year or two, so we recommend them all together. That said, at the same time, you can take your time to get there, because we believe in each company individually, as well.

CHRIS HILL:

Another member question. Do you think we can get a better buy price on GNTX? I hate chasing.

JEFF FISCHER:

Gentex. Yes, it was in the mid-$20s maybe a month ago, and now it's mid-$30s. They had another good earnings report…

CHRIS HILL:

Damn them…

JEFF FISCHER:

…margins are expanding them. Yes, Gentex, stop making car mirrors so well. They make the auto mirrors, the rearview mirrors that dim automatically when headlights hit them and they make rear camera display images in the mirror, too. Cameras in the mirror, as well. And they're the leading company. They're really well managed. Really strong management.

The shares, traditionally, have not been volatile. They've been very steady, until the last couple of years, where they hit some bumps, and that's where we bought shares. Maybe we'll get another opportunity, but the shares are rated a buy. We believe they represent a good value now. If you don't want to chase it, maybe take a partial position, so it's on your radar and it's in your portfolio more importantly. And then if we get a dip, you can buy shares or if you're selling puts and can buy at least 100 shares, then sell to open a put option on Gentex to target a lower buy price and get paid while you wait.

CHRIS HILL:

A question from David. I know you should think long term, and timing the market is impossible, but I still fear, as a new member, that I will buy into the Pro stocks and six months from now, the market will be down 25% and I will feel like a "f" Fool. Any thoughts?

JEFF FISCHER:

That's a very rational fear and new members have had it. All the new members that have joined, since probably 2010, have felt that way, and rationally so. You see prices rising. You feel that you're getting there right before that shoe drops.

We do believe all of our companies are priced in a way that they will generate the returns we want over the next three years, though. Now I say three years, so that does mean you should have some time to average in. So, if you are concerned — and we all are [as] this is our money [and it's] important to us — average in over time. Even if the market doesn't fall, some stocks that we have will, and you'll get a better price by averaging in.

I would say take your time and be comfortable with what you're doing. And keep in mind we're going to get to a point where we're 70% net long, maybe less. So, right now we're [approximately] 80%, which still leaves room for taking advantage of a drop. And once we're at 70% again — which should happen soon [and] then even further if the market falls — we have 30% we can put to work still and that's a good percentage to put to work. I know it's probably not the most satisfying answer, but take your time and be comfortable with what you're doing.

CHRIS HILL:

A related question from Ken. If the market did begin to collapse again, as it did in 2008, not knowing how much longer the fall would continue, how would you know whether to invest more in hedges or invest in new long positions?

JEFF FISCHER:

Very easily. For new long positions, we look at the business and we look at its valuation compared to its earnings power. And if a business that we know and like looks underpriced, we'll want to buy it. As far as hedging, again, that's an insurance policy that we can start in an instant. If we want to hedge a lot of the portfolio, we could short or buy puts on the S&P in a large amount tomorrow and be market neutral just like that, if we wanted to. So, if something were happening that we wanted to do that, we could and the worst case is we have a fairly flat portfolio for a while. So, what?

So, the answer to your question is it will be a case-by-case basis. If there's some reason we feel we should suddenly hedge out our exposure, we can do that quickly, but at the same time, we want cash and we have cash to buy companies that are underpriced.

What we don't want to do is sell out of our positions that we own, because that creates commissions and taxes and then you have to try to get back in and people are not good at timing. So the great thing about hedging with market hedges is you can keep all of your core stocks. When we buy a company, we're buying it. We want to keep it. We can keep them and yet hedge out our risk with a hedge if we want to do that.

CHRIS HILL:

A question from JimsAFool. As a retired investor who will be adding little, if any funds to my Pro portfolio, should I consider allocations any different from the ones Pro recommends?

JEFF FISCHER:

I would love to know how much money you're taking out of your portfolio. If you depend on it for living, then you should keep any money you need in the next three years out of stocks. Don't invest them in the stock market. Don't invest that money in the stock market. That aside, I would put the 70% that you're going to keep in the market at least three years and follow our allocations closely. The one standout is AmTrust Financial, which keeps growing faster than we expect. It's 7.5% of the portfolio now. You might want to put that down to like 5% — more in line with the other positions in the portfolio — if you have any near-term concerns about your money.

CHRIS HILL:

Another member question. My observation is the Pro portfolio leans heavily on financials and tech. Does sector allocation play any part in choices for the Pro portfolio or more specifically my attempt to replicate it over the next year?

JEFF FISCHER:

Yes, that's a great observation and it's certainly true. We have been more invested in tech and financials almost since the beginning and for the very reason that they look the most promising. They were, and I think still are, among the most undervalued or attractively valued sectors and they still have a lot of things going in their favor. So, we consciously went to those areas because they presented a lot of opportunities and the companies in them are strong and attractively priced.

We have avoided, thankfully so far, energy because they're assuming more sources of energy coming online. We thought energy prices would decline and we didn't want to invest there. If companies don't have pricing power, we don't usually want to own them. So, commodities we have avoided. Energy. And we've leaned on financials and tech which still look attractive. As that changes over time, we'll change. We'll find opportunities in other sectors as they emerge and our sector allocation may evolve. But right now we're happy where we are.

CHRIS HILL:

You mentioned pricing power. If I'm not mistaken, that is the business quality Warren Buffett has said is number one on his list that he likes to see in a company — their ability to raise prices time and time again.

JEFF FISCHER:

And that makes such great sense. It tells you so much about a business that can consistently raise prices. It means they have a competitive moat protecting their business. Protecting their profits. They have some advantage that others can't take away. Because if you didn't have that advantage, your profit margins would go down over time because competitors will come and nip away at your profits and that becomes a constant headwind. So, the very best investments are the ones that can raise prices and get away with it.

CHRIS HILL:

A very specific question. EXPD — is that Expedia?

JEFF FISCHER:

It is Expeditors International.

CHRIS HILL:

Oh, that's right. Expeditors International moved higher right after the recommendation. Would you move the strikes of the strangle a notch higher?

JEFF FISCHER:

If you haven't set up the strangle yet, I would still set up the $43-45 as long as the stock is around $45 something. If the stock is at $46 or above, then I would move the strangle to $44 or $46. So, right now it still stands where it was [the] last I looked. And members should know — especially new members — for any option position we have, and the shorts, we'll issue updates in the Pro Catch-Up Trades any Monday that they look attractive. It will be in that Monday Memo email. We can say, "Here. Pro members who don't have this position yet, here's the catch-up trade to catch up, because it looks good right now."

CHRIS HILL:

We've just got a minute or two left. Any final thoughts as we wrap up not just this event, but as we look to wrap up 2014?

JEFF FISCHER:

Well, it's going to be, I think, a great time to be an investor the next three years, because we own so many companies that are doing better than ever, and not just financially, but management-wise, too. It's been interesting to see the last 12-14 years, or so, how management has evolved to run their businesses better at these leading companies. And the focus on shareholder value, I think, has never been more acute than it is right now.

But what I really love seeing is the convergence between serving all shareholders well — customers, shareholders, the greater good — and we see that with Gilead as it offers its hepatitis C drug to [90 countries in] emerging markets in a cheap, generic version, and yet the company is still set up to make record profits overall.

So, here we are. We're about 80% invested, Chris, in companies we really love. We're looking at a hedge that will take us to 70% — maybe even 65% long — so I think we'll go into the next year strong and ready to take advantage of whatever comes our way, whether it's more upside or some volatility up and down. Sideways. That would be great, too. We think we own a lot of stocks that are going to do well, even if the market doesn't do that well, and we have lists of things we want to do when those opportunities do come up and we're also building more short positions into the portfolio over time.

So, I like where we're at and it's surprising to say this now. But I like where we're at about as much as I ever have when I look ahead the next couple of years and I think as long as all members remember that's why we're here — is to make money the next two or three years on an ongoing basis — and take the volatility that we do see, if we do, as an opportunity, then we'll be in a great position because we really believe in what we own and that's why it's rated a Buy or a Buy First.

Yes, I feel good about where we're at. I appreciate the Pro membership base. So many, now, have been with us since we started in 2008 and the new ones that joined last year. We just opened once last year and so many of them are still with us and now we just opened once this year, and we have these new members and I hope they'll be with us a year from now again, because that's how we all succeed together is having the right time frame.

CHRIS HILL:

And, as Jeff said, this is a full-portfolio service, so by all means, keep the questions coming on the Pro boards [and] and the help desk. Make Pro fit for you.

JEFF FISCHER:

Yes. And I'll jump into the chat version for the last ten minutes right now, too. And then we'll see you on the boards.

CHRIS HILL:

We'll see you on the boards. For Jeff Fischer, I'm Chris Hill. Thanks for watching. Fool on!

[End]

The Buckle Plods Along

Published Nov 25, 2014 at 11:53AM

The Buckle's (NYSE: BKE) third-quarter results continued the trend set forth by the prior two: not great, but not horrible either given the current retail environment. The company continues to plod along with its controlled expansion plans and hold steady on pricing even as competitors offer promotion after promotion after promotion.

Fiscal Q3		change
Sales	$292.2 million	↑ 1.3%
Operating margin	22.1%	↓ 20 bps
Net income	$40.6 million	–
Diluted EPS	$0.85	↓ $0.01
Comparable store sales		↓ 0.3%
Online sales	$22.8 million	↑ 3.8%
Year to date		
Sales	$799.6 million	↑ 1.3%
Operating margin	20.3%	↓ 30 bps
Net income	$102.4 million	↓ 0.9%
Diluted EPS	$2.13	↓ $0.02
Comparable store sales		↓ 0.5%
Online sales	$61.4 million	↑ 2.8%

Updated Guidance: Buy (no change)

Recommended Allocation: 2.5%

Fair-Value Estimate: $53 (no change)

CAM Price: $37 (no change)

Current Valuation	
P/S	2.2
P/E	15.6
P/FCF	23.2
EV/S	2.0
EV/EBIT	8.9
EV/EBITDA	8.1
EV/FCF	21.1
Dividend Yield	4.1%

The Results

Top-line growth was muted because of weak store performance, though this really didn't come as a surprise; the company releases monthly comp figures. Online sales were up 3.8% and continue to account for between 7% and 8% of total sales. Sales per square foot were up sequentially but essentially flat year-over-year at $115. Store traffic continues to be a weak point; units per transaction rose 2% and contributed to the 5% rise in the average transaction cost. Weak store performance also put pressure on margins, though cost controls were able to mitigate the impact to a loss of around 30 bps for most metrics.

The dichotomy between merchandise sales for men and women continued. Sales of men's merchandise was up approximately 8% in Q3 and now accounts for 41.5% of sales, up 250 bps from last year. Women's merchandise sales fell 1.5%, but average price point actually increased 2% to $51.80. Private-label sales held steady at 35% of the total.

The company opened five new stores this past quarter and also remodeled eight, which brought the percentage of total stores that are using its newest formant up to 79%. With the addition of two more openings and one remodeling since the quarter ended, the company has now opened 16 stores year-to-date and remodeled 18. Management is forecasting for unsurprisingly modest expansion in 2015 — six or so new stores and 10 substantial remodels.

Inventory rose by almost 15% to $147.2 million as the company continued preparing for the holiday quarter, but this was only a $0.9 million increase over last year's Q3 inventory level. The company now has approximately $5.22 in cash and investments on a per-share basis, so even though management has yet to announce a special dividend, one seems likely given the modest expansion plans for 2015.

Our Thesis

The Buckle offers retail exposure with low fashion risk — jeans and tops accounted for 46.5% and 31% of sales in Q3, respectively. Its management team is properly incentivized, has meaningful ownership, and runs the business wonderfully well. We expect measured growth from store openings, online expansion, and an expanded merchandise assortment (including footwear and children's clothes). We are not expecting dramatic operational improvements, but we believe in-house brand penetration and an improved online experience are opportunities. The Buckle should increase its earnings and pay a regular dividend, and we expect it to pay out excess cash distributions more years than not.

Pro's Take

Generally speaking, results this year for companies in the apparel industry have been tepid -- especially for those like The Buckle who are reliant upon physical locations for most of their sales.

But hope springs eternal this time of year, and forecasts for the holiday shopping season have received an added boost recently with the decline in gas prices. The company probably won't shoot the lights out next quarter, but given its current valuation, it doesn't have to. Just as one bad quarter doesn't break our investment thesis, one great quarter won't make it.

Buy ProShares Short VIX Short-Term Futures ETF

Published Nov 25, 2014 at 10:19AM

Is this for you? This recommendation is for *Motley Fool Pro* members who are comfortable owning a small stake in a volatile position that we plan to add to during market downturns. *Pro* is a portfolio service, so all positions are meant for everyone, to the extent you can do them and wish to. But this position will be especially volatile, so only follow it if you're comfortable with high volatility.

How You Participate

- **Action:** Buy **ProShares Short VIX Short-Term Futures ETF** (NYSEMKT: SVXY).
- **Allocation:** 1.35% (*Pro* will buy about 400 shares, or $1,350 worth for every $100,000 managed.) Do not over-allocate! We plan to buy more on sharp drops.
- **Scorecard Status:** Buy
- **Fair-Value Estimate:** N/A
- **Recent Price:** $76
- **Price Guidance:** Use a **limit order** to buy at the price available as you enter your order.

What We're Thinking

With China and Europe acting last week to shore up slowing economies, and with the U.S. economy stable, it's possible 2015 will be another year of lower-than-average volatility for stocks. Government backstops appear to be the new normal, suggesting that any further economic weakness may bring more fiscal support from federal bodies, whether it's in China, Europe, or here again in the United States. We don't believe monetary support like this can persist indefinitely, but it could continue for several more years.

Enter the **ProShares Short VIX Short-Term Futures ETF** (NYSEMKT: SVXY) — and say that 10 times fast! This vehicle increases in value when stock market volatility, as measured by the CBOE Volatility Index (or VIX), goes down or is rangebound. How so? This ETF *sells short* futures contracts on the VIX that have one month and two months to expiration. Unless volatility in the S&P 500, as measured by the VIX, increases above and beyond the premium already baked into the futures contracts being shorted, the positions turn a profit and the ETF goes up in value.

Helping further, VIX futures contracts are historically in a state of "contango" up to 90% of the time. This means future-month contracts are increasingly more expensive than earlier months and than the current VIX level itself (much like a call option has a premium above the current stock price). The VIX is measured as a number, rather than in dollars. A VIX of 12 suggests that 12% *annualized* volatility is expected in the S&P 500 index over the next 30 days. If the VIX itself is 14 (for example), its futures contracts for the next two months may be 15 and 16 (as they were recently). That's a 6.6% and 14.2% premium, respectively, to the current VIX level. The VIX needs to go up enough to make its futures prices increase even more than the current premiums, otherwise short sellers (such as ourselves through this short ETF) benefit.

In the past two years, this ETF has gained approximately 98% while the VIX has declined about 18%. But we don't need the VIX to decline to ultimately see the ETF go up. A flat VIX should lead to gains as well, thanks to contango. If some of this explanation has you feeling like you've already eaten a lot of turkey and want to sleep it off, don't worry; we'll discuss the position further on the new discussion board we have for this ETF, and in our Dec. 3 Portfolio Positioning Event.

Now, the downside risk? When volatility spikes, and it will when the market falls, the value of this ETF can fall *fast and sharply*. October's 100%-plus spike in the VIX level sent this ETF down 39% . At extremes like that and worse, we'll want to add to our position and wait for volatility to revert back down, restoring the ETF price. Since the long-term contango math works in our favor, as does volatility's reversion from spikes, the key to this position is *long-term staying power.* We'll start with a small position, and we're ready (at whatever point) to see it decline in price by half or even more when market volatility spikes. When it does, we plan to add to the position. As the position gains in value over long stretches, we will trim it if it becomes too large — a good problem we hope to have years down the road.

Since its debut in October 2011, the ETF has gained more than 550%. But that's not to say we've missed anything — its "valuation" is not inflated since it has no underlying valuation. Its past appreciation is simply the value created by repeatedly shorting monthly futures contracts that, most times, end with less value. The ETF rolls this strategy forward every month, ultimately collecting more proceeds as long as volatility doesn't gain much ground. When volatility does rise sharply, we'll need to wait through a falling ETF price and consider buying more shares at lower prices.

How It Fits Into *Pro*

Pro has been profiting by shorting ETFs over the past few years, selling short the **Direxion Daily Financial Bear 3X ETF** (NYSEMKT: FAZ), and the **ProShares UltraShort Real Estate ETF** (NYSEMKT: SRS). Both are difficult to borrow and expensive to short now, but the ETF we're buying has had similar or better returns than these shorts, and has moved in price similar to them. Now that those two shorts have shrunk from a 3.5% position in *Pro* to only 0.9% in exposure, and they are not easy to short any longer, we have room to add to our exposure in an ultimately similar vehicle. Adding 1.35% in SVXY increases our exposure to this "basket" to 2.25% total — leaving room to add much more if desired later.

Some things I appreciate about buying SVXY instead of shorting more flawed ETFs or shorting this ETF's opposite, the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) ETF, include:

- We don't need to borrow shares (which can be difficult) and pay shorting fees, though SVXY does have a 0.95% annual management fee.
- We don't risk being called out of the position at the worst time, as you do with a short.
- As shorts decline in value, they reward you less. The more correct you are on a short, the smaller your future reward. You can attempt to short more shares, but that's not always easy. Buying SVXY is the opposite: The more right we are, the more it will compound over time.
- Our potential loss is limited to the capital invested (so we always know our risk), while a short can of course balloon well beyond your starting risk.
- As SVXY declines against us, it grows smaller in value, making it easier for us to commit more capital to it — which we want to do on downturns (taking a positive action in a negative market). Shorts are the opposite: The more they work against you, the larger they become in your portfolio, making it harder to commit more to the position; they can handcuff you.
- If we own SVXY for more than one year, we should be able to claim a long-term capital gain when we sell it (though do note that we're not professing to give tax advice). In contrast, all shorts are considered short-term gains or losses. That said, because it's set up as a partnership, **SVXY does issue a yearly Schedule K-1 form in March** to owners, so you will likely have small gains or losses to report annually. If this is off-putting to you, consider skipping the investment, and again please note that we can't be tax advisors!
- SVXY is now more than three years old and has tracked its objective very well. There's no reason to suspect it won't continue to do so, because it uses a regimented formula to short the same VIX futures in the same rolling percentages every month (the same formula other similar VIX products use).
- Finally, it bears repeating that, in contrast to a short, we can manage this position's size in a way that's logically beneficial to us: We can comfortably add more when it declines, and sell some when it grows.

This is a *Pro* type of position. It's not something you're likely to find recommended in many traditional places. If you participate, you'll need to commit to it for the *long haul* given that volatility will at times send this position's value much lower. You also need to assume that, like any stock, it could lose all or virtually all its value.

Over the long term, though, the odds are stacked strongly in our favor because spikes in volatility revert to lower levels over long periods, and because contango (like writing options) benefits a short seller over time. This ETF has existed more than 700 trading days, and has returned 568% over that time. But over 30-day and 90-day periods, its maximum drawdown or decline has been 40%. Over any 250-day trading period, its maximum fall has been 3%. Every period longer than that has been positive. We need to commit to the long haul.

ProShares Short VIX Short-Term Futures ETF (NYSEMKT: SVXY)

- **Inception:** Oct. 3, 2011
- **Assets:** $506 million (as of 11/21/14)
- **Annual management fee:** 0.95%
- **Average daily trading volume:** 1.9 million shares
- **ETF's beta to the VIX:** 0.64 (moves 64% as much as the VIX, since 2009 based on tracking index)
- **ETF's correlation to the S&P 500:** (0.74)(inverse relationship correlated 74% to the S&P 500, since 2009 based on tracking index)
- **More Info:** Fact Sheet (link opens PDF)
- **Structure:** Partnership, so owners will receive Schedule K-1 IRS forms each year

The Foolish Bottom Line

Members should realize this is *not* a hedge — it's the opposite. This is an investment that benefits from a *lack* of volatility, and its price will rapidly move against us when volatility increases, let alone spikes, when stock prices decline. So, we're actually inviting a bit more volatility into the *Pro* portfolio with this position. We're willing to do so because we believe the long-term rewards will be well worth it, and with this vehicle we should be able to manage the position sustainably whatever comes our way. Should volatility soar, we'll be ready to add shares at much lower prices. Over the years, the position could appreciate enough that we'll want to sell some shares during periods of low volatility (freeing us to buy more at lower prices again). And so forth. The key is to start small, so we can add more when desired — and then be ready to hold the position for years.

Alternative Trades

- **Already short VXX?** Then you already have exposure identical to owning SVXY. Keep your exposure reasonable; don't buy SVXY if that would increase your total exposure beyond our recommended level. If you want to swap your short VXX for long SVXY, realize that at times VXX loses more than SVXY gains. But keep in mind that SVXY can compound while VXX is gaining an ever-smaller sum for short sellers, even if it declines more on a percentage basis than SVXY gains at times. If you want to swap, consider the tax consequences of closing your VXX short. They can be large.
- **Only want to potentially buy SVXY lower?** Consider selling to open any puts — sell one put for every 100 shares of SVXY you would buy lower.
- **We're not offering more alternatives.** This recommendation — buying shares — is simple enough for anyone, and should be relatively easy to manage with additions and subtractions over time as desired.

Pro Can Help

- **Ready to do the long-term "contango"?** Ask questions on our new SVXY discussion board.

Thankful for 3 Investing Tips

Published Nov 24, 2014 at 11:06AM

Pro Guidance Changes

- **Apple** (NASDAQ: AAPL): Fair value estimate increases to $110. Shares remain a Buy, with a 4.6% allocation. See our new earnings review.
- **Gilead Sciences** (NASDAQ: GILD): Fair value estimate increases to $120. Shares move up to Buy First, with a 4% allocation. See our latest earnings review.
- **MasterCard** (NYSE: MA): Fair value estimate increases to $75, and shares remain a Buy at a 4.5% allocation. We explain our conservative fair value in our earnings update.
- **Medtronic** (NYSE: MDT): Fair value estimate increases to $66. Shares remain a Buy with a 3.2% allocation. See our earnings review.

Dear *Pro* member,

As we take time this week to enjoy the Thanksgiving holiday, it's a Foolish chance to remind ourselves that the values that we treasure in life are appreciated — and beneficial! — in how we approach investing, too.

Namely, thoughtfulness; good planning; sticking to strategies that work to reach long-term goals; a sense of humor; modesty; a willingness to keep learning, to know you can always improve. And an acceptance of mistakes, whether it's an overcooked turkey or a stock that went south. That's part of the journey, so we better take it with levity.

Overall, those who are able to invest in a calm, reasoned, and cheerful manner through thick and thin are likely to enjoy life more, too. Both investing and life can, for the most part, run smoothly for years, and then suddenly be visited by hardship. How will you react? What you do will influence how strongly you emerge from a challenge, and how much you grow afterward. Will you continue to reach new highs in your life, even after setbacks? Does your portfolio do the same?

We enjoy investing, and we believe this helps us enjoy life more, too. Whether you're new to *Pro* or have been here since the beginning, we hope you revel in your investing with us — and approach it gradually and calmly, taking a long view, just as we do in life. No one can build a complete life in mere months or even a decade. It also takes years to build an investment portfolio that will give you more than you need, financially, for the rest of your days. It will be sweet when you get there, but enjoy the process, rather than just waiting for the outcome.

Heading into the holiday, we're delighted to offer you Tom Gardner's recent talk to *Motley Fool One* members in Austin, Texas. Kicking off a day of Foolish festivities, Tom spoke about three steps investors should take to improve their investing results — for life. Simply click here, and you'll get the transcript, too. Enjoy it!

We'll be back tomorrow with our fourth Portfolio Building Report. After that, have an excellent Thanksgiving! Remember to stop by *Pro*'s site next week for our Dec. 3 live Portfolio Positioning Event.

Thank you for being a Fool with us. We're grateful for your trust and for our shared community of excellent investors (and life enjoyers!).

Fool on!

— Jeff (TMFFischer)

***Pro* Completed Trades**

- **Expeditors International** (NASDAQ: EXPD): We rolled our November 2014 $43 short calls to February 2015 $45 short calls for a $0.05 debit. And we sold February $43 puts for $1.05 in credit as our November 2014 $39 puts expired as income.

Tom Gardner on Your 3 Biggest Investing Risks

Published Nov 24, 2014 at 10:00AM

Watch as Tom Gardner digs into the three biggest risks of investing -- and how The Motley Fool aims to help you position yourself to combat them. Recorded at the November 2014 *Fool One* member event in Austin, Texas.

{%video%}

Transcript

Chris Hill: Please welcome Tom Gardner.

Tom Gardner: Thanks, Chris. Thank you. Good morning! Awesome. Awesome answer. I won't say that twice.

We have been in business for 21 years, and in a way we may have had a better front-row seat at observing the behavior of investors than any organization in the world, by virtue of the fact that we're seeing, online, what's happening with investors in different market environments.

One of the things I've learned to do is, when the market is down to emphasize opportunity, and when the market is up to emphasize risk. The market is up, so I'm going to talk a little bit about risk in my opening remarks, just so we're seeing clearly together how to make sure we've set up our portfolio for every environment.

Again, we've been watching the behavior out in the community message folders, talking to people, the financial planners in Motley Fool Wealth Management, and learning how you're doing what you're doing.

I would like to emphasize three different types of risk that I see, in rank order for me, as the greatest risks that you face in using The Motley Fool for your investment and financial needs.

The first risk is time horizon risk.

Time horizon risk. That is the number of people over the 21 years that have used our service with a time horizon that is simply too short to get the value out of the work that we're doing. The average holding period for a "professional" -- and I intentionally put quotation marks around that word -- investor is less than a year. The average holding period for an individual investor is about 185 days. That's not going to work with The Motley Fool.

I'm probably preaching to the choir on this one, but it's important for everyone in the room to know that what we've set up across our services, and if we talk specifically about the Everlasting Portfolio, which we will later today, we mandate a five-year holding period in the Everlasting Portfolio, as you know. We do that primarily for behavioral reasons.

I think the data will show that that is the best way to get great long-term returns. I think you may be able to squeeze slightly better returns out if you find a few opportunities to sell in certain situations with less than a five-year holding period, but you may have seen David Gardner's video on Stock Advisor and his side of the scorecard; he has utterly obliterated both the market and his younger brother!

What he and his team on his side of the scorecard found is that, had they never sold a stock since 2002 in Stock Advisor, their returns would be better ... had they never sold.

That data, and the data provided by the investment performance of Shelby Davis, whom I'm sure many of you have read about in the book *The Davis Dynasty*, a man who bought stocks, essentially never sold, rarely sold, died with 1,200 stocks in his portfolio. Started with $50,000, and 40 years later had $900 million in his portfolio. Did not add much money at all, along the way; he got 24% annualized returns.

The one thing he did that we don't do at The Motley Fool is he used margin, but I won't go into that. You don't need 24% annualized returns to have more money than you'll ever need.

The key lesson from Shelby Davis' life is he basically said, "Why sell? If I focus myself on finding great organizations, I'll just ride them. I'll have a certain number of losers and they won't matter to the overall performance of the portfolio."

And that's exactly what's happened in Stock Advisor, so my action on Risk Number One is, align yourself with the work that we're doing, which is seriously consider making investments that you'll hold for at least three years, ideally five years.

Of the six largest holdings of Warren Buffett's, one of them, **IBM**, was bought in the last couple years. The other five, the average holding period for Buffett of those companies is north of 20 years. North of 20 years.

The evidence is everywhere, for us and for our families, for the future generations of your family, that if they can learn to find great businesses and ride along with them, their chances of success go way, way up.

That's the first, and I think the greatest risk that anyone faces in using The Motley Fool. The number of people that come into the Fool and buy some stocks with us, and then six months later say, "It's not really working," they're missing an opportunity to build wealth in the way that the evidence demonstrates it is built, using the public markets.

The second risk is diversification risk. Diversification risk; having enough stocks in your portfolio so that, in any environment, when some go down you're OK because you can look in your portfolio and see that there are a couple at least -- when markets are really down, it's nice to see one green mark in your portfolio!

There's a lot that goes into the emotions of being an investor, and diversification really gives you a number of benefits. One of them is, of course, you see a number of stocks across a number of industries, so you're able to get some sense of what's happening. You don't feel as isolated as if you have five stocks in your portfolio.

Now, there are some great investors like Buffett who have said if everybody had a punch-card with 8 or 10 holes that you could punch, and those were the only stocks you ever bought in your entire life, the average person would do better.

I think that that's probably true for somebody who spends their life investing and really digs deeply into companies, but for the majority of stock investors, I think holding a minimum of 30 stocks is a very good idea.

I would look at your portfolio and see, "Do I have more than 30 stocks?" If you don't have more than 30 stocks, then I would say you hopefully are spending a good deal of time on your investments, and have deliberately made the decision to have fewer than 30. If somebody in the room has six stocks, great -- if you have deliberately and intentionally made that decision. Otherwise, 30 or more stocks.

The second factor I'd put in diversification risk is to have no position larger than 15% in your portfolio.

Now, those are guidelines but I observe, again, in looking at the data and working with investors for 21 years, that the top two mistakes that people make when they come in to work with The Motley Fool is their time horizon is too short, and they're hoping for success from too few investments.

I can pretty much stop there in my opening remarks and say that if everyone in the room and everyone across the world that uses The Motley Fool simply said, "Okay, I'm going to buy more than 30 stocks and I'm going to hold them for more than five years," I'd feel very, very good about their success, relying on the research that we're doing as a company and all of us as a community, following businesses together.

The third risk I'll just say is the risk of market extremes. That is the risk of getting extremely excited when all of your stocks are up and the market's up 20% a year for a couple years in a row, and then getting completely dejected to the point of never wanting to invest again when the market is down.

Now, the data shows that the market rises two out of three years, and that the stock market rises on average somewhere in the range of 9-10% a year, historically. That means that actually, you probably don't need to spend too much time trying to manage your emotions when the market is rising, because that's typically what it does, so I wouldn't get too worried when the market hits highs.

But I would definitely want to position yourself to be happy when the market declines. I probably say this at each member event; it's because it's one of my favorite Motley Fool concepts ever, and it's from Jeff Fischer.

Jeff says you need to put your portfolio in position to be able to take a positive action in a negative market. That is so important to human nature. The data shows that most people are buying stocks with enthusiasm when the market's rising, and selling them in distress when the market's falling. We should at least flip one of those two, and that's we should be buying when the market is declining.

As you know, to close -- or maybe not everyone in the room knows -- I made a bet with our Motley Fool One member base on January 1 of this year, that the market would fall 10% at least one point during the year.

It maybe would rise 70% -- that would be absurd and it hasn't happened -- but at some point in the year there will be a 10% decline. The reason I did that is I wanted to prepare us all for the reality that this is going to happen. Morgan Housel's great research in Motley Fool One shows that the market has fallen 10%, on average, every 11 months going back 100 years, and that's pretty evenly distributed.

There are some periods where you don't get a 10% decline; for example, the one that we're in right now, unfortunately! The market has not fallen 10% for three years, I believe; a little bit more than three years. It has fallen 9.86%, which just feels so incredibly unfair!

In order for me to win the bet, the S&P 500 had to get to 1,817. That was the target. We were on a retreat in Maryland, and I was refreshing the S&P 500 quote every six seconds; something I never thought I would ever do in my life! It got to 1,820, and then turned around.

Thankfully, because of Morgan's work, because of our commitment to some of the principles I mentioned, because of some of the things that we'll learn together today, and that we're learning together in Motley Fool One, there we were right in the middle of October, using our Wildcard Round in the Everlasting Portfolio and saying, "Why not?"

Mathematically, if the market goes up on average 9-10% per year, and has one 10% decline on average, every 11 months, for long-term investors with a diversified portfolio, what a mathematically awesome moment in time to buy.

Every 11 months -- obviously there are multi-year periods where it doesn't happen -- but whereas most of the market is getting worried and the headlines are absurd and extreme, we as Fools are using that as an opportunity to pick up some great investments.

We'll talk about that Wildcard Round but that, to me, is one of the most delightful things that has happened in our Motley Fool One work, going back a number of years, and that is to really use all the data and research we're doing to go contrary to the market and take advantage of some beautiful prices, which I think we got together in mid-October.

There is a look at three significant risks.

I think if you -- in your portfolio, your family's portfolio, with your children, grandchildren; with anyone you talk to about investing -- can teach them, "You should hold your investments for more than five years. You should have more than 30 of them in your portfolio, and you should set your portfolio up to be able to take a positive action in a negative market," I think those are three ingredients to beating the market, something that still so many academics think can't be done, and that we know can be done. We believe we've demonstrated with you that it can be done for many years.

Thank you all for coming. You're going to get probably too much of me today, at different points through the day, but you will now get Bill Mann and Tim Hanson. But before that, we have a video with some tips on how to use Motley Fool One.

Giant Gilead Grows Greatly

Published Nov 24, 2014 at 9:36AM

Gilead Sciences (NASDAQ: GILD) reported record results even as doctors put off orders of its Hepatitis C drug, Sovaldi (Sovaldi revenue fell 20% from Q2). Doctors were waiting for Gilead's new single-pill solution, Harvoni, which was approved in October and is off to a very strong start. Our fair value estimate increases to $120 and the stock returns to Buy First from Buy. To see our full report and post questions, just click through, Fool!

Medtronic Stays Healthy

Published Nov 24, 2014 at 9:29AM

Medtronic (NYSE: MDT) pleased investors with better growth and a steady outlook for more on the way. The company expects gross margin to improve sequentially, and expects multiple benefits (savings, growth, and much more cash available to it) from its pending merger with **Covidien** (NYSE: COV). Shares in this leading medical device maker remain a Buy, and our fair value estimate ticks up. See our full report and ask questions by clicking here.

Apple Connects Again

Published Nov 24, 2014 at 9:22AM

Apple (NASDAQ: AAPL) shared an outstanding quarter and excellent guidance, with healthy growth, stable margins, and giant revenue and cash flow numbers. The most valuable company in the world is on track to become larger still -- nearing $200 billion in annual revenue. The stock remains a Buy and our estimated fair value increases. To get our full report, click here.

MasterCard Remains in Charge

Published Nov 24, 2014 at 9:16AM

MasterCard (NYSE: MA) reported results that showed strong year-over-year growth even in a difficult environment, and shares ascended to a new high. Our fair value estimate increases, and we explain why it looks conservative. When the economy around the world is stronger, profits are poised to balloon, and still most transactions are done in cash. To see our full report and ask any questions, click here.

Reset Your Short Strangle on Expeditors International

Published Nov 18, 2014 at 12:18PM

Is this for you? This is for *Pro* members who manage at least $250,000, are seeking an income position, and can sell puts. Members with our existing position can follow this "re-up" trade exactly, and newcomers can jump on board now, too. If it's not possible for you to make some part of this trade, consider the Alternative Trades at the end of this recommendation. **If you're new to options, this trade may be too complex**; in that case, you should wait, make simpler trades instead as we offer them, and join in this extra income trade later.

How You Participate (If You Already Have a Position)

- **Trade One:** Roll your November 2014 $43 calls on **Expeditors International** (NASDAQ: EXPD) to February 2015 $45 calls. (Leave your November 2014 $39 puts alone.)
  - **Use a rolling order:** Buy to close your November 2014 $43 calls, and simultaneously sell to open an equal number of February 2015 $45 calls.
  - **Price guidance:** Aim to roll for a zero to $0.05 net debit.
- **Trade Two:** Sell to open February 2015 $43 puts to complete your strangle. Our November $39 puts expire Friday; we will wait at least until that day to write new puts.
  - **Price guidance:** Lately, use a **limit order** to be paid $1.30 for each put you write, or 3% in nearly three months.

How You Participate (If You're New to the Position)

- **Trade One — set up a synthetic long:** Sell to open January 2016 $42 puts, and buy to open an equal number of January 2016 $42 calls.
- **Trade Two — sell a strangle:** Then use a strangle order to sell to open February 2015 $43 puts and sell to open February 2015 $45 calls, same as above, selling one each for every synthetic long you set up.
- **Price guidance:** Aim to pay approximately $1.60 or less to set up the synthetic long, and receive at least $2.30 to sell the strangle. Realize the synthetic long price will change as the share price moves, and the strangle credit will go down over time.
- **Allocation:** Approximately 1.8% exposure on the synthetic long if turned to stock, and another 1.7% exposure through your short puts in the strangle if turned to stock, for 3.5% total exposure. Each new syn long combined with a written put represents about $8,700 in exposure to the stock. So, for 3.5% exposure, set up one synthetic covered strangle (one each of all four options) for approximately every $250,000 you manage. *Pro* used 10 contracts of each option.

- **Recent Prices:**
  - Stock: $44.10.
  - November 2014 $39 put/$43 call strangle (combined bid/ask)(buy to close): $1/$1.25

- February 2015 $43 put/$45 call strangle (combined bid/ask)(sell to open): $2.35/$2.55
- **In sum:** Your account will begin with $2.35-$2.45 in credits on the new February 2015 $43 put/$45 call strangle. Members already in the trade who close the November $43 calls first will net a total credit of around $1.10-$1.20.

What We're Thinking

We have a gain on the synthetic long we set up in August on Expeditors International, and we've made some income on our short strangle, too. We're continuing this income strategy by setting up a new strangle that expires in February.

More That Matters

- **Maximum loss:** The same as owning 200 shares of stock (per synthetic covered strangle), minus the option premiums received.
- **Maximum gain:** The current strangle caps the upside on our synthetic long at $45, plus the new premiums received.
- **Follow-up:** The plan is to keep writing strangles at various strikes to earn income. Ideally, we'd also like our synthetic long to continue to tick up in value, too, though that's of secondary importance.

Alternative Trades

- **IRA-friendly:** If you're unable or unwilling to write puts (even cash-secured), then you can consider using a buy/write order to buy at least 100 shares of stock and sell to open the February 2015 $45 covered calls. Start about a 1.8% allocation and be ready to add more if the stock falls and we accept more shares; or, start a 3.5% allocation and don't plan to add later.
- **Traditional covered strangle:** Rather than using a synthetic long, if you prefer you could simply buy shares in round lots of 100 and then sell the same short strangle we are.
- **Managing less than $250,000?** You can consider just buying 100 to 200 shares to write the covered calls on them, as long as it keeps your allocation below 3.5% (which means your portfolio is at least $126,000, because $126,000 x 0.035% allocation = $4,410 as a stock purchase, or exactly 100 shares).
- **Already wrote covered calls?** You can roll those just as we are above.

Pro Can Help

- **Want more on this strategy?** Dust off our guide to covered strangles, and synthetic longs, too. We're just combining the two into a synthetic covered strangle.
- **Questions?** Visit our revitalized Expeditors board.

Investing for 2015 and Beyond

Published Nov 17, 2014 at 2:26PM

Pro Guidance Changes

- **Skyworks Solutions** (NASDAQ: SWKS): Fair value moves up to $66. Shares remain a Buy First, with a 3.4% allocation.
- **OpenText** (NASDAQ: OTEX): Fair value moves up to $55. Shares remain a Buy, with a 3.7% allocation.
- **Tupperware** (NYSE: TUP): Fair value moves down to $80. Shares remain a Buy First, with a 2.7% allocation.
- **AmTrust Financial Services** (NASDAQ: AFSI): Fair value moves up to $43. Shares remain a Buy, lately at a 7.7% allocation. Given its size, this one in particular you may want to buy in thirds or halves over time. Or you may want to begin by buying only 5% or so to start, as we may eventually trim the position (and if we don't, you can add more later).

Dear *Pro* members,

The team and I are analyzing recent earnings reports, SEC filings, and conference calls from our companies. As you can tell from the links in today's *Pro* Monday Memo email, we've gone through several companies in recent days, publishing our takeaways and updated guidance (summarized above).

The good news is that a majority of our companies are growing more rapidly than we or the market expected. Meanwhile, the few that are hitting bumps in the road don't expect the bumps to last. When managing a portfolio, you always expect some positions will be going through rough patches at any given time; as long as worthwhile promise lies ahead, it's not a lasting concern.

Veteran members know that after earnings coverage, we typically make some moves in the portfolio -- adding to a position or sometimes selling one, using options, or adding a whole new company to the fold. We tend to make these changes in small batches, because we invest -- and think -- in terms of the *whole portfolio* and how it works together. Many investors begin with just a stock or two and consider themselves investing, but in reality, that's closer to gambling. When you start to think in terms of a diverse portfolio, instead of a few "stock picks," you set yourself up for lasting success.

A well-constructed portfolio is like a tall building with multiple safeguards. If it gets hit by a tornado, or a 100-year flood, it will withstand the assault. Meanwhile, it increases in value.

New *Pro* members are advised to steadily build a *Pro* portfolio by following our (appropriately named) Portfolio Building Reports. Part one and part two recommended 10 *Pro* stocks to buy, adding up to about a 36% allocation. Our subsequent reports will outline the rest of the *Pro* stocks we believe you should invest in; after that, since you'll be largely invested, we'll have a Portfolio Positioning Report (and accompanying live chat) for those who want to short, hedge, and use options. With these tools, you can manage your market exposure for upside and downside.

Common questions include:

- **How do I meld *Pro* stocks with my existing stocks?** One approach is to treat *Pro* as a sleeve of your total assets, and with that sleeve follow the whole portfolio as closely as possible. Some members do like to mix *Pro* stocks with other positions. If this is you, we still recommend that you eventually own as many *Pro* stocks as you are happy to own. Our portfolio is meant to work as a whole. If you're selling some stocks to get there, first sell your least favorites -- ones you believe in least -- to add *Pro* stocks. And realize you can take your time. We don't want you racking up giant tax bills by selling winning stocks you love. Taxes are a real cost. You can follow our portfolio and apply our hedging strategies to your own portfolio, while gradually moving into more *Pro* stocks over time. You can ask related questions on our "Making *Pro* Fit You" discussion board.
- **Should I buy a full allocation of each stock today?** We're advising that you mirror our current allocation. We make certain we like how our portfolio is constructed, and to guide you over the years, we can only know what your allocations are if you follow our own. That said, many members average into positions over time. If we recommend 4% in a stock, some of you may buy 2% to start, and 2% later. That's fine, and would be beneficial if prices slip -- as long as you finish the job later. Experienced options users sometimes "sell to open" puts to target lower buy prices on some of their shares.

- **Some stocks are above fair value. Should I buy anyway?** If they're rated a Buy, we believe they will still perform well over our time frame, meeting or beating our goals. Fair value is an estimate, and it's the price *from which* we expect our desired rate of return. If a stock is a bit above our estimate, it doesn't mean its promise is gone.
- **How long will I own these stocks?** The Motley Fool has always said that you shouldn't invest money in stocks for anything less than three years. That's smart advice. We view all of our core stocks with a rolling three-year time frame.
- **Do I need to hedge, short, and use options?** The short answer is no. Many investors do perfectly well by just owning stocks -- our stocks alone should lead to success. But for those who want to use these dynamic tools, we'll help you incorporate them into your *Pro* portfolio starting with our Portfolio Positioning Report on Dec. 3.
- **How do I use *Motley Fool Options* alongside *Pro*?** *Pro* members receive *Motley Fool Options* free for the life of their *Pro* membership. *MF Options* provides individual options ideas and education. For members who want *additional* options positions in their portfolio, these are a perfect portfolio complement and return enhancer.

For other common questions, see our welcome note from last week. And as you go through our Guidebook, enjoy the process! Investing is a marathon, never a sprint. If you make a little progress each week, you're headed toward the long-term success that is compounding, which can only happen over many years. Already, we're analyzing investments with 2015 and beyond in mind. Never do you invest for "today." You invest for a more rewarding tomorrow.

To veteran members, thank you for so kindly welcoming new *Pro* members to the service! Our reopen last week was the first time in a year that we opened to new members, and it's fun to see new names here and in *Motley Fool Options*. To everyone, we expect a series of recommendations (in both services) as we go through the rest of the year. In *Pro*, we like to use the end of the calendar year to reassess and make adjustments. We have this in mind already as we guide new members. I also like to get new, desired positions into the portfolio as the year ends, looking ahead to 2015 and its possibilities (including higher interest rates).

But always think "marathon," never "sprint." Any money you can make in a day or week won't be enough to matter. The money you make over many years, by being invested, is what makes all the difference.

Fool on!

— Jeff (TMFFischer)

Nov. 22 Expirations

- **Expeditors International** (NASDAQ: EXPD): We plan to let our $39 puts expire as income, and write new ones. We'll roll our $43 calls. So, we'll keep a covered strangle going on these shares for income.
- **SPDR S&P 500** (NYSEMKT: SPY): Our $200 puts are on track to expire without value. If we can get some value, we'll sell by Friday with a trade alert. This hedge quickly became worthless as the index rapidly recovered. But our portfolio went on to new highs regardless. We are considering new hedges.

OpenText Keeps Growing

Published Nov 17, 2014 at 10:56AM

Guidance Update on OpenText (NASDAQ: OTEX)

• Fair Value Estimate increases to $55 (from $52)
• Remains a Buy, at our 3.7% allocation

Summary: First quarter 2015 new license sales rose 6% in a slow environment as the new software that debuted early this year gains traction; separately, the GXS acquisition is going well. Management projects continued strength given its new product lineup and industry growth of around 10%. Little else changed in the business the last 90 days, but year-over-year growth is strong thanks in part to acquisitions, and profitability is up strongly the past year.

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Q1 2015 Results
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• Revenue: +40%
• Diluted EPS: +41%
• License Revenue: +6%
• Oper cash flow: +73%
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OpenText (NASDAQ: OTEX) sells enterprise information management (EIM) software via cloud and license to help customers organize and manage electronic content, business processes, regulatory and other data. It also conducts, invoices, and manages business transactions through its GXS acquisition. The company's sales are spread across industries, governments, and geographies.

Pro's thesis: The enterprise information management (EIM) software industry will grow by about 10% annualized, and OpenText will grow stronger than the industry. In addition, OpenText will be a leader in business exchange transactions, and recurring, fee-based revenue will grow. As long as shares are reasonably valued, they'll compound for us.

Guidance: Shares remain a Buy at a 3.7% allocation. If you're using options, you can also write puts to potentially buy (some of your) shares or target income.

To see our full review, please visit the OTEX board.

Coca-Cola Carries On

Published Nov 17, 2014 at 10:47AM

Pro Guidance

o No *Pro* guidance change on Coca-Cola (NYSE: KO)

o Not to be confused with *MF Options*, *MF Pro* has a January 2016 synthetic long with a 3% look-through allocation. Here's our original recommendation.

o Newcomers should wait for our Dec. 3 report, but those with experience could set up a January 2017 synthetic long, lately at the $42 strikes. Each syn long is worth $4,200 in stock, so you would set up one syn long (sell one put, buy one call) for every $140K you manage. Assuming no changes, we'll have this guidance in our **Portfolio Positioning** report on December 3.

Key takeaways:

- Coca-Cola is refocusing the business by market segment and geography to perform better.
- The company is streamlining operations for cost savings and margin improvements by 2017 to 2019, with $3 billion in annualized savings planned by 2019.
- They still target long-term sales growth of 4%-6% and high single-digit EPS growth.
- 2015 will be a transition year for the business as Coca-Cola works to lower costs and increase return on investment over the long haul.

In summary, expectations are low for Coca-Cola, and shares are reasonably priced such that any business improvement could push the stock (and our syn long) higher. Now that Wall Street is starting to focus on the company's cost savings plan, management may have just lowered the bar a bit. Investors will likely be happy if margins increase and sales volume holds up.

We may eventually write calls on our syn long to target income during a transitional 2015.

For our full review, please see the board.

Tupperware Parties Less

Published Nov 17, 2014 at 10:37AM

Pro Guidance on Tupperware (NYSE: TUP):

• Buy First (no change)
• Our Fair Value estimate declines from $85 to $80 on low growth
• Members lacking a 2.9% allocation should buy; or, those who wish can write puts ($60s or $65s) to target a lower price for some shares, though today's price looks attractive already for the long haul.

Summary

Tupperware failed to execute again, falling short of expectations with emerging market sales up 8% and developed markets down 4% (goals are 10%+ and flat-ish).

Currency headwinds, a 2% drop in the *active* sales force, and recent problem areas like Venezuela dragged down results. That said, earnings per share came in at recent guidance, even as spending was elevated. Higher spending should ultimately lead to greater sales as the company is investing to grow its infrastructure. Emerging markets could return to 10% sales growth as soon as this quarter. However, management did not lay out any bold new plans; it just needs better execution and a more active sales force.

Tupperware remains a choppy business because it's rare that all markets do well any given quarter. As long as the business as a whole is moving forward, we should ultimately be rewarded. Over the last 5 years, sales have grown at a 5.5% CAGR, operating earnings at 7.2%, and EPS at 11.8% annualized. Dividends have grown 24.8% annualized. But now we need to see increased spending start to result in stronger sales, even if it takes another few years. Overall, I believe the odds still favor a pleasing North Star return with moderate risk.

How it Fits Into Pro

In the *Pro* portfolio, we like that Tupperware provides non-tech exposure and consumer retail exposure in large emerging markets (70% of sales), while trading at a reasonable price (P/E of 14) with a strong 4.2% yield. It doesn't face the same retail risk (or costs, or limitations) as a bricks and mortar retailer. It pays no retail rent and doesn't advertise. The meta-thesis is Tupperware can grow free cash flow and EPS -- in a choppy fashion -- strongly enough to top the North Star, including the dividend, annualized over the next 3-10 years as the salesforce grows from 2.9 million to potentially 5 million long term.

Projections

- 2014 FCF of $220-$230 million, down from $250M
- 2014 sales in local currency up 4% to 5%
- 2014 EPS of $5.21 to $5.26 -- up modestly

- Long term, they're still aiming for 6% to 8% annualized revenue growth in local currency, comprised of about 10% emerging market growth and small moves in established markets. But for 2015, modeling for 4% to 6% revenue growth because that looks more likely.

To see our full review, please visit this post on the board.

New Quarter, Same Old Story at AmTrust

Published Nov 12, 2014 at 2:52PM

AmTrust Financial Services' (NASDAQ: AFSI) third-quarter results for fiscal 2014 continued the precedent set in prior quarters. Acquisitions and organic growth drove impressive top-line results, while favorable loss development and prudent cost management ensured that bottom-line metrics were equally impressive. AmTrust is currently *Pro*'s largest holding, but it didn't start out that way; strong operating results have lead to outsized returns for shareholders over the past few years. This quarter served as a great reminder of why our initial investment has increased fivefold.

AmTrust Financial Services Q3 2014

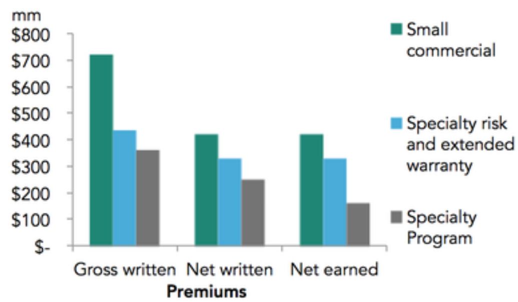
Consolidated Results

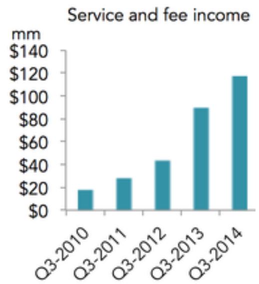
		change
Gross written premium	$1.5 billion	41%
Net earned premium	$914.4 million	49%
Operating diluted EPS	$1.70	205%

Insurance ratios	
Loss Ratio	66.6%
Expense Ratio	24.7%
Combined	91.3%

Rolling returns	
ROE	29.4%
ROA	4.6%

Segment Results





Updated Guidance and Valuation

Updated guidance: Buy (no change)

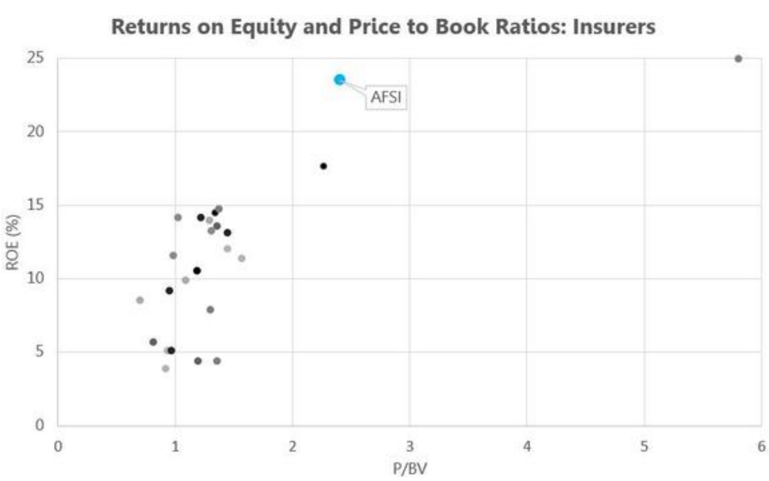
Recommended allocation: 7.3%

Fair-value estimate: $43 (up from $40)

CAM price: $30 (up from $28)

Current Multiples	
P/BV	2.4x
P/Tangible BV	4.31x

Dividend Yield 2%



For an insurer, 2.4 times book value definitely isn't cheap, but as the chart above illustrates, AFSI is no ordinary insurer. Not only is it one of the fastest-growing around, it also has some of the highest returns in its peer group.

Comin' Out Swinging

With all the drama surrounding the recent acquisition of Tower Group's commercial lines (click here if you want to read what the kerfuffle was about), CEO Barry Zyskind decided to break from tradition and discuss the deal as soon as the legal niceties were finished. The transaction was reviewed by nine separate regulators, scrutinizing every facet of AmTrust's business. The New York State Department of Financial Services (DFS) alone made more than 65 requests. Though some claim this level of scrutiny is a sign that regulators are becoming increasingly concerned with AmTrust's complexity and the speed of its growth, we see things in a different light: Regulators may have attached conditions to the deal, but they still gave AmTrust their vote of confidence. In particular, the New York DFS — having already been burned by Tower Group — should have good reason to make sure the deal doesn't backfire. That organization considers two factors when making an approval determination: the financial condition of the acquirer and the insurer, and the trustworthiness of the acquirer or any of its officers and directors. AmTrust was approved on both counts, and every regulator signed off on the deal.

Division Results

Gross written premiums in the small commercial business division were up an impressive 72% to $723 million. These results were driven primarily by two factors: strong growth in the company's workers' compensation product and the renewal rights from the Tower transaction. Workers' comp policy accounts increased by 55% as

California, Florida, and New York continued to be pockets of strength. Rapid policy growth when pricing favors the insuree often results in trouble down the line for insurers, but pricing continues to hold up in AmTrust's largest markets. For example, the average third-quarter rate increase in California and New York was 10% and 8.5%, respectively. Tower's commercial line renewal rights contributed $125 million of premiums during the quarter. Management now believes that this deal will likely add north of $500 million in premiums on an annualized basis (the original estimate was $350 million to $500 million), which would make this one of the most accretive transactions in AmTrust's history. To put the size of the deal in perspective, gross written premiums for the entire small commercial business division were $1.6 billion in fiscal 2013.

Results for the specialty risk and extended warranty business were impressive, even with a sizable currency headwind. Gross written premiums were up by 24% to $437 million, driven primarily by strong international results (up $71 million). The specialty program division, the smallest of the three insurance divisions, saw premiums increase by 24% as well, benefiting from many of the factors that boosted the small commercial business division.

Loss ratios remained favorable, but a shift in business mix in the small commercial and specialty risk and extended warranty divisions meant higher expenses, driving the consolidated combined ratio higher for the quarter. Even with the increase, AmTrust's combined ratio continues to be one of the best in the industry. The big differentiator for the company is its expense ratio. And while the shift in business will likely put pressure on this ratio going forward, the biggest advantage for the company from an expense perspective — its proprietary operating platforms — will continue to be exactly that. Mix may pull the ratio a little higher in the coming quarters, but I don't foresee it being much of an issue. Tower's commercial business is actually a great example of the savings AmTrust is able to realize immediately just by moving an acquired business onto its platform — it was running on six different platforms before the acquisition.

Revenue growth for the service and fee business rose by $27.6 million (31%) to $117.6 million. As is common for AmTrust, growth here was driven primarily by businesses that have been acquired over the past few years. Management has been willing to pay up for businesses that were folded into this division — they actually account for the majority of the goodwill on AmTrust's books. But the economic value here is far in excess of what is currently being recorded, and it's part of the reason investors are so willing to pay such a high P/BV multiple for the stock. EBITDA margins continue to be strong for this segment at around 25% and should expand as the company leverages its existing platform and workforce with each new deal.

Pro's Take

The shrewd and opportunistic management team at *Pro*'s largest holding continues to impress us. They're also great at timing buybacks. The company repurchased 843,000 shares during the quarter at an average price of $39.85 — only 3% higher than the quarterly low, and 20% below recent levels. Book value per share was up 6.8% this quarter and 27.2% over the first three quarters of fiscal 2014. Given that pricing is still holding up and AmTrust is still relatively new to its largest markets (and therefore doesn't have to deal with legacy losses from prior years), the company still has a lot of operational flexibility — it can charge as much as competitors and make more in profits or undercut the competition on price in a bid to take market share. But the devil is always in the details when it comes to insurers, so I'll be combing through the 10-Q that was just filed in the coming days and will get back to you if I find anything.

Welcome, New Pro Members!

Published Nov 10, 2014 at 3:47PM

Dear *Pro* member,

To those who just joined *Pro*, the team and I welcome you! Thank you for putting your trust in us.

We know you signed up for *Pro* with high expectations, and we're working hard to meet and ideally exceed them. But of course some of your success will depend on you. Now that you've made the commitment to join this special portfolio service, here are some of the best ways you can guarantee your success:

1. **Have the right time frame.** We buy all of our stocks with a minimum three-year outlook, and that's how we need to value businesses, as well. We assume certain growth rates, which lead to value estimates, which suggest stock appreciation. Right now, we want all of our stocks to return at least 10% annualized, to meet or beat our North Star goal.
2. **Take your time.** Don't rush. We want you to be 100% comfortable with our approach. We do the research for you, but we still want you to enjoy owning the businesses you buy. As you get up to speed, consider averaging into all of our Buy and Buy First stocks over time (you'll get our Portfolio Building Reports one by one). Slowly putting your money to work over several months, even a year, is *not* a long time in the grand scheme of your investing life -- and it could offer you some more attractive price opportunities along the way.
3. **Ask questions.** Like *Motley Fool Options*, which you receive free for the life of your *Pro* membership, *Pro* enjoys an outstanding community of successful investors. Take some time to learn how to navigate the discussion boards. They're a great resource, and we aim to leave no question unanswered.
4. **Enjoy the process.** Enough said. We've been investing for years, and we've enjoyed it. This makes it all the sweeter: We're earning great returns, and enjoying it together.

Between our Portfolio Building Reports, our upcoming live chat (in which we'll cover hedging, shorting and options), our regular emails and more, we know there's a lot to take in. Take your time. Take one step at a time, focusing on the big picture and the goal we share with you: to have an outstanding portfolio built to handle turbulence and provide returns.

Meanwhile, here are some common questions and answers:

- **Do I buy the Buys?** Yes, all of our Buy First and Buy-rated stocks are buys today, at the allocation shown on the Recommendations page. Our Portfolio Building Reports will help you get up to speed with them over the course of the month, as well -- and as noted, you can average in over weeks or months if desired. If you have some options experience, you can sell puts to try to target some shares at lower prices, if you wish, and get income while you wait. (If you don't have options experience, you can follow along on the discussion board with members who do!)
- **What does "fair value" mean in *Pro*?** Fair value is a price *from which* we expect our desired rate of return, generally 10% a year or more. It's an estimate, and a growing business is always adding value, so there is leeway and flexibility to this price. Remember, fair value is a fair price estimate for a seller *or a buyer*. Fair-value estimates go up as a business grows, so we update ours often.
- **What is the "Consider Adding More" price?** This is a low price at which *Pro* will consider adding more to a position we own. Within 30 days of when the stock hits that price, we'll review the position and consider increasing (or decreasing) it. If we decide to act, we'll let you know with a trade alert in your email.
- **When are new recommendations issued?** Anytime! We email recommendation reports as soon as they're ready for you. As you know, they can be new stock buys, shorts, hedges, or options. That said ...
- **... Do I need to use shorts, hedges, and options?** You don't need to, no. Some members don't use any of these, and that's fine. But for those who want versatility in all markets, they can be great tools.
- **Can you explain your exposure table?** On the bottom right side of the Recommendations page, we show you how we're invested -- our long, short and hedged exposure. Lately, we've been 65% net long, or net invested. This lower exposure decreases our risk and should help our volatility in down markets.

We know you're here to earn strong returns with less risk in various market environments. We will work to get you there step by step this month. Beyond that, we're here to help you become a better investor for life, using and teaching simple strategies that you can always use to become stronger and more confident in your skills. (And if you just want to follow everything we do to a T, you have that option, too!) We don't have to tell you that hedges, shorts, and options are great tools -- you're here because you've shown an interest in them. We look forward to helping you use them profitably and enjoyably.

To new members, welcome to *Pro*!

To our amazing veteran members, thank you for all of your help on the discussion boards and for being part of the *Pro* community.

Forward we go, Foolishly!

-- Jeff (TMFFischer)

Earnings News From 4 Core Holdings

Published Nov 10, 2014 at 2:30PM

Dear *Pro* member,

It's been a busy earnings season for us here at *Pro* as we welcome new members (speaking of which: Welcome, new members!) and work to translate companies' reports into news Fools can use. This was my first quarter of coverage for four *Pro* companies: **Broadridge** (NYSE: BR), **Gentex** (NASDAQ: GNTX), **Parexel** (NASDAQ: PRXL), and **Papa John's** (NASDAQ: PZZA). In the same vein as Jeff's Memo two weeks ago, I thought I'd give a quick overview of each of these companies, summarizing earnings and recapping our investment thesis now that I've had a chance to dig into the numbers and monitor business progress. **All four positions remain Buys on our scorecard for new and veteran members alike.**

The Results

This leading provider of investor communications management and securities processing delivered a solid start to its fiscal 2015, posting record first-quarter recurring revenue closed sales (RRCS) of $32 million. This metric represents anticipated annual revenue for new client contracts signed during the period, and it's up from $15 million in the first quarter of 2014 and $14 million in Q1 2013.

Once Broadridge's customers are on board, high switching costs discourage them from changing providers; revenue recurs at stratospheric rates of 97% to 98%. Thus, tracking RRCS gives us insight into future revenue trends, sales momentum, and market acceptance of the company's offerings. I'm pleased to see strong growth in RRCS, and management is optimistic about continued progress, citing a "robust and growing" sales pipeline that provided an "unusually strong start" to the company's sales goals for the fiscal year. This bodes well for the coming quarters, as Q1 is typically the slowest; the company is well ahead of schedule on achieving its full-year guidance of $110 million to $150 million in RRCS.

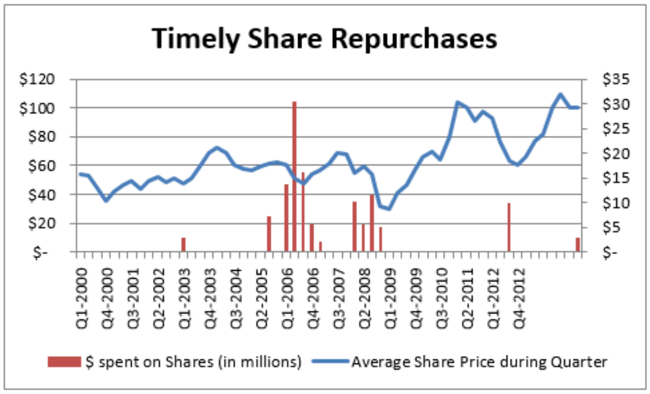
Gross margins for trailing-12-month (TTM) fee revenue were up 290 basis points to 44.2%, and operating margins rose 10 basis points to 22.4% compared with the year-ago TTM period. (Because Broadridge is a seasonal business — activity spikes in the company's fiscal fourth quarter as clients file proxy materials and annual reports — we prefer to look at TTM margins to smooth out quarterly fluctuations.) The difference between gross and operating margin trends primarily reflects higher spending on staffing and marketing as the company focuses on increasing its sales capabilities, and as we can see from RRCS trends, this investment is already paying off. I expect margins to hold steady or decline slightly in coming quarters as the company plans strategic growth investments to be executed in the second half of the fiscal year; in the meantime, I'm satisfied with this quarter's margin progress.

Broadridge continues to benefit from a trend toward increased regulatory compliance and digital communication, and management's capital allocation skills and investments in growth should lead to stronger sales performance and reinforced competitive advantages over time. Although the stock is trading slightly above our (relatively conservative) fair-value estimate of $43 per share, it should continue to be a steady, risk-adjusted outperformer. **New members should feel comfortable initiating or adding to their position at current prices.**

Our mirror maker had an excellent third quarter, with 22% year-over-year net revenue growth, 29% EPS growth, total mirror unit growth (interior and exterior) of 10%, and an improved exterior attach rate of 38%. The exterior attach rate shows how many of Gentex's interior mirror systems come with exterior mirrors "attached" as well; because exterior mirrors are both more complex and more profitable, higher is better, and this was the highest rate in more than three years. IHS forecasts suggest worldwide auto production was up only 3% in the quarter, so these figures imply healthy market-share gains, which is exactly what we want to see. Management expects sales growth of between 10% and 15% in the fourth quarter of 2014 despite the IHS forecast of a 1% decline in auto production, suggesting the trend will continue.

Gross margin was down slightly year-over-year to 39.5%, but management's guidance implies stable to improving margins for the fourth quarter. Like the improved exterior attach rate, this guidance demonstrates Gentex's continued commitment to lowering production costs and fighting automaker-imposed price reductions by continually adding features and pursuing effective research and development.

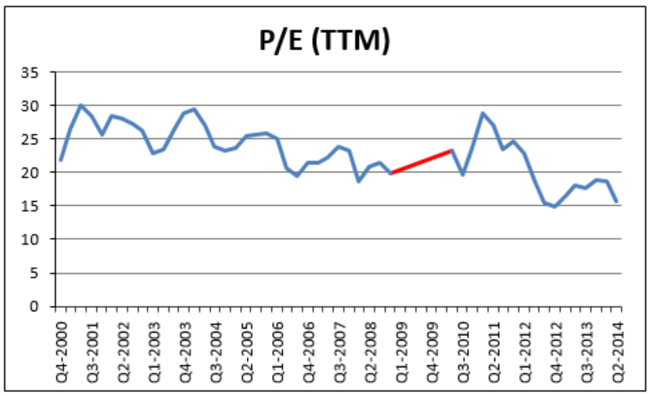
Interestingly, the company repurchased $10 million of shares in the quarter at an average price of $28.44. Gentex is incredibly selective with its share buybacks, and in past periods, such buybacks have been very well timed, showing strong capital allocation skills from management and the board:



Source: Company filings, S&P Capital IQ

This quarter's round of share buybacks was no different; shares are already trading 17% above the company's average purchase price. Such buybacks are a major signal that management felt shares were undervalued, but they also add significant shareholder value when they're executed effectively, as Gentex has been able to do throughout its history.

The buybacks, along with strong revenue, EPS, and unit growth and healthy fourth-quarter guidance, made the market happy; the stock price was up almost 9% on the day of the release. And despite approaching all-time highs, the stock is actually still pretty cheap when compared to its historical P/E range:



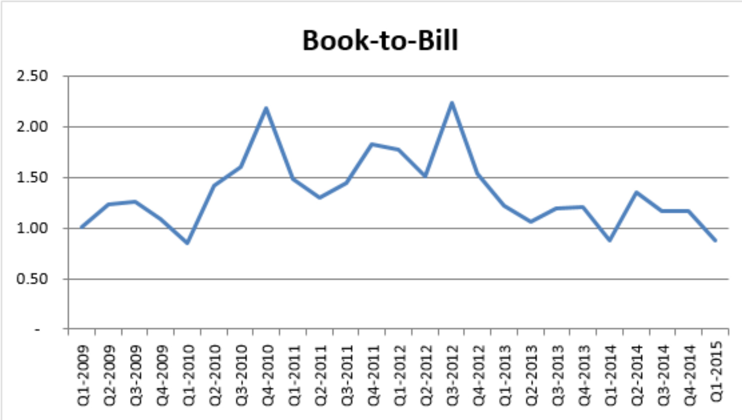
Source: Company filings, S&P Capital IQ. Red line represents omitted outlier P/Es that correspond to recession-depressed earnings.

For a strong compounder like Gentex, where business fundamentals are advancing faster than the stock price, a higher price can actually correspond to a better value. **As with Broadridge, new members can feel comfortable initiating or adding to their Gentex position at current prices.** Because of its strong business performance, I'll be revisiting my growth assumptions in the coming weeks to see if my valuation model is due for an update.

PAREXEL®

Pro's biopharmaceutical outsourcing company was the black sheep among the companies I covered this quarter. Despite a 9% increase in service revenue, improved operating margins (10.9% vs. 9.3% in the year-ago period), and 49% year-over-year EPS growth, the market hammered Parexel's stock to the tune of a 16% drop on the day of the earnings release. Analysts on the call harped on the low net book-to-bill ratio of 0.88 (a book-to-bill ratio higher than 1 generally implies strong demand and vice versa) and management comments that seemed to suggest a further slowdown. Management also lowered fiscal 2015 guidance on revenue, but increased guidance on EPS.

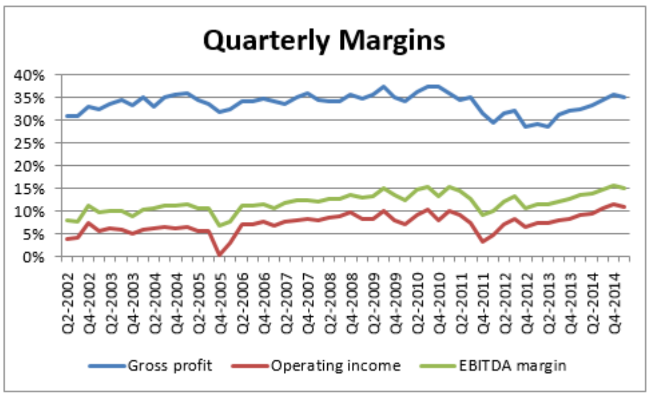
The declining book-to-bill ratio is a bit worrisome, as management noted that slower-than-expected sales to its strategic partners were the culprit. Since continued adoption of the partnership model between biopharmas and and contract research organizations (CROs) is critical to our investment thesis, we want to see this trend reverse. Management comments on the call suggest that the weakness resulted from non-recurring issues of timing. And the company's book-to-bill ratio has been volatile in the past:



Source: Company filings

... but has generally bounced back pretty quickly after dipping below 1. I'll be watching to make sure backlog and market penetration trends progress as we expect in the quarters ahead.

On the positive side, margin performance was sound despite weak revenue growth affecting sequential comparisons:



Company gross margins were up 270 basis points year-over-year to 35.2%, and gross margins expanded across all three business segments. This trend should continue, as the company expects further margin expansion, although aggressive price competition from smaller competitors and the slowing pace of converting its backlog may put a lid on improvements.

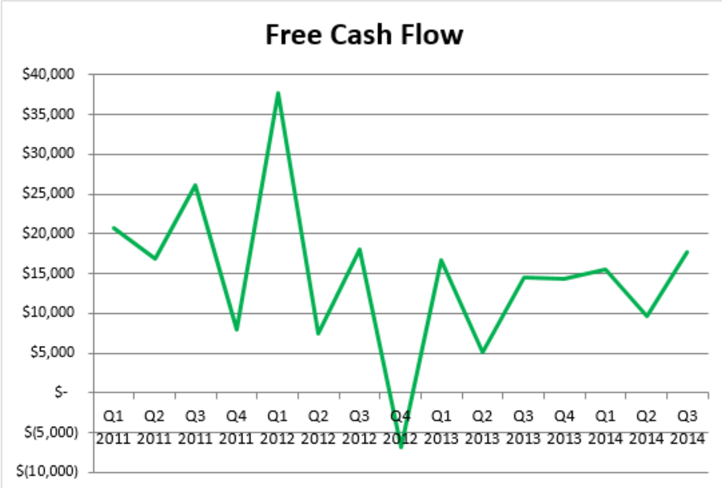
So long as this quarter's sales trends are an anomaly rather than a new normal (and I believe they are), **the current price is a reasonable entry point for new investors or those who wish to fill out their allocation.** The stock is about 5% below our fair-value estimate and should outperform so long as the company can deliver on our low-double-digit expectations for revenue growth. I'll be keeping a close eye on the competitive environment over the next few quarters to make sure our thesis is still intact.

PIZZA PAPA JOHN's

Tasty! Our international pizza slinger continues to post impressive comparable-store sales: North American restaurants increased comps by 7.4% and international restaurants did so by 5.5%. Papa John's is on track for its 11th consecutive year of positive or flat comps — incredible consistency throughout a volatile economic period. The increase in sales was driven by limited-time offers and continued migration to digital ordering (now just less than 50% of domestic sales). Since the domestic and international pizza markets are increasing at about 1.5% and 3% per year respectively, Papa John's comps suggest continued market-share gains at the expense of smaller rivals. More new restaurants (241 more than in the third quarter of 2013, up about 6% year-over-year) added more growth to the top line; total revenue was up 13%.

Elevated expenses, including higher cheese and meat prices and continued spending on implementation of the FOCUS point-of-sale system, continued to eat into operating margins. But an easy comparison to a weak year-ago period led to 17% year-over-year growth in operating profit and 13% in net income as debt-fueled share buybacks boosted EPS. Papa John's continues to carry out its strategy well (as evidenced by the systemwide comp sales), and recent investments are starting to pay off as comps accelerate; free cash flow was up 22% year over year. When commodity costs and investment spending normalize (the FOCUS rollout should be completed by Q1 2015), I expect margins to improve.

The company's focus on supporting franchisees and investing in growth has led to lumpy business results:



Source: Company filings ($in thousands). Cash from ops minus purchase of PP&E net of acquisitions/divestitures.

It's also meant some stock-price volatility; the stock reached a high of $55 in March, then retreated to a low around $37 in September before recovering to its current price around $50. Because much of Papa John's value lies in its hard-to-predict international growth opportunities, the market isn't sure what it wants to pay for the company's future earnings stream. However, if Papa continues to perform as it has in recent quarters, paying up for that growth may be justified. Its price is almost 10% higher than our reasonable fair-value estimate of $46, making me a bit more cautious with Papa John's than with the other companies in this recap. But a few more quarters of strong comps and improved margins may prove my estimates to be too conservative. **Papa John's is a Buy at current prices, but of all the stocks on this list, it might be the last one I'd add to.**

The *Pro* Bottom Line

Each of these four companies remains a Buy on our scorecard, with no changes to our recently updated fair-value estimates. Performance ranged from excellent (Gentex) to steady (Broadridge) to volatile (Papa John's) to disappointing (Parexel). Despite the market gyrations, we maintain our long-term view and believe that each company will deliver North Star-beating returns (lately around 8% to 9% annualized) over the next rolling three-year period.

If you have any questions about this Memo, feel free to stop by the appropriate company's discussion boards:

- Broadridge
- Gentex
- Parexel
- Papa John's

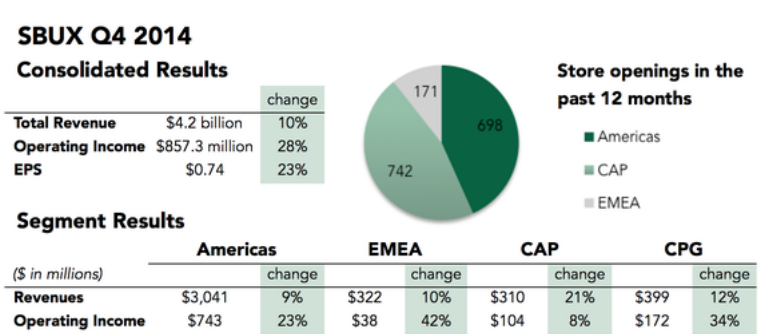
Fool on!


— Billy (TMFTailwind)

Sit Down, Relax, Have a Cup of Starbucks

Published Nov 7, 2014 at 7:47PM

One week ago, **Starbucks** (NASDAQ: SBUX) reported results that missed analyst expectations and sent the stock lower by almost 3%. This will probably come as a surprise if you're just tuning in since the stock has already recovered all of its post-earnings losses (and then some). This delayed reaction fits better with our assessment of the quarterly results -- that they highlight the strength of the Starbucks brand in the face of a less-than-ideal retail environment and what CEO Howard Schultz refers to as a "cultural shift in consumer behavior" away from brick-and-mortar shopping.


SBUX Q4 2014

Consolidated Results

		change
Total Revenue	$4.2 billion	10%
Operating Income	$857.3 million	28%
EPS	$0.74	23%

Segment Results

($ in millions)	Americas	change	EMEA	change	CAP	change	CPG	change
Revenues	$3,041	9%	$322	10%	$310	21%	$399	12%
Operating Income	$743	23%	$38	42%	$104	8%	$172	34%

Updated Guidance and Valuation

Updated guidance: Buy (no change)

Recommended Allocation: 2.8%

Fair Value estimate: $79 (up from $76)

CAM price: $64 (up from $61)

	Current Multiples	
	trailing	forward
P/S	3.5x	3x
P/E	29x	25x
P/FCF	28x	
EV/EBITDA	15.3x	

Investment Thesis

Starbucks offers a unique blend of sales drivers (domestic and international growth, food and beverage innovation, channel development, just to name a few) and cost reduction opportunities (payment innovation, European restructuring, consumer product margin expansion). We believe the coffee is just a gateway for the company to repeatedly sell customers an experience rooted in comfort, quality, health, community, and conscience. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand into new products, new platforms, new dayparts and new brands. We expect new store openings across the globe to strengthen the company's brand and cost-based competitive advantages and improve profitability over time.

Taking control of the remaining stores in Japan will result in near-term margin pressure, but the we believe that the long-term impact of this move is a positive one. Morning traffic still accounts for over 45% of total traffic, but the company is seeing strong growth in other segments of the day and recent investments have already begun bearing fruit. Don't let the fact that this is a coffee company fool you; Starbucks is one of the most innovative companies around and poised to serve up North Star-like returns going forward.

Segment Results

Comps	**Q4 2014**			**Fiscal 2014**		
	Sales Growth	Change in transactions	Change in ticket	Sales Growth	Change in transactions	Change in ticket
Consolidated	5%	1%	4%	6%	3%	3%
Americas	5%	1%	4%	6%	2%	3%
CAP	5%	2%	2%	5%	3%	2%
EMEA	5%	6%	-1%	7%	6%	0%

Q4 marked the 19th consecutive quarter Starbucks achieved comparable (comp) store sales growth of at least 5%. Comp growth slowed from both an annual and quarterly perspective, but these results were admirable considering they were on the back of strong 2013 results. Some analysts may have not been thrilled with the numbers, but as CEO Howard Shultz put it:

When I look at the results, and this is not on the script, when I look at the results of this year, the stunning accomplishments on so many levels, I hear somebody be disappointed with a 5% comp on a base of over 7,500 stores, I just got to ask myself, "Is there any company in your universe putting up these kinds of numbers?" And the answer is no.

Americas

Some may like to joke that there's a Starbucks on every street corner, but the question of when the company will saturate the U.S. market is serious business for shareholders. The Americas segment is by far the biggest in terms of revenue (73%) and profitability (71% of operating income), and Q4 results reaffirmed our belief that the company hasn't reached the end of the runway just yet.

New stores continue to drive incremental traffic and set record levels for new store performance, suggesting untapped demand. Ticket growth in Q4 was the strongest it's been over the past few years. Only one percentage point of this growth came from increasing prices, suggesting that product mix and new offerings are resonating with customers. A great example of this was the addition of Teavana Shaken Iced Teas, which were the single most profitable addition to Starbucks menu last year. Performance at company owned drive-thru stores continued to be robust, as this segment accounted for 55% of profit in the Americas even though it only makes up 42% of the store portfolio.

Europe, Middle East, and Africa (EMEA)

The smallest geographic segment for the company (8% of sales), EMEA results suggest the measures taken by management to improve lackluster performance continue to take hold. Licensed store comps came in above the 5% reported by the company-owned stores as results from the UK and Germany, markets where others have struggled, were encouraging. This segment also benefited from favorable foreign currency exchange in Q4.

China Asia Pacific (CAP)

Total net revenue was up 21% in Q4, marking the 17th consecutive quarter it exceeded 20%. Transaction growth continued to be strong, but ticket size actually contracted one percentage point as fewer seasonal items were sold. The company opened an average of one new store per day in China, and management only expects this pace to quicken as time goes on.

It's important to note that the company will be taking ownership of the remainder of their Japanese joint venture stores next year. The difference in accounting treatment will result in the appearance of margin pressure, but Japanese Starbucks stores actually have some of the highest operating margins in the company's international portfolio. Management claims that this conversion of the remaining 1,000-plus stores will enable them to increase the pace of new store openings and provide the company with many new opportunities. The ready-to-drink (RTD) market is a perfect example of this. Japan has one of the largest and most penetrated RTD markets in the world, but Starbucks' current share in that market is a fraction of what it is in the U.S.

Consumer Product Goods (CPG)

Revenue growth came in at 12% but operating income grew 34% as the company saw a more favorable sales mix and benefited from various cost cutting measures. In particular, K-Cup sales grew 26% as the company shipped 750 million K-Cups in fiscal 2015. And 1.5 million of the 8 million My Starbucks Rewards (MSR) members earned Stars through the grocery channel.

Plans for the Holiday Quarter

Management has every intention of continuing the momentum from last holiday quarter. "Meet Me At Starbucks," the company's first global television advertising campaign, launched last month. With pumpkin spice lattes becoming ubiquitous, Starbucks will attempt to differentiate itself once again by offering a Chestnut Praline Latte. Roughly 1 in 8 Americans received a Starbucks gift card during the 2013 holiday quarter, and the cumulative amount loaded on those cards was an impressive $1.4 billion. This year Starbucks will up their game even further by offering 100 unique designs and greet customers with freestanding card walls in stores. But the biggest draw is likely to be their "Starbucks for Life" giveaway. Every customer who uses a gift card or their MSR account this holiday season has a chance to win one of almost 500,000 food and beverage prizes, and 13 lucky cardholders here in the U.S. will win Starbucks for the rest of their life.

Plans for 2015 and Beyond

Starbucks will continue to expand its super-premium coffee offerings with its sub-brand, Starbucks Reserve. The company is currently targeting 100+ Reserve stores around the world as well as several Starbucks Roasteries. In addition to being storefronts, these roasteries will enable the company to double the number of regular stores that offer Starbucks Reserve coffees by the end of fiscal 2015.

Looking to further cement its position as a leader in mobile payment, the company will be rolling out mobile order and pay next year. This not only has the potential to increase customer satisfaction by reducing or eliminating wait times, but it will also increase store profitability. Regarding the importance of mobile, Schultz noted that:

In 2013, payment for purchases by use of all mobile devices in the U.S. totaled $1.3 billion. That was the entire market. Now listen to this. With over 90% of those purchases taking place in a Starbucks store, that means we had 90% share of mobile payments in 2013, while bricks-and-mortar commerce in 2013 totaled more than $4.2 trillion... Already close to 7 million transactions per week, 16% of all transactions conducted in U.S. Starbucks stores occurs via a customer's use of a mobile device. No company and no retail store domestically or internationally even comes close. And while that figure has been growing by almost 50% per year, the real growth is yet to come.

In a move that caught most off guard, Schultz also revealed what he referred to as "e-commerce on steroids." Starting in the second half of 2015, Starbucks will begin offering food and beverage delivery in select markets.

2015 Estimates

Revenue – Forecasting for growth of 16% to 18%, $1 billion of which will come from the Japan acquisition. Ex-Japan the company should still be able to hit its 10%+ per year target.

Margins – Flat to slightly lower due to the Starbucks Japan acquisition.

EPS – $3.42 to $3.54 on a GAAP basis. Similar to revenue, if you exclude the impact of the change in accounting for Japan, the company is guiding toward the middle of its long-term goal of 15% – 20% growth.

Stability and Focus at AIG

Published Nov 5, 2014 at 6:15PM

What?

($in millions)	**Q3 2014**	**Q3 2013**	**Change Y-o-Y**
Total Revenue	16,654	14,826	12.3%
After-tax Operating Income	1,745	1,421	22.8%
Net Income	2,192	2,170	1%
EPS	$1.52	$1.46	4.1%
Book Value Per Share	$77.35	$67.10	15.3%
P&C:			
Pre-tax Op. Income	1,096	1,126	-2.7%
Accident Year Combined Ratio	95.6	98.0	
Accident Year Loss Ratio	61.3	63.7	
Expense Ratio	34.3	34.3	
Life & Retirement:			
Pre-tax Op. Income	1,348	1,144	17.8%
Mortgage Guaranty:			
Pre-tax Op. Income	135	43	214%

CEO Peter Hancock:

> "The solid third quarter results were driven by consistent performance across our businesses.While no one quarter is a trend, our risk-adjusted return focus could be seen in various metrics including improved accident year loss ratios, modest net spread compression, and continued capital management. In the quarter and through early October, we repurchased $1.5 billion of AIG Common Stock and completed over $4.0 billion in liability management, excluding DIB activities. As a result of our strong capital position and a positive outlook for our businesses, the Board has authorized additional share repurchases of $1.5 billion."

So What?

After looking over the financials, I don't feel much different than I did when I glanced at the headline numbers right after earnings were released (here). This was another solid quarter from **AIG** (NYSE: AIG), with continued signs of operational improvement that provide evidence that the company is more stable and focused than it's been in a long time.

With the CEO transition from Bob Benmosche to Peter Hancock now in the rear view mirror, the investment community wanted to see what Hancock was able to deliver in his first full quarter as CEO, and he didn't disappoint. Hancock has been very clear on how he plans to manage AIG with his "value over volume" approach, and here are some quotes from this quarter's conference call that provide more insight into his management style:

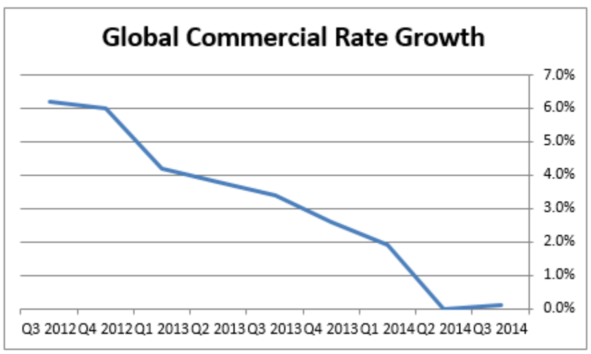
> "*We're looking to improve operating efficiency and decision making by eliminating layers in the organization*."
>
> "*You've heard me discuss science and technology to drive problem-solving and to reduce claims costs. Science is already paying dividends to us and is working across our businesses to provide critical insights and further data segmentation. Our one claim technology provides more enriched and consistent data to science, actuarial and others to drive better decision-making*."
>
> "*...going forward, you can expect a broader implementation of value-based metrics at AIG*."
>
> "*A framework of assessing the economic value of all our products won't result in dramatic changes to our business mix, but is an important discipline for us to continue -- to continually access the highest return on our capital, taking into account risk and sustainable growth*."

Hancock continues to impress me with his temperament and focus, and I am hopeful that his imprint on the company will lead to further improvement in financial metrics.

One of the most important metrics we watch for AIG is the Property and Casualty (P&C) Segment combined ratio. Pro members following AIG should know by now that a combined ratio consists of the expense ratio (overhead as a percent of premiums) and the loss ratio (claims paid as a percent of premiums). A combined ratio below 100% means that the company is earning an underwriting profit.

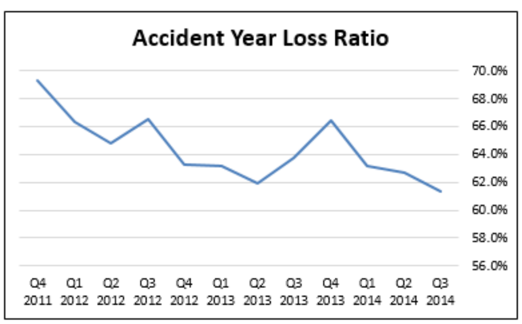
The accident year combined ratio (which is adjusted for catastrophes and prior year developments) came in at 95.6%, which is the lowest its been since I've been covering the company. This is an encouraging result given that the company continues to make investments in technology that are elevating the expense ratio, and that global commercial insurance rates were again flat compared to the year-ago period (rate increases make insurance companies more profitable, all else equal).

Last quarter, I noted that the rate of pricing increases has been decelerating, which hurts year-over-year combined ratio comparisons. It's harder to generate improved underwriting margins when you can't increase prices as much as you could in the quarter you're comparing to. This quarter it appears that the pricing trend has moderated, a good sign, and hopefully rates will act as a contributor rather than a detractor from results in the quarters ahead.



Source: AIG Earnings Presentations

The accident year loss ratio also continued its trend of improvement, which is encouraging and shows that the recent investments in technology and the focus on risk-adjusted profitability are paying off. It bears repeating that improvements here will be lumpy (as you can see in the graph), but the long-term trend is encouraging:



Source: Company filings

The rest of the business outside of the P&C segment performed well too, with the Life and Retirement segment posting an 18% increase in pre-tax income (driven by a 15% increase in policy fees) and the small Mortgage Guaranty segment (~5% of AIG's pre-tax operating income) growing its own pre-tax income by an impressive 214%.

Book value grew 15.3% year-over-year to $77.35 per share, after-tax operating income grew 23%, ROE came in at an acceptable 8.1% (and 9% ex-AOCI), and value-accretive share buybacks continued ($1.5 billion of shares repurchased in the quarter, retiring 1.5% of shares outstanding).

Our investment thesis remains intact and is summarized as follows: we believe that underwriting profitability will improve and that AIG should be able to earn an ROE of 10% over the long run.

Now What?

- P/B: 0.70
- ROE: 8.1%

- Market Cap: $77.6 billion
- Fair Value: $64
- Consider Adding More: $48
- Allocation: 3.7% in stock and about 0.7% in warrants or LEAPS
- Status: Buy

This quarter's results weren't enough to change our recently updated Fair Value estimate of $64 and Consider Adding More (CAM) price of $48. Shares are a Buy with an allocation of 3.6% in stock and 0.6% or so in warrants or LEAPS.

Fool on!

--Billy (TMFTailwind)

If you have any questions, file your claim on the AIG discussion board.

Barbarians at the Gate

Published Nov 3, 2014 at 3:41PM

Pro Guidance Changes

- **Facebook**'s (NASDAQ: FB): fair value moves up to $67. Shares remain a Buy, with a 4.8% allocation.
- **Gilead Sciences** (NASDAQ: GILD) moves to Buy from Buy First after appreciating 40% for us as of Friday, up to our fair-value estimate of $110. We have a 4.5% allocation.
- **O'Reilly Automotive** (NASDAQ: ORLY) moves to Hold pending a strategy review. The stock is up 77% for us since our 2013 recommendation, and is about 15% above our fair value. Fair value increases $9 to $149. Consider Adding More increases $9 to $119. We have a 4% allocation.
- **Valmont Industries**' (NYSE: VMI) fair value moves down to $160 from $170 as results lag estimates. It remains a Buy at a 2.4% allocation.

Fellow Fools,

"Your activities are mean, shameful and loathsome. They are motivated by appalling avarice and greed, and they will not be permitted to go unanswered."

This quote is from 1998, but I suspect a sizable percentage of the investing public still holds a similar attitude toward short sellers. The author of this gem was a large money manager who was upset with the actions of one Manuel Asensio — a short seller who was one of the first to use the Internet as part of his strategy. Mr. Asensio's position on a company called Avant!'s wasn't very popular, but it was correct. From the date of his initial sell report until Avant!'s was acquired, the company's stock price fell 87%, and management ultimately pleaded no contest to charges of conspiring to steal software.

Short selling is not for everyone. Those without the right skill set and temperament often find the time they spend as short sellers to be rather painful and (*ahem*) short. Since most who aren't cut out for this practice tend to exit in short order, many consider short sellers to be part of the "smart money" crowd. And you know what Wall Street says about smart money: We retail investors should never, ever go against it. Academic research actually tends to support that idea in this case, as portfolios of stocks with high short interest ratios (SIRs) tend to underperform by a statistically significant amount.

Fashionably Late

I like to think of shorting as a game of identifying catalysts. Just like buying stock in a great company can be a poor decision if you pay too much, your ability to profitably short depends on when you act. In fact, I believe timing is even more important when it comes to shorting, because in addition to fighting the natural upward pull of the market, you're paying a fee to borrow shares. That means there's a monetary cost, not just an opportunity cost, associated with waiting for your thesis to play out. But successful shorting doesn't require you to become a market timer in the sense of darting in and out of stocks. Rather, you simply need to be willing to sit on your keister until the stars align in such a way that the risk/reward trade-off skews heavily toward the latter.

This is why I take into consideration the volume and quality of the negative chatter around a stock when hunting for short candidates. I have no interest in being first to the party; I prefer gains over glory. What can go wrong when you're early, you ask? The first foray into short selling by Jim Chanos, perhaps the best-known short seller of our time, is a textbook example. Chanos' first short recommendation was on Baldwin-United Corp., a company that ultimately ended up declaring bankruptcy — but his timing was, as he is fond of saying, nothing short of impeccable. The stock fell a couple of points on the day his recommendation came out. It then proceeded to almost triple.

Just Another Piece of the Puzzle

It is important to remember that a high SIR and a lot of negative chatter may signify a great short opportunity, but they don't guarantee underperformance, so they should not be considered in isolation. While we may know the *number* of shares sold short, we don't know the reason. Perhaps the seller wanted to hedge some type of exposure or engage in arbitrage, neither of which provides any information on expectations regarding the stock itself. In addition, those academic studies I cited above were looking at baskets of stocks. Within those baskets, there were stocks that went to zero, some that underperformed, some that outperformed, and some that absolutely crushed the market.

Take a look at the following chart:

What we have here is a volatile stock (white line with blue fill) that the bears loved to hate, as evidenced by the steadily growing short interest (orange line). The doubters came out of the woodwork as soon as the company IPOed in 2010, and by March of 2013 (the end of the above chart), 32.3 million shares were sold short — a whopping 45% of the company's equity float. So what happened afterward? The arrow on the chart below indicates where the prior chart left off.

For those who couldn't tell, the company in question is **Tesla** (NASDAQ: TSLA). The final chapter for this company has yet to be written, but this "slam dunk" of a short has been anything but. Turns out that "follow the smart money" is just like the other Wall Street maxims in that it's intuitively appealing and works ... unless it doesn't. Never be afraid to think for yourself — sometimes the smart money just isn't that smart.

Foolishly yours,

— JP (TMFYossarian)

Valmont Waits for Better Days

Published Nov 3, 2014 at 11:47AM

Third-quarter results at **Valmont Industries** (NYSE: VMI) were lower than hoped due to continued weakness in the Utility Structures business. CEO Mogens Bay said, "Most of our businesses had a good or decent quarter, the exception being our Utility Structures business, which had a very difficult third quarter." However, significantly higher revenues and operating income should return to Utilities in the current quarter, based on backlog already booked.

- Shares remain a Buy
- 2.5% allocation in *Pro*
- Fair Value Estimate falls to $160 from $170 as results lag estimates

Surprises: The weak utility business has been the big surprise this year. More competitors moved in and pricing has suffered. As shared last quarter, management does not expect operating margins to return to previously high levels in this division, but should return to respectable levels above 10%. Elsewhere, commodity prices have fallen, and crop supplies are up, are both are a drag on the irrigation business. Irrigation had a good quarter, but it sales will decline year-over-year this quarter as farmers put off new purchases. Lower commodity prices also slow Valmont's coatings business in Australia.

Fool's Take: We know this is a cyclical business entering a slower period, which is why the stock was cheap. We should face limited pricing risk as Valmont works through this period, and we should see nice upside when the cycle turns the other way, even if it takes time. As Mogens said, "Every peak of the cycle exceeded the previous one, and every bottom of the cycle was higher than the previous one." He was speaking of irrigation equipment cycles, but might as well be speaking about the entire business. We like owning some stocks that are not rising with the market (counter-intuitive as that seems) because they're more likely to be in favor (as defensive cyclicals that turn up first) when other stocks are not doing as well. We keep Valmont as an exceptionally run, long-term buy.

For financial and conference call details, please see our post.

Way to Go, O'Reilly

Published Nov 3, 2014 at 11:39AM

O'Reilly Automotive (NASDAQ: ORLY) reported another strong quarter, topping expectations and increasing margins, sending shares to a new high. Management remains "very confident" in its long-term growth prospects as cars stay on the road longer (leading to more repairs) and more miles are driven. The company plans to open 205 stores in 2015, on par with 2014. *Pro's* fair value estimate increases to $149, but that's still 15% below the current share price. Our guidance on the stock is under review for 30 days, so it moves to "Hold" for now. Owners need to realize the stock *could* have a flat year or two, all told, given the "bull market" valuation it enjoys.

- Shares move to **Hold** for a 30-day review
- Fair Value increases to $149
- Consider Adding More increases to $119

Surprises: Same-store sales (SSS) grew 6.2% -- more than the top of management's 5% guidance. This was on top of 4.6% growth a year ago, leading to a great "two-year stack" of 10.8%. Costly car repairs continued to help O' Reilly, presumably from damage that began with the harsh 2014 winter. That should subside soon. The company increased its 2014 same-store sales guidance to a range of 5%-6% (up from 3%-5.5%); increased its 2014 EPS guidance to $7.19-$7.23 (up from $7-$7.10). And increased its free cash flow guidance to a range of $675-$725 million (up from $625-%$675M).

Fool's Take: Wall Street likes increased guidance. The stock is up 17% since results, and 77% since our April 2013 purchase. The company has raised the bar still higher, though, and growth comparisons will be tougher in 2015, especially if this winter is mild. The upshot is the results are great, but we're cautious on the valuation after a big 18 month run, so it moves to Hold for a review.

For more numbers and conference call details, please see our board post.

Facebook Banks on the Future

Published Nov 3, 2014 at 11:29AM

Facebook (NASDAQ: FB) reported strong third-quarter results, with revenue up 59%, ad revenue up 64%, and operating costs only up 41%. The company's 3-year plan remains to grow value for users and businesses (it's investing heavily in new ad platforms to do so); the 5-year plan includes monetizing platforms like Messenger, WhatsApp and Instagram. The 10-year plan includes Internet.org initiatives to connect the world.

The stock remains a long-term Buy in *Pro* with a 4.8% allocation. Our fair value estimate moves up to $67.

Surprises: The long-term story has not changed as Facebook works to grow and monetize its world-leading traffic (which keeps growing). But management guided expenses considerably higher in 2015 as the company invests to grow. Much of the cost is in hiring new employees and stock grants related to acquisitions. GAAP expenses including stock compensation should now grow 45% to 50% in 2014 (up from prior guidance), and a big 55% to 75% in 2015. That may dwarf revenue growth, bringing margins considerably lower. But this reminds us of **Google's** (NASDAQ: GOOGL) big investing years early on. That spending looked excessive, too, but the business grew into it. I believe Facebook will, too, and if Wall Street sees that starting to occur, the spending will be accepted.

Fool's Take: The coming year is one of heavy investment at Facebook. This is likely a smart long-term move, but will dampen bottom line and free cash flow results in 2015. Knowing Google as I have, I assumed this would start to happen, so our fair value estimate has reflected a few years of heavy investment. We'll need time to see how the investments pan out, though. We go forward banking on management's abilities. We also know Facebook has major properties and traffic it has not even tried to monetize yet. Upside in those properties should off-set some of the increased spending as soon as later next year.

For more numbers and conference call notes, please click to our board.

American Tower Stands Tall in Q3

Published Oct 31, 2014 at 2:43PM

What Happened?

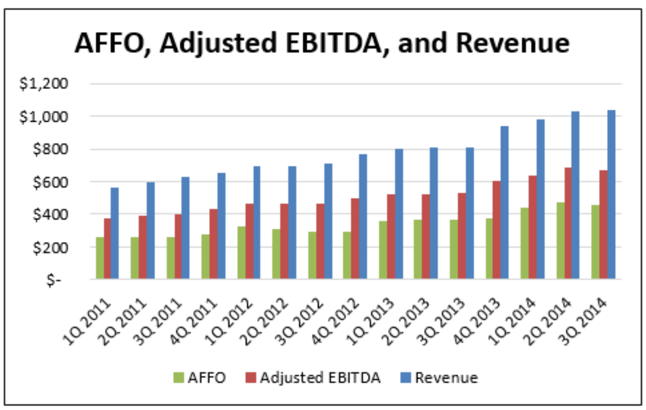
- Total rental and management (R&M) revenue of $1.01 billion (year-over-year core* growth of 31%)
  - Domestic R&M segment revenue of $664 million (Y-o-Y core growth of 28%)
    - Organic** core growth of 9.1%
  - International R&M segment revenue of $348 million (Y-o-Y core growth of 37%)
    - Organic core growth of 18%
- Adjusted EBITDA of $666 million (Y-o-Y core growth of 32%)
- Adjusted funds from operations (AFFO) of $460 million (Y-o-Y core growth of 28%)

*Core growth reflects adjustments for foreign currency exchange rates and prior period one-time items

**Organic growth excludes revenue associated with new properties (acquisitions and new site builds) that have been added to the portfolio within the previous year

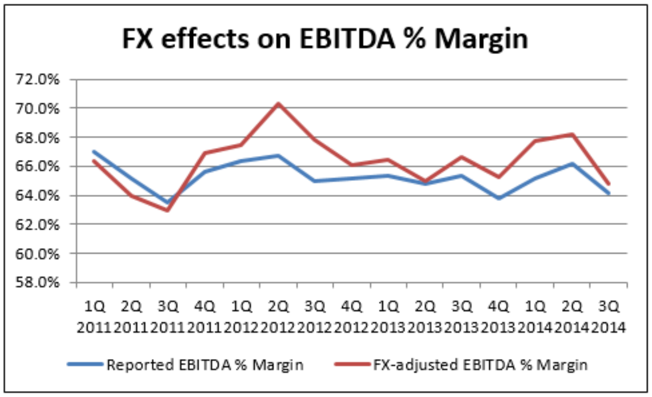
So What?

American Tower (NYSE: AMT) reported yet another strong quarter, prompting management to yet again raise full-year 2014 guidance, even after raising it the past two quarters. The company reported very healthy core growth in revenue (31%), Adjusted EBITDA (32%), and AFFO (28%), the three headline metrics I watch closely. The company's performance on these three metrics has been been admirable, with compound annual growth rates of 19% (in revenue), 18% (in Adjusted EBITDA), and 18% (in AFFO) over the last 3.5 years:



Source: Company filings ($in millions)

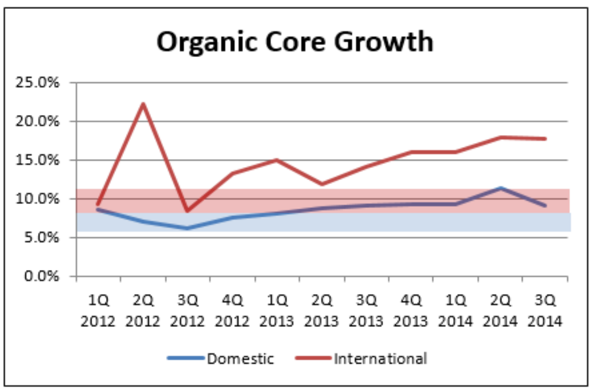
Although ideally I'd like to see growth in Adjusted EBITDA and AFFO outpacing revenue growth (meaning that margins would be expanding), there are a few reasons why we aren't seeing that happening. For one, margins this quarter were affected by more normalized SG&A expenses, after last quarter where SG&A expense as a percent of revenue was the lowest its been since I started covering the company. Additionally, margins are affected by significant acquisitions, since there are one-time integration costs and new assets often have margin profiles that are initially lower than the company's existing portfolio. And finally, because of the company's significant international presence (34% of revenue comes from international operations), the company has faced negative currency effects in every quarter since 4Q 2011, impacting reported margins. In some quarters, the effects have been enough to impact margins by more than 5%. Here's what Adjusted EBITDA looks like when adjusted for negative currency effects:



Source: Company filings and analyst calculations

It's important to understand that these FX (foreign exchange) effects are *unrealized*. This means that until the company converts their international cash flow into dollars, the unrealized currency effects aren't significantly harmful. A currency swing in the other direction will very quickly boost reported results. Additionally, negative international currency swings relative to the US dollar can actually be beneficial to the company, since they can use their now-more-valuable US dollars to build and acquire more assets in international markets, increasing their US-denominated return on investment. Management has demonstrated that they are very capable when it comes to capital allocation across geographies; investing where it makes the most sense depending on currencies, political/economic environments, wireless market dynamics, and strategy.

Organic growth (growth excluding properties that have been in the portfolio for less than a year) took a bit of a breather after an outstanding performance last quarter, coming in at 9.1% domestically (vs. 11.4% last quarter vs. 9% a year ago) and 17.7% internationally (vs. 17.9% last quarter vs. 14% a year ago). Even though organic growth ticked down a bit quarter-over-quarter, the results were still very strong relative to management's long-term expectations (6-8% domestically, and 8-11% internationally) and to competitors (AMT's biggest competitor Crown Castle (NYSE: CCI) yesterday reported 7.5% domestic organic growth). Here's what core growth looks like since Q1 2012 (shaded areas represent management guidance):



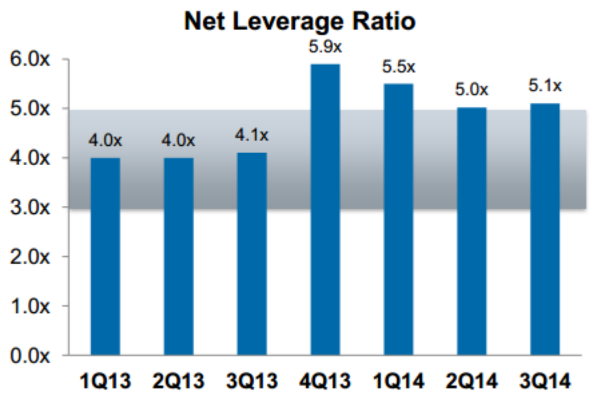
Source: Company filings

As you can see, domestic organic growth has been outpacing management's targets for several quarters, and international growth is absolutely blowing it out of the water. So long as organic growth remains above the midpoint of management's guidance, I'll be happy.

There's a lot of momentum in American Tower's markets, and CEO Jim Taiclet's comments bode well for the prospect of continued strong organic growth:

> "Our combined domestic and diversified international portfolio delivered nearly 12% Organic Core Growth in the third quarter. Consumer adoption of increasingly advanced mobile devices and services, which ultimately drives our organic growth, continues unabated in both the U.S. and in our other served markets.
>
> In our latest analysis of the individual factors that correlate to American Tower's U.S. organic growth rates, the increase in the amount of total mobile data traffic emerged as the number one driver. This, coupled with forecasts that U.S. mobile data usage is expected to double every two years through at least 2018, gives us confidence in the strength of our long-term domestic growth trajectory. Moreover, since nearly all of our international assets are in markets that are three to ten years behind the U.S. in the deployment of mobile broadband services, we continue to believe that these markets will further enhance and lengthen our overall long-term growth trajectory."

As far as leverage is concerned, the leverage ratio (net debt/EBITDA) ticked up a bit to 5.1x. The company is just above its long-term target leverage range (3 times to 5 times):



Source: American Tower Q3 Earnings Presentation

Management expects to get the leverage ratio below 5x by 2015, but if the company sees an acquisition opportunity it likes, I wouldn't be surprised to see them take advantage of their flexibility and change course to pursue it. The company has plenty of liquidity ($3.4 billion in cash and borrowing capacity under its revolvers) to pursue opportunities so long as they are, as CFO Thomas Bartlett said on the conference call, "strategic and make sense for us".

Because of the focus on paying down debt and delevering into the target range, the company's acquisition spending has decreased relative to past years (about $1.5 billion year-to-date vs. $4.5 billion in fiscal 2013). It looks increasingly likely that the company might open up its pocketbooks in 2015 and make another significant acquisition.

Now What?

The market liked American Tower's earnings report, with the closing stock price up 4% compared to the day before the report. I also viewed the earnings report favorably, with continued strong organic growth rates and business momentum across the company's markets.

This quarter's report yet again provides confirming evidence that our investment thesis (that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time) continues to play out.

Data and Guidance

- Current Price: $97.67
- Fair Value estimate: $110
- Consider Adding More: $78
- Market Cap: $39.3 billion
- EV/EBITDA (TTM): 20.4

American Tower remains a Buy First, with no change to our recently updated Fair Value estimate of $110 and Consider Adding More price of $78. Those who have yet to initiate or fill out their position in this fast-growing company can feel comfortable doing so with the stock currently at about a 12% discount to our relatively conservative Fair Value estimate.

Fool on!

--Billy (TMFTailwind)

Please post any questions on the American Tower discussion board.

TD Ameritrade Finishes Strong

Published Oct 30, 2014 at 1:16PM

First off, if you haven't yet, read my primer on **TD Ameritrade**'s (NYSE: AMTD) business here. It's a long read, but it provides a background on the business model and an explanation of a lot of the terminology in this write-up. If you just want a quick summary of the quarter and fiscal year, you can safely skip to the end of this write-up.

What Happened?

- Net Revenues of $795 million (up 12% year-over-year)
  - Transaction-based:
    - Funded accounts grew to 6.3 million (up 5.1% Y-o-Y)
    - Trades per funded account of 4.06 (vs. 4.05 last quarter vs. 4.05 a year ago)
    - Average commissions and fees per trade of $12.97 (vs. $12.55 last quarter vs. $12.61 a year ago)
    - Totals up to:
      - 6,300,000 x 4.06 x $12.97 = $332 million in transaction-based revenue (up 8.5% Y-o-Y)
  - Spread-based:
    - Total spread-based revenue of $367 million (up 15% Y-o-Y)
    - Average spread-based balance of $92.9 billion (up 4.6% Y-o-Y)
    - Thus, Net Interest Margin (NIM) =
      - $367 million / $92.9 billion = 0.395% (quarterly)
      - NIM (annualized) = 0.395% x 4 = 1.58% (vs. 1.54% last quarter vs. 1.44% a year ago)
  - Fee-based:
    - Fee-based revenue of $83 million (up 24% Y-o-Y)
    - Record average fee-based balance of $144 billion (up 18% Y-o-Y)
    - Thus, Investment Product Fee Yield =
      - $83 million / $144 billion = 0.058% (quarterly)

    - Investment Product Fee Yield (annualized) = 0.058% x 4 = 0.231% (vs. 0.228% last quarter vs. 0.219% a year ago)
- Record total client assets of $653.1 billion (up 18% Y-o-Y)
- Net new assets* of $13.4 billion (8.2% annualized growth rate, up 32% Y-o-Y)
- EPS of $0.38 per share (up 6.3% Y-o-Y)
- Trailing twelve months (TTM) average return on equity (ROE) of 17% (up from 14.6% a year ago)
- Capital management:
    - Paid $0.98 per share in cash dividends in 2014 (a 3% yield on the current share price), which included four quarterly dividends of $0.12 per share, and a special dividend of $0.50 per share, paid in December 2013
    - Repurchased approximately 6 million shares of its common stock at a weighted average share price of $31.37 per share
    - Declared a $0.15 per share quarterly cash dividend (up 25% Y-o-Y), payable on Nov. 20, 2014 to all holders of record of common stock as of Nov. 6, 2014.

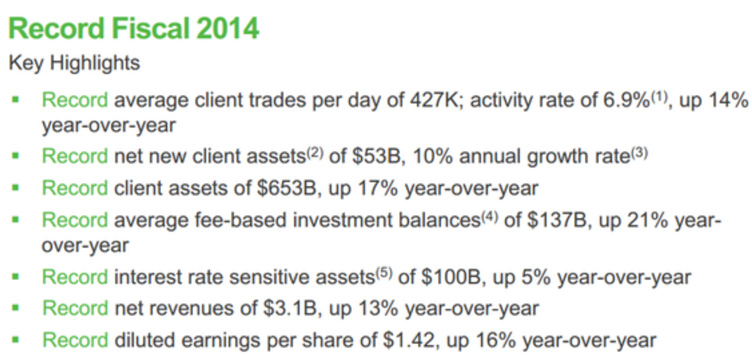
*excludes changes in client assets due to market fluctuations

President and CEO Fred Tomczyk:

> "With improved investor sentiment, retail investors returned to the markets in 2014, increasing engagement across our platforms and boosting trading volumes. Asset gathering remained strong, as we gathered a record $53 billion of net new client assets, our sixth consecutive year of double-digit growth. In fact, over the last five years, we have gathered a total of $219 billion of net new client assets, one-third of our total client assets. We had a strong year and have good momentum as we start 2015. We will continue to adapt and evolve as an organization by optimizing newer technologies like big data, social media and mobile, in order to enhance our clients' investing and trading experience and drive continued strong organic growth."

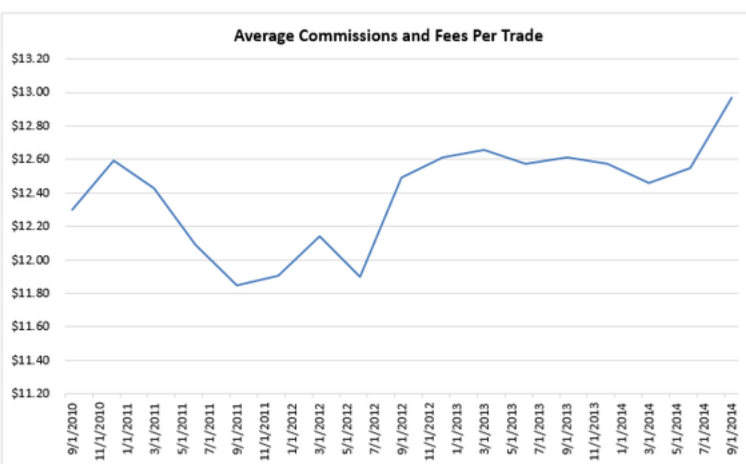
So What?

TD Ameritrade finished out Fiscal 2014 on a strong note, with record performance across several areas of the business:



Source: TD Ameritrade September Quarter 2014 Earnings Presentation

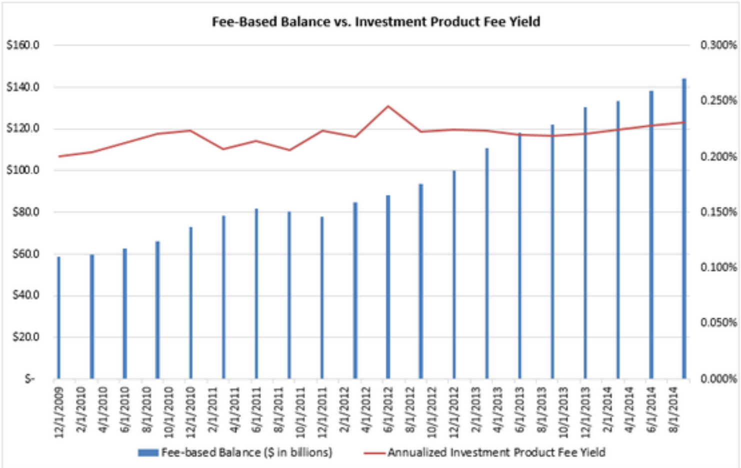
The company continues to excel at gathering client assets, with 17% Y-o-Y growth vs. the prior fiscal year, and 6 consecutive years of double-digit growth. The company also benefited from higher trading activity relative to the prior two years, with higher-margin derivatives comprising a record 41% of trades per day (vs. 39% a year ago), and mobile trades (mobile users are typically higher-activity traders) comprising a record 13% of trades per day. As a result, average commissions and fees per trade showed a very nice increase. If the company can maintain the recent increases in average commissions and fees per trade, that bodes well for transaction-based revenue moving forward:



Source: Company filings and analyst calculations

I am particularly impressed by the fee-based segment, which is the one area of the business that less subject to unpredictable market forces (that is, trading activity for the transaction-based business, and interest rates for the spread-based business).

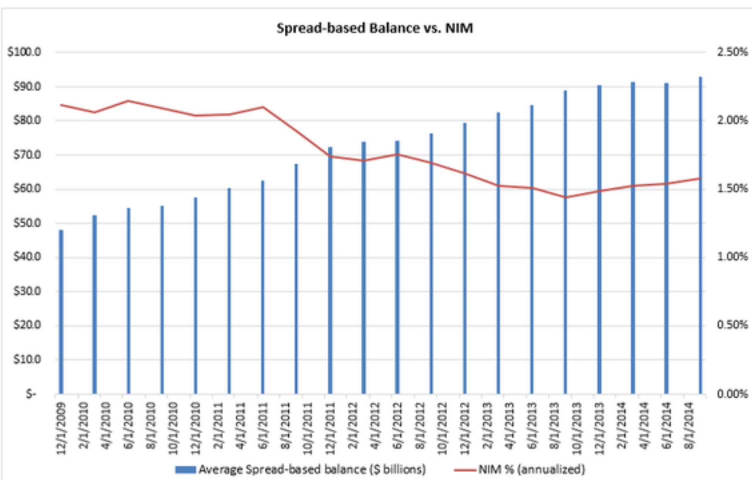
For the fee-based business, which now comprises more than 10% of net revenues, revenue continues to grow very strongly, with 20%+ Y-o-Y growth rates every quarter for the last 10 quarters (this quarter clocked in at 24% Y-o-Y growth). In addition to growing the balance of fee-based client assets at a very high rate (16% compounded over the last 7.5 years), the company has been able to increase the yield (essentially, the management fee) on that balance as well:



Source: Company filings and analyst calculations

TD Ameritrade continues to innovate and provide relevant products and services with this area of the business (see this press release from 10/29 for an example), and I'm expecting continued strong growth from this segment.

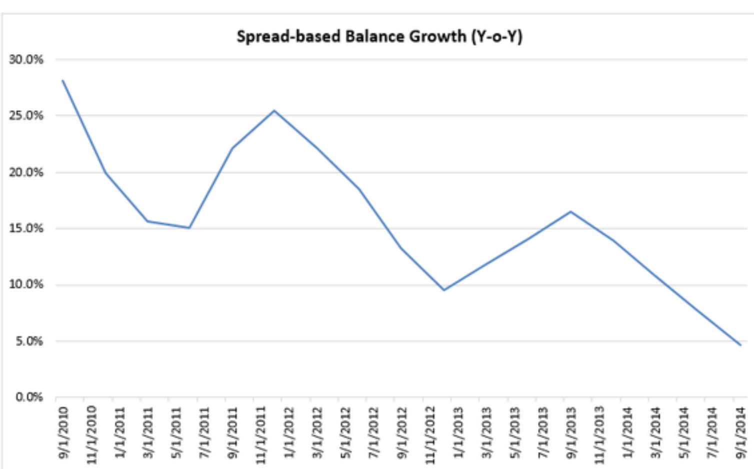
As for the spread-based (i.e. interest rate-sensitive) portion of the business, the spread-based balance grew 4.6% Y-o-Y to $93 billion, and the annualized Net Interest Margin (NIM) ticked up to 1.58% in a quarter where the yield curve was volatile:



Source: Company filings and analyst calculations

This spread-based portion of the business is very sensitive to changes in interest rates, and it will provide a big boost to profitability if and when interest rates rise. The company has guided that a 100 basis point increase in the Fed Funds Rate will increase annual earnings by $0.38 per share in year 1, $0.44 in year 2, and $0.51 in year 3. Given that EPS this year was $1.45 per share, that's some pretty healthy upside (26%, 30%, and 35%, respectively).

Given that information, we want to see that spread-based balance continue to grow at a healthy clip. When interest rates eventually do rise, we want TD Ameritrade to have as many interest rate-sensitive assets as possible. I'm a bit concerned that growth in the spread-based balance has been trending down, and we've seen four straight quarters of decelerating growth:



Source: Company filings and analyst calculations

Although the spread-based balance has grown at a 17% annualized growth rate over 8 years, the above graph shows that growth may be stagnating. My valuation model assumes mid-single digit growth in the spread-based balance, so if TD Ameritrade can't reverse the current trend, I may have to revise my estimates downward.

Now What?

Overall, TD Ameritrade posted a good quarter and had a very solid Fiscal 2014. Although on a nominal basis, EPS was up just 6% year-over-year, once you back out non-recurring gains on investments in both periods, EPS was up an impressive 33%. The market liked the results and bid up shares about 3% on the day of the report. This well-managed company continues to excel at gathering client assets, the transaction-based portion of the business benefited from higher trading activity and higher commissions and fees per trade, and the fee-based portion of the business continues to grow at a rapid, 20%+ clip. TD Ameritrade is still very well-positioned for rising interest rates (who knows when that will happen), and they are doing well at managing the parts of the business that are under their control.

Data and Guidance

- Current Price (per share): $33
- Fair Value (per share): $34
- Consider Adding More (CAM): $25
- Market Cap: $18.2 billion
- P/E (TTM): 22.8x

Due to the volatile nature of TD Ameritrade's business, this quarter's results were not enough to change our FV estimate or CAM price. Share buybacks and strong operating performance were offset by moderated growth assumptions in the valuation model. I'll be watching to make sure that the company can execute on key value drivers (spread-based balance growth, pricing, etc.), and in the meanwhile, we'll continue to benefit from the company's safe (and growing) $0.15 quarterly dividend (good for a 1.8% yield on the current share price). Due to the company's healthy cash position on the balance sheet ($1.5 billion vs. $1.1 billion a year ago), I wouldn't be surprised to see another special dividend before year-end (the company has paid a $0.50 per share special dividend in December each of the last two years).

TD Ameritrade remains a Buy First on our scorecard with a 3% allocation, and those who have yet to initiate or fill out their position should feel comfortable doing so at current prices.

Fool on!

— Billy (TMFTailwind)

Portfolio Positioning Event: Dec. 3, 2014

Published Oct 29, 2014 at 2:52PM

During our Portfolio Positioning Event on Dec. 3, advisor Jeff Fischer and the *Pro* crew will discuss the Portfolio Building Reports for new members, share their insights on the *Pro* investing and portfolio management philosophies, and offer guidance.

You'll be able to watch the video and participate in the live chat from this page. Watch your inbox for a reminder on Dec. 3!

Portfolio Building Reports

No. 1 (Nov. 6, 2014)

- HTML version to come
- PDF version to come

No. 2 (Nov. 13, 2014)

- HTML version to come
- PDF version to come

No. 3 (Nov. 20, 2014)

- HTML version to come
- PDF version to come

Portfolio Building Report No. 3

Published Oct 29, 2014 at 2:43PM

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new Pro *portfolio.*

Part 1 **Part 2** **Part 3** **Part 4** **Portfolio Positioning Event**

Dear *Pro* member,

From the most popular social website in the world to a small-but-great software company you've probably never heard of, from the top manufacturer of "smart" car mirrors to the leading producer of irrigation systems — the six *Pro* stocks we cover in today's report span various industries across the globe. That's especially true when you include the emerging-market ETF that tops off our list today. We believe each of these investments will offer healthy returns over the coming years, with reasonable risk. Along with the other holdings delineated in our first and second reports, adding these is another step toward building your *Pro* portfolio. If you have questions about any of these positions, please visit the company-specific discussion board linked in the report. If you have questions about your portfolio as a whole, visit the Making *Pro* Fit You board.

Enjoy! And Fool on!

— Jeff and the *Pro* team

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Download this report as a PDF

Buy: Facebook (NASDAQ: FB)

The world's leading social network — and most-trafficked website, period — is being well managed for long-term growth.

Suggested Allocation: 4.6%

What It Does

More than 1.3 billion people use **Facebook** (NASDAQ: FB) to connect to friends, families, companies, organizations, marketers and celebrities each month. Incredibly, more than 850 million people visit daily. Most traffic arrives through mobile devices, and the company has had great early success monetizing that traffic with ads in its popular mobile news feed. Over the longer term, management wants to make the ads on the site as targeted and relevant to users as are the updates from their friends and family. Meanwhile, Facebook keeps working to stay on the edge of social technology. The company has the equity to acquire competing platforms and then build traffic before monetizing them once it hits critical mass — which in Facebook's opinion is 1 billion users.

How It's Working

For More

- *Pro*'s original recommendation (9/18/12)
- Our most recent earnings coverage (10/31/14)
- Talk about Facebook

Facebook reported strong third-quarter results in October, with revenue up 59%, ad revenue up 64%, and operating costs only up 41%. The company's three-year plan is to increase additional value for users and businesses, so it's investing heavily in the site and in new ad platforms to do so. The five-year plan includes monetizing platforms like Messenger, WhatsApp and Instagram, which intentionally aren't running any ads yet. The 10-year plan includes Internet.org initiatives to connect the world, the majority of which is still not online.

What We Expect

Facebook will greatly increase spending in 2015 as it hires for future growth. Demand for advertising is outpacing Facebook's ability to serve widespread customers adequately, and — like **Google** (NASDAQ: GOOGL) in its early days — it wants to stay ahead of its technological needs with ample hiring and spending. Lately, the stock trades at 40 times expected earnings for the next 12 months, making it reasonable for its growth rate, and attractive for the coming years. We're reminded of when Google went public, and we expect Facebook's increased spending will pay off in higher revenue and earnings, ultimately pleasing investors like us.

Buy: Gentex (NASDAQ: GNTX)

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 3.4%

What It Does

In 1982, a small company in Zeeland, Mich., called **Gentex** (NASDAQ: GNTX) made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands almost 90% of that market, and it sells eight times more units than its closest competitor.

How It's Working

In 2000, the company sold 6.8 million units; in 2013, it sold 26.2 million. That growth has been driven by an increased focus on safety, higher car sales, and greater market penetration (more car makers offering Gentex mirrors as a trim option). Gentex has turned these market dynamics into wonderful financial performance. Revenue has risen by nearly 20% annually since 1990, and over the past decade, the company's net margins have bounced around the mid-to-high teens. Those numbers are shockingly good for an auto-parts supplier, showing that its fancy mirrors are showing up in more and more new cars.

What We Expect

For More

- *Pro*'s most recent update (11/10/14)
- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex

Currently, fewer than one in every four cars made worldwide has an auto-dimming rearview mirror, and only 6% have auto-dimming exterior mirrors. For context, prior to 1987 those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher penetration; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror, both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy: OpenText (NASDAQ: OTEX)

This company's information management software keeps the digital lives of businesses in order, and its exchange platform drives business transactions.

Suggested Allocation: 3.7%

What It Does

OpenText (NASDAQ: OTEX) is a leading provider of solutions in enterprise information management (EIM). It sells software (both in the cloud and on premises) that lets companies organize their electronic content, and it offers a leading business exchange platform for enterprise commerce. OpenText's products help companies, governments, and universities operate more efficiently and effectively, meet compliance requirements, communicate with colleagues, customers, and partners, and make transactions. Its software helps its customers manage digital information, and its Information Exchange platform lets customers manage their business-to-business communications and transactions. Both units generate strong recurring revenue.

How It's Working

For More

- *Pro*'s original recommendation (8/31/11)

- [Most recent earnings coverage]() (11/16/14)
- [Talk about OpenText]()

OpenText has increased sales and cash from operations by more than 14% annualized over the past three years, and the goal is to continue to grow by at least 10% annualized as its industries expand. Sales were up 40% last quarter, and operating cash flow jumped 73%. Margins have trended higher as growth continues, and OpenText expects recent upgrades to its software to continue to drive demand.

What We Expect

Electronic content management industries served by OpenText should increase top-line demand by at least 10% annualized over the next several years, and OpenText should take market share, too. The company has a long history of steady growth through acquisition, and it enjoys diversified software sales to multiple industries. With new products rolling out in cloud services (off-site servers), renewed sales execution through more distribution channels, exciting acquisitions in the works, and an intense focus on its financial performance, this medium-sized company looks to have a big future.

Buy: Papa John's Pizza (NASDAQ: PZZA)

Deliver a slice of the profit pie right to your doorstep.

Suggested Allocation: 3.9%

What It Does

Papa John's International (NASDAQ: PZZA) operates and franchises more than 4,500 pick-up and carry-out pizza joints in more than 36 countries. For the past 30-plus years, Papa John's has been making pizza and building its brand around the "Better ingredients, better pizza" tagline. Bringing that unwavering focus to each pie has resulted in the company's perceived quality advantage over its big-chain pizza competitors, which allows it to consistently price a dollar or two higher and attract the best franchisees. Now that its brand advantage is sufficiently established in North America, Papa John's is turning its sights abroad, believing that delicious American pizza is a language every taste bud speaks.

How It's Working

For More

- [*Pro*'s most recent update]() (11/10/14)
- [PZZA position review]() (5/23/14)
- [Talk about Papa John's]()

As sure as a fresh pizza will be gobbled up by hungry kids, Papa John's delivers results. For 11 consecutive years, the company has recorded positive or even North American comparable-store sales growth. Recently, international comps have been in the 5% to 8% range, offering lip-smacking evidence that Papa John's flavors travel well. It has opened between 200 and 300 restaurants in the past two years, a pace that should continue — expectations are for about 230 new units this year. And because Papa John's is primarily a franchisor, it doesn't have to bear the cost of that expansion (it is taken on by the franchisees). Competing for a share of the global appetite is tough business, but Papa John's has been able to increase sales and profits at commendable rates over the past decade, which has resulted in plenty of cash generation. Management initiated a dividend in 2013 and has consistently bought back stock over the years.

What We Expect

We believe the company will maintain its brand positioning, modestly improve underperforming franchise locations, and continue to be an attractive entrepreneurial outlet for new franchisees abroad. We think the brand can easily support 6,600 worldwide locations by 2023. The company should also be able to take modest market share from mom-and-pop pizza shops in established markets as digital ordering continues to gain adoption; it's a tough hurdle for smaller players to overcome. With a little bit of menu innovation and the maturation of new markets, we believe 3% same-store growth is sustainable over this period. We rate shares a Buy and encourage members to do plenty of field research on this one.

Buy: Valmont Industries (NYSE: VMI)

Providing irrigation systems and support structures, this company benefits as agriculture needs increase and countries build infrastructure.

Suggested Allocation: 2.4%

What It Does

Valmont Industries (NYSE: VMI) offers investors a consistent suite of four business divisions, each serving a growing need around the world. Founded in 1946, Valmont's engineered products division supplies steel and aluminum poles to infrastructure projects worldwide, including road and traffic lights; stadium and parking lights; and wireless communications poles and support towers. This division also sells highway safety products including barriers and road grating. In addition, because it sells steel and concrete support structures for the global utilities industry, Valmont profits as electrical grids are renovated or built out.

Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot and mechanized irrigation systems are the world's leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient mechanized irrigation, so there's lots of room to run.

To top it all off, the company provides hot-dip galvanizing (just like Mom used to make), anodizing, and other coatings to protect aluminum and steel from corrosion. One of the largest custom galvanizers in the world, Valmont expects continued growth because it still captures only a small percentage of the total market. Overall, the company operates in more than 80 countries and has more than 10,000 employees.

For More

- [*Pro*'s original recommendation]() (11/5/13)
- [Our most recent earnings coverage]() (11/2/2014)
- [Talk about Valmont]()

How It's Working

Valmont's stock has returned 14% annualized since 1993, outperforming the vast majority of stocks on the market, even the likes of **Starbucks** (NASDAQ: SBUX) and **Whole Foods** (NASDAQ: WFM) over the past 10 years. By focusing on strong returns on invested capital, smart acquisitions, new markets, and product-line expansion, Valmont has been able to increase profits as the world economy expands. Yet it's still a relatively small company (at $3.4 billion) with plenty of potential in all business lines, and it trades at valuation multiples below market averages.

What We Expect

With outstanding management and four business divisions that continue to expand around the world, we expect Valmont to grow at more than 11% overall — riding through cyclical bumps — and the stock to ultimately perform admirably in our pursuit of our North Star. As mentioned, we will have to ride through cyclical downturns along the way. But as management says, each low is higher than the previous one, and each high is a record high. We hope to have a long, rewarding relationship with this recent *Pro* stock. It's going to require patience, but that patience should be rewarded.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund (NYSEMKT: DGS)

Diversification in emerging markets with some of the best small, high-yield companies you've never heard of.

Suggested Allocation: 2.3%

What It Does

At *Pro*, we like to invest in emerging-market small caps to diversify and target higher growth. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) (the longest ETF name in the world!*). This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields more than 3%). For *Pro*, owning shares of this well-managed ETF offers exposure to up to 600 of the most promising international business we couldn't easily buy in another way.

Serving as direct exposure to emerging markets, this ETF gives us an excellent way to invest in unfamiliar companies in locations where we don't have a discernible edge but where growth exists — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The diversifying benefits of investing outside our home market are equally important over long periods.

How It's Working

It's no surprise that small-cap companies (even dividend-paying ones) in emerging markets are volatile. We expect DGS to continue to experience higher-than-average volatility. So far, emerging markets have badly lagged U.S. markets. But eventually that will change.

For More

- *Pro*'s original recommendation (11/22/10)
- Talk about DGS

We'd always prefer to own great businesses over great ETFs, so this holding has a permanent spot on our short list of positions we'll sell if we need cash or find a higher-conviction alternative. In the meantime, though, for a low expense ratio, we get a basket of businesses with a history of exceptional performance, weighted by the size of their annual cash dividend. The fund's heavy weighting toward financials, industrials, and the consumer discretionary sector leaves it well positioned to benefit from an economic recovery if and when one comes along.

What We Expect

This is a top-notch fund, and you don't have to take our word for it; Morningstar has bestowed its coveted five-star rating on DGS. It's also made Morningstar's list of the top eight funds in its category in each of the past three years, and it's ranked No. 2 when considering five-year performance. We expect these impressive long-term results to accrue to us eventually. In the meantime, the watchword with small caps, emerging markets, and this ETF is: patience.

**Statement may or may not be accurate.*

Portfolio Building Report No. 2

Published Oct 29, 2014 at 2:35PM

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new Pro *portfolio.*

Part 1 **Part 2** **Part 3** **Part 4** **Portfolio Positioning Event**

Dear *Pro* Member,

This report marks Part 2 of your *Pro* portfolio-building experience. We recommend that you add capital to these stocks next, as you continue to build your *Pro* portfolio. Once we build your foundation in strong *Pro* stocks, we'll address hedging, shorting, and options for those members who want to use these versatile extra tools — which, as we know, is many of you. For now, we're starting easy as a Sunday morning by introducing you to our stars — our core holdings, which should compound our core capital over the years. Each Portfolio Building Report introduces you to a selection of them one by one and explains why we like owning them, the upside we see, and how much we believe you should allocate to each right now. When you have questions on any company, please visit its discussion board; all of them are linked in the report.

Welcome again to *Pro*! Enjoy the process and ask questions. We're here to help. Fool on!

— Jeff and the *Pro* team

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Download this report as a PDF

Buy: American International Group (NYSE: AIG)

Time and even average performance should lead to solid returns from this undervalued insurer.

Suggested Allocation: 3.6% stock, 0.7% warrants

Today's **American International Group** (NYSE: AIG) is not the same company that disgraced itself so profoundly in 2008. AIG has divested itself of whole business units since the financial crisis, managing to eliminate almost all of its previous exposure to the nasty derivatives that nearly brought down the economy. Left behind are three steadfast and improving insurance businesses.

What It Does

Insurance is a business of collecting premiums, investing the float, and paying out claims — and AIG is getting ever better at it. Improved underwriting is showing up in a lower loss ratio, which in turn is driving a lower adjusted accident-year combined ratio. All that is a fancy way of saying that the company's insurance operations are stronger than they've been in years and are poised for continued improvement.

For More

- *Pro*'s original recommendation (8/24/12)
- Most recent earnings update (11/5/14)
- Talk about AIG

At Your Broker: AIG Warrants

- eTrade: AIG.WS
- Fidelity: AIG/WS (paste CUSPID 026874156 into the quote page)
- Interactive Brokers: Find AIG; select "warrants" from the drop-down menu
- optionsXpress: AIGwS
- Schwab: AIG/WS
- TD Ameritrade: AIG+
- Vanguard: AIG_t
- OptionsHouse: AIG.WS

Helpful Links

- AIG's explanation of the warrants
- AIG's warrant registration statement filed with the SEC

AIG's insurance offerings consist of three divisions: AIG Property Casualty, AIG Life and Retirement, and Mortgage Guaranty. The first provides casualty, property, financial, and specialty insurance to commercial clients and consumers, typically through brokers. The life and retirement division offers domestic life insurance and retirement products (annuities, mutual funds, financial planning) through a diverse network of financial-services companies, brokers, agents, and advisors. The mortgage guaranty division insures lenders against losses from defaulted mortgage loans. Overall, AIG is writing fewer premiums at better prices than it was in past years, which is a great indication of improved underwriting discipline.

How It's Working

When we recommended buying AIG stock and warrants in August 2012, we were confident in the momentum of the company's turnaround, but we underestimated the rapid rate at which our thesis would unfold. In late 2012 (after our recommendation), the U.S. Treasury sold another $26.5 billion worth of its AIG shares. Management wisely used the opportunity to purchase billions of dollars' worth of stock at about half book value; that, of course, further increased book value in a virtuous cycle. Management continues to repurchase shares and, reflecting the company's remarkable improvement in balance-sheet strength, has paid a dividend (lately $0.125 per share) for the last five quarters.

What We Expect

Underwriting discipline will continue to drive increased earnings and a higher valuation. That plus a renewed focus on capital management will improve AIG's credit rating, reducing its cost of debt and providing another lever for higher profitability. We expect newly installed CEO Peter Hancock to stay laser-focused on improved underwriting and capital allocation, repurchasing shares so long as AIG continues to trade meaningfully below book value and maintaining or increasing the quarterly dividend if business performance supports it.

The *Pro* Bottom Line

We recommend buying 3.6% of AIG stock and 0.7% of AIG warrants (see below for more on those). AIG has cleaned up its business, so by purchasing now, you get in after all the hard work has been done. Book value — the best measure of an insurance company's worth — is steadily growing. And AIG's current share price is right around 0.7 times book value. That's cheap, especially given the company's momentum. Investors who buy AIG now are positioning themselves for outsized future returns with less risk. That's contrarian investing at its best.

A Note on Warrants

Warrants are similar to call options, except that they are issued by the underlying company. They offer the purchaser the right (but not the obligation) to buy the stock in question at the specified price. The warrants we're recommending on AIG are valid for 10 years from the date of issue (Jan. 19, 2011), and they can be exercised at any point before they expire on Jan. 19, 2021. When exercised, they allow the holder of the warrant to buy shares of AIG at $45 per share, regardless of the market price.

That $45 strike price adjusts favorably in the event of dilution or annual cash dividends greater than $0.675 per share (which would also lower the share price). Warrants are illiquid, and Goldman Sachs is the designated market maker for them; when you buy them, be sure to use a limit order so Goldman doesn't get more than a fair price.

Be aware that if our investment in AIG works out, those who own warrants will earn leveraged returns on them. But it's possible that the warrants could end up as a total loss if AIG's stock price is below the $45 strike price at expiration (even though they're currently in-the-money by a few bucks).

Buy: AmTrust Financial Services (NASDAQ: AFSI)

Its talent at capitalizing on human laziness is just part of what we love about this insurer.

Suggested Allocation: 7.4%

What It Does

At *Pro*, we speak a lot about the importance and power of recurring revenue — mostly because we know that humans are inherently lazy. Insurance purveyor **AmTrust Financial Services** (NASDAQ: AFSI) handily proves this point for us; many of the policies it writes (more than 80% in most lines!) renew at the end of their term without their owners even shopping for a better rate. Most of us, it seems, are guilty of preferring inertia to bargain-hunting, and AmTrust and its fellow insurers are the beneficiaries.

AmTrust focuses on insurance niches (workers' compensation, product warranties, and Italian medical malpractices, just to name a few) that are low-hazard and generally too small for large insurance companies to care about. But though AmTrust writes small policies, it's no small fry. Its high renewal rates and predictable cash flow allow it to focus on writing new policies, acquiring new books of business at prices that range from fair to an outright steal, and hunting for obscure investment opportunities.

How It's Working

AmTrust's focus on specific niches, its use of technology to keep its expenses low, and its opportunistic acquisition of policies other insurers struggle to find profitable have all resulted in impressive growth. Gross written premiums have risen from about $1.1 billion in 2008 to more than $4 billion this past year. But AmTrust is no one-trick pony; income from its high-margin and equally sticky service and fee business grew from $29 million to more than $331 million during the same time span. This growth, combined with a laser-like focus on low expenses, has resulted in consistent increases in earnings, dividends, and book value.

What We Expect

For More

- *Pro*'s original recommendation (4/3/09)
- Talk about AmTrust

The insurance market works in cycles, and AmTrust's strategy is built around taking advantage of this. The company targets markets in which pricing has risen as other companies struggle to deal with losses from policies written in prior years. Pricing has remained favorable in AmTrust's largest markets as of late, which means it can do one of two things: either charge as much as its competitors and make more in profit thanks to its lower expense structure, or undercut the competition on price in a bid to take market share, since it isn't dealing with legacy losses. If the economy continues to improve, the small businesses AmTrust insures should hire more workers and consumers should purchase more insurable goods, so there seems to be plenty of growth ahead.

AmTrust stock has consistently traded higher than our estimate of fair value, but we believe the company's premium valuation is warranted given the consistency of its growth, quality, and profitability. AmTrust is *Pro*'s largest holding and we're happy to let this winner run, expecting to increase our fair-value estimate over time.

Buy: Broadridge Financial Solutions (NYSE: BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 4.2%

What It Does

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in its fiscal 2014, which ended June 30, its platforms processed more than 80% of all shares in the United States. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider to manage investor communications.

The company's smaller division, securities processing solutions, accounts for 27% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

How It's Working

Both earnings and free cash flow are modestly depressed because mutual funds have been scrimping on investor communications recently and investor skepticism around the global economic recovery has led to low trading volume. Still, in fiscal 2014 Broadridge's sales were up 5%, earnings per share rose 25%, and the company hiked its dividend by 17%. The business is positioned for strong sales and margin performance for years to come. And Broadridge continues to serve its customers masterfully; its 98% retention rate sets the stage for recurring revenue (and deepening relationships) in future years.

What We Expect

For More

- *Pro*'s original recommendation (4/27/10)
- Talk about Broadridge

We think Broadridge will continue to write the e-book on electronic investor communications. Its dominance of this market should strengthen its competitive advantages, making it indispensable as transparency in the financial system increases. We also expect banks and brokerages to continue outsourcing their non-core operations to save money and increase flexibility; this should bring increased business and greater efficiency to Broadridge. We expect modest sales growth to translate to earnings growth of around 10%. Much of Broadridge's revenue is recurring, making its sales and earnings growth highly reliable, and its impressive free cash flow will likely bring an ever-higher dividend and increased share buybacks.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy First: Skyworks Solutions (NASDAQ: SWKS)

This leading designer of analog semiconductors for smartphones and connected devices is growing sharply.

Suggested Allocation: 3.2%

Skyworks Solutions (NASDAQ: SWKS) makes technology that powers wireless connectivity in a wide variety of products: **Apple** (NASDAQ: AAPL) and Samsung smartphones and tablets, **Medtronic** (NYSE: MDT) medical devices, **Google** (NASDAQ: GOOG) and **General Electric** (NYSE: GE) products, and the list goes on. In what's being called the "Internet of Things," billions of physical objects are being connected to the Internet for the first time -- and Skyworks is uniquely positioned to benefit. Not only does it serve all of the top-tier mobile device makers, the company is also diversified across industries to serve more than 2,000 customers.

What It Does

Skyworks sells more than 2,500 high-performance analog semiconductors and related products, supported by nearly 1,000 patents. The list includes amplifiers, attenuators, receivers, switches, diodes, modulators, GPS power and voltage regulators, and more, often sold together as components of a phone or other connected device. Skyworks earns industry-beating operating margins of 30.5% selling specialized solutions to giant customers with growing connectivity needs. Here are just a few examples:

- GE plans to connect all of its industrial products to the Internet -- from jet engines to dishwashers.
- Medtronic will connect many of its medical devices to the Web for monitoring.
- A majority of new automobiles will be connected to the Internet by 2017.
- Smartphone sales are expected to surpass 1 billion by 2016

All told, **Cisco Systems** (NASDAQ: CSCO) expects 50 billion devices will connect to the Internet by 2020.

How It's Working

Skyworks is already reaping some benefits, and it's ready for much more. As CFO Donald Palette said this summer, “We've spent the last decade investing significant resources and leveraging our technology to expand our presence in traditional analog markets like automotive, medical, and industrial. We have established significant traction in these higher-margin growth avenues, and we see tremendous opportunity ahead."

Whatever the device being connected to the Internet, the smaller, more complex, and more efficient the technology needs to be, the more Skyworks benefits. Also, as more data flows through networks and more connection nodes are required, the company's products become even more indispensable. As Palette said in the July conference call, "Complexity for us drives profitability. And there are fewer and fewer people in the space that can do it" -- even as complexity accelerates. Given this, Skyworks expects profit margins to continue to move higher.

What We Expect

We expect continued strong growth, and we think the reasonably-priced stock will ultimately appreciate at rates higher than the market average. CEO David Aldrich recently said, “Skyworks is entering a new and exciting growth phase driven by global wireless proliferation and the Internet of Things. Quite simply, we are capitalizing on the macro trend to connect virtually everyone and everything, all the time." Most significantly, he continued: “Skyworks is setting the pace for analog semiconductor industry growth in terms of both revenue and value creation." In the quarter just ended, revenue jumped 51% year over year, while operating income soared 81%. And for the fiscal 2015 that just began, Skyworks increased first-quarter guidance.

For More

- *Pro*'s original recommendation (8/5/14)
- Talk about Skyworks

CEO Aldrich summed things up on Nov. 6: “Our advanced solutions are at the heart of mobile connectivity and the Internet of Things, and are empowering exciting new applications spanning mobile payments, to streaming music services, to on-demand media. Given our accelerating design win momentum and deep product pipeline, we have never been better positioned to grow demonstrably faster than our addressable markets and in turn, to deliver best-in-class financial returns.” Here at *Pro*, we hope to be owners for many fruitful years — as long as is merited.

Buy: Starbucks (NASDAQ: SBUX)

A global powerhouse devoted to creating experiences stands poised to brew up great returns going forward.

Suggested Allocation: 2.8%

What It Does

You may not realize it, but “**Starbucks**” (NASDAQ: SBUX) is no longer a synonym for “coffee.” In January 2011, the company dropped the word “coffee” from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense it’s just a front. We *think* we go to Starbucks for the coffee, but those little white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

Starbucks began opening America’s eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 21,300 stores in 65-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences to fill more than 70 million mouths and hearts each week.

How It’s Working

By placing the customer experience first, Starbucks has cemented its role in the daily lives of consumers worldwide. People demand their Starbucks products at home, too, which has allowed the company to build out a consumer packaged-goods division that sells more than $1.5 billion worth of products in more than 100,000 locations worldwide. And the company is cultivating a portfolio of other brands (Evolution Fresh juices, Teavana tea bars, La Boulange bakeries, Starbucks Reserve) whose products can be sold in Starbucks stores and grocery stores alike. Between coffee, health foods, and tea, Starbucks believes its end markets are a massive $140 billion and growing.

Recent results have been robust. Starbucks continues to add stores at a rapid clip, and its same-store sales have been rising by an average of 7% per year over the past five years. Earnings and cash-flow performance have increased even faster, and all of this growth has been achieved by doubling down on the in-store experience and refocusing on quality. Starbucks constantly seems to be setting new records for sales, operating profits, and earnings.

What We Expect

For More

- [Most recent earnings update](#) (10/30/2014)
- *Pro*'s original recommendation (8/22/2012)
- Talk about Starbucks

Given its very recognizable brand, artfully crafted business, and fanatically loyal customers, we expect Starbucks' diversified growth to continue. We believe the world's coffee and tea drinkers will happily support 30,000 or so stores across the company's various brands, and that products bearing the aspirational Starbucks brand will expand the company's real estate on grocery-store shelves.

The company's scale and its ability to raise prices should help profits, as will its unique advantages in low-cost marketing. Starbucks is also the leader when it comes to incorporating technology into a physical store experience – 90% of mobile payments in the U.S. took place in a Starbucks store in 2013.

At around 29 times trailing earnings, Starbucks might look expensive to some, but the company has been knocking it out of the park since CEO Howard Schultz's return to power in 2008; it now has so many levers to pull that capturing its potential value in a spreadsheet is very difficult. Starbucks offers a truly unique blend of growth and cost-reduction opportunities that leave it poised to deliver North Star-beating returns going forward. We want to tag along for the caffeinated ride.

Portfolio Building Report No. 1

Published Oct 29, 2014 at 2:31PM

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new Pro *portfolio.*

Part 1 **Part 2** **Part 3** **Part 4** **Portfolio Positioning Event**

Dear *Pro* Member,

Pro is a premier service at The Motley Fool not only because it's a portfolio service that incorporates options, shorts, and hedges alongside core stock investments — but because it is a full portfolio solution, period.

Thought goes into each part of the portfolio, the allocation we give to every position, and how the positions all work together. This means that every addition to the portfolio serves a specific purpose. The following report (as well as those to come on Nov. 13 and Nov. 20) outlines our current thinking on all of *Pro*'s positions, as well as suggested allocations and the thesis behind each one.

Welcome to *Pro*. We're glad to have you!

— Jeff Fischer, advisor

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Getting Started With *Motley Fool Pro*

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that aims to generate winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* fit you.** We know not all investors are in the same situation! We can help you figure out how to buy the *Pro* investments given your personal situation, including investing in an IRA or coming to *Pro* already fully invested. Check out our advice for every approach to *Pro*: Invested Elsewhere | "Free-Range" | Whoever You Are
3. **Catch up with our portfolio at your own pace.** Start with the stocks in this report, and wait for our next two reports coming Nov. 13 and Nov. 20. You can always see our latest take on all of our positions on our What We Think Now page. As you explore our recommendations, it's important to remember that a stock's "scorecard status" (Buy First, Buy, or Hold) is the best indicator of how we feel about it. If a stock is listed as a Buy or Buy First on the What We Think Now page, that means we think you can buy it today.

Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 3.9%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Total U.S. mobile data traffic is expected to increase by more than 2,000% between 2012 and 2018, and the number of U.S. mobile lines in service (including smartphones, computing devices, and machine-to-machine applications) is expected to jump from 360 million in 2012 to 648 million in 2018. Communications site operator **American Tower** (NYSE: AMT) is well positioned to benefit from this trend.

What It Does

AMT leases antenna space on more than 69,000 cell sites (towers, rooftops, and more) to wireless service providers across the globe. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, non-cancellable, and feature contractual annual price escalations. About 60% of AMT's properties are located in 11 different countries outside the U.S., including India, Brazil, Germany, and South Africa, and AMT is intent on expanding its international portfolio as it continues to build and acquire more towers.

How It's Working

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE (or, in Africa, from voice to data), or to increase coverage density. Every time they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; 98% to 99% of AMT's customers up for renewal each year do so, and more than 85% of its current leases don't renew until 2019 or later.

What We Expect

Revenue is up 25.3% year-over-year in the most recent trailing-12-month (TTM) period, with the international division up 27.2%, outpacing the domestic side. We expect revenue to roughly double over the next five years through a combination of price escalations, new towers, and upgrades; year-to-date 2014 results suggest that the company is well on its way.

After its 2011 conversion into a real estate investment trust (REIT), AMT is required to pay out 90% of taxable income to shareholders. It currently distributes $1.44 annually, a 1.5% yield, and management expects to increase the dividend 20% annually over the next five years. (Importantly, only the U.S. business and a small portion of the international business is organized as an REIT. For more, see our original write-up, linked here and in the sidebar.)

For More

- *Pro*'s original recommendation (5/6/13)
- *Pro*'s "Buy More" recommendation (3/17/14)
- Talk about AMT

Management reduces taxable income though the use of net operating losses. And because the useful life of its tower properties exceeds the depreciation schedule, AMT also uses a depreciation shield, which further reduces taxable income and understates the value of some assets on the balance sheet. Thus, typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

The *Pro* Bottom Line

We value AMT at about $110 a share. Today's price provides an acceptable margin of safety for a business of this caliber. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network.

Buy First: Oracle (NYSE: ORCL)

This old-guard tech giant has more room to grow.

Suggested Allocation: 4.2%

What It Does

Oracle (NYSE: ORCL) is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems** (NASDAQ: CSCO), **Dell**, and **Microsoft** (NASDAQ: MSFT) — Oracle's value has steadily risen as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe. And when it comes to hardware, Oracle's own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

Combining hardware with boxed software and cloud services, Oracle is a full-service solution, one that's poised to enjoy long-term growth in free cash flow. The business is incredibly sticky — companies don't trust their data to just anyone, and it's tricky and even risky to make a switch. To add to its massive recurring revenue base, Oracle cross-sells new products to existing clients and continues to rope in new customers with its comprehensive software and hardware solutions, whether on site or in the cloud. The company has also been known to make some (read: *many*) acquisitions to propel growth.

How It's Working

Leading software sellers can write a program once and sell millions of copies, then provide small but critical updates on a regular basis. These updates drive a subscription business model, which leads to recurring revenue. Most of Oracle's customers renew annual software contracts that represent more than 40% of its revenue. This is stability upon which Oracle grows. Even better, as more customers move to a cloud-based relationship (rather than licensing on-premise software), Oracle enjoys growing, monthly, recurring cloud revenue, even as customers save money because they no longer need to host their own software. For Oracle, economies of scale make hosting inexpensive.

In the quarter that just ended, Oracle's core cloud revenue was up 33%, while total software-plus-cloud sales gained a respectable 6% to $6.6 billion. Following some quarters of slow license sales growth (the increasingly popular cloud contracts bring in revenue more gradually), the stock has dipped, providing a good buying opportunity.

More Resources

- *Pro*'s original recommendation (9/17/09)
- Latest earnings coverage (10/3/14)
- Talk about Oracle

What We Expect

At about $39, Oracle trades at about 13 times free cash flow, well below the S&P 500's average, and management expects more operating leverage ahead and greater overall profits as cloud revenue steadily increases.

The *Pro* Bottom Line

This is a good buying opportunity for a proven business that still has plenty of room to grow. From this valuation, we think the stock should produce a North Star-topping, 10%-plus annualized return over the coming three years.

Buy First: TD Ameritrade (NYSE: AMTD)

Assets and investment fees are rising; earnings should surge when interest rates head higher.

Suggested Allocation: 3.1%

Entrusted with more than $650 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NYSE: AMTD) hosts around 400,000 stock, options, and futures trades on an average day, collects investment fees, and earns interest on billions in cash.

What It Does

Aside from being a leading discount broker, TD Ameritrade has a partnership with **TD Bank** (NYSE: TD) (which owns 41% of the company), giving it a unique position in its industry. The partnership allows TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank, and with cross-selling opportunities and below- average risk to boot. So, when the current record-low federal funds interest rate (targeted between 0% and 0.25%) increases, TD Ameritrade will earn much higher interest income, all of it pure profit. Meanwhile, it continues to focus on increasing client assets and launching more investment products.

But about that federal funds rate: In 2007, it was 4.75%, up from 1% in 2003 during the last recession. Today, it's hovering between zero and 0.25%. The first year that it increases by 100 basis points (to 1.1% from today's 0.1%), management estimates TD Ameritrade's earnings per share will rise by an extra 26% compared with the prior year, on top of any other growth. And as history shows, interest rates could rise by much more than 100 basis points over the next three, five, and seven years.

How It's Working

TD Ameritrade has increased client assets by at least 10% annualized for the last six years and counting. Management says this rate of growth has been about double that of its nearest competitor. For context, the S&P 500 (including dividends) has delivered about a 43% total return since 2007, but client assets held at TD Ameritrade are up by 235% over the same period. Operating margins are strong, too, lately in the low-40% range.

Diligent capital management led Standard & Poor's to upgrade the business to an "A" credit rating in 2012 (and reaffirmed that rating in July 2014), which has helped fuel recent dividend increases (the quarterly dividend has grown 44% annualized since Q1 2011). With steady gains in customer accounts, decreasing shares outstanding, and a commitment to paying out roughly two-thirds of earnings to shareholders, the business should continue to reward owners — with the added benefit of much higher profits when interest rates increase. Meanwhile, the stock is trading right around its 10-year average price-to-book value of 4, although the company is more diverse and stronger now than over the past decade.

For More

- *Pro*'s original recommendation (7/11/13)
- Monday Memo on TD Ameritrade's business model (9/15/14)
- Talk about TD Ameritrade

What We Expect

Management will continue to be excellent stewards of capital, returning profits to shareholders and increasing additional investor value. All the while, we know higher interest rates will someday lead to much higher net income. But even as we look forward to that, we can admire the company's current results and should enjoy healthy returns.

The *Pro* Bottom Line

Our current fair-value estimate on TD Ameritrade is $34. The company's earnings are likely at a cyclical low. Believing as we do that TD Ameritrade's profit potential is much greater than recent results suggest, we think the stock is a compelling buy in anticipation of higher interest rates. TD Ameritrade's business model is powerful when rates are headed upward. Most investors have probably forgotten that power since 2007, but will remember it when earnings start to jump.

Buy First: Tupperware (NYSE: TUP)

This is not your mother's Tupperware.

Suggested Allocation: 2.8%

What It Does

Tupperware Brands (NYSE: TUP) earns 70% of its revenue from giant emerging markets including China and India, where its sales reps are still only scratching the surface of the vast potential markets in dense urban population centers. As these countries, Brazil, Malaysia, and others begin to enjoy disposable income, shoppers able to store food for the first time can afford inexpensive kitchen products offered by Tupperware. In addition, Tupperware offers women in these regions steady employment, something that's still tragically hard to find for many women in emerging markets.

Elsewhere in the world, the company's sales through its iconic "Tupperware parties" still thrive in places as erudite as France and as prosperous as Germany, as well as in the good ole U.S.A. Cutting out retailers to focus on direct sales continues to set Tupperware apart from the rest of the pack, and with a sales force of 3 million and new products every year, the company still has plenty of potential ahead.

How It's Working

Tupperware has been increasing sales in key emerging markets by 20%, 30%, even 50% or more year over year, and overall in those regions by 10% or more. Including its legacy businesses in developed markets, the company targets long-term annual sales growth in the mid-single digits and earnings growth higher than that. Today, storage products only account for about 30% of sales, while region-specific kitchen tools have the lead. For example, in China water purification products are top sellers, while Tupperware vegetable steamers do well in France. The company's diverse product line, driven largely by the requests of local sales representatives, gives Tupperware relevance and success across different markets. A significant part of sales come from new products each year, a fact in which management takes pride. Tupperware creates innovative products and then outsources production to keep costs down.

A few quarters of soft sales, partly because of challenges in the Ukraine and South America, have led to a pricing opportunity for new buyers, making the stock a Buy First.

More Resources

- *Pro*'s latest buy recommendation (7/30/14)
- Talk about Tupperware on our discussion board
- Latest earnings coverage coming soon!

What We Expect

The $63.75 stock trades at 14.7 times earnings and yields 4.3% in annual dividends. After a soft year, the company is set up to have much easier year-over-year financial comparisons in 2015, and we expect the stock to handily return more than 11% annualized the next three years as headwinds dissipate. Feisty emerging markets should continue to drive sales, but we expect developed markets to hold steady (and even grow slowly) as well.

The *Pro* Bottom Line

You don't have to attend a party in someone's living room to enjoy the benefits Tupperware can bring to your portfolio (though you can if you want to). The company's innovative approach to products and sales continue to set it apart, and the future looks bright.

Buy First: Wells Fargo (NYSE: WFC)

At heart, banks are simple businesses, and Wells Fargo is one of the best of the breed.

Suggested Allocation: 4.1%

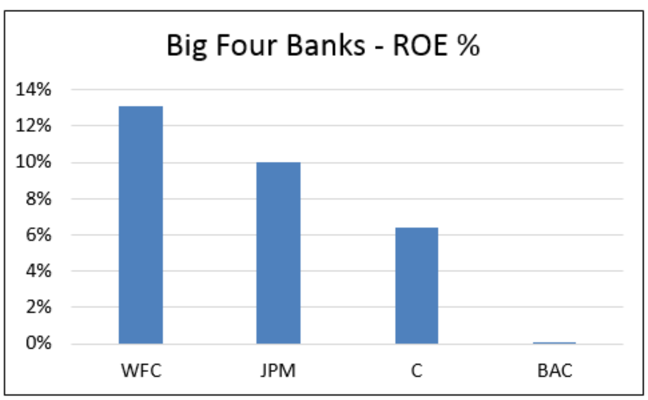
What It Does

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** (NYSE: WFC) is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 8,800 branches and 12,700 ATMs. It's the fourth-largest bank in America, it has a reputation for high customer loyalty and satisfaction, and it's the leader in mortgage and small-business lending.

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During tough lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

How It's Working

CEO John Stumpf and team are truly the best of the breed. Return on assets and equity for the most recent quarter (Q3 2014) were rock-solid, at 1.4% and 13.1% respectively — great results given the low interest-rate environment and new regulations that require higher liquidity levels (i.e., less leverage) than before the financial crisis. A look at ROE figures for the other three big banks shows how Wells Fargo is best in breed:



Source: Q3 2014 company filings (figures represent return on common equity)

Total revenue growth has been elusive, but expense reductions and improvements in credit quality have driven quarter after quarter of earnings growth, leading to higher earnings than before the financial crisis. Deposit growth has been tremendous (coming in at almost 10% in the third quarter of 2014), and as Wells Fargo grabs additional "wallet share," fee income increases as well. The credit quality of the loan portfolio is impressive and continues to improve. All of this has contributed to a very well-capitalized balance sheet, allowing Wells Fargo to comply with the aforementioned capital regulation requirements well ahead of schedule.

What We Expect

For More

- *Pro*'s original recommendation (12/10/10)
- *Pro*'s recent "Buy More" recommendation (7/29/14)
- Talk about Wells Fargo

Wells Fargo's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. In the current low-interest-rate environment, we should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But when the U.S. economy picks up, interest rates rise, and loan demand resumes, Wells Fargo's real earnings power — bolstered by growth in fee-based revenue — will hit its full stride. And many customers who start a deposit account or mortgage with Wells Fargo will explore the company's offerings in other areas, too.

Shares are trading at less than fair value, and they yield a growing 2.6% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. *Pro* has also used options in the past to generate even more income from this position, so try to invest using round, 100-share lots if it keeps you within half a percent (plus or minus) of our 4.1% allocation. If that's not feasible for you, share ownership alone is fine, too; with its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

Jeff's Take on Earnings From 4 Pro Companies

Published Oct 27, 2014 at 3:26PM

Dear *Pro* member:

This is the last time we'll see earnings reports from our companies in 2014. Management from **Coca-Cola** (NYSE: KO) to **Tupperware** (NYSE: TUP) is already talking about 2015, a year that (to me) still sounds futuristic and distant (by 2015, I want a flying robot to pour me coffee, wash the dishes, and teleport me to the office). As *Pro* companies report results, we're seeing pleasing growth at several and a slowdown at others — but all of our companies offer us healthy free cash flow and a stable, solid foundation upon which to grow. We could conceivably leave our long portfolio alone for years and come out well ahead.

We mainly do these quarterly reviews to stay 100% current on our companies, make sure we're not missing key factors, and reevaluate our fair-value estimate and growth expectations. We want to see healthy growth — or the likelihood of it — in our businesses, because lacking that, it's hard to imagine a stock ultimately rising along with our North Star. At the same time, we know growth is not linear. Every company has slow periods. Two of the four we touch on today are cases in point.

Four Earnings Results

Coca-Cola: The beverage giant is like your rich uncle who drives a Rolls-Royce and apologizes for not driving something faster. The world's leading beverage producer, with the planet's largest distribution network, has been on its heels the past few years as it struggles to increase unit volume sales. As thirsty as the world's growing population is, Coca-Cola is struggling to drum up enough new sales in young markets to offset soft soda sales in developed markets. If everything has a season, sugary soda may be experiencing its autumn in the Western world, though it will remain a cash cow for years.

The company has 15 $1 billion brands, including Dasani water, but its total volume was up only 1% in the third quarter, leading to flat revenue. Results were soft enough to make management lower its full-year guidance, and that sent shares down about 5%. Coca-Cola views 2015 as a major transition year. The company is cutting costs deeper than ever, looking for $2 billion in annualized savings by 2017 and $3 billion by 2019. Don't view the company's defensive posture as a surrender, though. Management plans to invest savings in marketing and branding in order to grow. Coca-Cola has such strong assets that we believe the long-term odds remain in its favor. Meanwhile, we're considering writing diagonal calls to earn income on our synthetic long, even though the calls don't pay richly.

OpenText (NASDAQ: OTEX): This enterprise information management (EIM) software company is another story. The need for its services is rising as digital content soars, sending shares 81% higher in the three years we've been owners. Including its business exchange acquisition, GXS, revenue was up 40% last quarter to $454 million. The stock sold off initially because new software license revenue rose "only" 6%, a slowdown compared to recent quarters, although it's still excellent in light of the struggles at competitors **IBM** (NYSE: IBM) and **Oracle** (NYSE: ORCL). (Oracle remains a Buy First for *Pro*. We believe it will emerge strong.)

OpenText has increased its license revenue by 11.9% year-over-year over the past 12 months, even as its cloud revenue rises sharply, too. It argues that customers want their software both on the premises (licensed software) *and* in the cloud. Oracle voices a similar argument, although it's struggling to increase license revenue. OpenText shares remain reasonably priced, and with its industry expected to grow by at least 10% annualized, we believe the stock should continue to outperform over the long haul.

O'Reilly Automotive (NASDAQ: ORLY): Perhaps understandably, the auto-parts retailer inspired the most yawns of any new *Pro* buy in recent years, yet the stock has gained a stellar 73% since the April 2013 *Pro* recommendation (which seems like yesterday). Surprisingly, that buy advice also brought the stock into the Fool universe for the first time. I say "surprisingly" because O'Reilly has been a strong business for a long time: Same-store sales jumped 6% last quarter, and earnings per share soared 22%, marking the 23rd consecutive quarter of at least 15% EPS growth. With locations everywhere across the country doing well, O'Reilly benefits as cars stay on the road longer, miles driven go up, and (now) the workforce grows. Management remains "very confident" in its future opportunities.

What's its secret sauce? It sounds cliched, but O'Reilly credits much of its repeat business to its superior customer service and ability to provide hard-to-find parts. In this business, the sales staff needs to know what they're talking about — which part you actually need — and must have it available quickly. O'Reilly prides itself on being able to deliver on both counts. The stock has revved above our fair-value estimate, but we're taking a fresh look at the financials to see if an update is in order. It may be, because management increased guidance last week, and it now outstrips our own estimates. Meanwhile, as with every stock we own, we still estimate an annualized North Star-type performance over our rolling three-year time frame.

Tupperware: The kitchen tool and storage company is our most notable loser this year; the stock is down 33% year-to-date, putting *our* position down 22%. It may be worth noting that we've made money on Tupperware overall in *Pro,* via our previous position and options; that's not an excuse, but a bit of context when we say we believe we'll make money on *this* position eventually, too. The company's results are more volatile than most partly because sales come from Tupperware parties. If sales reps aren't throwing enough parties, sales suffer. And let's face it: The typical rep waxes and wanes, throwing more parties around new product launches and fewer during holidays (Ramadan lowered results in many countries this quarter).

Tupperware has also been plagued by currency and political turmoil in Venezuela and the Ukraine as well as weakness in India, all of which led to lower sales in these countries. Still, total sales were up 4% as emerging markets — now 70% of revenue — rose by 8%. Tupperware management expects emerging markets to return to higher-than-10% sales growth soon. Both Coca-Cola and Tupperware spent valuable conference-call time describing less confident consumers in emerging markets of late, and that shows up in Tupperware's struggling share price as the stock yields 4.2% and trades at 14.7 times earnings.

We're keeping an eye on Tupperware's debt structure. Although the dividend is safe (the company's payout ratio is around 50%), the dividend won't likely increase this year because cash flow is stagnant. Also, Tupperware's share buyback program is much smaller this year — at much cheaper share prices! — because it, too, is tied to cash-flow generation. That construct all but guarantees the company will buy back more shares at higher prices, and fewer at lower prices, so it's an issue we want to discuss with management when we get them on the horn.

Summed Up

Enjoy today, but of course think longer-term for money you've invested.

In summary, all four stocks remain Buy-rated here at *Pro*. We believe they will increase shareholder value by at least 10% annualized over the time frame that matters to us, a rolling three years. We also know that won't happen without bumps along the way, and in some cases, we'll want to add options to the mix to increase our odds of success. We'll publish valuation updates as they're ready. If you have questions today, please visit us on the Memo Musings board.

Invest on! And Fool on!

— Jeff (TMFFischer)

Anonymous Investing

Published Oct 20, 2014 at 3:11PM

Fellow Fools,

There are people in this world — educated, intelligent people — who believe investors would be better off not knowing the names of the stocks they own. If you're anything like me, your first response to this idea is "That's crazy!" But what if I told you this is part and parcel of a strategy that was used to achieve an average return of 25% a year over the past 12 years and 67% in 2013 alone?

No, this is not an April Fools' joke six months too late. The company responsible for those returns is AthenaInvest, and its co-founder, C. Thomas Howard, is helping spearhead the behavioral portfolio management movement. Howard believes that in order to outperform, investors must "release their emotional brakes," or drive emotion out of their investment decision-making process. Something as simple as a company name can be emotionally laden enough to affect an investor's decisions, preventing them from maximizing their returns. For the same reason, Howard also believes investors should remain blissfully unaware of a position's cost basis if possible. He suggests identifying the few key aspects of your investing strategy and forgetting or ignoring the rest. And he does mean *all* the rest.

The approach may sound extreme, but I believe the underlying rationale is sound. Is there anyone out there who believes investors are better off letting emotion drive their decision-making process? From myopic loss aversion to buying a stock based on a fanciful story that ends up lacking in substance, our emotions can compel us to make some ... *interesting* ... investing decisions. These choices often turn out to be obvious mistakes in hindsight, but seem irresistible at the time thanks to the pull of our emotions. Pets.com, Webvan.com, Flooz.com — the list of firms that went from darling to dud is rather lengthy (and, unsurprisingly, includes quite a few with ".com" at the end of their names).

Cater to the Crowd

Here's the kicker: Even though most people know that mixing emotions with investing creates a dangerous cocktail, very few do anything to keep the two separate. And many aspects of our industry actually exacerbate the problem. Quarterly evaluations of a company's performance, an unhealthy fascination with volatility, constant media coverage of market darlings, real-time quotes that are just a swipe away on our smartphones — these are just a few examples of how our world caters to the emotional investor.

But there is a silver lining. All of this catering to the "cult of emotion" ensures no shortage of opportunities for Foolish investors to construct a portfolio that outperforms their benchmark. In the world of behavioral portfolio management, the emotional crowd dominates the market, not rational investors. This gives rise to behavioral price distortions that are strategy and style agnostic. According to Howard, it doesn't matter if you're a top-down or bottom-up investor, if you're into deep value or high growth, because active investors are all seeking the same thing: Market prices that have become dislodged from reality, often thanks to emotion. Not every road leads to Rome, but there are more than a few that do when it comes to investing.

Consistency, Consistency, Consistency

This means we don't have to adopt AthenaInvest's approach in order to be successful (and it sure would be hard to send you recommendations if we did!). Since everyone is hard-wired differently, they key is to develop a strategy and style that works for you and then stick to it. *Pro*'s are based on the cumulative experience of current and prior team members; they help us figure out what to buy and what to sell, and they prevent us from focusing on the unnecessary and spinning our wheels. Having these two aspects of our investment process so clearly laid out does not result in complacency. Rather, it forces us to demonstrate that any potential modifications will lead to improvements. There are many places where change for change's sake is actually a good thing, but I believe your portfolio is not one of them.

Foolishly yours,

— JP (TMFYossarian)

Pro Completed Trades (see all trade alerts)

- **SPDR S&P 500** (NYSEMKT: SPY): *Pro* bought 17 Nov. 22, 2014, $200 puts for $11.17 each, for a 15% look-through allocation as a hedge.

Pro's Take: Wells Fargo Q3 2014

Published Oct 17, 2014 at 2:38PM

Wells Fargo (NYSE: WFC) posted yet another solid quarter in Q3 2014. The results were typical of what I've now come to expect – excellent credit performance, continued focus on efficiency gains, and steady performance as a result from the company's diversified business model. The company is executing very well in a difficult environment of uneven economic growth and low interest rates, and management continues to take steps to position the company for earnings growth in more favorable environments. In the meanwhile, the company is still incredibly profitable and generates returns (ROE/ROA) that are the envy of its big bank peers.

What Happened?

- Diluted EPS of $1.02 per share (up 3% from Q3 2013)
- Revenue of $21.2 billion (up 3.4% from Q3 2013)
- Efficiency ratio decreased to 57.7% (vs. 59.1% in 3Q 2013)
- ROA of 1.40% (vs. 1.53% in 3Q 2013)
- ROE of 13.10% (vs. 14.07% 3Q 2013

Continued increases in loan/deposit growth and credit quality:

- Record core* loans of $775.8 billion (up 7% from 3Q 2013)
- Record average deposits of $1.13 trillion (up 9.9% from 3Q 2013)
- Net charge-offs as a % of total loans down to 0.32% (vs. 0.48% in 3Q 2013)
- $300 million reserve release** (vs. ~$900 million 3Q 2013)

Capital allocation:

- Share buyback activity continued (diluted share count declined 40.4 million, or 0.8% of total shares outstanding, from last quarter), with more buyback activity expected to settle in Q4
- Quarterly common stock dividend of $0.35 per share (vs. $0.35 last quarter, no change)

Operating segments:

- Community Banking: Net income of $3.5 billion (up 4% from 3Q 2013)
- Wholesale Banking: Net income of $1.9 billion (down 3% from 3Q 2013)
- Wealth, Brokerage, and Retirement: Net income of $550 million (up 22% from 3Q 2013)

*"Core" loans excludes the impact of the non-strategic/liquidating loan portfolio

**Reserve release represents the amount by which net charge-offs exceed the provision for credit losses

CFO John Shrewsberry:

> "This was a strong quarter for Wells Fargo and again demonstrated the benefits of our diversified business model. Despite the low interest rate environment, revenue and pre-tax pre-provision profit increased linked quarter, and we continued to operate within our target ranges for ROA, ROE, efficiency ratio, and capital return to shareholders. We also remain well positioned to benefit from higher rates in the future, and our balance sheet has never been stronger, with higher levels of capital and liquidity, and improved asset quality."

So What?

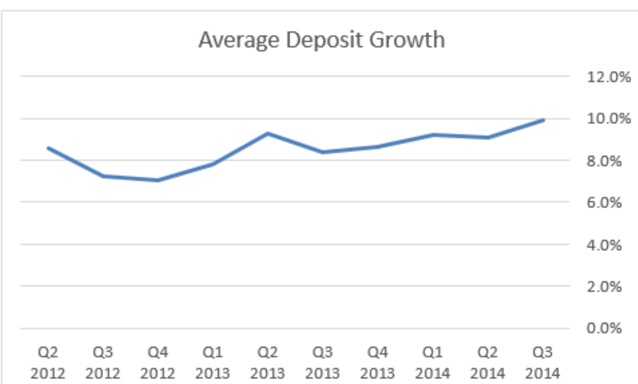
The 3 key items that I watch for Wells Fargo:

- Growth (or lack thereof) in core loans and deposits
- Trends in credit quality (as monitored via net charge-offs and reserving policy)
- Trends in the efficiency ratio and expense reduction

1) Growth in loans and deposits

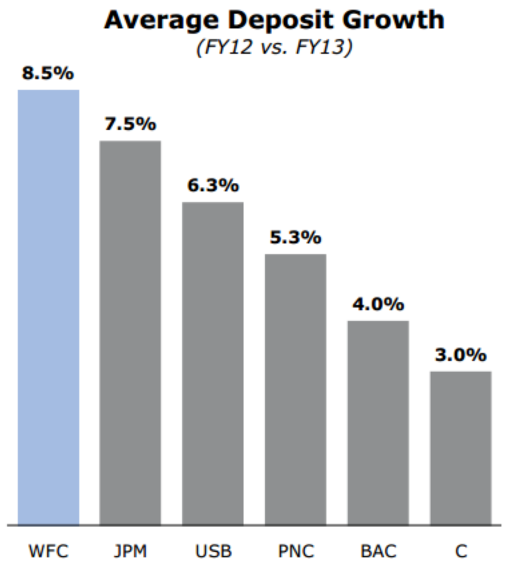
Core loan growth for the quarter came in at 7% year-over-year. This is a very solid figure given the uncertain economic environment, low interest rates, and Wells' continued focus on credit quality, which inherently reduces the pool of potential loanees. When long-term rates rise (who knows when that'll happen), I expect loan growth to really pick up. In the meantime, if the company can keep its loan growth stable or generate modest growth, I'll be happy. Here's a board post with some more info on loan growth this quarter.

As for deposits, Wells again demonstrated its outstanding deposit franchise, with 2.3% quarter-over-quarter growth and 10% year-over-year growth. Funding costs were stable at a rock-bottom rate of 0.10%. If they're only paying 0.10% on deposits, they should be gathering as many deposits as they can, and that's what they're doing. Deposit growth is accelerating in recent quarters:



Source: Company filings, analyst calculations

and is best in class (old data, but demonstrates Wells proficiency in gathering assets):



Source: Wells Fargo 2014 Investor Day Presentation

Wells has been able to leverage its dominant, nationwide branch network presence into strong, low-cost deposit growth. This is perhaps one of Wells' biggest competitive advantages.

Since deposit growth again exceeded loan growth, compression of the net interest margin (NIM) continued, coming in at 3.2% (down from 3.27% last quarter and 3.48% a year ago). I've written about net interest margin compression here. Quick summary is, it's not a big deal and we will likely see NIM compress until rates rise and loan growth picks up.

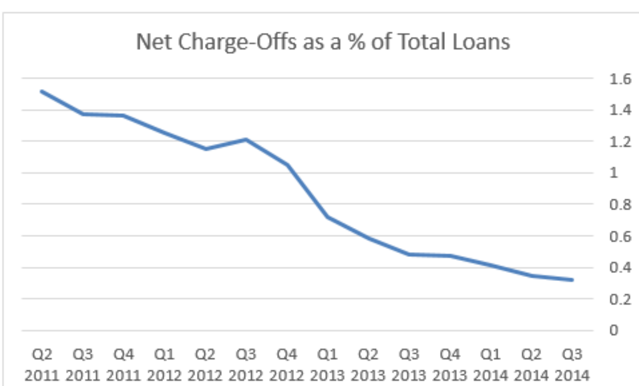
2) Trends in credit quality

Credit quality continued to increase, with net charge-offs as a % of average total loans down to 0.32% (from 0.35% last quarter). Two quarters ago, I wrote:

> "It's impressive how management continues to wring out improvements in credit quality, and it is a testament to WFC's conservative underwriting (one of the many reasons I think WFC is the best-run big bank)"

and that quote still applies now. Quoting myself again (and updating for this quarter's numbers):

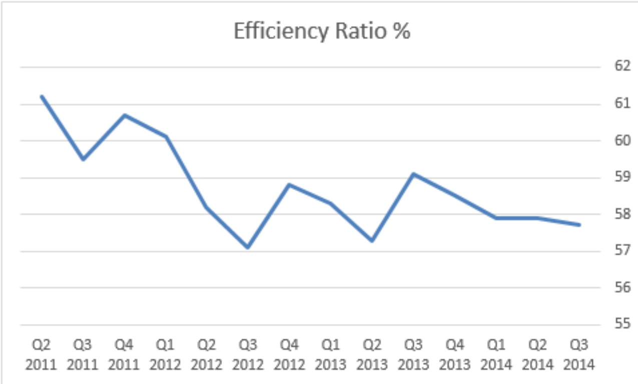
> "Improvements in credit quality are starting to level off (as well they should-the trend in this figure has been unsustainable, as charge-offs can't possibly decline below zero)":



> *Source: Company filings*
>
> "Credit quality improvements should continue to level off in the coming quarters and Wells Fargo will need to find other ways to drive profit growth. The [$300] million reserve release represents about [5%] of Wells Fargo's earnings this quarter (down from [$500 million and roughly 9%] last quarter). See the thread beginning with Dom's question here for some more color regarding reserve releases if you are interested."

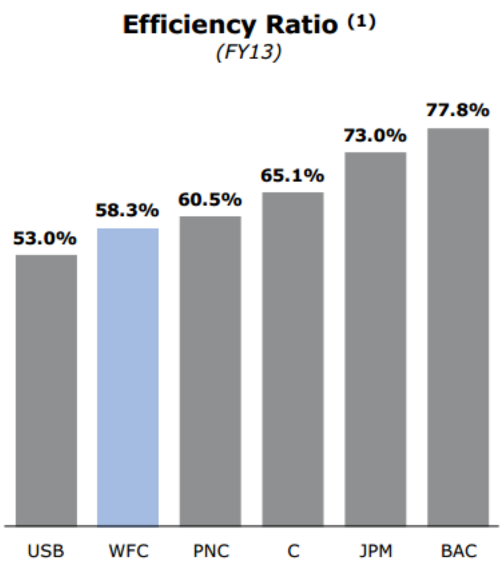
3) Trends in the efficiency ratio

This quarter showed continued improvements in efficiency, with the efficiency ratio (a measure of the bank's overhead costs as a % of its revenue) declining to 57.7% from 57.9% last quarter. Management continues to impress me with their consistency and ability to deliver as they promise with regards to efficiency. Management has stated that their goal is to ultimately get the efficiency ratio down to 55%. I'm confident in management's ability to steadily drive this figure lower over time, although the improvement won't always be linear:



Source: Company filings

Like deposit growth, the efficiency ratio is also very strong when compared to peers (again, old data from FY 2013 but still relevant):



Source: Wells Fargo 2014 Investor Day Presentation

Now What?

I'll quote myself again:

> "Not much different from last quarter (or the quarters before for that matter). Wells Fargo continues to execute its strategy and boast admirable consistency despite a fluctuating and uncertain macroeconomic environment. The company's performance is a testament to its diverse operating model. The company has so many levers to pull that if one segment falls (e.g. mortgage originations) others pick up the slack."

The market wasn't particularly pleased with this quarter's results, with shares trading down over 2% on the day of the earnings release (10/14). Some investors might look at the 3% year-over-year EPS growth and declines in ROE/ROA and be concerned, but I'm not. Consider this – in last year's 3rd quarter, the reserve release (what some might consider a non-recurring item) was ~$900 M vs. $300 M this quarter. If you strip out that $600 M difference in the reserve release, EPS grew 15%. The underlying business results remain strong and the core earnings power of the business remains intact and is poised for eventual improvement.

Data and Guidance

- Current Price (per share): $48.69
- Fair Value (per share): $56
- Consider Adding More (CAM): $44.00
- Market Cap 253.4 B
- P/B 1.54

This quarter's results weren't enough to warrant a change to our $56 Fair Value estimate (representing a 1.77x P/B multiple) or the $44 CAM (1.39x P/B). In the valuation model, increases in book value were offset by slightly tempered ROE assumptions based upon the reduced likelihood of rising interest rates.

Wells Fargo remains a Buy First on our scorecard with a 3.9% allocation, and those who have yet to fill out their position should feel comfortable doing so, especially given the recent decline in the share price.

Fool on!

Billy

Pro Live Chat, October 2014

Published Oct 17, 2014 at 11:03AM

At 1 p.m. on Wednesday, Oct. 29, the entire *Pro* crew — advisor Jeff Fischer; research analyst Billy Kipersztok; research analyst JP Bennett; and editor/publisher Ellen Bowman — answered your questions during a live text chat. Read the transcript below!

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Keeping Your Wings Level

Published Oct 13, 2014 at 3:56PM

Dear *Pro* member,

If you've been with us awhile, you might know that I like to compare portfolio management to piloting a plane. True, I've never actually piloted a plane, but I still think the metaphor is pleasing. To fly, you load up your cargo, go through your checklists, fire up the engines, and lift into the air. To manage a portfolio, you open a brokerage account, fund it with cash, learn what you're doing, and start to invest for growth.

If you've been investing for many years, you may be close to fully invested -- in our metaphor, that puts you at cruising speed, perhaps even on autopilot much of the time. It's rare that you'll want to make large adjustments once you get to this state, but every once in a while, you do.

For example: If you know the right input (say, hedging with a market index), you can lower your market exposure with one easy trade (like the one we recommended today). Similarly, you can simply dial down your altitude in a plane (or so I'm told). Once at a new altitude, you'll get a feel for your new flight path, and adjust again later if you wish. Perhaps you'll want to throttle the engines again with some new buys, or perhaps you'll want to go even softer on the engines by adding to your new hedge. (Yes, I'm enjoying this metaphor a bit.)

Your decision probably depends on whether you're comfortable going through turbulence, or whether you want to try to avoid at least some of it. And this decision must be weighed against the opportunities and risks you see moving past your windshield or on your computer screen.

In flight or in investing, we can't know what our next risk will be. The risks seem to come from nowhere. The goal, then, is to have your portfolio (or your plane) positioned so that it will sail through risk without a dangerous outcome. Nobody can avoid every market decline, but some can fly through them much better than others. They are the pilots who have the highest-quality cargo (the best companies) and whose equipment (portfolio exposure) is tuned to take turbulence.

Enough now with the airplane metaphor. ("Whew," you say!)

On a Hedge and a Prayer (or a Short)

A portfolio is always evolving. In *Pro*, we're working to build our "short book" -- a sub-portfolio of direct company shorts -- so we're able to ride the ups and downs of the market more smoothly, and ideally have gains in both directions.

Beyond company shorts, hedging with market indexes assures that we'll have at least one position (the hedge) making money when the indexes fall. Index hedges also have long shelf lives and (comparatively speaking) limited upside risk compared with shorting stocks. In contrast, direct shorts on companies don't usually last that long. Your gains (or large losses) may occur within months, and then you're often inclined to close the short.

This makes selling companies short a time-intensive endeavor, requiring a lot of jockeying positions, and getting it wrong can be costly. We use our "Buzzard Bait" approach to shorting, outlined two weeks ago, to try to mitigate risk.

So, expect us to continue to both sell short companies *and* hedge indexes, because both offer advantages. In a market meltdown, most of our company shorts should cooperate (because most stocks fall in a meltdown). But in a market downturn of just, say, 10% to 15%, our company shorts may or may not help us -- the stocks may hold up as **Five Below** (NASDAQ: FIVE) has so far. If we have an index hedge, however, that hedge could help us in a smaller market decline. So, by combining index hedges and company shorts, we're better able to cover our bases for both modest market falls and large ones.

If It's for You

You don't need to short or hedge to succeed in investing with *Pro*. By far the most important thing we do here is choose our long-term, core holdings. The stocks we buy to compound our dollars over many years represent the fuel that keeps lifting us ever higher (OK, so I fibbed about the metaphors being over). But as a long/short portfolio, we'll continue to add company shorts and use index hedges, too, to try to soften or avoid the turbulence the market periodically throws our way -- and to enable us to own more core holdings without feeling too exposed.

When severe turbulence knocks other planes down 4,000 feet in a matter of moments, and we dip only 1,500 feet: That's when all the extra work is worth it.

Questions? Visit us on the Memo Musings board. Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades: Oct. 13, 2014

Published Oct 13, 2014 at 2:59PM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking, or on trades where price guidance was due for an update*.

- **MasterCard** (NYSE: MA): The money transaction giant has declined to trade near our $70 fair value estimate. Shares remain a "Buy" with a 4% allocation in *Pro*. Average in over time if you want to spread out your purchases to get to 4%, or sell to open puts for every 100 shares you could buy.
- **Skyworks Solutions** (NASDAQ: SWKS): Volatility in chips has sent Skyworks for a loop. The volatile stock remains a "Buy First" at a 2.6% allocation. You can also consider selling to open puts if you want to target lower buy prices.
- **Tupperware** (NYSE: TUP): Has been cooked and cracked! But it remains a "Buy" at a 3.2% allocation. If you're targeting income and don't mind more exposure, you could consider selling to open January 2015 $65 puts, lately for around $2 each with the stock at $68 (where it yields a 4% dividend).

Buy Puts on the SPDR S&P 500 ETF

Published Oct 13, 2014 at 11:55AM

Is this for you? This is for *Pro* members who have exposure to the market of at least 80%, and who want to lower that exposure with a hedge. You don't need to hedge to succeed long-term, but *Pro's* mission often leads us to hedge to lessen downside risk.

How You Participate

- **Trade:** Buy to open Nov. 22, 2014, $200 puts on the **SPDR S&P 500 ETF Trust** (NYSEMKT: SPY).
- **Allocation:** 15%. With a net start price of about $189.50, each put equates to a nearly $19,000 short of SPY, so buy one put for approximately every $127,000 you manage. *Pro* will buy 16 to 17 contracts.
- **Price Guidance:** Pay time value of about $0.50 or less. If SPY trades at $190, you would aim to pay $10.50 or less for the $200 puts.
- **Recent Prices (11 a.m.):** SPY: $190; Nov. 22, 2014, $200 puts (bid/ask): $10.40/$10.60. (So in this case, until prices change, aim to pay $10.50 or so — meaning $0.50 in time value.)
- **Closest Stock Equivalent:** Short SPY (as a hedge).

What We're Thinking

As of Friday, the S&P 500 was 5.6% below its all-time high. That's an example of the standard volatility that can — and usually does — happen a few times per year. In *Pro*, we generally hedge against larger declines; today's recommendation will start us on that path, see us through earnings season, and be in place during the Federal Reserve's October meeting, when the stimulus is finally likely to be withdrawn.

Elsewhere in the world, concerns exist, as they always do, and they're fairly widespread at the moment. Europe's economy remains hamstrung, and fighting in the Ukraine isn't helping; the Middle East has several hot spots of growing instability; and West Africa is suffering the worst Ebola outbreak in history, with no end in sight and more cases likely around the world. Could any of these affect worldwide GDP growth? Of course. Will they? We don't know yet. However, we can inexpensively lower our exposure to the stock market, keep our long-term investments in place, and be ready to buy great companies at better prices if stocks continue to decline.

How It Fits Into *Pro*

S&P 500 companies earn a majority of revenue overseas, and many *Pro* companies are large multinationals, both of which make us want to use SPY as a hedge this time. The resurgent U.S. dollar may weaken overseas profits and future outlooks for S&P 500 companies, too, further increasing the index as a "reasoned" hedge.

But why purchase in-the-money puts on SPY expiring in just 40 days? A quick glance at the option chain shows you that SPY puts near-the-money are expensive, carrying a lot of time value. This is almost always the case, since there's high demand to hedge with SPY. But we don't want to pay a lot of time value and dilute the effectiveness of our hedge in the process. We would rather buy puts deep in-the-money, pay little time value, and have a hedge that responds to swings in the underlying index quickly and nearly in kind.

As of Friday, the $200 puts have a delta of 0.85, meaning they'll move $0.85 for every $1 change in SPY. In comparison, the at-the-money $190 puts only have a 0.51 delta, offering us a $0.51 move for every $1 change in SPY. That will improve if and when SPY declines, but it will take several dollars in movement to get there. We want something responsive from the start, and with a net short price close to the current index level.

In summary, we want:

- A hedge that is responsive from the start
- One that doesn't require us to to pay much time value

- One that leaves us free to close the trade on any large decline without hindrance (so a bear put spread, for example, is out of the question right now; that said, we may write puts later)
- Capped risk, even if it's $10 per share of risk
- To be forced to revisit the position by expiration just more than one month from now
- Bonus: Buying puts is possible in retirement and regular accounts alike

As of last week, the *Pro* port was 80.1% net long, after years of averaging around 70%. We've been spending our time seeking out direct shorts, but while we work on that, this hedge can help bridge the gap. After adding this position, our net exposure (on a look-through basis) will decline to about 65%. We'll still have about 15% cash that we're able to invest in new longs, and if SPY declines, we can sell our puts for a profit and have even more cash to invest. Meanwhile, we plan to add more direct shorts as we have them.

Finally, in addition, we may manage this hedge incrementally as we go along, adding to it if we add more longs to the portfolio, reducing it if we add more direct shorts, and so forth.

More That Matters

Maximum Reward: Minus any waning time value, the value of these puts will grow indefinitely as SPY declines.

Maximum Risk: The full cost of the puts. If SPY rises about 5.2% to above our strike price by expiration, the puts end without value.

Follow-Up: We'll assess whether we want to keep hedging this way before expiration, and if we want to, we'll effectively "roll" the puts to a later month and potentially different strike price.

Alternative Trades

- **Short SPY directly?** You may if you prefer. We're buying puts instead because it caps our risk at about a 5.2% move higher in the index, and the expiration forces a sincere reassessment soon.
- **Use later expiration months?** You may if you wish; we still recommend buying deep in-the-money puts to avoid paying high time value.
- **Mini-SPY options?** "Non-standard" or mini options exist on SPY, each representing just 10 shares (or $1,900 at the $190 strike) rather than 100 shares. If you're managing less than $127,000, consider using the mini options, buying one mini-put for every $12,700 you manage. Just make sure you want to spend precious capital to hedge.

Pro Can Help

- **Questions on the trade?** Visit our handy SPY board.

Correlation, Diversification, and Risk

Published Oct 6, 2014 at 3:11PM

Fellow Fools,

"Diversification" is a common investing buzzword — and an intuitively appealing concept. To diversify means to minimize nonsystematic (idiosyncratic) risk by increasing the number of unique investments in your portfolio. Worried about the results of a Phase III trial for one or your favorite biopharma companies? How about the ability of a tech firm to develop the next big (or little) doohickey that leaves people waiting in lines for days? If your answer to either is "yes," then it sounds like you could benefit from diversification. By increasing the number of assets you hold that are not perfectly positively correlated, you can greatly minimize these company-specific risks.

But the focus of this particular Memo is not to talk about what diversification can do. Rather, I want to remind *Pro* Fools that diversification is *not* a panacea for all kinds of risk in our portfolio. Diversification does not remove what is referred to as systematic, or market, risk. This type of risk will remain regardless of how many assets we add to our portfolio, and it has a nasty habit of taking control during the most inopportune of times.

Before we continue, let's take a moment to provide a brief refresher on correlation for anyone who needs it. In the world of investing, correlation refers to the historical tendency of two investments to act in a similar fashion. The correlation coefficient of two assets can range from +1.0 to -1.0. If they move *together* 100% of the time, the result is a coefficient of +1.0; if they move in the *opposite direction* 100% of the time, the result is a coefficient of -1.0; and if there is *no relationship*, the result is a coefficient of 0.

Now, many consider correlation to be one of the primary building blocks of portfolio construction. This is because, in theory, by combining investments that are not perfectly positively correlated (anything less than +1.0), one can often reduce a portfolio's expected volatility *without* significantly affecting returns. But (and I'm sure you knew there had to be a "but" coming!) correlation is a backward-looking measure, and volatility is dynamic. There's no rule that says historical correlations must hold going forward, and the shorter your time horizon, the greater the likelihood that the realized correlation will differ from its historical value. During times of crisis or acute market stress, historical correlations tend to move toward 1.0 (sometimes sharply so) as systematic risk takes control and the benefits of diversification start to lessen as prices fall in unison.

Consider the following two correlation matrices. The first presents the correlation coefficients for various S&P 500 sectors from October 2000 until the start of the bear market in October 2007. The latter does the exact same thing for the start of the bear market until its bottom in March 2009. As you can see, 32 out of the 36 correlation coefficients increased during the most recent bear market. And two sectors that sound like perfect candidates for diversification — technology and materials — actually saw their correlation coefficients increase more than sevenfold to +.95!

Correlation Matrix: 2000 — Start of the Bear Market

Sector	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Materials	Tech.	Utilities
Consumer Discretionary	1.00	0.49	0.85	0.92	0.90	0.84	0.95	0.13	0.71
Consumer Staples		1.00	0.59	0.67	0.51	0.78	0.51	0.73	0.87
Energy			1.00	0.90	0.86	0.92	0.93	0.27	0.86
Financials				1.00	0.90	0.94	0.92	0.39	0.86

Correlation Matrix: 2000 — Start of the Bear Market

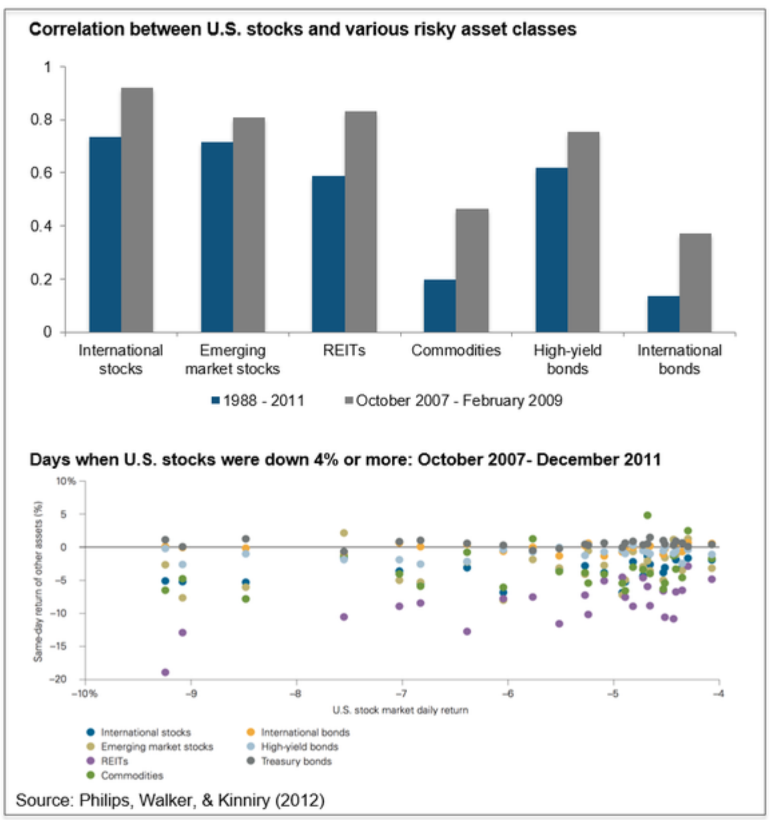
Health Care					1.00	0.83	0.89	0.24	0.73
Industrials						1.00	0.88	0.54	0.93
Materials							1.00	0.13	0.75
Tech.								1.00	0.62
Utilities									1.00

Correlation Matrix: Bear Market of 2007-2009

Sector	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Materials	Tech.	Utilities
Consumer Discretionary	1.00	0.94	0.88	0.97	0.94	0.98	0.95	0.97	0.93
Consumer Staples		1.00	0.89	0.89	0.90	0.95	0.94	0.92	0.91
Energy			1.00	0.81	0.79	0.93	0.97	0.90	0.94
Financials				1.00	0.93	0.96	0.90	0.95	0.91
Health Care					1.00	0.93	0.87	0.95	0.92
Industrials						1.00	0.98	0.98	0.96
Materials							1.00	0.95	0.95
Tech.								1.00	0.97
Utilities									1.00

Sources: S&P Capital IQ, author's calculations.

But let's take a step back and expand our analysis horizon a little. After all, some might argue that diversification among U.S. equities really isn't diversification at all. As the following two charts illustrate, the correlation between US. equities and multiple other risky asset classes also increased during the recent bear market.



Technology and globalization have enabled (forced?) our financial markets to become intertwined to the point where financial contagion is no longer a rare phenomenon. There will always be a few asset classes that do well during bear markets. But Neal Soss (an economist at Credit Suisse) cut straight to the heart of the matter by noting that when you need to sell, "you don't sell what you should. You sell what you can." During times of acute market stress, everything is fair game.

All this doesn't mean we should ignore the benefits of diversification. We simply need to realize that diversification can only take us so far in our quest to continually outpace our North Star target over rolling three-year periods. This is one of the reasons we are constantly on the lookout for attractive hedging opportunities here at *Pro*. Effective hedging not only serves to reduce the volatility of our portfolio, it also puts us in a better position to take advantage of situations where prices have become detached from reality. Remember, a portfolio that falls by 25% has to rise by 33⅓% before it can start setting new highs, while a portfolio that falls 15% only has to rise a little over 17½%. And the latter result gives the investor far more capital at his or her disposal to take advantage of attractive opportunities during market pullbacks.

Foolishly yours,

— JP (TMFYossarian)

Pro Completed Trades: Oct. 6, 2014

Published Oct 6, 2014 at 2:03PM

Pro's recent completed trades:

- **Expeditors International** (NASDAQ: EXPD): Per our recent Catch-Up Trade, we completed the second half of our synthetic long strangle. We sold five more January 2016 $40 puts, and bought five more January 2016 $40 calls, for a net debit of $0.40, bringing our total synthetic long to 10 contracts of each with an average net cost of $0.55. We then sold five more November 2014 $39 puts and five more November 2014 $43 calls, for a combined credit of $1.20. In total, we wrote 10 strangles at an average credit of $1.45. Overall, we set up the whole position for a $0.90 credit, close to the $1 credit suggested on day one. (Today, members can do even better. You can get a $0.10 credit (lately) to set up the synthetic long, and a $1.20 credit to write the strangle, for $1.30 in combined credits. See today's Catch-Up Trades.)
- **Caesars Entertainment** (NASDAQ: CZR): We sold short a 2% position, per last week's trade alert, at $12.02.

Pro Catch-Up Trades: Oct. 6, 2014

Published Oct 6, 2014 at 1:36PM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking, or on trades where price guidance was due for an update.*

- **Caesars Entertainment** (NASDAQ: CZR): In our trade alert last week, we said to initially sell short the casino operate at $12 or above. Our "short around" price remains $12. With the stock now $11.80, that is still an acceptable level to short at; it is still "around" $12.
- **Expeditors International** (NASDAQ: EXPD): You can set up your January 2016 $40 put, $40 call synthetic long for no cost to a net *credit* of $0.10 lately. And then write (sell to open) a November 2014 strangle, selling $39 puts and $43 calls, for a combined credit of $1.20. Sell one of each November option for every synthetic long you set up, up to 3.5% total exposure. For more on this strategy, but with older pricing, please see our original alert.

Sell Short Caesars Entertainment

Published Oct 1, 2014 at 10:55AM

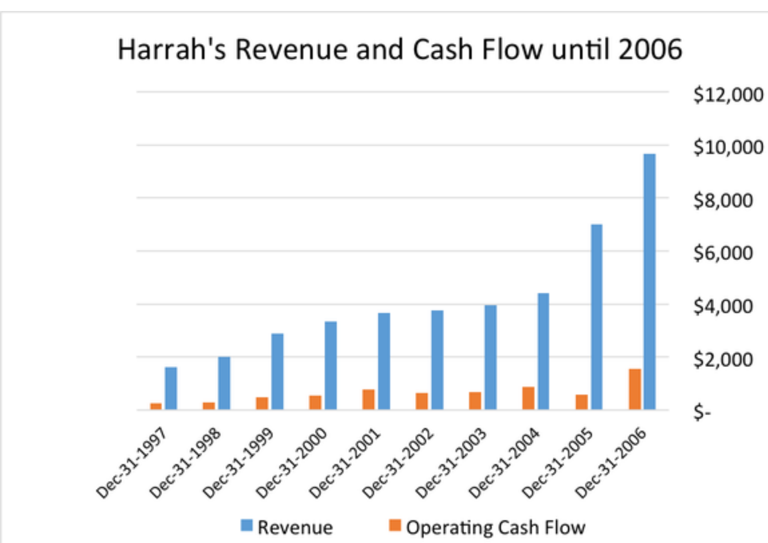
Is this for you? This is for Fools with a margin account and who can locate shares to short with their broker. Prior to releasing this alert, Interactive Brokers had shares available to short (TD Ameritrade requested that an individual inquires with them). Check with your broker to locate shares and inquire about fees involved. Alternative trades at the end of this report suggest using 2016 options. Either way, this trade is only for Fools who don't mind volatility and the special stresses of shorting — this could be a bumpy ride. Remember, shorting isn't necessary to succeed as an investor.

How You Participate

- **Trade:** Sell Short **Caesars Entertainment** (NASDAQ: CZR)
- **Allocation:** 2%
- **Price Guidance:** Use a limit order at going prices. Initially, only short above $12.
- **Recent Price:** $12.65
- **Availability at Interactive Brokers (Sept. 30):** 450,000 shares
- **Current annualized shorting fee (Sept. 30):** 2.375%
- **Percentage of float already shorted (Sept. 30 per S&P Capital IQ):** 29%

What We're Thinking

The saga of U.S.-based casino operator Caesars Entertainment begins during the Age of the Mega Buyout. In December 2006, private equity firms TPG Capital and **Apollo Management** (NYSE: APO) agreed to take Caesars (then known as Harrah's) private in one of the largest leveraged buyouts (LBOs) in stock market history, for a total consideration of almost $30 billion. At the time, Harrah's was the world's largest gaming company by revenue, and business was booming. Harrah's 10-year chart of revenue and cash flow looked like this:



Source: S&P Capital IQ.

In an LBO, the idea is that the private-equity sponsors pony up a small amount of equity (i.e., their own cash) and finance a much larger portion of the purchase with debt, using the target company's cash flows as collateral to secure and repay that debt. The appeal of LBOs is that the private equity companies can use other people's money to earn massive, "levered" returns on their small equity investments, so long as the company's cash flows remain strong enough to pay down their debt.

With a chart that looks like the one above, what could possibly go wrong? Well, you know what comes next. Shortly before the deal closed in January 2008, the financial system started its epic freefall and nearly collapsed, and the economy sank into the Great Recession. What looked like a brilliant idea in 2006 became a fight to pay off creditors and stay afloat.

The same casinos that were once rolling in cash and experiencing never-ending increases in demand were suddenly no longer profitable. When revenue began to drop precipitously, the casino's significant fixed costs remained and the company began to burn cash. Compounding the problem, Caesars was unable to crack into the lucrative Macau gambling market, which has been a big boon to competitors **Las Vegas Sands** (NYSE: LVS) and **Wynn Resorts** (NASDAQ: WYNN) as a way to stem losses from the anemic U.S. gaming market.

With stagnating revenue, massive amounts of leverage due to the LBO, and mounting losses driven by interest expense, the company is in a crippling financial position. As of the most recent quarterly filing, Caesars had only $3.4 billion in cash, more than $24 billion in debt, and greater than $2 billion of annual interest expense. At the current burn rate, the company is set to run out of cash as early as 2015. In its most recent annual SEC filing, the company admits that it can't service its long-term debt on its cash flow alone, so it will ultimately need to take action in some form (including restructuring or refinancing).

With its high-powered private equity backers determined to protect their investment, Caesars is hell-bent on avoiding bankruptcy. As of a May 2014 *Wall Street Journal* article, since the LBO, Caesars has raised new debt or refinanced 18 times, asked lenders to ease terms six times, sold new stock five times, and swapped or bought back debt at a discount 16 times. In our view, this tenacity may finally give way to exhaustion, or the company may run out of options.

Even now, the company is embroiled in legal battles with creditors who allege that Caesars is engaging in illegal asset transfers in order to shield its valuable assets from bankruptcy claims. All the while, the operating business (the casinos) continues to suffer under increased competition, and the sky-high interest expense on Caesars' mammoth debt load persists in crippling the company's financial flexibility.

To a trained eye (or even a blind one), a debt restructuring or eventual liquidation appear as likely outcomes, unless the casino business can somehow find a way to dramatically increase revenue or substantially decrease operating costs in order to improve profitability. Or, unless debtors throw Caesars a lifeline at their own expense, but it seems doubtful that most bondholders would agree to that. With operating earnings (adjusted for one-time items) showing no signs of improvement, we think it's likely that the equity — the lowest tier of capital in the ownership hierarchy — will continue to decline in value.

Buzzard Bait Rundown

Let's run this bait through our 20 criteria. Numbers first:

- **Average daily dollar volume of at least $20 million:** Trade volume has been lower than $15 million per day lately. That's a bit shy as the stock goes down and perhaps trading interest wanes.
- **Market capitalization value of at least $1 billion:** $1.88 billion.
- **Shares short ratio no higher than 35%:** 29%.
- **Increasing diluted shares outstanding the past three years:** Yes, from 125 million shares at the end of 2011, to 144 million last quarter, up 15%.
- **Debt of at least 8 times cash, investments, and equivalents:** Just about. As of June 30, Caesars had cash and equivalents of $3.4 billion, and liabilities of $29.6 billion — $24.4 billion of which was long-term debt.
- **Total liabilities greater than total assets:** Yes. The company is saddled with more than $29 billion in liabilities against $27 billion in assets, the majority of which is property.
- **Interest expense that's 10% or more of revenue:** In the past year to June 30, interest expense was $2.3 billion compared to revenue of $8.3 billion, or 27.7% of sales.
- **At least 350,000 shares available for shorting from Interactive Brokers:** 450,000.
- **A current annualized fee of 5% or less to short:** 2.375%.
- **Relative strength (measured by *Investor's Business Daily*) of 15 or lower:** It's only 5.

Now let's consider the business:

- **Little competitive advantage:** Increasing competition is crimping Caesars' style as more states legalize casinos. Atlantic City is suffering a severe blow from lost Pennsylvanian traffic now that casinos have opened in the fracking mecca. With 52 locations at the start of this year (mostly in North America and England), Caesars has venues and brands that are a draw, including Caesar's Palace, Bally's Las Vegas, and Paris Las Vegas, but many of its second-tier venues are a drag, and competition (including online) is spreading.
- **No pricing power:** Try increasing room rates or (somehow) the cost of gambling, and see how that goes.
- **Little or no recurring revenue:** A casino is making its best customers poorer, and the more the casino cleans up, the more discouraged the customer becomes. That said, Vegas is a popular repeat-visit destination.
- **Negative free cash flow:** Yes, since 2008 — and to the tune of negative $1.4 billion the past 12 months.
- **A weak balance sheet:** $24 billion in mostly high-interest debt against just $3.4 billion in cash and $16 billion in property that may be inflated on the balance sheet.
- **Little optionality in the business:** Atlantic City has dreams of turning itself in a beachfront shopping destination, but the change will be years in the making. And Vegas is Vegas. Caesars can keep opening new riverboats and casinos around the country, but competitors are doing the same.
- **A limited customer base:** In its current form, Caesars mostly depends on big-ticket gamblers and steady visitors to Las Vegas and Atlantic City.
- **Unattractive acquisitive value to other companies:** We believe most of its properties aren't new or lucrative enough to merit buying out the whole business in today's environment. The best properties may be sold to raise cash, though, leaving shareholders with the weakest.
- **A dated brand or way of doing business:** Caesars still has a decent brand, but the whole industry is starting to feel a bit "last century" to us. It could use another refresh, which is expensive.
- **Non-founder management who own little of the stock:** Due to its leveraged buyout, insiders with least 5% equity own about 50% of the stock, with Apollo Management owning 18% and Paulson & Company owning 9%. Rather than being founders of this 1937 company, they're recent investors (levered with others' money). It's gutsy to invest against big firms, but their highly leveraged 2008 gamble could either go well or not, and we believe it will continue to suffer. Their timing may prove too poor to rectify.

How It Fits Into *Pro*

Shorting 2% in what we hope is a Buzzard Bait stock will initially lower our net long exposure by the same percentage, but it's no guarantee that it'll improve our returns in a weak market. Only time will tell. That said, if the economy weakens, so should Caesars' business. We would look to close the short if Caesars meaningfully refinances its debt or can turn profitable again. Barring that, if the buzzards keep circling, we may hold out for a brutal end. We intend to build a basket of direct short positions over time, and this should be just one of several eventually.

Alternative Trades

- **January 2016 Synthetic Short:** We don't want to unnecessarily send you all into the same options, affecting pricing. If you're an advanced options investor, you can set up a 2016 synthetic short using any of strike prices you like. Sell calls, and buy puts at the same strike price, in equal amounts, to mirror shorting. You will start at a deficit to account for the fees of shorting. Keep your look-through allocation to 2%.
- **IRA Friendly?** You can't sell short or use synthetic shorts in an IRA, but you could set up bear put spreads.* Buy higher strike January 2016 puts, and sell to open an equal number of lower strike puts. Your profit potential is the difference between the strike prices, minus the cost to set up the trade. Only risk what you can afford to lose.

Pro Can Help

- Questions? Come on over, high roller, to the Caesars Entertainment board.

**An earlier version of this trade alert incorrectly said "bull put spreads." We regret the error.*

Q&A With William Thorndike, Author of The Outsiders

Published Sep 30, 2014 at 11:04AM

Joe Magyer, the advisor of Inside Value *and* Motley Fool Pro *in Australia, recently interviewed William Thorndike, author of* The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success, *often hailed as the best investing book in years. They discussed what makes for a stellar CEO, which CEOs may be poised for outsize success now, and how investors can spot successes-in-the-making. Read on!*

JOE MAGYER:

Hi, Fools. This is Joe Magyer, and I'm here today with Will Thorndike, the founder of Housatonic Partners and the author of *The Outsiders*. *The Outsiders* is a book that all the cool investing kids are talking about, and in all seriousness, it's the best and most original investing book I've read in years.

Unlike most investing books that focus on either how to get rich quick or how to pick stocks, *The Outsiders* is more focused on a group of super successful, iconoclastic CEOs that delivered huge returns, not just over one, three, five years, but over a span of decades. And for a sense of the scale of research that went into this book, Will's team did more than 100 interviews and studied more than 1,000 company years' worth of financial data while researching this book. So, thanks very much for joining me and talking to us about the book today, Will.

WILLIAM THORNDIKE:

Thanks, Joe, for having me.

JOE MAGYER:

I appreciate your taking the time. I guess a logical place to start would be to talk about Henry Singleton — who the guy is and why he's the best CEO of the past century.

WILLIAM THORNDIKE:

Yes. Henry Singleton had a unique background for a CEO. He was trained as an engineer and scientist. He got his undergraduate degree, master's, and a Ph.D. from MIT in electrical engineering, and for his doctoral thesis, he programmed the first computer at MIT. He subsequently went on to develop a degaussing technology that allowed naval ships to avoid radar detection during the Second World War. He ended up working for one of the pioneering conglomerates in the 1950s, Litton Industries. While he was there, he developed an inertial guidance system that's still in use in military and commercial aircraft.

He was a super-talented engineer. When he was an undergraduate, he won something called the Putnam Medal, which is awarded to the top mathematician in the country. Later in his career, at the age of 43, he founded his own company, **Teledyne** (NYSE: TDY), which grew to be one of the most successful of the '60s-era conglomerates, and in running that business over almost 30 years, he generated exceptional returns: 20% compounded over 28 years.

It roughly doubled the rate of return for his conglomerate peers. In doing that, he developed a whole range of varied, unusual, idiosyncratic practices, including pioneering stock buybacks, never selling his stock, and doing a whole range of things that were unheard of at the time. He was a remarkable figure and the first in this series of chapters in the research project.

JOE MAGYER:

Why is it that despite what is an incredible track record, only a small group of investing nerds actually know who this guy is?

WILLIAM THORNDIKE:

Yes, it is remarkable. He is still relatively unknown. Part of that stemmed from his personality type. He disdained the limelight and was very reticent to spend time with the business press and with Wall Street analysts. In his day, he gave no earnings guidance. He never appeared in Wall Street sell-side conferences and that sort of thing. He preferred to stay apart and focus on building value in his company over time.

JOE MAGYER:

Yes. A pretty big contrast to the CEOs that most people could name.

WILLIAM THORNDIKE:

He would not have been on *Squawk Box*.

JOE MAGYER:

Yes. How did you go about choosing this group? Part of the reason I ask is I know the obvious answer might be the equity returns over a long time horizon, but you're careful to point out, early in the book, that you're focused on folks who were, through the different processes, citizens of Graham-and-Doddsville, and not ideally just being the levered-up survivors of a series of coin flips.

WILLIAM THORNDIKE:

Yes, that's right. Each of the CEOs had to meet two classes. There's an absolute returns test, which says they had to have better returns relative to the S&P over their tenure than Jack Welch had during his 20 years at **General Electric** (NYSE: GE) at the helm. And then they had to materially outperform their peer group.

And in looking at the specific actions that led to that higher performance, by definition, these CEOs were doing things very differently than their peers, but it turned out that the specific actions were remarkably similar across the group. They centered around things relating to capital allocation and more broadly resource allocation.

JOE MAGYER:

I see a lot of *Outsider* tools being used today. Share buybacks. All sorts of creative tax minimization or deferment. One thing I feel I don't see a lot of — but I'm curious about your thoughts on this — is a lot of the underlying principles that made some of these folks so successful. Two of the big ones that spring to mind are frugality and decentralization. Is that just because frugality isn't fun as a CEO?

WILLIAM THORNDIKE:

Yes, and I think those two things, honestly, go together. I think an ethos of frugality in a corporation — usually stemming from a CEO at the top — it infuses a culture and it naturally leads to a bias toward decentralization: the hallmark of decentralization being lean corporate headquarters staffing and often, relatedly, non-fancy corporate headquarters buildings.

I think that in corporate America, there is a natural tendency to want to grow your business. Have the business be bigger. More prestigious. Have a larger corporate headquarters building. Have it designed by a leading architect. Surround yourself by MBAs and generally engage in the behavior that's commonly associated with CEO-ness. This group pretty actively disdained that.

JOE MAGYER:

We have something I jokingly call the Lobby Test where we'll go into the office of a new company we're researching, and if there is a waterfront view from the lobby, we're immediately concerned about the cost management. And it's a surprising number of companies.

In contrast, we're invested in **Sky Network Television** (ASX: SKT), which is the dominant pay-TV company in New Zealand, and it's run by John Fellet, who formerly worked with John Malone. And when we went out to visit with them, we took a cab and keep driving and driving and driving.

We're out in the suburbs and we're surrounded by houses. I'm starting to get angry with the cabdriver. We finally stopped and turned into what looked like a driveway. It turns out Fellet built this office and these massive satellite dishes right out in suburbia, surrounded by homes sitting right next to these massive dishes.

WILLIAM THORNDIKE:

Oh, that's great. I love that. I have a similar story. I grew up around Boston. Of all the CEOs in the book, only one of them is from Boston. It's a guy named Dick Smith who ran a company called General Cinema. And when I grew up as a kid, I went to the movies at one of his movie theaters in a local suburban strip mall.

I went in and out of that movie theater probably 100 times in my youth, and I never realized that the nondescript door to a back office to the right of the theater I used to go to was actually the door to the corporate headquarters for General Cinema. And General Cinema, at that point in time — behind that nondescript door — was the headquarters for a company that controlled the largest **PepsiCo** (NYSE: PEP) bottler in the country, the Neiman Marcus legion of retail stores, and Harcourt Brace, the largest educational publisher in the U.S. The same thing — just extraordinarily nondescript was the headquarters. So, yes. I love that.

JOE MAGYER:

Who are the younger CEOs you see out there today who are succeeding with Outsider-style leadership and capital allocation?

WILLIAM THORNDIKE:

I think there are a number of CEOs who are currently following this path. It would include the Rales brothers of **Danaher** (NYSE: DHR) and **Colfax** (NYSE: CFX). Nick Howley of **TransDigm** (NYSE: TDG), which is a wonderful aviation components company that I know you guys are familiar with. The guy who runs a software company in Canada called **Constellation Software** (NASDAQOTH: CNSWF). The CEO's name is Mark Leonard.

I know you know a group of insurance companies that follow these sort of Buffett principles and are very close to this whole approach: **Markel** (NYSE: MKL) and **Fairfax** (NASDAQOTH: FRFHF) and **White Mountains** (NYSE: WTM). There's a home builder called **NVR** (NYSE: NVR). There's a reinsurance company called **Arch Re** (NASDAQ: ACGL). I recently came across a utility business called **Calpine** (NYSE: CPN) that's doing some interesting things. There are definitely current exemplars out there. We were following this to different degrees. It's been fun to watch that.

By the way, **Valeant Pharmaceuticals** (NYSE: VRX) is a really interesting case as to whether or not the CEO there, Mike Pearson, is an Outsider. Of course, being very much in the news with the **Allergan** (NYSE: AGN) bid.

JOE MAGYER:

One of the funny things about the style of management is that it's easy to look back at a single instance and say, "Well, this was clearly brilliant, and it clearly worked." But at the time, these guys were totally either ignored or they were ignoring other people. As you look at some of these, like the Valeant situation today, there are a lot of people who have strong opinions about whether or not its approach is working. I think you could look at other names like Jeff Bezos of **Amazon** (NASDAQ: AMZN), which a lot of value investors wouldn't consider, but there's a lot of Sam Walton and John Malone there.

I guess what I'm getting at is if you're in the moment of looking for the qualities that you have as an outsider CEO, how do everyday investors go about identifying those kinds of CEO leaders in the here and now? A lot of times they're off the grid or their style is so unconventional that they'd never show up on a screen and you wouldn't see them on television.

WILLIAM THORNDIKE:

That's a good question. And by the way, I do think that the current reaction to the Valeant-Allergan side and sort of the bear case is very similar to concerns that were heard across John Malone's entire career at TCI. There are very interesting similarities there, I think, to the reactions and concerns being raised.

I think, over time, you can assess a CEO's fit with this approach by their actions: by the acquisitions they make, by the stock repurchases. And I think over time what they do, ultimately, is sort of the key guide to whether or not they're following this approach and whether or not they're CEOs that you want to invest with. A marker of this that could be quite predictive is the way they describe — or they think about and describe — their business I think can be very revealing.

And specifically, if they have developed idiosyncratic metrics that they are optimizing the business around, I think that can be a very strong signal of the presence of this sort of worldview, specifically to the degree they're talking about the cash economics of the business as opposed to the broader accounting conventions and expressing those on a per-share basis. Those are the two key hallmarks, I think.

JOE MAGYER:

I love a good, clear, intrinsic value-oriented shareholder letter. They're few and far between, but they're nice to find.

WILLIAM THORNDIKE:

Yes, and I would agree with you. I think Bezos is a very interesting case. I think he is the most Outsider-like by a wide margin of the sort of visionary tech CEO. His letters are great reading and they are very revealing of a highly rational, analytical mind-set.

JOE MAGYER:

Well, as an Amazon shareholder, I love hearing your confirmation.

WILLIAM THORNDIKE:

Yes.

JOE MAGYER:

I have a screen that I run looking for Outsider companies. In a way, it's a waste of time, because the qualities that you're looking for don't as readily show up on the screen. I don't know if TCI would have shown up on the screen. But anyway, we're typically looking for something like shrinking share count and growth in book value per share, just as a rough guide. In the U.S., I'll find 200-plus names and that's great, but when I do the same screen in Australia, I get zero names.

It's not that there aren't any savvy capital allocators in Australia, just that different tax laws have a big impact on how companies go about returning cash to shareholders. Adding the local layer of complexity makes screening for Outsiders feel that much more futile. This all leads to my noticing that there are no international CEOs featured in the book. Was the difficulty in identifying some of these Outsiders who were successful locally but less known in the States part of the reason there weren't any international CEOs featured in the book?

WILLIAM THORNDIKE:

It's a good question, Joe. I would love to include an international name in the book. The reason that I didn't is just data availability. I worked with a group of HBS students in researching the book, and through them I had access to the incredible Baker Library of the Harvard Business School. Unfortunately, the databases there are heavily focused on the domestic U.S. market. So, I think it's something that would be a very interesting exercise. I do think there are examples internationally, and I also think these ideas are much less developed outside the U.S. So there's an even greater, longer-term opportunity over time. I think that's exciting.

JOE MAGYER:

Thinking about either an international version or a second edition where we might see an international name leader pop up, one group that springs to mind is 3G Capital. They've done amazing work with some of their acquisitions. Organic growth, cost cutting, incredibly smart use of leverage. I've really been impressed by those. I'm curious if you've spent any time studying 3G and have any thoughts on them.

WILLIAM THORNDIKE:

Yes. I have spent a little bit of time studying them, and I agree that they share these traits. They remind me a lot of, from the book, Capital Cities. I think there are some very interesting similarities there, and it will be interesting to see, over long periods of time, whether they add the share repurchase arrow to their quiver the way Capital Cities did. But I think they're a very interesting international example. Yes.

JOE MAGYER:

I'm curious. There are Buffett, Malone, and Stiritz who are also out there applying their trade. I'm curious. Do you have any money with the three of them?

WILLIAM THORNDIKE:

I own a bunch of the Malone entities and have for some time. Then I do own **Berkshire Hathaway** (NYSE: BRK-B) shares. I do not own any of Bill Stiritz's shares currently, although I have enormous regard for him. But two out of the three I do own actively.

JOE MAGYER:

Got you. Last one. I noticed in the epilogue that you thanked Charlie Munger for his early encouragement and insights. How much fun was it talking shop and old stories with Uncle Charlie?

WILLIAM THORNDIKE:

Oh, my gosh. That was great. Charlie Munger is such an amazing individual and unbelievably insightful. He was very supportive of this project from very early on. I spent a fair amount of time with him — all of the chapters where he had first-hand experience with the companies. That was really fun. And then after the book came out, I had a chance to breakfast with him in L.A. What a wonderful, gracious, and talented man. That was a really fun part of the project.

JOE MAGYER:

Well, going to the Berkshire meeting every year is a favorite pastime of mine, so I can only imagine sitting down with him. We'll call it there. Will, I really appreciate your taking the time, and I encourage everybody reading ... to simply check out the book. It's a wonderful read. It's the first investing book I nudge people to read these days. Thanks again, Will, and thanks everybody. ... Fool on!

WILLIAM THORNDIKE:

Thank you, Joe. Take care.

Bring Out Your Buzzard Bait!

Published Sep 29, 2014 at 3:56PM

Dear *Pro* member,

In the 1990s, David Gardner offered the term "Buzzard Bait" to describe the type of short-selling candidates we were hunting in the original *Rule Breakers* portfolio. These dismal creatures of Wall Street were stumbling over dusty, barren terrain while a committee of buzzards perched on dead branches overhead, just waiting for a thud on the earth and a last breath. The stocks we wanted to short were Buzzard Bait. The term and the shorting strategy have staying power, and today we're bringing them back to life in *Pro*!

What Is Buzzard Bait?

The biggest defining factor of a Buzzard Bait stock has always been its crippling debt load. We originally defined this as "lower current assets than current liabilities and long-term debt." Today, we'll quantify it further.

Other than that, we sought to sell short stocks (and buy them back later at a lower price to earn our profit) that carried enough market value and daily trading volume to be liquid; and, to give us better odds at success, stocks that sported relative strength of 10 or lower, putting them among the 10% of weakest equities on the market.

Let's add several more qualitative factors today, and refine the quantitative factors. Using the following criteria as guidelines, we seek stocks that we should be comfortable and happy to sell short for a profit when they or the market falls. In fact, I expect we'll recommend our first official Buzzard Bait shorts in *Pro* this week.

Buzzard Bait Qualities

To learn, invert. In a *Motley Fool Pro* core investment, we seek seven qualities: A sustainable competitive advantage; pricing power; significant recurring revenue (typically at least 30% of sales); increasing free cash flow; a strong balance sheet; expanding product possibilities; and a diverse customer base. In seeking a short, we want to get as close to the *opposite* of these qualities as possible:

- Little competitive advantage
- No pricing power
- Little or no recurring revenue
- Negative free cash flow
- A weak balance sheet
- Little optionality in the business
- A limited customer base
- Unattractive acquisitive value to other companies
- A dated brand or way of doing business
- Non-founder management who own little of the stock

Examples that might roll off your tongue could include **Sears Holdings** (NASDAQ: SHLD), which meets most guidelines above. However, given how many people are short that stock already (58% of the float is sold short), and that it lately costs 15% to 25% in annual fees to short it, it would not meet all of our next guidelines — some of which are aimed at protecting us against short squeezes:

Buzzard Bait Numbers

- Average daily dollar volume of at least $20 million
- Market capitalization value of at least $1 billion
- Shares short ratio no higher than 35%
- Increasing diluted shares outstanding the past three years
- Debt of at least 8 times cash, investments, and equivalents
- Total liabilities greater than total assets
- Interest expense that's 10% or more of revenue
- At least 350,000 shares available for shorting from Interactive Brokers
- A current annualized fee of 5% or less to short
- Relative strength (measured by *Investor's Business Daily*) of 15 or lower

Guidelines, Not Rules

The 20 criteria above won't typically *all* be met on any short, but the *more* met, the better. These are guidelines for finding hunched over, tongue-dragging businesses that we should be able to sell short and — the real test — be able to *stay* short through volatility. In the past, criteria less sweeping than these were used to successfully sell short Trump Hotels & Casino Resorts (which went bankrupt after we covered it), Sirius Satellite Radio (which we covered at a profit; it's now **Sirius XM** (NASDAQ: SIRI)), and Movie Gallery (which was shorted to bankruptcy), among others. What will be next on our list? Watch your inbox.

You Don't Need to Short

Before new short recommendations roll out in *Pro*, it's well worth repeating that *you don't need to short to be a successful investor* — just as you don't need to use options, either. You can succeed by owning Foolish long-term stocks alone, such as *Pro*'s core holdings. Those are a portfolio unto themselves. But for those who are comfortable shorting, we aim to populate the portfolio with a *basket* of shorts that net us profits as a whole. This basket will likely come to be dominated by Buzzard Bait shorts, along with others based on criteria we'll also spell out for you.

Questions? Visit us on the Memo Musings board. Fool on!

— Jeff (TMFFischer)

Pro Catch-Up Trades: Sept. 29, 2014

Published Sep 29, 2014 at 12:12PM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking, or on trades where price guidance was due for an update.*

- **Expeditors International** (NASDAQ: EXPD): You can complete your January 2016 $40 put, $40 call synthetic long for a net debit of $0.40 to $0.50 as of today. And then write (sell to open) a November 2014 strangle, selling $39 puts and $43 calls. Sell one of each November option for every synthetic long you set up. Now, you can accept a combined credit on the November strangle of $1.20. For more on this strategy, but with older pricing, please see our original alert.
- **Tupperware** (NYSE: TUP): Shares continue to decline, and remain a "Buy First" with a 3.2% allocation. We have the long term in mind (as always, rolling three years).

Pro Catch-Up Trade: Sept. 26, 2014

Published Sep 26, 2014 at 2:15PM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking, or on trades where price guidance was due for an update*.

- **Expeditors International** (NASDAQ: EXPD): You can complete your January 2016 $40 put, $40 call synthetic long for a net debit of $0.40 to $0.50 as of today. And then write (sell to open) a November 2014 strangle, selling $39 puts and $43 calls. Sell one of each November option for every synthetic long you set up and have not yet covered. Now, you can accept a credit on the strangle of $1.20 or higher. For more, but with older pricing, see our original alert.

A Note From Jeff About Pro's Monday Memo Emails

Published Sep 22, 2014 at 4:49PM

Dear *Pro* members,

You've probably noticed that your Foolish inbox has more color, photos, coverage, and links lately.

That's because our Monday Memo-branded email now includes everything we've published in *Pro* in the past week, including the analysis our team shares with you — day in and day out — on our discussion boards.

That's right, we're liberating our best boards analysis and publishing it simultaneously as articles on the *Pro* website. Sharing this analysis with you on the boards *as well as* in articles helps us also share it with you in our Monday Memo emails. It also helps us archive it for you, so you can easily find all of our thoughts about earnings or guidance changes, for example, in one place on our site.

As part of this archiving project, we're phasing out the phrase "Monday Memo" in our article headlines — because the Memo, as our Monday email communication with you, is much bigger than a single article ... it's *all* of them from the past week!

Overall, our Monday Memo emails aim to bring you more content from *Pro*, of greater variety, with a more timely than ever focus on investing.

We hope you enjoy them!

Foolish best,
Jeff (TMFFischer)

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6 Points on the Pro Portfolio

Published Sep 22, 2014 at 4:21PM

Dear *Pro* member,

Briefly, I wanted to share a few quick thoughts about where our portfolio stands today and how we want to direct it in the future:

- We've done well this year so far, despite none of our hedges helping us. Expirations have irked us, coming up just before bigger market moves like Monday's.
- We've done well since inception, despite being more cautious than most, as we're only about 70% net long. (Well, short-sighted hedge funds aside, which were *very* cautiously buying gold while great businesses had cash flow yields of 7% and higher — ouch!).
- Our returns as of August 31 are 14.1% annualized, while the North Star (which is going to be more relevant when the stock market goes nowhere or down) is up 8.6% annualized.
- We don't want to be greedy and don't want to chase prices that look risky, where those exist.
- In sum, we want to hedge and short more, and leave our longs — that we really like — alone to keep growing over time.
- We want to be really comfortable with our direct shorts and to hedge in a way that doesn't drag on our returns much (or at all, where possible).

So, we need to get to our shorts and hedges now. We've been working on shorts for a long time (and prices are starting to suggest more shorting now), and we've hedged all year (except for now, as our last one just rolled off; we seek a new one).

Finally, regarding our core investments: We always do this, but the last quarter of the year is a good time to go through our positions one by one and make sure we're 100% committed to each. We'll consider whether we want to sell any by year-end for any reason.

Fool on!
-Jeff (TMFFischer)

Five Below's Lukewarm Quarter

Published Sep 22, 2014 at 2:36PM

It was a bit of a ho-hum quarter for **Five Below** (NASDAQ: FIVE). Before Monday's sell-off, the stock was essentially flat compared with where it closed before earnings, and this wasn't all that surprising — the good didn't make us want to run for the hills, while the bad didn't leave us itching to double down on our short position. Let's take a look as some of the notable aspects, shall we?

Stores and Distribution

- Opened 30 in this quarter (49 in the first half of the year) and still targeting 62 stores for the year
- Eight stores were in Houston (a new market), "very strong, similar to Dallas and Houston"
  - Now 26 stores in Texas; still targeting 100 in total
- Signed a lease to build for a new Northeast distribution center
  - 700,000 square feet initially, could be up to 1 million; the location is close to the current center

  - $4 million of the estimated $20 million will be spent in 2014
  - The company's two new facilities together should be able to support about 750 stores

Inventory

- Total inventory on a per-store basis was essentially flat year over year (YoY) and quarter over quarter (QoQ)
- Days inventory outstanding ticked down slightly (1 day) on a YoY basis and fell six days QoQ
- Inventory/total assets was also down YoY and QoQ, though this is still high compared with others in the space
- Management expects inventory on a per-store basis to increase in the double-digit range next quarter

Performance

- 3.2% comparable-store sales growth was driven by the number of transactions (as is almost always the case for Five Below)
  - Weakness was concentrated at the start of the quarter and got better in June and July
  - Comp drivers were sports, games, and technology items
- Forecasting for flat to slightly positive comps for the third quarter compared with 9% comps last year
  - Still forecasting for 4% comps for the year, so that calls for 5% to 6% comps in the fourth quarter on the back of 0.3% in 2013
- The performance of the company's new stores was the reason behind the raise in top-line guidance
- Net sales increased 30.2%, to $152.5 million; adjusted operating income rose 37%, to $13.3 million; and EPS came in at $0.15 — all of which were essentially in line with estimates

A Few Notable Q&A Responses From the Conference Call Q&A

(Head over to our FIVE board to see them all.)

Q: How did the comps trend during the quarter, and why it was weaker than expected?

A: I think part of it we actually planned summer conservatively not aggressively. And if you recall last year, not that I want to go that far back, but with some of the weather issues, etc. that we had coming out of last year, I think its fair to say we planned parts of our summer business a bit conservative.

Q: Why won't the company disclose more about segment variability?

A: Here is what I'd say as far as really being very consistent about our message. We have in the past and we will continue to have variability among category; that's a good thing. This flexibility around the eight category worlds is what makes us special. So when one underperforms, the other steps in because it could be a preference that the kids are choosing to make. It could be product that's changing, and I think it's what speaks to the consistency and performance as you've seen over the last 33 quarters. ... But I will tell you there is nothing that I see in the overall mix of a business and the category/world performances that I'd say is in anyway inconsistent with our performance in the past or that I see anything that I'd conclude or draw a conclusion against future performance. That I think is something we really need to make sure, and really, I welcome your suggestion, because that's part of the reason why I choose at times not to comment on categories because I think it actually may confuse the issue. We love when our customers shift, because that tells us that today's category that maybe is underperforming is a great opportunity the next time the customer comes in or maybe even next year. And trends don't happen in specific categories. They change all the time, and it's that variety of offering, that excitement, and the breadth of offering that gives us the leverage and the engagement that we have with our customer, which drives consistent traffic and drives performance through transactions and traffic.

Q: Regarding store density ...

A: In every one of our states that we were in, we believe there is densification opportunity. Pennsylvania was the first state that we were in. We continue to densify that market still and we will be doing that. I think there is an opportunity to densify across all markets and we really don't get what I'm going to be report a breakout numbers externally, but identification opportunity by market we have the numbers out there and still a potential over the long haul in the 2000 range.

Q: Will the new distribution facility accelerate growth?

A: I will tell you our growth to date I think has served us really well. It's been aggressive enough that we really have, I think, delivered a very good return for our shareholders, for customers that look toward to have more stores in the marketplace. Will there be capacity in the distribution center to handle more stores? Absolutely, and that's why we're building it. I think for now, though, our goal is to continue to manage our growth in the way that we have to date. To continue to manage our performance, remember we could open more stores if we chose to, even to date.

The Foolish Bottom Line

So where does this all leave us? First and foremost this gives me and Jeff more time to take an even deeper dive into the company and its competitive positioning. Extra time is always nice.

Because we're dealing with a high beta stock, the road forward could get quite bumpy. But it's important to try to identify which bumps are because of company fundamentals versus the market movements or investor sentiment. Fundamentals and sentiment have to line up in the long run, but they often become unhinged at various points. That being said, we're always on the lookout for an attractive way to hedge our position because it would be (lowercase "f") foolish to end up in a situation in which we're forced to cover early at a loss because of market sentiment when the fundamentals are really starting to deteriorate.

- Comments or questions? Visit our FIVE discussion board!

Sell to Close Your Long Puts on IWM

Published Sep 17, 2014 at 2:01PM

Is this for you? *Pro* members who *own* September 2014 $115 puts (or other strikes, if you deviated) on the **iShares Russell 2000** (NYSEMKT: IWM) ETF should consider this closing trade by sometime Friday.

How You Participate

- **Trade:** Sell to close your Sept. 20, 2014, $115 puts. (We're letting our $105 puts expire, doing nothing with those.)
- **Price Guidance:** With expiration nigh, take what the market is paying thee by Friday.

- **Recent Prices:** IWM, $114.86; September 2014 $115 puts (bid/ask): $0.80/$0.81.
- **Stock-Equivalent Rating:** Short IWM (as a hedge).

What We're Thinking

As luck would have it, the Russell 2000 ETF is flirting with our $115 strike price as expiration approaches Friday after the market closes. This means the puts we own as a hedge are right at-the-money, and their value is fluctuating considerably as IWM shares bounce above and below $115. This will continue into Friday unless IWM makes a decisive move in either direction.

Should shares of IWM decline sharply, our puts will balloon some in value, replacing their current time value with intrinsic value. Should IWM appreciate and stay above $115, our puts will deflate and ultimately end without value. In the teeth of this uncertainty, all we can really say is: Sell to close these puts for what you can get before expiration, whether you opt to do so today, tomorrow, or Friday.

Two things to keep in mind:

If Scotland votes tomorrow to leave the U.K. on the dance floor all by itself, markets may trip down the stairs on Thursday and possibly Friday. *Pro* personally can't close these puts until 24 hours after this alert goes out, so the Scots' decision will be out by then. If there's a negative surprise, our puts should benefit. If you want to wait and see, wait a day, too.

Second, we're simply letting our short $105 puts expire. However, once you sell your $115 puts, the $105 puts we wrote as part of this spread are no longer "covered," and should IWM decline nearly 10% to below $105, those puts will start to show a loss and become an obligation to buy shares of IWM unless you close them. The odds of the index falling 10% in a few days appears low — but you never do know, do you? So, it may make sense to only sell your $115 puts on Friday, when all is clear, even if that means collecting less for them. Or, use a spread order and buy to close the $105 puts for pennies (just to be safe) when you sell to close your $115 puts.

How It Fits Into *Pro*

You don't need to hedge or sell short to succeed in the stock market over the years (quite the contrary, if you have the resolve to stay invested and buy more during large drops). *Pro* has an absolute-returns goal, though, so it's important that we manage our market exposure. If we're 100% long, we enjoy few to no advantages when the market declines. Given this, we are seeking new hedges (and direct shorts) to keep the portfolio both long *and* short, giving us the resultant market exposure we desire at the time. This is an ongoing work in progress, as always. As this hedge expires, we're on the heels of another one, which will be announced as soon as decided.

Alternative Trades

- **Shorting IWM directly?** Most brokers do *not* have shares of IWM available for shorting, but If you're short IWM, you could choose to stay short as your hedge. We are very likely to use IWM (or its options) in our next hedge, too, and that should be soon.
- **Used different strikes?** You should still sell to close your long IWM puts by Friday, to capture any value they offer.
- **Used later expiration months?** Let the hedge ride as long as you're fine keeping it.

Pro Can Help

- **Questions on the trade?** Visit our always-bubbling IWM discussion board.

Monday Memo: Reviewing Pro's TD Ameritrade Position

Published Sep 15, 2014 at 3:55PM

This Memo is long and involved, but we love this sort of stuff at Pro, and we know you do, too. But if you don't want to read — really, study *— this whole detailed update on TD Ameritrade, then just know that our thesis remains in place, our Fair Value estimate remains $34, and the Earth continues to spin. Now, into the breach we go!*

Dear *Pro* Fools,

After picking up coverage of **TD Ameritrade** (NYSE: AMTD) from Jeff a few months back, I wanted to take some time to familiarize myself with the business and learn its key value drivers. Now that two quarters have passed and I've spent quite a bit of time researching the company, I'm finally at a point where I'm comfortable with the valuation framework that helps guide our Fair Value estimate and Consider Adding More price. I'll use this article to talk about TD Ameritrade's business model, the valuation framework and its key inputs, and thoughts on how I see this position going forward.

The Business

Jeff summed it up well in our original buy report last year:

"Entrusted with $517 billion in assets from retail investors and registered investment advisors (RIAs), discount broker TD Ameritrade hosts 378,000 stock, options, and futures trades on an average day. ... At the same time, TD Ameritrade's partnership with **TD Bank** (NYSE: TD) (which owns 45% of the company) gives it a unique position in its industry. The partnership allows TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank, and with cross-selling opportunities and below-average risk to boot. So, when the current record-low Federal Funds interest rate increases, TD Ameritrade will earn much higher interest income, all of it pure profit. Meanwhile, it continues to focus on job No. 1: Grow client assets, and launch more investment products."

TD Ameritrade now has over $665 billion in client assets, trading activity has picked up (average trades per day over the last year is about 425,000), and the company continues to pile up interest rate-sensitive assets (up to $94 billion from $88 billion last year) that will boost revenue and earnings once interest rates rise. Along the way, the TD Ameritrade increased its regular quarterly dividend by 33% to $0.12 per share, and used excess cash to pay a $0.50 special dividend at the end of fiscal 2013. The increased trading activity along with higher client asset balances have fueled solid revenue and profit growth, with a current revenue run rate of $3.1 billion for FY 2014 vs. $2.8 billion in FY 2013 (about 11% growth). The company now boasts an EPS run rate of $1.41 per share for FY 2014 vs. $1.26 per share in FY 2013 (around 12% growth). This business performance has led to the market bidding up TD Ameritrade's shares over the last year, with the stock price over $33, compared to $25.60 when *Pro* first issued our buy alert last year (good for a 29% absolute price return, not including the $1.07 per share in regular and special dividends we've received).

How TD Ameritrade Makes Money

TD Ameritrade has three main revenue drivers. The first is transaction-based revenue, primarily consisting of commissions and clearing fees on trades. The second is spread-based revenue, which is driven by interest earned on client margin balances, securities lending and borrowing, and insured deposit accounts. This is the portion of revenue that's sensitive to interest rate changes — more on that later. The third driver is fee-based revenue, which is based upon fees earned on company investment products. These three revenue sources make up about 95% to 99% of TD Ameritrade's revenue. Here's the revenue breakout over the last few years, and then I'll dive into each one individually (fiscal year 2014 is year to date, and numbers are as a percentage of total revenue).

	FY 2014	FY 2013	FY 2012	FY 2011	FY 2010
Transaction-Based Revenue	44%	42%	41%	44%	47%
Spread-Based Revenue	44%	46%	43%	45%	43%
Fee-Based Revenue	10%	9%	7%	6%	5%

Source: Company filings.

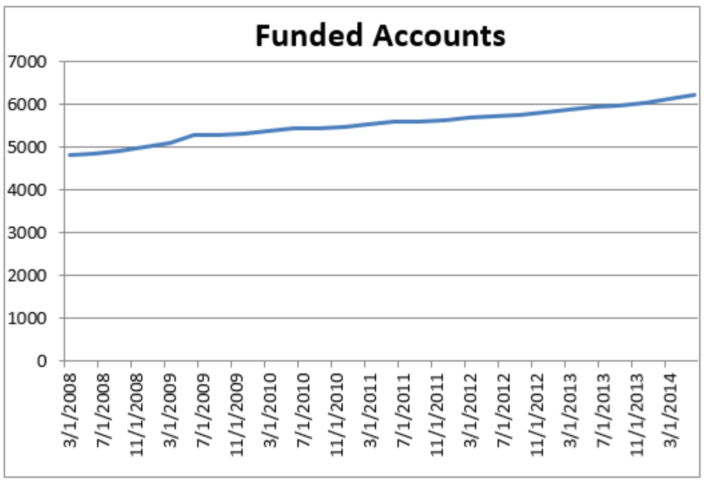
Transaction-Based Revenue

There are three major components that go into transaction-based revenue: the number of funded accounts (open client accounts with a liquidation value greater than zero), trades per funded account, and average commissions and fees per trade. When you multiply those together, you get total transaction-based revenue. Here's what it looks like for the most recent quarter (June quarter for fiscal 2014):

- Funded accounts: 6.24 million
- Trades per funded account: 4.05
- Average commissions and fees per trade: $12.55

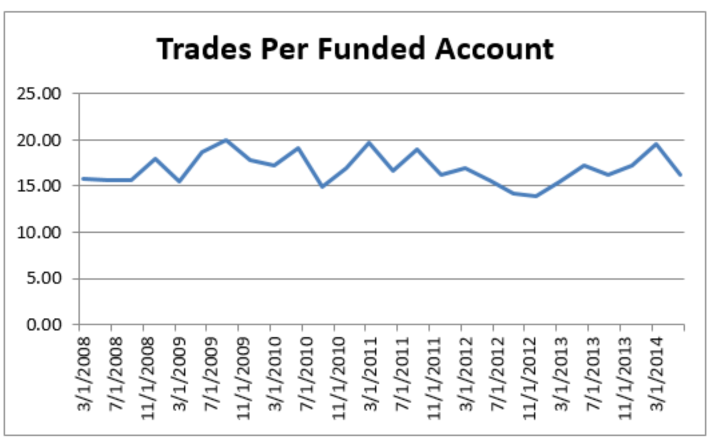
6,240,000 x 4.05 x $12.55 = $317 million

Each component of transaction-based revenue has followed its own trend over time. Funded accounts have grown steadily as TD Ameritrade has continued to attract new customers and retain assets:



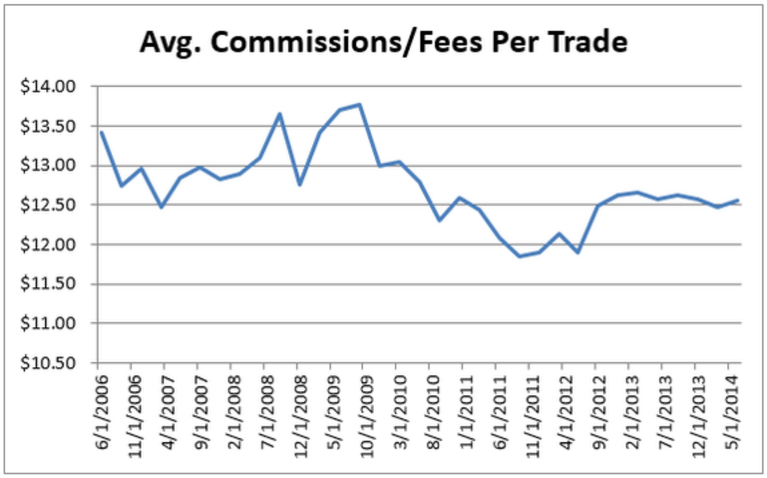
Source: Company filings (numbers in thousands).

Trades per funded account has fluctuated between 15-20 trades (this number is annualized — multiplied by 4 —compared to the quarterly number used in the above example) as investor activity has waxed and waned:



Source: Company filings and analyst calculations.

And average commissions and fees per trade has declined since 2006 as low-cost discount brokers have competed on price, but this has recently stabilized as higher-fee derivatives trading has become a larger portion of trading activity and broker consolidation has mitigated pricing pressure:



Source: Company filings and analyst calculations.

Spread-Based Revenue

This interest-rate-sensitive portion of revenue generation is a bit more complicated than transaction-based revenue. There are two sources of spread-based revenue: interest-earning assets (or IEAs) and insured deposit accounts (or IDAs). The revenue from these sources, taken together, is TD Ameritrade's total spread-based revenue.

Interest-Earning Assets

IEAs consist primarily of client margin balances, regulation-mandated segregated cash, and securities borrowing/lending balances. The predominant source of IEA revenue is client margin interest. If you've ever borrowed money from your broker and bought stock on margin, then you've paid margin interest. In the most recent quarter, client margin interest accounted for about 70% of IEA revenue.

The revenue from IEAs depends on the total balance of the IEAs and the interest yield on that balance. Both of those sources are variable. When bullish sentiment predominates, investors tend to borrow more on margin, which boosts the IEA balance. And the interest yield on IEAs depends on the interest rate environment — when rates are low, the yield is lower, and when rates rise, the yield is higher.

The total revenue earned on IEAs is calculated as follows (numbers from most recent quarter):

Average IEA balance ($18.8 billion) x IEA quarterly yield (0.73%) = IEA revenue ($149 million)

Insured Deposit Accounts

The IDAs are where TD Ameritrade's relationship with TD Bank comes into play. Under the IDA agreement (which can be read here for those who enjoy finance jargon), TD Ameritrade funnels client cash balances to TD Bank and receives an interest-rate-dependent "marketing fee" in return. Generally, the higher interest rates go, the more money TD Ameritrade earns on its IDA assets. The IDA agreement is a win-win for all parties — TD Ameritrade earns low-risk IDA fees on client cash balances, clients have their cash held by an FDIC-insured bank, and TD Bank receives a low-cost source of funds.

The total revenue earned on IDAs is calculated as follows (the numbers are from most recent quarter):

Average IDA balance ($72.4 billion) x IDA annualized yield (0.28%) = IDA revenue $202 million

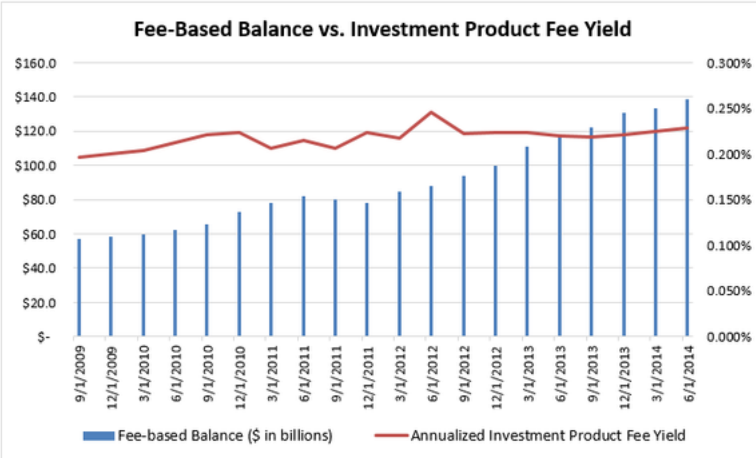
Spread-Based Revenue and Net Interest Margin

Putting it all together, when you combine IEA revenue with IDA revenue, you get the total interest rate-sensitive portion of TD Ameritrade's revenue, or spread-based Revenue. Then, when you blend together the yields on the IEAs and the IDAs, you get a metric called net interest margin, or NIM. When interest rates are higher, NIM is higher. You can calculate NIM as follows (again, numbers from the most recent quarter):

Spread-based revenue ($351 million) / Average spread-based balance ($91.2 billion) = Net interest margin, quarterly (0.385%)

Fee-Based Revenue

The third method of revenue generation is through fees earned on money market mutual funds, other mutual funds, and through company investment products such as AdvisorDirect and Amerivest. Fee-based revenue depends on fee-based investment balances and investment product fee yield. TD Ameritrade has done a good job growing this segment of the business recently, as the average fee-based balance (blue bars in the chart) has increased from less than $60 billion in late 2009 to more than $135 billion today (almost 20% annualized growth), while the average fee yield (red line in the chart) has grown slightly:

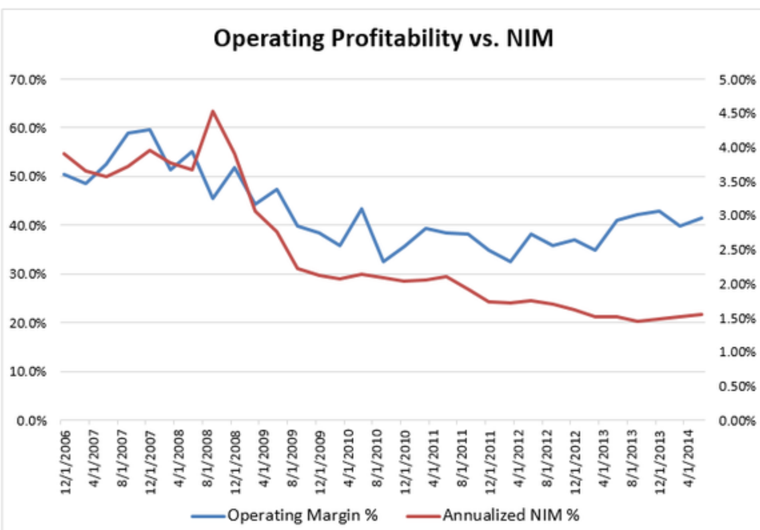


Source: Company filings and analyst calculations.

Valuation

Now, let's talk valuation. Once you understand TD Ameritrade's revenue drivers, coming up with a valuation model isn't terribly difficult, since the company's cost structure is relatively fixed and predictable. We like to say companies like these exhibit operating leverage, and TD Ameritrade is a good example. As revenue increases, costs increase at a slower rate and the company becomes more profitable. Conversely, when revenue decreases, costs stay the same or increase, and the company becomes less profitable.

This is where TD Ameritrade's interest-rate sensitivity comes in. Since the company incurs no incremental expenses in collecting interest from clients and from its IDAs with TD Bank, any growth in spread-based revenue is virtually 100% profit. And since TD Ameritrade's NIM (and thus spread-based revenue) grows quickly when interest rates rise, operating leverage starts to kick in and the company becomes much more profitable. Take a look at TD Ameritrade's operating profitability compared to its NIM since 2007:



Source: Company filings and analyst calculations.

There is a clear relationship between the NIM and profitability. When interest rates are high, TD Ameritrade's NIM is elevated, and its profitability grows. TD Ameritrade achieved peak operating margins of nearly 60% in late 2007, when short-term interest rates hovered between 3% to 5%. When short-term rates fell off a cliff to the current near-zero interest rate environment, NIM fell and operating margins followed suit.

Given the historically low interest rate environment, our investment thesis depends on rising interest rates. As Jeff wrote in our original buy alert, "TD Ameritrade's earnings are very likely at a cyclical low. Believing as we do that the company's profit potential is much greater than recent results suggest, the stock is a compelling buy in anticipation of higher interest rates."

Our valuation model's main assumptions (base case):

- NIM grows from the current 1.54% to a peak of nearly 3% in 2017 as rates rise and then declines to 2% in perpetuity (for context, TD Ameritrade's peak NIM was 4.5% in 2008).
- Operating margins expand from the current 44% to nearly 55% in 10 years (peak operating margins were 60% in 2007).

A 10.5% cost of capital and a 2.5% terminal growth rate in free cash flow gets us to a valuation of $34 per share.

Including some sensitivity analysis, if we assume rates never rise and NIM stays permanently at current levels near 1.5%, all else equal, I get a valuation of nearly $25 per share (which is, not coincidentally, our Consider Adding More price). And finally, if we assume that NIM steadily climbs to 4% over 10 years, then I get a valuation of more than $50 per share. The main lever with this investment is interest rates, and that's the metric we should be watching with respect to our long-term investment thesis.

Of course, as investors, we know the futility of false precision and we can't expect the financials to play out exactly as we assume in our models. But as Jeff likes to say, it's better to be generally right than precisely wrong. So long as the most important variable plays out as we expect (that rates will eventually rise and unlock TD

Ameritrade's latent earnings power), we should be amply rewarded. In the meanwhile, we're happy to patiently benefit from owning a highly profitable, well-managed business that rewards shareholders with regular and special dividends and stock buybacks.

The *Pro* Bottom Line

TD Ameritrade is an interesting component of the *Pro* portfolio. Given the company's interest-rate sensitivity and revenue/earnings volatility, it's a bit of an odd duck among our portfolio of predictable, compounding-machine-like [core stocks](). Nonetheless, in owning TD Ameritrade, we gain exposure to a profitable, shareholder-friendly company that benefits disproportionately from rising interest rates.

If you have any questions, stop by the [TD Ameritrade board]().

Fool on!

— Billy (TMFTailwind)

Your Most Active Conversations

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Pro Catch-Up Trades and Expirations: Sept. 15, 2014

Published Sep 15, 2014 at 11:39AM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking*.

Pro Catch-Up Trades

- **Expeditors International** (NASDAQ: EXPD): We have filled half of our position and continue to target a $0.70 debit or lower, as guided, to set up the rest of our synthetic long. Once we have the rest of the synthetic long in place, we'll sell a strangle on it at the going strangle prices.

Pro September 2014 Expirations

- **Five Below** (NASDAQ: FIVE): Our protective $45 calls are on track to expire without value, with the stock lately at $43. Owners are able to sell for a nominal amount, and should do so if they wish — if it's deemed worthwhile. It appears unlikely, but Five Below's stock could still climb above $45 by Friday. Anything is possible.
- **iShares Russell 2000** (NYSEMKT: IWM): Our put ratio spread expires Friday; right now, our long $115 puts are in the money and have some value. We'll issue a trade alert this week to close and very likely guide to set up a new hedge right on its heels.

Pro Live Chat, September 2014

Published Sep 15, 2014 at 11:03AM

At 1 p.m. on Tuesday, Sept. 16, the entire *Pro* crew — advisor Jeff Fischer; research analyst Billy Kipersztok; research analyst JP Bennett; and editor/publisher Erin Kennedy — answered your questions during a live text chat. Relive the conversation below!

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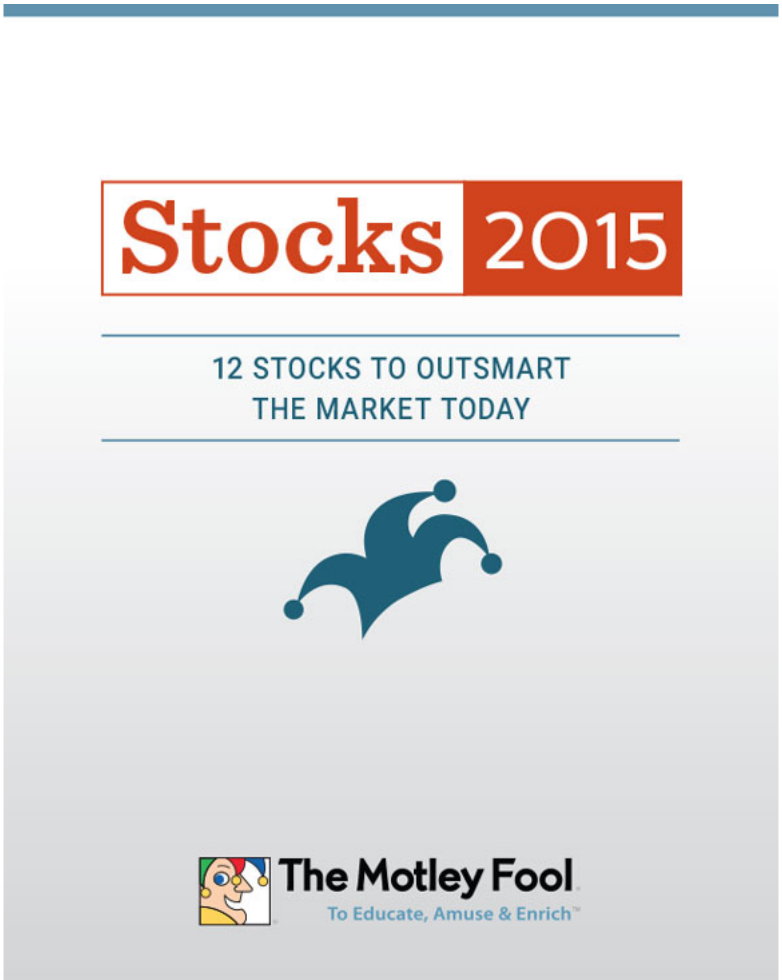
Stocks 2015: 12 Stocks to Outsmart the Market Today

Published Sep 11, 2014 at 2:30PM



Apple Unveils a Bigger Phone, a Watch, and a Payment System

Published Sep 9, 2014 at 5:14PM

I'm sure you've heard plenty about what **Apple** (NASDAQ: AAPL) announced at its release event today, so I'll keep this brief. In short, the iPhone got bigger, the iWatch is real and isn't called the iWatch, and a digital payment service will be available.

iPhone

The iPhone 6 and 6 Plus, as they're called, will have a 4.7- and 5.5-inch screen, respectively. The smaller screen is a 0.7 inch-increase from the existing 5S model. The larger exceeds the Galaxy S5 by 0.4 inches. In addition, the phones will offer improved battery life, camera performance, and display.

Apple Watch

The anticipation for a new product has been relieved by a smart watch. The Apple Watch will allow users to communicate directly from their device and comes in various versions, including 18-karat gold. It will also act as a fitness device. Consumers will have to wait until early 2015 to get their hands (err, wrists) on the watch, which is expected to start at $349. Customers will also need an iPhone (5 or newer) for the watch to work.

Apple Pay

This is Apple's first attempt at a mobile payment platform that could displace the traditional credit or debit card using magnetic strip technology. The payment platform will work on near-field communication technology, which lets a device send a radio signal to a receiver. The service will be able to store credit cards from all the major processing companies. Each transaction is said to be encrypted and secure — an extremely important factor the company will have to ensure. Several major merchants will be able to accept payment via Apple's digital wallet, and the service will be compatible with several apps that are used to accept payment. Each transaction will generate a small fee for Apple, so volume will be the key metric to follow.

The Foolish Bottom Line

I'll start by saying the watch doesn't excite me all that much — especially at $350. However, this is Apple's first advance into wearable technology, so we'll see where this takes the company. We will know more when this thing hits the market and customers can provide their feedback. As for the iPhone, increasing the screen size was a necessary move. I'm a fan of the two sizes, too. The fact is some smartphone users want a bigger screen, and despite the value of Apple's ecosystem, some moved to competing products. With this model, Apple has introduced an opportunity to keep customers who may have been on the fence about screen size — and to win back customers who may have moved along because of the screen. This is a solid move that could help drive market-share gains. I'd also say this slightly extends the phone's market opportunity to those who will only purchase devices with larger screens.

Apple Pay is exciting — if they get it right. This could be a completely new source of revenue for the company. Merchant adoption will be important, but the company has announced that 220,000 can already accept payment, including several big names like Macy's (NYSE: M) and **McDonald's** (NYSE: MCD). Consumers are different, and Apple will have to convince them the process is simple and secure. We are all very accustomed to swiping our cards for payment, and change can be difficult. I see this being a solid opportunity, but they've got to get it right.

Buy Protective Calls on Your Five Below Short

Published Sep 9, 2014 at 11:00AM

Is this for you? This trade is only for members who have a direct short position on shares on **Five Below** (NASDAQ: FIVE). All others should ignore this recommendation, or bring your questions to the Five Below board.

How You Participate

- **Trade:** Buy to open September 2014 $45 calls.
- **Allocation:** Buy one call for every 100 shares of FIVE that you're short; if you're short less than 100 shares, buy one call, assuming you're fine with the $95 cost.
- **Price Guidance:** Initially, use a limit order of $0.95 or lower. If necessary, we'll pay more to trade by Wednesday's close.
- **Recent Prices:** Stock: $42; September $45 calls (bid/ask): $0.90/$1.05
- **Special Notice:** Five Below reports earnings after market close on Wednesday, Sept. 10, so we want to buy this protection before then.

What We're Thinking

Change can be good, sure -- but when it works against us, it's like sand in our water glass. Five Below has been kicking up sand almost since the day we shorted shares in July, with two big events conspiring to drive its stock price higher.

First, **Dollar Tree** (NASDAQ: DLTR) and **Dollar General** (NYSE: DG) have escalated a bidding war to acquire **Family Dollar** (NYSE: FDO). Despite lacking the word "dollar" in its name, Five Below operates in the same low-cost arena (its goods are all priced at $5 or less), so it has been caught up in the news cycle that goes something like this: "If Dollar General is willing to pay $9.1 billion for Family Dollar, what might Five Below be worth?" That's enough to push a stock price higher in a bull market.

Second, Five Below has typically benefited -- as you would imagine -- when shopping center sales increase, and recent reports suggest shoppers are starting to loosen their purse strings. Same-store sales for retail in general grew 4.5% in August, based on the Thomson Reuters index. Discount retailers saw a 6.8% increase, and although teen retailer sales climbed a measly 1.7% in August, Five Below has lately experienced leveraged results above the general trend. That may suggest the company will meet its 3% to 4% guidance for the quarter.

July and August are important months, too, because students are out of school, presumably free to shop, and there are back-to-school sales. Of course, we don't know if Five Below will report pleasing results Wednesday night, but we can cap our risk on the short today and still be positioned to benefit if the company disappoints. Given our 18% loss so far on this volatile, highly shorted IPO, being defensive ahead of results makes sense.

How This Fits Into *Pro*

This small, direct short position entered the *Pro* portfolio with a longer-term thesis. We believe the stock price is rich, competition is growing, and there are some red flags among management and the financials. Additionally, Five Below represents our desired start to build a portfolio of direct shorts to hedge our longs.

However, we're entering a pivotal near-term point for the Five Below bear thesis already, and we're not interested in suffering a ballooning loss. If Five Below reports strong results and healthy guidance on Wednesday, the giddy holiday season isn't far away, and investors may already start to lick their lips in anticipation. Rather than see if that happens and be forced to make a tough decision at a potentially much higher share price after earnings, we'll set up our defense ahead of time and give ourselves more than a week after earnings to decide our next move. The money we'll spend to cap our risk is about 0.04% of the portfolio.

More That Matters

- **Maximum Loss:** On this trade, we only risk what we pay to buy the calls, which end without value if FIVE remains below $45. We also risk further losses in our FIVE short, up to $45.
- **Maximum Gain:** These calls will go up along with FIVE shares, capping our risk at $45 plus our cost to buy them.
- **Follow-Up:** After earnings, we'll decide whether to use our calls to cover our short if FIVE is above $45, or if we want to keep our short (and perhaps hedge it again) if shares remain below $45.

Alternative Trades

- **None.**

Pro Can Help

- Questions? Visit our Five Below discussion board.

Is this the #1 stock across the entire Motley Fool universe right now?

Published Sep 8, 2014 at 2:53PM

Motley Fool co-founder David Gardner has recommended this stock three times in *Rule Breakers*... and his *Supernova* team has even put our company's own money behind it for their Odyssey 1 mission.

Meanwhile, former hedge fund manager Ron Gross has over $75,000 invested in it for *Million Dollar Portfolio* — and recently named it a "Buy First" stock.

But that's nothing compared to our Chief Digital Officer, Jeremy Phillips — who's so blown away by this company's "triple threat" business model that he's personally scooped up $117,238 worth of shares over the past few years.

And not only has Motley Fool co-founder and CEO Tom Gardner recommended this stock to *Stock Advisor* members and bought shares for the Everlasting Portfolio he runs inside our premier, all-access *Motley Fool ONE* service on *four separate occasions*, **but it's actually his *second-largest personal stock holding*.**

In fact, Tom and Jeremy recently sat down to discuss what's got everyone here at Fool HQ so excited about this stock, and as a *Motley Fool Pro* member you're cordially invited to listen in on everything they had to say (simply click the image below to watch their brief "executive summary" now).

Better yet, Tom Gardner and his *Motley Fool ONE* team have offered to give loyal *Motley Fool Pro* members like you access to *an entire week's worth* of in-depth coverage on this stock (and two of Tom's other top holdings) — *at absolutely no cost to you*. All they ask in return is that you simply follow this link and answer a few quick questions.

Cows Are More Expensive Now, Too

Published Sep 8, 2014 at 2:16PM

Pro Guidance Changes

- **AmTrust Financial Services** (NASDAQ: AFSI): Our fair value estimate increases to $40, while the stock remains a Buy. We have a 6.5% allocation.
- **Broadridge Financial Services** (NYSE: BR): Our fair value estimate increases to $43; shares remain a Buy with a 4.2% allocation.
- **O'Reilly Automotive** (NASDAQ: ORLY): Our fair value estimate increases to $140, and the stock remains at a Buy at a 3.6% allocation.

Dear *Pro* member:

Whether it's the worst moment of your 2-week vacation (say, dropping your iPhone in the ocean), or the best moment of your wedding day (that first magical glimpse of the bride... or groom), it's life's highs and lows that often burn into our brains, creating reference points. But one place where giving weight to extremes makes little sense is the stock market. Here, we're not dealing with a living being or a story with a beginning, middle, and end; the stock market is simply a place for buyers and sellers to set prices and make an exchange. Over its history, the market has been incredibly predictable if you merely broaden your scope, climbing steadily over many decades as GDP and earnings have grown.

The market has no end in sight, so referencing market prices -- let alone the extremes --- of yesteryear is nearly as relevant as quoting the price of milk in 1995 to your local grocer. So much has changed; even the cows themselves cost more than they did back then. On a much grander scale, the same is true with the stock market. In the year 2000, **Johnson & Johnson** (NYSE: JNJ) earned $5.2 billion in free cash flow. Over the past 12 months, it has earned $15.8 billion. Of course the business is more valuable today, and unless free cash flow dwindles, why would the stock return to earlier levels?

A Heavy Anchor

In today's market commentary, many are keen on measuring how much stocks have gone up since the March 2009 low, exclaiming we're due for a large drop as a consequence. The intraday market low on March 6 five years ago drums up the most dramatic number the media can use, but never do you hear the context surrounding it. During this time, the S&P 500's earnings were taking a massive nosedive, from nearly $100 per share to less than $15 per share, mainly because financial companies suffered giant losses. The S&P 500 is up 200% since hitting 667 in March 2009, but earnings are up much more, now above $100 per share.

Sensationalism aside, why measure returns from the panic-driven low, as if that capitulation by unfortunate sellers should limit the market's ascent to follow? After all, if you dial back to Sept. 5, 2007, the S&P 500 is up just 36% in the past seven years, well less than average.

Let's play more silly number games.

If you go back to the tumultuous start of this millennium, measuring from Jan. 3, 2000, the S&P 500 is only up 38% in the past 14 years. On this argument, we should be ready for a giant rally!

Or should we? That 38% gain neatly mirrors how much U.S. GDP has grown since the end of 1999: We've seen 30% U.S. GDP growth from 1999 to 2013 (inflation adjusted, using 2009 dollars), and the S&P 500 is 38% more valuable over the same period. The S&P's advantage likely comes from additional international growth and improving margins -- or simply from reinvested dividends.

At any rate, those who are anchoring to March 2009 are on pins and needles waiting for a market decline. In fact, many have not invested at all. And they're right in one sense. We will see a market drop, and odds are, soon. Anytime. But "anytime" could end up being next month, next year, or two years from now. And from what price level to what new price level, we don't know -- but it's hard to suggest another tech implosion like we had in 2000, or a financial debacle like in 2008, when average earnings plummeted. Still, it's easy to be edgy after witnessing 2000 and 2008, and because we live in a world of hyper news.

Valuations Today

So let's rationally step back and look at valuations today. The S&P 500 index trades at 17 times "normalized" expected earnings for this year, and 15.6 times expected 2015 earnings; it yields 1.9%; by comparison, the 10-year treasury yields 2.5%. The index's P/E has enjoyed a long-term average of 14 to 16 since 1900, depending on how you measure it. It has averaged slightly higher during "modern history" (itself an oxymoron, but I digress). In other words, the valuation of the index based on expected 2014 results is not much different from its long-term average. Still, perhaps the market (and many of our stocks) will trade sideways, ultimately, for a year or so, until earnings "catch up" -- that is, unless earnings grow more than expected, or if investors continue to favor stocks due to record-low yields obtainable elsewhere.

In 2000, the 10-year treasury yielded 6.6%, and in 2007, it yielded 4.8%, compared to today's mere 2.5%. Given how little you get paid to park money elsewhere, stocks are the most attractive alternative for anyone who can handle some risk, and since interest rates are not likely to climb much soon, that may remain the case for some years more.

Pockets of Frothiness

Today's missive isn't meant to give stocks a pass. Many do look generously priced, and I see people everywhere making excuses for that (even this column, perhaps?). Analysts are writing to justify free cash flow multiples in the high 20s and up, while we would all be more comfortable if they were in the teens. Some stocks look as rich as whipping cream, though in many cases, those stocks have for years. In *Pro*, we work to make sure that we want to own everything we own, and we seek unique businesses that should do well the coming years whatever the economy does. Recent buys of **Gilead Sciences** (NASDAQ: GILD) and **Skyworks Solutions** (NASDAQ: SWKS) are two examples.

You know *Pro*. We'll also keep hedging and have cash for opportunities. As Billy reminded the team in our *Pro* meeting last week, it's not just how we perform in a downturn that matters, but how we perform throughout an entire market cycle. There are many ways we can take advantage before, during, and after a decline, whenever we're able -- and it's our job to help you do just that.

See you on the Memo Musings board. Fool on!

-Jeff (TMFFischer)

Performance as of 8/31/2014

	Annualized		
	Since Inception	Rolling 3-Year	YTD
Charter Portfolio	**14.1%**	**16.9%**	**10.3%**
North Star	**8.6%**	**8.9%**	**7.1%**
S&P 500 Total Return	13.9%	20.6%	9.9%
MSCI World	8.6%	13%	5.3%

*Start close of 10/6/08.

Pro Completed Trades (see all trade alerts)

- **Expeditors International** (NASDAQ: EXPD): We sold November 2014 $39 puts and November 2014 $43 calls on our synthetic long for a credit of $1.70. Note, we have *half* of our position filled now (five of 10 synthetic long contracts and strangles), all at our guided price of a $0.70 debit to set up the synthetic long, and $1.70 credit to short the strangle. We'll keep trying to fill our last five contracts at these prices, and update guidance if need be.

Your Most Active Conversations

AmTrust Is Movin' On Up

Published Sep 3, 2014 at 5:29PM

The time is finally upon us! Today, *Pro* is finally updating our Fair Value estimate for **AmTrust Financial Services** (NASDAQ: AFSI).

Status: Buy

Allocation: 6.7%

Fair Value Estimate: $40 (up from $30.45)

Consider Adding More Price: $28 (up from $22.27)

Since this equates to a 31% increase in our FV estimate, we thought it might be best to spend a little time discussing everything that went on behind the scenes. Also, if you'd like to know more about my thoughts on my recent call with management and what I think about the future prospects for the company, make sure you check out the AmTrust board for my latest post.

There are two things we would like you to keep in mind when thinking about this dramatic increase in our estimate. The first is that quite some time has passed since we last updated our estimate for AmTrust. When a company continues to at least meet expectations (and it is definitely safe to say that AmTrust has done that), its fair value will increase over time due to the time value of money. The second, and perhaps more significant, reason is that we are now using what I would consider to be a "better mousetrap" to value the business. I use the word "better" instead of "different" because the framework that *Pro* now uses includes much of Bryan's original work in its foundation.

As some Fools may recall, Bryan previously mentioned on the boards that he wasn't completely satisfied with his approach to valuing AmTrust. Soon after my return to the Fool at the end of June, I began having regular meetings with him where the topic du jour was always AmTrust. Though I had been valuing the company on my own, I was uncomfortable with using my framework as the primary method for *Pro* because — to be perfectly frank — I felt that our members deserved far better. In no time at all I was spending the vast majority of my time in and out of the office letting my thoughts be consumed by all things AmTrust related. I even had dreams about valuing AmTrust.

Seriously. *I had dreams about building a model to value AmTrust*. Feel free to make suggestions on the Social Banter board as to what this says about my psyche.

Unsurprisingly, Bryan was eager to lend a helping hand throughout this process and in time we were able to build what I believe to be a better framework for understanding and valuing the company. Though the current market price is still above *Pro*'s new estimate of fair value, we have no immediate plans to change our guidance, as we believe that the company can still achieve North Star-like returns over the coming years from these levels. My tendency as far as valuing a company has always been to err on the side of conservatism when it comes to valuation, because I find it far more pleasing to have my surprises be to the upside.

But don't let the phrase "better mousetrap" confuse you; even though we have made meaningful strides in providing members with a Fair Value estimate that better encapsulates our current beliefs about the company, I will never be completely satisfied with our approach. I am, however, hopeful that we have reached the point where Jeff, Bryan, Billy, the Karfunkel brothers, Barry Zyskind, and GeoInvesting will no longer hold round table discussions in my dreams.

Foolishly yours,

— JP (TMFYossarian)

O'Reilly Automotive Keeps Rolling

Published Aug 28, 2014 at 4:27PM

Greetings,

O'Reilly Automotive (Nasday:ORLY) is reaching new highs as earnings-per-share growth continues to draw in new investors and keeps existing shareholders from selling. We need to keep thinking long term, though, because like most stocks, shares carry a "bull market" valuation (ORLY has long enjoyed a premium) -- but aren't so expensive that we want to sell. Additionally, it's unclear how long ORLY can keep growing EPS as such a faster rate than revenue, although its share buy-back plan shows no signs of abating, and margins can continue to tick higher -- let alone if employment and consumer strength grows. Our allocation is such that we'd be inclined to add on a steep decline. As management summed up, "We remain very confident in the long-term outlook for our industry as we expect to see better engineered and manufactured vehicles stay on the road longer."

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***Pro* Guidance**
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- **Status:** Buy (and/or write puts if wished)(no change)
- **Allocation:** 3.6%
- **Fair Value Est.:** $140 (up from $138)
- **Consider Adding More:** $110 (no change)

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Key Q2 Stats

- Revenue: +7.7%
- Same-Store Sales: +5.1%
- Gross Profit Growth: +9%
- Operating Income Gth:+14%
- Net Income: +16%
- Earnings Per Share: +21%

Results Summary & Notable Changes: O'Reilly continued to benefit from the harsh winter, which continued to drive more repairs in Q2. They're cautious on the summer months, though, which have been mild so far, leading to fewer A/C and other heat-related repairs (although "July was fine.") Guidance increased for the year only on the heels of the strong first half. No notable changes to the strategy, store opening plans, distribution center buildout, long-term opportunities, or outlook.

Management Full-Year 2014 Guidance

- Same-store sales gain of 3% to 5.5%
- Gross margin of 50.9% to 51.4%
- Operating profit of 17.1% to 17.5%
- EPS of $7 to $7.10 (up from $6.82 to $6.92)(excludes more share repurchases)(at $156, the stock fetches 22x guidance)
- Free cash flow of $625 to $675 (up from $580 million to $620 million, but just more in line with our estimate)
- Q3 EPS guidance is $1.91 to $1.95

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Stats
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- Price: $156 (up from $146 last Q)
- Dividend Yield: N/A
- Store Count: 4,257
- Employees: 67,000

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Valuation
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- Market Cap: $16.1 billion
- Cash & Equiv.: $453 million
- LT Debt: $1.39 b
- Enterprise Value: $15.1 b

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TTM = trailing twelve months
NTM = next twelve months

Metric   Multiple
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- P/Sales 2.4
- EV/EBITDA 12.4
- EV/EBITDA NTM est. 11.3
- EV/EBTIDA 10-Yr. Avg.10.8 (includes lows of 2008-2009)
- P/E 23.5
- P/E NTM est 20.2
- P/FCF 22.6

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TTM Cash Flow
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- OCF: $1.124 billion
- Cap EX: $414 million
- FCF: $710 million

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Ratios
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- Gross Margin 50.9% (all trending up)
- EBITDA Margin 19.9%
- FCF Margin 10.9%
- ROE 34.8%
- ROC 21.3%

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Past 3-Year CAGR
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- Revenue 7.3%
- EBITDA 12.9%
- Oper. Cash Flow 7.3%
- FCF 12%
- Net Income 16.1%
- Diluted EPS 27.1%

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Conference Call Notes

o ORLY opened 41 net new stores, for 91 net so far this year, still on track to open 200 by year-end.

o From a macro standpoint, they look forward to the next 18 months. The biggest driver is going to be the health of the consumer, miles driven, and how many people go back to work and start commuting. They'd also like to see a little bit of price inflation (that's good, as we think we will) to help drive top-line sales and more gross margin dollars.

o Renegotiations with vendors are mostly complete and ORLY is happy with the results.

o Margins should continue to tick higher, though not be the big gains of recent years. This is driven by new distribution centers, higher volumes, more efficiencies, price optimization opportunities, and acquisitions.

o Saw modest gains in miles driven as unemployment "very gradually" improves.

o Q2 operating profit grew 94 basis points to 18.2%, a record, but it will mitigate a bit as high-ticket winter repair sales wane.

o Professional customers were again the bigger driver of same-store sales growth, although DIY was strong, too, and ORLY is pleased with its market share gains in both. Overall, the sales mix is at about 42% professional and 58% do-it-yourself.

o Average ticket continues to trend higher due to increased parts complexity and higher costs of repairs; and as the vehicle population continues to age (as cars stay on the road longer), they're selling more parts for older vehicles.

o The company has an adjusted debt-to-EBITDA ratio of 1.81x, while they target a leverage range of 2 to 2.25x. They'll move into this leverage over time.

o They bought back 2.6 million shares at $149 on average, for $389 million.

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What We Think Now (unchanged): *With exceptional management in the driver's seat, O'Reilly Automotive will grow impressively by adding new auto parts stores, acquiring others, controlling costs, and growing same-store sales.*

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- Investor Relations
- Press Release (PDF)

To discuss, please visit our ORLY discussion board.

Best,

Jeff

MasterCard Charged Up to Grow

Published Aug 28, 2014 at 2:19PM

Greetings,

MasterCard (NYSE: MA) reported results that generally pleased investors; shares have trended higher since. More important, results suggest MasterCard remains on a long-term path to attractive value creation.

Pro Guidance
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Status: Buy (and/or write puts if wished)(no change)
Fair Value Est: $70 (no change)(21x FCF)
Current Allocation: 4.2%
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Key Q2 Stats

Net Revenue: +13%
Operating Expense: +14% (acquisition related increase)
Earnings Per Share: +14%
WW Gross $Volume: +13% (local currency basis)
U.S. GDV: +9%
Volume Growth X-US: +16% (local currency)
Cross-border Volume: +16% (")
Processed Trnsactns: +12% to 10.6 billion
Card Growth: +8% to more than 2 billion

Results Summary & Notable Changes: The company still sees a soft worldwide economy, and August started soft. Still, net revenue grew 13% and the company continues to target at least mid-teens growth. Management is investing in acquisitions and this added three percentage points to operating expense growth this quarter. This will moderate. MasterPass, the company's digital acceptance platform connecting consumers and merchants, should be in all major markets in two years. Making it simple to use MasterCard online is important as digital payment competition grows.

Overview
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Recent Price: $76
Dividend Yield: 0.6%
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Valuation
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Market Cap: $86 billion
Cash & Equiv.: $5.7 b
LT Debt: $1.5 b
Enterprise Value: $81.8 b
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Metric **Multiple**
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EV/EBITDA 16.2
EV/EBITDA NTM 14.6
P/E 27.7
P/E NTM 23.7
P/FCF 23.4
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TTM Cash Flow
========================
OCF: $3.8 billion
Cap EX: $146 million
FCF: $3.67 billion
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Ratios
========================
EBITDA Margin 58.7%
FCF Margin 40.7%
ROE 49.5%
ROC 41.5%
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Past 3-Year CAGR
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Revenue 13.8%
EBITDA 17.3%
Net Income 16.2%
Diluted EPS 19.7%
Oper. Cash Flow 21.1%
FCF 26.1%
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Conference Call Notes

o Q2 SpendingPulse data showed U.S. Retail sales (ex-automobiles) grew 3.8%, up from 2.3% in Q1. However, the trend slowed as the quarter went on (partly on lower fuel sales) and MasterCard still thinks "the U.S. economic recovery is very much a work in progress."

o European volume growth was in the low teens, with transaction growth in the high teens, with growth driven by Russia, Turkey, Sweden, Italy. Latin America remains soft, and Asia Pacific, Middle East and Africa continue to do well, with processed transaction growth remaining about 30% and GDV growth in the high teens.

o Mobile is "one of the most significant changes in our space," as consumers shift from physical (card based) to digital payments. Along with working with Samsung and other mobile-point providers to integrate MasterCard-branded digital payments, MasterPass is now running in 10 markets and should be in all markets that represent about 75% of MA's total volume in two years. MasterPass geographically is well ahead of Visa's comparable technology so far.

o In the last two years, MA has launched more than 100 new programs to bring access to more than 350 million people who lacked financial products like prepaid cards and mobile payments -- this is MasterCard's "financial inclusion" initiative.

o U.S. Debit growth was 9%; and U.S. credit had strong volume growth of 10%. Outside the U.S., double-digit growth in transactions continues in most regions.

o Europe remains "an enormous opportunity" given that, outside of the Nordics, so many transactions are done in cash.

o This is less relevant now as 2015 approaches, but it suggests better growth directly ahead: MasterCard still believes that it will deliver 11% to 14% net revenue CAGR growth and at least 20% EPS CAGR between 2013 to 2015. We're half-way through this time period, and EPS growth will need to strengthen a bit.

o Recent acquisitions include DataCash, Access Prepaid, and the five done this year alone: Provus, C-SAM, ECS, Pinpoint and HomeSend. MasterCard usually partners with other companies for years, and only acquires them later once they find value in the product. These acquisitions largely target mobile and digital growth. The latest five will dilute EPS by about $0.06 to $0.08 this year. That's already in guidance. There are other possible deals in the hopper. Dilution in 2015 should be about half as much.

o MasterCard is growing rapidly in emerging markets, but there are different yield structures in many of them. You have to align your pricing structure with the local scenario. First, newcomers to cards use ATMs most (withdrawing cash to go make purchases); those are lower-yield transactions for MA. These users migrate later toward debit card and then credit card use. Right now, MA is still in the lower-yield phase of many emerging markets.

o The U.S. Chase account continues to roll off to Visa, and should continue to be a headwind the next few quarters, but that's already in guidance and estimates.

o MasterCard's main goal is to grow the franchise and grow revenue. They want to grow usage and they'll provide rebates -- pricing benefits -- to do so. (It sounds like they're being less strict on rebate levels in order to grow market share -- a long-term approach we don't disagree with; MasterCard has plenty of margin strength to share, but we will watch that margins hold up as they help the shares afford the premium valuation they enjoy on Wall Street.)

o CEO Ajaypal Banga's closing words: "There's no shortage of growth opportunities in our business, frankly. And while our investments are having an impact on our (operating expenses) right now, we believe that we are investing in a thoughtful way that ensures continued top-line growth and good long-term returns for all of you who invest in our stock."

What We Think Now *(unchanged): MasterCard's global network is a financial toll road that takes a small slice of each transaction. Though there are many established and upstart competitors, the world leader is cash with 85% market share, representing plenty of room for MasterCard to grow by offering a more convenient alternative.*

To discuss, please visit our MasterCard board.

Best,

Jeff

The Buckle Is Hangin' Tough

Published Aug 26, 2014 at 12:34PM

Pro's Take: BKE Q2-2014 Earnings

The Buckle (NYSE: BKE)

Quarter Quick Take

While The Buckle's year-to-date results are uninspiring in an absolute sense, the company continues to perform dramatically better than its mall-based, teen retailer peers thanks to its better operational execution, middle-of-the-road fashion assortment, and more loyal customer base. The Buckle grew net sales +1% due to a net six new stores during the quarter and a +2% rise in online sales. Store-level performance remains resilient: same store sales declined only -0.5% and merchandise margins held steady. Fewer shoppers are coming into Buckle stores, but the ones who are purchased more and higher priced items, which contributed to the respectable sales per store performance and down-tick in average inventory per store. While the ramping contribution from footwear and accessories appears to have matured, the next multi-year leg of growth we are monitoring is expanding youth merchandise. On a positive note, management commented that development of a digital rewards program continues and it should be rolled out next year.

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Q2-2014

Revenue growth: +1%

Operating profit margin: -50 bps to 16.4%

EPS growth: -3%

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Guidance Update

The Buckle's results were very respectable given the current apparel retail environment. Our expectations for the company over the next decade are modest, so a year or two of challenging industry or macro headwinds doesn't throw our estimate of value into a tizzy. The Buckle is a Buy and is Pro's smallest holding at 2.5%. I believe shares are worth $53 and are undervalued. With about $4.75 in extra cash per share, I suspect the board could elect to pay a $1-$2 special dividend, which we will likely hear about in September.

Updated guidance: Buy (no change)

Recommended Allocation: 2.5%

Fair Value estimate: $53 (no change)

End of Fiscal Year expected FV estimate: $55

CAM price: $37 (no change)

Shares normally trade in a range of 6-9x EBITDA (currently 7.4x) and I'd look to write puts for an effective buy price around 6x, which is our CAM price.

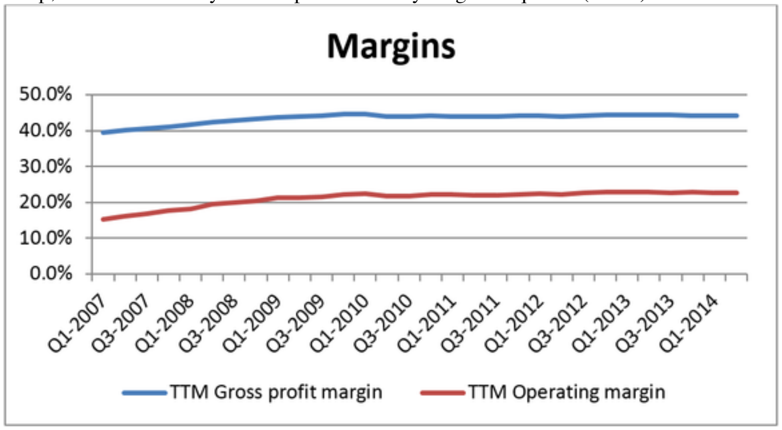
Our Thesis

The Buckle offers retail exposure with low fashion risk (jeans and tops). Its management team is properly incentivized, has meaningful ownership, and run the business wonderfully well. We expect measured growth from store openings, online expansion, and expanded merchandise assortment (footwear and children's clothes). We are not expecting dramatic operational improvements, but we believe in-house brand penetration and an improved online experience are opportunities. The Buckle should grow its earnings, pay a regular dividend, and we expect it to pay out excess cash distributions (more years than not).

The Most Important Things

1. ***Store Performance***: Same store sales, sales per square foot, store sales per store, and invested capital per store are all worthwhile metrics to assess store performance. The reason The Buckle has generated so much value over the years is because it has been able to sell more (profitably) through each store without having to invest much more. And while same store sales growth is noisy, it is consistently positive. On a trailing twelve month basis, store sales per average store (excludes online sales) declined marginally. This marks the fifth consecutive trailing twelve month decline in this key metric. While the trend is negative, it isn't a surprise given the current operating environment, and the absolute decline is only -4% -- and that is off of the highest mark ever. A revival in traffic is the most likely cure for reversing the ebb in sales per store.

2. ***Operational Acumen (margins and inventory):*** Retailer gross margins and inventory levels expose whether or not merchandise selection is on the mark: if you've got items nobody wants you either have to put it on sale (which will ding gross margins) or let it sit on your shelves (which will ding inventory turnover). Historically, The Buckle has merchandised well, and margins have risen steadily. In Q2-2014, gross and operating margins declined slightly, but on a trailing twelve months basis remain above 44% and 22% (respectively -- see the chart below). Margins remain steady but further improvements will be tough to come by. Inventory days ticked up, but remain healthy. The surprise inventory bulge last quarter (+13%) was corrected without sacrificing gross margin – a testament to operational acumen.



WWTN

The Buckle is holding steady in a difficult apparel retailing environment. Even at lower per-store sales and profitability we think opening new stores still makes sense for The Buckle. The company's modest valuation and still-small store base, combined with brilliant operational execution point to upside in the shares. With almost $5 per share in cash and investments and the biggest cash generating quarters still to come, another special dividend is likely.

Conference Call Notes

- On sales: Sales were up +1% in Q2 and up +1% in 1H. SSS held up, with a -0.5% mark in Q2 and a -0.7% mark in 1H. Men's sales outperformed women's and growth in footwear and accessories moderated. Online sales were up just a bit and have risen +2% so far this year. Still, online sales represent <10% of Buckle's total sales.
- On expenses: Merchandise margins held steady, but the decline in SSS hurt gross margins a bit. Selling expenses were up just a touch, but G&A largely offset that.
- On inventory: Inventory was down -4% year-over-year and inventory per average store was just about flat.
- On CapEx: CapEx for the 1H was $23 million, with $17 million going toward new stores construction, store remodels, and store technology upgrades, with the remaining $6 million going to corporate and the build of a new office building. For the full year, capital expenses should come in at $48 to $53 million. At the end of the quarter, 356 of 456 stores are in the newest format.
- On transactions: UPTs increased +2%, the average transaction value increased +4%, and the average unit retail increased +2%. Seeing this next to the SSS and net sales performance suggests that fewer shoppers are coming to the stores, but the ones who are coming, are buying a bit more.
- On denim: Average denim prices rose a bit for men's and women's.
- On private label: As a percentage of sales, it was flat, at 32%.
- On expansion plans: The strategy continues as it always has: look for the best opportunities without artificially setting a goal number of new stores or desired location – let the opportunities dictate the pace and location of growth. CEO Dennis Nelson said: "*We will continue our strategy of looking at the opportunities and what makes sense for us and where we see the retail markets going in the future to decide new stores, and not set a planned number of stores and then work to high that number.*"
- On the current environment: CEO Dennis Nelson: "*I think the promotional environment continues to be pretty much the same as we've seen it for a while. Maybe even a little more. That's why we work with our exclusive and developing our own brands and really having fashion and details that other people – the way we see a lot of them is that they're just trying to hit the lowest price and sell by price. And we're looking at the total idea of fashion, style, comfort, and to give the exclusive product. And we also work with our brands as well to develop exclusive product that is special and gives the guest a reason to want to buy.*"

Pro's Historical Performance With the Brand New vs. the Tried and True

Published Aug 25, 2014 at 4:07PM

Pro Guidance Changes

- We raised **Gilead Science**'s (NASDAQ: GILD) Fair Value estimate from $105 to $110 after reviewing second-quarter 2014 results.

Dear *Pro* Fools,

A few days ago, Jeff wrote that as a portfolio grows, your new positions must be larger in order to maintain the same position sizing. In other words, a 3% position for a $1 million portfolio is $30,000, but a 3% position for a $2 million portfolio is $60,000. Your stakes (in dollars) get higher, but your return profile on a percentage basis stays the same. "So," as Jeff put it, "your new ideas better be good."

Jeff's post reminded me a bit of an oft-quoted Peter Lynch investing principle. Lynch ran the Fidelity Magellan fund from 1977 to 1990 and earned a 29% annual return over that period, and one of his principles was "The best stock to buy may be the one you already own."

Enjoy Labor Day, Fools! The Monday Memo will be taking the day off next week. Stay tuned for our next Memo on Sept. 8!

Lynch's popular principle, Jeff's board post, and *Pro*'s recent new position in **Skyworks Solutions** (NASDAQ: SWKS) made me wonder: What is *Pro*'s historical performance on brand-new buys compared to *Pro*'s historical performance when it adds to existing positions?

The Experiment

I decided to run an analysis on *Pro*'s historical stock purchase activity using data beginning with *Pro*'s inception in October 2008.

The fine print: I only included simple stock purchases and sales in the data set, and I did not include any stock buys that were associated with options strategies for income (e.g., covered calls or strangles) at the outset. I also excluded any active stock positions that have been in place for less than a year (to eliminate noise from calculating annualized returns on short-term positions) and I excluded any positions that were outside of the equity asset class (e.g. ETFs).

Before running the analysis, I hypothesized that *Pro*'s performance was likely better when it was adding to existing positions. I reasoned that *Pro* is better able to leverage existing knowledge on positions it has followed and analyzed for some time.

After inserting the data and crunching the numbers, here's what I found.

The Results

	n =	Average CAGR*	Average Holding Period (Years)
All Buys (New and Add More)	54	25%	2.1
New Buys	39	22%	2.2
Add More	15	33%	1.8

*CAGR = compound annual growth rate.

As I expected, it turns out that *Pro*'s performance when adding to existing positions is indeed better than when *Pro* initiates a brand-new position. Since inception, *Pro* has made 54 equity purchases, averaging an impressive 25% annualized return while holding those positions for an average of two years. But when we drill down further, we can see that on our 39 brand-new buys, the average annualized return is 22%, while on our 15 purchases where we added to existing positions, our average annualized return is an astounding 33%.

The Even Finer Print

Although this analysis is interesting, it's important to view the results in context. The calculated returns are simple averages and do not account for portfolio weighting/position size. Since *Pro* is a real-money service, a purchase with an allocation of 5% has a much greater impact on the portfolio than a purchase with an allocation of 1%. This analysis disregards the impact of position sizing, so it distorts the true impact on the *Pro* portfolio's actual returns.

Additionally, *Pro* often employs options strategies (e.g., written puts, covered calls, strangles, etc.) on positions that were initially established as simple stock purchases. This data ignores the effects of options strategies on position-level returns. In reality, *Pro* manages its positions with an eye on both simple stock returns *and* accompanying options activity. Interpreting only the stock portion of position-level returns misrepresents the way *Pro* actually works.

Nonetheless, this analysis can serve as a simple barometer for how good *Pro* is at starting new positions compared to adding to existing positions. As I hypothesized, one likely reason for the outperformance of "Add More" purchases is that *Pro* is able to use existing knowledge on active positions and can react to market conditions with greater confidence.

On existing positions, the analyst or advisor is likely already familiar with management, the competitive environment, typical trading ranges and valuation multiples, as well as any other criteria that might help decide when adding to a position is attractive. With more subtlety and nuance embedded in the decision-making process, those picks have a higher likelihood of outperformance. In contrast, for new positions, the analyst or advisor likely doesn't have the benefit of having followed a company closely for several quarters, as they would if it were an active recommendation.

As an example, let's look at the case of **Gentex** (NASDAQ: GNTX). Gentex was brought into the *Pro* portfolio in [May 2012](). If you bought shares that day, you were able to buy at a dividend-adjusted price of about $21.88. At today's pre-market price of $29.22, that's good for about a 34% absolute return in 2.2 years, or about 14% annualized, handily topping our North Star.

However, in late July 2012, just a few months after the initial purchase, Gentex shares got slammed after releasing bad news during earnings, declining 29% in one day. After [thoroughly analyzing the market's reaction](), *Pro* recognized that the stock price decline was likely too harsh. Shortly thereafter, *Pro* officially added more to its Gentex position, issuing an alert in early [August 2012](). If you bought in that day, you were able to buy at a dividend-adjusted price of around $15.18. At today's pre-market price of $29.22, that Add More purchase has an absolute return of 92% in 2.1 years, or about 37% (!) annualized. Gentex is a great example of how adding to an existing position at an opportune time can lead to very strong outperformance.

The Foolish Bottom Line

This analysis shows the benefit of leveraging existing knowledge when adding more to an already-active position. It's very easy to be tempted by the fresh recommendations that offer novelty and the excitement of learning about a new company. However, in *Pro*'s history, although we're pretty good at initiating brand-new positions (averaging 22% annualized returns), we're *even better* at adding to existing positions (averaging 33% annualized returns). So the next time *Pro* decides to Add More, the numbers strongly suggest you should be paying close attention.

Fool on!

— Billy (TMFTailwind)

Pro Completed Trades (see all [trade alerts]())

- **Expeditors International** (NASDAQ: EXPD): We were able to set up five of our 10 $40 synthetic long contracts at a net debit of $0.70 per contract. We will continue this week to try to fill the last five of our contracts at our guided price of $0.70, and then we will write our short strangle once the synthetic long is complete.

Your Most Active Conversations

[Today]() [Past 7 Days]() [Past 30 Days]()

Broadridge: Delivering Today and Investing for Tomorrow

Published Aug 25, 2014 at 3:55PM

Pro's Take: BR Q4-2014 Earnings

Broadridge Financial Solutions (NYSE: BR)

Quarter Quick Take

Broadridge closed out fiscal 2014 with a strong Q4, headlined by a large closed sale with Fidelity Investments covering investor communications outsourcing. Remember, such closed sales represent future revenue that will come on-line over time; the value they provide today is confirmation that the company's products and services are in demand and that Broadridge remains the partner of choice for outsourcing mission-critical but noncore activities. For the year, recurring fee revenue registered +9% growth (+11% in ICS and +5% in SPS) and had a positive impact on operating leverage and profit growth. While there were modest tailwinds out of the company's control, recurring revenue closed sale growth of +5% and continued operating margin expansion suggest that Broadridge is performing well in the areas of its business it can control.

....

Q4-2014 | FY-2014

Total recurring fee revenue growth: +7% | +9%

TTM Operating profit margin*: +529 bps to 25.6%

EPS growth: +4% GAAP | +25% GAAP, +20% non-GAAP

*Operating profit / Fee revenue

This removes the impact of distribution revenue, which is a pass-through, and distorts the true economics of the business

....

Guidance Update

Management's initial FY-2015 guidance looks achievable and even a bit conservative: recurring revenue growth of +5% to +7%, EPS growth of +8% to +13%, recurring revenue closed sales of $110-$150 million, and FCF of $320-$370 million. The free cash flow number looks especially impressive in conjunction with the announcement of another round of accelerated investment in growth – so last year's $330 million and next year's $350 million (at the midpoint) of FCF both understate the true cash generating abilities of the business. Provided the investments result in sustainable organic growth, and management has a good track record of this, we are happy to make that trade-off.

Business is tracking well against our thesis, and Broadridge appears more in control of its business and future than at any time in its public history. Recently, the board announced a 29% (not a misprint) increase in the dividend to $1.08 per share. A sensible valuation (15x slightly depressed FCF), this 2.6% dividend yield, and very achievable 8% EPS growth (at the low end) are a formula for greater than North Star returns over time.

Updated guidance: Buy (no change)

Recommended Allocation: 4.1%

Fair Value estimate: $43 (up from $42)

End of Fiscal Year expected FV estimate: $46

CAM price: $35 (up from $34)

I'm happy with our 4.1% allocation to Broadridge. The company's business lies at the nexus of Pro's largest sector bets (technology and financials) and its business results are as consistent as we have in the portfolio. Members lacking a (full) position should feel comfortable purchasing shares today – they trade at a slight discount to our estimate of Fair Value. If the market presents the opportunity, I'd entertain written puts or buying shares to bring the position up to 5% allocation, or an outright resizing if shares fall near CAM territory.

Our Thesis

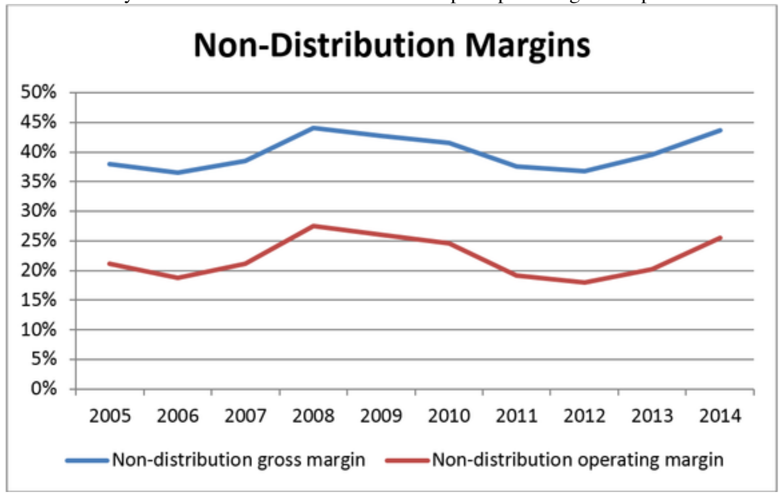
Broadridge has a near monopoly in proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record and sound capital allocation policies make Broadridge a sturdy rock to build the Pro portfolio upon. We expect modest growth in fee revenue, slight operating leverage, plenty of free cash flow and a growing stream of dividends to help achieve North Star-like returns.

The Most Important Things

1. ***Recurring Revenue Closed Sales:*** RRCS amount to an estimate of the annualized new business won during the period. Given the nature of the company's business, the revenue should recur at extremely high rates (we're talking 98%). Tracking this metric gives us insight into future sales, how new products are resonating with customers, and the degree to which customers are partnering with Broadridge. After failing to grow in fiscal 2013, RRCS were up +5% in fiscal 2014. These sales, which have a long cycle, are lumpy, so we look for progress over time. Comments from management suggest the pipeline and Emerging and Acquired (E&A) products are being well-received by customers. I expect 2015 to begin to show some fruits internationally as the company's partnership with Accenture matures. Fiscal 2015 guidance for RRCS of $110-$150 million suggests growth in the range of -13% to +18%.

2. ***Fee Revenue Margin Performance:*** Broadridge maintains a technology platform upon which its business operates. As it brings more business (volumes) on board, it should benefit from low variable costs and increasing margins. I track gross and operating profits as a percentage of fee revenue, which ignores distribution revenue and costs, and makes my numbers differ from what you might read in the press release. Broadridge achieved fee revenue gross margins of 43.6% during FY-2014, up from 39.6% a year ago and the second highest level on record. Fee revenue operating margin for FY-2014 was 25.6% up from 20.3% a year ago.

Operating margin should have further room to expand given the company's natural operating leverage, the fact that FY-2014 included non-recurring growth investments, and that FY-2015 will include additional growth expenses in SG&A. My base case model assumes no further pickup in margins – a potential source of upside provided the bulk of recent investment is in fact non-recurring.



3. ***Capital Allocation:*** Although BR is a slow-grower, it generates a lot of cash and has low reinvestment needs. Management has a very clear plan to put that cash to work: it targets a 45% payout ratio, then looks for bolt-on acquisitions that can achieve a 20% IRR, or it looks to repurchase shares. Over the past five years, Broadridge has only had to reinvest 13% of profits to grow fee revenue by 35% (a 6% CAGR) and profits by 38% (a 7% CAGR). Much of that reinvestment was in building new products and acquiring companies that should grow faster than the company's legacy business as their products are sold through existing Broadridge relationships. I believe the stage is set for continued modest growth with even less capital intensity, which should allow for further dividend increases (which the board has granted each year since it initiated its dividend – seven years running) and share repurchases (share count is down -14% over the last five years). Broadridge management gets high marks for capital allocation and stewardship in my book.

WWTN

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Conference Call Notes

- On FY-2015 guidance: Recurring revenue growth should be in the range of +5% to +7%, and 60% of revenue should convert from closed sales. EPS growth of +8% to +12% should be driven by net new business – the source of growth most under management's control. CEO Rich Daly said: *"Big picture, I view our fiscal year 2015 plan as the strongest plan we have ever compiled. Our plan strikes the right balance between earnings growth and an appropriate level of investment into the future and does not depend upon market-based activities for growth. As a result, Broadridge is well positioned to achieve its guidance."*
- On continued investment: $40 million of additional growth investment (in addition to the $34 million of incremental spend in 2014) may occur in FY-2015. CEO Rich Daly always notes that it is difficult to spend money well, so while this level of spending has been earmarked, it will only be spent if the business opportunities are in place and the company is confident in the returns.
- On RRCS: The strong momentum has carried over into Q1 – BR signed another large deal already. The deal is with a major global bank to provide BPO and outsourcing services. Management did announce it no longer intends to communicate which deals are large and which aren't, instead, it will focus on when closed sales will convert to revenue.
- New CFO Jim Young: This was new CFO Jim Young's first conference call. He joined BR from Visa, and he had some interesting things to say. "***To start, I would like to offer a few thoughts on the business. Before taking this job, I did a lot of due diligence on the Company, and my first six weeks have affirmed many of the special attributes that drew me to Broadridge. First, leadership position. Broadridge is a trusted and vital partner to many of the largest financial services firms in the world. Second, importance. This is a business whose core products and services are woven into the fabric of the capital markets and their mission-critical processes. Third, opportunity. Broadridge's brand and track record give it permissions to expand the sets of services and products it offers. And the company is successfully doing this today through a series of focused and carefully calibrated investments. And finally, as a result of all of this, strong and resilient free cash flow. The combination of growing and predictable recurring revenue and low capital intensity has enabled the business to demonstrate a clear capacity to generate stable and significant free cash flow.***"
- On internal growth: Internal growth (primarily stock record growth) outpaced expectations and helped BR achieve its great results. This source of growth is probably unsustainable and it is out of management's control, so we shouldn't count on it in the future. Management's forecast does not assume further contribution from internal growth.
- On the target payout ratio: Management raised its target payout ratio to 45% of trailing earnings from 40%. It assured call participants that this does not inhibit the company's ability to invest for growth.

Gilead's Healthy Results

Published Aug 21, 2014 at 9:44AM

Greetings Fools,

Guidance Update: **Gilead Sciences'** (NASDAQ: GILD) fair value estimate increases from our $105 valuation that came with our April buy report, to $110 today, as the business grows in a quarter (and grows a bit more than expected). It remains a Buy First at a 4.2% allocation today.

Summary: Gilead reported second-quarter revenue growth of 141%, to $6.4 billion; $3.5 billion in sales came from Hep C cure, Sovaldi. Earnings grew 378% to $2.20 per share. For the year, GILD expects revenue to about double to $22 billion. Here's the press release.

What We Think Now: *Biotech Gilead Sciences offers a great investing trifecta: size, growth and value, all in one. Its HIV franchise is stronger than ever, and its liver franchise is taking off. Targeting deadly diseases with novel treatments, Gilead is working to improve lives.*

Notable Changes?: Nothing has changed since our April thesis, except Sovaldi sales are a little bit stronger out of the gate than we estimated (and much stronger than Wall Street estimated). That's happening even as some doctors are waiting to prescribe Sovaldi ("warehousing" it) until the single-drug regimen comes out, which is expected this fall. This may affect current quarter results a bit. Sovaldi continues to gain regulatory approval outside the U.S. Meanwhile, Gilead's drug pipeline continues to move forward positively, with no negative surprises so far.

Looking Ahead: What matters most the coming few years are Sovaldi sales -- how long is the tail here? Since the drug cures patients, its revenue growth won't be linear. Sales will subside eventually, leaving a sizable headwind for year-over-year growth comparisons for quite some time. But we expect sales will be healthy for longer than is generally estimated, past 2018, as ever more patients are treated and pricing for this cure (from Gilead and competitors) remains rational.

Conference Call Notes

Sovaldi:

o More than 70,000 U.S. patients and about 10,000 EU patients had been treated (as of June 30)

o The single-tablet Sovaldi regiment for genotype 1 should have a PDUFA from the FDA on October 10, and EU approval is expected later this year

o Q2 Sovaldi sales of $3.5 billion; $3 billion were U.S. and most of the remaining $500 million were from Germany and France -- where both governments gave Sovaldi high marks for being an innovative, new solution worth reimbursement. Gilead is still working on pricing with France even as the drug is offered to severe patients. We should hear from Germany soon on final pricing.

o Scotland gave Sovaldi a positive initial review -- it's moving forward

o Australia approved Sovaldi and discussions for pricing and reimbursement are ongoing

o Patients have been treated with Sovaldi in 34 countries; the number keeps increasing

o Some doctors are delaying treatment, waiting for the single-tablet regimen this fall -- namely in the U.S.

o Gilead expects pricing in the EU, as a whole, to be a bit below the U.S. The U.S. is expected to be a slightly bigger market, as a result, and have sales that are more spread out over time than Europe.

Oncology and HIV

o Zydelig/idelalisib (with break-through status on one indication) was approved July 24th for 3 B-Cell malignancies: chronic lymphocytic leukemia, follicular B-cell lymphoma and small lymphocytic lymphoma. This is Gilead's first oncology drug, and is an oral medicine. Gilead is exciting to keep working to help oncology patients with new medicines.

o In HIV, GILD's new single-tablet regimen is in a number of studies with filing for U.S. and European approval in the first quarter of 2015 expected.

o Prescription volume continued to grow on GILD's HIV products, with 9 of 10 new HIV patients prescribed a Gilead medicine.

General

o Gilead repurchased 15.2 million shares for $1.2 billion ($78.94 average price). They plan to spend $1.7 billion more this quarter, to complete an old authorization. They have a new $5 billion share repurchase authorization to start after that. This $6.7 billion represents about 4.8% of existing shares.

o Project 2014 sales of $21 to $23 billion. Risks to this include the October 10, 2014 PDUFA date for single-tablet Sovaldi, and warehousing before that date, as well as ongoing pricing discussions with various countries, and how those play out. As well as new competitive risks on the horizon. So, risks to Sovaldi do remain.

o Single tablet regimens "are the way ahead in our opinion," in any treatment where possible.

o "We've never had so many things going forward as we do today, and we feel very, very confident in the pipeline that we have today." So, they may target very selective acquisitions that augment their pipeline.

To dicuss Gilead with us, please visit its board on Pro.

Overview
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Recent Price: $100.79
Dividend Yield: 0% (GILD may start a dividend later)
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***Pro* Guidance**
=========================
Est. Fair Value: $110 (up from $105)
Current Allocation: 4.2%
Status: **Buy First** (no change)
Consider Add' More: $75 (up from $65)

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Valuation
========================
Metric Multiple
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EV/EBITDA: 14.6
EV/EBITDA NTM est: 9.2 (same as Apple, incidentally)
P/FCF: 22.1
P/E: 22.8
P/E NTM est. 11.1
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Our Best Days Are Ahead

Published Aug 18, 2014 at 4:03PM

Pro Guidance Changes

- Last week we moved **Skyworks Solutions** (NASDAQ: SWKS), **Tupperware Brands** (NYSE: TUP), and **Wells Fargo** (NYSE: WFC) to Buy First. Read more here.
- We raised **Parexel International**'s (NASDAQ: PRXL) Fair Value estimate to $57 after reviewing fiscal 2014 results.
- **Apple**'s (NASDAQ: AAPL) Fair Value estimate increased to $102 on business growth.

Dear *Pro* family,

We have a policy around these parts of ripping the Band-Aid off quickly. It's my sad duty to report that this is my final Memo. In a few weeks I'll be leaving the *Pro* team to pursue an exciting opportunity with our affiliate, Motley Fool Asset Management, LLC. While the dive into uncharted waters is nerve-wracking for me, I have the utmost confidence the *Pro* ship will continue on sailing swiftly. Jeff remains at the helm and the course, guided by our North Star, has never been clearer. Thankfully, my duties as director of The Motley Fool's Analyst Development Program afforded me the unique ability to literally hand-select Jeff's first mates, Billy and JP. Our ship retains its nimbleness by housing a small crew, but pound for pound these sailors are hearty and able. For more on my transition, please see the More Awkward Goodbyes section at the end of the Memo. And now, because I'm fresh out of sailing vocabulary, let's tack back on course (OK, one more!) and discuss why our best days are ahead.

Investing Is Science *and* Art

It doesn't take very long for investors to realize that investing isn't all science. Just when we think we've applied the appropriate business-school frameworks and spreadsheet kung fu to uncover a wildly undervalued opportunity, we watch it plummet in price and never recover. I was reminded of the shortcomings of a purely science-focused approach in a recent book club session of our Analyst Development Program. We were discussing John Train's 1980 book *The Money Masters*, which profiles nine of the greatest investors of that era, and what quickly becomes apparent is that the super-investors have wildly different, and sometimes opposite, approaches to investing. The takeaway is that there is no one right way to invest, so embrace the motley style that works for you and master it. It is critical, of course, to understand and borrow from the science of classical finance and investing training — all the masters did this — but there has to be something else. My belief is that Train's subjects are abnormally creative, and they found a way to use that to set themselves apart from the thousands of also-ran investors of that era.

Learning From the Creatives

In search of a better understanding of creatives, I came upon a paper by Carnegie Mellon Professor John R. Hayes published for the Center for the Study of Writing in 1990. The paper surveys academic research going back to the 1920s to characterize creative and non-creative people (PDF here). Academic literature claims there are four traits that differentiate the more creative from less creative: devotion to work, independence, a drive for originality, and flexibility. This rubric fits the nine investors Train highlights perfectly — heck, it fits the investors profiled in Train's two follow-up *Masters*' books, too.

These four traits are largely intrinsic, but Hayes goes on to analyze cognitive processes involved in everyday thought and action that creatives embrace. Three that are heavily emphasized in *Pro*'s philosophy and process are preparation, goal-setting, and representation.

- Preparation is largely tied to the effort invested to acquire the knowledge and skills relevant to the creative act. Studying those businesses? Speaking with management teams? Questioning one another's assumptions? Check, check, and check.
- Goal-setting refers to the identification and formulation of a unique problem. Our goal is to double our portfolio's real purchasing power each decade, achieved by making steady progress every rolling three-year period. That goal is shepherded by our North Star focus.
- Representation is how we frame the job at hand. *Pro*'s embrace of a broad strategy (options, shorts, ETFs, and more) is evidence of a different representation of the task of achieving acceptable risk-adjusted returns than what you find in most plain-vanilla investment programs.

Our Best Days Are Ahead

If investing is a creative endeavor, I have some good news — *Pro* is just getting started. Hayes provides evidence that the most notable composers require years of preparation before they produce their best, most creative, work. He surveyed all the composers listed in Harold Schonberg's *The Lives of the Great Composers* where clear data was available regarding when they got serious about their craft (there were 76). He then looked at their body of work and determined the most notable compositions (based on current-day recordings), of which there were 500. Shockingly, only three were composed before the 10th year an the artist's career, and those three were composed in years eight and nine. The time of maximum creativity for composers happens in years 10-25 of their careers. Similar studies have been performed on other creatives and revealed similar results; painters hit their stride six years into getting serious and poets five years in.

I can't say when we as investors might reach our peak creativity, but Charlie Munger believes Warren Buffett is a better investor now (more than six decades into his investing life) than he was when his physical self was in its prime. It seems like *Pro*, at 5.5 years, is only getting better, too — a few more gray hairs on our end, but better nonetheless. I truly believe our best and most creative thinking lies ahead.

More Awkward Goodbyes

I joined the *Pro* family in early 2010. Philosophically, my transition was easy — my entire eclectic investing career up to that point had built a perfect foundation for the *Pro* way of investing. What was much less certain was how I was going to fit into the close-knit *Pro* community. I was, and am still, blown away by how warm and accepting our Fools are. I've loved getting to know so many of you, sharing jokes, educating and being educated, and working together to achieve financial freedom. It has truly been an honor to work for you and with the *Pro* team. I'm very excited about the new opportunity in front of me and believe it will provide an incredible platform to help impact a great number of Fools. I will always consider myself a *Pro* Fool, and I look forward to seeing the even better future you all and the *Pro* team create.

Onward,

— Bryan (TMF42)

P.S. Please join us in congratulating Bryan on his exciting step forward and thanking him for his 4.5 years on the *Pro* and *Options* teams. Bryan was tirelessly diligent, thorough, curious, calm and reasoned in his investing roles here in your services — all the things you want to be as you invest. Bryan also brought a great attitude and sense of humor to his endeavors — qualities you definitely want in life. We'll miss Bryan, but we're excited for his future. Fools haven't seen the last of him! — Jeff (TMFFischer)

Pro Completed Trades (see all trade alerts)

- None

Apple Creates Value Each Day

Published Aug 18, 2014 at 8:22AM

Hi Fools,

Guidance Update: Apple's fair value estimate increases from a long-standing $94 to $102 as the business grows. From that price we target North Star-like returns, although much depends on new product popularity.

Apple (NASDAQ: AAPL) reported third-quarter revenue growth of 6%, to $37.4 billion; 12% profit growth to $7.7 billion; and 20% EPS growth to $1.28. iPhone unit sales gained 13% despite the lack of a new model, and Mac sales rose 18%. iPad sales were lighter than hoped. This was attributed to lower channel inventory and a 5% decline in the U.S. tablet market and weak tablet sales in Europe (this will be interesting to watch).

What We Think Now: Apple is the leader in mobile computing products, and the number of people buying into its ecosystem continues to grow — yet the stock is cheaper than it has been in years. (That's our 2012 statement; still relevant today, although the valuation multiples are now much higher).

Notable Changes?: Nothing negative has happened to challenge our thesis, which is that mobile computing will continue to grow and Apple will continue to lead in value share. Apple's now-stable margins further support our thesis. What Apple really offers is a familiar, powerful operating system (now 7 years old); its hardware houses it, and gets all the attention, but it's the O/S that tie people into the ecosystem most. As we become more reliant on our mobile devices, and as they do more, the relationship strengthens.

Looking Ahead: Still, what matters most in the immediate are Apple's new product releases. iPhone models with larger screens are expected to be announced on Sept. 9, and Apple is expected to introduce a new product category this fall.

Overview

========================
Recent Price: $98
Dividend Yield: 1.9%
========================

Pro Guidance
========================
Est. Fair Value: $102 (up from $94; 13x FCF)
Current Allocation: 4.1%
Status: BUY (No change)
========================

========================
Metric Multiple
========================
EV/EBITDA: 9.8
EV/EBITDA NTM: 9.1
P/FCF: 12.0
P/E: 15.8
P/E on NTM est. 14.4

========================

Select Financials

========================

Market Value: $587 billion
Cash & Invest: $164 billion
LT Debt: $29 billion
Enterprise value: $452 billion

========================

TTM OCF: $56.3 billion
TTM Cap EX: $7.7 billion
TTM FCF: $48.6 billion
========================

TTM Margins
========================
Gross Margin 38.4% (all up recently)
EBITDA Margin 33.2%
Oper. Margin 21.6%
Lev. FCF Margin 21%
ROE 31.6%
=========================

To discuss, please visit our Apple board.

Best,

Valmont in a Shallow Valley

Published Aug 18, 2014 at 12:00AM

Greetings,

Guidance Summary: The company remains a Buy at 2.7%, and fair value remains unchanged at $170.

Second-quarter results at **Valmont Industries** (NYSE: VMI) softened compared to record sales and earnings one year ago, as irrigation volume in North America slows on lower commodity prices, and the utility industry conducts far fewer large projects (mostly just small ones). Both sectors should improve eventually. Shares remain inexpensive while we wait.

What We Think Now: Selling light and traffic poles, irrigation systems for farms, towers and platforms for utilities and telecom, and offering steel and aluminum galvanizing for third parties, Valmont has consistently and strongly grown profits over the long term. Countless opportunities continue around the world, and we believe long-term owners of this well-managed company will do well.

Notable Changes: Although it doesn't threaten our long-term thesis, the most notable challenge from this quarter comes from the revelation that operating margins in the utility business may not return to the 17% to 19% range recently achieved. Given extra capacity in the industry, mid-teens margins are more likely, management says. They will work to improve on that with a focus on costs. This change to one-quarter of the business is not enough to harm the long-term valuation or thesis by a meaningful amount, but likely by a small bit.

Overview
=========================
Price: $145
Dividend Yield: 1%
=========================
Pro Guidance
=========================
Status: BUY (no change; and/or write puts)
Fair Value Est.: $170 (no change)(8.7x EBITDA)
Current Allocation: 2.7%
=========================
Valuation
=========================
Market Cap: $3.8 billion
Cash & Equiv.: $446 million
LT Debt: $479 m
=========================
Metric Multiple
=========================
P/Sales 1.2
EV/EBITDA 7.5 (10-yr avg = 9.3x)
EV/EBITDA NTM est. 7.5
P/E 16.8
P/E NTM est 14.4 (prior to any buy-back)
P/FCF 17.7
=========================
Cash Flow
=========================
TTM OCF: $313 million
TTM Cap EX: $99 million
TTM FCF: $214 million
=========================
Ratios
=========================
Gross Margin 27.7% (all down as lower revenue de-levers profits)
EBITDA Margin 14%
FCF Margin 7.3%
ROE 15%
ROC 13.2%
=========================
ttm = trailing twelve months

Conference Call main points

o The company maintains a positive outlook for the utility business; volume was flat in the sector, but there were fewer large projects, and small projects have smaller margins. Fewer companies can serve large projects, so VMI favors those, and they have better pricing. Many large transmission projects are in the works over the next few years.

o Irrigation sales grew in international markets, led by Brazil, the Middle East and Asia, and operating income was a strong 19% of sales, despite a revenue decline led by North America. It's too early to know how the next ordering season will go in N.A., but softer corn prices are one concern. For now, though, Valmont expects results about even with last year when looking ahead the next two quarters.

o For the year, Valmont sees EPS of $9.35 to $9.65 (before any shares are bought back), putting the stock at about 15x earnings. This guidance was lowered by about $1 per share on weaker first-half results in three of four divisions.

o Looking ahead at the rest of 2014: Engineered Infrastructure Products should grow organically with improved profitability compared to 2013; Utility Support Structures should have revenue similar to last year's second half, but at lower profitability; Irrigation could be similar to last year's second half, although it hinges on U.S. farm purchases; in the Coatings segment, results should be similar to last year's second half.

o Incentive bonuses will be smaller this year due to lower earnings growth (or no earnings growth).

o Priorities for cash remain: organic growth; complementary acquisitions; dividends or buybacks.

Foolish Bottom Line

Priced inexpensively below 8x EBITDA (and well below the 9.3x average the stock has held since 2004), Valmont remains a value stock that has also been an excellent growth stock over the years. Believing in management and its business lines, we believe growth will resume and be healthy in coming years. Valmont offers us diversification in several growing areas (infrastructure *writ large*, and agriculture) with management who knows how to execute, and ride the ups and downs. This is an investment that really requires patience, though.

After earnings fall about 14% this year (from a record year last year), we currently estimate a double-digit rebound next year; that hinges on good revenue gains in utilities and irrigation.

To talk about this investment, please visit its [discussion board.]()

Best,

Jeff

Set Up a Synthetic Covered Strangle on Expeditors International

Published Aug 15, 2014 at 11:44AM

Is this for you? This is for *Pro* members seeking an income position, managing at least $200,000, and who can sell puts. If some of that doesn't describe you, consider Alternative Trades at the end of this recommendation.

How You Participate

Actions on Expeditors International (NASDAQ: EXPD):

1. **Set up a Synthetic Long:** Sell to open January 2016 $40 puts, and buy to open an equal number of January 2016 $40 calls.
2. **Sell a Short Strangle:** Then use a strangle order to sell to open November 2014 $39 puts and sell to open November 2014 $43 calls, one each for every synthetic long you set up.

- **Allocation:** Approximately 1.8% exposure on the synthetic long, and another 1.7% exposure through your short puts in the strangle, for 3.5% total exposure. Each synthetic covered strangle represents $7,900 in exposure to the stock. So, for 3.5% exposure, set up one synthetic covered strangle (one each of all four options) for approximately every $200,000 you manage. *Pro* will use 10 contracts of each option.
- **Recent Trade Prices:** Approximate $0.20 to $0.30 net debit to set up the synthetic long. Approximate $1.95 to $2 credit to sell the short strangle.
- **Price Guidance:** Initially, target the above prices using a limit order for both trades. As prices change, accept no lower than $1.70 on the short strangle. The synthetic long price will change as the share price moves, but even in the days ahead aim to pay no more than a $0.70 debit.
- **Recent Stock Price:** $40.70
- **Fair Value Estimate:** $44

What We're Thinking

Expeditors International was first recommended by *Pro* in [2009](), so we're not strangers to this time-tested business. An innovator in global shipping logistics, Expeditors doesn't own any airplanes, trucks, or ships — instead, it buys space on carriers at wholesale prices, portions it out, and resells it at higher prices. The company also provides services to make moving goods much easier for customers, including custom brokering, cargo insurance, and distribution management. With nearly 200 full-service offices around the world, Expeditors helps companies move their products nearly everywhere, but Asia-Pacific and North America account for a majority of its $6.2 billion in annual revenue, with Europe a distant third.

- **HQ:** Seattle, Wash.
- **Founded:** 1979
- **Employees:** 13,910
- **Market Value:** $8 billion
- **TTM Revenue:** $6.2 billion
- **TTM Net Income:** $351 million
- **TTM Free Cash Flow**: $332 million
- **P/FCF:** 24

As trade grows, Expeditors has more opportunity to grow. When trade slows, such as during a recession, Expeditors is equipped to endure it while maintaining profitability, even when revenue declines (profits remained strong in 2009 as revenue dropped sharply). Lately, competitive pricing has kept a lid on operatingprofit growth, and the stock has traded in a tight range (mostly $40 to $45) since mid-2011. As we've done in the past, we're entering the position looking to earn income on a stable business. In this case, we're looking for leveraged income. Our synthetic long requires no cash outlay (just equity to hold the puts open), and the short strangle pays us well — starting with the potential for 5% in income on a blended $39.50 put obligation (our $40 puts and our $39 puts) between now and the November expiration for the $39 puts.

Whether the stock goes up or down, we'll seek to roll our short strangle in future months, to keep earning income, unless we decide (on a decline) that we want to take physical shares instead. But for now, view Expeditors as a *Pro* income position with long-term upside potential with our synthetic long.

Initially, if we obtain a $2 credit (on our short strangle alone; the syn long is separate), our break-even points on our $39/$43 short strangle are $37 and $45, respectively. Ideally, the stock will stay between our strangle strike prices, so we earn full income. Over time, if the stock slowly rises, we should be able to keep strangling it for more income and earn gains in our synthetic long, too, by rolling our strikes higher. That's the ideal.

More That Matters

- **Maximum Loss:** The same as owning 200 shares of stock, minus the option premiums received.
- **Maximum Gain:** The initial short strangle caps upside on our synthetic long to $43, plus the $2 in premiums received. The most this first short strangle can pay us is $2 per share.

- **Breakeven**: The synthetic long mirrors stock ownership starting a bit below today's share price, while the short strangle has break-even points at $37 and $45 (although at higher prices than today's, our synthetic long will be making money even if the short strangle is break-even).
- **Follow-up:** The plan is to keep writing strangles, at various strikes, to earn income, and ideally see our synthetic long tick up in value, too.

Alternative Trades

- **IRA friendly:** If you're unable or unwilling to write puts (even cash-secured), then you can consider using a buy/write order to buy at least 100 shares of stock and sell to open the November 2014 $43 calls. Start about a 1.8% allocation and be ready to add more if the stock falls and we accept more shares; or, start a 3.5% allocation and don't plan to add later.
- **Traditional covered strangle:** Rather than use a synthetic long, if you prefer you could simply buy shares in 100 round lots and then sell the same short strangle we are. The benefit is you get the dividend (although that is imputed in the options prices) and it may present a more favorable tax situation if you own shares for more than a year.
- **Managing less than $200,000?** You can consider just buying 100 shares to write the covered calls on them, as long a it keeps your allocation below 3.5%.

Pro Can Help

- **Want more on this strategy?** Dust off our guide to covered strangles, and synthetic longs, too. We're just combining the two into a synthetic covered strangle.
- **Questions?** Visit our revitalized Expeditors board.

Guidance Changes: Skyworks, Tupperware, and Wells Fargo

Published Aug 14, 2014 at 1:02PM

Greetings, *Pro* members.

You might suspect we're just making small guidance changes to the stocks that are at the *end* of our portfolio's list of names alphabetically (S, T, W). In fact, we're moving these Buy stocks up to Buy First simply to reflect the reality that we recently bought shares in all three, and analyzing our portfolio, we *still* would buy shares of these three first today, along with our other Buy Firsts. So, they belong in that group. We also want to round out our Buy First "portfolio," if you will, into more industries.

So, these three companies are moving from Buy to Buy First today:

- **Skyworks Solutions** (NASDAQ: SWKS)
- **Tupperware** (NYSE: TUP)
- **Wells Fargo** (NYSE: WFC)

They join **American Tower** (NYSE: AMT), **Gilead Sciences** (NASDAQ: GILD), **Oracle** (NYSE: ORCL), and **TD Ameritrade** (NYSE: AMTD) as our seven Buy First stocks.

We believe our Buy First stocks represent an attractive risk-to-reward prospect. We're not suggesting that they'll provide the biggest gains, but simply that their potential comes with especially reasonable risk. If you're first starting to invest, you want to invest your money in stable places as you slowly build to a full portfolio. Thus, that's how we think about our Buy First stocks.

For allocation guidance and more, see our Recommendations page (and there, click any ticker to get to its snapshot page).

Parexel's Ps: Performance, Profits, Partnerships

Published Aug 12, 2014 at 2:14PM

Pro's Take: PRXL Q4-2014 Earnings

Parexel International (NASDAQ: PRXL)

Quarter Quick Take

Parexel ended its fiscal 2014 with a bang. Backlog finished over $5 billion and cancellation rates are continuing to trend down, both of which bolster our belief that the partnership model between large pharma and select CROs is gaining traction. In fact, Parexel announced it won a new partnership via competitive negotiation during Q4, but it didn't spill the beans on who it is. The company's financial model played out beautifully: 10% revenue growth and meaningful (+320 bps) operating margin expansion resulted in 30% earnings growth. This business momentum prompted management to raise the low end of its FY-2015 revenue and EPS guidance.

....

Q4-2014 | FY-2014

Sales growth: +10% | +12%

Operating profit margin: +320 bps to 11.4% | +248 bps to 10.3%

EPS growth: +30% | +28%

....

Guidance Update

Business continues to track well against our thesis. Parexel's largest business segment, CRS, is leading the way in growth and operating improvement. The company's Consulting and Informatics segments continue to grow, but at more modest rates. Longer term, these businesses should be meaningful contributors to results too.

Accounting for the quarter's performance and the time value of money, I'm raising the estimate of fair value to $57 and keeping CAM at $40. Once the 10-K is filed, I adjust any assumptions as necessary and provide a FY-2015 year-end expected FV estimate.

Updated guidance: Buy (no change)

Recommended Allocation: 3.5%

Fair Value estimate: $57 (up from $54)

End of Fiscal Year expected FV estimate: To be updated once 10-K is available

CAM price: $40 (no change)

Members lacking a (full) position should feel comfortable purchasing shares today. If you've been paying attention, you know Parexel shares have been volatile so far. Customer concentration and a high multiple make this likely to continue, so we may look to be opportunistic with put writes. Our September 2014 $45 put options appear set to expire, at which point we will reassess.

Our Thesis

Because of its reputation, global reach, and technology prowess, Parexel International will win its fair share of the growing market pharmaceutical development market. In addition, we expect the proportion of R&D dollars outsourced to contract research organizations to grow as large biopharma companies adopt the strategic partnership model and smaller biotechs become responsible for more drug discovery. Finally, as new business wins mature, the true earnings power and margin potential of the company's business will shine through.

The Most Important Things

1. ***Penetration and Backlog***: Penetration refers to the proportion of biopharma R&D dollars that go to CROs versus being used in-house for development and provides evidence that the biopharma/CRO partnership model is winning. We'll check in on this driver annually, when the best data becomes available. In the interim, we'll monitor backlog trends to ensure Parexel is filling the pantry with future business – backlog that converts to sales usually represents ~80% of the sales in any given quarter, so strong backlog growth suggests strong future sales growth. Backlog's ability to explain future sales is influenced by conversion rates and cancellation rates, so we monitor this, too. Backlog grew 2% sequentially and 9% year over year. It has grown sequentially for five consecutive quarters now. The trailing book-to-bill is 1.16, a bit below the 1.20 goal, but strong enough to support 10% revenue growth going forward, and acceptable given the rising conversion rate trend (declining cancellation rates mean Parexel is converting more of its backlog into revenue). Parexel also announced a new partner (not named), which lends credence to our thesis that the partnership model will be adopted over time.

2. ***Margin Performance***: (I remove pass through revenue to more clearly track the business, so my numbers may be different from what is reported in the press.) Company gross margin expanded 133 bps sequentially and 369 bps year over year. The impressive improvement was driven by gross margin expansion in all three business segments. We expect this trend to continue, although not to this magnitude, with CRS and PI leading the way. The how is also important; much of the improvement appears to have life remaining – the only source of improvement that appears maxed out is the benefit from using fewer contract workers. I expect the next step higher to come from increased productivity of recent hires. SG&A is temporarily elevated due to important investments in the business, but company operating margins increased to 11.4%. This reflects 86 bps improvement over last quarter and 319 bps improvement over last year. Improved margins and SG&A leverage remain key to our thesis.

3. ***PI Business Trends:*** Technology is a core competence for Parexel. The company's PI segment is the lifeblood of innovation for transforming the traditional clinical trials process into a more efficient, more effective, technology-driven one. We want to see this business perform well to ensure it remains a competitive differentiator for Parexel and helps it win business in its CRS and PC segments. Now reaching scale, we also expect PI to exhibit operating leverage and become a more meaningful portion of profits. Revenue continues to grow (+7% during the quarter), and with a longer sales cycle we expect this growth to exhibit some lumpiness. New business awards and the pipeline for new business appear strong. Gross margin expanded sequentially (to 46.8%), and continues on its ascent toward 50%. The biggest contributors to this margin expansion have been scale and the shift of activities to low-cost countries. I expect PI to achieve 55% gross margins in seven years given its current product mix – performance is tracking nicely.

WWTN

Helping pharmaceutical companies get drug candidates to market, Parexel is poised to benefit as those companies gradually outsource more of this process to select CRO partners who can perform the work better, faster, and cheaper. We also expect margin expansion as recent investments pay off and continued growth of the Parexel Informatics technology segment.

Conference Call Notes

- On operating margins: The full-year adjusted operating margin (10.3%) was a record, and up 250 bps over FY-2013. Improved gross margins in each segment, controlled spending, and moderating headcount growth drove operating margins higher.
- On CRS: Q4 revenue growth was 12.3% and for the year was 11.6%. Gross margins expanded for the sixth straight quarter and management expects this trend to continue.
- On PC: Revenue grew 1.7% in the quarter and 6.7% for the year. Removing the HERON acquisition, PC actually declined a touch during Q4. Gross margins expanded nicely. Management is actively engaged in returning growth to this segment.
- On PI: Revenue grew 6.7% in the quarter and 17.3% for the year. Gross margins expanded. "*MyTrials basically is a platform that we have created where we can put our applications, but also competitive applications, or even legacy or internal applications can be put on. This is getting, I'd say, slow traction. And I say slowly – it's a relatively long sales cycle. We are finding out companies are really carefully evaluating whether they want to go with this platform, because once you make a commitment, this is a long – has a long future and it's not so easy to get off it. But it's gaining traction, and we're basically happy with the positioning, and feel it's obviously a great product from a technical point of view.*"
- On headcount: Parexel grew headcount by 5.9% during the year and now has 15,560 employees globally. The company is investing in training and development programs to ramp productivity and prepare for changing staffing needs.
- On cancellation rate: For the quarter, cancellations were 2.9% of beginning backlog. The rolling four quarter average cancellation rate was 3.7%, at the low end of the 3.5%-5% comfort zone.

- On the new partnership: CEO Joe Von Rickenbach said: "*I'm pleased to report that we recently were selected as a strategic partner to another of the world's leading pharmaceutical companies*." We don't know who it is yet, but Von Rickenbach noted it is a company Parexel has worked with for years. It also represents a competitive negotiation and highlights the strengths of Parexel as a partner relative to competitors. He went on to say "over time, you'll probably see more and more of these types of customers adopt some form of partnership or another. And this is an important one, of course, for us; and we're pleased that we won it, and also feel that there are some out there that we are still pursuing."
- On debt: Net debt was $77 million, up a bit as the company used its line of credit to repurchase some shares.
- On guidance: Due to the strong business momentum, management raised the low end of its revenue and EPS expectations for FY-2015. It now expects revenue of $2.13 b to $2.15 b and EPS of $2.57 to $2.75, about 15-20% growth and putting shares at ~20x EPS.

Pro's Earnings Lift Us to New Highs

Published Aug 11, 2014 at 4:02PM

Dear *Pro* member,

Another quarter of earnings is wrapping up, and we like what we've seen from *Pro* companies. We see consistent management. We see clear business strategies. We see prudent use of capital with growing returns. We see more opportunities ahead. We don't hear many excuses.

Only a handful of *Pro* companies have yet to report:

- **Medtronic** (NYSE: MDT), due Aug. 19
- **The Buckle** (NYSE: BKE), due Aug. 21
- **Five Below** (NASDAQ: FIVE), due Sept. 8 (estimated)
- **Oracle** (NYSE: ORCL), due Sept. 15 (estimated)

The rest have already been to the rooftop to shout out results. Highlights include:

- **AIG** (NYSE: AIG) showed profitability in its underwriting business, and the new CEO wants to maintain the path of improvement AIG is already on. We like his steady approach and lack of bravado.
- **AmTrust Financial** (NASDAQ: AFSI) grew book value to a new high as fee income increased and insurance profitability remains strong.
- **Facebook** (NASDAQ: FB) grew revenue, margins, and earnings more than expected as mobile ads continue to gain traction and please customers, who are willing to pay more. Even though Facebook predicts higher spending in order to grow — much as a young **Google** (Nasdaq: GOOGL) always increased its spending — growth may swamp its costs.
- **MasterCard** (NYSE: MA) grew net revenue 13% and earnings per share 14% even as spending around the world remains tepid. The company is taking market share from paper money, and when economies get stronger, MasterCard should grow even more.
- **OpenText** (NASDAQ: OTEX) grew new license sales 27%, a great initial showing for its new suite of products.
- **O'Reilly Automotive** (NASDAQ: ORLY) grew same-store sales 5.1%, continuing its incredibly long streak on this metric and so many others. It sees plenty of room to keep adding new stores.
- **Papa John's International** (NASDAQ: PZZA) cooked up more pizzas than ever before in the most recent quarter, and even though Wall Street was disappointed with earnings because the company is spending for future growth, we agree with the strategy, and we view it as upside just waiting to be capitalized on.

And on our list goes.

In cases where companies hit an earnings snag and a stock declines, we may have a chance to step in and buy more. I believe we obtained an attractive price on the additional shares of **Tupperware** (NYSE: TUP) we recently purchased, at $72.90 with a 3.7% dividend yield, as well as our newest **Wells Fargo** (NYSE: WFC) purchase.

You can see full earnings coverage of our companies in our weekly email sent to you today with this Memo, or by visiting the *Pro* site. Overall, as well as our companies are performing, many are trading at value multiples that reflect this strength. In a weaker market, any could fall 10% and we wouldn't be surprised. We can't reasonably trade around that possibility, so we would wait it out, or we'll hedge if we see reasonable opportunities.

The Portfolio

On the whole, the portfolio is reaching new highs today even though the major market indexes are still decently below theirs. That's great for us, because our North Star is always making new highs, too, and even in a strong market you can see how difficult it is to keep up with our goal — our aspirational North Star. We're doing so this year, barely, as our year-to-date numbers show:

	Annualized		
	Since Inception	Rolling 3-Year	YTD
***Pro* Portfolio**	**13.6%**	**12.1%**	**6.6%**
North Star	**8.6%**	**9%**	**6.6%**
S&P 500 Total Return	13.3%	16.8%	5.7%
MSCI World	8.4%	9.5%	3.2%
*Start close of 10/6/08.			

Performance as of 7/31/14.

Since our inception nearly six years ago, we've generated a very healthy annualized cushion above our North Star, but we may need that the next time the market takes a tumble (assuming we're net long, not net short). You can always see our annualized returns at the bottom of the Recommendations page, updated monthly using our brokerage statement.

The exceptional news behind our approach is that we have been, and remain, only about 70% exposed to the market on a look-through basis. We're 72% net long right now, and have only been about 70% net long most of this year, and the past five years, yet we're doing better than the indexes. Here's the breakdown:

Exposure

Long	86.6%
Short	14.4%

Net Long	72.2%
Hedged Out	0%
True Long	72.2%
Cash Ex-Shorts	14.9%
Short Puts	5.6%
Free Cash	9.3%

As of 8/7/14.

That table, too, is at the bottom of the Recommendations page. We often celebrate our returns in the context of our exposure because these results are extremely rare in the world of funds — whether it's a mutual fund (most of which are 98% long all the time, and still trail the S&P 500), or a hedge fund (which on average are doing terribly, on a relative basis *or* absolute basis, since 2009).

Earning strong returns with less risk is the best of investing, at least for those who dislike extreme roller-coaster rides, or who know they might react poorly to steep losses.

Our work is always ahead of us, though, rather than behind us. We need to keep our eye on our positions, our hedges, our big-picture strategy and goals, and always keep learning and thinking — and adjusting to stay on the course we believe is best. That's much more possible when you keep your eyes on the horizon.

I hope you're enjoying August. Fool on!

— Jeff (TMFFischer)

Pro Completed Trades (see all trade alerts)

- **Skyworks Solutions** (NASDAQ: SWKS): We bought a 3% stake (1,300 shares) at $51.42.
- **Intel** (NASDAQ: INTC): All of our shares were called away. For those who kept shares, we recommend continuing to own them if they fit into your portfolio well and you want to avoid taxes. Alternatively, reduce your approximate 6% stake in Intel to 3% to make room for a 3% stake in Skyworks. To match us, though, you would sell your entire stake. Just realize that we may target Intel for put writing later down the road, so selling may prove unnecessary. We don't know.

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Pro Catch-Up Trade: August 11, 2014

Published Aug 11, 2014 at 3:20PM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking*.

- **iShares Russell 2000** (NYSEMKT: IWM): If you lack this portfolio hedge, and you want to hedge, set up one September 20, 2014 bear put spread for every $115,000 you manage. Use a spread order to simultaneously *buy to open* Sept. 20, 2014 $113 puts, and *sell to open* an equal number of Sept. 20, 2014 $105 puts. Lately, this can be set up for a **net debit** of about $1.83 ($183) per spread. That is your maximum loss per spread, which occurs if IWM is above $113 at expiration. The maximum value achievable is $800 per spread, earned if IWM is $105 or lower at expiration.

Pro Live Chat, August 2014

Published Aug 11, 2014 at 12:19PM

At 2 p.m. on Wednesday, Aug. 20, the entire *Pro* crew — advisor Jeff Fischer; senior analyst Bryan Hinmon, CFA; research analyst Billy Kipersztok; research analyst JP Bennett; and editor/publisher Erin Kennedy — answered your questions during a live text chat. Relive the magic below!

Pro's Take: AIG Q2 2014

Published Aug 8, 2014 at 11:17AM

What?

- Fair Value estimate increases from $62 to $64 (representing 0.85x book value)
- Consider Adding More increases from $46 to $48 (representing 0.61x book value)

($ in millions)	Q2 2014	Q2 2013	Change Y-o-Y
Total Revenue	16,105	17,315	-7%
After-tax Operating Income	1,833	1,781	10.8%
Net Income	3,073	2,731	12.5%
EPS	$2.10	$1.84	14.1%
Book Value Per Share	$75.71	$66.02	14.7%
P&C:			
Pre-tax Op. Income	1,355	1,205	12.4%
Combined Ratio	98.8	102.6	
Loss Ratio	64.6	68.0	
Expense Ratio	34.2	34.6	
Life & Retirement:			
Pre-tax Op. Income	1,180	1,151	2.5%
Mortgage Guaranty:			
Pre-tax Op. Income	210	73	187.7%

CEO Bob Benmosche: "*AIG's results in the second quarter were solid. Overall, our businesses demonstrated our continued discipline and resilience, underscoring our focus on improving the results of our core insurance businesses. In many ways, this quarter, my last as President and CEO of AIG, was punctuated by two significant milestones: the completion of our sale of ILFC to AerCap, which marks the last disposition of AIG's non-core businesses, and the appointment of Peter Hancock to succeed me as AIG's next President and Chief Executive Officer.*

We are pleased with the strong performance across all of our Property Casualty, Life and Retirement and Mortgage Guaranty businesses. Our operating results demonstrate our continued progress, and it was another very active quarter for capital management activities. As we look toward the future, I have every confidence that Peter will lead AIG to even more sustainable prosperity in the days and years ahead. Under Peter's leadership, I have no doubt that we will continue advancing our core strategies and priorities with integrity and a profound sense of the responsibility that AIG exceed the expectations – financial, regulatory, and community – of all of our stakeholders."

So What?

This was a strong quarter for AIG (NYSE: AIG), with good (but not spectacular) operating results aided by the benefit of some non-operating items (to be discussed in the following paragraphs). After recently moving AIG to "Buy" from "Buy First" (alert here and more discussion here), I was very happy to see the strong performance in this transitional quarter, as the company closed its final divestiture of a non-core business (ILFC, the aircraft leasing business) and CEO Bob Benmosche retired, setting the stage for the next era of AIG under new CEO Peter Hancock.

As for Hancock, I was very curious to hear his comments on the call in order to assess his management style and temperament, and I was not disappointed. Although not as brash as Benmosche, Hancock came off as intelligent, measured, and capable. Here are a few candid quotes from Hancock that bolster my confidence in his leadership:

> *"There's 3 points I'd make. One is that there will be no abrupt change in strategy. This is clearly a vote for continuity. We're on the right track. We're in execution mode. Second, I remain very committed to focusing on value versus simply bulking up the volume of the company. And third, I will not be replacing myself with a Head of Property Casualty sector."*

I like the comment about value versus volume. In insurance, disciplined underwriting means being willing to forgo revenue growth in order to maintain profitability. I like Hancock's thought process here.

> *"While we have said that no one quarter marks a trend..."*

> *"Our focus remains on balancing growth, risk and profitability right across AIG."*

> *"We continue to expect the accident year loss ratio to decline for the remainder of the year but at a slower pace than we've seen in the last couple of years."*

> *"Commercial Insurance net premiums written declined slightly from the same period in the prior year, primarily from our decision to walk away from certain risks."*

> *"And at this point, to speculate on the exact pace is to speculate on the market cycle."*

All of these comments demonstrated frankness, a willingness to admit obstacles in the road, and a measured and cautious approach. All of these characteristics are very important in insurance, where over-aggressiveness and carelessness can blow up in your face (as AIG itself knows!).

Overall, Hancock seems like a very grounded leader that knows what he has to do to continue AIG's improvement. He also provided some insight on the investments AIG is making to improve its underwriting and insurance operations:

> *"...we are very focused on making the whole company more -- flatter in the hierarchy. And so we want to minimize the layers of management between the CEO and the trenches to improve our responsiveness to customers and markets."*

> *" we are diversifying our book of business, so we're less subject to the cycle and are focusing on subsegmentation at a more and more granular level so that we have greater confidence in these trends in a more sustained way."*

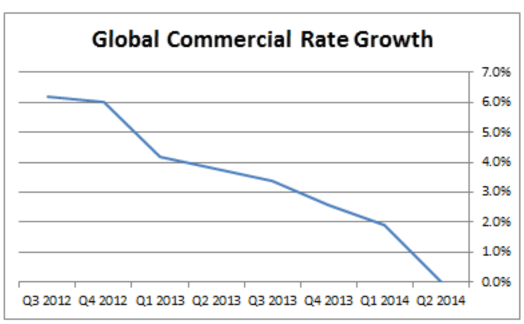
> *"So an enormous reunderwriting of the book over the last 4 or 5 years, a quite considerable change in our claims practices. And so the emergence of loss trends has a fair amount of noise in it. So our actuaries are being quite cautious in recognizing improvements. And we are always on the lookout for any emerging threats."*

> *"While overall rate trends are a metric that we and others disclose, we believe it is the granularity and agility of our pricing strategy that has the greatest impact on our margins."*

> *"Commercial Insurance net premiums written declined slightly from the same period in the prior year, primarily from our decision to walk away from certain risks."*

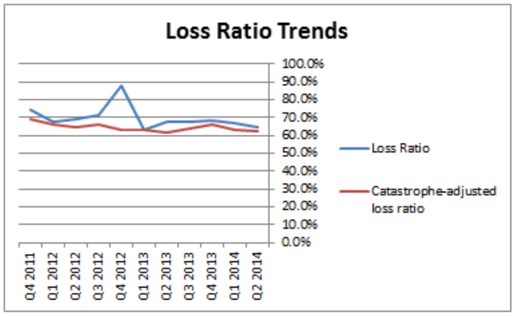
Some pretty encouraging remarks from the new CEO that, along with this quarter's improved performance, suggest continued improvements on the horizon.

Regarding this quarter's improved performance, the key metric we watch is the P&C Segment combined ratio. Pro members following AIG should know by now that a combined ratio below 100% means that the company is earning an underwriting profit. At 98.8%, this quarter's performance was very good, especially in the context of the fact that the combined ratio has been above 100% for the prior 4 quarters. Global commercial insurance rates were flat compared to the year-ago period, making this quarter's performance even more impressive (rate increases make insurance companies more profitable, all else equal). I wrote last quarter that *"the rate of pricing rate increases has been slowing (decelerating from over 6% growth in late 2012 to just below 2% this quarter), which will act as a headwind to combined ratio improvements if the trend continues"*. Now that commercial rate growth was flat, I suspect that quote will continue to come into play in the quarters ahead:



Source: AIG Earnings Presentations

The loss ratio (claims paid/premiums collected) also continued its trend of improvement, although it's important to note that AIG experienced a significantly lower rate of catastrophe losses than it has in prior quarters, so there may be some noise here and we can expect continued lumpiness. But nonetheless the trend is encouraging, and Hancock's comments on underwriting discipline suggest that we might be seeing more improvement when we zoom out and look long-term (again, short-term will be volatile and lumpy, as you can see in the graph):



Source: Company filings

As I mentioned above, the net of some non-operating items added significantly to EPS, most notably the close of the sale of ILFC. That sale led to a $1.4 B after-tax gain on sale, adding $0.96 per diluted share to EPS. Additionally, AIG spent $1.1 B on share repurchases, a value-accretive move with shares below fair value, adding some juice to the per-share numbers.

Despite the non-operating items, operating performance was still very good, with after-tax operating income up nearly 11% year-over-year, ROE of nearly 12%, book value per share up nearly 15% year-over-year to $75.71, and the small (2-5% of total AIG pre-tax operating income) Mortgage Guaranty business showing a 188% year-over-year increase in pre-tax operating income. Revenue declined 7% year-over-year to just over $16 billion, something I'm fine with as Hancock's focus on value over volume shined through.

Overall, it was a strong quarter and one I've been waiting for – performance that adds some strength to the case for our investment thesis – that underwriting profitability will improve and that AIG should be able to earn an ROE of 10% over the long run. Let's wait a few months and see if the business can keep up its newfound momentum.

Now What?

- P/B: 0.69 (down from 0.74x last quarter)
- ROE: 11.6%
- Market Cap: $76.3 billion
- Fair Value (updated): $64 (up from $62)
- Consider Adding More (updated): $48 (up from $46)
- Allocation: 3.7% in stock and about 0.7% in warrants or LEAPS
- Status: Buy

After recently notching AIG down to Buy from Buy First, this quarter's performance strengthens our investment case. Another quarter of good performance might make us reconsider whether we want to bump AIG back up to Buy First (of course, depending on where the stock price goes). This quarter's performance was enough for us to tick up our Fair Value and Consider Adding More to $64 and $48, respectively (to account for an increase in book value) and we have an allocation of about 3.7% in stock and 0.7% or so in warrants or LEAPS. Members who have yet to match our allocation should feel free to do so at the current valuation.

Fool on!

Billy (TMFTailwind)

OpenText Sells More Software

Published Aug 7, 2014 at 3:45PM

Greetings, Fools.

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Pro Guidance Update

• Fair Value Estimate increases to $52 (up from $44)

• Consider Adding More goes up to $45

• Still a Buy, and we're happy to own 3.6%

Summary: New license sales jumped 27% at **OpenText** (NASDAQ: OTEX) and margins jumped as the new software that debuted a few quarters ago starts to gain traction; separately, the GXS acquisition is starting to integrate. Management projects continued strength given its strong, new product lineup and industry growth of around 10%. Little else changed in the business the last 90 days, but the numbers certainly indicate how strong the financials can be when sales gain ground.

Q4 2014 Results

• Revenue: +42%

• Diluted EPS: +46%

• License Revenue: +27%

• Oper cash flow: +108%

Background

OpenText (NASDAQ: OTEX) sells enterprise information management (EIM) software via cloud and license sales to organize and manage electronic content, business processes, regulatory and other data for customers. It also conducts, invoices, and manages business transactions through its GXS acquisition. The company's sales are spread across industries, governments, and geographies.

Pro's thesis: The enterprise information management (EIM) software industry will grow by about 10% annualized, and OpenText will grow at least that quickly over time. In addition, OpenText will be a leader in business exchange transactions, and recurring, fee-based revenue will grow.

Guidance: Shares remain a Buy at a 3.6% allocation. If you're using options, you can also write puts to potentially buy shares or target income. Looking ahead at the newly merged business with GXS, we should see value ratios back to average or below-market average multiples in about a year (11x EBITDA, 13x EPS).

Overview

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Pro Guidance

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- Fair Value: $52 (up from $44)
- Consider Adding More:$45 (up from $34)
- Current Allocation: 3.6%
- Status: Buy (and/or write puts for income)
- Yield: 1.27%

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Valuation @$54.50

$6.6 billion market cap

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Metric Multiple

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- EV/Sales 4.6
- EV/EBITDA 14.6
- EV/EBITDA NTM est 11.7
- P/FCF 17.7
- P/E GAAP 30.4
- P/E NTM est. 13.5

NTM = Next Twelve Months

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Cash

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- OCF $417 million
- Cap Ex $42 million
- FCF $374 million
- Cash & Equiv. $428 million
- LT Debt $1.2 billion (due to recent acquisitions)

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Past 3-Year CAGR

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- Revenue 16.3%
- Net Income 21%
- FCF 22%

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Ratios

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- Gross Margin 72.8% (all good numbers trending up)
- Cont. Op Earnings 13.4%
- FCF 22.3%
- ROE 14.6%
- Debt/Equity 80.3% (we'll want to see this trend down; down from 85% last Q)
- Debt/Capital 44.5% (down from 46%)

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Fiscal 2014 Results

• For fiscal 2014, revenue grew 19.2% to $1.62 billion, with 54% of sales in North America.

• License revenue grew a strong 10.6% (almost all of it organic).

• Cloud revenue grew 108% and gross margins jumped to 62.5% from 58.4%.

Q4 Conference Call Notes

• Q4 adjusted operating margin was 32.8%, up from 29.5% the prior quarter

• The company has increased its guidance for non-GAAP operating margin to between 28% to 32%

• Q4 adjusted net income grew 52%

• CEO Barrenechea: "The more we can help our customers simplify, transform and accelerate their information needs, the more successful we will be. Collectively, this is what we call Enterprise Information Management, or EIM. We have never been more aligned with those priorities of our customers, and you can see this in our Q4 and full year results."

• Average deal size grew to $429,000 including 16 deals at $1M+, and 10 cloud bookings over $1M, including wins over IBM. "We win more than we lose."

• The company is in the middle of a strong product cycle with its EIM suites and B2B services both. They'll unveil next gen Blue Carbon in November. It centers on Cloud Services, applications, analytics and will extend naturally from OTEX's current suites (Red Oxygen).

• The company is looking to expand its B2B integration efforts, and is expanding its sales effort.

• OTEX looks to put $3 billion of capital to work over the next few years, looking to acquire and invest to grow.

• Organically, OTEX grew revenue 8% this year while the industry is growing 10% to 11%, so it has more work to do to capture more share.

Want more? Want to talk?

- For more from OpenText, including full investor presentations, please see the company's IR site: http://investors.opentext.com
- To discuss OpenText, visit the discussion board on *Pro*.

Best,

Jeff

Fighting Cheese and Taking Share

Published Aug 7, 2014 at 11:15AM

Pro's Take: PZZA Q2-2014 Earnings

Papa John's International (NASDAQ: PZZA)

Quarter Quick Take

Papa John's continues to sling pies at an impressive rate: North American restaurants increased comps by +6% and International restaurants increased comps +9%. Limited time offers and continued migration to digital ordering (which garner higher average tickets) helped drive comps higher. These growth rates suggest continued market share gains at the expense of smaller rivals, and likely other large pizza chains. Modest new unit growth (47 more restaurants than Q1-2014, about +1%) added a bit more growth to the topline. But the growth stopped there; The Company shielded franchisees from rising cheese and prices at the expense of commissary margins and continued spending to roll out the new point of sale system (called FOCUS) ate into profitability – operating profit was flat and net income dipped. Debt fueled buybacks boosted EPS. Overall, Papa John's is carrying out its strategy well (as evidenced by the systemwide comp sales and recent announcement of being voted the highest customer satisfaction among major pizza chain by ACSI for the 13th year out of the last 15) but financial results are lagging business results – a problem that I believe is only temporary.

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Q2-2014

Total revenue growth: +9%

Operating profit margin: -63 bps to 7%

EPS growth: +3%

....

Guidance Update

Papa John's is currently a Buy. The current headwinds don't give me reason to adjust my longer-term assumptions. Papa John's is doing the right things for long-term success: supporting franchisees during a time of rising commodity costs, investing in technology to drive sales and productivity, and maintaining its focus on quality. There will be more bumps in the road as the company expands internationally, but I believe the long-term economics of the business remain intact and that share are modestly undervalued.

Updated guidance: Buy (no change)

Recommended Allocation: 3.5%

Fair Value estimate: $46 (up from $45)

End of Fiscal Year expected FV estimate: $49

CAM price: $35 (up from $34)

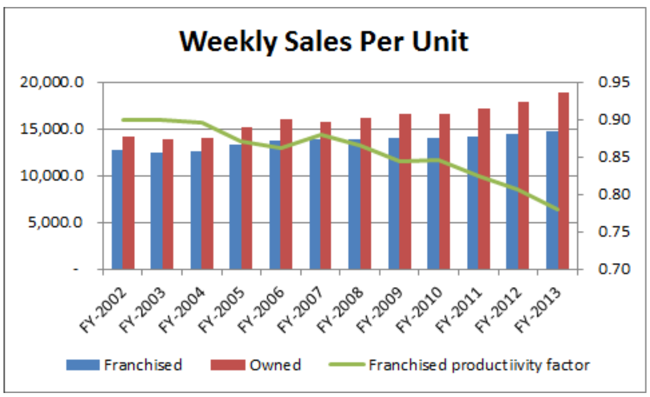
PZZA shares have fallen about -8% this year and about -24% from their high – completely attributed to valuation compression. Shares fell from an EV/EBITDA multiple of 17x to 13x, which is a discount to other prominent franchise operations like **Domino's** (NYSE: DPZ) 15x and **Dunkin' Brands** (NASDAQ: DNKN) 17X. Once Papa John's begins to translate its business success into financial success, we should begin to see that discount narrow. We got a nod from the Board that future cash flows should be strong as indicated by the 12% dividend increase ($0.56 per share, up from $0.50).

Our Thesis

Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main QSR-pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only 1,000 international restaurants the company has a long runway for growth. Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

1. ***Store Performance:*** Without healthy franchisees Papa John's has no business. Same store sales offer one look into store performance, but we also track sales per store, store-level profitability, and how all of this translates into the pipeline of committed new franchisees. During Q2-2014, systemwide restaurant sales increased a +10%. Domestic stores experienced strong +6% comp growth while international comps increased +9%. Management raised comp sales guidance for the year to +4% to +6% for North America stores and to +6% to +8% for International stores. This was a disappointment given both domestic and international comps stand at +8% through the first half of the year We won't know more about store-level profitability until the end of the year. Overall, the solid restaurant performance keeps franchisees signing up: PJ opened 265 restaurants (net) in 2013 and expects to open 220-235 (net) in 2014, which was narrowed from 220-250. Its pipeline consists of 300 domestic commitments (to be opened over the next three years) and 1,100 international commitments (to be opened over the next six years).

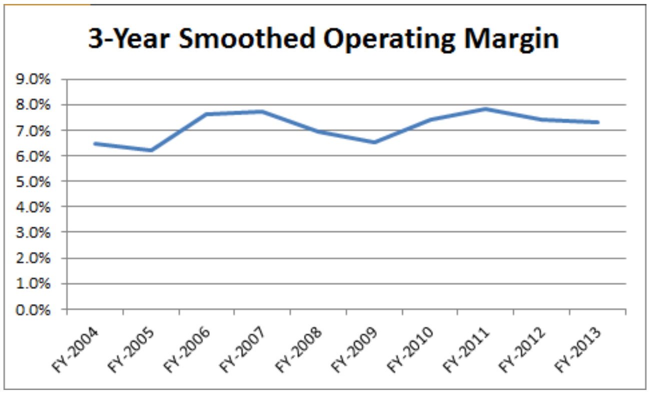


2. ***Brand***: Brand strength is challenging to measure, but we need to monitor it because it is key to the company's brand-based advantaged and higher price per pie. Papa John's domestic outperformance and share gains suggest its brand positioning remains strong. Management is as committed to quality and the "better ingredients, better pizza" mission as ever, as evidenced by: continued drum-beating on conference calls, consistent media messaging, increasing the franchisee marketing spending rate, and the hiring of a new marketing agency to spread the message beyond television. Papa John's continued its winning ways in the ACSI customer satisfaction survey (just released). The company scored the highest among its pizza chain competitors for the 13th year in the past 15, and extending its streak to three.

ACSI Customer Satisfaction Scores

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Papa John's	76.0	77.0	78.0	76.0	76.0	77.0	78.0	79.0	77.0	76.0	75.0	80.0	79.0	83.0	82.0	82.0
Little Caesar	70.0	69.0	70.0	74.0	75.0	74.5	74.0	77.0	75.0	75.0	75.0	78.0	80.0	82.0	82.0	80.0
Domino's Pizza	67.0	69.0	73.0	75.0	75.0	73.0	71.0	75.0	75.0	75.0	77.0	77.0	77.0	77.0	81.0	80.0
Pizza Hut	68.0	70.0	71.0	70.0	75.0	73.0	71.0	76.0	72.0	76.0	74.0	78.0	81.0	78.0	80.0	82.0
Limited-Service Rest. Avg.	69.0	70.0	71.0	71.0	74.0	75.0	76.0	77.0	77.0	78.0	78.0	75.0	79.0	80.0	80.0	80.0
Papa John's	**76.0**	**77.0**	**78.0**	**76.0**	**76.0**	**77.0**	**78.0**	**79.0**	**77.0**	**76.0**	**75.0**	**80.0**	**79.0**	**83.0**	**82.0**	**82.0**
Competitor average	68.3	69.3	71.3	73.0	75.0	73.5	72.0	76.0	74.0	75.3	75.3	77.7	79.3	79.0	81.0	80.7
Gap	7.7	7.7	6.7	3.0	1.0	3.5	6.0	3.0	3.0	0.7	(0.3)	2.3	(0.3)	4.0	1.0	1.3

3. ***Margins***: Ultimately, we expect the capital light business model to result in higher operating margins that propel free cash flow generation. In the near term, we expect Papa John's to continue to spend heavily to support the build-out of its technology platform, new POS system, and international infrastructure. This trend continued in Q2-2014, exacerbated by spiking cheese prices, and operating margins declined by 63 bps to 7%. Eventually, PJ should leverage its buying power and corporate overhead to improve margins and drive cash flow. Although PJ isn't demonstrating operating leverage right now, temporary blips don't mean that the long-term economics of the business won't play out.



WWTN

Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. Near term headwinds (commodity prices and technology investments) should prove temporary and Papa John's should deliver improved financial performance.

Conference Call Notes

- On units: PJ opened 47 net global units during the quarter, with 42 of those international. Management narrowed its expected unit opening range to 220-235 from 220-250. It looks to me like that is more of a timing thing, because at the same time, the pipeline of domestic restaurants expanded from 200 to 300.
- On Papa Rewards: PJ was the first national chain to launch a loyalty program (2010) and it continues to grow in popularity. In fact, Bond Brand Loyalty announced survey results that show Papa Rewards was the highest rated QSR rewards program. Members are "proud" to be in the program (a reason that finished ahead of the actual rewards portion, and was a rarity among programs) and the program received scores higher than Starbucks!
- On Steve Ritchie promotion: After Tony Thompson was poached, PJ promoted from within to fill its COO slot. Schnatter said: "*With all the success we have had, Papa John's has become an example of constant team member advancement and opportunities. A people growing machine, if you will. Over the past quarter, we have made ten management changes with nine leadership promotions, including the promotion of Steve Ritchie to COO. Now, Steve started out as a driver. At $4.50 an hour, more than 18 years ago, and working his way up as director of operations and Vice President of global operations support and training to now COO. Steve is the ideal individual to lead Papa John's to its next stage of growth and is a great example of the opportunities Papa John's is able to provide for hundreds and hundreds of hard working team members who put dignity into their work.*"
- On digital ordering: Domestic digital sales continue to climb well over 45%, and nearly 60% of all delivery sales came through digital channels.
- On the quarter: CEO John Schnatter said: "*In short, from our quality to our digital capabilities to our new marketing creative, we are firing on all cylinders right now and we are gererating a lot of momentum that continues to lead to increased sales and increased market share. But remember, it all starts with quality. And our consistent focus on it continues to resonate with customers. During the quarter, for the 13th time in the past 15 years, consumers recognized us as a leader in customer satisfaction by rating Papa John's number one in the survey.*"
- On Guidance: PJ reaffirmed its 2014 full year EPS guidance ($1.64 to $1.72 – putting shares at 25x earnings at the midpoint). However, it raised domestic comp expectations to +4% to +6% and international to +6% to +8%.
- On future financial performance: "*The market share we are gaining through our strong sales bodes well for higher earnings growth once commodities return to more normalized levels.*"
- On FOCUS: The last system is 18 years old, so all of the hardware is being upgraded. The software is designed to improve order entry (to increase speed and accuracy). It will also have an enhanced graphical driver dispatch system and routing capabilities. It should help franchisees better manage labor, and it introduces biometrics with the intention of helping loss prevention. The roll out will hurt EPS by $0.08 this year, but benefits should begin to show in 2015.
- On commissary: PJ reiterated that it manages commissary margin on an annual basis, so this temporary margin hit will be made up in the back half of the year, hopefully as commodity prices moderate. Taking the hit on margins is designed to smooth out costs for franchisees.
- On Corporate China stores: Sales growth hasn't played out as expected. PJ has 210 stores in China and franchised units are outperforming company-owned units. PJ is stepping up its marketing efforts a bit and trying to learn from the success of its franchise units.

Buy Skyworks Solutions

Published Aug 5, 2014 at 2:09PM

How You Participate

- **Action:** Buy **Skyworks Solutions** (NASDAQ: SWKS).
- **Allocation:** 3% (*Pro* will buy about 1,200 shares).
- **Scorecard Status:** Buy
- **Fair Value Estimate:** $64
- **Recent Price:** $51.55
- **Price Guidance:** Use a limit order and initially aim to pay less than $52.20. As prices change over time, this starting guidance loses relevance, and our guidance remains "**Buy**" until that officially changes.
  .

What We're Thinking

Skyworks Solutions makes technology that powers wireless connectivity in everything from **Apple** (NASDAQ: AAPL) and Samsung smartphones and tablets, **Medtronic** (NYSE: MDT) medical devices, to **Google** (NASDAQ: GOOG) and **General Electric** (NYSE: GE) products. Dubbed the "Internet of Things," the world is starting to connect billions of new objects to the Internet, and Skyworks is uniquely positioned to benefit. Not only does it serve all of the top-tier mobile computing device makers, but Skyworks is also diversified across industries to serve more than 2,000 customers.

The company sells more than 2,500 high-performance analog semiconductors and related products (supported by nearly 1,000 patents), including amplifiers, attenuators, receivers, switches, diodes, modulators, GPS power and voltage regulators, and more. They're often sold together into a phone or any connected device. Skyworks earns industry-beating operating margins of 30.5% selling specialized solutions to giant customers with growing connectivity needs. Here are just a few examples:

- GE plans to make all of its industrial products (from jet engines to turbines) Internet-enabled.
- Medtronic will connect many of its medical devices to the Web for monitoring.
- A majority of new automobiles will be connected to the Internet by 2017.
- Smartphone sales are expected to surpass 1 billion units by 2016.
- Plus, wearable technology is likely to come into vogue.

All told, **Cisco Systems** (NASDAQ: CSCO) expects 25 billion devices will connect to the Internet by 2015, and 50 billion by 2020.

Skyworks is already benefiting, and it's ready for much more. As CFO Donald Palette said in July, "We've spent the last decade investing significant resources and leveraging our technology to expand our presence in traditional analog markets like automotive, medical and industrial. We have established significant traction in these higher-margin growth avenues, and we see tremendous opportunity ahead."

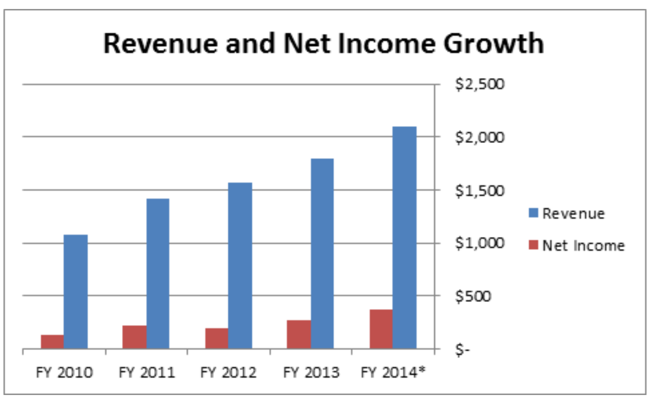
Whatever device is being connected to the Internet, the smaller, more complex, and more efficient the technology needs to be, the more it benefits Skyworks. Not only that, but the more data flowing through networks, and the more connection nodes needed, the more Skyworks products are needed. Palette said in the July conference call, "Complexity for us drives profitability. And there are fewer and fewer people in the space that can do it," even as complexity accelerates. Given this, Skyworks expects profit margins to continue to move higher. It is helped in this regard by having its own manufacturing facilities for many differentiated products, and contracting the rest.

Following the company's most recent earnings report, CEO David Aldrich said, "Skyworks is entering a new and exciting growth phase driven by global wireless proliferation and the Internet of Things. Quite simply, we are capitalizing on the macro trend to connect virtually everyone and everything, all the time." But most significantly, he continued: "Skyworks is setting the pace for analog semiconductor industry growth in terms of both revenue and value creation."

How It Fits Into *Pro*

We seek financially strong companies with growing market opportunities and proven management. We want to see strong growth in free cash flow as revenue grows. That's particularly true (and rare) with semiconductor companies, which too often grow revenue but struggle to balloon profits at the same time. Here, Skyworks stands out. Since 2010, revenue has nearly doubled from just over $1 billion a year to $2 billion the past 12 months. Over the same time, operating income is up 138% to $473 million as margins expand. Net income is up 168% to $367 million. Free cash flow the past 12 months is $565 million, up 322% from fiscal 2010. Finally, the balance sheet is strong, with $893 million in cash and no debt.

Valued around $9.8 billion, the stock trades at 17.3 times free cash flow, and 16.5 times $3.13 in normalized earnings per share expected for the year ending September (right around the corner, and likely in the bag). Conservatively, normalized earnings per share are estimated to grow another 25% by September 2015, putting the stock at 13 times estimates 14 months ahead. In the July conference call, management spoke of hitting $5 per share in earnings before long, as revenue grows and margins float higher.



*On a run-rate basis.

- **HQ:** Woburn, Mass.
- **Founded:** 1962
- **Employees:** 4,750
- **Market Value:** $9.8 billion
- **TTM Revenue:** $2 billion
- **TTM Net Income:** $367 million
- **TTM Free Cash Flow:** $565 million
- **P/FCF:** 17.4
- **Most Recent Quarter Sales Growth:** 35%
- **Most Recent Quarter EPS Growth:** 54%

Yet this is all short term. It's the long term that interests us. Skyworks plans to continue to expand its portfolio, is investing in sensors, and wants to add to its Internet of Things portfolio, perhaps with acquisitions. The company foresees "sustainable above-market growth" as far forward as it can look, and leans conservative with its long-term guidance of annualized *industry* growth rates in the mid-teens. Its gains in market share partly come at the expense of single-component manufacturers, who are getting squeezed by increasing complexity that asks for full, or modular, and specialized solutions like Skyworks provides.

As to our portfolio: As we let our **Intel** (NASDAQ: INTC) shares get sold, we're letting go (for now) of an excellent but slow-growing semiconductor company, one that is far from turning a profit on mobile computing, and that still struggles to have much relevance in smartphones and tablets. We replace it with a business creating strong, growing value in Internet connectivity — and in mobility — for a wide array of objects, and trading at a lower multiple to free cash flow than Intel. Skyworks also complements *Pro*'s investment in cell-tower owner **American Tower** (NYSE: AMT), fitting our thesis that mobile connectivity will grow for years. The riskiest overlap in the portfolio is arguably with Apple, a major customer for Skyworks, but one that is becoming a smaller piece of the revenue pie as the broader Internet of Things grows.

The Foolish Bottom Line

Skyworks' CFO said in July, "We take a very long-term strategic view of our business, and we think we're positioned extremely well. I don't think we've ever been positioned as well as we are today for the long term." We make this investment with solely the long term in mind, too. If management continues to execute, demand should flourish, and it's plausible our investment at least doubles in five or six years. Meanwhile, today's valuation and the company's customer list for the coming year (and longer) should mitigate our risk while we wait. However, expect a bumpy ride. Chip stocks are volatile and cyclical, and technology evolves and always carries extra risk. Overall, though, a large, long-term move toward connectivity favors value creation at Skyworks.

Alternative Trades

- **Only want to target lower buy prices?** You can sell to open puts, one for every 100 shares you would buy at lower prices. Take your pick of options, but realize this is a Buy stock and we're starting with a direct 3% stake.
- **Synthetic long?** You could set up a January 2016 synthetic long instead, but in a taxable account that may not be as tax efficient as simply owning shares for years.

Pro Can Help

- **Feeling an urge to connect?** Ask questions and comment on the new Skyworks board, where we're ready to spark a discussion.

The Battle Between Your Ears

Published Aug 4, 2014 at 3:23PM

Fellow Fools,

It's official: I'm the newest member of the *Pro* and *Options* teams. Only a few short years ago I was a doctoral student in psychology who thought that investing was destined to remain merely my favorite hobby. But following a career-changing epiphany, a very Foolish internship, and an MBA, I now stand before you as a member of the newest Analyst Development Program cohort here at the Fool.

Many faculty members in the Ph.D. program (politely) asked me why I was leaving to study something that had little to do with the subject to which I'd devoted most of my life. My response was simple: These subjects are not disparate and my time spent studying psychology would be put to excellent use in my new field. That belief has only strengthened over time, and I can think of no better topic for my first Memo than some of the psychological traps I'll be working to avoid to help *Pro* continue racking up North Star-beating returns.

Anchoring

Our brains are hardwired to make comparisons. Although this can help simplify and speed up many of our daily activities (who wants to judge the intrinsic value of two different bottles of ketchup, anyway?), it can definitely be a detriment when it comes to investing. It's true that anchoring can lead us to stubbornly hold onto shares — when we really should sell — simply because we bought in at a higher price. But I think it is important to recognize that anchoring can also cause us to miss out on huge gains.

As investors, we need to focus on where the stock is *going*, not where it's been. I can remember more than a few friends proclaiming around July of last year — the time **Facebook** (NASDAQ: FB) finally climbed back up to its IPO price — that the time to buy was when it fell below $20 and now the opportunity had passed them by. As *Pro* members can attest, that type of thinking isn't just flawed; it's downright costly. The stock has climbed over 100% since then.

Sunk Costs

Have you ever spent hours and hours working on something only to realize it was never going to meet your expectations and it was time to move on? How'd it feel? If your response was "not good," don't worry; you're not alone. Our decisions are tainted by the investments (money, time, emotions, you name it) we make, and the more we invest in something, the harder it becomes to abandon. Much to the chagrin of many economists, we are not rational automatons. We fear losses of all kinds, even in the face of a reward that will far outweigh the risk. Or in the case of someone who is unable to objectively value a stock because of the amount of time and effort spent researching the company, we set ourselves up for financial losses because we are unable to treat our efforts as what they truly are — namely, sunk costs. For what it's worth, research has shown that we're not born like this, as children are less prone (link opens PDF) to falling prey to this trap. Perhaps it really does pay to never grow up.

Knowledge Can Be Dangerous

It can sow the seeds of overconfidence. Just ask the principals of the now-defunct Long-Term Capital Management. Its payroll included two of the three minds responsible for creating the most well-known options pricing model, and yet LTCM still managed to bring the global financial market to its knees. The fund-management firm crippled the financial world through its excessive leverage and mind-boggling $1 trillion worth of derivative exposure.

Extensively studying an investment opportunity and poring over various filings may lead you to a better understanding of the risks involved, but doing your homework doesn't make every firm-specific and macro risk magically disappear. Even so, it's only natural for your confidence to grow as the time you spend analyzing an opportunity multiplies. This is why it is imperative that any valuation embeds a margin of safety into the analysis.

And since this is my first Memo, I'll even throw in a bonus: Though knowledge of various psychological traps can give us a sizable leg up over other investors, it (unfortunately) does not make us immune to their influence. Trust me — I almost became a doctor.

Foolishly yours,

JP (TMFYossarian)

P.S. from the *Pro* team: Please stop by the Meet & Greet board and give a hearty welcome to JP!

Pro Completed Trades (see all trade alerts)

- **Wells Fargo**(NYSE: WFC): We bought 500 more shares at $51.80, bringing our total stake in the leading bank to 1,700 shares, or 4.1% of the portfolio. The stock currently yields 2.8%.
- **Tupperware**(NYSE: TUP): We bought 300 more shares at $72.90, bringing out total stake in the container company to 1,000 shares, and 3.5% of the portfolio. The stock currently yields 3.7%.

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Pro Catch-Up Trades: Aug. 4, 2014

Published Aug 4, 2014 at 12:52PM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking*.

- **Gentex** (NASDAQ: GNTX): With earnings behind it, shares remain a Buy up to a 3% allocation.
- **Tupperware** (NYSE: TUP): Down sharply after earnings, the container guy's new price looks like a good entry point for those lacking a 3.5% stake.
- **Wells Fargo** (NYSE: WFC): Another good earnings report and a tick higher in our fair value estimate. If you lack a 4.1% position, get out your checkbook and buy.

Pro Completed Trades: Week of July 28, 2014

Published Aug 4, 2014 at 12:48PM

In the last week, *Pro* acted on its two most recent "Buy" recommendations.

- **Wells Fargo** (NYSE: WFC): We bought 500 more shares at $51.80, bringing our total stake in the leading bank to 1,700 shares, or 4.1% of the portfolio. The stock currently yields 2.8%.
- **Tupperware** (NYSE: TUP): We bought 300 more shares at $72.90, bringing out total stake in the container company to 1,000 shares, and 3.5% of the portfolio. The stock currently yields 3.7%.

Pro's Take: American Tower Q2 2014

Published Jul 31, 2014 at 9:39AM

What Happened?

- Total rental and management (R&M) revenue of $1.0 billion (the first billion-dollar quarter in the company's history)
- Domestic R&M segment revenue of $660 million (year-over-year core* growth of 30%)
- International R&M segment revenue of $346 million (year-over-year core growth of 39%)
- Adjusted EBITDA of $682 million (year-over-year core growth of 34%)
- Adjusted funds from operations (AFFO) of $474 million (year-over-year core growth of 31.4%)
  - Record per-share growth of 29.3%

*Core growth reflects adjustments for foreign currency exchange rates and prior period one-time items

Remarks From CEO Jim Taiclet

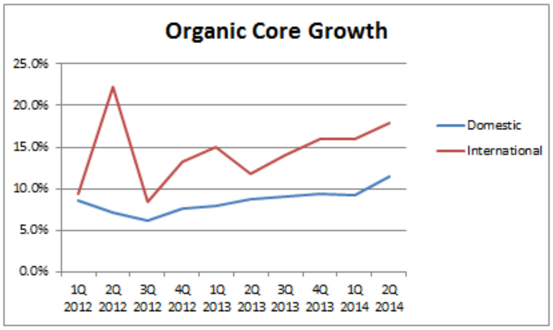
"Our second-quarter 2014 results exceeded our expectations across all key metrics due to strong global demand for our tower space. 4G coverage and densification initiatives by our major tenants drove Organic Core Growth of over 11% in the U.S., and significant investment levels by tenants internationally drove Organic Core Growth of nearly 18%. These strong Organic Core Growth trends, in combination with contributions from new assets, led to record AFFO per share growth in the quarter of over 29%.

We expect favorable leasing demand for communications real estate to continue and accordingly, we are raising our full year outlook for total rental and management revenue, Adjusted EBITDA and AFFO by $45 million, $55 million and $30 million, respectively."

So What?

Another outstanding quarter from **American Tower** (NYSE: AMT) as business results continue to blow past management's (and my) expectations. There's a lot of momentum in American Tower's markets, and management *again* raised its full-year 2014 outlook, even after raising it just last quarter. Growth rates continue to accelerate: organic core growth for the quarter clocked in at 11.4% (vs. 9.2% last quarter and 8.7% for FY 2013) and nearly 18% internationally (vs. 16% last quarter and 13.5% for FY 2013). The weighted average organic growth (U.S./ international blended) was 13.6% (vs. 11.5% last quarter and 11.2% for FY 2013). Organic growth excludes growth from acquisitions and new site builds and is more reflective of the underlying economics of the business.

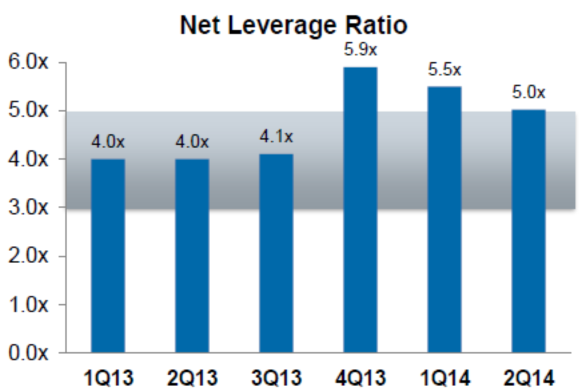
I wrote after Q4 2013: "For 2014, I'm expecting continued strong organic growth, and barring unforeseen macro-economic changes, I'd be surprised if organic growth rates were below the mid-point of guidance (7% in the U.S. and 10.5% internationally)." Including last quarter's strong performance, American Tower continues to blow away those estimates. In the graph below, you can see how organic growth is accelerating. Although international growth is a bit lumpy, due to growing off of a smaller base and due to American Tower's varied international presence, there is a clear upward trend in growth rates since late 2012:



Source: Earnings presentations and analyst calculations.

Although carrier network investment (the key driver of organic growth) happens in cycles and we can't expect this acceleration in growth to continue unabated, it's nice to see and results are better than I projected. Consequently, I've increased the relatively conservative growth assumptions built into my valuation model.

As far as leverage is concerned, American Tower continued to pay down debt with cash flow and reduce its leverage ratio (debt/EBITDA). This was expected, and after two quarters where the company operated above its target leverage ratio, American Tower is now sitting at the high end of its target range (3 times to 5 times):



Source: American Tower Q2 Earnings Presentation.

Last quarter I wrote: "Management expects to get the leverage ratio below 5x by 2015, but if the company sees an acquisition opportunity it likes, I wouldn't be surprised to see them take advantage of their flexibility and change course to pursue it. That would potentially drive the leverage ratio higher again (if another major acquisition does indeed happen – who knows if it will)."

Because of the focus on paying down debt, the company has dialed back on big acquisition spending (around $500 million year to date on acquisitions vs. $4.5 billion in 2013), instead focusing on growing its tower count more slowly through new site builds and minor acquisitions. Despite this, American Tower announced an approximately $1 billion acquisition of Brazilian company BR Towers in June, and that transaction is expected to close in the fourth quarter of 2014. This management team is constantly on the hunt for attractive investment opportunities, and I suspect that we might be looking at another large-scale acquisition sometime soon (maybe in a new market), perhaps once the leverage ratio gets toward the lower end rather than the higher end of management's target range.

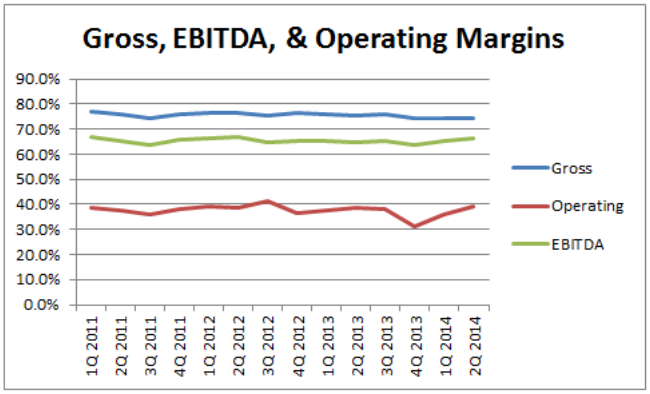
Yearly distribution growth continues to track ahead of management's 20% growth target, coming in at 26% growth ($0.34 per share). 20% annual distribution growth continues to look like a more than reasonable target for 2014 and beyond.

Now What?

The market viewed American Tower's earnings report favorably (I don't blame it), bidding up shares on the day of the report about 4.2% compared to the previous day's closing price. The company's strong results on all of its key metrics support a positive stock price move.

This quarter's report yet again provides confirming evidence that our investment thesis (that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time) continues to play out.

Margins continued to tick up nicely as the company integrates its big acquisitions and improves its efficiency (for example, increasing its pass-through revenues in international markets):



Source: Company filings and analyst calculations.

Foreign exchange (FX) effects continued to impact results and projections, with management expecting that FX fluctuations will knock 3.2% off revenue for full-year 2014. Once foreign exchange effects turn the other way, American Tower's results will look that much more impressive.

Data and Guidance

- Current Price: $96.25
- Fair Value estimate (updated): $110
- Consider Adding More (updated): $78
- Market Cap: $38.3 billion
- EV/EBITDA (TTM): 21.2

AMT remains a Buy First, with an **updated Fair Value estimate of $110 per share and an updated Consider Adding More price of $78**, reflecting continued strong results that prompted me to increase my growth forecasts. If you've yet to start a position or didn't add to your stake when we did so in mid-March, don't anchor on the recent positive stock price move. Now is as good a time as any to match our 4.1% allocation in this accelerating business that's selling for about a 14% discount to Fair Value.

Fool on!

Billy (TMFTailwind)
Long AMT

Buy Tupperware

Published Jul 30, 2014 at 2:30PM

Is this for you? *Pro* is increasing its allocation to **Tupperware** (NYSE: TUP) by 43%, bringing the stock's percentage of the portfolio to 3.4% (up from a current 2.4%). If you're following our portfolio closely, you should buy more Tupperware with us.

How You Participate

- **Action:** Buy Tupperware
- **Allocation:** Increase your allocation to 3.4%. *Pro* will buy another 300 shares, bringing our total to 1,000.
- **Recent Price:** $72.77
- **Price Guidance:** Use a limit order at current prices, and initially aim to pay less than $73.00.

What We're Thinking

Tupperware operates around the world but remains underrepresented in key markets such as Asia, Latin America, and Central Europe. Large opportunities remain despite 65% of Tupperware's revenue already being generated in emerging markets. Through 1,900 distributors, 93,000 managers, and a sales force of 2.9 million, the company sells consumer kitchen products that are often custom-made for a local market. In China, water purification products are a top seller. In France, it's a microwave steamer. Throughout Asia, rice products sell briskly.

Operating in dozens of countries and relying on citizens themselves to host Tupperware parties means some markets will see weakness in any given quarter. Last quarter, one of Tupperware's historically best-managed countries, Germany, suffered a sudden 29% decline in sales. We expect a recovery as management regroups and more parties are planned. Sales in Indonesia grew 16%, but that was well below the country's recent 25% growth rate. The culprit? Tupperware increased prices in the region due to higher input costs, and there was a presidential election. We've seen politics dampen results in various countries over the years, not to mention conflict doing the same, which is affecting Israel, Ukraine, and Russia — all areas where Tupperware operates.

As a result, Tupperware's quarterly reports are always interesting. When most of its key markets do well, the company usually grows more than expected. But when a few large markets suffer, the stock can tumble, as it has since this month's earnings report. Near $72, shares trade at 13.2 times expected 2014 earnings of about $5.45 per share, and yield a 3.7% dividend. We believe the problems of last quarter will resolve before long, and Tupperware will grow enough in the coming years to challenge our North Star.

How It Fits Into Pro

At an attractive price well below our $85 Fair Value estimate, we're increasing our Tupperware allocation to 3.4%. This leaves us more room to add still more exposure later if we wish. Unique in our portfolio, we appreciate Tupperware's low-cost, direct-sales approach, and its long-term desire to grow its sales force from 2.9 million to 5 million to address opportunities in burgeoning population centers, including India and China. The company has increased its leverage to address opportunities and buy back shares, so we'll be keeping a close eye on its capital-spending decisions.

Stock Info

- **Fair Value Estimate:** $85
- **Consider Adding More:** $75
- **Scorecard Status:** Buy

Alternative Trades

- **Write Puts.** If you would rather sell to open puts to potentially get more shares, consider writing any $70 or $75 puts. Write $75 puts if you're more eager to get shares, as they're in-the-money but still offer decent time value.

Pro Can Help

- Questions? Pop on over to our Tupperware board.

Pro: What We Think Now

Published Jul 29, 2014 at 2:12PM

See all our active trades at a glance, including our strategies and high-level thinking. We've highlighted recent changes with icons, and you can click on any column header to sort the table, which is initially sorted by allocation.

Holding	Ticker	Rating	Summary
SPDR S&P 500 ETF	SPY	Option: Put Ratio Spread	We're using low-cost hedge strategies called put ratio spreads to protect against downside in the S&P 500 while not risking anything if the market goes higher.
Facebook	FB	Buy First	Facebook remains a young story about monetizing the largest, most engaged online audience ever hosted by one company, and Facebook's future is in strong hands because management is showing patience and care as it monetizes more of its properties, putting visitor experience first. The billions of connections maintained on Facebook's properties are making the sites extremely sticky, offering the potential for increased value to advertisers (and thus Facebook owners) for years to come.
Broadridge	BR	Buy First	Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.
O'Reilly Automotive	ORLY	Buy	With exceptional management in the driver's seat, O'Reilly Automotive will grow impressively by adding new auto parts stores, acquiring others, and growing same-store sales.
AmTrust	AFSI	Buy	Under the radar, AmTrust is a disciplined underwriter of workers' comp and warranty insurance policies that is expanding opportunistically into other low-hazard areas and new geographies. Book value should continue to grow.
MasterCard	MA	Buy First	MasterCard's global network is a financial toll road that takes a small slice of each transaction. Though there are many established and upstart competitors, the leader is cash with 85% market share, representing plenty of room for MasterCard to grow.
Wells Fargo	WFC	Hold Option: Write Partial Covered Calls	Given recent scandal being uncovered at Wells Fargo, the position is on hold while we assess whether we want to go on owning call options on Wells or not. We have to believe there is upside in a few years or we'll sell our calls to get back time value.
American Tower	AMT	1Buy	A U.S.-based global tower operator, this business with excellent returns on incremental capital benefits from exponential growth in worldwide demand for mobile bandwidth. We expect strong growth as international markets continue to invest in wireless technology. We are invested in some LEAPS call options to leverage upside.
Apple	AAPL	Buy	Apple is the leader in mobile computing products, and the number of people buying into its ecosystem continues to grow. Apple capitalizes on this by making its operating system work seamlessly across devices, increasing stickiness. The mobile computing revolution is still in early stages, and Apple still has no equal.
Oracle	ORCL	1Buy	Oracle is an "old guard" tech giant that continues to grow strongly thanks to its expanding database software and hardware sales. It also has room for more margin expansion.
Papa John's	PZZA	Buy	Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. Near-term headwinds (commodity prices and technology investments) have proved temporary and Papa John's should deliver improved financial performance.
OpenText	OTEX	Buy	Selling software that lets companies and governments manage growing reams of digital information, OpenText should grow steadily for years. Plus, we plan to write options on it for income along the way, as long as the options pay well.
Starbucks	SBUX	Buy	The world's specialty coffee leader will continue its global retail expansion and will leverage its brand to offer consumers more choices — including tea, carbonated beverages, and juice — at more times in more convenient locations. The company has dynamic growth opportunities, operational discipline, and deft management. Starbucks stores and its trusted brand are a powerful platform off of which to introduce locally relevant new products, build relationships with customers, and compound intrinsic value.
Parexel International	PRXL	Buy	Helping pharmaceutical companies get drug candidates to market, Parexel is poised to benefit as those companies gradually outsource more of this process to select CRO partners who can perform the work better, faster, and cheaper. We also expect margin expansion as recent investments and restructuring costs pay off as well as continued growth of the Parexel Informatics technology segment.
Medtronic	MDT	Buy	Medtronic has a sound strategy to deal with the more regulated and costlier health-care environment. We're confident the business remains competitively advantaged, operates in an attractive industry, and is well-positioned to grow, especially in emerging markets. With reasonably-priced shares, we target North Star-type returns.

Holding	Ticker	Rating	Summary
Skyworks Solutions	SWKS	Buy Option: Write Covered Calls	Skyworks Solutions is positioned to keep increasing profits at a healthy clip as more smartphones are sold and connected devices (the Internet of Things) proliferate. Long-term growth rates overall could remain above 10% for many years.
Expeditors International	EXPD	Option: Synthetic Covered Strangle	The shipping logistics leader offers a stable business on which to set up an income position. The *Pro* team is targeting leveraged income with upside.
Gentex	GNTX	Buy First Option: Write Puts	Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time. We're also writing puts for income or to potentially buy more shares lower.
Gilead Sciences	GILD	Buy Option: Write Covered Calls	Gilead Sciences has seen surging free cash flow thanks to its market-leading Hepatitis C treatments, which accounted for nearly 60% of 2015 revenue. As sales growth tapers, the stock is cheap, and we believe management can find future growth opportunities through acquisitions. Meanwhile, Gilead has a large pipeline of drug candidates targeting deadly diseases including cancer, but for the coming few years, it's our belief in a stable Hepatitis C market and good use of its growing capital that makes the stock worth owning in *Pro*.
Visa	V	Buy	Expected to grow earnings per share by at least 14% to 18% annualized for several years, Visa's giant payment network should keep driving results as electronic money replaces cash, affluence increases, and new markets are added.
TD Ameritrade	AMTD	Buy	TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and when interest rates increase, the company is positioned to grow earnings sharply.
FactSet Research Systems	FDS	Buy First	Selling subscription data and analysis tools to investment professionals, FactSet enjoys a 95% contract renewal rate and has 35 consecutive years of sales growth. With high returns on capital, it meets *Pro*'s criteria for a compounder.
Verisk Analytics	VRSK	Buy	Also owned by Buffett but still under the main Wall Street radar, this leading provider of rich data to insurers and other industries has a strong competitive position, recurring revenue, and pricing power. It's a long-term buy we want to own and add to over time.
Domino's Pizza	DPZ	Short	As a paired trade, we are shorting the leading pizza chain only as a way to hedge 2% of our long exposure in Papa John's, since the two stocks have historically moved together. These two positions should be taken together.
Valmont Industries	VMI	Buy Option: Write Covered Calls	Valmont's end markets remain weak and we considered selling to harvest the tax losses, but recent news that Congress is making progress on a new highway funding bill leads us to believe it's worth holding on to this solid business for a bit longer.
WisdomTree Emerging Markets SmallCap Dividend Fund	DGS	Buy	This emerging-markets ETF is a large fund of nearly 500 stocks; its fate is tied to emerging economies (mainly Taiwan, South Korea, Thailand, Malaysia, Brazil, China). The ETF is well-managed and yields more than 3% while owning small, consumer-centric companies. Moved back to Buy 3/28/16 after review.
CurrencyShares Euro Trust	FXE	Short: Hold	The euro is held together by rubber bands and scotch tape (and financial threats). We believe the currency should be worth much less to the dollar. We may manage this short by adding to it when it spikes.
Deere & Company	DE	Short	John Deere should serve *Pro* both as a short with favorable odds of generating a North Star-like return and as a macro hedge to reduce our portfolio's sensitivity to the strength of the global economy.
ProShares Short VIX Short-Term Futures	SVXY	Buy	Over the long term, the futures on the CBOE VIX index should persistently trade at a higher level than the spot VIX level, until they dissipate into expiration. This situation — known as contango — will ultimately make this ETF go up in price, because it sells short the futures, which are a wasting asset. We expect price volatility, though, and we will look to add to the position on large drops. So, keep your allocation small.
Pier 1	PIR	Short: Hold	Coming soon!
Caesars Entertainment	CZR	Short: Hold	With interest on debt consuming all operating profits and then some, Caesars' back is against the wall as competition increases and traffic slows. We believe a restructuring is fairly likely, and equity holders may not end up with snake eyes, but something close to it. So, we're short.
Direxion Daily Financial Bear 3X Shares ETF	FAZ	Short	We believe financial stocks are inexpensive, so we're shorting the bearish financial ETF, which also suffers from compounding flaws that work in the favor of shorts like us.
SRS	SRS	Short: Hold	We're bullish on a real estate recovery, so we're shorting this flawed, leveraged, bearish real estate ETF -- but it has become too small for new investors to short.

See the team's and David and Tom Gardner's holdings here.

Buy Wells Fargo

Published Jul 29, 2014 at 2:12PM

Is this for you? *Pro* is increasing our allocation to **Wells Fargo** (NYSE: WFC) by more than one-third, bringing its percentage of the portfolio to 4.1%. If you're following our portfolio closely, you should do the same.

How You Participate

- **Action:** Buy Wells Fargo
- **Allocation:** Buy shares to bring your allocation up to about 4.1% (up from 2.9%). *Pro* will be buying another 500 shares.
- **Recent Price:** $51.60
- **Price Guidance:** Use a limit order at current prices, but aim to pay less than $52.50.

What We're Thinking

Stock Info

- **Fair-Value Estimate:** $56 (recently raised from $53.50)
- **Consider Adding More:** $44 (but we're adding more anyway)
- **Scorecard Status:** Buy

In late April, *Pro* wrote a covered strangle on Wells Fargo that expired prior to second-quarter earnings, hoping to earn some income in addition to Wells' dividend while waiting for an update on business performance. With the close of our short call in late May and expiration of the short put in June, our strangle strategy concluded successfully, earning a modest net $0.35 per share, but effectively doubling our quarterly yield on the position alongside the payment of our $0.35-per-share dividend on June 1.

After Wells reported second-quarter earnings on July 11, we felt confident enough in management and in current business and economic trends to increase our Fair Value estimate by almost 5%, reflecting more optimistic assumptions on near- and mid-cycle return on equity. Despite a difficult environment, Wells' management has done a remarkable job wringing out efficiency and hitting the high end of its internal performance targets. When we eventually see a rising rate environment, our expectation is that Wells Fargo's earnings power will ultimately increase, possibly even higher than what our reasonably conservative forecasts assume. Additionally, Wells has continued to buy back shares at prices below our Fair Value estimate, a value-accretive move that provides even more upside to our estimates.

In the original strangle trade alert for Wells Fargo, we wrote that "we view the business and the stock favorably. It's a well-run bank with limited downside and steady but unspectacular upside," and "we'd be happy to own more shares of this well-run compounding machine" at a price below our Fair Value estimate. Both of those statements are being reflected in today's trade. Although we've hinted at continuing our strangle strategy on this position, we think current prices provide an asymmetrical risk/reward ratio to the upside, in which case it would not be prudent to continue covering our shares.

As such, we think that increasing our allocation to about 4.1% (from 2.9%) is a smart decision. If you've yet to start a position in Wells Fargo, now is a great time to match our allocation. We expect to benefit from North-Star-beating returns from Wells over the next rolling-three-year period, and we want to make this position a more meaningful contributor to our overall results.

Alternative Trades

- **None** (although members who wish could write puts instead; they don't pay well, though, and we favor owning more shares for the long haul).

Pro Can Help

- Questions? Drive your stagecoach over to our Wells Fargo discussion board.

Surrendering Intel

Published Jul 28, 2014 at 3:26PM

Dear *Pro* members,

Intel's (NASDAQ: INTC) performance this year — up 31% — reminds *Pro* investors of the rules for writing covered calls:

- Only write covered calls if you're willing to sell the stock.
- Be prepared to miss upside in the shares.

Covered calls provide a limited return while capping the upside (but not the risk) on your capital, so if you're going to use them, we suggest only a few approaches:

1. Set up new buy/write trades in which you buy a stock *specifically* to write covered calls on it for income. Or ...
2. When you're ready (or at least willing) to sell a stock you own, and you don't mind missing upside, write calls on it for income and a higher sell price.
3. Use diagonal calls, in which you buy long-term calls to write calls on them, aiming for income and leveraged upside but realizing that you may miss much of the upside.

After You Write Covered Calls

In many instances, when the stock rises slowly or stays within a range, you're able to roll covered calls to a higher strike price without much or any detriment. But if the price of the underlying stock rises sharply and quickly, your rolling choices will not be attractive.

This is what's happened with Intel. Even though we rolled our calls three times this year, the stock has gained enough ground that we stand to make virtually zero incremental return by rolling our calls higher yet again. Even if we invest considerable extra capital in the position to keep our stock longer, our potential gain would be slight if we roll to new covered calls. Instead, we could simply buy to close our calls for about $8 per share, uncapping our upside again, but then we risk the stock declining. It's not worth it at this point.

Fortunately, we were — and are — willing to let our stock get sold at our strike price. (We just didn't expect this to happen so quickly.) This will occur to our position by Aug. 4 (the ex-dividend date is August 5).

Intel Today

If history is a guide, Intel is not great at predicting its business. In 2012 and 2013, it predicted sales growth on improved PC volume, but both years ended flat. In January, it predicted a flat year, and soon PC sales were rising. Now the company forecasts stronger PC sales through the end of this year and growth in revenue as a result. But many years of following Intel tells us that this outlook could change rapidly; it wouldn't be surprising to see PC sales slow again.

Meanwhile, Intel isn't cheap the way it used to be. Near $34 a share, it's more than 10% above our updated fair value estimate and is trading at 21.6 times free cash flow and 17 times earnings. And for the second year in a row, it appears that Intel won't increase its dividend, a curiosity after years of increases. As a result, the stock yields a relatively modest 2.6%, well below the 3.8% it sported at times last year.

As we prepare for our shares to get called away, we're not happy to miss extra upside, but we agreed to do so the day we wrote covered calls, so we can't be surprised. After years of expecting the PC market to stabilize and tick upward, we took Intel's flat guidance to heart in January and initiated our covered calls for income. It was a calculated risk, but it proved less than ideal. We'll reinvest the capital that's being freed up in new positions — and keep watching Intel for future opportunities. After all, this is the second time in our history that we're having our shares called away.

Your Taxes

Pro doesn't have tax implications to consider as we let our Intel get sold, but you might. If you own Intel in a taxable account and want to avoid a long-term-capital-gains tax bill, you need to buy to close your calls to keep your shares. (There are not any rolls worth entertaining today.) Buy to close your calls and then consider writing new out-of-the-money calls. Just realize that buying to close your calls will cost $8 per share, so that may be more expensive than your long-term tax bill would be if you let your shares get sold.

Going Forward

Pro will to continue to only rarely use covered calls on our existing stocks. Why? Mainly because the risk-to-reward is skewed. For small payments, we forfeit our upside. It's a great income strategy, but we want to continue to use it only in the instances spelled out above: As new buy/write trades, or when we're truly willing to sell. And, we want to set up diagonal calls for income, so there's plenty to look forward to.

Earnings

Meanwhile, we're in the middle of an earnings bonanza! With 229 companies in the S&P 500 reporting so far, *Investor's Business Daily* reports that on average, sales are up 3.5% and earnings have risen 6.5%. Most *Pro* companies are growing much more than that. You can see our earnings coverage as it rolls out in a daily scorecard email if you follow *Pro* tickers in your scorecard — or see it all in our weekly Monday wrap-up of *Pro* coverage, in the same email that brought you this Memo.

See you on the boards! Fool on!
Jeff (TMFFischer)

Your Most Active Conversations

Today Past 7 Days Past 30 Days

Discount Retailing Landscape Is Shifting

Published Jul 28, 2014 at 3:19PM

Fools,

This morning **Dollar Tree** (NASDAQ: DLTR) announced it was acquiring **Family Dollar Stores** (NYSE: FDO) for $9.2 billion ($74.50 per share), a 23% premium to Family Dollar's previous closing price. This move represents the second and third largest players in the discount retailing space shacking up, and has potential implications for **Five Below** (NASDAQ: FIVE), the bargain-bin tween retailer that we are betting against.

In short, we view the acquisition announcement as further evidence that supports our assessment of the difficult discount retail competitive landscape in which Five Below competes. In the alert, we called out cut throat competition, increasingly overlapping merchandise categories, and the importance of having scale-based sourcing leverage. The logic behind a combined Dollar Tree and Family Dollar seems to support each of these assertions, making this deal one more challenge that Five Below will ultimately face. Below are five takeaways.

1. A Note on Price

Dollar Tree is paying 11.3x EBITDA for Family Dollar. Over the past 10 years, Family Dollar traded, on average, for an EBITDA multiple of 8x, and hasn't traded over 9.7x since 2005. The 11.3x multiple is interesting to us in that it provides a data point on what a fair private market value might be for a retailer in this space, which we can use as a helpful insight into what Five Below might be worth. Now, full disclaimer, Family Dollar and Five Below are very different businesses. Family Dollar serves lower income families and predominantly sells consumables. Still, my argument is that there is some overlap, and that the two stores compete for the time involved in the trip and the marginal dollar of income. Five Below is also growing much more quickly than Family Dollar, which would likely justify a higher EBITDA multiple. But let's see where this gets us...

Over the last twelve months, Five Below earned $70.2 million in EBITDA. Applying the 11.3 multiple to Five's trailing EBITDA suggests a fair enterprise value of $793.3 million. Compared to the Five's current Enterprise Value of $1,903.8 million, shares look 58% overvalued.

Of course, 11.3x ;might not be a fair multiple given Five's growth potential and economics. Perhaps a multiple 50% higher is more appropriate. if we apply a 17x multiple to Five's trailing EBITDA it suggests an enterprise ealue of $1,190, still 37% below Five's current enterprise value.

One obvious risk of shorting a modestly-sized company is that we run the risk of having it acquired. If Dollar Tree's price is at all indicative of the going rate, or at least an anchor off of which to consider pricing an acquisition, it appears an acquirer would have a hard time justifying the price to purchase Five Below.

2. The *Deals* Concept Appears Safe

In the original alert we pointed out that, in an effort to step away from the $1 price ceiling, Dollar Tree created its *Deals* store concept. Dollar Tree is growing that franchise rapidly and the concept appeared to us to be the closest direct competitor to Five Below of any of the discount retail or dollar store formats. On the conference call held to discuss the acquisition, Dollar Tree CEO Bob Sasser was asked several times about the acquisition's impact on *Deals*. Sasser was clear that he and his team are high on the *Deals* concept and that it is quite different than the Family Dollar concept. *Deals* stores have a more discretionary and seasonal product assortment than Family Dollar's. While he stopped short of saying the growth plans would continue as planned, the tone of his comments imply that the *Deals* format is safe and that Dollar Tree intends to grow it.

3. Changing Product Mix at Family Dollar?

Sasser pointed out that the Dollar Tree product assortment of 50% consumables and 50% discretionary/seasonal is likely the optimal mix. Family Dollar's merchandise focus is consumables heavy (72% of sales). Logic, recent successful Family Dollar holiday merchandise efforts, and comments made on the call suggest that Dollar Tree would seek to rebalance Family Dollar's mix a bit toward discretionary/seasonal merchandise given the success it has had with that model. Sasser noted: "We like at Dollar Tree what the seasonal business brings for our customer segment. We like the merchandise energy, we like the ever-changing mix, we like the margins." To the extent that Family Dollar, with the help of Dollar Tree's merchandising team, begins to stock more discretionary and seasonal items in the $1-$5 price piont, Five Below could feel a bit of competitive pressure -- at least on the margin.

4. Large and In Charge; Small and Disadvantaged

The strategic rationale for the acquisition appears to be (1) diversifying the customer base and (2) adding purchasing scale to obtain better merchandise pricing. Family Dollar's lower-income customers complement Dollar Tree's middle-income customers, and the larger combined customer and store base should strengthen the company's purchasing power. In discount retail, where customers are price sensitive and in search of deals, size does matter. This highlights the natural disadvantage of being small and beholden to a single target demographic -- the position Five Below finds itself in.

5. A Cover For Slowing Growth?

In late 2012 I wrote about how growth at discount stores was set to slow -- I proposed that not every discounter can open 10% more locations every year for the next decade (which most planned on trying to do) because they'd run out of profitable real estate locations. Most have continued with these expansion plans, including **Wal-Mart** (NYSE: WMT), which has stepped up expansion of its small-store formats. Family Dollar, on the other hand, announced in April that it would cut its growth plans and actually close 370 under-performing stores. Dollar Tree could be finding growth harder to come by, too, and has turned to this acquisition to keep the growth train on track. That is speculation on my part, but things line up to make it a plausible explanation.

The Foolish Bottom Line

Our short position is a small 1.5%, but we're pleased that the first bit of meaningful news appears to support our research. Even though these competitive threats will likely take a while to have a meaningful impact on Five Below's performance, we expect the mounting evidence to make bullish Five Below investors question the premium valuation they have attached to its shares. We expect second quarter earnings from Five Below in early September.

Onward,

Bryan (TMF42)

Facebook Books Gains

Published Jul 28, 2014 at 1:32PM

Greetings, *Pro* members,

Summary: **Facebook** (NASDAQ: FB) reported excellent second-quarter results, with mobile ad revenue up 151%, total ad revenue growing 67% to $2.68 billion, and earnings per share jumping 121%. The average effective price for an ad increased 123%, driven by more ads in the newsfeed and fewer, less lucrative ads on the desktop sidebar, and by customers willing to bid higher given a healthy return on investment from the ads. Continuing to grow, 1.32 billion people are on Facebook each month, and 63% visit daily. The company is rolling out more free Internet connection services around the world, true to its "connecting the world" goal.

***Pro* Guidance**: The shares remain a buy at a 4.9% allocation. Our fair value estimate increases to $63, but we recognize that there's a lot of room for error in naming a price. Facebook could grow much more than we estimate. We try to estimate on the more conservative side, but in this case I also feel that we're giving the company ample recognition with our valuation. We still face the risk that it's a young social media business, and the staying power of its massive traffic is unproven.

Overview
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Guidance
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Status: Buy
Allocation: 4.9%
Fair Value Est: $63 (up from $58)
Consid. Addin' More: $50 (up from $37)
========================
Stats (7/28/14)
========================
Share Price: $74.60
Market cap: $194 billion
Cash & Equiv: $13.9 billion
LT Debt: $0
Enter. value (EV) $180.1 billion
========================
Cash Flow
========================
TTM OCF: $4.8 billion
TTM CapEx: $1.6 billion
TTM FCF: $3.2 billion
========================

Valuation @ $74.60
========================
Metric -- Multiple
========================
EV/Sales 17.9
EV/NTM Sales Est. 12.6
EV/LTM EBITDA 33.0
EV/NTM EBITDA Est. 19.8
P/FCF 60.6
P/E 79.9

P/E NTM Est. 42.2
P/E 2015 Est. 36.9
5-year EPS grw est 37%
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Ratios
========================
ROE 15.4%
ROC 16.4%
Gross Margin 80.9%
Net Income 23.8%
FCF Margin 31.3%
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Conference Call Notes

o Facebook has three large goals: Connecting everyone; understanding the connected world; and building the knowledge economy.

o The company will continue to invest heavily. They believe there's much more room to grow. Americans spend around 40 minutes per day on Facebook (more than any other app by far), but more than 9 hours per day engaging with digital media.

o 30 million small businesses use Facebook pages, but only some 1.5 million of them are active marketers (room for growth).

o Facebook believes it's building the world's first ad platform that delivers personalized marketing at scale, but believes "it's still early days."

o More than 1 billion messages are sent on FB per day; more than 200 million monthly active users on both Messenger and Instagram.

o FB is launching more free, basic Internet services in several countries this year.

o More than 1 billion search queries are made on FB each day; the company continues to work on Search. It is also working on Public figure pages. Nearly 800 million people are connected to public figures on Facebook (competing with Twitter).

o More than 80% of the top Apps on iOS and Android use a Facebook login (stickiness).

o Video ads will slowly be rolled out as they're optimized. Ads in general will slowly roll out on Instagram, Messenger and any properties when those communities are ready.

o Nearing $1 billion in an annual run-rate, payments and other fee revenue rose 9% to $234 million.

o Q2 GAAP expenses grew only 22% (showing great leverage in the business model), and GAAP operating expenses rose 33% as employee count gained 36% to 7,185 people.

o In 2015, Facebook expects significant stock-based compensation and amortization expenses. The share count will also rise from 2.6 billion to 2.9 billion by the end of 2014, an 11% increase (due to acquisitions). This is part of what keeps our fair value from rising much right now, of course.

o Year-over-year growth rates will naturally decline meaningfully as the comparisons become more difficult.

o Zuckerberg is thinking in terms of 10-year time periods for his goals for Facebook, he says the company is going to "go very deep on the priorities that we have to make sure that we completely nail them all, whether it's a five-year or a 10-year timeframe." In the process, they hope to invest accordingly to help define what the next generation of computing and online platforms will look like.

In summary, we expect more volatility from the financials as Facebook's expenses grow, but we expect ad revenue to continue to grow sharply over time. We'll be watching that Facebook continues to maintain its traffic, and then grow it. Advertising will follow eyeballs, especially as Facebook continues to invest to improve the ad experience for both visitors and advertisers. We have to view our position with a multi-year timeframe.

To discuss the position or ask questions, please visit the Facebook board.

Best,

Jeff (TMFFischer)

Pro Catch-Up Trades: July 28, 2014

Published Jul 28, 2014 at 11:24AM

Catch-Up Trades are timely ideas to catch up on a Pro *portfolio position you may be lacking*.

- **Gentex** (NASDAQ: GNTX): With earnings behind it, shares remain a Buy up to a 3% allocation.
- **Tupperware** (NYSE: TUP): Down sharply after earnings, the container guy's new price looks like a good entry point for those lacking 2.4%.
- **Wells Fargo** (NYSE: WFC): Another good earnings report and a tick higher in our fair value estimate. If you lack a 2.9% position, get out your checkbook and buy.

Community We Share: July 28, 2014

Published Jul 28, 2014 at 11:07AM

Join the *Pro* community in some of our favorite discussions from the past week:

- With more earnings on the way, TMFMoosie updates *Pro's* weekly calendar.

- Fools discuss the merits of tool maker **Snap-On** (NYSE: SNA) versus **O' Reilly Automotive** (NASDAQ: ORLY).
- Member nevercontent posts his put-writing ideas.
- We happily welcome back longtime *Pro* member "spinningstuff"!

Starbucks: 'I'll Have My Usual'

Published Jul 28, 2014 at 10:53AM

Pro's Take: SBUX Q3-2014 Earnings

Starbucks (NASDAQ: SBUX)

Quarter Quick Take

New stores (+344 in the quarter, +1,096 this year), new food and beverage offerings, impressive comps (+6% globally), and solid execution translated to impressive sales and profit growth. The formula remains the same for Starbucks, and while that may sound boring, its results are powerful. For the third time this year, management raised guidance, but preliminary FY-2015 targets of +15-17% EPS growth may have disappointed investors. Still, Starbucks growth profile is dynamic, robust, and durable – the results achieved in Q3 only support that assertion.

....

Q2-2014

Sales growth: +11%

Operating profit margin: +200 bps to 16.7%

EPS growth: +22%

....

Guidance Update

Starbucks is a star – the company set quarterly revenue and operating profit records in each of its segments. It has raised EPS guidance after its first and second and now third quarters, suggesting it remains capable of compounding intrinsic value at attractive rates. Nothing in this quarter caused me to rethink any longer-term assumptions, but accounting for the time value of money, the company's fair value ticked up a bit and is on track to hit $78 by the end of its fiscal year. Pro has a 3% allocation, and shares remain a Buy. Shares are flat on the year, and Starbucks needs to execute well to justify its valuation (25x forward earnings). We expect that to happen and believe upside surprises are more likely than downside ones as Starbucks has set the stage to compound its intrinsic value faster than we anticipate.

Updated guidance: Buy (no change)

Recommended Allocation: 3%

Fair Value estimate: $76 (up from $75)

End of Fiscal Year expected FV estimate: $78 (no change)

CAM price: $61 (up from $59)

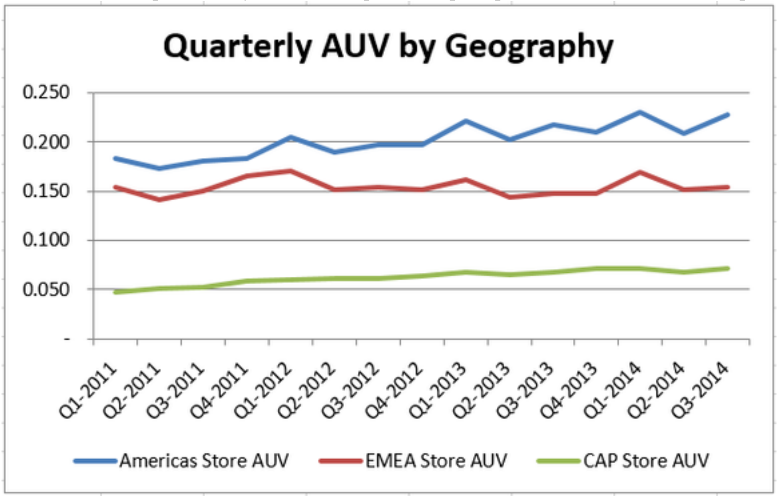
Our Thesis

We believe the coffee is just a gateway for the company to repeatedly sell customers an experience rooted in comfort, quality, health, community, and conscience. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand into new products, new platforms, new dayparts and new brands. We expect new store openings across the globe to strengthen the company's brand and cost-based competitive advantages and improve profitability over time.

The Most Important Things

1. ***Americas store performance.*** At the end of 2013, the Americas segment still accounted for 75% of Starbucks' total revenue – so as *it* goes, Starbucks financial performance goes (for now). Americas comparable store sales growth was up +6% driven by a +2% growth in traffic and a +4% growth in ticket. The company's ability to drive sales on such a large and mature base is impressive. Improved food (primarily La Boulange) offerings continue to be the largest driver of incremental sales, and with the roll-out expected to be completed by September management is already turning its sights to improving lunch offerings. Combined with continued expansion of the Fizzio carbonated beverage program and growth in digital marketing and app acceptance, the Americas segments still has meaningful tailwinds to drive comps and average unit volumes higher (see chart below). As we've noted before, alternative format stores are another growth vector, and management's

confidence in the profitability of these unique stores prompted the announcement this quarter that 50 additional units will be opened this year.



2. ***Channel Development.*** As the company's second largest segment, CD leverages the brand strength of Starbucks' cafe stores into alternate channels (primarily grocery stores). Segment sales grew 13% (up from 7% and 11% the last two quarters) and profits were up 45%. VIA and K-Cup sales are strong and new flavors are on the way. Starbucks K-Cup sales appear to continue taking share. Lower coffee costs helped drive operating margin expansion, but that cost tailwind is turning – with only 60% of coffee prices locked in for next year we should expect a bit of margin pressure as Starbucks dabbles in the spot market or locks in higher-priced beans. Finally, international consumer packaged goods (CPG) opportunities should begin to drive growth in the coming quarters.

3. ***Future growth drivers.*** There is quite a bit to cover. (A and B) With the pastry portion of the La Boulange roll-out about three-quarters complete in the US Starbucks is turning its sights to additional lunch SKUs. Remember, the LB roll-out was measured, with lots of test and learn, and lunch will be too. This should drive transactions, ticket, and attach rates (which are currently only 1 in 3 transactions in the US). It will also introduce further complexity to orders and throughput but can be very meaningful to sales and profits – food sales represent ~20% of US store sales. (C) Starbucks' "evenings" program tests were a success and it will begin expanding the program to more than 1,000 stores. Interestingly, evenings has seemed to revitalize Starbucks as the "third place" – with shared platters among friends being the centerpiece of the evening hang out. (D) Carbonated beverages will soon be in 3,000 US stores as well as some Asian stores. So far, these sales have helped sales during softer dayparts and been largely incremental. (E) Teavana products should be getting a boost from a pair of marquee NYC tea bars. It is often cited that the tea market is larger than the coffee market, but what could be more relevant is that tea currently only makes up ~9% of Starbucks sales. (F) There was no update on the potential licensing or white labeling of the Starbucks app and mobile payments package. If anything comes of this opportunity, it could represent a very high margin, recurring revenue stream for the company.

WWTN

The world's specialty coffee leader will continue its global retail expansion and leverage its brand to offer consumers more choices — including tea, carbonated beverages, and juice – at more times in more convenient locations. The company has dynamic growth opportunities, operational discipline, and deft management. Starbucks stores and its trusted brand are a powerful platform off of which to introduce locally relevant new products, build relationships with customers, and compound intrinsic value..

Conference Call Notes

- Starbucks now has 300,000 partners serving >70 million customers in 65 countries each week at its 21,000 stores. Q3-2014 marked the 18th straight quarter of 5% or more SSS growth.
- U.S. stores delivered an above-estimate 7% comp – a pretty remarkable feat on a store base of 6,800+.
- On success abroad: Schultz commented: "*New stores in different countries on different continents with different coffee cultures and no aided awareness to speak of, but the same results – lines out the door and customers clamoring to get in day after day, rom morning until night. These openings remind me that despite the size of our current global store footprint, pent-up demand for the Starbucks experience continues to increase and that we have untold markets yet to open and expand in the years ahead.*"
- On food: In the US, improved food quality and variety drove two points of the comp growth, and it is driving margin improvement. The rollout of La Boulange breakfast sandwiches, the first real formula change in 10 years, resulted in a 40% increase in breakfast sandwich sales. Now that the LB rollout is largely complete, Starbucks is turning its attention to expanding its lunch lineup with additional SKUs. COO Troy Alstead noted "*By the end of fiscal 2015, we expect the lunch program to look very different than it does today.*" CEO Howard Schultz said: "*I think we could all admit that for many, many years, [food] was a weakness and a challenge for us. And I would say unequivocally, with the acquisition of La Boulange and the execution of Cliff and his team, has now become a significant strength and a driver of multiple occasions, need states, and the opportunity for Starbucks to leverage dayparts that we did not have access to before. And we're just getting started.*"
- On drive thru: More than 40% of company-operated domestic stores have drive-thru ability and they're growing double digits. Starbucks is going to experiment with ordering and payment to speed throughput on drive-thru locations. Management thinks drive-thru has been so successful because the Starbucks relationship already existed and it simply added a layer of convenience.
- On China: Schultz commented that China has "*never been stronger.*" Starbucks opened two flagship stores in the country, including its first ever 24-hour location. CAP has logged 15 consecutive quarters of revenue growth >20%, driven by new store openings and strong comp sales.
- On Channel Development: Revenue grew +13% on the back of share gains in packaged and single serve coffee and tea. Growth should continue to be strong with limited-time offerings, single-origin coffee promotions, new K-Cup SKUs and additional teas. Favorable coffee costs (relative to last year) helped operating profit grow 45% to $139 mm and expand operating margins 800 bps.
- On tea: Starbucks is slowly opening a few marquee tea bars (in NYC right now) to draw attention to the tea category and elevate the Teavana brand. Expect to see more of these stores, which will serve as a tea marketing expense (at least until the unit economics are figured out), a product R&D lab, and a testing ground for tea bar operations.
- On Fizzio: Fizzio is now in 3,000 stores across the US Sunbelt, in Japan and in Singapore. Customers are inventing their own concoctions like mad, which Starbucks believes is encouraging.
- On MSR, digital, and payments: The Starbucks card is available in 29 countries. MSR has over 8 million active members. Astoundingly, MSR (My Starbucks Rewards) transactions account for 40% of total tender in China. Almost 12 million people are active users of the mobile app in the US and Canada, and the app facilitates ~15% of tender. Starbucks believes the app is the fastest way to pay, and it will be experimenting with app-enabled "order ahead" programs in select stores.
- On Guidance: Non-GAAP EPS for Q4 should be +22%-25% and about 22% for the full-year. The longer-term targets of sales growth of 10% and operating margin expansion remain in place. The company raised its new store opening target by 50 stores to 1550, with the additional stores expected to be opened in the Americas

segment. **The company released its first cut of 2015 guidance. EPS should grow +15%-20%, but likely toward the lower end of that range as coffee costs rise. Next year, coffee costs will be neutral to a minor headwind – only 60% of next year's coffee costs are locked in. Revenue growth of 10%, global comps in the mid-single digits, and 1600 new stores seem doable. The Americas segment should see 650 openings, 150 in EMEA, and 800 on CAP.**

Tupperware Cracks a Little

Published Jul 25, 2014 at 4:15PM

Greetings, *Pro* members.

Summary: Quarterly revenue at **Tupperware** (NYSE: TUP) fell short of expectations, though earnings per share were in-line with guidance. Three regions lowered results significantly, all for different reasons (shared below): Germany, Russia, and Indonesia. Management believes these are short-term issues, to be resolved in quarters, not years. Meanwhile, China, Singapore, France, both beauty businesses, and many others did well. The company lowered full-year EPS guidance to a range of $5.40 to $5.50 per share. The $74 stock trades at 13.5 times the mid-point of updated earnings guidance. Our $85 fair value estimate (unchanged, having been conservative to begin with) assumes 15.5 times these lower earnings and a 3.2% yield, and assumes low double-digit EPS growth in dollars (TUP is now modeling 11% itself).

Pro Guidance: **Buy 2.5%.** Members lacking a 2.5% allocation are advised to buy it. The stock remains a buy. We are considering adding to our 2.5% allocation or writing puts; any such decision will be sent to you in a trade alert.

Overview
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Shares
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Recent Price: $74
Dividend Yield: 3.67%
Market value: $3.7 billion
52-week range: $73-$97
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Guidance
========================
Est. Fair Value: $85 (no change)
Consider Adding More:$75
Allocation: 2.5%
Status: Buy
========================

Valuation@$74
=============
Metric Multiple
========================
EV/EBITDA 9.9
EV/EBITDA NTM 9.7
P/E 14.8
P/E NTM 13.5
P/FCF 19.1
P/FCF 2014 est. 15.4
========================

What We're Thinking

The past few years, Tupperware has disappointed as much as it has pleased investors. This is the third quarter the past year that has led to lower expectations, but each time the problem is in a different area (France, or Mexico, or the U.S., Germany or Russia). On those rare quarters where most areas go well, results top expectations. This quarter, Germany alone knocked revenue considerably as sales in Germany fell 29%. Why? Some 70% of sales occur on weekends, and five of the 12 weekends this quarter were holidays in Germany (not to mention the World Cup). Then there's Russia/Ukraine/CIS, disrupted by war. And in Indonesia, Tupperware had to increase prices 25%, which knocked sales growth to 16% from 25% in prior quarters. Each problem should improve. We're content to own 2.5% in this business, and are now considering adding to it at these prices.

How it Fits Into Pro

In the *Pro* portfolio, we like that TUP provides non-tech exposure and consumer retail exposure in large emerging markets (66% of sales), while trading at a reasonable price with a strong yield. It doesn't face the same retail risks (or costs, or limitations) as a bricks and mortar retailer. The meta-thesis is Tupperware can grow free cash flow and EPS -- in a choppy fashion -- strongly enough to top the North Star, especially including the dividend, over the next 10 years as the salesforce grows from 2.9 million to potentially 5 million.

Notes from the Call

Projections:

*2014 FCF of $235-$245 million (down from $263 million in 2013)
*2014 sales in local currency up 4% to 5%
*2014 EPS of $5.40 to $5.50 -- up 11% in local currency at the high end

*Q3 2014 EPS up 7% in local currency at the high end of a range of $0.89 to $0.94
*Long term, still aiming for 6% to 8% annualized revenue growth in local currency, comprised of about 10% emerging market growth and small moves in established markets.

Misc.:

*Sales in local currency were up 3%, with emerging markets up 10% and established markets down 7%. It will take a long time to strengthen the U.S. market.

*Tupperware's sales force is 2.9 million, up 5% from last year, but the active sales force slipped 1%; TUP has a new focus on on-boarding, retention, and party activity.

*Fuller Mexico and BeautiControl both improved (BC sales were up 8%).

*Sales in Germany declined 29% as discussed above. Russia, U.S. and Canada were also weak (with North America down 6%, but better than the previous quarter). TUP has taken numerous actions to change the momentum of the business and expects progress in a matter of quarters (its actions include management changes, fresh marketing promotions, new products in the third and fourth quarters, better merchandising and fewer discounts -- frequent discounts make consumers wait for the next one before buying).

*Big opportunities remain in China and India (and the region in general). TUP did no more than $100 million in sales in each of these countries last year.

*Expect better year-over-year results in Germany and CIS next quarter.

*The last six years, a 2% increase in sales force retention would have resulted in $800 million in more sales; retention is a new focus.

*Keep in mind, the bulk of TUP's 2.9 million in sales staff are volunteers. They only get paid when they sell. Some need to be more motivated to sell.

In closing, after two disappointing quarters, we hope to see improvements the rest of this year, and to follow (even if in choppy fashion). Sales per country are randomly hot or cold, and we give the company leeway for cultural holidays and seasonality, but we hope to see operations implemented that start to bring a bit more consistency over the years. We're also watching TUP's leverage ratio and use of capital. Let's point out that TUP's share repurchases at $89 and $85, etc, are losing money. We were a bit concerned about that use of capital at the time. Long-term, we certainly hope it will prove a good investment.

Here is TUP's IR site: http://ir.tupperwarebrands.com/events.cfm

To discuss the position, please visit [Pro's Tupperware board.]()

Best,

Jeff (TMFFischer)

Gentex Shines Bright (No Glare, Of Course)

Published Jul 25, 2014 at 7:02AM

Pro's Take: GNTX Q2-2014 Earnings

Gentex(NASDAQ: GNTX)

Quarter Quick Take

Gentex sold 12% interior and exterior mirrors than it did in Q1-2013. That growth was spread evenly across geographies and product lines, and it outpaced global auto production, which suggests that the core element of our thesis (higher auto-dimming mirror penetration rates) is playing out. The sales growth translated into strong all-around financial performance. Management also presented a compelling new product lineup which lends credence to our longer-term growth and profitability forecasts.

....

Q2-2014

Sales growth: +18%

Operating profit margin: +460 bps to 29.5%

EPS growth: +45%

....

Guidance Update

Gentex is right on track with our model and I'm not making any changes to our guidance this quarter. The first half of the year has been strong and management reiterated its guidance (I think they could be sandbagging a bit). At sub-$29, shares look a bit undervalued and are trading for 15.5x EPS, a discount to the market's 19.7x.

Updated guidance: Buy (no change)

Recommended Allocation: 3.0%

Fair Value estimate: $33 (no change)

End of Fiscal Year expected FV estimate: $35

CAM price: $25 (no change)

Pro has a 3% allocation to Gentex. Members lacking a (full) position should feel comfortable purchasing shares today – they're priced to notch NS-like returns over the long-run. Writing puts to buy shares lower is also a sensible strategy. If given the opportunity, I would look to add to this position.

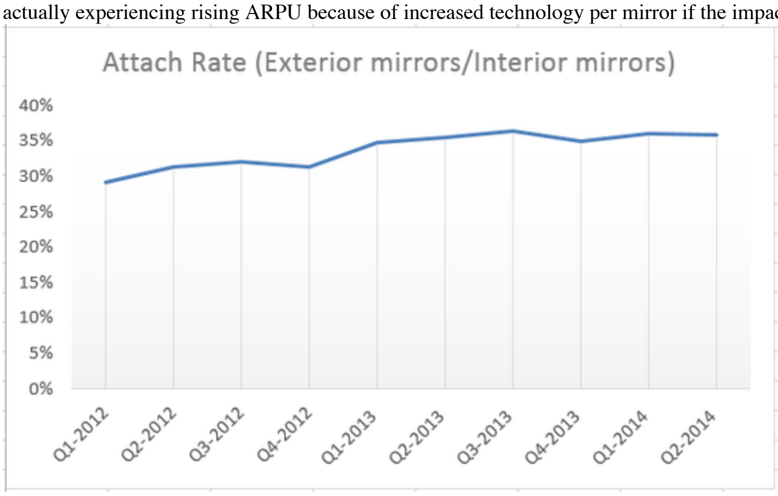
Our Thesis

Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1. ***Penetration: Unit growth vs. auto production.*** Over time, we want Gentex's auto-dimming mirrors to become standard in every car produced. If, over time, the company is growing units faster than auto production, it is moving in the right direction. Interior mirror unit volumes were up +11% and global auto production was up only +1% (suggesting further penetration). For the first time in a few quarters, the volume strength was evenly spread between North America, Europe, and Japan/Korea. Interior unit growth should continue to be pressured by the slowdown in RCD unit shipments, but Gentex has dealt with this issue well. Interior units sold in North America increased +6% and international increased +15%, for 11% interior unit growth overall. Exterior mirror unit volumes grew even faster, up +13% in both North America and International. The exterior mirror attach rate was 0.36, modestly higher than previous quarters.

2. ***Pricing and value: Unit growth vs. automotive segment sales.*** Auto makers force annual price concessions on their suppliers and Gentex isn't immune. Management contends that recent concessions have been in the range of 2%-3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices and gross margins. During the quarter, total units (interior + exterior mirrors) increased +12% and automotive segment sales were up +18% (including HomeLink). Making my best estimate adjustment for sales without HomeLink, sales were up around +5-7%, suggesting lower ARPU and consistent with the continued pressure from lost RCD sales. During the call management addressed this directly, noting that the company is actually experiencing rising ARPU because of increased technology per mirror if the impact of RCD is removed.



3. ***Margin performance.*** During the quarter gross margin was 39.7%, up from 35.8 % in Q2-2013. For the trailing twelve months, gross margin was 38.8% compared to 34.6% in the year-ago TTM. If Gentex can continue its strong unit sales growth it may be able to eke out further gross margin improvements, but they will be tough to come by. Management is clear that it can hold the line on 39% gross margins (give or take), but at the moment it doesn't see dramatic upside. SG&A and R&D expenses are in-line with historical norms and are contributing to operating margin expansion (29.5% in the quarter versus 24.9% in Q1 last year).

WWTN

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house development should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

Conference Call Notes

- Units were up 12% overall while automotive revenue was up 18% to $338 mm. My best guess is that HomeLink generated $33-$37 mm in revenue this quarter, which suggests organic sales automotive sales of $303, or 5-6% organic growth.
- Non-automotive revenue was $8.9 mm, up 24% over Q1-2014.
- SG&A expenses were a touch higher than expected, but they should grow in-line with sales over time.
- The balance sheet is strong, with $3.42 in cash per share, and cash greater than debt. We should an update next quarter on the capital allocation plan going forward. Perhaps one piece of the puzzle is a rising quarterly dividend, which now stands at $0.16 per share and a 2.2% yield.
- The company announced it will begin construction of a new manufacturing and distribution facility. The project will cost $30-$35 mm, of which $5-$10 mm will be spent in 2014. This is consistent with the company's build capacity 'as needed' philosophy.
- Management spent a bit of time talking about exciting new products. Four are worth calling out:
  - CMOS imager camera chip. This chip is the physical brain behind the SmartBeam product. A smarter brain means more features available on SmartBeam products. Mirrors with the new chips should begin to ship near the end of the year.
  - New SmartBeam functionality. With the power of the new chip, Gentex is improving the vision detection and features available on SmartBeam enabled mirrors.
  - Video camera technology. Gentex has been working on this technology for a long time and testing it in concept and race cars. It is now rolling out its technology on passenger vehicles. Importantly, having in-house camera technology should allow Gentex to capture more of the profit pie for SmartBeam (and other driver assist features) by using more of its own technology and relying less on licenses from MoblilEye. It is also possible that in-house production with the company's manufacturing prowess could lower the cost sufficiently to make RCD mirror unit prices more attractive to car makers.
  - HomeLink line extensions. Gentex is releasing a battery powered version of HL, which could help drive adoption more quickly. Right now, HL has to be designed into new models, which only change every six years or so. A battery powered version removes the design and wiring requirement. Gentex is also touting HL applications in non-autos, like motorcycles, ATVs, farm equipment, etc. It announced a pair of contract wins outside of auto.
- On guidance: management expects Q3 sales growth of 15-20% and gross profit margin of 39.5% to 40%.
- HL performance so far: Management noted that HL sales are running toward the higher end of the $125-$150 mm in sales they expected, and slightly higher than gross profit margin expectations as well. A "low double digit" sales growth rate is not out of the question, and is consistent with my estimate of this quarter's performance.

- On longer-term gross margin: Management commented on gross margin performance and I suspect analysts will hang on this news and use it as a reason to bash the stock. Gentex has increased its gross margin from 33%-39%, and thinks the 39%-40% is the "sweet spot" and is sustainable. Getting higher is unlikely. "We're not looking out beyond this year saying, we see 41% or 42%, we just don't see a path to get there right now with the current volume and product mix that we're shipping. But like I did mention, anything about 39% we feel comfortable with, like we can manage the business in and around that range."
- Gentex benefited from an R&D tax credit that may not repeat. The benefit was ~$5.5 mm, or $0.04 per share. This does not diminish the solid performance during the quarter.
- Gross margin improvement was due to HomeLink, improvements in product mix (higher technology per unit), purchasing cost reductions, and leveraging fixed overhead costs. Per usual, these gains were offset by normal price concessions.

Coca-Cola Still on Ice, but Thawing?

Published Jul 24, 2014 at 10:05AM

In another sequentially improving quarter, **Coca-Cola** (NYSE: KO) reported 3% growth in unit case volume, including 2% growth in global sparkling beverages (sodas). Coca-Cola's total net revenue grew 3%, and operating income grew 5% excluding currency headwinds. Free cash flow remains strong with $4.5 billion in cash from operations this year, and the company is valued at 21 times free cash flow. With our fair value estimate of $44, *Pro* is content to keep its 2016 synthetic long position in place right now.

Brand Coca-Cola grew 1% in North America, but most growth continues to reside in emerging markets, including China and India. Diet Coke and Coca-Cola Light volume declined by mid-single digits; the company continues to fight negative press associated with diet soda, and healthier alternatives. The company's "still" beverage portfolio saw 5% volume growth, led by sports drinks (up 6%), water (up 7%), tea (up 4%) and energy drinks. Juice had a challenging quarter, but held up despite price adjustments to offset higher costs.

Management wrapped up by saying that they're "pleased with these results in a difficult operating environment, and to get growth back into sparkling [beverages] is a significant achievement." CEO Muhtar Kent said, "...I believe our approach is working," as they make gradual progress to restore growth, and the company "is where they hoped to be by mid-year." Kent (and I!) believe the company's long-term growth objectives remain obtainable, although they know challenges remain ahead. Our position in *Pro* is sized accordingly, even though we're optimistic for better quarters. Keep in mind, northern hemisphere summer weather can play a substantial role in the year, so we'll keep an eye on temperatures.

What We're Thinking -- or What Makes Us Different?

I realize that reciting financial metrics -- quarterly numbers -- is of little value. You can read the press release. The only interesting thing is, "What's our take? How do we differ from the market?" And in this case, we believe in the strength of Coca-Cola's distribution and branding to overcome challenges that surround the soda market. For better or worse, we think there's more growth to be had in sparkling beverages around the world, while much of Wall Street seems to think the growth there is all but done.

Conference Call Extras

- Coca-Cola and its bottling partners will invest another $8.2 billion by 2020, on top of global systems investments of $60 billion+ since 2010. This speaks to Coca-Cola's competitive moat: Few can invest that type of cash in bottling and distribution. (Keep in mind: *what* it bottles and distributes can always evolve.)
- YTD revenue growth is 3%; operating income was dinged by 4 percentage points this quarter due to currencies, but is up 6% year-to-date excluding currencies.
- Coca-Cola's use for cash remains: 1) reinvest in the business (about $2.5 billion this year); 2) pay a healthy dividend (it has increased it for more than 50 years straight); 3) acquisitions, partnerships, etc, to grow; 4) repurchase shares ($2.5 to $3 billion this year).
- EPS will be dinged by $0.02 per share the rest of this year due to structural items and changes in Venezuela.
- The balance of the year, Coca-Cola "should be able to fall within the corridor of the long-term growth targets" it sets for itself.
- Smaller packaging resulted in about 60% of the uptick in North America Coca-Coal sales; customers want smaller servings, which offer Coke better price value.
- Latin America should start to improve toward the end of this year
- Marketing costs continued to go up, to drive sales, with spend increasing as Q2 ended. Coke is in a place where it wants to reinvest proceeds into building growth momentum again, and it has a "whole lot more work to do." They're focused on driving long-term growth.
- Much of Europe improved.

Coca-Cola remains a long-term growth resumption story, supported by strong fundamentals and a distribution network second to none. The stock, with its 3% yield, still looks reasonably priced for long-term, patient owners.

For more financials, please visit the *Pro* Coca-Cola board.

Best,

Jeff

Stop Making So Many Decisions

Published Jul 21, 2014 at 2:57PM

Pro Guidance Changes

- **Wells Fargo** (NYSE: WFC): Another solid quarter from Wells has Billy and the *Pro* team impressed. We're raising our Fair Value Estimate to $56 and our Consider Adding More price to $44.

Dear Fools,

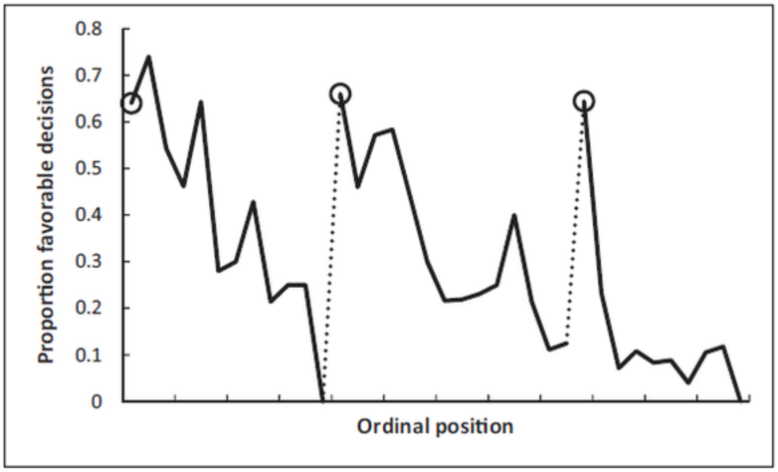
The longer I live, the more I wish I had an instruction manual to keep from doing dumb things. Two years ago, I wrote about how the weather (the weather!) influences serious financial decisions we make — like buying a house or a car. Of course, the weather wouldn't impact *our* decision making; we're all too smart, right? But now I read that being hungry impairs my decision making, too. I'm doomed!

Just Like the Rest of You, Your Brain Gets Hungry and Tired

Researchers from Ben Gurion University of the Negev and Columbia University studied more than 1,100 judicial rulings regarding prisoners asking for an adjustment to their parole arrangement (a parole request, the removal of a tracking device, or a change in prison). The 1,100 rulings were made by eight judges in large chunks — about

23 cases per day. If you're thinking this sounds like a lot of serious decisions to be making in quick succession, you're right. To cope with this, the judges were given two food breaks per day (an average of 38 minutes each), breaking each day into three distinct decision-making periods.

Now, these are judges, remember. They're trained in the consistent application of the relevant laws to the facts presented. This stuff is black and white (or should be). So what did the study reveal? Well, if you were a criminal whose case was heard at the beginning of one of the sessions, you had about a 65% chance of receiving a positive ruling. But if your case was heard at the end of one of those sessions? Sorry Charlie, you had almost no chance of a positive ruling. Check out how dramatically the likelihood of receiving a positive ruling fell as the judges grew tired:



Source: [Proceedings of the National Academy of Sciences (link opens PDF)](#).

Unfortunately, you're not seeing that wrong. As each session went on, the likelihood of receiving a positive outcome declined dramatically. The study controlled for variables such as the severity of crimes, prisoner demographics, and months served, so we can be pretty confident that the phenomenon demonstrated, known as decision fatigue, is real. While not exactly life or death, these *were* serious decisions made by professionals, and it doesn't appear that each prisoner was given a fair shake.

Give Your Brain a Break

Now consider the impact of being tired or hungry on your investing decisions. *Yikes*. Here are some tips on how to set up your investing life to avoid making bad decisions because of fatigue:

1. **Make fewer decisions.** Clearly, the more decisions you have to make, the more tired your brain gets. One way to make fewer decisions is to buy and own the shares of great businesses. Like our core holdings in *Pro*, you don't need to worry about selling at the slightest hint of overvaluation provided that the business is likely to compound its intrinsic value over time. Another trick is to use the options expiration date every month to act as a "trigger point" to think about each of your holdings. By having a set date to think things through once per month, you save yourself from the tendency to think about your holdings more frequently.
2. **Don't tax your brain.** One of the benefits of running *Pro* in front of you, our members, is that we have to document the rationale for every action we take. While this slows us down sometimes, it gets us on record, and when we have to make a decision down the line we don't rely on taxing our brains to remember what we expected or why we took the action. We can simply pull up the alert and refresh our memories, which frees up some mental space and makes it easier on our brains. Another way to lighten the brain's load is to share the decision making. *Pro*'s team approach and your access to the Fool community do just that.
3. **Take a load off.** It's frightening to realize the number of decisions we ask our brain to make every day. It is so many, in fact, that we make many of them on autopilot to reserve some decision-making capacity. I propose that the more menial decisions you can make automatically, thanks to well and deliberately constructed habits, the more computing power your brain will have for the really important things. For example, I eat the same thing for breakfast every day — no hemming and hawing; I get my nutrition without thinking. I shop at a grocery store that has basically one brand of everything — not six to choose from. I'm also considering the Steve Jobs approach to dressing: jeans and a black t-shirt, every day (my wife is not amused by this one). Autopilot can be dangerous, of course, which is why spending a little time to develop and implement *good* habits is the key to this strategy.

The *Pro* Bottom Line

Investing is hard enough as it is, and our brains don't do us any favors. For long-term success, we have to master ourselves as much as our portfolios. My advice: [Keep some good dark chocolate and butter handy at all times](#), don't be afraid to take a break, and use the strategies above. Tell us how you prevent decision fatigue and use good habits by dropping by the [Memo Musings](#) or [Optimize Your Life](#) discussion boards.

Onward.

— Bryan (TMF42)

Pro Completed Trades (see all [trade alerts](#))

- **Five Below** (NASDAQ: FIVE): We sold short 900 shares at a cost basis of $35.31.

Your Most Active Conversations

[Today](#) [Past 7 Days](#) [Past 30 Days](#)

Intel Raises the Bar, but Moves to Hold

Published Jul 21, 2014 at 12:57PM

Intel (NASDAQ: INTC) adjusted expectations higher in June, and surpassed them in July. After two years of flat results, the company grew Q2 revenue 8% to $13.8 billion, while earnings per share jumped 41% from depressed levels as gross margins gained 6.2 percentage points to 64.5%. Margins are expected to stay above historical levels the rest of this year.

Looking a bit deeper, the Data Center business enjoyed 19% revenue growth year-over-year, while PC Client Group unit volume jumped 9% as more enterprises refreshed aging computers (although average selling prices declined 4%). Intel estimates the number of PCs four years or older to be 600 million, and with **Microsoft** (NASDAQ: MSFT) support for XP ending, there are more reasons to upgrade. Plus, Intel is taking market share with the likes of two-in-one PC/tablet designs.

The company expects enterprise PC strength to continue the rest of 2014, but we need to take Intel's prognostications with a grain of salt. In January, the company predicted a flat year, which is proving quite wrong; in the past, Intel has predicted sustained up-cycles that then faded away as quickly as summer itself. Still, there's no denying that enterprise PC sales are currently on the rise, Intel is making headway into mobile computing (though profits here won't materialize until at least 2016), and Intel maintains a multi-year nanometer technology lead over competitors.

Plus, the consumer PC business remains weak. Representing roughly 60% of Intel's business, consumers represent a large catalyst if and when they revive. Already Intel sees "more optimism" from PC manufacturers for the second half of the year in regards to consumers, but stocking won't equate to sell-through unless consumers come to the table. Intel needs time to see the results, and our crystal ball lacks an ability to foresee short-term customer behavior, although we've always argued that consumer PC sales would revive in one form or another.

Aside from higher margins, one of the largest financial revelations this quarter was Intel's decision to run the business at net-zero cash-to-debt going forward. In other words, rather than maintain net cash on the balance sheet in the billions, Intel is going to use excess cash to buy back shares and pay dividends, while relying on cash from operations to fund internal investments. This suggests that Intel isn't eyeing any large acquisitions anytime soon (unless it were to use stock or take on more debt), but would rather manufacture more shareholder value.

The company increased its share buyback authorization by $20 billion (nearly 12% of its current market value), and intends to purchase about $4 billion in stock in the third quarter alone (that represents three days worth of normal share volume). This aggressive use of capital was not modeled for by us, and it -- along with stronger results at higher margins -- increases our fair value estimate by about 10% to $30. **The stock moves to Hold as we assess our in-the-money covered call options.** To discuss Intel, please visit its board on *Pro*.

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               Intel Financials
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Share Price:      $34 (up from $26.80 last Q)
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                  Guidance
========================
Fair Value Est.:     $30 (up from $27)
Cons. Adding More:$24  (up from $20)
Allocation:           5.8% (grew from 4.8% last quarter)
Yield:                 2.7% (down from 3.6%)
Status:               Hold (Under Review)
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                  Valuation @ $34
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Metric          Multiple
========================
EV/EBITDA                7.5
EV/EBITDA est. NTM    6.6
P/FCF Est*               19.5
P/E                        16.7
P/E est. NTM            14.7
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NTM = Next Twelve Months
*The 10-Q isn't filed yet, so FCF numbers are estimated.
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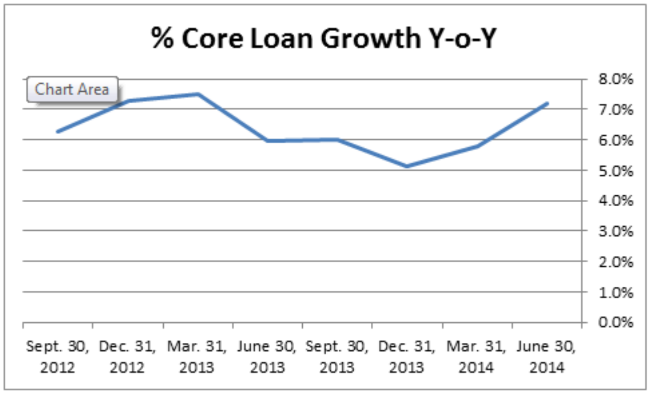
Guidance Change: Wells Fargo Continues to Impress

Published Jul 18, 2014 at 9:56AM

Wells Fargo (NYSE: WFC) reported Q2 earnings on July 11. Despite solid results, as of pre-market today, the stock price is down about 2% since the day before earnings, and about 4.5% from its year-to-date high of $53 on July 3.

Core loan growth (i.e., excluding non-strategic/liquidating loans mostly related to the Wachovia merger) was encouraging, up 7.2% year over year and 2% quarter over quarter. I view trends in core loan growth as the best representation of trends in the lending business, as non-strategic/liquidating loans now represent less than 8% of total loans, down from about 9.5% last quarter. That number should continue to tick lower over time as those old loans roll off the books.

Core loan growth is accelerating in recent quarters, which is an encouraging sign as economic activity picks up after an awful (-2.9% GDP) first quarter:

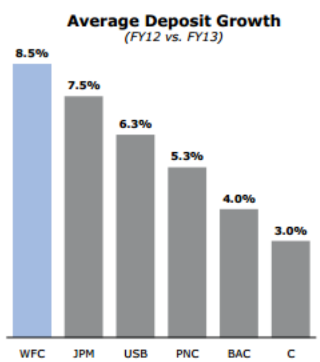


Source: Company filings and analyst calculations.

There was particular strength in commercial and industrial loans (up 10% year over year), auto loans (up 11% year over year), and credit card loans (up 10% year over year. Accelerating loan growth is a big driver for Wells Fargo, since loan income represents 75% of interest income, and interest income represents half of the company's earnings power. As loan growth picks up, we should expect to see interest income increase as well.

And this acceleration in loan growth is occurring even in the face of stagnant interest rates, which is very encouraging. When long term rates finally rise, I'm thinking it could be a big boon for the banks — especially Wells Fargo with its conservative lending nature. This is because as the spread between short-term and long-term rates increases, loaning becomes more profitable for the banks, which allows them to take on additional risk and lend to businesses and households that haven't qualified for years.

As for deposits, Wells again demonstrated its strong deposit franchise with growth coming in at 5.9% year over year, up from 5.2% last quarter and 4% the quarter before that. Its scale, proficiency in cross-sell, and network effect (largest nationwide branch network) allow it to collect assets at a higher rate than competitors, and at a lower cost. It's 0.10% cost of deposits (down from 0.11% last quarter) is best in class. Here we can see how Wells has been outperforming its peers in gathering deposits:



Source: Wells Fargo 2014 Investor Day Presentation.

As short-term rates rise, Wells should be able to put more of those deposits to work in investments (Wells' management has been conservative with its investments due to the low rate environment), increasing the business's earnings power.

So, in my estimation, Wells Fargo is well-positioned for any interest rate environment. Short-term rate increases should be beneficial via increases in investment income and ability to put deposits to work, and long-term rate increases should be beneficial via an increase in the profitability and growth of loans as the rate spread grows.

After analyzing the quarter, the Pro team remains bullish on Wells Fargo as a long-term holding and we think it will continue to achieve North Star-beating returns. **I've increased my Fair Value estimate from $53.50 to $56 and Consider Adding More price from $41 to $44, reflecting a book-value increase from last quarter and more optimistic return-on-equity assumptions.**

After our strangle strategy on Wells Fargo concluded with a well-timed close of our short call and a fully profitable expiration of the $48 short put in June, the *Pro* team is presently deciding how we want to proceed with this position.

Fool on!

— Billy (TMFTailwind)

Short Five Below

Published Jul 16, 2014 at 10:25AM

Is this for you? This trade is for Fools with a margin account and who can locate shares with their broker. Prior to releasing this alert, Interactive Brokers and TD Ameritrade had shares available to short. OptionsXpress did not have shares. Check with your broker to locate shares and inquire about any fees involved. This trade is also only for Fools who don't mind volatility — we expect this to be a bumpy ride.

How You Participate

- **Trade:** Sell Short **Five Below** (NASDAQ: FIVE)

- **Allocation:** 1.5%
- **Price Guidance:** Short above $33
- **Recent Prices:** $36
- **A Special Note of Caution:** Five Below is currently a recommendation in our *Hidden Gems* and *Rule Breakers* newsletters. We're motley, and are disagreeing with some smart investors who believe in Five Below.

What We're Thinking

Five Below is a specialty retailer that sells "trend right" merchandise to teens and pre-teens for five bucks or less. Its stores are a place for young folks to spend their allowance money. The company believes it is transforming the experience for young shoppers with a unique merchandising strategy (a combination of branded toys, accessories, and tchotchkes teens actually want to buy) and high-energy, fun shopping experience.

The typical store is 7,500 square feet, located in a strip mall, and stocks 4,000 distinct products. Store economics are compelling: New stores cost $300,000 and log sales of $1.5 million to $1.6 million in the first year, with most stores having a payback period of just 10 months. Average sales per store were $1.9 million at the end of 2013, increasing from $1.3 million five years ago. Today, Five Below operates 338 stores in 20 states and is set for rapid growth. The company expects to open 62 new stores in 2014 (for about 20% unit growth) and sees a potential for 2,000 or more stores in the U.S (about 11 more years of 20% unit growth). On top of opening new stores, existing stores have notched 32 consecutive quarters of positive same-store sales.

A new retail concept, great store economics, and a high-growth profile made for a successful initial public offering in July 2012. Shares priced at $17, and as they rose, the private equity firm that controlled the company sold off its entire investment. Shares have risen more than 100% since the IPO and we believe they're priced too dearly at about 3.5 times sales, 28 times EBITDA, 40 times 2015 expected earnings, and 31 times 2016 expected earnings. We wouldn't short solely on valuation, of course; Five Below shows signs of trouble in each of the three key areas we focus on for short candidates:

- **Competitive flags.** Five Below is performing well, but we think it is unlikely to ride into the sunset unchallenged.
  - We don't believe the company has a sustainable competitive advantage. It doesn't have proprietary merchandise, it doesn't have exclusivity agreements with suppliers, it doesn't have the advantaged locations a first-mover might, and it doesn't have a brand that translates to the ability to charge higher prices (in fact, it has painted itself into a corner by capping prices at $5). Success attracts competition and competes away profits, and we think this will play out with Five Below.
  - We've seen the promise of skill in selecting "on-trend" and fashion merchandise fall short more often than not, and Five Below has built its business on getting the fashion right in the eyes of teens and pre-teens. Having just lost its executive vice president of merchandising (more on this below), we think the fashion risk just went even higher.
  - The competition is coming, and coming hard. While dollar stores don't solely target teens and pre-teens, they fight for the car trip the parents provide, they fight for similar store locations, and they're increasingly fighting for more of the dollars spent in the same merchandise categories. For example, **Dollar Tree** (NASDAQ: DLTR) has ramped up openings of its "Deals" store concept, which allow it to sell merchandise up to $5. The expanded price point allows for more merchandise categories, increasing its product assortment overlap with Five Below. With 214 Deals stores already, Dollar Tree plans to grow unit count of this concept about 15% per year, and based on their success, the company could choose to transition some of its traditional Dollar Tree stores into Deals store formats and attack even more aggressively. **Family Dollar** (NYSE: FDO) has also expanded its higher price point offerings and new merchandise categories, including a big push into branded toys this past holiday season. Finally, after years of testing and learning, **Wal-Mart Stores** (NYSE: WMT) is putting the pedal to the metal in small-format store openings (its Neighborhood Market and Express store formats). Wal-Mart expects to open 300 small-format stores this year — nearly as many stores as Five Below has after being in business for 12 years. Even if this competition isn't a direct assault on Five Below, it is illustrative on how easy it is to pop up competing stores and how tenuous profits can be without a competitive advantage.
- **People flags.** None of the below flags are damning in their own right, but taken together, they raise doubt about long-term great performance at Five Below.
  - David Schlessinger (the executive chairman) and Thomas Vellios (CEO) are longtime business partners. In the late '90s, they ran a public company together called Zany Brainy. It sold "on trend" children's toys (think of here-today, gone-tomorrow toys similar to Pokemon cards and Beanie Babies) and more classic games. That business went bankrupt in 2001. It appears to have failed because the pair (a) tried to grow it too fast, (b) made a big acquisition, (c) spent too much building out their online presence, and (d) had no competitive advantage. Causes (a) and (d) are extremely relevant to the path of Five Below, and we're watching (c) in light of a recent Internet specialist executive hire.
  - In August 2013, the company abruptly announced Chief Operating Officer David Johnston was leaving. Johnston was poached from Wawa to become the COO in June 2012, meaning he spent barely one year on the job before jumping ship. The terms of his severance agreement included a non-disparagement clause, so there is little published on why the split actually occurred.
  - Just a few days ago Five Below announced Executive Vice President of Merchandising Jeff Moore was leaving. Moore had been with Five Below since 2007 and worked his way up to the EVP ranks. Five Below claims that it has a deep bench of general merchandising managers, but things don't add up. At the time of its S-1 (IPO filing), the company listed two GMMs, Moore and Lisa Surella. Surella stayed at Five Below for only eight months. The two GMMs cited in the Moore departure press release appear to be brand-new employees with little Five Below (as recent as February 2014 hire) or teen merchandising experience. For a company that relies on getting its merchandise assortment right, this is problematic.
  - Executives are unloading shares. In late June 2014, CFO Ken Bull sold $1 million worth of Five Below shares, eliminating one-third of his ownership stake. Recently, Executive Chairman David Schlessinger established a 10b5-1 trading plan to sell 400,000 shares, half his ownership in the business. Just days ago, the plan unloaded the first 100,000 share block. CEO Thomas Vellios also established a 10b5-1 trading plan, so in the near future we can expect him to divest some of his ownership in Five Below, too.
- **Financial flags.** Five Below shouldn't have a problem opening up new stores — they're cheap to erect and have a quick payback. However, rapid growth with stellar operational performance isn't easy to balance, and great performance attracts attention from competitors. We have our eyes on inventory and operating profits.
  - Even prior to the EVP of merchandising's departure, we were watching inventory. Days inventory outstanding, a measure of how long inventory sits on the shelves, has risen for five consecutive quarters (all the publicly available data we have). If inventory builds, it could be a sign that customers aren't buying as the company expected, or that some merchandise isn't resonating with customers.
  - We think margins could come under pressure not only from the looming competitive threats, but because Five Below appears to be heavily reliant on sales of holiday merchandise in the fourth quarter. Sales from its "party and snack" category, which includes seasonal goods, have grown to nearly 20% of full-year sales, and operating profits generated in the fourth quarter alone account for more than 75% of full-year operating profits. Together, these two facts suggest that Five Below probably does compete head to head with Dollar Tree, and that if it has a poor holiday season, its profitability will fall dramatically.

How It Fits Into *Pro*

This small direct short position will modestly lower *Pro*'s net long exposure to the market. Furthermore, as a teen retailer, Five Below shares some of the same end-customer spending risk that **The Buckle** (NYSE: BKE) does. If the general retail or spending environment weakens unexpectedly, this short should help offset some of the pain inflicted on The Buckle.

Remember, this direct short can only gain 100%, while its potential loss is unlimited. We intend to build out a basket of direct short positions over time and believe the most prudent way to follow-along is to match the entire basket, rather than pick and choose among them.

Alternative Trades

- **None.**

Pro Can Help

- Questions? Visit our Five Below discussion board.

Catch-Up Trades: July 14, 2014

Published Jul 14, 2014 at 12:54PM

Catch-Up Trades are the Pro *team's timely ideas to catch up on a portfolio position you may be lacking*.

- **iShares Russell 2000** (NYSEMKT: IWM): If you lack a hedge, and you want to hedge some of your assets, then set up a bear put spread on this ETF, similar to ours. Simultaneously buy to open Sept. 20, 2014 $114 puts (one dollar lower than our official trade, to account for different pricing), and sell to open an equal number of Sept. 20, 2014 $105 puts (to finance part of your cost). Lately, you can set this up for $2 or less per spread, or about $200 each. That is your maximum risk, while your maximum reward is around $7 ($700) per spread. Set up one spread for every $112,000 you have invested long and want to hedge. Realize this hedge will expire without value unless IWM declines by expiration, so don't risk money you don't want to lose.

Monday Memo: At 11 for 11, Pro's Building Success

Published Jul 14, 2014 at 11:40AM

Dear *Pro* members,

We start another earnings season this week, making now a good time to remind ourselves that quarterly reports are not what make for investing success. They're merely one step along a long path. Much more important is how you put your portfolio together and maintain your convictions for the long haul.

At least once a year, I like to review the entire history of the *Pro* portfolio to relive past decisions, assert what has worked and what hasn't, and confirm that our approach to building the portfolio is sensible. Sometimes I tighten the scope, as I'll do today by looking at what we've bought (and some sells) since January 2013.

In the last 18 months (about 380 market days, for those counting), we had 11 buys in the portfolio. That's one on average every 1.6 months — or one every 35 market days. That's a rapid pace for long-term investors like us, with a fixed amount of money and low portfolio turnover.

What makes me happy about the buys is they're all making money: We are 11 for 11.

What makes me even happier is they're outstanding businesses that we're excited to own with just a few exceptions: One we already sold; one we bought because it's average but priced below average; and one is an ETF where we see long-term promise. Here's the list of positions we bought anew or added to since January 2013, in order:

- **Apple** (NASDAQ: AAPL): Bought more when it was down
- **GrafTech International** (NYSE: GTI): Bought more, and sold those shares at a strong profit
- **O'Reilly Automotive** (NASDAQ: ORLY: A new buy
- **American Tower** (NYSE: AMT): New; bought twice
- **TD Ameritrade** (NYSE: AMTD): A new buy
- **AIG** (NYSE: AIG): Bought more
- **Valmont Industries** (NYSE: VMI): A new buy
- **Parexel** (NASDAQ: PRXL): A new buy
- **Coca-Cola** (NYSE: KO): New; set up through a synthetic long
- **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS): Added more
- **Gilead Sciences** (NASDAQ: GILD): A new buy

AIG is the "average business" that could become much better if the company improves its underwriting, and GrafTech has already been sold. What's left are eight outstanding companies that share common traits:

- Return on equity greater than 10%
- Consistent management
- Growing market opportunities

I realize those last two traits are squishy, but they're valid. We're comfortable with what we own largely because management has consistently run these businesses for greater shareholder value, and we believe there's more opportunity ahead.

Each company made it into the *Pro* portfolio because it displays the right mix of business opportunity, valuation, and good management — all of which put the odds of investment success in our favor. Each remains Buy rated today. (And note, we could add **Facebook** (NASDAQ: FB) to this list if we wanted, since we turned our calls to stock in January.)

The best performers over this short period? The auto parts retailer, up 55%, and Apple, also up about 55% since our March 2013 buy (not including dividends).

And the "Other"

Compared to our buys, our other actions lately have created little value. Hedging since January 2013 hasn't proven necessary (although it has allowed us to comfortably hold more long exposure, which pays off); option income has been modest as volatility remains low and we focus on stock buys; and in most cases our sells have left money on the table as the market keeps rising, but we are happy to be free of the likes of GrafTech and **StoneMor Partners** (NYSE: STON).

My main takeaway from looking at our past 18 months is that our buying process looks healthy. Countless stocks have fallen over this period, but each of our dozen buys (including Facebook) is green since purchase. In fact, all two dozen of *Pro*'s long holdings (and two of three shorts) are profitable. That gives the portfolio near 100% accuracy. We are stringent about what we allow into the portfolio, and for your money (and ours), we will continue to be.

Can we do better? You bet. I see many weaknesses, and questionable decisions, when I look back at our past 18 months, let alone the last six years. Before I cast judgment in print, ballooning this Memo into thousands of words, I'll think some more about our mistakes and save that Memo for another day. Rest assured: We always want to improve how we invest and our results. It may be a curse, but we're never satisfied when it comes to this pursuit.

Tonight, look at your portfolio history the last few years. What can you learn by looking? To start a discussion on the topic, as always, visit the Memo Musings board.

Fool on!

— Jeff (TMFFischer)

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Community We Share

Published Jul 14, 2014 at 9:07AM

- A baby is born! Help us celebrate Ellen (TMFKabellen) and her husband Tony's new baby girl, Lorelei Frances, born on July 3rd. Ellen is blissfully on leave after years of managing content on *Pro* and *Options*. Enjoy that baby!
- Earnings are coming! Earnings are coming! TMFMoosie posts his *Pro* earnings calendar.
- Margin debt at record highs? Market set up for a big fall? aleax debunks some stats and reminds us that journalists are trying to get eyeballs.
- Member Invest51 asks, "What's your largest portfolio position?" His is **Apple** (NASDAQ: AAPL) at 15%. Is that too large? Members share thoughts and their own stats.
- **Tupperware** (NYSE: TUP) in Israel? A Fool member — adi101 — gives us the field report.
- More members are buying **Papa John's International** (NASDAQ: PZZA).
- ADrumlinDaisy shares a quick update from New Caledonia.

Pro Live Chat, July 2014

Published Jul 9, 2014 at 11:21AM

At 2 p.m. on Wednesday, July 16, the entire *Pro* crew — advisor Jeff Fischer; senior analyst Bryan Hinmon, CFA; research analyst Billy Kipersztok; and editor/publisher Erin Kennedy — answered your questions during a live text chat. Relive the magic below!

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A Mid-Year Review: How Are We Doing?

Published Jul 7, 2014 at 3:52PM

Pro Guidance Change

- **Medtronic** (NYSE: MDT): We raised Medtronic's Fair Value estimate to $65 and its Consider Adding More price to $52 after digging into its proposed acquisition of **Covidien** (NYSE: COV). Shares remain a Buy and *Pro* owns a 3% position.

Dear *Pro* members,

It's hard to believe that the first half of 2014 has come to a close (it seems like just yesterday Jeff was reviewing 2013). Now that we're officially into the third quarter the year, I thought it would be a good time to assess our performance year to date and tell members what to expect for the second half of the year.

It's been an interesting six months for the market, though you wouldn't think so just looking at the total return for the S&P 500 year to date, which sits at about 7% on an absolute basis (on pace for about a 14.4% annualized return this year). After a spike in volatility around late January and early February (the VIX hit an intraday year-to-date high of 21.48 on Feb. 3) that coincided with some sharply negative stock price movements in high-flying growth companies, the market has calmed down. Volatility has steadily drifted lower since the early spike, and as of this writing it sits at 10.32, which is about as low as the index has been in its history. The major indexes now sit at or near all-time highs, and the relentless bull market of the last five-plus years continues to march on.

As for the first six months of 2014 for the *Pro* portfolio, it's performed quite well. Our total return year to date is about 7.4%, outpacing both the S&P (up 7%) and our North Star (up about 4.8%) over the same time frame. We've achieved these returns despite currently sitting at about 73% net long, about in line with *Pro*'s historical averages.

As far as our activity, we're trading at about the same pace as we did through the first six months of 2013. Here's a comparison of our important trading activity for the first half of 2013 vs. the first half of 2014:

	2013	**2014**
New Purchases	2	2
Allocation Increases	2	1
Options for Income	8	8
Hedging	4	4
Sales	2	3

As you can see, *Pro* has maintained its steady, consistent approach. As is typical for us, we haven't tried to do too much trading with our core stock positions, although we've invested in two new companies so far this year (**Coca-Cola** (NYSE: KO) and **Gilead Sciences** (NASDAQ: GILD)) and increased our allocation in another (**American Tower** (NYSE: AMT)). We like to invest in compounding machines and let them be, avoiding the drag of frictional trading costs when it comes to our equity positions.

Where we are more active is with hedging and using options for income, and we continue to employ a combination of strategies, including seeking lower buying prices and hedging against declines. We expect to keep using options opportunistically throughout the next half of the year, specifically looking to continue our strangle strategies on **Wells Fargo** (NYSE: WFC) and **Tupperware** (NYSE: TUP) after the two companies report earnings on July 11 and July 23, respectively. Of course, not all income strategies pan out. Our covered calls on a formerly sleepy **Intel** (NASDAQ: INTC) have cost us significant missed upside in the lively stock this year. We'll manage that position however is best, but if writing options on Intel continues to look reasonable, we may eventually earn income on it.

While we aren't market prognosticators and we can't tell you what to expect from the market over the second half of 2014, we can tell you what our approach to portfolio management will be. We will continue to invest in core stock positions (i.e., compounding machines) when the balance of risk and reward looks favorable. We will continue to use options strategies either for income, to add to our positions at lower prices, or for leverage, depending on what opportunities present themselves. We will seek to short weak, disadvantaged companies that appear poised for a stock price decline, and we will manage our net long exposure via index hedges as market conditions dictate. Here's to a successful first half of 2014, and hopefully to a successful second half as well.

Fool on!

— Billy (TMFTailwind)

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Are Covidien and an Irish Domicile Medtronic's Lucky Charms?

Published Jul 1, 2014 at 1:32PM

Fellow Fools:

Back in October 2012 we introduced to Pro members a framework for analyzing acquisitions. The gist of that essay was that corporate marriage is tough to get right and it has historically destroyed value, so we should skeptically view most acquisition activity our companies engage in.

I've dusted off that framework and used it to analyze **Medtronic's** (NYSE: MDT) proposed $43 billion acquisition of **Covidien** (NYSE: COV). The details and complete analysis are in the table below, but here are the highlights:

- This acquisition is about strategy.
  - The larger and more diversified Medtronic plc will be better positioned to win business in the new global health care regime where hospital administrators and governments are the primary customers. Being large (#1 or #2 in six of the top 10 hospital purchasing categories) allows Medtronic to sell in bulk and offer the convenience of a one-stop surgical shop to these customers.
  - Medtronic plc is in a stronger lineup of businesses -- more diversified and less subject to pricing pressure. This makes its profit stream safer, more resilient, and arguably more valuable.
  - With nearly $4 billion in sales to emerging markets, this move should accelerate Medtronic's leadership position in key emerging markets and set the stage for prolonged sales and profit growth abroad.
- Medtronic will have increased financial flexibility. It frees up trapped cash and regains control of the ability to allocate capital in the geography and method of its choosing.

Accordingly, **we're raising our Fair Value estimate to $65 and our Consider Adding More price to $52**.

Onward,

Bryan (TMF42)

Overview of the Deal

On June 15, 2014 Medtronic announced it would acquire Covidien for $93.22 per share, consisting of $35.19 in cash and the remainder in stock. That price represented a 29% premium to Covidien's closing price the day prior, about 15x 2015 EBITDA and 21x 2015 earnings. When the deal closes. a new Irish-domiciled entity will be formed, called Medtronic plc. This course of events will create a taxable transaction for both Medtronic and Covidien shareholders because both legacy companies will cease to exist and shareholders receive shiny new shares of Medtronic plc. (Please note, we aren't tax experts, but this is our understanding. We'll be researching the mechanics of this more as the closing date nears.) Medtronic CEO Omar Ishrak will be the CEO of the new entity, but all key Covidien executives are expected to stay on board and continue running their divisions. The deal is expected to close in late calendar 2014 or early calendar 2015 and is subject to Medtronic and Covidien shareholder approval.

Prior to the transaction, Medtronic had an enterprise value just shy of $60 billion and Covidien had an enterprise value of almost $37 billion. Medtronic plc will have more than 87,000 employees. For a reference point, Johnson & Johnson (NYSE: JNJ) has 128,000 employees and an enterprise value north of $285 billion.

Filter #1: Guilty Until Proven Innocent

This proposed acquisition is large -- a $43 billion consideration by a company valued at $60 billion. History tells us that large acquisitions perform worse than bolt-ons, and that the acquiring firm's stock tends to underperform over the subsequent five years. Although these are facts, they're averages, so they belie all possible outcomes and instead focus on the middle of outcomes. Still, we should put our skeptical shades on for the rest of this analysis -- Medtronic is making a big bet and it has a history of charges (ironically called "one-time charges" and equal to a nontrivial 4% of sales over the past decade) that suggest this or any merger not guaranteed to sail smoothly.

Filter #2: Key Considerations

Key Consideration	Details	Our Take
Size	Medtronic is paying $43 billion for Covidien's $10 billion in annual revenue and $1-$1.5 billion in annual free cash flow. Covidien was probably the third largest company Medtronic could have reasonably made a play for (behind **Abbot** (NYSE: ABT) and **Baxter** (NYSE: BAX).	This qualifies as a megamerger in terms of size and geography, but has little complexity in terms of overlapping product portfolios.
Strategic Rationale / Vision	**Cost**: Covidien is perhaps the only medical products company ahead of Medtronic in responding to the changing buying patterns of hospitals, where purchase decisions come from administrators instead of surgeons. In an increasingly cost conscious world, Covidien quickly organized its business assets and processes around saving hospital clients money -- a natural shift given its strength in medical instruments. With #1 or #2 market share positions in almost all of its product categories, Covidien has sufficient scale to maximize cost efficiencies. **Marketing/distribution**: Covidien has a sales force of more than 4,000 strong, and when combined, Medtronic will do business in 150 countries. The business will generate nearly $4 billion in revenue from emerging markets and have meaningful ability to be close to customers with marketing, manufacturing, and research and development. **Technological advantage**: Both firms rely on patents and technology. Covidien has recommitted to innovation with considerable investment over the past five years. Both companies have strong pipelines. **Industry balance**: With hospital administrators doing an increasing amount of purchasing, Medtronic and Covidien now meaningfully share customers. Hospitals, and abroad governments, are large customers with significant bargaining power. **Visionary investment**: This business combination may not be visionary, but it is clearly making a bet that the future of health care (surgery, at least) will be increasingly controlled by large customers (hospitals, governments, and other payers).	**Cost**: Medtronic could not have achieved the cost advantages Covidien has in its product lines. It should be able to eliminate some overlapping back office functions, find sourcing savings, and outfit existing sales people with additional products. In all, management expects to achieve cost synergies of at least $850 million over the next few years, which represents about 10% of Covidien's operating costs and 4% of the combined company cost structure. **Marketing/distribution**: This acquisition should accelerate Medtronic's penetration into emerging markets. This is critical because growth in emerging markets is responsible for much of total sales growth. The two companies are highly complementary with their emerging market strategies, with Medtronic adept at innovating into the value segment and Covidien's strong hospital distribution. **Technological advantage**: Covidien should benefit from Medtronic's relationships and experience in navigating the regulatory morass of device approval and study completion. **Industry balance**: Medtronic CEO Omar Ishrak's strategy to focus on economic value was an admission that hospital's are price conscious. Traditionally, Medtronic has had a difficult time convincing hospitals its products save money because all of the savings come once the patient has left the operating room. With Covidien's surgical supply products, Medtronic is now armed with the ability to sell in-hospital savings. In addition, it can bundle surgical products with devices, or sell with volume discounts and trade margin for sales. Medtronic is now the leader in six off the ten largest hospital purchasing categories. The company's ability to master the price and volume trade-off to its advantage is helped immensely. Not only does the larger product portfolio help balance the power between Medtronic and its large customers, but it tips the scales in Medtronic's favor in terms of pricing more attractively than smaller or less diversified competitors in device or surgical supply sales. **Visionary investment**: This move was an offensive one, with Medtronic aggressively realigning the balance of industry power before it had much of a chance to shift. In addition, this move accelerates the ability to expand in emerging markets and brings local presence in key markets. While not visionary, this transaction shows foresight.
Performance and Price	Covidien was spun off of Tyco several years back. Under Tyco's umbrella, Covidien underinvested and growth stagnated. Once independent, it used its cash cow surgical supplies division to fund investment and rekindle innovation. Recently, it spun-off a decent, but not great, specialty pharmaceutical business, and put the pedal to the metal in terms of reinvestment and the results are beginning to show. Covidien was modestly undervalued prior to Medtronic's offer, but probably not 29% undervalued.	There aren't many medical device or medical technology deals to compare this one to. In 2011 JNJ acquired Synthes for $18 billion. It paid 11x EBITDA and 4.9x sales for the quickly growing device maker. In 2007 a few private equity firms purchased Bioment for $11.4 billion, and paid 16x EBITDA and 5.5x sales. Medtronic clearly paid a full price for Covidien, but at 15x EBITDA and 4.1x sales it didn't pay a crazy price. Additionally, Covidien's growth profile looks strong going forward and the use of trapped cash (see opportunity costs below) gave Medtronic more wiggle room in paying up.
Culture and People	It appears the majority of key Covidien managers will stay on board. Medtronic's mission and values are very similar to Covidien's.	Ishrak noted: 'It is important for us that the vast majority of the Covidien leadership team obviously stays with us. I mean, the company is built around its people. "
Opportunity Cost and Experience	Medtronic could not have reasonably replicated Covidien's assets and market position. It could have acquired different companies, but no company would have been as purely complementary. Finally, Medtronic could have instead returned cash to shareholders (via a dividend or share repurchases), but its ability to do this was severely limited by the fact that most of its $14 billion in cash is trapped overseas. Repatriating its overseas cash to return to shareholders or make a domestic acquisition would trigger massive repatriation taxes and destroy value.	The opportunity cost argument is key to Medtronic's rationale. Acquiring Covidien, an Irish company, it puts to constructive use much of its trapped cash. Not destroying value (by repatriating cash and triggering taxes) counts the same as creating it. Re-domiciling in Ireland and taking on a bit more debt should structurally lower Medtronic's tax rate. Furthermore, the new structure provides improved flexibility in deploying future cash flows appropriately -- whether at home or abroad and to dividends, repurchases, acquisitions or reinvestment. Prior to this proposed transaction, Medtronic's capital allocation policies were arguably unsustainable because of the geographic mismatch between where cash was generated and cash was allocated. Finally, Covidien's business provides Medtronic with more diversified business lines subject to lower pricing pressure than its legacy businesses. In this way, Medtronic's profit stream is safer and more resilient.

Impact on Value and Risk

Linking strategy to value is critical. Over the next five years, we see this business combination accelerating Medtronic's revenue growth as (a) Covidien's pipeline goes live and more of its revenue come from higher priced devices, (b) cross selling opportunities arise, and (c) as Medtronic flexes the breadth of its product line and becomes a preferred customer (relative to competitors) of hospitals and governments. Overall, these changes should boost Medtronic's modest five year revenue growth rate to 4.5% per year.

We expect the margin impact from the deal will be largely neutral. Covidien's operating margins are below Medtronic's, but new product margins should look more like the high device margins Medtronic is used to. In addition, Medtronic will likely give up some margin to large hospital clients in exchange for higher sales volumes. Meaningful cost synergies should offset these pressures. Both management teams believe that "at least" $850 million in cost synergies are recoupable within a few years. To be clear, Medtronic must realize these savings to justify the price paid (If I assume $0 in synergy savings Medtronic's fair value estimate falls by $6-$7.) Given CEO Omar Ishrak's focus on execution, $850 million could be a low-ball number, but merger integrations are difficult and nothing is guaranteed. Thanks to a bit of cost savings from taxes, we expect pre-tax profit margins to reach 23% in five years, which should drive returns on invested capital into the low 20% range.

Finally, the acceleration of growth into emerging markets should help Medtronic establish a leadership position in faster-growing markets which will provide a benefit long into the future. This will enable the company to sustain its excess returns and grow profits at 4% for the life of its competitive advantage period.

Our bear case scenario looks much more like a continuation of the blended entity (plodding growth and declining margins) with only modest synergies. We weight that case with a one in four chance of happening given the large degree of integration risk and accounting for a challenging health care landscape. Our bull case assumes 5.5% revenue growth and a bit operating leverage, but we assign a lower likelihood of it becoming reality. Blending these scenarios together, **we are raising Medtronic's Fair Value Estimate to $65 with the belief that the proposed merger will be approved by shareholders**.

Given the lowered business and cash flow variability risk of the new company, we're willing to change our allocation to Medtronic at a 20% margin of safety, which **suggests a Consider Adding More price of $52**.

The Foolish Bottom Line

Pro has 3.1% of its portfolio allocated to Medtronic and we rate shares a buy. Priced at $64, shares look fairly valued.

We do believe there is a chance that investors will choose to reward the new Medtronic with a higher multiple, based on its diversified profit stream (a la JNJ) and the fact that price-resilient surgical supplies sellers are typically rewarded a higher multiple than price-pressured device makers. Should this rerating happen, we may look to sell our shares unless the expected cash flows tell us something different.

The Problem With Single-Variable Analysis

Published Jun 30, 2014 at 4:00PM

Dear *Pro* members,

On Friday, as I was perusing one of my favorite financial blogs (The Big Picture, by Barry Ritholtz), I came across an article written by Barry that really struck a chord with me.

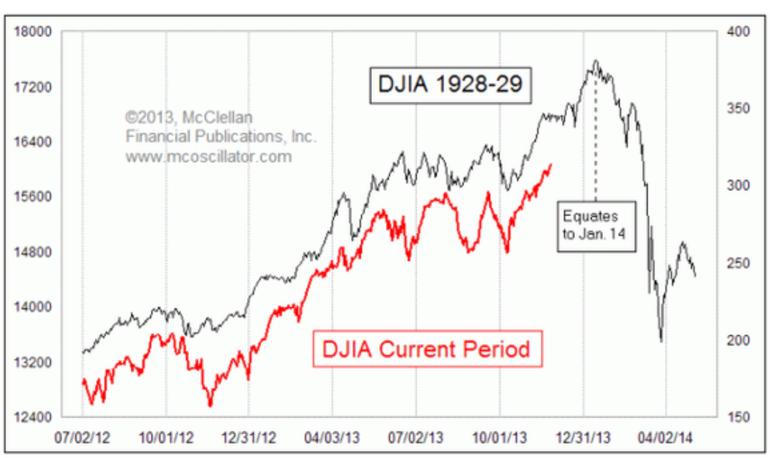
The article was titled, aptly, "Single Variable Market Analysis is for Losers." The article can be summarized by one quote (emphasis Barry's):

*"The behavior of markets or economies simply can't be explained by looking at **just one thing**."*

This is a topic I think about quite often in relation to financial markets, and I've mused about it in the past on the *Pro* boards. I often see financial commentary that relies upon historical data to make predictions about where the market is headed. I have no problem with using this type of methodology for static systems with fixed rules (e.g., coin flips, or throwing a ball in the air). These types of systems have defined mathematical relationships, where output is only dependent upon the value of the input.

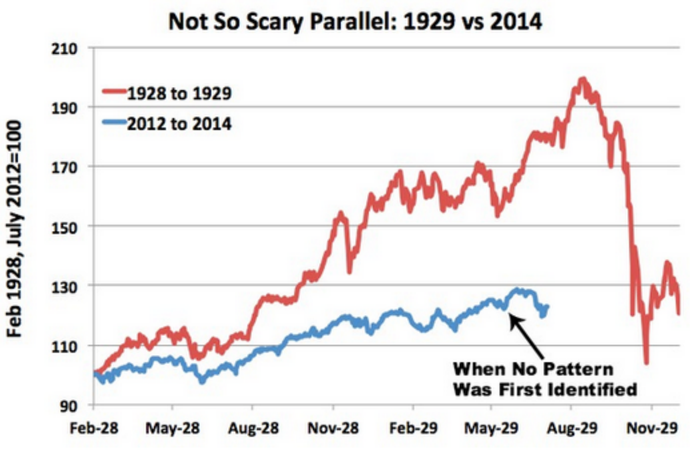
But for dynamic, chaotic systems like the stock market (or a double pendulum), the rules of the system are highly dependent upon initial conditions. One given input could generate a very large number of outputs, depending on the time that the input is introduced to the system. For systems like these, there is no guarantee that historical data is even relevant to the current state of the system. In my mind, using historical data to predict future stock market behavior is almost akin to using the output from a random number generator to try to predict the future sequence of numbers from that same generator.

Here's a widely circulated example of single-variable analysis that, if interpreted incorrectly, could lead to faulty decision making. In October 2013, Tom DeMark of DeMark Analytics identified a pattern in stock market price data that appeared to parallel the price movements of the stock market in the months leading up to the 1929 crash. Then, in late November, Tom McClellan posted about the 1929 price movement analog, where the price movement synchronicity appeared to continue. Here's the chart (and supposed pattern):



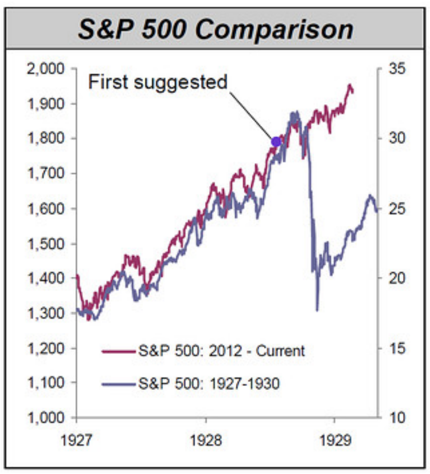
Source: McClellan Financial Publications, "Chart In Focus," 11/27/13.

Not only was this a case of single-variable market analysis, but it's also a case of misleading data visualization (check out "How To Lie With Data Visualization" by Heap's data blog for more examples of misleading charts and graphs). If you account for the fact that the dual vertical axes are on different scales, the chart ends up looking like this:



Source: Matthew O'Brien, *The Atlantic*, 2/11/14.

And finally, here's a graph of the same data series, updated for recent stock market price movements:



Source: Birinyi Associates.

A single-variable analysis (in this case, market index price movements) made it very easy to apply incorrect conclusions to make future market predictions. In addition, a misleading visualization confounded decision making even further.

I'm not saying that data analysis is useless and should be completely disregarded. I'm simply arguing that we need to decouple our minds from "coin flip" or "ball-in-the-air" thinking as it relates to the stock market. We need to understand there are so many variables at play that making forecasts is incredibly difficult and unlikely to yield actionable insight in and of itself. We should use data analysis to inform, but not dominate, our decision making. And we should think in terms of probabilities instead of certainties.

Fool on!

— Billy (TMFTailwind)

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

AIG Moves to Buy

Published Jun 30, 2014 at 4:00PM

We're moving **AIG** (NYSE: AIG) to **Buy** from **Buy First**. The margin of safety on this so-so business is narrowing and a CEO transition is on the horizon, but we're very comfortable with shares as a Buy.

- Head on over to the boards to discuss AIG's latest move.
- See all our coverage on AIG.

Checking In With Broadridge

Published Jun 23, 2014 at 3:31PM

Fools,

Earlier today I had a brief telephone conference with a few members of the team from **Broadridge Financial Solutions** (NYSE: BR). I didn't have much of an agenda, but am always happy to chat with management when they offer up time. Below are the notes from my call, in two sections. The first section contains the key takeaways -- they don't contain anything earth shattering but do help construct a more complete mosaic. The second section is the raw notes I was able to scribble down.

Broadridge is a 4.1% position for *Pro*, it remains a Buy, and we think shares are modestly undervalued.

Bryan (TMF42)

Takeaways

- 98% customer retention rates don't come easily or automatically. Pleasing customers is deeply rooted in the Broadridge culture, it is reinforced with incentives, and it is constantly espoused by management.
- While I understood the company's scale-based (low cost) and brand-based (trust, experience, and relationships) advantages, I have underestimated the power of these advantages when it comes to acquisitions. The large, global customers demand strong financial footing and a track record of security. Putting promising acquired products under the Broadridge umbrella provides instant credibility and opens up considerable growth opportunities, which should fuel emerging and acquired sales growth for some time.

Call Notes

What defines the culture at Broadridge?

Very customer centric. The "value profit chain" is the message delivered from the top. You see our commitment to customers the in high customer retention rates. It's almost unbelievable how much we study each client loss. We feel all customer losses the same – material (big customer) or not (small). You see our commitment to our employees in the "best places to work" awards. The culture is also seen in our values: trustworthy, respectful, accountable, engaged, client centric. Every employee can recite them. Finally, Broadridge tries to maintain a small company feel. We're constantly having events to bring employees together, and in almost all cases (no matter how small) a C-level executive is present and accessible.

How do you keep employees of all ranks engaged and motivated?

Associates are already an "extremely passionate bunch." Work gets hard (during proxy season, it gets to be an "all-hands on deck situation"), and hours get long. Broadridge is careful to reward appropriately – customer retention is built into the rewards system.

Engagement is also driven by mobility and empowerment. Al (one of the people on the call) is currently on a rotation across departments (he is a finance guy, and is on a rotation with the IR team). Being empowered matters – if you see something you don't like, change it. Broadridge encourages employees to be strong in business. HR is responsible for training the habits of highly effective people and general business thinking. Again, it loops back to being able to retain clients, and having happy, engaged, educated employees helps.

Are you seeing the competitive landscape change at all? What are the key developments (by segment) that you are keeping an eye on?

Most of our competition is someone doing what we do themselves (internally). Not much is changing there – few new entrants on the horizon. There are definitely a few key developments across ICS and SPS. Security is a big deal – we tell customers how much we spend on security. Compliance is huge – we highlight the cost of compliance failures. Regulation is always a source of change and uncertainty for our clients.

One of the criticisms often cited about Broadridge is slow growth. Why is that criticism wrong? What is underappreciated about the company's growth prospects?

Recurring revenue growth rate over the past five years is 7% -- which is pretty good. That is more indicative of the true business growth than tracking revenue – Broadridge is disrupting its distribution business by helping customers digitize – so while revenue growth might be low, profits are moving just fine: EPS growth should remain in the double digits. Overall, Broadridge is concerned with delivering top quartile total shareholder return, and modest double digit EPS growth with a growing dividend will go a long way to getting there.

Emerging and Acquired product sales have been a strong contributor to growth. Can you explain how they contribute to the company's competitive advantage?

Broadridge has dissected each element of what its customers do. Every node, every piece of the value chain, can be optimized. Broadridge is really trying to become an ecosystem to optimize each step of the process. Many of the emerging/acquired products are solutions to improve one small step along a customer's workflow where Broadridge can do it better, faster, cheaper, more securely, or free up capital. Also, financial services companies are very hesitant to adopt and institutionalize a product from a $10-$20 mm company. They need to know it will be a long-term solution and not be out of business in a few years. Under the Broadridge umbrella, small products is given immediate credibility and durability.

The word "data" is popping up more and more in your calls and presentations. What data does Broadridge have that is proprietary and difficult to replicate? How is Broadridge using this information? How are you communicating the value of that data to customers? What is the sales pitch?

In ICS, we have information on who corporate issuer investor base is, how they're voting, and what their preferences are. Through SPS, Broadridge has access to client data (which is owned by the customers), and with permission it can scrub that data and offer insights. The combination can help inform how customers use their marketing dollars, align resources, etc. Broadridge is really just scratching the surface with data.

SPS client wins generally require customer "switching" – what are the key factors that have to align to push a potential customer over the edge and decide to outsource? What can/is Broadridge do/doing to push those factors forward? How do you translate those factors into numbers/forecasts/expectations?

The underlying regulatory landscape seems to only be getting more intense. Broadridge has helped inform regulatory changes, so both customers and regulators look to the company as a thought leader. Regulation can help speed things up, but Broadridge prides itself on driving that change.

Eventually, companies remember that it is important for them to focus on where they truly add value, and Broadridge will be there to enable them to offload support functions that don't fit that bill. Proxy took about 20 years to move completely away from in-house (now almost nobody does it in-house). Fixed income processing is ~50% processed through Broadridge, equity is about 30%. Eventually, there comes a tipping point in non-value adding (but necessary) services. Broadridge keeps chipping away at market share and driving cost out of the system.

What problems is the Accenture partnership solving? How is the international sales cycle/decision process different than in the US?

First off, it is really hard to cover the rest of the world (outside US) – it is a big place. Having Accenture validating the Broadridge brand internationally lends instant credibility. Accenture also brings in immediate C-suite access, which is where the large-deal outsourcing decisions are made. International agreements will take a while to materialize and implement, but they will be meaningful.

What are the major factors of your cost structure that are under your direct control and how do you manage them? Should SG&A eventually leverage (grow slower than sales)? Do you have any longer-term margin goals?

Labor is the largest component of the cost structure – Broadridge does use some part-time labor during the high proxy season. For much of the business, we're selling scale, so technology investment is huge. Spending on technology will continue to be critical. SG&A has ticked higher, at least in part, because we pay up to keep our acquired talent on board. The return on that investment is an increase in recurring revenue over time. We don't focus on leveraging SG&A immediately – retaining the leadership teams of the companies we acquire is more important than a few basis points of margin. We expect a 30-60 bps increase in EBIT on top of each 100 bps in recurring revenue growth.

How should I think about a normal year of capital spending? What specific areas take the lion's share of reinvestment? What are the major components of reinvestment to support the growth of the business and protect the existing franchise?

Mostly technology. We want to support capabilities to support mutualization of costs, digitization, and analysis of data. The extra investment we are making right now is in the capabilities to support those three things, which is what will drive our growth over the longer term.

What does the future of shareholder communications look like?

60% of people are getting proxies in digital form – Broadridge hopes to get all client communications to that level (higher, really). In general, investor communications are a utilitarian relic – they aren't user friendly at all. Broadridge would like to change that. Everything has to be digital. There has to be intelligence. The information has to be portable (available where investors want it). It has to be consumable.

Remember Where You Started

Published Jun 23, 2014 at 10:58AM

Dear Fellow Fools,

A long bull market can make some investors greedy. Some start to expect gains as a given, and they always want more. A stock account may be worth much more than it was a few years ago, but the account owner may not feel very different. That's because extra money by itself isn't a catalyst for much of anything; it just sits there. Only decisions on what to do with money — action — can really bring it to life. So when you have more money, but life feels the same, it's easy to believe you just need *more* to make a difference, and greed starts to creep.

At times like these, it's helpful to remember what we've been through. Five years ago, nobody had any idea how we would pull out of the steep dive the economy was suffering. The system appeared about to collapse, and only outrageous sums of bailout money from the government might possibly stop the worst (and with untold consequences). When you remember how uncertain, and unstable, everything recently was, it's remarkable that today we stand at new market highs.

Short-sellers, those buying gold, those relying on commodities, those who hedged too much — they've all missed one of the strongest bull markets in our lifetime. Who would have guessed? It's very fortunate that you, along with *Pro*, showed the reasoning and bravado to invest the way we have. We didn't overly hedge our investments. We didn't run to gold. We haven't been 50% short. Instead, we enjoyed this incredible market recovery while investing rationally, maintaining portfolio flexibility, and — perhaps most important — being comfortable along the way.

We shouldn't feel compelled to change our overall approach now. Of all things, we should not become greedy and take bigger chances now that valuations are universally higher. We also shouldn't shy away from hedging, because eventually we'll need it. So far, most market hedges have gone unused in recent years, and option income has paled compared to stock gains. But eventually hedges will help smooth losses, and option income will matter more again. In the end, all markets suffer a setback.

When that happens, let's remember where we came from. No one knew how we would survive the crisis. We're *still* in that state of flux, with the Fed's balance sheet bloated, interest rates artificially low, hiring slow, and share buybacks and operating margins at record highs. Rubber bands are stretched in either direction, and eventually they need to give back ground.

So don't anchor on all-time highs and think that's what you deserve — and more. Portfolios flux. We will enter periods where values go down. Remember where you stood five years ago, and be grateful for where we are today. We'll do our best in *Pro* to continue creating value in a steady way, but we can't always expect it, nor assume that's what we deserve. The reality is, forces much larger than us exist, which means we'll see setbacks at times. We're spirited, so we'll come back stronger, and work harder to keep climbing to new heights.

Rather than greed, we seek new highs out of principle. Building is what we're here to do. Market storms may slow us down, but our foundation is solid, and we have many ways to build when dynamic times call for it. Meanwhile, check out our *Pro* mid-year review.

A Foolish Note

Today I'm headed down to Jupiter, Fla., as family gathers to celebrate my mother's 70th birthday. I'll return after July 4. Have a wonderful holiday! Thank you for being here with us, and to chime in, please visit the Memo Musings board.

— Jeff (TMFFischer)

Pro Completed Trades (see all trade alerts)

- **iShares Russell 2000** (NYSEMKT: IWM): We covered (bought to close) all of our short shares near $118, and set up eighteen September 2014 $105/$115 bear put spreads on the ETF instead, at a cost of $2.10 per spread, capping our risk on this hedge per our two trade alerts from June 18.

Your Most Active Conversations

Today Past 7 Days Past 30 Days

Oracle: Seeing Through a Cloud

Published Jun 23, 2014 at 12:09AM

- **Oracle** (NYSE: ORCL)
- *Pro* Status: Buy First
- Fair Value Est.: $42
- Allocation: 4.7%

Enterprise software leader **Oracle** reported fourth quarter 2014 results to boos and whistles. The stock declined after the database management giant fell short of expectations for the second time in the last four quarters. The stock has gained more than 20% over that time.

In the fourth quarter, revenue grew 3.4% and earnings per share were flat, while free cash flow climbed to a record $14.3 billion. Oracle now claims to be the second-largest Software-as-a-Service (SaaS) company in the world, behind **Salesforce** (NYSE: CRM). Founder and CEO Larry Ellison has a goal of becoming the largest SaaS and PaaS (Platform-as-a-Service) cloud company. Revenue in these cloud divisions grew 25% last quarter, with an annual sales run-rate near $2 billion -- but that remains small compared to Oracle's $38 billion in yearly sales.

It's important to realize that Oracle's revenue base is evolving. For years, it has sold software via a license, receiving a bulk payment as customers bought rights to its software, followed by support and maintenance revenue later. Now more revenue is being booked on a subscription basis – a cloud subscription – so the revenue is earned and recognized on a gradual basis. In fact, it takes Oracle approximately three years of a cloud subscription to match the revenue dollars of one traditional license sale. But, cloud revenue could then continue for another 5, 10, 15 or more years, leading to greater revenue overall than the license model. Oracle looks forward to those days, as do we, but they're far off.

For now, it's encouraging that traditional software license revenue was flat on the year, at $9.4 billion, even as cloud revenue grew at its expense. And, license updates and related support revenue grew 6% to $18.2 billion. This strong recurring revenue (Oracle's traditional bread and butter) makes the business more stable and predictable.

Near $41, Oracle trades at 13.3 times free cash flow and 12.9 times expected earnings for the year ahead. The valuation is attractive as long as Oracle can continue to grow cloud revenue while minimizing the impact on license revenue. As CFO Safra Catz said in the conference call, "I'm actually thrilled that we are where we are in new license [business] considering how much cloud growth we've got."

Us, too. We're still banking on license revenue to be stable in coming years. We have little doubt cloud will keep growing at Oracle, but we need to make sure it's not too much at the expense of license revenue. Many companies want to get their software in a combination of ways, including onsite (usually a license) and offsite (cloud). Oracle is well positioned for this scenario, and we believe it can juggle both well.

A Mid-Year Pro Review

Published Jun 22, 2014 at 10:58PM

As we near mid-year, the *Pro* Portfolio has had six months with little to complain about. As of June 20th, the portfolio is up nearly 6%, outpacing the North Star, the Nasdaq, the Russell 2000, the MSCI World, and on par with the very mighty (the last few years) S&P 500.

We've avoided costly decisions thus far, evidenced by a lack of big losers. But we do continue to seek new investments to grow our returns. We have so far this year missed a handful of opportunities (long and short) that we had been analyzing. We missed simply by not acting, thinking we had more time and might get better prices – which may still be the case in some instances. However, the dip in the market early in the year lasted much shorter than we'd hoped.

Going forward, we're eager to start new positions (long, short, and income) whenever opportunity presents itself.

We've kept the *Pro* portfolio hedged to the tune of 12% to 17% this year, including our deep in-the-money covered calls on **Intel** (NASDAQ: INTC). But hedging hasn't stopped our returns from being respectable, and it has lowered our risk. We're also carrying 18% in cash for new opportunities and continued flexibility. We've only been net long to the tune of about 70% this year, so our returns are all the more pleasing.

Notable winners so far this year have included our two ETF shorts, **AmTrust Financial** (NASDAQ: AFSI), new *Pro* entrant (via a synthetic long) **Coca-Cola** (NYSE: KO), as well as **Medtronic** (NYSE: MDT), **Facebook** (NASDAQ: FB), and **O'Reilly Automotive** (NASDAQ: ORLY) and **Valmont** (NYSE: VMI) -- those last two still fairly new to us.

Laggards have included **MasterCard** (NYSE: MA), **Papa John's** (NASDAQ: PZZA)(which we had on Hold until recently returning it to Buy), **Gentex** (NASDAQ: GNTX), **The Buckle** (NYSE: BKE), and **Tupperware** (NYSE: TUP) -- which we strangled to put into the green by a tad so far.

Back on the positive, we've seen gains from **AIG** (NYSE: AIG), **Wells Fargo** (NYSE: WFC) and new *Pro* entrant **Parexel International** (NASDAQ: PRXL). Parexel's gain followed a sudden drop that allowed us to write puts to target additional income.

Here's the rundown of individual results – biggest winner to biggest loser -- from January 1 to June 20 on positions we've held since December 31 (so, new positions in 2014 aren't included). Keep in mind, we run a portfolio because we don't know how any individual position will ultimately do; we want our portfolio to work as a whole.

AmTrust Financial	30.7%
ProShares UltraShort Real Estate (NYSEMKT: SRS)(SHORT)	(27.2%)
Parexel	22.8%
Facebook	18%
Direxion Daily Financial Bear 3x (NYSEMKT: FAZ)(SHORT)	(17.8%)
O'Reilly Automotive	17.3%
Wells Fargo	16.5%
Intel (unfortunately covered for much of this gain)	16.4%
Apple (NASDAQ: AAPL)	13.4%
American Tower (NYSE: AMT)	12.5%
Medtronic	11.3%
AIG	8.9%
Valmont	7.9%
Oracle (NYSE: ORCL)	6.7%
WisdomTree Emerging Markets SmallCap (NYSEMKT: DGS)	4.9%
Broadridge Financial (NYSE: BR)	3.4%
OpenText (NASDAQ: OTEX)	3.1%
TD Ameritrade (NYSE: AMTD)	2.5%
Starbucks (NASDAQ: SBUX)	(2.3%)
Papa John's	(7.3%)
MasterCard	(11.7%)
Tupperware	(11.8%)
Gentex	(12%)
The Buckle	(13%)

Returns do not include dividends; source: Google Finance YTD returns.

Including **Coca-Cola** (NYSE: KO) and **Gilead Sciences** (NASDAQ: GILD), we have 20 winners on the year, and 6 losers so far. Our allocation decisions largely favor our winners, fortunately, MasterCard and Papa John's aside, both of which started the year among our top 7 positions.

One small frustration this year has been our hedge with **iShares Russell 2000** (NYSEMKT: IWM). We issued the alert to short it as a hedge in January, and by the time we could place the trade ourselves the index was down a meaningful amount. It since rebounded. Our hedge has not been necessary so far, but it has made it easier to stay more fully invested, and the portfolio is up as a whole, which is the point.

Looking ahead to the second half of 2014, we look forward to covering second-quarter earnings for you in July, hopeful that we'll see more sales growth traction than in the tepid first quarter. All of our stocks are rated "Buy." Looking ahead further, with the Fed's Janet Yellen signaling low interest rates for at least another year, stocks may continue to have support from those seeking investment returns.

We'll continue to invest stock by stock, based on a stock's valuation compared to the strength of the underlying business. Overall, we'll continue to invest targeting healthy North Star-type returns over any rolling three-year period. As we enter the second half of 2014, expect more income trades, new buys, and perhaps -- finally -- some direct shorts of weaker companies as the Fed's monetary easing *finally* comes to a close likely before year end.

Meantime, we hope to see you on the *Pro* boards talking about a topic we all love -- investing! Stay long term, stay invested in great businesses, and manage your portfolio for gains as a whole -- remaining comfortable along the way.

Fool on,

-Jeff (TMFFischer)

Community We Share

Published Jun 21, 2014 at 9:14AM

In the last week, *Pro* members shared hundreds of posts and conversations. Some favorite, most active, and popular discussions include:

- Long-time Fool and *Pro* Polaris Award winner [RockyTopBob celebrates] his 9th year of Foolishness! Members share congratulations and (if you're ADrumlinDaisy) Foolish stories.
- Let the number crunching continue! Members discuss *Pro's* returns in the relation to the S&P 500, with an eye toward how *Pro* may [perform against the North Star] over the long haul. Jeff shares how he views *Pro's* strategies.
- Inquiring members want to know: What's up with **AmTrust Financial Services**' (NASDAQ: AFSI) valuation? Bryan [shares] where we're at.
- Nevercontent shares his experimental [put writing ideas].

Close Your Short Position on IWM

Published Jun 18, 2014 at 6:26PM

Is this for you? The relatively few *Pro* members who are short the **iShares Russell 2000** (NYSEMKT: IWM) ETF should consider closing, or covering, their short to match *Pro's* new guidance — the bear put spread shown in today's concurrent alert. Make sure to also look at the alternative trades below, to make sure to do what's best for you.

How You Participate

- **Trade:** Close, cover, or buy to close your short shares of IWM.
- **Allocation:** Close all your short shares.
- **Price Guidance:** The ETF is liquid. Simply cover when you're ready.
- **Recent Price:** $117.16

What We're Thinking

Pro has a 9.5% short position in the IWM ETF as a hedge, but it seems only Interactive Brokers and sometimes TD Ameritrade have shares of IWM available for shorting, so most *Pro* members likely do not hold this position along with us. Members who did the alternative bull put spread were able to close last month at a profit at expiration, and we've been watching for a new recommendation to make since. Our new trade alert — another bear put spread — hit your inbox today alongside this one. So we're recommending members who are still short IWM close that short to start the new bear put spread with us instead. Why?

- We know we can stay in the bear put spread, while we always risk potentially having our short of IWM called away on us, as has happened to other members (in the biz, this is called "recall risk").
- The new bear put spread caps our risk to a nominal amount, while the naked short that we're now closing has unlimited capital at risk.
- By closing our short, we avoid having to pay IWM's dividend in July.
- We prefer having all members in the same positions, with trades all can do in any brokerage account — and the bear put spread fits that bill. And, of course, the spread is attractive on its own merits.

How the IWM Short Fit Into *Pro*

We short market-index ETFs such as IWM as a simple way to hedge our long portfolio exposure. We do not expect our market hedges to make money, but they will if the market declines. On bigger declines, the "insurance" that is a hedge kicks in and offers us a profit that buffers our downside and can be put to work in cheaper stocks. In a rising market, a hedge ends up going unused. Individually, such a position looks like a loss — except for the important fact that a hedge may let you stay comfortably invested in *more* stocks, stocks that ideally rise with the market. That's the case with *Pro*. With our goal of absolute returns, we hedge for downside risk, but we enjoy greater gains during a strong market as a result, too, because we have more dollars invested than we would if we didn't have our hedge.

So, even as we close our direct short of IWM, we'll open a new bear put spread instead — staying hedged, but in this case capping our risk on day one. Please read that alert after you close your direct IWM short.

Alternative Trades

- **Don't want to set up a bear put spread? Want to stay short IWM instead?** Feel free! That's in the same spirit as our new bear put spread, and has greater profit potential in a bad market. But we recommend you set a stop-loss order at around $119 per share, or buy calls at that level to cap your risk. Then sit tight on your short as a direct hedge for your portfolio.

Pro Can Help

- Questions? Visit our IWM discussion board.

Set Up a Bear Put Spread on IWM

Published Jun 18, 2014 at 6:26PM

Is this for you? *Pro* members who want to hedge some of their portfolio should consider this bear put spread to profit on about a 3.8% to 10% decline in the **iShares Russell 2000** (NYSEMKT: IWM) ETF by our September expiration. Our portfolio currently targets net long market exposure of 70% to 75%, so if you're already at that exposure or lower, you don't need to hedge.

How You Participate

- **Trade:** Use a spread order to simultaneously buy to open Sept. 20, 2014, $115 puts and sell to open an equal number of Sept. 20, 2014, $105 puts.
- **Allocation:** For about a 10% look-through allocation, set up one spread for every $113,000 you manage ($112.55 is our approximate break-even on the trade). *Pro* will set up 18 spreads. Or, you can set up one spread for every $233 you're willing to lose, and no more.
- **Price Guidance:** Aim for a net debit of $2.33 or lower.
- **Recent Prices:** IWM, $117.16; September 2014 $115 puts (bid/ask): $3.49/$3.53; September 2014 $105 puts (bid/ask): $1.20/$1.23; net debit (mid): $2.30
- **Stock-Equivalent Rating:** Short (as a hedge)

What We're Thinking

Setting up bearish positions on market-index ETFs allows us to comfortably keep more money invested in long stocks, because the bearish position lowers our net exposure (or risk) in the market. If stocks continue to rise, we won't need the hedge, and individually it'll lose money — but our portfolio as a whole (which is what matters!) will be appreciating regardless of the hedge. If the market declines, a hedge — even a small one — adds some green to the portfolio, reducing losses and providing new capital to invest.

How It Fits Into *Pro*

Pro has an absolute-returns goal, so it's important that we manage our market exposure. If we're 100% long, we enjoy no advantages when the market declines. By keeping our market exposure lower, lately around 68% net long, we maintain flexibility even during market drops (and flexibility is very important during downturns). Our hedges help us achieve lower market risk and increased flexibility while still keeping the vast majority of our cash invested in great businesses for upside. Given our goals, this is why we've run hedges during most of *Pro's* existence so far.

A bear put spread is an especially friendly way to hedge: It can be done in any account; it caps your risk to only the limited capital that you pay on day one; and you will have no problem staying in the position (you don't risk being called out early, as you do with many shorts). Plus, you can set it up to be quite profitable during a decline (we could make $7.67 on our $2.33 at risk), although a spread is most responsive right near expiration.

More That Matters

- **Maximum loss:** The net debit you pay to set up each spread, so lately about $2.33 ($233 per spread). You can't lose more than that.
- **Maximum gain:** The difference between your spread strike prices ($10 in this case), minus the cost to set up the trade (about $2.33). So, in this case, you clear $7.67 if IWM declines below our $105 strike by expiration, earning more than 300% on your $2.33 at risk.
- **Breakeven:** $112.67 on IWM at expiration.
- **Follow-up:** Spreads are usually "one and done," but we may break the spread (close part of it) if that looks beneficial before expiration, or set up a new one as it nears expiration.

Alternative Trades

- **Like other strikes better?** Move your strikes up or down to find a spread you like best, if you wish.
- **Want to short IWM directly?** Most brokers do *not* have shares of IWM available for shorting, but If you're short IWM already, you could choose to stay short rather than set up this bear put spread. If you do, we recommend that you cap your risk with a stop-limit order around $119 or $120, or buy calls around that strike to cap your risk.

Pro Can Help

- **Want more on bear put spreads?** Visit *Pro*'s guide!
- **Questions on the trade?** Visit our storied IWM discussion board.

Birds, Hands, and Bushes: Pro's Dividends

Published Jun 16, 2014 at 1:04PM

Dear Fools,

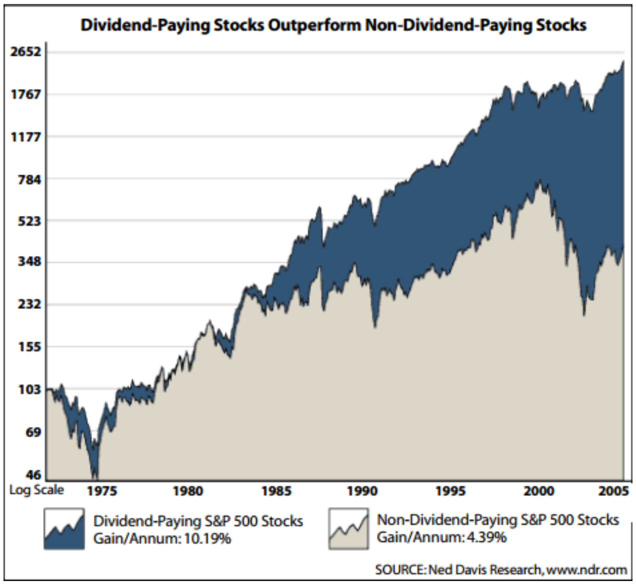
A bird in the hand is worth two in the bush. Like many proverbs, the literal interpretation of this one leaves me scratching my head -- why would you chase birds in the first place? Get a life. The figurative interpretation is a bit more useful: A certain payoff is better than the prospect of a larger, uncertain one.

Now, the math guy in me has all sorts of issues with this logic, but instead of going down the path of probability and expected utility, I'm going to turn to dividends -- the investing topic to which the bird-and-bush proverb is most commonly applied. Adapted to dividends, the saying translates about like this: Dividends provide shareholders cash, and certain cash on a schedule is preferable to unknown, possible cash in the future. We rarely talk about dividends here at *Pro*, so today I'd like to discuss why we like chasing birds and how the *Pro* portfolio stacks up.

Dividend-Paying Stocks Win

Two truths point to dividend stocks winning over their non-dividend-paying brethren:

1. Financial theory holds that any asset can be valued based on the discounted value of its future cash flows. Dividends are real cash flows -- money transferred from the company to the shareholders -- so dividends help determine value. The theory behind the dividend discount model dates back to 1938 and it is still universally accepted today. We frequently use free cash flow as a proxy for what dividend payments *could* be, but that is often a perilous assumption because there is no guarantee that shareholders will ever see those cash flows.
2. Study after study shows that dividends matter with respect to returns -- dividend-paying stocks outperform non-dividend payers. For example: Professor Jeremy Siegel found that from 1926 to 2008, 97% of the S&P 500's total return came from dividends. Research from Credit Suisse shows that the real return on U.S. stocks over the last 103 years has been 6.3% annualized, 2% from capital gains and 4.3% from reinvested dividends. Research from Ned Davis Research suggests that over long periods of time, the stocks of companies that pay dividends considerably outperform those that don't: 10.2% per year vs. 4.4% (see the image below). I could go on, but I think you get the point -- there is significant evidence that points to the goodness of dividends.



Dividends Are Stupid Insurance

The evidence in favor of dividend stocks is compelling, but *why* are dividend payers superior? I believe the answer lies firmly rooted in psychology. In the United States, dividend payments are a commitment -- a social pact companies make with their shareholders promising that, barring extreme circumstances, the dividend can be relied upon. This creates a constant pressure applied to management and boards of directors to keep the company in healthy enough financial shape to sustain the dividend. No CEO wants to be the one responsible for cutting or canceling a dividend ("Not on my watch!").

Complementing that pressure, dividend payments make less money available for value-destroying projects (these often take the form of empire-building, pet projects, or acquisitions). They force discipline in capital allocation, making less money available to be invested poorly. As Charlie Munger says, "It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent." With less money available to invest, management teams have less money to make big dumb mistakes, and they are pressured to do more -- or at least the same (in terms of growth) -- with less. Empirically, this has resulted in fewer terrible capital allocation decisions ... and, relatedly, outperformance.

Pro's Dividend Payers

Of the 22 stocks in the *Pro* portfolio, 18 pay a dividend -- that's 82%. That high proportion is reflective of the quality businesses we own, a result of their cash-generating ability. While the weighted average dividend yield on our portfolio is less than 2%, the forced discipline counts for much more, precisely because we own businesses that are so profitable. When a business becomes awash in cash, the pressure to spend it builds, and that psychological impact can lead to poor capital allocation decisions. Even though we generally trust our management to make sound choices, we like the idea behind the forced discipline that a dividend conveys.

Our four companies that don't pay a dividend are **Facebook** (NASDAQ: FB), **Gilead Sciences** (NASDAQ: GILD), **O'Reilly Automotive** (NASDAQ: ORLY), and **Parexel International** (NASDAQ: PRXL). I'd classify the first three as growth businesses that have historically had immense reinvestment opportunities worthy of retaining all earnings. Given its slowing growth rates and ample cash flow, however, I would be surprised if O'Reilly didn't begin paying a dividend within the next few years. As for Parexel, the lumpiness of its revenue and cash flow (before partnerships began to change this dynamic) made management leery of paying a dividend.

The *Pro* Bottom Line

Provided we remain disciplined and own stocks trading at reasonable valuations, even a small nominal dividend yield will help the *Pro* portfolio track its North Star -- especially when that yield increases over time and at least keeps up with inflation. Do you have a favorite dividend-paying stock that is ready to fly into *Pro*'s hand? Let us know on the Memo Musings discussion board.

Onward,

— Bryan (TMF42)

Pro Completed Trades (see all trade alerts)

- **Parexel** (Nasdaq: PRXL): Wrote (sold to open) $45 strike September 2014 puts, as outlined in the adjusted trade alert.

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Parexel Increases Our Ownership Stake

Published Jun 16, 2014 at 10:10AM

Fools,

On June 2 **Parexel International's** (NASDAQ: PRXL) board announced a $150 mm share repurchase authorization.

http://investor.parexel.com/phoenix.zhtml?c=94569&p=irol-newsarticle&ID=1936515

This morning, he company announced it is moving ahead with that repurchase. It will buy back about 2.3 million shares directly from Goldman Sachs, with the actual number of shares to be determined by a backwards looking volume-weighted average pricing formula.

http://investor.parexel.com/phoenix.zhtml?c=94569&p=irol-newsarticle&ID=1940017

Here are the takeaways:

1. PRXL is retiring ~4% of shares outstanding, increasing our ownership stake in future earnings.
2. The board is sending two signals: it thinks shares are undervalued and that the company's cash flows are consistent enough to warrant a smaller cash cushion over interest and debt payments.
3. PRXL has plenty of cash (almost $300 million) and access to credit (close to another $300 million) to handle this repurchase without any trouble.
4. This action doesn't have a meaningful impact on our estimate of fair value ($54), but the signal from management on the reliability of future cash flows suggests that our Consider Adding More Price ($40) might be a touch low. For now, I'm leaving it unchanged.

Parexel is a Buy and 3.3% position for Pro.

Bryan
TMF42

The Importance of Limit Orders

Published Jun 9, 2014 at 2:17PM

Dear *Pro* member:

Have you ever sat down at a restaurant, looked at the menu, ordered what you wanted and said to the waiter, "And I'd like to pay $5 *more* than the price you list on the menu." Almost certainly you have not. Yet, if you rush to trade on the stock market using a "market order," you risk doing something very similar, and you'll likely sacrifice much more than $5 from your brokerage account.

To get a fair price when you go to enter an investment order — even if it's just getting the current price — it's important to use a limit order. Case in point: Last week, we issued updated guidance on **Parexel International** (NASDAQ: PRXL), suggesting that members write (sell to open) September 2014 $45 puts. At the time, the options bid $0.80 and asked $1.10.

That means a put seller could get paid $0.80 immediately at that moment (as long as the price didn't change after hitting send on the order), while a put buyer would need to pay $1.10 immediately to buy.

But with such a wide spread between the bid/ask (37.5% if you measure from $0.80), there's no reason to accept *either* price. A buyer ora seller should attempt a limit order, splitting the bid/ask, to see if their price is met. Especially because there is a market maker behind most option trades — a professional who provides liquidity in options, takes the other side of a trade, and hedges their own exposure. If you don't use a limit order when trading options, you're at the whim of a market maker who could take advantage of you.

That appears to have happened last week with the Parexel trade. Within minutes of the recommendation being emailed to members, the puts were being sold at $0.70 or even $0.60, despite the bid being $0.80 just moments before, and despite our limit guidance being $1 to start (and $0.80 as a minimum). Members were letting orders go through at much lower prices.

To be fair, the market maker could have lowered the bid upon seeing our orders flowing in, but the trades would not have gone through at lower prices if we had all used limit orders. Instead, apparently more than a few members used market orders — accepting the going price, even as it plunged lower. Had we all used limit orders, the pricing should have been much more stable, and trades would not have been filled at those less favorable prices.

The same has happened on many (if not most) of our stock orders over our history. When we suggested a year ago that members not sell **StoneMor Partners** (NYSE: STON) for less than $27, the stock fell well below that price in mere minutes. It happened again this year with our $25 limit order guidance. Now, perhaps the market sees all of our sell orders (even with limits at higher prices), gets worried, and sellers emerge, pushing prices lower. That may be true -— and the opposite may be happening when we're buying.

But a more likely influence is that too many of us simply aren't paying heed to the guidance to use limit orders, and unfortunately that hurts all of us. So, we kindly ask that you start. Please read our pricing guidance in every recommendation we send, whether it's in *Pro* or *Options* or elsewhere across the Fool, and then kindly follow the guidance with a limit order. Let's see if we can conquer this issue. Let's see if we can all get better prices together by all following the limit order guidance!

As Fools, we're not usually in a rush to trade, so we can be patient and wait for our price. We have a much, *much* better chance of everyone getting that price if we all use limit orders. Let us know if you have questions on the Memo Musings board, and let's see how we do with our next recommendation.

Thank you, and Fool on!

— Jeff (TMFFischer)

Catch-Up Trades: June 9, 2014

Published Jun 9, 2014 at 2:17PM

Catch-Up Trades are the Pro *team's timeliest ideas for catching up to our positions right now.*

- **Gilead Sciences** (NASDAQ: GILD): If you haven't matched our 3.4% allocation yet, shares are down today on acquisition news in the industry. Newcomers should consider starting a position in this Buy First stock.
- **iShares Russell 2000** (NYSEMKT: IWM): Just an update here. As the small-cap index rebounds, new potential hedge strategies start to look better for those who closed May spreads. We're still short shares, but we realize that most members can't short IWM directly, so we continue to watch for option spreads you could set up. Higher prices may make this more attractive soon. We'll put it here if so.
- **Papa John's International** (NASDAQ: PZZA): After spending some time on Hold, PZZA recently moved back to Buy, so build a 3.7% allocation to match us if you haven't yet.

Roll Your Covered Calls on Intel

Published Jun 3, 2014 at 2:30PM

Is this for you? This is for *Pro* members who own shares of **Intel** (NASDAQ: INTC) and have written August 2014 $25 covered calls.

How You Participate

- **Trade:** Use a rolling order to buy to close your August 2014 $25 calls, and simultaneously sell to open an equal number of September 2014 **$26** calls.
- **Allocation:** Roll every call you have previously written. For *Pro*, that's 36 contracts.
- **Price Guidance:** Aim for a net debit of $0.75 or less. If you later have to pay a bit more to get it done, that's OK -- ideally you won't pay more than your past combined credits.
- **Recent Prices:** Intel, $27.45; August 2014 $25 calls (bid/ask), $2.57/$2.64; September 2014 $26 calls, $1.83/$1.88. See current prices. Rolling cost (splitting the bid/ask): $0.75 debit.

What We're Thinking

Shares of Intel are enjoying a strong year (for Intel), up nearly 8% including dividends and pushing well past the $25 strike price on the covered calls we wrote for income. We've already rolled these calls twice this year for a small credit each time. In sum, our three written covered calls since February have brought in $0.85 per share in net credits (your mileage may vary by pennies or nickels, depending on when you traded). We're now about to give most of that credit back, paying about a $0.75 debit to roll to a $1 higher strike price. Why do this? Many reasons:

1. Intel is trading at our fair-value estimate, and we don't want to lose our shares and their 3.3% yield.
2. Our $25 calls already have less time value (lately $0.13) than the $0.225-per-share dividend that will be paid Sept. 1, so we would lose our shares if we don't roll by the August ex-dividend date at the latest.
3. We can roll now and still have a small credit overall on our (four, after this) Intel covered-call trades this year, along with getting a higher potential sell price.
4. If we were to wait and shares climbed higher, rolling would become more costly.
5. Finally, we'll still have a defensive position in our portfolio after this roll, with about $1.85 in short call value that cushions about a 6.7% decline if the stock falls to about $26 or lower.

Paying $0.75 for an extra $1 in stock upside is "only" a 33% return on the capital we're putting back into the position, but we view this position more holistically than that. Again, the $0.75 we'll pay to roll is money that was paid to us to begin with, so we're simply giving it back. This is one way to start to "catch up" to the higher share price at no out-of-pocket cost to us, save commissions. But we won't be entirely caught up; assuming we still have a net credit of $0.10 or so after this roll, our net sell price will be $26.10 on a $27.45 stock. And again, we don't want to sell yet. So, Intel either has to give back some ground, or we'll be rolling our calls again by late summer. In that case, today's recommendation is just another proactive step to better position ourselves (we believe) for our future with Intel.

The business, meanwhile, remains uninspiring but stable, and that seems to be all investors want from it right now. The stock is inexpensive and yields about 30% more than a 10-year Treasury bond. Like us, investors are hopeful about Intel's slowly unfolding mobile business, especially because Intel expects to maintain its historical profit margins as mobile sales hit critical mass and the company pares away sales incentives (even if that's a few years away). We hope to be around to keep watching it unfold, and ideally earn a North Star-matching return while we wait.

More That Matters

- **Maximum loss:** Our exposure remains the same as stock ownership, minus the credits we have in the covered calls.
- **Maximum gain:** Our profit potential will be limited to around a net $26.10 per share, so we're already there.
- **Breakeven:** Around $24.15 per share on these covered calls in isolation.
- **Follow-up:** As long as it's attractive, we aim to keep managing the covered calls to keep our shares and ideally earn premium, too.

Alternative Trades

- If you wrote different covered calls on Intel, visit the Intel discussion board to ask any questions you have.

Pro Can Help

- **Want to learn more?** See our guide to writing covered calls in our sister service, *Motley Fool Options*.
- **Questions?** We'll try to cover (heh!) any questions you have on the *Pro* Intel board.

Position Adjustment: Parexel International

Published Jun 3, 2014 at 1:10PM

Is this for you? This alert is for *Pro* members who ***did not*** write September 2014 $40 puts on Parexel International (NASDAQ: PRXL) per our May 6 alert. Members who ***did*** write the $40 puts should read the Alternative Trades section below and decide how to proceed.

How You Participate

- **Trade:** Sell to open September 2014 $45 puts
- **Allocation:** 2.7% — write one put for every $150,000 you manage; *Pro* will write 12 contracts
- **Price Guidance Now:** Use a limit order of $1 or higher to start (for a 2.2% yield in 108 days)
  - **Later:** We think an 6% annualized yield is acceptable given our willingness to own more shares; that equates to a minimum acceptable credit of $0.80 at the moment
- **Prices (May 5):** Stock, $51.50; options, $0.80 bid / $1.10 ask

What We're Thinking

Mr. Market's "shoot first, aim later" mentality can lead to some wild price movements. We knew **Pfizer** (NYSE: PFE) had made a bid to purchase **AstraZeneca** (NYSE: AZN) when we issued our May 6 alert on Parexel; in the alert, we noted our skepticism about the deal going through and opined that even if it did, the potential impact on Parexel wouldn't be all bad. Still, Mr. Market shot first, assuming the worst, and whacked Parexel's stock price down to the low $40s, prompting us to recommend writing September 2014 $40 puts.

Now that Pfizer has given up on its acquisition attempt and Mr. Market is taking the time to aim, Parexel shares have been bid back up to $52. Unfortunately, this all unfolded very quickly and *Pro* wasn't able to transact near the pricing guidance we originally issued. But the thought process behind our May alert remains intact -- we think the company's business performance and stock-price volatility make it a good candidate for option income, and our willingness to buy more shares makes writing puts a bull's-eye.

At this point, the September 2014 $40 puts don't pay nearly enough to recommend to members who haven't yet followed the original alert (especially for members with more modest portfolios). It does mean that those who did transact are well on their way to a successful expiration. For the rest of us, the September 2014 $45 puts have a risk-reward profile that's sensible given our view of Parexel's business and stock. Writing these puts should provide a $44 breakeven price and a modest 7.5% annualized yield.

How It Fits Into *Pro*

With *Pro*'s recent purchase of **Gilead Sciences** (NASDAQ: GILD), our health-care exposure is now around 9% of the portfolio. We're comfortable with the possibility of more, but are mindful of our current net exposure. We are opting to generate income with written puts rather than purchase more shares directly because Parexel is still relatively new to the *Pro* portfolio, and we'd like to get to know it further before decidedly upping our stake. Should these puts become in-the-money at September's expiration, we'd get shares at a reasonable discount to what we believe they're worth ($54), or we'd have the option to roll them to a later date if we choose.

More That Matters

- **Maximum gain:** Unless the stock declines and we get to buy shares by expiration, the most we can gain is the put premium. At $1, that's a 2.2% yield in 108 days, or about 7.5% annualized.
- **Maximum loss:** Our risk is the same as share ownership starting around $44, 15% less than the current price.
- **Follow-up:** As September expiration nears, we'll be extra certain to clearly communicate our recommended action for writers of both the $40 and $45 strike-price options.

Alternative Trades

- **If you already wrote September 2014 $40 puts per our original alert:** First, congratulations! Things are going as planned. You have two options:
  - You can do nothing. Your written puts look like they'll expire as full income in September. This is precisely our intention for the $45 puts we're recommending in this alert. If you have little desire to purchase more Parexel shares at this time, this is the choice you should consider foremost: Do nothing, or even buy to close your $40 puts early for a majority of the profit.
  - You can roll your $40 puts to the $45 puts to match *Pro*. You should consider doing this if you're willing to trade a bit more risk (a higher breakeven price) for the chance to earn additional income. If you nabbed our guided price of $1.20, your net roll today could nab you another $0.80 or so on top of that. If you are looking to add to your Parexel position, this is the choice you should consider.
- **If you don't own stock already:** We think you should match *Pro*'s 3.2% allocation first — Parexel's shares are a Buy. Then, you should consider writing puts for income or the potential for additional shares.

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Outsource your problem-solving to the Parexel International discussion board.

Keeping Pro at Cruising Speed

Published Jun 2, 2014 at 4:00PM

Guidance Updates

- **Parexel** (NASDAQ: PRXL) moves to **Buy** from **Buy First**, based on price.

Pro Completed Trades

- **Wells Fargo** (NYSE: WFC): We bought to close all of our $50 covered calls expiring June 21. Please note: Because of a trading error at the Fool's trading desk, the portfolio initially bought to open $50 calls on Wells Fargo expiring June 6. Those calls then had to be sold, and our $50 calls expiring June 21 were correctly bought to close. The result was an approximate $72 net detriment to the portfolio, plus extra commissions.

Dear *Pro* member:

Good investing aims to strike a healthy balance between activity and inactivity. Our trade alerts may get all the headlines, but most of the work we do is much less visible, and does not lead to portfolio action. That's how it should be. We've yet to meet a millionaire who got there by actively trading in and out of stocks, but we know of plenty (many of them Fool members!) who have achieved that goal by largely sitting on their hands. When you own great businesses at good prices, you're positioned to compound your money over the years, because everyone at the business is aiming for that outcome, too.

We Have a Winner!

Fools, please congratulate the winner of the 2014 Polaris Award: **aleax**! Thanks to all who voted, and our congratulations to all who were nominated. We're thrilled to have all of you as part of our community.

At *Motley Fool Pro*, we have a bit more shuffle in our investing step because we include options in our strategy. However, much of our time is still spent learning more about our companies and their competitors, eyeing our portfolio construction and allocation, and subtly managing our market exposure. Every quarter, we particularly enjoy getting a new look at the financials of our 24 core holdings, and going through quarterly conference calls to glean more details from each business.

In fact, if I were on a deserted tropical island and could make investment decisions based on only two factors, I'd want the company's financial SEC filings and its conference call transcripts. If given a third factor, I would want to know the current valuation of the business, because that ties directly to the return we might achieve on our estimate of future value.

All of this is a way of saying that investing is complex and simple at the same time — two conflicting attributes that make it extra fascinating. In the past, I've compared managing a portfolio to flying a jetliner, and perhaps that's more accurate than I (a non-pilot) realize. Once you're at cruising altitude, generally the less you do with the plane the better, yet you must be aware of everything going on with the instruments. If we're pilots of a sort here in *Pro*, then as we watch our progress, we're also frequently on our microphones sharing our lessons and our thinking with you the best we're able. Today I want to share some of things we've been working on in the cockpit. Think of this as your *Pro* in-flight checklist.

Position Considerations

Some altitude adjustments we've made, some turbulence we've hit, and some possible changes in our flight path:

- **AmTrust Financial Services** (NASDAQ: AFSI) hit a rough patch today after *Barron's* published another negative article. The gist of the critique: AmTrust writes more insurance premiums than its tangible asset base safely allows, setting it up for a capital shortfall should it get flooded with claims. Additionally, the accounting doesn't always line up when analyzing its relationship with **Maiden Holdings** (NASDAQ: MHLD), and its reinsurance operations overseas are a black box. Ever since Maiden was created years ago, not to mention the Luxembourg reinsurance entities, critical lack of understanding has abounded in the media. But we take these accusations seriously (we take any critique of *any* of our companies seriously), and we'll keep addressing them as part of the *Pro* service. We just need some time. Today, AmTrust offered [a response] to *Barron's*, and we'll have a deeper take on that soon.
- **Intel** (NASDAQ: INTC): It appears we'll want to roll our $25 covered calls again, this time likely to a $26 strike. Shares are lately higher than $27. We don't want to lose our Intel shares — we enjoy the 3.3% yield and still see long-term upside — so we'll actively manage our covered calls to keep our stock and ideally earn option income, too, eventually. We'll roll soon if Intel remains strong, because the higher the stock goes, the harder the roll becomes.
- **iShares Russell 2000** (NYSEMKT: IWM): We remain short this small-cap index ETF as a hedge, but we know those who closed their May spreads at expiration lack this hedge today. Our next decision is whether to keep the hedge, and if we do, whether to offer those lacking it another alternative trade. The last iteration paid off well because IWM declined, but as a result our desire to continue to hedge is lessened a bit, especially as the S&P 500 is again making new highs.
- **Parexel** (NASDAQ: PRXL) quickly recovered in share price now that **Pfizer** (NYSE: PFE) withdrew its offer to buy **AstraZeneca** (NYSE: AZN). We weren't able to write $40 puts at the price we recommended to you, so we're considering alternate positions (which would require a new trade alert). However, bravo! to members who wrote those puts in time and earned a quick return. We'll offer guidance there as needed.
- **Wells Fargo** (NYSE: WFC): We're buying to close our June $50 covered calls as Wells stock lifts to new highs (but remains inexpensive). Assuming our June $48 puts expire, our latest strangle on Wells will result in a small profit, and we'll look to write a new one after earnings in July. We'll actively manage our **Tupperware** (NYSE: TUP) strangle this way, too, if needed. Right now, both options on Tupperware are on track to expire as income this month.
- Elsewhere, we're watching for chances to write puts or add to our positions in **Starbucks** (NASDAQ: SBUX) and **The Buckle** (NYSE: BKE), both of which currently have less than a 3% allocation, among others. We're also continuing to go through shorting candidates (though we want to believe the market favors shorting before we go out on that limb; otherwise there's more to gain by going long), and we always have new potential buys under consideration, as well as — right now — new option income strategies.

Service Enhancements

Along with the focus on our investments, you should know that we're working on new guides to hedging, shorting, and portfolio management in general, as well as possible new options strategies. We're also going to streamline our welcome experience for new members, and keep aiming to be more interactive, including our monthly live *Pro* chats and regular involvement on the discussion boards. Finally, have you seen our new [allocation calculator]?

Thank you for flying with us! We'll aim to keep the bumps manageable.

— Jeff (TMFFischer)

Quick Note: Chopping Up Apple

Apple (NASDAQ: AAPL) is executing a 7-for-1 stock split after the market closes Friday; you should see the results in your portfolio on Monday. If you're following Apple in Scorecard, you'll need to divide your cost basis by 7 and multiply your shares by 7 to reflect the change. Otherwise, no action should be required — the value of your holdings will remain the same, and the value of this excellent company won't be affected at all.

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Videos: Key Points on American Tower

Published Jun 2, 2014 at 3:47PM

Hey Fools – this extra by our own Billy Kipersztok originally ran as part of Supernova's Explorer 1 "The Tough Get Foolish" series. Supernova's Exploration No. 5 examined four of the largest and least risky stocks in the Supernova Universe. The challenge was to find the one company with the best chance of beating the market — to become Explorer 1's recommendation for **The Tough Get Foolish**. The winner of the challenge was our very own American Tower! Check out the research here to see why.

American Tower (NYSE: AMT) has already been a [steady winner] for *Rule Breakers*. But after a closer look at this linchpin of the wireless world, I see plenty of reasons why investors should continue to expect market-beating performance.

American Tower and its two publicly traded competitors, **Crown Castle** (NYSE: CCI) and **SBA Communications** (NASDAQ: SBAC), use the same business model: They own wireless towers and lease them to telecommunication carriers like **Verizon** (NYSE: VZ) and **Vodafone** (NASDAQ: VOD) on long-term contracts. The tower industry is an oligopoly in the U.S., with these big three accounting for 82% of the market, although the global market is much more fragmented.

Demand for wireless tower space is driven by consumers' wireless data usage. If any of you have kids with iPads or iPhones, you can probably guess that wireless data use is skyrocketing with exponential growth rates. This momentum should boost demand for tower space worldwide, and global providers like American Tower are well positioned to benefit.

To explore American Tower, I've created three videos to walk you through the key points for investors.

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1. Demand for Towers

As smartphone and tablet penetration increase, and development of mobile Internet applications continue, it becomes even more important to carriers that their wireless networks can handle the increased strain of data use. The carriers have been and will need to continue to invest in their networks by increasing capacity and deploying new technology. This is precisely what drives demand for the tower space offered by American Tower.

text

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5 minutes, or read the transcript

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2. Long-Term Security

American Tower is a stable, lower-risk investment because of its long-term, guaranteed contracts. Most of its customers' tower leases expire in 2019 and beyond, and the structure 3% to 5% annual price increases and careful lease roll-off management leads to steady, consistent growth of revenue and cash flow.

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5 minutes, or read the transcript

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3. Tops in Towers

Within this booming industry, American Tower stands out. It has the largest international exposure, the most favorable debt profile, and the highest margins of the big three tower companies.

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Video problems? Help. Failure? Try HTML5 format instead (opens in new tab).

8 minutes, or read the transcript

The Foolish Bottom Line

American Tower is a best-of-breed operator in an industry with strong demand and a great business model. With explosive growth in data use, stable revenue, and a strong competitive position, American Tower is a perfect example of a "safety in the storm" type of stock.

Discuss American Tower

Transcript 1

Hey, *Supernova* Fools. Billy Kipersztok here — excited to talk to you guys about why American Tower is a great example of a "safety in a storm" type of stock. I will be annotating over these slides like this, so keep an eye out for the telestrations.

This slide demonstrates how key demand drivers for American Tower are seeing absolutely explosive growth. The data comes from a 2013 Cisco VNI (that stands for Visual Networking Index) study and it shows expected growth rates in users, in monthly usage per device and total monthly traffic between 2012 and 2017 for both smartphones and tablets in North America.

As you can see, there are some pretty astounding growth rates across the board. Numbers getting up into the thousands. This reflects the exponential growth trends in data use here in the United States and in North America — and if any of you guys have kids with iPads, you probably won't be surprised to see that total monthly traffic for tablets is expected to increase nearly 4,000% to 561 petabytes by 2017. One petabyte is just over 1 million gigabytes, so that is a *lot* of data use.

Now with all of that growth in data usage, wireless carriers like Verizon, AT&T, T-Mobile, etc. need to invest in their networks to be able to handle the increased strain resulting from that growing data use. This graph shows the actual and expected capital expenditures from U.S. wireless carriers including — you can see them at the bottom — AT&T, Clearwire, Leap, MetroPCS, Sprint, T-Mobile, U.S. Cellular and Verizon.

The point of this graph here is to show that the carrier spending environment is robust and it's not decelerating. And so you say, "Hey, Billy. You say it's not decelerating, so what's going on here in 2015? It looks like we're getting a decline in 2015." My response to that would be that first off, the 2015 figure is expected, obviously, because 2015 hasn't happened yet and it's subject to change. It could likely be revised upward — just like 2014 estimates were revised upward earlier this year.

Last year if you looked at this figure, Cisco might have given you maybe $32 billion. Now we're seeing $34 billion as 2014 spending figures are more publicized and carriers are talking about their plans for the upcoming year. So, it's possible that this $32 billion figure could increase.

Secondly, carrier network investment happens in waves corresponding to the wireless generations such as 3G and 4G, so you shouldn't be surprised to see carrier capital expenditures be a little bit lumpy and they're not going to go up in a straight line. You're going to see peaks and valleys corresponding to investment and rollout of new generations of technology. That's really what we're seeing here.

This graph is a bit of a narrow view. It only has four data points — four years — but if you were to zoom out, you would see that the graph has a tendency to kind of look like this. It's going to be little bit lumpy and then each of the peaks are going to correspond to different generations. For example, this right here might have been the rollout of 3G and now, in 2013 into 2014 into 2015 and beyond, we're seeing investment in 4G. And you might expect to see, later on in the future once we get to the next generation, whatever they're going to call it ... 5G, maybe ... we might see even higher spending.

That's why I like what I'm seeing from the current demand environment. We're seeing explosive data use growth, we're seeing carriers invest in their networks and all of that bodes well for American Tower and for their demand story.

Transcript 2

Hey, again, *Supernova* Fools. This video is going to describe how and why American Tower qualifies as a great "safety in a storm" type of stock. I think this video makes the most compelling case for business stability, so if there's one video out of the three that you pay attention to, this one is it.

This slide shows American Tower's global tenant lease renewal schedule. The numbers represent percent of leases up for renewal in a given year. For example, in 2014, only 6% of leases are up for renewal. In 2015, only 4%. So on and so forth.

First off, what we know is that American Tower's leases are noncancelable and anything that's on the books is locked in until it's time for renewal. So, this slide is pretty important. And since their tenants are investment-grade — multibillion dollar companies — there's very little risk of default or failure to pay. Their customers are going to pay and American Tower is going to collect their rent, so to say.

Secondly, American Tower's management does a great job managing the roll offs of the contracts. As you can see, over 70% of American Tower's leases are set to renew in 2019 or beyond, meaning that very little revenue is at risk of falling off the table anytime soon. Even if none of their customers renew in 2014-none of the leases that are up for renewal are due — American Tower will only lose 6% of their revenue, which is not that alarming.

Now, that doesn't mean that 6% of revenue is going to fall off the table. Historically, American Tower's renewal rates are around 98-99% ... pretty impressive ... meaning that only about 1-2% of revenue is lost on an annual basis due to churn. That's evidence, right there, of strong switching costs preventing carriers from not renewing.

Customers typically renew and they might renew even early for a number of reasons, so management does a great job of pushing off expirations into further years. Some of that 6% might even get pushed into 2016. Some of the 5% in 2016 might get pushed into 2019 and beyond. American Tower's constantly looking to get its customers to renew and the roll offs of the contracts into a more favorable position for the company.

These long-term, contracted leases with high renewal rates and low churn lead to very stable financial performance. As you can see on this slide, anytime you're looking at a financial company or at a stock or an investment or a business ... whenever you see trends that go up and to the right, generally that's a pretty good thing ... and as you can see in this slide, American Tower has been very stable and very consistent. I think that's a testament to its leases and its contractual obligations and to the annual escalations that they have into their contracts.

I didn't really touch on that, but their lease agreements include annual price escalations that range from about 3-5% every single year. That's basically guaranteed growth of 3-5% every year, and any additional activity adds onto that growth rate. As you can see, both revenue and EBITDA (earnings before interest, taxes, depreciation and amortization — basically a proxy for cash flow for this business) have both increased at very healthy rates over the last seven years, well over 100%, up around 150%, on an absolute basis. So, American Tower has very stable, very steady performance.

Also of note. I'm sure you guys remember in 2008-2009, the stock market had a pretty terrible year and a lot of stocks collapsed. Cyclical companies may have seen huge drop-offs in revenue and in cash flow, but due to the contractual nature of the relationships between American Tower and its customers, American Tower didn't really see any hit to its business in 2008 and 2009, and things continued to progress very nicely in a linear ... well, almost even exponential ... up and to the right pattern.

So, this right here is why I think American Tower is a very stable, steady, "safety in a storm" type of company.

Transcript 3

Okay, Fools. So, in this last video, I'm going to talk about why we prefer American Tower over its two biggest competitors — Crown Castle and SBA Communications.

The trends and the business model advantages that I talked about in the previous two videos benefit all tower operators. With that said, why would you want to pick American Tower over its other two U.S. listed adversaries?

This slide, right here, which shows the tower portfolios for the three tower operators does a good job of explaining one facet of why I prefer American Tower to its two biggest competitors. Obviously the biggest differentiator in this slide is American Tower's international exposure. You can see compared to Crown Castle and SBA Communications — their international exposure represents a far bigger portion of their tower portfolio and that's a big deal for a few reasons.

For one, American Tower was the first mover in the international consolidation of the tower industry. Obviously, the international market is much bigger than the U.S. market. The U.S. market is also more mature. And so being the first mover gives them a big advantage operationally from getting in on the ground early in some of those frontier markets.

Their top three international markets are Brazil, Mexico and India. I'm not sure if they're exactly in that order, but those are the top three and they also have operations in Europe and in Africa, as well. So, the international tower market is growing even faster than the U.S. tower market and the growth cycle in those markets is anywhere from three to fifteen years behind, depending on geography. What that leads to is stronger growth in those international markets.

For example, in American Tower's last quarter, international organic growth was about 16% compared to U.S. organic growth of just about 9% or a little more than 9%. So, even though U.S. growth isn't exactly lagging at 9%, international growth is even faster.

Another reason why I like American Tower's international exposure is because margins are higher internationally than they are in the United States. American Tower is able to pass on some of its expenses, such as land costs, to its tenants overseas, boosting margins. This is going to come up later, so remember that point.

This slide here is a debt overview of the three competitors and it shows why I think American Tower is in the best position with respect to its debt. In the tower industry with very steady, stable cash flow, these companies can support a good deal of debt due to their cash flow, so they're never really at risk of defaulting on their debt because they can plan for and predict what their cash flow is going to look like and how much they need to pay off their debt whenever they need to.

This is a very common ratio here used in the industry, which is the leverage ratio and the calculation for that is debt-to-EBITDA. Remember that EBITDA is basically like cash flow — so it's just basically a cash flow coverage ratio — so how much debt do you have and how much cash flow would you need. Basically how many years of cash flow would it take you to pay off all of your debt if you wanted to do that.

You can see American Tower's debt-to-EBITDA ratio is 5.5x meaning that it would take 5.5 years of cash flow to pay off all of their debt. Crown Castle at 4.6x. SBA at 7.2x. This is a little bit misleading, because historically, American Tower has stayed in the 3-5x range, usually around 4x, which is lower than Crown Castle and SBA. Also, Crown Castle is a little bit lower than their historical average which is about 4-6x. SBA typically stays within 7-9x.

So, American Tower is historically a little bit more conservative with their debt. Right now it's a little bit misleading because they've made some recent acquisitions which pushed up their leverage ratio, but they're historically more conservative. What that leads to is a higher credit rating. If you're levering up to seven to nine times your annual cash flow, creditors are going to reduce your credit ratings. You can see for SBAC — they've got a B+ rating. Crown Castle's got a BB- rating and American Tower's got a BBB rating.

You can look up these credit ratings. These are S&P (Standard & Poor's) credit ratings. The more letters you have, the better your rating, so BBB is better than BB and BB is better than B. Obviously A is better than BBB, as well. And then the minuses and the pluses mean the trends.

So, American Tower's trend is negative and so is Crown Castle's and SBA's is positive. That's not really too worrying. The reason why it's negative is because, like I said, American Tower has made recent acquisitions, as has Crown Castle, which increased their leverage ratio ... whereas SBA Communications has been paying down their debt and they're at the lower end of their historical debt-to-EBITDA range at about 7x.

In this industry — with companies that carry a good deal of debt — having a lower cost of debt is very important, so American Tower has the lowest weighted average cost of debt at 4% compared to 4.2% and 4.1% for SBA Communications. Interest expense is one of the biggest expenses for this company and companies in this industry, so having a lower cost of debt is an advantage and it can help give you better margins than your competitors if you're paying less on your interest.

Speaking of better margins, here is a margin comparison for American Tower, Crown Castle and SBA Communications. And as you can see, across the board American Tower has higher margins ... gross margins, operating margins and EBITDA margins.

Now the reason for that is severalfold. Like I said earlier — I told you to remember the point from the first slide of this video — they have higher international exposure and that international margins are higher than domestic margins. So, obviously, if you have a higher mix of international towers compared to United States towers, your margins will be a little bit higher. Also, this is just a testament to skillful management and operational efficiency ... driving down costs and having higher margins than their competitors.

So, American Tower, for a variety of reasons. Higher international exposure, better debt management (lower cost of debt) and higher margins. I think they are the best operator in the industry. I think they have the best prospects moving forward to capitalize on these nice, secular trends in growth and data use and carrier network investment spending and they should be one of the biggest beneficiaries of all of these trends.

The Buckle: Not Great But Better Than Most

Published May 28, 2014 at 6:01PM

Pro's Take: BKE Q1-2014 Earnings

The Buckle (NYSE: BKE)

Quarter Quick Take

The Buckle remains resilient in a challenging fashion retail environment. Not much changed: store count (450: one opened, one closed) and overall sales were flat, margins were about the same, and earnings didn't budge. It was a sleepy quarter, but one that was very respectable compared to peers. One positive: inventory improved from last quarter. One negative: online sales increased a sluggish +3%. Cash flow generation is reliable, and The Buckle has almost $5 per share in cash. With 17 stores slated to open this year much of that $5 per share is excess.

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Q1-2014

Revenue growth: +1%

Operating profit margin: -20 bps to 21.8%

EPS growth: -1%

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Guidance Update

The Buckle's results were very respectable given the current apparel retail environment. While many teen retailers have seen large same store sales declines, The Buckle saw a modest -1%. The Buckle is a Buy and is Pro's smallest holding at 2.4%. I believe shares are worth $53 and are undervalued.

Updated guidance: Buy (no change)

Recommended Allocation: 2.4%

Fair Value estimate: $53 (no change)

End of Fiscal Year expected FV estimate: $56

CAM price: $37 (no change)

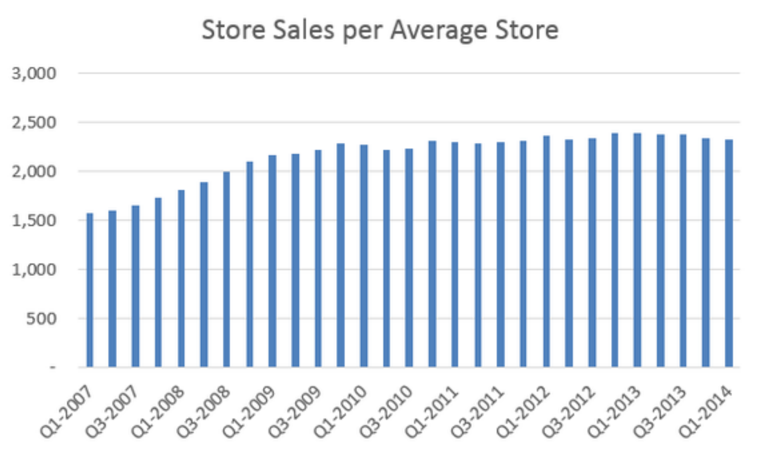
Shares normally trade in a range of 6-9x EBITDA (currently <7x) and I'd look to write puts for an effective buy price around 6x, which is our CAM price.

Our Thesis

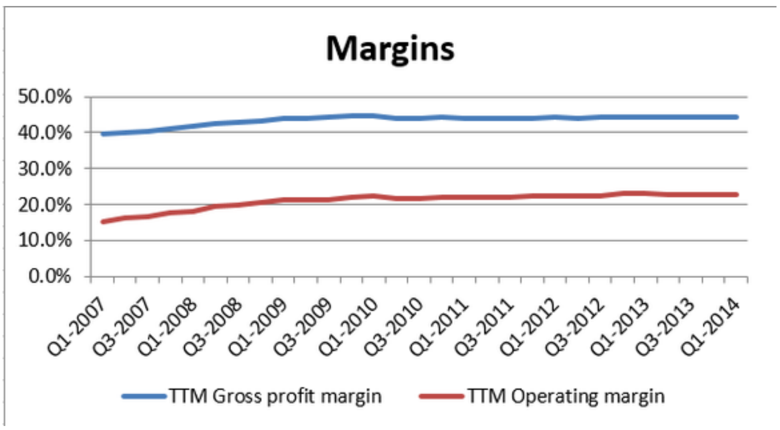
The Buckle offers retail exposure with low fashion risk (jeans and tops). Its management team is properly incentivized, has meaningful ownership, and run the business wonderfully well. We expect measured growth from store openings, online expansion, and expanded merchandise assortment (footwear and children's clothes). We are not expecting dramatic operational improvements, but we believe in-house brand penetration and an improved online experience are opportunities. The Buckle should grow its earnings, pay a regular dividend, and we expect it to pay out excess cash distributions (more years than not).

The Most Important Things

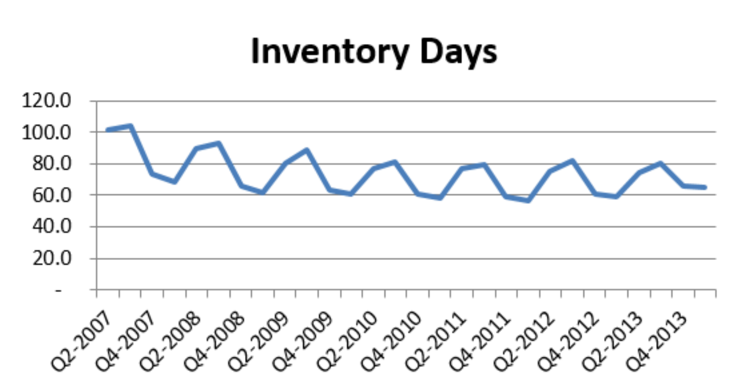
1. ***Store Performance***: Same store sales, sales per square foot, store sales per store, and invested capital per store are all worthwhile metrics to assess store performance. The reason The Buckle has generated so much value over the years is because it has been able to sell more (profitably) through each store without having to invest much more. And while same store sales growth is noisy, it is consistently positive. On a trailing twelve month basis, store sales per average store (excludes online sales) declined marginally. A revival in traffic is the most likely culprit for reversing the ebb in sales per store.



2. ***Operational Acumen (margins and inventory):*** Retailer gross margins and inventory levels expose whether or not merchandise selection is on the mark: if you've got items nobody wants you either have to put it on sale (which will ding gross margins) or let it sit on your shelves (which will ding inventory turnover). Historically, The Buckle has merchandised well, and margins have risen steadily. In Q1-2014, gross and operating margins declined slightly, but on a trailing twelve months basis remain above 44% and 22% (respectively).



Inventory grew 13% over last year, but is improving off last quarter's build. In Q4 management said that the inventory build was the result of running a bit too lean coming out of the holiday season and missing sales, ordering ahead of the Chinese New Year (which is a minor disruption to getting merchandise), and filling the shelves with children's clothes (a new initiative). The improvement makes sense given that explanation.



WWTN

The Buckle is holding steady in a difficult apparel retailing environment. We've incorporated current headwinds, higher investment expected in 2014, and continued strong operational execution into our estimates and think shares remain undervalued and have plenty of long-term upside. With almost $5 per share in cash and investments, another special dividend is likely.

Conference Call Notes

- On SSS: Q1 SSS were down -0.9%.

- On e-commerce sales: Q4 online sales were up +2.5%, a slower pace than trend. Analysts asked about the online strategy and management reiterated its strategy: it's a complement to the in-store experience. CEO Dennis Nelson said: "We see our online business to be just part of our strategy with our stores. We focus on the great specialty service in our stores, as well as with the wide selection. We're always working to drive people to the stores, and we do a lot of special orders with our guests in our stores from our online store. We are working on CRM that we hope to be in place by the first part of next year. We have several projects that we think will not only help our business online, but will help also drive the guest to the store to shop as well."
- On merchandise and store performance: For the quarter, UPTs increased +3%, average transaction value increased by +2%, and the average unit retail decreased -1%. Men's performed a bit better than women, average denim selling price increased (denim selection resonated with customers), and accessories and shoes growth moderated.
- On private label: 32% of sales.
- On stores: The company expects to open 17 new stores next year and 18 remodels.

Steady Performance at Medtronic

Published May 28, 2014 at 3:00PM

Pro's Take: MDT Q4-2014 Earnings

Medtronic (NYSE: MDT)

Quarter Quick Take

This quarter was more of the same for Medtronic: pockets of weakness (spine and coronary) were offset by pockets of strength (diabetes and surgical tech) and the company continues to hold the line on industrywide pricing pressures. Medtronic's broad product portfolio allows gives and takes across product segments that even out to modest, but consistent, sales growth. For the year, Medtronic generated modest operating leverage and prolific free cash flow (~25% of sales). The company also announced it reached a patent litigation settlement with Edwards Lifesciences over transcatheter valve technologies. Medtronic will pay a lump sum of $750 million and an annual royalty of $40 to $60 million. This should allow Medtronic to focus on competing freely in and developing a growth market. Management offered initial guidance for FY-2015, in line with what we had modeled, of sales growth of 3-5% and earnings growth of 5-7%.

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Q4-2014 | FY-2014

Total revenue growth: +3% | +4%

TTM operating profit margin: +10 bps to 31.5%

EPS growth: -54% GAAP, +2% non-GAAP | -11% GAAP, +2% non-GAAP

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Guidance Update

Business is tracking well against our thesis of stable legacy markets, success in emerging markets, and stable margins. We expect steps forward and backward from individual products along the way but Medtronic is executing well in the areas it controls and has a very modest valuation (15x expected earnings and 13x FCF). I am lowering my estimate of the company's Fair Value by $2 (incorporating slightly lower realized FY-2014 results, the Edwards settlement, and the ongoing royalty) and CAM price unchanged.

Updated guidance: Buy (no change)

Recommended Allocation: 2.9%

Fair Value estimate: $61 (down from $63)

End of Fiscal Year expected FV estimate: $66

CAM price: $47 (no change)

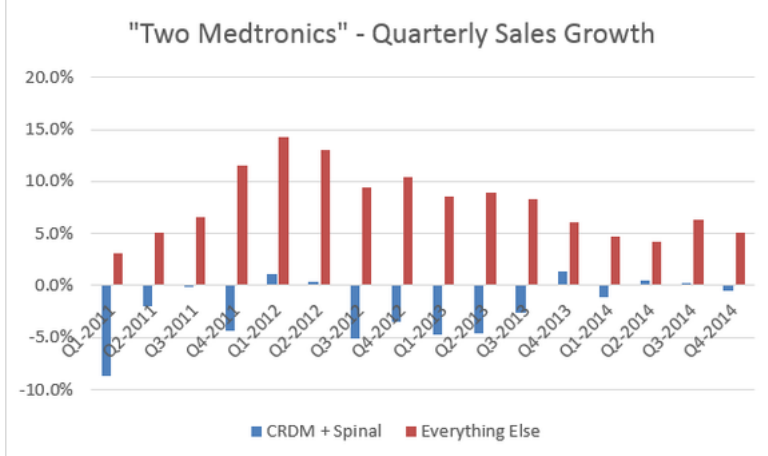
I'm happy with our 2.9% allocation to Medtronic. Shares are fairly priced and poised to achieve North Star-like returns over the coming years. The company's core markets are maturing and achieving growth is difficult; Medtronic's competitive advantages will help it succeed in the new environment, but increased global competition and more cost-sensitive buyers will drive down returns over time. This is a position we'll look to convert into an income play (likely via covered calls) at some point.

Our Thesis

In key product lines, Medtronic operates in an oligopoly that has historically behaved very well, and we expect that rational competition to persist. Competing devices are distinct enough that comparison shopping is tough and switching costs that come from surgeon and physician training support stable market shares. These factors support the notion that mature legacy product lines will continue to be cash cows that fund higher growth product development and international expansion. Medtronic has a strong pipeline and the company distances itself from the crowd with its emerging markets game plan. We admire the company's well designed emerging markets growth strategy and think it will leverage its mature market competitive advantages (scale and intangible assets) to build the distribution and development expertise needed succeed with new products in new geographies. The combination of new product launches, demographic-driven demand, and success abroad suggests that Medtronic can achieve modest revenue growth over the next five years and copious free cash flow.

The Most Important Things

1. ***Two Medtronics:*** One of the company's strengths is its broad product lineup, which allows for segment demand and leadership cycles to be smoothed by other, independently moving, segment demand and leadership cycles. I call this phenomenon "two Medtronics" and I look at the CRDM + Spinal segments (~52% of sales) and the remaining segments (~48% of sales). For the last 16 quarters, CRDM+Spinal has declined an average of -2% per quarter while all other segments have grown +8%. For Q4-2014, year-over-year growth for the two Medtronics was -1%/+5%. The CRDM+Spinal bucket has shown signs (for the last six quarters) of stabilizing and could begin to contribute to growth in FY-2015. If this persistent headwind turns into a tailwind sales growth should come a bit easier and we could see investors regain interest in this sleepy stock.



2. ***Margins:*** The Affordable Care Act (and resultant medical device tax), a challenging insurance reimbursement market, increased hospital buying power, and ever-present competition create a dangerous elixir to pressure margins. With continued innovation I expect Medtronic to hold the line on gross margins (~75%) but see modest deterioration in operating margins over time as the cost to bring products to market (namely more labor- and data-intensive research studies). During Q4, SG&A expenses were higher than expected – management admitted to poor forecasting and has implemented changes to tighten controls over what should have been a controllable line item. More importantly, the long-term profitability and margin profile for the company remain intact.

3. ***Emerging Market growth and strategy:*** Medtronic has truly distances itself from the crowd with its emerging-markets game plan. The company has made emerging-markets growth a strategic priority and has attacked it aggressively (with investments in R&D and physical infrastructure), on several fronts (high-end and low-end products, academic partnerships) and via several models (acquisitions, joint ventures, organic growth). Emerging Market sales represent only 13% of total sales, but mid-teens annual growth rates (it grew 14% in Q4) could make EM sales reach $4 billion in a few years and drive near half of Medtronic's total revenue growth. I expect emerging market sales growth to contribute40-50% of the company's sales growth next year. Changing funding mechanisms in Russia are slowing sales there and distribution challenges in India persist. However, growth in China and elsewhere should keep things on track.

WWTN

Medtronic has a sound strategy to deal with the more regulated and costlier health care environment. We're confident the business remains competitively advantaged, operates in an attractive industry, and is well-positioned to grow in emerging markets. The company's modest earnings growth outlook and valuation make it a prime candidate for covered calls.

Conference Call Notes

- On the vision: CEO Omar Ishrak: "Healthcare payment and delivery systems are changing and evolving around the world. Through these efforts, we feel we are well-positioned not only to respond to these system changes, but to demonstrate the role medical technology and related services can play in making these health care transformations successful." Also: "Medtronic is uniquely positioned to lead the shift to value-based health care, directing our products and solutions to help providers, payers, and governments achieve their goals in driving more value into health care systems around the world. I am pleased with the early work we have done to establish our leadership position, and I look forward to sharing with you at our analyst meeting the opportunities we have ahead as we transform Medtronic from being primarily a device provider today into the premier global medical technologies solutions partner of tomorrow."

- On emerging markets growth: Emerging market growth should accelerate next year – likely to achieve mid-teens sales growth.

- On gross margins: Removing a few one-time expenses, gross margins came in just shy of 75%. Because of increased spending to deal with quality issues (in response to FDA letters) gross margins will likely remain in this range.

- On the medical device tax: Medtronic expects to pay $125 million in FY-2015, a slight increase from what it paid in FY-2014.

- On goals: Medtronic strives to provide consistent results – sales growth in the 3-5% range and earnings growth 200-400 basis points greater than that. It also intends to return 50% of free cash flow to shareholders. The company's three growth avenues are: new therapies, emerging markets, and independent services and solutions.

- On SG&A: Management was very honest about what happened: "although the targets are clear, there was a breakdown in our forecasting process, and, therefore, our control process. We are acting swiftly to plug that hole, and we'll do everything we can to avoid this in the future. But it really is a mismatch between our forecasting process and what we actually got."

- On the Edwards settlement: CFO Gary Ellis: "The good news about settling this long-going patent litigation between ourselves and Edwards is now both of us can focus on growing the market and investing in growing the market versus investing in fighting each other. And so, yes, there is a royalty stream that we've agreed to. There's an upfront payment we've agreed to, but basically now -- we've set things at the table; we know what the costs are related to that. And we can now continue to invest and drive the market going forward, which will benefit not only both of us, but benefit obviously the patients and the customers."

- On negative trial results: CEO Omar Ishrak understands the nature of the business – bad trial results happen and it is part of developing new products. "Like I said at the ACC, look, this comes with the territory. You do clinical trials for a reason, and every so often, you are going to get negative results. And we don't give up on strategic opportunities based on that. We continue to strive on them, because we believe in the long-term need for that kind of therapy."

- On cash: CFO Gary Ellis addressed the idea of repatriating cash from overseas. In short, he said it doesn't make sense for MDT right now because of their ability to borrow at attractive rates in the US. For now, I account for O-US cash at 100% (assuming the company will be able to invest it abroad). If I were to account for a tax penalty, fair value would be reduced by ~$3 or so. "The idea of actually bringing back cash and paying the penalty right now, we are not looking at doing that. And I think most companies who have done that have done that for basically, if they needed to for various reasons. And unless you need to, if you can continue to borrow and have effective use of that, it financially does not pay. So there is no incentive at all for us right now to bring back that cash and pay the type of penalty we would have to pay in additional taxes. So we have enough flexibility with our cash generation and our debt, such that we continue to do our capital allocation as we've discussed up to this point in time. So we have no expectation of making any change to that."

Buy to Close Your Written Calls on Wells Fargo

Published May 28, 2014 at 1:00PM

Is this for you? This alert applies to *Pro* members who are aligned with our recent **Wells Fargo** (NYSE: WFC) covered strangle recommendation.

How You Participate

- **Trade:** As soon as is reasonable, buy ("buy to close") all previously written June 2014 $50 calls on Wells Fargo (*Pro* will be closing all 12 of our written calls). In doing this, we're regaining our upside. We're leaving our written $48 puts alone.
- **Allocation:** We own a 2.9% position, plus we've written June 2014 $48 puts to potentially increase our allocation to about 5.5%.
- **Price Guidance:** Use a limit order and, today, aim to pay no more than $0.45 of time value. Since time value will diminish as we approach expiration, if you don't get to this trade today, pay no more than the time value implied by the ask price.
- **Prices (May 28):** Stock, $50.44; June 2014 written calls, $0.87 bid / $0.89 ask ($0.45 time value at the ask)

What We're Thinking

Just more than a month ago, *Pro* set up a June 2014 $48/$50 covered strangle on our 2.9% Wells Fargo position. Our thinking was as follows:

- With our North Star in mind, we were seeking alternative ways to generate portfolio income.
- We were comfortable accepting more shares of Wells Fargo at an attractive price should the written-put leg of our strangle be assigned.
- We did not anticipate any upcoming catalysts that would push the stock price much higher before the second-quarter 2014 earnings report set for July 11.
- We planned to take action and either roll our strangle or close our written calls if it looked like we were at risk of getting our shares called away.

Nothing has changed since our original recommendation, and with the recent run-up in the stock market and in Wells Fargo's share price (which hit a 52-week intraday high of $50.70 on May 27), it looks like point No. 4 above is coming into play. Thinking long-term, your *Pro* team feels it's prudent to uncover our shares and remove the risk that our written calls could be assigned should the market and Wells Fargo continue to gain investor favor. In closing the written-call portion of our strangle, we're on pace to capture a small profit on the overall strategy, and we'll reassess our valuation and look to continue the strategy (if business and market conditions dictate) after Wells reports Q2 2014 earnings on July 11.

At current prices, if we buy to close our written calls (and assuming our written puts expire fully as income), we will have earned a modest $0.35 per share in 56 days, good for a 0.7% absolute yield and about a 5% annualized yield on the share price at the time of the original covered-strangle recommendation. Although the absolute and annualized returns on this strategy so far are modest, we expect to have more opportunities to generate additional income on this position in the future. It's a nice consolation to know that in 56 days, we've earned more income from this strategy than we did from our dividend payment in Q1 2014 ($0.30 per share). Our return on this strategy also matches the expected dividend payment in Q2 ($0.35 per share), so we've effectively doubled our quarterly yield on the position by initiating this strategy.

For follow-up, we expect to wait until after Q2 earnings on July 11. We'll then consider reopening our strangle at the same or different strike prices, depending on the quarter's performance, market conditions, and our updated assessment of fair value for the business. Until then, we're happy to take our $0.35 per share in profit and wait for the next pitch.

Alternative Trades

- None.

Pro Can Help

- Want to learn more? See our guide to strangles in our sister service, *Motley Fool Options*.
- Step up to the tellers at the Wells Fargo discussion board with questions!

PZZA Still Delicious: Papa John's Moves to Buy

Published May 23, 2014 at 11:42AM

From April 2013 to April 2014 **Papa John's International's** (NASDAQ: PZZA) valuation (the price investors were willing to per dollar of cash flow) expanded by 55%, to a level well above historical norms. Increases in valuation don't have to be scary, but if the expansion isn't sustainable and justified by operations it magnifies every risk inherent in the business – the cost of a mis-assessment rises even if the likelihood of a worse-than expected outcome doesn't change. We changed our guidance on Papa John's to Hold in April to reassess the company's valuation and dig into a few key risks. Since then, two things have happened: the valuation has come down to a more reasonable level and our research on the business revealed that everything on the business front looks delicious.

We're moving shares of Papa John's back to Buy, with a $45 Fair Value Estimate and a $34 Consider Adding More Price. Pro investors who haven't matched our 3.7% position have a great opportunity to do so.

Discuss PZZA with us here!

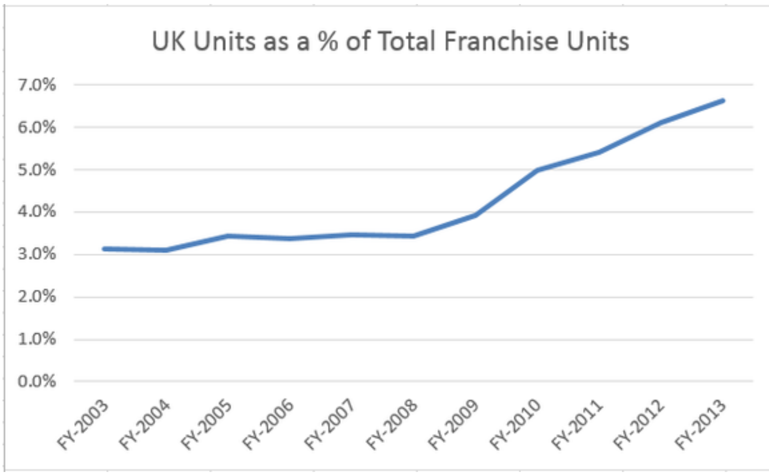
Dear Fools,

As you know, moving a position to Hold in the Pro guidance system triggers a review. I started with questioning the validity of the assumptions that drive our forecast of growth and returns, I reviewed the key risks that could derail those assumptions, and I spoke with company management. Here is a quick rundown of that review:

Slower than expected free cash flow growth

I identified two primary causes of lagging growth in free cash flow that warranted further investigation.

1. *Growing accounts receivable was consuming cash*. For Papa John's accounts receivable balances are money it hasn't collected from its franchisees from selling them sauce, dough, and boxes. It generally collects these payments in seven to ten days, so a growing balance per restaurant suggests something has changed in the business or franchisees are having trouble paying. On my call with CFO Lance Tucker I learned that the bulk of the rise in accounts receivable is due to the nature of franchising in the United Kingdom. As the franchisor, Papa John's must act as the land lord as well, which dramatically alters both the receivables balance per unit and the length of time it takes to collect (rent is paid monthly). Over the past few years Papa John's has expanded quickly in the UK, from 3% of total franchise units to near 7%. As growth in the UK slows but continues in other markets (which don't have the land lord stipulation) the impact on receivables and cash flow should moderate.



2. *Failure to leverage corporate overhead costs*. Papa John's should be able to add 200-250 restaurants per year, with the bulk of those units franchises. Supporting this growth shouldn't take a ton of cash, bodies, or assets at the corporate level (this is one of the reason franchise business models are attractive). Over time, I'd expect this to play out in margin expansion, because the costs incurred to support growth should be moderate. This leverage hasn't played out in Papa John's. Further investigation revealed that this is more fiction than fact; the company's reporting structure classifies most of the costs of operating internationally (other than international commissary related ones) as corporate overhead. These costs are still being incurred, but they're obscuring the eventual margin profile and earnings power of the business. The Papa John's management team is working on presenting its line items in a more helpful way, but more importantly, understanding the obfuscation reinforces the benefit of scale I forecast for the company in the future and its ultimate impact on free cash flow generation.

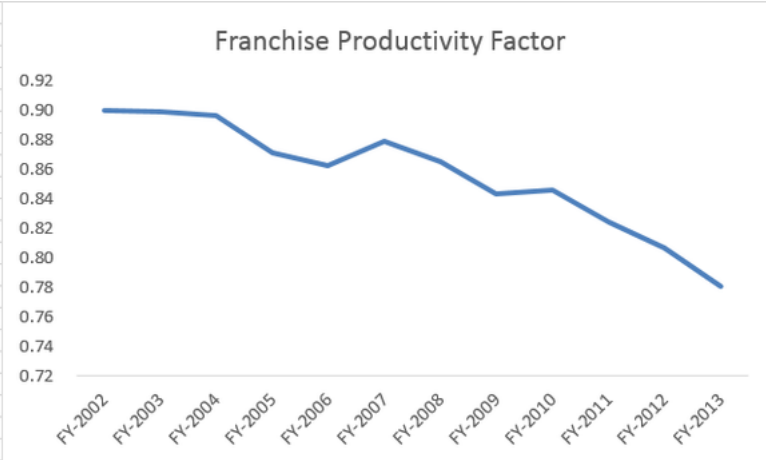
The big two business risks

The two largest threats to the company's business, in our opinion, are the maturation of the domestic pizza business and emerging competitive threats (primarily from the democracy of delivery).

1. *Domestic pizza market*. Although the international growth potential grabs most of the headlines, domestic pizza sales drive 94% of company sales and all profits. A slowdown or decline in the domestic quick-serve pizza market (a $37 billion market) would have an outsized impact on Papa John's. Health trends suggest a modest decline could occur, but even if this happens Papa John's looks poised to grow its share of the market as large chains take share from independent pizza shops. The costs of technology and marketing needed to support mom and pop pizza chains can be oppressive. Add in volatility of commodity prices and it's easy to see why large pizza chains have stolen share from smaller joints, growing their market share from 31% to 36%. If other quick-serve food categories are even close to a guide, we shouldn't be worried about that trend slowing: QSR Hamburger chains control 96% of their market, QSR Mexican chains control 82% of their market, and QSR sandwich shops control 71% of their market.
2. *The rise of delivery services*. One of the primary benefits of pizza is the convenience afforded by delivery. The spread of drive-through formats ate into that advantage a bit, but pizza continued to thrive. The most recent threat is the proliferation of delivery consolidators, or businesses designed to make ordering and delivery accessible to restaurants that don't offer the service in-house. The best known example is recently public **GrubHub** (NYSE: GRUB). While GrubHub is small, it is profitable, and making local restaurant delivery more accessible. We're monitoring this trend, but don't expect too much impact on the pizza business.

The underperformance of Franchisees

I track the performance, as measured in weekly sales per restaurant, of Papa John's franchise stores relative to its company-owned stores (I call it a "productivity factor"). Over time, the performance has diverged dramatically and persistently, with franchise unit performance falling from 90% in 2002 to 78% in 2013.



It turns out there are two primary reasons for this divergence. First, corporate stores perform better because they are in dramatically more penetrated markets. With more Papa John's stores in a given market, the local advertising kitty is larger and there is more mindshare for busy customers driving around town. Second, corporate restaurant operators are, on average, just better. They're longer tenured, are motivated to embrace policy to keep their jobs, and they generally benefit from improvements and best practices early. Franchisees, on average, are slow to embrace best practices and have different motivations. International growth also skews this relationship a bit. The divergence should naturally narrow as existing markets achieve higher penetration, and management is intent on narrowing this gap by offering productivity tools, training, and incentives to franchisees. Accordingly, I assume the productivity factor worsens in my bear case assumptions, improves just a bit in my base case, and improves more meaningfully in my bull case.

The Pro Bottom Line

Papa John's valuation got stretched and has since corrected. We were a touch slow in deciding whether or not to trim our position. The decision we can make is what to do *now* – and we think our thesis remains intact, the company's competitive position is secure, its financial model is attractive, and its management is appropriately focused on the right things to grow intrinsic value over the long term. Papa John's has the hallmarks of a compounding machine and we're happy to move our guidance back to Buy.

Bryan (TMF42)

Questions? Come chat on the Papa John's discussion board.

O'Reilly Drives Toward Results

Published May 20, 2014 at 4:06PM

One of the country's leading auto parts retailers, **O'Reilly Automotive** (NASDAQ: ORLY) reported 18.1% growth in Q1 earnings per share, on a 9% gain in sales and 6.3% same-store sales jump. The company was helped by the harsh winter, and should see benefits from it linger the coming months as damaged or strained parts break down. A severe summer (extreme heat) would help it, too, as any severe weather (and temperature swings) brings more wear and tear to cars.

Overall, O'Reilly improved margins again and is on track to open 200 new stores this year, for nearly a 5% increase in store count. The stock remains a long-term **buy** at a current 3.6% allocation in *Pro*. You could also write puts if you're ready to potentially buy shares at a lower price.

Our main concern is the stock looks priced for perfection (or close to it), or it may be approximately a year "ahead" of itself on valuation. But for the long term, this management and business has plenty of runway. We're up 46% on our 500 shares bought just 13 months ago, and we may now consider covered calls for income on this large retailer, although we don't want to lose our shares, so we would need to be careful and proactive.

Please see all of our financial metrics in this post.

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Competitive Moat: Locations, parts-availability, expertise, exceptional customer service -- all leading to customer loyalty which drives same-store sales growth.

What We Think Now (our summary/thesis): With exceptional management in the driver's seat, O'Reilly Automotive will grow impressively by adding new auto parts stores, acquiring others, and growing same-store sales.

Conference Call Highlights

- Reminders: O'Reilly is a domestic-only retailer; it benefits from severe weather (hot or cold); it benefits from lower unemployment which leads to more miles driven; it benefits from lower gas prices.
- Total sales grew 9% to $1.7 billion, while operating margins went up 78 basis points to a Q1 record of 16.6%.
- Same-store sales growth of 6.3% was driven equally by the professional and DIY consumer, and equally by higher tickets and more traffic.
- The increasing complexity of vehicles leads to higher-cost repairs, and ORLY expects this trend to continue; old vehicles also have costlier replacement parts.
- We're on track to open 200 stores this year; ORLY opened 50 net stores in Q1, spread over 23 states. They could have as many as 300 stores in FL at some point, as FL is proving stronger than hoped.

- The industry is and remains very rationally priced; you can't jack up prices on parts, nor should you cut your margins to the bone, so you tend to compete on part availability and customer service. ORLY's new distribution centers help on both.
- ORLY offers customers diagnostic tests when the engine light is on, changing the battery, replacing the wipers -- simple services. It doesn't advertise this much, but word-of-mouth gets the word out and leads to repeat customers who want these things done for them. This is slowly building.
- The company's rewards program has 5.5 million customers.
- Professional sales are about 42% of companywide sales.
- The company's adjusted debt-to-EBITDA is 1.86x, while their targeted leverage range (for optimal performance) is 2.0x to 2.25x. They'll move to this range when the opportunity seems right.
- Gross margins should slowly continue to improve, although it appears that the low-hanging fruit has been picked in recent years.
- ORLY bought back $56 million worth of shares at $145.94 on average.

Management 2014 Guidance

- Full-year same-store sales gain of 3% to 5% (with 2% to 4% in Q2)
- Full-year gross margin of 50.9% to 51.4%
- Full-year EPS of $6.82 to $6.92 (excluding any more share repurchases)
- Free cash flow of $580 million to $620 million

Summary

As with many companies today, O'Reilly is growing the bottom-line partly through share buybacks. The share count is down nearly 20% since 2011. Revenue growth of near 10% is healthy, too, and same-store sales are very healthy lately, but in a tepid economy, the company is still pulling out all the stops to generate nearly 20% EPS growth. That can't continue indefinitely.

Our valuation estimate doesn't take into account more share repurchases (nor, of course, possible acquisitions, of which O'Reilly says plenty remain). But, we need ORLY to keep executing very well or else we're going to probably have a year or eighteen months of letting the stock "catch up" to its valuation. We'll consider if and how we might want to address that possibility. The stock is a Buy that we believe will still challenge *Pro's* North Star the next three years.

Questions? Of course ask here!

Best,

Jeff

Reference: ORLY Q1 2014 10-Q filing.

The Difficulties of Shorting

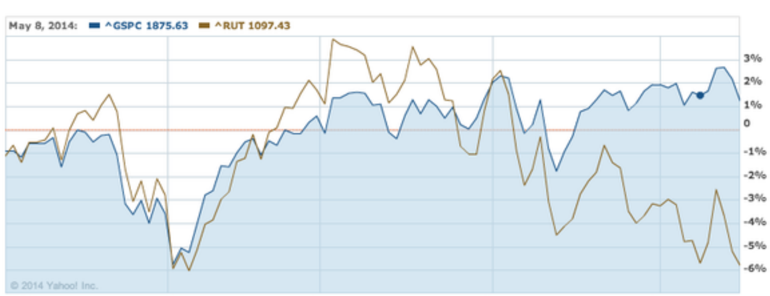
Published May 19, 2014 at 2:00PM

Pro Guidance Changes

- **AIG** (NYSE: AIG): Our fair-value estimate increases to $62 from $60, and our Consider Adding More price increases to $46 from $44. We have a 3.8% stock position and 0.7% in LEAPS (for members, we recommend warrants). See more here.

Dear Fools,

This year's rising market has seen the S&P pushing new all-time highs, but there's been a disparity between larger companies like those in the S&P 500 (the blue line in the graph below) and smaller companies like those in the Russell 2000 (the brown line in the graph below). The former are up about 1% year-to-date, while the latter are down about 6% in the same time frame.



Source: Yahoo! Finance.

May Live Chat This Week!

Questions. Answers. Hilarity. You know the drill. Set a reminder for Wednesday's live chat here!

No Monday Memo Next Week

The stock market, and thus the Fool, will be closed next Monday for Memorial Day, so there will be no Monday Memo in your inbox on May 26. We'll see you again June 2!

Polaris Award Update

Fools, we have a winner for the 2014 Polaris Award, but we have yet to hear back from him about claiming his prizes (and glory). We'll keep you posted! Thanks to all who participated and to all of the deserving nominees.

Combined with investor skittishness, this situation has catalyzed some sharp downward stock-price moves in heavy growth companies. For example, **Yelp** (NYSE: YELP) has declined from a 52-week high of $101.75 in early March to its current price of $55 (a 46% decline in about 2.5 months).

In this type of market environment, we continue to seek ways to earn absolute profits as we aim to meet or exceed our ever-rising North Star. One great way to earn absolute profits in any type of market is to short weak, competitively disadvantaged companies. If successful, this helps us earn profits whether the market goes up, goes down, or stays flat. To that end, since the beginning of the year, your *Pro* team has been very active in seeking short opportunities to add to our portfolio. It has been a constant area of focus for Jeff, Bryan, and me.

In today's Memo, I'll detail the timeline of our decisions regarding a company we researched as a potential short position in the *Pro* portfolio, but ultimately decided to pass on because of a deteriorating risk/reward balance. The company? **Plug Power** (NASDAQ: PLUG).

The Company

Plug Power is a leading provider of fuel-cell technology focused on the design, development, and commercialization of fuel-cell systems for the industrial-material-handling market (think forklifts in high-volume warehouses for companies like grocers or retailers). The company went public in 1999 but has never reported a profitable year. Continual stock offerings have provided it investor cash as fuel to burn in search of profits. Since its public debut, shares outstanding have soared from 2.6 million to more than 97 million as of the most recent 10-Q, and the stock price has declined from a reverse-split-adjusted all-time high of about $1,500 per share in March of 2000 to the current $4.45 today (a 99.7% decline for anyone who has held shares since then — ouch).

Source: Yahoo! Finance.

The Timeline

1. December 2013 Business Update

On Dec. 4, 2013, Plug Power held a special update call it termed the "2013 December Business Update" (link opens PDF). On this call, CEO Andy Marsh enthusiastically and optimistically proclaimed that Plug Power would be profitable by the end of 2014. Just the day before, Plug Power's stock closed at $0.79 per share; the day of the call, it closed at $1.27, a 61% increase in one day.

2. Wal-Mart Order Announcement

On Feb. 26, 2014, Plug Power issued a press release disclosing a "milestone" order from **Wal-Mart** (NYSE: WMT). The stock jumped 13%, continuing its meteoric, momentum-fueled rise.

3. CEO Andy Marsh Appears on CNBC

On March 7, Marsh appeared live on CNBC to talk about Plug's business and investors' resurgent interest. Marsh again proclaimed that Plug would be profitable in 2014, and he sang the praises of the company's recent progress. The share price jumped the following week to a year-to-date high of more than $11 per share (a return of approximately 1,300% in just more than three months!).

4. "Stock of the Day" Segment and Billy's CAPS Call

On March 12, my colleague Simon Erickson (TMFInnovator) filmed a "Stock of the Day" segment on Plug Power, discussing the market's feverish interest in the company and why said interest might be misguided. After chatting with Simon about the company, I quickly looked up its financials; a glance at the numbers was all I needed to lock in a thumbs-down CAPS call. Knowing that *Pro* was seeking shorts, I also began to research the company to better understand the industry and make sure this was a viable opportunity. On March 26, I sent an email to Jeff explaining my interest in a short position and outlining plans for further research. Jeff encouraged me to continue to pursue the idea.

5. Kerrisdale Capital Discloses Short Position in Plug Power

On April 2, Kerrisdale Capital, a New York-based investment partnership, released a blog post with a detailed short thesis on Plug Power. At the time, Plug's stock price was $7.48 per share. The gist of the short thesis is summarized by the conclusion:

> The speculative ramp-up of PLUG's share price is unjustified, and we believe the downside potential is immense. PLUG has never been profitable, operates a business with low barriers to entry, and operates in an unproven industry, all while shareholders have suffered extreme dilution.

6. The Team Reviews Billy's Short Thesis

A day after the Kerrisdale Capital report, I sent my final research on Plug to the *Pro* team. We discussed the idea a bit but were drowning in earnings at the time, so we decided to table Plug until we had time to iron out final details and compile the write-up. We did not feel compelled to act in haste; the nearest catalyst was Q1 2014 earnings, due on May 14, and we had no reason to suspect that the investor enthusiasm surrounding the stock would recede until then. At the time, the stock was hovering around $6 to $7 per share.

7. Plug Power Issues Public Stock Offering to Raise Capital

On April 22, Plug Power announced its intention to sell common stock in a public offering. At the time, Plug shares traded around $7 per share, declining to $6.70 the day of the announcement. Three days later, Plug issued another press release detailing the pricing of the common offering ($5.50 per share), which drove the price down to close that day at $5.37 per share. By offering obviously overvalued stock to the public, the company raised more than $124 million to help offset operating cash burn and to provide ongoing liquidity for operations.

However, all this harmed our short thesis, eliminating much of the "easy gain" to be had from shorting the company and altering the risk/reward balance to the point where we felt uncomfortable initiating our position. On April 28, I updated the team on my research, noting that by that point the price had fallen so much that the opportunity was not nearly as enticing.

8. Plug Power Reports Q1 2014 Earnings

On May 14, Plug released first-quarter 2014 earnings. The company continued its streak of operating losses, demonstrating that attaining profitability in 2014 would be a difficult challenge after all. The market didn't like the results, bidding shares down the day of earnings to $3.82 per share. At this point, the *Pro* team decided that initiating a position was not feasible at this price, and that we would table the idea until we saw a more favorable risk/reward balance.

The Foolish Bottom Line

Members ask us from time to time why we don't have more short positions. I hope today's Memo has helped outline some of the difficulties of shorting intelligently. When you research long positions, you seek fairly priced businesses that will slowly compound over time. But with shorts, you're looking for market expectations that are out of whack with the reality of a business. These opportunities are rare, and when you do find them, the value discrepancy generally remains until there's a concrete reason for the market to change it (in Plug's case, this was the unexpected announcement of a secondary offering). Thus, the pursuit of shorts can turn into a game of timing rather than a simple issue of right or wrong.

Nonetheless, the *Pro* team continues its tireless search for opportunities, short and otherwise. Just last week we had a meeting discussing — among other topics — a new short idea. I hope this Memo was a helpful look at your *Pro* team's research process! To discuss it, click on over to the Memo Musings board.

Fool on!

— Billy (TMFTailwind)

Pro Completed Trades

- **None**

Coverage & Community

- Get our latest on results from **AIG** (NYSE: AIG), **Broadridge** (NYSE: BR), **MasterCard** (NYSE: MA), **Papa John's** (NASDAQ: PZZA) and **Valmont** (NYSE: VMI)

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Broad Strength at Broadridge

Published May 18, 2014 at 10:43AM

Pro's Take: BR Q3-2014 Earnings

Broadridge Financial Solutions (NYSE: BR)

Quarter Quick Take

Broadridge continued its strong fiscal 2014. Q3 showed that (1) recurring revenue closed sales performance (the core, predictable business) is tracking as expected and the pipeline for new business is robust, (2) the modest market tailwind is providing the opportunity to step-up investment for long-term growth, and (3) the company's ability to scale well does not require massive revenue growth. Both segments (Investor Communications and Securities Processing) contributed to the performance, together turning 5% revenue growth into 14% operating profit growth and 17% net income growth. Management guided to the high end of its expected earnings and free cash flow range (remember it raised guidance last quarter). Broadridge has made two small acquisitions so far this year, remains in excellent financial health, and is generating excellent returns on the capital it puts back into its business. Most importantly, I expect the sales and profit momentum to continue based on the company's robust pipeline of business and the sales opportunities that accompany dialogues related to implementing the adoption of new NYSE proxy rules (which took effect January 1).

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Q3-2014

Total fee revenue growth: +8%

TTM Operating profit margin*: +410 bps to 23.4%

EPS growth: +17% GAAP, +13% non-GAAP

*Operating profit / Fee revenue

This removes the impact of distribution revenue, which is a pass-through, and distorts the true economics of the business

....

Guidance Update

Business is tracking well against our thesis, and the dust is settling on two recent issues (event driven revenue and new NYSE rules for proxy). The current business environment is finally free of headwinds and Broadridge is executing very well – it is starting to exhibit some of the operating leverage we've long said was inherent in its business model. I am pleased to see the company stepping up growth investment (an extra $33 mm of expenses this year) to set the stage for (still modest) growth over the long term. I remain confident that Broadridge will spend this capital wisely – its history with capital allocation discipline suggests a rigorous and thoughtful process.

Updated guidance: Buy (no change)

Recommended Allocation: 4%

Fair Value estimate: $42 (no change)

End of Fiscal Year expected FV estimate: $44 (no change)

CAM price: $34 (no change)

I'm happy with our 4% allocation to Broadridge. The company's business lies at the nexus of Pro's largest sector bets: technology and financials. It is Pro's fifth largest position. Members lacking a (full) position should feel comfortable purchasing shares today – they trade at a discount to our estimate of Fair Value. If the market presents the opportunity, I'd entertain written puts or buying shares to bring the position up to 5% allocation, or an outright resizing if shares fall near CAM territory.

Our Thesis

Broadridge has a near monopoly in proxy solicitation and all other investor communications management. It has a very strong franchise in global securities processing and is increasingly helping its customers off-load technology-based cost centers that require accuracy and security. Broadridge offers a defensible, scalable, low-growth business with strong competitive advantages and very predictable cash flow. Its modest growth, capital-light and scalable business, promising new product pipeline, excellent acquisition track record and sound capital allocation policies make Broadridge a sturdy rock to build the Pro portfolio upon. We expect modest growth in fee revenue, slight operating leverage, plenty of free cash flow and a growing stream of dividends to help achieve North Star-like returns.

The Most Important Things

1. ***Recurring Revenue Closed Sales:*** RRCS amount to an estimate of the annualized new business won during the period. Given the nature of the company's business, the revenue should recur at extremely high rates (we're talking 98%). Tracking this metric gives us insight into future sales, how new products are resonating with customers, and the degree to which customers are partnering with Broadridge. RRCS were up +7% in the quarter (and +7% through the first three quarters of 2014). Broadridge hasn't signed any large transactions (>$5 mm) so far this year which underlies the strength of its diversified product offering and sales efforts. Emerging and Acquired (E&A) recurring revenue closed sales have been particularly strong, with the recent Bonaire acquisition (Q1) contributing more than expected.

2. ***Fee Revenue Margin Performance:*** Broadridge maintains a technology platform upon which its business operates. As it brings more business (volumes) on board, it should benefit from low variable costs and increasing margins. I track gross and operating profits as a percentage of fee revenue, which ignores distribution revenue and costs, and makes my numbers differ from what you might read in the press release. Broadridge achieved fee revenue gross margins of 42.5% during Q3-2014, up from 37.5% a year ago. On a TTM basis (to smooth the calendar lumpiness) fee revenue gross margin was 43.2% versus 39%. Fee revenue operating margin for Q3-2014 was 19.5% up from 18.2% a year ago. On a TTM basis fee revenue operating margin was 23.4% versus 19.3%. The increases were largely due to the natural leverage off of higher sales volumes. Last quarter management announced an extra $28 mm of growth investment spending because it saw the opportunity and the year's performance allowed for it – this quarter it raised that figure to $33 mm. Only $10 mm of that spending will be recurring.

3. ***Capital Allocation:*** Although BR is a slow-grower, it generates a lot of cash and has low reinvestment needs. Management has a very clear plan to put that cash to work: it targets a 40% payout ratio, then looks for bolt-on acquisitions that can achieve a 20% IRR, or it looks to repurchase shares. Last quarter, management raised full-year FCF guidance to $275-$325 million. This quarter it guided to the high end of its range (earnings too). Broadridge will likely spend ~$100 mm on dividend payments, and has spent $141 mm spent so far on CapEx and acquisitions so far this year, suggesting that Broadridge will add to its cash reserves next quarter. This will likely prompt a raise in the quarterly dividend (BR currently yields 2.2%). Broadridge remains in great financial health.

WWTN

Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. Revenue growth will modest, but cash flows are predictable and returns should improve further as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.

Conference Call Notes

- CEO Rich Daly summed up the quarter: "*In our seven years as a public company, our confidence in our business is higher today than it has ever been*."

- On investing: Broadridge is taking advantage of the strong year and upping its investment in growth by an additional $5 mm (on top of the $28 mm it announced last quarter). $14 mm will go to SPS, $12 mm will go to ICS, and $7 mm will go to corporate. Year-to-date, only $9 mm has been spent, so the remaining $24 mm will be expensed in Q4.

- On the Emerald acquisition: Emerald is a 27-year old company that provides compliance-friendly marketing tools to support financial professionals. Emerald should add to earnings in fiscal 2015.

- On E&A contributions: In Q3, emerging and acquired product solutions made up more than 46% of recurring revenue closed sales booked, and will likely be 50% for the full-year. This speaks to the broadening of the Broadridge product suite, the diversity of its revenue stream, and successful cross selling efforts.

- On the big picture: CEO Rich Daly said: "*Overall, we are well-positioned to deliver steady financial growth over the long-term. Our business has evolved significantly over the past several years. We've leveraged our expertise and unique positioning in both segments to develop and introduce the next generation of product solutions to further strengthen our existing client relationships and expand into new opportunities. The benefits of our efforts will continue to be evident as we take our business to the next level, enhanced by this year's meaningful investments into new growth opportunities. Combined with our capital stewardship program, we believe this will translate into substantial value creation and sustainable top quartile returns for our stockholders for years to come.*"
- On strategy: CEO Rich Daly summed up the company's strategy succinctly: "*Our solutions address two client needs: Reducing non-differentiated spending and providing solutions that enhance our clients' revenue growth. We will continue to create new products that expand our solutions in these areas, and through this effort further strengthen our position in the marketplace and generate additional net new business momentum*"

A Lot of Pizza, Less Profit

Published May 16, 2014 at 3:38PM

Pro's Take: PZZA Q1-2014 Earnings

Papa John's International (NASDAQ: PZZA)

Quarter Quick Take

Papa John's achieved remarkable systemwide comparable store sales growth (+13%), but that didn't translate to even higher profit and cash flow as we would have expected. Instead, cheese prices soared, growth-related expenses remain elevated, and PJ rewarded its employees for a strong 2013 with performance-based compensation, resulting in flat bottom-line performance. The commodity cost headwinds and looming expense of implementing a new point of sale system caused 27 domestic franchisees to close, but the company still added net 12 stores during the quarter and expects to open 220 or so stores in 2014. Long-term business drivers appear to remain, but we continue to study competition from fast casual pizza concepts and the democracy of delivery.

Since the earnings call was announced, Papa John's COO Tony Thompson was hired away to be the new CEO of Krispy Kreme. The COO role was quickly back-filled by promoting from within, with Steve Ritchie stepping up to the plate.

....

Q1-2014

Total revenue growth: +13%

Operating profit margin: -36 bps to 8%

EPS growth: +7%

....

Guidance Update

Papa John's is currently on Hold. I have an outstanding call with the company's CFO, Lance Tucker. I'm going to hold off making any guidance update until I'm able to get a few of my questions answered.

Updated guidance: Hold (no change)

Recommended Allocation: 3.6%

Fair Value estimate: under review

End of Fiscal Year expected FV estimate: under review

CAM price: under review

It's worth reviewing what I wrote last quarter:

My decision to hold our shares at this valuation rests squarely on the upside potential that remains if things go right and management's skill in execution and protecting the brand. Also contributing to the decision is the fact that PJ has a resilient business, a strong growth profile that should hold up well in a rocky economy, and the marks of a compounding machine (precisely the type of company you don't want to sell because of valuation). Of course, I won't ignore the downside – cash flows and valuation matter. I'm getting uneasy with the valuation, but I'm not compelled to sell or reduce at this point.

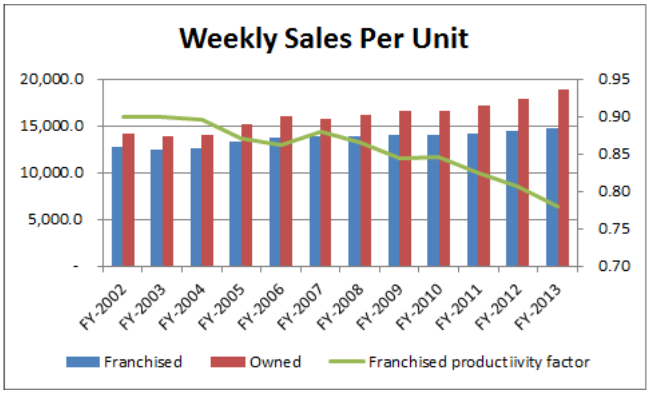
Hindsight says I should've listened to my uneasiness – the air has come out of the valuation. At the time, PZZA shares were trading for 17x EBITDA and they're now down to 13x or so, much closer to the historical norm. Little has changed with the business, but a lot has changed in what investors are willing to pay for PZZA earnings and cash flow. My focus is on where we go from here, and speaking to management should help make that decision.

Our Thesis

Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main QSR-pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only 1,000 international restaurants the company has a long runway for growth. Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

1. ***Store Performance:*** Without healthy franchisees Papa John's has no business. Same store sales offer one look into store performance, but we also track sales per store, store-level profitability, and how all of this translates into the pipeline of committed new franchisors. During Q1-2014, systemwide comps increased an astounding +13%. Domestic stores led the way with +10% comps while international was +8%. This is strong performance, but it can be bumpy. The rolling two and three year comps are still very impressive. We won't know more about store-level profitability until the end of the year, but management did hint that store operating profit margins increased. This solid performance keeps franchisees signing up: PJ opened 265 restaurants (net) in 2013 and expects to open 220-250 (net) in 2014. Its pipeline consists of 200 domestic commitments (to be opened over the next three years) and 1,100 international commitments (to be opened over the next six years).



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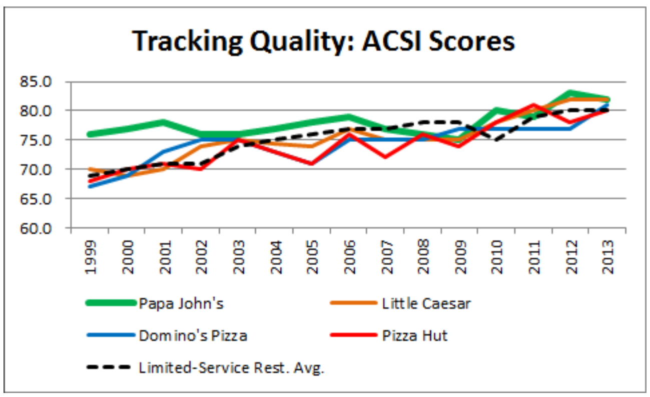

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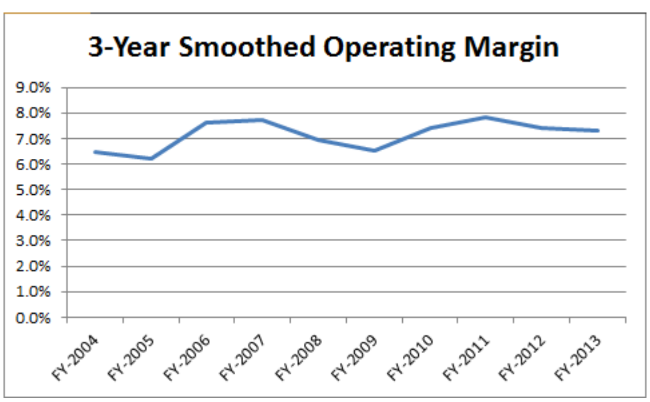

WWTN

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Conference Call Notes

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- On higher G&A: This is attributable to performance-based compensation. PJ had a very good 2013 and it rewarded its employees.

- On share repurchases: PJ repurchased $32.8 mm worth of stock – much of this was accomplished by taking on more debt. PJ generated $26.7 mm in CFFO and spent $11.1 mm on CapEx, resulting in $15.6 mm in FCF. From that, it paid $5.2 mm in dividends, leaving $10.4 mm in FCF after dividends. It spent all of that, and $22.4 mm more to repurchase shares and boost EPS. PJ's business can support a much, much higher debt level, but I still wish there was more clarity on its policy here.

- On Guidance: Management reaffirmed previously announced full-year guidance, but warned that given the persistently high commodity costs it is more likely to come in on the low-end of the range. For a refresher, that is sales growth of +5%-7%, EPS ogf$1.64-$1.72 (and about $0.08 per share higher if we exclude spending on the new POS), domestic comps of +2-4.5%, international comps of +5-7%, and flat free cash flow.

- On international: CEO John Schnatter said: "*Papa John's is the quality leader in the international markets we serve. While our international markets will have their ups and downs as we gain scale, we are extremely bullish on our long-term prospects across the world. Today, we only have about one restaurant per 3 million people in our international market. So there's a long runway for growth for Papa John's internationally.*" Later, he said: "*Both our larger competitors have over 6,000 stores international. So we feel like there's a lot, a lot of runway internationally for growth.*" Regarding quality abroad: "*Your quality is only as good as your consistency. And we have a demonstrably better product here in the US than our competitors. But that gap is way bigger internationally. And I think that's going to pay huge dividends when that kicks in.*"

- It bears repeating: I admire PJ management. They say the right things (that is, the things I'd want them to say if I owned 100% of the company and they worked for me), are incredibly consistent, think long-term, and execute well. My favorite two examples of this from the call came from CEO John Schnatter. 1) "*Going forward, we will deliver on our well positioned to continue to deliver on the three things we know drive shareholder value: driving new unit development, two, building same-store sales growth, three, driving strong unit-level economics. We are confident we will continue our momentum throughout 2014 with steady growth in sales and EPS along with continued digital and technology gains.*" 2) "*We have a fundamental belief, as painful as it is in the short term, at a time when the competition cuts costs, thus cuts quality, that's when we pour it on. That's when we have to stick to our guns. And we are.*"

- On what's going right: The company's marketing messages, digital efforts, customer satisfaction scores, and limited-time offers (LTOs) are combining to drive very impressive domestic comps.

- On why we aren't seeing more operating leverage: CFO Lance Tucker was quick to point out that every segment did see operating leverage – it was the corporate side of things that weighs down the consolidated operating margin. The tax rate, a JV accounting lap, and bonus-related G&A spending all contributed, but shouldn't be recurring. With regard to the performance-based comp, CEO John Schnatter said: "*With the Company executing at this level, the two things that myself and the Board are keen on is to continue to take care of the management team. So there was some executive compensation on long-term incentives. And then, of course, not losing anything on that [demonstrable] value piece with the customer experience. So I think its money well spent to incent and reward high performance. And that's what's going on right now at Papa John's -- high performance.*" He hit on this again later in the call: "*All the business units were up on profitability. The things that went backwards were executive incentives, long-term. I think that's a good thing. Incentives to get stores open. We think that's a good thing. And incentives to run higher comps with the franchisees. That's a good thing. And why it hurt us a little bit in Q1, I think it's going to pay huge dividends in the future. Now, in a year or two we're going to have another great quarter. And you're going to say why did you all have such a great quarter? And we're going to say it's what we did back in Q1 of 2014. It's what we've been doing the last five years, reinvesting in the business and continuing to grab and excel market share.*"

- On new competition in the fast casual space: CMO Bob Kraut: "*We're certainly cognizant of the emergence of the fast casual segment and we've been monitoring and studying the new entries into the category. With that said, we feel that we're in a very good position to gain market share in the foreseeable future. And that's for two reasons. First, we believe that the fast casual segment attracts a different customer with a need for a different usage occasion. But we are prepared to compete with those concepts to the extent, or even in the event, they impact our group occasion delivery carry-out customer. And then secondly, we believe, in echoing John's comments on quality, we believe we're well positioned to grow in delivery carry-out as a result of our superior quality leadership position and our technology leadership position. We believe we've got the best quality pizza available today and that almost half of our customers have discovered that it can be easily ordered on any of our digital channels, which we noted earlier is the highest percentage of any of our national competitors. And then when you couple that with our restaurants delivering some of the highest customer service scores we've seen, you've got an unmatched quality experience that is delivered to your door and one that we believe fast casual can't compete with right now.*"

A Lot of Pizza, Less Profit

Published May 16, 2014 at 3:38PM

Pro's Take: PZZA Q1-2014 Earnings

Papa John's International (NASDAQ: PZZA)

Quarter Quick Take

Papa John's achieved remarkable systemwide comparable store sales growth (+13%), but that didn't translate to even higher profit and cash flow as we would have expected. Instead, cheese prices soared, growth-related expenses remain elevated, and PJ rewarded its employees for a strong 2013 with performance-based compensation, resulting in flat bottom-line performance. The commodity cost headwinds and looming expense of implementing a new point of sale system caused 27 domestic franchisees to close, but the company still added net 12 stores during the quarter and expects to open 220 or so stores in 2014. Long-term business drivers appear to remain, but we continue to study competition from fast casual pizza concepts and the democracy of delivery.

Since the earnings call was announced, Papa John's COO Tony Thompson was hired away to be the new CEO of Krispy Kreme. The COO role was quickly back-filled by promoting from within, with Steve Ritchie stepping up to the plate.

....

Q1-2014

Total revenue growth: +13%

Operating profit margin: -36 bps to 8%

EPS growth: +7%

....

Guidance Update

Papa John's is currently on Hold. I have an outstanding call with the company's CFO, Lance Tucker. I'm going to hold off making any guidance update until I'm able to get a few of my questions answered.

Updated guidance: Hold (no change)

Recommended Allocation: 3.6%

Fair Value estimate: under review

End of Fiscal Year expected FV estimate: under review

CAM price: under review

It's worth reviewing what I wrote last quarter:

My decision to hold our shares at this valuation rests squarely on the upside potential that remains if things go right and management's skill in execution and protecting the brand. Also contributing to the decision is the fact that PJ has a resilient business, a strong growth profile that should hold up well in a rocky economy, and the marks of a compounding machine (precisely the type of company you don't want to sell because of valuation). Of course, I won't ignore the downside – cash flows and valuation matter. I'm getting uneasy with the valuation, but I'm not compelled to sell or reduce at this point.

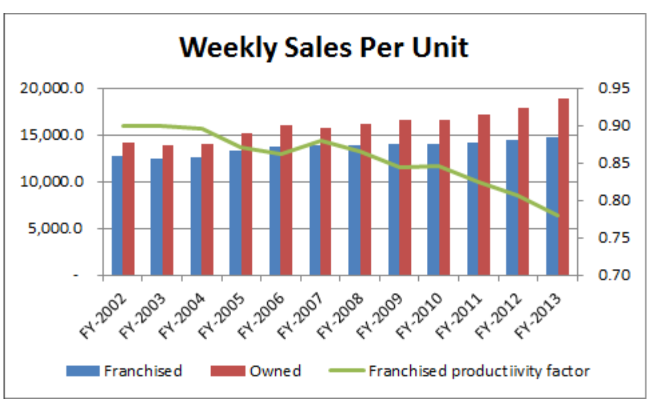
Hindsight says I should've listened to my uneasiness – the air has come out of the valuation. At the time, PZZA shares were trading for 17x EBITDA and they're now down to 13x or so, much closer to the historical norm. Little has changed with the business, but a lot has changed in what investors are willing to pay for PZZA earnings and cash flow. My focus is on where we go from here, and speaking to management should help make that decision.

Our Thesis

Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main QSR-pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only 1,000 international restaurants the company has a long runway for growth. Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

1. ***Store Performance:*** Without healthy franchisees Papa John's has no business. Same store sales offer one look into store performance, but we also track sales per store, store-level profitability, and how all of this translates into the pipeline of committed new franchisors. During Q1-2014, systemwide comps increased an astounding +13%. Domestic stores led the way with +10% comps while international was +8%. This is strong performance, but it can be bumpy. The rolling two and three year comps are still very impressive. We won't know more about store-level profitability until the end of the year, but management did hint that store operating profit margins increased. This solid performance keeps franchisees signing up: PJ opened 265 restaurants (net) in 2013 and expects to open 220-250 (net) in 2014. Its pipeline consists of 200 domestic commitments (to be opened over the next three years) and 1,100 international commitments (to be opened over the next six years).



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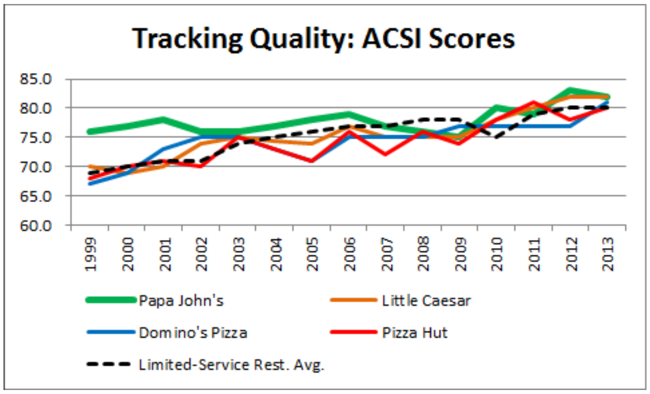

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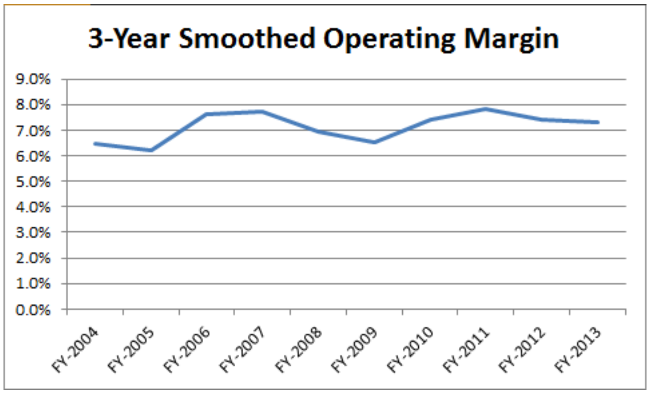

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Valmont Industries Holds Up on Earnings

Published May 16, 2014 at 10:50AM

Greetings,

Summary: **Valmont Industries** (NYSE: VMI) had a blow-out first quarter one year ago (with earnings up 48%), so it was tough to top it this year. But this year, it had its *second-best* first quarter in its history -- and that's despite softness in the U.S. irrigation market and the international utility structure market.

Overall, the company expects business to improve over the balance of the rest of this year, and sees healthy project demand shaping up into 2015 and 2016 for its engineering businesses. The company announced a 12-month, $500 million share buy-back plan (12% of its market value), and doubled its dividend. Priced 8% below our fair value estimate, shares remain a **Buy** at a 3.1% allocation *Pro*.

Conference Call Main Points

- Commodity prices have dropped considerably, leading to lower investment by U.S. farms.
- But looking ahead, Valmont sees irrigation revenue and profitability more in-line with 2013 the rest of this year; Utility Support Structures should see higher volumes but flat revenue due to lower pricing, but still healthy operating margins of at least 15%; Engineered Infrastructure Products should see positive comparisons the remainder of the year. And the Coatings business should be in-line with 2013.
- For the year, Valmont sees EPS of $10 to $10.50 (that's before any shares are bought back).
- If commodity prices just stay where they are (let alone increase), management expects more confidence in the U.S. irrigation market to emerge; international irrigation needs are greater regardless of pricing, and results were strong this quarter; as those markets grow, the irrigation business line should become less cyclical.
- It's the "much smaller projects" in utility structures that are seeing lower competitive pricing pressure, rather than larger projects. So, the pressure may sound daunting, but it affects relatively little revenue (even though it affects the quality, or margin, of earnings in the division considerably if many small projects are signed). Don't expect pricing to fall further. Meanwhile, the extra industry capacity built up in serving this business (due to boon years) will likely be absorbed as little new capacity is coming online now and the market should keep growing.
- The recent acquisition in N. Europe has been seeing double-digit annual earnings growth, with 10% margins.
- Incentive/bonuses will be smaller this year due to lower earnings growth (or no earnings growth).
- The 4G build-out in China helps Valmont's wireless communications structure business there, though they're not big in China yet.
- Priorities for cash are: organic growth; complementary acquisitions; dividends or buybacks.
- After earnings dip about 5% this year, we currently estimate a double-digit (11%) climb next year; none of this includes the new buyback plan, which could change these numbers (favorably) considerably, depending on how much the company spends to buy shares. That's not part of operations, of course, but it can help.

In Sum

Priced inexpensively below 8x EBITDA (see our financials on Valmont here), Valmont remains a value stock that has also been an outstanding growth stock over the years. Believing in management and its business lines, we believe growth will resume and be healthy overall in coming years. And the business may become less cyclical as it becomes more international, which could ultimately afford it higher value multiples, although that's not necessary. Shares remain a buy for the longer haul.

We've owned Valmont since November 2013 in *Pro*, and we're up about 9% so far. It helped to buy it while it was out of favor.

Best,

Jeff (TMFFischer)

Celebrate Our Community: Polaris Award 2014

Published May 15, 2014 at 11:59PM

Fools,

Pro Polaris Award 2014

Let's give a wild round of applause and a standing ovation to aleax!

The team would also like to extend our congratulations to all the (very worthy) nominees, and our thanks to everyone who voted. We appreciate it very much that you are part of our community!

As proposed by ADrumlinDaisy last year, the Polaris Award is "a *Pro* community analogue of the Feste Award, an annual award given to the member who provides the most value to his or her fellow members." Criteria include a regular, frequent, Foolish presence on the *Pro* discussion boards; helpful, expert-level advice; creativity; and efforts to foster a sense of community.

We asked you: Amidst *Pro*'s remarkable community, which members on the discussion boards have truly distinguished themselves to you? Which posts have been most helpful, most thought-provoking, most illuminating? We took nominations through May 1 on this discussion-board thread, and for those who had never explored our discussion boards, we offered the following places to start.

mpfdCPT on his 10-year investing review **JSergeant** on analyzing the analysts **ADrumlinDaisy** on a kookaburra in the coal mine

As this year's winner, aleax will receive a discussion-board charm and $250 to use at Apple or Starbucks — winner's choice! See the full rules here.

Best,

The *Motley Fool Pro* Team

P.S. Want to talk about this award? You're in good company. And if you've never visited (or never posted), introduce yourself!

MasterCard Charges into 2014

Published May 15, 2014 at 7:11PM

Greetings,

MasterCard (NYSE: MA) grew Q1 2014 net revenue 14%, while operating expense grew 12% (showing a bit more leverage), and earnings per share climbed 18% (aided a bit more by buybacks).

The world economy remains mixed, with U.S. slower in the harsh winter weather, Europe continuing a slow recovery, and Asia and Latin America pockets of hot and cold. MasterCard is growing well in most regions, though, as it continues to attack 85% of all transactions that are done in cash. Trading near our fair value estimate, the stock remains a long-term (3 years to start) **Buy** in *Pro*, with estimates for North Star-topping returns over that period.

Some of the incredible things about MA's business:

- Extremely high margins and return on equity
- Minimal investment (compared to operating cash flow) needed in capital expenditures
- The likelihood the dividend could go much higher over time
- And of course, as we know, the leverage in its network. More transactions drive more revenue but not typically more cost. Free cash flow grows much more than revenue, historically.

Conference Call Main Points

- Overall, the U.S. and Western Europe seem to be on paths of continued slow recovery.

- Gross Dollar Volume grew 14% in local currency; and U.S. GDV grew 9%. U.S. debit also grew 9% as MA takes market share. Cross border volume grew 17%. Process transactions grew almost 14% to more than 9.8 billion, and number of MA-branded cards grew 8% to more than 2 billion.

- The Durbin Amendment remains unchanged, which is good for the industry at this point.

- Russia is a bit more than 2% of MA's revenue, and could be a headwind -- right now, the regulatory and political climate is a big unknown. MA expects a small impact from it in 2014.

- MA signed several major deals this quarter, including with SEB Group in the Nordics, which will lead to MA being the leading payment brand in the Nordics; and, it signed with the second-largest retail bank in Sweden, Svenska Handelsbanken, who is converting all cards to MA. This is MA's largest European conversion since Swedbank. Sweden has the lowest use of cash in the world, and now MA will be the leading debit brand there.

- **Wal-Mart** (NYSE: WMT), Sam's Club and **Target** (NYSE: TGT) are converting their cards to MA. Tokenization and security is part of the reason, among many other reasons.

- Europe remains "an enormous opportunity" given that, outside of the Nordics, so many transactions are done in cash. Even if regulation proves tougher in Europe (which is an ongoing possibility), there should be opportunity that overrides it in the longer term.

- New payment flows is an exciting evolution for MA, perhaps the biggest change since the introduction of plastic cards years ago. MA is developing a foundation to provide products, services, and standards for the new digital ecosystem, including MasterPass Digital Wallet, tokenization and C-SAM (which MA acquired as a leading providing of mobile wallet software). MasterPass is now in 7 countries and will soon be an in-app option in mobile shopping software that eliminates the need for a consumer to enter any card information to make a purchase.

- MA stands by its 2013-2015 objective of an 11% to 14% CAGR in revenue, and a 20% EPS CAGR, with an operating margin above 50%. But MA should come in at the low-end of guidance in 2014 given Russia and the continuing loss of Chase customers to **Visa** (NYSE: V), which could stretch into early 2015. It is working hard on new business to make up for it, though, and keep growing.

***Pro* Summary**

Free cash flow has grown much more strongly than revenue the past three years (see our link below), but we conservatively (somewhat, anyway) estimate fair value at $70, or 21x free cash flow. Assuming a bottom-line growth rate that maintains the mid- to upper-teens over time, that's the premium we're willing to attach (even while knowing that FCF growth should expand more quickly than other results).

But keep in mind, we're in a relatively tepid economy worldwide, and in a very strong world economy, this business will scream. Profits should leap. But barring that, we should continue to have a decent long-term investment here anyway. And if the economy does get considerably better around the world, we could have much more upside. For now, we wait for that, happily owning one of (we think) the better businesses out there -- a business that gets a cut of billions of transactions, whatever is being bought or sold, and that levers its profits as transactions grow.

Please see our financial metrics on MasterCard on our discussion board, here.

Fool on!

-Jeff (TMFFischer)

IWM, Valmont, OpenText ... and Foolishness

Published May 12, 2014 at 4:00PM

Pro Guidance Changes

- **The Buckle** (NYSE: BKE): Shares move down to Buy from Buy First after price appreciation, but please continue to buy jeans for all of your friends and family. We own (and recommend) a 2.6% position.

Dear fellow Fools,

Vote for the 2014 Polaris Award Winner

Pro Polaris Award 2014

We're taking your votes until Thursday, May 15! Honor the members who make our community so wonderful — click here.

Congratulations, Jeff!

As Jeff notes in today's Memo, the Fool's annual company meeting took place last week. What he didn't mention, because he's too modest, is that he was the recipient of a Founders' Award — the TMF award chosen by Tom and David Gardner to be given to the Fools they most consider "part of the family." It goes without saying that such an award is well deserved; who wouldn't love to have Jeff as part of the family? Drop him a note to congratulate him here.

Last week, the Fool hosted its annual company meeting for employees, dubbed Foolapalooza, on the shores of the Choptank River beside the Chesapeake Bay. Great weather helped fuel a productive two days, with speeches, breakout sessions, outdoor activities, dinners and festive parties for some 300 Fools, including employees from Australia, the U.K., and Singapore. The bigger purpose of the event? To talk about how to serve more investors, ever better. The vast majority of the world remains unaware of the benefits (and relative ease) of long-term Foolish investing, and many people will initially lack the emotional fortitude to ride out their first bear market. So, the Fool — and now I mean all of us, including you — has plenty of fun work ahead to strive to reach more people and teach more generations how to invest, better. At the same time, we want to keep doing better work for you.

Today, we have some good ground to cover.

May Option Expiration

Our position on the **iShares Russell 2000 Index** (NYSEMKT: IWM) is the only option *Pro* has expiring this week. We remain short the shares directly, as a hedge, and our risk-capping $122 long calls are set to expire worthless. We'll do nothing and let them. The decision we need to make next is: Do we stay short IWM as a hedge? If so, do we cap our risk again, either by buying more calls or perhaps by setting a stop-loss order? (We're not against such a move with a hedge of this nature; it would ensure our short is automatically covered if IWM rises above a set level.) We'll issue any such decision in a new trade alert, but for the moment, we'll stay short IWM shares as a hedge.

Those with an alternative trade — a put purchase or a bear put spread — should close those positions this week. You have little choice as expiration nears. We assume that you used puts because you can't short shares directly; as the puts near expiration, take your gain this week. Sell to close the puts you bought, or close both sides of your spread. This is an unusually nice situation: You have a gain on the hedge, yet the *Pro* portfolio is up overall, too, because many stocks have gained ground but small caps have declined (we used them to hedge given their relatively expensive price). For more on what to do with your alternative trades, see today's post.

Valmont Holds Up (a Lot of Things)

Maker of poles, utility structures, and irrigation equipment **Valmont Industries** (NYSE: VMI) announced quarterly results that initially sent the stock lower, but shares recovered, suggesting that others see the value we do in this well-run business. Despite some softness in the international utility market and in domestic irrigation sales, Valmont still notched the second-best first-quarter results in its history (behind only last year). International revenue and earnings continue to increase, and gains were spread across most all of Valmont's countries of business.

Although its utility-structure business saw more pricing competition, customers are lining up to spend significant amounts on new projects in 2015 and 2016, and Valmont expects to maintain at least a 15% operating margin in this division. That's healthy; management confirmed that the price competition it's seeing *isn't* irrational, just more pronounced. Over the last 10 years, Valmont has increased this business line from $100 million in annual sales to nearly $1 billion, and there's plenty of opportunity ahead. Meanwhile, as emerging markets continue to expand, Valmont's irrigation system business should become less cyclical.

After spending close to $200 million on high-quality, complementary acquisitions in Northern Europe in the first quarter, Valmont remains open to more purchases. However, management also said that a stock buyback or dividend are on the table, too. Valmont views a stock buyback the same way it views an acquisition, except that it knows its own business best. If a buyback is a strong use of its capital, it will consider it. The stock remains a **Buy** in *Pro*, with a 3% allocation.

OpenText Opens Up

Shares of software provider and business commerce platform leader **OpenText** (NASDAQ: OTEX) reported quarterly results that drove the stock price up again. Legacy software license revenue was up a healthy 6%, and total revenue gained 31% including the recent GXS acquisition. Cloud revenue is soaring, but interestingly, just as **Oracle** (NYSE: ORCL) has said, OpenText tells us that its customers don't just want cloud services; they want the option of cloud *and* on-site services, integrated and hybrid, with ultimately the same software running in any deployment model. If this holds true and the desire is widespread, it speaks well to the strategies on offer at both Oracle and OpenText.

The company's new Enterprise Information Management (EIM) software suite, code-named Red Oxygen, started shipping, and many six- and seven-figure sales deals have already been booked. About 25% of sales are to new customers, the others are upsells. By November, OpenText plans to roll out its next release, code-named Blue Carbon, with three big value drivers focused on applications, cloud services, and analytics. The vast majority (more than 80%) of the company's revenue is of the recurring nature, and renewal rates on its licenses remain in the low-90% range. North American license sales were one weak point in the quarter, but OpenText believes it has rectified the issue and will be back on track in the U.S. in a quarter or two. Finally, OpenText increased its dividend 15%. The stock remains a **Buy** and we have a 3.3% allocation.

Priced to Compound?

Many exciting businesses surround us, but if the price when estimating future results doesn't seem to offer much chance of compounding, we'll continue our search. As both are capable of upping their bottom line by more than 10% annualized, Valmont and OpenText appear priced to continue delivering compounding returns.

Business	EV/EBITDA NTM est.	P/E NTM est.	P/FCF	ROE
Valmont ($149)	7.5	14.2	14.4	16.8%
OpenText ($47)	10.8	12.8	21.2	12%

Terms: Enterprise Value/EBITDA next-12-months est.; P/E next-12-months est.; price/free cash flow, current; return on equity, current.

Thank you for being a member of *Pro*! To discuss the Memo, click on over to the Memo Musings board.

Foolishly,

— Jeff (TMFFischer)

Pro Completed Trades

- **Tupperware** (NYSE: TUP): We sold to open a covered strangle on all of our shares, writing June 2014 $80 puts and June 2014 $85 calls, for a combined credit of $2.27. The stock remains a **Buy** with a 3% stake.

Coverage & Community

- Get our latest on results from **American Tower** (NYSE: AMT) and **Facebook** (NASDAQ: FB).

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Pro Live Chat, May 2014

Published May 8, 2014 at 3:26PM

At 2 p.m. on Wednesday, May 21, the entire *Pro* crew — advisor Jeff Fischer; senior analyst Bryan Hinmon, CFA; research analyst Billy Kipersztok; and editor/publisher Ellen Bowman — answered your questions during a live text chat. Read the transcript below!

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Write a Covered Strangle on Tupperware

Published May 6, 2014 at 3:05PM

Is this for you? This is for *Pro* members who own shares of **Tupperware** (NYSE: TUP) and can write options for income while staying near our allocation guidance.

How You Participate

- **Trade:** Use a combo order to write a covered strangle on your owned Tupperware stock. A written strangle is an income strategy with two option legs — a written put and a covered call — having the same expiration date but different strike prices:
  - Write ("sell to open") June 2014 $80 puts
  - Write ("sell to open") June 2014 $85 covered calls
- **Allocation:** Write one strangle (one written put *and* one covered call) per 100 shares of Tupperware you own. For *Pro*, that's seven puts and seven calls. This could increase our 2.8% stock holding to more than 5%.
- **Price Guidance:** Use a limit order. Aim for a credit higher than the combined real-time bids of the put and call options. As we go to print (so to speak), the combined bid is $2.45, and the combined ask is $2.80. So, aim to be paid around $2.60 or higher initially. As prices change later, we recommend you accept no less than $2 to make rolling easier if need be.
- **Stock Rating:** Buy
- **Recent Prices (1 p.m. ET, 5/6/2014):**
  - Stock: $82.50
  - June 2014 $80 puts (bid/ask): $1.50/$1.65
  - June 2014 $85 calls (bid/ask): $0.95/$1.15
  - Combined bid/ask: $2.45/$2.80 (with this pricing, use a $2.60 limit initially)

What We're Thinking

As I (digitally) pen this, the S&P 500 is up 1.6% year-to-date, while *Pro*'s North Star has increased nearly 4%. We know our North Star (inflation plus 7% a year) won't let up, so we need to work hard to stay near it, especially when stocks are lazing about. One favorite tool at our disposal is writing options for premium, or income. When our targeted stocks cooperate, we can repeatedly pocket new cash.

Expecting revenue growth of only 5% to 7% this year, Tupperware doesn't qualify as a high-growth business. But it pays a 3.2% yield, trades at a reasonable valuation (near our $85 fair-value estimate), and should be able to increase earnings per share by 10%-plus in the years ahead. In the meantime, between quarterly earnings announcements, we should be able to put a lid on some option income.

With shares lately $82.30, this June strangle expiring in just 45 days plays out like so. If the stock price at expiration is:

- **Less than $80**: We'll be assigned to buy new shares around a net price of around $77.40, or about 6% lower. Or we can roll to new options instead of buying more shares.
- **Between $80 and $85**: Our covered strangle expires unused, earning us the equivalent of a 3.2% yield on the current share price in 45 days.
- **Higher than $85**: Our covered calls could be exercised, forcing us to sell our shares at a net $87.60, or 6.4% higher from the current price, and above our $85 fair value, if we don't take action. Or we could roll our strangle to higher strikes.

With second-quarter earnings due in mid-July, news should be scarce from Tupperware over the next month and a half (although you never know!) leading to our June expiration. If that's the case, the stock will bounce around at the whim of the broader market, hopefully staying between our strikes, or close enough to earn us some income.

More That Matters

- **Maximum loss:** The same as stock ownership, minus the credits we received for setting up the strangle.
- **Maximum gain:** Our upside is capped at about $87.60, or 6.4% higher than the recent price.
- **Breakeven:** There are two breakeven points for a strangle — in this case, $77.40 at the low end, and $87.60 at the high end.
- **Follow-up:** We'll likely write a new strangle if this position expires fully as income. If not, we may roll the strangle to avoid stock action, or we may let the strangle result in a stock trade. We'll cross that bridge if and when we need to, but for the record, we're ready for anything: If the market falls sharply, taking Tupperware with it, we'll be ready to buy more shares. If it soars, we may let our shares get sold (again) and look to write new puts.

Alternative Trades

- **You could just write the puts, or just write the covered calls**, if you don't want to strangle the shares. Just realize you'll collect much less premium, and rolling will be more difficult. Be ready to buy shares if you write puts, or sell your shares (though that's not desired today) if you write covered calls.
- **If you don't yet own shares, buy 2.8%**. Shares are rated Buy. Then consider writing this strangle if you want to target income and have bought at least 100 shares, amounting to less than a 3% allocation.

Pro Can Help

- Want to learn more? See our guide to strangles in our sister service, *Motley Fool Options*.
- Put your Tupperware party hat on and swing by the Tupperware board with questions!

Write Puts on Parexel International

Published May 6, 2014 at 3:05PM

Is this for you? This alert or its alternate trades should be applicable to most *Pro* members, whether you already own shares of **Parexel International** (NASDAQ: PRXL) or not.

How You Participate

- **Trade:** Sell to open September 2014 $40 puts
- **Allocation:** 2.7% — write one put for every $150,000 you manage; *Pro* will write 14 contracts
- **Price Guidance Now:** Use a limit order of $1.35 or higher to start (for a 3.4% yield in 136 days)
    - **Later:** We think an 8% annualized yield is acceptable given our willingness to own more shares; that equates to a minimum acceptable credit of $1.20 at the moment
- **Prices (May 5):** Stock, $44.50; options, $1.35 bid / $1.40 ask

What We're Thinking

Last week, Parexel announced a very good third quarter. The company, which helps pharmaceutical companies get drug candidates to market, turned 8% service revenue growth into 20% earnings-per-share growth and continues to book new business at a healthy rate. With one quarter left in the fiscal year, management raised its forecast for revenue and earnings.

The quarter's business performance, however, was overshadowed by news that Parexel's largest customer, **Pfizer** (NYSE: PFE), intends to purchase **AstraZeneca** (NYSE: AZN). I outlined my initial reaction here. The business combination could be a negative for Parexel because Pfizer and AstraZeneca together could wield more pricing power in contract negotiations and could prune similar drug-development projects as the pipelines are joined.

We are not overly concerned about these outcomes because:

- AstraZeneca has rejected Pfizer bids three times already
- Taxes, rather than operational cost savings, seem to be a key driver of this merger
- We have seen no evidence that Pfizer views its partnership with Parexel as unfairly priced or a cost center to be exploited
- Recent layoffs at AstraZeneca suggest its thinned-out research and development department could actually benefit from more outsourced trials

Furthermore, we believe that over the longer term, the possible Pfizer-AstraZeneca combination could speed outsourcing adoption and lend further credence to the partnership model, which would be a significant benefit to Parexel and other large contract research organizations.

How It Fits Into *Pro*

With *Pro's* recent purchase of **Gilead Sciences** (NASDAQ: GILD), our health-care exposure is now around 9% of the portfolio. We're comfortable with the possibility of more, but are mindful of our current net exposure. We are opting to generate income with written puts rather than purchase more shares directly because Parexel is still relatively new to the *Pro* portfolio, and we'd like to get to know it further before decidedly upping our stake. Should these puts become in-the-money at September's expiration, we'd get shares below our Consider Adding More price ($40) and at a very attractive discount to what we believe they're worth ($54), or we'd have the option to roll them to a later date if we choose.

More That Matters

- **Maximum Loss:** Our risk is the same as share ownership starting around $38.65, 14% less than the current price and 14 times next year's earnings estimates.
- **Maximum Gain:** Unless the stock declines and we get to buy shares by expiration, the most we can gain is the put premium. At $1.35, that's a 3.4% yield in 136 days, or about 9% annualized.
- **Follow-Up:** We'll buy shares if the stock is below our strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire unused, we may write new puts for more income.

Alternative Trades

- **If you don't own stock already:** We think you should match *Pro*'s 2.8% allocation first — Parexel's shares are a Buy First. Then, you should consider writing these puts for income.
- **If you're more aggressive:** You can write September $45 puts for $3.30 or more. These puts are in-the-money. They provide greater income in exchange for a higher breakeven price and a higher likelihood of resulting in being assigned shares.

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Outsource your problem-solving to the Parexel International discussion board.

Earnings: American Tower Q1 2014

Published May 6, 2014 at 2:36PM

American Tower (NYSE: AMT) Q1 2014

What Happened?

Consolidated Results:
-Total Rental & Management Revenue of $960 M (up 23.5% nominally, and up 30.2% on a core* basis from 1Q 2013)
-Adjusted EBITDA of $640 M (core growth of 28.3% from 1Q 2013)
-Adjusted Funds From Operations (AFFO) of $439 M (core growth of 28.2% from 1Q 2013)
-AFFO per share of $1.10 (up 22.2% from 1Q 2013)

*Core growth reflects adjustments for foreign currency exchange rates and prior period one-time items

Segment-specific Results:
-Domestic Rental & Management Segment Revenue of $636 M (core growth of 26% from 1Q 2013)
-International Rental & Management Segment Revenue of $324 M (core growth of 38% from 1Q 2013)

Investing and Financing:
-Total Capital Expenditures of $214 M (down from $277 M Q-o-Q, up Y-o-Y from $124 M in 1Q 2013)
-Cash Paid for Acquisitions of $62.8 M (down from $4.1 B (!) last quarter, when the big GTP and NII acquisitions hit the books)
-Net Leverage Ratio of 5.5x (down from 5.9x last quarter)
-Stock Repurchase Activity: None in Q1 – repurchases have been suspended since GTP acquisition in order to pay down debt and reduce leverage ratio
-Quarterly Distribution of $0.32 per share (up 23% from Q1 2013)

CEO Jim Taiclet:
"The technology transition from 3G to 4G wireless services in the U.S. is in full swing. We expect 4G device penetration to expand from 26% to 33% during the course of 2014. This 3G to 4G transition, coupled with even more applications, games, music and video services is putting significant strain on wireless networks and is driving elevated demand for tower space.

We are experiencing the benefit of this phenomenon, not only on our legacy domestic sites, but also on the GTP assets we acquired last year, which are already exceeding our original expectations. The resulting strong growth in the U.S. business, augmented by our even faster growing international segment has put us firmly on track to achieve double-digit annual growth in AFFO per Share for the foreseeable future."

So What?

Start off by reading TMFDatabaseBob's excellent recap of the quarter if you haven't yet! It's always useful to have multiple perspectives when researching a company, although I must say Bob and I are in the same ballpark when it comes to big picture conclusions.

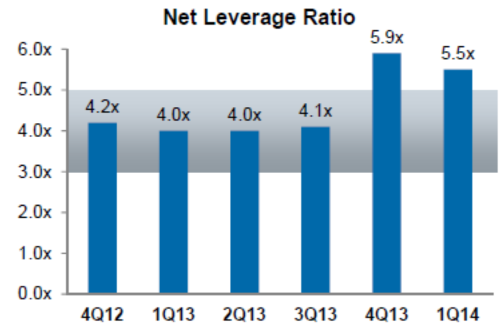
Business momentum at American Tower is quite strong, and management raised its full year 2014 outlook to reflect its robust demand environment. Growth rates continue to outpace my expectations: organic core growth for the quarter accelerated to 9.2% domestically (vs. 8.7% for FY 2013) and 16% internationally (vs. 13.5% for FY 2013). The weighted average organic growth (U.S./ international blended) was 11.5% (vs. 11.2% for FY 2013). Positively, the new GTP and NII assets have been performing above management's expectations, contributing nearly 19% to core growth this quarter.

I wrote last quarter: "*For 2014, I'm expecting continued strong organic growth, and barring unforeseen macro-economic changes, I'd be surprised if organic growth rates were below the mid-point of guidance (7% in the U.S. and 10.5% internationally).*" This metric gets a big fat check. So far so good.

Notably, acquisition and capex activity slowed this quarter, with cash paid for acquisitions coming in at a modest $63 million (compared to $4 BILLION last quarter when the big acquisitions closed). Capex also declined sequentially to $214 million (from $277 million last quarter).

No real surprise here, as management has stated consistently that the recent flurry of acquisition activity would slow and they would focus on extracting efficiency from the new assets (check!) and paying down debt to reduce the leverage ratio.

On that front, meaningful progress was made, with the leverage ratio (Debt/EBITDA) declining to 5.5x (from 5.9x last quarter) as AMT paid down its debt with cash flow:



Source: American Tower Q1 Earnings Presentation

Management expects to get the leverage ratio below 5x by 2015, but if the company sees an acquisition opportunity it likes, I wouldn't be surprised to see them take advantage of their flexibility and change course to pursue it. That would potentially drive the leverage ratio higher again (if another major acquisition does indeed happen – who knows if it will).

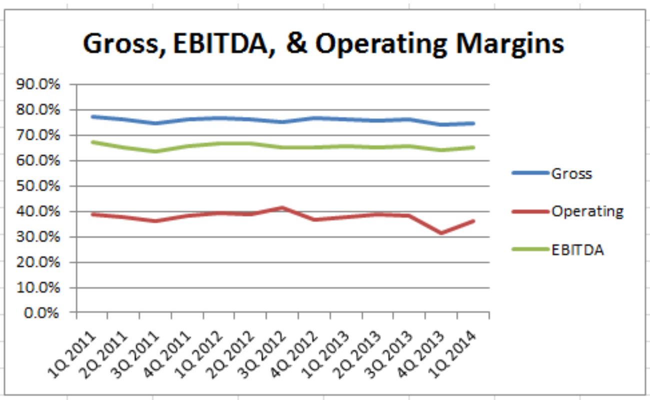
Yearly distribution growth continues to track ahead of management's 20% growth target, coming in at 23% growth ($0.32 per share). 20% annual growth continues to be a more than reasonable target for 2014.

Now What?

The market liked AMT's earnings report, bidding up shares on the day of the report about 3.2% compared to the previous day's closing price. I'm not surprised by the positive reaction, as almost every metric I watch looked great.

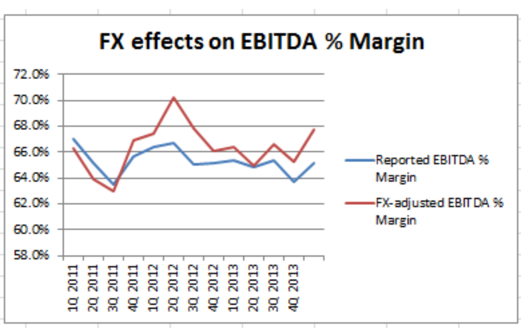
This quarter's report again provides confirming evidence that our investment thesis (that global growth in data consumption will stimulate wireless carrier network investments, leading to strong tenancy growth and rising returns on capital over time) continues to play out.

Notably, after a decline in margins last quarter (see this post for why), we saw a nice uptick in gross, operating, and EBITDA margins this quarter as big acquisition-related costs came off the books and the company extracted efficiency out of its new assets:



Source: Company filings, analyst calculations

Even more notably, we saw this uptick in margins despite continued FX pressure, with an estimated -5% impact on core revenue growth from FX fluctuations this quarter compared to about a -3.3% impact last quarter and a -2.8% impact the quarter before. If we adjust for FX effects, margin performance was even more impressive:



Source: American Tower Supplemental Materials, analyst calculations

All in all, things look pretty promising for American Tower for the rest of 2014 and beyond.

Data and Guidance:

- Current Price: $87.54
- Fair Value: $105
- CAM (updated): $76

- Market Cap: 34.9 B
- EV/EBITDA: 19.2

AMT remains a Buy First, with no change to our recently updated $105 fair value estimate and a 3.9% allocation after adding to our stake in mid March. I'm bumping up CAM a bit to $76 to reflect improved cash generation since last quarter and increased confidence in my valuation due to the accelerating demand environment in the industry. Even though the stock price is higher, you could argue that AMT is a better value than it was last quarter, as the EV/EBITDA (my preferred metric for AMT) is lower (19.2 vs. 20.6 last quarter). This is a good example of how you can find value in a company despite a higher price. If you've yet to start a position or didn't add to your stake when we did so in mid March, now is as good a time as any to match our 3.9% allocation.

Fool on!

Billy
Long AMT

What Drives Coca-Cola, Facebook, and Tupperware?

Published May 5, 2014 at 4:00PM

Pro Guidance Changes

- **Parexel** (NASDAQ: PRXL): Shares move up to Buy First from Buy, and our Consider Adding More price increases to $40. We have a 2.9% position. See more here.
- **Apple** (NASDAQ: AAPL): Shares are up more than 40% since we moved them to Buy First and added to our position. Now, after that large gain, we're lowering shares back down to Buy.

Dear *Pro* member:

An extraordinary business is not easy to copy, because its success is driven by unique attributes that, combined, are difficult to recreate. Brand, products, distribution, customers, and financial strength: They all come together to give an exceptional business a soul of sorts that resonates and carries it forward.

Polaris Award Nominations Closed

Pro Polaris Award 2014

Fools, we've collected your nominations for our second annual Polaris Award — which, unsurprisingly, include some truly exceptional Foolish community members — and we'll be asking for your votes shortly! In the meantime, you can see the full details of the contest here.

But you *can* boil down most businesses to a single driver — the one thing that determines the company's fate more than any other. This is a key exercise in understanding what you own, so let's run through it with three *Pro* positions. We'll use last quarter's earnings as a jumping-off point.

Coke's Volume Is the Real Thing

In the first quarter of 2014, **Coca-Cola** (NYSE: KO) increased unit case volume 2% worldwide (excluding currency fluctuations). That's on top of 4% volume growth the year before. Two percent may not sound like much, but it represents an incremental 100 million unit cases sold, or the equivalent of 27 million additional servings every day. (A unit case is equivalent to 24 eight-ounce servings.) That's a lot of new customers drinking more Coca-Cola products. Because Coke enjoys pricing stability, unit case volume is the single biggest driver of the business. Its several billion-dollar brands (both sparkling and still), hard-earned relationships with bottlers, a giant distribution network — everything it's built over the last century is geared toward generating higher volume. And with spending power rising in the most populated parts of the world, its potential customer base is increasing just as hoped.

Although volume declined 1% in developed markets last quarter, emerging markets were up 3%, with China 12% higher and Brazil 4%. For the year, Coca-Cola is confident that overall unit case volume will return to its long-term goal of 3% to 4% growth. Coca-Cola also has pricing power., and when you couple volume gains with two to three percentage points in annual price increases, increased efficiency, and a 3% dividend, you can see 10% annualized returns. But the business hinges *most* on volume growth. Last year's growth disappointed, providing us an opportunity to start a position as others sold. Sellers were looking back, while we work to look forward.

To drive growth this year, Coca-Cola is improving its marketing and spending more on the brand. Management can model returns on effective marketing, and strong campaigns more than pay for themselves. The company plans to increase its investments in branding by $400 million this year, and by $1 billion total by 2016. So far, only about 5% of its 2014 brand spending has been broadcast to customers — meaning it's all yet to come. The main goal: Drive unit case volume.

Clicks Drive Facebook's Ad Revenue

One could argue that **Facebook**'s (NASDAQ: FB) fate relies most on maintaining its giant user base, and there's truth to that. But the factor driving its financial destiny *most* is the effectiveness of its advertising. The more relevant the ads, the more people will click on them (even if the audience is smaller during some quarters). This will cause advertisers to spend more, and drive Facebook to make more money.

Last quarter, Facebook's ad revenue jumped an impressive 82%, and the effective price per ad rose 118%. Ad impressions declined 17% on a continued shift toward mobile, where fewer ads are shown, but the new ads are more effective and cost more — supporting our argument that quality matters. Nearly 1.28 billion people use Facebook each month, and 63% of them visit daily. Each visitor has a unique experience depending on what they like and how often they click ads. If Facebook can deliver more relevant ads to more people, it will have stronger results. This is why the company continually promotes its goal of having advertising that is as relevant to each visitor as the "organic" social content.

So far, the company is only showing ads on Facebook. Its other apps — Messenger, Instagram, and WhatsApp (once that deal closes) — will not be monetized with advertising until later. The company wants to increase the audience of each and improve the services before starting to populate them with ads. In other words, Facebook has *much more* room to grow its revenue base, and it will take its sweet time doing so. Video ads are another "really big opportunity"; for the first time, consumers are spending more time online each day than they are watching TV.

To sum up, although it's 10 years old already, Facebook is still in "phase one" of its business. With a goal of not just connecting the world but understanding those connections, it will continue to create or acquire new apps that help hundreds of millions of users share content in unique ways. When the audience has settled in and the content is strong, the company will monetize those apps, and in the end, clicks on ads will drive its financials. Just as Coke depends on bottling partners and distributors to help it increase its volume, Facebook depends on the size of its audience in a supporting role. The *star* is ad effectiveness when coupled with a mass audience.

It's All About the Party

The single biggest driver of results at **Tupperware** (NYSE: TUP) is the number of parties its sales representatives throw. With 2.9 million representatives around the world overseen by regional managers, the company keeps close tabs on the number of parties on the calendar. In many countries, the party schedule is planned five weeks ahead of time. If Tupperware doesn't see enough parties scheduled, or the parties aren't bringing in the desired revenue, the company offers incentives to sales reps to host more parties. This is how they steer the Tupperware ship.

These days, less than one-third of the products Tupperware sells are food storage. Most are kitchen tools. The company's best-selling product in France, for example, is a Microsteamer (which turns a microwave into a steam oven) — it costs up to $150 in France and has become a top seller in the United States as well. Tupperware is more innovative than it gets credit for, and it offers lifetime guarantees on quality-made products that are designed for each culinary region it serves. But it's still the Tupperware parties that move the product. Even in China, where apartments are too small to host parties, the company has set up 4,300 storefronts where customers gather for cooking classes and demonstration parties led by representatives. As with Coca-Cola, emerging markets (not developed ones) are driving growth.

Three Companies, Three Drivers

So, three companies, three key drivers: unit case volume; effectiveness of advertising; and the number of parties thrown.

The Price We're Paying

As investors, we aim to look ahead, because what's going to happen is more important than what just happened. All three of these stocks are rated Buy (in Coca-Cola's case, we've set up a synthetic long), and you can see our allocations on the Recommendations page. Here are some estimated 12-month valuation multiples on these three:

Multiple on next 12-month estimates	EV/EBITDA	Price/Earnings	Price/Free Cash Flow
Coca-Cola ($40.70)	14.7	19.2	23
Facebook ($60)	18.1	39.8	37
Tupperware ($84)	10	14.4	17

Sources: CapitalIQ, analyst estimates.

You pay a premium for the strong growth at Facebook, but I estimate it's a reasonable premium. Coca-Cola and Tupperware both pay investors a 3%-plus dividend, and both are increasing their sales by 5% to 7% annually, and earnings more than that. With Coca-Cola, you're paying for a world-class franchise with staying power. With Tupperware, you're paying closer to (and in some cases less than) average market multiples.

What Drives You?

Now, what single factor *most* drives your other companies? You should be able to explain it to an 8-year-old. And to close on a Foolish note ... what is it that drives *you*? What gives you the most reward each day? How do you double down on that?

To discuss the Memo, visit the Memo Musings board. Fool on!

— Jeff (TMFFischer)

Pro Completed Trades

- **GrafTech International** (NYSE: GTI): We sold all our shares at $11.23.
- **Gilead Sciences** (NASDAQ: GILD): We bought 900 shares, for a 3.5% stake, at $78.86.
- **Intel** (NASDAQ: INTC): We rolled our July 2014 $25 covered calls to August 2014 $25 calls for a $0.07 credit — to keep our shares and get the dividend.
- **Wells Fargo** (NYSE: WFC): We wrote a covered strangle, selling to open June 2014 $48 puts and June 2014 $50 calls on all our shares. Aiming for income, we were paid a $1.23 combined credit.

Your Most Active Conversations

Today Past 7 Days Past 30 Days

Buy Gilead Sciences

Published Apr 30, 2014 at 2:45PM

Is this for you? All *Pro* members can participate in this investment in a regular or IRA account.

How You Participate

- **Action:** Buy a 3.5% stake in **Gilead Sciences** (NASDAQ: GILD)
- **Scorecard Status:** Buy First
- **Recent Price:** $77
- **Price Guidance:** Gilead is large and liquid; you can buy at going prices.
- **Fair-Value Estimate:** $105
- **Consider Adding More:** $65
- **Options:** We may use them someday, but they aren't necessary.

What We're Thinking

Gilead Sciences helps millions of people fight life-threatening diseases. Currently, eight HIV products account for the majority of Gilead's revenue, and those drugs are being joined by newcomer Sovaldi, which treats (and cures) various forms of hepatitis C. Sovaldi's debut last quarter was the most successful drug launch in history, yet so far it only reaches a tiny portion of its potential customers. An estimated 2.7 million to 3.2 million hepatitis C patients reside in the United States, and a whole 2.8% of the entire world (almost 200 million people) is thought to have this common bloodborne infection. That means tens of millions could conceivably benefit from Sovaldi — and this would still leave plenty of room for upcoming competing drugs to do well, too.

Thankfully for us, the pending approval of those competing drugs has Wall Street concerned. This allows us to buy shares of Gilead at a reasonable price even as the business stands on the cusp of mighty growth. Gilead enjoys the strength of a $119 billion market value, yet its earnings per share are expected to soar more than 200% this year, leading to 38% annualized growth the next five years. Gilead offers a rare investing trifecta: financial strength and size; extreme growth on hand; and a value seeker's price. With Gilead trading at 11.8 times estimated 2014 earnings, we're glad to become investors for the years ahead.

What We're Watching

Gilead depends on a handful of products to generate most of its revenue, but it's no one-hit wonder — management is adept at building on past successes. HIV treatments originally required taking multiple drugs every day, making the regimen harder to follow. Gilead was able to combine many of its previous treatments into single-pill regimens and obtain new patents on them before key expirations hit. The company continues to work to improve its HIV franchise, with several drugs in clinical trials; management's long-term goal is to ensure that all various-stage HIV patients can choose a single-tablet regimen (of which Gilead currently sells three).

HIV and liver-disease treatments drove 83% of Gilead's revenue in 2013, representing $9.3 billion of $11.2 billion total. In the pipeline are new treatments for cancer and cardio diseases; in the meantime, new iterations of existing drugs should help Gilead maintain long-term revenue from many of its past successes. And many top sellers have years until patent expiration anyway.

Gilead's Top Products	2013 Sales (in thousands)	Indication	U.S. Patent Expiration
Atripla	$3,648,496	HIV	2021
Truvada	3,135,771	HIV	2021
Viread	958,969	HIV	2018
Complera/Eviplera	809,452	HIV	2023
Stribild	539,256	HIV	2029
Letairis	519,966	Cardio	2018
Ranexa	448,624	Cardio	2019
AmBisome	351,827	Infection	2016

Source: Gilead 2013 10-K.

Atripla, with $3.6 billion in sales last year, will give up its crown to Sovaldi this year. Sovaldi earned $2.3 billion in sales during the first quarter alone, tripling Gilead's year-over-year profits in the process. Wall Street is concerned that Sovaldi will face pricing pressure from competitors, though that concern was softened last Friday when top competitor **AbbVie** (NYSE: ABBV) — which has filed its hepatitis C drug for FDA approval — said a pricing war is not in its strategy. Wall Street is also concerned that Sovaldi is a "one-and-done" drug (in many cases, eight to 12 weeks of treatment leads to a cure). Analysts worry that this will result in a burst of revenue that then trails off sharply. There's no question revenue will be front-end-loaded this year and early next, but sales are likely to remain robust afterward as the drug's approval spreads around the world, and as more patients come forth for treatment. At any given time, only a minority of the population is even aware they have hepatitis C. We expect steady demand in the years ahead, even if it won't match the initial burst this coming year or so, and management at Gilead has said the same. After all, in the U.S. alone, 20,000 to 30,000 new patients are diagnosed with hepatitis C each year.

Meanwhile, Gilead has more than 200 active clinical studies taking place, and at least 10 compounds filed for regulatory approval or in final phase III development. Yet, as earnings grow, the company could soon be the cheapest it's been since the 2008-2009 financial crisis.

Since 2004, Gilead has averaged an EV/EBITDA multiple of 17.8. Thanks largely to Sovaldi, the stock trades at only 8 times our estimated EBITDA for the next 12 months. Assuming Sovaldi sales start to taper by early 2015, the stock still needs to gain at least 50% from today's price to trade at least *near* its long-term valuation average (at a multiple of 12). As Sovaldi sales slowly deflate (but persist well enough) and the fear of a revenue cliff abates, investors should have no reason to let shares maintain a valuation discount. Meanwhile, the odds favor Sovaldi exceeding expectations the next 18 months, rather than falling short of a skeptical Wall Street. The sheer size of the patient population and the fact that more patients will come forward upon hearing of a cure weighs in the drug's favor; also, it helps that a meaningful price war with a top competitor (who still lacks FDA approval) does not appear likely. Finally, more patients are likely to be diagnosed than before, because now there's something a doctor can do about hepatitis C: cure it.

How Gilead Fits Into *Pro*

With 5.6% of our portfolio in **Medtronic** (NYSE: MDT) and **Parexel** (NASDAQ: PRXL), *Pro* is underweighted in health care. Starting a 3.5% stake in Gilead, we gain exposure to a top-rated, growing biotechnology company with a healthy pipeline and acquisition strategy. We're investing at an estimated valuation multiple that, on many measures, should make Gilead one of the more attractively priced stocks in the portfolio.

Alternative Trades

- We see enough value in shares to buy outright, but if you'd rather target a lower potential buy price, you can write ("sell to open") pretty much any puts you like.

Pro Can Help

- **Questions?** Let's make this a two-way discussion on our new Gilead Sciences discussion board.

Roll Your Covered Calls on Intel

Published Apr 29, 2014 at 3:00PM

Is this for you? This is for *Pro* members who own shares of **Intel** (NASDAQ:INTC) and have July 2014 $25 covered calls written on them.

How You Participate

- **Trade:** Use a rolling order to buy to close your July 2014 $25 calls, and simultaneously sell to open an equal number of August 2014 $25 calls.
- **Allocation:** Roll every call you have previously written.
- **Price Guidance:** Aim for a net credit of at least $0.08, but as Friday nears, execute at the prices offered.

- **Recent Prices:** Intel, $26.50; July 2014 $25 calls (bid/ask), $1.66/$1.74; August 2014 $25 calls, $1.78/$1.79. See current prices.

What We're Thinking

Intel will pay its next $0.225-per-share dividend on June 1, but its ex-dividend date is May 5. This means that folks need to own shares by Friday, May 2, in order to get paid the June dividend. Our July $25 covered calls currently have less time value than the dividend is worth ($0.20, splitting the bid/ask), meaning we strongly risk having our shares called away (and not receiving the dividend) if we don't roll our calls this week.

It's unfortunate that this is the case, because this is not a roll we're anxious to make. But ultimately it's a small one-month difference in expiration in order to keep shares that we've owned for years, avoid turnover or taxes, and earn the dividend. We're rolling out one month to August, but keeping our defensive $25 strike price. In the process, our new calls should have enough time value that we won't risk an early exercise this week (lately, their time value at the ask is $0.28).

Thanks to this roll, we'll keep our stock, enjoy the dividend, and still have our shares covered against about $1.78 (or 6.7%) in potential downside. We also continue to seek to earn option premium as additional income.

More That Matters

- **Maximum Loss:** Our exposure remains the same as stock ownership, minus the credits we have in the covered calls.
- **Maximum Gain:** Currently, our profit potential is limited to the credits in the calls, since they're in-the-money.
- **Breakeven:** Around $24.72 per share on these covered calls; our stock position is lately up 29% for us, not including several years of dividends.
- **Follow-Up:** As long as it's attractive, we aim to keep managing the covered calls to keep our shares and ideally earn premium, too.

Alternative Trades

- If you wrote puts on Intel as an alternative trade, just wait for those to expire as income. If you wrote different covered calls on Intel, make sure that they have more than $0.225 in time value, so you don't risk losing your shares this week. If they lack that much time value, roll to a different option (ideally the one in this trade).

Pro Can Help

- **Want to learn more?** See our guide to writing covered calls in our sister service, *Motley Fool Options*.
- **Questions?** We'll try to cover (ha) any questions you have on the *Pro* Intel board.

Sell GrafTech International

Published Apr 29, 2014 at 1:20PM

Is this for you? This trade is for Fools who own shares of **GrafTech International** (NYSE: GTI).

How You Participate

- **Trade:** Sell GrafTech International.
- **Allocation:** We recommend selling all shares. For *Pro*, that is 4,500 shares and 2.6% of our portfolio.
- **Price Guidance:** Be patient. Use a **limit order to sell at $11.20 per share** or higher.
- **Recent Price:** $11.50
- **Scorecard Status:** Sell

What We're Thinking

For businesses that are struggling, sometimes just the promise of doing less is a big deal. That's what happened when GrafTech announced its "rationalization plan" after its third quarter, promising to close two smaller electrode plants, eliminate 20% of its workforce, and slim down its cost structure. The market applauded these measures and sent shares up 40%, but we can't ignore the reality that brought all this on: GrafTech operates in a competitive industry plagued by cash-strapped customers and, it seems, increasingly irrational competitors. We have long believed that adoption of electric arc furnaces (EAFs) to produce steel abroad and a position as a quality leader in electrode manufacturing would be enough to overcome the competitive landscape and enable GrafTech to earn acceptable returns over a cycle. But we're not so sure anymore, and here's why.

- **Weak EAF adoption in Western economies:** Even though the benefits of EAF steel production are well-known (lower energy consumption, lower CO2 emissions, more flexible cost structure), Western economies have failed to embrace it as quickly as anticipated, and with the North American energy boom dampening a rise in global energy costs, the cost of running more energy-intensive facilities may not be felt as painfully.
- **We aren't so confident GrafTech will win:** Even though we believe in the long-term trends favoring EAF adoption, there is no guarantee GrafTech will succeed in providing electrodes to those facilities. Chinese and Indian electrode producers have continued to expand output even in the face of low demand, and we don't see evidence that more rational behavior or meaningful consequences are on the horizon. Even though the steel cycle may be firming, electrode pricing may not recover in kind.

As if this operating environment weren't challenging enough, management and the board of directors are engaged in a proxy fight brought on by a group led by former director Nathan Milikowsky. Milikowsky's criticisms have already resulted in a new CEO, but his plans to fix the company seem to revolve around competing on market share — not quality. We think this is a dangerous game given the competitive landscape, because it implies accepting lower margins. Another possible consequence of this brouhaha is that new CEO Joel Hawthorne has failed to communicate his long-term vision for the company. After numerous unsuccessful attempts to talk with members of management (who were unresponsive and even questioned why they should talk with us), we're left guessing blindly, which lowers the confidence we have in assessing the risk-and-reward equation. So, with shares trading a bit above fair value (which historically has been a volatile number), we're choosing to let our position in the steel-company supplier melt away.

How It *Doesn't* Fit Into *Pro*

We don't mind the volatility of cyclical businesses as long as we believe there are underlying secular growth trends that create the possibility of strong compounding over cycles. We're now questioning that with GrafTech, and think our capital will be better invested elsewhere. We're happy to have exposure to industrials, manufacturing, and emerging markets via **Tupperware** (NYSE: TUP), **Valmont** (NYSE: VMI), **Gentex** (NASDAQ: GNTX) (three companies that will talk with shareholders, incidentally), and the **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS). If you haven't matched our allocations there, do so. Meanwhile, we look forward to putting this capital to work elsewhere.

Pro Can Help

- Questions? We smelt answers on the [GrafTech International discussion board].

News: Mr. Market Questions Parexel's Partnership Value

Published Apr 28, 2014 at 4:38PM

Fools,

Parexel International (NASDAQ: PRXL) was down 7% today. I don't always feel the need to comment on a 7% swing (they're not that uncommon), but because the news that likely caused the price move could have business implications I figured I'd throw my hat in the ring. Parexel announces earnings tomorrow, so we'll hear more in short order. For now, here are my thoughts.

Bryan (TMF42)

What Happened?

This Merger Monday featured two large health care announcements. Shares of British pharmaceutical giant **AstraZeneca** (NYSE: AZN) soared 12% today as news broke that **Pfizer** (NYSE: PFE) is willing to purchase the company for around $100 billion. The strategic fit of the oncology franchises seems like a no-brainer, and the fact that AstraZeneca is a UK domiciled company suggests that Pfizer will save a ton on taxes by using cash that is trapped overseas. The second deal, much smaller in size, has **Forest Labs** (NYSE: FRX) offering $1.5 billion to buy **Furiex Pharmaceuticals** (NASDAQ: FURX). Both of these deals see big companies getting bigger – with promises of the business combinations leading to cost savings and possibly bolstered research departments.

It is that last piece that likely sent shares of Parexel lower. At the end of fiscal 2013 Pfizer accounted for 17% of Parexel's revenue. Pfizer has been one of the early adopters of the partnership outsourcing model. As a refresher, this model centers on biopharma companies (like Pfizer) integrating tightly with a large contract research organization (like Parexel) for a baseline of R&D work. The relationship allows the biopharma company the ability to keep a smaller R&D department (which offers cost savings), outsource trials work to its trusted partner, and allow it to spend more time on what it does really wellt: drug discovery and drug marketing. Outsourcing the more rote portion of the value chain, clinical trials, to a specialist gets better results and costs less.

What Does It Mean?

The worst case here is that the combination of two mammoth biopharma companies may provide Pfizer some reason to take back its clinical trials work in house. AstraZeneca has not embraced the partnership model, but Pfizer has. If a Pfizer/AstraZeneca merger go through the combined entity would need to decide what role its CRO partners will play. That unknown is scary for Parexel because 17% of revenue is potentially at stake.

The less bad case is simply that a combination creates a mammoth biopharma company with even stronger contract pricing levels. I don't think this is all that likely – what good does it do Pfizer to bleed its chosen partner? A poorly balanced partnership would also encourage cutting corners and would likely hurt trial performance. In any case, larger biopharma customers does probably put a cap on how high CRO profit margins can get. But that was never the basis for our thesis. (Margin improvement, yes, but not 'margins to the moon'.) I view the biopharma/CRO relationship as symbiotic, not cut-throat.

To be clear, this could just as easily be a boon to Parexel (run some portion of AstraZeneca trial work through the Parexel network – more revenue and ability to leverage its fixed costs) as it could be a punch to the gut (lost business or lost pricing power) – but the market's reaction has clearly cast its vote in the direction of a punch to the gut. I'm not so sure this awful news.

Here's What We Know

- Pfizer's behavior has recently been to outsource more to Parexel, not less. It accounts for 17% of revenue (as of the 2013 10-K).
- AstraZeneca recently laid off a 5,600 workers – at least 1,600 of those jobs came from R&D. In addition, AstraZeneca folded plans to expand R&D in Bangalore.
- Whatever happens, there will little immediate business impact. Trials take time and Parexel will complete the work it is already engaged in.

Pro's position in Parexel is now modestly in the red and down to 2.9%. I'm inclined to leave the shares rated Buy knowing that we'll learn more tomorrow and that the bulk of our thesis rested on analysis that the partnership model was superior to the transaction model – I have seen no evidence that Pfizer has changed its mind on that stance either. Whether we change our mind or have our thesis confirmed, you'll be the first to know.

From Strategy to Valuation

Published Apr 28, 2014 at 4:00PM

Pro Guidance Changes

- None this week

Dear Fools,

Starbucks (NASDAQ: SBUX) carries a $54 billion market value and is followed closely by at least 24 highly paid sell-side analysts patrolling Wall Street. So what business does a (much) more modestly paid Foolish analyst roaming the colonial bricks of Duke Street have trying to more accurately estimate the intrinsic value of the coffee king? Well, that analyst is me, and if I weren't open to thinking a bit differently than my brethren in the Big Apple, I would be neither Motley nor Foolish.

Nominate a Fellow Fool!

Pro Polaris Award 2014

Fools, it's time to honor our amazing community by nominating those members you think especially distinguish themselves on our discussion boards. We'll be accepting your nominations through May 1; the winner receives a shiny discussion-board charm and $250 toward their choice of Apple or Starbucks! See the full details here.

As evidence of my willingness to think differently, here are three takeaways from Starbucks' second-quarter earnings. These observations are probably too nebulous to ever find their way into the big-broker valuation models, but they feature prominently in mine. Although the concepts are a bit squishy, the attempt to analyze how they may create value is very serious and rooted in finance and valuation theory. The quest to go from strategy to value is challenging, but it's worthwhile because so many other analysts don't even try.

Ability to Manage Through Difficulty

Starbucks has struggled in Europe for years. Even with around 2,000 stores in the region and a mature coffee culture already in place, customers found the Starbucks experience poor and the division struggled to make money. In fiscal years 2010 through 2012, Starbucks' European division (which also includes the Middle East and Africa) earned only $40 million in pre-tax profits off of more than $3.1 billion in sales -- a pre-tax profit margin of only 1%, which is a few venti Frappuccinos short of the 19% the rest of the company earned. Frustrated, CEO Howard Schultz threw talent at the problem, putting first Michelle Gass and then Cliff Burrows in charge of engineering a turnaround focused on building brand relevance, improving the in-store experience, and licensing more stores. The plans are finally starting to take hold: The last four quarters have seen accelerating same-store sales growth (up an impressive 6% this quarter) and profitability beginning to climb toward longer-term targets.

How does managing through difficulty affect value? Starbucks was able to turn around its European operations by narrowing its focus -- doubling down on the relationships it builds with its customers. It sounds silly, but a concerted effort to write names on cups signaled the reestablishment of the barista-customer relationship and the company's determination to make sure the brand was relevant because of the relationships and experiences, not just the product. Knowing that the executive office is willing to deploy top talent to fix trouble spots and that the first steps to recovery involve better and more personal service gives me confidence to make longer-term forecasts with the belief that the Starbucks brand can endure and remain relevant to customers. This relevance should translate to sustained elevated profitability 20 years into the future (in my model), which drives value.

The Third Place Lives On

For the past 13 years, Starbucks' Americas division (mostly stores in the U.S.) averaged same-store sales growth of 5% a year -- an astounding feat. Given its almost 14,000 locations, we'd be lower-case fools not to wonder whether maturity, and much lower sales growth, will be brewed into the next pot. But much of the commentary on the conference call was about the success of the food program, starting with the La Boulange upgrades to the pastry case and slowly extending to better lunch offerings. The opportunity to improve the food attach rate (the number of transactions in which a food item is purchased, currently about one in three) is immense, and improvements to the existing food lineup and headways into lunch options are already bearing fruit. Management also commented that its evening beer-and-wine tests have been a success; they believes there's room for 1,000 or so locations offering the expanded evening lineup. So far, the success seems to be attributable to Starbucks offering a comfortable, convenient place for friends to meet up rather than a strong attraction to alcoholic options. Schultz has been preaching for years that Starbucks is a "third place" between home and work; the company seems to be breathing new life into that role as works toward becoming a relevant stop-off for more hours each day.

How does the revival of the Third Place affect value? If Starbucks has success in increasing its lunch, happy-hour, and evening sales, its mature Americas store base should be able to sustain elevated same-store sales growth for years -- 4.5% per year over the next decade in my model. And offering additional food and beverage choices requires little additional investment (the stores are already built and the staff hours are already logged), so the added business should translate to high returns on modest incremental capital investment. Big profits and modest investment are the recipe for strong free cash flow (about 8% of sales in my model) and increasing value.

Playing Offense

At the end of January, Starbucks announced a few promotions and the expansion of its senior leadership team. This move shored up the day-to-day management of the core business while freeing up Howard Schultz to focus on innovation, dream big, and expand the vision of the company. To me, this announcement was a clear sign that the core business is set up for years of success and that Schultz can turn his attention to the factors that will drive growth five years from now. Right now, it looks like Schultz is spending his time on mobile payment initiatives; on the call, he noted that Starbucks has been approached by several retailers and tech firms about possibly licensing some of its technology. The company began planting the seeds for its digital marketing and payments system years ago, and it's now on the cusp of monetizing that work in a way that compliments its benefit to the core business. I believe this is just one of the areas Schultz is focusing on -- he's likely making long-term bets on several fronts with large market opportunities (perhaps health foods and tea in the near term, sustainable farming and supply chain changes down the road).

How does playing offense affect value? Playing offense allows Schultz to expand the vision of Starbucks well beyond beverages. It also keeps employees challenged and thinking big. It's difficult to capture this undefined "what if" in a spreadsheet, but my attempt takes the form of sustained earnings growth and a 25% weighting to the "bull case" scenario. (My model has three scenarios, bear, base, and bull; with Starbucks, I give the bull case a 25% probability of occuring.) Under the suite of bull-case assumptions -- an attempt to capture how the company could grow if many things go well -- Starbucks could be worth $107 per share.

The *Pro* Bottom Line

A willingness to factor in softer elements of company strategy, in my opinion, gives individual investors an edge. Quantifying the ability to manage through difficulty, the reinvigoration of Starbucks as the Third Place, and a visionary leader able to play offense is an imprecise challenge, sure -- but these things are just as likely to affect the company's financial future as its coffee hedging program and new store opening costs. They contribute to our belief that Starbucks shares are currently undervalued and worthy of a 2.9% allocation. Starbucks remains a Buy.

Onward,

— Bryan (TMF42)

Pro Completed Trades (see all trade alerts)

- None this week

Your Most Active Conversations

Today Past 7 Days Past 30 Days

Starbucks Brews Impressive Results

Published Apr 28, 2014 at 10:39AM

Pro's Take: SBUX Q2-2014 Earnings

Starbucks (NASDAQ: SBUX)

Quarter Quick Take

Global same store sales (+6% consolidated, +6% Americas, +6% EMEA, and +7% CAP) and accelerating channel development growth drove another good quarter for Starbucks. Margins expanded in all four segments and the company raised FY-2014 EPS estimates to $2.62-$2.68. Food – primarily from the rollout of La Boulange pastries – and effective mobile marketing brought customers into Starbucks stores despite horrible weather and show a glimpse of the levers that exist to continue driving future sales. The quarter's big news is that Starbucks is investigating the license of its digital payment, loyalty, and marketing assets to other companies.

....

Q2-2014

Sales growth: +9%

Operating profit margin: +130 bps to 15.1%

EPS growth: +17%

....

Guidance Update

Starbucks is performing as expected so far this year – it has raised EPS guidance after its first and second quarter suggesting it will continue compounding intrinsic value. Nothing in this quarter caused me to rethink any longer-term assumptions, but accounting for the time value of money, the company's fair value ticked up a few bucks and is on track to hit $78 by the end of its fiscal year. Pro has a 2.9% allocation, shares remain a Buy and are undervalued. We are looking for opportunities to add to our position.

Updated guidance: Buy (no change)

Recommended Allocation: 2.9%

Fair Value estimate: $75 (up from $73)

End of Fiscal Year expected FV estimate: $78 (no change)

CAM price: $59 (no change)

Pro has a 2.9% allocation to Starbucks. Members lacking a (full) position should feel comfortable purchasing shares today – they're priced to notch NS-like returns over the long-run. Writing puts to buy shares lower is also a sensible strategy. If given the opportunity, I would look to add to this position.

Our Thesis

We believe the coffee is just a gateway for the company to repeatedly sell customers an experience rooted in comfort, quality, health, community, and conscience. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand into new products, new platforms, new dayparts and new brands. We expect new store openings across the globe to strengthen the company's brand and cost-based competitive advantages and improve profitability over time.

The Most Important Things

1. ***Americas store performance.*** At the end of 2013, the Americas segment still accounted for 75% of Starbucks' total revenue – so as *it* goes, Starbucks financial performance goes (for now). Americas comparable store sales growth was up +6% driven by a +2% growth in traffic and a +3% growth in ticket. The company's ability to drive sales on such a large and mature base is impressive. Comments during the call revealed that food (primarily La Boulange) was the largest driver of incremental sales. This benefit should continue as La Boulange pastries are put into more US stores through September. Store unit volumes and profits ticked up over Q2-2013 and management commented, for the second quarter in a row, that the opportunity in the US and Canada for more stores remains huge. This opportunity seems to be in drive-through locations (in popularity and ability to drive higher food attachment), the economics of "unique configuration" stores, and increasing food options making marginal locations more economically viable.

2. ***Channel Development.*** As the company's second largest segment, CD leverages the brand strength of Starbucks' cafe stores into alternate channels (primarily grocery stores). Segment sales grew 10% (up from 7% last quarter and expected to accelerate through the rest of the year) but profits were up 35%. VIA and K-Cup sales are strong and new flavors are on the way. Starbucks K-Cup sales appear to continue taking share. Lower coffee costs helped drive operating margin expansion to 34%. The company also called out strength in ready to drink sales in some Asian markets.

3. ***Future growth drivers.*** There is quite a bit to cover here – with all this opportunity comes heightened execution risk, but so far, there are no cracks in the foundation. (A and B) With the pastry portion of the La Boulange roll-out about three-quarters complete in the US Starbucks is turning its sights to lunch. Remember, the LB roll-out was measured, with lots of test and learn. The company seems confident it understands the formula and is looking to add incremental food options to the mix. This should drive transactions, ticket, and food attach rates. It will also introduce further complexity to orders and throughput. With the potential for so many hiccups, I expect lunch to be a 2015 store more than a 2014 store. (C) Starbucks also announced that its "evenings" program tests were a success and it would begin expanding the program to more than 1,000 stores. Interestingly, evenings has seemed to revitalize Starbucks as the "third place" – with shared platters among friends being the centerpiece of the evening hang out. (D) Carbonated beverages will be rolled-out in 3,000 US stores as well as some Asian stores, just in time for summer. (E) Teavana products will start showing up more in Starbucks stores, and a new tea with Oprah's name on it could speed up acceptance. (F) Schultz announced that Starbucks has been approached by "tech companies and national retailers" to see if the company would consider licensing or white labeling its mobile platform. This underscores the strength of the Starbucks digital program and validates the technology. Schultz says "we are actively

pursuing a number of conversations because we strongly believe that, one, there is a tidal wave of consumer adoption, smart phones and mobile commerce, and we are in the sweet spot of being in a position to take advantage of that in a very unique fashion." This could represent a very high margin, recurring revenue stream for the company.

WWTN

The world's specialty coffee leader will continue its global retail expansion and leverage its brand to offer consumers more choices — including tea, carbonated beverages, and juice – at more times in more convenient locations. The company has dynamic growth opportunities, operational discipline, and deft management. Starbucks stores and its trusted brand are a powerful platform off of which to introduce new products, build relationships with customers, and compound intrinsic value.

Conference Call Notes

- Q2-2014 was the 17th consecutive quarter of comp growth greater than or equal to 5%. The +6% comp growth in EMEA was its strongest in 14 quarters, suggesting that the turnaround of that segment is firmly under way.
- On new stores: Starbucks claims it has never been better at site selection and new store opening procedures. New store sales to investment ratios are not over 2-to-1. The company continues to believe drive-throughs and unique-format stores are large opportunities. (This marks two consecutive calls where management hinted that the U.S. is nowhere near saturation. My base case calls for 19,500 Americas stores by 2022 – if the success of alternative format stores continues this estimate may prove a bit low.) Cliff Burrows said: "There is a strong indication that we have a significant upside in the US and in Canada. Also, I think we have done a very good job over the last 12 to 18 months in creating store designs that are linked to real estate segmentation which gives us the ability to almost create any configuration now in terms of size and the kind of real estate it is...there is so much upside we believe in the incrementality of creating new day parts, fulfilling the needs base that customers have other than the peak morning period. And as a result of that, we can put Starbucks stores in areas that previously we probably thought were not the kind of stores that we would have gone after because they were morning day part driven."
- On Teavana: Schultz says: "By summer, Starbucks customers will be able to sample and experience a full range of Teavana branded, hand-crafted tea beverages, loose leaf teas and tea merchandise inside their local Starbucks stores." Teavana tea bars (tested in NY and Seattle) will be rolling out – for further testing – to Chicago, Los Angeles, and additional NY locations.
- On Fizzio: Hand-crafted carbonated beverages will be rolled out to 3,000 stores across the US, as well as in Singapore, Korea, and a few stores in China.
- On mobile and digital: Over 10 million customers are actively using the Starbucks mobile app. Mobile payments account for 14% of tender and 25% of transactions in company-owned stores in US/Canada. Starbucks also believes it is only scratching the surface in terms of serving up targeted offers to its members. Schultz confirmed the rumors that Starbucks may monetize its digital assets by licensing the technologies to other companies. "Today, as the retail industry's unquestioned leader in mobile payment and mobile loyalty, we are uniquely positioned to leverage our digital leadership and to both develop and monetize new platforms, revenue streams and opportunities for growth in ways that will be highly complementary to our existing core business and our customer base. By way of example, major tech companies and retailers have recently begun inquiring about whether or not Starbuck would be willing to license and/or white label our technology and mobile platforms. We are taking a very thoughtful and disciplined approach as we consider these overtures and what we believe will ultimately prove to be a very significant additional driver of long-term share value."
- On food: Food purchases are still only about 1 in 3 US transactions. La Boulange is now in 6,000 US company owned stores and 2,500 licensed stores. The bakery roll-out should be complete by the end of September. The "much larger prize" is lunch, which will be given much attention in the coming quarters. COO Troy Alstead said :food was the single largest incremental driver of comp growth in the second quarter, and food attach is clearly and consistently higher after the launch of La Boulange in the market." Later, Alstead said "we're seeing an acceleration of the contribution from food, and remember, that is coming despite the fact that food is only in three-fourths or so of the US system...we'll always do learnings and check and adjust...in fact, throughput will be at its highest level, highest historical level this year."
- On evenings: The evening beer/wine tests have shown great results. Alstead said: "Based on these results, we are no longer testing evenings. We are now moving forward with the rollout of the program in a disciplined way over multiple years. Ultimately, I would expect certainly greater than 1,000 stores across the US to have an evenings offering."
- On EMEA: Growth was driven by +5% transaction increase.
- On CAP: This was the 14th consecutive quarter of revenue growth greater than 20%. Starbucks opened 174 net new stores in Q2 and almost 700 in the past 12 months.
- On Channel Development: K-Cup sales are strong – up +33% in dollar terms. Margins were helped by lower coffee costs.
- On margins: Much of the quarter's margin improvement was due to lower coffee costs (locked in for 2014 and 40% is locked in for 2015 at even better prices). Since the beginning of the year Starbucks has suggested commodity costs would be a $0.09-$0.10 EPS benefit. (I suspect that we'll hear plenty of fears over margins not being sustainable because of artificially low coffee costs, but keep it in perspective – coffee is shockingly only about 15-20% of COGS and declining with new ventures. It has also navigated turbulent coffee price markets in the past. I am not worried.)

Write a Covered Strangle on Wells Fargo

Published Apr 25, 2014 at 3:40PM

Is this for you? This is for *Pro* members who own shares of **Wells Fargo** (NYSE: WFC) and can write options for income.

How You Participate

- **Trade:** Use a combo order to write a covered strangle on your owned Wells Fargo stock. A strangle consists of two legs – a written put and a covered call – with different strike prices but the same expiration date:
  - Write ("sell to open") June 2014 $48 puts
  - Write ("sell to open") June 2014 $50 covered calls
- **Allocation:** Write one strangle (one written put *and* one covered call) per 100 shares of Wells Fargo you own. For *Pro*, that's 12 puts and 12 calls.
- **Price Guidance:** Use a limit order. Aim for a credit slightly higher than the combined bids of the put and call options (around $1.33 as of the day we issue this trade; realize that it will change. We recommend you accept no less than $1.15).

- **Recent Prices**
  - Wells Fargo: $49.15
  - June 2014 $48 puts (bid/ask): $0.76/$0.81
  - June 2014 $50 calls (bid/ask): $0.57/$0.60

Why Write a Strangle?

- With our North Star in mind, *Pro* has been seeking income trades as an alternative way to generate portfolio income.
- Wells Fargo pays a nice dividend (2.8% if you annualize next quarter's expected payout) and tends to trade within a narrow range, making it a worthy target for a covered strangle.
- Covered calls alone don't pay very well, so adding written puts allows us to earn an acceptable yield. Additionally, we'd be happy to own more shares of this well-run compounding machine (if necessary) at a net price of 87% of our fair-value estimate.
- This income-generating strategy could earn us a 2.7% yield on shares in 56 days, or about 19% annualized.

Why a Covered Strangle?

A covered strangle is an income-generating strategy that allows us to profit within a certain range of stock prices. Specifically, at expiration, if the stock price is ...

- Less than $48: We'll be assigned to buy new shares at a net price of $46.67.
- Between $48 and $50: Our covered strangle will earn us the equivalent of a 2.7% yield on the current share price in 56 days.
- Higher than $50: Our covered calls could be exercised, forcing us to sell our shares at a net $51.33 if we don't take action.

Note that the third bullet point above violates Rule No. 1 of writing covered calls: Don't write calls on shares you don't intend to sell. We want to continue to hold Wells Fargo and we intend to roll this strangle as needed, but if we are forced to sell our shares, we'll do so at 96% of our $53.50 fair-value estimate — not a terrible outcome.

If you've read our write-up on Wells Fargo's recent first-quarter 2014 earnings, you know that we view the business and the stock favorably. It's a well-run bank with limited downside and steady but unspectacular upside. With no catalysts in the coming months, we think it's unlikely that the stock price will run away from us in either direction, which makes this covered strangle an opportunistic attempt at earning some income.

Choosing a June expiration means we will sidestep any potential earnings surprises (and associated stock-price volatility) coincident with Q2 earnings, which will be announced in mid-July. Our $48 and $50 strike-price choices provide us with acceptable outcomes on either end of the strangle, as well as flexibility to roll up or down if necessary.

More That Matters

- **Maximum loss:** The same as stock ownership, minus the credits we received for setting up the strangle.
- **Maximum gain:** Our upside is capped at $51.33, or 4.4% higher than today's price.
- **Breakeven:** There are two breakeven points for strangles -- in this case, $46.67 at the low end, and $51.33 at the high end.
- **Follow-up:** We'll likely write a new strangle if this position expires fully as income. If not, we plan to roll the strangle to avoid accepting new shares (for the written-put leg) or selling our owned shares (for the covered-call leg).

Alternative Trades

- None. Neither individual leg (the written put or the covered call) pays well enough on its own, so we only suggest pursuing this strangle.

Pro Can Help

- Want to learn more? See our guide to strangles in our sister service, *Motley Fool Options*.
- Step up to the tellers at the Wells Fargo discussion board with questions!

Earnings: GNTX Q1-2014

Published Apr 25, 2014 at 1:08PM

Pro's Take: GNTX Q1-2014 Earnings

Gentex(NASDAQ: GNTX)

Quarter Quick Take

Numbers are a bit inflated (when comparing to prior periods) because of the inclusion of HomeLink, but regardless, underlying business performance was strong. Offshore performance drove unit and sales results, margins improved, and cash flow generation was strong. Gentex remains in excellent financial health and its strategy is sound.

....

Q1-2014

Sales growth: +25%

Operating profit margin: +520 bps to 28.9%

EPS growth: +47%

....

Guidance Update

I'm not making any changes to our guidance for Gentex after this quarter. RCD mirror declines continue to weigh on North American mirror unit volumes (this should continue throughout the year) but Europe has begun to show signs of turning. In aggregate, results are tracking nicely against our expectations.

Updated guidance: Buy (no change)

Recommended Allocation: 3.3%

Fair Value estimate: $33 (no change)

End of Fiscal Year expected FV estimate: $35

CAM price: $25 (no change)

Pro has a 3.7% allocation to Gentex. Members lacking a (full) position should feel comfortable purchasing shares today – they're priced to notch NS-like returns over the long-run. Writing puts to buy shares lower is also a sensible strategy. If given the opportunity, I would look to add to this position.

Our Thesis

Gentex (1) will continue to penetrate the global light vehicle market with its auto-dimming mirrors as automakers focus on safety and technology and (2) will drive up the value embedded in each unit through new technology and functionality. We expect IP, know-how, and manufacturing-based cost advantages to strengthen over time and help Gentex sustain margins and excess returns.

The Most Important Things

1. ***Penetration: Unit growth vs. auto production.*** Over time, we want Gentex's auto-dimming mirrors to become standard in every car produced. If, over time, the company is growing units faster than auto production, it is moving in the right direction. Interior mirror unit volumes were up +12% and global auto production was up +11% (suggesting further penetration). Once again, the strength was not evenly spread. North American interior unit growth continues to suffer because of continued pullback in sales of RCD units. In some cases (not all, of course), where Gentex has lost the RCD sale, it has lost sale of the mirror as well. In North America, interior units slid -3% while auto production expanded +3%. Domestic weakness was offset by offshore strength. IHS data for Europe + Japan/Korea shows production growth of +15%, while Gentex interior unit shipments grew +23%. Exterior mirrors continue to increase penetration too, with both North American and offshore units increasing faster than broad production (+5% for North America and +21% for offshore).

2. ***Pricing and value: Unit growth vs. automotive segment sales.*** Auto makers force annual price concessions on their suppliers and Gentex isn't immune. Management contends that recent concessions have been in the range of 2%-3% (well within historical norms). Gentex strives to reduce production costs and add new features to hold the line on average selling prices and gross margins. During the quarter, total units (interior and exterior mirrors) increased +13% and automotive segment sales were up +24% (including HomeLink). Making my best estimate adjustment for sales without HomeLink, I believe automotive segment sales were up around +11%, suggesting lower ARPU and consistent with the continued pressure from lost RCD sales.
3. ***Margin performance.*** During the quarter gross margin was 39.1%, up from 34.7% in Q1-2013. For the trailing twelve months, gross margin was 37.8% compared to 33.9% in the year-ago TTM period. If Gentex can continue its strong unit sales growth it may be able to eke out further gross margin improvements, but they will be tough to come by. management is clear that it expects to hold the line on 39% gross margins (give or take), but at the moment it doesn't see dramatic upside. SG&A and R&D expenses are in-line with historical norms and contributing to operating margin expansion (28.9% in the quarter versus 23.7% last year).

WWTN

Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in all-time high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house development should continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time.

Conference Call Notes

- The quarter's solid results were driven by strength in Europe, Japan, and Korea.
- SVP Mark Newton addressed the KTSA legislation: "*On March 31, 2014, the National Highway Traffic Safety Administration issued a final rule requiring rearview video systems in the US light vehicle application space by May 1, 2018, with a phase-in schedule requirement of 10% of vehicles after May 2016, 40% of vehicles after May 2017, and 100% of vehicles after May 2018. In this release, NHTSA estimated that 57% of model year 2014 vehicles already have a rear video system, and that even without a final rule, 73% of the vehicles sold in North America would have already included a rearview video system by 2018. This NHTSA ruling, as is clearly indicated from the percentage of US vehicles already having a solution, does not currently indicate an immediate opportunity for new Gentex RCD mirror applications. Customer opportunities may exist by the time the 100% requirement is in place, but no new material guidance is available from us at this time. The Company's rear camera display mirror application meets all the technical requirements of the NHTSA ruling, when installed in a vehicle and appropriately paired with an OEM specified camera. We have previously reported that in anticipation of the NHTSA ruling requiring rearview video systems, that four of our customers had implemented standard equipment rear video display in the radio in place of the Gentex RCD mirror option, and that the Company would experience those lost US applications on interior mirrors in 2013 and 2014. Actual RCD unit shipments for calendar year 2013 decreased 21% as a result, and we expect similar unit shipment declines in 2014. But in spite of this headwind, the Company is growing with new technology in mirrors, cameras, and HomeLink, and this is the area we are hoping to emphasize with you in this earnings release and in further discussion.*"
- On Guidance: GNTX estimates net sales in Q2 up +15%-20% and expects gross margin in the range of 39%-39.5%.
- On the integration of HomeLink: It continues to run slightly ahea of expectations. The focus so far has been on customer approvals, transitioning manufacturing to Zeeland, Michigan, integrating suppliers and compatibility partners, order processing, logistics, sourcing, and new product development.
- On RCD: Gentex continues to see RCD applications for the mirror outside the US.
- On the balance sheet: Management is going to wait until the back half of the year before determining the financial plan – the priority of debt repayment, share repurchases, cash build, etc. Gentex has $3.34 in cash per share, about 11% of the stock price.
- On the risk of cameras replacing mirrors: Mark Newton handled this question well, noting that the risk "is not new" and that safety-related barriers are real and of the utmost importance. This is the answer we'd expect to hear, but he went on to explain in more detail that, regardless of how this plays out, Gentex will be a player in the solution. The company has always kept its R&D work very close to the vest, but he revealed that Gentex was "*a market leader in designing and supplying the video camera for the Audi E-tron digital rearview mirror development in 2012.*" This was news to me, and provides added confidence that the disruption and displacement risk often referred to (for as long as I have followed the company) isn't lost on Gentex, and it hasn't sat idly by. Newton continued: "*We look forward to further product announcements in this area. So, for us overall, it's our intention – and has long been – to participate in both sides of this as a market leader.*"
- On success in Europe: SVP Mark Newton summed it up: "*It's starting to become visible that we're penetrating. And we're achieving new applications in addition to increasing take rates.*" Notably, it seem Gentex is having success moving "down market" into less expensive cars, which is a strong positive.
- Hinting at acquisitions and life outside the mirror: The new blood running Gentex (even though Bauer is still CEO) is clearly focused on the company's strategic options and sustaining growth. The stance to take on debt, the possibility of issuing shares, and recent comments all suggest Gentex is open to making a big splash – which is a distinctly different view than has pervaded the last decade.

Earnings: PRXL Q3-2014

Published Apr 25, 2014 at 1:08PM

Pro's Take: PRXL Q3-2014 Earnings

Parexel International (NASDAQ: PRXL)

Quarter Quick Take

Parexel had a very good third quarter. Organic revenue growth drove impressive gross margin expansion (+360 bps); each of the company's three of Parexel's three segments expanded margins. The business showed its operating leverage, turning the 8% service revenue growth into +20% EPS growth. With one quarter left in the fiscal year, management raised its forecast for revenue and earnings (by about 1% and 7% respectively).

The quarter's business performance, however, was overshadowed by news that Pfizer (NYSE:PFE) intends to purchase AstraZeneca (NYSE:AZN). I outlined my initial reaction here. Since then, AstraZeneca has declined Pfizer's offer, but the market seems to think PFE will simply raise the price and ultimately prevail. CROs continue to be under pressure due to fears that a combined Pfizer/AstraZeneca will eliminate redundant drugs in development, causing the CROs to lose near-term business. This is a possibility, but overshadows the long-term likelihood that the combined entity will, over time, drive more trials work to CROs under the partnership model (upon which our thesis is based). The driving factors of the merger appear to be tax related (allowing Pfizer to put trapped overseas cash to work and access a lower tax rate over the long term) as much as business related, and in no way suggest that Pfizer is souring on its adoption of the partnership model. We think the price movements create an opportunity for patient investors. [I have copied in some of management's comments on all of this in the Q&A section below.]

....

Q3-2014

Sales growth: +8%

Operating profit margin: +270 bps to 10.6%

EPS growth: +20%

....

Guidance Update

Business is tracking well against our thesis so far. Margins have improved slightly faster than modeled revenue growth outside of the core CRS segment have been a touch light. I'm not making any changes to the Fair Value Estimate, but I am raising the Consider Adding More price to $40 with as I get more comfortable covering the company, gain confidence in the thesis, and watch the company strengthen its balance sheet. Given the stock price discount to Fair Value, we're moving shares to Buy First.

Updated guidance: Buy First (up from Buy)

Recommended Allocation: 2.8%

Fair Value estimate: $54 (no change)

End of Fiscal Year expected FV estimate: $57

CAM price: $40 (up from $38)

Members lacking a (full) position should feel comfortable purchasing shares today – they are one of the rare opportunities we see to buy a good business for less than we think it is worth. Writing puts to buy shares lower is also a sensible strategy. We're considering this action ourselves.

Our Thesis

Because of its reputation, global reach, and technology prowess, Parexel International will win its fair share of the growing market pharmaceutical development market. In addition, we expect the proportion of R&D dollars outsourced to contract research organizations to grow as large biopharma companies adopt the strategic partnership model and smaller biotechs become responsible for more drug discovery. Finally, as new business wins mature, the true earnings power and margin potential of the company's business will shine through.

The Most Important Things

1. ***Penetration and Backlog***: Penetration refers to the proportion of biopharma R&D dollars that go to CROs versus being used in-house for development and provides evidence that the biopharma/CRO partnership model is winning. We'll check in on this driver annually, when the best data becomes available. In the interim, we'll monitor backlog trends to ensure Parexel is filling the pantry with future business – backlog that converts to sales usually represents ~80% of the sales in any given quarter, so strong backlog growth suggests strong future sales growth. Backlog's ability to explain future sales is influenced by conversion rates and cancellation rates, so we monitor this, too. Backlog grew 2% sequentially and 9% year over year. It has grown sequentially for four consecutive quarters now. The trailing book-to-bill is 1.15, a bit below the 1.20 goal, but strong enough to support 10% revenue growth going forward.

2. ***Margin Performance***: (I remove pass through revenue to more clearly track the business, so my numbers may be different from what is reported in the press.) Company gross margin expanded 100 bps sequentially and 300 bps year over year. The impressive improvement was driven by gross margin expansion in all three

business segments. We expect this trend to continue, although not to this magnitude, with CRS and PI leading the way. The how is also important; much of the improvement appears to have life remaining – the only source of improvement that appears maxed out is the benefit from using fewer contract workers. I expect the next step higher to come from increased productivity of recent hires. SG&A is temporarily elevated due to important investments in the business, but company operating margins increased to 10.6%. This reflects 100 bps improvement over last quarter and 270 bps improvement over last year.

3. ***PI Business Trends:*** Technology is a core competence for Parexel. The company's PI segment is the lifeblood of innovation for transforming the traditional clinical trials process into a more efficient, more effective, technology-driven one. We want to see this business perform well to ensure it remains a competitive differentiator for Parexel and helps it win business in its CRS and PCMS segments. Now reaching scale, we also expect PI to exhibit operating leverage and become a more meaningful portion of profits. Revenue continues to grow around a 9% rate, organically. New business awards and the pipeline for new business appear strong. Gross margin declined sequentially (to 44.3%), but continues on its ascent toward 50%. The biggest contributors to this margin expansion have been scale and the shift of activities to low-cost countries. I expect PI to achieve 55% gross margins in seven years given its current product mix – performance is tracking nicely.

WWTN

Helping pharmaceutical companies get drug candidates to market, Parexel is poised to benefit as those companies gradually outsource more of this process. We believe this is likely to continue even if large biopharma companies merge and Parexel loses a bit near-term trials work as pipelines are combined and redundant drugs are eliminated. We also expect margin expansion as recent investments pay off and continued growth of the Parexel Informatics technology segment.

Conference Call Notes

- It probably goes unnoticed by most, but Parexel increased the "supplemental disclosures" it releases on its company website with each earnings call. I truly appreciate this and view it as a shareholder friendly action. This company already presents things very clearly, but I applaud the additional information.
- On Book-to-Bill: B:B came in at 1.16, slightly below the company's stated goal of 1.20. While some analysts may see this as a shortfall, here is what CEO Joe Von Rickenbach had to say: "*You all know that the increment above 1 in the net book-to-bill basically is growth. If we have a 1.2 forever, we would grow at 20%. That is not our growth target. Our growth target really is as Ingo just said, roughly in the double-digits, 11%, 12% let's say. If all else stays the same, conversion stays the same, we could -- our book-to-bill could be as low as 1.12 or 1.123 maybe. The reason why we needed it at 1.2 was because we had erosion in our conversion rates over a long time. But as you, I'm sure, have observed, over the last three years or so, the conversion has basically plateaued and maybe even come up a little bit. As that happens, the net book-to-bill above 1 and the growth rates are now starting align much more. So with that, we're actually not that worried about the net book-to-bill being a tad lower. Although, of course, we're still striving higher. As I also pointed out in my comments, we have a good proposed portfolio. So fourth quarter from an opportunity perspective looks pretty good.*"
- On Contract Research Services (CRS) segment: Revenue grew +9% and gross margins improved for the fifth consecutive quarter. The margin improvement remains the result of numerous efforts and still has room to improve further.
- On Parexel Consultiing (PC, formerly PCMS) segment: Organic sales dipped slightly (loss of some business) but grew when including the HERON acquisition. Gross margins improved and remain at normal levels.
- On Parexel Informatics (PI) segment: Segment sales and gross profit grew 9% and 11%, respectively.
- On client concentration: Parexel's largest client (16% of sales) is Pfizer. Its top five clients account for 49% of sales, and its top 20 clients account for 79% of sales. The remaining 21% of sales is spread across more than a thousand customers.
- On Backlog: Backlog is $4.9 billion, up 9.3% year over year and 2.3% sequentially. Conversion and cancellation rates are in normal ranges. Right now, the backlog is filled with work from large customers, but that concentration is coming down with the recent wins in the company's Biopharm unit.
- On the PFE/AZN merger announcement: CEO Joe Von Rickenbach was asked numerous questions about this. Here are some highlights:
- ...
- "*Several biopharma companies have reported that they are engaged in strategic repositioning activities. While big pharma M&A activity in the past has occasionally caused short term disruption, in the long run it has consistently led to higher outsourcing penetration rates for our industry. Successive waves of biopharma consolidation has had less and less of a disruptive impact on us. Partly because our back log has become an increasingly larger stabilizer. In addition, the quality of our clients' portfolios has improved. We are in close communication with our clients and we feel that the benefits of outsourcing are increasingly evident to them. Combined with continuing strong opportunities from small and emerging biopharma companies and potential market share gains for the top CRO's we believe that prospects for our business continue to be quite positive.*"
- ...
- *"First of all and maybe most importantly, this is not the kind of activity that we experienced 15 years ago when this all started. In the interim, most of these large pharma companies and the industry overall for that matter has really purged their pipelines. The name of the game is not so much anymore a question of taking out projects and culling the portfolios, but much more, if you want, other strategic elements are probably overriding. So, what that means for us, specifically, is that the safety, if you want, of our projects and our work is much higher than it used to be in the past. So our review is that even if this were to happen, that the positives are actually higher because the experience has been that every time an event like this happens actually eventually outsourcing gets bigger. But the projects that are ongoing right now are very high priority for all of these companies. I would be very surprised, in fact, I would be shocked if there were delays in that. In fact, maybe the exact opposite may happen. Because they may rely on us to make sure that things stay on track. So our view is not one of concern actually that much and rather one of a situation where we can make potentially a positive contribution to keep things on track."*
- ...
- *"One of the benefits of our strategic partnerships is that we have basically an intimate discussion with them about these things. As of right now, we have been completely reassured that things are on track."*
- ...
- *"In the big scheme of things, it really doesn't even change really much of anything actually and certainly not negatively. I mean, overall, as I kind of pointed out before, we view this, actually, probably more with an optimistic approach. I think the benefits outweigh the potential downsides here -- for us, that's specific for PAREXEL."*

Intel's Results Promise More to Come

Published Apr 23, 2014 at 1:56PM

Intel (NASDAQ: INTC) reported first quarter 2014 earnings last week, and investors were sated enough to keep the stock near recent highs. Although revenue, net income, and EPS declined year-over-year, investors currently like the direction Intel is going. Even though the company lost $929 million in its young mobile operations division last quarter (and lost $3.1 billion last year in this division), management has a roadmap to turn the division profitable. Meanwhile, PC sales stabilized a bit (revenue down 1%, but units up) as companies resumed purchases. Consumer PC purchases remained relatively weak, but ticked up in emerging markets. Finally, the company's high-margin data center business continued its double-digit sales growth, up 11%. With Intel's mobile division starting to get traction, investors may be banking on more good news down the road.

Foolish Summary: Intel remains an exceptional operator in an average industry. Although the industry is filled with competitors, Intel stands out for its manufacturing and design prowess, its market share in PCs and servers, and its sheer size. Now its size is letting it start to take market share in mobile, mainly tablets. The key insight garnered this quarter is that Intel doesn't fear selling into lower-end markets, including tablets, because it believes it can eventually maintain healthy profits doing so. That's instrumental to an investment case as the company starts to sell much lower-priced mobile processors.

Guidance: The stock trades near *Pro's* $27 fair value (a fair price for a seller or a buyer), and yields 3.36%. Pro's guidance remains Buy, and we're content to manage covered calls on Intel in hopes for additional income. Assuming reasonable prices, we'll roll our covered calls whenever we need to in order to keep our shares and get the dividend. May 5th is the next ex-dividend date ($0.225), so we may need to roll before then.

Outlook

The company expects flat revenue in 2014, capital expenditures of around $11 billion (up slightly), and flat gross margins of around 61%. The data center group should grow revenue by low double digits (helped by Cloud), and the PC Client Group by mid-single digits. Overall, completely flat EPS is expected this year, and 6% growth estimated next year (helping drive our decision to write options now).

Intel Financials

- Share Price: $26.80 (up from $24.70 last Q)

Guidance

Fair-Value Est.	$27 (no change)
Consider Adding More:	$20 (no change)
Allocation	4.8% (up from 4.6% last quarter)
Yield	3.3% (down from 3.6%)
Status	Buy (no change)
Options use	Write covered calls (if you want to follow Pro)

Valuation

Metric	Multiple
EV/EBITDA	6.2
EV/EBITDA est. NTM	5.8
P/FCF Est*	15.9
P/E	14.3
P/E est. NTM	13.8

NTM = Next Twelve Months
*The 10-Q isn't filed yet, so FCF numbers are estimated.

Q1 2014 Conference Call Notes

*PC Client unit volume grew year-over-year for the second consecutive quarter, as enterprise clients bought more; mobile PC unit volume was up year-over-year for the first time since Q2 2012, while desktops were flat. Notebook unit volume was up YOY, but keep in mind that last year was very weak (inventories were low), so it was an easy YOY comparison. Inventories are now in very good shape across the chain.

*Intel's new Internet of Things division saw revenue of $482 million, up 32% YOY.

*The company has a goal to ship 40 million tablets this year. They have 90 design wins on Android and Windows, and shipped 5 million in the first quarter.

*Intel is subsidizing its mobile and communications (tablet and phone) sales, and will continue to this year, leading to large losses in this division. This "contra-revenue" is a straight deduction from revenue, and a hit on gross margins. It should start to abate (smaller losses) in 2015. Profits will take longer. But, see how Intel's size allows it to take market share by cutting prices to win designs? Then it gets into product architectures to ideally stay even as the contra-revenue ends.

*The company admits that it still has a lot to learn about being a foundry. Altera is helping them learn. Foundry partners signed up today will probably not see volume ramp until 30-36 months from now. The foundry work will run side-by-side with Intel's own manufacturing.

*14 nanometer should arrive in late 2015 or early 2016. Intel remains about 2 years ahead of competitors here, it claims.

*If Intels sells into 40 million tablets, it will have 15% to 20% market share in tablets.

*Intel believes it's crucial to be in PCs, tablets and phones, because you want products across the board being designed on Intel architecture. So, it needs to be in all of them, and win long-term contracts based on its architecture.

*CFO Stacy Smith: "We don't fear the low end of the market... Our manufacturing leadership can give us the cost structure to play profitably at the low end as well."

Property & Casualty Insurance Industry Checklist

Published Apr 21, 2014 at 4:00PM

Dear *Pro* members,

A few Monday Memos ago, I shared my investing checklist for the wireless tower industry, outlining five key areas to focus on as you research the wireless tower space. This week, I'll continue my checklist miniseries with a look at the property and casualty (P&C) insurance industry.

The Second Annual Polaris Award!

Pro Polaris Award 2014

Fools, it's time to honor our amazing community by nominating those members you think especially distinguish themselves on our discussion boards. We'll be accepting your nominations through May 1; the winner receives a shiny discussion-board charm and $250 toward their choice of Apple or Starbucks! See the full details here.

In contrast to the wireless tower industry and its three-headed oligopoly, the P&C industry is much more competitive, with the top three companies commanding only about 21% of the market, and the top 25 commanding only about 65%. (I'm focusing on U.S.-only market share for simplicity's sake.) Here are the top 10 U.S. insurers by amount of premiums written (source: April 2013 NAIC P&C Industry report):

1. State Farm — 10.3%
2. **Zurich Insurance** (NASDAQOTH: ZURVY) — 5.5%
3. Liberty Mutual — 5.4%
4. **Allstate** (NYSE: ALL) — 5.1%
5. **American International Group** (NYSE: AIG) — 4.5%
6. **Travelers** (NYSE: TRV) — 4.4%
7. **Berkshire Hathaway** (NYSE: BRK-B) — 3.9%
8. Nationwide — 3.3%
9. **Progressive** (NYSE: PGR) — 3.2%
10. United Services Automobile Association — 2.6%

With such a wide distribution of competitors, it's clear that there aren't strong barriers to entry in this industry, and competitive pressure (often in the form of pricing) is much more fierce than in the wireless tower industry. In competitive industries like the P&C industry, operational excellence is often one of the most important ingredients for success.

My P&C insurance industry checklist covers five key areas to focus on to help you find those insurance companies that are the operational cream of the crop.

Investment Checklist: P&C Insurance Industry

1. Underwriting Discipline

Perhaps the most important contributor to a P&C insurer's success is disciplined underwriting. Take a look at the company's combined ratio. If the ratio is less than 100%, it means that the company is collecting enough premiums to cover both its operating expenses and its payments on claims (i.e., the company is underwriting profitably).

Next, check how this ratio has trended historically. Is there a clear trend upward or downward? Does the company consistently underwrite profitably? Looking at underwriting trends can give you a sense of a company's discipline, the strength of its management, and the direction it may be headed.

2. Reserving History

Because insurers take on risk now and pay out claims later, they need to reserve some of their capital to pay for those future liabilities. Since no one knows what the actual liabilities will be until they happen, management must estimate expected losses and reserve enough capital to cover them.

And since reserves are based on management estimates, it's important to make sure management has a conservative history of reserving. If management is playing the earnings game by under-reserving, management is simply stealing from the future to boost today's profits.

You can find historical data on reserves and payouts in the company's 10-K. For an example of an insurer with a conservative reserving history, check out **Markel** (NYSE: MKL), which has reserve redundancies every year going back to 2003 (see page 115).

3. Investments

By collecting premiums up front and paying out claims later, during the time between premium collection and claim payment, insurers benefit from access to virtually no-cost capital (i.e., float).

In order to generate profit in addition to the income generated from profitable underwriting, insurance managers can invest their float in investment securities. Most often, insurers invest in conservative fixed-income portfolios, but that's not always the case, so it's important to review the investments.

Check out the insurer's investment portfolio and try to estimate its expected future return by comparing the split between bonds and equity. Get a sense of the riskiness of the fixed-income portfolio by looking at credit ratings and the duration of the securities.

In rare cases, great investment managers can be the single biggest driving force behind long-term returns. That's the case with Warren Buffett's investment portfolio with Berkshire Hathaway, which has helped drive an astounding 19.7% annualized growth in book value per share over the last 48 years.

4. Management

As hinted in the previous section, extraordinary management can often be the difference between an average insurer and an exceptional one. Each of the preceding three factors in this checklist is heavily influenced by management.

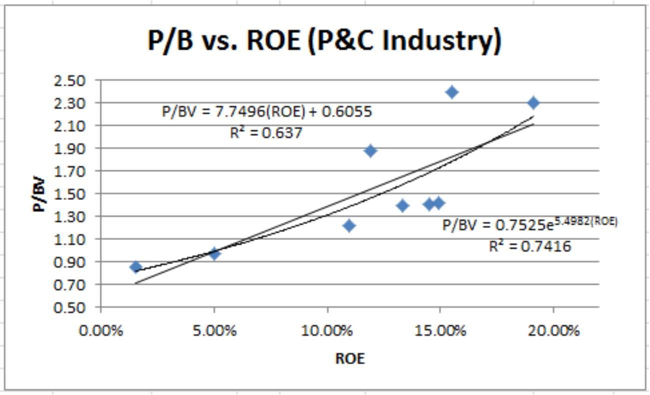
Take a look at management's tenure and track record. A good measure of an insurance manager's track record is growth in book value per share. Over the long term, anything higher than 12% annualized is pretty darn good.

Next, check management's incentives. Do the incentives align management with common shareholders? Does management own a significant amount of stock? You can find this information in the company's proxy filings. The best compensation policies are based on long-term metrics that drive shareholder returns, such as returns on capital, underwriting profitability, and growth in book value per share.

5. Valuation

Finally, armed with all this research about the company's fundamentals, take a look at valuation to see if now could be a good time to buy. My preferred metric to watch for insurance companies is the price-to-book (P/B) ratio. The more profitable the company (as measured by ROE), generally, the higher the P/B.

Here's a graph showing both linear and exponential trend lines for ROE and P/B for a peer group of 10 publicly traded P&C insurers:



Peer group: Allstate, Progressive, Chubb, ACE, Alleghany, RLI, Zurich, and Hartford. Source: S&P Capital IQ.

The Foolish Bottom Line

There you have it, Fools – my top five areas to research when looking at companies in the P&C insurance industry. We Fools love checklists because they help simplify the investing process and make sure you are focusing on the most important variables. I hope this one will help you better understand our investment in AIG and inform your future research on the industry and its participants. Just like the wireless tower industry checklist, this is a continual work in progress, so, again, stop by the Memo Musings board to give your input and/or suggestions for improvement.

Fool on!

— Billy (TMFTailwind)

Pro Guidance Changes

- **Papa John's International** (NASDAQ: PZZA): The stock moves from Buy to Hold while we reassess the valuation. We continue to own a 4.3% stake.

Pro Catch-Up Trades

- **American Tower** (NYSE: AMT): A reminder that we recently increased our allocation on this Buy First stock to 3.7%. Match us if you haven't, or write near-the-money puts (take your pick) if you'd rather target a lower buy price.
- **Oracle** (NYSE: ORCL): A reminder that we recently increased our fair value estimate to $41. We have a 4.8% allocation and Buy First guidance.
- **Tupperware** (NYSE: TUP): If you don't yet own 3% in stock, you can buy shares up to that amount, or sell to open May 2014 $85 puts for about $2 each, for a 2.4% yield in less than a month (or sell later, lower-strike puts if you want to be more defensive). Sell one put for every 100 shares you could buy at $85 (or $83 net), up to a 3% allocation.

Pro Coverage & Community

- Get Billy's take on **Wells Fargo** (NYSE: WFC) earnings.
- ADrumlinDaisy gets Foolish and asks questions about our **Coca-Cola** (NYSE: KO) position in a fashion unique to him.
- Jeff celebrates 24 for 24. All 24 of *Pro's* long holdings are making money. That's the sort of accuracy we like.
- Member nevercontent shares his screen of put-writing and (now) call-writing ideas.

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Thanks to Scott Hall (TMFRoseTint) and Brendan Mathews (TMFWillSommers) for their contributions to this Memo.

Earnings: Wells Fargo Q1 2014

Published Apr 16, 2014 at 1:14PM

Another quarter in the books, and we got more of what I've now come to expect from Wells Fargo (NYSE: WFC) - excellent execution from the management team in a less-than-robust macro environment. WFC yet again continued its streak of record quarterly profit (now 12 consecutive quarters), again achieving efficiency gains (i.e. reduced expenses) and improved credit quality in a tepid demand environment.

What Happened?

- Record net income of $5.9 billion (up 14% from 1Q 2013)
- Record diluted EPS of $1.05 per share (up 14% from 1Q 2012)
- Revenue of $20.6 billion (vs. $20.7 billion 4Q 2013 vs. $21.3 billion in 1Q 2013)
- Efficiency ratio decreased to 57.9% (vs. 58.5% 4Q 2013 vs. 58.3% 1Q 2013)
- Net interest margin declined to 3.20% (vs. 3.27% 4Q 2013 vs. 3.48% 1Q 2013)
- ROA of 1.57% (vs. 1.47% 4Q 2013 vs. 1.49% 1Q 2013)
- ROE of 14.35% (vs. 13.81% 4Q 2013 vs. 13.59% 1Q 2013)

Continued increases in loan/deposit growth and credit quality:

- Total average loans up to $824 billion (vs. $817 billion 4Q 2013 vs. $798 billion 1Q 2013)
- Total average core deposits up to $974 billion (vs. $966 billion 4Q 2013 vs. $926 billion 1Q 2013)

- Net charge-offs as a % of total loans down to 0.41% (vs. 0.47% 4Q 2013 vs. 0.72% 1Q 2012)
- $500 million reserve release* (vs. ~$600 million 4Q 2013)

Capital allocation:

- Share buyback activity continued (common stock share count declined 7.5 million from 3Q 2013)
- Quarterly common stock dividend of $0.30 per share (up from $0.25 per share 1Q 2013)
- Received a non-objection to 2014 Capital Plan under the Comprehensive Capital Analysis and Review (CCAR), which includes a ~17% increase in the quarterly dividend to $0.35 per share (2.9% yield as of today's stock price) and a 350 million share increase in proposed share buyback activity

Operating segments:

- Community Banking: Net income of $3.8 billion (up 32% from 1Q 2013)
- Wholesale Banking: Net income of $1.7 billion (down 15% from 1Q 2013)
- Wealth, Brokerage, and Retirement: Net income of $480 million (up 41% from 1Q 2013)

*Reserve release represents the amount by which net charge-offs exceed the provision for credit losses

CEO John Stumpf:

"Our solid first quarter results again demonstrated the ability of our diversified business model to perform for shareholders... First quarter 2014 earnings were another record for our Company and capital levels continued to strengthen... As we move forward in 2014, I am optimistic about the opportunities ahead and believe that we are well positioned for growth."

So What?

I started using a new format in my last earnings write-up, focusing on 3 key items that I watch for Wells Fargo:

- Growth (or lack thereof) in loans and deposits
- Trends in credit quality (as monitored via net charge-offs and reserving policy)
- Trends in the efficiency ratio and expense reduction

1) Growth in loans and deposits

After three straight quarters of accelerating loan growth, the acceleration finally reversed, with loan growth up 0.9% Q-o-Q (down from 1.5% growth Q-o-Q in Q4 2013). I wrote last quarter that I'd have been pleased to see the acceleration of loan growth continue, but this result isn't at all disappointing. There were likely some seasonal and economic factors at play here, with record low mortgage originations, a continued low interest rate environment, and poor weather all combining to pressure loan growth. That loan growth still grew in this environment is an impressive feat, especially given that Wells was the U.S.'s largest mortgage originator through the recent refinance boom and they have also tightened standards on credit quality, which inherently reduces the pool of potential loanees. I have no qualms with trends in loans. As intermediate-to-long-term rates rise (who knows when that will happen... rates have *decreased* since the beginning of 2014... play around with this visualization if you want to see how rates have changed over time), I'd expect to see a resumption of accelerating loan growth from WFC. Let's see how it plays out.

As for deposits, it was another strong quarter, with 2.7% Q-o-Q growth and 4% Y-o-Y growth. Funding costs stayed stable, as WFC again reported a rock-bottom 0.11% cost of deposits. WFC is nearing $1 trillion in deposits (!). Since deposit growth again exceeded loan growth, compression of the net interest margin (NIM) continued, coming in at 3.2% (down from 3.27% last quarter and 3.48% a year ago). I've written about net interest margin compression here. Bottom line is, it's not a big deal and we should see NIM compress until rates rise and loan growth picks up.

2) Trends in credit quality

Credit quality continued to increase, with net charge-offs as a % of average total loans down to 0.41% (from 0.47% last quarter). It's impressive how management continues to wring out improvements in credit quality, and it is a testament to WFC's conservative underwriting (one of the many reasons I think WFC is the best-run big bank). The story here is not much different from last quarter, so I'll just quote myself from last quarter's write-up (updating it for this Q's numbers):

"Improvements in credit quality are starting to level off (as well they should - the trend in this figure has been unsustainable, as charge-offs can't possibly decline below zero). If you were to graph charge-offs as a percent of total loans since 4Q 2012, it looks like a negatively sloped asymptotic line approaching 0%. Credit quality improvements should continue to level off in the coming quarters and Wells Fargo will need to find other ways to drive profit growth. The [$500] million reserve release represents about [8.5%] of Wells Fargo's earnings this quarter (down from [$600 million and roughly 11%] last quarter). See the thread beginning with Dom's question here for some more color regarding reserve releases if you are interested."

3) Trends in the efficiency ratio

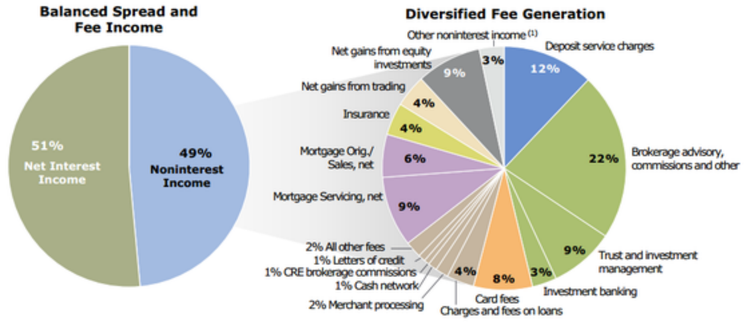
Nothing much here to analyze: we saw continued improvements in efficiency, with the efficiency ratio declining to 57.9% from 58.5% last quarter. Management continues to impress me with their consistency and ability to deliver as they promise with regards to efficiency. Management has stated that their goal is to ultimate get the efficiency ratio down to 55%. There was a veiled comment on the conference call suggesting that this ratio may increase next quarter (let's see!):

"We also plan to continue to invest in our businesses, and revenue-based incentive compensation expense could increase as businesses grow. However, we expect our efficiency ratio to remain within our target range of 55% to 59% in the second quarter." - CFO Tim Sloan

but I'm still confident in management's ability to steadily drive this figure lower over time.

Now What?

Not much different from last quarter (or the quarters before for that matter). Wells Fargo continues to execute its strategy and boast admirable consistency despite a fluctuating and uncertain macroeconomic environment. The company's performance is a testament to its diverse operating model. The company has so many levers to pull that if one segment falls (e.g. mortgage originations) others pick up the slack:



Source: Wells Fargo 1Q14 Supplement, Slide 4

There's no change to the $53.50 Fair Value estimate (representing a 1.75x P/B multiple) or the $41 CAM (1.35x P/B). Depending on next quarter's figures, I might alter my long-term ROE assumptions and update my model (ROE this quarter slightly exceeded my expectations), but for now it'll stay put.

Due to this company's stable performance, I likely won't be providing in-depth quarterly analysis from here on out (changing perhaps to bi-quarterly), unless there is an item in the quarter that stands out. I'll provide my high-level thoughts and do a deep dive anywhere that requires special attention.

Data and Guidance:

- Current price: $49.03
- Fair Value: $53.50
- CAM: $41
- Market Cap: $262.4 billion
- P/B: 1.61x
- Allocation: 2.9%

Wells Fargo remains a buy on our scorecard, and now is as good a time as any to match our 2.9% allocation in this workhorse of a company if you haven't yet.

Fool on!

Billy

Taking Stock of Where We Stand

Published Apr 14, 2014 at 4:00PM

Dear *Pro* member:

As you wrap up your tax filings for 2013, it seems a good time to take financial stock of where we stand here in *Pro*, too, before we all head deeper into the second quarter and earnings reports this month. We'll start by noting that the first quarter of 2014 was tranquil in the end, though it may have felt volatile. *Pro* had a stealthily good first quarter, matching our North Star, as shown in the column to the right (from our Recommendations page):

	Annualized Return Since Inception	Annualized Return, Rolling 3 Years	Year-to-Date Return
Pro	13.7%	11.6%	2.6%
North Star	8.4%	8.8%	2.6%
S&P 500	13.4%	14.7%	1.8%
MSCI World	8.4%	7.8%	0.8%

Table returns are as of March 31, 2014. Start date for annualized inception return is the close of Oct. 6, 2008. Pro *opened the morning of Oct. 7, 2008.*

The annualized S&P 500 index return over the past five-and-a-half years is historically high (topping 13%) and is likely to slowly revert toward the long-term mean, which is much closer to 10%. To keep our gains running stronger than that, we need to work to create additional returns, as discussed in last week's Memo. We also need to make some money when prices decline.

Price Volatility

Live Chat Coming Up!

We've got another live chat coming up Wednesday, April 23! Set a reminder and bring your questions.

The Nasdaq Composite fell more than 3% last week, and the S&P 500 nearly as much. That's a blip in the grander scheme, but it brought the market into negative territory for the year, with the S&P down nearly 2% as of Friday and the Nasdaq down more than 4%. The *Pro* portfolio started the year at $1,975,109, so it had declined only 0.8% (to $1,958,123) as of Friday. That's close to nothing, a single day's move, although it has felt like more.

It certainly could be more in the future. As we've been writing since mid-2013, some of our stocks look "ahead of themselves" on valuation by about a year or so. What does that mean? It means investors *appear* to be pricing in the assumed growth of 2014 and some of 2015 already, in some cases. So we may need to wait for results at some companies to "catch up" and for their valuation multiples to come down from, say, 18 times free cash flow to a more average 15 times (for example).

Why don't we sell instead? With some stocks, we may. But in many instances, we need to remind ourselves that valuation is an estimate, and far from precise, and the only way to compound your money with great companies is to own them for a long, long time. If we sold **MasterCard** (NYSE: MA) or **Starbucks** (NASDAQ: SBUX) because its valuation multiple looked a year ahead of itself, there's no guarantee we would get back in at a better price, especially if we take into account any taxes we may need to pay. These stocks will actually remain Buys as long as the valuation stays within reason.

The bottom line is that we're investors, not traders. So even when we see some valuations *reasonably* stretched, we need to be patient and stay true to our beliefs regarding what works best in the market, in order to reap the full long-term rewards of ownership. It's only when a business appears to be priced far ahead of its fundamentals — a few years' worth of results or more — that we will certainly lean toward selling it, or at least using options to generate returns or protection while we wait. We know that investing is three parts patience and one part a winning discipline, but we want all of our positions working for us as often as possible.

Middle Ground Now

Where do we stand now? After last week's decline, only five of our stocks trade higher than our fair-value estimates, and modestly so. For instance, Starbucks and MasterCard have already dropped below our fair-value guess; you can see that on the Recommendations page. Does this mean the decline is over? We don't know. But it makes it "easier" to own the stocks. As I wrote last year, I dislike seeing the market soar, because it's only stealing from future returns. I'd rather see reasonable, steady, annualized returns of around 10% a year. The market doesn't work that way in the short term, but that's how we think as we analyze our buy and sell decisions. Because ultimately annualized returns *have* smoothed out that way going back to 1927.

But right now, we're in a sort of middle ground. Our stocks aren't low enough to hit their Consider Adding More prices — prices where we may be eager to increase our allocations. Nor are most stocks we're watching for new purchases low enough to make us want to leap just yet (although some may be close). It also remains a tricky market for shorting. A word from the Fed about loose monetary policies can send the market soaring again, as it did last Wednesday. We need high conviction to short companies in what is still an accommodating Fed environment, especially as Europe begins to consider quantitative easing now, too. But we expect steady options trades to bring us profits within a price range in the market, and we expect earnings results this month to shake out some new opportunities, too, if the market itself doesn't. A falling market would open new doors.

All told: We may be in for a seesaw market for now. Children tend to love a seesaw; as adults, though, most of us already have enough adversity in life, so we don't tend to enjoy more of it. But adversity is part of the market, so we should view it as an opportunity when it occurs. The *Pro* portfolio is built on a solid foundation that provides flexibility, and we like our current market exposure of around 70%. Where we stand today, we're ready to act on any new opportunities we choose, long *or* short. One way or another, this middle ground that we're sitting on right now won't last. And that's good, because it will lead to opportunities in either direction.

Fool on!

— Jeff (TMFFischer)

Don't Miss It: Tom Sits Down With Michael Lewis

Did you know that Michael Lewis — famed author of *Moneyball* and *Flash Boys*, the No. 1 best-seller on Amazon right now — is a Fool? After watching Tom Gardner's interview with this great business thinker, I couldn't be more certain that Lewis understands why Foolish, long-term investing is a winning approach even in the face of high-frequency traders moving billions of dollars in the blink of an eye. Tune in, and you'll see why I think every investor should know the incredible story behind these fast-moving market makers — and find out whether we Fools should be concerned. Fool on! — Andy Cross, Motley Fool Chief Investment Officer

Watch Tom's Chat With Michael Lewis Now

Scorecard Tip: Set Your Own Bar

Looking for different ways to measure your performance? Click the small edit box at the top right of your scorecard, and you can add more than 20 different performance calculations.

Pro Completed Trades (see all trade alerts)

- **Intel** (NASDAQ: INTC): We rolled all of our April $25 covered calls to July $25 calls for a $0.26 credit.
- **Tupperware** (NYSE: TUP): Our April $90 puts were exercised, buying us 700 shares (a 2.9% allocation for *Pro*) at about $86 per share, net. The stock is rated a Buy. Welcome back, TUP!

Pro Coverage & Community

- phooLon reminds that options expire this Thursday, since the market will be closed Friday.
- mpfd shares his 10-year performance history with the Fool! Congratulations!
- TMFMoosie posts the weekly earnings calendar. Thank you!
- Neil (nevercontent) shares his experimental put-writing report.
- Is **Facebook** (NASDAQ: FB) launching a payments system? Join the conversation.

Your Most Active Conversations

[Today](#) [Past 7 Days](#) [Past 30 Days](#)

Pro Live Chat, April 2014 (Part II)

Published Apr 10, 2014 at 4:34PM

At 2 p.m. on Wednesday, April 23, the entire *Pro* crew — advisor Jeff Fischer; senior analyst Bryan Hinmon, CFA; research analyst Billy Kipersztok; and editor/publisher Ellen Bowman — took your questions during a live text chat. Read the transcript below!

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A Note of Appreciation, and a Look Forward

Published Apr 7, 2014 at 4:00PM

Dear *Pro* member:

It's neither Thanksgiving nor the holiday season, but today I want to pause to thank you for being a Fool with us. We're grateful that you put your trust in the Fool and in *Pro*, and that you invest alongside us. We would not be here without your support, so you mean everything to us.

Relive Our Last Live Chat!

Our April live chat took place last week; if you missed it, you can read the transcript here!

In fact, it is your belief in the Fool that makes it possible for us to share our work with you. That has been true since The Motley Fool began in 1993; the community has lifted the Fool up every step of the way. Working together, we believe we're much stronger than we could be alone. And in *Pro* (and across the Fool), we want our service to add *much more* value to your life than it ever extracts. That's the core reason we're here.

Additionally today, we offer a warm welcome to new *Motley Fool One* members who are visiting *Pro* for the first time. If our investing strategies geared toward steady profits appeal to you, we hope you'll become a regular part of our family. You can learn much more about *Pro* in our Guidebook.

So, on an ordinary April day, thank you! We appreciate you, and over the coming months and years, we aim to show you just how much as we continue our dedicated work for results.

What's Up?

The first quarter of 2014 recently drew to a close. After a fairly volatile three months, the S&P 500 index was up nearly 2% for the year through March 31. The *Pro* portfolio was up a bit beyond that at quarter's end, on pace with our North Star (inflation +7% a year), which runs at about 2.6% per quarter right now.

Though one never knows, it seems likely that the higher-than-average stock market returns of the last few years will not recur this year. With that belief, we're compelled in *Pro* to undertake more activity to keep sight of our always-positive North Star. TheNorth Star is a relentless taskmaster. It goes up steadily. When we close our eyes, we have creepy visions of a clown-like star climbing an endless ladder and smiling down at us, mockingly.

So what are we going to do?

Income

We've been on the hunt for new option strategies with which we can confidently begin to generate recurring income. We want the allocations to be large enough that the income makes a difference – ideally, we'll start a small handful of such positions, and each will target 0.5% to 1% in income on the portfolio per year. Added up, that would make a sizable difference in returns. But it's no easy task when share prices are up considerably. If we're setting up diagonal calls, for example, we need to be confident that the underlying stock will hold its ground. An income strategy has little value if you impair your invested capital in the process. But we're confident that we can start several positions that will lead to steady income and long-term returns.

Shorts

We've been going through short candidates all year; we don't short stocks lightly. The most you can make on any short is 100%, so if you find a great short candidate, it shouldn't matter much whether you short it after it has already fallen for a while. In fact, in many instances that's preferable to shorting it on the rise and risking being called out early. We expect to have new individual shorts (for those members who use them) to help us profit on weak companies and when the market is weak.

Hedges

Meanwhile, we hedge by shorting market indexes. This way, we keep our market exposure lower even though much of our capital is invested. Our net market exposure continues to average around 70% (as shown at the bottom of the Recommendations page).

It's important to remember what a hedge is: It's a position that tempers your market exposure, but *will* lose money if the market goes up. This year, our hedge hasn't helped at all yet. The market is still higher than the price where we set the hedge up, and we pay a cost to cap the risk in the hedge. It's like any insurance policy -- you usually lose money on your insurance in the end, unless you have an usually large claim. And do you really want that catastrophe? Still, hedges let us keep more money invested for long-term appreciation, and will ultimately help in large declines.

Long Calls and Stocks

Finally, we would welcome a quick rout in the market for at least one other reason: We know several stocks we would like to buy – or, perhaps more interesting, long-term call options we would like to buy, or synthetic longs we'd like to set up – if more attractive prices come along.

Remember, there are two ways to capitalize on a market downturn: Either you can be mostly short as the market falls (which is a costly approach when you're wrong, and requires knowing when to close); or you can be ready to put more money to work at good prices when you see them. In an ideal scenario, *Pro* does both, but in some cases we're going to need to be happy with less than that. As long as we capitalize one way or the other, we can make a downturn work for us in the end. Right now, we're still hoping to capitalize in both directions the next time the market declines more than, say, 7%. But we need to work to get there.

Summing Up

By owning our core companies, adding more option income strategies, shorting carefully selected companies, and being ready to buy great opportunities when we see them, we're going to continue to work to generate our desired returns. We like what we own, but we realize that the market will not always have our backs by lifting prices higher. Sometimes you need to do more of the heavy lifting yourself, and the coming year or two may be one of those times. Right or wrong, we are going to proceed as if that's true, so that we ideally earn returns either way.

Visit Memo Musings to share thoughts, and Fool on!

-- Jeff (TMFFischer)

Pro Completed Trades (see all trade alerts)

- **StoneMor Partners** (NYSE: STON): We sold all our shares at $25.25.

Your Most Active Conversations

Today Past 7 Days Past 30 Days

Roll Your Covered Calls on Intel

Published Apr 7, 2014 at 1:20PM

Is this for you? This is for *Pro* members who own shares of **Intel** (NASDAQ: INTC) and have April 2014 $25 covered calls on them.

How You Participate

- **Trade:** Use a rolling order to buy to close your April 2014 $25 calls, and sell to open an equal number of July 2014 $25 calls.
- **Allocation:** Roll every call you have previously written.
- **Price Guidance:** Aim for a net credit of at least $0.25, but as expiration draws nearer, execute at the prices offered.
- **Recent Prices:** Intel, $26.50; April 2014 $25 calls (bid/ask), $1.74/$1.80; July 2014 $25 calls, $2.02/$2.08. See current prices.

What We're Thinking

We wrote covered calls on Intel early this year to target extra income after the company announced lackluster earnings guidance for 2014. Shares have gained ground since then, forestalling our income and now forcing us to roll our covered calls to keep our shares. Rather than pay to chase the stock higher as it zigs, we will keep our strike price the same at $25 and wait to see if the stock zags back down, perhaps after earnings next week.

But if shares keep climbing higher, we'll be inclined to roll our calls again before long (and perhaps add some other options to the mix to boost our premium). The bottom line is that we're targeting extra income on the stock given a belief that it will stay in a general price range, but we aren't eager to sell our shares (with their 3.4% yield) right now, so we'll keep managing our covered calls as necessary and as long as it's attractive to do so. So, let's roll to keep our shares, get a bit more credit, and see what happens after earnings on April 15.

More That Matters

- **Maximum Loss:** Our exposure remains the same as stock ownership, minus the credits we have in the covered calls.
- **Maximum Gain:** Currently, our profit potential is limited to the credits in the calls, since they're in-the-money.
- **Breakeven:** Around $25 per share on these covered calls; our stock position is lately up 30% for us.
- **Follow-Up:** We'll keep managing the calls to likely keep our shares and ultimately earn premium, too.

Alternative Trades

- If you made the alternative trade of writing puts on Intel, for now wait as those expire as income.

Pro Can Help

- **Want to learn more?** See our guide to writing covered calls in our sister service, *Motley Fool Options*.
- **Questions?** Post your thoughts on the *Pro* Intel board.

Wireless Tower Industry Checklist

Published Mar 31, 2014 at 4:00PM

Pro Guidance Changes

- **Oracle** (NYSE: ORCL): Following third-quarter earnings, our fair value increases 9% to $41, and Consider Adding More rises $3 to $33. We have a 4.6% allocation, and the stock remains a Buy First.

Dear *Pro* members,

Recently on the boards, my colleague Sara Hov (TMFTycoon) posted a checklist detailing her process for analyzing companies in the retail industry. We at the Fool are big fans of using investment checklists to help us systematize our thinking and make smarter decisions. While a checklist isn't the end-all and be-all for our decision-making, it does make an excellent starting point and/or self-checking mechanism. As a member of the Fool's Analyst Development Program (ADP), I was assigned the same project as Sara and chose two different industries for which to make checklists.

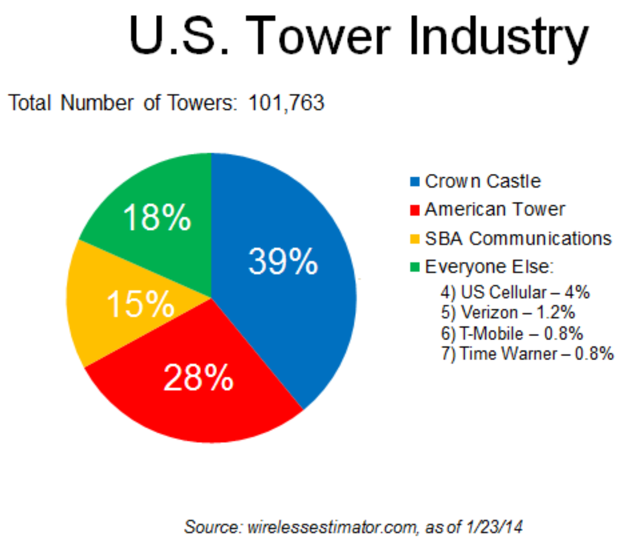
Live Chat Coming Up!

Our April live chat is coming up soon! Mark your calendar for 2 p.m. Wednesday, April 2, and bring your questions for the team. We'll see you there!

I picked the property and casualty (P&C) insurance and wireless tower industries. These choices were deliberate -- for *Pro*, I cover companies in each of those industries (**AIG** (NYSE: AIG) and **American Tower** (NYSE: AMT), respectively), and I figured that developing these checklists would dovetail nicely with my *Pro* coverage.

Being as *Pro* recently added to our stake in American Tower, giving us a 3.7% total position in the company, I thought I'd dedicate this Memo to discussing how I use a checklist to think about American Tower and its competitors in the wireless tower space.

The wireless tower industry is small in terms of the number of investable companies it offers -- there are only three U.S.-listed tower companies, namely American Tower, **Crown Castle** (NYSE: CCI), and **SBA Communications** (NASDAQ: SBAC). In the U.S., the big three collectively command 82% of the industry, with the rest being a fragmented mix of wireless carriers and independent tower owners.



The big three tower companies have historically been rational and profit-focused competitors, and this oligopolistic market structure enables healthy economic profits and consistent cash-flow generation, so long as the current market structure stays the same. They all benefit from scale, switching costs, and zoning and/or regulatory barriers to entry.

My checklist covers five key areas to focus on as you research the wireless tower industry. I'll discuss each area and provide a few examples of applying the checklist.

Investment Checklist: Wireless Tower Industry

1. Leverage

Tower companies all use leverage for several reasons:

- Consistent, contracted revenue and cash flow allow tower companies to easily service their debt
- It takes significant capital to fund acquisition-fueled growth
- Debt lowers the firm's weighted average cost of capital (up to a point)
- Interest payments are deductible and provide tax savings

So start by checking the company's debt covenants to see whether its leverage ratio (some form of debt/EBITDA) and interest coverage ratio (some form of EBITDA/interest) fall comfortably within the allowed ranges. You'll also want to check the company's weighted average cost of debt (the average interest rate it pays to its creditors), as well as its debt maturity schedule (when it needs to repay its loans), to make sure it can effectively service its debt.

For example, here is a table showing the current weighted average cost of debt for each of the tower companies.

Company	S&P Rating	Weighted Average Cost of Debt
American Tower	BBB-	4.9%
Crown Castle	BB-	4.9%
SBA Communications	B+	6.1%

Source: S&P Capital IQ

Get a good handle on the company's overall liquidity: Does it have undrawn credit or loans? How much cash does it have? If these metrics don't add up or seem untenable, this may be as far as you need to go to rule out the company as a good investment.

2. Tower Portfolio

Assuming the debt picture looks sustainable, it's time to look at how many towers the company has. How many are in the U.S. versus abroad, and what do margins look like? Here's the tower count for the big three:

Company	U.S. Towers	International Towers
American Tower	28,019	39,399
Crown Castle	39,600	1,700
SBA Communications	19,683	5,196

Source: Company filings

Since international wireless penetration rates are generally lower than in the U.S., tower companies have seen faster growth and often better margins abroad. We want to see tower companies investing in the most attractive opportunities, so look for tower portfolio expansion plans focused on the highest growth and/or most profitable areas.

Then move on to how effectively the towers are used. How many tenants are there per tower, and in each geographical area? How are those trends moving over time? Since each additional tenant increases profitability, the higher the tenancy rate the better.

And because tenants sign long-term leases, you'll also want to check on the company's recurring lease revenue. What does the renewal schedule look like, and what's the typical or historical lease renewal rate?

The same applies to the real estate on which the towers stand: Does the company own the real estate or hold long-term leases? Are many of those leases up for renewal soon, and is it likely the company will be able to get the same or similar rates when it renews? We want to make sure the company's revenue and cash flow are secure, so the longer the amount of time until a company has to renew its leases, the better.

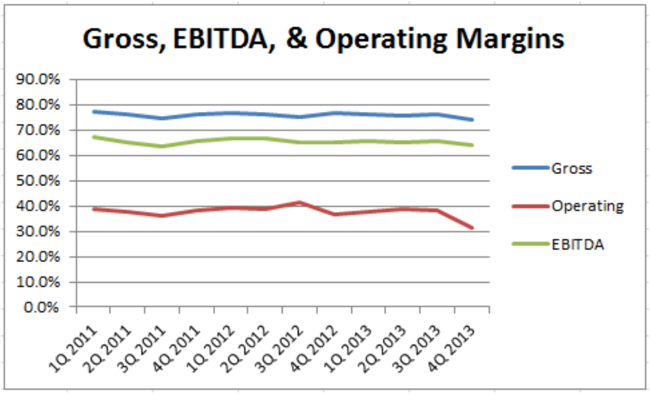
3. Financial Performance

Now it's time to dig in to how well the company is deploying the cash flow its towers generate and allocating its capital. Check out historical revenue growth, breaking out organic versus acquisitions, if possible. Healthy organic growth is a good sign.

You'll also want to study return on invested capital (ROIC) trends over time. As the company increases its portfolio and leases unused tower space to more tenants, expect ROIC to gradually rise. A good formula to use for ROIC is EBITDA (earnings before interest, taxes, depreciation, and amortization) minus maintenance capital expenditures divided by property, plant and equipment plus goodwill and intangibles:

(EBITDA – maintenance capex)
(PP&E + goodwill / intangibles)

Finally, take a look at gross, operating, and EBITDA margin trends over time. Are the margins growing? If so, the company's operations, its bargaining power, and/or trends in the larger market are likely growing stronger. Here's what American Tower's margin trends look like since 2011:



Source: Company filings and analyst adjustments

4. Management

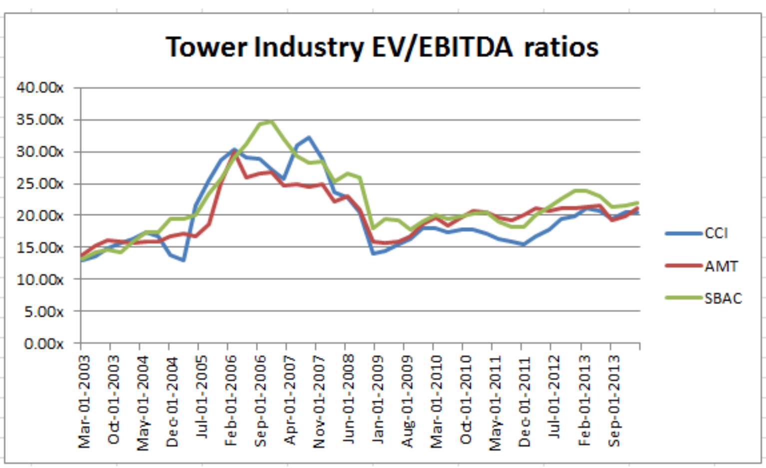
Now you'll want to look into the company's leadership. Does management's tenure, experience, and historical performance align with a strong outlook? Are executives spending their capital sensibly, on projects likely to earn the highest returns? Are management's incentives aligned with shareholder-friendly goals?

It may be worth reading transcripts or listening to webcasts of the company's recent earnings calls to get a sense of the personalities heading up the company and their levels of confidence. I prefer level-headed, rational, efficient managers who can make quick yet prudent decisions. I also like to see managers who are optimistic, but not overconfident.

5. Valuation

Armed with all this research, you can now take a look at the company's valuation to see if now is a good time to buy. Because tower companies are capital-intensive and use lots of debt, their cash flows are tax-shielded by large depreciation and interest expenses. As such, their reported earnings (the denominator of the P/E ratio) are not representative of their true cash flows.

To strip out these distortions, I prefer to use the enterprise-value-to-EBITDA multiple (EV/EBITDA) instead. Check how it's changed over time, and how it compares to those of other wireless tower companies. Based on the other information you've found, does this multiple seem higher or lower than it should be? And how does this picture align with your investment goals? Here's what the EV/EBITDA ratio looks like for the three tower companies since 2003:



Source: S&P Capital IQ

The Foolish Bottom Line

Checklists can help simplify the investing process and make sure you are focusing on the most important variables. I hope this one will help you better understand our investment in American Tower and inform your future research on the industry and its participants. Almost all of this information can be found in the companies' SEC filings, investor presentations, and conference-call transcripts. As Sara mentioned in her original post about her retail checklist, this is a continual work in progress, so stop by the Memo Musings board to give your input and/or suggestions for improvement ... and keep an eye out for my P&C insurance checklist in a future Memo!

Fool on!

-- Billy (TMFTailwind)

Your Most Active Conversations

Today Past 7 Days Past 30 Days

Earnings: ORCL Q3-2014

Published Mar 26, 2014 at 11:26AM

Oracle (NYSE: ORCL) reported healthy numbers in a slow environment and is confident about its future. With new products in hardware, software and cloud, Oracle has a total business computing solution and scale (giving it better pricing) that smaller rivals can't match; and, it has a newly larger, trained sales-force to go after new deals. As companies look to move their processes, applications, and data onto the cloud, and not worry about hardware, Oracle can make the process easy and comprehensive by offering a full solution under one roof. Customers commit to long-term contracts with Oracle, especially data customers, as they invest in the relationship.

Our Fair Value increases 9% to $41, and Consider Adding More rises $3 to $33. We have a 4.6% allocation and the stock remains Buy First.

Synopsis for Q3

- Currency neutral software revenue grew 6% YOY
- Software updates and product support (aka, recurring revenue) grew 7% and were nearly half of total sales
- Q3 renewal rates hit a four-year high
- New software license revenue grew 5%
- Database software (Exadata, Exalytics, B.I.) all grew more than 30%
- Hardware revenue grew 10%, with Engineered Systems up more than 30%
- Total revenue grew 6% to $9.3 billion; operating margin was steady at 47%
- Free cash flow increased 11% to $14.4 billion over the past 12 months
- Guidance: Q4 revenue could grow 3% to 7% in dollars, as software and hardware both grow from 0% to 10%, currency neutral

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       Overview
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     Pro Guidance
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Current Price:    $38.40 (up from from $36 last quarter)
Fair Value:       $41.00 (up 9% from $37.50)
Consider Adding More:$33 (up from $30)
Current Allocation:  4.6%
Status:        Buy First (no change)(one could also write puts or buy ITM LEAP calls)
Dividend:            1.24%
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       Valuation
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Metric          Multiple
========================
EV/EBITDA            9.6
EV/EBITDA NTM Est.   8.0
P/FCF               11.9
P/E                 16.0
P/E NTM Est.        12.3
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    Past 3-Year CAGR
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Revenue              3.3%
Gross Profit         6.2%
Oper. Cash Flow     14.7%
Unlevered FCF       10.4%
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Gross Margin        81.9% (up)
Op Margin           29.3% (flat)
ROE                 25.0% (flat)
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Historical EV/EBITDA

2002   13.8
2003   15.8
2004   14.3
2005   12.0
2006   13.7
2007   13.9
2008    8.8
2009   10.6
2010   11.1
2011    6.9
2012    8.4
2013    9.8
Now     9.6
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Business Highlights

- It was Oracle's best cloud quarter, with booking growth up more than 60% (more than doubling revenue growth, since revenue is earned over time)
- Engineered Systems is growing rapidly for the same reason that Cloud is: Customers want an integrated hardware and software solution so they don't have to do it themselves; Oracle is uniquely positioned to offer both together
- Oracle believes it is replacing IBM's pSeries as the leader in high-end computing
- Oracle's hardware grew in every single region, while competitors are seeing declines. It views its Engineered Systems as a new category in high-end computing, especially since it allows Cloud implementations of all your Applications
- Engineered Systems started small and are now about 30% of sales, and soon it's going to be more than 1/2. They've gotten out of the commodity storage business and into computing systems running its own IP -- these are rapidly growing businesses with "very high margins."
- Database continues to grow strongly, and Oracle anticipates its 12c roll-out this summer, which should improve data analytics performance by more than a factor of 10, and in some cases a factor of 100, will drive more deals. Oracle wants to become the #1 data analytics company in the world.
- Oracle is ready to compete with Amazon (even though it's a commodity business, it's not a bad one, it says), and feels great about its competitive position against Workday and the others often noted.

- Oracle has more feet on the ground. As you'll recall, it greatly grew the sales staff the last few years, and that staff is now becoming more adept at selling Oracle's new product lines.
- The company believes its ecosystem is complete and highly competitive for the future -- with performance and cost benefits smaller companies can't match
- The company will keep adding salespeople next year, as it moves to take on competitors in new arenas
- Cap Ex spending is down YOY; the company believes it has "enormous scale" that it has not fully tapped yet. They've been investing for scale for years, and they have a lot more scale to gain from it. So, they're very happy with where they are right now.
- As a result of past investments, ORCL's current cap ex should not ever be as high as its infrastructure competitors in the cloud. The company is ready to roll.

Going Forward

- Database, cloud applications, and Engineered Systems should continue to drive FY 2015 growth.
- ORCL is driving to be a leader in all three cloud areas: SaaS, Cloud Applications and platform and infrastructure. They're cost competitive at the infrastructure level, and highly differentiated at the platform and application level. They say they're positioned to offer better performance, complete solutions, and lower overall prices. Following Oracle for nearly 10 years now (remembering how they started cloud programming 8 years ago), I believe them.

For More

- Q3 Press Release
- Discuss This News

Hedging Our Way to Portfolio Success

Published Mar 24, 2014 at 4:00PM

Dear *Pro* member:

Live Chat Coming Up!

Our April live chat is coming up soon! Mark your calendar for 2 p.m. Wednesday, April 2, and bring your questions for the team. We'll see you there!

Last week, I attended the annual Risk Management Conference hosted by **CBOE Holdings** (NASDAQ: CBOE). As in years past, about 300 analysts and investors from every major Wall Street firm you could name (and several I couldn't) gathered to hear presentations on volatility and risk. As you might imagine, this year it seemed everyone was talking about an illusion — some fictional character named "volatility" that long ago used to haunt the market. Volatility has been slight the past 15 months, and memories are short, but surely we'll see more of it eventually.

That makes it all the more ironic that many investors are no longer hedging. Indications are that many institutional clients have told their money managers they no longer wish to hedge, because they're tired of sacrificing returns. One has to wonder if this collective "throwing in the towel" is a contrarian sign that suggests now *is* a good time to hedge. Our plan in *Pro* is to invest as we normally do. We haven't sacrificed greatly by hedging, because most of our hedges have been low-drag or low-cost. Sure, we've given up some good ground by being short market indexes, but on the whole, we can't complain that we're topping the North Star and the S&P 500 while only being about 70% net long.

Our bottom line on hedging remains this: *A hedge is a position that helps you keep more money invested (otherwise, why hedge?). So, in the long run, reasonable hedges can lead to greater total gains because you have more invested than you otherwise would — while exposing you to less risk.*

A similar belief was voiced at the conference, when a panelist noted that if you lose 40% on a hedge that makes up 5% of your assets, but that hedge allowed you the peace of mind to be 95% invested, and you earned 30% on that 95% of your money ... then you've won by far.

I summarized my experience at the Risk Management Conference on the *Pro* philosophy discussion board. To whet your appetite, here are just three points:

- Pricing models suggest that buying long-term calls (namely LEAPs) and writing short-term puts (expiring in 30 to 60 days) remain two of the more attractive option strategies today — when done well. With the VIX (the CBOE volatility index) and interest rates both low, long-term option prices could go up over the coming few years as implied volatility and interest rates tick higher.
- The average mutual fund using options has gained 10% annualized since the market bottom in March 2009, while mutual funds not using options have gained 18% annualized. That's a large difference (one *Pro* is happy to have sidestepped), but when the market is flat for a few years, funds using options should be relatively stronger.
- Historically, hikes in interest rates have *not* led to substantial increases in stock volatility, although implied volatility (the VIX) may trend higher. Right now, many expect interest rates to start to rise in 2015.

I hope you'll enjoy much more from my summary of the event, even though (or possibly because!) my experience there reiterated my belief in the Foolish way of investing. Thousands of smart people spend their time trying to understand and invest for volatility. Meanwhile, Fools like us have focused for years on buying outstanding companies to compound wealth. There's no question in my mind which group is coming out ahead. We'll continue to hedge, short, and of course enjoy the great power of options in *Pro*, while aiming to smooth our returns and capitalize on downturns; but our long-term goal is to compound the bulk of our assets by owning great businesses at good prices.

One Fool to Rule Them All

Speaking of compounding, now there's a way to compound your exposure to Foolish advice, all in one service. Members have been talking about *Motley Fool One* on the *Pro* discussion boards, so I want to share some thoughts about the service. First, *One* is the Fool's all-access offering to every Fool service in existence. *One* also gets you access to services only offered in *One*, including:

- Tom Gardner's real-money service, the Everlasting Portfolio.
- Access to Motley Fool Wealth Management (MFWM), including Ayco financial advisors you may call on the phone, and real-time portfolio analysis tools.
- *One* members can also use Motley Fool Wealth Management's new separately managed accounts (SMA) service to automatically mimic the real-money Fool portfolio of their choice, without needing to make any trades themselves.

If you're subscribing to a few Fool services, a long-term *One* membership may save you money in the end. You keep your *Pro* and *Options* memberships, of course (again, *One* is all-access), and any credit remaining in your existing services goes toward paying your *One* membership. We hope you're delighted with *Pro*, of course — but if these other offerings sound appealing, please do consider *One*. If you've already applied, check your inbox for your invitation; if you haven't, you can click here to join the waitlist.

Fool on,

— Jeff (TMFFischer)

Pro Completed Trades (see all trade alerts)

- **American Tower** (NYSE: AMT): We bought 300 more shares at an average cost of $81.62, bringing our total stock allocation to 3.6%. The stock remains a Buy First.
- **iShares Russell 2000** (NYSEMKT: IWM): We rolled our long March 2014 calls to long May 2014 $122 calls, and let our short calls exercise into a short of IWM shares. This left us with a covered short position in IWM at a 9.9% allocation -- as a market hedge.
- **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS): We let our short March 2014 $46 puts exercise into more shares, bringing our stock allocation in DGS to 2.6%. Shares remain a Buy.

Guidance Changes

- **WisdomTree Emerging Markets SmallCap Dividend Fund**: Our fair-value estimate moves down to $54. Emerging-market stocks in aggregate trade at a 20% discount to their long-term average valuation, so we're comfortable buying more, but after a few years of little growth, our fair-value estimate needs to come down. Our Consider Adding More price also comes down because we did just buy more. The new CAM is $40. Shares are a Buy at 2.6%.

Coverage

- **The Buckle** (NYSE: BKE): Bryan published an update on the jeans retailer's results. Shares remain a Buy First at a 2.6% allocation.

Your Most Active Conversations

Today Past 7 Days Past 30 Days

Pro Live Chat, April 2014

Published Mar 24, 2014 at 1:01PM

At 2 p.m. on Wednesday, April 2, the entire *Pro* crew — advisor Jeff Fischer; senior analyst Bryan Hinmon, CFA; research analyst Billy Kipersztok; and editor/publisher Ellen Bowman — answered your questions during a live text chat. Relive the magic below!

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Roll Your Long Calls on IWM

Published Mar 18, 2014 at 2:15PM

Is this for you? *Pro* members with a March bear call spread on the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF who wish to continue the hedge, or end it, should follow the guidance in this trade alert or its alternative trades.

How You Participate

- **Actions:**
  - **If you *can't* stay short shares of IWM because of your broker:** Close your entire March spread and follow the alternative put-buying or put spread trade at the end of this report, assuming you want to continue to hedge.
  - **If you *can* stay short shares of IWM:** Use a rolling order to simultaneously sell to close your March 2014 $118 calls (substitute your adjusted strike price if you adjusted your original position up or down), and buy to open an equal number of May 2014 $122 calls (adjust up or down a strike if you like that roll better for your situation).
  - Assuming you can short shares of IWM at your broker, leave your March 2014 $100 calls alone; they'll exercise into short shares by the weekend. Their risk will be capped by the long calls you're rolling to.
- **Allocation:** As before, 10%. Keeping the same allocation you had before, roll one long call for every 100 shares of IWM you are or will soon be short. If you're setting up an alternative spread trade, set up the same number of contracts as before (one spread for every $118,000 you manage, now). If you're just buying puts, only invest what you're willing to risk.
- **Price Guidance:** Prices will vary as the ETF moves, and with expiration near, specific price guidance is not practical. Lately, the roll will come at a small debit.
- **Recent prices:** IWM, $119; March 2014 $118 calls, $1.61; May 2014 $122 calls, $1.78; subsequent roll debit, $0.17 (but that will change; use what you get).

What We're Thinking

What *Pro* Is Doing

We can stay short IWM, but we'll cap our risk by rolling (selling to close our long March 2014 calls, and buying to open an equal number of May 2014 $122 calls) our long calls. We're leaving our short March 2014 calls alone to turn into additional short shares of the ETF by this weekend. Those who can't short should follow an alternative trade if they wish to hedge.

The bull charges on! The iShares Russell 2000 ETF enjoyed a record-long rebound from February into March. Thankfully, our bear call spread capped our risk on this hedge from day one, so we didn't sweat the ascent. The core *Pro* portfolio enjoyed the market's rebound, and our capped-risk hedge added some peace of mind.

Now, though, this hedge is coming to an end, our hand forced by the approaching March 21 expiration. We want to maintain a 10% market hedge as we continue to seek individual shorts to buttress the portfolio against downside. The cleanest way to continue the hedge is to let our short March calls ($100 strike price for most of you) simply get exercised this weekend, resulting in a short position on the ETF itself. Assuming you can short shares of IWM at your broker, just wait and the options will be exercised soon. Given our original credit when we wrote these calls earlier this year, most of us start with a short price of around $112.

But we do want to continue to cap our risk on this short, so we're rolling our protective long calls ($118 strike for most of you) to May $122 calls. This will cap our risk at that strike price, while we'll still enjoy (if that's the right word) unlimited gains from our IWM short if the index falls. So, in summary, we're simply letting our short calls turn into a short of the stock, and rolling our protective long calls to a later expiration and higher strike. Our hedge remains in place, then, with just one roll trade on the higher-strike calls we own.

We hedge to smooth volatility and have a profitable position should the market decline. If you don't care about those things, you don't need to hedge.

More That Matters

- **Maximum Loss:** Risk is capped at our $122 strike, so about $3 per share higher.
- **Maximum Gain:** Our maximum gain stems from the short position and occurs if IWM declines to zero (minus the cost of our long calls).
- **Follow-Up:** We'll stay short IWM and manage our risk with long calls for as long as we desire, but not likely more than a handful of months.

Alternative Trades

- **Unable to short IWM directly?** Close both sides of your March spread, and then – if you want to remain hedged – simply buy to open May 2014 $118 puts (they're lately about $3.15 each). Buy one put for every $315 you're willing to risk. The puts will go up in value if IWM's price falls more rapidly than the time value does, but will expire worthless if IWM doesn't decline.
  - Or, set up a May 2014 bear *put* spread. Simultaneously buy to open May 2014 $118 puts and sell to open an equal number of May 2014 $110 puts to finance part of your put purchase. You'll profit on a decline in IWM all the way to your lower strike (about 7% lower), and your risk is your net debit to set this up -- lately about $2, or $200 per spread. To target a 10% allocation, set up one spread for every $118,000 you manage.
- **IRA-friendly:** You can't sell short stock in an IRA. If you have the March bear call spread, close both sides of it with a spread order, and set up the alternative put-buying or bear put spread trades in the bullet points directly above.
- **Or do nothing!** Remember, you hedge only if you want to protect against some downside. You don't need to hedge if you don't have that desire at present.

Pro Can Help

- **Questions?** We imagine there will be some! Visit our IWM discussion board.

Earnings: BKE Q4-2013

Published Mar 17, 2014 at 4:19PM

Pro's Take: BKE Q4-2013 Earnings

The Buckle (NYSE: BKE)

Quarter Quick Take

The fourth quarter completed a steady but uninspiring year for The Buckle. The company opened 10 stores (net) and saw growth in its online sales but only held the line everywhere else. The lack of a dramatic decline in sales and profits during the year actually puts The Buckle's performance near the top of its mall-based apparel retailer peers. The company's exclusive merchandise strategy (roughly 70-80% of items can't be found elsewhere) has greatly helped maintain margins in a period of industrywide discounting. In 2014, management expects to open the most stores (17) it has since 2010, build a new headquarters, and sell more jeans.

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Q4-2013 / FY-2013

Revenue growth***: +1% / +2%

Operating profit margin: +70 bps to 27.8% / -10 bps to 22.8%

EPS growth: -4% / -2%

Corrects for the 53rd week in 2012

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Guidance Update

The Buckle's results were a bit worse than I had modeled, but very respectable in the current apparel retail environment. Management does not provide guidance, but they did announce healthy 2014 store expansion plans (17) and a high capital budget ($48-$53 million for new stores, remodels, and a new building at HQ). The new building at HQ will ding near term cash flow and won't have any positive impact on future growth or profitability. Still, the long-term drivers of value remain in place: new store openings, modest profitability improvement from increased BKE branded products, and slight comp store improvements as new stores age and merchandise assortment expands. Accounting for stronger near-term headwinds, I'm lowering the company's Fair Value a bit to $53 and Consider Adding More to $37. The Buckle remains a Buy First and we're content with our 2.5% allocation.

Updated guidance: Buy First (no change)

Recommended Allocation: 2.5%

Fair Value estimate: $53 (decreased)

End of Fiscal Year expected FV estimate: $57

CAM price: $37 (decreased)

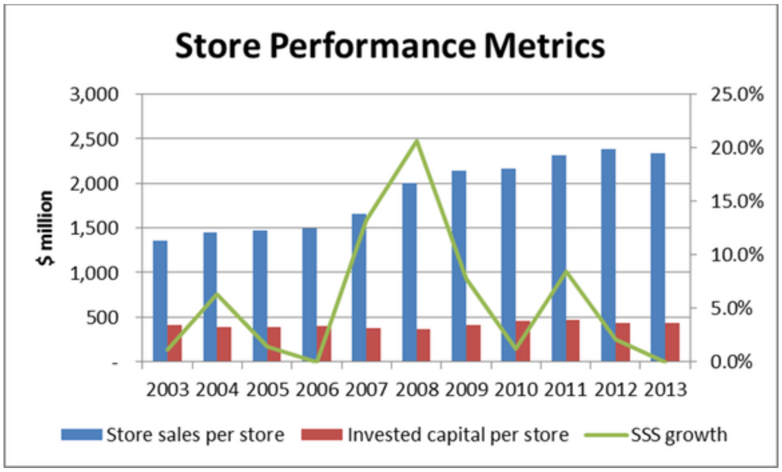
Shares of The Buckle remain undervalued. Shares normally trade in a range of 6-9x EBITDA (currently <7x) and I'd look to write puts for an effective buy price around 6x, which is our CAM price.

Our Thesis

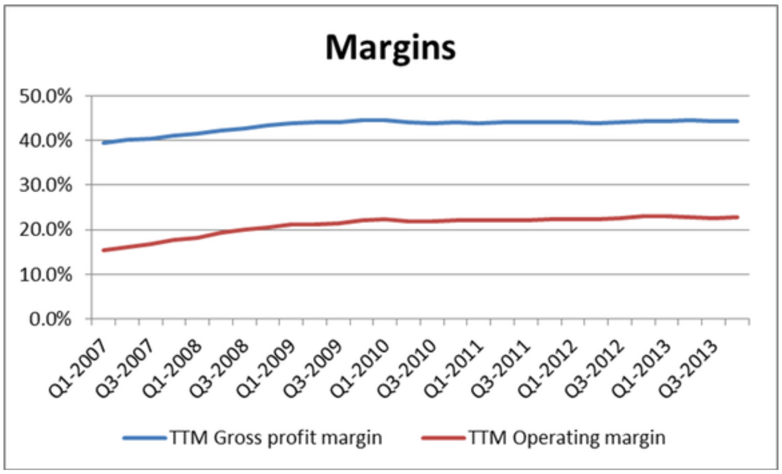
The Buckle offers retail exposure with low fashion risk (jeans and tops). Its management team is properly incentivized, has meaningful ownership, and run the business wonderfully well. We expect measured growth from store openings, online expansion, and expanded merchandise assortment (footwear and children's clothes). We are not expecting dramatic operational improvements, but we believe in-house brand penetration and an improved online experience are opportunities. The Buckle should grow its earnings, pay a regular dividend, and we expect it to pay out excess cash distributions (more years than not).

The Most Important Things

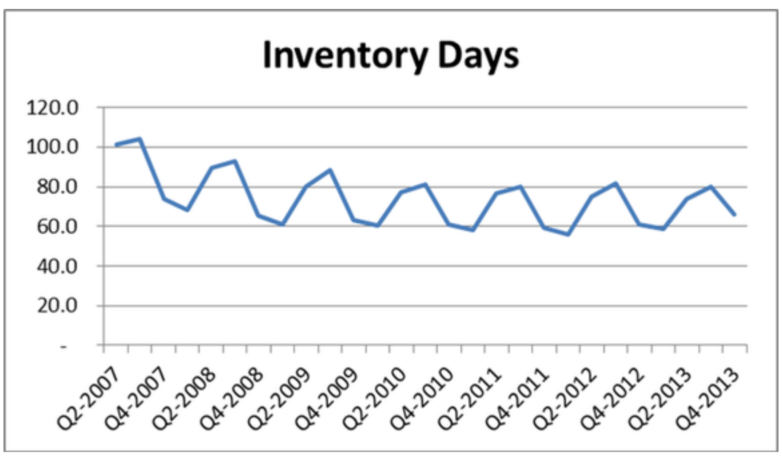
1. Store Performance: Same store sales, sales per square foot, store sales per store, and invested capital per store are all worthwhile metrics to assess store performance. The reason The Buckle has generated so much value over the years is because it has been able to sell more (profitably) through each store without having to invest much more. And while same store sales growth is noisy, it is consistently positive. Store sales per store ($2.3 million) and sales per square foot ($461) both modestly declined in 2013, mostly because the 2012 included a 53rd week and because the units sold per transaction declined a bit.



1. Margins and inventory: Retailer gross margins and inventory levels expose whether or not merchandise selection is on the mark: if you've got items nobody wants you either have to put it on sale (which will ding gross margins) or let it sit on your shelves (which will ding inventory turnover). Historically, The Buckle has merchandised well, and margins have risen steadily...



...while it's days in inventory have also improved:



I don't expect much improvement in gross margin going forward. Inventory management will remain critical. Inventory grew 20% over last year, which is a yellow flag when compared to flat sales growth. However, management contends that the inventory build is the result of running a bit too lean coming out of the 2012 holiday season and missing sales, ordering ahead of the Chinese New Year (which is a minor disruption to getting merchandise), and filling the shelves with children's clothes (a new initiative). I'll be watching this – BKE management has certainly earned the benefit of the doubt, but this could signal slowing sales or declining gross margins to come.

WWTN

The Buckle is operating admirably in a difficult apparel retailing environment. We've incorporated current headwinds, higher investment expected in 2014, and continued strong operational execution into our estimates and think shares remain undervalued and have plenty of long-term upside.

Conference Call Notes

- On SSS: Q4 SSS were down -2.8%, FY-2013 SSS were flat. Q4-2012 included an extra week which makes these figures appear worse than they are.
- On e-commerce sales: Q4 online sales were up +7.3% (excluding the 53rd week last year) and up +7.5% for the full year. When asked about why online sales continue to grow at below market rates, management said "we have not been promotional with our online sales, and have not had any free shipping specials. We continually run it, our business, full price like our stores." I continue to believe BKE is underperforming with its online strategy – this remains an opportunity.
- On merchandise and store performance: For the quarter, UPTs increased +3%, average transaction value increased by 0.1%, and the average unit retail decreased -2.5%. For the year, UPTs increased approximately +3.5%, the average transaction value increased +2.5%, and the average unit retail decreased -1%. Sales per square foot was $461, compared to $475 last year, and BKE has 2.271 million square feet of retail space. Accessories and shoes continue to perform well, and sales of men's clothing was stronger than women's.
- On private label: Now 34% of sales.
- On stores: The company expects to open 17 new stores next year and eight remodels. At the end of 2013, 341 of the company's 450 stores were in its newest format.
- On merchandise margins: CEO Dennis Nelson: "But our margins have continually improved and they are at a level now that we don't promise continued improvement there. But we will do our best to work at improving that."
- On the new stores: The 17 new stores reflect opportunities for great long-term investment .
- On the performance drivers: CEO Dennis Nelson: "The biggest impact on our business and the stores is our manager and the teams they develop. And so, region-wise, I don't see any great exceptions to different areas. It basically comes down to the quality of the store manager, and the experience the guest has there, that has an impact on the store."
- On losing share to e-commerce (show-rooming): CEO Dennis Nelson: "Well, I think the key to our success, along with our people is in our selection. With our brands, we almost are probably 70%, 80% exclusive styles in most seasons. And so, to find that exact product, or sometimes it is a exclusive fit for us as well as design, so that the guest cannot go elsewhere to buy that product. And then, among our own brands, we have several of our own labels in both men's and women's that our teams merchandise and design, and are also exclusive. And not only have a great look, fit, but is unique styling, and has been very successful as well. So it would be very difficult for somebody just to shop us, and then go elsewhere to make the purchase."
- On the core customer: CEO Dennis Nelson: "I think the misunderstanding is that we are only high school and college shop -- for a lot of investors think that's our only customer. And we have actually developed, where some of our stores where we have a little longer history will tell us that they are -- they have more guests over the age of 25 than under the age of 25."

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3 Takeaways From Our Talk With O'Reilly

Published Mar 17, 2014 at 4:00PM

Upcoming Expirations

- **iShares Russell 2000 Index** (NYSEMKT: IWM): We will provide official guidance on our bear call spread this week. We plan to keep our hedge going and will offer guidance for those who want to do the same.
- **WisdomTree Emerging Markets Small Cap Dividend Fund** (NYSEMKT: DGS): Our $46 written puts are currently (slightly) in-the-money, and we expect to accept new shares at expiration after Friday. This will bring our stock allocation to around 3%.

Dear Fools,

Your *Pro* team is committed to understanding the companies we are part-owners of. We believe the key to sensible portfolio management is a deep understanding of risks, opportunity costs, and alternatives — weighing potential new investment opportunities (whether stocks, options, or cash) against our current investments with respect to our North Star and our understanding of any potential external derailments.

One way we attempt to refine our understanding of the companies we own is by speaking to their management teams. We understand this can be a controversial practice, but in the end, we'd rather have the added information — and be responsible for sifting through its fluff and bias — than not have it at all. As a result, we visited **AmTrust Financial** (NASDAQ: AFSI) in December, spoke with management at **Valmont Industries** (NYSE: VMI) later that month, and touched base with **The Buckle** (NYSE: BKE) in February. Last week, I sat down and spoke retail again; this time, the topic was auto parts retailing, and my conversation was with management at Buy-rated **O'Reilly Automotive** (NASDAQ: ORLY). Here are my takeaways.

Plenty of Miles Left to Travel

O'Reilly's consistent performance has been remarkable: twenty-one consecutive years of positive comparable-store growth and 20 straight quarters of 15% or greater earnings-per-share growth. But now, with more than 4,100 stores across the U.S., how much additional room for growth is there? Plenty. So far, O'Reilly is only in 42 states — it has yet to crack states as large as Pennsylvania. Management also believes it has lots of room to expand in key geographies: It has about 100 stores in Florida and thinks that market can easily handle 300, and its penetration of the northeast is really just beginning.

Management contends that the availability of attractive locations does not constrain its potential growth, but the ability to find and promote the right people to run those stores the O'Reilly way *does*. Because O'Reilly is a "promote from within" culture, the company's ability to find the right people and train up its teams is the real anchor to its new-store growth rate (which the company caps at about 200 stores per year). It also sees opportunity to win additional market share in established markets, both in its retail segment (sales to do-it-yourselfers) and its commercial segment (sales directly to mechanics).

O'Reilly is also steadily improving its e-commerce platform, which seems to be less of a massive sales engine than it is a gateway to the store — auto-parts sales to the weekend DIYer most often require a bit of hand-holding and advice that's best delivered in person. The final piece of the growth puzzle is the occasional acquisition, ideally of a small chain of stores with a motivated seller (these are admittedly rare occurrences, but the O'Reilly team keeps a close watch on worthy candidates).

The math seems to work out to another 5 to 10 years before O'Reilly begins to saturate the United States market, at which point its sales growth will be a function of store-level improvements, market share, commercial penetration, and organic growth. But we expect profits to grow even faster, and the company is likely to at least explore expansion into the rest of North America, which should pave the way for North Star-like returns.

Relationships Breed Stickiness

I typically avoid investing in retail companies because the barriers to entry are low and customers typically have no switching costs. As I tried to understand what might set O'Reilly apart, the answer kept coming back to "relationships." For commercial customers (mechanics), availability of parts, delivery, and price are critical — but that's just the beginning. It turns out mechanics don't buy their parts from O'Reilly; they buy their parts from "Joe, the local O'Reilly salesman."

This distinction is critical because it makes the transaction personal. O'Reilly trains its Joes (and Josephines) not only to sell parts, but to take ownership in the operation and growth of each customer's shop as a business enterprise. This means understanding the local market, having the systems to tie into the technology that runs each mechanic's shop, having the parts and training to assist in the repair of the equipment the mechanic uses to run the business, and never giving a customer a reason to call another supplier.

All this does appear to have resulted in some customer stickiness — which bodes well for O'Reilly as the leader in the commercial market that competitors are trying to enter. It also speaks to the challenges of entering new markets and winning share. O'Reilly's strategy is simply to establish the relationship, and when the opportunity arises to fill a customer's first order, "to service the heck out of 'em."

Culture Is the Glue

Selling auto parts to DIYers and mechanics doesn't seem like a business that should be as profitable and growth-laden as O'Reilly has proven it to be. The secret may lie in the company's culture, which jumped out at me through the phone. You can read about it here.

Two culture-related anecdotes will best show its impact. First, as noted, O'Reilly is a promote-from-within organization — most of the senior leadership team started behind the counter (including CEO Greg Henslee, who started as a parts specialist about 30 years ago). The company's leaders believe its district and regional managers should move up from store-level management. This ensures that they're in touch with store-level happenings, have established relationships, can empathize, and know how to foster great communication. The other culture-sustaining practice is requiring each meeting to start with a "culture statement," where the meeting leader tells a story of one of the company's values they've witnessed in action. While this may seem hokey, it ensures that the culture persists, remains prominent, and touches every decision.

The *Pro* Bottom Line

Pro owns a 3.7% allocation to O'Reilly, and shares are rated a Buy. Today, I have a better understanding of how the company has been able to achieve its remarkable financial and operational performance. While the retail industry is notoriously competitive and rarely conducive to competitive advantages, I'm learning that companies that can create service-focused niches, supported by unique cultures and leaders who are lifelong employees, have a fighting chance and are capable of great things. O'Reilly, as well as The Buckle, seems to fit that mold.

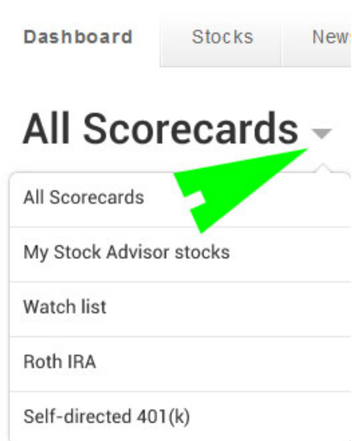
Onward,

— Bryan (TMF42)

Insider Tip: Track Multiple Portfolios in Your Scorecard

By popular demand, the Fool's new scorecard tool lets you track multiple portfolios! Keep your IRA holdings in one, your brokerage account in another, and stocks you're watching in a third — the possibilities are endless.

To get started, head to the tool and click the "Create a New Scorecard" button on the Settings page. You can then filter your Dashboard, Stocks, and News views using the portfolio selector drop-down menu at the top of the page, like so:



Pro Completed Trades (see all trade alerts)

- **iShares Russell 2000 Index** ETF: Eight of our 17 short call contracts were turned into short shares of stock. We're holding these short shares, and the rest of our IWM hedge, for now. We'll have new guidance this week.

Your Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Buy American Tower

Published Mar 17, 2014 at 1:45PM

Is this for you? *Pro* is raising our allocation to **American Tower** (NYSE: AMT) to 3.6%, so if you're following our portfolio closely, you should do the same.

How You Participate

- **Action:** Buy American Tower
- **Allocation:** Buy shares to bring your allocation up to 3.6%. *Pro* will be buying another 300 shares.
- **Recent Price:** $80.50
- **Price Guidance:** $82 or better
- **Options:** We may use them later, but they aren't necessary

What We're Thinking

Stock Info

- **Fair-Value Estimate:** $105 (recently raised from $100)
- **Consider Adding More:** $72
- **Scorecard Status:** Buy First

Pro members who have been following our **American Tower** (NYSE: AMT) position since its addition to our portfolio know that we have been writing puts since July 2013 with the goal of eventually adding a second helping of shares. Since our last put write expired as income in January 2014, *Pro* has been considering other ways to increase our allocation to this Buy First position.

We wanted to wait for Q4 earnings to be reported before making a decision, in order to update our valuation methodology to account for business performance over the past year or so. Those earnings have been out since Feb. 25, and we feel comfortable enough with our assessment of the business to increase our allocation by about 50%, bringing our 2.4% stake up to 3.6%. We expect that continued global growth in data consumption will stimulate wireless carrier network investments, leading to tenancy growth (meaning more service providers per AMT tower) and rising returns on capital over time.

American Tower continues to make progress against the checkpoints in our thesis, increasing our confidence that that the current discount to fair value is unwarranted.

- **We expected American Tower to continue to invest in and grow its tower portfolio, both domestically and overseas:** Check. 2013 was the most acquisitive year in the company's history, with more than $4 billion in acquisition spending, including two big transactions. Those acquisitions, along with continued investment in new site builds, contributed to more than 23% growth in 2013 in the company's tower portfolio, which now stands at more than 67,000 towers.
- **We expected strong organic growth in both domestic and international revenue, with international growth outpacing domestic growth:** Check. Organic growth (that is, growth *not* including acquisitions or new site builds) for full-year 2013 was 8.7% domestically (vs. 7.3% in 2012) and 13.5% internationally (vs. 13.6% in 2012). Both domestic and international growth outpaced management's guidance (6% to 8% domestically, and 10% to 11% internationally).
- **We expected tenant co-location to contribute to rising returns on invested capital (ROIC):** Check, sort of. We calculate returns on capital thusly: (adjusted EBITDA-maintenance capital expenditures) / (Gross PP&E + Goodwill/Intangibles). The company's big acquisitions of assets with low tenancy rates inflated both parts of the denominator of this equation (PP&E and Goodwill/Intangibles), causing downward pressure on ROIC. This downward pressure should only be temporary, and as those underutilized assets become more productive and gain more tenants, overall ROIC should continue to rise. Adjusting for the dilutive effect of acquisitions, 2013's ROIC was the highest in American Tower's history (just over 11%, vs. about 10% in 2012), and we expect it to continue its steady march upward.

To summarize: Our investment thesis is progressing nicely, the stock is undervalued relative to our recently updated $105 fair-value estimate, and we think now remains a good time to increase our small 2.4% stock position. Rather than write puts again and risk missing a further share-price increase, we'll increase our position to about 3.6% now, and we may consider more written puts in the future as business performance and market conditions dictate. If you prefer writing puts instead yourself, feel free to!

Alternative Trades

- **Looking for a lower potential entry price?** The April 2014 $80 and the July 2014 $80 and $77.50 puts offer reasonable premiums. Remember to use a limit order!

Pro Can Help

- Questions? Please consume data by accessing from your cell phone on our American Tower discussion board.

Your Slow-Mover Advantage Over Wall Street

Published Mar 17, 2014 at 12:42PM

Wall Street's short attention span makes it seem like the odds are stacked against snail-paced Fools like us. But in reality, high-frequency traders, big-pressure hedge fund managers, and supercomputers that calculate moves by the millisecond make our investing strategy even more successful.

In this exclusive glimpse at *Motley Fool One*, Morgan Housel reveals evidence for your single greatest — possibly even your only — advantage over Wall Street, along with three easy steps for maximizing your edge. Plus, listen to the *Fool One* podcast to hear Morgan and analyst Bryan White talk about how you can invest against the market's shortsightedness.

Get the PDF of Morgan Housel's report

Listen to the Podcast

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Run time: 10 minutes; originally aired January 2014

We hope you enjoyed this free bonus content brought to you by *Motley Fool One*. If you'd like a further behind-the-scenes look at this premier, all-access service — as well as the opportunity to take advantage of a wide range of free special gifts and exciting content from Motley Fool co-founder and CEO Tom Gardner and his entire *Motley Fool One* squad — simply click here.

Podcast Transcript

BRYAN WHITE:

Welcome to EP Weekly. I'm Bryan White joined in the studio today by Morgan Housel. Thanks for joining us today, Morgan.

MORGAN HOUSEL:

Thanks for having me.

BRYAN WHITE:

And today, folks, it's just me and Morgan. Jason and Robert Brokamp and Chris Hill couldn't make it today, so you're stuck with just both of us, but we should have a great discussion today as Morgan has put out another special free report. It's called "Your Slow-Mover Advantage over Wall Street." We'll dig into that and also earnings season is just beginning for our EP companies. Coach reported yesterday and Starbucks reports today after hours.

First let's dig into this report, Morgan. A very interesting report -- another one from you. What gave you the motivation? Why did you pick this topic?

MORGAN HOUSEL:

I think there have been a lot of investors over the past couple of years -- maybe not necessarily all of our members from *Motley Fool One* -- but I've seen a lot of investors really start to question why is it worth being an individual investor when the evidence seems overwhelming that Wall Street has an edge over you. That the game is rigged in their favor against the individual investor. Things like high-speed trading, insider trading. We hear all these stories about how Wall Street can succeed over you.

But I think there's one huge advantage that individual investors have over Wall Street and it's this concept of *time arbitrage* -- which very simply put is if Wall Street is focusing on the next five months and you, the individual investor, are focusing on the next five years, that is a tremendous advantage that you have over them.

And you have that advantage over them because the way that Wall Street is set up ... And when I say Wall Street, I'm really talking about hedge funds -- big institutional, professional investors. They're by and large graded on the short term. They have to focus on the next quarter or else their clients start firing them. It's really a very short-term focus game. So, they're kind of stuck in that short-term bubble. If individual investors can get away from that and focus on years, it's a huge advantage.

So, I had some statistics in the chart about if you go and look back the past 150 years of the S&P 500 ... If you're looking at the market based on a one-day basis or a one-month or three-month basis, the odds of you making money is pretty close to a coin toss. The market goes up, goes down. That's what it is. If you can invest for five or ten years, your odds of making money are very good. And that flows down to individual companies, as well. If you're talking about stocks that miss earnings by a penny per share and then fall 20% after hours ...

BRYAN WHITE:

Yes ...

MORGAN HOUSEL:

... well that's Wall Street's game. But if you're in this for the next five years -- not only does that not affect you, but that becomes your opportunity at that point. So, really I think when investors focus on this, it becomes that this is the advantage that you hold over Wall Street and this is why individual investors can, indeed, outperform the market over the long run.

BRYAN WHITE:

Well, I think as One members, you do have an advantage. I think as members of One, you have a huge collection of great companies to choose from ... from all of the different services here at the Fool. And then, taking some cues from this report, we're likely to continue to see dramatic moves based on headlines, based on earnings reports, and especially with the more-and-more high-frequency trading that's going on in the market.

So, there's two different perspectives. One, the game's rigged against me or the perspective that hey, prices are going to jump quite a bit, and if I can only get my hands on a nice list of great companies for the future, I can be patient and wait for the most part. Or at least set my portfolio and then my incremental investments going forward -- part of them can be some of these things that move huge based on headlines and the news.

Obviously, you want to look at the fundamentals because sometimes a stock deserves to get hit, but a lot of times we're seeing an earnings season that stocks are just getting crushed just based off the headlines. The headline barely comes out and the stock's moved double digits.

MORGAN HOUSEL:

And I think it's really tempting for some investors to look at those moves and think, "What does Wall Street know that I don't?"

BRYAN WHITE:

Yes.

MORGAN HOUSEL:

My stock is down 20% after hours. Do they know something that I don't and should I be worried about that? And maybe sometimes that is the case, but I think most of the time the answer is no. It's just that they're just focused on the next 90 days. So, this move after hours or in the short run really doesn't apply to your goals as a long-term investor.

BRYAN WHITE:

Let's flip the coin on the other side. The short-termism, let's say, and let's say the advantage of high-frequency trades. What would be one negative that you would point out for individual investors like us that take the long-term approach -- but one negative that we should be mindful of because it's a true negative. Not everything is a positive story. What is one thing that we should watch out for?

MORGAN HOUSEL:

Well, I think it's really interesting. About two years ago at Fool.com, there was a group of writers that did this long, in-depth report on the flash crash which happened in May, 2010. The Dow fell a thousand points in a matter of minutes. So, they did this report and they set out to do this big investigation. They wanted to find an individual investor who had been harmed by the flash crash ...

BRYAN WHITE:

Okay ...

MORGAN HOUSEL:

... and they looked for weeks and weeks and they could not find one.

BRYAN WHITE:

Yes ...

MORGAN HOUSEL:

The flash crash -- the Dow fell a thousand points and then about five minutes later, it regained most of that. It's called a flash crash because it was over before most people knew it ...

BRYAN WHITE:

Yes.

MORGAN HOUSEL:

So really, I think when we're talking about high-frequency trading, it might harm individual investors if for whatever reason you need to sell stocks right this minute. I don't know why you would need to do that -- because you've got to raise money to pay a bill or whatever. Then, you know, it makes the day-to-day action more volatile.

But in terms of the value as an investor, and that we look at it, is owning real businesses for the long term, just like you would as a private investor. You own a McDonald's franchise and that's your business. If you think of investing that way, I really, firmly believe that high-frequency trading does not pose any risk to you whatsoever.

BRYAN WHITE:

I think you bring up a good point in your perspective. For investors [00:05:59] your portfolio is one of your small businesses. You may own another small business, but one of your small businesses ... it's your portfolio.

MORGAN HOUSEL:

Right.

BRYAN WHITE:

And to make snap decisions ... I mean, why not view it as if it was a small business? Would you run around and make snap decisions every day?

MORGAN HOUSEL:

Right.

BRYAN WHITE:

Every week? Acquire a company. Sell it off. Hire someone. Fire them the next day.

MORGAN HOUSEL:

You know, I've made the analogy before. If you own your home, let's say, and you go to Zillow.com one morning and you look up the value of your home and Zillow's having problems with its servers and it says your home is worth zero dollars ... Your home isn't actually ... Like, nothing happened to your house. Like, it's still warm. You've still got a roof over your head. Just because you get a bad quote or you get a problem in your servers -- nothing happened to the value of that house. And it's really the same thing when we're looking at stocks and talking about volatility and high-frequency trading.

BRYAN WHITE:

Well, it's a great report, Morgan. I hope everyone reads it. It's out there on the One home page if you haven't seen it yet, and we'll be looking forward to the next report, Morgan.

MORGAN HOUSEL:

Thanks.

BRYAN WHITE:

Now moving onto Coach. Coach reported yesterday. Basically the quick summary for Coach is the same struggles are still there. Comparable store sales, comps, in the United States or in North America fell 13.5%, which is a pretty disappointing result. They're still in the middle of a turnaround. The financials are not looking great right now. There's sort of a debate internally and within the market that Coach is a great value right now, great buy ... and then there's also the argument from the bears that Coach is in some big trouble. There's legitimate arguments on both sides.

We're obviously going to hold pat. We bought it for at least the next five years when we did buy it, so we've got about four years to go with Coach. Where I stand ... See, we all think differently. Between Tom, Jason and myself ... Jason tends to be more bullish on the name. I came into Coach incredibly bullish, but there are some warning signs out there. Number one -- fashion. Fashion is fickle. You can invest in a genius, but when it comes to fashion, if it turns on you, it turns on you. Not one person can really turn that around.

MORGAN HOUSEL:

Do you remember B.U.M. Equipment from the 1990s?

BRYAN WHITE:

Yes. Yes, I do. Wow!

MORGAN HOUSEL:

Things go from huge to laughable really quickly.

BRYAN WHITE:

Well, yes, and I wouldn't compare that ...

MORGAN HOUSEL:

No, I'm not making that equation, but when you said fashion is fickle ...

BRYAN WHITE:

Well, I think Coach is a great example, because Coach is one of those iconic brands ... and if it can happen to Coach, it can definitely happen to anybody out there. And then at the same time, it's almost a perfect storm for Coach. Huge management turnover. Both their lead designer and their leader and CEO, Lew Frankfort, stepping down. A lot of turmoil.

And at the same time, you have a category that Coach dominated, which was the affordable luxury category. The price point for handbags -- they dominated it for years. And now, all of a sudden, out of the woodwork, while you have management turnover, you have companies like Michael Kors and others that come into your territory and start taking share and they're very successful ...so far taking shares. So, Coach is under some pressure. Come to the boards. Jason's going to have a recap of the quarter after going through the conference call. We'll have further discussion on Coach. Tom's been out on the boards talking about Coach in the past, so you'll find his board posts out there. And then after hours today, Starbucks reports, so that'll be a big report. We'll be covering that today after the market.

All right, folks. That's all we have today. We will see you next week.

Save Time, Make Money

Published Mar 10, 2014 at 4:00PM

Pro Guidance Changes

- **Papa John's International** (NASDAQ: PZZA): We have raised our fair-value estimate to $46.50 and our Consider Adding More price to $35. Shares remain a Buy with a 4.7% allocation. Get the details here.
- **Parexel International** (NASDAQ: PRXL): We're moving Parexel from Buy First to Buy after the stock's strong price appreciation. We have a 3.6% allocation.

Dear Fools,

Live Advisor Roundtable With Tom Gardner Tomorrow!

In preparation for the reopening of *Motley Fool One* in just 10 short days, we're bringing you a special investor roundtable on **Tuesday, March 11, from 5 p.m. to 6 p.m. ET.**

Tune in to see a LIVE video stream of Fool co-founder Tom Gardner, *MDP* and *Deep Value* advisor Ron Gross, *Pro* and *Options* advisor Jeff Fischer, and *Supernova* Odyssey 1 mission lead Matthew Argersinger as they discuss the current market and answer your questions. It's not too often we're able to pull the wide-ranging investing insight of these top-notch Motley Fool advisors and analysts into a single chat, so **set your reminder now**!

In case you missed it, on Jan. 30, the Bureau of Economic Analysis announced that for the fourth quarter of 2013, U.S. gross domestic product (GDP) increased at an annualized rate of 3.2 percent. Woohoo! Then, on Feb. 28, the BEA revised its GDP estimate down to 2.4 percent (that's a reduction of 25 percent, but hey, who's counting?). I'm not picking on the BEA statisticians — it's hard to measure the entire output of a country. What *does* seem silly is that many investors hang on the 8:30 a.m. first releases and feel compelled to alter their portfolios and investing strategies based on what they hear — but it never seems like the first and second revisions (often dramatic) receive much consideration at all. Compounding the problem, I'm not even sure GDP measures what we, as investors, should really care about.

What Should We Care About?

Calling the GDP's usefulness into question isn't new or very helpful. An economy, or any measure of a population's welfare, is much more of a complex system than a discrete structure. In the last few years, there has been no shortage of proposed alternatives to the GDP with which to measure general progress:

- The United Nations came up with the Human Development Index, which considers life expectancy, educational attainment, and income.
- Friends of the Earth makes environmental adjustments (like the cost of climate change and ozone depletion) to traditional economic measures to calculate the Index of Sustainable Welfare.
- The Center for Bhutan Studies suggests that happiness is what matters, and has proposed a method of measuring Gross National Happiness.
- The OECD has identified 11 vectors to measure how life is improving or not; the intersection of those 11 vectors provides the Better Life Index.

While these measures clearly vary in their usefulness, they suggest GDP is not the be-all, end-all, and that we should be open to thinking about progress differently.

Productivity and Free Time

In his excellent book *The Rational Optimist*, Matt Ridley proposes that "prosperity is simply time saved," and that innovation and idea exchange are the engines that power that prosperity. Ridley didn't concoct a bespoke statistical measure to track this, but instead used existing measurements to triangulate and support his thesis. Of course, considering prosperity as time saved means we don't get the comfort that comes with a nice clean number like GDP. But then again, is a measurement really nice and clean when it can change by 25% after 30 days?

Happy Birthday, Internet!

On Wednesday, March 12, the World Wide Web turns 25. Happy birthday, Internet! Ridley opines that, if we look at productivity and the ability to spend time on what we want, things have never been better and the pace of improvement has never been more dramatic. The Internet's 25th birthday is a potent reminder of that belief — in 25 short years, the Web has changed almost every aspect of the world we live in by enabling the sharing of ideas, increasing productivity, and providing alternative ways to spend our resulting free time.

Productivity, free time, and wealth creation

When we circle back with more traditional measures of progress, it's hard not to think Ridley is on to something. The Internet has created immense wealth in its 25 short years — and its contributions to productivity and free time have been the backbone of the creation of some wonderful businesses and investing opportunities. Just look at the *Pro* portfolio to see it: **MasterCard** (NYSE: MA) adds efficiency to consumption habits, **Papa John's** enables productivity by outsourcing dinner prep and delivery, and **Facebook** (NASDAQ: FB) automates data collection on consumers for advertisers and provides a platform for efficient social connection. (And that's just to name a few.) In very clear ways, *Pro*'s companies embody Ridley's thesis about prosperity and time saved. These businesses' success in saving time has resulted in fantastic financial performance. We would be wise to consider adding another criterion to our "compounding machine" checklist: magnitude of time savings.

The *Pro* Bottom Line

The willingness to pay for time savings hits home here at *Pro*. Our recently opened Optimize Your Life discussion board has hosted some great discussions on this topic so far, and has the potential to meaningfully affect the lives of many members as our community increasingly shares its own time-saving secrets. Let's also be open to these discussions informing possible investment opportunities.

Onward,

— Bryan (TMF42)

Pro Completed Trades (see all trade alerts)

- **Coca-Cola** (NYSE: KO): We established 3% exposure with a January 2016 $37 synthetic long for a net credit of $0.12 per contract. We sold to open 17 January 2016 $37 puts, and bought to open 17 January 2016 $37 calls.

Your Most Active Conversations

Today Past 7 Days Past 30 Days

Live Advisor Roundtable With Tom Gardner and Jeff Fischer

Published Mar 10, 2014 at 1:29PM

In preparation for the reopening of *Motley Fool One*, the Fool hosted a roundtable discussion with Fool co-founder Tom Gardner, *MDP* and *Deep Value* advisor Ron Gross, *Pro* and *Options* advisor Jeff Fischer, and *Supernova* Odyssey 1 mission lead Matthew Argersinger.

Miss the action? Click the player below or read the transcript to see what they said.

{% ooyala id="E5anQ2bDrNtZDUkVMWhXYF-ppCuIHw5n" type="article" %}

Transcript

TOM GARDNER:

Welcome to the *Motley Fool One* Live Chat. We're going to get right into it. We've got an hour together. I have the promise of my panelists that this will be the most interesting and entertaining one hour of investment programming …

RON GROSS:

We made no such promise.

TOM GARDNER:

And the reason we make the promise is because we've heard that Ron Gross, our advisor in *Million Dollar Portfolio* and *MDP Deep Value* … his parents are watching today, so …

RON GROSS:

Hi mom and dad. Thanks for joining us.

TOM GARDNER:

So, we've got Ron. We've got Jeff Fischer — *Motley Fool Options*, *Motley Fool Pro*. The original Fool portfolio, as well. And we've got Matt Argersinger — *Supernova*, *Rule Breakers*, in *Stock Advisor* probably pitching in some ideas there …

MATT ARGERSINGER:

I'm on there — sure …

TOM GARDNER:

They're all over the place. Someday — perhaps not that far away — Motley Fool Germany, as well.

MATT ARGERSINGER:

That's right.

TOM GARDNER:

Pre-announcement there. So, we're going to get right into it. We have a couple of conversations that we're going to start with. Then we're going to talk to a member of *Motley Fool One*, Mark Timmerman. Very excited about that. And then we're going to be taking your questions throughout, so please know that you can submit questions about our conversations or any questions you have about *Motley Fool One*. We have a number of analysts out in the chat ready to answer your questions directly there. And, of course, we'll take some of your questions and answer them here as a panel.

I just want to start, team, with a conversation about where the market is today and what it makes you think about investing. Are you thinking the same way about investing in stocks that you did three years ago, or has there been a change because of the remarkable performance? Or even one year ago, before the market had risen 30%-plus?

So, where are you now …

RON GROSS:

Hm. Can I jump in?

TOM GARDNER:

Yes …

RON GROSS:

My preferred answer, when anyone ever says to me, "What do you think of the market," is to say, "I don't know. I honestly don't know." If you had asked me on January 1 of 2013 when unemployment was high and GDP was low … interest rates were also very low …would the market have been up 32%, the S&P 500 … I would have never guessed. I think it's very difficult to opine where the market, as a whole, is. What I prefer to do is each day, every day, look at stocks, look at stocks, look at stocks …

TOM GARDNER:

Blind to what's happening with the macro issue.

RON GROSS:

It's there. I'm educated on it, but I don't make predictions and I don't make investment decisions by it. But what I can see as I analyze stocks every day, all day, is some patterns that are emerging …

TOM GARDNER:

It's getting harder.

RON GROSS:

… is it's harder to find good stocks.

TOM GARDNER:

Is it harder to find good stocks?

RON GROSS:

I am definitely finding it harder to buy stocks, especially if you're looking at stocks in the *Deep Value* service. We're almost 50% cash in that service. Very hard to find deep value stocks. In *Million Dollar Portfolio*, a little bit easier because we can look at growth stocks, high-growth stocks, innovative rule breakers …

TOM GARDNER:

Which is more important to you, Ron, when you're looking for these stocks? Are you looking for stocks that are going to make you money over the next five years, or stocks that are going to beat the market over the next five years or the next three years? If you knew that you were going to buy a stock and the market would be down 8% and you'd be down 2%, is that satisfying to you, or is the baseline that it's profitable?

RON GROSS:

It's a really difficult question to answer — but my standard answer to that is that I'm looking to beat the market under the assumption that over periods of time, the market does very well. Let's call it 9 or 10%. And if I can consistently beat it, even in bad years, then not only will I outperform the market, but I will also make investors money.

TOM GARDNER:

Now just before we came on air, you were calling the person to your left and to the audience's right fanboy Jeff Fischer. There are so many fanboys for Jeff Fischer. So, great answers, but I guess the world wants to know what Jeff thinks.

JEFF FISCHER:

That must be true. It must be true. And I'll start by saying to Ron's parents that Ron is really a nice guy.

RON GROSS:

Thank you, Jeff.

JEFF FISCHER:

He's nice to work with and he's genuine.

RON GROSS:

I appreciate that.

JEFF FISCHER:

He's the real deal.

RON GROSS:

Very thoughtful.

JEFF FISCHER:

Well, it's true. Speaking the truth. On the market. When I look ahead, the next three to five years, I'm excited. I'm excited about what good companies, what good stocks could do over the next three to five years. When I think in the next one to two years, it's more of a random guess. I don't know.

TOM GARDNER:

Is that always true for you, or do you have a particular feeling that the market, having gone up quite a bit over the last couple of years, it's cloudier …

JEFF FISCHER:

Yes. I think it's cloudier. The higher the valuations go in general, the more uncertainty there is in the next couple of years. Because you could say a stock needs some time to catch up to the valuation as much as we may dislike that phrase. So, yes. When the market, as a whole, was 20% or 30% cheaper a year ago, it was much more easy to be excited about the next year or two. But now, where they're at …

TOM GARDNER:

Getting a little harder. But your view of three to five years forward not seriously impacted by valuations today.

JEFF FISCHER:

I agree with Ron. It's harder to find things you're clamoring to buy, but there are still good companies that we're very happy to own and to recommend today, especially given our rolling three-year outlook.

TOM GARDNER:

Matthew?

MATT ARGERSINGER:

I tend to pay attention to the headlines.

RON GROSS:

What about my parents?

MATT ARGERSINGER:

When I'm not paying attention to Ron's parents, I tend to pay attention to the headlines because I think understanding market sentiment is kind of important. And what I see is there is a lot more enthusiasm about the market today. At the same time, there's still definitely a genuine level of skepticism. And I think as long as that's out there, I feel pretty good about investing and like Jeff, I feel very good about the next three to five years. But there are pockets, I would say, of the market that I would say are probably a little beyond their expectations …

TOM GARDNER:

What's a pocket for a company?

MATT ARGERSINGER:

As much as I love the social media companies, I think they're pricing in a lot of future growth today. They might very well be worth what you're paying for them today several years from now. I just don't know if they've earned that yet. We all know Seth Klarman. I don't know if he's been mentioned in previous …

TOM GARDNER:

Baupost Capital …

MATT ARGERSINGER:

Sure. Tremendous track record. He was out the other day saying, "Listen. The market's pretty high in certain places." And I look at that as a little bit of a shot across the bow. I think he's early and I think there's still a lot of skepticism.

RON GROSS:

Value investors are typically …

TOM GARDNER:

He's closer in the deep value camp, so he's going to come out with those shots earlier, but there's an analogy that I can't come up with here, but it's basically … Well, you can say *canary in the coal mine* … But it's basically an early indicator that you should consider thinking a little bit differently about what's happening than what's been the environment that we've been in over the last couple of years …

JEFF FISCHER:

I agree with that Tom, and I think you could easily look at this video a year from now and talk about, "Oh my gosh, so many stocks were overpriced or declined quite a bit in the year since," but then look at the video two or three years from now and most good businesses will be worth more.

TOM GARDNER:

Absolutely.

MATT ARGERSINGER:

Absolutely.

RON GROSS:

One thing I love about Foolish investing is you'll rarely hear someone in the building say, "The S&P 500 is 16x forward earnings — therefore we're moving to cash." You're more likely to hear that on CNBC. We're more company-centric. One company at a time. Is Tesla overvalued? Has it run its course? Is Netflix overvalued? Does Intel represent a good value? Do I want to own that? Rather than making these big, big macro stock market calls.

TOM GARDNER:

Quick question from each of you about your personal portfolio and then we're going to go to Mark Timmerman. We're going to start with MattyA this time and go from the audience's right to left. What percentage of your personal portfolio is in cash? Or you don't have to share your personal details. You could say what percentage of a portfolio that you would buy someone to manage right now would be in cash?

MATT ARGERSINGER:

I'd say less than 10%.

TOM GARDNER:

Less than 10%. But more than 1%?

MATT ARGERSINGER:

More than 1%.

TOM GARDNER:

But some cash on the sidelines.

MATT ARGERSINGER:

There's something on the sidelines for sure.

JEFF FISCHER:

Mine is around 25-30%.

TOM GARDNER:

Twenty-five to thirty percent in cash.

RON GROSS:

Woo!

TOM GARDNER:

Okay.

JEFF FISCHER:

That's pretty standard.

TOM GARDNER:

That's standard.

JEFF FISCHER:

It's close to standard. It fluctuates. But when you're chugging along …

TOM GARDNER:

Why is that happening?

JEFF FISCHER:

I use options, so the cash secures a lot of those options. Pro members see this in Pro where we have about 20% cash and that's partly defensive given Pro has absolutely …

TOM GARDNER:

If you were not using options at all — you had an all-equities portfolio and it was all long — what percentage in cash would you feel comfortable having? Or what would your standard …

JEFF FISCHER:

Well, then at my age, I would think I'd be more 90% invested maybe …

TOM GARDNER:

Because you're what? You're 26?

JEFF FISCHER:

I'm 44.

TOM GARDNER:

You're 44. Very healthy.

JEFF FISCHER:

So, I think I'd have less cash.

TOM GARDNER:

You'd have less cash.

JEFF FISCHER:

I'd have less than 30%.

TOM GARDNER:

But let's modify the question. I apologize. You're a 58 to 64-year-old right now. How much would you have in cash?

JEFF FISCHER:

Whatever money you need in three years should be in cash.

TOM GARDNER:

Got it. Ron?

RON GROSS:

Personally, about 10-11% in cash, *Million Dollar Portfolio* is 5% in cash. I don't see a huge difference between that. There's a 5% swing.

TOM GARDNER:

And is 5% a statement that it's difficult to find stocks or 5% …

RON GROSS:

No, I think having 95% of your capital at work means you can still find stocks to purchase. At any given time, we may have sold something and not put the cash back to work yet because we are managing a finite amount of money. So, portfolio management is all about sometimes selling a good stock to buy a great stock. So, sometimes we'll have some cash on the sidelines as that's taking place.

But as I mentioned earlier, *Deep Value* is almost 50% in cash because it's very difficult to find deep value stocks right now, and that's exactly how that philosophy is supposed to work.

TOM GARDNER:

I mean, Seth Klarman … It will not be unusual for Seth Klarman to be 40%-plus in cash and yet he's delivered something like 18% per year results going back 20-plus years. He's obviously a brilliant investor. One of the things I love about investing …

Obviously some investors or some members of The Motley Fool are trying to have it done for them as much as possible and trying to minimize the amount of time you're spending on investing. Others want to dive deep and learn more about business, about your portfolio, about portfolio strategies.

As somebody in the latter group for all four of us — it's really fascinating and has been for 21 years to study how other people are investing. Because Seth Klarman could sit down with growth investors at our company that are in that camp and I think they would find, actually, a fair amount of common ground, but they've taken a different path to getting extraordinary long-term results.

JEFF FISCHER:

Well, Tom, Warren Buffett, too, has quite a bit of cash. I don't know, offhand, how much right now, but he almost always carries cash for opportunities.

TOM GARDNER:

And Wally Weitz, I know, who's in Buffett's circle of great investors … He's often 30-40% in cash, even though he's all equity, all long. Okay. We're going to put our headphones on and we're going to tune in with Mark Timmerman from Des Moines, Iowa. First of all, Mark. Is it Des Moines or Des Moynes?

MARK TIMMERMAN:

It's Des Moines. Des Moines, Iowa. Thanks for having me here.

TOM GARDNER:

I'm sure you're passionate about making sure that people know how to pronounce your hometown.

MARK TIMMERMAN:

Oh, absolutely. We get really touchy about it, especially after the kind of winter we've had.

TOM GARDNER:

Actually, yes. Before we talk investing with you, just give us a quick snapshot of the winter in Des Moines — this winter.

MARK TIMMERMAN:

Did anyone see the movie *Frozen?*

RON GROSS:

Yes.

MARK TIMMERMAN:

That's pretty much it. We had more school snow dates because of temps below 10, 15 below and wind chills up around 35 to 40 below. But that's the Midwest. Anyone can live in Florida, can't they?

TOM GARDNER:

I love that. Trash talking. So, Mark, before we talk a little bit about your experience as a Motley Fool member and a *Motley Fool One*, I just want to hear a little bit about your investment philosophy. How do you think about investing and how's your portfolio been doing the last couple of years?

MARK TIMMERMAN:

The investing philosophy has evolved a lot. One of the things … I was just getting ready to talk to you folks. It's just amazing to look back — since I joined the Fool back in 1997 — and really not knowing much about how to do any of this. I knew I needed to save. I knew I needed emergency reserves.

It's evolved so much over the years, but I do understand and have refined so much more of the long-term focus on owning not stocks, but great businesses and sticking with them through the long term. That's grown a lot, but I always had that seed and that's grown so much with all my learning that's taken place over the last 17 years or so.

TOM GARDNER:

What is an example of a great business that you have held and enjoyed the fruits of their success? And what is an example of a great business that you sold too soon?

MARK TIMMERMAN:

Whoa!

TOM GARDNER:

Sorry.

JEFF FISCHER:

Shudder …

MARK TIMMERMAN:

My largest position, actually, is one of my smallest investments … Netflix. I've talked a lot about it on the boards. That was something I invested in, in 2004. My cost basis in Netflix was between $10-12 a share …

TOM GARDNER:

They're $440 now …

MATT ARGERSINGER:

Bravo …

MARK TIMMERMAN:

Yes. That's the fun part. But to me, the much more important part of that story is that I rode it down 85% in what was it? 2011? 2012? I've tried to block it from my memory completely. But I rode it down maybe 5%. Didn't sell a single share and continued to believe in what the company was doing. They hit some road bumps, but that taught me so much about sticking with a company that I felt like I truly understood.

Some of the other ones — I've owned Starbucks since 1998. Obviously, that's been very rewarding. Buffalo Wild Wings I've owned since 2004. That's been rewarding. One of the things I wanted to mention is it's really rewarding when you, Tom, select companies like that for another five-year holding period in the Everlasting Portfolio and the conviction is there to add your own money to those positions after all that growth. So, I'm really excited about just holding onto companies for the long term and really watching them blossom.

TOM GARDNER:

I notice that you've avoided the second question.

MARK TIMMERMAN:

I picked up — I invested — my first position in Tesla. My cost basis was around $30 a share. It must have been probably two, two and a half years ago — whenever it was $30 a share. I held it for about a year and just before earnings were coming out at that particular time, the price was hovering around $63 a share.

I just didn't have the conviction of understanding that company. I completely am amazed by Elon Musk — I admire him greatly — but I just didn't understand the size of the market with electric cars and what he was trying to do. One of my faults is that I sold it at $63 just before earnings. Obviously they blew out earnings and it's been on a rocket ride since.

TOM GARDNER:

Out of curiosity Mark, do you view that as a mistake, or do you view that as just the natural course of having conviction and you're thankful that, that conviction caused you to hold Netflix and certain times that conviction will steer you wrong, but it's important to follow through your belief and thesis and then try and learn from it after.

MARK TIMMERMAN:

That's a really good point, and I firmly believe that the discipline of following a process where I feel like I understand what I'm doing, I know why I'm doing it and I can stand by it — I've built into the assumption that I'm going to make some mistakes like that. I certainly can't own all the stocks that are going to do wonderfully out there. I'm certainly not going to sell all the stocks that should have been sold — but I'm going to be right more than I'm wrong and the winners have more than made up for my mistakes. So, on balance, I'm very happy about it. Still, when you put a microscope on it, it's a little tough to look at, but that's just part of how this works.

TOM GARDNER:

Sorry to pull the microscope out. So, we have Ron Gross, Jeff Fischer and Matthew Argersinger here with us from *Million Dollar Portfolio*, Options Pro, *Supernova*, *Rule Breakers*. I just wanted to talk a little bit, Mark, about your experience in Pro and Options and how that has impacted your investment approach. I'm presuming that in 1997, you were not using options when you joined The Motley Fool.

MARK TIMMERMAN:

No. Back then, remember, options were evil back then.

TOM GARDNER:

Absolutely.

MARK TIMMERMAN:

We didn't talk about options then. I was listening in on your conversation as I was waiting to join and I heard you talking about cash. My personal position on cash or percentage is hovering around 22-23%. By contrast, in 2001 when we had the big recession and 2007 and 2008, I was fully invested both times. That stuck with me, because I was stuck in not being able to act or have any opportunity to take advantage of the situation. And that, to me, was really painful.

As far as having cash now, the ability to use options — to productively use that money — while I'm waiting for opportunities and the ability, now that my portfolio has grown to the extent it has … I have the ability to hedge in a way that I never had before. So, the tools I've learned through Pro and Options have been priceless. Jeff's guided a real neophyte through this process. I was very apprehensive and had a lot of anxiety about making a mistake or doing something that was really going to cost me a lot of money by doing something stupid.

TOM GARDNER:

Out of curiosity, because of the deployment of options in your portfolio, does that cause you to feel less anxious about where the market is or what's happening in the macro environment because you have some built-in protections and hedges with options?

MARK TIMMERMAN:

It really does. I have an even more holistic view of how things are playing out. I just have more tools in the toolbox to use. Obviously the meat and potatoes of my portfolio is long-term positions that I anticipate growing nicely over the years, but while I wait for that, while there is volatility in the market, there's a nice opportunity for part of your portfolio to generate returns that not only add to your returns, but also stabilize your portfolio a little bit more.

In 1997, I was starting a family. Now I have kids that are going into college and I'm within 10 years of retirement. My objectives have evolved over time, and now I'm thinking about how can I generate income at sufficient levels? How can I take advantage of a special opportunity? That's allowed me to do it.

JEFF FISCHER:

That's a great point, Mark. So many people nearing retirement or in retirement use these really conservative options strategies, as you know now, to generate income month after month … and meanwhile you can let your stocks be for the long term to appreciate. So, I love how you put that … that the meat and potatoes of your portfolio remains great businesses …

TOM GARDNER:

Are meat and potatoes really recommended, though, at this point?

RON GROSS:

In Iowa, I think.

TOM GARDNER:

In Iowa.

MARK TIMMERMAN:

If you come to Iowa, that's all we have.

TOM GARDNER:

Okay, got it.

RON GROSS:

Mark, it's Ron Gross. Thank you so much for joining us. I really appreciate it.

MARK TIMMERMAN:

Hi, Ron.

RON GROSS:

I was curious. Obviously, you really like your experience with Jeff at Pro and Options. So what made you join One and how do you use the service?

MARK TIMMERMAN:

One of the things that drew me to One is that with things changing in our family's life where my wife is almost six years younger than I am, so my objectives for some of the IRA portfolios I've been managing were starting … I could see retirement or at least I was going to start working for fun and stop having to work at a certain time within 10 years. Pro became a really big lever for that.

But my wife — I've moved more of the new money and she's adding more money on a regular basis, too. So, *Supernova*, Odyssey 1 …

MATT ARGERSINGER:

Right on …

MARK TIMMERMAN:

… and the Everlasting Portfolio have been home for that new money.

TOM GARDNER:

How is your wife connected into the investment decisions and what success have you had in getting your children investing? But really looking at the entire family and trying to get every family member of a *Motley Fool One* member investing has been an aim of ours, but it's going to become a much more intentional aim in the year and years to come. So, how's that going in the Timmerman household?

MARK TIMMERMAN:

I'm really excited about the future, but I can tell you right now. I have a 17-year-old that's getting ready to go into a pre-law program, and I've not been as successful at luring him in or interesting him in the way I want, but I'm giving that time. I'm also trying to make sure that I do the right things to meet him where he's at rather than try to bring him along where I'm at. My daughter is more focused on probably being a teacher some day and has not shown any interest at this point. That's a development area for me.

But my wife is an actuary by profession. She's hardwired for number crunching. She leaves the more organic side to investing to me, but we talk about it constantly and she's very interested and has a tremendous amount of confidence in watching my experience over the last 17 years with the Fool. So, very supportive. She's hands-off, but very interested in hearing about how things are working.

MATT ARGERSINGER:

Mark, Matt here from *Supernova*. Thanks for joining us. How are you doing?

MARK TIMMERMAN:

Hi, Matt.

MATT ARGERSINGER:

I love the story about Netflix, Starbucks and Buffalo Wild Wings. You've held those companies for so many years. That really is the game that we're trying to play in *Supernova* with Odyssey 1 and I know Tom's playing that game with the Everlasting Portfolio. Is there a company that you see in *Supernova* or in the Everlasting Portfolio that you say, "This is the one. I'm going to hold this one for many, many years. I see so much upside for it. This is going to be a driver, a meat and potato of my portfolio for a long time."

MARK TIMMERMAN:

Oh, gosh. I should have my portfolio in front of me.

MATT ARGERSINGER:

I'm putting you on the spot, I realize.

MARK TIMMERMAN:

I'm really excited by what I see in LinkedIn. I've been very fortunate to get in well under $100 on that one and the growth has been nice. One of the most valuable parts of any of the services — and with *Motley Fool One* — you get access to all them … are the discussion boards. And the education I've received is literally priceless. In my estimation, you could almost get a finance degree really, if you wanted to dig in deep enough with all the information that's available to you.

LinkedIn is one of those companies that I've learned a lot more about. I knew very little about it. I apologize …

TOM GARDNER:

Here's what we're going to do for you, though, Mark … or at least I've got a couple of ideas … and then if anyone wants to chime in any. I've got some stocks for your kids. I'm going to make a couple of recommendations for your children …

MARK TIMMERMAN:

Excellent.

TOM GARDNER:

They may not have taken to the subject yet, but maybe if we go into the center of their area of interest … So, for the lawyerly son, there's a company called RPX Corporation. I believe it's Rational Patent Exchange. It has to do with patents — essentially large technology companies helping this organization buy patents that they then rent to the larger businesses. It came public in the last year and a half.

And in general, when trying to get a child interested, it is more important to pick something that's interesting to them than to pick a winner … although both is the ideal. But for your daughter that's interested in becoming a teacher, I would say obviously Amazon. That's the place to go for all the reading materials that you can find. LeapFrog or K12. That's a *Rule Breakers* recommendation, I believe. Do you all have any legal or educational stocks to give to Mark before we let him go?

RON GROSS:

Hm.

MATT ARGERSINGER:

Hm. [00:24:39]

RON GROSS:

Coach. They're going to need briefcases.

TOM GARDNER:

I love that …

RON GROSS:

I vote for Coach.

TOM GARDNER:

And Coach is …

MATT ARGERSINGER:

He's got to play video games, too. Activision and Blizzard's out there.

TOM GARDNER:

Yes. Activision Blizzard. Okay, Jeff. You're on the spot now. Everyone's got one.

JEFF FISCHER:

I would say eBay. Let's do — when you're filling up your dorm room — that's eBay's price point.

MATT ARGERSINGER:

And probably going to be involved in some big legal dispute over the next few months.

TOM GARDNER:

Sounds like it. [crosstalk 00:25:02]

MARK TIMMERMAN:

MercadoLibre is one of the ones that I've been very pleased with lately. It's [00:25:10] nicely and that's the one I've followed which is kind of a Latin American sister to eBay.

MATT ARGERSINGER:

Absolutely.

TOM GARDNER:

Mark, let me say in closing, it's our honor to serve you as an investor and to provide tools and ideas to help you build your portfolio and a financial plan of that portfolio. But I also just want to say how much I've enjoyed talking to you at the last member events. Hanging at the Minor League baseball game in St. Paul, Minnesota. That was a really great summer two-day that we had there. So, thanks so much, and I look forward to seeing you again at a future event.

MARK TIMMERMAN:

You're very welcome, and it was a real pleasure. It was a real thrill to talk with all of you folks.

RON GROSS:

Thanks, Mark.

TOM GARDNER:

Fool on!

JEFF FISCHER:

Thanks, Mark. Fool on!

TOM GARDNER:

Now we turn, without headphones, to your questions. I'm just going to take them in order. So, we've got Hilltop Gray has written in. "Should options be a part of every investor's portfolio?"

JEFF FISCHER:

I'll take that, and I'll say no.

MATT ARGERSINGER:

Thank you.

JEFF FISCHER:

I'll say no. You should give it a try, like anything. If you have a goal to make income stay or to protect your portfolio or you're adverse to downside and you want to hedge — then options are a tool you can certainly use. And see if you're comfortable with it. I honestly believe there's no better place than The Motley Fool to learn to use options in a Foolish way as an investor — when you use them as investors, not as traders.

And so, if you have a goal such as income, protecting yourself, or leveraging for upside with less money at risk … Like you can buy calls on Coca-Cola instead of buying Coca-Cola stock and pay a fraction of the money and have the upside. But then, there's a place for it. So, give it a try and see.

RON GROSS:

Awesome. Jeff, would you agree that it takes a little bit more activity, you need to pay a little bit more attention … or maybe a lot more attention … to your portfolio if options are a part of it?

TOM GARDNER:

This is Ron competing with you.

RON GROSS:

No, no. It's literally a question …

TOM GARDNER:

… over the *Million Dollar Portfolio*.

RON GROSS:

It's literally a question … versus a [00:27:06] like *Million Dollar Portfolio*? Shameless plug. Would you agree that it does require some more attention?

JEFF FISCHER:

It depends on the strategy you use, but in general, it requires a bit more. But you can do — as we did recently in Pro — we set up a 2016 option position on Coca-Cola …

RON GROSS:

Mm-hmm …

JEFF FISCHER:

So, we can let that go for two years.

RON GROSS:

That's great.

JEFF FISCHER:

If you're making income every month, then as those ideally expire, you write a new one. So, that's some monthly activity.

TOM GARDNER:

For regulatory reasons, I'm not going to be able to say very much about this right now, but I know that you have heard about our new solution that's part of *Motley Fool One* and that's separately managed accounts. And separately managed accounts — there will be a separately managed account option for *Motley Fool Pro*, so you will be able to have your money essentially managed by Jeff's ideas, and that will bear no assets-under-management fee. That's a really incredible … Just one statement on that.

You're not going to find many places out there in the financial world that are going to manage or help you manage your money without an assets-under-management fee. But when you actually look at that fee play out over — not just a year or three years or five years … but over ten years, fifteen years, twenty years where you're paying 1-2% of your portfolio in fees — what I think is going to happen here is we're going to see subscription membership at The Motley Fool significantly undercut that and our move to offer separately managed accounts where you can have *Motley Fool Pro*-like performance without having to spend any time should you choose not to.

Now we go to Pinky who says something in here … Pinky, you're going to upset one member of our panel with this. "I'm a Pro member. I'm an ex-*Supernova* member …"

MATT ARGERSINGER:

Oh …

TOM GARDNER:

Oh, wow. There have been some great returns in *Supernova*, but you had your reasons, Pinky, I'm sure.

"Now my question is in *Motley Fool One*, how do you suggest a member divide their capital between all the services? Is it only for those who have enough to create a reasonable portfolio in each of the multiple services?" I'll take a shot at that first, and then if anybody wants to jump in …

No, it is not our belief that you should have a full-blown portfolio that matches up with each one of the services. In fact, one of the key features in *Motley Fool One* is our Top Recs ranking of … Gosh, there are more than 450 active recommendations across all of our services. And what the Top Recs list does — and our analysts and advisors work on that each month — is it ranks from 1 to 50 the recommendations across all of our services. What we're trying to do is to help you build the right portfolio for yourself.

Now, there are certainly *Motley Fool One* members that are managing multiple portfolios. There are people who are running family offices. There may be a reason to set up multiple portfolios. But our goal in *Motley Fool One* is to set up the right portfolio for you that meets your needs, your risk temperament, your interests, the businesses that you want to learn about and focus on and your style of investing. No, our goal isn't … We're not trying to push you to a huge, huge allotment across each service.

From Diane. "I'm very interested in joining. I currently have *Motley Fool Options*, *Stock Advisor*, *Rule Breakers*. I am really enjoying Options and what I'm learning. Is *Motley Fool Pro* — which I'm interested in joining — is *Motley Fool Pro* part of *Motley Fool One*, Jeff?"

JEFF FISCHER:

Yes. A beautiful, easy answer. *Motley Fool One* is all access to all full services and big extras, including Tom's Everlasting Portfolio that is only in *Motley Fool One* … financial planners financial planning tools and the separately managed accounts that Tom mentioned. So, yes, you get everything and that's the beauty of this service. And you get to apply your current membership as a credit towards your One membership, so it all rolls over into One.

TOM GARDNER:

I guess I'll put it this way. I think that what we're trying to set up is the easiest pathway for you to be as involved and to build as much of your portfolio around our concepts as possible — and one of the key principles in that is the one-year money-back guarantee.

So, if I were living in Missoula, Montana, as I once did, and I were tapping into The Motley Fool not working for the organization — I would take advantage of that one-year money-back guarantee because you can come in, look around. Any service — whether it's *Motley Fool One* or any other service you're interested in — enjoy it for a day, a week, a month, 362 days. And if you decide it's not right for you, you let us know and we refund you in full. Our desire is to set you up on the right path for the next 10 to 20 years, and if a particular service is or isn't right for you, we want you to check it out.

I love the screen name of this next Fool member. MFNorway, which is awesome because MF used to be our nomenclature for somebody working on our staff back in the days when were on AOL. We were all MF … MFJoe … and now we're TMF out there. But MFNorway harkens back to another era.

"Hi, Fools. Given that as you discussed initially, it's more difficult to find attractive investments after the five-year bull market … and that some shares that are attractive long term but which missed their market may feel have run ahead of themselves … the question that I have is should *Rule Breakers* and *Supernova* customers rotate away from the growth stocks which tend to struggle in volatile market times?"

MATT ARGERSINGER:

Ow. [crosstalk 00:32:13] My initial answer would be no, and that's because we are looking at all these companies with three to five-year time horizons in mind and I would say … One thing David will often say and that I repeat — because I like to repeat everything he says — is that we are always interested in buying high.

It might look like we're paying an expensive price for a stock, but that's because we love the fact that the market's recognized that we're paying a high multiple and generally that's a little bit contrarian. Most investors out there are looking to buy the bargains. They're looking to buy cheap stocks. Stocks have come down in value.

We're actually the opposite. We get actually more excited about stocks that have run up quite a bit because we actually think there's a lot more to go and we think that says something about the business behind the stock, as well. So, we're not afraid of high-priced stocks.

TOM GARDNER:

What happens in an environment where so many companies have seen their stocks rise? In other words, is there a period at which you or the *Supernova*/*Rule Breakers* philosophy says it's no longer a distinguishing feature to be considered overvalued because …

MATT ARGERSINGER:

Yes, because everything's overvalued …

TOM GARDNER:

… because the market has gone up. It's like at 2000 and everything looks overvalued. Is that a time where you change or modify your approach or literally it's, "Hey, rolling ten years. We're trying to optimize it. If we have a roller coaster ride that takes us down 30% in an 18-month period, that's not going to present us a problem."

MATT ARGERSINGER:

No, not at all. One thing I always harken back to is that you could look at an investor who came in, in October of 2007, which was the month prior to the peak of the last bull market before … Of course, we know what happened in 2008. And that person, even if they invested their entire net worth, at that point in time … as long as they were investing a proportionate amount every month beyond that into the index or into their favorite companies … a few years later, they were not only in positive territory, they were way ahead of the market.

TOM GARDNER:

So, if you have income and you're getting into the market on a monthly, quarterly, annual basis … you really should be much less concerned about what the overall market's telling you …

MATT ARGERSINGER:

Right …

TOM GARDNER:

If you are at a point where you have no new income and you need to draw off that portfolio, does your philosophy change at all if your time horizon or need for the capital changes or not?

MATT ARGERSINGER:

I'd probably say it does. I mean, I would have to say if you don't have new income coming in, and you know you're going to need money within a five-year time frame, then I think your decision making changes a little bit.

TOM GARDNER:

Got you. But so many people in semi-retirement or retirement — they've got 30 years. We've got more time in our lives in semi-retirement or full retirement. I think at The Motley Fool we're probably big advocates of semi-retirement. Staying active …

MATT ARGERSINGER:

Right …

TOM GARDNER:

… working as Mark said because you love it, not because you have to … so, finding something you love, continuing to generate some income and invest that. But regardless, we're going to live much longer and I think many people are not preparing their portfolio for that and are fearful of the equities market short-term blips when they really should be reminding themselves that "Hey, rolling 10 and 15 and 20-year periods are exactly the place to be."

MATT ARGERSINGER:

Right.

JEFF FISCHER:

And I think if you're concerned about a downturn, which will inevitably happen at some point … maybe this year …

TOM GARDNER:

I hope so. Are you aware …

JEFF FISCHER:

I know you are. I know you're rooting for lower prices …

TOM GARDNER:

Yes, yes. I have to explain that in a second.

JEFF FISCHER:

So, remember that. Mark that down. This is going to take ten minutes, but …

TOM GARDNER:

Good. Go for it. I love it. I'm going to see if I can find water.

JEFF FISCHER:

Uh, where is my train of thought? So, it's important to have a positive action that you can take when prices fall. The people who are saving money — of course, they have something to do with it — so their mind is in the right place. Like, "Great. I can invest this money." But if you're not saving any money — if you're 100% invested and the market falls, your reaction is to start to worry …

TOM GARDNER:

The only positive action would be departure from looking at my portfolio …

JEFF FISCHER:

That would be good.

TOM GARDNER:

So, my positive action … If I have no new income, the market's down 30%, I will not go look, because I can't make, really, any meaningful changes.

JEFF FISCHER:

But as every action calls out for a reaction, too many people, as we know, will sell, because that's all they can really do. They feel trapped, so they'll sell. So, that goes back to having some cash, especially if you need money or you're not adding money …

TOM GARDNER:

Mm-hmm …

JEFF FISCHER:

… or, like we do in Pro, hedging frequently and when the market declines, your hedge pays you and you can then reinvest that cash.

TOM GARDNER:

Jeff, I really love the concept of what's your positive action when the market declines. What have you created that's going to allow you to be somewhat excited by a 10-20% recline? Ron?

RON GROSS:

The question focused on Mr. Market and I would really prefer that investors don't think about Mr. Market. Think about companies.

TOM GARDNER:

Anti-Buffett. This is an anti-Buffett play from you.

RON GROSS:

I would prefer that the individual investor focus on companies. We talked once before about it. I wish it was called the "company market," and not the stock market, because you're truly an owner of each of these companies.

And, as Buffett says, you can buy the same steak on Friday that you bought on Monday at a discount, you should be a happy man, because you're getting a steak at a discount. And that's the way I think about stocks, as well. If I can buy a company that I love at a cheaper price than I bought it a month, a year earlier … then I'm a happy man. I am not sad in any way. Because I am a long-term investor and I have a long-term time horizon — I will let Mr. Market do whatever he wants to do and I will be an owner.

TOM GARDNER:

These are the days when saying you're a long-term investor looks really, really smart … and you know there are a lot of people out there … and there were a lot of headlines in the financial media … and I read a lot of people that I see giving investment advice out there that were saying, "Long-term investing is dead," four years ago or six years ago or ten years ago. And now, you see the benefits of sticking with businesses in the company market and thinking about the prospects and adding money in down periods.

What I want to do now is I want to start with Ron. Put you on the spot first with a slightly trick question. Whoever goes first should be allowed to defer — but here's what it is. I want to know what your most controversial belief is. What your most unorthodox, unusual or flat-out controversial belief is about investing.

It could be about a particular company. It could be about the market. It could be about a philosophy. It could be something you disagree with that you've heard others say at The Motley Fool.

RON GROSS:

I come from a relatively traditional Wall Street background. I used to be a hedge fund manager. I lived and worked in New York for years and I come from that realm. And when I get together with friends or former colleagues that are still of that mind-set — which I am no longer. I am a proud Fool — I get those same kind of conversations and those same kind of questions. What do you think of the markets? What do you think of this? What do you think of that? What are you doing? What deal are you doing?

And I just want to say to that person, "You've got to calm down. Turn off CNBC. Focus on companies one at a time for the long term. It's not about what are you going to do this month or this quarter and what kind of returns did you put up and what kind of fees can you generate? Relax. Invest in companies long term."

TOM GARDNER:

Love it. Jeff. Be radical.

JEFF FISCHER:

Be radical. Well, I don't know how radical this is, but I will say I think probably all of us here, and maybe everyone watching, would have more money in the end if they just never made any sell decisions ever. But how do you get there? That means you're trapped. Why are you investing, then, if everything you invest you can never touch?

TOM GARDNER:

Well, you touch it if you need the cash or have something you want to enjoy. You don't sell because of the valuation, the business, anything that's going on. You let all of your existing investments just run until the end of time and you say, "Recognize that you may need to take cash out at different points along the way." But you're saying, "Leave that factor aside. That portfolio will outperform what you're doing right now."

JEFF FISCHER:

I believe so. And now that may signal that we're at the end of a five-year bull market. But really looking back even further from … Say you started in 1987, as I did. Almost everything I've sold along the way has been a mistake — almost everything — and the few things that I sold that then went down … well, they've become minuscule over time …

TOM GARDNER:

Thanks for the feedback there …

JEFF FISCHER:

… next to the things that I held or would have held.

TOM GARDNER:

Your losers get smaller and less relevant every day.

JEFF FISCHER:

Yes. Now, we're not about to go there in Pro …

TOM GARDNER:

Why not? You just told me this is the best way.

JEFF FISCHER:

Because it's over a lifetime and it's in aggregate and Pro is a very focused portfolio. Twenty positions, twenty-five is all we have. And we don't have new money coming in. So, if we see something we like better, we need to sell to buy it. But for most of us who are fortunate to be working and have savings, we should take some [crosstalk 00:40:31] …

TOM GARDNER:

So, if you have someone in your family that's under the age of, let's say 30, your primary advice to them as an investor to get the maximal, optimal results, is to buy the things according to a variety of factors that we teach at The Motley Fool and never sell …[00:40:44]

JEFF FISCHER:

Find what we call in Pro — taking it from Chuck Akre — find compounding machines like a MasterCard or a Google. Buy those and keep adding to them. Don't think about selling, especially at this age.

TOM GARDNER:

Love it. Radical!

MATT ARGERSINGER:

Oh, God!

TOM GARDNER:

Okay. Matthew. Shake the world.

MATT ARGERSINGER:

Jumping off Jeff, here. I think the buy high, buy higher idea … It's just not practiced enough by most investors. I think what David says often — we're so willing to trim the flowers and water the weeds and you should almost be doing the opposite. You should be ignoring the weeds and forgetting the weeds and continuing to buy and invest in your flowers. And I think that's so hard to do.

If I look at some of our biggest winners in *Supernova* … Zillow, for example. We've bought Zillow three times, and each time it's been at a much, much higher price.

TOM GARDNER:

And it's been volatile. There have been times when it's down and you're like …

MATT ARGERSINGER:

It's very volatile …

TOM GARDNER:

… wow. Could be we made the wrong decision. But if that happens, that's going to happen. However, it's ended up being, obviously, an unbelievable business.

MATT ARGERSINGER:

Right. This might sound crazy because we're in a big bull market and we have nothing but rising stock prices — but back to Jeff's point — over time, if you look at long periods of time, if you just added to your winners … the winners are the ones that are usually being recognized, not only just because the stock market's excited and people are excited about the stock, but people are excited about the business. And the business is going places and it's being recognized by the market. And it's achieving a higher value for a reason and you should double down on those all the time as much as you can.

TOM GARDNER:

Love it. I'm going to go, contrary to Jeff, for the fun of it … even though I basically agree with Jeff …

RON GROSS:

Just to confuse everyone …

TOM GARDNER:

I really do. I think that for the most part, our discipline should be to never sell … not just because we don't lose a great winner … which is the greatest mathematical pain to your portfolio is to watch something rise 5-20x and you sold it. Because how many bankrupt investments are you going to have to make to catch up to the losses that you didn't get by holding that incredible winner?

But I'm also going to agree with Jeff before taking him out at the knees for a second for another reason, and that is that if you have the mentality of "I never sell," you look for very different types of businesses. You look at the culture of the company. You look at the leadership differently. You look at the product line. It's not like, "Wow. They have one incredible innovation right now." It's, "Do they have a system for innovation that's going to lead to greatness over 15 years from now when we can't even know what the consumer marketplace will look like?"

There may not even really be malls. There may just be warehouses where products are being dropped off in driverless cars and it's all incredibly convenient for us to just sit at home and order everything, and it's all the home-related things we should be focused on, as investors now.

We don't know what the world is going to look like, but what do I think is a company that can adapt through those multiple different environments? And so, those are two great reasons to never sell. Mathematically you'll do better and number two, you'll look at the companies that you invest in differently before you make the investment.

I do think that there are a couple of situations where I would sell and I want to share those now. I guess it's not radical, but I just wanted to go contrary to Jeff. As Ron was saying, everyone loves Jeff and Ron's parents are watching, so it's indirectly a way of saying, "Solidarity to the Gross family!"

Here are a couple of sell rules that I have and in the Everlasting Portfolio and *Motley Fool One*, we're mandated to hold at least five years every single investment. We're going to learn from them. We're going to get the best long-term results out of all of them. I know it's surprising to some to think that you would continue to hold something you don't believe in, but I can assure you that some things you don't believe in now end up delivering awesome results. They just had a downturn and a bad cycle in their industry or bad performance with this leadership and something changes. And of course, we'll have some losers that just remain losers … but your best results will come from what Jeff said.

But here are my four sell rules, if I can remember them all *after* holding a business for five years.

1. If there is a major shift competitively in the marketplace that makes me think the business is losing pricing power. Warren Buffett's number one factor is he looks back across all the investments he made through his life. The single factor that he sees matches up with the best performance in his portfolio is pricing power. They have the ability to raise prices.

That's why when I interviewed Jim Sinegal in *Motley Fool One*, I just loved what he said about Costco … that they feel they have always had pricing power, but they have never fully utilized it and they never will. That is true pricing power. It's not like, "Wow. We have pricing power and we're extracting every additional dollar we can from our buyers." No. "We have pricing power and will never do that because we want to maintain a great relationship with our buyers."

So, if I see loss of pricing power, that's a real concern.

2. Succession. Leadership change. Will Thorndike, the author of *The Outsiders*, which is a great part of our *Motley Fool One* experience right now in the member lobby … I highly recommend that you join us. *The Outsiders* is a wonderful book that shows eight CEOs that allocate capital in an unorthodox way and have run their businesses differently and have delivered in excess of 20% a year, in most of those 8 cases, for more than 20 years.

And I can tell you that if you run the numbers on your calculator to what happens when you invest in something and it rises 20% a year for 20 years, you have your family taken care of financially with small, regular investments in businesses like those.

And when I talked to Will and interviewed him about the book about three or four weeks ago, he told me that he spends, in evaluating the CEO — just the CEO of his investments — 30-50% of his investment time is just on the CEO.

First of all, I love seeing that. As we talked about, I love the opportunity to study how different people invest … Seth Klarman, different approaches and all the rest. And I believe that you could crush the market by spending 50% of your time on just the CEO, because you'd start to see things about leaders that are different and a distinguishing factor. And so when I see succession away from an awesome leader, I get concerned.

Talking to John Mackey, our board member … co-founder and co-CEO of Whole Foods … we were talking about the difficulty in succession at Coach, which is a wonderful business under Lew Frankfort. It's a tough industry, and we'll see whether the next CEO can manage things as well as Lew Frankfort did, but it's definitely a concern point. None of these are automatic sell. They're just, "Hey, I have to start thinking what I should make of this situation."

3. The third one I'll say is companies that are too big to succeed. I know this is going longer than we expected. There will be a quiz. So, companies that are too big to succeed worry me. The data going back to 1950 shows that the largest company by market capitalization in the world loses to the market by 40% over the next 10 years.

It still makes money. It just doesn't do as well as the market, so I look very closely when a company is just the largest in the world or the largest in its industry. Those, actually, tend to become points where they slightly underperform and the disrupters come along and take a lot of the market opportunity in that industry away from the frontrunner. So, that's a concern.

4. And then the fourth one is whenever a stock, for me, has become more than 20-25% of the overall value of the portfolio. That would be a time to sell and bring it back into line so that I don't have 60% of my portfolio in a single position. We all feel differently about that, but those are my four sell rules.

JEFF FISCHER:

Nice.

RON GROSS:

Your sell rule about the companies that get too large — is that your proxy for valuation in the sense where you think at a certain point the stock goes up so much that it's unlikely to get you market-beating [crosstalk 00:48:03] …

TOM GARDNER:

That's a really beautiful way of thinking about that, and I'm not just saying that because your parents are watching. I think that's really a great way to view it. I mean, you look at Apple, and Apple's trading at 9x earnings. And everybody's like, "This is shocking." And in a way, it *is* shocking because Apple's a much better company than trading at a multiple … almost a 35-40% discount to the market's average multiple.

But I think that if you look back at the last great performing market … Well, let's go back to the late nineties … Microsoft, Intel, Cisco — they were basically like sure things. They had Bill Gates, Andy Grove, John Chambers. They were like lock-ins. They had balance sheets that were bigger than Fort Knox. They had the future on their side. Software. Chips. Networking. I could imagine so many different ways that they could take their businesses, but their size made it difficult.

Google has been an awesome investment for us across The Motley Fool and in the Everlasting Portfolio. I didn't expect it to essentially double since we recommended it, and it's done better for others who recommended it earlier. Google, to me, is one of if not the greatest companies in the last 100 years. And given how more difficult it is to run a company today — more global, 50,000 people — it's more difficult to run a business today than it was 50 years ago, so I think Google's probably the greatest company in the last 50 years.

But it's of such a size and scope now that I definitely don't feel I'm getting a triple from Google over the next seven years or eight years. And so, it just becomes a little bit less interesting to me as an investment, although as a company I love reading and studying and learning about they're doing.

JEFF FISCHER:

Sounds good.

TOM GARDNER:

Wow.

JEFF FISCHER:

I was going to say. It will be interesting, when Google is twice as big, to see what you're thinking at that point. In the next seven to ten years, it may be twice as big …

TOM GARDNER:

I certainly think it could double in the next seven to ten years. You know, one think you learn from *The Outsiders* is that I wonder whether these companies should begin spinning off divisions and paying special dividends. Essentially, you could have had Microsoft … In fact, I said this on CNBC in 2003, I think, on … What's that? I forget the name of the show. I'm sorry. I'll remember it.

But I said basically Microsoft should voluntarily break themselves up right now. Create entrepreneurial units and essentially give all the shareholders stakes because it happened to Standard Oil, and what happened to those oil companies over the next 70 years? Their market performance was unbelievably outperforming. I mean Exxon — you had incredible performers, and when you broke them apart, you gave them a new entrepreneurial lease on life.

RON GROSS:

Especially with companies like Google or Amazon, where there are going to be so many business lines that are not core to search or online retailing, it may make very good sense …

TOM GARDNER:

To capitalize them and spin them off. Yes. I guess I'll say that maybe my most controversial belief is that I have a little anxiety about the large … [00:50:58] about social media companies … about the large technology companies and the almost can't miss feeling about them that develops because of their incredible performance. That would be an area of a little caution that I would be placing as an investor.

JEFF FISCHER:

Tom, that makes me think of Everlasting Portfolio and *Motley Fool One* and it makes me want to ask …

TOM GARDNER:

Bring it!

JEFF FISCHER:

… to share your vision for Everlasting Portfolio and then for One, as a whole for the investors out there.

TOM GARDNER:

Great. So, Everlasting Portfolio adds $100,000 every quarter. We buy five separate investments. We have the option to leave some of that money in cash or to make investments. We've made investments all the way through. We're about 29 percentage points ahead of the market, maybe 27 percentage points ahead of the market today. That's been awesome. It doesn't compare to Odyssey. So, *Supernova*, which is part of One … That's the great thing, is that anyone who beats me, is a part of *Motley Fool One*.

MATT ARGERSINGER:

It makes it tough to be an employee.

TOM GARDNER:

Just so you know. I created *Supernova*. No. So, the Everlasting Portfolio benefits from all of the research that's happening at The Motley Fool. I get kind of a bird's-eye view, as a *Motley Fool One* member does, on everything that's going on in *Income Investor, Inside Value, Million Dollar Portfolio*, *Supernova*, Pro, Options, *Hidden Gems*. So, I've got a great view.

And then we do all of our own original research, as well, alongside that. So, we're building with a team of about ten investors now, our approach. We'll make five rounds of investments. We mandate holding for five years.

And I guess my view is we've got about $1 million in the portfolio now and I'm excited about looking down and seeing that at $5 million, $10 million, $15 million, $25 million and higher. I think when you run the numbers and show what happens if you generate 13-14% a year — which I think is possible with great long-term business focus, tax-deferred investing — and you run that forward 20-40 years, it's unbelievable the snowball that grows.

JEFF FISCHER:

When does your next investment take place?

TOM GARDNER:

Our next scheduled investment takes place on April 1. And then overall, *Motley Fool One* … Guys, I'm speaking quite a bit right now. I apologize … *Motley Fool One*, by integrating all of the services, is designed to give you the dashboard for what we believe in most. It gives you the opportunity to learn from each of our advisors and to see their most highly beloved investments right now and to see those investments compared across services with a ranked list.

I think what you're going to find in The Motley Fool — now we are adding separately managed accounts as we mentioned. There are pretty much two pathways with *Motley Fool One*. One of them is … Let's put it in the "lite beer" commercials from fifteen years ago.

One of them is Tastes Great. I'm avid. I'm passionate about this. When John Mackey joined our board he had, a couple of months before, become a member of *Motley Fool One* and he called and told me, "Pretty much, I'm done almost nothing for the last two days. I am totally obsessed. I've read through all back issues of *Rule Your Retirement*. I've read *Inside Value, Income Investor*. I'm not just improving my investment portfolio. I am actually learning a lot about these companies and I'm learning a lot about business that's useful for me." So that's the Tastes Great group that wants to dive in and loves this subject.

Then there's the Less Filling group and I think we're going to build out a lot of Less Filling services, particularly because our Tastes Great member has family members … a spouse, children, grandchildren … that they want to pass this onto …

MATT ARGERSINGER:

Plus parents …

TOM GARDNER:

… connecting them in through the Less Filling. Like, "I don't have a lot of time or interest, or my temperament isn't right to be an investor." Separately managed accounts. The access to a financial planner. And I frankly believe that more and more of your investing and financial advice that you see out there is going to be initiated by human research and proven, long-term public performance records which you don't see across the financial services industry.

Please tell me when you meet with an advisor or broker if you can look at their record and if that record is published and compare it to everyone else. It's very difficult to do, but that's coming because of the Internet, and I think that you're going to find a lot of this will be automated. Off of the initial research that is done, you'll be able to put your personal factors, your needs, essentially in surveys, building a profile, and then you'll get the guidance that really works most effectively for you. And that will happen for your kids, your spouse, your parents, etc.

JEFF FISCHER:

And *Motley Fool One* is already going down that route with [crosstalk 00:55:33] …

TOM GARDNER:

That's a big focus of ours. I kind of feel like the best comparison for our company right now … It's very nice to say this with our stock at $250 a share having gone up almost 10x in value in the last two years … but I think of us, a lot, like Tesla because I think that what we're doing does run contrary to the industry, so I'm sure we'll get some complaints.

But that's not important. We want them to follow. Tesla wants as many electric cars out there in the market as possible and we want as much long-term business focus investing with transparency, performance records that you can follow and that have beaten the market over long periods of time — we want as much of that out there for the individual as possible and it's not readily available and hasn't been in my lifetime. So, that's one of the biggest motivators for us. Team!

JEFF FISCHER:

Thank you.

RON GROSS:

It's great.

TOM GARDNER:

Okay. One stock from each person. Here we are. It's 6:13. I guess we have two minutes left, although Steve, our producer. Steve, you have appeared to check out on this. I'm looking at you looking down at the monitor as if you're playing World of Warcraft or Ticket to Ride, which is integrated into *Motley Fool One*. But we probably have about two minutes? Would that be right? Yes, excellent. Two minutes. Each one of us will share one investment that we think is a market beater over the next five years.

RON GROSS:

This is a little staid. It's not too sexy, but it's just a wonderful company …

MATT ARGERSINGER:

It's Markel.

RON GROSS:

It's Markel. MKL is the ticker symbol. Specialty insurer run by wonderful people who are Foolish in their own right. Tom Gayner, the chief investment officer, has an incredible track record. Not only does Markel make money on insurance which many insurance companies don't, but they invest their capital and they're great stewards of investors' capital, as well. I would be happy to own that company forever.

RON GROSS:

MKL.

JEFF FISCHER:

MKL. Markel is sexy compared to the company I'm about to …

TOM GARDNER:

Okay, love it. I think I know where you're going. I know where we're going here.

JEFF FISCHER:

At the *Motley Fool One* member event here in Alexandria last month, I brought this up …

TOM GARDNER:

Telephone poles.

JEFF FISCHER:

Telephone poles and light poles and utility poles. Valmont Industries. Ticker is V as in victory, M - I. And it's beaten down right now because irrigation sales were … they also sell irrigation systems for farmers … were a record high in 2012 and softened up last year and they're going to be softer this year, too. But we like that. It's in a down cycle. The stock is inexpensive in a relatively more expensive market. It's a defensive investment and it should grow well over the next five years. And it's been an outrageously great stock for the past 20 or 30 years topping pretty much everything I can look at.

TOM GARDNER:

Out of curiosity, do you expect your stock to double over the next five years? Markel? Valmont? Are you thinking 15% a year? Is that your target when you make an investment?

RON GROSS:

The Rule of 7 would say 7 years at 10%. So, can we do five years? Yes, I think we can. I think Markel can.

JEFF FISCHER:

We're hoping for that, too.

TOM GARDNER:

Double in five years. Right on.

MATT ARGERSINGER:

I'm going with the outsider theme here. One stock that makes up a big part of my personal portfolio is Biglari Holdings. It's ticker BH run by Sardar Biglari who counts, among a lot of his heroes, Henry Singleton which is certainly one of the premier outsiders I think for the last 50 years in terms of investing. So, you've got Sardar Biglari, Biglari Holdings. They own Steak 'n Shake, which is a Midwest burger chain. Pretty well known. They own a big chunk of Cracker Barrel.

And they recently, a week and a half ago, bought *Maxim* magazine. Talk about sexy, right? But he's amalgamated all these businesses together and I think, more than any investment that I've known … and I've studied Biglari. I've met him several times. I've been to every annual meeting over the last five years. And I think this is a company that I'm confident he can deliver 15-20% annual returns per year.

TOM GARDNER:

Love it. Is that a *Supernova* or *Rule Breakers*? Is that a Live Rec?

MATT ARGERSINGER:

I have tried and I have tried … [crosstalk 00:59:19]

TOM GARDNER:

There's a team-based approach.

MATT ARGERSINGER:

[00:59:23]

RON GROSS:

He's an activist, and something …

MATT ARGERSINGER:

He's a bit of an activist …

RON GROSS:

… and he rubs some people the wrong way.

TOM GARDNER:

So, Biglari is not a Live Recommendation anywhere because of you at the Fool. Is it a Live Recommendation?

RON GROSS:

It used to be a *Million Dollar Portfolio* one when it was Steak 'n Shake.

MATT ARGERSINGER:

When it was Steak 'n Shake …

RON GROSS:

Then he took it over and we said bye.

TOM GARDNER:

Got it. Got it. So, there's a disagreement about Biglari as a leader of a public company.

RON GROSS:

Yes.

TOM GARDNER:

Awesome.

MATT ARGERSINGER:

I would say he's the meaner version of Selim Bassoul. Of course, as the CEO we love him and Middleby that you own in Everlasting Portfolio …

TOM GARDNER:

And why do you say that out of curiosity? What do you read in him? Obviously you favor him. What is the edge to him and how do you …

MATT ARGERSINGER:

So, Sardar. If you look at Buffett or Selim, to a certain extent … I mean, these guys are always trying to do friendly deals. Friendly investments. "We want to work with you." Sardar is a guy who comes in and says, "No. I think I can do it better than you."

TOM GARDNER:

Like icon, a little bit. There's a little icon flavor.

MATT ARGERSINGER:

A little bit of icon. Better than icon, but certainly more of an icon flavor.

TOM GARDNER:

But would we say an icon? He's been an unbelievable investor, right?

MATT ARGERSINGER:

Absolutely.

TOM GARDNER:

Interestingly, about these three companies, because I'm actually going to add four to them, but it's the four outsider companies that we're following right now in *Motley Fool One* in our showdown to our March Madness of finding the best one to invest in. But what's interesting to me is that each of you has essentially picked an outsider company. I don't know about Valmont's leadership, but with a 20-30 year return, I'm going to be interested to learn more with them having done so well.

But these are three companies that the average person has never heard of. I mean, please tell me if anyone in your family has ever heard of Markel, Valmont Industries or Biglari Holdings. I'm going to guess that the answer is no for 99% of the adult U.S. population. And we need to remind ourselves at certain points in time that the stock market is an auction market and where everyone is bidding, two things can be happening. One, there's something unbelievable there and the bidders are right. Rembrandt is Rembrandt — but remember there was also a time in Rembrandt's life where Rembrandt could barely sell his paintings to pay off his debts in the end of his life.

So, you guys have identified three unknown companies that there aren't a lot of conversations about — therefore there aren't casual buyers of the stock who don't really follow it, because they've never heard of it. And I'm going to add to those three Leucadia, which is an outsider business that we're following, Valeant Pharmaceutical, Amazon, which is known, and Berkshire, which is known.

So of the seven stocks we've given you, two of them you've heard of. You would never really have heard of Berkshire Hathaway if it weren't for the fact that Buffett became, essentially, a legend as an investor. The businesses that he is buying, for the most part, and the way he's run his company is much more Markel-like or Biglari-like and not necessarily would you ever follow and get to know what that holding company is all about.

So, there are seven stocks. I'm going to put these seven stocks in the CAPS portfolio. I believe these seven stocks are going to deliver excellent returns over the next five years and I am interested to see in this environment — maybe it was or wasn't in this environment — that we've all focused on companies that are unknown great performers. And that's how I tend to think. When the market starts to look a little bit stretched to me, I look for the underfollowed and the unknown star performer to find the better values out there.

The most important point I can close with is that we're super long-term investors. Morgan Housel has done so much great work for us in *Motley Fool One* over the last year — the special reports — one of them showing that the market falls 10% every 11 months going back more than 100 years and that those drops are pretty evenly distributed. It's not like they're all bunched into a six-year period and then you have fourteen years with no 10% drops …

RON GROSS:

And your earlier comment that you were rooting for …

TOM GARDNER:

You're right, Ron. Thank you for reminding me. I made a bet in our *Motley Fool One* membership on January 1 that given a variety of factors, I felt that this year we would have a 10% decline. And again, they come every 11 months, pretty evenly distributed. We haven't had one for about two years. And so, my bet is that if the market does not fall 10% at some point in this year …

So, in a sense I'm cheering for like, "Well, let's rip it up a little higher here before the summer doldrums start to slough off a little." If it doesn't decline 10% peak to trough at some point this year, I will be walking a marathon on my treadmill desk each day for five days in a row. You know, it was so easy to write that sentence … and now I'm had like an Ironman in our member community and a couple of people here at the Fool that are marathoners go, "You know what? Day four you're going to be in pain, because walking a marathon, you'll be fine." Plus, I can space it out. It's not like I have to do it continuously throughout the day. I can do six hours here and there. But it's going to be a long five days for me.

The reason I did that is I want to make sure that we set ourselves up, eloquently said by Jeff, to have positive actions should the market decline. That we're prepared and expect that a natural course of investing is to see a 10% decline. Because I can promise you one thing. The media's going to make it sound disastrous. They already made it sound disastrous in early January when the market fell 5.5%. So, you can only imagine what's going to happen when it's down 10% and that's going to happen multiple times along the way as our portfolio grows throughout the year.

So, Ron Gross, Jeff Fischer, Matthew Argersinger, thank you all.

RON GROSS:

Thank you.

JEFF FISCHER:

Thank you.

MATT ARGERSINGER:

Thank you.

TOM GARDNER:

Some of my happiest times at The Motley Fool is hanging with the three of you and with our advisors and talking investments and working with you and for you in The Motley Fool. So, I've got some comments that I need to make here in closing our conversation.

First of all, thank you for spending your time with us. I hope you found this valuable and useful in its own right for you as an investor. If you're interested in *Motley Fool One*, the *Motley Fool One* member lobby is a really great place for you to go. If you click the link below, you begin the application process and you join us in our member lobby and our member lobby is fully free.

You're going to find everything from the four outsider companies that I mentioned — but more importantly, the explanation behind those businesses and why we believe they're going to deliver excellent results. You also gain access to my CEO interviews with Jim Sinegal and John Mackey and Selim Bassoul and Monty Moran, the co-CEO at Chipotle, which has been such an incredible investment for us.

We love to sit down and talk on camera with our CEOs, with the companies that we're invested in, not just to learn about the company and its prospects, but we learn things about the industry and about other businesses they love. We've learned so much from those interviews.

Finally, you gain access to interviews at our most recent member event, which I know many of you attended — but for those of you who didn't — our Malcolm Gladwell interview and Pete Miller's great talk, the CEO of National Oilwell Varco who will be a part of a spinoff out of that business and run the spinoff which is a really interesting dynamic that we've talked about in *Motley Fool One*.

So, *Motley Fool One* gives you access to all of our services, to these advisors, to my brother David, to *Income Investor, Inside Value, Hidden Gems*. We're very excited that in the next year it's going to provide you access to all of our international services, as well. It also gives you access to a financial planner. It's going to help you build a financial game plan around your investment portfolio so you really are thinking through not just the equities that you have, but what about allocation with bonds? What about insurance? What about building out your estate and taxes and thinking through the tax efficiency in your portfolio. That's a really important part of *Motley Fool One*.

We have the separately managed accounts coming. For regulatory reasons, I'm not going to go into great detail about it here other than to say that we want you to be able to invest with us whether you want to spend a lot of time on it or not. We want to make sure that you and members of your family can invest the Motley Fool way and aim for great, long-term returns that are tax efficient.

Beginning April 1, our *Motley Fool One* members will see the winner of our Final Four showdown and March Madness of our four outsider companies. If you'd like to see that and be a part of *Motley Fool One*, click the link below to join and apply to join *Motley Fool One*.

Last point is that it bears a 100% money-back guarantee. I have talked to members who have been members of particular services of ours and have stuck with it for 190 days and then felt bad bailing and taking the refund — but that's the nature of what we're trying to do. That's our purpose at The Motley Fool — to help you invest better.

I'll begin inviting members into *Motley Fool One* on March 20. I look forward to working with you, with our entire team … that's what you get as a *Motley Fool One* member …and to helping you invest better for the rest of your life and to set your family up for generations to come. Thanks so much for spending time with us. Ron, Jeff, Matthews …

JEFF FISCHER:

Ron's parents …

RON GROSS:

Bye, mom. Bye, Dad.

TOM GARDNER:

Thank you all and Fool on!

Earnings: PZZA Q4-2013

Published Mar 7, 2014 at 2:42PM

Pro's Take: PZZA Q4-2013 Earnings

Papa John's International (NASDAQ: PZZA)

Quarter Quick Take

This was a strong quarter and excellent finish to the year for Papa John's. Domestic restaurant performance was remarkable, and while the competitive landscape is always treacherous, Papa John's is using technology and key marketing partnerships to take share. The company continues to focus on the long term and increase the value of its business. Looking ahead, Papa John's will be doubling down its quality-focused marketing efforts on web and mobile (it announced a new ad agency to help) and it should see international profitability improve as key markets become more highly saturated.

....

Q4-2013 / FY-2013

Total revenue growth: +12% / +9% (both correcting for the 53rd week in 2012)

Operating profit margin: -10 bps to 7.3% / Flat, 7.4%

EPS growth: +32% / +20%

....

Guidance Update

Papa John's 2013 sales were stronger than I expected while profitability lagged a bit due to increased spending to support international growth. The company's business fundamentals are tracking well against our thesis and management's consistency and long-term focus remains impressive. After reviewing the history/progression of other franchise business growth and profitability trajectories I feel confident in assuming a bit more profitability from international market density and maturation and operating expense leverage for Papa John's. Basically, I think the company's future profitability has the potential improve meaningfully, and I'm confident Papa John's has the growth runway and execution prowess to get there. Accordingly, I'm raising my Fair Value estimate to $46.50 and Consider Adding More price to $35.

Updated guidance: Buy (no change)

Recommended Allocation: 4.7%

Fair Value estimate: $46.50 (increased)

End of Fiscal Year expected FV estimate: $50

CAM price: $35 (increased)

Strong business performance has driven part of the stock's impressive multi-year run (up +184% since 12/31/2011). Multiple expansion has contributed greatly, too. Historically, Papa John's has traded for 12x EV/EBITDA and it now trades for 17x. I believe some of this expansion is warranted based on a lengthening growth runway (international and domestic strength thanks to struggling mom and pops, delivery taking share, and increased order rates/checks/satisfaction from technology), a lowering risk profile (the brand is proving it translates abroad), and outperformance of peers. Still, shares are richly priced, and Papa John's is now Pro's third largest position at 4.7%.

My decision to hold our shares at this valuation rests squarely on the upside potential that remains if things go right and management's skill in execution and protecting the brand. Also contributing to the decision is the fact that PJ has a resilient business, a strong growth profile that should hold up well in a rocky economy, and the marks of a compounding machine (precisely the type of company you don't want to sell because of valuation). Of course, I won't ignore the downside – cash flows and valuation matter. I'm getting uneasy with the valuation, but I'm not compelled to sell or reduce at this point.

I'm also watching three yellow flags that have recently appeared. None of these are damning...but they're worth watching.

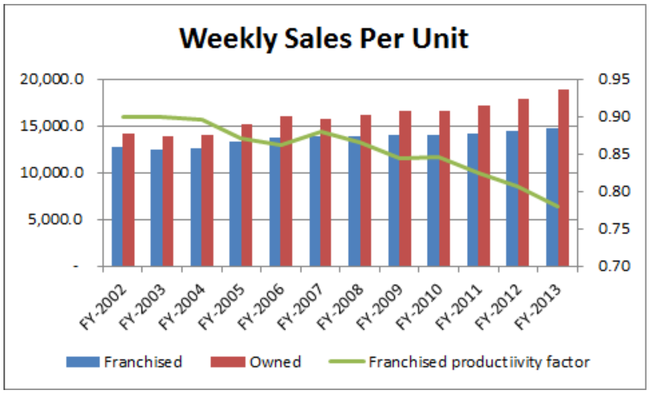
1. Buried deep in the 10-K (note 16) was notice that the company repurchased one million shares ($38.6 million worth) of stock from Founder and CEO John Schnatter. Schnatter still owns 10.3 million shares (25% of the shares outstanding), but he cashed out almost $40 million.
2. Over the past two years PJ has repurchased $225 million worth of shares, but it has funded more than $100 million of that with debt. To be fair, there is nothing wrong with this – debt is cheap right now and the business can support it. However, the company has not communicated a change in its capitalization policy and it hasn't grown FCF to support its repurchase activity. These repurchases juice EPS growth rates, but have no impact on the core earnings power of the business.
3. The initiation of the company's dividend (in light of the Papa himself selling shares and shares and multiple expansion) halfway through the year may be a signal that management sees a more prudent way to return capital going forward is through dividends rather than repurchasing expensive shares. I'm interpreting this myself ... management has not stopped repurchases or said it would slow the rate.

Our Thesis

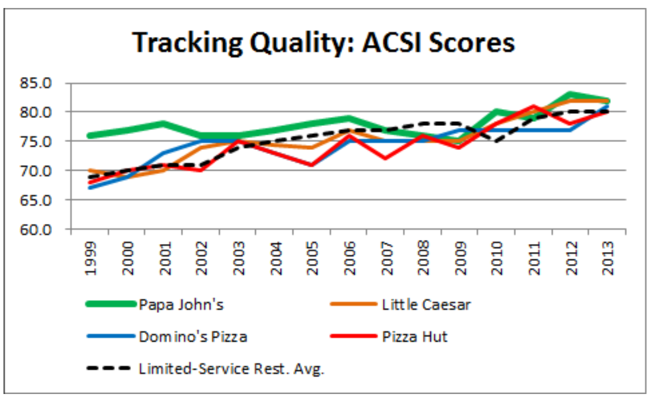
Papa John's has a competitive advantage in North America that stems from its 30+ year-old brand and consistent messaging. It is known, trusted, and perceived to be higher quality than its main QSR-pizza competitors, which allows it to charge marginally higher prices. It has a competitive advantage vis-à-vis smaller, independent chains based on scale in the purchasing, marketing, and tech development business areas. We expect these domestic advantages to persist and lead to modest share gains in the mature QSR-pizza market. We believe the company's brand advantages are translating internationally and that Papa John's is laying the groundwork to develop scale-based advantages there, too. With only 1,000 international restaurants the company has a long runway for growth. Our thesis relies on management strengthening the brand via messaging about quality relative to peers, continued investment in technology, and a focus on the health and quality of franchisees.

The Most Important Things

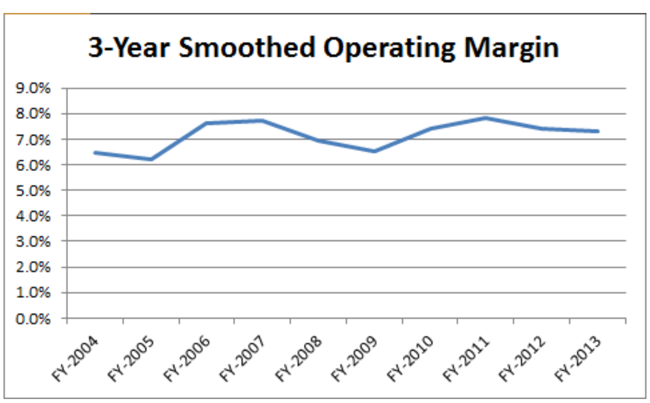
1. ***Store Performance***: Without healthy franchisees Papa John's has no business. Same store sales offer one look into store performance, but we also track sales per store, store-level profitability, and how all of this translates into the pipeline of committed new franchisors. During Q4-2013, systemwide comps increased +9% in North America and +7% for international. For FY-2013, systemwide comps increased +4% in North America and +8% for international. This is strong performance, but it can be bumpy. The rolling two and three year comps are still very impressive. The average domestic company-owned store (633 comparable units) had $988k in sales – the third consecutive year of increase and up from $737k ten years ago. This solid performance keeps franchisees signing up: PJ opened 265 restaurants (net) in 2013 and expects to open 220-250 (net) in 2014. Its pipeline consists of 200 domestic commitments (to be opened over the next three years) and 1,000 international commitments (to be opened over the next six years).



2. ***Brand***: Brand strength is challenging to measure, but we need to monitor it because it is key to the company's brand-based advantaged and higher price per pie. Papa John's domestic outperformance and share gains suggest its brand positioning remains strong. Management is as committed to quality and the "better ingredients, better pizza" mission as ever, as evidenced by: continued drum-beating on conference calls, consistent media messaging, increasing the franchisee marketing spending rate, and the hiring of a new marketing agency to spread the message beyond television. In June PJ rated #1 in customer satisfaction among national pizza chains (and in 12 of the last 14 years) as rated by ACSI.



3. ***Margins***: Ultimately, we expect the capital light business model to result in higher operating margins that propel free cash flow generation. In the near term, we expect Papa John's to continue to spend heavily to support the build-out of its technology platform, new POS system, and international infrastructure. Eventually, it should leverage its buying power and corporate overhead to improve margins. During the quarter and year, operating margins were flat, but management guided for margin improvement in 2014 (ignoring one-time costs associated with the new POS system).



WWTN

Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities.

Conference Call Notes

- On Guidance: EPS is projected to be in the range of $1.64-$1.72. North American comparable sales should be in the range of +2%-4.5%. International comparable sales are projected to range from +5%-7%. Pre-tax margin should increase 20-40 bps (excluding the impact of the new POS system). Worldwide net new unit growth will be in the range of 220 and 250 units, of which 70% will be in international markets.
- CEO John Schnatter on comps: "In the face of increasing competitive pressure throughout the year and a global economy that is still struggling to gain its footing, our global system continues to excel at the fundamentals in deliver on our Better Ingredients, Better Pizza brand promise throughout the world. That focus resulted in North America comp sales of 9% for the quarter and 4% for the full year, representing the 10th consecutive year of flat or positive comp sales."
- CEO John Schnatter on how the business works: "Satisfied customers lead to more loyal customers, and loyal customers lead to more profitable franchisees who want to grow their business. It also leads to new franchisees entering the system who want to partner with a winner and want to be part of something special."
- COO Tony Thompson on technology leadership: "We continued to extend our technology leadership position in 2013 by becoming the first national pizza company to have more than 45% of domestic system sales coming to our digital channels. In doing so, we topped the $5 billion mark in all-time digital sales during the year. We are well on our way to becoming the first national pizza chain to achieve a domestic systemwide digital sales mix of 50%. Among others, Papa John's was the first national pizza company to offer systemwide online ordering in 2001. We were the first to offer systemwide text ordering in 2007. And we were the first and still the only pizza company with a systemwide digital loyalty program, Papa Rewards, which launched in 2010. Our digital leadership continues to play a vital role in moving the needle for our brand, both in terms of sales and customer satisfaction. In addition, our technology leadership continues beyond consumer facing innovation to back-of-house initiatives, such as our new point-of-sale system, that we will soon begin to roll to our domestic restaurants."
- On China: Papa John's is moving toward profitability in China...but probably won't get there in 2014. Management is very confident that its investments abroad will pay off – things are progressing as planned.
- On the pace of store openings: PJ could probably grow faster, but it doesn't want investment and build-outs to outpace the infrastructure or compromise the ability to ensure quality.
- CEO John Schnatter on the future: "I don't see anything that doesn't say that our execution is going to get better, our marketing is going to get better, and our scale is getting better. I don't see anything but good." And later..."We are actually out two or three years in our vision. I can tell you next year, 2015, when we have the call that we are having today, Papa John's will be a better company then than it is today."
- On competition: When I started covering PJ I didn't think I was going to keep it in the portfolio. Then I realized they played a different game than their competitors. This quote sums it up: "We certainly pay attention to what they are doing, but we manage out of our own playbook."

Sell StoneMor Partners

Published Mar 6, 2014 at 1:00PM

Is this for you? Only members who still own these shares need heed this alert.

How You Participate

- **Action:** Sell **StoneMor Partners** (NYSE: STON)
- **Allocation:** We're selling all of our 1,400 shares, which represent a 1.8% position.
- **Scorecard Status:** Sell (no change)
- **Recent Unit Price:** $25.40
- **Price Guidance:** Use a limit order and please **do not sell for less than $25.25**.

What We're Thinking

Will StoneMor Partners beat *Pro*'s North Star over the long term?

For reasons explained below, we find it difficult to formulate a reliable answer to that question, and that's part of the reason we're selling. We originally recommended a sell in May 2013, using a covered-call equivalent limit order of $27.50. But that trade alert moved StoneMor's price, so our desired sell has remained uncompleted. Since then, we've collected $2.40 in distributions; when we add that figure to today's unit (or share) price of $25.40, the result is in effect higher than our original desired sell price. Now we can recommend selling by using a limit order of no less than $25.25, and ideally no less than today's price (lately $25.40).

This master limited partnership distributes 9.4% in annual income annually, not much lower than the current performance of our North Star. So why not keep owning it? The dilemma isn't the distribution, but the dilution of StoneMor's units outstanding. Since we originally bought units in the second half of 2011, StoneMor's unit price has declined 10.2%, largely due to the pressure of new units being issued. Adding back the distributions we've received, we have a 14.3% total return in two-and-a-half years. That's not abysmal, but it's below our North Star goal.

The pertinent question looking ahead is, "Would this relative underperformance continue?" We think it may, and here's why. In four of the past five years, StoneMor has created more units each year, diluting the value per existing unit. The partnership's annual distribution remains reliable, but if unit dilution creates a steady headwind, we may be left with only a 6% to 9% annualized return (and lower than that after taxes, since distributions are taxed as income). That's less than our desired 10% or higher, and the difference would add up over time. Many unit owners may be accepting of this yield, but it falls short of our goals.

Starting from 12 million units outstanding, StoneMor created 2.1 million more units in 2010, with the majority sold to the market at $24 each. In 2011, management created another 4.8 million units at $29.25 each. In 2013, 1.4 million new units were created at $25.35 (a big step down in unit price); and last month 2 million more units were sold at $24.45, another step down. Clearly, management is not opposed to creating more units at lower prices, suggesting that this sort of dilution is a regular part of the plan. That might be fine if the distribution were rising in kind, but lately it hasn't. We've seen 45% unit dilution since the end of 2010, while the distribution per unit has increased just 8%, from $2.22 per unit to $2.40. This is a relatively short time to measure, but the problem is we can't reasonably estimate what's next.

How It *Doesn't* Fit Into *Pro*

We can't know the magnitude of future unit dilution; even management doesn't know. It's largely based on capital needs for desired acquisitions of new properties. Not knowing how much dilution to expect leaves us invested in a black box of sorts. Although we continue to believe the company's distribution is safe, we don't know how much of it will be eroded by new units, or if the business will grow enough to offset ongoing dilution. Management has shown skill at acquiring new properties, and StoneMor's long-term track record is enviable, but greater than 10% annualized returns will likely be difficult to realize.

So, we don't have a reliable answer when we ask ourselves our pivotal question: *Is StoneMor a compounding machine that will meet, or beat, our highly competitive North Star and compound our dollars over the years?* We can't say "yes" with enough confidence to merit continuing to own our position. Our 1.8% stake is (still) a sell, and now we're willing to accept $25.25 or higher to exit. We look forward to putting the capital to work elsewhere.

Pro Can Help

- We're not deadbeats! We'll answer any questions you have on the StoneMor discussion board.

Set Up a Synthetic Long on Coca-Cola

Published Mar 4, 2014 at 3:44PM

Is this for you? This is for *Pro* members who lack at least 3% exposure to this company.

How You Participate

- **Trade:** Simultaneously sell to open January 2016 $37 puts and buy to open an equal number of January 2016 $37 calls on **Coca-Cola** (NYSE: KO).
- **Allocation:** 3% if converted to stock. For *Pro*, that's 16 puts and 16 calls, for 1,600 potential shares. Each synthetic long represents $3,700 in stock exposure.
- **Price Guidance:** Since this trade mirrors stock ownership, aim to set this up when Coca-Cola's stock price is less than $39.
- **Recent Prices:** Stock, $38.33; January 2016 $37 puts (splitting bid/ask), $3.80; January 2016 $37 calls, $3.45. Net credit: approximately $0.35.
- **Stock-Equivalent Rating:** Buy First
- **Fair-Value Estimate:** $45

What We're Thinking

The world's largest beverage company is out of favor on Wall Street. Coca-Cola is trading at its lowest multiple to free cash flow (19.9) since 1991, which is as far back as we can check. Despite its low price historically, growth in unit case volume last year, and a 3.2% dividend yield (with another dividend hike expected this quarter), it seems the only ones buying Coca-Cola shares lately are company insiders.

Why are investors flat on Coke's prospects? In a word, soda. Coca-Cola is the world's largest non-sparkling water, juice, *and* soda company, but Coke and Diet Coke brands drive a large portion of profits, and sales of the sugary beverage and its aspartame counterpart are slipping in North America, leading to volume declines as consumers choose healthier options. Against this headwind, management believes North America remains a growth market and is investing in extra advertising to regain lost ground.

The company is also investing in healthier diet soda options and a "truth campaign" surrounding current offerings. Coca-Cola expects to see improvements in North American soda volume as soon as a quarter or two from now, and suggests the improvements will grow over time. The table below shows how the company's *total* worldwide unit case volume growth has stacked up the last several years (a unit case is 24 eight-ounce servings):

KO	2006	2007	2008	2009	2010	2011	2012	2013
Unit Case Volume Growth	4%	6%	5%	3%	5%	5%	4%	2%

Last year's results were dragged down by performance in North America, so the first sign of improvement there should bring investors back, lifting share prices. Meanwhile, it's not as if Coca-Cola is a dying business — far from it. As the table above shows, management knows how to increase volume year after year even from a massive base. And relatively small volume gains can result in healthy earnings growth.

Excluding currency differences, operating income was up 6% in 2013, and earnings per share climbed 8% on a 3% revenue gain. Coca-Cola's worldwide beverage volume grew 2% last year, with a 5% gain in still beverages and a 1% gain in sparkling brands. That mere 1% volume increase meant nearly 100 million more cases of Coca-Cola products were sold last year, and that lapped a big 3% soda volume increase in 2012.

Still, including currencies, 2013 results were down from 2012 and flat with 2011 — hence the market's consternation. But in the bigger picture, Coca-Cola sells approximately 1.9 billion beverages a day, enjoyed nearly $8 billion in free cash flow in 2013, and has a goal to sell 3 billion daily servings by 2020.

How It Fits Into *Pro*

Many investors are excited about stocks right now. Margin debt is at all-time highs, suggesting that if history is a guide, we should be more careful than not. On a risk-to-reward basis, Coca-Cola should not disappoint. Our downside should be modest, and our upside — especially on the synthetic long — more than compensates for the risk. At $45, our fair-value estimate is 17.6% higher than today's price, valuing Coca-Cola at 18.75 times our estimated 2016 earnings — a cheaper valuation than today's, and lower than the stock has averaged for years (excluding a brief dip during the financial crisis).

If the stock gains nearly 18% to $45, our 22.8% return on cash (assuming a net start price of $36.65 on our synthetic long) converts into a 113% return, assuming 20% equity is set aside to secure our puts. Meanwhile, the synthetic long in a margin account ties up little cash, and our potential follow-up is to turn our options into a 3% stock stake at a net $36.65 by expiration. That would be an inexpensive 15.3 times expected 2016 earnings.

All told, if Coca-Cola executes half-decently, this low-risk position should handily surpass our North Star over the next 22 months while offering a chance to buy shares should we want them. Consumer staples are a defensive industry, one in which we're comfortable adding exposure. The world won't stop drinking, and no company matches Coca-Cola's distribution system, product breadth, and brand names — including 16 billion-dollar brands under the Coca-Cola wing.

More That Matters

- **Maximum Loss:** The same as share ownership.
- **Maximum Gain:** Unlimited as the stock rises.
- **Breakeven:** Lately $36.65, or your strike price minus or plus the credit or debit to set up the trade.
- **Follow-Up:** We can allow our syn long to turn into stock by expiration by doing nothing, or we can close it early or roll it to a future year.

Alternative Trades

- **IRA-Friendly:** You can write cash-secured puts in an IRA, but you'll need to set aside $3,700 per put you write. You could instead simply buy 3% in the stock.
- **Less Money:** You can just buy to open January 2016 $35 or $37 calls if you prefer. If you don't plan to turn these calls into stock, then only allocate an amount of capital you are willing to risk.
- **Already own calls from *Motley Fool Options*?** Either sell to close those January 2015 $35 calls to start this synthetic long instead, or (our preferred move) keep them and add enough synthetic long exposure to bring your total KO exposure up to 3%.

Pro Can Help

- Fools are always learning! Visit *Pro*'s guide to synthetic longs.
- Questions? Visit our fizzy new Coca-Cola discussion board.

Put Your Stocks to the 20% Test!

Published Mar 3, 2014 at 4:00PM

Dear *Pro* member:

Is *Motley Fool One* Right for You?

With a $20 billion market cap already, just how much upside does Whole Foods have for investors still considering whether to grab a piece of the all-natural pie? In this exclusive sneak peek inside the world of Tom Gardner's "crown jewel," all-access service -- *Motley Fool One* -- analysts Bryan White and Alyce Lomax and Motley Fool chief investment officer Andy Cross join host Chris Hill to talk about why they see green pastures ahead for the conscious capitalism pioneer. Simply click below to listen in to the latest *Motley Fool One* weekly podcast.

Listen Now!

The S&P 500 climbed about 4% in February, bringing the lurching giant back to positive territory for 2014, and to new all-time highs on Friday.

Record highs mean little without the context of valuation, so as of Friday (on S&P Capital IQ numbers), the S&P 500 trades at 18.3 times profits over the last 12 months. That prices it toward the higher end of its historical value range. Earnings per share must rise by at least 7% this year to meet current average expectations, and if they do, that could help keep the index at today's level or higher.

But day by day, not nearly as much is changing at the typical business as the market's recent volatility would suggest.

Free cash flow generation ("earnings") at any business rarely falls or soars monthly, let alone weekly or daily. And if a company is growing by 10% a year, its free cash flow is growing by, on average, less than 1% a month. It certainly isn't experiencing 10% fluctuations up and down, the way the market often swings.

So, why are stock prices sometimes as bumpy as your favorite roller coaster ride?

We can't forget that the stock market is an auction market. Nothing more than active bidding makes prices go up, while selling (or merely wanting to sell) can make prices tick lower. The last few years, steady bidding has led more and more people from the sidelines into the market, increasing the bidding pool. Johnny-come-lately doesn't want to be left behind.

Meanwhile, overconfidence about rising prices is causing others to make the mistake of borrowing money to invest: Margin debt is at record levels. Of course, the more you borrow to invest, the more bidding you can do, adding still more to the bidding pool.

Historically, when prices are rising, people slowly get excited, and start to invest more and more aggressively. Bidding feeds on itself. Barring bad news, this can drive prices up for years. So why are many people buying lately? Because they believe prices will keep going up.

But when stock prices are *falling*, why do you buy? Once the bidding has dried up, and there are more sellers than buyers in the room, what *compels* you to step up and buy?

The answer: Valuation. There's no other reason to buy when prices are falling, except when you see a valuation you like.

So, let's review.

When prices are going up, why do many (non-Foolish) investors buy? Because they believe prices will keep going up.

When prices are going down, what makes you want to buy? Valuation.

This is why the market can climb for so long, but often falls quickly when it declines. Once prices are truly falling, you only want to buy when valuation is attractive. Sometimes that doesn't happen until something falls far.

The 20% Test

One quick way to assess your positions is to ask: All else equal, how would the valuation look if my stock fell 20%? Would the decline *compel* me to buy more shares?

If **Facebook** (NASDAQ: FB) declined 20% from Friday's price to about $54, it would trade at about 32 times expected earnings for 2015. Would we be compelled to buy a bit more? Given the strong growth we expect from Facebook, possibly, yes. If **Valmont** (NYSE: VMI) declined 20%, would we be driven to buy more? Almost certainly, yes! Valmont would then trade at about 5.4 times EBITDA, making it about as cheap as it has been looking back to 1991.

One more example, this time on a stock not in our universe: As of Friday, **Yelp** (NYSE: YELP) trades at 259 times expected 2015 earnings. If the stock declined 20%, would we want to step in and buy? It would then trade at 207 times expected 2015 earnings. It's hard to imagine why I would raise my hand to bid on it at that price, especially in a falling market. Plus, it's easy to imagine more owners wanting to sell even after a 20% decline.

This, I would suggest, is how prices can fall far, and quickly, on some stocks. Yelp may be a great business to own for the long haul, but it may be getting bid up lately mostly because ... it's been going up. However, when prices are falling, you can't expect robust bidding to return until the valuation offers a compelling reasonfor new investors to step in and buy. What valuation multiple will that be?

In the *Pro* portfolio, we want to own companies that we (and as importantly, others) will be compelled to buy (or buy more of) on a 20% decline. In a rising market, *everything* looks good, and oftentimes the riskier stocks rise the most. In a falling market, you need to use valuation to measure what looks good. Sometimes that means a long roller coaster ride down before you start to see the ground. We aim to avoid that with *Pro* stocks.

Share your thoughts on the [Memo Musings board]; see our update on a Buy First stock below; and stay Foolish for the long haul!

-- Jeff (TMFFischer)

Pro Guidance Changes

- **American Tower** (NYSE: AMT): *Pro*'s fair value increases to $105. The stock remains a Buy First with a 2.4% allocation. We're considering strategies to add to our shares. Check out Billy's [full business update here], in our new format.

Your Most Active Conversations

[Today] [Past 7 Days] [Past 30 Days]

Fool One Podcast: Can Whole Foods Pair Price With Purpose?

Published Mar 3, 2014 at 12:44PM

Stream It!

Rather listen on the go? Stream this podcast on your mobile device by [clicking here].

With a $20 billion market cap already, just how much upside does **Whole Foods Market** (NASDAQ: WFM) have for investors still considering whether to grab a piece of the all-natural pie?

In this exclusive sneak peek inside the world of Tom Gardner's "crown jewel," all-access service, analysts Bryan White, Alyce Lomax, and Motley Fool chief investment officer Andy Cross join host Chris Hill to talk about why they see green pastures ahead for the conscious capitalism pioneer. Listen in below!

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Run time: 11 minutes

We hope you enjoyed this free bonus content brought to you by *Motley Fool One*. If you'd like a further behind-the-scenes look at this premier, all-access service — as well as the opportunity to take advantage of a wide range of free special gifts and exciting content from Motley Fool co-founder and CEO Tom Gardner and his entire *Motley Fool One* squad — [simply click here].

Transcript

CHRIS HILL:

Welcome to EP Weekly. I'm Chris Hill joined in-studio this week by Bryan White, Alyce Lomax and chief investment officer here at The Motley Fool, Andy Cross. Thanks everyone for being here.

ANDY CROSS:

Chris.

ALYCE LOMAX:

Hi.

CHRIS HILL:

We've got Middleby's earnings to talk about, but I should kick things off by officially welcoming Alyce Lomax to the Fool One team. Alyce has been working for years at Fool.com. I'm sure a lot of our listeners know her writing from there. And Alyce, before we get to Middleby's earnings, I wanted to touch on one company that I know you follow very closely because a big part of the work you've been doing at Fool.com … a big part of your focus as an investor … is on conscious capitalism. I think it's fair to say there's no one at The Motley Fool we identify more closely with conscious capitalism than John Mackey from Whole Foods.

Where are we now with Whole Foods? When you look at this as a company, you and I are both shareholders … longtime shareholders of this company. But I am curious. What do you see when you look at Whole Foods right now? What stands out to you in terms of their business today?

ALYCE LOMAX:

Well, I'm not sure that everybody is aware of just that holistic sense of conscious capitalism that Whole Foods and John Mackey have tried to further. I think that, that is such a wonderful thing for business. It's such a wonderful example to make that you can have that sense of all stakeholders and do well. I think that it's actually an exciting time right now because of the value. They're trying to get away from "Whole Paycheck." I think that's great for actually spreading the word about their business … Showing people that you can take care of your employees, you can take care of the environment, customers … And I think that a lot more people are going to start to understand that as opposed to a lot of the other grocers.

CHRIS HILL:

On the one hand, if they're lowering prices … if they're offering more value opportunities within their stores … that's potentially great for getting more people in the door. On the other hand, selfishly, as a shareholder, I'm wondering what this is going to do to margins. At least in the short term, it's got to hit them.

ALYCE LOMAX:

Absolutely. Unfortunately, that is going to hit them, but I believe that it's worth the risk right now, especially in the current environment, too. I mean, consumers aren't exactly feeling too flush right now. But I believe that they still have the sense of … I mean, they do still have a lot of … let's face it … high-margin products …

ANDY CROSS:

I had heard, I think, both John Mackey and Walter Robb, who is the …

CHRIS HILL:

Co-CEO …

ANDY CROSS:

Co-CEO and co-founder, talk about much more … When I heard him at the Conscious Capitalism Conference a couple of years ago, he talked about it's really about education. You really want to find consumers … We want to go into highly educated markets because that's as important as the demographics when it comes to how much money they make and how wealthy they are …

ALYCE LOMAX:

Absolutely …

ANDY CROSS:

… because they're a more educated consumer. So, this is the one thing Whole Foods had done very well and they continue to do, and that is try to educate the consumer around the benefits of living a healthy lifestyle. Eating healthier. Organics. Not everyone can afford organics, but when they go into Detroit … And they just went into another, I think, inner city market. They're not offering a ton of organic food because they can't get the supply and also they know a lot of the customers can't necessarily afford it. But these are from customers who have no access at all to any kind of fresh …

ALYCE LOMAX:

They're food deserts. Yes, absolutely.

ANDY CROSS:

Absolutely. So, Whole Foods is going in and they're trying to educate the market. They're doing this in just little test markets, but it really does align with what John wants to do from a conscious capitalism perspective.

ALYCE LOMAX:

Yes, and from a strategy perspective, absolutely. I mean, you're going in where there's a major need for better food, basically. Like you were saying, there's really no fresh food in a lot of these places. And also, the community aspect … Some of them are hooked up with nonprofit things that are actually educating …

ANDY CROSS:

Yes …

ALYCE LOMAX:

… helping people get job skills. Actually supplying the Whole Foods. So, this is exciting, holistic stuff for the long term.

ANDY CROSS:

And as we think about how they are actually expanding their store footprint and trying to increase sales per square foot with including things like the bar that they have in there …

CHRIS HILL:

Right …

ANDY CROSS:

Coffee, much more. It's actually a little bit … I'm kind of mixed on this. Sometimes it gets a little crowded because they're using the floor space to kind of peddle and introduce you to new goods. It gets a little bit crowded in there, but expanding into other lines and trying to make the experience of Whole Foods as not just going to a grocer, but you're actually going to almost a restaurant.

CHRIS HILL:

That's what you want to hear if you're a shareholder, right? The place is too crowded.

ANDY CROSS:

Yes.

ALYCE LOMAX:

Yes. And they're being entertained and having a nice drink …

ANDY CROSS:

Yes. And if only they can continue to push the throughput through the line, which is really important. That's a premium I'm willing to pay for.

CHRIS HILL:

I was just going to say. I'm still bitter about the fact … Right before we started taping, I felt really good about the Whole Foods closest to us here at The Motley Fool because they do have the bar where they have espresso drinks and all that sort of thing. Then I heard about the one near where Bryan lives where it's so big they have multiple restaurants. And a sports bar?

BRYAN WHITE:

A sports bar right at the front door. Yes.

CHRIS HILL:

Hoh! Now, I'm just bitter that there's not a sports bar in the one near me.

ANDY CROSS:

How long will it be until Whole Foods is actually in a sports arena? They may be. I don't even know.

ALYCE LOMAX:

Well, see, expanding the demographic like that … We do not know what is going to happen in 20 years, 10 years. Who knows? Maybe next year.

ANDY CROSS:

And that's a very important point. The stock really has pulled back pretty dramatically here over the last say …

BRYAN WHITE:

Yes …

ANDY CROSS:

… six months …

CHRIS HILL:

Yes …

ANDY CROSS:

… and some members who are listening, who own the stock, may be wondering what's going on. It's a $20 billion market cap and they do probably $1 billion in free cash flow. That's double where it was five years ago during the financial crisis. You have to understand that as they continue to expand that — whether it's internationally, domestically, new markets, test different store concepts, large, small — they are really trying to live up to their mission and do it in a way that is good for all stakeholders, which is a big principle of conscious capitalism. Over time, that's proven to win out and I think it still will. Twenty billion dollars — it's not a real large company.

CHRIS HILL:

Let's move over to Middleby and their latest earnings. Bryan, profit's up 36% …

BRYAN WHITE:

Yes …

CHRIS HILL:

… revenue up nearly 40%. Stock hitting an all-time high today. I mean …

ANDY CROSS:

It's making me hungry. Talking about Middleby now is making me hungry …

CHRIS HILL:

It's really …

ANDY CROSS:

For the stock and for …

BRYAN WHITE:

Well, they're executing against their strategy — which is essentially acquisitions fuel growth — so the top line near 30% growth is not a surprise. Organic growth was around 8.5%. It's that bottom line that long-term investors need to keep an eye on, because the strategy is to acquire smaller players that are inefficient, roll them into Middleby's system and improve the profitability. And then also the reach, too. When you flow them through Middleby's system, you expect some revenue growth, also. But the core reason to go out and acquire these businesses is to really improve their operations and their profitability. And quarter after quarter, they continue to show that they're having success.

ANDY CROSS:

Not just quarter after quarter. Selim's been …

BRYAN WHITE:

Yes, exactly.

ANDY CROSS:

… doing this for years. I mean, they shell out anywhere between … I don't know. Call it $50 million and $300 million in cash …

BRYAN WHITE:

Yes …

ANDY CROSS:

… acquisitions per year. They've gobbled up probably maybe more than 40 …

BRYAN WHITE:

More, yes …

ANDY CROSS:

… companies that are entering different markets with the Viking Range into the consumer market. So, Selim really has this and Bryan's exactly right. They have it down to a model and Selim's going to continue to operate it. He's a sales guy. I feel like he could … What's it? Sell me sand if I'm stuck in the desert. I just feel like he has that. And that's really what you want from a person who is an acquisitive CEO who's going to go in there and turn things for the better, absorb those companies and really drive sales higher. That's been good for shareholders. The stock's more than doubled here in 10 months, maybe. Something like that, right?

BRYAN WHITE:

Yes.

CHRIS HILL:

Well, and one of his strengths must be hiring. I'm assuming he has a smart team around him because …

BRYAN WHITE:

Oh, yes …

CHRIS HILL:

… it's one thing to make acquisitions. It's another thing to make them work well. A lot of companies, regardless of the industry, really struggle with acquisitions and it seems like Middleby is the exception to that.

BRYAN WHITE:

Well, that's an excellent point, Chris. A lot of times we'll focus on the capital allocator and give them all the credit. But absolutely, the managers underneath Selim are doing a lot of work … a ton of work. And look at what they've done with Viking. I mean, this was a business where their sales got cut in half during the downturn …

ANDY CROSS:

Yes …

BRYAN WHITE:

… and they're turning that around. EBITDA margins were up over 15% and that's way ahead of schedule, so they're doing really well.

ANDY CROSS:

And astute, outsider-esque CEOs, to borrow a phrase from Will Thorndike's book, they are very effective users of capital strategies … so, whether it's debt or equity … In Middleby's case, it's mostly debt equity benefitting from low interest rates. Going out there and finding companies they can acquire, bringing them into the family and improving operations. I mean, that's a recipe for success that you can do again and again.

CHRIS HILL:

Brian, last question on Middleby. The market cap's only about $5.5 billion …

BRYAN WHITE:

Yes …

CHRIS HILL:

Over the next five years, how much bigger can this company get?

BRYAN WHITE:

Oh, it can get quite a bit bigger, and I think over the next year or two … maybe three years … it's going to start to become more of an emerging-market story, and I think the investors will appreciate that a little bit more. We're a little ahead of the game because we look at the business and we focus on the business so much — but their food processing segment has a lot of opportunity out there in emerging markets. There's demand that's expected to pick up quite a bit in emerging markets for processed food — the food that we're used to shopping and filling our fridges with here in the U.S. Demand in emerging markets is expected to pick up.

And then we also have the big story in terms of food safety. Middleby will be rolling out its solutions in emerging markets, and we know that's a big story in China with Yum! brands. So, food safety's also going to drive sales from emerging markets for Middleby. It's got a ways to go. The story is far from over for Middleby.

CHRIS HILL:

All right. For Bryan White, Alyce Lomax and Andy Cross, I'm Chris Hill. Thanks for listening. We'll see you next week.

Earnings: American Tower Q4 2013

Published Mar 2, 2014 at 8:41PM

Hey Fools, check out the inaugural article in our new approach to news, analysis, earnings, and guidance changes -- we're going to start sharing that news in articles like these (in our "Extras" section on the site) instead of on the boards. I'll cross-post a link on the boards as well, if you prefer to access your content that way. We think this new format will lead to better readability, search functionality, and we can more easily include graphs, pictures, or rich text. Let us know what you think!

What Happened?

Consolidated Results:

- Total Rental & Management Revenue of $942 M (up 22.6% nominally, and up 30.8% on a core* basis from 4Q 2012)
- Adjusted EBITDA of $600 M (core growth of 27.3% from 4Q 2012)
- Adjusted Funds From Operations (AFFO) of $378 M (core growth of 27.4% from 4Q 2012)
- AFFO per share of $0.95 (up 28.4% from 4Q 2012)

*Core growth reflects adjustments for foreign currency exchange rates and prior period one-time items

Segment-specific Results:

- Domestic Rental & Management Segment Revenue of $623 M (up 24.6% from 4Q 2012)
- International Rental & Management Segment Revenue of $301 M (up 25.6% from 4Q 2012)

Investing and Financing:

- Total Capital Expenditures of $276 M (up from $191 M in 4Q 2012)
- Cash Paid for Acquisitions of $4.1 B (includes Brazil/Mexico and GTP acquisitions)
- Net Debt / EBITDA (Leverage Ratio) of 5.9x
- Stock Repurchase Activity: None – repurchases have been suspended since GTP acquisition in order to pay down debt and reduce leverage ratio
- Quarterly Distribution of $0.29 per share (up 21% from Q4 2012)

CEO Jim Taiclet:

"In 2013, our global sales and operations teams delivered record levels of new leasing business. Collocations, amendments and annual escalators, net of churn, drove Organic Core Growth of 8.7% domestically and 13.5% in our international markets. In addition, we added over 10,000 towers to our portfolio via acquisitions, predominantly in our three largest markets, the U.S., Mexico and Brazil. We are especially pleased with the quality and performance to date of the Global Tower Partners assets, which expanded our domestic tower count by over 20%.

Moreover, we completed the construction of over 2,000 towers in 2013, ending the year with a total of over 67,000 sites. Taken together, our strong organic growth and successful portfolio expansion initiatives made for a great start to achieving our aspirational goal of doubling our 2012 AFFO per Share by 2017."

So What?

To start, if you haven't yet read TMFDatabaseBob's recap of the quarter (here), go read it! It's a great primer on American Tower's (NYSE: AMT) terminology and this quarter's performance. If you read it, I suspect it will make deciphering this report a lot easier.

With that said, American Tower carried its strong momentum from the first 9 months of 2013 into the 4th quarter. The business continues to perform above my expectations and above management's stated guidance. Organic growth (that is, growth *not* including acquisitions or new site builds) for full year 2013 was 8.7% domestically (vs. 7.3% in 2012) and 13.5% internationally (vs. 13.6% in 2012). The weighted average organic growth (U.S./ international blended) was 11.2% (vs. 9% in 2012).

Organic growth comes from 3 main sources:

1. Annual rent escalators (~3.5% in the U.S. and ~4-8% internationally, depending on geography)
2. Altering a lease to add new equipment to towers (i.e. "amendments"), and
3. Adding new tenants to existing towers (i.e. "co-locations")

Last quarter, I wrote: "*Current levels of carrier investment (especially in the U.S.), pricing trends in the market, and current growth rates are leading me to believe that even the high end of [organic growth] guidance (6-8% domestically and 10-11% abroad) might be too conservative*."

This quarter's and full year 2013's results are helping to confirm that hypothesis. For 2014, I'm expecting continued strong organic growth, and barring unforeseen macro-economic changes, I'd be surprised if organic growth rates were below the mid-point of guidance (7% in the U.S. and 10.5% internationally).

As we know, in addition to organic growth, American Tower also generates growth via acquisitions and new site builds. The company spent over $4 billion for acquisitions in the quarter, for the purchase of 4,869 towers in the U.S. (associated with the GTP acquisition) and 4,241 towers internationally (predominantly Brazil and Mexico). With 30.8% core revenue growth and 11.2% organic growth, the remainder (19.6%) can be attributed to new properties. This compares to 10.3% growth from new properties in Q4 2012, and we can see how AMT's big acquisitions have positively affected revenue growth. I'd expect growth from new properties to be lower in 2014 due to a slowing pace of acquisitions, as a result of AMT's higher-than-usual leverage ratio (now at 5.9x Net Debt/EBITDA) resulting from the GTP acquisition (see this post for more information on AMT's leverage ratio).

Yearly distribution growth was about 21%, exceeding management's annual target of 20% distribution growth. I see no reason to believe the 20% growth target is not feasible for 2014.

Now What?

The market reacted negatively to AMT's earnings report the day it was released (2/25/14), with the stock ending the day down about 4.2%. I usually prefer not to speculate on the reason for short-term market moves, but if I had to guess, I'd point the finger at acquisition-related increases in expenses and foreign currency headwinds causing a year-over-year decline in net income, and a decline in operating income margin.

The stock price decline in reaction to earnings looks like classic Wall Street short-term thinking to me. Stripping away these short-term effects, the business continues to perform admirably, with core growth of 30.8% in revenue, 27.3% in EBITDA, and 27.4% in AFFO. The company continues to expand its tower count via acquisitions and new site builds – the overall tower count (U.S. plus international) now stands at over 67,000 towers vs. about 54,000 last year. Strong carrier network demand continues to bolster organic growth at rates above our expectations. Our investment thesis (that global growth in data consumption will stimulate wireless carrier network investments, leading to tenancy growth and rising returns on capital over time) continues to play out.

Additionally, I'm becoming more and more comfortable with the management team. Their level of disclosure is outstanding – they release very detailed and granular data, and most likely they wouldn't be so open with disclosure if they had something to hide. They're not the most affable bunch, but they're darn effective. These guys know the tower business inside and out, they've developed strong relationships with carriers, and they're disciplined capital allocators. They are investing where it makes sense, buying back their (in our estimation) undervalued stock when they can, and they are willing to turn down deals if they don't meet internal hurdle rates. Check out this quote from management in response to an analyst question at a presentation earlier this year:

Michael Rollins – Analyst, Citigroup:

"Now as time has gone on and you were early in the international expansion phase relative to some of your competitors, relative to some private equity and start-up companies that are now surveying the landscape to basically do what you've been doing for the last few years, is it getting tougher? And is the incremental return kind of getting squeezed a little bit because the competition for these assets has gone up?"

James D. Taiclet – CEO, American Tower:

"There is this increase in some markets in the competitive entry of other players in certain deal opportunities. We haven't changed our investment criteria at all, though. And when we sort of mark up the scorecard over the year, we've locked away or not been the recipient of more deals than we have won. And so those criteria don't change. If asset prices exceed what we think they're worth, we just don't do the deal."

For a company that's as acquisitive as American Tower, I love that quote. They aren't willing to sacrifice profits for the sake of willy nilly revenue growth. And if smaller competitors with lower margins are less disciplined and are paying more than American Tower, I'm willing to bet that some of them might get into trouble down the road and that could eventually lead to some opportunities for American Tower to acquire assets on the cheap. Bottom line, I really like what this management team has done over the past 5 years or so and they have an effective strategy in place to extend their success.

Data and Guidance:

- Current price: $81.12
- Fair Value (**updated**): $105
- CAM (**updated**): $72
- Market Cap: $32.1 billion
- EV/EBITDA: 20.6x
- Allocation: 2.4%

AMT remains a Buy First, with an updated $105 fair value estimate and an updated CAM (Consider Adding More) of $72. With our most recent put write having expired in January (at a $74.65 strike), the team is actively exploring new put writing opportunities. If you've yet to start a position, now is as good a time as any to match our 2.4% allocation.

Fool on!

Billy

Long AMT

Peaks, Valleys, and Valmont Industries

Published Feb 24, 2014 at 4:00PM

Dear Fellow Fools,

Take a Peek at Fool One!

Is the market finally due for a pullback? In this exclusive sneak peek inside the world of Tom Gardner's "crown jewel," all-access service – Motley Fool One – analyst Morgan Housel joins Robert Brokamp, CFP, to discuss the past, present, and future of stock market drops ... including why many investors think a real pullback could be on the horizon. Make sure your portfolio is properly fortified against any impending market moves by digging into this exclusive from Motley Fool One.

Get the Report!

Valmont Industries' (NYSE: VMI) stock price declined 6% on Friday after the company announced earnings. The decline brought shares back to the same price they last traded at on ... Feb. 10. Despite a lack of drama in that fact, the earnings news still merits revisiting our investment thesis. The stock is a Buy today, moving from Buy First only because we want to ask management some questions about our assumptions for the utility business. Here's where we stand today.

The Scoop

Valmont is out of favor, just as it was when we bought it. As of Friday, the business traded at 6.9 times EBTIDA, a 35% discount to its 9.3 average since 2004. The stock fetches 14.1 times earnings – well below its 19.7 average P/E since 2004.

Following a strong three years during which revenue rose almost 19% annualized, investors – including us – are expecting a near-term slowdown in the business, and have priced the stock accordingly. We're happy to have started a 3% position at this valuation while looking ahead. Ultimately, Wall Street looks ahead, too, and although 2014 may be a year where Valmont just holds the line (as we hoped), this would make growth in 2015 and beyond more likely, and that's what we're invested for. Plus, history suggests the stock is likely to resume its long upward trend in anticipation of a return to growth. After a weak start to this year, Valmont's business is expected to improve in the second half of 2014.

While we wait, the business remains inexpensive and healthy ... but barring large acquisitions, it is not likely to grow in 2014. For the full year, management expects a slight decline in earnings as irrigation sales remain below records set during the commodity boom and recent drought, and as international utility structure sales weaken. In this latter product line, supply has caught up with demand for the first time since 2010, and the company is waiting to see how rational (or stable) the pricing remains.

As with many cyclical companies, Valmont enjoys strong leverage when demand jumps, but its fixed costs limit its profit level when demand slumps. Having been through multiple business cycles over the decades, the company prides itself on riding through them profitably. Wall Street is fearing it, but Valmont does not see a deep trough ahead for its diversified business, just a flat 2014 as two of its four business segments take a breather. And its long history of navigating through valleys gives us comfort just the same.

Live Chat Coming Up!

Join us at 2 p.m. Eastern this Wednesday, Feb. 26, for a live text chat with the whole Pro team! Set a reminder here.

In summary, we assumed a slowdown in irrigation would take place in 2014, and we'll be talking to management to get more details about competitive utility sales in international markets and what that means for pricing. Although the condition is expected to be temporary, we want more details than were shared in the conference call.

The Foolish Bottom Line

The bottom line remains that we're paying an attractive price for Valmont, so as long as the business can even stay flat, we should not see much downside volatility. Following that, we're positioned for upside as the market begins to anticipate growth again. We hope to invest in this business long enough to compound our money. With exceptional management, Valmont has been an outstanding stock for decades, yet it remains a relatively small $4 billion company with four promising lines of business. This was our thesis. It stands tall as a light pole today. Meanwhile, if we see more ways to profit on the situation (perhaps using options), we will certainly aim do so.

If you have questions, please visit the Valmont discussion board. For now, Fool on!

-- Jeff (TMFFischer)

Pro Guidance

- **O'Reilly Automotive** (NASDAQ: ORLY): After 50% appreciation, the stock moves to Buy from Buy First. Our fair value increases to $138.
- **Valmont Industries** (NYSE: VMI): Shares move to Buy from Buy First while we wait to speak to management.

Pro Catch-Up Trades

- **Oracle** (NYSE: ORCL) remains a Buy First at a 4.6% allocation. Buy shares if you haven't, Fools.
- **Tupperware** (NYSE: TUP): If you don't have 2.7% exposure through existing puts (we're short April $90 puts), then sell to open April 2014 $75 puts for at least a 2% yield ($1.50 each). If you're not using options, you can buy shares of stock instead.

Pro Coverage

- **Medtronic** (NYSE: MDT) stays healthy and remains a Buy at a 2.9% allocation. See Bryan's earnings coverage.
- **AmTrust** (NASDAQ: AFSI) increased its dividend 40%, giving shares about a 2.2% yield.

Your Most Active Conversations

Today Past 7 Days Past 30 Days

The Next Market Meltdown

Published Feb 24, 2014 at 1:18PM

In this exclusive glimpse at the *Motley Fool One* weekly podcast, listen as Robert Brokamp invites expert analyst Morgan Housel onto the show to discuss his new *Fool One* exclusive report, The Next Market Meltdown. Topics include:

- Why we should always expect a pullback (34 seconds in)
- Whether bigger drops lead to sharper rebounds (3:21)
- What caused the 10 biggest drops (5:17)
- What's a better predictor of the market: earnings growth or ... rainfall? (5:53)
- Is our optimism just survivorship bias? (7:35)
- How individual investors can increase their odds of landing gains (10:45)

Get the PDF of Morgan Housel's report

Listen to the Podcast

{% ooyala id="djOTV4ZDo02LHZT3CoBvkgTrEJ9xO7rJ" width="580" height="326" %}

Run time: 11 minutes; originally aired Aug. 22, 2013

We hope you enjoyed this free bonus content brought to you by *Motley Fool One*. If you'd like a further behind-the-scenes look at this premier, all-access service — as well as the opportunity to take advantage of a wide range of free special gifts and exciting content from Motley Fool co-founder and CEO Tom Gardner and his entire *Motley Fool One* squad — simply click here.

Podcast Transcript

Robert Brokamp: Hello everyone and welcome to the EP Weekly. This is Robert Brokamp sitting in for Chris Hill, and of course we're joined by Bryan White as always. But today we have a special guest, Morgan Housel, down from all the way in Baltimore. How are you doing, Morgan?

Morgan Housel: Doing well, thanks for having me.

Robert Brokamp: Great to have you here and we have you here because you are writing a special report that One members will get this week. It's called *[The] Next Market Meltdown*. So Morgan, are you a market timer?

Morgan Housel: I am absolutely not a market timer, but when I talk to fellow investors, when I communicate with readers at The Motley Fool and talk to my friends about investing, one question that keeps coming up quite a bit recently is look, stocks have come so far. Stocks recently hit all-time highs. We've pretty much gone straight up for the past four years. Are we due for some sort of market pullback, maybe something more like a market crash? And many people I have talked to are looking at this and getting nervous about it in a sense of is this a bad time to invest with stocks at an all-time high?

So I just want to think of different ways that I can think about stock crashes and pullbacks with the market at an all-time high, and I think there are two things that I thought about with this report. One is that the stock market being at all-time highs right now is really a matter of perception when you think about the rally we've had over the past four years. So yes, stocks are up about 170% since March 2009, which is an incredible four-year period. It's actually one of the best four-year periods in the history of the stock market.

But that's just anchoring, really focusing to the March 2009 lows. If you think about the last five or six years, since 2007, stocks have barely kept up with inflation, so it really depends on what starting point you're looking at when you talk about how far stocks have come. Two rational investors could look at the stock market and be amazed at how far it's come, or shocked at how flat we've been for the past six years, right?

Robert Brokamp: And I think even since 2000 on an inflation-adjusted basis, it's still not reached its peak.

Morgan Housel: Right, exactly. And then so the other thing I think about with market crashes is in this report I went back and looked at the long history of the Dow and the S&P 500, and I just counted the individual times that stocks have pulled back 10%, 15%, 20%, 30%, 50%, from its recent highs. If you look at 10% market pullbacks, that's happened 89 times since the 1920s, which is about once every 11 months.

So when people ask the question, Should we expect a market pullback, the answer is always yes, no matter what the economy is doing, no matter what that stock market has done recently, the answer should always be yes. These are just intrinsic things that the stock market does. It's a natural phenomenon on the stock market. And when you look at even big drops like 20%, that usually happens about once every four years, so I think most investors at The Motley Fool are investing for more than four years. We're talking about hopefully 10, 20, 15, 20 years we'll be investing for. So when you think that 20% drops happen on average every four years, you are going to experience hopefully several of those during your lifetime as an investor, so when I put those two together, that it's really not that clear how far, how overbought the stock market is and that these drops are much more inevitable than we think.

Really the conclusions that I come up with is that these things are unpredictable and that rather than trying to think about and time around them, we should just accept that they are parts of the stock market and that's just life as an investor.

Robert Brokamp: Right, so you have the drop; those drops are going to happen. The question then is how long does it take to get back to where you were, and you include some of that in your research as well.

Morgan Housel: Right, so historically the bigger the drop, the sharper the rebound that occurs after it. One of my favorite examples is in 1929, which is the massive crash of the Great Depression. From peak to trough, the stocks fell almost 90% during that period, but when you factor in inflation and dividends, stocks were back at an all-time high within six or seven years after that. And that was true for the financial crisis in 2009 too. That was the worst financial crisis in 80 years. It took four or five years for stocks to get back to an all-time high, so there's little precedent in American history at least, for stocks when you include dividends to crash and then not return to their all-time highs in less than a decade, and usually much faster than that.

Robert Brokamp: Right, and then there's the question of all right, so you were saying it happens pretty regularly, so you could think, well, if it happens that regularly, maybe I can predict it, maybe I do know what happens. And also in your report you talk about, all right, so what causes these crashes?

Morgan Housel: Right.

Robert Brokamp: And the answer is really, they're pretty unpredictable.

Morgan Housel: Right, it's really we don't know. You know the biggest factor is it moves stocks around when we have crashes like this is just human psychology. It's people getting optimistic and then people getting fearful. People move in hordes and in droves, they all move together. There's a great quote that I like that says, "Nobody knows what the American people are going to do next, but we know that they're all going to do it at the same time. And that's really true for the stock market. We really don't know when people are going to get fearful or greedy next and there's really no way that you can forecast human emotions like that. We know that people are going to change their moods significantly from time to time, but it's really difficult to nail down the precise timing of that.

Robert Brokamp: Right, and you cite some research by Jeremy Siegel about the causes of the top ten biggest drops. There are things you couldn't predict, like the September 11 attacks, things like that.

Morgan Housel: Right, yeah, so Siegel went back and looked at I think the 20 biggest market drops in the last hundred years, and at least ten of them were tied to things that nobody could have seen coming before hand. President Eisenhower having a heart attack, the start of wars, September 11, things like that. No one could have predicted those things, even 24 hours before they occurred.

Robert Brokamp: Right.

Morgan Housel: So it's certainly not something that we can sit here and try to guess what the stock market's going to do over the next ten years.

Robert Brokamp: Right, so there are events, but then there are various metrics you might want to look at and say like, Oh, this tells me that what the stock market's going to do and some other research you cite is from Vanguard. So you tell us, what has the biggest correlation to future returns: P/E ratio, 10-year Treasury yield or the amount of rain?

Morgan Housel: Right, so there's this really interesting report. Vanguard, the fund giant, looked back at all these interesting metrics that analysts use to forecast where stocks might go next. They just looked at these metrics and said, Okay, in hindsight, how good are they at explaining what the stock market is going to do over the following ten years? So they looked at things like the P/E ratio, the trend growth that the economy is growing at, how fast earnings are growing, things like interest rates and profit margins. Virtually all of them explain next to nothing about where stocks are going to go next during the following ten years.

The biggest, the most important variable that tells us where stocks are going next is the P/E ratio. That's just the basic idea that you buy stocks when they're cheap and they'll do well over the following period; buy stocks when they're expensive, they'll do poorly after that. But even the P/E ratio explains only a minority of stock returns over the following ten years. And things like earnings growth and interest rates and profit margins tell us literally nothing at all about where stock might go in the next ten years, and that really all comes back to the point that what's really driving the stock market over time, in short periods of time especially, are human emotions, just how optimistic and fearful people are about the future.

Robert Brokamp: So I can get rid of that barrel in my backyard that measures the amount of rain? Because that's not going to help me.

Morgan Housel: That's not helping you at all.

Robert Brokamp: Darn, right. All right, so I'm going to play Devil's Advocate because this is all good news. This is all very encouraging. Sounds like you just have to buy and hold, that type of stuff. Some people might say this is actually a bit of survivorship bias and that we're looking at the U.S. market, twentieth century, the American century. We all know that the Japanese stock market is still down about 70% from where it was in 1990 and through most of that period it was the second biggest economy in the world. Great economy, bad stock market, only recently surpassed by China.

So are we focusing too narrow here or is there something so awesome about being American that we can believe in our stock market?

Morgan Housel: Well I think there are two things to think about. If you look at the long history of stock markets, there's one even that consistently throws all of this analysis out the window. There's one event that can really destroy long-term stock returns, and that's of course war. We really saw that a lot in the twentieth century with large developed countries that saw their stock markets go to zero and never recover. During World War II when your currency is destroyed, when you have a dictator in power that's going to really run roughshod over the economy, that's really the variable that can destroy stock returns. But that's not a way of living that I think is very intelligent and to sit here and to think that we're going to have another war and worry about that...

Robert Brokamp: Or zombies.

Morgan Housel: Or zombies. That might be something to worry about. I think when you talk about Japan, the key variable there is that the Japanese stock market has done nothing for the past 25, almost 30 years. The big factor there is that the bubble that they had when stocks peaked around 1990 was like nothing we have ever seen in the United States. It put our dot.com bubble to shame really.

And really when you look at the Japanese stock market over a longer period, when you're not starting at the top of the bubble, but you look at the Japanese stock market over the past 40 or 50 years, it's done quite well. so really that just goes back to valuations, like we were talking about earlier, and that yes, if you buy stocks when they are grossly expensive, just off the charts expensive, then you're not going to do very well.

That's true of the Nasdaq too. The Nasdaq peaked in 2000 at around 5,000; I think today it's somewhere in the three thousands. It could be another decade or more before we return to an all-time high, so that would be 20 years or more before the Nasdaq recovers.

Robert Brokamp: Right, and the other aspect with Japan was they had a huge real estate bubble as well, and that never happens in America. But I was going to bring up the Nasdaq as well as my other devil's advocate because you looked at the S&P 500, and that says a lot about someone who owns an S&P 500 index fund, but individual investors, especially stock pickers, those are how fans of The Motley Fool, have different portfolios. I would say some of them probably have a portfolio that's closer to the Nasdaq. Still 30% down from where it was in 2000. From here you've got to get a return of about 40 or 45% just to get back to break-even.

So even if you are a U.S. investor investing in a major U.S. index, it doesn't necessarily mean that you will recover as well as the S&P 500 has.

Morgan Housel: That's absolutely right, and I think what that really shows is the power of diversification. If you have a portfolio that is heavily weighted toward one industry or even one broad sector like technology, that certainly increases your chances that you're going to go through very long periods of disappointment. It's really imperative for all investors I think to have a well-diversified portfolio.

That's not only true for individual stocks and sectors, but across assets too between stock, bonds, cash and real estate.

Robert Brokamp: Right, right, which I personally am a big fan of. The readers of *Rule Your Retirement* will know that that's one of our major points.

So that's all good stuff. The report will be available soon, if not by the time you listen to this podcast. Morgan, thanks for stopping by, and everyone else thanks for listening in and we'll talk to you next week.

A Quick Word From Jeff Fischer and Tom Gardner About Motley Fool ONE

Published Feb 21, 2014 at 4:04PM

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To learn more about *Motley Fool ONE* — and claim a series of unique and valuable gifts in the process — simply click here.

FoolFest 2014: The Pro Team's Presentations

Published Feb 19, 2014 at 3:50PM

Watch the *Pro* team's presentations from February's member event, and download the accompanying slides at the bottom of this page. Transcripts are at the very bottom!

Jeff on "Portfolio Construction With a *Pro* Blueprint"

{% ooyala id="txb21xazpmrrbm0SMkSPM9S2Ttu5dvPt" width="580" height="326" %}

Run time: 46 minutes. *Read the transcript*

Bryan on "Worldly Wonders, Albert Einstein, and *Pro* Core Stocks"

{% ooyala id="pnb21xazpcPTMuoSBoYsEFmZ1RcqkAFO" width="580" height="326" %}

Run time: 25 minutes. *Read the transcript*

***Pro* Stock Talk (with a brief Q&A)**

{% ooyala id="5zMHFxazq5c94kH514whXtoDW5-wvqwS" width="580" height="326" %}

Run time: 29 minutes. *Read the transcript*

Make the Most of *Pro*

Jeff and Members:

{% ooyala id="l0bXBxazrLdAfpsIRlsqVWNAXk1w_i2G" width="580" height="326" %}

Run time: 53 minutes. *Read the transcript*

Jim Gillies on Using *Options* Alongside *Pro*:

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Run time: 15 minutes. *Read the transcript*

Ask the *Pro* Team!

{% ooyala id="lwbXBxazr-iS_kJxcqsMxpcya9JAD1Ig" width="580" height="326" %}

Run time: 42 minutes. [Read the transcript](#)

***Pro* presentation slides:** [Download the PDF of all of our presentations here >>](#)

Transcripts

Jeff on "Portfolio Construction With a *Pro* Blueprint"

Jeff Fischer: So first, thank you for being here. I'm Jeff Fischer. In the room with us is Bryan Hinmon, *Pro* senior analyst; Billy Kipersztok, *Pro* analyst; and Jim Gillies I believe as well, the *Motley Fool Options* co-advisor. And later we'll have Ellen Bowman here. She is *Pro*'s and *Options*' editor and site manager. And we have special guests in here, Tom Jacobs, *Special Ops* advisor, and all of you, thank you for being here with us.

So, just so you know, this is all being recorded and the slide deck will be on the Web site and that's true of every session so you won't miss anything today, you can see it all later when you get home and you'll have all of the slides as well.

If you have any questions I believe you have paper and pen, write down your question during the presentation so you can ask it right afterwards.

Now, a little bit of *Pro* history, very briefly, we started in October 2008. It's been an interesting 5.5 years. We're no longer the new kid on the block, the shiny new toy. We've seen some amazing things, we've seen Greece, of course, collapse and bring down all of Europe with it, we've seen the dollar plummet in value and interest rates soar. We've seen the U.S. default and -- no, wait, wait, wait, that's what we were thought we were going to see or that's what everyone said we might see. We've been though a lot of risk events since 2008 to be sure and thankfully so far we've come out well ahead by investing in strong businesses at good prices.

Let's talk about that for a minute. When you're at a cocktail party or maybe last night or anytime with friends, family, even if you're on the Fool site or the Web in general, what you most frequently see are a stock idea, this stock, that stock, get this hot stock. The Fool's guilty of it, I am as well, we all are and it's understandable, it's exciting to talk about a single stock but it's also a little bit wrong-minded because any single stock is hit or miss. What really sets you up for success, long-term and short-term, is a portfolio that works. A portfolio that is built to compound and be flexible when the market throws you a curve and keep growing as you grow; not just a single stock that can flare up like a firework and then fizz out, and yet we spend all of our time, or much of our time, in this world talking about single stocks. When's the last time at a party someone said, hey, let's sit down, I want to talk to you about how my portfolio is constructed? It's never happened to me. Usually it's either a single stock that we talk about or it's are you in the market or out of the market and that's not a strategy at all.

So, I want to ask you, what is a portfolio and feel free to shout out your answer. What is a portfolio? Diversification, collection of holdings.

Audience Member: Allocation.

Jeff Fischer: Allocation.

Audience Member: Everything that's not (invested in) (unclear).

Jeff Fischer: Excellent, those are all great true answers. Now, what makes for a portfolio, what are the factors that make something a portfolio? Strategy. Pardon me?

Audience Member: Balance.

Jeff Fischer: Balance. Protection. Risk management, money! All right so a portfolio, all of those answers are correct and that's what's so great about a portfolio. It's one of the most complicated things in some ways that we build in our lives, in our financial lives and then there are these four things that a portfolio, I believe, should always have. One is a goal, it's goal-driven. So this is a collection of assets that you're putting together with a certain goal in mind and that goal will, of course, evolve over time.

When I was 17 I bought my first shares of stock and I bought a small Florida real estate company called (unclear) for about two or three dollars a share because I loved tropical climates and I still do and I thought how fun to own a little piece of Florida, this was in 1987, I should have done well, you would think over time. That company went bankrupt in a year or two.

I also bought those shares of Citibank and my reason behind that was I wanted to -- whether I knew it or not at 17, I wanted to associate myself with the power of a big American bank. So we have goals that are financially driven but whether we realize it or not they're also driven just as much or more so by something within us, some emotion, some need that's much more powerful. Our goal is to provide for our family, provide retirement, school, education and when all of that is bound up into your portfolio, into your goals, it's hard not to be emotional about your portfolio when things get rocky.

So you have a portfolio, you have goals that drive it and those goals change over time. By the time I was 23 my goal wasn't just to own some Florida real estate it was to get some financial freedom. Man, I had been working in the real world for a year! I need some freedom. So my investing goals changed rapidly, how do I grow whatever I'm making and saving?

So a portfolio, a second attribute, is it demands choices, it's anything but passive. This seems obvious but it's important to realize in yourself at all times. You're taxing yourself a little bit, you're devoting part of your life, part of your energy, to your portfolio because it's going to demand a lot from you over time.

Next as you all hit on so very well, a portfolio has multiple positions, this is a given but it varies greatly. Some of us may only own seven stocks and say some bonds or cash. Some may own 100, would anyone like to say how many positions they hold approximately?

Audience Member: Fifty-three.

Jeff Fischer: Fifty-three. Thirty, 70, 80 …

Audience Member: Twenty.

Jeff Fischer: Twenty and …

Audience Member: Three.

Jeff Fischer: Three, all right! And the beauty of being so young, when I was in my 20s I stared with -- how do you start with more, you start with a couple! And then I've heard some people in their 60s who own 200 are happy and comfortable with that. David Gardner himself, he doesn't own that many but recommends that many.

So the final attribute of a portfolio is that it faces unique risk and reward that you yourself are constructing.

So as we look at these four things we realize that you have a goal and that goal evolves over time and that goal demands and drives your choices. What you put into your portfolio should, of course, feed your goal. And you have multiple positions because you don't know which one or which ones are going to do best. Peter Lynch has always said, if you can bat 60% or .600 -- if six out of 10 of your positions win you're a great investor and you'll do very well because those six out of 10 will hopefully compound over time. Finally you're facing risk and reward. Let's talk about what risk is. That's what we want to narrow down to right now.

Who can define risk? What is risk?

Audience Member: Maybe depends on the (unclear) risk might be completely different (unclear).

Jeff Fischer: That's so true, risk is different for everybody. I'll repeat, risk depends on the individual. For one person risk is very different than for the other and like Anne in her 20s, she may not see much risk at all because she has the bulk of her savings ahead of her and she's going to put that into stock. If you're in your 50s or 60s and you've saved most of what you think you will and now it's in your portfolio and you need that for the future, your risk is very different. You may not want to see a large loss over any three- to five-year time frame so risk differs by individual, that's very true.

My definition of risk, as well, is it's when you're unable to respond in a constructive way to market adversity or adversity in your financial life and that leads you to be compelled to sell at the worst times or when you don't want to.

So, to reiterate that point, it's when you're unable to respond to something terrible. 2009 is fresh in our memories, of course, easy to flash back to that. How many of us were hand-tied and frozen by that and even if you didn't need the money right then because -- you probably didn't, hopefully you didn't if you had it in stock -- you may have been borderline terrified because you're watching your life savings, your emotional ... all of these emotions that you've put into it inadvertently are not your life savings, your self-worth, your family's security, you're watching it evaporate and it's impossible to not become emotional about that and that may force you to do things that you wouldn't otherwise want to do. Your emotions are getting the best of you because you have an inflexible portfolio and all you can see to do -- the only way you see that you can wiggle out of it is to do something a few months ago that you weren't thinking of doing at all: selling something, getting out.

So, what does this come down to? Does anyone want to take a guess what this comes down to, if you're unable to respond or if you're forced to sell, does that come down to allocation, exposure, fear, I'll argue portfolio risk, construction, that's another way of saying this. Allocation, construction and fear works into it.

When your market exposure and your portfolio incapacitates you, the manager, at the worst time. I mean, you don't have any risk really when the market's going up, there's no risk, you sit back, your risk is selling foolishly but when the market's going up your risk is basically nil. When it's going down that's when you need to have risk control already in place and if you don't you're incapacitated at the worst time, at the one time when you need it, it's as if when you're driving a car and when you lose control and you have no hedge. What have car makers done? They've put in seat belts and air bags to help you during that time. Does your portfolio have such a protection to it?

So you have to ask what price do you pay when your hands are tied when as a portfolio manager you're incapacitated at the worst time but what are some of the prices that you pay as a result. Think back to 2009, if that was you in that situation -- it was many of us -- but what are some of the costs of being frozen just when things get rocky.

Audience Member: (Unclear).

Jeff Fischer: Exactly! You're unable to act in a positive way. There are two sides to everything, every well said and you're all one directional at this point. You don't have a backup plan, you see all of these great opportunities and instead of thinking about them and being able to act on them you're thinking the opposite of what you should be thinking. You're thinking, how do I get out of this? I'm stuck, I'm trapped, it's like any creature who's cornered, you don't want your portfolio cornered because that forces you to think differently than you really want to be thinking.

Any other opportunities that you missed out on? I guess they're all related to the same thing but if anyone has a different way to say it -- you don't think well. You may panic, you don't act in your own best interest when you're trapped. So knowing what risk is as we define it here today that it's exposure that takes you out of the game just when you don't want to be. There are ways to manage, there are ways to manage for that and they're not as tricky as it may seem.

Let's think about *Pro*, so let's go to *Pro* and run through quickly the four attributes of the portfolio because that comes first and that will drive how you manage your risk. *Pro* has a goal. I was going to ask somebody if they could name it but here it is. Our goal is inflation plus 7% a year and double our real purchasing power every 10 years. So on the spectrum of say a 30-year-old to a 50-year-old we lean more towards the 50-year-old, I would say, because we want real positive returns on every rolling three-year basis. We don't want to lose money over any rolling three years and then we have this bigger goal of doubling our real purchasing power after inflation every 10 years.

So other than these goals we have other goals that are more human. We want to teach you well how to earn returns with less risk. We want to do well by our coworkers and by the company. We want to be proud of what we create and what we do, so we have a lot of our self-worth behind all of these goals, tied up behind these goals. These are the goals that we put out there but just to remind you just as you have a financial goal and it's driven by emotions, it's the same with us and so we need to make sure that we have ways to keep our emotions in check when things start to get rough.

Now, the second quality of a portfolio, of course, is you have to make choices and *Pro*, as you've seen, we tend to make a choice every week or two with a new trade but at its core, at *Pro*'s core we seek to buy compounding machines, and both Bryan and Billy are going to talk about these with you today and explain exactly what they are. We're trying to buy companies that will compound our money over time. That's the surest way to reach our goals, that's the core of our portfolio.

But other choices that we've made are we want 3% to 5% allocations, that's us, 3% is large enough to make a difference but small enough if we lose it all we can recover and we start a full position or consider a full position to be 5% but if it grows beyond that we're happy to let it grow, we're happy to let our winners go as long as we see potential there and reasonable risk but it's good to know your parameter of what your allocations are when you start.

Some of you have 80 stocks you said so each position is maybe closer to 1%, if that works for your goals that's perfect. *Pro*, another decision we've made is we want index hedges to quickly hedge when we see risk or to hedge over the long term with low drag. As you've seen with bear spreads or ratio spreads, you can set up options to hedge the market index and yet drag very little on your upside returns. We've decided that's how we want to do it in most cases, that's how we've wanted to do it since 2009 and it's going to evolve though and we'll talk about that in a minute and we also want, when we find them, high-conviction shorts.

It's very easy to be wrong when you're short and it's mentally very taxing and it isn't for everybody but when we see things we really believe in we'll want to and I think that's around the corner for us.

Now, next we seek to sell when the potential of any position is impaired or when it's well beyond our estimate of where it should be on value. And then we use options for income and for other strategies, and with all of these choices it's important to remember that choices consume your energy. Every choice that you make consumes some energy. You burn some energy deciding to come to the *Pro* session as opposed to the other two, and we appreciate that, and luckily they're all taped so you can see them all -- but remember, you have a finite number of choices every day that you can make before your ability to make them starts to go down and that's every day, every year, every month so the more choices that you pack into your life the quality of your choices are going to degrade the more you force yourself to make.

So, we try anyway to minimize our choices by having a portfolio of 20, 24 core positions and knowing those extremely well and investing around those and, of course, we're always looking for new ideas because as we've talked about earlier this morning the world's always changing, there are always more things to consider. So, third quality, as we just talked about, multiple positions. These are *Pro*'s top five as of Monday -- it hasn't really changed since, but our top five positions account for 23.6% of the portfolio at the time -- as of right now, basically -- and three of these five, possibly four if you want to include Facebook maybe but I wouldn't yet, three of these five have long-term recurring revenue; something that we look for and something that Bryan is going to talk about. Long-term recurring revenue which feeds into our goal of compounding returns and then Intel we just recently have turned into an income position that yields 3.6%. Unfortunately we don't see much growth there in the coming year. Now, a company doesn't need to grow to go up. Intel hasn't grown its business much for several years but the stock is up 20-some percent for us which is, ah, you know ... but we're going to use options on it to turn it into a greater income position and that, again, feeds into our goal of absolute returns every year or every rolling three years at least, every year would be great too.

So, the point is for every position you have some reason to own it. You have some goal behind it. Now, let's talk about risk! *Pro*, of course, has unique risk and reward and how have we done? The portfolio since 2008 has averaged, and it's actually a little lower than that, but just using the last three years it's averaged 70% market exposure and it's earned more than 100% of the market measured by the S&P of its return. And when we started out we had even less exposure in 2009, we had 50% as the market was rebounding and we took our time because our goal wasn't to take big risk it was to steadily grow.

So, that's a great result. Most funds that are long and short have done horribly the last five years and I think that's because their goal has been short-term returns and that's how they're measured. They want to make something every month or at least every quarter; that's how they're rewarded; horrible results for anyone who invested that way. Our goal, as you know, is a three-year outlook and then five-year and then 10-year, so we're able to invest in a way that is based on core stocks that we believe will compound from the prices that we buy at and that we hedge around them to get a sort of result that we have gotten.

How has our math worked out this way? How has it turned out? Well, one thing to realize is if you just outperform the market by 1% or 2% a year that adds up a lot over time, over 10 years, let alone 20 because that 1% or 2% compounds so if we can just -- it might not sound ambitious, but if we can be only 70% exposed and make 1% or 2% more than the market per year on average we'll have an amazing result over the longer term and all along the way we'll have cash in hedges that we ideally can put to work when there are great dislocations either in a stock or the whole stock market.

Now it just happens that we haven't really seen that since 2008 or '09. Since 2009, we've seen things steadily rise but when we get a big hit we do have cash to put to work, we have a flexible portfolio. We won't be stuck with our hands tied.

Now, the next slide ... I'm breaking a rule, I have way too many words on the next slide, but we're going to talk through it together. Okay, not this slide. Let's talk through this together, way to … So this is how we've -- 80% long, invested in stock and it's fluctuated a bit between 70 to 90 but average 80, about 20% cash and that of course fluctuated from 30 to 10% and 10% hedged, on average, for the most part. That's how we got to our net 70% long and that's a pretty simple formula is now on this overwhelming slide. This is how the math worked behind it, our thinking behind it, and it's great that we're now five years in because we can see it working.

We assume and we measure the weighted average beta or assumed volatility of our stocks, of our core stocks and it came to, or it comes to, about 1.25. So that implies the average stock that we own will be about 25% more volatile than the S&P 500. We have that on 80% of our assets, which, of course, gives us 100% market volatility so we've got the upside exposure, great!

We add this 10% low-drag index hedge which we've had much of the time and that lowers us down to 90% volatility. Now, you guys know it's not perfect, the options that we use are frequent spreads that need some time to come to fruition but if at the time of expiration they work as they're implemented to then this is what the exposure comes to precisely and we've seen it a few times when the market has fallen right around our spreads, expirations.

So now we're down to 90% volatility. We have less exposure with this hedge downside than the market and we have 20% cash to invest on downturns, plus our hedges when we need them create more cash in a downturn to put to work and, again, we have these low-drag hedges for the most part that won't hurt in an up market. And as a result of that because you're 80% invested, that's it, at 1.2 beta you have 100% upside potential. If you get our performance from just some of your stocks, and I sure hope that we do, your portfolio will go up more than the market in a rising market as *Pro* has but you have 20% cash and you have option hedges for when it declines and you sleep better too and it's more fun because you're waiting for a downturn.

So this is the equation that, although we haven't advertised it much on the site, maybe on some board posts here and there that get buried, the equation that has driven *Pro* through this market. And it felt appropriate in a market that had a lot of uncertainty, it feels appropriate if you have absolute-return goals every couple of years or if you're nearing retirement or not adding money to your portfolio anymore, but of course you can adjust it as you need to. If you want less exposure, if you're feeling much more defensive, you can adjust it really quickly. You can throw on another 10% or 20% index hedge just by using options on SPY or the Russell 2000 or shorting it directly as we've done in the past with costlier results in an up market. That does become a drag but even when the index goes up 20% in a year or two that's a far cry from shorting the stock that goes up 100% so shorting the index directly is an option. But say you want less exposure, say you want much less, only 40% -- you can go 60% long stock and have 40% cash and maybe you're sailing around the world and just don't want to think about it and be 20% hedged and you will only have 40% market exposure which, in 2008 and '09 would have felt great!

The market went down, S&P went down 37% at one point. You would be down 18, 19, 18% -- not such a big deal! Plus you'd have all of this cash that you're hopefully putting to work and yet if your stocks are this higher-beta type of thing that Fools at large seem to cotton to, MasterCards and you name it, anything that's a little more volatile than the dodgy old S&P. If they're 1.25 beta and your hedge is low, a low-drag option hedge, you're exposed to 75% of the market's upside in this scenario and only about half, 55% of its downside due to your 20% hedge. And you have, again, this massive 40% in cash for opportunities or just if that's all that you want in the market, you've reached a point in your life where you want to have the safety of cash, this is one way to construct a portfolio that gives you ideally a long runway for your cash to work for you and not to mention your hedge, 20% hedge, which will grow cash for you when the market falls.

Now, we're just talking about shorting, or hedging, market indexes. There's also for the more adventurous among us -- and *Pro* is included in that -- shorting stocks directly as we've done with Sony in the past and that's possibly where *Pro* is headed now, now that the market has lifted all boats. The past three or four years of the market, the sense has really been clearly very steady and very strong, and that's lifted even weak companies. And so fortunately we've avoided shorting most anything directly, we just use these lower-risk hedges to short, but when we're ready we can be more of a long-short portfolio, long with our core stocks and shorting companies directly that we don't see a good future for and that will allow us, if we want to, to increase our long exposure even more. For example, we could be, say 90% long, we could even be 100% long if we wanted but we do like cash. It could be 90% long and short 40% of the portfolio's value in weak companies directly like Sony, like others we're considering.

And I almost said one but I better not. It's a short, I don't want you to jump in. And so if we do this, 90% long, 40% short weak companies we only have 50% net long exposure and yet we have 90% invested in great companies and 10% cash and, of course, it goes without saying but if your longs and shorts are both on the whole, successful, you'll earn much more than the market's return if you care about that in this construct. I mean, if you have longs working for you when the market is going up and shorts that work for you whether the market goes up or down you have a very flexible portfolio that should win very well over time.

Now, why even talk about the market? As you know, in *Pro*, beating the market isn't our goal. Our North Star is our goal, but the North Star has, unfortunately or fortunately, beaten the market since the 1970s. So if we want to be anywhere near our North Star goal we realize we probably have to beat the market too.

All right, but today we're just talking about index hedges for the moment and to avoid being incapacitated in a downturn we're talking about having a flexible portfolio. Flexible is stronger than something that won't bend and flexibility usually includes some cash. Do any of you, no I don't want to say it that way … What are some direct benefits of having cash, can anyone share a benefit of having cash in your portfolio?

Pardon me? Pay your bills. Okay, so you can use cash for emergency or to pay your bills. Yes? Sleep well, very important, very important. What good is life without a good night of sleep? It's also there for, as we talked about earlier, capitalizing on downturns, adding calm to a downturn, focus on the buying opportunity when things fall. You're less likely to panic and make poor decisions.

In my opinion the key overall is reacting well to a downturn. You never want to put yourself in a corner as many of us were in 2009 where you can't react to a downturn in such a way that would help you and so you're compelled to react in a way that hurts you. So what are some downsides to having cash in your portfolio? This should be easy, you guys have got to hit this one. Lower return. Missed opportunities, losing to inflation, I agree with all -- you guys nailed it, that's all the three that I have.

But let's talk about that, a missed opportunity, yeah? But don't you expect to see some great opportunities eventually for that cash even if it takes a few years? Even if it takes five years and then you're able to buy, and I hate to say it because it probably pains all of us, you're able to buy Whole Foods at $7 in 2009 or Starbucks at $10 assuming you can wait that long. You may have bought at $20 but it would still work out in the end. The point isn't to try and time the bottom and -- but just to buy it at a good price.

So, yeah, cash, you might miss an opportunity, but *Pro* has had cash, we're still happy, we're still meeting our goal. It's really about your goal overall that matters and eventually you'll see some opportunity for that cash and the good thing is as your portfolio matures you're going to have positions that you're selling or being bought out as we've had with Pacer and BMC, and as you put your cash to work, more cash will be coming in. So to always carry this cash balance is something that we lean towards wanting to do as much as we can.

Warren Buffett always carries cash, he wants it for a rainy day and he generates more cash, of course, from selling insurance, his insurance businesses and we do that by writing options. So cash loses to inflation, it's a great true point but, of course, a losing stock can lose years' worth of inflation in a day or let alone a week or a month. Lately inflation is running around 3, 3.5% a year. Yeah, it's -- you'll lose a little to inflation if you have cash for too long you may lose quite a bit to inflation even these days of low inflation but when an opportunity comes along you could crush that inflation in really short order.

So, it brings us back to your Motley and your Foolish portfolio. And what I would ask today, what I would love to hear from you is how it would appear on this slide, what would you put there? And you can email it to me if you want. I want you to ask yourself what is your portfolio's goal at this point in your life? What is the goal behind your portfolio? What choices are you making to meet your goal? Of course, what do you own in your portfolio and does everything that you own align with your goal?

And finally, the big one that we talked about quite a bit, what is your risk, what is your exposure, is your portfolio flexible? Will you be in a good position when the market inevitably falls 20 or 30%, will you feel fine? Will you whistle down the street looking for opportunities?

And then everything in your portfolio says something about you. Think about what it's saying. For some it may say that you're disorganized or that you don't know yet what you're trying to do, and that's perfectly fine, but think about these four factors and your flexibility as you go forward and I think it may help you build a portfolio that you enjoy more and get more from.

So let's talk about one interesting figure, I have two minutes I've been told but I might go a bit over, an interesting public figure with a strong personality who we all know. He was a good investor, surprisingly I've never heard him get credit for that and you may not have thought he would have been a good investor, I wouldn't have thought so, but he was and it's curious to me what that says about him and it was Hemingway. Ernest Hemingway was -- when he died in 1961 his assets were worth about $1.4 million. That doesn't sound like that much for someone so world-famous but that's nearly $11 million in today's money, speaking of inflation!

So $1.4 million, nearly $11 million today. He had about a quarter of that in stock and so that's about $3 million in today's dollars in his stock portfolio that he managed himself. And he owned 36 stocks, very focused -- and what did he own, he owned things like Eastman Kodak, GM, AT&T, Bethlehem Steel and in the last five years of his life his dividend income exceeded ... his publishing profits and that's -- even though he earned nearly $400,000 in today's money from *The Old Man and the Sea*, he rarely sold anything, mostly he owned for decades. He was a buyer in the Great Depression with his proceeds from *The Sun Also Rises* and *A Farewell to Arms* and so what does this tell us about this tough guy author who had this adventurous life? I think he had more turnover in his marriages than he did in his portfolio.

All kinds of other problems and yet even as he saw friends panic many he wrote letters to, consoling letters in 1929 as they lost it all in the market, he was an investor who was buying and who let his portfolio be and grow. It's, to me, an interesting look into another part of his mind that we don't hear much about. He was a good investor! He was kind of like -- but he was kind of chaotic in life. He had many challenges in life. He was kind of like a careful doctor here who owns a lot of Rule Breaker stocks, kind of the opposite.

So your portfolio said, it's another dimension of you and yet its' a reflection of your life? So what does your portfolio say about you, what do you want it to say about you from here forward? What is the story and then finally what will be its legacy?

For myself, my portfolio began in the early '80s when I was delivering newspapers just outside of Chicago. I had mowed, I think, every lawn in the neighborhood but this was my first *job* job, seven days a week delivering that paper, I was up at 5:00 AM every day and I kept this job for three years and I don't know how my parents put up with it because I tried to be quiet but I know they heard me every morning, 5:00 AM. I'd have to go outside the front door to the driveway, get all of the *Chicago Tribune*s, lug them up, put them on the fireplace mantel and then drop them into a plastic bag if it's raining out or rubber-band them. Either way it makes noise. So I know they heard me and it was Chicago so there were some cold days. It took a really cold day though for my dad to help me and when he did, I'm of course grateful that he did, but I remember the 30 below, 40 below days where he would help me. He'd drive around and it may sound like an exaggeration but there are four-foot, five-foot high snow drifts and I'm drudging through them with these papers and throwing them – I wanted them on the doorstep and it had to be at the right side of the door so when you open the door you can just pick it up, you don't have to maneuver around. I have some issues!

I can still feel the cold on my face, I can still see my dad's face as he's driving and we're just frozen and I love that that is now part of my portfolio. Some of those meager savings, I think I was paid $200 a month to work seven mornings a week, it went into my savings and into my portfolio and now is somewhere in my MasterCard shares and that's just great that that's part of his legacy, that's where this legacy begins and where it ends. I hope it ends with helping more of my extended family and helping good causes and things like that.

I will say the worst part of delivering newspapers was after I watched *An American Werewolf in London*, does anyone remember that movie? Classic! In a way, a horrifying movie when you're 12 or 13 and you're out in the dark delivering newspapers looking over your shoulders when there's a full moon, forget it!

Man I literally, I've never admitted this before, ran when there was a full moon and I had that route done fast! So right now my portfolio says about me I like to own things that are profitable soon after they go public. There's MasterCard, there's AmTrust Financial, there's Google that I personally own. There's Facebook as well in *Pro*. It also says that I sold too many things far too soon. I sold Starbucks far too soon. I sold Amazon and I'm much less quick to sell today. I like recurring revenue as you guys know, I like to create income with options and I believe in the credit card networks creating more value for the credit card companies over time and there's a big Motley Fool imprint on my portfolio as well as my family, my parents, my dad, my paper route. What does your portfolio say about you? What are its goals, what are you decided to get there? How are you protecting yourself against risk and keeping your portfolio flexible for when adverse events do happen, that's what I want us to think about today and talk about more today.

So the best time to plant the tree was 20 years ago and it was 30 years ago I was delivering newspapers. The second best time is right now. Your portfolio, your new -- your portfolio begins today, anew every day and we're here to help you and watch you grow it and make sure all of the branches, or most of the branches, are growing upward and that you trim off the little sucker branches and have a *Pro* portfolio.

Thank you for listening! Couple of questions?

Man: Two.

Jeff Fischer: Okay, two questions we have time for and then we've set aside this afternoon a whole hour for Q&A and also a good half-hour for, we're really excited, a member panel Q&A. We will have *Pro* members up here an we'll all just get to talk.

Man: Only two so raise quickly.

Audience Member: That was great, thanks! One question is how do you incorporate tax efficiency into that overall picture that you just described?

Jeff Fischer: Great question. *Pro* -- we do try to be tax-efficient aside from our options. So with 80% invested in core stocks, as I would imagine most of you are or want to be for the years ahead, we want low turnover in those positions so that's another of our goals underneath of the bigger goals: to have low turnover to own compounding machines that we ideally won't touch, and then we also have income, which helps us not need to sell a stock. If we think something is overvalued for a while, we might write options on it to monetize it for a while, or we just write options in general for extra income and then hopefully we don't have to sell our stocks that have really compounded and that we still believe in and that have these large capital gains. But, of course, hedging and shorting in a regular account is always a short-term tax gain or loss.

Audience Member: So I had a question about selling, so maybe not so much a question as a comment. We have had some growth stocks in our portfolio, namely DDD and I know another company, I forget now, but yeah, maybe -- have you considered making valuation less of an issue with growth stocks as compared to maybe some of the other stocks, having different models for different types of companies?

Jeff Fischer: Great question and the short answer is yes. We -- with Facebook, for example, it reminded me a bit of Google in 2005 and '06 valuation-wise. And as long as the valuation is reasonable enough that you can earn a good return on it compounded we'll consider it. 3D Systems is a really interesting company, of course, and *Pro* was the first service in The Motley Fool to buy shares of 3D Systems so I felt a little bit like I was betraying ourselves and our company or 3D Systems by getting rid of it, but every quarter the results were getting weaker when you really looked at the numbers and the stock kept going up. So that sort of disconnect concerned us and we wrote covered calls on it and that -- and we rolled, I think once or twice, but eventually we got to a price where we let it go. But I think the lesson there was don't cover a volatile growth company because, in a way, that ties your hands anyway, just sell it when you think the price has well exceeded what you're seeing in the results. And the problem there was the results, we just didn't like what we were seeing.

If they were getting better every quarter, I think we would have let it run, but they have an earnings quality issue and we may see that keep coming to light. That said, long-term I would still believe in them but given *Pro*'s goals, it didn't fit in beyond a certain price into *Pro*'s goals. Good question!

Bryan on "Worldly Wonders, Albert Einstein, and *Pro* Core Stocks"

Bryan Hinmon: Hey Fools! We have a hard stop -- wow, it's narrow back here. We have a hard stop at 12:30 so I was planning on some time for Q&A, hopefully I will leave some but no promises on that. I've been with the *Pro* team for four years now and I consider myself to be pretty lucky to have that post, and while I know that you all signed up for … Hello? I know everybody signed up for the *Pro* track to see all Jeff Fischer all the time, and he is superhuman, but he does need bathroom breaks and water breaks, so Billy and I are going to give him a little bit of a reprieve, so stay with us.

My talk today is called "Worldly Wonders, Albert Einstein and *Pro* Stocks." The first worldly wonder I want to talk about actually is *Pro*. I truly believe *Pro* is the greatest investing service that exists and that is, in part, in no small part to you our members. So, before I get into things I just want to say thank you for being great members and thank you for being here as well.

So, a few years ago the New 7 Foundation came out and said, hey, we want to solicit nominations for mankind's greatest. So they had plenty of responses, ultimately they (coaled) the list down to a few finalists and put it out to a vote. They opened it up to the world, there were over 100 million responses and on 7/7/07, fittingly, they announced the new seven wonders of the world. Now, hopefully some of these images will be familiar to you. Hopefully you've been able to be in the presence of them, the pyramids of Chichenitza of the Yucatan, Christ Redeemer in Rio de Janeiro, The Great Wall of China. I heard I had a laser on here, is that true? Oh yeah!

Machu Picchu, the Petra in Jordan, the Taj Mahal, the Roman Colosseum; they're truly, truly breathtaking, they're truly marvels. But rumor has it that the voting was really close and they had already named it the New 7 Foundation so they knew they could only pick seven, there were the seven ancient wonders of the world so they were pretty much locked into seven. But the eighth one was pretty dang good and so I used my Google-fu to find out what the eighth wonder of the world was and as it turns out it's compound interest!

Well, so obviously I'm fibbing a little bit about that, but Albert Einstein was a fairly smart guy; he knew that compound interest was a forced to be reckoned with. And even though it's not a new seven wonder, we're Fools here -- it should be near and dear to our hearts, and more importantly, it should be near and dear to our wallets.

So for the rest of the presentation I want to talk a little bit about compound interest and the basics of compound interest, which doesn't sound very exciting but then I want to tie it to business and say how it's, in fact, the business principle more than it's a math principle, or as much as it's a math principle, and then finally I want to take the last leap and show you how compound interest actually plays a role in *Pro*'s investing process.

So, for the example that I'm going to walk through, we're just going to think about a very simple investment here; $1,000 invested for 10 years where you earn an 8% return. Nothing fancy here. Compound interest basically captures the idea that the interest that you earn on your principal can be reinvested and turned into an interest-bearing asset itself. Said way more simply than that, your interest can earn interest. It's fairly magical and we'll walk through why that is.

So, when you think about returns from compound interest they come from three sources. The first source of return, not very sexy here, your principal. You invest $1,000 in the beginning for 10 years, you get back your principal of $1000 -- that's a pretty lousy return, [and] it's worse ... if it went backwards.

Second source of return is called simple interest. Now, you remember that we're paid 8% in this example on that $1,000 interest every year; 8% of $1,000 is $80. Over time those $80 payments accumulate, 10 payments of $80 is $800. Not so bad -- at the end of 10 years, our $1,000 investment is now worth $1,800. Don't worry, Fools, it gets better!

Instead of using those $80 checks as coasters or decorations, what we can do is choose to reinvest it. We can essentially roll this red portion here, we can roll that back into principal and reinvest to earn and additional 8% on that. That's the interest on interest, that's compound interest.

That's represented by the green sliver here. Now, that green sliver looks fairly small but you'll notice that our investment has grown into a sum of $2,159 so we've earned an additional $359 earning interest on interest; essentially magic.

$359 is no chump change in this example, it's nearly half of what the simple interest paid us, so it's a pretty big force. The key takeaway here is simply that compound interest, the ability to reinvest interest, to reinvest money that we're paid back into our investment, is sort of like rocket fuel for our returns.

This is really where the magic begins. This is my favorite slide. Everyone thinks that this was a Photoshop job. This is just a dinner party. This is actually what Jeff looks like when he comes to the office most days. No, so the real magic comes when we try and optimize the rate of return at which we're able to reinvest and the length of time that we're able to reinvest for; so time and rate. When we optimize those things it's really when the getting gets good!

So let's look at each of those, time and rate. So, for time what I've done here in this chart is simply extended the time horizon. So back here was our original 10-year investment. Let's say we're able to reinvest for 40 years. So our 10-year investment, not bad, turned into $2,159 for a nice 116% return. Adding 30 years, you'll see that we still have an additional 900%. The benefits of compounding improve the longer you're able to reinvest. Ignoring the numbers, right, ignoring the fact that here we had $2,100 and now we have $21,000, 10 times as much.

Ignoring the numbers, simply look at the color here. The green has completely taken over the graph. Compound interest over a long period of time is our friend. So the second one that we want to talk about here is rate and this should be no surprise. The higher return that you're able to earn, the more money that you're going to have at the end. So again, 40 years, this represents what I showed you on the last slide, an 8% return over 40 years. If we're able to, instead, earn 12%, the red line, 50% more, you see we have 358% more money at the end of the period.

So optimizing time and optimizing rate are key when it comes to compound interest. So at this point you're probably saying thank you very much for all of the math, thank you for the simple compounding interest lesson, what the heck does this have to do with businesses? What does this have to do with finding the investments that are going to make our account do this?

Well, thankfully the principles port over really pretty well and we can lean on a friend of ours to get there pretty simply. So this is a quote from Warren Buffett's 1989 shareholder letter that really encapsulates the time and rate concept. He's basically saying, if you've got a moat, that means that you can earn higher returns and if you can earn those high returns for a long time, wonderful things are going to happen to your account value.

Warren Buffett's wisdom, folksy wisdom is wonderful but I'm sort of a numbers guy so I like to put this to the empirical test a little bit. So I'm going to walk you through now, very exciting, two academic studies that basically provide some data to support what Buffett so eloquently says. I apologize you're probably not able to read this but I will do my best to walk through it as well as possible.

This study was done, it's a 25-year study or so performed by Fidelity. And what Fidelity did was at the beginning of every quarter for 25 years they took the S&P 500 and lopped it into two portfolios; one portfolio was what they called good businesses and one was bad businesses. It doesn't matter how they split it up -- it was return on assets. They basically drew a line in the middle and if you were above the line on return on assets you were a good company, below the line you were a bad company.

And basically then they said, OK, so for every time we form a portfolio we hold that portfolio for 25 years or 24 years or 23 years or five years. And whichever portfolio performed better, the good businesses or bad businesses, they gave you a green bar. So essentially what we can see here is a couple of things; number one is good businesses outperform bad businesses about 75% of the time; high-return businesses outperform low-return businesses in terms of profitability 75% of the time. There should be no surprise there.

We can also see here, it wasn't -- bad businesses didn't start to win until really late in the period here, so the second takeaway that we can have here is if you're going to invest in good businesses and you can hold them for a long period of time, it's a near certainty that you're going to win.

I want to draw the parallel here between good businesses being high rate of return businesses. The second study here is really about duration, the length of time that we can invest for. This study was performed by McKinsey and they took the S&P 500 and divided it into five portfolios, again, based on by a metric of good or bad, high return, low return, return on invested capital.

And then they followed that portfolio for 15 years and basically we can see here, again, is high-return businesses are above 20%, maintained their good returns over time, and bad-return businesses stayed bad-return businesses.

So if we find those good businesses to invest in, chances are they're going to stay good businesses over time. Now, capitalism works and you see those returns are competed down and everything is mean-reverting here, but good businesses stay good businesses and bad businesses more often than not stay bad businesses, but you can earn those returns over long periods of time; so high returns and investing for a long period of time.

That should dovetail really nicely with something that is near and dear to all of our hearts and that is *Pro*'s core stock philosophy. We have basically said that core stocks have three main characteristics. They have sustainable competitive advantage, they're good businesses. They have strong compounding dynamics, they can reinvest those high profits for a long period of time and then they have great management. So they have the people in place to make the right decisions about where to invest that money and how to invest that money.

Now, Jeff wrote a Memo a while back that outlined our core stock philosophy, our great editor Ellen Bowman turned it into a one-page takeaway. If you do any sort of searching on the Fool or the Internet you're going to find a lot of talking about competitive advantage and you're going to find a lot of talking about management.

So what I want to do for the last few minutes of my presentation here, 10, I want to talk about strong compounding dynamics because it may be a concept that is not as familiar to you as competitive advantage or great management.

So the first characteristic of strong compounding dynamics that we look for is what I like to call easy earning. Now, this harks on the fact that business is really hard. Customers are fickle. What we want to find are structural characteristics that make the sales process as easy as possible, as close to a slam dunk as it can for our companies.

So, some telltale signs of easy earning are business model characteristics like a subscription model like we have in Oracle, where the customers are billed every month or every quarter depending on how they've signed up, and it's almost automatic; or a high-transaction model like TD Ameritrade, where it's basically like a tollbooth -- you have to pay the toll to get access to the service that you want. A contract model like American Tower where for years we know what our profits [will be], the business knows, and [what] revenues are going to be to a large degree. Or one that may not be so obvious, when your product is so good and so dominant and meets the needs that you're trying to fill so well that it's become the de facto standard and there's no reason to have to turn elsewhere.

Now, that's like GenTech's auto-dimming rearview mirrors. Now, these telltale signs are great, you may be able to find them but what I want you to focus on here is why we care about this. We care about it because if we know that the near-term is under control, it allows the management teams, it allows the employees who are running this business the mind space, the open space to think long-term, to think about how they're going to strengthen those advantages -- to think about how they're going to grow their business, to think about how they're going to do even better and make their customers even that much more happy.

So the second characteristic of strong compounding dynamic is ample reinvestment opportunity. Now, this refers both to the ability to reinvest, you have access to the capital and a runway to be able to do that. So, some things that we look for are a growing core business. MasterCard is such a great example of this because, still, to this day, 85% of transactions take place using cash.

They have plenty of runway to reinvest in their core business. The next best thing is natural piggyback extensions. It's the next best thing because what we like to see is we like to see a company building upon its competitive advantages. Anytime they go slightly outside of their circle of competence there's a risk that the competitive advantages don't (work), and we don't ever want our companies to be playing on a level playing field.

A company that has exhibited this really well is Broadridge Financial Solutions. Broadridge has done a great job of expanding its circle of competence, expanding its business lines at the margin, only when it's able to use the competitive advantages it already has in place.

Finally, when we think about ample reinvestment opportunity, we like companies that have multiple possible futures. Ones that are totally even unaware to us at this point, and a great example of this in the *Pro* port is Facebook. When Facebook came public they basically had no advertising revenue for mobile and now it's 50% of their revenue and growing like weeds. Could they enter the payments or video game industry, who knows!

It's a possible future that we don't even know about. We look for these because we like that they're -- it gives them the ability to either dig their moat deeper or dig their moat wider, and if the company can reinvest in its business it doesn't have to pay out dividends that trigger taxes for us.

The third dynamic or characteristic of a compounding dynamic that we like is a relevant product to a large market, and this goes back in our discussion of compound interest, this goes back to time. If you're going to reinvest in your business for a long time you have to have a product that's going to stay relevant for a long time and so one of the ways that we can achieve this is if you operate in an industry that has a modest pace of product or feature change.

Now, you're probably not going to find this too often in a tech company but in an industry like Valmont that makes sprinklers and poles, things aren't changing too quickly. So we believe that the money that Valmont does earn it's going to reinvest in its business and it won't be subject to disruption very quickly.

Starbucks is a great example of product relevance in massive markets. We also like a respected valuable brand that can transcend geography like Apple. A brand that can leap geographic boundaries probably means that it can compound for a longer period of time.

And finally what we like to see is we like to see a company that has its reputation built on excellence. We spoke earlier about word-of-mouth advertising and the net promoter score. A company that has a wonderful reputation gets a seat at the negotiating table for their sales, for their sales process. It is far easier to win a sale with a good reputation than a bad reputation.

So we care about this because market tailwinds without boundaries lengthens the amount of time that we're able to reinvest at high rates of return in the great businesses that we find. But the real magic is when we find elements of all of these in our *Pro* companies and I'm proud to say that we're really happy with the *Pro* portfolio. We really like the companies that make up our core stocks and we think that they obviously exhibit many of these characteristics.

With that I think I have-- yeah, I have a few minutes for questions if we want to open it up for questions?

I think we have a microphone coming.

Audience Member: Can you name a stock with these characteristics?

Bryan Hinmon: Can I name a stock with all of those characteristics? Not with all of -- whoops, that's going the wrong way. Not with all of the compounding dynamics but I will say that, man, this one is easy because this is most of the *Pro* core stocks right here. In order to gain a meaningful allocation in the *Pro* portfolio it has to have -- the companies have to have this as an example. So, we just go right down the line here. Oracle has strong compounding dynamics in that it's a subscription model. We believe that they have a competitive advantage in database and middleware businesses, in their database and middleware businesses.

And they have a guy running the show and an incredibly deep management bench that have proven to make really wise capital allocation decisions even though most people don't think acquisition is a very good strategy; Oracle has proven time and time again that it knows what it's doing on the acquisition front.

So I think Oracle meets all three of those. Every company that I've highlighted here, two, it's a spectrum. Not every company is going to be as strong as possible in each one of those but we like to see characteristics of all of them in our companies.

Audience Member: If you were starting from scratch today would you just invest in the portfolio as it stands or do you have another way of starting?

Bryan Hinmon: Man, pin me down! Disclaimer -- OK, so you asked me. If it were me I would have to answer the question, how closely am I following the *Pro* portfolio? If I am not concerned about following along closely I would probably pace myself for sure. I would start with the Buy Firsts, obviously, and feel very comfortable buying them today. The second thing that I would do is I would look through the list of Buys and look at which businesses resonated with me, which ones I understood, which ones I agreed with the thesis right away and I would probably buy those and then I would pause and then I would probably start to learn more about the companies that I hadn't chosen to buy and go from there. I would cross-reference that with any existing investments that I currently had so maybe there is some industry overlap there, I don't want to get overweighed in a certain industry. But that was sort of my answer.

I think that the broader answer that I can give that's more helpful is it is futile to try and time the market. It's so easy to second-guess yourself with hindsight by saying, I should have gotten all in at the beginning, or investing 30% up front has turned out to be a disaster. You can't play that game with yourself or you're not going to make it for the long term. So what I would do is almost try and take your emotion out of the game and I would set up a schedule probably for myself and say, I want to get invested in four installments and, you know, arbitrarily choose four dates over the next calendar year or whatever. The first installment I would do just as I said. The second installment I would do just as I said because there will probably be different Buy Firsts, new Buys that I might be familiar with. And then I would just start biting the bullet and add a few more companies to get myself more aligned with the *Pro* portfolio each time.

***Pro* Stock Talk (with a brief Q&A)**

Billy Kipersztok: My name is Billy Kipersztok, I am a research analyst for *Motley Fool Pro*. I started here in April of this year. I'm part of the Analyst Development Program which is spearheaded by Bryan Hinmon who is our very own [senior] analyst and also Nick Crow who was formerly on *Pro*. So I'm excited to be here and I'm glad that you guys are all here and I'm going to be talking about American Tower today as a great example of one of those core stocks that Bryan Hinmon was talking about in his presentation earlier.

So this is going to be a little bit more in-depth and kind of with numbers and financials so bear with me here but hopefully it'll be -- you'll learn something from it.

So American Tower, you guys are probably familiar. Most of you guys are probably *Pro* members. What they do is they lease tower space to wireless cell phone carriers such as AT&T, Verizon, T-Mobile, etc., but let's go a little bit more in-depth and let's talk about the industry and what exactly is a tower and how do these things work and how does American Tower make money?

So a cell tower is a site where antennas and electronic communications equipment are placed usually on a radio mast tower or other high place to create a cell in a cellular network. Now, it's important to note that they don't have to be towers, they could be on top of roofs or on some other structure but we traditionally refer tot hem as cell towers for simplicity sake and the majority of American Tower's portfolio are towers.

So, the towers are cells in a cellular network so what is a cellular network? These are the things that you're placing your phone calls on. It's a wireless network distributed over land areas called cells served by at least one fixed location cell site like a tower. So, with respect to the tower asset, who owns what? What exactly is American Tower's responsibility and what is the responsibility of the tenant which would be the carriers?

So this red right here is the tenant responsibility and you can see that in the pictures and then the grey is American Tower responsibility. So what you see is that American Tower owns the land and the space around the tower, the physical tower structure itself, whether it be a tower or, like I said, a rooftop or some other site and then the tenant is responsible for putting up the equipment, they own the equipment, they have to put it up themselves, American Tower does not do that and they pay American Tower for the space on these towers. So basically it's just a real estate business; you have space and you're leasing it to your tenants.

98% of American Tower's income is generated from leasing its properties. The other 2% is sort of consulting or development type of arrangements with its customers.

Now, the tower structure can support multiple tenants per tower. This is a very important part of American Tower's business story so make sure that you keep this slide in mind later but basically what happens is once you've built the tower structure it can support not only one tenant but two tenants or three or four or even more.

Now, you're constrained in most markets because if you think about the United States, how many wireless carriers are there? There's probably four big ones, AT&T, T-Mobile, Verizon and **Sprint** so really you're only going to be able to get as many tenants as you have carriers in your market. But, again, remember this slide as we go forward. This will be important.

And then as far as the U.S. tower industry, now this is U.S. specific, American Tower does own towers internationally but I'm going to just talk about the U.S. tower industry because the data is a little bit easier to find and it's a more developed market.

As you can see 39%, well as you can see the top three, **CrownCastle**, American Tower and **SBA Communications** represent about, what is that, 82% of the entire market so that is a characteristic of kind of an oligopolistic market structure where you have a few very dominant players and then the rest is very fragmented. That 18% you can see the top one operator among that 18% is **U.S. Cellular** at 4, Verizon at 1.2, T-Mobile at 0.8, **Time Warner** at 0.8 so the rest of that is very, very fragmented and you have those three main players at the top and what you'll see is that allows those three big players a competitive advantage versus all of these smaller operators as far as operating their business and expanding their advantages and I'll touch on to that a little bit later.

So, with the overview of the industry and what is a tower and all of that, why do we think American Tower is a Pro core stock? The three characteristics that I have up here are the things that Bryan talked about in his presentation, does it have a sustainable mote? I believe that it does, check! Strong compounding dynamics? Again, check! Skilled management, that's Jim Taiclet, the CEO of American Tower right there. I believe that he's skilled. They have the lowest debt profile in the industry, highest margins in the industry and intelligent capital allocation. So that gives us a check there.

So I'm going to go into each of these, actually no, I'm going to go into just the top two sustainable mote and compounding dynamics and go a little bit more in depth and show why American Tower is a great example of these types of attributes that we look for in a stock.

So, one of the biggest parts to American Tower's mote and it has several aspects that give it a mote is switching costs. So, the way that American Tower's structures its lease is that there's an initial five to ten-year non-cancellable term which is followed by multiple five-year renewals periods after that so if you have a five to ten-year non-cancellable term you've just locked in a revenue stream for five to ten years.

In addition to that locked in rate there are annual embedded escalators so each year the contract rate that the tenant is paying is escalated at a rate of, in the United States, it's about 3.5% on average and as most of us know inflation, the current environment, is around 1.5 or 1% so you can see that they're able to increase just from annual rent increases in excess of inflation.

Now, internationally their escalators are fixed based on local inflation which is generally higher; Africa, Europe, etc., those can be up to 6, 7, 8% escalators depending on the local market.

Now, in addition to just the lease structure which creates switching costs for the tenants, there are labor costs to remove equipment, say you want to cancel your lease after the initial five to ten years well you have to put the equipment up on the tower and you have to take it down. So there are costs to that as opposed to just renewing where you wouldn't have to do any of that and there's no time or anything like that. Additionally all of these tenants operate networks. So if you move equipment and you don't renew at a tower that may adversely affect your network quality and that's not something that the tenants want to do and then thirdly, if you decide to move your equipment from one tower there may not be another place to put your equipment so that you can keep the quality of your cellular network.

So what does this lead to? It leads to, as you can see on this graph, a recurring long-term revenue stream and very high renewal rates! One to 2% historical turn on its contracts and as you can see from this graph this is the tenant lease renewal schedule; 81.3% of their leases are set to renew in 2018 or beyond so they're locking up their contracts, they're locking up their revenue streams, many, many years into the future. This is exactly what we want to see with our investments as far as the reliability and the predictability of its cash flows and it gives management a lot of flexibility in that they know what their financial picture is going to look like moving forward.

In addition to switching costs there's also another part to American Tower mote which is barriers to entry. You guys may have heard of this acronym NIMBY, it stands for not in my backyard. So if somebody wants to erect a tower and you own a house and it's going to be right in your backyard you're going to say, hey, hey, no, we don't want that! So there are NIMBY concerns with towers. There's also zoning and permitting restrictions. You can't just erect a tower anywhere, you have to work with the city commission or the local governments. Typically it takes up to a year to lease, permit and build a tower site depending on where it is. And then again, there's a high capital cost to build meaningful skill; the big three incumbents that I mentioned, SBAC, American Tower and CrownCastle have invested billions of dollars in creating this network of towers and if you want to immediately be able to compete on the same cost profile you're going to have to spend billions and billions of dollars to build similar scale. So that's another aspect to American Tower mote.

Just as I mentioned, economies of scale is the other aspect to American Tower's mote. You guys remember this graph; big three incumbents with low fixed and maintenance costs it's a big advantage to have more market share and be able to attract customers to a bigger degree because when you attract more customers and you gain more market share you're able to spread your costs out over a wider base and it makes you more profitable and what that does is that means that these little operators are at a disadvantage and we would expect to see the big three operators expand share over time.

Now, beyond sustainable mote the second aspect of a Pro core stock that we look for is strong compounding dynamics. A relevant product to a large market, that was on aspect to strong compounding dynamics. So, it's American Tower, does it have a relevant product to a large market? I believe the answer is yes. So the question here is what drives demand for wireless tower space?

So, networks need to invest or carriers need to invest in their networks and that is what is driving demand for wireless tower space. So as demand for carrier networks increases, demand for towers increase. And this graph right here does a great job of showing why we can expect that the demand for carrier networks will increase over time.

The blue is 2012, the green is 2017 expected. This came from a CrownCastle presentation which, in turn, came from a **Cisco** presentation on data use and things of that nature. You can see top part is smartphone, bottom part is tablet. Smarphone users are expected to double. Monthly uses per devices is suspected to 6X, total monthly traffic and petabytes, which is one times ten to the six gigabytes for all of you guys counting is expected to 10X to 2017 and then for tablets, similar trends.

So data growth is exploding. I'm sure you guys all know and you guys use, some of you use tablets and things of that nature, access the Internet remotely, wirelessly, that kind of demand is going to continue to increase meaning that the carriers are going to continue to need to invest in their networks which means that they're going to continue to need American Tower towers to build out and densify their networks.

Additionally, relevant product to a large market; more evidence that the carriers need to invest in their networks are carrier capital expenditures and these numbers are in billions and these are expected, again, from a CrownCastle investor presentation. This includes AT&T, Clearwire, Leap, Metro PCS**,** Sprint, T-Mobile, U.S. Cellular and Verizon. Some of these have consolidated since then but basically the overall capital expenditures for the carriers is expected to grow slightly or remain a little bit constant but that's a lot of money being dumped into expanding their networks and building out their network quality. It's clear that the demand is there for this service.

The next aspect to strong compounding dynamics is ample reinvestment opportunity. If you can't reinvest your cash you're not going to be able to compound quickly over time. So, you can see this is American Tower's capital allocation, year-to-date 2013 through the first three quarters. They haven't reported their fourth quarter yet, they report the end of February but as of the first three quarters you can see that the vast majority of their capital allocation has gone towards acquisitions and now why is that? It's because they're reinvesting in their business because each time that they reinvest in their business they're increasing the profitability of the business and this is what we want to see, we want a lot of places to put your money and we don't want to see companies where necessarily they're allocating out all of their cash towards dividends because they can't find places to reinvest. 87% of their allocation was towards reinvestment towards acquisitions so that's a good sign for us.

Now, why should they reinvest in the business and why is American Tower putting 87% of their capital towards reinvestment? It's because the profitability of that investment is off the charts and I'll explain it to you, here's why! Remember this slide that I told you to keep a look at and remember? One tenant, two tenants, three tenants, each additional tenant is virtually 100% profit. You don't have to pay anything else to add another tenant. You've already paid for the infrastructure of the site so each tenant is incredibly profitable so it leads to something that looks like this in a financial picture. You've got the construction cost, tenant revenue, operating expenses, gross margin, margins, good, 40%. That's for one tenant. Return on investment 4%.

But look what happens with two tenants and look what happens with three tenants? You have no additional costs, your gross margin conversion rate, that's whatever revenue that comes on that goes down toward profit, 95% of the revenue that comes from a new tenant is converted to profit and the returns on investment quickly rise; 12, 20% to three tenants, four tenants you can imagine it would be even better and in some markets where there are four carriers you will see four tenants on towers.

So basically what that gets to is that we want to see, over time, American Tower growing their tenancy ratio. You want to see 1.5 to 2 to 2.5 to 3, ideally that number goes up over time. So what have we seen in the past?

Well, this is tenants per tower for American Tower's Brazil operations. These are sites in the portfolio since 2002 so that means that over the last 12 years they've had an opportunity to lease up these towers and gain more tenants and you can see the line is pretty linear and they've been able to increase their tenancy ratio at a pretty healthy rate.

What does that do for return on invested capital? I just showed it in the previous slide and what would you expect that it would do? It would rise and in fact it has. This isn't from 2002 but it's from 2007. This is overall returns on invested capital and it's risen over time as you would expect as they increase their tenancy. This is something that we expect to continue as they make acquisitions, the tenancy ratio is low, they attract more tenants, they get more profit and you should see returns on invested capita rise, that's key to our thesis for American Tower and it's been playing out recently but we want to make sure that it continues to play out.

So all of those things that I talked about, the sustainable mote, the management, the compounding dynamics, the large market, all of that has led to very strong historical financial performance. You can see the tower count has grown pretty steadily over time, the revenue growth has grown pretty steadily over time and I think also it's interesting to note that even in 2008, 2009 where if you were to look at this graph for most companies it would look like this, boom, boom and then go back up, very steady, very consistent growth.

EBITDA growth which is basically a little bit of a rough proxy for cash flow gone up on the same trajectory and then finally relative stock performance. This is a little bit of a confusing chart, there's no axes but basically it's -- if you were to have invested the same amount of money in American Tower and in our North Star, even though you can't invest in it, what would the returns have looked like over time? Even with starting in 2008 when the stock price faltered even though the business didn't falter you would still end up with higher returns from American Tower, 13.2 annualized since 2008 versus 8.3 annualized for the North Star.

So American Tower is an investment that satisfies a lot of our core stock criteria and it has been shown to beat the North Star over time and we believe that it will continue to do so.

So that's it! Question?

Audience Member: (Unclear)

Billy Kipersztok: Sure, yeah. I think you kind of hit some of the points there. Yeah, so the question is, a lot of the same characteristics that American Tower has you might expect its competitors to have; CrownCastle, right? So if the graph of the industry looks like this and it's an advantage to be big, why wouldn't we want the bigger one?

Well, it's a combination of the things that you said, I think that management of American Tower is more shrewd. Their debt profile is lower which gives them flexibility to pursue more deals overtime. I don't know if you've been following American Tower recently but Dave made two big acquisitions recently and I think that they have more flexibility than the other tower companies to make these acquisitions because of their debt profile which is lower and they don't have to worry about servicing their debt.

Additionally their margins are higher and, like you said, they're investing more in international. So, this kind of obscures the real picture which is that American Tower has the majority actually of its portfolio overseas and it's grown pretty rapidly over time and they're really the only tower company to be investing very significantly overseas. SBAC is also doing it but it's at a more measured pace. The reason being, SBAC is more highly levered, like I said, so they don't have the flexibility to acquire as many towers and do it as quickly as American Tower can.

Additionally, a good thing about the international segment is that they're able to pass on some of their revenues, excuse me, pass on some of their expenses to the tenant. So it's actually more profitable to American Tower to have tenants overseas than it is to have them in the United States so this is why they're investing overseas so heavily is because they get a higher return on their investment.

So it's for a variety of reasons and hopefully that helped to answer your question.

Audience Member: With American Tower, does most of their tower sites, is that owned property, do they own real estate holdings or is it all leased property, leasing a farmers field to put the tower up so you would have that increased cost for them later on as they have to renew those lease contracts?

Billy Kipersztok: Yeah, that's a good point. They own, I believe, so you're talking about the land underneath the tower or just the tower itself?

Audience Member: Whatever the tower is sitting on. The building …

Billy Kipersztok: Right, yeah. I think the owned versus lease ratio is about 30%. So they own about 30% of the land or whatever it is that it's sitting on. The rest of those leases, they're very careful and they structure the contracts and the roll-offs of the contract carefully such that it doesn't -- you don't end up where now we're in a situation where we need to renew no matter what and we're under pressure and it's going to cause an increase in price. I believe up to 75% or more kind of like this slide here, they have a very similar slide in their presentation that's not tenant lease renewal but its land lease renewal and it looks very similar in 2018, 70% of their land leases are set to renew or more past 2018.

So they're careful about that and they understand that that's a risk and I think management does a good job of mitigating that.

Audience Member: Are we competing with the other companies or is American Tower competing in the same geographical area or is it one -- American Tower comes in they own the entire city, county, neighborhood or geographical?

Billy Kipersztok: I think it depends on geography but in many geography's you'll have multiple tower operators operating in the same place but it doesn't -- you won't find necessarily a CrownCastle tower right next to an American Tower, tower because it just doesn't make much sense. What will happen is American Tower will have some of the network density in one area and then in the same geographical space CrownCastle will have some of the density there.

Audience Member: (Unclear).

Billy Kipersztok: You mean relative to competitors?

Audience Member: Yes.

Billy Kipersztok: Yeah, no, I mean, I don't think that American Tower has any specific advantage with respect to over its competitors in terms of pricing. But I do think that the way that the market is structured, all three of the big incumbents, SBAC, CrownCastle and American Tower should -- not one of them is going to have an advantage over the other but all of them together are going to have good bargaining power against the carriers because it's such a consolidated industry.

Audience Member: So there are other costs associated with running a tower like the landlines that come in to support the communications and so forth, is that all born by the tenants or does American Tower -- does that factor into what their costs of operation are?

Billy Kipersztok: Yeah, so American Towers is not responsible for the equipment or the lines or the electricity or those things, that's all paid for by the tenant. The only thing that American Tower is responsible for is upgrading the structure itself, making sure that it doesn't break or fall and then paying the lease for the land that it's on if it is leased or not owned and then a certain portion of their costs, like I said, internationally are passed on to the tenant but in the United States they're not so certain portion of the cost maybe.

Audience Member: You showed a slide that projected data usage going out a number of years and I thought that it combined cellular data and Wi-Fi data. Those aren't exactly the same thing. Do these towers have anything to do with Wi-Fi and if not if people start using Wi-Fi more than cellular could that undercut some of the prospects?

Billy Kipersztok: Yeah, that's definitely a concern and that's something, a risk, that people raise about American Tower all the time is increased Wi-Fi usage. To be honest I'm not intimately familiar with the technology regarding the towers themselves whether it's Wi-Fi or not but I do know that investors have raised that concern and the typical response that I've heard from management is that Wi-Fi is going to be something that's important and it's in kind of denser urban areas but it's not something that's going to meaningfully adjust the usage patterns of data, cellular data, across an entire country. Maybe in very specific locations it may reduce the demand for towers but overall it would have a minor affect. But to be honest, I'm not extremely familiar with that but that's just kind of the answer that I've heard.

Audience Member: This shows a tremendous increase in traffic but how does that traffic actually transfer to their revenue? Do they need more towers?

Billy Kipersztok: Yes.

Audience Member: Do they put more equipment on the towers?

Billy Kipersztok: Yep, so it's both. Let's see here. So what happens is in this cellular network the cells are a certain size, the broadcast can reach a certain area. Now, as the throughput of data increases the area that the cell can reach decreases and that's just a matter of physics etc. So as more data flows through the network the network itself gets smaller. So what happens is they have to do what's called cell splitting which is where this may have been one cell, now we're going to make it two cells and we've got two towers in there. So that increases demand for the tower itself. Additionally, kind of like you said, there's add ons that you can use so if you have equipment on the tower you can add additional equipment, more technologically advanced, it allows more data throughput, different frequencies, etc.

Audience Member: Do they get paid (unclear).

Billy Kipersztok: Yeah, so in the contracts it's called amendments. If you add a certain amount, I'm not sure exactly what the structure is, but then there's an increase in rate.

Audience Member: I'm curious how many, I mean, who are the largest tenants?

Billy Kipersztok: Largest tenants in the United States are the cell phone carriers which are Verizon, Sprint, T-Mobile and AT&T.

Excuse me? Yes, all four of the carriers do business with American Tower. It doesn't exactly break up in the way of market size. So the biggest carrier doesn't necessarily represent the largest portion of American Tower's revenue, it's dependent upon geography and where their markets are but all four of them are significant customers of American Tower.

Audience Member: So I would have expected that the number of towers in the United States would be saturating and that's what your bar graph showed but internationally it's still going up. So can you anticipate the level where that will go up and then saturate?

Billy Kipersztok: Yes, management has stayed at -- let me start also by saying I'm being told that I have one minute left so that is probably the last question or maybe one more but management has stated on their calls and things of that nature and I mean of course you don't always take what management says at face value but they believe that the adoption curve in non-developed markets, obviously there's some wiggle room here is about five years behind the adoption curve in developed markets. So where we're seeing big increases in 3G, 4G, developed markets are just now getting into 3G. So five to ten years I think saturation but then again just because there's smartphone saturation doesn't mean that data growth doesn't still occur.

Make the Most of *Pro*: Jeff and Members

Jeff Fischer: Now, I'm going to talk a bit about making the most of *Pro*, but more exciting is we're going to have four *Pro* members come up here and we're going to talk with them as well -- big conversation. So if you're in the back you might want to move up during that time unless you can hear no problem and we'll be passing microphones around.

The idea is to share best practice, share ideas, for how we all use *Pro* to make it more useful to us, profitable for us and work in our particular situation. We know from our surveys, which may be a little too shallow, especially after hearing this morning's talk, our surveys of some of you that the majority of you answering these surveys do not follow the *Pro* portfolio exactly by any means. Most of you, according to these surveys, own stocks across many different Fool services or outside Fool services and *Pro* is one small part of it.

So one of the challenges we always have that we enjoy tackling is how to help you make the most of *Pro* given your particular situation. As we talked about earlier this morning too, everyone has different goals, different risk profiles and different needs basically. So my short talk about making the most of *Pro* is going to be three site tips from the *Pro* team. Afterwards we'll go into our illustrious *Pro* member panel discussion and finally this hour, Jim Gillies will share thoughts on using *Motley Fool Options* and then we'll take a break at, just so you know, just before 3:00 we'll take a short break and then we come back and we have a full hour of Q&A with all of us so we'll just have an hour to discuss.

So think of your questions because I think one of my favorite things about these events, of course, is interacting and hearing your voice and hearing what you have to say and then trying to answer in a helpful way hopefully.

So let's see, tip number one, and I'm keeping these simple I hope. Tip number one is the recommendations page on *Pro*. That has everything current, all of our current guidance is there. So if you wanted to start using *Pro* in five minutes you could go to this page and start to use it because it has what to do and that is: always current Buy Firsts ... the recommended allocation, which by nature is always current because we look at the portfolio every week if not every day to make sure that allocations are where we want them and if they weren't we would change them. So even as they move around, we're comfortable with them and if you're starting today we would tell you to match our current allocation.

Of course this page has a few other things that we need to talk about; fair value and consider adding more. Now, before I skip forward, can anyone tell me what fair value means?

Phil: Fair value to the buyer and seller.

Fischer: Thank you, is that Phil? Thank you Phil! Fair buyer is a fair price, yes…

Phil: In addition to that you expect more North Star-type returns from that price or where you're at (unclear).

Fischer: That's a good *Pro* addition to it, very good! That's a better answer than I had. So, Phil said, fair value is a fair price for a buyer or a seller, or said better, for a seller or a buyer. So many people, too many people, view fair value as a sale price. Oh, it hit fair value, I need to sell it! That's only if you only want to own stocks at a discount to fair value with a so-called margin of safety which, for most of us, is not important. We want to own a stock around its fair value that we think is going to compound from that fair value today at a rate that we favor; our North Star or better. So in our case it's 10 to 11% compounded is what we're looking for from the fair value today. And fair value is a range, it's a price but it's a range, it's -- we come at the fair value evaluations through these kinds of cash flow models that have a range of poor scenario, average and good scenario basically. So it's a range of prices and we kind of average it out.

Now, one thing to keep in mind with fair value if we think MasterCard is going to grow 15% a year and that's our model and then they end up growing 18 or 19% a year, our fair value is blown out of the water quickly and we'll adjust for it as we see that playing out but keep in mind with *Pro* we use what we believe are conservative fair value estimates. We're not swinging for the fences, they're conservative. So frequently a stock will run up beyond our current fair value and that's just the result of us trying to be conservative with how we value that business. It still is most important to follow ... what we do; the Buy or Buy First, and we only put things on Hold that are under review where we're thinking about changing the allocation in a meaningful way.

So the next thing on the recommendations page is consider adding more and that's a price where we will reconsider our allocation. If a stock falls so much below our fair value that something's going on, we need to either add more to it, get our allocation back up, or if we're missing something we need to figure that out and our reconsideration of allocation may be to sell it down to zero.

So, consider adding more could also be just consider, consider what's going on, consider your thesis but our bias is towards adding more as long as we continue to believe in the business.

So sorry about this page but I just wanted to point out, at the bottom of the rec page is the glossary of all of these -- consider adding more, fair value. A lot of people, it seems, don't see this but it's at the bottom of the recommendations page, the big recommendations tab on the *Pro* site and there it also has our annualized returns and some good Fool yesterday was asking for historical returns and we have that on *Pro*. We have annualized since inception and the past rolling three years and then year-to-date.

The bottom of the recommendations page on *Pro* also shows, you can't see it here, just the bottom of it, are exposure, our exposure table at any given time and we update that whenever we make a significant change in it or every month.

So all on this recommendations tab you get the whole current snapshot of *Pro*, what to buy and what amount and you can click through any ticker to get to the trade reports on that company and you get our returns and more. So that's one tip, everything on that page is current and here now we're looking at *Pro* site again.

Tip number two are the Monday Memos which arrive to your inbox every Monday at 4:00 PM Eastern Time assuming the servers are working and they usually are. And the Monday Memo every week summarizes what happened in the past week in *Pro* as well as giving where we can lessons or thoughts on current companies, thoughts on the market, thoughts on the economy sometimes, what we believe every year we lay out in the Monday Memo. So the memo is your touchstone every week and now to some of you that may be obvious but, again, our surveys show that only about half to sometimes fewer than half of *Pro* members read the memo and then we see, I assume, those *Pro* members on the boards asking what happened to this or what happened to that and it was outlined in the memo.

So one key takeaway is read this memo every week that you can, it's every Monday, just once a week and it's pretty short, usually you'll take five minutes to read, maybe 10 at the most and it outlines everything from the past week, all the trades we've made, guidance changes, links you to all of the earnings coverage that we've done and so it's your touchstone every week to summarize the past week while your recommendations tab is your current look at everything today.

Those two things you could say are all that you need to follow *Pro* but there's one more that's outstanding and that's the community, that's all of you! Now, I will say, again, according to our surveys almost the majority of *Pro* members don't visit the community, slightly more than half do and that's among the best of any Fool service. Across the Fool, in most services, a pretty good majority don't visit the discussion boards for whatever reason, time or they don't know how to get there, but the community is great and it's your way to plug into thousands of other investors and ask any question that you want and typically get a great answer in a short amount of time so it's a whole different value to you and service for you because you can ask about almost anything that you can imagine and get an answer out there. So I really encourage you to use the community tab.

When you click it you get this general page and then you can click on the top left and, again, this is PowerPoint if you think it's helpful to you, if you haven't navigated the site before and want to come back to this, it will be on the site, it will be on *Pro*'s site, this PowerPoint.

So then you click there and get all boards and then it gives you a list of all *Pro* boards because you're on the *Pro* service and then you can click any of those and I clicked in the *Pro* philosophy board and then clicked the heart. I'm assuming a lot of you don't know this, click the heart to make it a favorite and then it tracks for you -- as long as you're signed, in it will track for you and you can come back to it anytime by going to community and then favorites and replies and you just click there and all of the boards that you've favorited are now yours for the easy reading and very easy to get back to. You can bookmark this link in fact and just come back to the boards whenever you want and whenever you do it will just show your list of favorite boards and how many posts there have been that you have not read, and I circled SPY. I made this three days ago or so. I was wondering what was going on, on the SPY board so I'm like, oh, 23 posts! I need to get on that board and see what people are saying or I could just click mark read and zero it out which I honestly never do.

So those are three quick tips to making great use of *Pro* in short order. The rec page, it's all the current guidance, the Monday Memo summarizes the week and use your community. It's a great, great value to you and speaking of that, that is what we're rolling into right now. We have a *Pro* member panel and let me introduce, I need to get to my slide and they will come up here and we will ask questions and talk about how they use the service and we want to hear how you use it as well. All right, well we have Ned who has been a *Pro* member since 2008 -- since Day 1!

And for privacy reasons I'm using the first name only but Ned -- when I realized that Ned joined on Day 1 I realized that we need to do something for you, a gift of some kind. John, (JSergeant) who joined on Day 3 of *Pro* has been here since 2008 as well and we have Lon, proLon, who I haven't seen yet today but I hope Lon is here. Lon, there you are, excellent! Lon joined in the past year or so, a year ago, but it seems much longer because Lon, I'm sure you've seen Lon on the boards, he's extremely helpful and very thoughtful and Foolish as with all of these members up here and the next one is Phil, philsylvester, also a member for the past year and a half, two years.

And all of these screen names when I see them on the boards I am excited to click in and read and see what they have to share because it's always good. Now the four of you, I've never hosted a panel like this before so we'll see how it goes. We need the microphones and we need member questions and I will get us started by asking you each to briefly share, as briefly as you can, it's not an easy question, how you use *Pro*. Do you use it for your full portfolio, do you mix it with other portfolios and we'll go from there.

Phil: I'll start since I was closest … Is this guy on? I'm maybe in a little bit of a unique situation that I'm kind of managing two portfolios, one for my parents and then one for me and due to our different time horizons and different balances I manage those differently in conjunction with the *Pro* portfolio. For example, because my time horizon is a little longer I tend to not do the hedges in my accounts like I would in my parents' accounts where they, if there is a big drop, they don't have necessarily the time potentially to recover that I would as to having a longer time horizon but I just love analyzing businesses and I'm actually -- the stock picks themselves are kind of secondary to me in the *Pro* service. I think that's OK to say since …

Fischer: That's OK!

Phil: I heard Jeff say. I'm more here for the philosophy, developing the right mentality, forming a portfolio, how to look at businesses to identify the right types of businesses, how to come up with a thesis for a business and apply the right financial tools to that business that fit, And we've seen a lot of different types of businesses from a 3D Systems which is more the high growth, high flyer, to an Intel which is more the steady performer, the leader, that's been around for a while and you apply different strategies and different circumstances so I appreciate learning about the philosophy and how that works.

Fischer: Thank you Phil, we'll go to Lon.

Lon: OK, my situation is a little complicated so a year ago I started moving things into the *Pro* portfolio along the way learning not just from Jeff and Brian and Billy and Jim for options but also paying attention to other community members and tip of the hat to, I don't know how to pronounce, Aleax, but the comments there about debentures and I've started building that into my portfolio. And I'm getting to the point where I've got a goal in terms of percentage allocations between *Pro*, *Options*, debentures and what I'm just calling speculative which is really old stuff that I haven't bothered to liquidate yet or I'm in the process of doing very slowly perhaps because I like it too much for one reason or another or because the timing's been wrong and I'm waiting for it to reach prices that I like.

And then I had told the tale on the boards, which unfortunately is entirely true of George and Martha, George is one of my siblings, oops! And I'm now managing George and Martha's account as of about a month and a half ago and now I need to start shifting them as well. So it's a very slow process. The goal is kind of the same but it is a journey and I'm very grateful for the amount that I'm learning because the last thing that I wanted to do is a knee jerk, OK, let's just sell everything and get it all in *Pro*. That's got to be a losing proposition, it's got to be done carefully and that's a lot of work that I'm learning.

Fischer: John?

John: OK. Well, I guess first of all I'd have to say that I have followed Jeff for a long time back when he was originally on The Motley Fool when he moved to run, along with Tom Jacobs, the Complete Growth Investor, and then when he came back to The Motley Fool I followed him back. I really appreciate what I have learned from Jeff about using options and if there's one thing that I think people should take away from maybe this conference is that I have to say that using options wisely as part of your investment strategy can really make an enormous difference to your returns. And I don't know how many of you have come across my posts on The Motley Fool -- I do a lot of tracking of my options portfolio performance, my regular portfolio performance so you can find it mostly on *Stock Advisor* but I also do post things on *Pro* or I've done that recently updating where things are.

I don't follow all of the Pro portfolio although I do have a number of the picks. For example, I do own American Tower. I have other of the picks that I probably owned before Pro did like **Apple**. I tend to be a story stock person so my big investments have been Apple, **Netflix**, **Tesla**, currently **Solo** (unclear 21:13) so a little different from some of the type of picks that are in Pro which I think are probably a lot safer and more conservative.

Fischer: Thank you John and Ned?

Ned: How's everybody doing? See, I came to The Motley Fool I guess early 2000 through some of the free content online and I think it was 2003 I signed up for *Stock Advisor*. When *MDP* came out I signed up for that and I think it was *Pro* not too shortly after that, I signed up for *Pro*. I signed up for *Pro* because I wanted to learn about options. I had heard about puts and calls, I had no idea what they were and I don't like not knowing about stuff so I figured this might be a good chance to learn and after, I'm going to say, a year or two I kind of realized *Pro* might be all that I need so in my mind I made a plan to start just kind of transitioning the things I had bought in *MDP*, *Stock Advisor* and some older positions I had owned and just move towards the *Pro* portfolio, I would say, all the while learning about options and I'd say I'm about 75% aligned with *Pro*. I still have some older positions, companies that I like and believe in that some day that may change but I'll hold them until that story changes.

I think *Pro* I just, when it comes to options especially, is an amazing service the way they teach options. I don't think you're going to get that kind of delivery in other services anywhere. I mean, the fact that they don't talk about the Greeks and certain things like that, I mean, it's there if you need it but they really … For a guy like me in layman's terms they make it understandable and it's been a big benefit and it's fun. I mean, its entertainment for me too; I just enjoy it and I like going to the boards and seeing what people have to say, getting my questions answered and I might come to a board two weeks after the last post and just read it then and make a post, say, sorry I'm late guys but here's what I've got to say. So it's been great.

Fischer: Thank you Ned, thank you, all of you, we appreciate those kind words as well. I'll just touch on options for a minute and we'll open it up to more questions too. So, John, you mentioned how options have really changed your financial situation. Can you share your favorite strategy and then anyone else here who uses options please just share your one favorite strategy?

John: I would have to say my favorite strategy is writing puts for income. I've been doing that since 2005 and I do that every year with the aim of trying to improve my portfolio returns by about 20%. I don't always get to the 20% but I've done 10 to 12% or above every year since 2005.

Fischer: And John has posted that on various sites. And writing puts for those who don't know is selling a put option into the market, you are agreeing to buy a stock at a set price, typically a lower price so say a stock is 25 you would be happy to buy it at 22. You'll sell a 22 strike price put option, you're agreeing to buy the stock at 22 and you're paid for that agreement. If the stock doesn't decline to your price by the expiration, the option expires, you've made that income, you can do it again. It's also the strategy I've used most since 2000 by far because it's a simple -- it's very similar to setting a limit order on a stock that you want to buy at a price that you want to buy, except getting paid while you wait to see if it hits that price, and it's a great income strategy.

More, John?

John: Well, I also have used covered calls occasionally. I don't like them so much. I used them at the very beginning and I think they're -- in some ways they're a deceptively safe strategy for beginners, but too many times you end up losing a lot of the upside of the underlying stock, so nowadays I only really use covered calls if my intention is to be ready to sell the stock, I'm just seeing if I can get a little more from the sale.

I do use some other things. I've used spreads occasionally, the bull call spreads. I've used synthetic longs occasionally and occasionally I just outright buy long calls and every once in a while … One of the things about options is apart from the long-term investing strategy it probably satisfies the gambling need. So occasionally I'll buy like I have some calls on Tesla right now that expire in two or three weeks that if Tesla stock performs particularly well it will run up to earnings, minimally I expect those to double and possibly do much better than that but it's a small enough amount of money that if I lose it, it doesn't matter.

Fischer: That's a great point too about options kind of scratching the itch for short-term returns. I think all of us do desire short-term returns, I'm not ashamed to admit that, and by writing put options you can generate income most months very steadily and meanwhile the good benefit of that is you're not touching your stocks because you're taking care of that desire for a return next month with an option which is made for that and you let your stocks be.

OK, Lon?

Lon: It's interesting because about half a year ago I would have had one of those answers that covered calls or the puts and the thing -- but I'm not a gambler. I mean, I've never bought a lottery ticket in my life and I won't. I'm a math geek and I know the odds. I've read the statistics, I understand what's going on and I love it when people buy lottery tickets because they offset my property taxes, please buy lots of them, but I'm not going to.

So, the gambling thing is not for me. I'm also, and even more so lately, terrified of margin. It's not that I don't have margin, I believe it's a tool, but it's a tool that has to be managed very carefully and, again, I've recently dealt with George and Martha who could have financed their first daughter's college which starts this fall in what they paid to a certain brokerage in a margin loan that they didn't know they had.

So I have a very strong bias there. So my favorite option strategy, I'm really getting to answer your question, at this point because I like the idea of leverage but I don't like the idea of margin I'm really becoming fond of diagonal calls.

Fischer: Jim Gillies is applauding there!

Phil: I've mostly written puts as well though I really found the back ratio spreads that we've done for hedging was a new concept for me that if the market continued its tear upward, which at the times that we wrote it, it did, that it wouldn't drag returns but that you had a bit of a cushion to give you some cash for if some other investments got to more attractive prices. I thought that was a really effective strategy that I hadn't thought of before and in some of the low volatility that we've had over the last year or so I've done some synthetic longs and used a bit of leverage to my benefit. We did some purchase calls, I know, with Facebook in *Pro*, I did that as well. I did the same in Google and making sure that they were good allocations that if it dropped below, in terms of the written call, that it wouldn't take too much of my portfolio. But I'm using leverage in that way expecting that in a higher volatility market that the time value amounts would be larger.

Fischer: Thank you Phil! Jeff?

Man: Jeff, we've got a question back here.

Fischer: All right and then we'll go to Ned.

Jeff: Just along the lines of how you take care of your accounting for -- let's say you write a put and it expires or you get assigned, same with a call, how you keep track of the cost basis or do you keep track? Do you just carry it as cash or do you somehow affect the cost basis of that stock because I don't think the scorecard thing doesn't really aid in that other than to just the purchase price and the sale price kind of thing. Does that make sense, that question?

Fischer: It does make sense, do you mean for the *Pro* portfolio or personally?

Jeff: Well, these guys are all doing …

Fischer: For themselves, how do they keep track of it? OK, great.

Ned: I can kind of tell you how I do it, I can't guarantee you it's right, maybe somebody will tell me if I'm doing it wrong. I have a -- yeah, auditors close your ears. I have a three-ring notebook about three inches with tabs in it that I have for each of my positions and when I opened one five years ago I put the date and wrote what I was thinking and my cost basis if I bought it then or if I wrote a put, which I write puts a lot probably my main thing, I write what I collected for it and I just kind of carried down the right-hand tab of those pages, every time I collect some income from a put, you know, I note that that was a credit. If I end up getting assigned shares I deduct that from the cost of the stock at that time and from the strike and then if I write more puts I continue to just carry that down.

You know, tax accounting and all of that stuff, it doesn't really matter it just encourages me in my mind and reminds me that if someday I write a call on it and it gets called away what really all the income I've collected against it and what my theoretical cost basis was and it can be encouraging when you think maybe things didn't go as good because the stock came back down after going up. You realized well, man, look at all of this income I've got writing puts or calls or whatever so that's the way I do it.

Fischer: I use -- TD Ameritrade has a very good gains tracker, Gains Keeper I think they call it. Year by year they list it out, you can sort it by ticker, by strategy and it keeps, clearly, an accurate count of your gains and losses. When you do sell a put option, when you get the shares, when you get to buy the shares you deduct that single put option, what it paid you, and that lowers your cost basis for simple record keeping.

Yes?

Audience Member: So I want to -- I do something similar to Ned but I then keep a second spreadsheet which my CPA told me how to set it up so he can handle it and it's totally different because it does not track, it does not keep it going other than if I sell a put that is then assigned, where I'm assigned the shares, that does offset the cost basis according to what my CPA told me what to do. I'm not telling you what to do, I am suggesting that if you have a tax advisor make sure that you keep track of it in the format that they like.

Fischer: All right, so here is an unfair question and you don't have to answer because it's personal but after this morning if you know offhand do you care to share the exposure of your portfolio, how allocated are you overall and how do you think about the flexibility of your portfolio?

Phil: Different for the two, well the one for my parents is less, it has a lower exposure and I think one of the harder things with doing options right is measuring your portfolio allocations and your exposure. One you start adding options I use a pretty extensive spreadsheet in Google Docs to do that that I've created. I don't know if it would make sense to anybody else but it does to me to look at that but my parents' account it is 75% long. I have the hedge on IWM that was recently released, is that what you're asking, market exposure?

Fischer: Yep, yeah.

Phil: Whereas my account is much more -- it depends on how you look at it. I look at some other things. I look at Delta exposure for my -- meaning the expected change for as the market changes the expected change in price for each position in my portfolio based on where the strike is relative to car pricing, etc., to the underlying. But all of that to say I'm much longer in my account, I'm more like 90% long and I don't have a hedge but I do have some covered positions that are hedged out essentially because the current price is above where my covered call strike is. So they have a ways to come down in some cases. So I have a little bit of a built-in hedge there.

Lon: So I have two answers also. I've got about 70% in my personal stuff long and another, I'm guessing because I'd have to really look, probably about 18% short and about 30% cash for George and Martha who I'm now managing. They are down to about 98% long and up to about 1% short as they're selling covered calls to slowly liquidate certain positions.

John: Yeah, I guess I'm probably in my non-retirement account I'm about 85% in the market and the rest is basically cash. At the moment I don't have any other hedges except for various options that give some hedging. I did my retirement account probably like 95% in the market I would say.

Fischer: And are you guys all comfortable with where you are?

Ned: I'm pretty closely aligned with *Pro*, probably 70% long. I want to say I have about 25% in cash right now and I have a few written puts. I'm just starting to write some deeper in the money calls like on Coke which was a recommendation. I converted some of my Netflix to some in the money leaps. So you know, pretty closely aligned with *Pro*. I don't have the hedges because I have the cash but just coming back to how you use *Pro*, I mean, I wouldn't even have known how to think about all of those kinds of things if they hadn't outlined it for me in terms of if you have this much cash maybe you don't need to participate in this hedge. If you're this long maybe you need to consider a hedge and now I have all of that kind of thinking that goes in. I have a spreadsheet like these guys do that I try to track all of that. It's not really easy, it's not automatic. I mean, you have to think about, well, I'm in the money on -- I've got some deep in the money calls on this, I'm getting some leverage and it gets a little tricky but I don't worry about making sure it's to the half a percent, I just get it close. So I basically feel comfortable. I hope the market goes down to be hones with you so we get some good opportunities. I mean, it's just been up and up and up, it's kind of depressing in a weird sort of way.

Fischer: It has, the anguish of things continuing to rise, there's a certain anxiety to that too, it doesn't feel quite right. Well, thank you for answering the reason I asked is it's a small group but it's a much respected group and, yes, maybe it's a biased group given that we're all in *Pro* but it's interesting that you're all in the 70 to 80%-ish exposure range on your portfolio and I've just found that over the years to be a comfortable measure for most markets as well. So it's good to hear, I know many people who are 120% invested and they're usually new investors.

So a quick round of if you have any single tip or secret or advise for how to use *Pro* or the Fool at large, something that you have found over the years to work well for you or to benefit you in any way?

Man: I actually made a list of some things but …

Fischer: Great!

Ned: I don't know that they're in any particular order but I think learning how to use options if you're considering joining the services you'll really like it, it's not that hard. I would say take your time, don't be in a hurry. I've been doing it for five years and I still feel like I'm just beginning to learn what to do. I think *Pro* -- after being in The Motley Fool, not certainly checking out all of them but *Pro*, the way they deliver the message and incorporate it into kind of the whole approach to living is just outstanding. It's amazing to me and I think it's something that everybody should experience. It's pretty cool and see if I have anything else here.

I mean, I use it to help me think about risk and asset allocation. That's probably one of the biggest things that I didn't get anywhere else that's real important. Of course I do use *Pro* to find companies to invest in and to help me think about how to think about owning a company. That's something that changed, I think, as I started to listen to *Pro* and think about what it means to own a company to believe in the story, who their customers are, all those details. I mean, it's the whole soup to nuts thing.

Fischer: Thank you Ned.

John: Yeah, I think probably the biggest thing that I would say, which Jeff has already said I guess but just to re-emphasize it; if you haven't been online or don't go online and actually spend time reading the boards you really should do it.

I think that the *Pro* boards and the boards for the other services, I subscribe to most of them, they're just a phenomenal resource, there is some incredibly knowledgeable and experienced investors out there and apart from what you learned from Jeff and his team you can learn an incredible amount from the other people that are posting on the boards.

Man: My number one tip would be to just repeat what John said. Read the messages on the discussion boards and I have taken to reading almost every message that's posted now and my purpose is not to jump in as often as I can but I'm learning a lot often from the banter back and forth of, well, what do you all think of this? Well, I think that's a bad idea because of this. Well, what about this? Those discussions are fascinating and there's a lot of, pardon me to use a phrase from a different service, there are a lot of hidden gems in there, a lot of wisdom that's not where you always expect it to be.

The other single one which is the only frustration I have with the discussion boards that I would mention is don't panic!

Man: And prices do move after alerts come out. Expect it! No. Just a little bit of a clarification there for some of you that might be sitting out there thinking that you might not have time. There's massive amounts of great educational content on there but it's not forced content, right? Whatever amount of time you have, you can do different things to customize it that maybe one week you don't have as much time so maybe there are certain people that you want to make sure that their board posts, that you make sure that you see. So you can favor an individual that may be, that week, if you don't have time to go through all of that maybe you just go into the boards in the community area, you can actually look at your favorites and it's a list of posts by different people that you can follow and so maybe one week you only have time for that or maybe as you get more time you go more into some of the different one-pagers on options and then you go into the message board if you have more time and post some questions that you come up with.

So the beauty is that you can do it to whatever extent or level are just. There are some of you that are going to come to *Pro* and say, these guys are phenomenal investors, they've got great educational content but frankly I don't have the time to do any of this so I'm just going to make my portfolio look exactly like theirs and put it on autopilot and for some of you that's what's great for *Pro*. Then there are others of us, most of the people sitting up here, that we love this. This is our hobby and I listen to conference calls in the shower, literally, of businesses. I have a Bluetooth wireless speaker and I listen to conference calls while I shower regularly and I love it.

Fischer: You just raised the bar! That's just …

Man: And while I mow the lawn and my wife loves *Pro* because it saves her from listening to all of my blabbering about all of these businesses and all the stuff that I learn about them. So some of us will delve in deeper, we'll read everything that's on there that we can get our hands on and so you can kind of adjust it to what works for you. Some of you will want to take a more active role, some of you won't and that's great because it's not forced, nothings forced on you but you have a great community backing you up and if for nothing else than when those times hit to be able to see other people to have that temperament when you're in that risk panic mode to see other people reinforcing those values and the philosophy so that you've thought of it before that happens. If you think it through and you have a plan for when it happens then when it happens it's much easier to follow through on things rather than to do the impulsive actions that usually are really bad decisions.

So I guess that's what I would …

Fischer: Great answers all of you, thank you. I was listening so intently I don't have a question lined up next. Does anybody in the audience have a question? Yes?

Audience Member: Diagonal calls, what kind of characteristics (unclear)?

Fischer: Jim will be up here soon.

Audience Member: And what kind of timeline? I mean, you're looking at when it's dropping down, going up, earnings …

Lon: The answer to the question on diagonal calls is best going to be given during the next segment when Jim Gillies is up here. When I say I love diagonal calls, I don't say I love them because I know how to plot them out and choose them myself, I know how to follow excellent advice from Jim.

Audience Member: There's a monthly memo where he lays out the characteristics though. Weekly memo, excuse me. There's a weekly options memo.

Lon: Options Weekly.

Audience Member: Yeah.

Audience Member: Just a quick one, most of my money is in IRA, mine and my wife's but we can't do shorts. What we can -- I have a small brokerage account and I have a couple of shorts in it that you've recommended over the years but you mentioned that you might be doing more shorts since things are getting pretty serious it looks like in the middle of the year but if that's the case then I've got it in my brokerage account, I've got to sell some of those stocks so I can have more money free. Are we going to do that where we have more shorts?

Fischer: That's a great question and in a traditional -- in a margin account, of course, shorts are easy to set up and beneficial because you don't have to sell anything to short. In an IRA though, of course you can't short but we will, wherever we can, offer an alterative and it could be a bear call spread or a bear put spread, something that you have limited risk and a pretty good reward the way that we'll set it up. So we are very IRA conscious and we'll always put in an alternative where we can but I don't … We were talking during lunch and I don't know if we'll sell anything as we move our way to shorting more and that's one great thing about a portfolio, of course, it evolves over time. You have a plan but then it evolves on it's own as you follow valuations.

Some of your businesses may become priced such that you do sell and meanwhile you're adding shorts at the same time and your exposure can change pretty quickly and steadily just by taking what you see the market giving you and implementing it.

So we may not sit here and say, oh, we're 70%, 80% long now and we want to be 60% long by the summer but that may just happen naturally as the prices seem to dictate so we'll see but we'll always try to offer alternatives for IRAs.

Do any of you use IRAs within *Pro*? All of you. We've seen, again, from our great surveys which may be better than I give them credit for, a majority of members are investing at least some of their money with *Pro* in an IRA so it's high on our radar to offer alternatives and make that work. Good question!

Audience Member: I like the writing put philosophy but my concern is if we have a major downturn all of the sudden I own a bunch more stock and I have a bunch less cash. So I've kind of minimized that. You talk about whether that's a correct approach to minimize the number of written puts?

Fischer: John, do you want to talk about that?

John: I mean, as I said, I've been selling puts since 2005 so basically I've sold them through the 2007, 2009 downturn although what actually happened was that as the market conditions deteriorated I pretty much eliminated put selling. If a market is obviously falling apart it doesn't make sense to sell anymore. So I didn't really experience too much portfolio damage from it I would say.

There was a period, I think it was almost, I know I wrote that up, I think it was almost two years or a year and a half that I didn't write any puts.

Fischer: It's great to hear that. That was my experience too and it was in CGI as well, the former service where we just stopped writing puts as things seemed to get rocky. So the key then is to never be too exposed, we're back to exposure, at any one time and if you're always in that position then you can just let up and still have room to maneuver. If you're always, you know, over exposed when it hits there's nothing you can do. So yeah, the answer is to write puts in a reasonable amount and as John has done for so long, his numbers also add up to what I've found over the past 14 years now, 13 years, 10, 12% a year you can make with this sort of strategy with reasonable risk.

I have mostly written puts on things like large caps really. That has some volatility but for the most part mid to large caps and we have time for, it looks like, one more question. Yes? Two more questions.

Audience Member: I guess this is for the panel, as you've become more comfortable with option strategies have you started doing your own options trades not based on what they come up with but just what you find interesting?

John: Somebody asked me that on the boards the other day. I think basically personally I have been doing mostly my own options trades for a long time. I mean, I learned and understood the basic ideas from Jeff and I was able to apply them to stocks that I was interested in. I will say though that I do follow though quite a number of The Motley Fool options specific trades, for example, diagonals which I only really -- I guess the light bulb went off on those last year and I've been following those now. So there are some official recommendations that I do but most of my options trades are just my own.

Fischer: That's a great point too, you can start with just one strategy and just do that one simple strategy for years, that's all I did and mostly all I still do.

Man: I'll just add briefly that, yeah, I use options with a lot of my holdings that are not in *Pro* and were never in *Pro* so I think once you become comfortable particularly with writing puts, maybe covered calls, buying some deep in the money leaps or something, when that's appropriate you think you'd kind of understand that, yeah, you'll be able to do that with other companies.

Lon: I'll add that there are a couple of strategies where it's very, very safe to jump into the options on your own. So if you have a stock you're looking to sell and you don't think it's going to be going down, right covered calls to liquidate it where you're going to end up making a little more money than you could at today's price plus getting the premium on top of it; icing on the cake so to speak.

Similarly there's a stock that you really want to buy, it doesn't happen to be in *Pro*, there are some other good stocks occasionally and if you're convinced it's a good one puts may be a good way to have -- and this is the way that I look at anything I try to choose for myself with options, I only do it if I think there's a win/win situation. I'm going to win because I get the premium and darn I don't get the stock or I'm going to win because I get the stock and I wanted to get the stock. If I have a win/lose thing I don't want to go there.

I don't like gambling. I want my choice of winning scenarios.

Phil: Yeah, I use options on some of my own, in fact, I have written put on National Oilwell Varco right now. So we'll hear from the CEO so I definitely have quite a bit over the last few years. I actually was an undercover *Pro* member for the first couple of years and then my dad joined later and then I took over his account. So I actually only have a gap of maybe a year but they didn't know that because of the different name that it was under before.

Fischer: Sneaky, yeah!

Phil: Which is why I went by my dad's name for like the first year that I was on here again even like signing his name on the boards. I was like, this is ridiculous. I've got to change this. So it was a confusing email chain with Jeff and I where he's like Chuck, Phil …

Fischer: I remember that now. Anyway, glad it just sorted out for me right now.

Phil: How well that happens.

Fischer: One more question we have time for?

Audience Member: Yes, I just want to know whether you have any special recommendations for Roth IRA?

Fischer: For Roth IRA, any special recommendations? Are any of you using a Roth IRA?

Lon: I'm using a Roth, I use it -- let me say this, different brokerages treat IRAs differently. The federal law has what Jeff was talking about before, there's specific limitations on any retirement account where you cannot short. You cannot end up in a situation where there's a margin loan because there's no margin available in a retirement account. But then brokerages may set tighter rules. So I had been with one brokerage I ended up changing because I was only allowed covered calls in my Roth and while that was a good start because that's all I did for a little while but I wanted to be able to do more and many brokerages allow more flexibility; there are a lot of complicated reasons to check out what potential brokerage you move to very carefully, all the fees, all of what's allowed, the trading platforms, etc., but you should be able to do most other things there and I'm going to go back to one other thing, make sure if you are adding to a retirement account, etc., you're checking with your tax advisor and making sure everything is okay and the IRS doesn't get upset.

Man: I do income trades more in the IRA, Roth IRA and I do more leverage things like a synthetic loan doesn't make much sense in an IRA because it's cash secured anyway, the cash is held aside for the put part of that anyway so it's equivalent of owning the shares or the diagonals and things like that. So things where I'm intentionally trying to use leverage I'll use a regular brokerage account and I'll use the IRA for more income generation, strategies, writing puts and things like that for tax purposes.

Lon: Diagonal calls also.

Man: Yeah, that's true.

Man: So I guess it depends because you are writing on those as well, that's true.

Fischer: Well, Phil, Lon, Ned, John thank you so much! We owe you all a great amount of gratitude and all of you, when you're on the boards, look for these guys, they're very helpful, very Foolish and we just really appreciate that you're here and that you've participated today and on the boards all the time. Thank you very much!

Make the Most of *Pro*: Jim Gillies on Using *Options* Alongside *Pro*

Jim Gillies: Thank you, I'm happy to report, or perhaps you'll be happy to hear, I have nothing original to say. I think I've heard pretty much every point that I was going to make in here so are there any questions?

Can we have the next slide or I've got the clicker here I guess. Good, OK. You've probably seen this, I didn't realize how close I was to the edge, I'm going to fall off at some point, anytime I've ever done any kind of options presentation with a Foolish audience or an audience that I'm hoping are going to become a Foolish audience I always kind of start off with our seven rules of using options Foolishly so you've probably seen this. I hope you've seen this, it's on the Web site, this is how Jeff and I do approach a service and manage the service we have different approaches very much; apparently I like diagonals, apparently Jeff likes written puts but the principals underlying everything are the same and the last couple of, we'll say month and a half or so, I've really – if you've read today's *Motley Fool Options* weekly column, I kind of touch a little bit on this.

The first two principals are really kind of, I think, need reminding and people need reminding of these. So the markets been kind of nasty the last month since we had a great 2013 and now people -- how far has the market fallen in 2014 so far?

It's actually below five. It's below five given the strength the last two days. I mean, this is nothing. I think Morgan Hauser wrote a great article where he basically cited the statistic, the market has fallen on average 10% or more every 11 months for a century so we've had an unfortunate month but sometimes people get a little bit angsty and it doesn't help in the options world, I mean options are averaging instruments so a 5% market move might be a 15, 20, 25% option move and if you're doing pure leverage with a synthetic long it might get – you can get a little bit anxious but we are really pushing the first two principals here and we're very much thinking long-term and the topic of today's weekly was the fact that you should always have a planed weekly where we talk about our positions that are expiring every month and how a company, Blue Nile, which has been in the service for two years had a very bad day yesterday and yet it's been in the service for two years, the valuation approach has not changed, we have been writing puts on it, we've never put a dime out, we've pulled in $13 or $14 I think and we're just going to continue doing it and I would be happy if that company, which I'm not thrilled about the company but I actually love their option premiums if we could just keep it in there for another ten years but we are very much going to – what do we think a stock is worth first of all and we have different approaches to that and then always keep in mind that the long-term approach when we're using even the short-term strategies and for our purposes, all our strategies are short-term including diagonals which last two years, for example. We'll get to the diagonal question in a minute.

But, you know, so because this is really *Pro*'s show and I'm just a guest here I have an opinion on *Pro*, it's a complementary opinion on *Pro*, as individual investors we do have Peter Lynch talked about how we have advantage and Buffett has talked about how we have advantages and our advantages are the fact that we are able to sit quietly and do nothing when everyone else is panicking or you somehow think you need to do something, you've got that itch! I've got to do something! And I think Buffett's famous quote from 1999 basically IQ and investing, once you hit a certain level you're fine. You don't need a higher IQ, we don't need the math wizards of Wall Street who invented the collateralized debt obligation, have much higher IQs than me and tried to blow up the Western world.

Basically it is our temperament and in my opinion, apologizes to Tom and the Everlasting Portfolio, in my opinion *Pro* does the best job of teaching temperament around The Motley Fool. I like the long/short aspect, I know, I know, I was just fired folks. But, no, from …

Audience Member: (Unclear).

Jim Gillies: From a temperament point -- I like the five-year hold in there believe me. No, but I think for my money, and I do follow some like yourselves, I don't follow religiously everything in *Pro* but I have a few shall we say *Pro* holdings that are in my portfolio because my good friends Jeff and Bryan said do this, great, fantastic!

That you are able to teach the temperament and to teach people you're never too high when the markets going euphoric, you're never too low when the market's falling down. We're always looking for opportunity and I think that's a good message to send and I think that that's the proper message to send because as we've seen over the past five years the proclivities towards greed and fear are very strong. People forgot 2008 pretty fast but -- and that's kind of what I've talked to people before, well, the subject is everyone thinks they have the temperament to invest in 2013. Absolutely everyone, absolutely I have the temperament!

How was your temperament in 2008? And a good friend of the long-term Fool, Bill Mann once told me he says, you know, if you're not basically puking when you hit the buy button you're paying to much and so I'm like, okay, okay I like that!

But the -- it's sometimes a lesson that we have to learn the hard way and that's where I -- I've already quoted Buffett's, I'll pull out my favorite Charlie Munger quote, which is man is too soon old and too long stupid. It takes some of us a little while to learn and there is a column in The Motley Fool weekly archive that talks about my early forays into options and the best that can be said is thank goodness I wasn't too long stupid.

But there are, again, proclivities towards greed and options are a great vehicle for putting greed into action and that might not be the best thing.

So because I'm occasionally accused of being mathematical I felt the need to throw a formula up there but, no, using options alongside *Pro*, I mean, you've heard it before; Jeff has said it, Bryan said it, we are a complement. We are an a la carte idea service, they are additive. It doesn't take away from the long-term investing and long-term thesis that is *Pro*.

So basically the simplest thing is -- if everyone is religiously following only *Pro* no one is playing with Motley Fool One Everlasting Portfolio or *Hidden Gems* or *MDP* or what have you, that formula. *Special Ops*! Don't tell Tom this, one of my largest personal holdings is a *Special Ops* company. Shh …

FFNW for anyone who wants a real good read that is outstanding. Anyway, and that's all Tom and Jim Royal's fault, not mine.

Anyway so where was I going with that. So basically if you are just playing in the *Pro* and *Options* pool I would suggest that, you know, ring fence your portfolio to the extent that you're playing with at least 80% *Pro* money and then play over with the remainder in options; some from Jeff, some from myself because even though we do have very different, or even though we use the same rules and guidance for the service, we have very different approaches. You'll never see Jeff do a broken wing condor I don't think. But, by the way, did everyone find out what the -- you saw the broken wing condor trade right? Did you find out what the alternate name was? I didn't know this and I'm like -- I was crying I didn't know this; Billy?

Billy Kiperstock: Jade lizard.

Jim Gillies: So when you see a jade lizard come out because you know it's going to come like it's going to come, absolutely, but Jeff and I have very different styles but the same operating principals and I think they work well and I think they're complementary in and of themselves but essentially then you have to -- and there's no right answer for how much money you should have in only *Pro* versus *Options*. What are you backstopping your *Options* side thing with? Are you backstopping it with just pure cash, maybe that's not bad, you can increase your holdings. Are you backstopping it with shares that you've held long-term in say Starbucks that when the market correction comes and everything falls and all of your puts come due and you have to sell some stock to buy something else and so now you sell your Starbucks stock which is down 30% as well but you've still got a big capital gain so you're paying a big tax bill in addition to taking a large hit on your options.

Unfortunately there's no real good answer for everyone. The other thing is, and this was mentioned earlier, are you tracking your look through exposure? Are you tracking your written puts? Do you know how much you have, do you know how much you are particularly on the hook for if things go pear-shaped? Because if you're not may I encourage you strongly to start because 2008 shows up and like John Sergeant, like Jeff, I don't think I sold a put between February of 2008 and maybe June of 2009. Like things were getting bad enough that you kind of stop and let what you have roll off but still there are days. Blue Nile yesterday got waffled on earnings and we have a put expiring in two weeks and so there's at least one member who, this morning, was assigned already.

So, from the posts that went up, the person might not have had the cash or wasn't expecting to own those shares, we'll put it that way.

And then what is your evaluation basis for anything that you do? And, again, going back tying back to our first principal, valuation first which is like 90%, 90% of our work is on the business and the valuation and everything, 5 or 10% is on options.

Are you -- do you have your idea of what something is worth and why you think its worth? That's almost as important because you ask me what a stock is worth. What do you want it to be worth? I can make you a model that will give you any number you want. So the issue isn't the quality of the model, the issue is what are the quality of the assumptions that go into the model and realize that there are certain stocks that are frankly too hard to model. If you want a precise number for Netflix look elsewhere. It depends on what the subscriber growth rate is. Well, what's the subscriber growth rate going to be? I don't know! There's a whole range and we've got a model, I borrowed it from Jim Mueller, TMFGebinr. I can give you any number that you want from 50 to 500, well that's a useless model!

So know why you think something is worth what you think it's worth and that valuation, that understanding of valuation will give you an additional margin of safety for your option work because the number one thing that we want you to do with options is complement to Pro is know what risk you have, know what your exposure is. So in the event of the black swan or at least mildly grey swan that you won't panic and get all upset.

So that's my whole three slides but someone asked about diagonals so you get one more quick one for free before we -- are we going to break first and then a panel? OK.

Diagonals; great strategy, love the strategy. I have two minutes, I can do that. Basically there is an options weekly that you can look up, it is dated June 14, 2013, but everyone understands what a diagonal is. A diagonal is the purchase of a long-term in the money call option as long as you can get. So right now you'd be going to 2016 leaps and then you sell -- and that's a buy to open. And then you sell to open a near-term, say three months out, out of the money, higher strike call against it. It's very much like a covered call except instead of buying stock you are buying a long dated deep in the money call option.

And what this does, this allows you to lever up the returns that can be achieved with a covered call. So if you're going to do a covered call on Berkshire Hathaway, you know, big bloated and massive but excellent maybe that gives you 5% a quarter, maybe, that the equivalent diagonal would give you maybe 10 to 15% a quarter. So it allows you to lever up your potential ROI but there are certain criteria that you want to look for, in my opinion, you don't -- anyone who say had a diagonal on 3D Systems going into this week learned a lesson they could learn no other way this week.

So basically you want to kind of have a certain target. My criteria that I generally use, big profitable industry groups, consumer staples, healthcare materials, industrials. I would advocate avoiding banks, that you can go off message on that but that tends to be my one thing. You want a big company. You want an ocean liner, you don't want a speed boat so start your bidding at $25 billion or more which, again, would disqualify 3D Systems. You want a company that's not going to run into any leverage problems so, again, banks. So debt to capital below 50% please. You want a history of strong returns on equity. You want Walmart you don't want Tesla. I love Tesla but you don't want Tesla.

Ideally 12% year-in-year-out for a long period of time. You want an equally strong history of free cash flow and earnings growth in generation and finally you want to have a valuation model where it's trading at or below fair value because you would much prefer that the stock runs away from you and you have to close early for a profit then the stock drops 10 or 15% because you started with an overvalued target and it ruins your long-term owned (call).

So, with all of that said, Anne already shot me a negative sign, so we can I guess adjourn for five minutes and come back for a panel? Groovy, thank you!

Jeff on Portfolio Construction With a *Pro* Blueprint

Ellen Bowman: I am Ellen Bowman, I am the editor, publisher, general cook, bottle washer for *Pro* and *Options*, and I am here to take your questions for these gentlemen and help to make sure that they answer them in the time we have allotted, which, I am holding my phone because we have a hard stop.

Sir?

Audience Member: I have a question for Jim, Jim are you still a seller of puts or are you just kind of holding fast?

Jim Gillies: It depends on the put.

Ellen Bowman: They must have heard you.

Jim Gillies: Yes, yes, I'm a seller of puts.

Audience Member: Still even with the …

Jim Gillies: It depends on the company. I am not a seller of puts in say Green Mountain Coffee Roasters. I am a seller of puts in Barnes & Noble. There are two psychoses implicit in that one statement.

Ellen Bowman: I have a couple of starter questions here that I can start with but if anyone has something to say please -- hello!

Audience Member: Particularly for, I think Jim probably uses the most options, how do you track your portfolio allocations given -- I have trouble with it because I can look at it in a lot of different ways, right? You can look at the look through amount. You can look at your initial capital at risk, you can look at delta percentage …

Jim Gillies: Why do we have to talk about the Greeks?

Audience Member: Yeah, sorry. You can look at your actual dollar amount that's in each position and in a lot of cases you're going to come up with very different percentages of your investable money in each of those cases. Do you consider all of those things? How do you…

Jim Gillies: Yes!

Audience Member: OK! But I'm doing it like you.

Jim Gillies: Excel sheet, track your look through basis, compare against your valuation estimate because there's no perfect valuation. Again, I've already referenced Barnes & Noble so I'll do it again. Barnes & Noble at $14.00 assumes that two of the there divisions are worthless, one of those is a good assumption by the way. Two divisions are worthless and the third division bleeds it's free cash flow at 11% per year forever and ever amen. I think they'll do better so that's it; look through basis, valuation estimate, overall portfolio and Excel.

Bryan Hinmon: So this is an open call to all *Pro* and *Options* members, we realized that we, I don't want to say do a disservice by not providing that tool for you, but it's hard and it's imprecise and there are a lot of ways to do it. Everyone in this room does it in some way. We should all do a better job figuring out how to share that I think, so open call to everyone to share spreadsheets, no judgment, we will help you get your formulas correct and kindly point out when they're wrong and you will do the same for us but I think we should share them more.

Audience Member: I have a question, earlier today I think it was Jeff who was talking about some of the companies that have been selected by *Pro* and you briefly mentioned Sony as being a weak company. Am I remembering that right?

Jeff Fischer: Yes, we had shorted Sony in 2012 I believe and we closed it last year.

Audience Member: OK, so my question is the following. Since I was a little kid Sony's always been this great electronics firm and I haven't looked at the financials at all and so I guess there's something wrong. I'm wondering on what basis is Sony now a weak company in your mind?

Jeff Fischer: Sure, and this speaks so highly to, or so well to the perils of investing in tech where everything changes so quickly. Sony of course missed the boat from -- they used to have the Walkman which was everything for music and iPod just started to destroy it and on computers as well. They weren't into mobile in any timely fashion with phones or tablets. You know, like everybody, **Apple** took their market share there but mainly what's really hurting them is their TV business which used to be extremely profitable and it's just become unprofitable. TV's just became commoditized across the board. There's cheaper competition in Korea and that just hurt a lot of Japanese technology companies and so Sony just saw its profits -- it didn't have a sustainable moat and therefore its profits went south and it began losing money for a long time at the same time as being a highly leveraged business with a lot of debt.

So we shorted it, we made money on it while the market went up so that was one good example of a short working but they have a big turnaround plan in place. They're selling divisions left and right where they can to focus on their music and entertainment business and try to turn TVs around. So we don't have a position now either way.

Bryan Hinmon: I'm going to jump on top of that and just say that just like we look for companies to invest in that have those competitive advantages, a great place to look for shorts are the companies that don't. The most common competitive advantages are network effects, intangibles like a brand, cost advantages or switching costs for some reason.

If you look at Sony through that lens you might be able to -- or the common thinking is that they have a brand. It's true they have a brand but their brand doesn't allow them any premium pricing. So we looked at basically that rubric and said, hey, these are where competitive advantages are found. Sony has none of these, there's no reason that they should be able to earn reasonable profits going forward.

Ellen Bowman: Anybody?

Audience Member: I do a lot of selling of put options and I'm highly sensitive to earnings time. In fact, I've learned that the month before earnings time is often fraught with peril because at any point the CEO or CFO can come out talking about earnings before the actual public announced date. So I have this tendency to look at things from a perspective of if I have an expiration date, let's say in April, I'm already starting get out of that position anywhere from 30 to 60 days ahead of time and I also have a tendency to avoid having a position where it's expiring a couple of weeks after earnings. I never buy just before earnings. I'm just wondering what your commentary might be on worrying over earnings dates and company events in terms of thinking about when to get in and out of options?

Jim Gillies: A couple of things; you must learn to stop worrying and love the bomb basically. One of the things that -- first of all, if you're buying back your puts ahead of earnings what you're going to often see … So option prices are positively correlated with volatility premiums or volatility assumptions and what you're going to see in the vast majority of cases is volatility in an individual stock with actually rise ahead of earnings and then plunge immediately afterwards or am I going backwards? Canadian!

I'm going back to two feet of snow apparently on my front yard. So basically by buying back you are perhaps actually buying back at a premium that you don't need to be buying back at frankly. You're overpaying for something just because the market realizes the uncertainty, the same uncertainty that you're worried about.

So that's one thing and the other thing is what is your valuation because valuation is not going to change; valuation isn't stock price. The stock price might do whatever it's going to do after – again, Blue Nile yesterday is a perfect example. It was $43 on Monday, it was $34 yesterday. The valuation really hasn't changed much. Before this thing I thought it was kind of low to mid 30s, I still think it's low to mid 30s unless they actually are capable of growing larger than 5% a year which they have done in the past, maybe they'll do it.

So it really is just a case of just, you know, you must chill! I think I wrote today's weekly, you must chill out! Just don't worry about it. Sorry, that's mine.

Jeff Fischer: Thanks Jim, I'll add that personally a lot of the put options I sell or write are one month, and that doesn't play so well in a service, but personally one month and then it expires and then the month of earnings I typically don't write on companies that are reporting that month. You can find ones that report off months and then write on them. But this is just to be clear, put writing for income where if you get the shares you'll take them but that's not your main objective. So for income put writing I'm looking monthly and avoiding the earnings months.

Audience Member: This is kind of a follow-up question to both of you guys because I'm less experienced with options. I just started this year. Can you read into an increase in implied volatility prior to earnings and say, you know, the magnitude of the increase of the volatility is greater for this stock than it is for this stock so is this earnings report more risky than something else? Is that reasonable or feasible?

Jeff Fischer: This is the Greek known as Vega. No!

At some point yeah, it will just happen but it very much is the macro-theme of the market doesn't know what its earnings going to do so that's why it rises. It might not be worth any more than that analysis than to say, okay, its ahead of earnings and then, of course, after the earnings come out whether good or bad, the volatility and the option plunges typically too.

Bryan Hinmon: I'll let Jim answer that question, I'll just chime in on the first one. The more you worry up front, the less you have to worry on the back end. So if you worry about selecting the right stock and being very comfortable with the valuation the less you have to worry if and/or earnings quarter is bad or the market reacts poorly to what you think is a perfectly reasonable earnings score.

Ellen Bowman: Somebody over here? Here you are.

Audience Member: This question might be for Jeff but all of you are welcome to comment. This concerns WisdomTree Emerging Markets position, recognize that that was an initial position that I took when it was recommended. I wasn't able to successfully trade for the put where we were going to double the position. I recognized it's unlike a lot of small cap funds, it pays almost a 3% dividend which has been a wonderful thing. There's been so much attention with emerging market volatility for a variety of reasons. I know Jeff you've written about the cycle or the investment cycle for emerging markets lasting, you know, maybe five years or more and you need to be in for the full cycle. My question is, what is your thinking with where we go forward with that and to any folks that might not have been able to get in on the original put. It seems like now would be an opportunity but I guess I'm personally trying to figure out how to sync up a little bit more with *Pro* and what your latest thinking is on that.

Jeff Fischer: Great question. WisdomTree Emerging Markets is a dividend small cap fund that owns small caps that pay dividends in emerging markets. I bought myself some time there. The stock is a buy and we have written puts, as (Mark?) said to potentially buy more and we assume we'll take those shares and double our small position to around 3% so it starts to become a more meaningful position.

I like having it in the portfolio right now and I like that emerging markets are so out of favor and haven't gone up at all for a couple of years, so their valuations are more reasonable in a lot of ways, most measures, than ours in developed markets so you're getting an investment class that's very unpopular that's less expensive than the popular ones and that's generally where you want to go. That said, we don't know how soon emerging markets will start to recover or when the stocks will because the two may not go hand in hand. So I'm glad that we're starting small and I don't think we'll grow it beyond 3% anytime soon. It's -- to speak to something that David Gardner has often said, he likes to see some results before he adds more money so he'd rather pay up before adding more.

So we may wait to see some recovery or some good signs from the emerging markets and then maybe go a little beyond 3% but right now we're comfortable with our allocation and with that well-run ETF. It's done much better than most emerging market indexes.

Bryan Hinmon: Yeah, I think too if you look at the construction of that ETF you find that the companies in emerging markets, fragile markets, new markets, companies that are able to promise a dividend, tend to be of a different ilk than what you might think of for an emerging market stock and so this isn't the bleeding edge of frontier market stuff that we're talking about.

We can handle some bumps in the road. These companies can handle some bumps in the road and backstopping that if you look at the look through valuation on the companies inside of this ETF it's actually incredibly reasonable. So we're not all that concerned. It strikes me that people -- this is the risk (unclear) is the troubles in emerging markets. But if you look at the *Pro* core stocks and the amount of their revenue tied to emerging markets we can't forget that almost every company has identified emerging markets as a critical growth area going forward. No one is changing their mind on that. It's just going to be bumpy. We're okay with that!

Pablo: Hello, I have a portfolio which it's mirroring *Pro* so unfortunately I don't have that much money to have 100% of *Pro* in assets but I have like 20% of a real *Pro* portfolio and I'm mirroring exactly every move that you make and then the question is, if I have more money to throw in, how should I do it? Should I do it on the best buy first and then I will be totally unbalanced with *Pro*. Should I just write puts on every single stock that I want to increase my percentage on or should I buy – (unclear) which could be using less money to increase my whole *Pro* portfolio.

Ellen Bowman: Take it away!

Bryan Hinman: Well, the first question asked I think is what makes you most comfortable. The first place to look is at our exposure. I would, if you're trying to mirror the *Pro* portfolio the first thing that you should try and mirror is the exposure so don't worry about constituents but worry about matching the long and the cash or the short. So that's Step 1. Once you do that the place that we tell people to turn to is buy firsts. Look at the buy firsts first. If you're going to have allocations that are out of whack with what we have, we want your out of wackiness to be in the stuff that we feel the most strongly about at that moment. That's' an okay position to be in and realizing that being out of balance is sub-optimal in some ways that's sort of the best of the worst. And then you can march down form the buy firsts through the buys and get merged into the *Pro* portfolio over time.

Jeff Fischer: And I would say Pablo flew in from Madrid for this weekend so welcome! I'm going to tell the Fool really to make things easier for you, next year's event should be in Spain.

Ellen Bowman: Yes it should!

Jeff Fischer: Better weather, yes. And Hawaii, Hawaii would work as well. Anywhere warm. I lost my -- OK, so I like Bryan's answer. I would just say that if you -- I think you said you're following the *Pro* portfolio pretty exactly with his money so I would look to match up the allocations if your commissions are reasonable and anywhere that you're off at the time that you're investing your incremental capital, match it up so that you're matching what we own.

Ellen Bowman: Somebody else over here? I'll do you first and then the gentleman in the collard shirt right behind you.

Audience Member: Pacer, I have it to sell at $8.95 but I just wonder, I keep hearing a few things. It's still okay to hold on to it until it probably will go back up?

Jeff Fischer: Yeah, so the buy out offer is around $9.00 per share and so we, of course, want to get as close to that as we can on Pacer, P-A-C-E-R. It's done in the *Pro* port so don't go buy it. They're being bought out at $9.00 but we're trying to sell at $8.95 to get as close to that as possible. We're still talking about whether we'll take less, $8.90 just to get out and get everyone's capital freed up or if we're really going to hold out for $8.95. I think that's something that we need to just weigh the risk/reward of that nickel and decide what we want to do.

The other dilemma that we have slightly is if we go out and say, okay, take $8.90 now the price may go down lower than that when people try to sell so, bottom line though, is, yeah, it's good to sell it and free up the capital. So, hopefully we'll get near our price.

Bryan Hinmon: Yeah, I'll just say generally speaking when we get in these buyout situations the price of the stock that's being bought out approaches the price, the offering price, it doesn't get all of the way there most times because there is always the outside chance that for some reason the deal will fall through. Now the deal can fall through for many reasons, the most common reason is the company announces earnings that are horrible and basically it triggers a clause in the buyout contract that says, hey, you weren't up front with us with what was really going on in your business, we're going to pull our offer.

Now we just went through that with Pacer and there was nothing to worry about. The other reason that the deal might fall through is because financing of the acquirer falls through. The company that's buying Pacer is called XPO Logistics and they are financing partially with stock and partially with cash. So we don't really have any financing risk to worry about there.

I could go down a rabbit hole here but I won't. So anyway the closer we get to the deal going through which should be the second quarter, you should see the price converge on $9.00 over time. The interesting spot that we're at is we're now up on our 30-day window where we said we were going to sell our shares at $8.95 and we haven't gotten that price so we need to either sell them at below that or communicate that we're going to change our mind.

Audience Member: What are good characteristics to look for, for a company to short?

Jeff Fischer: Great question! Companies to short, that we prefer to short, are ones with no competitive advantages that remain or they're being encroached upon by other companies, ideally no profits to speak of and no visibility into profits anytime soon. A poor balance sheet with a lot more depth than cash and if they pay high interest rates too, great!

I guess it might be instructed to say that some of our best shorts have been the one example that we were talking about just a few minutes ago before this panel, Trump Hotel Casinos and Resorts which is our real estate entity of Donald Trump that owned resorts in Atlantic City and had billions in debt and no cash and was trying to pay $50 million a month in interest and the whole thing just toppled, they went bankrupt.

So looking at balance sheets of companies that are highly leveraged and at the same time not creating any cash flow themselves is a sure sign that there may be trouble ahead as long as the market hasn't already beat you to it and beat the stock down to a dollar.

So I hope this answer isn't too generic but companies that lack advantages out there lack profits and have bad balance sheets are a good place to start.

Bryan Hinmon: Jeff's favorite shorts are called buzzard bait so they look like they've already died but they still have a lot of room to go in their death. So this is an awesome question and a great time to bring up Charlie Munger who cites the mathematician, Jacoby. He says invert, always invert. So we just gave -- we spoke a lot today about what we look for in a company so if you flip that on its head you should be able to tell what we look for in a company to short. So the three things that make up a *Pro* core stock are competitive advantage, compounding dynamics and good management. So if you find a company that does not have a competitive advantage like Sony that does not have good compounding dynamics like Sony and does not have good management, management was unproven at the time at Sony. You've got yourself a pretty good candidate.

Now, Tom Jacobs is in the room so I must say, pay homage, that if you're going to short it helps to be right on timing and one of the ways that you can put timing in your favor is to find a company that has some earnings quality issues. It just sort of puts the odds in your favor.

Jim Gillies: A couple of things just to add, one, shorting is hard so I'm going to second what Bryan said. Pick up a copy of Tom's book, Tom and John Del Vecchio's book. It will help you with earnings quality issues.

The other thing is, this is a small subset of shorting. When you find a company that just rockets like triples in a year or what have you, follow the insiders, insiders, executives, have to file what their activities are with the SEC on a Form 4. And don't follow the CEO or the CFO, or do follow them, but if you start seeing what we call lower echelon insiders like the controller or the treasurer. If you start seeing these people selling everything they have and moreover, you know, they've got like option grants that vest over a five-year period and every month they're selling 1/60th of that – this happened with Blue Nile in 2007. You could see that in real time they were getting out as fast as they could even though they got like nine years left on the option. That's a real big tell because the CEO who's getting paid millions of dollars and has penny options that's one thing but the treasurer who's making, I don't know, $80,000 a year and these options are like real money to her, that's -- follow that! That's a great sign, the person closest to the money is selling hand over fist.

Jeff Fischer: One more thing I feel I must add, I believe you are the youngest Fool member here no question about it. So you should spend 99 to 100% of your time finding great businesses to own and that will change your financial life if you buy some of those early and just hold on to them. So I would devote very little to maybe no time shorting right now.

Bryan Hinmon: Yeah, I just wanted to add maybe one thing, I mean, these guys did a good job of explaining most situations but I think maybe one more situation where you could short a company is in an industry where it's getting disrupted. Things like – you think of Circuit City, Best Buy, Amazon disrupted them. Things like long-term trends where you have a disrupted industry and then those competitors who are not able to adapt to the disruption. Sony comes to mind because they weren't able to adapt to, say, the iPhone or things like that so that's another area as well.

Audience Member: Speaking of shorts, AmTrust Financial seems to be recovering from the short attack, some of us wrote puts to take advantage of that. Have you seen anything to suggest that AmTrust might not come out of this problem?

Jeff Fischer: The short answer is our faith in AmTrust has not been shaken. We've done all of the due diligence that we can do at the moment. We look forward to seeing their earnings results next week, I think a week from yesterday so next Thursday. And the company has said they want to, within a quarter, and this was in December, share more financials with everybody even though they don't have to. They report everything as they should but to try to disprove the criticisms against them they are very open and we're very hopeful that they could through their auditors share much more by this quarter or so.

But it's a company that I've known since it came public in like 2006 and we had the good fortune of meeting management in December; Bryan set up a meeting with the CEO, CFO. It was a great meeting and that helps and we talked to them and we believe in the business as a real compounding machine. One thing a lot of people don't understand about AmTrust is it goes into insurance niches that are ugly and struggling and it goes in because it can buy them cheaply and turn them around but it makes it kind of a black sheep of the insurance world and an easy target. But the short answer is we still believe in it, it's still rated by, and it's actually our largest position at 5.4% but price-wise it's had a great run. It's still up quite a bit for longer-term owners if someone bought it last year, of course, but we believe that it will continue to do well over the long-term but it could remain volatile for quite a while.

Bryan Hinmon: So the punch line here is, no, I don't see anything different that would change my mind from what I said, hopefully clearly on the discussion boards but I do want to call into question simply the idea of anchoring just because AmTrust traded at $43 a share doesn't mean that's the right price for it to have traded at in the first place. The stock had consistently been above our estimate of fair value and we were perfectly okay with owning it as it had that rise is now falling in the wake of the short attack, it has fallen much closer to what I had estimated the companies fair value at and so there's one way to look at it here is simply that the premium that was placed in the stock has been sort of eviscerated now because people are questioning it a little bit more but I don't want to anchor on the fact that there is some magic number, $42, $43, that we will recover to simply because time passes or simply because the company releases more information.

Now, I don't mean this to sound dour on our outlook for AmTrust Financial or that sort of thing but we just have to be careful not to anchor on what the stock price is, or what the stock price was before it fell. What I do believe is true is that there's fundamental misunderstandings about AmTrust's business and more than an insurance company it is sort of a hedge fund with a developing recurring revenue fee business and so I don't know that looking at it as an insurance company, anymore, is the right way to value it.

So, I'm not sure at this precise moment what the exact right fair value for AmTrust is. I suspect that it's higher than where it is now but I don't know that it's the $41 or $42 or $43 where it was before the attack.

Jeff Fischer: I'll just add while Ellen's -- anything we own and (rate by?) we continue to believe it will challenge or top our North Star at the time and if that changes you're the first to know about it.

Audience Member: Hi, I have a couple of questions, I'm just wondering whenever there is a new recommendation coming out, do you all review it and agree upon it first?

Jim Gillies: I don't!

Audience Member: You don't, you're just *Options*.

Jeff Fischer: Jim and I work separately even though we complement each other well, I like to think. So we just do what we do, Jim in Canada, I wherever, and the team is involved -- everyone sees the alerts before they go out, of course, but Jim and I -- our responsibility is to make the decision and we'll go to Bryan and Billy for feedback and ideas most of the time but it's on us to make the decision. In *Pro* it's on me to make the decision and so that it operates the same way there but when Bryan or Billy have an idea we will all talk about it in-depth for quite a while, quite a while. Some buys we're working on for months on end but the important thing is early in the process we all agree, this is a compelling candidate and so no one is wasting their time on it. So when Billy or Bryan bring an idea we agree early that it's worth pursuing and then whoever has that idea pursues it. Bryan very recently Parexel was all a Bryan idea that he's been following and researching for at least a couple of years and that's all Bryan but we all agree at the same time, yeah, let's make it a 3% position.

And that was after Bryan pitched it to us. The Fool is very big on stock pitches inter-team, within the team, so just like we offer it to you we'll offer it to one another and share the idea.

Audience Member: That's great. My other question is what is your take on Chipotle Mexican Grill? I mean, it just went up and up so fast and it's still going up higher.

Jeff Fischer: My take is I wished we owned it. Yeah, it's -- the company has always looked expensive but I think what's happening is those who own the stock have been right to estimate how much it can grow and those who said, oh, it looks so expensive have been wrong on how much it can grow and that they're still growing same store sales so strongly, 9% last quarter and they're still a pretty small footprint restaurant. They have, I think, 1700 locations and they're on track to double that in the next X number of years, five or seven years I think.

So it's still an early story and though it trades at a premium price you're also getting a few other food ideas that they're rolling out, the Asian Chophouse and the pizza idea too. So they may be the new king of fast quality food. I don't want to oversell them but right now they're in that position and after last week's earnings I'm looking at it again because I don't want to keep missing it if it can do a North Start type return or better we may want to be in it.

Jim Gillies: As I've just been reminded I love crappy restaurants and I really do! And I'm also happy that I am actually in it but that's another story. The thing about Chipotle, just to reiterate some of what Jeff has just said is the -- and Tom talked yesterday about having co-CEOs, Chipotle probably does that better than anyone else out there. They have Moran on operations and Steve Ells I believe his name is. Yeah, he's more of the strategy and the concept.

So they have a visionary and a guy who gets it done. They have – from the perspective of the growth runway I'm just outside Toronto. Toronto is the fourth largest city in North America. We've got something like eight million people in the greater Toronto area and I think we have six Chipotles. I mean, there are neighborhoods that have six McDonald's and that's just Toronto. I think there might be – I think there's less than 10 Chipotles in Canada. If Canada can support 3,000 Tim Hortons we can probably support 300 Chipotles and how many can the U.S. do and how many can England do? And how many can the Middle East do? And then where you take the Asian Chophouse and then where you take the pizza offering, so I've unfortunately sold some of my Chipotle along the way up but I haven't sold it for a number of years because I kind of realized, you know, whatever -- I can't put a pin in their growth.

The other thing for Chipotle is they are at the forefront of a broader societal trend towards healthier eating. I don't know if you've seen they're got a television show coming out on Hulu, Chipotle has a television show! Its exploding cows and agribusiness, look it up, it's coming! And they are at the forefront of eating healthier, the food with integrity movement so no antibiotics in your dairy, no antibiotics in your meat, organic guacamole, etc., that's something that people in aggregate society and aggregate care about right now and I think that's only going to grow and so not only do you have this growth runway ahead of you but you have a societal trend pushing you from behind and so, you know, I probably came across I kind of like the company. A little bit!

Ellen Bowman: Gentlemen, we are down to almost five minutes so I'm going to take one more question and Jeff, I did not mean to interrupt you, please go ahead!

Jeff Fischer: All I was going to say listening to Jim speak so well, the trend of healthier food clicked in my mind, well, what's going to be the mote there? How many people are going to come along and try to copy Chipotle? First of all, it's location that's part of their mote but not eternally a mote so it's just an extra thought like, yeah, healthier food is becoming a trend, is that a mote that you can sustain and build profit margins on or once it becomes the mainstream what happens?

Ellen Bowman: All right, sir, I think I skipped over you before for which I apologize.

Audience Member: Follow-up to the gentleman behind me on shorts, every time, well not every time, but almost every time I get into or think about shorting I find that the stock has already sunk a whole lot so it's kind of the opposite of what you were talking about, how much lower can it go? And even sometimes this seems impossible because there seems not to be any shares to (buy?) or there's likely to be a short squeeze. Do you have any comments on like how to shorten that situation or should you shorten it?

Jeff Fischer: Yep, when it's impossible it's usually best to walk away because the short squeeze may happen next and even if you do get some shares on a lark you may get called out of them right away. So really illiquid things are risky even riskier to short. You could maybe buy put options to profit when the stock falls but they'll usually be expensive so you have to really think the stock has further to fall.

A final point, good news about shorting something that's fallen a lot is the most that you can make, of course, on any short is 100% so whether you shorted 100 and it goes to zero or seven and it goes to zero like we shorted Sirius Satellite around 7 and closed it around 3. You're still the most that you can make is what you can make so sometimes buzzard bait we like to see things fall quite a bit before we do short. We like to see that it's really flailing or failing.

Ellen Bowman: All right, that was more succinct than I expected. One more anybody? Sir?

Audience Member: I'll squeeze in a couple. What are your thoughts on the short on euro that's been dragging on for a long time?

Jeff Fischer: It has, speed round here. Shorting the euro, I still like it because I think the risk/reward is skewed to the short side. Sorry Pablo, it's hard to see the euro take off.

Pablo: I'll show you the euro (unclear).

Jeff Fischer: One caveat that I would add though is if you're shorting FXE, the euro ETF make sure your fees are low because we don't want to pay a lot every year to short it, 0% is great. 1% maybe. You don't want to pay a high fee on what may be a low probability short but our thought it is something really does go awry in Europe it could be a nice profit on the short and once interest rates go higher the dollar should be stronger.

Audience Member: And the other quick one, O'Reilly is way above fair value but it's still a buy first, thoughts?

Jeff Fischer: That's not fair, it just jumped yesterday. It was up 10% yesterday on earnings about, it's been a great stock. We bought O'Reilly, so boring right, so boring! It's up 50% in about eight or nine months since we bought it last April I think. It's due for a fair value re-evaluation, the year just ended and I need to go through results and raise that but it's a great lesson that fair value is a range and an estimate. It's been above our fair value for quite a while but it stayed buy first because we thought the risk/rewards was still, especially looking forward three years, still very good.

So, we still like it and we'll have an update soon!

Ellen Bowman: What are you thinking, one more, can we squeeze in one more? All right, I'll sprint.

Jeff Fischer: Jim has a plane to catch.

Jim Gillies: I have a plane to catch in two hours and seven minutes.

Audience Member: Yeah, I just wanted to sneak in a question for myself. Two companies that I'm really interested in investing in are SolarCity and Tesla. It seems to me they meet a lot of the criteria that *Pro* has as good investments. I'm just curious if you looked at them and what your opinion is?

Jeff Fischer: Looked at both of them early last year. Here's where everyone gets out their tomatoes and can throw them at me.

Ellen Bowman: I forgot to provide those, I'm sorry!

Jeff Fischer: Ellen!

Ellen Bowman: Sorry.

Jeff Fischer: We even talked about briefly setting up a little Elon Musk basket like 1 or 2% in each of these companies both of which he has a big hand in and we didn't because they don't seem to match *Pro*'s goal despite the businesses being very alluring and growing quickly in revenue anyway right now they don't have free cash flow to speak of and the valuation was not there or really impossible to measure. So it just didn't fit with our North Star goal. If you're a Rule Breaker type investor it may fit better there and the final thought, if they do become, on a valuation basis attractive enough to put them in *Pro* then we would and we don't think we would have missed the boat at that point. So many companies, once they do reach that point, then go on to compound for a long, long time. So we'll keep watching!

Ellen Bowman: OK, they are about to start dismantling the walls Anne says so I have to stop this. I did bring some printouts of some of our PDFs back there so there's one on *Pro*'s core stocks, there's one on selecting option strategies and there's one on writing covered calls. They are on the table in the back if you want them and thank you very much!

Jeff Fischer: Thank you everybody!

FoolFest 2014: Video Archive

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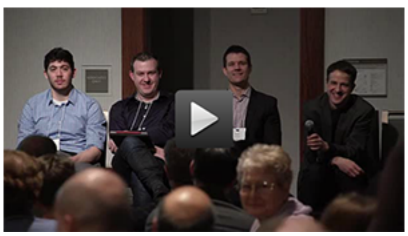
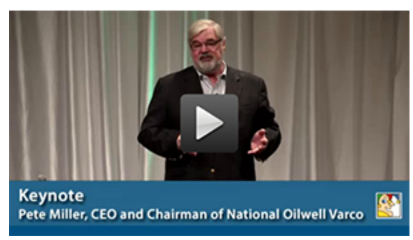
The Motley Fool hosted a member event early in February featuring speeches, interviews, and Foolish conversations with visitors and denizens of Fool HQ alike. Videos (and trasnscripts) of the event are available below, with the *Pro* team's presentations at the top. Enjoy!



The *Pro* Team's Presentations: Jeff discusses portfolio construction, Bryan tackles Albert Einstein (not literally), Billy takes on American Tower, and our members share their tips on making the most of *Pro*. Plus, a Q&A with the whole team, including *Options*' Jim Gillies. Watch the videos >>

Malcolm Gladwell: We were thrilled to have acclaimed author Malcolm Gladwell sit down for an interview with Tom Gardner. Watch as the two talk about Gladwell's latest book, *David and Goliath*, and why many people would rather "lose conventionally than run the risk of catastrophic loss unconventionally." Watch the video >>



Pete Miller: National Oilwell Varco (NYSE: NOV) CEO Pete Miller both entertained and impressed our audience of Fools at February's member event. Watch as he talks about how his company's oil rigs are reaching new markets, the recent spinoff, and what's next for this company. Watch the video >>

Fred Reichheld: Reichheld, the creator of the Net Promoter System and a longtime partner at the consulting firm Bain & Company, goes in-depth about how companies can capitalize on feedback from their customers, measuring customer loyalty, and how simple changes can make a big impact on companies' success. Watch the video >>

Eddy Elfenbein: *Fool One*'s Morgan Housel introduced Elfenbein as "one of the wisest investors I've ever come across" — and you'll soon see why. The editor of Crossing Wall Street, Elfenbein talks about the big trends he's seeing in the stock market, how people really make money investing, and what he looks for when he's researching a potential investment. Watch the video >>

Michael Kitces: Award-winning financial planner and writer Kitces turns many of the ideas you have about saving and retirement on their head. Watch as he lays out what's changing in the world of financial planning and how you can take advantage. Download his presentation and watch the video >>

Tom and David Answer Your Questions: Topics include why Berkshire Hathaway isn't in the Everlasting Portfolio, David's long-term take on SodaStream, why Tom hasn't recommended The Container Store — while David has — and more. Watch the video >>

FoolFest 2014: Tom and David Gardner Answer Your Questions

Published Feb 19, 2014 at 11:51AM

Watch as Tom and David Gardner take the stage together to tackle your questions at our February member event! Topics include why Berkshire Hathaway isn't in the Everlasting Portfolio, David's long-term take on SodaStream, why Tom hasn't recommended The Container Store — while David has — and more.

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Run time: 41 minutes

Transcript

CHRIS HILL:

(Picking up from Tom's three EP lessons learned talk.) Tom, 30 seconds or so. We've got a question about ...

TOM GARDNER:

LinkedIn's earnings? Hey, does anyone want to buy LinkedIn under $200 a share? You'll have an opportunity tomorrow morning.

CHRIS HILL:

Very nice. Question about — oh, Berkshire Hathaway and the Everlasting Portfolio.

TOM GARDNER:

Sure. In a way, Berkshire Hathaway is the everlasting company, so it does provide a lot of the evidence that this type of investment works. Buffett has pretty much never sold a share. I mean, he's dedicated his life to the company and that's what I like to find. It's kind of the Lew Frankfort scenario a little bit. Just succession. You'll remember that there was somebody who was kind of one of the lead dogs who's no longer at Berkshire and left without a great ending to his time at Berkshire.

Succession just concerns me. I do totally believe what Buffett said recently, which is that — I don't think he took it to this extreme — but of all the companies that have been created, his is probably the one that's best set up to be a trillion dollar market cap someday. He didn't express it to that extreme, but he did say he's been creating the company so that it is diversified in a way that it can be in a lot of different industries and have a huge market cap.

So, I may very well add Berkshire Hathaway. I may. Just the succession question is one that lingers out there for me and I guess in the end, what I would like to see in succession at Berkshire is what I like to see in many different companies and that is a much younger leader who's going to be the CEO for the next 30-plus years just as Buffett was ... rather than the right-hand person who's maybe in the last five years of their career. I don't like that dynamic, as much. And, of course, we don't know who his successor is yet, so that's just pure musings on my part, but great question.

CHRIS HILL:

We will go to the audience in a few minutes, but first the questions that came from the Fool One board. The markets shook as Fool favorites Coke and Green Mountain are now linked and some are suggesting bad things for SodaStream as a result. Give us a Foolish perspective, please.

DAVID GARDNER:

Sure. I own SodaStream. I also have recommended SodaStream and Green Mountain Coffee Roasters, thanks to my good friend Rick Munarriz, who is such a wonderful stock picker for *Rule Breakers*.

It was really interesting to watch SodaStream close up about 9% today, I think. I have admiration for what the company's doing. I like companies that improve our world. I believe that a bottle-less world is a better world, whenever possible. I've enjoyed my SodaStream machine, lo these three years or so, of regular usage. I don't really buy the syrups — it's just carbonated water for me — and I sure did enjoy Green Mountain Coffee Roasters' stock today.

Initially, it sounded like after hours, which I don't really follow much, it was down yesterday. So, it closed up today. It's a little surprise. I think this is a valuable space, and when you have a big company like Coca-Cola come in and make an investment in a company that's playing there, I think it definitely raises the tide for all boats in my mind. I don't think that SodaStream is going to go out of business, now, because Coke and Green Mountain can work together on a Green Mountain soda machine.

I think so often we tend to think in binary terms, when the truth of business is, more often than not, everybody wins. If you're playing the game well, you're going to win, too. If you're investing well, you're going to win. It's all about winning. I don't think it's a zero sum. I don't like phrases like "iPad killer." I've ranted before in *Rule Breakers* columns on this. I don't think it's zero sum. So, I'm glad to see SodaStream up. I'm sorry to see it down. I've owned shares, too. It's been a laggard, no question, over the last year. It's one stock. Those are my quick thoughts.

CHRIS HILL:

Another question. After two years of investing reserves into the Everlasting Portfolio, expecting to have $500,000 per year is impossible going forward. My portfolio might end up in uneven allocations. Any recommendations on how to handle this?

TOM GARDNER:

I think we owe it to *Motley Fool One* members to follow what has been created in *Supernova* in the Phoenix portfolio. I think that was a great innovation that *Supernova* brought to The Motley Fool and it is the portfolio that is not adding new capital, essentially ... so, it teaches you to manage the everlasting way ... in this case with a finite amount of funds. So, I think you're going to see us create something similar. I don't know that it will be exactly like Phoenix, but I think Phoenix is a brilliant addition at The Motley Fool portfolio of services.

CHRIS HILL:

My question for Tom is what is your strategy for using the cash accumulating in the Everlasting Portfolio?

TOM GARDNER:

So, we have about $6,000 and so it's a very small ...

CHRIS HILL:

Round of drinks for everyone?

TOM GARDNER:

It's less than 1%, but we're being paid dividends and overall I expect to reinvest that. It's difficult to figure out how to demonstrate to all of you how I think about being fully invested because with $100,000 a quarter coming in and a $100,000 wild card round — which given where the market is, I wouldn't be surprised to see that coming relatively soon — that's a half million dollars of new capital each year.

So, really if you look at our *Million Dollar Portfolio* and Everlasting Portfolio right now, we're 50% in cash just in terms of how much cash there is going to be invested this year. So, if you actually look at the pathway of new capital coming into the *Everlasting Portfolio*, you would really say that the portfolio, even with a million dollars with $6,000 in cash on the sidelines is actually primarily not in equities because of the income that we have coming forward.

I don't know if you watched the Jack Bogle interview, but I love what Jack said, for example, about social security. You have to view that as a cash portion of your overall portfolio. So, I would view future income coming in as cash, as a cash position in your portfolio that's not invested. So, that's probably not comparable to everyone out here and everyone watching the stream.

I guess I'll just say think of us as being opportunistic with the wild card round, but pretty much having the mentality that we're going to invest all our cash whenever we like it and at this point, $6,000 is just not significant enough for us to have rolled it in, but I wouldn't be surprised to see it get rolled into investments in the next six months.

CHRIS HILL:

Two more questions, and then be on the lookout for Dan Boyd and Susan as we'll go to the audience for questions. Could the Fool please post one-year, three-year, five-year, 10-year and since-inception performance numbers for its newsletters?

DAVID GARDNER:

I have no direct reports at The Motley Fool, so let's find out from our CEO.

TOM GARDNER:

[Laughing] I have one very serious report that I have, and that's the co-chairman of our board I report to. So, I'll say that I have mixed feelings about it. I definitely like showing everyone how everything is doing and making that very clear. I don't like to emphasize shorter time periods when I think that the biggest mistake that individual investors are making is to trade too frequently. I've said before I think the number one way to improve your returns right now is to double your holding period. I think it's just a simple way that will start to change your mind-set — have you look for companies differently out of the gate than you're looking for and you'll do better as an investor because of it.

So if we start reporting last three-month returns, last six-month ... I know you didn't ask that, so it's unfair for me to go with shorter time frames. But I can just tell you. In the Everlasting Portfolio, I want to have since-inception in trailing five-year returns. We're just not in the trailing five-year period yet. But given that you've been persistent in asking that question, and I know you have a passion for it, I have to believe that we can provide that and we've got Xander.

I just recently saw the question — so now that I hear it, I think it makes sense and we'll find a way to do it.

DAVID GARDNER:

I'll just add that at the outset of *Motley Fool Stock Advisor*, we weren't really thinking of it in terms of a portfolio or wanting to compare ourselves to mutual funds or index funds. In some ways, I object to the notion because at least in *Rule Breakers* and *Stock Advisor*, where I've been picking stocks from the outset for a dozen-plus years in one of those services and ten in the other, every single month, month in and month out ... I'm basically doing it on like the third Thursday or something like that, every single month, month in, month out.

That's very different from what a mutual fund manager does, and if the intent of asking what our one, three, five and 10-year performances are is to compare it to your mutual funds ... just realize that we at the Fool are really playing a different game ... so that kind of gives a lingua franca connection of what we do to what they do, when what we do is fundamentally different from what they do.

And I think what we do should be serving you better than what they do. I can at least tell you you'll learn a lot more through us which is — I see a lot of heads nodding because you are and you get that. So, on the one hand, I think it's very misleading for us. On the other hand, if you actually do the numbers, smokin' hot. Smokin'. So, I never shy away from anybody wanting to run those numbers and put them up there. More than happy any period. One, three, five, ten ... And when it's red, which it has ... I like people to see that, too, because you know that we're losing right along with you when the market goes down and sometimes I lose worst of all.

CHRIS HILL:

Final question — then we'll go to the audience here in the room. This relates to the Everlasting Portfolio and its current lack of long-term dividend growth plays. I'd enjoy hearing Tom comment on the role of dividends in a buy and hold strategy and their effect on Everlasting Portfolio selections.

TOM GARDNER:

Sure. I don't look for dividend-paying companies as a factor that's important to me. There is one case when I do, but in general, dividending is a use of earnings ... so if that's the way the company would like to use those earnings, I don't favor them or disfavor them for that. Obviously they're choices that are being made there to not reinvest that capital in the business. Or in some cases, you're providing dividends to large shareholders and they have a real interest in that. So, there are a myriad number of reasons to pay a dividend. I don't view it as a positive or a negative as an isolated factor — but I know that some people like to generate income from their portfolio, as it goes, and would prefer to do it via equities.

My favorite dividend payers are small cap companies, because I think a small cap company that's paying a dividend is communicating something important. And, of course, you need to pay attention to the payout ratio. And what James Early does, and has done with his team ... beating the market with income investing stocks all the way through ... has been awesome.

But with an excellent payout ratio, a small cap company that's paying a dividend is doing something pretty remarkable as a David in an industry that likely has at least one Goliath ... and that is they're choosing to return some of their earnings to their shareholders. That could mean that they feel they have no future growth prospects, but just as often, what it means is that the company feels it's got a dominant position in its niche. It feels very comfortable there and it's indicating to the marketplace that it can afford to pay some of its earnings out rather than reinvest it all in the business.

Case in point. A company became public in the early 1970s at a $30 million market cap. Within the first year of its IPO, its stock was down 50% — from a $30 million market cap down to $15 million. When it had a $19 million market capitalization, it began to pay a dividend. I mean, a $19 million market cap. Obviously, money was different in the early 1970s, but we're still talking about a tiny, tiny, tiny microcap of a business began paying a dividend at the market cap of $19 million. Its first year as a public company. That company is Wal-Mart. It ended up being one of the greatest-performing investments in American history.

So, I think combing — if you're doing your own research — the small cap universe for dividend-paying companies ... Again, it's not a single factor. Some of them are doing it because their founder owns 72%, he's treating the company as a piggy bank and he's a semi-fraud. I've seen that. It's happened to me as an investor. So, I'm not saying, "Hey, all small cap dividend payers will succeed." I just think that's an interesting factor to follow, and if you see a great, really well-run business doing that as a small cap, that's a very strong indicator for me.

CHRIS HILL:

And with that, we'll go out to the audience for any questions.

TOM GARDNER:

By the way, thank you Dan for jogging around the arena.

CHRIS HILL:

We'll go down front here and then back there.

MALE:

My question concerns The Container Store and my statement is great CEO, bad balance sheet. So, walk me through your decision to The Container Store. Either one.

DAVID GARDNER:

Sure. To me, The Container Store represents a company that is still early stage, but has been around for a couple of decades. So, you're right. Even after an IPO and raising a bunch of cash, they still have a lot of debt ... but, sometimes when we focus in too much on one or two numbers, we don't want to exclude the rest of the story. And to me, most of my great stocks in companies ... I feel like I'm buying a culture.

Culture's kind of an overused word these days. In fact, I'm almost starting to think that my Rule Breaker self is starting to... I want to be the anti-culture guy because I hear almost how too important culture is — but I'll just say that for ten or fifteen or twenty years now, I really have been trying, as best I can, to invest in culture and The Container Store is a very strong culture. And I believe that with still not even full U.S. coverage and with international possibilities, that it represents a better-than-average bet, a probable market beater three to five years from now.

All that said, my money's where my mouth is. It's right up there on our score sheet, and if we're wrong ... And we were right the first month and wrong the second month so far — then it will be an also-ran. But I'm confident in The Container Store, and Tom, obviously, has a great sense of this, as well. Has gotten to know Kip, as have I. It starts with the people, and I just think Kip Tindell is an amazing CEO.

TOM GARDNER:

I will say that I have not recommended The Container Store up to this point. They're only a recent offering. Kip is unbelievable. I think The Container Store has been a remarkably great business. It was private equity restructured, in a way, in 2008, and that meant that the IPO capital went to the private equity firm rather than to the company's balance sheets. So, that would be a reason that they're not flush with cash after their IPO. You can view that as a very unfortunate thing or just view it as a reality of the way that they financed their business and now they're good to go and run their business and generate the cash out of it.

Amazon could be a big competitor to The Container Store, too. So, I haven't made my mind up, yet. I've learned to believe in my brother's investment philosophy, so the fact that he loves Container Store here is a very strong indicator for me, but I just haven't gotten to a place where I feel comfortable enough with it. But I love Kip and I love the stores and the business, although I'm not at all organized and I don't have a ...

CHRIS HILL:

Yes, in the back ...

TOM GARDNER:

... any use for the products, but I admire people who do and if any of you would like to come over to my apartment and help me out, that'd be great. I'll take the closet. I'll take the travel stuff. I'll take the containers ...

MALE:

I own stocks in AFSI — AmTrust Financial Services — and I believe they were a recommendation of the *Special Ops*. About a month ago, there was an article ... It was in *Pro*, I'm sorry. There was an article in Seeking Alpha, unsigned, that it was kind of a "hit job" somebody called it. And the stock hasn't really recovered from that. How do you see that playing out? Do you have any insider information?

TOM GARDNER:

I love that. Love that.

DAVID GARDNER:

Well, let me say first of all that, that is a *Pro* pick so Jeff is standing up and waving his hand. So, during the cocktail hour ...

TOM GARDNER:

Right now with the microphone ...

DAVID GARDNER:

Or right now, Jeff wants to speak to us ...

TOM GARDNER:

Sure. In song.

DAVID GARDNER:

We've got the advisors here. We've got the stocks and your questions.

JEFF FISCHER:

I almost broke into song about, "We love AmTrust ..." but that could come back to haunt me if it doesn't go well. AmTrust is a company I've known since it went public in 2006. Bryan Hinmon and I, on the *Pro* team, visited management in December, soon before the Seeking Alpha article was released.

We talked to them subsequently since then. We've gone through the reports. We've gone through all their financials that we can. We believe AmTrust is going to release greater detailed financials very soon. They said that's what they were hoping to do. But to be clear, they already release everything they need to as an insurance company. They're going to release above and beyond that to disprove what the so-called short sellers are saying.

So, long and short is we've kept our position the same size. It's actually *Pro*'s largest position at about 5%. It's something I've known a long time. It's an insurance company. There's risk, but we believe in it for the long term.

DAVID GARDNER:

I would like to add only something about articles and not about that interesting company that Jeff obviously has his money where his mouth is. And that is I would encourage all of us to be selective about what we read, retweet, quote and be influenced by. And I think the number one thing I'd be looking for is someone's real name signed to anything that I'm going to be influenced by.

And the second thing I'm going to look for is any public track record that convinces me that, that person is worth listening to. I'm much harder core on this than I was 20 years ago. Twenty years ago, there weren't as many people writing, and there weren't as many fast money movements in our markets. But I think we're only hurting ourselves if we consult sites that feature anonymous authors and who have no track record attached to what they're doing.

I think one of the reasons we're all in this room — and I know we have a lot of people on this live stream — is we get a lot of stuff wrong at Motley Fool, and we do get some things right, but one thing's for sure. You know who we are and you know exactly how we're doing and how we've done. We feature a Motley array of writers. We have lots of people with different viewpoints. But what's important to me is signing your name and having a record.

So, I challenge every other investment source — Internet or not — to adhere to what I believe is the only standard that you and I should be guided by 2014, going forward.

TOM GARDNER:

Yes. Vote David Gardner, two thousand ...

FEMALE:

Could you both give us your most exciting "Best Buy Now?" Thanks.

TOM GARDNER:

LinkedIn at $199.

DAVID GARDNER:

I have approximately 171 stocks under active recommendation in my two services, so I start to struggle when you ask me what my best one is, because I think my best one is that there is no one. I'm not going to dodge the question, though. I'll throw out a couple of companies that I think are worthy of our attention. I've already heard a bunch today. When Matt Argersinger opened up his mouth and talked about MercadoLibre, I think that, that is a company that I believe in, as does Matt.

I find interesting companies all the time. I'm like a kid in a candy store when I have to recommend three new stocks every single month. I have more than that, that I would recommend. And so to me, it's never about one company or one great stock story ... even though in our marketing, that tends to be what people look for and in fact at events, that tends to be a natural question and I would ask the same question, too.

But I think the real story is having 15 to 30 ideas and making sure you're invested in them. So, Bank of Internet, OpenTable, Yandex, 51Job. iRobot. Those are all companies I don't think I've heard mentioned at all in the conference today. And those aren't probably my favorites, and I'm not sure they were on our "Best Buy Now" list in *Rule Breakers* last month, but I like to nudge those kinds of companies forward, because I think of those as the leaders of tomorrow. In some ways, they're leading today. OpenTable is definitely the leader at what it does today.

I think I'm feeling a little edgy today. I don't know what it is. For example, I almost don't want to talk about Apple anymore or 3D Systems. They're wonderful stocks. We own them. We've made multiple times our money on behalf of our membership in those companies. Some of them are volatile. Some of them aren't. LinkedIn is another good example. But it's about much more than the headline stocks.

And the good news is I think The Motley Fool has a good long-term record of getting our members into these stocks, often well before they hit the headlines. But then we end up getting asked those questions all the time about those companies once they're in the headlines. So, just nudging forward, those aren't my best plays now, but those are good companies. I think I own each of them, and I would recommend those for your attention. And thanks for the good question.

TOM GARDNER:

Yes. Full disclosure. He is on our board of directors, but I think Whole Foods ... John Mackey, the co-founder and co-CEO ... I think Whole Foods is an attractive buy. It's $54 now. It was $51. It may have even gone below $50. I think these are attractive prices long-term for Whole Foods. Of course, we're always going to say this. Who knows what will happen in the next year?

But I think looking forward five-plus years, I think Whole Foods has done something that many companies should seriously consider, and that is co-CEO. I think that's a really elegant approach to leadership. And Goldman Sachs, in fact, has done studies to show that the best form of leadership you can have is co-leadership. It's just that if you don't do the work beforehand to get it right, it can be the worst form of leadership. And Whole Foods and Walter Robb and John Mackey have worked together for decades. They're purpose driven. We're conscious capitalist believers.

I think they have new competition — I mean, it's been around. There's emergent public company competition now and awareness that there's competition to Whole Foods. So, alternatives mean they don't have as much pricing power, perhaps ... but I still think Whole Foods has a great position in the market. A lot of growth. There are a lot of people who are learning to eat healthier, and I think that's a trend that's going to continue forever from here, because the Internet helps us be much more informed about what we're putting into our system. So, I would think Whole Foods would be a very fine investment now. And LinkedIn.

MARK:

Hi, David.

DAVID GARDNER:

Hi, Mark.

MARK:

Tom. Chris? All right. I want to put you on the spot.

TOM GARDNER:

We weren't already?

MARK:

No, you guys look too comfortable.

DAVID GARDNER:

This is a little bit of a loungy couch. I just don't see myself standing up, but go ahead.

TOM GARDNER:

One they gave you the microphone, I got very uncomfortable.

MARK:

Tom, you talked about right and wrong. David, you mentioned wrong in a context. And so I want to ask about that. It sounds like that is a bipolar kind of thinking about a stock. Once we thought Apple was fantastic at $700 and I'm not talking about the media. I'm talking about our community. And then they go down to $400 or $385 and they're terrible. And our thesis is broken. And Netflix. The same thing happens, and there's conversation throughout. SodaStream. Tom, you're not wrong today, are you?

TOM GARDNER:

I'm not sure ...

MARK:

So, is that what it is? That we go back and forth? We're right, we're wrong, we're right, we're wrong. But as Ron says, is the thesis broken? And maybe today it is, but our long-term view may not be.

TOM GARDNER:

Someone who is great on this point — Mark, thank you for asking that question. I think David's going to have a better response than I do. That's why I'm jumping in first so you get the real great effect — that and clean-up.

But I'll say Tom Engle, TMF1000 ... you know him in the community if you've seen him. He's done extraordinarily great work in showing — started in *Hidden Gems* in 2005 with us, I think, 2006 — that you really should just pretty much hold what you have forever and look to add along the way with the dips and the rises and falls of the price of the company. Expect that businesses are going through difficult twists and turns and that you just stick with them and that if you have that as your mind-set, you're going to get better investment results. You're going to learn a lot more along the way. We had some of these concepts discussed earlier in my talk.

I would say that I believe that you are coming at this the right way, and it's a very fair and challenging question. At the same time, as a business evaluator, I do look at certain situations and challenge whether or not it would be a good investment now relative to the alternatives. And that can happen when a stock has risen high. I would not personally buy shares of Google now, even though it's been incredible. It's the greatest business in the world, and I'm delighted that we bought it when we opened the Everlasting Portfolio. But at today's valuation and the size of the business, I wouldn't add to it.

I'm not making a moral judgment about them, nor do I need to make a critical series of points about SodaStream. I just don't think it's as good an investment right now as the alternatives that are out there. It's how I felt about Apple in June of 2012. I just didn't feel like it was as good an investment alternative as Google and other companies that are out there, given that it was the largest business in the world and it had a new CEO, and there were some questions that I had. In that one case, I was right, but in many other cases, I'm wrong in that thinking. So, I guess my answer to the question is I think you should stay active in evaluating your businesses and have your disposition that you should be willing to stick with the companies and learn from them over time.

DAVID GARDNER:

Right and wrong come down to the game that you were playing in the first place and the rules that you set up if you did, to define what rightness or wrongness is. So, Mark, you gave an example of our community. Almost the vox populi always getting it wrong — being excited at the top and wrong at the bottom. And that's natural that you would see that or expect that to happen, especially with a lot of new investors.

The Motley Fool has a wonderful ability to inspire and switch on people to investing for the first time. It also means during New Years' times of year where resolutions are kept and lots of members join that you'll see some knee-jerk posts along those lines from people who really are new and it's their first stock and it dropped 15% and it's horrible for them. Whereas for me, I barely noticed it ... not to minimize the importance of any drop.

So, that's the vox populi kind of thing. But I think, at least for me ... and there are any number of styles represented that you've already heard from today ... for me, from day one, every stock pick ... I'm in the batter's box. I'm taking my best swing that particular month — usually three swings through the month — and my aim is to beat the S&P 500. And so, for every single stock that I pick, for me right is that I beat the S&P 500 and wrong is that I lost to the S&P 500 and it's as simple as that.

And I don't get down on myself too hard. In fact, I try to almost forget that I'm wrong. As Tom pointed out in his comments earlier, if you're an investor ... which I know you are ... and you tend to add to your winners, which I do ... your losers actually become almost irrelevant. Not totally, but if they really lose, then the percent that they occupy of your portfolio becomes smaller and smaller and you're like, "Why am I spending that much time bemoaning this?"

So, I think that right and wrong is fine. I like a world with right and wrong. But it all comes down to how you want to set it up ...

TOM GARDNER:

This is wrong.

DAVID GARDNER:

Somebody is persistently trying to dial me on my cell phone. Sorry. So, that's how I think about it.

CHRIS HILL:

We'll go here, and then over there.

MALE:

One of the first stocks that you recommended was Baidu, and it came out and I got it in $25. I bought it and I bought it right on down to about mid-$80s. And I'm really happy with that. A stock nobody seems to talk about anymore, and it's been totally flat, but I'm wondering what you could say about it, is Markel.

TOM GARDNER:

Oh, yes. And by the way, I love Baidu here, as an investment, in the $150s. I wish I had added to it when it dropped. It's an extremely well-run company. A great leader running Baidu. I'm glad you own it and I'm glad you held and added to it along the way.

I think Markel is a very fine investment here. I think this would be an excellent investment. Tom Gayner continues as the chief investment officer there. He's in his mid-fifties.

They're digesting a huge acquisition, still, in Alterra. I don't know if you saw the Tom Gayner interview that we did — this would be 18 months ago now in Richmond with Tom — and he said basically if you look at the historical performance of our stock, after every acquisition we lag, because we're digesting and transitioning that company to our culture ... which is expensive ... to get them to change their practices.

And we embrace that. That's not a problem for us because we're not sitting here worried about our stock price or our quarterly earnings announcement. So, I would say that we're still in that zone now, and I would not be at all be surprised to see us add to that position in the Everlasting Portfolio in the next couple of rounds.

CHRIS HILL:

Over here.

FEMALE:

In the Phoenix portfolio, Panera Bread is back down to about $169, its buy-around price. I was wondering if you have any current thinking on Panera as a good investment right now? It's one of my favorite places to eat.

DAVID GARDNER:

You know, Roslyn, I certainly am glad that we recommended Panera when we did in *Stock Advisor*, and that Phoenix has it because I think it's very appropriate to the Phoenix 1 Mission in *Supernova*. Tom has interviewed Ron Shaich. I got to meet Ron a few years ago. He kind of unplugged from the company a little bit and then came back — almost a Howard Schultz move there. I think that's promising. And overall, I don't have any strong feelings for or against it right now, other than having generally good feelings about it.

You know, Panera is a company that if you look at the clientele, it's mainly women. And there's something that I've always liked about those companies, because I always feel like Wall Street won't quite get it. I still feel there's that male macho vibe to Wall Street and the media that surround Wall Street. And so, I always think they won't really understand Lululemon or Panera. Not to say they can't, because these are really consumer-facing businesses that are almost overexposed in terms of how much we hear about them, but that's something that I just like about Panera.

But, you know, we've had some really good active discussion on our discussion board about Panera and I would encourage you — you may well participate — to plug in. Because one member just announced that his Panera is closing. That reminds me of how much I appreciate our discussion boards, where I hear things that won't come out for press releases a month later. And I'm not used to hearing a Panera closing. And certainly the stock, as you point out, is down some. I try to maintain a very even keel for those kind of businesses — Container Store another one — where we're definitely buying the business. I like owning that business and I think the stock will be an outperformer over the next five years.

CHRIS HILL:

In the back?

MALE:

I wanted to make more of a comment than I have a question, but I'll get there with it and it goes to the discussion of the short-selling articles before. I really wanted to thank your teams in the efforts they put in on the boards when something like that comes out and the stock drops hard — kind of looking at that and providing the analysis.

I think it really helps — I know with my temperament — in just not reacting, maybe, to outside news of these sometimes very strong claims ... to the point where at times I start to rethink about it. Is this now, instead of a bad thing, maybe a good opportunity to either invest a little more or start an investment in a stock and I guess I'd just like to get your thoughts on those events and looking at it positively versus negatively and some of the pros and cons with that.

TOM GARDNER:

Sure. I'll take a shot. I guess I think that anytime a stock or business that you're following sees its valuation drop suddenly for something that isn't really material, that presents an opportunity for you to validate and affirm your position in it. Of course, sometimes those rumors are right. Sometimes a shadowy post from left field is a whistle-blower at a business or the person who spotted Enron early on. Remember. Enron had a lot of affirmation about that business. That was an incredibly successful stock.

In fact, I've taken the blame for this although if Mac Greer is here ... Mac, you know you're the one that fed me this question. But when we interviewed Ken Lay on the floor of the Houston Chronicle Newspaper Conference, in our questions to ask him, my question next on the list, unfortunately forever captured in audio that can be replayed (as it was at my 40th surprise birthday party by Mac, who said he would never do it) I asked Ken Lay if he would like to be CEO of The Motley Fool. So ...

DAVID GARDNER:

A classic audio archive.

TOM GARDNER:

Audio gold. So, I don't believe in so overweighting a position that you're just blindly adding and assuming that everything is wrong out there. But yes, if the information that's coming in can't be verified, it's usually an opportunity to look and think, "Wow. Am I so thankful that this absurd point has been made?" Remember, this one was actually named, but it was David Einhorn, who's a very bright person, comparing Chipotle to Taco Bell and saying that Taco Bell's new burrito was going to take out Chipotle and that's what got us into Chipotle in the Everlasting Portfolio at around $260 a share.

So, I don't know I can be angry at him or make fun of him for being wrong. He's been right in a lot of other situations. But in this case, I'm thankful that he was wrong in a very public way that brought the price so far down that we've basically been given a double in Chipotle because of it. So, yes, I think that your disposition is right, and to look at those situations where there isn't something really verifiable that's been said and the price has come as an opportunity to add ... but also to remain vigilant and to see if maybe there's something about the thesis that you haven't come up with that is at least worth considering.

CHRIS HILL:

We'll take one more question and then we'll throw it over to David.

MALE:

This question isn't specific to stock picking. Obviously you guys are very good at what you do. I appreciate you guys giving us the good and the bad. I don't think anyone would be in the room if they didn't have some confidence in your ability and your team, so thank you for that. It's more in the portfolio composition specific to the Everlasting, taking into account ... and I may be off ...

TOM GARDNER:

I see you looking at notes, meaning that you prepared, and I'm backing up on the ...

MALE:

... but it seems like when we're taking a look at the Everlasting Portfolio ... a Zillow, which is killing it and then conversely, a SodaStream. And it looked like — and again, I'm not speaking for you — that they're still both at holds. At what point in your portfolio composition do you take into account opportunity cost and cutting losers?

I understand your five year, but when you almost get cut in half, you've got to have 100% year to get back to even. When Zillow, or some of your other likes, or perhaps adds ... why not replace and move forward? Or do you guys take into account the opportunity costs? In more of a stagnant portfolio, obviously, you're adding as well. That was my question.

TOM GARDNER:

Sure. I guess the first thing is that, that would assume that I'm right about the "loser." That would assume that I'm right that they should be sold. I believe Xander — if you haven't gotten to meet Xander, who is the NASA rocket scientist behind the tool that we've been creating — Xander has gone back and done analysis of Motley Fool selling and found that we do not sell well in aggregate as a company. And we've thought about that and why is that, and it's often that you sell after the bad news has hit and after the price has gone down.

I mean, I can't sit here right now and say that Coach is just terribly unattractive at $44 a share. I think it's pretty attractive from a valuation standpoint. But from a five-year business-focused hold, I can't yet see the market share losses in the U.S. hitting a floor that makes me feel like the business is now solidified and the valuation is attractive. So, I'm not going to buy something where the business feels uneasy, even if the valuation is very low, if that makes sense.

So, I'm not directly answering your question in that it goes back to my commitment to the five-year hold which is SodaStream is a sub-2% stake in the overall portfolio. It's not going to have a big impact reallocating that money and I think we're going to learn more and possibly find some winners out of our losers that we're thankful we held all the way through.

Really and truly, if you want to know my answer, I would never sell anything in the Everlasting Portfolio, period. I'd Shelby Davis it, and teach the world that this is the way to turn $50,000 into $900 million over a 40-year period. I'm not going to get as good returns as Shelby Davis, nor are you, unless you're using leverage and you have the ability to get margin in a very cheap way, and you're willing to ride the huge ups and downs that Shelby Davis did, but he got 24% a year for 40 years and turned $50,000 into $900 million by never selling. Died with 1,200 stocks in his portfolio. Pretty much never sold.

So, I just think that discipline is so important to teach. That there need to be more and more portfolios out there and more and more investors out there in this financial media, short-term circus that exist showing that investing isn't nerve-wracking. You don't have to be on top of it every day. You can put your money into businesses and let them ride with the leaders and the cultures and the products that are being created by the people at those companies, and it's better to have that perspective than to constantly be trying to rejigger your portfolio. That's my answer. Maybe we'll talk more in the cocktail party hour and go a little deeper on it.

CHRIS HILL:

And with that, Tom and I will exit the stage. We will wrap up day one with some closing remarks from David Gardner.

FoolFest 2014: Tom Gardner's Kickoff and 3 EP Lessons Learned

Published Feb 19, 2014 at 11:46AM

Watch Tom Gardner kick things off at our February member event; then, see him discuss the three biggest lessons he's learned from both the success and failures of the Everlasting Portfolio in *Fool One* so far.

Tom's Welcome

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Run time: 13 minutes

Tom's 3 Lessons Learned

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Run time: 38 minutes

Transcript: Tom's Welcome

TOM GARDNER:

Good morning. What a great turnout. What an exciting day and two days that we have together. The first thing I want to do is just thank you for taking out of your schedules and lives to come spend time with us and with each other.

I just was walking up the stairs ... Anyone who works with me knows that it's surprising that I'm anywhere near on time in life. So, I was jogging up the stairs, just moments ago, and talking to Pablo who flew in from Madrid to be here for this gathering. I know some other people have come from different parts around the world, around the U.S. and it's just great to get a chance to spend some time together. So, thank you.

I also want to thank all the Motley Fool volunteers that you'll be encountering at different points along the way today and tomorrow. We've got a lot of people that are putting in some extra time, so thank you all, Fools all, for helping out.

We've got a great program. Really looking forward to the interview with Malcolm Gladwell. If you've never encountered Eddy Elfenbein, he is a force on Twitter and a real advocate of long-term investing. Pete Miller tomorrow — National Oilwell Varco. We just have a great collection of speakers and it's going to be a great two days.

It's been an incredible year — 2013. Let's reflect on just a few things that happened here. The market up 30%. That's unbelievable. Our services are beating the market, extending their lead over the market, one service after another. This year, as you may have heard, for organizations with an employee count between 250 and 1,000 in the U.S. ... and there are thousands and thousands of such organizations ... The Motley Fool was named the number one best place to work on Glassdoor among all those companies, which is exciting for us.

We're a stakeholder-focused company. What you see in our business reflects our beliefs and principles in 21 years of being Fools — but also all of the amazing things that we've learned from our members — from the organizations that you've created. From the companies that we follow and think about investing in. Best practices across stakeholders helps us think better about the company that we're running, but helps us find better investments for you. So, it's been a great year.

But that means it just gets a little tougher, because it's a little bit more difficult to readjust your expectations after a 30%-up year. There's no way we're going to be up 30% this year. We're already down 5%. If you've been following along in my reports and coverage of our portfolio and new selections, you know that I'm cheering for the market to go down another five percentage points ... hopefully today ... because if it doesn't, I'll be getting on my treadmill desk five days in a row and walking a marathon each day.

When I made that promise, I didn't really consult anyone, so I've had a few people, a couple of members, a couple of people that work at the Fool let me know ... You know, day one, you should be fine. That's probably about a 10-hour walk on your treadmill. Day two, actually, you'll be feeling a little stiff, but you'll make it. Day three, you're going to start wondering if you can make it to day five. Day four, you will be in pain. I have no prediction for you on day five. So, I've never wanted the market to go down so much as I do right now.

And, in fact, I actually think that's a good perspective to have. Certainly, in my earliest period as an investor ... I know I'm in a room full of investors. Many of you have invested for more than five years, more than ten years, more than fifteen years, more than twenty years. I've been investing about 25 years, really seriously about 22 years. And in the first year, if I saw the market go down 5% as it has now, I'd be very worried. I'd be looking at my stocks frequently throughout the day.

In fact, that's how the financial media ... The financial media covers the stock market as if they are a first-year investor. That's why you see things like, "Stocks Cratering!" "Dow Down 140 Points!" with no real perspective on the percentage decline of the Dow and, of course, no larger context. And that's why having someone like Morgan Housel working with us in *Motley Fool One* is so important. He's been such a great addition. Morgan's here in the back of the room. You'll get a chance to talk with him. He'll be on a discussion group today and he'll be around all day and tomorrow.

And just Morgan providing that guidance that may have ruined my year — the guidance that the market goes down 10% on average every 11 months — it's pretty evenly distributed going back 150 years. More. So, you can pretty much expect a 10% decline every year and what you choose to do with that, as an investor, can either hurt or help your portfolio. In our case, we're going to choose to use that as an opportunity to add. We're going to look forward to those 10% declines and hopefully, as I said, we're going to get it this year.

We have a lot to achieve for you today. We have a lot to achieve for you in the year ahead. You will learn from Malcolm Gladwell's book *David and Goliath* as we discuss it — if you haven't read the book yet — that one of the things that Gladwell looks for in great disrupters like David versus Goliath is that they are disagreeable. They're very open-minded, they're very persistent, they're very driven, they're relentless ... but they're also disagreeable. They're never satisfied.

And I can tell you that we're nowhere near satisfied with *Motley Fool One* today. Nowhere near. We're excited. We're thankful for where we are, but we've got a lot of new offerings to improve your experience as a *Motley Fool One* member in the year and years to come. So, you're going to see some of those right after me. Nick Crow and team are going to get up here and present. And Alex Pape and Ally are going to present some of the things that we've been working on.

But, we need to improve the tools that you have — the portfolio tracking tools. Hopefully some of you have gotten a little glimpse of it and you'll get more of a glimpse on our upgrade to our scorecards, and we have a lot of big dreams about that.

I'll just throw one example out that's not yet part of the tool just to show that although I'm extremely excited by what we've worked on and what we've developed, there's going to be more to come. I'm excited about the ability to publish your scorecard to the community without dollar amounts visible — so just percentages — so that you can get a review of the community ... about how you're doing and a commentary below it that you can respond to.

I know that we have some people here in the room or that are streaming live, watching us, and/or watching the tape that have a huge position in their portfolio in a company that they worked at. Sometimes as much as 60% of someone's portfolio is in a single stock. If that stock ends up being Google, awesome. You are buying us drinks this evening. If that ends up being Enron, that's disastrous, and that happened to people, of course.

We want to help you think through the allocation of your portfolio as a company to Motley Fool — and as a community, we want to give you the ability to work with each other on that. I think that's a very exciting additional element to that tool that you're going to see some of ... the work that we've been doing today. So, we need to improve the tools that you have as an investor.

The second thing we need to do is we need to meet you on your terms, more. The technology allows it. All of the dangerous worrying things about privacy have a counterbalancing reality that the ability to create greater convenience and better personal care for your interests as an investor are sort of multiplied, right now, by the technology. So, just two examples.

Some of you want to spend a couple of hours a day investing. Maybe most of your day investing. Some of you would like to spend no more time investing than the time you're spending with us today. In fact, the majority of people in the U.S. and around the world would like to hit the space bar and have their financial life taken care of. So, I know that that's not typical to our team, our group here ... but there are folks among us and there are going to be more and more people in your family, also, who just haven't taken the interest that you have. And we need to create tools and services that make it very easy for you, wherever you are down that continuum.

I remember a great email we got from a member earlier this year who said, "You know, I'm all in pursuing mastery. I care about investing. I love watching the CEO interviews. I love studying businesses. But I've just taken a new job responsibility and I really have to put this on autopilot now, and I don't see a way to do that." So, our position as an investor can change at different points in our career and we need to meet you on your terms more.

The final thing I'll say is we need to continue to pick better and better investments and avoid SodaStream. By the way, SodaStream is up today. I'm kind of shocked by that — I've got to say. Yes, let's hear it. Thank you, Jim. I see that high-hand applause back in the back row. Yes, SodaStream, there's a rumor ... I love the headline I remember. I think it's "Deutsche Bank sees slim possibility that SodaStream will partner with Pepsi," following yesterday's partnership announcement between Green Mountain Coffee and Coca-Cola.

So, we need to avoid more losers and pick more winners for you as investors, and that's always going to be true. We're going to talk a lot about that today and I'm going to have a talk a little bit later today about three things I've learned from the Everlasting Portfolio this year — sort of my annual talk at each gathering.

Those are some of the challenges we face, but I want you to know that we're incredibly excited about tackling those challenges, and I know that pretty much everyone here has a suggestion for how we can do what we're doing better for you and we want to hear them. So, you've got a notepad, a pen. Please feel comfortable writing down all the questions you have or suggestions you have and handing them to any Motley Fool employee that you see.

We'll be gather those trying to respond to some of them in real time over these two days — but really committing in full to answering them on the site. For example, if you literally sat and wrote 14 or 39 questions down over the next 2 days and handed them in, we're committing to answering those questions for you on the site. So, that's going to help us get better at what we're doing.

One example of what we're going to be doing, before I turn it back to Chris, is we're a company now that's right on the cusp of being 100% internally held with no debt. You would be happy if you looked at our financial statements right now. You would think, "This is a great situation. They can reinvest now. They can really build on the service that they've created thus far."

Here's an example of an investment that we're making. Probably at each annual gathering, we'll have some special announcements. Here's one of the special announcements for this gathering and that is that working with some of the *Motley Fool One* members — some of you that are out there in our whole family investing folder — you know that it is our desire, and many of your desires, to figure out how to get your whole family investing.

So, you're going to see some additions to your service here over the next couple of months that are going to allow you to include some of your family members in different ways that we're very excited about. We know that many of you want to get your children invested or your grandchildren — your nieces and nephews. So, we are investing $250,000, beginning today, in Fool Junior, getting young people in your families to start investing alongside you and we're pumped about that.

That's something for us to circle some ideas around here over the next two days, because as we know, money doesn't solve all problems. We're making that investment, but we've got some good ideas. We've got great ideas out in a discussion group. We've got a great team of people that are interested in it internally and in the community, so that's something that we're very excited about.

So, there's a lot coming your way here over the next two days. I'm looking forward to talking to every single one of you, but you probably have heard this from us already. I think some of the most important connections you'll make of new ideas and great people here are actually other members — so please feel free to introduce yourself to anyone. Most of us don't know most of us, so let's spend the next two days getting to know each other better and having fun, pumped up. Chris Hill. This is where I throw the mic to Chris. Let's see how he does.

Transcript: 3 EP Lessons Learned

TOM GARDNER:

... so I want to share three lessons learned from the last year. This is what I did at last year's gathering and I think I want to do it each year — just looking back over the 12 months that were and see if there are any lessons that we can draw that help us as long-term thinkers and business-focused investors. So, we're looking at a discrete amount of time. I may laugh a little bit about the SodaStream investment and then maybe it will be acquired for $93 a share in two weeks and I'll be here going, "Let me tell you why SodaStream was built to last."

I mean, we're all learning as we go, and there are going to be some ground rules for my three lessons, so here they are. You may write these down if you'd like to follow along, and hold me accountable and also I want to reiterate what Chris said. We are changing our mentality on Q&A at The Motley Fool and we are starting to build ourselves up to be able to answer any question you have at any time. That's what we're aspiring to.

So, when you go home, and you're in front of your device that you're accessing the Fool from ... right now you maybe navigate your way into the message folders and maybe you feel uncomfortable posting something in public. So, that makes it harder and harder for you to get answers to the questions that you have. And what we want to do is to begin to build the wheel that allows us to answer them continually and to build up a database of answers that we can share with you, as well, that's searchable. So, every question you ask helps us, truly, and if you drop them in the box, David and I can answer them later today or we'll answer them on video on the site.

So, here are the ground rules. First of all, by the way, we're about two hours away from LinkedIn's earnings. I can't wait ...

So, it's three factors. They're principles. I am considering making them mandates, requirements, as investment principles. I do that rarely — and I will say I'm only considering it — but I am considering it. These are lessons that I've learned. The goal is to optimize our long-term performance from them.

I believe that these three lessons are more important than the valuation of a business, and valuation matters to me. But we talked about this a little bit in our last event and video — namely that when you're a long-term, business-focused investor, valuation is not as important as other factors. So, we'll talk a little bit more about that, but I'm advancing that these three matter more to me than valuation.

And finally, they're not clear reads. It's not like, "Oh, OK. Obvious. Check, check, check, check. This one's going to be a winner." So, rarely they are clear, but sometimes you have a good sense of them.

So, last few basic bullets before going into the talk. As you know, from reading at The Motley Fool, we're going to be right like six or seven times out of ten. Maybe five or six times out of ten. That's just the nature of the game of investing in stocks — making sure that we're all building our portfolios for those few losers that congregate in every 10 selections that we make. It's just the nature of the game. Now, some of you may be sitting there thinking, "You know what? I'm actually at about 90%," in which case I'd like to talk with you afterwards and jobs.fool.com is open to you.

Second obvious statement is there will be blood in the markets, as we know. We've seen it five years ago. We've seen it thirteen years ago. It happened in the early 1970s. Happened on a single day in 1987. We all have to build our portfolios and build our temperament to handle downturns and here we are just five percentage points down —

even less — because the market, unfortunately, is up today. And we see the headlines. So, people are being trained to get emotional by the media and we have to counterbalance that in our investments.

I said this last year. The best investments, in my research, fall 40% twice within a decade. You see the volatility of a company like Tesla stock — you can expect that one is going to get cut in half at some point in the next decade. I would guarantee that, in fact, and yet a lot of us at The Motley Fool — found, recommended and invested in that company before I did. Here we were at $146 in the *Everlasting Portfolio* and it's at high $170s now. It's a short-term return, but obviously we believe in Tesla.

Finally, you will be right and I will be wrong frequently, so that's how we're going to learn together.

So, here are my three principles:

1. The first one is that I think every month that passes, every person that I get to interview, every business that I study ... I become more and more certain that looking at the leader is incredibly important. I'm going to make a few recommendations on a couple of factors to think about when you're evaluating a person.

The first is what is their tenure in the industry? And I don't want you to get too caught up on *they've been in the business for 31 years* because you couldn't say that about Mark Zuckerberg. So, I'd like to know what's the tenure in the industry as a percentage of their professional career.

And overall, you probably know I'm not excited about CEOs that jump from one industry to the next. There are some of them that are excellent at it because they're turnaround specialists, and so I might look at their industry differently — like their industry is turning around businesses and they know how to do it. So, that would be an example of an exception to this rule. But overall, if I'm not finding somebody who started the company and is running it, I want to know that they've really been in the industry and they care.

Selim Bassoul did not found Middleby. He discovered it broken, but he was not the founder of the business. But if you look down the top 12 holdings in the *Everlasting Portfolio*, which makes up 75% of the portfolio — the top 5 companies make up 50% — you're looking at one founder CEO after another.

You've got Monty Moran at Chipotle. Mark Zuckerberg. You've got John Mackey at Whole Foods. In fact, Jeff Weiner was not a founder of LinkedIn, but I see him in the industry going back to his days when he came out of Wharton. So, I really want to see the tenure of the industry — that essentially, pretty much, their entire career is in that industry. Tomorrow, Pete Miller, National Oilwell Varco. Graduated from West Point, 1980. Was in the Army for five years and has been in oil and gas ever since. I love to see that and we'll be learning more from him tomorrow.

The second is that there's a clear demonstration that they're on a mission. They have a purpose that's driving them. You know, the more that I look at these qualities as I wrote them down, the more I thought, "Gosh, it's just Elon Musk. It's just obvious. It's just sitting right in front of us. It's so obvious." And what a great job by David and his team finding that stock. Alex Scherer in our *Stock Advisor* team putting it on my side. Elon Musk is demonstrating all of these qualities, but a number of the CEOs in Everlasting Portfolio are, so number two, they have a mission. They're aspiring to change the world for the better. That doesn't happen in every CEO that I meet. I don't get that feeling in every CEO that I meet.

The third is that they have an ownership stake that matters — so, their capital is on the line. Once again, I'll just say Elon Musk. Gosh, didn't he own enough Tesla already to not have to go out and buy more in the public markets? And that's just a really great sign when you see that happening. Warren Buffett has said he loves to find a CEO that is managing that asset as if it's the only asset that their family will have for the next hundred years. So, really looking and seeing if we have that type of person running the business that we're investing in together.

And finally, from a business standpoint, I would say I like to find the youthful founder CEO on a mission with a big equity stake. Mark Zuckerberg, in 20 years, will be the same age as Jeff Bezos is today. He's got 20 years in his professional life to impact the world. Now, returning to one of the ground rules, I'll be right six or seven out of ten times. Mark Zuckerberg may step down as CEO of Facebook this year or the company may fire him in four years as Apple did to Steve Jobs.

We don't know what's going to happen, so we're playing the probabilities, but I think finding those qualities in our leaders is really important, because what we want to find is somebody who cares more about their company than we care about the investment we've made in their company. In fact, what a sickening feeling if you ever have that sense and have had that sense — which I have in my investment career — of wow, I'm not sure the CEO cares nearly as much about the future of this business as I do about the money that I've invested into it. That's not a great feeling to have at all.

It's easier and easier to get that read on what's happening out there in the business world and how passionate and purposeful the leadership is. And let me mention an example of where this has worked against us. That is that in my interviews and interactions in the time I got to spend with Lew Frankfort, the founder of Coach, he demonstrated everything that I look for.

And I was talking to Selim Bassoul, about four weeks ago, about different companies in the *Everlasting Portfolio*, and he was saying, "You know, the thing about Lew Frankfort is that think how uniquely great you have to be to deliver the results that he did in the fashion-fickle business. Just think how brilliant he must be. Therefore, his successor ... it's going to be very tough." And I've written before in the past that it's actually when you are the successor to a company like Coach — that business is larger, more complex than at any point in Lew Frankfort's leadership of it — so you actually need somebody who's going to be better than Lew Frankfort running Coach.

So, the transition point on succession is increasingly important to me and really trying to understand do they have a culture that's going to produce a leader that's ready to be as great or better than the present CEO. So, that's where leadership and culture start connecting.

Those are some of the factors that I see in leadership. The Ron Shaich interview — if you got a chance to see it from the Conscious Capitalism Conference itself on *Motley Fool One* — Ron talks about his investment approach. He's the founder and CEO of Panera, or actually he's the founder of Au Bon Pain which bought Panera and then spun off Au Bon Pain and they went all in behind Panera. And basically Ron said — at one point we were talking about leadership — and he goes, "Oh, yeah, yeah, yeah. When I invest, I invest in founder run. I want to know the person is there and this is their life. They're passionate about it."

There are enough of these companies out there in the public markets that they at least deserve our serious, serious attention. In fact, it is my aim to make the Everlasting Research Center the number one place to study and understand founder-led companies and CEOs with ownership mentalities. So, we're going to be building out that in the year ahead.

So, there we are. We've got Selim Bassoul. We've got Mark Zuckerberg. We've got Monty Moran, John Mackie, Frank D'Souza at Cognizant, Spencer Rascoff, Pete Miller. These are ownership CEOs. Whether they founded the company or not, they're all in and I love to find that. That's point number one. I kind of feel like maybe I should mandate that — that those are the only companies that earn their way into the *Everlasting Portfolio* — the companies that meet the criteria that we're developing about leadership and culture.

2. The number two important factor is pricing power. Does the company have pricing power? How many of you watched the Bruce Greenwald interview? If you did, you saw Bruce attack everything about my investment approach, which was very fun for me. Bruce is a professor at Columbia University. He's kind of like the anchor at Columbia that still says you can beat the market in the major wave across academia that's trying to just present that it's impossible to do and you might as well passively index. Of course, we're fans of passive indexing, but I love people like Bruce who are standing out there and demonstrating that you can be above average. And so, Bruce and I debated my investment approach and we talked a lot about pricing power, but I want to go through a few principles for identifying whether or not your company has pricing power.

This is Warren Buffett's number one factor. He said that he looked back across all of his best investments over the last 50 years, and the single factor that connected with each of his best investments is that they had pricing power. And if you saw the Jim Sinegal/ Costco interview that we did, Jim said, "Yes, we feel that we have a lot of pricing power at Costco, but we never actually put it to use." Like it's even better to have pricing power and to not have to use it, but you want to find companies that do have pricing power. So, one of the easiest ways is to look and see a product that you think is just overpriced but you, yourself keep buying it. There's an alternative that's less expensive, but you're just not willing to really consider it.

Bernard Baruch, the great investor, was asked by a woman at a party to name a few stocks that she should go home and buy, and he said, "I'm not going to give you a few stocks. I'm going to give you a few principles. Just use these and I think you'll end up succeeding." By the way, this woman, who started with a small portfolio, died with more than $15 million and about $10 million of it in one stock. And she did it all based on his principles, so he totally changed her life at the cocktail party with these three factors.

They were only invest in companies whose products you buy every 30 days or less, throw them away and buy them again. Those companies have pricing power because they have your habits, they have developed a brand. There are many great household product companies. There are many great beverages. Starbucks is a great example of this. So, having that mind-set of, "Wow. I'm repeatedly buying from this business and there is a less-expensive alternative, but I'm not really willing to entertain it." And then more important than that, of course, is broadening beyond your own view and observing what's happening in the world. There is a less expensive phone, but no one's buying it.

And then, of course, you might start looking at your company and seeing there's a less expensive alternative and people are starting to buy it. How innovative is my company to go to the next product where they can maintain or develop pricing power around that product? So, the world is always evolving. Pricing and competition are always changing. The incredibly unique offering of today could be the commodity of three years from today. So, it's not an easy, clear read. But trying to figure out does my company offer something that's truly unique? Is it offering it in a way that I am repeatedly using it and/or other people are repeatedly using it and/or buying it? So, repeated, habit-driven use or purchasing.

And, I guess the last thing ... I don't know that I've ever seen this term out there, so maybe I'm coining a term right now, but probably somebody's used it, and that is, is there a brand flock? Are people flocking to that brand? Just look at the line at Chipotle. Just look at the enthusiasm that people have when they hear that one of their friends has a Tesla and they might be able to test drive it. I mean, who here would test drive a Tesla right now if we had one out front? Hey, David Gardner, in the back row. Don't you own a Tesla? Out front? I won't do that to you. I won't say that.

Try and see what you're excited about. People celebrate a Chipotle coming to their neighborhood. We have contacted Chipotle and said, "Please open one near our office." So, whatever your neighborhood is getting excited about or you're getting excited about that offering coming your way, that's a sign of something unique that can develop pricing power.

I don't think SodaStream has any pricing power. So, it would be good to maybe mandate that we look for businesses that are gaining or maintaining pricing power, and of course, referring back to the original principles, we'll be wrong three or four out of ten times. But I think that what Buffett said, as is often true, makes a tremendous amount of sense, and that is that pricing power really matters.

And one last point on this. Things are always changing. I don't think it's good news — the announcement that Starbucks just made. I think it was a smart move with their executive shift — that they've placed greater emphasis now on the world's changing. There's a seismic shift, as Howard Schultz said, in retailing and that is going to negatively impact Starbucks.

The repetitive demand that Starbucks gets by being in malls and other retail areas will be drawing smaller crowds because people will simply be ordering more and more things online. That takes away some of the natural foot traffic that Starbucks gets just from people being out there. That's not a good thing for Starbucks. I think Starbucks is smart in making some shifts to focus on the future. Maybe we'll be getting our Starbucks delivered to us in a self-driven, driverless Google car. Brought to you by Uber. Delivered to your door. Who knows? But Starbucks is right to be thinking that way.

In fact, one of the interesting things about having pricing power and habit and repetition is that you actually can lose that sense of innovation in your organization and start to just assume you've got it made and that's, of course, when you're starting to look like Goliath and a David is going to come along and disrupt you. So, these are some of the challenges that businesses face out there, but I know we want to find businesses that are gaining pricing power.

3. So, the third lesson that I've learned. I guess I'll say the first two lessons — I like to learn as much from my failures as from my successes, and I like to learn as much from my successes as my failures. I would like to place an equal emphasis on both. If you forced me to try and learn more from one than the other, I would say my better long-term returns are going to come from learning from my successes ... just sitting and studying what are the patterns and factors that have led to these great businesses and how can I find more of them. And if I'm trying to preserve wealth and reduce the volatility of my portfolio, I'm going to learn more from my failures and try and figure out how to avoid the mistakes that I've made.

So, if I look at the failures of the first two principles, I would say when we talk leadership and culture, we have a turnover in leadership at Coach at a crucially competitive time with Michael Kors and I think that is definitely one of the primary reasons that I have not added to Coach. Even though I know from a valuation standpoint it may look attractive — as I said, these principles are more important to me than valuation. On the pricing power front, I don't think SodaStream has pricing. It doesn't matter to me how big your market opportunity is. In the long term, if you don't have pricing power, it just means you're ultimately going to be undermined by somebody, and that worries me. So, those are my learnings from my losers.

If I'm to learn from my winners, I'll just put Facebook for both of them. I think Facebook has a lot of great leadership and culture as business, and I think it's gaining momentum. Obviously, there's questions about teen usage in Snapchat and that will be an important factor for them, but the bulk of people are using Facebook a lot and advertisers are more excited about being there than they were a year ago.

So, my third factor is simply a reminder of a prior factor and one that naturally will always be questioned, and I understand why. And I remind you that you don't have to follow this or any factor that I present. But the third factor is, this past year I've learned how much I love, even more, requiring that I may not sell within five years, because I have a friend who, through our recommendations in *Rule Breakers* and *Supernova* has bought 3D Systems. She's up. She's very happy. But we saw what happened yesterday.

And she sent me an email — an exchange she had with her financial advisor — and it reads like a playbook as to why you should hold a stock for a minimum of five years and have that mind-set. Because the amount of anxiety that went through that email because of the big single-day drop — it's just too easy to confuse volatility in pricing with long-term business performance.

And I'm not here to predict right now whether 3D Systems is going to succeed or not from here. I'm just saying that the entire conversation that happened about that stock and that email I saw was about short-term price volatility. It wasn't like, "Hey, I've looked at the business and the leadership team and I have some questions about it." It was, "What should I do now that the stock is down 20%?" I totally understand that. That's human nature, but it doesn't lead to better investment performance.

So, here are a few reasons that I love the five-year hold. I encourage you to follow me in this. I would encourage you to even double it to a 10-year hold. If you're feeling like you want to improve your returns, I would go even longer-term. Warren Buffett's sixth largest holdings — one of them is IBM, which he bought somewhat recently, so we'll kick that one out. The other five — the length of the holding period of those five companies — twenty years for Warren Buffett. So, I'm suggesting ten years. Best investor in American history — 20 years across his largest holdings.

So, these are some of the reasons that the five-year hold is so important to me. Number one, let's talk about the losers, the ones we want to sell. The beauty of holding SodaStream for another four a half years is that I will learn this lesson every month and there may be other great lessons about SodaStream. It may succeed. So, I still have skin in the game. I made the commitment to start, so I'm going to learn.

And let's say it doesn't work out. Let's say SodaStream falls to $19 a share and it's just sitting there four years from now. I was able to learn some very important lessons about a tiny portion of my portfolio. That's what your losers become. They become insignificant percentages in your portfolio. So, the ratio of important lessons learned to actual cost of learning them is very favorable by holding onto your losers. I know it's a contrary way to think, but I truly believe that.

Number two and far more importantly, it starts to develop the discipline in you to hold your winners, which is the most painful way to lose money. So, you've heard me say it in the past, but I bought Dell in 1995. I know Dell had some troubles here in the last five years — but all in all, as a public company, it was an incredible stock. I bought Dell in 1995. Stock went up 25%. I celebrated. I was like, "Wow. Twenty-five percent in six months?"

I ran my valuation numbers. I sold. Let's say the stock was at $25 and I waited for it to return back to my original buy price of $20. I was like, "Sweet. Got it." Stock dropped to $21. Never got to $20. I was waiting for my price, sure that my valuation was right all the way along and I'd make 25% in less than a year. Then the stock went up 40x in value. So how many losers would I have to sell in order to make up for the money that I lost by selling Dell too early? So, the mathematics suggest the most important thing about long-term focus is that it teaches you to hold onto your winners.

Final quick points. It separates environmental, large macro issues from the strength of your business that you're invested in. It separates volatility in pricing from the strength of the business that you're investing in, and it basically, finally, sets you up to add more along the way to those companies. In some cases, the price has gone down, but you've researched the business. You love that situation.

Interestingly, I have added to none of my biggest losers and none of my biggest winners in the *Everlasting Portfolio*. That's what I've done. I'm pretty sure you know the answer, but should I be celebrating that or should I be bummed out by that? The answer, I guess, is at this point we don't really know, because we'll see how the businesses play out over time. But if we took a snapshot right now and this is where we were, and this was it ... then far and away the worst thing mathematically is that I didn't add to my winners.

So, I can celebrate that I saw the problems with the losers, but I haven't seen enough of the opportunities in our winners, and I think really committing ourselves to being business students focused on leadership, pricing power and long-term commitment to our investments opens the possibility that we'll learn enough to realize where we should add along the way. And the beauty of it is, with all these mistakes, here we are in the *Everlasting Portfolio* up 25 percentage points. What we're trying to do is get better and better together and apply these principles and see where it takes us.

I think there is maybe three or four minutes left and I can take a few questions and/or we could break early if you wanted to.

FEMALE:

You call the losers, or the ones that you consider as losers now "losers," but with a long-term time horizon, they may not be losers. So, maybe it's too soon to call.

TOM GARDNER:

That is true. Definitely, Roslyn, true. So, I called the losers "losers," but here we are. If we had only started in the spring of 2012, we would have called Baidu a loser at one point. Now we call it a winner. So, depending on when you purchased LinkedIn, you may be calling it a loser right now, or you may be calling it a huge winner. That's what time horizon allows us to do, is to widen the lens, and it is very easy for the human brain to focus on what's happening right now, including my brain focusing on what's happening right now.

However, I would say that in the context of Coach and SodaStream, I have to see some profound change, now, to their situation for me to believe that they're going to be successful investments. I may be proven wrong. Succession planning at Coach may go incredibly smoothly. I have a bet with Alex Scherer, who I don't think is here right now ... When Michael Kors and Coach were pretty much right around the same price — I think in the low $50s — we made a five-year bet and he has to buy me dinner in New York City if Kors is better, because I think Michael Kors is a better situation. Michael Kors is at $91 now and our Coach is at $44.

So, you might say, "Well, why didn't you just make that flip?" Because, again, I think the lesson is going to be more important in that investment. But, you're right. Those two companies may end up being winners for us. I see fundamental business problems for them.

FEMALE:

[00:28:19]

TOM GARDNER:

Let's hope so.

MALE:

[00:28:38]-[00:30:07]

TOM GARDNER:

At this point, just enter the sound of a question mark. I agree with many of the things you're saying. How do I do valuation or how do I think about valuation? A few of the points that were made were you've got Michael Milkens out there. You have companies that are frauds that, that concerns. How do you think about the time horizon and the principles that you're applying to look for a great business?

I guess I'll say that each of us has to figure out how to set our portfolio up. I think what we're trying to do, when we showcased our financial planning tool earlier today ... that has a fiduciary, SEC set of rules applied to it ... is we're trying to set an example for you of how to create a balanced portfolio. Whether you choose to use that tool or not is up to you, but we want to show and provide context, and I think some of the lessons and principles I'm sharing here are trying to help set a context for how to think about the individual businesses you're choosing to invest in and then how to set your portfolio up to accept the natural ebb and flow that's going to happen in the market — rather than feel that you can time it one way or the other.

I think my portfolio view, from a technicals or from a perspective of when to be invested or not ... I'm fully invested. My approach is to be fully invested. To invest the money when I have it. To take the Shelby Davis approach of just buying stocks and using it like a bank over your lifetime, accepting that you're going to make some mistakes. And valuation is important to me, but valuation is just as unclear as the principles. Each situation comes along. We try and figure it out, and if you're me, you're like, you know what? No, I'm not going to buy Under Armour here at $49. I'm not going to buy it here at $82. It just looks too expensive. And here it is at $105.

And so, the way that my mind works is to say, I'm not actually going to let myself walk away from that. I'm going to go back and look at it, and try and understand why I was wrong. Not to assume that the market was wrong, or other investors got lucky, or that's just a style I would never embrace. Even if I won't embrace a particular style, I'd love to understand it more and more.

The study of Under Armour is going to be a very fun one for me this year — to understand why have I missed a company whose leader meets all the criteria, which has pricing power pretty solidly at Under Armour ... although I will say that I slightly misread that. So, all of these principles I'm trying to apply to literally every company. I definitely love to study the companies that I've missed, which are often because I placed valuation too high on the list. It's the Buffett line — it's better to pay a fair, full price for an incredibly great company than to get a great discount on trash.

FEMALE:

First, I just want to thank you for the extraordinary day that your team has set up for us here. This has been terrific. And given some of the things you're talking about in your lessons learned and your principles are really about discipline and thorough thinking. So, having said that, why have you chosen not to add to your winning positions in the EP?

TOM GARDNER:

I think that probably valuation crept in a little too much. Now, we live in a particular point in time. There may be a moment where, all of a sudden, dare I say it, Under Armour's at $67 a share and it's like, "Wow!" But I will probably never be glad that I waited and didn't buy it when Jason Moser did in the $40s.

So, I like to keep resetting to the present day and trying to modify my principles to understand where they've been wrong while recognizing that my principles may actually have been right. They just haven't played out that way, yet. So, that's some of the multilayer complexity of being an investor, is trying to figure out, "When do I tweak my principle because it's actually not working? Or when is it just a matter of time until it does work?"

You could have been sitting there in 2000 going, "Why have I not purchased JDS Uniphase? Why have I not bought the stock? It's gone from $15 to $340 while I've been watching it." And then in 12 months, it's below $3 a share. And you're like, "Wow. Was I ever right." Hey, by the way. Who did own JDS Uniphase and was talking to me for the last 18 months? Oh, I wasn't meaning that in any specific way. I had plenty of those.

My point is that sometimes given enough time, your principles play out. Other times, you see enough evidence that your principle isn't right. And I think that David, for growth companies, has the right principle that valuation. My dad has said to me something that's been profoundly helpful for me over the last 10 years, and that is, "It's not a good idea to be a value investor in disruptive growth companies." You've got to look somewhere else. You can be a value investor in other industries, but saying, "Hey, this is awesome. The cheapest company here is Dell. I'm going to buy that," when Google, Facebook and real disruptive growth businesses are in early phases of their trajectories. So, I just think I applied valuation a little too tightly on some of my winners and hopefully that will play out differently.

MALE:

I recognize your five-year hold period — that's a rule that you're following — so you're down on SodaStream and Coach. And if you're a portfolio manager, and you're trying to maximize returns, and that's the position you're in, do you sell or do you hold?

TOM GARDNER:

If I'm trying to maximize my returns over a short period of time, I'd probably sell. If I'm trying to maximize my returns over the next 20 years, I hold. That's my belief. The mathematics may not support it, but maybe some unquantifiable, educational truth is out there that learning as much as I did from Select Comfort got me into different types of companies and out of different types of companies because I stuck with it and had to eat crow and die my remaining hair, at that point, green because Select Comfort did not succeed. So, I think that there's a bigger value reward for staying in it in the long term than the monetary award of getting out and into something else quickly.

There are a lot of questions, and I see time's off in the back. We're here together for the next two days, so I'm happy to answer everyone's questions along the way. We do have the resolution table with the box. I am personally committing that we're going to answer your questions, so I love that you have them. Sorry that we don't have enough time to answer them all right now, but I look forward to doing so over the next 36 hours together.

FoolFest 2014: Eddy Elfenbein of Crossing Wall Street

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Run time: 55 minutes

At our February member event, *Fool One*'s Morgan Housel introduced Eddy Elfenbein as "one of the wisest investors I've ever come across" — and you'll soon see why. The editor of Crossing Wall Street, Elfenbein talks about the big trends he's seeing in the stock market, how people really make money investing, and what he looks for when he's researching a potential investment.

Transcript

MORGAN HOUSEL:

The worst position that any speaker can be in is having to go onstage after Malcolm Gladwell, I think, but we're going to try this. My name is Morgan Housel. I'm a writer for *Motley Fool One* and I write for Fool.com, as well. I'm here today to introduce our next speaker sitting next to me, but first I want to talk about something that's near and dear to my heart, which is the intersection of finance and the media — so the news articles and the blog posts that we read learning about the market and learning about stocks.

I did some research at the Library of Congress this week. I wanted to see how has the financial media changed over the last century. So, I found some numbers. In the 1920s — it's almost a century ago — there were about 7,000 news articles and magazine articles published every year that had to do with investing that contained the words "stock" or "market" or "bond" or something like that. Seven thousand per year. By the 1960s, that was up to about 18,000 articles per year about investing. In the 1990s, it rose to 48,000 per year. And does anyone want to guess how many investing articles were written in the last 30 days? It's not talking years anymore. In the last 30 days, how many investment articles were published? That's everyone. All news sources. Everyone. Yes.

The answer is 890,000 in the last 30 days. So, we publish, in every 90 minutes today, we publish more investing articles than were written per year one century ago. And in many ways, I think that's great news because that's the democratization of publishing. There are thousands of investors today that have a voice that would not have even five years ago — and that's wonderful, because there are so many brilliant investors. They're not journalists. There's investors — people like yourselves in here — that everyone can learn from. But there's also a point where that's just completely overwhelming. If you wake up in the morning and you want to read financial news, and there are almost a million articles published every month about investing, where do you start? That's the classic drinking from a fire hose. There's even no place to start.

So, I think today, more than ever and growing by the day, it's important to have some sort of filter on what you read, and to have a list of people that you know you can go to consistently to find the best news information. And for me, over the last several years, one person who's been near the top of that list is this guy sitting next to me, Eddy Elfenbein.

Eddy is not a journalist. He runs a blog called CrossingWallStreet.com. If you're not familiar with it, write it down. Bookmark it. You won't be disappointed. He's an investor. He has a track record of outperforming the market. He's one of the wisest investors I think I've ever come across. He's one of the best and funniest writers that I've come across, as well. So, I hope I didn't set the bar too high, Eddy, but I think you're going to enjoy him today, so please welcome Eddy Elfenbein.

EDDY ELFENBEIN:

Thank you, Morgan. Thank you for those generous words. As I thought about what I wanted to talk about today, I could come up and talk about stocks and P/E ratios and dividends and things like that ... but instead I want to take a step back and talk about some of the trends going on, on Wall Street and in the economy that affects us as investors, and things that are important and shaping how we think about our investments. And I see two particular trends that are tied together that are impacting the investing world.

One aspect, one trend is we're seeing the dispersion of knowledge and twinned with that, we're seeing the concentration of authority. Another way to think about this is it's the dispersion of expertise and the concentration of power. And these two happening at the same time — and I think in many ways reinforcing each other — are causing frictions within the investing world.

Probably one of the best examples — this would be one way of looking at the financial crisis. It's the divide, you may have heard, between the suits and the geeks. At many of these large investment banks, they just didn't know what was going on with the structured products. It was a whole new world. The managing directors — they had no idea what was going on with all the formulas and the quantitative analysis and the rocket scientists. Another way we can look at this is what happened with the Obamacare rollout and the website and the problems with that. It's this divide between the suits and geeks and the dispersion of knowledge and the concentration of power.

We see this happening on Wall Street where we used to have the large, big banks and the cult of the analyst. Do you remember years ago the analysts would come up and they would give their view of a stock — and it was so important as far as hitting earnings or not. A lot of that world has really changed. The banks have cut back on their research departments. They just don't have the coverage. They'll cover the larger companies, but the smaller companies, the up-and-coming companies ... they really are not covered by a lot of Wall Street. This really changes the investment landscape. It also changes how we think about risk and what goes into investing.

Now we see some of the most important names —when they give their advice on a stock — we see the rise of the active managers. You may see this on CNBC. These are people like David Einhorn and people like Bill Ackman. We had Carl Icahn. Just think about this. He tweeted his opinion on Apple — this was a tweet — and it moved the stock $17 billion just off one tweet. The role of the analyst has fallen dramatically. We see people like Jeffrey Gundlach. Many of you people may know him. He's one of the bond experts.

But who are these people? They're not from the old Wall Street. Gundlach is one of these people — maybe you've known people like this — one of these people who's superintelligent and sort of bored by this, bored by that. He had near-perfect SAT scores. Went to Dartmouth and was kind of bored, so went to Yale for graduate school in theoretical math getting his PhD program. And he wanted to, for his dissertation, his idea was he wanted to prove that infinity does not exist. They said, "Maybe this isn't the right place for you being in the graduate program," so he was like, "Okay," and he went off to Wall Street and made an incredible fortune. But it's these kinds of people — these are the people who have the voice now on Wall Street. These are not the kind of people that you would see many years ago if you saw Louis Rukeyser.

I'll give you another very good example. On the first season of *The Sopranos*, Carmela Soprano — she decides she wants to learn about the stock market. She sees that her friends and her neighbor, in their tony neighborhood ... they're into the stock market and she wants to know about it, too. She doesn't go to Morgan Stanley. She doesn't go to Merrill Lynch. She certainly doesn't go to Lehman Brothers. Do you remember where she goes? What was that? That's right! She went online and you could see she was on Motley Fool. These are the kinds of things that did not exist years ago. These are the dramatic democratizations, as Morgan talked about.

Another good example. This happened about 30 years ago at Salomon Brothers, which at this time was a private investment bank. So, they had their managing partners and the firm was bought out by a public company. So, the head of their equity trading division was a man named Michael Bloomberg, and Mr. Bloomberg was told on the same day, "Here's $10 million and you're fired." He was no longer needed at Salomon Brothers, but since he was a managing director, he got part of the buyout. So, he took his $10 million and was never heard from again ... No, no. He started Bloomberg and he's one of the wealthiest men in the United States and the entire world.

But think about this. His fortune was not through inventing a new company, a new consumer product. It was financial news. That's what he was providing. Everything flows from those Bloomberg machines and Bloomberg News and Bloomberg TV. It all started with those Bloomberg machines. It's giving news to investors. We live in a world where we're drowning in information, but there's not enough news, and this changes how people think about their investments. It changes how people think about what is risky and what is safe.

Now, let me give you a good example. I'm going to talk a little bit about NFL football, but I'm actually talking about the same themes. There's a man named Brian Burke. He lives in this area. He was in the Marine Corps. He was an F-18 pilot flying the Hornet. Those are the guys — they certainly have the right stuff. And when Brian left the Marine Corps, he was into numbers and football, and he dissected football and exactly what goes on in the game.

And his theory — and he's not the only person who's developed it. He's probably the most prominent — but he says that in the game of football, coaches don't go for it on 4th down nearly as much as they should. They should go for it on 4th down far more often. Now, I'll skip over the technical parts. You're not a sports fan. But basically he said, if it's 4th and 3, you should be going for it. And unless you're really backed up inside your 20, or it's 4th and very long, should you punt ... but your punter should be doing a lot less business. In fact, even field goals, you should always be ... If it really comes down to it, you need the ball to score.

Now, this is exactly how we think as investors — what is risky and what is not. It's management of resources — forecasts of different moves — if you do this, they do that ... and it's risk/reward. It's exactly how investors think. And what he's saying is it's all wrong. But then we see this exact suits and geeks divide. NFLs, who are you? Who are you to tell us this? You're just a geek running your numbers. We know what's going on. These are players. We know what's going on. Authority always argues from a position from authority.

And Brian has had absolutely zero success in changing the game of football. He's talked about this now — he has a space at the *New York Times* and nobody listens to him. The NFL coaches just go on doing what they're doing. Now, some of you may remember there was money involved where that had an impact on the game, but actually that was on the game. That was at the GM level. This is different, because it's actually going into how football is played.

And it's a fascinating aspect because there's something about the human brain that just doesn't get statistics. We just do not understand probabilities. It's so much against our instincts and how we think, and we see this happening on Wall Street all the time. Fear and greed are not the same. One of the deep truths about the market is bull markets tend to rise very slowly. Bear markets tend to be very sharp, very sudden and very painful and that's because it reflects something about human nature. In the earlier discussion, they were talking about short selling. Short selling is very, very difficult but you can make a quicker profit if you get it right because it's much more common for a stock to drop 50% or 70% in a day or in a week than it will to rise that much.

I'll give you another good example. Some of you may remember this. This happened in the late 1970s. There were two brothers. They were named William and Nelson Hunt. Some of you may remember this. And they had a plan. What they wanted to do was they wanted to buy silver. Actually I undersold that. Their plan was to buy all of the silver in the world. Every ton. Every pound. Every ounce. All of it. And once they did that, then they were going to set the price. Their father was a famous oil tycoon billionaire. These were the wealthiest people in the world. Actually one of their brothers was Lamar Hunt, longtime owner of the Kansas City Chiefs. One of the founders of the AFL. The AFC trophy is still called the Lamar Hunt trophy.

So, the Hunt brothers went in their plot to corner the world's silver market. When they started, silver was between $1 and $2 and they bought massively. Now, you're thinking, "How does someone possibly buy all the silver in the world? How can that possibly be done?" Well, what you do is you buy all the futures contracts more than can possibly be delivered, and the only silver that's not owned is on Grandma's china cabinet. Outside of that, they have it and they bought massively. And it went from $2 up to $3 up to $4.

But then people caught word of what was going on, so there were traders who slid in behind that and they had the safest trade in the world because they were riding behind these billionaires who were just buying silver. And we're not talking about years. We're talking about days when silver went up to $5. Then it went up to $7 an ounce. At that time, Tiffany took out a full-page ad in the *New York Times* that said, "This is outrageous. How can we let this happen? This is against the public interest." It's always interesting how the public interest sort of merges with their private interest but ...

Silver eventually peaked at $50 an ounce.

They made billions, but they were borrowing heavily. Now there's something about a futures contract. In stocks, you can double up with margin. In futures, you can go up tenfold. So, the Hunts were borrowing huge amounts of money to buy futures which they were, in fact, borrowing to borrow money and they were making astounding profits. But the Hunt money, the people riding in ... they were making the easy money.

But then something happened. The COMEX changed the margin rules on the Hunts. Very slowly, people got nervous and they started to sell and silver went down. Then as silver went down, people got nervous, and they sold, and silver went down. Then people got nervous, and they sold, and silver went down. It happened very slowly. Then on March 27, 1980 — which we now call Silver Thursday — the bottom fell out and silver crashed and the Hunt Brothers were wiped out.

But worse than that, the Federal Reserve had a problem on their hands, because people had lent the Hunt Brothers so much money. Tell me if you've heard this story before or if this sounds like anything you may recognize. And so the Fed had to go in and try to rescue ... A lot of money came from the Saudis who lent them money through their oil connections.

But we changed what is safe — what is risky. So the people who went in, early on and just rode behind them — they had the safest trade in the world. The people who lent them money — they thought they were making prudent loans. What was so safe was then risky. What appeared to be risky could have been safe. It's exactly what we see on 4th downs in the NFL. People are afraid to do it.

I think one of the reasons — it's like people just don't get the math. About the 4th downs, it's not that you're going to convert. It doesn't say the odds are in your favor of conversion. What it says is — and this is what people don't get — it's the benefit of the conversion versus the cost of not converting. So think of it this way. If you have a one in three chance of getting that 1st down, the benefit is five times, so therefore it's in your favor. People don't get that. That escapes them. They will always go with the more conservative view, and they will not risk what they have.

Now, there's a famous instruction in game theory where ... It'd be a room like this. A room full of people and the exercise is to ask them to write down any number between zero and one hundred. And they'll say, "We'll give a cash prize to the person whose number is closest to two-thirds of the average of all the other numbers." So you think about this. Well, OK. If people are going to do zero to a hundred — well, then the average will be fifty. So two-thirds of that would be thirty-three. That's what I'll write down. I'll write down thirty-three.

Wait a minute. Wait a minute. What if everybody else says thirty-three? So, ah! I'll be a step ahead of them. I'll do two-thirds of that, so I'll say twenty-two. Wait a minute. I see a hole in this one.

Well, people run this experiment. This is a fascinating experiment. Now, there may be some of you who say, Ah! I know the answer. It's the Nash equilibrium — people taking too much math. I know what the answer is. It's zero. That's the answer. Very good. You get an A for the day, but the problem is you applied rationalism to human behavior. Big mistake.

It turns out when you run this experiment for whatever reason, the winning number is about 21.8. It really makes no sense at all why that is, but that's how people act. And it shows something — that in finance, there's an attempt to quantify things that aren't so easily quantifiable. The reason is in finance, the participants know what the score is.

I'll give you a very good example — is in horse racing. People have studied, looking at horse racing, what are the best horses to bet on and what are the worst ones. It turns out that the favorite is the best bet — meaning you lose the least betting on the favorite and the absolute worst is the long shot. But here's the interesting part. Why do people bet too much on the long shot? They over-bet on the long shot and they do it *because* it's the long shot. And if you think about that, "Yeah, sure. I'll put some money on the long shot. It's kind of fun. Get a big payout." But they're aware of the odds, where people don't think about that for the other horses.

Same thing happens in the movies. We know studying the return on equity by ratings of Hollywood movies. Do you know what the highest ROE is by rating? It's the G movies. It's the G movies by a lot. And they're even better because they have the lowest variability in returns. Now, I say its ROE is lowest [sic], not the box office. The biggest box office draws are the R-rated, but it's the same thing as lottery. It's swinging for the fences, because then you have the huge bombs. It's the variability versus the consistency. It's the same things we see — how risk is played.

Now, I'll give you another example actually from the world of sports. In the 1970s, some of you may remember there was the ABA. This was the rival franchise to the NBA. And the NBA said, "We're going to merge, and we're going to have four teams come in." I think it was the Nets — now in Brooklyn. The Nuggets. I think the Clippers and I think the Spurs. I could be wrong on that, but I think those were the four teams. Actually the Will Ferrell movie was vaguely about what had gone on. Most of the rest of the teams — the franchises and the ABA — they weren't very strong. The others they paid some money to go away.

But one franchise said no, we're not going away, and this was the Spirit of St. Louis. Their announcer was a very young Bob Costas. They said, "We're not giving in." So, the NBA made a deal with the Spirit of St. Louis and they said, "What we'll do is we will give you one-seventh of the TV revenue for the four teams coming in and we'll do it in perpetuity. Forever."

The owners were brothers — the Silvas. Last year they got $15 million. Over the course of the last 35 years, they've been paid $250 million and the Spirit hasn't played one minute of basketball. They've done absolutely nothing. They just get this check every year. And every couple of years, the NBA says, "Okay. We'll buy you out. We'll give you some money, and then we're good." No, no. That's not how it's going to be. And I found out finally — this just happened very recently — that the Silvas finally agreed. $500 million.

But what were they thinking in 1978? It's a risk/reward. Are you going to take the time or are you going to take the money? Who would have thought that? It's always how we're thinking as investors — managing risk, looking at time horizons. Same thing we see in horse racing. You've probably heard stories of an art gallery. They have a painting that just won't move. They triple the price and it sells the next day.

The problem is that human beings — we're not entirely rational. We're vain. We're egotistical. We have no short-term thinking. And this impacts the market. A good example is — and I hate these discussions — but in finance, it's the capital/asset/pricing model. I wish these things would finally die. But the idea is that risk and return are related. The more risk an investor takes, the better return they'll have. This is a beautiful theory. It has one problem. It's never showed up — *never!* I mean, there's absolutely zero real-world evidence, but it's a beautiful theory, I'll give you that.

We've studied looking at beta. We've looked at bond yields. We've looked at high-yield bond yields. We've looked at futures. We've looked at options. We look at everything and it's just not true — higher risk does not bring greater returns. There's a very slight — from the lowest risk up to moderate risk — you get slightly more return but then it's flat and at the highest risk, just like the horse race, it's the worst.

Again, this represents human psychology being brought to the market. And what happens is within finance — basically I think there's an inferiority complex — and finance wants to be a science. They want to have these grand equations and formulas and Nobel Prizes. And they are beautiful, but in chemistry if you put boron in a tube, it's boron. It doesn't know it's boron. But just like I talked about with the two-thirds of the average, people know what's going on. They watch the scoreboard. People want to bet on the long shot because it's the long shot. The very worst stocks to buy are the most volatile — the names you hear of most in the news.

One of the things as investors we have is an enormous opportunity to look at unfollowed stocks — stocks that are not as well-known, and I think it's a great advantage that there are companies out there that aren't followed by many investors. I'll give you an example. I'm not recommending this company, but I was able to get in the ground floor many years ago — a small company called Nicholas Financial. And Nicholas Financial is a publicly traded, very small company and they make car loans for used cars. And during the financial crisis, the stock got completely clobbered and basically people thought it was a subprime lender.

The good thing was they're a very, very well-run outfit. They have a very good portfolio of loans, but everything that vaguely was like subprime was thrown out the window. The stock at one point got to $1.60 and that was about their earnings two years later, so they were trading at 1x — not one year forward earnings — but the year after that. That's how cheap it was. It was trading at pennies on the dollar and I'm happy to say I did buy it.

Nobody followed the company at all. I got the 10K reports. I got the 10Qs right off the Internet and then I did something that a lot of investors never think about doing — I called the company and I talked with the CFO. A lot of these smaller companies — you say, "I'd like to talk to you about what you do for a living." A lot of people they aren't asked that, and they're happy to talk about it and also you can tell which are better-run companies. Of course, they'll tell you about what's going on. You can talk about the quarter and ask questions about what's going on. Nicholas Financial was just recently bought out at $16 a share — so at tenfold where it was at the height of the financial crisis.

I'll give you a good example. When I go to a hardware store, I ask the person behind the cash register, "What's moving? What's selling?" They'll tell you. People don't think. That's how investors think. They'll tell you what's popular and what's not. If you're thinking about investing in a car company, you shouldn't be reading *Barron's* and the *Wall Street Journal*. You should be reading things like *Car and Driver* and *Consumer Reports*. That's how you have to think as an investor, because the world has changed and the big banks — it's not the world where we can sit and watch Louis Rukeyser and we just hear a few major mutual fund companies. That world is gone.

Now, I'm going to tell you a few other anecdotes about how risk and reward get oddly related. One of these — and we just recently celebrated the 50th anniversary of this — and this was the Great Salad Oil Swindle. Some of you may know this. It was a man named Tino De Angelis, was his name, and he had this plot. What he was going to do was he was going to borrow huge amounts of money from a new company called American Express and as collateral for his loans, he was going to have salad oil — enormous vats of salad oil. But he didn't have enormous vats of salad oil. He had a tiny, tiny bit of salad oil. He had water. And what does salad oil do on top of water? It floats.

So, these enormous vats — the pipes underneath they filled up with water and the salad oil floated up to the top. So, the auditors came by and they saw full tanks. Then they would go to the next tank. The water would drain out, go into a pipe and fill up and the salad oil would go up. And he borrowed tons and tons of money. It was a great, great scheme. I don't like the Jordan Belforts. I like the really clever scams — people who have to think about it.

And things were going very, very well for this scam. It was mid-November, 1963. What could possibly go wrong?

Well, then there was some unpleasantness and there was a break in the market and very quickly, the scam fell apart. And American Express was hugely embarrassed by that and the stock plunged. But that wasn't the end of the story. As American Express plunged and the stock went to a very small fraction of its book value, it was bought heavily by a young investor from Omaha, Nebraska. Actually, he's not from Omaha. He's from Washington, D.C. They don't say that. He's a product of D.C. public schools, but we'll say Omaha, Nebraska. And Warren Buffett was about 30 years old and that was his first big killing — in American Express. Again, we see these things. It's the patience and the discipline to look for good values.

A few other things. This is how we can fight or stand opposed to the trends of knowledge and expertise. So often, when people talk about the market, they do what I call investing from 40,000 feet. Well, first it will be about the Federal Reserve. What's going on with the Fed? What's going on with the macro economy? What's going on with partisan politics? And these really have very little to do with what investors need to know. In the broader market, absolutely the Fed is important ... but there are lots of great companies that it really just doesn't matter whatsoever.

I'll give you a few examples. Has anybody heard of Raven Industries? The ticker symbol is RAVN? I see some of these have. They're fans. This is one of the best-performing stocks of the past several generations. It's outperformed Apple hugely. It's outperformed the market by many, manyfold. This is a larger company. Maybe you've heard of Danaher. The headquarters is in D.C. What do they do? Industrial supplies? It's nothing really fancy. They do what they do, and they do it well.

It always comes back to Johnny Cash — do what you do and do it well. People think that to invest they start at the top and they think, "Oh, I want to do something that's going to be really big. What's going to be big? Oh, it's biotech." So, then they work down. Or they think green energy and they work down. Or China. What's going to work down? You could probably have an IPO of a company called China Green Tech Cloud Solar and investment bankers will just start running down the street throwing money at you.

But that's not what we need. Money can be made anywhere and has been made anywhere. Sometimes some of the dullest companies are the best investments. Colgate. Look at the long-term chart of Colgate. It's been a huge winner. Vornado, the REIT has been a gigantic winner and it's done far better.

Here's another one. Hawkins. It used to be Hawkins Chemical. Now it's just Hawkins. It's a small company in Minneapolis. It's a chemical supplier. If you need lye in Fargo, by God, these are the guys to call. And they've been doing it for decades. The thing about Hawkins that's interesting is that every couple of years they have a stock split of 11:10 or a 5% stock dividend. So people don't realize just how well this company has done over the years, but it's been an enormous winner, and these companies aren't followed on Wall Street whatsoever.

Another good example of where investors should be going is in the lowest-volatility stocks — the stocks that are not traded often. There you can see enormous potential for gains, precisely because people are not involved in that. You don't get the frenetic level of trading.

Well, that's about the things I have to cover. Do we have time for questions?

MALE:

When you talk about Wall Street, what about some of the other exchanges — stocks that, for instance, are on the Philadelphia exchange or the American exchange on the West Coast. Are those companies on dual exchanges? Are they not followed as closely as Wall Street stocks?

EDDY ELFENBEIN:

No, they're not and that's another good area. And also this ties into the consolidation that we see of power and authority where the New York Stock Exchange has really muscled people out. The American Stock Exchange is good for ETFs, but we really don't see the regional exchanges. Where years ago there were true competitors to the other exchanges, we just don't see that. And the New York Stock Exchange is becoming more and more dominant. Internationally in places like London, their dominance has become all the stronger.

I think that's actually a problem. I would like to see more of that refracted through the larger economy — and also in places like the Federal Reserve where the Federal Reserve Bank of New York is the largest among equals. I think it's gotten far too powerful and I'd like to see that broken up. But they are great areas of finding smaller companies in niche areas. I think it's an important development and I hope we will see more of that.

MALE:

I'm not much of a sports guy, but I was fascinated by something in both Mr. Gladwell's basketball story this morning and your football story — that these are both cases where people running teams are pursuing less than optimal strategies to keep from looking dumb. They want to comply with conventional wisdom.

But the other thing is that in both of those cases, the people who are pursuing the suboptimal strategies ... while they compete to win games, they collaborate to keep people watching games, and there's a perhaps justified fear that if some of these conventions changed, the game would become less watchable and the big game of keeping people watching and buying beer and all that would fall off.

What kind of parallel do you see in the world of American business to that sort of situation where a number of nominally competitive players or actors in the market have interests to keep the status quo going and where do you find the disruptions in that kind of system?

EDDY ELFENBEIN:

I would actually say that in the larger economy, I think they're much more accountable, because there are always the disruptions happening ... maybe not as fast as they should be ... but they do eventually bubble up. I mean, why are there three car companies and none is younger than 100 years old?

But we come back to the baseball with the story of *Moneyball*. Why did that happen? What was the necessity spurring a change for what the Oakland As did? It was economics. They were getting outspent so much by the other teams, they had to do it. They were forced to do that. In football, it's not as much, so they don't see that.

But in the larger economy, I think they do a much better job of getting disruptions. I think we do see that in the pharmaceutical business. Now there are areas, I think, in financial services where I think we're going to see greater disruption. I really think at some point a company like J.P. Morgan will be broken off and spun off into smaller groups. I think that could happen with Citigroup and perhaps Bank of America, as well.

MALE:

One of the things you just talked about very early was dispersion of knowledge and the question I have about that and the question that bothers me about that is that you've got a lot of knowledge that's out there but how you do you qualify whether the information is of any validity? You can go out on lots of different forums, besides The Motley Fool, and find a lot of useless information. So, I'm not very comfortable with the dispersion of knowledge because I can't quantify its quality.

EDDY ELFENBEIN:

The classic answer would be the best mechanism to aggregate information, disperse knowledge, is the markets. That is classically what has been the question, that information is conveyed through prices. I just think of something like looking at college majors, where it used to be history and English and math. Now you go to a college campus and look at the graduate level — there's a gazillion levels of different majors.

And look at the different job titles we have of things that didn't exist years ago — things like social media strategist or chief information officer where the expertise is being spread so thinly. And in specialization, I think that's an important driver when we talk about inequality in the economy and what defines the modern economy ... people becoming specialists in one particular field. That's a great way where people in their own careers set up and protect themselves and create their own career.

But as far as deciding what is good and what is bad, I don't think there's any good way. The market is ultimately the judge, but I think that's something we're going to have struggle with as information and the expertise is spread everywhere. There really is no good answer when you just have to take the market's judgments as ultimately the final one.

MALE:

One point you mentioned — that macroeconomic factors may or may not be a real big deal in your evaluation of how you want to invest. I'm just wondering from a broad perspective not what particularly is going to happen in the next three months of broad macroeconomics, but the fact that the latest round of financial engineering that's been occurring at the macro level doesn't have a historical precedent. Does that affect your thoughts about the macro environment in general or does it have any particular effects in particular sections of the financial world?

EDDY ELFENBEIN:

It does at a certain level. I think, for example, I always keep a close eye on what the yield curve is saying. In a larger sense, I'll look, because that tells us the level of risk in the economy. But as far as like particular things about quantitative easing and the strategies that the Federal Reserve is undertaking right now ... no, I really don't. We say while it's unprecedented — it's always different. It's never the same. There's always different levels of what the Fed is trying to do and different circumstances for the macro economy.

Now there are certain levels ... I absolutely will look if I think equity prices are too expensive or if I think there is a great bargain in bonds or bonds are too expensive. But as far as flying at 40,000 feet and trying to make these broad pronouncements about the economy — I generally try to steer clear of that. It's because even if you're right, it doesn't necessarily pay off for you. How does that transfer to a small company like Raven Industries or a small company like Hawkins? As an investor, I just don't see the payoff.

MALE:

I got the impression that you had a disparaging view of traders and I was just wondering if you thought that traders tended to give false values to stocks.

EDDY ELFENBEIN:

I don't have a bad view of traders. I have a bad view of me doing trading. I think it was Malcolm Gladwell who said this: I've seen people who can trade, and they can do it and that's great for them. It's something that I don't think I have the inclination for and when I talk to people about getting investing, I hear very often that people want to get into day trading, and I think it's a big mistake going in for that.

One of my very first jobs in the industry was working for a company not too dissimilar from Stratton Oakmont, and I saw the kinds of things that went on and lives that get ruined by that. If people can trade and they can do it well, more power to them. I'm not worried about their impact on stock prices because I invest for the long term. I understand that prices bounce around in the short term — but in the long term, I think that's where the true value shines and that's the side that I like to be on.

MALE:

I've got a couple of questions, if you can indulge them, but I'll ask one at a time. I think the conventional wisdom now seems to be that given the great blow-out year in 2013, one shouldn't expect very much of the market this year. And on the longer-term basis, I think there's also a growing conventional wisdom that the returns that we've seen in the past few decades aren't going to continue in future decades. You're not going to see an 8% annualized return — maybe half that in the future — and that we're foolish to make plans based on those historic numbers.

But I've seen at least some comments you've made indicate that you have a much more sanguine outlook and I wonder if you could share your longer-term outlook and on what you base that view.

EDDY ELFENBEIN:

I do agree. I think that the historical numbers we have — the 7-8% historical real return on the stock market — those are the accurate numbers. The problem is that's from the American century. Everything went America's way. We won two world wars and we went through the Great Depression. Enormous postwar prosperity. I think the problem is that people have looked at this level of data — it usually begins in the 1920s with the advent of Wall Street in a modern sense — and they say, "Well, this is a stylized truth. This is what we're going to see in the future." And I don't think we're going to see that.

I'm not saying problems, but I'm saying I would expect real returns — this is including dividends and capital gains and after inflation — will probably be, I think we can expect, about 5% going forward. I think probably about half of that will be 2.5% from the growth of real GDP and the other from dividend yield and the growth of dividends. So, I think that's a safe assumption. I'm not saying that that's accurate. I'm saying that's what we should assume when we plan as investors. Another question?

MALE:

This past year was a wonderful year, and I'm heavily invested in Motley Fool stocks. I've been fortunate enough to actually do a bit better than the Fool, primarily by over-allocating in some areas and not buying certain selective stocks ... and perhaps being a little more fortunate on timing.

What I wonder, as I read your work ... I wonder how I, as an investor, could take the Motley Fool universe of stocks that I've depended on for a long time as my investment ideas and combine that with some of your insights regarding trends, perhaps, and help myself with timing a bit or determining when to sell some of these stocks? Do you see a way for the two views of the world? We're very bottom-up, long-term buy and hold sort of investors here. How can your philosophy, your view of the market help us improve?

EDDY ELFENBEIN:

I guess the simple answer is basically my view and the view of The Motley Fool is very much the same, so I don't know in a direct way or how any particular stocks could add to that. And also, it's one of those things people say, "How can I goose my returns?" And I think that's always the beginning of some trouble.

Let me just make a closing with a couple of things. We really come back to the old virtues of being well diversified, not being rattled in the short term, focused on the long term, realizing that bear markets do happen, corrections happen. It's not a mistake. They just come. Focusing on high-quality companies. Focusing on cash flows. Focusing on dividends. These are the strategies that have worked and these are the strategies that will work.

I always think of a quote from Sir Isaac Newton, actually, a lot of people know. He was the warden of the mint in Great Britain years ago. He did the Recoinage Act and he lost money in the South Sea Bubble. He famously said, "I can calculate the motion of heavenly bodies, but I can't calculate the madness of men." If he can't do it, then we can't either and we focus on what works.

So, thank you very much for your time.

FoolFest 2014: Net Promoter Creator Fred Reichheld

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Run time: 46 minutes

From our February member event, watch as Fred Reichheld, the creator of the Net Promoter System and a longtime partner at the consulting firm Bain & Company, goes in-depth about how companies can capitalize on feedback from their customers, measuring customer loyalty, and how simple changes can make a big impact on companies' success.

Transcript

FRED REICHHELD:

I've been working on the same subject for almost 40 years now — 37 of those years at Bain & Company, a consulting firm — and I'm going to try and condense what I've learned in that period into 40 minutes or less, which means I better talk really fast.

I'd like to start with this notion. It's something — if you've gone to Davos in Switzerland where all the captains of industry and mucky mucks go, you would have heard that loyalty is completely irrelevant in business today. And that's not a new idea. Some people ascribe it to the Internet, millennials, young people — but loyalty has been dead for many, many years.

So, when I come here to talk to you about loyalty, I realize that there will be some skeptics and some people who think it is, maybe, less relevant to their future than they'd like on this nice morning in February. So, I'm not going to talk about loyalty, although it's what's I've focused on for my entire career.

Instead, this is bait and switch. I am going to talk about growth. Today's lecture is going to be on growth, because it turns out that the only way to grow a sustainable and profitable business is to earn the loyalty of your customers and employees. I'll show you some evidence of that.

We could talk about loyalty or we could talk about growth, and you'll see they're essentially the same thing. The evidence that I give you is at Bain, where we have been studying this for many, many years, we find that the company with the highest customer loyalty in its sector is growing at about a little over 2.5x the rate of its competition. And as you know, growth is precious. Growth is rewarded by the stock market. Growth is what makes a place good to work because there's opportunity and you get the idea.

Well, if loyalty leaders are growing this fast, why is it? Well, it's so obvious. In fact, if I ran a little quiz, and I said, what are the four things that loyal customers do that would indicate proof that they are loyal, those are the same four building blocks that create profitable growth — and let's see how many of the four you can get.

Well, one, loyal customers come back and buy again. They repurchase. Two, they buy more stuff because they get to know you and vice versa. There's a relationship that can evolve. They bring their friends and four — many people miss this last one — they give feedback.

Now, is feedback important? Well, of course it is. That's getting good ideas about how to improve and positive feedback to energize your employees so they feel proud of their job and reinvest themselves and go the second mile. This is what business is about, I think. It's creating a community where people want to invest their time, their energy and their resources, because that's what creates growth.

But even though some of us know this intuitively — how many of these four building blocks of loyalty and growth are measured according to generally accepted accounting principles — is the right answer. So, the measurement, the science that we've built to understand business, to track its progress, to set budgets, to reward bonuses and so forth completely ignores this underlying reality of there's only one way to grow a profitable business, and it's treat your customers so they come back for more and bring their friends.

And because we forget it, businesses do things to their customers and employees that destroy their loyalty, make loyalty a joke and make many people come to the conclusion that loyalty is irrelevant in business today. Well, it is, unless you want to grow a profitable business, in which case it continues to be the core of these great companies.

Now, what I think the problem is, is the fellow on the left ... you probably recognize the chief financial officer of your firm. Well, he's a tyrannical gorilla ... not because they're so powerful, necessarily. It's because they have science behind them. Accounting has been developed as a science since the Middle Ages in Italy — this notion of double-entry bookkeeping. I think it was in Venice. They've sort of gotten a little better every year at this. The point today — there are crowds this big in accounting who are worried about how you should amortize software investments. So, it is a science, and that gorilla has some really good metrics behind him or her.

Well, of course, most companies have this puppy dog, the satisfaction survey or the customer engagement survey. Loyalty — if you want loyalty, get a cocker spaniel. That's a little inside joke. But this little puppy — imagine. The CEO is talking to the head of marketing or the head of HR who's thinking about employee loyalty, and they're having a good conversation and the gorilla stomps into the room. You know what happens? The puppy wets the floor and runs away.

In some ways, it's a good thing because the techniques — they don't have a science for measuring this. It's not taken seriously at all. They use surveys. What a joke! These people — you want to know how loyal your customers are. You send out a hundred-question survey. Three percent of the people respond to it and you wonder, "Who are these three percent? Don't they have anything to do with their time? Are they lonely? Are they bored? Are they just compliant?"

And that little population sends back a survey and then we pretend that they have anything in common with the 97% who have something useful to do with their lives. We take their answers and extrapolate through very sophisticated statistical techniques what the truth must be about our customer loyalty. It's horrible and I'll show you it's wrong — and it has led to a diminished focus on loyalty.

Now, I went around criticizing surveys for all these reasons. You know, it's wasting our time. It's ridiculous. And then I ran into Andy Taylor, the CEO of Enterprise Rent-A-Car, who had grown from a little niche player in St. Louis, Missouri to the largest car rental company on earth. Somehow had bought the largest fleet of automobiles of any private purchaser in the world without ever having to go public. His dad was not rich, by the way. They did this on internally generated cash flow. And you wonder.

Well, I went up to St. Louis and I met Andy. I said, "How did you do this? It sort of broke all the rules that I learned at Harvard Business School about, first of all, never try to compete in a commodity business like car rental." And trust me, they're all renting the same Chevrolets and Toyotas. A total commodity. Never try to gain share. Oh, and it's low growth and almost no margin. That kind of business is not really where you want to put your heart and soul and try to gain market share. That's a formula for bankruptcy.

I read in Forbes that the Taylor family is worth somewhere between $10-20 billion today. And you go, "What is in the water in St. Louis?" Well, I went there, tasted the water, asked Andy how he did it. And this is where he said, "Fred, there is only one way to grow a profitable business. You treat your customers so they come back for more and bring their friends."

Duh. And actually — oh, did I mention? They measure it. He said, "We used to have a puppy dog. We'd measure satisfaction. But no matter what I did, because we pay our people based on the profits they earn, the profits in the branch where they work every week ... and these are young people, so they care about how much they earn every week ... they were listening to the gorilla and treating customers in a way that made me ... I was humiliated because this is my personal reputation. This is my company."

He had to change that. So, he changed the puppy dog into a very different beast and he said, "Stop making fun of surveys, Fred, because that's how we did it. The most important management tool that we have developed at Enterprise ..." The thing that Andy would give credit for — among all of the other developments for getting them past $2 billion in revenue and shooting off into wherever they are, $10-15 billion in revenue today, largest in the world ... it was this survey.

And I said, "Oh, Andy. What do you get? A 10% response rate?" And he said, "No. A 90-95% response rate." I said, "Whoa. You must have taken 100 questions and shrunk it to 12." He said, "No, it's two questions.

"That changed my life, and we took it seriously. The reason that dog has teeth is we started by measuring it scientifically. We spent a lot of money to measure how happy our customers were and then we would rank order our branches from best to worst every month and now every week.

"And if you're in a bottom-half branch, you can't get promoted. And, well, it's an up or out system at Enterprise, so that is the nuclear switch and therefore, so much of their focus ... Yes, of course they care about profits. That's what they get bonused on, but they know they can't grow their careers at Enterprise unless they're finding ways to delight customers profitably and it's that balance that I think has transformed Enterprise into the powerhouse it is today."

The one other thing they do with this feedback where they're asking customers one or two questions — when they get a failing grade — they ask if the branch manager where they rented could call them. Eighty percent of those people say yes — and they close the loop. So, it's the branch manager who is talking to a customer, apologizing, probing for the root cause, understanding in context what do I need to do better at my branch ... and this is not a PowerPoint presentation from headquarters where they're doing statistical samples through PhDs and then great presentations three months after the fact.

And everyone in the branch is saying, "Was this one of those nutty customers we lose money on, or is this a good customer with reasonable expectations?" No, no. That's the stupid approach. The smart approach is from the branch, call the next day while it's still fresh in everyone's mind and, "Oh, it's Suzy. This is the third unhappy customer. I have a training or a personnel issue." So, you get relevant, granular learning and it's changed the world for them.

This raised a question for me. I'll bet you this would be a good idea for any company — actually getting serious about measuring loyalty at a granular level so you could actually drive learning and priorities. And I started searching for what's the one question you could ask, and I found the answer. It's pretty consistent. *How likely is he to recommend us to a friend?*

And why does this work so well as a litmus test of have I earned your loyalty? Am I worthy of your loyalty? Well, because you don't recommend to a friend unless it's a good idea. It's logical. This is good value, good price, good engineering. But that's not enough. There's a higher standard for recommending to a friend.

It also has to make sense to your heart. This has to be a group of people who you trust. Who are going to fix problems the right way. They share my values. That's a Harley tattoo. There's a quick story. I have companies who think this loyalty stuff is important. Harley was one of the early adopters. The guy at Harley said, "Fred, we don't measure this retention rate and all this stuff that you write about." He was sort of teasing me, but it was funny.

He said in their annual report, they claim to have the world's most loyal customers at Harley, and so I pushed him on that. I said, "So, is this made up by some marketing/PR guy or do you actually have something to back this up?" He said, "We measure the percentage of our customers who have our brand tattooed on some body part." So that is a Harley tattoo.

And if I'd listened more carefully, when you recommend to a friend, you are tattooing the brand that you're recommending in a very public way. You are co-branding your personal reputation with that firm. And I think that's why recommending is almost a sacred thing. Enthusiastic recommendations mean, "This has my name behind it," and it's a big deal.

And when you cross that threshold — this is why I developed the Net Promoter System. I wanted a universal language that people could start speaking around the world to get this loyalty thing to become real. And so, we said one question — how likely to recommend us to a friend on a scale from zero through ten. No confusion of whether aces are high or low. It's not one through ten. It's zero. If I say you're a zero, you don't say, "Does that mean good or bad?" It's just obvious. And same thing. "She's a ten." Everybody knows what ...

So, language that everybody gets without overtaxing their brain and it turns out nines and tens are the true assets of your business. They are out there building your reputation, making your employees proud, giving you the best ideas. And until the Net Promoter System, they were sort of just hidden there in the shadows where really smart leaders understood that, but not in big businesses where metrics are vital in how you communicate and how you set bonuses.

This notion of a Net Promoter is just taking the percentage of customers that you touch who give you nines and tens. Those are the assets. Subtract the liabilities — the zeros through sixes — and you find that you have a bottom line, like net worth or net profit, that you can focus on and learn on and hold people accountable for and build a big dog system around.

And that's what companies have started to do. When I started this — it was actually the 10th year anniversary. I wrote a *Harvard Business Review* article. Shared my brilliant insight. "Fred invented the Net Promoter System, and three people paid attention."

GE — I don't know how GE found out about it. I worked with Intuit, the software firm. The founder and I were friends at Bain in the old days, and he loved this idea because his whole thing at Intuit was, "I don't deserve another customer until I delight my existing customer." I sort of like that philosophy. And when he heard about Net Promoter, he said, "This is what I've been looking for." It turns out that the CEO that worked for him at Intuit used to work at GE. So through back channels, GE found out about Net Promoter.

I write this *Harvard Business Review* article. There's only two companies in the world that are actually using it — but we made a strategic choice. We made this an open-source system. Instead of having to pay Fred every time you use Net Promoter, we thought that if we just made it available to everyone, that we would have creative experimentation and it would have a bigger influence and it had the chance of becoming a universal language.

Over the last ten years, that has come true. There are thousands and thousands of organizations that have begun to adopt Net Promoter. I think if you did the math right now, you'd see that over half of the world's large companies use Net Promoter as a way of measuring customer feedback, customer loyalty at this point. They don't do a great job, but they are at least starting.

Now, this created a problem because I had written a book that explained what this ultimate question, "recommend to a friend" was. The red book — it was a book of theory. I had two companies in the world that were actually using it. Within five years, there were thousands, and I had to rewrite the book to one of practice. *The Ultimate Question 2.0* is the book that shows what companies are doing as they're experimenting with Net Promoter and turning it into a science.

NPS used to be the Net Promoter score for most people. Today, NPS stands for Net Promoter System because it is an entire system. Some people call it the Net Promoter Spirit because as you'll see, it takes a certain philosophy, and what you believe about your life, to make this the center.

Has it had an impact? Boy, for some people. I'll just show you a couple of examples. Entrepreneurs, like the fellow who founded 1-800-Got-Junk said, "This is the most important decision we made since deciding to franchise." I said, "That's a little over the top." But as you'll see, it has transformed businesses, just as it transformed Enterprise Rent-A-Car. It was Enterprise's idea, not mine, essentially. Keep track of your promoters, your detractors. Close the loop with your detractors. People who are good at creating customers who are promoters — promote them. Make them rich.

It works on the Internet. Tony Shea — who sold his company for a billion dollars to Amazon — they continue to use Net Promoter to figure out how many of their customers are being wowed ... and how many of their employees. And, as you'll see, many of these companies in the open-source community are using Net Promoter just as heavily on the employee side ... people whose loyalty is vital.

The guy who runs Intuit today — Brad Smith. Very capable guy. He said, "Thank goodness we've got this Net Promoter system, because now it's a framework that makes sense in the world of the Internet. You've got all these promoters and detractors out there on social media, on Amazon. We actually have a language, a framework, a measurement process at Intuit that helped us manage according to that."

And it's true. This system, even though it was invented before social media, I think was built with that same set of ideas. Your reputation is everything. Your reputation is not just a fuzzy subject. It is the number of promoters that you have out in the world compared to your competitors.

Apple is one of the companies. Apple retail has done one of the best jobs of adopting Net Promoter and extending it way beyond any idea I ever had, but there's so many examples I could tell you. The guy who founded the Apple stores said, "Our mission is to enrich the lives of our customers and employees." You know, a lot of people adopt these high-minded missions and they're just baloney.

He was serious. He said, "I've got to measure this." And the reason he picked Net Promoter was he said, "Suddenly I have a way of measuring if I invest the money to get the system to work — I can tell of all the people I touch in the branches in my stores, every day, every product, every team — how many lives are enriched. Because if I get a nine or a ten on how likely I'd recommend this store to a friend from my customer, or a I get a nine or a ten from an employee who says, 'I'd recommend this store as a great place to work,' I know of the lives that I've touched, how many are truly enriched." And that turns a fuzzy, well-intentioned mission into something that actually becomes a basis for running a business, driving learning, setting priorities, rewarding people.

They also are using it as a science, because what is innovation? Well Apple's really good, but when you think about the retail stores, it's astonishing. Think about the cool things they do in those stores. One example, to show you how they use this. Because they're measuring every day, every store ... you'll get a situation like their NPS dropped by seven or eight points after the holiday season a few years back. And they have their management committee meeting and they're all arguing about what their pet theories are.

One guy's theory was, "Well, it's the color of the shirts. We use to have holiday shirts. It makes it easier to find our employees. Now they like going back to black shirts because that's cool. That's what all their customers are wearing and therefore they can't find their employees. Well, let's take five stores, put the bright shirts back on and see what happens to Net Promoter."

Within a week, the entire world was wearing bright shirts again, because this experiment demonstrated that those stores with the bright shirts popped right back up. Now apply that by all of the cool ideas that have either succeeded or failed so that their learning cycle at testing innovations in the Apple stores is so much faster than the Best Buys of the world, and look what happens when you innovate faster and have real facts about is this a smart innovation or not.

Now, let's bring the gorilla back into this equation. I gave a talk like this — it was actually a little bit bigger room — I was the entertainment for the Apple store annual gathering a couple of years. The CFO was sitting right there. I said, "Do you use this Net Promoter?" And he said, "Oh, yes. Think about the iPads — when we had people out in the line. We just couldn't get enough iPads made to service the market.

"We had some stores that decided, creatively, they were going to take people with their iPads and get them on the activation table and give them some extra training so they'd download an app, make sure they can use their email. Test drive." But that's stupid to the typical gorilla. Get that employee off the activation table and on the cash register line because we want to sell more iPads. That's what Wall Street wants.

But they didn't do that, and the CFO was one of the biggest fans for not doing it because he said, "We keep track. When someone buys an iPad and then has the activation table experience, we know how many turn into promoters, and that lets me do the math. And I know what a promoter is worth — how many thousands in extra they buy per year so we can figure out the cost per promoter created. The activation table is one of the best investments we have."

That's why every store in the world encourages you to go to an activation table when you buy your iPad or whatever the next product is — even if they've got people out in the mall standing in line to buy more — because they're not trying to maximize growth of revenues. They're trying to maximize the growth of promoters that they can serve profitably. So, their objective function is cost per promoter. It seems like a subtle difference, but it makes all the difference in the world.

Zipcar adopted this several years ago, and they've come up with a language they call "frugal wows." They want to find ways to delight customers. And by the way — nines and tens don't just fall of trees. You have to do something special that gets someone enthusiastic. That means innovation, so you test things. They discovered one of the best things they could do at Zipcar was for those customers who were good customers (returned the cars on time and clean. You're supposed to put gas in the car. If it goes below a quarter of a tank, you fill it up. Now Zipcar pays for it, but you're supposed to do it).

If you've been a good customer and followed the rules — each anniversary, they will upgrade you to a BMW or a luxury car as a thank you. And it turns out their community just loved that. And they figured out the cost per promoter. A very smart thing to invest in. That kind of progress is what more companies need.

American Express has recognized this. Well, I'll take you back two or three years. American Express saw this. They've known Bain very well over the years and they've looked at all 2,000 touchpoints for a credit card. Which touchpoint are you going to invest in to wow your customer? Someone says, "Well, it's a very emotional experience when you're applying for a new card. Let's work on the welcome part of the new customer."

And so, they had teams experimenting, and one team came up with the idea of, "Don't just mail the card with the 800 number that activates the card. Let's have an outbound phone call to welcome them and let's do it before they even get the card. And whenever we can, we give them a higher credit limit than they asked for."

So, we bring this good news through a phone. *Oh, and if you have a couple of minutes, let me explain the card so you get the value. You're going to Europe. Thank goodness you told me, because you would have been on the fraud alert on the second charge. They'd cancel your card. Now I will put that in your record.*

But this costs money, right? Fifteen minutes on the phone. Well, let's see how many promoters we created, which they did. It was very promising, so they've invested that and rolled it out. And, of course, they then look at real behaviors like share of wallet and retention rates which are reinforcing what this Net Promoter metric indicated would happen. The cool thing about Net Promoter is it's real time. You can get information now and then make sure you're doing it in a wise way that does connect to the behaviors, like spend, that will drive cash flow.

Airbnb has adopted Net Promoter and is off the charts. When I talk to organizations trying to get better about Net Promoter, they have identified ... You know who Airbnb is? No, God, well. You're like me. You're just like me and Enterprise Rent-A-Car. I was doing this talk years ago and Enterprise said, "Oh, you know, we should talk because we use this system you're talking about, but we actually have it." And I didn't know how impressive ...

Airbnb rents hotel rooms, but they're owned by people — houses, and so forth. So they're a clearing mechanism for getting spare rooms and spare beds, and they've grown so fast that they now have 50% more rooms to rent than the largest hotel chain in the world and soon it will be dozens of times. Airbnb is a phenom. They continue to get better because they look at all of the touchpoints of renting a room from Airbnb as well as the renter — there's two sides to this equation.

They've drawn up little cartoons. They call it Snow Whiting, because Snow White was the first movie where they had moving pictures. And then all of the employees focus on innovative ideas — they put yellow stickies — that would delight customers or the renters that they can then test and then use Net Promoter as the quick litmus. Is this the smart test that we ought to roll out or not?

Now, the really interesting thing. This is so obvious, right? You guys are bored thinking how could one guy take two Harvard degrees and focus his life on this and this is all he comes up with. Loyalty's a good thing and gee, you should measure it.

This is the chairman of the board of Rackspace. I'm not a big fan of serving on boards of public companies. You save up enough money to have a good life. You don't want to risk it with some crazy scheme and get sued. But Rackspace convinced me that they were the kind of company that I would be willing to publicly ... When you serve on a board of directors, it means something. I did join their board, after several years, and they are very serious about making Net Promoter the core of what differentiates them.

Their chairman drove me to the airport in San Antonio and he said, "Fred. I'm sort of disappointed. We've had you working on this for a long time. Board level attention. Why is this still so hard? Every time we turn away and get our attention focused on something else, it seems ... What's going on?" And it made me think very hard. And here's some answers.

Number one. Too many companies — they've got this new toy and they fixate on the score. It's not about the score. You don't want to go from a 70 to a 75. The score is a way of letting you understand whether this innovation or this experiment is working. The key is to delight more customers profitably and the score is a way of testing out whether that is taking place.

But then it gets worse, because so many companies are just measuring this in the most slap-dash foolish ... They take that market research survey that I made fun of that gets a 3% response rate and they use that — but they ask, "How likely are you to recommend us to a friend," and suddenly they have a Net Promoter score. And if they can get a high score, they advertise it in the paper. They have press releases. Maybe you've seen how high some of these scores are. Well, let me show you how silly this is.

This would be a typical company — this is a really good company, by the way — who says, "Let's see. I'm going to survey a bunch of my customers. Sixty percent of the responses were promoters. They were nines or tens. I only had a few, 10%, who were detractors. Therefore sixty minus ten is fifty. Net Promoter score of 50 is darned good. It's almost in Fred's Hall of Fame." And so, you're feeling really proud and you call your PR department to issue a press release.

Well, the response rate on this survey — let's be generous and let's say it's 20%. What about the 80% who ignored your survey and didn't think it was worth their time to invest in this relationship? What about those people — because they're the preponderance. Well, when Bain teams go out and interview those customers who don't bother to respond to surveys, they tend to look something like this. They're mostly detractors and passives.

And so the true Net Promoter score of the population of customers, if you do the weight average, is minus 22 ... whereas some nut in the PR department is saying we have the world's highest Net Promoter score in our industry. It's plus 50. And that is not the basis for a big dog with teeth — at least one that doesn't make a lot of messes that you'd like to get rid of. It's a horrible ... The measurement would make an auditor blush.

We have companies who really love Net Promoter, and then they put bonuses based on them and then discover that they have no audit-worthy system. Somebody at PWC or Ernst asked them for some proof that this is a reliable system and then they're dead because they tend to be people in the marketing department who just aren't familiar with the rigor that the person in the CFO's area is comfortable with.

What else goes wrong? Linking incentives to these flimsy metrics. Oh, this is a joke. In the Bain's New York office, you go down to Penn Square. There's a Kmart store. This was in the window, so it's a lousy picture because it's on an iPhone. This shows you what happens when you link flimsy measures to bonuses. It's sort of silly, right, but you've seen this all over the place.

Car dealers do this kind of stuff all the time, because they care about the score. They don't really care about turning you into a promoter. It's all about them. When they are saying, "Yeah, I know I lied and I cheated, but can you please give me a top-box score, because if you don't, I'll get in big trouble and lose my job." What is that about? That's what people are used to. Low integrity.

Not establishing a financial linkage. Remember I told you the Apple CFO — they knew what it was worth turning someone into a promoter. This is something Bain has published so I can use it easily. You just look at the cash flows and turn them into a net present value for retail banking. The detractor is a negative net present value. Why are bank market values so horrible? Well, they've got a lot of detractors and true cash-on-cash, that's a negative. If you say passives are indexed at one, promoters are worth 3.4x that, so you can say, "Gosh, I know how much I can afford to invest to wow customers."

But this, of course, has to be by segment. If you looked at the high net worth segment of bank customers, probably this group ... turning those people into detractors is 10x as valuable as leaving them as a passive ... and then you can start making wise investment decisions to start innovating. Banks haven't innovated because they've gone down the path that the gorilla has shined a lot on. Get unit cost down. Charge fees when you can get away with it — which abuses loyalty and destroys growth. And, you know, the stock market's not stupid. If you understand that a promoter is worth 10x or in this case 3x, you know how much you can afford to invest to make someone a promoter.

What else goes wrong? They don't have this closed loop with the branch manager calling. Apple stores do this. Apple has an app on their iPhone where every day, the manager will sit down at the Starbucks or whatever they do before the opening huddle. They'll go through the responses from customers the previous day. They've got the little grumpy and smiley faces like I showed you and the verbatim explaining why. And they say, "Oh gosh, there's a couple of detractors." Push the button twice. The phone rings. Calls the customer. Store manager apologizes, probes for the root cause. Tries to fix it.

But then, when they kick off the opening huddle, everyone is talking not about attach rates and how much you can sell more computers. They're talking about, "Here's some detractors we had yesterday. Let's group problem solve and figure out how we can make this happen less frequently. Oh, and Jarrod at the Genius Bar, you got a ten. It was 11:15 in the morning. Mrs. Smith. Do you remember her? Can you tell the crowd what you did?" You get the story for everyone and you're learning what creates promoters. Then at Apple, they give a standing ovation, because when you get a ten from a customer, that's what you get from your peers, and that is the right thing to get. And in fact, a ten is a standing ovation from a customer. The thing is, you can't hear it if your company isn't measuring tens in a reliable way that gets the credibility of your work force, your managers.

This leads me to where I think the cutting edge, the frontier of the Net Promoter world is today. Maybe one of the most interesting ways to think about it is as an investing tool. If you want to have a great Net Promoter score, that's 100 faces, so you just go through the math. It's an easy way to communicate. A seventy-five percent Net Promoter score, which is what Apple has — you're never going to earn that kind of loyalty from customers when it's delivered through a work force that looks like that. It might be a zero. And that's the problem most people face today. Most CEOs know they want loyal customers. Duh. They've seen the Andy Taylors of the world, but they don't recognize what they have to do differently with their teams, especially frontline teams, to get them energized and excited.

I'll show you what we're doing. I think the basic thing you're managing — and should be measuring, of course, in business — is this. When you put an employee next to a customer, whether it's on the phone, or on the Internet, or face-to-face ... you want that employee to be able to serve that customer and make their life better. Really enrich it. And when you've got a Net Promoter system, that ten is what fuels the fire of good employees. Martin Luther King — we can't all be rich, but we can all be great because we can all serve. Well, just serving somebody isn't great, but when you get a ten, you enrich their life, you made it better, and I think that is the true bonus for a good person.

And when you get this loop going — then you get some economic advantages that I've written about in my older books — you can pick the best employees because good employees want to work in an environment when they can earn tens from their customers. People like standing ovations. They stay longer. They get to know their customers and their colleagues, which is the basis of innovation and learning and, of course, productivity. So you've got all of these things that drive cash flow, but it's all centered on have I put my frontline employee in a position where they can earn a ten, and how often do I do that versus my competitors.

Now, that team is vital. We'll talk about it in a second. Most companies when they get big, they think, "Oh, I'm at the center." The reason that's a little puzzle is because the frontline calls it the "puzzle palace." The headquarters. You know, I've got all the engagement surveys and all the things I'm trying to do to make the customer service better. Let's hire some crazy consultants to figure out how to fix this. What you've got to fix, for most situations, is I've got a bunch of disengaged employees on that team, and if I want my employees touching customers to really stay energized, I better have a different approach to running this business.

This is where I sort of admit failure, because if you were to think about my strategy of an open-source system for Net Promoter, the customer Net Promoter metrics and methods and vendors has just been a successful explosion of possibilities. I'm very proud. I give myself an A. On the other hand, on the employee Net Promoter ... yes, there's some daily huddles and Agile Scrums if you're in the software business. There's annual engagement surveys. But think of the irony. Our most important asset is our employees — therefore, we measure it once a year. Come on. You don't make decisions once a year. We don't have weekly, monthly rhythms of measurement.

And this is where over time I've been so frustrated and decided a little over a year ago, I'm going to fix this personally. I'm going to invest my own money and create a business that is going to solve this problem. I've learned a lot from the Apples and the Bains of the world because Apple has the app on their iPhone for their customers. Well, I'm creating that app on the employee side. So, what I did was study the companies that had the highest customer-employee loyalty that I was aware of. Most of you probably haven't heard of Bain or maybe you did because Mitt ran for president, but what does Bain do?

Bain is the best place to work in the world, and not just because I'm 50% Bain. For the last 20 years, I've been a Bain fellow, so this is the non-Bain half. Just look at the facts. They've been the best place to work in consulting forever since they measured it. Best place to work five years in a row on Glassdoor. Do you know what Glassdoor? It's company employees talking about their company anonymously. In 2014, Bain was number one in the world. So, they're good. But so is Apple retail and so we're into it.

And I've taken these methods that the companies have used that I have been most impressed with and turned it into a tool called Huddle Up, which is just an app, but it bottles some of those best practices and it's based on this simple idea ... what I observe when I see great companies and great leaders. They don't tell their people what to do. They just make sure they're asking the right questions at the right times, and that gets ownership.

What Huddle Up is, is an app that lets teams — whether they're on an iPad or a phone or their computer — have a conversation. It asks two or three key questions to get the huddle off on the right foot, and it makes people spend five minutes preparing for the huddle and scoring things or rating them. How happy are you with progress of delighting customers, zero through ten? And it takes out some of the noise because, "Oh, I don't remember what I scored last week on this." Well, it shades in the seven. It says, "That's what you scored last week, so, if you feel differently this week, let's get all signal and no noise." But that, then, leads to a productive conversation at the team level.

That's what Bain has done for years and years and years. What the app does is just makes it easy. "Oh, and give a shout-out to the team member who deserves to be recognized for helping the team succeed." You know how most big companies — they reward people who are good at kissing up and kicking down — real political baloney. Well, how about if a team gives out stars that are serious — it's anonymous — but it's the team who's recognizing who's helping the team succeed.

Oh, and high response rates — because this is no good without high response rates. Even though it's a secret ballot, this is transparent who bothered to vote. And so, if Fred hasn't filled out his little three-question poll, his teammates are going to put some pressure on Fred. We've got to have our meeting. Let's go. And so I expect ... Well, in fact, in the beta, we've got very high response rates. And then this thing just sits in a cloud configuration, so it lets you customize.

I'm not so bold as to say I have the eight magic questions or the twelve magic questions that will tell you whether your teams are engaged. I think it's different for every industry, for every team. If you're in a turn-around situation, that's different. But what it does do is it creates a cloud of data and lets you have all of the questions that the great companies are asking so team members can pick it.

And then you sort of picture it. Well, if I'm at the center of the company, I can ping a question or a template or a library of questions that I want my people to choose from. Oh, sure, and they can customize their own. I've got a team leader and he wants to have a weekly huddle. He can customize. It goes out to his team. They respond and then they share the results at their huddle in real time. Some people do this at the beginning of a meeting, but you can imagine the rigor.

Oh, and I can track progress. Over time at Bain, teams ... Oh, and this becomes part of how we run the place. At Bain, we rank order all teams. Just like Enterprise rank orders their branches based on customer scores, Bain rank orders all of its teams on how likely they'd recommend their team leader as a person to work for — and how proud they are of the results they're getting for their clients.

So, those become the barometers of progress that let you know where you've got problems, where you get best practices. So, I won't go through this in any depth except I think this is a revolution waiting to happen on the team front, because suddenly we can get the power of Net Promoter in the hands of teams.

What are the questions that most of these companies are asking? Well, on the center, they're using the Bain question. *I'd recommend my team leader. I'd recommend my company as a great place to work.*

So, the reason I share this with you is a) it's, I think, where the Net Promoter movement is going but b) if you had an investor's mentality, would it be amazing to be able to get into the scores of what the employees really feel about the progress they're making at delighting customers? I would. That's one of the reasons I built this app, and I think it will have that investment, the insight along with real benefits to the center of the company, real benefits to the team leader and benefits to the team.

So, that is the cutting edge. I hope you'll be reading and hearing more about Huddle Up. The way that we're doing it is sort of an open-source movement. Eight or so of the companies who are real Net Promoter leaders are in a beta with this tool and using it, rolling it out. We'll be going to a second wave later in the year. There's room for one or two more companies, but by the end of the year, it will be a commercial app that any of you could use in your own businesses.

So, in conclusion, think about this goal of Net Promoter as delighting customers profitably. And if delighting customers is your goal, it is a team sport. And Huddle Up to Win is my little tag line — but that, I think is where investors ought to be focusing more of their time.

Now, I've got question time here, but I'd like to put one question in your mind before I take your questions. Why isn't Motley Fool offering you reliable Net Promoter data on some of the industries that might be a good leading indicator of what the growth rate and how energized the employees are? It just seems like they owe that to you — but that's just a rhetorical question. But let me go back to where I'm supposed to be and open up to any questions in the audience.

MALE:

Big fan of all of your work and I've been studying it for a long time. I think what you're doing with Huddle Up is really intriguing and I'd love to beta test it with my company. The flip side is while you talk about the open nature of the Net Promoter score, is there a simple way for small businesses to do this?

FRED REICHHELD:

Yes, there are. There are a number of vendors on the customer side who have very low-cost mechanisms to ping out to customers. One that comes to mind is called Delighted.

MALE:

Delighted ...

FRED REICHHELD:

Yes. Delighted.[net].

MALE:

Thank you.

FRED REICHHELD:

Airbnb uses them, for instance. Next question.

MALE:

Yes. I have to jump on this use of Net Promoter scores, Fool publishing scores, things like that. I have to ask myself whether I would trust it or not, or would you get into the same syndrome you were talking about using satisfaction scores to reward managers and that sort of thing? How are you going to ...?

FRED REICHHELD:

Can you trust a Fool?

MALE:

Yes — could be trusted.

FRED REICHHELD:

I think that's exactly the right question, so before I'd pay much for that, I'd want to understand the rigor that they're using to get reliable data, and I think we know how to do that. It takes an investment. You've got to go carefully, but it's a great question.

Are we down to the ultimate question? There's people staying, "Stop. I'm wasting my time." Okay. The ultimate question. Well, I'll make the ultimate question, then.

I hope, in this open-source community — go to NetPromoterSystem.com. There are an amazing set of resources there for free that will help you understand Net Promoter, see the organizations who are doing the best job on this. Maybe help you if you want to embrace it in your company and also maybe push you down this path of could we use this as a tool for investing in the companies that are going to grow faster and will make more money.

But I love the way David described his mission — I mean he implied this, at least to me. We want you voting with your dollars in the companies who are our future. And if I were you, I would want to put my votes behind the companies who believe that it is vital that they earn the loyalty of their customers and employees and that reputation, that concept of serving others is at the basis of all good things. And if I had votes to give, I'd like to know that I was putting them with the right people.

And with that, thank you very much.

FoolFest 2014: Pete Miller, CEO of National Oilwell Varco

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Run time: 57 minutes

National Oilwell Varco (NYSE: NOV) CEO Pete Miller both entertained and impressed our audience of Fools at February's member event. Watch as he talks about how his company's oil rigs are reaching new markets, the recent spinoff, and what's next for this company.

Transcript

PETE MILLER:

Thank you all. I really appreciate the opportunity to talk to you. I'm not too excited, though, to be the last speaker before cocktail hour. That kind of sucks, but I'll try to get through it pretty quickly for you.

What I want to do today is a couple of things. I want to familiarize you a little bit more with who National Oilwell Varco is, but I think more importantly, I want to tell you a little bit about the oil and gas business. I want you to see what's going on around the world, what's happening in the industry and hopefully it will allow you to make a few more educational decisions about whether or not you want to be invested in the energy arena. There's a lot of turmoil. We're all high beta stocks, so you can make a bunch of money. You make the right choices and it really kind of works out pretty well. So, that's my goal today — to try to give you an understanding again of us and of the oil industry.

First, I'll tell you a little bit about the NOV growth story. We've grown pretty well, but we do it really through four ways. First one and probably the biggest one for us is M&A. We think we're very good at M&A. We do it. There are a lot of opportunities out there, and it really is worldwide M&A. Of course, then you have organic growth, I think new market entry, and believe it or not, there's still a lot of new markets in the oil and gas business. And finally, new product introduction and new service introduction and really pressing the envelope on technology. And I'll talk about each one of these today to give you an idea of what it is that we're trying to do and the way we do things.

The first one, on the M&A front, take a look ... and here are some of our bigger deals. Since I've been the CEO, we've actually done about 300 deals. Some of them have been very small. Some of them have been very large. The one that was more or less transformative for us was back in 2005, and that's when National Oilwell and Varco came together. That was a big deal. We basically doubled the size of the company — but more importantly, each one of the companies brought products together that really made a lot of sense and really did things together.

We bought Grant Prideco, which was a bit and drill pipe company in 2008 and you can see some of the other things that we've done. Each one of these had a very specific, strategic reason for doing it. One of the things that we wanted to become was the manufacturer of the oil field. Nobody else wanted to do it. We wanted to do it. We didn't want to be Slumberj. We wanted to sell to Slumberj. We didn't want to be Baker. We wanted to sell to them. We didn't want to be an E&P company. We wanted to sell to them.

A lot of people didn't want to do that, and I will tell you the key to business is getting involved with the uncontested marketplace. If nobody else wants to do it, that really leaves a lot for you to do. And so, we bought a lot of these companies when things weren't that good for them, but it really, really made a lot of sense for what we were doing and how we built this company. I get too jumped up here.

We're always looking, and I think here are the keys when you're sitting there and really talking about doing a lot of M&A. We keep our balance sheet very clean. I believe debt is a four-letter word. We try to make sure that we do everything with free cash flow. This year we've generated over $1.5 billion in free cash flow. The good news is I'm not a big capital eater. You know, when we buy companies, we use it, but we don't have a lot of things like a Slumberj that has to continually reinvest in their equipment and everything. My big capital are things like buildings and machine tools. That doesn't take anywhere near as much with a lot of the other stuff that we do.

We have unparalleled access to capital. And you know why? It's because we don't have debt. We've got a little bit of debt — but our capital, our cash actually outstrips our debt. That's where we want to be. It gives us flexibility.

But I think the most important thing to realize in the M&A game is you have to be patient. I don't think people realize, many times, what M&A is all about. You just don't wake up one morning and say, "Oh, I'm going to go buy Varco and go do it." It takes a lot of patience. To give you an example, we concluded the Varco deal in 2005. I had my first conversation with Varco in 1998. It took that long for the moon and the stars to align. Grant Prideco we did in 2008. I had my first conversation with them in 2005. We kept going back to the table. We kept saying, "Here's what makes sense," and ultimately the stock prices and the valuation came together so that we were able to do it.

And we were able to do it because we kept our balance sheet clean, we had a lot of free cash flow and we could strike fast. That's what you have to be able to do. And a lot of people ask me today, "Well, who'd you talk to two years ago so we know who the next target is?" And I'd have to shoot you if I told you, so that's the problem.

You know, as you take a look, M&A is a big deal. The other one that's really huge for us is getting into new markets. And even new markets are not new, necessarily, but they offer new opportunities. You take a look at the shales — and I'm going to show you something on the shales in just a moment. If you look at the Permian Basin — in the United States today, the Permian Basin is one of the oldest oil fields around — yet it's one of the most exciting plays today because of our ability to drill horizontally and to be able to get into shales and things we never thought we've have an opportunity to do. And so, while it seems like that can't be a new market, it absolutely is a new market.

But you take a look at this world map — and where I'm flashing up those big stars right there — that's where shale plays are all over the world. And you hear a lot about shales here in the U.S., but I tell everybody God didn't just put shales in the U.S. They're all over the world. Actually, in Argentina right there, where you see the big one in South America ... one of the best shale plays going. Russia is ultimately going to become one of the best shale plays going. China — they need it. There's so much pollution in China today, the quick and easy solution is natural gas. They're going to exploit those shales and I'll come back to that in just a moment and talk a lot about it.

Shale plays are also equipment eaters. Here's a list, on the left-hand side, of all the equipment that you have to have when you're drilling shale wells. You look at that, and I'd like to be able to tell you this ... we build everything that's on that left-hand side. And that's why shales were really kind of created with us in mind. So, there is divine providence in this world. But when you look at everything that's up there, that's what you have to have around the world. And a lot of what you'll hear today are people saying, "Well, we're going to exploit shale a little bit slower in the rest of the world because we don't have all that equipment." And my answer to that is, "Golly. I build all that equipment," so it works out pretty well.

And let me show you, really, what the shales are all about. You know, we're able to take a look at this rock that comes out and our scientists were able to figure out that if we blasted that ... that if we hit it hydraulically with water and brine and a few other things ... that we would release oil and gas molecules. And that's a hard rock. When people think about shale, it really is. Now you see all the equipment that's associated with it on the surface — but you couldn't have drilled shales unless you had these fixed cut bits because you're going in and ripping that ground horizontally.

So, we were able to develop these bits and develop everything you see in that drill string. You have to have downhole motors so you can actually turn that bit at about 400 rpm. This is a coil tubing unit. You know, coil tubing has always had a lot of promise, but never a realization. We finally figured out how to use it. These are perforating guns. This is when you go down and you perforate the casing so then that hole can get the fracturing fluid through it, and that's what releases those molecules in the oil and gas and the rock. And here's all the fracturing equipment that you see on the surface.

So again, what you see here is the equipment intensity that's necessary to be able to drill these shale wells, and all of that there, fortunately, is built by me. And we're able to do things with that all over the world that really enhance our business. And you notice all the different wells you can drill from that one pad. It's very economically sound. We go down, we make the turn, we fracture that, and away we go. In the old days, you would have drilled one well on each one of those. Today, you can notice we've probably got about 24 wells and we're figuring out every day how to do even more.

So, that's why the shales all over the world are such a great story. They'll continue to be a good story in the United States. We basically, almost can become energy independent because of what we're finding in the shales, but it's also going to enhance the rest of the world as they go through the same processes that we've gone through.

One of the areas, when I talk about new areas and where the shales are, is Mexico. The stars are aligning in Mexico. That's a quote from President Nieto down there. And I believe, and I would offer up to everybody in here as you're looking for investment ideas, think Mexico right now. It's a very enlightened leadership. We have the NAFTA benefits. They just changed their constitution when it comes to energy. I think you'll see a lot of cross-border investment in Mexico and today we believe that that's really one of the best spots in the world to be. And I'll show you something a little bit later, and I'll have you think back to this particular slide because there are a lot of really good and positive things that are going on in Mexico today that I think really will lead to awfully good investment opportunities.

There's some risk. You may have heard about some of the violence down there. No question about it. But our experience — and I have a lot of operations in Mexico — the violence doesn't come looking for you. If you stay out of the wrong areas, you're going to be OK. But there's some tremendous opportunities in Mexico.

Then you've got new products and services introduction. You know, I think this is a key element to anybody that's going to do well in the oil and gas business. We're always pushing the envelope. You've seen what we've done on shales. You're going to see more and more later on different things that we can do. One of the things is the FPSO, and I believe this is the next growth step for National Oilwell Varco. The FPSO is a floating production, storage and offloading vessel. It's really the approved solution for the way that you produce the deepwater reservoirs that we're finding.

I tell everybody — and I'll show you a drill ship a little bit later — but these drill ships are out there drilling in 8,000 to 10,000 feet of water, and they're not drilling for practice. They're drilling to find oil and gas. And when they find oil and gas, the approved solution on being able to produce that oil and gas is the FPSO. The problem is we don't make them cheap enough, so we put our engineers on this. We bought a couple of companies that do it and today, we think we're online for being able to reduce that $750 million level down to a much lower level to make it much more affordable for the E&P companies so they can continue to explore.

This is an example of what you see. It used to be an FPSO could only be used in benign waters. The benign waters were West Africa, Brazil. You don't get the storms that you get in the Gulf of Mexico or the North Sea or the South China Sea. But we were able to design something here, and that's the turret that you see going up here. And this turret is connected to the manifolds on the ocean floor. All the oil and gas is being developed through that turret or produced through that turret.

Then that turret, in turn, moves the oil and gas down through the compression systems. They're able to take a lot of the water out, some of the other impurities. Then they're able to put it on tankers and take it back to the shore. Now if a storm comes in, what we've developed is we can actually drop the turret and then the ship, just like a drill ship, can now get out of harm's way. So it's able to sail away with the turret floating underneath the water — not to be bothered by the hurricane. Once the hurricane goes through, you go back in, regrab the turret, and away you go. What that's done is it's opened up every part of the world for the ability to be able to use the FPSOs.

So, I would offer that when you take a look at this market, I think over the next seven or eight years, you could see as many as 200 of these things built because we need to have them. That's the cheapest and most efficient way to produce the deepwater reservoirs, and I think that's going to be pretty cool to see that.

Another thing that we've been able to do is we look at game-changing technologies. One of the things you'd really like to be able to do is get seismic well drilling. Today, you've got to take your seismic stuff out. You've got to thump the ground or you've got to have noises go down in the ocean so you can figure out what the formations look like. If we could actually drill in there and get real-time data back, it's kind of the Holy Grail of being able to look at production.

So, what we've done is we created what I would call a superhighway with drill pipe in which we can actually get information, on a real-time basis, from the bit back up to the surface to be able to tell people what's going on. And that really looks like this. It's called wire drill pipe. Drill pipe comes together 30 joints at a time. We've wired it, we've made that connectivity so that it works ... so that now what you can do is actually get that information up to the surface and be able to make critical decisions as you're drilling the well, which is exceedingly important.

So, now we've got sensors in this bit that are feeding that info. It's gone all the way up that drill string, and so when it gets to the top, it tells you, "Here's the formations that we're seeing." The driller sits there. He's looking at everything. He can make decisions about what he wants to do, and then he can lower the weight, speed it up, do different things that allow him to drill past areas that he doesn't want to drill into. And you can see that here, in the old days, you just would have drilled straight down and hoped. Today, with things like this, you can go straight down and you can start to deviate and you can do different things and it gives you a much better opportunity to actually find out where your oil and gas is.

So, I think the new product development is huge when you take a look at the things we're doing. We're changing technology every day. The oil and gas business, I think, is one of the best at being able to adapt to things and figure it out, and it's because of products like this.

Now, we also look all over the world for where can we get organic growth, and those of you that know what the BRICs are ... Goldman Sachs, a few years ago, said they were going to be the most important element of what we did in the world economy. That's Brazil, Russia, India and China. How's it worked out? Not so much. But when you think about it, for us, it's still a pretty big deal.

Here's Brazil. Brazil is probably one of the biggest oil basins in the world. I would offer Brazil could use every rig that we've got in the world down there on that East Coast that you see right there on the second slide. But you also look at the economic activity. That's the blue line. And then the bar graph — and that's the one to concentrate on right now because that's the exchange rate. That's the Brazilian real.

The bad news is the economy has been very, very up and down. The good news is the dollar's going further than it did before because the exchange rate's really improved toward the dollar. Brazil's a big deal to the oil business. It's a big deal to NOV. We've got over 20 drill ships that we're building in Brazil today. But the economy has let us down a little bit and you have other issues associated with training, education and things like that, that make it a fairly difficult place to do business. However, it is where there will be a lot of growth.

Russia. Again, you take a look at the blue line and you see the big dive that it had after the financial crisis in 2008, and then you look at what the ruble's doing. Again, the dollar's getting stronger than the ruble. Much like Mexico, I would offer that Russia is going to be the next great place for the oil and gas business. And you think about the size of Russia — the United States is four time zones wide. Russia is eleven times zones wide, so think of the opportunity. And when you see all those basins right there — many of those are virgin basins. They have not been touched.

Today, the big effort in Russia is to be able to go in and have local content. I'm currently building about a $150 million plant in a town called Kostroma, which is just a little bit northeast of Moscow. The one thing you always figure out in Russia in the oil field — if you build it anywhere, you've built it in the wrong place. It's just too damn big. But we've made the decision this is where we're going to do it. I think this is going to be a tremendous opportunity, but you can see it's not been that line just going up and to the right the way everybody had anticipated.

And you look at India. India is probably more valuable to the oil and gas business as a consumer of oil and gas than it is going to be as a provider of oil and gas. But you see again the rupee — the dollar is very favorable toward that. You look at the different basins that they have. But again, it's the world's fourth largest consumer of petroleum today. I would offer that's going to do nothing but get more and more and more. As more people in the country — as the middle class expands, that's going to be a big deal — and it's a bigger deal to us to be able to actually manufacture in India and export that product than it is to actually think about things going into India.

And then finally China. And you take a look at the Chinese story. Again, the blue line's gone up and down, but you'll note, it's still well over 8% growth. That ain't half bad. But here's the key to this one. Look at where the renminbi is on the exchange rate. When we started our factories in China, the exchange rate was about 8.2 to 1. Today it's more like 6 to 1. And what that has done — I showed you the Mexico slide earlier — it's cheaper for us today to manufacture in Mexico than it is in China.

And so, we're starting to move a lot of what we did over there to other places around the world. The nice thing about my business — a lot of it's fungible. I can move it around. But you can see, with that exchange rate right there, China is becoming a more and more expensive place to do business. We actually build stuff in the U.S. and ship it into China. Imagine that. But as a manufacturer — the coil tubing unit I showed you earlier? We build those and move them in. It's amazing, but that's what's going on over there right now.

Where China is though, big, is the consumer. They will continue to use a lot of oil and gas. They've got issues with air pollution. I mentioned it earlier. The real solution to that is natural gas, and they have some tremendous shell basins. All the stuff I showed you on shale we're going to be doing in China — we're starting to do in China right now — and I think the opportunities for the oil and gas business are pretty amazing.

So, they're slowing ... but they're still very important. So, you can see the way it's kind of bounced around. I think the BRICs are very important, but there's other parts of the world that are equally important. I would tell you South Central Asia — I would tell you Southeast Asia are areas that are going to be every bit as important as the BRICs were when everybody said that about ten years ago.

North America's going to get stronger. I think those of you that follow the oil business know that North America's a little flattish today, but it will get stronger, and I think one of the real reasons is technology. You've got a bifurcation of the rig market. Everybody wants the best technology. You know, rigs rolled. When you take a look at the rigs that were built, most of them were built in the late 1970s, early 1980s. Think about your car. You might like your little Ford Mustang that was built in 1964, but you like to drive it on a Saturday morning ... not to and from work every day. And these guys want to have the best rigs that are out there. That's why I think you're going to see North America come back.

The second reason you're going to see North American gas come back is LNG. As the LNG facilities open up on the Gulf Coast, they're going to need to have feedstock. That feedstock is going to come from places like the Haynesville. It's going to come from Fayetteville. It's going to come from Oklahoma. It's not going to come from Marcellus or anyplace up in the Northeast because we don't have the infrastructure to get it to the Gulf Coast. That's why you'll see a resurgence down in Louisiana, Texas and Oklahoma — because they've got to have that LNG feedstock.

Deepwater drilling rigs — this is another area. We're in the process of building a bunch right now, and everybody says we're probably building too many. We're not. Rest assured of that. I mean, think about the world. There's 150 rigs working in the state of Oklahoma. They're drilling one well each. There are about 150 deepwater drilling rigs in the rest of the world drilling one well each. So, people need to get their hands around the fact that the world needs a whole lot more of these drill ships and I'm there to help them. So, when you take a look at it, the economics are still very compelling today, and it really is a unique piece of equipment.

This is just a chart that shows you that a man — on the left-hand side, the little blue — is what was there. The right-hand side shows you what each area's going to need. I actually think this might even be a little bit outdated. We're probably going to need a lot more. And this means an awful lot to NOV. Every drill ship that's built — my take on it is about $250 million.

And this is what it looks like. This is the Stena DrillMAX which is one of the best ones. We built this in Samsung in Korea. Everything you'll see on here I manufacture, but you also see the technology. You see the fact that there's no one around the rotary table. Very few people are here. The driller is running everything out of the driller's cabin. We're using robotics and automation as much as we can. Just like a plant that builds cars, people don't want to do the real hard work that's associated with being a roughneck, so we've tried to take that out of the equation. We've tried to have it so you can have this sort of technology, you can move things around pretty quickly, and they're doing it all with the control system that you see right there in that chair. Now, that's pretty neat stuff.

We've built about 100 of these since 2005. There's more to come. We're changing the technology every day. We're at the point today where we can drill in 12,000 feet of water. We also can drill in pressures up to as much as 20,000 PSI. That really means you can drill just about any place on the planet with the exception of the Marianas Trench. But the fact is that we're going to continue to push that envelope and you're going to continue to see these drill ships built. So, when you add the drill ships and the FPSOs, life looks pretty good for NOV, and I really think it will be as we push forward.

Jack-ups. Those are another thing. They need the same sort of retooling that I've talked about. Now, when you think about the jack-up rigs, 57% of the fleet is over 25 years old and again, the technology advances that are made are really incredible. And in that bifurcation of the rig market, today you see a lot of people continue to order jack-up rigs and most prognosticators say we're ordering too many. We're not. The reason is because the bifurcation, the new rigs are getting the work the old rigs are not. You're marginalizing old rigs.

This is an example. If we were to maintain the 25-year average, we've got to build about 20 new jack-up rigs a year. It takes about two years to build a jack-up rig. And you can see the age. Even if we built more than that, we barely dent the average age. And again, the technology differential on those older rigs is incredible versus the newer rigs, and because of Macondo, today you just can't run the risk of not drilling the rigs unless you have the best possible equipment. That's why we like where we are in the food chain. That's why we think you're going to continue to see a lot of good things happen.

Then reality is the proof is kind of in the results. You see in 2000 what our revenues were and you see where they've gone today. You can see the profits that followed. That's been, I think, the thing that we wanted to make sure that whatever we did, we were growing the company and we built it. You can notice even going from 2008 to 2009 there was just a short dip. That's because we had a big backlog. Even though the price of oil got very low, the price of gas got very low ... we were able to weather that storm quite well.

And the one thing I think most businesses forget about is cash is king. You know, when I was in grad school, an old professor of mine said, "Miller, you can do a lot of stupid things, but the only one that's terminal is running out of cash." And I believed him. So, you can see the free cash generation that we were able to do over the years. You've got to have that, and you've got to make sure that you're generating cash. You can have some years that you might not generate as much as you like, but gosh darn it, why are you in business if you're not in business to generate cash? That's what it's all about.

This backlog — that's really been the key to our success. If you notice back in the third quarter of 2008, when the world fell apart financially, I had about a little less than a $10 billion backlog and you can see I lived off that for the next couple of years. Today, my backlog is much higher. So again, we've built that to be able to withstand it.

I'll tell you just one cute story. A couple of analysts back in 2008, when I had my backlog sitting out there, said 75% of it was going to be cancelled and I'm like, "They don't quite get it. We get prepays. We've got hard contracts." We ended up having 3% of our backlog cancelled. And the good news is I made more money in that 3% because I didn't give the equipment back to them. I sold it to somebody else, so it worked out really, really well.

But you can see the same thing today. You can see the build of the backlog which gives us tremendous visibility into 2014, 2015 and 2016. We're still a lot of orders coming in, and if you talk to folks, that really is the key to what we're doing. That backlog gives us the certainty that the things we're doing are very positive.

Financials — you see what we've done with margins and I would say, as a manufacturing company, to get 20%-plus margins is pretty good. I think there's a lot of them that would like to do that. Our dividend today is about a little less than 1.5%, but we've raised it. We doubled it this past year and we'll probably raise it significantly again as we move through this year.

One of the things that we're doing is I'm going to spin off the distribution business. What's happened is we've got a really good distribution business and it has the size today to be able to live on its own. And so, we're going to spin that off to our shareholders on a tax-free basis. I think it's a great business. It's one we're going to be able to grow. And when I first told distribution I was spinning them off, they looked at me and they said, "Well, you're just trying to get rid of us," and I said, "Well, that's not the case." I said, "There's something I can't tell you yet."

Two months later I went back and said, "Oh, by the way, I'm coming with you." And so, I'm not going to be the CEO of NOV anymore. I'm going to go over and become the executive chairman of the new distribution business. So, I have a guy ready to take my job and this way I can keep my finger in the pie ... but I think this is going to be a good deal. I think when people see this — when our current shareholders get this — they're going to be excited about the products that we're giving them. About the company that we're giving them.

When you take a look at what we're doing — again, we use a lot of technology here, as well. When we go out in our distribution business, it's really kind of selling ... it's like any distributor. We're a Wal-Mart. We're a Home Depot. We're a Costco. We're out there selling the products that these guys need in the oil and gas business. But our folks have come up with really unique ideas. This is RigPAC right here. And what we do is we actually take a warehouse out to the rig. We're able to put it on the rig on a consignment basis. We have a great computer system. All of our distribution business is tied together through SAP and we're able to know where everything is at any one point in time.

We can take the barcode readers out there, just like at Wal-Mart when you buy a tube of toothpaste, you take it through the cashier. They wand it. They immediately tell their warehouse, "Restock the toothpaste." We do the same thing here on these drilling rigs. We're restocking them as soon as they use the product. But more importantly, we can go to our customer and we can say, "Oh by the way, your rigs are using too much. The rigs down the road aren't using the same amount, and so there's something going wrong here. You need to take a good look at it." And many of the folks go, "Oh, gosh. We didn't know that."

So, we're able to work with them through this RigPAC concept and that's value added. And as we can add that value, it no longer looks like a distribution company. It looks like a company that can go out there, take care of your needs, be able to add that value and the result is we're going to get a higher margin. So, I'm excited about this business. I think it's going to be a good spin for our shareholders and we're going to be pushing forward probably sometime in the early second quarter with this.

A couple of other things I just want to touch base on and then I'll make sure you can all get to the Happy Hour. The first one is we are still a cyclical business, though. You've got to know that. The price of oil and gas don't keep moving up and to the right. I think as you take a look at what you're trying to do, you need to make sure that you're planning for all contingencies. I think there's going to be an up and down in the gas business. It just happens.

You can say, "I think that it's going to be the high price, I think it's going to be the reference or I think it's going to be the low price," but make sure you build your company to be able to take advantage of that. I think that's the most important thing. That's one of the reasons I don't like debt — because when you've got a lot of debt and you get into a cyclical business and you go down, it hurts you. When you've got a lot of cash in a cyclical business and it goes down, you're not hurt anywhere near as badly. And you combat the cyclicality — leverage, liquidity, dividends. What we've tried to do is build this company to withstand the cyclicality as best we could, knowing we could never get rid of it, but at the end of the day have higher highs and higher lows. We think that's the most important thing that you can do.

And you want to be everywhere. You want to be all over the world because if the United States is down, maybe the Middle East isn't. If the Middle East is a little soft, maybe South America isn't. So, at some point in time, you're going to be hitting someplace on that map. We've got 1,250 locations around the world in 65 countries. That means I'm everywhere, and so the cyclicality can really be abated by that.

And the other thing is have the best technology — just absolutely have the best technology. That's winning the game today. Not only are you seeing it in the tech arena, but you're seeing it in our arena. This goes back to what we were showing before. It used to be everything you see on here was done manually. There were tongs. You had men that were up there just making these things bite. It was a backbreaking job. Today, everything you see up there is being done robotically because we're able to control everything that we have. We're able to control the system. We're able to do the things that we need to get done, and we do it through the best technology.

And people want to work on the rigs with the best technology, so it makes it easier on our customers to be able to really recruit employees because they bring them in there. They're able to come in and see this, and this job is a heck of a lot nicer than a job on one of the old rigs that doesn't have anywhere near this level of technology. So, you keep that technology up-to-date.

And the other thing I'll tell you is our engineers did an ergonomic study when we were building this, and the chair that we use for the driller is the chair that comes out of a Porsche 911. When that driller is sitting there, he thinks he's going real fast, so it works out very, very well. But the best technology wins.

When you look at the things that I've talked about today — financial flexibility, being around the world, technology, increase your offerings — that's what makes a successful company in the oil and gas business. I love this quote because this is what we try to do. Wayne Gretzky, when I asked him why are you so good, he said, "Others skate where the puck is. I skate where the puck's going." And what we try to do at NOV is figure out where the puck's going. I think that really sums up our strategy very, very easily and very quickly. That's what we do.

So, that's a little bit of an overview of what's it's about. I think it's an exciting business. I think today there are some real bargains in the oil and gas business. I think E&P companies are depressed. I'll tell you — all the drillers are down. And you look at companies like Ensco and Transocean and Noble — a couple of years from now, their share prices will be way up and it's because today everybody thinks that it's never going to get nice in an oil field again. And then about two years from now, it won't ever get bad again.

So, I think those are great opportunities. As you look at this industry — it's a fun industry, it's an exciting industry and it's one that's not going anywhere. I understand we're doing a lot of things with renewables, but Socrates once said, "Only the dead have seen the end of war," and I would suggest only the dead have seen the end of oil and gas. The world needs it and it's going to continue to need it for a long, long time.

So, that's my story, and if anybody has any questions, I think I'm doing good on time. I knew that the drinks were waiting. Yes, sir?

MALE:

You touched on a couple of things that I was wondering about in that there's a lot more shale plays throughout the world that aren't necessarily being taken advantage of to the extent that they are in the United States. My question to you is that as those plays are taken advantage of, does that drive down the cost of oil and gas? And if the answer to that question is yes, how does that impact the future of the renewables industry because one of the issues that we've always had is the cost of fossil fuels versus the cost of renewables such as solar or any of those other wonderful things. Could there be a slowdown in the conversion to renewables as a result of the drawdown of the cost of the fossil fuels?

PETE MILLER:

I think absolutely. I think you're seeing it today. As you take a look around the world — Germany just came on and they're starting to cut back on a lot of the subsidies that they're giving. I would offer — and again, I'm not trying to make a comment one way or the other — but the price of natural gas being at the level it is today makes wind, solar, a lot of the different things that you're seeing out there that much less viable without government subsidies. And so, I think that clearly is going to be an issue. But I would also offer that I think things like natural gas offer some real advantages when it comes to the carbon footprint. But you're absolutely spot-on. The lower those prices go ...

I mean, why do you think the United States is having a renaissance in manufacturing today? It's because of the price of natural gas. If you go back four or five years ago, natural gas could be over ten bucks in mcf. Today, we're delighted it's at $4.30 in mcf. A year ago or two years ago, it was $2.20 in mcf. But anything that's below about $5.00 in mcf is really a boon to manufacturing, it's a boon to most of us that heat our houses with gas, but it does impact the race to renewables without question.

MALE:

Good afternoon. Sheik Yamani from Saudi Arabia once said that the Stone Age didn't end for lack of stones. From your point of view this oil and energy market — how long will it take before technology like electricity in electric cars take over? My expectation is three to four years. Could it be more?

PETE MILLER:

Well, it could be. But first off, to go back to part of your question ... the electricity in electric cars — have got to have the generated electricity in electric cars. They get that from oil and gas. Mark Twain once said, "The rumor of my death has been greatly exaggerated," and I think the rumor of the death of the oil and gas business has been greatly exaggerated. It's a business and we're finding ...

I'm sure you've heard of peak capacity. I'm not the youngest guy in the room, but the world's been running out of oil and gas since I was born and today we're finding more oil and gas because of technology. It goes back to what I'm talking about on shales. We had no idea. So, I think the oil and gas business is going to be vigorous for quite some time.

MALE:

I'm a very proud shareowner in your company ...

PETE MILLER:

Thank you.

MALE:

... and I see you're spinning off your distribution system. Is that going to be a partnership? Or how are you doing that?

PETE MILLER:

No. We're giving it completely to our shareholders.

MALE:

Oh, so I stay right in that.

PETE MILLER:

And we're giving it tax-free. If you own ten shares of NOV — and we haven't figured out the exchange rate yet — but you'll get shares of the new distribution company.

MALE:

I really like tax-free.

PETE MILLER:

And you get me with it.

MALE:

First, thanks for the really nice presentation. My question is more along the steel line. You talk about coil tubing. Where do you produce that?

PETE MILLER:

Actually, one of the things you'll see when I answer a lot of these questions is we're the world's largest manufacturer of coil tubing, and we do it all in Houston, Texas. What we do is we get flat plate and then we roll it together, we bend it, and we have a seamless weld in it. And we've made coil tubing strings as long as 30,000 feet. So, think about that. And if you come to see one of our plants, it's about a quarter of a mile long. We start on this end with flat plate. We come out on this end with about 2-3/4 inches of tubing like that.

MALE:

Would you ever consider coming to Pittsburgh?

PETE MILLER:

Well, sure! No. Actually, I have a lot of operations in Pennsylvania and we have some operations in Pittsburgh. I hate to tell you this, but I have to buy my steel from Sumitomo, because that's the best grade of steel. And you can imagine that coil tubing. It's going through a lot. You put it on the reel. It's going down the well. We're working with U.S. Steel right now to see if we can certify their steel. The other thing is the big steel manufacturers in the U.S. — it's about tonnage. It's not about specialty steel, and my coil tubing's more specialty. But we'll keep looking and I'll come look you up when we go on to Pittsburgh.

MIKE OLSEN:

Kind of interesting, but I would presume that among the Fools here, how many National Oilwell Varco shareholders are there here?

PETE MILLER:

Well, thank you very much.

MIKE OLSEN:

You are in fond company. I guess that in mind, I've followed the business for quite a while and I know having the distribution business coupled to it made a great deal of strategic sense. So, I'm just curious as to the rationale in separating it. And then, not to get into your dinner table conversations, but I guess I will. Why did you decide to go there?

PETE MILLER:

First off, the distribution business has worked very well being part of NOV, but it also had some downsides because there's a lot of equipment out there to distribute that other people didn't want to use us as a distributor because we were NOV. We took a look at it, and we'll continue to distribute most NOV products, but, we'll also be able to distribute other product. Plus, whenever the distribution folks came in to see me with a good idea and they wanted to expand and do stuff, I would just push them back and go, "I'm sorry. I've got better uses and a better rate of return on my money."

And so we think for our shareholders number one, you're still going to have the meat of NOV but secondly you're going to have new stock in a company that I think is going to grow and is going to grow fast. And so for us, it was a win-win for everybody ... a win-win for the shareholders and a win-win for, we think, the two companies that are going to be there.

The second part of it — the reason for me going. One of the things that I've worked with my board on, every board meeting for ten years, is succession planning. And my position on it — my board was always told if I get hit by a truck tonight, something happens — here's the guy you ought to promote to CEO. And if something else happens, here are the other people. And I go up and down the line. Every one of my top managers, I have a succession plan for. And the time is right. I've got a young guy named Clay Williams. Clay has worked with me as the CFO. He's been my COO for the last year and a half.

He's ready, and I've always said I'm not going to stand in his way. I don't want a guy hoping that I have a heart attack so he can get promoted. So, he was ready. I've worked my entire life — since I was about 14 years old — and so I thought this is a great opportunity for everybody. My board wasn't too excited about it initially, but I think they've come around a little bit, too. So, that's the reason. He was ready. You're going to get a great leader in Clay and I think those of you that hold the stock of NOV now, you're going to find that's going to be a great company, as well and I'll be the executive chairman of that with a great CEO. That was the rationale.

MALE:

My question is a little off topic, but you're talking about a drilling company and a lot of new technology, and we have refinery capacity issues in a lot of these fuel sources bringing a different quality of fuel. Are you seeing more demand for your products to do more separation and cleaning?

PETE MILLER:

You know, for the most part, most of the things that we do ... It's a great question. I've stayed upstream, for the most part. I've done that for a lot of reasons that I won't go into — but I've kind of stayed upstream. But the midstream and downstream really do need new products and they're getting new things for the separation. And I think as you look at companies like Dresser ... I think if you look at some of the compressor companies and some of the other — those will probably be good investments because they have to retool, as well. They have the same thing that these drillers have. You've got some refinery that's 40 years old, and it's not real efficient. And you're seeing a lot of retooling done right there.

MALE:

A couple of questions. How do you compare the political roadblocks of doing business in the U.S. compared with Mexico, Russia? And are you applying any 3D printing techniques in your manufacturing?

PETE MILLER:

The first one is every part of the world has its own problems. You've got problems building plants in the United States depending on what states you go into. If I go to Pittsburgh, it's a little harder than if I'm in Texas. I didn't say that, but ... In most countries, it's tough. I mean, Brazil is real tough. There's a big bureaucracy and you've got to get a lot of things done. Russia — there's a big bureaucracy. That's why when people tell me they're going international, I just kind of chuckle.

Our experience on going international is don't shoot your way through the door. Go buy it. And you go buy companies in these countries because they know how to handle all the regulations and the rules. But each place has its own issues. And if people say it's easy doing business in the United States, I would say, "Au contraire." There's other places in the world that it's harder, and there's other places that it's easier.

On 3D, that's a great question. Just to show you how connected I am in my company, I'm sitting there watching something. I think it was — what is it? The 3rd Rock from the Moon or one of those shows. Anyway — no. It was *The Big Bang Theory*. So it shows you what I do at night. I've got an exciting life. So I'm watching it, and I see this 3D printer on there. I came into my guys the next morning and I said, "This is cool. We are going to go get some 3D printers." And my chief technology officer said, "We already have ten of them." And I just drank my coffee and said, "I knew that. I knew that."

So, I'll tell you where the 3D printers come best for us is design and getting something off of the design table and into the manufacturing process right away. We wouldn't build any parts with 3D. Our parts have got to be a lot stronger, ultimately, than that. But boy, I'll tell you what. You go in there with a new BOP design and if you come to my office in Houston, I've got all kinds of little models around there, because I want to show I'm connected now. But I've got all these things that we built on 3D printers. It is magic. It cuts engineering time on designs by leaps and bounds. The biggest advance we ever made was getting off the drafting board onto things like SolidWorks and being able to design on computer — and just as big is being able to take those computer designs, build a model overnight and be able to take a look at it. It's big-time stuff for us.

MALE:

Similar to 3D printing, you mentioned automation as a big part of your business. If you can discuss what companies are you working with, with respect to automation and how do you see that factoring into your business going forward?

PETE MILLER:

Interestingly enough, one of the things we've discovered ... We've put venture capital into some small companies, but more importantly, we do it on our own, because we've seen that a lot of the companies that specialize in automation don't get our business, and they don't get the fact that you've got drill pipe like this that you're smacking around out there and you've got to tighten it up. So everything you saw in here, like on the very last one ... that chair, and all the automation and all the software are done in Norway.

We bought three companies in Norway and Norway is our center of excellence for electronics. I discovered when I want to hire an EE in the U.S., they want to go to work for Google or Yahoo! They don't want to come to work for NOV. But in Norway, the oil and gas business is still the big deal, and so we get all of our electrical engineers over there out of schools like Trondheim and Bergen and some of the really top European schools. So, for the most part, we're doing it all in-house.

FEMALE:

[00:51:40]

PETE MILLER:

You're asking me. I'm the guy that didn't even know I had them, OK? I actually don't know. I don't know the brand name.

FEMALE:

[00:51:49]

PETE MILLER:

Absolutely.

FEMALE:

I'm also a proud National Oilwell Varco shareholder ...

PETE MILLER:

Thank you very much ...

FEMALE:

... and now even prouder after your superb and impressive presentation.

PETE MILLER:

Well, thank you.

FEMALE:

I was wondering if you could share with us, from your deep knowledge in the field of fracking, your insights into the problems surrounding frack water cleanup and how might that impact your business going forward?

PETE MILLER:

Sure, that's a great question. First off, we've been fracking since 1949. Earl Halliburton invented fracking — consequently you have Halliburton Company. We've been doing things, actually, awfully good and then we came up to Marcellus and got a little bit closer to the Northeast. Down in Texas and Louisiana, we handled it pretty good, but not so much ...

But, I'll tell you this. The industry is doing a great job. Today we're looking at different concepts on fracking with brine water, because a lot of times you have to use fresh water, but I think we're making great strides. I just bought into a company that's really got a cool reverse-osmosis system that is small and compact that you can actually put on location and be able to clean the water up real well.

The biggest issue is reducing the amount of water we have to use. That's the biggest issue and I think people from Halliburton, Slumberj, BJ, Baker Hughes ... they could talk much more eloquently about it than I can ... but I will guarantee you. The same industry that figured out how to go out and do that horizontal drilling and figured out that the Permian Basin had a lot more oil in it than we thought, and figured out that the Marcellus Shale had a lot more gas in it is also going to figure out how to do this with less water, if any water. I think one more. She's getting ready to pull me off stage.

FEMALE:

Is there a significant competitor in your equipment and technology manufacturing business?

PETE MILLER:

Do we have any government employees in here? Yeah, there's a lot of competitors. Okay, last question and not about competition.

MALE:

I have one question for you. This is a slightly different take. You said you had a lot of new technology that requires using computers. Are you finding that you have the labor to staff all of this new equipment that's trained and able to do that? It feels like a big shift in what you need.

PETE MILLER:

It's a big shift in the quality and the training of the individuals, no question about it. One of the things that we did — about eight or nine years we opened up technical colleges. I've got them in Houston; Stavanger, Norway; Singapore and Macaé, Brazil. What we're doing is we're rotating over a thousand people a year through these technical colleges, and it's specifically to address those issues.

What we're finding, though ... One thing is the oil field pays pretty well when you start taking a look at a guy who works out of one of those offshore rigs with a high school degree and a little bit of training's making over $25 an hour. Plus, if he's offshore, he's getting all of his meals paid for. If he stays away from the poker table, he's going home with a lot of money every tower, so he can do it. And we're finding that you have to make the commitment to train.

And the other thing that we're also discovering — we're a worldwide business and a lot of the engineers that we're getting today we're getting out of Romania. One of the reasons I talked about the plant that we're building in Russia in Kostroma and one of the reasons we went to Kostroma is it's got a wonderful college. It's a town of about 250,000 people and they graduate 2,000 to 3,000 engineers every year. And those engineers love to come to work in our business. So, we teach them English. We teach them how to do certain things.

So, we're finding if your goal is only to get employees out of parts of the United States, you're going to have trouble. But if you're willing to go worldwide — and we're a worldwide business — you're going to find the folks. You're going to find them.

MALE:

And that is it. Let's give Mr. Miller a big hand.

FoolFest 2014: Author Malcolm Gladwell

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Run time: 60 minutes

We were thrilled to have acclaimed author Malcolm Gladwell sit down for an interview with Tom Gardner at our February member event. Watch as the two talk about Gladwell's latest book, *David and Goliath*, and why many people would rather "lose conventionally than run the risk of catastrophic loss unconventionally." The two talk about disruption, playing to your weaknesses, and how David and Goliath principles play out among some of our favorite companies, including Amazon and Facebook.

Transcript

TOM GARDNER:

Okay, so as our *Motley Fool One* members know, I have my questions on my iPhone in this highly, highly formal setting of Foolishness. By the way, what are the chances that my [00:00:12] slides off the back? That will be entertaining.

This is the David and Goliath of hair. So, I guess I have the unique advantage in this, given the great disadvantage that I have. But Malcolm, what would be great is just to have you start by ... First of all, thank you so much for coming and spending time with us. Just outline the overall premise of the book.

MALCOLM GLADWELL:

Well, I was interested in a book describing in asymmetrical conflicts ... or more generally in this notion of is our understanding of what an advantage is accurate? And that's the theme that runs throughout the whole book. So, if our understanding of what an advantage is, is so accurate, why does the weaker party in a war win as often as it does? Because the weird thing about it, if you look at the history of warfare, is that the "underdog," the much smaller party in any kind of conflict, wins an astonishing number of times, which suggests that maybe we're fixating on the wrong variables in explaining conflict. And then I run with that idea and talk about schools and education and dyslexia and all kinds of entrepreneurialism and all kinds of things along those same lines ... wondering whether our kind of intuitive accounting of these things is accurate.

TOM GARDNER:

What I'd like to do is just spot up some of the characters, some of the narrative of the book so you can just tell maybe a couple of short, little tidbits about each one. So, why don't we start with Vivek and since I'm going to mispronounce names, why don't I have you pronounce the full name.

MALCOLM GLADWELL:

Vivek. Runadiv ...

TOM GARDNER:

Vivek.

MALCOLM GLADWELL:

... who is the guy who founded Tibco, a software company in Silicon Valley. He's sort of the one who got me rolling on this because I ran into him at a conference once, and I really had no idea who he was. This is a problem that I have — that I have very, very poor facial recognition. In fact, parenthetically, I once was at a dinner at some conference. Sat next to a guy who, for the whole dinner— I thought he was a graduate student — and I made him discuss Michigan State basketball with me the entire time. Discovered at the end of the conversation that it was Larry Page. It was almost like, "Did you really get to talk to Larry Page?" It was like, "That was Larry Page? I thought he was a graduate student." So, I'm bad at this.

Anyway, I run into this guy Vivek, and I start talking to him, not realizing that he's the head of Tibco, about his daughter's basketball team. He had just finished coaching his 12-year-old daughter's basketball team, and Vivek being from Mumbai doesn't know the slightest thing about basketball. And so, he went to watch basketball to educate himself on this, and concluded that the way Americans play basketball was utterly insane.

He didn't understand why you retreated after you scored. Why do you run back to your own end and wait for the other team to bring the ball up? I mean, sometimes he will play the full-court press, but his whole point was why wouldn't you press all the time? Particularly for the weaker party — if you're the weaker party, why would you allow the other team, which is better at shooting and passing and scoring than you, to shoot, pass and score more quickly than they would otherwise? Why wouldn't you try and stop them from doing the thing that makes them good?

And particularly when you're talking about 12-year-old girls, you realize that if you play the full-court press with 12-year-old girls, they won't even get the ball inbounds. And furthermore, he realized that his team that his daughter was playing on was a team of girls from Silicon Valley. They were the daughters of people like him. In other words, these were not girls who went home every night and shot baskets. They were girls who went home at night and dreamt about becoming marine biologists. They had no talent whatsoever, basically.

So, he gets these girls together and he says, "Look. I don't know anything about basketball. You have no talent whatsoever. It's pointless for us to shoot, dribble, do anything. What we're going to do is get in insane shape, and I'm going to teach you how to play the most aggressive form of the full-court press." And so, they start winning games by scores like 6-0 and they go all the way to the national championship.

Now, the fascinating thing about that story is that it's the rational strategy if your team sucks. In fact, any team that is a decided underdog in any basketball contest ought to play the full-court press. Even though there's a chance that the other team can break the press, you're going to get blown out. But his point is, "So, what? You're going to lose anyway. Your only chance of actually winning is to do something radical."

So interesting that number one is why, then, do so few underdog teams play the full-court press? Why is there an unwillingness to follow a strategy that is in your best interest? And the answer is because it's hard and because people don't like it. And people didn't like Vivek when he was coaching this team.

TOM GARDNER:

Is it also possible that there's a mind-set that it's better to lose in a conventional way than to get utterly blown out in an unorthodox way?

MALCOLM GLADWELL:

Yes, but that's irrational ...

TOM GARDNER:

Absurd ...

MALCOLM GLADWELL:

It's absurd. But what's interesting with this is it is — we could go on and on and talk about this — but it's a perfect allegory for so many things in the marketplace. That people would rather lose conventionally than run the risk of catastrophic loss unconventionally. They would rather 100%, or a 95% chance of losing unconventionally, than a 40% chance of losing and taking a risk.

TOM GARDNER:

Let's hear about Caroline Sacks.

MALCOLM GLADWELL:

Caroline Sacks was a pseudonym. I got really interested in this literature on what's called *relative deprivation*. And so the question is if you're choosing a college, do you want to go to the best college you can get into? Everyone says you should. But there's reams and reams and reams of educational data to suggest, actually, that's not a good strategy at all. With some exceptions, you shouldn't go to the best school you can get into.

You should go to the school where your chances of finishing in the top third of your class are greatest. The psychological costs of being at the bottom of any class, particularly if you're in a competitive field like science, math or engineering, are so overwhelming that it's too risky. If you really want to get a science degree, you should go somewhere where you can feel smart.

Caroline Sacks is a girl who was really good at science. Got into Brown. Went, because everyone said that's the best school you should get into. Got to Brown. Dropped out of science, because she looked around at the other brilliant kids in her class and thought she couldn't do it. And realized, belatedly, that she was just in this absurdly elite environment. By any real-world measure, she was good at science, and had she gone to her safety, University of Maryland, she would today have the most valuable commodity in the marketplace ... a science degree. So, that's a case where, again, our obsession with a certain kind of advantage ... in this case, prestige ... completely distorts our rationality.

TOM GARDNER:

David Boies, the well-known lawyer, and his journey to the law.

MALCOLM GLADWELL:

He's dyslexic. He reads, at most, one book a year, and he is America's greatest trial lawyer. When I heard that, I was like, "Whoa!" So, I went and talked to him. I was like, "How do you even get through law school?" I mean, he can read, but really, really slowly. And this fit into this larger theory of if dyslexia is such a terrible problem, then why are such an extraordinarily high percentage of successful entrepreneurs dyslexic?

And the answer is that some portion of dyslexics compensate for their disability in ways that leave them better off. So, Boies said, "I got through school by doing two things. I developed my memory to the point where if you say something, I'll always remember it. Secondly, I learned how to listen." So, in law school, he would sit. No paper, no pen. He'd sit in the front row, focus on the professor, listen to everything the professor said and commit everything the professor said to memory.

He gets into a courtroom. All of a sudden, he's a dynamo. In day four of the cross-examination, he can say to you, "Wait a minute. On day one, you said X, Y, and Z. Now you're contradicting yourself." He's that guy. And that's not something he's born with. It's something he developed as a result of being denied the ability to read fluently.

And you can make the same argument for entrepreneurs — that deprived of the ability to succeed conventionally in school, you are forced to delegate. I must have interviewed 10 very successful dyslexic entrepreneurs. Every single one of them — what do they do in first grade? Identify the smartest kid in the class and make friends with them. Of course! How else are you going to get through school?

They also, by the way, all cheated ... which I didn't go through in my book. But I was actually fascinated by this. Cheating — but it's not cheating. Cheating, most of the time, is where, "I don't want to do the work, so I take a shortcut. I don't really care about school. I have a contempt for it."

These guys care passionately about school, but they can't do it constitutionally. And they care so much that they say, "You know what? I have to stay in school. I am going to come up with strategies that allow me — someone who is constitutionally incapable of reading easily — to continue to flourish." And so, they cheat. At one point, I had a whole chapter on the cheating techniques of successful, dyslexic entrepreneurs, but I left it out.

TOM GARDNER:

Let's hear about Wyatt Walker.

MALCOLM GLADWELL:

Hm. Wyatt Walker, my favorite character in the book. Wyatt Walker is Martin Luther King's shadowy, less-known deputy. He's the *fixer*. He's brilliant. So, King is like the saint, running the show. Walker's behind the scenes. I wrote a chapter on Birmingham — what happens when King goes to Birmingham to take on Bull Connor — the climactic event of the Civil Rights Movement in 1963.

And the question is, if you have been oppressed for 200 years, what do you learn through that process? What are the lessons — if you're smart and adaptive and resilient — what do you take home from being kicked around for 200 years? And the answer is, you get really, really, really, really clever and you learn how to play tricks.

King, in Birmingham, has nothing. He's got no money. He's at the lowest ebb of his ... He'd just gotten schooled in Albany, Georgia. He's being denounced by everyone, including the black press. He starts to hold marches in Birmingham at the beginning and 12 people show up. Bull Connor is looking at him and laughing. He doesn't even bother to send his cops out after King, because King's so pathetic. And Walker proceeds to play a series of tricks on Bull Connor that have the effect of defeating him. I won't go through all of them, and I'm not going to ruin the chapter for you, but I'll tell you the first one.

They have 12 people marching every day in Birmingham, which is ridiculous. Nothing. One day, they're arguing in the church before they go out on the march and they get delayed. And what happened is that after work, all of the African-Americans who worked in downtown Birmingham would come to 16th Street Baptist Church and just hang out to see what was going on. So, they're delayed until after workers got out.

So, they send their march out with 12 people, and the next day, Walker reads in the press that a thousand people marched in Birmingham, Alabama. He was like, "A thousand? We only had twelve." And he realizes, "Oh, wait a minute." To the reporters, they can't tell the difference (a black person is a black person) between someone who's just a bystander and a marcher. So, he's like, "Oh, duh! We're always going to march after work now!" And so in the press, from then on, it's like, "Twelve hundred people marched yesterday in Birmingham." He was like, "We had a dozen." And everyone is fooled. Even Bull Connor is like, "Whoa. All these ..." And it's hilarious. The story builds from there.

A lot of what people assumed were protesters in Birmingham were always bystanders. Some of the famous photos of the firemen turning the water hoses on protesters were not protesters. Wyatt Walker figured this out. They were bystanders who were really hot (it's Birmingham) who went to the firemen and said, "Turn on your hoses. We're really hot." So, then Wyatt Walker had all the photographers line up, take these photos. Then he said, "Oh, look what they're doing!" This man totally outsmarts Bull Connor. It's just a textbook case of how just because you've got nothing doesn't mean ... It's the same lesson as Vivek. Just because you've got nothing doesn't mean you have to roll over and die. There's all kinds of means available to you.

TOM GARDNER:

Use what you got.

MALCOLM GLADWELL:

You've got to use what you've got.

TOM GARDNER:

Let's close in the narrative section here with your version or your interpretation of the real showdown between David and Goliath.

MALCOLM GLADWELL:

Oh, yes. David — first of all — the sling is one of the most feared weapons in ancient times. It's not a child's story. The rock that goes from David's sling has a stopping power that's equivalent to a bullet from a .38-caliber handgun. When David decided to bring a sling to a sword fight, he's got superior technology. He's not messing around here. He knows exactly what he's doing.

Second, Goliath probably had something called acromegaly, which is a condition where there's a tumor on your pituitary gland, and so your pituitary overproduces human growth hormone. And many of the great giants in history had acromegaly. André the Giant — the great wrestler — acromegaly. Tallest man in history — a guy named Robert Wadlow — had acromegaly. He was 7'11", I think. Acromegaly makes you really, really big and tall. It also comes with a side effect that the tumor starts to compress the optic nerves and radically diminish your vision.

And if you read the biblical story of Goliath very closely, it's clear the guy can't see. He's led onto the valley floor, much more than this, by an attendant. He's the mightiest warrior in Palestine and he has to have a boy lead him by the hand to the battlefield. And then there's this whole thing about it takes him forever to figure out where David is and what David is doing — because David comes down from the mountain and doesn't have a sword. Doesn't have a shield. Isn't wearing armor. Duh! He does not intend to fight you in a sword fight. Why does Goliath take forever to respond to this? Because he can't see him.

So, here you have a kid who is really fast moving, nimble, has superior technology. Has changed the rules of the conflict without telling his opponent and his opponent is largely blind. That is not the story of an underdog. David holds all the cards, properly understood. And that's a beautiful example of how the stories we tell about advantages are just so screwy. Why do we worship size, for example, in all forms? Not just in warriors, but also in companies? We have this obsession. If something is big, it must also then be ferocious and a terrifying opponent. Wrong, wrong, wrong, wrong, wrong. And that's the lesson of the original story.

TOM GARDNER:

What I want to do now is search for patterns in your work, in the book, that might overlay nicely to looking for disruptive, smaller companies that might succeed — when we make the assumption that Microsoft will, of course, squash every business that gets in its competitive space 15 years ago and that doesn't end up happening. Or we assume that Apple must win because Apple is of the size and scope that it is today. So, we're going to look for more disruptive companies, smaller companies and see if these principles help us find them. Number one would be *occupy a spot off the beaten path*. So, maybe the story of the Impressionists and the Salon.

MALCOLM GLADWELL:

The Impressionists are a really interesting group. They come along at a time in the art world in Paris, France, where there was something called the Salon, which was the big art show every year. What every artist did was they competed to get accepted into the Salon. And the Salon was very conservative. It had very strict ideas about what was an acceptable painting.

The Impressionists were doing something radical, and they faced this choice. Should they try and get their paintings into the Salon — which would mean they would have to dumb them down and make them more conventional — or should they go off on their own, and give up all of that prestige and do their own thing. And they decide to give up on the Salon and do their own thing. They start their own little show — which in the beginning no one goes to — which is just in a little upstairs in some little room. And that ends up being the greatest thing they ever did, because they privileged the freedom to do what they wanted over conforming to, as it turned out, a dying set of standards about what art represented.

And that, you know, is a tried and true principle for revolutionaries — that before you can challenge the status quo, you need to leave the status quo. You need to find a safe haven where you can pursue what you think is the right answer free of the deadening constraints of conventional thinking.

TOM GARDNER:

Warren Buffett, Omaha, Nebraska. Leaving New York. Unable to get a job, in a way, in New York City and goes off to Omaha where he can carve his own space out. A little bit of the Ikea story in Poland.

MALCOLM GLADWELL:

Oh, yes. I love that story. Yes. Ingvar Kamprad who has this brilliant idea, which is if you make furniture and don't assemble it, you can ship it flat. You can save on assembly, save on shipping and sell it for much less. And then he gets shut down in the late '50s by his competitors. He's basically blacklisted in Sweden and facing bankruptcy — and he has this second great idea which is Poland, across the Baltic Sea. Really, really cheap labor. Lots of trees. And Ikea is ...

TOM GARDNER:

And Communism.

MALCOLM GLADWELL:

And Communism. He's able to pull it off. It's an extraordinary story of how he manages to build his first plant in Poland, because it wasn't easy to build a modern manufacturing facility in Communist Poland in 1961. And also, it's the height of the Cold War, and he goes to the enemy. It's like going to North Korea today, essentially. It's the same thing. But he is so convinced of his vision and of his business model that he's willing to thumb his nose at everyone and leave the country where he came of age. He's never really gone back.

TOM GARDNER:

So, we're outside the status quo and we turn for expert advice, and I want just a little riff on that in the form of Roger Craig, San Francisco 49ers running back and his sister. So, in other words, Vivek is outside the status quo, but he probably couldn't have pulled that all off by himself without turning to one of his employees.

MALCOLM GLADWELL:

Yes. Going back to the story of Vivek and his girls' basketball team, it turns out that Roger Craig works for Vivek and Roger Craig's daughter was an all-American basketball player at Duke. So, he recognized the fact that he only really knew cricket and basketball was a little bit of a foreign thing.

Craig's very interesting, actually, as an advisor, because the whole theme of Vivek's basketball experiment was to substitute effort for skill. And his argument, I think, is a very accurate argument ... that in many domains effort properly expressed is an adequate substitute for skill. More than an adequate substitute for skill.

And if you know about Roger Craig's career — that's his whole M.O. He's an effort guy — he's also a very skilled guy — but the thing that set him apart was an extraordinary work ethic. Roger Craig has run seven marathons since retiring as an NFL running back. Most NFL running backs can't walk after they retire. So, he knew what he was doing, in other words. He was bringing people who reinforced this really central notion which is that if you're willing to really work, that can make up for a lot of deficiencies.

TOM GARDNER:

So, third factor. *You don't overplay your greatest strength*. I phrased it that way from your discussion of the inverted-U curve. Maybe explain that concept. Should a David, even though he has a strength, not think about overdoing it or is he still on this side of the U curve and should be anchoring hard on his strength as far as he can take it.

MALCOLM GLADWELL:

The inverted U is a chapter where I talk about how I think one of the mental models we use to describe relationships between resources and outputs really leads us astray. We have this notion that if a little bit of resources (money) makes the problem better, then a lot of money will make the problem best of all go away the most. And the answer is no. In most situations where we look at relationships between what you put in and what you get out, the curve does not look like that. The curve looks like that or the curve looks like a U. That in the beginning, things get better, and then they flatten out, and then they get worse.

I use the example of class size. It is absolutely the case that if classes are very large and you make them smaller, kids will do better. But then there's a long stretch between probably the high 20s and the low 20s where you can make a class smaller and you will see no effect on kids' performance. And if you go too far below 20, kids are worse off. There's really interesting, compelling evidence of this — that it is not a good thing for a child to be in a class with 14 other students.

One, you cannot get a discussion going with 14. Not enough voices in the room. Two, one bad apple can totally ruin a small class, because there's nowhere for that person to hide. And thirdly, children who are struggling ... what they need most of all is not more attention from the teacher. What they need most of all is another person appear who is learning at the same pace as they are so they don't feel marginal and isolated. You need to have someone who's asking the same questions, struggling with the same problems. If a class gets too small, the struggling kids are just wiped out.

And that's a lesson that is so routinely violated. I made fun of expensive, private schools in my book because, I'm sorry ... they deserve it. They take $50,000 of your money and they boast to you that your kid is in a class with 12 other students. Whoever said that's a good thing? All they're doing is justifying the fact that they took $50,000 of your money.

TOM GARDNER:

And they have 20 Steinway pianos. That was the Hotchkiss School where you, I thought brilliantly, pointed out that a school like that is often serving its primary customer, which is the parent ... not actually the outcome for the student. It's to impress the parent that we have the very best of every piece of equipment times ten.

MALCOLM GLADWELL:

And by the way, where it is written ... I even find the whole notion that the point of a classroom is to maximize the attention that a student gets from a teacher insane. A student has to go through extended periods where they are forced to solve the problem in front of them by themselves. That's called *life*, right? The teacher should be there for when you are truly stuck and also should be there to get you to the point where you can solve it on your own. It is not a good thing to have the teacher hovering over your shoulder at all times. That's debilitating. We start to make the mistake where we push our use of resources well past the point where they are useful.

TOM GARDNER:

There's a business writer named Les McKeown, and he was the first person to make me see that a company with too much cash — that can be a weakness ...

MALCOLM GLADWELL:

Oh, yes ...

TOM GARDNER:

... because of course, as an investor, you're thinking, "Well, at least I know they've got this huge safety net of billions and billions of cash set aside." But in fact, one of the lines from the book — "shirtsleeves to shirtsleeves in a few generations" — having too much money actually can create a lot of problems and bad incentives inside that system.

MALCOLM GLADWELL:

I think this is at the heart of the R&D drought in big pharma. I think that they have overspent on R&D. If you look at it, it's really fascinating. So, we know, looking over the last 25 years, that the bulk of innovation in the pharmaceutical arena has come from smaller biotech companies who are spending, over the course of developing their products, a fraction of what the big companies are spending.

And the reaction of big pharma to that problem is to spend even more money as opposed to asking, "Does having virtually unlimited resources available for R&D change the nature of the questions you ask and change the nature of the strategies you pursue and change the nature of what you consider to be a worthwhile product?" I think that a lot more time should be spent on wondering whether they have gone too far.

TOM GARDNER:

One last David principle that we might apply to looking at leaders and companies — they truly have nothing to lose.

MALCOLM GLADWELL:

Yes. I'm always really interested by the difference in the strategies that you pursue when you are in a position of relative strength and when you are in a position of weakness — and there is a marked difference. We know that. We all know that intuitively — that when our back's to the wall, we consider a wider range of options than when we are in a comfortable position. And that's what we all know — that a cornered rat is a very, very dangerous opponent — not that struggling companies are rats.

But it's the mistake that the United States makes in Vietnam. It's a mistake we're making now in Afghanistan. We underestimate our opponent because we see that our opponent is relatively impoverished — forgetting that, that very state of relative impoverishment gives our opponent a huge source of strength.

TOM GARDNER:

Is it true that every Goliath was once a David?

MALCOLM GLADWELL:

Not everyone. In New York City, there are lots of Goliaths who are born Goliaths and will no doubt die Goliaths. No, but the most interesting trajectory is when people or companies go from one state to the next ... and the question is can you continue to embody the David values, even as you become Goliath?

On my book tour, I went to Microsoft, and I hadn't been to the Microsoft campus in Seattle for maybe seven or eight years. And I don't know how it's possible, but it's gotten even bigger. And this is not a good thing. I mean, it's like a huge city, now. Are there any vestiges that remain of that really hungry, nimble, innovative company of 20 years ago? So, it is a constant problem — the act of becoming successful undermines the very reasons why you became successful.

TOM GARDNER:

I wonder. What do you think the principles of a great Goliath are? I mean, I can guess one of them has something to do with empathy in the context of the story you tell about Belfast in 1972 and the use of police and power and the assumptions of what would work and what, instead, worked. Maybe through that story or any other examples — what makes for a smart Goliath?

MALCOLM GLADWELL:

Well, one of the things I've been thinking a lot about recently is that when companies become large, one of the things they need to do is to use their size and strength to become more tolerant of dissent, confusion, argument. To back off, in a certain sense. I always remember this. I used to work, many years ago, at the *Washington Post* in its heyday when it really was Goliath. There was a reporter there named Michael Isikoff. He's still around. One of the single, greatest investigative reporters of my generation. I mean, a legend. And also, I like Michael. A deeply obnoxious guy. But the point was he was a great investigative reporter *because* he's obnoxious. He's a pit bull. Doesn't take no for an answer.

And I remember that at a certain point that editors at the *Washington Post* got fed up with him and got rid of him. That is absurd. The whole point of being at the *Washington Post*, and having tons and tons of resources in a vast newsroom is that you ought to be able to find room for that kind of character. And that requires more work from management — dealing with someone who's difficult and who yells at you when you mess with his stories, and who goes off in quixotic things and disappears for a while. It's more headaches, right? It makes your life more complicated. But you have to understand — that is the price you pay for remaining on the cutting edge — is you have to deal with that.

Now, it's easy if you're a small company to deal with that because everything's chaotic, and you realize, "We have no choice. We have to be this way." When you're large, you fall into the trap of thinking, "I can make everything run smoothly now. I can have layers of comfortable management. We can all do things by the book." As opposed to saying, "No, no, no. You have to continue to find ways to shake it up — to have a kind of disputatious culture."

I write for Grantland, sometimes, the ESPN ... And Grantland's in L.A. and ESPN is, of course, in Bristol, Connecticut. And nothing makes me happier than when I read in some blog about how the guys in L.A. are denouncing the guys in Bristol. I just think that's why ESPN remains interesting and vital and important — because they argue, and they argue in public and they don't care. They're fine with having a public image as a company that is in a state of semi-turmoil.

TOM GARDNER:

A Goliath that's open to dissent ...

MALCOLM GLADWELL:

Is, I think, a Goliath that can stave off the worst parts of bigness.

TOM GARDNER:

And a Goliath that has a smooth tempo — total convention, marches in a line, everyone has a job description, EVP of this, everyone's got a role — you would prefer to bet on the seemingly weaker, smaller, chaotic, disruptive, niche-dominating opponent in their marketplace.

MALCOLM GLADWELL:

I've become more and more convinced, particularly from writing this book, but also just from my experience in this, that company culture is the hardest thing to quantify but the most important predictor of where a company is headed. And spending a lot of time in a large room of people from an organization gives you, I think, really valuable insights into how that company works and how it innovates. If you have that feeling that people have turned down the volume in their brain — then you know that there's trouble.

TOM GARDNER:

I want to talk about the leaders that set up cultures and throw three adjectives at you from the book. Maybe I'm slightly tweaking the wording, but open-minded, persistent and disagreeable. Why are those three important to find in a great leader?

MALCOLM GLADWELL:

Some wonderful work has been done on innovators, recently, and they looked at what is the prototypical profile of an entrepreneur/innovator/leader. The most obvious one is that they are open, meaning they are creative — and that goes without saying. You have to be someone who considers all. The second thing is that you must be conscientious — in the psychological sense of that word — so there are five basic character traits. Conscientiousness is one of them. Are you someone who can follow through on your ideas?

Now, right away we have an interesting situation, here, because there are lots of people who are open and there are lots of people who are conscientious. Those that have both those traits are rare. I can find in any coffee shop in Brooklyn lot and lots and lots and lots of creative people who can't finish their screenplay. I can also find in any law firm in America tons and tons of conscientious people who we don't want to think outside the box. We want them inside the box. They're not creative. But that overlap is rare.

Then add the third, the most important one, which is disagreeable, which is you cannot be someone who requires the approval of others in order to do what you intend to do. That's crucial and that's the hardest of the three because we're hardwired as human beings to want the approval of our peers.

I always remember when I was writing my book, *Blink*, I hung out with that guy who studied marriages. He was talking about the one emotion that a marriage cannot survive in the face of — contempt — because contempt is the emotion of exclusion. If your spouse argues with you, they are including you. They are saying, "I care about you enough to want to work this out." When they are contemptuous toward you, they are saying, "I'm done with you." And as human beings, we need that kind of approval so much that, that can end a marriage.

Well, the really great entrepreneurs, at some key moment, or innovators or leaders at some key moment ... as they are putting forth their vision ... need to be disagreeable. They need to not need that kind of approval — because the one thing we know is that there's always a moment in the birth of any great idea when the consensus is it's crazy. Find me a transformative idea that was not denounced and criticized at some key moment during its gestation. So, you've got to be that person who can stand up to — Kamprad is one of those people. He goes to Poland in 1961. He's denounced as a traitor and he doesn't care. And that's why Ikea exists. If Kamprad is normal — if he's like me — he whimpers and goes back to Sweden and is probably running a small real estate practice right now in Gothenburg.

TOM GARDNER:

Where do you see yourself in the continuum of David to Goliath, to the extent that they can both be put on a continuum? Where do you see yourself professionally? Where do you see your journey? Where do you see elements of the David qualities having shown up in the work you're doing?

MALCOLM GLADWELL:

Well, you know, I was clearly once David. What I used to do, as a young journalist, is what all young journalists do, is I used to write long, angry, vicious takedowns of prominent, successful journalists who I considered to be Goliaths and therefore worthy of my disdain. Now, of course, I'm Goliath, and what happens? Young journalists write long, lengthy, vicious takedowns of me. And I always read them and I just think, "I have become everything I once despised."

TOM GARDNER:

And as that person, are you an investor and how do you invest?

MALCOLM GLADWELL:

Well, my father, who is a very smart man, has many great qualities, but the one that I have learned the most from is that my father is intellectually humble and it's expressed in the following way. When he meets someone, he makes an immediate assessment of whether in the domain that they're going to be talking about, does this person know more than me or less than me? If the person knows even a little bit more, my father totally defers, which is a lovely trait.

So, here's a guy with a PhD in applied mathematics, and I have seen him deep in conversation with our Mennonite farmer neighbor who has a fifth-grade education. He has that element of humility. Anyway, he taught me this. So, when it comes to investing, my basic position is identify someone who knows more than me and just do whatever ... So, I have someone who manages ...

But, for fun, I have a little Schwab account and I play with it. And it has the wonderful effect of reinforcing that humility ... because try as I might, I cannot beat the market, even though I have a series of what I consider to be brilliant ideas.

TOM GARDNER:

What is your most recent brilliant idea in the form of an option trade?

MALCOLM GLADWELL:

Well, I was just telling you this. I had this whimsical notion. So, if I were to found an investment company, I would call it Stopped Clock Investments, because I have been right twice in my life, like the stopped clock. Once was — and I'm boasting now — I went all cash in 2007. And the second was, in a very minor way, in the beginning of January, I bought protection for my portfolio ...

TOM GARDNER:

Right now — just this month.

MALCOLM GLADWELL:

Right now. From January 1 to April, if the market goes down 10% or more, I'm in the money, I guess. Is that what the phrase is? But as I was saying to you, I only did it because I wanted to know what it felt like to short something, because I've always been fascinated by short sellers.

And I had done this big piece years ago on Nassim Taleb as he described the torture of betting on catastrophe. I was just fascinated by that, so I wanted to feel like it. What was it like? So, I bought my little option and then the market goes *drrr* for a couple of days. I had this initial surge of elation because my option has suddenly soared in value, and then I feel gross. And now I'm not sure I ever want to do it again. I don't know.

There's a reason why someone like Warren Buffett is so much more appealing than a short seller — not that he's a better person, necessarily — but what he's doing seems so much more consistent with how we want to think as human beings. Or at least a better way of saying it is, it's so much easier to think his way than that the things might fall apart.

TOM GARDNER:

And the mathematics really support that because in a short you can make 100% ...

MALCOLM GLADWELL:

Yes...

TOM GARDNER:

... but if you buy Netflix at $25 and it's at $350 a share, you've ended up making a multiple on your money. I want to throw out just a couple of company names for you and see if you have any reflections on them — David, Goliath, or any observation. Let's start with Google. Is Google a Goliath that welcomes dissent and is demonstrating some of the great qualities of how to be beloved?

MALCOLM GLADWELL:

Well, I don't know. That's a good question. It once was. I don't know enough about the kind of internal culture to know whether that spirit of giving people time to work on their own thing — that whole kind of thing that was so part of the original culture — whether that's still a powerful element. I'm also really curious to see how it manages that transition where you had that early stage where everyone's a millionaire and then that stage where the newcomers aren't millionaires in the same way — and I wonder how that changes the level of excitement in the company. It would be hard to believe they would feel the same as they did 10 years ago.

TOM GARDNER:

How about Apple?

MALCOLM GLADWELL:

Well, I've never been a huge Applite. This has nothing to do with the company. It has to do with a product, although it may reflect ultimately in the company. I like to work in coffee shops. Sometimes I get on my bicycle, I go into Brooklyn and I work in one of those hipster coffee shops. You walk into the hipster coffee shop where everyone there is doing something radical and edgy and interesting. They're in bands. They've done several apps. They have whatever — the cool things they do. And every single one of them has exactly the same Macbook Air and exactly the same iPhone. And if you talk to them, you would discover that their parents also have the same laptop and the same ...

And I just think, "In my day, if you considered yourself rebellious, you made a conscious choice to make rebellious choices, different choices in your personal ..." The badge of your rebellion was the objects you surrounded yourself with. Today's young consumer doesn't feel the same way. They're fine with all having the same phone, and I just find that weird.

And so, the business model of Apple is based on this very, very curious psychological and sociological fact that you can carve out a "rebellious premium position" for your product, even though you are ubiquitous. Has that happened before? I find that weird.

TOM GARDNER:

The Smurfs maybe was the closest.

MALCOLM GLADWELL:

Yes.

TOM GARDNER:

Two more companies, and then we're going to turn it out for some questions. What about Amazon? What are your thoughts? They're helping to sell a lot of your books?

MALCOLM GLADWELL:

Yes.

TOM GARDNER:

You're helping to bring a lot of people to their site.

MALCOLM GLADWELL:

Yes ...

TOM GARDNER:

To buy your books.

MALCOLM GLADWELL:

No, and I am a huge Amazon customer. My favorite line about Amazon is that they are engaged in "postal arbitrage." I can't get over how ingenious that is. I have never owned the stock. I'm curious to know what will happen if they ever attempt to make money. I don't know.

The one serious question I have is this. I don't understand how long the physical distribution model that they have — how long you can maintain that kind of hegemony. It strikes me as being more vulnerable than it looks for a number of reasons, but the notion now that when I'm wanting to buy something real or virtual, my default mode is Amazon ... that strikes me as something that may not be sustainable.

In other words, I feel like we are in the same kind of trajectory that we went through with the department store and the specialty store. That in the beginning, when that whole notion of modern retail was new, you had one stop. You went to the one big building where everything was all there. And then over time, what happened? That all got disaggregated and the department store went into decline and we were comfortable with the fact that I will go to this little place for my shoes and this little place ...

And I think that something very similar may happen down the road to Amazon. In other words, as much as I am in awe of where they are now, I confess to being a little bit uncertain about where they'll be ten years from now.

TOM GARDNER:

Last company — Facebook. And do you think they're a David or a Goliath right now? And any other impressions of Facebook?

MALCOLM GLADWELL:

I feel similarly about Facebook as I do about Amazon. When I go to L.A., I always stay with this friend of mine, and he has three teenage daughters. Now, they're scarcely representative and it's a sample of three, but their attitudes toward social media are really interesting and I'm sure any of you who have teenagers see the same thing. They're on Facebook, but their level of enthusiasm for it is quite low. It's not where the action is for them.

I'd be concerned if I was Facebook, by that, because I think in order to be something that is a commercial enterprise as opposed to a social utility ... I'm quite convinced it's going to be a social utility for a long time. But in order to be a commercial enterprise that actually generates a lot of money, you have to have a certain amount of cultural excitement around you — but it has to matter what is on your Facebook wall. Someone's got to realize they've got to go and check it out.

Now when the action's moved elsewhere ... Like, when I observed these three teenage daughters of my friend, they're just Snapchatting all day long. The excitement is somewhere else, now. Now, where I could be wrong is maybe there's more money in being a simple utility than I imagine. But I don't know. I think that they think that their future lies with something that is culturally exciting and I'm suspicious.

TOM GARDNER:

What's your time in the 1500 meter now? Because I know you were a competitive and successful runner ...

MALCOLM GLADWELL:

I'm fifty. Let's be clear. I ran a five-minute mile at the Fifth Avenue Mile last year.

TOM GARDNER:

Wow. (Applause)

MALCOLM GLADWELL:

The first time I get a sign of genuine support and emotion from the crowd is when I mention ...

TOM GARDNER:

In the back, first.

MALE:

I'd like to ask both of you about the future. How do you look at things in the future? If you look at our society, the only thing to point to that was successful as a future prediction is the Dick Tracy wristwatch. And I remember being at a conference in the 1980s called Network Supercomputing. It was in Research Triangle Park and this guy had the only viewgraph I ever remembered. We had the head of the postal service, the Postmaster General, saying the Pony Express would never be successful. We had the head of the Pony Express saying the telegraph would never be successful. The head of the telegraph saying that telephones wouldn't be, radio, TV, right down the line.

So, the one thing I learned from that viewgraph is the worst place to go for finding out where the industry is going or the future is, is by going to the people who are in the industry now. So, I'd just to hear from both of you where you go to find out about the future?

MALCOLM GLADWELL:

Well, I totally agree with you that this is the most difficult of all. I think the answer is to stop worrying so much about the future. It's pointless. Aside from relatively short-term things that you can plan for, it just makes no sense to worry about what's going to happen five years from now and to give any kind of long-term ... All you can do is to commit to processes that are predictable — but I don't think you can have any clear sense of where you're going to be. It's a fool's game.

TOM GARDNER:

It *is* a Fool's game. Honestly, I go to my brother's work and his teams, and I'll identify a few factors; but, of course, these are generalizations and these are only a few factors. But you all have studied and read the work that David's doing and I'm not going to pretend to speak for him, so I'll just put them in the context of how I think about it.

One of them is high-sales growth rates of small companies are some indication of future demand. Obviously, that demand can fall off the side of the table, but many of the great companies over the last 20 years that have been great investments — we've talked about Whole Foods, Starbucks, Apple, Google, Microsoft, LinkedIn — if you look at the early stages after their IPO, their sales growth rates are very high. They're not growing sales at 12% or 18%. They're growing their sales at 40% or 60% and obviously that's going to decelerate over time. But if you look at smaller companies with high sales growth rates, you'll get some indication of the future.

And then, I think it's a good idea to find a founder CEO, because in a way, that's the David who is putting his or her life into that entity. Of course, you're going to get that wrong, sometimes. Sometimes they are only there for a short period of time — then they're going to cash out or they're fraudulent and they're running the company like a piggy bank or they're just incompetent and they happen to be the founder so they're in a power position, but they're not very competent. But against that, you will find enough huge success stories like Jeff Bezos at Amazon, early on as David found. So, I think high sales growth rate and a founder is a good starting point for where the world's going.

MALE:

Reflecting on how you think that Goliath is broken, what's your take on Jeff Bezos buying the *Washington Post?* Is it a good thing, a bad thing or does it really not matter?

MALCOLM GLADWELL:

Well, it's a good thing if you work at the *Washington Post*. He bought it for so little that it's not like it's a great financial risk one way or the other. I'm very, very curious to see what his tolerance for losing money is, because I think in the short term, particularly as he tries to expand the editorial base of it ...

The one thing I don't know that any of us knows is whether he has a grander strategy behind that acquisition. I suspect that someone as smart as he is does — that there's something interesting he wants to do with that, and that's why I look on this purchase with a certain amount of excitement.

The news business is really, really interesting. I think it's in this period of transition which is the demand and the need for news has never been higher. More people read the *New York Times* today than at any point in the *New York Times's* history. You can express it any way you want — as a percent of population, as a total number. There is no question that some of these media portals have audiences today that dwarf their audiences in their so-called heyday.

It is just simply the case now that in this moment of unparalleled success, the business model has fallen apart. But I don't think that's permanent. I think all that's happening right now is that we are looking for a new way to create a business model behind this insanely successful product. If there's anyone who can figure out that, it's Jeff Bezos. So, I'm really, really, really curious to see what is up his sleeve, and I suspect he does have something interesting up his sleeve.

TOM GARDNER:

We have to close to let you get on your way, but could you just close by sharing a little bit about how we should think about our disadvantages in life? Anyone in the room that sees, "I have this weakness, I have this flaw, I have this thing that's held me back or this shortcoming." Or, "I see it in my child. I see them struggling with this." How should we think about disadvantages?

MALCOLM GLADWELL:

Well, it is a cliché, but as learning opportunities, you can learn by capitalizing on your strengths or you can learn by compensating for your weaknesses. The compensation path is far more difficult, it's far more rare, but it's way more powerful. The things you learn as you are working around or through adversity are lessons that are far more deeply felt than the things you learn because of your strengths.

I chose dyslexia in my book for a reason — because that is just about the most serious impediment you can throw in the path of a child, and the idea that there are lots and lots and lots and lots of really, really successful people who, when faced with that impediment at the age of six and seven, just were undaunted by it and just found another way to go about the business of getting through school and then ultimately through life ... that, to me, is such a beautiful example of how we radically underestimate our ability as human beings to deal with adversity. I think we're much better at it than we think.

TOM GARDNER:

No question. Malcolm Gladwell is a true Fool, and I think we need to get Malcolm in *Motley Fool One* and give him the service for free so we can help him beat the market. Don't you think we can? So, Malcolm Gladwell, thank you very much.

FoolFest 2014: Tax Expert Michael Kitces

Published Feb 19, 2014 at 10:20AM

More from our February member event! Award-winning financial planner and writer Michael Kitces turns many of the ideas you have about saving and retirement on their head. Watch as he lays out what's changing in the world of financial planning and how you can take advantage. **Download his presentation here.**

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Run time: 49 minutes

Transcript

ROBERT BROKAMP:

Hello, I'm Robert Brokamp, senior advisor for *Rule Your Retirement* and part of The Motley Fool Financial Planning team.

You know, every once in a while you come across a younger person and you see them do their professional thing and you think, "Hm, there's some talent there." Then you see their name turn up more and more places. Websites, books, magazines. You see them appear in front of bigger and bigger audiences. And then maybe a really big audience. And you think, "Wow. That was something. I hadn't really thought of things that way. I hadn't thought of using the things that way. I'm going to remember this for a while."

Well, as I assume you know, I'm talking about Miley Cyrus. But our next speaker, Michael Kitces, does have a lot in common with Miley Cyrus, but I can't promise he's going to dance with a foam hand here — although he had a minor in theatre and you were an EMT in college, as well. He's also the treasurer for the Washington Improv Theater. But really what he has in common with Miley Cyrus is that he is a superstar, at least in the world of financial planning, and he began his ascendancy at a pretty young age.

Now, I don't want to build him up too much. We are going to talk about taxes, after all. Someone at the Fool saw that we were going to do taxes after lunch and they said, "Maybe we should call it Napxes." But if you ever read his blog, his books, his newsletter ... you'll see that he knows an awful lot about a lot of things ... insurance, annuities, estate planning, retirement planning, investing.

You may have seen him in *The Wall Street Journal* last week. It was an article about a study that he did with a fellow named Wade Pfau. What they found was people should lower their equity allocation as they approach and enter retirement to about 20% or 50% — but then, for every year afterwards, you should increase your stock allocation by one percentage point until you reach 60-80%. So, he's not afraid to question conventional wisdom.

He's a recipient of the Financial Planning Association's Heart of Financial Planning Award. Industry magazines have called him a "deep thinker," "part of the Power 20." He co-founded NexGen, which is a community, really, of younger financial planners and it's when I had to acknowledge that I'm middle age, because last year I asked Michael if I could join this group and he said, "I'm sorry. You're too old."

He's a partner with Pinnacle Advisory Group. They help oversee $1.3 billion. He was telling me earlier that at any point he could have five different monitors of various things going on at one time. That's how he gets so much done. And finally, for more than 20 years, he's been playing bridge at the same bridge club with his father. So it's my pleasure to introduce someone who is sort of like the Miley Cyrus of the financial planning world, Michael Kitces.

MICHAEL KITCES:

Thank you. Thanks so much, Robert. Welcome, everyone.

Wow. I feel like I can't follow my own introduction. We're going to be talking taxes. There will be no twerking.

My goal here with you for the next 45 minutes or so is just to take you through some tax planning ideas and opportunities about the current environment. Where we stand. Certainly since we're here talking at Fool Fest, we're going to have a tilt toward some investment-related strategies, although we're going to talk a little bit more broadly than that, as well.

Now, as we dive in, I always like to start off with this cartoon as a little bit of a caveat. This is the Lockhorns. They're sitting down with an IRS agent who says, "Don't think of it as an audit. Just think of it as our way of keeping it real." And I like to put this forward to make the point that I am what most people would call, in our environment, a relatively conservative tax commentator.

And that's not about whether I lean to the left or the right of the political aisle. It's that I tend to talk about the relatively conservative tax strategies — the kind of things where you will not be sitting down with an IRS agent who says, "I'm adjusting all the stuff you did in order to keep it real."

So everything we're going to be talking about today is about as real and straightforward as it gets under the tax code and you'll find, as we dive in — in this kind of environment that we have right now — there's a lot of planning opportunities and tax savings that you can generate just by using the black and white code as Congress has given it to us.

Now, when we really talk about today's tax planning environment, we have to set it in a little bit of context for where we've been over the past decade or so, because frankly where we've been has kind of been a roller coaster. So, the roller coaster kicked off when President Bush took office in 2001 and shortly thereafter passed the first of what were labeled his two major tax acts, the Economic Growth and Tax Relief Reconciliation Act of 2001 — or what we called EGTRRA for short, not that that's much shorter.

EGTRRA was the legislation that set in motion all the roller coaster of the estate tax that was rising, then it was gone, then it was back again ... and all the tax brackets that were going to sunset. Then we added on the 2003 Tax Act or JGTRRA. JGTRRA was the one that did the 15% capital gains rates and the 0% rates for the lower brackets again with the vanishing act in 2010.

And of course we never really thought we were going to go all the way until 2010 in dealing with this and then we gridlocked for the entire decade and we really did go to 2010 and turned it into the fiscal cliff of 2010 and then couldn't figure out what to do with it, so we kicked the ball two years down the road and made it the fiscal cliff of 2012, instead.

What was notable, though, when we finally figured this out at the end of 2012 is that when we finally passed the fiscal cliff legislation at the end of 2012, it was permanent legislation. Now, to be fair, particularly being this close to Washington, is we certainly know that permanent legislation doesn't mean it's what we're going to have for the rest of our lives. It's what we're going to have until Congress changes their mind and makes it something else.

But the reason why it matters is when the tax legislation is permanent, it means the only time anything changes is when Congress comes together, in bipartisan compromise, with their hands clasped across the aisle, to pass something new. Who thinks this is highly likely in the next couple of years?

The reality, when we look over the past decade is notwithstanding a couple of minor things we did along the way, we really only had two major pieces of tax legislation for a decade — fiscal cliff number one and fiscal cliff number two — and we got rid of the cliffs.

So, it's not to say that we don't have some fiscal issues. That we're not still dealing with a lot of other problems at the government level, but I view this as a new era of tax stability that we're in right now and that we're probably going to stay in at least through the end of this presidential cycle, where we may get a couple of loophole closures and a couple of tweaks at the margin ... but we're not likely to see really dramatic, reformative kinds of tax law change for the next couple of years.

Once we get to 2017, all bets are off. I have no forecast about who's going to win the 2016 elections, but depending on who wins and which way both the White House and Congress goes, we could get to some big reform legislation starting in 2017. You can kind of feel it in the air, that we're due. Like it's gotten a little messy now for where we stand on the tax environment.

Now, when we look at where we stand, we did have a couple of changes that came through last year as a part of the fiscal cliff legislation. One of the big ones was we added back a seventh tax bracket. So, we used to have six tax brackets that went from 10% to 35%. Now we have seven brackets that go from 10% to 39.6%. So, we took a brand new seventh tax bracket. I was going to say we put it on the top, but in my chart we put it on the bottom, here, that says we've got a new maximum threshold. And the amusing part of it in the process — we almost accidentally obliterated the 35% bracket in the process.

So, if you look down the column, particularly for individuals, your entire 35% tax bracket goes from $405,000 to $406,000. That's the whole bracket. While it would have been nice to have Congress send off a study for the Congressional Research Service to say, "Please determine the optimal place to create a new top tax bracket that properly balances long-term fiscal health and economic growth and fairness and responsibility," they plucked a number out of thin air between the number the Republicans wanted and the number Democrats wanted ... and then after they did that, they went back and looked at the inflation adjustments for the 35% bracket and said, "Oh! Thank goodness! We almost broke it." We didn't even know we were going to keep the 35% bracket until after the inflation adjustments came out after legislation and we found out it was going to survive with a whopping $1,600.

On the married couple side, it's a little bit better. It's a $52,000 bracket, but it's still kind of this winding path where the brackets get larger and larger. The 33% bracket is very wide, then the 35% is very narrow and then 39.6% applies for basically everything thereafter.

And, at a broad level, this is basically what we call, in tax parlance terms, a more progressive tax structure and progressive simply means lower tax rates on lower income individuals ... higher tax rates on higher-income individuals and we now have a more progressive structure meaning the brackets ramp up more quickly, more sharply and to higher levels. Which basically creates planning opportunity. Bad news — higher tax burden. Good news — more ways to plan on a higher tax burden. For people like me, it's an employment act, so we really appreciate it.

Now, part of what we still have to deal with this ... we still have a lot of the built-in challenges of the tax code. We still have the so-called marriage penalty, which is the challenge that married couples, at high-income levels in particular, end up paying more in taxes than two individuals would. So, if I wind back to my chart here, if I have two individuals that are each earning $300,000 ... they're kind of winding through the 10%, 15%, 25%, 28% bracket and a little bit of income in the 33% ... but if they get married and it's a married couple reporting $600,000 worth of joint income, a quarter of their income is in the top tax bracket instead of filling the bottom four. Same income, same two people, higher tax liability. We call that the marriage penalty.

Now, on top of this, layering onto the progressivity of the system, we also brought back last year the phase-out of personal exemptions and itemized deductions. So, when our income gets to a certain level, we begin to phase those out. We're going to talk in more detail in a few minutes. But what we see by the time we layer all these things on top — again, much more progressive system. Rates at higher levels and higher-income individuals ramping up more quickly and a lot of different layers.

So, it's getting harder and harder now even just to figure out what your actual tax rate is. Like at the margin, if I earned a little bit more money, what would I owe on it, because your bracket, your good, old bracket that we just looked at actually only tells a small fraction of the story between the phase-out, the new Medicare taxes, all the other pieces that layer on top ... as well as the fact that we have different treatment depending on whether it's wage income, self-employment income, investment income, non-investment income, ordinary income, capital gains. All of those have different treatments or different pieces that apply.

Now, when we look at how this begins to implement in things like portfolios, one of the biggest areas that we're seeing as getting sort of hotter and hotter as a planning opportunity is maximizing asset-location strategies. So, asset location ... We're familiar with asset allocation. So, I'm going to own a pie. It's going to have a lot of different slices. We call it diversification.

Asset *location* says, "Okay. Once I've got my pie with all the different slices and all the different investment holdings, in which accounts am I going to own them?" Because for many of us, we have several different account types. I have taxable brokerage accounts. I have IRAs. I have Roth IRAs. I've got other employer retirement plans. If I don't have access to some of those, I can get a non-qualified annuity and build a tax-deferred bucket. And so, this pressure rises to say, "Well, where should I own all these different things?" Because what actually emerges is there's opportunity for basically a little bit of extra free money and free wealth by making good asset location decisions.

And what we find as we look at this is that asset location is basically driven by two factors. The first and kind of the obvious one is tax efficiency. So, if I rate everything on the scale here from the most tax efficient on the left to the least tax efficient on the right, then I can line up my investments and it starts to become pretty clear. Like the really tax efficient stuff I obviously want on the left. That's where the brokerage account stuff goes. If I got something that's a stock with very little dividends and I'm just going to hold it for a really long time and I'm not going to turn it over anyways, so it's going to be tax-deferred simply under the standard capital gains treatment, and I get preferential capital gains rates. This one's pretty straightforward. Let's put it right there.

At the other end, we get things like the really inefficient stuff ... actively turned-over stock positions. Maybe that's certain types of commodity funds out there. Maybe that's even things like high-yield bonds where we're going to be kicking off more of a return and there's going to be a lot of ordinary income. There's going to be a lot of interest. There's going to be a lot of short-term capital gains or even if they're long-term, we're not holding them that long. Where all of a sudden we say, "Well, maybe this should tilt toward the traditional IRA," or if it's really high-return stuff, maybe we even put it in the Roth, or if we don't have those buckets, maybe we get a non-qualified annuity and put them inside of that as a tax deferral shelter.

Now, then we've got kind of the valley in the middle. The valley word doesn't matter. I find we have a lot of focus on things like, "Oh, I've got these bonds and they generate ordinary income, so I absolutely have to put them in my IRA." Well, as it turns out, you don't get much tax deferral value from something that only yields about 2.5%. You can't compound more tax-deferred growth when there's not much growth to compound in the first place. And it's not that it's necessarily bad to put things like bonds in the IRA, but this is a rather unique environment we're in where the bond returns right now are so low that except for exceptional things like maybe some emerging markets bonds and some high-yield stuff that's really generating more return ... that it just basically doesn't really matter where it goes.

And what we're finding is the optimal approach to asset location in this environment — if you look at this chart and you'll line up your investments beneath it where you've got the high-return efficient stuff on the left and the high-return inefficient stuff on the right — that the optimal strategy is basically you work from the outside in. So, find the most efficient, highest return stuff that clearly belongs in your brokerage account and put it there. Take the stuff that is rather inefficient, but high return ... maybe that's some of your more active strategies that are going to have shorter holding periods. Maybe that's things like commodities, high-return, high-yield investments ... or they're less tax efficient because they're kicking a lot of that stuff out every year ... that gets tilted heavily toward the retirement accounts.

And then as you figure out those investments at the extremes, you'll just start working your way in. And what inevitably happens — if I have a million dollar account balance and I've only got $100,000 in my IRA because the rest is in a brokerage account — I'm going to put the few things that are most important to be in my IRA inside of my IRA, and then I'll run out of IRA dollars and everything goes in the other account.

But that focus on asset allocation and in particular, I'm making sure the highest-return investments end out in the right place either because they're really efficient and they go to one side, or they're not so efficient and they go to the other — is very powerful, especially over long-term periods of time where you let the compounding work. And actually what we see is if you're looking over very long periods of time that these are retirement accounts and these are dollars you might not spend for 20 or 30 years, the compounding is actually so valuable, you can even beat long-term capital gains rates. You can convert the money into ordinary income — you still finish with more money, because you've got decades' worth of compounding growth instead of annual tax drag. Even capital gains treatment can whittle down over time.

Now for others, this isn't necessarily about the investments and the asset location, but it's sort of a general strategy that I call, "tax bracket arbitrage." So, the standard for tax deferral is pretty straightforward. Paying taxes is not very appealing. If the government has to take it at some point, I'd rather have them take it as far away as possible so I get to keep my tax dollars working for me in the meantime. We variously call that the power of tax deferral, the time value of money, letting my dollars work for me. Got lots of different labels. It's good stuff.

But there's a problem to this when you do too good of a job. If you push enough income down the road, when you ever actually want to spend it, you notice you've got this giant mountain of income that you can't dig through without blasting yourself into the top tax brackets. Which means your optimal strategy is actually a little bit more of a balance. Certainly if you're at higher brackets, you clearly want to defer. If I'm paying at top tax brackets, what's the worst-case scenario? I'll pay in a high bracket now, or I'll push it down the road and pay the same high bracket later. Not really a big deal. I'd rather pay it later.

But if you're having low-income years, it turns out the optimal strategy is not always to just defer, defer, defer. Sometimes the best thing you can actually do, to save on taxes, is to pay them as quickly as possible if you can harvest them at lower rates. And that's the balance that we're seeing starting to emerge now, so I'll give you one example of this where we see it commonly, which is with retirement accounts.

So, we look at someone who's in their sixties. The standard strategy, "Oh, well, I'm in my sixties. My income's probably fairly low. Maybe I'm drawing a little bit of social security. I'm managing my investments tax efficiently. I've got a lot of stuff inside a retirement account, so my tax bracket's hanging out at 15% pretty steadily. It does that all the way through my sixties until I reach that unfortunate date where I turn seventy and a half and the government says, 'I would appreciate it if you would start liquidating your retirement accounts now,'" and we take our first required distribution from an account that we've been compounding with growth for a couple of decades and suddenly our tax bracket blasts through the roof. And unfortunately, because we weren't touching that IRA at any point through our sixties, basically the whole thing is now going to get liquidated at 30%+ tax rates. This is not a good deal.

The better deal is to actually try to smooth it out. So, you know what? If I whittle down that account when I'm in my lower brackets, I whittle it out at 15% and 25% each and every year just enough to fill the 15% or 25% brackets — then by the time I get to seventy and a half, my income doesn't go up. It basically doesn't change, because I've whittled down my IRA just enough that I don't really have this problem in the future anymore. I've smoothed out my tax rate and I get all my IRA dollars at a lifetime average tax rate of 25% instead of a tax rate of 33%. Compounded over a lifetime, it's a very significant difference in wealth.

And of course, with retirement accounts, I can do this especially easily because we have the Roth conversion rules, now, with no income limits that let me do these as conversions, and not only do I just get to whittle the income down, but I turn it in tax-free on the other end, so I never have to deal with it later, as well. And so, we see this getting done with Roth conversions and as I'll touch on a little bit later, we actually see it getting done with capital gains strategies, as well ... where sometimes you harvest the losses and sometimes you actually harvest the gains.

Now, part of what we have to deal with, as well ... It's not just, as I said earlier, about our tax brackets. We have these new rules or I should really say old rules that we brought back for the phase-out of itemized deductions and personal exemptions. So, this is the rules we have through the 1990s and 2000s. In the infinite wording wisdom of Congress, we "phased out the phase-out," because that's not confusing. So, we phased out the phase-out. Then we repealed the phase-out. Then we brought back the phase-out. So, now we've got a phase-out again. Well, welcome to the tax code. I live in this stuff all day.

So, this is really two sets of rules. The first one is commonly called the Pease limitation after Congressman Pease who originally created the rule. The Pease limitation is the one that says as your income elevates above certain thresholds, you start phasing out your itemized deductions, and for every dollar you're over the line, three cents of that is subtracted against your deductions. And you can do that all the way up until you phase out 80% of your itemized deductions.

Of course, the problem with that for people in most states is as you ratchet up your income, you do things like pay taxes to your state — unless you live in Florida or Texas or Nevada or one of the few that doesn't have one — so the more income you have, the more you pay in state taxes. The more you pay in state taxes, the more you have in deductions, which means you never, ever, ever reach this cap. So, for most people, it just goes all the way up. You keep earning more income — you keep phasing out a small slice of your itemized deductions as you go.

And the same thing happens for personal exemptions. This is a separate but similar rule. It says once your income crosses the line, you start phasing out 2% of your personal exemptions for every $2,500 that you're over the line. Now this one kind of starts and stops, so I'm phasing out 2% for every $2,500 which means after 50 units of $2,500 I phased out 50x2 is 100%. So, the personal exemption phase-out actually starts and stops while the Pease limitation basically goes all the way up. The thresholds for this we did change last year. We made them $250,000 for individuals, $300,000 for married couples. It's indexed for inflation, so this year we'll be at $254,000 and $305,000 respectively and it will creep forward every year going forward.

Now, this has to be one of the worst-named labels under the tax code, and I don't say that lightly given our tax code. But we see so much confusion around this label of the phase-out of itemized deductions, and the reason why it's kind of weird the way that it's labeled is it's not actually calculated based on your deductions. It's calculated based on your income. You lose a portion of your deductions for every dollar your income is over the line, which means if you have more deductions, it doesn't matter. When you have more income, you pay more taxes.

Which means when we actually do the math, you start earning more money, you start out phasing out deductions. The deductions were giving you credits at a 33% tax bracket. You kind of wind through the circular math and basically it's just a 1% surtax. You thought you were in the 33% bracket — it's 34%. You thought you were in 35% — it's 36%. You thought you were in 39.6% — it's actually about 40.8%. It hits the top bracket a little bit harder because of the circular math to it.

Now frankly, it would have been a whole lot easier if we just raised the top three brackets 1%, but as you may recall during all the fiscal cliff negotiations in 2012, what we were going to do with just the top tax bracket — whether we were going to go back to 39.6% and what threshold was so incredibly controversial — there was no way to pass a rule saying, "Let's also raise the other top brackets 1%, as well." So, we just did this by doing the exact same thing, but calling it something else. But that's really all it is. It's not a disincentive for itemized deduction strategies. It's just a 1% surtax because it's calculated on your income.

When we go through the personal exemption phase-out, 2% of your personal exemptions times the amount per $2,500 ... you go through a bunch of really messy math and what you basically get to is another 1% surtax ... almost exactly, within a basis point. This one's a little bit different, though, because the personal exemption phase-out is actually a 1% surtax per exemption. We take one exemption for every member. So, this is actually a 1% surtax for an individual, 2% for a married couple, 5% for a family of five.

This starts to get a little bit nasty for a lot of dual-income couples that we see — where by the time we take the whole family into account, you're a little over $300,000 in joint family income, you're at a 33% bracket plus 1% for Pease plus 5% personal exemption phase-outs for the five family member exemptions you're losing. Which means you're actually in the 39% bracket — not all the way up at $450,000-plus of income, but it kicks in at $300,000. More progressive tax system, higher tax rates and higher-income individuals ramping up more quickly. That's the whole theme to it.

So basically what we find is the PEP basically lifts up the 33% and the 35% brackets. When you actually look at the charts, as it turns out, it starts in the middle of the 33% bracket and it ends at the top of the 35%. It's just the way the math lines up — so it just lifts the middle two brackets. Pease lifts all three of the top brackets by 1%.

But again, one of the biggest things to it — and we always encourage clients to think of it this way for the folks that we work with, as well — forget all the terrible labels for it. They're just surtaxes. They're just higher rates at the top brackets. You don't need to avoid charitable giving. It doesn't mean — notwithstanding what the media likes to write — this is not a disincentive to charitable giving. It has no impact on it unless you're one of the rare few that are actually capping at 80% of your reductions. Then when you go through some of the math, it's a little bit of a disincentive. For everybody else, it's actually no disincentive whatsoever for a charitable giving. If you're interested in some of the math of how that works, I'll give you a link up here and we'll make sure you have it in your handouts, as well.

Now, a few other areas to look at. One of the other big changes that came through with the fiscal cliff legislation last year were the new long-term capital gains rates. So, just as with the old system, we went from six ordinary brackets to seven ... we went from two capital gains brackets to three. It used to be 0% at lower income levels and 15% in the middle. Now it's 0%, 15% and 20%.

And they're graduated rates, just like the regular tax system. So, just as with the regular tax system, if I went all the way from zero dollars up to $0.5 million of income in one year, some of it's at 10%, some's at 15%, 25%, 20%, 33%, 35% and only the last little slice is actually at 39.6%. We get the same thing with long-term capital gains. Now, if I had a $0.5 million worth of capital gains in a single year, the first $73,000 or so was taxed at 0%, the next roughly $380,000 is taxed at 15% and then the last little under $50,000 is taxed at 20%. So, similar graduated rate structure.

But it's a very different environment from where we were before, especially when we layer on this new Medicare tax that also kicked in last year. So, the reality is we don't really actually have three capital gains brackets. We have four. We have the 0% bracket for those in the bottom two ordinaries. We have a 15% rate for those who are in the middle brackets but not yet subject to Medicare tax. We have an 18.8% rate — the 15% plus the 3.8% for those who are in the upper-middle brackets and then as it turns out, no one will ever actually pay the 20% capital gains rate.

If you're at a high-enough income to be eligible for the 20% rate ... Eligible-eh. If you have the great privilege to generate so much wealth you can give the government 20% of it on your gains, you will have to be subject to the 3.8% surtax, as well. That's just the way the math works out for it. And so, that's actually how we look at and manage capital gains exposures — four brackets, 0%, 15%, 18.8% and 23.8% and obviously for many of you, you're going to have to add your state liability on top of that, as well.

What happens when we start planning for this? Again, kind of similar to the discussion that we had earlier. This basically becomes a form of bracket arbitrage opportunity where sometimes you want to harvest the losses, which is obviously a very popular strategy already, and sometimes we actually want to harvest the gains. Because we do too good of a job of systemically pushing the capital gains bill down the road, we get the exact same problem that we do with the IRA.

A decade or two of fantastic work deferring your capital gains bill. Congratulations. Now you can't get out from under it without either dying, donating it or paying a giant slice because you pushed yourself in the top bracket by doing such a good job of pushing your capital gains down the road. And the problem is harvesting losses actually makes it worse — because every time I harvest a loss, I have an investment that I bought for $50,000 and fortunately it went the wrong direction. It's down to $40,000 ... so I harvest the loss. I buy something else with the loss sale rule for a while, then I switch back to the original thing. The good news is I get my tax savings on a $10,000 deduction. The bad news is my cost basis is now $40,000, not $50,000. My future capital gains are bigger. So, the more effectively I systematically harvest my losses, the bigger I make this tax burden down the road, not to mention all the gains that I'm deferring on the things that are up.

Now historically, this wasn't a big deal. For decades, we've only had two capital gains brackets. We've moved them a little bit about where they were, but we had one bracket if you happened to be in one of the lower two ordinary brackets, and then we had a second rate ... 15%, 20% before that. You could have had $50,000, $500,000 or $50 million — it was all subject to the same rate, which basically made tax deferral really easy. You just always kicked the ball as far as you could down the road because it couldn't get worse. The top rate was the same top rate and it applied to everybody once you got to $70,000 income.

Well, now it's not our environment anymore. We went from two capital gains brackets to four, so now bracket management ... Unless you're someone who persistently earns $0.5 million or more as a minimum and it's all up from there, you have to be really careful about navigating your capital gains brackets. If you do too good of a job of harvesting losses and pushing it down the road, you're not going to be able to exit from these investments without paying more in taxes in the future. Which means the optimal strategy — yes, if you're a high-income year, you want to harvest the losses — but if you're having a low-income year, you actually want to harvest the gains.

Now, harvesting gains, it turns out, is a lot easier. Harvesting losses is kind of a nuisance — loss sales rules, 30-day something else, switchback, transaction costs, tracking and there are all the other issues. Harvesting gains is easy. Sell it and buy it back. If you can type the trade in three sections, you'll be out for three seconds. Congress did not create a rule that says, "You owe us money, but since you reinvested in your stock, you can keep your tax dollars." You sell it and buy it back, you owe them the money, except it's actually a good deal if you can whittle down your capital gains and make sure you're always paying at 15% so you never get to that point in the future where you push yourself up into 23.8%

If you're one of those folks [00:29:28] manage your income and up that you're all the way down in the bottom two tax brackets, you're harvesting at zero. You bought it for ten, it's up to twenty. You sell it for twenty, you buy it back for twenty. Your cost basis is now twenty. Your tax bill is zero. It's a free step-up in basis every year. You want to take advantage of it. Fill yourself all the way up to $73,800 of income as a married couple, and that's $73,800 after all deductions, so you can sometimes get quite a bit of capital gains in there. Free step-up in basis. Obviously you still have to deal with your state tax exposure, so you may have a little bit at the state level depending on where you live, but it's still a pretty phenomenal deal.

Now, the other thing we find that people sometimes misjudge is just the overall value of deferring capital gains. Capital gains deferral is a really great deal for the long term and a really minuscule, irrelevant deal on the short term. I'll give you an example of what this looks like. Let's say we have an investment. We bought it for $100,000. Had a fantastic run. It's up to $150,000. So we're up 50%.

So, we got a $50,000 gain. If I'm going to assume a 15% capital gains rate, your tax bill is going to be $7,500. Now the reality is if you were ever going to spend this, you are always going to pay this $7,500. I can't really make it vanish. Unless you're going to die with it or donate it, you've got to pay the $7,500 tax bill if you ever want to spend the money.

What you can do is keep $7,500 working for you instead of putting in Uncle Sam's pocket. That's the time value of money. So, if I assume this thing can grow at an 8% rate of return as sort of a long-term average, basically the actual economic value of this tax deferral is growing 8% on my $7,500 tax bill. It's worth about $600 to me. Now, that's not bad. I certainly don't want to shake a stick at $600, but $600 relative to an investment that was worth $150,000 on something that's actually had a run that's up 50%. Six hundred dollars on a $150,000 investment — the actual economic value of pushing this tax bill out for a year is 0.4%. So, like a rough five minutes in the market.

So, think about that the next time you're looking at an investment and it's November, and you're going, "Oh, it would be really nice if I could hold this until the end of the year to get it next year." Or you're within a month or two of your long-term capital gains threshold and you're trying to eke it out to get there. Over short-term periods of time like that, there's remarkably little value in trying to avoid a tax bill and defer it for another year compared to the investment risk of holding something if you otherwise really don't want to hold it. So, we actually give you a chart here. Again, this will be in your handout materials, as well where you can kind of apply it. Not surprisingly, the larger the gain, the more value there is to continue to defer it. The higher your tax rate, the more value there is to continue to defer it, and this does compound over time.

So, decade-long or multi-decade periods of tax deferral by holding a position is hugely, immensely valuable. There's a lot of wealth created there. But over short-term periods of time — like trying to make it to a holding period requirement, or trying to make it to the end of the year to push it in the next calendar year — you can lose the entire value you're trying to create in minutes, so be very careful not to let the tax tail wag the investment dog on that.

So, a few other things to look at. We had a change for qualified dividends, as well. Qualified dividend treatment. So, at one point, the concern was qualified dividend treatment was going to go away, and we were going to go from taxing dividends at long-term capital gains rates at 15% to treating them as ordinary income. Anybody notice late 2012, you got a couple of extra dividend checks you're not used to receiving late in the year?

That was corporations saying, "Hm. I'm not quite sure how this legislation is going to turn out, but if I'm wrong, my dividend income goes from being taxed at 15% to being taxed at 43.4%. Not really interested in gambling on that. Let's push out a bunch of dividends." And so a huge amount of dividend distributions happened in December from all sorts of companies that were afraid of that. Now as it turned out, we didn't lapse qualified dividend treatment. We kept it around. But because it's attached to the capital gains rate, we now have the same four tax-rate structure for dividends — 0%, 15%, 18.8%, 23.8%, state goes on top of it.

Now a practice — at least from what we've seen so far — the higher-dividend tax rates have not really moved investment behavior that much. If I'm going to calculate the after-tax yield of something that yields 4% ... it pays a 4% dividend ... at a 15% rate, my after-tax yield would have been 3.4% at an 18.8% rate because of this new Medicare surtax. My after-tax yield is ever so slightly less than 3.4%, so negligibly different and I'm probably not going to do anything different. So, it's certainly a little bit of a tax drag on our ability to generate after-tax return, but it doesn't really materially change our investment decisions that much. At least, that's what we've seen so far. And there's still a preference for dividends over ordinary income investments, all else being equal.

The one exception we probably do see for that is for any of you that actually happen to own your own business that's structured as a C corporation, so structured the same as any other large, publicly traded corporation. Because at the end of the day, the only requirement for qualified-dividend treatment is it has to be a domestic C corporation, so it has to be a U.S. C corp or a couple of certain foreign ADRs work. And you have to hold it for 60 days — for 90 days for a preferred stock.

So, if it's the family business that you've had for 50 years — you're 49.8 years past the holding-year period requirement and it's a C corporation. But the difference is if I'm having a low-income year, I can't go out there and say, "You know. This is a low income year. This would be a fantastic year for Apple to distribute some of the cash. Like I want the dividend now. My rates are low."

When it's your business, you do control the timing of the income, and so we see a lot of closely held businesses that are being very specific about dribbling out income and profits in the form of dividends exactly enough to fill the bottom brackets, and then they stop before they get to the top ones and then they let the rest of it carry to the next year and they do the same thing over again. So, there are a lot of business strategies around unwinding that.

Now, one of the other big areas that we have to deal with in terms of our tax environment is the infamous alternative minimum tax. So, this has had a huge roller coaster over the past couple of years. We've had no less than half a dozen different pieces of legislation since 2001 that have extended or reinstated a lapse of the AMT rule. So, we patch them. We patch them short term. They lapse. We come back in and say that would be a bad idea, so we extend them again. Then they lapse. Then we extend them again, then they lapse. Sometimes they lapse and we have to go the whole year before we realize that this is bad and we retroactively fix it.

The good news from the American Taxpayer Relief Act and the 2012 fiscal cliff legislation is we finally, permanently fixed the problem. We didn't repeal it. We can't really repeal at this point. AMT repeal is depending on whose numbers you want to use — something on the order of a $2 trillion tax cut for a decade. Not getting through Congress right now. But we did permanently patch it. So, no more temporary lapses and things that keep falling off and coming back again where we never know, from year to year, whether 5 million or 30 million people are going to be subject to the AMT.

We basically fixed everything at the 2011 levels and permanently indexed it for inflation going forward, so we got rid of this whole creeping problem where the AMT system wasn't adjusting for inflation. The individual system was, so we pushed a couple of hundred thousand people over the line every year, which is why in 2001, there were fewer than a million people subject to the AMT, and by 2011, there were 5 million subject to the AMT. If we went off the AMT cliff, it would have been 30 million, so we backed away from that.

But where we basically stand now is if you're one of those people that find yourself subject to the AMT, we didn't get rid of it. You're pretty much going to continue to be subject to the AMT until you have a big change in your income circumstances. If you're one of those people who's not subject to the AMT, you're going to continue to not be subject to the AMT unless you have a significant change in your income or circumstances. So, it kind of took everyone where they are and sort of locked them in place.

Now, what we find, though, for those people who are subject to the AMT, they would sometimes underestimate how much planning opportunity there is. So, AMT is kind of a funny system on its own. How we calculate it is really a mess, because basically we calculate all our regular stuff, then we undo half of it, then we redo part of it, then we calculate a bunch of rates. It's a total nightmare.

But in practice, the AMT is actually a really simple system. It says, add up all your income. Take relatively few deductions. Everybody gets one big giant deduction. We call it the AMT exemption. It basically makes up for all the other things we didn't get. And then there's an almost flat tax on the rest — 26% for the first chunk, 28% for the rest. So, it's basically add up your income, get one big deduction, flat tax the rest.

Now, the caveat for the AMT is that big deduction that everybody gets — that AMT exemption — actually has a phase-out. The AMT exemption, itself, phases out at higher income levels. Now, as we looked at earlier with the Pease limitation — the phase-out of itemized deductions — what phase-outs of deductions do in practice is function as surtaxes on our income. The caveat, though, is the AMT exemption phase-out is much more harsh. The Pease limitation of phased-out itemized deductions — when we go through the math — it's like a 1% surtax. The AMT exemption phase-out is actually about a 7-8% surtax.

And so, if you think of AMT as this relatively flat-tax system where everything is subject to a 26-28% rate, the AMT exemption phase-out creates this bump in the middle. I labeled it up here as the AMT Bump Zone. When your income falls in that range, you're not subject to the 26-28% rates anymore. It jumps up to 35%, which means, not surprisingly, the planning opportunity becomes relatively straightforward. Avoid that. So, if your income is at the lower end of the bump range, you want to spread income out, you want to defer it, you want to stretch it, however best you can, to avoid hitting that bump zone. I illustrated it here in terms of ordinary income. It applies for capital gains, as well. It will bump your capital gains rate from 15% to about 21%.

If your income is high though — and this is the surprise we see for a lot of people — if your income is high ... if you're actually so high that you've gone out of the AMT bump zone so you phase the whole exemption out as down to zero —there's no more [00:39:36] — you end up being subject to a flat tax of 28% that goes rather high up the income scale. Exactly how high up it goes depends on exactly what your deductions are and what state you live in. It can end anywhere from about $600,000 of income up to about a million before you leave the AMT zone.

But while you're in that area, you're subject to a flat rate of 28%. There are actually a bunch of people out there with a $0.5 million of income, and because they have the great blessing to be subject to the AMT, the bad news is it makes them pay more money on the income they're already earned. The good news is at the margin, their rate's actually lower. It's at 28%.

And so, what we actually see for a lot of people is you have a big income year ... Maybe you have a big capital gains distribution. Maybe you got some big bonus from business. Something else happens that pushes your income up already and you've gone through the bump zone — turns out one of the best planning strategies for a lot of individuals is to take your income from $400,000 to $600,000. It's a flat rate of 28%. You're not going to get better than that at high-income levels.

Married couples — it's very similar. The bump zone is just a little bit wider. It's just how the math works out. The AMT exemption is a bit bigger for married couples and so the bump zone starts a little bit later and it goes a little bit longer, but you get the same kinds of planning opportunities.

Now, in general we find in terms of what creates exposure to the Alternative Minimum Tax, there are a couple of things that tend to do this rather consistently. The first one is high state income taxes rates. So, any of you that are living in states that have relatively high rates ... Around this area. D.C. and Maryland are fairly high. Virginia is sort of a mid-tier state. And I give you a list of some of the others up here. States that have 8-10% tax rates — it's really hard to avoid the AMT in those states once your income gets above about $100,000 to $125,000.

High property tax bills are an AMT trigger, as well. Any deduction that you take for state taxes paid to a state or local municipality come back for AMT purposes. So, big state income tax bills do it as well as the local taxes. Big property tax bills do it. Now, depending on where you are, for some people this is just because you pay a big property tax bill. A lot of counties in this area here — the tax rate's only 1%, but our real estate is ridiculously expensive, so your property tax bill is pretty big.

We have clients we work with up in New Hampshire — the good news is their real estate is a whole lot cheaper. The bad news is their property tax rate is 2.5-3%, so a lot of them actually pay more in property taxes than I do. So, whether it's a high property tax rate, or a high property tax bill because of just the expense of the property, anything that generates a big property tax bill ends out being an AMT trigger.

Now, other triggers that we see. Large numbers of dependents end out being a trigger. Because AMT gets rid of your exemptions, every family member for which you claim an exemption is something you lose for AMT purposes. Now ironically, because we now get rid of exemptions for the ordinary income brackets and higher income levels, this primarily hits large families from $100,000-300,000 of income. I was going to say that's the sweet spot. Like, that's the bad sweet spot. About $100,000-300,000 with large families.

And this was actually challenged a couple of years ago. There was a famous court case in the mid-1990s from a farmer in the Midwest who had — I forget exactly — I think it was nine children. He actually took this to tax court and basically said, "Your Honor, the AMT was intended for people taking advantage of these aggressive, esoteric tax structures. It was not meant for middle class farmers like me with lots of children to help tend the farm. I shouldn't have to pay this." And the tax court judge's response is basically, "You're right. This really wasn't intended for you at all, but it is how the laws are written, so pay your bill and take it up with Congress." And twenty years later, we haven't done anything to change it. So, large families at middle-income levels actually become AMT triggers.

And then anything that generates a lot of miscellaneous itemized deductions. That could be investment management fees. That could be variable annuity losses. Anything that goes in that big, broad bucket — miscellaneous itemized deductions subject to 2% of AGI floor — anything in that bucket can become an AMT trigger.

Now the reality for all of these — it doesn't mean you don't claim these deductions. If you don't claim your deductions, you just pay Uncle Sam more money under the regular system ... so, it's not as though you dodge these things and save any money. The point to this, though, is if you have a lot of these deductions, you're likely to be subject to the AMT, which means a) you may not be getting nearly as much tax benefit from them as you thought. In fact, you may not be getting any at all and b) you're planning to be focused more around planning for the AMT bump zone than thinking about all those regular tax brackets, because that's actually the environment that you're in.

And another chart that you'll have for your handout materials that you can use is a way that you kind of quickly gauge when you'll be subject to the AMT. So, how you read this chart. Let's say your income, after you've gone through all of your deductions and everything else for your family, is $200,000. So, we go to the $200,000 line and we read across to the right. So, if you're a married couple filing a joint return, the number is $30,000. What that means is if I go through the list of things that we just showed you — state income taxes, property taxes, personal exemptions, etc. — you add up those things. It adds up to more than $30,048 — you're going to have an AMT problem.

Now, it doesn't take much here. If I'm in California, $200,000 of income, I'm paying almost $20,000 in state income taxes. If I'm a married couple, I have $8,000 worth of personal exemptions. So, I'm at $28,000 out of $30,000 and all I did was live there and be married. You have a child — you're over the line. You own a house — you're over the line. You claim any miscellaneous itemized deductions that add up to anything — you're over the line. This is kind of the point. High state tax rates — that state tax bill alone throws you right over the line. Look at what happens if you're at $300,000 of income. Your state tax bill alone puts you over the line here in Virginia. So, it gets very, very hard to avoid the AMT in those middle zones.

Now, ironically, when your income gets high enough, you're adding at 39.6% in the regular system so much that basically it's almost impossible for million dollar incomes to actually pay this. It hits married couples, primarily, from about $150,000 up to about $500,000 or $600,000 of income. Individuals — it's more like about $125,000 to $400,000 or so. And if you're in those ranges, it's really hard to avoid the AMT, especially if you're living in a state that has even a moderate state tax rate.

So, as we wrap up here, unfortunately, I guess, if there's one thing that you take away from this, it's that there's kind of a lot of different parts in figuring out what your tax rate is now. There's a lot of different layers that you have to take into account. We've got not just our tax brackets but the phase-outs of the itemized deductions and the exemptions. Different rates for capital gains and qualified dividends. You might be subject to the AMT and be dealing with that side. You might have to deal with the AMT exemption phase-out and the bump zone that comes there. We've got these new Medicare taxes layered on top. If you're a retiree, we have other income thresholds for the taxation of your social security benefits and the threshold for your Medicare Part B and Part D premiums to rise, as well. So, there are a lot of different layers that go on top. And this is pretty much the simplest chart I could come up with to summarize it.

This will be in the handout materials, as well. I also make it available on my site, here, so you can download it directly if you want. This is basically every different possible income type and adjustment that applies to you. So, depending on the nature of your income, you may have to add one to five different columns simultaneously to figure out what tax rate you'll actually be exposed to between, "Oh, well, it's AMT and I've got the AMT exemption but it's also investment income and it's capital gain and I've got the Medicare surtax on top of it. Oh, and my phase-out of itemized deductions applies as well, though I'm so high, I don't have to deal with the personal exemption."

And, of course, even figuring out what income it applies to is kind of messy because for some of these, it's based on earned income. For some of it, it's based on adjusted gross income. Some of it's based on taxable income, which is AGI ... after itemized deductions. And some of it's based on AMT income, which has its own peculiar calculation with limited deductions. So, even just figuring which income you're supposed to use for the formulas is kind of horrific.

So, the good news, at least, when we look out a couple of years ... tax reform will make this easier. And the formula for tax reform is pretty standard. When we actually look back through what we now have is about a 100-year track record of income tax in this country — when you look at it from a broad, generational perspective, we actually are amazingly consistent with it. We have a relatively simple system. We spend 20 to 30 years mucking it up. Then we reform it and make it simpler again. Then we spend another 20 to 30 years mucking it up. So, we started in 1913. We had a big change at the end of the Great Depression. We had a big change in 1959. The last big change we had was the Tax Reform Act of 1986, so we went 27 years from 1959 to 1986. We're now 28 years out from the Tax Reform Act of 1986. Anybody feel like we're sort of due for tax reform? Like it's gotten a little crazy? All right.

We're due. I actually thought the odds were decent that we could get it done last year or this year, but once the American Taxpayer Relief Act turned out to be permanent, all the pressure was off and tax reform, I think, basically came off the table. So, it's probably going to be a 2017, next-election kind of thing where we'll see how it boils out, but I do think we'll get there.

Ultimately, tax reform means fewer boxes, fewer lines. If we get any legislation in the next couple of years, unfortunately, it's likely to be the other direction which is more boxes, more lines. We'll call them "loophole closers," but if we get any legislation, unfortunately, that's kind of the tilt of what it looks like.

So, I hope that was helpful for you and kind of some food for thought around tax planning ideas, strategies, opportunities and stuff that's out there. I can see the hook over here to the left, but I'll hang around afterwards and during your break, so if you've got any questions, feel free to come up and ask. But thank you very much for your time.

What’s Driving O’Reilly Automotive?

Published Feb 18, 2014 at 4:00PM

Dear Fellow Fools,

Take a Peek at *Fool One*!

Do you hold cash in your portfolio? Then you absolutely cannot miss this exclusive sneak peek inside the world of our "crown jewel" service — *Motley Fool One* — as analysts Bryan White and Jason Moser talk with nationally syndicated columnist Morgan Housel about his "cash optionality" plan. Find out why Morgan firmly believes it’s one of the single biggest hidden opportunities for savvy investors looking to build long-term wealth.

Read More!

We all love to buy a stock and have it rapidly appreciate in only a year or two. But we have a much larger goal at *Pro*: We want continual compounding from our stocks.

Compounding is the hidden treasure of investing, unfolding slowly but surely with great companies over the years. All of us should want to own a portfolio full of "compounding machines." Rather than short-term home-run stocks that, following a burst, may not compound for years, we want compounding that almost never ends. That means buying businesses that earn high returns on reinvested capital, have ample room to keep growing, and have good drivers at the wheel.

In many cases, it also means buying companies that are ... boring. A boring business is less likely to face constant change in its industry, so it's more able to focus on simply *growing*. Warren Buffett caught this early, and teaches by example, but relatively few of us take heed.

Our pole maker, **Valmont Industries** (NYSE: VMI), went public in 1978. **Apple** (NASDAQ: AAPL) went public in 1980. Since their respective IPOs, Valmont has vastly outperformed the iconic computing company — up 26,100% vs. Apple's 15,000%. How much media attention has Valmont received compared to Apple? As good as zero. What could be more boring than poles?

That was a rhetorical question, but perhaps the answer is an auto-parts retailer. **O'Reilly Automotive** (NASDAQ: ORLY) is up nearly 700% over the last 10 years, to Valmont's 618%. What's driving O'Reilly? The same factors lifting Valmont.

Having learned efficient expansion, management can steadily sell in more places and increase earnings in the process. Like **Starbucks** (NASDAQ: SBUX), O'Reilly can continue to plunk down new stores and see its cash flow rise. Meanwhile, it's an excellent steward for stakeholders. The diluted share count at O'Reilly is about the same today as it was in 2004. (Valmont is another shining example of this: Earnings growth gets passed down to all shareholders.)

In the fourth quarter just announced, O'Reilly's earnings per share were up 23% year over year, and same-store sales 5.4% — that's on top of a 4.2% same-store sales gain a year ago. Keep in mind, that's all *additional* revenue on top of an already strong, recurring sales base. For 2013, O'Reilly's earnings per share were up 27%, marking the fifth year in a row that this number exceeded 25%.

For 2014, management's guidance for same-store sales growth mirrors that of last year, with another 3% to 5% gain projected. And after the company opened 190 new stores last year — more than one every two days — another 200 are expected in 2014. Concurrently, O' Reilly is building massive new distribution centers across core markets, increasing its delivery capabilities and setting up for higher margins.

Looking ahead, management keeps repeating its own words from past years (which we love to hear): "We continue to believe that the best use of our cash flow and the best return to shareholders is to invest in our business by maintaining our existing store base, opening new stores ... and opportunistically consolidating in the industry. To the extent these opportunities do not use our available cash in 2014, we intend to continue to return capital to our shareholders by prudently executing our buyback program."

Answering the first question in the conference call, CEO Greg Henslee added, "Well, really ... we're executing the same business plan that we've always executed."

Ho-hum. How boring. Yet how great, given the results.

That isn't to say O'Reilly rests on its laurels. It seeks continual operational improvement and ever-greater customer loyalty, and it evolves with the industry. Henslee's very next sentence was, "We have adapted to focus on the changing vehicle population in the U.S. ..." In other words, O'Reilly executes a core business model known to work, but adapts it as the landscape changes.

Return on equity has grown from 14% a decade ago to 33% last year, and gross margins from 42% to 51%. That sort of steady improvement over 10 quick years led to a nearly 700% gain for owners of this compounding machine. Right now, there's every reason to believe the business will compound value over the next 10 years, too, and with more certainty and safety than the hottest new stocks of today.

To discuss this column, visit our Memo Musings board. To see our current buy guidance, visit Recommendations.

Fool on!

— Jeff (TMFFischer)

Pro Guidance

- **Broadridge Financial Services** (NYSE: BR): Fair value increases to $42. The stock remains a buy at a 3.9% allocation.
- **MasterCard** (NYSE: MA): Fair value increases to $70. The stock remains a buy at a 4.6% allocation.

Pro Catch-Up Trades

Same as last week, Fools!

- **Facebook** (NASDAQ: FB): Following strong earnings, newer members with only a half allocation can increase their allocation to as much as 4.6% (to match us).
- **Tupperware** (NYSE: TUP): If you don't have 2.7% exposure through existing puts (we're short April $90 puts), then sell to open April 2014 $75 puts for at least $2.25 each. Sell one put for every 100 shares you could buy, up to a 2.7% allocation (you could also sell higher-strike puts, but they carry very little time value). If you're not using options, you can buy shares of stock instead.

Pro Coverage & Community

- Get our full earnings coverage on **AIG** (NYSE: AIG), Broadridge, and MasterCard. Alo see our initial thoughts on earnings from **AmTrust Financial** (NASDAQ: AFSI).
- Optimize your life! And use our new discussion board to do so. Share best ideas, favorite reads, places to go, and more — all is good on *Pro*'s new Optimize Your Life board. Start a conversation!
- ADrumlinDaisy is ready to rumble (in a way) about passive investing. Fools join in.

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Morgan Housel's Cash Strategy for Beating the Market

Published Feb 18, 2014 at 10:42AM

Do you hold cash in your portfolio? Many Foolish investors dismiss cash strategies as market-timing, short-sighted, or worse. But Morgan Housel disagrees. Find out why he believes the "optionality" value of cash is one of the biggest hidden opportunities for investors looking to build lasting wealth. Your cash isn't sitting ... it's waiting.

Get the PDF of Morgan Housel's report

Plus! Check out the *Fool One* podcast to hear our team talk with Morgan about what it takes to follow his cash optionality plan — and an investing exercise to try even if you can't stomach his strategy (starting at about 4 minutes in).

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Run time: 11 minutes

We hope you enjoyed this free bonus content brought to you by *Motley Fool One*. If you'd like a further behind-the-scenes look at this premier, all-access service — as well as the opportunity to take advantage of a wide range of free special gifts and exciting content from Motley Fool co-founder and CEO Tom Gardner and his entire *Motley Fool One* squad — simply click here.

Podcast Transcript

JASON MOSER:

Welcome to EP Weekly. I am your host this week, Jason Moser. Chris Hill is out of the office. I thought maybe it was just because of the snowstorm, but I think he's still up in Philly for whatever reason, so we'll go forward without him. It's going to be a slow week anyways, so not much to talk about today. We've got what? MasterCard news and really the news of the week for us we want to talk about — Morgan Housel's report that just dropped yesterday, if I'm correct...

MORGAN HOUSEL:

Yes...

JASON MOSER:

I'm joined in the studio today with Bryan White and Morgan Housel. Guys, thanks for being here.

MORGAN HOUSEL:

Good to be here.

JASON MOSER:

So, really quickly let's just cover this MasterCard news because, you know, share splits seem to always make a bit more news than they're worth. Stock splits to me are — we know they don't create a whole heck of a lot of value, but they do create a perception out there, at least, that shares maybe are cheaper than they were before, and with MasterCard you're getting ten new shares for one old one. You don't see many 10:1 splits like that — or much more you see reverse splits with big numbers — but not the other way around.

But I think the bigger news of this MasterCard release was the 83% boost in the quarterly dividend along with the new $3.5 billion share repurchase program. Bryan, you know, when I was looking at this news, the two things that stood out to me were the share repurchase program and the dividend because those are the way that MasterCard really returns their capital to shareholders first and foremost. The stock split, not so much. I mean, maybe they open that share base up to a new buyer. Who knows? What's your take on that?

BRYAN WHITE:

Well, I'd say the number one thing would be the buyback. That's probably going to add the most value for shareholders. The dividend — they still don't pay a very high dividend, so you're talking around the 1% range. The dividend's not a big deal. It's nice to see them up that and in the future maybe we can get to a 2% yield and then you can talk about a somewhat significant yield there at 2%.

The interesting thing about the stock split is obviously it's going to open up liquidity in the market. You're going to have a share price around $80. It's going to be more accessible for folks. And we don't care too much about that. We want management focused on the long term. But the good thing is the CEO and the leadership team has shown that they are focused on the long term. They let the stock run to $800 a share — so it's obvious that we're not talking about a company that splits every time they get to $100 a share and brings it back down to $50 or $25 a share.

So, this is a company that obviously there's been plenty of discussion ... and most likely from the institutional side ... asking for a split and things like that, so it's not such a big deal. They've shown that they're focused on the long term. They let the stock run to $800 a share, so it's not as if they're a company that always does stock splits and things like that.

JASON MOSER:

Yes, and again it's worth remembering too, with the share repurchases, that they do bring that share account down. I think that's really what you want to look for in the share repurchase authorizations is it's just an authorization. It gives them the ability to execute those buybacks — but really at the end of the day you want to see those buybacks resulting in the share count coming down ... which for MasterCard it has. Since 2009, it's down about 7%, so that's good. That means that they're not just offsetting a bunch of dilution and inflating earnings per share.

MORGAN HOUSEL:

So many share buybacks are just offsetting share issuances...

JASON MOSER:

Yes, absolutely...

MORGAN HOUSEL:

...and from options from the managers and whatnot...

JASON MOSER:

No question...

MORGAN HOUSEL:

...and it's really almost a trick that some companies can play on their shareholders by announcing, "Look. We're doing this major buyback," and it's really not doing anything to the share...

JASON MOSER:

It's always a headline, too. I think that's one of the first things I learned really quickly was to approach every share buyback headline with skepticism. I mean, the first thing I look at is to see what are they doing with those buybacks? Is that share count coming down...

MORGAN HOUSEL:

You know, really interesting. In 2007, it was the biggest year for share buybacks in history, and among the S&P 500, the actual number of shares outstanding went up that year...

BRYAN WHITE:

That is incredibly interesting...

MORGAN HOUSEL:

It was more buybacks than ever and shares went up — because that was the year, 2007, that companies were paying their CEOs $50 million a year in stock and options, so buybacks were just offsetting that...

JASON MOSER:

Yes, and with all these social media companies (Twitter, Facebook and the like) out here you know you're missing a lot of restricted stock awards ... options being granted to employees and stuff like that. So, tech companies you do see more of that dilution. But, yeah, it's one of those things to always keep an eye on.

MORGAN HOUSEL:

Yes.

JASON MOSER:

Well, we also want to talk this week ... Morgan, you had a report that just came out that really, when I read it last night, I was thrilled, because I share the same perspective. It's titled, "My Cash Strategy for Beating the Market..."

MORGAN HOUSEL:

Right...

JASON MOSER:

"See why Morgan Housel keeps up to 40% of his assets in cash." And I think this is a question that we deal with a lot in members asking, "I have this lump sum in cash. What do I do with it? I want to earn something on it. I don't want to just stick it in a savings account that's going to pay 0.1% or whatever." But you know, I've always felt that having that cash is an opportunity. It serves as what you called "optionality" in the report...

MORGAN HOUSEL:

Yes...

JASON MOSER:

...and so to me, when I read this report it makes a lot of sense. It's how I look at things, and I was really thrilled to read it. What prompted you to write this?

MORGAN HOUSEL:

Well, first I think it's important to point out that just because I keep this high level of cash in my portfolio, I'm not recommending that all of our members go out and do the same. It's really different for everyone. It's dependent on how much money you have, your risk tolerance, your age. So, it's really important to point out that this is not advice for people.

But how I think about cash ... You know, for the past five years, all investors have been looking at the yield that they earn on their cash. It's probably 0% or something close to that. And they say, "Well, look. I'm earning 0% on my cash. We've got 2% inflation. I'm losing money here and that's painful." And I think that's pushed a lot of investors maybe into bonds where maybe there's a lot more risk. Putting more money into stocks than they might be comfortable with.

But I think, as I explain in this report, there's another return you can earn on your cash. It's invisible. It's sort of this theoretical return. But I refer to it as "optionality," which is basically the idea that sometime in the future, stocks are going to crash again. If you have cash on hand to take advantage of those low prices, the value you get from having that cash around can be massive, and that extra value is basically a yield that you are earning on your cash by holding it today that you don't really know of yet. And it's really important.

There's one quote that I had in the report from Warren Buffett and his quote was, "Cash combined with courage in a crisis is priceless." And that's really true. Having cash around hurts when the market is going up. When the market crashes, it's just the most beneficial thing you can ever have around.

And the other point I made in the report, too, is that for your long-term wealth measured over decades, what's really going to hurt your wealth is not necessarily earning a low return on your cash. It's being forced to sell stocks when you don't want to because of unemployment or illness or divorce or whatever it may be. If you're forced to sell stocks when the market is down, that's going to crush your long-term net worth.

JASON MOSER:

Yes, I guess that brought out the economist in me and I'm sure in you, right there ... just the whole idea of being a desperate seller ... whether it's stocks or a house or whatever it may be. You don't want to get caught in a position of being a desperate seller because you really limit your options at that point. Bryan, what stood out to you in this report as far as maintaining cash balances? Is that something you agree with? Is it something you prefer to stay 100% invested or get your money elsewhere where it's even earning some small yield?

BRYAN WHITE:

First, I would say it is an excellent report, Morgan. I enjoyed it thoroughly...

MORGAN HOUSEL:

Thanks.

BRYAN WHITE:

And I agree with what Morgan said to start off. Everything is different, right? I'm young. I tend to skew toward I want, throughout my investing career, to be able to take advantage of the major opportunities. We saw one in '08, '09. I'm young enough where I think I can get one or two or maybe three of those. Those are massive wealth-building opportunities and you cannot really take advantage of them unless you have some cash. So, it's different. If I was in retirement, I'd think much differently. I hope that would not be my focus, because I may not see one of those. It depends where you are in your time frame.

And then Morgan, the quote that you brought up is fabulous. So, if you're at home and you're a member, and you're thinking about this report and it appeals to you ... here's the thing that you have to definitely think about also and prepare for. You have to prepare for the emotional ... the feeling that's going to happen. If stocks drop 20% — if the market drops 20% — are you truly going to be willing to pull into your cash file and go all in or go a significant portion in?

Because it's easy to say, but it's hard to do. The good thing is, for everyone at home, we have a good measuring stick ... '08, '09. How did you feel? What were your emotions like? Were you scared? Were you mad at everything in the world in terms of stocks and market? Did you think it was all rigged against you? Those kinds of things will tell you probably how you're going to feel next time. So, it's not really smart to go after a strategy of 20, 30, 40% cash if you know you're the type of person that is going to become very, very fearful when everybody else is.

MORGAN HOUSEL:

Right. It's much easier said than done...

BRYAN WHITE:

Yes. You need to know your personality if you're going to employ something similar.

JASON MOSER:

I think there's a technical term for having the ability to pull the trigger like that. It's called "intestinal fortitude."

MORGAN HOUSEL:

Right.

JASON MOSER:

Make sure you have the intestinal fortitude to pull the trigger. In one other part of this report, I will encourage members to go through and actually do this exercise. You know, Morgan, you provide a road map...

MORGAN HOUSEL:

Yes...

JASON MOSER:

...and I know this road map would be different for everyone depending on what stage you are in life. Are you protecting your wealth? Are you growing your wealth or whatnot? And maybe it's not even a road map that you adhere to strictly, but it's a first step. It gets it down on paper. It gets your thoughts out there of if the market falls by this much, I would invest this much. And how often may this happen? It really, I think, helps to provide a lot of perspective and I think that no matter what stage you are as an investor, it could be a helpful exercise to do and then to also go through and revisit maybe once a year. I think that having a road map like that is just a wonderful exercise.

MORGAN HOUSEL:

Yes. It's really important to think of these things before they happen — because when a crash comes, you're probably not going to be thinking straight — and if you're just trying to figure it out ... if you're trying to figure out what to do with your cash in October 2008, you're probably not going to be thinking ... It's good to figure this out beforehand. Have it written down on paper. Here's what I would like to do. Here's what I plan to do. You might not follow it to a T when it actually arrives.

BRYAN WHITE:

Well, here's the thing, Morgan. Actually in 2008, if you were heavy in cash, you'd feel like you were the smartest man alive.

MORGAN HOUSEL:

Sure. Absolutely...

BRYAN WHITE:

...and you're probably pretty hesitant to dip into that and go into the stock market because you're laughing at all the fools that are 100% invested and rah rah through 2006, 2007...

MORGAN HOUSEL:

And that cash just saved your rear end. You don't want to get rid of it. It's your best friend.

BRYAN WHITE:

Yes. So, it's tough. You definitely need to think it through.

JASON MOSER:

Cash will save your rear end. Let's leave it there, guys. For Bryan White, Morgan Housel ... guys, thanks for being here...

MORGAN HOUSEL:

Thanks a lot.

JASON MOSER:

...and we'll see you next week.

Don't Let the Rules Keep You From Winning

Published Feb 10, 2014 at 4:00PM

We're moving The Buckle (NYSE: BKE) to Buy First. Here's why.

Dear *Pro* Fools,

Jeff on Starbucks

Interested in an exclusive sneak peek inside the world of *Motley Fool One*? Listen in on the *Fool One* podcast as your very own Jeff Fischer drops by to discuss **Starbucks**' (NASDAQ: SBUX) true growth potential with *Fool One* analyst Bryan White, Sonny Kirtley (TMFTiptree), and award-winning host Chris Hill. Does the 'Bux still have the magic beans required to caffeinate your portfolio? Or has it already gotten too frothy? We've got the skinny!

Listen in!

Billy (TMFTailwind) and I recently spoke with the management team at The Buckle, and the conversation reminded me a bit of playing Go Fish with my 4-year-old nephew, Landon. Landon has determined that playing by the established rules of the game is suboptimal, so if a player is asked for "sevens" and is sent fishing, he demands it be his turn and promptly asks the fisher for their sevens. Because the point of the game is to win, Landon is on the right track, but it's hard to say the game he's playing obeys the rules laid out by the creators of Go Fish.

The rules of jeans-focused specialty retail, as practiced by the most notable industry participants (think **Abercrombie & Fitch** (NYSE: ANF), **American Eagle Outfitters** (NYSE: AEO), and **Aeropostale** (NYSE: ARO)), make for a game that's difficult to win. So, like Landon, The Buckle simply makes up its own rules and plays a fundamentally different game. Buckle investors over the past 10 years have definitely won, notching compound annual returns (including dividends) of 21% per year, outpacing the market by more than 17% per year. So, what is the game The Buckle is playing, and are its rules the right ones for the next 10 years? Let's take a look ...

The Buckle's Rule Book

1. **Focus on service.** Service is what differentiates The Buckle from its peers. In fact, when we asked for the key tell in determining whether a store is being well run, CFO Karen Rhoads said that anyone entering should be quickly greeted by a Buckle teammate showing interest in why you're there and offering a willingness to help consult on fashion. Buckle teammates, unlike the staffers at other mall clothiers, aren't just there to punch buttons at the register and fold shirts; they're denim specialists trained to help find the best style and fit to match your wants and body type. In fact, The Buckle is transforming more into a boutique than a mall retailer — it offers call-ahead fitting appointments and reaches out to frequent customers when new items that fit the look become available. This creates a "personal shopper" experience closer to **Nordstrom** (NYSE: JWN) than Aeropostale. This focus on service is reinforced by incentivizing store managers based on store performance and tracking measures such as call-ahead denim fittings.
2. **Brand choice and exclusive merchandise.** Roughly one-third of The Buckle's sales consist of its in-house brands. The bulk of sales come from name-brand designers The Buckle brings in as demand and popularity warrant. Contrast that with Abercrombie, American Eagle, and Aeropostale, which stock their shelves with proprietary brands only. When those brands lose steam (and they do — teen shoppers are notoriously fickle), sales suffer badly. Offering outside brands allows The Buckle to diversify its product line and fashion risk, but it goes a step further. The Buckle partners with designers to bring in exclusive merchandise, which prevents shoppers from price-shopping on a mobile phone and simply ordering from another merchant online.
3. **Be a trend-follower, not a trendsetter.** The bleeding edge of fashion is bloody for a reason — misread a trend and you end up dramatically discounting your merchandise, swimming in red ink, and potentially alienating your customers. The Buckle is happy to take it slow in its relationship with fashion, focusing on staples that aren't going anywhere (jeans and tees) and experimenting with higher fashion only around the edges. Even then, the company leaves that experimentation up to proven experts; the vice presidents of men's and women's merchandising have more than 50 combined years at the company (starting as store salespeople) and have held their VP posts for decades.
4. **Grow only as it makes sense.** Given the importance of service and well-trained staff, The Buckle can only grow as quickly as it is able to find great store managers. According to management, it is this — and not lease terms or finding attractive locations — that has the greatest impact on new store openings. The Buckle has a management training program, aggressively promotes its rising stars, and offers bonuses to store managers who hire salespeople that ultimately become store managers themselves. The Buckle's growth has been far more modest than its peers — its rule of only opening a store led by a star manager helps reinforce the focus on service and limits the chance of mistakenly opening a low-return store.
5. **The Internet is a tool, not a business.** The Buckle's online strategy is definitely unconventional. It doesn't push its shoppers online, because it's nearly impossible to differentiate itself through its service there. Instead, it uses its website as a tool to enhance in-store selection and to improve inventory management, and as a convenience for loyalists without a nearby store. Management was clear that online is a "complement" to the core brick-and-mortar business. When asked what the retail business model would look like in 20 years, the company said that service will still be paramount.
6. **Stay in touch with stores and customers.** The company's executives spend a "majority" of their time traveling to stores and talking to district and store managers. It made sense, then, when controller Tom Heacock said that one of the most important parts of his job is making sure systems are in place to accurately track key store-level performance indicators and disseminate that information quickly to the executive and merchandise teams to make adjustments as needed. Quick corrections, informed by store-level employees and shoppers, help keep mistakes small.

If We Made the Rules

The Buckle's rule book is internally consistent and reinforcing — and it has achieved dramatic success. Still, I wish the company were studying companies (like Bonobos or Zappos) that have built impressive, service-led, online retail offerings. I also wish the company would double down on building out its loyalty program. The Buckle's brand is not well known, the service it offers in-store isn't apparent when it enters a new market, and it relies almost exclusively on word-of-mouth advertising. Its loyal customers are therefore an incredibly important asset, and it needs to maximize the relationship it has with them. Its existing loyalty program is subpar (it still uses punch cards, for crying out loud!) and would benefit from a study of the system **Starbucks** (NASDAQ: SBUX) has built. But inside the four walls of its brick-and-mortar stores, The Buckle's rule book is solid and difficult for established brands to imitate.

The *Pro* Bottom Line

A read of The Buckle's 10-K or a visit to its website would not reveal that it has written the rules to a different game than the one other mall-based specialty retailers play. The Buckle knows what my nephew Landon knows: Like Go Fish, mall-based specialty retail is a game for suckers. We like that the company plays a different game altogether and that its strategy is misunderstood — it offers us opportunities like this, when its shares are meaningfully undervalued. We're happy with our current allocation, but think shares at this price are worthy of being moved to Buy First.

Onward,

Bryan (TMF42)

Site Update

Pro has eliminated the CAPShot feature from our individual recommendation pages. As we continue to try to optimize our site — and the real estate on each page within it — we found that the CAPShot was not regularly used (and *Pro* hasn't used it for years). The CAPS Community itself is still alive and thriving at caps.fool.com.

Memo Coming Tuesday Next Week

Because of the Presidents' Day holiday, next week's Monday Memo will be a Tuesday Memo, hitting your inbox at 4 p.m. Feb. 18. See you then!

February Live Chat Coming Up!

Our January live chat was so much fun that we're repeating the magic this month. Join us at 2 p.m. Wednesday, Feb. 26, and bring your questions! Click here to set a reminder.

Pro Guidance

- **The Buckle:** The stock moves to Buy First (from Buy) on valuation. We have a 2.4% allocation that we'll continue to consider adding to; we'll issue a new trade alert if we do.
- **Pacer** (NASDAQ: PACR): Thirty days have passed since our trade alert, but we continue to wait for our recommended sell price of $8.95. Unless we issue an updated alert, we'll continue to target that sell price.

Pro Completed Trades

- **Intel** (NASDAQ: INTC): Following our trade alert guidance, we sold to open 36 April 2014 $25 calls for $0.58 each, covering all of our 3,600 shares.

Pro Catch-Up Trades

- **Facebook** (NASDAQ: FB): Following strong earnings, newer members with only a half allocation can increase their allocation to as much as 4.6% (to match us).
- **Tupperware** (NYSE: TUP): If you don't have 2.7% exposure through existing puts (we're short April $90 puts), then sell to open April 2014 $75 puts, lately paying you about $2.75 each, for a 3.7% yield in less than three months. Sell one put for every 100 shares you could buy, up to a 2.7% allocation (you could also sell higher-strike puts, but they carry very little time value). If you're not using options, you can buy shares of stock instead.

Most Active Conversations

Today Past 7 Days Past 30 Days

Fool One Podcast: Starbucks’ True Potential and TipTree’s Trip to DC

Published Feb 10, 2014 at 2:16PM

Stream It!

Rather listen on the go? Stream this podcast on your mobile device by clicking here.

Interested in an exclusive sneak peek inside the world of *Motley Fool One*? Listen in on the *Fool One* podcast as your very own Jeff Fischer drops by to discuss **Starbucks**’ (NASDAQ: SBUX) true growth potential with *Fool One* analyst Bryan White, Sonny Kirtley (TMFTiptree), and award-winning host Chris Hill. Does the ’Bux still have the magic beans required to caffeinate your portfolio? Or has it already gotten too frothy? We’ve got the skinny!

{% ooyala id="tzZ2hqazokdDtUb_WghmtitkwAsOhNuu" width="580" height="326" %}

Run time: 8 minutes

We hope you enjoyed this free bonus content brought to you by *Motley Fool One*. Over the coming weeks, we’ll be giving valued *Pro* members like you the chance to get a behind-the-scenes look at this premier, all-access service and take advantage of a wide range of free special gifts and exciting content from Motley Fool co-founder and CEO Tom Gardner and his *Motley Fool One* team. So please stay tuned!

Transcript

CHRIS HILL:

Welcome to EP Weekly. I'm Chris Hill, joined in-studio this week by Bryan White, and from *Motley Fool Pro* and *Options*, Jeff Fischer … and the newest member of the team, James Kirtley. You may know him on the boards as Tiptree. Is it Tiptree or TiptreeTwo?

JAMES KIRTLEY:

It was TiptreeTwo. Now I am TMFTiptree.

CHRIS HILL:

That's right, because you're official now.

JEFF FISCHER:

Hooray.

BRYAN WHITE:

Welcome, Sonny. It's great to have you.

CHRIS HILL:

Welcome. We're going to talk Starbucks first and foremost because Bryan, as you and I have talked about before, this is a holding but Jeff, this is also a stock that you watch very closely. It is part of your universe …

JEFF FISCHER:

Yes, we own it in Pro, as well.

CHRIS HILL:

Where are we now with Starbucks, because I'm a longtime shareholder? This is a company that continues to put up great results. In some ways, this is, I suppose, a good problem for a shareholder to have, but I look at it now, and I wonder, "Gosh. Is it now getting to the point where it's too big?" Or not too big, but too big to expect the kind of returns that we've seen over the past decade.

JEFF FISCHER:

Yes. Or is it too big to fail, maybe? No. Anything can fail. So, it's doing extremely well, Chris. And one thing CEO Howard Schultz said in the last conference call is Starbucks may have underestimated the additional store locations they can open in the Americas — so they may actually have more room to expand than they even thought previously before — and that's great news because even today, still 75% of revenue at Starbucks comes from the Americas and it's the highest-quality revenue. By far the biggest earnings store for Starbucks is a new or newish location in the Americas. Now, it's expanding in Asia and overseas, as well, but that's still a minority of the company's profits.

CHRIS HILL:

Bryan, when you think about Howard Schultz and his leadership … I don't want to scare anyone here … but one of the things I think about, every once in a while …

BRYAN WHITE:

Yes …

CHRIS HILL:

… with Howard Schultz is, "Gosh, he's done such an amazing job as CEO. I really hope he's started to think about a succession plan."

BRYAN WHITE:

Well, I think he has and I think we just saw the signs of it now. He's going to step down from the day-to-day operations and focus more on some of their longer-term opportunities. And Starbucks does — I mean, they have a great bench there — so the COO is going to step up. I don't think that there's really any worries about the succession. I think Howard has spent enough time there planting the seeds for all these ways to win that I think they'll remain focused. And the fact that Howard's going to step down from daily operations and focus on the long-term opportunities is a win. I think that's a win.

JEFF FISCHER:

I hope Bryan's right, and I would suspect he is. But it's also accurate or reasonable to be concerned, because the last time Howard …

CHRIS HILL:

I was going to stay — the *last* time …

BRYAN WHITE:

Yeah, the last time …

JEFF FISCHER:

… things went south and he stepped back in and turned things around. But he remembers that, too, of course, so I think Bryan's right. When he steps back a little bit this time, he'll still be involved enough to make sure everything stays on the right track.

CHRIS HILL:

Well, and part of the success of Starbucks — and this makes me think that both you guys are right … that Schultz has learned from that experience — is if you just step back and look at the last 20 years or so and the way he has tried things and failed and learned from those mistakes … And Jeff, I'm thinking primarily of, gosh, back in the nineties where he announced in a conference call, "We're going to be a lifestyle portal and we're going to sell luxury furniture and all that stuff…"

JEFF FISCHER:

I had forgotten about that …

BRYAN WHITE:

Wow …

CHRIS HILL:

And the stock got whacked. But now you think about not only the acquisitions that Starbucks has made over the last 7 to 10 years, but also the new products they have rolled out. Anyone who ever listened to MarketFoolery knows I was leading the charge saying, "This is a horrible idea that won't work." And I'm so happy I was wrong. Even things like the instant coffee VIA — that sort of thing — it's really been … I am hard pressed to come up with any sort of misstep over the last 7 to 10 years.

JEFF FISCHER:

Yes, and now they're tackling food, of course, with La Boulange, which they expect to roll out to 10,000 U.S. stores by the end of this fiscal year. And that's maybe what I'm most excited about for Starbucks in the next couple of years is the company upping its game in food in the U.S. which are, as we just said, already their most profitable stores … but a minority of people go in there and leave with food. A vast majority only buy coffee. You can change that.

CHRIS HILL:

Sonny, you were saying before we started taping here. Some people are saying, "Gosh. What's the next big thing for Starbucks? It's the drive-thrus." But you're saying where you live, in Indiana, it's nothing but drive-thrus.

JAMES KIRTLEY:

That's right. Most of the Starbucks weren't built as Starbucks. They were taken over from failed fast food stores, so they already had the drive-thru built in. And I can tell from my own experience that the drive-thru is probably the greater source of revenue than the …

BRYAN WHITE:

It's a highly profitable model for them. And like Jeff was saying, they're seeing an increased footprint for potential new stores and that's essentially where they're coming from — is the ability to set up these drive-thru locations.

JAMES KIRTLEY:

Yes, the store is never empty, but the drive-thru line is also very long.

CHRIS HILL:

Last thing, Jeff. When you look at the stock — where it's priced right now, hovering just a couple of bucks below an all-time high — does it look richly valued? Fairly valued?

JEFF FISCHER:

Oh, and then there's that.

CHRIS HILL:

Well, you know …

JEFF FISCHER:

Great question, Chris. Shares are lately right around $70. And as you would expect, after a long bull market, it's harder to be excited about them or their valuation at this moment, but I still want to own them. But the shares do trade at 22x expected earnings for September 2015. So, we're waiting about 18 months to get to 22x P/E multiple while earnings are growing, or expected to grow right around 20%.

So, if you had to put a number on it, I'd say shares might be a year ahead of themselves, more or less. But, I wouldn't want to bet against them, and they have so many levers that they are pushing and pulling to grow even more. Basically, they have so many upside opportunities ahead of them in food and new stores overseas, that it's something to own.

BRYAN WHITE:

I'd say Starbucks deserves a premium given the fact that if you look out, you can see a great repeat-purchase model that Starbucks has successfully developed here in the U.S. And when you look at their potential in China and India — just those two markets alone — a repeat-purchase model out there …

JEFF FISCHER:

Of something that's addicting. There's that, too.

BRYAN WHITE:

I think the potential is pretty big out there.

CHRIS HILL:

And I think it was either in the most recent conference call or maybe an interview that he had done right after the latest quarterly earnings — Schultz had that great line about the growth of e-commerce and saying, "Fortunately you can't make a latte on the Internet." So, the possibility for disruption there …

JEFF FISCHER:

Not yet.

CHRIS HILL:

Before we wrap up — Sonny, part of the reason you're in this studio is you're in town for our two-day member event which starts on Thursday … the Fool One event ... and then on Friday MDP/Supernova/Pro. Hundreds of members coming to [00:07:21]. You've been to these events before. I'm curious. What are one or two things that you're particularly looking forward to?

JAMES KIRTLEY:

Every time I've been to one of these things, I meet people that are just extraordinary people. The members that come to these things … Of course, they start with a common interest — investing — and I always have nice conversations about investing with people. But it always segues into talking about life and children and legacies and things like that. It is such an enriching thing to connect with these other people. You see them on the boards, or maybe not. But you get to talk to them, put a face to their user name. A lot of great times. A lot of great memories from the past events. I'm looking forward to this one.

CHRIS HILL:

We will wrap up there. Bryan White. Jeff Fischer. James Kirtley, guest. Thanks for being here. Thanks everyone for listening. We'll see you next week.

Live Video From Our Member Event!

Published Feb 7, 2014 at 5:30PM

Members are descending on Fool HQ to take part in our member event this week — and if you can't make it, we've still got you covered. We'll have live video streaming on this page from **10 a.m. to 11 a.m.** and again from **4:15 p.m. to 5:30 p.m.** on **Friday, Feb. 7**. Details are below, and we'll also record the most popular sessions and make them available after the conference.

Following along? Join the conversation by using **#FoolFest** on Twitter, Facebook, and Instagram — we'll take at least one question from social media during each session!

Friday, Feb. 7

- **10 a.m.:** Welcome from **David Gardner**, co-founder of The Motley Fool
- **10:10 a.m.: Fred Reichheld**, business strategist and author of *The Loyalty Effect*

(break in live stream)

- **4:15 p.m.: National Oilwell Varco CEO** Pete Miller
- **5:15 p.m.:** Motley Fool co-founder **Tom Gardner's closing remarks**

Pro Live Chat, February 2014

Published Feb 5, 2014 at 3:39PM

At 2 p.m. on Wednesday, Feb. 26, the entire *Pro* crew — advisor Jeff Fischer; senior analyst Bryan Hinmon, CFA; research analyst Billy Kipersztok; and editor/publisher Ellen Bowman — answered your questions during a live text chat. Read the transcript below!

Results and More From Apple, Facebook, and OpenText

Published Feb 3, 2014 at 4:00PM

Dear *Pro* member:

Member Event This Week!

The *Pro* team will be joined by members from far and wide at this Friday's Foolish member event in Alexandria, Va.! If you won't be in attendance, don't worry: The *Pro*-specific events — including Jeff's talk on "Portfolio Construction with a *Pro* Blueprint," Bryan's presentation on "Worldly Wonders, Albert Einstein, and *Pro* Core Stocks," Billy's dive into "*Pro* Stock Talk," and our member panel on making the most of *Pro* — will be recorded and broadcast on the *Pro* site after the event. We'll ping you! Whether live or virtual, we hope to see you soon.

Every quarter, we scour our companies' earnings reports. We seek out anything we may have previously missed, and more than that, we look to add to our knowledge and support — or alter — our theses. It's unfair to paint every company with the same brush, but year-end 2013 results are generally looking fair. Early 2014 guidance seems much the same: fair. And in general, stocks appear valued that way, too: fair(ly). Expecting as always the usual big bumps in the road, this still suggests decent long-term upside for the average stock, and even better for those strong companies that surprise Wall Street. We seek to own plenty of the latter.

Here are key takeaways from three of our companies this quarter (and don't miss more earnings reviews at the end of the Memo).

Apple

(NASDAQ: AAPL)

Achieving higher quarterly revenue than any technology company in history, Apple increased its first-quarter sales 6% year-over-year to a record $57.6 billion. Margins appear to be stabilizing, with operating profits at 30%, sending Apple to record net earnings of $14.50 per share. That's growth of 5% after a full year of declining results because of lower margins. Despite supply constraints, iPhone sales were up 7% to 51 million units, and Apple remained the top smartphone supplier in the United States. iPad and Mac sales both exceeded expectations, with sales of the former up 14% to 26 million units, and sales of the latter jumping 19% to 4.1 million units.

But Apple's stock price declined on lackluster guidance for the coming quarter. Wall Street didn't care that several unusual factors are resulting in this soft second-quarter outlook: Channel inventory increases that Apple made one year ago are not being repeated this year; the U.S. dollar is stronger; and there's been a change in the way Apple accounts for revenue from Mac and iOS devices. Now that Apple gives away its core software free of charge, it defers a greater amount of revenue from each computing device sold. Deferred revenue was $11.4 billion at the end of the quarter, and it will take four quarters to recognize even $8.4 billion of it.

No matter. The stock sold lower on a perceived lack of growth prospects — a perception that has some merit. Apple will plug into China Mobile's 750 million subscribers this quarter, and the hope was that guidance would reflect those big numbers. CEO Tim Cook is excited about the China Mobile deal, and though Apple is selling in just 16 China Mobile 4G cities so far, that number is expected to increase to 340 by year-end. But it doesn't appear China Mobile alone can send Apple's results to the next level. More than ever for this giant business, it appears Apple needs a successful new product in a whole new category to fuel growth. Mr. Cook has all but promised exciting new products (possibly plural?) in new categories this year (perhaps wearables?), and we don't expect Apple to disappoint. While we wait, the stock is priced inexpensively and remains a Buy First, with a good risk-to-reward profile.

- Share price: $500
- EV/EBITDA: 7.5
- EV/EBITDA Next 12 Months (NTM): 7.2
- P/E: 12.4
- P/E NTM: 11.6
- P/FCF: 13.4

Facebook

(NASDAQ: FB)

Enjoying record traffic, Facebook saw its fourth-quarter ad revenue surge 76%. Meanwhile, its effective price per ad climbed 92%, starting to fulfill a key point in our original thesis: Ad rates are likely to continue climbing higher as the ads become more effective. Facebook enjoyed estimate-topping 56% non-GAAP operating margins, and increased its earnings per share 80% with strong free cash flow.

In the conference call, management sounded extremely upbeat about Facebook's prospects. This is only the beginning of building a strong mobile-ad business — and "it's working." The key takeaway: User sentiment about ads in mobile *improved* even as ad volume *increased*. The ultimate goal is to have Facebook users appreciate ads as much as hearing from friends and family, because the ads are so relevant to them. Launching ads in Instagram now as well, Facebook is investing in ad quality, believing that will drive more value than quantity ever could. An international rollout of ads is happening incrementally, too, once critical mass has been built in a region and Facebook opens local offices.

CEO Mark Zuckerberg has a three-year plan to build many new ways for the site's users to share experiences with one another, while always improving the platform for advertisers. The five-year plan is to help people network even more effectively — to solve their problems, find solutions to most anything, and make new connections. To this end, Facebook's Graph Search is rolling out on mobile, and Artificial Intelligence is in the works. Over 10 years, the company aims to get much more of the world to the Internet through its Internet.org campaign; a third of the globe is not yet connected.

From a business standpoint, the fact that social advertising is in its infancy is what's most exciting. The massive advertising industry still spends more on old-school paper ads than it does on social sites, and we doubt that will remain true. Despite an aggressive-looking valuation, Facebook remains a Buy, and we're considering topping off our allocation. The business and valuation remind me of **Google** (NASDAQ: GOOG) circa 2005-2007.

- Share price: $62.50
- EV/EBITDA: 39
- EV/EBITDA NTM: 22
- P/E: 104
- P/E NTM: 50
- P/FCF: 54

OpenText

(NASDAQ: OTEX)

Following its acquisition of privately held GXS for $1.2 billion, *Pro*'s favorite enterprise information management software company is poised for leadership in the field of business information exchange. Such communication is mission-critical, allowing trading partners to manage billing, invoices, pricing, cash flow, and more, all on a common platform. Not only does this provide OpenText with strong network effects (and cross-selling opportunities), it increases its recurring revenue, too. Management estimates that recurring revenue is now going to account for 80% to 85% of OpenText's sales. We love that stability, and we believe it commands a higher valuation for the stock, too.

GXS had nearly $500 million in revenue in 2012 (2013 numbers aren't available yet) and $147 million in EBITDA. The acquisition should immediately add to OpenText's earnings, and within 18 months OpenText expects to increase GXS's margins to its own high level. GXS is another in OpenText's history of acquisitions that are complementary to the core business, so odds for success should be better than average.

In the last 20 years, OpenText has made 48 acquisitions for a total of $3.4 billion. Over the next five years, management estimates at least another $3 billion in additional acquisition capacity. The industry is taking root now, so now is the time to keep investing. That OpenText is growing even as it expends some of its focus on acquisitions suggests that its products are in demand. In a sluggish environment for software, its new license revenue was up 7% last quarter.

Although there's risk with any large acquisition, the stock remains a Buy, and we've increased our fair value (see "*Pro* Guidance Changes" below) to account for the new business. This is just a rough estimate, though, until we see results. Meanwhile, Gartner expects OpenText's core industry to increase by 11.4% annualized between 2012 and 2017. Finally, keep in mind that OpenText stock splits 2-for-1 (from $98 to $49) on Feb. 18. Don't spill your coffee on yourself that morning.

- Share price: $98
- EV/EBITDA: 14.6
- EV/EBITDA NTM: 10
- P/E: 39
- P/E NTM: 14
- P/FCF: 18

A Good Fool Asks, "What's Next?"

I'll next review **MasterCard** (NYSE: MA), **TD Ameritrade** (NYSE: AMTD), and other *Pro* stocks reporting soon. But right now, there's even more *Pro* earnings coverage below. Fool on!

— Jeff (TMFFischer)

Pro Coverage

- More earnings coverage! Click for our latest on **Gentex** (NASDAQ: GNTX), **Intel** (NASDAQ: INTC), **Parexel** (NASDAQ: PRXL), **Starbucks** (NASDAQ: SBUX), and **Tupperware** (NYSE: TUP).

Pro Guidance Changes

- **Gentex** (NASDAQ: GNTX): Fair value increases from $29 to $33, and Consider Adding More to $25. We have a 3.7% position.
- **OpenText** (NASDAQ: OTEX): Our fair-value estimate increases from $81 to $88; Consider Adding More increases to $70. We have 3.6%.
- **Parexel** (NASDAQ: PRXL): Fair value increases from $51 to $54. We have 3.3%.
- **Starbucks** (NASDAQ: SBUX): Fair value increases from $71 to $73. We own 2.9% (and we watch for put-writing opportunities).
- **Tupperware** (NYSE: TUP): Fair value decreases from $84 to $82 on lower results. Shares remain a Buy (or you can write puts for 2.8%).
- You can always see all of our current guidance on the Recommendations page. Also see there our exposure — we have 20% cash — and detailed returns.

Completed *Pro* Trades

- **iShares Russell 2000** (NYSEMKT: IWM) ETF: We set up a March 22, 2014, bear call spread, selling 17 $99 calls and buying 17 $117 calls, for a net credit of $12. (We had to lower our strike price one dollar to get our pricing because the market had already declined.)

Most Active Conversations

Today **Past 7 Days** **Past 30 Days**

Write Covered Calls on Intel

Published Feb 3, 2014 at 3:15PM

Is this for you? *Pro* members who own at least 100 shares of **Intel** (NASDAQ: INTC) and are willing to potentially sell higher in exchange for income can participate. If you don't yet own shares, see our Alternative Trades at the end of this report.

How You Participate

- **Trade:** Sell to open April 2014 $25 calls.
- **Allocation:** Sell one call for every 100 shares of Intel you own and are willing to sell. *Pro* is covering our full 4.6% allocation — all 3,600 shares.
- **Price Guidance:** Your call credit will change as Intel stock moves. With 74 days until expiration, aim for at least a 2% yield on the current stock price.
- **Prices:** Stock: $24.10; April 2014 $25 calls (bid/ask): $0.52/$0.53 (for a current 2.2% yield on the share price in two and a half months).
- **Guidance for Stock Purchasers:** Buy (and write covered calls), or write puts (see Alternative Trades at the end of this report)

What We're Thinking

Intel is starting to gain traction selling processors for mobile devices, and PC sales are showing some stability, but management still expects flat results in 2014 as the company continues to invest in itself. To those hoping for modest growth, this recent news is a disappointment, especially because flat sales and earnings in 2014 may only lead to single-digit growth in 2015.

As the resurgence of growth for Intel seemingly slips further into the future, we're looking to earn our desired rate of return on the position by writing options and collecting the 3.7% dividend. With shares trading at less than 6 times EBITDA and 13 times earnings, our valuation risk should be modest as we target North Star-like, 10% annualized returns.

As long as we want to keep our shares, we'll actively manage our covered calls, rolling them if necessary to keep our stock. Were we to lose our shares, though, we could likely turn around and write puts — our alternative trade. Suffice to say, for now we view Intel as a *Pro* income position (again; it started that way in 2008), through both options and (for those not using options) the strong dividend yield. Eventually, though, we hope to see free cash flow and earnings growth again, and we will stop our covered-call income strategy if we anticipate that.

More That Matters

- **Maximum Loss:** The same as stock ownership, minus the call premium received.
- **Maximum Gain:** Currently, we have a net sell price 6% higher than the current stock price; our trade earns 11% annualized if unexercised, and 32% annualized if exercised.
- **Breakeven:** On this trade, today's share price minus the call premium received.
- **Follow-Up:** As shared above, we'll manage the covered calls pre-emptively to keep our shares as long as we want to own them. If we lose the stock, we may write puts.

Alternative Trades

- **Don't own shares yet?** You can use a "buy/write" order to buy at least 100 shares and simultaneously write these calls with us. *Or*, you can sell to open April 2014 $23 puts, lately for a 2.5% yield at $0.58 each. That price will change, but aim for 2% or higher the coming few weeks. Be ready to buy 100 shares per put you sell.
- **Is 100 shares too many?** If 100 shares would be greater than a 5% allocation for you, then don't use options. Just keep your stock position around 4.6%.

Pro Can Help

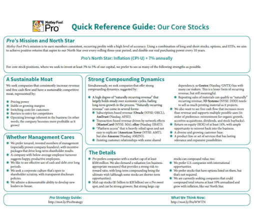
- **Want to learn more?** See our guide to writing covered calls in our sister service.
- **Need an ear?** Post your thoughts or questions on the *Pro* Intel board.

Pro's Watch List: AMERCO

Published Jan 27, 2014 at 4:00PM

Dear *Pro* Member,

A Guide to *Pro*'s Core Stocks



In today's Memo, Billy references several characteristics the *Pro* team looks for in a portfolio candidate. Our printable one-page PDF guide to *Pro*'s core stocks shows you what we're seeking at a glance — view or download it here!

Last week's overall market decline would seem to be a logical topic for this Memo — the S&P dropped more than 2% on Friday alone, and the index posted its worst weekly percentage loss since June 2012. But as Jeff's note on the discussion boards reminded us, it's important to keep perspective; as he put it, "If that mere 2.4% dip [from the S&P's Jan. 15 all-time high] feels heady to you, you may be too exposed to the market (or just not used to falling prices after about 18 months since we've seen a real decline)." So rather than focus on what is actually a pretty minor market change, the *Pro* team thought it would be more fun — and more useful — to show off an example of what we've been working on lately (see the last paragraph in that link).

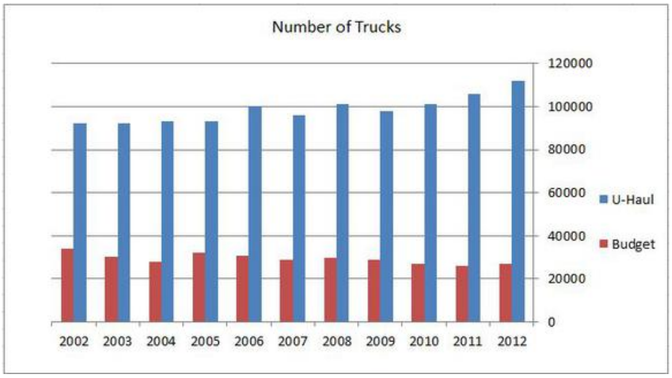
The title of this Memo is somewhat misleading; *Pro* doesn't have an official "Watch List." But Jeff, Bryan, and I each have a set of companies we follow to ensure a steady steam of potential portfolio additions, and we monitor their business performance to ensure we'll be alert if the market presents us with an opportunity we can't refuse. One company that has been on my personal list for awhile is **AMERCO** (NASDAQ: UHAL), the holding company for do-it-yourself moving and storage business U-Haul. Here are a few reasons why I'm intrigued by this company and will be watching its performance over time to see if it's potentially worthy of a spot in the *Pro* portfolio.

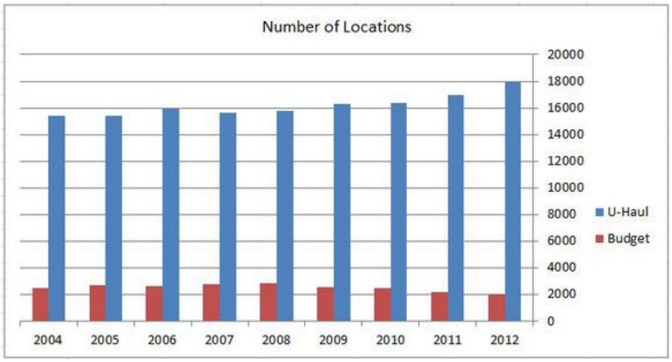
Significant Skin in the Game

Pro values tenured, invested management teams; we want to see leaders with significant financial and reputational stakes in their businesses. AMERCO takes skin in the game to the next level — current chairman/president/CEO Joe Shoen (son of founder Leonard Shoen) runs the business, and Shoen family members litter AMERCO's organizational chart, with most of them having worked with the company for the majority of their adult lives. The Shoen family owns more than 55% of the company's common stock, and executive pay is modest — perhaps even excessively so — for a company with more than $2 billion in annual revenue (total CEO compensation is consistently less than $1 million). What this means is that the vast majority of the Shoen family's wealth is concentrated in AMERCO stock. We can rest assured that the leadership team is running the business with a long-term mind-set that's well aligned with that of common shareholders.

A Strong and Expanding Moat

Another attribute we look for in our investments is a sustainable competitive moat. I believe that AMERCO has a moat in its moving-equipment rental business and is taking steps to reinforce and expand its dominant position there. When you rent out trucks, it's a big advantage to have more vehicles and more drop-off/pick-up locations than your competitors, as U-Haul does. That means that for many routes, U-Haul is the only operator that can ensure an available truck at the start of the trip and an available drop-off location at the end. Take a look at these graphs showing the number of trucks and locations for U-Haul compared with its closest competitor, Budget (owned by parent company **Avis Budget Group** (NASDAQ: CAR)):





Sources: AMERCO and Avis Budget Group

With more than four times as many trucks and nine times as many locations, it's clear U-Haul has a vast and growing lead over its nearest competitors in the size of its rental network. As such, U-Haul should be able to attract customers to a greater degree; this in turn should increase the company's profits, allowing U-Haul to invest in even more trucks and more locations, furthering the virtuous cycle.

Hidden Asset: Self-Storage Real Estate

In addition to its core moving-equipment rental business, AMERCO also operates a self-storage real estate business. AMERCO owns or operates about 40 million square feet of rentable storage space, giving it the third largest self-storage real estate portfolio in the United States (behind REITs **Public Storage** (NYSE: PSA) and **Extra Space Storage** (NYSE: EXR)). Self-storage real estate companies trade at high valuations for a few reasons, including:

- They provide stable, recurring revenue streams with high renewal rates
- The properties require very little maintenance expenditures
- Margins are high, with average EBITDA margins at about 60% for the publicly traded self-storage REITs

Comparing it to its publicly traded peers, I calculate that AMERCO's self-storage portfolio could reasonably be worth up to 35% or more of the value of the entire business. Management is actively developing and growing the real-estate portfolio, and I expect this portion of the business to continue to be a strong contributor to financial results in the future.

The Foolish Bottom Line

AMERCO is a quirky, underfollowed business. This family-run company has an unusually high percentage of insider ownership, a ubiquitous brand, a strong competitive position in its core business, and a valuable real estate portfolio that's perhaps obscured by its holding-company structure. Over the past five years, margins have been expanding, and the company is now generating record revenue and profits. However, the market's been warming up to the story, with the stock price up about 37% over the past six months, well outpacing the S&P 500 over the same span. I'll be keeping an eye on margins to determine whether recent trends are sustainable, and I'll also keep an eye on the stock price to see if Mr. Market is willing to offer us a deal we can box up and store in our portfolio.

Fool on!

— Billy (TMFTailwind)

Pro Catch-Up Trades

- **Tupperware** (NYSE: TUP): If you don't have 3% exposure through existing puts (we're short April $90 puts), then sell to open March 2014 $80 puts, lately paying you about $3.20 each, for a 4% yield in less than two months. Sell one put for every 100 shares you could buy, up to a 3% allocation. If you're not using options, you can buy shares of stock instead. Just realize Tupperware will announce earnings on Wednesday, Jan. 29, before market open. If you'd rather wait until after that event, feel free.

Pro Guidance Changes

- **Starbucks** (NASDAQ: SBUX): Fair value increases to $73 (from $71), and Consider Adding More increases to $59 (from $57). The stock remains a buy at a 3.1% allocation.

Coverage & Community

- Earnings again! TMFMoosie shares the *Pro* calendar.
- After three months of legwork, TMFTailwind can explain the specific logic behind a recent tower industry deal.
- Bryan gives us the scoop on Starbucks Q1 2014 earnings

Most Active Conversations

Today Past 7 Days Past 30 Days

Set Up a Bear Call Spread on the iShares Russell 2000

Published Jan 27, 2014 at 2:30PM

Is this for you? Any *Pro* member seeking a market hedge can consider this position, which earns its maximum profit on a 10.7% market decline and caps our risk at a 5.4% market increase.

How You Participate

- **Trade:** Use a two-legged order to set up a bear call spread on the **iShares Russell 2000** (NYSEMKT: IWM) ETF. Sell to open March 2014 $100 calls, and buy to open an equal number of March 2014 $118 calls.
- **Allocation:** 10%. Set up one bear call spread for every $112,000 you manage. Pro will set up 17 spreads. Or, simply set up one spread for every $600 you're willing to risk to potentially make $1,200.
- **Price Guidance:** Aim for a net credit of $12 or greater as long as IWM is $112 or higher. If IWM declines before you trade, you'll get a lower credit unless you lower both your strikes by $1 for every $1 IWM has declined (which is fine to do, and what we will do if necessary).
- **Prices:** IWM, $112.10; sell to open March 2014 $100 calls (bid/ask), $12.70/12.85; buy to open March 2014 $118 calls, $0.71/$0.72. Net credit: About $12.05.

What We're Thinking

Currently lacking hedges, the *Pro* portfolio is more than 80% invested. By setting up this 10% hedge, we will lower our portfolio's market exposure to a level closer to 70%. This hedge will assure us a winning position whenever the market is declining, and although a 10% allocation isn't large enough to make a very sizable difference, it will still help. We may add to the hedge later or add different shorts.

The small companies in the iShares Russell 2000 Index are more richly priced than the rest of the market, and should continue to be more volatile, offering our short greater potential downside in a topsy-turvy market.

This bear call spread offers us profits if IWM declines by any amount, but our gain is maximized and capped when IWM declines 10.7% . If the ETF falls below our $100 strike, we'll have our maximum gain at expiration, but we can't earn more. On the flipside, our loss is capped at $118 against our net start price of about $112. This position expires in less than two months because we don't want to "set and forget" a hedge like this for a long period. We will be forced to reassess in March whether we want to continue a similar strategy, adjust it, or let it end.

More That Matters

- **Maximum Loss:** If we set up our spread at a $112 net cost, we risk losing up to $6 per spread ($600 each) if IWM is $118 or higher by expiration. Our loss can't exceed that.
- **Maximum Gain:** We will earn a maximum $12 per spread ($1,200) if IWM declines to $100 or below by expiration. We can't earn more than that.
- **Breakeven:** $112 on IWM; it's your net credit added to your $100 strike price.
- **Follow-Up:** We can close our spread at any time. By March 20, we will need to decide if we want to start a new one or not.

Alternative Trades: Please see this post on the IWM board.

Pro Can Help

- Want to learn more? See our guide to bearish spreads.
- Questions? Visit our IWM board.

Pro Position Updates

Published Jan 21, 2014 at 4:00PM

Dear fellow Fools,

The New Year is off to a fast start — I feel like we barely had time to review 2013 before we had to get ready for a busy expiration Friday (and NFL Conference Championship Sunday). But time marches on, and so do we, methodically reviewing our holdings, evaluating our exposure, and positioning our portfolio with respect to our North Star. We handle all the commotion by remaining focused, striving to make dispassionate analyses about business strategy and competitive landscape, and maintaining a balanced risk-and-reward profile. Here is the thinking behind our three latest position updates.

Medtronic Moves to Buy (Today)

Long gone are the days when **Medtronic** (NYSE: MDT) was a high-growth company being rewarded by the market with a heart-zapping EV-to-EBITDA multiple of 16 to 18. In fact, during my early days covering Medtronic for *Pro*, I spent some time pounding the table and insisting that the market was chronically undervaluing the company's solid business (albeit in the face of some uncertainty), though it had admittedly grown a bit fat and lazy. Medtronic's stock price has recovered nicely since then, and a few weeks ago, we decided to move shares to Hold for a chance to review the long-term impact of several factors: increasing regulatory risk, lower reimbursement rates, slowing growth, and the company's ability to succeed with a new sales model in emerging markets. Here's what I found:

- The current regulatory and reimbursement landscape is the new normal for medical technology companies. CEO Omar Ishrak's clear strength in driving execution (expense control, more focused innovation, smaller acquisitions, etc.) should help fight the margin pressure being impressed upon all medical device makers. Furthermore, Medtronic's geographic footprint, scale, and low-cost manufacturing advantages translate well into the new operating environment and will likely bring it continued (if slightly lower) economic profits for decades.
- In key product lines, Medtronic operates in an oligopoly that has historically behaved very well (few price wars). Without as much growth in these markets, price may play a bigger role, but the competing devices are distinct enough that comparison shopping is still tough. Differentiation is supported by the switching costs that come from surgeon and physician training. These factors support the notion that key legacy product lines will continue to be cash cows that fund higher growth product development.
- The next few years should be a great time for new products. Even assuming declines in a few important, mature product lines, the combination of new product launches and demographic-driven demand suggest that Medtronic can achieve modest revenue growth over the next five years.
- The company truly distances itself from the crowd with its emerging-markets game plan. Medtronic has made emerging-markets growth a strategic priority and has attacked it aggressively (with investments in R&D and physical infrastructure), on several fronts (high-end and low-end products, academic partnerships) and via several models (acquisitions, joint ventures, organic growth). This wide-ranging approach is tied together by a new sales model acknowledging the fact that success in emerging markets requires more than a narrow focus on patient outcomes. Instead, Medtronic has reframed its sales pitch to focus on customer economics and training and feedback in addition to patient outcomes. Historically, measuring customer economics was an afterthought, but saving money is a universal concern that's critical to today's market, and Medtronic's early adoption of this new paradigm and its ability to drive cost savings via scale and dedicated R&D put it ahead of rivals.

We're moving shares to Buy with a $63 fair-value estimate and a $47 Consider Adding More price. Shares are modestly undervalued and poised to exceed North Star-like returns over the coming years. New members without a position should feel comfortable matching our 3% allocation. All that said, the industry is maturing and achieving growth is difficult; Medtronic's competitive advantages will help it succeed in the new environment, but increased global competition and more cost-sensitive buyers will drive down returns over time. This is a position we'll look to convert into an income play (likely via covered calls) if the share price extends too far beyond our estimate of fair value.

Facebook Moves to Buy (Jan. 15)

Our recommendation to sell about half of our **Facebook** (NASDAQ: FB) calls was largely an allocation decision. What wasn't mentioned in the headline (but was noted in the text) was the fate of other half of the calls — specifically, letting them turn into a 3.5% to 4% position in the social networking giant. As we noted in the alert, Facebook shares are a Buy with a fair-value estimate of $58 and a Consider Adding More price of $37. Price-conscious *Pro* members will note that this means we see Facebook shares as fairly valued at the moment. Here are a few things to consider if that makes you uneasy:

- Shares are being rewarded with about the same valuation multiples as they were near the May 2012 offering price — that is, the market is pricing the company's future about as richly as it was then. Impressively, Facebook shares are up about 47% since its IPO pop, meaning that the company has not only lived up to those rich expectations, but increased its intrinsic value far beyond what those early investors expected. We think this can largely be attributed to the company's impressive success in mobile advertising. More generally, we think this highlights the company's potential to dramatically increase its intrinsic value in a short period of time, and that's why we're happy to make the fairly valued shares a Buy.
- As Jeff wrote in the alert, advertising is a very large pie, and the migration of ad dollars from traditional sources to online and mobile media is a shift we contemplate over years, not quarters. While we understand the adoption rates and uniqueness of **Google**'s (NASDAQ: GOOG) ad business were and are truly special, we're emboldened by its historical reality and believe it offers a ballpark estimate of what Facebook could achieve.

Have Patience in Selling Pacer (Jan. 10)

Pacer's pending takeover by **XPO Logistics** (NYSE: XPO) is expected to close during the second quarter. Although we think the deal has a high probability of going through without a hitch, we don't feel the need to wait around; we advise selling your shares at $8.95 or better. Shares have been stubbornly pinned below that price, but we expect the price to converge to $9 as time passes. Stay patient and wait for your price. We plan on staying patient, too.

The *Pro* Bottom Line

Early into this earnings season, market reactions to announcements have been large. Stay tuned to our Monday Memos, the discussion boards, and the What We Think Now page to get our up-to-date thoughts in real time.

Onward,

Bryan (TMF42)

Pro Guidance Changes

- **Facebook** (NASDAQ: FB) and **Medtronic** (NYSE: MDT) are both Buys. See above.
- We've raised **Wells Fargo**'s (NYSE: WFC) fair-value estimate to $53.50 and its Consider Adding More price to $41. Shares remain a Buy.
- We adjusted **The Buckle**'s (NYSE: BKE) fair-value estimate ($54.80) and Consider Adding More price ($38.35) to reflect payment of the special dividend. Shares remain a Buy.

Pro Completed Trades

- **3D Systems** (NYSE: DDD): Our January 2014 puts expired as income. We lack any exposure now.
- **American Tower** (NYSE: AMT): Our January 2014 puts expired as income. We seek new ones to write.
- **Facebook** (NASDAQ: FB): We sold to close 12 of our January 2014 $20 calls at $37.17 (bought for $6.80). We let 14 calls turn into shares at a net $26.80. At current prices, this gives the portfolio about a 4% stake in the stock.
- **ProShares UltraShort Real Estate** (NYSEMKT: SRS): Yes, we miss trades sometimes, too! In the hustle last week, we didn't click "send" to sell to close our January $25 puts. They turned into 600 additional short shares this morning, which we bought to close at $20.23. The outcome is the same. We maintain just a 0.7% short in SRS for those who can follow along per last week's Memo. Our January $25 calls expired as income.

Coverage & Community

- No deposit slip necessary to read Billy's review of Wells Fargo's latest quarter.
- We love sharing lessons and learning from one another. Thanks thinkingbig.
- America's car culture is a trend we have our eye on.

Most Active Conversations

Today Past 7 Days Past 30 Days

Sell to Close About Half of Your Facebook Calls

Published Jan 15, 2014 at 5:58PM

Is this for you? This alert is directed to *Pro* members who own January 2014 calls on **Facebook** (NASDAQ: FB) — but *all* members should follow this alert's guidance to establish exposure to the stock.

How You Participate

Summary: Members who own January 2014 calls should "sell to close" about half of them, and keep the rest open to turn into roughly a 4% allocation of stock this weekend. Members who don't have any exposure should buy a 2% stake in shares, and we'll see about adding another 2% after Jan. 29 earnings.

Trades:

- **Old timers:** Sell ("sell to close") about half of your January 2014 $20 calls, leaving enough calls open to turn into a 3.8% to 4.1% position in stock.
- **Newcomers:** If just starting a position, buy 2% in shares. After Jan. 29 earnings, we'll see if you should add 2% more.
- **Allocation details:** *Pro* owns 26 calls, which left alone would turn into 2,600 shares at a recent $58, for a value of $150,800, or 7.5% of our $2 million portfolio. We're going to sell 12 or 13 contracts (depending on where shares trade at the time), leaving 14 to 13 calls open. Fourteen would turn into 1,400 shares worth $81,200, or 4.1% of the portfolio.
- **Price Guidance:** Sell to close your calls using a limit order at the current price (lately around $38). Aim to get intrinsic value. So, if FB shares are $58, your $20 calls should sell for $38. Be sure to close by Friday, unless you want more shares.
- **Prices:** Stock, $58; January $20 calls (bid/ask): $37.90/$38.10

What We're Thinking

Stock Info

- **Fair-Value Estimate:** $58
- **Consider Adding More:** $37
- **Scorecard Status:** Buy

In September 2012, we bought $20 call options on Facebook. The social-media giant's stock traded near $20 at the time. Since then, the calls have appreciated 450%, while shares have risen to nearly $58. The $17,700 we invested has grown to nearly $100,000 as expiration approaches this weekend. If we allowed all of our twenty-six $20 calls to turn into Facebook stock, the company would become a 7.5% position — by far the largest in our portfolio.

Instead, we're going to sell about half of our calls, and let the rest get exercised into shares. In the process, we'll be removing *all* of the capital we initially invested, plus some profits; meaning, existing profits from our calls will more than finance our new Facebook shares. Depending on how pricing plays out, we'll have a 3.8% to 4.1% stake in Facebook stock come Monday, with a net start price of $26.81.

Why keep this investment going longer?

As long as Facebook is able to maintain or expand site traffic and increase ad revenue, we should see steep revenue gains in the coming years. We expect Facebook to increase its earnings per share approximately 40% in 2014, and the stock trades at less than 50 times our estimated non-GAAP earnings. Shares trade at a fairly reasonable 50 times trailing free cash flow , but free cash flow will be sporadic the coming years. Overall, the company isn't cheap.

However, most of Facebook's value multiples *are* lower than **Google**'s (NASDAQ: GOOG) multiples were in 2005 and 2006, when the search giant was similarly sized (and fetched 125 times free cash flow). And just like Google's online ad revenue in 2005, mobile and social ad revenue is a tiny slice of the world's advertising pie — even though usage of social sites, led by Facebook, continues to increase. Like Google, Facebook could realistically see ad revenue expand from less than $7 billion during the last 12 months, to several times that figure in the years ahead. Google's ad revenue is likely to hit $50 billion in 2013, even though it has less traffic (and *less engaged* traffic) than Facebook.

But in most ways Facebook is no Google yet, and risks do abound. Will site traffic increase? Can management continue to navigate the fast-changing mobile landscape? Will ads on the site continue to (reportedly) please customers? Will teens who leave the site return? And on and on. Facebook remains one of *Pro*'s riskiest positions, but at the same time, it is *the most trafficked website in the world* (though it still lacks 6 billion of the world's people — that's opportunity). If Facebook maintains its lofty mantel, increases its nascent ad revenue, and drives free cash flow higher, long-term investors should be amply rewarded.

Alternative Trades

- **Different allocation?** Unless you followed our guidance precisely in September 2012, check to see how many calls you own, and let as many get exercised as you're comfortable owning shares in Facebook. For some of you, letting *all* of your calls get exercised may only lead to a few-percent allocation to the stock, so you might want to do that. (In that case, do nothing, and your calls will turn to stock by Monday.) Other members may already own shares in a greater than 4% allocation, so they may want sell to close *all* calls. We're recommending a stock allocation of 2% (for newcomers) to about 4%.
- **Own 2015 calls?** Let those alone for now.
- **Want to roll your calls?** If you want to just keep owning calls, you can roll 2014 options to January 2016 $25 or $30 calls. Sell to close your existing ones, and buy to open new ones. Just realize that selling to close is a taxable event (while accepting shares through exercise is not).
- **Want to target a lower new buy price?** Newcomers can consider "selling to open" most any puts, one put for every 100 shares you would buy. Just realize that earnings are around the corner, on Jan. 29, so expect volatility.

Pro Can Help

Questions? Please get social on our Facebook board.

Sell to Close Your Puts on ProShares UltraShort Real Estate

Published Jan 14, 2014 at 11:45AM

Is this for you? Only investors who own January 2014 $25 (or other) puts on **ProShares UltraShort Real Estate** (NYSEMKT: SRS) ETF need partake in this alert.

How You Participate

- **Trade:** Sell ("sell to close") all the January 2014 $25 puts on SRS you own.
- **Price guidance:** Use a limit order to obtain as close to intrinsic value as possible — lately, that's about $4.20. But close by Friday's end.
- **Prices (1/14/13):** ETF, $20.84; options, bid/ask: $4.10/$4.30.

What We're Thinking

In *Pro's* original recommendation to set up a synthetic short on SRS, we targeted a debit price of only about $1. We ended up having to pay $2.51 to set this up, so today we walk away with a 67% profit when we sell around $4.20. Why not do it again? Because long-term options no longer exist on SRS, and short-term ones aren't worth trying. So we plan to let our short January 2014 $25 calls expire this weekend, and we'll sell to close our $25 puts before the market closes Friday.

Alternative Trades

- SRS no longer has long-term options, so there are no option alternatives to speak of. We still have a 0.7% direct short in SRS that members can match if their broker has shares available for shorting for less than 7% in annual fees. (Most decidedly do not.) It is not a vital or core position for us, but you can see this week's Monday Memo for other alternatives to matching our remaining 0.7% short in SRS if you wish.
- If you followed the original alternative to buy January 2014 $35 puts on SRS, you should sell to close those now, too, booking your gain.

Pro Can Help

- Questions? Visit our SRS discussion board.

Update: Pro’s Option Expirations and Shorts

Published Jan 13, 2014 at 1:43PM

Dear *Pro* member:

Today's Memo will provide an overview of all of our January options and current shorts — but before we dive in, this is an opportune time to touch on the importance of portfolio management. People you meet at a party, or relatives at a holiday dinner, typically want to talk about *a* stock or two, but rarely want to talk about portfolio management. That's not right. You can own any stock you want if you have a portfolio that's built to grow over the years. But you probably shouldn't own *any* stocks if you don't have something resembling a portfolio.

Keep that in mind as you consider our individual positions below. *Pro* is a portfolio service focused on diverse core investments. By having a core portfolio much like *Pro*'s, we believe you can add — or subtract — any other position you like, in small amounts, and still do well. So, you could ignore our shorts and options if you like. But for those enjoying these tools along with us, it's time to update you regarding our pending January expirations, and get members who joined in November up to speed on shorts.

January Option Expirations

Of our four expiring options in *Pro*, let's deal with the easiest ones first.

- **3D Systems** (NYSE: DDD): Our puts are expiring as income; we'll watch the company for potential opportunities.
- **American Tower** (NYSE: AMT): Our puts are set to expire as full income again. We're looking for new puts to write to potentially add more shares to our existing 2.5% stake in the stock (which remains a Buy First).
- **Facebook** (NASDAQ: FB): Our $20 calls have gained about 450% since our purchase in September 2012, turning less than $18,000 into nearly $100,000, about 5% of the portfolio. Our 26 contracts represent 2,600 shares of stock that would be worth about 7.5% of our assets if we let them all be exercised. That would be a bit much at today's valuation. We're going to issue a trade alert this week to advise closing some of our calls, booking their profit, and leaving the rest of our calls alone to turn into shares of stock this weekend. (If you bought 1.2% in stock instead of calls initially, your position should be small enough to let alone.) The trade alert will guide new members into the position, too.
- **ProShares UltraShort Real Estate** (NYSEMKT: SRS) ETF: Our *synthetic option* short is expiring (our direct short of SRS, of course, is not). Our short $25 calls are expiring as income (we won't touch them), and this week we'll issue a trade alert to "sell to close" our $25 puts. This ETF no longer has long-term options, so we cannot start a new option position.

That's it for *Pro*'s options this week. We have two income positions expiring with no action needed, and we have puts on SRS to sell to close, and about half our calls on Facebook to sell to close as well. We'll let our remaining Facebook calls turn into shares. Watch your inbox for specifics in these alerts!

Pro Short Positions

Our current short positions are small, and in two of three cases, they're not really shorts at all. That's because those two are shorts of *inverse* (or already short) leveraged ETFs. Since we're shorting a short, our position works as a long. Our third short is of a trust that owns euro. New members can short all three alongside us today if they're ready and if their broker has shares available (or, in two cases, if you want to use options).

1) Guggenheim CurrencyShares Euro Trust (NYSEMKT: FXE) (formerly ProShares): We have a 3% short position that will grow in value if the dollar gains against the European currency. Fed tapering is slowly sending U.S. interest rates higher, which may help the dollar strengthen. And Europe's currency block woes remain unresolved, with Greece, Spain, and other members struggling mightily.

- **Newcomers to shorting FXE:** Members not yet short can directly sell short ("sell short" or "sell to open") FXE in an amount up to 3% of your portfolio's value. Shorting is our preferred trade here because it allows you to more easily get into or out of the position. But if your broker does not have shares available to short, you can set up a 2015 or 2016 synthetic short (assuming 100 shares at $135, for a total of $13,500, is a reasonable allocation for your portfolio). Sell to open January 2015 or 2016 $135 calls, and buy to open an equal number of $135 puts. The expiration year you use is your choice, since we don't know how long we'll be in the short. Neither year has a distinct advantage.

- **Past alternative trades on FXE:** If you set up a 2014 synthetic short, you can roll it to 2015 or 2016 (or close it and start a new one). If you set up a 2014 bearish spread (at various strikes), it is likely expiring without value. A new one is not recommended.

2) Direxion Daily Financial Bear 3X Shares (NYSEMKT: FAZ): We have a 0.8% short on this inverse ETF that is itself short the financial giants of America. We believe financial stocks remain inexpensive, so — along with owning many such stocks — we're investing against this leveraged *bearish* ETF. Twice we've increased our short to 1.5% and have seen it pleasantly shrink to its current level of 0.8%. We may add to it again later.

- **Newcomers to shorting FAZ:** If your broker has shares available to short, newcomers can short up to 1% today to roughly match us.If you can't short directly, then set up a synthetic short using January 2016 options. Sell to open January 2016 $20 calls, and buy to open an equal number of January 2016 $20 puts. You'll be charged a premium compared to shorting at the current share price, but that's in lieu of annual shorting fees.Each pair of contracts represents a $2,000 short. Keep in mind that you could *add* another 1% to your **Wells Fargo** (NYSE: WFC) or **AIG** (NYSE: AIG) stake instead, as an alternative trade.

3) ProShares Ultrashort Real Estate ETF (NYSEMKT: SRS): Alongside our SRS options that are being closed and expiring, we have a 0.7% direct short on SRS that we're letting ride awhile longer. We still believe in the thesis that U.S. real estate is recovering, but this inverse ETF has become very small, with only $50 million in assets. Options are no longer viable to use on it, and shorting the ETF is logistically difficult. We'll keep our position (and may add to it if we can), but it may not be sensible for many newcomers (see below).

- **Newcomers to shorting SRS:** Most brokers don't have shares available for shorting, and those that do charge a high fee. Our own Interactive Brokers charges 6% of the short's value annually to short SRS. If your broker has shares available and charges less than 7%, you can sell short up to 1% in shares to roughly match us. Otherwise, pass on shorting this. Either way, at this point the alternative trade of *investing* up to 1.5% in the **iShares Dow Jones Real Estate** (NYSEMKT: IYR) ETF looks at least as attractive, if not more so. You can buy those shares instead, or add another 1.5% to your stake in **American Tower** (NYSE: AMT) if you prefer.

In Summary

Pro doesn't have much short exposure to speak of today, but that's been a good thing, and we're continuing to work on building our short positions in struggling companies. We believe in our small shorts of FXE, FAZ, and SRS as much as we ever did, so you can start positions (or alternative positions) in all three if you lack them.

Newer members who have bought all of our Buy First and Buy stocks are about 68% invested with us, and will be around 70% long after shorting our two inverse ETFs (excluding the 3% FXE short). That's a comfortable exposure number from which to continue to build, while already being positioned to profit nicely. It all comes back to your portfolio, and being positioned well for the coming year and beyond.

So, to repeat: We'll have a Facebook trade this week, and a closing trade on our SRS $25 puts, too.

Ask any questions on the Catch-Up Trades board. And Fool on!

— Jeff (TMFFischer)

Pro Completed Trades

- **Parexel** (NASDAQ: PRXL): *Pro* bought 1,300 shares (3%) at $46.15. Remember that our guidance was to pay no more than $44.25 the week of Dec. 23, and after that, to pay less than our fair-value estimate, which is $51.

Pro Guidance Changes

- **Pacer International** (NASDAQ: PACR): The stock moves to Sell (from Hold) on an acquisition offer that equates to $9 per share. We'll be selling all of our shares (2.2% of the portfolio) at about $8.95 or higher for a nearly 65% gain in about two years.

Pro Catch-Up Trades

- Read this Memo for three on our three shorts!

Coverage & Community

- Earnings are here! TMFMoosie has the 411 on our earnings calendar.
- Foxes and hedgehogs? FoolishRob99 compares Tom Gardner's investing to Warren Buffett's.
- Hedge funds had another poor 2013.
- Jeff points to the "Everything *Pro*" page. Know it! Bookmark it! Live it!
- KBecks (Karen) asks, "Do you use *Pro* and *Options* together?" and gets many good member responses.

Most Active Conversations

Sell Pacer International

Published Jan 10, 2014 at 11:00AM

Is this for you? This alert is for *Pro* members who own shares of **Pacer International** (NASDAQ: PACR).

How You Participate

- **Action**: Sell Pacer International
- **Allocation**: We recommend selling all shares. For *Pro*, that is 4,900 shares and 2.2% of our portfolio.
- **Scorecard Status**: Sell
- **Recent Price**: $8.92
- **Price Guidance**: Sell your shares for more than $8.95. Be patient — this deal is expected to close in the second quarter, so you have time.
- **Fair Value Estimate**: $7.75

What We're Thinking

Earlier this week, **XPO Logistics** (NYSE: XPO) announced an agreement to acquire Pacer for $335 million. The deal offers Pacer owners $9 per share, consisting of $6 in cash and $3 worth of XPO stock. Between now and the end of June, when this deal is expected to close, a few things could happen:

1. The deal could go through as planned. We'd get $6 per share in cash and hold a tiny position in the combined company represented by XPO stock sometime in June.
2. The deal could fall apart for any variety of reasons (usually this happens because of meaningful changes in business fundamentals or financing troubles). Our Pacer shares would fall in price, probably considerably.
3. The announcement could attract other suitors with (likely higher) counteroffers. Alternatively, Pacer shareholders could reject the offer and demand a higher price, which could extend this process but result in additional upside.

We believe the most likely scenario is the first. Both Pacer and XPO seem more valuable combined than apart, which means the $9 price tag XPO is willing to pay is likely higher than Pacer would receive from a more traditional intermodal company looking to get bigger. The business combination makes strategic sense, and the fact that Pacer management has agreed to stay on is a strong sign that it liked the deal too. However, we don't think the newly combined company, a small-cap provider of third-party logistics with a business strategy focused on serial acquisitions, has a place in the *Pro* portfolio. We think we can redeploy the cash proceeds better than XPO and its acquisition-centric business.

And we'd prefer to sell early, because we believe this deal is a great opportunity to sell a company we've felt handcuffed by. Pacer has been on Hold for some time because any actionable guidance from us was likely to seriously affect its market price as *Pro* members attempted to follow along. This week's news will likely usher in a trainload of merger arbitrage investors looking for Pacer shares to buy for their books, providing us with a rare opportunity in the form of plenty of demand to sop up the shares *Pro* members are selling.

Perhaps most importantly, we believe this is a fair deal for Pacer shareholders. Given our $7.75 estimate of fair value — which we most recently revised *lower*, down from $9 — the offer price represents a 22% premium to the average closing price over the last three months. We are happy to turn what seemed like a tenuous paper gain into a more certain realized gain. After just more than two years, *Pro*'s rocky ride on Pacer's tracks should result in a gain approaching 65%.

Pro Can Help

- Deliver any questions via plane, rail, or truck to the Pacer International discussion board.

2013 in Review, and Lessons Learned

Published Jan 6, 2014 at 4:00PM

Dear *Pro* Member:

Get Ready for Wednesday's Live Chat!

Got questions? We want to hear them! At 2 p.m. this Wednesday, Jan. 8, the entire *Pro* crew will be answering your questions during a live text chat. We're here for everything you need, from how best to use this service to what to do if you can't follow our options recommendations exactly. Click here to set a reminder!

Last year was one of the best for the stock market in the last four decades, so we're grateful that *Pro* performed even better, gaining 35.1% compared to the S&P 500's total return of 32.4%. We performed especially well given our hedges and generally more defensive stance.

It was a year that made our North Star's 8.7% return look tame, so it's fortunate that we didn't choose to safely lock in many gains early in 2013. When the market suffers negative periods, the North Star will still be positive, so we can't rest on our laurels any particular year.

Winners and Laggards

We saw strength throughout the *Pro* portfolio, but we enjoyed especially large one-year gains of greater than 60% in **MasterCard** (NYSE: MA), **Broadridge Financial Services** (NYSE: BR), **OpenText** (NASDAQ: OTEX), **Gentex** (NASDAQ: GNTX), **Papa John's** (NASDAQ: PZZA), and our January 2013 short of **Direxion Daily 3x Financial Bear** (NYSE: FAZ). Even better, **Facebook** (NASDAQ: FB) shares nearly doubled, sending our calls up more than 400%. For newer members, new opportunities in these last two names should come along.

The **WisdomTree Emerging Markets SmallCap Dividend** (NYSE: DGS) fund continued to be a notable laggard in the portfolio, as was **StoneMor Partners** (NYSE: STON), which spent much of the year as a Sell while we hoped for a $27 sell price. As for the well-run DGS, we believe emerging markets will have their day in the sun, so we're writing puts to potentially add to our shares.

What We Did

Some key decisions (good and not so good) from last year included:

- **January:** Short FAZ, close your **Sony** (NYSE: SNE) short, and write covered puts to close your **SPDR S&P 500** (NYSEMKT: SPY) short
- **March:** Buy more **Apple** (NASDAQ: AAPL) at $431, and buy more **GrafTech** (NYSE: GTI) at $7
- **April:** Buy **O'Reilly Automotive** (NASDAQ: ORLY), and write covered calls on **CME Group** (NASDAQ: CME)
- **May:** Buy **American Tower** (NYSE: AMT), and short more FAZ
- **July:** Buy **TD Ameritrade** (NYSE: AMTD)
- **August:** Buy more **AIG** (NYSE: AIG)
- **October:** Close your covered calls on **OpenText** (NASDAQ: OTEX)
- **November:** Buy **Valmont Industries** (NYSE: VMI), and close the new short calls on SPY
- **December:** Buy **Parexel** (NASDAQ: PRXL)
- And, among other recommendations, we issued 17 option-writing and option-rolling trades targeting income throughout the year.

Many of our best decisions were ones you never saw: sells we didn't make, shorts we passed on, covered calls we didn't write. But we still made plenty of mistakes, and we can take some great lessons from 2013.

Use Covered Calls Sparingly

Specifically, to sell a stock or for income-only positions

We all know this: Only write covered calls on stocks you're ready to sell, or on positions you set up *specifically* for income ("buy/write" trades). I don't regret selling **CME Group** (NASDAQ: CME) or **Rockwood Holdings** (NYSE: ROC) through covered calls. We were ready, and selling led to buys we like better today in **TD Ameritrade** (NYSE: AMTD) and **Valmont Industries** (NYSE: VMI).

But writing covered calls on **3D Systems** (NYSE: DDD) all but forced us to sell our shares at far less than the current share price. That stock looks expensive, so we might have sold long before today anyway, but we didn't even have the choice. We know better than to write covered calls on growth stories. This was a mistake inspired in part by 3D's past volatility and juicy call premiums. Unlike the previous few times that it surged, this time 3D Systems stock did *not* give back its ground — instead, it doubled again and then some, without us. Don't expect to see *Pro* write covered calls on sharply growing companies such as 3D Systems or, for that matter, on outstanding businesses such as MasterCard in future.

What to expect from Pro*:* Only "buy/write" income trades, diagonal calls, or covered calls to strategically sell a stake in a lower-growth business — not covered calls on our most promising positions.

Concerned? Buy Puts and Keep Your Upside

Buying puts can also minimize your shorting risk

Writing covered calls is not very defensive. It may pay you a 3% to 6% premium, but that income will pale if a stock falls sharply. If you're concerned about downside, you might *buy* puts instead, and keep your upside on what you own. This may also apply to index hedges. In October, we set up a synthetic short on SPY that ultimately cost us about $10,000 in losses after our written calls ran against us. Buying the puts alone would have cost us less than $3,000 — a much smaller loss. We didn't need to write calls to pay for our puts, but we did, and we paid a bigger price in the end. Sometimes, simply buying puts is the best route for protection with limited capital at risk.

What to expect from Pro*:* More put buying to hedge and protect, with a focus on risking little capital when the puts expire unused, and no additional pain from the position if prices keep rising.

Writing Puts Can Be a Poor Substitute for Stock Ownership

If the business is a great one, you'll likely want to own shares as well

It's tempting to write puts to target a lower buy price on a stock, but if you're seeking to buy an outstanding business, we usually suggest that you buy some shares initially, too. Writing puts on any of our big winners last year paid relatively little compared to owning the stock. This may be a "bull market problem," but it's still something to keep in mind. It follows that using options to make *any* transaction can sometimes backfire. We started writing covered puts to close our SPY short at $146 in January of last year, and didn't get to cover our 1,000 shares through covered puts until the price was $164 in June. That's 12% higher.

What to expect from Pro*:* We've been good about buying stocks we want to own rather than just writing puts. Expect that guidance to continue. On other trades, we'll continue to weigh carefully whether getting options involved makes sense, or if we just want to execute the trades directly.

Short-Term Returns Vs. Avoiding 'Style Drift'

What's more important?

This is more of a question than a lesson. For several months early in 2013, I contemplated setting up a small "Elon Musk basket" in the *Pro* portfolio, buying shares of **Tesla Motors** (NASDAQ: TSLA) and **SolarCity** (NASDAQ: SCTY). Tesla shares were between $34 and $40, and SolarCity traded in the teens. Both went on to become among the best performers on Wall Street last year. Even a small 1% stake would have grown to at least 3% in each. Today, for better or worse, we would have sizable stakes in two companies that don't fit into our fundamentals-based, North Star-seeking approach.

So the question is, will we be better off by sticking to our knitting over the long haul, or should we "drift" into more speculative positions from time to time? We have faced this question before. In my heart, I believe we will be better served by following our disciplined approach. We may forego extra short-term results, but over the long haul, our steady discipline should reward us as much, or more, than would the insertion of more speculation into our process.

There *is* a place in *Pro* for reasoned speculation — that's exactly what our **Facebook** (NASDAQ: FB) calls were — but there needs to be an underlying valuation we can estimate. Buying stock or call options on Tesla or SolarCity this early would have been speculating. That's great if it's what your approach calls for, but our goal of absolute returns demands our own kind of steady discipline. The good news is that most companies *can* be valued — even young, exciting companies — so we're sure to have more wins like Facebook. And if cash flow at Tesla or SolarCity starts to lend itself to valuation estimates, it won't be too late to profit on either.

What to expect from Pro*:* More focus on earning oversized gains like we enjoyed on Facebook (including using call options on new positions) when fundamentals-based opportunities present themselves — but little outright speculation. We're seeking put-buying opportunities, too, on stocks we believe may fall.

You Can Excel Even With Reduced Risk

... and beat most fund managers to boot

Finally, there's a lesson in the fact that we didn't swing for the fences — we didn't use margin, or make gross speculations — but we still did better than a record-strong stock market. In fact, we defensively held cash of around 20%, and our net exposure to the market averaged 69.6%. Yet we earned 108% of the S&P 500's return. That's an extremely pleasing risk-to-reward result . And it handily tops the vast majority of professional money managers and hedge funds, once again showing us that Fools like us can manage our own money.

2013	*Pro* Net (or True) Long Exposure
January	70%
February	66%
March	70%
April	71%
May	59%
June	66%
July	70%
August	72%
September	69%
October	70%
November	74%
December	78%
Average	69.6%

Throughout 2013, we stuck close to our 70% desired exposure level, adjusting as hedges and new buys or sells demanded. This, I believed, was the right exposure for us to perform well in a strong market given what we owned, and should have helped buffer us in a downturn, too. In 2014, we may lower our net exposure as stock valuations go up.

What to expect from Pro*:* Continued focus on our exposure, both as a rule in the portfolio and in our content for members.

It's a Wrap

2013 was a great year for investors in the U.S. market. But not all did well, of course, and most investors in mutual funds earned less than the S&P 500. A big congratulations to you for being a Fool, and for winning by managing your own money! We're looking forward to investing with you, and learning more for you, in 2014.

Comments? Please visit the Memo Musings discussion board.

Fool on!

— Jeff (TMFFischer)

Pro Trades Completed

- None last week. Our new 3% buy in **Parexel** (Nasdaq: PRXL) is still pending.

Pro Catch-Up Trades

- **AmTrust Financial Services** (Nasdaq: AFSI): Shares remain a "buy," up to a 5.8% allocation. If you're just buying now, start with a 2% to 3% allocation and add to it over time. Or, sell to open put options to start. The February $32.50 or $30 puts pay well — just be ready for more volatility.
- **Tupperware** (NYSE: TUP): Sell to open April $90 puts for $3 or more, for up to 3% in shares.

Pro Coverage & Community

- **Pacer** (Nasdaq: PACR) is being acquired for the equivalent of $9 per share, a 65% gain for Pro.
- **Oracle** (NYSE: ORCL) reported promising earnings. Our fair value will likely increase soon.
- Member nevercontent shares his experimental put report.
- Fools share best practices for being efficient (and enjoying the day)!

Most Active Conversations

Today **This Week** **Past 30 Days**

Our Favorite Memos From 2013

Published Dec 30, 2013 at 4:00PM

Dear fellow Fool,

January Live Chat Coming Up!

At 2 p.m. on Wednesday, Jan. 8, the entire *Pro* crew will be answering your questions during a live text chat. We're here for everything you need, from how best to use this service to what to do if you can't follow our options recommendations exactly. It wouldn't be the same without you; set a reminder by clicking here, and we'll see you soon!

It was a good year for *Pro*'s Monday Memos. We try to provide value with these communications each week, and you can of course browse our past Memos at any time to find tidbits. It may be thanks to the recency effect, but some of my favorite Memos from the past 51 weeks are new, including our recent interviews with **AmTrust Financial** (NASDAQ: AFSI) and **Valmont Industries** (NYSE: VMI). I also think our *Pro* one-pager Memo on stocks we like is a good first step for several *Pro* one-pagers that will follow. And we enjoyed RockyTopBob's Memo welcoming new members so much that we ran it twice in 2013!

Here are a few of the many other Memos I enjoyed this year:

- Bryan Hinmon's "A Fresh Start... Every Day" is a great reminder to think fresh at all times as you manage your money. And Bryan's column on "Why We Manage Volatility" covers a topic that should be relevant to all investors, because while volatility can be an opportunity, it can also be a giant step backward if you don't prepare for it or you react to it poorly. Finally, "How to Use Your Jackhammer" features Bryan talking about valuation in his own Foolish and helpful way.
- Nick Crow has since departed the *Pro* team, but his "No Crying Over Income" in March offered a prescient look at income strategies during a year when, unknown to all of us, the market was going to soar. I also found Nick's "Six Ways to Fail at Being a *Pro* Fool" an excellent way to present key lessons to members.
- Billy Kipersztok, our newest addition to the team, was thinking ahead when he wrote "The Furor, the Frenzy, the Earnings." Billy shared what he was watching for from a few companies about to report earnings — showing his desire to help members invest better and be prepared. Billy's debut Memo, "3 Things I've Learned from *Motley Fool Pro*," is another great example of what we have in Billy: a member-centric investor here to help you succeed. (You can see why Bryan and Nick brought Billy to the *Pro* team.)

And now for some favorites from the rest of the team!

From Bryan Hinmon:

- 5 Things Every Investor Should Know: This January 2013 Memo from Jeff gives a simple, useful look at the five things it's most important to know about *yourself* when investing.
- Why We Manage Volatility: Yes, Jeff mentioned this one above, but I'll pat myself on the back a bit by repeating it. As noted in this Memo, *Pro*'s efforts to lessen portfolio volatility — through shorts, hedges, and a constant focus on our North Star — are a down payment on better decision-making, a goal we are always pursuing for you.
- Are You Optimizing Your Life? Well, *are* you?! In all seriousness, this Memo from Jeff is a great (and characteristic) look at what it takes to excel, not just in investing but in all areas of life. One point in particular is especially relevant in this season of resolutions: "We can't have everything, and we'll never be perfect. We're aiming to do the best that's sustainably possible in every area of life."

From Billy Kipersztok:

- For an introduction to the history of *Pro*, check out the best of *Pro*'s early years; Nick highlights some of the team's best Memos all the way back to 2008.
- Knowing when to sell is one of the most difficult challenges many investors face. Jeff's Memo on why most stocks we sell will do well dovetails nicely with Nick's (final) Memo on when not to sell.
- Bryan's deep dive on Buckle and his discussion of industry structure showcase how we think about analyzing our companies — focusing on key, value-driving business metrics overlaid with an understanding of competitive positioning.

Looking ahead, we'll work to continue to deliver extra value to your inbox every Monday in 2014. With new investment guides on the way, one-pager guides, more Catch-Up Trades, updated guidance, and much more, the Monday Memo remains a touchstone of the service. We welcome your thoughts on what you love and what could be improved — drop us a line on the Memo Musings discussion board. Happy New Year, Fools!

Best,

— Jeff (TMFFischer)

Pro Completed Trades

- None.

Community & Coverage

- New improvements to the discussion boards! The intrepid TMFMojoMan (Beegee Alop in real life) has added a feature to help those who don't have as much time to keep up with the discussion boards as they might like. You can now view the most active discussions by day, week, or month!
- Member PhilSylvester asks about diversification in new recommendation **Parexel**'s (NASDAQ: PRXL) customer base, and Billy, Bryan, and other members weigh in.
- Member KBecks offers holiday wishes.

Pro Looks Ahead to 2014

Published Dec 23, 2013 at 4:00PM

Dear fellow Fools:

The *Pro* team and I hope you're ready for a wonderful holiday week. We're wrapping up the year with the portfolio at a record high, but the better news is that we own a few dozen outstanding businesses at good prices -- and we believe many *more* new highs are in store the coming years. Today, let's take a fun look ahead.

The Market in 2014

As the Federal Reserve starts to decrease its monthly asset purchases in January, we should expect interest rates to eventually creep higher, benefiting *Pro* holdings including **TD Ameritrade** (NYSE: AMTD) and ticking bond prices lower. Drifting bond prices could drive more investors to stocks, especially if the economy continues to strengthen. Businesses are more likely to borrow and spend funds as the economy improves, investing for future growth. Many companies had been waiting (for some weird reason) to see what the Fed did before addressing new opportunities. We're not short-term prognosticators, but factors like these could help the stock market the coming few years.

A more important factor is valuation. At 1,818 on Friday, the S&P 500 traded at 16.6 times expected normalized earnings for 2013, and 15.3 times expected 2014 earnings. This is smack in the middle of historical averages, suggesting the average stock is neither cheap nor dear. The bigger risk here seems to be the 2014 earnings estimate itself, which calls for 9.2% year-over-year growth. That follows just 4.9% expected growth in 2013. Can earnings really accelerate that much next year? The answer to that question is surely one key to the market's performance in 2014.

Pro in 2014

We will continue to recommend owning strong companies that we believe *will* grow value in a rewarding fashion for competitive, qualitative, and fundamental reasons. If the broader stock market is a headwind next year, giving us choppy prices, we'll have a chance to ramp up our options strategies for extra returns. Generally speaking, aside from pursuing North Star-type returns, we have several service objectives for the new year, including:

- Continuing our goal of offering you at least 12 income trades per year
- As opportunities arise, building out short positions in companies we doubt
- Hedging for market volatility of 7% or greater
- Strengthening our personal relationships with our companies, and reporting to you all we learn
- Hosting regular live chats, so you have more chances to ask your questions in "real time." Our first live chat of the new year is at 2 p.m. ET Jan. 8 -- save the date!
- Sharing more of our research on the competitors of our companies, and companies we choose *not* to buy
- Continuing to concentrate the portfolio in companies we believe will be long-term "compounding machines" of your capital
- Making our trade alerts more useful and pleasurable to read, and (with options) more actionable over longer periods of time
- Offering more "catch-up" trades
- Offering more unique, *Pro*-type positions. You'll know them when you see them!

Monday Memo Topics

Coming soon, our weekly Memos will discuss:

- Lessons learned, good and bad, in 2013
- "What We Believe" -- our yearly column, as we look forward
- Hedging
- Shorting
- Portfolio construction: market exposure for upside with less risk

Giving Right Now

It's fun to look forward, but right now it's time to relax, enjoy the holiday with family and friends, and appreciate all that you have -- and to consider giving something back if you're able. The Fool's charity of choice this year is Pencils of Promise, an organization that builds schools in areas where children historically lack education. Pencils of Promise gets the local community involved -- and invested in -- the process, and then monitors the school's progress, helping ensure success. Read about Pencils of Promise to see why it has the Fool's support, and we hope yours, too.

Thank You!

Members old and new alike, we hope you enjoyed this year as much as we did! The big reason we enjoyed it? You. The *Pro* community is amazing. Thank you for being a part of our lives, and for being a *Pro* member. The world is vast, but we all share a home at the Fool.

Have a wonderful holiday! And to share your good tidings, visit the Social Banter board. Fool on!

-- Jeff (TMFFischer)

Pro Completed Trades

- **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS): We profitably closed and rolled our four Dec. 2013 $46 puts to March 2014 $46 puts, for a net credit of $1.05 each. Shares remain a Buy with a 1.7% allocation, and we're writing puts for about another 1% more.

Community & Coverage

- *Pro* spoke with **AmTrust Financial Services** (NASDAQ: AFSI) for a second time last week, and Jeff's confidence in the long-term business remains unshaken, even as *Pro* works to learn more. To see all of the recent posts on AmTrust that members valued most, click here.
- **Oracle** (NYSE: ORCL) reported strong quarterly results, looks well-positioned, and remains a Buy First. Get our take.
- With **MasterCard** (NYSE: MA) as the subject matter, Jeff explains why our fair-value estimates can be so conservative -- hint: it's all about the value multiple the market is willing to pay for a stock.
- **American Tower** (NYSE: AMT) gets some love from *Barron's*.
- Member nevercontent shares his experimental put-writing idea list.

Buy Parexel International

Published Dec 23, 2013 at 1:30PM

Is this for you? *Pro* is allocating 3% to **Parexel International** (NASDAQ: PRXL), so if you're following our portfolio closely, you should do the same.

How You Participate

- **Action**: Buy Parexel International
- **Allocation**: 3%
- **Scorecard Status**: Buy First
- **Recent Price**: $43.50
- **Price Guidance:** This stock trades with moderate volume, so **use a limit order and this week pay no more than $44.25**. If you're not starting a position now, then over time, aim to do so below the fair-value estimate.
- **Fair-Value Estimate**: $51
- **Consider Adding More**: $36
- **Options**: We may use them later, but they aren't necessary.

The Business

Parexel is one of the world's largest and most respected contract research organizations (CROs). Over more than 30 years, it has built a stellar reputation on helping drug makers navigate complex clinical trial processes quickly, which has enabled it to cement important relationships and have a role in developing more than 90% of the top 200 selling drugs.

What We're Thinking

Parexel has many of the markings of a *Pro* core stock:

- *A strengthening competitive advantage*. Parexel's size and global reach give it a cost advantage over the smaller competitors in its fragmented industry. Its intangible assets, including its good reputation and its relationships with clients and regulators (built over time and from thousands of trials with successful outcomes), provide an advantage in winning new business.
- *Contracted and reliable revenue streams from trusted partners*. An industry shift from transactional, project-based relationships to integrated partnerships improves revenue reliability.
- *A founder-CEO*. He's run the business for more than 30 years and owns more than 1% of the shares outstanding.
- *Improving financials*. We think natural operating leverage as Parexel's technology segment grows larger and more efficient asset utilization as its partnerships mature will boost margins and eventually yield returns on capital around 20%.

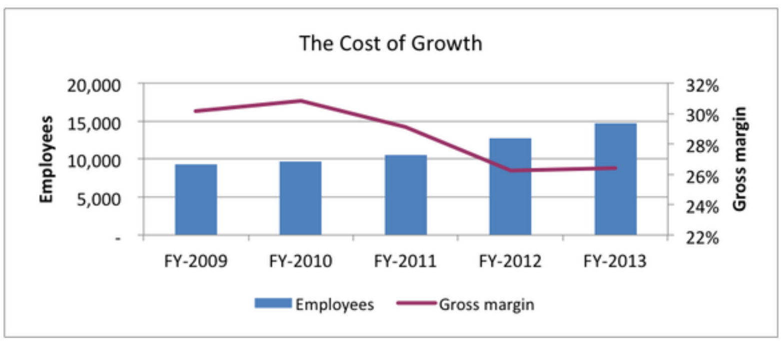
From today's price, we believe the company's strong business performance will drive its stock to out-earn our North Star over the next decade. If our forecasts of the company's core business and industry tailwinds prove too optimistic, we could still see a nice return from the company's rapidly growing technology division, Perceptive Informatics -- whether that's in the form of a possible spinoff, or just the market's acknowledgement of Perceptive's hidden value.

What We're Watching

Hoops. Lots and lots of hoops. Moving a new drug from discovery through clinical trials to commercialization involves jumping through a lot of hoops. For pharmaceutical and biotechnology companies, the stakes are huge -- on the order of 10 years and $1 billion per new drug. And because the patent clock starts ticking in the early stages, every extra second a drug spends in development is an extra second it can't turn sales into fat, patent-protected profits. This is why biopharmas are increasingly turning to CROs, which specialize in navigating the clinical trials process more quickly and efficiently than the drug companies are able to do on their own.

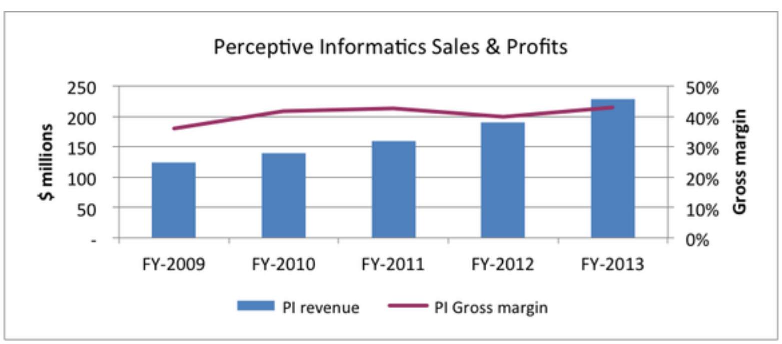
From 2004 to 2013, the number of development dollars outsourced to CROs (outsourcing penetration) has increased by almost 50%. Outsourcing is a cheaper alternative to the traditional high-fixed-cost model of staffing lots of white coats across various therapeutic specialties all around the globe. For large drug developers, letting CROs handle the development work -- and those massive staffing needs -- can boost profits and time to market, and for smaller drug developers who can't afford a huge staff, there is no other choice. As regulators require more efficacy data, larger patient participation, and increasingly global results, navigating the challenges of the 110,000-plus trials being conducted globally has become frustratingly complex, making large, proven CROs with expertise and global capabilities more of a value-adding *partner* than a transactional customer.

Parexel fits that mold, and it has been a leader in signing multi-year partnerships with major biopharma companies including **Eli Lilly** (NYSE: LLY), **Merck** (NYSE: MRK), and **Pfizer** (NYSE: PFE). These partnerships represent more predictable business, a chance to cross-sell services, and tighter integration with ongoing processes that we believe will strengthen the partnership bond over time. To adjust to these new contracts and the massive business that comes with them, Parexel has had to scramble to hire thousands of researchers, use contract employees as a stopgap, and build out relationship monitoring and management teams. All of this has cost money and hurt margins.



Source: Company filings

However, we believe the future financial picture will look vastly different than it has over the past few years: Contracts should mature and bring increasing workloads; hiring needs should slow and new hires become more productive; people and resources should be better utilized across projects; and workflow visibility (knowledge of upcoming tasks over the long term) will aid in efficient planning. Additionally, Parexel's technology segment, Perceptive Informatics, is a leader in several e-clinical applications that turn archaic trial-related processes digital, and should become increasingly profitable as it grows. Its underlying market is expected to increase by at least 10% per year , and if the segment's MyTrials solution becomes the industry standard platform for accessing e-clinical apps, growth should handily eclipse that.



Source: Company filings

The fact that other large CROs -- Parexel's mortal enemies! -- are customers who rely heavily on Perceptive products leads us to believe that the company is well-positioned to compete in the market. As this segment grows, we expect its margin profile to resemble that of other niche software providers with a service bent. Aside from the advantage Parexel enjoys from having technology closer to -- and better integrated with -- its clinical research services division, the potential size and profitability of this under-the-radar segment gives us confidence that gross margins should eventually and sustainably eclipse former highs.

To track the company's progress against our thesis, we'll be watching these things:

- *Health of existing partnerships, renewals, and success in winning new ones*. Success of existing partnerships should bring higher outsourcing penetration and encourage new biopharmas to make the business-model shift. New partnership agreements should lower customer concentration and modestly eliminate risk. Furthermore, a partnership mentality levels the bargaining power and improves the CRO's long-term profitability.
- *Business trends*. We think backlog and gross margin trends are the ones to watch. Backlog will be lumpy, but we expect it to increase over time. The conversion of backlog into revenue is captured in the "book to bill" ratio, which also exhibits some noise -- and has provided us with this buying opportunity. We expect gross margin improvement in the company's core clinical research segment and in its technology segment.

How It Fits Into *Pro*

Pro's only direct exposure to health care is longtime holding **Medtronic** (NYSE: MDT), which is currently on Hold and considered fairly valued. With increasing regulation and changing industry landscapes, we've been focused on researching companies likely to benefit from the Affordable Care Act and adoption of health care abroad. With Parexel's core stock characteristics and its focus on saving industry participants time, money, and headaches in wading through the complexities of clinical trials, we think we've found just that. In addition, we feel we have an adequate margin of safety at today's prices and that Perceptive Informatics offers another possibility to unlock value in the future. We prefer to start most new holding allocations around 3%, which is what we are doing here.

Alternative Trades

If you prefer a lower potential buy price, you can write March 2014 $40 puts for an attractive annualized return.

Pro Can Help

- Trial out (get it?!) our new Parexel International discussion board.

Pro Live Chat, January 2014

Published Dec 19, 2013 at 4:14PM

At 2 p.m. on Wednesday, Jan. 8, the entire *Pro* crew — advisor Jeff Fischer; senior analyst Bryan Hinmon, CFA; research analyst Billy Kipersztok; and editor/publisher Ellen Bowman — answered your questions during a live text chat. Relive the magic below!

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Roll Your Puts on DGS

Published Dec 19, 2013 at 2:00PM

Is this for you? *Pro* members who wrote December 2013 $46 puts on the **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) ETF with us should consider this rolling trade for more credits. Those lacking 3% exposure to DGS should also consider writing the new March 2014 $46 puts with us.

How You Participate

- **Trade:** Use a rolling order to "buy to close" your December 2013 $46 puts, and "sell to open" an equal number of March 2014 $46 puts.

- **Allocation:** We're looking to increase our 1.8% existing stock exposure to DGS to about 3% total, so write puts for a potential 1.2% or so more. *Pro* is rolling all four of its existing December puts (which equates to about 1% more at current prices).
- **Price Guidance Now:** Aim to roll for a credit of approximately $1.25. Pay as little time value as possible to buy to close your December puts, which expire Friday. For example, if DGS is $45.30, aim to pay only about $0.75 to close the December puts ($0.05 in time value). Lately, you can collect about $2 to write the March puts, for $1.25 in net credit.
    - **Friday:** We need to roll by the close of market Friday to avoid buying shares this weekend, so use a limit order, but accept the best credit available.
- **Prices (Dec. 19):** DGS, $45.30; December 2013 $46 put options (bid/ask), $0.65/$0.85; March 2014 $46 put options, $1.80/$2.15

What We're Thinking

Little has changed since we wrote these December puts in September, except that the Federal Reserve finally announced its intention to begin tapering its asset buying in January. Emerging markets have largely been treading water since September, leaving DGS about where it started. However, you might recall that the ETF's price did increase soon after our trade alert, making us accept a lower credit than we originally hoped for writing the December puts. Today, we can add to our credit, lowering our potential buy price further, by rolling those puts to March.

Pro was paid $1.24 to write the December 2013 puts. We should collect $1.25 or so, net, this go-around, leading to about $2.50 in total credits to date, and a potential $43.50 start price on new shares if we get them. Today's credit amounts to 2.7% in extra yield on our strike price in three months. So, rolling now is simply a way to be a bit more defensive and target a lower buy price on any new shares. We don't know how much the Fed's tapering will increase the value of the dollar, affecting debt obligations in emerging-market economies, so rolling for another credit feels Foolish as we wait and watch.

How It Fits Into *Pro*

Although most *Pro* companies sport healthy international sales, our portfolio has modest direct exposure to emerging-market companies. This has been a *good* thing since 2009, because U.S. stocks have easily outrun emerging-market stocks. But as we shared with you in September, emerging-market stocks are much cheaper than U.S. equities now, so we're looking to increase our 1.8% DGS exposure to a full position of at least around 3% with today's trade, and possibly more over time. If we don't get new shares anytime soon, we'll keep targeting income.

More That Matters

- **Maximum Loss:** After this roll, our risk is the same as share ownership starting at about $43.50.
- **Maximum Gain:** Unless the stock stays at less than $46 and we get to buy new shares, the most we can gain on this trade is the put premium, or about a 2.7% incremental yield in three months (more than 10% annualized). By rolling, we may miss additional upside if the stock price recovers before March.
- **Follow-Up:** We'll buy shares if the stock remains below our strike price at expiration, or we'll roll again if we want to be more defensive. If our puts are on track to expire unused, we'll look to write new puts for more income.

Alternative Trades

- **If you don't own any shares:** DGS is a Buy. Match our current 1.8% allocation with a direct purchase. Then write these puts for about 1.2% more.
- **If you can't write puts:** Simply buy shares — 1.8% now, and up to 3% on a dip closer to $43.50.
- **If commissions are high on one contract:** If commissions to roll one contract would eat up much of your credit, simply do nothing and accept new shares this weekend. That's fine!

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Visit our DGS discussion board if you have questions or comments!

Pro Talks With Valmont Industries

Published Dec 16, 2013 at 4:00PM

Fellow Fools,

Early in *Pro*'s still-new relationship with **Valmont Industries** (NYSE: VMI), which manufactures irrigation systems and steel poles, Bryan got on the horn with the company at its balmy Nebraska headquarters. Valmont's head of investor relations, Jeff Laudin, was happy to speak with The Motley Fool, so we set up a one-hour phone conference.

Live-Stream Our Holiday Party!

We're celebrating an amazing 2013 with a small group of local Fools, and we want to make sure you don't miss a minute of the action!

Starting at 6 p.m. ET, tune in here to watch speeches from David and Tom Gardner, CIO Andy Cross, and more of your favorite Foolish analysts and advisors. Plus, we'll be sharing off-the-cuff conversations happening between your fellow members and Fools from HQ. Join us!

Bryan and I selected the smallest conference room in Fool HQ (see how considerate we are?) and enjoyed a lengthy chat with Mr. Laudin. He seemed thoughtful, very knowledgeable, modest, and long-term-oriented — reflecting the approach of his company. Mr. Laudin has been in his position since 1998, sporting tenure like so many Valmont employees. What follows are our edited notes from our conversation with *Pro*'s newest investment, on our scorecard since November.

The Business

- The company's two primary businesses are infrastructure development and irrigation for agriculture.

- This is a time of economic austerity, and management has seen challenges, but the company's products are eventual "necessities" -- as record results even now attest.
- The public needs safe roadways (some states raise the gas tax to pay for them), and infrastructure buildout is politically attractive.
- Valmont's "Valley" irrigation systems use an estimated 30% to 50% less water than flood irrigation, and they maintain better soil quality while improving crop yields.
- Valmont operates globally in long-term growth industries, even though they're cyclical. "Economies can't grow without investing in infrastructure."
- Austerity "is *not* a long-term concern" at the company.
- Management embraces the fact that it operates in cyclical industries, and seeks to control the things it *can* control. For decades, this has served it well. "We take pride in managing cyclicality well."

Company Culture

- Founded in the 1940s, Valmont strives to maintain a "family feel," reflecting the founder's vision.
- Integrity is paramount, and "doing the right thing" is highly valued.
- Passion is necessary. Employees should be passionate that highway safety saves lives, irrigation feeds the world, and electricity powers it.
- Because Valmont is a results-oriented business, employees are held accountable.
- Employees are given autonomy to excel. At the same time, investment in management is integral. Valmont has found through its own Gallup study that "employees don't leave a company — they leave their manager." To keep turnover low, Valmont cultivates its managers. Countless managers and employees have lifelong careers at Valmont, and that makes the company stronger.

Results

- We liked hearing that management doesn't set specific targets for results, because targets can create bad behavior and short-term thinking. Instead, Valmont's goal is "*continual improvement*" on every metric that matters.
- Margins have increased strongly over time, and in response to our questioning, Mr. Laudin said he believes "there is more operating leverage in the business." The company seeks to increase operating income as a percentage of sales in a steady, continued manner, but (again) doesn't set targets.
- Valmont also focuses on a proprietary measure it calls Total Value Impact. TVI = net operating profit after tax, divided by invested capital. Everyone at the company uses this measure, and it drives bonuses and promotions.
- The current management team took over in 1993. Since then, the stock has returned about 17% annualized, putting it in rare company indeed. Shares have outperformed the likes of **Starbucks** (NASDAQ: SBUX) and **Whole Foods** (NASDAQ: WFM) over the past 10 years, too.

Acquisitions

Like many of our companies, Valmont enjoys strong extra growth through acquisitions, and plans to continue the strategy.

- When acquiring, Valmont seeks to: add to its existing business platform; bring more products to market; gain more expertise to offer customers; enter new geographies; make certain it can achieve a high return on invested capital; make sure the culture fits.
- Valmont is not interested in entering markets entirely different from those in which it has expertise. "You have to know who you are. We are a manufacturing company. We want to stay true to that ..."
- As with **AmTrust Financial** (NASDAQ: AFSI), many acquisition targets are pointed out by division managers and employees in the field ("feet on the ground are able to bubble up ideas").
- Many acquisition candidates are small, fragmented, and privately held.
- Management knows that "seventy percent of acquisitions don't work, so we don't do them unless [the price is right and] we know we can add value."

Share Dilution and the Dividend

- Over the decades, Valmont has not taken any notable action to dilute the value of investors' shares (it had 23.2 million diluted shares out in 1989, and has 26.9 million out today). This is, according to Mr. Laudin, "a fortunate result of how we operate."
- The dividend payout ratio is currently only 8.6% of net income, and has been as high as 20% in the past. But this only means net income has grown more quickly than the dividend. The company aims for "steady dividend increases," rather than a stated payout ratio or dividend yield.
- Management is averse to having more than 40% debt compared to its average invested capital. If the company takes on extra debt for a large acquisition, they'll want to pay it back quickly.

Our conversation with Valmont was another step toward growing our conviction that we're invested in a well-run, long-term business — a company we hope to be proud to own for years, and nicely rewarded for it. If you have questions about Valmont, please visit our Valmont discussion board. Valmont remains a Buy First stock in *Pro* with a 3% starting allocation. You can revisit its original recommendation, which is always available on our Alerts page.

Fool on!

— Jeff and Bryan

Pro Dec. 21 Expirations

- **The Buckle** (NYSE: BKE): Our $45 puts are set to expire as income this week. We'll opportunistically look to write new ones at attractive prices.
- **WisdomTree Emerging Markets SmallCap Dividends** (NYSEMKT: DGS): Our $46 puts are near-the-money, but will expire as income this week unless the stock declines to less than $46 by Friday. We're ready to accept new shares, but we may roll our position with a trade alert on Friday if the premiums are attractive and the stock is flirting with $46. We weren't paid much to write these puts and may want to collect more premiums by rolling forward another month.

Pro Catch-Up Trades

- **Tupperware** (NYSE: TUP): Follow our month-long price guidance in the alert to get your put-writing trade completed.

Pro Completed Trades

- **Tupperware**: We sold to open seven April 2014 $90 puts on Tupperware today for $4 each, per our trade alert guidance last week. This exposes us to a potential 3% stake at a net $86 if Tupperware is below $90 by expiration.

Coverage & Community

- A decline in **AmTrust Financial** (NASDAQ: AFSI) stock has Jeff sharing additional perspective, while Bryan summarized the situation as of last week. Today at 5 p.m., AmTrust is hosting a conference call that *Pro* will attend — we'll update you shortly after.
- Member "nevercontent" shares his put-writing ideas.
- **The Buckle** (NYSE: BKE) announces a special dividend.
- Pro member Lon shares a sad story of surprise margin loans, a warning to be Foolish about your finances.
- ADrumlinDaisy's daughter buys her first stock!

Write Puts on Tupperware

Published Dec 11, 2013 at 3:00PM

Is this for you? *Pro* members who lack 3% exposure to **Tupperware** (NYSE: TUP), either through existing stock ownership or written puts, should consider this new recommendation or its alternatives.

How You Participate

- **Trade:** Sell to open April 2014 $90 puts
- **Allocation:** 3.1% — write one put for every $270,000 you manage. *Pro* will write seven contracts.
- **Price Guidance Now:** Use a limit order of $4 or higher to start (for a 4.4% yield in 4.26 months).
    - **Later:** If $4 doesn't fill by Dec. 18, then accept no less than $3.60 until Dec. 24 (4% in about 4 months).
    - **Still later:** From Dec. 26 to Jan. 11, accept no less than $3 (3.3% in just over 3 months).
- **Prices (Dec. 11): Stock:** $93.85; **Options:** $3.80 bid / $4.20 ask

What We're Thinking

After losing our Tupperware shares through covered calls, and having our latest written puts expire as income, we want to reinitiate exposure to the company. We estimate the shares' fair value at around $85, and if Tupperware executes its plans well, by next April its estimated fair value will be $87.50. These puts could allow us to pick up approximately a 3% position below that price.

How It Fits Into *Pro*

Key factors make Tupperware unique in the *Pro* portfolio:

- The company's direct selling method, with 2.8 million salespeople, sets it apart from our other retailers and negates the need for expensive retail space.
- Tupperware's low-cost, culture-specific kitchen tools and storage give it strong opportunities in emerging markets (about two-thirds of its sales) — even those where income is limited.
- Tupperware can benefit from a weak job market that sends more quality candidates for employment its way.
- The company adds some lower-tech flavor to balance out the spicy side of our high-tech portfolio.

Several other traits make Tupperware a desirable investment, including management's focus on growing in immense urban markets (such as major cities in Brazil, China, Malaysia, and India) and goals of increasing the dividend with net income growth and using excess cash flow to lower the share count.

Annual sales growth may only register in the single digits, but long-term earnings per share may sustain 10% or greater annualized growth. Coupled with the dividend (lately 2.6%), we expect North Star-type returns — with lower-than-average long-term risk — if we get to buy shares at our desired start price.

More That Matters

Maximum Loss: Our risk is the same as share ownership starting around $86.

Maximum Gain: Unless the stock declines and we get to buy shares by expiration, the most we can gain is the put premium. At $4, that's a 4.4% yield in 128 days, or about 13% annualized.

Follow-Up: We'll buy shares if the stock is below our strike price at expiration, or we'll roll our puts for another credit. If our puts are on track to expire unused, we may write new puts for more income.

Alternative Trades

If you own stock already: Keep holding a 3% or so position.

If you can't write puts: The shares remain a Buy, though we're aiming for a lower start price. If you're not writing puts, you can start to average into shares in 1% increments, or wait to see if we get shares in April and then buy with us.

If you're more defensive: To target a still-lower buy price, consider selling to open April 2014 $85 puts. They're well out-of-the money, so you'll have to accept what they pay you. Also consider writing July 2014 $80, $85, or $90 puts. They don't yield as much per day or annualized, but offer higher absolute payments that result in lower potential start prices.

Pro Can Help

- See our Options U guide to writing puts if you want more on this strategy.
- Visit our Tupperware discussion board if you have questions or comments!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Puts on Tupperware

Published Dec 11, 2013 at 12:00AM

Is this for you? *Pro* members who lack 3% exposure to **Tupperware** (NYSE: TUP), either through existing stock ownership or written puts, should consider this new recommendation or its alternatives.

How You Participate

- **Trade:** Sell to open April 2014 $90 puts
- **Allocation:** 3.1% — write one put for every $270,000 you manage. *Pro* will write seven contracts.
- **Price Guidance Now:** Use a limit order of $4 or higher to start (for a 4.4% yield in 4.26 months).
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- **Prices (Dec. 11): Stock:** $93.85; **Options:** $3.80 bid / $4.20 ask

What We're Thinking

After losing our Tupperware shares through covered calls, and having our latest written puts expire as income, we want to reinitiate exposure to the company. We estimate the shares' fair value at around $85, and if Tupperware executes its plans well, by next April its estimated fair value will be $87.50. These puts could allow us to pick up approximately a 3% position below that price.

How It Fits Into *Pro*

Key factors make Tupperware unique in the *Pro* portfolio:

- The company's direct selling method, with 2.8 million salespeople, sets it apart from our other retailers and negates the need for expensive retail space.
- Tupperware's low-cost, culture-specific kitchen tools and storage give it strong opportunities in emerging markets (about two-thirds of its sales) — even those where income is limited.
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Pro Can Help

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- Visit our Tupperware discussion board if you have questions or comments!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro Visits AmTrust Financial

Published Dec 9, 2013 at 4:00PM

Dear Fools,

Last week, Bryan and I boarded Amtrak at D.C.'s Union Station and "rode the rails" up to New York City. During our three-mile walk from Penn Station to the headquarters of **AmTrust Financial Services** (NASDAQ: AFSI), we stopped to grab lunch at a divey-but-excellent Greek restaurant (the owner scolded me when I asked if I could order a *decaf* Greek coffee; she said, "You'll have regular, and it'll be strong"). After lunch, we stopped by the Fool's New York office (where we were delighted to see fellow Fools including Tom Gardner) before heading to our appointment.

AmTrust HQ is situated in a giant building on Maiden Lane, not far from the new Freedom Tower (an impressive sight) and Wall Street itself. Plaques on the many glass doors outside read, "This building is a holding of AmTrust Realty," and we later heard how the building was bought under duress for a song – as was AmTrust's other headquarters in Ohio. The man at the front desk pointed us past holiday decorations to the elevator for the top floor – 48 or 49 – and Bryan and I headed up.

Before long, we were in a large glass-walled conference room with a view that seemed to stretch to Canada ("We can see Jim Gillies's house!"). There, we were joined by AmTrust CEO Barry Zyskind, CFO Ron Pipoly Jr., and Senior Vice President of Investor Relations and Corporate Development Elizabeth Malone, CFA. With a tray of bottled water between us, we made our introductions and began to pepper our hosts with questions, including the ones you – *Pro* members – asked. As we progressed, we got the sense that management was forthright, honest, open to tough questions, and generous with their thoughts and time. In an effort to share as much as possible from our meeting, here's where our narrative ends and the news begins.

From AmTrust to Us

Pro's largest holding, AmTrust is a specialty insurer with a focus on workers' comp policies at small businesses. The company also insures extended warranties on consumer products, among other things and has a growing fee-income business in related fields. I (Jeff) have followed AmTrust since its 2006 IPO. Sporting an industry-leading combined ratio (a measure of its profitability) and outstanding growth, AmTrust clearly has competitive advantages. But what are they? Are they sustainable? We asked and listened.

The Business

- As a young company in an old industry, AmTrust has built its entire business around new technology. All of its software is developed in-house, with 150 programmers working in Cleveland referred to as "the middle of the company." The CTO attends all the risk meetings and has a say on acquisitions, and the tech team has to know the insurance industry.
- This technology means that AmTrust's costs of processing are much lower than those of most competitors or companies it acquires, so it can generate strong new cash just by moving acquisitions onto AmTrust software.
- With real-time technology, management is able to measure the business in an extremely granular fashion and keep tight tabs on losses.
- As one member of management put it, "We take risk very seriously. We spend 2.5 days per month going through every line of business and review[ing] our performance – these are our 'loss reserve meetings,' or business reviews. These meetings are intense and we get everyone on the phone together." Seeking ways to continually improve, AmTrust knows of no other company that reviews losses this often.
- CEO Zyskind started to build AmTrust when he was in his late 20s. At the time, the company was tiny and every risk (or policy) mattered. So Zyskind and his small team studied every claim and every policyholder. They knew the insureds and the claims, and were reactive to every need. That level of care, concern, tracking and paranoia has become embedded in the culture of AmTrust.
- Technology allows AmTrust to play better defense – to monitor its business from every angle to protect against growing losses. And it gives offensive advantages as well by lowering costs, improving long-term profit ratios, and identifying areas of opportunity (or improvement).
- AmTrust sees itself as a franchisor: It provides vital back-end services -- technology, central office responsibilities, cost-effective reinsurance, and an A-rated balance sheet -- to the policy writer. Then it lets its divisions (including companies it acquires) run their businesses, assuming each business line is fundamentally sound from a loss perspective.
- The CEO's favorite part of the business is "playing offense" – finding creative ways to grow the business in low-risk ways. (You could see the excitement in his face as he talked about "knowing when you've found a great deal and you're going to make money.")

Dividends

Recently, AmTrust issued a special 10% stock dividend -- twice. *Pro* members wanted to know why. We asked management that question and added one of our own: "Where is the quarterly dividend headed?"

- The Karfunkle family, which controls more than 50% of AmTrust shares along with Zyskind, likes dividends. The company doesn't have a specific dividend-yield target, but will likely increase the dividend as income and book value increase – so, steady increases are the general goal.
- As for the special 10% stock dividend: This has been issued when AmTrust has high confidence that earnings will rise by more than that amount. So management views the 10% stock dividend as a "very clear signal to the market," a "bullish message," that near-term earnings should increase by at least 10%. Institutional investors have sought more liquidity in the shares, and the stock dividend serves that purpose by increasing the share float. As a still-small company, AmTrust would like to continue this practice, but Canadian shareholders loathe the taxes it triggers, so AmTrust is rethinking the strategy.

Acquisitions

AmTrust has added considerable value through acquisitions. The company plans to continue down this path. Management spoke about their approach and strategies for several minutes:

- First and foremost, AmTrust makes sure the underlying business it's acquiring is fundamentally sound from a loss perspective. "Then we ask ourselves if we have the system capabilities to improve the operations and fix the problems. We care about maintaining a 15% or greater return on equity, so we tend to look at areas that are in trouble for one reason or another," but that can be fixed quickly.
- The company prefers to string together small deals that don't look like much individually, but together are very meaningful. It recently closed several small deals ($30 million here, $40 million there) that add up to a quarter-billion dollars in new premium. But the individual deals were small enough to fly under competitors' radar. AmTrust doesn't like bidding against anyone else, so it goes where nobody else is.
- In its acquisitions, AmTrust targets niche businesses that it can lead, seeking minimal acquisition and integration risk. It does extreme due diligence on why a particular target got in trouble in the first place, and management makes sure the target can be moved to AmTrust's tech-centered platform.
- Getting the right people involved in the underwriting and adjudicating process is key to an acquisition from the very beginning; from there, AmTrust communicates the direction it wants the business to go. Fixing a misstep can take a long time, so AmTrust tries not to veer off course in the first place, preferring to take advantage of *others'* mistakes.
- Everyone is excited about fee-based businesses at the moment, so their pricing isn't attractive. Thus, as CEO Zyskind put it, "We're focusing on organically growing our fee businesses, and finding more merger and acquisition activity in traditional [insurance] policy businesses as competitors flee some markets," sending those prices lower. When fee-based businesses are cheaper, AmTrust will look to acquire there. These things cycle.
- Often, it's agents in the field who first flag a potential acquisition after noticing opportunities where someone has stumbled. To be clear, AmTrust is not interested in buying bad books to clean up, because those often leave little premium standing. It wants to buy businesses that offer healthy renewals; otherwise, it's not building on the past.

Fair Maiden?

In 2007, AmTrust played a key role in forming a reinsurer that agreed to reinsure 40% of certain AmTrust premiums. The company is called **Maiden Holdings** (NASDAQ: MHLD), and Zyskind remains the non-executive chairman of its board. This company's stock has done well, too, though not as well as AmTrust's. But since the beginning, the relationship has come under media scrutiny from time to time. I've been familiar with Maiden since its founding, and I remain comfortable with it. In fact, Maiden offers meaningful advantages to AmTrust, as management shared:

- CEO Zyskind said, "Nowadays people look at Maiden as a related party, but most don't understand where it came from. Maiden came about in 2007 as a way to optimize AmTrust's capital structure. In 2007, every possible source of capital would have been seriously dilutive – we wanted to avoid this. Maiden offered a long-term, risk-sharing partnership, with a solid balance sheet to backstop AmTrust's underwriting – something that ratings agencies loved. AmTrust helped Maiden develop its platform." (I'll note that it has indeed done this – Maiden no longer only does business with AmTrust.) "AmTrust has definitely benefited from the relationship; with an A-rated reinsurer behind it, AmTrust was able to grow through the financial crisis."

- Put another way: Maiden is an advantage to AmTrust because it's like having access to another balance sheet without the risk. And, again, it's a long-term relationship, so there's no chasing short-term results.
- Reinsurance is a commodity business, so a long-term partner that cares about risk and not just price is a company AmTrust can trust and work with on similar books of business.
- The partnership is sealed through June 2016. AmTrust has provided predictable, low-risk premium to Maiden, so the relationship is expected to continue.
- As Zyskind put it, "We go to bed with our balance sheet, and we wake up with our balance sheet." Not romantic, but definitely what you want to hear from an insurance company you own. And Maiden in effect allows AmTrust a better balance sheet with less risk.

Future and Tidbits

The company expects acquisitions to continue. AmTrust should grow its insurance and fee-income businesses organically, and make acquisitions in either business line when prices are low (right now, insurance has the best potential there).

- CEO Zyskind said, "We think the fee businesses themselves [that AmTrust now runs] might be worth $800 million to $1.2 billion." (AmTrust's total market value is $3 billion today.) "The businesses are very niche-y and very sticky." Margin expansion should be the name of the game. The main reinvestment there is the cost of acquisitions to buy out competitors and complementary businesses.
- Although the CEO is only 41, AmTrust has built up "great bench strength" and remains risk-averse, conservative, and entrepreneurial. "And we are young," Zyskind smiled.
- The greatest testament to the company's conservative nature lies in how it sailed through the financial crisis, allowing it to acquire falling companies cheaply.
- The CEO has never sold shares and doesn't expect to anytime soon. He's in for the long haul.
- Employees are often granted shares as part of their annual bonus, but if you sell shares, you may get a visit from the CEO himself – asking you why you sold.
- All the meeting rooms have glass walls, so the CEO can see and walk into any meeting. Hey, it's an open environment!

We left with the impression that AmTrust is well and tightly run. It's the CEO's baby, and although employees may have reason to fear him when they make mistakes, they also respect him. The CFO was no-nonsense (and took an hour out of his day for us despite travel and conference plans), and the senior vice president was candid ("We're not allowed to sell our shares!" she said, only half teasing).

After saying our goodbyes, Bryan and I rode the elevator down and walked along Broadway as night fell. We shared a greater understanding of AmTrust, and more confidence to remain long-term owners in a dynamic young business that we rate a "Buy." That said, we will never let our critical guard down. We *are* allowed to sell our shares if we decide to -- but we hope to own them for years and years.

Upcoming *Pro* Monday Memos

- **Do you like company interviews?** Let us know if you'd like to see more.
- **Next week:** A summary of our hour-long chat with **Valmont Industries** (NYSE: VMI).
- **Upcoming Memos:** A review of our mistakes, successes, and lessons from 2013, and some guides to hedging and shorting.

Fool on!

Jeff

Pro Trades Completed

- **American Tower** (NYSE: AMT): We sold to open seven Jan. 2014 $74.65 puts for $1.10 each, looking to potentially double our holding in this Buy First stock.

Pro Guidance Changes

- **The Buckle** (NYSE: BKE) moves to Buy from Buy First on valuation.

Pro Catch-Up Trades

- None this week. Most of our stocks remain Buy-rated.

Coverage & Community

- Bryan reviews recent results from Buy stock T**he Buckle** (NYSE: BKE).
- Jeff provides a summary on **Apple** (NASDAQ: AAPL) after nice price appreciation. It remains a Buy First for now.
- Want our 30-second pitch on **Valmont** (NYSE: VMI)? Sure ya do!
- North Star or North-facing fox? Thanks to member Arjayh for sharing the amazing video.
- Member aleax shares a Vanguard study that says Boomer retirement won't hurt stocks.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Special Report: Stocks 2014

Published Dec 9, 2013 at 11:01AM

Click below to download *Stocks 2014: 12 Stocks to Outsmart the Market Today*!

[Stocks 2014: 12 Stocks to Outsmart the Market Today]

Black Friday and Beyond

Published Dec 2, 2013 at 4:00PM

We Keep on Top of Our Companies! Today, Jeff and Bryan are visiting **AmTrust Financial Services** (NASDAQ: AFSI) at the company's New York City headquarters, meeting with the CEO and CFO of *Pro*'s largest holding. Thank you to members for your questions! Jeff and Bryan will report back with a summary as soon as it's ready.

Dear Fools,

Here in the U.S., Thanksgiving weekend is a time to spend with family, friends, and others you cherish, and to reflect and be thankful for what you have. We hope you were able to enjoy the holiday.

The weekend also represents one of the most important periods of the year for retail-related businesses. Since 2005, Black Friday (the Friday after Thanksgiving) has ranked as the busiest shopping day of the year in the United States. And given that we're all investors here, there's plenty of data from this busy shopping period that has implications for us. Here are a few takeaways from the preliminary data for this year.

1. Online commerce continues to grow.

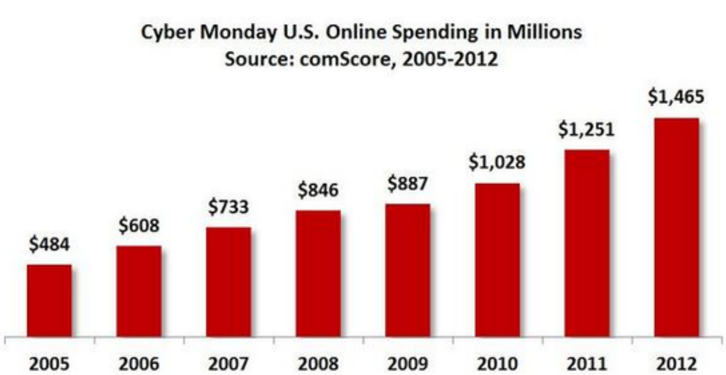
According to **comScore** (NASDAQ: SCOR), this holiday season has already broken records for e-commerce. Black Friday 2013 (Nov. 29) was the heaviest online spending day of all time, with a record $1.2 billion in desktop/laptop online sales, a 15% increase over last year's $1.04 billion. Additionally, a record 66 million Americans used their computers to score some deals, a 16% increase over last year.

2. Mobile devices are changing the landscape.

Not only are desktop and laptop sales increasing, but mobile sales are increasing even faster. **IBM** (NYSE: IBM) reported that mobile traffic grew to almost 40% of all online traffic, an increase of 34% over Black Friday 2012. Mobile sales also increased to almost 22% of total online sales, up 43% year over year. There was some interesting data regarding purchase activity on smartphones and tablets: Alhough smartphone users were more likely to browse (25% of all online traffic vs. 14% for tablets), tablet users were more likely to buy (driving 14% of all online sales vs. 7% for smartphones). Also interestingly, **Apple** (NASDAQ: AAPL) device users are more likely to shop online and buy online, with iOS traffic (iPhones, iPods, and iPads) reaching 28% of all online traffic vs. 11% for **Google**'s (NASDAQ: GOOG) Android. Mobile Apple devices made up 18% of all online sales, compared with just 3.5% for Android.

3. Cyber Monday is going to be big.

By all accounts, today (Cyber Monday, the first day most of us return to work after Thanksgiving) should be the heaviest online spending day in history, breaking Friday's record. Although today's books are obviously not yet closed, Cyber Monday has been the top online spending day of the year for the past three years, and a quick look at historical data makes it easy to see why comScore expects Cyber Monday sales to approach $2 billion:



The Foolish Bottom Line

There's a pretty obvious theme in the shopping data from this past holiday weekend: Online commerce and mobile commerce are becoming increasingly important to the retail industry. The *Pro* portfolio has a few positions that are affected by these trends, including **The Buckle** (NYSE: BKE), Apple, and **MasterCard** (NYSE: MA). This data reinforces the need for retailers to improve their online channels (something we've seen The Buckle do) and is good news for MasterCard, as online sales have to be processed through payment networks like the one it owns.

Thoughts on Black Friday or Cyber Monday? Did you shop online this year? Chat with us over leftovers on the Memo Musings board.

Fool on!

Billy

Pro Catch-Up Trades

- **American Tower** (NYSE: AMT): Write ("sell to open") January 2014 $74.65 puts for at least $1.10 if and when the stock dips. We're looking to potentially double our stake in the stock to about 5%.

Community & Coverage

- We hope you all had a wonderful holiday!
- New *Pro* members are introducing themselves on the Meet & Greet board, and getting started on (unsurprisingly) the Getting Started board. Ask your questions!
- Jeff summarizes the highlights of **OpenText's** (NASDAQ: OTEX) planned $1.16 billion acquisition of GXS Group, which will make OpenText the leading B2B integration services provider.
- Member Dom (dsciola) asks if **TD Ameritrade** (NYSE: AMTD) benefits from high-speed trading.

Billy Kipersztok owns shares of Google, Amtrust Financial Services, Apple, MasterCard, and American Tower. Bryan Hinmon, CFA owns shares of American Tower. David Gardner owns shares of Google and Apple. Jeff Fischer owns shares of Google, Amtrust Financial Services, Apple, MasterCard, and Open Text. Tom Gardner owns shares of Google and MasterCard. The Motley Fool owns shares of American Tower, Amtrust Financial Services, Apple, Google, International Business Machines, MasterCard, Open Text, TD Ameritrade, and The Buckle and has the following options: short December 2013 $45 puts on The Buckle.

Write Puts on American Tower

Published Nov 26, 2013 at 10:30AM

11 a.m. Editor's Note: Fools, pricing on this recommendation changed quickly, and it has been updated below as of 10:50 a.m. Please use this updated guidance to place your trade!

Greetings, New *Pro* Members! In this recommendation, we are writing ("selling to open") put options to potentially buy more shares of AMT at a lower price, and generating income in the process. You need put-writing permission to complete this trade, and you should be able to buy $7,465 worth of the stock (and still have that be a reasonable allocation) for every put you write (remember, each option represents 100 shares of the stock). If you're new to options and aren't ready to make the trade, don't worry. There is always another opportunity. Brush up with the Fool's Guide to Writing Puts. Finally, AMT remains a Buy First stock, so you should have already allocated 2.4% to it. This option trade is to potentially double our position. If you have questions, please visit the AMT board linked at the end after reading this report. Enjoy!

- **What We're Doing**: Writing puts for income or to potentially add about 2.7% to our stock position (which would bring our total allocation to just more than 5%).
- **What We're Thinking**: We want to keep this strategy going — we're writing puts for a fourth time to earn income and lower our effective buy price on a potential second helping of shares.
- **What We're Expecting**: Recent earnings results confirm that company fundamentals remain strong and will drive long-term performance, but other factors continue to cloud the near-term outlook.

Guidance Essentials

- **Action:** Write (“sell to open”) January 2014 $74.65 puts on **American Tower** (NYSE: AMT).
- **Allocation:** About 2.7% more, enough to potentially bring our stake to about 5%. For Pro, that means writing seven contracts. Each new contract represents a $7,465 potential obligation.
- **Recent Price:** $77.83
- **Option Price** (bid/ask): January 2014 $74.65 puts: $1.15/$1.25
- **Price Guidance:** Use a limit order, aiming for $1.20 to start. As prices change, ideally accept no less than $1.10, for a 1.5% yield in about two months.
- **Alternative Trades:**
  - If you don't yet have an allocation to American Tower, we recommend you buy a 2.4% allocation to match Pro (in 100-share lots, if you can) and then write the January 2014 $74.65 puts for about $1.10 or higher, representing about another 2.7% worth of shares. The stock is a Buy First.
  - If you'd like to be more conservative than Pro, consider writing the January 2014 $72.50 puts, which yield less but give you more breathing room if the stock price declines.
  - If you aren’t using options at all, consider doubling your allocation to the stock now or if it dips to $74.65 or lower and we get “put” new shares.

What's New?

Our November $72.50 puts on American Tower expired this month as income, so we're going back to the well (or shall we say back to the tower?) for another put write. The stock is a Buy First, so we've been looking to add to our position with a written put strategy that's been active since July. Numerous short-term concerns (a July short "report," sector-correlation concerns, the looming taper decision from the Fed) leave us continuing to believe we'll be able to add to our position at a lower price.

There's been a flurry of activity from the tower sector in recent months, with American Tower making two sizable acquisitions and competitor **Crown Castle** (NYSE: CCI) hyping its own deal with **AT&T** (NYSE: T). Tower operators are taking advantage of low interest rates and financing costs to add to their tower collections (a prudent strategy in our view).

Additionally, the recent activity in the industry provides evidence that carriers increasingly favor leasing towers over owning them. There are two reasons for that: Tower operators can do it cheaper thanks to their scale and ability to "co-locate" tenants, and it frees up capital for carriers to invest elsewhere (say, in network capacity and coverage upgrades). And as carriers invest in their networks, who benefits? You got it — the tower operators, including our very own American Tower. The company reported earnings Oct. 30, and the results confirmed that our thesis is on track — the business is executing its strategy just as we expect, with climbing returns on capital and continued healthy demand both domestically and abroad. While AMT the stock has been volatile, American Tower the business continues to execute. In the meanwhile, we're happy to write puts and get paid to wait for our buy price on a second helping of shares.

Return Math

- **Maximum return:** We make 1.5% in 52 days (about 11% annualized) on this put write if shares of AMT remain higher than $74.65. If that's the case at expiration in January, including our three prior put writes, we will have earned put premiums of about $4,010, or about 7.8% of the capital we're putting at risk and 8.7% of our initial investment in AMT shares.
- **Breakeven:** We begin to lose money on this ongoing put strategy when shares fall below $68.15, or about 12.4% lower than where they are today. Considering just this iteration of the strategy, we'd begin to lose money if AMT fell to less than $73.55. Meanwhile, we own shares of stock already, too.
- **Maximum risk:** We're on the hook to buy shares if the stock price falls to less than $74.65 by expiration. If that's the case, we'll consider accepting shares or rolling to keep the strategy going.

Next Step: Please post any questions on the American Tower discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Puts on American Tower

Published Nov 26, 2013 at 12:00AM

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Next Step: Please post any questions on the American Tower discussion board.

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Finding Bits of Pro in New York

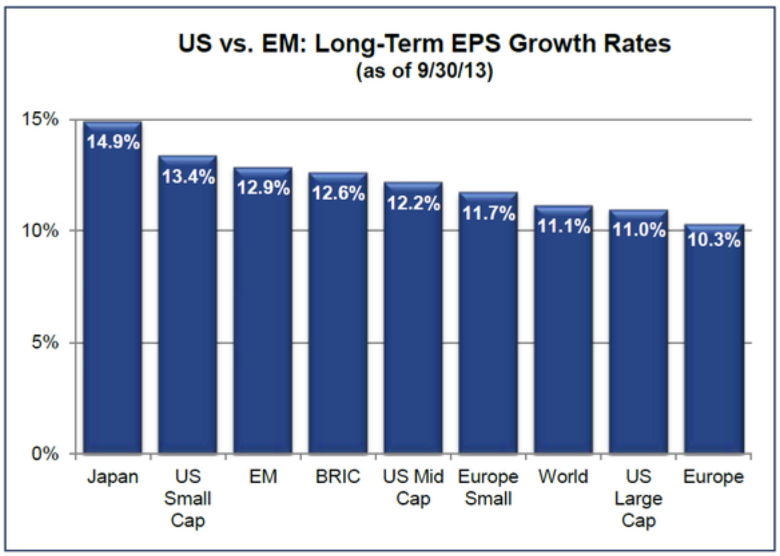
Published Nov 25, 2013 at 4:00PM

Dear Fool,

Once or twice a year, The Motley Fool releases me from my cage onto some unsuspecting city, and I have the privilege of hobnobbing and rubbing elbows with folks who wear much nicer suits than I do. Last week, that took the form of the CFA Equity Research & Valuation Conference in New York City, where I spent two days submerged in several interesting issues regarding stocks and investment management. As far as I know, the entire conference isn't designed around me, but there were plenty of *Pro*-centric takeaways from this year's event. Here are the most interesting ...

Are Emerging Markets a Trap?

Market maven Richard Bernstein, known for studying market cycles to inform his investing decisions, spoke about emerging markets — specifically, how investors seem to be ignoring a few issues those markets face. His argument (part of which you can read here) has a few pillars. First, he posits that focusing on the demographics of emerging markets is silly, because what matters is whether those populations can become wealthier and spend their newfound riches. It's not a certainty that they can, especially given that the only regions currently suffering from harmful rates of inflation are emerging markets — so even while per-capita incomes are rising, purchasing power isn't. Bernstein drove this point home by asking, "How are these people supposed to buy toasters when they increasingly can't even afford the bread?" Furthermore, if wealth accumulation in these markets were considerable, we'd see it reflected in superior earnings growth of businesses located there. Bernstein used the chart below to show that relative earnings growth is actually quite modest.



Source: Richard Bernstein Advisors LLC, Factset.

Finally, Bernstein showed that investors' expectations for emerging-market performance are still too high: Companies in these markets miss earnings almost twice as often as U.S. companies, yet cash is still pouring into emerging-market mutual funds.

My take: Currently, *Pro* has a 1.8% allocation to the **WisdomTree Emerging Market Small Cap Dividend Fund** (NYSEMKT: DGS), and we've written puts to purchase another 1%. If Bernstein is right, we are (at best) in the middle of a cycle during which this ETF will underperform. I don't disagree with the inflation data Bernstein presents, or with inflation's impact on consumer spending in emerging markets, but I do take issue with his conclusion that the result is uninspiring earnings growth. The chart he cites (above) shows expected earnings growth of 12.9%, which in absolute terms is pretty good, and it's the third-highest among the groups he tracks (behind only Japan and U.S. small caps). I'd bet the difference between those groups' EPS growth and that of emerging markets is probably within the standard error of the data. (Standard error is the fudge factor introduced by making an estimate based on a sampling of companies, instead of using every single one.)

He also fails to take into consideration the price investors pay for that earnings growth — a factor *Pro* dealt with by selecting the DGS ETF, which features small-cap dividend payers with modest valuation. The fund's average price-to-earnings ratio is 12.9, and its price-to-cash-flow ratio is 7.9. We think these factors increase our odds when investing in underfollowed, relatively stable, established companies with access to these markets. Overall, I'm happy with *Pro*'s approach to investing in emerging markets.

Medtronic: Great Business, Real Headwinds

Scott Black manages Delphi, a value-oriented investing firm headquartered in Boston. His talk focused on Delphi's approach, which shares many commonalities with what many of us have learned from Warren Buffett: Buy great businesses at sensible prices. A quick scan of the regulatory filing showing Delphi's holdings reveals that *Pro* holding **Medtronic** (NYSE: MDT) fits this mold; the company has been in the Delphi portfolio since mid-2010. (Delphi also owns **Oracle** (NYSE: ORCL) and **The Buckle** (NYSE: BKE).)

Speaking of Medtronic, the folks at Morningstar apparently think it's a great business, too — they award it their highest economic moat rating of "wide." However, when Damien Conover (who leads the health-care team at Morningstar) spoke about economic moats in the health-care sector and the effects of the Affordable Care Act, he did note that the act's 2.3% medical device tax is punitive for Medtronic. He also pointed out that competition in the company's core product lines is increasing, and that regulatory and reimbursement pressures continue to mount.

My take: Currently, *Pro* has a 3% position in Medtronic. We recently moved the company to Hold, citing that very regulatory and reimbursement pressure, as well as a changing risk profile given the increasing importance of an unproven sales model in international markets. Conover's confirmation of the increasingly difficult operating environment is telling, and it supports my suspicion that there are probably better places for *Pro's* dollars within the health-care sector. The quality of Medtronic's business and its current pipeline are solid enough that we won't be forced into taking action just yet, but I do have my eye on a few health-care businesses that are benefiting from tailwinds rather than fighting a headwind. I'm not sure if Scott Black stuck around for Conover's presentation, but he too should consider the fact that Medtronic may struggle to grow earnings at above-average rates given its changing industry dynamic.

The Foolish Bottom Line

Fool HQ is located in Alexandria, Va., and that geographic distance from the hustle and bustle of Wall Street is part of what allows us to think clearly and independently. But it's also refreshing and informative to venture into the chaos from time to time to talk stocks with some of the industry's best and brightest. Beyond the *Pro*-specific nuggets I highlighted above, the conference offered plenty more useful insights – you can check out my notes here, here, and here. Seeking out divergent opinions helps us make better portfolio decisions, so if you have a unique insight or strong opinion on the investment thesis for one of our holdings, we invite you to share it on the company's discussion board. Our investing brains are bigger combined than apart, and thankfully, our boards are less crowded and more collegial than the streets of New York City.

Onward,

Bryan (TMF42)

Completed *Pro* Trades

- None

Coverage & Community

- *Pro* members wonder if any of the *Stocks 2014* selections will find their way into the *Pro* portfolio.
- Member RockenD wastes no time, but uses more than 140 characters, in putting a bearish bet on **Twitter** (NYSE: TWTR).
- Jeff offers to count sheep with any *Pro* member who asks.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Portfolio Check-In Event

Published Nov 25, 2013 at 2:00PM

During our Portfolio Check-In Event on Nov. 25, advisor Jeff Fischer and senior analyst Bryan Hinmon, CFA, were on video to discuss the Building Your *Pro* Portfolio reports, share their insights on the *Pro* investing and portfolio management philosophies, and offer guidance. Meanwhile, the rest of the *Pro* team took member questions via a live text chat.

An archived version of the video and a transcript are below, along with a transcript of the live chat.

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Portfolio Building Reports

Our Most Recent Buys (Nov. 13, 2013)

- View the HTML version
- Download the PDF

Portfolio Building Report (Nov. 20, 2013)

- View the HTML version
- Download the PDF

JEFF FISCHER:

Hello, Fools. Welcome to *Motley Fool PRO's* live portfolio check-in event. I'm Jeff Fischer joined by Senior Analyst Bryan Hinmon. Joining all of us in the text portion of today's chat is Analyst Billy Kipersztok. We think we're going to have Jim Gillies checking in from *Motley Fool Options* and Jim Mueller helping us on the chat, as well. And Ellen Bowman, who oversees everything that we do in PRO and Options.

We are delighted you are here with us. Thank you for being a *Motley Fool PRO* member — and to new members — welcome to the service. We're glad you're here. Today we're going to have a fun hour to talk about PRO a little bit, our philosophy, tease a trade that we have coming out later this week and answer your questions … as many of them as we can.

If you see on your page — I'm going to take a minute or two here to slow down. Make sure your video feed is working. You'll see on your page you'll have a video feed — and that's us right now live — and you'll have a text portion which is also live and there you can type in your questions. Billy or Jim or Jim or Ellen will answer your questions … as many as they can … and Bryan and I will be looking at your questions as well and answering them throughout the course of this hour.

It's going to be a fun, full hour and our goal, of course, is to get you a little more comfortable with PRO, with how we invest … and for those of you who need a little help … some help getting started. And remember. It's just one step at a time here. And another thing we always tell members as they join is we're not here to make a little money. We're not here to make a little money one week and a little money the next month. We're here to make a lot of money over a meaningful amount of time. And so as you invest with us, extend your horizons. Look out at least a couple of years, because real wealth is made or grown by having an appropriate time frame ahead of you and that makes it a lot more fun, too. Bryan, you were going to say something and I was going to give you a chance…

BRYAN HINMON:

I was just going to say — we'll talk about it a lot later on. But you've set up and framed this whole discussion saying that our members — what we want them to do is extend their time horizon. You want to consider your entire investing life — and one of the things that really defines *Motley Fool PRO* is our North Star and our mission which we've set out. And we distinctly considered time frame when we were hashing that out and figuring out how we wanted to really build the service around that. I won't spoil it all here, but time frame is so important to what we do that we try to embody that with North Star and our mission.

JEFF FISCHER:

That is certainly true, Bryan and it's a great jumping-off point. Before we get to your questions, we'll talk a little about our philosophy. Bryan, why don't we start with the North Star. I'll ask you to define the North Star for everybody, but I'll start by saying we have a constant rolling three-year goal. We want to always make money every rolling three years. That's our absolute returns goal, which means PRO is not about relative investing. We're not trying to do better than the market index, which could easily be down over three years. We're trying to make money no matter what the market does.

Realistically we think over every rolling three years — we need to make money at least every rolling three years — whatever the market does. So, even if the market is down, our goal is to make money. Now over time, of course, our return goal is quite, quite generous…

BRYAN HINMON:

It's way more aggressive than just make money every rolling three years…

JEFF FISCHER:

So, let's talk about that. That's our North Star, Bryan. Can you define it and let's talk about it.

BRYAN HINMON:

Yeah, I'm happy to. PRO's mission, as you just pointed out, is consistent recurring profits with a high level of accuracy. Well, that's really pretty abstract and so the North Star was really our effort to quantify that. You pointed out inflation matters because I don't know about everybody out there, but I plan on living for another 90 or 100 years…

JEFF FISCHER:

Bryan is healthy enough that he will. He's the healthiest guy I know, so you're in good hands…

BRYAN HINMON:

I'm going to try my darndest — that's for sure. So with a 90 or 100-year investing horizon — I'm being a little facetious here, but…

JEFF FISCHER:

I mean, your children will have that sort of horizon, at least, and your grandchildren…

BRYAN HINMON:

Exactly. And so, that's the mind-set that I have here. Well, over 90 or 100 years, or 30 or 40 years, or even 20 years for that matter … inflation can eat away at your purchasing power, and so we need to be cognizant of that and acknowledge it and so that's what we've done with the North Star which, as I said, quantifies our mission.

All the North Star is — it's a very simple concept — it's inflation plus 7%. We've already explained why we care about inflation. Why 7%. Well, as it turns out, the rule of 72 essentially says that if you earn 7% a year, essentially your money doubles every 10 years. And so what we've said is, "That seems reasonable." It's an aggressive return number to throw out there…

JEFF FISCHER:

Yes…

BRYAN HINMON:

…but over time, if we achieve such results, we will probably be able to live the lifestyle that we want to live. We'll probably achieve the goals that we've set out for ourselves under a variety of scenarios. While we don't know all of our members' goals — we don't know their horizons — we don't know their personal situations … we have set up North Star (inflation plus 7%) to double the real purchasing power of our portfolio and our members' portfolios every decade. And if we do that, we're probably going to be serving our members really well.

JEFF FISCHER:

That's right, Bryan. Inflation as we define it, just to go a little deeper into the weeds, is CPI-U or Consumer Price Index All Urban, so it includes pretty much everything. Right now, inflation's running around 3%. The last I looked, it's maybe a little above 3% a year. So when you add 7% — which is our absolute return bogey every year on average — 7% to current inflation, we're looking at 10% plus per year is what we aspire to make. That's our North Star. And obviously, no one can say, "Oh, we'll make 10% a year no matter what, every year." But over time, over a rolling three years, we hope to make 10% annualized. Over 10 years, we hope to make 10% plus annualized, so it's over longer periods we hope to make that.

BRYAN HINMON:

And I think that we should provide a little bit of context here. We're not playing T-ball here. We haven't just put the ball on the T. Or it's not even slow-pitch softball where we have a larger ball and it's coming in really slowly for us to take a big, old swing at. As we've defined it, the North Star, as a return, is really pretty heady. From 1970 to 2012, the North Star has actually increased at a compound annual growth rate of 11.3%...

JEFF FISCHER:

Uh-huh…

BRYAN HINMON:

…just far and away above what the S&P returned over that same time of 9.9%. And so, that return differential is huge over that 42-year time horizon…

JEFF FISCHER:

It truly is. And so, if we're going to stay close to our North Star — remember, it's an aspirational goal — if we're going to stay close to it, odds are we need to do better than the S&P 500, as well … but, that's just incidentally…

BRYAN HINMON:

Right…

JEFF FISCHER:

…I think the key strength or one key strength of North Star is that it makes us look away from the market. If the market's rising really, really sharply … say it gets ahead of itself valuation-wise … we should not feel pressured to pursue it…

BRYAN HINMON:

Right…

JEFF FISCHER:

…because you go down that path, and you're going to fall with it when it falls. We need to stay on a steadier course which are steady returns, year in, year out. So, when the market looks more risky, we're more likely to hedge it … to set up shorts, things like that … because we want to make money in the next year or two if we can.

BRYAN HINMON:

Jeff, I love the point you made there about how North Star allows us to focus on what we think matters and not get caught up in the current market environment. When I'm explaining to people what I do and about PRO and about the North Star, the way that I explain the North Star is that it's almost like built into some glasses that we wear. And then the North Star provides the lenses through which we look at our portfolio and make our portfolio decisions…

JEFF FISCHER:

Mm-hmm…

BRYAN HINMON:

And so, when we're having our internal conversations and we're debating a stock and we're debating an allocation move or something like that, we always put on those North Star glasses and frame the discussion around, "Well, is this going to help our portfolio track the North Star or is it going to detract from that?" And we believe as long as we are making our portfolio decisions through those lenses — more often than not, we're going to come out pretty close to making the right choice.

JEFF FISCHER:

I like that Bryan, and we need to trademark that before Google grabs it. Patents it. That's certainly how we look at everything. When you look at fair value on the site for a company, what we're looking at, even more than fair value is yes, it plays in … but can that stock, from today's price exceed or match the North Star in the next three-year period?

That's our main bogey for any stock that we rate a "Buy," and we need to believe every day that that buy is a worthy buy for the portfolio and for every member who's just joining the service now should they buy that stock today. And if it's rated, "Buy," then we think they should because we believe it's going to at least match our North Star to come in three years.

Let's talk about a few essentials here that veteran members know very well, but new members may not. That is, in general, we are a full portfolio service and so portfolio management is part of what you're getting here. Whether you mirror the PRO portfolio exactly, (which many members do), or if you pick and choose from it, (which many other members do, as well, just choosing your favorites), you should know that we aspire to have about 20 to 24 core positions and right now we're at exactly 20…

BRYAN HINMON:

Mm-hmm…

JEFF FISCHER:

…and therefore, on average, each position starts at around 3% and can go all the way up to 5% to start and then we'll manage the allocation on an ongoing basis, whether we want to make it larger or smaller over time. We're a fairly focused portfolio and we believe that's going to result in stronger returns over time, because we know our positions extremely well. We can adjust them as we need to. When opportunities do come along, we're ready to act. We have the confidence to act because we have the knowledge of our companies and their competitors and the valuation and all those factors that matter so much. We also, then, add into these 20, 24 core positions. When we feel it appropriate, we hedge and we'll short. And, of course, we use options.

Now, things to keep in mind. Our core positions — we're always thinking in terms of rolling three years. Shorts, hedges and options are, of course, shorter-term vehicles so those we think of in terms of months to a year or two. And you combine all these things and that's how we manage the portfolio.

But, just one point before we move forward. Quite a few members do not use shorts or some don't even use options, and that's okay. You can just use PRO's core positions and that can be your long-term stock portfolio or part of it. But if you want to use shorts and options — and we encourage you to — we will get you started in those, new members. We'll get you started in those in real time with reports that come out in the near future. So, first we wanted to get you focused on building your core portfolio and then we'll move into shorts and options … options, first, actually. We plan to have an options trade this week that anyone who is ready to make some income can jump onboard with us tomorrow…

BRYAN HINMON:

Sure…

JEFF FISCHER:

…when that goes out.

BRYAN HINMON:

Well, before we move forward, I want to apologize. Jeff and I — this is new for us. We're not used to dancing in front of the camera. We don't have our trusty MC here so we forgot one bit of housekeeping — just to remind everyone that this event is, of course, going to be recorded and logged on the PRO website. So, if you need to refer back to it, this and the chat portion will be available for you.

But enough with that nonsense that we're not good at. Jeff, let's dive a little bit deeper into something that you said. You know, 20 to 24 core positions. What the heck do you mean by core position — and I'm going to tee you up here by saying that … When was this? September 30th you wrote a memo called, "PRO One-Pager - Stocks We Like," and in it, you sort of answered this question…

JEFF FISCHER:

Mm-hmm…

BRYAN HINMON:

So, run through with me how you think about a core position. What traits in the companies do you like to see?

JEFF FISCHER:

The key things we look for in a long-term company we want to own, Bryan, as you know are strong returns … mainly returns on equity, returns on invested capital, healthy margins which tie into a sustainable competitive advantage. And that's probably where we actually start most of the time. What advantage does this company have that allows it to generate profits on an ongoing basis and how is that sustainable — because without a sustainable advantage, today's profits are going to dissipate.

And then we look for management who knows how to reinvest the proceeds of the business to grow the business still further. And if the company also has recurring revenue or annuity-like revenue (like a software provider does on a subscription basis) so much the better. It just makes it all the easier for that company to be a compounding machine which is a term we took from Chuck Akre.

We're going to favor a business that looks like it can compound its growth, year by year, over the long term. That sort of really outstanding business — like MasterCard, which is a "Buy" or Amtrust Financial, a "Buy" in our portfolio — that sort of great business is the type that we want to own and we hope to own for years and years to come and really grow wealth with those businesses.

BRYAN HINMON:

Yes. You don't even have it up on your screen here — I'm peeking — and you walked through that really smoothly. It's because over your years of looking at businesses, these sort of common traits have bubbled to the top and are common themes among the companies that you have personally invested in and had the most success with. And now I'm proud to say they populate the ranks of our largest holdings in our portfolio, in general.

It brings up a good point, a reminder to me that I should write a memo on compounding. As investors, we always talk about how compounding is sort of a wonder of the world and is truly remarkable. But what I don't think enough investors pay attention to is how compounding gets better and better the longer you let it work…

JEFF FISCHER:

That's certainly right, Bryan, and it's difficult to even get your head around it … how the numbers actually work and how a business can grow so much more after it's already grown.

BRYAN HINMON:

Yes. So, note to self. That memo is coming…

JEFF FISCHER:

All right. Compounding memo from Bryan is on the way.

BRYAN HINMON:

That's coming. And it also reiterates the fact that selling is a really hard decision and so…

JEFF FISCHER:

Yeah. At what point do you cut off that so-called compounding machine if you've really bought into one?

BRYAN HINMON:

Exactly. And so, the easy way out is to say "don't sell." Well, of course, that's a mistake in many instances. But the better the work we do in identifying the compounding machines on the buy side, on the front end of the transaction … the less we have to worry about when to sell. Even if they get a little bit overpriced — a little bit beyond our estimate of fair value in the near term — as long as the compounding dynamics are still there over a long-enough time frame, we know that that is going to contribute even still an outsized proportion of our portfolio's gains.

These great companies — we don't worry about slight over-valuation or extended valuations or these sorts of things. We would rather own compounding machines that are a little bit expensive over average businesses almost any day of the week.

JEFF FISCHER:

That's exactly right, Bryan. The other thing to keep in mind, too, is if we do see prices escalate to a point where we think it's going to be a couple of flat years in the market, we can set up all kinds of positions to make money in a flat environment … options positions or hedges or shorts … and meanwhile let our core stocks be … so that we don't have a turnover, we don't have a taxable event and we make money other ways and let this compounding continue afterwards.

It's remarkable how a business can grow value. I made a post today on the PRO Philosophy board about most of the families I know who have made real wealth — well, all of the families I know who have made real wealth, and it's a few dozen — have done so by owning some stocks and keeping them … not by trading in and out. Not by trying to guess where the market's going. It's more owning good companies for years, for decades, really.

And Coca-Cola, you would think… In the 1920s people were saying Coca-Cola's growth is done. Why buy that stock now? Of course, it's gone on to make billions for people since then literally, and in just the past seven years I think it's about doubled again … like all new value creation. And this is a company that's not in PRO right now, but it's a great example of a well-known name that still hopes to grow their beverage volumes 60% between now and 2020.

BRYAN HINMON:

Sure. And you know, that brings to the forefront that when people were doing their analyses in the 1920s of Coke at that moment, they could only see so far out. They couldn't see the next shoe to drop was international expansion and that Coke was going to replicate its advantages all across the world as the world grew. And then, okay, well, that started to slow down a little bit and investors got worried. What is the next shoe to drop? Well, Coke just continued adding categories. Water. Healthy beverages. You name it — they just kept adding to the portfolio.

That highlights the fact that even though I think you're a pretty smart guy, I know you can't see 40 or 50 years into the future with any sort of certainty. The best we can do is choose businesses that have those sustainable competitive advantages intact now to buy them the time and resources to invest for the future. And as long as we are partnering our money with great managers and great business thinkers — we're stacking the odds in our favor of finding those companies that are going to be able to compound for decades instead of years.

JEFF FISCHER:

That's right, Bryan, and well said. So, Bryan, I'm going to run through the high-elevation look at PRO quickly just to recap … for new members especially … and then let's get to some questions. If you see some questions in the live chat that you'd like us to answer, we certainly will.

BRYAN HINMON:

Sure.

JEFF FISCHER:

So, Fools, to recap. PRO is The Motley Fool's only long, short and options real money portfolio and you joined because you want to make money on an ongoing basis. You want to do better in poor markets when the market is finally flat — and it will be — or when it goes down. And you want to make really good money over the long term and that's what PRO is set up to do — make money, smooth out the rough times in the market. Make money during flat markets. We have strategies that will make money in flat markets. That will make money in falling markets. And then, of course, we have these 20 to 24 positions that we believe will compound the rest of our assets over the longer term.

PRO has returned, just to review, more than 13% annualized in the five years we've been in operation — not that we compare to the market — but that's better than the market which is a good thing, because that means we're also doing better than our North Star right now and that will be our ongoing goal from here forward.

A few housekeeping notes — to new members especially. *Motley Fool Options* is the sister service to PRO. PRO is the full portfolio service that you signed on for. Options you get free with your PRO membership for the life of your PRO membership. We think that's a great combination with our team and Jim Gillies, as well, in Options. The two services do go well, together.

You can use the ideas in *Motley Fool Options* to complement your *Motley Fool PRO* portfolio and Options also has great educational content in Options U and an amazing options community which is a whole other set of members who are in *Motley Fool Options* that you can converse with, learn from and help, as well.

BRYAN HINMON:

Jeff, I've got a couple of questions for you, if you're ready.

JEFF FISCHER:

I am ready. I am ready.

BRYAN HINMON:

All right.

JEFF FISCHER:

And we're going to try to fly through these. We have a lot of questions coming in, which is great to see. Let's see how we can help.

BRYAN HINMON:

Sure. There seem to be a lot of questions. Even though you said, "Hang tight on shorting," everyone seems a little worried about a frothy market.

JEFF FISCHER:

Is it 2009?

BRYAN HINMON:

I'll get to that joke in a minute. They want to know how to get started with shorting. I think there's a general answer that you can give and then sort of a PRO-portfolio-specific answer you can give. And if you think that might feed into a nice conversation about PRO's exposure and how the portfolio is exposed right now.

JEFF FISCHER:

That's exactly where I would go, Bryan.

BRYAN HINMON:

Well, fire off, then.

JEFF FISCHER:

Let's talk about it. Let's talk about it together. PRO is exposed. We're about 75% net long to the market. We have more than 20% cash, that means, and that's a pretty good hedge right now for our current desires and purposes. We are looking at building our so-called short book or building our short positions into the portfolio and those will do two things. They'll raise cash for us because you get cash when you short (not that we plan to use that cash because it does hold the short open … but it also hedges our long positions and lets us keep, as we just talked about, our core holdings for the long haul).

New members — I joked about 2009 because in early 2009 and even March, 2009, members were clamoring for shorts and we were not shorting anything as the market fell. And throughout 2009, one critique was, "Where are your shorts? You don't have shorts?" And then 2010. We have not shorted much since then, thankfully, and we still don't see valuations that demand a lot of shorting.

In fact, that there's a lot of concern out there is maybe a good sign — not that we care about terms like this — but that stocks may climb a wall of worry. Really, we just focus on valuation and we will short companies that we think are failing and overvalued … and we'll hedge when we think our market exposure is too great … but right now it's 70%, 75% and so we'll get there and we're working on it.

But if you buy all of our longs, you're less than 70% long because we have a few stocks on hold which means if you're following PRO, you're more than 30% cash. And when you have that much of a buffer or that little exposure, we don't think you need to add shorts right away. You want to have upside potential. Bryan, what do you want to add?

BRYAN HINMON:

I can't add much on top of that, Jeff other than to say that we realize that part of the allure of PRO is that it is billed as a long-short portfolio…

JEFF FISCHER:

Mm-hmm…

BRYAN HINMON:

…that uses options. The way we view it is at least a "go anywhere" portfolio — more than putting titles on it — and so I think of the portfolio, at least in my head, as we have our core longs and then we have our positioning, our exposure. That clumps together the short book and the cash position.

That's how I would encourage members to view it, as well. Just to say, "Hey. Right now we're 75% invested in our core holdings and 25% out of the market right now … or ultimately, when we find the opportunities, short the market." But the starting point is that we're only 75% invested, so even if we're worried about a frothy market, we have 25% out of the market and our stock selection has been sufficiently good that our returns have been great this year…

JEFF FISCHER:

Yes. Since inception, that's a good point. We've had some shorts and hedges in cash since inception and our returns, really including all those so-called drags on the portfolio, have been great … so our returns on risk are great.

BRYAN HINMON:

Yes. So that 25% that is basically the two buckets here — the 25% that's other stuff — over time, as the opportunities present themselves, we'll figure out the right allocation for that 25% … be it 25% in shorts or be it 12% in shorts and 12% in cash or whatever. The bottom line is that we hear you about the frothy market. We're not overly concerned. It doesn't keep us up at night — but we do have 20% to 25% dry powder right now that is removed from the market and obviously would be removed if the market were to do something treacherous.

Keep in mind that the exposure, which you can find on our recommendations page and Jeff is responsible for updating that whenever there are major changes … at least once a month…

JEFF FISCHER:

Yes…

BRYAN HINMON:

…but honestly you do it …

JEFF FISCHER:

…every couple of weeks or whatever. It was updated Friday.

BRYAN HINMON:

It seems like you've been doing it almost every week or every other week lately.

JEFF FISCHER:

Bryan, let's talk about the macro just for a minute. As we outlined at the beginning with our companies, we care how our companies are valued and what we think they'll return for you the coming three years. That's how we think. That's a reasonable way to think.

But we also keep an eye on the macro — namely in relation to our potential hedging and shorting positions. And the macro right now — I like that everyone's quite concerned. And yet you have the S&P 500 at an average valuation. It's not, at all, like far extended. It's not yet to a valuation where most bull markets do end. People cite the returns since 2009, which I find absurd. Why cite it from the bottom…

BRYAN HINMON:

Right…

JEFF FISCHER:

…of 2009? Since 2007, the market's up a paltry 15% to 20%, the S&P. So, it's really gone nowhere for six years, almost. You have pretty weak GDP growth around the world this year, which is a good thing. You have pretty weak earnings growth in the S&P, this year. Nearly flat, which I consider a good thing. I hear people saying, "It's stalled out. It's stalling." Well, it's not an airplane. The fact that growth was so light this year makes it more likely that there will be growth next year. It makes the comparisons next year better.

Meanwhile, GDP was really weak this year and could tick up higher next year … at least that's how current models look. Now, you have the Fed changing hands, which means they're very unlikely to rock the boat. Now, Bernanke does not want to rock it right before he leaves and Yellen does not want to…

BRYAN HINMON:

Not on her watch…

JEFF FISCHER:

Not on her watch. She's going to very, very slowly change any policies that are in place. I think when they do start to taper, it's going to be so gradual, and people are already so on edge about it, that it could very well turn out to be a positive for stocks when everyone sees, "Oh, the world's not ending. Instead of buying $85 billion in bonds this month, they're buying $80 billion, and look. The market didn't implode." And they're going to take it down so slowly and keep rates as low as they can for as long as they can. But I think tapering could end up — not that we're investing with this in mind — but could end up being a non-event or even a plus for stocks.

Finally, Treasuries have already gone up. They've already recouped. They've already gone up back to rates that people were … They've already taken into account tapering, to a large extent. So, the market has already adjusted. The 10 year, I think, was down to one point something, 1.7%. Now it's back almost to 3% just on the hint of tapering to come. So, that adjustment's been made and it's back near an average of where you would expect it to be.

Long and short is we're not macro-minded all the time, but we keep it in mind at all times, if that makes sense. We look at the valuations of our companies foremost and then we'll put hedges and shorts in place as we see fit month by month, quarter by quarter. Remember, we can be market-neutral in a day if we want to be. We could just hedge out all of our exposure if we wanted to be.

BRYAN HINMON:

Yeah, Jeff. It's funny. There's always some sort of activity going on in the bigger picture — in the economy that worries people. There's almost always some bigger picture, geopolitical risk that's out there. And now is the time of year when you start hearing the Wall Street wizards making their year-ahead stock return predictions. They're going to come fast and furious pretty shortly here.

I was reading in the *Wall Street Journal* over the weekend — over the last past 14 years a firm called Birinyi Associates put together consensus year-ahead estimates — basically, the average prediction, year-ahead prediction for stocks of all the major Wall Street firms.

Well, over the past 14 years, exactly 0 years did they predict that returns would be negative. So, a biased group. Keep that. But also, in 4 of the 14 years, we had negative returns, so they were in the wrong direction … not just wrong in terms of they guessed 9% and the market went up 11% that year. They had the totally wrong direction. All I'm saying is that it's very difficult to make the linkage between what's going on in the economy and how that's going to play into stock market performance.

JEFF FISCHER:

That's true…

BRYAN HINMON:

So, to a large degree, we don't try. We pay attention to the extent that we think it is going to cause dislocations or cause structural changes to our businesses or at least very prolonged impacts on our businesses. Otherwise, what we really care about is how our businesses are doing. And that's not how the stock prices of our businesses are doing — but how the businesses themselves are performing. Again, it's a different mind-set.

JEFF FISCHER:

That's so true, Bryan, and it reminds me of what we have always told veteran members since 2008: One key to successful investing is to remain flexible. It's very unlikely that you'll ever see us 100% long and that's it — everything pointed in one direction — because when things do go against you, (and they will … it's inevitable for short periods or even a year), you would have nowhere to go.

We like to remain flexible, so that if we do have a dislocation, as Bryan talked about, that's an opportunity. It becomes an opportunity right away. And if you have cash on the side or if you have hedges in place, as a majority of the time we do, we take advantage of that dislocation and make it work for us and that does a lot for peace of mind during market declines, as well.

It's funny how over history — and I don't want to keep thinking of very long stretches of time — but over history, the market has only ever gone up. We're sitting here and it's at an all-time high, which it has done almost every decade and many, many times over that decade as far back as you care to look. But despite that and despite the chart that is up, up, up … so many people, ourselves included, think about those short, down periods. And you can get into a blind spot if you worry too much about them.

So, we do exactly what Bryan said. We make sure our businesses our strong, reasonably priced, have a competitive advantage and then as we see fit, we'll hedge and short and we'll short failing businesses which is fun to do when that works out. Earlier this year we were short Sony and we made money on Sony while the market was going up, so that was fun.

BRYAN HINMON:

Jeff, I have a member question for you.

JEFF FISCHER:

Let's get to questions. More questions, great.

BRYAN HINMON:

Yes. Frank asks, "Should I add some ETFs for diversification?" I guess the question is how do you think about diversification in the PRO portfolio and then we'll answer Frank's question specifically.

JEFF FISCHER:

Great question. A lot of studies have shown if you own a dozen different companies in different industries, you are diversified. Now for a lot of us, that may feel like it's not enough diversification. A lot of people aren't comfortable unless they have 20 or 30 stocks or more. Well, PRO is diversified. We believe it's well diversified. You can certainly further diversify if you wish. The key is that you're comfortable by adding some ETFs very easily.

But the thing to keep in mind with an index ETF is that it will move with the market and with a specific ETF — such as a commodity ETF or a Brazil ETF — you're making a very specific investment, very specific bet in that one niche. So, ETFs don't always add diversification is what I'm saying. It depends on the ETF.

BRYAN HINMON:

Yes. And I would remind Frank that you should consider your entire asset allocation. I have no idea what the right asset allocation for Frank is, but for someone … let's say someone my age … maybe something appropriate is 75% stocks and 25% bonds. We'll just keep it easy with the two asset classes there.

We think PRO is appropriate for that larger stock bucket because we are putting money into the market and even though we're managing the portfolio in a way that is different from just riding the market's vicissitudes, we're putting capital at risk in the market and so we think it fits into that larger stocks bucket. Frank, should you add ETFs to complement that? Sure, especially if it's filling out your broad asset allocation plan.

JEFF FISCHER:

Good answer, Bryan. And I'm going to run through four of the questions I've seen on the text chat commonly and they're common questions on the community boards, as well. One is, "Can you mix PRO with other Fool services?" And our answer is yes. We've seen many members do it successfully. They add favorites from other services to PRO or vice versa and build their own Foolish portfolio that way. They're all Foolish recommendations, so you can mix them. Just be sure to try to stick to our allocation guidance on your PRO selections and if you have any questions about your diversification, because you're only choosing some PRO stocks, let us know on the boards.

And finally, do keep in mind we build the portfolio very specifically because it is a portfolio service. We want and expect the portfolio over time to work together as a whole, so that's one of our core missions and what we work towards every day. So, if you're breaking the portfolio apart, you'll have different results, but many members do add other stocks to the portfolio from other Fool services.

The other one. Do I buy everything, all your buys a person buys right now, or can I average in? You can certainly average in. If you're all cash right now, we would say buy most of them. Get up to 50% exposure and go from there. If you're already largely invested, then average into PRO stocks as you're able and you can buy them in halves if you want to go gradually rather than buying the whole allocation at once.

IRAs. That's another common question. Most PRO strategies work in an IRA. Most of our Options strategies do, as well. Shorting does not work in an IRA, so if you want to make shorting a key part of your strategy, or a part, you'll need to open a brokerage that's friendly to shorting and any discount broker will do. Members use everyone from TD Ameritrade to Interactive Brokers to E-Trade. And Interactive Brokers has great short availability on some of the more unique tickers we like to short or ETFs we like to short. A reminder on shorts and hedges. We'll get you up to speed with live trade alerts in the coming weeks on those. Those are four common questions. I hope that helps.

BRYAN HINMON:

So, Jeff. You spoke a little bit about income. There's a question on here about if you're looking for reliable income, what can PRO do in that regard and then do you have any other suggestions for George?

JEFF FISCHER:

Great question. PRO has a mission of issuing to members at least 12 income trades a year or, obviously, at least one a month. And we're on track for that — maybe beyond it this year. A lot of what we do for regular income is writing options and our preferred strategy is writing put options. When you sell a put option Bryan, as you know, you are getting paid income up front and you're obligating yourself to buy shares of a stock if it declines below your strike price by expiration. If it doesn't, you keep the income and you can write another put, and that's how it becomes steady income.

If it does decline below your strike by expiration, you can take shares … and you should be happy to do so … or you could roll your put options to another month and go for income again. Either way, if you do take the shares, you keep what the options paid you, again, so it lowers your cost basis. So, regular income. Is it reasonable to invest, George is asking, $1 million into the portfolio and expect a fairly regular income from the portfolio?

The long-term answer is yes. Again, we promise to deliver 12 income trades a year. The market, though, has been obviously more geared towards owning stocks the past several years, so we haven't written as many income positions as we otherwise would. There will come a time when the market is flat for a long time and we'll be writing a lot more income positions. So, over time, it should smooth out and income, no matter what, will be a steady, ongoing part of PRO.

BRYAN HINMON:

I have another comment or two for George — the first being that I don't know the number off the top of my head, but numerous PRO companies do pay dividends…

JEFF FISCHER:

Mm-hmm…

BRYAN HINMON:

…in fact The Buckle even pays almost regularly a special dividend, as well.

JEFF FISCHER:

The yield on the portfolio — the whole thing, last I looked was around — I don't want to get it wrong, but it was up there. It was close to the S&P…

BRYAN HINMON:

It was close to the S&P's yield. It's about what it was the last time I looked, as well…

JEFF FISCHER:

And that's with a lot of cash on the side.

BRYAN HINMON:

Yes. Another thing that George can consider is creating his own dividend — selling off positions every time he chooses to rebalance. Maybe that's quarterly. You can sell down positions to get them back in line and create a synthetic dividend in that regard.

And then I think now's a good time to peel back the curtain a little bit and tip our hand and talk about two income trades that we're currently considering. I don't think there's anything wrong with that, is there?

JEFF FISCHER:

Hm-mmm…

BRYAN HINMON:

So, the first one is Medtronic, which is a company that I cover for PRO and put on hold recently. Basically, I've been starting to ask myself and converse with the team. Does Medtronic, from here, help us achieve our goals? I think there's serious head winds at the company. The company's trading a little bit beyond what I think it's worth right now, which, again, isn't a huge deal because it's a very good company, a very good business…

JEFF FISCHER:

Mm-hmm…

BRYAN HINMON:

…but it does call into question, given the head winds the company's facing, that I wonder if it can help us achieve the portfolio returns that we're going after. So, one of the ideas that's on the table is to convert Medtronic into an income position and maybe use it as an aggressive covered call candidate. Ideally, then, we'd be able to take what is a fairly valued stock … but a company that we know well. We feel very comfortable in the downside … and turn it into an income generator. And that's not something that we have done all that often in PRO. Tupperware — we've done it with Tupperware over time and Plum Creek Timber back in the day…

JEFF FISCHER:

Yes, we like to write covered strangles…

BRYAN HINMON:

Yes…

JEFF FISCHER:

…which is a combination of writing covered calls and writing puts.

BRYAN HINMON:

So, Medtronic is currently being wrung through our wringer as potentially becoming an income play. Who knows where it will turn out in that debate? We're still very much having that conversation. But that's an idea of something we're considering.

JEFF FISCHER:

That's right. And there's another trade that we plan to go out tomorrow, Tuesday morning, early Tuesday morning Eastern Time, probably in the first couple of hours of trading. Assuming everything goes right — assuming the numbers line up — that trade will go out tomorrow.

That's an income trade. That is writing put options on a stock where you're paid income, day one, and you're committing to buying that stock. We'd be happy to buy it if it declines below our strike price by the expiration. And this one is pretty short-term. These options expire in January, so it's about a two-month income put-writing trade that you'll have tomorrow in your Inbox, and then if you have any questions about it, you can ask the company board there at the bottom of the trade alert which goes out tomorrow.

BRYAN HINMON:

Yes. So, that one is probably coming.

JEFF FISCHER:

Yes, very likely.

BRYAN HINMON:

Another idea — I won't give the name here — but another idea that we've been actively debating for some time is we just had the final batch of 2016 LEAPS become available. Our team has been actively scouring those options for diagonal call candidates…

JEFF FISCHER:

Yes, that's exciting, too…

BRYAN HINMON:

…and strangely, we haven't done that, really, in PRO.

JEFF FISCHER:

We haven't done that in PRO at all.

BRYAN HINMON:

I think Jim Gillies might have a monopoly on it in *Motley Fool Options*. But it's an income strategy that we're both fond of and it's one that we have been giving a lot of consideration to on a couple of names in PRO.

JEFF FISCHER:

And I do think after these five years of rising stocks, you're starting to get to a price which … it still looks reasonable … but where we're going to want to overlay more income strategies into the PRO portfolio to get our returns that much higher because we can't just rely on rising earnings and rising share prices.

One thing to keep in mind about fair value which I see questions about in the chat is that fair value is a fair price for a buyer or a seller today. A lot of people equate fair value with the sell price — but fair value is a good price. It's a price from which you can expect to earn your desired return which, for us, as you may know now, we look to earn at least 10% annualized from any stock we buy.

So, if we say a company … its fair value is $55 … we expect from that $55 to earn 10% a year … which means that fair value will go up 10% a year. So, a year from now, when we update it, we'll say, "Oh, now its fair value is $60." So, two things. Fair value is good for a buyer — or a seller if someone wants to get out — but it's not, default, a sell price. And a fair value will go up every year, typically by 10% or more, if the business does well.

BRYAN HINMON:

Yes. That's a great point. We comment on that a lot. And ideally what we find is the companies that we buy are so good that they compound their intrinsic value at a rate greater than what we expected. And then basically all that means is we have a certain level of business performance embedded in our valuation models, and to the extent with which the company can improve its operations … grow sales, improve margins, reduce costs beyond what we have forecasted … they're able to grow that intrinsic value far beyond 10% or whatever our chosen discount rate is. Again, that just plays into the importance of finding those core stocks that exhibit those great business characteristics.

JEFF FISCHER:

Good point, Bryan. Here's a comment from Sarah. She just asked, "The market is kind of too hot and not sustainable. I want to protect my portfolio. Will buying the S&P index put option do the job? How do you figure out which option to buy?"

It's a very good question, Sarah. And we talked about the market earlier. If you heard that, this will be archived and you can go back to it, as well. We think the market is reasonably priced. We like that there's a lot of concern out there. That said — it's about exposure. If you feel your portfolio is too exposed to the market, you can hedge some or much of it by buying put options on the S&P 500 or shorting the S&P 500 directly.

If you are buying put options on the S&P 500 as a hedge or on anything to protect it, what put you choose depends on how long you want your insurance to last and how much money you want to risk for that insurance. For those who don't know, a put option, as a tool, we'll certainly use. We have in the past and we will again. When you buy a put option, it's like buying insurance, because a put option goes up in value when the underlying asset falls.

So, if you buy a put option on the S&P 500 … when the S&P 500 falls, that put option will go up in value for you. You can then cash it in when you want and you've made money while the index fell. It's very important to know that "buying" a put option is the opposite of "selling" the put option. We sell to open options to make income on them, but you'll learn that as we go forward with you together. So, I would ask Sarah how long do you want to protect your portfolio against a fall in the S&P 500. How much of your portfolio do you want to protect? That would lead to your answer of which put options do you buy on the S&P 500.

But we would advise that you protect your portfolio only when you have good reasons to do so — not just because you feel the market's unsustainable. A lot of people have felt that the past three years and a lot of insurance money has been for naught.

BRYAN HINMON:

So, Jeff. I'm going to ask a question by C.R. Parr here. Dig into your brain a little bit. C.R. Parr asks, "Are you still writing options for Coke, Tupperware, Buckle and Disney?"

JEFF FISCHER:

Great. So, Coca-Cola and Disney are two live trade recommendations in *Motley Fool Options*, our sister service. We have recommended buying calls on both Coca-Cola and on Disney — so go to the Options service to see that advice. You can just go to the *Motley Fool Options* and put in the tickers and you'll get the trade alerts. Those are also trades you can make in the Friday Options Weekly Column.

Tupperware and Buckle are two PRO positions. We are writing puts on Buckle. They come due in December and we'll probably be writing new ones if an opportunity exists. And Tupperware, yes. We are looking at writing new puts and perhaps very soon. That should be a trade alert in your Inbox as soon as it's ready. So, just watch that. Bryan, let's see…

BRYAN HINMON:

Uh, oh. I see your wheels spinning round…

JEFF FISCHER:

We had a question about DGS — Wisdom Tree Emerging Markets ETF — and then we'll have to wrap up with some closing thoughts. We only have eight minutes left. A new member asks, "This is your one international exposure investment…" that they see — direct international exposure — emerging markets he means. Is there a reason for that? And what is our thought about international investing and how PRO accesses that?

BRYAN HINMON:

Well, excellent foresight. There is a blurb in today's Monday Memo which is going to come out shortly about DGS, so be sure to read it. It's written very well.

JEFF FISCHER:

It is. You did a good job, Bryan.

BRYAN HINMON:

More seriously. More seriously. You know, what's surprising or may be surprising to people is … I'm going to get the number wrong, but I'm not off by an order of magnitude here … something like 60% of revenue from S&P 500 companies now comes from outside of the United States. So, the whole notion, I believe, of international investing is a little passé, at this point, because the bulk of companies of any size … they're international companies already. Their operations are incredibly diversified.

It almost means nothing, now, where a company is domiciled. What's far more important is where it's manufacturing its products and where it's selling its products. And so, when we think about diversification and we think about the risks we're taking on, we don't think about where a company is headquartered or in terms of trying to achieve some sort of allocation abroad or trying to achieve some allocation to the U.S. We think about it in terms of where the company is actually doing business.

JEFF FISCHER:

Right…

BRYAN HINMON:

So, true. Wisdom Tree Emerging Markets small cap dividend fund is our only — by name — international investment. We have companies that do the preponderance of their business abroad. Graftek — the preponderance. Tupperware is something like 80%. Intel. So, most of our companies, honestly, are multinational companies that somewhere between 40% and 60% of their revenues come from abroad. It's honestly the rare company that is U.S. centric — a company like The Buckle who only has retail locations in the United States.

JEFF FISCHER:

Right. Even Papa John's Pizza, which is actually called Papa John's International, has all kinds of room to grow overseas. So, that is how we think about it. We look at each company and where they're selling and the PRO portfolio is diversified around the world by that measure.

And I think, Bryan, it also brings up … I just read today an article about how the market is valued to GNP — the Gross National Product here in this country — the market looks a little expensive compared to that … but that needs to take into account now that more than 60% of earnings come from around the world, so you have to look at world GDP or whatever the term would be. You have to look at the whole worldwide productivity…

BRYAN HINMON:

Absolutely. Our companies benefit from growth around the world.

JEFF FISCHER:

And we love to own U.S.-based companies for a few reasons, when they are international, because we know their market. We know them better. We know how the SEC treats them. We know their disclosure rules. Historically, U.S. companies the past many decades have actually outperformed emerging markets and international companies. And a study many people have heard of by now is that developed markets outperform emerging markets because they get a higher value multiple because there's more certainty there. So, we love owning developed companies that are expanding greatly, like Starbucks, in emerging markets. It's the best of both worlds.

That said, we like DGS, too. It's rated a "Buy" right now. It's a high-yield, small-cap diversified ETF in emerging markets around the world. It's rated "Buy" and we're writing put options on it to potentially buy more, so it's paying us income, as well. So, check that out and get onboard with that purchase.

BRYAN HINMON:

And one of the commonly-cited reasons that people put some assets in international markets is that historically the correlation with U.S. markets has tended to be lower. Stepping back really quick — what we're talking about here is if the U.S. markets are zigging — to add a little buffer to your portfolio. You can find things that move in a slightly different zig and zag direction, and it will dampen the volatility of your portfolio. So, people have turned to international investing as a way to, maybe as the U.S. market is declining, find an investment that will go in the opposite direction.

Unfortunately what we've seen over the past decade is those correlations have gotten much, much, much closer and so the benefit of investing abroad, at the expense of investing in the United States, has really been whittled away. We like that idea though, of finding a diversifier for the portfolio, and so one of the ways we found that you can still do that, where the correlation differential has really held up, is by going into small caps in emerging markets. So, that's part of the reason that we chose to go that route.

JEFF FISCHER:

So, be sure to check out DGS. Again, if you go to the PRO site or you're already there, enter DGS in the right-hand corner ticker box and you'll get the original alert … but you'll also get it … and we have to wrap up now … you'll get it in the portfolio-building report. It's summarized right there for you.

So, members. Thank you for joining PRO. It's an exciting time in the service. You're joining at a great time, new members, and I think veterans are here at a great time because the past five years of work have really led to the core positions that we own right now and we see great things in those companies.

Now we're starting to look to build out our short portfolio, which we haven't seen a need to have much need for, for the last five years — but we're going to want to add more shorts and that's going to be a big focus in 2014, assuming we see the need for it. Meanwhile, we love what we own. We look forward to adding more to the positions that we own and really making money over time with these stocks that are, I think, 1 in 10,000 … each one of these are. They're really high-quality companies.

So, remember to go to your PRO guidebook on the PRO site. That has everything you need to get started including your portfolio-building reports. Then take your time building your portfolio with us. Ask your questions. Move into positions gradually as you're ready. There's no rush. Watch for options and shorting educational content and then trades alongside that in the coming weeks.

And then we're here to help you on the discussion boards. One good board that we'll always go to is the Getting Starting and Help board. We'll be there to help new members, especially. And we're looking forward to a great 2014 with you and more returns beyond that time. Bryan, thank you. Do you have any closing thoughts?

BRYAN HINMON:

Jeff, I can't add too much on top of that, so I'll just use this opportunity to say thank you to our great team who answered questions on the live chat. Say thank you to our existing members who have been wonderfully welcoming on the boards to new members. And say thank you to new members and old members alike for putting your trust in the PRO Team. All I can say is we'll work hard for you. We'll keep on keeping on.

JEFF FISCHER:

Exactly right. Well said, Bryan. Thank you again, everybody. Thank you for taking this first step with PRO, new members, and we look forward to the next step and the one after that. Fool on! Have a great Thanksgiving holiday.

Portfolio Building Report

Published Nov 20, 2013 at 12:00PM

AmTrust Financial Services (NASDAQ: AFSI) | **Apple** (NASDAQ: AAPL) | **Broadridge Financial Solutions** (NYSE: BR)
The Buckle (NYSE: BKE) | **Gentex** (NASDAQ: GNTX) | **Intel** (NASDAQ: INTC) | **MasterCard** (NYSE: MA) | **OpenText** (NASDAQ: OTEX)
Oracle (NYSE: ORCL) | **Papa John's International** (NASDAQ: PZZA) | **Starbucks** (NASDAQ: SBUX) | **Wells Fargo** (NYSE: WFC)
WisdomTree Emerging Markets SmallCap Dividend Fund (NYSEMKT: DGS) | **The *Pro* Bottom Line**

Download this report as a PDF

Dear *Pro* Member,

The way we manage *Pro* is pretty simple: We own a portfolio of investments that we expect to earn healthy positive returns over every rolling three-year period, so we can double our real purchasing power (that's after inflation) every 10 years. We own strong stocks and promising ETFs; we hedge to protect gains; we "sell short" to profit on falling prices; and we use options strategically and for income. Whether you use all of our strategies or just own *Pro* stocks, our mission is to earn you strong returns over our time frame. That's likely the prime reason you're here. Not all of our investment decisions will be right, and we won't always come close to our constantly positive North Star goal, but with a firmly plotted course, a stellar crew of analysts, and our wonderful community, we expect to stay firmly on track and enjoy the journey together — and to come out far ahead.

In our Most Recent Buys report last week, we highlighted our latest portfolio additions. Although those holdings may be our newest, shiniest toys, their true value is only apparent as a part of our larger portfolio puzzle. To complete that puzzle and execute our mission, we present to you this Portfolio Building Report, which summarizes our remaining Buy First and Buy positions.

Here are a few things to consider along the way:

- **Don't anchor on fair value.** We expect every investment we rate Buy First or Buy to play a role in helping us achieve the return goal stated in our mission. Yes, that's true even if the current stock price is a touch higher than our estimate of fair value! For one thing, our fair-value estimate is an imprecise figure, and for another, a "fair value" is really a range of values, one that doesn't take into consideration the holding's part in the portfolio puzzle.
- **Where to look first.** The reason we distinguish between Buy First and Buy is simple: We want to draw attention to our most compelling return opportunities at the moment for those members with limited capital available, or for those who don't follow the Pro portfolio step-for-step. Our decisions, however, are made in the context of all of the pieces of the portfolio puzzle, working in concert toward our mission.

- **What about Tupperware?** In October, we recommended writing puts on **Tupperware Brands** (NYSE: TUP). Those puts expired in November; some members may own shares (around 3%) as a result of that position or of our Alternative Trade recommendation. Although Pro has no official position in Tupperware right now, we will likely have an official follow-up recommendation soon. New members should hang tight and wait for the Trade Alert.
- **Say hello.** If you haven't already, please introduce yourself on our Meet & Greet discussion board. More than anything else, it's Pro's community that differentiates us from every other investing service in the world. Stop by, say hi, and carpool with the other intrepid members on this journey with us.

Onward,
— Bryan Hinmon, CFA, senior analyst

Buy: AmTrust Financial Services

Its talent at capitalizing on human laziness is just part of what we love about this insurer.

Suggested Allocation: 6.9%

What It Does

At *Pro*, we speak a lot about the importance and power of recurring revenue — mostly because we know that humans are inherently lazy. Insurance purveyor **AmTrust Financial Services** (NASDAQ: AFSI) handily proves this point for us; many of the policies it writes (more than 80% in most lines!) renew at the end of their term without their owners even shopping for a better rate. Most of us, it seems, are guilty of preferring inertia to bargain-hunting, and AmTrust and its fellow insurers are the beneficiaries.

AmTrust focuses on insurance niches (primarily workers' compensation and product warranties) that are low-hazard and generally too small for large insurance companies to care about. But though AmTrust writes small policies, it's no small fry. Its high renewal rates and predictable cash flows allow it to focus on writing new policies, look for struggling insurers to acquire, and hunt for obscure investment opportunities.

How It's Working

AmTrust's strategy — being a disciplined underwriter of low-hazard, small policies in well-defined niches; using technology to keep its expenses low; and opportunistically acquiring policies other insurers struggle to find profitable — has resulted in impressive growth. Gross written premiums have risen from about $1.1 billion to about $3 billion over the past five years, and this increase, combined with a laser-like focus on low expenses, has resulted in consistent growth in earnings, dividends, and book value.

What We Expect

More Resources

- *Pro*'s recommendation history
- Talk about AmTrust on our discussion board

The insurance market works in cycles, and recent signs indicate an upswing on the horizon, which means pricing and profit should improve across the board. AmTrust should thrive in a strengthening market: It can charge as much as its competitors and make more in profits thanks to its lower expense structure, or it can undercut the competition on price in a bid to take market share. If the economy continues to improve, the small businesses AmTrust insures should hire more workers and consumers should purchase more insurable goods, so there seems to be plenty of growth ahead.

AmTrust has consistently traded higher than our estimate of fair value, but we believe the company's premium valuation is warranted given the consistency of its growth, quality, and profitability. AmTrust is *Pro*'s largest holding, and we're happy to let this winner run, expecting to increase our fair-value estimate over time.

Buy First: Apple

The leader in mobile computing products is cheaper than it's been in years.

Suggested Allocation: 3.5%

What It Does

Led by its iPhone and iPad, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the Apple operating system, which centers on its iTunes and App Store marketplaces. Apps turn a piece of hardware into a personalized, go-anywhere computer that becomes ingrained into the user's daily life.

The company's uniquely integrated hardware and software have made for a great consumer experience that provides disincentives to switch to a competitor. Apple will have to fight harder to win new customers as competitors close the quality gap, but we maintain that it remains one of the best companies in the world, with the best products in its class, and it has one of the least expensive stocks among large caps.

How It's Working

Apple refreshed all of its product lines over the past 12 months, with the iPhone 5S achieving record debut sales and brand-new iPad models reportedly selling like hotcakes (literally, they're so thin). The iPad may set new sales records, too, this holiday quarter. This year's product refreshes show that Apple has not lost its touch and is not chasing the lower-priced market, instead aiming to protect profit margins. We like this choice. We also like that Apple is taking time to debut a new product category, which it hints it may do in 2014. Whether it's a TV, watch, or something else, Apple needs to get the product right and should take its time. It remains the most cash-rich company on earth, and generates tens of billions of new free cash flow every year.

More Resources

- *Pro*'s original recommendation (2/14/12)
- Talk about Apple on our discussion board

What We Expect

In the longer term, we expect more great innovations from Apple, including whole new product categories. Meanwhile, we believe customer loyalty will drive healthy recurring sales, and new customers, new market expansion, and product refreshes will fertilize stability and growth. The stock is too inexpensive for such a high-quality company at the very heart of the mobile computing revolution.

Buy: Broadridge Financial Solutions

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 4.0%

What It Does

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in 2013, its platforms processed 85% of all shares in the U.S. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider to manage investor communications.

The company's smaller segment, securities processing solutions, accounts for 27% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

How It's Working

Both earnings and free cash flow are modestly depressed because mutual funds have been scrimping on investor communications recently and investor skepticism around the global economic recovery has led to low trading volume. Still, in fiscal 2013 Broadridge grew sales 6%, grew earnings 11%, raised its dividend by 17%, and continued to position its business for strong sales and margin performance for years to come. And Broadridge continues to serve its customers masterfully; its 99% retention rate sets the stage for recurring revenue (and deepening relationships) in future years.

What We Expect

More Resources

- *Pro*'s original recommendation (4/27/10)
- Talk about Broadridge on our discussion board

We think Broadridge will continue to write the e-book on electronic investor communications. Its dominance of this market should strengthen its competitive advantages, making it indispensable as transparency in the financial system increases. We also expect banks and brokerages to continue outsourcing their non-core operations to save money and increase flexibility; this should bring increased business and greater efficiency to Broadridge. We expect modest sales growth to translate to earnings growth around 10%. Much of Broadridge's revenue is recurring, making its sales and earnings growth highly reliable, and its impressive free cash flow will likely bring an ever-higher dividend and increased share buybacks.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy: The Buckle

This well-managed retailer has fit into its jeans admirably over the past decade.

Suggested Allocation: 3.0%

What It Does

The Buckle (NYSE: BKE) sells jeans, other apparel, and accessories at 452 retail locations across the United States, and we think the fantastic management team has figured out a formula that works: measured growth, middle-of-the-road merchandising, and great service.

Your *Pro* team doesn't know much about fashion, but we can read financial statements. And if the next decade of business performance by specialty retailer **The Buckle** (NYSE: BKE) looks anything like the last one, we'd be willing to wear whatever getup the company suggests. The store concept is in the middle of its life cycle, and the company's financial prudence and operational acumen should lead to a growing stream of free cash flow, dividends, and extra payouts — all of which can help the *Pro* portfolio in our pursuit of our North Star.

How It's Working

The Buckle is a surprisingly steady operator in the notoriously fickle specialty retail space. The company reported modest same-store sales growth of 2.1% last year and has notched another 2.2% gain through two quarters so far this year. We accept a degree of lumpiness here and don't get too bent out of shape when these numbers bop around — The Buckle's target demographic is fickle teens and twentysomethings, after all. We simply monitor these figures for clues about the overall shopping experience and brand relevance. Management's stellar performance has earned getting the benefit of the doubt:

Metric	2002	2012	Annual Growth
Stores	304	436	3.7%
Sales per Store	$1,339	$2,387	6.0%
FCF per Store	$57	$406	21.6%
Sales per Square Foot	$274	$475	6.0%
Inventory Turnover	4.7x	6.0x	3.0%

Dollars in thousands. Per-store calculations based on average stores open during the period. Sources: SEC filings, S&P Capital IQ, analyst estimates.

What We Expect

More Resources

- [*Pro*'s original recommendation] (6/20/12)
- [Talk about The Buckle on our discussion board]

With 452 stores at the end of fiscal second-quarter 2013, we believe The Buckle has plenty of room to grow as it expands from the middle of the country to both coasts; it should be able to achieve wonderful store economics with the 650 to 850 locations we ultimately expect. Recent expansion into footwear, accessories, and children's offerings should provide enough fuel to keep same-store sales healthy, while the company's commitment to customer service entices repeat visits.

The Buckle also has a history of paying special dividends with its excess cash; it's done so for six of the past seven years. Just last December, *Pro* members holding the stock received a $4.50-per-share payout from the company in addition to the regular $0.20 dividend. Naturally, we encouraged all members to celebrate by buying themselves and their loved ones a few new pairs of jeans. While we can't count on special dividends, the average yield over the past six years, including special dividend payouts, has been approaching North Star-level returns.

We're typically leery of the risks of investing in retail, especially fashion, but the proof is in the numbers for The Buckle.

Buy: Gentex

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 3.5%

What It Does

In 1982, a small company in Zeeland, Mich., called **Gentex** (NASDAQ: GNTX) made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands almost 90% of that market, and it sells eight times more units than its closest competitor.

How It's Working

In 2000, the company sold 6.8 million units; in 2012, it sold 23.8 million. That growth has been driven by an increased focus on safety, higher car sales, and greater market penetration (more car makers offering Gentex mirrors as a trim option). Gentex has turned these market dynamics into wonderful financial performance. Revenue has risen by nearly 20% per year since 1987, and over the past decade, the company's net margins have bounced around the mid-teens. Those numbers are shockingly good for an auto-parts supplier, showing that its fancy mirrors are showing up in more and more new cars.

What We Expect

More Resources

- [*Pro*'s original recommendation] (5/29/12)
- [Talk about Gentex on our discussion board]

Currently, fewer than one in every four cars made worldwide has an auto-dimming rearview mirror, and only 6% have auto-dimming exterior mirrors. For context, prior to 1987 those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher penetration; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror, both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy: Intel

Rumors of the PC's death have been greatly exaggerated.

Suggested Allocation: 4.6%

What It Does

Intel's (NASDAQ: INTC) goal is to be "the preeminent computing solutions company that powers the worldwide digital economy." Whether it's a high-speed server for a data center, a new Ultrabook with a touchscreen and detachable tablet, a new smartphone, a tablet, a car, or just about anything else: Now more than ever, Intel has the computing technology to drive it.

Admittedly, the company was late to the smartphone and tablet markets, but there's a silver lining: As these devices eat into PC sales, investors' fear about Intel's tardiness brings us the value opportunity we see in the stock. And because smartphones and tablets have very short life cycles, Intel can catch up quickly by steadily inserting its technology into new product designs.

How It's Doing

Intel asserts that the tablet is broadening the PC market, not shrinking it, and we agree. Tablets are wonderful for what they are, but it seems likely that the PCs of tomorrow will have the best qualities of both a tablet and a PC. If not, people will continue to need tablets for some uses, and PCs for others (which is fine with us, too!). Intel's new Atom chips are making their way into an increasing number of new tablets and smartphones – and Intel's chips continue to power the vast majority of all PCs, in whatever form they take. High-powered servers are also selling in record numbers as the cloud is built.

More Resources

- *Pro*'s recommendation history
- Talk about Intel on our discussion board

Intel is investing for greater growth in computing devices, period, whatever shape they take. Wall Street is leery of the company's expensive capital investment plans, designed to maintain its leading-edge manufacturing abilities, but we view this spending as a strong indicator for the company's future. Intel's confidence in the future of microprocessors seems well-placed in our increasingly digital age; as the number of devices connecting to the Web grows exponentially, so does the need for more computing power.

What We Expect

Historically, buying true blue chips (Coca-Cola, Johnson & Johnson, IBM …) when they're out of favor has been an excellent investment strategy. We believe Intel will fit that bill, too. Eventually, we believe Wall Street will realize Intel is here to stay -- and is indeed at the heart of a worldwide computing revolution. When that happens, investors will start to price the stock at a valuation that at least matches,if not exceeds, the market average. In the meantime, we can buy it at a good discount and enjoy a 3.7% yield, too.

Buy: MasterCard

Plastic is overtaking paper as the world's way to pay, and MasterCard leads the charge.

Suggested Allocation: 4.8%

What It Does

MasterCard (NYSE: MA) is among the most attractive businesses in the world. Here's why: The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders, who are actually exposed to the card users' finances; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

Though MasterCard competes with a very large number of well-heeled and (in some cases) innovative businesses, the company's profitability is growing quickly even though the global economy isn't. And that makes perfect sense, because when it comes to paying for stuff, the global market leader isn't **Visa** (NYSE: V), or PayPal, or banks ... it's cash. While MasterCard's stock price has risen since we recommended buying in September 2011, our thesis remains intact: Cash has a still-astounding 85% market share of transactions, but it's slow and inefficient, and with no one managing its brand, it's quickly losing out to better alternatives.

How It's Doing

More Resources

- *Pro*'s original recommendation (9/8/11)
- Talk about MasterCard on our discussion board

This trend has already taken hold in the U.S., where we use cards for a third of our personal expenditures, so Americans often underestimate the opportunities — domestically and especially in developing nations. In the first nine months of 2013, MasterCard processed $2.1 trillion in purchase volume, $1.4 trillion of which came from outside the United States. Growth in its U.S. business was 7%, strongly outpacing our economy (as measured by GDP). And worldwide growth, excluding the U.S., clocked in at a tremendous 15.4% in local currencies. Cash is losing, and fast, but there's a long way to go — and a lot of opportunity for MasterCard.

What We Expect

Management recently confirmed guidance for continued 11% to 14% compounded annual revenue growth and 20% earnings-per-share growth through 2015. We think this is possible under current (difficult) conditions, and we expect even better if economies around the world can turn the corner. CEO Ajay Banga and team are doing a tremendous job moving the company forward, so much so that results have outpaced our expectations every quarter since we bought shares. We expect MasterCard will continue to surprise the world with its strong growth for years to come.

Buy: OpenText

This company's information management software keeps the digital lives of businesses in order.

Suggested Allocation: 3.1%

What It Does

OpenText (NASDAQ: OTEX) sells software that lets companies organize and manage their growing reams of electronic content. Its products help companies, governments, universities, and others operate more efficiently and effectively, meet compliance requirements, and communicate with colleagues, customers, and partners.

OpenText is the leading independent provider of solutions in the enterprise content management (ECM) market and a leader in the broader enterprise information management (EIM) industry. Its top competitor, **IBM** (NYSE: IBM), may be larger, but OpenText enjoys longstanding sales relationships with **Microsoft** (NASDAQ: MSFT), **Oracle** (NYSE: ORCL), and **SAP** (NYSE: SAP).

With its newly planned acquisition of privately held GXS Group for $1.1 billion, OpenText is also positioned to become the largest provider of business-to-business transactions in the world, ahead of IBM. This should lead to strong recurring, high margin, transactional revenue, and more customers to whom to cross-sell.

How It's Doing

More Resources

- *Pro*'s original recommendation (8/31/11)
- Talk about OpenText on our discussion board

OpenText has increased sales and cash from operations by more than 14% annualized over the past three years, and seeks to continue to grow by at least 10% annualized as its industry expands. Trading at 14.5 times free cash flow, the business is attractively priced to increase shareholder value by at least its annualized cash-flow growth rate.

What We Expect

Electronic content management industries served by OpenText should increase top-line demand by at least 10% annualized over the next several years, and OpenText should take market share, too. OpenText has a long history of steady growth through acquisition, and enjoys diversified software sales to multiple industries. With new products rolling out in cloud services (off-site servers), renewed sales execution through more distribution channels, exciting acquisitions in the works, and an intense focus on its financial performance, this medium-sized company looks to have a big future.

Buy First: Oracle

This old-guard tech giant has more room to grow.

Suggested Allocation: 4.4%

What It Does

Oracle (NYSE: ORCL) is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems** (NASDAQ: CSCO), **Dell** (NASDAQ: DELL), and **Microsoft** (NASDAQ: MSFT) — Oracle's stock price has steadily risen as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe. And when it comes to hardware, Oracle's own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

By combining its software expertise (both in the traditional sense and in the cloud) with its young hardware business, Oracle is poised to experience another period of growth. The business is incredibly sticky — companies don't trust their data to just anyone, and it can be tricky and even risky to make a switch. So to add to its revenue base, Oracle mainly needs to cross-sell new products to existing clients, while continuing to rope in new clients with its great breadth of modular software solutions.

How It's Doing

Leading software sellers can write a program once and sell millions of copies, then provide small but critical updates on a regular basis. These updates drive a subscription business model, which leads to recurring revenue. Most of Oracle's customers renew annual software contracts that represent more than 40% of its revenue. This is stability on which Oracle can grow.

Where is it looking to grow? Oracle is targeting new cloud software sales, software as a service (SaaS), and groundbreaking data hardware sales — and we're pleased with its progress to date and the prospects of all three.

More Resources

- *Pro*'s original recommendation (9/17/09)
- Talk about Oracle on our discussion board

In the fiscal year 2013 that ended May 31, Oracle's new software sales topped a record $10 billion, up 6% in constant currency. Non-GAAP earnings per share rose 11% to $2.68, non-GAAP operating margin hit an all-time high of 47%, and free cash flow hit a record $13.6 billion.

What We Expect

Wall Street loves growth, but it especially loves growth that comes with higher margins. Oracle trades at 11.4 times free cash flow, well below the S&P 500's average in the mid-teens. With management expecting more operating leverage ahead and growth in hardware sales, the stock should produce a North Star-topping, 10%-plus annualized return over the coming three years. We expect the company's hardware and modular software combinations to continue to create a clear value proposition, driving new sales. We also expect Oracle's transition into more SaaS and cloud sales to go smoothly. With 390,000 customers, including all 100 of the Fortune 100, Oracle is the company we admire most and want to own in the enterprise software market.

Buy: Papa John's International

Deliver a slice of the profit pie right to your doorstep.

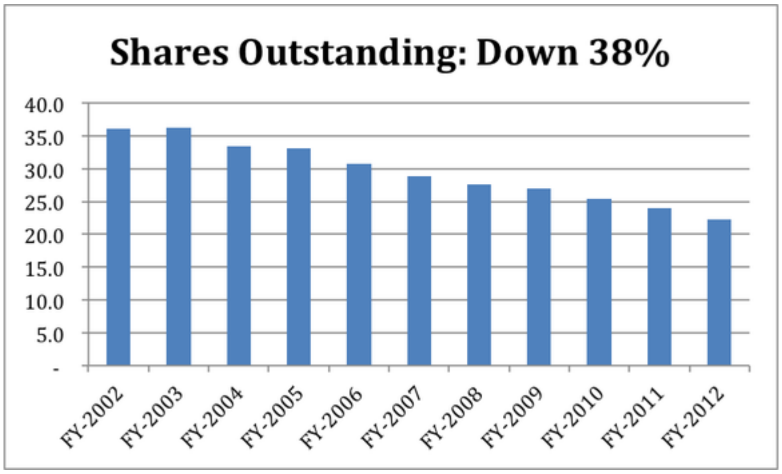
Suggested Allocation: 3.7%

What It Does

Papa John's International (NASDAQ: PZZA) operates and franchises more than 4,000 pick-up and carry-out pizza joints in more than 35 countries. For the past 30-plus years, Papa John's has been making pizza and building its brand around the "Better ingredients, better pizza" tagline. Bringing that unwavering focus to each pie has resulted in the company's perceived quality advantage over its big-chain pizza competitors, which allows it to consistently price a dollar or two higher and attract the best franchisees. Now that its brand advantage is sufficiently established in North America, Papa John's is turning its sights abroad, believing that delicious American pizza is a language every taste bud speaks.

How It's Working

As sure as a fresh pizza will be gobbled up by hungry kids, Papa John's delivers results. For nine consecutive years, the company has recorded positive or even North American comparable-store sales growth. Recently, international comps have been in the 7% range, offering lip-smacking evidence that Papa John's flavors travel well. It has opened more than 230 restaurants in both of the past two years, a pace which should continue. And because Papa John's is primarily a franchisor, it doesn't have to bear the cost of that expansion (it is taken on by the franchisees). Competing for a share of the global appetite is tough business, but Papa John's has been able to increase sales and profits at commendable rates over the past decade, which has resulted in plenty of cash generation. Management recently initiated a dividend and has consistently bought back stock over the years.



Source: S&P Capital IQ. Shares in millions.

What We Expect

More Resources

- [Pro's most recent update (10/18/13)]
- [Talk about Papa John's International on our discussion board]

We believe the company will maintain its brand positioning, modestly improve underperforming franchise locations, and continue to be an attractive entrepreneurial outlet for new franchisees abroad. We think the brand can easily support 6,600 worldwide locations by 2023. The company should also be able to take modest market share from mom-and-pop pizza shops in established markets as digital ordering continues to gain adoption; it's a tough hurdle for smaller players to overcome. With a little bit of menu innovation and new markets maturing, we believe 2% same-store growth is sustainable over this period. We rate shares a Buy and encourage members to do plenty of field research on this one.

Buy: Starbucks

You only think you go for the coffee — Howard Schultz & Co. are serving up an experience.

Suggested Allocation: 3.4%

What It Does

You may not realize it, but "**Starbucks**" (NASDAQ: SBUX) is no longer a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense it's just a front. We think we go to Starbucks for the coffee, but those little white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

Starbucks began opening America's eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 19,700 stores in 60-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences to fill more than 70 million mouths and hearts each week.

How It's Working

By placing the customer experience first, Starbucks has cemented its role in the daily lives of consumers worldwide. People demand their Starbucks products at home, too, which has allowed the company to build out a consumer packaged-goods division that sells more than $1 billion worth of products in more than 100,000 locations worldwide. And the company is cultivating a portfolio of other brands (Evolution Fresh juices, Teavana tea bars, La Boulange bakeries) whose products can be sold in Starbucks stores and grocery stores alike. Between coffee, health foods, and tea, Starbucks believes its end markets are a massive $140 billion and growing.

Recent results have been robust. Starbucks continues to add stores at a rapid clip, and its same-store sales have been growing by an astounding 7% per year. Earnings and cash-flow performance have increased even faster, and all of this growth has been achieved by doubling down on the in-store experience and refocusing on quality. Starbucks constantly seems to be setting new records for sales, operating profits, and earnings.

What We Expect

More Resources

- [*Pro*'s original recommendation](#) (8/22/12)
- [Talk about Starbucks on our discussion board](#)

Given its very recognizable brand, artfully crafted business, and fanatically loyal customers, we expect Starbucks' diversified growth to continue. We believe the world's coffee and tea drinkers will happily support 30,000 or so stores across the company's various brands, and that products bearing the aspirational Starbucks brand will expand the company's real estate on grocery-store shelves.

The company's scale and its ability to raise prices should help profits, as will its unique advantages in low-cost marketing. Starbucks is a pioneer in social marketing, and is perhaps better positioned than any other brand to reach out to its customers, nurture their relationship with the company, offer deals, and customize experiences.

Starbucks is riding high since CEO Howard Schultz's return to power in 2008, and it now has so many levers to pull that capturing its potential value in a spreadsheet is very difficult. We're not worried that shares trade higher than our fair-value estimate; we think Schultz & Co. have many tricks up their sleeves that will allow Starbucks to grow into and beyond its current valuation, and we want to be along for the caffeinated ride.

Buy: Wells Fargo (WFC)

At heart, banks are simple businesses, and Wells Fargo is the best of the breed.

Suggested Allocation: 2.7%

What It Does

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** (NYSE: WFC) is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 9,000 branches and 12,000 ATMs. It's the fourth-largest bank in America, it's consistently No. 1 in customer satisfaction for American large banks, and it's the leader in mortgage and small-business lending.

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During tough lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

How It's Doing

CEO John Stumpf and team are truly the best of the breed. Return on assets and equity for the most recent quarter (Q3 2013) were very attractive, at 1.5% and 14% respectively — great results given that the bank is using less leverage than before the financial crisis. Total revenue growth has been elusive, but expense reductions and improvements in credit quality have driven quarter after quarter of earnings growth, leading to record earnings. Deposit growth has been tremendous, and as Wells Fargo grabs additional "wallet share," fee income increases as well. The credit quality of the loan portfolio is impressive and is continuing to improve. All of this has contributed to a very well-capitalized balance sheet, allowing Wells Fargo to comply with upcoming capital regulation requirements well ahead of schedule.

What We Expect

More Resources

- [*Pro*'s original recommendation](#) (12/10/10)
- [Talk about Wells Fargo on our discussion board](#)

Wells Fargo's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. In the current low-interest-rate environment, we should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But when the U.S. economy firms up and loan demand resumes picks up, Wells Fargo's real earnings power — bolstered by growth in fee-based revenue — will hit its full stride. And many customers who start a deposit account or mortgage with Wells Fargo will explore the company's offerings in other areas, too.

Shares are trading at less than fair value, and they yield a growing 2.8% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. *Pro* has also used options in the past to generate even more income from this position, so try to invest using round, 100-share lots if it keeps you within half a percent (plus or minus) of our 2.7% allocation. If that's not feasible for you, share ownership alone is fine, too; with its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund

Diversification with some of the best small companies you've never heard of.

Suggested Allocation: 1.9%

What It Does

At *Pro*, we would love to invest in emerging-market small caps if it were easily accomplished and we could diversify. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS).

This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields about 3.5%). For *Pro*, it offers exposure to 521 of the most promising business we've never heard of.

This ETF gives us an excellent way to invest in unfamiliar companies in locations where we don't have a discernible edge — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The risk-reducing benefits of investing outside our home market are equally important.

How It's Doing

It’s no surprise that small-cap companies (even dividend-paying ones) in emerging markets can be volatile. We expect DGS itself to continue to experience higher-than-average volatility, even though the diversification it brings to our holdings will likely lower the portfolio’s volatility overall.

More Resources

- *Pro*’s original recommendation (11/22/10)
- Talk about DGS on our discussion board

We’d always prefer to own great businesses over great ETFs, so this holding has a permanent spot on our short list of positions we’d sell if we needed cash or found a higher-conviction alternative. In the meantime, for a reasonable 0.64% expense ratio, we get a basket of businesses with a history of exceptional performance, weighted by the size of their annual cash dividend. The fund’s heavy weighting toward financials (23%), industrials (16%), and the consumer discretionary sector (14%) leaves it well positioned to benefit from an economic recovery if and when one comes along.

What We Expect

This is a top-notch fund, and you don’t have to take our word for it; Morningstar has bestowed its coveted five-star rating on DGS. It’s also made Morningstar’s list of the top eight funds in its category in each of the past three years, and it’s ranked No. 2 when considering five-year performance. We expect these impressive long-term results to continue. In the meantime, the watchword with small-caps, emerging markets, and this ETF is: patience.

The *Pro* Bottom Line

Once you’ve purchased our most recent buys, and the Buy First and Buy stocks in this report, you will be on your way to building your *Pro* portfolio with us! If you want to start slowly and average in, that is a Foolish approach, too. Some members buy positions in halves, or thirds, over several months. Just be sure, over time, to at least approximate our allocation guidance, since that’s key to our portfolio approach. In the coming weeks and months, we will also lead you into *Pro* shorts and options (for members using those strategies with us) with real-time opportunities. Just watch your inbox for trade guidance.

Welcome again to *Pro*! We’ll enjoy investing with you. Fool on!

— Jeff Fischer, advisor

See Pro*’s holdings here. See the team’s and David and Tom Gardner’s holdings here.*

RockyTopBob's Guide to Pro

Published Nov 18, 2013 at 4:00PM

For just the second time this year, we're welcoming new members to Pro *— and we're very pleased to be able to do so by sharing the perspective of a seasoned* Pro *member, RockyTopBob. Bob starred in a column over the summer that we thought was so good, it's worth passing along a second time. Today, we — and Bob — happily welcome all of our new* Pro *Fools! Enjoy ... — Jeff Fischer*

Fellow Fools,

At certain Metro stations in downtown Washington, D.C., just over the river from Fool HQ, there are "ambassadors" who hand maps to tourists as they step off the escalators. Those maps will help you find the Smithsonian museums, the local brewpubs, and Ripley's Believe It or Not — all of which are absolutely worth seeing. But if you want to know where to find a great cheap burger, small music venue, or low-key karaoke joint, your best bet is to ask a local. (For the record, our nominations for all three in D.C. are at the end of this Memo.)

Pro isn't exactly like D.C.; we weren't designed by Pierre L'Enfant, and we proudly answer to exactly zero lobbyists. But we opened our doors to new members for two days last week, and we think that — like the nation's capital — we're best explained to first-time visitors by a longtime resident. Nobody fits that bill better than RockyTopBob, the community-chosen winner of our inaugural *Pro* Polaris Award. A Fool since 2005, Bob joined *Pro* in January 2011, and he's distinguished himself time and again with his honest, thoughtful, endlessly helpful answers to other members' questions on our discussion boards.

We thought his insights deserved a broader platform, so in today's Memo, we've asked Bob to share his tips for putting your *Pro* membership to best use. We hope they'll serve as an insider's guide for new members and veterans alike.

Without further ado, a Q-and-A with RockyTopBob:

***Pro*: What are the first three places on the *Pro* website to which you would point a newcomer?**

RockyTopBob: No. 1, obviously, is the wonderful Guidebook tab, and I would recommend reading every link under the "Site Directory" tab (starting with "Meet the Team"). No. 2 is the Community tab, with a quick run-though of the available boards, followed by a post to the Meet & Greet board to introduce yourself. No. 3 would be the Recommendations tab, to review the *Pro* positions, namely Buy Firsts and Buys, and What We Think Now.

***Pro*: What are the first few pieces of advice you'd give to someone upon joining *Pro*?**

RockyTopBob:

1. Don't be in a hurry to trade anything.
2. Learn the ropes first by getting acquainted with the site's contents and *Pro*'s philosophy.
3. Read the Broker Data link in the Guidebook to determine if you are with the best one for you, and then set up your options missions.
4. Participate on the discussion boards to learn about the team and members and take advantage of all the information available there.
5. Pay attention to the Portfolio Building Reports and ask questions on the discussion boards if you don't understand the trades or the reason behind the position [click the "heart" above any board to make it a favorite, making it easy to return to].

***Pro*: What's the best advice you'd give to someone unsure if *Pro* is a fit for them?**

RockyTopBob: Post your concerns to the boards and ask other members what makes *Pro* a fit for them.

***Pro*: You are a past and present member of several TMF services — what do you think distinguishes *Pro* from other Fool offerings?**

RockyTopBob: The investment options, which go above and beyond long stocks, and the quality of the *Pro* team, especially their communication with members and willingness to answer all questions. A managed portfolio is a great advantage over a suggestions service.

RTB: The FAQ

Tennessee resident **RockyTopBob** spent his career in the space program, retiring early at 61 "because of some very good investment results." He's been investing for more than 40 years and loves everything about stocks, owning more than 200. He was born and raised in Chicago and still likes the Cubs! He and his wife and have two rescued golden retrievers and three ex-show Maine Coon cats.

To read more about the Polaris Award and Bob's formidable competition, click here. And finally, our favorite things in D.C.:

- Burger: BGR the Burger Joint / Elevation Burger (tie)
- Small music venue: Rock & Roll Hotel
- Hole-in-the-wall karaoke joint: Rock It Grill, Alexandria, Va. (reports of Fools being sighted there regularly are neither confirmed nor denied)

Whether you've just signed up or you've been with us since the beginning, thanks for being part of *Motley Fool Pro*. And thank you to RockyTopBob!

Best,

Ellen (TMFKabellen), *Pro* editor, and Jeff (TMFFischer), advisor

Pro Guidance Changes

- **American Tower** (NYSE: AMT) and **O'Reilly Automotive** (NASDAQ: ORLY): Both move to Buy First.
- **MasterCard** (NYSE: MA): Fair value and consider adding more both increased. MasterCard remains a Buy.
- **Medtronic** (NYSE: MDT): Shares move to Hold while we assess the stock (and other opportunities) after a strong advance. Get the full scoop.

Completed *Pro* Trades

- **SPDR S&P 500** (NYSEMKT: SPY) ETF: We bought to close all 11 of our November 2013 $170 calls, ending the short.

Pro November Expirations

- **American Tower** (NYSE: AMT): Our $72.50 puts expired as full income. We're eyeing new trades.
- **Tupperware** (NYSE: TUP): Our $85 puts expired as full income; we're eyeing new trades.
- **OpenText** (NASDAQ: OTEX): Our $65 puts expired as full income. We're... you know. Watch your inbox!
- **SPDR S&P 500** (NYSEMKT: SPY) ETF: Our long $164 puts expired without value.
- **iShares Russell 2000** (NYSEMKT: IWM) ETF: Our put ratio spread expired unneeded. We're considering new market hedges.

Coverage & Community

- To discuss the Monday Memo, please visit the Memo Musings board.
- New members are saying hello on the Meet & Greet board!
- With good stuff ahead, Jeff prepares *Pro* for 2014 and beyond.
- Senior analyst Bryan Hinmon (TMF42) reviews recent strong results from "buy" stock **Broadridge Financial** (NYSE: BR).
- Bull market getting old? We call hogwash on that tired statement.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Buy to Close Your Written Calls on SPY

Published Nov 13, 2013 at 3:30PM

Guidance Essentials

- **Action:** Prior to the closing bell on Friday, buy ("buy to close") all previously written November 2013 $170 calls on the **SPDR S&P 500** (NYSE: SPY) ETF. *Pro* is closing all 11 contracts. (If you have SPY puts, you can just let them expire. They have no value.)
- **Price Guidance:** You may close these liquid call options at the going price when you place your order.
- **Recent Share Price:** $177.60
- **Call Price (bid/ask):** $7.60/$7.70 (this isn't price guidance — it's just a quote; close at the going price to end your position)
- **Alternative Trades:**
  - **Did you just buy puts or set up a bear spread?**They're expiring without value.
  - **Are you short SPY directly?** To follow *Pro*, you would close your short now. If you'd rather remain hedged, SPY remains a good direct market hedge.

What's New?

The government shutdown has not seemed to dent most corporate earnings or fourth quarter guidance, and although the government may shut down again in early 2014, the near-term catalyst for our hedge no longer exists. We purposely set up this position to expire in just over one month, giving us the opportunity to reassess and then "start over" as we deem appropriate. As the environment keeps changing, that's exactly what we'll do.

Rather than roll our short call options to a later date (which wouldn't give us much of a hedge unless we also bought new puts), or let these written calls turn into a direct short of the ETF, we're going to close them and reassess with a clear slate. We're already considering other hedges, on SPY again or on other vehicles, and we will issue a trade alert once a decision is made. This hedge – as with so many hedges – proved unnecessary, but our portfolio is up considerably since we set it up.

Next Step

- If you have questions about buying to close your November 2013 $170 calls, or anything related to this position, please visit the SPDR S&P 500 board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here*.

Portfolio Building Reports for New Members

Published Nov 13, 2013 at 11:18AM

Building Your *Pro* Portfolio

To help you get started with a few positions at a time as you build up funds, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new *Pro* portfolio.

If you want to dive into our full set of holdings, you can see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our portfolio page's Recommended Allocation to help build your portfolio.

We recommend that you invest along with the reports in the order in which they are released, as they will contain our latest guidance and thinking on every stock in the *Pro* portfolio, and will make it a snap to match your portfolio to *Pro*'s.

Our Most Recent Buys (Nov. 13, 2013)

- View the HTML version
- Download the PDF

Portfolio Building Report (Nov. 20, 2013)

- View the HTML version
- Download the PDF

Portfolio Check-In Event (Nov. 25, 2013)

- Archived here!

Buy to Close Your Written Calls on SPY

Published Nov 13, 2013 at 12:00AM

Guidance Essentials

- **Action:** Prior to the closing bell on Friday, buy ("buy to close") all previously written November 2013 $170 calls on the **SPDR S&P 500** (NYSEMKT: SPY) ETF. *Pro* is closing all 11 contracts. (If you have SPY puts, you can just let them expire. They have no value.)
- **Price Guidance:** You may close these liquid call options at the going price when you place your order.
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Next Step

- If you have questions about buying to close your November 2013 $170 calls, or anything related to this position, please visit the SPDR S&P 500 board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here*.

Pro's Most Recent Buys: November 2013

Published Nov 12, 2013 at 6:01PM

Dear *Pro* Member,

Pro is a premier service at The Motley Fool not only because it's a portfolio service that incorporates options, shorts, and hedges alongside core stock investments — but because it is a full portfolio solution, period.

Thought goes into each part of the portfolio, the allocation we give to every position, and how the positions all work together. This means that every addition to the portfolio, including our most recent, serves a specific purpose. The following report outlines *Pro*'s five most recent stock purchases. These investments are our newest "core holdings" that we believe every *Pro* member should own; we believe they'll bring very healthy returns over the coming years.

Welcome to *Pro*!
— Jeff Fischer, Advisor

Getting Started With *Motley Fool Pro* | **American International Group** (NYSE: AIG) | **American Tower** (NYSE: AMT)
O'Reilly Automotive (NASDAQ: ORLY) | **TD Ameritrade** (NYSE: AMTD) | **Valmont Industries** (NYSE: VMI)

Download this report as a PDF

Getting Started With *Motley Fool Pro*

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that generates winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* Fit You.** We know not all investors are in the same situation! Our "Make *Pro* Fit You" PDF will help you figure out how to buy the Pro investments given your personal situation, including investing in an IRA or coming to Pro already fully invested.
3. **Catch up with our portfolio at your own pace.** Start with our most recent buys, delineated in this report. Then move on to the rest of our Buy and Buy First stocks in our Portfolio Building Report (hitting your inbox Nov. 20). You can always see our latest take on all of our positions on our What We Think Now page. As you explore our recommendations, it's important to remember that a stock's "scorecard status" (Buy First, Buy, or Hold) is the best indicator of how we feel about it. If a stock is listed as a Buy or Buy First on the What We Think Now page, that means we think you can buy it today.

Buy First: American Int'l Group (NYSE: AIG)

Time and even average performance should heal the company's wounds.

Suggested Allocation: 3.8% stock, 0.6% warrants

Today's **American International Group** (NYSE: AIG) is not the same company that disgraced itself so profoundly in 2008. AIG has divested itself of whole business units since the financial crisis, managing to eliminate almost all of its previous exposure to the nasty derivatives that nearly brought down the economy. Left behind are two steadfast and improving insurance businesses and an aircraft leasing company, and AIG plans to rid itself of the leasing business, too.

What It Does

Insurance is a business of collecting premiums, investing the float, and paying out claims — and AIG is getting ever better at it. Improved underwriting is showing up in a lower loss ratio, which in turn is driving a lower adjusted accident-year combined ratio. All that is a fancy way of saying that we're seeing underwriting profits for the first time since Q3 2010.

AIG's insurance offerings consist of two divisions: property and casualty, and life and retirement. The former provides casualty, property, financial, and specialty insurance (think aerospace) to commercial clients and consumers, typically through brokers. The life and retirement division offers domestic life insurance and retirement products (annuities, mutual funds, financial planning) through a diverse network of financial-services companies, brokers, agents, and advisors. Overall, AIG is writing fewer premiums at better prices than it was in past years, which is a great indication of underwriting discipline and a hardening market.

How It's Working

When we recommended buying AIG stock and warrants in August 2012, we were confident in the momentum of the company's turnaround, but we underestimated the rapid rate at which our thesis would unfold. In late 2012 (after our recommendation), the U.S. Treasury sold another $26.5 billion worth of its AIG shares. Management wisely used the opportunity to purchase billions of dollars' worth of stock at about half book value; that, of course, further increased book value in a virtuous cycle. Management continues to repurchase shares and has even instituted a dividend for the past two quarters.

For More

- *Pro*'s original recommendation (8/24/12)
- Talk about AIG

At Your Broker

- eTrade: AIG.WS
- Fidelity: AIG/WS (paste CUSPID 026874156 into the quote page)
- Interactive Brokers: Find AIG; select "warrants" from the drop-down menu
- optionsXpress: AIGwS
- Schwab: AIG/WS
- TD Ameritrade: AIG+
- Vanguard: AIG_t

Helpful Links

- AIG's explanation of the warrants
- AIG's warrant registration statement filed with the SEC

What We Expect

Underwriting discipline will continue to drive increased earnings and a higher valuation. That plus a renewed focus on capital management will improve AIG's credit rating, reducing its cost of debt and providing another lever for higher profitability. Management is still ridding the company of non-core assets, including the aircraft leasing business mentioned above. We expect CEO Bob Benmosche to stay laser-focused on capital allocation, repurchasing shares so long as AIG continues to trade meaningfully below book value and maintaining or increasing the quarterly dividend if business performance supports it.

The *Pro* Bottom Line

We recommend buying 3.8% of AIG stock and 0.6% of AIG warrants (see below for more on those). Benmosche has cleaned out the business, so by purchasing now, you get in after all the hard work has been done. Book value — the best measure of an insurance company's worth — is steadily growing. And AIG's current share price is just over 0.7 times book value. That's cheap, especially given the company's momentum. Investors who buy AIG now are positioning themselves for outsized future returns with less risk: contrarian investing at its best.

A Note on Warrants

Warrants are similar to call options, except that they are issued by the underlying company. They offer the purchaser the right (but not the obligation) to buy the stock in question at the specified price. The warrants we're recommending on AIG are valid for 10 years from the date of issue (Jan. 19, 2011), and they can be exercised at any point before they expire on Jan. 19, 2021. When exercised, they allow the holder of the warrant to buy shares of AIG at $45 per share, regardless of the market price.

That $45 strike price adjusts favorably in the event of dilution or annual cash dividends greater than $0.675 per share (which would also lower the share price). Warrants are illiquid, and Goldman Sachs is the designated market maker for them; when you buy them, be sure to use a limit order so Goldman doesn't get more than a fair price.

Be aware that if our investment in AIG works out, those who own warrants will earn leveraged returns on them. But it's possible that the warrants could end up as a total loss if AIG's stock price is below the $45 strike price at expiration (even though they're currently in-the-money by a few bucks).

Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 2.5%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Internet traffic from mobile devices in 2012 was nearly 12 times total Internet traffic in 2000, and the average connection speed of a mobile device doubled from 2011 to 2012. Communications site operator **American Tower** (NYSE: AMT) is well positioned to benefit from both trends.

What It Does

AMT leases antenna space on more than 57,000 cell sites (towers, rooftops, and more) to wireless service providers. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, non- cancellable, and feature contractual annual price escalations. About 60% of AMT's properties are located in 10 different countries outside the U.S., including India, Brazil, Germany, and Uganda, and AMT is intent on growing its international portfolio as it continues to build and acquire more towers.

How It's Working

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE (or, in Africa, from voice to data), or to increase coverage density. Every time they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; 98% to 99% of AMT's customers up for renewal each year do so, and more than 80% of its current leases don't renew until 2018 or later.

What We Expect

Revenue was up 17.7% year over year in 2012, with the international division up 34%, well outpacing the domestic side. We expect revenue to double from 2012 levels in the next five years through a combination of price escalations, new towers, and upgrades; year-to-date 2013 results suggest that the company is well on its way.

After its recent conversion into a real estate investment trust, AMT is required to pay out 90% of taxable income to shareholders. It currently distributes $1.12 annually, a 1.4% yield, and management expects to increase the dividend 20% annually for the next five years. (Importantly, only the U.S. side of this business is organized as an REIT. For more, see our original write-up, linked in the sidebar.)

For More

- *Pro*'s original recommendation (5/6/13)
- Talk about AMT

Management reduces taxable income though the use of net operating losses. And because the useful life of its tower properties exceeds the depreciation schedule, AMT also uses a depreciation shield, which reduces taxable income and understates the values of some assets on the balance sheet. Thus, typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

The *Pro* Bottom Line

We value AMT at about $100 a share. Today's price provides an acceptable margin of safety for a business of this caliber. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network.

Buy First: O'Reilly Automotive (NASDAQ: ORLY)

One of the best-managed companies in a growing space — with a great stock to match

Suggested Allocation: 3.3%

O'Reilly Automotive (NASDAQ: ORLY) is America's second-largest auto parts retailer, with more than 4,000 stores. Auto parts are a big business, estimated at $231 billion, and O'Reilly is an exceptional competitor, with an addressable market size of about $131 billion.

What It Does

Running 24 regional distribution centers and 240 hub stores as part of a two-tiered distribution strategy, O'Reilly provides same-day or overnight availability on more than 142,000 items, including many its competitors don't usually stock. Basic auto parts, tools, and services complement those hard-to-find treasures. As a result, O'Reilly's sales are historically split between "do-it-yourself " retail customers and more lucrative professional-services customers (such as auto repair shops), a luxury many competitors don't enjoy.

How It's Working

Since going public in 1993, O'Reilly has achieved 20 consecutive years of record revenue and operating earnings and has increased same-store sales every single year. Diluted net earnings per share have jumped more than 20% annually over the past decade, with 25% growth in 2012. All signs point to more growth ahead.

O'Reilly will open about 200 net new stores in 2013, increasing its 2012 year-end store count by 4.8%, and same- store sales are expected to rise by 3% to 5%. By clustering stores together, O'Reilly is able to rapidly achieve economies of scale, and by serving professionals and retail customers, it's able to enter smaller markets where competitors don't often tread. There's also no shortage of independent stores or chains to acquire in this highly fragmented industry. In 2012, O'Reilly acquired 56 locations on top of opening 180 net new stores. O'Reilly has steadily improved profitability, generated strong free cash flow, and maintained a healthy balance sheet while growing. As a result, shareholders have been greatly rewarded. But it's still young.

What We Expect

More Online

- *Pro*'s original recommendation (4/15/13)
- Talk about O'Reilly

By opening new distribution centers in key locations, and surrounding them with "spoke" stores, management sees more growth and operating leverage in its business model. Plus, cars last longer these days — meaning used cars are on the road longer, needing more costly repairs when something goes wrong.

The *Pro* Bottom Line

O'Reilly trades near our fair-value estimate today, but remember: Fair value is the price from which we can expect our desired rate of return, which is around 11% annualized on this stock. Plus, we think there's upside to that estimate as past success points to more to come. Last quarter, O'Reilly increased its earnings per share by a strong 28% year-over-year. This is a business we want to own for the long haul.

Buy First: TD Ameritrade (NYSE: AMTD)

Assets and investment fees are rising; earnings should surge when interest rates head higher.

Suggested Allocation: 3.1%

Entrusted with more than $500 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NYSE: AMTD) hosts about 378,000 stock, options, and futures trades on an average day, collects investment fees, and earns interest on billions in cash.

What It Does

Aside from being a leading discount broker, TD Ameritrade has a partnership with **TD Bank** (NYSE: TD) (which owns 45% of the company), giving it a unique position in its industry. The partnership allows TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank, and with cross-selling opportunities and below- average risk to boot. So, when the current record-low Federal Funds interest rate (targeted at 0%) increases, TD Ameritrade will earn much higher interest income, all of it pure profit. Meanwhile, it continues to focus on job No. 1: Increase client assets and launch more investment products.

But about that Fed Funds rate: In 2007, it was 4.75%, up from 1% in 2003 during the last recession. Today, it's hovering between zero and 0.25%. The first year that it increases by 100 basis points (to 1.1% from today's 0.1%), management estimates TD Ameritrade's earnings per share will rise by an extra 27% to 32% compared with the prior year, on top of any other growth. And as history shows, interest rates could rise by much more than 100 basis points over the next three, five, and seven years.

How It's Working

TD Ameritrade has increased client assets by at least 10% annualized for the last four years and counting. Management says this rate of growth has been about double that of its nearest competitor. For context, the S&P 500 is nearly flat since 2007, but client assets held at TD Ameritrade have more than doubled over the same period. Operating margins are strong, too, lately in the mid-30% range.

Diligent capital management led Standard & Poor's to upgrade the business to an "A" credit rating in 2012, which helped fuel a recent 50% increase in the dividend (likely the first of many). With steady gains in customer accounts, decreasing shares outstanding, and a commitment to paying out roughly two-thirds of earnings to shareholders, the business should continue to reward owners — with the added benefit of much higher profits when interest rates increase. Meanwhile, the stock trades about 20% below its 10-year average price-to-book value of 4, although the company is more diverse and stronger now than over the past decade.

What We Expect

For More

- *Pro*'s original recommendation (7/11/13)
- Talk about TD Ameritrade

Management will continue to be excellent stewards of capital, returning profits to shareholders and increasing additional investor value. All the while, we know higher interest rates will someday lead to much higher net income. But even as we look forward to that, we can admire the company's current results and should enjoy healthy returns.

The *Pro* Bottom Line

Our current fair-value estimate on TD Ameritrade is $34. The company's earnings are likely at a cyclical low. Believing as we do that TD Ameritrade's profit potential is much greater than recent results suggest, we think the stock is a compelling buy in anticipation of higher interest rates. TD Ameritrade's business model is powerful when rates are headed upward. Most investors have probably forgotten that power since 2007, but will remember it when earnings start to jump.

Buy First: Valmont Industries (NYSE: VMI)

The company's income is increasing as infrastructure expands around the world.

Suggested Allocation: 3%

Valmont Industries (NYSE: VMI) offers investors a proven, consistent suite of four business divisions, each serving a growing need around the world.

What It Does

Founded in 1946, Valmont's engineered infrastructure products division supplies steel and aluminum poles to infrastructure projects across the globe, including road and traffic lights; stadium and parking lights; and wireless communications poles and towers. This division also sells highway safety products such as barriers and road grating. In addition, by selling steel and concrete support structures for the global utilities industry, Valmont profits as electrical grids are renovated or built out.

Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot and mechanized irrigation systems are the world's leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient mechanized irrigation, so there's lots of room to run.

To top it all off, the company provides hot-dip galvanizing (just like Mom used to make), anodizing, and other coatings to protect aluminum and steel from corrosion. One of the largest custom galvanizers in the world, Valmont expects continued growth because it still captures only a small percentage of the total market.Overall, the company operates in more than 80 countries and has more than 10,000 employees.

How It's Working

Valmont's stock has returned 17% annualized since 1993, outperforming the vast majority of stocks on the market, and the likes of **Starbucks** (NASDAQ: SBUX) and **Whole Foods** (NYSE: WFM) over the past 10 years. By focusing on strong returns on invested capital, smart acquisitions, new markets, and product-line expansion, Valmont has been able to steadily increase profits as the world economy expands. Yet it's still a relatively small company with plenty of potential in all business lines, and it currently trades at valuation multiples well below market averages.

What We Expect

For More

- *Pro*'s original recommendation (11/5/13)
- Talk about Valmont

With outstanding management and four business divisions that continue to expand around the world, we expect Valmont to continue to grow at a healthy rate (any cyclical bumps aside), and the stock to perform admirably in our pursuit of our North Star.

The *Pro* Bottom Line

Our fair-value estimate on Valmont is $170, providing plenty of upside. And remember, fair value is the price from which to expect your desired rate of return. A growing company's fair value will go higher annually. We hope to have a long, rewarding relationship with this new *Pro* stock.

The Motley Fool owns shares of Whole Foods Market. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Stacking the Deck

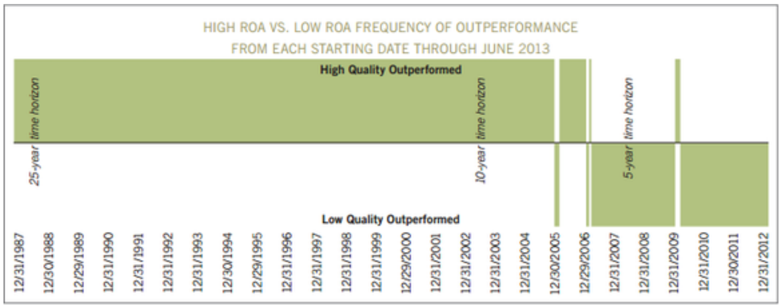
Published Nov 11, 2013 at 4:00PM

Dear Fool,

I don't like to lose money, so I'm not a big poker player. But I'd probably gamble more if I got to start each hand with a pair of aces. Anyone care to sit at my table under those rules? In cards, such a setup may look like cheating — but in investing, it's exactly the type of rigged scenario we hunt for in our core positions. A company's success depends in part upon the structure of the industry in which it operates, and an advantage in industry structure can work like a pair of pocket aces: It doesn't guarantee a win, but it sure shifts the odds in your favor. We probably don't talk enough about industry structure here at *Pro*, so let me deal you a hand ...

Pocket Aces Mean Dollar Bills

A simpler way to talk about industry structure is ask whether a company and its competitors operate "good businesses." Before we dive into the details of how to make that determination, here is why it matters:



Source: [The Intersection of High Quality and Cheap Valuation](), Fidelity Investments, 2013.

The chart above splits the investment world into two portfolios: good businesses (companies with a higher-than-average return on assets) and bad businesses (companies with a lower-than-average return on assets). The green shading then fills in based on the prospective returns from holding either portfolio from the date listed through June 2013. Two things jump out:

- The longer your holding period, the more quality matters to outperformance.
- In three-quarters of all investment periods in the study, higher quality beats lower quality.

Although this study focuses on the frequency of outperformance and not the magnitude, it's compelling evidence for investing in good businesses (those with advantaged industry structure, among other things) over bad.

Assessing Aces in Business

Investors love checking out a company's return on assets, because it's a great quick-and-dirty method of distinguishing between good and bad businesses. But stopping there is like only looking at two of your five cards in poker — you miss a lot of information. That's where competitive strategy — a company's plan to compete in its market — comes in. An effective strategy comes from a company's unique competitive advantages, but also from the structure of its industry. Harvard professor Michael Porter, who's sort of the Godfather of competitive strategy, constructed the Five Forces framework of assessing industry structure and the landscape our businesses operate in. Porter contends that the relative strength of, and interaction between, the five factors in the image below determines an industry's ultimate profitability.

Source: Harvard Business Review, Michael Porter, 2008.

All of the actors in this scenario (competitors, suppliers of inputs, buyers, makers of substitutes, and potential industry entrants) pursue the same profit pie, but the playing field is rarely even. The Five Forces framework is a great tool to help assess industry structure and parse advantaged situations from disadvantaged (for more detail, you can check out an updated reprint of Porter's original 1985 work [here]()). But some find it unnecessarily complicated.

Columbia professor Bruce Greenwald takes a simpler approach, suggesting in his book *Competition Demystified* that we should focus intently on "barriers to entry," or factors that deter competitors from encroaching on a company's business. Barriers to entry are equivalent to Porter's "Threat of New Entrants," and the thinking here is simple: Smart people and organizations are always on the prowl for profits, so unless there's some structural deterrent protecting a business' profit stream, someone (or someones) will be along to take a cut of the action.

Presto Change-O! Aces Aren't Forever

It's that assertion that should be our primary concern. Identifying these barriers, and their strength, is part of our research process for new investments, while the potential for disruptions and changes greatly informs our assessment of risk with our current holdings. The *Pro* team often says it's the quality of the business that helps determine whether we sell a stock, and a primary determinant of the quality of the business is the stability of its industry structure.

For example, former *Pro* holding **Rockwood** (NYSE: ROC) operates in several business lines; a few of them do offer advantages, but the company spent a good deal of its time and energy on the less appealing commodity titanium dioxide business. That business showed flashes of being OK, but we determined that its industry structure was worsening. Rockwood was already challenged by competitors willing to add unnecessary capacity, and as other competitors sponsored by Asian governments came on the scene, it became clear that barriers to entry were low. In addition, Rockwood's competitive response concerned us; in an effort to better control industry supply, it acquired competitors and took capacity offline. We viewed this strategy as unlikely to improve the industry structure over the long term, while at the same time diluting our ownership of Rockwood's other, better businesses. The adverse industry developments had increased our risk, so we sold.

The Foolish Bottom Line

When the dynamics of an industry undergo structural change, years of altered performance tend to follow. Take a gander at railroad company stocks over the past decade — industry consolidation, increased fuel efficiency, and rational pricing behavior have all led to huge profits for railroads and railroad investors. Some investors, like renowned Legg Mason fund manager Bill Miller, think the airline industry is still in the early stages of a similar change. I'm not yet convinced on that front, but we are examining a few industries applying the railroad recipe in search of potential long investments. Rest assured that *Pro* will keep searching for investments poised to benefit from structurally advantaged industries. And we'll keep using Porter's framework to assess risk so we know better when to hold 'em, when to fold 'em, and when to go all in.

Onward,

Bryan (TMF42)

Completed *Pro* Trades

- **AIG** (NYSE: AIG): We rolled our seven January 2014 calls to January 2016 calls for a net credit of $4.10 per contract. (This should have gone in last week's Memo, but we missed it. We blame Billy ... not because it's his fault, but because we can.)
- **Tupperware Brands** (NYSE: TUP): We wrote seven November $85 puts for $0.90 per share.
- **Valmont Industries** (NYSE: VMI): We purchased 400 shares at an average price of $143.69.

Pro Guidance Updates

- **GrafTech International** (NYSE: GTI): We moved shares to Hold and raised our estimate of fair value and our Consider Adding More price to $11.20 and $6.70, respectively.
- **Starbucks** (NASDAQ: SBUX): We raised our fair-value estimate and CAM price to $71 and $57, respectively; shares remain a Buy.

Coverage & Community

- Fools have a great conversation about Fair Value and CAM with respect to **Starbucks**.
- *Pro* Fools are digging in and getting more comfortable with our latest rec, **Valmont**.
- A little firsthand research goes a long way — we love to hear our members' experiences.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Buy Valmont Industries

Published Nov 5, 2013 at 3:30PM

Guidance Essentials

- **Action:** Buy **Valmont Industries** (NYSE: VMI)
- **Allocation:** 3%
- **Scorecard Status:** Buy First
- **Recent Price:** $142.60
- **Fair-Value Estimate:** $170
- **Consider Adding More:** $115
- **Dividend:** 0.7%
- **Options:** We may use them later, but they aren't necessary
- **Price Guidance:** This is **a thinly traded stock, so please use patience and a limit order**. When you make your investment, do not enter an order above the going ask price, lately $142.60.

The Business

Valmont offers investors a proven, consistent suite of four business divisions, each serving a growing need around the world, including in North and South America, China, India, and Africa.

> **Engineered Infrastructure Products** (33% of sales). Have you ever wondered how many light poles line the highways of the world? Or how many traffic lights stand at intersections? The scientific answer is "a lot," and more go up every year – many of which are sold by Valmont. The company's engineered infrastructure products division supplies steel and aluminum poles to infrastructure projects around the world, including road and traffic lights; stadium and parking lights; and wireless communications poles and towers. This division also sells highway safety products such as barriers, road grating, and more. Last quarter, sales in this division were up 6% to $260 million, with nearly 10% operating margins. Strong long-term potential exists around the world.
>
> **Utility Support Structures** (30% of sales). Selling steel and concrete support structures for the global utilities industry, Valmont profits as electrical grids are renovated or built out. Developed nations are upgrading transmission grids, developing nations are building them, and increased use of renewable energy drives additional demand. This division achieved 18% operating profits last quarter on $229 million in sales.
>
> **Irrigation Systems** (23% of sales). Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot and mechanized irrigation systems are the leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient mechanized irrigation. With an 18% operating margin, this division enjoyed a record $175 million in third-quarter revenue. Valmont sees continuing growth opportunities in irrigation used for water, fertilizer, and pesticide application.
>
> **Coatings** (11% of sales). To top it all off, the company provides hot-dip galvanizing (just like Mom used to make), anodizing, and other coatings to protect aluminum and steel from corrosion. One of the largest custom galvanizers in the world, Valmont expects continued growth because it still captures only a small percentage of the total market. Operating margins in this segment topped 22% on last quarter's $89 million in revenue.

Does all that sound boring? Absolutely. We *love* boring businesses that are likely to achieve profitable, long-term growth. The stock is up 584% over the past 10 years, and 24,510% since the late 1970s (while paying dividends since 1990). Yet Valmont still sports a modest $3.8 billion market value, and it has lifelong revenue opportunities in the tens of billions.

The Financials

New contracts, opportunities to reinvest in the business, acquisitions, and strong return on equity have combined to make Valmont a compounding machine.

The company operates in traditionally cyclical industries, and it's dependent on three things: infrastructure spending (on private and government projects alike); utility spending; and farmer spending. While each segment does go thorugh hot and cold periods, the company as a whole has not shown great cyclical swings in revenue and profits over the past 10 years and beyond. Valmont's four business lines sell in more than 100 countries, and no single customer accounts for a substantial portion of sales, so Valmont's risks are diversified. To be safe, we certainly *expect* peaks and troughs in its industries, but over time we expect continued growth.

In the table below, you'll see how revenue and operating income have grown fairly consistently, and how the stock's value multiples have fared over the past decade as the share price climbed. Recently around $142, the stock is trading at the low end of its 10-year value range, at only 6.8 times EV/EBITDA and a P/E of 13. Meanwhile, return on equity has far surpassed our 11% North Star hurdle almost every year.

Valmont	2005	2006	2007	2008	2009	2010	2011	2012	Now
Sales ($billions)	1.11	1.28	1.50	1.91	1.79	1.98	2.66	3.03	3.29
Operating Income ($millions)	83	111	156	229	238	192	266	381	485
EV/ EBITDA	8.6	11.3	13.9	7.3	7.4	11.2	8	8.6	6.8
P/E	21.5	25.1	26.5	12.7	13.8	26.2	16.2	12.8	13.3
P/FCF	13.9	23.9	91.6	41.1	10.9	44.2	32.7	29.5	17.6
ROE (%)	12.5	16.9	20.8	23.3	21.4	11.1	22.1	18.7	20.2

Source: S&P Capital IQ.

Risks

Valmont's irrigation systems provide farmers a healthy return on investment, but most farmers only buy when they're feeling flush and crop prices are high. This year, North America enjoyed a record harvest, so 2014 farming income may suffer by comparison. This has already spooked investors into selling Valmont and competitors including **Lindsay** (NYSE: LNN), in part leading to today's low valuation multiple. However, Valmont CEO Mogens Bay said in the October conference call that he expects just a "small softening" in irrigation next year, and not a sharp decline. Still, it's a risk -- as is the pace of infrastructure spending around the world. If governments don't spend on roads, and utilities don't spend to upgrade, Valmont will suffer.

Additionally, if there's a steep, sudden price increase in any of Valmont's key raw materials (rolled steel coil, zinc, aluminum, etc.), the company can't pass the extra cost on to customers that are already under contract, so profit margins could temporarily be hurt. It's worth repeating that Valmont is dependent on large, time-intensive projects from government and private corporations, utilities, and farms – and all such spending will be cyclical, perhaps separately, perhaps simultaneously. There is a chance we're starting to invest at a near-term peak in at least one of Valmont's divisions. Plus, Valmont's customers typically need financing to fund their large projects, adding another layer of dependency. Finally, the company competes on customer service, product quality, and price. Seven decades of experience helps, but Valmont doesn't operate in a vacuum.

The Foolish Bottom Line

Roads need traffic poles, safety barriers, and lighting, as do parking lots and stadiums. Farmland needs irrigation and fertilizer systems. Utilities need support poles and towers. Steel and aluminum must be protected from costly corrosion. And demand for all these items rises as economies expand. In business since 1946, Valmont is not likely to be left behind by fast changes in technology or the competitive landscape, and is positioned to grow as economies do. Our thesis is Valmont will continue to serve growing markets and increase its profits. Prudent management should be able to reinvest for more growth, make smart acquisitions for even *more* growth, and expand into new areas of the world. Valmont could be a business we'll happily own for years -- even if we don't necessarily want to see the world covered in light poles.

Next Step: Have questions? Stop by and light up our new Valmont discussion board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Buy Valmont Industries

Published Nov 5, 2013 at 12:00AM

Guidance Essentials

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- **Scorecard Status:** Buy First
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>
> **Utility Support Structures** (30% of sales). Selling steel and concrete support structures for the global utilities industry, Valmont profits as electrical grids are renovated or built out. Developed nations are upgrading transmission grids, developing nations are building them, and increased use of renewable energy drives additional demand. This division achieved 18% operating profits last quarter on $229 million in sales.

Irrigation Systems (23% of sales). Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot and mechanized irrigation systems are the leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient mechanized irrigation. With an 18% operating margin, this division enjoyed a record $175 million in third-quarter revenue. Valmont sees continuing growth opportunities in irrigation used for water, fertilizer, and pesticide application.

Coatings (11% of sales). To top it all off, the company provides hot-dip galvanizing (just like Mom used to make), anodizing, and other coatings to protect aluminum and steel from corrosion. One of the largest custom galvanizers in the world, Valmont expects continued growth because it still captures only a small percentage of the total market. Operating margins in this segment topped 22% on last quarter's $89 million in revenue.

Does all that sound boring? Absolutely. We *love* boring businesses that are likely to achieve profitable, long-term growth. The stock is up 584% over the past 10 years, and 24,510% since the late 1970s (while paying dividends since 1990). Yet Valmont still sports a modest $3.8 billion market value, and it has lifelong revenue opportunities in the tens of billions.

The Financials

New contracts, opportunities to reinvest in the business, acquisitions, and strong return on equity have combined to make Valmont a compounding machine.

The company operates in traditionally cyclical industries, and it's dependent on three things: infrastructure spending (on private and government projects alike); utility spending; and farmer spending. While each segment does go thorugh hot and cold periods, the company as a whole has not shown great cyclical swings in revenue and profits over the past 10 years and beyond. Valmont's four business lines sell in more than 100 countries, and no single customer accounts for a substantial portion of sales, so Valmont's risks are diversified. To be safe, we certainly *expect* peaks and troughs in its industries, but over time we expect continued growth.

In the table below, you'll see how revenue and operating income have grown fairly consistently, and how the stock's value multiples have fared over the past decade as the share price climbed. Recently around $142, the stock is trading at the low end of its 10-year value range, at only 6.8 times EV/EBITDA and a P/E of 13. Meanwhile, return on equity has far surpassed our 11% North Star hurdle almost every year.

Valmont	2005	2006	2007	2008	2009	2010	2011	2012	Now
Sales ($billions)	1.11	1.28	1.50	1.91	1.79	1.98	2.66	3.03	3.29
Operating Income ($millions)	83	111	156	229	238	192	266	381	485
EV/ EBITDA	8.6	11.3	13.9	7.3	7.4	11.2	8	8.6	6.8
P/E	21.5	25.1	26.5	12.7	13.8	26.2	16.2	12.8	13.3
P/FCF	13.9	23.9	91.6	41.1	10.9	44.2	32.7	29.5	17.6
ROE (%)	12.5	16.9	20.8	23.3	21.4	11.1	22.1	18.7	20.2

Source: S&P Capital IQ.

Risks

Valmont's irrigation systems provide farmers a healthy return on investment, but most farmers only buy when they're feeling flush and crop prices are high. This year, North America enjoyed a record harvest, so 2014 farming income may suffer by comparison. This has already spooked investors into selling Valmont and competitors including **Lindsay** (NYSE: LNN), in part leading to today's low valuation multiple. However, Valmont CEO Mogens Bay said in the October conference call that he expects just a "small softening" in irrigation next year, and not a sharp decline. Still, it's a risk -- as is the pace of infrastructure spending around the world. If governments don't spend on roads, and utilities don't spend to upgrade, Valmont will suffer.

Additionally, if there's a steep, sudden price increase in any of Valmont's key raw materials (rolled steel coil, zinc, aluminum, etc.), the company can't pass the extra cost on to customers that are already under contract, so profit margins could temporarily be hurt. It's worth repeating that Valmont is dependent on large, time-intensive projects from government and private corporations, utilities, and farms – and all such spending will be cyclical, perhaps separately, perhaps simultaneously. There is a chance we're starting to invest at a near-term peak in at least one of Valmont's divisions. Plus, Valmont's customers typically need financing to fund their large projects, adding another layer of dependency. Finally, the company competes on customer service, product quality, and price. Seven decades of experience helps, but Valmont doesn't operate in a vacuum.

The Foolish Bottom Line

Roads need traffic poles, safety barriers, and lighting, as do parking lots and stadiums. Farmland needs irrigation and fertilizer systems. Utilities need support poles and towers. Steel and aluminum must be protected from costly corrosion. And demand for all these items rises as economies expand. In business since 1946, Valmont is not likely to be left behind by fast changes in technology or the competitive landscape, and is positioned to grow as economies do. Our thesis is Valmont will continue to serve growing markets and increase its profits. Prudent management should be able to reinvest for more growth, make smart acquisitions for even *more* growth, and expand into new areas of the world. Valmont could be a business we'll happily own for years -- even if we don't necessarily want to see the world covered in light poles.

Next Step: Have questions? Stop by and light up our new Valmont discussion board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

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9 Pro Companies Reviewed!

Published Nov 4, 2013 at 4:00PM

Dear Fool,

Quarterly earnings have been announced at most of *Pro*'s companies, and I'm ready to review key points from nine of them today. Besides refreshed financials, what I seek most from each quarter's reports are the key metrics, trends, and initiatives at our companies — as well as any warning signs. The *Pro* portfolio has been enjoying an exceptional year (up 28% as of Oct. 31), but it's more important to look forward than back. Let's dive in.

3D Systems

(NYSE: DDD)

The additive manufacturing company continues to pursue the consumer and professional markets with several new models of printers launched each year. Our shares were called away by covered calls, but we still have puts open (which keeps the stock a Buy at considerably lower prices).

- For the second quarter in a row, 3D is increasing its R&D and marketing spending to address growing opportunities, something we've long wanted.
- The competitive landscape is shifting, with giants like **Hewlett-Packard** (NYSE: HPQ) expected to enter the 3-D printing market next year, so the time is ripe to lock in new customers.
- Since December 2011, 3D's diluted shares outstanding are up 23.7%, and diluted earnings per share are down $0.01. Free cash flow is up only modestly since 2011, and 3D has yet to prove that its many dilutive acquisitions will result in strong returns on investment.
- High-margin materials sales continue to lag company projections; it's possible that average owners won't use as much material as hoped.

Despite these critiques, 3D Systems remains a pioneer in a promising space. Shares of most 3-D printing companies are flying high, reminding me of many similarly soaring dot-com stocks in the late 1990s. Not all will come out winners, but 3D Systems has a lead in the industry. For better or worse, we just want it at a lower price.

Apple

(NASDAQ: AAPL)

Speaking of pioneers, inexpensively priced Apple may enter a new product category as soon as 2014. Will its latest innovation be a watch? A TV? Or something else? Apple remains a Buy First on our scorecard.

- Apple's mighty free cash flow continues to be powered by the iPhone and iPad, while Mac computers are taking PC market share even as Apple Mac sales dip.
- Thankfully, Apple's margins appear stable for now; management has not lowered the price of the iPhone, and we like that choice.
- CEO Tim Cook tells us that by 2017, the global smartphone market will have expanded by about 70%, and the tablet market by 78%. New buyers of Apple products will likely account for much of that growth, and customer satisfaction surveys show that existing buyers have extreme loyalty to Apple products. Those loyal customers are likely to refresh their products every few years.

Facebook

(NASDAQ: FB)

At 42 times trailing free cash flow and 48 times expected earnings for the next 12 months, Facebook actually looks reasonably — even attractively — priced. It's less expensive than Google was one year into its life as a public company, and it's much cheaper than most of its social-networking peers (which does *not* mean Facebook deserves to trade much higher).

- In the third quarter, 725 million people visited Facebook daily, up 25% over last year.
- Revenue was up 60% to $2 billion, and the average price of an ad increased 42% over last year.
- Ads are starting to run on Instagram.
- Of some 20 million small businesses with pages on Facebook, only about 1 million are advertising so far.
- Only about a third of the world is online, and Facebook is intent on getting more people connected; to that end, it recently helped launch the Internet.org initiative for affordable Internet access.

We'll take action on our January 2014 Facebook calls before they reach expiration; I expect we'll continue our exposure to Facebook for the longer term. We just need to be as sure as possible that the Facebook we marvel at today has yet to hit the peak of its traffic; we need its amazing traffic to continue to rise.

Intel

(NASDAQ: INTC)

Rated a Buy, Intel remains inexpensive as Wall Street waits to see how its fate unfolds in mobile computing. The company is making gains with chips in new tablets and smartphones, but its mobile revenue is still dwarfed by its chip sales to the slowing PC market and the healthy server market.

- Management said the enterprise (or corporate) market is improving, both in PC sales and servers, although the consumer PC market remains hobbled, with many consumer dollars going to tablets and smartphones.
- "Two-in-one" computing devices (tablets and PCs combined) powered by Intel are starting to take market share in the traditional PC market.
- Intel's server and data businesses continue to expand robustly as companies store more terabytes on off-site servers (the cloud).
- The stock yields 3.7% and trades at a discount to the broader market.

MasterCard

(NYSE: MA)

The world's second-largest payments processor increased third-quarter revenue 16% and earnings per share 18%. Despite tepid economies, MasterCard enjoyed strong volume and transaction growth in every region of the world.

- MasterCard projects a compounded annual revenue growth rate of 11% to 14% from 2013 to 2015, and at least 20% annualized growth in earnings per share.
- Rebates are key to getting banks to issue your cards, and MasterCard does not foresee any significant change in its rebates or incentives compared to the last three years. This is excellent news given how strongly the business has been growing.
- Commercial credit spending remains weak; when businesses begin to loosen the purse strings, it should be another positive catalyst for MasterCard.

The company likes its positioning around the world, including in China, and should continue to benefit as cards replace cash and checks. I'm going through the financials now and will update our valuation guidance shortly, but I'm comfortable saying MasterCard is a long-term core holding.

OpenText

(NASDAQ: OTEX)

The enterprise information management provider continues to demonstrate its mastery of digital data.

- OpenText's operating cash flow was up a strong 29% last quarter even as revenue flattened because of the government shutdown and a general lull in the software industry. Margins improved in all business lines.

- In 2014, OpenText will launch Red Oxygen, a seven-package software suite to replace its current model (selling hundreds of modules). The company is moving aggressively to expand sales by at least 10% a year as customers invest in information management systems.
- Business is returning to normal now that the government (a significant customer) is back in operation.

Inexpensive OpenText is a Buy, and we're looking at writing new puts as our November $65 puts prepare to expire as income.

O'Reilly Automotive

(NASDAQ: ORLY)

Among the many stocks I cover, auto-parts retailer O'Reilly hosted the strongest conference call of the quarter. The company continues to execute and remains right on message.

- O'Reilly has opened 48 net new stores so far this year, and will open about 109 by year-end.
- Margins are up and 2013 earnings-per-share guidance ticked higher. EPS increased 28% year-over-year in the quarter just ended.
- The company is investing in new distribution centers and improved product acquisition costs, and sees plenty of acquisition targets and new market possibilities. Accounting changes and some investments will bring short-term headwinds in early 2014, but should lead to long-term rewards.

Today's well-made cars are a boon to O'Reilly — they last longer. And repairs to a car made in the last decade are typically costlier, because they're more complex. O'Reilly will continue to add more stores around the country, and will continue its discipline to increase same-store sales, too. The stock remains a Buy.

TD Ameritrade

(NYSE: AMTD)

This little compounding machine is strongly positioned for any increase in interest rates, and it's excelling even without that. In the year just ended, client assets were up 18% to $556 billion, and $96 billion of those assets are interest-sensitive. Importantly, *new* client assets gathered hit $50 billion in the year, up 10% annualized.

- Annual net revenue hit a record $2.8 billion, and investment product fee revenue was up 28% to $250 million.
- Yearly diluted earnings per share were up 15% to $1.22.
- The company just increased its dividend 33% to $0.48 per share annually and announced an extra $0.50-per-share special dividend payable in December.
- Operating expenses were flat — and have remained at the same level over the past three years even as TDA invests in and expands its business organically. Outstanding!

Shares trade at 3.2 times book value, offering plenty of upside potential when interest income increases. As a newer position in *Pro*, the stock is still rated Buy First.

Tupperware

(NYSE: TUP)

Our favorite maker of food-storage solutions continues to shine in emerging markets, but ...

- Tupperware continues to show tepid sales growth (just 1% last quarter, or 6% excluding currencies) and rapid earnings-per-share growth (16% when adjusted for currencies). A good part of EPS growth is thanks to share buybacks as the company levers up with debt.
- Free cash flow has not increased meaningfully since 2010. We believe FCF will rise as capital investments slow and emerging-markets sales continue to expand.
- Weakness in age-old Germany and France last quarter is hoped to be short-lived, while emerging markets (now nearing 70% of revenue) fared well.

With a share price that looks fully valued at the moment (meaning things need to go right to unlock more value), the stock remains a Buy when you remember our three-year outlook and acknowledge that the shorter term could be bumpy. We're watching to see how Tupperware manages a transition as its share buybacks likely slow over the next few years, but in the meantime, it's full steam ahead for a declining share count that drives EPS growth. After losing our shares to covered calls, we suggested puts in October to potentially buy back a partial (3%) position below today's price. We'll actively manage that recommendation.

Valuations

Here's a look at current valuations.

Company	Approx. Price	EV/EBITDA	P/FCF	P/E	P/E NTM Est.
3D Systems	$63	55	250	136	53
Apple	$520	8	14	13	12
Facebook	$50	41	42	225	48
Intel	$24	5.7	14.2	13	12.8
OpenText	$73	10.7	12.4	29	12.5
MasterCard	$737	17.5	31	29	25
Oracle	$33	8.5	10.9	14.4	11.3
O'Reilly	$124	11.5	24.8	21.5	19.1
TD Ameritrade	$28	N/A	N/A	22.7	20.8
Tupperware	$91	11.9	20.6	19	15.2

Source: S&P Capital IQ.
EV/EBITDA = Enterprise Value/Earnings before interest, taxes, depreciation and amortization.
P/FCF = Market Cap/Free Cash Flow
P/E= Share Price/Earnings
P/E NTM Est = P/E on next-12-month estimated earnings.

For comparison, I included Buy First stock **Oracle** (NYSE: ORCL), which reports earnings on its own schedule (thank you, Oracle!). Keep in mind, growth rates matter. MasterCard is expected to increase its earnings by 20% annualized, so this high-moat, high-margin business — while not cheap — can reasonably fetch 25 times forward earnings in a bull market. But we are not pretending that *isn't* a premium price. It is. It just still offers long-term potential. O'Reilly increased its earnings 28% last quarter, and has long achieved more than 20% annualized growth, so its forward P/E of 19 is justifiable, too. We just need to make sure management is on track to continue its success.

Apple, Intel, OpenText, and Oracle all look inexpensive on absolute terms, while Facebook and O'Reilly look attractive given their growth rates. TD Ameritrade is a good business at a fair price as well as a special situation (a play on any rise in interest rates). The rest of the companies above are either in the middle of the road on valuation (MasterCard, Tupperware), or they look expensive (3D Systems on free cash flow and EBITDA). Finally, trailing earnings here are on GAAP measures. You'll see lower P/E multiples listed for Facebook, OpenText, and some others on popular finance websites, because they exclude so-called "special" charges like stock option grants.

Chime In

Please let us know on the Memo Musings board if you like this format or prefer individual updates on each company discussion board, one by one. We can discuss this! Meanwhile, as always, you can see all of our recommendations right now on the Recommendations page.

Fool on!

— Jeff Fischer (TMFFischer)

Pro Guidance Updates

- **Gentex** (NASDAQ: GNTX): Fair value increases to $29.75, and "consider adding more" to $23.50. The stock remains a Buy with a 3.4% allocation.

Pro Coverage & Community

- More earnings!Get our takes on Gentex, **AIG** (NYSE: AIG), **American Tower** (NYSE: AMT) and **Pacer** (NASDAQ: PACR).
- Lessons learned on 3D Systems?
- Member McTwidget shares his Facebook ads experience (thank you!).

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Celebrating a 100-Bagger — and Looking for the Next One

Published Oct 31, 2013 at 1:43PM

Amazon.com (NASDAQ: AMZN) is a special stock for The Motley Fool, and it recently hit a special — even mind-boggling — milestone. David's initial recommendation of Amazon for the Fool's Rule Breaker Portfolio back in September 1997 has become a *100-bagger*.

Today, we know Amazon as the A-to-Z king of e-commerce, but how did it look in 1997? And perhaps more important, how can we find the next 100-bagger opportunity?

In this special video, David and Tom talk all things Amazon and Foolishness:

- What inspired David to invest in Amazon before it conquered the online world
- What it took to ride out Amazon's lows so we could hit the unimaginable heights
- What to watch for so you can spot the next great growth stock

Watch below or scroll down for the transcript!

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Transcript

Tom Gardner: Hi, Tom Gardner and David Gardner here, co-founders of The Motley Fool and we're here to talk about the incredible investment that has been Amazon.com.

So, since buying Amazon.com in 1997, the stock is now up 100x in value for you, so part of this is a celebration of long-term investing, of finding great businesses and of getting incredible results. But the first part of our conversation today, Dave ... I just want to hear a little bit about how you found Amazon, what you were looking for, a little bit about the *Rule Breakers* methodology ... but particularly as it applied to Amazon.

It's a $165 billion company today, but if you rewind and take it back a hundred-bagger, it's a small cap, at that point, or a relatively small company. And what were you looking for and why did you make your first investment in Amazon?

David Gardner: I think there are three things I'll just point out right out of the gate, Tom. Number one, it was a company that had a visionary leader and it was a leader at the time. It was perceived to be that. It's was Earth's biggest bookstore — I still have the mousepad, by the way — when I first recommended it, but it was very clear they'd named it "Amazon." It wasn't "OnlineBooks.com." So, you saw a visionary leader in play.

Second thing — the stock had already doubled from its IPO before we bought it on September 9th of 1997...

Tom: Now, that would be a reason that a lot of people would stay away from it...

David: Absolutely. Like I asked myself, "Did I miss this? Oh, darn." So, obviously we'd be talking about a 200-bagger today had we bought three months earlier, but absolutely no regrets. In fact, so often in my style of investing, we're buying the company after it's already doubled. That's happened any number of times in *Rule Breakers* and *Stock Advisor* among our best picks.

Third, I was in touch with it as a consumer. I was using Amazon. I'm pretty sure you were, too. You couldn't really miss it. It was for people who loved e-commerce — and there were big doubts at the time, maybe we'll talk about that later — big doubts that e-commerce would even work or could work as expansively as it turns out it has. And I'm by no means the visionary who was saying, "Look at what e-commerce would become." We were kind of thinking through it — looking for it a little bit ourselves. But to be a consumer, to be using it, to be in touch with that — helpful.

Tom: I just want to put those three factors in the context of finding the next 100-bagger. Maybe just give an example — you don't have to give a specific company — but what sorts of trends and themes are out there today that are bringing together the visionary leader with the broad approach — the Amazon-like name rather than in the narrow niche and the consumer experience that you're having.

David: So, of those three factors we talked about — if you're looking for the next 100-bagger — I think the primary factor of those three would be the second, which would be the business itself and the momentum and the technology and the disruption. Amazon, in a sense, is just a poster child for e-commerce. E-commerce was the real story in 1997 and has been for the 16 years since. E-commerce has been unbelievable. Amazon is the greatest brand and greatest example of that, but e-commerce benefited many companies. EBay was an early pick of ours that we still have maintained. It's done very well.

And so, Tom, I think looking and thinking ahead of trends and asking yourself what's going to be really big ... it would be the best way to locate the next 100-bagger.

Tom: And how about sales growth? We were talking off-camera beforehand that if you go back to — I could only date back in the SEC filings online to 1999. It was two years after you bought...

David: For Amazon? Okay...

Tom: For Amazon. And Amazon in that single quarter did about $350 million in sales and in the same quarter the previous year was $150 million in sales. So, they had at least a run rate of more than a billion in sales, but their growth rate was north of 100% in revenue. So, is that a factor that is an indicator for you of whether there's a huge market opportunity and a big theme ... is the top-line growth rate?

David: Yeah, I think it is. As a Rule Breaker, obviously, I'm never going to say that's it and that's always it — because there's all kinds of exceptions. It's always about context. But I think that's a pretty good indicator.

When we talk about big things like e-commerce or two recent trends that we've been early on and it's been to our benefit — 3-D printing and cloud computing, both of those in the *Rule Breakers* and *Stock Advisor* services — we had early picks in those. Those are really big stories and they had big sales growth. It wasn't just a hope and a dream. And there are many examples of it.

It doesn't always have to be the biggest thing of all. I mean biotech, in a big way — but also small ways, like just genomics or just a given cure — exhibits these characteristics on a more microcosmic level. Anyway, it's not always about the next big trend, but Tom, sales growth is definitely a factor.

Tom: Okay, so I just want to put these factors together. I'm really restating what you've said. So, if you're looking for the next 100-bagger today, you would be looking in a big trend that has a visionary leader, high sales growth rate and you have connection to it as a consumer ... that they're useful. Not the only place to find the next 100-bagger — but those four factors would be a useful way. And maybe the fifth is that it's a relatively small company. You have visionary leaders at Google, but it's not going to be a 100-bagger over the next 10 years.

So, it's a smaller company. Let's say market cap sub-$2 billion. Visionary leader. Big trend. High sales growth rate with consumer connection to you. And that would be a good way for somebody to look...

David: That's not a bad template. One thing I want to point out is you've described, in many cases, just what cool businesses are. Like, they have those things. A 100-bagger takes it from the realm of business into investing and how you, as an investor, achieve a 100-bagger, which is what we've done in Amazon.

And that's a little bit of a separate story, right? Because to get a 100-bagger — I mean, Amazon is one of the few stocks that's actually done that — that you could have done in the last 20 years and it took 16 years and it took watching that stock go from $3 (our cost) to $95 and then back to $7, and we held all the way through back to $95 and then $100, $200, $300. So, it took 16 years of patience in a world that is very myopic...

Tom: Six months is the average holding period...

David: ...and a lot of people sell off in advance of bad... Like worried about the next earnings. So, there's a whole separate story. We don't have to talk about it too much in this conversation...

Tom: No, I like it actually. Were you worried? When it went from $95 to $7, did you second-guess yourself at any point? You had a 30-bagger as an investment and you watched it fall...

David: To a 2-bagger...

Tom: To a 2-bagger. So, you still had the joy of saying, "I've doubled my money," but you watched a 90% decline and obviously in order for a stock to decline that much, most people have sold. So, what is it that allowed you to hold that? What are some factors in your approach to portfolio management or individual company investment?

David: Sure, and I'm going to be quick, because we're going to run out of time, but I'll just say for now, it's mostly looking at the business, not the stock. And you know that. I know I'm preaching to the choir — although while Tom and I have kind of got it for about 20 years, I think a lot of the world doesn't think about things that way.

Every time I watch financial television — which, by the way, I don't, really — I'm reminded again of how people are thinking too much about stocks, wigs, wags and short-term moves, and they're not really looking at the business. While Amazon's stock dramatically declined over that, the business did not nearly.

And it's not just Amazon, obviously. I'll just throw in another example near and dear to our hearts — **Netflix** (NASDAQ: NFLX). Netflix stock had dropped from a high in 2011ish over $300 down to $55 within about 18 months. We held all the way down and we've held all the way back — but did the business crumble? Even at its worst Qwikster moment, I think they lost about 500,000 subscribers from maybe 24 million to 23.5 million.

So, if you're looking at the business and you're not seeing any kind of drama there, I think it makes it a lot easier to continue to hold 30-baggers down to 2-baggers back to 100-plus-baggers.

Tom: Now, there are some of these huge multibaggers we've had that have not come back.

David: Sure.

Tom: And how does that fit into your approach as an investor?

David: Well, I can think about Iomega, which back in the day at The Motley Fool — as you remember, we were on the cover of *Fortune* magazine and it was partly a story about Iomega, but Celera Genomics was a 9-bagger in six months and we ended up selling not far above cost. So, obviously I can always think back on times that I wish I'd sold something that I held...

Tom: But the holds end up mathematically massively outweighing...

David: Yeah, when you take it all and all. Absolutely. In fact, I gave this talk internally — you heard this two months ago at our monthly huddle at The Motley Fool. I said, "*Rule Breakers* has had 32 stocks that have lost 50% or more." That's the *Rule Breakers* service. I know I'm speaking to some members today. Thirty-two stocks have lost 50% or more. That sounds horrible and it's not easy. In fact, it's painful, and every one of those I'm accountable for.

The good news, though, is that the 32nd-best pick in *Rule Breakers* is up 160%, so you've got to do the math. You've got to be mathematical here. It's not advanced math, but play that forward and you see the incredible benefits of being happy to occasionally give away a 10-bagger and end up at cost or suffer a 50% loss because you're holding all these other great things as the world is reshaped by these companies and you're a part owner of them measured in decades.

Tom: So, you're the best investor at our company. What does it feel like, to you, to have a 100-bagger investment in the portfolio that you know members are buying and talking about? Like what is motivating you as an investor when you're looking for the companies that you're finding?

David: Well, this is the last thing I'll say for now. Basically, Tom, for me, the purpose of our company is to help the world invest better and what I think about all the time is the people who are buying with us. And you're taking a risk when you buy companies with very high price-earnings ratios or Amazon.com — all of a sudden *Barron's* comes out with Amazon.bomb on the cover in the year 2000 or so.

But if you stay focused on the businesses — us, as investors — Tom your service's incredibly accomplished work in great numbers and across The Motley Fool. Heck, *Inside Value* was recognized by Hulbert Financial Digest as one of the top three performers in the last five years.

So, The Motley Fool has an incredible efflorescence of market-beating services and advice and I think what unites us all, more than anything, is that we're business-focused. That's the number one thing that I see running right through The Motley Fool. We are essentially MBAs without MBAs. We love business and we're doing that — we're just becoming part-owners of businesses. We're not playing with stocks.

Tom: A 100-bagger. Amazon.com. What an incredible achievement by you and the team in *Rule Breakers*, *Stock Advisor*, *Supernova* and all the services you're running. I will just close with this point of emphasis (although there are five or six or seven different great points here in this conversation).

Amazon, a 100-bagger, it took 16 years. And that's just a reminder that that's how you get these multibagger, awesome returns. They happen over 5 or 10 or 15 or 16 years, and it can transform your portfolio. So, Dave, thanks for sitting down and talking a little Amazon. And best of luck finding the next 100-bagger. I can't wait to buy right along with you.

David: Thanks a lot, Tom. That was fun.

Part 1, Step 2: Using This Service

Published Oct 30, 2013 at 12:00AM

How *Pro* Works

In this video, advisor Jeff Fischer walks you through the *Pro* experience.

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Email

Here's an overview of the email you can expect from *Pro*.

Trade Alerts: We send these email alerts at any time during normal market hours; they contain a link to our full recommendation on the *Pro* site. After we announce a trade, we wait one to 30 days to make the trade for the *Pro* portfolio. Click here to see an archive of all trade alerts »

Monday Memos: Stay on top of *Pro* happenings — every Monday at 4 p.m. ET, we'll send you stock news, market insights, community highlights, and more. Click here to see an archive of all Monday Memos »

Guides, Audio Extras, Special Updates: Become a better investor! Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio. Click here to see an archive of all Extras »

Manage Your Email: Click here to customize your Motley Fool email settings »

Help and Contact

Help: Our comprehensive FAQ covers recommendations, options, and much more. Click here for the *Pro* FAQ »

Contact: If you have a question we didn't answer, help is close by. Contact our Member Services team, post on our Member Suggestions & Help discussion board, or email us at membersupport@fool.com.

← Think Like a Pro Next Step: Meet the Team

Learn About *Pro*

Part 2, Step 1: Get Ready ...

Published Oct 30, 2013 at 12:00AM

Choose a Broker

You'll need a place for your money to reside and a platform to buy and sell. Any broker will do, but we prefer ones with low costs, transparent fee structures, a good options platform, and robust features. We don't endorse any broker in particular, but *Pro*'s account is housed at Interactive Brokers. You may find these resources helpful when deciding where to set up your account:

- ***Options* Brokerage Board:** Over at *Motley Fool Options*, which you receive free as part of your *Pro* membership, we've got a whole discussion board about brokerages. Visit the board »
- ***Options* Weekly:** If you think you're going to branch out into advanced options investing, be sure to read this can't-miss analysis from our sister service every Friday. See the *Options* Weekly archive »
- **TMF Broker Center:** This table compares features of six popular online brokerages. Visit TMF's Broker Center »

Request Options Permissions

Ask your broker (via the Options Permissions section in the account application, or just call them to request a form) for full options approval. Typically, this means level 2 or level 3 approval (it can vary by broker). The "levels" refer to what type of options strategies are allowable, so the higher your approval level, the more strategies you'll be able to participate in. Fill out, sign, and mail in the simple document, and after a few days you'll be approved. If you aren't granted a high level, be sure to submit another request after a few weeks with an account. You should be able to get promoted to higher levels over time and as your account size and experience grow.

Update Your Beneficiaries

Chances are, your account has a beneficiary designation. That is, when you set the account up, you answered the question: "Who should get my dough if space matter falls from the sky and makes me one with a crater?" That person, or entity, is your beneficiary, and now is a great time to make sure it is accurate. Life changes quickly and these things can be outdated. Your broker will have a beneficiary designation form that should be simple to fill out and submit.

← Back to Index Next Step: Get Set ...

Invest With Us

Part 1, Step 1: Think Like a Pro

Published Oct 30, 2013 at 12:00AM

Our Mission

Pro's mission is to earn members consistent, recurring profits with a high level of accuracy.

Our Philosophy

In this Audio Extra from September 2011, titled "The *Pro* Philosophy," Jeff and former *Pro* analyst Nick Crow discuss how to feel comfortable holding a stock through volatility; how options can increase our ability to match our investing theses to the opportunities we see; and why *Pro* doesn't "overdiversify." Click here to listen in or read the transcript »

Our Strategy

Using a combination of long and short stocks, options, and ETFs, we aim to meaningfully increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years. The Motley Fool *Pro* Strategy Guide is a compilation of key articles going back to *Pro*'s earliest days, highlighting this approach and demonstrating a philosophy that is steady and rational, featuring strategies that work over the long haul. Click here to read »

Our North Star

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward. ***Pro*'s North Star = inflation (as measured by the Consumer Price Index) + 7% annually.** Click here to view your guide to our North Star »

← Back to Index Next Step: Using This Service

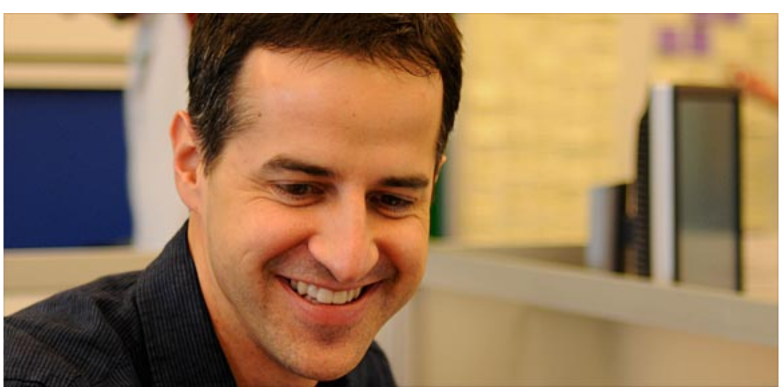
Learn About *Pro*

Part 1, Step 3: Meet the Team

Published Oct 30, 2013 at 12:00AM

Jeff Fischer

Advisor



Jeff Fischer (TMFFischer), advisor of *Motley Fool Pro* and *Motley Fool Options*, started working at the Fool in 1996, soon after he won the Fool's first year-long online portfolio contest. Jeff co-managed the original Fool Portfolio with co-founders David and Tom Gardner, and co-founded and managed the Fool's Drip Portfolio. Jeff also wrote *Investing Without a Silver Spoon* and served as editor on several other Motley Fool best-sellers. All four of the real-money portfolios Jeff has managed or co-managed publicly since 1996 have beaten the S&P 500, although that isn't his first objective, which is steady returns with reasonable risk. Jeff is married to an actress/professor and has a young son.

Billy Kipersztok

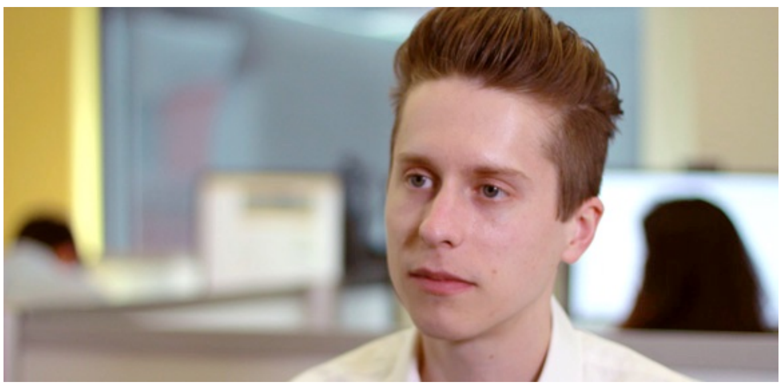
Research Analyst

Billy Kipersztok (TMFTailwind) was introduced to investing by his father, and began reading The Motley Fool as a teenager. He is a voracious reader of investment literature, and he enjoys scouring the market for investments with two characteristics: (1) favorable economics and (2) a fair price.

Prior to joining the Fool, he interned in the analytics department of the NBA's Atlanta Hawks, picked up an MBA and a master's degree in sport business management at the University of Central Florida, and earned a bachelor's degree in chemistry from the University of Florida. He enjoys learning, playing/watching sports, and cheering on his alma mater. (Go Gators!)

JP Bennett

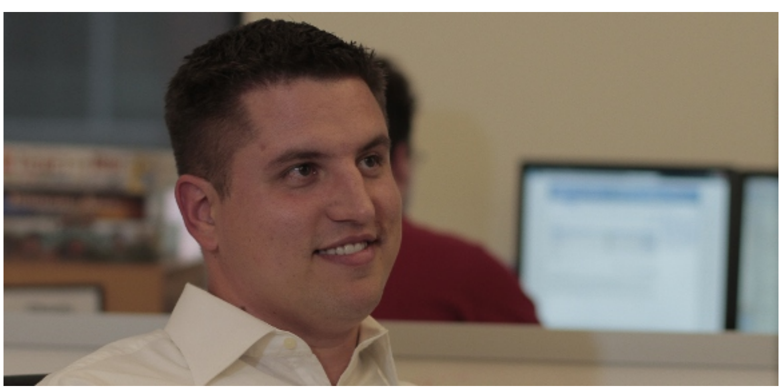
Research Analyst



JP Bennett (TMFYossarian) was once a doctoral student in psychology who thought that investing was destined to remain merely his favorite hobby. But following a career-changing epiphany, a very Foolish internship, and an MBA degree, he has returned to The Motley Fool to become a member of the *Pro* and *Options* teams. JP spends most of time researching companies and reading anything that might make him a better investor. He is also an avid runner and road cyclist, since these activities serve to counteract most of the negative consequences of his sedentary job and primary hobby (and also the fact that his favorite course of every meal is dessert). He is also a 2015 Level III CFA candidate.

Jeremy Myers

Analyst



Jeremy Myers, CFA (TMFTank) is a senior analyst for *Hidden Gems* and *Motley Fool Pro*. Jeremy joined The Motley Fool in 2009 after spending five years teaching ninth-grade biology and coaching football at a nearby public high school -- and, in his spare time, reading every investment book he could get his hands on. Jeremy attended the University of Virginia, where he majored in economics and spent two years as a member of the football team. After graduating, he started his career as an investment advisor for a large insurance company before returning to school to pursue a graduate degree in education.

As a devoted Fool since college, Jeremy developed a healthy skepticism for the financial establishment, which complements his deeply ingrained tendency to buy quality on the cheap. He also believes that the biggest advantage we have as individual investors is our ability to control our time frame and temperament. When he's not searching for the next 10-bagger, Jeremy can be found spending time with his young family, taking on home renovation projects that are over his head, or pursuing the elusive single-digit handicap on the golf course.

Ellen Bowman

Editor/publisher

Ellen Bowman (TMFKabellen) has been with The Motley Fool since 2006, first as a copy editor for Fool.com and then as an editor (and publisher, and chief bottle-washer) of various subscription services. She has worked on services from *Stock Advisor* to *One* and beyond, but considers *Pro* and *Options* "home." Ellen has a degree in creative writing from the University of Houston, and is amazed every day at how much a liberal-arts major can learn about investing when she has teachers like these!

← Using This Service Next Step: Community

Learn About *Pro*

Part 1, Step 4: Community

Published Oct 30, 2013 at 12:00AM

We may be a tad biased, but we genuinely think the *Pro* community is among the best in Fooldom (if not the Internet in general). *Pro* Fools are knowledgeable, kind, intelligent, thoughtful, and helpful.

Discussion Boards

We have discussion boards for every stock we've ever recommended (listed alphabetically), a board for members just getting started, a board to help you catch up with our portfolio, and more. Stop in and say hi on our Meet & Greet board, or see all of our discussion boards »

← Meet the Team Part 2: Invest With Us

Learn About *Pro*

Part 2, Step 2: Get Set ...

Published Oct 30, 2013 at 12:00AM

Know How We Think

Check out this strategy guide, full of tips for developing a diverse portfolio that generates winning returns regardless of the market environment — what we call investing like a *Pro*. Inside, you'll learn:

- How We Invest: Six rules we live by
- How we'll allocate between stocks (long and short), ETFs and options
- Some thoughts on portfolio management, including letting winners run and allocation sizing
- Insight into the types of businesses we love and how to value them

Click here to read »

← Get Ready ... Next Step: Go!

Invest With Us

Part 2, Step 5: Options Resources

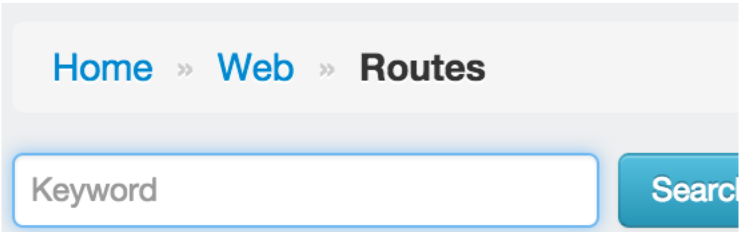
Published Oct 30, 2013 at 12:00AM

Options in 3 Steps

Jeff explains options in not two, not four, but three easy steps.

No route matching given url configured.

Ensure you have a Route model configured in the admin that matches the request path. Yes that is a regular expression for matching the path.



Pro's Sister Service: Motley Fool Options

Your subscription to *Motley Fool Pro* includes full access to *Motley Fool Options*, an options-only service led by Jeff Fischer, the rest of the *Pro* team, and options guru Jim Gillies (TMF Canuck). *Options* is designed to root among the Foolish universe of stocks and provide a steady stream of actionable options ideas to complement your stock portfolio. It's up to you to determine how you wish to use *Options* in conjunction with Pro, but the vibrant *Options* community is a great place to cut your teeth, learn new strategies, and talk shop. Click here to visit *Motley Fool Options* »

Get Up to Speed With Options

You don't need to use options to follow *Pro*, but we view them as a valuable tool for retaining maximum flexibility in response to what the market throws at us. For sure, options can be confusing at first, but we've got you covered with our Options University (housed over at *Motley Fool Options*). Earn your Basic and Intermediate degrees, explore advanced strategies, and ask for help along the way. Here is a roll call of options education resources available to you:

- Options U Essentials
- Options U Strategies
- Discussion Boards: Options U and All About Options
- *Pro*'s 14 Option Strategy Guides
- Get Up to Speed With Options
- Options Glossary
- Options FAQ

← Keep TrackBack to the *Pro* Homepage

Invest With Us

Part 2, Step 3: Go!

Published Oct 30, 2013 at 12:00AM

Ratings/Guidance Overview

For each of the holdings in the *Motley Fool Pro* portfolio, we will keep you updated on what to do — check out the "What to Do" column on our Recommendations page to see the Buy First, Buy, Hold, and Sell categories for all of our stocks and exchange-traded funds.

- **Recommended Allocation %**: If we were building a portfolio today, we'd invest this much (match us!).
- **Fair Value**: The price around which we think investors will earn a fair return for the risk taken.
- **Buy First**: Start here when building or adding to your portfolio. This is the best place for limited capital.
- **Buy**: After matching the Recommended Allocation % of the Buy Firsts, turn here next. We expect North Star-like returns or better over the next three years.
- **Hold**: This position is under review.

Make *Pro* Fit You

Check out the links on the Guidebook page to figure out how to buy the *Pro* investments given your personal situation. Consider it a choose-your-own-adventure: Figure out which category best applies to you, then follow along.

- **Free-Range**: You're new to *Pro* and able to follow every *Pro* portfolio move to a T.
- **IRA**: You invest predominantly through a tax-advantaged account that prohibits shorting and all but the simplest of options strategies.
- **No Complex Options**: You like to "Keep It Simple Stupid" and either aren't down with complex options strategies or don't have the requisite permissions.
- **Old Fool, New to *Pro* / Fully Invested**: You came from another Fool service or already have a fully invested portfolio of stocks.

Click here to find your style »

Allocation Calculator

Tell us how much you are interested in investing with *Pro*, and our handy tool will calculate how much we think you would need to put toward each holding in the *Pro* portfolio.

Click here to calculate »

Portfolio Building Reports

Our Portfolio Building Reports will get you invested in all the *Pro* stocks that are currently recommended as Buys or Buy Firsts. The first highlights our Buy First positions, the second addresses our Buys, and the Portfolio Positioning Report will help you align with our options and short positions. These updates will serve as your buy recommendations (we'll also link to our original buy reports, of course), so purchase these stocks to get started with *Pro*. You'll be getting some very good prices! They're available on the Guidebook page.

Catch-Up Trades

In most of our Monday Memos, we'll highlight a few trades that represent ways to get on board with *Pro* positions you're lacking. Typically, these will be ways to build positions in stocks we have on Hold. If you've got your own ideas, bring them to our Catch-Up Trades discussion board.

Our Most Current Thinking

The "What We Think Now" page holds our current thinking in brief on every position in the *Pro* portfolio, showing you where we stand on each of our investments right now, all on one page. Click here to see what we think now.

← Get Set ... Next Step: Keep Track

Invest With Us

Part 2, Step 4: Keep Track

Published Oct 30, 2013 at 12:00AM

Measure Us

We all have different investing goals, but the bond that holds together all *Motley Fool Pro* investors is the desire to better control our financial lives (present and future) so that we can fully embrace life outside of our brokerage accounts. When you're trying to assess *Pro*'s performance, your goals are the best place to start: Is *Pro* helping you progress toward your financial goals? Are you learning and having fun? Are you sleeping well at night and able to enjoy your life outside of investing?

You can always find our results at the bottom of our Recommendations page. For something a little more detailed, try this on for size:

- **The Truest Way**: We'd like to help you double your money, taking inflation into account, every 10 years. In a nutshell, that is our North Star, an omnipresent fixture that offers us direction and reminds us what we're striving toward. If we are able to meet or approach this goal, it will mean that many Fools are achieving financial success.
- **The Simplest Way**: While you're likely most focused on whether your investment portfolio is achieving your goals, the investing community demands relative return comparison to a stock index. The most common stock indexes don't have much in common with our strategy, and we don't care much how any given stock index performs — but we realize many investors appreciate the reference point, and we cite the performance of the S&P 500 Total Return Index and the MSCI World Index on our Recommendations page.
- **The Risk-Adjusted Way**: Looking at returns in isolation is a dangerous game. For instance, it could be silly to compare two investments with completely different risk profiles, or two investments with completely different goals. We realize that the absolute level of returns is only one component in assessing the returns we achieve. A few of our favorite performance measurements, popular with academics, institutional investors (like pension plans), and hedge funds, attempt to adjust returns for the level of risk taken. Even though these measures are far from perfect (some assume returns conform to a normal distribution and/or that price variability is a good measure of risk, among other deficiencies), they shed some light on the outcomes of our investing process. We'll do the math for you from time to time and show you our score.

Measure You

Track your stocks using My Scorecard. My Scorecard is your personalized, one-stop shop for information about the stocks that matter most to you. It's part scorekeeper and part coverage collector. Enter your holdings, and it'll keep track of your performance and whether you're beating the market; enter more stocks you're interested in, and it'll help you follow your watch list.

Plus, My Scorecard brings together all of the premium Foolish coverage for your companies — updates, articles, discussion board posts, and more. You can filter this feed, below your list of stocks, to zero in on just the type of content you're looking for.

Unfortunately, My Scorecard doesn't yet handle options, but it's a great tool to help follow the stocks that you are long and short. Check out My Scorecard here »

← Go! Next Step: Options Resources

Invest With Us

The Furor, the Frenzy, the Earnings

Published Oct 28, 2013 at 4:00PM

Dear Fool,

As you may have noticed, we're once more in the thick of earnings season. Several of our *Pro* companies have already reported earnings, and 11 more (yes – 11!) of the names on our scorecard are set to report this week, beginning with **Apple** (NASDAQ: AAPL) today after market close. Some earnings reports have been surprisingly strong (see **Gentex** (NASDAQ: GNTX)), some have been boring and steady (see **Wells Fargo** (NYSE: WFC)), and some have been poorly received by the market (see **O'Reilly Automotive** (NASDAQ: ORLY)).

With such busy days ahead, I thought I'd take this opportunity to highlight a few things I'll be watching from the two companies I cover that are set to report this week:

American Tower (reports Wednesday)

1. The effect of recent acquisitions on the company's financials and leverage ratio.

There's been a lot of news from the tower industry this past quarter, with **American Tower** (NYSE: AMT) making two sizable acquisitions since the last earnings report in early August, and competitor **Crown Castle** (NYSE: CCI) recently resolving a big deal with **AT&T** (NYSE: T).

One of the key ratios for American Tower is its leverage ratio (calculated as net debt/EBITDA). American Tower has assumed a significant amount of additional debt in order to make its recent acquisitions, and I'm interested to see what the effect of the acquisitions will be on both components of the leverage-ratio equation. The earnings report and management commentary should sate my curiosity.

2. Rates of growth in international and U.S. markets.

The tower industry is currently in a growth phase, as wireless carriers race to improve their networks to keep up with fast-paced growth in end-user data consumption. Last quarter's growth rates were strong, with 12% and 32% year-over-year growth in U.S. and international revenue, respectively. Based on recent industry activity and carrier investment, I expect continued strong growth, and I also expect international growth to continue to outpace domestic growth.

AIG (reports Thursday)

1. Results from insurance operations.

Our investment thesis for **AIG** (NYSE: AIG) depends on continued improvement in performance from the company's insurance operations. The last two quarters have shown that AIG is executing as we expect; rates and pricing are on the rise, and the combined ratio (expenses as a percentage of premiums – ideally this is lower than 100%) is moving in the right direction. We'll see if AIG has been able to keep its insurance operations on track this quarter.

2. What's up with ILFC?

AIG has been looking to divest itself of its non-core aircraft leasing segment, ILFC, for some time. As detailed in last quarter's report, AIG has been trying to sell ILFC to a group of Chinese buyers, but it appears that may have fallen through. We'll likely hear news this quarter on what AIG plans to do with ILFC.

3. CEO Bob Benmosche's commentary.

Bob Benmosche has proven to be a shrewd operator in his time at AIG, completely transforming AIG's business and turning around its operations in admirable fashion. He also provides some honest and insightful commentary during the quarterly calls and investor presentations. Last quarter, I was encouraged by his comments on capital allocation, and it's likely he'll have some interesting things to say this quarter as well.

The *Pro* Bottom Line

So there you have it, Fools – two to three things I'll be watching from both of my companies reporting earnings this week. The boards should be plenty active in coming days with updates, insight, and commentary from the *Pro* team and the rest of the community – so get out there and join in the discussion!

Happy earnings season!

– Billy (TMFTailwind)

Pro Trade Roundup

- **Open Text** (NASDAQ: OTEX): We closed our November 2013 $70 calls for $8.10 per contract. We are still short November $65 puts.
- **The Buckle** (NYSE: BKE): We wrote eight December $45 puts for $1.30 per contract.

Coverage & Community

- Mistakes + *The Princess Bride* = winning discussion.
- Jeff reiterates that *Pro* will be *Pro* and may mention a stock he'd own for the next 30 years.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy to Close Your Written Calls on OpenText

Published Oct 22, 2013 at 11:45AM

Guidance Essentials

- **Action:** Prior to Oct. 30 earnings, buy ("buy to close") all previously written November 2013 $70 calls on **OpenText** (NASDAQ: OTEX). In doing this, we're uncovering our shares. We're leaving our written $65 puts alone.
- **Price Guidance:** Use a limit order, aiming to pay $1 or less in time value.
- **Share Price (Oct. 21 close):** $76.88
- **Call Price (bid/ask):** $7.50/$7.90 ($1.02 in time value at the ask)
- **Scorecard Status:** Buy
- **Fair-Value Estimate:** $81
- **Consider Adding More:** $65
- **Allocation:** We own 2.9%, plus we've written November 2013 $65 puts for another 2.4%
- **Alternative Trades:**
- **Have you written different calls?** If you've written $75 calls or calls that expire later than November, they will still have considerable time value, so you *may* be better off waiting to close those nearer expiration.
- **Not using options?** Continue to own 2.9% to 5.1% in OpenText stock without using options on it.

What's New?

Software provider OpenText will announce first-quarter 2014 earnings the evening of Oct. 30. Prior to that, we will be uncovering our shares – simply buying to close our existing covered calls. As the company's new fiscal year begins, our fair-value estimate has increased again -- this time to $81, or 14 times our estimated earnings for the year ending June 2014. This valuation is still conservatively lower than market multiples, so we don't want to cap our upside at today's price any longer.

Additionally, the *Pro* portfolio is changing, and we need to adjust for that. We're very likely to let our **3D Systems** (NYSE: DDD) shares get called away, and we're still angling to sell **StoneMor** (NYSE: STON) at a reasonable price before January. We've also set up a synthetic short on the **SPDR S&P 500** (NYSE: SPY). These defensive moves lead to a desire to remove some other hedges. As a small software provider that grew adjusted operating cash flow 31% in fiscal 2013, OpenText has the potential to significantly increase shareholder value over the coming few years and beyond.

For those keeping score (and we certainly are!), before today's action, we'd earned just more than $6 in option credits on OpenText. We'll give a few of our own dollars back in closing these calls (don't forget what they paid us originally), but we're also on track to earn more than a few dollars from the expiration of our November 2013 $65 puts (if we don't roll them for new income). Overall, our options are still on track to add roughly $6 to our OpenText profit so far, in addition to stock gains. And we're likely to write options on the company again -- most likely puts rather than calls.

Finally, closing our written calls prior to earnings isn't meant to suggest an opinion on the strength of quarterly results. We don't know what those will be; in fact, given that the government is a substantial OpenText customer, management will likely say the federal shutdown eliminated its ability to close some deals. But it's management's tone regarding the coming quarter and year that will guide the stock most. I do believe the company could perform better in 2014 than widely expected, given how the sales staff has recently been retrained, the young CEO is driven to succeed, and industrywide software sales have been weak for several quarters but will eventually pick up.

Next Step

- If you have questions about buying to close your November 2013 $70 calls, or anything related to this position, please visit the OpenText board.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

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Published Oct 22, 2013 at 12:00AM

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See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Are You Optimizing Your Life?

Published Oct 21, 2013 at 4:00PM

Dear Fool,

The Motley Fool's mission is "To Help the World Invest — Better." With around 300 full-time employees, the Fool's companywide values are:

- Collaborative
- Innovative
- Fun
- Honest
- Competitive
- Motley

For "motley," each employee chooses his or her own value, which is printed on a nameplate by his or her desk. Senior analyst Bryan Hinmon's motley value is "Better every day." Research analyst Billy Kipersztok's value is "Curiosity. Why?" My value is "Simplify ... to Amplify!" Our editor and content director Ellen Bowman's value is "Enthusiastic."

Combine these four motley values and the *Pro* team's bases are well covered. We're curious, and we like to ask why; we're enthusiastic about what we do, and we try to get better at it every day; and we seek to simplify (and focus on what counts) in order to amplify our results.

Coincidentally, all of our values are rooted in behaviors. Behavior, it turns out, is core to successful investing. Your temperament, your approach (are you deliberate or impulsive?), your outlook (optimistic or dour?), and your ability to stay the course all affect your investment returns.

We write about investing behavior often here in *Pro*, but we might as well be writing about life behavior, because the two go hand in hand. As we ponder our investing successes and failures, we should simultaneously ask ourselves, "Are we getting the most out of *life* that we can?"

In life and in investing, we want to maximize our current well-being and enjoyment, of course. But we also want (nay, need!) a *sustainable* approach that uses our time and energy efficiently — one that endures and improves over the long haul.

One of Bryan's favorite blogs is Farnam Street. It's new to me, but already this week I've found value in it. Among other posts, one titled "What can we learn from the science of high performance?" offered valuable reminders of some important guidance. To excel sustainably at anything, you need to:

1. **Develop healthy routines — in part to eliminate non-core decisions.** Good routines (including successful investing frameworks) compound into an enriched life,and allow you to make *fewer* trivial decisions. It's proven that every decision consumes energy, leaving you less able to make the next one. Like me, you likely feel this acutely during active times. So, in life, *cut all trivial decisions to a minimum*. I'm trying an experiment where I'm relinquishing non-pivotal decisions to others. If my wife and I go out to eat, what do I order? Nothing! I'll ask the restaurant to bring a dish they suggest. In business, **Google** (NASDAQ: GOOG) helps employees eliminate trivial decisions every day (including where to get lunch, and how or when to do laundry). President Obama only wears two shades of suits because he doesn't want to spend energy choosing what to wear. Did Steve Jobs have the same idea with his black mock turtlenecks and jeans?
2. **Focus; your daily routine should help you master your objectives.** Focus is instrumental to success. The blog offers these tips to help adhere to your healthy routines: Turn off all communication devices when you're doing work that requires thought. Remove any distraction. Do your creative work *first* in the day, and your reactive work second; your most important work should get your best energy. And finally, tackle your email in batches, during a set block of time, rather than leaving your email open all day.
3. **Practice.** Though experience helps a great deal in investing and elsewhere, deliberate practice is even more necessary to achieve mastery in most areas. There's a lot on this topic, so visit Farnam Street (the Oct. 15 entry) for details.
4. **Exercise.** Regular exercise leads to better cognitive performance in the realms of memory, reasoning, attention, problem-solving, and decision-making — not to mention more energy and better health.
5. **Rest.** Enough sleep is instrumental to long-term health and success.The amount may differ for everyone, but most studies suggest we need seven to eight hours minimum to maintain healthy cognitive function. Further, a new study suggests that our brains repair themselves greatly *only* during sleep.

To this list I would add a host of other ideas, including:

- You have less time than you think each day, so be ruthless in determining what's most important to achieve.
- Document your short- and long-term goals, and review them regularly.
- Aim for fulfillment in all areas of life (work, family, friends, etc.); otherwise you'll fail in more areas than you succeed.
- Foster productive routines, but break dull ones.

And a reminder: Don't cry for the moon. We can't have everything, and we'll never be perfect. We're aiming to do the best that's sustainably possible in every area of life.

And that returns us to values. What is David Gardner's motley value? Appropriately, it's "Excelsior. Ever higher." And Fool CEO Tom Gardner? His value is "Act like a monkey." That's another way of saying Tom's favorite motley value is *Billy's*: Stay curious; keep moving. When I spoke with renowned fund manager Chuck Akre, his biggest advice to me was: Stay curious; keep learning. It seems that all these Fools are on to something.

Have a curious week!

— Jeff (TMFFischer)

Pro Trade Roundup (from last week)

- **Write Puts on Tupperware Brands** (NYSE: TUP): Still pending for us (we may wait until after Oct. 23 earnings now that the puts pay so little)
- **Roll Your 2014 Calls on AIG** (NYSE: AIG): Still pending for us

- **Write Puts on The Buckle** (NYSE: BKE): Still pending for us
- **Papa John's Moves Back to Buy** (NASDAQ: PZZA): Buy 3.5% if you don't own it already

Pro Guidance Changes

- **Papa John's International** (NASDAQ: PZZA): Shares move to Buy from Hold. We have a 3.5% stake.
- **The Buckle** (NYSE: BKE): Shares move to Buy First from Buy on valuation. We own 2.8%.

Coverage & Community

- Following Bryan's Memo last week, members talk about risk management.
- We look at the early valuation of **Facebook** (NASDAQ: FB) compared to the early valuation of **Google** (NASDAQ: GOOG).
- Member nevercontent shares the results of his put-writing screen.

The Motley Fool owns shares of Google. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Pro Position Update: Papa John's International

Published Oct 18, 2013 at 1:15PM

Papa John's International (NASDAQ: PZZA) has been on hold on the *Pro* scorecard for a long time now. Recently, analyst Bryan Hinmon (TMF42) reviewed everything about Papa John's as though it were a new position: Would we spend our hard-earned cash to add this stock to the *Pro* portfolio right now? His exhaustive research has led to a status change for Papa John's on our scorecard (it's now a Buy) and an uptick in both our fair-value estimate (to $73 from $60) and our Consider Adding More price (to $55 from $48).

We wanted to give you a look at Bryan's proposal to the team. You can download it by clicking here or on the green button below. Read it to see how he convinced advisor Jeff Fischer and research analyst Billy Kipersztok to go back out for PZZA. Or, if you just want the highlights: *Pro*'s current allocation to Papa John's is 3.5%, and we recommend that members match that allocation. We think the stock is a Buy at its current price, so if you have yet to add PZZA to your portfolio, consider doing so now.

Questions? Thoughts? Comments? Feedback? We're here for you on the delicious, savory Papa John's discussion board.

Click here to download Bryan's PZZA proposal!

The Motley Fool owns shares of Papa John's International. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Write Puts on The Buckle

Published Oct 17, 2013 at 2:15PM

- **What We're Doing**: Writing puts for income, or to potentially add to our stake. (That said, we may roll our puts, if necessary, to target a net new buy price closer to our $41 "Consider Adding More" level. This trade is the first step, a stake in the ground that will pay us if shares hold up.)
- **What We're Thinking**: Poor single-month same-store sales in September will have little impact on the company's bright long-term future.
- **What We're Expecting**: Monthly results will be bumpy, but The Buckle will continue to open new stores; design, display, and manage its merchandise well; and operate wonderfully.

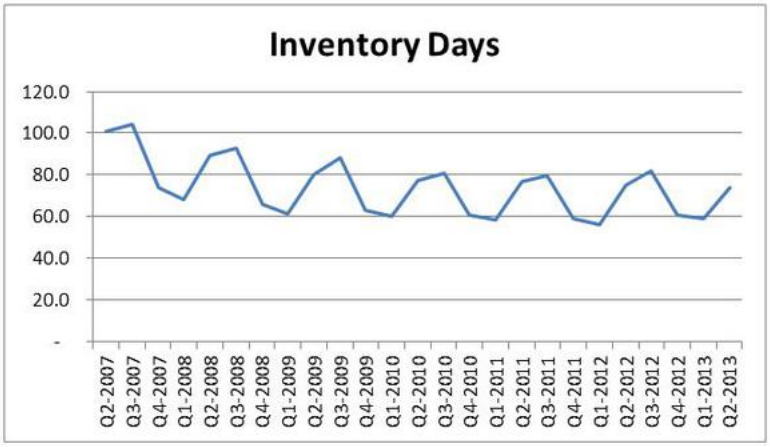
Trade Essentials

- **Action**: Sell to open December 2013 $45 puts on **The Buckle** (NYSE: BKE)
- **Allocation**: About 2%; we already own and recommend buying 2.9% in the stock, and today's put-writing recommendation gives us the potential for a total stake of about 5%. *Pro* will write eight contracts.
- **Share Price (Oct. 16)**: $47.79
- **Option Prices, bid/ask (Oct. 16):** $1.45/$1.50
- **Price Guidance**: Split the bid and ask, aiming for $1.45 or better. Over time, ideally accept no less than $1.20.
- **Alternative Trades**: If you don't yet have an allocation to The Buckle, we suggest you buy a 2.9% stake and write puts for another potential 2%. If your portfolio is less than $100,000, it might not make sense to write these puts. If that is the case, hang tight and see if we end up taking new shares by expiration (at which time you can buy shares directly). For a more conservative put write, you can choose the December $42.50 strike.
- **Be Aware of Special Dividends**: Historically, The Buckle has announced a special dividend between September and November; last year, it was $4.50 per share. There's no guarantee this will happen again, but if it does, the strike price of these put options will be reduced in accordance with the dividend. Here is the Options Clearing Corporation's Infomemo (PDF file) explaining how options were handled last year. If a dividend does come our way, we'll be sure to make sense of its impact (or non-impact, really) by spelling it out on the boards.

What's New?

Monthly same-store sales for The Buckle have historically been spotty, but over longer periods, the company demonstrates it can sling denim as well as Peyton Manning slings touchdowns. Over the last 10 years, The Buckle has scored flat or positive yearly same-store sales 10 times — that 100% completion percentage is enough to make Peyton jealous. The last decade doesn't promise us anything about the next one, of course, but it does suggest that management knows a thing or two about merchandising and creating a store experience that denim-loving debutantes (guys too) return to again and again.

September's sales performance was crummy, and growth has been decelerating since April — but we see no reason to believe those things are any indication that The Buckle has lost relevance with its customers or is losing its place among the operational kings of retail. The company's stores are still wonderfully profitable, and inventory levels (Inventory Days in the chart below) remain in check.



Source: Company filings and analyst calculations.

In short, consumer demand (in all its finicky glory) will ebb and flow, but we believe The Buckle will manage its business steadily. We're writing these puts to generate income; we would be comfortable taking shares, but at this point we assume our follow-up action on this trade will be to roll it if necessary. The Buckle remains a Buy First on our scorecard, and we think shares are worth $56.

How to Follow Along

Write ("sell to open") one December $45 put for every $4,500 in stock you'd be willing and able to purchase if the share price falls below $45 at expiration (and we choose not to roll). Use a limit order, splitting the current bid/ask. *Pro* will write eight contracts to potentially grow our 2.9% stake to around 5%.

- **Maximum return**: We make 3.2% in 64 days (18.4% annualized) if shares of The Buckle stay higher than $45 by expiration.
- **Breakeven**: We lose money by expiration if shares fall below $43.55, or 8.9% lower than where they are today.
- **Maximum risk**: If shares fall $4.24 to $43.55, our loss matches that of owning shares outright.

Next Step: Please post any questions on our The Buckle discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Puts on The Buckle

Published Oct 17, 2013 at 12:00AM

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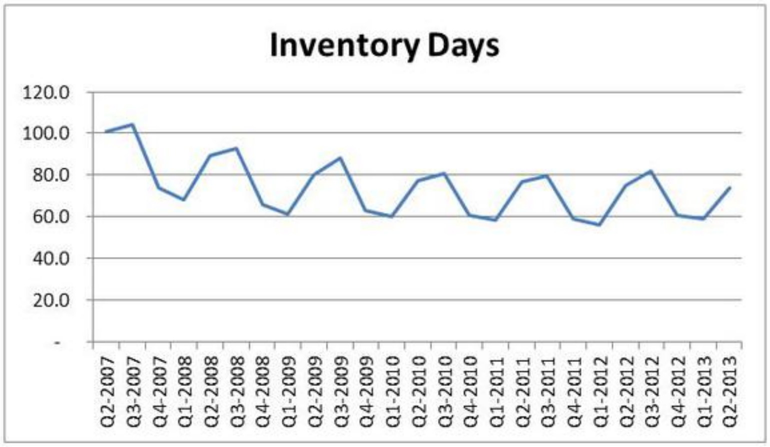

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Roll Your 2014 Calls on AIG

Published Oct 16, 2013 at 3:30PM

Is This Trade for You? This trade should **not** apply to most members. As per our original trade alert, the official recommendation on this position is to own year 2021 warrants alongside your stock. That recommendation still holds, so if you own the warrants, **do nothing**. *Pro* was not able to buy the warrants ourselves, so we bought calls as an alternative. **We still recommend the warrants over the calls**. But if you can't buy warrants (say, they're not listed with your broker), you own calls instead, or you want to buy calls now, then read on.

Guidance Essentials

- **Company: AIG** (NYSE: AIG)
- **Scorecard Status:** Buy First. *Pro*'s official recommendation is a 4% equity stake and about a 1% stake in warrants.
- **Action:** Using a rolling order, sell ("sell to close") all previously owned January 2014 $25 calls, and simultaneously buy ("buy to open") the same number of January 2016 $30 calls (*Pro* is rolling all six of the calls it owns).
- **Share Price (Oct. 16):** $51.15
- **Option Prices (Oct. 16):**
  - **Sell to close Jan. 2014 $25 calls (bid/ask):** $26.05/$26.25
  - **Buy to open Jan. 2016 $30 calls (bid/ask):** $22.15/$22.50
- **Price Guidance:** You should be able to roll for a **net credit** of approximately $3.60 per call (our best guess), but because bid/ask spreads on the 2016 calls can get wide, you may want to try various (higher) credits and gradually move your limit lower until the trade fills. You have plenty of time over the coming weeks and months, so be patient.
- **Account Considerations:**
  - If you own the 2014 calls and execute this rolling trade, your 2014 calls will count as a realized gain in 2013 for tax purposes. If realizing the tax gain this year is undesirable, then simply wait until after Jan. 1, 2014, to execute this trade. (*Pro* has owned the calls for more than a year, so they count as long-term for us; check your start date.)
- **Alternative Trade**: If you don't invest in warrants or calls, simply buy up to 5% in AIG stock to match our total allocation.

What's New?

Nothing! Our stance on AIG has not changed. *Pro* owns calls rather than warrants because of tracking issues with our scorecard, but we still recommend owning AIG stock and AIG warrants (again: if you own the warrants, **do nothing!**). Since *Pro* can't own the warrants, we bought calls instead, and now we are rolling our calls because:

1. We want to continue our leveraged strategy as a proxy to owning the warrants.
2. Our owned calls are approaching their January 2014 expiration.
3. The 2016 LEAPS were listed on Monday.

This is simply a maintenance trade and does not reflect any change in thinking with respect to our position. Our 2014 calls have made us about 109% in just more than one year, while AIG stock is up about 48%. AIG continues to trade for less than book value, so we're happy to own shares and earn leveraged returns with calls, too (one more time, though: *warrants are preferred over calls* if you're able). AIG's next earnings release is set for the end of October, and we'll be watching to make sure our thesis is still on track.

Next Steps

- If you have questions about this trade, file your claim on the AIG board.

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Published Oct 16, 2013 at 12:00AM

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Write Puts on Tupperware

Published Oct 15, 2013 at 3:30PM

What We're Doing: With this position, we're reestablishing our exposure to **Tupperware** (NYSE: TUP) with short puts that may let us buy shares lower.

Guidance Essentials

- **Action:** Sell to open November 2013 $85 puts on **Tupperware** (NYSE: TUP)
- **Allocation:** 3.2%. (If you already own 3% or more in the stock, you don't need to write these puts.) *Pro* is writing seven puts.
- **Prices (as of Oct. 15 12:30 p.m.)**
  - **TUP:** $87.20
  - **November 2013 $85 puts (bid/ask):** $1.80/$1.90
- **Guidance:** Sell to open for $1.80 initially. As prices change, ideally accept no less than $1.60, for a 1.9% yield in 32 days.
- **Considerations:** With the government still trying to battle out a budget deal, the next few days could make for volatile stock prices. Write puts before Thursday's potential showdown only if you're comfortable doing so. Or, hope for downward volatility and then write puts at better premiums. *Pro* can make its trade starting at 24 hours from issuance — so, late Wednesday at the earliest.
- **Alternative Trades:**
  - If you can't write puts, simply buy up to 3.2% in stock. Shares remain a Buy.

- If you'd like to be more defensive, sell to open January 2014 $80 puts, lately paying you around $1.70, or a 2.1% yield, or January 2014 $85 puts, lately $3.20.

What's New?

Our favorite direct seller of storage, preparation, and serving products for the kitchen and home is finding its offerings stacked in more and more cabinets around the world. In emerging markets, Tupperware is a growing premium brand. Emerging markets now account for 65% of Tupperware's annual revenue, and yet the company is only beginning to crack the lid on this long-term potential.

Optimism about the future has propelled management to buy back large amounts of stock this year, with more buybacks planned, on top of a dividend that grows with earnings. Revenue should grow 6% to 7% this year, while diluted earnings per share should climb around 11% (or 14% in local currency), to approximately $5.50 per share. Shares trade for around 15.9 times this year's expected earnings, and the $4.5 billion company is valued at approximately 18 times expected 2013 free cash flow of $250 million. The stock yields 2.8%.

Shares are no longer inexpensive, but they're still priced reasonably enough to merit a Buy rating from *Pro*. Our previously held shares were sold away by covered calls, so we're reinitiating our exposure to this unique, moderate-risk business — and we're hoping to regain shares a bit cheaper by writing puts.

How to Follow Along

Sell to open one put for every $8,500 in stock you would be happy to buy (about $8,320 net). Come the November expiration, if the stock trades below $85, we'll either accept ownership of shares or roll our puts to a later month to gather additional credits and target a still lower start price. Here are more trade stats:

Sell to Open:	November 2013 $85 puts
Bid/Ask:	$1.80/$1.90
Yield (at $1.80):	$1.80/$85 = 2.1%
Days to expiration:	32
Break-even (or potential buy price):	$85-$1.80 = $83.20
Recent share price:	$87.20
Difference to buy price:	4.5%

Next Step: Please visit our Tupperware board if you have any questions!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

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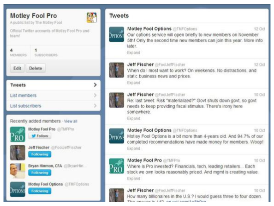
Risk Management for All Seasons

Published Oct 14, 2013 at 4:00PM

Dear Fool,

With so much great seasonal stuff to talk about (October baseball! Apple- and pumpkin-flavored desserts! Leaves on the hiking path!), I was shocked this weekend when a friend I was catching up with wanted to discuss the government shutdown. As usual, he wanted to pick my brain about investing, but this time his focus was on risk, and the shutdown had him spooked. Maybe you're in his shoes, or maybe you're just as excited about this topic as I was (read: not very). Either way, I'll tell you much of what I told him; I hope to ease your mind if you need it and reassure you if you don't, so we can get back to analyzing Big Papi's grand slam with no hard feelings.

We're Pros on Twitter



Follow the official accounts for *Motley Fool Pro* and *Motley Fool Options* — plus Jeff, Bryan, and Billy — all in one place on Twitter! Click here or on the above image for our *Motley Fool Pro* list.

What Is Risk?

Author and financial advisor Carl Richards (who stopped by Fool HQ last week) has a knack for simplifying complex concepts, usually by turning them into simple drawings. His definition of risk is "what's left when you think you've thought of everything." That isn't very comforting — but it is a pretty good definition. The sooner we accept risk as an unavoidable part of investing, the better we'll be able to behave when it presents itself. Where I think Richards' definition falls short, though, is that it presupposes that investors have taken basic measures to combat risk — that the "unknown unknowns" are all that remain. Personally, my definition of risk is "the permanent loss of capital that keeps us from achieving our financial goals." It's not nearly as pithy, and it's unlikely to get me a book deal — but I hope it's helpful.

Living to Play Another Round

The surest way to lose the financial game is not to play it. I once knew a boy named Bryan who got so upset about losing that, if it appeared his recess game of kickball would end in defeat, he was known to kick the game ball into the woods. He was too immature to realize that by doing so, he was throwing away any chance at a comeback and ensuring a much greater loss than just that afternoon game. I hope that poor lad turned out OK ... Anyway, the (stretched) investing parallel here: To continue to play the game (invest), you need a ball (an adequate rainy-day fund). Having some cash stashed safely ensures that even if your portfolio gets kicked into the woods from time to time, you still live to play another round.

Pro's Approach to Risk Management

Our approach to managing risk in the *Pro* portfolio is always evolving, but we generally assess it within the following buckets:

- **Company.** We're picky about the stocks we choose. We believe the business characteristics we seek out (strong competitive positions, compounding dynamics, and caring management) leave us with durable businesses unlikely to destroy value permanently. We also take care not to pay too much, and we monitor business developments to ensure our companies aren't engaging in value-destroying activities.
- **Portfolio.** *Pro* is a portfolio, so we think about how our individual holdings complement one another. We consider risk in terms of customer segments, key economic and business drivers, and obsolescence, and we try to diversify across those categories. We also manage risk by using tools (options and shorting) to change the risk-and-return profile of our portfolio, and by having a wide set of opportunities from which to choose complementary investments.
- **Behavioral.** Perhaps the most powerful risk-management tools we have are those designed to manage our behavior. We have a well-defined strategy, and our North Star provides a constant focus on combating loss of purchasing power. This framework provides a clear guide for our investing decisions. Finally, we have a commitment to communicate with you, the *Pro* community. While I like to think we're good at remaining dispassionate under fire, it helps to have to communicate our portfolio decisions publicly and address your discerning questions. Not only is it more difficult to misbehave with all of you watching, but tapping your collective knowledge helps us make better decisions.

The Foolish Bottom Line

Note that in this discussion of risk, we haven't cited volatility or cycles. Carl Richards would point out that investors can and do think about these things, so by his definition, they aren't risk. Stocks wiggle: that's a given. The economy wiggles: that's a given. Our government's refusal to compromise leads to a shutdown: recently, that's a given, too. Reframing the shutdown according to my definition of risk, the question becomes: Will it permanently impair the cash flows of the businesses we own? *Permanently* is the key word here. Even a temporary default or recession is unlikely to show lasting effects 10 years from now. In the end, I offered this bit of advice to my friend concerned with the shutdown: Instead of focusing on the supposed risk *du jour*, remain vigilant on sensible risk management (company, portfolio, and behavioral) — and go enjoy the delights of fall.

Onward,

Bryan (TMF42)

Pro Guidance Changes

- **The Buckle** (NYSE: BKE): We're moving The Buckle to Buy First. Short-term fashion and mall traffic fears are normal in this business — the company's business advantages haven't changed. (See more.)

Coverage & Community

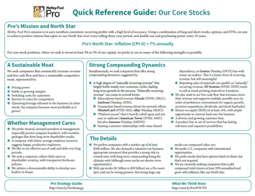
- Billy (TMFTailwind) reviews third-quarter earnings from **Wells Fargo** (NYSE: WFC).
- The Buckle dropped 8% in one day last week — here are our thoughts.
- **Intel** (NASDAQ: INTC) continues to show signs it will be a major player outside of PCs.

See the team's and David and Tom Gardner's holdings here.

Pro Quick Reference Guide PDF Downloads

Published Oct 11, 2013 at 12:48PM

We'll collect all of our PDF Quick Reference Guides on this page!


Quick Reference Guide: Our Core Stocks

Pro's Mission and North Star

A Sustainable Moat

Strong Compounding Dynamics

Whether Management Cares

The Details

[Our Core Stocks]

Twitter Tweets With #LongTermPotential

Published Oct 7, 2013 at 4:00PM

Dear Fools,

By the time you gather with family and friends for a festive Thanksgiving, Twitter will likely be a public company. Anticipation is flying high, as it did for **Facebook**'s (NASDAQ: FB) IPO, but Twitter is a sparrow compared to Facebook's eagle, destined to debut at a much smaller valuation. And that's good! Both companies are in pursuit of the same thing: the advertising dollars that are starting to migrate to social media, where marketers can target audiences in unprecedented ways.

Each company has strong long-term potential, along with substantial risk. Both need to keep and grow traffic; both need tireless passion from employees; both need to show how social media is worthy of more and more ad dollars; and both need to stay sharp as the Internet evolves. Disruption of business models is a constant risk, and site visitors can drain away fast.

Twitter, What Are You?

Twitter seems to serve a niche between Facebook and **LinkedIn** (NYSE: LNKD). If Facebook is your portal for keeping up with friends and family, and LinkedIn is central to your professional life, then Twitter is where you refine your public persona and share with the world what matters to you. Twitter is a media and personality portal, where everyone is a personality with a voice. What makes the service so compelling is that you can follow anyone you wish, and anyone may follow you.

As a micro-blogging site, Twitter has inadvertently cultivated a news-breaking, real-time immediacy. Everyone from country presidents (including @BarackObama – 37.8 million followers) to Warren Buffett (@WarrenBuffett -- 656,000 followers) to the Dalai Lama (@DalaiLama – 7.8 million followers) uses the service to make announcements. (Then there's Justin Bieber, the biggest Twitterati at 45.5 million followers.)

Media outlets and publishers, sport franchises, charities, movie stars, and corporations have set up camp on Twitter, sharing news and events with followers in 140 characters or less. With a hashtag (for example, #greatstocks or #MotleyFoolPro), you can try to make a topic go viral on Twitter. And for a fee, you can run a sponsored "tweet" (Twitter's word for a post) to a mass audience. This is how Twitter makes most of its money. It also sells information about site usage.

Some question how Twitter can become a marketing force when advertisers need to make their pitch in 140 characters, but it's worth pointing out that ad banners and paid links on **Google** (NASDAQ: GOOG) often use less.

For comparison, here's how Twitter stacks up against Facebook and LinkedIn over the most recent reported trailing 12 months (TTM).

Metric	Twitter	LinkedIn	Facebook
Active Monthly Users	215 million	143 million (238 million users total)	1.15 billion
TTM Revenue	$448 million	$1.24 billion	$6.1 billion
TTM Operating Income	($98) million	$64.5 million	$1.9 billion
TTM Free Cash Flow	($46) million	$182 million	$2 billion
Market Cap	$9 billion to $12 billion est. at IPO	$26.8 billion	$123 billion
Price-to-Sales	20x-26x	22x	20.2x

Sources: Twitter S-1, S&P Capital IQ, Facebook and LinkedIn press releases.

And at What Price?

None of these companies is inexpensive; that goes without saying. But of the three, Twitter may have the most potential to compound (from a projected $9 billion to $12 billion IPO) over the coming 10 years. It has plenty of room to add users; it offers a universally applicable interface that's easy to join; it's an efficient way to follow your interests whether they're people or organizations (although that's the case on Facebook, too); and it's a compelling platform for those looking to build an audience.

As a result, the world is taking to Twitter with a vengeance. For example, countless websites link everything they produce to Twitter, and television shows and sporting events are enhancing programs with Twitter feeds. This viral phenomenon is building a powerful network effect around the business.

Lead the Way, Facebook

Adding to Twitter's momentum, Facebook is starting to forge a wide path for social advertising. Twitter may benefit from Facebook's efforts, and it could piggyback on those successes with its own twists on social marketing. Social advertising is in its infancy, and Facebook and Twitter stand to benefit most.

How High Is Too High?

It's unfortunate for all of us that leading companies like these no longer come public at $2 billion or less, as they did in the '90s: **Amazon.com** (NASDAQ: AMZN) was worth $438 million at its IPO and is up to $143 billion today, and **eBay** (NASDAQ: EBAY) ended Day One at $1.9 billion and is up to $71 billion today. The valuations given to leading IPOs these days tells us investors have gotten smart to the long-term potential. But Wall Street still gets it wrong much of the time, as **Groupon** (NASDAQ: GRPN), **Zynga** (NASDAQ: ZNGA), and so many other fallen IPOs attest.

Wall Street's excitement over any given IPO is proven justified only if there's still plenty of profit to enjoy later. Despite substantial share dilution, Google is up 700% since its 2004 IPO, to $290 billion in market value. Its IPO priced at $23 billion, and Google was widely considered overvalued then at about 10 times sales. Today's

Internet darlings tend to fetch a heady 20 times sales, but if Google had priced similarly, it still would have doubled a few times over the next decade (and maybe more, since it would have had more money at its disposal from its IPO).

If Twitter debuts at around $10 billion, there's no reason to think it will be the next Google. In fact, it almost certainly won't. But if it succeeds at what it does, it could compound investor value in similar fashion over the next 10 years. It will be a risky investment when it first takes flight, but we'll be watching the IPO and weighing our options.

Follow Us on Twitter!

If you haven't, now's the time to get to know Twitter. You can follow extra thoughts from *Pro*, our sister service *Motley Fool Options*, and team members!

@TMFPro

@TMFOptions

@BryanHinmon

@bk1p (Billy Kipersztok)

@FoolJeffFischer

Fool on! And Tweet on ... ?

Jeff (TMFFischer)

Completed Trades

(See all past alerts.)

- **American Tower** (NYSE: AMT): We sold to open six Nov. 16, 2013, $72.50 puts for $1.50 each. This may increase our stake by about 2.5% to 5% total. The stock remains a Buy.
- **SPDR S&P 500** (NYSE: SPY): We set up a synthetic short, selling to open eleven Nov. 16, 2013, $170 calls, and buying to open eleven Nov. 16, 2013 $165 puts. We received a small net credit (averaging $0.04 each) to set up the trade.

Catch-Up Trades

- **American Tower** (NYSE: AMT): You can still write ("sell to open") Nov. 16, 2013 $72.50 puts for more than $1.50 lately. Follow our original recommendation.
- **SPDR S&P 500** (NYSE: SPY): You can still set up the synthetic short as recommended, per our Friday alert.

Coverage & Community

- Talk about Twitter with fellow Pro members!
- Get Bryan's latest take on AmTrust Financial Services (Nasdaq: AFSI).
- Members actively discuss our SPY synthetic short. Have a question or comment?
- Earnings are coming (as are some dividends)! TMFMoosie shares his calendar.

The Motley Fool owns shares of Amazon.com, eBay, Facebook, Google, and LinkedIn. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Set Up a Synthetic Short on the SPDR S&P 500

Published Oct 4, 2013 at 12:30PM

What We're Thinking: If the U.S. government is shut down for several weeks, then fourth-quarter earnings may be dampened by a lack of federal spending, lower consumer confidence, and less corporate activity (including delayed mergers, hiring, and spending). Although we remain calm and optimistic, we're initiating a new market hedge to account for the economic risks that grow a bit each day the government is bickering behind closed doors.

Guidance Essentials

- **Action:** Use a spread order (or custom order, or other order depending on your broker) to set up a Nov. 16, 2013 synthetic short on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
- **Allocation:** 10%. Initiate one synthetic short for approximately every $170,000 you manage. Or, using the non-standard mini-options that represent 10 shares rather than 100, set up one synthetic short for every $17,000 you manage. *Pro* will set up 10 or 11 contracts of the standard options (not minis).
- **Trade Details:**
  - **Sell to open:** Nov. 16, 2013 $170 **calls**
  - **Buy to open:** An equal number of Nov. 16, 2013 $165 **puts**
  - **Possible adjustments:** If SPY moves up or down before you trade, adjust your strike prices up or down to keep your cost neutral and your short call strike a few dollars above SPY's price. *Pro* will do this, too, when we're able to make our trade.
  - **Trade cost:** Near zero or a small credit. The cost will fluctuate with that of SPY (which is recently near $168), but adjusting your strikes if need be can lead to a near-zero cost.
  - **Exposure:** You're either agreeing to potentially short 100 shares ($17,000 worth) of SPY at $170 for every standard $170 call you write, or you're agreeing to potentially short 10 shares ($1,700 worth) of SPY for every $170 mini-call option you write.

The Big Picture

Nobody knows how long the first U.S. federal government shutdown in nearly two decades will last (the last closing, in 1996, lasted three weeks) — or how the market will react. Historically, one month after a shutdown ends, the S&P 500 is up 65% of the time, although the median gain is only 0.7%. The worst decline was 6.7% in 1978, one month after a 17-day shutdown. Our concern this time around: If the shutdown lasts more than a week or two, it could start to dent earnings at many companies in the now-under way fourth quarter.

How so? Well, foremost, the government is a big spender on technology, transportation, services and other industries, but it's not spending much money during the shutdown. Further, nearly one million government employees are not being paid, so they'll spend less the longer the impasse lasts. Additionally, lingering uncertainty from Washington may lower confidence at public companies and among consumers at large, slowing spending in the near term.

The shutdown began Oct. 1, the first day of the fourth quarter. The possibility of earnings being compromised grows with each passing day that Capitol Hill sits on its hands. So, rather than sit on *our* hands, we want to hedge the growing risk. Even if the government gets rolling again by the end of next week, it will likely take another week or longer for spending to get back on track. In other words, nearly a month of full federal spending could be lost from the quarter. If so, we're likely to begin hearing about this in mid-October as companies report third-quarter results and provide fourth-quarter guidance.

This November hedge (one of perhaps others to come) will take us through that time period and about a month beyond. *Pro*'s mission includes having gains in up and down markets, so rather than stare at this emerging uncertainty, we'll set up a hedge against it.

The Strategy

With the *Pro* portfolio about 75% long, this 10% synthetic short will bring us to about 65% net long. Make sure a hedge makes sense in your portfolio before following along. If you're already 35% cash, for instance, you probably don't need to hedge. (For more on hedging the *Pro* way, see this 2011 Memo.)

We've written about synthetic shorts since 2009, but we have not used them during a strong market. The strategy involves selling naked calls and using the proceeds to buy protective (or bearish) puts. With this trade, we're setting up a "split-strike" synthetic short — that means our call strike is higher than our put strike. This gives us a bit more breathing room on our naked calls, with a strike about $2 higher than the current ETF price. If the government makes nice soon, earnings will probably not be in danger, and we may be able to close our options without much cost (depending on how far the market jumps). If the shutdown drags out and the market keeps falling, our puts will be in-the-money soon. With SPY lately at $168, our $165 puts will be in-the-money on a 1.7% market decline. Our naked calls, meanwhile, will be in-the-money on a 1.1% market increase. If the ETF is between $165 and $170 at expiration, our synthetic short expires unused.

So, the possible outcomes:

- SPY is at less than $165 at expiration: Our puts have value; our calls expire, having financed our puts.
- SPY is between $165 and $170 at expiration: Our synthetic short expires unused; it hasn't cost us anything material (you may have even received a small credit setting it up).
- SPY is higher than $170 at expiration: We can roll or close our calls at a loss, or let them get exercised into a short of SPY. We'll cross that bridge.

You need a margin account to sell naked calls. Again, you can use the standard SPY options to represent a $17,000 short for each written call, or the non-standard mini-options that represent $1,700 each. Make sure you know which ones you're using! Minis are denoted by a "NS" at most brokers. And if you'd rather not write calls at all, please see the alternatives below.

Alternative Trades

- **IRA-friendly option: Just buy puts.** Although it would lately cost you about $230 per put, you could just "buy to open" the Nov. 16, 2013 $165 puts on SPY. You'll have a hedge with no further obligation and no extra risk if the market rises — other than what you invest in the puts. Only invest what you can afford to see go "poof" if SPY remains above $165 by expiration.
- **Short SPY directly.** We've been here before. If you want to short SPY directly, you can. It's a quick, liquid hedge. We're not shorting it this time because we like the modest-but-appealing 1.1% price cushion the synthetic-short strategy gives us, and we appreciate the automatic Nov. 16 deadline for our next decision.
- **IRA-friendly option: Set up a bear put spread.** Using a spread order, you can "buy to open" Nov. 16, 2013, puts and "sell to open" an equal number of puts at a lower strike. Your risk is capped to the net debit of your trade. For instance: Buy to open Nov. 16, 2013, $167 puts, lately around $2.88, and sell to open an equal number of $157 puts for about $0.90. On this net debit of about $2, you stand to make $8 if SPY declines to $157 or lower. If SPY remains above $167, your spread expires worthless. The most you risk is the $2 cost per spread. Feel free to use different strikes than provided here if you see ones you like better!

Next Step: To discuss or ask questions about this hedge, visit our SPDR S&P 500 board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Set Up a Synthetic Short on the SPDR S&P 500

Published Oct 4, 2013 at 12:00AM

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Pro One-Pager: Stocks We Like

Published Sep 30, 2013 at 4:00PM

Dear fellow Fool,

Happy Monday! In particular, happy Monday Memo!

As mentioned in a previous Memo, we at *Pro* are working on one-page strategy guides to efficiently summarize our approach to shorting, hedging, portfolio management, and other topics you're asking for. Today's Memo features the first of these guides (which I hope to improve with your input – more on that below). Its goal is to outline the core, long-term companies we like to own *most* in the *Pro* portfolio.

But before we jump into that, let's touch on the potential U.S. government shutdown. This morning, my colleague Ron Gross (the manager of the Fool's *Million Dollar Portfolio* service) shared some data from SentimenTrader that goes back to the 1970s. The takeaway: In 65% of cases, the stock market is *higher* one month after a government shutdown. In other words, the odds are better than a coin toss that stocks will soon shrug off this shutdown if it happens. We focus on earnings power at our companies, and only a long shutdown might start to crimp that for some businesses.

This said, given our mission (reiterated below), we don't take risk lightly. We're always considering our market exposure, and right now we're content with the 24% cash we're holding and the flexibility it gives us -- flexibility to, for example, buy more high-quality stocks that fit the criteria below if the market declines.

So without further ado, here's our first *Pro* One-Pager!

Pro One-Pager: Our Core Stocks

Motley Fool Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns that aspire to our North Star over every rolling three-year period, and double our real purchasing power every 10 years.

***Pro*'s North Star: Inflation (CPI-U) + 7% annually**

For core stock positions, where we seek to invest at least 3% to 5% of our capital, we prefer to see as many of the following strengths as possible.

1. We seek companies that consistently grow revenue and free cash flow with a sustainable competitive moat, represented by:

- Pricing power
- Stable or growing margins
- Switching costs for customers
- Barriers to entry for competitors
- Operating leverage inherent in the business (in other words, the company becomes more profitable as it grows)

2. Simultaneously, we seek companies that offer strong compounding dynamics, suggested by:

- A high degree of "naturally recurring revenue" that largely holds steady over economic cycles, in the process fueling long-term growth. "Naturally recurring revenue" can come in several forms:
  - Subscription-based revenue, as with software (**Oracle** (NYSE: ORCL)) or insurance (**AmTrust** (Nasdaq: AFSI)).
  - Transaction-based revenue driven by network effects, as with **MasterCard** (NYSE: MA) or **eBay** (Nasdaq: EBAY).
  - "Platform access" that is heavily relied upon and not easy to replicate (**American Tower** (NYSE: AMT), but also **Amazon** (Nasdaq: AMZN)).
  - Existing customer relationships with some shared dependency, as **Gentex** (Nasdaq: GNTX) has with many car makers. This is a lesser form of recurring revenue, but still meaningful.
  - Finally, repeating materials sales can qualify as "naturally" recurring revenue; **3D Systems** (NYSE: DDD) needs to sell as much printing material as it projects, while **Green Mountain Coffee** (Nasdaq: GMCR) counts on K-Cup sales.
- We also want to see free cash flow that grows more than revenue and supports multiple possible uses; in order of preference, those include reinvestment for organic growth, accretive acquisitions, dividends, and stock buybacks.
- Return on equity (ROE) of at least 14%, with ample opportunity to reinvest back into the business for more growth.
- A diverse and growing customer base.
- A product line or set of services that has lasting relevance and expansive possibilities.

3. We care about whether management cares.

- We prefer tenured, invested management (especially proven company founders), with incentive packages that drive long-term shareholder results.
- A company with below-average employee turnover suggests happy, productive employees.
- We like to see effective use of cash and debt over long periods.
- We seek a corporate culture that's open to shareholder scrutiny, with transparent disclosure policies.
- We admire a demonstrable ability to develop new leaders in-house.

4. We don't neglect the details.

- *Pro* prefers companies with a market cap of at least $500 million. We also demand a valuation (on business-appropriate measures) that provides a strong risk-to-reward ratio, with long-term compounding being the ultimate wish (although some stocks are shorter-term opportunities).
- Mid-caps ($1 billion to $20 billion) are a *Pro* sweet spot, and can be strong growers. But strong large-caps can compound value, too.
- We prefer U.S. companies with international opportunities.
- We prefer stocks that have options listed on them, but that's not required.
- We are currently seeking companies that could compound total returns at least 10% annualized, and grow with inflation, like our North Star.

Please let us know on the *Pro* Member Suggestions board what else you may like to see on this one-pager. We'll consider every idea, and respond. Remember, our topic for this one is not valuation; this is a guide to the qualities we like to see in a core *Pro* stock. We will offer a one-pager on the core valuation aspects we consider a bit later. Also, remember that not every stock we buy will have the qualities listed here; some stocks are special situations. For instance, we own some cyclical businesses, including **GrafTech International** (NYSE: GTI), in anticipation of an upswing.

In the end, we hope each one-pager will be a handy companion in your long-term journey to becoming a Foolish investing pro. To that end, once finalized, they'll also be available to print in a visually stunning PDF format (OK, "stunning" may be overselling it – but maybe not!).

Fool on,

Jeff (TMFFischer)

Completed Trades

- **WisdomTree Emerging Markets Small-Cap Dividend Fund** (NYSE: DGS): We sold to open four December 2013 $46 puts for $1.25 each, accepting today's price before our 30-day trade window starts to close. This nets us a 2.7% yield in 82 days. This position may increase our stake by 1% to 2.9% total, at a net $44.75 for these new shares. The stock remains a Buy.

Guidance Changes

- **Oracle** (NYSE: ORCL): Our fair-value estimate increases to $37.50 from $35.50. Our "consider adding more" level holds steady for now, at $30. We have a 4.4% position in this Buy First stock.

Coverage & Community

- Get our take on earnings from Oracle (or as we should say, America's Cup-winning Oracle!).
- Following last week's Memo, thinkingbig starts a good discussion on covered calls.
- Jeff visits an **Apple** (Nasdaq: AAPL) store in Maryland and finds phones all alone.
- ADrumlinDaisy's new chief investment officer, Sammie, makes her*Pro* board debut!
- Earnings are coming! TMFMoosie shares a calendar.

- Longing for still more put-writing ideas? Member nevercontent offers some independent possibilities.

The Motley Fool owns shares of Amazon.com and Apple.See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Write Puts on American Tower

Published Sep 30, 2013 at 1:15PM

- **What We're Doing**: Writing new puts for income or to potentially add about 2.5% to our stock position (which would bring our total allocation to 5%).
- **What We're Thinking**: Our September written puts expired as income, and we want to keep the strategy going – writing puts to lower the effective buy price on a second helping of shares.
- **What We're Expecting**: Company fundamentals remain strong and will drive long-term performance, but other factors are clouding the near-term outlook.

Guidance Essentials

- **Action**: Sell to open Nov. 16, 2013, $72.50 puts on **American Tower** (NYSE: AMT).
- **Allocation**: About 2.5% more, enough to potentially bring our stake to 5%. For *Pro*, that means writing six contracts. Each new contract represents a $7,250 potential obligation.
  - **Recent Price**: $74.20
- **Option Price (bid/ask)**:
  - November 16, 2013 $72.50 puts: $1.60/$1.75
- **Price Guidance**: Use a limit order, aiming for $1.65 to start. As prices change, ideally accept no less than $1.50, for a 2% yield in one-and-a-half months.
- **Alternative Trades**:
  - If you don't yet have an allocation to American Tower, we recommend you buy a 2.5% allocation to match *Pro* (in round lots, if you can) and then write the November 2013 $72.50 puts for about $1.50 or better, representing about another 2.5% worth of shares. The stock remains a Buy.
  - If you're transacting in just one or two contracts and commissions are eating up your income, consider writing the January 2014 $72.50 puts. They currently pay around $2.90. If you'd like to be more conservative than *Pro*, consider the November $70 puts, which yield less but give you more breathing room if the stock price declines.

What's New?

In mid-August, American Tower's stock was being sold off along with the rest of the REIT sector, and we rolled our August written puts into September to continue our strategy (income and/or a lowered effective buy price). Since then, the REIT sector has remained in the doldrums, while American Tower has experienced a positive catalyst – a multi-billion-dollar acquisition of Global Tower Partners that confirms our investment thesis is on track. The acquisition also appears to be providing some positive momentum to the stock; since our last put roll in August, American Tower's stock is up 7.3%, while the S&P is up only 1.4%.

Although it appears that the market is finally beginning to de-couple American Tower from the rest of the REIT sector (and rightfully so, in our opinion), the pending "taper decision" from the Fed still looms on the horizon. Resulting pressure on REITs and other payout-focused assets remains a distinct possibility, and we still believe we'll be able to increase our allocation to American Tower at a great price at some point in the future. So far, writing puts has netted us about $4 in premium income; adding another $1.50 or better from today's put write, our effective buy price on our new shares would be around $67. In the meantime, we'll monitor American Tower's earnings (set to be reported Oct. 28) and keep an eye on what happens with **AT&T** (NYSE: T) as it looks to sell its tower portfolio.

Return Math:

- **Maximum return**: We make 2.1% in 46 days (about 16% annualized) on this put write if shares of AMT remain above $72.50. If that's the case at expiration on Nov. 16, we will have earned put premiums of $5.51, or nearly 8% of the capital we've risked since writing our initial August puts.
- **Breakeven**: We begin to lose money on this ongoing put strategy when shares fall below $67, or about 10% lower than where they are today. Considering just this iteration of the strategy, we'd begin to lose money if AMT fell below $71. Meanwhile, we own shares of stock already, too.
- **Maximum risk**: We're on the hook to buy shares if the stock price falls below $72.50 by expiration. If that's the case, we'll consider accepting shares or rolling to keep the strategy going.

Next Step: Please post any questions on the American Tower discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Puts on American Tower

Published Sep 30, 2013 at 12:00AM

- **What We're Doing**: Writing new puts for income or to potentially add about 2.5% to our stock position (which would bring our total allocation to 5%).
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Next Step: Please post any questions on the American Tower discussion board.

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Building on Strength: Pro's Future

Published Sep 23, 2013 at 4:00PM

Dear Fools,

With the five-year anniversary of the *Pro* service approaching in early October, our portfolio is in a strong position – one we want to sustain, and grow from, over the *next* five years. As of Friday, the *Pro* portfolio had gained 23.7% this year; that's ahead of both our North Star (running around 11% annually) and (for context) the S&P 500, which was up 21.8% as of Friday.

Our results are especially pleasing given that we've carried hedges, shorts, and cash all year; in fact, we're currently about 24% cash. That means we've earned strong returns with lower-than-average risk and market exposure. We're about 70% net long at the moment, and that has been our rough average over the past five years, as well.

Since inception in October 2008, the *Pro* portfolio is up more than 80%, or around 12% annualized – again, a bit ahead of both our North Star and a strong S&P 500, even after accounting for our more defensive approach to investing. Let's not forget how much uncertainty existed over those years, and still does today!

We're happy with *Pro*'s progress over the past five years – but it's just the beginning. We're basically still on day one with the *Pro* portfolio and the service we dream of creating (and continually improving) for you. And The Motley Fool itself is anything but placid; at 20 years old this year, with a track record that's starting to demonstrate just how well the buy-to-hold philosophy truly works, the Fool, too, is just getting started.

On Deck

So what's next for *Pro*? First, we have a near-term agenda for our investments. Specifically, as we approach the final quarter of the year, we are seeking to:

- Hedge ourselves adequately for any market decline of more than 7%.
- Directly short companies that are losing their battles for success.
- Increase our **American Tower** (NYSE: AMT) position by writing new puts or buying shares (our $70 puts expired Friday as income).
- Likely roll our covered strangle on **OpenText** (NASDAQ: OTEX) to higher strike prices.
- Decide on our next move with our **3D Systems** (NYSE: DDD) covered strangle.
- Write puts on **Tupperware** (NYSE: TUP) or buy back our stock, which was called away early. Our fair value remains around $80, and the stock remains a Buy; members who own shares should sit tight.
- Reach new decisions on **Facebook** (NASDAQ: FB) and **American International** (NYSE: AIG) as our January 2014 calls on both companies reach their end.
- Invest more of our cash in strong companies with great competitive moats trading at reasonable prices. This is always on our agenda.
- Have a portfolio that is positioned for – and stands to benefit from – the likelihood of higher interest rates (and/or higher inflation).
- Short more **Direxion Daily Financial Bear 3x** (NYSEMKT: FAZ) and **ProShares UltraShort Real Estate** (NYSEMKT: SRS) to maintain our short exposure in these ETFs as they depreciate – or, write naked calls on FAZ to potentially short at higher prices.
- Short the **iPath S&P 500 Short Term VIX Futures** (NYSEMKT: VXX) ETN on a spike in volatility; or, when contango is steep, start a very small short position and add to it on volatility.
- We have not yet written our puts on **WisdomTree Emerging Markets Small-Cap Dividend Fund** (NYSEMKT: DGS), but we will do so within our 30-day window following the Sept. 11 trade alert, taking what we can get.

As you can see, we have a lot of activity ahead. This list (which is not exhaustive!) suggests at least 12 potential trades over the next three months, so watch your inbox. Additionally, earnings in October may shake out more opportunities.

Mid vs. Large?

Looking further ahead, I see the *Pro* port buying stock in more mid-sized companies. Giant companies have served the market well the past five years, and many of them will continue to provide healthy returns, but we often see greater long-term compounding opportunities with faster-growing, medium-sized leaders on Wall Street. We want to own more companies around the size of **Gentex** (NASDAQ: GNTX) ($3.7 billion), OpenText ($4.3 billion), and 3D Systems ($5.4 billion) – in some cases, even smaller. While behemoths such as **Oracle** (NYSE: ORCL) ($155 billion) will continue to serve as bedrocks of the portfolio, it's the mid-caps that will likely lead much of our charge higher in coming years.

Covering Upside?

This is partly the bull market talking, but I expect *Pro* to use even fewer covered calls over the next five years than we have in the past. Unless they pay very well, and unless they're used as an ongoing, dedicated strategy on specific positions, covered calls provide relatively small rewards for a portfolio our size, and they can cap our upside on substantial amounts of capital. Fortunately, we can use positions like bear call spreads to earn returns that emulate those of covered calls, but leave us free to sell our stock at will, without limiting upside.

Bottom Line: It's All Good!

Pro is in a strong position after our first five years. This gives us a great foundation to build on as we work to continually improve and make still better choices over the next five years. Thank you for being a *Pro* member! And thank you for your suggestions for our forthcoming *Pro* guides, too – please keep your ideas coming. Finally, if you have any comments about this Memo, please visit the Memo Musings board.

Fool on!

– Jeff (TMFFischer)

Catch-Up Trades

- **iShares Russell 2000 Index** (NYSEMKT: IWM): If you never set up our put ratio spread and want one, follow our past trade alert's general guidance, but use different strike prices. Sell to open Nov. 16, 2013, $95 puts, and buy to open Nov. 16, 2013, $100 puts (in a 2:1 ratio). Lately, you need to pay a net debit of about $0.11 per spread to set this up. Your protection starts at $100 on IWM, and you're also on the hook to potentially buy shares of IWM at a net $90. IWM is lately around $107.

Coverage & Community

- *Pro* is nearly five years old! And thanks to Morgan Housel, today you can relive many key headlines from the past five historic years.
- As **Apple** (NASDAQ: AAPL) sold a record 9 million-plus iPhones over the weekend, *Pro* members were discussing the new operating system (and loving it, for the most part).
- Member nevercontent shares his list of potential put-writing trades (cool dragon included!).
- TMFMoosie's calendar gives us a peek ahead at our earnings deluge on the way.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

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722 Mastications and Buying in Thirds

Published Sep 16, 2013 at 4:00PM

Dear Fools,

Insanity, I tell you! At some point when you were a kid, a well-meaning person probably advised you to chew each bite of food 32 times for better health. Plenty of us still live by that advice — even if we aren't quite sure why. Turns out the idea originated in the late 1800s with British Prime Minister William Gladstone, who was a fine statesman ... but not a doctor. I was reminded of this "rule of 32" by a recent conversation on our *Pro* discussion boards about a certain investing rule of thumb, one that plenty of investors may also adhere to without fully knowing why: buying in thirds. Let's chew on this topic for a few hundred words.

The Real Magic of Buying In Thirds

Buying in thirds just means dividing each stock buy into three transactions. There is nothing inherently magical about that; the real power comes from the action, which reinforces some very simple, and very critical, Foolish investing beliefs. Specifically:

- **You can't time the market.** Neither can I. Unfortunately, academic research and a lot of red ink on brokerage statements support this assertion. Because of this, whenever we choose to buy a stock, only luck will allow us to nail the precise bottom. And while the stock might trade higher in the subsequent days and weeks, it might also trade lower; our very-short-term predictions are about as accurate as a coin toss. Committing to buy in thirds makes the timing of any single purchase less important, so we waste less time and energy fretting about each penny or nickel and keep our focus on the time frame that really matters — the long term. Win.
- **Own the stocks of great businesses.** Have you ever bought a crummy business because you thought it was cheap, watched its price get halved (making it even cheaper!), then found yourself too scared to buy more? Now imagine buying a *great* business you think is cheap, then watching *its* price fall by half. In that situation, is it easier to pull the trigger and buy more? Absolutely. When you commit to buying in thirds, you're likely to choose higher-quality businesses, whether you realize it or not. That's because if the price of a great business falls, it's much easier emotionally to go through with additional purchases. This also makes it easier to add to winners whose prices have started to rise. Another win.
- **The math doesn't lie.**Mathematically, stock returns are determined by three factors: the purchase price, which we control; any intermittent cash flows, which are uncertain; and the selling price, which is uncertain too. Mathematically, that looks like this:
  - [Return = (Sell price – Buy Price + Cash Flows) / Buy Price]
  - We control only one element in this formula: the buy price. The surest path to a high return is to buy as low as possible; buying in thirds encourages the practice of adding to our initial position, even when it has fallen, which can lower our cost basis. Yet another win.

So Why Doesn't *Pro* Buy in Thirds?

With all these wins stacking up, why doesn't *Pro* buy in thirds? First, there's a very practical consideration: Doing so would triple the time we spend writing up, editing, assembling, and distributing recommendations, which seems like a suboptimal use of our time. Because we value that time, we'd prefer to get paid for committing to another purchase instead, which is one reason we're so fond of writing put options to add to our positions. Also, we have a different tool to reinforce our Foolish investing beliefs: our community. Being active and involved on the discussion boards ensures that we're constantly clarifying the *Pro* way of investing. Conversing with members keeps our philosophy front and center for us at all times — and that means other rules of thumb (like buying in thirds) can recede a bit for us, because we're actively reinforcing our beliefs every day, on the boards, with our members.

The Foolish Bottom Line

It's natural to think that if splitting your buys into thirds is good, splitting your buys into fifths — or tenths! — must be even better, right? Well, let's go back to chewing. The economic nutritionist Horace Fletcher believed chewing should continue until each bite liquefies. He wrote: "One-fifth of an ounce of the midway section of the young garden onion, sometimes called 'challot' [sic], has required 722 mastications before disappearing through involuntary swallowing." Fletcher believed that chewing to liquification optimized nutrient absorption and aided digestion, at the small cost of just 10 minutes per shallot. Every choice we make has trade-offs, and considering the time, money, or jaw soreness on the other side of each choice should keep us from going to extremes.

How you choose to reinforce your investing beliefs and carry out your strategy is up to you. But I can promise that *Pro* will never recommend chewing any meal, *or* any investment, 722 times.

Onward,

Bryan (TMF42)

Care to discuss your chewing habits or buying in thirds? Bring your comments to the Memo Musings board.

Completed *Pro* Trades

- **Tupperware Brands** (NYSE: TUP): This weekend, *Pro's* short October $75 call options were exercised early, resulting in the sale of all 700 Tupperware shares. Despite this, the stock remains a Buy on our scorecard, and we're assessing our options to consider a new position.

Pro Catch-Up Trades

- **Wisdom Tree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS): We recently recommended writing puts for another 1% of DGS, ideally aiming to get paid at least $1.50. Right now, we would need a good dip to get that price, but we're waiting for it a bit longer ourselves. If you don't write puts, match our allocation by boosting your stake to 3%.

Coverage & Community

- Chime in to help us build a new watchlist feature.
- It's not too late to assign Jeff some more work — what one-page *Pro* guides would you most like to see?

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Motley Fool Pro Exclusive: A Candid Conversation With Tom Gardner About Motley Fool ONE

Published Sep 12, 2013 at 5:21PM

{% ooyala id="tnNmxmZTqywskufMcybopVA1IjQV0kN-" width="580" height="323" %}

Click here to learn more about *Motley Fool ONE* and complete your "early acceptance" application.

Write Puts on DGS

Published Sep 11, 2013 at 3:30PM

Guidance Essentials

- **Action:** Sell to open December 2013 $46 puts on **WisdomTree Emerging Markets Small-Cap Dividend Fund** (NYSEMKT: DGS)
- **Allocation:** We own 2% in stock already (match us if you haven't yet done so). We will write puts to add 1% more in the stock, for 3% total. *Pro* will sell four puts to potentially buy 400 more shares.
- **Prices (as of noon, Sept. 11):**
  - **DGS**: $46.78
  - **December 2013 $46 puts (bid/ask):** $1.55/$1.85
  - **Guidance:** Aim to sell to open for $1.70 initially. As prices change, ideally accept no less than $1.50, for a 3.2% yield in about 100 days.
- **Alternative Trades:**
  - If you can't write puts, simply buy 1% more in stock, ideally at less than $47, bringing your total allocation to 3%.
  - If you'd like to potentially get shares sooner, sell to open October 2013 $46 puts instead, lately paying around $0.90, or 2% in just over a month.

What's New?

The U.S. stock market has outperformed most others around the world over the past one, three, and five years, clobbering World Market indices — including emerging markets. Rather than lament this state of affairs, the *Pro* team responded by reassessing our allocation to emerging markets, which currently stands at just 2%. The result? We see an opportunity to increase that allocation, initially by writing puts on **WisdomTree Emerging Markets Small-Cap Dividend Fund** (NYSEMKT: DGS). We *want* to invest in promising areas when others are selling, and billions of dollars have fled emerging-market stocks this summer.

When the U.S. Federal Reserve suggested it would begin tapering down its stimulus programs later this year, rapid devaluation of many foreign currencies followed, making those countries' dollar-denominated debts more expensive. Emerging-market pundits are screaming "fire," but we believe that — as is usually the case — the emotional reaction is wrong. Overall, GDP and income per capita continue to rise in our ETF's targeted countries (see below for a list), and we expect leading small businesses to grow, too. That should eventually lead to share price appreciation, a reversal of fortunes over the last three years:

ETF Returns (to Sept. 11, 2013)	5-Year	3-Year	1-Year
WisdomTree Emrg Mkt SmallCap Div (DGS)	29%	(1%)	2%
Vanguard Emerging Markets (VWO)	8%	(4%)	(1%)
S&P 500 (SPY)	36%	52%	17%

Source: Google Finance

Over the past five years, DGS performed very well compared to other emerging-market funds, and nearly kept pace with a torrid S&P 500. But in the past three years, or roughly the time we've owned it, emerging markets have fallen as the S&P 500 gained 52%. Such a vast divergence should not last if the fundamentals of the "losing" investment remain intact, as we believe is the case with DGS. After all, emerging markets now account for more than half the world's GDP, and growing.

The latest data available (from June 30, 2013) evaluated our ETF at $46 (nearly the same as today's price). It trades at only 12 times trailing earnings, 1.5 times book value, and 0.9 times sales. And the ETF's dividend yield is well above average, and likely to continue to hug 3% to 4%. For a valuation comparison, the small-cap index in the U.S. — the **iShares Russell 2000** (NYSEMKT: IWM) ETF — trades at 28 times earnings and nearly 4 times book value as of Aug. 30. And that valuation caps book value multiples at 25 and excludes companies with negative earnings. Emerging markets should receive a discount to their less risky U.S. counterparts, sure — but *this* discount is pronounced. More importantly, the small-cap stocks in our ETF are inexpensive enough on their own that we're happy to increase our exposure either through put writing or (an alternative trade) a direct purchase.

As of Sept. 10, here's where DGS is concentrated. The list has not changed drastically since 2010, although Taiwan exposure is up from 20% when we first bought (we keep an eye on Taiwan):

Country	ETF Weight
Taiwan	26.7%
South Korea	9.7%
Malaysia	9.6%
South Africa	9.3%
Brazil	8.4%
Thailand	8%
China	6%
Chile	4.9%
Turkey	4.7%
Poland	3.6%

Source: WisdomTree

How to Follow Along

Sell to open one put option for every 100 shares of DGS you want to buy at a net purchase price of around $44.20 to $44.50 ($4,420 to $4,500), up to 1% in new shares, or 3% total if you lack DGS exposure today. (Or, buy 2% and write puts for the last 1%.) If you're not using options, simply buy shares up to 3%, ideally below $47.

Why are we writing puts rather than buying outright? For a basic reason: The Fed's tapering action is set to begin within weeks, and emerging markets are likely to remain volatile. Thus, we believe we can eventually nab a lower price by writing near-the-money puts until we get shares. Today's puts could result in a 5.3% lower buy price. But we also believe those buying shares today will be rewarded in the long run.

For the record, we're willing to eventually invest 4% to 5% in this ETF if it continues to be managed well and pricing remains favorable. So today's step up to 3% may not be our last.

Next Step: Please visit our DGS discussion board if you have questions!

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Write Puts on DGS

Published Sep 11, 2013 at 12:00AM

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Source: Google Finance

Over the past five years, DGS performed very well compared to other emerging-market funds, and nearly kept pace with a torrid S&P 500. But in the past three years, or roughly the time we've owned it, emerging markets have fallen as the S&P 500 gained 52%. Such a vast divergence should not last if the fundamentals of the "losing" investment remain intact, as we believe is the case with DGS. After all, emerging markets now account for more than half the world's GDP, and growing.

The latest data available (from June 30, 2013) evaluated our ETF at $46 (nearly the same as today's price). It trades at only 12 times trailing earnings, 1.5 times book value, and 0.9 times sales. And the ETF's dividend yield is well above average, and likely to continue to hug 3% to 4%. For a valuation comparison, the small-cap index in the U.S. — the **iShares Russell 2000** (NYSEMKT: IWM) ETF — trades at 28 times earnings and nearly 4 times book value as of Aug. 30. And that valuation caps book value multiples at 25 and excludes companies with negative earnings. Emerging markets should receive a discount to their less risky U.S. counterparts, sure — but *this* discount is pronounced. More importantly, the small-cap stocks in our ETF are inexpensive enough on their own that we're happy to increase our exposure either through put writing or (an alternative trade) a direct purchase.

As of Sept. 10, here's where DGS is concentrated. The list has not changed drastically since 2010, although Taiwan exposure is up from 20% when we first bought (we keep an eye on Taiwan):

Country	ETF Weight
Taiwan	26.7%
South Korea	9.7%
Malaysia	9.6%
South Africa	9.3%
Brazil	8.4%
Thailand	8%
China	6%
Chile	4.9%
Turkey	4.7%
Poland	3.6%

Source: WisdomTree

How to Follow Along

Sell to open one put option for every 100 shares of DGS you want to buy at a net purchase price of around $44.20 to $44.50 ($4,420 to $4,500), up to 1% in new shares, or 3% total if you lack DGS exposure today. (Or, buy 2% and write puts for the last 1%.) If you're not using options, simply buy shares up to 3%, ideally below $47.

Why are we writing puts rather than buying outright? For a basic reason: The Fed's tapering action is set to begin within weeks, and emerging markets are likely to remain volatile. Thus, we believe we can eventually nab a lower price by writing near-the-money puts until we get shares. Today's puts could result in a 5.3% lower buy price. But we also believe those buying shares today will be rewarded in the long run.

For the record, we're willing to eventually invest 4% to 5% in this ETF if it continues to be managed well and pricing remains favorable. So today's step up to 3% may not be our last.

Next Step: Please visit our DGS discussion board if you have questions!

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

A Pro Guide Gala

Published Sep 9, 2013 at 4:00PM

Dear Fools,

Over at our sister service, *Motley Fool Options*, I recently started a new initiative: writing a single-page reference guide for each strategy the service employs. To get the ball rolling, I asked members (that means you! As you may know, *Pro* members get free access to *Options*) for suggestions on what these guides should include. The first draft of our first guide, on writing puts, is now being edited to include those ideas. Single-page guides to our other option strategies will follow, each one intended to serve as a concise complement to our longer guides in Options U. We hope members will find these one-pagers to be tactical, handy companions on their investing journey.

What does that have to do with *Pro*? Well, on ourPhilosophy & Strategy discussion board, member connie137 recently asked for more guidance on how *Pro* invests. The in-depth *Pro* Guidebook on our site includes a good look at our investing strategy — including our North Star and seven qualities we seek in strong companies. But I think it's time to concisely outline how we approach investing across the board, with succinct guidance on shorting, hedging, and the use of options in a stock portfolio.

To address this, I'm planning to write several single-page guides outlining *Pro's* multi-pronged approach — and as with *Options*, I'm seeking your input. Which topics do you feel need to be addressed with short, informative *Pro* guides?

To get us started, here's my initial list of single-page *Pro* guides to write:

- *Pro*'s Investment Objective
- Winning Core Investments
- Cost-Efficient Hedging
- Successful Shorting
- Options as Tools
- Allocation & Exposure

The first topic, "*Pro*'s Investment Objective," is self-explanatory: What is our investment goal? How are we different? "Winning Core Investments" would outline the qualities we seek in companies we buy for the long haul. Next up, the ways we like to hedge, followed by shorting, options, and finally a guide to allocation and exposure.

One challenge will be to keep these short, but I know it can be done. We'll channel Steve Jobs and Google and keep to the point. Chuck Akre's investment site is also an excellent example: In just three short pages (actually three *half*-pages!), Akre Funds outlines its philosophy, stock selection, and portfolio construction process. (If you follow the link, you can see them on the left sidebar there.)

We'll want our *Pro* one-pager guides to be just like that: concise but very helpful. But first, let's make sure we're writing about the right topics! If you can take some time this week to think about it and share your thoughts — tell us what you want covered by brief guides — on the *Pro* member suggestion board, the team would greatly appreciate it.

Thank you! I'll start working on the list above soon, once it has been edited and updated with your thoughts and desires.

Also This Week

Among other possibilities, this week we'll share a decision on whether to add more **WisdomTree Emerging Markets Small-Cap Dividend Fund** (NYSEMKT: DGS) to the portfolio. The ETF has declined below our "consider adding more" price as investors fret about emerging markets. With our longer-term outlook on this investment, we aren't feeling their angst.

Fool on!

— Jeff (TMFFischer)

Completed *Pro* Trades

- **iShares Russell 2000** (NYSEMKT: IWM): We set up a 5% put ratio spread by selling to open 20 November 2013 $91 puts and buying to open 10 November 2013 $96 puts. We set it up for a net credit of $0.02 each.

Pro Catch-Up Trades

- **iShares Russell 2000** (NYSEMKT: IWM): You can still set up last week's recommendation — this morning for a credit of $0.03 per spread.

Coverage & Community

- **American Tower** (NYSE: AMT) gets all "spendy" and buys another tower company for billions. We'll assess the purchase, and we may write new puts if our Sept. $70 puts expire as income.
- Members ask for details on our IWM hedge and its timing — so Jeff answers.
- TMFVenus announces the first *Pro* Foolerang contest winners!
- Just as compounding sneaks up on you, numbers aren't always what they appear to be. See how much we've made on IWM hedges so far, and how DGS has really done for us.
- Member nevercontent posted a new list of option ideas from his experimental screen.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Set Up a Put Ratio Spread on IWM

Published Sep 5, 2013 at 11:15AM

- **What We're Doing:** We're creating a market hedge that will reward us if this small-cap index declines more than 5.7%, but won't cost us anything if the market keeps rising.
- **Who Should Follow Along:** We hedge to smooth returns during market declines. You don't need to hedge to succeed with *Pro*, but if you want to -- and can write naked put options -- then you should follow along. Those who can't write naked puts should consider Alternative Trades at the end of this report.

Trade Essentials

- **Action:** Use a spread order to set up a put ratio spread on the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF.
- **Allocation:** 5%. Set up one 2:1 put ratio spread for every $180,000 you manage; *Pro* will sell 20 puts and buy 10.
- **Price Guidance (all prices as of Sept. 4):** Seek a small net credit.
    - Write ("sell to open") two Nov. 2013 $91 puts, and simultaneously buy ("buy to open") one Nov. 2013 $96 put for every $180,000 you're hedging.
        - Sell to open two Nov. 2013 $91 puts: $2.02
        - Buy to open one Nov. 2013 $96 put: $1.93 (prices will change, but just aim for a small credit)
        - Net credit: $0.09 per spread
        - IWM price: $101.80

The Big Picture

Longtime *Pro* members (hello out there!) know that since 2011, we've set up several put ratio spreads on the **iShares Russell 2000 Index** (NYSEMKT: IWM), an ETF that tracks the 2,000 smallest companies in Russell's universe. It's liquid and more volatile than the S&P 500, making for an effective hedge. This trade has handed us profits a few times during market declines, and hasn't hurt us when prices climbed -- a key advantage of a put ratio spread.

The only catch is that -- as with any put-writing trade -- you need to be ready to buy the underlying investment (IWM, in this case) if its price falls enough. In this case, our break-even is about 16% lower than the current price – a healthy cushion on a large index. But it's also worth noting that this hedge doesn't benefit us at expiration unless IWM is at least 5.7% lower. That's by design; as we often say, there's little to be done about small market declines (say, 5% or less), but we want to consistently hedge against larger ones. This hedge will reach its maximum profit if the index declines 10.6%.

Finally, this is the first hedge we're setting up for autumn. It's a small first step. Another may soon follow. Here's how this one would play out at various index prices.

Return Details

iShares Russell 2000 Index ETF Price at Expiration	Value of 1 Purchased $96 Put	Value of 2 Written $91 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%) From $101.80

iShares Russell 2000 Index ETF Price at Expiration	Value of 1 Purchased $96 Put	Value of 2 Written $91 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%) From $101.80
$96 or higher	$0	$0	$0.09 per spread (or the credit received initiating the trade)	Any increase in price, or any decline of less than 5.7%
$95	$1 x $100 = $100	$0	$100	6.7%
$94	$2 x $100 = $200	$0	$200	7.7%
$93	$3 x $100 = $300	$0	$300	8.6%
$92	$4 x $100 = $400	$0	$400	9.6%
$91	**$5 x $100 = $500**	**$0**	**$500** (max profit)	**10.6%**
$90	$6 x $100 = $600	($1) x 200 = ($200)	$400	11.6%
$89	$7 x $100 = $700	($2) x 200 = ($400)	$300	12.6%
$88	$8 x $100 = $800	($3) x 200 = ($600)	$200	13.6%
$87	$9 x $100 = $900	($4) x 200 = ($800)	$100	14.5%
$86	**$10 x $100 = $1000**	**($5) x 200 = ($1000)**	**$0** (break-even)	**15.5%**
$85	$11 x $100 = $1100	($6) x 200 = ($1200)	($100)	16.5%

The bolded lines above show that our maximum profit will be earned if IWM declines 10.6% from its recent price, to $91, by our November option expiration. Our break-even on the strategy is $86 per share.

Assuming we set this up for a credit, the trade will result in a small profit even if the market rises or treads water. But you must be ready to fulfill the $91 put obligation if the market falls more than 10%. Depending on the situation, we'll either happily start a 5% allocation in the small-cap index then, or look at rolling our strategy to future months if we wish to avoid buying shares.

Alternative Trades

- **If you're hedging in an IRA or can't write naked puts:**
  - For a cost, you can set up a **bear put spread**, a strategy with capped risk that most IRAs allow. Using a spread order, "buy to open" November 2013 $96 puts, and "sell to open" *an equal number* of November 2013 $91 puts. Recently, this will cost you around $0.93 ($93) per spread, and that is your maximum risk. This strategy could pay you up to $4.07 ($407) per spread on a market decline to $91 or lower, but you should be prepared to lose your $0.93 if the market doesn't decline enough. As with any market hedge that you pay to set up, you have to *expect* to lose your investment most of the time, especially on a hedge that only kicks in after a nearly 6% decline.

- **To lower your market exposure while following our official trade (and make it possible in some IRAs):**
  - Set up the original put ratio spread as recommended, but also "buy to open" half as many November 2013 $86 puts as the $91 puts that you write. So, if you write 20 puts at $91 and buy 10 puts at $96, then also buy 10 puts at $86. This caps the downside in your previously uncovered $91 puts, and limits the capital required to hold the trade. The $86 puts cost about $0.50 lately, making the cost for the entire position (the put ratio spread plus these protective puts) about $0.41 per contract – that is also the most you can lose.

Next Steps

- **Questions or comments?** Visit our iShares Russell 2000 Index board.
- **Follow it:** Add iShares Russell 2000 Index to My Scorecard.

See Pro *'s holdings here. See the team's and David and Tom Gardner's holdings here .*

Set Up a Put Ratio Spread on IWM

Published Sep 5, 2013 at 12:00AM

- **What We're Doing:** We're creating a market hedge that will reward us if this small-cap index declines more than 5.7%, but won't cost us anything if the market keeps rising.
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Next Steps

- **Questions or comments?** Visit our [iShares Russell 2000 Index board].
- **Follow it:** [Add iShares Russell 2000 Index to My Scorecard].

See Pro *'s holdings here. See the team's and David and Tom Gardner's holdings here .*

Football Fanatics and Passionate Communities

Published Sep 3, 2013 at 4:00PM

Dear Fools,

This past weekend marked the opening salvo for college football teams across the country, soon to be followed by the NFL this coming Sunday. To honor the occasion (and because I'm both a Florida alum and a huge sports nut), I ventured out to the local "Gator bar" here in D.C. — a cramped, three-story dive in the heart of Capitol Hill. On Saturday afternoon, the typical dingy atmosphere was replaced by legions of orange-and-blue-clad fanatics, all joyfully watching our team beat up on Toledo (sorry to any Rockets among our membership ...).

A day earlier, in different clothing, this group of people might never have interacted. But on this Saturday, we were gleefully high-fiving, sharing buckets of wings, and joining arms and swaying in unison at the end of the third quarter.

The Value of Community

The pageantry and the camaraderie of that experience reminded me strongly of the community we're lucky enough to be a part of here at *Motley Fool Pro*. True, we may not be as nonsensical, rambunctious, or ridiculous as a group of Gator fans who have been drinking beer since 10 a.m. But some other characteristics are more similar: a sense of loyalty, support for one another, and a connection to a community that is bigger than ourselves.

I've written more than once on our discussion boards about how impressed I am with the community atmosphere that's so apparent at *Pro*. I strongly believe that the process of investing is greatly enhanced by a knowledgeable, grounded, and diverse community. Each individual brings a unique perspective, knowledge, and set of experiences to the table. And while all that input comprises but a drop in the bucket of valuable investing information, as the size of the community grows — and more people provide their "drops" — the bucket inevitably begins to fill.

The Foolish Bottom Line

The beginning of the college football season gave me an opportunity to reflect on the concept of passionate and engaged communities (and also gave me a reason to throw in a plug for my Gators!). Real football fans don't care whether their team is a perennial championship contender or a perpetual basement-dweller; they stay loyal to the team and to the community. And while *Pro* members may not don lucky Jeff Fischer jerseys or bellow stadium-filling "Go *Pro*!" chants (or do they?), this community sticks together, too — working in mutual pursuit of our goals whether our investments and/or the market are up, down, or flat.

If you've yet to participate on our discussion boards, I feel like you're missing out on what may be the most valuable part of the *Pro* experience. Come comment on the Memo Musings board, do some exploring, and see for yourself what I'm talking about — then tell me why the Gators are bound for glory.

Fool on!

— Billy (TMFTailwind)

Pro Community & Coverage

- Jeff has had his eye on the VIX ... again.
- Pro member aleax ponders profit margins and investment returns.
- A good read on historical returns.
- Last call for Foolerang entries!

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Smiling Under the Redwoods

Published Aug 26, 2013 at 4:00PM

Dear Fools,

Labor Day Scheduling Notice: The market, and TMF, will be closed Monday, Sept. 2. Your next Memo will hit your inbox at 4 p.m. Tuesday, Sept. 3!

Will You Be the One? On Sept. 19, Motley Fool co-founder and CEO Tom Gardner will invite a few of our most ambitious Fools to **give up their *Pro* memberships** and join him in a premier "club" that gives them access to every wealth-building tool, product, and service we've developed over the past two decades — including *Pro*. **Only about one out of every 100 Fools will be able to join.** To see if you qualify and to learn more about this one-of-a-kind endeavor, simply click here.

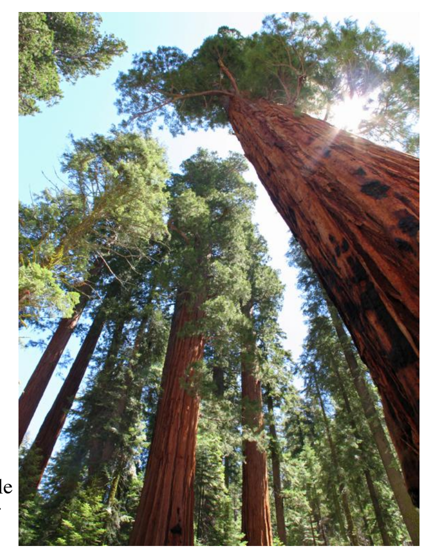
Halfway across the Golden Gate Bridge, the gnarly, toothed fog finally released its grasp on the hybrid my wife and I had rented (we're in San Francisco, after all), and our subsequent descent into Marin County was nothing but sunshine and ocean air. The sight of the Pacific Ocean — and the houses perilously perched on the hills above it — grabbed us immediately, but was challenged in short order by the wondrous draws tugging playfully at our other senses. After a few more switchbacks and a short hike, we were standing at the base of some incredible coastal redwoods.

No Left Turn

At this point in the Memo, I'd normally take a left turn onto Investing Boulevard and begin relating the magnificence of the trees to *anything* financial. Some ideas:

- The coastal redwood's bark is 12 inches thick. That resilience is a defense against predators and the elements — just like a meaningful, competitive barrier to entry that deters newcomers to an industry and protects a company's excess profit.
- The trees' 100-footwide root system ensures health and nutrients are always flowing from one direction, even if others may be barren — just like portfolio diversification ensures strong returns from one asset class even though others may suffer.
- The size and vitality of the great trees themselves fosters an entire ecosystem hundreds of feet below their canopies, just as a portfolio that grows tall and strong can fund years of life — and fun — for our families.

But I'm not going to turn left in this Memo. Instead, I'm going to glorify the moment exactly as it was. I love investing, but this was one of those experiences I invest *for* — a reward for all of the hard work, stress, and deliberate practice. In one sense, it's too bad such moments don't happen often, but the rarity is precisely what made it so special. We were able to fly across the country to take this vacation because of the saving and investing we undertake every day.



Holding my wife's hand, I allowed the clean air to dance under my nose, as bright and invigorating as the aroma of fresh-ground coffee beans first thing in the morning. As my nose followed the air upward, my eyes slowly closed, and I felt myself break into a great big grin. That smile was entirely organic, a gesture of pure appreciation. *That* is why I invest.

The Foolish Bottom Line

Many of those redwoods are more than 600 years old. I can only hope their beauty and magnificence have brought similar joyful revelations to millions of other visitors. And more specifically, I hope *you* have had a "redwood moment" or two in your investing career — an incident that reminded you of the adventures and memories your investments make possible, and of the people and experiences that make the process so worthwhile.

Thoughts? Comments? "Redwood moments" of your own? Share them on the Memo Musings discussion board.

Onward,

Bryan (TMF42)

Pro Catch-Up Trades

- **American Tower** (NYSE: AMT): Shares remain a "buy" for those lacking our 2.4% allocation. To potentially double your position to nearly 5%, write September 2013 \$70 puts if you haven't already. These puts recently bid \$1.50, for a 2.1% yield in 26 days. Or, write October 2013 \$70 puts for \$2.50 — that's a 3.6% yield in 54 days.

Pro Community & Coverage

- We'll miss Tom, but we welcome Daisy with open arms.

- What's a Foolerang? It's a contest that could win you a *Pro* hat, that's what!
- Unlike age-old redwoods, technology is always evolving. Will the competitive moat around **Intel** (NASDAQ: INTC) keep out foes? We have our eyes on it.
- Member nevercontent posts put-writing ideas.
- Why buy **AmTrust** (NASDAQ: AFSI)? Members discuss.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here .*

Rockwood Moves to Sell

Published Aug 19, 2013 at 4:00PM

Dear Fools,

Remember those agonizing dating decisions you had to make in high school? Today, the mere mention of a particular ex may still put your nerves on edge.

Breaking up with a stock can be just as difficult, especially because a stock won't tell you it's getting bored or wants to see other people — cutting the cord is solely on you. At *Pro*, we consider selling a position under the following circumstances, among others (and we don't care if prom is right around the corner):

- Any hint of management dishonesty
- A sudden, unexpected change in top leadership
- An ongoing failure to execute on goals or fulfill our thesis
- A share price that increases much more than the fundamentals support
- A large restructuring of the company that will change the business and financials

That last bullet point speaks directly to **Rockwood Holdings** (NYSE: ROC). The specialty chemicals company is on track to divest itself of three of its five divisions, leaving just lithium and surface treatments. Although this may be a smart long-term move, it creates a large degree of uncertainty.

The new, much smaller Rockwood will generate approximately just one-third of the revenue and 52% of the EBITDA it currently enjoys. Based on trailing 12-month results for its two remaining divisions, Rockwood will soon trade at approximately 14.2 times EV/EBITDA (enterprise value to earnings before interest, taxes, depreciation and amortization). That compares to just 6 times EV/EBITDA in 2011, when we were buying, and 11 times EV/EBITDA today. Plus, my estimate assumes management will use proceeds from the spin-off to pay off a generous $2 billion in long-term debt. It may pay down less.

Not only is Rockwood's stock getting more expensive, but its business is becoming more dependent on lithium prices — and there's no guarantee those will rise as industry leaders (including Rockwood) plan for more production. Rockwood will also need to increase its surface treatment revenue, which has stagnated this year. At the same time, freeing itself of three business divisions may not lower expenses as much as hoped; "right-sizing" the company may require more cuts and more time.

When we started buying Rockwood in early 2011, we (and management) believed the business was worth about 9 times EBITDA. To repeat, today it trades at 11 times EBITDA, and soon that figure will be an estimated 14.2. Granted, the new company will have higher margins, and management projects a long-term 20% revenue growth rate — but today that growth is elusive, and either way the valuation looks generous. Wall Street is excited about the company's plans, and seems to be paying up as a result. This happened when **GrafTech International** (NYSE: GTI) bought Seadrift, too, but that large change has not created value years later, and the stock has surrendered all of its gains.

At any rate, valuation estimates and uncertainty with the new business meant that we allowed our shares to be sold over the weekend through the $60 covered calls we wrote in April. Our whole 5.3% stake was sold at a net $64.59 (almost exactly where the stock traded Friday, incidentally). With this sell, the stock moves from Hold to Sell for those who still have a position.

A Recharged Future?

In the 30 months we've been involved with Rockwood, our position (bought in two increments) returned 42% on average (excluding dividends and option income), making it a strong performer. There is a lot to like about this company, including its transparent management, and we will closely watch it for future investment. Lithium demand should grow sharply this decade as its use in electric cars expands, and Rockwood is likely to be a high-margin business with potentially strong growth.

But we want to own the "new" Rockwood at a reasonable price, so we're targeting a lower valuation multiple, and we look forward to any market decline that may help us find it. We want to see how costs shake out in the new business, too, and how much debt management pays off. This will take time. But at the right price, we could write puts or buy Rockwood anew.

In closing, consider this an indefinite break from Rockwood. We can date other companies now, but like old high school sweethearts, we may yet have a future together. For now, the stock is a Sell.

To discuss the Memo, please visit the Memo Musings discussion board. Thank you for being a *Pro* member!

Best,

Jeff (TMFFischer)

Pro Guidance Changes

- **Amtrust Financial Services** (NASDAQ: AFSI): Our fair value and "consider adding more" prices were both adjusted lower to account for the company's 11-for-10 (10%) stock dividend, which went into effect Friday. We should get our new shares soon (one new share for every 10 we already own). Shares remain a Buy.
- **Rockwood Holdings** (NYSE: ROC): For those still in it, the stock moves to Sell from Hold.

Pro Trade Roundup

- **American Tower** (NYSE: AMT): We rolled all six of our August 2013 $70 puts to September 2013 $70 puts for a net credit of about $1.52 each. If exercised next month, this would double our stake to about 5%.
- **Rockwood Holdings** (NYSE: ROC): All 1,400 of our shares were sold via August $60 calls, for a net sell price of $64.59.

Pro Coverage & Community

- New member "turningitblue" has us Foolishly discussing position sizes in the portfolio. Is 5% large?

- RichardinReno launches a long discussion on how to integrate *Pro* with other Fool services. Great thoughts from members!

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Roll Your Puts on American Tower

Published Aug 15, 2013 at 11:30AM

Hey, *Pro* Fool! This Alert is time-sensitive because these options expire on Friday, Aug. 16. If you're following along, make sure you take action by market close on Friday.

- **What We're Doing**: Rolling out our written puts, which will either bring us additional income with reduced capital at risk or will allow us to potentially add 2.5% to our stock position, bringing it to around 5%.
- **What We're Thinking**: With our current puts near-the-money and the stock trending lower, rolling choices are very attractive.
- **What We're Expecting**: Company fundamentals remain strong and will drive long-term performance, but other factors are ruling the near term.

Trade Essentials

- **Action**: Roll your August 2013 $70 written puts on **American Tower** (NYSE: AMT) to September 2013 $70 written puts. Your broker should allow this in one trade ticket, for a net credit.
- Buy to close your August 2013 $70 puts
- Sell to open new September 2013 $70 puts
- **Allocation**: Close all of your short August puts and write an equal number of September puts. If these new puts are exercised in September, our stake in AMT will increase by about 2.5%, bringing your total to a 5% position. *Pro* will roll all six of its contracts. Each new contract represents a $7,000 potential obligation.
- **Recent Price**: $69.18
- **Option Price (bid/ask)**:
- August 2013 $70 puts: $1/$1.15
- September 2013 $70 puts: $2.65/$2.80
- **Price Guidance**: What matters is the net credit to roll, not either individual leg. Split the bid and ask, aiming for a net credit of $1.50 or better. **You must complete this roll by market close on Friday afternoon if AMT stock remains at less than $70, so as that time approaches, you may need to accept a smaller credit.**
- **Alternative Trades**:
- If you don't yet have an allocation to American Tower, we recommend you buy a 2.4% allocation to match *Pro* (in round lots, if you can) and then write the September 2013 $70 puts for about $2.65 or better, representing another 2.5% worth of shares.
- If you didn't write August puts but have an allocation to American Tower, we suggest you write the September 2013 $70 puts for another potential 2.5%.
- If you're transacting in just one or two contracts and commissions are eating up your income, consider rolling to the October 2013 $70 puts (or writing them to begin an income position). They currently pay around $3.30 – a $2.15 net credit from rolling. If you'd like to be more conservative than *Pro*, consider the October $67.50 puts, which also pay well.

What's New?

One month ago, we speculated that American Tower's structure as a real estate investment trust (REIT) was prompting market participants spooked by REITs to sell the stock. Since then, the REIT sell-off has continued, with REITs underperforming a mostly flat stock market by more than six percentage points. And once again, American Tower is along for the ride. Although we think this broad-brush approach to buying and selling is silly, we don't think American Tower is immune – at least in the near term. Over a longer time frame, business fundamentals will drive stock performance, and we're quite comfortable with how American Tower's business is going:

- Recent results were A-OK, and management raised guidance for the year.
- The company announced a significant purchase of towers in Brazil and Mexico, which we believe provides a platform for increased cash flow per tower as those countries expand their mobile data usage and telecom companies look to support that growth in an economical way.

How to Follow Along

We believe our thesis is intact and we're happy to own more shares, so this roll is very much a numbers game. The market is presenting us with an attractive reward (3.8% in 36 days) for lowering our capital at risk (to $66). Shares could run away from us, but we believe continued pressure on REITs will allow us to increase our allocation at great prices at some point. So we're obliging Mr. Market and going back for another helping of income.

ROLL OUT YOUR WRITTEN PUTS		
Cost to close August $70 Put	($1.15)	
Income from writing September $70 Put	$2.65	
Gross Yield on strike price		*3.8%*
Annualized (36 days)		*38.4%*
Net credit from rolling out	**$1.50**	
Net Yield on strike price		*2.1%*
Annualized (36 days)		*21.7%*
Strategy breakeven and net buy price	**$66.00**	
Downside protection		*-4.6%*
Previous breakeven and net buy price	$67.50	

- **Maximum return**: We make 3.8% in 36 days (38% annualized) on this iteration if shares of AMT rise above $70. If that's the case at September expiration, we will have earned put premiums of $4, or nearly 6% of the capital we've risked for just two months.
- **Breakeven**: We begin to lose money on this strategy when shares fall below $66, or 4.6% lower than where they are today.
- **Maximum risk**: We're on the hook to buy shares if the stock price remains less than $70 – a fate we're perfectly happy with at this point. If shares fall $3.18, to $66, our loss matches that of owning shares outright.

Next Step: Please post any questions on the American Tower discussion board.

See Pro'*s holdings here. See the team's and David and Tom Gardner's holdings here.*

A Soul That Tastes Like Pizza

Published Aug 12, 2013 at 4:00PM

Dear Fools,

I love it when the opportunity to talk stocks pops up in unexpected places. As the frequent victim of this phenomenon, however, my wife loves it decidedly less -- but she promised "in sickness and in health," and she is fully aware of my investing sickness. (The stack of **Papa John's International** (NASDAQ: PZZA) annual reports piled on our kitchen table is a clue; she knows I'm taking over coverage with Nick's departure.) Plus, we were mid-row watching baseball at Nationals Park, so she was captive. With two oversized slices of fresh Papa's pizza in our laps and a prominently displayed Papa's logo plastered on the left-field wall, she asked: "So how's the Papa John's research going?" While my position review isn't yet complete, I'll tell you what I told her (well, maybe with a few more details) about what has impressed me so far.

Impressed by Management

Papa John'sis still run by its committed founder, John Schnatter (yep, the guy from the commercials). Schnatter owns 26% of the company, but more impressive to me is that, almost 30 years into making pizza, his passion remains infectious. It apparently even infected his wife, who owns a franchise! Here is what I've found notable:

- Schnatter keeps his entire management team laser-focused on quality. "The Papa John's Way" is the company's philosophy of ensuring quality in every facet of the business. It means avoiding shortcuts and winning over every customer one pie at a time. In fact, it seems management can't finish a sentence without adding the word "quality" -- on average, the Q-word is spoken an absurd 12 times per quarterly conference call. (Since 2010, the word has been spoken 164 times ... yes, I counted.) Management is on message all the time, not because they're robots, but because they truly believe quality will win.
- The company is incredibly disciplined. Not a quarter goes by without analysts getting into a tizzy about competitors' pricing strategies, but Papa John's steadfastly refuses to compete on price. Instead, the company has remained stoutly committed to its premium pricing (its brand, as you can guess, is centered on quality vis-à-vis its chain competitors). This strategy means more profit per pie, and it allows the company to leverage its advertising by keeping to a consistent message: "Better ingredients, better pizza." Papa John's is simply playing a different game than its price-focused competitors, and it can do so because of a nearly 30-year investment in consistent branding and execution.
- A long-term mind-set influences decision-making. The point about price ties in here: Matching competitors' prices would undermine the brand Papa has spent three decades building. However, *not* doing so might drive the most price-sensitive pizza buyers elsewhere, meaning Papa loses market share. This may seem like a tough decision for the company, but it isn't – time and time again, Papa John's has displayed its willingness to trade short-term pain for long-term gain. The company has also taken the hit on rising commodity costs when it believed franchisees needed the financial break, and it often waives the initial franchise fee to encourage its best franchisees to open more restaurants. These actions hurt financial performance today, but ensure the health of the company for the long term.
- I admire how Schnatter chooses to spend his time. He is very often traveling to visit, check in on, and reinforce the Papa John's Way with his franchise owners and employees. Culture and message don't often permeate if they're just handed down from on high, but a genuine, hands-on manner works wonders. Schnatter also spends time on developing leaders. He has stepped away from the CEO role twice in 30 years, and both times, the company lost its way. To keep this from happening again, Schnatter has been developing more and more leaders, promoting from within like crazy, and building bench depth.

The *Pro* Bottom Line

Papa John's is up nearly 200% for *Pro*, yet it seems like few members actually own shares. The PZZA discussion board is sleepy, and it's easy to write off this business as just a crummy pizza chain. But the results don't lie: There's something else going on here that has allowed this company to thrive in a cutthroat industry. It's something softer and more nuanced. I believe the difference is that Papa John's has a soul its competitors simply lack. It's hard to quantify and hard to model, but it has sustained this successful company for nearly three decades. It's the foundation upon which my emerging thesis for Papa John's will rest, and it will be a key area of focus as I begin to follow the business for *Pro*.

As it happens, my wife didn't buy the soul argument. But as Stephen Strasburg took the mound for the Nats with "Seven Nation Army" blasting over the ballpark speakers, she did manage to say (with a full mouth) that "at least their soul tastes pretty good." And that, I suppose, might be an even better thesis.

Onward,

Bryan (TMF42)

Pro Trade Roundup

- **AIG** (NYSE: AIG): We purchased 500 more shares of AIG for $48.09 per share, bringing our total allocation (stock plus options) to just shy of 5%.
- **BMC Software** (NASDAQ: BMC): We sold 1,600 shares for $46.01, exiting our position entirely.
- **iShares Russell 2000 ETF** (NYSE: IWM): We closed our August 2013 $91 short put options for $0.01 per contract. We did nothing with our August 2013 $96 long puts.

Pro Expiration Notices

- **American Tower** (NYSE: AMT): Our August 2013 $70 short puts are at the money. We're happy to take shares if the stock falls a bit this week, bringing our position closer to 5%. If shares are flat or rise a bit, we may look to write another round of puts to increase our position.
- **iShares Russell 2000 ETF**: Our August 2013 $96 long puts will likely expire worthless on Friday, but require no action.
- **Rockwood Holdings** (NYSE: ROC): Our August 2013 $60 short calls are in the money, and with no action, our entire position will be called away. Right now, we're likely to let this happen, although a final decision will be made by midweek.

Pro Coverage & Community

- Here is a classic *Pro* discussion about the market and so much more.
- Keeping tabs on insider selling is important, but not always damning.
- Did your favorite pizza make the list of the 33 best?

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Buy More AIG

Published Aug 7, 2013 at 12:30PM

- **What We're Doing**: We're raising our equity stake to 4%.
- **What We're Thinking**: We want more capital behind our highest-conviction ideas.
- **What We're Expecting**: Improving insurance markets will continue to boost underwriting results, bringing the share price closer to book value.

Trade Essentials

- **Action**: Buy shares to bring your equity stake up to 4%, or your total allocation (stock plus calls or warrants) to around 5%. *Pro* will be buying another 500 shares.
- **Buy Around**: $48
- **Fair Value**: $60 (raised from $55)
- **Status**: Buy First

What's New?

Pro's one-year anniversary with embattled insurer **AIG** (NYSE: AIG) is fast approaching, and the stock remains a Buy First on our scorecard. Now seems like a great time to check in on how our thesis is playing out.

- **We expected AIG to slowly improve its underwriting.** Check. The company's second-quarter results show that, while results will be bumpy, things are modestly improving. Thanks to a solidifying pricing environment and AIG's continued discipline in managing underwriting and controlling expenses, we're optimistic this progress will continue.
- **We expected AIG to buy back shares from the U.S. Treasury at a discount to book value.** Check. The Treasury no longer owns shares of AIG, and although oversight will continue to be significant, the company's freshly announced dividend provides evidence that AIG has more control over its capital structure and decision-making than at any time since the financial crisis.
- **We expected AIG to earn improving returns on equity.** Check, mostly. AIG's messy past does make for a complicated present, but we believe core returns on equity are improving. As we sift through the moving pieces, we're confident that the drivers of ROE (insurance profitability, controlled asset growth, and intelligent use of leverage) are all moving in the right direction.

In fact, AIG has improved its business at a slightly higher rate than we expected, prompting us to raise our fair-value estimate and Consider Adding More price to $60 and $44, respectively. The compounding factor that bolsters our confidence is company management; CEO Robert Benmosche has consistently talked the talk *and* walked the walk with regard to vision, execution, and capital allocation. We understand he won't be around forever, but we believe he has assembled a deep bench of employees who are passionate about AIG's turnaround, are motivated by the proper incentives, and have our common interests in mind.

Next Steps

If you have any questions, file your claim on the AIG discussion board.

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Next Steps

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Rock ’Em Sock ’Em Earnings Review

Published Aug 5, 2013 at 4:00PM

Dear *Pro* Member,

We reviewed more than half a dozen earnings reports last week. But instead of squeezing our findings into a list of links at the very bottom of this Memo — and running the risk that you might miss something — we're making them thebulkof today's content. After all, while we know you hired the *Pro* team to monitor your *Pro* investments closely, we also know *you* want to hear about what's going on in your companies. So our reviews listed below are shared in that spirit.

Before we get started, though, let's touch on the big elephant in the room: the still-rising stock market, which is currently printing money even faster than the Federal Reserve. As of today, according to S&P Capital IQ, the S&P 500 trades at 16.4 times trailing normalized earnings and 15.6 times expected profits for 2013. That's still well within the bounds of the historical average, although the latter multiple is counting on a strong end to the year.

Even so, our ears are perked up and our eyes are peeled for new hedges and shorts (andlongs!) as we seek steady rolling three-year results with less risk. In the meantime, once we complete our recently recommended sale of **BMC Software** (NASDAQ: BMC), the *Pro* portfolio will be holding about 18% cash — a reasonable sum that leaves us open to opportunities. Now about those earnings ...

Terms to Know

Before we jump in, let's review some important ground. The bulk of the *Pro* portfolio is invested in strong businesses we believe will grow and compound value over time. We review results every quarter not so we can overreact to some arbitrary earnings "miss" or "beat," but to see whether the business in question still appears likely to compound our money over the coming years, or whether something is starting to threaten our thesis. These terms are important in that determination:

- **Fair Value (FV):** Our fair-value estimate seeks to name afair price for a stocktoday – and that's fair for a seller *or* a buyer. From its fair value, we expect a stock to deliver our desired long-term rate of return (generally 10% annualized or better today, in line with our North Star). When a business grows in any given year, its fair value should go up, too, as long as we see continued growth ahead. So, we will typically increase our fair-value estimate for every growing business we own during every successful year.
- **Consider Adding More (CAM):** We recommend that *Pro* members own our current allocation in any stock that's rated Buy First or Buy on the Recommendations tab. From there, we'll consider adding *more* to a position – increasing our allocation – if the stock falls to or below our "consider adding more" price.Of course, we may add to (or cut) any stock anytime if we believe it's the right choice, but the CAM price is a formal way to make us reassess.

Now, finally, in summary form ...

Guidance and Earnings Updates

3D Systems (NYSE: DDD): This printer's fair value increases to $30 and its CAM price rises to $26, but shares remain on hold for newcomers. The stock looks expensive given the company's lackluster net income and free cash flow growth. Management (and the business) remains long on promise, though. See our full review.

American Tower (NYSE: AMT): The company has made fewer tower acquisitions of late, but the business remains strong and revenue is of course contracted for years to come. This great business remains a Buy with no guidance changes. We've also written $70 puts.

Facebook (NASDAQ: FB): Our thesis that the world's stickiest website would generate strong advertising revenue appears to be taking shape. Newcomers can consider starting a small position in call options. See our full review first, then consider our Catch-Up Trades below.

GrafTech International (NYSE: GTI): Will steel see a bottom soon? Maybe. But right now, it remains ugly. No guidance changes on this Buy-rated stock, though.

OpenText (NASDAQ: OTEX): Fair value increases to $74 and CAM to $60. New license revenue was weak this quarter, but it jumped the quarter before that; this metric will be choppy but should grow overall. See our full review.

O'Reilly Automotive (NASDAQ: ORLY): The company revved up a very strong quarter. Fair value increases just a bit on this new holding, to $118, and CAM inches forward to $94. See the good news.

Starbucks (NASDAQ: SBUX): The company is more caffeinated than it has been in years, with earnings per share up 28% last quarter. FV jumps to $67 and CAM perks up to $53.50. See what's brewing at Starbucks.

Tupperware (NYSE: TUP): We announced this in last week's Monday's Memo, but it's worth repeating today: We've moved the container king to Buy and popped its FV to $80 and its CAM to $72. Read the update on this emerging-markets story.

- **Can't get enough reviews?** You can see more, and follow along as they're posted, on the central column of the *Pro* homepage.
- **See FV, CAM, and allocations for everything** on the Recommendations tab.
- **Want to discuss this column?** Hit up the Memo Musings board.

Fool on!

— Jeff (TMFFischer)

Pro Guidance Changes

- Please see above!

Pro Catch-Up Trades

- **Facebook** (NASDAQ: FB): Newcomers can invest about 1% by buying ("buy to open") January 2015 $20 to $25 calls. Start small. You could add more on dips to build closer to our 2.9% stake.

Pro Coverage & Community

- Long-time member aleax shares his view from the road (and from Motel 8) after discovering (again) how truly bad trading is for your returns.
- RockyTopBob's wife is on television! Wait, it gets better — it's for rescuing golden retrievers!!
- The turnaround story at *Pro* holding **AIG** (NYSE: AIG) continues to progress nicely; here's TMFTailwind's take.

- Earnings aren't over yet! See TMFMoosie's *Pro* calendar.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy to Close Your Short Puts on IWM

Published Aug 5, 2013 at 12:30PM

Trade Essentials

- **Action:** Buy to close all of your August 2013 **$91** puts on the **iShares Russell 2000 Index** (NYSE: IWM). (Keep holding your long August 2013 $96 puts!)
- **Price Guidance:** Use a limit order to attempt buying to close at **$0.01**. That should work eventually.
- **Recent Price** (bid/ask): $0/$0.01
- **Recent IWM Price:** $105.50

What's New?

The iShares Russell 2000 Index, which tracks the 2,000 smallest companies in Russell's universe, has continued to ascend to new 52-week highs this summer, making our August put ratio spread "hedge" on it unnecessary. Fortunately, this strategy doesn't cost us when the market goes up. Today, the index is 16% higher than our $91 put strike price with less than two weeks until expiration.

You can argue that we could just let these puts expire a week from Friday — and we almost surely could. But we've made 99% of what the puts have paid us, and we can close them for just $18 (perhaps even without a commission, which many brokers don't charge when closing an option with less than $0.05 of time value left). Closing the written puts removes our potential obligation to buy a 5% stake in IWM should it decline 15% or more before Aug. 17 expiration, which is unlikely, but not impossible.

To be clear, we *will* keep our August $96 long (or owned) IWM puts in the portfolio. At this point, those long $96 puts are cheap insurance that will pay us if the market falls about 9% in the next week or so. We're also looking at new put ratio spreads (and other strategies) to hedge the market going into autumn. So, stay tuned.

Next Step: To discuss closing your $91 puts, visit our IWM board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

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Next Step: To discuss closing your $91 puts, visit our IWM board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Sell BMC Software

Published Aug 2, 2013 at 12:30PM

Trade Essentials

- **Action:** Sell all shares of **BMC Software** (NASDAQ: BMC)
- **Price Guidance:** Use a limit order to sell above $46
- **Recent Price:** $46.02

What's New?

BMC Software agreed to be taken private at $46.25 per share this spring, but the stock had remained at least 1% below that price until recently — and I'm stubborn enough to want most of that 1%! Today, shares are only 0.5% below the buyout price, and with the prospect of a higher offer now all but gone, there's not much more to gain by keeping our 4.2% position.

Also, while we don't expect it, there's always a risk that the deal will fall through. We predict that the consortium of private equity buyers will complete the deal as planned ... but we're not behind the closed doors, sitting at long tables, to see the contracts getting signed and the billions of dollars preparing to change hands. We wouldn't know until afterward if there was a snag, or if the deal came apart at the last minute. BMC did announce on July 31 that it's looking to raise $1.38 billion to help fund the deal — and credit market problems could always rear up in a sudden economic crisis.

Given that we don't think such complications are likely, we could wait until sometime in September (perhaps later) to get another $0.23 per share — but that's not worth the risk of the stock price falling by several dollars, which could happen if problems do arise. BMC isn't holding quarterly conference calls any longer, so if management makes changes to the business, we won't know about them. We're choosing to give up about 0.5% in additional upside over the coming few months, but in exchange, we'll take our profit and remove any risk.

Overall, BMC returned 16.3% for us in about 22 months — somewhat shy of our North Star. We bought this struggling business after its problems arose, and it never found a way to grow consistently. However, our double-digit return supports the argument that if you buy a good business with stable free cash flow at a very good valuation, you can still make money even if the business doesn't improve. Thank you, BMC, for the memories — and the return.

A Bit of Sentiment ...

BMC first entered my universe in about 2005; its new business direction was featured in an airplane magazine, of all things, that I happened to read while on a flight to Costa Rica. (So stay curious as you go about your day! Ideas come from everywhere.) I bought shares and ended up doing well with them. This week, I returned to Costa Rica for another visit ... and we at *Pro* decided it was time to sell BMC. It feels like we've come full circle, which is rare in investing. People tend to like the neatness of "finality" — that's probably why many are too eager to sell their winning stocks. In most cases, we'll want to hang on to our winners. But in this case, finality was given to us. I'll raise a pineapple to that.

What's Next: To discuss our sell recommendation, visit the BMC board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

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BMC Software agreed to be taken private at $46.25 per share this spring, but the stock had remained at least 1% below that price until recently — and I'm stubborn enough to want most of that 1%! Today, shares are only 0.5% below the buyout price, and with the prospect of a higher offer now all but gone, there's not much more to gain by keeping our 4.2% position.

Also, while we don't expect it, there's always a risk that the deal will fall through. We predict that the consortium of private equity buyers will complete the deal as planned ... but we're not behind the closed doors, sitting at long tables, to see the contracts getting signed and the billions of dollars preparing to change hands. We wouldn't know until afterward if there was a snag, or if the deal came apart at the last minute. BMC did announce on July 31 that it's looking to raise $1.38 billion to help fund the deal — and credit market problems could always rear up in a sudden economic crisis.

Given that we don't think such complications are likely, we could wait until sometime in September (perhaps later) to get another $0.23 per share — but that's not worth the risk of the stock price falling by several dollars, which could happen if problems do arise. BMC isn't holding quarterly conference calls any longer, so if management makes changes to the business, we won't know about them. We're choosing to give up about 0.5% in additional upside over the coming few months, but in exchange, we'll take our profit and remove any risk.

Overall, BMC returned 16.3% for us in about 22 months — somewhat shy of our North Star. We bought this struggling business after its problems arose, and it never found a way to grow consistently. However, our double-digit return supports the argument that if you buy a good business with stable free cash flow at a very good valuation, you can still make money even if the business doesn't improve. Thank you, BMC, for the memories — and the return.

A Bit of Sentiment ...

BMC first entered my universe in about 2005; its new business direction was featured in an airplane magazine, of all things, that I happened to read while on a flight to Costa Rica. (So stay curious as you go about your day! Ideas come from everywhere.) I bought shares and ended up doing well with them. This week, I returned to Costa Rica for another visit ... and we at *Pro* decided it was time to sell BMC. It feels like we've come full circle, which is rare in investing. People tend to like the neatness of "finality" — that's probably why many are too eager to sell their winning stocks. In most cases, we'll want to hang on to our winners. But in this case, finality was given to us. I'll raise a pineapple to that.

What's Next: To discuss our sell recommendation, visit the BMC board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Shorting: The Good, the Bad, and the Alternatives

Published Jul 29, 2013 at 4:00PM

Dear *Pro* Members:

Like bungee-jumping and bodysurfing, short selling isn't for everyone. Many investors lack the will, interest, patience, and/or broker to sell a stock or ETF short. For starters, you need to understand that shorting means you're borrowing shares to sell, and you'll usually pay your broker an annualized fee to do so. You're also responsible for paying any dividends distributed by the underlying investment. There's always a risk the shares will be "called away" from you on a spike in price. You can't short in an

IRA. And finally, you need to be ready to stomach a jump in the price of the security (i.e., a decline in the value of your short), while accepting that the most you can earn on a short position is 100%.

The Good

All that said, short-selling can be lucrative and enjoyable. Being short an imploding stock is nearly as rewarding as watching a stock you own climb. Even better in our eyes, shorting a flawed ETF or ETN -- one that uses futures contracts or leverage, causing its value to erode -- can be like finding the Golden Ticket in a Willy Wonka bar. As the flawed vehicle erodes in price, you gradually short more of it ... and grow your profits along the way. That's our plan with our short of **Direxion Daily Financial Bear 3X** (NYSE: FAZ), among others (many of which have yet to debut in *Pro*).

The Dilemma

You'll doubtless have noticed that the first two paragraphs above pit perfectly against one another. Many people aren't open to shorting, but shorting can have significant benefits – so what's the right choice for you? We believe only *experience* will tell you. As with snowboarding, you won't know if you like it until you try. So try! Today's market gives us more reasons to be *ready* to short than we've seen in years, offering up not just a panoply of struggling companies but dozens of flawed ETFs, many of which will find their way into *Pro*. If you think you might be interested in shorting as part of your long-term investing strategy (which is, of course, how we use these positions in *Pro*), then certainly make sure your broker is friendly to shorting. Here's how.

Not All Brokers Are the Same

When it comes to companies (or flawed ETFs) with high short interest, most brokers lack any shares to lend. In our experience, Interactive Brokers (*Pro*'s broker) and TD Ameritrade (I use them personally, along with Interactive Brokers) have the most shares available for selling short. Interactive Brokers has the largest inventory, but charges an annual fee (ranging from about 1% to 6%); TD Ameritrade doesn't charge anything extra to short. Check with your broker to determine its fees and charges for short positions. And ask about availability: Do they have shares of FAZ to short? What about FXE? What about SRS? If the answer is no, consider opening a second account elsewhere to handle your short sales. (*Pro* members' take on several brokers can be found here.) And if in the end you don't want to short, *Pro* will usually offer you alternatives to any short position we recommend.

There Are Alternatives to Shorting

Currently, the *Pro* portfolio is only directly short three vehicles, as shown on the Recommendations page (and sent in past trade alerts, and highlighted in a recent Positioning Report for new members). It is not easy to borrow shares of any of these ETFs unless you use Interactive Brokers or (sometimes) TD Ameritrade. Fortunately, there are alternatives to shorting for two of them.

- **Direxion Daily Financial Bear 3X Fund** (NYSE: FAZ): If you can't match our current 1.3% short position with a short of your own (again, shares are scarce anywhere but Interactive Brokers), then we suggest you *add* 1.3% to your holdings in your *Pro* financial stocks. After all, shorting this bearish financial ETF is a vote of confidence in (read: equates to owning) industry giants like **Wells Fargo** (NYSE: WFC) and **MasterCard** (NYSE: MA). So you could add 1.3% *more*, total, to your allocations among our financial stocks. I would lean toward adding to **AIG** (NYSE: AIG) and Wells Fargo right now.
- **ProShares Ultrashort Real Estate** (NYSE: SRS): This flawed ETF uses leverage to short U.S. real estate and is even more difficult to borrow for shorting than is FAZ. Again, only Interactive Brokers seems to have shares, and it charges about 5% a year to short them. Your alternative is to *invest* about 1% (to start) in the **iShares Dow Jones US Real Estate** (NYSE: IYR) ETF. Owning this basket of REITs is essentially the same as being short SRS, but without the leverage. You own U.S. commercial and residential real estate and enjoy a 3.8% dividend yield. Just realize the ETF has been volatile since the phrase "Fed tapering" entered the national lexicon, but I believe interest rates will remain historically low and the market will calm down.
- **CurrencyShares Euro Trust** (NYSE: FXE):This fund is easier to borrow for shorting, and when you do, you'll profit if the dollar gains value against the euro. If you can't short this trust, though, we don't have an alternative today – except just holding onto U.S. dollars so you can potentially buy more euros someday if the euro goes down. An inverse euro trust does exist, but we do *not* recommend that you buy it, just as we don't recommend buying leveraged *long* ETFs. The flaws inherent in leveraged compounding are why we *short* leveraged ETFs.

In Sum: What Do You Do Next?

If you believe you want to short with *Pro* (and we will recommend many more shorts!), then make sure you have a broker friendly to shorting. If you don't believe shorting is for you, or you're investing in an IRA, then just watch for the alternative trades we'll offer whenever possible with each short we recommend. Of course, some shorts won't have alternatives. Finally, remember that the surest, steadiest way to build wealth is by owning strong companies for long time periods; in other words, shorting isn't essential. But for those who like the black-diamond runs at the mountain ski resort, shorting can add to your enjoyment and returns – and if you're still on the bunny slopes, your *Pro* instructors can help you increase your skills at your own pace.

To discuss this Memo, please visit the Memo Musings board. Fool on!

-- Jeff (TMFFischer)

Pro Trade Roundup

- None last week.

Pro Guidance Changes

- **Tupperware** (NYSE: TUP): Shares move to Buy (from Hold), and our estimated fair value increases to $80 (shares are only about 3% higher than that). Our Consider Adding More price increases to $72. (We'll address our October $75 covered calls before expiration as time value dissipates, and look to write new puts.)

Pro Catch-Up Trades

- **OpenText** (Nasdaq: OTEX): As shared last week, members who hold an August 2013 covered strangle ($55 puts, $60 calls) can begin to roll that position to match our newer November 2013 strangle ($65 puts, $70 calls). Although your August $60 calls still carry about $0.40 in time value, you can "buy to close" those calls (and your $55 puts, to be safe) between now and expiration, and "sell to open" the November 2013 $65 puts and $70 calls to set up the strangle, selling one of each option for every 100 shares you own. Newcomers to the position should write the November strangle – again, $65 puts, $75 calls.
- **Tupperware** (NYSE: TUP): Those lacking a 3.4% position can buy shares now. Or, "sell to open" October 2013 $80 puts, lately for around $2.40 each. That's a 3% yield in less than three months, with a $77.60 potential start price. Sell one put for every 100 shares (at a net cost of $7,760) you could buy. Those who wrote the October $70 puts for an initial allocation to the stock can profitably roll up to October $80 puts (buy to close the $70s, and sell to open $80s). Those who wrote $70 puts to target a second purchase ("adding more") can let those be, or roll up to $75 puts.
- **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSE: DGS) remains a buy at a 2% allocation, if you lack shares.

Coverage & Community

- ***Pro* Earnings Coverage:**
    - **Apple** (NASDAQ: AAPL) reassured investors with its earnings, and our guidance remains steady.
    - **Facebook** (NASDAQ: FB) made a lot of new friends on Wall Street last week. Jeff posted quick thoughts, and will have an update for everyone ASAP.
    - **Gentex** (NASDAQ: GNTX) remains a steady buy.
    - **Intel** (NASDAQ: INTC) remains reasonably valued as we await mobile chip growth.
    - **Pacer International** (NASDAQ: PACR) continues to work on a turnaround, but is too illiquid to recommend to newcomers.
    - **Tupperware** (NYSE: TUP) is buying back stock like crazy, and our fair value increases.
- There's much more news on the way! Don't miss TMFMoosie's *Pro* calendar of earnings, dividends, and events.
- Invest $100,000 in 1993 ... in Beanie Babies? One family's costly mistake, with a lesson on the *demand* side of the investing equation.

The Motley Fool owns shares of American International Group, MasterCard, TD Ameritrade, and Wells Fargo. The Motley Fool is short CurrencyShares Euro Trust, FINANCIAL BEAR 3X, and UltraShort Real Estate ProShares and has the following options: long January 2014 $25 calls on American International Group, short January 2014 $25 calls on UltraShort Real Estate ProShares, and long January 2014 $25 puts on UltraShort Real Estate ProShares. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Bull-Market Problems, and a Departure

Published Jul 22, 2013 at 4:00PM

Dear *Pro* Family,

In the spirit of ripping the Band-Aid off quickly, it's my sad duty to report that this is my final Memo: I will soon be leaving the *Pro* team. I'm not going far — I'm transitioning to a new role at the Fool — and I know I'm leaving you in excellent hands. Jeff remains captain of the *Pro* ship, and he has a world class crew. If you want to know more, you can jump ahead to the "Awkward Goodbyes" section at the end of this Memo. First, though, I want to take one last chance to talk about one of the most powerful and underappreciated aspects of *Pro* investing: knowing when not to sell.

On (Not) Selling

Deciding when to sell is perhaps the most difficult dilemma an investor will face. The disposition effect suggests that our natural inclination is to sell winners too soon, because we want to lock in gains, and hold on to losers too long, because we want to get back to even. Clearly, you need a better framework than that for making sell decisions (or potential sales through covered calls). Here are my top five reasons to sell an investment, in ranked order. (These are for full sales, not adjustments for portfolio allocation purposes.)

1. **Error.** As investors, we will make errors. As soon as we discover an error in our analysis that impairs the value of our thesis, we should sell.
2. **Fundamentals.** If the fundamentals of the business decline or fail to support our thesis, we should sell.
3. **Opportunity cost.** We should sell when we find a better risk-adjusted opportunity in another investment. (Cash is sometimes better; consider taxes as well.)
4. **Valuation.** If we buy a crummy business when it's mispriced, making it an attractive investment, we should sell that below-average business around fair value. (But we won't necessarily sell great businesses at fair value.)
5. **Life.** We might need the money to fund education or retirement, for example.

I try very hard not to sell great businesses at fair value (remember, it's ever-increasing) or because I have large gains. Instead, I remind myself that when you find great compounding machines, you should let them run. Add more capital to them when you can, and only sell when you can demonstrate that the company is no longer a great compounding machine. In doing this, look at the business, not the price.

Bull-Market Problems

This could be characterized a bull-market problem, but I can't remember a time where someone wasn't telling me we're at a market top, then either asking for my advice or offering me theirs. When I joined *Pro*, our portfolio balance was not quite $1.2 million, compared with almost $1.7 million as I write this. We have earned good returns and built a robust portfolio during a time of great uncertainty. Throughout *Pro*'s short history, we've been inundated with chatter about price manipulation, market tops, when to sell "the bounce," the when/why/how of short positions (with many saying we should short much more), and whether we should write more calls against our great businesses. Often, we talked ourselves out of those perspectives; at other times, we helped to talk members off the ledge. (Temperament is a team effort!) The wrong position at the wrong time can limit returns, preventing our compounding machine from doing its job.

We've certainly made errors during this period of growth, too. One of our biggest errors — and one we're likely to repeat — has been selling too soon (or writing calls) as a stock is moving upward on stronger business results. But — and this is a *huge* "but" — over that time, we have remained invested in great businesses; we've bought much more than we sold; and we've stayed more long than short. Perhaps most important, we've always taken the long-term view. It's the *Pro* way.

Awkward Goodbyes

You skipped all that text just to see why I'm leaving, huh?

OK, but first some backstory: I fell in love with *Pro* in October 2008, just after its launch. I was invited on board in September 2009, soon after founding *Motley Fool Options* with Jeff Fischer and Jim Gillies. Jeff, Bryan, and Ellen are some of my very closest friends, and I genuinely consider the *Pro* community to be my extended family. So you can imagine how tough a decision it was for me to leave *Pro* and *Options*. At the end of this month, I'll be stepping into a new role in product development at The Motley Fool, and while I believe this role will allow me to create additional value and ultimately help more Fools invest successfully with the company ... it's still bittersweet.

I find goodbyes awkward, and I'm terrible at them. And while I won't be interacting with members with the same frequency, I will be thinking about you and would welcome hearing from you. So instead of a goodbye, I offer my heartfelt thanks. Thank you for your trust and friendship, and know that all *Pro* Fools are in good hands. I've provided Jeff, Bryan, and Billy with my updated thoughts on every company I cover and my perspective on where to go from here, and I expect you'll benefit from their fresh perspective and from *Pro*'s continued great performance.

Thoughts? Comments? Awkward goodbyes? Bring them to the Memo Musings board.

Fool on,
Nick (TMFCrow)

Pro Trade Roundup

- **American Tower** (NYSE: AMT): We sold to open six August 2013 $70 puts for $2.50 each before commissions, looking to potentially increase our allocation to around 5%.
- **TD Ameritrade** (NYSE: AMTD): We purchased 2,000 shares at $25.70 before commissions, initiating a 3% position.

Pro Guidance Changes

- None this week.

Pro Catch-Up Trades

- **Tupperware** (NYSE: TUP): For those lacking at least a 3.2% position, "sell to open" October 2013 $70 puts, lately for around $1.50 each, or a 2.1% yield in three months. Sell one put for every 100 shares (at a cost of $7,000) you could buy. These puts set you up to potentially start a stock position below our fair value estimate. The stock remains on Hold at its recent $78 per share.
- **OpenText** (NASDAQ: OTEX): Members who hold an August 2013 $55 put, $60 call covered strangle on OpenText can begin to roll that position to match our newer November 2013 $65 put, $70 call strangle. Although your August $60 calls still carry about $0.50 in time value, you can "buy to close" those calls (and your $55 puts to be safe) between now and expiration, and "sell to open" the new November 2013 $65 put, $70 call strangle. Sell one of each option in the November strangle for every 100 shares you own.

Coverage & Community

- Glenncv responds to 20 Years of Foolishness with a moving post.
- In good spirits, ADrumlinDaisy takes Billy to task on his first Memo, and Billy responds.
- TMFMoosie shares his *Pro* calendar of earnings, dividends, and events.
- We discuss the weak performance of hedge funds and big old doomsday predictions.
- Member PhilSylvester shares his Foolish revelation on all-time price highs and what they mean.

Portfolio Positioning Report

Published Jul 18, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1 • Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our portfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

PDFDownload this report as a PDF file

Introduction

Dear Pro Fools,

The majority of the recommendations in this report are "shorts" of vehicles we consider to be flawed — they're investments that should slowly decline in value, adding profits to the short part of our portfolio. But let's take the pressure off right away: For reasons I explain below, we don't expect that many of you will initiate most of the positions in this report right away, or perhaps at all.

Shorting in Short

For those new to shorting, let's step back for a quick overview. When you sell something short, you borrow shares from a broker and immediately sell them, collecting the proceeds. In the future, you'll need to buy shares back (called "cover" or "buy to cover") to replace the shares you borrowed. You hope to buy those shares back at a lower price. The difference between your original sell — or short — price and the price you pay to buy back (and return) the borrowed shares is your profit. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock soars to $30, you've lost $10 per share when you buy it back.

Why do we short in *Pro*? It's one way we're able to profit when the market (or a weak company) falls. We also like to short flawed investments that, because of the way they're constructed, are destined to lose value in most environments. Most of these instruments use leverage and/or hold futures contracts that eat away at their daily value; when we sell short a vehicle like this (two of which are outlined below), we anticipate this steady decline in price.

Shorting Is Optional

As interesting as it is, not every *Pro* member is comfortable with shorting. Practical considerations can have an impact as well. First, you cannot sell short in an IRA — you need a margin account. Second, you have to accept that shorts can run strongly against you. Third, you'll usually pay an annual fee of anywhere from 1% to 5% (of the short value) to short something. Finally, in many cases it's hard to borrow shares to short, period. That is the unfortunate situation with our suggested shorts today. When we initiated the short positions in this report, they were a bit easier to borrow, but today, most brokers don't have shares of these vehicles available for shorting.

So, what do you do? You can use options to short in some cases; we explain how to do so below. You can also consider opening a new brokerage account (Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does); or you can wait and see if shares become available in your existing, traditional brokerage account. Or, not short at all, if you're not drawn to it.

This Positioning Report

Returning to the main show, this Portfolio Positioning Report (and the special live chat accompanying it at 1 p.m. July 18) will — when you're ready! — help you short vehicles we believe will decline, and generate options income. Keep in mind that this is just a start — we'll have many brand-new trade recommendations as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way! On the other hand, if all this looks overwhelming at first — or if you're still catching up with our long positions — that's OK, too. You don't need to make all of these trades now. Stock investments are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and rewarding — aren't necessary to succeed with *Pro* in the long term.

As you progress with us, just keep your exposure to the stock market in mind; hedging is about portfolio exposure. If you've bought all of our stock recommendations to date, your *Pro* portfolio is only about 63% invested, meaning you have enough cash that you don't need to hedge yet! We've kept that in mind in putting together this report (which does not carry any market hedges), and we'll do so with our future recommendations to you, too. That said, we do plan new market hedges for all members who are interested soon.

In closing, I'll stress again that you don't need to feel pressured to act. We will continue to make recommendations on an ongoing basis — there are always new opportunities. So, as always, take your time, and make an investment only when you're ready. Finally, please bring any questions to our Making*Pro*Fit You discussion board.

Foolishly,
Jeff Fischer, *Pro* advisor

Short: CurrencyShares Euro Trust (FXE)

Shorting the euro against the dollar is relatively low-risk disaster insurance

Suggested Short Allocation: 3.4%

We're shorting the euro against the dollar. We view this position as an asymmetrical investment where the downside is relatively known (and reasonable) and the upside, while less known, is much larger. For this position to work against us, the euro would strengthen against the dollar, but likely only by so much (assuming the U.S. doesn't go belly-up).

Even if the euro returns to its all-time high against the dollar ($1.60 — currently one euro is worth $1.31) our losses will be tolerable. Meanwhile, our possible upside — hard as it is to believe — may be as much as 100%. If the worst happens, the euro could fall apart completely. The trust we're shorting only holds physical euros, so it could end with negligible value. We don't hope for that calamity, but we can accordingly view this position as disaster insurance with relatively low downside risk.

More Resources

- *Pro*'s recommendation history
- Talk about FXE on our discussion board

Alternative Trade: Shares of FXE are available for shorting at various brokers, but if your broker does not have shares available, and you're trading in a margin account, you can instead "sell to open" January 2015 $100 call options on FXE. These calls currently pay you about $30 each (that price will fluctuate). This naked shorting of calls will provide you profits on any decline in FXE down to $100. Just realize that you are, just like us, short the vehicle at today's price, and you will have paper losses if FXE's price goes up. Only sell to open one call option for every $13,000 in FXE you can afford to be short, at a reasonable total allocation of around 3.4%, remembering that each option represents 100 shares. There are no IRA alternatives at this time that are attractive enough to merit your IRA dollars.

Short: Direxion Daily Financial Bear 3x (FAZ)

Rebalancing costs keep constant downward pressure on this bearish ETF

Suggested Short Allocation: 1.3%

This bearish ETF is meant to provide 3 times (300%) the daily inverse results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. By shorting this ETF, we'll effectively be 3 times long, on a daily basis, the U.S. large-cap financial sector. Leveraged ETFs like this one are flawed vehicles because they rebalance their derivative positions daily in order to maintain a constant leverage. Over longer holding periods, the costs involved with rebalancing eat away at returns, keeping constant downward pressure on the vehicle as a whole. As our full report linked below details, we continue to believe that large-cap U.S. financials are cheaply priced — and we own several of them as a result. That belief makes shorting this flawed bearish financial ETF all the more attractive.

More Resources

- *Pro*'s recommendation history
- Talk about FAZ on our discussion board

Alternative Trade: Shares of FAZ are available for shorting at only one broker we know of right now — Interactive Brokers — and sometimes at TD Ameritrade. If you can't short shares directly, then in a margin account you can "sell to open" January 2015 $20 naked calls on FAZ, lately paying you about $10 per contract. This effectively makes you short FAZ at $30 (just as we recently did, adding to our position), and sets you up to earn as much as $10 if FAZ falls to $20 or lower by expiration. Be sure to use the "standard" FAZ $20 call option, not the "NS" option. Again, it will pay you around $10 (or $1,000) for every call you write. Only sell one call for every

$3,000 in FAZ you are able to comfortably short, up to a 1.4% allocation. Never over-allocate to a short, whether you're shorting with naked calls or shorting directly. Given the expense of FAZ put options, there are no IRA-friendly alternatives for this short.

Option Trade: Write a Covered Strangle on OpenText (OTEX)

Earn income while you wait to potentially buy more shares of this *Pro* holding on a decline

Suggested Allocation: Write one put option and one call option for every 100 shares you own

In our Catch-Up Report No. 2, we recommended that you invest about 3% of your funds in software leader OpenText. Now, to catch you up to our option position on this stock, we recommend you write a covered strangle on your shares. This means you'll write (or "sell to open") one put option and one call option for every 100 shares of the stock you already own. (If you don't own 100 or more shares, but already own 3% in the stock, simply keep holding the stock.)

A covered strangle pays you significant option income. It also sets you up to buy more shares (in this case, doubling your share count) if the stock falls enough, or sell your existing stock if it rises enough. Most likely, though, is we'll continue to manage our covered strangle together for income, rolling it to later months when expiration nears. So, to get started, you should:

- Use a strangle order if you can, and "sell to open" November 2013 $65 puts and November 2013 $70 calls on OTEX. Sell one of each option for every 100 shares of OTEX you already own (and we're assuming you only own a 3% allocation in the stock). Do not buy these options — sell them.
- Lately, look to get paid about $7.60 to $7.80 combined to sell this strangle. So, you'll collect about $760 to $780 per strangle that you write, or sell.

More Resources

- *Pro*'s recommendation history
- Talk about OpenText on our discussion board

This sets you up to potentially buy more shares around a net $57.40 (using the low end of recent prices), or sell your existing shares around a net $77.60. That's a nice wide range. If the stock stays between our $65 and $70 strike prices at expiration, we simply earn all $7.60 as income. We'll manage the position together with a real-time trade alert, if necessary, as expiration gets closer in November. But mostly, we'll just wait for these options to slowly lose value, paying us in the process.

If you have questions about this trade, please visit our OpenText board. And remember, you don't need to use options if you don't want to. We enjoy just owning the stock, too, and see good long-term things ahead for it.

Short: UltraShort Real Estate ProShares (SRS)

Another leveraged ETF with rebalancing flaws from which we benefit

Suggested Short Allocation: 1%

This ETF is meant to provide twice (200%) the daily inverse results of the Dow Jones U.S. Real Estate Index (from here out, "the index"). In other words, if the index goes up 1% in a day, the ETF will decline 2%, and vice versa. By setting up a short position on this inverse ETF, we are setting up a bullish position on the underlying index, and thus on U.S. commercial real estate. This is another leveraged ETF where we benefit from compound flaws as the ETF is rebalanced to maintain its 2:1 leverage.

More Resources

- *Pro*'s recommendation history
- Talk about SRS on our discussion board

Availability and Alternative Trades: Lately, shares of SRS are only available for shorting at Interactive Brokers and perhaps a few other brokers. This ETF does not have long-term options on it, so there are no alternative shorting trades available for anyone. However, if you want to follow the spirit of this trade, you can instead buy about 1% in shares of the bullish **iShares U.S. Real Estate ETF**, with its current 3.8% dividend yield. Our real estate investment thesis, and this alternative purchase, is outlined further in the full report link at right.

The Motley Fool owns shares of OpenText. The Motley Fool is short CurrencyShares Euro Trust, FINANCIAL BEAR 3X, and UltraShort Real Estate ProShares and has the following options: short January 2014 $25 calls on UltraShort Real Estate ProShares and long January 2014 $25 puts on UltraShort Real Estate ProShares.See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Portfolio Positioning Report: Live Chat

Published Jul 18, 2013 at 12:00AM

Welcome to our Portfolio Positioning Live Chat! In today's event, we'll discuss the three short positions and one new options income trade we've recommended for you in today's positioning report — including alternative trades. We'll also discuss our plans for hedging the portfolio against market declines, generating more income, and profiting when price volatility finally returns. Jeff and Bryan will be on screen for the first half hour or so in the video portion of the chat; then they'll join Nick, Billy, and Ellen in answering questions via text. Archives of both portions will be available on this page after the event ends. Fool on!

You need to have the Adobe Flash Player to view this content.
Please click here to continue.

Transcript

Jeff Fischer: Good day, Motley Fool PRO members. We are glad you are here with us today for our PRO positioning report that you've received in email and now live event. For the next hour, the whole PRO team is here to discuss the positioning report and the portfolio with you.

Resources

- [The Portfolio Positioning Report]
- [Our Getting Started & Help discussion board]
- [The *Pro* Strategy Guide]

I'm joined by Senior Analyst, Bryan Hinmon right here.

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Bryan Hinmon: Jeff, it's good to be here, thanks. PRO members, happy you're here too.

Jeff Fischer: Thank you, Bryan. You're both here on video and I see you posting in the live event at the same time as you speak. That's a great talent.

Bryan Hinmon: Jeff, we're really hoping to keep the video portion of this on the shorter side, just so we can cover as many questions as possible on the tech side, so we're going to talk I guess for as long as we feel it fit. As long as we're going through the positioning report and we feel like it's making sense, so we can hop on the text portion and really pound out those questions.

Jeff Fischer: That's exactly right, Bryan, so thank you for joining us for this brief video with Bryan and me.

On the text chat right now is Ellen, our editor, Ellen Bowman. Nick Crow, senior analyst and Analyst, Billy, Billy K.

Bryan Hinmon: Kiperzstock; we don't know how to spell it, so we're just going to call him Billy K.

Jeff Fischer: "Kiperzstock", perfect name for a stock analyst. And so let's get into today's report. First, members realize we're in earnings season. Earnings season is starting right now. We'll be covering earnings from every PRO company for you, but the main thing to remember is to stay calm. It's just another quarter in the course of many. We're investing to make real money over the coming years. We're not worried about what happens in one quarter.

Portfolio building, the last month or so you've been building your portfolio or starting to with us using our catch-up reports. If you have bought everything we've recommended to date, you're still only about 60% invested long. That's great. That's plenty of money put to work, but there's plenty more to go and we're excited to bring you there the coming weeks and months and to get you into position to have a fully rounded PRO portfolio that's built for both good markets like the one we have right now and that's hedged for when the market does inevitably turn south for a while or become more volatile. So we're getting there and the key is to go gradually and take your time. Make sure you're comfortable. It's never a race, as I just said; we're here to make money, real money, over the next couple of years and much longer. We're not concerned about the next couple of weeks, per se.

So let's get Bryan into our positioning report and talk about the shorts, three shorts that were recommend today and one options trade, options income trade that we recommend today in today's report. I'll start again by saying if you don't make these trades right away, don't worry; it's not a race. Some of you may never make them. Many PRO members only buy our stocks and look to own them for years and compound their wealth that way, but if you are interested in shorting and using options, you're in the right place.

One thing you may learn is that you may want to use a broker that is very friendly to shorting and we talk about that in the positioning report that you can read today. Because many brokers are not as friendly to shorting as others, and with the things that we short, we go out of our way to find unique short situations that we have high conviction in, but that are not always easy to short with a typical broker because there are not always shares available.

Now let's get into those.

Bryan Hinmon: But Jeff, you mentioned sort of two distinct types of PRO members. The first type of PRO member is the type of member who does everything, follows the PRO portfolio to a T. They obviously are going to be very interested in finding a friendly broker so that they're able to short when we recommend shorting and they're able to use whatever options strategy we throw at them.

Jeff Fischer: That's right.

Bryan Hinmon: The second type of PRO member is the one who might not be comfortable with shorting, and you speak about this in the intro to this PRO positioning report. That type of PRO member, what it's important to realize is you can still follow the spirit of the PRO portfolio spot on. Instead of shorting, all you need to do is focus on the net exposure that we highlight in our Net Exposure Table on the Recommendations tab right below our scorecard. So you see there essentially how much you should have invested and how much you should have sort of cash sitting on the sidelines.

Jeff Fischer: That's exactly right and right now you would be about 60, 63% invested long if you followed all of our catch-up trades to date, so you're still invested but conservatively so, and that's why we will now gradually get you into shorts and hedges, as we also recommend new long positions. So our typical balance or aim is about 70-80% long with some cash on the sidelines for opportunities and for income-generating opportunities as well.

But as Bryan was just speaking to, you can, if you only want to be a stock-long investor, you can do that with PRO and just up your allocation to get as exposed, as allocated as you want to be. And those who are using shorts and options will follow the exposure table and our exposure allocation guidelines.

Bryan Hinmon: Yeah, I'm really not sure what the expression means. There are many ways to skin a cat, but the two ways that we manage our net exposure is either by raising our cash balance or by staying invested at the same level of long investing and then adding on shorts and hedges, so if you want to be PRO investor type one who follows us to a T, that's one way to achieve this. And if you want to be the type that manages their cash balance a little more closely, that's another way, so they're perfectly acceptable.

Jeff, before we get started on the positioning report, let's just walk through really quickly the mechanics of shorting and make sure that the PRO members who are following are fully comfortable with what shorting really is.

Jeff Fischer: Great idea, Bryan. In the report today in the text, you can read a bit more about this. Shorting is where you borrow shares from a broker and then sell them immediately and you collect the proceeds, and your hope is in the future to buy the shares back at a lower price and your profit is the difference between what you sold at and what you buy back at later.

So it's very different from buying a stock to own because you're not owning the asset; you're selling it to begin with and hoping you're gong to replace it later, ideally at a lower price and you keep the difference.

Bryan Hinmon: Yeah, investors are very familiar with the adage, "Buy low, sell high," and that is how we make money on the long side of the equation, but on the short side it's the opposite. You want to sell high and buy low. Sometimes it helps me to think in terms of cash in, cash out, because it can get confusing with the buying and selling.

So when you buy a stock, you're putting your cash out initially, and so when you take your cash back in, you hope to have a lot more of it. And when you're shorting a stock, you're getting your cash in upfront and you're putting your cash out, the invested portion, later on down the line, so you hope the price to be lower.

Jeff Fischer: Exactly, Bryan. There is a difference between shorting and hedging. When you are shorting, you are just taking a high-conviction position, as with the three that we recommend today, in something that you believe will fall, no matter what the market does. When you're hedging, you are shorting some large part of the market typically, as a way to make money or decrease your volatility when the market as a whole falls. But with a hedge, you may not expect your hedge to make money; you actually expect the rest of your portfolio to make money and the hedge is there as insurance, so that's an important distinction.

Bryan Hinmon: We joke about this on the team in that we actually root for our hedges to lose money because if our hedges are losing money, that means the rest of our portfolio, or the bulk of the rest of our portfolio, is probably doing well enough to offset the loss on the hedges, plus a lot more.

Jeff Fischer: That's right.

Bryan Hinmon: So we actually root against our hedges.

Jeff Fischer: And so right now in the portfolio, we thankfully have very few hedges because it's been a very strong market all year. And for new members who are only about 60% invested, there is not a strong reason to hedge yet, but as we said, we'll get there in the near future too.

One way we're looking to profit on increased volatility is we're looking at the volatility index, which is low right now, and we're looking at ways to go long or invest in that index for the end of summer and into the fall when volatility typically goes up, and it may really go up this year if the Fed indeed begins to taper. So although everything is kind of smooth sailing right now, we're thinking ahead and we're looking to put positions in place soon that will capitalize on more market volatility whenever it occurs, and that could be sooner than we think.

Bryan Hinmon: And Jeff, I want to touch really quickly before we get into the actual positions here. You highlighted that a hedge is really a broader bet, a protection method, and a short is a more direct, high-conviction idea. I want to drill down on that just a little bit and tell members why it has to be such a high-conviction idea, and it has to do with sort of the mechanics of shorting.

First of all, we have to ask the question, can you short, period? And so you wrote nicely in the intro that check with your broker. You have to check with your broker to see if shares are available for shorting. The best way to do this is probably to call them, but some online brokerages also have shares available to short list that you can find somewhere on their website.

But the mechanics of why it has to be high conviction; well, if you're borrowing shares, what it means is you're borrowing them from someone else who actually owns them. And so to do this, you have to pay the dividend out. You also typically have to pay a fee to borrow it. Ultimately you can get untimely closes. If your broker determines that hey, we really don't have enough shares to be lending out, they can close your position automatically. And so you can think you have a short on and are taking advantage of your thesis when in reality they realize that they goofed or all of a sudden someone sold the shares and they no longer have them available for you to borrow.

Those are sort of frictional costs to shorting that make us say for us to put on a short; we really have to have a high conviction. We have to believe that our return is going to be great enough to achieve North Star-like returns, plus overcome these frictional costs.

Jeff Fischer: Exactly, Bryan, and that's another reason why shorting is not for everyone and you need to have a certain tolerance or a risk tolerance for it. At the same time, it's a great tool, especially with a broker that makes you comfortable. You're wondering which ones. Personally, I've used TDAmeritrade for years and I've had shorts in that account for years that just go on and on. And TDAmeritrade very nicely does not charge for shorting, whereas most brokers do charge a small annual fee for shorting, for the privilege of borrowing shares. So TDAmeritrade is one to look at.

PRO's broker is Interactive Brokers, which has the most availability of anything you'd want to short. They do charge for shorting, and it's, as we write in today's report, anywhere from 1% to 5% a year on average of the asset value of the short. Obviously we're only putting shorts on that we think could fall much more than that over time. So those are two brokers to consider, because if you are adding shorting to your toolbox for the long haul, then you need to be in a broker that makes you comfortable. Bryan, can you see what Steve is saying out there behind the…?

Bryan Hinmon: I can't see. (Unclear).

Steve Broido: Actually I'll just jump in the audience.

Jeff Fischer: All right. So the report today, positioning report, we summarize shorting for you. We remind you that it's optional; you don't need to get started right away and then we get into three issues that you could short right now, if the shares are available at your broker and you're ready to short them.

Let's go into the first one, and that is CurrencyShares Euro Trust. The ticker is FXE. All right, so we were just told by the producer, be sure to refresh your video player by hitting F5 on your keyboard. Hit F5 on your keyboard to refresh your player to correct any video that has been cropped or shortened or…?

Bryan Hinmon: We were just playing an incredible video of charades. Now I do not feel bad about not being able to guess what the clue was the entire time.

Jeff Fischer: So Fools, hit F5 to refresh your video player and now let's go into CurrencyShares Euro Trust, ticker is FXE. This is a short against the Euro. It's the Dollar versus the Euro, and by putting on this short, we are saying that we believe the Dollar should be worth more per Euro than it is right now. And/.or, in the worst case, the Euro could really plummet in value. If Europe cannot get its act together or its problems proliferate further, the Euro, which is around $1.30 per Euro right now, up from its low of about 80 cents, could really fall sharply.

So this short we view as kind of a low risk, high potential return short. But in most cases, it's likely to not go much of anywhere, but it's disaster insurance against if something really bad does happen in Europe.

Bryan Hinmon: Yeah, and one of the reasons that we feel it's low risk is because we feel like we've studied the history of how these two currencies trade versus one another, and we feel like we have a really good basis off of sort of how out of whack the ratio can go. Of course if the world changes dramatically, we won't be able to rely on that history. But until that happens, we feel like really the downside is truly pretty limited here. It's why we like this short so much.

Jeff Fischer: That's right, Bryan. Over its history, the Euro has traded from about 80 cents to a Dollar to $1.60 to a Dollar since the late nineties. It's around $1.30 now, so it's been very resilient, and we shorted it around this price about a year ago, maybe a bit more. So yeah, we don't think it has much chance of running up against us, but it could really fall if Europe weakens. And it could also fall when the Fed starts tapering because interest rates will go up on the Dollar, of course, and that makes the dollar a stronger currency against other currencies around the world.

I do think the U.S. is much closer to higher interest rates than Europe is right now. Europe is a couple years behind us on the whole easing and easy money program, so the U.S. will probably come out of that sooner and the Dollar should get stronger as a result. So we like shorting FXE right now. Shares are available at many brokers for low cost, for no cost at TDAmeritrade and it is a 3.4, 3.5% short position for us right now, so you would short about $3,400 worth for every $100,000 in your portfolio.

Bryan Hinmon: Right, so I'll talk about the next one really quickly.

Jeff Fischer: Great.

Bryan Hinmon: This is a short, about 1.3% allocation for PRO right now of the Direxion Daily Financial Bear, 3X levered ETF. This ETF is designed to match the opposite levered three times up movement on a daily basis of the largest, most steady, most stable, best financial institutions that we have across the globe.

Jeff Fischer: Yeah, the top ten holdings include things like MasterCard, Berkshire Hathaway, AIG I believe is up in there.

Bryan Hinmon: Absolutely.

Jeff Fischer: Wells Fargo.

Bryan Hinmon: American Express in there as well, so the preeminent financial service companies in the world that have been through; essentially been to hell and back and are now on sort of the strongest financial footing they've been almost in their entire lifetimes. Well this fund is designed to bet against them and achieve as a group whatever their price performance is each day, three times negative to that.

So first of all, the base of our thesis is do we agree with that? Do we agree that we would want to, if we bought this, bet against these big financial services companies?

Jeff Fischer: Many of which we own.

Bryan Hinmon: Many of which we own. So obviously the answer to that is no, so we're taking a contrary bet to what this fund is set up to do.

Jeff Fischer: Exactly, Bryan.

Bryan Hinmon: But the real kicker here is the structure of the fund. In order to achieve that three times returns, the fund invests using derivatives, and because it wants to match the daily movements, it has to rebalance is derivative portfolio every day. And quite simply, that isn't free; that's not a costless transaction. They can't just do that without paying anything. So every day when they rebalance, they end up having to pay a little bit, take money out of the value of the fund so that they can minimize their tracking error and keep close to what they're trying to do, is match that daily performance.

Jeff Fischer: Exactly, so it's what we would call a flawed fund, a flawed ETF or ETN, and there are many of them out there. Many are very difficult to short or are on their way to just disappearing, which would be ideal for a short.

We plan to have many more of them in PRO in the future, there are many that we have our eyes on for shorting, but FAZ is one of them and if you're interested in something like this, you will need to go to a broker that has availability .TDAmeritrade sometimes does; Schwab almost never does unless you're shorting $50,000 or more worth. Interactive brokers always have shares available.

So again, just to reiterate, if you want to short with us long term, and we definitely think there's a lot of profit to be made doing it over the long term, consider opening a different account to short positions like this, like this flawed ETF, FAZ. To summarize a little more, on average, the average company in this fund trades at 1.2 times book value. We think it's undervalued. This fund, as Bryan said, is shorting these great financial stocks. By shorting the short ETF, we are going long these companies. So whenever MasterCard, Berkshire Hathaway go up in price, we make money on this short ETF.

Now if you're not shorting with us or not shorting the ETF, an alternative trade is just to add a bit more to your AIG, your MasterCard or Wells Fargo position; that's the same thesis.

Bryan Hinmon: It accomplishes the same thing. So essentially what we're saying is we think it's silly to short the greatest financial institutions in the world right now because they're cheap, and we're saying that it's also silly to want to own a flawed vehicle like this.

Jeff Fischer: Yeah, that's the cherry on top is that these vehicles are flawed and they're made practically to slowly lose value because of the derivatives that they use and roll every day, like Bryan said. So we're shorting things like that and we'll continue to do so on PRO and add more to our roster too in the future.

Let's skip OpenText for now and stay with the shorting. We'll talk about the next short, UltraShort Real Estate ProShares, ticker is SRS. It's another leveraged ETF that has flaws, and it is shorting another sector or industry that we believe in greatly in the U.S. right now, which is real estate, which much like financials, the two do go hand in hand, is on a foundation now of slow, but steady recovery and the shares are still cheap, so why you would want to short right now if you have a couple year outlook is questionable. We, instead, want to be long real estate in the U.S, so one way we're accomplishing that, aside from owning Wells Fargo and things like that, is shorting this real estate ETF.

Bryan Hinmon: Some members might ask why the allocation to FAZ and SRS are pretty small, about 1%. Some of that has to do with the fact that we sort of view these together because as those financial services, the industry is going to go, so too largely is the commercial real estate industry, so you can sort of lump these two together and it makes the allocation seem a much higher conviction.

Jeff Fischer: I'm glad you brought that up, Bryan. Another great point is they've all started around 1 to 1.5% allocations. As they work for you, they shrink in size. You make money as they get smaller, so recently our allocation to FAZ went all the way from 1.5% to about 7.8%, and so we shorted more to bring it back to 1.5%, and that's our long-term plan too. Anytime it becomes much smaller, we'll short more, bring it back up to where we want it and we'll keep making money that way.

The great thing is, these things are so flawed that over many years, if you look at their long-term history, they've lost 896, 97% of their value, but they can keep doing that. From today's price, they can lose 96, 97%, they can lose 100%. They can keep losing that amount of money, so we can keep adding to them and growing our proceeds that way as they slowly go down in value.

Bryan Hinmon: So the theses here are similar, right? With FAZ we say it's silly to short financial services companies and it's silly to be invested in, to not bet against a flawed vehicle. With SRS we're saying it's silly to short U.S. commercial real estate and again, we have another flawed vehicle, so we want to bet against it.

Jeff Fischer: That's right, and SRS is much smaller than FAZ, so it's harder to borrow shares. You'll need a broker that has them available. There are no alternative trades. There are alternative trades on the Euro and FAZ, as you'll see on the report. There are not any on SRS because its options are not liquid or long term. So SRS you'll need a broker to short it directly, and interactive brokers we know have shares available. TDAmeritrade sometimes does, but not right now.

So again, if you can't make that trade or don't want to short, there is an alternative in the report today which is to buy the bullish ETF on real estate. Just buy shares of that instead, 1.5% in IYR, but just look it up in the report; it's right there as a very viable alternative trade for anybody.

Bryan Hinmon: All right, Jeff, let's chat OpenText.

Jeff Fischer: Yes. So this is an option income trade that we're recommending. It pays right now more than 10% in about five months, by a November expiration. Shares on OpenText are around $69 per share. This option strangle trade, when you sell a put and sell a call, will pay you more than $7 per share combined, so more than 10%, and expires in November. Bryan, do you want to talk about the mechanics of it?

Bryan Hinmon: Sure. So first off, I'll just say that OpenText is a company that you have followed for what?

Jeff Fischer: Since 2005 or so.

Bryan Hinmon: Two thousand five or so, so really what drives this strategy is your underlying comfort with the business of Open Text because when we set up a covered strangle, we have to be saying we know a price that we're willing to buy more into this business. And we also have to know a price where we're saying, you know what? I'm okay with selling my existing shares at this certain price. If you're not able to set those two prices, well then you're not going to be able to choose the strike prices wisely for setting up the strangle.

So a covered strangle involves three pieces here. First and foremost, own a hundred shares of the stock. Once you own a hundred shares of the stock is when those other two questions, what price would I buy more and what price would I be willing to sell come in. And essentially what we have done is we have said here's OpenText's price. We're willing to buy more shares here, so we write some puts and are paid income for that, the promise to buy at that strike price. And we write calls above the current strike price saying if OpenText shares rise beyond the call strike price at expiration, we're perfectly okay with letting the shares that we own go.

We're paid on both of those options, so essentially doubling our income for making those two promises. We're willing to buy at some price below the stock price and we're willing to sell at some price above it.

Jeff Fischer: Exactly, Bryan. So we recommended in Catch-Up Report Number Two that you buy about 3%, allocate about 3% of your funds into OpenText shares and by now selling to open this covered strangle on the stock, which is optional. You can just keep your shares and not use options on it, but by using these options on it, we are agreeing to either buy more shares at a lower price or sell at a higher price, and we get this $7-8 in option income, so that gives us a very wide price range, $57 to about $77, 78, to make income on the stock. If it stays in that wide range, we can close the strangle by expiration, maybe write another one, make some income, keep the stock, write another strangle. So it gives us a lot of optionality, a lot of flexibility.

Covered strangles are a great income strategy. One thing to remember is just combining writing puts and writing covered calls, so it's two simple strategies combined on one stock. You can make this trade today, as long as you own at least 100 shares of OpenText. Sell to open one, strangle. That's one of each, one put, one call, for every 100 shares you own, and we're assuming you have about a 3% allocation and can double that allocation if it comes to that. That's exactly the position we have in the portfolio right now.

Bryan Hinmon: And PRO members who don't choose to take part in the covered strangle here, don't fret at all. The reason that we threw out, that we recommended that you buy 3% allocation in OpenText is because we believe in the company. We believe that the value is there and that the downside risk that we take in owning the shares is perfectly acceptable.

All that we're doing with this covered strangle; it's important to realize that what we're doing with this covered strangle is we are saying we are so comfortable with the downside that we'd be okay with owning twice as much stock if it were a little cheaper. So a little reassurance there to the PRO members who just own shares of OpenText.

Jeff Fischer: Perfect, Bryan. I think we can wrap up the video portion and jump on to the live text chat and answer your questions. I see there are many questions coming in and Billy and Nick and Ellen are working to answer them, and now Bryan and I will jump on there as well to answer them.

Before we leave the video, we'll just say again, take your time, do as you're doing, ask questions. Never be anxious to invest; investing is a long-term endeavor. We're looking to make very real returns, very real money and that happens over a year, two years, three years, five years or longer really, and then beyond that. We're not worried about what happens today or tomorrow, so just keep your perspective, stay calm. You're in a great place.

We believe in PRO. You're in the right place to make real returns, North Star-like returns, annualized as we look forward, and all it takes is buying the stocks that we recommend, and now as you want to, start to learn the hedging, shorting and options strategies. We're here to help you each step of the way to that end. Let's get into the chat. Bryan, any closing words?

Bryan Hinmon: Yeah, I'd just like to say that I'm really excited about the crop of new members that we have here in PRO. The discussion boards have been fantastic. I feel like there have been a lot of business-oriented questions, at least on the companies where I'm the primary analyst. I've been answering a lot of business-specific questions, and it's always wonderful when new members come in and they don't just blindly jump in, but they look at the analysis we've done, they assess our thesis, they ask questions about it, they question us and it just shows that they're truly trying to get comfortable with what they're doing. As you noted, if you're going to be a successful investor, you need conviction because you need conviction to make it through the inevitable ups and downs of the market.

Now we've structured PRO to hopefully help even more deal with the ups and downs of the market and we truly believe that our strategy is built to do that, but you need the conviction too, and so I'm really happy that the PRO members that we have are here and I look forward to serving you for a long time and in a few minutes on the text portion.

Jeff Fischer: Here, here, well said, Bryan. It is a great group of new members that we have and existing members have done such a great job welcoming them and helping them get started. It's been a great couple of weeks and we look forward to the rest of the summer and the rest of the year, and really making sure that all members have portfolios that make them very comfortable in up and down markets and bring in steady income if you want. In short, invest the PRO way and do so very successfully.

So thank you for being here. Let's join you on the text chat right now. We hope you enjoyed the video chat and we'll see you on the boards as well after this chat. Fool On! Thank you members, Fool On!

Catch-Up Report: Part 4

Published Jul 16, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1 • Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in [What We Think Now](). Use this alongside our portfolio page's [Recommended Allocation]() to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our [*Pro* Community]().

In This Report

[Buy: AmTrust Financial Services]() | Its talent at capitalizing on human laziness is just part of what we love

[Buy: The Buckle]() | This well-managed retailer fits into its jeans admirably

[Buy: Starbucks]() | You only *think* you go for the coffee

[Buy: Wells Fargo]() | Banks are simple businesses, and Wells Fargo is the best of the breed

PDF[Download this report as a PDF file]()

Buy: AmTrust Financial Services (AFSI)

Its talent at capitalizing on human laziness is just part of what we love about this insurer.

Suggested Allocation: 6.9%

At *Pro*, we speak a lot about the importance and power of recurring revenue — mostly because we know that humans are inherently lazy. Insurance purveyor **AmTrust Financial Services** handily proves this point for us; many of the policies it writes (more than 80% in most lines!) renew at the end of their term without their owners even shopping for a better rate. Most of us, it seems, are guilty of preferring inertia to bargain-hunting, and AmTrust and its fellow insurers are the beneficiaries. Even better, companies with such high renewal rates can actually grow their recurring revenue stream by raising prices a teensy bit at renewal time. This is just one of the characteristics of AmTrust's business we love, and it contributes to our confidence in making it *Pro*'s largest holding.

What It Does

AmTrust is an insurance underwriter. In general, insurance companies make money in two ways. First, they get paid to take on risks other people don't want (like the cost of repairing your car if you get in an accident); if a company takes in more in these policy premiums than it pays out in policy claims and handling, it makes an underwriting profit. Second, because policyholders pay for their coverage up front, insurance companies can invest that money — the industry calls it "float" — until they need it to pay claims.

AmTrust focuses on insurance niches (primarily workers' compensation and product warranties) that are low-hazard and generally too small for large insurance companies to care about. But though AmTrust writes small policies, it's no small fry. Its high renewal rates allow it to focus on writing new policies and looking for struggling insurers to acquire — and AmTrust has proven to be a very opportunistic acquirer.

How It's Working

AmTrust's strategy — being a disciplined underwriter of low-hazard, small policies in well-defined niches; using technology to keep its expenses low; and opportunistically acquiring policies other insurers struggle to find profitable — has resulted in impressive growth. Gross written premiums have risen from about $1.1 billion to $2.7 billion over the past five years, and this increase, combined with a laserlike focus on low expenses, has resulted in consistent growth in earnings, dividends, and book value.

What We Expect

The insurance market works in cycles, and recent signs indicate an upswing on the horizon, which means pricing and profits should improve across the board. AmTrust should thrive in a strengthening market: It can charge as much as its competitors and make more in profits thanks to its lower expense structure, or it can undercut the competition on price in a bid to take market share. If the economy improves at all, the small businesses AmTrust insures should hire more workers and consumers should purchase more insurable goods, so there seems to be plenty of growth ahead.

More Resources

- [*Pro*'s recommendation history]()
- [Talk about AmTrust on our discussion board]()

The *Pro* Bottom Line

Although AmTrust currently trades for more than our $33.50 estimate of fair value, we believe the company's premium valuation is warranted given the consistency of its growth, quality, and profitability. AmTrust is *Pro*'s largest holding and we're happy to let this winner run, expecting to increase our fair-value estimate over time. We have high confidence that owning a piece of this business will help *Pro* Fools achieve satisfactory returns.

Buy: The Buckle (BKE)

This well-managed retailer has fit into its jeans admirably over the past decade.

Suggested Allocation: 3.6%

Your *Pro* team doesn't know much about fashion, but we can read financial statements. And if the next decade of business performance by specialty retailer **The Buckle** looks anything like the last one, we'd be willing to wear whatever getup the company suggests.

What It Does

The Buckle sells jeans, other apparel, and accessories at 443 retail locations across the United States, and we think the fantastic management team has figured out a formula that works: measured growth, middle-of-the-road merchandising, and great service. We're typically leery of the risks of investing in retail, especially fashion, but the proof is in the numbers for The Buckle. Shares are modestly undervalued, the store concept is in the middle of its life cycle, and the company's financial prudence and operational acumen should lead to a growing stream of free cash flow, dividends, and extra payouts — all of which can help the *Pro* portfolio in our pursuit of our North Star.

How It's Working

The Buckle is a surprisingly steady operator in the notoriously fickle specialty retail space. The company reported a modest same-store sales increase of 2.2% so far this year, but that's an improvement from the 1.2% increase through April. We accept a degree of lumpiness here and don't get too bent out of shape when these numbers bop around — The Buckle's target demographic is fickle teens and twentysomethings, after all. We simply monitor these figures for clues about the overall shopping experience and brand relevance. With this performance, we feel confident that the 13 stores management expects to open this year should be solid contributors. As the company expands cautiously, we marvel at its ability to boost margins, improve inventory management, and boost profitability per store.

What We Expect

With 443 stores at the end of fiscal third-quarter 2012, we believe The Buckle has plenty of room to grow as it expands from the middle of the country to both coasts; it should be able to achieve wonderful store economics with the 650 to 850 locations we ultimately expect. The table below outlines the key metrics we monitor for a retailer, and as you can see, The Buckle has fit into its jeans pretty well over the past decade.

Metric	2002	2012	TTM Q1 2013	Annual Growth
Stores	304	436	441	3.7%
Sales per Store	$1,339	$2,387	$2,398	6.0%
FCF per Store	$57	$406	$484	21.6%
Sales per Square Foot	$274	$475	n/a	6.0%
Inventory Turnover	4.7x	6.0x	n/a	3.0%

Dollars in thousands. Per-store calculations based on average stores open during the period. Sources: SEC filings, S&P Capital IQ, analyst estimates.

Not only has the company's footprint grown wider than a pair of bell-bottoms, it has sold more — and earned more — at each location thanks to its tight control over operations. The Buckle also has a history of paying special dividends with its excess cash; it's done so for six of the past seven years. Just last December, *Pro* members holding the stock received a $4.50-per-share payout from the company in addition to the regular $0.20 dividend. Naturally, we encouraged all members to celebrate by buying themselves and their loved ones a few new pairs of jeans.

More Resources

- *Pro*'s original recommendation (6/20/12)
- Talk about The Buckle on our discussion board

The *Pro* Bottom Line

To us, The Buckle has two sides: a very healthy operating business and a not unimpressive bank account. We trust management to allocate the cash in that bank account appropriately, and we appreciate their propensity to return any extra to shareholders. While we can't count on special dividends, the average yield over the past six years, including special dividend payouts, has been approaching North Star-level returns. Meanwhile, the company's operating business has grown bigger, more profitable, and more valuable. An investment in The Buckle suits *Pro*'s penchant for superior businesses, steady income, and a favorable risk/reward profile.

Buy: Starbucks (SBUX)

You only think you go for the coffee — Howard Schultz & Co. are serving up an experience.

Suggested Allocation: 3.3%

You may not realize it, but "**Starbucks**" is no longer a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense it's just a front. We think we go to Starbucks for the coffee, but those little white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

What It Does

Starbucks began opening America's eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 18,000 stores in 60-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences to fill more than 70 million mouths and hearts each week.

By placing the customer experience first, Starbucks has cemented its role in the daily lives of consumers worldwide. People demand their Starbucks products at home, too, which has allowed the company to build out a consumer packaged-goods division that sells more than $1.2 billion worth of products in more than 100,000 locations worldwide. And the company is cultivating a portfolio of other brands (Evolution Fresh juices, La Boulange bakeries) whose products can be sold in Starbucks stores and grocery stores alike. Between coffee, health foods, and tea, Starbucks believes its end markets are a massive $140 billion and growing.

How It's Working

Recent results have been robust. Over the past three years, Starbucks has added almost 1,500 stores, its same-store sales have grown by more than 7% per year, and it has more than doubled earnings. All of this growth has been achieved by doubling down on the in-store experience and refocusing on quality. Starbucks constantly seems to be setting new records for sales, operating profits, and earnings. And if the lines at the two locations nearest to Fool HQ (where we perform our daily channel checks, purely for science) are at all indicative of larger business trends, Starbucks' mojo remains strong.

What We Expect

Given its very recognizable brand, artfully crafted business and fanatically loyal customers, we expect Starbucks' diversified growth to continue. We believe the world's coffee and tea drinkers will happily support 30,000 or so stores across the company's various brands, and that products bearing the aspirational Starbucks brand will expand the company's real estate on grocery-store shelves.

The company's scale and its ability to raise prices should help profits, as will its unique advantages in low-cost marketing. Starbucks is a pioneer in social marketing, and is perhaps better positioned than any other brand to reach out to its customers, nurture their relationship with the company, offer deals, and customize experiences.

More Resources

- *Pro*'s original recommendation (8/22/12)
- Talk about Starbucks on our discussion board

The *Pro* Bottom Line

Starbucks is riding high since CEO Howard Schultz's return to power in 2008, and it now has so many levers to pull that capturing its potential value in a spreadsheet is very difficult. We're not worried that shares trade higher than our fair-value estimate; we think Schultz & Co. have many tricks up their sleeves that will allow Starbucks to grow into and beyond its current valuation, and we want to be along for the caffeinated ride.

Buy: Wells Fargo (WFC)

At heart, banks are simple businesses, and Wells Fargo is the best of the breed.

Suggested Allocation: 3%

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 9,000 branches and 12,000 ATMs. It's the fourth-largest bank in America, it's consistently No. 1 in customer satisfaction for American large banks, and it's the leader in mortgage and small-business lending.

What It Does

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During tough lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

How It's Working

CEO John Stumpf and team are truly the best of the breed. Return on assets and equity for 2012 were very attractive, at 1.4% and 13% respectively — great results given that the bank was using less leverage than before the financial crisis. Total revenue growth, while modest, has combined with expense reductions to drive quarter after quarter of earnings growth, leading to record earnings. Deposit growth has been tremendous, and as Wells Fargo grabs additional "wallet share," fee income grows as well. The credit quality of the loan portfolio is impressive and is still improving. All of this has contributed to a very well-capitalized balance sheet, allowing Wells Fargo to comply with upcoming capital regulation requirements well ahead of schedule.

What We Expect

Revenue growth will be slow until U.S. loan demand resumes, but management's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. We should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But when the U.S. housing market emerges from its general malaise, Wells Fargo's real earnings power — bolstered by growth in fee-based revenue — will hit its full stride. And many customers who start a deposit account or mortgage with Wells Fargo will explore the company's offerings in other areas, too.

More Resources

- *Pro*'s original recommendation (12/10/10)
- Talk about Wells Fargo on our discussion board

The *Pro* Bottom Line

Shares are trading at less than fair value, and they yield a growing 2.8% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. Pro has also used options in the past to generate even more income from this position, so try to invest using round, 100-share lots if it keeps you within half a percent (plus or minus) of our 3% allocation. If that's not feasible for you, share ownership alone is fine, too; with its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

Buckle's Fair Value Bucks Higher

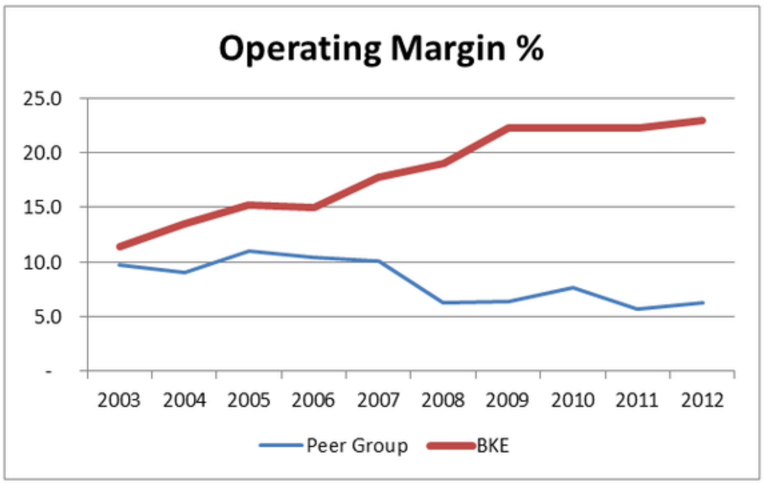
Published Jul 15, 2013 at 4:00PM

Fellow Fools,

Just a few days ago, as Jeff and I were walking to our local Starbucks (for a channel check, of course), I mentioned that I've worn one of my favorite T-shirts so many times I fear it may entirely disintegrate during its next wash. In response, Jeff lamented that his favorite T-shirts tend to disappear – his wife finds them quite comfortable. It's fair to say that when it comes to fashion, your *Pro* team is a Hold at best; we may even be due for a fair-value reduction. But *Pro's* only fashion-focused holding, **The Buckle** (NYSE: BKE), remains a Buy – and today, we're **boosting its fair value up to $56** and its Consider Adding More price to $41.

Why BKE is Better

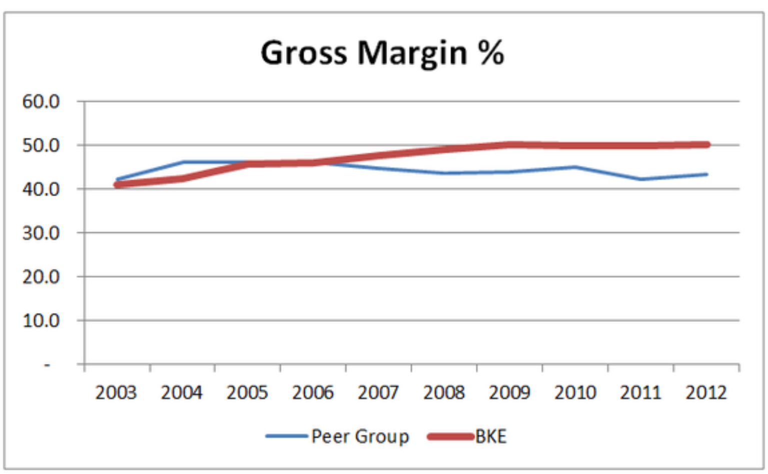
The Buckle has performed exactly as we expected since we purchased it just over a year ago: It has opened new locations, maintained a great in-store experience, and kept costs under control. In fact, the primary driver of the bump in fair value comes from my increased confidence in the company's ability to maintain its already impressive operating margins.



Fiscal years. Sources: Standard & Poor's Capital IQ and analyst estimates.

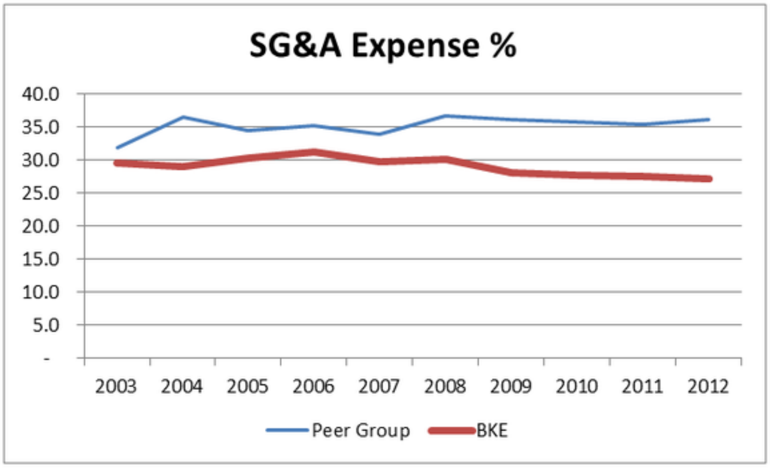
The chart above nicely demonstrates that The Buckle's business has performed admirably vis-à-vis its competitors over the last decade ... but we should care more about *how* it has been able to do this, and what we should expect over the next 10 years.

Regarding the how: The Buckle has improved its gross margins by selling more of its house-brand clothes and using its size to get better purchasing arrangements. Last year, 34% of sales came from Buckle brands, up from 20% 10 years ago. This shift has helped The Buckle expand gross margins by about 25%, while its peer group has basically held the line.



Fiscal years. Source: Standard & Poor's Capital IQ and analyst estimates.

The Buckle's investment in training sales associates, and its desire to promote from within, have led to lower employee turnover (compared with competitors) at and above the store-manager rank and reduced costs associated with rehiring. I don't have any hard data to prove this, but employee reviews and common sense suggest it to be true. We *can* be sure the company has done a great job holding down other overhead costs, which is captured in the proportion of each sales dollar that goes to sales, general, and administrative costs (SG&A expenses).



Fiscal years. Source: Standard & Poor's Capital IQ and analyst estimates.

What Does the Future Hold?

With the pretty pictures above, we dug into a few of the sources of The Buckle's great financial performance. But as we noted, the company's intrinsic value hinges on how it will perform in the future. To that end:

- Although private-brand sales are up 75% over the past decade, their expansion has stalled a bit, only expanding from 33% in 2010 to 34% in 2012. Still, the company is adding house brands across products, with plenty of room to go in kids' clothes, accessories, and tops.
- As The Buckle opens new stores closer to the coasts, rent will likely be higher than in the heartland, which would pressure gross margins. But increased sales via the company's website should help offset that trend (go get yourself one of the 5.5 million pairs of jeans the company sells each year!). I expect online sales growth to outpace in-store sales growth, which should benefit margins.
- There are also incremental benefits to be found in The Buckle's expansion plans. As it opens new stores contiguously and to fill in geographic gaps, shipments from its still-new distribution facility will achieve further efficiencies. In a similar vein, the growing store base shouldn't require much expansion at headquarters, so there will be slight benefit from overhead costs growing more slowly than sales.

Overall, I think The Buckle's margins are unlikely to change much over the next few years -- but I underestimated the sustainability of those impressive margins in my prior model, which caused me to underestimate the company's performance. I now expect management to hold the line over the next five years, at which point operating margins should begin to decline to more a sustainable level for a mature specialty retailer (about 17%).

The other main drivers of value are store openings, same-store sales growth, and the company's reinvestment profile (store remodel expenses and inventory requirements). All of these metrics look about the same as in the past, accounting for rising costs; I expect 4% growth in store openings and 2.5% same-store sales growth, on average, over the next decade.

The *Pro* Bottom Line

Will The Buckle have 639 stores, $2.1 billion in sales, and $244 million in free cash flow in 2023, as my model predicts? No. Of course it won't. But the modeling and valuation exercise is instructive because it shows us that, to justify today's price and earn us North Star-like returns, the company only has to expand modestly, and its financial performance (growth and margins) could actually deteriorate. To the extent the long-tenured, stellar management team is able to delay this deterioration, our returns should be even higher. As we await the company's second-quarter earnings next month, we should all keep an eye out for clues about what The Buckle may look like in 2023. The only thing I know for sure is that my favorite T-shirt will be long gone by then -- but I hope to be consoled by still owning shares of The Buckle.

Onward,

Bryan (TMF42)

Pro Catch-Up Trades

- None this week.

Pro Guidance Changes

- In case you didn't read the artfully crafted 900 words above, we're raising The Buckle's fair value to $56 and its Consider Adding More price to $41. Shares remain a Buy.
- We moved **BMC Software** (NASDAQ: BMC) to Hold as we wait for the company to be taken private.
- We increased our estimate of fair value for **Papa John's Pizza** (NASDAQ: PZZA) to $60. Shares remain on hold.
- We increased our estimate of fair value for **Wells Fargo** (NYSE: WFC) to $46. Shares are a buy.

Coverage & Community

- A note of reassurance from *Pro* member DWSCHULZ.
- Don't miss out on all the action happening in response to our newest recommendation.
- Our new guy writes his first Memo and only Carp can muster the courage to give him a hard time? C'mon, *Pro* community, let him have it.

The Motley Fool owns shares of BMC Software, Papa John's International, The Buckle, and Wells Fargo. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Write Puts on American Tower

Published Jul 15, 2013 at 3:35PM

- **What We're Doing**: Writing puts for income and to potentially add 2.5% to our stock position, bringing it to around 5%.
- **What We're Thinking**: The slide in the stock price is unwarranted, and we're happy to take advantage of the volatility.
- **What We're Expecting**: This company's towers will enable the world's Internet junkies to use their mobile phones more and more.

Trade Essentials

- **Action**: Sell to open August $70 puts on **American Tower** (NYSE: AMT)
- **Allocation**: About 2.5%; with the 2.8% already in our portfolio, today's recommendation gives us the potential for a total stake of about 5%. *Pro* will write six contracts. Each contract represents a $7,000 potential obligation.
- **Recent Price**: $75.96
- **Option Price (bid/ask)**: $2.35/$2.45
- **Price Guidance**: Split the bid and ask, aiming for $2.40 or better. Over time, accept no less than $2.
- **Alternative Trades**: If you don't yet have an allocation to American Tower, we suggest you buy a 2.8% stake and write puts for another potential 2.5%. If your portfolio is less than $300,000, it may not make sense for you to write these puts. If that is the case, hang tight -- we might raise our stake if shares approach our Consider Adding More price. For a more aggressive put write, you can choose the $72.50 strike; for a more conservative put write, you can choose $67.50.

What's New?

American Tower is down 10% in the two months *Pro* has owned it. We don't even have a new quarterly release to update us on how business is progressing, so what's up? We see two possibilities.

1. The Fed. Chairman Ben Bernanke occasionally hints at rising interest rates (or at least that's how the pundits interpret his words), and each time, high-dividend stocks and real estate investment trusts get whacked as marginal investors rotate out of these assets and into now higher-yielding bonds. We think American Tower's inclusion in this dynamic is silly – while the company is structured as a REIT, the underlying dynamics of Internet usage on mobile phones make it a growth stock in a real-estate wrapper. If the company performs as we expect it to over time, investors will begin to see it for what it really is.
2. Debt. American Tower is one of the most indebted companies in the *Pro* portfolio; more than 70% of the company's capital is funded by debt. Higher interest rates make debt more expensive, so some investors may be scared by this large debt load. There are a few reasons we're not. First, the company's contract revenue is very consistent. Second, while debt coverage has been rising for past few quarters, interest coverage has fallen; this suggests the company is simply taking advantage of attractive borrowing opportunities. Third, management has indicated that the company's financial condition is strong enough to buy back shares in the face of all that debt. And finally, most of the company's debt is fixed-rate (so it won't adjust upward automatically when rates do rise), and very little of it will come due until 2015.

American Tower announces earnings at the end of the month, and while we have no idea what it will report, we're confident that the results will reflect the advantages we see in its business: a unique asset portfolio, a growing underlying market, and a financial position that will allow it to persist.

How to Follow Along

Write ("sell to open") one August $70 put for every $7,000 in stock you'd be willing and able to purchase if the share price falls below $70 by expiration. Use a limit order, splitting the current bid/ask. *Pro* will write six contracts to potentially grow our 2.8% stake to around 5% if we get shares.

- **Maximum return**: We make 3.4% in 33 days (45% annualized) if shares of AMT stay above $70.
- **Breakeven**: We begin to lose money when shares fall below $67.60, or 10.8% lower than where they are today.
- **Maximum risk**: If shares fall $8.36 to $67.60, our loss matches that of owning shares outright.

Next Step: Please post any questions on the American Tower discussion board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Write Puts on American Tower

Published Jul 15, 2013 at 12:00AM

- **What We're Doing**: Writing puts for income and to potentially add 2.5% to our stock position, bringing it to around 5%.
- **What We're Thinking**: The slide in the stock price is unwarranted, and we're happy to take advantage of the volatility.
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Next Step: Please post any questions on the American Tower discussion board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Buy TD Ameritrade

Published Jul 11, 2013 at 1:30PM

Trade Essentials

- **Action:** Buy **TD Ameritrade** (NYSE: AMTD)
- **Allocation:** 3%
- **Scorecard Status:** Buy First
- **Recent Price:** $25.60
- **Fair-Value Estimate:** $34
- **Consider Adding More:** $20
- **Dividend:** 1.4%
- **Options:** We may use them later, but they aren't necessary
- **Price Guidance:** When you're ready to buy, use a limit order to avoid pushing the stock higher

What It Does

Entrusted with $517 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NYSE: AMTD) hosts 378,000 stock, options, and futures trades on an average day. Since 2008, against a "perfect storm" of weak trading volume, near-zero interest rates, and a flattened yield curve (where short and long-term interest rates don't differ by much), this $14 billion company has managed to double client assets, contain operating costs, and return ever-more cash to shareholders.

At the same time, TD Ameritrade's partnership with **TD Bank** (NYSE: TD) (which owns 45% of the company) gives it a unique position in its industry. The partnership allows TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank, and with cross-selling opportunities and below-average risk to boot. So, when the current record-low Federal Funds interest rate increases, TD Ameritrade will earn much higher interest income, all of it pure profit. Meanwhile, it continues to focus on job No. 1: Grow client assets, and launch more investment products.

But about that Fed Funds rate: In 2007, it was 4.75%, up from 1% in 2003 during the last recession. Today, it's hovering between zero and 0.25%. The first year that it increases by 100 basis points (to 1.1% from today's 0.1%), management estimates TD Ameritrade's earnings per share will rise by an *extra* 27% to 32% compared with the prior year, on top of any other growth. And as history shows, interest rates could rise by much more than 100 basis points over the next three, five, and seven years.

The table below shows where TD Ameritrade has earned its revenue over the past six years.

% of TD Ameritrade's Revenue	2007	2008	2009	2010	2011	2012
Commissions and Transaction Fees	37.4%	40.1%	52%	46.6%	44.5%	41.2%
Net Interest Revenue	25.6%	21.7%	14.4%	16.5%	17.8%	17%
Insured Deposit Account Fees	24.6%	24.8%	23.6%	26.6%	27.6%	31.4%
Investment Product Fees	10.7%	12.2%	7.7%	5.1%	6%	7.4%
Other Revenue	1.7%	1.2%	2.3%	5.2%	4.1%	3%

Total revenue is up since 2007 despite a decline of about one-third in net interest revenue, as you can see above. But by growing client accounts, TD Ameritrade now has a much larger asset base on which to earn income when interest rates rebound (not to mention other benefits when trading volume grows). As of May, the company oversaw $88 billion in interest rate-sensitive assets. It also enjoys recurring fees from an expanding line of investment products: retirement accounts, advisor and institutional services (including AdvisorDirect), and exchange-traded and mutual-fund offerings.

How It's Doing

TD Ameritrade has increased client assets by at least 10% annualized for the last four years and counting. Management says this rate of growth has been about double that of its nearest competitor. For context, the S&P 500 is nearly flat since 2007, but client assets held at TD Ameritrade have more than doubled over the same period. The company's lucrative, quickly growing registered investment advisor business has contributed to this success, as have its new investment services. As evidence, two quarters into the current fiscal year, revenue from investment product fees is up 32% to $106 million.

Operating margins are strong, too, lately in the mid-30% range. Diligent capital management led Standard & Poor's to upgrade the business to an "A" credit rating in 2012, which helped fuel a recent 50% increase in the dividend (likely the first of many). With steady gains in customer accounts, decreasing shares outstanding (from 595 million in 2007 to 550 million last quarter), and a commitment to paying out roughly two-thirds of earnings to shareholders, the business should continue to reward owners – with the added benefit of much higher profits when interest rates increase. Meanwhile, the stock trades about 20% below its 10-year average price-to-book value of 4, although the company is more diverse and stronger now than over the past decade.

Following is TD Ameritrade's year-end book value multiple, along with the last Fed Funds rate for the given year:

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
TDA P/BV	4.9	4.8	6.4	5.7	5.5	2.9	3.2	2.9	2.1	2.1
Fed Rate	1.0	2.25	4.25	5.25	4.25	0 – 0.25	0 – 0.25	0 – 0.25	0 – 0.25	0 – 0.25

Today the stock trades at 3.3 times book value. The table tells the story well: When interest rates head higher, investors anticipate higher earnings and higher return on equity, so they pay a higher value multiple for TD Ameritrade. And with rates currently at a generational low, we could see a steady climb upward for many years. At the same time, as noted above, TD Ameritrade continues to be a well-run business with a long runway. This isn't *just* an investment in higher interest rates -- but higher rates will be an impressive booster rocket for earnings.

What Could Make Us Sell

TD Ameritrade needs to continue to increase customer accounts and client assets against tough competition (lately, it is drawing assets away from old-school, full-service brokers). Beyond that, it's a waiting game for more trading volume, more investment fees, and higher interest rates. Although we don't believe it likely, the United States could maintain very low interest rates for years, as Japan has; if that happens, our patience will be tried. If rates do increase, higher interest income may drive new commission wars as brokers fight to gather assets. We believe this less likely in today's mature, consolidated industry, but if we see such issues developing, we'll temper our expectations and consider selling. Finally, as with any financial stock, if we have any reason to lose trust in management, we'll enter a sell order.

Alternative Trades

- Although we recommend buying shares today, if you want to potentially buy the stock lower, consider "selling to open" one November 2013 $25 put for every 100 shares you could buy. Lately, these pay about $1.30, or a 5.2% yield in just more than four months. You can also consider other strikes and months.
- If you want to invest less capital, consider "buying to open" January 2015 $20 call options for upside exposure until that date.

The Foolish Bottom Line

TD Ameritrade's earnings are very likely at a cyclical low. Believing as we do that the company's profit potential is much greater than recent results suggest, the stock is a compelling buy in anticipation of higher interest rates. TD Ameritrade's business model is powerful when rates are headed upward. Most investors have probably forgotten that power since 2007, but will remember it when earnings start to jump. We'll begin with a 3% stake within the next 30 days and will consider increasing it over time.

Next Step: Head over to *Pro's* new TD Ameritrade board to discuss this investment.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy TD Ameritrade

Published Jul 11, 2013 at 12:00AM

Trade Essentials

- **Action:** Buy **TD Ameritrade** (NYSE: AMTD)
- **Allocation:** 3%
- **Scorecard Status:** Buy First
- **Recent Price:** $25.60
- **Fair-Value Estimate:** $34
- **Consider Adding More:** $20
- **Dividend:** 1.4%
- **Options:** We may use them later, but they aren't necessary
- **Price Guidance:** When you're ready to buy, use a limit order to avoid pushing the stock higher

What It Does

Entrusted with $517 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NYSE: AMTD) hosts 378,000 stock, options, and futures trades on an average day. Since 2008, against a "perfect storm" of weak trading volume, near-zero interest rates, and a flattened yield curve (where short and long-term interest rates don't differ by much), this $14 billion company has managed to double client assets, contain operating costs, and return ever-more cash to shareholders.

At the same time, TD Ameritrade's partnership with **TD Bank** (NYSE: TD) (which owns 45% of the company) gives it a unique position in its industry. The partnership allows TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank, and with cross-selling opportunities and below-average risk to boot. So, when the current record-low Federal Funds interest rate increases, TD Ameritrade will earn much higher interest income, all of it pure profit. Meanwhile, it continues to focus on job No. 1: Grow client assets, and launch more investment products.

But about that Fed Funds rate: In 2007, it was 4.75%, up from 1% in 2003 during the last recession. Today, it's hovering between zero and 0.25%. The first year that it increases by 100 basis points (to 1.1% from today's 0.1%), management estimates TD Ameritrade's earnings per share will rise by an *extra* 27% to 32% compared with the prior year, on top of any other growth. And as history shows, interest rates could rise by much more than 100 basis points over the next three, five, and seven years.

The table below shows where TD Ameritrade has earned its revenue over the past six years.

% of TD Ameritrade's Revenue	2007	2008	2009	2010	2011	2012
Commissions and Transaction Fees	37.4%	40.1%	52%	46.6%	44.5%	41.2%
Net Interest Revenue	25.6%	21.7%	14.4%	16.5%	17.8%	17%
Insured Deposit Account Fees	24.6%	24.8%	23.6%	26.6%	27.6%	31.4%
Investment Product Fees	10.7%	12.2%	7.7%	5.1%	6%	7.4%
Other Revenue	1.7%	1.2%	2.3%	5.2%	4.1%	3%

Total revenue is up since 2007 despite a decline of about one-third in net interest revenue, as you can see above. But by growing client accounts, TD Ameritrade now has a much larger asset base on which to earn income when interest rates rebound (not to mention other benefits when trading volume grows). As of May, the company oversaw $88 billion in interest rate-sensitive assets. It also enjoys recurring fees from an expanding line of investment products: retirement accounts, advisor and institutional services (including AdvisorDirect), and exchange-traded and mutual-fund offerings.

How It's Doing

TD Ameritrade has increased client assets by at least 10% annualized for the last four years and counting. Management says this rate of growth has been about double that of its nearest competitor. For context, the S&P 500 is nearly flat since 2007, but client assets held at TD Ameritrade have more than doubled over the same period. The company's lucrative, quickly growing registered investment advisor business has contributed to this success, as have its new investment services. As evidence, two quarters into the current fiscal year, revenue from investment product fees is up 32% to $106 million.

Operating margins are strong, too, lately in the mid-30% range. Diligent capital management led Standard & Poor's to upgrade the business to an "A" credit rating in 2012, which helped fuel a recent 50% increase in the dividend (likely the first of many). With steady gains in customer accounts, decreasing shares outstanding (from 595 million in 2007 to 550 million last quarter), and a commitment to paying out roughly two-thirds of earnings to shareholders, the business should continue to reward owners – with the added benefit of much higher profits when interest rates increase. Meanwhile, the stock trades about 20% below its 10-year average price-to-book value of 4, although the company is more diverse and stronger now than over the past decade.

Following is TD Ameritrade's year-end book value multiple, along with the last Fed Funds rate for the given year:

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
TDA P/BV	4.9	4.8	6.4	5.7	5.5	2.9	3.2	2.9	2.1	2.1
Fed Rate	1.0	2.25	4.25	5.25	4.25	0 – 0.25	0 – 0.25	0 – 0.25	0 – 0.25	0 – 0.25

Today the stock trades at 3.3 times book value. The table tells the story well: When interest rates head higher, investors anticipate higher earnings and higher return on equity, so they pay a higher value multiple for TD Ameritrade. And with rates currently at a generational low, we could see a steady climb upward for many years. At the same time, as noted above, TD Ameritrade continues to be a well-run business with a long runway. This isn't *just* an investment in higher interest rates -- but higher rates will be an impressive booster rocket for earnings.

What Could Make Us Sell

TD Ameritrade needs to continue to increase customer accounts and client assets against tough competition (lately, it is drawing assets away from old-school, full-service brokers). Beyond that, it's a waiting game for more trading volume, more investment fees, and higher interest rates. Although we don't believe it likely, the United States could maintain very low interest rates for years, as Japan has; if that happens, our patience will be tried. If rates do increase, higher interest income may drive new commission wars as brokers fight to gather assets. We believe this less likely in today's mature, consolidated industry, but if we see such issues developing, we'll temper our expectations and consider selling. Finally, as with any financial stock, if we have any reason to lose trust in management, we'll enter a sell order.

Alternative Trades

- Although we recommend buying shares today, if you want to potentially buy the stock lower, consider "selling to open" one November 2013 $25 put for every 100 shares you could buy. Lately, these pay about $1.30, or a 5.2% yield in just more than four months. You can also consider other strikes and months.
- If you want to invest less capital, consider "buying to open" January 2015 $20 call options for upside exposure until that date.

The Foolish Bottom Line

TD Ameritrade's earnings are very likely at a cyclical low. Believing as we do that the company's profit potential is much greater than recent results suggest, the stock is a compelling buy in anticipation of higher interest rates. TD Ameritrade's business model is powerful when rates are headed upward. Most investors have probably forgotten that power since 2007, but will remember it when earnings start to jump. We'll begin with a 3% stake within the next 30 days and will consider increasing it over time.

Next Step: Head over to *Pro's* new TD Ameritrade board to discuss this investment.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Catch-Up Report: Part 3

Published Jul 9, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1 • Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our porfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

Buy: Broadridge Financial Solutions | This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Buy: Gentex | The maker of auto-dimming car mirrors has a bright future.

Buy: Intel | Rumors of the PC's death have been greatly exaggerated.

Buy: Medtronic | For once, maybe we can all profit from growing older.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund | Diversification with some of the best small companies you've never heard of.

PDF Download this report as a PDF file

Buy: Broadridge Financial Solutions (BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 3.5%

Broadridge Financial Solutions helps the global financial system work. It operates the technology and logistical plumbing behind the scenes of global securities trading and the communication between banks, brokers, funds, and shareholders, and it made about $2.3 billion last year doing so. It's not sexy, but Broadridge dominates its niches, has remarkably steady recurring revenue and cash flow, and has recently broadened its suite of products and services with some small acquisitions. We expect the company to be a slow grower, but its consistent earnings growth and a healthy 2.7% dividend should help achieve North Star-like returns over time.

What It Does

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. Broadridge's investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in 2012, more than 85% of shares voted electronically used the company's platform. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider to manage investor communications.

The company's smaller segment, securities processing solutions, accounts for 28% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance Broadridge technology kicks into action — the company processes more than $4.5 trillion worth of global stock and bond trades each day.

How It's Working

Mutual funds have been scrimping on investor communications recently, and low trading volume has dinged sales and profit growth. Still, it's a testament to the company's resilient business model that sales growth, profit margins, and free cash flow remain attractive — revenue grew 6% last year and earnings advanced 13%. And Broadridge continues to serve its customers masterfully; its 99% retention rate sets the stage for recurring revenue (and deepening relationships) in future years.

What We Expect

We think Broadridge will continue to write the e-book on electronic investor communications. Its dominance of this market should strengthen its competitive advantages, making it indispensable as transparency in the financial system increases. We also expect banks and brokerages to continue outsourcing their non-core operations to save money and increase flexibility; this should bring increased business and greater efficiency to Broadridge. Management expects 3% to 4% revenue growth this year, which should translate to more than 9% earnings growth. Much of Broadridge's revenue is recurring, making its sales and earnings growth highly reliable, and its impressive free cash flow will likely bring an ever-higher dividend and increased share buybacks.

More Resources

- *Pro* 's original recommendation (4/27/10)
- Talk about Broadridge on our discussion board

The *Pro* Bottom Line

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns. While we wait for the market to come around to the Broadridge story, we believe management is buying back shares at an attractive price. We think shares are worth $27.50 today.

Buy: Gentex

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 3.1%

In 1982, a small company in Zeeland, Mich., called **Gentex** made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors. Today, the company commands almost 90% of that market, and it sells eight times more units than its closest competitor.

What It Does

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. In 2000, the company sold 6.8 million units; in 2012, it sold 23.8 million. That growth has been driven by an increased focus on safety, higher car sales, and greater market penetration (more car makers offering Gentex mirrors as a trim option).

How It's Working

Gentex has turned these market dynamics into wonderful financial performance. Revenue is up by nearly 20% per year since 1987, and over the past decade, the company's net margins have bounced around the mid-teens. Those numbers are shockingly good for an auto parts supplier, showing that its fancy mirrors are showing up in more and more new cars. Gentex has reinvested in its business to sustain its advantages; it pioneers its own manufacturing technologies; it owns all of the manufacturing plants it builds (the land, too); and it sets aside 7% of sales for research and development. It's also got almost $5 per share in cash and investments, sending a strong signal to automakers that Gentex should easily avoid any potholes in auto demand.

What We Expect

Currently, less than one in every four cars made worldwide has an auto-dimming rearview mirror, and only 6% have auto-dimming exterior mirrors. For context, prior to 1987 those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher penetration; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More Resources

- *Pro* 's original recommendation (5/29/12)
- Talk about Gentex on our discussion board

The *Pro* Bottom Line

More and more technology is finding its way to the auto mirror, both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. With shares trading around our estimate of fair value, we think Gentex reflects a great opportunity.

Buy: Intel

Rumors of the PC's death have been greatly exaggerated.

Suggested Allocation: 5.2%

The world's leading producer of microprocessors and chipsets for computing devices, **Intel** trades at less than 12 times earnings, or more than a 35% discount to the average S&P 500 stock. It also pays nearly twice the average dividend yield, at 3.8%. That's cheap enough to indicate that all is clearly not right in Intel's corner of Silicon Valley.

While the media loves to talk about the demise of the personal computer, it's our job at *Pro* to sift through that constant chatter to see the truth and invest accordingly. And to our minds, the death of the PC has been erroneously predicted. Mobile computing is indeed changing our online behavior, and PCs are evolving as a result. But the outcome is more computing devices, not fewer, and Intel is positioning itself to be the brains behind ever more of them.

What It Does

Intel's goal is to be "the preeminent computing solutions company that powers the worldwide digital economy." Whether it's a high-speed server for a data center, a new Ultrabook with a touchscreen and detachable tablet, a smartphone, a tablet, a car, or just about anything else, Intel has the computing technology to drive it.

Admittedly, the company was late to the smartphone and tablet markets, but there's a silver lining: As these devices eat into PC sales, investors' fear about Intel's tardiness brings us the value opportunity we see in the stock. And because smartphones and tablets have very short life cycles, Intel can catch up quickly by steadily inserting its technology into new product designs.

How It's Working

Intel asserts that the tablet is broadening the PC market, not shrinking it, and we agree. Tablets are wonderful for what they are, and the hype surrounding them is admittedly intense. But it seems likely that the PCs of tomorrow will have the best qualities of both a tablet and a PC.

In emerging economies, PC unit volume has steadily risen for years; in North America, it slipped in 2012 for the first time in 11 years, but we believe that was because consumers are excited about the novelty of tablets, not done with PCs forever. Even as the market is expected to shrink, data company IDC expects 2017 shipments to be less than 5% lower than in 2012. We view this as a mature market where Intel will continue to dominate — and generate cash for reinvestment elsewhere.

What We Expect

More Resources

- *Pro* 's recommendation history
- Talk about Intel on our discussion board

Intel is investing for greater growth ahead. Wall Street is leery of the company's expensive capital investment plans, designed to maintain its leading-edge manufacturing abilities, but we view this spending as a strong indicator for the company's future. Intel's confidence in the future of microprocessors seems well-placed in our increasingly digital age; as the number of devices connecting to the Web grows exponentially, so does the need for more computing power.

The *Pro* Bottom Line

Historically, buying true blue chips (Coca-Cola, Johnson & Johnson, IBM …) when they're down has been an excellent investment strategy. We believe Intel will fit that bill, too. Our fair value on the stock is about $27; on a price-to-earnings basis, that would still leave the stock trading at a healthy discount to the S&P 500. We don't expect this value gap to be bridged immediately — first, Wall Street needs to believe in the company's future again. But this year or next, we expect Intel to show skeptics that it's here to stay.

Buy: Medtronic

For once, maybe we can all profit from growing older.

Suggested Allocation: 3.2%

Bryan likes to tell people that the mounting gray strands in his hair represent rapidly increasing wisdom. Nick claims his sore back is the result of lifting cars over his head. Jeff … well, Jeff just thinks cruising around on a Hoveround makes him look hip (it doesn't). The honest truth is that your *Pro* team is aging, and global demographics are shifting in that direction, too. Cost issues aside, global health care is a growth market we'd be silly to miss. Since 2009, *Pro* has stood by **Medtronic** because of its global reach, unrivaled commitment to research and development, and attractive financial profile.

What It Does

Medtronic is in business to "alleviate pain, restore health, and extend life" for the chronically ill. Sure, it also makes money for its shareholders and provides a good life for its employees, but the company has grown from a garage operation into the world's largest medical technology company by keeping its patient-centric mission front and center.

Today, Medtronic has a vast suite of high-tech products; it boasts market-leading share in key technologies; and it has successfully defended that position over time by keeping the pedal to the metal regarding research and development. And with more than 9% of sales directed back into R&D, there are research dollars left over to keep the company's new product pipeline humming. Finally, Medtronic has made selective acquisitions to target higher-growth areas and fill product holes, and it now racks up $7.5 billion a year in international sales (45% of the company's $16.6 billion total).

How It's Working

Over the past few years, some of Medtronic's core markets have come under duress; in some cases, competition has picked up, while in others, product efficacy and sales practices have been questioned. As of late, though, all that has been stabilizing — and the company's other businesses, and its 20% annual growth in emerging markets, were busy picking up the slack. Product diversification has been a big help in maintaining sales levels, and management's deft execution of its goals and impressive expense management have turned modest sales performance into admirable bottom-line results and cash generation.

Although sales have only advanced 4% annually over the past five years, earnings, dividends, and free cash flow have grown faster as management has cut costs, consistently rewarded shareholders, and maintained discipline with its reinvestments.

What We Expect

Under new CEO Omar Ishrak (who came aboard in 2011), we expect Medtronic to continue its clinical excellence and focus on chronic diseases. However, we expect more disciplined execution, a stronger focus on building the infrastructure for ongoing emerging-market growth, and an evolving balance between the clinical benefits of the company's products and their economic value. Management expects the company to generate $25 billion worth of free cash flow over the next five years, and half of that is likely to be returned to shareholders in the form of dividends and share buybacks.

More Resources

- *Pro* 's original recommendation (7/1/09)
- Talk about Medtronic on our discussion board

The *Pro* Bottom Line

We recommend you match our 3% allocation in this leading medical technology company. If it's as good an investment as we believe, we can all buy Hoverounds to chase Jeff — and truly profit from getting older.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund

Diversification with some of the best small companies you've never heard of.

Suggested Allocation: 2.1%

At *Pro*, we think we could develop an edge when it comes to investing in emerging-market small caps — but the investment in time and energy would be tremendous. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund**.

What It Does

This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields about 3.5%). For *Pro*, it offers exposure to 521 of the most promising business we've never heard of.

This ETF gives us an excellent way to invest in unfamiliar companies in locations where we don't have a discernible edge — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The risk-reducing benefits of investing outside our home market are equally important.

How It's Working

It's no surprise that small-cap companies (even dividend-paying ones) in emerging markets can be volatile. We expect DGS itself to continue to experience higher-than-average volatility, even though the diversification it brings to our holdings will likely lower the portfolio's volatility overall.

We'd always prefer to own great businesses over great ETFs, so this holding has a permanent spot on our short list of positions we'd sell if we needed cash or found a higher-conviction alternative. In the meantime, for a reasonable 0.64% expense ratio, we get a basket of businesses with a history of exceptional performance, weighted by the size of their annual cash dividend. The fund's heavy weighting toward financials (23%), industrials (16%), and the consumer discretionary sector (14%) leaves it well positioned to benefit from an economic recovery if and when one comes along.

What We Expect

Let’s be frank: We’ve lost a bit of money on DGS since recommending it in November 2010. But you shouldn’t fault DGS for our timing — it had great returns in 2010, before we bought it, and great returns in 2012, too. It’s the middling 2011 results that have us just now breaking even.

This is a top-notch fund, and you don’t have to take our word for it; Morningstar has bestowed its coveted five-star rating on DGS. It’s also made Morningstar’s list of the top eight funds in its category in each of the past three years, and it’s ranked No. 2 when considering five-year performance. We expect these impressive long-term results to continue.

More Resources

- *Pro* ’s original recommendation (11/22/10)
- Talk about DGS on our discussion board

The *Pro* Bottom Line

Overall, DGS provides cheap diversification and income for us, and it remains a well-run fund that has earned its place in the *Pro* portfolio. All that said, it needs to do its part in helping us achieve North Star-like returns over the coming years if it wants to stick around. We still believe that income and value within growing economies are worth investing in, and we suggest you match our 2.1% allocation now.

The Motley Fool owns shares of Broadridge Financial Solutions, Gentex, Intel, Medtronic, and WisdomTree Emerging Mkts Small Cap Div. See Pro*’s holdings here. See the team’s and David and Tom Gardner’s holdings here.*

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3 Things I’ve Learned From Motley Fool Pro

Published Jul 8, 2013 at 4:00PM

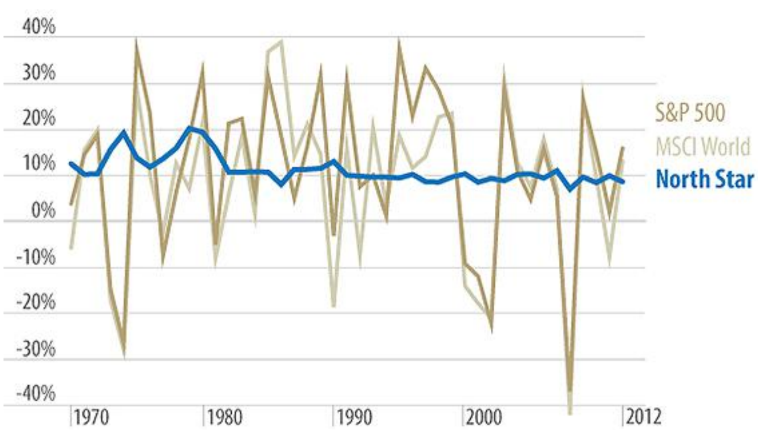
Dear *Pro* members,

Billy Kipersztok here (TMFTailwind), *Pro*'s resident analyst in development. Having joined the team in mid-April, I've only been with *Pro* a bit longer than our newest cohort of members. For the benefit of those Fools and our veteran members alike, the team thought it might be useful for me to share three of the most important takeaways I've learned in my time so far on the (awesome!) *Pro* team.

1. The *Pro* Philosophy and Our North Star

Pro's philosophy is unique among Motley Fool services in that we are a real-money portfolio service that aims to generate *positive real returns*in any market. Instead of comparing our performance to a market benchmark, we instead set our sights on our North Star: inflation + 7% annually.

Unlike a market index, which regularly produces negative returns over a given period, the North Star has virtually always been positive over the last 80 years. Using this graph from our Guidebook, you can see that over the past 43 years, U.S. and world markets (the S&P 500 and MSCI World, respectively) have dipped into negative territory with regularity, while our North Star has been positive in *every single year.*



2. Volatility and the Magnitude of Changes

That graph leads me to my next important takeaway: *Pro*'s thoughtful approach to volatility. Volatility is defined as "a statistical measure of the dispersion of returns for a given security or market index," which is just a fancy way of saying "uncertainty about the size of changes in a security's (or portfolio's) value." The price of a stock with high volatility can change dramatically over a short time period, while a low-volatility stock's price will remain much steadier.

As you can see in the first chart above, our North Star has exhibited much lower volatility than the U.S. and world market indices, which have swung wildly from one extreme (-40% in the mid-2000s) to the other (+40% in the mid-1990s). This means that as we aim for our North Star, over time, we should see smooth, steady returns over *any* market cycle.

Remember, though, that volatility isn't constant. As it changes, it can be measured indirectly with options prices. There's an index that tracks overall market volatility via options prices on the S&P 500: the Chicago Board Options Exchange Market Volatility Index (^VIX). Paradoxically enough, volatility itself is actually very volatile. Here is a graph of the ^VIX index over the last 10 years.

Spikes in volatility usually coincide with market corrections (most notably the late 2008-early 2009 spike), and for this reason, VIX is often referred to as the "investor fear gauge." As investors concerned about smooth, steady real returns, the *Pro* team keeps an eye on the VIX index to aid in our investment decision-making.

3. Tools in the Toolbox

So we've talked about our goals — whatwe aim for in *Motley Fool Pro*. My final takeaway is about *how* we invest in order to keep on track with our performance goals, as guided byour North Star.

As we learned from our first graph, stock market indices frequently dip into negative territory. Thus, if our goals are to minimize volatility and consistently achieve positive real returns, we obviously need to use strategies that differ from those indices. To that end, we generally aim to keep our invested capital allocated as follows: 70% stocks (long/short), 15% ETFs, and 15% options. Stepping outside the world of long-only stocks helps us to de-couple our portfolio's performance from that of any stock index and achieve our performance goals.

That said, while we do establish short positions, make sector-based bets with ETFs, and employ options, *Pro* is primarily focused on the long term. Often, our short positions are used to hedge downside risk (and thus decrease the portfolio's volatility). At other times, we may use such positions to leverage profit opportunities, but when we do, it is always with a very careful eye.

The *Pro* Bottom Line

In the past few weeks, we've welcomed in a new class of *Pro* members and celebrated our longer-tenured members. In sharing my three biggest takeaways from *Pro* so far, my hope is that *Pro* community members both old and new can benefit from what I've learned.

At *Motley Fool Pro*, we aim to generate positive real returns, minimize volatility, and skillfully employ a variety of investment tools to achieve our goal. Jeff, Nick, Bryan, and the rest of the *Pro* team are all here to help you profit with us as we continue on the ongoing journey toward our North Star. And let me know what you thought of my first Memo on the Memo Musings board!

Fool on,

Billy Kipersztok (TMFTailwind)

Pro Catch-Up Trades

- For new members and for those catching up, we issued Catch-Up Report No. 2 last week. No. 3 will be issued tomorrow (July 9), and No. 4 will be issued next Tuesday (July 16). If you're eager to jump ahead, all Buy First and Buy stocks on our Recommendations page are, of course, recommended to buy anytime.
- Our *Pro* Positioning report and live event takes place next Thursday, July 18. We'll recommend timely options and any hedges or shorts for those using these strategies with us.

Pro Guidance Changes

- **O'Reilly Automotive** (NASDAQ: ORLY):The shares move from Buy First to Buy after healthy appreciation.

Coverage & Community

- New members are introducing themselves on the Meet & Greet board!
- FoolishRob shares how he's a put-writing pro.
- Bryan Hinmon (TMF42) shares his take on prospects at **GrafTech** (NYSE: GTI).
- Earnings are around the corner! TMFMoosie shares a *Pro Calendar*. You can also see important dates in our calendar on the Alerts tab at the top right here.

Catch-Up Report: Part 2

Published Jul 2, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1 • Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our porfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

PDF Download this report as a PDF file

Buy: American Tower (AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 2.7%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Internet traffic from mobile devices in 2012 was nearly 12 times *total* Internet traffic in 2000, and the average connection speed of a mobile device doubled from 2011 to 2012. Communications site operator **American Tower** is well positioned to benefit from both trends.

What It Does

AMT leases antenna space on nearly 55,000 cell sites (towers, rooftops, and more) to wireless service providers. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, noncancellable, and feature contractual annual price escalations.

About 60% of AMT's properties are located in 10 different countries outside the U.S., including India, Brazil, Germany, and Uganda, and that percentage is growing quickly as AMT erects more towers.

How It's Working

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE (or, in Africa, from voice to data), or to increase coverage density. Every time they do, AMT increases the lease rate — on top of the scheduled price escalations.

Switching costs in this space are high; 98% to 99% of AMT's customers up for renewal each year do so, and nearly 80% of its current leases don't renew until 2022 or later.

What We Expect

Revenue was up 17.7% year over year in 2012, with the international division up 34%, well outpacing the domestic side. We expect revenue to double in the next five years through a combination of price escalations, new towers, and upgrades. After its recent conversion into a real estate investment trust, AMT is required to pay out 90% of taxable income to shareholders. It currently distributes $1.04 annually, a 1.3% yield, and management expects to grow the dividend 20% annually for the next five years. (Importantly, only the U.S. side of this business is organized as an REIT. For more, see our original writeup.)

Management reduces taxable income though the use of net operating losses. And because the useful life of its tower properties exceeds the depreciation schedule, AMT also uses a depreciation shield, which reduces taxable income and understates the values of some assets on the balance sheet. Thus, typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

More Resources

- *Pro* 's original recommendation (5/6/13)
- Talk about American Tower on our discussion board

The *Pro* Bottom Line

We value AMT at about $100 a share. Today's price provides an acceptable margin of safety for a business of this caliber. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network.

Buy: GrafTech International

Steelmaking is evolving, and graphite electrodes will help build the emerging world.

Suggested Allocation: 2%

The International Monetary Fund reduced global GDP estimates three times during 2012, an admission that its rosy outlook for the world economy had been too sanguine. Currently, it expects global growth of 3.25% this year and 4% next year. The share price of **GrafTech International**, a leading supplier of graphite electrodes that are used in the production of steel, dances pretty closely with GDP, so 2012 was an electric slide downward for this economically sensitive *Pro* holding. The first quarter of 2013 wasn't much better, but there are plenty of reasons we think this bumpy ride in the short term will pay off for *Pro* investors in years to come.

What It Does

With a diverse customer base and six facilities on four continents, GrafTech creates products used in the electronics, defense, oil and gas exploration, and aerospace industries. Its customers span 70 countries, and it's well positioned to grow as governments increase their spending on infrastructure, technology, and energy. Its worldwide factory network puts the company near its customers and renders more than 70% of GrafTech's annual sales outside the United States.

How It's Working

Unfortunately, demand for graphite electrodes is driven by economic activity, and prices are set (for the most part) by that demand relative to the industry's supply. This suggests that GrafTech is largely a price-taker, and it leads to lumpy results that can look ugly for long periods. Accordingly, when we analyze GrafTech, we pay particular attention to the long-term trends for steel demand (and our outlook on same), GrafTech's strategic positioning, and how the company manages the costs it can control.

On each of these points, things look bright. Steel use should grow modestly as the emerging world builds out infrastructure, and environmentally friendlier electric arc furnaces should take share from dirty, costly blast furnaces in the production of steel. Strategically, GrafTech recently took control of its primary input (needle coke) so it could better control costs and quality. It also retains a reputation for being the highest-quality producer of electrodes. Finally, the company continues to wring costs out of its structure under the guidance of experienced management.

What We Expect

While supply expansion from other industry players will keep downward pressure on electrode prices, this sort of behavior is not uncommon in the steel supply chain that GrafTech inhabits, and the company has successfully navigated such turbulence in the past. If Chinese suppliers persist in exporting their product at a loss, we think the most likely outcome is that GrafTech's low-quality, high-cost competitors will suffer the most — maybe even go belly-up. Meanwhile, as a large, high-quality, low-cost producer, GrafTech is the best positioned in the industry to weather this storm. The company has the financial wherewithal to withstand a downturn; all we have to do is wait.

More Resources

- *Pro* 's original recommendation (12/16/08)
- Talk about GrafTech International on our discussion board

The *Pro* Bottom Line

At about $7 per share, GrafTech is selling for just about the book value of its assets, but it's the electrode kingpin with a history of strong profitability and a portfolio of graphite science patents. In any given period, we're along for the economic ride — but over entire cycles, GrafTech is proving it is a business worth owning.

Buy: MasterCard

Plastic is overtaking paper as the world's way to pay, and MasterCard leads the charge.

Suggested Allocation: 4.2%

Simply put, **MasterCard** is among the most attractive businesses in the world. Here's why.

What It Does

The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders, who are actually exposed to the card users' finances; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

Though MasterCard competes with a very large number of well-heeled and (in some cases) innovative businesses, the company's profitability is growing quickly even though the global economy isn't. And that makes perfect sense, because when it comes to paying for stuff, the global market leader isn't **Visa**, or PayPal, or banks ... it's cash. While MasterCard's stock price has risen since we recommended buying in September 2011, our thesis remains intact: Cash has a still-astounding 85% market share of transactions, but it's slow and inefficient, and with no one managing its brand, it's quickly losing out to better alternatives.

How It's Working

This trend has already taken hold in the U.S., where we use cards for a third of our personal expenditures, so Americans often underestimate the opportunities — domestically and especially in developing nations. Last quarter, MasterCard processed $947 billion in gross dollar volume, $653 billion (69%) of which came from outside the United States. Growth in its U.S. business was 4%, outpacing our economy (as measured by GDP) like America was standing still. And worldwide growth, excluding the U.S., clocked in at a tremendous 16% in local currencies (15% in USD). Cash is losing, and fast, but there's a long way to go — and a lot of opportunity for MasterCard.

What We Expect

More Resources

- *Pro* 's original recommendation (9/8/11)
- Talk about MasterCard on our discussion board

Management recently confirmed guidance for continued 11% to 14% compounded annual revenue growth and 20% earnings-per-share growth through 2015. We think this is possible under current (difficult) conditions, and we expect even better if economies around the world can turn the corner. CEO Ajay Banga and team are doing a tremendous job moving the company forward, so much so that results have outpaced our expectations not once but twice in the short time we've owned shares. We wouldn't bet against a three-peat.

The *Pro* Bottom Line

MasterCard's current share price is near our $550 estimate of fair value, a fair price for a great business that's strengthening every year. Buy now, then sit back and enjoy your take every time millions of people around the world present their MasterCards.

Buy: OpenText

This company's information management software keeps our digital lives in order.

Suggested Allocation: 3%

As you may have noticed, the world is going paperless. Most of us have fewer files and binders lying around our homes and offices these days. But there's a flip side: Right now, your computer is storing ever-growing piles of email, not to mention digital documents so numerous that, if you're like me, you're getting ready to unfurl the white flag of surrender. This is where **OpenText** comes in.

What It Does

Put very simply, OpenText provides information management software. Specifically, it sells software that lets companies organize and manage their growing reams of electronic content. Its products help companies, governments, universities, and others operate more efficiently and effectively, meet compliance requirements, and communicate with colleagues, customers, and partners. OpenText is the leading independent provider of solutions in the enterprise content management market and a leader in the broader enterprise information management industry. Its top competitor, **IBM**, may be larger, but OpenText enjoys longstanding sales relationships with **Microsoft**, **Oracle**, and **SAP**.

How It's Working

In quarterly results announced in May, OpenText's revenue rose 15.5% year-over-year, and adjusted earnings per share were up 25%, reaching record levels. New license revenue jumped a strong 13.3% last quarter. The company's profit margins grew substantially over the past year, as did cash flow.

The stock trades at around 13 times free cash flow (below the market average by a significant degree). Most customers only have one to three of the company's software product modules, leaving OpenText strong opportunities to sell many more product suites to existing customers, not to mention new ones, as its sales force expands (see below).

What We Expect

We estimate that the electronic content management industries OpenText serves will grow top-line demand by at least 10% annualized over the next several years, and OpenText will continue to take market share — perhaps even surpassing IBM in its niches. OpenText has a long history of steady growth through acquisition, and its young CEO (who's only been at the helm for about a year) is also intent on growing the sales team, both to reach out to new markets and to upsell more products to current clients. OpenText already enjoys diversified software sales to numerous industries, most notably financial services, general services, technology, basic materials industries, consumer goods, and the public sector.

More Resources

- *Pro* 's original recommendation (8/31/11)
- Talk about OpenText on our discussion board

The *Pro* Bottom Line

No one-trick pony, OpenText has multiple growth avenues ahead across all industries as the world's piles of electronic data grow ever larger and in need of management. With new products rolling out in cloud services (off-site servers), renewed sales execution through more distribution channels, and an intense focus on its financial performance, this medium-sized company looks to have a big future.

Note: Although you don't need to use them, we also recommend options alongside owning OpenText stock. For those who want them, we'll recommend a complementary OpenText options strategy on July 18 in our *Pro* Positioning Report.

The Motley Fool owns shares of American Tower, GrafTech International Ltd., International Business Machines, MasterCard, Microsoft, OpenText, and Oracle. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

The Time of Your Investing Life

Published Jul 1, 2013 at 12:00AM

Dear *Pro* members:

As we welcome our newest fellow Fools, let's take a moment to remember that we live during an amazing time. Our lives are surrounded by "luxuries" we take for granted, even though 100 years ago they were practically unimaginable:

- Cars that propel us when we push a pedal, and roads waiting to carry us from Alaska to Patagonia
- Affordable plane tickets that can place us anywhere in the world in 24 hours
- The near-eradication of many of history's deadly diseases
- Tiny rectangles that have GPS, music, videos, the Internet — and that we sometimes use to call anyone on the planet, too
- In major cities, we can enjoy any type of cuisine imaginable (powerful kings of the past couldn't accomplish this, even with a kitchen staff in the hundreds)
- Online investment services let you communicate with thousands of investors, working together to succeed

- And we have more peace, trade, and prosperity than the world has ever seen

And yet, so many sharing our planet obsess on the negatives. The world isn't perfect; it will always have problems (for those who are truly optimistic, "solutions in hiding"). But how many millions of individuals compromise their financial standing because they, too, fall prey to the negatives? Too many people can't shake a short-term view, so they sell when stocks are down — even though equities are arguably the best, most accessible long-term path to wealth on the planet.

In a world of so much abundance, many of us fail to reach our financial goals because of our own emotions. We instinctively harbor a fear that "it will all fall apart," even though over the course of history humans have steadily made progress, and rarely regressed. Now is your time to capitalize on the best companies in the world, owning a part of them; now is the time to recommit to protecting and growing your financial freedom the coming years. We invest to be free.

In *Motley Fool Pro,* we have more ways to grow our wealth than any other investing service I know of. We naturally own stocks — the biggest engine in our portfolio. We also use options for income — and we will use them much more when we see stocks taking a long-term breather. We hedge to smooth out market downturns, have money to invest when stocks are cheaper, and eliminate a desire to sell core holdings during declines. We short to profit on falling prices. And we use ETFs that can invest anywhere and in anything. Yet, overall, our approach is simple and powerful — our strategies will work together for a lifetime, and work well.

Pan back, and you'll see that the stock market has historically headed higher over time. That makes perfect sense as the population grows, companies expand and become more efficient, new products are created, and prosperity increases. But at *Pro*, we don't rely on a rising market. With our long/short and income strategies, our first goal is to make money every rolling three years, no matter how stock indexes perform. Over the long haul, we will compound our wealth by owning exceptional companies. In the shorter term, we'll greatly pad our gains with steady income, add further to our profits with successful shorts, and see our hedges turn green when they come into play.

Our North Star guides us. We define this *Pro*-only feature as inflation plus 7% each year. Lately, the North Star is running around 10% annually. We aspire to this type of steady return. Historically, the North Star has never had a negative year, and as inflation rises, our guiding light will see higher returns, too. The North Star reminds us we're not here to compete with a stock index that goes up and down. We're here to earn steady, positive returns, because inflation rarely rests. In fact, inflation is part of prosperity. As wealth spreads, demand grows, and prices go up. We want our investments to go up much more, and we want our *real* purchasing power to at least double every 10 years (that's our second ambitious goal).

Sharing our strong and clear objectives, we welcome new *Pro* members to the fold — and we thank veteran members for being so helpful on the discussion boards! New members: Please say hello on the Meet & Greet board (and tell us your goals), and enjoy your *Pro* welcome experience, including the *Pro* Guidebook and Catch-Up Reports. We look forward to growing your investments for years to come — and teaching you all you need to know for steady investing prosperity.

Thank you to everyone here for being a *Pro* member! We're in great company with fellow investors, and I look forward to recommending more new investments this summer and the rest of the year.

Foolishly,

Jeff (TMFFischer)

Coverage & Community

- To discuss the Monday Memo, please visit the Memo Musings board.
- New members are saying hello on the Meet & Greet board!
- Member nevercontent talks about business at "Buy First" company **Apple**.
- Senior analyst Bryan Hinmon, CFA (TMF42), explains Buy guidance versus "fair value."
- TMFMoosie shares a *Pro* calendar as earnings approach.

Pro Catch-Up Trades

- For new members, we published Catch-Up Report No. 1. (No. 2 is coming tomorrow!)
- For all members, we want to point out that **American Tower**, at a 2.7% allocation; **GrafTech International**, at 2%; and **WisdomTree Emerging Markets Small-Cap Dividend Fund**, at 2.1%, are all down in price lately and rated Buy. If you have not started these positions yet, consider buying shares to match our allocations. These positions will also be featured in future Catch-Up Reports for new members.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Catch-Up Reports for New Members

Published Jun 28, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio. You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our porfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

Catch-Up Report No. 1 (June 24, 2013)

- View the HTML version
- Download the PDF

Catch-Up Report No. 2 (July 2, 2013)

- View the HTML version
- Download the PDF

Catch-Up Report No. 3 (July 9, 2013)

- View the HTML version
- Download the PDF

Catch-Up Report No. 4 (July 16, 2013)

- View the HTML version
- Download the PDF

Portfolio Positioning Report (July 18, 2013)

- View the HTML version
- Download the PDF

RockyTopBob's Guide to Pro

Published Jun 24, 2013 at 12:00AM

Fellow Fools,

At certain Metro stations in downtown Washington, D.C., just over the river from Fool HQ, there are "ambassadors" who hand maps to tourists as they step off the escalators. Those maps will help you find the Smithsonian museums, the local brewpubs, and Ripley's Believe It or Not — all of which are absolutely worth seeing. But if you want to know where to find a great cheap burger, small music venue, or low-key karaoke joint, your best bet is to ask a local. (For the record, our nominations for all three in D.C. are at the end of this Memo.)

Pro isn't exactly like D.C.; we weren't designed by Pierre L'Enfant, and we proudly answer to exactly zero lobbyists. But we're opening our doors to new members today for a short time, and we think that — like the nation's capital — we're best explained to first-time visitors by a longtime resident. Nobody fits that bill better than RockyTopBob, the community-chosen winner of our inaugural *Pro* Polaris Award. A Fool since 2005, Bob joined *Pro* in January 2011, and he's distinguished himself time and again with his honest, thoughtful, endlessly helpful answers to other members' questions on our discussion boards.

We thought his insights deserved a broader platform, so in today's Memo, we've asked Bob to share his tips for putting your *Pro* membership to best use. We hope they'll serve as an insider's guide for new members and veterans alike.

Without further ado, a Q-and-A with RockyTopBob:

***Pro*: What are the first three places on the *Pro* website to which you would point a newcomer?**

RockyTopBob: No. 1, obviously, is the wonderful Guidebook tab, and I would recommend reading every link (starting with "Meet the Team"). No. 2 is the Community tab, with a quick run-though of the available boards, followed by a post to the Meet & Greet board to introduce yourself. No. 3 would be the Recommendations tab, to review the *Pro* positions, suggested Buy Firsts, and What We Think Now.

RTB: The FAQ

Tennessee resident **RockyTopBob** spent his career in the space program, retiring early at 61 "because of some very good investment results." He's been investing for more than 40 years and loves everything about stocks, owning more than 200. He was born and raised in Chicago and still likes the Cubs! He and his wife and have two rescued golden retrievers and three ex-show Maine Coon cats.

***Pro*: What are the first few pieces of advice you'd give to someone upon joining *Pro*?**

RockyTopBob:

1. Don't be in a hurry to trade anything.
2. Learn the ropes first by getting acquainted with the site's contents and *Pro*'s philosophy.
3. Read the Broker Data link in the Guidebook to determine if you are with the best one for you, and then set up your options permissions.
4. Participate on the discussion boards to learn about the team and members and take advantage of all the information available there.
5. Pay attention to the Catch-Up Reports and ask questions on the discussion boards if you don't understand the trades or the reason behind the position.

***Pro*: What's the best advice you'd give to someone unsure if *Pro* is a fit for them?**

RockyTopBob: Post your concerns to the boards and ask other members what makes *Pro* a fit for them.

***Pro*: You are a past and present member of several TMF services — what do you think distinguishes *Pro* from other Fool offerings?**

RockyTopBob: The investment options, which go above and beyond long stocks, and the quality of the *Pro* team, especially their communication with members and willingness to answer all questions. A managed portfolio is a great advantage over a suggestions service.

To read more about the Polaris Award and Bob's formidable competition, click here. And finally, our favorite things in D.C.:

- Burger: BGR the Burger Joint / Elevation Burger (tie)
- Small music venue: Rock & Roll Hotel
- Hole-in-the-wall karaoke joint: Rock It Grill, Alexandria, Va. (reports of Fools being sighted there regularly are neither confirmed nor denied)

Whether you've just signed up or you've been with us since the beginning, thanks for being part of *Motley Fool Pro*. And thank you — and congratulations — to RockyTopBob!

Best,

Ellen (TMFKabellen), *Pro* editor, and Jeff (TMFFischer), advisor

Pro Trade Roundup

- **SPDR S&P 500**: Our June 2013 $164 covered puts were exercised, closing our remaining short SPY stock position.

Coverage & Community

- **Any Buyers Out There?** Bernie has the right idea today, buying stocks or writing puts while prices are down. FoolishRob99 shares some good ideas.
- **Oracle Reports Earnings:** Jeff provides a quick summary on this Buy First stock.
- ***Pro* calendar:** No earnings reports for a few weeks, but then they start arriving fast in July.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

How We Think About Options

Published Jun 21, 2013 at 12:00PM

Pro's Sister Service: Motley Fool Options

Your subscription to *Motley Fool Pro* includes full access to *Motley Fool Options*, an options-only service led by Jeff Fischer, the rest of the *Pro* team, and options guru Jim Gillies (TMF Canuck). *Options* is designed to root among the Foolish universe of stocks and provide a steady stream of actionable options ideas to complement your stock portfolio. It's up to you to determine how you wish to use *Options* in conjunction with Pro, but the vibrant *Options* community is a great place to cut your teeth, learn new strategies, and talk shop. Click here to visit *Motley Fool Options* »

Get Up to Speed With Options

You don't need to use options to follow *Pro*, but we view them as a valuable tool for retaining maximum flexibility in response to what the market throws at us. For sure, options can be confusing at first, but we've got you covered with our Options University (housed over at *Motley Fool Options*). Earn your Basic and Intermediate degrees, explore advanced strategies, and ask for help along the way. Here is a roll call of options education resources available to you:

***Pro* resources**

- *Pro*'s 14 Options Strategy Guides
- Get Up to Speed With Options
- Options Glossary
- Options FAQ

***Motley Fool Options* resources**

- Options U: Your one-stop shop for a complete options education

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How We Think About Options

Published Jun 21, 2013 at 12:00AM

Options in 3 Steps

Jeff explains options in not two, not four, but three easy steps.

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- Get Up to Speed With Options
- Options Glossary
- Options FAQ

***Motley Fool Options* resources**

- Options U: Your one-stop shop for a complete options education

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How to Use Your Jackhammer

Published Jun 17, 2013 at 4:00PM

Fellow Fools,

Jeff's Memo last week reviewed one of his favorite valuation metrics: EV/EBITDA. Obviously, the fact that each of us has his own favorite valuation metric automatically grants us access to the cool kids' table in the lunchroom, but our Certificates of Coolness seem to have been delayed in the mail. So while we wait, let's be sure we really understand how to use the tool Jeff introduced in the broader context of any valuation multiple. After all, it's a great idea to use a jackhammer to bust up some concrete, but it doesn't work as well when trying to polish a diamond.

YGWYPF

You get what you pay for. One way to think about any valuation multiple is like this:

$$Bang\ for\ Your\ Buck = \frac{What\ You\ Pay}{What\ You\ Get}$$

Reward a Fellow Member!

Voting is now open for our As-Yet-Unnamed Pro Community Award. Vote on who should be the inaugural winner — and on what the award's name should be! Click here to cast your ballot.

Jeff's Memo used some successful *Pro* examples to highlight the fact that paying a modest price relative to a known earnings stream (buying at a low multiple) often works out well. (I can hear *Special Ops* Advisor Tom Jacobs screaming "hallelujah!" all the way from Marfa, Texas.) This passes the buy-low-sell-high test, but it isn't always foolproof (small f). If the denominator is inflated — if it doesn't accurately represent the earnings to be realized over the long term — then the low multiple is misleading, because the benefit we're expecting won't materialize.

Multiple Lesson 1: Make sure you understand the reliability and accuracy of the denominator as a measure of future benefit.

Looking Forward

And that point leads us nicely into an alternative way of interpreting valuation multiples:

$$Expectations = \frac{Expected\ Performance}{Realized\ Performance}$$

If the formula above returns a high multiple, the implication is that the future will be better than the past. The inverse — a low multiple – means we can expect the future to be worse than the past. This view fits nicely with Chief Rule Breaker David Gardner's propensity to prefer companies that look expensive to other investors. He's seeking out businesses that are going to change the world, which almost always ensures that future expectations for those companies will be grand — and their resultant multiples high.

Multiple Lesson 2: Think about the future and how it relates to the company's performance history.

Payback Period

A final way to think about valuation multiples is in terms of payback:

$$Payback\ Years = \frac{Payment}{Annual\ Benefit}$$

"Payback" in this context has nothing to do with *The Godfather* – rather, I'm referring to recouping your investment. If you pay $45 for a business consistently generating $3 per year of earnings, that's a price-to-earnings ratio of 15. If we assume that Lesson 1 above holds true — that the denominator ($3) is an accurate and reliable measure of the earnings stream we'll own going forward — it will take us 15 years to recoup our investment, not accounting for the time value of money. Under this framework, it's easy to see why a low valuation multiple is preferred: When buying at a P/E of 15, we earn back 6.7% of our investment each year, but when buying at a P/E of 12, we earn back 8.3% of our investment each year. (It's worth noting here that that long-term government bonds currently have a payback period of about 50 years.) The problem, of course, is that for these calculations to be useful, the benefit has to be sustainable over the entire period. Making accurate predictions is hard enough, but it's even harder when you have to think 10, 20, or 30 years out.

Multiple Lesson 3: Consider the length of time you can confidently rely on the expected benefit.

The *Pro* Bottom Line

Few things in investing are cut-and-dried, and the use of multiples as a decision tool is no exception. So if we can't confidently say that a low (or high) valuation multiple is good (or bad), where does that leave us? Well, a quick review of the lessons outlined above suggests a good starting point: Understand the accuracy of the metric, acknowledge the expectations built into the stock price, and consider the durability of the benefit expected. Mush those together, and you get this:

Invest in companies that can earn higher economic profits than expected, or that can earn economic profits for a longer time than expected.

Measuring the economic profits themselves is fairly straightforward; it's the "higher" and "longer" that gets difficult. That's why we at *Pro* spend so much of our time thinking about industry structure and competitive advantage. Jeff's Memo last week dealt extensively with those matters as they relate to **Intel** (NASDAQ: INTC), **Oracle**

(NASDAQ: ORCL), **BMC Software** (NASDAQ: BMC), and **O'Reilly Automotive** (NASDAQ: ORLY); those companies' strong scores when it comes to industry structure and competitive advantage seem to support our use of EV/EBITDA as a decision tool. On the other hand, **Rockwood Holdings** (NYSE: ROC) – another company Jeff mentioned last week — scores the worst of the group, which is why we wrote covered calls at an EV/EBITDA multiple that no longer looked cheap.

EV/EBITDA succinctly summarizes bang for your buck, expectations, and payback, meaning it can be a very useful tool to inform your investing decisions. But just as you wouldn't use a jackhammer on your fine china, be aware that EV/EBITDA (or any valuation multiple, for that matter) works best in certain circumstances. Always understand the limitations of your chosen valuation multiple, and remember to focus on what really matters: industry structure and competitive advantage.

Onward,

Bryan (TMF42)

Pro Trade Roundup

- Per the June 12 trade alert, we rolled our covered calls on **Tupperware Brands** (NYSE: TUP) to October for a net cost of $2.95 per contract.

Upcoming Expirations

- **Special Note on StoneMor Partners** (NYSE: STON): The 30-day execution window on our recommended June $25 covered calls on StoneMor expires today, and because pricing hasn't offered us a net sell price in line with our guidance ($27), we have not yet executed this transaction. (We likely won't get our pricing today, either.) The June options expire Friday, so if you wrote June $25 calls, your shares will likely be called away – mission accomplished! If you, like us, couldn't match the net sell guidance, keep trying to sell your shares at a net around $27. Pro will issue a new trade alert when the opportunity arises. The stock remains a sell, but ideally at higher than $27.
- **SPDR S&P 500 ETF** (NYSEMKT: SPY):Our June $164 covered puts are near-the-money. Currently, we plan to let our remaining short shares get called away if SPY is at less than $164 on Friday.

Coverage and Community

- **REWARD A COMMUNITY MEMBER!** Help award a free year of *Pro* – and name our new community award. Click here to vote!
- **Test and Learn**: FoolishRob99 updates us on a written-put *Pro* port.
- **Existential exercise**: Why are we *Pro* investors? Bob knows.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Inside the Portfolio

Published Jun 17, 2013 at 1:00AM

Once you've decided what to buy, the next crucial question is how much. Here's how we approach allocation for our portfolio — and yours.

Pro Strategy Guide

Get up to speed in no time with this series of articles that will show you how to invest like a Pro:

- How We Invest
- Our North Star
- **▼ Inside the Portfolio**
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  - ETFs: 15%
  - Options: 15%
  - Long vs. Short
  - Cash
  - Reassessment
  - Letting Winners Run
  - Slowly, Slowly, Slowly
  - Allocating Your Dollars
- Finding Great Companies

As your portfolio managers, the *Pro* team is here to help you with allocation, diversification, and reassessing your holdings (many people call that last one rebalancing — a name we don't love, for reasons we'll explain shortly). Luckily, because we're managing a diverse portfolio and we want all of the pieces working in unison, the answer to "How much?" is quite clear.

Allocation: How We Decide How Much

When it comes to a long-term portfolio, the goal is to preserve what you have while boosting it with sensible growth. There's no reason to swing for the fences by throwing half of your savings into just a few equities or by crossing your fingers and taking enormous bets on just a few options.

At *Pro*, when we're right about a position, we want to be amply rewarded — and we want you to be rewarded along with us. When we're wrong, we want us all to easily live to see another day. We can never know everything about the investments we make, so we must remain humble, and we must allocate accordingly. That said, the more we know, the more we may allocate into the strongest opportunities.

Here's how we generally divide our portfolio into strategies, along with the typical starting size for new positions:

Strategy	Portfolio Allocation	Starting Position Size

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Core Stocks	70%	3% to 5%
ETFs and Indexes	15%	1% to 4%
Options	15%	0.5% to 3%

That works out to 33 to 38 total positions, with an average allocation of 2.5% to 3%.

As you can see, our average starting size will be about 3%. This suggests we could own about 33 positions, along with typically holding 3% to 5% in cash.

Stocks: 70%

The majority of our portfolio will be in stocks that we believe will deliver steady returns over the long run. The size of each position will generally stay in the 3% to 5% range.

When it comes to *Pro*'s core stock holdings — those with truly exceptional potential and an outstanding margin of safety — we may invest up to 5% of the portfolio, most likely over the course of a few purchases. We're confident in any position we buy, but if we decide to make a position larger than 3%, that means we're extremely confident. We often buy a stock across two transactions to spread our timing and volatility risk. You'll know quickly where we stand on a stock buy: if we like it, 3%; if we're ga-ga over it, 4%; if we can't even sleep because we like it so much, 5%. As of October 2015, only seven stocks make up 4% or more of the *Pro* portfolio.

ETFs: 15%

We're going to use 15% of the portfolio to make sector-based decisions via exchange-traded funds. There are hundreds of specialized ETFs, and they offer tremendous opportunities to take advantage of macro and micro trends in the global economy. As you follow along, you'll find that most of the ETF investments will take a long position, but you'll also be able to go short in sectors we believe are mispriced.

These calls could be a bit riskier in nature than the stock portion of the portfolio, particularly if we buy an ETF that uses leverage, but we will be sure to fully explain any added risks in our trade alerts.

Our allocation to exchange-traded funds will average 2% to 3% in size. With ETFs, we're betting on a whole sector — or area of the globe — to move in a certain direction. Where there's more uncertainty involved, we may only invest 2% or less, and when we're very confident in an ETF and its core holdings, we may invest up to 4%. More often, we'll invest 3% or less.

Options: 15%

The final 15% of the portfolio will be reserved for options. This includes the premiums paid as option buyers, the credits we receive as option sellers, and the money we set aside to purchase the underlying stock when we sell puts.

Options are by nature smaller investments, and most of ours will average around 1.75% of the portfolio at the start — sometimes much less, rarely much more. If we do put 2% or more into, say, a call option, we'll do so very carefully.

Long vs. Short

Even though we'll go short with ETFs and options, *Pro* is primarily focused on the long term. Most often, the short positions we take will be used to hedge downside risk. Overall, we don't expect shorts to represent more than 30% of the portfolio.

And Then There Was Cash

We'll also keep about 5% of the portfolio in cash most of the time so we can catch extraordinary opportunities that pop up and write options.

We know what you're thinking: Wait, all this adds up to 105%! It does, but what we're saying is that while we'll keep an overall mix of 70/15/15 in stocks/ETFs/options, we'll save room for a modest but worthwhile cash balance.

Diversification

As we build the portfolio, we're mindful not to have too much exposure to any one industry, sector, or region, and we'll hedge if our exposure to one area is too great. Meanwhile, if we're missing a piece of our portfolio puzzle, we have the luxury of CAPS data to help us find the most compelling opportunities we're lacking. With a maximum of less than 40 positions, we're striving for diversification with focus.

Reassessment

What's the harm in rebalancing? Whenever part of a portfolio gets out of line with the rest, many investors trim it back; if it shrinks, they add to it. Makes sense, but if you're not smart about it, rebalancing can translate to selling your best winners — and buying more of your worst losers. Now *that* doesn't make sense.

At *Pro*, we prefer to call our portfolio upkeep process *reassessment* — flows off the tongue, doesn't it? — and we'll reassess on a regular basis, most ardently after quarterly earnings or any other significant events. But rather than letting a stock's size in our portfolio dictate our investing decisions, we let a stock's valuation and fundamentals guide us.

Our reassessments start with a vigorous study of every filing our companies make, every quarterly report, and every quarterly conference call as well as all the data at our fingertips. We want to know our companies so well that we could recite their business models in our sleep — so when there's volatility (and there will be!), we'll know how it affects our companies and whether it requires action. To us, reassessment is constant — but that doesn't mean trading is.

Letting Winners Run

In the original Motley Fool and Rule Breaker Portfolios, we outperformed the market by buying high-growth companies and letting them grow — while we held on for years. We didn't trim our biggest winners just because they had come to represent more of the portfolio than other positions — though we would trim back our position in a stock if the business started to merit doing so.

We won't be afraid if a 4% position doubles to become an 8% position, and then a 12% position. We want that! But we'll be mindful of our largest positions and do everything to ensure we don't let our biggest gains evaporate. We have the power to hedge or protect our positions, too, which provides us with more breathing room to let them grow.

Slowly, Slowly, Slowly

In "*Slowly, Slowly, Slowly*" *Said the Sloth*, Eric Carle's sloth hangs from a tree in the rain forest while animals scamper by — toucans, peccaries, a jaguar, and a howler monkey — and ask him why he is so slow, so boring, so calm ... and so lazy. The sloth says, "I am not lazy." He just likes to take his time, think about things, and not rush.

It's the same with a portfolio: Build it slowly. Enjoy each step, and make each selection count. Know every selection before you make it. You're embarking on what should be a long-term relationship with a company — even with options, as you can employ the same options, on the same stocks, again and again.

We manage the *Pro* portfolio thoughtfully (with our own money on the line, we're managing our own portfolio right alongside you). Sometimes we'll be rather active, but sometimes we'll be quite quiet. That's how investing works. Regardless of how often we're trading, you can always find us talking stocks on our members-only discussion boards.

Allocating Your Own Dollars

So how do you mirror our real-money portfolio, assuming that is your goal — even if you have $100,000 or less? In most cases, you can simply follow our percentage allocations rather than our dollar-based actions.

If you have a $100,000 portfolio, and we invest 2% of our funds into a certain position, it's easy for you to do the same thing. However, if you have $50,000 or less, you'll want to watch your commissions and try to keep them well below 2% of any trade you make.

If you're using a smaller account, you also may not want to write many options until you have more assets. For put writing, we recommend an account value of at least $75,000. You may write covered calls with considerably less, and you may buy puts or calls with very little money if you wish. That's one of the advantages of options. But put writing typically requires greater funds.

To discuss your situation and how you can best benefit from our investment decisions, please post your questions on our discussion boards. We'll be there to help.

Next Step: Finding Great Companies →

Invest Like a Pro: If You're Free-Range

Published Jun 17, 2013 at 1:00AM

How to build a *Pro* portfolio — if you have money to invest now and are ready to own what we own.

We manage the *Pro* portfolio using a wide range of tools — including long and short stocks, options, and ETFs — to earn absolute returns with reduced volatility. But we know no two members have identical investment situations, and that means not all members will use all of our strategies. That's where we can help you find the best way to use *Pro* for *your* individual situation.

The most important thing to remember is that *Pro* is a portfolio, not merely a collection of investment ideas. All of our positions exist in the context of our portfolio; if you elect to pick and choose *Pro* investments, it is critical that you understand how they fit into *your* portfolio. Our trades are intended to integrate with existing positions and to form a portfolio of assets that keeps our North Star firmly in mind.

Building Your *Pro* Portfolio

Start Here: Portfolio Building Reports

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new *Pro* portfolio.

Part 1: Our Buy First Stocks
Part 2: Our Buy Stocks
Part 3: Our Buy Stocks, Continued
Portfolio Positioning Report
Important: A note on fair value

What's Next?

Once you've matched the guidance in the Building Your *Pro* Portfolio reports, all you need to do is wait for further trade alert emails from the *Pro* team. However, our alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want.

You may decide to modify the strategy we choose for a trade; for example, writing puts instead of buying a stock outright. If you choose to deviate from our recommendation, though, make sure you:

Uniquely *Pro*

If you're joining us from another Motley Fool service, it is critical that you understand what makes *Pro* so powerful. At *Pro*, we are building a portfolio, not simply offering investment recommendations. *Stock Advisor* and *Rule Breakers*, for example, offer stock recommendations from which members can pick and choose.

In contrast, *Pro*'s trades are intended to be integrated building blocks of an overall portfolio. We cannot emphasize this enough: Anytime you decide to deviate from the Pro portfolio, make sure you understand how the trade in question is intended to fit with our portfolio — and how the modified trade will fit with yours. With every trade, keep the portfolio context in mind.

1. Understand why we chose the strategy we did
2. Have a reason that the modified strategy better fits your portfolio
3. Exercise caution by sizing the position a bit smaller than you would otherwise

If you have any questions about our trades or making a strategy fit your investing goals, drop by our Making Pro Fit You discussion board, where the *Pro* team and community are happy to help.

You'll also receive the team's Monday Memo email every Monday afternoon, with commentary, news, and any updates to our guidance.

If You're Investing in an IRA

IRAs are tax-deferred accounts that usually don't allow shorting and allow only simply options strategies. If you're building your *Pro* portfolio in an IRA, you can follow our stock-buying trade alerts directly. Most IRAs allow you to write covered calls, so you can also follow those trade alerts (check with your broker to see if you have permission). For trades that go further afield, here are several points to consider:

Writing Puts: Some IRAs don't allow put writing (although many do, if they are cash-secured), so you should simply buy shares in these positions over time. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Other Options Trades: If you can't make a trade in your IRA, check our trade alert for a list of alternative trades. For example, when we write puts to try to buy shares of Stock X more cheaply, you might be able to simply buy shares of Stock X. (If there are no alternate trades, we'll say so.)

Shorting: Some inverse ETFs can be purchased in IRAs (purchasing an inverse of something is similar to shorting that thing). As with options, we'll mention suitable alternatives in the trade alerts.

As tax-deferred accounts, IRAs are well suited for income-generating strategies like covered calls, high-yield dividend stocks, and ETFs with large taxable distributions. If being unable to follow all our recommendations leaves a hole in your portfolio, you may be able to fill the gap with additional income-generating strategies — for example, by writing covered calls on *Pro* stocks you'd be willing to sell at your strike price.

Because IRAs do not allow the use of margin or shorting, you will likely find it difficult to follow along with most of our hedging strategies. If that's the case, we recommend keeping an eye on both your cash balance and *Pro*'s hedging strategies. When the *Pro* portfolio adds hedges, increase your cash balance; when we pull hedges off, reduce your cash balance by investing more in our Buy and Buy First stocks.

Finally, you may want to consider opening a separate, non-IRA account if possible. You can then manage both your IRA and non-IRA accounts as a single portfolio, with income-focused and shorter-term strategies in the IRA and more complex, speculative, and short trades in the second account.

If You Can't Trade Complex Options

You can still follow most of our trade alerts directly — except, obviously, those involving complex options strategies. In those cases, we offer simpler alternatives whenever possible, such as writing puts, writing covered calls, or buying or shorting a stock or ETF directly. If we issue a trade alert using an income-generating strategy you're unable to employ and there are no workable alternatives, consider using the strategies you do have at your disposal to generate income elsewhere in your portfolio.

If you want to expand your repertoire, you should continue to request higher options permissions from your broker every couple of months until they are granted. Account size is one factor brokers consider when making this decision, so to up your odds of success, consider consolidating accounts or moving funds to the account in which you wish to trade options.

In the meantime, don't lose sight of the big picture; remember that we're building a portfolio. If you can't make a particular options trade, you may be able to make an alternate trade or you may need to sit that trade out — either way, it's no big deal. That said, you'll want to pay particular attention to any trade alert in which we use options for hedging purposes (for example, a synthetic short or a ratio put spread on an ETF or an index). Trades like these are important to our integrated portfolio, so don't ignore them. If alternatives are available, we'll outline them. If not, you may want to take action elsewhere in your portfolio to meet similar goals. For example, one way to accomplish this would be to raise your cash position by trimming a few holdings. As always, we're available on the Making Pro Fit You discussion board to field your questions.

Hungry for more *Pro* goodness? Check out our strategy guide!

Go to the Strategy Guide

Invest Like a Pro: Whoever You Are

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How to build a *Pro* portfolio — whether you have cash to deploy or you want to go slowly.

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Portfolio Positioning Report
Important: A note on fair value

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our portfolio page's Recommended Allocation to help build your portfolio.

We recommend that you invest along with the reports in the order in which they are released, as they will contain our latest guidance and thinking on every stock in the *Pro* portfolio, and will make it a snap to match your portfolio to *Pro*'s.

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If You're Already Fully Invested

If you're already fully invested, you may need to sell existing positions to add *Pro* picks. We recommend that you do this gradually and deliberately, and we've offered advice on how to approach this task.

List your existing positions in order from your highest-conviction holding to your lowest-conviction holding. If you own stocks from another Motley Fool service, you can use that service's guidance on those stocks in building your list. If you don't know why you own a stock, that's a good reason to sell it.

Be mindful of your sector and geographic allocations. You don't want to unintentionally end up owning nothing but oil or European stocks just because they were your favorites. If you're struggling with what to sell, post to our discussion boards — the *Pro* team can't give you individual advice, but our community members can and frequently do weigh in with helpful guidance.

When you're ready, incrementally sell your lowest-conviction stocks and use the proceeds to move into our Buy First and Buy stocks. Review your positions and portfolio after studying *Pro*'s mission and reviewing our North Star. Use that analysis to craft your portfolio going forward.

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Finding Great Companies

Published Jun 17, 2013 at 1:00AM

Nearly three decades of investing have helped us home in on the qualities we seek in each company we consider for *Motley Fool Pro*.

Pro Strategy Guide

Get up to speed in no time with this series of articles that will show you how to invest like a Pro:

Not every business we buy or use options on will possess all eight of these qualities — but for core stock positions, we prefer to see as many of the following strengths as possible. These qualities aren't in order of importance, but you'll often find that one quality builds to the next. They typically all combine to produce a company that could compound our returns.

Quality 1: Sustainable Competitive Advantage

Healthy profits in a business attract competition; everyone wants a piece of the profit pie. The only way a company can maintain its profit margin and grow is to have a sustainable competitive advantage that serves as a protective moat around the business.

You often hear this quality talked about, from Warren Buffett on down, but many investors typically fail to find companies that sustainably meet the bill. That's because it's the rare company that truly has lasting advantages — but they're out there.

They are usually mid-sized or larger and enjoy assets or market share that provide enduring advantages over all others. Think **Gentex**, which commands the market in auto-dimming rearview mirrors; **Broadridge Financial Solutions**, which has provided annual proxy services for 90% of the public companies and mutual funds in the United States since 1999; and **Facebook**, whose network effects have enabled the company to continually occupy the top spot in the social media space -- and buy would-be competitors. Each of these businesses has traits that keep competitors at bay, helping it maintain healthy profit margins.

Quality 2: Pricing Power

We're always on the lookout for companies that enjoy a degree of pricing power, those that can pass on rising costs to customers. The strongest companies may also implement modest price increases every few years without losing or alienating customers. A leading example of this is **Verisk Analytics**, a leading risk-assessment and decision-analytics firm. The company was able to push through annual price increases for many of its offerings to the insurance industry between 2007 and 2010 (some of the worst years for insurers in recent memory) without seeing any negative effects on customer retention. **Netflix** and **Chipotle** have also demonstrated pricing power. Pricing power gives a company one more important arrow in its quiver as it hunts for strong long-term annualized growth.

Quality 3: Dependent Customer Base

A competitive advantage may *not* be worth much if the business depends on only a few customers, or if its customers can get the service provided just as conveniently elsewhere. We're excited to find a captive or at least loyal customer base. In some cases, this might take the form of a product being integrated into customers' daily lives, a la **Starbucks**. It could also be evident in customers' desire to work with that company, as is the case with **Parexel,** a leading biopharmaceutical and medical device contract research organization. Such customer dependence often supports quality no. 2, pricing power.

Quality 4: Predictable Revenue

If a business exhibits the first three qualities and also has significant predictable or recurring revenue, we become even more interested. This means we're looking for sales that repeat all but automatically, often with the same customers again and again, and usually without the company needing to spend more on marketing or reinventing itself or its products.

Some examples from our *Pro* portfolio: **Oracle** and **OpenText** get a majority of their revenue in the form of long-term contracts with high renewal rates. Insurance companies enjoy recurring revenue every time a policy is renewed, which happens more than 80% of the time at the best providers, including our own **AmTrust**. Transaction-based revenue driven by network effects, like with **MasterCard** and **Visa**, also qualifies as predictably recurring; so does "platform access" that is heavily relied upon and not easy to replicate, which is exactly what we have with **American Tower**.

Predictable revenue helps management plan its future better, and it helps maintain a business even during recessions. For a contrast, consider apparel manufacturers, which are constantly battling with one another to win your business and capture fashion that's inherently fickle. This can result in feast-or-famine financial results – which we try to avoid here in *Pro*.

Quality 5: Growing Free Cash Flow With Compounding Returns

The qualities we've mentioned so far will usually lead to strong free cash flow, which is the lifeblood of a company. By definition, free cash flow is cash from operations minus capital expenditures and any other nonoperational cash income, such as tax benefits from stock options.

We're looking for free cash flow that's likely to increase by at least 10% annualized over the long term. No company grows in a straight line, but over time we want expanding free cash flow to drive the value of the businesses we own -- and that cash flow should be investable in more growth for compounding business returns. Free cash flow is a much more important proxy for value at *Pro* than are earnings per share, which are easily manipulated.

Quality 6: Financial Resilience

These first five qualities go far toward building strong financial statements — if not right away, then with time. On the balance sheet, the appropriate amount of leverage and cash on hand will depend on the industry and a particular company's business model; however, we seek to invest in companies that can do more than just weather the storm when times are tough. We want to find companies that can take advantage of turmoil to gain additional market share and maneuver for an even brighter future – and that's difficult to achieve if the financials aren't resilient enough to let management strive to grow even during hard times.

Quality 7: Expanding Possibilities

A company can increase its bottom line either by cutting costs to expand margins or by growing its top line. But there is a limit as to how much fat can be cut out of any business, and being too aggressive in slashing costs can actually be detrimental in the long run. So, in order to find companies poised to deliver North Star-like returns over the next rolling three years, we seek businesses that can both control costs *and* profitably expand operations. Often, that means companies that are riding long-term (rather than cyclical) tailwinds; this can lead to years of above-average growth. And this growth can take the form of increasing market share at home as well as developing new products or entering new markets. **Apple**, **Skyworks Solutions**, **O'Reilly Automotive, Gilead Sciences** -- most of the companies in our portfolio exhibit this characteristic.

Quality 8: The Three C's of Management

Warren Buffett once recommended investing in businesses that even a fool (with a lower-case "f") can run, because someday a fool will be in charge. This may be true, but here at *Pro* we believe you can have the best of both worlds: great businesses that are also run by top-notch management teams. Every situation is unique, but as a starting point, we generally look for the following in company management:

- **Clarity:** Do they have a vision for the company and can they succinctly articulate how they're going to get there?
- **Consistency:** It isn't enough to talk the talk; we want management teams that have also proven they can walk the walk. We avoid revisionist historians and look for managers that achieve what they said they would.
- **Capability:** Are they the right people for the job? Sometimes this means going with a founder-led company early on (the Fool invested in **Amazon** shortly after it went public); other times we're looking for a track record of smart capital allocation decisions (**Verisk Analytics** has generated an average annualized return of about 20% on all of its deals from 2002 to 2012).

Combine our eight qualities, and the company is likely to be a long-term performer on par with -- or stronger than -- our relentless North Star.

We're not making it easy on ourselves by using our North Star as our investing guidepost; however, we wouldn't have chosen to do so if we didn't believe it was possible. One of the keys to this approach is to have a high rate of accuracy when it comes to selecting stocks, and this quality checklist is just one of the many tools we use in our attempt to do exactly that.

To talk about the business qualities we seek — and to share your own — join us on the Philosophy & Strategy discussion board. Invest Foolishly!

Back to the *Pro* Guidebook

Strategy Guide

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Our mission is to earn you consistent, recurring profits with a high level of accuracy using stocks, options, and ETFs. This Strategy Guide takes you behind the scenes, detailing the steady, rational approach that makes *Motley Fool Pro* so successful.

How We Invest: 6 Pro Principles

See the ways we turn our flexible approach into a comprehensive strategy.

Our North Star: Inflation + 7%

To stay on course toward a winning portfolio, we take our direction from this guidepost.

Inside the Portfolio: Stocks, ETFs, and Options

For each type of investment, we have a plan for how we decide how much.

Finding Great Companies: 8 Qualities We Seek

Two decades of investing experience help us home in on the best positions for the *Pro* portfolio.

Our Guide to Hedging Like a Pro

A hedge is a position that reduces a portfolio's overall exposure to risk. We hedge in several different ways.

How We Invest

Published Jun 17, 2013 at 1:00AM

6 *Pro* Principles: We always want you to know how we're thinking as we invest — and why — so see how we tie together our broad tools into a comprehensive strategy with focus and direction.

Pro Strategy Guide

Get up to speed in no time with this series of articles that will show you how to invest like a Pro:

Motley Fool Pro is here to help you build a diverse portfolio that generates winning returns no matter what the stock market throws our way. You can trust that our team relies on years of investing experience and on our array of tools and collective insight to produce outstanding long-term results — and we're thrilled that you're here investing along with us.

Our *Pro* portfolio has incredible flexibility — we can go long or short and use options and ETFs. We'll invest wherever we see the best opportunities — any sector, stock, country, or option. This makes our overall strategy wide and deep, but we'll do our best to clearly explain the specifics behind our actions.

Pro Principle 1: Accuracy Is Our Top Priority

Some portfolio managers are happy to speculate — and often be wrong — so long as their few big winners more than compensate for the losers. That is not our approach at *Pro*.

Our aim is to be correct the vast majority of the time. We will only put our cash to work when we feel extremely confident about an investment — and on that note, our ambitious goal is to have at least three out of four positions profitable by the time we close them. Yes, that's a sterling 75% success rate — and it includes all of our stocks, options, ETFs, and hedges.

In fact, it's more important to us to achieve absolute gains on each position than beat the S&P 500. Why is that? Because gains are our first goal. Period. But heck, if most of our positions are profitable, we should beat the S&P 500, too, over the years.

Pro Principle 2: When It Comes to Stocks, We Are Focused on Superior Businesses We Can Hold for 3 to 5 Years

Our portfolio primarily consists of long positions. The goal is to hold these stocks for three to five years — or as long as the investment merits. Each stock will have a catalyst (or several) that should kick our returns into gear through our target time frame.

The *Pro* team has found that the stocks that perform the best over the years have a lot in common. These companies have superior business models that we believe will remain strong in any market, strong and lasting competitive advantages, margins ripe for expansion, and growing market opportunities. We like dynamic companies with light business models — they don't need hefty, constant infusions of capital — and plenty of naturally recurring revenue. After we've found a company that makes the grade, we then aim to buy at a price that gives us both ample upside and a solid margin of safety.

Pro Principle 3: When It Comes to ETFs, It's the Big Picture That Counts

For exchange-traded funds, broad is the way to go. Say you want to invest in Brazil, which is growing rapidly. But which companies will lead the way? If you can't devote months to learning Brazil's competitive landscape, you can buy into the entire economy with a Brazilian ETF.

ETFs are an excellent way to invest in the rise or fall of just about any broad category — financials, biotech, China, Brazil — especially when you wouldn't otherwise know where to invest in a sector. These investments, long or short, are more macro-focused than business-focused. We study any ETF we buy to make certain that we agree with its largest holdings, but we'll still be betting on a macro trend — up or down — when we pick up an ETF.

With our ETFs and options, our outlook is usually a bit shorter than with stocks. We may take advantage of a 12-month option opportunity; we may buy an ETF in gold, only to sell it nine months later if the price of gold jumps. ETFs can be long-term macro investments, too; we bought into **Vanguard Emerging Markets** in 2008 to profit on a rebound, selling nearly three years later. Many of our short sales also have a shorter-term outlook, usually measured in months or a year.

Pro Principle 4: We Are Not Options Traders

When we invest with puts and calls, we're not twirling our pretend mustaches, making slick statistical bets, or using formulas and complicated computations. Our options investments are based on extensive knowledge of the underlying stock and its valuation.

So if we believe a stock is priced exuberantly, we can short it by buying a put option. If a stock looks deeply undervalued, we can use long-term call options to capture greater upside. In the end, all of our option trades are based on a full analysis of the underlying equity.

Pro Principle 5: We Won't Over-Diversify

We expect to hold no more than 40 positions. For a carefully constructed portfolio, that's plenty of diversification, especially because we'll use ETFs to gain broad exposure to various categories.

An investor diversifies for safety but still needs to stay focused when hoping to perform much better than the market average. Along these lines, it's likely that we'll usually only carry about 24 to 28 core positions, with open options positions representing other possible buys down the road, and always with stocks coming and going from the portfolio as necessary. With focus, we have an especially good chance of being rewarded strongly whenever we're right with a position.

We prefer to let our winners run as long as merited, so we won't rebalance just for the sake of doing so. But we will continually reassess. As of October 2015, we recommend buying 24 core stock positions — right in our sweet spot.

Pro Principle 6: We Never Want to Lose Money

As we strive for accuracy, we will always try to avoid permanent loss of capital. It's not about avoiding mere paper losses — these are common, as stock prices fluctuate. We're talking about losses you never earn back because you invested in a failing business or paid too much for a stock.

While we're more than comfortable with temporary losses that come about with the market's ups and downs, we'll do everything in our power to avoid permanently losing money — although keep in mind that this doesn't apply to options or shorts, in which permanent losses are part of the risk. So far, as of October 2015, we have only closed a few positions at a loss without recourse.

Putting It All Together — the *Pro* Way

We're here to help you become a more profitable investor in any market. We want you to learn, but remember, you're also here to have fun! So dive into our library of investing know-how, read about our array of strategies, and if you ever have any questions, visit us on the discussion boards! We're at your service.

Next Step: Our North Star →

Catch-Up Report: Part 1

Published Jun 17, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1• Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our porfolio page’s Recommended Allocation to help build your portfolio.

Remember, there’s no need to rush into any trades, so take your time. We’re here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

Buy First: AIG | Time and even average performance should heal the company’s wounds.

Buy First: Apple | The leader in mobile computing products is cheaper than it’s been in years.

Buy First: Oracle | This old-guard tech giant has more room to grow.

Buy First: O'Reilly Automotive | Exceptional management should deliver impressive growth.

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A Note on Pricing

We've classified the four stocks in this initial report as "Buy First" positions for *Pro* members, because they are attractively priced and will remain so even if the price moves around a few dollars. As long as these stocks remain listed as Buy First on our scorecard, then we recommend that you buy them first for your *Pro* portfolio. If that status changes, we'll let you know in our Monday Memo and note the change on our scorecard.

Buy First: American International Group

Time and even average performance should heal the company's wounds.

Suggested Allocation: 2.8% stock, 0.7% warrants

Today's **American International Group** is not the same company that disgraced itself so profoundly in 2008. AIG has divested itself of whole business units since the financial crisis, managing to eliminate 95% of its previous exposure to the nasty derivatives that nearly brought down the economy. Left behind are just two steadfast insurance businesses and an aircraft leasing company, and AIG plans to rid itself of the leasing business, too.

What It Does

Insurance is a business of collecting premiums, investing the float, and paying out claims — and AIG is getting ever better at it. Improved underwriting is showing up in a lower loss ratio, which in turn is driving a lower adjusted accident-year combined ratio. All that is a fancy way of saying that we're starting to see underwriting profits for the first time since Q3 2010.

AIG's insurance offerings consist of two divisions: property and casualty, and life and retirement. The former provides casualty, property, financial, and specialty insurance (think aerospace) to commercial clients and consumers, typically through brokers. The life and retirement division offers domestic life insurance and retirement products (annuities, mutual funds, financial planning) through a diverse network of financial-services companies, brokers, agents, and advisors. Overall, AIG is writing fewer premiums at better prices than it was in past years, which is a great indication of underwriting discipline and a hardening market.

How It's Working

When we recommended buying AIG stock and warrants in August 2012, we were confident in the momentum of the company's turnaround, but we underestimated the rapid rate at which our investment thesis would unfold. In late 2012 (after our recommendation), the U.S. Treasury sold another $26.5 billion worth of its AIG shares. Management wisely used the opportunity to purchase billions of dollars' worth of stock at about half book value; that, of course, further increased book value in a virtuous cycle.

What We Expect

Underwriting discipline will continue to drive increased earnings and a higher valuation. That plus a renewed focus on capital management will improve AIG's credit rating, reducing its cost of debt and providing another lever for higher profitability. Management is still ridding the company of non-core assets, including the aircraft leasing business mentioned above; once that's complete and coverage ratios are in check, CEO Bob Benmosche will likely reinstate a dividend (provided the Federal Reserve gives the go-ahead).

More Resources

- *Pro*'s original recommendation (8/24/12)
- Talk about AIG on our discussion board

At Your Broker

- **E-Trade:** AIG.WS
- **Fidelity:** AIG/WS (paste CUSPID 026874156 into the quote page)
- **Interactive Brokers:** Find AIG; select "warrants" from the drop-down menu
- **optionsXpress:** AIGwS
- **Schwab:** AIG/WS
- **TD Ameritrade:** AIG+
- **Vanguard:** AIG_t

Helpful Links

- AIG's explanation of the warrants
- AIG's warrant registration statement filed with the SEC

The *Pro* Bottom Line

We recommend buying 2.8% of AIG stock and 0.7% of AIG warrants (see below for more on those).

Benmosche has cleaned out the business, so by purchasing now, you get in after all the hard work has been done. Book value — the best measure of an insurance company's worth — is growing quickly. And AIG's current share price is two-thirds of book value. That's cheap, especially given the company's momentum. Investors who buy AIG now are positioning themselves for outsized future returns with less risk. That's contrarian investing at its best.

A Note on Warrants

Warrants are similar to call options, except that they are issued by the underlying company. They offer the purchaser the right (but not the obligation) to buy the stock in question at the specified price. The warrants we're recommending on AIG are valid for 10 years from the date of issue (Jan. 19, 2011), and they can be exercised at any point before they expire on Jan. 19, 2021. When exercised, they allow the holder of the warrant to buy shares of AIG at $45 per share, regardless of the market price.

That $45 strike price adjusts favorably in the event of dilution or annual cash dividends greater than $0.675 per share (which would also lower the share price). Warrants are illiquid, and Goldman Sachs is the designated market maker for them; when you buy them, be sure to use a limit order so Goldman doesn't get more than a fair price.

Be aware that if our investment in AIG works out, those who own warrants will earn leveraged returns on them. If we're wrong, though, the warrants will be a total loss, because they're out-of-the-money.

Buy First: Apple

The leader in mobile computing products is cheaper than it's been in years.

Suggested Allocation: 3.3%

There's only one type of apple we like to buy when it's bruised, and it's not a Red Delicious. Once the largest corporation in the world, the **Apple** we want to own has fallen from the market's good graces on investors' worry about declining profit margins, slowing growth, and a lack of innovation.

Is this commonly chirped refrain right? Has Apple lost its edge in the marketplace? We don't believe
so, because the company's uniquely integrated hardware and software have made for a great consumer experience that provides little incentive to switch to a competitor. We do realize the company will have to fight a harder and more expensive battle to win new customers as competitors close the quality and experience gap, but we maintain that Apple shares are one of the greatest deals in the Pro portfolio.

What It Does

Led by its iPhone and iPad, Apple designs computing devices people love to use. Its products tie into the Apple operating system, which centers on its App Store marketplace. Apps turn a piece of hardware into a personalized, go-anywhere computer that gets ingrained into the user's daily life.

The gadget that kicked off the company's renaissance, the iPod, is joined not just by the iPhone and iPad but also by Mac computers, iCloud, software, and the small Apple TV to round out the surprisingly compact product line. By selling relatively few products, Apple can generate production efficiencies to earn higher margins and more effectively guide consumer behavior.

How It's Working

Apple's recent second-quarter results disappointed many investors, even though the numbers were just fine. Total sales were up 11% to $43.6 billion; gross margin, a measure of profitability, decreased to 37.5% from 47.4%; and operating cash flow climbed to $35.9 billion. The quick read is that Apple continues to sell a huge number of devices, but as product cycles ebb and flow, the company's profitability will do the same (because of differing pricing and cost structures for each product). One thing remains consistent: Apple's free cash flow is absurd — more than $45 billion over the past 12 months. That's enough to give $5 and a free iTunes song to every person on earth!

What We Expect

Apple refreshed nearly all of its product lines in 2012, driving sales but dinging margins. The company was unable to meet consumer demand for its two newest iPhone models, its new MacBooks, and its iPad Minis, so it wasn't running as efficiently or profitably as it could have. But it is ramping up production to keep that situation from happening again, which should also soften production costs per unit and set Apple up for a respectable 2013.

More Resources

- *Pro*'s original recommendation (2/14/12)
- Talk about Apple on our discussion board

In the longer term, we (like everyone else) expect more great innovations from Apple. While we wait, we think customer loyalty will drive healthy recurring sales, while new customers, emerging markets, and brand-new products fertilize growth. The resulting earnings should reassure investors that Apple isn't going bad.

The *Pro* Bottom Line

As much as we miss the late Steve Jobs at the helm, we believe he built a company that will continue to delight the world with its products. With investors running scared from one of the most groundbreaking businesses in recent history, we believe now is a good time to put our jester caps on and buy when others are selling.

Buy First: Oracle

This old-guard tech giant has more room to grow.

Suggested Allocation: 4.5%

Leading software sellers can write a program once and sell millions of copies, then provide small but critical updates on a regular basis. These updates drive a subscription business model, which leads to recurring revenue. **Oracle** is no exception, with most of its customers renewing annual software contracts that represent more than 40% of its annual revenue. This is stability on which Oracle can grow.

Where is it looking to grow? To name three areas, Oracle is targeting new cloud software sales, software as a service (SAAS) in general, and groundbreaking data hardware sales — and we're pleased with its progress to date and the prospects of all three.

What It Does

Oracle is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems**, **Dell**, and **Microsoft** — Oracle's stock price has steadily risen as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe. And when it comes to hardware, Oracle's own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

By combining its software expertise (both in the traditional sense and in the cloud) with its young hardware business, Oracle is poised to experience another period of growth. The business is incredibly sticky — companies don't trust their data to just anyone, and it can be tricky and even risky to make a switch. So to add to its revenue base, Oracle mainly needs to cross-sell new products to existing clients, while continuing to rope in new clients with its great breadth of modular software solutions.

How It's Working

In the fiscal year 2013 that just ended May 31, Oracle's new software sales topped a record $10 billion, growing 6% in constant currency. Non-GAAP earnings per share grew 11% to $2.68, non-GAAP operating margin hit an all-time high of 47%, and free cash flow hit a record $13.6 billion. Total revenue was up a modest 2% to $37 billion after very strong growth in fiscal 2010. Such a pause is not unusual, especially given that Oracle has sliced low-margin hardware products from its product line and hired thousands of salespeople to sell cloud software. On June 20, management doubled the dividend and announced a new $12 billion share buyback.

What We Expect

More Resources

- *Pro*'s original recommendation (9/17/09)
- Talk about Oracle on our discussion board

Wall Street loves growth, but it especially loves growth that comes with higher margins. Oracle trades at 10.8 times free cash flow, well below the S&P 500's average in the mid- teens. With management expecting more operating leverage ahead and growth in hardware sales, the stock should produce a North Star-topping, 10%-plus annualized return over the coming three years. We expect the company's hardware and modular software combinations to continue to create a clear value proposition, driving sales and resulting in pleasing growth — even for this large company.

The *Pro* Bottom Line

With 390,000 customers, including all 100 of the Fortune 100, Oracle has few equals in the enterprise software market. Now it's making headway in the related hardware market, and we believe this hard-driving company will continue to reward shareholders.

Buy First: O'Reilly Automotive

Exceptional management should deliver impressive growth.

Suggested Allocation: 3.4%

What It Does

O'Reilly Automotive is America's second-largest auto parts retailer, with more than 4,000 stores. Auto parts are a big business, estimated at $231 billion, and O'Reilly is an exceptional competitor, with an addressable market size of about $131 billion.

Running 24 regional distribution centers and 240 hub stores as part of a two-tiered distribution strategy, the company provides same-day or overnight availability on more than 142,000 items, including many that its competitors don't usually stock. Basic auto parts, tools, and services complement those hard-to- find treasures. As a result, O'Reilly's sales are historically split between "do-it-yourself " retail customers and more lucrative professional-services customers (such as auto repair shops).

Personalized customer service by long- tenured store managers paves the way for continued success. More than 800 managers have worked an average of 13 to 18 years with the company.

How It's Working

Tenured employees share a common history and learn to improve a business in a consistent fashion. Since going public in 1993, O'Reilly has achieved 20 consecutive years of record revenue and operating earnings and has grown same-store sales every single year. Diluted net earnings per share have jumped more than 20% annually over the past decade, with 25% growth in 2012. All signs point to more growth ahead.

O'Reilly plans to open 190 net new stores in 2013, upping its 2012 year-end store count by 4.8%, and same-store sales are expected to increase 3% to 5%. By clustering stores together (one-quarter of its locations are in California and Texas), O'Reilly is able to rapidly achieve economies of scale, and by serving professionals and retail customers, it's able to enter smaller markets where competitors don't often tread. There's also no shortage of independent stores or chains to acquire in this highly fragmented industry. In 2012, O'Reilly acquired 56 locations on top of opening 180 net new stores.

O'Reilly has steadily improved profitability, generated strong free cash flow, and maintained a healthy balance sheet while expanding. Rewarding this consistent showing, the stock has been a steady, top performer over the past five and 10 years.

What We Expect

Management should continue to build value as the auto store retail industry consolidates (O'Reilly may lead the way in acquisitions), and customers will continue to walk through the doors in record numbers as used cars last longer than ever. For every neighbor buying a brand-new car, somebody is buying the used one they're trading in, keeping it on the road. We expect and will demand steady, reliable business performance from O'Reilly over any reasonable time period, or we'll show it a stop sign.

More Resources

- *Pro*'s original recommendation (4/15/13)
- Talk about O'Reilly on our discussion board

The *Pro* Bottom Line

Older cars require more maintenance. The average car in America was 10.8 years old in 2011, near a record high. The number of registered cars in the United States increased 15% in the past decade. Even as more new cars drive off the lots, older cars are rarely being destroyed. O'Reilly is well positioned to be profitably supplying car parts and accessories to your grandchildren, who may very well be driving souped-up versions of today's Lexuses and Acuras decades down the road.

The Motley Fool owns shares of American International Group, Apple, Microsoft, Oracle, and O'Reilly Automotive and has the following options: Long Jan 2014 $25 calls on American International Group. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Our North Star

Published Jun 17, 2013 at 12:00AM

Our North Star is a guide for our investing behavior, and like the real North Star, we can use it to navigate on our course to a winning portfolio.

Pro Strategy Guide

Get up to speed in no time with this series of articles that will show you how to invest like a Pro:

Motley Fool Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star.

Pro's North Star: Inflation + 7% annually

This isn't a specific destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward.

Why inflation + 7%? our mission is to grow the real purchasing power of our capital. Therefore, the first competitor we need to beat is inflation, as measured by the Consumer Price Index.

We want to grow our dollars by more than the rate of inflation — that's a given. Exactly how much more is a difficult figure to pinpoint, but history tells us that if we can double the real purchasing power of your dollars every 10 years, we'll be doing what few manage to accomplish.

To double your dollars in a decade, we need to book a compound annual return of about 7%. To double your real dollars, we need to return 7% plus inflation. Thus, this figure is born directly out of our mission of absolute returns — returns that improve your financial standing in the real world.

Our North Star has several important characteristics that make it appropriate, challenging, and aspirational for all of us. It:

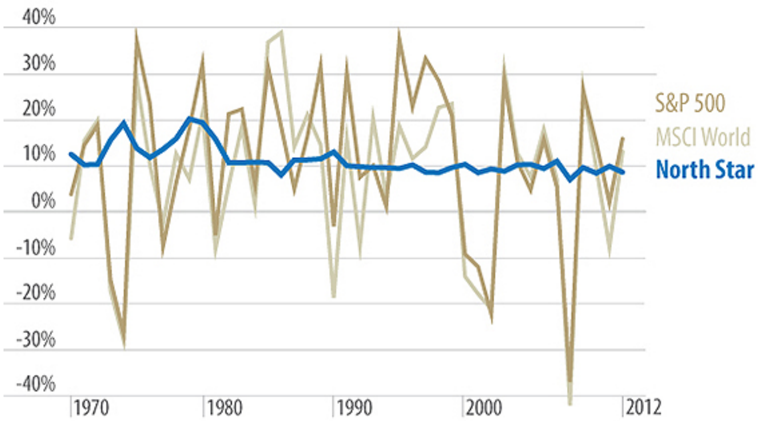
- **Never goes negative.** This lines up with our goal of positive returns over all three-year periods.
- **Is not investable.** It's impossible to lock in a return of inflation plus 7% with some other vehicle.
- **Is not a benchmark.** By definition, benchmarks are investable; they are used for evaluating the performance of a relative-returns strategy. Absolute returns are our goal.
- **Is not a hurdle.** A hurdle is something you must leap over to avoid tripping. Our North Star guides us to make appropriate investment decisions. We're more likely to reach our goals if we let it guide us. If we come close to our North Star, let alone jump over it, we'll be over the moon (sorry!).
- **Is not a gimmick.** We are working to better explain our philosophy and strategy to you, and our North Star will be an ever-present factor in our investment decision-making.
- **Is a challenging reference point.** Historically, our North Star has outperformed the U.S. and world stock markets. Over rolling three-year periods since 1970, our North Star has put up a compound annual return of 11.3%, versus 9.9% for the S&P 500 Total Return Index and 6.4% for the MSCI World index. Our North Star also delivered that return much more steadily than the market indexes, without a single down year.
- **Guides our behavior** as we invest with the tools available to us. It is a framework to explain and reinforce consistent portfolio decisions. Approached consistently over long periods, it should help us and our members achieve strong financial rewards.

Historical Performance

Here's a summary of the past 43 years:

Annualized Return, 1970–2012

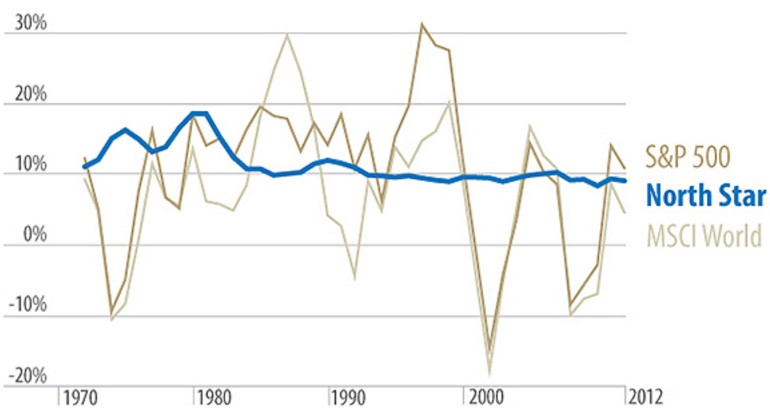
Target	Average	Compound Annual Growth Rate	Best Year	Worst Year
North Star	11.3%	11.3%	20.3%	7.1%
S&P Total Return	11.4%	9.9%	37.6%	-37%
MSCI World	7.8%	6.1%	39.1%	-42.1%



Here are the same data, showing rolling three-year annualized returns. Again, note the lack of volatility for our North Star:

Annualized Rolling 3-Year Return, 1972–2012

Target	Average	Compound Annual Growth Rate	Best 3 Years	Worst 3 Years
North Star	11.4%	11.3%	18.6%	8.4%
S&P Total Return	10.4%	9.9%	31.2%	-14.6%
MSCI World	6.9%	6.4%	29.7%	-17.7%



Note that we look at both average and compound annual historical growth rates. To investors, the one that matters is the CAGR. We include both to show the power of compounding: Even though our North Star has averaged an almost identical annual return to that of the S&P Total Return index over the past 43 years, the North Star — inflation plus 7% — has outperformed the index by about 1.4 percentage points annually. That's because when the index has those deeply negative years, much higher positive years are needed to claw its way back to positive territory. Since it never goes negative, our North Star doesn't have that problem. That is the power of steady, positive returns.

Pro's Performance

Here are *Pro*'s annualized returns lined up against our North Star. (Again purely for education, we've also included the returns for the S&P Total Return and MSCI World indexes.) The chart shows the annualized return as of the end of each month. The data begin one year after *Pro*'s start, because annualized returns based on less than a year of data aren't very useful.

These returns are annualized, not cumulative. Annualized returns are more useful to investors because they allow easy comparisons. Also, a note on the recency of data: The Consumer Price Index (inflation) data is reported with a several-week lag, while Pro's performance is in real time. Inflation is quite stable from month to month, so we use the previous month's inflation figure as an estimate for the current month's until the actual data are released. Any adjustment required is usually negligible, especially given the rolling three-year viewpoint we favor. This approach allows us to keep our performance tables updated all the time. (Updated October 2018; click for larger version.)

More on the North Star

It's a bird, it's a plane, it's our North Star discussion board!

Relive our live chat with members about the debut of the North Star

FAQ About Our North Star

How are you measuring inflation?

We're using the change in the Consumer Price Index. The Consumer Price Index is a measure of the average change over time in prices paid for a "market basket" of consumer goods and services. In plain language, it measures how many more dollars it takes to buy things over time.

Specifically, we're using the CPI-U, or the Consumer Price Index for All Urban Consumers, which covers about 87% of the U.S. population. We're using the "all items" version of the CPI-U, which means that we aren't excluding anything. This is worth pointing out because media-reported CPI figures often exclude food and energy prices.

Wait a second. I'm pretty good at math, and you need to return 7.177346% annually to double your money in 10 years. What gives with your 7% figure?

Yes, to be precise, we'd need to return $2^{(1/10)}$-1, or about 7.177346%, per year to double a portfolio in 10 years. Spelling out our North Star as inflation + 7.177346% doesn't in any way make it more useful as a guide, though.

Is the North Star a hurdle or benchmark?

Our North Star is neither a hurdle nor a benchmark. Hurdles are things you intend to leap over, and benchmarks represent an alternative for your investment dollars. Our North Star is neither of these things. Its purpose is to offer us direction, guide our behavior, and keep our mission front and center.

What is a rolling three-year period?

Rolling three-year returns measure performance over the most recent three years. So the rolling three-year return as of Oct. 31, 2011, measures the return since Oct. 31, 2008. A month later, the rolling three-year return as of Nov. 30, 2011, measures the return since Nov. 30, 2008.

How will the North Star change how *Pro* is managed?

Our strategy will not change, but our implementation of it should improve with the North Star as a guide. Our North Star should remind us to lower our risk when we have large, abnormal returns, or increase our exposure to stocks and income if we're not close to our North Star. Thankfully, this should work well in the marketplace. If stocks are up sharply, we *should* be looking to lower our exposure, as our North Star would suggest. If returns are lackluster, we *should* be looking for more stock values or income strategies. Following a steady North Star should help us make better decisions.

Why is the North Star better than the S&P 500?

Pro has never been an alternative for the S&P 500 index. We use options for income, we short, and we hedge. The index is a long, stock-only vehicle. *Pro* is also not about returns relative to an index; we're about positive gains over any reasonable period. The North Star never goes negative, so it's a much better measure against our goal than is the volatile S&P 500, which can be negative for years.

Inflation is relatively tame lately. What happens when it soars?

Then our North Star's annual return is going to soar, too. Thankfully, stocks typically compete well with inflation, so to follow our North Star, we know we'll need to be largely invested in stocks during periods of high inflation, and we'll likely use fewer income strategies, because fixed income may not keep up with inflation.

What if you don't top your North Star?

We'll be happy if we just stay on track with it — or stay relatively close. If we *can* top it over many years, that would be excellent. But we need to realize the lofty challenge of topping a measure that *never* has a negative year while we're investing in stocks. Our North Star is our aspiration, not a hurdle or benchmark.

Can I measure the North Star against my portfolio at home?

Absolutely. Using the Bureau of Labor Statistics CPI stats, you can obtain historical CPI measures along with a monthly update to compare the CPI+7% to your portfolio. We've already done the 41-year history for you above, and we'll be updating the North Star results monthly for you.

Where can I talk about the North Star with the *Pro* team and other members?

Our North Star discussion board is always shining (sorry!).

[Next Step: Inside the Portfolio →]

Roll Your Covered Calls on Tupperware

Published Jun 12, 2013 at 1:00PM

Is This Trade for You? This is for *Pro* members who (a) already own at least 100 shares of Tupperware and (b) have July 2013 $70 covered calls on those shares as part of our July covered strangle. (We are not rolling the July puts right now.) You need to **roll your calls by Friday, June 14 because of the upcoming dividend,** if you intend to keep your shares and receive the dividend. Any puts you may have written on Tupperware are on track to expire as income, so you don't need to do anything with those. We plan to write new puts in future via a separate trade alert.

Trade Essentials

- **Company: Tupperware Brands** (NYSE: TUP)
- **Scorecard Status:** Hold. Members who own shares can hold them and use options with us or not, as they choose. Those without shares should continue to write puts as we've recommended in the past and will continue to do (for all members) in future.
- **Trade Action:** Using a covered call rolling order, buy ("buy to close") all previously written July 2013 $70 calls, and simultaneously sell ("sell to open") the same number of October 2013 $75 calls.
- **Share Price (June 12, 12:45 p.m.):** $80
- **Option Prices (June 12, 12:45 p.m.):**
  - **July 2013 $70 calls (bid/ask):** $9.40/$10.80
  - **October 2013 $75 calls (bid/ask):** $7.20/$7.70

- **Price Guidance:** Aim to pay as little time value as possible when buying to close your July calls. So, lately, with the stock at $80, aim to pay not much more than $10 to close the July $70 calls. That said, this roll needs to be completed by sometime Friday, June 14 (in advance of the ex-dividend date on Monday, June 17) to potentially avoid having your shares called away. You must pay a debit to roll, and that debit will change as the share price moves. Lately, going somewhere between the options' bid/ask prices, the debit to roll is around $2.50. (Fret not: We plan to make that back writing new puts in the future, and we're well ahead overall with our written options on Tupperware so far.)

- **Allocation:** Roll one covered call for every covered call you already have on Tupperware.
- **Alternative Trades:**
  - If you don't own Tupperware stock yet, it remains on hold. As noted above, we've suggested put-writing trades to try to get shares at a lower price, and we'll do that again in the future.
  - If you own shares but don't have covered calls on them yet, consider writing the October 2013 $85 calls, lately $2.70 (there's not a good reason to write in-the-money calls if you're coming fresh to this trade).
  - If you've written puts already: Again, those are all on track to expire as income. Watch for new put-writing trades from us.

What's New?

Tupperware continues to be an emerging-markets story: Sales are growing sharply in countries many Americans would consider exotic (India, Malaysia, Brazil), but results in developed markets, including North America and Europe, are just puttering along. Because emerging markets now represent a majority of revenue, though, Tupperware's free cash flow is growing.

Feeling flush (and wanting to reward owners), management has become aggressive with automatic, quarterly share buybacks and an ever-higher dividend. The stock's yield now touches 3%. Shares are neither cheap nor dear (at $81.96 as of these calculations), trading at 14.7 times expected earnings this year, 16.1 times trailing free cash flow, and 11 times EV/EBITDA (which is a bit high historically for Tupperware).

The stock is above our $71 fair-value estimate (an estimate that goes up as the business grow — and remember, fair value is an estimate of an attractive *buy* price). Given the ongoing positive developments in Tupperware's financials, we still want to keep our shares for the long haul. But we also want to hedge and monetize them with options. To fulfill these desires, we need to roll our covered calls up now to keep our shares and get the next $0.62 dividend. Following this roll, we'll look to write new puts again, too — especially on a dip in price.

Here's how this roll looks, and our future plans:

This Is How We Roll in *MF Pro*	
Credit received for writing July strangle	$3.48 (many members received $4-plus)
Debit to close July $70 calls (with shares at $80)	(approx. $10)
Net debit to close (what a bull market)	(approx. $6.52)
New credit received for writing October 2013 $75 calls	approx. $7.50
Total credit we're still clinging to	**about $0.98**
The next step in our strategy	As our outstanding puts near expiration, or on a dip in share price, we'll look to write new puts to grow our credit; if shares fall enough, they'd move back to Buy on our scorecard.
The next step for these covered calls	If Tupperware gives back some ground, our calls hedge out that decline by today's $7.50 in value; if the stock continues to hang tough, we'll likely roll our calls again.

Next Steps

- For our recent analysis of Tupperware, you can review our last quarterly report.
- If you have questions about this trade, visit our always fresh Tupperware board.

See Pro*'s holdings [here](). See the team's and David and Tom Gardner's holdings [here]().*

When Cheap Is Cheap: Intel, Oracle, and More

Published Jun 10, 2013 at 4:00PM

Dear *Pro* Member:

The surest way to avoid permanent losses in the stock market is to buy healthy companies at discounted valuations. Sticking to this approach should also lead to a high accuracy rate (one of our goals at *Pro*), with few investments ending as losers. One valuation metric I consider in most of our buy and sell decisions is a company's enterprise-value-to-EBITDA multiple.

The As-Yet-Unnamed *Pro* Community Award

Our *Pro* community contest is under way! We're collecting your nominations for the most exceptional poster among the brilliant, funny, helpful, dedicated Fools on our discussion boards. [Click here to read and discuss]() the nominations so far. We also want to hear your submissions for a name for the award (whose winner will receive a free year of *Pro*). [Here are all the details]()!

EV Is Everything

Enterprise value (EV) is a company's market capitalization (its diluted shares outstanding multiplied by the current share price), *minus* its cash and equivalents, *plus* its long-term debt. By including key balance-sheet metrics, it provides a *true cash price* for the business as a whole.

To illustrate, a company with a $10 share price and 1 million diluted shares outstanding has a $10 million market capitalization. But if the business has $1 million in cash and $5 million in long-term debt, its enterprise value is $14 million ($10 million in market value, minus $1 million cash, plus $5 million debt). That, dear Fools, is the cash price you'd pay to acquire the whole business, because you'd be acquiring the balance sheet, too.

EBITDA Is Less Than Everything

The second part of our equation is EBITDA: earnings before interest, taxes, depreciation, and amortization. This number isn't as vital as the free-cash-flow figure we reference so often, but it supplies a meaningful view of a company's earnings power, unclouded by four non-operational or non-cash factors. One example of its utility: In today's international economy, where tax rates vary by country, excluding taxes by using EBITDA allows a clearer apples-to-apples comparison of earnings power between companies.

EV/EBITDA = Enterprise Multiple

Taking a company's enterprise value and dividing by its trailing 12 months of EBITDA gives us its EV/EBITDA multiple (also called the enterprise multiple). Acquiring companies, analysts, and the *Pro* team all use this resulting multiple much like the common price-to-earnings, or P/E, ratio, is used.

Very generally speaking, an EV/EBITDA multiple in the single digits is typically considered reasonable to inexpensive. The higher the multiple climbs into the double digits, the richer the company's valuation. Many premium stocks can trade at P/E ratios in the 20s (or even higher) for years, but EV/EBITDA multiples rarely stay at similar levels for nearly as long; an EV/EBITDA multiple in the mid-teens can be sustainable, but is considered "premium."

Pro Stocks Under the EV/EBITDA Microscope

So, let's look at the valuations some *Pro* stocks have held over the past 10 years. Here are fiscal year-end EV/EBITDA multiples for one of our largest positions, **Intel** (NASDAQ: INTC):

2004	2005	2006	2007	2008	2009	2010	2011	2012	Now
8.6	8.2	9.0	11.7	4.6	8.5	4.9	5.2	4.3	5.6

Source for all: S&P Capital IQ; year-end EV/EBTIDA.

After years in the upper single digits, Intel has failed to command a respectable EV/EBITDA multiple since the financial crisis, even though the company's EBITDA soared to record highs after 2009. Why so depressed? Many investors don't believe the company's current results are sustainable as the traditional PC market shrinks. We believe Intel has much more staying power than today's valuation suggests, and we suggest a multiple of at least 7 would be reasonable today.

Now we'll consider another large company (also one of *Pro's* largest positions). Here are EV/EBITDA multiples for software leader **Oracle** (NASDAQ: ORCL):

2004	2005	2006	2007	2008	2009	2010	2011	2012	Now
14.3	12.0	13.7	13.9	8.8	10.6	11.1	**6.9**	8.4	8.5

Able to grow more steadily than Intel, Oracle has commanded the higher valuation multiples between the two. However, at the end of 2011, Oracle announced a disappointing quarter, sending the stock to a multi-year low multiple (in bold above). We bought our first shares in 2009 (and they remained profitable for us), but we used the opportunity of 2011 to buy more. The stock was too cheap to ignore at 6.9 times EBITDA. Shares have rebounded nicely since then, but the stock's still inexpensive today.

In the same industry, **BMC Software**'s (NASDAQ: BMC) EV/EBITDA multiple is instructive. When we first bought shares in 2011, we suggested that the going price of only about 7 times EBITDA could attract takeover activity, because a buyer could offer a premium to the market price and still get a good deal. Now the company is being taken over at more than 10 times EBITDA. Here's BMC:

2004	2005	2006	2007	2008	2009	2010	2011	2012	Now
17.1	14.5	16.8	12.3	8.9	10.2	11.3	6.3	9.0	10.3

We bought our first shares in 2011, and more in 2012 around 9 times EBITDA. As a business with healthy recurring revenue and strong free cash flow (like Oracle), BMC was too inexpensive to forego – that is, as long as our analysis continued to support the view that BMC's competitive moat would keep cash-flow-robbing foes at bay.

Another business that called me like a siren with its EBITDA valuation was specialty chemicals producer **Rockwood Holdings** (NYSE: ROC):

2004	2005	2006	2007	2008	2009	2010	2011	2012	Now
N/A	7.4	7.9	8.3	5.5	8.8	7.9	5.9	6.9	10.0

The stock was cheap when we first bought in 2011, especially as management was growing EBITDA, paying down debt, and passing along price increases. It remained cheap into 2012, so we wrote puts and bought more shares. Though it's a cyclical business, we argued that it could trade at 9 times EBITDA. Now, around our fair value, it trades higher than that, and we have covered calls on it.

Let's round out our study with an extremely steady performer over the past 10 years, **O'Reilly Automotive** (NASDAQ: ORLY):

2004	2005	2006	2007	2008	2009	2010	2011	2012	Now
10.6	12.6	10.9	9.9	13.5	9.7	10.4	10.9	9.6	11.4

The auto-parts retailer enjoyed an EV/EBITDA multiple higher than 10 during most years in the past decade. Early this year, we bought shares around that same multiple (it's up about 10% since). We're angling for a share price that appreciates as the business grows, maintaining a valuation multiple that's rarely less than 10. Should it fall much below that without good cause, we'll look to add more shares.

I'll EBITDA for Ya

Boy George may tumble for ya, but we EBITDA for ya. You can take your pick. Our guess is that you'll stick with *Pro* and forego membership in Culture Club. (Although, you *could* always enjoy both.)

Fool on! And to discuss this, please visit the Memo Musings board.

-- Jeff (TMFFischer)

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Pro Trade Roundup

- **iShares Russell 2000 Index** (NYSEMKT: IWM): We set up an August 2014 $91/$96 put ratio spread at a 5% allocation by selling 18 $91 puts and buying 9 $96 puts, for a $0.12 credit per spread.

Pro Catch-Up Trades

- Patience remains our watchword. Meanwhile, of course, all Buy and Buy First stocks can be purchased at current allocations.

Coverage and Community

- **Facing Facebook**(NASDAQ: FB): Jeff summarizes quarterly results and valuation. By the way, Facebook trades at 13 times next year's expected EBITDA.
- **Short or Syn Short?:** FoolishRob99 analyzes shorting the Direxion Daily 3x Financial Bear (NYSEMKT: FAZ) ETF directly or by using options. Which is friendlier?
- ***Pro* Calendar:** TMFMoosie posts his weekly *Pro* calendar (thanks to our editor/content maven, Ellen, and to Moosie, these key events are also always in our *Pro* Calendar scroll box on the site!).
- **Making Mistakes:** It's part of investing. Though it may be early, Jeff looks at our **CME Group**(NASDAQ: CME) trade and regrets the original thesis unfolding further without us. A lesson learned.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

What's Next for You

Published Jun 6, 2013 at 12:00AM

In this video, *Pro* advisor Jeff Fischer explains what makes *Pro* different from other Foolish services. With far less risk than an "all-in" investor, we've earned double-digit annualized returns since we began, and we always have cash at the ready for great opportunities. Watch Jeff's three reasons why our *Pro* journey together is so compelling:

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Audio Extra: Talking Starbucks With Fool One

Published Jun 4, 2013 at 12:00AM

Download!

Rather listen on the go? Download this podcast as an mp3 file by clicking here.

Listen in as Jeff sits down with the *Motley Fool One* team as part of their weekly podcast! In this *Fool One* exclusive Jeff is sharing with you, the gang talks about all things **Starbucks**, including why Jeff believes it has plenty of growth left here in *Pro* and how it earned a spot in *Fool One*'s Everlasting Portfolio. The "EP" is Fool co-founder Tom Gardner's investment vehicle for the ultra-long term — and it contains the only stocks he's buying personally for the rest of his life.

Grab your headphones as host Chris Hill chats with Jeff and *Fool One* team members Bryan White and Robert Brokamp about these topics and more:

- Why Starbucks can grow from here, despite its size
- How the company is focusing on the home
- That nagging question: Will it *ever* get food right?
- And Robert answers a member question: Is a Roth IRA a good fit for me? (6:17)

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Run time: 8 minutes

Transcript

Chris Hill: Welcome to EP Weekly. I'm Chris Hill joined in studio this week by Jeff Fischer, Bryan White and Robert Brokamp. Good to see you, gentlemen.

Jeff Fischer: Hi, Chris.

Robert Brokamp: Thank you.

Chris Hill: We're going to get to Bro's question of the week in just a moment, but we're going to kick things off with, I've got to say, I was thrilled when we were talking this morning because this is my favorite public company, and it's Starbucks. And there's a lot going on with Starbucks, and Jeff, there are a bunch of things we can get to, but first and foremost, this is a company that has had really strong results lately, and really strong results seemingly everywhere.

Jeff Fischer: Yeah, Chris, and I love that you say "really strong results lately." When this company goes back in the Fool's history, back to 1998 is when David Gardner and I first bought it in the Rule Breaker portfolio. The company was worth around $4 billion then; now it's $47 billion. So more than ten times your money in 15 years, and yet it's still growing sharply now 15 years later.

It reminds me of a point that was recently made on the Fool.com site by Morgan Housel, which was that Warren Buffett has made most of his money, some $57 billion of his $60 billion in wealth, since he was 60, so just in the past 20-some years. That's how compounding works and it works for individuals and it works for companies too. You don't always become too big to keep growing. You become so big that you can then compound much more easily and the absolute returns are great.

So Starbucks right now is really doing well in North America. Sales are up sharply. Loyalty among customers is record high by most any measure you could take. And they're growing sharply overseas too, in mainly China. Not everything is great. They're struggling in Europe, but for the most part…

Chris Hill: Isn't everyone?

Jeff Fischer: Yes, sure. I mean it's hard…

Chris Hill: I mean, not to pick on Europe, but aren't most companies struggling in Europe?

Jeff Fischer: Yeah, when the economy in the EU is that weak, how can you not struggle a bit? But they're making a tiny bit of money in Europe, even as they struggle. But overall, Chris, you're right. They're growing earnings per share around 20% annually right now, and the stock reflects that. The stock has had a great couple of years on top of a great 15 years.

Chris Hill: And Bryan, part of the story here is the packaged goods, the move into grocery stores, which is expanding in ways that probably some people didn't expect.

Bryan White: Well, yeah, during your last conference call, Howard Schultz definitely pounded the table on their ability to grow here in North America. You know most folks, if you just mention Starbucks as an investment opportunity, it's easy to think that they're mature here in the U.S., the growth is done, the stores are all over the place.

But they're really going to attack the home, and what they're doing is they're revamping their loyalty program, their My Starbucks reward program, and right now they're going to launch it within the grocery stores where they feel like they've got about ten times the audience than they do in their individual stores. And what they're going to do is they're going to just spread it out amongst all the products, even Teavana. So you can now use your card when you purchase tea within the Teavana stores. The interesting thing, Chris, is they have 3,000 Starbucks stores within the highest value grocery stores within the country, so it's going to be a huge rollout within those grocery stores. It's going to be interesting. It's going to be very interesting going forward.

Chris Hill: I was probably more excited than I should have been last year when Starbucks announced their acquisition of La Boulange, which is the San Francisco-area bakery, and I'll give credit to our colleague, Bill Barker, who's in Motley Fool Asset Management, who made the point that it's amazing that Starbucks has done as well as it has as a company without ever really getting food right. And that's true.

Jeff Fischer: That's so true.

Chris Hill: They really haven't, and so where are we on the La Boulange acquisition. And now it's about a year later. When is it coming to Alexandria? I know they're going to roll it out to big cities and all that stuff…

Jeff Fischer: All you care about is Alexandria.

Chris Hill: All I care about is when is it coming here?

Jeff Fischer: It is exciting. La Boulange products are now in 439 stores, basically all the San Francisco Bay area, Chris, so you have to fly across the country. But they're rolling them out as we speak throughout the Pacific Northwest, again, sorry, Chris, in June. And then they're expanding to L.A., Chicago and then Boston/New York, so that's the order they gave. So it sounds like we're last on the list. They're spreading east, which makes sense. You have to roll out these distribution networks.

Chris Hill: Sure.

Jeff Fischer: But by the end of 2014, which is sooner than I had anticipated, they should be, La Boulange products should be in all U.S. company-operated stores. So that's only a year and a half from now.

Chris Hill: Well and my own selfish desires and all kidding aside, what do you think that means for the business? Because it seems like whereas once upon a time with Starbucks it was just about how often can we get people to come back and buy coffee? Now there's a significant opportunity to really raise the average ticket price.

Jeff Fischer: Yeah, I think "significant" is right. It's a very big opportunity because as you said Chris, most of us, many of us go in there for the coffee. We don't buy food unless we're starving, because the food has never been up to snuff. If they can get food and coffee right and have these millions of people every day, every morning coming in for coffee, start to add food to their ticket, it could double the average ticket sale.

Chris Hill: Just to wrap up on Starbucks, what do you think of the stock today? Is it cheap? Is it fairly valued? Does it seem a little frothy? Is it something where people should maybe wait for a little bit of a pullback? What do you think?

Jeff Fischer: It seems like it has a little extra whip on it, a little froth on there. It's the low sixties now, which puts it at 29 times estimated earnings for this year and 31 times trailing free cash flow, so 29 times and they're growing around 20%. It's a premium, clearly, for a premium company. That said, if food does as well as it could and consumer packaged goods and China keeps growing, it could maintain a premium for years to come and keep rewarding shareholders. I think over the long term it will.

Chris Hill: Question for our man, Robert Brokamp, from one of our members on the boards who writes, "I've read that investors should choose Roth Retirement accounts since tax rates have nowhere to go but up. my current tax rate is 33%, but in retirement I would probably not withdraw the same amount of money as I'm making today since I expect to pay my mortgage off, plus I'm paying a 9% state tax now, whereas during retirement I may move closer to family in Texas, which does not have an income tax. Does the Roth make sense for me?" What do you think?

Robert Brokamp: Well first of all, just to make sure we all understand what a Roth is, a Roth is when you put the money in, you don't get a deduction on the contribution, but money comes out tax free. Traditionals are the other way around. You get a deduction on the money that goes in, but you pay taxes on the way out.

So the question is, when do you want to pay your taxes? And this person has hit on the key variables, and that is what's your tax rate today versus your tax rate in the future? Of course we don't know the future, but this fellow is in a high tax bracket today, and for retirees, generally spending does go down, as does the tax rate. This person also brought up an interesting point in that he's moving from a state with an income tax, that currently has an income tax, and he's moving to Texas, doesn't have one. Same with Florida, same with Nevada, which are popular places for people to retire.

So in this situation, as much as I love Roth accounts, for this guy, it probably does make sense to stick with the traditional because even though tax rates most definitely will go up, I think retirees will get hit the least by rising rates. And just a reminder, if you're a member of Fool One, you have the benefit of calling an Ayco financial counselor to ask these types of questions. This is the perfect question for them, should you choose a Roth and should you convert to a Roth? You have unlimited amount of calling to those folks.

Chris Hill: All right, we will wrap up there. Robert Brokamp, Jeff Fischer, Bryan White, guys, thanks for being here. Thanks everyone for listening. We'll see you next week.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

You Hedge to Stay Long-Term

Published Jun 3, 2013 at 4:00PM

Dear *Pro* Fools,

This afternoon, *Pro* issued a recommendation to use options to set up a small hedge on the **iShares Russell 2000 Index** (NYSE: IWM) ETF. With that recommendation as context, let's take a few minutes to talk about hedging in general.

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Pro Community Award

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As today's trade alert also mentioned, you don't need to hedge to succeed with *Pro*. If your investing time horizon is three years or longer, and you don't mind market volatility while you wait — and you also don't mind not having any winners during market declines — then hedging may have little relevance to your investing strategy.

Pro's mission is to earn consistent returns over every rolling three years, so rather than sit back and accept 100% of the market's volatility, we seek smoother sailing by establishing some positions designed to make money when the market falls. As part of our mission, we also manage our market exposure. Lately, we've been around 70% net long (or invested), but only 60% "true long," including our in-the-money covered calls. This accurately reflects the opportunities we see (or don't see) in the market lately. Likewise, the guidance we've given to members who joined in February has added up to about 64% long.

But the *Pro* portfolio is never static. Our long-running 10% hedge in the **SPDR S&P 500** (NYSE: SPY) ETF is covered by puts, so it may be closed this month. If so, that will increase our net exposure to the market by 10%. This is where today's new put ratio spread of 5% comes in — it's simply another part of managing our market exposure. This new position will help maintain the portfolio at between 60% and 70% long, while making sure we have some positions that will profit in a decline. When we find compelling reasons to buy, of course, our market exposure will confidently climb.

Hedging

As we've often discussed, hedging is a way to lower your exposure to the market without having to sell your long-term stock holdings. If the market declines, your hedges will reward you, and you can reinvest the proceeds in stocks at lower prices. Meanwhile, you continue to own your favorite companies for the long haul. In this sense, hedging has a much more long-term focus than the obvious alternative defensive move — selling a stock outright. You hedge so you can keep your stocks for the long haul while maintaining the risk profile most appropriate for the short term. That's really all a hedge is meant to do: decrease your exposure, or risk, while letting you stay invested in what you believe in most. It's a small insurance policy of sorts, meaning you generally don't expect to make money on a hedge — though of course sometimes you do.

Shorting

Shorting is very different from hedging. A direct short of a company reflects a belief that the stock will decline, no matter what the stock *market* does. When we shorted **Sony** (NYSE: SNE) last year, it wasn't a hedge. It was a position of conviction, much like our long investment in **Intel** (Nasdaq: INTC). Selling a company short is a time-intensive activity, requiring at least as much research and attention as something you own. So I'm excited to announce that *Pro* is now working with renowned short seller John Del Vecchio. Starting now, John is delivering his favorite short ideas to us behind the scenes for our consideration. When he suggests — or we find — company shorts that fit in with the portfolio, you'll get a trade alert and full report from us. We welcome John's contributions to *Pro*!

Keep Your Wits About You

If the stock market has a volatile summer, it'll be the first period of market volatility in about a year. That means you — and every other investor — will likely be sensitive to it at first. If and when that happens, remember that in *Pro*, we own strong businesses that we believe will create strong value over the next three years and longer. We have cash to invest in new opportunities, and we'll continue to set up hedges to target smoother returns (though, as always, you don't need to hedge to be successful with us). We're also going to short some stocks directly to profit on an expected decline in their prices. Finally, we'll use options more as volatility goes up, ideally for higher income.

In every case, it's most important that you do what's best for *you*. If you only want to own*Pro*'s long stock positions, just own our stocks and let time be your friend. Keep your emotions in check, your risk measured, and most of your money invested, and we'll reach our long-term goals in style.

To discuss the Memo, please visit the Memo Musings board.

-Jeff (TMFFischer)

Pro Trade Roundup

- **Direxion Daily Financial Bear 3x ETF** (NYSE: FAZ): We sold short 300 more shares at $31.58, bringing our short allocation back up to 1.5%.

Guidance Changes

• **Medtronic** (NYSE: MDT): Fair value moves up to $53 from $48; Consider Adding More price moves up to $42 from $39.

Pro Catch-Up Trades

- Nothing again this week, but patience is the watchword.

Coverage and Community

- **The Earnings Season That Wouldn't Die:** Bryan (TMF42) gives the read on recent results from **Medtronic** (NYSE: MDT) and **The Buckle** (NYSE: BKE).
- **Intel Will Be Worth Much More?** Not that we give it much heed, but *Barron's* is starting to sing our song on **Intel** (NASDAQ: INTC).
- **Of Moose and Mavens? And the Market and Mom?** This can only be another Foolish post by Rich — ADrumlinDaisy.
- ***Pro* Calendar:** TMFMoosie (lotta Moose today!) keeps you abreast of dividend dates and — yes, already — July earnings dates.

You Hedge to Stay Long-Term

Published Jun 3, 2013 at 12:00AM

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As we’ve often discussed, hedging is a way to lower your exposure to the market without having to sell your long-term stock holdings. If the market declines, your hedges will reward you, and you can reinvest the proceeds in stocks at lower prices. Meanwhile, you continue to own your favorite companies for the long haul. In this sense, hedging has a much more long-term focus than the obvious alternative defensive move — selling a stock outright. You hedge so you can keep your stocks for the long haul while maintaining the risk profile most appropriate for the short term. That’s really all a hedge is meant to do: decrease your exposure, or risk, while letting you stay invested in what you believe in most. It’s a small insurance policy of sorts, meaning you generally don’t expect to make money on a hedge — though of course sometimes you do.

Shorting

Shorting is very different from hedging. A direct short of a company reflects a belief that the stock will decline, no matter what the stock *market* does. When we shorted **Sony** last year, it wasn’t a hedge. It was a position of conviction, much like our long investment in **Intel**. Selling a company short is a time-intensive activity, requiring at least as much research and attention as something you own. So I’m excited to announce that *Pro* is now working with renowned short seller John Del Vecchio. Starting now, John is delivering his favorite short ideas to us behind the scenes for our consideration. When he suggests — or we find — company shorts that fit in with the portfolio, you’ll get a trade alert and full report from us. We welcome John’s contributions to *Pro*!

Keep Your Wits About You

If the stock market has a volatile summer, it'll be the first period of market volatility in about a year. That means you — and every other investor — will likely be sensitive to it at first. If and when that happens, remember that in *Pro*, we own strong businesses that we believe will create strong value over the next three years and longer. We have cash to invest in new opportunities, and we'll continue to set up hedges to target smoother returns (though, as always, you don't need to hedge to be successful with us). We're also going to short some stocks directly to profit on an expected decline in their prices. Finally, we'll use options more as volatility goes up, ideally for higher income.

In every case, it's most important that you do what's best for *you*. If you only want to own *Pro*'s long stock positions, just own our stocks and let time be your friend. Keep your emotions in check, your risk measured, and most of your money invested, and we'll reach our long-term goals in style.

To discuss the Memo, please visit the Memo Musings board.

-Jeff (TMFFischer)

Pro Trade Roundup

- **Direxion Daily Financial Bear 3x ETF**: We sold short 300 more shares at $31.58, bringing our short allocation back up to 1.5%.

Guidance Changes

• **Medtronic**: Fair value moves up to $53 from $48; Consider Adding More price moves up to $42 from $39.

Pro Catch-Up Trades

- Nothing again this week, but patience is the watchword.

Coverage and Community

- **The Earnings Season That Wouldn't Die:** Bryan (TMF42) gives the read on recent results from **Medtronic** and **The Buckle**.
- **Intel Will Be Worth Much More?** Not that we give it much heed, but *Barron's* is starting to sing our song on **Intel**.
- **Of Moose and Mavens? And the Market and Mom?** This can only be another Foolish post by Rich — ADrumlinDaisy.
- ***Pro* Calendar:** TMFMoosie (lotta Moose today!) keeps you abreast of dividend dates and — yes, already — July earnings dates.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Set Up a Put Ratio Spread on IWM

Published Jun 3, 2013 at 12:00AM

- **What We're Doing:** Using options, we're setting up a new, small market hedge that won't cost us anything if the market keeps rising.
- **Who Should Follow Along:** Our recommended exposure to the market reflects the opportunities we see right now; collectively we're at a comfortable 60% to 70% net (or true) long (or invested in the market). We continue to believe in our stocks for the long term, but we hedge to smooth returns during market declines. You don't need to hedge to succeed, but if you want to and can write naked put options, then you should follow along with us.
- **How We Profit:** We're buying puts to profit on a market decline, and writing puts at a lower strike price to pay for the puts we purchase. This position will make money if this small-cap index ETF declines between 2% and 12% by our August expiration. Our returns will not be affected negatively if the market continues to increase. The catch? If the ETF falls more than 12%, this position is no longer a hedge, but instead becomes a potential obligation to buy shares.

Trade Essentials

- **Action:** Using a spread order, set up a put ratio spread on the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF.
  - For every ratio spread you want to set up, write ("sell to open") two August 2013 $91 puts, and simultaneously buy ("buy to open") one August 2013 $96 put.
  - Recent bid (on two $91 puts): $3.20
  - Recent ask (on one $96 put): $3.05
  - Net credit: $0.15 per spread
  - Recent IWM price: $98
- **Price Guidance:** Barring extreme market changes, you should be able to set this trade up for a **net credit** of $0.10 to $0.20 per spread.
- **Allocation:** *Pro*is setting up a 5% position; we're ready to potentially invest about 5% in the ETF. So we'll write 18 puts and buy nine. It breaks down like so:
  - Portfolio value (June 3): $1,625,000
  - 5% of that value: $81,270
  - Buying to open $96 puts: Nine contracts x 100 x $96 = $86,400 in look-through exposure, or about a 5% hedge on our portfolio value.
  - While selling to open 18 $91 puts (half of which become a potential obligation) finances the purchase of the aforementioned nine $96 puts (and pays us a little income).
  - Simply stated, set up one 2:1 put ratio spread for approximately every $200,000 you're managing.

The Big Picture

Here we go again, Fools! We've set up several put ratio spreads on the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF since 2011, and we made good returns when the market declined (yes, the market *did* decline a few times over the past few years). This ETF tracks the 2,000 smallest companies in Russell's universe. It's highly liquid and has been 21% more volatile than the S&P 500 the past year, making for an effective market hedge.

Hedging with a put ratio spread is advantageous because the position doesn't decrease your portfolio returns if stocks rise. It does have limitations, though. Unless you set up a large allocation, the strategy offers you only modest (but still worthwhile!) rewards when the market falls. Also, if the ETF falls *sharply*, we may want to revert to buying shares of it, meaning the strategy would no longer be a hedge but rather potential long exposure. That's all right, though: We would be content to invest 5% in the small-cap index at prices around 12% lower than today's.

For now, though, let's not get ahead of ourselves. Let's see how this position pays us in a market decline.

Strategy Details

iShares Russell 2000 Index ETF Price	Value of 1 Purchased $96 Put	Value of 2 Written $91 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%) From $98
$96 or higher	$0	$0	$0	Any increase in price or any decline of less than 2%
$95	$1 x $100 = $100	$0	$100	3.1%
$94	$2 x $100 = $200	$0	$200	4.1%
$93	$3 x $100 = $300	$0	$300	5.1%
$92	$4 x $100 = $400	$0	$400	6.1%
$91	**$5 x $100 = $500**	**$0**	**$500**	**7.1%**
$90	$6 x $100 = $600	($1) x 200 = ($200)	$400	8.2%
$89	$7 x $100 = $700	($2) x 200 = ($400)	$300	9.2%
$88	$8 x $100 = $800	($3) x 200 = ($600)	$200	10.2%
$87	$9 x $100 = $900	($4) x 200 = ($800)	$100	11.2%
$86	**$10 x $100 = $1000**	**($5) x 200 = ($1000)**	**$0**	**12.2%**
$85	$11 x $100 = $1100	($6) x 200 = ($1200)	($100)	13.3%
$84	$12 x $100 = $1200	($7) x 200 = ($1400)	($200)	14.3%

The bolded lines above show that we'll earn the maximum profit on the strategy if the ETF declines 7.1% from its recent price, to $91 by our August option expiration. Our break-even on the strategy is $86 per share, or 12.2% below the ETF's recent price.

Any returns here won't occur smoothly or immediately. If the market falls soon, our position will largely retain its current value, with the two sides of the spread largely canceling each other out. As with most spreads, we'll need to wait until closer to expiration to achieve results. With this spread, that's only 75 days away.

Assuming we set this up for a credit, this trade will result in a small profit for us even if the market rises or treads water. But to be safe, you must be ready to fulfill the $91 put obligation if the market falls around 10% or more.. If that does happen, given that many small-cap stocks are relatively illiquid individually, we'd be happy to start a 5% allocation to them through this index ETF..

Next Steps

- **Questions or comments?** Visit our iShares Russell 2000 Index discussion board.
- **Get more ETF info:** See the fund's overview at us.ishares.com.
- **Follow it:** Add iShares Russell 2000 Index to My Scorecard.

Alternative Trade

- **If you're hedging in an IRA or can't write naked puts:** For a cost, you can set up a bear put spread, a strategy with capped risk that most IRAs allow. Using a spread order, buy to open August 2013 $96 puts, and sell to open an equal number of August 2013 $91 puts. Lately, this will cost you around $1.53 ($153) per spread, and that is your maximum risk. This strategy could pay you up to $3.47 ($347) per spread on a market decline to $91 or less, but you should be prepared to lose your $1.53 if the market doesn't decline.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Ugly Can Be Great

Published May 28, 2013 at 12:00AM

Fellow Fools,

The As-Yet-Unnamed
Pro Community Award

Our *Pro* community contest is under way! We're collecting your nominations for the most exceptional poster among the brilliant, funny, helpful, dedicated Fools on our discussion boards. Click here to read and discuss the nominations so far. We also want to hear your submissions for a name for the award (whose winner will receive a free year of *Pro*). Here are all the details!

Every June, many budding oenophiles board their fancy Labradoodles at doggy day care and fly first class to Sonoma, Calif., to sniff, swirl, and sip the area's finest wines. This is not that kind of Memo. Meanwhile, another crowd sets aside the moonshine, postpones the evening stoop session, and makes the trek to Sonoma — "homely" canines in tow — for a very different festival: the annual World's Ugliest Dog Competition. This is most definitely *that* kind of Memo.

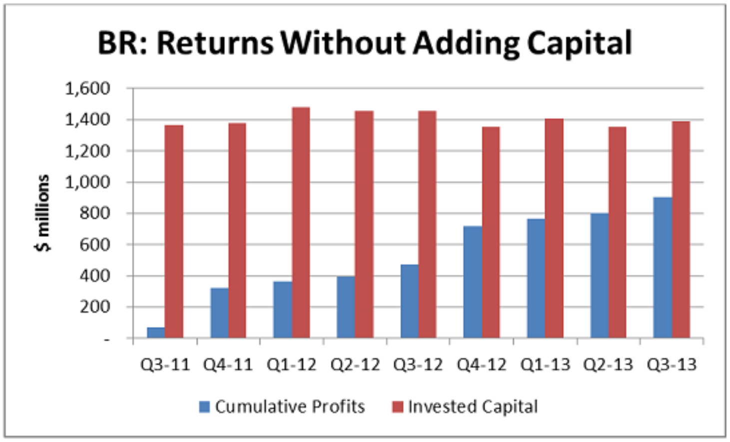
When a Dog Is Ugly ...

Pro holding **Broadridge Financial Solutions** is an ugly dog in our portfolio. I say that because, in a qualitative sense, we've never really been thrilled to own it. Don't get me wrong: We did a lot of homework before recommending members buy shares back on April 27, 2010, and we believed in our thesis. It's just never seemed to distinguish itself as best in show for us. During Broadridge's tenure at *Pro*, one of its partners went bankrupt, it got rid of one business, and another business line's revenue plummeted. Almost from the time we bought it, it's been somewhere on the list of positions we'd consider selling — although it was clearly able to fight off our efforts to that end.

... and Still Scores a Blue Ribbon

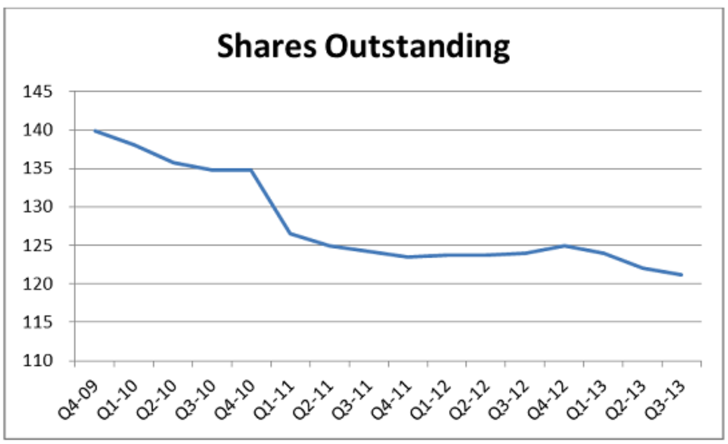
But even ugly dogs win prizes once in a while ($1,500, in the case of this year's World's Ugliest Dog champion). Not only that, they love you just the same as purebreds, and you probably worry less if they roll around in the mud or bring home a dead squirrel every once in a while. Viewed in this light, Broadridge deserves a blue ribbon. After a mere 1,100 days in our portfolio, two rounds of put writing, and a dozen dividend payments, Broadridge has returned a tidy 10% annualized and outpaced our North Star (which has notched 9% annualized). How did this happen?

- **We chose a fundamentally good business with competitive advantages.**
  Broadridge serves a variety of boring niches within the financial services industry, and it has dominant market share in all of them. It's a good business because it generates highly predictable recurring revenue and requires very little reinvestment, meaning it enjoys copious, low-risk free cash flow. The chart below shows that Broadridge's growing earnings (blue bar) have come without additional capital investment (red bar).



Sources: SEC filings and analyst estimates.

- **The company focused on the things it could control.**
  Broadridge's management team graciously thanks its employees on every conference call, and employee happiness seems to be a genuine corporate priority. In 2013, Broadridge was named one of the best companies to work for in New York State for the sixth consecutive year — especially impressive given that this period includes the financial crisis. Customers are happy, as demonstrated by Broadridge's ongoing client retention rates of 98% or more. And management strives to make shareholders happy, too, via share repurchases — the company has bought back 11% of its shares outstanding since we bought ours, and has tripled its dividend since going public in 2008.



Source: Standard & Poor's Capital IQ.

- **Our patience helped us out.**
  Pro is three years into its ownership of Broadridge. That time has passed quickly, so it's surprising to realize we've already owned this company for four times as long as the average mutual fund holds any given position. To complement our naturally long-term mind-set — and in typical *Pro* style — we wrote puts on Broadridge twice, in July 2010 and in May 2011, to generate additional income. Doing so paid us more than $2,200. While that may not sound like much, it represents 15% of the total dollar gains we've logged from Broadridge; without the added income, our position would not have pulled its weight in helping the portfolio seek North Star-like returns.

The Foolish Bottom Line

This is hardly a victory lap. When I recommended *Pro* buy Broadridge three years ago, I thought returns would be higher than 10% per annum; I overestimated its performance over the first few years, and I'm disappointed it hasn't been more rewarding for us. Still, the lesson holds: Even an ugly dog can be prizeworthy. Love your dog for its heart and soul, not the shine of its coat. If it has a snaggletooth, or even spends a little too long sniffing its "newly marked territory," it can still love you back just fine. And when choosing stocks, remember to look for competitively advantaged, fundamentally good businesses that focus on the things that matter. Be patient, spiff things up from time to time with a bit of options income, and you'll have a great shot at achieving your financial goals.

Onward,

Bryan (TMF42)

Pro Trade Roundup

- **SPDR S&P 500 ETF**: We wrote June $164 covered puts for $1.28 each.
- **CBOE Volatility Index** (^VIX): Our bull call spread expired at a full loss (0.1% of the portfolio).

Coverage and Community

- **Thoughts on CAPE**: dsciola asks a few great questions following upon Jeff's Memo from last week.
- **Who Doesn't Like Pictures**? VTDave shares some graphical handiwork on one of the world's largest companies.
- **Behind the TMF Curtain**: Musings on *Pro*, *MDP*, and how our teams work together. If this doesn't answer your questions, we invite you to come see how things work with your own eyes.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Short More Direxion Daily Financial Bear 3X Shares ETF

Published May 23, 2013 at 12:00AM

- **What We're Doing:** Financial stocks remain attractively valued, and our short of this inverse ETF has given us a 34% gain this year, shrinking our allocation to only 1%. So, we're increasing our stake to a 1.5% short once again.
- **What We're Thinking:** Shorting this flawed inverse ETF is another way to profit on the financial sector's recovery.

Trade Essentials

- **Action:** Sell short more shares of the **Direxion Daily Financial Bear 3X Shares** (NYSEMKT: FAZ) ETF.
- **Allocation:** Increase your allocation to 1.5% of your portfolio ($1,500 short for every $100,000 you manage).
- **Recent Price:** $33.20
- **Price Guidance:** Use a limit order at the market's going price (we'll make our trade between 1 and 30 days from now).
- **Short Availability:** Interactive Brokers recently showed 400,000 shares available for shorting at a 4.125% annual fee. TD Ameritrade has shares available periodically, with no fee. Other brokers vary, but shares are scarce. We offer some alternative trades at the end of this report.

What's Changed?

The bearish ETF known as Direxion Daily Financial Bear 3X Shares is meant to provide 3 times (300%) the daily *inverse* results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. That means this ETF is betting against *Pro* holdings **Wells Fargo** (NYSE: WFC)and **MasterCard** (NYSE: MA), not to mention several of their peers. We don't believe that's a good long-term call, and so far, our thesis has been true in the short term, too: Since initially selling short this inverse ETF in January, we've achieved a 34% return. That has shrunk our short position from its initial 1.5% stake to just 1% of the portfolio.

Our plan all along has been to steadily add to this short after a meaningful move, aiming to rebuild its size to at least 1.5% (as long as the valuation still merits it). Think of today's recommendation as averaging into a winner because you expect more long-term gains and want ample exposure to it. So, in one to 30 days following this trade alert, we'll increase our 1% short in this ETF back to 1.5%.

The Vehicle

By shorting an ETF that shoots for 3 times the inverse results of the Russell 1000 Financial Services Index, we're effectively going 3 times long that same index. Why not use more traditional methods? You certainly can; see our alternative trades below. But we're choosing to sell short because the ETF's compounding flaws should continue to erode its value in up and down markets, further helping our short. Meanwhile, the index the FAZ is meant to short counts **Berkshire Hathaway** (NYSE: BRK-B), **Visa** (NYSE: V), and other stalwarts among its top 10 holdings; as a whole, it trades at 1.3 times book value as of April 30. That's up from 1.16 times book value when we first shorted it in January, but still low by historical measures. Please see our original report for more on our thesis.

How to Follow Along

Interactive Brokers has shares available for shorting; unfortunately, many other brokers do not. If yours does, when you're ready, "sell short" or "sell to open" enough shares so that your total short exposure to FAZ is once again 1.5%.

Alternative Trades

- **Options (Regular Account):**If your broker doesn't have shares available to short, consider adding to your short using a January 2015 synthetic short on FAZ. Sell to open January 2015 $30 calls, and buy to open an equal number of January 2015 $30 puts. You can also buy fewer puts if you like; this will reduce the amount of capital you need to make the trade, but provides a lower profit potential on the puts, too. (Be careful not to use the "NS" or non-standard options.)
  - **Price guidance:** Shorting the ETF remains a long-term recommendation anywhere around today's prices, so when using options for a syn short, simply aim to split the bid/ask on each option. Set up one syn short for every 100 shares you want to short. (See our guide to synthetic shorts for more on the strategy.)
- **Options (IRA):** There are no strategies to suggest. An IRA allows you to *buy* puts, but the puts are too expensive to suggest today without writing calls to pay for them. See the next alternative!
- **Any account, bullish on financials:** If you can't short this financial index directly or with options, you could instead *increase* your stakes in *Pro* stocks **Wells Fargo**, **MasterCard**, or **AIG** (NYSE: AIG)(or split your capital between them). Our short expresses a bullish stance on large-cap financials, including these; we own a total of 10.6% in these three companies, including calls (or warrants for members). To approximate our 1.5% short exposure in FAZ, own 12.1% in these three companies instead.

Next Step

- **For discussion:** Our bank window is always open! Visit our Direxion Daily Fin'l Bear board.

The Motley Fool owns shares of Berkshire. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

What Pretty Eyes You Have

Published May 20, 2013 at 12:00AM

The As-Yet-Unnamed
Pro Community Award

Celebrate our community and help us award a free year of *Pro* to a fellow member! [Click here for more](#).

Dear *Pro* member:

That headline get your attention? Sorry to be a tease, but we're actually talking about the stock market.

All year long, the market has been batting its big green eyes at the world, drawing more and more people into its promising embrace. This is nothing new. For decades, North America's most alluring bazaar for capitalism has been making multitudes of steadfast investors wealthy, while causing heartbreak and loss for many others — often, because of emotional decisions and using leverage.

But for all the headlines and drama, when you get down to it, the stock market is simply an auction house for partial ownership in companies. As an owner, you share in the profits of a business through dividends and appreciation. Sometimes the crowd is willing to bid higher and higher for a stake in these benefits, and sometimes buyers are few and far between.

Introducing Charlie the Bull Market

Next Memo: Tuesday May 28

Fool HQ and the market are closed on Monday for Memorial Day. We'll return with our next Memo on Tuesday — have a great holiday, Fools!

Today, buyers surround us, and we're witnessing history repeat itself. New market highs are earned as the population, businesses, and earnings grow. New highs can go on for years, as they did in the 1980s and '90s. Other times, the market hits a peak and then doesn't touch it again for a decade or longer, as was the case after 2000. Where this fate is concerned, the stock market's price-to-earnings multiple is the largest determining factor.

So, where do we stand on the market's P/E today?

- S&P 500's current P/E on trailing normalized earnings: **18.6**
- Average P/E at the end of a bull market: **19.7**
- Five decade (1949-2009) average P/E: **16.5**
- Average length of a bull market since 1962: **Four years**
- Age of this bull market: **Four years, two months**

Source for P/E: S&P Capital IQ; average data from Bloomberg; bull market length data from Birinyi Data.

The numbers suggest that this bull market — which I would like to name Charlie, after my late grandfather, who lived to be 91, and who was cranky yet funny in his final years — is nearing its end. But Bull Market Charlie could surprise us. Earnings growth, or the lack of it, will almost surely determine its short-term fate.

Analysts are notoriously awful at predicting earnings busts, basically never getting it right. Currently, they expect the S&P 500 in aggregate to achieve $108.52 in normalized earnings per share in 2013, up just 4.6% from last year (with all the growth in the second half). Next year, they're gunning for $116.72 in earnings per share, up 7.6% from this year.

Let's put some multiples on this. With Bull Market Charlie's S&P 500 currently trading at 1,667, we have:

- S&P 500 forward P/E on 2013 estimates: **15.4**
- S&P 500 forward P/E on 2014 estimates: **14.3**

If earnings growth resumes in the second half of this year and accelerates in 2014 as predicted, Bull Market Charlie should continue to enjoy himself. In fact, although the S&P 500 trades at 18.6 times trailing earnings right now, it would need to increase considerably to reach the average bull market's expiration price of 19.7 times trailing earnings by the end of 2014 — if earnings do indeed grow.

But that's the big "if."

Over the past two quarters, earnings growth has been nonexistent, and the average S&P 500 company's revenue actually ticked *lower* year-over-year for the quarter that just ended. In other words, resurgence in earnings growth is far from a slam dunk, and if the second half of this year disappoints, stocks will probably give back some ground. Bull Market Charlie might get cantankerous for the first time in a long time.

What Do We Do? We Do What We Do.

Motley Fool Pro is the Fool's only premium service with a long/short, absolute return dictate that does not use the S&P 500 as its benchmark. With full latitude to be long or short, we've done remarkably well (if we do say so ourselves) during one of the most uncertain times in recent market history.

As of April 30, *Pro* had earned 91.6% of the market's gains since its inception in 2008, while only being about 60% net long at the end of 2009 to about 70% net long on average since then. So, as an absolute returns vehicle carrying lower-than-average risk, we still earned outsized returns of 10.9% annualized. The average hedge fund is nowhere close. Overall, I give us a "B" rating (I know best all the mistakes we've made) and hope to do better over the next five years.

So, what we do from here is: Stick to our mission. We're selling some positions that are priced more richly than the S&P 500, and we're closing (as was suggested in January) our remaining direct S&P hedge. We'll continue to hedge in various ways and continue to add new buys to the portfolio where we see value. It should be comforting that I'm not suggesting drastic strategy changes in the near future. Our strategy works — as long as we're consistent. Bull Market Charlie may thrive for much longer, or he may start getting cranky, but we need to set up the portfolio to benefit either way.

This is not your average market recovery, after all. So when people say, "This can't go on," or, "It's all Fed driven," or, "This isn't real," we know that we can't afford to take such a one-sided stance. We need to play both sides of the coin to earn steady profits and keep our North Star in sight.

To discuss the Memo, please visit our [Memo Musings board](#). Fool on!

— Jeff (TMFFischer)

Pro [Trade Roundup](#)

- **CME Group**: We sold all shares through May $60 covered calls.
- **Medtronic**: We sold some shares (keeping 3%) through May $44 covered calls.
- **OpenText**: We rolled our May covered strangle to a November $65 put/$70 call covered strangle.

Guidance Changes

- **CME Group**: Shares moved to "sell" as we sold through covered calls.
- **StoneMor Partners** : Units (rather than shares) of this company moved to "sell" as we prepare to exit through covered calls.
- **FAZ, SRS, FXE:** Our "short around" prices on all three were lowered. Please see them on the Recommendations page.

Coverage & Community

- **A New *Pro* Award, Yours for the Awarding!** As we mention above, we're thrilled to be hosting a new community contest in honor of you!
- **AIG is A-OK:** The company earns another thumbs up in Nick's earnings review.
- **Are Jobs Enough?** Member jj asks, and hearty conversation ensues.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Celebrate Our Community and Help Award a Free Year of Pro!

Published May 17, 2013 at 12:00AM

Be impressed ... be very impressed!

We're proud to announce the winner of the first annual *Pro* community award,
henceforth to be known as the Polaris Award:

RockyTopBob

And the charming and talented runner-up:

DangerScott

A very well-deserved congratulations to both Fools for their tireless contributions to our community. Look for new charms on their discussion-board profiles alerting the world to their status as Polaris Award Fools — and stay tuned for next week's Monday Memo for a formal announcement of the results!

Fools,

Longtime *Pro* member and regular discussion-board poster Rich (ADrumlinDaisy) has shared dozens of good ideas in his time with us. At last, we've been able to make one of them a reality. Introducing:

As proposed by Rich, the award is "a *Pro* community analogue of the Feste Award, an annual award given to the member who provides the most value to his or her fellow members." Criteria include a regular, frequent, Foolish presence on the *Pro* discussion boards; helpful, expert-level advice; creativity; and efforts to foster a sense of community.

We loved this idea, and between now and June 12, we want to hear your nominations. Amidst our remarkable community, which members on the discussion boards have truly distinguished themselves to you? Which posts have been most helpful, most thought-provoking, most illuminating?

Rich also suggested a contest for the naming of the award. We loved that idea, too. So without further ado:

Check out **our TAYUPCA discussion-board thread**

If you've never visited our discussion boards (we know you're out there!), we hope you'll consider this an invitation to take advantage of the amazing body of knowledge there. To get you started:

jjayhowe on "Are Jobs Enough?"	**stamleo** on bear attacks and short selling	**FoolishRob99** on how he invests with *Pro*

The winner will receive a discussion-board charm and **a free year of *Pro* membership**; runners-up will receive a discussion-board charm and bragging rights. We'll also follow up with the TAYUPCA winners in *Pro* content, including Monday Memos, interviews, and the like.

Pro has an incomparable community, and we want to reward you, celebrate you, and publicly thank you. Tell us who you want us to honor.

Best,

The *Motley Fool Pro* Team

P.S. Want to talk about this award? You're in good company. And if you've never visited (or never posted), introduce yourself!

CME Group Moves to Sell; Upcoming Options Expiration Guidance

Published May 16, 2013 at 12:00AM

Dear *Pro* Member:

Our May options are set to expire this weekend. Here's a quick review of what we're doing with each, plus a word on future expirations and some thoughts on the stock market.

CME Group Shares to Be Sold Through Calls

CME Group : The stock moves from Hold to Sell as we (and veteran *Pro* members) let our shares get sold this weekend through our May $60 calls. We've only held the shares for 15 months, so we won't win any awards for lengthy ownership. But the stock has delivered a handsome North Star-topping return, including dividends, even though the fundamentals have not yet improved.

At today's valuation, CME appears less likely to meet our desired return over the next three years, so we're content to let it be sold. If the stock price declines, we'll reconsider buying or writing puts on it. Members with $55 written puts on CME (from a past Catch-Up Trade) are in good shape making income; if this is you, there's no need to do anything. And as noted above, the same applies to members who (like us) wrote the May $60 calls: Your shares will be sold automatically this weekend; there's no need to take action. If you own shares without options on them, the stock moves to Sell on our scorecard today. Sell if you're mirroring us.

Other May Option Expirations

CBOE VIX Index (^VIX): This May spread is set to expire without value after Wednesday, May 22 (VIX options expire on a Wednesday). We need not do anything. Volatility did not increase (in fact, it remains very low — around 13), so the spread is ending worthless and at a small loss for us (0.1% of the portfolio is what we risked).

iShares Russell 2000 ETF: Our May put ratio spread is set to expire. This hedge was designed to protect against a downturn, so the market's continual increases rendered it largely unnecessary. But it didn't cost us much of anything — we're considering setting up a new one for a later month.

Medtronic : Late last year, we wrote covered calls on less than half of our Medtronic shares, aiming to sell them to reduce the position size. Thus, we're not doing anything to those May calls now — as with CME, we're going to let them get exercised this weekend. This will reduce our Medtronic stake from 5.7% to about 3%, putting it in line with members who joined in February. We don't need to do anything now.

OpenText : In case you missed it, we already announced last week that we would roll this covered strangle higher before Friday's expiration. Here's that past recommendation. Members with an August expiration strangle can sit tight — we'll address that strangle closer to August.

Future Option Expirations

Of course, we'll have more options expiring in the months ahead, too. We'll address those as they get closer to expiration. Right now, we are staying the course on all of them, and we will until you see a Trade Alert announcing any change.

Market and *Pro* Overview

The stock market's record-strong advance continues to boost valuations more quickly than the average company's free cash flow (or other fundamentals) can grow. In other words, the rapid ascent is taking away from future returns by banking on free cash flow that is yet to come.

Higher valuations today make it less likely that some positions will achieve our future return goals, so we're content to sell those (such as CME). In doing so, we're raising cash that we'll re-invest when and where we find better opportunities. For some stocks, this may be the best market we've seen in five years — for selling, that is. That doesn't mean one should sell indiscriminately, of course. Will stocks go higher in the short term? Nobody knows. But we do know that new opportunities appear on many good stocks every year.

Because *Pro* is about absolute returns, rather than relative, we can — and should — keep our calm in the face of soaring prices. We see our investments as vehicles meant to provide us a desired rate of return, rather than as horses in a race against an index. We're hedged, and only about 60% of our assets are entirely long right now — and we're exceeding our return goal while still keeping our risk profile much lower than average. We'll always strive to earn the best returns that a long, short, and hedged approach can provide, but we have to do so while keeping in mind that stocks don't only go up.

Questions on these May options expirations? Please visit the *Pro* Options Strategies board.

Fool on!

— Jeff Fischer, *Pro* Advisor

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on StoneMor Partners

Published May 16, 2013 at 12:00AM

- **Is This Trade for You?** This is only for members who already own shares.
- **What We're Doing**: We're looking to exit this entire position in June as we focus the portfolio further on our favorite buys.

Trade Essentials

- **Action**: Write ("sell to open") one covered call for every 100 shares of **StoneMor Partners** (NYSE: STON)you already own.
  - **Sell to open:** June 2013 $25 calls
  - **Recent bid/ask:** $2.10/$2.80
  - **Stock price:** $27.50
- **Price Guidance**: Use a limit order and **do not accept less than the intrinsic value** for writing these calls. With shares at $27.50, you should accept $2.50 or more to write the $25 calls.
- **Allocation**: *Pro* is covering all of its 1,400 shares.
- **Alternative Trades:**
  - **Own odd lots or a small share count?** The stock moves to Sell today, so use a limit order to carefully and patiently sell odd-lot shares. Try not to accept less than $27.60.
  - **Want to sell sooner?** Write May 2013 $25 calls, expiring tomorrow. Use a limit order to get a price that equates to intrinsic value.

What's Changed?

Several times over the past year, I've written of our desire to focus the *Pro* portfolio on our favorite positions as we steadily critique opportunities. We want to center our energy, time, and knowledge on a universe of stocks we're especially compelled to own, and we expect this approach to result in stronger results in line with our North Star over the years. Of course, not all of our stocks can make the cut as one of those favorites, but until recently, many of our holdings were too inexpensive to sell. That's not the case now, with prices up so much in 2013. Shares of StoneMor have climbed 32% this year, so we're taking this opportunity to exit our entire position.

Because the stock is so thinly traded, we suspect a *Pro* order to sell could push the price down considerably. So we're writing in-the-money covered calls instead, hoping this will have less effect on the price as we attempt to capture today's valuation or better. More than anything, realize that our intent to sell StoneMor is meant to capitalize on today's decent price *and* position us to put greater focus on favored portfolio positions. It's not a sign that our opinion of the company has died. Those who enjoy owning this cemetery and funeral home operator (and who wouldn't!?) with its 8.7% yield should consider keeping it. (Do note, though, that said yield is taxed as income by each state in which StoneMor operates.) To close, if you follow along with us, make sure to use a limit order.

How to Follow Along

We will sell our entire stake if the price remains higher than $25 at our June 22 expiration.

StoneMor units (as a MLP):	$27.50
"Sell to open" June 2013 $25 calls:	$2.50
Trade type:	Intent to sell
Potential sell price:	$27.50 (same as today)
Break-even price:	$25
Days to expiration:	37

There now, we're finished. Kaput. Finito. And we didn't dig up, or throw in, any stiff jokes about mortality.

Next Step

- As you get ready to sell to open one call at a limit price for every 100 shares you own, ask any questions on the rockin' StoneMor discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write New Covered Puts on the SPDR S&P 500

Published May 16, 2013 at 12:00AM

- **Is This Trade for You?** This is for *Pro* members who are directly short a market index.
- **What We're Doing:** We're again writing covered puts on our short position in the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
- **What We're Thinking:** We have gradually reduced this index short over the past year, and exiting remains our desired course of action.
- **What We're Expecting:** If the S&P 500 index declines below our put strike price by expiration, we'll buy shares through the puts to cover our short, ending the position. We'll keep the premium received from these puts, of course. If the index does *not* decline below our strike, we'll earn income that offsets at least some of the index's gain, and we can consider repeating this strategy.

Trade Essentials

- **Action:**Write puts on your short SPDR S&P 500 position.
  - **Sell to open:** June 22, 2013, $164 puts
  - **Recent bid/ask:** $1.90/$1.92
  - **Recent SPY price:** $166
- **Price Guidance:** Write the puts at the going price. If the index moves significantly before you trade, you can move your strike price up or down to keep it within $2 of the current index price.
- **Allocation:** Write one put for every 100 shares of SPY you're short. For *Pro*, that's 10 contracts. If you own less than 100 shares, you can write one **non-standard** or "mini" option for every 10 shares you're short.
- **Alternative Trade Guidance:**
  - **Own ProShares Short S&P 500** (NYSEMKT: SH) or **ProShares Short Russell 2000**(NYSEMKT: RWM) **instead?** Write near-the-money June covered calls, one for every 100 shares you own. Or, as we've advised previously, just sell your remaining shares.
  - **Directly short the ProShares Russell 2000** (NYSEMKT: IWM) **ETF?** You can write June covered puts near the money, as we are. Write a covered put on every 100 shares you're short. Or, as we've advised before, buy to cover or buy to close your short position.
  - **Short odd lot shares on an index?** We advised closing those earlier this year; that hasn't changed.

What's New?

Like a cockroach you can't kill, our remaining short position in the **SPDR S&P 500** (NYSEMKT: SPY) index has lingered despite our attempts to close it. Once, our covered puts missed being exercised by just a hair (or an antenna). We've recommended "covering," or closing, this position since January 4, but we've attempted to do so by writing covered puts for a better exit price. That strategy often works ... but sometimes — you know — a record-strong stock market leaves your puts far behind.

Though it may seem counterintuitive, we have less need for this hedge as the market runs higher. That's because many of our stocks are now hedged by deep-in-the-money covered calls; some stocks are going to be sold; and one, **BMC Software** (NASDAQ: BMC), is slated to be acquired. In other words, we're raising cash, and several positions are hedged.

Add it up, and *Pro* is about as defensively positioned as it has ever been in this bull market. That's exactly how you want hedges to work as the market goes higher, but at this point as we sell some positions we can stand to remove some hedges and up our exposure. Plus, we're working to add some new direct shorts to the portfolio — ultimately we will; so far, it has been best not to. All that means we maintain our intent to exit the rest of this index hedge, so we're continuing to try to do so — at this point, for a modestly better price.

To be clear, we're not suggesting with this trade that the market will keep going higher in the short term. We don't know. Nobody does (if I had to guess, I'd guess for a summer pullback — but who knows). As always, we're doing what seems best for the portfolio. As our market exposure changes, and we plan other ways to short and hedge, closing this remaining SPY position is still as logical as it was in January.

Next Step

- **Have questions about any of your shorts?** Visit our SPDR S&P 500 board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

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3 Qualities of Winning Stocks

Published May 13, 2013 at 12:00AM

Dear *Pro* member:

At *Pro*, we look for three primary qualities in almost every company we consider as a potential investment; then, every quarter, we review those qualities anew. We began to see first-quarter 2013 earnings more than a month ago, and we're still going through many reports — meaning that when we close our eyes lately, these are the traits we dream about.

No. 1: Free Cash Flow Generation

If you ever had a lemonade stand as a kid, then you know the formula for free cash flow success. From your sales, subtract the cost of your supplies (a pitcher, cups, a table), marketing costs (a sign in front of your table), costs of goods sold (lemonade, water), and labor expenses (we'll assume you love lemonade so much you worked for free); what's left over is your operating income. That's a start. But moving to the cash flow statement, what we really want to see is your free cash flow. This is the money left over with which you can do exactly what you wish: pay a dividend, invest in growth, buy back all 10 shares you created when you opened shop, or acquire your neighbor's competing stand, for example.

The formula is simple: Cash from operations *minus* capital expenditures = FCF

You'll often need to adjust the result — for example, by removing one-time cash benefits or expenses. But free cash flow is instrumental to analyzing a business, because unlike earnings per share (which can easily be manipulated) and the lauded P/E ratio, a company's market value divided by its free cash flow offers us a reliable, truthful look at the price we're paying. Almost all *Pro* stocks generate strong free cash flow, which typically leads to both a strong balance sheet and staying power in bad economies.

No. 2: Durable Competitive Advantages

Let's say your highly profitable lemonade stand has attracted competitors who seek to gain market share by undercutting your price. You'll be forced to lower your price, too … unless you have durable competitive advantages. Maybe your lemonade's secret formula gives it a truly special taste, so you can charge more and not lose customers.

In our quest for strong long-term results, durable competitive advantages are as important as free cash flow generation — because without them, a company will eventually be undermined by competitors. Warren Buffett calls this advantage a moat, but however you refer to it, every great business has qualities that hold its foes at bay. In some cases, the moat is as strong as a patent; in others, it can be as nebulous as a trusted brand name. But no matter what, a company needs a moat if it's going to excel.

Watching a company's profit margins is one way to monitor its competitive advantage. If margins are falling because the company needs to lower its price to compete, then the moat is under attack. In contrast, expanding margins can signal a growing moat. But our question every quarter is always, "How sustainable is the moat?"

No. 3: Growth Avenues

Strong free cash flow and durable competitive advantages are great, but they only take a company two-thirds of the way through *Pro's* initial sniff test. We also need to see clear growth avenues ahead. After all, we're not buying bonds — we're investing in stocks that need to appreciate, and doing so almost always requires free cash flow growth and attractive opportunities to reinvest in the business (and earn strong returns doing so). A steady base of *recurring* free cash flow is especially beneficial to future growth, so we favor companies with that outstanding quality.

When it comes to growth objectives at our companies, we gain most of our insights not from the quarterly press releases, but by listening to quarterly conference calls and annual analyst meetings and scouring the company's annual 10-K filing. This is part of why we review conference calls for you every quarter (we link to our latest two below).

In Summary

Given *Pro*'s objective of positive returns on a regular basis, we seek three qualities from our businesses: strong free cash flow generation; durable competitive advantages that protect company profits for the long haul; and clear avenues for growth. Once we see all three in a business, we estimate the company's future value to be as sure as possible that we'll earn an attractive return.

This process lets us find individual investments. Then we put them together in a portfolio, combining allocation, diversification, and market exposure in hopes of reaching our return goals with reasonable risk. The portfolio is always evolving (and some more evolution is just about due), but our principles for finding good investments remain rooted in these tried-and-true qualities.

Thank you for reading! There's more news below — enjoy, and Fool on!

— Jeff (TMFFischer)

Pro Trade Roundup

- **American Tower** : *Pro* purchased 600 shares (a 3% stake) at $83.96.

May 18 Option Expirations

- **CME Group**: A decision on our covered calls will be made this week.
- **CBOE VIX** (VIX): Our May spread is set to expire. We're considering a new one.

- **iShares Russell 2000 Index**: Same as immediately above.
- **Medtronic**: As has been the case, we plan to let some of our shares be sold via our covered calls, to reduce our position to around 3%.
- **OpenText** : We're rolling our May covered strangle higher and to a later expiration, as recommended last week.

Guidance Changes

- **3D Systems**: Our fair-value estimate and Consider Adding More prices both moved up $3, to $24 and $27 respectively. Shares remain on hold.

Coverage & Community

- **Earnings Coverage:** See our latest takes on **MasterCard** and **3D Systems**

  …. and **CME Group**.

- ***Pro* Exposed!** Jeff explains the new "Exposure Table" showing how long and short *Pro* is today.
- **Investing in MLPs?** ADrumlinDaisy endorses TaxAct to do your taxes on MLPs such as **StoneMor Partners**.
- **10 Years a Fool!** TMFmd19 celebrates a milestone with *Pro* members.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Roll Your Covered Strangle on OpenText

Published May 7, 2013 at 12:00AM

Is This Trade for You? This is for *Pro* members who have a May 2013 strangle on **OpenText** (NASDAQ: OTEX). Those with August 2013 options should wait until closer to August, when we'll provide guidance for those options. Those who only own the stock should continue owning it.

Trade Essentials

- **Company: OpenText** (NASDAQ: OTEX)
- **Recent Price (May 6 close):** $66.64 ($3.9 billion market value)
- **First Action:**Buy ("buy to close") all previously written May 2013 $60 calls. (We're letting our May 2013 $55 puts expire, but you can close them, too, if they're tying up cash.)
  - **Price Guidance:** Use a limit order, but pay the going price to close the May $60 calls, lately $7.10.
- **Second Action:** Using a strangle order, simultaneously sell ("sell to open") November 2013 $65 puts and November 2013 $70 calls**.**
  - **Price Guidance:** Lately, you can write this new strangle for a credit of $8.80 (exclusive of your cost to close the May calls). Check current prices and then use an appropriate limit order so you don't push them lower.
- **Allocation:** Sell one strangle for every 100 shares of OpenText you own. *Pro* is selling seven strangles on its 700 shares.
- **Alternative Trades:** If you don't own the stock yet, it remains a buy at a 2.9% allocation. If 100 shares is a 2.9% or smaller allocation for you, you can write this strangle after buying shares. Alternatively, you can also just write $65 puts to potentially buy cheaper, using puts that expire in June 2013 or later. Or you can own 2.9% to 5% in OpenText stock without using options on it.

What's New?

Feisty revenue growth from new customers has sent software purveyor OpenText's stock soaring, meaning we need to take action on the call portion of our May 2013 strangle in order to keep our shares. That strangle paid writers, including *Pro* members, about $5.50 originally. (Because *Pro* makes our transactions after we announce them to you, we earned less — $4.73.) So, the strangle allowed us upside until $64.73 per share, meaning it hasn't dampened our gains much compared to the recent share price. But because shares are priced at only 12.5 times free cash flow, and OpenText remains below our $70 fair-value estimate, it makes sense to roll the strangle to higher strike prices to keep our shares. In the process, we'll recapture more credit in the options and more upside in the stock. It's about that simple.

This was the third time we've written options on OpenText, and overall these positions have added meaningfully to our returns, as you'll see below. I knew each time that writing a strangle with covered calls striking *below* our fair-value estimate was a calculated risk — but because the options pay well, we can now roll higher without much difficulty.

Here's how the roll looks:

This Is How We Roll in MF *Pro*	**Price Per Share**
Credit received for writing May strangle	$4.73
Debit to close May $60 calls (with shares at $66.64)	($7.10)
Net debit to close ("What are ya doin' to us, Mr. Market!?")	($2.37)
New credit received for writing November 2013 $65/$70 strangle	$8.80
Total net credit from rolling to the November strangle	**$6.43**
New potential net sell price	$76.43
Potential net sell price improvement from roll	18% higher ($76.43 vs. $64.73)
New net potential second buy price	$58.57 (12.1% lower than recent price)
Earlier Option History	
Credits earned from our two earlier options strategies on OTEX	$6.03
Extra yield earned so far on stock price	9% ($6.03/$66.64)

Returns Times Two

We had two OpenText positions that expired in 2012, for a total earned credit of $6.03 per share. That means we earned an extra 9% on the stock's recent price while it went nowhere last year. This year, we're sitting on a 14.7% gain in the stock — exclusive of our latest strangle. This is a good example of the *Pro* way to use options: Last year, we were able to earn a healthy return while OpenText stagnated; this year, we're able to enjoy the stock's price appreciation and finesse our options as we need to.

Roll May Options Only

As mentioned in the yellow box atop this report, newer *Pro* members who were guided to use August 2013 options should wait until the time value in those options dissipates. We'll provide guidance on the August position later this summer. But our May options expire next week, so it's time we roll them. So ... giddy-up! Close those May calls and write a November strangle, using limit orders.

Next Steps

- Want to know more about covered strangles? We can tell you everything there is to know about covered strangles. (Well, we can come close.)
- If you have questions about strangles or your position in the stock, visit our OpenText board.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here*.

Our Machetes Are Sharp

Published May 6, 2013 at 12:00AM

Dear *Pro* Members:

For an image of what earnings season feels like for us every quarter, this is the best I can scavenge:

Image credit: 20th Century Fox, *The African Queen*

To be clear, we *love* the jungle. It's rich with resources, full of excitement, dripping with new things to discover and analyze. But staying healthy and alert in the heat of the moment requires vigilance and dexterity. Most *Pro* companies announce quarterly results within days of one another, and many stocks move dramatically on the news, pushing us to review results as soon as we responsibly can.

In the interest of continuing our earnings coverage and potential trade alerts, I'm going to keep this Memo brief. Consider it a five-second transmission from a shortwave radio somewhere deep in the Congo: "We're still here! We're making progress!" And that's equally true of our companies reporting — so far, none of them have lost their way.

Below is our earnings coverage so far this quarter. Click any company's name to read our take.

- **Apple** : The world's most talked-about company has seen its shares rebound on a higher dividend and a massive share buyback plan. The stock is a buy; we own 3.6%.
- **Gentex** : Performing well in a tough environment, Gentex remains a buy. We own a 3.3% stake.
- **GrafTech International** : Shares are a buy; we own a 2.1% position just waiting for a recovery in steel demand.
- **Intel** : Shares are up nicely this year, but they remain a buy. We have a 5.3% allocation.
- **OpenText** : This mid-sized software company made a rumble in the jungle with 13% license growth, and shares soared. The stock remains a buy, and we're looking to roll our covered options this month. Excluding puts, we own a 2.9% stake.
- **Pacer International** : Although it's on "hold" because the stock is so illiquid, Pacer's turnaround continues and our 1.8% position has been on the rise. The company's debt-free balance sheet, strong cash flow generation and managerial discipline give us confidence to wait for the turn.
- **Rockwood Holdings** : With a stock price that's a bit above fair value for a business that arguably doesn't deserve a giant premium, this one is on hold for now. We'll manage our covered calls and suggest newcomers consider writing puts (see Catch-Up Trades below). We have a 5.6% position.
- **Starbucks** : The coffee king's food opportunities look delicious. Even though the price has risen, the stock's a long-term buy. We have 3% and will look to add more on declines.
- **Tupperware** : Although growing sharply in emerging markets, Tupperware's stock looks a bit above fair value, so it's on hold for newcomers. We'll manage our options on it and will at times suggest newbies consider put-writing for establishing a position.

We're less than halfway through our trek into the earnings jungle, with many more *Pro* companies to cover, including **3D Systems**, **AIG**, **CME Group**, **Facebook**, **O'Reilly Automotive** … and the list goes on.

Our machetes are sharp, we have bug spray at the ready, and we're well-fed on cacao and coffee (don't ask how we're brewing it). So, you'll continue to hear from us all week on the boards! And in my downtime, at night by the campfire, I'll be reading Paul Theroux's latest book: "*The Last Train to Zona Verde*: *My Ultimate African Safari*."

Thank you for being a Fool member — Fool on!

— Jeff (TMFFischer)

Pro Trade Roundup

- **CME Group**: We sold to open 10 May 2013 $60 covered calls for $1.59 each.

Guidance Changes

- **Rockwood Holdings**: Fair value ticked up $1 to $59.
- **Tupperware**: Fair value and Consider Adding More both increased $3, to $71 and $63, respectively.

Catch-Up Trades

These are for members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Rockwood Holdings**: For those lacking a 5.6% position, sell to open August 2013 $60 puts aiming for a minimum of $2.20 each, for a 3.7% yield in just more than three months. Sell one put for every 100 shares you could buy.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Privacy Please: BMC Software** is reportedly selling itself to private equity for $46.25 per share. Opining on the pending sale, Jeff is happy with the gains *Pro* members have made.
- **TMF42:** Although he's much younger than the number in his moniker, we congratulate Bryan Hinmon on his promotion by The Motley Fool to Senior Analyst!
- **A *Pro* Award?** We like the idea proposed by ADrumlinDaisy. Chime in with your thoughts!
- **Life Is Good!** Is it time to pinch yourself? Jeff argues, "Why, yes; yes it is."
- **Invest in Europe?** MountainTom asks fellow members for thoughts on investing in the beautiful Old World.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy American Tower

Published May 6, 2013 at 12:00AM

Trade Essentials

- **Action:** Invest 3% of your funds in **American Tower** (NYSE: AMT)
- **Recent Price:** $82.80 ($32.7 billion market value)
- **Fair Value Estimate:** $100
- **Consider Adding More:** $64
- **Scorecard Status:** Buy
- **Dividend Yield:** 1.26%
- **Price Guidance:** When you're ready to buy, use a limit order to avoid pushing the stock price higher.
- **Alternate Trades:** None, but members who do not want to buy today can consider writing puts instead.

The Big Picture

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Internet traffic from mobile devices in 2012 was nearly 12 times *total* Internet traffic in 2000, and the average connection speed of a mobile device doubled from 2011 to 2012. According to Cisco, mobile data traffic will reach 11.2 exabytes per month by 2017. (An exabyte equals 1 million terabytes, which equals a *whole lot* of people "liking" baby photos on Facebook and uploading pictures of their dinner to Instagram.) That's a 66% compound annual growth rate — a 13-fold increase in just five years. As a U.S.-based communications site operator doing business worldwide, **American Tower** (NYSE: AMT) is positioned to profit from this trend.

The Business

AMT leases antenna space on nearly 55,000 cell sites to wireless service providers. Though most of those sites are towers, it also manages rooftop sites and distributed antenna system networks that provide coverage within malls and casinos. About 60% of its properties are located in 10 different countries outside the U.S., including India, Brazil, Germany, and Uganda, and the international percentage is growing quickly as AMT erects more towers.

Think of AMT as a multi-tenant apartment building that benefits from sweet lease agreements. Instead of families, the tenants are wireless service providers, and instead of rooms, they rent space to house communications equipment. And those sweet lease agreements? They're long-term and non-cancellable, and they have contractual annual price escalations (set at a fixed rate domestically, indexed to inflation internationally). On top of this recurring, escalating revenue, AMT benefits from high switching costs that keep tenants renewing at 98% to 99% annually. And nearly 80% of its current leases don't renew until 2022 or later.

As noted above, wireless data usage is growing exponentially, and tower operators benefit from the organic demand. AMT's customers are continually adding sites and upgrading antennas to improve their coverage or increase its density and capability, making the jump from 3G to 4G LTE to VoLTE (or, as in Africa, from voice to data) possible for *their* customers. And whenever a service provider upgrades its antenna, AMT increases the lease rate — on top of the scheduled price escalations.

Better yet, when AMT is able to add an additional carrier to an already leased tower (essentially just hanging more equipment on what's already there), the additional operating cost is minimal, so the incremental revenue quickly makes its way to cash flow. There are few technical limitations to multiple tenancy, but in practice, each tower can only have as many tenants as there are cellular carriers in the area. In most countries, that's a maximum of four, though actual penetration is currently about two per tower (2.6 in the U.S., 1.5 internationally). And because towers are long-lived assets made from galvanized steel and concrete, they cost little in annual maintenance capital expenditures (a measly $500 to $1,500 per site; Jeff spends more on birdseed every year).

American Tower faces two primary competitors in the wireless infrastructure space: **Crown Castle International** (NYSE: CCI) and **SBA Communications** (NASDAQ: SBAC). CCI, AMT's biggest competitor by market cap and tower base, is focused predominantly on the domestic market, deriving 94% of its consolidated net revenue from its U.S. operations in 2012. SBA Communications is the smallest major player here; it's focused on investing heavily in growing its tower base, both domestically and abroad. Both competitors use more leverage and have lower margins than AMT.

Management

CEO Jim Taiclet began serving as COO in 2001 and transitioned to his current role in 2003. Shareholders have benefited tremendously during his tenure, with shares gaining more than 1,100% in those 10 years. Along with CFO Tom Bartlett, who spent nearly 25 years at Verizon, Taiclet is focused on allocating capital in three ways: building new sites and upgrading existing sites (this offers the highest return); acquiring communication sites (the fastest way to grow); and maintaining sufficient capital to pay the REIT distribution, with excess cash directed toward repurchasing shares.

Financials and Valuation

AMT's revenue rose by 17.7% year over year in 2012; the international division was up 34%, well outpacing the domestic side. We expect revenue to double in the next five years through a combination of price escalations, new towers, and upgrades. After its recent conversion into an REIT, AMT is required to pay out 90% of taxable income to shareholders. It currently distributes $1.04 annually, a 1.3% yield, and management expects to grow the dividend 20% annually for the next five years.

Importantly, only the U.S. portion of the business is organized as a REIT – the international business is a taxable REIT subsidiary (TRS). A TRS isn't required to distribute its net income to the parent REIT, and it's free to reinvest to grow its business; we think that's a good thing in this case because we're less likely to be subjected to frequent capital raises. (REITs can't retain earnings, so they often invest in the business by issuing shares.)

As the TRS grows, we expect AMT to fold portions of it into the parent REIT as reinvestment prospects dim or tax benefits look appealing. In the meantime, if AMT continues to add tenants to its towers (which takes little capital, compared with building new ones), returns on capital will improve. Management also reduces taxable income though the use of net operating losses. And because the useful life of its tower properties exceeds the depreciation schedule, AMT uses a depreciation shield, which reduces taxable income and understates the values of some assets on the balance sheet. All of this is to say that typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

Ignoring the multiples altogether and discounting future cash flows instead, we value AMT at about $100 a share. Today's price provides an acceptable margin of safety for a business of this caliber. This is a great high-margin, recurring-revenue business — one that's able to reinvest at good rates in quickly growing markets — offered at an attractive price.

Risks and What Would Make Us Sell

Telecommunications is a capital-intensive business in which scale matters, so there are usually only a few competitors in each market. This limits AMT's potential customer base: Its largest 15 customers make up 80% of revenue. Over time, some of its customers may undergo mergers, and others — like Sprint and a handful of international tenants — aren't investment-grade credit risks. In either case, coverage redundancies or temporarily tenantless towers could affect profitability. Given the spectacular growth in foreign markets, though, it's likely that these occurrences (should they occur) would be only temporary setbacks. We're also keeping an eye on potential technological disruptions like mini cell phone towers and femtocells, both of which can be used to fill in coverage holes. If any of these threaten to permanently impair AMT's earnings power, we will sell.

The economics of the business are such that each incremental tenant added at very low cost will greatly increase per-tower returns, so we're not likely to sell the second the stock hits our estimate of fair value. Unless other portfolio considerations demand otherwise, we expect to own AMT for many years to come.

The *Pro* Bottom Line

We're buying the best and largest global tower operator, a business with excellent returns on incremental capital that serves a rapidly growing worldwide industry. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network.

Next Steps

Bring any questions to our new American Tower discussion board!

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Our Machetes Are Sharp

Published May 6, 2013 at 12:00AM

Dear *Pro* Members:

For an image of what earnings season feels like for us every quarter, this is the best I can scavenge:

Image credit: 20th Century Fox, *The African Queen*

To be clear, we *love* the jungle. It's rich with resources, full of excitement, dripping with new things to discover and analyze. But staying healthy and alert in the heat of the moment requires vigilance and dexterity. Most *Pro* companies announce quarterly results within days of one another, and many stocks move dramatically on the news, pushing us to review results as soon as we responsibly can.

In the interest of continuing our earnings coverage and potential trade alerts, I'm going to keep this Memo brief. Consider it a five-second transmission from a shortwave radio somewhere deep in the Congo: "We're still here! We're making progress!" And that's equally true of our companies reporting — so far, none of them have lost their way.

Below is our earnings coverage so far this quarter. Click any company's name to read our take.

- **Apple** : The world's most talked-about company has seen its shares rebound on a higher dividend and a massive share buyback plan. The stock is a buy; we own 3.6%.
- **Gentex** : Performing well in a tough environment, Gentex remains a buy. We own a 3.3% stake.
- **GrafTech International** : Shares are a buy; we own a 2.1% position just waiting for a recovery in steel demand.
- **Intel** : Shares are up nicely this year, but they remain a buy. We have a 5.3% allocation.
- **OpenText** : This mid-sized software company made a rumble in the jungle with 13% license growth, and shares soared. The stock remains a buy, and we're looking to roll our covered options this month. Excluding puts, we own a 2.9% stake.
- **Pacer International** : Although it's on "hold" because the stock is so illiquid, Pacer's turnaround continues and our 1.8% position has been on the rise. The company's debt-free balance sheet, strong cash flow generation and managerial discipline give us confidence to wait for the turn.
- **Rockwood Holdings** : With a stock price that's a bit above fair value for a business that arguably doesn't deserve a giant premium, this one is on hold for now. We'll manage our covered calls and suggest newcomers consider writing puts (see Catch-Up Trades below). We have a 5.6% position.
- **Starbucks** : The coffee king's food opportunities look delicious. Even though the price has risen, the stock's a long-term buy. We have 3% and will look to add more on declines.
- **Tupperware** : Although growing sharply in emerging markets, Tupperware's stock looks a bit above fair value, so it's on hold for newcomers. We'll manage our options on it and will at times suggest newbies consider put-writing for establishing a position.

We're less than halfway through our trek into the earnings jungle, with many more *Pro* companies to cover, including **3D Systems**, **AIG**, **CME Group**, **Facebook**, **O'Reilly Automotive** … and the list goes on.

Our machetes are sharp, we have bug spray at the ready, and we're well-fed on cacao and coffee (don't ask how we're brewing it). So, you'll continue to hear from us all week on the boards! And in my downtime, at night by the campfire, I'll be reading Paul Theroux's latest book: "*The Last Train to Zona Verde*: *My Ultimate African Safari*."

Thank you for being a Fool member — Fool on!

— Jeff (TMFFischer)

Pro Trade Roundup

- **CME Group**: We sold to open 10 May 2013 $60 covered calls for $1.59 each.

Guidance Changes

- **Rockwood Holdings**: Fair value ticked up $1 to $59.
- **Tupperware**: Fair value and Consider Adding More both increased $3, to $71 and $63, respectively.

Catch-Up Trades

These are for members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Rockwood Holdings**: For those lacking a 5.6% position, sell to open August 2013 $60 puts aiming for a minimum of $2.20 each, for a 3.7% yield in just more than three months. Sell one put for every 100 shares you could buy.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Privacy Please: BMC Software** is reportedly selling itself to private equity for $46.25 per share. Opining on the pending sale, Jeff is happy with the gains *Pro* members have made.
- **TMF42:** Although he's much younger than the number in his moniker, we congratulate Bryan Hinmon on his promotion by The Motley Fool to Senior Analyst!
- **A *Pro* Award?** We like the idea proposed by ADrumlinDaisy. Chime in with your thoughts!
- **Life Is Good!** Is it time to pinch yourself? Jeff argues, "Why, yes; yes it is."
- **Invest in Europe?** MountainTom asks fellow members for thoughts on investing in the beautiful Old World.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Stop and Smell the Half-Smoke

Published Apr 29, 2013 at 12:00AM

Fellow Fools,

Live From Omaha!

We're sending a team of Fools to cover the year's biggest investing event — the Berkshire Hathaway annual meeting! Follow our exclusive, real-time coverage all week at berkshire.fool.com.

I have some friends who dislike their jobs. In fact, they spend the bulk of each weekend worrying about Monday morning. At a baseball game recently, on one of those spring afternoons with weather so perfect it makes every color seem crisper and more vivid, I found myself square in the middle of one of these conversations, playing the role of listener and optimist. Aided by a full mouth — complements of D.C.'s hometown food, a half-smoke, from the legendary Ben's Chili Bowl — I took in the rant for almost a full inning before interjecting: "Hey, take a deep breath. Stop and smell the half-smoke."

Step 1: Stop

As I write this, we're less than 1% away from the market's all-time intraday high — yet again. On the cusp of May, we're staring at a sixth straight month of gains, and the market has surged almost 11% this year. But there always seems to be something to complain about: Headlines continue to lament that stocks aren't cheap and earnings are disappointing. Before we succumb to the negativity, let's take a moment to ask what each of these claims really mean.

- **Stocks aren't cheap.** Investment theory holds that, if the market is basically fairly valued, stocks should deliver total returns that compensate for their inherent riskiness. Without getting too far into the weeds, this generally means about 10% — so there are definitely worse places to invest than a fairly valued market. (The degree to which the market is overvalued eats away at that expected return, so guarding against owning overvalued assets is key.)
- **Earnings are disappointing**. Investment theory also holds that the value of an asset equals the present value of all its future cash flows. For stocks, which are generally thought of as assets with an indefinite lifespan, this means a quarterly disappointment today should have little impact on value — plus or minus 1%, perhaps. What really matters, of course, is what the current earnings suggest about the *future* earnings, which account for 99% of value.

At *Pro* (hedges aside), we don't care all that much about the overall market valuation or general earnings performance in the short term — we care about the valuation and performance of the *Pro* portfolio over time. With that perspective, let's take a whiff.

Step 2: Smell

We can get a ballpark estimate of the valuation of each *Pro* company by examining its weighted market-to-fair-value ratio. For example, *Pro* owns 2,400 shares of **Oracle**, valued by the market at $77,674 ($32.36 per share, last Friday's close). However, because our fair-value estimate is $35.50 per share, we think those shares are worth $85,200 — giving Oracle a market-to-fair-value ratio of 91%. From today forward, we believe Oracle should earn a return commensurate to its risk (about 10%), plus a little more to make up for the current valuation discount. Here's a quick look at the *Pro* holdings on each end of the spectrum:

3 Lowest Market-to-Fair-Value Ratios	
Apple	0.63
Pacer International	0.70
GrafTech International	0.72
3 Highest Market-to-Fair-Value Ratios	
3D Systems	1.50
Papa John's International	1.44
Starbucks	1.09

Source: *Pro* estimates.

We can look across the entire *Pro* portfolio to get a sense of over- or under-valuation (always keeping in mind that a fair-value estimate is really a range of values, not a precise number). Looking only at our long positions, which have clearly marked fair-value estimates, and adjusting for positions that are neutralized via in-the-money covered calls, the *Pro* portfolio has a weighted market-to-fair-value ratio of 94%. Of course, all else equal, we'd like that margin of safety to be a bit larger, but it does suggest that we think the average *Pro* holding is modestly undervalued, giving it enough juice to achieve North Star-like returns.

As for earnings, you can read our thoughts on Oracle, **Intel**, and **Gentex** so far, with many more on the way. As always, we assess current business performance with respect to long-term future prospects; more earnings updates are on the way.

The *Pro* Bottom Line

It's easy to get so caught up in the bad stuff that we lose perspective and fail to live in the moment. On the whole, *Pro*'s long holdings are superior, undervalued businesses that should grow their value over time; to provide a little more cushion, our net exposure to the market is only about 70%, and we focus on the long-term implications of earnings results. We should enjoy this rising market because we're well-positioned with the right perspective — the "weather" in our portfolio is gorgeous, and the colors are crisp and vivid. And we're also prepared to take advantage of any storms in the form of a market decline, with cash, hedges, and a list of stocks we're ready to buy when the moment is right. The next time you're in D.C., treat yourself to a "half-smoke all the way" from Ben's Chili Bowl, and enjoy the sweet taste of investing the *Pro* way.

Onward,

Bryan (TMF42)

Coverage & Community

- **Minding the Store**: The inside scoop on auto-parts retailing.
- **Jeff's Calendar**: As usual, it looks full — here is how *El Jefe* will cover earnings.
- **Full Earnings Calendar**: TMFMoosie has the *Pro* earnings line-up.
- **Welcome a New Fool**: DashmanLegacy begins a new journey, with the full support of the *Pro* community.

I've asked our editor, TMFKabellen, to enable scratch-and-sniff technology on this Memo, so please try it out and smell the half-smoke for yourself. (Editor's note: This is actually not possible, but I didn't want to crush Bryan's dreams. Please tell him how good this Memo smelled on the discussion boards.) See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Audio Extra: Why O'Reilly?

Published Apr 23, 2013 at 12:00AM

In today's Audio Extra, Jeff and Bryan discuss *Pro*'s emost recent recommendation, **O'Reilly Automotive**, including why they think management is a competitive advantage, what distinguishes O'Reilly from competitors like AutoZone, and what's in store for the company's future. Listen in below (or read the transcript), then bring questions and comments to our O'Reilly discussion board!

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Transcript

Bryan Hinmon: Hey there, Fools, thanks for joining us for this edition of *Pro* Audio Extra. I'm Bryan Hinmon joined here with the man, the myth, the legend, lead advisor Jeff Fischer.

Jeff Fischer: Hey, Bryan; good to see you. That was an overly-generous introduction from TMF42.

Bryan Hinmon: You've got to give the people what they want, Jeff. So Fools, we're here today to talk about *Pro*'s most recent recommendation, **O'Reilly**, and Jeff, since O'Reilly is your baby, you're on the hot seat today.

Jeff Fischer: Um-hmm, I'm used to that.

Bryan Hinmon: Well let's dive right into things. Please read the write-up, Fools, if you haven't already, but essentially O'Reilly Automotive, when we boil it all down to it, is a retailer that sells stuff for cars and it competes on some level with Wal-Mart, Amazon and is sort of kissing cousins to some well-known players like …

Jeff Fischer: Nice image, Bryan.

Bryan Hinmon: *(Laughs)* AutoZone, Advance Auto and others, so Jeff, what is O'Reilly's special sauce? What makes them different?

Jeff Fischer: Great question, Bryan. In this highly competitive retail world of ours, ORLY is the ticker and I like it; it's just kind of fun to say "ORLY". But O'Reilly, there are basically four things that make it really different, and the first is what it sells and where it's located.

Now with car parts, it's frequently the case that you want the part right away. You're in the middle of a job; you realize you need an extra part that you didn't know you needed, as Nick Crow, TMFCrow will tell us.

Bryan Hinmon: I bet if you look in their cash register, half of the dollar bills have grease on them.

Jeff Fischer: *(Laughing)* You're probably right. So they're really trying to move toward credit, which helps MasterCard. So what it sells is mostly an on-demand item in many cases, and then where it's located is key. You're going to run to the shop that's nearest you, so O'Reilly locates its locations very carefully, places its locations very carefully where they will have attractive traffic.

Second, they then overlay it with a two-tiered distribution network where they have distribution centers that serve a block of stores. That allows the company to effectively stock about 142,000 units per store. Now they're not all in that store, but they're in a distribution center that's close enough that they can get you a part that day or the very next day in the vast majority of the cases. And these are many parts, Bryan, that other retailers don't carry. O'Reilly's able to carry a lot of hard-to-find parts. So that's two, what it sells, where it's located and how they get you the parts that others don't have.

A third advantage they have is they have a dual customer base. The company serves equally just your average retail customer like me or you, and the professional jobber market, as it's called, all the professional mechanics out there, so their sales have historically been split 50-50 between these two and the jobber market is, as you would image, the more lucrative, higher margin, usually bigger job ticket sales that the company enjoys. But that they're able to serve both customers from the same store really helps them, enables them, to put stores into smaller markets where big chains normally don't go. So they have that location advantage as well.

Fourth, and O'Reilly would probably put this first, is the company's customer service. Now that's pretty boring. Your eyes are probably rolled back. So many companies claim that to be a competitive advantage, whether you're Amazon or at one point even Best Buy, but I think in this case it really is for O'Reilly.

They've always cared about it since they came public in '93. You read their first annual reports; it was front and center on their minds. They invest heavily in their employees so that their employees can answer questions because again, most customers come in with a question about a tool or a part, how to do it, so they help them solve their; they help their customers solve their problems. And retention at this company is stellar, as the report touched on. Much of management has been there for a lifetime, and that success builds on itself.

Bryan Hinmon: So Jeff, I think most investors are very skeptical when they hear "management" as a source of competitive advantage, and honestly I think they're right to be. What we need to remember is it's the exception, not the rule, because we have a very similar line of thinking with The Buckle, right? Usually it's not a source of competitive advantage until you see it across a 20-year track record of incredible operating history.

Jeff Fischer: Right, and then the company really stands out from all the others. I looked, of course, at O'Reilly's competitors and didn't see enough there to want to buy them. I am not the type of guy who gets excited about an auto parts retailer by any means, but this one really, obviously, interested me enough to buy it.

Bryan Hinmon: Great. Let's give the viewer something special here. Can you tell me something that you learned that didn't make it into the "Tremo" as we're calling it, the trade/memo?

Jeff Fischer: I hope members like that. We may do it more, where the trade went out right before the Monday Memo, and then the Monday Memo shared more about the position. One thing I learned, Bryan, that I didn't work into the report was really all about the historical valuation of this company, which is to say that over even the last ten years, it has typically traded at higher multiples than it does right now.

Even during periods where it was not growing as quickly, and that I found very encouraging. Its average basically an enterprise value to EBIDTA multiple of around 9 to all the way up to almost 15, 14, 15, and right now it's around 10.5. And so it's below its long-term average, which is right around 12, even though it's really grown sharply in the past four years, past five years, more than 20% annualized EPS growth. They're accelerating their store growth right now, growing store count more quickly than they have in every recent year. So in this market, I was really encouraged to find it trading at that price.

Bryan Hinmon: Great, let's switch gears here and talk about acquisitions. So a few years back, ORLY made a huge acquisition, its largest ever, acquiring CSK Auto. So it's been a few years now since they've had CSK under their belt. Can you assess for us how you think management did with integration and how has their strategic intent played out? Looking back with a few years under its belt, was this a good decision?

Jeff Fischer: Sure, Bryan. So first of all, it's a much better name, isn't it? "O'Reilly" is a lot more fun than "CSK". So O'Reilly acquired CSK in 2008, is when they announced in April, I think April 1st, 2008, that they were going to acquire them for $500 million in cash and stock, plus an additional $500 million in debt that it was taking on from the company, so it was about a…

Bryan Hinmon: It was a big acquisition.

Jeff Fischer: A $1 billion acquisition. For a company at the time, that was a fraction of its $11 billion market cap today.

Bryan Hinmon: Yeah, I think CSK had a thousand or so stores.

Jeff Fischer: It had 1,349 stores.

Bryan Hinmon: Jeff Fischer with the stats.

Jeff Fischer: But okay, so O'Reilly mainly paid for this acquisition with stock, and when the stock was around mid-20s per share, and it acquired more than 1,300 stores, including the Checker Auto Parts brand in 22 states, but why it made sense for O'Reilly was CSK was mainly in the west, and O'Reilly was mostly in the mid-west and southeast, so it quickly helped O'Reilly leap into a national footprint, which then let it expand and continued to expand into these new markets that have picked up. Because as we talked about earlier, it has a hub strategy, hub and spoke, I guess you could say, where once it puts in a distribution center, it surrounds it by stores and then grows outward from there, as many retailers do, but they do a very good job of it.

So it helped it expand quickly and little did they know that the financial world was about to blow up months later, which actually helped sales increase, auto parts sales for used cars really did well from the end of 2008 until now.

Bryan Hinmon: They held up really well.

Jeff Fischer: Held up well and grew as people put off buying a new car. And at the time, too, CSK had had some internal fraud in the mid-2000; they had some bad apples in management, so they were looking for a fresh start. Everything had been cleared up, bad management was gone, but they needed a fresh start and someone would have bought them if it wasn't O'Reilly, and I think O'Reilly did a good job and didn't pay a rich price as a result of the recent black eye.

So I think all in all, it was a good acquisition, and since then O'Reilly has continued its streak of record sales and earnings each year. The acquisition did add to earnings. They have been able to lower the cost of the stores that they acquired to make them more efficient.

Bryan Hinmon: A sign of good management.

Jeff Fischer: And continue their dual-customer strategy, which they really brought into these stores. So I think overall, it's gone well.

Bryan Hinmon: Yeah, I always question the use of stock, but it really seems like this acquisition was a pretty good one for O'Reilly.

Jeff Fischer: Yeah, especially if the stock had gone down afterwards. You'd say, Oh, good way to spend some stock. Well with stock up so much, it has to be a really good acquisition to justify itself, and I think it has been.

Bryan Hinmon: So Jeff, look into the future for me and what do you think ORLY can look like in ten years?

Jeff Fischer: I'm really hoping they'll branch into ice cream sales. So Bryan, this is what we do, as you know, with our discounted cash flow models when we try to model out how a company's going to look in 10, 20 years. You did it with the buckle, Starbucks, so we do it with all our companies.

With O'Reilly, I estimate that organically, they could have about 5,500 stores in ten years, up from about 4,000 today. So that's about 38% more stores, and that comes to around 3% store growth per year.

Bryan Hinmon: That's really not all that much.

Jeff Fischer: That's not much; it's conservative, I hope. They're growing closer to 5% right now, and keep in mind, this does not take into account any acquisitions that they may make, and I think they'll make some significant ones. As the report shared, it's still a highly-fragmented industry. There are a lot of little individual shops, but better than that for O'Reilly, a lot of small chains of dozens of stores.

Bryan Hinmon: Yeah, I urge any inquisitive *Pro* Fools to go to the O'Reilly investor relations website. They have a bunch of investor presentations there that really outline pretty well the state of the industry, so definitely worth looking into.

Jeff Fischer: That's very true, Bryan. They really organized things well, which is interesting and a whole other topic. Sometimes when you find companies that present their history and their current business success or outlook extremely clearly and have it very well organized, it reflects on how well organized they are in their lives and running the business. But as you just said, O'Reilly has a great investor relations page, so check it out.

So they're growing stores about almost 5% this year is the plan, and over the next ten years, I think around 2.8 to 3% annualized is possible. Add in same-store sales growth, which has been positive every year the past 20 years now.

Bryan Hinmon: It's remarkable.

Jeff Fischer: There will be some slip at some point, and we'll probably be right there in the middle of it, but it'll happen at some point, but I still think they will grow same-store sales low single-digits on average over time. And if you add that all together, and we're looking at around 10% or better annualized returns the next ten years.

Bryan Hinmon: That's great. Well enough rah-rah and patting ORLY on the back, Jeff. Let's turn pessimistic here. Tell me something that you don't like about the company or something that you have your eye on or the key risk. Give me something on the flipside here.

Jeff Fischer: I will go right to the biggest thing that jumps to mind and that is the way cars keep getting better and better and need less and less work. Now that said, when you sell your old car, rarely do you trash it. Someone else takes it and keeps driving it. I just sold a '91 and it's back on the road after someone put a lot of parts into it, so there is that silver lining. But still, cars get more and more reliable, and in the long-term, you would think that would have some influence on used car part business.

Number two, of course is online sales. Car parts, not too unlike books, have all the makings of being the perfect thing to sell online, assuming you don't need it immediately. But even if you need it quickly, nowadays there is same-day delivery becoming more possible or next-day delivery, of course. But it's very easy to categorize car parts online, find what you need, and move on, assuming you know what you need. So they have to keep their eye on online competitors, and they do have an online business, and the good thing is the jobbers, the pros in this business, know to go there to find a part because they know O'Reilly to begin with.

Bryan Hinmon: Great. All right, Jeff, so step back a little bit and tell me about O'Reilly in the context of the *Pro* Portfolio. why is it a good addition to what we already have, and you spell it out pretty well how you think it's going to achieve North Star returns, but tell me how it fits in in general.

Jeff Fischer: All right, Bryan. So one thing I was happy to find in this company is that it has somewhat of a defensive stance. We're all still concerned that the so-called recovery we've had has been largely driven by stimulus and may not be as sustainable as we'd hope, and there may be another shoe to drop. And that's part human nature, to still be concerned after you saw something like 2008-2009, but it's also reality that we haven't really solved our growing deficit problems, let alone our unemployment problems and others.

So if the economy does get worse, we can expect O'Reilly's business to initially weaken, sure, it's a retailer. But in the long run, benefit by more used cars on the road, so there is that defensive nature to it, which I really liked putting it into the portfolio in the context of stocks have been up so much lately, it's hard to find a defensive, reasonably priced company that's also growing more than 20% a year. So it had all those kind of "needs", for lack of a better word, qualities to it.

And it fits in the Monday Memo last week, on April 15th, tax day; we issued this on tax day. The Monday Memo on that day talked a little bit about this, how this historically is a very low beta, low volatility stock, 33% as volatile as the S&P 500, so it will have its big up and down days, of course, but over time it has been much,

much more stable than the market and we like that defensive nature as well. And yet despite being so non-volatile, it has done very well the past five and ten years.

Bryan Hinmon: Great. All right, Jeff, well I have one more question for you, and this is a question that all of our members really would be disappointed if I didn't ask.

Jeff Fischer: I reserve the right to not answer.

Bryan Hinmon: So since O'Reilly has found its way into our portfolio, there have been plenty of discussions on our boards about you and the cars that you love. And it turns out that you have a little bit of a Magnum, P.I. thing. And so I think the question, the direction I want to go with this is will you grow out a Magnum, P.I. moustache and let us post it on the *Pro* site?

Jeff Fischer: *(Laughing)* Oh, I think I need to lose some bet and then I will do it. I won't do it just for the sake of…

Bryan Hinmon: So you're putting the ball back in my court to come up with a bet that you are a surefire loser too?

Jeff Fischer: I'll choose my bets carefully, but it's true, I grew up in the eighties. I was a teenager when Magnum, P.I. had its heyday. And what teenage guy doesn't like the idea of living on an estate in Hawaii, on the ocean, no real responsibilities. I don't even think Magnum paid rent. Just guarded the place and drove a Ferrari free of charge. I'm still aspiring to it, much to my wife's disappointment.

Bryan Hinmon: All right, Fools, that's all we've got for you. Thanks for joining us on this *Pro* Audio Extra. Thanks for tuning in. I'm Bryan Hinmon, speaking for Magnum Fischer. Fool On.

Jeff Fischer: Thank you, Bryan.

The Best of Pro's Early Years

Published Apr 22, 2013 at 12:00AM

Fellow Fool,

As we hope you've noticed, the *Pro* team is always striving to improve our investing process and outcomes. But you may not realize that we're also continually working to better our "on-boarding" process for the new members we welcome every few months. For our most recent reopen in February, we used "Catch-Up Reports" to get members up to speed and invested with *Pro*; these reports detailed our up-to-date investing thesis for each stock and provided instructions on how to implement each trade. We think this iteration of the new-member process is our best yet, but we're still working on ways to improve it for next time. (In fact, thanks to your suggestions, we even made some improvements during the process this time.)

As I considered topics for this week's Memo, though, it occurred to me that there's one thing we *don't* currently do for new members: introduce them to the history of *Pro* through some of our best Memos from the past. Every family has its story that forms a fabric of common experience, and the *Pro* family is no different. In that vein, I offer this Memo to provide some historical context for our new members and a bit of nostalgia for our charter members.

2008: Building a Foundation

- Here and Now: Jeff looks forward into great uncertainty and discusses the folly of calling a bottom, yet makes a couple of prognostications anyway. This memo starts to detail the bedrock of *Pro* investing — absolute returns. The sharing of stock and ETF screens was typical during our early Memos, when the portfolio was still in its infancy.
- Swami Says ...: In its early days, *Pro* used CAPS to leverage the insights of crowd-sourced investment research. This memo captures the way Jeff and former *Pro* Fool Todd Wenning were looking at the market, and the way they leaned on a community of CAPS All-Stars to help them keep a measured pace — unlike many investors at that time, who assumed the market had already permanently bounced off the bottom.

2009: Hitting Our Stride

- Getting Through a Deep, Dark Wood: What's Jeff like under pressure? In a word: mercurial. If I could have a *few* words, I'd say "mercurial with measured optimism" — it's a rare trait. But don't let me be the judge; read this Memo, in which Jeff is at his most introspective. Leading right into the market abyss of early 2009, he muses on the dire state of everything and offers a glimmer of hope through the eyes of a little boy.
- *Pro* Makes a Buffett Move: It's always fun to look back to see when — and why — you bought your most successful investment. In this Memo, Jeff makes like Buffett and talks about buying **AmTrust Financial Services**.
- Mr. Market's Merry-Go-Round: Five months into 2009, the market had fallen 25% and rallied 33%. In the midst of the whirlwind, Jeff gave advice on how to think about market rallies (and how to control your emotions); some things never change. Remember, no one ever knows when the market has bottomed; Jeff's measured approach and detailed plan in this Memo speak well for early *Pro*.
- An Artificially Sweetened Market: Macroeconomic concerns were clearly in focus during 2009, and they were a frequent topic for *Pro*. In this memo, Todd captures many of the concerns surrounding stimulus efforts and how they might affect the economy and *Pro*: Would any of it last?
- A Surprising Short Story: Shorting has its own set of challenges; this memo, more than any other, should help members appreciate *Pro*'s measured, cautious approach to short positions. In it, Jeff discusses what could have been had he shorted 10 weak companies in the fall of 2008.
- So Long to a Down Decade: Jeff always says he dislikes making predictions, but with a little taunting, he's usually game to share one. At the end of 2009, he was goosed into sharing his predictions for 2010. Take look to see how clear (or murky) his crystal ball was.

2010: A Year of Growth

- Don't Sleep on Rising Interest Rates: Ten months into a stock-market recovery, the bond market and interest rates were hot topics, and "quantitative easing" was now a household term. Experts and talking heads (and regular people) were still debating whether stimulus plans would ultimately be inflationary or deflationary; Todd detailed how *Pro*'s holdings would likely fare in this environment.
- Time to Get Active With *Pro*: This Memo marks an interesting inflection point in *Pro*'s history. Stock-picking is one of the skills necessary to manage a portfolio, but it's not the only one; at this juncture, the *Pro* portfolio was now invested enough that Jeff was anticipating the need to sell fairly valued stocks to buy cheaper ones. This marks the end of *Pro*'s honeymoon period.
- How Europe Can Help America: As cracks began to appear in Europe's economic foundations, Jeff taught members how to focus on cash — and how a weak Europe might actually benefit U.S. investors.
- Why Investing Requires Uncertainty: Jeff salutes our members for being part of a small group of investors who actually stayed the course and remained invested through a historically uncertain period in investing history. Uncertainty certainly can benefit investors.
- *Pro*'s Keys to Great Investing: *Pro*'s portfolio was growing, and the team was growing with it. In this Memo, each member shared their top three qualities that make a good investor. This is timeless advice.

- The Dollar's Death ...: As measured by email and discussion-board posts, this Memo was the most controversial in *Pro*'s early history. Discussed within are quantitative easing, inflation, and the end of the U.S. dollar (or not), as well as why fears of hyperinflation are just that: fear.
- What Would Ben Graham Think of *Pro*?: The father of value investing wished to do something foolish, something creative, and something generous every day. So it seems safe to say that Graham was a very Foolish man indeed. But what would he think of *Pro*?
- *Pro* Looks Back — and Forward: In the last memo of 2010, Jeff detailed *Pro*'s overall investing results to date, providing a snapshot of a portfolio still chock-full of many of the original picks. He looked forward to 2011 feeling less guarded and more invested.

The *Pro* Bottom Line

Looking back on our great decisions — and analyzing our mistakes — is fodder for continued improvement and a sense of community. Especially for new members, a look back at *Pro*'s early years during a tumultuous market provides insight into *Pro* investing at its best.

Though I tried to highlight the best Memos from 2008 through 2010 to capture the spirit of the time, I've probably missed one of your favorites. If so, please post a link and give us your take on our Memo Musings board.

Pro Trade Roundup

- Bought 500 shares of **O'Reilly Automotive** at an average price of $99.42.
- Wrote 14 contracts of August 2013 $60 covered calls on **Rockwood** for $4.59 per share.

Coverage & Community

- **In Brief:** Jeff (TMFFischer) shares a mid-April briefing on the *Pro* portfolio.
- **Got Yield?** Dividend yield has been added to the Recommendations page.
- **Rule No. 1:** Rob (FoolishRob99) lectures on the first rule of the stock market.
- **Really Like O'Reilly:** Jeff expands on his ORLY bull case.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy O'Reilly Automotive

Published Apr 15, 2013 at 12:00AM

Trade Essentials

- **Action:** Buy **O'Reilly Automotive** (NASDAQ: ORLY)
- **Scorecard Status:** Buy First
- **Allocation:** 3%
- **Recent Price:** $100
- **Fair Value Estimate:** $114
- **5-Year Estimated Return:** 11% annualized
- **Consider Adding More:** $90
- **Dividend:** None
- **Options:** We may use them eventually, but options aren't necessary.
- **Price Guidance:** When you're ready to buy, use a limit order to avoid pushing the stock price higher.

What It Does

O'Reilly Automotive (NASDAQ: ORLY) is America's second-largest auto parts retailer, with more than 4,000 stores, one-quarter of them in California and Texas. Auto parts are a big business, estimated at $231 billion, and O'Reilly is an exceptional competitor, with an addressable market size of about $131 billion.

Running 24 regional distribution centers and 240 hub stores as part of a two-tiered distribution strategy, the company provides same-day or overnight availability on more than 142,000 items, including many its competitors don't usually stock. Basic auto parts, tools, and services complement those hard-to-find treasures. As a result, O'Reilly's sales are historically split between "do it yourself" retail customers and more lucrative professional services customers (such as auto repair shops), a luxury many competitors don't enjoy.

Personalized customer service by long-tenured store managers paves the way for continued success. More than 800 managers have worked an average of 13 to 18 years with the company, showing how O'Reilly is accomplishing its mission:

O'Reilly Automotive intends to be the dominant supplier of auto parts in our market areas by offering our retail customers, professional installers, and jobbers the best combination of price and quality provided with the highest possible service level.

In order to accomplish this mission, O'Reilly will provide a benefit and compensation plan that will attract and keep the kind of people that will enable the company to reach its goals of growth and success.

Rarely does a mission statement cite compensation and benefits for employees, but this focus seems right on the money. And it's working.

How It's Doing

Tenured employees share a common history and learn to improve a business in a consistent fashion. Since going public in 1993, O'Reilly has achieved 20 consecutive years of record revenue and operating earnings and has grown same-store sales every single year. Diluted net earnings per share have jumped more than 20% annually over the past decade, and over the last four years, with 25% growth in 2012. All signs point to more growth ahead.

O'Reilly plans to open 190 net new stores in 2013, growing its 2012 year-end store count by 4.8%, and same-store sales are expected to increase 3% to 5%. By clustering stores together, O'Reilly is able to rapidly achieve economies of scale, and by serving professionals and retail customers, it's able to enter smaller markets where competitors don't often tread. There's also no shortage of independent stores or chains to acquire in this highly fragmented industry. In 2012, O'Reilly acquired 56 locations on top of opening 180 net new stores.

O'Reilly has steadily improved profitability, generated strong free cash flow, and maintained a healthy balance sheet while growing. Rewarding this consistent growth, the stock is a steady and top performer the past five and 10 years. Here's the company's vital top line:

Metric	2009	2010	2011	2012
Revenue	$4,847	$5,397	$5,789	$6,182
Gross Margin	48%	48.6%	49%	50.1%
Operating Income	$538	$734	$865	$978

Dollars in millions.

Factors to Watch

Along with strong management, key factors driving O'Reilly's business include the average age and number of cars on the road; the number of miles Americans drive; the economy; and the severity of weather.

Older cars require more maintenance. The average car in America was 10.8 years old in 2011, near a record high. The number of registered cars in the United States increased 15% in the past decade, but the number of total miles driven is slightly lower since 2007 because of a smaller workforce and higher gas prices. When the economy is weak, more people delay repairs if they're able to (though of course many more fixes are unavoidable). Finally, severe weather (hot or cold) leads to more wear and tear on cars.

Ultimately, a weak economy may slow sales, but it also results in more old cars on the road for future business. And that's a blessing in disguise for O'Reilly, because new cars are more reliable than ever.

Next Steps

Pro will invest with a 3% allocation in the next 1 to 30 days. The company reports earnings on April 24; you can choose to buy before that date or after. We don't have a strong opinion, because we hope to own the stock for three to five years to earn our desired compounded return. We'll discuss how this investment fits into our portfolio in today's Monday Memo, issued at 4 p.m. ET. To ask questions, visit our new O'Reilly Automotive discussion board. And think green!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Green Lights for O'Reilly Automotive

Published Apr 15, 2013 at 12:00AM

Dear *Pro* Member:

Today's recommendation to add **O'Reilly Automotive** to the *Pro* portfolio doesn't just bring an aftermarket auto-parts retailer into the fold. It brings us a stock that historically has low volatility with very strong returns.

With a beta of just 0.33, O'Reilly shares have been one-third as volatile as the S&P 500, and yet they're up more than 625% over the past 10 years. That handily tops the results of O'Reilly's largest competitor, **AutoZone**, beats other fast-growing retailers like **Panera Bread**, and clobbers any market index you care to measure — including our own North Star. That last, of course, is what's important to us; I believe O'Reilly can return north of 10% annualized in coming years, matching or topping our always-positive North Star.

How It Fits

The retail sector drives the majority of the U.S. economy, but it's highly competitive. The *Pro* portfolio is invested lightly in retail (stalwart **Starbucks** and steady-handed denim darling **The Buckle** are about it). I think we've found another retailer worth owning in O'Reilly. Though they're not as physically addictive as caffeine, cars are an integral part of Americans' lives, and most of them need repairs — small or large — every year.

That alone wouldn't be enough to lead me to buy an auto-parts retailer, though. I'm leery of retail overall, because customers are fickle and margins are usually low. But O'Reilly's 20-year operating history as a public company points to remarkable, and ever-improving, execution. The company is the Ferrari of retail operators, boasting record sales and operating earnings — and growing same-store sales — every year for the past two decades. It's leveraging its experience and strong free cash flow to open more new stores this year than in each of the last several. Ultimately, if it wishes to, I believe O'Reilly could become the country's largest and most profitable auto-parts seller, someday dethroning AutoZone.

O'Reilly's ability to serve two sets of buyers (consumers and professionals) within the same store allows it to enter smaller markets, those typically not served by large chains, and still generate strong profits per square foot. Meanwhile, its historic ability to pass along price increases to at least keep up with inflation is an important defense.

What It Allows

Bringing a stock with low historical volatility into the portfolio provides potential balance against a stock that's more volatile, too, should we want it. And O'Reilly has passed our safety inspection; at 10.7 times EBITDA, I believe this investment has lower risk than average. Auto parts are not going to change nearly as much as, say, the computer industry over the next five years; even people's tastes in food may be more likely to change dramatically than will replacement car parts. And in many cases, O'Reilly's customers have not just an immediate need for a part, but questions about it — both of which help to protect against competing online sales. Overall, buying a business with an above-average degree of stability allows us to consider different risks with other positions we may take.

Warren Buffett espouses simplicity in investing. But that doesn't necessarily mean simple *businesses* — stocking 142,000 parts, as O'Reilly does, is no easy task. Buffett's point is that you should target predictable sales and competitive moats that guard profits. Businesses in quickly shifting industries have less stable moats, so the stocks are typically afforded lower value multiples. But the leaders in stable and growing industries, with comfortable moats, often enjoy higher-than-average value multiples. Buffett saw early on that boring businesses can be among the most lucrative. It doesn't get much more boring than auto parts, and few stocks have been as lucrative as O'Reilly since it went public in 1993.

We hope to be along for the ride for the next five to 20 years. Enjoy our trade alert, and post your thoughts on our new O'Reilly discussion board!

Foolishly,

— Jeff (TMFFischer)

Guidance Updates

- **Apple** and **Oracle**: Both move to Buy First (from Buy) on valuation.
- **BMC Software**: Moves to Buy (from Buy First) on valuation.

Coverage & Community

- **Earnings Approach!** TMFMoosie has the earnings calendar, showing which Pro stocks are on deck first.
- **In AmTrust Financial We Trust:** Bryan (TMF42) shares a recent review of AmTrust .
- **Intel in the World: Intel** continues to work to move beyond PCs, as we wait for earnings on Tuesday night.

The Motley Fool owns shares of Panera Bread. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro's First Quarter 2013 Review

Published Apr 8, 2013 at 12:00AM

Dear *Pro* Members:

We just witnessed the S&P 500 gain 10% over the first three months of the year. The Dow gained more than 11%, its strongest first quarter since 1998. And with the market having increased in value every year since 2009 (including dividends), it may be tempting to forget that negative returns do happen approximately one out of every four years — and sometimes, as with 2000-2002, for several years in a row.

Pro investors don't rely on market kindness to earn returns. We want to generate profits on our own in various market environments; however stock indexes behave, we want to make money over every rolling three-year period. This typically means we carry defensive positions to profit from and dampen the effect of falling prices.

We ended this year's first quarter with approximately 71% market exposure (members who joined in February are about 60% invested), with 17% of our portfolio in cash, and nearly 15% short. This profile is obviously less risky than a portfolio that's 100% in equities. In the process, *Pro* earned 71.7% of the broader market's gain this quarter. That's a lower percentage than we've historically captured during a period when stocks are charging higher, but it's exactly in line with our market exposure (again, 71%). Should the market decline, our lower exposure will benefit us on a relative basis and keep our absolute-returns goal within closer reach.

The Market's Q1 2013 Results

Before we look more closely at how we just did, let's consider the "hero and goat" sectors in the market at large from Jan. 1 to March 31.

Q1 U.S. Stock Market Sector Performance	
Health	15.8%
Consumer Staples	13.8%
Utilities	11.1%
Financials	10%
Real Estate	6.9%
Technology	6.8%
Communication	5.8%
Natural Resources	3.8%
Equity Precious Metals	(17.2%)

Source: The New York Times*, April 7, 2013, except consumer staples, which is from S&P 500 Capital IQ.*

The most defensive sectors — health care, consumer staples, and utilities — led the way. Fund managers want market exposure, but they appear cautious in their equity selection. Gold and precious metals had a miserable quarter, and technology was a relative laggard, too. The *Pro* portfolio is heavily weighted in technology and financials. We don't expect both to always lead the pack, but we do expect the baton to change hands; both sectors should ultimately run a strong marathon from today's low valuations.

Pro's Q1 2013

Here's how our 12 largest holdings performed in the first quarter. They're listed below in descending order of allocation (including any options exposure but not dividends).

Q1 *Pro* Portfolio Largest Holdings Performance*	
AmTrust Financial Services	21.3%
Medtronic	14.5%
Rockwood Holdings	33.1%
Oracle	(3.0%)
Tupperware	28.5%
Starbucks	6.6%
OpenText	5.6%
Intel	7%
BMC Software	16.9%
MasterCard	10.2%
CME Group	22.1%
Papa John's International	12.5%

**Dividend-adjusted.*

Eleven of our 12 largest positions were in the green, with Oracle, which reported disappointing earnings, as the lone offender. As glad as we are to see our stocks perform, and as confident as we are in their management teams, three months still means next to nothing to us; we know a weak stock market could flip this positive story on its head (and provide opportunities to add to these stocks). So, what about our shorts?

Q1*Pro* Hedges and Shorts Performance (note that a negative return is good)	
SPDR S&P 500	10.5%
CurrencyShares Euro Trust	(3.0%)
Proshares UltraShort Real Estate	(15.5%)
Direxion Daily Financials Bear 3x	(30.6%)*

*Pro *shorted FAZ on Jan. 23, so has earned less than this full Q1 return.*

In addition to the above, we covered our **Sony** short in late January for a 21% gain — so all four of our shorts provided gains to the portfolio in a strong market. This isn't surprising when it comes to SRS and FAZ, because they're inverse ETFs that actually express a bullish stance on real estate and financials. Meanwhile, we're continuing to wind down our SPY index hedge, which naturally went up this quarter with the market. In January, we recommended closing the position (and all variations) or writing covered puts, which we have done twice since then, offsetting some of the loss. If you, like us, are still hedging with SPY, never fear; we'll continue to manage this hedge until we replace it with more individual shorts.

What's Next for *Pro*?

Since our October 2008 inception, *Pro* has earned 10.6% annualized, tracking ahead of the absolute-returns goal exemplified by our North Star. At the same time, while carrying cash and shorts, and with an average market exposure of only about 70%, we've earned 91.3% of the S&P 500's total return (including reinvested dividends). In sum: In a strong bull market, we've earned most of the market's gains with about 70% of the exposure (which means lower-than-average risk) — and while holding some positions that would profit in a falling market, too.

When stocks do finally decline for a year or two, our defensive positions and our cash (which we'll put to work) will be a benefit. Most importantly, whatever comes our way, we need to stick to our positive-returns goal. The stock market has been giving of late, but it won't always be that way. When weaker years inevitably arrive, we'll need to earn far more of our returns "on our own." This doesn't worry me much — it's just a reality, and it's why we're here. At the same time, we'll continue to enjoy owning strong companies for long-term appreciation. That's Foolish investing at its core.

Have a question or comment? Please visit the Memo Musings discussion board!

— Jeff (TMFFischer)

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **CME Group**: Sell to open one September 2013 $55 put for every 100 shares you'd like to buy, up to a 3.9% allocation. Lately, these pay $1.85, or a 3.4% yield in more than five months. This isn't particularly strong, but is worth considering if you are not invested.
- **3D Systems**: Sell to open one August 2013 $25 put for every 100 shares you'd like to buy, up to a 3% allocation. Lately, these pay $2.10, or an 8.4% yield in just more than four months.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Wisdom from Pascal and More:** Fool Morgan Housel pens another strong column, this one called "25 Important Things to Remember as an Investor."
- **Life Advice:** Poetical *Pro* member ADrumlinDaisy shares "A Sojourn and a Memory."
- **From a Distance:** Consummate Fool member RockyTopBob shares a view of our planet from space.
- **Where We Stand:** In its monthly ritual, *Pro* updated its exposure and returns tables.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on CME Group

Published Apr 3, 2013 at 12:00AM

- **Is This Trade for You?** This is *only* for members who already own shares of **CME Group** (NASDAQ: CME). The stock remains on hold for newcomers.
- **What We're Doing**: Following strong stock price appreciation, we're covering all of our shares so we can earn something if they decline.

Trade Essentials

- **Action**: Write one covered call for every 100 shares of CME Group you already own.
  - Sell to open: May 2013 $60 calls
  - Recent bid/ask: $1.85/$1.95
  - Recent stock price: $60.15
- **Price Guidance**: Aim to be paid at least $1.85 initially; you'll have to accept less if the stock declines in coming days.
- **Allocation**: *Pro* is covering all of its 1,000 shares.
- **Alternative Trades:**
  - **Own odd lots or a small share count?** Cover what you can; if we lose our shares, we may write puts to buy again later. So, if you can't write puts on CME Group, consider keeping the odd-lot shares you already own.

What's New?

Shares of global futures exchange **CME Group** (NASDAQ: CME) are up 19% this year amid a rally in financial-exchange stocks in general. The fundamentals don't yet support this jump, given that trading volume at CME remains flat year-over-year. However, we did believe the stock was undervalued, and now it has increased to our fair-value estimate. We're writing covered calls to capitalize on that fact, and to be a little defensive.

How to Follow Along

Over the past year, we've enjoyed North Star-topping returns of 13% including dividends. If we sell our shares via these May covered calls, we'll turn around and consider writing puts to buy shares again cheaper. We still believe CME's trading volume will eventually grow, taking the share price with it, but that may take a few years. Here's more on the covered call trade:

CME Group stock price:	$60.15
"Sell to open" May 2013 $60 calls:	$1.85
Trade type:	Income, defensive
Yield on current share price:	3.1%
Break-even price:	$58.30
Days to expiration:	44
Potential net sell price:	$61.85
Upside to potential net sell price:	2.8%

Next Step

- Before you sell to open one call for every 100 shares you own, ask any questions on the CME Group board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on Rockwood Holdings

Published Apr 3, 2013 at 12:00AM

- **Is This Trade for You?** This is *only* for members who already own shares of **Rockwood Holdings** (NYSE: ROC). For newcomers, the stock is still on hold.
- **What We're Doing**: Following strong stock-price appreciation, we're defensively covering all of our shares; this way, we earn a return even if they decline, and can potentially sell higher.

Trade Essentials

- **Action**: Write one covered call for every 100 shares of Rockwood you already own.
  - Sell to open: August 2013 $60 calls
  - Recent bid/ask: $4.20/$4.40
  - Recent stock price: $60.75
- **Price Guidance**: Rockwood's stock is volatile; aim to be paid at least $4.20 initially, though you'll have to accept less if the stock declines in coming days.
- **Allocation**: *Pro* is covering all of its 1,400 shares.
- **Alternative Trades:**
  - **Own odd lots or a small share count?** Cover what you can; because we're writing in-the-money calls, use a limit order at current prices to sell shares you can't cover. Or, if you prefer, hang on to your odd-lot shares and hope to sell them around $64.

What's New?

Shares of specialty chemicals and lithium leader **Rockwood Holdings** (NYSE: ROC) have gained 23% this year, largely thanks to management's promise to divest itself of its titanium dioxide business before year-end (either through a sale or a spin-off). The market now values the company at slightly higher than our fair-value estimate, and at nearly 9 times EBITDA.

Rockwood is a good business, but it's not an outstanding business — so we're allowing it less wiggle room above its fair value than we might for other, superior businesses. We're going to write in-the-money covered calls as a defensive play on our large position.

How to Follow Along

We're prepared to sell our stake if the stock remains higher than $60, but we're also open to the possibility of rolling our covered calls to a higher strike price if that seems appropriate by expiration this summer. Here are some more trade details:

Rockwood Holdings stock price:	$60.75
"Sell to open" August 2013 $60 calls:	$4.20
Trade type:	Income, defensive, possible sale
Yield on current share price:	6.9%
Break-even price:	$56.55
Days to expiration:	135
Potential net sell price:	$64.20
Upside to potential net sell price:	5.7%

Next Step

- As you get ready to sell to open one call for every 100 shares you own, ask any questions on the Rockwood board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

A Cure for the Trading Sweats

Published Apr 1, 2013 at 12:00AM

Fellow Fools,

If your heart rate quickens and sweat beads tremble on your brow when you're about to transact with your online broker, you've got a case of what Dr. Google might diagnose as the "trading sweats." The Internet doesn't list a fix, but I've got the cure for what ails you: Take a dose of DEF 14A and call me in the morning.

You won't find any DEF 14A at your local pharmacy, nor can you buy it in any back alleys. DEF 14A is the fancy name for the proxy statement — the document that so cordially invites you to a company's annual shareholder meeting and presents matters to be voted upon. The proxy, which is mailed to shareholders at the end of each fiscal year, cures the trading sweats in just one dose by reminding you that you own a portion of a real business, not just a ticker. And that transforms each buy or sell from a trade into an investment.

Here's how I tackle the proxy statement, using the 2012 proxy for **Broadridge Financial Solutions** as an example.

Rub Elbows With Your Partners

Somewhere toward the front of the proxy, there's a section that lists and introduces the important managers (pages 17 to 20 if you're following along with Broadridge). After reacquainting myself with the executives, I take note of their tenure and ownership. At Broadridge, the average tenure is 16 years, which represents about 30% of these executives' lives (almost 50% of their working lifetimes) — that's loyalty! Of course, we can't read too much into this, but it does suggest that top brass is emotionally invested in, and committed to, the business' success. In the table that details common stock ownership (page 20), we see that managers and directors own 6.7 million shares, or 5.4% ($167 million worth) of the total company — not too shabby. The combined investment of time, energy, and dollars suggests that Broadridge managers have enough on the line to keep them acting like owner-operators.

Checking the Carrots and Sticks

I then flip forward a few pages to the Executive Compensation section (page 25). Here, the board details how management is rewarded. Typically, their compensation will be split between a base salary, cash bonuses, and longer-term rewards.

- Broadridge CEO Rich Daly's base salary is rising 3% this year — pretty modest, especially considering that it didn't budge in 2010 or 2011.
- Daly's cash bonus is tied to financial goals (pre-tax profits, fee revenue, and recurring revenue), key strategic initiatives (setting a five-year vision), and client satisfaction scores. Importantly, the financial metrics in question have thresholds and aggressive target values — during 2012, Daly didn't receive a full payout because Broadridge didn't hit its targets.
- Longer-term compensation consists of stock options and performance-based restricted stock awards. The options vest over four years and only benefit their recipients if Broadridge's stock rises. The performance-based stock is awarded based on two-year average earnings-per-share results; for the cycle that ended in 2012, only 70% of the potential stock grant was awarded because Broadridge failed to hit its stretch earnings targets.

In this section, you should also find any share ownership guidelines and clawback provisions the board has instituted. In Broadridge's case, executives must own stock that equals between two and six times their base salary, and all bonuses and equity awards are subject to reimbursement if the company's financials turn out to be fictitious. In general, I like it when this section includes reasonable absolute rewards, incentives tied to metrics that align with what I believe drives the business, and a system that's simple in structure but difficult to game.

Get Some Perspective

It's critical to have perspective when reading a proxy. I like to pull up the prior year's DEF 14A and check for consistency; moving targets are a yellow flag that warrants further investigation. In Broadridge's case, everything checks out. The only notable change in 2012 was the addition of customer satisfaction as a determinant of cash bonuses; this was done because customer satisfaction is a performance metric for all other Broadridge employees, so it makes sense to grade executives on it, too.

The Foolish Bottom Line

By now, we've investigated the executive team's ownership mentality and incentive structure; now we get to voice our opinion about whether we think it's acceptable. Remember, the proxy statement solicits the company's owners — us — to give our permission regarding any proposed plans (and opine on other matters). The first few pages of the proxy should identify the proposals to be voted on. For Broadridge, that includes the election of directors, auditors, and the performance scheme. Just like you learned in civics class, your vote matters! You own a fraction of each business whose stock you hold, so behave like an owner and vote. If you need a little incentive, remember that each time you do so, another coin drops into your piggy bank — because if you're following *Pro*'s portfolio, you own Broadridge, the tollbooth that rules the proxy voting highway.

Happy Opening Day, Fools!

Bryan (TMF42)

Coverage & Community

- **Coffee Talk**: International channel check notes from a few *Pro* members abroad.
- **Is the World Going to End**? Nah. Don't panic.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Alternative Ideas for 3 Shorts

Published Mar 25, 2013 at 12:00AM

Dear *Pro* Members:

During last week's live chat about the newly released portfolio positioning report, we heard from members who couldn't obtain shares to short from their broker, and from others who wanted alternative strategies because, of course, you can't sell short in an IRA. Fear not, Fools: We'll get to the bottom of all this by the end of today's Memo.

The Basics of Shorting

Let's start with a definition of shorting, or selling short: You're borrowing shares and selling them, aiming to buy them back later at a lower price.

Keep in mind that **you do not need to sell short to succeed at *Pro***. Not everyone has the constitution for shorting. But if you do, we think you'll make strong extra returns over the years. Here are a few things to consider as you decide whether shorting is right for you:

Know your broker: To make success more likely, the first step is to use a broker that is friendly to shorting — meaning, a broker that usually has shares available to borrow. Most brokers charge an annualized fee to sell short, anywhere from 1% of the short value to 7%, depending on how difficult (or expensive) the shares are to borrow. We suggest you check out your broker's shorting fees — some don't have them — know the policy, and consider switching to a better broker if yours seems unreasonable.

Speak the language: The trade command to sell short is usually "sell short" or sometimes "sell to open." Your allocation math is the same as with a long investment. If we say to sell short 1% of something, then short $1,000 worth for every $100,000 you manage. When you short, you're paid cash up front that is then marked to the closing value of the short asset each day. Your cash balance rises and falls with the short value, until the day you "buy to cover" or "buy to close," the commands to close a short position. When you buy it back cheaper than where you sold it, you're making money.

Face the risk: Realize that since you're borrowing shares, the true owner of those shares could transact in them, which would require you to return the shares to their rightful owner. If your broker can't find different shares to borrow, you'll be forced to close your position whether you want to or not. In my experience, this is rare — but it happens, and it's probably the biggest potential risk we face when selling short because it's outside our control.

Shorting at *Pro*

When *Pro* issues a trade alert to short a stock, we have looked at the company inside and out before deciding to recommend a particular strategy. While it's true that alternative trades have advantages and disadvantages, it's best to make the official trade and sell short directly if you're able. That's the quickest, clearest trade; you can short as few shares as you like, and it's the easiest position to manage (add to, or reduce) by following directly along with us at *Pro*. One example: When you use options, each contract represents 100 shares, you'll usually pay capital to set up the position, and you'll typically pay high friction costs at the start. In contrast, fees for selling short are annualized.

One other note about our current short recommendations: At the moment, these companies are all described as "hard to borrow" at some brokers, which simply means they can be hard to come by (as opposed to "easy to borrow" shares that are more readily available). In our original reports on these shorts, we offered alternative trades — and we'll always do that when possible. Further, many of our new shorts will be easy and inexpensive to borrow. But for now, the flawed ETFs we're shorting may be hard to borrow. Again, we've given these companies and strategies a thorough look before recommending this course of action — it might seem complicated, but we believe it represents our best chances of success.

Our Current Short Recommendations

That all said (I never said the short story was, er, short), here's a rundown of our existing short recommendations, along with viable alternatives depending on your broker and other circumstances.

1. ProShares Ultrashort Real Estate : Short about 1.8% (we may add more later). We believe U.S. real estate will continue to recover, so we're shorting this bearish ETF that is leveraged 2:1 *against* real estate and has historically tracked its underlying index very poorly. (See our original reports.)

- **Taxable account alternative:** If you can't borrow shares to short, you can use options to set up a synthetic short. Sell to open January 2014 $22 calls, and concurrently buy to open an equal number of January 2014 $22 puts. Using a limit order, this should cost around $2 ($200) per pair of options you set up. Each $22 call you sell represents $2,200, so allocate using that number. This synthetic short will track the ETF as if you're short it, minus your cost to set it up.
- **IRA account alternative:** In a similar spirit to our short, you could instead *buy* about 1.8% in the bullish **iShares Dow Jones U.S. Real Estate** ETF. This diversified real estate fund should continue to appreciate as real estate recovers. In the past year, it's up 11%. That said, the ETF we're shorting is down 31% over the same period — that's why we're shorting it; it's flawed.

2. Direxion Daily Financial Bear 3x Shares : Short about 1.3% (we may add more later). On average, the U.S. financial leaders in the underlying index this ETF is short trade not much above book value, making them ripe for a long-term recovery. So, we're short the ETF that is short U.S. financials. As with the Ultrashort Real Estate ETF, the leverage used by this ETF is a long-term drag on results — helping short sellers like us. We just shorted it in January; see our original report.

- **Taxable account alternatives:**
  - If you can't borrow shares to short, you can use options to set up a synthetic short. Sell to open January 2015 $10 calls, and simultaneously buy to open an equal number of January 2015 $10 puts. Using a limit order, this should lately cost around a net $0.70 ($70) per paired contract. Each $10 call you sell represents $1,000 in short value, so allocate by that number. The synthetic short will track the ETF as if you're short it, minus your cost to set it up.
  - Instead, you could just write ("sell to open") naked calls on FAZ. Your profit is limited to what the calls pay you, but as long as the ETF doesn't rise sharply, you'll make money. For instance, the January 2015 $12 call pays you more than $2 (or 16.7% on your strike price) with a break-even price above $14, while the ETF trades at $10.55. Do not over-allocate when writing naked calls. Your risk is the same as shorting (unlimited), but your potential reward is limited, so size accordingly.
- **IRA account alternatives:**
  - Our short position in FAZ is simply another way to express a bullish position in leading U.S. financials. So, if you can't short FAZ, consider adding another 1.3% to your *Pro* positions in **AIG** and **Wells Fargo**. This is our best long-term alternative for retirement accounts.
  - They're expensive, but you could buy ("buy to open") put options on FAZ. Buy to open January 2015 $18 puts, lately for about $10 ($1,000 per contract). This gives you a break-even of around $8, so it will require patience. This is a viable — if expensive — alternative, but we like increasing your stakes in our financial stocks better.

3. CurrencyShares Euro Trust : Short about 3.6%. This ETF tracks the euro against the U.S. dollar, and our thesis is that the dollar is built on a much stronger foundation than the euro. It deserves to be more valuable compared to the euro than it currently is. (See our original reports.)

- **Taxable account alternative:** If you can't borrow shares to short, you can use options to set up a synthetic short. Simultaneously sell to open January 2015 $127 calls, and buy to open an equal number of January 2015 $127 puts. This should have little net cost per contract, but each $127 call you sell represents $12,700, so allocate by that number — and don't make this trade if it's too expensive. This synthetic short will track the ETF as if you're short it, minus your cost to set it up.
- **IRA account alternatives:**
  - An IRA-friendly trade that requires much less capital is to set up a bear put spread. Using a spread order, simultaneously buy to open January 2015 $128 puts, and sell to open an equal number of January 2015 $118 puts. Lately, this should cost a bit more than $4 (or $400) per spread. Only invest what you can afford to lose. If the euro falls to $118 or lower, your spread will be worth $1,000, more than doubling your money. But if the ETF ends your expiration above $128, your spread expires worthless.
  - Finally, you could just "buy to open" puts on FXE. The January 2015 $150 puts cost about $23 each ($2,300) and give you a break-even of around $127, close to the ETF's current price.

You'll notice that we **do not** recommend buying the leveraged inverse ETFs as alternatives to any of our short recommendations — that's because they have tracking flaws. For example, buying the **ProShares UltraShort Euro** ETF would get you short exposure to the euro, but it is deeply flawed; over the long term, it's down 23% even while the euro is perfectly flat. That is a perfect example of how leveraged ETFs can misbehave, and why we short them rather than buy them.

Shorts Summed Up

One more time: You don't need to short these stocks, or any others, to succeed with *Pro*. If you want to keep your investing simpler, focus on the companies we own and on our basic option strategies (including for income) as we announce new trades. But if you *do* want to short, strongly consider getting a broker that makes it easy for you to succeed. It's vital that your broker has shares available for shorting, both now and especially when the market gets volatile. Brokers that lack short availability on a steady basis are more likely to call you out of your short positions at the worst times.

If you don't want to open another account for shorting, then consider our alternatives above, using options or other investments entirely. Finally, keep in mind that many of our shorts will be simpler than these — they will be company-specific shorts that are cut and dried. These inverse ETF shorts are more counter-intuitive! If you have questions, please visit the new Making Pro Fit You board. We'll be there to help!

Take your time, keep your eye on the long-term prize, and we'll help you get to your investing destination with us.

Foolishly,
Jeff (TMFFischer)

Coverage & Community

- **3D Systems reports earnings:** Get our take! The stock remains on Hold, but newcomers can write puts, as shared in the post.
- **Oracle surprises:** The stock is down, but we don't think it's down for the count. Get our earnings take on the value we see in this leader.
- **BMC Software** : Is the company likely to be bought out? That's the rumor.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

No Crying Over Income

Published Mar 18, 2013 at 12:00AM

Dear *Pro* Members:

"How much income will you need?" What I thought was a simple question brought fear, and then a tear, to a fellow parent's eyes. Immediately, I wished that I'd just said "covered calls" when he asked which option strategy was best for earning income in retirement. As Fools, we're accustomed to answering questions on the boards and in live chats where thoroughness and completeness are valued — expected, even — by our members. But on the soccer field, among parents, sound bites and perhaps platitudes would serve me (and possibly them) better.

I learned that my peer in parenting — senior to me in everything else by about 25 years — would be taking a mandatory retirement before our daughters (his youngest) leave for college in four years. He needs to replace the majority of his salary from his investment portfolio but, based on the rough numbers he provided, has less than half the portfolio he'd need to generate that income. Sitting on the sidelines, I realized this guy didn't need a goal — he needed a miracle.

We Build Portfolios, Not Miracles

Consistently and Foolishly using covered calls, written puts, and other income strategies will indeed produce useful income — but not miracles. Without a sufficient asset base, no income-producing strategy can replace a healthy salary. It sounds obvious, but building a large enough asset base should be the primary concern of preparing for retirement. Of course, what is "sufficient" varies from person to person (any income earned through employment will drastically reduce the necessary portfolio size, and being debt- and mortgage-free also helps).

Coming Soon: The Portfolio Positioning Report

Tomorrow, March 19, we'll release a Portfolio Positioning Report that tells you how to short, hedge, and use options to match our exposure and general portfolio position, even if you can't or don't want to engage in every strategy we employ. **We'll also have a live chat at 1 p.m. ET to coincide with the report's release.**Click here to set a reminder!

Here's a tip: It helps to start backward by asking the question that kicked all of this off: "How much income will you need?" With that ballpark number in hand, you can then compare different philosophies about rates of drawdown, dividends, and options to come up with a reasonable way to get there.

Total Return Framework

Like the parent above, you may think that to meet your annual personal liabilities, you should invest in more income-producing assets. Equity investors have long used insights from fixed-income markets to inform their decisions. One of my favorite insights is the Total Return Framework, which is simply the idea — even for bond investors — that maximizing after-tax returns is most important and that investors should be agnostic about whether we earn that return from yield or appreciation.

The interest-rate environment has made all assets with a yield more attractive to investors, some of whom might not otherwise consider them. Many of these investors are thinking about yield first and forgetting about total return. After all, doesn't share ownership grant us our proportional share to all of the firm's earnings? It makes sense to focus on owning as much earnings (or free cash flow) as possible, period. Focusing on owning the highest dividend-yielding stocks often doesn't make the most sense from a tax perspective — plus, for those without current income needs, it makes little sense as a primary consideration because yield is only one component of returns.

When entering retirement, the three most important considerations are

- starting asset base
- income needs
- how long you'll need that income

For current net savers preparing for retirement, growing that asset base (not yield) is the first priority. Capital appreciation and yield both matter, but focusing solely on either one misses the point. It is total after-tax returns that capture the whole picture.

Be Like Buffett ... or Sam

In Buffett's recent annual letter, he closely detailed investor preference for dividends. Many Berkshire Hathaway shareholders are getting on in years, and there have been requests for a regular dividend. His response is clear and thorough — I'll share the conclusion here, but I strongly suggest that you read it too (dividends on page 19).

Buffett begins his explanation with an average business that offers a 12% return on equity and earns the same rate on its reinvested earnings. Shares trade at 1.25 times book value. Even for this average business, it makes more sense — even from an income perspective — to forgo a dividend. To make his point, Buffett offers one investor — I'll call him Don — a 4% dividend, while another investor — Sam — sells 3.2% of the shares to achieve the same annual income in the first year. Both Don and Sam benefit from a growing income. After 10 years, we check back to see who is faring better. Even though Sam sold off some shares every year, the stock will be worth 4% more than Don's because the company reinvested the earnings it would have paid out. And here's the kicker: Sam will also have a 4% larger annual paycheck after 10 years — an advantage that will continue to grow.

Let's get back to assets. It should be obvious that the logistics of selling shares is much more difficult than receiving dividends. Do you own enough shares to sell 3.2% if them every year? The point still stands: Even when maximizing income, a larger dividend isn't necessarily the right answer. Obviously this is another example where having a larger portfolio is better. We need to manage our investment to achieve that goal. If the goal is retirement, the nest egg needs to be large enough to support either strategy (offset a bit with Foolish use of options). At *Pro*, our aim is to achieve North Star-like returns. For most investors, saving and living below their means before retirement — or enjoying retirement with a suitably sized portfolio — North Star-like returns should help make for a comfortable retirement.

Two Businesses Worth Owning

Because we shouldn't care whether we earn after-tax returns through yield or appreciation, it helps to know what we should expect from the managers running different types of businesses.The best businesses earn high returns on capital *and* have the ability to regularly reinvest large amounts of capital at those high rates. A business like that, one with a durable competitive advantage, is a great way to create shareholder wealth — paying a dividend will only slow it down.

The second-best type of business is one that earns high returns on capital, but has little need for reinvestment — cash is a drag here, or at least doesn't really affect future earnings. For this business without solid investment opportunities, cash will build up and should be returned to investors. If shares are cheap, I prefer share buybacks; if they're pricey, a dividend is better. Though the dividend policies differ, both companies will build significant wealth for their owners. Matching policies with business reinvestment needs, not investors' preferences, is actually better for investors.

The *Pro* Bottom Line

Avoid tears and poor long-term strategies by thinking like a total return investor and focus only your total returns. By knowing what really matters, we can always risk our investment dollar where we expect the highest return. Sometime that'll be yielding stock, other times it'll be capital-light businesses that are buying back shares, and still other times we'll use options to earn returns. The key to recognizing the best opportunities is to remain flexible and to avoid a dogmatic approach to investing — it's the *Pro* way.

—Nick (TMFCrow)

Pro Trade Roundup

- Bought 1000 shares of **GrafTech** at an average price of $7.285, increasing our allocation to about 2%.
- Bought 17 shares of **Apple** for $430.16 a piece, increasing our allocation to about 3.5%.

Guidance Changes

- **The Buckle**: Fair value increased to $52.

Pro Catch-Up Trades

- **3D Systems**: If you don't have exposure to this 3D printer company, sell to open August 2013 $22.50 puts, lately for about $1.20 each (that's a 5.3% yield in about five months). Sell one put for every 100 shares that you could buy at a net $21.30, up to a potential 2% stock allocation in your portfolio.

Coverage & Community

- **Apple** and **Starbucks**: Pro Member Cacell makes a splash on the message boards with two excellent posts. One describing Apple as a crusty old sailor and another sharing insight in Starbuck's competitive position in Europe, Middle East, and Africa.
- **The Buckle** : Bryan covers Q4 earnings and raises his estimate of fair value.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Portfolio Positioning Live Event

Published Mar 14, 2013 at 12:00AM

The final piece of the “catching-up-with-Pro” puzzle, our Portfolio Positioning Report, will be released Tuesday, March 19. In that report, we’ll walk you through all of our current shorts, options positions, and hedges, and explain how you can get on board alongside us now. We’ll also have a live member event on this page that day; the whole team will be on hand to answer any questions you have about those positions specifically or catching up with us in general. Set a reminder below, and we'll see you on the 19th!

Transcript: The Portfolio Positioning Live Chat

Published Mar 14, 2013 at 12:00AM

The final piece of the "catching-up-with-*Pro*" puzzle, our Portfolio Positioning Report, is out now! In this report, we walk you through all of our current shorts, options positions, and hedges, and explain how you can get on board alongside us now.

We also hosted a live chat for all *Pro* members with questions about the positioning and catch-up reports and other timely topics. You'll find the full transcript in the window below -- simply hover your mouse over (or click) the triangle to get started.

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Buy More Apple

Published Mar 12, 2013 at 12:00AM

- **What We're Doing**: Increasing our allocation in **Apple** (NASDAQ: AAPL) to 3.5% from its current 3.05%-ish.
- **What We're Thinking**: The number of people buying into Apple's ecosystem continues to grow, and yet the stock is cheaper than it has been in years.
- **What We're Expecting**: Skepticism on Wall Street will ultimately give way to optimism as Apple grows in new markets and maintains attractive, above-average profit margins.

Trade Essentials

- **Action**: Buy more Apple
- **Allocation**: Increase your position to 3.5% of your *Pro* portfolio (*Pro* will buy about 14 more shares — yes, just 14 — for 125 total)
- **Price Guidance**: Use a limit order when you're ready to buy.
- **Recent Share Price**: $431

What's New

In its year ended September 2012, Apple's sales were up 45%. Its gross margins jumped to nearly 44%, while earnings per share leapt 59%. But during the subsequent holiday quarter, year-over-year earnings growth stalled and margins dropped sharply, and the stock has tumbled since that news. CEO Tim Cook explained that the company's inability to meet demand for the iPhone 5, iPhone 4S, and iPad Mini played some role. In addition, Apple's product line was almost entirely refreshed last year, and margins will come in lighter until production efficiencies start in earnest. (For more, see the section on Apple in our recent Catch-Up Report, available here in PDF form.)

That's not the whole story, though. We all know that Apple is selling cheaper, older model iPhones to get into lower-end markets, and that competition from the likes of **Samsung** (NASDAQOTH: SSNLF) and **Google** (NASDAQ: GOOG) is intense. But Apple has staying power: It actually surpassed Samsung during the fourth quarter to become the top smartphone seller in the lucrative United States market, with approximately 34% market share. Judging from its share price, you'd think the opposite had happened. At the same time, iPhone unit sales in China leapt by triple digits last quarter, and worldwide iPad unit sales were up 48% to 22.9 million. Apple remains a growth story, and we expect its profit margins to remain strong thanks to the company's operational expertise — even if lower-price-point products do bring margins down from record highs. Once Wall Street is convinced Apple won't become a low-margin company, the stock — trading at less than nine times free cash flow today — should enjoy a higher valuation.

The Foolish Bottom Line

Apple declined below our "Consider Adding More" price last month, triggering a timely review and a report back to you. Today, our decision is made. We're adding more to our stake, and recommend you do, too, matching us at 3.5%.

Alternative Trade

- **Bull Call Spread:** If you set up a bull call spread on Apple in *Motley Fool Options*, continue to follow guidance from our sister service, but keep your total allocation to Apple in mind before buying more for *Pro*. If you'd rather set up a bull call spread than buy more shares today, you can use a spread order to "buy to open" January 2015 $410 calls, and "sell to open" an equal number of January 2015 $420 calls, for a net debit of around $4.50 ($450) per spread. Each spread will be worth $1,000 if Apple stays above $420 by expiration, more than doubling your money; but the position ends without any value — meaning you'll lose your entire investment — if Apple is below $410 at expiration.

Next Steps

- Bring your questions to the Apple discussion board.
- For more details on the most recent earnings, see this post.
- See our original 2012 Apple buy report.

The Motley Fool owns shares of Google. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy (or Buy More) GrafTech International

Published Mar 12, 2013 at 12:00AM

- **What We're Doing**: Increasing our allocation in **GrafTech International** (NYSE: GTI) to 2%, from its current 1.6%, and recommending that newcomers buy 2% to match us.
- **What We're Thinking**: We think shares are undervalued and GrafTech has the balance sheet to survive near-term headwinds.
- **What We're Expecting**: It'll be a bumpy ride in the short term, but the long-term outlook for graphite electrodes coupled with low market expectations warrant increasing our stake.

Trade Essentials

- **Action**: Buy (or buy more) GrafTech
- **Allocation**: Make your position 2% of your *Pro* portfolio (*Pro* will buy about 1,100 more shares, for 4,600 total)
- **Price Guidance**: **Use a limit order** around current prices, and be patient; this stock is volatile and easily influenced by sudden demand or selling pressure.
- **Recent Share Price**: $7
- **Special Notes**: This report on GrafTech serves as the most current guidance for new members and veterans alike; we won't be commenting on the company in our Catch-Up Reports (though we will link to this guidance from there). Also, we realize some members held written puts that recently resulted in assignment; if this is you, check your allocation and make sure it isn't too far off from our 2% recommendation.

What's New?

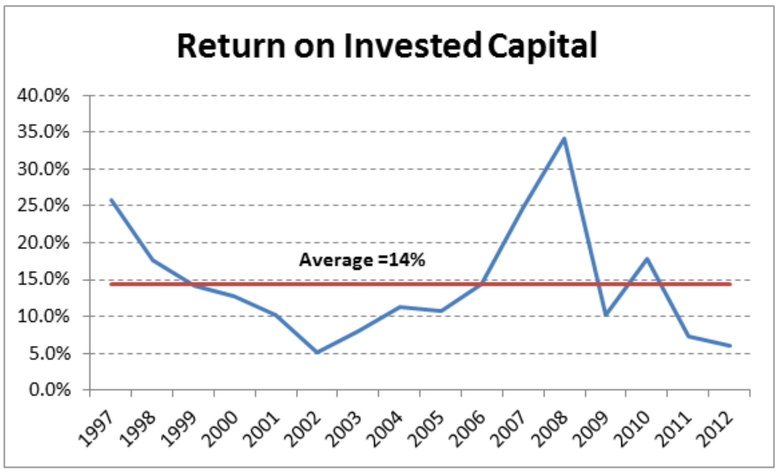
The International Monetary Fund reduced global GDP estimates three times during 2012, an admission that its rosy outlook for the world economy had been too sanguine. The share price of GrafTech International, a leading supplier of graphite electrodes that are used in the production of steel, dances pretty closely with GDP, so 2012 was an electric slide downward for this economically sensitive *Pro* holding, and the new year has yet to bring improvement.

Management's commentary on the recent conference call highlighted the company's Chinese competitors behaving badly, adding capacity in the face of soft demand and showing willingness to export electrodes at a loss. Thanks to those competitive challenges, GrafTech is faced with 10% price reductions instead of the 10% price increases it had expected. Couple that with a capital-hungry business, and our estimate of GrafTech's intrinsic value falls to $9.75.

Additional capacity without pent-up demand is not good for any supplier in the industry, but we don't think the new supply will prove to be oppressive. Up to 100 million metric tons of new electrode capacity will be available this year, and while that number could increase by an additional 130 million over the next few years, not all of that supply is of the typical high grade that GrafTech sells. We estimate that supply will expand by 14% at worst over the next couple of years. We also believe that many of those excess electrodes will find eager buyers in more electronic arc furnaces, driven by ever-higher quantities of scrap steel and a renewed focus on environmentally clean production.

While supply expansion will keep downward pressure on electrode prices, this sort of behavior is not uncommon in the steel supply chain that GrafTech inhabits, and the company has successfully navigated such turbulence in the past. If Chinese suppliers persist in exporting their product at a loss, we think the most likely outcome is that GrafTech's low-quality, high-cost competitors will suffer the most — maybe even go belly up and be flushed out of the market. Meanwhile, as a large, high-quality, low-cost producer, GrafTech is the best positioned in the industry to weather this storm.

GrafTech also has the financial wherewithal to sustain a downturn. True, the company is making use of debt, but that debt doesn't mature for a few years; in the meantime, GrafTech has an impressive history of cash flow generation behind it, plus an extra source of cash in the upcoming release of extra inventory as its disadvantaged take-or-pay needle coke supply contracts roll off. (In order to obtain Department of Justice approval for its acquisition of its main input supplier, GrafTech had to accept disadvantaged, multi-year sourcing contracts from a competing supplier; those contracts should be fulfilled by mid-year, allowing management to better control inventory and working capital.) On top of that, GrafTech's heavy investments in increased quality at its needle coke plant are now complete, so future long-term returns on capital should be attractive. Even in a sloppier competitive environment, GrafTech should still be able to earn attractive full-cycle returns.



Source: Analyst estimates.

The Foolish Bottom Line

The last piece of the GrafTech puzzle is the price we're paying. At about $7 per share, GrafTech is selling for just about the book value of its assets, but it's the electrode kingpin with a history of strong profitability and a portfolio of graphite science patents (graphene!). At today's valuation, we believe it deserves a bigger position in our portfolio.

Next Steps

- Bring your questions to the GrafTech discussion board.
- For more details on 2012 earnings, see this post.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Hedging Vs. Shorting

Published Mar 11, 2013 at 12:00AM

Dear *Pro* Members:

We're almost there! This Thursday, March 14, we will issue our last Catch-Up Report, which will complete our guidance on our long positions for members who joined in February. Then, on Tuesday, March 19, we'll release our Portfolio Positioning Report for all members, in which we'll discuss hedging, shorting, and options and provide you with our most current guidance on those parts of our portfolio. We'll have a live member event to coincide with that report, as well. Finally, we'll be making new trade decisions soon, so it'll be a full March as we roll into another glorious spring in the United States.

As we gear up for all this, let's talk about the difference between hedging and shorting — especially for the uninitiated.

Hedging Is About Market Exposure

Hedging is fundamentally different from shorting. Hedging is about determining how much market exposure you want to have at any given time and setting up your portfolio accordingly. Beautifully, hedging makes it possible to reduce your exposure to market risk without selling any of your stocks.

Here at *Pro*, our goal is to make money steadily, so we want to have positions that work for us in declining markets as well as rising ones. A good hedge serves this purpose, allowing us to stay invested in great businesses while reducing exposure to the market's periodic falls. Here's how that looks in practice: Let's say you're 90%

invested in stocks and 10% in cash, but prices have risen considerably and you want to reduce your market risk. You could set up a 15% short position on a market index that's closely correlated with your portfolio — then, with one simple trade, you suddenly have only 75% net exposure to the market, and yet you haven't sold a single stock.

Hedging in this way ensures that you'll continue to enjoy upside, but at least one position — your large index hedge — is certain to work in your favor when the market declines. You're still 75% net long, and many of your stocks should go up *more* than the index you're hedging with — in other words, if you choose your stocks well, your portfolio will outperform the index when it rises even when you're hedging with the index. Ideally, you'll end up with strong returns but with much less risk than someone who's 100% long, all while holding a diversified portfolio that has positions that will benefit you in a downturn, too.

Hedges like these help you stay calm and focused during market declines, and when you close them at a profit, they're a source of capital you can reinvest. Just remember: Hedging is about determining how much *market exposure* you want, then sensibly positioning your portfolio to match. *Pro* has opted to be majority-long since 2009, and we're here to guide your exposure higher and lower as we see fit, because it will change.

Shorting Is a Directional Investment

Unlike hedging, shorting — selling individual companies (or ETFs) short, aiming to profit when they fall in price — is purely a directional investment. Just as we buy companies because we believe they will increase in value, we sell stocks short when we believe they will decline in value. Shorting is not, by definition, a market hedge (a stock you sell short can easily go *higher* even when the market falls, while a proper hedge cannot). You short a position when you're convinced it will fall in price eventually, but as you've no doubt heard (or even experienced), short sellers often suffer during unexpected bull markets. At *Pro*, we sell short very selectively because of this, and because we're mindful that any shorts must compete for our attention and dollars with long investments, which often have more potential.

For more on hedging and shorting, please visit some past Memos:

- Losing Is Mission-Critical
- Hedging the *Pro* Way
- Sharing Our Shorts
- The Long and Short of It
- See all *Pro* Memos here!

We'll be in touch again soon! Meanwhile, meet us on the Memo Musings board for discussion. Thank you for being a *Pro* member, and Fool on!

— Jeff (TMFFischer)

Coverage & Community

- **AIG Gets Jiggy With It:** Seriously, the business continues to move in the direction we want to see. It remains a Buy First.
- **GrafTech Gives Us the Nitty-Gritty:** The electrode producer for steel mills is going through hard times. Do we have a great buy here? You'll hear our decision soon.
- **"Making Pro Fit You" Debuts!** This brand-new board will help you make *Pro* the perfect service for your personal needs.

Guidance Changes

- **CME Group**: After leaping this year, the stock moves to "hold" while we reassess its attraction for new potential buyers.

Pro Catch-Up Trades

- **3D Systems**: If you don't have exposure to this 3D printer company, sell to open August 2013 $22.50 puts, lately for about $1.20 each (that's a 5.3% yield in about five months). Sell one put for every 100 shares that you could buy at a net $21.30, up to a potential 2% stock allocation in your portfolio.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Alpha Transition Reports

Published Mar 8, 2013 at 12:00AM

Welcome, Fool! These Catch-Up Reports are designed to provide you with the guidance you need as you transition from *Alpha* to *Pro*.
Start with Report No. 1, and watch this space for new reports through March 18.

Alpha Transition Report No. 1: March 8, 2013

- Download (PDF)

Alpha Transition Report No. 2: March 12, 2013

- Download (PDF)

Alpha Transition Report No. 3: March 15, 2013

- Download (PDF)

Alpha Transition Report No. 4: March 18, 2013

- Download (PDF)

Why We Manage Volatility

Published Mar 4, 2013 at 12:00AM

Fellow Fools,

Pop quiz: Which portfolio would you prefer to own?

Year	Portfolio A	Portfolio B	Portfolio C
Year 1	(20%)	20%	15%
Year 2	(10%)	15%	(20%)
Year 3	10%	10%	(10%)
Year 4	15%	(10%)	10%
Year 5	20%	(20%)	20%

Portfolio Positioning Report Coming March 19

Our Catch-Up Reports are focused on getting you into our long positions, but we haven't forgotten about shorts, hedges, and options (far from it, as this Memo proves). On Tuesday, March 19, we'll release a Portfolio Positioning Report that tells you how to short, hedge, and use options to match our exposure and general portfolio position, even if you can't or don't want to engage in every strategy we employ. **We'll also have a live chat to coincide with the report's release.** We'll email you about this event as it gets nearer, but mark your calendar now!

The right answer, as far as math and reason are concerned, is "it don't matter." A hundred bucks invested in each of these portfolios would be worth $109 at the end of five years — but nonetheless, you were likely drawn to one portfolio over the others. Perhaps you started at A, saw negative performance in the first two years, and hopped to B, which looked good until you realized you'd face a losing streak in years four and five. Or maybe you went with portfolio C, which seems to have gotten its act together after a middling two years. Then again, maybe you saw through my little ruse from the beginning. But even if you did, the return streams shown above had *some* emotional or physiological impact on you, whether you're aware of it or not.

Neuroscience Nuggets

Each time you make an investing decision, you call upon three primary regions of the brain: your wanting system (found in the evolutionarily ancient midbrain), your risk-aversion system (in the newer temporal lobe), and your utility system (in the most recent prefrontal cortex). But don't worry, Fool, your brain is super-efficient; the three sections often do battle without your even knowing it. And it's good at its job — even in the face of many dangers, your brain has kept you, and your portfolio, alive. Still, staying alive and making the best decision are two very different things.

Imagine: You're meandering through a field near your home when you stumble upon a grown lion licking its chops. Upon sighting it, you don't take time to worry about why a lion is near your house or how it escaped from the zoo. You'll ponder those questions later, if you survive, but priority numero uno is not becoming cat food. Instinctively, your brain triggers a few "fight or flight" responses designed to keep you safe: Your heart rate, blood pressure, and breathing pick up, and before you know it you're slowly retreating. You've reacted without consciously having to think.

That's because our brains are highly efficient when it comes to fear. They're always ready to leap into action — and in the presence of a rogue lion, that's great. But your temporal lobe isn't tasked with distinguishing between a hungry jungle cat and stock price volatility; as far as your reaction is concerned, they're effectively the same thing — "threats" to be avoided. The problem, of course, is that the two are completely different, and a sweaty, tense, breathless, reactionary decision to buy or sell is less likely to serve you well in the future than a sweaty, tense, breathless retreat from a lion.

Staying the Course

Pro's efforts to lessen portfolio volatility — through shorts, hedges, and a constant focus on our North Star — are a down payment on better decision-making.

- Lower portfolio volatility lets you make your financial decisions deliberately, not reactively (steady breathing and a less sweaty brow are bonuses).
- When your temporal lobe kicks into auto-pilot, it can call upon past experiences to influence your response. In this way, practice makes perfect: The more volatility you live through, the better your brain can distinguish between volatility and a lion, and the better prepared you are for next time.
- Lower volatility means you're less likely to buy and sell hyperactively, keeping your transaction costs and tax consequences lower.

Making deliberate decisions, accumulating ever more experiences to call on, and avoiding "anti-returns" are all great ways to stay the course and stick to your financial goals. Adding our North Star to the mix reinforces that discipline by providing a constant fixture upon which to orient our focus.

Manage Your Portfolio's Volatility

We've written about behavioral economics (the study of common deviations from rational financial choices) on several occasions. (Clearly, we think it's important!) The budding field of neuroeconomics is bolstering the findings of behavioral economists by applying scientific observations to their results, and both groups are finding evidence that our brains and bodies are hard-wired to work against us in some situations. That means that without the proper defenses, well make bad decisions.

But fear not, *Pro* Fool — we've built those defenses into the *Pro* portfolio, and we're constantly refining our thinking to make sure they evolve as we do. Our portfolio is designed to dampen volatility via cash, shorts, hedges, and diversified business risks. If you're currently catching up with us, you'll have noticed that our Catch-Up Reports are focused on our long stock holdings. That's because we think you need a long portfolio in place before you begin using other strategies to protect it — so after our final Catch-Up Report is released on March 14, we'll issue a Portfolio Positioning Report that tells you how to short, hedge, and use options to match our exposure and general portfolio position, even if you can't or don't want to engage in every strategy we employ. **We'll release the Portfolio Positioning Report simultaneously with a live chat on Tuesday, March 19.** Whether you're a new *Pro* member or a wily vet, this report (and chat) should help make sure you've got the information you need to get aligned with all aspects of our portfolio.

Onward,

Bryan (TMF42)

Guidance Changes / *Pro* Trade Roundup

- None this week!

Coverage & Community

- **The Road Ahead**: Jeff lays out what to expect from *Pro*.

- **Mandatory Reading**: Warren Buffett's annual letter to shareholders is now available.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Catch-Up Reports for New Members

Published Feb 28, 2013 at 12:00AM

Ready to Become a *Pro* Investor? These Catch-Up Reports give you everything you need to match your portfolio with ours — quickly, painlessly, and (we hope) enjoyably. Start with Report No. 1, and watch this space for new reports through March 19. (Veteran *Pro* Fool? The guidance in these reports is not new, but if you need some help catching up with us, feel free to peruse them!)

Catch-Up Report 1: Feb. 14, 2013

- Download (PDF) (All in Cash Version)
- Download (PDF) (Currently Invested Elsewhere Version)

Catch-Up Report 2: Feb. 28, 2013

- Download (PDF)

Catch-Up Report 3: March 7, 2013

- Download (PDF)

Catch-Up Report 4: March 14, 2013

- Download (PDF)

Portfolio Positioning Report: March 19, 2013

- This report will tell you how to short, hedge, and use options to match our exposure and general portfolio position, even if you can't or don't want to engage in every strategy we employ. We'll also have a live chat at 1 p.m. ET on March 19 to address any questions you may have about this report.
- Download (PDF)

Pro Academy

Published Feb 28, 2013 at 12:00AM

Looking for the info from our "*Pro* Academy"? You can find it here!

Video 1 (PDF)

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Video 2 (PDF)

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Video 3 (PDF)

ZsYjI1OTphCOF4rfuL_khmGE8zGZFxvF

Join Us on the Pro Tour

Published Feb 25, 2013 at 12:00AM

Fellow Fools,

This week's Monday Memo comes to you in video form, as Jeff explains what to expect from *Pro* over the coming few weeks. Click the player below to watch — the transcript follows!

Enjoy, and let us know your feedback (more videos? Fewer videos? More videos, but with Jeff wearing hats?) on the Memo Musings discussion board.

— The *Motley Fool Pro* team

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Transcript

Greetings, *Pro* members, and welcome to this week's Monday Memo!

Will YOU Be the ONE?

On March 14, Motley Fool co-founder and CEO Tom Gardner will invite a few top Fools to **give up their *Pro* memberships** and join him in a premier "club" that gives you access to every wealth-building tool, product, and service we've developed over the past two decades — including *Pro*. **Only about one out of every 100 investors**

who apply will be able to join. To see if you qualify and learn more about this one-of-a-kind endeavor, simply click here.

I'm Jeff Fischer, advisor on *Motley Fool Pro*. First, I'd like to welcome our new members. We're delighted that you've made the smart choice to join. Here in *Pro*, we invest to make steady returns in any market. We aim to do this by owning shares of great companies — our "core holdings," usually numbering around 20 or so. But we go further than that. At *Pro*, we also hedge our portfolio to protect our results, and we sell short to profit on falling prices, whether it's a failing company we'll sell short, or a flawed ETF. Last, but certainly not least, we use options — primarily to generate steady income whatever the market does, but also to leverage our upside with much less capital at risk, protect against downside, and smooth out volatility.

This four-pronged approach in our portfolio, an approach that I've been developing for more than a decade, is what makes the Pro strategy such a robust and successful one over the years. And yet, it's simple enough for everyone. To review, we have:

- Core stocks, for long-term compounding
- Hedges, to protect our gains
- Shorts, to profit on falling prices
- and options to generate income, along with their many other advantages

Now, as new *Pro* members start to get up to speed with us, I want to thank our many veteran *Pro* members for helping them on the discussion boards. It has been outstanding to see so many great Fools helping other members on the boards, including — to name just a few — stamleo, RockyTopBob, fullofcarp and BlackLineVestor. Thank you, to these Fools and so many others, for your amazing work helping new members start to invest successfully.

That's obviously why the *Pro* team is here, too — we're here to help all of us reach our financial goals. We know the stock market doesn't always go up; in fact, the so-called "easy gains" of the last few years are sure to wane in strength, and at times the market will reverse. This is why we want to maintain an opportunistic and yet defensive portfolio. We want to own the great companies of our age, to grow value with these leaders over time; but we want to be positioned to have winners when the market falls, too, including our shorts and options; and, we want to see price declines as opportunities. That's easily possible when we have cash on the side, as we do today.

As I tape this, the Pro portfolio is 65% net long, with nearly 20% of our value in cash. We will welcome pricing opportunities, and put our money to work in new ones, whenever we see them. In fact, a few are in the works right now.

At the same time, we strongly believe in the stocks we own and currently recommend, so we expect new members to start to build a *Pro* portfolio to match ours. We'll help you every step of the way. New members should take advantage of the welcome materials we offer, starting with our two Buy First stocks — AIG and BMC — detailed in a special Catch-Up Report.

Next, on Feb. 28, in a live *Pro* event, we'll recommend our next handful of positions that should be bought and why. All members should benefit from this event. We'll send you reminders, but put Feb. 28 on your calendar. After that big day, we'll follow-up with more buys soon after, and then we'll help new members who want to get into our hedges and options, too.

All you need to do is watch your inbox for our guidance. And as you settle into *Pro*, at your leisure you can read our *Pro* Guidebook to see what we believe, how we invest, and much more. And finally, every member will receive our brand-new recommendations to their inbox as soon as we have them. Expect several in just the near future as we position the portfolio for 2013 and beyond.

As always, here in *Pro*, we will move with purpose, but at a reasonable, gradual pace. We invest to build real wealth over time. We're not interested in small short-term gains and losses that come at a high cost, eating up hours of our precious time every week. Instead, we're interested in steady, recurring profits that drive our portfolios ever higher over time, while letting us live our lives Foolishly. That's *Pro*.

To close today: Every Monday, you'll receive this *Motley Fool Pro* Monday Memo in your inbox. It's a great touchstone column (or sometimes video!) exclusively for *Pro* members. The Monday Memo shares our current thoughts, lists our recent trades, points you to great *Pro* community discussions, and recommends "Catch-Up Trades" that you can use anytime to get into a *Pro* position you lack. So, mark off five to 10 minutes every week to read — or listen to — the Monday Memo. It's a good investment, just like *Pro*.

Welcome again to new members! We're very glad you're here — we're glad you want a portfolio that doesn't *only* make money when stocks go up. And thank you again to veteran *Pro*s for welcoming new members into the fold. I look forward to investing very well together in 2013. We'll see you on the discussion boards, and we'll talk to you again soon. Fool on!

Guidance Changes

- **AmTrust Financial Services**: Fair Value rises to $33.50 from $30.45.
- **Rockwood Holdings**: The stock moves to Hold pending a review of earnings, the recent surge in share price, and management's statement that three divisions are up for sale assuming the right buyer.
- **3D Systems**: We're not making any official guidance changes, but the stock split 3:2. Our options on the stock did, too. Nothing changes, except our strike prices will adjust 3:2, along with the share price, our Consider Adding More price, and our Fair Value estimate.

Coverage & Community

- **All Tests Look Normal:** Bryan (TMF42) reviews earnings at medical devices giant **Medtronic**, which we rate a "Buy."
- **Rockwood Rocks the Rumors:** The company is willing to sell three of its five divisions. Jeff reviews results.
- **Meet & Greet:** Say hello to our new *Pro* members as they Foolishly introduce themselves!
- **Getting Started:** Remember when you were just starting out with *Pro*? Now's your chance to help our newest investors start off on the right foot. See if you can answer any questions — and thanks in advance from the *Pro* team!

Pro Trade Roundup

- **SPDR S&P 500** : Our February 22, 2013 $151 covered puts on our index hedge expired as income. We'll look to re-up the position.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

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6 Ways to Fail at Being a Pro Fool

Published Feb 19, 2013 at 12:00AM

Fellow Fools,

With advisor Jeff Fischer (TMFFischer) returning from Costa Rica as we speak, I have the honor of publishing this, the first *Pro* weekly memo that many new members will see. First, I want to extend a sincere “Welcome to the *Pro* family!” to everyone who’s just joining us. The desire to help all *Pro* Fools invest better and achieve their financial goals — and thereby add a little value to the world every day — is what drives not just the *Pro* team but also many of our amazing members. As you get caught up with us, we hope you’ll see proof of this on our active, thriving discussion boards. There are some thoughtful people on the other side of the screen who spend their free time welcoming, tutoring, debating, teaching, and learning with (and from!) their fellow Fools, and over the years, we’ve genuinely become family and friends.

So in other words, it’s a good time to be a *Pro* Fool! And even better for my purposes, the most helpful topic for this space — how to get the most out of your *Pro* service — has already been written. Whether you’re brand-new or have been with us since 2008, if you’re reading this but haven’t already read the *Pro* Site Directory twice (or, fine, once, but *carefully*), you should click this link and ignore this memo.

Still here? OK, but consider: This Site Directory isn’t like the instruction booklet for your smartphone, or the manual for your car. After all, you already know how to make a phone call and drive a car — but while *Pro* might look like other Fool services you’re already accustomed to, we’re different, and the same rules don’t always apply. You’ll need the Site Directory to get acquainted quickly. Go ahead and get started here.

“Invert, Always Invert”

OK, now that everyone but you is flipping through the directory, let’s steal a page from Charlie Munger and “invert, always invert.” I’m going to detail the easiest ways to fail at being a *Pro* Fool. If we can avoid the common mistakes, we can also improve the outcomes.

1. Use market orders and good-'til-canceled market orders.

Pro members can move the market for a stock or option for several days after we issue a trade alert, so we always recommend using a limit order (which allows you to set a specific buy/sell price). If you want to ensure that you, and others, pay too much, ignore our limit-order guidance and place market orders (which are executed immediately at current prices) instead.

Also, *Pro* is many members’ first experience with options investing. If you’d like to give up a bit of your income so your favorite market maker gets a healthy raise, you should use good-’til-canceled market orders for your options trades. Unlike ordinary orders, which expire at the end of the trading day, good-’til-canceled orders will stay open until they’re filled — and that means those poor enterprising market makers, who stay late to trade after hours, can take a portion of your profits.

2. Over-bet and over-leverage.

If we recommend a mouthwatering investment opportunity, why not invest more than we suggest? You’re more aggressive than *Pro*, after all. Besides, we’re probably understating the reward and overstating the risk, so you can safely ignore our recommended allocation. The same is true for the leveraging power of options; if your portfolio is smaller than you like, just apply more leverage by writing more puts than you can afford. You always have time to start over, right?

3. Only buy our Buy First stocks.

Currently, our portfolio features two Buy First stocks and 16 Buys. If Buy First stocks are the best place for limited capital, isn’t it even better to *only* buy into those stocks and ignore our upcoming Catch-Up Reports, which will help you establish positions in the Buy stocks? For investors who want to have a very un-*Pro* experience, two stocks is diversification at its best.

4. Wait for better prices for our Buy stocks.

Most of the stocks in our portfolio are trading above the prices at which we initially bought shares, so investors looking to miss out on future *Pro* returns should wait until they fall back to our original prices. Such un-*Pro* investors realize that if these were really good buys at this exact second, they’d be Buy Firsts, so why put money toward them now? To these investors, the *Pro* team isn’t managing a portfolio, they’re picking stocks — so it’s OK to buy a few of the ones you really like and expect to get the same benefits as someone following the portfolio to a T. Plus, you still have a bad feeling about this market, and everything will be cheaper soon. You’ll be right this time.

5. Don’t participate

Be a wallflower! Just sit back and observe. Don’t buy into the *Pro* portfolio; taking control of your investing probably isn’t as much fun as it looks, anyway. And for heaven’s sake, please don’t ask or answer questions on the discussion boards. Who has time to learn new skills, achieve better returns, and enjoy some camaraderie?

6. Focus on beating the market

Focus only on beating the market and ignore our North Star. The market is a perfect reflection of your financial goals; when you beat the market, you’ll be able to fund education accounts, pay off the mortgage, retire early, and generate a healthy income in retirement. Plus, everything in life is a race. Steady returns and income-producing tools that beat out inflation have no role in reasonable investors’ tool boxes — ignore them.

The *Pro* Way

By following those six easy steps, you too can ruin your *Pro* experience. But we think it’s more likely that as a *Pro* Fool, you’ll sidestep those mistakes, instead following our guidance to the extent that makes sense for your portfolio. After we close our doors to new members this week, we’ll bring you additional Catch-Up Reports to get you invested alongside us in a sensible, measured manner (and provide some updated thinking for veteran members). Together, we’ll be on our way to earning North Star-like returns.

If you're new, welcome to *Pro*. Either way, we’re very glad you’re here.

Fool on!

Nick (TMFCrow)

Coverage & Community

- **Ubiquitous Bryan:** TMF42 covers earnings for three *Pro* holdings — **AmTrust Financial**Q4 2012; **Broadridge Financial Solutions**Q2 2013; **Pacer**Q4 2012.
- **To CAM or Not to CAM:** A great discussion on *Pro*'s new Consider Adding More price.

Pro Trade Roundup

- **SPDR S&P 500**: February $140 and $145 puts expired.

- **Pebblebrook Hotel Trust**: Sold all shares at an average price of $24.53.

The Motley Fool owns shares of Pebblebrook Hotel Trust. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Pro's Investment Strategy Guide

Published Feb 13, 2013 at 12:00AM

Getting Started With *Pro*

1. Catch-Up Report No. 1
2. ***Pro* 's Investment Strategy Guide**
3. What *Pro* Believes
4. Use Options Like a Pro

Back to Guidebook | Site Directory

You may already have noticed two things about *Motley Fool Pro*:

- Between our real-time trades, our Monday Memos and other communications, and our active discussion boards, things can move quickly in *Pro*-land.
- Despite that fact, advisor Jeff Fischer and the analyst team are some of the calmest, most reasonable investors you're likely to meet anywhere.

We think that combination of nimble thinking and sound, sensible decision-making is part of what makes Pro so great, and to highlight the second half of the equation, we've put together this Investment Strategy Guide. It takes you behind the scenes, detailing the steady, rational approach that has made Pro so successful. Our mission is to earn you consistent, recurring profits with a high level of accuracy using a combination of stocks, options, and ETFs. We use stocks for long-term gains and options for shorter-term strategies. This Investment Strategy Guide shows you all the ingredients to our secret sauce, including how we invest, how we allocate our capital, details on our North Star, and more.

Click here to download the Investment Strategy Guide

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Published Feb 13, 2013 at 12:00AM

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1. Catch-Up Report No. 1
2. ***Pro* 's Investment Strategy Guide**
3. What *Pro* Believes

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Click here to download the Investment Strategy Guide

"Invest Like a Pro" Live Event

Published Feb 12, 2013 at 12:00AM

Don't miss our upcoming LIVE event for new *Pro* members (current members welcome too, of course)! On Thursday, Feb. 28 at 1 p.m. ET, Jeff and the *Pro* team will release our second catch-up report for new members — and then answer your questions on video and via a live chat. If you can't participate live, don't fret; the Catch-Up Report and archives of the video and chat will all be available on the *Pro* site immediately following the event.

The live event is a great chance for new and veteran members alike to get to know the *Pro* team and ask your burning questions about the service, how to align your portfolio with *Pro*'s ... anything at all. We look forward to "seeing" you on this page on Thursday, Feb. 28!

"Invest Like a Pro" Live Event

Published Feb 12, 2013 at 12:00AM

At our live event on Thursday, Feb. 28, at 1 p.m., Jeff and the *Pro* team discussed our second Catch-Up Report for new members and answered your questions on video and via a live chat. Relive the magic below!

Watch the video (the transcript is at the bottom of this page):

Replay the text chat:

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Transcript

Danny Hsia: Hello Fools, welcome to the Motley Fool *Pro* member chat. My name is Danny Hsia. I'm the publisher on the Motley Fool *Pro* service, and I'm here with an amazing team. Folks, introduce yourselves, please.

Jeff Fischer: Thank you, Danny. I'm Jeff Fischer, advisor on *Pro*.

Nick Crow: I'm Nick Crow, senior analyst on *Pro*.

Bryan Hinmon: And I'm Bryan Hinmon, analyst on *Pro*.

Danny Hsia: And of course, if you're familiar with our process here, right here you're watching us on the live video stream and below the stream you will see what you're familiar with also, which is the text portion of the chat. That's being manned by our illustrious editor, Ellen Bowman, as well as a few other former *Pro* analysts in Jim Mueller and Alex Pape.

Just to set up the hour that we have with you today, for the first probably 15, 20, 30 minutes, we will discuss the Catch-Up Report, which if you are new to Motley Fool *Pro*, and welcome, you would have received an email just a few minutes ago. It's called Catch-Up Report Number Two. It's very creatively named, and we're going to go through the Catch-Up Report. The guys here will talk about the three specific stocks in the Catch-Up Report and what action you should take. Then after that, we want to makes sure Nick and Bryan are able to get to the text questions, because we know not everyone was able to watch or listen to the video stream, so they'll be taking off, heading back to their computers and answering questions and then Jeff will have the unfortunate luck of being in the studio with me for the rest of the hour.

Jeff Fischer: Perfect. And we'll answer as many questions as we can during that hour too.

Danny Hsia: Exactly, we'll also answer as many questions during that time here on the stream. Now you guys want to say hello, say hello to the new members, say hello to the veterans?

Jeff Fischer: It's a great pleasure to welcome you again, new members, and to see you again, veteran members, whether you've been with us since 2008 or any year to follow, we're very glad you're here. We're looking forward to a very good 2013 together, and it all starts right now with these next investing steps that will then lead to more steps next week and so forth. It's all in process. Thank you.

Danny Hsia: Now Nick.

Nick Crow: No, we might as well get started. I know how these live chats go and the questions are rolling in and I can't answer them, so …

Danny Hsia: Sure, well let's get started. So I mentioned the Catch-Up Report number two, so if you're new to Motley Fool *Pro*, when you joined us you should have gotten a link to go to the site and from the site you would have seen a link to the first Catch-Up Report. Nick, why don't you tell us what's the point of these Catch-Up Reports? Why do we have them?

Nick Crow: Well we've been running the *Pro* Portfolio since 2008 and there are lots of wonderful positions there that we want to get our brand new members invested in, and sometimes that's difficult for them to do because they have an existing portfolio and they don't know how do I get started? Are these things still okay to buy? So we write up these reports to let you know, yes, in fact they're okay to buy. It says how much to buy and this is why we like them now at the current prices.

Bryan Hinmon: It can be a little overwhelming at first to walk into a new portfolio, right? You come to *Pro* the first time, you go to our portfolio recommendations page and you see a list of 25 long holdings, four or five short holdings and a handful of options positions. So the Catch-Up Reports are really designed as a systematic way to get new members comfortable with what we own and why we own it.

Jeff Fischer: Yeah, imagine the portfolio as a river that's moving along at a really good pace. We're helping new members step into it where it's very shallow and gradually work their way into it until they're swimming along with us for all the years to come.

Bryan Hinmon: Yeah, a more violent way to look at that is merging onto a super highway, right? What we're trying to do is give members a reasonable merge, an on ramp.

Danny Hsia: Especially if you get one of those guys that are going 40 M.P.H. in the right lane and there's no way you're going to get into the left lane, right?

Jeff Fischer: See, I like the rive analogy.

Nick Crow: I do too, and we once got to drop Jeff in the river out of raft in a very abrupt fashion, so he's sensitive to merging people into the river gradually.

Danny Hsia: And he let you guys back on the team.

Nick Crow: He did.

Danny Hsia: Like we mentioned, we've already released the first Catch-Up Report, which for new members you received when you joined, and just to make a quick point for anybody that's an existing member, if you haven't seen these Catch-Up Reports, just head to the guidebook tab on the *Pro* site and you will see a link to all of the Catch-Up Reports, so you can access those Catch-Up Reports there.

Now the thing we want to make sure we stress is the stocks in any Catch-Up Report are already existing recommendations that the team has made and you should have already seen as an existing member. This is really geared for the new members, but of course as an existing member, feel free to look.

Jeff Fischer: Yeah, it's a great reiteration of why we own what we own, why we believe in it. The first report, Danny, as you mentioned from a week or so ago, was to buy AIG, insurance giant AIG, and BMC Software, which is a software provider, obviously. Two companies we really believe in at current prices, and so they were our two Buy First Stocks. we told you exactly how much to buy in each one, and now we have three new stocks that we're going to recommend to all members to buy in the allocation we recommend, if they don't already have it.

Danny Hsia: And that's a great segue. So we mentioned there are three stocks in Catch-Up Report number two. Let's get right into it. The first one, Gentex, and Bryan, I believe you know the most about this one or this was the one you researched the most, so why don't you tell us a little bit about it.

Bryan Hinmon: Yeah, absolutely. The way I think about how recommendations come through here is the more boring they are, the more likely they are to be one of my selections.

Danny Hsia: This is personal for him, as well, just in life. No, that's not true.

Bryan Hinmon: Fits my personality well. Yeah, very quickly, Gentex operates in the very exciting business of making mirrors for automobiles. Now many people would not think that making mirrors, or any auto part for that matter, is a very good business, but Gentex is really a freak of nature. The company started making smoke detectors. It was in that business for a while. That's obviously not a very good business.

Throughout its entire history, it has invested a lot of money in research and development. Early in its years, that research and development turned out the, somehow they generated the ability to create dimming mirror technology. They kept going with that and in 1987, they were the first to figure out electrochromic mirrors, which basically is a way that takes a reflective mirror and dims it appropriately so that you can; its reflective properties aren't impacted.

So this obviously comes into play when you're driving on the road and someone comes up behind you with their lights on. Their lights go through your rear windshield, bounce off your mirror and they blind you, so it's a safety concern. So Gentex mirrors solve that problem by when the light comes through, the mirror automatically dims to the appropriate level so that the reflection remains clear and you remain safe.

Danny Hsia: You seem very concerned with highway safety today.

Bryan Hinmon: You noticed that I linked to that, right? I'm trying to scare…

Danny Hsia: Highway safety awareness year, is that right?

Bryan Hinmon: I'm trying to scare all of our members onto this highway safety thing so that they rush out and buy cars that have Gentex mirrors in them.

Nick Crow: Excellent.

Danny Hsia: So they're benefiting themselves.

Bryan Hinmon: Yes, precisely. So anyway, these mirrors are better than standards mirrors, but as it turns out, the adoption of them has taken a while. So they introduced it in 1987; today almost 50% of new cars in the United States have these auto-dimming mirrors. Worldwide it's only about 23%. So that adoption we think worldwide, where it stands at 23%, can ultimately get somewhere close to where it is in the U.S. now. And it's important to know that adoption in the U.S. is still growing. Over the past couple of years, Gentex has picked up a couple percentage points of penetration from about 45 closer to 50. So we're coming off of really low car sales. People are putting more of these mirrors in cars, and then we have this global focus on safety where more Gentex mirrors are being put into new models.

So there's a long runway of growth for Gentex. The company is incredibly competitively advantaged, too. It has eight times more market share than its closest competitor. So it invented the technology, it's eight times bigger than its next competitor; it sells the most units and sells them at the best cost. So it's in a really good position to sell to auto manufacturers. And because of its cost advantages, it earns really good returns on capital and profit margins. This is very uncommon for an auto parts supplier, so this is really, Gentex is really a diamond in the rough.

Jeff Fischer: And Bryan, I'll add that Gentex, those following Wall Street closely and Gentex even closer, recognize it as a quality, premium company and historically it's been giving us a premium to the market regarding its valuation. In the past year when we started to buy it, shares had come down to a price where we found them especially attractive and that remains the case today.

Bryan Hinmon: Yeah, that premium valuation was the result of, like I said, the company's ability to generate big profits and high returns on capital, but also because you've got this sort of dual growth trajectory of more cars being made and sold every year and more cars adopting this mirror technology, the company has increased sales close to 20% over a 20-year period. That's really, really remarkable. Few companies are able to compound their sales growth at that high a rate over time. if global penetration can get anywhere close to where it is for the U.S., we see no reason that that shouldn't, that double-digit, close to 20% growth, shouldn't continue for another decade plus.

Jeff Fischer: Right, and what we love too, Danny, is Gentex continues to innovate. Their research and development budget is very healthy and they're working on things, of course, such as auto-dimming side view mirrors, smart beam headlights.

Bryan Hinmon: I want to tell our members as soon as the chat is over, don't do it now, but as soon as the chat is over, go to YouTube and search for "Gentex Smart Beam" and watch a couple of the videos there. The Smart Beam technology is really pretty cool.

Danny Hsia: And is it something that no one else has?

Bryan Hinmon: It is something that no one else has, so the mirror has also become a home for different technologies. So for a while there, you know how mirrors had sort of cardinal directions, like you said. You're going north; you're going south, right? Now it's being homed to, because we look at the mirror so frequently, it's a great place to communicate with the driver, so more and more technology is moving on to the mirror.

So now you're seeing things like road sign recognition, so it tells you that, Hey, the speed limit changed or it's saying, Hey, there's a car ahead of you or, Hey, you just ran out of your lane; what's going on, right? So all of these technologies are; Smart Beam is really cool. Smart Beam is a forward-facing camera that senses everything around you, so there have been all sorts of studies shown that say drivers do not use their high beams and low beams optimally. And so having this camera look forward, it automates the use of your high beams and low beams, so it senses cars in front of you and turns your low beams on instead of your high beams.

And it also senses curves in the road and will move the headlights so that you can sort of see better around those curves. So it's all safety driven, all technology driven, and it all focuses on a better mirror.

Nick Crow: Now I like this, but you were talking about communicating with the driver, and my daughter starts driving in the next few years and I think what she'd really like is like her Twitter feed and Facebook up there, so how long till that happens?

Bryan Hinmon: Well this is why I feel good about knowing that the company is focused on safety improvements.

Nick Crow: Not going the other way.

Danny Hsia: Distraction improvements? That's an oxymoron, right?

Bryan Hinmon: And Danny, the last thing that we really like about Gentex is it's really conservatively managed. The company has no debt, has $4 a share in cash and it's a $19 stock. So it's very conservatively managed and that's important in this industry because as we saw a couple of years ago, auto sales can fall off a cliff and bad things can happen. Not only did our automakers almost go bankrupt or some did, but the auto parts suppliers also had to be bailed out by the government. Gentex sailed through that smoothly. Their sales went down, but they were never in any sort of financial duress.

Nick Crow: We've mentioned that they bought back shares during that period of time, which shows you a management team who's built a business that they're incredibly confident in, even while sales are dropping.

Danny Hsia: That's a good kind of long-term signal, right?

Nick Crow: It's phenomenal, when shares are down and sales are down and you're able to deploy capital into your own shares, it was a really smart move.

Bryan Hinmon: Yeah, management has only bought back Gentex shares three or four times in the company's long history. Each of those, until this recent one, which we don't know yet, each of those has proven to be a really, really smart time. So they're very discerning about when they buy shares back, but they have started buying shares back recently.

Jeff Fischer: And one more quick thing, I don't believe we touched on, Danny, is they also provide rear camera display in their mirrors themselves, which is of course…

Danny Hsia: Right, so you can see as you're backing up from the…

Jeff Fischer: And eventually we don't know yet exactly when the law will pass, but eventually all cars are going to be required to have that sort of display. Bryan, can you quickly tell members how much we believe they should allocate to Gentex, and then add on to that how much we're comfortable with we may add more at other prices. We're always thinking in two steps.

Bryan Hinmon: Yeah, absolutely, sure. So the allocation will bounce around in the past couple days, so I might not get this exactly right, but I think the recommended allocation we put out was 2.7%, so 2.7%. We have purchased Gentex twice now. As soon as we bought it, the company came out with some bad news and the shares got hammered and we jumped in and rebuilt our position there to about 2.7%.

Personally, when I'm looking at a business for the *Pro* portfolio, I like to assess whether or not it's a really, really high quality business or if it's just a really, really good value. Really, really high quality businesses are ones that we're willing to make oversized positions. I look at Gentex and see it in that mold. This is a very, very high quality business that could one day be an oversized position in PRO if the price was right.

So a normal starting position for us is about this, 2.7%. But if we get the opportunity to buy shares really attractively, we would absolutely bump this up to I'd say probably four or five percent.

Danny Hsia: Folks, I think if you're playing along at home and you're looking at the Catch-Up Report, that information is all, of course, in this Catch-Up Report, and if for some reason you lose the link to the Catch-Up Report or you want to look on the site, it's also available on the site. So you can find these things from your email and on the site, so just make sure you check all those places if you're not able to find it.

Bryan Hinmon: The specific guidance for Gentex was buy 2.7% at about current market prices, which is about $19 a share.

Jeff Fischer: Yeah, it's a good price, great starting allocation that we can always add to if we decide to.

Danny Hsia: Okay, are we good on Gentex? Are we ready for the next one?

Bryan Hinmon: I'm good.

Danny Hsia: Okay, now if you're looking at the Catch-Up Report, the next company's Intel, but we're going to hold off because Jeff is going to detail Intel for us, but we'd like to get Nick to talk about MasterCard and then once they're done, we'll let Nick and Bryan get back to the text portion of the chat.

Nick Crow: Do you want to get to the text portion now?

Danny Hsia: No, no, you don't have a choice. I'm sorry; you do have to cover your company.

Nick Crow: No, no, if he wants to, since I'll be covering this one.

Danny Hsia: No, let's let Bryan hang out. He can ask you a couple of questions…

Bryan Hinmon: I've got to grill you on MasterCard.

Danny Hsia: So Nick, please tell us about MasterCard.

Nick Crow: Well I didn't want to say this while Bryan was here. MasterCard is much more interesting than Gentex. And much easier to explain, because members at home are probably very familiar with MasterCard.

Danny Hsia: Rear-facing…

Nick Crow: Rear-facing payments, no. So MasterCard brands and markets, the MasterCard label and banks license this from them basically. They set up an agreement to put the MasterCard label on their cards and then the MasterCard transactions go over their network. This is a beautiful business, so essentially they get a cut of every single transaction that goes over their network. That's phenomenal business.

We talk about toll roads, Buffet's made them famous, financial toll roads are awesome because it doesn't take a lot to set them up; well actually it takes a lot to set them up. Once they're set up, it doesn't take very much to grow the business. You just have to sign up new customers, increase card penetration, which one way to think of that is wallet share.

You want more of your cards in people's wallets than the next guy, and all of that can be very difficult and very competitive business, if your biggest competitor didn't suck. And I just hate to say it, but the biggest competitor isn't Visa; they're actually great also. The biggest competitor is cash. Around the world, 85% of all those types of transactions are still handled in cash, and so that's who you're beating. And when you realize right now that in some countries, it's not always safe to carry a large amount of cash with you. If you're a merchant, you would like to receive payments quickly and cash is great, but as a parent company, taking cash from all of our little outlets and moving them back to the parent company, that costs money also, so it's really nice if you just handled it all electronically.

Bryan Hinmon: Danny, we really like how CEO, Ajay Banga, has framed this competition versus cash versus Visa. He has declared a war on cash. We love it.

Nick Crow: The war on cash is a wonderful way to think of this. So we have a bunch of different warriors. Some have the banner of Visa, some are MasterCard and I like all of them. We have American Express out there too; another wonderful company that we've taken positions in over time, but this in particular here, this is a beautiful business that earns very, very high returns on capital and very, very high profit margins.

They're actually ridiculous, the profit margins that MasterCard's able to earn. And anytime a business earns that type of profits, you always have the eye of regulators, and so the primary risk we always have here are governments taking a look and wanting a larger cut or worried about whether or not competition is even and who's getting most of the value over these networks, and that's going to remain a risk going forward, but MasterCard's navigated that wonderfully, and we expect to see those bumps in the road in the future.

And what's so great is the business is so wonderful and it's providing such a great service and making transactions easier, that we'll continue to profit no matter what happens on that level, short of something that really would make no sense. They'll take those in stride.

Danny Hsia: Great.

Jeff Fischer: Another point, just to make, Danny, is that I believe Nick and I have both followed MasterCard since it came public in 2006 or 2007, so we know it extremely well.

Danny Hsia: Which really surprised me. I really just would have assumed that MasterCard had been public. I mean how long has Visa been public?

Jeff Fischer: Even less time than MasterCard.

Nick Crow: So these were all held under the banks.

Danny Hsia: That's why I don't do these stocks (unclear) and these guys do.

Nick Crow: The banks owned these networks.

Danny Hsia: Okay, I get it, I get it.

Jeff Fischer: So we know them extremely well. We've watched them slowly improve their business, the public-facing side of the business. They came out with an extremely strong business, but they've been slow to reveal exactly how strong their leverage is for the reasons that Nick just mentioned, regulation and whatnot. And they're also still investing in their business because there's so much more room to grow. Nick's exactly right. The vast majority of transactions are still cash, and cash at its basis, is less safe, less transparent, there's less record of it. I think everything in our lifetimes, nearly everything is going to move, certainly in this country and in many parts of the world, to digital transactions, and you need a trusted network and a worldwide network to handle those, and that's where MasterCard, Visa and AmEx are really in the sweet spot there. They have these established networks that all the vendors are plugged into and that all the banks are plugged into and support, so you hear a lot about competitors coming in and disrupting these three giants, but that's very unlikely too. PayPal depends on these networks as well.

Danny Hsia: Right, you can't pay unless you've got…

Nick Crow: There are literally thousands of little payment processors popping up and oftentimes what you see is that some of them are getting financed by the MasterCards and Visas and those types of businesses too.

Danny Hsia: So they're smart enough to kind of get that relationship with these small groups ahead of time.

Nick Crow: Yeah, and you don't tend to hear about those investments upfront. You hear about them once they're kind of paying off in some of those other markets and they kind of are brought under the fold, but they're investing lots of different digital payment networks that go across cell phones and mobile payments primarily is where that innovation has been occurring. But they're wonderful businesses who are going to smartly manage the future as well.

Danny Hsia: All right, sorry, Jeff, go ahead.

Jeff Fischer: No problem. I think one kind of side point that newer members will realize soon enough, but that I'd love to say right now is that in *Pro* we seek to make great money with companies we've known a long time. Bryan has known Gentex for a long time, many years.

Bryan Hinmon: Yeah, close to a decade.

Jeff Fischer: Close to a decade. I've known it nearly that long too, but Bryan's really studied it closely. Same with MasterCard. The company I'm about to talk about, Intel, everyone's heard of it, but I have studied it and known it since the mid-nineties, so nearly, hmm, nearly 20 years.

Danny Hsia: Oh wow. The mid-nineties was almost 20 years ago.

Jeff Fischer: Everyone will tell you, whether it's Warren Buffett or Tom Gardner, you make real money by knowing companies very well and staying with them as long as it's justified, as long as it's merited. We'll have many, many new names come into *Pro*. We always do. Last year we had more than half a dozen, maybe eight or nine new names come into *Pro*, so we'll always have that. And even in those cases, a lot of those names are ones one of us has known for a long time; it's just new to *Pro*.

But the point is, we're going to make very good money by sticking with companies that we know inside and out…

Danny Hsia: And have for a long time.

Jeff Fischer: And have for a long time. And then when we see really great ones that are worth bringing into the fold, we of course do that too.

Danny Hsia: Okay, well so if we…

Male: Let's just review the guidance of today.

Danny Hsia: Yeah, I was going to ask you to review the guidance, and actually I just had a question come in. I wanted Bryan, before you and Nick leave, there was a specific question about Gentex, so I'll just ask that to you after we're done with the guidance on MasterCard.

Nick Crow: Yeah, so to round out MasterCard today, we, in our Catch-Up Report, we're suggesting you take 4.1% of the funds that you're allocating to *Pro* and invest in MasterCard at today's prices. It would be around $515. You can see big dollar changes in MasterCard's price. It might go from 515 to 520, and five dollars seems like a lot in other stocks. That's not a lot in MasterCard because the share is over $500 a piece, so keep that in mind. We're happy at current prices, 4.1% of your money.

Jeff Fischer: And keep in mind, Fools, 4.1%, if you round it to 4% or even up to 4.4%, whatever works for you, just keep it close to that allocation if you really want to mirror our portfolio and our exposure and our hedging; keep it close to the allocation and regarding the odd lots, if you can buy a hundred shares or in 100 share lots of Gentex and it keeps your allocation still close to what we want, then do that because we may use options on it in the future. MasterCard we're much less likely to use options on it.

Nick Crow: Yeah, you'd need over a million dollars to be making that type of purchase in MasterCard. And to his point, there will be some rounding because if you have a more modest portfolio, maybe you're deciding between two or three or four or five shares of MasterCard and so your allocation won't be able to hit that 4.1% mark exactly, don't worry about it. Just get as close as you can.

Danny Hsia: Awesome. Folks, this is such amazing information and this is mostly for the new members; not the only time you're going to get this sort of guidance. You're getting this all the time, every day from this team, so you're really in great hands here.

So Bryan, let me get to this question for Gentex and then Nick, I'm sorry, we don't have a question for MasterCard specifically yet, but I'm sure one will come in. The question was from the text chat from Susan. She wanted to know if the headlights hit a traffic sign, do the high beams adjust down? This technology was used on higher end vehicles many years ago and kind of, sort of worked.

Bryan Hinmon: So the headlight adjustment, so I'm not a smart beam expert, but, the headlight adjustment has to do more with identifying vehicles.

Danny Hsia: Okay.

Bryan Hinmon: Because it's been a long time since I took my driver's test but driver rules say that you have to turn to low beams when you get to within so many hundred feet, right? The processors in the camera and the mirror do that calculation for you. They identify the car in front of you and flip down to low beams in the appropriate way. It's a slightly different technology used for the street sign, road sign identification. It doesn't really have anything to do with the headlights it has to do with the camera coming out.

Danny Hsia: That there's a street sign coming up.

Bryan Hinmon: Correct. Correct. But highly, highly recommend going to watch the videos. Gentex actually has a YouTube channel and so you can get more information on just the base mirrors and the smart beam technology as well as the RCD the rear camera display. And even more entertaining than that, YouTube videos around the MasterCard "Priceless" campaign.

Danny Hsia: So, gentlemen thank you very much, you're welcome to stay or head on over...

Bryan Hinmon: We have to answer questions.

Danny Hsia: So Bryan and Nick will head over to their desks and you can enjoy them digitally on the text portion of the chat and in just a few moments we have our video producer Gail coming in to adjust the camera angle. Now Jeff, while she's doing that, why don't we get into Intel.

Jeff Fischer: Right, a name we all know and some may love. A name that's in many of our computers at home.

Danny Hsia: Sure.

Jeff Fischer: Intel is the largest microprocessor manufacturer in the world and by far the most advanced. It's always a generation or two ahead of the competitors which are generally processor foundries that are located in Asia that produce chips, processors on a mass level for outside customers. Intel owns all that in-house. They own the best processor manufacturing facilities in the world by far and they produce all their own product of course and sell mainly to PC client-based manufacturers, computers, servers, things like that, for data centers, for what you have right there.

Danny Hsia: An iPad and a laptop right there.

Jeff Fischer: Now Intel, you might be surprised to learn that revenue fell 1% last year. Tiny bit (unintelligible) to stay right at its record level of $53 billion which, in the years prior, it had never reached $40 billion a couple years ago. So Intel's much larger on revenue and income than it was a mere three years ago and yet all we hear in the media is the death of the PC. The PC's going away. The PC is not going away. What is happening is our computing devices are evolving. Intel believes, and we happen to agree, that the tablet is not in its final form. There will always be inexpensive tablets that basically just do what the current tablets do which, kind of media consumption. But a lot of people are finding, and we see this around the office Danny, that they want more from their tablet. A lot of people are now reconstructing laptops. They buy a tablet and then they buy the keyboard to attach to it and even a mouse...

Danny Hsia: Before they know it, they have a laptop. It's just not all in one piece.

Jeff Fischer: Exactly. So I think Intel recognized that or got lucky, but either way, what Intel came up with a few years ago was the Ultrabook and they're now shipping, I want to get the number right, it's hundreds, it's much more than a hundred, I have it right in here somewhere. Hundreds of Ultrabook models are shipping now and what these are are a laptop PC, but a lot of them have touch screens like the tablet and a lot of them have screens that come off and you can walk away with as your tablet, so it's the combination product. And thanks to technology becoming smaller all the time, they're extremely light, they can compete with a tablet on size and weight but they're much more powerful than a tablet in processing power and speed, even. So, long way of saying, the number of computing devices that we're all using is growing rapidly and to call things "PC" or "tablet," that's kind of going to merge together. There are going to be all kinds of devices. The name doesn't really matter as long as Intel's processors are in more and more of them. And as the market continues to expand, Intel is now positioned, for the first time, starting last year, they now have products selling to tablet, smart phone, PCs, Ultrabooks, of course, servers, everything that's out there right now they have a product for that's competitive and powerful.

Danny Hsia: And are they, obviously they're focusing on this kind of hybrid tablet-laptop-PC you're talking about but are they just sort of maintaining status quo and there are other areas where they've traditionally (interrupted) or are they doing more?

Jeff Fischer: In the other area like PC in general where those are becoming less important, cheaper models bring in less profit for Intel, so they're really focused on Ultrabooks which are is another way to say a laptop that's superior to ones of the past. And Intel's newest chip, the Haswell chip will launch this year and it will bring the most meaningful performance improvement to PCs, whether it's an Ultrabook or maybe a tablet, since 2003. The best improvement in battery life since 2003, all other kinds of improvements. So they have not backed away at all from just trying to provide the best product they can, whatever the end computational device is. Smartphone standing, they have now chips that compete with ARM Holdings which is the main competitor, on all the various measures you care about--performance, battery life, speed, heat. So, yeah, they're competing on each product level.

Now obviously Intel was slow to get into mobile devices. Part of the reason was that it wasn't profitable in the past when they were just ramping up and they really wanted to continue to lock down their lead in computers and servers. Servers are where they make the highest margins, the most profit and where they're really unmatched right now. PCs, they still have 80% market share. And PCs, the other thing is, in the Catch-Up Report, I hope I'm not rambling too much.

Danny Hsia. No. No, no. Keep it up. That's okay. We've got a lot of questions to get to but go ahead.

Jeff Fischer: PCs, their volume just keeps soaring in China, which is now the biggest PC market in the world. In Brazil, which is becoming one of the biggest markets in the world, I think it's Top 3. And in North America, they're all flat, down maybe 3% last quarter. So it's not dropping off a cliff.

Danny Hsia: That's surprising to hear that, I would have thought that would have dropped off more.

Jeff Fischer: And especially in the face of all the hype around tablets the last couple years and I think that did draw away from PC sales. Everyone wanted a tablet. We bought everyone I know in the office who wanted one, got one, because they're affordable and a fun new thing. But when you put that down and look at what you need to do with a computing device, you come back to your laptop a lot of times. And a lot of us have laptops that are five, six years old now. I do. And we need to refresh. And we're going to go back to these laptops that are very small and slim. The best of a tablet and the best of a PC combined now. And I think that sales are going to at least stay stable if not go up over time.

Danny Hsia: Great. Well, do you want to let the folks know about the guidance for Intel?

Jeff Fischer: Guidance. We have a full position in Intel. It's a 5.1% stake. So about 5% actually now, flat. 5% stake. It's below our "consider adding more" price, so it's a great price to buy it for newcomers. And if Fool's don't have a 5% stake, they can up their allocation to 5%. We're already at 5% so we're going to stick with that.

Danny Hsia: And just to clarify the "Consider Adding More" price, that's what you'll see when you're on the recommendations tab at the *Pro* site for whatever holding you're interested in. That's basically your guidance, the team's guidance on what the price needs to be or near for a member to consider adding more.

Jeff Fischer: Exactly, thank you Danny. So we start with an allocation. We have a current allocation and then we have a "Consider Adding More" price where if the stock falls below that price, we then, it kicks in automatically a thirty day period where the team reviews it and decides whether or not we want to add as a service, more to that position. And then we let you know within that thirty day time period with a trade alert or an update saying "No we're not going to add more now and here's why" or "Yes, let's up our allocation to 5 percent again." So it's a great way to keep all our positions meaningful. We really only want to own things we believe in strongly and then we want to own enough in each to make a difference.

Danny Hsia: Okay. Great. Anything else to add for Intel?

Jeff Fischer: No, I think, I hope all members will read the report and then ask any questions on the Intel board. Let's get to as many questions as we can.

Danny Hsia: Sure. We'll do that right now so we, folks we've got about thirty minutes left on the live stream. And just to reiterate Jeff's point, so we've just gone through Gentex, Intel, MasterCard and then Intel and these are the three latest buy now or buy stocks the team would like you to add to your portfolio in the second Catch-Up Report.

Jeff Fischer: And it makes sense Fools that we're buying larger companies for the most part. As you start to build up a portfolio, it makes sense to us that you start with big blue chip companies. And then over time in the next couple weeks, not a very long time, we'll work in smaller companies and then, once you have a so-called "bullish" or "long" bullish portfolio, then we'll guide you into the hedges and options for those who want to do hedges and options.

Danny Hsia: Which you don't have to do but if you want to you can.

Jeff Fischer: Yes.

Danny Hsia: And like Jeff said, you will be getting more guidance especially for you new *Pro* Fools. And again, for existing *Pro* Fools that have been here, these are all companies that you should be familiar with or at least have seen recommended. And again you can get to the Catch-Up Report either through the e-mail we sent out shortly before the event and from the *Pro* site under the Guidebook tab. Okay let's get to some questions, we have a really really good list here.

Jeff Fischer: Great.

Danny Hsia: Thank you for, to our editor Ellen for queuing these up for me. Let's get right into it. A question from TorFool, I believe it is. "I just sold off my former pre-*Pro* portfolio and am sitting on cash ready to buy the stocks and options to mimic the *Pro* portfolio. I've already bought the first two buy recommendations a week or more ago. My question is, with the market near a record high today, what should I begin buying? Certainly not today. What strategy would you suggest?"

Jeff Fischer: Great, so you're in mostly cash, so you're very well hedged already. Cash is a great hedge. And yet, you're missing up side. What we always try to find in PRO is a balance where we have strong up side exposure and we're hedged, because our goal is, of course, returns in any market. So your hedge is all your cash. You could start to steadily buy and it's great you bought our first two buy first stocks and now today we're recommending these three. So start to buy these. Two of them are, well, one's four percent and one's two point seven percent and one's five percent, so that's about eleven percent of your cash. If that's too much for you to invest right now, do half now and half a week or two from now or whenever you're comfortable doing it. But the goal is we're giving you this roadmap with allocations so that you can get to it at a pace that's comfortable for you and for your situation. A lot of members will point out tomorrow that the sequestration may begin, so we don't know, honestly, how that will go. Prices could be much higher tomorrow for some reason. The market surprises you half the time. Or prices could be much lower tomorrow, or they could do nothing. And so we're not trying to manage for daily prices, we're trying to make investments now that we think will make money over the next year and the next two and the next three and so forth.

Danny Hsia: Great. Next question. This is a little more of a general question that we certainly get from *Pro* members, especially new ones. It's from PaulUC. "Will we be doing a lot of shorting? My account may not allow shorting. Is there an equivalent strategy to use?"

Jeff Fischer: Paul, there's almost always an alternative strategy that we offer in the recommendation in the trade alert itself. If we're shorting something directly, usually you can buy put options on it instead which is identical to shorting with sometimes even identical costs, maybe a little bit more cost sometimes for the put itself. The short answer is there are alternatives and to date we have not done much shorting, we have chosen not to since 2008, 2009. We've always had some hedges and some shorts but we haven't done that much because of the prices we see and the opportunity we see. So the answer to your first question, will there be a lot of shorting, that really depends on what the market gives us. If the market looks overpriced, our shorts will increase. If we continue to see bullish opportunities, we'll stay in mostly bullish, that's paid off well since we launched. But we will always have an alternative to a short whenever we can.

Danny Hsia: Great. Okay, question from G Burke. I've been a member for a little while and pretty much in sync with the model portfolio but he or she does point out "except AIG, I hate those..." I'll just; I'll just use my own word and replace the one that was used, "those people." But I've recently gotten a chunk of money and I want to add it to my designated MF Motley Fool *Pro* portfolio. In general, do you recommend increasing the amounts of the Buy Now buy stocks to get the allocations aligned or just save it and buy new recommendations that the team allocates based up on the increase in portfolio size.

Jeff Fischer: Okay, first I'll say I never thought we'd be buying AIG either. I despise them. (crosstalk) Yeah, very much so, but I love taking that contrarian investment. It's been a good investment for us in the short time we've had it. And we think there's much more fuel in the tank from there. The stock is so far below its book value. It has new management. It's really obviously had to clean up all its horrible businesses that are now gone and it's so on the straight and narrow because it's probably the most scrutinized company out there now.

But I agree with you, we all really disliked AIG for what we saw as gross negligence on their previous management's part but now we believe it's a business that has found its way again and will stay on the straight and narrow and has a great management team now and offers value. But if you don't want to buy it, you should match the allocation that we have right now. We always review our current allocations as shown on the recommendations page and so those are what we're comfortable with and recommend right now.

If you're light on any of those allocations, match them. I don't know that I would say go above them, Maybe to a little bit if you want to, we want all Fools to be confident in what we own, but if you're trying to mirror us then just match what we have and wait for new recommendations and keep in mind we're about sixty-five, seventy percent net long so we have cash as well. So if you have some cash that's okay, that's a good hedge and we look forward to opportunities. We have a few in the works right now. New ones for new buys.

Danny Hsia: Okay, great. Next question from a guest, "What does it mean when the *Pro* team says "PACR or Pacer International is in the middle of a transition"?

Jeff Fischer: PACR is a turnaround story, or even more than that, a revamped business model story. They are changing where they focus in their intermodal; they basically help companies move goods from point A to point B via rail and trucking, and they're changing to become more of an intermediary and less of an executioner. So they're in transition from one business model to another. The new one is much more attractive than the old one and it's taking more time to get grip, for the tires to get grip, than we thought it would.

Danny Hsia: Right.

Jeff Fischer: But we still believe in management, we still believe we have a value here.

Danny Hsia: Okay. Question here from Moley918, "Since I got X amount of money, should I just follow along with your recommendation and ensure the options are funded properly? Also, can retirement accounts be used in certain situations?"

Jeff Fischer: Okay, two things. First, I'll finish up on PACR.

Danny Hsia: Oh, I'm sorry.

Jeff Fischer: No, it's not your fault at all, Danny. I just forgot to say it. It is on hold and the reason that is on hold, that PACR is on hold, is it's such a small company; a hundred some million dollar market cap. It's tiny. We found we can't get into and out of it effectively, ourselves or as a service, so we're just going to keep it on hold. So the question is; let's see.

Danny Hsia: "Since I have a certain amount of money, should I just follow along with your recommendation and ensure the options are funded properly?" And I think by "options" I think the member probably means just the different allocations in the company.

Jeff Fischer: Yeah, or maybe writing put options to get shares.

Danny Hsia: Yeah, we could answer both of those questions.

Jeff Fischer: We haven't done any options recommendations yet, so we are recommending that you follow our stock purchase recommendations…

Danny Hsia: And these are the things in the Catch-Up Report, the first Catch-Up Report and the second, which you just got.

Jeff Fischer: So now that's five companies we're recommending you buy shares of at specific allocations, as you'll see on the site. That's what we can recommend right now. Options we'll get to shortly. Adoptions are timely, of course, so we're going to issue all of our timely and possible or I should say attractive options trades all at once to members soon, so that we can do them all at once and walk you through it at the same time. Again, we want to build up your stock portfolio first and then we'll work in the hedges, shorts and options.

Danny Hsia: And they will guide you along this whole journey, so fear not there.

Jeff Fischer: And everybody has to realize that we have to take our time. We're not here to make money in a week or two; that small amount of money wouldn't make a difference. We're here to make good returns year after year, steadily, so keep your timeframe out several months. You'll be happier for it. You'll make better decisions for it and we'll all do better over time.

Danny Hsia: Okay, great. Question here from Steve, "Has *Pro* considered investing in LLPs, yes or no? And," well why don't you go ahead and answer that question first and then I'll get to the second one from him.

Jeff Fischer: Yes we have and we actually have and yes, so yes we have. I don't know that we will frequently because of the tax implications, but members have told us StoneMor is one we own, that it has not been complicated tax-wise.

Danny Hsia: Okay, good. This is not a follow-up question, but from the same member, Steve, "Why are there," well it is a follow-up question, excuse me. Why are there none in the recommended portfolio, but you just said we do have the one in the recommended portfolio?

Jeff Fischer: StoneMor Partners, STON is the ticker, is an MLP, and it's on hold because it has run up lately and it's on hold because there are other positions that we're considering that we like better, so before we tell new members to get into it, we want to make sure we want to keep it for the long term.

Danny Hsia: I think what Jeff is trying to get at there, Steve and other new members, is really if you follow the guidance that they're giving you in the Catch-Up Reports, we think that that's probably the best path to getting you caught up to the portfolio to where we currently have everything set up that are Buys and Buy Firsts and if and when either Stone or another MLP is a good opportunity, they'll certainly let you know.

Jeff Fischer: Yeah, and if we turn it back to Buy, then we'll tell you with an alert. Anything that's on hold in the portfolio is under consideration, which just means we don't want new investors to buy it right now.

Danny Hsia: Question here. This is kind of related to MasterCard a little bit, so I'll ask it and hopefully Nick gets to it on the text section. The text portion of the chat from Joseph, "Couldn't new smart phone applications change the manner in which payments are made and make the credit card companies obsolete? For example, if companies taking funds were to give a small discount, less than what they're paying to the credit card companies, customers could be convinced to move to ACH-like payment systems directly from their bank accounts."

Jeff Fischer: Sure, that's certainly a threat and something we watch all the time, and MasterCard and Visa and Amex are all watching those threats as well. They actually end up, as Nick mentioned, investing in a lot of these upstarts. Any that get any traction, they're likely to invest in or buy.

Danny Hsia: Oh, so while he was talking about that, it wasn't necessarily investing in small companies that are utilizing a credit card, but it's something like this.

Jeff Fischer: Even things like this.

Danny Hsia: Something that's just not even what they're traditionally known for.

Jeff Fischer: Exactly, and yet the problem these upstarts still have is you need a network that's broad, that reaches all points of contact, and that's accepted by the banks. The advantage that MasterCard and Visa have is the banks have a stake in these companies, and so they want to keep using them and not let in all these little things that would nip at even the banks' profits. The banks make money using MasterCard and Visa, so it's really hard to break into a network this gigantic and this strong, and that keeps growing every year. I mean MasterCard and Visa are growing volumes, 10-20% a year. They get more powerful as they do so.

Danny Hsia: We've got this question a couple of times, "If I don't have the money to buy 100 shares of most of the stocks in the portfolio, am I doing the wrong thing by participating in *Pro*? Will it impede my ability to have the money to make money with options?"

Jeff Fischer: No, not at all. With many options trades, you need to own 100 shares or at least, but not all of them. There are many reasons why we'll use options, precisely because we don't want to buy a hundred shares or more. We bought calls on Facebook instead of buying any stock at all, and you can do that with as little as a few hundred dollars if you want.

With our stocks, we focus on core holdings and it doesn't matter there if you own 50 shares or 5,000. Obviously we'll use options on some of them, but we won't use options on most of them is a pretty safe bet.

Danny Hsia: Just to reiterate, you can participate, be a member, a successful member of *Pro* without participating in options.

Jeff Fischer: Exactly, and that's what wraps it all up, really, is that you don't need to use options to succeed with *Pro*. Many members since we started haven't. They've just bought our stocks and ETFs, and that's a great way to go.

Danny Hsia: All right, here's a question from Dave. This is a little bit more just about general allocation or questions about how we, what we mean when we recommend a stock. "As I make purchases over time, when you recommend 4.1% for a company, is that 4.1% of the current portfolio or 4.1% of the original capital?

Jeff Fischer: It is of your current portfolio, and we do this because every day we review the PRO portfolio and make sure money is where we want it. Now obviously we can't be perfectionists or we'd be tweaking positions by a tenth of a percent day after day and just rack up commissions and taxes. That would be crazy. But we always base it on the current value because we know that's a baseline that we can always all agree on. Rather than say we started with a million dollars and now it's a million and five-something, but let's base our decisions on a million. That's confusing and it would be confusing for you at home too, if you started with X amount and two years from now you had much more. What always matters when you boil it down is where your money is invested today and what it's worth today. So it's all about the current allocation based on the current portfolio value.

Danny Hsia: Okay.

Jeff Fischer: Good question.

Danny Hsia: There's another question that we've gotten a couple of times, and this is kind of actually going back to the previous question about whether you need a hundred shares for options. This member, "It's all me" has just heard about mini options, ten shares. Are those relevant to *Pro*?

Jeff Fischer: They're going to be. I have a big feeling they're going to be. These are new, where these options only represent ten shares of stock instead of one hundred.

Danny Hsia: Is that similar to something like Share Builder?

Jeff Fischer: No, it's an actual option contract that the options listers have gotten wise to, realizing they'll have a lot more volume if the contracts are smaller. So I like it in that it welcomes more smaller investors into options. What we have to be careful about, Fools, is racking up commissions. Generally we're not option trading; we're using options strategically, so we should be fine in *Pro*.

But we're still sussing out how we want to use minis in *Pro*, and I think the short answer is we will provide guidance on them because it makes sense. If we have a million point five portfolio and you at home have a $150,000 portfolio, a mini option, which is ten shares instead of 100, would make perfect sense for you at home. So yeah, we're going to provide guidance on that to any extent that we can.

Danny Hsia: Great. We have ten minutes left in our time with you today, folks, but I just wanted to remind folks. So earlier, in case you missed it, Bryan and Nick and Jeff went through the three companies in Catch-Up Report number two. For new *Pro* members you received an email with a link to it shortly before the live chat started, and that was Gentex, Intel and MasterCard. And when you joined us, you got two recommendations in Catch-Up Report number one. Catch-Up Report number three is coming out on March seventh where the team will give you some more guidance and then there will be one more coming out on March 14th, so please keep an eye on your inboxes for those.

Jeff Fischer: Yup, and then right on the heels of that is the short, hedging and options guidance.

Danny Hsia: Exactly, exactly.

Jeff Fischer: I will say quickly on the mini options, which represent ten shares of stock instead of one hundred, there are not contracts available for most stocks right now. They're still rolling those out.

Danny Hsia: There's a question here from Sara, that she says she, "likes to see fair value figures in the form of probability distributions. Any chance *Pro* will begin to do that?"

Jeff Fischer: We do do that internally and sometimes we provide it to members, and if many members want it, we certainly could. Where we backed away from it was, on a probability here you're weighing your low case scenario, middle case and best case and then a range of possible valuations that result, and the range can be quite large at times. It can, on a stock like 3D Systems say your fair value may range from 20 to 50, and so when you do that, the guidance starts to have less value because you're basically saying a lot of things can happen.

So what we kind of average what we believe is most likely to happen and arrive at a valuation that we believe is most reasonable. And then of course we adjust that. Every quarter we look at results and adjust it if need be, and every year you adjust your fair value for what happened in the past year. Fair value, everyone should remember, will go up every year that the company grows, and fair value is the price from which to expect your desired rate of return. It's not a sell price. It's a fair price for a buyer or a seller, so it's a fair price today, so a price that's worth owning it. So we try to pin that down so members have a good idea of what we expect.

Danny Hsia: Another question from Moley918, "When a recommendation becomes available, i.e., when the team executes a trade alert or sends a trade alert to members, is there a specific timeframe to execute the trade, or should it be that day, the next business day or what kind of timeframe should members be expecting to make these trades?"

Jeff Fischer: In most cases, no, and this answer may be surprising. In most cases I would say the more time you take, the better, because we want you to be comfortable and understand what you're doing and read the report and see what we're thinking. Even if you're mirroring the *Pro* portfolio exactly or very closely, make sure that it's right for you, that this position makes you comfortable. Yes, you're paying us to make those decisions for you and we do. we're telling you what to buy and what to sell all the time, but we want to make sure too that you're comfortable with it, so take your time to read the report, make sure it makes sense to you and then make the trade.

Usually the trade can be made any number of days to weeks later, especially with the stocks that we buy where we're looking out a year, two, three years. With options, the prices may change within a number of days, so options are the ones where you want to be a little more timely on it.

Danny Hsia: And if there is a situation where it's not an options trade, it's a long trade, but maybe the stock is a little more volatile than members are used to, you will probably say, Okay, this one's going to move a little bit more, so we will recommend you making a move in two days, but if you're not comfortable with it, don't. You will provide that guidance for the members.

Jeff Fischer: And what we specifically provide is price guidance. We'll say "try to make this option trade today around these prices. As prices change, accept no less than X because we want to make a certain yield, for example, in a certain number of months. So we'll give you the limit prices to use.

Danny Hsia: Okay, good. Question from It's All Me. I think this is a really interesting one. Like we've been talking about, we've provided Catch-Up Report number one, Catch-Up Report number two is today and the next two are coming in the next couple of weeks and the question from It's All Me is, "At the current rate, it'll take six months or more to catch up to the full *Pro* Portfolio." I don't know that we necessarily think it will take that long, when obviously everyone has their personal situation. But the member is concerned that that current environment is going to be more volatile and risky and that the new members, those are those of them that are catching on the slower catch-up path, they'll be missing out on the hedging possibilities in the portfolio. If they have cash in the portfolio today, is there some way to get caught up more quickly and get hedges in place now?

Jeff Fischer: Well interesting question because if you have cash, that's typically a better, as good a hedge as anything, really.

Danny Hsia: So the member may be thinking hedge.

Jeff Fischer: Although hedges will make money when the market falls, so (unclear; talking at the same time).

Danny Hsia: The member is a little concerned about that volatility (unclear.)

Jeff Fischer: Let me back up and share how we're thinking about it. First of all, it won't take six months. It will take much shorter. Danny just outlined…

Danny Hsia: Yeah, within a month, you'll have all the guidance on what companies you need to have in your portfolio to be caught up.

Jeff Fischer: And the hedges and shorts and options.

Danny Hsia: And the hedges and shorts, right.

Jeff Fischer: I think it's within three weeks to a month from now.

Danny Hsia: From now.

Jeff Fischer: So what we're doing, and I'm aware that we're in a potentially volatile market environment and that prices are up, the S&P is up 5% this year so far, which doesn't sound like that much, but it is. Plenty of stocks are up 10%, what have you. So we're looking at the valuations every day and we're going through earnings right now too, and we feel it is best to start everyone gradually, as we have done with two stocks that we really strongly believed in. Three more now that we really strongly believe in today's prices, and next week more. And at that point, once you get up to be about 50% invested, and then we'll move into the hedges, shorts and options. But until then, you're, as far as we know, you're mostly in cash. As far as our guidance is concerned, you're mostly in cash because we've only offered five stocks that add up to maybe 20% long.

That said, we know many of you came to the service with a full portfolio of stocks, and the way we view that is you are already invested. You're already in the river, so to speak, that we've spoken about, and now you're just going to be moving some of those funds out and replacing them with *Pro*. Within a few weeks, we'll get to the hedges, for those of you who want to hedge and short as well.

Danny Hsia: And again, you don't have to do the shorting and the hedging if you don't want to.

Jeff Fischer: Yeah, you don't have to, but we do recognize it's a delicate time to get members up to speed with us and we want to do it in a reasonable, rational way that minimizes risk and still lets you participate in buying these stocks at prices that we view as being very attractive right now.

Danny Hsia: Great, and it can be a little bit of a complicated question, which is why you have a little bit of a longer answer than normal, and so if on the stream, on this video stream the answer is you're still a little confused, post that question to the boards. I promise you, it'll get answered and hopefully it will be clear for you.

Jeff Fischer: Yeah, we know members arrive to us from all different; they're all over the map. Some are all cash, and that makes it very easy for them to gradually invest with us. Some are fully invested and so we're telling you to sell off your least favorite positions, and the ones you don't even know why you own. You don't want to own those anyway, and move that money into *Pro* stocks as we do so, and know that right around the corner we have the hedges and shorts, but frankly we are right now mostly long ourselves, and our hedges that we have in place are now at price points that are for the most part, quite a bit lower than today's market price.

So that's the short way of saying that we're mostly bullish right alongside you, and we're going to adjust and add hedges very shortly.

Danny Hsia: All right, great. I think we have about two minutes left here.

Jeff Fischer: That's it.

Danny Hsia: I know, two minutes. Sorry folks. Question from KHGuy, "*Pro* has around a third allocation in cash, correct? Are the percentages in the guidance including that amount or are they just for the stock portion of the portfolio?"

Jeff Fischer: Good question, quick answer is it's the entire portfolio value is what our portfolio is worth and what the allocations are about. So if we have, say to make it easy, one million dollars and we're saying $300,000 of it is in cash, we're saying buy 5% of the one million, so buy $50,000 worth of the stock.

Danny Hsia: Question from WYP, "Do recommended option trades always correlate with the stock portfolio in the *Pro*?" And we actually have a surprise guest.

Tom Gardner: Guys, I just wanted to say hi. It's great to see you all. I left my coat in here and I need to make a flight down to Jackson, Mississippi to see the CEO of Middleby.

Danny Hsia: Nice to see you, Tom.

Tom Gardner: I apologize. Excellent.

Danny Hsia: CEO and Co-Founder of The Motley Fool, Tom Gardner.

Jeff Fischer: Have a good trip.

Danny Hsia: Tom never springs surprises on us every day. This is not something we don't come to expect from him every single time we're live on air. Thank you, Tom. Nice to see you.

Jeff Fischer: It's always great to see Tom.

Danny Hsia: Nice to see you. Have a safe flight.

Tom Gardner: Love you guys.

Jeff Fischer: Love you too.

Danny Hsia: Let's go back to the question from WYP, "Do recommended options trades always correlate with a stock portfolio in *Pro*?"

Jeff Fischer: Does he mean The Motley Fool Options service or just options?

Danny Hsia: I think options trades; the question's probably, Do options trades always correlate with a long position in *Pro*, right?

Jeff Fischer: The answer is no, they do not. Many options trades will be on their own, an independent thing. Many of them are hedges to hedge out some of the long positions.

Danny Hsia: Okay, great.

Jeff Fischer: Some will leverage stocks we do own, but again as Danny said, you don't need to use options to use *Pro*. They are a great tool, so I hope anyone who is interested will learn to use them with us. That's why we're here.

Danny Hsia: Okay, last question from Nack, "Could you please explain the positive/negative MOS indications?"

Jeff Fischer: Margin of Safety indications. I don't know where you're seeing those on the *Pro* site.

Danny Hsia: I wasn't sure either, but the question was listed.

Jeff Fischer: That may be on the Special Ops site. They have a margin of safety indication, last I saw on the recommendations page itself. *Pro* doesn't use them publicly, but we do use them as part of our Consider Adding More Price, so we like current prices. We already view the current price has having a margin of safety because it's typically below fair value. Consider adding more as an even greater margin of safety, where we would consider buying even more stock. So we do use it internally and sometimes publicly, but it's another way of saying we want to buy below fair value. That's all we're saying.

Danny Hsia: Okay, great. I think that's all the time. I'm being told our time is up, so folks, thank you very much. Jeff, thank you for your time. Last parting words?

Jeff Fischer: Thank you, Danny. Thank you, members. Again, we're here to help you each step of the way. As you have questions, ask on the boards. We'll continue to be there each day and I really hope you're thinking in terms of the next few months, building the *Pro* portfolio that you want with us and then going forward for the years to come. We're going to make money over the coming months and then really over the coming years, so be patient. Enjoy yourself. Don't feel panicked to do everything all at once. Everything great is built gradually, so thank you for being with *Pro*.

Danny Hsia: Thank you, Fools, and remember, your second Catch-Up Report is in your inbox right now for new Fools, and if you're an existing Fool, *Pro* Fool, go ahead to the guidebook tab on the *Pro* site and keep an eye out for Catch-Up Report number three, which comes out on March 7th. Fool On!

Jeff Fischer: Thank you, Danny.

Danny Hsia: Thank you.

Jeff Fischer: Fool on!

A Fresh Start … Every Day

Published Feb 11, 2013 at 12:00AM

Dear Fellow Fool:

Next Week's Memo Coming Tuesday

TMF HQ (and the NYSE) will be closed Monday, Feb. 18, for President's Day, so our next Memo will hit your inbox at 4 p.m. Tuesday, Feb. 19!

Another morning. As the alarm clock coaxes me out of my warm bed, my eyes quickly adjust to the familiar, refreshing darkness of a nascent new day. I've never been one to remember dreams, so my thoughts soon turn forward-looking; I try to map out my day with enough structure to ensure progress toward my sincerest goals, but enough flexibility to allow for inevitable uncertainties. And so it is — or should be — with portfolio management: Every day, we assess the portfolio's position with respect to its mission and guiding light, but with a bias toward doing little (because over-activity costs money). When it comes to portfolio management, here is how *Pro* rolls.

In my eyes, portfolio management is the process of optimally matching your assets to your objectives, always keeping in mind the costs and risks. It's a science, but it's also an art. In many investment shops, portfolio management involves a lot of math, computing power, and fancy modeling — resulting in both a precise outcome and a false sense of security. In *Pro*, we've made this imprecise process easier by defining a clear-cut mission (to earn consistent, recurring profits with a high level of accuracy) and constructing an aspirational reference to guide our behavior (our North Star). We don't kid ourselves about knowing the future; we simply review our goals and set our course with the hope of being approximately right as opposed to precisely wrong.

Our Big-Picture Framework

At *Pro*'s launch in 2008, Jeff set a baseline allocation for the portfolio — 70% stocks, 15% ETFs, 15% options, and up to 30% short. This division not only fulfilled a general desire for long exposure and reduced volatility, but was also well suited to the team's skill set (we're better at analyzing businesses than making macro, trend-based calls, so we have more stocks than ETFs). Since those early days, we've introduced the concept of exposure as a better way to manage our allocation. Our "default" portfolio (meaning we aren't taking a particular market view) is 70% net long. Typically, if we deviate from that number, it's because of a conscious choice to grab more (or less) market exposure. The 30% of the portfolio in non-long positions (cash, hedges, and shorts), meanwhile, is a function of opportunities and our ability to exploit them.

We determine position size for new long stock positions with a few factors in mind.

- First, we want the position to matter, which generally means it must be at least 3% of our portfolio.
- Second, we look at the position's covariance (tendency to move directionally in tandem) with our existing positions. We also examine its key risk exposures and revenue sources. We may buy a smaller position if we aren't diversifying our risk exposure, or a larger position if we are.
- Then, we consider our expected return in relation to its range of outcomes. Our fair-value estimate and the price we pay figure prominently into our expected return. Further, each business we own has a range of possible futures (ideally from "great" to "holy cow!"), each with its own probability of coming to fruition. The wider the dispersion of those outcomes (the less predictable the company's future), the lower our certainty that we'll experience a good one. The higher the numerator (expected returns) and the lower the denominator (range of outcomes), the larger we're willing to make the position.
- Finally, we make downward adjustments for any peculiarities – for example, low liquidity, a strange share structure, complicated disclosures, etc.

The ideal holding is one that has high liquidity, diversifies our risk exposure, and has a bright and highly certain future — and that we can buy cheap.

Tweaking Along the Way

When considering *Pro*'s Recommended Allocation % for any position, think about the metaphor above: waking up and calibrating your plans for each day in line with your overarching goals. Every day, we pretend the *Pro* portfolio is 100% cash and we get to reconstruct it to be North Star-optimized. Would we put 6.3% in **AmTrust Financial** if we were building our portfolio from scratch? With sensitivity to taxes, commissions, and other opportunities, that is *precisely* the claim that our Recommended Allocation % makes. And that's why the bulk of our positions are rated as Buys: In classifying them thus, we're telling you we'd buy that amount if we were rebuilding our portfolio, so we're comfortable recommending you do the same. The day we feel our allocation is out of whack, we'll adjust it (and our Recommended Allocation %).

Note my caveat above: "with sensitivity to taxes, commissions, and other opportunities." This clause gives us a bit of a fudge factor, which we need because:

- Markets are noisy.
- Our fair-value estimate is a range, not a precise point.
- Commissions eat into our returns.

If we were glued to absolute precision regarding our Recommended Allocation %, we'd end up transacting all day long, racking up massive commissions and ending with no time to analyze our businesses (or live our lives). To guard against such an outcome, we establish a Consider Adding More (CAM) price for every position, which acts as a trigger for reassessment. Once a stock hits our CAM price, we spend (up to) 30 days forcing ourselves to reconsider how the position fits into the portfolio. If our thesis is intact and the opportunity is now more attractive, we'll make the case for increasing our allocation; if the thesis now looks incorrect, we'll make the case for reducing it. (Or, of course, we might just leave it alone!) In any case, we'll communicate our decision to you as quickly as possible — and if an answer isn't readily apparent, we'll move the position to Hold while we dig in.

The Foolish Bottom Line

The final piece of portfolio management is selling, which Nick covered beautifully in this July Memo. As with many things in life, portfolio management can't be reduced to a universal formula. It's nuanced, messy, and involves a bunch of moving parts. *Pro*'s portfolio management process will continue to evolve, and we'll keep striving for improvement in its consistent application and clear communication. We hope this Memo (and the Recommended Allocation % and Consider Adding More columns on our Recommendations page) are the next steps in doing just that. Got questions? Let's chat on the Memo Musings discussion board.

— Bryan (TMF42)

Guidance Updates

- **MasterCard** moves to Buy from Hold.
- **Pacer** moves to Hold from Buy (we'll give you details in our upcoming earnings review).
- **SPDR S&P 500** moves to Hold from Short.
- **StoneMor Partners** moves to Hold from Buy.

Coverage & Community

- **CME Group** : Jeff looks at fourth-quarter earnings for the public derivatives exchange.
- **Facebook** : From zero just a few months ago, mobile advertising revenue is growing quickly.
- **MasterCard** : Nick takes a fresh look at MasterCard and raises his estimate of fair value.

Pro Trade Roundup

- **CBOE VIX** (VIX): We set up 10 May $17/$25 bull call spreads for a $1.45 debit on each.
- **SPDR S&P 500**: We rolled our Feb. 16, 2013, $146 covered puts to Feb. 23, 2013, $151 puts for a net credit of $0.75 each.

The Motley Fool owns shares of Facebook. See Pro's *holdings*[here](). *See the team's and David and Tom Gardner's holdings*[here]().

Use Options Like a Pro

Published Feb 11, 2013 at 12:00AM

Getting Started With *Pro*

1. Catch-Up Report No. 1
2. *Pro* 's Investment Strategy Guide
3. What *Pro* Believes
4. **Use Options Like a Pro**

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How Options Fit the *Pro* Portfolio

While we generally seek long-term capital gains from stocks, most of our options are used for *short-term* income or gains. By combining these strategies, along with ETFs and shorts, *Pro* investors can make profits in the coming weeks *and* the coming years, accomplishing our goal of earning steady, recurring profits with high accuracy in both the short and long term.

We use options strategically, as part of portfolio management. Options work hand in hand with stocks, and your *Pro* portfolio should come to reflect that. Finally, although most options do make money in the short term, we're not *traders* of options. We use them tactically and appreciate the fact that they expire in a matter of weeks or months.

The Strategies We Love

Pro will use more than a dozen options strategies, depending on what's most appealing at the time. But we rely on just a handful, and knowing how to use even one or two strategies is enough to change and improve how you invest. In addition to writing puts and writing covered calls — two of our favorite strategies — we will be buying calls to leverage gains; buying puts to protect positions or to short a stock; writing covered strangles (selling both puts *and* covered calls on a stock to double our income); using option spreads to earn large returns on investment with low risk; buying straddles to profit on big price moves in either direction; and more.

How to Learn More

If you are new to options investing, or just need a refresher, we recommend that you take advantage of the great educational resources at *Motley Fool Options* (to which you have unlimited access, as part of your *Pro* membership). Start at the Guidebook, take our quick survey, and then follow the steps to (re)learn the basics.

Catch-Up Reports

Published Feb 8, 2013 at 12:00AM

Ready to Become a *Pro* Investor? These Catch-Up Reports give you everything you need to match your portfolio with ours — quickly, painlessly, and (we hope) enjoyably. Start with Report No. 1, and watch this space for new reports through March 19. (Veteran *Pro* Fool? The guidance in these reports is not new, but if you need some help catching up with us, feel free to peruse them!)

Catch-Up Report 1: Feb. 14, 2013

- Download (PDF) (All in Cash Version)
- Download (PDF) (Currently Invested Elsewhere Version)

Catch-Up Report 2: Feb. 28, 2013

- Download (PDF)

Catch-Up Report 3: March 7, 2013

- Download (PDF)

Catch-Up Report 4: March 14, 2013

- Download (PDF)

Portfolio Positioning Report: March 19, 2013

- This report will tell you how to short, hedge, and use options to match our exposure and general portfolio position, even if you can't or don't want to engage in every strategy we employ. We'll also have a live chat at 1 p.m. ET on March 19 to address any questions you may have about this report.
- Download (PDF)

Building Your Pro Portfolio

Published Feb 8, 2013 at 12:00AM

Pro is designed to make it easy for you to invest alongside our portfolio and stay up-to-date with the latest news that affects your stocks.

- **Trade Alerts:** When we see an opportunity, you're the first to know. Anytime during normal market hours, we will issue a real-time Trade Alert email with a link to our full recommendation — including details on why and how to make the trade — on the *Pro* site. See the archive here »
- **Monday Memos:** Every Monday at 4 p.m. ET, we'll send you our latest thoughts on the *Pro* portfolio, plus market insights, community highlights, and a list of active *Pro* positions we think still represent good opportunities for new money. See the archive here »
- **What to Do:** The *Pro* portfolio shows at-a-glance — and in real time — which positions the team thinks are ripe for new money now, and which are best to hold for the moment. See the portfolio here »
  - **Buy First:** Just what it says. If you're starting to build your *Pro* portfolio and plan to mirror us, we recommend allocating your capital here first.
  - **Buy:** We believe in these as much as our Buy First stocks and suggest you buy them next as you build your portfolio. (We like to buy these in chunks over time.)
  - **Hold:** This means to keep holding the position if you own it already, but don't add more cash to it. If you don't own this position yet, don't buy unless you can get shares near our preferred Buy Around price.
  - **Sell:** 'Nuff said. We're selling this position and recommend you do, too.
- **What We Think Now:** See the team's current thinking in brief on every position in the *Pro* portfolio. You'll know where we stand on each of our investments right now, all on one page. See What We Think Now »
- **Guides, Audio/Video Extras, Special Updates**: *Pro* helps you navigate the market by delivering market-beating recommendations right to your inbox. But we also aim to teach you how to find those gems yourself. Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio. See the archive of extras »

Catch-Up Report No. 1

Published Feb 8, 2013 at 12:00AM

Getting Started With *Pro*

1. **Catch-Up Report No. 1**
2. *Pro* 's Investment Strategy Guide
3. What *Pro* Believes

Back to Guidebook | Site Directory

Welcome to *Motley Fool Pro*! This Catch-Up Report is designed to help you match your portfolio to *Pro*'s. You'll find the two stocks we recommend you buy right away — along with our analysis, allocation guidance, and much more — on pages 2 and 5. But first, we'll start with the portfolio you have right now. Since you have cash ready to deploy into your new *Pro* portfolio, we recommend you follow along with us as closely as you're able — and we provide guidance on exactly how.

Download the report to get started!

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Published Feb 8, 2013 at 12:00AM

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Download the report to get started!

Roll Your Covered Puts on the SPDR S&P 500

Published Feb 6, 2013 at 12:00AM

- **What We're Doing:** We're again writing covered puts on our short position in the **SPDR S&P 500** (NYSEMKT: SPY) ETF. This trade rolls up the puts we wrote last month, and it will allow us to potentially exit the short or earn income while we wait.
- **What We're Thinking:** We have gradually reduced this index short over the past year, and with the Federal Reserve committed to supporting the market, exiting remains our desired course of action.
- **What We're Expecting:** If the S&P 500 index declines below our put strike price by expiration, we'll buy shares through the puts to cover our short, ending the position. We would keep the premium received from these puts, of course. If the index does *not* decline below our strike, we'll earn income that offsets at least some of the index's gain, and we can consider repeating this strategy.

What's New

Last month, we wrote $146 covered puts on the **SPDR S&P 500** (NYSEMKT: SPY) ETF. Those puts expire Feb. 16, and today they've paid us nearly all they can as the underlying ETF has risen to $151. We'll buy to close these puts and sell to open new ones at the $151 strike, covering all of our short shares again. This time, we're using weekly options that expire only one week later, on Feb. 22. We're simply trying to exit the position at better than current prices (or get paid in the process), in favor of setting up other hedges that drag less on our results when the market rises.

Trade Essentials

- **Actions:** Roll up your puts on your short **SPDR S&P 500** (NYSEMKT: SPY) position (use a single roll order if you're able).
  - Buy to close your Feb. 16, 2013, $146 puts
  - Sell to open Feb. 22, 2013, $151 puts
- **Recent bid/ask:** At market prices, this roll recently results in a net credit of $1.23. That price will change.
- **Price Guidance:** Roll the options at the going price. If the index moves significantly before you trade, you can move your new strike price to keep it closer to the current index price.
- **Allocation:** Write one put for every 100 shares of SPY you're short. For *Pro*, that's 10 contracts.
- **Recent SPY Price:** $151.12
- **Alternative Trade Guidance:**
  - **Are you short fewer than 100 SPY shares, or short an odd lot?** Roll your puts on all your round lots, and buy to cover, or buy to close, any odd-lot shares – ideally on a dip in price.
  - **Own ProShares Short S&P 500** (NYSEMKT: SH) or **ProShares Short Russell 2000** (NYSEMKT: RWM) **instead?** These don't have weekly options, so you'll need to roll to March if at all. If the calls don't pay enough to make this worthwhile, just sell your remaining position, ideally on a rise in price.
  - **Directly short the ProShares Russell 2000** (NYSEMKT: IWM) **ETF?** Roll your covered puts up and forward one week, as we are, to the Feb. 22 options. Write covered puts on every 100 shares you're short, using a strike close to the current ETF price. Or, as advised before, buy to cover or buy to close odd lots, ideally on a drop in price.

Next Step

- **Have questions about any of your shorts?** Visit our SPDR S&P 500 board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Set Up a Bull Call Spread on the CBOE Volatility Index

Published Feb 6, 2013 at 12:00AM

- **What We're Doing:** As a hedge, we're risking a small stake in a low-probability position that will reward us substantially if volatility spikes by our May expiration.
- **What We're Thinking:** The CBOE volatility index closed yesterday below 14, well below its average of about 20. Investors look complacent, so any big surprises could send the VIX back above 20.
- **What We're Expecting:** If the VIX spikes, we'll profit. If not, we expect to lose the full (but modest) amount invested. We should expect to potentially set up this trade several times before profiting.

The Big Picture

The **Chicago Board Options Exchange VIX Index** (ticker: VIX, or ^VIX at some brokers, or $VIX.X) (VOLATILITYINDICES: ^VIX) estimates the S&P 500's volatility over the coming 30 days. Also called the "fear gauge," the VIX has historically enjoyed an inverse relation to the S&P 500 nearly 90% of the time, rising when the market falls. This trait would make "ownership" of volatility via the VIX a good hedge against a falling market.

However, you can't buy the VIX directly, and the exchange-traded funds that attempt to track it are flawed. Options on the VIX are available and liquid, but they're pricey. This is where our bull call spread helps. The spread will lower our cost to set up a bullish VIX position, yet still reward us smartly if the VIX spikes high enough by expiration.

Most of the time, however, **we must expect a VIX hedge to go unused, becoming a cost rather than a benefit**. Our potential payout of 416% tells us that the odds of success are small, but as a hedge, it's worth the small amount of the portfolio we're risking.

Trade Essentials

- **Action:** Set up a May 2013 $17/$25 bull call spread on the **CBOE Volatility Index**(ticker: VIX, or ^VIX at some brokers, or $VIX.X).
  - Use a spread order to:
    - Buy ("buy to open") May 2013 $17 calls
    - Sell ("sell to open") an equal number of May 2013 $25 calls
- **Price Guidance (bid/ask):**
  - **May $17 calls:** $2.40/$2.50
  - **May $25 calls:** $0.85/$0.95
  - Initially, aim for a total net debit, or cost, of $1.55 ($155) or lower per spread. If the VIX rises, you may need to pay more.
- **VIX level (Feb. 5):** 13.72
- **Allocation:** Only invest what you can afford to lose. *Pro* will set up 10 spreads at a cost of $155 each, risking $1,550 total. This is only about 0.1% of the portfolio.
- **Maximum Profit:** $6.45 ($645) per spread if the VIX closes at 25 or higher. That would be a 416% return on our money at risk.
- **Maximum Loss:** $1.55 ($155) per spread if the VIX remains at less than 17.
- **Alternative Trades:** None. If you can't make this trade now, don't sweat it.
- **Follow-Up:** None expected. A spread either pays off or doesn't. However, we may try again with another trade.

Next Step

- Please visit the VIX discussion board if you have any questions.

Editor's note: A previous version of this article listed a potential return of 316%. The correct figure is 416%, and the text has been updated.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Your Guide to Our North Star

Published Feb 5, 2013 at 12:00AM

Like the real North Star, our North Star offers direction and guides our investing behavior. Learn more below.

Pro's Mission

Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years.

***Pro*'s North Star: Inflation + 7% annually**

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward.

Why inflation + 7%?

Our mission is to grow the real purchasing power of our capital. Therefore, the first competitor we need to beat is inflation, as measured by the Consumer Price Index.

We want to grow our dollars by more than the rate of inflation — that's a given. Exactly how much more is a difficult figure to pinpoint, but history tells us that if we can double the *real* purchasing power of your dollars every 10 years, we'll be doing what few manage to accomplish.

To double your dollars in a decade, we need to book a compound annual return of about 7%. To double your *real* dollars, we need to return 7% *plus* inflation. Thus, this figure is born directly out of our mission of absolute returns — returns that improve your financial standing in the real world.

Our North Star has several important characteristics that make it appropriate, challenging, and aspirational for all of us. It:

- **Never goes negative.** This lines up with our goal of positive returns over all three-year periods.
- **Is not investable**. It's impossible to lock in a return of inflation plus 7% with some other vehicle.
- **Is not a benchmark**. By definition, benchmarks must be investable; they are used for evaluating the performance of a relative-returns strategy. Absolute returns are our goal.
- **Is not a hurdle**. A hurdle is something you must leap over to avoid tripping. Our North Star guides us to make appropriate investment decisions. We're more likely to reach our goals if we let it guide us. If we come close to our North Star, let alone jump over it, we'll be over the moon (sorry!).
- **Is not a gimmick**. We are working to better explain our philosophy and strategy to you, and our North Star will be an ever-present factor in our investment decision-making.
- **Is a challenging reference point**. Historically, our North Star has outperformed the U.S. and world stock markets. Over rolling three-year periods since 1970, our North Star has put up a compound annual return of 11.3%, versus 9.9% for the S&P 500 Total Return Index and 6.4% for the MSCI World index. Our North Star also delivered that return *much* more steadily than the market indexes, without a single down year.
- **Guides our behavior** as we invest with the tools available to us. It is a framework to explain and reinforce consistent portfolio decisions. Approached consistently over long periods, it should help us and our members achieve strong financial rewards.

More Guidance

It's a bird, it's a plane, it's our North Star discussion board!

Relive our live chat with members about the debut of the North Star

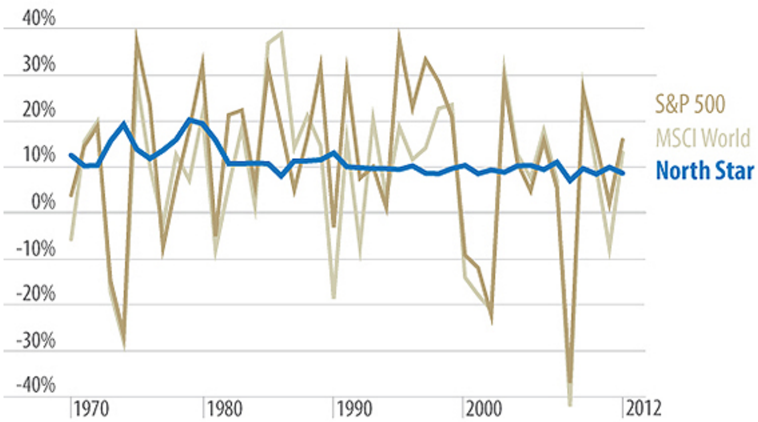
Historical Performance

How has our North Star performed historically? We're glad you asked, and we hope you like data! Here's a summary of the past 41 years. Below that are charts of the full history.

Annualized Return, 1970–2012

	Average	CAGR	Highest	Lowest
North Star	**11.3%**	**11.3%**	**20.3%**	**7.1%**
S&P Total Return	11.4%	9.9%	37.6%	-37.0%
MSCI World	7.8%	6.1%	39.1%	-42.1%

Annualized Return, 1970–2012

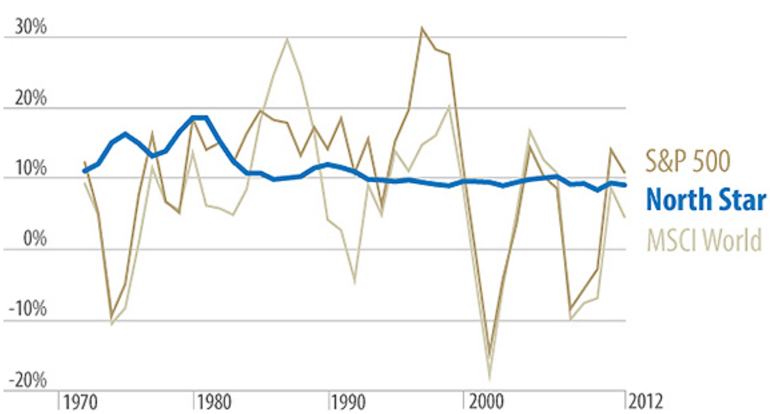


Here are the same data, showing rolling three-year annualized returns. Again, note the lack of volatility for our North Star.

Annualized Rolling 3-Year Return, 1972–2012

	Average	CAGR	Highest	Lowest
North Star	**11.4%**	**11.3%**	**18.6%**	**8.4%**
S&P Total Return	10.4%	9.9%	31.2%	-14.6%
MSCI World	6.9%	6.4%	29.7%	-17.7%

Annualized Rolling 3-Year Return, 1972–2012



Note that we included both average and compound annual (CAGR) historical growth rates. To investors, the one that matters is the CAGR. We included both to show the power of compounding: Even though our North Star has averaged an almost identical annual return to that of the S&P Total Return index over the past 43 years, the North Star (again, inflation plus 7%) has outperformed the index by about 1.4 percentage points annually. That's because when the index has those deeply negative years, much higher positive years are needed to claw its way back to positive territory. Since it never goes negative, our North Star doesn't have that problem. That is the power of steady, positive returns — see below for visual representation.

(We're including the S&P Total Return and MSCI World returns purely for the sake of education. Our investment strategies are not focused on either.)

Performance Since Inception

How has *Pro* performed against its North Star since our start in 2008? We hope you *really* like data: Here are *Pro*'s annualized returns lined up against those of our North Star. (Again purely for education, we've also included the returns for the S&P Total Return index and the MSCI World index.)

These returns are annualized, not cumulative. Annualized returns are more useful to investors because they allow easy comparisons.

A note on the recency of data: The Consumer Price Index (inflation) data is reported with a several-week lag, while *Pro*'s performance is in real time. Inflation is quite stable from month to month, so we use the previous month's inflation figure as an estimate for the current month's until the actual data are released. Any adjustment required is usually negligible, especially given the rolling three-year viewpoint we favor. This approach allows us to keep our performance tables updated all the time.

Annualized Return

To read this chart, remember that the return data are annualized, not cumulative: The chart shows the annualized return since inception *as of the end of each subsequent month*. The data begin one year after *Pro*'s start, because annualized returns based on less than a year of data aren't very useful.

And here are our rolling three-year annualized returns — again, our preferred measurement.

Annualized Rolling 3-Year Return

Date	*Pro* Portfolio Balance	*Pro*	North Star	S&P Total Return	MSCI World
10/6/08	**$1,000,000**				
10/31/08	**$1,001,292**				
...					
11/30/12	**$1,451,264**	**6.90%**	9.23%	11.25%	4.61%
12/31/12	**$1,461,698**	**6.14%**	9.20%	10.87%	4.63%

Questions We Anticipate May Be Frequently Asked

How are you measuring inflation?

We're using the change in the Consumer Price Index. The Consumer Price Index is a measure of the average change over time in prices paid for a "market basket" of consumer goods and services. In plain language, it measures how many more dollars it takes to buy things over time.

Specifically, we're using the CPI-U, or the Consumer Price Index for All Urban Consumers, which covers about 87% of the U.S. population. We're using the "all items" version of the CPI-U, which means that we aren't excluding anything. This is worth pointing out because media-reported CPI figures often exclude food and energy prices.

Wait a second. I'm pretty good at math, and you need to return 7.177346% annually to double your money in 10 years. What gives with your 7% figure?

Yes, to be precise, we'd need to return $2^{(1/10)}$-1, or about 7.177346%, per year to double a portfolio in 10 years. Spelling out our North Star as inflation + 7.177346% doesn't in any way make it more useful as a guide, though.

Is the North Star a hurdle or benchmark?

Our North Star is neither a hurdle nor a benchmark. Hurdles are things you intend to leap over, and benchmarks represent an alternative for your investment dollars. Our North Star is neither of these things. Its purpose is to offer us direction, guide our behavior, and keep our mission front and center.

What is a rolling three-year period?

Rolling three-year returns measure performance over the most recent three years. So the rolling three-year return as of Oct. 31, 2011, measures the return since Oct. 31, 2008. A month later, the rolling three-year return as of Nov. 30, 2011, measures the return since Nov. 30, 2008.

How will the North Star change how *Pro* is managed?

Our strategy will not change, but our implementation of it should improve with the North Star as a guide. Our North Star should remind us to lower our risk when we have large, abnormal returns, or increase our exposure to stocks and income if we're not close to our North Star. Thankfully, this should work well in the marketplace. If stocks are up sharply, we *should* be looking to lower our exposure, as our North Star would suggest. If returns are lackluster, we *should* be looking for more stock values or income strategies. Following a steady North Star should help us make better decisions.

Why is the North Star better than the S&P 500?

Pro has never been an alternative for the S&P 500 index. We use options for income, we short, and we hedge. The index is a long, stock-only vehicle. *Pro* is also not about returns relative to an index; we're about positive gains over any reasonable period. The North Star never goes negative, so it's a much better measure against our goal than is the volatile S&P 500, which can be negative for years.

Inflation is relatively tame lately. What happens when it soars?

Then our North Star's annual return is going to soar, too. Thankfully, stocks typically compete well with inflation, so to follow our North Star, we know we'll need to be largely invested in stocks during periods of high inflation, and we'll likely use fewer income strategies, because fixed income may not keep up with inflation.

What if you don't top your North Star?

We'll be happy if we just stay on track with it — or stay relatively close. If we *can* top it over many years, that would be excellent. But we need to realize the lofty challenge of topping a measure that *never* has a negative year while we're investing in stocks. Our North Star is our aspiration, not a hurdle or benchmark.

Can I measure the North Star against my portfolio at home?

Absolutely. Using the Bureau of Labor Statistics CPI stats, you can obtain historical CPI measures along with a monthly update to compare the CPI+7% to your portfolio. We've already done the 41-year history for you above, and we'll be updating the North Star results monthly for you.

Where can I talk about the North Star with the *Pro* team and other members?

Our North Star discussion board is always shining (sorry!).

Most Stocks We Sell Will Do Well

Published Feb 4, 2013 at 12:00AM

Dear Fellow Fool:

Most of the stocks we sell will subsequently trend higher in price. You may be surprised to read that, but it's exactly the result I expect. Higher prices in the years ahead, including on the stocks we've sold, will stand as a testament to our stock selection process.

What We Think (Right) Now

Fools, we've updated our thinking on every stock on our scorecard — click on over to our What We Think Now page for an at-a-glance view of our positions!

You see, we generally sell a position in order to increase our defensiveness, refocus the portfolio, or raise cash for another investment. In other words, in *Pro*'s four-plus years and counting, we've rarely sold a stock because the company turned from Jekyll to Hyde on us. Our companies are carefully selected for sustainable competitive advantages and recurring revenue, so we shouldn't be surprised if a business we initially lauded continues to grow value – even after we've decided to sell it. Unless something has fundamentally changed, we should *expect* it to keep thriving.

So Why Sell at All?

We're running a portfolio that has no new cash inflows aside from what we make investing, so selling is a large part of our portfolio management process. We aim to sell stocks that appear to have *less* potential compared to our others — but in most cases, they still have plenty of promise. We simply hope (and expect) that the companies we continue to own will do even better.

Since the beginning, we've focused the *Pro* portfolio on a couple of dozen core positions at most. We only want to own positions that we know inside and out, forward and backward, competitors included. I believe a more concentrated portfolio will lead to stronger performance as a result.

Alongside these holdings, we maintain cash to invest in new opportunities (including adding to our positions) and to anchor our shorts and options strategies. So when we sell, we're often saying "this is not quite good enough to keep right now" — but we're rarely saying "this was wrong to own." When we *do* get it wrong, we'll be the first to say so.

To date, of our non-options trades, we've sold 47 positions, 38 of them (more than 80%) for a profit. The majority of them have gone on to still higher ground since.

So, consider this a *Pro* service announcement: Unless we say otherwise in the sell alert, we typically sell a company for portfolio-management reasons, *not* because we no longer believe in it. Valuation plays a key role in some sell decisions, of course, but remember that the valuation of a good company will grow over time. It's not a static number. If we did our job well with the original buy recommendation, most of our sells should do well for years even after we let them go. With our sells, as with every portfolio decision, we're always focused on positioning the portfolio to achieve our rolling three-year North Star goal — and to help ensure gains in various markets.

Portfolio Page Changes

Time for some more good news! You'll soon see some changes to the columns shown on the Recommendations tab of our site, which holds our portfolio performance and guidance. The key changes are**:**

- **Our "% of Port" column is being renamed "Recommended Allocation."** As ever, this shows the percentage of your funds that should be invested in each holding to match us. We always stand behind our current percentage, and we'll change it with a trade alert when we feel an adjustment is needed.

- **Our "Buy Around" guidance is being renamed "Consider Adding More."** Too often, a company's stock price would eclipse our "Buy Around" price soon after a recommendation. Because the stock would still (purposely) be rated "Buy" on our scorecard, this could be confusing for newcomers (and vets!). First and foremost, we *want* members to follow our "Buy" and "Hold" guidance — that's much more important than the "Buy Around" price, which is initially anchored to a specific moment in time (when the recommendation is sent). To remove this confusion and make *Pro* a better service, we've changed the title of this column: "Consider Adding More" makes it clear that the price listed here is an *ideal* price. When the stock hits that level, we ourselves will consider adding more … and we'll tell you our decision within 30 days of the price being reached. We hope this new structure makes clear that all of our positions rated "Buy" are buys today. As for "Consider Adding More," that's the price at which we'll do exactly that — consider it, and then report back to you.

- **Positions will be sorted by allocation, largest first.** Our "long" positions will be displayed largest to smallest, so we all focus on our largest holdings first. You can also re-sort the table by company name, ticker, etc., by clicking on the header of each column.

These changes should appear on the Recommendations page this week (along with an explanation of each at the bottom of that page). We're excited about the increased clarity, and we hope you'll enjoy and profit from the improvements!

Earnings Smorgasbord

For the most part, earnings are coming in strong, especially considering that fourth-quarter GDP growth wasn't impressive (as in, it was negative). Last week, we posted deeper reviews on:

- **Apple** , which is largely a margin story right now.
- **BMC Software** , which needs to grow new sales.
- **Gentex** , which withstood industry headwinds well.
- **OpenText** , which continues to look like a good strangle candidate with long-term upside.
- **Tupperware** , which is growing on share buybacks and jacked up its yield.
- And we'll have coverage on **Facebook**'s results soon; our first take is that things are moving in the right direction and spending to grow makes sense.

To discuss the Memo, please visit the Memo Musings board. Fool on!

— Jeff Fischer (TMFFischer)

Guidance Updates

- **Pebblebrook Hotel Trust**: Moved to sell.
- **Apple**: Fair value moved down to $660. Shares remain a buy.
- **BMC Software**: Fair value estimate moved down to $50. Shares remain a buy.
- **Gentext**: Fair value estimate moved up to $23.50. Shares remain a buy.
- **Tupperware**: Fair value estimate moved up to $68. Shares remains on hold.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **CurrencyShares Euro Trust**: Sell short up to 3.9% exposure if you haven't already.
- **OpenText**: Shares remain a buy, but if you only want to potentially buy the stock lower, sell to open May 2013 $55 puts, lately for $2.20 (a 4% yield), up to a 2.6% initial allocation — and a 5% total allocation (which we'll have if our $50 puts are exercised).
- **Gentex**: Shares remain a buy, but if you only want to potentially buy the stock lower, sell to open June 2013 $17.50 puts, lately for $0.80 (a 4.5% yield), up to a 2.7% total allocation.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Earnings Smorgasbord!** Please see above for our latest earnings coverage.
- **Exuberance alert?** StamLeo asks if we're seeing the first signs of market exuberance, kicking off an exuberant conversation among *Pro* members.
- **BigOil1 is a Poet:** Enjoy his immortal prose on the **StoneMor Partners** board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Sell Pebblebrook Hotel Trust

Published Feb 1, 2013 at 12:00AM

- **What We're Doing**: We're selling our shares.
- **What We're Thinking**: The risk-to-reward ratio of this investment is no longer compelling.
- **What We're Expecting**: The hotel industry is no longer in distress, shares are no longer mispriced, and our yield expectation proved too optimistic; these factors make North Star-like returns less likely.

Trade Essentials

- **Action**: Sell **Pebblebrook Hotel Trust** (NYSE: PEB)
- **Allocation**: Sell all of your shares; for *Pro*, this frees up 4.2% in cash.
- **Price Guidance**: The stock is thinly traded, so **be patient and use a limit order**; *Pro* may use up our full 30 days to complete the transaction. Sell your shares for more than $24.50.
- **Recent Share Price**: $25

What's New?

When we purchased Pebblebrook in May 2011 (and again in July and September of the same year as the stock price fell), its financial statements were a disaster. What little information was provided was hard to understand, and that fact, combined with the overall uncertainty of the company's future capital allocation decisions, provided a likely source of mispricing in our favor. Our simple thesis hinged on three points: Desperate sellers were selling hotels too cheaply; an industry veteran at the helm provided us an edge; and a rising yield, which we forecasted would be at least $1.48 per share by now, would drive our returns.

Just over 20 months later, our investment is up almost 25% and management is still buying hotels. This investment has exceeded our North Star! So why are we selling?

1. We Were Too Optimistic

This is hard to admit, but all three points of our original thesis have proved only partially true. First, there's evidence that while Pebblebrook did purchase some of its hotels at a discount, it overpaid for others, including its Manhattan joint venture. Management has boasted that the company's reputation for overpaying brings in more off-market deals, but we're not sold — Warren Buffett underpays and still gets private offers. And having a well-connected industry veteran at the helm, while undoubtedly a benefit, is par for the course in the industry; novices don't tend to run REITs. Our largest error, however, was one of potential yield. The low range of our dividend forecast for 2013 was three times higher than the current payout, and it's now clear it will be years before Pebblebrook will meet our previous expectations.

2. We've Already Captured the Upswing

The whole industry benefited from an upswing in revenue per available room (a key metric for hoteliers). Conditions appear to have normalized since the 2009 trough, but REIT managers will continue to do what REIT managers do — namely, raising capital and buying properties. Shares outstanding have tripled since Pebblebrook's 2009 IPO and continued to increase quickly during the time we owned shares. That's a good thing as long the capital raised is invested in properties that earn strong returns, but frankly, we're not optimistic that the current market supports high levels of reinvestment at great rates. Management is targeting an 11% leveraged return on invested capital, not enough to be attractive to us.

3. We Can Better Focus Our Portfolio Elsewhere

Any asset can make a great investment at the right price. Hotels aren't great businesses, but we invested opportunistically and earned a good return. Now it's time to check out and focus our efforts on higher-conviction ideas. At our recent over-or-under meeting, the team agreed that Pebblebrook, at current prices, was likely to perform worse than our North Star. Thus, selling the stock and redeploying our funds was a unanimous decision and will give us a better chance at achieving North Star-worthy returns.

Next Step

- Bring your questions to the Pebblebrook message board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

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5 Things Every Investor Should Know

Published Jan 28, 2013 at 12:00AM

Dear Fellow Fools,

If you don't keep your wits about you, a rising market can make you almost as anxious as a falling one. Should you sell some positions that have gained ground? If you have cash on the sidelines, should you invest it in stocks, or does it make more sense to add hedges instead? These are questions we're asking every day for you, and thankfully, the answers are typically available if you know the following five things about yourself as an investor.

1. Know Your Time Frame

At *Pro*, we think in terms of three years or longer with most of our core investments: Will a business create enough value over the next three years to make owning it at today's price worth the risk? Whenever the market seems overheated or beaten-down, it pays (and is calming) to remember your time frame before you assess your next step. Your time frame should take into consideration any tax burden you would face when selling, too. In relation to time frame, remember that "fair value" is an estimated fair price for a seller *or* a buyer today, and this value should appreciate annually as the business grows.

2. Know Your Thesis

You should have a clear and up-to-date reason for every position you hold. It's important not to hold so many positions that you don't recall why you own some of them or can't keep current with each business and its competitors. Write the reason down, so you can review it as necessary. (This week, we're going to summarize our thesis behind each position on *Pro*'s "What We Think Now" page.)

3. Know Your Portfolio

First, an investor must last. Your portfolio should be weighted strategically and diversified enough to withstand a potential sharp drop in several positions at once. Don't neglect the importance of building a portfolio that can safely endure a market slide, because setbacks are inevitable. *Pro* is most heavily invested in financials and technology, because we see attractive value and opportunity in both, and our largest long position is **AmTrust Financial** at a still-reasonable 6.4%. We're also maintaining hedges, on some positions and on indexes, to soften declines.

4. Know Your Objectives

When you invest, you don't expect to be right in every choice you make. In fact, you maintain a diverse portfolio because you *know* you'll frequently be wrong. Nobody has enough information to make a perfect decision, and even if they did, that information is always evolving. *Pro*'s objective is to make steady money *overall* with our portfolio, not with every position within it — because try as we might, we know that's not realistic. The portfolio is our true "body of work" — positions in it are the means to make the whole.

5. Know Your Humanity!

Finally, realize that the qualities that make you a good investor also contribute to your mistakes. There are lessons to be learned when positions don't perform as expected, but whatever led you to buy those positions also led you in different ways to buy your winners. Just as you need valleys in order to define mountains, you need mistakes to define your successes. So cut yourself some slack, because perfection is impossible.

For example, our three-year time frame (see No. 1) means we're currently holding some strong winners, including **MasterCard** and **Tupperware**, even as their valuations appear to have gotten a year or two ahead of themselves. We want to grow our gains further as these businesses grow, even though this desire may lead to some missed opportunities to sell before a decline in these positions (or some others). We're fine with that, because we know that on the whole, this patience should help us come out ahead over our time frame.

So, as we focus on getting earnings reviews to you over the coming days and positioning our portfolio for 2013, we continually revisit these five principles. I hope that you will at home, too, whether you mirror *Pro* exactly or (especially) if you only follow our portfolio moderately. To discuss these ideas, please visit our Memo Musings discussion board.

Foolishly,

Jeff (TMFFischer)

Pro Trade Roundup

- **Sony** : *Pro* bought to cover its full position at $13.27, resulting in a 21% gain on the short while the indexes reached new five-year highs over the same period.
- **Direxion Daily Financial Bear 3x Shares** ETF: We sold short 1,900 shares at $12.53, opening a 1.5% short.

Guidance Updates

- **Starbucks** and **AmTrust Financial Services** move to Buy from Buy First due to valuation.

Coverage & Community

- **Earnings Ahoy!** TMFMoosie shares an updated earnings calendar. You can also see earnings dates on the site's alerts tab. This week we'll see results from **BMC Software**, **Facebook**, **Tupperware**, and others. You know what we'll be working on!
- **Starbucks Serves Up Rich Results:** Our favorite mass-market café reported healthy growth.

See Pro*'s holdings [here](). See the team's and David and Tom Gardner's holdings [here]().*

Ready to Become a Pro Investor?

Published Jan 28, 2013 at 12:00AM

Get Started Now!

As an experienced investor, you probably don't need too much ramp-up time to start making money the *Pro* way. (Want to take our survey again? Click here.)

{% ooyala id="x0b2xkNToYBbOOwQBbaPwQbHIXYlMzjb" width="264" height="201" %}**Video**: Jeff gives a quick introduction to *Pro*

Create Your *Pro* Portfolio
Read our first catch-up report
+ Catch-Up Report 2: 2/28/13
+ Catch-Up Report 3: 3/7/13
+ Catch-Up Report 4: 3/14/13
+ Check-In Event: 3/19/13

***Pro*'s Investing Strategy Guide**
The recipe to our secret sauce

What *Pro* Believes
NEW: Jeff's investing outlook for 2013

Quick Links: Our Most Important Resources, One Click Away

Mission & Philosophy

- Investing Strategy Guide (PDF)
- Our North Star
- What We Believe
- Audio Extra: The *Pro* Philosophy
- Philosophy & Strategy discussion

Catch Up With Us

- All of Our Catch-Up Reports
- Investing Strategy Guide (PDF)
- Make *Pro* Fit You
- Building Your *Pro* Portfolio
- Use Options Like a Pro

Tools & Help

- FAQ
- Get Oriented
- Manage Your Email
- The *Pro* wiki
- Getting Started & Help discussion

Using Options

- Use Options Like a Pro
- Make Your First Options Trade
- Options in 3 Steps
- Options Glossary
- Options discussion

Short the Direxion Daily Financial Bear 3X Shares ETF

Published Jan 23, 2013 at 12:00AM

- **What We're Doing:** Financial stocks are attractively priced, so we're selling short a bearish financial ETF that is additionally compromised by its use of leverage.
- **What We're Thinking:** Shorting this flawed ETF is a way to profit on the financial sector's recovery. (An added benefit: The ETF's losses could potentially compound daily.)

Trade Essentials

- **Action:** Sell short **Direxion Daily Financial Bear 3X Shares** (NYSEMKT: FAZ) ETF
- **Allocation:** 1.5% (short $1,500 worth for every $100,000 you manage)
- **Recent Price:** $12.80
- **Price Guidance:** Use a limit order at the market's going price.
- **Short Availability:** Interactive Brokers recently showed 500,000 shares available for shorting at a 5.34% annual fee. TD Ameritrade has shares available periodically, with no fee. Other brokers vary, but shares are scarce. We have alternative trades at the end of this report.

The Big Picture

Would *you* like to sell short, or bet against, **Wells Fargo** (NYSEMKT: WFC), **Berkshire Hathaway** (NYSEMKT: BRK-B), **Visa** (NYSEMKT: V), **Goldman Sachs** (NYSEMKT: GS), **American Express** (NYSEMKT: AXP), and **MasterCard** (NYSEMKT: MA) right now? Nor would we. But that's exactly what the **Direxion Daily Financial Bear 3X Shares** (NYSEMKT: FAZ) ETF does — and it levers up three times in the process.

This bearish ETF is meant to provide 3 times (300%) the daily *inverse* results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. The companies mentioned above are six of the index's 10 largest holdings. By shorting this ETF, we'll effectively be three times long, on a daily basis, the U.S. large-cap financial sector — including these leaders.

Less than five years after a banking meltdown the likes of which America hadn't seen in 29,000 days (read: since 1929), many still view these companies with suspicion. But throughout history, banks periodically collapse and are revived. Following the largest bailout in modern times, the financial sector is likely a more sensible investment now than it has been in decades, and yet it trades inexpensively because the memory of 2008 holds strong. As Warren Buffett said last week, "The banks will not get this country in trouble, I guarantee it ... Our banking system is in the best shape in recent memory."

The Vehicle

The FAZ ETF holds nothing but "financial swaps" (and cash equivalents) that give it short exposure to the underlying index (and it charges a 0.95% annual fee for this privilege, which helps our short). The underlying Russell 1000 Financial Services Index is deceptively comprised of only a few hundred stocks; it's a subset index of the Russell 1000 itself. As of Sept. 30, 2012, the index was concentrated in banks (20.4%), insurance (19.3%), real estate investment trusts (18.5%), and diversified financial services (16.9%). Some key statistics as of Dec. 31, 2012:

Russell 1000 Financial Services Index

Average market cap (dollar-weighted)	$66.9 billion
Median market cap	$4.3 billion
Price-to-book value	1.16
Dividend yield	2.08%
Long-term growth forecast (I/B/E/S %)	10%

The index trades at an average valuation of only 1.1 times book value — well below the long-term average of at least 2. The index also sports approximately the same yield as the S&P 500; many of its components' dividends are currently depressed and should slowly grow. For what it's worth, I/B/E/S expects average earnings per share for the index to expand 10% a year for the next five years. More tellingly, we at *Pro* expect return on equity to slowly improve as major financial institutions heal, and net interest income should jump if interest rates start to increase in the next few years, as I believe they will.

As with many leveraged, bearish ETFs, this one has lost the majority of its value since its 2008 inception, but — in a testament to investors' lingering concern — it remains viable and liquid, with $330 million in assets and more than a million shares traded daily. Direxion will likely once again conduct a reverse split if shares decline to single digits; it enacted a five-to-one split in 2011.

How to Follow Along

Despite Buffett's guarantee, there is no guarantee. Plenty of risk remains hidden in the banking sector, so we should not be surprised to see some shocks, such as **JPMorgan Chase**'s (NYSEMKT: JPM) "London Whale" trade loss last year. Banking woes in Europe could rapidly spread to U.S. banks, too. By definition, we can't anticipate every risk, so **it's extremely important that you adhere to our allocation guidance and short no more than a 1.5% position**. That way, even if the ETF *doubles in value* and — for argument's sake — your broker forces you to close your short, you would only lose 1.5% of your portfolio.

On the other hand, if we make money on this short, its allocation will shrink among our holdings. (As a short works in your favor, it becomes a smaller position.) If that occurs, we can consider adding to the position as frequently as we wish to maintain around a 1.5% allocation — as long as shares remain available for shorting and we like the valuation of the index. This way, we could earn very meaningful profits over time even on what starts as a small position.

Because this ETF's shares are leveraged and hard to borrow, one of our largest risks is getting called out of our short on a spike. Should financial stocks fall 20% quickly, this ETF could rise at least 60%, and our shares could be called away at the worst time. Thus, again: **Start with a small allocation, no more than 1.5% (less if you want to test the waters)**.

I'll repeat that this position is not without risks: a possible negative impact on financial firms from the slow but steady implementation of the Dodd-Frank regulations; any changes in the Basel capital requirements; any remaining off-balance-sheet or derivative contracts on the banks' part, which could rear up and bite us. But if you believe, as we do, that further stability and recovery are most likely in the coming years, then short a small amount of shares with us — no more than 1.5% — to get started.

Alternative Trades

A Note on the Opposite ETF

We don't suggest buying it. We don't recommend buying the **Direxion Daily Financial *Bull* 3X Shares** (NYSEMKT: FAS), because like the one we're shorting, this ETF is flawed, even though it's up more than 60% since 2008.

- **Options (non-IRA):**If your broker doesn't have shares available to short, consider setting up a January 2015 synthetic short on FAZ. Sell to open January 2015 $13 calls, and buy to open an equal number of January 2015 $13 puts.
  - **Price guidance:** Lately, this syn short can be set up for a net debit of around $1.70, resulting in a start price of $11.30 per share. That's 11.7% below the ETF price, which nearly equals the fee you'd be charged for shorting for two years. Set up one syn short for every 100 shares you want to short at $11.30 – at 1.5%, that's one syn short for every $75,000 you manage. (See our guide to synthetic shorts for more on the strategy.)
- **Options (IRA):** You could simply "buy to open" Jan. 2015 puts at a strike price and for a total cost that you're willing to risk. With strikes near-the-money, I expect you'll earn a profit before expiration, although the puts are expensive, so this is a "last resort" trade for a small sum. (In other words: Don't allocate 1.5% of your funds, just what you're willing to potentially lose.) Lately, you can buy to open January 2015 $15 puts for about $6 and change. Or, buy to open January 2015 $10 puts and risk about $2.60 each.
- **Bullish on Financials:** If you can't short this financial index, you could instead buy an additional 1.5% in *Pro* stocks Wells Fargo or **AIG** (NYSEMKT: AIG) (or split it between both). Our short is expressing a bullish stance on large-cap financials, after all.

Next Step

- **For discussion:** Our bank window is always open! Visit our Direxion Daily Financial Bear 3X Shares board.

The Motley Fool owns shares of Berkshire Hathaway and JPMorgan Chase & Co. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Cover Your Sony Short

Published Jan 22, 2013 at 12:00AM

- **What We're Doing:** Buying to cover, or close, our short on **Sony**.
- **What We're Thinking:** Our hedge on this short expired Friday, and rather than pay to hedge the short again, we'll take our gain.

Trade Essentials

- **Action:** Buy to cover, or buy to close, all of your short shares of Sony.
- **Recent price:** $13.20
- **Price guidance:** Use a limit order to close at current prices; let's not push the stock up.

What's New

We've made approximately 20% being short **Sony** (NYSEMKT: SNE) since April 2012, while the stock market has run to multi-year highs. The company is continuing to lower costs and raise cash by selling assets — including its New York headquarters, for $1.1 billion — and by eliminating 10,000 jobs. At some point this year, Sony believes it could turn a net profit, reversing years of losses. The question is, how weak will the company and its long-term prospects be by that point? Will focusing on higher-margin products pan out?

As of now, we won't be around to ask. Our protective calls expired on Friday, and buying new ones at a reasonable strike price for several months out would eat into a fair amount of our profits, so instead we're taking our money and going home. Recall that last week, we told members who were just short calls to buy to close those calls to end the position, so closing our direct short places us all on the same page.

As speculative stocks such as **Research in Motion** (Nasdaq: RIMM) soar from $6 to $17, Wall Street's appetite for risk appears to be growing. In this spirit, Sony could garner more buying interest as management continues to promise a recovery. Given the more speculative nature of staying short at this juncture, we'll take our profit instead and keep an eye on Sony for future opportunities.

To discuss this position, please visit the Sony board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

What We Believe — 2013 Update

Published Jan 22, 2013 at 12:00AM

Dear *Pro* Members:

Starting each year by reassessing your largest business beliefs can help ensure that your investments are aligned with your deepest convictions. Last January, we first published a list of the core beliefs that drive the *Pro* portfolio; today, it's time to update you on what we believe.

Last year, two of my most significant new beliefs were that housing and auto sales would start to recover. Both theories are so far proving out, but aside from two *Motley Fool Options* positions (**Lowe's** and **Ford**) and *Pro*'s purchase of **Gentex**, we haven't capitalized on them yet. Of course, it's not enough just to have beliefs. The hard work is to invest well alongside them so you profit when they prove to be right.

Beliefs must also remain fluid. Last year, I posited that oil and energy prices could increase. Once that happened, *Pro* sold its two main oil positions, because the *Pro* team and I now believe energy prices are likely to remain stable — or even decline, thanks to the vast new oil and natural gas reserves the U.S. is tapping.

Without further ado, below are many of my strongest big-picture beliefs.

I Believe …	So We Own …
Technology is essential to our world; the sector will grow and become even more important. But tech will remain cutthroat, with players rapidly coming and going, allowing both long and short opportunities.	**3D Systems** , **BMC Software**, **Intel**, **OpenText**, **Oracle**
Well-managed financial companies are still inexpensive and will reward long-term owners.	**AIG** , **Amtrust Financial Services**, **Broadridge Financial Solutions**, **Wells Fargo**
U.S. home construction will continue to recover.	**GrafTech International** , **Rockwood Holdings**
Cash and checks will continue to lose market share to electronic payments.	**MasterCard**
The euro is overvalued compared to the dollar.	Short **CurrencyShares Euro Trust**

The 14 positions listed above represent nearly 60% of the assets in the *Pro* portfolio. We carry the other positions because we believe they'll help us keep pace with our always-positive North Star, or because we believe in management or the notion that (for example) the world could almost never have too many coffee bars. Below are some of my other beliefs that we'll also seek to capitalize on:

- Energy prices will be relatively stable and will potentially decline as the U.S. taps new reserves.
- Flawed ETFs will continue to offer profit opportunities, especially for shorting.
- Auto sales will recover and reach new records, and autos will offer many more technological bells and whistles.
- Our interaction with technology will evolve to commonly include voice commands.
- Most all products will eventually contain a computer chip of some sort.
- Big data will drive ever more pinpointed marketing, and social websites will become still more popular (and profitable).
- Paper media of all forms in the U.S. will come close to disappearing within 10 years.
- Younger generations will want to be memorialized online more than with a tombstone.
- I will live to at least 100 years of age, as will all *Pro* members.
- Healthy eating will remain a growing theme in the U.S.
- Many dominant U.S. companies will thrive, if not lead, in emerging markets.
- Some big retailers will revive and prosper by offering a specialized experience unavailable online.
- Cloud computing — storing files on remote servers — will be an even larger business than expected.
- A sustainable competitive moat will be more important than ever to strong stock performance.
- Interest rates will start to tick up in the next 24 months, but not by much initially.
- Alongside owning great businesses, *Pro* will do well by generating increased income and doing more targeted shorting.

Last year, I also believed "some European stocks look[ed] very cheap." In my estimation, we let ourselves down in 2012 by not investing in European markets that have since rebounded sharply. But with our goal of absolute returns, taking a flier on Greece wasn't in our wheelhouse, and we didn't find a comfortable stock to express our belief. I also suggested that water management and agriculture will be strong investment industries in coming years (not a hard belief to reach). We've owned companies aligned with this belief before, **Flowserve** and **Lindsay**, both of which we sold on valuation. We're seeking new companies through which to express this belief; **Deere** was high on my list of possibilities in early 2012.

Finally, last year, I believed emerging markets were an attractive place to invest. This year, I'm dropping that belief from my list; I *suspect* emerging markets will perform decently, but I believe *Pro* can perform just as well or better, with lower risk, by investing in American companies capitalizing on new markets, such as **Starbucks**.

What Bryan Believes

I asked the team to share their updated beliefs for this year, too. Bryan Hinmon's (TMF42) are below. Nick Crow (TMFCrow), on the other hand, said his job is to talk us *out* of our beliefs. He'd rather not think in terms of beliefs as he looks for investments — a diverse viewpoint we welcome. Here are Bryan's:

- Governments at all levels will begin to peel away conservatism by trying new ways to save money.
- People will try to be healthier, but they will fail and look for quick fixes.
- Web security is a big deal, for companies and for individuals.
- People will see their houses as homes, not investments. (Sub-belief: Kitchens will get bigger and more high-tech.)
- Electronic payments will continue to take share from cash.
- Brands viewed as soulless or "corporate" will suffer as consumers embrace individualism and companies with a heart.
- Chocolate is awesome (the new coffee).
- The impact of "big data" is likely to prove overhyped except in specialized instances, such as targeted advertising or health care (for example, the self-tracking movement exemplified by sites like NutritionData.com). In both cases, the data is relevant not for its size but for what can be culled from it.

What Do You Believe?

There you have it, Fools — many of our beliefs updated and laid bare. What are your key investing beliefs? Share them on *Pro*'s Philosophy discussion board so we can discuss whether and how to put them into play this year.

Foolishly,

Jeff Fischer (TMFFischer)

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **OpenText**: Shares remain a buy, but if you only want to potentially buy the stock lower, sell to open May 2013 $55 puts, lately $2.80 (for a 5% yield), for up to a 2.6% initial allocation and a 5% total allocation (which we'll have if our $50 puts are exercised).
- **GrafTech International**: Shares remain a buy at a 2.2% allocation, but if you want to target modest income with a low probability of getting shares, sell to open June 2013 $7.50 puts, lately paying $0.25. That's a 3% yield (before commissions) in five months — not outstanding, but it has a breakeven price 23.2% below last Friday's closing price.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Intel Reports and Retreats: Intel**'s stock turned south as PC sales declined. Read our initial take on the company's quarter.
- **Sony Soaring:** It's an upside-down world, with **Sony** and other beleaguered stocks soaring. Jeff explains why the short is still a success, and how *Pro*'s methodical approach should lead to higher gains overall.
- **Earnings Time:** TMFMoosie shares an updated earnings calendar. You can also see earnings dates on the site's alerts tab. This week we have results from **Apple**, **OpenText**, and **Starbucks**.
- **ADrumlinDaisy's 2012:** Rich shares why his 2012 was great in all the ways that matter, but in some ways awful for some of his investments.

The Motley Fool owns shares of Ford. See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Keeping Sight of Our North Star

Published Jan 14, 2013 at 12:00AM

Dear *Pro* Member:

Despite tamer earnings growth, a foundering European economy, a slowdown in China, and budget battles in the United States, the U.S. stock market last year had its strongest performance since 2009, treating Foolish owners like you and me to healthy appreciation of between 10% (the Dow Jones Industrial 30) and 16% (the S&P 500).

Last year's concerns are not likely to subside in 2013. Earnings growth is likely to slow further, the U.S. budget battle will continue on Capitol Hill, unemployment in Europe is bleak, and it's easy to question the growth numbers coming from China. In other words, there's plenty of healthy skepticism in the market, and it may serve *Pro* Fools well in the long run by keeping stock prices reasonable. We remain dedicated to finding great businesses to own, because even in the eye of the storm, there's always something thriving.

Past buy decisions paid off for us in 2012, with the *Pro* Portfolio advancing 14.3%. Below is how our returns since inception stack up against our always-positive North Star.

Date	*Pro* Portfolio Value	*Pro* Period Return	*Pro* Cumulative Return	North Star Period Return	North Star Cumulative Return
10/6/2008	$1,000,000	--	--	--	--
12/31/2008	$1,002,558	0.3%	0.3%	1.6%	1.6%
12/31/2009	$1,222,428	21.9%	22.2%	9.7%	11.5%
12/31/2010	$1,382,924	13.1%	38.3%	8.5%	21%
12/31/2011	$1,278,774	(7.5%)	27.9%	10%	33.1%
12/31/2012	$1,461,697	14.3%	46.2%	9.3%	45.4%

We enjoyed a strong 2012 despite having a 30% hedge on the S&P 500 as the year began. We slowly reduced that hedge to 10% by year-end, but on average last year we had net long exposure of only about 75%. In other words, we achieved strong returns with less risk, because we were always hedged — and because we always had cash, which made up 14% of the portfolio at the end of the year.

It's hard to quibble with our raw numbers when comparing *Pro* to the market or to our aspirational North Star — and it's especially hard when comparing *Pro* to other portfolios that hedge. Hedge Fund Research's "Equity Hedge Total Index" showed only a 7.4% average return for hedge funds in 2012, and a five-year annualized return that is actually negative. As has been widely reported, hedge funds have had a rough go of it since 2008.

But quibble we will, because we can always improve. Last year, we struggled to find short candidates to replace our S&P 500 hedge, and we missed a large gain by not being short volatility. For those who weren't with us in 2011, the sole reason we lost value that year was a short volatility position. The short ran sharply against us as the **CBOE Volatility Index** (VIX) soared following the U.S. credit downgrade. Had we been able to wait out the position (rather than being forced out by our former broker's lack of available shares to short), it would have turned into a very large profit last year.We lacked the wherewithal or desire to get back into the position right away, but plan to do so incrementally now that short availability is much less of an issue.

But that's in the past. We always live for the future. Our guiding goal is to keep our losses as small as possible while managing the portfolio for steady gains akin to our North Star/Remember, the North Star (inflation plus 7% annually) historically outperforms the broader stock market and of course does so with much less volatility than the indexes, and nary a negative year. It's a tough taskmaster to come close to, so as we enter our second year following our North Star, we are dedicated to finding even more innovative, sensible ways to build a portfolio that produces strong returns with more modest drawdowns than the market at large.

2012 Summed Up

Last year, *Pro*:

- Issued 53 trade alerts (averaging one per week)
- Thirty of those were options-centric, making 23 stock or ETF-focused
- Welcomed 12 new positions to the service, including **Sony**, **Starbucks**, **The Buckle**, **Facebook**, **ProShares UltraShort Real Estate**, and **AIG**.
- Completely closed eight stock positions, including **Ebix**, **Autodesk**, **L3 Communications**, and **Vanguard Energy**. (I'll write more about our sells early this year.)
- Sent you 50 Monday Memos with countless Catch-Up Trades
- Read and wrote thousands of posts on the discussion boards! (Thank you!)

As Nick outlined last week, our cash winners in 2012 were led by **AmTrust Financial Services** for the second year running, validating our longstanding decision to keep the stock as a Buy First. **3D Systems** was second in our cash returns, but first in absolute gains — in fact, it was one of the biggest gainers across the entire market. In retrospect, the stock's performance proved wrong our initial decision to write covered calls and let some shares go, but I believe our covered strangle is sensible now.

Overall, the reality is that we don't particularly care which positions do the heavy lifting for us in any particular year. We have a portfolio precisely *because* we don't know where our biggest winners will be — we simply want the portfolio to perform as a whole, while letting us sleep well at night. The *Pro* portfolio did that last year. Now it's time to improve all we can in 2013 and beyond.We still want to introduce new shorts, continue to focus our longs, and keep cash for new ideas.

If you'd enjoy a few more thoughts about our portfolio, look no further than Fool member Gunnar Peterson's column on *Pro*'s look-through earnings and yield in 2012.

We'll talk more about the lessons learned in 2012 (and indeed, every year since 2008) as the year goes on. We're glad you're here, and we look forward to another full 12 months of Foolish investing, *Pro*-fashion! To discuss this Memo, please visit the Memo Musings board.

— Jeff Fischer (TMFFischer)

Pro Trade Roundup

- **iShares Russell 2000** ETF: We set up a new put ratio spread at a 10% allocation (on the long puts) by selling to open 34 May 18, 2013, $80 puts, and buying to open 17 May 18, 2013, $86 puts. We received a $0.05 credit before commissions.
- **iShares Russell 2000** ETF: We bought to close our Jan. 19, 2013, $75 puts for $0.01.
- **SPDR S&P 500**: We set up a put ratio spread at a 10% allocation (on the long puts) by selling to open 20 Feb. 16, 2013, $140 puts and buying to open 10 Feb. 16, 2013, $144 puts. We paid a $0.09 debit before commissions.
- **SPDR S&P 500**: We wrote covered puts on our 1,000 short shares, selling to open 10 Feb. 16, 2013 $146 puts for $2.51 each.

Guidance Updates

- **Tupperware**: Shares move from buy to hold on valuation.

Expirations

We have three options expiring after Friday's close this week:

- Our **Starbucks**$47 puts are due to expire for a full cash gain, and we'll look to write puts again.
- We already suggested closing your January put ratio spread on the **iShares Russell 2000 Index**. You should buy to close your $75 puts and, given that there's no bid, you might as well leave your long $78 puts alone. If the market tanks enough this week (no thank you!), they'll become a boon.
- If you still have your January 2013 bear call spread on **Sony**, buy to close your $5 calls, and let your long $22 calls expire. You've made a good return on this bearish spread. We're reassessing our direct short of the stock (which our spread turned into) but I don't currently believe that setting up a brand-new short at today's price is that attractive.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **BMC Software**: Shares remain "buy first," but if you only want to potentially buy the stock lower, sell to open May 2013 $40 puts, lately $1.40, for up to a 4.5% allocation.
- **The Buckle**: If you want to target a purchase price near our $36.50 buy around guidance, sell to open June 2013 $38 puts for around $1.90. That's also a 5% yield in just over five months. Our current stock allocation is 3.1%.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **It's Earnings Time Again!** Reports start this week, and we'll hear from **Intel** first. Many others follow; see TMFMoosie's calendar.
- **Are Bond Buyers' Eyes Open to Risk?** TMFMoosie shares Howard Marks' thoughts on investing in fixed income securities. Then visit our Bond Banter board if you have questions.
- **Is Apple Ripe?** Andy (member hkspike in Hong Kong) shares the market's concerns that Apple's growth could fall short of expectations.

The Motley Fool owns shares of Ebix and L-3 Communications. See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Roll Your Put Ratio Spread on the iShares Russell 2000 Index

Published Jan 8, 2013 at 12:00AM

- **What We're Doing:** As our January hedge on the small-cap index nears expiration, we're closing it to open a new one at higher strike prices, expiring in sun-washed May.
- **What We're Thinking:** We want to continue to use hedges that won't ding our returns in a rising market; this one allows us to profit if the index falls as much as 14.5%.
- **What You Should Do:** Set up this new hedge to mirror the *Pro* portfolio. If you're not interested in hedging, you don't need to. We believe the companies we own will continue to provide strong returns.

Trade Essentials

- **First Action (Closing Old Trade):** Using a ratio spread order, close your Jan. 19, 2013, put ratio spread on the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF.
  - Buy to close all of your January 2013 $75 puts
  - Sell to close all of your January 2013 $78 puts
  - Recent ask (on two $75 puts) / bid (on one $78 put): $0.02/$0.01
- **Price Guidance:** You'll pay a net debit of $0.01 to close the spread. Because the price is less than $0.05, many brokers won't charge a commission. You could instead let the spread expire next Friday, but that would leave you sitting on a potential obligation if the ETF falls below $75.
- **Recent ETF Price:** $86.60

- **Second Action (New Trade):** Using a ratio spread order, set up a May 18, 2013, put ratio spread on the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF.
  - Sell to open two May 18, 2013, $80 puts
  - Buy to open one May 18, 2013, $86 put
  - Recent bid (on two $80 puts) / ask (on one $86 put): $3.94/$3.81
- **Price Guidance:** Lately you'll receive a net credit of $0.13 per spread. As prices change, just aim to set it up for any credit.
- **Allocation:** *Pro*is hedging nearly 10% of its long exposure and is ready to potentially invest about 10% in the ETF, so we'll write 34 puts and buy 17. It breaks down like so:
  - Portfolio value: $1,500,000
  - 10% of that value: $150,000
  - Buy to open $86 puts (17 contracts, representing 100 shares each) = $146,200 in look-through exposure, or nearly a 10% hedge on our current portfolio value
  - So, sell to open 34 $80 puts (half of which become a potential obligation)
  - Simply stated, hedging 10% of your assets, you would buy one $86 put for every $86,000 you want to hedge
- **Alternative Trades:** Please see the end of the report.

Strategy Details

The **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF tracks 2,000 small companies, and it is one of our preferred vehicles for hedging because of its high historical volatility. This ETF should be especially sensitive to a declining market.

Using a spread order, we're writing $80 puts that obligate us to buy shares of IWM (unless we close the puts beforehand) if they decline below that strike by expiration. We're using most of the money we receive for writing the puts to *buy half as many* $86 puts that expire the same month. The $86 puts will profit if IWM declines, and they cancel out half of our $80 put exposure. Here's how the math and potential returns tally:

iShares Russell 2000 Index ETF Price	Value of 1 Purchased $86 Put	Value of 2 Written $80 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%) From $86.60
$86 or higher	$0	$0	$0	(0.7%) or less, or any increase
$85	$1 x 100 = $100	$0	$100	(1.8%)
$84	$2 x 100 = $200	$0	$200	(3%)
$83	$3 x 100 = $300	$0	$300	(4.2%)
$82	$4 x 100 = $400	$0	$400	(5.3%)
$81	$5 x 100 = $500	$0	$500	(6.5%)
$80	$6 x 100 = $600	$0	**$600**	**(7.6%)**
$78	$8 x 100 = $800	($2) x 200 = ($400)	$400	(9.9%)
$76	$10 x 100 = $1000	($4) x 200 = ($800)	$200	(12.2%)
$74	$12 x 100 = $1200	($6) x 200 = ($1200)	**$0**	**(14.5%)**
$72	$14 x 100 = $1400	($8) x 200 = ($1600)	($200)	(16.9%)
$70	$16 x 100 = $1600	($10) x 200 = ($2000)	($400)	(19.2%)
$68	$18 x 100 = $1800	($12) * 200 = ($2400)	($600)	(21.5%)
$66	$20 x 100 = $2000	($14) x 200 = ($2800)	($800)	(23.8%)

As noted in bold above, we earn our maximum profit if the ETF declines 7.6% to $80 by our May expiration, and we start to suffer losses if it declines more than 14.5%, or below our $74 break-even. To summarize:

If the ETF (i.e., the Market) Does This ...	Then Our Strategy ...
Goes up, stays steady, or declines less than 0.7% (staying at or above $86 at expiration)	Doesn't cost us anything — in fact, we earn any credit paid to us when we initiated it.

Declines between 0.7% and 14.5%, to between $85.99 and $74.01	Earns a partial to full profit, depending on the amount of the decline.
Declines more than 14.5%, to $73.99 or less	Shows a loss by expiration. We can close the options and roll to a new ratio spread; take shares of the ETF to own; close the options and buy calls instead; or set up a synthetic long to lower our cash outlay and turn bullish.

Returns on this strategy won't occur smoothly or immediately. As with most spreads, we'll need to wait until close to expiration to achieve results, because the two opposing options in the spread at least partly cancel each other out until time value in each dissipates. But assuming we set this up for a credit, the position will result in a small profit even if the market rises or treads water — and much more importantly, it will pay us well if the ETF declines about 4% to 10% by May 18.

Alternative Trade

- **If you're hedging in an IRA or can't write naked puts:** For a cost, you can set up a bear put spread, a strategy with capped risk that most IRAs allow. Using a spread order, buy to open May 2013 $86 puts, and sell to open an equal number of May 2013 $80 puts. Lately, this will cost you around $1.90 ($190) per put, and that is your maximum risk. This strategy could pay you up to $4.10 per spread on a market decline to $80, but you should be prepared to lose your $1.90 if the market doesn't decline. We don't recommend just buying puts alone, given how expensive they are.

Next Steps

- **Questions or comments? Need help setting it up?** Visit our iShares Russell 2000 Index discussion board.
- **Get more ETF info:** us.ishares.com
- **Follow it:** Add iShares Russell 2000 Index to My Scorecard.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Pro in 2012: Our Portfolio's Biggest Chutes and Ladders

Published Jan 7, 2013 at 12:00AM

Fellow Fools,

In a coming Memo, Jeff will no doubt offer some thoughtful musings on *Pro*'s 2012, looking at what we learned and where we're going in 2013. This isn't that memo. Instead, I'm playing St. Nick with a *Pro* naughty-and-nice list for 2012, based purely on each position's contribution to the total return our portfolio achieved this year. That return, by the way, was awesome — 14.3%, trouncing our North Star, which came in at 9.3%. Though we should be pleased (and we are!), we're also aware that the real test will come in those years when the broader market is in negative territory.

We're (somehow) supposed to love all our companies equally, but I don't feel that way at all. Still, to avoid hurting any feelings, I'm going to draw from a board game I played as a child, Milton Bradley's Chutes and Ladders. In this game, players who display good behavior are rewarded with the ability to climb ladders, moving them forward more quickly, while those who behave poorly are sent down a chute that hinders their progress. So our stocks will be "Chutes" if they were a drag and "Ladders" if they advanced us toward our goal.

Our Chutes

We task each one of our positions with helping us obtain North Star-like returns, but we realize — and even hope — that some will zig while others zag. In a strong market like 2012's, most positions made money, so I've set the threshold for inclusion on this list at about $3,000 in total mark-to-market losses in 2012. I'm also ignoring our large SPY hedge, which is designed to lose money (and did — $41,000 last year). Under those criteria, only six positions qualified as Chutes:

1. **GrafTech**: ($15,000)
2. **InvenSense**: ($13,000)
3. **Intel**: ($10,000)
4. **Pacer**: ($8,000)
5. **CBOE S&P 500 Volatility Index** (VIX): ($3,000)
6. **CME Group**: ($3,000)

We must have shown good behavior in 2012, because we slid down very few chutes — and those chutes could very well become ladders this year. Only two are permanent losses; having exited the positions, we won't be making our money back in InvenSense or the VIX.

Our Ladders

We had some real climbers this past year! Though I wanted to keep this list concise, it seemed wrong to leave off any position that contributed at least 1% of our starting portfolio's $1 million to our coffers. So here are the 13 companies that made at least $10,000 for us in 2012:

1. **AmTrust Financial Services**: $36,000
2. **3D Systems**: $28,000
3. **EBIX**: $22,000
4. **Papa John's**: $21,000
5. **Oracle**: $19,000
6. **Rockwood**: $16,000
7. **Autodesk**: $15,000
8. **MasterCard**: $14,000
9. **Covanta**: $13,000
10. **The Buckle**: $13,000
11. **Pebblebrook Hotel Trust**: $11,000
12. **Wells Fargo**: $10,000
13. **BMC Software**: $10,000

I know I promised this Memo would be light on the deep thoughts, but I can't help myself: In gathering this data, I noticed some peculiarities about measuring gains in dollars over an arbitrary period of time. First, measuring financial results in actual dollars is superior to coming up with a return figure. Which resonates with you more, "I made $183,000" or "I made 14.3%"? Second, isolating just one calendar year can lead you to some silly conclusions. Some of our big gainers were bouncing back from a painful 2011, and in 2013, some of 2012's winners could end up struggling. It's long-term results that really matter.

To that end, then, let's look further back. Since inception (October 2008), we've made $461,697.75 on that $1 million in capital (as of Dec. 31); that's 9.3% annually, a point better than our North Star's 8.3%. Here's to a 2013 full of similar good behavior.

Happy New Year, *Pro* Fools!

Nick (TMFCrow)

Coverage & Community

- **The Future Looks Bright: Oracle** results shine, suggesting more upside in margins and the long-term stock price.

Trades Completed

- **ProShares UltraShort Real Estate** : *Pro* sold short 650 shares, for a 1% allocation, at $23.36 each. Including our earlier synthetic short, we're now about 2% short this ETF.
- **Tupperware** : *Pro* wrote a covered strangle, selling to open July 2013 $55 puts and July 2013 $70 calls for a combined $3.50. We covered all our shares, writing seven contracts of each option.

Catch-Up Trades

- **Gentex**: If you lack a position, sell to open March 2013 $17.50 puts for up to a 2.8% allocation, lately for at least $0.65 each. That's a 3.7% yield on cash in less than three months.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Set Up a Put Ratio Spread on the SPDR S&P 500

Published Jan 4, 2013 at 12:00AM

- **What We're Doing:** Using options, we're setting up a new market hedge that won't cost us anything if the market keeps rising.
- **What We're Thinking:** Plenty of market uncertainty remains (upcoming earnings results, the pending debt-ceiling and deficit debate), so we want to remain hedged. We just don't want to do so in ways that cost us when the market rises.

Trade Essentials

- **Action:** Using a ratio spread order, set up a put ratio spread on the **SPDR S&P 500** (NYSEMKT: SPY) ETF.
  - Sell to open February 2013 $140 puts.
  - Buy to open February 2013 $144 puts
  - Sell two $140 puts for every $144 put you buy
  - Bid (on two $140 puts) / ask (on one $144 put): $1.70/$1.72
- **Price Guidance:** Use a spread order and aim to pay close to nothing to set up the trade — a penny or two at most as your net debit.
- **Recent ETF Price:** $146.20
- **Allocation (based on the uncovered written puts):** About 9.3%. This replaces the 9.5% SPY short we're aiming to exit via written puts (see today's concurrent trade alert). But only write two puts and buy one for every $14,000 in SPY you could afford if you were forced to buy shares; *Pro* will write 20 $140 puts and buy 10 $144 puts.
- **Alternative Trades:** This unique strategy requires put-writing in a margin account. Because we're moving out of inverse index ETFs and direct index shorts, alternatives are not easy to come by. You could simply buy $144 puts on SPY, but that's expensive, and we don't advise it for such a short time period. If you're unable to use put ratio spreads (or don't want to), but still want to be hedged, you could keep your existing inverse index ETFs or direct index shorts.

Strategy Details

Pro veterans should be familiar with this strategy by now, but let's take a look at the profit/loss table on this particular trade.

SPDR S&P 500 ETF Price	Value of 1 Purchased $144 Put	Value of 2 Written $140 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%) from $146.20
$144 or higher	$0	$0	$0	(1.5% or less)
$143	$1 x 100 = $100	$0	$100	(2.1%)
$142	$2 x 100 = $200	$0	$200	(2.8%)
$141	$3 x 100 = $300	$0	$300	(3.5%)
$140	$4 x 100 = $400	$0	$400	(4.2%)
$139	$5 x 100 = $500	($1) x 200 = ($200)	$300	(4.9%)
$138	$6 x 100 = $600	($2) x 200 = ($400)	$200	(5.6%)
$137	$7 x 100 = $700	($3) x 200 = ($600)	$100	(6.3%)
$136	$8 x 100 = $800	($4) x 200 = ($800)	$0	(6.9%)
$135	$9 x 100 = $900	($5) x 200 = ($1000)	($200)	(7.6%)
$130	$14 x 100= $1400	($10) x 200 = ($2000)	($600)	(11.1%)

This spread will earn us a profit at expiration on any decline in the S&P 500 index of between 1.6% and 6.8%, with our maximum profit achieved on a 4.2% market decline. Should the index decline by greater than 6.9%, we would start to lose capital on this trade. In other words, this isn't "disaster insurance" — it hedges against a moderate decline in the SPY over the next six weeks.

Why not go longer-term? As today's concurrent trade alert explains, we're writing puts on our direct SPY short in an attempt to close that short over the same six-week time period, which limits its effectiveness as a hedge to just a few dollars per share. This put ratio spread is meant to hedge several *more* dollars per share over the same period, replacing some of the hedge we're losing by writing puts on our SPY short.

Additionally, our January put ratio spread on the **iShares Russell 2000** (NYSEMKT: IWM) ETF is less effective now that the index is so far above our strike price, so we're looking to roll that position to a later month at higher strike prices. That, along with today's trade, will give us hedges that run to February and beyond.

Must You Do This?

As always, not every *Pro* member needs to hedge. We feel strongly about all of the stocks we own and believe we'll earn strong returns over time. So if you'd rather not hedge your positions, then don't worry about our hedging trades like this one.

Next Step

- **Questions or comments? Need help?** Visit the SPDR S&P 500 board.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Write Covered Puts on the SPDR S&P 500

Published Jan 4, 2013 at 12:00AM

- **What We're Doing:** We're writing puts on our short position in the **SPDR S&P 500** (NYSEMKT: SPY) ETF as a way to potentially exit the short or earn income while waiting to do so.
- **What We're Thinking:** We have gradually reduced this index short over the past year, and with the Federal Reserve newly committed to supporting the market, exiting completely remains our desired course of action. We'd rather target weak companies for our short positions.
- **What We're Expecting:** If the S&P 500 index declines below our put strike price by expiration, we'll buy shares through the puts to cover our short, ending the position. We would keep the premium received from these puts, of course. If the index does *not* decline below our strike, we'll earn income that offsets at least some of the index's gain, and we can consider repeating this strategy.

Trade Essentials

- **Action:** Write puts on your short **SPDR S&P 500** (NYSEMKT: SPY) position.
  - Sell to open Feb. 16, 2013, $146 puts
  - Recent bid/ask: $2.41/$2.42
- **Price Guidance:** Write the options at the going price. If the index moves significantly before you trade, you can move your strike price up or down to keep it within $2 of the current index price.
- **Allocation:** Write one put for every 100 shares of SPY you're short. For *Pro*, that's 10 contracts.
- **Recent SPY Price:** $146.19
- **Alternative Trade Guidance:**
  - **Are you short fewer than 100 SPY shares, or short an odd lot?** Write puts on all round lots, and buy to cover, or buy to close, any odd-lot shares – ideally on a dip in price.
  - **Own ProShares Short S&P 500** (NYSEMKT: SH) or **ProShares Short Russell 2000** (NYSEMKT: RWM) **instead?** Write February 2013 covered calls with a strike near the current ETF price. If the calls don't pay enough to make this worthwhile, just sell your remaining position, ideally on a rise in price.
  - **Directly short the ProShares Russell 2000** (NYSEMKT: IWM) **ETF?** Write covered puts on every 100 shares you're short, using a strike price close to the current ETF price. Or buy to cover or buy to close odd lots, ideally on a drop in price.
  - **Have a put ratio spread on IWM, as we do?** Leave that alone. We're keeping that.

What's New

Veteran *Pro* members know we've been reducing this direct index short (which serves us as a hedge) for the past year. As we eliminate it, we'll continue to replace it with other options-based hedges (like our put ratio spreads) and with direct company shorts. Why?

Well, because I'd like our market hedges to ding us minimally — or not at all — when the market goes up. That's not possible when you short the whole index. Plus, shorting the S&P 500 was always an intermediate-term solution; we chose it as an "alternative" trade when liquidity in many other vehicles was lacking.

We could simply close our short on the heels of recent gains, but we'd rather write covered puts to target a lower closing price or earn income if the index doesn't decline. Meanwhile, as you'll see in your inbox, we are concurrently recommending a new put ratio spread on SPY to replace the hedge we're effectively removing here.

Next Step

Have questions about any of your shorts (or pants, slacks, or knickerbockers)? Seriously, visit our SPDR S&P 500 board.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

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Published Dec 31, 2012 at 12:00AM

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Our Philosophy and Strategy

Published Dec 31, 2012 at 12:00AM

Our Philosophy: In this Audio Extra from September 2011, Jeff and Nick discuss how to feel comfortable holding a stock through volatility; how options can increase our ability to match our investing theses to the opportunities we see; and why *Pro* doesn't "overdiversify." Click here to listen in or read the transcript »

Our Strategy: The Motley Fool *Pro* Strategy Guide is a compilation of key articles going back to *Pro*'s earliest days, showing that the *Pro* approach to investing is steady and rational, featuring strategies that work over the long haul. Click here to download »

Back to Think Like a Pro | Next Section: Our North Star

Our North Star

Published Dec 31, 2012 at 12:00AM

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward. Click here to download your guide to our North Star »

Back to Think Like a Pro

Email

Published Dec 31, 2012 at 12:00AM

Here's an overview of the email you can expect from *Pro*.

Trade Alerts: We send these email alerts at any time during normal market hours; they contain a link to our full recommendation on the *Pro* site. After we announce a trade, we wait one to 30 days to make the trade for the *Pro* portfolio. Click here to see an archive of all trade alerts »

Monday Memos: Stay on top of *Pro* happenings — every Monday at 4 p.m. ET, we'll send you stock news, market insights, community highlights, and more. Click here to see an archive of all Monday Memos »

Guides, Audio Extras, Special Updates: Become a better investor! Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio. Click here to see an archive of all Extras »

Manage Your Email: Click here to customize your Motley Fool email settings »

Back to Using This Service | Next Section: Help and Contact

Help and Contact

Published Dec 31, 2012 at 12:00AM

Help: Our comprehensive FAQ covers recommendations, options, and much more. Click here for the Pro FAQ »

Contact: If you have a question we didn't answer, help is close by. Contact our Member Services team, post on our Member Suggestions & Help discussion board, or email us at membersupport@fool.com »

Back to Using This Service

Choose a Broker

Published Dec 31, 2012 at 12:00AM

You'll need a place for your money to reside and a platform to buy and sell. Any broker will do, but we prefer ones with low costs, transparent fee structures, a good options platform, and robust features. We don't endorse any broker in particular, but *Pro*'s account is housed at Interactive Brokers. You may find these resources helpful:

- **Wiki Broker Page:** Go here to get a list of features and pros and cons directly from firsthand users in the *Pro* community. If you have insights or comments – add them to the wiki! Visit the brokerage section of our wiki »
- **Options Weekly:** If you think you're going to branch out into advanced options investing, be sure to read this can't-miss analysis from our sister service, *Motley Fool Options*. See the*Options*Weekly archive »
- TMF Broker Center: Here is a table that compares features of six popular online brokerages. Visit TMF's Broker Center »

Back to Get Ready ... | Next Section: Request Options Permissions

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Update Your Beneficiaries

Published Dec 31, 2012 at 12:00AM

Chances are, your account has a beneficiary designation. That is, when you set the account up, you answered the question: "Who should get my dough if space matter falls from the sky and makes me one with a crater?" That person, or entity, is your beneficiary, and now is a great time to make sure it is accurate. Life changes quickly and these things can be outdated. Your broker will have a beneficiary designation form that should be simple to fill out and submit.

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Request Options Permissions

Published Dec 31, 2012 at 12:00AM

Ask your broker (via an Options Permissions section in the account application, or just call them to request a form) for full options approval. Typically, this means level 2 or level 3 approval (it can vary by broker). The "levels" refer to what type of options strategies are allowable, so the higher your approval level the more strategies you'll be able to participate in. Fill out, sign, and mail in the simple document and after a few days you'll be approved. If you aren't granted a high level, be sure to submit another request after a few weeks with an account. You should be able to get promoted to higher levels over time and as your account size and experience grow.

Back to Get Ready ... | Next Section: Update Your Beneficiaries

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Know What We Believe

Published Dec 31, 2012 at 12:00AM

Know What We Believe: Every position in our portfolio should reflect our beliefs. Click here to read more about those beliefs »

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Measure Us

Published Dec 31, 2012 at 12:00AM

Measure Us: Click here etc. »

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Know How We Think

Published Dec 31, 2012 at 12:00AM

Know How We Think: Our strategy guide is a compilation of articles going back to our earliest days, with updated thinking as of September 2011 and details on how our theses played out. Click here to read or download »

Back to Get Set ... | Next Section: Know What We Believe

Measure You

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Measure You: Click here etc. »

Back to Get Set ...

Make Pro Fit You

Published Dec 31, 2012 at 12:00AM

Making *Pro* Fit You: This guide shows you how to invest with us whatever your situation -- coming from another TMF service, for example, or using an IRA. Click here to read or download »

Back to Get Set ... | Next Section: Know How We Think

Ratings and Guidance

Published Dec 31, 2012 at 12:00AM

Ratings and Guidance: We rate our stocks as Buy First, Buy, Hold, or Sell. These ratings help guide you toward what we consider the best opportunities for your *new* money right now. Learn more about our ratings and guidance »

Back to Go | Next Section: Ketchup Report

Ketchup Report

Published Dec 31, 2012 at 12:00AM

Ketchup Report: This Foolishly named Ketchup Report is meant to catch you up to all the *Pro* stocks that are currently recommended as Buys or Buy Firsts. Following our allocations to these stocks will get you well on your way to mirroring the *Pro* portfolio. Click here to read or download »

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Catch-Up Trades

Published Dec 31, 2012 at 12:00AM

Catch-Up Trades: Text text texty text. Click here to read or download »

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Options in 3 Steps

Published Dec 31, 2012 at 12:00AM

Options in 3 Steps: It's never too late to start using options to earn income, hedge, and land better buy and sell prices on stocks. In this video, lead analyst Jeff Fischer explains how. Watch the video »

Back to *Pro* Education | Next Section:*Motley Fool Options*

Pro Options Guides

Published Dec 31, 2012 at 12:00AM

***Pro* Options Guides:** Get up to speed on options with our first three guides, then dive into more advanced techniques with the rest. Click here to read or download »

Back to *Pro* Education

Get Up to Speed With Options

Published Dec 31, 2012 at 12:00AM

Get Up to Speed With Options: A big part of *Pro*'s investment approach involves the use of options to boost profits, smooth out volatility, and maintain our valuation discipline. We want to help you get up to speed using options so you'll have this useful weapon in your investing arsenal. To help you get comfortable, we've compiled this list of resources — consider it your road map to conquering options. Click here to read »

Back to *Pro* Education | Next Section:*Pro*Options Guides

Motley Fool Options

Published Dec 31, 2012 at 12:00AM

Motley Fool Options: Text about that goes here. A link goes here »

How Pro Works

Published Dec 31, 2012 at 12:00AM

How *Pro* Works: In this video, lead advisor Jeff Fischer walks you through the *Pro* experience.

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Back to Using This Service | Next Section: Email

12 Resolutions Supporting Pro’s Mission

Published Dec 31, 2012 at 12:00AM

Dear *Pro* Members:

News Returns Next Week

There are no completed trades to report thanks to the holiday lull, and we don’t want to offer catch-up trades before we know what Washington is going to do (or not do) about the fiscal cliff. Those features will return next Monday – in the meantime, you’re invited to talk holiday traditions with the team on the discussion boards. Happy New Year!

We hope you’re enjoying the holidays and festivities that wrap up 2012. As we begin a new year together, it’s important to know what we’re aiming for over the next 365 days, so to that end, let's revisit *Pro’s* mission statement:

Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years.

This comes from our North Star document, where we outline why inflation plus 7% is the number that guides our decisions.

But did you know that we also have an internal mission? We call it *Pro*’s road map:

Equip *Pro* members with tools and coaching to invest well in all markets.

And our supporting strategies to achieve this are:

1. Manage the *Pro* portfolio with the North Star as a guide.
2. Communicate Foolishly to encourage members to invest the *Pro* way.
3. Build an active and vibrant community on the discussion boards by being ever-present, value-adding, and responsive.

Behind the scenes over the past year, we’ve been building frameworks around these goals to improve our investing and our service to you. The groundwork we’ve laid over the last 12 months should help make 2013 an even more efficient, more effective year for *Pro*.

For example, the North Star guided us for the first time in 2012, and it should become an ever-brighter light that helps with our decisions in 2013 and beyond. We’ll provide a review of *Pro’s* 2012 in January, but as Dec. 31 draws to a close, the portfolio is up 13% year-to-date -- a strong showing, especially given our lower-than-average risk. We were hedged all year, rarely being more than 80% net long (and we’re ending the year around 70% net long).

We look forward to reviewing our full results soon, and continuing to build on those results in 2013. For today, I’ll leave you with 12 Foolish resolutions from Bruce Jackson and Scott Phillips. Many of you will recall Bruce as a great *Pro* analyst in our first two years, before he left to successfully launch Motley Fool Australia (where you can now find him every day). Today, Bruce and Scott published the following list of resolutions in their popular *Share Advisor* subscription newsletter. Reading it this morning, I knew I wanted to share it with you. Take it away, Fool Australia -- you will be ringing in the New Year long before us, after all!

We'd love you to stop smoking and get fit (we want to have you around for many years to come), but if you're looking to add some financial resolutions to the list, here are a dozen we think you'll benefit from:

1. I will live below my means -- spending less than I earn.
2. I will save money into a rainy-day fund so I'm ready for what life might bring.
3. I will invest money I don't need for at least 3-5 years to build my nest egg.
4. I will regularly add to my investment account.
5. I will learn more about investing, taking control of my financial future.
6. I will invest in quality businesses, buying a slice of the company, not just a code on a screen.
7. I will buy shares in a company with the intention of holding them for the long term.
8. I will sell when my investment thesis fails, the company is overvalued or I have a better idea.
9. I will avoid anchoring my decisions to the price I paid for my shares.
10. I will remember that the market can be moody and over-react, both on the upside and the downside.
11. I will expect volatility, and I won't let it spook me into selling.
12. I will let the market offer me prices (be my servant), not dictate my mood or actions (be my master).

… At The Motley Fool we're in the 'time in the market, not timing the market' camp. Investing regularly and letting the creative power of capitalism do the heavy lifting works for us.

It's an approach decried as unsophisticated and 'old-fashioned', but that's okay with us. Warren Buffett has been accused of that many times -- he ignored the jibes and was proven right. We're not comparing ourselves to the Oracle of Omaha in terms of investing results, but we're happy to follow in his footsteps when it comes to ignoring the so-called 'smart money'."

Have a wonderful New Year’s Eve, and let’s have a great 2013 together!

Foolishly,

Jeff Fischer (TMFFischer) on behalf of the *Pro* team

Sub-Subtopic Page

Published Dec 31, 2012 at 12:00AM

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Published Dec 31, 2012 at 12:00AM

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Write a Covered Strangle on Tupperware

Published Dec 27, 2012 at 12:00AM

What We're Doing: Generating income with the potential to buy more shares cheaper, sell our existing stock higher, or roll our options to a later date at their July expiration.

- **Action:** Use a strangle order to write options on **Tupperware** (NYSE: TUP)
  - Sell to open July 2013 $55 puts
  - Sell to open July 2013 $70 calls
  - Options' combined bid/ask (Dec. 21, 4 p.m.): $4/$4.70
- **Price Guidance:** Aim for a **combined credit of $4.30** or higher. As prices change, ideally accept no less than $4, or a 6% yield on the current share price in 7 months.
- **Recent Stock Price:** $63.50
- **Buy Around/Fair Value:** $56/$65
- **Allocation:** Write one call for every 100 shares you already own, and one put for every 100 additional shares you could buy. *Pro* is writing seven contracts of each, covering our 700 shares and potentially increasing our position from 3.1% to around 5% (accounting for depreciation).
- **Alternative Trades:**
  - If you don't own shares, aim to buy up to 3.1% by selling to open July 2013 $60 puts for close to $4, or July 2013 $55 puts for above $2. Or, just look to buy shares if the stock drops to around $56.

How to Follow Along

We've written options on **Tupperware** (NYSE: TUP) for income several times, and today's strangle is no different. Revenue is still growing strong in emerging markets, which are now a majority of sales, while it's struggling to grow in North America and developed markets. Overall, non-GAAP earnings per share should clock in 11% higher in 2012 compared with last year, and the stock trades at a P/E of about 13 times that estimate. We could still enjoy North Star-like returns over the long term, but we can increase our returns with options.

Writing a covered strangle combines writing covered calls on a stock you own with writing puts to potentially add to your stake.

- **Strategy type:** Bullish to neutral; income with upside potential
- **Maximum gain:** The credit received plus upside in the stock to your calls' strike price
- **Maximum loss:** The same as stock ownership, minus what the calls pay you

Here's more on how to place the trade:

- **Requirement:** You must already own at least 100 shares, with an ability to double that
- **Sell to open:** July 2013 $55 puts/$70 calls using a strangle order
- **Allocation:** Sell one of each option for every 100 shares you own
- **Receive credit of around:** $4.30 combined (this is all "time value," so it decreases by the day unless volatility increases)

And here's more on the numbers:

- **Days to expiration:** 205 (6.8 months)
- **Time value per day:** $0.02
- **Yield on share price ($4.30/$63.50):** 6.7%
- **Yield on share price and 30% cash ($16.50 of $55) to hold open puts:** 5.3%
- **Net potential sell price on existing shares:** $74.30
- **Net potential buy price on new shares:** $50.70
- **Recent share price:** $63.50
- **Upside to net sell price:** 17%
- **Downside to second net buy price:** 20%
- **Range in which to earn total income:** $55-$70

Next Steps

- **Want to know everything there is to know about covered strangles?** We can tell you everything there is to know about covered strangles. Or Santa Claus can tell you next year.
- **Discuss this trade:** Get our latest update on Tupperware, and post any questions.
- **Can't participate?** You don't need to make every trade in *Pro* to benefit. Own our core positions in sizes suitable to you — that's our core strategy. Tupperware remains a buy, although we'd prefer you buy closer to $56.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Short ProShares UltraShort Real Estate

Published Dec 20, 2012 at 12:00AM

- **What We're Doing:** We believe in a recovery for commercial U.S. real estate, so we're shorting shares of a flawed, leveraged, *bearish* real estate ETF. We will also keep our synthetic short option position on this ETF that we set up in July. So, by shorting shares directly (now that they're available for shorting), we're increasing our allocation.

Trade Essentials

- **Action:** "Sell to open" or "sell short" (more shares of) **ProShares UltraShort Real Estate** (NYSEMKT: SRS) ETF
- **Allocation:** 1% (short $1,000 for every $100,000 you manage); this will give us about 2% total exposure including our synthetic short from July that expires January 2014.
- **Recent Price:** $24.41
- **Price Guidance:** Use a limit order at market prices on this thinly traded ETF. The "bid" is the relevant price because you're selling shares that you've borrowed from your broker.
- **Short Availability and Cost:** Interactive Brokers shows 500,000 shares available for shorting, at a 6.37% annual fee with a 6.19% rebate rate.
- **Alternative Trades:**
  - **Options:** If your broker doesn't have shares available to short, or you can't short, consider setting up a January 2014 synthetic short on SRS as we did in July. At a total allocation no larger than 2%, sell to open January 2014 $25 calls, and buy to open an equal number of January 2014 $25 puts. Lately, you may be able to set this up for a net cost of around $2.30 to $2.60 per synthetic short, given you a break-even of around $22.50. (See our guide to synthetic shorts.)
  - **Bullish Real Estate:** In similar spirit to our short, but not leveraged, you could *buy* 2% in the long, bullish **iShares Dow Jones U.S. Real Estate** (NYSEMKT: IYR) ETF.

What's New?

The **ProShares UltraShort Real Estate** (NYSEMKT: SRS) ETF is meant to provide 2 times (200%) the daily *inverse* results of the Dow Jones U.S. Real Estate Index, which has been flat since our July synthetic short trade on the ETF. Despite its sleepy performance since July, we think the index will once again recover in 2013 and beyond, making our short profitable.

Using derivatives, this inverse ETF is in effect 2 times short the 83 companies that make up the underlying index, which is chock-full of dividend-paying real estate investment trusts (REITs). The underlying index trades at 2.3 times book value and yields 4.1%, and the ETF has an expense ratio of 0.95%; these numbers help our short, although we won't collect the dividend. By betting against the ETF that is 2 times inverse this index, we'll effectively be 2 times long its companies on a daily basis.

Our bullish position on real estate got a boost from the news that the Federal Reserve intends to buy bonds until unemployment declines to 6.5%. In other words, the Fed is likely to keep interest rates low at least into 2015, which in turn should help real estate prices improve. Mortgage rates are already at record lows, and most commercial real estate metrics — including rental rates and occupancy — are on the mend. Meanwhile, REITs on the whole are attractively priced as investors lick their wounds from 2008, and the ETF we're shorting is deeply flawed, losing value every year since its 2007 inception (except its first partial year).

How to Follow Along

Shorting shares outright requires a margin account, and most brokers do not have shares of this ETF available for shorting. If yours doesn't, consider our alternative trades above in the yellow box. As we short this ETF, perhaps our greatest risk is having our short closed early against our will. If the market declines and this inverse ETF jumps sharply, we may be forced by our broker to buy back our short at the worst time. We're keeping the position small as a way to manage this risk. Please revisit our original report from July if you want to learn more about the flawed ETF that we're comfortable shorting, directly and with options, up to 2% today.

Next Step

-
  - **For More Discussion or to Ask Questions:** Please visit our ProShares Ultrashort Real Estate discussion board.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Waiting on Washington

Published Dec 17, 2012 at 12:00AM

Dear Fellow Fools,

No Monday Memo Dec. 24

We're taking a break for the Christmas holiday, so there will be no *Pro* Memo next Monday, Dec. 24. We'll be back in your inbox Monday, Dec. 31!

Many great insights have been shared on our discussion boards over the years. I print and keep at my desk some of the posts I find most meaningful, including messages about how the service has helped you, ideas on how we can improve, and your thoughts about life in general. One post I highly value was written by ADrumlinDaisy in 2011, when he posted as MazonCreekRich. In part, he wrote:

I honestly would give everything I have to see my father again. Many of you still have that opportunity, and you are thus far wealthier than I, at least in the coin that I recognize.

After Friday's horrific loss of life in Connecticut, this sentiment sadly has a new and painful meaning for even more people today. So many of us would instantly give everything we own to have a loved one back with us again. There's no question what matters most in life, and it isn't anything that can be bought or sold. As we pause at this time of year for the holidays, we hope you're able to spend time with those you value above all else.

Year-End Market Machinations

As the year comes to a close, it's likely that markets in 2013 will be affected by the recent uncertainty in Washington, D.C. Many companies have apparently slowed spending and investment while waiting for a resolution to the fiscal cliff, meaning we should already expect a soft quarter to end 2012. Additionally, some companies have doled out large special dividends ahead of presumed tax increases. This is discouraging in one sense, because it means some companies would rather return funds to owners than invest in employees and growth. That suggests a lack of strong growth opportunities.

I had planned to close our remaining 10% hedge in the **SPDR S&P 500** ETF before year-end, but given the uncertainty on Capitol Hill, as of today, we're planning to keep this hedge open a little bit longer. (Please note that SPY goes ex-dividend on Dec. 21, so close your short before then if you wish to avoid paying the estimated $0.88-per-share dividend; that said, realize the ETF will adjust its price lower by the same amount.) If a favorable fiscal-cliff resolution is reached, we'll likely be inclined to close this hedge despite its probable higher price. But if there's no resolution, the market could easily decline. In that case, we'll be glad to still have this 10% hedge (and our **iShares Russell 2000** hedge) — and we'll likely close the SPY hedge after the market declines.

So, for now, we are waiting on Washington.

In other portfolio news, our 3.4% stake in **Covanta Holdings** was recently called away through our covered calls, and our 1.2% stake in **InvenSense** is on track to be called away after this Friday. These two moves would increase our cash balance to 15%. Given the uncertainty we face in the New Year, we'll be content to have that level of cash coupled with our hedges. We look forward to continuing to bring greater focus to the *Pro* portfolio, and investing our cash in attractive opportunities.

Taxes on Your Mind?

We do still plan to close our remaining SPDR S&P 500 hedge soon in favor of more options-based hedges that won't ding us if the market rises, as well as more shorts of specific companies. So if you're adjusting some of your positions before 2013 for tax reasons, you can consider closing your SPY hedge for the capital loss this year. Just keep in mind that it may be weeks before we close ours; we just don't know. And capital gains tax rates are almost certain to rise in 2013. That means it may be more valuable for you to keep — and use — your capital losses starting *next* year, because on gains you take this year, you'll likely pay a lower rate than in future years. We are not tax experts, though, so please bring any questions to the Fool's public Tax Strategies discussion board.

In closing, we'll review *Pro*'s complete 2012 in early January, once we have our final year-end returns.

We wish you a peaceful holiday season — and a 2013 that brings us all forward.

Foolishly,

Jeff Fischer (TMFFischer)

Pro Trade Roundup

- **Medtronic**: We sold to open May 2013 $44 covered calls on nearly half our shares (nine contracts), potentially reducing our position from 5.6% to around 3% if these shares are called away. We were paid $1.27 per call, or $1,143 before a $5.53 commission.
- **Covanta**: All of our 2,700 shares were called away last week via covered calls at $17.50. Including our call proceeds, we received $17.90 per share (members generally received $18.10 or higher) and sold with a long-term gain.

Guidance Updates

- **Covanta Holdings**: Shares move to Sell as our shares were called away.
- **The Buckle** : Fair value was reduced to $48.30 and Buy Around to $36.50 to account for the large, $4.70-per-share special dividend we'll be paid later this month. The stock remains a buy.

Expirations & Dividends

- **Covanta Holdings** December 2012 $17.50 covered calls: As planned, we suggest you let these shares be called away this week if they haven't been already. We'll consider future positions on this stock at lower prices or by writing puts.
- **InvenSense** December 2012 $10 covered calls: As planned, we're ready to let our whole position be called away as we focus the portfolio further.
- **SPDR S&P 500** goes ex-dividend Dec. 21: Close your short by Dec. 20 if you want to avoid paying an estimated $0.88-per-share dividend. Keep in mind that the ETF price automatically adjusts lower by the dividend amount at the market open the next day.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Apple**: With shares back around $500, buy up to 3.9% in stock if you haven't already. If you only want to buy lower and a $50,000 position remains a reasonable allocation, sell to open any puts that look attractive to you.
- **BMC Software**: Buy up to 4.6% in shares if you haven't. Or, if you only want to buy lower, sell to open February 2013 $40, $39 or $38 puts.
- **ProShares UltraShort Real Estate** : Interactive Brokers reports 500,000 shares available for shorting, with a 5.8% rebate rate and a 6% fee rate. As long as that holds true, if your broker has shares available, you can sell short up to 1% to start. (Revisit our original report.)

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Who Do We Owe?** We're a country of debtors; who do we owe big-time? Nick points the way.
- **Apple Getting Cored?** Members discuss the stock's decline. We mainly view it as the old Apple volatility returning.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on Medtronic

Published Dec 13, 2012 at 12:00AM

- **What We're Doing**: Trimming a 5.6% position to 3%, or earning income if the stock price pulls back.
- **What We're Thinking**: Medtronic is still undervalued, but not dramatically, so we're attempting to size the position based on today's risk and reward.
- **What We're Expecting**: A few more quarters of solid performance should help the market realize the stock deserves to be valued higher, but we wouldn't be shocked if shares took a breather.

Trade Essentials

- **Action**: Write covered calls on *some* of your **Medtronic** (NYSE: MDT) position.
  - Sell to open May 2013 $44 calls
  - Recent bid/ask: $1.48/$1.51
- **Price Guidance**: Aim for $1.48 per contract; as prices change, ideally accept no less than $1.40.
- **Allocation**: Leave a 3% allocation to Medtronic uncovered
  - *Pro* has 1,900 shares. A 3% allocation for us is about 1,000 shares, so we we're covering 900 shares (writing nine contracts).
  - If a 3% allocation to Medtronic leaves you with fewer than 100 shares remaining, take no action, but read the alternative trade below.
- **Recent Stock Price**: $42.50
- **Stock Rating**: Buy
- **Alternative Trades:**
  - **Working with odd lots or a small share count?** Don't fret. We believe Medtronic can still deliver North Star-like returns from here forward (our fair-value estimate is 13% higher than today's price), but the certainty of those returns is lower after the stock's steady rise. Hold your shares, just as we're holding *at least* a 3% position.
  - **Want to more aggressively manage your position and earn higher income?** The May 2013 $43 calls are also attractive, lately paying $1.90.
  - **Don't own any shares?** You can buy up to a 3% position in Medtronic at today's prices.

What's New?

- **Recent Recommendation**: In August 2011, we recommended buying more Medtronic. Since then, shares have risen 25%.

Like a jolt from one of the company's famous pacemakers, CEO Omar Ishrak has shocked **Medtronic** (NYSE: MDT) back on course. Although the company's product breadth, clinical expertise, and pails full of physician relationships were never in question, execution had become sloppy, focus obfuscated, and growth stalled. After analyzing Medtronic's end markets, general demographic and health-care trends, and the company's pipeline, we concluded that its ability to generate free cash flow was top-notch, and that once a few overhanging clouds burned off, the market would wake up to Medtronic's leading competitive position.

And in fact, the stock's near-20% rise over the past year and recent analyst upgrade do suggest that Medtronic may be sitting at the cool kids' lunch table again. Fiscal second-quarter revenue increased 5%, with international growth leading the charge. Business lines that have dogged results for well over a year are finally showing signs of stabilizing, the remaining business segments have been growing at a healthy clip, and the product pipeline is robust.

But Medtronic now trades near the bottom end of our fair-value range, prompting us to write these covered calls. Medtronic's customers remain very cost-conscious, insurance companies and the government are closely monitoring reimbursements, and competition is fierce. We have a 5.6% position today, and we're happy to own an unencumbered 3% allocation, but we want to protect (via call option income) or trim the extra 2.6%. We still believe in Medtronic, and we think it's worth $48 — but we only want to own 5.6% if we can do so with a larger margin of safety than today's price gives us.

How to Follow Along

Writing covered calls will achieve one of two outcomes: If shares are higher than our $44 strike price at expiration, we'll sell 900 shares at a net $44.95 (touching the lower end of our fair-value range), leaving us with 1,000 shares. If shares are less than $44 at expiration, we'll retain our entire 1,900-share position and get to keep the option income. Here are the details:

Medtronic stock price:	$42.50
"Sell to open" May 2013 $44 calls:	$1.48
Trade type:	Income, defensive
Yield on current share price:	3.5%
Breakeven price:	$40.99
Days to expiration:	155
Upside to $44 strike price:	3.6%
Potential net sell price:	$45.48
Upside to potential net sell price:	7.1%

Next Steps

You'll first need to calculate your allocation to Medtronic. If yours, like ours, is well above 3%, write these covered calls on round lots (100-share groups) above that allocation to potentially trim your position.

- Page Dr. Pro with your questions about allocation or trade execution by dialing 1-555-CHATMDT.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

2+2=3: A Framework for Acquisitions

Published Dec 10, 2012 at 12:00AM

Fellow Fools,

We Want Your Thoughts!

Take this short survey to tell us what you love about *Pro* and what could be better. We really do listen to your feedback, and we'd genuinely appreciate your thoughts!

Charlie Munger often speaks of developing a "latticework" of mental models as a way to think through problems. Having automated processes for approaching challenges helps us meet them more capably; stringing together a series of those processes helps us do so more efficiently. And as long as we remain open to the uniqueness of each problem, we don't risk dangerous mental shortcuts. With that said, I'd like to share my framework for analyzing acquisitions, using the recently announced **Starbucks** acquisition of **Teavana Holdings** as an example.

Filter No. 1: Guilty Until Proven Innocent

Mergers and acquisitions are commonplace in business: Over the past 20 years in the U.S., there have been more than 12,000 of them worth more than $1 million apiece. But as your mom told you, just because it's popular doesn't mean it's a good idea. Large acquisitions destroy value in the short term — about $0.06 for every $1 spent, according to one study, for a total of $226 billion over the past 20 years. And the long-term picture isn't much better: The stocks of companies who engage in M&A underperform the stocks of those who don't by 26% in the following five years, and between 50% and 80% of business combinations ultimately end up destroying value. Corporate marriage ain't easy, so when we analyze the merger activity of the businesses we own, we should take off our rose-colored glasses and put on our skeptical shades.

Pro Trade Roundup

- **OpenText**: We wrote a covered strangle on our shares, selling to open seven May 2013 $50 puts (for $2.29 per contract) and seven May 2013 $60 calls (for $2.44 per contract).

Guidance Changes

- Following the analysis in this Memo, we're raising *Pro*'s fair value estimate for **Starbucks** from $53 to $55.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the *Recommendations* *page.*

- **GrafTech International**: If you don't own shares yet, it may be a good time to buy a 2.2% allocation to match us.
- **Pacer International**: If you don't own shares, you can match our 1.3% allocation in this turnaround micro-cap. Just use a limit order to buy.
- **CurrencyShares Euro Trust**: If you're not short shares with us, you can try to sell short up to 3.9%. Some brokers have availability.

Filter No. 2: Key Considerations

All that said, some mergers do work out. Here's what I consider when determining whether management's move was blockhead or bombshell.

1. **Size.** In M&A, size matters. I don't think there is a true linear continuum, where super-small is best and super-big is worst; instead, what we're looking for here is "not huge." Immense acquisitions have too many moving parts and massive integration risks, and while promises of significant "cost synergies" are often used to justify a high price tag, empirical evidence shows that profitability tends to worsen in the years following a merger. Cost synergies are far from automatic, and we should be skeptical of very large transactions.
2. **Strategic rationale/vision.** There are some good reasons to combine businesses. The most common include (1) radical improvement in costs or cash flow; (2) accelerated marketing or distribution for a promising product; (3) access to a technological or comparative advantage; or (4) to better balance supply and demand in the industry. Visionary (or lucky) managers can sometimes also pinpoint and acquire winners-to-be early in an industry's life cycle, but this requires *Rule Breakers*-like mastery. If I find one of the above reasons behind a particular merger, I don't automatically assume it's a slam dunk, but I do think the odds of success are greater than otherwise.
3. **Performance and price.** As stock investors, we know the price you pay for an investment matters greatly to your future returns. And that may be extra-true for mergers, because they're 100% investments — there is no way to lower the average price paid. A low takeover premium often indicates bad business performance from the target company, so any improvements the acquirer makes to generate meaningful returns right away will require some expensive changes. And the opposite scenario — paying top dollar for a company firing on all cylinders — makes subsequent business improvements a tall order. Furthermore, a merger paid for with stock may dilute existing owners' positions — is the acquisition really worth a lower ownership stake in the combined business?
4. **Culture and people.** I generally believe great people are worth paying up for, so in any merger, I take particular note of the target company's management team: Are they staying on board after the acquisition, or are they running for the door? Are the companies' cultures compatible? This variety of integration risk is tough to quantify, but it's worth thinking about, especially when there is a clear cultural divide. The human case can make or break the business case.
5. **Opportunity cost and experience.** Most investors (and business folk) don't focus on this enough. There's rarely just one solution to a problem, and an acquisition isn't always the best option. It's important to consider the what-ifs: Could the acquiring company have built its own in-house solution? Would a joint venture have been more appropriate? Is bigger always better? Does the future potential benefit justify the risk? Does the post-acquisition balance sheet still allow for optimal financial flexibility? Would patience have offered up a better price? Does the management team have any experience completing successful integrations?

A Rooibos Latte: Yum or Yuck?

So how does Starbucks' proposed acquisition of Teavana fit this framework?

- **Filter 1:** Most acquisitions destroy value, so let's be skeptical. Guilty until proven innocent, remember?
- **Filter 2:**

Key Consideration	Details	My Take
Size	Starbucks is paying $620 million in cash for Teavana's 300 stores and less than $200 million in annual sales. (Starbucks has 18,000 stores and $13 billion in annual sales.)	The price is less than 25% of the cash Starbucks has on its books and less than the $894 million in free cash flow it generated last fiscal year. Teavana is a small, but not negligible, bet.

Key Consideration	Details	My Take
	Cost: Teavana has excellent loose-leaf tea sourcing and buying experience, which could give it a cost advantage. **Marketing/distribution:** Starbucks does not plan on selling Teavana-branded teas in its existing coffee bars.	**Cost:** Starbucks could get good at loose-leaf tea quickly, or it could just hire the person who currently does this stuff for Teavana. **Marketing/distribution:** Starbucks will use its knowledge of social marketing to help drive sales, and it will eventually use its distribution prowess for grocery stores, too.
Strategic Rationale / Vision	**Technological advantage:** N/A **Industry balance:** We're not suffering from tea or tea bar saturation. **Visionary investment:** It took Starbucks 25 years to make espresso-based beverages a routine part of American life. Teavana barely sells any prepared beverages, so it's safe to say the business is early in its life cycle.	**Technological advantage:** The technology involved here is measure, steep, drink. **Industry balance:** Nope. **Visionary investment:** Starbucks CEO Howard Schultz is a visionary. He knows the recipe for democratizing an uncommon drink, and more importantly, he knows how to build an experience people are willing to pay for. He'll make delicious, approachable beverages, and he'll deliver a great experience.
Performance and Price	Teavana has tripled revenue over the past few years by opening stores. It has achieved excellent store-level profitability, too. Still, its shares are down almost 50% from its 2011 IPO high.	Teavana was once valued at more than \$800 million; Starbucks made its offer when that number was closer to \$500 million. Still, 21 times pre-tax operating profit is a rich price. With more operational experience, it's likely Starbucks can improve profitability.
Culture and People	Teavana founder and CEO Andrew Mack is staying on board to run day-to-day operations.	These cultures should blend well — both hinge on the in-store experience. Starbucks will likely work to create more repeat visits and stronger bonds with customers, although without prepared beverages (particularly addictive ones), this may prove challenging.
Opportunity Cost and Experience	Starbucks is far from a serial acquirer, but it still has sufficient resources and people to pull this off. The company generates sufficient cash to grow, pay a growing dividend, and buy back shares. Its balance sheet remains healthy.	What else could Starbucks have done with its cash? It could have paid a \$0.83 special dividend. It could have repurchased 1.7% of its shares. It could have done nothing and waited for Teavana's shares to fall further. It could have built its own tea bars using its Tazo brand, or developed a super-premium brand.

The Foolish Bottom Line

Starbucks didn't bet the farm. I think Schultz believes the Teavana brand has already captured mindshare in the premium tea category and that acquiring an established leader is less risky than developing a competing brand. Also, the Teavana brand becomes more valuable when combined with Starbucks' expertise in the development of prepared beverages and the distribution of consumer packaged goods. The odds say this merger is unlikely to be a winner, but I believe it can be. Following this analysis, we're raising *Pro's* fair value estimate to $55 because the potential benefits of this working out far outweigh the losses that would result if it doesn't.

Agree? Disagree? Want to discuss your favorite beverage? Bring it to the Memo Musings discussion board!

Onward,

Bryan (TMF42)

Coverage & Community

- **Optimize This**: Fools discuss **t**he optimal *Pro* portfolio.
- **On Hedging**: This post sparked a great conversation and a Memo.
- **Bryan's Conference Notes**: They're raw, but here are day 1 and day 2 notes from the CFA Equity Research and Valuation Conference last week.
- **Options Pricing Theory**: stamleo brings a reality check to pricing theory.

The Motley Fool owns shares of Teavana Holdings. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Nassim Taleb on Motley Fool Money: Options, Volatility, Hedges, and Washing Machines

Published Dec 7, 2012 at 12:00AM

Chris Hill of the *Motley Fool Money* radio show recently interviewed best-selling author and NYU professor Nassim Taleb. The transcript of that interview is below — if you'd prefer to listen in, click here! (The interview is from the Dec. 7 edition of the show and begins at about the 18:50 mark.)

Introduction

Chris Hill: Welcome back to Motley Fool Money. I'm Chris Hill. Nassim Taleb is Distinguished Professor of Risk Engineering at NYU's Polytechnic Institute. He is also the best-selling author of books like *The Black Swan, Fooled by Randomness* and his latest book is *Antifragile: Things That Gain from Disorder*. He joins me in-studio now. Wonderful to see you.

Nassim Taleb: Thank you. Thank you for inviting me. But to get the book, you have to describe what I am. When you tell people, "He's a professor," they think I'm some professor. But in fact, I'm an options trader disguised as a professor …

Chris: [Laughing]

Nassim: … in a second career.

Volatility Is Key

Chris: I was going to get to that eventually, but let's start there, then. I mean, you're not the typical professor. You did really start out as an options trader. What got you out of options trading?

Nassim: Because when you're an options trader — and this is why this book is directly linked to my experience, rather than the other one, which is more intellectual efforts — an options trader views the world in two categories: things that are long volatility and things that are short volatility. Things that gain from volatility, and things that are harmed by volatility.

"An options trader views the world in two categories: things that are long volatility and things that are short volatility. Things that gain from volatility, and things that are harmed by volatility."

So, you have this black-and-white bimodal view of the world, and it's very hard to communicate, outside options, that concept. And the word *antifragile*, for me, is long volatility. It's nothing else. If I explain it to an options trader, they find this trivial, but it takes me hours to try to drill it into other people's minds that it's not robust. It's not resilient. It's not adaptive. It's just something that loves volatility.

Chris: And that gets to the first thought I had in looking at your book. If someone had asked me what the opposite of fragile is, I would have used a word like resilient or robust. And in fact in the book, you put things into these three categories: fragile, robust, and antifragile. What puts something — or, in this case, since this is a show for people who are interested in business and investing, what puts a particular industry in one of those three categories?

Nassim: You can see very clearly to which category you belong if we define fragility. I define fragility (and it took me 25 years to do so) as *what does not like volatility*. You see this cup on the table? This coffee cup? Actually, I was looking at a coffee cup when I figured it out. This coffee cup does not like earthquakes. There's nothing that can help it. It has absolutely no upside for random events — nothing but downside. Therefore, it's like short volatility. So, once you're able to define fragile as short volatility, then automatically, you can identify and measure fragility. You can measure it. Of course, you can figure out what's robust, and you can figure out what is antifragile.

What is fragile is something that has an exposure that is asymmetric to random events. You have more downside than upside if an event happens. For example, the market. Say your sales go down 10%. You're harmed a lot more than you gain. If your sales go up 10%, then you are fragile. You have an asymmetry. So we can multiply the examples in identifying them, but there's an asymmetry. Or you could look at it another way — another way to view it. If the sales go down 10%, you're harmed; but if they go down 20%, you're harmed more than twice. Then you're fragile.

It's just like an options position. If the market moves down 10%, you're harmed more than twice than if the market moves down 5%. And this is how I figured out that anything that we have that has survived is not linear to random events, but is asymmetric. And once you can prove it (mathematically it's elaborate, but you can sort of prove it) then from there, you can identify the fragile; identify the robust; identify the antifragile.

Unexpected Antifragility

Chris: One of the examples I saw you make grouped two industries that I wouldn't have necessarily grouped as being antifragile: one was restaurants, and on the other side you had banking. Typically what you hear about the restaurant business is it's a very tough business, and so I would automatically put it, just reflexively, in the fragile category. But, in fact, you make the case that restaurants are very antifragile.

Nassim: Exactly. Have we had any bailout of the restaurants in Washington, here …

Chris: [Laughing]

Nassim: … or the government had to step in? No. Why? Simple. Because just like transportation, a mistake is never wasted by the system. So, an individual restaurant is fragile …

Chris: So, an airline industry …

"Every time a plane crashes, the probability of the next plane crashing is lower. That's a good system. You exploit the mistake — the fragility of the individual plane — to make the individual system more robust."

Nassim: Exactly. Or air transportation. The airline may not financially benefit. But let me use the airline and then go to restaurants. Every time a plane crashes, the probability of the next plane crashing is lower. That's a good system. You exploit the mistake — the fragility of the individual plane — to make the system overall more robust. Whereas every time a bank crashes, the probability of another bank crashing is higher. Or a bank crashing in the U.S. increases the probability of a bank crashing in Western Siberia. You see the connectedness? So it's not a good business. It's not a good industry.

You can generalize the long volatility to anything that converts error for the improvement of individuals or the improvement of the collective of the system. So, you need the fragility of the restaurant individually for the sake of the stability of the overall system — because if restaurants were not fragile, we'd be eating Soviet-style cafeteria food. And believe me, I've tried it once. Not very good. I'm still trying to recover from it.

Uncertainty Is Desirable

Chris: [Laughing] You're listening to Motley Fool Money. Talking with Nassim Taleb. His book is *Antifragile: Things That Gain from Disorder*. One of the other things that you touch on in the book counteracts this common phrase we hear about investing in Wall Street all the time, which is that "the market hates uncertainty." And one of the cases that you make is that uncertainty is a necessary thing, and maybe even a desirable thing.

Nassim: It's actually immensely desirable. People in trading understand it. Outside of trading they don't. Let me start with an example of the careers of two brothers, where you realize that variability and volatility helps one of them. From there, we can translate that to markets.

In the book I have the example of two brothers. One is a taxi driver, and his twin brother (who is actually born in the same place — Cyprus) works as a clerk in a bank, doing something that earns about the same amount of money. They both live in London, the same suburb.

The taxi driver has a volatile income. The one employed in the personnel department has a very stable income. He has been employed with the same bank for 38 years, and you get a gold watch every 25 years …

Chris: Yes, right.

Nassim: The taxi driver has very small risk of ending up with zero income or being unemployed, because every day he adjusts to the exact needs of the environment. Every error he makes and every wasted afternoon teaches him something about neighborhoods. He converts error, and his variability converts into activity and information. A complex system or anything organic communicates with the environment via stressors. A stressor teaches you something. This is how we learn, not through lecturing.

Now, his brother has no idea …

Chris: By the way, that's hilarious. You're a professor, and you're saying we don't learn through lecturing. Have you passed that onto your students, as well?

Nassim: I actually teach students that — that optionality is vastly more important than intelligence. Other academics don't like it, and I can predict the review of my book and the emotion in the book review based on the name of the reviewer. I don't have to read the reviews. I can tell you exactly how angry and what he is going to say based on this idea of intelligence. Anyway, the second brother, therefore, is much more fragile.

So, let's compare it to political systems and then to economic systems. Saudi Arabia — zero political volatility. Zero. Zero variability. Compare it to Italy, where since the Second World War we've had about 65 to 75 governments. Nobody counts anymore. Italy is much more volatile. Saudi Arabia is much riskier.

It's the same thing with markets. We have tried currency controls, exchange controls, everything. It destabilizes. Markets are information. The problem in finance is that people want to fear volatility, so they do a Greenspan. A Greenspan …

Chris: [Laughing]

Nassim: … or Greenspanization is you try to artificially stabilize everything. And just like a forest in which you repress every small fire to stabilize it, the flammable material and hidden risks accumulate, and then the big one is monstrously bad.

So, this is what happens in an economic system. You have to learn to love volatility for the sake of the system, because variability, if you embrace it, gives you information that makes you adapt very quickly; and, of course, it protects from big tail events. And you can apply it to so many things. Like in life. You can have no variables in your life by spending six years in bed. Hopefully you are reading my books. I have 600 pages of math, so you can probably do that …

Chris: That would take me about six years to get through.

Nassim: Whatever. Or you can have *The Sopranos*, the entire episode. But, anyway, you spend six years in bed. You have no volatility. Now, what happens to you when you get out of bed, and someone invites you …

Chris: Atrophy …

"If you embrace volatility, you get a lot more out of it than if you fear it."

Nassim: You could break a limb very easily, your bones would be brittle, and you may not survive a subway ride, particularly in New York. So this is the illusion. If you embrace volatility, you get a lot more out of it than if you fear it. And I know that people who invest in fixed-income instruments and sell tail options — their income is so steady because they want steady income — and all these people end up blowing up. They say, "Oh, I only lost money once."

Like the banking system. Like Citibank. In 1982, they blew up and lost everything. The money that Citibank lost everything made the history of banking in one ... They said, "We only had one down quarter." That's what they said. And it happened to them again, of course, in 2007 and 2008.

The Cat Vs. the Washing Machine

Chris: You're listening to Motley Fool Money. Talking with Nassim Taleb. His book is *Antifragile: Things That Gain from Disorder*. You mentioned big events and how they come up. All you have to do is pick up the newspaper or turn on CNBC to know that we've got our own sort of big event that we're facing here in the United States and that is the fiscal cliff. What do you think of that?

Nassim: I have so little clue, it's not even funny …

Chris: [Laughing]

Nassim: … but let me tell you one thing, honestly, about the fiscal cliff. People talk about it as if they're panicking. They're afraid of variation. I'd rather have the market deal with problems than politicians. The little bit of volatility would shake people up and would cause solutions, rather than this artificial stabilization we have had with this quantitative easing (which continues, in fact, what Greenspan did, and weakens the system even further).

"When the world was smarter (in other words, when economists were confined to doing moral philosophy), the world was great. People never mistook the cat for a washing machine."

Let me get into the fundamental problem we have. When the world was smarter (in other words, when economists were confined to doing moral philosophy), the world was great. People never mistook the cat for a washing machine, and let me explain. The washing machine is a machine. It needs continuous maintenance. It's never going to get better on its own, and you don't want volatility for the washing machine.

But something organic needs volatility. The problem is when they started teaching economics to people, they started teaching the world how to blow up. Economists are trained, mentally, to mistake the cat for a washing machine — in other words, to mistake the economy for something mechanical rather than organic, and something that doesn't respond to stressors. Take the textbooks. Economists have problems with particular textbooks, and you realize that they don't get the point, and everything they've done is fragilized. This is why I call them in the book *fragilistas*.

Chris: Have you patented that? Do you have a trademark going on all of the versions of antifragile?

Nassim: No, it's OK. I don't need it. If you patent this, you guys can take it. Like Motley Fragilista.

Mistakes Should Harm Their Makers Most

Chris: We talked earlier about your career in options trading. I am curious. What has been your biggest shift in thinking when it comes to investing over the last, say, 25 to 30 years?

Nassim: I started viewing the world again, as I told you, and I took my ideas to their natural conclusion and started to realize one thing — I'm becoming obsessive about *skin in the game*. So, I will tell you in a minute about my investments. I have a rule that the reason the economics profession or people make bad forecasts, without anything changing, is because those who make the forecasts are never harmed by their mistakes. And as an ethical rule, I don't think that anybody should give forecasts. People should tell you first what they have. So, I don't respond. I'll tell you what I do.

In the book, I talk about never asking a doctor what you should do. Ask him what *he* would do if he were *you*. Just psychologically switch, and he will give you a different answer. So, I don't say what people should be doing or my view of the world. I will tell you what I would be doing, or what I would do, or what I am doing. This is like an ethical shift, and I feel a lot better, because I don't feel guilty if I make a mistake. I'm harmed first. I should be harmed more by my mistake than any other individual.

Chris: That's something that we've talked about on our show plenty of times: the whole notion of, when it comes to company management, and all things being equal, tending to lean towards companies where the management, the CEO, etc., have much more significant skin in the game. They have a greater ownership of the company. They're probably going to be better stewards of the shareholders' money as a result.

Nassim: Definitely. I mean, there's still a game. If the company is listed, you already have something unfavorable going; that they may benefit from impressing the security analyst. Where if the company is not listed, it's just really cash flow out of the business. Like someone owns a bakery or something like that. It's cleaner.

But you're right. Skin in the game is necessary. In the book, I started looking at skin in the game as optionality. Someone has a free option, and someone shorted the option. And people package things because we don't understand options. The executive of the company has all upside and no downside.

"When Adam Smith thought of what we now call capitalism, his idea was skin in the game, and he used to call entrepreneurs *adventurers*."

When Adam Smith thought of what we now call capitalism, his idea was skin in the game, and he used to call entrepreneurs *adventurers*. He did not like the joint stock company that limited liability, on the grounds that people would game the system. I'm not against limited liability. You can have limited liability, but you've got to have skin in the game. They're not incompatible.

Removing Moral Hazards With Heuristics

Chris: I wanted to ask you another question about banking. Earlier this year, I believe it was the former head of Citi came out and said that he thought the big banks should be broken up. Obviously that was not his position when he was the head of Citi …

Nassim: [Laughing] Yes, of course …

Chris: … but when you look at the big Wall Street banks, if someone gave you the power to wave the magic wand to make some sort of fundamental systemic change to improve Wall Street banks, what would you do?

Nassim: I belong to the school of heuristics. Heuristics means find rules of thumb (like learn from your grandmother) that have a big impact with minimum side effects. We call them less is more — more impactful heuristics. That's my school. There are very simple rules of thumb. I came with seven or eight rules of thumb to remove what I call the *moral hazard* option, the free option.

The first one is as follows: If a company (not just a bank — any company) is to be bailed out by the taxpayer in the event of failure, then automatically that company is de facto owned by the taxpayer. Therefore, the taxpayer should decide the salary of the executive.

Now, if you have a law or rule like that — it's a very simple rule. Instead of a thousand regulations, you say, "If you're going to be bailed out because of a national emergency, if Tesco fails in the U.K. because of disruption in the food chain, executives are no longer allowed to earn more than civil servants at the same rank. What would it do? It would force people to go under the radar. They'd have to think, No, I can't be bailed out if I fail.

Chris: It's a simple rule. It makes a lot of sense. That's probably why it's never going to happen.

Nassim: Probably. And I have two or three rules like that. Let me give you another rule. You know, when you work for a government, a lot of people use it as a revolving door. Again, there's corruption. I mean, in a lot of African countries, there's outright corruption. Here, corruption is you end up working for an investment bank later, or an industry, or Boeing, or something.

So the rule should be — I call this one the Tony Blair rule. If you're going to work for government, it should not be an investment strategy. What you earn later should no longer come from the taxpayer above a certain amount. There's two, three or four simple rules, called *less is more* rules, that can have a lot of impact on things.

"Small Is Beautiful"

Chris: The whole notion of less is more, I was thinking, fits into one of the other things you touch on in the book—this notion of companies and their size. You make the point — I think the way you put it is *small is beautiful*. You seem like someone who is very much against the notion of mergers — or certainly the notion that mergers and making a company bigger automatically makes it stronger and more anti-fragile.

Nassim: Well, sometimes you have gains from size, but you should let the market decide. When governments get involved, you have a problem, and let me explain. I was debating once at a public library (and not even a debate, but a discussion) and there was the chairperson of PepsiCo, I think, or one of those companies.

Her argument was, "I employ 700,000 people." That was the argument. So I looked at her and I said: "You're hijacking the system now, because you employ 700,000 people. Someone who owns a nail salon can't make that claim. Therefore, we're going to bail you out, not the nail salon owner. And this is my money that's going to be used to bail you out."

"Corporations like to become large, because the state takes care of them."

You realize that corporations like to become large, because then the state takes care of them and it becomes part of the state, like in France and in Europe. Executives — it's very incestuous. There are effectively some market economies of scale; but as companies become large, they become much more vulnerable to errors. Errors in the system blow up much faster than with smaller companies.

In addition, the larger the company, the less the skin in the game of the executives, because they have an option. They can cash out and go to Florida. The company blows up 10 years later, and they don't care. And you can see it in a lot of data. For example, a £100 billion project in the U.K. has 30% more cost overruns from errors than £5 million projects. You can see it right there …

Chris: Yes …

Nassim: You have economies of scale way offset by effective errors in the system. This applies to anything top-down where you have decision-making that's concentrated, versus distributed bottom-up. The same thing pervades everywhere.

And moral hazard also appears at another level. If something is big … Say you no longer have the soul in the game — the artisan has his ego in the product. An author is an artisan, so he has his pride in it — you no longer have that. It becomes a spreadsheet. And the same thing with government. If you're mayor of a small village, you're put to shame when you go to church on Sunday if you make a mistake. If you're someone five miles away from here, sending information …

Chris: Just across the river …

Nassim: Exactly. In Washington, it's a spreadsheet. The spreadsheet doesn't look at you and shame you; at least not the ones we make so far. So, the whole thing is not favorable, yet people still believe in the economies of scale and that bigger is better. You see, the *small is beautiful* used to be a romantic idea. I tried to prove (this has an appendix of 400 pages amassed so far, with 200 more coming) where there's fragility, there is short volatility. A big company has vastly more short volatility than a small company.

"No Such Thing as a Wine Connoisseur"

Chris: Your last book was *The Black Swan,* which refers to unexpected events. My final question is in that notion — it's a bit of a *Black Swan* question. One of the things I read about you is that you are something of a gourmand. This weekend I'm going to dinner at a friend's house and I know he likes wine, but I don't know what's being served. I don't really know anything else. Can you recommend a good bottle of wine that's not going to break my bank account?

Nassim: This is a very interesting question, because I'm actually not that into fancy wine.

Chris: That's good. I'm not into buying fancy wine.

Nassim: Very good. Put the cap on a bottle of wine, all right? No more than $20 …

Chris: No more than $20 …

Nassim: No more than $20, and your odds are, empirically, you'll do a lot better than if you go higher. You know, there's also something more you should know about me — that I don't like (let me try to find a polite way to describe them) the people …

Chris: Snooty?

Nassim: There's a word that unfortunately I can't say on the radio …

Chris: [Laughing]

"Good wine is a wine your taste buds love, and typically odds are you'll find it under $20."

Nassim: … that describes the class of people that are overly sophisticated a little bit more than necessary. And usually you find them into wine. When you have a lot of money, what do you do? You can spend it on wines, or vacation, or with your decorator, or on a swimming pool, that kind of stuff. So, that class of people is into wine. Good wine is a wine your taste buds love, and typically odds are you'll find it under $20. So, put that limit on it.

Chris: The book is *Antifragile: Things That Gain from Disorder*. He's not just a bestselling author. He is also a wine connoisseur …

Nassim: No, no, no. I'm not a wine connoisseur at all …

Chris: I was just trying to broaden your resume — not that it needs broadening …

Nassim: No, no, no. Plus there's no such thing as a wine connoisseur.

Chris: There isn't?

Nassim: No! I mean, if you take experts, and you have them taste wine, their ability to predict the price of a bottle between $9.99 and $999 is uniform. It's like almost random. So, there are a lot of pseudo-connoisseurs. I mean, they may be able to tell you where it's from vaguely, but not necessarily similar to your taste.

Chris: I think your next book needs to be an exposé of the wine industry. I'm picturing like a blockbuster investigative journalism piece.

Nassim: Oh, let me think about it …

Chris: [Laughing]

Nassim: … but if you volunteer to write half of it, I may consider that.

Chris: I volunteer to write a blurb on the back. [Laughing]

Nassim: That's done. Then deal done.

Chris: Nassim Taleb. Thanks so much for being here.

Nassim: Thanks for having me. Thanks.

Gold, Real Estate, and Hedges

Chris: How do you invest your own money?

Nassim: I'll tell you what I have, and I'll tell you what I'd like to have. I got nervous with gold. I bought gold after the crisis and a few years of monetary policy. I want a repository of value, of things not to worry about; and gold scares me a little bit. So, I'm getting out, progressively, from gold.

I bought real estate for rentals, where you get cash flow. I'm mostly motivated by hedges against inflation. I own some stocks, visibly, but mostly as hedges against inflation. I have some hedges against long-term interest rates rising — some complicated hedges, but that will pay me if that happens. I own land visibly, also, as a hedge against printing money. And I would do a deal with anyone — if I could get 95% of my purchasing power back 20 years from now; I'm done.

The problem is that I'm nervous that what I own doesn't really track my consumption inflation. Since it's a very difficult environment today, you don't know where your inflation rate is. Some things are going up in price, others are not. I mean, companies are doing very well in the United States (for the time being) and this is a lot better than government bonds. They have cash flow.

So, I own some. I'm not worried about owning companies, but I'm really worried about the situation we're in — in which the 1% of the 1% are getting richer while, at the same time, the median American or Westerner is getting poorer. This is not a long-term steady situation, so, I think there may be social unrest. I have no hedge against that.

(Want to talk Taleb? Bring your thoughts to the *Pro* Philosophy & Strategy discussion board!)

Write a Covered Strangle on OpenText

Published Dec 4, 2012 at 12:00AM

What We're Doing: Generating income with the potential to buy more shares cheaper, sell our stock higher, or roll our strangle by its May expiration.

- **Action:** Use a strangle order to write options on **OpenText** (NASDAQ: OTEX):
  - Sell to open May 2013 $50 puts
  - Sell to open May 2013 $60 calls
  - Options' combined bid/ask: $5.35/$5.80
- **Price Guidance:** Aim for a combined **credit** of $5.50 or higher. As prices change, ideally accept no less than $4.30.
- **Recent Stock Price:** $56.40
- **Allocation:** Write one call for every 100 shares you already own, and one put for every 100 additional shares you could buy. *Pro* is writing seven contracts of each, covering our 700 shares and potentially increasing our position from 2.7% to around 5% (accounting for depreciation). You need a portfolio size of approximately $200,000 to strangle a potential 5% position around $50.
- **Alternative Trades:**
  - If you don't own shares, buy a 2.7% stake and then write the strangle with us (assuming you're managing $200,000 or more).
  - If you're managing less money, just buy a 2.7% stake or sell to open May 2013 $55 puts for up to around 5%, lately paying you $4.40.

How to Follow Along

We wrote a covered strangle on OpenText in August using the same strike prices as today's recommendation. In November, that option position expired as full income, and we published our review of the company's quarterly results. The only other recent news that might affect OpenText was **Hewlett-Packard**'s (NYSE: HWP) admission that results at Autonomy (a software company it acquired) were weaker than had originally been stated, suggesting dishonesty on Autonomy's part. Although disturbing, that's a potential positive development for OpenText, perhaps sending some of this competitor's business our way. Our recent strategy remains unchanged, though; we're strangling the stock again to potentially earn more income.

Writing a covered strangle is a combination of two strategies: writing covered calls on a stock you own, and simultaneously writing puts to potentially add to your shares. It provides meaningful income and a wide share price range in which to earn it.

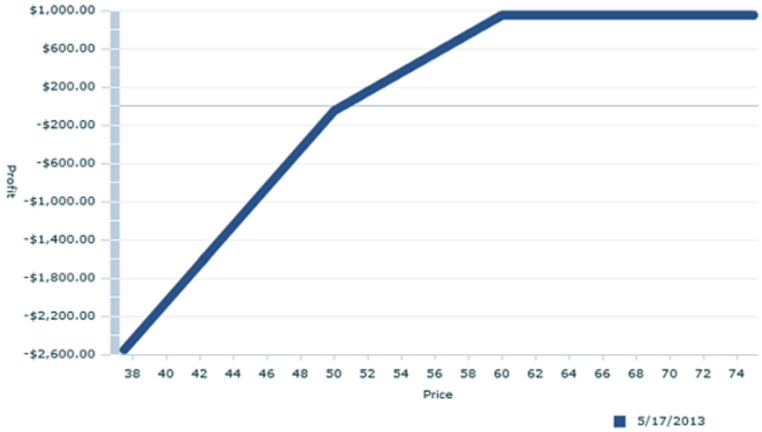
- **Strategy type:** Bullish to neutral; income with stock upside potential
- **Maximum gain:** The credit received plus upside in the stock to your call strike price
- **Maximum loss:** The same as stock ownership, but starting at a lower price on any new shares

Here's a look at the numbers on this trade (along with a profit chart, which assumes a strangle of 100 shares bought today):

- **First:** Own or buy at least 100 shares, with the ability to double that number to 200
- **Sell to open:** May 2013 $50 puts/$60 calls using a strangle order
- **Allocation:** Sell one of each option for every 100 shares you own
- **Receive credit of around:** $5.50 combined (this is all "time value," so it decreases by the day unless volatility increases)
- **Days to expiration:** 165 (5.5 months)

- **Time value per day:** $0.033
- **Yield on share price ($5.50/$56.40):** 9.7%
- **Yield on share price and 30% cash ($15 of $50) to hold open puts:** 7.7%
- **Net potential sell price on existing shares:** $65.50
- **Net potential buy price on new shares:** $44.50
- **Recent share price:** $56.40
- **Upside to net sell price:** 16.1%
- **Downside to second net buy price:** 21%
- **Range in which to earn total income:** $50-$60

The chart below shows your potential profit or loss, assuming you buy shares today to write the strangle.



Next Steps

- Want to know everything there is to know about covered strangles? We can tell you everything there is to know about covered strangles. (Well, we can come close.)
- If you have any questions about writing this strangle or starting a position, visit our OpenText board. You don't need to make every trade in *Pro* to benefit. Own our core positions in sizes suitable to you — that's our core strategy. OpenText remains a buy.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Losing Is Mission-Critical

Published Dec 3, 2012 at 12:00AM

We Want Your Thoughts!

Take this short survey to tell us what you love about *Pro* and what could be better. We really do listen to your feedback, and we'd genuinely appreciate your thoughts!

Pro Trade Roundup, Guidance Changes, and Catch-Up Trades

- Nothing this week. Not a single thing!

Fellow Fools,

I'm glad investing isn't an Olympic sport. It's not just that playing at an Olympic level takes titanic levels of commitment and sacrifice — did you know that Olympians can't even lose on purpose if it increases their odds of earning a medal? Eight female badminton players from three countries were disqualified from the London games this year for sandbagging in an attempt to manipulate the tournament structure. But isn't winning a medal the point? Is it ever OK to lose on purpose to achieve the higher goal? Perhaps not in sporting events, but investors can lose on purpose with good results (and without disqualification!).

Losing Is Mission-Critical

Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To do this, we focus on our North Star: inflation + 7% annually.

Given this mission, hedging is a necessary part of our approach. To achieve positive returns over *every* rolling three-year period, we need to profit when stocks are down as well as up. Sure, asset prices have marched upward for the past three years, but we only know that with the benefit of hindsight; the next three years are always unknowable. Elroy Dimson of the London Business School may have said it best: "Risk means that more things can happen than will happen." We make portfolio decisions based on our forecasts for the future. That isn't to say that we know what *will* happen, only that we make the very important effort to detail the things that *may* happen. Most of those things — good and bad — won't come to pass.

What does this have to do with losing? When we establish a portfolio hedge, like the **SPDR S&P 500 ETF** short, we are planning for a range of outcomes and hoping — yes, hoping — to lose money on the position. Heck, if it were up to me, I'd love to lose a boatload of money on SPY. No, I'm not trying to give you (or Jeff) a heart attack; it's simple math. If SPY were to double, it would reduce our portfolio's value by 10% (on top of what we've already lost). But our 90% long positions in some great companies would likely double, too, and at nine times the size of our short … well, the resulting North Star-crushing returns could hardly be called a bad result.

Some observers (and members) might think our SPY hedge hasn't worked out as hoped. There's certainly merit in that critique; we would have higher returns, and more money, if we had never hedged our portfolio. Specifically, by Stamleo's count (thanks, Leo!), we'd have $53,091.75 more in our account without the SPY position, meaning it's been a nearly 4% drag on our portfolio. But we don't hedge for returns alone — we do it to lower risk. Our SPY position was meant to reduce market risk, which allowed us to keep a higher percentage of our portfolio invested in *Pro* stocks. To that end, it's worked out nicely.

Counterfactually Thinking

Because hedging is a risk-reducing measure and risk is "all those other things that could have happened," any evaluation of a hedge's effectiveness also needs to consider the hypothetical results if things had turned out differently. In the case of SPY, if the market had gone down instead of up since we established the position, we'd have made money on the short but lost even more money on our long positions (because of their higher allocation). Sure, this would make hedging feel like a smart move, but it's actually a suboptimal outcome when compared with losing money on the short.

That said, there is another layer of nuance to this scenario, and it has to do with how we plan to use our hedged positions. If the market dropped significantly, we'd likely deploy the money earned from the hedge into some really cheap stocks that we'd expect to offer higher future returns. That's the real beauty of a hedge — it gives you liquidity without having to sell your (now cheaper) core holdings.

Targeted Shorts

In *Pro*, we talk a good deal about targeted shorts like **Sony**, and I wonder if this creates some confusion. To me, a targeted short like Sony is no more a hedge than a long position like **Covanta** is. Yes, both can buffer us a bit in a down market and we appreciate that, but neither is a true hedge; to meet that description, a position must neutralize a risk factor (price risk, commodity exposure, etc.) to which our portfolio is exposed.

One thought experiment I like to use when determining whether a position is a hedge: Look for offsetting price movement. As mentioned, it'd be highly unlikely for SPY to double in price (a large loss for our short) without our long positions doubling as well. That's not the case for Sony. If Sony surprised the world by announcing a return to profitability and margin expansion, the stock price would shoot up (a loss to us), but we wouldn't automatically see corresponding gains in our other positions. In fact, such news could signal more competition for our consumer tech companies. And what if Google were to offer $20 billion in cash and stock for Sony, giving Big G access to its patent portfolio? Shares would double, again without similar movement in our other portfolio positions. These admittedly implausible examples show that Sony offers its own risk exposures that aren't offset by our portfolio. Therefore, it is not a hedge; it is a high-conviction position like any other on our scorecard.

Putting It All Together

Pro investors prefer to lose money on their hedges, because their offsetting positions will gain even more. Hedging is like having sandbags ready *before* the storm: You're prepared for the worst, but you still hope they're ultimately unnecessary. This preparation gives you a higher probability of a good outcome. So if you've been bummed by the history of our SPY short, be glad that we didn't need it. In fact, Jeff identified this potential outcome when we initiated the hedge: "Remember that when things look bleakest, stocks may be poised to perform the best they have in years (because everyone has already sold and valuations are too cheap). Are we at that point yet? Possibly not. But either way, we want to set our portfolio up to hedge a macro-driven decline, allow our selectively chosen businesses to outperform, and keep a cash balance that lets us be opportunistic."

In investing, it's OK to lose on purpose. In fact, for the right reasons, it is the *Pro* way. And if we approach North Star returns while hedged, you'll know the strategy is a success.

Best,

Nick Crow (TMFCrow)

Coverage & Community

- **Intel on Wintel?** Fools talk about their Windows 8 experiences — and what they think now about Intel.
- **Indexing Index Hedges:** *Pro* investors still make good gains with big index hedges in place. Stamleo outlines the situation and Jeff shares his thinking and the plan.
- **Waiting for Real Estate: ProShares UltraShort Real Estate** is performing as expected: not well compared with its objective. The real estate index has just been down a bit.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Make 2013 Your Most Focused Year Yet

Published Nov 26, 2012 at 12:00AM

Dear *Pro* Members,

We Want Your Thoughts!

Take this short survey to tell us what you love about *Pro* and what could be better. We really do listen to your feedback, and we'd genuinely appreciate your thoughts!

I hope you all had a refreshing holiday with your loved ones. Most of the *Pro* team traveled to see family, putting us all around the country:

- Our intrepid editor, Ellen, and her husband (who is also a Fool!) left their newly purchased first home for a trip to the New River Gorge of West Virginia, where they met up with family and confirmed that their 14-month-old niece is the smartest, cutest, sweetest baby in human history.
- Bryan gave thanks with his in-laws near the original Thanksgiving site in New England. Much of the rest of his trip was spent on intense doses of family time and helping his mother-in-law bring her town's Christmas program for the less fortunate into the 21st century. (Ideally, this will automate much of his future involvement and free up time for playing in the leaves.)
- Nick spent Thanksgiving with his in-laws in wild Montana. He was able to visit Yellowstone Park, where he learned that buffalo will chase you if you get too close (see below). He recovered — from the in-laws, not the buffalo — by soaking in the "Boiling River." Luckily, the park's wolf packs stayed at bay.
- Much more tamely, I spent Thanksgiving with family and friends at home in Washington, D.C., after which we moved to a house that's closer to our son's school. So we spent the weekend opening boxes and ordering Thai food and pizza for delivery.

We hope you had a memorable weekend, too! As our thoughts start to turn toward 2013, I'd like to use this holiday-infused Memo to touch on some ways of preparing for the year ahead.

Set Your Compass True

I started this year knowing that I wanted to end it much better organized and more effective.

To get the ball rolling, I created a new personal mission statement, which I hoped would complement *Pro*'s and *Motley Fool Options*' missions while including the much broader scope of life. Having these missions in one prominent file on the computer desktop makes them easy to refer to, reminding me of my goals and values every day.

I also asked my wife and son to list the things they'd love to do or accomplish over the next one, three, and five years; then we consolidated our lists. Our seven-year-old son wants to see a hippopotamus attack a giraffe, so perhaps not everything will be checked off the list. But with work and family road maps in place, we're much more likely to achieve things that otherwise would never come to fruition.

These short documents (I call them "one-pagers") also include things that remind us how to live better. For instance, our family one-pager has a list of five of the favorite days of our lives. Looking at them reminds us why they were so great — many are very simple memories. The page also lists some of our least favorite periods in life, reminding us that there are big ups and downs.

As part of my investing one-pagers, I listed "What I Believe" early this year. As you may recall, this year's list included a belief in a housing recovery and growing auto sales. I'll update the list for 2013 soon (with input from the rest of the team), and *Pro* will work to invest alongside our beliefs. On my investing one-pager, I also list my most respected companies of all time (including 20 I'd love to own at the right price), and my best and worst past investments (they serve as great reminders). Eventually, we may share more of our thinking along these lines as part of *Pro*.

For both *Pro* and *Options*, I keep running lists of top trade considerations and other research to conduct, and I finish each Friday with a look at what I hope to accomplish in the week ahead, so I'm already thinking about it. Finally, wherever I list my investment positions (whether on My Scorecard, our new What We Think Now page, Google Finance, or at my broker), I list them by allocation, *largest to smallest*, so my attention is always drawn first to the positions that matter most. This alone can change how you view your portfolio.

All this (and a bit more) is coming together into a compact working document that helps ensure I'm on task every week, while also making certain I'm working toward bigger, long-term goals for our investing services and life in general. As we roll into 2013, you might enjoy taking some time to do these exercises yourself. List out your beliefs and goals in life and in investing, and create some guiding "one-pager" documents of your own. Store them all on your desktop in a single folder, so they're never far away. To talk about this or share your best practices for staying true to your goals (true to your North Star, we would say here), please visit our Philosophy & Strategy board.

Thank you for being a *Pro* member. Stay Foolish!

— Jeff Fischer (TMFFischer)

Pro Trade Roundup

- **iShares Russell 2000 Index**: We set up a new put ratio spread, selling to open 56 January 2013 $75 puts and buying to open 28 January 2013 $78 puts (one ratio spread for every $50,000 we manage), for a net credit of $0.12 per spread ($336 total).
- **InvenSense**: We sold to open December 2012 $10 calls for $0.60. On all our 1,600 shares, this brought us $960 and a potential sell price of $10.60 next month.

Guidance Updates

- InvenSense moved to "Sell" last week (technically, "Aim to sell via covered calls").

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **ProShares UltraShort Real Estate** : Interactive Brokers reports 500,000 shares available for shorting. If that holds true tomorrow, you can sell short up to 1% to start. (Revisit original report.)
- **Rockwood Holdings**: With shares at $43.65, if you don't own at least 4.4%, you can buy shares. If you only want to buy lower, sell to open January 2013 or February 2013 $40 puts.
- **AIG**: Buy up to 2.3% in shares, or if you only want to buy lower, sell January, February, or May 2013 puts, from a $33 strike on down, depending on what looks appealing to you.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Satisfaction:** Our earnings summary on **Medtronic** claims perfect satisfaction from recent results (OK, "perfectly satisfactory"). Shares remain a Buy.
- **Gratitude:** *Pro* members share their Thanksgiving wishes.

Buffalo

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Set Up a Put Ratio Spread on IWM

Published Nov 20, 2012 at 12:00AM

- **What We're Doing:** Using options, we're setting up another market hedge that won't cost us anything if the market keeps rising.
- **What We're Thinking:** We're hopeful for political resolution on the "fiscal cliff" before January, but if nascent negotiations stall, the market could decline in response.

Trade Essentials

- **Action:** Using a ratio spread order, set up a put ratio spread on the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF.
    - Sell to open January 2013 $75 puts
    - Buy to open January 2013 $78 puts
    - Sell two $75 puts for every $78 put you buy
    - Bid (on two $75 puts) / ask (on one $78 put): $2.60/$2.30
- **Price Guidance:** Initially, use a spread order for a **net credit** of around $0.30; as prices change, ideally initiate the spread for, at worst, zero net cost.
- **Recent ETF Price:** $78.86
- **Allocation (based on the written puts):** Thirty percent, half of which is insured by our purchased puts, making our true exposure 15%. Write two puts and buy one put for every $50,000 you manage. *Pro* is writing 56 puts and buying 28.
- **Alternative Trades:** None like this. This is a unique strategy that requires put-writing in a margin account. You could instead just buy to open the $78 puts with your own capital, but that's relatively expensive, with a break-even point 3% below $78. You could short shares of the ETF directly if your broker has shares, but realize that hedge will cost you if the market rises.
- **Your Other Index Hedges (including SPY, SH, and previous iterations of IWM) Remain Unchanged:** This put ratio hedge can be set up in addition to any index hedges you already carry. *Pro* has a 10% short on SPY (and has been advising just 10% in direct index shorts since this summer).

The Big Picture

We recently closed the prior iteration of this hedge for an $8,200 gain, adding about 0.6% in extra value to the *Pro* portfolio while the **iShares Russell 2000 Index** (NYSEMKT: IWM) index itself declined about 5%. We chose a put ratio spread as a hedging strategy because it won't drag on our returns if stocks rise, and we chose the IWM index — which tracks the 2,000 smallest companies in Russell's universe — as our underlying hedge because of its highly liquid options and because it has historically been 35% more volatile than the S&P 500.

Such volatility potentially benefits us because this put ratio spread is a "frictionless hedge," meaning it won't cost us anything if stocks rise, but we can expect a larger relative drop in the ETF if the S&P 500 falls. Meanwhile, the Russell 2000 looks overpriced compared with the S&P 500, with the profitable companies in this small-cap index trading at an average 24.9 times earnings (the average P/E for the larger companies in the S&P 500 is 14). The many *unprofitable* companies in the Russell 2000 are left out of its valuation altogether.

Strategy Details

Using a spread order, we are writing $75 puts that obligate us to buy shares of IWM (unless we close the puts beforehand) if they decline to less than that price by expiration. These puts expire in two months (on Jan. 19, 2013). We're using the money we receive for writing these puts to *buy* half as many $78 puts that expire the same month. That's where our hedge comes in: The $78 puts will profit if IWM declines, and they also cancel out half of our $75 put exposure, lowering our total break-even point on the strategy. Here's how the math and potential returns tally:

iShares Russell 2000 Index ETF Price	Value of 1 Purchased $78 Put	Value of 2 Written $75 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%) from $78.86
$78 or higher	$0	$0	$0	N/A
$77	$1 x 100 = $100	$0	$100	(2.3%)
$76	$2 x 100 = $200	$0	$200	(3.6%)
$75	**$3 x 100 = $300**	**$0**	**$300**	**(4.9%)**
$74	$4 x 100 = $400	($1) x 200 = ($200)	$200	(6.1%)
$73	$5 x 100 = $500	($2) x 200 = ($400)	$100	(7.4%)
$72	**$6 x 100 = $600**	**($3) x 200 = ($600)**	**$0**	**(8.7%)**
$71	$7 x 100 = $700	($4) x 200 = ($800)	($100)	(10%)
$70	$8 x 100 = $800	($5) x 200 = ($1,000)	($200)	(11.2%)

The bolded lines above show that we'll earn the most profit on the strategy if these puts expire with the ETF at $75, down 4.9% from its recent price. Our break-even on the strategy is $72 per share, so the ETF can decline 8.7% before our strategy starts to show a loss by expiration. To summarize:

If the ETF (i.e., the Market) Does This ...	Then Our Strategy ...
Goes up, stays steady, or declines less than 1.1% (so it's at or above $78 at expiration)	Doesn't cost us anything — in fact, we earn any credit paid to us when we initiated it.
Declines between 1.1% and 8.7%, to between $77.99 and $72.01	Earns a partial to full profit, depending on the amount of the decline.
Declines more than 8.7%, to $72 or less	Shows a loss by expiration. We can close the options and roll to a new ratio spread; take shares of the ETF to own; close the options and buy calls instead; or set up a synthetic long to lower our cash outlay and turn bullish.

Any returns here won't occur smoothly or immediately. If the market falls a long time before expiration, our spread will largely retain its current value, with the two sides of the spread mostly canceling each other out. As with most spreads, we need to wait until closer to expiration to achieve results. With this spread, that's only 60 days away, but there's a trade-off — we have less downside room until our break-even price than in spreads we've set up in the past. Although nobody can be a market genie, with this timing, we're trying to target any end-of-year or early January political risk. By early January, we should be able to close this at a profit (if we wish) if the market is lower by around 7% or less.

Finally, assuming we set it up for a credit, this trade will result in a small profit for us even if the market rises or treads water. But to be safe, you must be ready to fulfill the $75 put obligation if the market falls out of bed and we don't want to keep the strategy going.

Next Steps

- **Questions or comments? Need help setting it up?** Visit our iShares Russell 2000 Index discussion board.
- **Get more ETF info:** See the fund's overview at us.ishares.com.

- **Follow it:** Add iShares Russell 2000 Index to My Scorecard.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Putting Your Best Positions in Play

Published Nov 19, 2012 at 12:00AM

Fellow Fools,

Guidance Updates

- **Thanksgiving:** We're moving Thanksgiving up to Buy First. Enjoy!

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **ProShares UltraShort Real Estate** : Interactive Brokers reports shares available for shorting. If that holds true tomorrow, you can sell short up to 1% to start. (Revisit our original report.)
- **Rockwood Holdings**: With shares at $43, if you don't own at least 4.4%, you can buy shares. If you only want to buy lower, sell to open January 2013 $40 puts, lately for $1, or a 2.5% yield in two months. Or sell February 2013 $40 puts for $1.60.
- **AIG**: Buy up to 2.3% in shares. Or, if you only want to buy lower, sell January, February, or May 2013 puts, from a $32 strike on down, depending on what looks appealing to you.

Questions on these? Visit our "Catch-Up Trades" discussion discussion board.

Imagine you're the manager of a baseball team. You have 40 talented players in the dugout, and you like them all — so much so, in fact, that instead of just putting nine players on the field, one day you decide to send *30* of them out to the diamond. The crowd is stunned, waiting and watching to see what happens.

It doesn't take long for the air to leave the stadium. The field is too crowded with your players — trying to play the same position, chasing the same ball, and running into each other. It's a true case of "Who's on first?" Before long, you're not sure who is bringing value to the team and who is in the way; after all, even the most talented players in the league are only as good as your focus in using them. Making matters worse, when you want fresh players, there's almost nobody in your dugout — and no room on the field.

You can see what I'm getting at. To achieve excellence in most anything, you need a focused, tactical strategy. *Pro* is no different; to better manage for our North Star, we need a concentrated portfolio. We want a reasonable number of skillfully managed players on the field; more power in the dugout; and the nimbleness to jump into action whenever we want to swing at a fat pitch, or (here's where the baseball metaphor starts to unravel) hedge, or change the long-short exposure of the portfolio.

Getting More From Your Core

This isn't a new idea; we've been working to concentrate the portfolio (and keeping you posted on our progress) since this summer.

Focusing our assets in "core" positions (those that make up 3% to 5% of our portfolio) will help us leverage our best knowledge in pursuit of our always-positive North Star. Instead of spending days researching a decision on a mere 1% position, we can redirect that effort toward our core positions — learning more about them and setting up extra strategies on them to earn more profit with less risk. After all, while stocks generally move up and down together, out-of-the-money options can earn us returns even when markets are flat or declining. Our strangle on **OpenText** did just that between August and last week's expiration.

But consider a new example: **Rockwood Holdings**' share price has recently declined to the low $40s, displaying its usual volatility amid minor news events. We already have a 4.4% stake in Rockwood, but with its shares down, we might want to capitalize by setting up a bull put spread. For little equity and no cost, we could sell $40 puts and buy to open $35 puts, capping our risk and positioning ourselves to earn extra income (and a strong 29% return on risk) as long as Rockwood stays above $40 by expiration.

And another: **Tupperware** stock is nearing our $65 fair value, and we plan to hang on to our shares for more upside — but we could also set up a bear call spread to earn some income if the stock cools off or stays below $65. If shares keep rising, the spread (set up by writing $65 calls and buying $70 calls) has capped risk, and our stock still rewards us.

I'm calmly excited about the extra returns that strategies like these, efficiently implemented as part of a focused portfolio, could bring. For me, this is somewhat of a new way to view the *Pro* portfolio, one I've arrived at this year thanks to the North Star and its relentless gains. Of course, if you can't or don't want to use options: Our core stock strategy remains in place the same as ever, and our increased focus on a more concentrated portfolio should benefit those positions, too.

Sum It Up: Focus Matters

Absolute or positive returns have been my personal investing goal for years, but I never specified an annualized number — I just always aimed to earn "enough" for my circumstances. *Pro* is more systematic than that; we're seeking a strong annualized return that keeps pace with (or tops!) our North Star, right now running at around 10%, as much as possible. Here are some actions I believe will bring us much better odds of achieving our goal:

- We want to concentrate our attention on around 20 core, long positions — ones that are large enough to matter. (We have 26 long positions right now.)
- We need to patiently sell small positions that require as much analysis as our large positions but don't offer dramatically more potential.
- We need to capitalize on our core positions more often than we have in the past, using options, incremental buy and sell decisions, and other strategies to take advantage of price changes in the positions we know best.
- Finally, we need to short weak companies and flawed ETFs, and use option hedges that don't drag on our upside potential much (or at all!).

This is the path we're on, and it's one we're excited to really put into in place in 2013. We'll patiently sell the few small positions we're not eager to build on. We'll get to know our core positions better all the time — and we'll recommend more strategies on them for incremental returns, with a focus on generating profits even in wayward markets. And expect us to pursue smart short strategies, including more focused shorts like **Sony** and **CurrencyShares Euro Trust**, *Pro*-style hedges (like put ratio spreads) that don't cap our upside potential, and other positions offering protection when we want it.

As we reflect this week on family, friends, and how fortunate we are to have the means to invest, we wish you a joyful Thanksgiving holiday with those you care about. If you want a break from food and family, visit the Memo Musings board. We'll keep the light on for you!

Stay Foolish!

— Jeff Fischer (TMFFischer)

Pro Trade Roundup

- **iShares Russell 2000 Index**: We closed our entire put ratio spread for a net credit of $2.86 per spread, earning around $8,250. We're looking to set up a new one.
- **OpenText**: Our short November 2012 $50/$60 strangle expired for the full profit, netting us $2,360 total. We're looking at new strangles.

Coverage & Community

- **What We Think Now:** We're not just thinking about Thanksgiving dinner. We also updated our new page!
- **Buckle Up:** It's in style to know what your companies are up to. Bryan summarizes last week's earnings from **The Buckle**.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on InvenSense

Published Nov 15, 2012 at 12:00AM

- **What We're Doing:** Aiming to sell our 1.2% position via covered calls.
- **What We're Thinking:** The founder/CEO has been ousted, and the young company is trading at an above-average valuation after less growth than expected.
- **What We're Expecting:** With new management at the helm and new competitors on the horizon, InvenSense may be a rocky ride even from today's price.

Trade Essentials

- **Action:** Write ("sell to open") December 2012 $10 calls
- **Allocation:** Write one call for every 100 shares you own
- **Recent option price (bid/ask):** $0.80/$0.95
- **Recent share price:** $10.25
- **Price guidance:** Use a limit order. Aim to be paid at least $0.85 to start; as prices change, ideally accept no less than $0.70.
- **Alternative Trade:** With this announcement, the stock moves to a Sell on our scorecard — specifically, "sell via covered calls." If you can't write calls, use a limit order to sell your shares at $10 or higher (be patient).

What's New?

When we purchased **InvenSense** (NYSE: INVN) in March, our thesis featured estimated sales growth of about 50% annually over the next few years (similar to what the company had recently reported, and as management projected), as well as even faster operating earnings growth as leverage kicked in. Instead, the motion-processing sensor provider grew sales just 28% last quarter and income from operations only 16.5%. That's a large difference. Couple that with the surprise ouster of the CEO, who was instrumental in developing the company's technology (and who does remain on the board of directors), and we aren't resting easy even with our small 1.2% position.

In the last conference call, management mentioned the possibility of new competition in the motion-sensor market from the likes of Bosch and Kionix. If others do enter the market aggressively, all players may experience pricing pressure — including InvenSense, despite its head start with the technology. The motion-sensor market should continue to grow handsomely, and if InvenSense one day wins a major client like **Apple** (NASDAQ: AAPL) away from leader **STMicroelectronics** (NYSE: STM), we might regret selling. But based on what we know today, the stock appears likely to lose to our North Star. Considering the slower-than-expected growth, today's valuation of 32 times free cash flow looks aggressive — especially in the semiconductor industry, where stocks too often settle at single-digit multiples to free cash flow once the hyper-growth phase subsides.

How to Follow Along

This trade is at least partially a *portfolio* decision, as well. As the year ends, we're reconfirming our commitment to every *Pro* position. If we can't confidently stand behind a holding given its latest quarterly results, we're aiming to sell it before 2013 begins, or as soon as reasonably feasible. This investment has been a large loser for us, down 46%, and it's dinged the portfolio for about 1% in the process. We knew when we went in that young companies are riskier, more volatile investments, so we kept it small; the broad thesis behind the investment still makes sense to us, but the growth we expected to drive the share price hasn't occurred, and new risks have emerged.

Sell to open one December 2012 $10 call for every 100 shares you own. At a recent bid of $0.80, the calls afford us a 7.8% downside cushion from today's $10.25 share price. Our break-even on this trade is $9.45 per share, but we hope to have shed these shares by the end of the year. These calls will do the trick for us if the stock stays above $10 by Dec. 22 expiration. If you have questions, please visit the InvenSense discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Close Your Put Ratio Spread on IWM

Published Nov 14, 2012 at 12:00AM

- **What We're Doing:** Taking our profit before Friday's expiration.
- **What We're Thinking:** With the index near our $80 strike price, most of our gain could quickly disappear if the index jumps.
- **What We're Expecting:** Given the uncertainty surrounding the "fiscal cliff," we'll look to set up a new hedge like this one shortly (prices willing).

Trade Essentials

- **Action:** Using a ratio spread order if you're able, "sell to close" all of your November 2012 $80 puts and "buy to close" all of your November 2012 $75 puts.
- **Nov. 13 Closing Prices (bid/ask)**
  - Sell to close November 2012 $80 puts: $1.41/$1.45
  - Buy to close November 2012 $75 puts: $0.02/$0.03

- iShares Russell 2000 Index : $78.87
- **Price Guidance:** These options are liquid, so you can close them at the going price. Because we wrote twice as many puts as we bought, on the above prices, you would close the position for a combined net credit of $1.35 per spread (accepting $1.41 to sell your $80 puts, and effectively paying $0.06 to close twice as many $75 puts).

What's New?

As of Tuesday's closing prices, we have a nearly $4,000 gain on our hedge using the iShares Russell 2000 index of small-cap stocks. Since we recommended this position Aug. 29, the index has declined 3% from $81.33, enough to put our long $80 puts in-the-money. We were paid a small credit to set up this hedge, so we'd be closing it out with a tiny profit even if the index had gone up (we like that kind of hedge!). Because the index declined instead, a few days out from expiration, we currently stand to see a much more significant profit. Although we could profit more if the index declines further, we risk losing most of our profit if it rises by expiration. So we'll take our gain and aim to recommend a new hedge soon.

Alternative Trades

If you only own the November 2012 $80 puts, we suggest you sell to close those along with us if you want to lock in your profit by Friday. If you're short the index directly, whether you close that position depends on how hedged you want your portfolio to be; we have a 10% index hedge ourselves with the **SPDR S&P 500**. If you have a direct IWM short, you don't have a clock ticking the way we do with options, so taking action now is not critical.

- **Questions or comments? Need help closing?** Visit our iShares Russell 2000 Index discussion board.

See Pro's *holdingshere. See the team's and David and Tom Gardner's holdingshere.*

Expirations, Reviews, and What We Think Now

Published Nov 12, 2012 at 12:00AM

Dear Fools,

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Covanta Holdings** : Write covered calls. Sell to open December 2012 $17.50 calls, lately for around $0.45, writing one call for every 100 shares you already own and are willing to sell. This would get you into the same trade *Pro* already has.
- **3D Systems**: Write ("sell to open") January 2014 $30 puts, one each for every 100 shares you could buy, up to a 3% potential allocation. Aim to be paid at least $3, or around 10% on cash you set aside between now and expiration; that return rivals our North Star, and is in fact much higher than itwhen writing puts on some of your buying power instead of all cash.

Questions on these? Visit our "Catch-Up Trades" discussion board .

We hope you've made time for something memorable to honor Veterans Day, either today or over the weekend. The official holiday was Sunday, meaning the NYSE was open today — and so, of course, is the Fool.

There are just four more market days until November options expiration, meaning our put ratio spread on the **iShares Russell 2000 Index** and our short covered strangle on **OpenText** are both set to expire this week. Both are performing well for us: We're making at least some money on the defensive IWM spread, with the $80 puts we own just in-the-money. And our written $50 put / $60 call strangle on OpenText is set to earn us the full profit from its premiums upon expiration — that's a great 8.4% yield on the starting share price from our August recommendation. (We earned about 6.7% ourselves.)

Around expiration, I'd like to set up both strategies again. That shouldn't be a problem for the OpenText covered strangle (after some more due diligence), but put ratio spreads like the one we have on IWM aren't nearly as attractive right now. Pricing is skewed defensively, with puts remaining expensive even as you move to lower and lower strike prices. But I think we'll be able to find a strategy we like — and we want to do it this week, so I'm headed off to continue work on that as soon as I wrap up this short Monday communiqué with you.

Other things on my agenda this week: I'm reviewing earnings from **IBM**, specifically its content management software division, before we decide on our next OpenText strangle. IBM is OpenText's largest competitor, and given the recent soft sales of new licenses at OpenText, I of course want to see how IBM is faring. Also, I'm going to review results from key **Intel** competitor **ARM Holdings**. We want to see Intel break into ARM's mobile stronghold, and we must make sure ARM doesn't make headway into the lucrative server microprocessor market dominated by Intel. So even though we just posted reviews of both OpenText and Intel on the discussion boards (links below!), our work isn't done. I don't expect our thoughts on either company to change, but if they do, you'll know about it right away.

What We Think Now

We strive to always improve *Pro* and communicate clearly and efficiently with you, so you always know exactly why your money is invested how it is. To that end, on Friday, we launched a new page called "What We Think Now." This always-current page tells you our latest thoughts on each position in the portfolio. The positions' default order on the page is by allocation, with the largest at the top, so we all focus on the most important positions first. Please visit this new What We Think Now page (accessible from the top of the Recommendations tab, too), read our intro, bookmark the page, and post any feedback! Members have been doing so all weekend, and we appreciate it.

Our latest quarterly reviews and guidance changes are below. We should see you again this week with some trade alerts. In the meantime, Fool on!

— Jeff (TMFFischer)

Pro Trade Roundup

- **Vanguard Energy**: We sold all our shares at $105.05, for an 84%, 52%, and 42% gain on our various lots of shares bought at different times.
- **3D Systems**: We bought to close all of our November 2012 $35 calls and sold to open a January 2014 $30 put / $55 call covered strangle.

Guidance Updates

- **BMC Software**: Moves up to Buy First from Buy as license sales resume growth; also, the company is likely to buy back about 10% of its shares this quarter. The stock is lagging because it no longer appears that BMC could potentially engage in a sale of itself. We're fine with that.
- **CME Group**: Fair value moves down to $60 from $62 as trade volume lags. Buy Around remains $52.
- **Intel**: Moves up to Buy First from Buy, now trading at less than 5 times EBITDA and yielding more than 4%. But fair value moves down to $27 from $29 and Buy Around moves down to $23 after stalled growth in the second half of this year.
- **Pacer International**: Moves down to Buy from Buy First. The turnaround is taking longer than hoped and still involves uncertainty. It's a tiny company and a tiny position.

Coverage & Community: *Pro* Earnings Reviews

- **AIG**
- **AmTrust Financial Services**
- **Apple**
- **Broadridge Financial Services**
- **CME Group**
- **Facebook**
- **Intel**
- **Oracle**
- **Pebblebrook Hotel Trust**
- **Rockwood Holdings**
- **StoneMor Partners**

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

The Quarterly Shuffle

Published Nov 5, 2012 at 12:00AM

Dear Fools,

Pro Trade Roundup

- Pending: We still need to sell **Vanguard Energy** and roll our calls on **3D Systems** into a covered strangle.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Tupperware**: Though we still rate the company a "buy," shares (at $62) are above our buy-around price. If you'd prefer to potentially nab shares cheaper, then write ("sell to open") April 2013 $55 puts, lately for around $2.15. Write one put for every 100 shares you could buy, up to a 3.1% allocation. This option offers a 4% yield in more than five months — not outstanding, but not awful.
- **Intel**: Buy up to 5.6% if you haven't already, or write puts to potentially buy cheaper. Sell to open February 2013 $21 puts, lately for around $0.80. That's a 3.8% yield in just more than three months.

Questions on these? Visit our "Catch-Up Trades" discussion board.

As the links at the end of this Memo will attest, we're in the heart of earnings season. The activities — dare we say festivities? — surrounding this period are enough to rival the annual holidays, at least if you're an investing geek (or Fool) like us. As the news keeps rolling in, we'll have several more earnings reviews this week, followed by investment decisions and/or trades. Today, I'll outline a few of the factors that will inform those determinations this (and every) quarter.

What Is *Pro* Looking At Every Three Months?

When a company reports earnings, the first thing I look at is usually the cash flow statement. I want to see how money is moving through the business, and ideally I'll find increasing cash from operations. A free cash flow calculation is the simplest way to calculate the actual money a business is generating. Here's the base calculation (all inputs can be found on the cash flow statement):

Operating Cash Flow (or cash from operations)
— Capital Expenditures
= Free Cash Flow

Sometimes you need to factor out non-cash items (such as tax benefits from stock options) from operating cash flow. Either way, once you have your free cash flow number, you can compare the company's market capitalization to its free cash flow, arriving at a P/FCF number that's similar to (but more relevant than) the price-to-earnings ratio.

But there's more to do. From the cash flow statement, I head to the balance sheet. There, we want to see how the cash and debt balances are trending, whether anything unusual has appeared, and if accounts receivable or accounts payable have changed meaningfully in relation to sales. One easy but deceptive way a company can grow free cash flow is to delay paying its accounts payable; sharply growing receivables can be a danger sign, too, because some of that money may never be paid to our company. We also review the goodwill numbers on the balance sheet; this is important at companies that make frequent acquisitions, such as **Oracle**.

After the balance sheet, I head to the income statement. There, I look at gross and operating profit margins — are they holding steady or improving? What is the company spending money on? Is the research and development budget adequate? What's happening with diluted shares outstanding? These days, most companies *Pro* owns are steadily buying back shares, lowering the share count, and increasing earnings per share for shareholders. We need to make sure we agree with those stock purchases — do the cash flow statement and the balance sheet easily fund share buybacks? And of our companies that are issuing *more* shares, is the dilution reasonable?

After a preliminary first pass over these items and others on the cash flow statement, balance sheet, and income statement — and after looking at metrics like return on equity and return on capital — I'll have a good idea of how the latest numbers are shaping up at one of our companies. But that's just the start. We need to review the narrative, too. So next, we dig into the conference-call transcript, going through management's opening remarks (which can run for pages) and the analyst Q&As. This sometimes lengthy process is worth it if you gain even a few nuggets of new insight — and you usually do. (For instance, last week **Tupperware** said India and Indonesia were likely to eventually become its largest markets.)

But even scouring our companies' conference calls isn't enough. We want to go through their key competitors' conference calls and look over their numbers, too.

Finally, once we've done all this, we can review the company's quarterly 10-Q SEC filing as it gets filed (or, once a year, the 10-K annual report instead). We labor (a kind word) over that extremely thorough document for still more numbers, news, and the beloved footnotes that almost never get mentioned in press releases or conference calls.

No Two Are Identical

Like children (or apple souffle!), no two investments are identical, so each one needs to be approached on its own merits. On the *Pro* scorecard, **AIG** and **AmTrust** are companies whose book value is more important than traditional free cash flow. With some of our other companies, we need to keep an eye on their ability to keep paying dividends. With still others, growing margins are instrumental to our thesis.

Whatever the situation, earnings are always interesting, and we get to enjoy them four times a year! So if you're wondering what we're doing every three months when we fall quieter for awhile … this is it. We're going through results one company at a time, reporting back to you, and preparing to make new investment decisions.

Have questions? Please visit the Memo Musings board. Stay Foolish!

— Jeff Fischer (TMFFischer)

Coverage & Community

- ***Pro*'s Latest Earnings Coverage:** **3D Systems** , **Wells Fargo**, **Pacer International**, **Papa John's International**, **OpenText**, **BMC Software**, **MasterCard** ... pause, take breath ... **Starbucks** and **Tupperware**.
- **How a Pro Invests:** FoolishRob99 shares how he's investing with *Pro*. Many members chime in.
- **The Mayans Have Nothing on TMFMoosie:** See Joe's *Pro*calendar board for the latest.
- **Strangle Me This:** MikeSki9117 asks for guidance on writing strangles (one of our preferred option strategies).

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Roll Your Covered Calls on 3D Systems Into a Covered Strangle

Published Oct 31, 2012 at 12:00AM

What We're Doing: This expensive-looking stock still has more long-term potential, so we're rolling our covered calls into a long-term covered strangle to capture more upside and potentially buy more shares much cheaper.

Trade Essentials

- **Company: 3D Systems** (NYSE: DDD)
- **First Action:** Buy ("buy to close") your November 2012 $35 calls
- **Second Action:** Using a strangle order, simultaneously write ("sell to open") January 2014 $30 puts and January 2014 $55 calls
- **Allocation:** Write one strangle (total) for every 100 shares you already own and every 100 additional shares you could buy — for *Pro*, that's six contracts of each option. We own 600 shares (representing 1.8% of our assets), and we're willing to double our share count at a lower price; doing so would grow our allocation to around 2.5% (given the price decline) if exercised.
- **Limit Order Guidance**: Pay the current price to close your November $35 calls; separately, aim to write the January 2014 strangle for a $10 credit. As time goes by, you'll need to accept a lower credit unless the stock's volatility increases.
- **Recent January 2014 $30 put/$55 call bid/ask**: $9.50/$11
- **Share Price:** $43
- **Stock Status:** Hold, and write puts or covered strangles.
- **Alternative Trades:** See the end of this report.

What We're Thinking

Selling printers that allow manufacturers, professionals, and consumers to print three-dimensional objects, **3D Systems (NYSE: DDD)** is at the forefront of an exciting technological revolution. Management is working to sell as many printers as possible, at moderate prices if need be, in order to earn greater profits from recurring materials and services. But while the technology has received scads of media attention, the 3D printing industry is still minuscule — and it's growing relatively modestly, with 3D Systems reporting 24% organic growth year to date.

That's why we believe there's much more growth potential ahead. Even though the company's stock trades at a premium price today (see our latest quarterly update on the 3D discussion board), the potential size of its market means we'd like to stay invested.

This expensive stock that still has long-term potential places *Pro* in a unique position. With our absolute-return North Star as our goal, we don't want to own a stock whose valuation may leave it treading water for three years, earning us little to nothing. But we want to be invested — and enjoy the upside — when long-term appreciation does occur. Also, because our stock is covered with in-the-money calls that capped our gains at $35, we want to recapture upside we've already missed. This leads us to the rare decision to strangle our shares with options that expire in more than one year, rather than our usual time frame of several months. Sometimes longer-term options suit your purposes better; in this case, they position us for North Star-type returns even if shares stagnate and allow us much greater upside.

What We're Expecting

Closing our November 2012 $35 calls to write January 2014 $55 calls increases our upside potential by $20 per share, or 57%. Shares are lately $43, so by rolling our calls (on a steady stock), we're in effect recapturing $8 in upside that has *already* occurred — a 23% gain from $35. Even if the stock goes nowhere between now and our January 2014 expiration, we would achieve this North Star-topping return by rolling our calls. Our new strangle, meanwhile, offers us even greater potential returns, and it'll cushion us from a decline before our new put obligation kicks in. Here are more details analyzing the strangle in isolation:

January 2014 $30 Put/$55 Call Strangle	If Our Credit Is $10
Potential second share buy price	$20
Potential net sell price	$65
Upside to net sell price from current $43	51%

Upside to $55 call strike price	28%
Potential net new buy price	$20
Downside to potential net new buy price from current $43	(53%)
Downside to $30 put strike price	(30%)

By writing options that expire in 444 days, we buy ourselves a large amount of wiggle room. That fits in with our objective here: To capture much more upside we're currently locked out of, while continuing to cushion against a potential stock decline. We want long-term exposure to 3D Systems still at today's price, and 15 months from now, we could roll this strangle in either direction — bullish or defensive — if desired. In the meantime, we should expect the stock to remain volatile.

How to Follow Along

First, buy to close any existing November calls you have on 3D Systems (but don't sell the shares). Then, make sure you can afford additional exposure to the stock; keep your total potential allocation around 3% or lower. Then write ("sell to open") this January 2014 covered strangle, using a strangle order. If your situation differs from *Pro*'s, see our Alternative Trades below, and ask questions on the 3D Systems board.

Alternative Trades

- **Already had your shares called away, or never took a position?** You can start to establish a position by writing ("sell to open") May 2013 $30 puts, lately more than $2, for a 6.6% yield on cash in just more than six months. Write one put for every 100 shares you're willing to buy, up to 3% of your assets.
- **Can't afford 100 or 200 shares without going over 3% of your portfolio?** 3D shares are on hold in our portfolio. Those who only own shares should keep holding; those who don't own any and can't use options should wait for a lower buy price (our "Buy Around" is $27).

Bring any questions to our 3D Systems discussion board!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Fiddlin' With Your Process

Published Oct 30, 2012 at 12:00AM

Hey, Fools! Here's your *Pro* Monday Memo, delayed a day because of Hurricane Sandy. TMF HQ remains closed today (as does the NYSE), so in today's Memo, we're skipping our usual Catch-Up Trades, Guidance Changes, and Trades Complete sections. We will provide updates on those, and more, as soon as HQ is back up and running. Thanks for your patience, and we hope you and yours made it through the storm unscathed! -- The *Pro* Team

Fellow Fools,

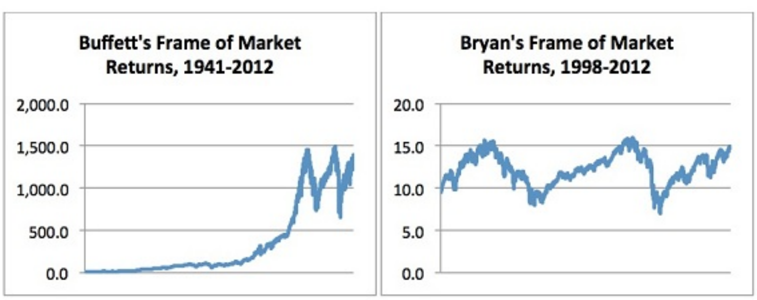
Last Wednesday, the Oracle of Omaha (Mr. Warren Buffett) spent a couple of hours hanging out on a makeshift CNBC set. As usual, he offered some great thoughts on the state of the world, touching on QE3 and even **Facebook**. (Surprise: He said he wouldn't buy it because he doesn't understand the business – and no, you can't friend him, because he's not one of the site's billion-plus members.)

Overall, though, the Oracle's message was simple: Just buy. Stop worrying and buy. Investors could do worse than simply following that advice blindly … but at *Pro*, we want to dig deeper. If we consider the context around Buffett's situation – and our own – as we parse the meaning of his words, we can improve our investing process. We can increase the chance that we'll do what he means, not just what he says. So: Let's fiddle with our process, shall we?

Frame

The human brain is a tricky thing. It constantly assesses every experience we have, using each one as input to develop the unconscious rules of thumb that feed the split-second decisions that help us survive. I can't argue that survival is great, but if we're not careful, this process can hijack our investing decisions … with suboptimal results. Your experiences – the "frame" within which you formulate your rules of thumb – can affect your decisions, sometimes without your even realizing it. It's important for investors to be aware of this tendency and combat it if necessary.

For example, Buffett bought his first stock when he was 11 – way back in 1941. Since then, the S&P 500 is up 13,657%, or 7.1% annualized (this data doesn't include dividends). Within his frame, buying stocks clearly looks awesome. I bought my first stock in 1998; since then, the S&P is up 48%, or 2.7% annualized. Within my frame, researching stocks looks like a lot of wasted time and energy.



The Fix
Given our frames, it would be easy for Buffett to think stocks always go up, and for me to think that stocks always go sideways. I'm not sure whose frame is closer to the truth (we *could* live in a fundamentally different world today than in 1941), but it behooves both of us to have a solid understanding of the history of risky assets, even pre-1941. Investors will make better decisions by stepping out of the frame of our own experiences and rounding out our understanding of history. Pick up a copy of *Against the Gods: The Remarkable Story of Risk* by Peter Bernstein (if you haven't already) for a bit of help.

Factors

There’s another reason it’s easy for Buffett to say “buy” – he has more money than any of us can imagine. All of his needs are met and his estate is squared away; there’s a good chance that the biggest line-item expense on his monthly budget is Cherry Coke. Because of this, he can invest for bequests and for the future of his company, which is in no danger of disappearing anytime soon; there are few constraints on his investing strategies. My wife and I, on the other hand, are paying down student debt, saving for a house, planning vacations, and building a larger nest egg. Each of these factors affects our risk-taking abilities.

The Fix
Before we decide to "just buy," we need to make sure we have a cohesive, diversified financial plan that includes a rainy-day fund and insurance. There’s room in such a plan for a “risky assets” category, and in that category, we can follow Buffett to the letter – but only within the context of a thoughtful, big-picture strategy. Make sure you've got one.

Follow-Up

Early in his investing career, Buffett became majority owner of Berkshire Hathaway, a Massachusetts textile manufacturer that looked cheap. It subsequently got cheaper as its business worsened, but he maintained the textile operations long after he realized the business was dying. In 2010, Buffett admitted that buying the failing textile business was his largest investing mistake ever. His lesson: Buy good businesses. The moral: Study your mistakes and learn from them. Buffett has made it a habit to publicly share his largest mistakes (see page 8 of his 2007 letter to shareholders, for example) every few years.

The Fix
Keep a journal. Write down why you made each investment (or didn’t), and check back later to see how the progress of each one compares with your initial thoughts. When things go awry (or well!), investigate why; when you can diagnose errors, be sure to put procedures in place so you don’t repeat them. Buffett's inventory of his own mistakes has helped him classify his three most common errors: misjudging the future economics of a business; partnering up with poor management teams; and paying too much. It's no coincidence, therefore, that his investment philosophy now has a three-pronged approach: Buy good businesses run by honest, capable management teams for a reasonable price.

The Foolish Bottom Line

Investing is a journey. The improvements we make today compound for the rest of our journey, so it's worth a little time and effort to tinker with our process. At *Pro*, we want to help by adding tools to your toolbox and by continually challenging you to improve. We’d love to hear about your investing frame, the general outline of your larger financial plan, and how you've learned from your mistakes on our Memo Musings discussion board.

Onward,

Bryan (TMF42)

Coverage & Community

- **Uber-Summary:** Ever wonder what Jeff's brain looks like? Here ya go.
- **Earnings!** We've got reviews of **GrafTech International**, **InvenSense**, **Gentex**, and **Intel** so far.
- **Straight From the Journal:** Member nevercontent posts some great thoughts on the mobile-processor dogfight.

Audio Extra: Interview With StoneMor CFO Tim Yost

Published Oct 26, 2012 at 12:00AM

Motley Fool Income Investor advisor James Early recently interviewed StoneMor Partners CFO Tim Yost, a limited partnership whose units (or shares) yield nearly 10% today and are rated a buy in *Pro*. But the company is not without controversy — as you know from our original buy report and follow-up reviews on the company discussion board. Why are the company's financials so difficult for most to understand? Is the dividend sustainable? We believe so, and you can hear why straight from the CFO's mouth.

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See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Counting Cash

Published Oct 22, 2012 at 12:00AM

Fellow Fools,

Miscounting cash almost got me fired. I worked as a bank teller for three months in a former life, and on my first day out of training, the branch received a newly printed batch of $100 bills, which is pretty rare. As cashiers and bank tellers know, new bills are dangerous. Sure, they smell wonderful, but without the benefit of having passed through many hands, they’re a little rough … and they stick together like Velcro. At the end of my shift, it became clear — because my drawer was short a hundred bucks — that I’d given an extra bill to one lucky patron. I kept my job, but not without a heightened awareness of the importance of accounting for every penny.

Sticky bills or not, miscounting plagues tellers and investors alike. Let’s review how to count *Pro*’s cash positions so we’re never short of cash when we need it most.

Short Stock, Puts, and Calls

First, a quick review. When we sell a stock short, we borrow shares from another investor, then simultaneously sell those shares on the open market (meaning a negative entry shows up on our brokerage statement) to yet another investor, who pays us cash (meaning a positive entry shows up). These entries offset one another, so our portfolio value stays the same (minus transaction costs). The same thing occurs when we sell options, only instead of borrowing shares, we actually write a brand-new contract. The portfolio value remains flat, and our cash balance increases to offset the negative value of the short option. These transactions can present a problem for new *Pro* investors unaccustomed to counting cash in a long, short, stock, and options portfolio.

$306,795.70

Though a glance at our Recommendations page would make it appear that we have more than $300,000 of cash waiting to be invested, much of that cash is already accounted for. To find out how much cash is free to use without employing leverage, we need to back out the cash that came from our short positions:

Cash	**$306,795.70**
subtract cash offsetting our **SPDR S&P 500** short	$143,360.00
subtract cash offsetting our **CurrencyShares Euro Trust** Short	$56,900.80
subtract cash offsetting our **Sony** short	$20,655.00
Cash Ex-Shorts	$85,879.90

Source: *Pro* portfolio as of close 10/19/2012.

You can find this "Cash Ex-Shorts" figure on the bottom of our Recommendations page under the "Exposure" heading. Using the above figures, you'll see that 6.1% of our portfolio is in cash ex-shorts.

Leveraging Options

Spreadsheet ninjas at home will note that we haven't accounted for the obligations of our written puts. For U.S. investors using an IRA, written puts need to be secured, dollar for dollar, with cash. As such, they won't benefit from portfolio leverage. That's not the case for the *Pro* portfolio, where we're using a conservative amount of portfolio leverage through options. Under a worst-case scenario, the following is our portfolio's obligation for written puts. Remember that we have diversified our expiration dates, and that we can roll or buy to close puts early to reduce our obligation.

Written Puts	Strike Price	Contracts	Shares	Potential Obligation
iShares Russell 2000 Index	$75	28	100	$210,000
OpenText	$50	7	100	$35,000
Starbucks	$47	8	100	$37,600.00
Total Potential Obligation				$282,600.00

Source: *Pro* portfolio as of close 10/19/2012.

With about $282,600 in potential, albeit unlikely, obligations (remember, Jeff has stated that we'd likely roll or close the Russell 2000 short if it came to that) and $85,879 in cash (again, after backing out our shorts), you can see that we are using a bit of leverage — and that the stated cash balance doesn't reflect the full reality of the portfolio. That said, we have enough cash to fulfill the puts we seek to fulfill, namely $72,600 in OpenText and Starbucks, and (again) would roll the puts on the Russell 2000 if needed.

Of course, the cold hard numbers above aren't fluid enough to capture the nuanced reality of our exposure. One obvious example is the huge short position we have on SPY: If the market crashes, forcing us to make good on some of our written put obligations, we could use the resulting considerable profits on our SPY position to that end.

The Foolish Bottom Line

Don't be a miscounter like poor young Nick; fire up your calculator to see how much of *your* cash is free to deploy and how much is being used to leverage your portfolio. For *Pro* Fools, counting cash isn't as simple as looking at your cash balance.

Fool on,

Nick (TMFCrow)

Guidance Changes

- **Vanguard Energy** moves to Sell as we focus on better situating our portfolio with respect to our North Star.

Trades Complete

- **American Express**: We closed our October $60 calls and October $55 puts for $0.29 per spread, capturing most of our potential profit. Our protective October $65 calls expired over the weekend.
- **Tupperware**: Our October $55 puts expired as full income.

Catch-Up Trades

- None this week as we wait for more earnings reports; we expect more activity on existing positions afterward.

Coverage & Community

- **Earnings from Intel:** Jeff reviews the third quarter.
- **Getting Existential:** Where are we? Where are we going? Discuss.
- **A full calendar:** It's earnings time for real!

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Close Your Strangle on American Express

Published Oct 16, 2012 at 12:00AM

- **What We're Doing:** Closing our strangle a few days early, before American Express reports earnings.
- **What We're Thinking:** We've earned 96% of the available profit.
- **What We're Expecting:** Barring business surprises, we aim to write a new strangle for more income soon after Wednesday's earnings report.

Trade Essentials

- **Action:** Buy to close your existing strangle (October 2012 $55 puts and October 2012 $60 calls) for as little cost as possible, lately about $0.15 combined. Leave your long October 2012 $65 calls alone to expire (they have no bid price anyway).
- **Price Guidance:** Use a **limit order** aiming to pay a net debit of $0.15 or less (less is better); if the stock price moves meaningfully, you may need to pay a bit more.
- ***Motley Fool Options* Member Guidance:** If you've written a January 2013 covered strangle on American Express in *Motley Fool Options*, continue to follow that strategy with me in that service.

What's New?

- **Recent share price:** $58

When we originally presented our option trade on **American Express** (NYSE: AXP), we called it a written $55 put plus a $60 / $65 bear call spread. The same set of options can also be viewed as a written strangle ($55 put / $60 call) plus a purchased $65 call.

In June, we were paid $3,500 to write the strangle on American Express (we wrote eight contracts). Less than four months later, we can close these two options at a cost of about $120, so we'll keep more than 96% of the premium we were paid.

Why Close?

With shares trading squarely between our strike prices, you might wonder why we're closing the strangle a few days early. The answer is earnings, which American Express is due to report Oct. 17 (tomorrow) after the market closes.

If the stock were to move more than 3.4% up or 5.1% down, it would break through one of our strike prices. Not a big deal, because we could still just roll the strangle on Friday before expiration — but it's potentially more profitable, and it affords us more flexibility, to take our healthy gain today and set up a new strangle after we go through Wednesday's earnings. Thus, we'll close this iteration of the trade and look to write a new one soon.

How to Follow Along

We recommend you:

- Buy back ("buy to close") your October 2012 $55/$60 strangle for as small a net debit as possible, lately $0.15 combined.

Next step: If you have questions before you close your strangle, visit our American Express discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Savor Your Time

Published Oct 15, 2012 at 12:00AM

Dear *Pro* Member,

There are dozens of investing strategies — long and short — that *Pro* has not yet employed, but eventually plans to. One option income strategy you'll likely see us tee up one day is a neutral calendar spread. You set this up on a stock or index by buying an option that expires in about four months or longer, and writing (or selling) a similar option that expires in just a few months or less. The near-term option you write will lose value more quickly than the longer-term option you purchase, and as the first option nears expiration, you can close both and keep the difference as your profit.

Last Call ...

... to snap up a never-to-be-repeated deal on *Million Dollar Portfolio*.

For a large number of Motley Fool members, better and more confident investing often comes down to knowing *when to buy stocks* ... how large a part of your portfolio to *allocate to each* ... and *when to sell*. That's why until midnight Tuesday, Oct. 16, you can get into *Motley Fool Million Dollar Portfolio* on the easiest and most generous terms ever. Watch your inbox for your invitation!

It's called a neutral calendar spread because you're basically neutral on the underlying stock or index, and you're "spreading" your options over a few months to profit via "time value" arbitrage. You'll typically earn a healthy profit on your capital at risk with this strategy, even if the underlying investment moves in a wide price range. That said, if the stock or index falls sharply below your strike price, you can lose the entire net debit you paid to set up the spread, but no more.

As mentioned in *Pro*'s guide to neutral calendar spreads (which features examples and charts!), you could set up such a spread on the **SPDR S&P 500** if you're neutral on the index over the next few months. The market's most popular index currently trades at 15 times trailing earnings, and although Bloomberg says the average bull market ends with said index at 19.7 times earnings, perhaps you're neutral in the near term. Options on the SPDR S&P 500 are popular, so they're typically a bit overpriced. But that doesn't really matter with a calendar spread, since you're simultaneously buying and selling options on the index.

As an example, with SPY recently at $143, you could buy to open March 2013 $144 calls for $4.95, and write (sell to open) January 2013 $144 calls for $3.64. Your net cost is $1.31 per spread ($131). As the expiration of the January option nears, if SPY hasn't moved too meaningfully in either direction, the March calls you own should still hold much of their value, and the January calls you wrote will be worth little. You could close both and have a profit overall, perhaps even double your $131 cost per spread.

For much more on this strategy before you consider it on your own, see our guide. You'll likely find *Pro* employing calendar spreads as another income strategy in coming weeks and months; in our current period of low market volatility, neutral calendar spreads can be a good strategy. And if volatility goes up and options premiums increase, the change is largely neutralized, because this strategy involves two opposing options.

Earnings Redux, Part 3

Third-quarter earnings begin in earnest this week, with **Intel** reporting on Tuesday after market close. As ever, we value quarterly reports for the updated insight they provide. We invest with a focus on the long term, but we still want to see our businesses performing well quarter by quarter on measures that matter to us. In other words, we're not investing with blind faith that they'll eventually do well; we want our companies to be doing well *today*, too.

Oracle's recent healthy results reassured us about new cloud software offerings and about hardware revenue — two concerns of ours that management focused on in the conference call. With Intel, we'll want to see how adoption of its mobile processors is growing and how server microprocessor sales are holding up, as they're the most lucrative part of the business. **American Express** also reports this week; there, we'll watch delinquent loan and charge-off numbers, among other things. And the list goes on. We're always eager to dig into each of our companies' results for you as we get updated numbers. We want our businesses to be on the path to create value for all of us the coming few years — and ideally beyond.

Make Your Week Memorable

We recently held a contest on the boards challenging members to have an exceptional week (or day) and share the experience with all of us. Four members officially stepped up to the plate, and following member voting, we have our winners! Congratulations to first-prize winner BlackLineVestor, followed by Wantingmaxvalue in second, then latimerburned and antmark. Click on each member's name to relive their great experiences! Prizes (gift cards to **Apple**, **Starbucks**, and **Papa John's Pizza**) will be in the (e)mail this week. Thank you for participating and for making our community even more Foolish!

See you on the boards,

Jeff Fischer (TMFFischer)

Catch-Up Trades

- **Covanta Holdings**: If you don't own at least 3.4% in the stock yet, sell to open March 2013 $17.50 puts, lately around $1, or December $17.50 puts for at least $0.50. (To be clear, we own shares and have written December $17.50 calls on them. Writing puts generates similar income.)

Coverage & Community

- **Savor Your Time, Reiterated**: Paladin306 shares his advice after suffering a heart attack.
- **Swanky Stays**: nrlbuild details his stay in D.C.'s Hotel Monaco, a **Pebblebrook Hotel** property.
- **Puts for Writin'**: alex340 shares more puts that members can consider selling to target buying *Pro* shares at lower prices.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here*.

Checking In on DGS

Published Oct 8, 2012 at 12:00AM

Dear *Pro* Members,

Guidance Changes

- The **WisdomTree Emerging Markets SmallCap Dividend Fund** moves to Buy from Hold.

Trades Complete

- **Wells Fargo**: We bought to close 12 October 2012 $33 puts at an average price of $0.096.

Catch-Up Trades

- Invest up to 2.4% of your Pro funds in the **WisdomTree Emerging Markets Small Cap Dividend Fund**.

In a way, owning a diversified fund like **WisdomTree Emerging Markets Small Cap Dividend Fund** is a luxury. Sure, we have to pay attention to global trends and how the fund performs (in particular, its contribution to our North Star), but that takes much less time than following quarterly earnings and conference calls. Like all luxuries, this one does come with a price: an expense ratio of 0.64%, which we think is a tiny sum compared with the difficulty of following 532 holdings ourselves.

DGS may not require as much care and feeding as some of our other positions, but we still keep a watchful eye on it. So how is our investment doing? We're glad you asked!

In Jeff's original recommendation, he cited three factors *Pro* wanted to capitalize on using this investment:

1. Small companies outperforming large companies
2. Dividend-payers beating non-dividend payers
3. Emerging-market investments outpacing those in developed markets

For their part, the fund's managers are focused on one objective: achieving investment results that correspond to the price and yield performance, before fees and expenses, of the index with which the fund shares a name. There are 623 companies represented in the index, but the fund managers use representative sampling to narrow this list down. Each position is weighted based on the annual cash dividends paid; the larger the dividend, the larger the allocation. Rebalancing annually based on this strategy, the fund's managers sell higher-priced stocks in favor of cheaper ones.

Emerging Performance

Pro Fools know that DGS is a 2.4% allocation for us, and that it's currently down about 10%. What Fools might *not* know is that DGS's managers are actually steering the fund to pretty exceptional performance when measured against other emerging-market investments. Morningstar has given DGS its coveted five-star rating, and it's the fifth-highest-rated fund in its category over the past three years. As Patricia Oey, the Morningstar analyst covering DGS, put it:

"Although this is a small-cap fund, since its inception in October 2007, its volatility has been slightly lower than that of the broad market, capitalization-weighted MSCI Emerging Markets Index. Over the same time period, it has also earned higher absolute and risk-adjusted returns than the market-weighted MSCI Emerging Markets Small Cap Index."

She notes that this may indicate that dividends are a viable strategy in emerging markets, a statement with which your *Pro* team agrees.

Digging In

With so many index components fighting for a place in this portfolio (that is these companies' only goal, right?), let's take a look at how the holdings have changed since we first bought in.

Top 10 Countries of Exposure

Country	Fund Allocation, 11/22/2010	Fund Allocation Now
Taiwan	19.19%	24.62%
South Africa	11.04%	7.19%
South Korea	10.54%	10.45%
Thailand	9.80%	10.24%
Turkey	9.04%	5.28%
Israel	8.29%	Not in the top 10
Brazil	7.78%	7.85%
Hong Kong	5.95%	Not in the top 10
Malaysia	4.59%	9.32%
Chile	4.23%	4.77%
Indonesia	Not in the top 10	4.33%
China	Not in the top 10	4.39%

Source: WisdomTree.

Taiwan, South Korea, Thailand, and Malaysia together account for 54.6% of the fund's holdings. The once-touted kings of emerging markets, the BRIC countries (Brazil, Russia (1.08%), India (0.91%), and China), come in at a lowly 14.2%.

Exposure by Sector

Sector	Fund Allocation, 11/22/2010	Fund Allocation Now
Industrials	23.43%	18.91%
Financials	18.99%	21.52%
Consumer Discretionary	17.60%	14.43%
Information Technology	10.91%	12.57%
Materials	9.07%	13.28%
Consumer Staples	6.96%	7.54%
Utilities	6.42%	4.77%
Health Care	2.87%	2.03%
Energy	2.21%	2.33%
Other	1.54%	1%
Telecommunications	N/A	1.62%

Source: WisdomTree.

The fund's heavy weighting toward financials, industrials, and the consumer discretionary sector leaves it well positioned to benefit from an economic recovery if and when one comes along.

None of the fund's top 10 holdings from 2010 remain today, so I won't provide the "before" list. As fund assets have grown, so has the number of companies in the portfolio, from 486 to 532; below are today's top 10.

DGS's Top 10 Holdings

Company	Industry	Country	Allocation
Tauron Polska Energia SA	Utilities	Poland	1.34%
Magyar Telekom Telecommunications plc	Telecommunications	Hungary	1.21%
Administradora de Fondos de Pensiones Provida SA	Financials	Chile	1.2%
Synthos SA	Basic Materials	Poland	1%
IPATH MSCI India Index ETN	Diversified India ETF	India	0.91%
Tofas Turk Otomobil Fabrikasi	Consumer Cyclical (Autos)	Turkey	0.9%
AFP Habitat SA	Financials	Chile	0.79%
MRV Engenharia e Participacoes	Homebuilding	Brazil	0.75%
Turk Traktor ve Ziraat Makineleri Anonim Sirketi	Industrials	Turkey	0.74%
Macronix International	Technology	Taiwan	0.72%

Sources: WisdomTree, S&P Capital IQ.

With portfolio turnover clocking in at 53% — much higher than 2010's 38% — it isn't surprising to see a whole new top-10 list. It's also worth noting that for many foreign companies, each dividend payment is often based on the company's current earnings (unlike here in the States, where companies try to maintain the same dividend no matter what). Earnings, and therefore dividends, can be quite variable, which might contribute to turnover if the fund manager chases the companies with the highest recent dividends. Current portfolio turnover is still relatively low, and I expect it to decline if global economies stabilize.

Valuation

If I were to attempt to value each of the fund's holdings, we'd be here until 2022, so we'll rely on summary valuation statistics for the fund as a whole. These are coarse numbers, but they show that the index:

- has a value bias.
- provides exposure to countries with the potential to grow GDP faster than developed nations.

These numbers are for the underlying index, *not* the DGS fund that tracks it:

Metric	Number
Dividend Yield	5.26%
Price to Earnings	10.7
Price to Book	1.0
Price to Cash Flow	7.1
Price to Sales	0.7

Source: WisdomTree Q2 Fact Sheet, 6/30/2012.

The *Pro* Bottom Line

Overall, DGS provides cheap diversification and income for us, and it remains a well-run fund that has earned its place in the *Pro* portfolio. All that said, it needs to do its part in helping us achieve North Star-like returns over the coming years if it wants to stick around. We still believe that income and value within growing economies are worth investing in.

Bring your thoughts to the Memo Musings discussion board.

Best,

Nick (TMFCrow)

Coverage & Community

- **Value Explosion:** Bryan brings us Value Investing Congress coverage: Day 1, Day 2, Audio.
- **Fresh as a ... :** ADrumlinDaisy delights us not once, but twice.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Audio Extra: The Value Investing Congress Extravaganza

Published Oct 5, 2012 at 12:00AM

Pro's own Bryan Hinmon (TMF42) spent Monday and Tuesday in New York City at the Value Investing Congress — an event where big-time value investors congregate to share ideas. He was joined by fellow Fools Joe Magyer (from *Inside Value*) and Mike Olsen (from *MDP* and *Special Ops*), as well as Fool.com's Joel South. In the following Audio Extra, Bryan, Joe, and Mike share their impressions of the event, plus a few of their favorite investing ideas. You'll also find links to their notes from the event and related Fool.com articles. Listen in, then share your thoughts on the Stocks That Interest You discussion board!

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More VIC Madness

- Bryan's notes from Day 1
  - **Investors mentioned:** Guy Gottfried, Kian Ghazi, Whitney Tilson, Zack Buckley, Barry Rosenstein, Mick McGuire, John Mauldin, Bill Ackman
  - **Companies mentioned:** ClubLink Enterprises, Canam Group, Layne Christensen, Netflix, Berkshire Hathaway, Howard Hughes, Splunk, Agrium, Alexander Baldwin, Gencorp, Brookfield Residential Properties, General Growth Properties
- Bryan's notes from Day 2
  - **Investors mentioned:** Lloyd Khaner, Alex Roepers, David Einhorn, Bob Robotti, Glenn Tongue, Jeff Ubben
  - **Companies mentioned:** Starbucks, Jamba Juice, Energizer Holdings, Rockwood Holdings, Clariant, FLSmidth, Joy Global, Green Mountain, General Motors, Cigna, Chipotle, CalFrac Well Services, AIG, Iridium
- Bryan's compilation of Joe's and Mike's notes
- Fool.com: Don't Be a Stock-Pick Junkie
- Fool.com: The Best Investors Share Their Favorites
- Fool.com: 4 Intriguing Stock Ideas From the Value Investing Congress

Transcript

Joe Magyer: Hello, Fools! This is Joe Magyer from *Inside Value*, and I am joined here today with *Special Ops* and *MDP*'s Mike Olsen and Bryan Hinmon from *Motley Fool Pro* and *Options*. Gentlemen, hello.

Mike Olsen: Cheers.

Bryan Hinmon: Hello, Joe.

Joe: Cheers! So we are fresh back from New York, where we were enjoying Italian food and craft brews, but also the Value Investing Congress, which is the biggest investing event this side of the Berkshire meeting every year. It was a lot of fun in a very nerdy sense. Some of the best minds in investing, specifically value investing, were there. Bill Ackman, John Malden was there, David Einhorn and a lot more really smart guys who, unless you're hardcore nerds like us, you wouldn't recognize, but they were there and very thoughtful and pitched a lot of great ideas.

So we are back from our trip, ready to talk about some of our impressions of the trip and some specific stocks and pitches that we thought were really compelling.

Before we get to the meaty part of actual stock ideas, though, I'm just curious for your general impressions, maybe anything that stuck out to you as being particularly interesting. Mike, maybe if you want to kick things off.

Mike: Sure. So one thing that I thought was particularly interesting, one guy who is not so much a household name, but is indeed a stellar investor, is a guy named Alex Roepers. He is the founder of Atlantic Investment Management. He is privy to show this awesome chart where he depicts his fund's performance, the S&P's performance, and Berkshire Hathaway's performance, and you might guess that the reason he depicts that chart is because his fund exceeds all of those measures since inception. They have earned 18.5% annualized returns. At the fund itself, they have a focus on investing with great businesses with recurring and significant cash flows, strong competitive advantages.

One thing that he brought up, these guys are kind of known to be soft activists: They like to engage with the companies they are invested in to realize value. He said it was an environment which is great for shareholder activism, and by that he means companies should be thinking about how they allocate their cash and allocating it effectively. Cash balances are near record highs, interest rates are very low and companies have been earning near record profits, on a nominal basis at least. And so when you think about managers and their sort of proclivities to throw good capital after bad, a guy like Roepers is good to have on your side as an investor.

Joe: Yeah, you know another good point that he made I hadn't really thought about was all the pent-up money that LBO Funds, private equity funds, have in store where basically they've done a lot of fundraising over the last couple of years and they haven't put all that money to work and at some point they've actually got to get out there and buy something. He specifically pointed to that style box at companies, and especially between one billion and ten billion in value, that are very hot targets for private equity funds. It could be natural hiccups for them.

Mike: Right. I think another thing that was interesting within that context is these funds, they aren't earning fees if they don't put that money to work and so that's pretty important. Another great quotation he had within the confines of the whole activism idea was, "Of course we would prefer to invest in companies with great managers, good leaders." He said, "You know, if you don't manage your company well, someone else will manage it well for you," which I thought was pretty funny.

Joe: Yeah, when he puts up that chart of his outperformance, you almost hear a sinister laugh in the back of your head. It's really pretty impressive.

Bryan: Those are just the blades of his private helicopter.

Mike: Which actually does exist.

Joe: So the thing that stuck out to me was there were at least three presenters who spoke in some form about time arbitrage, and time arbitrage is simply the ability to take a long-term perspective when other people are taking short-term perspectives. And really what this does for value investors is it allows them to look at ugly, really warty businesses, sort of see through what might be temporary, but what could be on the other side.

The reason this was interesting to me, not just taking it on face value was it struck me that equities are probably richly priced right now. People are having a real hard time finding ideas and so many of them are having to look at really ugly, really warty companies and so keeping the idea of time arbitrage front and center is becoming more and more important.

Mike: Right. I think one thing that is important strategically speaking, when you think about the idea of investing. In the age within which we exist, there is no shortage of information and as an investor, the odds of you finding some informational advantage is almost nil.

Where you can find an advantage is by looking at time horizon that other people are not. Most funds and institutional investors, they're concerned with making that return this year because otherwise money is going to lose them. We as individual investors and Fools, we have the liberty to think longer term, and that is certainly a huge advantage to us.

Joe: Yeah, we're coming up on one of my favorite examples of time arbitrage, which is Christmas tree sales and after-Christmas sales. I'm always amused that people will rush out and buy Christmas trees, the real ones that smell nice and need water and die on you and then you have to haul away, and they pay a lot for that; they pay a premium, but they oftentimes will skip over the plastic ones that will last you forever. And the amazing time component is that just a month after Christmas, you can buy these artificial Christmas trees for 75% off and companies end up throwing a lot of them away because they can't find people to come in and buy them. the ultimate test in it to me, an example of where you've got a durable asset that's selling at a price that it will quadruple in value in the next 11 months and that you can use forever, but people will walk right by because they can't get utility out of it in the next 11 months.

Mike: I thought you were going to bring up superhero tights on Nov. 2.

Joe: No.

Bryan: That's a close number two, Mike. Jeff Ubben of ValueAct actually spoke about how he built ValueAct Capital around time arbitrage in a sense because he spoke about the triangle of alignment where he needed to find long-term investors, take a long-term mindset in his investments, but also structure the incentives for himself and his other employees around that long-term performance.

Mike: I think Ubben is one of the more thoughtful and skilled value investors out there, and certainly he has put a lot of thought into how he can most effectively accomplish his and his investors' ends, and one of those was being able to invest in great businesses with a very long-term mindset. That works quite well.

Joe: So cutting to specific ideas, what were your favorite pitches coming out of the day or the two days? Bryan, you want to go first?

Bryan: Sure. So Mike spoke about Alex Roepers and he is an impressive, impressive guy. One of his pitches that I really liked was Rockwood Holdings. Rockwood is in the process of streamlining its business. Right now you can think of it as sort of a conglomerate of strange chemical businesses. They have a titanium oxide business that sort of dominates the headlines and he pointed out that the company trades on this commodity-like business, the swings of the commodity prices, but they're trying to sell it off, and once they do, the gems of the business are really going to be brought forward. And the gems are it is the second largest lithium producer. Lithium is a market that's growing about 8% a year without any benefit from electric cars at the moment, so …

Mike: Less manic that titanium oxide.

Bryan: Far less manic and they also have an incredible business, ceramics business, and right now those ceramics are used in a lot of healthcare applications. The ability for that ceramic business to grow within the healthcare industry I think is highly overshadowed by the titanium oxide business. So Rockwood is actually a company that we own in *Motley Fool Pro* and so we sort of share his belief and the company's balance sheet is going to look a heck of a lot better once they get rid of the titanium oxide business, and I think management is really doing the right thing there and it could be thanks to Mr. Roepers.

Mike: I don't think that's too far flung, to hop on Roepers' train, and certainly we don't want to make this the Roepers love fest, but another idea that was quite interesting was the company called Joy Global. To give kind of a sense of what they do, they are a supplier of underground and surface mining equipment. These are basically new age picks and shovels, and their primary market, about 75% of the revenues, come from global coal mines or the global coal market.

Quite understandably, as natural gas prices have fallen, utilities producers have opted to use natural gas instead of coal; 20-25% of the revenues come from the U.S. The market has kind of taken that as a negative. The stock has fallen quite substantially, and Roepers, in true form, got up there and said quite boldly that while coal may be a declining market within the United States, it is a growth market internationally. Seventy percent of Chinese power or Chinese electric power is from coal. They are a relatively undersupplied market. If electricity is the thing you're thinking about, India is also a growth market within that context. And Germany, they recently swore off nuclear, and so they're going to need to fill that power vacuum.

Joe: We'll see if they stick to that.

Mike: Right, but if they do, they're going to need to fill that power vacuum in some way shape or form.

The other thing that's pretty interesting about this business is 60% of their revenues come from maintenance and overhaul of their existing mining equipment, which creates a strong degree of recurrence in cash flows.

Bryan: They have about a $25 billion installed base right now to service, so it's a pretty long stream that they'll be able to service.

Mike: Exactly. As the stock itself trades at about nine times earnings and you think about the growth potential which is inherent in this business, it's quite attractive. One thing I might add to the end of that is you could say a lot of things about U.S., or the U.S. and coal, but the fact o the matter is, absent some sort of legislation, if natural gas prices move higher, which I believe they will, some of that coal and that gas switching, the demand will come back for coal.

Bryan: It's also worth noting that a few years ago, I think a year or so ago, Caterpillar bought Bucyrus, which is the major competitor to Joy Global. They paid a pretty hefty multiple. I think it was like 13 times pre-tax profits and Joy Global trades well, well, well below that. And so yeah, it looks like Cat sort of acted at the peak of the mining cycle, but still, they saw a lot in that business that they liked and so we can't ignore that altogether.

Joe: Yeah, well I thought one of the most compelling was a stock that I've recommended … Surprise! … was from David Einhorn on General Motors. It's essentially the same pitch that I've been banging the drum on for a while now, how recovery in U.S. vehicle sales will be lifting the fortunes of all the players involved, but specific to GM, there's kind of a GM hatred penalty out there in the market.

A lot of people are steering clear of the stock because they're anchoring on old GM, but new GM is a much cleaner balance sheet. They've got $32 billion in cash. They've done a lot to shore up their off-balance sheet items as well, lower cost structure. Done a great job of streamlining the business, closed a lot of brand lines that were non-core. They were wasting dollars in manufacturing capacity around that, and there's a lot to love; the stock is hated. I still like it. Unfortunately, we're about two years too early on GM and I think that's obviously not worked out as well as I'd like, and it was interesting because later there was a good talk from Boyd Conner, who I'm actually going to talk about one of his ideas in a second, but he's a turnaround specialist who got up there and mentioned that as a turnaround investor, you want to wait until the car, so to speak, is actually well into the turn before diving in because it can take a long time for both results to come through from a management team that's affecting change, but also for the market to respond to that.

So on a personal level, that's maybe a bit of a lesson there on GM. Fortunately, I think we're already well into the turn because of a lot of changes they've been making, but one of the ideas that came up that's fresh was actually Jamba, as in Jamba Juice. Total no-moat business…

Mike: Very fresh.

Joe: Very fresh. Not really my cup of OJ, terrible?

Mike: Too bad, too bad.

Joe: Yeah, it's not profitable, and they've had a bumpy ride, total no-moat business, again, so it's not really something I'd usually be interested in, but I'd definitely buy the upside range potential here where I think management, from what Conner said, has done an excellent job of coming in, cleaning up the business literally and figuratively, cutting costs and when you look at same-store sales, they're on a nice upward trajectory at 12% in the latest quarter. Pretty solid, and I think there's a good chance for a real fulcrum shift in how people think about this business from being a no-moat loser to something that's actually earning money, and I think they're coming up on turning the corner there.

Another thing that I really like is they're finding some great ways to kind of leverage the brand outside of just the store experience. One is consumer goods actually in stores are selling Jamba Juice at your local grocer, for example. That's a great, high-margin brand extension. Another is this thing called Jamba Go. It's basically just kind of a big box of juice that would be *(laughs.)* It's basically …

Bryan: I'm sure the CEO would love to hear you say that.

Joe: I'm sure. I've looked at the devices and I was just trying to think of the best way to describe it, but it's basically a mobile unit and a dispenser of Jamba Juice.

Bryan: It's a Jamba Juice without any employees. That's what it is. It's not a big juice box.

Joe: It is. You can see what I'm saying. It's a box with juice in it. It's very large and it has juice. I think that while it's not going to be a major driver for them anytime soon, there's a good chance for some high margin, long tail revenue here. They're hoping to have around 500 of these installed, mostly in schools, by the end of this year, and schools are kind of a natural target because we're all fattening up our children with terrible food at public schools. I know; I went to them and they fattened me up. It's a nice opportunity to get something healthy in school locations and it's a nice opportunity for Jamba to take advantage of that.

In terms of the size of the opportunity, if 500 sounds like a lot to you, there are 100,000 U.S. public schools out there, and I'm just talking about public schools, excluding colleges, so there is a lot of room to run.

Bryan: I think a really important part about that effort is what it could do for the brand. You sort of win the hearts of mothers and students and that builds some brand power that they can then transfer into their consumer products themselves.

Mike: Another thing to note, which is very interesting in the context of the restaurants themselves, is Conner noted that the restaurant-level margins are 20% to 23%, which to provide a little bit of context, who are the best restaurant operators? Chipotle, they do 25% restaurant-level operating margins, and that hasn't yet started to show in the results because they are dealing with a relatively small restaurant base, but as that restaurant footprint does indeed grow, you're going to start to see that in the cash flow, and those are just extremely compelling economics.

Joe: So, Mike, I'm going to pin you down on Chipotle. I know you've owned the stock before, made a lot of money on it.

Mike: I still do.

Joe: Well, David Einhorn came out, and as a lot of people probably heard, made a short case for Chipotle, basically talking about competitive rivalry coming on from an improved Taco Bell experience and valuation. Any thoughts on this?

Mike: I don't think there's any arguing that it is a pricey stock. It is priced to do excellent things, and so indeed if there is any threat at the margin, they could be due for some downside. That being said, I think this is a very interesting circumstance where you and I have discussed this before where somebody can be right in the short term, but wrong in the long term. And right here this is a circumstance where I think Chipotle is an excellent enterprise and they may well prove able to justify this valuation in the long term, but right now, I don't think it's anything; it's much of a stretch to say that they're exposed on the downside.

Bryan: Yeah, Einhorn's case was shockingly devoid of catalysts. The main crux of his argument was rising food costs, which they've been dealing with.

Joe: And it's true of every restaurant company.

Bryan: And it's true, yeah, and customer switching because of the new and improved Taco Bell and general industry dynamics. And none of those things seem to have a deadline on them or seem like they're going to — that they're any stronger at this moment than they were three months ago.

Mike: I would not be shorting this stock at these prices. I mean for the very reasons you say, I think another thing that that fails to acknowledge is he very much harped upon the fickle-minded nature of restaurant attendees and those consumers, but it ignores the extent to which Chipotle has been able to build a narrow moat, and a very narrow one, around the operational capacities and the economics variable to extract from the restaurants, which does provide some level of support on valuation relative to their competitors.

Joe: Rockin'. All right, well we're going to cut it off there. I'm Joe Mayger and I was here just now with Mike Olsen and Bryan Hinmon. Thanks everybody for listening. Guys, thanks for going to New York and coming on our little thing today. Good times.

Bryan: I had fun. Good times.

Joe: Thanks again for listening, folks, and Fool on!

Close Your Covered Strangle on Wells Fargo

Published Oct 2, 2012 at 12:00AM

- **What We're Doing:** Closing our strangle early.
- **What We're Thinking:** We've earned about 90% of the available profit.
- **What We're Expecting:** We'll keep our eye out for profitable new strangles in the future.

Trade Essentials

- **Action:** Buy to close your existing covered strangle (October 2012 $36 covered calls and October 2012 $33 puts) for as little as possible, currently about $0.42.
- **Price Guidance:** Use a **limit order**, aiming to pay $0.45 or less (less is better).

What's New?

- **Recent price:** $34.70

In March, we were paid more than $5,000 to set up our current covered strangle on **Wells Fargo** (NYSE: WFC). We can now close that position for $504, so we've earned about 90% of the potential income.

Why Close?

With shares trading evenly between the two strike prices, you might wonder why we don't just wait a few more weeks and earn the last 500 bucks. The answer is earnings, which Wells Fargo is due to report Oct. 12; while I can't forecast whether the team will beat the Street's expectations, the risk of bridging earnings for $0.45 per strangle contract isn't worth it to us.

Volatility on the stock is eerily low, so written puts and new strangles no longer pay well. That's rare because of the healthy dividend and the fact that financial companies' puts typically fetch attractive prices. Because of this, we're closing early instead of rolling; we'll look for better premiums before continuing this strategy.

How to Follow Along

We recommend you:

- Buy back ("buy to close") your October 2012 $33/$36 strangle for about $0.45.

Next step: If you have questions before you close your strangle, visit our Wells Fargo discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Sharing Our Shorts

Published Oct 1, 2012 at 12:00AM

Fellow Fools,

Invest Better, All Over Again

Did you miss Worldwide Invest Better Day on Sept. 25? Our replay will catch you up on the excitement.

I'd be tearing out my hair if I weren't so vain: Since Jeff wrote about moving into targeted shorts one whole human gestation period ago, the *Pro* team has just not made as much progress as we'd like toward that end. To be fair, we've identified **Sony** as a dead man walking (dead Walkman?) and added to our bet on the euro's decline, but those two results don't accurately reflect the amount of effort we've put in. In today's Memo, I'd like to share some of the work we've done identifying and vetting short candidates — and explain why we haven't yet put any of these shorts on. (Sorry.)

Caribou Coffee: Acquisition Risk

In February, I dug into **Caribou Coffee**, which was percolating near $18 at the time. Caribou has more than 400 company-owned coffeehouses and another 175 or so franchised units, and as you may have seen during your latest grocery-shopping trip, it also sells bagged coffee and K-Cups at 9,000 retail stores. My short thesis was simple:

- While Caribou has a strong brand and presence in the Midwest, its new store expansion plans will find some fierce competition from national darling **Starbucks** and Northeastern powerhouse **Dunkin' Brands**. If new stores struggle, investor expectations won't be met.
- Nearly a quarter of Caribou's revenue comes from coffee sold at grocery stores, and the company guides for 15% to 20% growth in that division. But in my trips to local supermarket chains, I found Caribou had failed to secure prime shelf space; more often than not, it was relegated to the bottom. That makes those robust growth rates look less probable.
- Long-term, Caribou wants its average store to generate $1 million in sales, up 68% from today. To get there, it plans to introduce new products and expand existing offerings. The problem, I posited, is that the company's small revenue base can't support the research and development investment needed to do this — and if Caribou did spend that money, investors wouldn't like the impact on near-term margins.

Despite all that, the premium coffee industry is hot: It's growing rapidly, aspirational consumers love it, and it's tied to the burgeoning healthy food movement. Even at a lofty valuation (I thought shares were worth closer to $10), I was scared that Caribou would be acquired, so *Pro* took a pass. That acquisition fear has proved correct … sort of. In July, competitor **Peet's Coffee & Tea** received a $1 billion acquisition offer, and it was already trading for 50 times earnings at the time. Caribou could be next, and with shares now down to $14, that outcome looks even more likely.

Discount Stores: No Catalyst

The terrible economy has been great for discount stores like **Dollar General**, **Family Dollar Stores**, **Dollar Tree**, **Fred's**, and **Big Lots**. Cash-strapped consumers have been migrating to these lower-end retailers in spades, and they've been market darlings through the downturn, expanding their store bases and consistently beating earnings. So why consider a short in the first place? As I saw it, the issues are competition and real estate.

- The five discounters named above have more than 21,000 stores combined. That is a lot of stores. Well-heeled competitors, including **Wal-Mart**, **Target**, **CVS**, and **Walgreens**, themselves boast a combined 20,000 stores — and they appeal strongly to bargain-minded consumers, too. I doubted the discount stores' growth would continue so easily.
- I also posited that the companies' share prices reflected too-aggressive assumptions about new store openings. Viewed on its own, each company could make a reasonable case for doubling its store count. But *all* of them thought they could do that — which would translate to more head-to-head battles, higher costs for the best locations, and closer proximity to the big guns listed above.

So why did *Pro* stay away? In the end, we didn't have a catalyst. We couldn't bank on an improving economy (and the more splurge-friendly consumers it would bring); it was hard to pinpoint when discount-store market saturation might occur; and frankly, most of the store locations were so lousy that we feared management could go after some low-hanging fruit to goose short-term same-store sales. Four of the five discount stores we looked at are up since March, and we continue to monitor the group.

Dunkin' Brands: Price Isn't Enough

In June, **Dunkin' Brands** traded near $34. At 7.7 times sales and 21 times expected free cash flow, it seemed priced for perfection to me — so if *Pro* wanted to short Dunkin', we needed to figure out what would stop investors from paying such a high price for this very good business. Here's what we thought could do the trick:

- Difficult comparables: Post-recession same-store sales could mean lower-than-expected growth for that metric. Plus, Dunkin's newest food offerings were uninspiring, and its efforts to draw lunch traffic didn't seem to be taking hold.
- Westward expansion: While Dunkin' doesn't have much of a presence west of the Mississippi River, coffee drinkers on the left coast aren't hurting for options. In fact, there are so many coffee joints per capita in its targeted expansion areas that to make inroads, Dunkin' would have to change the coffee drinking habits of its future consumers — and that isn't easy.
- Tough franchisee environment: Many franchisees use loans to fund their franchises, and those loans are becoming harder to get.
- Donuts ain't healthy: Americans' slow but (hopefully) steady move toward healthier food choices does not play to Dunkin's strengths.

Dunkin' has a fundamentally good business — we just thought investors were paying too much for it, given the risks we saw. That said, we weren't convinced they were paying *absurdly* too much, so we began to look elsewhere. In hindsight, the bear put spread we were toying with would have worked well. Shares have fallen 15% since we identified the holes in Dunkin's donuts.

The Foolish Bottom Line

Pro has fewer targeted shorts than we would like, but that's not because we haven't been working on finding them. These three tales are from my storybook — Nick and Jeff have similar stories. We simply refuse to put our capital (and more importantly, *your* capital) at risk without a fat pitch. Finding long positions is a bit easier: The market trends upward over time, so even random selections will drift higher (though for the record, we do not choose long positions randomly). I hope this memo pulls back the curtain a bit on how we think about building a short thesis, and why we haven't rushed to put our shorts on immediately. (Didn't think I was going to do it again, did you?)

Have you identified some lousy, overvalued businesses? Share them and your thesis on the [Stocks You'd Like to Short] discussion board.

Onward,

Bryan (TMF42)

Pro [Trade Roundup]

- **Covanta**: As our 30-day trading window closed, we sold to open 27 December 2012 $17.50 calls for a $0.40 credit on each. We wrote calls on all our 2,700 shares.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the [Recommendations] page.

- **3D Systems**: Sell to open February 2013 $25 puts, lately around $1.40, for a potential buy price of around $23.60 (shares this morning were $34.06). Sell one put for every 100 shares you would buy, up to a 1.4% allocation.

Coverage & Community

- **Bad Press**: Just because [*Barron's* says so] doesn't make it true.
- **Coffee Buzz**: Are you going to buy a [Verismo]?

- **Time for a Market Plunge**? Jeff is taking a well-deserved vacation, which usually means a market crash — consider yourself warned. Take his "Make Your Week Memorable" challenge anyway.

See Pro*'s holdingshere. See the team's and David and Tom Gardner's holdingshere.*

Sizing Up Pro's 10 Top Holdings

Published Sep 24, 2012 at 12:00AM

Greetings, *Pro* Fools!

Invest Better!

Don't miss the Motley Fool's first-ever Worldwide Invest Better Day! The big day is tomorrow, Sept. 25, and it runs all day long on investbetterday.com (or just visit Fool.com), with live roundtables, stock ideas, education, Q&A, and much more. There will also be in-person events around the world. Click here to see if you can meet a hearty group of Fools near you, including *Pro*'s own senior analyst, Nick Crow, in Portland, Ore.

Foolish investing is all in the name of long-term business ownership and growing wealth with some of the best companies on Earth. We're happy you're along for the ride, and we hope you find a little Foolishness tomorrow!

If anything keeps my mind running at night, it's allocation decisions (that, and dreams of living in a guest house on a Hawaiian estate with free use of a Ferrari). A great deal of thought, time, and consideration goes into where we decide to allocate our — and by default, *your* — money. Our 10 largest investments account for nearly 50% of the *Pro* portfolio, so if most of these companies are not long-term winners, it's unlikely that we'll love our total performance.

Although we have more than two dozen positions today, at least *half* of our attention should go to our top 10 holdings, because half our capital is with them. If we're confident in the long-term potential and valuation of these 10 investments, then we have much more freedom to buy smaller positions elsewhere where our confidence is less sure but we like the possibilities. And when we're comfortable with our largest positions, we effectively buy ourselves time and mental space to generate more income with options and seek poor companies to sell short (and daydream about palm-fringed beaches).

In summary, your largest holdings are the bedrock of your portfolio, and of your financial future, so only when your foundation is strong and tight should you consider adding additional, smaller positions on top of it. Here are *Pro*'s 10 largest positions and recent returns as of Friday.

Pro's 10 Largest Investments	Allocation	YTD Return	3-Month Return	Annual Dividend Yield
Medtronic	5.7%	13.3%	13.6%	2.4%
Intel	5.7%	(4.5%)	(14.1%)	3.9%
Oracle	5.4%	26.5%	15.9%	0.7%
Apple	5.4%	73%	20.3%	1.5%
AmTrust Financial (Nasdaq: AFSI)	5.3%	19.7%	(1.8%)	1.4%
BMC Software	4.7%	30.3%	(0.4%)	0%
Rockwood Holdings	4.7%	24.1%	8.5%	2.8%
Pebblebrook Hotel Trust	4.4%	29.3%	9.5%	1.9%
CME Group	4.0%	19.1%	6.6%	3.1%
MasterCard	3.8%	23.2%	5.6%	0.2%
Total Allocation and Average for the Rest	**49.1%**	**25.4%**	**6.3%**	**1.8%**

Dividends are not included in returns. Allocations and returns as of closing prices on Sept. 21, 2012.

Returns and yield taken from Google Finance, allocation from Pro*'s Recommendations tab.* Pro *has not owned Apple and CME all year (just much of it), but we're showing YTD performance for all stocks to make this an apples-to-apples comparison.*

Nine for 10

The first thing we should be very happy about is that nine of our 10 largest positions have made money this year. Peter Lynch says a 60% success rate with stocks is exceptional, so 90% is outstanding in any market. This is only a short-term result, but it suggests our due diligence and focus on buying quality at good prices for absolute returns is paying off. We're much less concerned about returns relative to the market, but eight of our 10 largest positions are up more than the S&P 500 this year, giving us a strong result:

Year-To-Date Average

- Pro Top 10: 25.4%
- S&P 500 Index: 16.1%

We invest with our always-positive North Star as a goal, so every month we ask ourselves if our stocks appear positioned to challenge a metric that's running at around 10% annually right now and essentially never lets up. We also hedge our portfolio, so ideally our largest positions will be strong enough to help compensate for our hedges in a rising market. In Pro, that's the main reason to track and point out this comparison to the S&P 500 at all.

Seven for 10

Over the past three months, though, only 70% of our largest positions have risen, despite an exceptional S&P 500 that's soared more than 9%. Intel is our largest loser, down 14% after lowering third-quarter guidance in the face of weak PC sales; and AmTrust Financial treaded water this summer after big gains in 2011, a 10% share dilution, and a nearly 20% advance so far this year.

Given the three-month performance of our top 10, and that we've been hedged, too, *Pro* hasn't gained as much ground as the market the last three months. Here are our top 10 over the summer, excluding dividends:

Past-Three-Month Average

- Pro Top 10: 6.3%
- S&P 500 Index: 9.3%

Why Most Investors Fail

If our top 10 stocks are looking a little mediocre in aggregate the last quarter, what should we do? As long as we continue to believe in the businesses, valuations, and our allocations, then we should do nothing. Most investors fail because they swap out of positions to chase something hotter, and then inevitably the hotter stocks cool and the abandoned tepid ones perform better.

I'd say one of the most Foolish columns I've written the last year was about this very topic, called "Why Most Investors Fail, and How We Avoid It." Rather than always leading the pack, a full 93% of top-rated money managers rank in the *bottom third* of all performers for at least one three-year period. They only remain great money managers because they stick to their knitting — just as Buffett did in the 1990s — even when it appears they're "lagging." If your investment process is proven, your returns will eventually follow, even if you need to wait through tepid years to get there. You can't rest on your laurels — you'll always have mistakes to learn from in a portfolio — but you still have to let your process have time to work.

Today, we're talking about our 10 largest stocks only going up 6% in average in three months, so it's hardly something to lament. But it still makes the point: If your portfolio isn't performing as well as you'd like lately, assuming you still like every position, more patience is usually your best course of action. Investing returns are not steady, consistent, or omnipresent; they tend to arrive in bursts and get interspersed with weakness. It's only after looking back at five or 10 years of holding a stock does it start to feel that it only ever went up.

In a future Memo, I'll review the rest of our holdings — because they, of course, make up the other half of the portfolio. In the meantime, we'll see you tomorrow for Worldwide Invest Better Day!

Foolishly,

Jeff (TMFFischer)

Pro Trade Roundup

- **Facebook**: We bought to open 26 January 2014 $20 call options at an average price of $6.81, for a 1.1% allocation.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **3D Systems** : Sell to open February 2013 $25 puts, lately around $1.40, for a potential buy price of around $23.60 (shares this morning were $34.55). Sell one put for every 100 shares you would buy, up to a 2% allocation (*Pro* has a 1.4% current allocation but would look to add at lower prices like this).

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Memo Musings:** Want to discuss this Memo?
- **Last Week's Most Recommended Post:** ADrumlinDaisy comes through again with Foolish wit and market observation.
- **Puts for the Writing:** Alex340 shares put-selling ideas for income or better buy prices.
- **Starry Eyed?** Fools discuss Yosemite and night skies.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy Calls on Facebook

Published Sep 18, 2012 at 12:00AM

- **What We're Doing:** We're giving a "like" to Facebook's 2014 call options, buying them to profit on the growth of the business.
- **What We're Thinking:** Market skepticism presents an opportunity to invest in an exceptional Internet brand.
- **What We're Expecting:** The company will earn more revenue on its enormous audience than estimated.

Trade Essentials

- **Action:** Buy ("buy to open") January 2014 $20 calls on **Facebook** (NASDAQ: FB). (As a reminder, these calls will appreciate with the stock; they give you the right to buy the shares for $20 any time before expiration if you so choose. Need a refresher on when and why we buy calls? Click here.)
- **Price Guidance:** Use a **limit order** at the current price you see. Ideally, you'll pay $5.80 or less per contract, but if the stock rises, you'll need to pay more.
- **Recent Option Price (bid/ask):** $5.60/$5.80
- **Recent Share Price:** $21.50
- **Allocation:** Invest approximately 1.2% of your *Pro* funds. In other words, buy around $1,200 in calls for every $100,000 you manage; at recent prices, this most closely equates to buying two call options for every $100,000 you manage, or 30 contracts for *Pro*. Were we to turn these calls into stock, it would lead to a 5.3% position. However, we may not choose to exercise any — let alone all — of these calls, and unless we do, we only risk 1.2%.
- **Maximum Gain:** Unlimited as Facebook rises.
- **Maximum Loss:** Our entire 1.2% investment if Facebook stock is less than $20 at the January 2014 expiration.
- **Break-even:** $25.80 at expiration.
- **Potential Follow-Up:** If the stock declines further, we may write puts to earn back option premium and target another lower buy price. We may also consider buying some 2015 calls when they debut in November. And come expiration, we may roll our 2014 calls to 2016 calls or buy some stock if we want to stay invested. Finally, if our call purchase is nicely profitable, we may eventually write diagonal calls against it or turn it into a bull call spread.
- **Alternative Trades:** If you don't want to buy calls for some reason, invest 1.2% directly in stock. Realize you won't have the leverage calls provide, although you will have a better break-even price and no expiration.

The Big Picture

Early this year, the world's largest social networking site was valued at more than $100 billion. Now, **Facebook**'s (NASDAQ: FB) enterprise value (including $10 billion in IPO cash) sits at about one-third of its recent peak. We're not going to argue that $100 billion was the right price for Facebook (it wasn't), but today's much lower price likely isn't, either.

With 955 million active users at the end of June, and $922 million in advertising revenue that quarter (up 28%), Facebook is essentially earning less than $1 in advertising revenue per user. Wall Street laments this, but I love it. Why? Because this metric will almost certainly improve, surpassing today's low expectations.

The Business

It's easy to forget how young Facebook is. In 2008, it sported just 100 million unique visitors. As it grew, CEO Mark Zuckerberg remained intent on keeping the social site free of intrusive advertising, but now that Facebook is public, even he realizes it's time to increase ad revenue. Wall Street seems willfully ignorant of this short history, punishing the stock because Facebook isn't monetizing its audience nearly as well as its more established peers, even though management's focus has been elsewhere. Now that Facebook is intent on growing ad revenue (including on mobile devices), we believe its growth will ultimately surprise Wall Street.

Early statistics may already support this belief. Take it with a grain of salt, but Facebook's advertising partners are claiming much more lucrative results — up to four times the return on ad dollars — on the new Facebook Exchange platform compared with other real-time bidding systems such as **Google** (NASDAQ: GOOG) AdWords. Facebook's platform (debuted in June and taken out of beta last week) allows companies to produce, monitor, and tweak advertising campaigns in real time, bidding for the words that are found most effective and placing ads where desired. ComScore estimates that more than 25% of the entire Internet's display ad inventory could be served on Facebook. As these ads become more effective, competing advertisers will need to pay higher rates for them — from today's basement-dwelling $0.25 per 1,000 page views, some estimate the cost will increase to as much as $2.50 per 1,000. Without falling prey to hype, it appears the upside potential in Facebook's revenue growth is not linear, but exponential.

Ad dollars as a whole continue to transition from old media to the Internet, with online ad spending up 15% year-over-year to $8.4 billion in just the first quarter of 2012. (Last quarter, Facebook's revenue grew 32% to $1.18 billion.) Advertisers seek a steady, large, targeted, and engaged audience and trackable results. In 2011, 16.6% of all time spent online was spent on social sites, naturally led by Facebook. This year, social media is on track to surpass search portals as the most popular activity online.

The number of daily Facebook visitors dwarfs that of most other websites (Google aside — its numbers are similar) and the audiences of all the most popular TV shows. Plus, the average Facebook user stays on the site much longer than users of other sites. It may surprise you that Facebook registers 1 billion search queries per day, rivaling Google — even though Facebook isn't considered a search engine. Although many users are searching for people, others are searching for restaurant or hotel recommendations, general information, companies, brands, and social or political movements. Facebook is intent on improving, growing, and monetizing its search capabilities, and ad dollars should grow as a result.

Key Facebook Stats

- **Monthly Users:** 955 million
- **FB Banner Ad Inventory:** Estimated to be 25% of the entire Internet's
- **FB Exchange Ad Rates:** Lately $0.25 per 1,000 clicks (compared with estimates of up to $2.50 per 1,000 clicks in the future)
- **Company Focus:** Grow ad revenue in desktop and mobile; improve search.

Recently, Zuckerberg spoke with the press, admitted mistakes, shared the company's focus, and reassured investors. Facebook is not working on a mobile phone (thank goodness), but it is intent on building out its search functions and earning much more revenue on mobile applications. (To that end, Facebook figures prominently in the most recent iPhone operating system.) The company foresees a day where 4 billion to 5 billion people have a smartphone, and its mission is to connect everyone with the people and things they care about every day.

Overall, the business potential of a site with nearly 1 billion engaged users looks much larger than the downside risk — as long as Facebook keeps its audience engaged. And this longtime skeptic believes it will. Unlike MySpace before it (which peaked at 75.9 million monthly U.S. visitors), Facebook has likely reached critical mass. Even if you tire of the site and leave it periodically (as many of us probably have!), you're likely to return eventually because enough of your friends and family are there, even if some of *them* are coming and going at times, too. Facebook's sheer mass gives it a gravitational pull that keeps bringing people back.

Additionally, users are building lifelong "Timelines" under the latest site format, making Facebook a homepage for their life stories, past and present — thus increasing its stickiness. In fact, today Facebook is *the* online identity for hundreds of millions of people, so as long as management continues to build on the user experience, the company has a strong chance of maintaining its position.

Valuation

Given how little Facebook is earning per user so far, it's not surprising that the stock is cheaper than its key Internet peers on an enterprise-value-to-user basis. But rather than increase our skepticism about Facebook's ability to create value, these older, more successful peers should suggest to us that Facebook has the potential to do exactly that. The company is only now starting to monetize its audience, a process it took several years for Google, **eBay** (NASDAQ: EBAY), and others to perfect. After these earlier online giants started to grow sales, their free cash flow and margins headed higher, and the same sequence of events should happen at Facebook as advertising dollars begin to flow.

With an enterprise value of $33.2 billion (as of Sept. 13), Facebook trades at 58 times 12-month free cash flow of $571 million. This result is depressed by the company's soaring (growth-oriented) spending and the fact that advertising is still novel on Facebook. But there's a lot of growth potential ahead as Facebook unlocks the value of its audience. If all goes well, eventually the business could command a valuation per monthly user that's much closer to its more successful peers (**Yahoo** (NASDAQ: YHOO) is included here as an example of a laggard):

Metric	Facebook	Google	Yahoo	eBay
Monthly Active Users	955 million	1 billion	500 million	217 million
Share Price*	$20.70	$706	$15.60	$49
Enterprise* Value	$33.2 billion	$192.1 billion	$16.5 billion	$58.7 billion
EV per User	$34.76	$192.10	$33	$270
Minutes Spent on Site per User per Month	413	101	151	N/A

*Enterprise value and share price figures as of Sept. 13, 2012; financial data compiled from S&P Capital IQ. Monthly active users for Facebook and eBay as of the quarter ending June from press releases; for Google and Yahoo as of September from Comscore and eBizMedia. Minutes per user estimates from Nielsen.com as of May 2012.

The market is granting every Google visitor *more than five times the value* it places on a Facebook user, even though Facebook users spend four times as long on the site each month. Right now, this is fair — Google has cracked the advertising nut. We're buying calls on the belief that Facebook will start to crack it, too.

How to Follow Along

Buying calls is as simple as buying a stock, except the command is usually "buy to open." You should pay cash — not use margin. If we own the calls for more than one year, they'll be taxed at a long-term rate. Buying calls is our way to risk less capital (our business thesis is unproven, after all) and still benefit from much of the upside.

We're able to invest just 1.2% of our funds but have a position that, if exercised, would equate to about 5% in stock, while risking just 1.2%. Here's how buying the stock at $21.50 compares to buying the $20 calls for $5.80, assuming one contract or 100 shares:

Facebook Share Price	Call Gain (Loss) on $580 Invested	Call % Return	Stock Gain (Loss) on $2,150 Invested	Stock % Return
$5	($580)	(100%)	($1650)	(77%)
$10	($580)	(100%)	($1150)	(53%)
$15	($580)	(100%	($650)	(29%)
$20	($580)	(100%)	($150)	(4%)
$25	($80)	(14%)	$350	16%
$30	$420	72%	$850	39%
$35	$920	158%	$1350	60%
$40	$1420	244%	$1850	86%
$45	$1920	331%	$2350	109%
$50	$2420	417%	$2850	133%

If Facebook fails to launch its advertising business in grand fashion, its stock price could end up closer to $10 than $20, but our loss with calls is capped, and it's much less than it would be with stock. If Facebook succeeds, these calls capture 85% of the profit we would have had on the stock should it increase to $50 ($2,420 gained on each call, compared to $2,850 owning 100 shares).

Put another way, our unlimited profit and limited loss potential looks like this, starting at $5.80 for every January 2014 $20 call we buy:

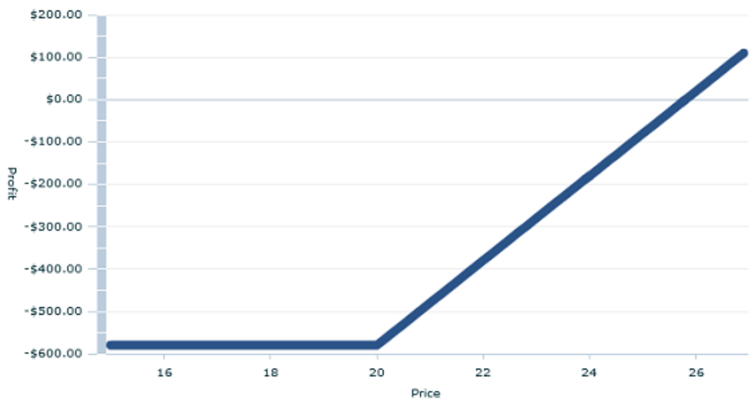

Chart courtesy of OptionsXpress

We recommend buying two calls for every $100,000 you manage, which will lately cost you $1,160, meaning nearly a 1.2% allocation. Ultimately, if the worst occurs and Facebook fails to monetize its users well, we can stomach a 1.2% loss by 2014. Along the way, as share lock-up expirations arrive (allowing employees to sell stock), we may add to our small position if prices are more appealing, perhaps by using the 2015 options that debut in November.

In the best-case scenario, Facebook will deliver effective ways to advertise, and the market will begin to realize that its free cash flow and margins will turn much higher as the business grows. If those events start to unfold, investors will rush into this top-tier Internet company — just as many did earlier at twice the price.

Next step: Visit our new Facebook discussion board, where we'll post more analysis and where you can ask questions (and tell us what you had for breakfast, share pictures of your dog ... OK, not quite).

The Motley Fool owns shares of Facebook, and Google. See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Retirement Expert Robert Brokamp on Trusts, Bonds, and More

Published Sep 17, 2012 at 12:00AM

Greetings, *Pro* Fools!

Want More Bro?

If reading this Memo makes you think, "This Robert Brokamp sounds like a charming, intelligent fellow, and I would like to subscribe to his newsletter" — well, you're in luck! Through Groupon, we're currently offering a year of *Rule Your Retirement* for $15. Click here to sign up (and hurry; the deal expires Wednesday).

Earlier this month, we opened our Retirement Revelry discussion board as a place to discuss retirement — both preparing for it and enjoying it. So far, the board has raised at least as many questions as answers; luckily, TMF has a retirement expert at the ready. In today's Memo, my friend (and *Rule Your Retirement* advisor) Robert "Bro" Brokamp, CFP, tackles your questions — those you posted on the message board, and some I received via email. Bro lives and breathes this stuff, as you'll soon see. Let's go!

The Care and Feeding of Your Financial Advisor

Nick: If a member doesn't subscribe to *RYR*, I imagine they'd have to get most of their financial planning information from a financial advisor or the Internet. What questions should members ask their financial advisor?

Bro: Well, they should subscribe!

Nick: Ha ha, I agree — I believe you are the best deal in town.

Bro: First, they should ask, “How are you compensated?” If [the financial advisor] receives their compensation from someone other than you — e.g., payments or commissions from fund companies, brokerages, or insurance companies — then there’s a conflict of interest, and you can’t be sure if their recommendations are best for you or for them. If they get paid as a percentage of assets under management, anything above 1% is too much. For pure financial-planning help — help with deciding when you can retire, whether you have enough insurance, when you should begin Social Security benefits — look for an advisor who charges by the hour, such as those in the Garrett Planning Network.

Nick: What else?

Bro: Ask, “Are you a fiduciary?” An advisor who is a fiduciary is legally obligated to put your interests first, and you have more legal options if they do you wrong. Most of the advisors who work for the big-name brokerages are *not* fiduciaries, and any disputes with them must be resolved through the industry-run arbitration process.

Nick: If the advisor’s first obligation isn’t to their client, we’ve got to assume their priority is their own wallet, right?

Bro: Exactly. Members should also ask, “What services will you provide?” Some advisors just manage investments, whereas others provide complete financial plans that cover insurance, taxes, retirement savings, estate planning, debt, and other topics.

Health Care: What Should You Expect?

Nick: On a recent *Pro* live chat, health care seemed to be a primary retirement concern. What’s the future of health-care costs? How can members protect themselves?

Bro: Health-care costs will continue to be a huge wild card. It’s safe to assume that costs will rise at a rate greater than inflation in the near future. Of course, that’s unsustainable. Otherwise, we’d spend just about every dime we have on doctors and medicine. One way costs will be contained is by reducing benefits; in the meantime, here’s how to figure these costs into your plan.

Most experts assume that a person’s expenses will drop dramatically after they retire, and that is what happens for most retirees these days. However, future retirees should not assume a drop in expenses, because they'll likely have to spend more on health care than current retirees. Also, it’s important to remember that much (if not most) of our health-care costs are the consequences of poor lifestyle choices — smoking, eating and drinking too much, and not moving enough. Reduce your future health-care costs by living a healthy life. I’ve lost 40 pounds over the past few years. If I can do it, you can, too.

Annuities and Trusts

Nick: Who needs a trust?

Bro: Creating a trust establishes a legal entity that holds property or assets for the person who created it. The three biggest reasons to own a trust are:

1. To avoid probate, which is the legal process of settling an estate according to a will. Assets in a trust bypass the probate process. Some people want to avoid probate because it can be time-consuming and public. A trust is more private and efficient, but setting it up can also be more expensive.
2. To maintain control over assets, perhaps because other family members are incapable (e.g., mentally disabled) or irresponsible (a spendthrift).
3. To shelter assets from estate taxes. This one is trickier because the laws regarding estate taxes change frequently, and putting money in a trust isn’t necessarily a “free lunch” when it comes to tax savings. Everyone should see an estate planning attorney regardless of net worth, but those whose assets exceed $1 million should discuss possible estate-tax strategies.

Nick: Who are annuities the right product for?

Bro: "Annuity" is a broad term applied to a varied collection of insurance products, with very different characteristics. The pure form — a monthly or annual income payment for life, which doesn't vary regardless of what happens in the markets — can make sense for some investors, especially those who won’t receive a traditional defined-benefit pension.

The types of annuities that are used as savings vehicles are the type we really don’t like, given their high expenses and limited investment choices. And a new breed of annuities that offer so-called “living benefits,” such as guaranteed withdrawals, sound good in theory, but tend to be too expensive and too complicated in practice.

Nick: It sounds like you’re not a fan of using an income annuity to hedge longevity risk.

Bro: Oh, good point. Yes, that’s the other benefit of an annuity. Most withdrawal rates assume a 30-year retirement, but if you live longer — which is generally a good thing — you can risk running out of money. So if you don’t have a defined-benefit plan, you can purchase one in the form of an income annuity.

Bonds, Bonds, Bonds

Nick: One of our members, Ed, wanted me to ask you this next question as sort of a litmus test so that he knows whether to continue reading.

Bro: Hah, OK.

Nick: Should people be investing in bonds right now?

Bro: Traditionally, bonds had two main purposes: to provide income, and to provide diversification to a stock portfolio. Now, with interest rates so low, bonds don’t offer much income, so the only reason to own them is to have something in your portfolio that won’t plummet the next time the stock market drops. On the other hand, when interest rates rise, the value of existing bonds falls. So for money that you must keep absolutely safe — such as money you need to spend in the next year or two — the best bet is cash or a very short-term bond fund.

It’s also important to remember how bond prices work. Let’s say you pay $1,000 for a newly issued bond, and it matures in five years, at which point you get your $1,000 back. But in the meantime, interest rates rise and the bond drops to $900. That’s no fun, but as long as you hold the bond to maturity and the company is still in business, the price of the bond will gradually move back to $1,000 as the maturity date approaches.

Nick: And then there is the ability to reinvest coupons over time.

Bro: Right. The value of your bond investment will also depend on what you do with your interest payments. Let’s say you own a bond fund, and interest rates rise. The value of your shares in the bond fund will drop, but if you’re reinvesting your payments, you’ll be buying more shares of the fund at a cheaper price; on top of that, these shares now have a higher yield, which can then be used to buy even more shares. In fact, while rising interest rates aren’t good for bonds in the short term, they can actually be better for bonds over the long term. (To learn more about the history of bond-market declines, read this excellent report from Vanguard.)

Nick: Another member, Bob, wants to know: What bond allocation do you recommend for a member in or close to retirement?

Bro: Start by keeping any money you need in the next five years out of the stock market. For retirees, that means building an "income cushion." If you're looking for income but don't need to touch the principal for many years, a diversified portfolio of high-quality, blue-chip, dividend-paying stocks is more attractive than bonds right now, especially since dividends have historically grown at a rate that exceeds inflation. But just know that even corporate stalwarts can cut their dividends (as we saw in 2008 and 2009), and these stocks can drop 50% or more, just like any other stock.

Nick: What investments do you like for diversification and risk abatement in retirement?

Bro: If you're looking to lower the volatility of your portfolio but don't need to spend the money in the next few years, then a low-cost, diversified, short- to intermediate-term bond fund will fit the bill, such as **Dodge & Cox Income** (DODIX), **Managers Pimco Bond** (MBDFX), and **DoubleLine Total Return** (DLTNX).

Nick: I'd just like to point out that in *Pro* we use hedges and options to reduce portfolio volatility, too. Back to Bob, who likes specifics: Do you have guidelines for allocation as a percentage of the portfolio?

Bro: As a very general recommendation, investors near or in retirement should consider having 30% to 40% of their portfolios in bonds, with that amount adjusted for net worth, risk tolerance, and the amount and security of other sources of retirement income (such as a pension).

Social (Not So) Security?

Nick: We have many members who are still growing their portfolios, too. How should younger investors think about Social Security in their plans?

Bro: Americans in their 50s and older will likely receive all or most of their projected Social Security benefit. Younger Americans should expect to receive half of their projected benefit. If I had to make a prediction, I'd say that most people will get closer to 75% of their projected benefit, with wealthier retirees receiving less. It's also likely that Americans will have to work longer to receive their benefits. The challenges facing the Social Security program are not nearly as daunting as those confronting Medicare.

A Worldwide Perspective

Nick: What are your thoughts on diversification across countries and currencies?

Bro: A good starting point is to invest a quarter of your equity allocation in non-U.S. companies. That provides both business and currency diversification. Younger investors might invest more; those near or in retirement might invest less. Many income-seeking investors are looking to international bonds for extra yield, which can be fine for a slice of your bond allocation. But non-U.S. bonds have additional risks, so for money you must keep safe, stick to highly rated U.S. issuers.

Saving Us From Ourselves?

Nick: A member noted that "*RYR* seems to recommend an index-based approach to investing. Is this in part a nod toward the inevitable cognitive decline that is associated with age — a decline that might, for example, manifest itself in an ill-advised short?"

Bro: *RYR* has model portfolios based on actively managed funds, index funds, and ETFs. We like the actively managed funds because we believe it's possible for great managers to beat their respective benchmarks and outperform their peers.

Nick: Well, we agree that a talented team can add value through active management.

Bro: However, we also know this is difficult, so we think index funds and ETFs make sense because they're a hedge against "manager risk" and they're very low-cost, and we're fundamentally cheapskates. And their low costs are one of the biggest reasons why they outperform approximately two-thirds of similarly invested funds.

As for the possibility of cognitive decline, that is a real risk that most people don't account for. Approximately half of people in their 80s suffer from some kind of cognitive impairment. Last summer, I interviewed Harvard professor David Laibson on this topic. His solutions didn't include index funds, but they did include income annuities, updated estate-planning documents, and heart-to-heart discussions with family members.

Should You Literally Set Money on Fire?

Nick: I've received this question in a number of different forms: What should we do with cash?

Bro: Smoke it!

Nick: There goes your health-care advice.

Bro: Otherwise, there's not much to do. Some online banks offer slightly higher interest rates. Some advisors have recommended long-term CDs that don't have onerous early redemption penalties. A short-term bond ETF, such as **Vanguard Short-Term Bond**, offers a higher yield than cash, but also the possibility that the investment will decline if rates rise. However, your money is likely in cash for a good reason: You want to keep it very safe. Thus, while earning nothing on your cash can be frustrating, at least it's safe, and that's your priority for that money.

Nick: Bro, thank you for meeting with me and answering our questions.

Members, if you'd like more, please give Bro's *Rule Your Retirement* newsletter a try. Bring more questions to the Retirement Revelry board!

Fool on,

Nick (TMFCrow)

Pro Trade Roundup

- **Starbucks**: We purchased 400 more shares at an average of $51.53 and sold to open four more January 2013 $47 calls at $1.54 each, bringing our total allocation to 800 shares and eight written puts, or around 5% total, as intended.
- **SPDR S&P 500** : We bought to cover 665 shares at an average cost of $146.14, reducing our *stock-based* index shorts to just 10% of our invested assets.

Guidance Updates

- **Pacer International**: Moves to Buy First from Buy on price.
- **Oracle**: Moves to Buy from Buy First on valuation and pending earnings Sept. 20.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **CurrencyShares Euro Trust** : Sell short directly with a 3.9% allocation in your portfolio. Alternatively, set up a synthetic short by selling to open January 2014 $131 calls and buying to open an equal number of January 2014 $131 puts. With the ETN around $130.40, aim to pay around a $1.40 net debit for each synthetic short you set up. Set up one synthetic short for every 100 shares you want to be short. (For more, revisit our original reports.)
- **ProShares UltraShort Real Estate** : Set up a synthetic short with a 1% allocation by selling to open January 2014 $23 calls and buying to open an equal number of January 2014 $23 puts. With the ETF around $23.50, aim to pay around a $2 net debit or less per synthetic short. Set up one synthetic short for every 100 shares you want to be short. (For more, revisit our original report.)
- **iShares Russell 2000** : If you haven't set up a put ratio spread yet, with the ETF at $85.80 this morning, you could sell to open two November 2012 $78 puts for every one November 2012 $82 put you buy. You'll pay a small credit to set up this trade, but you'll profit on declines to around $74, your break-even price. Set up one put ratio spread for every $50,000 you manage. (For more, revisit our original reports.)

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Why'd We Close More of Our SPY Short?** Jeff explains the trade in the context of the *Pro* portfolio. Here's the original report again.
- **Stock Performance Got You Down?** Focus on the business performance and think long term.
- **Foolish Feet on the Street:** ChuckVester gives us the lowdown on the enterprise content management market.

The Motley Fool owns shares of iShares Russell 2000 Index (ETF). See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Reduce Your Stock-Based Short Index Positions to 10%

Published Sep 12, 2012 at 12:00AM

- **What We're Doing:** For the second time this year, we're reducing our short of the S&P 500 index, this time down to a value of 10% of our invested assets.
- **What We're Thinking:** We continue to reduce our long exposure and favor different hedges (including our IWM put ratio spread), thereby reducing our need for this S&P 500 short.
- **What We're Expecting:** We'll continue to exit this position in favor of targeted shorts of individual companies and option hedges.

Trade Essentials

- **Action:** Buy to close (or buy to cover) enough of your short position in the **SPDR S&P 500** (NYSEMKT: SPY) (or other stock-based index shorts — see our Alternative Trades below) to match our updated 10% allocation. For *Pro*, this means closing about 600 shares.
- **Allocation:**
  - **If you're a veteran *Pro* member** with stock-based (not options-based) short positions on market indexes, you should reduce them to no more than 10% of your long assets. In other words, you want $10,000 worth of stock-based index shorts for every $100,000 you have invested long.
  - **If you're a new member** and/or you don't have any stock-based index hedges, you can ignore this trade. (Everyone who wants to hedge should already have our put ratio spread on the **iShares Russell 2000** (NYSEMKT: IWM).)
- **Limit Guidance:** You can buy to close or buy to cover at the going price.
- **Alternative Trades:**
  - If you're short *any* equity index directly (not using options), or if you own shares of an inverse index ETF, reduce those total positions to bring them to 10% of your invested assets. If your hedges are already less than that, you don't need to do anything. And no matter what, leave your ratio put spread on IWM alone. (After reading this report carefully, if you have questions, please visit our SPY discussion board.)

What's Changed?

- **Last trade:** We closed one-third of this hedge in late January.
- **Price change (from 1/26/12):** The index is up another 8.7%, but the *Pro* portfolio is up about as much despite our hedge.

Despite a recession in Europe and stalling economic growth in the United States, second-quarter earnings and guidance from S&P 500 companies have proven resilient, bringing the index higher. Any sign of economic progress, or any promise of more federal stimulus, could add to that advance — and more economic stimulus already appears likely.

We seem to be entering a new period in economic and fiscal policy, one in which Western governments have broad freedom — and practically a mandate — to stoke economic activity when needed, potentially for years. The European Central Bank just announced open-ended bond purchases to keep borrowing rates "reasonable" for any EU country, and the U.S. Federal Reserve is strongly hinting at a third round of liquidity stimulus in as many years. Although such policies may not result in more jobs, the Fed's liquidity has proven a forceful driver of stock prices: As interest rates scrape bottom under a flood of federal funds, investors seek higher returns on their assets elsewhere.

It made sense to hedge by shorting this market index as the Federal Reserve's latest liquidity program came to a close earlier this year. It makes less sense to keep the position unchanged as the threat of a new stimulus program builds. Further, the market often reacts positively to bad economic news because it suggests more stimulus will be on the way — while actual good news is also seen as positive because it promises earnings growth. In other words, shorts are between a rock and a hard place, and that may be the case as long as Europe and the U.S. continue to provide liquidity whenever economic numbers (or borrowing costs, in Europe's case) look threatening.

It also makes sense to reduce our SPY short because most of our long stock positions are valued attractively in light of recent earnings. Although ups and downs are certain, our buy-rated stocks appear ready to challenge our North Star from today's prices over the next two to three years. We do plan to put other hedges in place, because there's always the risk that the Fed disappoints or ultimately does as much harm as good. But those will be more targeted positions, using more dynamic hedges and shorts.

The direct index shorts *Pro* members are carrying are legacy positions, taken last year when shorting alternatives at our former broker were limited. These hedges continue to serve a purpose; in fact, they've let us stay almost fully invested, bringing comfort during volatile times. But we want to systematically reduce direct index shorts (or inverse ETFs, for those who have them) in favor of more targeted shorts and lower-risk option hedges.

How to Follow Along

Some members used alternative vehicles to effectively short various indexes. If that's you, follow along by adding up the value of your stock-based index shorts and inverse ETF positions, whatever flavor they are (other than options). Maybe you own the **ProShares Short S&P 500** (NYSEMKT: SH) ETF or the **ProShares Short Russell 2000** (NYSEMKT: RWM) ETF, or are short the iShares Russell 2000 ETF directly (not just with our put ratio spread), or maybe you are just short the SPDR S&P 500 directly like us.

In every case, compare the combined value of all of your stock index shorts (not your targeted shorts in things like **Sony** (NYSE: SNE) and the euro) against your long stock and long ETF positions. Decrease your relevant index hedges to around 10% of your invested assets. If you are 16% hedged with the SPDR ETF, as we are, you will simply need to close a bit more than one-third of the position to get down to 10%. You will "buy to close" or "buy to cover" the appropriate number of shares.

In summary, members wanting to mirror *Pro* should have these positions when it comes to hedges:

- **Veteran members** should have 10% in a direct index short like SPY; the put ratio spread on IWM; and shorts of **Sony** (NYSE: SNE) and the **CurrencyShares Euro Trust** (NYSEMKT: FXE).
- **Members who joined this summer** should have the put ratio spread on IWM; they can also set up the CurrencyShares Euro Trust short per Monday's Catch-Up Trade. That's it; there's no need to set up a 10% short on SPY because we plan to close it before long, and Sony is too low to short now.)

The Foolish Bottom Line

We'll reduce our position at some point after our 24-hour waiting period but before our 30 days are up. This index hedge has lost more than 16% for us, but the portfolio overall (which is what matters!) is up sharply since we initiated the short. We've kept pace with a rising market despite being hedged, which is a coveted result. But now, as promised, we're fine-tuning our hedging and shorting strategies.

Next Step: Questions about your shorts (or pants, slacks, or knickerbockers)? Seriously, visit our SPDR S&P 500 discussion board.

The Motley Fool owns shares of iShares Russell 2000 Index (ETF). See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Worldwide Fool Meetups on Sept. 25

Published Sep 11, 2012 at 12:00AM

As you know, The Motley Fool is dedicated to helping the world invest better. We think one of the best ways to do that is to have the support and help of a community around you — so this Sept. 25 (Invest Better Day), we encourage you, our members, to meet fellow Fools in your local community and make some Foolish connections offline.

In fact, we are sending our investing team to 12 different cities on Invest Better Day. They'll be sharing their thoughts on how to invest better and discussing some companies on their radar. Join them and your fellow Fools in these locations:

Washington, D.C.	New York	Chicago
Los Angeles	San Francisco	Miami
Seattle	Boston	Denver
Philadelphia	Minneapolis	Portland, Ore.

Meetups in these locations are filling up fast, but if your local meetup is at capacity — or if you're not near one of those cities — you can still participate. There are enthusiastic members starting meetups in cities all across the globe. Check here to find your local Fool meetup, then scroll down for tips on how to host it!

Host Your Own Motley Fool Meetup

As a Fool, you're already part of our awesome online community — but we want to help empower Fools to get to know each other offline, too. Here are some tips for putting together your own Motley Fool Meetup for Invest Better Day on Sept. 25:

Time and Place
The date should remain Sept. 25 to be connected to Invest Better Day. Set the time and place for your meetup as early as possible, as scheduling is a big determining factor for attendees. If someone already has a meetup in the same general location you're considering, contact that organizer and see if you can collaborate.

Promotion
By **solidifying the time and place early**, you leave ample opportunity for grassroots promotion. You can simply by sharing the event details with your local friends and colleagues who invest (non-Fools are welcome, too!). Creating a Facebook event can help you reach an audience; you can also send interested investors to your local Motley Fool Meetup page, where they can RSVP.

Format
An Invest Better Day meetup can be **just about any shape and size**. It could be a packed house listening to prominent local keynote speakers. Or (perhaps more likely) it could be an informal get-together of investors at a coffee shop, bookstore, or bar, discussing how they invest now and how to get even better.

Steps to Take

Here's exactly what to do to create your own Motley Fool Invest Better Day event:

1. Visit The Motley Fool's Meetup Everywhere page.
2. Your location will display directly below the map. If this is where you want to host your meetup, click the "Start a new community in…" link. (If you want to use a different location, type it into the search box at the top; that location will then display atop the list of nearby locations.)
3. Enter a name for your new community in the input field. Just use the name of your city (for a meetup in Des Moines, simply enter "Des Moines"), and hit the "Create" button.
4. Click on the "Needs a location, Got one?" link just below the event title. Add the event's location and time. You also can share details and comments about the event.
5. Consider getting the word out by sharing your Motley Fool Meetup on Twitter, Facebook, and the Fool's message boards. Let us know about it, too! Send a note with the details to meetup@fool.com.

6. Check your location's Motley Fool Meetup page frequently to answer questions and start the conversation with attendees before the event begins.

Live Chat: Friday, Sept. 14

Published Sep 10, 2012 at 12:00AM

Jeff, Nick, and Bryan took your questions from 2 to 3 p.m. Friday, Sept. 14. Click below for the transcript!

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More on Market Index Hedges

Published Sep 10, 2012 at 12:00AM

Dear *Pro* Members,

Live Chat Coming Up!

Got questions about our Ketchup Reports, our recommendations, our strategies, or anything else? Bring them on! Jeff, Nick, and Bryan will be available from 2 to 3 p.m. Friday, Sept. 14 for a live chat. Click here to set a reminder!

Last week, I wrote about hedging market indexes in your retirement accounts. This led to many great discussions on the *Pro* boards, in which I was able to better clarify my meaning: In my opinion, the need to hedge your account grows as the balance of the account surpasses 50% of your retirement goal.

In other words, if you're younger than 40, have $50,000 in an IRA, and hope to save $350,000 over the next 20 years, then your time is best spent improving your investing and adding regular savings to your account, rather than hedging the market to sustain your relatively modest balance at the cost of more upside.

But once you've saved around 50% of your ultimate goal, you should start to at least consider hedging to protect what you're building. Say you're 55 years old and you have most of the money you need to retire, but you remain fully invested in stocks. In that case, you certainly should consider selective market hedging in order to keep your principal balance healthy.

Of course, every situation, personal preference and comfort level is different. We know that many investors succeed wildly without ever hedging (or trimming positions, for that matter), and in this service, you don't need to use our hedges and options if you don't want to. Our core stocks are meant to be an exceptional portfolio on their own. Beyond them, we're here to help you grow your investment dollars no matter what over shorter time frames, too. Our specific goal is long-term annualized returns at least 7% higher than inflation — and positive returns over any rolling three-year period regardless of the market environment.

But outside that context, how much time you spend hedging the market by shorting indexes should depend on how much money you personally want to protect today. Weigh that against how much longer you plan to keep saving money to grow what you have. If you're lucky enough to be early in your journey, then don't spend much time worrying about hedging until you've built up more in assets. If you're lucky enough to be close to living off your funds (yes, both groups are lucky!), and you aren't pulling cash out of the market for that purpose, then strongly consider hedging to protect cash you'll want for certain in the coming three to five years.

Finally, keep in mind that hedging a market index differs from shorting weak companies directly. Shorting a stock, as we've done with **Sony**, is an investment choice much the same as buying a stock. No matter what the broader market does, our choice will work out for us or it won't, on its own merits. But when you hedge a market index, as we've done with the SPDR **S&P 500**, it's *guaranteed* that the hedge is going to work against you whenever the market goes up. So you only hedge a market index when you truly want to protect some portion of your invested assets. That's all an index hedge boils down to. I hope this makes your choice at home clear.

In *Pro*, our always-positive North Star is our taskmaster, so hedging remains high on our list of priorities. As we strive to offer our members creative, lower-cost ways to hedge, we're working to get every member who wants to follow our hedges on the same page regarding our index positions. We recently set up a put ratio spread on the **iShares Russell 2000**, for example; expect other low-cost hedges to replace our S&P 500 hedge and the inverse index ETFs that many of you have bought as alternative trades. As you already know, expect more direct shorts, too.

If you'd like to discuss this topic some more, please return to the Memo Musings board. We'll see you again soon — let's have a great five days!

Foolishly,

Jeff Fischer (TMFFischer)

Trades Complete

- **Bristow Group**: We sold all our shares at $49.57 for a 63.6% gain, raising 4.1% in cash.

Guidance Changes

- **StoneMor Partners** : Moves to Buy with a 2.2% allocation recommendation. Please see our last Ketchup Report for tax concerns and other caveats. This stock may not be worth a 2.2% allocation for you if you don't want to deal with the tax implications.

Catch-Up Trades

- **CurrencyShares Euro Trust** : If you haven't already — and if your broker has shares available for shorting — sell FXE short up to a 3.8% position. Ask questions on the FXE board.
- **OpenText** : If you haven't sold to open the November 2012 $50 put/$60 call covered strangle on your shares, you still can, despite lower pricing. Lately, the strangle pays a $3.30 credit.

Coverage & Community

- **Income or a Lower Buy Price?** See Alex340's puts that match *Pro* criteria.
- **Active Retirement:** Our new Retirement Revelry board is off to a fast start.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro's Seventh Ketchup Report: Our Final Three Buys

Published Sep 7, 2012 at 12:00AM

Dear *Pro* Member:

Today's three stocks mark the end of our Ketchup Reports, meaning you should now be armed with the information you need to get invested in our core holdings (those rated "Buy" or "Buy First" on our scorecard). We've now recommended that you build your *Pro* portfolio with 19 of our longstanding stocks and two new buys — **Starbucks** and **American International Group** — along the way, bringing you to 21 total. Here is the full list:

- **Ketchup One: The Buckle** , **Oracle**, **AmTrust Financial**
- **Ketchup Two : Gentex** , **Intel**, **Pacer**
- **Ketchup Three: Rockwood Holdings** , **Tupperware**
- **Ketchup Four: CME Group** , **Broadridge**, **Wells Fargo**
- **Ketchup Five: Apple** , **OpenText**
- **Ketchup Six: BMC Software** , **GrafTech**, **Pebblebrook Hotel Trust**

From here, we'll focus on getting everyone on the same page with our shorts and hedges, and we'll continue to recommend new, timely options trades. We'll also watch for opportunities to get you into the *Pro* stocks currently on hold because of price, suggesting them to you when better price opportunities come along or when we see appealing options strategies.

You're well on your way to building a strong *Pro* portfolio! And in the coming weeks and months, we will see it all come together very nicely. Now, on to today's three companies!

— Jeff Fischer (TMFFischer), *Pro* Advisor

InvenSense

- **Industry:** Microprocessor chips
- **Allocation:** Invest 1.4% of your funds ($700 for every $50,000 you manage in *Pro*)
- **Recent Price/Dividend Yield:** $12.22 / NA
- **Click For:** Original Recommendation; Recent Update

Summary: Motion tracking may have begun as a living-room craze, with family members bowling and playing tennis on their Nintendo Wiis, but the technology is now moving into smartphones, tablets, and even TV control interfaces. InvenSense designs the industry's leading motion-tracking sensors, making it the *de facto* provider for Android, Microsoft, and other (non-Apple) companies. Although games remain important, most of the company's revenue now comes from phones and tablets, and that revenue is jumping year over year. As motion-tracking sensors spread into health-care devices, manufacturing, and even tools, InvenSense has the makings of a long-term winner — as long as it maintains its competitive edge. We're starting with a small position and will add more as the company matures.

Medtronic

- **Industry**: Medical technology
- **Allocation**: Invest 5.4% of your funds ($2,700 for every $50,000 you manage in *Pro*)
- **Recent Price/Dividend Yield**: $41.58 / 2.5%
- **Click For:** Original Recommendation; Recent Update

Summary: Medtronic is the world's largest pure-play medical technology company, manned by 45,000 global employees who generate $16 billion in annual sales. The company furthers its mission ("Contributing to human welfare by the application of biomedical engineering to alleviate pain, restore health, and extend life") with products and technologies to treat heart problems, spinal disorders, diabetes, and a variety of other chronic conditions. Historically, Medtronic invests 9% of sales in research and development, the fruits of which keep its offerings on the cutting edge.

The struggling global economy has crimped procedure volumes and caused Medtronic's customers to demand lower prices. Even so, the company still earns impressive profit margins and returns on equity, though sales growth has been hard to come by lately. Shares are priced as if Medtronic will never grow again; we disagree, given America's aging population (the 60-plus crowd will grow at a 2.9% annual clip over the next decade) and the likelihood that medical care in emerging markets will evolve dramatically. We think shares are worth $48 and believe there is a lot to like about the company.

StoneMor Partners

- **Industry:** Real estate (well, sort of … specifically, cemeteries)
- **Allocation:** Invest 2.2% of your funds ($1,100 for every $50,000 you manage in *Pro*)
- **Recent Price/Dividend Yield:** $23.38 / 10%
- **Click For:** Original Recommendation; Recent Update

Summary: The second-largest cemetery owner in the country, StoneMor Partners has almost 300 properties in nearly 30 states. Thankfully, death care is not a high-growth business, but it is slow and steady, with revenue at the average cemetery going up about 3% a year. StoneMor is set up as a master limited partnership, meaning it pays out its earnings to unit holders (the MLP term for shareholders). This results in a 10% annual yield at current prices, rivaling our North Star even if the share price doesn't budge. However, we want to focus on the caveats here — as an MLP, StoneMor has special tax considerations. You'll need to file a K-1 form every year (members have said it wasn't difficult this year), and when you finally sell your stake, you'll need to pay income tax on the adjusted proceeds. If these tax requirements sound unappealing to you, then don't buy these shares!

This isn't our very favorite position to own, so we may be writing options soon to potentially sell our shares in the upper $20s — but shares have declined lately, so they are attractive for those who don't mind the tax implications (and who don't mind a potential sell in the upper $20s). We do not recommend buying StoneMor in a tax-advantaged account, since that can actually become a disadvantage with a MLP. You should buy it in a regular account if you're able.

Conclusion

Although we're ending on a somewhat subdued note with a cemetery operator (focus on that 10% yield instead!), we hope you've enjoyed our Ketchup Reports. Think of this not as a conclusion but as an exciting beginning: Now that you're catching up at your own pace, we'll be ready to manage our *Pro* portfolio together and work in more new positions, shorts, and options. We're glad you're here, and we're excited to move forward! Of course, if you have any questions, please visit our Office Hours board.

Fool on!

The *Pro* Team

See Pro's *holdingshere. See the team's and David and Tom Gardner's holdingshere.*

Sell Bristow Group

Published Sep 5, 2012 at 12:00AM

- **What We're Doing**: We're selling our shares.
- **What We're Thinking**: During the 2010 Deepwater Horizon disaster in the Gulf of Mexico, this was an opportunistic investment in the leading offshore helicopter services provider. Our thesis has since played out.
- **What We're Expecting**: Flight hours (and Bristow's fleet) will grow thanks to higher demand, but the business's economics are unlikely to change enough to make this one worth owning forever — or even at modestly elevated levels. We'll reconsider it on price dips.

Trade Essentials

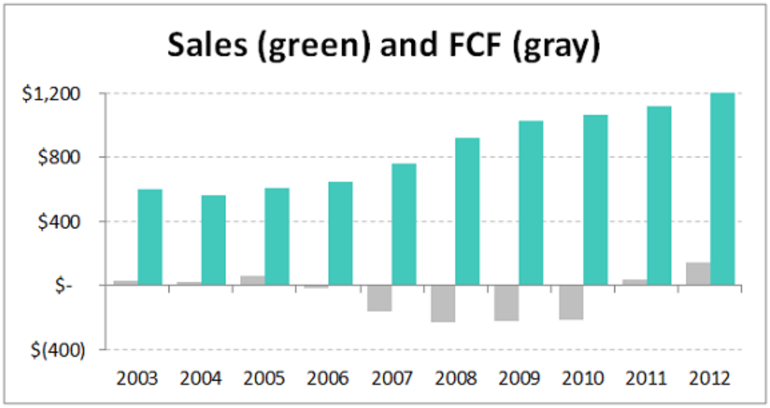
- **Action**: Sell **Bristow Group** (NYSE: BRS)
- **Allocation**: Sell all your shares; for *Pro*, this frees up 4% in cash.
- **Price Guidance**: The stock is volatile and thinly traded. Use a **limit order**, and sell your shares at $48 or higher. There is no rush to sell at any cost; *Pro* will be patient and aim to sell sometime over the next 30 days at $48 or higher.
- **Recent Share Price**: $48.50
- **Alternative Trades**:
  - If you prefer to wait patiently for a better price and are OK with the possibility that you might not sell your shares, you can sell to open December 2012 $50 covered calls.
  - If you wrote $40 puts via our Catch-Up Trades, your expiration month may vary. You have three choices:
    - Buy to close your puts when you've earned about 85% of their value.
    - Let your puts run to expiration and attempt to capture all of the time value.
    - Buy to close your puts today (you should be able to do so at a good profit!). Just know that if Bristow shares dip to around $40, we'll be looking for put-writing opportunities as income trades and to get shares again — in other words, you may have company if you choose not to close your position!

What's New?

In our last review of Bristow Group, we wrote:

"Our Bristow shares are on HOLD. We were attempting to sell them at our $50 estimate of fair value via June $50 covered calls. Now at $40, that possibility seems highly unlikely. [Our] long-term assessment of Bristow holds: BRS is a leader in a growing business but it suffers structural difficulties that will keep it from earning excess returns over the long run. We will continue to look for ways to milk income from this position as we look to redeploy our funds in more dynamic, higher-return opportunities that we want to own for the long run."

Today, shares are bouncing around the upper $40s, up 20% over the past few months, and the option strategies available to us aren't as attractive as we would like. Given the capital-intensive nature of the company's business and its low historical returns on capital, Bristow becomes far less attractive if we can't effectively use it as a (flying) vehicle for income generation. We prefer to own businesses that have an easy go of generating free cash flow, and Bristow simply doesn't fit that mold.



Sources: Analyst estimates and company filings.

The company's recent announcement that it will take a minority investment in Cougar Helicopters should add another stable, contract-based income stream, but it doesn't meaningfully impact our estimate of Bristow's value. Management has done an admirable job putting the company on a successful course; we simply think we can find businesses with better economics that can fly higher.

To that end, we're happy to sell our entire stake in Bristow and deploy that cash toward better long-term opportunities. We will sell at some point over the next two to 30 days, using a limit order (around $48). When we do sell, we'll exit this position with a healthy profit (today we're up 55% in just more than two years, adding $20,400 in portfolio value before dividends and options), and we'll continue to keep tabs on the business and its options.

Next Step

- Bring your questions to the Bristow discussion board.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Shorting Market Indexes in an IRA

Published Sep 4, 2012 at 12:00AM

Dear *Pro* Member,

Trades Complete

- **American International Group**: We bought 1,000 shares at $34.53 for 2.5% stock exposure, and six January 2014 $25 call options at $12, for total AIG exposure of about 3%.
- **OpenText**: We wrote a November 2012 $50 put/$60 call covered strangle on all of our shares, receiving a $3.70 credit.
- **iShares Russell 2000 Index**: Setting up a put ratio spread, we sold to open 56 November 2012 $75 puts and bought to open 28 November 2102 $80 puts, for a combined net credit of $0.09 each.

Guidance Updates

- **AmTrust Financial**: Buy Around and Fair Value decline 10% only in direct relation to the 10% stock dividend paid to us — so, no actual change. See "Coverage & Community" for more!
- **The Buckle**: Moves from Buy First down to Buy on valuation.
- **Pebblebrook Hotel Trust**: Fair Value moves down to $28 from $35 as Nick becomes the analyst covering it, but Buy Around stays at $24.

Catch-Up Trades

- We've published six Ketchup Reports for members in the last six weeks. These should conclude this week! Then we'll resume more options-focused Catch-Up Trades right here every Monday.

I hope you had a great Labor Day weekend and are enjoying the remaining days of summer! Here in Washington, D.C., near Fool HQ, the weather remains hot and muggy — but I spent the weekend in northeast Pennsylvania, where signs of fall are already starting to show in the Pocono Mountains. It was another reminder that there are only four months remaining in 2012, and in that time, we have goals for the *Pro* portfolio that necessitate steady progress on our part and should set us up to do very well in the years ahead.

With that in mind, today I'm going to write briefly about one topic: shorting, or hedging the market, in your IRA. When members ask how to follow one of *Pro*'s shorts in an IRA, we provide a method that's IRA-friendly if possible, but I don't believe that shorting always makes great sense in your IRA.

Why We Short and Hedge

Pro shorts weak companies or flawed ETFs to profit no matter what the market does. If you can do *that* in an IRA with us, you should. But we hedge and short *market indexes* — like the S&P 500 — simply to protect some of our gains should the market decline. Shorting a major index is like locking in a profit we already have by taking the opposite position on the market. If the market keeps going up, then the un-hedged portion of our portfolio should keep us firmly in the green. But if the market declines, we know our index short will turn profitable, off-setting losses elsewhere to the extent we're hedged.

Our stated objective in *Pro* is positive returns over any rolling three-year period, but even when the portfolio is up over a much shorter period, we may be inclined to hedge some recent gains. Our North Star (inflation plus 7%) has historically never had a negative year, and this year it will run at around 10%. If we want to stay close to it, we need to perform as consistently as possible. Therefore, we'll often hedge our shorter-term gains in hopes of staying green if the market doesn't. This is why we set up market index hedges.

The *Pro* portfolio is up about 11% this year. If the market were to decline about 8% from here, our portfolio — without hedges — would likely turn back to red on the year, because most of our stocks are more volatile than the S&P 500. We want to stay green, so we hedge. Today, we're more than 30% hedged, so even if the market falls about 10% from here, we *should* remain in the green on the year. This is why we have basic index hedges in place right now (while seeking more specific shorts). We are aiming to invest true to our stated objective of absolute returns; we're aiming to stay positive the same way our North Star does.

Does it make sense for you to do the same in your IRA if you're 10 or 20 years from retirement? Probably not; you likely don't need to worry about hedging the tax-advantaged, long-term IRA savings you don't plan to touch for another decade or two. Why not? Because your IRA money is (presumably) your ultimate retirement nest egg, so you want it to grow as unencumbered as possible. You want it to compound — not necessarily today or tomorrow, but over the next decade or two. So why bother crimping it with index hedges today?

Pro for Now, IRAs for Later

Pro is a "living" portfolio, not a retirement portfolio. It's managed in much the same way I've managed my own living portfolio over the past 10 years. I've used it to earn income, and I've sought to protect its capital because it's a foundation for the many things I want to do *before* retirement: places I want to travel, experiences I'd love to have, schools to pay for, parents to help, cars and a home to maintain, charitable gifts, emergencies, and any shortfalls. All of that comes from my living portfolio, which is a savings account that is actively invested — long, short, and for income. My IRA accounts, on the other hand, I'm setting aside until at least 20 years from now (I'm 42), so they're 100% invested long. They're by far the least actively managed accounts I have. I buy great businesses, watch them, but mostly let them be.

I wanted to share my approaches to these different accounts because I realized last week more than ever that many *Pro* members are hedging market indexes in IRAs. If you have a good reason to, please continue. But if this Memo makes you rethink that approach, then do so. If you want to short weak companies directly to profit in an IRA, that's one thing, and I support it, but I'd typically advise against hedging with market indexes unless you need a certain amount of money from your IRA, guaranteed, over the next few years. And if that's the case, then you should just set that cash aside right now anyway, outside the market! In short (sorry), I urge you to rethink shorting market indexes in your IRA (and buying inverse ETFs for that matter, too). To my way of thinking, vanilla hedges don't make great sense in a long-term retirement account.

If you want to discuss this topic, please visit the Memo Musings discussion board. We also set up a new board today for members to discuss retirement issues, tips, challenges, and strategies: Enjoy *Pro's* new Retirement Revelry board.

— Jeff Fischer (TMFFischer)

Coverage & Community

- **Pebblebrook Streams Along:** Nick provides an update on the hotel REIT's operations.
- **AmTrust's Stock Dividend:** Bryan has the scoop on the 10% in additional shares we all just received as a special stock dividend.
- **Stock Market Looks Attractive?** Member FoolSolo launches a great discussion on this topic.
- **Putting on the Puts:** alex340 shares put-writing trades meeting our pricing guidelines.
- **Do You Know What You Need to Know?** Nick shares what everyone ought to know.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro's Sixth Ketchup Report: Three More Buys

Published Aug 31, 2012 at 12:00AM

Dear *Pro* Member,

Welcome to our penultimate Ketchup Report! You can access our five previous reports here, here, here, here, and finally here. This week's report contains three more stocks, leaving us with one more report for next week; then, once all of our core investments are made, we'll move into more hedges and shorts. (We already issued one brand-new hedge for all members this past week, on the **iShares Russell 2000**.) As always, take your time. We invest to grow our money over the coming years, not just months.

Now, on to this week's stocks! Today's attractive lineup consists of a diverse batch of businesses to add to your *Pro* portfolio: a software provider, a well-run steel industry company, and an owner of new, upscale hotels (which you may want to visit!). On to your recommended investments!

— Jeff Fischer (TMFFischer), *Pro* advisor

Your Next Buys

BMC Software

- **Industry**: Enterprise software
- **Allocation**: Invest 4.7% of your funds ($2,350 for every $50,000 you manage in *Pro*)
- **Recent Price/Dividend Yield:** $41.20 / N/A
- **Click For:** Original Recommendations; Latest Update

Summary: Named after the initials of its three founders, BMC counts most Fortune 500 companies among its customer base. It sells software and services that tie together corporate mainframes, computing clouds, applications, and databases so they work smartly and efficiently as one; by optimizing hardware performance, BMC helps technology run smoothly. The company's young cloud-computing and Software as a Service (SaaS) divisions are growing rapidly, but its older enterprise server management software sales have been weak. However, recurring maintenance revenue helps keep total revenue steady, and we expect stronger results from the core older divisions over the next 12 months.

You may have noticed that the *Pro* portfolio is a bit "overweight" in software stocks. This is intentional: Software businesses have strong recurring revenue, healthy margins, and staying power, and we're investing in leaders in different key niches of the enormous industry.

GrafTech International

- **Industry**: Graphite products
- **Allocation**: Invest 2.3% of your funds ($1,150 for every $50,000 you manage in *Pro*)
- **Recent Price/Dividend Yield**: $9.36 / N/A
- **Click For:** Original Recommendation; Latest Update

Summary: GrafTech International is a low-cost producer of high-quality graphite electrodes. Those electrodes are used for high-efficiency steel production in electric arc furnaces (EAFs), and that steel helps build things like automobiles and replicas of Jeff's steely eyes. We believe EAF steel production will continue to grow in popularity because it's greener and cheaper than traditional methods, which should pull along demand for GrafTech's electrodes.

GrafTech is a volatile stock that bobs and weaves based on expectations for the global economic cycle (and steel demand in particular), but we believe the company's cost structure, know-how, and scale provide it lasting advantages over competitors. Shares are currently priced as if our stalled economy will never regain a forward push, making now a great time to start a position in GrafTech. Today's prices should reward patient buyers — we think shares are worth $16, and will consider adding to our small position over time. (We'll send new trade alerts in that case, of course.)

Pebblebrook Hotel Trust

- **Industry**: Real estate investment trust, focused on hotels
- **Allocation**: Invest 4.3% of your funds ($2,150 for every $50,000 you manage in *Pro*)
- **Recent Price/Dividend Yield:** $23.52 / 2%
- **Click For:** Original Recommendation; Latest Update

Summary: Pebblebrook CEO Jon Bortz knows hotels, so when he saw the fire sales in the industry during the financial crisis, he came out of retirement to start Pebblebrook Hotel Trust. The company has since busied itself buying cheap, marquee, luxury urban hotels in foreclosure and giving them new life. Pebblebrook now owns 18 hotels and has a 49% stake in six others. Several of them have been renovated and revamped to become strongly profitable, and we expect that to happen to all of Pebblebrook's properties in time. These profits should materialize into a growing dividend for shareholders. At the same time, Bortz continues to scout for more upscale hotels at temporarily cheap prices.

Still enjoying its early growth stage, the trust trades at a reasonable 18 times adjusted funds from operations (a measure of a REIT's cash flow) and at a discount to our $28 fair value estimate. Bank lending for large real estate deals remains tight, so even upscale property prices are attractive for those who *are* able to buy, like Pebblebrook, which launched opportunistically with zero properties in 2009. This recommendation is a good way to get some real estate diversification into your portfolio.

Questions?

You may make these investments at any time. And we'll have one more Ketchup Report for you next week, with a few more positions to recommend. If you have questions on this one, please post on the Getting Started discussion board. And we're available every weekday from 3 to 4 p.m. ET to answer your questions on the Office Hours board! We're very glad you're a *Pro* member. Enjoy your long weekend!

— The *Pro* Investing Team
Jeff Fischer (TMFFischer), advisor
Nick Crow, CFA (TMFCrow), senior analyst
Bryan Hinmon, CFA (TMF42), analyst

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Set Up a Put Ratio Spread on IWM

Published Aug 29, 2012 at 12:00AM

What We're Doing: Using options, we're setting up a market hedge that won't cost us anything if the market keeps rising.

Trade Essentials

- **Action:** Set up a put ratio spread on the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF
  - Sell to open November 2012 $75 puts
  - Buy to open November 2012 $80 puts
  - Sell two $75 puts for every $80 put you buy
  - Bid (on two $75 puts) / ask (on one $80 put): $3.08/$2.98
- **Price Guidance:** Use a spread order for a **net credit** of $0.10; as prices change, ideally initiate the spread for, at worst, zero net cost.
- **Recent ETF Price:** $81.33
- **Allocation (based on the written puts):** Thirty percent, half of which is insured by our purchased puts, making our true exposure 15%. Write two puts and buy one put for every $50,000 you manage. *Pro* is writing 56 puts and buying 28.
- **Alternative Trades:** None like this. This is a unique strategy that requires put-writing in a margin account. You could instead just buy to open the $80 puts with your own capital, but that's relatively expensive, with a break-even point 5.3% lower, so we don't advise it. You could short shares of the ETF directly if your broker has shares, but realize that hedge will cost you if the market rises.
- **Your Other Index Hedges (including SPY, SH, and previous iterations of IWM):** This put ratio hedge can be set up in addition to any index hedges you already carry. We'll have separate guidance on those another time.

The Big Picture

We want to have hedges on the stock market, but we don't want all of those hedges to drag on our returns if stocks continue to rise. To achieve these goals, we're returning to a strategy we've used before — a put ratio spread — on an ETF we've hedged with before: the **iShares Russell 2000 Index** (NYSEMKT: IWM). This ETF tracks the 2,000 small companies in the Russell 2000 small-cap index, a vehicle whose components sport a median market value of only $473 million; that small size explains why the ETF tracking them has been 35% more volatile than the S&P 500.

Such volatility potentially benefits us because this put ratio spread is a "frictionless hedge," meaning it won't cost us anything if stocks continue to rise, but we can expect a larger relative drop in the ETF if the S&P 500 falls. Meanwhile, the Russell 2000 looks overpriced compared with the S&P 500, with the profitable companies in this small-cap index trading at an average 24.4 times earnings (the average P/E number for the larger companies in the S&P 500 is 15). The many *unprofitable* companies in the Russell 2000 are left out of its valuation altogether.

Strategy Details

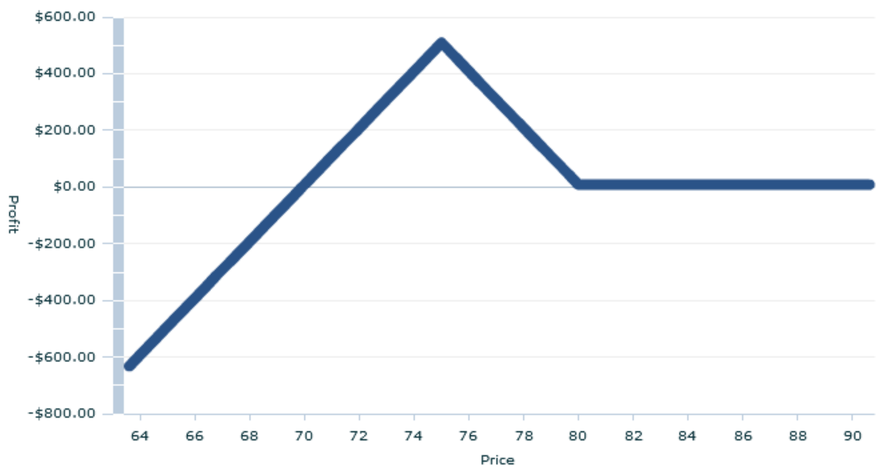
Using a spread order, we are writing $75 puts that obligate us to buy shares of IWM (unless we close the puts beforehand) if they decline to less than that price by expiration. These puts expire in November. We're using the money we receive for writing these puts to *buy* half as many $80 puts that expire the same month. That's where our hedge comes in: The $80 puts will profit if IWM declines, and they also cancel out half of our $75 put exposure, lowering our total break-even point on the strategy. Here's how the math and potential returns tally:

iShares Russell 2000 Index ETF Price	Value of 1 Purchased $80 Put	Value of 2 Written $75 Puts	Our Total Return (or Loss) on 1 Ratio Spread	ETF Price Change (%)
$80 or higher	$0	$0	$0	N/A
$79	$1 x 100 = $100	$0	$100	(2.8%)
$77	$3 x 100 = $300	$0	$300	(5.3%)
$75	**$5 x 100 = $500**	**$0**	**$500**	**(7.8%)**
$73	$7 x $100 = $700	($2) x $200 = ($400)	$300	(10.2%)
$71	$9 x $100 = $900	($4) x $200 = ($800)	$100	(12.7%)
$70	**$10 x $100 = $1,000**	**($5) x $200 = ($1,000)**	**$0**	**(13.9%)**
$68	$12 x $100 = $1,200	($7) x $200 = ($1,400)	($200)	(16.4%)
$65	$15 x $100 = $1,500	($10) x $200 = ($2,000)	($500)	(20%)

The bolded lines above show that we'll earn the most profit on the strategy if these puts expire with the ETF at $75, or down 7.8% from its recent price. Our break-even on the strategy is $70 per share, so the ETF can decline 13.9% before our strategy starts to show a loss by expiration. To summarize:

If the ETF (i.e., the Market) Does This ...	Then Our Strategy ...
Goes up, stays steady, or declines less than 1.6%	Doesn't cost us anything — in fact, we earn any credit paid to us when we initiated it.
Declines at least 1.6% and as much as 13.9%	Earns a partial to full profit, depending on the amount of the decline.
Declines more than 13.9% to less than $70	Shows a loss by expiration. We can close the options; take shares of the ETF; close the options and buy calls; or set up a synthetic long to lower our cash outlay and turn bullish.

For visually minded Fools, here's the profit graph on the smallest position possible, writing two puts to buy one:



The above returns won't occur smoothly or immediately. The chart represents returns *at expiration*. If the market falls before then, our spread will largely retain its current value, with the two sides of the spread mostly canceling each other out. As with most spreads, we need to wait until close to expiration to achieve results; we'll see our full profit in November if the ETF is down 7.8%. If the ETF falls more than 13.9%, the defensive benefit of this strategy disappears and we'll need to be ready to buy shares of IWM, or take other action. Basically, we're hedging against a market decline of less than 13.9% by November expiration.

Perhaps best of all, assuming we set it up for a credit, this trade will result in a small profit for us even if the market rises or treads water. But to be safe, you must be ready to fulfill the $75 put obligation if the market falls out of bed and can't get up.

Next Steps

- **Questions or comments? Need help setting it up?** Visit our iShares Russell 2000 Index discussion board.
- **Get more ETF info:** us.ishares.com
- **Follow it:** Add iShares Russell 2000 Index to My Scorecard.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on Covanta Holdings

Published Aug 28, 2012 at 12:00AM

What We're Doing: Seeking option income on our sleepy waste-management company.

What We're Thinking: We've owned Covanta for more than a year, and writing covered calls (followed by writing puts if our shares are called away) is likely the best way to squeeze more returns from it right now.

What We're Expecting: Unless natural gas prices soar, the stock will probably stay in a range conducive to option income — in addition to its 3.4% dividend.

Trade Essentials

- **Action:** Write covered calls on **Covanta Holdings** (NYSE: CVA)
    - Sell to open December 2012 $17.50 calls
    - Recent bid/ask: $0.65/$0.80
- **Price Guidance:** Aim for $0.70 per contract; as prices change, ideally accept no less than $0.60.
- **Allocation:** Write one call for every 100 shares you own (for *Pro*, that's 27 contracts).
- **Recent Stock Price:** $17.30
- **Stock Rating:** Hold
- **Alternative Trades:** If you own fewer than 100 shares, do nothing and continue to hold. If you don't own any shares, you can sell to open December $17.50 puts, one for every 100 shares you could buy, up to a 3.1% allocation (so, sell one put for every $52,000 you manage). This nets you a potential buy price of around $16.50, close to our $16 "Buy Around." Or, wait and buy shares closer to $16 if they decline and we return it to "Buy."

What's New?

- **Original Recommendation:** On July 15, 2011, we recommended a 3% stake. Since then, we've moved our Buy Around price down $1.50 to $16 and our fair-value estimate down to $22.

Covanta Holdings (NYSE: CVA) turns trash into energy, burning millions of tons of daily refuse and selling the steam to utilities. With its facilities running near capacity and approximately three-quarters of its waste revenue under long-term contracts (with inflation clauses), the business is stable and reliable. But it's also fairly sleepy.

Revenue and free cash flow are flat this year, which is actually a tribute to strong management in the face of multiple headwinds (lower trash volume, lower energy prices, lower metal recycling prices, and lower tip fees -- cash collected when trash is accepted for incineration without a contract). By cutting costs, recovering more metals, and adding to plant capacity, Covanta has generated healthy cash flow, bought back shares, and doubled its dividend this year for a current yield of 3.47%.

Despite all this, shares are likely to remain range-bound given the slow nature of the business. And importantly, Covanta's recent large investments in new plants and contracts have lessened the likelihood of it being an acquisition target or being taken private at a premium. We continue to admire the company and are comfortable holding shares, but in seeking a better chance for North Star-challenging returns of at least 10% annualized, we're adding options to the stock.

How to Follow Along

If, like us, you've owned shares for longer than one year, you can write any covered calls (even near-the-money ones like these) and have the whole trade qualify for long-term tax treatment if your shares are sold via your calls. "Sell to open" one call for every 100 shares you already own. Here are some details:

Covanta Stock Price:	$17.30
Sell to open December 2012 $17.50 calls:	Receive $0.70 per share
Trade Type:	Income; Defensive
Yield on Current Share Price:	4%
Downside Cushion:	The same -- 4%
Days to Expiration:	116 days (nearly four months)
Upside to $17.50 Strike Price:	1.1%
Potential Net Sell Price (including premium):	$18.20
Upside to Potential Net Sell Price:	5.2% (from current price)

If you don't own any shares of Covanta, you can wait for the price to dip closer to $16 to consider a 3.1% stake, or write December $17.50 puts to set up a potential start price of around $16.50. Sell to open one put for every 100 shares you would buy. If our shares are ultimately sold through covered calls, then — assuming we have space in the portfolio — we'll next consider writing puts. This slow but stable, steady business with its healthy yield should remain a lower-risk income target for *Pro* compared to many other stocks out there.

Next Steps

- If you have questions, please visit the Covanta Holdings discussion board.
- There you'll also find our latest Covanta company review.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Write a Covered Strangle on OpenText

Published Aug 27, 2012 at 12:00AM

What We're Doing: Generating income with the potential to buy more shares cheaper.

- **Action:** Use a strangle order to write options on **OpenText** (NASDAQ: OTEX):
    - Sell to open November 2012 $50 puts
    - Sell to open November 2012 $60 calls
    - Options' combined bid/ask: $4.25/$4.75
- **Price Guidance:** Aim for a combined **credit** of $4.50. As prices change, ideally accept no less than $4.
- **Recent Stock Price:** $53.50
- **Allocation:** Write one call for every 100 shares you already own, and one put for every 100 additional shares you could buy. *Pro* is writing seven contracts of each, covering our 700 shares and potentially increasing our position from 2.6% to around 5% (accounting for some depreciation). You need a portfolio size of approximately $200,000 to strangle a potential 5% position around $50.
- **Alternative trades:** If you don't own shares, buy a 2.6% stake and then write the strangle (assuming you're managing $200,000 or more). If you're managing less money, just buy a 2.6% stake and add more if we do (if shares fall below $50).

The Big Picture

An astounding 90% of content on the Internet is private, kept behind firewalls on corporate and government servers. And all of it is begging to be managed effectively. Luckily, there's a software industry here to save the day: Enterprise information management (EIM) is its name, and its leader is OpenText, a young company helping the world to organize and utilize its data-stuffed hard drives. Not only that, OpenText software ensures that the company's clients adhere to the numerous rules and regulations governing them, and its efficiency saves them money.

Analysts expect the EIM industry to grow by about 10% annually, and OpenText trades at 10.1 times expected non-GAAP earnings for the fiscal year ending June 2013, making it an attractive long-term investment. We analyzed its recent results on the discussion boards, so today, let's focus on the trade.

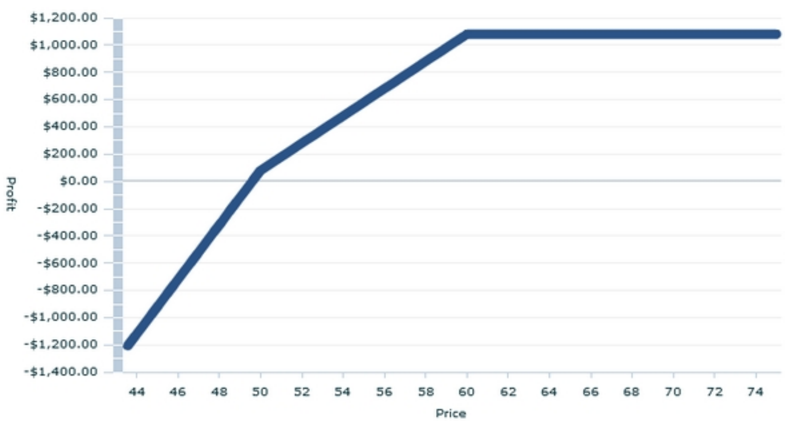
How to Follow Along

Writing a covered strangle is a combination of two strategies: writing covered calls on a stock you own, and simultaneously writing puts to potentially add to your shares. It provides meaningful income and a wide share price range in which to earn it.

- **Strategy type:** Income with stock upside potential
- **Maximum gain:** The credit received plus upside in the stock to your call strike price
- **Maximum loss:** The same as stock ownership

Here's a look at how the numbers on this trade play out (along with a profit chart, which assumes a strangle of 100 shares bought today):

- **First:** Own or buy at least 100 shares with an ability to double it to 200
- **Sell to open:** November $50 puts/$60 calls using a strangle order
- **Allocation:** Sell one of each option for every 100 shares you own
- **Receive credit of around:** $4.50 combined (this is all "time value," so it decreases literally by the day unless volatility spikes)
- **Net potential sell price on existing shares:** $64.50
- **Net potential buy price on new shares:** $45.50
- **Recent share price:** $53.50
- **Upside to net sell price:** 20.5%
- **Downside to second net buy price:** 14.9%
- **Range in which to earn total income:** $50-$60
- **Yield on share price ($4.50/$53.50):** 8.4%
- **Yield on share price and 30% buying power to hold puts:** 6.5%
- **Days to expiration:** 82



Remember that every option represents 100 potential shares of stock, which is why you need to have about $200,000 under management to set up a 5% covered strangle on OpenText. You would own 100 shares at a cost of about $5,350, and you'd write puts to buy 100 more shares at a cost of around $5,000 more ($10,350/$200,000 = 5.1%). If you're investing with less, just buy enough shares for a 2.6% allocation to start, as we mentioned in last week's Ketchup Report. Finally, a $4.50 credit is an ideal start price today if you can obtain it, but it's likely you'll need to accept less — eventually down to $4 — as time ticks away and option sellers (including our members) appear.

Next Steps:

- Want to know everything there is to know about covered strangles? We can tell you everything there is to know about covered strangles.
- If you have any questions about writing this strangle or starting a position, visit our OpenText discussion board. Remember, you don't need to make every trade in *Pro* to benefit. Own our core positions in sizes suitable to you — that's our core strategy.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

The Easy, Breezy Lowdown on Coming Trades

Published Aug 27, 2012 at 12:00AM

Fellow Fools,

Your Next Memo: Tuesday, Sept. 4

We're squeezing one last day out of summer, Fools — Fool HQ is closed for Labor Day, so watch for your next Monday Memo on Tuesday, Sept. 4. Happy grilling!

With earnings season all but behind us, I've turned my focus to reviewing everything we learned in the latest quarter — and the *Pro* portfolio decisions that will arise as a result. Last week, we announced two new buys: **Starbucks** and **American International Group**. Over the coming days and weeks, expect several more trades in your inbox. We've analyzed this quarter's results, and we're ready to align the portfolio more closely with the renewed objectives we outlined in our recent Monday Memo video.

Speaking of which, let's review our **broad portfolio objectives**. We want to:

1. Maintain a **focused portfolio** of about 20 to 24 core holdings — positions so strong that if all you do with *Pro* is own these, you should do very well.
2. Profit from sensible, steady **income trades**, averaging around 12 a year (at least).
3. Build out a **focused short portfolio,** betting against failing companies and ETFs and using **low-drag option hedges**.
4. Keep **cash** on the sidelines for the opportunities that always — inevitably, joyfully — arrive.

When considering these objectives, keep in mind that *time frame is everything*:

- We buy stocks with at least a two- to three-year outlook; we expect our companies to do well over that period (and ideally longer). But we have no idea how stocks will perform over the coming year or so — short-term results can be driven by any random market force.
- Our income trades should usually pay us within three to six months; once we have enough of these trades in place, we should generate income most months.
- We usually target our hedges and shorts for 12 months or less; however, some shorts (of failing companies or flawed ETFs, as opposed to most option hedges) may be held for years.

A Foolish reminder as more *Pro* Trade Alerts magically appear in your inbox: Take your time. Don't fret. Ask any questions about the trade on its dedicated discussion board, or on our Office Hours discussion board. Don't let investing add any extra stress to your life — instead, remember that we're here to build real value over time (just as many of us have for decades!), and small day-to-day price changes don't matter. And if circumstances don't allow you to make every trade right now, don't worry. I'll repeat: If you just own the majority of our stocks, you should do very well. And when you're ready to use options and shorts, we're here to help you make money with those strategies, too.

Alongside Trade Alerts, expect another (perhaps final) Ketchup Report this week. (You can see the most recent one here, with links to the previous four.) After this week, we'll have highlighted all of our current Buy First and Buy stocks in these reports, so we'll move on to shorts and hedges that can be placed now, as well as new options trades. As for stocks currently on hold, we'll get you into those positions at better prices when possible — if we don't sell them first. Watch your upcoming Monday Memos for individual "Catch-Up Trade" opportunities down the road.

Finally, in weeks ahead we'll continue to address Memo topics you've requested. If you have others, please share them. Thank you for being a *Pro* member! Have a great week; we'll see you in your inbox and on the boards!

-Jeff Fischer (TMFFischer)

Trades Made

- **Starbucks** : *Pro* purchased 1.4% (400 shares) of its pending 2.5% stock position at $47.47, and we "sold to open" four of our pending eight January 2013 $47 puts for $3.35 each. We have more than three weeks remaining to complete these trades.

Guidance Updates

- **Covanta Holdings**: Moves from Buy to Hold on valuation.

Catch-Up Trades

- None this week. Watch for a new Ketchup Report in your inbox.

Coverage & Community

- **Fools Ring the NYSE Bell!** To celebrate The Motley Fool's upcoming Worldwide Invest Better Day, David and Tom Gardner joined a motley clan of smiling Fool members to ring the NYSE opening bell Friday. Check out the video!
- **Earnings:** Sleepy dividend stock **Covanta Holdings** is executing very well, but we're moving it to Hold on valuation.
- **AIG's Price:** Members discuss fair value.
- **Consider Your Options:** Alex340 shares put options that match *Pro* criteria.
- **Bryan Recommends Brian:** Our own Bryan Hinmon gives a thumbs-up to Brian Stoffel's short column on keeping your priorities in life aligned.
- **Get the Buzz:** Jeff shares the advice he once gave to Starbucks CEO Howard Schultz and celebrates lower coffee bean prices (for Starbucks, not for consumers!).
- **Planning Ahead:** Earnings again? TMFMoosie is already providing the calendar for next quarter. It can help you with any independent option trades you're considering.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy AIG Stock and Warrants

Published Aug 24, 2012 at 12:00AM

- **What We're Doing:** We're buying an unpopular insurer for less than its book value.
- **What We're Thinking:** We'll earn North Star-thumping returns just for holding while time and average business performance heal AIG's wounds. We'll do even better if it regains a shadow of its former brilliance.
- **What We're Expecting:** AIG will slowly improve its underwriting, buy back shares from the U.S. Treasury at a discount to book value, and earn average returns on equity.

Trade Essentials

- **Action:** Invest 2.5% of your funds in **AIG** (NYSE: AIG) and 0.5% in **AIG warrants** (NYSE: AIGWS), investing 3% of your funds in total. ***Pro* will buy calls, not warrants**; for details, please see our alternate trade and the "Warrants" section of this report.
- **Buy Around:** Shares, $34.50; warrants, $13 (but you must use a **limit order** at current prices for the warrants, which are thinly traded)
- **Stock Fair Value:** $50
- **Status:** Buy First
- **Alternate Trade:** If you're not buying the warrants, use 0.5% of your funds to "buy to open" January 2014 $25 calls on AIG (**because we can't track warrants on our scorecard, this is the trade *Pro* will be making**), alongside your 2.5% stock purchase.

The Big Picture

Not long ago, insurance behemoth **American International Group** (NYSE: AIG) helped to nearly bring down the world's financial system. Four years later, this former disgrace is a very different company — and we're ready to buy shares.

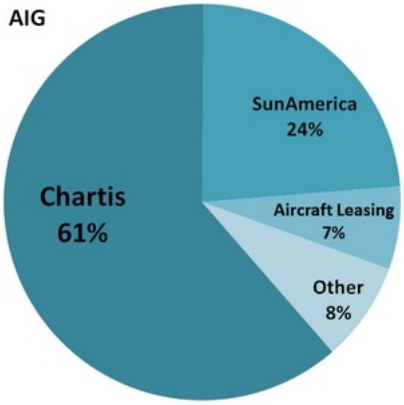
To prove we're not crazy, let's briefly review how AIG became the business it is today. Before the crisis, financial companies insured risky investments (for example, mortgages with high potential for default) with AIG. They then off-loaded those risky investments to AIG through swaps and other derivatives. AIG, for its part, linked and greatly concentrated those risky investments, destabilizing the whole system.

At the height of the crisis, the Federal Reserve (and later the U.S. Treasury) provided $182 billion in bailout funds to support the financial system through AIG. As an insurance company, AIG was a primary conduit for linking banks; in total, 16 banks' credit default swaps (instruments used to insure against bad debt) were made whole thanks to the intervention. In other words, by bailing out AIG, the Fed also supported the world's largest, most interconnected banks. When the dust settled, U.S. taxpayers owned the majority of AIG — and the financial system survived.

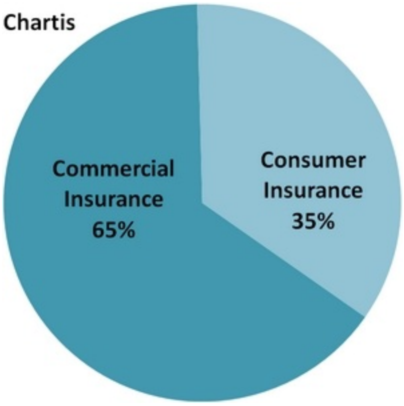
Today, we're able to buy shares from a motivated seller. The Treasury is only interested in making a small profit (along with appeasing other political concerns), so it's actively selling its large stake for less than what we think AIG is worth (not to mention less than book value).

The Business

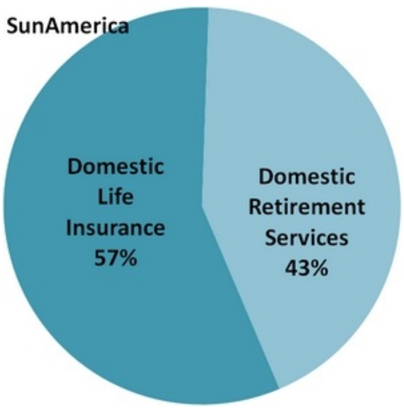
We can't stress it enough: Today's AIG is not the same company it was in 2008. The nasty derivatives that nearly brought down the financial system are gone; to reduce its exposure to derivatives and pay off the Fed and the Treasury, AIG has divested itself of whole business units, managing to eliminate 95% of its previous exposure to derivatives. Left behind are just two steadfast insurance businesses and an aircraft leasing company.



The first insurance company, Chartis, offers property and casualty insurance to commercial clients and consumers. Commercial products and services are typically sold through brokers; offerings there include casualty, property, and financial insurance, as well as specialty insurance like aerospace, environmental, and marine. AIG is focusing on growing the smaller but more profitable consumer division, where offerings include accident and health and life insurance policies, sold through agents and directly to consumers online.



The other insurance company is called SunAmerica; it provides domestic life insurance and retirement products including annuities, mutual funds, and financial planning. Products are distributed through a diverse network of financial-services companies, brokers, agents, and advisors.



Aircraft leasing, at 7% of AIG's total revenue, is the third largest single division. We (and many others) believe that AIG will eventually monetize this profitable business, potentially spinning it off in an IPO, or possibly sell it.

Management

The guys who blew a hole through AIG in 2008 aren't the same ones cleaning it up today. The entire company has been turned over; even Edward Liddy, the former Allstate chief the Fed picked as CEO and chairman during the bailout, resigned just eight months into the job. Former MetLife CEO Bob Benmosche continued where Liddy left off — and he's exactly what AIG needed. Benmosche knows insurance inside and out following a lifelong, successful career; he's tough, he's scrupled, he's brash, he speaks openly and honestly ... in other words, his style matches perfectly with the high level of disclosure expected of AIG from now-strict regulators and the company's largest shareholder, the U.S. taxpayer.

Benmosche is currently undergoing treatment for cancer, and while he's still running 15 to 20 miles a week, we count his health and future tenure as risks. We benefit the longer he stays on, but CEOs are in place at each of AIG's major businesses, too, so there's unlikely to be much disruption if the worst does occur.

Financials and Valuation

Neither of the insurance companies within AIG match the caliber of beloved *Pro* holding **AmTrust Financial Services** (NASDAQ: AFSI), but that shouldn't surprise you. AIG is still emerging from the crisis, and it's much larger — AmTrust did $1.4 billion in revenue last year, whereas AIG rang up nearly 46 times that much. That large size keeps AIG away from niche insurance, which is AmTrust's profitable edge; instead, it writes much less attractive policies in more competitive arenas. Check out AIG's combined ratio below, a measure of insurers' profitability — lower is better, so you can see that AIG has struggled at 102 (AmTrust compares at a recent 89).

Metric	Q2 2012	Q1 2012	FY2011	FY2010	FY2009
Total Revenue	17,123	18,443	64,255	77,798	76,645
Operating Income	2,716	5,558	5,806	8,526	3,132
Net Income	2,332	3,208	17,798	7,786	-10,949
Book Value	105,641	104,465	114,329	113,673	99,035
Book Value per Share	$60.58	$57.68	$55.33	$52.25	$34.46
Loss ratio	68.9	68.0	78.3	85.7	78.6
Expense ratio	33.5	34.1	30.7	31.1	29.4
Combined ratio	102.4	102.1	109	116.8	108
Excluding Catastrophic Losses			99.8	113.5	

Source: S&P Cap IQ. Numbers in millions, except per share.

But Benmosche is turning that around. A recent partnership with Johns Hopkins University is helping AIG analyze its tremendous data troves, leading to more accurately priced insurance. With time, we expect the combined ratio to improve, bringing earnings up and the share price with it.

Metric	Multiple
P/E	2.96
P/B	0.56
ROA	0.9%
ROE	8.9%

Source: S&P Capital IQ.

Even after all this, you may still be wondering: Why is *Pro* buying an average insurer with a history of financial mass destruction? The answer is simple: Any asset can make a great investment at the right price. AIG is trading at $0.56 per dollar of trustworthy book value, and the market is undervaluing its turnaround because it's afraid of past complexity and of the potential difficulties of the Treasury's still-enormous stake in AIG. But that overhang isn't a long-term ceiling on the share price — it's a source of future profit for us.

Again, the Treasury only wants to sell at a profit; it isn't interested in maximizing value. The government's breakeven price is $28.72, so it's been selling at $29 and above. AIG has been buying billions of dollars' worth of its own stock at those prices — and every dollar AIG allocates to buying back those discarded and discounted shares increases book value.

We used a number of different methodologies to value AIG. So many insurance companies are trading at less than book value that — even with regulators deeply involved — we didn't feel comfortable giving AIG credit for its full book value. Instead, we viewed the company as the combination of an average property and casualty insurer, an average life insurer, and an average aircraft leasing company, and gave no credit for buybacks. Under those parameters and using an average multiple for the comparable pure-play companies, AIG should trade for just more than 0.9 times book value, or about $55.

But until AIG can generate consistent underwriting profits, that figure is arguably too high. Next, I (Nick here) turned to an excess-return valuation model, which uses return on equity, book value, and an implied dividend-discount model. This allowed us to ding the company's valuation because AIG's returns are lower than its cost of capital. Under this model, one conservative scenario values AIG at $46. AIG is currently trading at about $34, meaning both models give us a hefty margin of safety for a purchase today — and demonstrate the value AIG is getting on its repurchases.

Warrants

In addition to shares, we originally planned to purchase 0.5% worth of AIG warrants. As it turns out, our scorecard doesn't have the technological capability to track warrants (we're told it would break the software), so we can't buy them — but that doesn't mean you can't. A quick explanation of warrants: In this context, they have nothing to do with criminality; rather, warrants are like call options, except they're issued by the underlying company. In January 2011, AIG paid shareholders a dividend in the form of warrants, allowing for the purchase of $75 million worth of shares at $45 each. That $45 strike price adjusts favorably in the event of dilution or annual cash dividends greater than $0.675 per share (which would also lower the share price). These warrants don't expire until Jan. 19, 2021 (!), and they trade on the NYSE under the symbol AIGWS. Warrants are illiquid, and Goldman Sachs is the designated market maker for them; when you buy them, be sure to **use a limit order** so Goldman doesn't get more than a fair price (recently near $13).

Be aware that if our investment in AIG works out, those who own warrants will earn leveraged returns on them. If we're wrong, though, the warrants will be a total loss, because they're out-of-the-money.

Instead of warrants, *Pro* is going to purchase ("buy to open") January 2014 $25 calls on AIG alongside our 2.5% stock purchase. There is, of course, a big trade-off here: With the call options, there are less than 18 months left for the thesis to play out, compared with 8.5 *years* for the warrants. And the calls don't benefit from anti-dilution adjustments. Because of these disadvantages, in-the-money call options make the most sense for us. Here is a comparison between the warrants, our soon-to-be purchased $25 calls, and the January 2014 calls with the same strike price ($45) as the warrants we suggest you buy.

Metric	January 2021 $45 Warrants	January 2014 $25 Calls (*Pro* Will Buy)	January 2014 $45 Calls
Strike Price	$45	$25	$45
Days Till Expiration	3,070	511	511
Premium	$12.95	$11.75	$2.38
Time Value Per Day	$0.004	$0.005	$0.005
Breakeven	$57.95	$36.75	$47.38
Maximum Loss at $33	$12.95	$3.75	$2.38

Source: Analyst calculations.

You'll notice the breakeven prices are very different, but keep in mind that they occur in very, *very* different time periods. The warrants are the way to go, but if you're more comfortable mirroring our trade, you can purchase the same calls we will instead. Please know we don't want to confuse you — we want you to make the best, most profitable trade possible. We think that means buying the stock and the warrants, even though *Pro* can't make the second part of that trade ourselves right now. As mentioned, we'll buy the stock and the January 2014 $25 calls instead.

What Would Make Us Sell

Our thesis hinges on buying AIG for less than it's worth. It is bolstered by our expectation that AIG will continue to buy back its own shares from the Treasury at a discount, which increases book value. If we later learn that book value is overstated and the shares are thus no longer discounted, we will want to sell. This investment could be very volatile during periods of economic uncertainty or financial crisis; we're willing to hold through price volatility, but could sell or hedge if we have portfolio management concerns. We'd also sell if we see an opportunity to buy higher-quality companies at a similar discount.

The *Pro* Bottom Line

AIG has been gutted of its ugly innards, so little remains of the pre-financial-crisis version of the company. What remains is the heart of what made a once-attractive business. But money managers concerned with guilt by association won't buy it, and the Treasury is selling its majority stake as steadily as it can. Both of these factors contribute to the market's mispricing of AIG shares. We expect the market's shortsightedness to be our long-term gain.

Next Step

Bring any questions to our AIG discussion board!

The Motley Fool owns shares of Amtrust Financial Services. See Pro's holdings here . See the team's and David and Tom Gardner's holdings here . Special thanks to analyst Scott Hall, who contributed to our thinking on AIG.

Pro's Fifth Ketchup Report: 2 More Buys

Published Aug 24, 2012 at 12:00AM

Dear *Pro* Member,

In our ongoing effort to make sure all members are aligned with the *Pro* portfolio, today we're recommending that you "catch up" with two technology companies. You're doubtless very familiar with one of them — in fact, you may be surprised we're recommending it! The other company, based in Canada, is less of a household name, but it's an industry leader with a bright future.

This report continues the process of building out your core *Pro* investments. Unsurprisingly, the stock market is becoming more volatile as summer vacation ends and trading volume increases. We should expect yet more volatility as Europe returns to the headlines, the U.S. election nears, and our own country's budget woes persist. Remember, though, that we consider at least a two-year outlook for every stock we recommend. The market's whims may mean ups and downs in the short term, but we believe our businesses will create enough value to grow the share price over the coming few years.

You can access our four previous Ketchup Reports here, here, here, and finally here. This week's report only contains two stocks because we also recommended two brand-new buys, **Starbucks** and **AIG**, to all members this week. Once your core investments are made, we'll get into hedges and shorts. Now, on to the stocks!

Foolishly,

Jeff Fischer, *Pro* advisor

Your Next Buys

Apple

- **Industry**: Technology hardware
- **Allocation**: Invest 5.1% of your funds ($5,100 for every $100,000 you manage in *Pro*)
- **Recent Price/Dividend Yield:** $662 / 1.6%
- **Click For:** Original Recommendation; Most Recent Update

Summary: As the world's most valuable company, Apple is no stranger to skepticism. Can it possibly remain a good investment? Can the business grow enough to propel the stock higher? Can the company still debut products that surprise and excite consumers? These are excellent questions, and we're actually comforted by the masses' skepticism about Apple's growth prospects.

That's because, despite its size, we believe Apple could become considerably larger for two primary reasons:

- The mobile computing revolution is still young; few people in the world own tablets, and most don't yet own a smartphone. (Plus, those who *do* own a smartphone are much more likely to upgrade to the next model than downgrade.)
- Apple is finally breaking into the enormous corporate (or enterprise) market. Fortune 500 companies are making iPads an integral part of daily operations. If there's truth to the rumors that Apple will offer a smaller tablet soon, that could drive still more adoption.

iPhones and iPads make up the majority of Apple's revenue now, but despite strong long-term growth prospects for both products, risks do exist. Profit margins could come down as lower-cost competitors hack away at Apple's lead, and Apple's lucrative partnerships with U.S. wireless carriers could eventually be renegotiated with less favorable terms for Apple — among other risks.

If you ever doubt that one person can make a difference in the world, consider Steve Jobs: Today's Apple isn't the same junkyard dog it was with him at the helm. Time will tell if the company can guard its profit margin as well as it did when Jobs called the shots. But we're optimistic Apple can continue to grow as wireless devices proliferate around the world. The Apple operating system is second to none, and it should prove effective at drawing in new customers and keeping the hundreds of millions it already has.

Apple is above our ideal Buy Around price, but the stock remains a Buy. From its fair value of $680, we model a North-Star-challenging 10% annualized return over the coming three years. Consider buying a 5% position in halves if that suits you better than buying all at once — 2.5% to start and the rest after this fall's new product debuts or the next quarterly report. Just realize that *Pro* already owns 5.1%.

OpenText

- **Industry**: Software (specifically, for information management)
- **Allocation**: Invest 2.6% of your funds ($2,600 for every $100,000 you manage in *Pro*)
- **Recent Price/Dividend Yield:** $54 / N/A
- **Click For:** Original Recommendation; Latest Update

Summary: OpenText is the largest independent provider of software used by corporations and governments to manage their sprawling electronic content. Such software (known as enterprise information management, or EIM) is expected to increase in popularity by the year as companies need to organize, protect, and manage ever-growing reams of e-data. (Fun, and relevant, fact: Only 10% of the Web's content is public; the other 90% is private, owned by businesses and organizations.)

If OpenText can maintain and grow its industry lead, we should expect its winning streak to continue — to the tune of 10% annual growth or more. In the year just ended, OpenText grew revenue 17% to more than $1.2 billion. The stock trades at an inexpensive 10 times adjusted earnings expected in the year ending June 2013. We have a 2.6% position to start, and may add more later as our confidence in management grows.

Questions?

You may make these investments at any time. If you have questions, please post on the Getting Started discussion board. And we're available every weekday from 3 to 4 p.m. ET to answer your questions on the Office Hours board! You'll hear from us again soon. Enjoy!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy Shares of Starbucks and Write Puts

Published Aug 22, 2012 at 12:00AM

- **What We're Doing**: Buying one of our favorite businesses and leveraging our insight to earn extra income.
- **What We're Thinking**: Starbucks should percolate higher and we want to be along for that caffeine rush, so we're buying shares. We're also writing puts.
- **What We're Expecting**: The coffee brings 'em in, the quality and experience builds trust in the brand, and the brand's reach will eventually extend far beyond what seems possible today.

Trade Essentials

- **Actions:**
  - Buy 2.5% of Starbucks ($2,500 for every $100,000 you manage)
  - Write ("sell to open") January 2013 $47 puts for a potential 2.5% more (that's one contract for about every $200,000 you manage; *Pro* will write eight contracts)
- **Price Guidance:**
  - Buy shares near our Buy Around price of $48
  - Use a limit order to write January 2013 $47 puts, aiming for a credit of $3 or higher
- **Buy Around/Fair Value:** $48/$52
- **Scorecard Status:** Buy First

The Foolish Bottom Line

"Tall Americano."

"Decaf solo espresso."

"Doppio con panna."

That's how it goes on many weekdays. Your *Pro* team has conquered the morning, eaten lunch at our desks, and finally broken out into the fresh air to talk shop, discuss progress, or relive the latest absurd office antics. We inevitably end up at one of the two green-logoed coffee shops within two blocks of the office; we love our coffee and spend too much money on it (though Nick and Bryan have mastered the art of looking at the ceiling when the tab comes due). Today, we're aligning the *Pro* portfolio with our wallets and buying **Starbucks** (NASDAQ: SBUX).

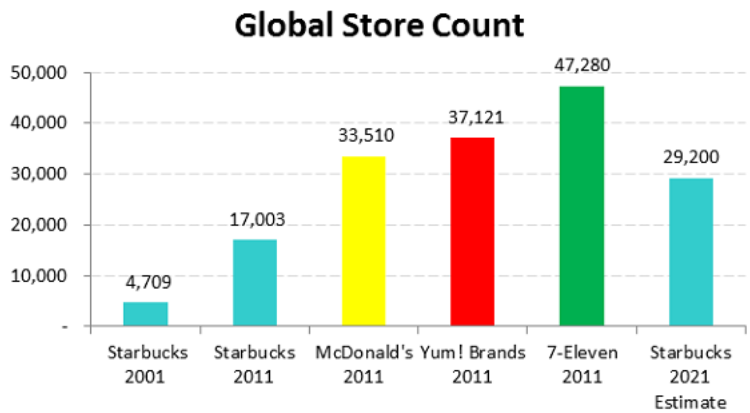
Shares of the java giant have been French-pressed lately — down 22% since their April high — yet the company's vision seems clearer and more likely to succeed than ever. It's rare that a widely loved stock's price declines significantly while your confidence in its future value simultaneously increases. Starbucks is one of our favorite businesses, and buying at today's price could set us up to earn North Star-like returns for years to come. Furthermore, we're confident in our knowledge of the business and hope to earn option income while patiently building out our position. You likely know Starbucks well, so we'll focus our digital ink today on the ways our view may differ from the consensus; then we'll explain the option-income component of the position.

The Siren's Song: Opportunity

You may not realize it, but "Starbucks" is no longer a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, coffee will be a major driver of the business for decades to come, but in a sense the java is just a front (although founder and CEO Howard Schultz would shudder to hear that). The coffee exists to allow the company to repeatedly sell us an experience, one rooted in comfort, quality, health, community, and conscience. We think we're coming for the coffee, but those clever green aprons have been planting the magic beans of a simple *experience* that lives up to caffeine in its addictive qualities and our love of it. Consumers' emotional ties to this experience are key for Starbucks in expanding the reach of its brand and driving its valuation higher.

So far, Starbucks hasn't had trouble finding buyers for the experiences it peddles. Here's what we expect from the company:

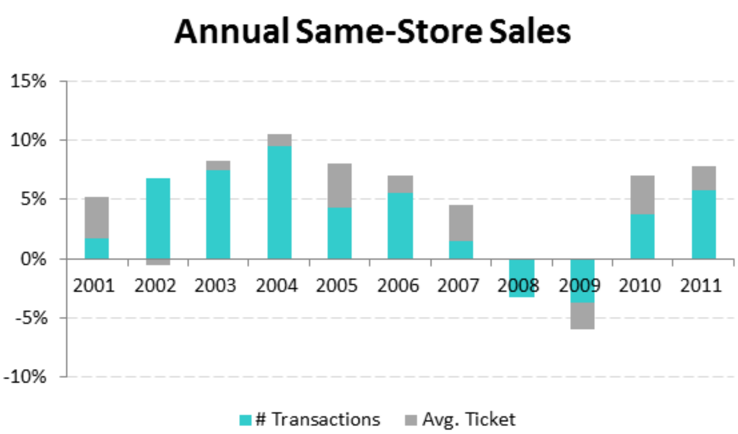
- **Platform growth.** We expect Starbucks to grow its store base, and we contend that it has plenty of room to do so. If you think there's already a Starbucks on every corner, think again: With only about 17,000 stores worldwide at the end of fiscal 2011 (through September), the Bucks' ubiquity pales in comparison to other convenience-focused food-and-beverage sellers like **McDonald's** (NYSE: MCD), **Yum Brands** (NYSE: YUM), and 7-Eleven.



Sources: S&P Capital IQ and company websites; 2021 estimate is Pro*'s*.

Store growth is critical because stores are the primary touchpoint for Starbucks to communicate its brand and build trust with customers. We believe the company can add 12,000 locations, and millions of new customers, over the next decade.

- **Product depth.** Product innovation is alive and well at Starbucks. Recent innovations (Bistro Boxes, Blonde Roast, and Refreshers, to name a few) have driven impressive same-store sales growth even as the global consumer is struggling. Historically, Starbucks has proven its ability to drive traffic through new innovations.



Source: Company filings.

More impressively, the company has plenty of new ideas in the works. Starbucks' recent acquisition of La Boulange bakery should do wonders for its food offerings over time — one-third of coffee purchases made in Starbucks already include a food item, so just wait until the food is even better and more varied.

- **Brand Expansion.** Since 1984, Starbucks has been on a quest to democratize premium coffee beverages. Now it owns the Evolution Fresh (juice) and Tazo (tea) brands, which present similar opportunities for like-themed stores in enormous markets (Evolution Fresh juice bars are now opening on the West Coast). The formula for success with these (and future) brands is simple: Introduce the products through the coffeehouse platform, refine the brands in that trusted environment, and branch the concepts out from there. In some instances, this means a separate restaurant concept, an experience that's built on the same pillars as Starbucks coffeehouses (comfort, quality, health, community, and conscience). In others, it may mean a prime spot on grocery-store shelves; consumer packaged goods, sold mostly through grocery networks, now make up nearly 10% of Starbucks' sales.

Starbucks-branded products will likely look very different a decade from now. But the common thread — a valued brand, built on the experience sold in today's Starbucks stores — will remain. And coffee, which is the world's third-most popular drink, will remain central to the Starbucks experience. The largest risk to our investment is that the brand's authenticity falls and its message becomes muted. We'll be watching this closely with plenty of firsthand store visits.

We believe Starbucks has the financial wherewithal to fund its ambitious growth plans and the management team in place to execute them. Shares are most likely worth around $52 now, and we expect average growth of about 10% a year; from today's level, then, the stock represents a solid chance at North Star-like annualized returns. And with so many opportunities brewing, we can make a case for shares being worth up to $67 in the more immediate future if plans unfold as hoped. We're happy to buy today with an eye on the future.

Writing Puts to Buy More

We're starting our position in Starbucks by buying a 2.5% allocation, but we'd be happy to refill our cup at a lower price — we do expect these shares to be volatile at times. To that end, we are selling put options that would have us purchasing a second shot of shares at about $44. In a sense, we're setting a limit order to buy more shares at a price we like, and we'll earn income while we wait to see if our limit order is hit. Here are the specifics on the put options:

Sell to open January 2013 $47 puts, one for every 100 additional shares of Starbucks you could buy. Lately, you'll effectively be paid around $3.10 per share to write these puts, for a 15.7% annualized yield. If Starbucks declines below $47 by our expiration in January, we'll be able to buy more shares at a net start price of $43.90.

Stock price	$48.22
Strike price	$47
Put premium received	$3.10
Days to Expiration	150
Strike vs. stock price	$1.22
Strike vs. stock %	2.5%
Capital at risk / 30% cash to hold trade	$47 / $14.10
Maximum option reward	$3.10
Option yield / leveraged yield	6.6% / 22%
Annualized yield	15.7%
Breakeven	$43.90
Downside protection in dollars	$4.32
Downside protection %	9%

Alternative Trades

We want to own shares, so we're buying a partial allocation outright and writing puts for the potential to purchase more.

- If your portfolio size doesn't allow you to buy shares *and* write options (you need at least a $200,000 portfolio), you should buy 2.5% today and hope for shares to drop near $44 to buy more.
- You can also write January 2013 $46 puts; these offer a lower payment and lower likelihood of being assigned.
- You can also write October 2012 $46 or $47 puts and write a second round for January's expiration if you aren't assigned.
- If you own Starbucks with a covered call in *Motley Fool Options*, make sure your allocation to the stock remains below 5% total as you add the company to your *Pro* holdings. We may or may not use covered calls on some of our *Pro* shares in the future.

Next Steps

- **Questions?** Please bring any questions about the business or options strategies to our velvet-chaired Starbucks coffee-lounge discussion board.
- **Foolish Blast From the Past!** For a fun distraction, read Jeff Fischer and David Gardner's *original* Starbucks buy report ... from 1998. The company was worth $4.6 billion then, compared to today's $36.6 billion. (Bryan penned most of today's report because Jeff's hands are still smarting from that endless 1998 report — where the guys got a lot of things right, if we do say so ... even though they're just Fools.)

The Motley Fool owns shares of McDonald's and Starbucks. See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Calculating Covered Calls

Published Aug 20, 2012 at 12:00AM

Fellow Fools,

Recently, we outlined how to calculate returns with a put-writing strategy. When you "sell to open" put options, you arrange to potentially buy a stock cheaper and earn income while you wait.

Writing Puts and Covered Calls 101

- **Writing ("selling to open") puts:** Allows you to earn option income while waiting for a stock to decline to your desired buy price. Each put you write obligates you to buy 100 shares if the stock price is below your put strike price by expiration.
- **Writing ("selling to open") covered calls:** When you already own at least 100 shares of a stock and are willing to sell them, you can write covered calls to earn income while waiting for your sell price. Each covered call you write obligates you to sell 100 shares if the stock price rises above your call strike price by expiration.
- **Follow-up:** In either case, if you decide before expiration that you want to take more time, aim for more income, or adjust your buy or sell price, you'll often be able to "roll" your written option to a later expiration date or a different strike price. You simply "buy to close" the option you have outstanding and "sell to open" a new one.
- **For more:** See our guides to writing puts and writing covered calls.

Today we'll examine a similar strategy, but with an inverse outcome: writing covered calls. When you write covered calls, you already own at least 100 shares of the stock, and you're willing to sell them at a predetermined price. You can write covered calls on your shares to earn income while waiting for your desired sell price.

The key points to remember (please see our sidebar for more) are that writing puts potentially obligates you to *buy* a stock, and writing covered calls potentially obligates you to *sell* a stock you already own.

Calculating Covered Calls

Writing covered calls is a common income strategy, steady enough that retirees rely on it. When you do this, you want the income you receive to be worthwhile on an absolute basis — in other words, big enough that it doesn't get eaten up by commissions and fees. Otherwise, it's not worth capping the upside on your stock. It also helps to calculate a handful of other numbers; let's use an example.

Imagine you bought 200 shares of **CME Group** at $53 last week. In this example, you're willing to sell your shares if they hit $60. While waiting for that possibility, as of Friday (with the stock at $54), you could sell to open March 2013 $60 calls for $1.30 per share. If you own 200 shares and write covered calls on all of them, you'll write two calls (because each option represents 100 shares) and receive $260 before commissions. In return, you're obligated to sell your shares at $60 by next March 16 if the stock is $60 or higher at the option's expiration.

In other words, even if CME reaches $70 by expiration, you'll still be required to accept $60 for your shares unless you close your calls early. If CME is anywhere below $60, you keep your shares at expiration and can write new calls if you wish. In either case, you keep the option premium you were paid. Here's some math to consider as of Aug. 17 (this is **not a recommendation,** just an example):

CME Group Buy Price	$53
CME Group Current Price	$54
Sell to open March 2013 $60 calls	Receive $1.30 per share
Yield on Current Share Price	2.41% ($1.30/$54)
Downside Cushion	The same, 2.4%
Yield on Buy Price	2.45% ($1.30/$53)
Upside To $60 Strike Price	11.1%
Potential Net Sell Price (incl. premium)	$61.30
Return to Potential Net Sell Price	13.5% (from current price)
Days to Expiration	208

This trade provides a decent 2.4% yield in just over six months, while providing 11.1% upside in the stock before it reaches the $60 strike price of the calls. Add in the option income and the trade has 13.5% upside to the potential net sell price set up by the covered calls. Over these six months, CME will pay another $1.35 in dividends (assuming it holds constant), bringing the total potential return from the current price to more than 16%.

The closer your strike price is to the share price, the more the covered calls will pay (a $55 call would pay us much more income), but of course, this limits the upside on how far the stock could run. We're not eager to sell CME Group, so this example has a strike price 11.1% above the current share price. Unless the stock rallies, this hypothetical trade would serve to provide income and provide a small downside cushion or hedge.

You most often want to write covered calls when:

- You're truly ready to sell a stock at a determined price and don't believe waiting to sell it is risky.
- You buy a stock specifically to write covered calls on it. This is called a buy/write trade, and because it's clear from day one that the position is for income, you shouldn't be upset if your shares are called away. This is usually the best, *least conflicted* way to use covered calls.

If you have questions about this column or the CME example, let's discuss it on the All About Options board. Fool on!

— Jeff Fischer (TMFFischer)

Trades Completed

- **ProShares UltraShort Real Estate**: Setting up a synthetic short, we sold to open six January 2014 $25 calls and bought to open six January 2014 $25 puts for a net debit of $2.70.
- **OpenText**: Our August $70 covered calls expired as full income.

Guidance Updates

- **Apple**: Fair Value moves up to $680 and Buy Around to $570; the stock remains a Buy.

Coverage & Community

- **Earnings Coverage Continues:** We have reviews of **CME Group**, **The Buckle**, **Apple**, **OpenText**, **AmTrust Financial Services**, and **MasterCard**.
- **Keep On:** etagordon shares his expertise in trucking, seeing dropping volume.
- **Call This, Put That:** Alex340 lists covered calls and puts one could consider writing.
- **Nightly Firmament:** ADrumlinDaisy muses about ancient evening skies and our minds.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro's Fourth Ketchup Report: 3 More Buys

Published Aug 15, 2012 at 12:00AM

Dear *Pro* Member,

Welcome to our next installment of trades to get you invested in our *Pro* portfolio! With this edition, we're investing in three very different companies in the financial sector, each attractive in its own way. Combined, we recommend that you invest 9.9% of your assets here — this sector remains enormously important, and standout companies are still attractively priced as investors' confidence slowly heals. This report continues the process of building out your core investments; once those are in place, we can start to address options for income and shorts for hedging (for members interested in those strategies).

Check out the three previous Ketchup Reports here, here, and finally here if you need them. And now, on to the stocks!

Foolishly,

Jeff Fischer, *Pro* advisor

Your Next Buys

CME Group

- **Industry**: Financial exchange
- **Allocation**: Invest 3.7% of your funds ($3,700 for every $100,000 you manage in *Pro*)
- **Recent Price/Dividend Yield:** $52.60 / 3.3% (excluding special dividends)

- **Click For:** Original Recommendation; Latest Update

Summary: CME Group is the largest public futures exchange in the world, offering businesses, governments, institutions, and investors a way to hedge interest-rate risk, currency risk, commodity risk, and more. Futures contracts allow a holder to buy or sell an underlying asset at a set price by a set expiration. CME Group makes money on all of the transactions that take place on its exchange, so it grows by expanding into international markets and introducing new contracts on different assets. *Pro*'s thesis is that trading volumes, which have been depressed since the financial crisis, will grow over the long haul — especially when interest rates start to rise — and CME's strong profit margins will hold steady.

We *may* write covered calls for additional income on at least some of our CME shares in the future, so if you can buy shares in 100-round lots while maintaining a reasonable allocation, that's advisable, though not necessary.

Broadridge Financial Solutions

- **Industry**: IT outsourcing
- **Allocation**: Invest 3.3% of your funds ($3,300 for every $100,000 you manage in *Pro*)
- **Recent Price/Dividend Yield:** $22.50 / 3.3%
- **Click For:** Original Recommendation; Latest Update

Summary: Broadridge Financial Solutions helps the global financial system work. The company operates behind the scenes to run the plumbing behind worldwide fixed-income and equity trading, as well as communications between banks, brokers, funds, and their shareholders. It ain't sexy, but Broadridge dominates its niches, has remarkably steady recurring revenue and cash flow, and recently broadened its suite of products and services via a number of small acquisitions. We expect the company to be a slow grower, but consistent earnings growth and a healthy 3.3% dividend should help the position achieve North Star-like returns over time.

Wells Fargo & Co.

- **Industry**: Diversified financial
- **Allocation**: Invest 2.9% of your funds ($2,900 for every $100,000 you manage in *Pro*)
- **Recent Price/Dividend Yield**: $34.15 / 2.9%
- **Click For:** Original Recommendation (though it's a bit dated); Latest Update

Summary: It may be the fourth-largest U.S. bank by assets, but Wells Fargo is No. 1 in customer satisfaction for American large banks, so it's no surprise that it also leads in mortgage and small-business lending. Its community banking, wholesale banking, and wealth, brokerage and retirement divisions provide services through more than 9,000 branches and 12,000 ATMs.

Shares are trading below fair value and yield a growing 2.9% dividend. Revenue growth will be slow until U.S. loan demand resumes, but we'll profit through earnings growth as management continues to cut costs and drive efficiency. At *Pro*, we're currently using options to generate even more income from this position; after buying the 2.9% we recommend above, keep an eye out for a new strangle alert on Wells Fargo in your inbox later this year so you can do the same.

Questions?

You may make these three investments at any time. If you have questions, please post on the Getting Started discussion board. And we're available every weekday from 3 to 4 p.m. ET to answer your questions on the Office Hours board! Welcome again to new members, and thank you again to our great veterans. You'll hear from us again soon. Enjoy!

— The *Pro* Investing Team
Jeff Fischer (TMFFischer), advisor
Nick Crow, CFA (TMFCrow), senior analyst
Bryan Hinmon, CFA (TMF42), analyst

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Monday Memo: Video Roundtable on Pro's Future

Published Aug 13, 2012 at 12:00AM

Fellow Fools,

Guidance Updates

- **GrafTech International**: Remains a Buy, but fair value moves down $1 to $16, and "buy around" moves down $1 to $12.50.

Today's Monday Memo is coming at you in video form for your viewing pleasure (we hope!). In this nine-minute roundtable, we discuss the direction of our investment recommendations for you during the rest of this year and beyond. Whether you're a new member or an old salt, you'll benefit from the five key initiatives guiding us. We want to:

1. Focus the portfolio on about 20 key, core positions
2. Use steady income trades to generate returns, whatever the market does
3. Focus our short positions on companies and strategies that should drag less when the market goes up, and protect us when it falls
4. Keep a cash cushion for new opportunities and continued flexibility
5. Use our proprietary North Star to work toward positive returns over any reasonable time frame

Enjoy the video (or read the transcript) as we elaborate on all five topics, then follow along with us as we put them into action with new trade alerts over the coming weeks, moving steadily forward for better returns.

If you have any questions or comments afterward, please visit the Memo Musings discussion board. Fool on!

— Jeff Fischer, advisor (TMFFischer)

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Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **ProShares UltraShort Real Estate** : Set up a synthetic short with a 1% allocation by selling to open January 2014 $25 calls and buying to open an equal number of January 2014 $25 puts. With the ETF around $26, aim to pay around a $2 net debit per synthetic short. That's about an 11% premium to short at this point (you get a $23 start price versus a $26 ETF price). This isn't ideal, but it's the best the options are offering on an ETF that's nearly impossible to short. Alternatively, you could just buy to open January 2014 $32 puts aiming to pay around $10, but realize that is more expensive, with a $22 break-even price. (Revisit our original report.)

Questions on these? Visit our "Catch-Up Trades" discussion board.

Coverage & Community

- **Earnings Coverage Galore:** We review results and our guidance on **GrafTech International**, **BMC Software**, **Rockwood Holdings**, **Wells Fargo**, **Papa John's International**, **Broadridge Financial Solutions**, and **StoneMor Partners**. Whew! That was a busy week. We still have a few more reviews on the way.
- **Did You See Last Week's Ketchup Report?** Progress continued, with two more buys recommended.
- **C-Ya, CFA Exams!** *Pro* senior analyst Nick Crow (TMFCrow) passed his Level III CFA exam, making him the proud owner of a CFA charter! *Pro* members helped him celebrate.
- **New Member Help:** Continue to get up to speed by asking questions on the Office Hours or Getting Started board.
- ***Pro* Chat and Audio:** Video, audio, text — *Pro* is everywhere! Don't miss last week's audio extra on earnings and our very enjoyable live chat with members. Thanks for joining us!

Video Transcript

Jeff Fischer: Welcome, Motley Fool *Pro* members. Thank you for joining us for a Motley Fool *Pro* roundtable. The team is here with you today. Two seats down is Nick Crow. Right next to me is Bryan Hinmon, and I'm Jeff Fischer, and thank you for joining us.

We're going to talk about five focus points for the *Pro* portfolio in the future, what we're working on to really make our returns shine in up, down, and flat markets. Nick, let's start with having a focused portfolio. How important is that?

Nick Crow: It's very important. We've been talking about it for the past year. We have nearly 30 positions now, and some of them we like better than others, as you can tell through Buy Firsts, Buys, and Holds. And we want to focus in the coming year on getting that closer to 20. Twenty positions, as you know, will help us spend more time on each of those, get to know their competitors better and we might actually be able to trade around the fringes a little better also. And what I mean by that is when a stock is down on no news, a little bit cheaper sometimes, we might be able to add to that and make some money on that mispricing. And then as things get a little bit richer, like we have in the past this year with Papa John's — selling a little bit of it when it was pretty rich — we could do that more frequently with a more focused portfolio. You'll note that the best investors in the world tend to be focused investors and that's … I hold you [Jeff] among that group.

Bryan Hinmon: Some members might hear fewer positions and think that that's increased risk, but we really think that the tradeoff there is that by having fewer positions, we're really going to be able to know our positions that much better, and having that knowledge is going to make us, help us make better decisions with each position instead of spreading ourselves a little too thin.

Jeff Fischer: And the bottom line, too, is things change. We've owned some things two or three years, and we look every quarter, really every week, and say are we compelled to own this? Do we feel we need to own this? And if not, that's a very serious question that we ask ourselves. If not, then what's better than it? Let's get it out and let's refocus our efforts, so going from positions that are in the high 20s right now to closer to 20 is our long-term goal for the portfolio as we increase our focus.

Now, right alongside that are more income trades. That speaks just to what Nick was talking about. For more focus we have more time and ability to add more income trades, and Bryan, let's talk about a few of those that we could be doing regularly.

Bryan Hinmon: Yeah, so we've been kicking around the idea of trying to introduce one income trade a month, so 12 a year. And really that stems from our guiding light, our North Star. With our focus on earning stable returns, positive returns every rolling three-year period, we really like the stability that income can bring to the portfolio. And so we're going to make a more concerted effort of generating one income idea per month so that we can have that steady stream …

Jeff Fischer: Sometimes more.

Bryan Hinmon: Yeah, and it's going to depend on market conditions and what is available, but we're definitely going to have just a more concerted effort to introduce regular occurring income trades.

Jeff Fischer: And that began the end of July, so August is the first month where that's really in place, and we've been working on that the past several weeks.

Bryan Hinmon: Yeah and I really see sort of probably two angles we're going to attack from most often, and that's either the use of options, which we will continue to do, but probably do at an increased rate. And then we'll also look for sort of stealth dividend plays. You've got something like CME Group that pays a special dividend, or The Buckle, one of our recent acquisitions, a company that is different than anything we have in the *Pro* portfolio, but we really liked the possibility there to earn that beefed-up dividend.

Jeff Fischer: Yeah, most people may not know outside of *Pro* that The Buckle has a 2%-some dividend, so when you draw it up on Google Finance or Yahoo, that's what it shows. But every year of the past several years, they've paid a special dividend in the fall, so that's coming up now. That brings the yield closer to 7%, 8%, and there's some serious income right there, along with appreciation potential.

So we also are working into the portfolio more specific shorts. We want to short companies, or in some cases overpriced indexes, where we have a specific reason to believe that it's going to go down or not go up that much, so it works as a hedge that doesn't drag on the portfolio as much as a direct index short does.

So we've been working on this all year, getting more focused shorts into the portfolio, like Sony, like other companies that are languishing. And ideally we'll have shorts that go down even when the market goes up, and that's the holy grail of shorting; that's what we're shooting for in the long term.

Nick Crow: Yeah, and if the market does go down, it'll be a sweet buffer because those crummy companies fall at a time when the market's under pressure.

Bryan Hinmon: Yeah, it's been a little bit of a point of frustration for us this year with our SPY hedge. The *Pro* portfolio is still reasonably correlated to the S&P 500, so having that hedge in place does make sense, but we just don't like that the S&P 500 is comprised of 500 of the best, largest and strongest companies, and we're choosing to hedge our portfolio by making a bet against those companies, and we just think we can do a better job finding more targeted shorts, companies that we don't believe in.

Jeff Fischer: Definitely so. More focus, more income trades, very targeted shorts and another thing to talk about is just cash. Cash on the sidelines for opportunities. Nick, what can you add to that?

Nick Crow: I love cash. Who doesn't love cash?

Jeff Fischer: That sums it up.

Nick Crow: But cash is an investment, and it's investment in the future. So when we have a cash position, maybe we equitize it by writing puts like we have, some strangles and just written puts in general. Or perhaps it's an investment in, "Hey, there's good opportunities in the market right now, but there aren't great opportunities," as a hypothetical. And so we will keep some cash there in order to invest in those future great opportunities that we know are likely around the corner.

Jeff Fischer: And Bryan spoke to our North Star, which I'll just review quickly. It's our goal, it's what we're shooting for. It's a construct that we came up with that's inflation plus 7% every year, so it's averaging about 10% right now, and since the '70s, it has averaged about 11% annualized. It's actually done better than the S&P 500. Our North Star has done better than the S&P 500 since the '70s.

But that's not why we chose it. We chose it because it historically has never been negative; it's always up, and that makes it one heck of a goal for us to shoot for as an absolute-returns portfolio. Our goal is, as Bryan said, as you know, to make money all the time. And to us, "all the time" means every rolling three years, if we can't do it every year. Because we may not be able to every year, but every rolling three years we want to make money whatever the market does. And so our goal is something that will do that no matter what. That's our North Star.

That's what we're investing for, and that frankly is why we need the five points we just spoke to. We need to be focused. We need steady income. We need very targeted shorts, and we need cash on the sidelines, too. By combining all these things, that's how we believe we will continue to make absolute returns that are extremely pleasing and rewarding and have less risk in the process. So that is …

Nick Crow: How many investors doubled their money in the last 10 years? At the current rate of the North Star, that's what that would represent. The doubling of the actual money in your portfolio and its buying power …

Jeff Fischer: After inflation.

Nick Crow: After inflation, right. That's huge.

Jeff Fischer: Yeah, the market the last 10 years is basically flat. So we have our work cut out for us, but it's a goal, and if we can get even close to it, we know we'll be doing very well. Because as you've seen in up markets, we're not giving up upside; we're running this portfolio to capture upside. What we need to focus on, by being focused and having income and shorts, is doing better in down markets as well.

Bryan Hinmon: And keeping focus on that North Star really allows us to do that. We've implemented that as part of our investing process where, as we're running through the criteria that we look for, we always have in front of our mind: Is this consistent with the North Star? Will this help us track the North Star? And we really feel like the points that we identified are the direction that we need to go in with the North Star as our guide.

Jeff Fischer: So we're excited you're with us. We thank you for being with us. It's going to be an active end to 2012, and we're looking forward to a great 2013 and beyond as we really keep managing this portfolio for superior returns with less risk. Thank you guys for being here.

Nick Crow, Bryan Hinmon: Thanks, Jeff.

Jeff Fischer: Thank you, members. We'll see you on the boards, and Fool on!

See Pro's holdings [here](). See the team's and David and Tom Gardner's holdings [here]().

Audio Extra: Earnings From 4 Pro Companies

Published Aug 9, 2012 at 12:00AM

Listen in with the *Pro* team in a new Audio Extra as they discuss recent earnings from buy recommendations **Gentex**, **Pacer International**, and **Tupperware**, as well as pizza purveyor **Papa John's International** (which is tasty, but currently on hold).

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Transcript

Jeff Fischer: Welcome to a new edition of Motley Fool *Pro* Audio Extra. I'm advisor Jeff Fischer and joining me in studio today is senior analyst Nick Crow and analyst Bryan Hinmon.

Male: Hi, Jeff.

Jeff Fischer: Guys, great to see you here. We're going to talk about many *Pro* companies that are reporting earnings as we burn through this earnings season, so let's kick it off, Bryan, with Gentex.

Bryan Hinmon: Sure thing. The funny part about this is that earnings actually were an afterthought to the story, but sales were good. They're up 15% in the quarter, 16% through the first six months, but again, like we said, those earnings were an afterthought to the news that I relayed on the board and there was actually really great conversation about on the discussion boards.

So the thesis here has changed a little bit, but the crux of the thesis still remains, and basically that crux of that thesis is that Gentex is in a growing market and is gaining increasing penetration within that market. And some numbers behind that, roughly 77 out of every 100 driving-age persons in the U.S.; there's an automobile for 77 out of every 100 driving-age persons. So that's sort of, if you think about that, like 77% of people have a car.

Jeff Fischer: That's quite an affluent country.

Bryan Hinmon: It is, and if you look at Tier One cities in China, that number is seven out of 100. Tier Two cities in China are three out of 100. Now I am not saying that China in Tier One or Tier Two cities will ever be anything close to what the United States is, but that is a huge differential. We're talking a 7X difference just in Tier One Chinese cities. So my point is simply that there is a lot of room for more automobiles to be sold globally.

Now within that, Gentex auto-dimming mirrors are in the 45% of U.S. cars, only about 25% of European cars and about 10% in Asian cars, so when you put these two things together, we've go the potential for a really large growing market and the potential for Gentex to grow penetration within those markets.

Jeff Fischer: Two things we of course believe will happen over time, and we see value in the stock, so we just bought more shares.

Bryan Hinmon: Absolutely. We have the shares rated at a Buy right now. We recommended a 2.5% allocation. That's up to 2.7 now, and we're quite pleased with that. And Gentex yields 3.1%, so as the market is casting doubt on this, we're getting paid to wait. We really like the management team.

Jeff Fischer: Exactly. So thank you, Bryan. Nick, let's talk about a stock that's on hold, but we still of course want to cover it, Papa John's Pizza.

Nick Crow: Yeah, Papa John's been an exciting name for us this year. It's up about 40% year-to-date, and for good reason. This last quarter was also excellent. Thirty percent year-over-year increase in earnings per share for us; most of that was on increased comp sales and new store openings, so honestly, this management team is just executing perfectly. A lot of the restaurant industry has kind of struggled in the last quarter, and they looked phenomenal.

Still, it's not a cheap stock right now. It's only generated about $50 million in free cash flow year-to-date, so free cash flow yield isn't that attractive, which is why it's on hold, but we have it valued still currently at about $43. I could make some arguments if this quarter's momentum continued to the rest of the year to raise that a bit, but not enough to put this on Buy, given that it's currently trading at 52.

Our allocation's healthy at 3.3%, and if the stock keeps risking, I'll actually trim it further down to about 3%. But there's reasons to hold this stock, even though it looks richly valued. CEO John Schnatter mentioned that — they have 4,000 stores right now, and he can envision a future with 10,000 stores, based on international growth. And as quickly as international's growing and as nice as those comp sales are, I think that might be a bit of pizza pie in the sky, if you will, but possible.

Jeff Fischer: But they're selling a lot of pizzas right now. Great execution, great promotions to move these pizzas and their maintaining margins throughout.

Nick Crow: Yeah, and getting better in lots of cases. I think they're taking share.

Jeff Fischer: So, members, we will look for better chances to buy in at a lower price. Maybe some options strategies, but right now it's on hold for those who do not own it. For those who own it already with us, we're holding.

So I will talk about Tupperware for a moment. Tupperware, which we all know since the '50s is selling food storage products, it's really a tale of two markets right now. About 60% of their sales now occur in emerging markets where growth is very strong. The rest occurs in developed markets where growth is slower and sometimes even negative. So in emerging markets, Tupperware offers a career path for thousands of people who otherwise wouldn't have one, and it offers products for a growing income class that can now afford to store food. They now have some disposable income.

So in these developed markets ... I'm sorry. Let's go back to developed markets. In developed markets, which are, as I said, about 40% of sales, Tupperware keeps the brand fresh by inventing new products all the time. Today only about one-third of sales are actually storage products. The rest are kitchen tools and utensils and the company aims to have new products account for about a quarter of sales every year.

But it's the emerging markets that are taking off. Brazil, China, India, all growing 30%, 40% year over year now the last couple of years and running. And there's still a very long runway there to continue to grow, so Tupperware is really — we should view it in the portfolio as an emerging-markets position, really, because that's some two-thirds of revenue, and it's the part that's growing strongly by double digits a year.

Overall, Tupperware aims to grow sales 6% to 8% a year, and that's with emerging markets leading the way, and they look to continue to improve operating margins every year and steady share buybacks and a rising dividend that goes up with earnings. So put it all together and you have a well-run company that is unique in its space, doesn't compete with others with its direct sales force and has really strong margins, and it trades around 11 times expected non-GAAP earnings for this year. So it remains a Buy. It's in the Ketchup Report as well as a Buy, and it yields about 2.7%, so I think it's a good, long-term holding.

Let's move on to another stock we've told all members to buy again recently, and that's Pacer.

Bryan Hinmon: Sure thing. Pacer International, so two businesses here on Pacer; the first is the intermodal business. This is the meat of the business right now, and it's growing, but it needs to execute a little better. This is the business that over the past two years the company has been turning around, and that turnaround sort of looks to be completed at this point, and now they're just sort of getting their sea legs. They need to execute a little better, but the business is growing. Profitability is okay, and it's really the crown jewel in the business.

The second business is the logistics segment. And what we found out this quarter was that the logistics segment is a little worse than we thought. It's more of a mess. So anyway, Pacer hired this guy named Bob Noonan to come in and right the ship, and he has basically come in with guns blazing. He's done three very notable things so far. He's put new people in place, new leadership in place and four strategic new managers.

He's also reset expectations prior to his arrival. The sales force was focused on hitting sales targets, and that sort of sounds like common sense, but Noonan came in and said, Hey, let's take a step back and let's focus on profitable sales, not just sales. So let's get more profitable, not just bigger.

And then finally, he began cutting fat and realized that in order to cut that fat, he was going to need to make some efficiency improvements and he picked out a new IT system for logistics to run on. So those three things are now sort of in the works, but they're probably going to take a little longer to play out than we had hoped for.

So that was a similar strategy to how the intermodal segment was turned around, so at this point we're giving the Pacer management team the benefit of the doubt. We are resting on the fact that the company's business is itself growing; the company's market, excuse me, is itself growing, and so while it'll be a bumpy ride as Pacer turns around the logistics business, we think it should grow into that growing market.

Jeff Fischer: All right, thank you, Bryan. So that's four companies we've covered now. Three are rated Buys and we've recommended everybody buy them in the very recent past, and right now they're rated Buys. Papa John's remains on hold for right now.

But to wrap this up, let's go around the table really quickly. I'll put you guys on the spot and tell me one thing about your company. Now Bryan, you spoke of two, so you'll have to do two.

Bryan Hinmon: Great.

Jeff Fischer: The one thing…

Male: Sweet.

Jeff Fischer: … of many that are possible, but one thing that's going to drive this stock higher that Wall Street may not expect, what is the catalyst that may; we'll start with you, Nick, because Bryan (unclear). Papa John's, what's to (unclear).

Nick Crow: So now that I've said that the stock is already high, we're looking for higher.

Jeff Fischer: Exactly. We still own it.

Nick Crow: And I already mentioned that the huge growth that we could see in store count, which is nice because the franchisees actually financed the growing stores. But I'll just mention something else that people might not recognize, but Papa John's this year won Brand of the Year in the pizza chain category from the 2012 Harris Poll, and they were No. 1 for the 11th time in 13 years in Prestigious American Customer Satisfaction Index, and they got the highest rating ever by an individual brand. I think Papa John's quality …

Male: Papa's in the house.

Nick Crow: Papa's in the house, and I think …

Jeff Fischer: It's crushing Starbucks even, because they're always way up there on the brand survey.

Nick Crow: Well there you go.

Jeff Fischer: Nice. All right.

Bryan Hinmon: I'll circle back with Pacer, because it's fresh on my mind.

Nick Crow: Pacer, top that.

Bryan Hinmon: Give myself some time to think about Gentex.

Jeff Fischer: You tackle Pacer; I'll do Tupperware, and then you're back on Gentex.

Bryan Hinmon: Fair enough. With Pacer, what I think we really need to keep an eye on is container turns, and basically this is a measure of efficiency, about how well the company is optimizing its root structure, how well it is planning a head on orders. And basically you should think of this almost like an airline. The less time that an airline stays grounded, the more efficient the operation is going to run and the more profitable the business will be.

It's the same thing with Pacer's containers. If they sit idle in a shipyard for a long time, they're not earning money, and so this is something that Pacer has a large degree of control over, and it is a metric that the company tracks and has said that it needs to get better at. So I think there's a focus there and we may see that clouded by what's going on with the logistics turnaround, but we need to dig deep and make sure that the company is doing well with what it can control.

Jeff Fischer: All right, thanks, Bryan. Tupperware, so two things people may not give it any credit for, is the developed markets that it sells in. The key ones are Germany, the U.S., France and Australia. And at times they have outstanding year-over-year growth, like close to double digits at times in Germany or France when the company goes in there and runs promotions and gets the sales force out there. What Tupperware is really about is motivating and keeping its sales force extremely productive, not unlike the containers. If they're not in use, they're not making money. So Tupperware has a large sales force foundation that it can get more leverage from if it motivates them and moves them in the right direction.

So I think the market is largely discounting — and in our valuation, too — that developed markets do not grow much at all, when there's a very good chance that they can, because the company shows how innovative it is and how when it moves from levers to sales force, sales force really kicks in and amps the sales up.

So now last one, Bryan, Gentex. What's it going to do to surprise investors to the upside?

Bryan Hinmon: Well I think what people are forgetting about with Gentex is that the company is an R&D powerhouse. They spend about 8% of sales annually on R&D, which is easily 3X what the typical auto parts supplier spends, and the company says that typically these developments take two to three years to work through and become commercialized. And then the automakers, because cars are designed on sort of six-year cycles or so, or six- to eight-year cycles or so, adoption is pretty slow.

All of this is to say that for the past 20 years, Gentex has been investing heavily in R&D, and so they have many more new product innovations waiting in the wings, and all the focus right now is on what's going on with the rear camera displays. But Gentex I don't feel like is worried about it that much because they have all of these other innovations that are sort of waiting to take center stage.

Jeff Fischer: All right, thank you, Bryan. Thank you, Nick. Thank you members for listening in. That's four companies we are very happy to own and recommend right now. If you have any questions, visit the boards. We'll be there to answer. We'll be talking to you again soon. Fool on!

Pro's Third Ketchup Report: 2 More Buys

Published Aug 9, 2012 at 12:00AM

Dear *Pro* Member,

We have two more stock recommendations today for members continuing to build out the equity portion of their *Pro* portfolio with us. In coming weeks, after you're all caught up on our stock buys, we'll start to add shorts and options to round out your holdings. You won't *need* to use these other vehicles if you don't want to, but they're part of *Pro's* absolute returns strategy for up and down markets. (For those ready to get rolling, we offer one possible option trade along with our second stock below.) If you're one of our many veteran members, please use these Ketchup Reports as recaps of why we like what we own and suggestions for catching up on your own allocations if you're lacking.

Check out the previous Ketchup Reports here and here if you need them. And now, on to the stocks!

Foolishly,

Jeff Fischer, *Pro* advisor

Your Next Buys

Rockwood Holdings

- **Industry:** Specialized chemicals and lithium
- **Allocation:** Invest 4.5% of your funds ($4,500 for every $100,000 you manage)
- **Recent Price/Dividend Yield:** $45 / 3.1%
- **Click For:** Original Recommendation; Latest Update/Discussion Board

Summary: Most people have never heard of Rockwood Holdings, but the company's products surround you in your everyday life. The lithium in your cell phone's battery, the fibers in your clothing, the coating on your car's disk brakes, the paint on your walls: Odds are high that Rockwood played a role in each product. The company is one of the largest miners of lithium in the world, and it produces synthetic chemicals used across a broad swath of industries, from pharmaceuticals to home construction and food packaging.

Management's focus on cost controls and its ability to raise prices on its highly specialized products has led to rising margins and profit, with about 10% earnings growth expected the coming year. The stock trades at just more than 8 times earnings and only 6.1 times EBITDA (9 times would be closer to fair). It also pays a new yield of 3.1%. Rockwood's earnings in Europe have been dinged in the conversion back to a stronger U.S. dollar, bringing investors a new buy opportunity.

Tupperware Brands

- **Industry:** Food storage and kitchen tools
- **Allocation:** Invest 2.6% of your funds ($2,600 for every $100,000 you manage)
- **Recent Price/Dividend Yield:** $53 / 2.8%
- **Click For:** Latest Update/Discussion Board (our original reports date us: they go back to 2009)
- **Alternative Trades:** If you're ready to use options, you can buy shares *and also* "sell to open" October 2012 $50 puts, lately around $1.20 per share, for a 2.4% yield in about 70 days. Sell one put for every 100 additional shares you could buy at $48.80 if the stock declines 6%; sell enough total puts to double your potential Tupperware position to 4.8%.

Summary: This is not your mother's Tupperware. With 61% of sales coming from emerging markets and only 30% of its products focused on food storage, Tupperware has come a long way from the parties that made it famous in 1950s American suburbia. Today, Tupperware is mainly an emerging-markets investment selling all kinds of kitchen tools. More than 85% of the world's population lives in emerging markets like China, India and Brazil, where Tupperware sales are growing strong. In those markets, the company has distinct advantages: It offers a viable career to people (mostly women) entering the workforce; it sells directly to the population, so it can grow rapidly in urban areas at low cost; and it sells affordable products perfect for families whose disposable income is growing, allowing them to begin storing food.

Growth is slower for Tupperware in developed markets, but those remain vibrant and filled with extra potential. Sales in Germany, a very large market, grew 8% last quarter, and the leading cookbook in France (yes, France!) is actually a Tupperware cookbook (so much for *haute cuisine*). Management buys back stock every quarter and increases the dividend with earnings growth, which is expected to reach 9% this year. The stock is down on worldwide economic concerns and the stronger dollar. It trades at 10.6 times expected non-GAAP earnings for 2012 and yields 2.8%.

Questions?

You can make these two buys at any time. Meanwhile, *all* of our active positions are listed on the Recommendations tab (click a ticker there to get more info). If you have questions, please post on the Getting Started board. And we're available every weekday from 3 to 4 p.m. ET to answer your questions on the Office Hours board! Welcome again to new members, and thank you again to veterans. You'll hear from us again soon. Enjoy investing!

— Jeff Fischer (TMFFischer), advisor

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Live Chat: Thursday, Aug. 9

Published Aug 7, 2012 at 12:00AM

Jeff, Nick, and Bryan answered your questions Thursday, Aug. 9, in this live chat. If you were wondering how to get started with *Pro*, what to do about our most recent recommendations, or how Nick plans to celebrate his new CFA credentials*, this was your chance to ask! And if you missed it, don't worry — the transcript is available below.

*Nick may or may not have answered questions about said celebration. Either way, we're all really excited for him.

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David Gardner on Pro

Published Aug 6, 2012 at 12:00AM

In this video, Motley Fool co-founder David Gardner welcomes you to the *Pro* service and explains why he thinks it's so special. Watch below, then bring any questions to our [Getting Started & Help discussion board]!

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Show Me the Money

Published Aug 6, 2012 at 12:00AM

David Gardner on *Pro*

In this new video, Fool co-founder David Gardner welcomes new members to the *Pro* service and [explains why he thinks it's so special].

Fellow Fools,

Successful investing means having a process that works and being disciplined enough to follow it. In my 25 years as an investor, I've seen many great examples of investments that deliver — and my fair share of those that don't.

Taking a high-level look at the lessons you learned from your past investments allows you to frame your questions around those lessons and discover the parallels between your holdings. Say you pinpoint the five stocks that have been your strongest over the past decade. What similarities do those businesses share? What has made them so successful? Find the common themes … and then do the same with your losers.

Live Chat Coming Up!

The *Pro* team is having a live chat this Thursday, Aug. 9, from 3 to 4 p.m. Join us with any questions you have about the service!

This exercise ideally will inform how you look at future investments, leading to better choices. In *Pro*, we want to make you money, true — but we also want to build you an intellectual framework for investing, something members can pass on from generation to generation in much the same way great investments are passed down. We want to build something that lasts, show you how to do it, and have you share it with those you care about, and we're still in the early stages of accomplishing all this.

Reframe, Fool

One key factor in success has to do with how you frame your investments. So many people throw companies into near-arbitrary buckets — technology, for example, or retail — without acknowledging that even for businesses in the same sector, revenue sources can differ tremendously. It's a much better strategy to frame your investments by *revenue source*. Whose money becomes the company's revenue? Why do they hand that money over? And how will it grow?

This exercise can illuminate how different, or similar, your positions may be, and how broad their revenue sources. That in turn helps you better diversify and manage your holdings. Let's run half a dozen *Pro* companies and two other favorites (**Google** and **Starbucks**) through this framework. Take your time thinking about each question and my provided answers (which can always be improved upon).

Company	Who Pays the Revenue?	On What Does It Depend?	How Does It Grow?
Covanta	Municipalities, utilities	Garbage disposal, energy consumption	Building more energy-from-waste facilities; higher energy prices
Gentex	Automobile manufacturers	Seeing value and utility in Gentex products	Selling to more manufacturers; developing new products
Google	Advertisers	Internet traffic; effective ad clicks	More traffic, more clicks, and higher click fees
GrafTech International	Electric Arc Furnace owners; other graphite electrode producers	Steel demand	More construction and industrial activity
InvenSense	Mobile electronics device manufacturers	A belief that motion-tracking sensors improve products	Getting motion-tracking sensors in more devices
Oracle	Corporations, governments, educational institutions	A need for database management	Adding new clients, cross-selling, price increases
StoneMor Partners	Families of the deceased; wills and trusts	Burials	Higher mortality rates; acquiring more cemeteries
Starbucks	Coffee drinkers	Enjoyment of Starbucks coffee	Adding more locations, greater beverage and food offerings

What Can We Draw From This?

For a start, we have three tech companies listed here — Google, InvenSense, and Oracle. But they sell to completely different parties, so the factors that lead to success will be independent for each. Is it instructive to lump them all under that broad tech label? Not really. They may all move with "tech stocks" in the short term, but in the long run they'll rise or fall on their own merits. We need to focus on who is paying these companies, and how well the businesses are growing that revenue. Risks are laid out in this table, too — just take the opposite of our "How Does It Grow?" answers: Google would suffer from lower click rates; InvenSense risks too few products attaching new motion sensors; Oracle risks market saturation.

Let's take a deeper look at Covanta, at the top. Our answers to "On What Does It Depend?" tell us this is a stable business as long as municipalities and utilities can pay the bills. Society is always disposing of trash, and people will always need energy. And Covanta isn't stupid: If a municipality backs out of a multi-year contract, in some cases Covanta takes ownership of the disposal facility the municipality paid to build. But our final question gets at Covanta's growth challenges: It takes time to build new energy-from-waste facilities, as the company is doing in Hawaii today. So Covanta offers us a stable but low-growth business; there's a place for that in our portfolio if long-term catalysts and a decent yield exist (and with Covanta, they do).

Extending this practice across an entire portfolio may show you more long-term overlap in revenue sources than you'd like in some places. *Pro* has some overlap of our own; our portfolio contains not just Oracle but also **BMC Software** and **OpenText**, both of which also sell software to corporations, governments, and educational organizations. Each company offers solutions for different needs, but owning all three puts our portfolio at risk if information technology budgets decrease. We know this, but we believe the valuations we're paying compensate for this intermediate-term risk, and we think IT budgets will ultimately grow as technology becomes ever more indispensible.

Overall, I recommend you get a nice notebook — I like the Moleskine ones — and make it your investing journal. Write down why you're buying something the day you buy it, so you can go back to your reasoning later, especially during tough times. Next, start to sketch out your whole portfolio with exercises like the one above. We'll have others later.

Earnings and Ketchup Reports Continue

We continue to work through earnings reports from *Pro* companies (see our latest coverage below), and we have another weekly Ketchup Report planned this week for new members and those who haven't taken positions yet. (See parts one and two.) We hope members are feeling as confident as we are as they start to build a *Pro* portfolio with us. Ask questions whenever they arise; we look forward to a long, profitable (and fun!) investment road ahead.

Foolishly,

Jeff (TMFFischer)

Pro Trade Roundup

- **3D Systems**: August $30 covered calls were exercised, selling 600 shares for a net $32 per share. We still own 600 shares (1.7%).
- **Gentex**: We bought 600 more shares at $16.44, bringing our total position back to 2.5%.

Guidance Updates

- None this week

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page. Questions on these? Visit our "Catch-Up Trades" discussion board .

- None this week. All Buy Firsts and Buys on our Recommendations page can be purchased now, but to avoid earnings surprises, you'll want to continue following our weekly Ketchup Reports in your inbox.

Coverage & Community

- **Earnings Galore:** We have coverage of **Pacer International**, **3D Systems**, and **Tupperware**. We'll have more this week.
- *Pro* **Calendar:** Who reports earnings next? See it in bold here.
- ***Pro* Office Hours:** We're here to answer your general questions; see our answers every weekday between 3 and 4 p.m. ET.
- **Working to Start Investing?** Ask any questions about your launch on our Getting Started board.

The Motley Fool owns shares of Google and Starbucks. See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Reduce Your Market Index Short Positions to 10%

Published Aug 6, 2012 at 12:00AM

Tickers: SPY, SH, RWM, IWM

Reduce Your Market Index Short Positions to 10%

By Jeff Fischer

What We're Doing: For the second time this year, we're reducing our short of the S&P 500 index by about one-third.

What We're Thinking: The time is right to trim our index hedge for higher-conviction individual shorts.

What We're Expecting: We'll continue to exit our index hedge in favor of targeted short positions on individual companies and option hedges.

Trade Essentials

- **Action:** Buy to close (or buy to cover) enough of your short position in the **SPDR S&P 500** (NYSE: SPY) to match our reduced allocation. For *Pro*, this means closing about 600 shares.
- **Allocation:** About 16% of our invested assets are currently hedged with this index short. We're reducing our position to around 10% of our invested assets ($10,000 for every $100,000 you have in long positions).
- **Limit Guidance:** You can buy to cover at the going price.
- **Alternative Trades:**

    1. **If you're short *any* equity index, or if you own shares of an inverse ETF, reduce those positions by the appropriate amount to leave you about 10% short. If you have questions, please visit our SPY discussion board.**

  What's Changed?

  - **Last trade: We closed one-third of this hedge in late January.**
  - **Price change (from 1/26/12):** The index is up another 5.6%.

Despite a recession in Europe and stalling economic growth in the United States, second-quarter earnings and forward guidance from S&P 500 companies have so far proven resilient. As a result, the S&P 500 is only a few percentage points below its 52-week high, and any sign of economic progress, or any promise of more federal stimulus, could lead to higher prices. Our stock positions are also valued attractively enough in light of recent earnings that reducing our **SPDR S&P 500** index short again makes sense.

The index shorts *Pro* members are carrying are legacy positions, taken last year when shorting options at our broker were limited. These hedges continue to serve a purpose, and they're a comfort during volatile times, but we want to continue to systematically reduce them in favor of more specialized, targeted shorts and option hedges.

How to Follow Along

Some members used alternative trades to short various vehicles. To follow along with us, add up the value of your index shorts or inverse ETF positions, whatever flavor they are; maybe you own the **ProShares Short S&P 500** ETF or the **ProShares Short Russell 2000** ETF, or are short the **iShares Russell 2000** ETF, or are just short the SPDR S&P 500 like us.

In every case, compare the combined value of all of your index shorts (not your targeted shorts in things like **Sony** and the euro) against your long stock and long ETF positions. (Do not include cash.) Decrease your index hedges to around 10% of your invested assets. If you are 16% hedged with the SPDR ETF, as we are, you will simply need to close a bit more than one-third of the position to get down to 10%. You will "buy to close" or "buy to cover" the appropriate number of shares.

The Foolish Bottom Line

We'll reduce our position at some point after our 24-hour waiting period but before our 30 days are up. This index hedge has lost more than 13% for us, but the portfolio overall (which is what matters!) is up sharply since we initiated the short. We've kept pace with a rising market despite being hedged, and we can't complain about that. But replacing our vanilla index hedges with specific shorts and option hedging strategies is our preferred plan.

Next Step: Questions about your shorts (or pants, slacks, or knickerbockers)? Seriously, visit our SPDR S&P 500 board.

See Pro*'s holdingshere. See the team's and David and Tom Gardner's holdingshere.*

Buy More Gentex

Published Aug 2, 2012 at 12:00AM

- **What We're Doing**: Bringing our allocation to **Gentex** (NASDAQ: GNTX) back up to 2.5%.
- **What We're Thinking**: We still believe in the company's business, and we like the price.
- **What We're Expecting**: The company's manufacturing advantages and know-how will keep it firmly atop the growing market for automagically dimming mirrors.

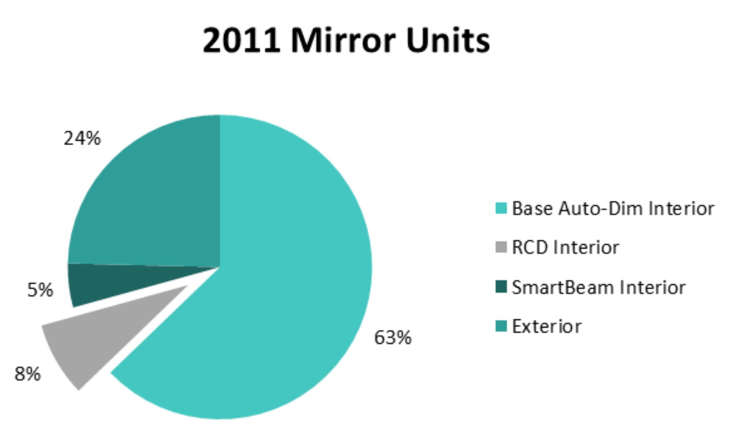
Trade Essentials

- **Action**: Buy more Gentex
- **Allocation**: Bring your position back up to 2.5% (*Pro*, will buy 600 more shares, for 2,200 total)
- **Price Guidance**: Use a limit order and buy below $17
- **Recent Share Price**: $15.85
- **Alternative Trade**: If you prefer to wait patiently for a lower share price and are willing to possibly miss out on buying more shares, you can sell to open December 2012 $15 puts, lately for around $1.15.

What's New?

Pro's first auto-related investment blew a tire in its first earnings announcement since we purchased shares. **Gentex** (NASDAQ: GNTX) makes fancy mirrors that include rear camera displays (RCDs), improving vehicle safety. The company shared that four out of 10 customers who currently use these mirrors would prefer the rear camera display on the radio screen instead. Automakers believe the radio option (while not yet commercially available) is less expensive than Gentex's mirror option and more in line with customer preferences. In our original recommendation, we mentioned a pending law that will require all new vehicles to be equipped with a rear camera display; no longer can we consider this a windfall of new business to Gentex, because at least 40% of its current customer base is going to choose the alternative radio-screen solution.

If RCD mirrors are no longer the lowest-cost way to ensure immediate compliance with the new law, adoption rates *will* slow, and our thesis on Gentex must change to reflect this new reality. That said, don't let the news blind you to the fact that RCD mirrors represent just 8% of total mirror units sold by Gentex.

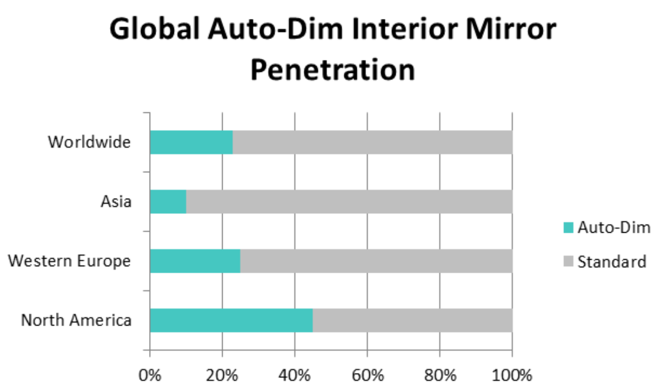


Source: SEC filings.

So how much will this change affect revenue and profit? Had it taken effect in 2011, we estimate that both numbers would have been 6% to 14% lower than was reported. The fact remains: The bulk of Gentex's business — and thus the bulk of its intrinsic value — is driven by global adoption rates of its more basic, but still unique, self-dimming (or auto-dimming) interior mirrors; they make up 63% of total units sold. In other words, *at least 92% of the company's unit sales should be relatively unchanged by last week's announcement*.

The key to our updated thesis is the belief that automakers will continue to include the company's base auto-dimming interior mirrors in new vehicles. Worldwide, only 23 of every 100 new cars has a Gentex auto-dimming mirror; we believe adoption worldwide should approach North American penetration rates (45%-50%) over the next 12 to 15 years as:

- the global middle class increases in number;
- cars get smarter and more technologically advanced; and
- more cars on the road bring an increased focus on driver safety.



Source: Gentex documents.

We believe the value proposition of auto-dimming interior mirrors stands on its own, regardless of what happens with RCDs. We're also confident of the value in the company's SmartBeam technology (which uses sensors and algorithms to optimize the use of high beams and low beams based on surroundings), and we love the ongoing R&D spending: Gentex regularly spends 8% of sales on research and development to bring additional features (like SmartBeam) to its auto-dimming mirrors. The company's product line is more diverse than it has ever been, it retains cost advantages in manufacturing, and it has the experienced management to carry out its plans. The price looks right for *Pro* to buy more shares and new members to initiate a whole 2.5% position.

Next Steps

- Bring your questions to the Gentex discussion board.
- For more details on the Q2 2012 announcements, see this post.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Pro's Second Ketchup Report: 3 More Buys

Published Aug 2, 2012 at 12:00AM

Dear *Pro* Member,

As you build a strong portfolio with us to bring you increasing value over the years, remember that success comes with an appropriate time frame. Sadly, there's no magic elixir that can double your dollars in a fortnight. But by investing in attractive businesses, you can make that magic happen nonetheless, doubling your money and beyond over longer periods. At *Pro*, we sweeten the recipe by adding option income, and we use hedges and shorts to score victories on falling prices. But it all starts with your core stock holdings.

Last week, we shared our three Buy First stocks. This week, we follow up with three Buys, and we'll have even more in the weeks to follow. If you're new to *Pro*, we recommend buying these stocks now or when you're comfortable; if you're a veteran hand, consider this a recap of the reasoning behind our holdings (and our suggested allocations). As always, take your time, use our Guidebook, ask questions on the discussion boards, and form your own personal plan to use *Pro* … and then stick to it. That's how you'll succeed with *Pro*, and whether you're a brand-new member or just catching up after being with us awhile, we're here to help you every step of the way.

Foolishly,

Jeff Fischer (TMFFischer), *Pro* advisor

Your Next Buys

Gentex

- **Industry:** Automobile parts supplier
- **Allocation:** Invest 2.5% of your funds ($2,500 for every $100,000 you manage)
- **Recent Price/Dividend Yield:** $15.85 / 3.28%
- **Click For:** Original Report; Most Recent Update; Discussion Board

Summary: Gentex makes fancy mirrors that improve the safety of vehicles. Most of those (more than 60%) are auto-dimming interior mirrors, which properly mute headlight glare during night driving. Another 25% of sales comes from are side mirrors with added electronic features, and super-premium auto-dimming interior mirrors make up the rest. This low-cost producer has nearly 90% market share in its core business, and it invests heavily in research and development to find new ways to add convenience and safety to its products. Only 23% of new vehicles are currently equipped with auto-dimming interior mirrors, and we expect that figure to grow significantly over the next decade — with Gentex leading the caravan.

Intel

- **Industry:** Microprocessors
- **Allocation:** Invest 6.8% of your funds ($6,800 for every $100,000 you manage)
- **Recent Price/Dividend Yield:** $25.85 / 3.48%
- **Click For:** Latest Update/Discussion Board (our original report from 2008 is exceedingly well-written, of course, but no longer current)
- **Alternative Trades:** If investing 6.8% of your funds at once isn't appealing to you, consider buying just half of a position to start. You can add the second half later or consider writing puts. Lately, you can "sell to open" October $25 puts for income of $0.87 per share, earning a 3.3% yield in less than three months. Sell one put for every 100 shares you can buy.

Summary: Intel is the world's leading manufacturer of computer microprocessors. The company's high-performance chips drive the powerful servers in data centers proliferating around the world. Its processors also power 80% of the world's personal computers, both desktops and notebooks, and those sales are growing in emerging markets. As if that weren't enough, Intel is now entering the enormous mobile space, too, with tablet and smartphone chips shipping in several new products this year. By investing billions in cutting-edge chip fabrication, Intel is able to steadily cut costs and improve performance, staying at least one generation ahead of the competition. Trading at less than 11 times earnings and yielding nearly 3.5%, with competitive advantages, this tech bellwether is an attractive foundation for a *Pro* portfolio.

Pacer International

- **Industry:** Transportation
- **Allocation:** Invest 1.5% of your funds ($1,500 for every $100,000 you manage). Please **use a limit order** at market prices so you don't push the price higher.
- **Recent Price/Dividend Yield:** $4.15 / N/A
- **Click For:** Original Report; Latest Update/Discussion Board

Summary: Pacer International is a broker of the shipping world, matching up small, disparate loads of cargo with empty capacity aboard various vehicles (usually trains and trucks). As an intermodal transport company, Pacer benefits from improving rail efficiency, lean inventory management trends, increased international trade, and a focus on the environment. We expect Pacer to become a larger player by capturing its fair share of this growing market and by turning around its third-party logistics business. This is a very small-cap company implementing a turnaround — it will be a bumpy ride, but one we think will end profitably.

Questions?

All of our current positions are listed on the Recommendations tab (click a ticker there to get more info). If you have any questions, please post on the Getting Started board. And we're available every weekday from 3 to 4 p.m. ET to answer your questions on the Office Hours board! Welcome again to new members, and thank you again to veterans! We'll see you again next week.

See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Putting on the Ritz With Our Returns

Published Jul 30, 2012 at 12:00AM

Fellow Fools,

It's been a turbulent earnings season so far, with many stocks rising or falling 20% or more right after reporting results. In most cases, the company in question hasn't actually created or destroyed 20% in business value over the previous quarter, so this volatility mainly reflects the market's skittish mood. This, too, shall pass. In the meantime, as veteran *Pro* members know, we comb through every quarterly result to get an updated read on the health of every *Pro* company. We then report back to you with a summary posted on the company's discussion board and link to it in the Monday Memo. Last week, it was **Gentex**, **Intel**, and **InvenSense** (click the company name for our review).

We post these earnings rundowns to give you quick and useful news on your companies, but these days we have one more purpose in mind: Prioritizing our guidance to members who are still getting up to speed. Suppose you see we have a positive take on a company's earnings and you notice we've rated the stock as "Buy" on our scorecard. Good place to start if you're building out your *Pro* portfolio, right? Well, we might have a better one for you — one that we'll bring you in our weekly "Ketchup Report" (not to be confused with the Catch-Up Trade ideas you'll find in these Monday Memos).

Why wait for the emailed Ketchup Reports? Because we're more likely to issue brand-new trades and make portfolio adjustments soon after earnings, so new members joining during this opportunistic time may avoid unnecessary trades by following our weekly emailed guidance — like last week's — rather than rushing ahead. We'll selectively build your core *Pro* positions over the coming weeks, and then move to shorts and options.

So far, we've recommended you buy **Oracle**, **The Buckle** and **AmTrust Financial Services**. Our next buys will be sent to you within a few days. Keep watching!

A Popular Option

Pro Trade Roundup

- **3D Systems**: Rolled half of our August $30 calls to November $35 calls for a net debit of $1.85 each. We left the other half alone.

Guidance Updates

- **Oracle** : Buy First; Buy Around and Fair Value prices move up to $30 and $35.50, respectively.
- **Intel**: Moves from Hold to Buy; Buy Around price moves up to $25 and Fair Value to $29.
- **InvenSense**: Buy; but Buy Around and Fair Value move down to $14 and $20, respectively.
- **StoneMor Partners**: Moves from Buy to Hold pending portfolio decisions and member education.
- **CME Group**: Buy; but Buy Around and Fair Value move down to $52 and $62, respectively.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page. Questions on these? Visit our "Catch-Up Trades" discussion board.

- **ProShares UltraShort Real Estate** : Set up a synthetic short with a 1% allocation by selling to open January 2014 $25 calls and buying to open an equal number of January 2014 $25 puts. With the ETF at $25, aim to pay around a 6% to 7% premium, or $1.50 to $1.80 debit per synthetic short, or less. Shares aren't available for shorting (members are being called out at Interactive Brokers) and cost more than 4% a year to short if they were. (Revisit our original report.)

We will all have our fill of earnings reviews as they continue to roll out, so let's take a scenic detour in this Monday Memo and discuss another key part of investing: Calculating returns. Specifically, let's talk about put options that you write.

For the uninitiated, when you "sell to open" (or write) a put option, you're obligating yourself to buy shares of the underlying stock at your option's strike price if the stock declines below that price by your option's expiration date. For writing this contract, you're paid a premium up front that's yours to keep. Put-writing is a popular income strategy because the worst-case outcome is you're obligated to buy shares of a stock at a price you chose on day one.

Calculating the return on your written put is, of course, different from buying a stock and measuring its gain or loss. With put writing, the return is initially calculated based on the cash or account equity that you need to set aside to hold the trade open in your account. Remember, each put you write represents a potential obligation to buy shares, so that's why they require at least some cash set aside. Let's run through a simple real-life example (this is not an official recommendation).

The Particulars

- "Sell to open" December 2012 $10 puts
- Amount: Sell 1 put for every 100 shares you can buy
- Days until Dec. 22 expiration: 145
- Option bid price: $1.00
- Stock price: $12.50

In this example, the newly public company, which makes tiny motion tracking sensors for mobile devices, is trading around $12.50. The Pro portfolio holds a small position in the stock already (1.4%), but if we wanted to potentially buy more at a lower price, we could sell one December $10 put for every 100 shares we're willing to buy. Lately, these $10 options will pay us an even $1 per share that we get to keep. Then, if InvenSense declines below $10 by our December expiration, we would be "put" — or sold — shares of the stock. Our net start price would be $9, since we get to keep the $1 the puts paid us. So, let's calculate the return on this in the few ways that are most relevant.

Return on Cash

- Cash set aside to keep puts open: $10
- Payment received for writing puts: $1
- Return on cash set aside ($1/$10): 10%
- Time to return: 145 days
- Annualized return: 25.2%

If you're using an IRA or non-margin account, your broker will require all of the cash for your potential stock purchase be set aside for the duration that your put is open, so $1,000 for every $10 put you write (because every option represents 100 shares of stock). Since you were paid $1 on your $10 buy price commitment, you're making 10%, or more than 25% annualized, given that this expires in less than five months.

Calculated even more accurately, you actually only need to set aside $9 because you're paid $1 up front to write the put. In this case, your return on cash set aside is 11.1%, or 28% annualized. Of course, if InvenSense declines 20% or more to $10 or less by expiration, you're obligated to buy shares (unless you "buy to close" your puts before then at some cost).

Return on Buying Power

Now assume that you write puts in a margin account that mainly uses your equity rather than cash to hold open your put obligations. Most brokers require only 10% to 20% of a stock's potential purchase price set aside in cash the day you write puts on it, because your account value backs up the rest of your potential purchase obligation. But in Pro and in Motley Fool Options, we conservatively assume that you always need to set aside 30% of your potential purchase price — and you should always have the ability to easily buy the stock in entirety if it comes to that. Using your equity (or buying power) alongside just some cash, your return is much higher than the previous example.

- 30% cash set aside to keep $10 puts open: $3.33
- Payment received for writing puts: $1
- Return on cash set aside ($1/$3.33): 30%
- Time to return: 145 days
- Annualized return: 75.6%

You stand to earn a 30% return on the cash you set aside for this trade as long as InvenSense doesn't decline 20% or more (from today's $12.50 to below $10) by Dec. 22. This trade pays an annualized return of more than 75%. Realize that you're not borrowing any money to write puts even when you do the trade on buying power like this. You're simply using some of your equity to hold the trade open.

You can see how put-writing offers very attractive returns on your cash and equity. The key is you need to be ready to buy the stock with cash if it declines, and with a recent IPO like this one, volatility isn't unusual.

The Foolish Bottom Line

We'll have new put-writing trades for everyone in the future, of course; meanwhile, please ask any questions about today's column on the Memo Musings board. We'll see you later this week with more earnings coverage and a new Ketchup Report with a handful of select buys. Thank you for being a *Pro* member!

Foolishly,

Jeff Fischer (TMFFischer)

Coverage & Community

- **Earnings coverage:** We're just making sure you see our updates on Gentex, Intel and InvenSense. We'll have several more reviews of *Pro* companies this week.
- ***Pro* Calendar:** Who reports earnings next? See it in bold here.
- **Facebook's future:** Jeff gave **Facebook** a questioning thumbs down on our "Stocks You'd Like to Short" board.
- **StoneMor's stance:** The company responds to short sellers who hit the stock.
- **Pro Office Hours:** We're here to answer your questions, and specifically at 3-4 p.m. ET.

See Pro's *holdings [here](). See the team's and David and Tom Gardner's holdings [here](). The Motley Fool owns shares of Facebook, Intel, InvenSense, and Oracle.*

Ketchup Report: Motley Fool Pro's 3 Buy First Stocks

Published Jul 26, 2012 at 12:00AM

Dear *Pro* Member,

It's a day to celebrate! With this report, our newly extended *Pro* family takes its first official step together in investing for rewarding profits for years to come.

Below, we review for newcomers and veterans alike our three current "Buy First" stocks. If you're just joining us, think of these as recommendations for getting started. And if you've been with us a while, this is a reminder of why we own what we do — and where we think it's most important for you to match our allocations. We plan to send you weekly recommendation updates like this for all of our current "buys" over the next several weeks — along with any brand-new trades, of course. We're in the middle of earnings season, so we suggest that you wait for these reports before you begin buying most of our stocks.

We'll focus on building your core holdings first, then add shorts and options for all those interested. We have more tips for you at the end of this report, but first, here are our three Buy Firsts.

Foolishly,
Jeff Fischer, *Pro* Advisor

Start Here

The Buckle

- **Industry**: Retail
- **Allocation**: Invest 3.1% of your funds ($3,100 for every $100,000 you manage)
- **Recent Price/Dividend Yield**: $38.23 / 2% normally; nearly 8% annually the last five years including special annual dividends
- **Click For**: [Original Report](); [Discussion Board]()

Summary: The Buckle walks the fashion runway with low fashion risk by selling timeless jeans and tops from several popular external brands, as well as its own brand. The Buckle's management team is properly incentivized, has meaningful insider ownership, and runs the business wonderfully. We expect measured growth from 10 to 15 new stores per year and online expansion. We do not expect further operational improvements — if that were to occur, it would be pure upside. The Buckle should continue to pay its regular dividend and we expect it to pay out excess cash distributions, too, as it has for several years. We stepped up to buy shares after a tepid retail environment sent the stock lower, offering us a value stock along with a strong annual yield, too.

Oracle

- **Industry**: Enterprise Software
- **Allocation**: Invest 5.1% of your funds ($5,100 for every $100,000 you manage)
- **Recent Price/Dividend Yield**: $29.26 / 0.82%
- **Click For:** [Original Report](); [Most Recent Update](); [Discussion Board]()
- **Alternative Trades:** If you'd rather target a lower buy price for some of your Oracle shares, you can write ("sell to open") September $29 puts and lately receive nearly $1 per share in income, or write December $29 puts for about $2 per share in income. Write one put for every 100 shares or Oracle you would buy at a net $28 or $27 (since you keep the option income) if the stock is below $29 by expiration.

Summary: Oracle stands tall as the world's leading data management software provider for business and government. With diverse software offerings across multiple industries, an enormous customer base, and strong renewal rates, Oracle enjoys breadth and scale that provide sustainable advantages. Now Oracle's software leadership is propelling its new, high-margin enterprise hardware sales as the hard-driven company works to surpass **IBM** as the leading business hardware vendor. All this is trading at less than 11 times free cash flow, making Oracle the third Buy First in the *Pro* portfolio right now, with a healthy 5.1% allocation.

AmTrust Financial Services

- **Industry**: Insurance
- **Allocation**: Invest 5.8% of your funds ($5,800 for every $100,000 you manage)
- **Recent Price/Dividend Yield**: $29.56 / 1.35%
- **Click For:** [Original Report](); [Most Recent Update](); [Discussion Board]()

Summary: AmTrust Financial Services is a specialty insurer focused on writing low-hazard policies, specializing in small-company workers comp insurance. The company was designed to scale quickly and provide efficient capabilities to agents. We expect AmTrust to continue to renew policies at a high rate, expand geographically, selectively enter new markets where it can lead, and keep a tight rein on expenses. "Business as usual" should lead to great results as AmTrust continues to build niche leadership in its business lines and grow book value. This very steady performer is still very unknown, and it offers excellent value to devoted owners like us.

Next Week: More Pro Buys to Your Inbox

Next week, we'll send you our *next* handpicked "buys" for your portfolio. Meanwhile, you can see all of our positions on our [Recommendations tab](). You'll notice on this page that we list Buy Around and Fair Value guidance for every stock we own. Buy Around means you should aim to buy within 5% to 7% of the price listed. Fair Value indicates our estimated fair price for the stock today. From a stock's fair value, we expect to earn our desired rate of return, typically around 10% annualized.

In other words, fair value does not mean a sell price in most cases. The most likely reason we'd sell right at fair value is if we want to own a different stock trading at a discount to its fair value (the new stock would embody a higher margin of safety).

Clicking any ticker on the recommendations page gets you to our original buy reports. The reports have a link to the company's discussion board. Finally, we consolidate all guidance changes and company updates and mail them to you in the weekly [Monday Memo]().

Welcome again to new members, and thank you again to veteran members! If you have any questions, please post on the [Getting Started board]() or [*Pro* Philosophy board](). And remember, we're available every weekday from 3 p.m. to 4 p.m. ET to answer your questions on the [Office Hours board]()!

— The *Pro* Team: Jeff Fischer (TMFFischer), Nick Crow (TMFCrow), Bryan Hinmon, CFA (TMF42)

See Pro'*s holdings [here](). See the team's and David and Tom Gardner's holdings [here](). The Motley Fool owns shares of Oracle.*

Roll Half Your Covered Calls on 3D Systems

Published Jul 24, 2012 at 12:00AM

What We're Doing: Allowing for more upside on half our shares by rolling half our covered calls up and out; we're leaving the other half of our covered calls alone.

What We're Thinking: Earnings are due the morning of July 26, and if shares jump for a good reason, it will be difficult to attractively roll our calls then.

What We're Expecting: We're content to potentially sell half our shares at a net $32 if it comes to that, retaining an investment in the company with the chance at more upside.

Trade Essentials

- **Company: 3D Systems** (NYSE: DDD)
- **Scorecard Status:** Hold
- **Action:** Ideally with one rolling trade, "buy to close" half your August $30 calls and "sell to open" the same number of November $35 calls.
- **Recent Prices (bid/ask):**
    - August $30 call: $4.90/$5.20
    - November $35 call: $3.50/$3.80
    - Share Price: $34.40
- **Price Guidance:** Roll before July 26, but aim for the lowest debit possible.
- **Allocation:** Of our 3% stock position, half will still be covered by August $30 calls, the other half by new November $35 calls. Of *Pro's* 12 covered calls, we're rolling six.
- **Alternative Trades:**
    - **Don't have any 3D position? Or had your shares called away?** Do nothing. We'll watch for put-writing opportunities closer to our $21 "Buy Around."
    - **Own just 100 shares or fewer?** Leave your covered calls or your stock alone. You can consider rolling your calls or potentially selling half your stock after earnings. The stock is on Hold.
    - **Own an odd number of covered calls?** Roll enough covered calls to leave you with as close to a 1.5% allocation in the stock as possible if some shares are called away at $30.

What's New?

- **Previous Recommendations:** We wrote August $30 covered calls in April; we bought shares in April 2011.
- **Price change:** The stock is up approximately 50% from the time we covered our shares.

3D Systems (NYSE: DDD) has acquired seven companies this year in its quest to bring 3D printing to the home and office, and it sold $100 million worth of stock at $27 (our fair value) in June, but this activity has not slowed down its ascent. 3D printing has become a hot topic in the media, propelling related stocks to new highs. Above $34 today, 3D Systems trades at 47 times free cash flow and 29 times expected non-GAAP earnings for 2012, putting the stock price above our fair value estimate.

Given how the printing industry has historically been diffused by numerous machine producers, we expect 3D printers will eventually be as commonplace as color printers are today, which isn't necessarily a good thing for profit margins. But for now, 3D Systems is making a land grab to lead the consumer market. Just as we recognize the risks behind rapid acquisitions and investing in unproven markets, we share 3D's enthusiasm for the long-term potential for the technology.

This dichotomy drives our two-pronged approach: We'll keep half our August $30 covered calls in place, and depending on how earnings look Thursday, we may let half our shares be called away at a net $32 in August if the stock remains above $30. But we're rolling the other half of our covered calls to the next higher strike price, and out several months, to set us up for more potential upside and a better chance to roll again if that makes sense by November.

How to Follow Along

Ideally, use a "roll" order to make this trade with one transaction, simply "buying to close" half of your August calls and "selling to open" the same number of November calls. Here's how *Pro*'s math works out at recent prices:

Rolling Our 3D Systems Covered Calls	Credit/(Debit)
Payment received for writing August $30 calls	$2.00
Cost to buy to close August calls (splitting the bid/ask)	($5.20)
Gain/(Loss)	($3.20)
Payment received for writing November $35 calls (bid)	$3.60
Net credits received	$0.40

This increases our potential sell price on these shares from $32 to $35.40, or 11%. Following earnings, we'll decide what we want to do, if anything, with the remainder of our August covered calls. For now, it's more defensive to not roll them all.

Finally, we realize some members only received $0.70 to $0.80 to write the August $30 calls. If that's the case, you'll need to invest a bit more to make this roll. Assuming you were paid $0.75 to write the August calls, your math is like this:

Rolling Your 3D Systems Covered Calls If You Were Paid Less Than *Pro*	Credit/(Debit)
Payment received for writing August $30 calls	$0.75
Cost to buy to close August calls (split bid/ask)	($5.20)
Gain/(Loss)	($4.45)
Payment received for writing November $35 calls (bid)	$3.60
Net credits received	($0.85)

In this case, you're paying a net $0.85 in incremental capital for a potential sell price that's $5 higher, a worthwhile investment assuming 3D Systems rises or holds its ground. If not, then just like we are, you're giving up $1.60 in downside protection ($5.20 vs. $3.60 in current covered call value).

Next Steps: Have questions about this trade? Visit our 3D Systems board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Welcome to Opportunity Season

Published Jul 23, 2012 at 12:00AM

Fellow Fools,

It's a fortunate time for new members to join *Pro*, because earnings season and European concerns are creating opportunities to buy great companies for less. Clear and Foolish thinkers can look ahead a mere year or two, past the horizon of most market traders, and pretty safely surmise that Europe will find some stability. More importantly, they know that great companies create value through thick and thin. This has always been true, and it's why the world's best investors — the likes of Warren Buffett and Peter Lynch — swear off obsessing with macro analysis and instead focus on knowing superior businesses.

We want you to own the best companies for years to come. That's how you grow wealth. Since we have an absolute returns goal, we also hedge and seek to generate steady income in any market.

New Member Guidance

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page. Questions on these? Visit our "Catch-Up Trades" discussion board.

- None this week as earnings roll in. Watch your inbox as we begin entire "Catch-Up Reports" on our stocks.

For newcomers who are also members of other Fool services, such as *Supernova*, we suggest that you manage the two services, and thus your money, separately — in your mind, at least. *Pro* is a standalone service and portfolio. Set aside an appropriate sum of money for *Pro* and manage *that* as your *Pro* portfolio. Treat your other Fool services as a diversification in investment strategies and manage each as an individual sleeve of your assets.

To start the great journey ahead of you, follow our Guidebook experience and focus on building your core stocks first. We'll be sending two to three attractive buy updates per week to everyone, so new members can build their holdings and veterans can be especially confident in what we own. As new members, you do not need to sell short until you're more fully invested; we'll catch you up once you are.

So start with the buys we'll send you to build your *Pro* portfolio. And if you don't want to use options — don't! (By the way, did you take your new member survey?) Each option alert usually has an alternative stock trade, and the ones that don't are just in addition to our core holdings. See more guidance at the end of this Monday Memo.

Earnings Rollin'

It's a pleasure to start to see quarterly earnings reports roll in, and especially nice to see some stock prices dip. Our companies are fundamentally strong, so any slowness now due to Europe is likely to lead to stronger growth in the year to follow as demand creeps up again. The stock market looks ahead, so once it believes the slowdown is playing itself out, it'll see things our way, too. As veteran members know, we post full quarterly reviews on each company's discussion board, and we'll link to them in each weekly Monday Memo, along with any updates to our buy guidance.

Let's check in on a couple now.

Intel Chips Ahead

Intel kicked things off by announcing 4.6% second-quarter revenue growth to $13.5 billion. The chipmaker — our largest long position, at 6.5% — continues to profit from server microprocessor sales as corporations build data centers. Emerging markets are driving growth while established markets tread water — for now. Spending billions to maintain its manufacturing and technology advantages, Intel is moving ahead more quickly than I've ever seen, confident its newest chips are going to continue to dominate servers and PCs — including Ultrabooks that launch this year — and start to take market share in mobile devices. With Windows 8 around the corner, the company expects sales growth of 3% to 5% in 2012 — not stellar like the last few years, but we'll take it in this difficult environment, especially as a stepping stone to better years ahead.

At $25, Intel's stock trades at less than 11 times earnings and yields 3.3%. Modestly above our $23.50 "buy around" guidance, the stock is currently on "hold," but we're reviewing results and there's a good chance our fair value and buy around guidance will increase soon. Stay tuned.

Covanta Offers Stability

Energy-from-waste recycler **Covanta** helps landfills by burning millions of tons of waste each year, turning the steam into energy. For 2013, about 75% of the company's waste revenue is due to remain under long-term contracts, and these contracts include inflation adjustments. This makes Covanta's revenue reliable *and* safeguarded.

Meanwhile, the energy generated in the process is largely sold under contract, too, with three-quarters of 2012 energy revenue already contracted or hedged. This stability allows Covanta to confidently predict $250 million to $280 million in free cash flow this year. The $2.2 billion company trades at just 8.3 times the mid-point of that free cash flow estimate, making it nearly 50% cheaper than the average S&P 500 stock. At the same time, the stock yields 3.6%. It's a stable, 3.2% allocation in our portfolio that remains a "buy."

Pro Speed Ahead

Earnings will roll in from several more companies this week, so new members should follow our Guidebook experience and Catch-Up trades rather than jump ahead; ask questions on the Getting Started board (or our new Office Hours board) and take your time to acclimate yourself to our happy corner of the investing world. An outstanding community of fellow investors is here to help you, too.

So watch your inbox for our Catch-Up trades, and you'll soon be on your way. You joined *Pro* to make money the coming few years and longer. Now make sure you follow through with us. We're glad you're here!

See you on the boards this week,

Jeff Fischer (TMFFischer)

Coverage & Community

- **Meet & Greet:** *Pro* members are welcoming newcomers. If you just want to introduce yourself and tell us your investing goal, this is the place to do it. Please do!
- **Good friends:** It's great to see old *Pro* Fools back in the fold, including ADrumlinDaisy (formerly MazonCreekRich) and 4stree. This makes us very happy!
- **Pro Calendar:** Get it at the top right of this page. Get even more calendar details from TMFMoosie's weekly post. We are looking forward to a great rest of 2012 and a terrific 2013.
- **Pro Guidebook:** Here's a groovy consolidation of *Pro* resources.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Ketchup Reports: Terms to Know

Published Jul 20, 2012 at 12:00AM

As you use our Ketchup Reports to get, well, caught up with the *Pro* portfolio, make sure you're familiar with the terms on this page. As always, if you have any questions, ask us on the discussion boards — we are available from 3 to 4 p.m. ET every weekday through the end of August on our Office Hours board!

Terms to Know

- **Buy First:** These are the investments you should make first, setting a foundation for your *Pro* portfolio. In our opinion, these stocks usually have the best risk-to-reward profile, offering healthy upside and low downside.
- **Buy:** We like these as much as our Buy First stocks over the long haul, but they may be more volatile, and they may offer more downside risk while we wait for our thesis to play out.
- **Hold:** We currently have 10 stocks on hold, and we won't cover them in this report. They're always listed on the Recommendations page. We don't suggest buying our stocks on hold today, but if you already own them, hold them. In every Monday Memo, we'll share "catch-up" trades to help you get into stocks on hold at lower prices.

The Recommendations page is your "King of Guidance." That page is always kept current, so if something is listed there as a Buy First or Buy, we believe it can be bought today, period. The moment we no longer believe that, we'll move it to Hold on that page and announce that change on the *Pro* home page, as well as in the following Monday Memo.

You'll also need to know these terms:

- **Buy Around:** This is the ideal price around (or below) which you'll buy our recommendations, give or take 5% or even 10%. Investing is not a precise science; if we like a company enough to buy it, a 5% price difference is not going to change the outcome meaningfully. We provide this guidance to give you an initial guidepost, but if a stock is listed as a Buy or Buy First on the Recommendations page, that guidance applies regardless of the Buy Around price.
- **Fair Value:** This is the fair price for the stock — what we believe it's worth today. It is not the automatic sell price. In fact, a stock that's reached its fair value should proceed to achieve our desired rate of return (typically 10% or higher annualized). We only sell at fair value if we want a margin of safety (occasionally, there are stocks we only want to own below fair value) or we see something at a discount we like better.
- **Allocation:** We recommend each position as a percentage of the total amount you're investing in *Pro* stocks (exclude your fixed-income investments). If we say to buy 4.5% in something, then invest $4,500 in that stock for every $100,000 in your *Pro* stock portfolio. There is wiggle room here, and you should allocate in a way that makes you comfortable. Keep in mind, though, that our future guidance will assume you're matching our current allocation.

Set Up a Synthetic Short on the ProShares UltraShort Real Estate ETF

Published Jul 17, 2012 at 12:00AM

- **What We're Doing:** We're bullish on commercial real estate, so we're using options to short an *inverse* real estate ETF. By shorting this bearish ETF, we will profit as the commercial real estate market stabilizes and related real estate stocks go up.

Trade Essentials

- **Trade:** Synthetic short on the **ProShares UltraShort Real Estate** (NYSEMKT: SRS) ETF
- **Actions:**
  - Sell to open January 2014 $25 calls
  - Buy to open an equal number of January 2014 $25 puts
- **Allocation:** 1% (one contract of each option for every $250,000 you manage)
- **Price Guidance:** Aim to set up the $25 synthetic short at a net cost that equates to the current ETF price as closely as possible, paying just some premium. So, if the ETF is $24, aim to set up the $25 short for not much more than a $1 net debit. If the ETF is right at $25, aim to pay dimes, not dollars. You may need to attempt various limit prices until filled.
- **Alternative Trades:** Short the ETF directly if shares are available (they're scarce), or if you're trading in an IRA that doesn't allow shorting, just buy to open January 2014 $35 puts, aiming to pay less than $2.30 in time value.

The Big Picture

Commercial real estate in the United States is shaking off some malaise, with vacancy rates falling, rental rates ticking higher, and sales prices increasing across a broad spectrum of properties. Businesses are always interested in owning top-tier commercial properties thanks to their inherent utility, steady rental income, and long-term appreciation potential. And with little new commercial construction going on, the cornerstone for a slow recovery in this sector appears to be in place.

Apartment properties are already benefiting from more renters (along with tight credit for would-be homebuyers). According to realtor.org, apartment vacancies are expected to decline to just 4.4% this year, and the average rent is expected to increase 4%. Vacancies at office properties are projected to slip nearly half a percentage point, with rent potentially rising by 2%, and industrial spaces should see vacancies fall a full percentage point and rent increase about 1.6%. Despite the struggles of some high-profile retailers, even retail vacancies are projected to drop, and retail rent is headed up, too.

Commercial Vacancies	2011 (Actual)	2012 (Forecast)	2013 (Forecast)
Multi-Family	5.2%	4.4%	4.3%
Office	16.6%	16.2%	15.8%

Industrial	12%	11%	10.7%
Retail	12.5%	11.2%	10.7%

Commercial Rent Growth	2011 (Actual)	2012 (Forecast)	2013 (Forecast)
Multi-Family	2.2%	4%	4.1%
Office	1.6%	2%	2.5%
Industrial	(0.5%)	1.6%	2.4%
Retail	(0.2%)	0.8%	1.3%

Source: Realtor.org

The Vehicle

The **ProShares UltraShort Real Estate** (NYSEMKT: SRS) ETF is meant to provide two times (200%) the daily inverse results of the Dow Jones U.S. Real Estate Index (from here out, "the index"). In other words, if the index goes up 1% in a day, the ETF will decline 2%, and vice versa. By setting up a short position on this inverse ETF, we are setting up a *bullish* position on the underlying index, and thus on U.S. commercial real estate.

The ETF is "two times" short the 83 companies comprising the index, which is chock-full of dividend-paying real estate investment trusts (REITs). The underlying index trades at 2.2 times book value and yields 4%, and the ETF has an expense ratio of 0.95%; all of these numbers help our short, although we won't collect the dividend. By betting against the ETF that is two times inverse to this index, we'll effectively be two times long its companies on a daily basis.

Top 10 Index Holdings	% of Assets	Business
Simon Property Group	9.1%	Retail malls, outlets, community-lifestyle centers
American Tower	5.6%	Owns communication sites and towers
Public Storage	4.1%	Storage facilities
Equity Residential	3.8%	Multi-family properties
HCP	3.7%	Healthcare properties
Ventas	3.6%	Senior housing and health-care properties
Boston Properties	3.2%	U.S. office properties
Annaly Capital	3.2%	Owns, finances real estate investments
Vornado Realty	3.1%	Office and retail properties
Prologis	2.9%	Industrial real estate

As of July 13, 2012. Source: iShares.

We're confident in the outlook for commercial real estate, and we want to profit on that thesis. But we also want to profit from the flaws in this "ultra" — meaning leveraged — ETF. Because the ETF compounds leveraged results daily, it has not actually tracked its index over time. Like many other leveraged ETFs, ProShares UltraShort Real Estate ultimately lost value even during periods when it would be expected to gain, and it has obliterated value over five years.

Annual Return	2007*	2008	2009	2010	2011	2012**
ProShares UltraShort U.S. Real Estate (SRS)	63%	(49%)	(86%)	(52%)	(33%)	(30%)
Dow Jones U.S. Real Estate Index (DJUSRE)	(28%)	(43%)	23%	21%	1%	15%
Maximum 1-Year Loss on SRS Short***	(89%)	(134%)	(77%)	(15%)	(15%)	(3%)
Maximum Loss on DJUSRE Long	(30%)	(47%)	(41%)	(7%)	(21%)	N/A

Source: Yahoo! Finance. *Since Feb. 1, 2007. **To July 10, 2012.
***Maximum loss based on year's chronological low vs. high or high vs. low point.

According to ProShares, the ETF lost 49% annualized between its February 2007 inception and March 31, 2012. Over the same time, the underlying index *declined* 2.3% annualized, suggesting the inverse ETF should have generated a positive return of 4.6% annualized. But leverage, compounded daily (especially during periods of high volatility), decimates value because it means ever-larger gains are necessary to make up for any compounded losses. That was how the ETF managed to lose 86% in 2009 even though the index went up just 23%; and after soaring initially, the inverse ETF still lost 49% in 2008 even though its index *declined* 43%.

While it has performed poorly in all years except 2007, the ETF can gain steeply at times, pressuring short sellers like us. The "maximum loss" line above shows the negative return people who shorted the ETF could have suffered in any particular year had they shorted at the bottom that year and closed at the top. This part isn't shown, but if you had the misfortune to short the ETF at its 2007 low and close at its 2008 high, you would have lost 306% as the ETF soared. By the year's end, though, the ETF was actually down from where it started. We don't expect a repeat of 2008, but if you're following along, be ready to wait through spikes.

Next Steps

- **For More Discussion or to Ask Questions:** Visit our new ProShares UltraShort Real Estate discussion board. We'll hold the door open for ya.
- **To Learn More About This Strategy:** Visit our guide to synthetic shorts.
- **To Place Your Trade:** Revisit our "Trade Essentials" above and follow the oh-so-Foolish guidance.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

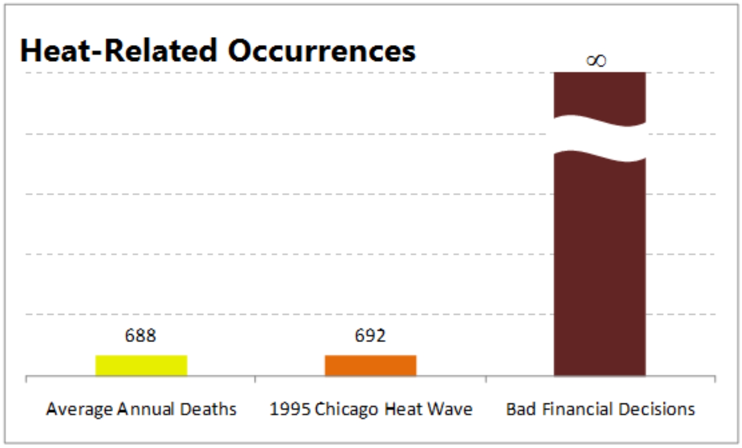
Apply Your Financial Sunscreen

Published Jul 16, 2012 at 12:00AM

Fellow Fools,

It’s hot. Washington, D.C. (and thus Fool HQ) recently sweated through our longest-ever period of temperatures higher than 95 degrees: 11 consecutive days. And the prior record was shattered, not just broken — we were treated to those 10th and 11th days even though nine was enough to set the new record. The average maximum temperature over the span (99.5°F) was also the highest ever, eclipsing that sweltering summer of 1930 we've all tried so hard to forget.

What's the big deal? Well, extreme heat is responsible for an average of 688 deaths each year in the United States. In ill-prepared areas, the toll can be much higher — the 1995 Chicago heat wave, for example, resulted in 692 deaths in 50 days. Secondly, extreme heat was the cause of 1.6 kajillion poor financial decisions in the last year alone.



Sources, left to right: Centers for Disease Control and Prevention; National Institutes of Health; analyst's extremely fertile imagination.

Weather Affects Your Financial Decision-Making Ability

Guidance Updates

- **Medtronic** moved down to from Buy First to Buy as we refocus our Buy First list.
- **WisdomTree Emerging Markets Small Cap Dividend** moved from Buy to Hold as we consider new investments.
- **Tupperware Brands** moved from Buy First to Buy in the face of greater currency headwinds.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page. Questions on these? Visit our "Catch-Up Trades" discussion board.

- None this week. Watch your inbox next week for the first "Ketchup Reports" on our stocks.

I don't mean to shock you, but I made up the 1.6 kajillion figure above. I'm also not out to make light of heat-induced death — but I did want to get your attention. As a recent academic publication ("Projection Bias in the Car and Housing Markets") shows, weather — whether extreme heat or extreme cold — impacts our ability to make rational decisions.

The study looked at records from 40 million automobile purchases and 4 million home purchases to establish baseline purchasing behaviors. It then applied a weather overlay (temperature, precipitation, and cloud cover) and found:

- When it's extremely hot, we buy more convertibles.
- When it's snowy, we buy more vehicles with four-wheel drive.
- When cloud cover is minimal, we buy more vehicles with black exteriors.
- When it's extremely hot, we overpay for houses with swimming pools (by about $1,600).
- When it's extremely hot, we overpay for houses with central air.

All that might seem logical at first glance, but think a bit deeper. Buying a car or a house is a major financial decision that can affect your life for years, maybe decades. Most of us work hard to be well-informed before taking on such momentous decisions — we do hours and hours of research, we build spreadsheets, we forego other purchases. All of that, and then a hot day rolls along and our brains betray us! The study goes on to show that cars purchased during times of extreme weather are more likely to re-enter the market via trade-in or resale — a telltale sign of regretting the purchase.

Where the Road ~~Melts~~ Meets the Rubber

Economics has a name for this behavior: projection bias. It's defined as the tendency to overweight the degree to which one's future desires will resemble one's current desires. The most common example of this is grocery shopping on an empty stomach: We project our current desires (being hungry) into the future (we shop like we will *always* be hungry). And while we might think we're smart enough to act differently when house-hunting than we do in the soda aisle, the results of the study suggest otherwise: "Projection bias may be prevalent in other important decisions ... that are similarly distinguished by having large stakes, state-dependent utility, and low-frequency decision-making." Everyone reading this is familiar with at least one "important decision" distinguished by "large stakes, state-dependent utility, and low frequency": investing.

Apply Financial Sunscreen

I'm not convinced the weather always causes terrible financial decisions, but I *do* believe the climate (both physical and economic) can do kooky things to our brains. I recently read an academic paper that showed investors take more risk when prior market performance has been good; in conjunction with the car-buying study, that news has me in SPF 70 mode. The current environment offers reason for concern: It has been physically hot this summer; fears of a Eurozone disaster have calmed at least a bit; and the S&P 500 has notched solid 8% gains so far this year. But we don't have to let the climate affect our investing decision-making. Here's how to avoid financial heatstroke:

1. *Use a cooling-off period*. Ready to plunk down some moolah on an asset (or in an investment) that seems like a great idea? Sleep on it (maybe even wait for a day with normal weather conditions), then ask yourself if your mind may be playing tricks on you. At *Pro*, we have an in-house contrarian constantly helping us assess the logic that underpins our decisions.

2. *Assess the decision in the context of your larger financial plan*. The investments we're discussing here are a bit higher-stakes than an impulsive pack of Tic-Tacs, so consider them in the proper context of a holistic financial plan. Is a philosophical fit? Ultimately, is it a net addition to your portfolio?
3. *Consider the cost of making a mistake*. Being wrong about whether you want a new car can really cost you – the vehicle depreciates significantly as soon as you drive it off the lot. Somehow a few thousand bucks disappear over the course of one tire rotation. With investing, you're putting capital at risk; there are also margin considerations and liquidity risk. Before taking the plunge on an investment, consider the costs involved if you were to change your mind.

The Foolish Bottom Line

Our brains are often wired to work against us, Fools. Acknowledging this fact puts us ahead of the crowd. A bit of financial SPF in the form of the steps above, combined with an investing journal that documents the results of previous decisions, can help us get us even closer to winning the battle with our minds.

Stay hydrated,

Bryan (TMF42)

Our Doors Are Open

Pro has reopened for a limited time, so you veteran Pros will be seeing some new handles on the boards. Please extend our new members a warm welcome as they get acquainted with their new service and start their *Pro* journey!

Coverage & Community

- **Great Links Just a Click Away:** Check out our new Guidebook page, chock-full of helpful links in a convenient central location. Be sure to thank TMFKabellen for all her work on this.
- **The Sparrow That Brought Perspective:** Feel good about life, Fools.
- ***Pro*'s Year in Review:** Thirty trades in, here is a recap of *Pro*'s 2012.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here*.

The Motley Fool Pro Site Directory

Published Jul 12, 2012 at 12:00AM

Part 1: Learn About *Pro*

Think Like a Pro

Why we invest
the way we do

\+ Our mission
\+ Our philosophy
\+ Our strategy
\+ Our North Star

Using This Service

**Communication
and site details**

+ Video tour of the site
+ Overview of email
+ Help and contact

Meet the Team

**Jeff, Bryan,
and Billy**

+ Video: "Inside Pro"
+ Team bios

Community

**Perhaps *Pro's*
greatest asset**

+ Discussion boards
+ Wiki

Part 2: Invest With Us

Get Ready …

**Prepare to invest
intelligently**

+ Choose a broker
+ Request options permissions
+ Update your beneficiaries

[Get Set …]

**How we approach
the market**

+ How we think
+ What we believe

[Go!]

**Where to start
and how to catch up**

+ How we measure ourselves
+ How we recommend you do the same

[Keep Track]

**Our performance
and yours**

+ How we measure ourselves
+ How we recommend you do the same

[Using Options]

**Everything you need
to master options**

+ "Options in 3 Steps" (video)
+ Intro to our sister service, Motley Fool Options
+ "Get Up to Speed With Options"

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Meet the Team

Jeff, Billy, and JP

+ Team bios

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+ Wiki

Part 2: Invest With Us

Get Ready ...

Prepare to invest intelligently

+ Choose a broker
+ Request options permissions
+ Update your beneficiaries

Get Set ...

How we approach
the market

+ How we think
+ What we believe

[Go!]

Where to start
and how to catch up

+ Ratings and guidance
+ Making *Pro* fit you
+ Allocation calculator

[Keep Track]

Our performance
and yours

+ How we measure ourselves
+ How we recommend you do the same

[Using Options]

Everything you need
to master options

+ Intro to our sister service, Motley Fool Options
+ "Options in 3 Steps" (video)
+ "Get Up to Speed With Options"

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+ Wiki

Part 2: Invest With Us

Get Ready ...

**Prepare to invest
intelligently**

+ Choose a broker
+ Request options permissions
+ Update your beneficiaries

Get Set ...

**How we approach
the market**

+ How we think
+ What we believe

Go!

**Where to start
and how to catch up**

+ How we measure ourselves
+ How we recommend you do the same

Keep Track

**Our performance
and yours**

+ How we measure ourselves
+ How we recommend you do the same

Using Options

Everything you need
to master options

+ Intro to our sister service, Motley Fool Options
+ "Options in 3 Steps" (video)
+ "Get Up to Speed With Options"

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Walkthrough, Part 2: Invest With Us

Published Jul 12, 2012 at 12:00AM

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Walkthrough, Part 1: Learn About *Pro*

Walkthrough, Part 1: Learn About Pro

Published Jul 12, 2012 at 12:00AM

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What Pro Believes

Published Jul 12, 2012 at 12:00AM

Getting Started With *Pro*

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Our investment mission and our North Star guide our portfolio decisions. But our portfolio itself is a reflection of the key beliefs we have about the world and investing. We attempt to make those beliefs come to life in the *Pro* portfolio, though some beliefs don't yet have a voice.

Below are many of Jeff's strongest big-picture beliefs in 2013.

Jeff Believes …	So We Own …
Technology is essential to our world; the sector will grow and become even more important. But tech will remain cutthroat, with players rapidly coming and going, allowing both long and short opportunities.	**3D Systems** , **BMC Software**, **Intel**, **OpenText**, **Oracle**
Well-managed financial companies are still inexpensive and will reward long-term owners.	**AIG** , **Amtrust Financial Services**, **Broadridge Financial Solutions**, **Wells Fargo**
U.S. home construction will continue to recover.	**GrafTech International** , **Rockwood Holdings**
Cash and checks will continue to lose market share to electronic payments.	**MasterCard**
The euro is overvalued compared to the dollar.	Short **CurrencyShares Euro Trust**

The 14 positions listed above represent nearly 60% of the assets in the *Pro* portfolio (as of Jan. 22, 2013). We carry the other positions because we believe they'll help us keep pace with our always-positive North Star, or because we believe in management or the notion that (for example) the world could almost never have too many coffee bars. Below are some of Jeff's other beliefs that we'll also seek to capitalize on in 2013:

- Energy prices will be relatively stable and will potentially decline as the U.S. taps new reserves.
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- Healthy eating will remain a growing theme in the U.S.
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- A sustainable competitive moat will be more important than ever to strong stock performance.
- Interest rates will start to tick up in the next 24 months, but not by much initially.
- Alongside owning great businesses, *Pro* will do well by generating increased income and doing more targeted shorting.

What about the rest of the *Pro* team? Well, Bryan Hinmon's (TMF42) beliefs are listed below. Nick Crow's (TMFCrow), on the other hand, are not; he said his job is to talk us *out* of our beliefs. He'd rather not think in terms of beliefs as he looks for investments — a diverse viewpoint we welcome. Here are Bryan's:

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- People will see their houses as homes, not investments. (Sub-belief: Kitchens will get bigger and more high-tech.)
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What Do You Believe?

There you have it, Fools — many of our beliefs updated and laid bare. What are your key investing beliefs? Share them on *Pro*'s Philosophy discussion board so we can discuss whether and how to put them into play in 2013.

Catch-Up Trades

Published Jul 12, 2012 at 12:00AM

First introduced in our Jan. 23, 2012 Monday Memo, Catch-Up Trades are our weekly suggestions for members who aren't yet entirely aligned with the *Pro* portfolio. As Jeff wrote then:

> Every week, when we see attractive trades, we'll share them in the Memo so members who are not already fully allocated to the position in question can follow along. (Assume that we, too, would be making these trades if we weren't fully allocated!) We hope the Catch-Up Trades will help you catch up with the *Pro* portfolio, or at least make money trying. We'll also single out stocks that have been freshly moved back to a Buy rating.

As well as in the Monday Memo, you'll always find the most recent Catch-Up Trades on our discussion board for the topic. Fool on!

Site Directory

Published Jul 12, 2012 at 12:00AM

Part 1: Learn About *Pro*

Think Like a Pro

Why we invest the way we do

+ Our mission
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+ Our North Star

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+ Video tour of the site
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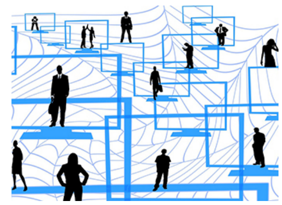

Perhaps *Pro*'s greatest asset

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Practice, Vertical: The Motley Fool Pro Walkthrough

Published Jul 12, 2012 at 12:00AM

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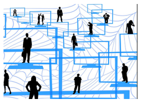

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- You can also click here to print a PDF of all of the information listed (and linked to) above.

What Pro Believes

Published Jul 12, 2012 at 12:00AM

Getting Started With *Pro*

1. Catch-Up Report No. 1
2. *Pro* 's Investment Strategy Guide
3. **What *Pro* Believes**

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Next Up in Pro: More Income, More Shorts

Published Jul 9, 2012 at 12:00AM

Dear *Pro* Member:

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Bristow Group**: Sell to open December 2012 $40 puts, lately $2.70 or higher, for up to 3.6%.

Questions? Visit our "Catch-Up Trades" discussion board.

As we enter the second half of 2012, the market is hounded by the same concerns investors had as early as 2010 … only worse. Greece's debt is now larger, Europe's monetary union is shakier, the U.S. economy is still struggling, and China's economic growth rate is now lower. And yet U.S. stock prices are broadly *higher* since then, because leading companies have been able to grow earnings and free cash flow.

I believe we may face this narrative, or one like it, for years to come. There are no easy fixes to federal debt burdens, and an aging population — especially in Europe and China — means a smaller tax base and larger social costs. Investors' worries about government obligations will periodically tug at the market, pulling prices into a seeming abyss — but as we've seen, leading companies will grow anyway, and the market will follow them higher.

We'll make most of our money in this tug-of-war by owning exceptional companies at attractive prices. We should also do very well shorting flawed companies and ETFs, and we'll add to our gains with options. But first, we need to get through second-quarter earnings.

Earnings Headed Lower?

A predicted 1% dip in the average earnings of companies in the S&P 500 this quarter compared to last year would break a 10-quarter streak of net income gains. Companies as diverse and dominant as **McDonald's**, **Procter & Gamble**, **Tiffany & Co.**, **Ford**, **Nike**, and **Starbucks** have all offered softer outlooks, citing economic realities in Europe (much of which is in recession) and China.

A majority of *Pro* companies are still expected to post higher year-over-year earnings when they step up to the plate beginning this week. But whatever the outcome, remember that slowdowns are common even during periods of long-term growth. No company, and no economy, grows in a straight line. Even the strongest bull markets in history have contained periods of weak earnings and lackluster economic growth. Investors who sell on weak earnings forget that disappointing quarters make it easier for the company to grow later — and the market is forward-looking.

Near-Term *Pro*

Changing gears, here's what to expect from *Pro* over the next few weeks:

- **Reopen:** *Pro* is opening to new members for a handful of days beginning July 16; this will be the second and final time *Pro* opens this year. Thank you in advance for welcoming new members with us!
- **Buy Updates:** Concurrent with the reopen, we plan to briefly review every Buy and Buy First stock we own to help everyone get invested with us. We'll e-mail you our updated thoughts on these stocks beginning in late July, focusing on a few companies a week. For veteran *Pro* Fools, we expect these reports to serve as an updated reinforcement of our thesis and a reason to reconsider any purchases you haven't yet made.
- **Sister Service:** *Motley Fool Options* will have many July expiration trades hitting your inbox soon. Keep in mind that *Options*' recommendations are separate from *Pro*'s.
- **Memo Topics:** You've suggested many good topics for the Memo. Thank you! We look forward to covering as many as possible.
- **Guidebook:** You'll see a Guidebook tab on the *Pro* homepage soon! This new section of the site will highlight the most important features of *Pro* at a glance, including our guiding philosophies, investment tutorials, and more.

And now, some portfolio notes I think you'll be especially happy to hear:

- **Monthly Income:** In deference to our North Star (and because taxes on dividends may head higher in 2013), we're stepping up our income trades. Our goal is to issue an *average* of at least one income trade each month (approximately 12 a year, when opportunity presents itself; some months will have a few income trades, some months none). Many of these trades will use neutral options strategies that require little capital. But purchases like **The Buckle**, with its high dividend yield, also count toward boosting our income. *Pro*'s new "income trade" initiative starts now!
- **S&P 500 Hedge:** Depending on how the market reacts to earnings this month, I hope to continue to decrease our S&P 500 hedge as we move toward more company and ETF-specific shorts. We have several other bearish or defensive positions under consideration.

Longer-Term *Pro*

It never hurts to keep a close eye on your desired destination. We want much of the *Pro* portfolio invested in great long-term holdings; we want to short flawed ETFs and failing companies; and we need to use options to generate income as we seek to follow our always-positive North Star. The portfolio is always a work in progress, and ideally its holdings — and our management of them — will always improve.

Thank you for reading, and posting if you like!

Foolishly,
Jeff

Coverage & Community

- **Kat and Buckle Talk:** LeKitKat posts about **The Buckle**.
- **Buy and Forget?** Another view of long-term buy-and-hold.
- **Socially Awed:** The Social Banter board bounces around the Higgs boson discovery.

The Motley Fool owns shares of Ford, McDonald's, Procter & Gamble, Starbucks, and Tiffany. See Pro's holdings here . See the team's and David and Tom Gardner's holdings here .

Pro Philosophy

Published Jul 2, 2012 at 12:00AM

This is a collection of articles illustrating the *Pro* team's philosophy on how to invest and why. Want to talk philosophy? We have a discussion board for that!

Resources

Strategy Guide (PDF): How we invest, breaking down our portfolio, our guide to finding great stocks, valuation, and more.

Our North Star: Like the real North Star, our North Star — inflation plus 7% annually — offers direction and guides our investing behavior.

What We Believe: Our portfolio itself is a reflection of the key beliefs we have about the world and investing.

Philosophy & Strategy discussion: Talk it out with the *Pro* team and your fellow Fools.

Market Musings

- *Pro* in 500 Words
- 5 Things Every Investor Should Know: Time frame, thesis, and more
- 4 Investing Truths
- Keeping Sight of Our North Star: And 2012 in review
- Why Most Investors Fail — and How We Avoid It
- Hedging the *Pro* Way

Portfolio Management

- A Fresh Start ... Every Day: Bryan outlines *Pro*'s approach to portfolio management
- On Hedging: Why investors can (and should) lose on purpose
- On Selling: Nick explains when and why

- On Allocation: Every stock has a role to play in our portfolio
- Our Fair Advantage: Nick explains how we value stocks

The Best of *Pro*'s Early Years

- 2008: Here and Now
- 2008: Swami Says ...
- 2009: Getting Through a Deep, Dark Wood
- 2009: *Pro* Makes a Buffett Move
- 2009: Mr. Market's Merry-Go-Round
- 2009: An Artificially Sweetened Market
- 2009: A Surprising Short Story
- 2009: So Long to a Down Decade
- 2010: Don't Sleep on Rising Interest Rates
- 2010: Time to Get Active With *Pro*
- 2010: How Europe Can Help America
- 2010: Why Investing Requires Uncertainty
- 2010: *Pro*'s Keys to Great Investing
- 2010: The Dollar's Death ...
- 2010: What Would Ben Graham Think of *Pro*?
- 2010: *Pro*Looks Back — and Forward

On Selling

Published Jul 2, 2012 at 12:00AM

Fellow Fools,

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Bristow Group**: Sell to open December $40 puts for around $3.40, for up to 3.5%.
- **Tupperware**: Sell to open October $55 puts around $3.50, or October $50 puts around $1.70, for up to 5.5% (or just buy shares).

Questions on these? Visit our "Catch-Up Trades" discussion board .

Bryan supported his Memo last week with a discussion-board post called "15% Sales Growers." Unsurprisingly given the many bright contributors here at *Pro*, what began with a simple list has grown into a 59-post collaboration (even Tom Gardner chimed in), with Fools discussing how long to hold a stock, the resultant portfolio turnover, and the ways actively managing a portfolio can add value. This memo is my contribution to that thread, so if you haven't read it, do so now — I think you'll find those posts at least as valuable.

When you manage your portfolio, make sure every decision is made with opportunity costs firmly in mind. In other words, it's important to hold an investment until you have a better one; the challenge is dealing with the very human desire that biases us toward more action. If we can do that successfully, opportunity costs alone should slow portfolio turnover to a healthy level.

That said, we know empirically that some investors add value to their portfolios by actively managing them — but most do not. We are here, as I assume you are, because we believe we are in the former group. And as the title of this memo suggests, I think the difference, in part, boils down to selling. We've written at length about the types of businesses we prefer to buy — those with stable, recurring revenue, high returns on capital, and strong competitive advantages. But selling is harder. Perhaps that's because we buy such good businesses, or maybe it's because it means the opportunity to be wrong twice (the sell itself, then the potential reallocation of capital). Perhaps we become attached to the businesses we own.

I don't know, but I do know that investors, on average, sell winning investments too soon and hold their losers too long. It follows, then, that we need to consider our sell decisions rigorously, and if we err, we should err on the side of selling too infrequently. Here (again) are my top five reasons to sell an investment, in ranked order. (This refers to full sales, not allocation adjustments.)

1. **Error.** As investors, we will make errors. As soon as we discover an error in our analysis that impairs the value of our thesis, we should sell.
2. **Fundamentals.** If the fundamentals of the business decline or fail to support our thesis or valuation, we should sell.
3. **Opportunity cost.** We should sell when we find a better risk-adjusted opportunity in another investment. (Cash is sometimes better; consider taxes as well.)
4. **Valuation.** If we buy a crummy business when it's mispriced, making it an attractive investment, we should sell that below-average business around fair value.
5. **Life.** If you have a pressing use for the capital in real life, consider selling.

It's also worth noting the following, from the last time I shared this list: "I try very hard not to sell great businesses at fair value (remember, it's ever-increasing) or because I have large gains. Instead, I remind myself that when you find great compounding machines, you should let them run and only sell when you have a better place for the money."

Making Adjustments

I admit I copped out a bit in my list above. I left out allocation adjustments, which made things simpler — and, unfortunately, less reflective of reality. Actual active management is more nuanced. I don't subscribe to the idea that I should know my holding period when I make an initial investment. Ideally, that holding period is forever. But the harsh reality is that few businesses last a lifetime, and even fewer last generations. If you own a company that's an exception to that rule (and you can somehow be sure of that), I suggest never selling it. In the meantime, knowing the reality of competition, we buy the best businesses we can at good prices and then keep our eyes on them. In fact, about half my research time is spent monitoring the businesses we've already purchased and their competitors.

Here's the process I use:

1. **Fair Value.** If shares reach our fair-value estimate, we review our estimate.
   a. If there is no further upside: We will sell or consider writing a covered call.
   b. If the long-term prospects are strong, but the risk-to-reward ratio is less favorable: We will reduce our allocation.

c. If more upside appears likely, and the business has grown even stronger, we'll keep our shares and may even add to them.
2. **Material Information**. We update our estimate of the business's value and its competitive advantage based on new corporate, legal, and macro information.
3. **Surprise.** When we're surprised by a stock-price move, we review the situation and incorporate any new information into our estimate.

Over time, businesses will either strengthen their advantages or lose them. The three checkpoints above allow us to update our holding period in real time with the benefit of new information not available when we first made the investment decision. If our review shows us that a business's prospects are improving, we won't sell. On the flip side, even our favorite companies risk having their profits and advantages eroded by able competitors; by keeping tabs on them, we can sell before it's too late — even if in a perfect world, we would have preferred to hold forever.

The Foolish Bottom Line

To keep the tax man at bay — and to benefit from our compounding machines' ability to reinvest capital at returns not available to us in the public markets — we need to hold our investments as long as we can. But even the leading businesses of today, some of which we own in *Pro*, may not always enjoy economic profits in the future. Keeping a keen eye on our businesses allows us to stay on top of any changes, which in turn helps us wisely allocate our capital to the investments we think offer the most attractive risk-adjusted returns. It's the *Pro* way!

Want to talk about this Memo? Join us on the Memo Musings discussion board. Fool on!

— Nick (TMFCrow)

Coverage & Community

- **Infamous:** Put an hour to good use by reading and contributing to the 15% sales growers thread.
- **Where We Stand:** Jeff shares his thoughts on *Pro*'s year so far.
- **That's So Weak: Oracle** remains inexpensive after a weak Euro has a negative impact on results.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Making Pro Fit You: If You're Fully Invested Elsewhere

Published Jul 2, 2012 at 12:00AM

Members joining Pro *from another Fool service and those who are already fully invested will need to consider changes to both their portfolios and their mindsets. Here's how to begin.*

As You Get Up to Speed

If you're already fully invested, you'll need to sell existing positions to add *Pro* picks. We recommend that you do this gradually and deliberately.

- List your existing positions in order from your highest-conviction holding to your lowest-conviction holding.
- If you own stocks from another Fool service, you can use that service's guidance on those stocks in building your list.
- If you don't know why you own a stock, that's a good reason to sell it.
- Be mindful of your sector and geographic allocations. You don't want to unintentionally end up owning nothing but oil or European stocks just because they were your favorites.
- If you're struggling with what to sell, post to the discussion boards — the *Pro* team can't give you individual advice, but our community members can and frequently do.
- When you're ready, incrementally sell your lowest-conviction stocks and use the proceeds to move into our Buy First and Buy stocks. Keep an eye on the Catch-Up Trades section of each Monday Memo for timely ways to enter our positions on Hold.
- Review your positions and portfolio after studying *Pro*'s mission and reviewing our North Star. Use that analysis to craft your portfolio going forward.

Once You've Settled In

Once you've built your Buy First and Buy positions, all you need to do is wait for further trade alerts from the team. Remember, though, that trade alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — one gradual step toward shaping the portfolio we want. You may decide to modify the strategy we choose for a trade; for example, you may wish to write puts instead of buying a stock outright. If you choose to deviate from our recommendation, make sure you (a) understand why we chose the strategy we did, (b) have a reason that the modified strategy better fits your portfolio, and (c) exercise caution by sizing the position a bit smaller than you would otherwise.

Your *Pro* Perspective

If you're joining us from another Fool service, it is critical that you understand the differences between *Pro* and some other Fool services. At *Pro*, we are building a portfolio, not offering investment ideas. *Stock Advisor* and *Rule Breakers*, for example, offer stock ideas from which members can pick and choose. In contrast, *Pro*'s trades are intended to be integrated building blocks of an overall portfolio. We cannot emphasize this enough: Anytime you decide to deviate from the *Pro* portfolio, make sure you understand how the trade in question is intended to fit with our portfolio — and how the modified trade will fit with yours. With every trade, keep the portfolio context in mind.

Next Steps

- **Got questions?** Bring them to our Making *Pro* Fit You discussion board.
- **Second opinion?** To see how we recommend you approach *Pro* under other circumstances (say, if you're building your portfolio in an IRA), download the entire "Making *Pro* Fit You" PDF by clicking here.

Making Pro Fit You: If You're Free-Range

Published Jul 2, 2012 at 12:00AM

So you're new to Pro *and able to follow every* Pro *portfolio move to a T? Here's what to do.*

As You Get Up to Speed

Match our portfolio positions and allocations, starting with the Buy First and Buy positions — and do so at your own pace. We'll be sending you four Catch-Up Reports designed to help you do just that, one per week through March 14. You'll find them in your inbox and on the Pro website, and they will include everything you need to know to make the trades. If you're comfortable with options, you can also consider writing puts to try to buy some of our stocks cheaper. Post on the discussion boards to get the community's feedback about any trades before you make them, if you like. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions. You can find a review of our most timely entry strategies for positions on hold in the "Catch-Up Trades" section in every Monday Memo.

Once You've Settled In

Once you've built your Buy First and Buy positions, all you need to do is wait for further trade alerts from the team. Remember, though, that trade alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want. You may decide to modify the strategy we choose for a trade; for example, you may wish to write puts instead of buying a stock outright. If you choose to deviate from our recommendation, make sure you (a) understand why we chose the strategy we did, (b) have a reason that the modified strategy better fits your portfolio, and (c) exercise caution by sizing the position a bit smaller than you would otherwise.

Your *Pro* Perspective

The most important thing to remember is that *Pro* is a portfolio service, not a collection of investment ideas. All of our positions exist in the context of our portfolio; if you elect to pick and choose *Pro* investments, it is critical that you understand how they fit into your portfolio. Our trades are intended to integrate with existing positions and to form a portfolio of assets that keeps our North Star firmly in mind.

Next Steps

- **Got questions?** Bring them to our Making *Pro* Fit You discussion board.
- **Second opinion?** To see how we recommend you approach *Pro* under other circumstances (say, if you're building your portfolio in an IRA), download the entire "Making *Pro* Fit You" PDF by clicking here.

Let's Get Growthy

Published Jun 25, 2012 at 12:00AM

Fellow Fools,

Pro Trade Roundup

- **American Express**: We wrote eight October 2012 $55 puts for $2.73 per share. We also established a bull call spread by selling eight October 2012 $60 calls (receiving $1.65 each) and buying eight October 2012 $65 calls (paying $0.47 each), for a net credit on the spread of $1.18. Our total net credit was $3.92 per share, earned in entirety if the stock is between $55 and $60 at expiration.
- **The Buckle**: We invested 3% by buying 1,100 shares at $38.16. Shares are a Buy First.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Intel**: Sell to open October 2012 $24 puts, lately $0.75, for up to 6.9%.
- **Vanguard Energy** ETF: Sell to open December 2012 $85 puts for $4.20 or higher, for up to 3%.

Questions on these? Visit our "Catch-Up Trades" discussion board .

I spend a lot of time with our summer interns here at Fool HQ, managing (with the help of an entire gaggle of Fools) the educational part of their experience. This has been a high-return way to invest my time over the past few years; plus, it's fun, and it helps me stay on top of the current slang among those crazy kids today. Past interns have indicated that they enjoyed their time here (no threats were made in the collection of this data) and that the experience helped them make significant progress as investors and business thinkers.

Earlier this week, I was talking to this year's interns about companies that grow quickly, and they seemed stunned when I challenged their assumption that growth, by default, is good.

Getting Caught Up in the How Much

Companies that grow quickly are exciting. They make for compelling news stories, and very occasionally, they create great wealth for their founders and investors. They're fun to talk about at cocktail parties and create a sense of regret if you missed out. And generally, the higher the growth rate, the bigger the hype. It's easy for investors to anchor on the loudest stories, even if they are incredibly rare: Just 11 companies currently in the Russell 3000 index have increased their revenues at or above 15% over each of the past 10 years.

In his book *Innumeracy*, John Allen Paulos writes, "There is a strong general tendency to filter out the bad and the failed and to focus on the good and the successful." Our psychology has us wired not to care that impressive, 15%-plus yearly growth has a low likelihood of persisting for 10 years. How low? Try 0.4% over the most recent decade. Ouch.

Focus on the How ...

I pressed our interns to let go of how *much* growth was being achieved and to instead focus their energy on assessing *how* that growth was happening. Very simply, growth can come in four ways:

1. Sell more stuff
2. Sell new stuff
3. Raise prices

4. Acquire sales

Not all of these are created equally, of course. Selling more stuff is easiest to do when the economy is strong. Selling new stuff is easiest when a company has resources — R&D, marketing and capital spending — focused on incremental and/or revolutionary improvements to its current product lines (or on creating new demand). It's easier to raise prices with the help of product differentiation or brand power. And acquired sales often come with a hefty price tag that makes them economically inferior to the other avenues of growth.

… And Focus on the How Long

The source of growth also affects its sustainability and duration. Acquired growth, of course, is a one-off. But pricing power can be an annual occurrence. An R&D engine can provide a lasting pipeline of new products to sell. And long-range trends that transcend the ebbs and flows of economic output can create decade-long tailwinds.

A quick look back at *Pro's* beliefs shows that we spend time thinking about just such trends, and we have our eye on companies that stand to benefit. What really matters for our purposes is having an informed opinion, one that differs from the consensus, on the potential duration of any growth. An extended period of above-average growth was the case given to me when I was pitched **Under Armour**. Internally, we've used such thinking to bolster our arguments in favor of **Apple** and **Papa John's International**.

The Foolish Bottom Line

Don't focus on outsized growth, however tempting it may seem. Growth is an outcome of a company's strategy, competitive position, and industry environment. As investors, we should instead turn our attention to the decisions and factors that allowed for the growth — and what might make it last.

Working with our interns is a great opportunity to review some of the vital basics of investing, stuff that can get lost in the day-to-day of being a portfolio manager and Fool. While my role as a teacher (or preacher, if you ask them) may put me front and center, this time of year I retreat back to the role of student more than they realize.

Happy summer, Fools,

Bryan (TMF42)

P.S. Come to the Memo Musings discussion board to see the list of 11 companies with 10 consecutive years of 15% revenue growth.

Guidance Updates; *Pro* Reopening in July

- **GrafTech International** , **Rockwood Holdings**, **OpenText**, and **Pacer International** all move down to Buy from Buy First. Why? Primarily because *Pro* is reopening to new members on July 16, so I'm fine-tuning what we end up telling our new members to buy first. Cyclical stocks (the first two), a stock with a new CEO (OpenText), and a stock in a turnaround (Pacer) are all worth owning for patient investors, but won't be suggested *first* to newcomers. We may return them to Buy First when we do tell new members to buy them, or after earnings are reported in July. *—Jeff Fischer*
- **Oracle**, which just reported satisfying earnings, moves up to Buy First from Buy.

Coverage & Community

- **Our Newest Rec:** *Pro* members are having great discussions on the merits of our latest stock buy — our first clothing retailer — and why we chose to act now.
- **Growth and Long-Term Buy and Hold:** *Pro* members discuss both in advance of today's Memo.
- **Our Hotel REIT Buying Again?** Member cnunlist does some investigative work and learns that **Pebblebrook Hotel Trust** is buying two new West Coast properties soon.
- **Positively Oracular:** Jeff has a drive-by post on an early earnings release from **Oracle**.
- **Battle Joined:** A proxy fight has begun at **BMC Software**. *Pro* is assessing.
- **Rules of the Game:** *Pro* Fools discuss margin requirements.
- **More Puts for Writin':** alex340 lists puts that meet *Pro* criteria.

The Motley Fool owns shares of Under Armour. See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Ready to Become a Pro Investor?

Published Jun 24, 2012 at 12:00AM

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Learn: Click through (or print out) our Walkthrough

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Published Jun 24, 2012 at 12:00AM

WxC – Invested, no options guidance

In the welcome boxes, list the future catch-up reports, but gray them out with dates they're be published, so members could see that they're coming and we can keep them foaming at the mouth and coming back for more

- Updated & redesigned Strategy Guide
- What Pro Believes
- Catch-up Report (invested version)

Email series:

1. Using This Service + Go! + strategy guide
2. Catch-up report (invested version)
3. Strategy guide

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Published Jun 24, 2012 at 12:00AM

WxB – Cash, options guidance

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- What Pro Believes
- Updated version of Use Options Like a Pro, containing:

a. How (and how often) Pro uses options
b. Link(s) to Options resources for new options investors
- Catch-up Report (cash version)

Email series:

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Published Jun 24, 2012 at 12:00AM

WxD – Invested, options guidance

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Buy The Buckle

Published Jun 20, 2012 at 12:00AM

Using Options

- [Options in 3 Steps]

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- **What We're Doing:** Adding low-risk domestic retail exposure, a solid dividend, and plenty of upside.
- **What We're Thinking:** This company doesn't have to do anything out of the ordinary to generate North Star-like returns.
- **What We're Expecting:** The Buckle will conservatively grow its store base, execute admirably, and generate sufficient cash to reinvest in the business, grow its regular dividend, and routinely pay out special dividends.

[Use Options Like a Pro]
[Options U.]
[Options Glossary]
[Options discussion]

Trade Essentials

- **Action:** Buy 3% of The Buckle
- **Buy Around:** $41 or less (but you must use a **limit order** at current prices; the stock is thinly traded)
- **Fair Value:** $53
- **Dividend Yield:** 2.1%
- **Scorecard Status:** Buy First

The Foolish Bottom Line

Your *Pro* team doesn't know much about fashion, but we can read financial statements. And if the next decade of business performance by specialty retailer **The Buckle** (NYSE: BKE) looks anything like the last one, we'd be willing to wear whatever getup the company suggests.

The Buckle sells jeans, other apparel, and accessories at more than 400 retail locations across the United States, and we think the fantastic management team has figured out a formula that works: measured growth, middle-of-the-road merchandising, and great service. We're typically leery of the risks of investing in retail, especially fashion, but the proof is in the numbers for The Buckle. Shares are undervalued, the store concept is in the middle of its life cycle, and the company's financial prudence and operational acumen should lead to a growing stream of free cash flow, dividends, and extra payouts — all of which can help the *Pro* portfolio in our pursuit of our North Star.

A Great Operator With Room to Run

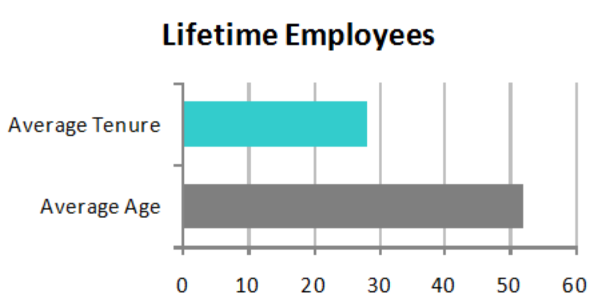
From 431 stores at the end of fiscal year 2011 (ending 1/28/12), we believe The Buckle has plenty of room to grow as it expands from the middle of the country to both coasts; it should be able to achieve wonderful store economics with the between 650 and 850 locations we expect. The table below outlines the key metrics we monitor for a retailer, and as you can see, The Buckle has fit into its jeans pretty well over the past decade. Not only has the company's footprint grown by 127 stores, it has sold more — and *earned* more — at each location thanks to its tight control over operations.

($ figures in thousands)	2002	2011	Annual Growth Rate
Stores	304	431	4.0%
Sales per store	$ 1,339	$ 2,498	7.2%
FCF per store	$ 57	$ 406	24.3%
Sales per square foot	$ 274	$ 462	6.0%
Inventory turnover	4.7x	6.2x	3.0%

Source: SEC Filings, S&P Capital IQ, and analyst estimates
Per store calculations are based on average stores open during the period

Management Who "Get It"

Another key factor we look for when assessing a retailer is its "soul." Anyone can sell jeans; Buckle's soul — what makes customers choose it over hundreds of other retailers — comes from its culture. Employees are trained extensively in providing service, from helping customers find the appropriate fit for the shape of their body (this is a bigger deal than many of us fashion-ignorant individuals realize) to offering lifetime hemming. Customers enjoy the special treatment, so they come back; employees enjoy being empowered fashion consultants, so they stay. In fact, the company's executive ranks are packed with staffers who started their careers folding T-shirts and cleaning dressing rooms. The key executives at The Buckle have spent, on average, 54% of their lives with the company.



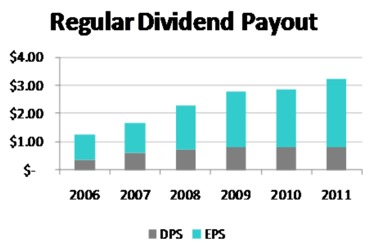
Source: Company filings.

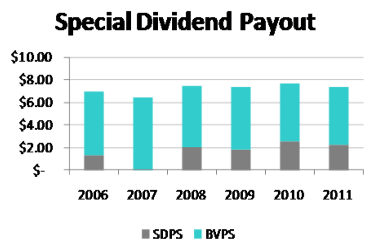
And insiders aren't just investing their time with The Buckle; they have their money invested there, too. Collectively, insiders own 43% of The Buckle's shares outstanding, and management's bonuses are tied to substantive performance measures like same-store sales, gross margin, and net income. We admire that executives are compensated for making The Buckle *better*, not bigger, and with management's interests tied so clearly to ours, we don't expect The Buckle to over-expand or engage in other practices that often get specialty retailers in trouble.

A Regular Dividend and So Much More

The Buckle began paying a dividend midway through 2003, and after quadrupling its annual dividend since 2004, it still pays out just 25% of its earnings. The company is funding its expansion with internally generated cash, but even accounting for this growth spending, the dividend eats up only 22% of free cash flow. On today's share price, the company's dividend yield of 2.1% is higher than the average (1.9%) yield on the *Pro* portfolio, and we think it has plenty of room to grow.

Now for this fashion show's big reveal: For five of the past six years, The Buckle has paid out special dividends. The total of these payouts comes to $9.88 per share, or 26% of today's share price. The company can afford to do this because it generates enough cash to keep its stores current (and fund new openings) and still has plenty left over — with no debt. At the end of 2011, 44% of The Buckle's total assets were cash and investments.





Source: Company filings.

To us, The Buckle has two sides: a very healthy operating business and a bank account. We trust management to allocate the cash in that bank account appropriately, and we appreciate their propensity to return any extra to shareholders. While we can't count on special dividends, it is worth noting that the average yield over the past five years, including these payouts, has been 7.9%. Meanwhile, the company's operating business has grown bigger, more profitable, and more valuable: Over the past six years, shares have doubled from $20 to $40.

An investment in The Buckle suits *Pro*'s penchant for superior businesses, steady income, and a favorable risk/reward profile. Shares can be purchased for only 9.8 times free cash flow – you won't see a sale this good at its retail locations. We recommend you try on some shares today.

Next Steps

- **Dig in**: Check out more details in this post.
- **Chat**: Discuss the company and this investment on our The Buckle discussion board.
- **Track**: Add BKE to My Scorecard.
- **Visit**: Check out a store near you and report your findings.

See Pro*'s holdingshere. See the team's and David and Tom Gardner's holdingshere.*

Trade Options on American Express

Published Jun 20, 2012 at 12:00AM

Trade Essentials

- **Purpose:** Earn income or buy shares if they fall
- **Trades:**
  - Note that some members may be able to complete all three actions in one trade. If you can't, do the following:
  - Sell to open October 2012 $55 puts, lately around $2.40.
  - Then in *one*other separate trade:
    - Sell to open October 2012 $60 calls in a number equal to the puts you just wrote, lately for about $1.95.
    - Buy to open an equal number of October 2012 $65 calls, lately costing about $0.55 (this sets up a bear call spread for a credit of about $1.40).
- **Price Guidance**: On the three legs combined, target a net credit of around $3.80 to $4.00. As prices change, accept no less than $3.50.
- **Allocation:** Three percent (if the $55 puts are turned into shares, for a net cost of around $51). Trade one contract of each option for every $170,000 you manage; for *Pro*, that's eight contracts.
- **Alternative Trades:**
  - Just write the October $55 puts, one for every 100 shares you would buy, lately paying you about $2.40.
  - If you can't write puts, aim to buy shares if they decline to about $52.
- ***Motley Fool Options* Member Guidance:** If you're already writing a covered strangle on American Express in *Motley Fool Options*, just continue to follow that strategy with me in that service.

How to Follow Along

We're interested in becoming investors in **American Express** (NYSE: AXP), one of Warren Buffett's largest equity holdings. But we're not buying outright today, because we have the tools to target a lower buy price — or earn income if our desired price isn't reached.

As with many large financial stocks, options on American Express enjoy healthy premiums, but unlike most large banks, the company is in excellent shape. The credit card giant was profitable throughout last decade's financial implosion and now enjoys historically low delinquency and charge-off rates. We'll talk more about the business below. First, here's how to follow along, and how the trade may play out:

- Sell to open one October 2012 $55 put for every 100 shares you're willing to buy ($5,500 worth). We're targeting a 3% allocation if we get shares.
- Using a spread order, set up one spread for every put you just wrote. Sell to open October 2012 $60 calls, and buy to open the same number of October 2012 $65 calls to cap your risk on the written calls. This sets up a bear call spread.

Here are our possible outcomes at Oct. 20 expiration:

American Express Stock	$55 Puts	$60/$65 Bear Call Spread
Below $55	We let the puts get exercised for a net buy price around $51, or we close early to write new puts	Expires as income
Between $55-$60	Expires as income	Expires as income
$60-$64	Expires as income	We can close the spread and enjoy a partial profit on the three options up to $64

$65 and higher	Expires as income	Overall, we lose a maximum of just $1 per contract at any price above $65

(Options pros will recognize this as a partial iron condor; the only part missing is the purchased puts to cap our downside on the $55 written puts. In this instance, we're confident enough to buy the shares instead if they decline.)

From its recent price of $57, the stock can move considerably and we'll still profit:

- American Express needs to fall more than 10%, to less than $51, for us to end up with a loss by expiration.
- The stock can increase by 12% before we start to see a loss on the upside.
- No matter what, our maximum loss if Amex soars higher than $65 is $1 per contract, because we have a $5 bear call spread and about a $4 credit to set up our positions.
- On the downside, our losses will mimic those of stock ownership if the price hits $51 by expiration.

Follow-up: Writing $55 puts leaves us ready to buy a 3% position, and we plan to strangle it (write more puts *and* calls on it) if we become shareowners. Over the long term, we view American Express as an "option income" stock with substantial upside. Once we have shares, we will likely want to roll our strangles to higher strike prices as the stock climbs, allowing us to keep our investment and enjoy the price appreciation. This business is worth owning.

The Business

- **Share Price:** $57
- **Buy Around:** $52
- **Fair Value:** $61

In the quarter ended March 31, American Express had 98.7 million credit cards in use, up 7% from a year ago — half in the United States and the rest spread around the world. Customers swiped their Amex cards to the tune of $211 billion in transactions last quarter (an average of $3,770 per card member), making its customer base the most lucrative per capita of any credit card.

Management's "spend-centric" business model drives up revenue by spurring customers to spend more on their "Amex" card. Finance charges and card fees make up most of the rest of revenue, but even so, customer loyalty runs deep and brand equity is top-notch. Card users appreciate the superior customer service and rewards, and merchants appreciate that Amex users on average spend more per purchase than other card users.

American Express operates what it calls a "closed-loop network," letting it capture more of the value chain in each transaction. The company issues and manages its card base, originates loans to users, manages its network with merchants, and runs the network. At competitors **Visa** (NYSE: V) and **MasterCard** (NYSE: MA), by contrast, independent banks issue cards and originate loans. That means American Express isn't as removed from its end users as these two giants are, making its hands-on customer service even more of a competitive advantage. For instance, the company is able to closely monitor customer spending and drive results where needed. The setup also helps Amex capture more revenue from each transaction, gives it control of its brand, and provides income on loans it makes.

American Express	2007	2008	2009	2010	2011
Net Interest Income	$3,443	$3,646	$3,124	$4,869	$4,641
Commissions and Fees	$18,939	$19,342	$16,571	$18,684	$20,974
Revenue Before Loan Losses	$27,559	$28,365	$24,337	$27,582	$29,962
Provision for Loan Losses	$4,103	$5,798	$5,313	$2,207	$1,112
Total Revenue	$23,456	$22,567	$19,024	$25,375	$28,850
Net Income	$4,126	$2,871	$2,137	$4,057	$4,899

Dollar amounts in millions. Source: S&P Capital IQ.

While transaction and card fees represent about 70% of Amex's revenue, loan losses can balloon during a crisis, punishing the stock. As the table indicates, this is what happened in 2009, when charge-off rates leapt from the mid-single digits to nearly 10%.

Today, accounts more than 30 days past due amount to just 1.4% of the total, and the net write-off rate is a historically low 2.6%. True, another financial crisis could disturb this calm and hit the stock. But we expect American Express to again prove its resilience in the face of any future adversity; since 2008, management has only become more stringent with its lending standards.

Finally, American Express is perpetually engaged in countless lawsuits around the world, including one with our own Department of Justice. We'll stay informed about these issues, but we don't expect them to disappear; that's the cost of running a dominant business that's so tightly tied to commerce.

Next Step: We can help you set up this options trade and answer questions on the business at *Pro's* new American Express discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Where We Yield and Where We Stand

Published Jun 18, 2012 at 12:00AM

Fellow Fools,

We're nearly halfway through 2012, the U.S. stock market is up modestly, and we're keeping a close eye on the *Pro* portfolio. Here's what we're watching and what it means.

Pro Trade Roundup

- **Pacer**: We bought 1,900 more shares through our June $7.50 puts, for a net cost of $6.70 each. This brings our total allocation to 2.3%.
- **Pacer**: June $5 puts expired as income.
- **Bristow**: June $50 covered calls expired as income.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Bristow Group**: Sell to open August $40 puts, lately $2.40, for up to 3.4%.
- **CurrencyShares Euro Trust**: Short up to 4% of your portfolio if you haven't.
- **Vanguard Energy** ETF: Sell to open December $89 puts around $4.50, for up to 3.1%.

Questions on these? Visit our Catch-Up Trades discussion board .

Where We Yield

GrafTech International is the only one of our companies to offer weak guidance lately. The reason — soft demand for the graphite electrodes used in steel production — is beyond the company's control, and it's not having operational issues, so we'll simply wait through this downturn in a cyclical industry. We believe steel demand will eventually grow again, and GrafTech should experience a nice upturn when it does (at which point we'll be attuned to selling). Shares look inexpensive while we wait, and the stock remains a Buy.

Specialty chemical purveyor **Rockwood Holdings** initiated a 3% dividend last week, continuing a trend we generally like to see — companies are increasing dividend payout ratios, or rolling out dividends for the first time, in numbers I haven't seen before. There are two main reasons: Managers know investors want yield in a nearly yield-free world, and businesses are flush with cash. A dividend benefits investors indirectly, too, because management tends to be more prudent with capital when they know they have a payout to make. Rockwood has been saying since last year that it would consider a dividend once its cash and receivables balance exceeded $500 million, so its generous 3% yield arrives right on schedule.

Our waste-disposal expert, **Covanta**, is riding the same wave; it recently doubled its payout, giving it a 3.8% yield. And global futures exchange **CME Group** hiked its dividend 59% this year, providing investors with a 3.2% yield that grows to nearly 5% when you include the special annual dividend it paid in March. And, of course, **Apple** is getting on board too, initiating a dividend of 1.8%.

Finally, **Pebblebrook Hotel Trust** increased its dividend 300% this year (and will continue to do so as income grows), giving us 2.2% today. And **MasterCard**'s dividend recently doubled — but the stock still yields just 0.3%, and the company only pays out 8% of its net income. It and **Oracle** — which pays out 12% of its income to yield 0.9% — could easily grow their dividends severalfold and not miss a beat.

Including our ample cash balance, the *Pro* portfolio as a whole is paying us 1.9% right now, on par with the S&P 500. Our dividend payers yield an average of 2.7% each. (Click here for a recent summary.) This is a good start, but we want more income.

Sideways, Snaky-Slithering Market Ahead?

Europe appears to be nowhere near a resolution to its debt and structural currency problems. At home, the United States is barreling toward a contentious election cycle; unemployment remains stubbornly high, and if action isn't taken this year, we'll face a "fiscal cliff" of tax increases and spending cuts in 2013. Income investments are important to us in this context; how else should we invest?

- We continue to own superior companies trading at prices that offer healthy, North Star-topping upside with reasonable risk. We're looking for new businesses that meet those criteria, too, and we're ready to hold through some volatility to get the results we seek.
- We are newly targeting a *steady flow of income trades*, so keep an eye on your inbox. Expect more income ideas of all shapes and sizes (though most won't require much capital, because we want to keep cash available for buying opportunities even while we earn income).
- We continue to carefully seek more companies (and ETFs) for shorting to join our lonely **Sony** short position.
- The **SPDR S&P 500** ETF serves as our general market hedge while we look for more companies to short (some members have other indexes as hedges, too).
- And we're still skeptical about the euro in its current format, so we remain short **CurrencyShares Euro Trust**.

What's It Mean?

We always want our *Pro* portfolio to work together, long and short, options and hedges. And it's always a work in progress, even though we work to keep our turnover low — we know active trading is a costly burden rather than a boon. Dividends aside, though, the income side of our portfolio has been light this year. We are looking to remedy that on an ongoing basis starting this month, whenever opportunities exist.

We'll keep buying and holding companies with strong upside (many with dividend yields to boot), shorting weak companies, hedging, and using options for strategies that include income. As a result, our portfolio should achieve what we all want over time: Healthy value, growing in numerous ways, with less risk than someone who is 100% invested long.

Please visit the Memo Musings board to discuss this weekly feature, and thank you for being a part of *Pro*! We care about your financial future, and that's what we're investing for.

Jeff Fischer (TMFFischer)

Coverage & Community

- **Stay Safe Out There:** *Pro* members are all over margin of safety.
- **Need More Puts to Write?** Alex340 delivers again.
- **We Love Checklists:** Jeff offers up a few must-haves when writing long-term puts.
- **Fancy, Fancy:** Chime in on this discussion about luxury brands and their role in the *Pro* portfolio.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

How Is Pro Performing?

Published Jun 11, 2012 at 12:00AM

Fellow Fools,

There's only one way to learn how your portfolio performs in good markets and bad: Hold the same positions through various market conditions, and let time pass.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Bristow Group**: Sell to open September 2012 $40 puts for about $2.70 or higher, or September 2012 $35 puts for about $1 or higher, for up to 3.6% of your portfolio.
- **Vanguard Energy**: Sell to open December 2012 $85 puts for around $4 or higher, for up to 3.1% of your portfolio.

Questions on these? Visit our "Catch-Up Trades" discussion board.

As we at *Pro* aim to follow our always-positive North Star, we work to manage risk despite our inevitable exposure to stocks' ups and downs. We want the *Pro* portfolio to match or exceed the market when it rises and to decline less than the market — or even earn a profit — when stocks fall. Time must pass and market conditions must fluctuate before we can ascertain how close we are to accomplishing either goal. If we're not, we can change our strategy — always remembering that this, too, takes time.

We should also note that our past performance may not reflect how we'll do the next time the market changes. Even if we're exceeding our expectations at any given moment, we may need to steadily adjust our holdings according to where we think the market will be strongest *next*. Over the last few years, we've seen strong value in technology, small stocks like **AmTrust Financial**, and health care.

The S&P 500 is not our benchmark, but it's still worth watching as we consider how our decisions are panning out. Again, we want to match or exceed the market when it rises and hold up better, or even profit, when it's down. We're always focused on our North Star (inflation plus 7%), because it's a much steadier performer than the market index over the last four decades. But because it's not investable, the North Star can't be our only tool for judging performance. We use the stock (and options) market to form a portfolio strategy that could mirror or exceed our North Star, and that means we need to contrast our results with both stocks *and* the North Star. So, here's how *Pro* has performed on a monthly basis this year in relation to the S&P 500 while in pursuit of our North Star.

Month End	*Pro*	S&P 500	2012 *Pro* Cumulative	2012 S&P Cumulative
Jan. 31	6.5%	4.5%	6.5%	4.5%
Feb. 28	2.4%	4.8%	9.1%	9.5%
March 31	1.3%	2.4%	10.5%	12.2%
April 30	1.0%	(0.3%)	11.6%	11.9%
May 31	(4.4%)	(6.0%)	6.7%	5.2%

Sources: Pro*'s results are from our month-end Interactive Brokers brokerage statements. S&P 500 numbers are from the S&P 500 Total Returns Index, which reinvests dividends daily.*

We're very happy to have kept pace with the S&P during its steady ascent, especially because *Pro* was 20% to 30% short and held some cash to boot (meaning we kept up with the index with less risk). And our portfolio is down less than the market since April, a combined result we know many funds would love to have. But we want to do better, and we think we can over time. Meanwhile, the North Star is up 5.1% as of May 31, compared with *Pro*'s cumulative 6.7% return. (You can see the North Star numbers at the bottom of the recommendations page.)

Nick, Bryan, and I joked in April that we should sell everything, take our North Star-topping 11.6% return, and call it a year. So far, the joke's on us. Commissions, taxes, and impracticality aside, *Pro* would be about 5% richer (so far) had we executed that rash idea. But we'd also be anxiously watching to start buying again, and history has proven repeatedly that selling everything in response to the market's whims is a losing way to invest. (In fact, it's not really investing at all.)

As investors, not traders, our goal is to build a portfolio that will do the hard work for us (in other words, for *you*). We want the portfolio to be constructed for healthy returns in both good and bad markets. We can't trade the majority of our assets in and out of the market rapidly, and we know it wouldn't pay off even if we could. The *Pro* portfolio has served us well by outpacing the market's rise year-to-date. Now how do we make it better?

How Can We Steadily Improve?

Maybe it's all those hours behind the controls of a Boeing 777 talking (I joke), but managing the *Pro* portfolio could be a bit like flying a plane. We want to find the right speed for a gradual ascent; we want to manage risk so we don't break up when we hit turbulence; and during a drop in altitude (or a decline in the market), we want to maintain enough height to stay above ground (and near our North Star). We want to rise ever higher over time, manage our risk, and maintain altitude even when the market doesn't.

To accomplish this, we need a sophisticated portfolio with low-cost, high-reward hedges and shorts that kick in when needed; stable investments in great companies that will grow; and steady yield from dividends and options strategies that don't tax our assets. The *Pro* portfolio has performed admirably so far this year, the first year following our North Star strategy, but I want to perform much better in falling markets, and we also need more income. In other words, we need to continue to work on improvements. As we strive to deliver results and then improve upon them, we're grateful you're putting your trust in *Pro*.

A Great Article on Investing

I'll close today by pointing you to an excellent article by Fool writer Brian Stoffel in which he demonstrates the folly of trading, the superiority of long-term thinking, and what Warren Buffett *really* meant when he wrote about fear and greed. This is right up *Pro*'s alley.

To discuss the Memo, visit the Memo Musings board. Thank you again for being a *Pro* member.

— Jeff (TMFFischer)

Coverage & Community

- **Are You Long-Term?** Exactly how long is your investing horizon, and how tolerant are you of short-term losses? *Pro*Fools debate on the Philosophy & Strategy discussion board.
- **Rockwood Holdings Goes Green:** The brand-new dividend offers us a 3% yield. Here are Jeff's thoughts.
- **Pigs and Buckets:** Have some time for a brainteaser? Member Hamiltionian offers a doozy.
- **Hungry to Write Puts?** Alex340 shares more puts that meet *Pro* criteria.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

As Stocks Fall, Comfort Grows

Published Jun 4, 2012 at 12:00AM

Fellow Fools,

Pro Trade Roundup

- **Gentex**: We bought 1,600 shares at a cost basis of $21.47.
- **CBOE Volatility Index** (Index: ^VIX): We closed our call ratio backspread, buying to close our June $19 calls and selling to close our June $26 calls, for a net debit of $1.50 per contract.

Guidance Updates

- **Rockwood Holdings** moves up to Buy First from Buy on valuation.
- **Tupperware** moves up to Buy First from Buy on valuation.
- **Oracle** moves down from Buy First to Buy as earnings approach.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Bristow Group**: Sell to open September 2012 $40 puts for around $3 or higher, or September 2012 $35 puts for around $1.25 or higher, for up to 3.6% of your portfolio.
- **Intel**: Sell to open July $24 puts for around $0.67 or higher, or August $24 puts for around $1, for up to 6.8% of your portfolio.
- **MasterCard**: Sell to open October 2012 $380 puts for around $29 or higher, providing a 7.6% yield in around four months; allocate up to 3.6% of your portfolio.

Questions on these? Visit our "Catch-Up Trades" discussion board.

The first thing to remember with the market is that earnings — specifically free cash flow — drive stock prices over the long term. Ideally, companies build their earnings quarter by quarter, and stock prices eventually follow. In the meantime, though, prices zig and zag as investors try to estimate how earnings will unfold based on macro information. A weak manufacturing report might mean decreased earnings estimates; the market responds by selling first and finding out later. Strong employment report? Earnings may grow more than hoped, so stock buying commences.

Once we've been investing long enough, we discover that the monthly economic reports themselves zig and zag, and stock prices follow suit — fluctuating more dramatically than the actual earnings usually do. This makes sense, since these reports are monthly (some even weekly), making them overly sensitive, while earnings are measured over longer stretches of time. This means market declines on shorter-term economic reports, especially during times of heightened anxiety, present opportunities. We clearly think as much, since we've recently moved many more of our stocks to "Buy" ratings as they've become cheaper.

Lower Prices, Higher Comfort

As the S&P 500 has declined more than 10% from its April high, several of our stocks have fallen at least halfway out of bed. But none of our *businesses* have done so — in fact, in most cases, recent earnings exceeded expectations. Will earnings come up shy next quarter? Maybe for some of our companies. But will the *businesses* face lasting trouble? We don't think so, not by a long shot. And this makes it easier for us to remain focused on our job: managing the *Pro* portfolio.

Every day, we look at what we own in the portfolio and make sure we're comfortable with it as it stands. As stocks fall, we tend to become *more* comfortable. Falling prices today mean higher returns from current levels in the future. That math is apparent and simple. Inversely, when the market is soaring, it's only stealing from future returns.

Returns Are Limited Over Time

Because earnings can only grow by so much each year, and stocks follow earnings, a falling stock market promises higher future returns, just as a rising market is taking away from future returns. As deep as the recession may be in the Eurozone, we already know from the 2009 crisis that strong companies will find ways to grow, and any weak earnings today should lead to strong growth later.

What about *our* returns? At *Pro*, we care most about our North Star (inflation plus 7%), which is running toward a 10% gain this year. As of Friday, five months into the year, the *Pro* portfolio has a 4.9% gain. If we hope to get near, or exceed, our guiding North Star, then we need to grow the portfolio at least another 5.1% this year. We're net 65% invested long, so we're obviously counting on rising share prices to help us. Every day we look at our businesses' valuations and ask, "Is appreciation a reasonable assumption?" The answer today is yes, and more so now than two months ago.

At the same time, we know we can only control our *process*, and not the short-term *outcome*. If our investing process and decision-making are sound (we aim for "exceptional"), we should reach our goals over time. But barring a magic share-price genie, we can't control the near term; the inevitable ups and downs will happen, and we'll do our best to make strong decisions as it all unfolds.

We feel good being 65% long right now. That doesn't seem too aggressive. However, we will add more longs *or* more shorts if that's where opportunities reside. Right now, opportunities seem fairly evenly split between longs and shorts, but we have a growing preference for longs as prices decline. The main risk we see is political, and that's hard to manage for: We don't know what European governments will do next. They could launch Euro bonds and send markets soaring, or the Eurozone union could start to dissolve and send prices lower. Given the potential for a binary near-term outcome, being something closer to 50% long and 50% short might be logical.

What We'll Do Next

Where we end up investing next depends on how quickly prices move and what looks best. Although we're seeking shorts and hedges, we also have a list of favorite positions to potentially buy — or buy calls on, spreading our cash around — if prices reach a certain level. There are also ETFs that move inversely to the indexes; we'll want to short those if the market falls enough. So we've formed a plan. Although we're not market timers (that way folly lies), we want to capitalize on dramatic market moves, and if we can't do that to our satisfaction during the slide because our portfolio is majority long and the decline is swift, then we certainly want to capitalize on the recovery.

My Strongest Investing Beliefs

A horror novel about the stock market could be titled *The Rising, the Falling, and the Rising*. In the midst of all the sunny peaks and shadowy valleys, we as investors need to be steady. I recently asked the *Pro* team to outline their strongest investing beliefs, and then shared mine. Mine are:

1. You must not get emotional.
2. You must hold good companies for years.

3. Income and shorting strategies must be disciplined.
4. Your portfolio must be focused so you can make informed decisions and execute.

Many more exist, to be sure: Don't borrow money to own stocks; keep a cash cushion; focus on industries you know best; don't expend energy studying the unknowable; and others. These are all important. In the end, it's key to remember that (again) we control process, not near-term outcome; we invest to be right in coming years, not coming weeks. Process is all we have, and we need to get it right. We see value in what we own today, and we'll use our process to aim for our North Star over the rest of the year.

To talk about the Memo, please visit the Memo Musings board. Foolishly,

Jeff Fischer (TMFFischer)

Coverage & Community

- **Earnings Continue:** Check out *Pro*'s takes on **Bristow Group** and **Medtronic**.
- **Europe's Master Plan?** Euro leaders want a blueprint to solve this whole mess (for real!) by the end of June (that's June 2012, believe it or not). And more importantly, in this same discussion we celebrate StamLeo's fifth Foolish anniversary!
- **Buy or Hold?** What goes into our Buy and Hold decisions? This post launched a larger discussion of the topic.
- **Gentex Redux:** There are some excellent conversations going on about our newest recommendation, on topics ranging from valuation to fresh-ground coffee.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Allocation Calculator

Published Jun 4, 2012 at 12:00AM

Introduction and instructions go here

Total Portfolio
Allocation %
Strategy

Calculate

Stock Price

Round Lots

Shares
Cost
Allocation
Strike
Call Price
Long Price:
Short Price:

	Strike	**Price**
Long :		
Short :		

Contracts

Allocation

Close Your Call Ratio Backspread on the CBOE Volatility Index

Published May 30, 2012 at 12:00AM

What We're Doing: Closing this option position because expiration is approaching.

What We're Thinking: Unfortunately, the VIX isn't yet high enough for us to profit, but waiting to close the trade increases our risk that the position works against us.

What We're Expecting: We'll keep watching the VIX for new possible positions.

Trade Essentials

- **Action:** If your broker allows it, use a spread order to buy to close all of your June 2012 $19 calls and sell to close all of your June 2012 $26 calls on the **CBOE Volatility Index** (ticker: VIX, or ^VIX at some brokers, or $VIX.X). (If not allowed in one trade, do both legs separately.)
- **Price guidance:** Use a limit order aiming to pay a **net debit of $1.50** or less, combined, to close both positions. If making the trades separately, still aim for this net cost.
- **VIX level (May 30):** 23.4
- **Option prices (May 30):**
  - June $19 call: $6.10
  - June $26 call: $2.30 (we own twice as many, so this works to $4.60 for us)

What's New?

- **Previous recommendation:** We announced this rolling position on April 17.

- **Change (as of May 30):** The VIX is up 23% since April 17, and it's now up 56% since we started these trades in March; but that's still not enough to turn our spread profitable.

We were correct in March to be concerned about Europe and to be perplexed by the low level of the **CBOE Volatility Index**, (VOLATILITYINDICES: ^VIX) or the "fear gauge," when it was only at 15 back then. But we still haven't profited. The VIX is up sharply, to above 23, but that's still not much above its long-term average of about 20. We need *real fear* — signified by a VIX of at least the mid-to-upper 20s, if not the 30s — to earn a profit on this strategy. The VIX has historically spent about 10% of its time above 30, so history says we have a 1-in-10 chance of a bigger VIX spike and a profit. But our spread position is running out of time and needs to be closed.

There's actually a risk that Greece will leave the Euro and Spain's borrowing costs may become too high to sustain, but rather than roll this month's VIX trade immediately into a new month, we're going to pause and reconsider the strategy. Is this the best way to profit on the potential for higher market volatility? Should our time and energy go into other strategies instead? Is the way VIX options are priced today hamstringing this trade?

While seeking answers, we'll close our VIX position, because if we don't, option pricing could steadily work against us as expiration draws closer. This strategy is never meant to be held to expiration, and unfortunately, the VIX is hanging around exactly where we don't want it, at 23. This level gives our short $19 calls ample value and our long $26 calls not enough. And barring a VIX change, it would worsen. We need to close, because if we don't, we risk the VIX being at 25 by our expiration, for example, and then we would owe $6 to close rather than today's $1.50.

All told, we've been approaching profits on these spreads a few times, but the VIX has stubbornly refused to go into the mid-and-upper 20s, let alone higher. It could jump that high tomorrow for all we know, but time dictates we close this expiring spread soon and actively seek whether we want to try again soon. Pricing will be the key factor in our decision, but either way, we have to close our June 20 spread on the VIX.

Next step: If you have questions about closing this trade, please visit the VIX discussion board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Buy Gentex

Published May 29, 2012 at 12:00AM

- **What We're Doing**: Investing in a growing, debt-free, best-of-breed auto-parts supplier.
- **What We're Thinking**: Delayed domestic safety regulations and fears of a deep European recession have put one of our most-respected companies on sale.
- **What We're Expecting**: A rebound in auto sales and new models will drive demand for the company's products.

Trade Essentials

- **Action**: Invest 2.5% in **Gentex** (NASDAQ: GNTX) (for *Pro*, about 1,500 shares)
- **Buy Around**: $22.50 (use a limit order)
- **Fair Value**: $27.50
- **Dividend Yield**: 2.3%
- **Scorecard Status**: Buy
- **Alternative Trades:** We want to buy shares now, but if you choose, you can instead sell to open July or September $22.50 puts to potentially buy shares more cheaply.

The Big Picture

In a Monday Memo in January, we laid out many of the beliefs that guide us at *Pro* and explained that we'd be looking for opportunities to invest alongside them. At the time, we listed the following as a belief that wasn't yet reflected in our portfolio: "U.S. automobile sales will return to their normal upward trend line, while auto sales will continue to grow in emerging markets." We feel even more strongly about that statement today, and that's why we want to buy auto-parts supplier **Gentex** (NASDAQ: GNTX). Consider these tailwinds, which could act more like a jet stream for global auto sales:

- **U.S. auto sales are terrible.** (In unison: "How terrible are they?") On a per-capita basis, fewer vehicles were sold and produced in 2009 than in any year since 1951 (the earliest data we can find). While things have since recovered a bit, sales and production remain more than 20% below long-term averages.
- **We see pent-up demand.** The tough economy has Americans driving their cars longer. The average vehicle is now a record 10.8 years old, up from 8.9 years in 2000. And we're no longer building them faster than we're scrapping them — since 2008, the ratio has been one new car for every hoopty sent to the great junkyard in the sky, far below the historical rate of 1.3:1.
- **The environment is ripe for new purchases.** Have you seen the fantastic new designs hitting the market lately? Plus, borrowing rates are still low and dealer incentives have returned.

The case for non-U.S. auto sales is also strong (well, everywhere except Europe) thanks to a generally rising middle class, improving infrastructure, and cars simply becoming more of a necessity. Looking out 20 years, we see a superhighway of growth potential in global automobile production.

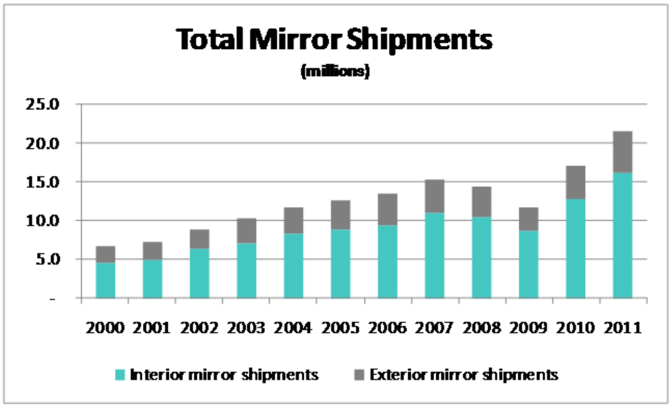
The Business

You know that road-rage moment when some joker driving way too fast approaches you from behind with his high beams on? There's no time to reach up to the rearview and flip the day/night knob (and you always knock the mirror out of place when you do that, anyway). As the glare bounces off your rear- and side-view mirrors and bores a hole in your retinas, you close your eyes in defense — only you're still driving, so that isn't safe. All that's keeping you from cursing loudly are the kids sleeping in the back seat.

It doesn't have to be this way. Gentex has your back. In 1982, the company invented the auto-dimming interior mirror; it revolutionized the product in 1987 using electrochromic technology, and it has since extended it to external (side-view) mirrors as well. Glare? Begone.

But saying "Gentex makes automotive mirrors" is like saying "Elvis was a singer." Both statements are true, but say either one to the wrong person and you're likely to be pelted with peanut butter and banana sandwiches. Gentex's technologically advanced interior and exterior mirrors serve as a strategic electronic module for advanced features, helping drivers monitor tire pressure, facilitating hands-free communication, sending blind-spot alerts, and warning of abnormal lane departures. (Compasses and temperature readings are *so* 2000.) So, yes, they're mirrors, but they're also an optimally positioned platform for the other information and safety features that we believe drivers will increasingly demand.

Today, trading at a market value of $3.2 billion, Gentex has an installed base of more than 180 million tech-enabled mirrors, and it has 88% market share in the auto-dimming mirror global market. That said, fewer than 1 in 4 light vehicles produced globally is equipped with an interior auto-dimming mirror (which is why that road-rage moment still happens so often). A rebound in global auto sales, an increase in demand from emerging economies, and more cars produced with auto-dimming mirrors should keep the production lines at Gentex whirring for years to come.



Source: SEC filings.

There are two promising, immediate features that will help drive accelerated adoption for Gentex mirrors: Rear Camera Display (RCD) mirrors and high-beam assistance.

- Rear blind spots cause 18,000 injuries and more than 290 deaths in America every year. In response, a new law in the works will mandate that all new light vehicles sold in the U.S. come equipped with a rear camera system. (While not yet finalized, the current version phases in over the next 2.5 years.) One possible location for the image display? That's right — the rearview mirror. Gentex shipped 1.7 million RCD mirrors in 2011 and should sell many more as the mandates are phased in; we could get final word on that process by the end of this year.
- The company's revolutionary SmartBeam feature embeds a forward-facing camera in the interior mirror. Sensors in the camera optimize the use of high beams and traditional headlamps during nighttime driving, recognizing other cars, the shape of the road, and other objects and dramatically improving driver vision and safety. Auto-dimming mirrors equipped with SmartBeam are currently installed on 66 vehicle models from 12 automakers, primarily in Europe.

Gentex behaves much more like a technology company than an auto supplier. The company invests 8% of sales in R&D and conducts all of its own manufacturing (right here in the U.S., no less). The novel, technical nature of Gentex's products has meant it's often had to invent the processes and machinery needed to make them, and this end-to-end control has resulted in unmatched quality, fantastic relations with the global auto community, and superb production capabilities. We expect new car models to continue featuring the company's products, and we believe Gentex's competitive advantages over its competitors will widen over time.

Financials

Gentex has a long history of impressive results. Over the past 25 years, it has grown sales by an astounding average of 20% annually. Its revenue and profit are less sensitive to economic fluctuations than many auto-parts suppliers, thanks to still-low penetration rates and high-tech products protected by patents, know-how, and economies of scale. Operating margins are consistently higher than 20%, and since 2000, more than $0.10 of every sales dollar has been counted as free cash. All those dimes add up, and Gentex retains nearly $4 per share in cash on its debt-free balance sheet — in addition to paying a 2.3% dividend.

(in millions, except per share)	2008	2009	2010	2011
Revenue	$623.8	$544.5	$816.3	$1,023.8
Operating Income	$108.8	$94.6	$191.0	$231.4
Net Income	$67.6	$64.6	$137.7	$164.7
Free Cash Flow	$75.1	$89.5	$81.7	$21.7
Dividends per share	$0.43	$0.44	$0.44	$0.48

Source: SEC Filings

Free Cash Flow = Cash Flow from Operating Activities-CapEx

What Would Make Us Sell

Gentex supplies more than 30 automotive customers, but some are bigger than others; sales to VW, GM, Toyota, Hyundai/Kia, and Mercedes all amount to more than 10% each. We don't have much fear of these customers defecting, but they do flex their muscles annually, demanding pricing concessions on the order of 3% to 5%. If Gentex can't offset these pressures with scale, manufacturing improvements, or new product introductions, we'll reconsider our stance. Also, 45% of the company's products are shipped to automakers headquartered in Europe, and more worrying, nearly 25% of global auto production comes from Europe. If the Continent implodes, we'll take note (to consider *adding* to our "starter" 2.5% position). Finally, lasting supply chain issues would tarnish the company's reputation as a reliable supplier and give us pause, and the company spends a large amount on capital expenditures whenever it builds new plants (as it has recently); we'll make sure its return on investment remains high.

The *Pro* Bottom Line

Gentex is a classic *Pro* company: Its revenue base is highly recurring as cars are replaced, it has a dominant competitive position, and over the years it generates steady free cash flow. On top of that, it is well-run by a sensible management team focused on the long run. We're excited to add shares of this premium business to our portfolio, and we expect to hold on through the inevitable potholes along the way.

Next Step: Visit our Gentex discussion board to let us know if you have a Gentex mirror in your car or to ask questions about the business.

Next Next Step: Check out some of Gentex's great products by watching these videos. If your car doesn't feature this technology, we recommend selling it and buying one equipped with a decked-out Gentex mirror.

- Auto-dimming mirror in action.
- RCD mirror in action.
- SmartBeam in action.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Sand in My Textbook

Published May 29, 2012 at 12:00AM

Fellow Fools,

Pro Trade Roundup

- None completed last week.

Guidance Updates

- None last week.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- As of last week, 18 of our 24 long holdings were rated Buy or Buy First, so there are plenty of *Pro* stocks you can buy outright, matching our current allocation.
- **Bristow Group**: Sell to open September $40 puts for $1.80 or better, for up to 3.8%.
- **Intel**: Sell to open August $25 puts for around $0.80 or better, for up to 6.7%.

Questions on these? Visit our "Catch-Up Trades" discussion board.

The stage was set for a Memorial Day weekend free of stock talk — just how my wife likes it. And I was on board. I had a long drive through the rural Delaware landscape to empty my mind, a happy copilot singing out of tune to the jams on the radio, and a refreshing wind blowing through my ears and clearing out the place in my head that usually holds diagrams of business models, earnings scenarios, and ticker symbols. By the time we were sprawled on our beach towels, my only to-dos were related to sunscreen, salt water taffy, and soft serve.

And then it happened. Barely sun-kissed, my wife turned to me and said, "So what the heck is going on with Facebook?" Two sentences into my explanation of what an initial public offering was and why **Facebook** needed to give up its private status, she snapped the conversation back to what many investors have been wondering themselves: Why was Facebook going down?

Class on the beach? Now in session. Here's what I told her.

Now Arriving at Valuation Station

Facebook stock was given the opening price of $38. Because stock represents a claim on a company's earnings, investors commonly assess value by looking at how the offering price compares to the earnings the company already generates. In Facebook's case, with a P/E ratio of 97, a $38 price tag represented 97 years of future earnings. In other words, if Facebook just kept on keeping on, investors at $38 would earn their money back in 97 years.

"That doesn't sound like a good deal," my bargain-hunting wife quipped.

Of course, it's a bit silly to take a snapshot of Facebook today (or any company, really) and assume no change in earnings for 97 years. Furthermore, markets consist of individuals, institutions, and gremlins trying to divine the future. Prices reflect their prognostications. Price, the P, is therefore a estimate based on *expected* earnings that have not yet been recognized in *current* earnings, the E. Another way to look at the P/E is as a ratio of future expected earnings relative to current earnings. If future earnings are expected to be massive, the P/E ratio will be high.

"How does anyone know what future earnings will be?"

I knew that I was running the risk of her thinking I was a complete quack, but I gave the honest answer: We don't have a clue.

Smart Bets

And that's the problem with Facebook. The offering price implies immense earnings growth far into the future, and the uncertainty around those earnings makes some IPO investors uncomfortable. The resulting selling pressure whacked the share price down to $31 or so as of Friday. Even investors who waited to buy shares are now paying a P/E of 82.

"Did we buy shares at $38?" she asked in a concerned tone.

Nope, I assured her. I don't even pretend to know what Facebook's future earnings might look like. We try to invest in situations where the future, though by definition unknowable, offers a little more certainty. She quickly grasped the stability of **Papa John's International** and the recurring revenue of **AmTrust Financial Services**. We place our chips on the table when the price offered is low for the expected future earnings, and in order to take a guess at that, we need reasonable clues. We know we'll misjudge the future, but we like our chances of making money over the long run if we stick to situations where we think we have a greater chance of being close to right.

My Wife's Takeaway

At this point I sensed her attention wandering to the crashing waves and the sandcastle construction going on around us, so I quickly finished up. Even though I know she hates it when I do this, she expects it, so I asked what her takeaway was.

"P/E is a bunch of baloney. It only tells you the relationship between what people think will happen — but don't know — and what has already happened."

I couldn't hide my smile, even though she said this completely cavalier, supine, and with more of her attention directed at optimizing her sun exposure. She nailed it.

P/E doesn't mean much on its own. What matters is our confidence in future earnings. Paying a high P/E is A-OK when the market is mispricing the magnitude or duration of elevated future earnings. **MasterCard**'s P/E of 26 is not high in our eyes given the size of the existing cash transaction market and our confidence in the company's ability to win share and maintain operating leverage by keeping costs down. **3D Systems**' P/E of 45 may reflect the annuity stream attached to its installed base of printers (as customers keep buying supplies) and possibly underestimates the size of the end market for three-dimensional printers.

High price-to-earnings ratios don't scare us at *Pro*, and they certainly don't scare my wife. Don't let them scare you either: Just make sure your assessment of the size and shape of future earnings is well founded.

Onward,

Bryan Hinmon (TMF42)

Coverage & Community

- Earnings continue: Check out *Pro's* take on **BMC Software** and **Broadridge Financial Solutions**.
- Jeff shares his thoughts on allocation.
- It looks like a *Pro* member event and local meet-up groups are ideas that have demand.
- *Barron's* is bullish on **Intel**.
- RockyTopBob puts Memorial Day in perspective.

The Motley Fool owns shares of Facebook. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Hunting for Great Ideas

Published May 21, 2012 at 12:00AM

Only a Few Spots Remain!

On May 15, Motley Fool co-founder and CEO Tom Gardner opened his exclusive new all-access service, *Motley Fool One*, to the Fool community. Days later, fewer than 12% of spots remain — meaning this may be your last chance to be among the select few investors who will get to witness Tom's unprecedented "all in" move on June 1 and profit from *Motley Fool One*. Click here to claim your spot before it's too late!

Fellow Fools,

Pro Trade Roundup

- **Plum Creek Timber** : All 1,000 shares were called at $39.42, eliminating Plum Creek from the portfolio.
- **Expeditors International of Washington**: We bought to close our 13 May 2012 $42.50 puts for $4.70. We let the remainder of our broken wing butterfly expire last Friday.
- **Tupperware Brands**: Sold to open six October $55 puts for $3.20, netting us a potential price on new shares of $51.80, which would double our position to about 5.4%.
- **Papa John's Pizza**: We pared our allocation down to 3% by selling 500 shares at $47.73.

Guidance Updates

- **Rockwood Holdings** moves up to Buy from Hold on valuation.
- **Wells Fargo** moves up to Buy from Hold on valuation.
- **Plum Creek Timber** moves down to Sell as we let our shares get called away.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **InvenSense**: Buy up to a 1.2% allocation if you haven't already.
- **Rockwood Holdings**: Buy up to a 4.7% allocation if you haven't already.
- **Wells Fargo**: Buy up to a 2.7% allocation if you haven't already.

See You Tuesday

The *Pro* Monday Memo will publish on Tuesday next week because of the Memorial Day holiday. Keep an eye out!

Questions on these? Visit our "Catch-Up Trades" discussion board.

Perhaps my favorite part of The Motley Fool (as a company) is its unabashed embrace of continuous improvement. For any Fools who dream up a better way to do something, little stands in their way as they give it the old college try.

To that end, the 250 or so employees at Fool HQ were divided into 20 teams this year and set loose on a company-wide improvement project dubbed "The Great Idea Hunt." The guidelines were simple: Find a business in the region that your team admires, visit it and speak with its leaders, and find one takeaway that would make the Fool better. The exercise was inspiring. I'm convinced it will prove lucrative for our business. And in that same spirit, I'm extending the Great Idea Hunt to you, our *Pro* Fools.

I Say 'Best Practices,' You Say 'Stealing'

You may think of the Great Idea Hunt as a hands-on best-practice pilfering, to which we'd say: Absolutely! In fact, executives at Living Social, **Markel**, AARP, and Dogfish Head (just to name a few) rolled out the red carpet for Fools and happily shared their inner workings. With notes in hand, each team produced a short video that captured its key takeaway, and the videos were unveiled at our company-wide annual meeting last week. When all was said and done, the Fool was left with 20 fantastic ways to make its business better, plenty of laughter-induced tears from the videos, and thought-provoking admiration for the passionate business leaders who share our geography.

Your *Pro* Team's Great Ideas

Jeff and his team visited the member services department at the Washington Capitals, who have a wonderful understanding of their most rabid and loyal fans. Nick's group interviewed Andy Shallal, the owner of Busboys and Poets, a restaurant and coffee shop with four locations in the D.C. area that sees itself as a gathering place and public forum for the issues of the day. My team and I (Bryan here) visited with a handful of bigwigs at NPR — a pretty spectacular organization that feeds on knowledge and tries to take full advantage of its staff's expertise.

All three of these businesses share something important with us, and we think the ideas we took away will help us do a better job of helping Fools like you down the road. While we can't go into much detail out in public, we think we've given our colleagues plenty to think about in making more connections with longtime members, getting more active in personal finance education, and putting the intellectual capital at HQ to more efficient use.

The winning idea came from our intrepid U.K. Fools, who visited the CEO of Hargreaves Lansdown, the largest fund supermarket in the United Kingdom. Hargreaves has put a lot of effort into meeting customers on their own terms, both in the services they receive and how they interact with the company. The Great Idea here? Make it easier for folks to become Fools! The specific plan our U.K. squad came away with sounded obvious at first, but it wasn't until these Fools were removed from their comfy surroundings and invaded an outside business that they had their a-ha! moment.

Remember, there were 20 of these ideas, and all of them had a healthy dose of Foolishness. The exercise was a welcome reminder that a great company's greatest elements may be more transferable than we may first realize. That's one of the reasons why the Fool prizes innovation and why we love to see it in the companies we recommend.

Great Idea Hunting for *Pro*

It's your turn, Fools. With years of work experience under your Foolish belts, countless business experiences, and some level of exposure to thousands of successful companies, you must have Great Ideas of your own. **So, your task, should you choose to accept it:**

1. Rack your brain, find a best practice from a great business that you've been exposed to, and translate that practice into a Great Idea that we might be able to implement at *Motley Fool Pro*.
2. Bring your idea to the Memo Musings discussion board and join the Great Idea discussion thread.
3. Check back through the week and provide feedback on any Great Ideas that you think are especially great.

If we get any traction with this, I'll host a poll to vote on the top ideas. In the end, I'll try and convince the team to do everything in our power to implement our member-suggested Great Idea. Together, we can make *Pro* even better.

Better every day,

Bryan Hinmon (TMF42)

Coverage & Community

- **Can't get enough earnings?** Jeff has you covered with quarterly updates and analysis on **InvenSense** and **StoneMor Partners**.
- **A new Fool is born!** A big congratulations to BigOil on his LittleOil2 spinoff (the first grandchild)!

The Motley Fool owns shares of InvenSense and Markel. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy to Close Your Puts on Expeditors International

Published May 15, 2012 at 12:00AM

What We're Doing: We're closing the one leg of our May butterfly that's in-the-money.

What We're Thinking: We only have a small profit on this income position, but pending expiration is forcing us to close it.

What We're Expecting: We'll likely set up a new income trade soon.

Trade Essentials

- **Action and Price:**
  - **Buy to Close:** May 2012 \$42.50 puts on **Expeditors International**, paying as little time value as possible. For example, if shares are \$38.50, aim to pay as close to \$4 as possible to close the puts (\$42.50 - \$38.50 = \$4).
- **Allocation:** Buy to close every May \$42.50 put you wrote. Let all other options in the spread expire Friday.

What's New?

- **Last Action:** In January, we set up a butterfly spread with \$42.50 center strike prices. We were paid a net credit of \$4.90.
- **Change:** Lately, we need to pay about \$4.30 to close the \$42.50 puts, so we're left with about a \$0.60 profit per contract.

After weeks trading near our \$42.50 strike price, where our maximum profit would have been achieved, our flighty **Expeditors International** butterfly spread has drifted off, leaving us disappointed. We still have a small profit of more than \$700 on our 13 contracts, but that's not nearly the amount of income we were hoping for. Butterfly spreads (like any straddle) can be tricky: You need the stock to end close to your center strike price in order to earn strong rewards, and a volatile market makes that more challenging. That said, we're glad to have some profit, and we're looking at setting up a new trade soon.

Disappointing first-quarter results at the shipping logistics company sent Expeditors stock lower. Management does not hold conference calls to provide details, but the press release suggests that volume was simply light. Customers are still shipping all around the world — they're just shipping fewer items, because they're cautious about the economy in light of Europe's upheaval. CEO Peter J. Rose went on to say that Expeditors will institute smart cost savings, as it did in 2009, and continue to focus on delivering the best customer service possible while waiting for a rebound in shipping volume.

We have no doubt a rebound will occur, and the stock of this premium business will likely find a higher valuation when it does. But, of course, we don't know when this will happen. Our fair-value estimate is in the low \$40s (where we wrote the butterfly). If your puts were already exercised and you now own shares, you can keep holding them, or simply sell them to stay on the same page as *Pro*. One commission aside, selling your new stock is the same outcome as buying to close the \$42.50 puts at this point. And then you could prepare to set up our next income trade with us.

Next Steps: Please visit the Expeditors discussion board to post questions.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Alphabet Stock Talk: BMC and CME, Plus PCL and EXPD

Published May 14, 2012 at 12:00AM

Fellow Fools,

Pro Trade Roundup

- None completed last week.

Guidance Updates

- **AmTrust Financial** moved up to Buy First from Buy.
- **Oracle** moved up to Buy First from Buy.
- **Tupperware** moved up to Buy from Hold.
- **InvenSense** moved down to Buy from Buy First for reasons explained here.

Pro Catch-Up Trades

For members lacking a position or full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **OpenText**: Buy up to 2.5% in shares if you haven't already.
- **CME Group**: Buy up to 3.7% in shares if you haven't already.

Questions on these? Visit our "Catch-Up Trades" discussion board.

One of our goals is to be ever more transparent with you, the members for whom we work. You should never have to guess what we think about any position, and because our thesis may evolve a bit with every quarterly report, we seek to share any updates as efficiently as possible. To that end, we post those updates on the discussion boards and link to those posts in every Monday Memo, along with sharing any guidance changes. When we want to convey our conclusions even more directly, we'll use the body of the Memo; we did that last week with **InvenSense** and **OpenText**, and this week, we'll touch on **BMC Software** and **CME Group**. We also have options expiring this week, so we'll update you on **Plum Creek Timber** and **Expeditors International**.

Business Runs on BMC

BMC Software has historically provided information technology management solutions for large companies; its recent acquisition of Numara, which provides IT management for smaller companies, is helping BMC expand to new markets. In layman's terms, BMC's software is designed to make all facets of a company's technology work well together. The company sums up its large opportunity with its slogan, "Business runs on IT."

Last quarter, BMC capitalized on this opportunity with strong revenue growth in cloud software, where bookings nearly doubled over last year, and Software as a Service (SaaS), where bookings nearly tripled. That said, its core Business Service Management business has seen weak new sales, which created the opportunity we saw in the stock price. Management now reports encouraging improvement as it grows the sales staff, and BMC expects new license revenue to move upward this year and non-GAAP earnings per share to grow about 9%.

Yet the stock looks inexpensive, trading at less than 10 times free cash flow and well below our $56 fair-value estimate (which would still value shares at only 12.6 times realized free cash flow). And some hedge funds agree — at least one fund has been building a large enough stake in the stock that BMC this morning announced a "poison pill" clause to guard against an unsolicited takeover offer. Given the low share price, I don't disagree with management's desire to be defensive, even if it involves some self-interest. Still near our $43 buy-around price, BMC Software remains a Buy.

CME Awaits Market Volatility

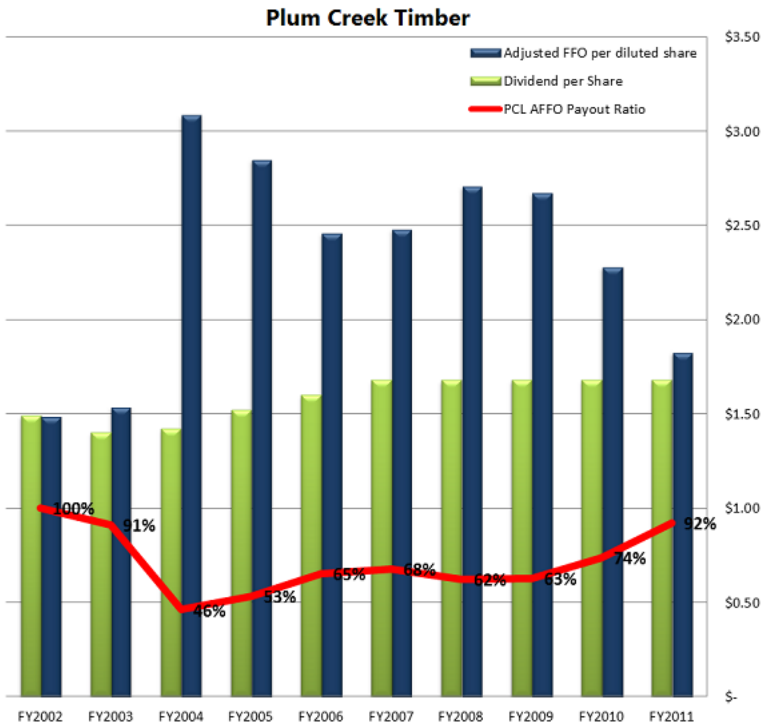
The world's leading futures exchange, CME Group, believes it's in a "cyclical low" for trading volume, and that's weighing on results. Just as **MasterCard** depends on transaction volume growth to fuel its business, CME needs increased trading volume — but for many good reasons, that's been in short supply. With interest rates in the basement and refusing to budge, the usually lucrative trading of contracts to guess where rates are headed next is understandably tepid. Other assets have been stretched, too, with oil recently near record highs, natural gas at record lows, and food commodities richly priced — yet none of these assets have been moving much in price. Add in the low volatility for stocks in the first quarter, and it's not surprising that CME's trading volume was down 11% from a year ago, when Greece and Japan shook up volatility. (Encouragingly, volume did grow 5% from the December quarter, when MF Global's collapse scared investors out of the futures market.)

The good news is we know pricing volatility will return (in fact, Europe has made sure of that already this month). That should lead to more trading on CME's exchanges, driving profits. And with its margins among the highest of S&P 500 companies, additional trading on CME brings dollars right to the bottom line. In this way, CME is a modest hedge against a volatile, trade-frenzied market.

Meanwhile, the company continues to roll out new products and invest to expand in Dubai, Brazil, and China. At this presumed cyclical low for trading volume, shares trade at a reasonable 15 times estimated earnings, and those earnings could leap once volume grows. Yielding 3.4% while we wait, the stock remains a Buy. (See more in our recent summary.)

Options Ahead: Harvesting Plum Creek Timber

It was a tough choice, but we plan to let our **Plum Creek Timber** stock get called away, sold, taken from us … adios, goodbye. We've owned it since 2009, and we've enjoyed the dividend and strangle income, but not enough is going in the company's favor to make us want to keep it, let alone write more puts on it. We're seeking new income positions as we raise additional cash with this sale. Why let it go? With Plum Creek's Adjusted Funds From Operations (AFFO) payout ratio up to 92%, there's some risk to the size of the dividend if operations don't improve (or if they weaken). Nick Crow (TMFCrow) put a chart together to illustrate. The converging blue and green lines, and the rising red line, tell the story:



The last time Plum Creek cut its dividend was in 2002, when the payout ratio was 100%. Likely or not, we wouldn't want to see that happen on our watch.

Our shares should get called away through our May $38 covered calls on Tuesday, May 15, the ex-dividend date. Our May $33 puts should expire Friday, May 18, after which we'll be out of the position entirely. If you wrote August $33 puts for around $1 as one of our Catch-Up Trades, you can buy to close them around $0.40 today (capturing 60% of the profit), or keep them open if you're comfortable with the position through August. We don't expect any potential risk to the dividend until the very end of the year at the earliest, and even then we don't want to overstate this risk.

Rolling Expeditors International

Finally, our butterfly spread on Expeditors International expires Friday; we have a small profit. We plan to buy to close our May $42.50 puts, let everything else expire, and set up a new spread soon. If you have shares put to you before then, you can sell them (one extra commission aside, it's no different than buying to close the puts), then set up the new spread with us when the Trade Alert arrives. Or keep your shares; we like the stock for the longer haul, and estimate fair value in the $40s.

Questions? Please visit the Memo Musings discussion board, or any particular company's board. Fool on!

Jeff Fischer (TMFFischer)

Coverage & Community

- **Tradin' Up:** Get our longer take on CME Group's earnings.
- **Cashin' In:** Get *Pro*'s thoughts on MasterCard's strong earnings.
- **Cashin' Out:** Facebook co-founder renounces U.S. citizenship, saving on his tax bill.
- **Snoopin' Out:** We go to **Qualcomm** to see why it's having a chip shortage that's affecting our InvenSense.

The Motley Fool owns shares of Qualcomm. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Puts on Tupperware

Published May 11, 2012 at 12:00AM

- **What We're Doing:** Writing puts for income or to potentially add 2% to our stock position, bringing it to 5%.
- **What We're Thinking:** The stock's recent decline represents an opportunity.
- **What We're Expecting:** We'd be happy to buy additional shares in the low $50s.

Trade Essentials

- **Action:** Sell to open October 2012 $55 puts on **Tupperware Brands**.
- **Allocation:** About 2% more, enough to potentially bring our stake to 5%. *Pro* will write six contracts. Each represents a $5,500 stock purchase.
- **Recent Price:** $58.40
- **Buy Around/Fair Value:** $56/$65
- **Option Price (bid/ask):** $3.00/$3.20
- **Price Guidance:** Use a limit order for $3.10 to start. As prices change, ideally accept no less than $2.75.
- **Alternative Trades:**
  - Write July 2012 $55 puts instead, lately around $1.40.
  - Buy shares directly. They're lately only 4% above our Buy Around, so we're moving the stock to Buy. Start with 3% to match us, and build to 5% on a decline to less than $55.

What's New?

- **Last action:** In March 2011, we recommended buying 1% more around $55.65.
- **Results:** We've been investing in Tupperware since 2009, earning yield, option income, and 19% on our stock position.

It may be an institution in the United States dating back to the days of *Leave it to Beaver*, but Tupperware is a novelty in emerging markets. Tupperware Brands CEO Rick Goings is fond of pointing out that only 14% of the world's people live in developed markets, and many of the rest reside in emerging behemoths like China, India and Brazil. Tupperware's sales have been soaring in these "new" markets as income grows and families are able to store food. In developed markets, sales have been holding steady, and the company does benefit from a softer economy when more people are eager to join its sales staff. So the investment offers a rare combination of defense and new opportunity at once.

This year, management expects adjusted earnings per share growth of around 13%, to about $5.05 per share. The $58.40 stock trades at 11.5 times that estimate and yields 2.5%. Today's valuation looks reasonable, so we're especially comfortable setting up an option position that would net us shares 11% lower.

How to Follow Along

Write (sell to open) one October $55 put for every $5,500 in stock you'd be willing and able to purchase if the share price declines below $55 by expiration. Use a limit order, splitting the current bid/ask (lately $3.00 bid, $3.20 ask). *Pro* will write six contracts to potentially grow our 2.9% stock stake to around 5% if we get shares.

- Share price: $58.40
- Strike price: $55
- Distance to strike: 5.8%
- Option premium: $3.10
- Yield if position is held on 100% cash: 5.6% in 5 ½ months ($3 in premium/$55 share price; yield is much higher using buying power)
- Break-even price: $51.90
- Cushion to break-even: 11.1%
- Estimated P/E at $51.90: 10.2
- Yield at $51.90: 2.8%

To summarize:

- We're writing puts to potentially build our 2.9% position to 5%.
- With the price just 4% above our Buy Around, we're moving the stock to Buy.
- Those new to the stock, who haven't already written puts as a Catch-Up Trade, can buy up to 3% to match our existing position or write puts for up to 5%.

Next Step: Please post any questions on the Tupperware discussion board before writing your puts. Then head over and buy some Tupperware for your kitchen.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Sell a Slice of Papa John's Pizza

Published May 10, 2012 at 12:00AM

- **What We're Doing:** Selling 1.8% of our 4.8% position in **Papa John's Pizza** (NASDAQ: PZZA).
- **What We're Thinking**: After a jump in share price, we're feeling a bit over-allocated. Selling part of our position allows us to manage our risk while profiting from future growth.
- **What We're Expecting**: We're happy to raise cash to eventually put toward more attractive opportunities.

Trade Essentials

- **Action:** Sell enough shares to bring your allocation down to 3% ($3,000 worth for every $100,000 you manage), using a limit order near current prices. For *Pro*, at current prices, that means selling 525 of our 1,400 shares. We'll round that down to 500 shares to keep our position in even lots.
- **Recent Price**: $48
- **Revised Fair Value**: $43
- **Price guidance**: Use a **limit order** so our selling doesn't push the price down.
- **Alternative Trade**: For a higher sell price (in exchange for the risk of a share price decline), sell to open covered calls with a strike price near the current share price, writing one call for every 100 shares you're willing to let go.

What's Changed?

- **Last action**: In October 2011, *Pro* recommended closing your covered calls on the shares.
- **Total return**: 100% (not counting option income) since our July 2010 purchase.

Nothing has changed at Papa John's since our last earnings review on May 4. The market has reacted very positively to the reported business momentum, driving shares much higher than our fair-value estimate. Speaking of which: Fully discounting the last two quarters of new information, I'm (Nick here) raising my fair-value estimate to $43 from $35.

But in a fixed portfolio, a rapidly rising share price can come to mean increased risk — which you can see in our rising allocation to this stock. Papa John's is now our fifth largest holding, and while our outlook for the company is still positive, it isn't our fifth best idea. So we're selling enough shares to bring our allocation back down to 3% — but we're holding on to most of our shares for the longer haul, and we hope you do, too. After all, the company has plenty of room to keep adding new locations around the world. In fact, at much lower prices, we could recommend new investors buy in, and we would consider adding more shares again.

How to Follow Along

This is a portfolio management decision. We don't foresee an imminent drop in share price. So be patient! Using a limit order, we'll sell enough shares of Papa John's in the next one to 30 days to bring our allocation back to 3%.

Next Step: Visit the Papa John's discussion board to post questions.

Tech Time: OpenText and InvenSense

Published May 7, 2012 at 12:00AM

Pro Fools,

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the [Recommendations]() page.

- **AmTrust Financial Services**: Buy up to 5% around $28 and lower.
- **Tupperware**: Sell to open July $55 puts, lately $1.20, for up to 3%, or a 2.1% yield on cash in 74 days. Or sell to open October $55 puts for around $2.80 and a 5% yield in 5.5 months.

Pro [Trade Roundup]()

- **3D Systems**: Sold to open 12 August 2012 $30 calls, at $2 each, covering all of our shares.

Guidance Updates

- **AmTrust Financial Services** moves up to Buy from Hold.
- **BMC Software** moves down to Buy from Buy First prior to May 9 earnings.
- **OpenText** moves up to Buy First from Buy on price, but the buy-around price moves down to $56 from $58.50, reflecting more uncertainty.

This is turning out to be a particularly interesting earnings season, with nearly all of our companies announcing Foolish tidbits that demonstrate how management is driving toward extra value. For example:

- **3D Systems** grew revenue from health-care / medical-device printers by 93% to $12 million; this important niche was 15% of first-quarter revenue.
- **Covanta Holding** is deriving extra earnings from its new program to capture more recyclable metals from the trash streaming to its incinerators. Trash-diving may not be glamorous (the jury is still out, right?), but it's adding to the bottom line.
- **MasterCard** now has a presence on about 50% of the debit card platforms in the country, up from 25% last year, as the Durbin Amendment opens competition with debit powerhouse **Visa**.
- **Papa John's International** opened 50 new stores last quarter, ahead of expectations, and bought back 44 stores from franchisees (the economics are stronger with company-owned stores). Meanwhile, same-store sales soared 8% overseas.
- **Rockwood Holdings** is building a plant to double its lithium production as demand for battery-grade material increases.

You can get all of this news, and much more, in our quarterly summaries, which are posted on each company's discussion board and [consolidated here](). Now, let's give two tech companies with made-up names, **OpenText** and **InvenSense**, a CloserLook to see why they disappointed.

OpenText Is an OpenPage

New license revenue at digital-data wrangler OpenText declined 10% last quarter, knocking shares for a loop even though total revenue and net income grew 11%. New CEO Mark J. Barrenechea put the blame solely on the company, which didn't execute on big sales. (Most of those were pushed back, so competition wasn't the issue, just execution.) Meanwhile, OpenText is undergoing a major shakeup. In his first 120 days, Barrenechea has replaced several top executives, reorganized the sales staff, and is broadening the company's software scope from Enterprise Content Management (ECM) to Enterprise Information Management (EIM). This grows OpenText's addressable market from $5 billion to $13 billion.

An incredible 90% of the Internet is not public — it's kept privately on government and corporate servers — and it needs to be organized, utilized and managed. That's EIM in a nutshell. OpenText already has its foot in the door in most of the five software segments that make up EIM, but now it aims to become a *leader* in all five niches. To get the gritty details, visit our [conference call summary]().

Despite a clear vision laid out by the new CEO, the market is shying away from the uncertainty of change, along with weak license revenue. Trading at less than 11 times expected earnings for the year ending next month, OpenText looks attractive. That's especially true given that management expects sequential improvement in license revenue this quarter and continued progress on that front over the year. **OpenText moves to Buy First today** on valuation; just realize a lot is changing at the company, and its risk profile is higher.

InvenSense Is Making Sense

Our favorite motion interface chip producer grew sales 38% in the seasonally quiet fourth quarter to $33.1 million. For the year, cash from operations soared 462% to $44.4 million, pricing this young, fast-growing company at 25 times free cash flow. Wall Street clobbered the stock Friday, sending it down 25% after management lowered first-quarter revenue guidance. That change? From a range of $38 million to $42 million in sales, to a new range of $38 million to $40 million.

The culprit? **Qualcomm** is suffering a shortage of processors for a new LTE smartphone, which gums up the whole operation for everybody. InvenSense's motion interface chip is attached to this phone, sales of which are constrained by the number of components the phone maker can get its paws on. In this instance, Qualcomm's gaffe is applying the brakes to sales of the new LTE phone. The hope is that Qualcomm can increase chip production soon, but there's still risk in InvenSense's revenue guidance for the quarter if that doesn't happen. InvenSense, meanwhile, now has the capacity to produce 300 million to 400 million chips a year using two different foundries, and still expects a 40% to 50% jump in revenue this year. There's more to be found in my [notes from the conference call]().

InvenSense is a recent IPO, meaning only time will tell us how good management is at providing guidance, and in this case, the Qualcomm problem is frankly outside of their control. But as long as the company maintains its grip on the hugely growing Android market, it should achieve much larger sales volume in years to come — and that's even without any success getting motion sensors into all kinds of other products. Shares remain a Buy First, but the stock *may* move down to Buy in the near future. We're reassessing all of our stocks against one another right now.

AmTrust Back to Buy

Finally, for those who don't yet have shares: **AmTrust Financial Services** has moved back to Buy for good reasons described in the link below. You can buy up to 5% around $28 and lower.

To discuss this Memo, visit the Memo Musings board. Fool on!

— Jeff Fischer (TMFFischer)

Coverage & Community

- **Earnings Galore!** Get *Pro*'s take on:
    - 3D Systems
    - AmTrust Financial Services
    - OpenText
    - Pacer International
    - Papa John's International
    - Plum Creek Timber
- **Life Lessons at 60:** Tony Schwartz shares 12 lessons for living on his 60th birthday, and Fools talk.
- **Europe in Flux (Still):** Voters reject austerity as France elects a new prez and Greece votes on its anger.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Test Calculator III

Published May 6, 2012 at 12:00AM

Allocation Calculator Strategy: Calculate

Total Portfolio
Allocation %
Stock Price
Round Lots
Shares
Cost
Allocation
Total Portfolio
Allocation %
Strike
Contracts
Liability
Allocation
Total Portfolio
Allocation %
Call Price
Contracts
Liability
Allocation

We Recommend This Earnings Cheat Sheet

Published Apr 30, 2012 at 12:00AM

Pro Fools,

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Tupperware**: Sell to open October $60 puts, lately around $3.60, for up to 3% in shares. If exercised, this nets a start price near our new Buy Around; if expired, it pays a 6% yield on cash in six months.
- **Wells Fargo :** Sell to open July 2012 $33 puts, lately paying you $1.53, or a 4.6% yield in less than three months. This results in a $31.47 potential buy price. Sell one put for every 100 shares you are willing to buy, up to 3% of your portfolio.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Pro Trade Roundup

- **CurrencyShares Euro Trust**: Sold short 140 more shares at $131.83, bringing our total short allocation to 4%.

Guidance Updates

- **Rockwood Holdings**: Moves from Buy to Hold on price, while its fair value moves up to $58 from $56.
- **Tupperware**: Buy Around and Fair Value both move up $1, to $56 and $65 respectively.

Despite the title, this memo isn't about earnings cheats or manipulation. We're not going to highlight a special tool for uncovering aggressive revenue recognition. But I think what we are offering is even better: I'm going to share a tool that will save you time, increase your enjoyment of your *Pro* membership, and help you invest. Better.

I'll get to that in just a minute, but first let's discuss the goings-on here at Fool HQ. We're about halfway through earnings season, which is generally characterized by lots o' hoopla after which nothing happens. When you're invested in good businesses you understand well, a quarterly checkup often just isn't that useful. Unlike 10-K Day — you know, the day shiny annual reports, courtesy of **Broadridge Financial Solutions**, start showing up in your mailbox — there's not even something to unwrap. That said, this particular earnings season feels a little different. At least our stock prices moved! I hate it when there's a blowout earnings report and nobody notices.

Did you notice? If not, click here to see a quick rundown of *Pro*'s earnings season to date.

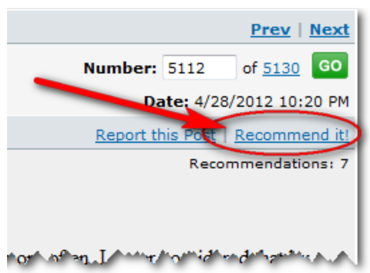
So What?

Over our investing time horizon — typically rolling-three-year periods — a single quarter is usually meaningless. Bryan (TMF42) aptly describes the weight analysts put on a single quarter's meet-or-beat status as a circus. He's right … but circuses are fun. Personally, I enjoyed watching Apple add $50 billlion in market value after announcing another blowout earrings report, and as a shareholder, you should have too. Jeff (TMFFischer) has opined that strong earnings drive our results; I'll add that we benefit most from strong earnings that are underappreciated by the market. That's what makes earnings season, despite the hundreds of pages of press releases, conference-call transcripts, and 10-Qs, a little fun.

Wall Street analysts small-f foolishly try to forecast earnings for just a few months out, basing their calculations largely on management guidance. The chart shows the consensus estimate for the companies in the *Pro* portfolio, their actual results, and the market's reaction. More importantly, I've linked to our reviews of the earnings results posted on the *Pro* discussion boards. Our wonderful editor, Ellen, willing (*Ed. Note: She's willing. Flattery will get you everywhere*), we'll update the page with new results and new links as we have them. And that brings me to the *Pro* community: Earnings reviews like those are just one thing you're missing if you don't participate on our discussion boards.

Recommendations: The Currency of the Boards

The *Pro* discussion boards are among the most active in Fooldom thanks to the selfless contributions of our loyal members, many of whom spend quite a bit of their free time answering questions, telling stories, sharing investment ideas, running contests, and even critiquing and challenging the *Pro* team. Without these contributions, your *Pro* subscription would be (in my opinion) less valuable — and this serious business of investing would be a whole lot less fun. We've recently thanked several of our most Foolish members with a small gift, but there many others we would have loved to thank personally. Fortunately, you can help us by using the "Recommend it!" link in every post that you find useful.



If you've never posted, or if you've never "rec'd" a post (as the cool kids say), don't feel bad — you're not the only one. Pro member fizzed101 recently shared:

I read the boards a lot (1-2 hours per day), and I feel bad that I don't post more often. I never considered that by using the Rec button I could show my appreciation and involvement even as a "lurker" - a term I prefer a whole lot more than "voyeur" :-)

I find the analysis and discussion to be incredibly helpful and entertaining. I mentioned to my wife just last night that the Fool site, though a bit antiquated, is the ONLY site where I can count on finding intelligent, in-depth, and polite discussion.

I can relate. I myself joined the Fool's discussion boards under the moniker THRLSKR all the way back in 2000, but didn't make my first post (under a new username) until 2005. I like to think I did a lot of recommending, but I'm honestly not sure.

When you recommend a post, you communicate your thanks or interest without writing a word. And if you're the author, seeing your post recommended provides a little jolt of energy that spurs additional high-quality posts, which may then earn their own recs. This virtuous cycle helps sustain a virtual but very real community like ours.

Don't spend much time on the discussion boards? Still not convinced that more recommendations benefit you as a member? Consider that recs are just as helpful for busier community members (like yourself, perhaps) because they allow you to filter for only the best posts. By recommending a post, you tell other members it's useful, getting good information in front of the most people possible.

Reasons to Rec a Post

1. Learned something new or provoked thought
2. Saved time
3. Appreciate the effort
4. Strongly agree
5. Strongly disagree, but are glad the viewpoint was shared
6. Made you smile

In closing: Our trades and Monday Memos fill us with pride and joy, but they're not the only valuable part of your *Pro* subscription. Please drop by the discussion boards. Poke around, introduce yourself, start or join a conversation. And if, while you're there, you read something you find useful or enjoyable … recommend it!

If you'd like to discuss any specific earnings results, please visit the company's discussion board. To talk about this memo, as always, please visit us on the Memo Musings board.

Fool on!

Nick Crow (TMFCrow)

Coverage & Community

- **A Bigger Competitor:** Jeff summarizes (and members discuss) the **Stratasys** and Objet merger, which brings about a competitor equal in size and more spread-out than our **3D Systems**.

- **Rocks That Fly: Rockwood Holdings** soared last week. Get the scoop on strong earnings.
- **Easy Storage:** Get Jeff's earnings update on **Tupperware**'s emerging-markets growth story.
- **One Man's Trash:** Get a sniff of results from trash-burning giant **Covanta**.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro's Q1 2012 Earnings Cheat Sheet

Published Apr 30, 2012 at 12:00AM

Earnings Cheat Sheet

Company	Wall Street Analyst Expectations	Actual	Market Response	Board Link(s)
3D Systems	$0.13	$0.18	3%	• SSYS & Objet merger • Q1 2012
AmTrust Financial Services	$0.67	$0.71	2.7%	Q1 2012
Apple	$10.07	$12.30	9%	
BMC	$0.80	$0.74	1.4%	Q4 2012
Bristow Group	$1	$1.22	(1.86%)	Q4 2012
Broadridge	$0.25	$0.28	(2.3%)	Q3 2012
CME Group	$4.02	$4.02	(2%)	Q1 2012
Covanta	$(0.08)	$(0.09)	(2%)	Q1 2012
GrafTech	$0.07	$0.12	5%	Q1 2012
Intel	$0.50	$0.53	(2%)	Q1 2012
InvenSense	$0.07	$0.07	(23.2%)	• Conference call notes • Q4 2012
MasterCard	$5.28	$5.36	(0.97%)	Q1 2012
Medtronic	$0.98	$0.99	(0.54%)	Q4 2012
Oracle				
OpenText	$1.16	$1.01	(1.9%)	Q3 2012
Pacer	$0.04	$(0.01)	(11%)	Q1 2012
Papa John's	$0.55	$0.69	20%	Q1 2012
Pebblebrook Hotel Trust	$0.08	$0.11	1%	
Plum Creek	$0.24	$0.18	(4.8%)	Q1 2012
Rockwood	$1.02	$1.23	10%	Q1 2012
StoneMor Partners	$(0.14)	$0.10	1.2%	Q1 2012
Tupperware	$0.96	$1.03	6%	Q1 2012
Wells Fargo	$0.73	$0.75	(3%)	Q1 2012

*Earnings per share or equivalent. Sources: StreetEvents, WSJ.com, and S&P Capital IQ.

Short More CurrencyShares Euro Trust

Published Apr 25, 2012 at 12:00AM

- **What We're Doing:** Increasing our short position in the CurrencyShares Euro Trust.
- **What We're Thinking:** We want a larger allocation to benefit from any decline.
- **What We're Expecting:** Europe could get much uglier, and even if it doesn't, the euro's upside is likely modest.

Trade Essentials

- **Action:** Sell short (more shares of) **CurrencyShares Euro Trust**
- **Allocation:** Bring your short exposure up to 4% (we're currently at 2.8%); *Pro* will sell short about 130 more shares.
- **Price Guidance:** Use a limit order and ideally short above $130.50.
- **Trust Price:** $131.40
- **Alternative Trade:** Set up a January 2014 $131 synthetic short (sell the calls, buy the puts, one each for every $13,100 you wish to short); aim to pay less than $2 to set it up. If the trust price moves before you set it up, use the strike price nearest the current trust price.
- **IRA Account Alternative:** Set up a January 2014 $120/$131 bear put spread. Buy to open $131 puts and sell to open $120 puts in equal amounts, for a net debit of around $4 or lower. That's a $400 cost per spread. The most you can make is $700 per spread (if the trust ends below $120), and the most you can lose is $400 per spread (if it's above $131 by expiration).

What's New?

Since we first recommended this short in December 2011, the euro's value has declined less than 1%, proving resilient against the U.S. dollar. These past five months have brought us a rip-roaring market rally and optimistic tidings, so given the general giddiness, the short has served us well simply by not rising.

But the mood in Europe seems to be darkening. Elections in France suggest President Nicolas Sarkozy could lose. The Dutch government collapsed Monday over budget arguments. Spain's bond yields are going up. Throw in rising unemployment and slowing growth, and from our distant perch, Europe continues to look like an economic and political mess.

Over the past several months, the European Central Bank lent roughly 1 trillion euros ($1.31 trillion) to at least 800 banks, flooding the region with cheap capital and bringing down many bond yields in the process. Analysis suggests that most of this money has been invested, and now banks lack spare cash to buy government bonds in bulk. Banks are extremely leveraged in Spain, France, and elsewhere in the zone and are already overexposed to sovereign debt, making the situation more precarious. If bond demand in Spain or Italy declines further, either country might require a bailout to bridge short-term budget gaps. Meanwhile, Greece has more debt than it did two years ago, and the situation there is proving to be a powerful argument against future austerity programs in the region. Even so, Germany continues to press for spending reductions as a solution to the eurozone's record debt. But we must ask, without GDP growth, how does a country's debt-to-GDP ratio sustainably improve?

The answer is it probably doesn't. Meanwhile, the euro could come under increased selling pressure. In our fiat money system, currently dominated by low interest rates as it is, currencies trade on GDP output, economic stability, and the confidence people have in the institutions underlying the paper. Although the United States is no bastion of smart spending, the foundation upon which the world's reserve currency is built looks rock-solid compared to the eurozone. Plus, the U.S. economy is competitive and expanding. In Europe, several countries are in a recession that could conceivably spread.

How can Europe solve its problems? It could initiate a highly expansionary monetary policy, which would likely lower the value of the currency, or it could forgive massive amounts of debt, which could topple banks and undermine confidence in the euro. Or weak countries could abandon the euro and recapitalize with their original currencies. Whatever happens, any additional cracks in the eurozone's facade could lead to a weaker euro against the dollar — perhaps much weaker, if investors move to the relative safety of greenbacks. As we noted in our original thesis, this short offers ample upside and reasonable-looking downside risk. The risk includes the reality that Europe's governing bodies will continue to consider new policies to right the ship — assuming the countries can reach agreement.

How to Follow Along

You need a margin account to sell short, and the trade order is usually "sell" or "sell to open." This trade will bring our total allocation in this short up to 4%, so your short position in the trust should ultimately be around $4,000 for every $100,000 you manage. If you can't short or you only trade in an IRA, consider our alternative trades in the "Trade Essentials" section above. You'll pay a modest premium to short using options, but you won't have ongoing shorting fees.

For those shorting directly, realize that being "called out" early is always a risk should the euro jump. And everyone should remember that a currency is a *relative* investment; in this case, the euro is battling the dollar. If the dollar dives, we could be correct in our thesis but still fail to make money. More likely, if the euro weakens again, the paper sporting the faces of Franklin, Grant, Jackson, Hamilton, Lincoln, and Washington is the currency that will benefit.

Next Step: Visit the CurrencyShares Euro Trust board to discuss this addition to our short.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Allocation Matters

Published Apr 23, 2012 at 12:00AM

Dear *Pro* Fools,

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **AmTrust Financial Services**: Sell to open September 2012 $25 puts for $1 or higher in credits, one for every 100 shares you're willing to purchase up to 5%.
- **Covanta Holdings**: Income trade. Sell to open June 2012 $15 puts, lately for $0.30 — that's a 2% yield in 54 days. If exercised, this would net a potential buy price below our Buy Around. Be ready to own up to 3%.
- **Wells Fargo :** Sell to open July 2012 $32 puts, lately paying you $1.65, or a 5.2% yield in three months. This results in a $30.35 potential buy price. Sell one put for every 100 shares you are willing to buy, up to 3% of your portfolio.

Questions on these? Visit our "Catch-Up Trades" discussion board.

With the market up five months straight, it's more difficult today to find buys we like — and we don't want to force any, especially because we know the landscape will change if we're patient. Thus, we're likely to have more options and short-selling trades in the near future than stock purchases. Of course, that could change anytime; perhaps the new earnings season will shake out some new buy opportunities, and irrational drops could also allow us to increase our stake in existing positions, as we did last quarter with **BMC Software** and **Oracle**.

I bring this up for a simple reason: If *Pro* begins using options more heavily for income (in a market that may go sideways) or shorting more frequently to be defensive, remember you don't need to follow these trades if you don't short or use options. The *Pro* portfolio is 91% long in stocks (net 70% long including shorts), and we have about 10% cash. Our gross long exposure should be more than enough for investors who only invest long, and it still leaves cash for new ideas. So, if you see more options and short-selling trades hitting your email inbox the coming weeks and you don't use these strategies, don't sweat it. The vast majority of our portfolio is in long positions, and we continue to seek new ideas and manage our long portfolio to make money the next few years and beyond.

Allocation Matters

When it comes to those long positions — again, 91% of our portfolio — how we allocate is instrumental. We typically put the most capital into ideas in which we have the most confidence. Riskier investments we're less sure about demand less capital, at least to start; over the years, perhaps we'll add to them as the outlook becomes clearer. So how are we doing with our allocation decisions? Pretty well so far. Here are our long stock and ETF positions, largest to smallest, and how they've performed (as of April 19).

Company	% of Port	Return
Intel (INTC)	7.1%	+35.1%
Medtronic (MDT)	5.1%	+5.3%
AmTrust Financial Services (AFSI)	5.1%	+156.6%
Oracle (ORCL)	5.0%	+26.9%
Rockwood Holdings (ROC)	4.9%	+7.5%
Apple (AAPL)	4.7%	+18.2%
BMC Software (BMC)	4.6%	+3.1%
Pebblebrook Hotel Trust (PEB)	4.3%	+15.5%
CME Group, Inc. (CME)	4.0%	-3.0%
Bristow Group (BRS)	4.0%	+54.6%
Papa John's Pizza (PZZA)	3.8%	+61.0%
MasterCard (MA)	3.7%	+34.6%
Broadridge Financial Solutions (BR)	3.4%	+1.8%
Vanguard Energy (VDE)	3.3%	+53.7%
Covanta (CVA)	3.1%	-5.9%
Tupperware Brands (TUP)	3.1%	+25.9%
OpenText (OTEX)	3.0%	+2.0%
Plum Creek Timber (PCL)	2.9%	+28.4%
GrafTech International (GTI)	2.8%	+32.7%
Wells Fargo & Company (WFC)	2.8%	+9.3%
StoneMor Partners (STON)	2.5%	-12.5%
WisdomTree Emerging Markets SmallCap Dividend Fund (DGS)	2.5%	-9.3%
3D Systems (DDD)	2.3%	+9.0%
InvenSense (INVN)	1.7%	-20.2%
Pacer International (PACR)	1.5%	+46.7%

Key Takeaways

- Our largest position, **Intel**, is the top-performing Dow Jones stock over the last 12 months, so we're happy to celebrate this allocation decision with our veteran members.
- On a whole, our largest positions are in the green; only one stock that makes up 4% or more of the portfolio is in the red. That's new holding **CME Group**, down a few percent.
- Most of our losers are our smallest positions. This suggests we were right to start small.
- We have 25 positions listed, so the average size would be 4%. If we had blindly put 4% in each, our performance would be weaker, so the effort we're spending on allocation is worthwhile.

Obviously, some of our best-performing positions are our largest in part because they *have* gone up, and in those cases we can't entirely credit our allocation decisions. But that's rare. For example, **AmTrust Financial Services** is up the most for us, but we've long had at least 5% invested there (remember, we recently cut this winner down from nearly 8%). And some large positions have done relatively very poorly. **Medtronic** is a 5% stake that's only up 5% (excluding dividends and options) over all the years we've owned it. Many stocks have clobbered that. This looks like a poor relative investment so far.

A Bizarre Request From Our Co-founder and CEO

On May 8, Tom Gardner will ask our most dedicated Fools to give up their *Pro* membership and join a one-of-a-kind "club" that gives you access to every wealth-building tool, product, and service we've developed over the past two decades — including *Pro*. Thousands will apply, but only a fraction will be able to join. To see if you qualify — or to simply learn more about this exciting new development — go to one.fool.com.

Among our smallest positions, it's a shame that we've only invested 1% so far in **Pacer International**, as it's already up 46%. We're writing puts to try to get more shares, and we've made some income, but in a perfect world we'd have more allocated to the stock already. Pacer is so tiny that we were concerned about a "*Pro* bounce" in the stock price after our recommendation, so we started small and used put options. Also don't forget that **GrafTech International**, once a 5% holding, has fallen by half. That was a poor allocation decision in reverse: We considered selling at least some shares in the $20s and didn't (we may next time).

Sum It All(ocation) Up

Add it all up, and our allocation decisions have added to our results. There's always room for improvement, though, and the knowledge that we can do better is continually driving us. We allocate our capital based on our beliefs about a company's risk versus reward and the likelihood of its success. We think this is a successful formula, and while we're always scoring ourselves and working to improve, we don't plan to fundamentally change our approach to allocation. To discuss the topic, visit the Memo Musings board.

Fool on!

Jeff Fischer (TMFFischer)

Pro Trade Roundup

- **CBOE Volatility Index** (VIX): We closed our May $20/$27 call ratio spread for a $0.50 debit. We opened a June $19/$26 call ratio spread for a $0.16 credit, selling to open 15 June $19 calls and buying to open 30 June $26 calls.
- **Sony**: We set up a January 2013 $5/$22 bear call spread for $11.15 in credit, trading 17 contracts each, for a 2% look-through allocation.

Guidance Updates

- **Rockwood Holdings**: We moved the stock back to "Buy" Friday when it declined to our $49 Buy Around price.

Coverage & Community

- **Earn It to Own It:** Earnings reports are showering down on us this week! TMFMoosie's calendar has the most detail.
- **Intel-ligent: Intel** is one well-run company. Get its latest earnings summary from Jeff.
- **News From the Stagecoach:** We're admirers of **Wells Fargo**. Nick checks in with his latest earnings update.
- **Sony Strategy:** Aleax shares the idea of buying January 2013 $22 puts on **Sony** as another way to mirror *Pro*'s Sony short.
- **Cutthroat:** Spinningwood's contest has lit up the *Pro*Social Banter board.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Set Up a Bear Call Spread on Sony

Published Apr 18, 2012 at 12:00AM

4/19/12: Update

Hey Fools — it looks like some members are already being assigned short shares through the $5 calls we're writing. That's perfectly fine, assuming you're setting this up in an account that's capable of shorting and your broker has shares available to short (and it seems all do right now). We wanted to be short shares, either through calls or directly, and we expected the exercise of our $5 calls would happen at some point — just not so soon.

However, **you should not set this trade up in an IRA**, because it is effectively a short, and direct shorting is not allowed in IRAs. If you can only trade in an IRA, simply buy to open January 2013 $22 puts, one for every 100 shares you want to invest against.

Also realize that **nothing has changed at all**. We want to be short Sony, and this recommendation is one way of getting there (quickly, as it turns out!). Just make sure you're shorting in an appropriate, short-enabled account.

For more, see this discussion-board post, and please ask any questions you may have on the board.

- **What We're Doing:** Profiting if Sony's stock declines, while capping our risk.
- **What We're Thinking:** The struggling electronics conglomerate has lost its way.
- **What We're Expecting:** Timely business improvements will be difficult to deliver.

Trade Essentials

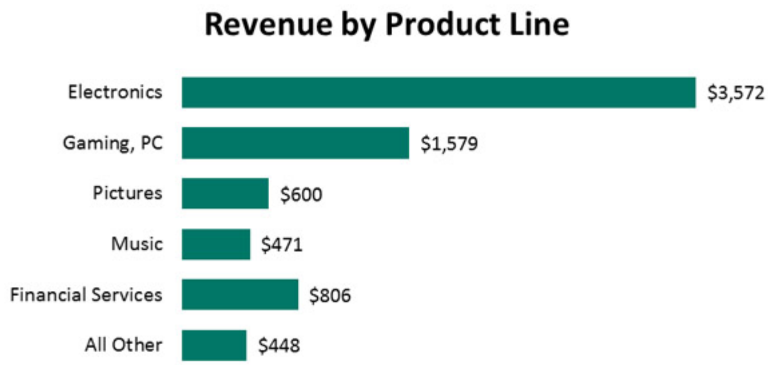
- **Actions:**
  - Sell to open January 2013 $5 calls and ...
  - Buy to open an equal number of January 2013 $22 calls
- **Price Guidance:** Aim for a net credit of $11.20 or higher, using a spread order. As prices change, aim to set up the spread a $0.60 or smaller discount to the share price (see details in "How to Follow Along" below).
- **Share Price:** $16.80
- **Allocation:** Measured from a short price of around $16.20, 2% (for *Pro*, that's 17 contracts of each option, or 1,700 shares). Roughly, set up one spread for every $80,000 you manage.
- **Potential Profit:** $11.20 per share if Sony falls to $5, but we don't expect such a large decline.
- **Potential Loss:** $5.80 per share if Sony rises above $22.
- **Strategy Guide:** Bearish Spreads
- **Alternative Trades:** At some brokers, you can short the stock directly for a small fee plus the 1.9% annual dividend; if you do this, don't write the $5 calls, but do buy January 2013 $22 calls with us (one for every 100 shares you short) to cap risk.

The Big Picture

With revenue down nearly four fiscal years in a row, **Sony** is sick — and not in the hip, cool way the kids use that word. The Japanese consumer electronics, gaming, and entertainment company makes much of its revenue from products that could soon be on display in Smithsonian history museums: DVD players, dumb TVs, home video recorders, compact digital cameras (what, with no phone function?), and old-school gaming consoles, including the PlayStation 3. The company has attempted several restructuring plans, but it hasn't generated positive net income for a fiscal year since the year that ended in March 2008. Its latest recovery attempt, outlined last week, involves layoffs of up to 10,000 people, cutting deeply into its staff base of 16,600.

What happened to the company that brought the world the Walkman (and, more recently, Blu-ray)? Well, **Apple**, for one thing. But the real problem is that Sony is playing catch-up. The company offers hundreds of different run-of-the-mill electronics products, but consumers are living amidst an amazing convergence of technology that allows them to do most of what they want with just a few. The world is moving to powerful mobile, server-based cloud computing, getting its entertainment in new ways, taking pictures with phones, and gaming on the fly.

It isn't that Sony isn't trying (you probably didn't know that it sells e-readers or that it launched a small Sony Tablet P that's more expensive than an iPad), but it hasn't captured enough consumer interest. And now that the tide has turned against Sony, it may be much harder to find the next wave to ride, because last week's layoff news won't help company morale or stem a likely exodus of talent. Although Sony has some divisions that aren't struggling, including its film and music offerings, they're a small part of the pie.



Revenue in billions of Yen for the fiscal year ended March 31, 2011. Source: 2011 Form 20-F SEC filing. "Pictures" is Sony Pictures Entertainment.

New CEO Kazuo Hirai laid out his turnaround vision on April 13, but we're unconvinced. Rather than outlining strategy per se, he listed product lines. His areas of focus are, in order: the core business (which he defines as digital imaging and image sensors in the semiconductor division, as well as digital imaging products for consumers and businesses); the games business; and mobile, including Sony's Xperia smartphones, tablets, and the Sony VAIO PC. After that comes the large TV business (where per-unit prices keep declining), which Hirai hopes to lead back to profitability after years of losses. Then there's growth in emerging markets, "creating new businesses and accelerating innovation," managing spin-offs and possible partnerships, and finally a new management team.

The CEO's plan was not clearly presented in the conference call, and his answers to pointed questions were scattered. Meanwhile, it's counterintuitive to us that a company that's laying off thousands of employees nonetheless hopes to create new businesses, accelerate innovation, and revive many struggling product lines. Our bearish position reflects our belief that it will be extremely difficult for Sony to turn its massive electronics business around in a timely or highly profitable fashion, yet shares already trade at an expensive 19 times earnings that *might* be achieved in an expected (guessed-at) return to profitability by March 2013.

How to Follow Along

We're writing deep-in-the-money calls to profit on a continued decline in Sony stock. Our written calls mirror a short of the stock down to $5 per share. The second part of our spread, buying $22 calls, caps our risk at $22. So, our trade looks like this:

- **Actions:**
  - Use a spread order to sell to open January 2013 $5 calls and ...
  - Buy to open an equal number of January 2013 $22 calls
- **Share Price:** $16.80
- **Potential Spread Price:** Net credit of $11.20 or higher, resulting in a $16.20 short price
- **Maximum Profit:** $11.20 if Sony declines to $5
- **Maximum Risk:** $5.80 if Sony increases to $22
- **Potential Return on Risk:** 193%
- **Break-Even at Expiration:** $16.20

As prices change, aim to set up the spread for no more than $0.60 less than the current share price. In other words, if Sony stock is $16 as you're setting up the spread, you should net a total credit of at least $10.40, for a break-even of $15.40 or higher. (The math: It's a $5 short strike, you'll get $10.40 in credits on the spread, and that equals $15.40 as a break-even while the stock is $16.) This discount to the current short price is the cost of capping our risk with $22 calls. We want to cap risk because if Sony does begin to master a turnaround, the stock could have plenty of upside. Sony could also sell assets to promote stock appreciation. A final risk we can't control is the early exercise of our short $5 calls. If that occurs, we'll need to borrow shares to short or adjust our position to maintain it.

Next Step: To discuss this bearish spread, visit our new Sony discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here. The Motley Fool owns shares of Apple.*

Roll Out and Down Your Call Ratio Backspread on the CBOE Volatility Index

Published Apr 17, 2012 at 12:00AM

What We're Doing: Rolling our volatility hedge from May to June and down one strike price.

What We're Thinking: The VIX has increased from 15 to a recent 19, but any number of risks could send it much higher by May.

What We're Expecting: Our loss should remain modest if the VIX treads water, but if volatility spikes enough, we'll profit.

Trade Essentials

- **First Action (assuming you followed last month's trade):** Buy to close your May 2012 $20 calls and sell to close your May 2012 $27 calls on the **CBOE Volatility Index** (ticker: VIX, or ^VIX at some brokers, or $VIX.X).
- **Price Guidance:** Use a limit order aiming to pay a net debit of $0.40 or less, combined, to close both May options.
- **Second Action (or first action if you're new to this trade):** Sell to open June 2012 $19 calls, and buy to open *twice as many* June 2012 $26 calls.
- **Price guidance:** Use a limit order and aim to set up the June spread for a combined debit as close to $0.00 as possible.
- **Allocation:** Set up one 1:2 call ratio backspread for approximately every $100,000 you manage. *Pro* will sell 15 June $19 calls and buy 30 June $26 calls.
- **VIX level (April 16 close):** 19.5
- **Alternative Trades:** None. If you can't make this trade, don't sweat it. Our short positions also provide hedges.
- **Follow-Up:** We plan to roll or close this position one month prior to its June 20 expiration. We will not hold to expiration, and if we see a profit, we may close.

What's New?

- **Previous recommendation:** We issued our first spread on the VIX on March 14.
- **Change (as of April 16):** As of Monday, the VIX had jumped 26% since our recommendation, to 19.5, but this wasn't enough for call owners with strike prices in the 20s (like us) to make a profit. However, unlike straight call buyers, our loss is small thanks to our strategy.

The **CBOE Volatility Index** (VIX) didn't stay around 15 for long. Within a couple of weeks of our March trade alert, the VIX had climbed to its long-term average of 20, but we needed a still higher level for our bullish call option spread to show a profit. Because the VIX remains depressed after a five-month stock rally, and we can set this trade up cheaply, we'll roll this position into a new month. We consider it an ongoing volatility or "shock" hedge — with a caveat.

Today, the trade we set up last month for $0.09 needs to be closed for a cost of around $0.40, meaning we'll lose around $0.50 per spread. That's a small, but not inconsequential, $750 loss on our position (about 0.05% of the portfolio). Going long volatility on a regular basis is a systematic way to lose money, even with a cheap spread like this. So we're only going to use the strategy when it *seems viable* that volatility could spike over our necessarily short time frame. And with presidential elections looming in France, bond yields in Spain rising almost as much as its unemployment, India due to launch its first missile capable of reaching China, and North Korea playing with malfunctioning fireworks itself, any number of factors could send the VIX above 20 over the coming month.

Our aim is to again set up a backspread for around zero cost. We'll profit if the market falls and volatility sends the VIX into at least the low 20s. If it doesn't, we're probably looking at another $0.50-per-spread or so loss a month from now. It is, of course, not our intention to lose money (even small amounts) on this strategy month after month — we covet every profit we earn, so we won't dither our gains away with bullish volatility options. But right now, at least decent odds for a spike in the VIX make us want to re-initiate the trade and roll it into May.

How to Follow Along

If you participated in our May spread, close it entirely. Buy to close the May 2012 $20 calls and sell to close the May 2012 $27 calls, using a spread order with a limit price. At recent prices, you can target a $0.40 combined debit to close this spread. That shouldn't change much over the next few days, but we won't list individual options prices because they *will* change steadily (though the total spread cost shouldn't).

Once the deck is clear, set up a new spread: Sell to open June 2012 $19 calls, and buy to open twice as many June 2012 $26 calls. We're moving the strike prices down by a dollar apiece; ideally, we'll benefit from slightly more sensitive $26 calls, and our $19 calls will largely shed their time value if the VIX spikes. At recent prices, you should be able to set up this new spread for around zero net cost. We plan to close or roll this spread a month before its June 20 expiration, so our potential loss should again be modest if the VIX isn't much higher or lower by late May.

Next step: Please be sure to visit our VIX discussion board if you have any questions before you make these trades.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Partnering Up With StoneMor

Published Apr 16, 2012 at 12:00AM

Dear Fools,

Pro Trade Roundup

- **Pacer International**: We wrote 19 June 2012 $7.50 puts for $0.80 each, to bring our potential holdings in Pacer to 4%.

Guidance Updates

- **StoneMor Partners**: With a better understanding of the tax implications and a juicy yield, we're moving the stock from Hold to Buy.

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **StoneMor Partners**: Using a limit order, buy up to 2.5% around $27 or lower.
- **AmTrust Financial Services**: Sell to open September 2012 $25 puts for $1.10 or better, one for every 100 shares you're willing to purchase up to 5%.
- **Rockwood Holdings** (NYSE: ROC): Sell to open May 2012 $50 puts, recently $2.25 one for every 100 shares you're willing to purchase up to 5%. If put shares, this trade will net a purchase price of $47.75, below our $49 buy-around price. This is an in-the-money put write, so expect to get shares.

Questions on these? Visit our Catch-Up Trades discussion board.

We placed **StoneMor Partners** on hold at the beginning of the year because we wanted a better understanding of the tax implications that come with owning shares in this master limited partnership (MLP). With tax reporting season almost over, many of you have indicated to us that we needn't have worried.

As a partnership that operates in more than two dozen states, StoneMor is capable of earning income that requires a partner (meaning unit holder, or shareholder) to file income taxes in many different states. But for various reasons, that income proved to be immaterial last year (and should continue to be), or it was easily dealt with by tax software or one's own accountant. So with this tax concern largely out of the way, we're able to refocus our attention on the business itself — and return it to buy status.

StoneMor is one of the country's largest cemetery operators — it owns more than 270 spread across the nation. The company makes money by providing the inevitable services that arise when someone passes away. It's one of the largest "pre-need" sellers in its industry, providing customers the peace of mind that comes with pre-planned and pre-paid plots, crypts, and funeral services.

However, as you may have guessed from the tax questions, StoneMor has a unique business model that requires us to look at it like a financial company. The complexities in its cash flow keep many investors at bay, allowing the stock to trade with a sustainable 9.7% dividend yield that we're happy to suggest you lock in.

Before we get into more details, let's outline the basics for new buyers.

- **Action: StoneMor Partners** moves from "Hold" to "Buy"

- **Allocation:** We have 2.5% of our funds invested in StoneMor
- **Fair Value:** $32
- **Recent Price:** $24.10
- **Dividend Yield:** 9.7%
- **Type of Holding:** Yield
- **Next Payment:** Likely to be $0.585 per share (or "unit" in a partnership), due in early May
- **Buy Around:** $27 and lower (use a **limit order** at current prices; the stock is thinly traded)
- **Original Buy Report:** Read here

The Market's Limited Perception

StoneMor's business is steady and reliable; the company has been running its operations much the same way for 30 years. In the "unintentional gallows humor" department, CEO Lawrence Miller said in the last conference call, "We're confident that we'll have a nice year." Indeed, death and taxes are two certainties in life.

Even so, Wall Street is skeptical. The stock took a knock last year following third-party reports regarding the company's weak cash flow up against its high dividend obligation. Standard & Poor's didn't help matters when it put out a mixed review of the company's debt and credit rating. Both instances have StoneMor management seeking to clarify its financial story to investors; they know they have an image problem, and they wish to correct it.

The issues involve massive trusts that StoneMor operates, and the borrowing or fundraising the company does to fuel operations. In a nutshell: StoneMor continues to grow assets by acquiring more cemeteries. With more plots, it can make more pre-need sales, which then increases the amount of cash it'll be one day able to book (it holds those accounts receivable in a trust). The business uses those receivables as collateral to draw on working capital loans. As CEO Miller says, "We haven't changed that model since the early '70s." StoneMor is required by law to put pre-need revenue aside and can't recognize most of it until the services are provided. This is why its cash flow from operations typically appears weak, especially when the company is spending to acquire more properties.

As the vice chairman says, "In a no-growth scenario, we don't burn cash." But for now, StoneMor looks like it's operating at a deficit, even though it has more than ample means to keep servicing the dividend and business. In fact, the company has much more in trusts than it will need to deliver to customers. If StoneMor fulfilled all of its pre-need contracts today, it says, it would have $250 million left over, along with another $130 million in reliable accounts receivable. The annual dividend is about $45 million. Yet a 9.7% yield implies that Wall Street believes the payment is unsustainable.

Management could stop the growth and close the apparent financing gap that way. But to the executives' credit, they believe the better way to operate is to grow when they see opportunities, using money in trusts as collateral to fund growth and operations. StoneMor is likely to acquire more cemeteries this year, and to keep running the books and business the same way it has for three decades.

Partnering Up

As in our original buy report, we're recommending this stock because it sports a very high yield backed up by a stable business that we believe will continue to deliver. The market should eventually gain more faith in the company, and that should push the price up until the yield isn't so egregiously large.

Realize that if you buy shares (or units), you may need to report income from this master limited partnership in various states. *Pro* members have said doing so took anywhere from two minutes (the income wasn't material) to 30 minutes. Also, try to buy shares in a *non*-tax-advantaged account. Owning shares in an IRA may not afford you as many tax benefits as a traditional account.

Finally, understand that the market could still *lose* faith, sending the stock lower, or something in the financials might not work out as analyzed, putting the dividend at risk. We believe those risks are small, and that's why we're comfortable making this high-yield stock a Buy again. Use a limit order to buy up to 2.5% in shares.

Are you ready to dig in to StoneMor? Talk about it on our discussion board!

Foolishly,

Jeff Fischer (TMFFischer)

Coverage & Community

- **Earnings Are Coming:** Keep abreast of the announcement dates using Moosie's calendar.
- **Pace Yourself:** Bryan (TMF42) shares the team's thinking behind **Pacer**'s new guidance.
- **Eyes to the Sky:** The *Pro* community makes sure the North Star remains True North.
- **Spin, Spin, Spin:** Fight the summer doldrums by winning a prize.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Puts on Pacer International

Published Apr 12, 2012 at 12:00AM

- **What We're Doing:** Selling puts to obtain an attractive buy price on shares.
- **What We're Thinking:** Pacer's stock is undervalued, and continuing to ease into a position will help us track our North Star.
- **What We're Expecting:** Our existing June $5 puts will likely expire as income, but we expect these new puts to result in owning more shares.

Trade Essentials

- **Action:** Sell to open a 1% position in June 2012 $7.50 puts (for *Pro*, that's 19 contracts), resulting in a potential 4% total allocation.
- **Recent Options Price (bid/ask):** $1.05/$1.40
- **Limit Price:** We don't write options for free, so set a limit to earn at least $0.10 of time value. At current prices, that means a limit of $1.15 or more. As prices change, remember that time value is any amount above the difference between the share price and your strike price (for example, if the stock is $7, the $7.50 puts should pay you at least $0.60 for $0.10 in time value).
- **Share Price:** $6.45
- **Buy Around:** $7.50
- **Fair Value:** $11.40

- **Scorecard Status :** Moving from Hold to Buy First
- **Alternate Trades:** If you don't use puts, you can buy shares using **a limit order at the current price** up to a 4% allocation. But note that we expect our June $5 puts to expire and these June $7.50 puts to be exercised, which would leave *Pro* with just a 2% allocation to Pacer. We'll only get to the full 4% if both puts are exercised (meaning the stock is below $5). So newcomers who don't write puts may only want to buy 2% total in the stock for now, using a strict limit order.

What's New?

- **Previous recommendations**: In December 2011, we wrote puts to potentially acquire 1% in stock; we ended up buying shares at a net $4.66 in December, and those shares are up 38% today. We currently have June $5 written puts for 2% more; those are likely to expire as income.
- **Updated guidance**:
  - We are moving **Pacer International** to Buy First.
  - We are increasing our Buy Around price to $7.50.
  - We are lowering our estimate of fair value to $11.40 from $12.
  - For more details, click here.

We think inter-modal is inter-esting. The domestic economy is slowly and steadily recovering. Railroads are expected to spend $13 billion this year improving their service and tracks and building out intermodal depots. And gas prices continue to rise. All of this makes rail transport increasingly more attractive than truck transport — and encourages shippers to call a little intermodal transporter named Pacer to make the switch. The intermodal value proposition is real and growing.

And Pacer continues to show us that its turnaround efforts are not in vain. In 2011, it tripled operating income, grew its core intermodal business, and continued to rein in costs. Over the past three years, Pacer has removed 28% of its overhead costs. Management is now turning its attention to rebuilding its smaller logistics segment, where it will revamp the IT infrastructure, put new leadership in place, cut costs, and make its offerings more competitive. Pacer doesn't need to work miracles — it simply needs to make the outfit more efficient and funnel business to its intermodal network.

How to Follow Along

We expect our June $5 put options to expire worthless, but they still represent a potential 2% obligation that we take seriously. When combined with the 1% we own outright and the additional 1% we are likely to be put by writing these in-the-money $7.50 options, our total potential exposure to Pacer will be 4%.

For those who may have September $5 put options after following a Catch-Up Trade, consider adding the June $7.50 puts to bring your total potential allocation in line with ours.

If you don't use options, you can simply buy shares outright. **However, remember that Pacer is a very illiquid stock, and we will all benefit from a little patience — please use limit orders**. Tread lightly.

Next Steps

- Check out the details behind our updated guidance on the Pacer discussion board.
- Stoked to learn more about writing put options? Head over to the All About Options discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on 3D Systems

Published Apr 11, 2012 at 12:00AM

- **What We're Doing:** With our absolute-returns North Star in mind, we're seeking income on our shares.
- **What We're Thinking:** The stock price has risen, meaning we can write far out-of-the-money calls above fair value for a decent yield – one way to monetize a dividend-less stock.
- **What We're Expecting:** 3D Systems is likely to remain below our $30 strike price by August.

Trade Essentials

- **Action:** Sell to open August 2012 $30 calls (one for every 100 shares you already own).
- **Limit Price:** Aim for at least $0.85 per contract; as prices change, ideally accept no less than $0.70.
- **Option Price (August $30 call, bid/ask):** $0.75/$0.95
- **Share Price:** $23
- **Buy Around:** $21
- **Fair Value:** $27
- **Scorecard Status:** Hold (and write covered calls if you use options)

What's New?

- **Previous recommendations**: On Feb. 3, we recommended new investors buy shares around $21; *Pro* bought shares in April 2011 at $24.95.
- **Change (as of April 10)**: The stock is up 9% since Feb. 3 and down 9% since *Pro*'s initial purchase.

Revenue was up 44% in 2011, to $230 million, at **3D Systems** after the number of printer units sold increased by 242%. Recurring revenue, made up of printing materials and services, grew to 71% of sales. We love to see that — with the caveat that customers need to keep buying those materials to make the number reliable. Despite this growth, though, shares are down modestly since our initial purchase one year ago, underlining the fact that we paid a premium for a young company that needs time to grow into its valuation. Its valuation multiple has already contracted greatly.

The stock trades for 20 times management's estimate for 2012 non-GAAP earnings per share (we're using the midpoint of the $1 to $1.25 guidance), which are expected to grow 39% versus last year's EPS. Shares are below our fair-value estimate, but the stock is volatile, and it's up enough over the past six months that we're able to write covered calls with a 30% higher strike price and still capture a healthy payment. Odds suggest this trade will become income, serving our North Star goal of absolute returns. But if shares soar 30% and are called away, we'll have a healthy profit as we sell more than 11% above our fair value (leaving us open to writing puts for a lower re-entry price).

How to Follow Along

Pro purchased its 3D shares exactly one year ago, on April 11, 2011, so by setting up this trade **tomorrow or later**, we're guaranteed a long-term tax rate whatever happens next. Check your statements to see when you bought 3D shares (we issued our trade alert on April 7, 2011). At the same time, realize that *whenever* you bought, since we're writing calls that are far out-of-the-money, your position still qualifies for long-term gains *if you own it for more than a year* before selling the stock (and we doubt we'll be selling the stock via these options). If the options you write aren't exercised, they are always short-term gains. Bottom line: If you bought the stock about one year ago, like us, check your purchase date and write the calls at least **a year and a day** after your purchase date, just to make it clear to Uncle Sam. If you've owned the stock much less than a year, this covered call doesn't change your ability to pursue long-term gains on the shares, unless, obviously, your stock is sold before you've owned it for a year.

When you're ready, sell to open one call for every 100 shares you already own (for *Pro*, that's 12 contracts). Further details:

- **Option yield (at $0.85 on a $23 share price):** 3.6% in just over four months (about 9.7% annualized)
- **Distance to $30 strike price (from $23):** 30.4%
- **Distance to net sell price:** 34.1%

Next Step: If you have questions, please visit the 3D Systems discussion board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Our Hedge-Fund Smackdown; Four Investing Rules

Published Apr 9, 2012 at 12:00AM

Dear Fools,

In last week's Memo, Bryan Hinmon (TMF42) outlined *Pro*'s first-quarter performance, detailing our winners, our laggards, and our overall returns (10.7%, while the S&P 500 gained 12%). Though of course we will always work to improve our processes and results, we're nonetheless pleased with this admittedly short-term performance. We've stayed modestly defensive and focused on our North Star this year, leaving us invested about 70% net long, on average; we've been more than 20% short all year, and we currently hold about 10% cash.

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **3D Systems**: Sell to open August 2012 $22.50 puts, currently $2.40, one for every 100 shares you're willing to purchase up to 2%. Or, sell to open August 2012 $20 puts, lately $1.40. If put shares, either trade provides a net purchase price below our $21 Buy Around.
- **Bristow Group**: Sell to open September 2012 $40 puts, recently $1.60, one for every 100 shares you're willing to purchase up to 4%. If put shares, this trade provides a net buy price of $38.40, below our $39 Buy Around.
- **Rockwood Holdings**: Sell to open May 2012 $50 puts, recently $2.50, one for every 100 shares you're willing to purchase up to 5%. If put shares, this trade will net a purchase price of $47.50, below our $49 Buy Around. Or, sell to open August $50 or $45 puts for a higher payment.

Questions on these? Visit our "Catch-Up Trades" discussion board.

That 70% net long gives us another way to look at our returns: A result on par with the S&P 500's 12% gain would be 70% of its return, or 8.4% (12 * 0.7). Our 10.7% return is well above that, showing outperformance in the stocks we've chosen to buy. Viewed another way, we achieved 89% of the index's return while holding 30% shorts and cash. That's a strong result, even though (as always) our focus remains on the always-positive North Star and not on relative returns.

As another reference point, I keep a close eye on the hedge-fund industry, because these exclusive vehicles share our same goal of absolute profits. According to Bank of America Merrill Lynch, the average hedge fund gained 2.3% in the first quarter, earning a fraction of our results. The average hedge fund is typically 40% or greater net long, according to BarclayHedge — but even at just 40% long, a performance on par with the S&P 500 would be a gain of at least 4.8% (12 * 0.4) last quarter. Hedge funds underperformed even this measure, suggesting subpar investments.

In fact, our hedge-fund brethren have performed poorly over the past few years. *Pro* is much more committed to long-term ownership of great companies, so we should be able to continue to outperform the vast majority of these high-rolling funds over time through lower turnover (less trading), staying committed for years to growing businesses, and continually seeking more companies positioned to deliver exceptional, recurring results. Long-term stock ownership is two-thirds of our approach. The other third is sensible options strategies (often with income in mind) and shorting.

Now let's gain some altitude and consider investing from a higher perspective.

Four Rules of Investing

First printed in *Financial Analysts Journal* in 1974, Charles D. Ellis's *The Loser's Game* (PDF) is just as relevant to investing today. It seeks to explain why most professional money managers fail to attain a goal — topping a benchmark, usually, or achieving absolute returns. The sweeping explanation is there are too many fund managers doing the same thing, and simply put, they're trying too hard, mistaking activity for results. The article offers four takeaways:

1. **Be sure you are playing your own game.** Know your strengths and your game plan, and keep them in mind for every decision. For instance, some *Pro* members only buy our long-term stocks and don't short or use options.
2. **Keep it simple.** Know what you're best at, and do it again and again. *Simplicity, focus, and efficiency are key attributes in achieving excellence over a lifetime.* Incidentally, The Motley Fool has five company-wide core values, and every employee is also asked to name one of their own, called their "motley." Nick Crow's value happens to be "Focus." Bryan Hinmon's is "Better Every Day." Mine is "Simplify."
3. **Concentrate on your defenses.** *The Loser's Game* suggests most money managers focus intently on buy decisions; therefore, few make good sell decisions. If you focus on being a great seller, you may find an edge. At *Pro*, we're focusing more energy on opportune sell decisions. We want to be reluctant but excellent sellers when it seems we should. We've already sold three stocks this year and written covered calls to potentially sell two others. We're seeking other ways to concentrate on our defensive edges.
4. **Don't take it personally.** *The Loser's Game* ends on a high note. People who manage money, whether it's you at home or us at The Motley Fool, are typically high performers who have succeeded in other areas of life (if we may say so!). You come into money management thinking you'll continue your winning streak, believing you can perform much better than not only your peers but a bloodless stock market. But investing is much more random than pursuing a degree or even running

your own business. You always invest with partial information, and randomness will play a role in your results. When you have weak years, don't take them personally. Learn what you can, and keep working to simplify, focus, and be efficient at achieving your goals.

That's what we're here striving toward for members. If you have thoughts on this Memo, or a personal value to share, please post on the Memo Musings discussion board!

Jeff Fischer (TMFFischer)

Coverage and Community

- **Want More Options Ideas?** Check out alex340's lists of puts and calls that meet *Pro* criteria (the criteria are meant for income trades, so may not match our investment theses).
- **City By the Bay: Pebblebrook Hotel Trust** is buying again, this time acquiring the Hotel Milano in San Francisco — another hotel Fools should visit!
- **Got Too Much Cash?** Fools discuss investing options when the Benjamins are piled high in your account. *Pro* is happy to have some cash, but we all seek returns on it.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

A Q1 Q&A, Plus What's in Our Queue

Published Apr 2, 2012 at 12:00AM

Fellow Fools,

Pro Trade Roundup

- **InvenSense**: We purchased 800 more shares at $17.85, filling out our position at about 2% of the portfolio.

Guidance Updates

- **CME Group**: Following price appreciation, the stock moves from Buy First to Buy.

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Rockwood Holdings**: Sell to open August 2012 $50 puts, currently $3.60, one for every 100 shares you are willing and able to purchase. If put shares, this trade will provide an effective purchase price of $46.30, below our $49 Buy Around.
- **3D Systems**: Sell to open August 2012 $22.50 puts, currently $2.10, one for every 100 shares you are willing and able to purchase. If put shares, this trade will provide an effective purchase price of $20.40, below our $21 Buy Around.

Questions on these? Visit our Catch-Up Trades discussion board.

The first quarter of 2012 was great for stock investors. The S&P 500 notched an impressive 12% gain, marking its best quarter since 1998. Our North Star, which tends to have a much steadier, constant climb throughout the year, clocked a 2.8% advance over the first quarter (remember, it will likely continue its ascent independent of the market's advances or declines).

Q: But How Did *Pro* Do?

A: The *Pro* portfolio was up 10.7% over the quarter, keeping pace with the market and outpacing our North Star. Of the 25 long stocks in our portfolio (ignoring the options strategies overlaying some of these positions), only two were in the red: **GrafTech International** and our newest recommendation, **InvenSense**. Impressively, 16 of our 25 stocks have outperformed both our *annual* rough estimate of the North Star (approximately 10%) and the smokin' returns of the S&P.

In short: The *Pro* portfolio performed well, especially considering we have hedges in place.

Q: Were These Our 10 Best Stocks?

A: Jeff rang in the new year with a Memo called "Are These Our 10 Best Stocks?" In it, he identified 10 stocks he, Nick, and I all agreed would outdistance our North Star over the next three years. To keep us honest, I'm looking back to see if we've gotten off to a good start. The verdict? A rising tide lifted almost all of our boats. We've since sold **Autodesk**, and eight of the nine remaining stocks are ahead of the North Star (and ahead of the S&P 500 — we mention that metric only because we're focusing on one quarter's return). For you curious Fools, **Medtronic** was the one laggard, but we're not concerned; although the company's turnaround will take time, it seems to be setting off on the right foot.

In short: Eight of the nine remaining stocks we identified are off to a quick start. Our three top performers from that list were **3D Systems**, up 63.5%; **WisdomTree Emerging Markets SmallCap Dividend Fund**, up 24.1%; and **Wells Fargo**, up 23.9%.

Q: What About the Five Duds We Identified?

A: In the same Memo, Jeff highlighted five stocks we unanimously believed would be laggards. With one quarter in the books, we were right on four of the five: **Bristow Group**, **Ebix**, **L-3 Communications**, and **Vanguard Energy**. **Covanta Holdings**, meanwhile, has advanced 19%. (Again, we added the criterion of keeping up with the S&P because of the very short time frame.)

Berkshire 2012 Will Not Be Televised

But we *are* sending a team of Fools to Omaha to analyze Warren Buffett's latest moves and what they mean for investors. Get your free dispatches here!

In short: Our dud radar seems to have been operational. We're now attempting to sell Bristow via covered calls, and the story with Covanta has changed a bit because the company has decided to double its dividend.

Q: Did We Make Wise Portfolio Moves?

A: This is a complicated question.

On one hand, we have definitely upgraded the *Pro* portfolio over the past quarter. A 30,000-foot flyby shows that we sold L-3, Ebix, and Autodesk and purchased **Apple**, **CME Group**, and InvenSense. (Notably, the three stocks we sold have not been impressive performers since.)

As for our decision-making, two of the three stocks we sold (L-3 and Ebix) were on our "laggards" list from January. (Autodesk simply eclipsed our estimate of intrinsic value.) We've also moved to sell Bristow via covered calls. From this standpoint, we're pleased with the decisions we made.

But mistakes of omission are just as costly as mistakes of commission. Your advisors all agreed in January that 3D Systems, **MasterCard**, **Pacer International**, and DGS would be long-term winners — and they all had small allocations in the *Pro* portfolio. With consensus in hand, did we add to our positions? Nope, we sure didn't. Thumb-sucking and fiddle-farting are euphemistic ways of describing our inaction. That said, though, MasterCard jumped while we were discussing it, we have puts open on Pacer, and we made a decision to add different growth companies to the portfolio — starting with InvenSense — rather than investing more in 3D Systems. We also bought more **BMC Software**, with strong results so far.

In short: We made some good decisions in the first quarter, but we missed some opportunities to potentially add to a few small positions that were down.

Q: What Have We Learned?

A: We don't place too much weight on a single quarter's performance. For that matter, we don't place too much weight on a single *year's* performance — after all, what does planetary orbit have to do with an investment thesis or business development? But regularly reviewing our actions and performance can help us improve our portfolio management process, and the calendar serves as a good reminder.

In short: Our clear takeaway from this review is that when we feel strongly about an investment, we should act on it appropriately in as timely a fashion as possible, whether that means buying *or* selling positions.

Foolish Final Thoughts

While we will (alas) never be error-free in our decision-making, we will strive to get better every day, learn from our mistakes, and look to do the next right thing. We plan to regularly reassess our positions relative to our North Star, and we will of course keep you updated on what we find. No matter what, we'll be sure to keep our focus on the long term and our compasses set to our true North.

How was your first quarter? Bring your tales of wins and losses to the Memo Musings discussion board.

Onward,

Bryan (TMF42)

Coverage & Community

- Jeff provides *Pro*'s take on recent results at **Oracle**.
- *Pro*'s lowest-paid analyst, Tom (MazonCreekRich's son), provides a spring investing update.
- Jeff counts the cash and looks at the *Pro* portfolio's dividend payers.
- There's a debate between tax annoyance and yield taking place on the **StoneMor Partners** board — have you sounded off?

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Managing Madness

Published Mar 26, 2012 at 12:00AM

Fellow Fools,

Pro Trade Roundup

- **Autodesk**: We sold all of our shares at $41.
- **Wells Fargo**: We rolled our covered strangle out and up. We now have 12 written October 2012 $33 puts and 12 written October 2012 $36 calls. We incurred a modest debit to roll.

Guidance Updates

- **MasterCard** moves to Hold following price appreciation.

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **3D Systems**: Sell to open August 2012 $20 puts, lately around $1.45, for a 7% yield in five months or a lower buy price. Sell one put for every 100 shares you are willing to buy, up to 2% of your portfolio.
- **Wells Fargo**: Sell to open July 2012 $33 puts, lately paying you $1.50, or a 4.5% yield in four months. This results in a $31.50 potential buy price. Sell one put for every 100 shares you are willing to buy, up to 3% of your portfolio.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Last week, I read a mind-blowing article on memory that mentioned the potential for a pill that could erase individual memories forever. It turns out our memories are reconstructed every time we access them, and after a few recollections, they can become only loosely related to reality. The thought that memories are more impressionist painting than photorealism was as mad to me as Van Gogh cutting off his own ear (and incidentally, like memories, that story might not be accurate either).

Of course, this is just more evidence that our brains are not to be trusted. If you, like me, are having trouble adjusting to that idea, then you may be suffering from cognitive dissonance, the mental discomfort that occurs when new information conflicts with previously held beliefs.

Warning: Thinking May Impair Judgment

The idea that our brains are imperfect tools for estimating probabilities and making rational investment decisions is not a new one for *Pro* investors. Striving for continual improvement is part of being a lifelong investor, and because most investing errors are born out of temperament and behavior, studying the ways and reasons we deviate from making rational decisions should be a top priority.

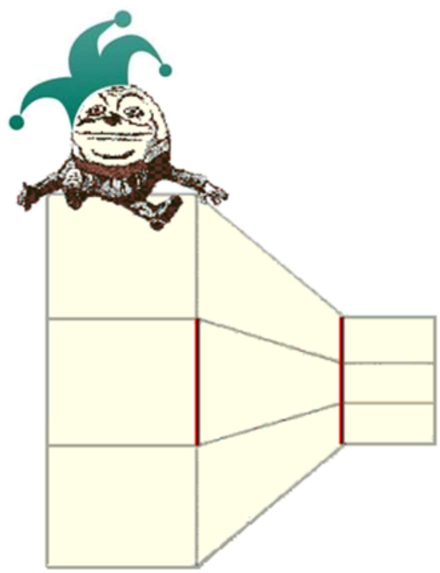
Most behavioral biases fall into two categories: faulty cognitive reasoning (cognitive errors) and decisions based on feelings or attitudes (emotional biases). Of the two, cognitive errors are the most easy to correct through identification and education, so in this memo, I'll focus on errors resulting from faulty reasoning — not those based on impulse, intuition, or emotion.

Of course, Jeff, Bryan, and I might be more susceptible to cognitive errors than you are — but if you make your own investment decisions and perform your own due diligence to any extent, what I'm saying will affect you, too.

Know Thy Enemy (and Know Thyself)

As longer-term *Pro* members know, I like to use pictures a lot, especially to demonstrate the faultiness of our brains. Here today to help me demonstrate is old-school Fool Humpty Dumpty, sitting on a wall.

Which of the two red line segments in the wall appears longer?



If you perceive things like most people, the line on the right looks longer, even though they are exactly the same size. Your brain is expecting the lines to conform to its preconceived, learned idea of what a wall is, so its perception of perspective is influencing — and incorrectly estimating — the length of the two lines. Go ahead, measure; I'll wait.

Humpty Dumpty's lines are an illustration of belief perseverance biases — a subcategory of cognitive errors in which we unwittingly ignore some information, modify the information we do see, and only remember the information that confirms our beliefs. Here are some of the ways our brains can trick us.

Confirmation Bias
When we seek information as evidence to support our preferred viewpoint or thesis, we're experiencing confirmation bias. Unfortunately, our desire to avoid cognitive dissonance can be stronger and more complex than our attempts to contain it. Even when we consciously seek out contrary evidence because we're aware of confirmation bias, we will unconsciously underweight — or outright ignore — strong evidence that's contrary to what we expect to see. In investing, this can manifest as an underdiversified portfolio with too much risk; worse yet, it can convince us of the merits of a single company or stock, ignoring negative news and gathering only positive information that confirms our glowing expectations.

- ***Pro* Tip:** Make an overt, conscious effort to disprove each of your investing theses. Take special care to fully consider negative information.

Conservatism Bias
It's natural to overweight the importance of our initial beliefs about an investment. After all, most research and analysis occurs before we make an investment decision. Compounding this is the human tendency to under-react to new information. But if we fail to modify our beliefs or theses based on the analysis of new information, we put ourselves at a disadvantage to those who do correctly incorporate those facts. Sometimes this bias expresses itself when an investor holds a losing investment too long after the initial thesis proves incorrect (that's conservatism and anchoring teaming up against you). The larger the change, the less likely we are to accurately incorporate the information.

- ***Pro* Tip:** Instead of using new information to justify your original thesis or belief, ask, "How does this information change my forecast?"

Representative Bias
Quick minds are often tempted to classify new information based on past experiences. Though expedient, this tendency can lead our brains to subconsciously interpret difficult-to-analyze data incorrectly — without alerting us to the complexity or chance for error. This reflex deceives us into believing we know more about a situation or investment than we really do, which can mean incomplete analysis and incorrect decisions. Perhaps we've stereotyped an investment as a growth stock or a value play, or a company as belonging solely in the technology or banking sector. Or maybe our opinions are based on personal experience or otherwise give too much weight to a small, non-representative sample size.

Berkshire or Bust!

Can't make it to Omaha for "Woodstock for Capitalists"? We've got your back! Register for our free trip dispatches from 2012's Berkshire Hathaway meeting.

- ***Pro* Tip:** Be aware of statistical mistakes — particularly if the underlying information is difficult to process (for example, if you've surveyed thousands of people). Ask yourself if you're overlooking or oversimplifying the reality of the investment situation.

Illusion of Control Bias
All it takes is a couple of successful put writes for an investor to succumb to this bias, but the belief that we can control or influence investment outcomes is irrational. Sure, we can do our due diligence, value the business, and make educated decisions, but the outcome — whether our options end up in or out of the money — is not ours to decide. This bias shows up as underdiversified (and sometimes overleveraged) portfolios and excessive trading.

- ***Pro* Tip:** Keep good records, including transaction costs. Ask yourself in advance, "Why am I making this investment? What do I expect will happen? Is this part of my plan?" Check back regularly to recalibrate your perception of control.

Behavioral finance for investors is often oversimplified. There is more to controlling our temperament — and our decisions — than understanding the effects of fear and greed. Being aware of known cognitive errors is an important step in becoming a better investor and overcoming the inherent limitations of our minds.

If you enjoyed this memo or would like to discuss cognitive errors or discuss the "mind-blowing" article I linked to, please visit us on the Memo Musings board.

Fool on!

Nick Crow (TMFCrow)

Coverage & Community

- **From the CPA:** A few tax notes regarding **StoneMor Partners**.
- **Keep It Simple:** fullofcarp talks about doing more with less.
- **Who You Callin' Short?** A host of Fools chat about hedging and shorting.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Roll Your Covered Strangle on Wells Fargo

Published Mar 20, 2012 at 12:00AM

- **What We're Doing:** Seeking income on our shares.
- **What We're Thinking:** The stock price has appreciated greatly, and we need to take action before the March 22 ex-dividend date.
- **What We’re Expecting:** We’ll either roll or close this position when expiration comes.

Trade Essentials

- **Action:** Buy to close your existing covered strangle (April 2012 $29 covered calls and April 2012 $21 puts) for about intrinsic value, currently $5. Then, using a strangle order, write ("sell to open") a new strangle: October 2012 $36 covered calls (one for every 100 shares you own) and an equal number of October 2012 $33 puts.
- **Price Guidance:** Use a **limit order**, aiming for a net debit of about $0.75.
- **Alternative Trades:** See the end of this report.

What's New?

- **Recent price:** $34

Four of the country’s largest 19 banks failed the Federal Reserve’s most recent stress test, but not **Wells Fargo**, which not only passed but also had its capital plan approved. Though the stress test is imperfect, passing is no small feat; to do so, a bank must prove it could survive a 50% drop in the stock market, a 21% drop in housing prices, unemployment peaking at 13%, and a worsening recession in all leading countries. For the second year in a row, the company’s capital plan included a special dividend to “true-up” the previously announced $0.12 first-quarter dividend to match the new dividend amount of $0.22, an 83% increase.

Why Roll?

The rising stock price and the special dividend (which provides an incentive for the owners of our call options to exercise them and buy our shares) mean we’ll need to roll this position if we are to keep our shares. When we established the covered strangle, we detailed this scenario in the trade alert:

> “At expiration, if shares are … higher than $29: Our covered calls could be exercised, forcing us to sell our shares at a net $31.79 (5% above our cost basis) if we don’t take action.
>
> "[This would violate] Rule No. 1 of writing covered calls: Don’t write calls on shares you don’t intend to sell. While we want to continue to hold Wells Fargo and we’d prefer to roll this strangle, if we are forced to sell our shares, we’ll do so at a 27% premium to today’s market price — not such a bad outcome.”

When we wrote that in November, the stock price was about $25. It’s now near $34, 36% higher. We need to buy back our calls at a loss so our stock isn’t sold at expiration, but the rise in stock price more than makes up for that loss. Overall, this has been a very profitable trade – albeit not as profitable as share ownership alone. This is a good example of trading maximum profitability for higher probability of an acceptable profit.

This Is How We Roll in *Pro*	Price Per Share
Payment received for writing previous strangle	$2.57
Estimated cost to close previous strangle	($5.00)
Net cost to close	($2.43)
Estimated payment received for writing October $36/$33 strangle	$4.28
Total net credit/(debit) from rolling into a strangle	**$1.85**
Original Net Sell Price	$31.57

New Net Sell Price	**$37.85**
Net Sell Price Improvement From Roll	**19.9%**

How to Follow Along

We recommend you:

- Buy back ("buy to close") the April 2012 $29/$21 strangle for about intrinsic value, currently $5.
- Then, using a strangle order, write ("sell to open") October 2012 $36 covered calls, and write ("sell to open") October 2012 $33 puts.

Remember: To write a covered strangle, you must own at least 100 shares of the stock, and you should be happy to buy at least 100 more at a lower price. In this case, write one covered call for every 100 shares of Wells Fargo you own, and write one put for every 100 additional shares you would be willing to buy.

Alternative Trades

- **If you don't own a 3% allocation in Wells Fargo yet:**
  - Sell to open (*do not buy*) July 2012 $33 puts, lately paying you $1.84, or a 5.6% yield in four months. This results in a $31.16 potential buy price. Sell one put for every 100 shares you are willing to buy.

Next step: If you have questions before you set up your trade, visit our Wells Fargo discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Sell Autodesk

Published Mar 19, 2012 at 12:00AM

- **What We're Doing**: We're selling our shares of **Autodesk** (NASDAQ: ADSK).
- **What We're Thinking**: The stock is now valued as if it will execute every business initiative perfectly.
- **What We're Expecting**: We're happy to raise cash to eventually put toward more attractive opportunities.

Trade Essentials

- **Action**: Sell all shares using a limit order at current prices (assuming the stock stays above $38).
- **Recent Price**: $41.50
- **Alternative Trades**: Sell at-the-money covered calls expiring in April or May if you're comfortable holding your shares and wish to target at least a modestly higher potential sell price.

What's Changed?

- **Last action**: In September 2011, *Pro* purchased 1,400 shares.
- **Total return**: 49%

Oh, that silly roller coaster of a stock market. In January 2009, Mr. Market thought **Autodesk**'s (NASDAQ: ADSK) business was worth less than $17. We disagreed and happily purchased shares, later selling for higher than $30 via covered calls. Last September, Mr. Market thought Autodesk's business was worth $25 per share, and we were once again glad to step in and purchase shares. Now, after a few quarters of solid business results and a 49% gain in the stock price since our purchase, we're cheerfully cashing in our chips to wait for the next market mispricing. Whether that'll be Autodesk or another great business, we don't know.

We've decided to sell Autodesk for a few reasons:

- **Price**: The company's stock price is above our estimate of fair value, and we don't think its potential returns from here justify the risk of continuing to hold.
- **Risk**: Autodesk is historically highly correlated to several other positions in our portfolio, including **Rockwood Holdings** (NYSE: ROC) and **GrafTech** (NYSE: GTI)— and more important, we believe it has exposure to similar macroeconomic risk factors. What's more, we expect many of those other positions to offer better potential returns from today's valuations.
- **Cash**: After this stock's sharp appreciation, we are happy to raise cash for portfolio protection and to deploy into undervalued opportunities, now or later.

How to Follow Along

Although we still respect Autodesk's business, we can't ignore the stock price. Using a limit order, we'll sell all of our shares of Autodesk in the next one to 30 days. If you're comfortable owning shares longer, consider writing at-the-money covered calls for a higher potential sell price, but remember that shares can be volatile.

Next Steps: Visit the Autodesk discussion board to post questions, and then make your trade.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

The Long and Short of It

Published Mar 19, 2012 at 12:00AM

Dear Fools,

Pro Trade Roundup

- **CBOE Volatility Index** (VIX): Ratio call backspread. Sold to open 15 May 2012 $20 calls; bought to open 30 May 2012 $27 calls. Net debit: $0.09.
- **InvenSense**: Bought 800 shares at $20.20, for 1% of a planned 2% allocation. We have three more weeks to fill the rest of the order, hoping to average in closer to our $18 Buy Around price, but putting a stake in the ground in case lower prices don't happen in time.

Guidance Updates

- **GrafTech International** moves from Buy **to Buy First** following a price decline.
- **Apple** moves from Buy First **to Buy** following price appreciation.
- **Wells Fargo** moves from Buy to Hold following price appreciation.

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **AmTrust Financial Services**: Sell to open September 2012 $25 puts, lately around $1.20, for a nearly 5% yield in six months or an attractive buy price, up to 5% of your portfolio.
- **3D Systems**: Sell to open August 2012 $20 puts, lately around $1.45, for a 7% yield in five months or a lower buy price, up to 2% of your portfolio.

Questions on these? Visit our "Catch-Up Trades" discussion board.

A relentless pursuit of improvement is one of humankind's better qualities, but sometimes our desire for perfection makes us miss the bigger picture. In the original *Jurassic Park*, billionaire John Hammond is intent on building a perfect theme park ("not a single expense spared") populated with dinosaurs. In pursuit of this ideal, he neglects to consider all that could go wrong with hundreds of giant creatures set loose on an island, not to mention the greed of others who might want to capitalize on the dinosaurs.

Believe it or not, this ties into our hedging strategy — and into our collective pursuit of a kind of investing perfection we'll never achieve. As the stock market continues its record-strong ascent, *Pro's* 16.5% short position in the **SPDR S&P 500** (or, for some members, other market indexes or inverse ETFs) feels like a thorn in our sides. Down 14%, this large position sticks out as our only *certain* loser whenever the market is up, and therefore there's a strong desire to close it after months of a rising market.

This desire for something closer to portfolio perfection overlooks the fact that the portfolio probably wouldn't exist in its current form if it weren't for this decent-sized hedge. At last count, we were 95% invested long (see our exposure table at the bottom right of the linked page). But if we didn't have this 16.5% hedge, we probably would *not* be comfortable being 95% long, given our goal of steady returns in various markets. Instead, we would likely be closer to only 80% invested (at most), with the rest in cash.

In other words, our S&P 500 hedge is at least partially responsible for us having another 15% invested in long stocks, and that 15% has made us a healthy return. In this light, our 14% loss in this hedge equates to a smaller opportunity cost for the portfolio, because this loss has allowed us to profit elsewhere instead of keeping more cash.

Meanwhile, as Alex Pape wrote so well last November in "Hedging the Pro Way," you typically *don't* want to make money on your market hedges, as that means the rest of your portfolio is going down. An index hedge is a form of insurance; it is one position you can be certain will make money if the market falls. But you want your portfolio to increase in value as a whole, as ours has been — so we'd rather have our hedges losing money than have our hedges green and everything else red.

The question must be asked, though: When do you close a hedge that is working against you? When I joined David and Tom Gardner in 1996 to work on the original Fool Portfolio, our rough rule was that any short position on a company should be closed at a 20% loss, because why let a short potentially run against you much more than that? When shorting market indexes, I considered this rule and then cut the loss limit in half, to about 10%, because that's a significant move for an index to make in a short time.

Today, though, I question whether that's the right way for me to think about an index hedge. After all, our whole portfolio has gone up strongly despite the hedge, and now that the S&P 500 is up 14% against the hedge, we should probably be considering *adding* to the position, rather than closing it. The portfolio is worth much more now, and the stock market is at a higher valuation.

Hedging vs. Shorting: Like Brontosauruses vs. T-Rexes

A hedge is quite different than a direct short of a company. A hedge is a low-conviction, somewhat slow and lazy position that serves to cushion our downside risk, even as we aim to make money overall by being mostly invested in stocks. In contrast, a short is an aggressive, high-conviction, targeted position that says "company X will decline." Although we're looking at company-specific shorts to initiate, for now we should continue to view our hedge in isolation and aim to make the best choice in regards to it and the rest of the portfolio. If we closed our index hedge, would we feel comfortable being 95% invested right now? Given our goals, and given what we've said above, the answer is no. Lacking this hedge, we'd want to raise more cash. Therefore, we shouldn't close our hedge until we have shorts to replace it with — shorts we like better.

So that's where we stand right now. Meanwhile, the index hedge offers us some cushion if (should I say "when"?) the S&P 500 declines, and at the same time allows us to be invested in our current number of stocks for upside. Year-to-date, the *Pro* portfolio is up 11%, and the S&P is up about 12%, so we're keeping up despite the hedge. We are also already above our annual North Star, which today is at about 10% per year, so we need to be mindful about protecting our gains even as we aim to earn much more in the coming years.

The bottom line: Remember that our hedge has made it reasonable for us to own more shares than we otherwise would, and therefore its loss needs to be compared to the gains it has simultaneously allowed us elsewhere, not to mention the gains we've enjoyed overall (the portfolio only matters as a whole).

Second, although I wrote in the original trade alert that we may close the hedge at around a 10% loss, the thoughts behind that idea are evolving. I believe we should only close the hedge if: (1) we don't want any hedges at all; (2) we find direct shorts we like better; or (3) we have more cash. Simply closing the hedge today would, in a way, be aiming for perfection: It would mean we expect the market to keep going up and that we want every position in the portfolio to be green when it does.

I can't help but believe this kind of thinking would lead to folly. Nobody would get eaten by a Tyrannosaurus (probably), but we'd be even more exposed to market declines. The market will not keep rising in a perfect line forever, so our portfolio shouldn't be invested as if it will. After all, when the market falls, the only position that *will* be perfect will be the hedge.

Visit us on the Memo Musings board, or let us know some stocks you'd like to short. And Fool on!

Jeff Fischer (TMFFischer)

Coverage & Community

- **Apple** announces a new dividend that amounts to a 1.79% annual yield and a $10 billion share buyback program (about 1.7% of shares outstanding).
- *Pro* members talk about Greg Smith's very public resignation from **Goldman Sachs**.
- Fools look forward to direct shorts, while Jeff wants to short flawed ETFs at opportune times and talks about a short he's glad he didn't make.

- April earnings are a month away. TMFMoosie provides a great earnings and dividend calendar.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Let Your AFSI Put Options Expire

Published Mar 16, 2012 at 12:00AM

Fools, our March 2012 $20 put options on **AmTrust Financial Services** will expire tomorrow. We mean to let them expire without taking action. For more information and the full recommendation, click here.

Audio Extra: SPY, Shorts, and More

Published Mar 15, 2012 at 12:00AM

The *Pro* team discusses what we'll do in case the market declines, our current **SPDR S&P 500** hedge, and what we've got planned for our shorting strategy in the future. Listen in below, then let us know your thoughts on our Philosophy & Strategy discussion board!

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Transcript

Jeff Fischer: Welcome to a new edition of Motley Fool *Pro* Audio Extra. In the studio we have Nick Crow, Bryan Hinmon, and I'm Jeff Fischer, so AKA, your *Pro* team is here. Thank you for joining us. We're taping this on Wednesday afternoon of March 14^{th}, and we're here to talk about, you guessed it, the stock market. The stock market, Bryan and Nick, has been up a lot; members as well. Since the New Year, the S&P is up approximately 12% as we tape this.

Bryan Hinmon: Not a bad start.

Jeff Fischer: Not a bad start at all, and in fact, a little heated for us, for our tastes maybe. It makes it a bit harder to set up options trades, a lot of things have kind of run away, but at the same time, we're doing fine. We've been hedge; we're going to talk about that. Our hedges, our shorts, and just our strategy in general going forward, should the market ever have a down couple of months, which it certainly will. Bryan first, what's gotten us here, since last fall?

Bryan Hinmon: Three things, I think. It's pretty easy to sum up. The first thing is we know what Greece's default's going to look like. The second thing is …

Jeff Fischer: And it ain't pretty.

Bryan Hinmon: Yeah. The second thing is the ECB is making it rain in the European banks. They basically have said you can have as much money as you need for the next three years.

Jeff Fischer: That is a great point, because that really seems to have been the pivot point, the market just has really taken off after that, along with also the U.S. Fed saying, We'll keep rates low through 2014.

Bryan Hinmon: A couple of times they've come out and said it now, so they are;

Nick Crow: They keep extending it.

Jeff Fischer: You know, we take that with a grain of salt. They're throwing fuel onto this fire, but is this fire something we really want to burn so hotly? That's the question. Okay, so Bryan…

Bryan Hinmon: The third thing is if we look on our shores, earnings by and large were really, really solid. Everyone makes a big deal out of record profit margins and say that they can't last, they can't last, they can't last. Well, companies are lean right now and they are executing really well, by and large. So those three things have led to a stock market that has gone in one direction for the past three months.

Jeff Fischer: All right, so what could change that direction then is the next logical question, and the answer, of course, would be lower earnings, new problems emerge in Europe, whether it's Greece or, probably not Greece or the moment, but Portugal or Spain.

Bryan Hinmon: Things over there are not just rosy just yet, and there are other geopolitical events that will not go away, so there are still things that could lead to big problems.

Jeff Fischer: Always a surprise (unclear).

Bryan Hinmon: Yeah, one of the new fears is China, a major slowdown in China, so there's always something new to worry about.

Nick Crow: Yeah, they recently had a trade deficit after years and many quarters of having major trade surpluses, so ...

Jeff Fischer: Yeah, that was shocking; "Shocking" was the headline. Everyone's shocked by Chinese trade deficit.

Nick Crow: Yeah, I don't follow that that closely, but I was surprised.

Jeff Fischer: Yeah, so this all said, we're not sitting here worried and ruining our lives with macroeconomic thoughts. We own great companies for the long term, and we use shorts and hedges to try to buffet the downdrafts that the market inevitably will have.

Now lately we've been short; well the market has gone up, and as much as that single short in market indexes; we all have different ones. We are in (unclear) ourselves. It can't hurt; the thing to remember is the portfolio has gone up much more as a whole than the short has dinged us. The short has dinged us about 3% performance since last October, while the portfolio was up; I don't have the latest numbers, but above 15%.

But Nick, let's talk about now. We're not thinking about the market being up; we're trying to think are we ready for when it goes down, because it will go down for a few months.

Nick Crow: Sure. I know you don't like me to say this, because you've scolded me in the past, but if the market were to crash, we all would have a place.

Jeff Fischer: That's such a loaded word.

Nick Crow: It is loaded, but I like to frame things as worse case first, and then we'll move back from there.

Jeff Fischer: See, I would say "steadily declined." If they market goes into a small decline of 10, 15% ...

Bryan Hinmon: And there you get the differences between Nick and Jeff. *(Laughter.)*

Jeff Fischer: All right, so a decline or crash of; and members know we don't try to juggle around 5%, 7% moves. You can't do much with those, but a decline of 10%, 15%, a crash; as Nick would say, what are we doing?

Bryan Hinmon: We have a few things we can do. First in my mind, of course, is we have those short positions that you just mentioned. We can always reduce that short and move any names that dropped that we might have on our watch list now that we'd like to buy at lower prices, or add the things that we love that are currently in our portfolio. And so that's a primary way you can see if those shorts provide a whole bunch of extra liquidity for us, if they worst is to come.

Jeff Fischer: And a second thing we can do is we have about 5% cash right now, so not that much, but we're very flexible even so, because if the market falls, some of our shares are going to fall more than others. We have many companies on hold that we may look to sell to then buy companies we like better, buy more shares of companies we like better that have hopefully fallen more.

Nick Crow: Yeah, absolutely. If we were to have a crash or major drop, it's nice to move out of names that you were in for maybe a shorter period of time, things that you knew you didn't want to own for the next ten years, but they were mispriced, to go ahead and sell those and buy things that you'd really love holding for the rest of your investing life.

Jeff Fischer: And now you could say, our members should say well, why not sell some of those right now, before the prices fall? And that is certainly on our to-do list and radar, potential names to sell. That could happen before you know it, but in the case it doesn't, we'll still; we have enough positions, two dozen positions, that we should have ones that lend themselves well to a sale later on, to selling to move the money somewhere we like better. Bryan, do you have thoughts on market up, market down?

Bryan Hinmon: Yeah, I was just going to comment while you guys were going up there, that some members know that we from time to time do an exercise where we talk about, amongst ourselves, our favorite businesses, the ones that we want to own forever.

Jeff Fischer: And we are going somewhere with that list. It will become more of a PRO document, I believe.

Bryan Hinmon: And it's when those dislocations happen that that is one of the first places that we turn. The first place we turn is what we already own, because we own them for a reason. Then the second place is we pit those hold stocks against those favorite businesses that aren't in our portfolio, and we sort of do a battle royale there to see which one offers the better opportunity at the time, so that's where my default goes in times like that.

Jeff Fischer: That makes good sense, because then you're able to pick up these super high quality businesses at if not a discount, a much better price than previously. So let's talk about our few shorts that we have right now, primarily the CurrencyShares, Euro Trust, which we are comfortable with, remain comfortable with. It's interesting the Euro has not rebounded despite Greece having a temporary resolution, a bailout package. That's only about a 3% position. It's possible we'll add to it over time.

And we also own, or short, about a 16% position in the Spyders S&P 500 SPY, which is our direct hedge, something that obviously when the market goes down sharply, we would look to harvest the money that we have there and then reinvest it in stocks. That said, we're down as of taping, about 13% on that position. So it's been, as Nick said this morning, almost all pain from the start; that short has almost never been green. So what do we do from here? We already reduced that short by a third about a month ago at a much lower price, and at this point, we have this discipline where a short we typically want to close around a 10% loss. There are always factors where you won't follow that discipline. There are cases where you would actually add to the short at that point. And that's where we are with SPY right now. Lately with volatility so low and with, it seems, bullishness so high, we're not in a hurry to close our one large hedge at this point. In fact, if the market has a much higher, a move higher, we may actually add to this short.

Now at the same time, we're look; to the SPY short. At the same time, as you all know, we've been looking for specific shorts to replace SPY with, and that continues and those shorts, as we pick up shorts that we like better, we'll move out of the SPY short or the index shorts that you have and into these targeted shorts that we like better.

Now this said, Nick is smiling because he knows what I'm going to say next.

Nick Crow: I'm not sure, but I know it's coming my way.

Jeff Fischer: Most individual company shorts, lower quality companies, high beta stocks, have done really well in this market rally, so it's a good thing we're not short those instead of SPY. As well as SPY has done, a lot of the shorts out there that we would target, have gone up even more.

Nick Crow: I can almost assuredly say that if we were short those individual names, we'd be losing more than our SPY short.

Bryan Hinmon: And they don't work as well as a hedge sometimes. They're more of a high-conviction idea. This, we own a lot of companies that move in line with the S&P, and so when it goes up, we profit and hopefully profit more, and so we're truly hedged in that way. There's a cost to this hedge; we sleep well at night knowing that if something were to happen in Europe that were unexpected or even expected, that we would have liquidity to move into cheaper names.

Jeff Fischer: That's exactly right, so I'll just point out again that yes; we had this 10% discipline. We still have it in mind and we're aware of it, but for now we're keeping our index shorts and we are actively looking to replace them, but while we are doing that, we do not want to remove our shorts at this point. *(Laughs.)* Or our jeans. So Bryan and Nick?

Nick Crow: Jeff is red right now; this is awesome. Doesn't happen very often.

Jeff Fischer: Thank you guys for joining us. Let's wrap it up right there. Thank you, members, for being here as well. We'll see you in the Monday Memo where we will continue to talk about long-short strategies. Thank you, and Fool on!

Set Up a Call Ratio Spread on the CBOE Volatility Index

Published Mar 14, 2012 at 12:00AM

What We're Doing: Hedging the bullish stock market with an investment in the "fear index" — the VIX — using its call options.

What We're Thinking: The VIX index closed yesterday at 14.7, far below its average of about 20.

What We're Expecting: If the VIX spikes, our position should start to profit. If the VIX doesn't jump, the position is costless to set up and should lose relatively little.

Trade Essentials

- **Action:** Set up a 1-to-2 May 2012 $20/$27 call ratio spread on the **CBOE Voaltility Index** (ticker: VIX, or ^VIX at some brokers, or $VIX.X).
- **Allocation:** Set up one ratio spread for approximately every $100,000 you manage. *Pro* will sell 15 $20 calls and buy 30 $27 calls. The maximum potential loss is $700 per spread ($10,500 in our case) if the VIX lands right at 27 at expiration, but we will roll or close this position a month before expiration, so even in a worst-case scenario, we won't lose nearly that much. (One-fifth to one-third of that amount, or between $140 and $233 per spread, is more likely as a potential downside.)
- **How This Works:** Up until a month prior to the May 16 expiration, the spread acts like a long call on the VIX. If the VIX spikes, our two long calls should increase in value more than our one short call. We don't need the VIX to increase dramatically to earn a profit; a figure in the high teens or low 20s could put this trade in the green a month from now.
- **Trade:**
  - Write ("sell to open") May 2012 $20 calls
  - Buy ("buy to open") two May 2012 $27 calls for every $20 call you write
  - Use a ratio spread order if your broker allows it
- **Prices (Bid/Ask) and Guidance:**
  - May $20 calls: $4.80/$4.90 (sell one)
  - May $27 calls: $2.35/$2.45 (buy two)
  - Aim for a total net cost of around $0 or even a small credit; use a spread limit order. As prices change, you can pay a small debit and still be in the spirit of the trade.
  - VIX level (March 14): 15.4
- **Alternative Trades:** None. If you can't make this trade now, don't sweat it.
- **Follow-Up:** We plan to roll or close this position around one month prior to the May 16 expiration, in mid-April. Again, we will not hold this to expiration.

The Big Picture

Disclaimer

The VIX moves rapidly, so this report will be short. We'll discuss it and take your questions on the new VIX discussion board. If you don't make this trade initially, and the VIX changes, you'll want to visit the board for the latest guidance or to ask questions. Finally, this trade is not key to a long-term investment portfolio. It's for those who want a "low-probability, high-volatility" hedge.

The Chicago Board Options Exchange VIX Index seeks to estimate the S&P 500's volatility over the coming 30 days. Called the "fear index," the VIX usually spikes when the market declines. Historically, the VIX sports an inverse relation to the S&P 500 nearly 90% of the time, and it can spike anywhere from 10% to 60% in a single day if the market tumbles even a few percent. A few times in 2011, the VIX spiked 35% on one-day declines in the S&P 500 of less than 5%. Theoretically, this makes "ownership" of volatility via the VIX a strong hedge against a falling market.

However, you can't buy the VIX directly, and the exchange-traded funds that try to track it are flawed. Options on the VIX are available and highly liquid, but they're pricey. This is where the call ratio spread comes in handy. It lowers the cost to next to nothing, and becomes profitable if the VIX soars. Most of the time, you **must expect** this hedge to come up snake eyes (typically resulting in a small loss by closure), but it is good protection against a spike in the VIX. The VIX has been higher than 30 roughly 10% of the time since 1990, but even a lesser jump over the next month could cause this position to turn green.

How It Works

If the VIX rises, because of the way VIX options move, the two options we own will start to gain more value than the one option we wrote. As volatility goes up, the premium on far out-of-the money options typically increases more than it does on near-the-money options, because the latter already carry an ample premium to account for a spike in the VIX. Additionally, out-of-the-money VIX calls hold a decent premium until close to expiration, because there is always the potential for a spike in the index. In our case, if the VIX goes nowhere, the trade should stay fairly close to breakeven (the calls we wrote will give us value, and the ones we own will lose value), and we'll close it a month before expiration for reasons explained below.

In technical terms for those with options experience, the attraction of this strategy is that the delta, gamma, and vega on the position are all flat right now. If the market were to fall sharply, the flat profile of this position would change rapidly as the VIX's delta and implied volatility increased and the vega sensitivity of the out-of-the money call soared. Translation (again): The two call options we own would gain value more quickly than the one we're short.

Again, to talk about all this further, please visit the VIX discussion board.

Setup and Follow-Up

Facts to Know

- VIX options settle on a cash basis; they are not "exercisable."
- VIX options expire on a Wednesday, and we'll close these about a month before they do.
- **Maximum Profit:** Unlimited as the VIX rises
- **Maximum Loss:** The maximum loss of $700 per spread would occur only if we went to the beach without closing the position first and thus mistakenly held it to expiration — and the VIX happened to end at 27. We plan to close a month early, so any loss will be less than that. In many scenarios, the loss is nominal. For example, the April $19/$26 spread would result in about a $0.90 loss per spread right now, assuming you had you set it up a month ago at similar prices with $7 at risk.

When setting up this particular strategy, you always want to use the options expiring two months in the future. This maximizes the position's responsiveness to changes in the VIX. Until about a month before expiration, the profit and loss on the spread will be similar to a long call. However, we never want to hold this position to expiration, because the delta on the position begins to turn negative. (Translation: If the VIX goes up as expiration nears, the short calls could begin to add more value than the long calls, the opposite of what we want.)

This should always be a one-month strategy, using options that expire two months after you initiate the position. We can roll this position every month if we like the strategy, prices, and its effectiveness, or we can just end it at any point. Ideally, we'd only want to set up such a position when the VIX is in the lower teens, or when we really want a volatility hedge. In this case, the VIX has fallen 20% in the last week to the lowest level since 2007.

Please revisit the Trade Essentials section above to see again how to set up this position (it's not complicated, but be methodical), and then ask questions on our new VIX Index discussion board. Do not rush. If you haven't used options much, you can watch how this works over the next month and get on board the next time the VIX is low.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Buy InvenSense

Published Mar 12, 2012 at 12:00AM

- **What We're Doing:** Starting a position in a new company with strong promise in the mobile computing industry.
- **What We're Thinking:** Motion-processing sensors for mobile devices will experience surging demand.
- **What We're Expecting:** As the industry leader, InvenSense will profitably sell hundreds of millions of motion-processing solutions the coming years.

Trade Essentials

- **Action:** Invest 2% in InvenSense
- **Buy Around:** $18 (use a limit order near current prices)
- **Fair Value:** $26 (a rough estimate)
- **Alternative Trades:**
    - **Seeking a lower buy price?** Sell to open April $17.50 puts (lately $1.50); June $17.50 puts (lately $2.75); or June $15 puts (lately $1.45).

The Business

If you've seen a Nintendo Wii in action, you're familiar with **InvenSense** (NYSE: INVN). The company is a leading designer of motion-processing solutions for consumer devices, selling single-chip microprocessors that make a device respond to physical and geographical inputs. It's InvenSense chips that make Wii games like *Just Dance* so gloriously interactive.

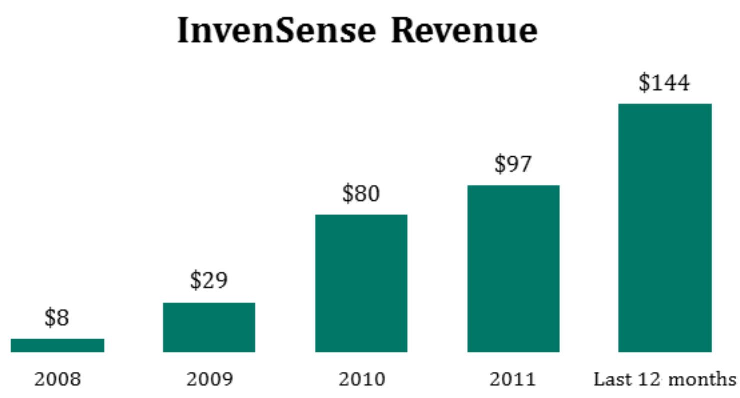
InvenSense Is a Buy First

We're buying InvenSense instead of adding to one of our other stocks, so that makes it a **Buy First**. It will appear that way on our scorecard as soon as we make our purchase.

InvenSense's most robust motion processing units are gyroscopes that include an accelerometer and a compass, all in a single chip. It's the accelerometer-gyroscope combination that enables real-time motion tracking in virtual 3-D space (as with the Wii), and that capability will soon make its way to smartphones and tablets, which in turn will make it possible to navigate with Google Maps in 3D, for example. InvenSense is targeting those devices, as well as gaming, smart TVs, 3-D mice, cameras, and portable navigation devices. But its affordable, tiny products have appeal outside traditional tech, too, including in medical devices, for industrial uses, toys, and in the military.

The company believes it was the first to provide motion-processing solutions for consumer devices. It began selling them in 2008, and it had shipped more than 184 million units by 2011. InvenSense now has more than 140 customers, including Nintendo, HTC, LG, Samsung, and Acer, and its technology is found in more than 100 devices, with many more in the works. The company believes its small form factor (or size), integration of multiple processes in a single package, performance, reliability, and reasonable cost all set it apart from the competition. Plus, it's first-to-market with technological breakthroughs: Latest is the world's first nine-axis motion tracking unit (gyro, accelerometer, compass) in a single package, shipping later this year.

InvenSense had $144 million in revenue during calendar 2011. Analysts at market research firm IHS iSuppli estimate that motion interface sensors for consumer devices will be a nearly $2.5 billion market by 2015. If InvenSense can capture even a portion of such sales, the opportunity is large, and because software drives hardware, the promise is beginning to unfold. **Google** (NASDAQ: GOOG) just made all 10 motion-sensing axes part of the latest Android operating system (that's a three-axis accelerometer, a three-axis compass, a three-axis gyroscope and a pressure sensor). **Microsoft**'s (NASDAQ: MSFT) Windows 8 is making nine-axis motion sensing a requirement, as well. InvenSense views these new software standards as "very positive" developments for its business.



Dollars in millions. Source: S&P Capital IQ. Numbers through the end of March, except last 12 months, which are through January 2012.

Amidst this emerging industry, InvenSense CEO Steve Nasiri says his company has "the lion's share of [the] Android ecosystem market, both in tablets and smartphones ... And we expect it to continue. We have a very strong pipeline ... We are engaged with all major handset makers, Android, Windows, both tablets and handsets. And ... we are one of the primary providers of these solutions. And ... the entire market is going in this direction."

Further, the $2.5 billion market estimate from iSuppli excludes pressure sensors and image stabilization, both areas in which InvenSense also has expertise. iSuppli estimates that close to 1 billion handsets will have at least 8-megapixel image sensors by 2015, and InvenSense conservatively estimates 50% of these will have image stabilizers attached. InvenSense already offers advanced stabilization technology for smartphones and has customers in the digital camera industry. Finally, the company also sees strong interest from "smart" TV makers who want remote controls and screens driven with a motion interface (like the Wii). In short, InvenSense provides technology that makes devices responsive and aware of their position in the world, and that makes countless applications possible.

Financials

InvenSense turned a profit as soon as it began to sell its products and has maintained high margins even while spending to grow. Management targets a 55% to 57% gross margin, which is close to the level **Intel** (NASDAQ: INTC) enjoys, and a stellar 30% to 34% operating margin (it was 33% last quarter). Expecting a steady decline in average selling prices for older chips, InvenSense still suggests it "expect[s] to live within those [margins] easily." Management also mentioned "significant potential for further leverage in the business model and our earnings capacity."

InvenSense Annual Results (in thousands)	Last 12 Months (to Jan. 1, 2012)	Year-End 2011 (April 3)	Year-End 2010 (March 28)	Year-End 2009 (March 29)
Revenue	$143,700	$96,547	$79,556	$29,025
Operating Income	$44,700	$21,478	$21,971	$300
Net Income	$33,600	$9,347	$15,142	$196
Free Cash Flow	$34,800	$5,700	$18,000	$(1,700)

Sources: Company SEC filings, S&P Capital IQ.

It only went public in November 2011, but InvenSense already produces strong free cash flow. This young, fast-growing business is priced at 40 times trailing free cash flow and 27 times estimated earnings for the fiscal year ending in March 2013, so it's not inexpensive by traditional measures — the price reflects some of its growth potential. InvenSense recently had $140 million in cash and no debt. It's a young technology company, though, so we do need to watch share count dilution.

What Would Make Us Sell

Handsets and tablets accounted for 47% of InvenSense's revenue last quarter, but gaming still accounts for most of the rest. As recently as fiscal 2009, Nintendo accounted for 80% of annual revenue, but thankfully that has declined to 34% as tablet and smartphone sales accelerate. Three customers do still account for more than 10% of sales: Nintendo (with its big 34%), HTC, and Samsung. Nintendo's Wii is due for a complete refresh as soon as this year, which could either drive new sales or disappoint. The overall market for motion-processing solutions, image stabilizers, and pressure detectors should prove large enough that InvenSense's concentration among a few customers will fade, but if it doesn't, we'll reconsider this risk.

Despite InvenSense's early lead, competition will be fierce. InvenSense's primary competitor is **STMicroelectronics** (NYSE: STM), which provided the gyroscope for the **Apple** (NASDAQ: AAPL) iPhone 4S. Whether it can court Apple or not, we need InvenSense to win multiple product proposals, maintain margins, and vastly grow its customer and product base. Finally, InvenSense outsources its manufacturing, so it needs dependable partnerships to ramp up volume and maintain quality. It currently works with some of the most dependable manufacturers, like Taiwan Semiconductor, but failings on any of the above measures may cause us to sell early.

There's no question that this recent high-tech IPO is a riskier investment than we usually recommend, so go in with your eyes open. Aware of the risks, we face strong potential rewards as this industry rapidly grows.

Next step: Visit our InvenSense discussion board to ask questions about this interesting new company.

More Resources:

- Market overview
- Management
- News Releases
- Latest SEC filing

Wake Up to Daily Progress

Published Mar 12, 2012 at 12:00AM

Dear Fools,

Guidance Updates

- **CME Group** moves up to Buy First on price.
- **Covanta Holdings** moves back to Buy after doubling its yield to 3.6%.
- **Oracle** moves down to Buy on price and as earnings approach.
- **Pebblebrook Hotel Trust** moves down to Buy as we work to update fair value.

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Papa John's International**: Sell to open July 2012 $34 puts, lately around $1 or higher, for up to a 3.7% stock allocation (sell one put for every $100,000 you manage).
- **3D Systems**: Sell to open May 2012 $20 puts, lately around $1.15, for a 5.7% yield in just more than two months, or a potential 1.9% stock purchase in your portfolio.
- **Rockwood Holdings**: Sell to open April 2012 $50 puts, lately around $1.80; or sell to open May 2012 $50 puts, lately around $2.80, for up to a 5.1% allocation.

Questions on these? Visit our "Catch-Up Trades" discussion board.

Too often, the stock market gets a bad rap. Throughout history (and especially since 2008), people have talked about it with some trepidation: "Are you in the market? Should I get back in?"

We all hear the horror stories: "Joe lost all of his family's money in the market." Or, "The market wiped them out." This invariably means someone used leverage or sold when prices were down.

We rarely get to hear the long-term stories of success, precisely because they *are* so long-term; they don't make great headlines. These are the stories of people who stayed invested and steadily bought more stock, like my late Great-Aunt Mary, who bought stock throughout the Great Depression. She ended up a millionaire by retirement — along with all of her best friends who, like her, worked at Sears in Chicago and invested steadily in the company.

Instead, we're made to believe that the market is always risky, even though an alien viewing a chart of the market's returns over almost any 10-year period would have to conclude it's practically certain to go up over time.

Despite that truth, do you ever wake up in the morning feeling anxious about the market? Does your pulse tick higher as the opening bell rings and prices are down?

If so, it comes back to those questions that are often asked with a touch of fear: "*Are you in the market?*" As if the market were a giant roulette wheel with no long-term rhyme or reason. But, of course, it's all about rhyme and reason over the years, and Fools like us who use the market for the long run understand that — and profit by it.

So the question shouldn't be, "Are you in the market?" It should go more like this: "Are you sharing in the profits of the best companies on the planet? Are you *invested* in great businesses?"

Every day, companies like **MasterCard**, **Oracle**, and **Broadridge Financial Solutions** bring in more money than they spend — much more. Every day, these businesses are building value, value that over years should amount to greater wealth for owners.

When the market opens down one morning and MasterCard's stock is down $10, do this: Instead of staring at the share price with dismay, picture thousands of people getting up and going to work at the company that morning, just to make it a little bit better than it was yesterday. Picture tens of millions of people pulling out their MasterCard that day to buy anything from a cup of coffee to a round-the-world airplane ticket. With every purchase, a tiny sliver of value goes to MasterCard's growing coffers.

When the market is down, picture **GrafTech International** taking more orders for graphite electrodes that morning from steel producers who steadily need more product. Picture**Intel** breaking ground on the world's first high-volume 14-nanometer wafer fabrication plant, while its 15 existing plants around the world crank out tens of thousands of perfect microprocessors that day.

When **OpenText**'s volatile stock is down, remember that last quarter it grew new license revenue 13% (with half of that coming from brand-new customers), and its maintenance revenue grew 21%, with a 92% renewal rate. The company is finding more ways to sell content management software to businesses and governments. The share price will be down at times, but the business continues to grow.

As the market goes up and down, remember that every day **Covanta** is firing up its 44 furnaces and burning 54,000 *tons* of our trash, turning it into energy that very day. The business is so strong and stable that last week management doubled the dividend payment, giving the stock a 3.6% yield. Nothing smelly about that!

You get the picture. The stock market will swing up and down, sometimes violently, but the businesses we own are anything but volatile. We own some of the most stable, steadily growing businesses out there, many with gobs (that's a technical term) of naturally recurring revenue, and some of that revenue is contracted for years to come. These companies will create value through higher dividends, growing earnings, and higher share prices as the future unfolds.

Our companies are stronger than any human: They tend to make progress daily. They never have a bad day and stay home in bed. They're never too tired to show up. As long as U.S. and worldwide GDP doesn't turn negative, most of our companies will steadily grow, and typically grow much more quickly than the economy. And when the economy *does* slip into recession for periods, we'll ideally be hedged and have cash — and we'll be reminded that to enjoy growth, you sometimes have to experience the flipside.

When the market is down, picture all of those people getting up and going to work, just like every other day, moving our companies forward, making it their life's work.

See you on the Memo Musings board!

- Get our review of results from Intel, **Papa John's International**, and **3D Systems**.
- Bryan calls up **GrafTech International** and has a chat. Get his summary.
- Longtime Fool mpfdCPT shares his eight-year performance history.
- Members begin to talk on its discussion board about our newest recommendation, **InvenSense**.

The Motley Fool owns shares of InvenSense. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Raising the Pro Bar

Published Mar 5, 2012 at 12:00AM

Dear Fools,

Pro Trade Roundup

- **OpenText** : Sold to open August 2012 $70 calls for $2.35, covering all shares

Guidance Updates

- **Covanta Holdings** is moved to Hold, as explained, with buy-around price moved down to $16, and fair value to $22

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Rockwood Holdings**: Sell to open April 2012 $50 puts, lately around $2; or, sell to open May 2012 $50 puts lately around $3 or higher. Sell one put for 100 shares you can buy, up to a 5.4% allocation (one put for every $100,000 you manage)
- **AmTrust Financial Services**: Sell to open June 2012 $25 puts, lately around $0.85 or higher, for up to 5% (one put for every $50,000 you manage)

Questions on these? Visit our Catch-Up Trades discussion board.

Your *Pro* team continues to comb through our companies' annual SEC statements, taking time to learn all we can about the state of these businesses. As April earnings approach, you can expect us to start adjusting the portfolio to reflect what we're seeing — and as we begin to do so, today's Memo provides you with an overview of four key things worth watching.

The Market's Up ... for Now

Up almost 9% for the year as of Friday, the S&P 500 is off to its strongest start since 1991, when Johnny Carson still hosted the *Tonight Show*. A 5% to 7% decline in the next month or two would not be surprising or necessarily unhealthy, even though this would likely clip many stocks 10% or more. The *Pro* portfolio is 75% net long (you can always see our long/short exposure at the bottom of the Recommendations page), so we're considering adding shorts — but we're not trying to outmaneuver small market moves. It's not realistic to predict and make plays against swings of less than 10%.

Even if a slip seems in the cards, a large market decline appears unlikely given the reasonable-looking stock valuations as interest rates hover at zero (the S&P 500 trades at 15 times reported earnings, 2.3 times book value, and has an average return on equity of 15%) and U.S. GDP growth sits at 3% as of last quarter. For now, we're holding onto our hedges, looking to add new shorts, looking at moderately defensive covered calls, and considering other changes as we wrap up earnings.

Volatility Ahead?

At only 17, the market's expected volatility as measured by the Chicago Board Options Exchange's VIX, is dangling below its long-term average of about 20 and is down from its 23.4 start to the year. Since 1997, the VIX has traded above 30 (often far above it) at *some point* during every calendar year except three. So, odds are high that the VIX will be above 30 some point this year, too. When it rises, we plan to begin a significant position shorting VIX futures because volatility — as always — will wane with time.

Fair Value Is Fluid

I want to reiterate an important point from last week's Memo. Nick wrote that *from* its fair value, a rewarding stock should earn your discount rate, or your desired rate of return, on an annualized basis. This being the case, your estimate of fair value for a growing company should march steadily upward. Fair value is not a static number — it's just a snapshot in time. When a company's cash flow rises, the stock's fair value (the fair price today for a seller *or* a buyer) should go up, too, all else being equal.

So, when investors sell at fair value and then see the stock double over the next seven years because earnings increased 11% annualized, it shouldn't be a surprise. This is why we don't hear Warren Buffett talk about selling stocks at fair value. He talks about never selling. Fair value is "fair" for *today*. And we invest for the future. We will sell lesser companies at, or even below, fair value to buy stocks we like better. However, it would be shortsighted to always sell outstanding companies at fair value.

Activity and Improvement

I still expect *Pro* to engage in significant selling this year (prices willing) as we invest the portfolio to our changing ideal. Investing is a work in progress, and we never reach our ideal, at least not for long.

This earnings season has been insightful, and since we only have 5% in cash, we'll be selling positions we like less for new ones we like better. When we were initially building the portfolio, cash was our bogey. Did a new stock look far better than cash? Now that we're invested, we've raised the bar, asking, "Does a new stock look better than one we own?" We must pursue this one-upmanship consistently, ideally replacing our good companies with ones that are better, and improving our positions over time.

To discuss the Memo, visit our friendly Memo Musings board!

Jeff Fischer (TMFFischer)

Community

- *Pro* members talk about and enjoy the idea of more abundance in the future. What do you think?
- Jeff reviews **BMC Software**'s third quarter, keeping the stock at Buy First.
- **Autodesk** reports strong numbers but its equally strong valuation keeps it on Hold.
- Jeff shares his take on **Covanta Holdings**, finding that despite strong management, growth prospects are falling short. **The stock moves to Hold** above $16.
- Nick looks forward to fiscal 2012 as he reviews **Pebblebrook Hotel Trust**'s earnings.
- New members, keep your feedback coming! We're reading (and posting when we can)!
- Alex340 continues to offer in-depth posts, showing puts and calls matching *Pro* and *Motley Fool Options* criteria.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Audio Extra: GrafTech, Pebblebrook, and Tupperware

Published Mar 1, 2012 at 12:00AM

In today's Audio Extra, Jeff Fischer and team members Nick Crow and Bryan Hinmon discuss earnings from **GrafTech**, **Pebblebrook Hotel Trust**, and **Tupperware**, as well as how *Pro* companies are investing for the future. Just click below to listen in!

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The full unedited transcript appears below.

Jeff Fischer: Welcome to a new edition of *Motley Fool Pro* Audio Extra. I am Jeff Fischer and in the studio today are Nick Crow and Bryan Hinmon, so we have the whole Pro team here today. We are here to talk about three companies, GrafTech, Pebblebrook and Tupperware, but we are going to start with one, big macro thought, and that is free cash flow and capx. What's going on out there with these companies?

Bryan Hinmon: Yeah, I think what we're seeing, Jeff, is we are seeing companies are not afraid to spend their money right now.

Jeff Fischer: That's certainly what I'm seeing; Intel, Tupperware, Rockwood are all spending increasing amounts of cash flow on capital expenditures. They are investing for the future. Why I find this interesting is companies look reasonably priced right now, especially Intel as well as Rockwood and Tupperware, despite spending all this money. So we have seen free cash flow flatten at these companies the last year, in some cases two years, and yet prices are reasonable and they should prosper in the future because of this.

Bryan Hinmon: Yeah, what we care about is if that capital spending leads to stronger business, more efficient business in the future, then our free cash flows down the road are going to be even stronger. So if they are reasonably priced now, maybe investors aren't really paying attention to the capx that's going on right now, or they just don't believe that it's smart spending.

Jeff Fischer: Right, and it's good to see management looking forward with optimism and investing for it. Nick, what do you think? You are probably one of the most cautious persons among us.

Nick Crow: Which surprises most people. Like Bryan said, as long as they are making economic profits from these investments it makes me happy, so if they can earn a return greater than their cost of capital, that should enrich shareholders. So if those capital expenditures are spent on great projects, I'm all for it.

Jeff Fischer: Excellent. Well let's move in now, speaking of that, to GrafTech.

Bryan Hinmon: Yeah, that's a perfect segue for what's going on in GrafTech right now. So I will give you the quick overview of the recent earnings call. What everyone was tuned in to was how GrafTech was doing with filling up their book because they sign contracts at the beginning of each year at certain prices for a certain number of electrodes, and we expected that book building process to be difficult, but we expected them to have some success in passing on prices, and they did. They built about 50% of their book at rates that are 10-15% higher than they did last year, and that's reflective of rising costs really, so it's not as though this is going to drop directly to GrafTech's bottom line.

There were two other pieces of news really. The first is everyone is sort of admitting a recession in Europe now, so GDP growth estimates are coming down. Steel demand is coming down, which basically hurts GrafTech, one of the reasons that they have only built about 50% of their book so far and they are slow to build the rest of it. All of that though is not that troubling. The real news that came from GrafTech was just like we were talking about with capx spending. The company let on, almost as an afterthought at the end of the call, that investors should expect capx to be about double of what I was thinking it was going to be.

Jeff Fischer: Wow, that's huge.

Bryan Hinmon: And they also noted that that was sort of what we should expect for a while, so it wasn't as though they just said, Hey, we have got some really interesting projects that we want to invest in this year; it's going to be higher than you thought. They basically said for the foreseeable future, we are going to spend about twice as much money as you thought we were, and the math of all of that means that what I was expecting to be free cash for us as investors is now being plowed back into the business. And like Nick said, if we don't think that that is smart spending, then that's really just taking money out of our pockets.

So the punch line here is I don't think that it's smart spending. I'm not convinced that the projects that they have announced have good returns associated with them. And so really what has happened is the fundamentals of GrafTech as a business have changed in my opinion. The reinvestment rates just jumped dramatically, and we went from a company that earns pretty decent returns on capital now to one that earns much more pedestrian returns on capital. In my view, that makes the company a little less attractive.

Jeff Fischer: Which all makes sense. The flipside of that, the positive side, is we are in a very weak period still for steel demand, and we have been since 2008, 2009 when we first bought GrafTech. We expected a recovery to start to happen last year, it really, it wasn't as strong as we hoped. Now this year is much weaker than we expected, and largely that's due to Europe. The good news is we have a company that's still nicely profitable, even if it's somewhat on a pedestrian level, and that when things get better, such that demand is very strong, the shares and the profitability, not margins so much, but net profits should jump quite a bit, the shares with it. And that's the time when you want to sell a cyclical business like this, is at the top when everything's looking great.

Bryan Hinmon: Yeah, everything that I mentioned, it's not lost on the market. GrafTech shares have taken a little beating recently, and I think the shares are still pretty cheap at sub $13 right now; I just updated the fair value to the company for about $17, so the company still isn't getting any love, and that's because of what you said with the economic slowdown and steel demand down. These companies just get beaten down. When everything is going bad or when expectations are low, that's when you want to be a buyer of these companies. The bottom line is GrafTech remains an okay business. We really like management; they're smart. They have built the business model so that it's a highly flexible cost structure, so they don't lose money, even when things are bad, they still make money. For a deeply cyclical industry, that's pretty impressive.

Jeff Fischer: And it's nice to have a position or two or three like this in the portfolio because it should be; at this point it's already beaten down. It should be a more defensive holding if the stock market takes a turn. Now granted, there's no guarantee, of course, but you invest for the future, not for right now. We are well aware that GrafTech's business is slow right now, but is it worth holding this company for when things really pick up two or three years from now? That's what we have to ask ourselves every day, or is there a better place for this 3% of our capital to go? And you could say, Well, throw it into something that's growing right now, but the market is priced whatever is growing right now for that, and if things turn, you are throwing decent money after (unclear) into a bad place. It's good to have not all of your stocks moving at once.

Bryan Hinmon: I think we still have a margin of safety here. We could have additional upside if I'm wrong and the capital spending that's happening now results in higher sales and profits in the future, well then that's pure upside based on what I'm thinking.

Jeff Fischer: And one extra tidbit for those who are newer to *Pro*, GrafTech has been really interesting because early on they made two key acquisitions, whereas they used to just make these electrodes with needle cope that they purchased. They bought the needle coke suppliers. So for a long time, veteran members will recall, we have been waiting to see how this newly merged business came together and worked out. And in one sense, we are still waiting for that, but it doesn't appear now that it's going to be as attractive as we hoped, at least under all market conditions. Maybe in boom times they will really rake it in, but right now, GrafTech has been; we have been a long time waiting to see how this plays out, and in a sense, we are still there waiting, but there should be a good floor on the stock and it's still a well-run business.

Bryan Hinmon: Right.

Jeff Fischer: Nick, let's jump into hotels, which of course have a lot of steel in them, but Pebblebrook is buying hotels that are already on the market, already built, already have a brand and they're cheap, at a discount. How did their quarter look?

Nick Crow: Well their quarter's hard to compare. The whole year's hard to compare because they are buying so many hotels, like you mentioned. In 2011 alone, they bought six properties, like full-on properties, for over $500 million, so those capx expenditures you are talking about fits here too, as we expected. I mean Pebblebrook just became public in 2009, and they need to buy a bunch of hotels just to build the business. They also took on a joint venture in Manhattan, and that joint venture gives them exposure to another six hotels with a 49% exposure to those, and that cost another $150 million, so lots and lots of expenditures here.

What's been great though is RevPAR has been growing quickly. RevPAR is one of the more important metrics to look at in the hotel industry, and it's really easy for you to think of as an investor. It's the average daily rate, so the average rate you can rent a room times the occupancy rate. So it makes sense. How full are those hotels and what are they charging? Put those together and you get RevPAR. And RevPAR is growing faster than industry RevPAR, so that's exactly what we expect to see here, if they are operating well under John Bortz.

Jeff Fischer: So overall in the quarter, was there anything that stood out as a warning flag or anything that concerned you?

Nick Crow: You know me, Jeff. I always see more things that concern me than (unclear).

Jeff Fischer: (Unclear) ask you question. (All speaking at once; unclear).

Nick Crow: Yeah, everything concerns me always. Specifically here though…

Jeff Fischer: Your poor wife.

Bryan Hinmon: Oh yeah, tell me.

Nick Crow: Tell me about it. So first off, I thought that we were kind of starting the cyclical upswing here in hotels, and some things that John Bortz said over the quarter made me think that maybe 2011 is as good as it gets. Fortunately, it was really good for Pebblebrook, but it makes you wonder. He mentioned that the cyclically advantageous period to purchase hotels might be over, or nearing over. And it seems to me that the way he frames that is if new supply is coming online, you have missed the period to buy. So you want to buy when no one is willing to build a new hotel. Makes sense; that's an indication that you are at the worst portion of the cycle, but I thought maybe we had some more of that to go.

He also said something else that concerned me, though he's not concerned, so take my thoughts as you will. He says he's been accused by many people in the industry as overpaying for hotels consistently. That's completely at odds with our thesis here, that John underpays for these hotels, gets them at less than replacement costs. He sees this as an advantage because he gets invited to more of those off-market transactions. I'm thinking to myself, well yeah, if you're paying too much, I'll sell you something too.

That was a red flag to one extent. What he said on face value, it would bother me, but when I look at the hotels that he's purchased, the prices that he's got, it doesn't seem like he paid a lot for them. And then he's been able to improve their performance almost immediately, so you have got to kind of balance those two together in your head.

Jeff Fischer: Yeah, you would think they do pay a bit more because it's an off-market exchange, if they wanted to wait to have other bidders come into the process, they might end up paying even more after that. and they are also, in my view, kind of in a way, to bring up David Gardner's service, they are targeting Rule Breaker hotels, or the best of breed, best of the best, like The Drake and The W and The Monaco, that have a strong brand and for which you may have to pay up a bit.

Nick Crow: Yeah, they look for a sweet spot, so like the very, very best hotels, he would classify as a luxury hotel. Luxury hotels I guess kind of suck, because you have to keep them in perfect shape, perfect experience…

Jeff Fischer: Oh sure, they're upper upscale. If you are paying $500, there better not be a smudge on your door.

Nick Crow: But if you can get upscale right before the luxury, that seems to be the sweet spot. You seem to benefit during the good economic times. You seem to drop off less when times get tough, and you can provide a really great experience, but you don't have to have as heavily a renovation expense, if you will, over time.

Jeff Fischer: So Pebblebrook is still a Buy First. We didn't see anything in the report that would change that. We are waiting for the yield to go up. The dividend yield is around 2%, and as a REIT, the more income Pebblebrook has, the more it has to, by law, it has to pay it out.

Nick Crow: He has to pay out 90% of its net income, if it's taxable income, in order to stay qualified as a REIT, so we can be sure that management's going to do that. Since yield is so important for us, he's not expecting to raise the yield beyond the minimum requirements that way any time soon. As long as they are a net acquirer of hotel assets we shouldn't expect them to use cash flows or basis for repayment, which is; so when we will see net income grow and we'll see our yield grow with that. But for the real big pop, we'll have to see a slowdown on acquisitions in order to get that benefit. Because we want them to make those acquisitions now to generate that yield engine.

Jeff Fischer: Although that may come sooner than we think, if they are seeing the window closing right now, which frankly I don't think any of us would mind. If they own a baker's dozen of really outstanding hotels and can make them more and more profitable.

Nick Crow: Yeah, they have exposure to 20 hotels now, if you consider their partnership too. Not a bad portfolio.

Jeff Fischer: I'd much rather them stop and just focus on what they own than keep buying, of course, at less attractive prices. So great, sounds good. I'm going to talk about Tupperware, which is currently on hold as we tape this, because it's around 62. It is still though, below our $64 fair value. Our Buy Around Price is in the mid-fifties though, because it's a volatile stock, about 1.5 times as volatile as the S&P historically, so we think by writing put options, our being patient members can pick up shares at lower prices. But rather than just have me monologue this, do you guys have any questions on Tupperware? And this is unscripted, so you want to try to stump me?

Male: How was their quarter? You told me earlier it was mixed, so talk a little bit about the mixed results.

Male: Let me focus that a little more.

Jeff Fischer: That's a good question, how as their quarter.

Male: Which quarter?

Male: So really one of the most attractive parts of Tupperware is their overseas exposure, so let's take next question, but direct it more at what's going on internationally.

Jeff Fischer: So only about 10% of sales now are from North America, and some 60% is from emerging markets, and Europe is the rest, of course. So Tupperware is very big in Europe and Asia and South America, and in almost all of those areas uniformly they are growing very strongly, whether it's India or Malaysia or China.

What's happening is the middle-income class, middle-income group is growing in all these markets, and as they do, Tupperware is actually an aspirational brand. It's better quality than the junky little items you can get at a store, and it's also a part of their social network, if you can believe it. These parties are kind of a sign that you're on the rise in Tupperware, which is to my understanding, frankly how they were in the 1950s as well in suburban America. A Tupperware party was a small sign of some affluence, actually.

What Tupperware does is they market products for each market they're in and they price it accordingly. They serve the local food needs, and they're not just kitchen storage anymore, but they're kitchen utensils, kitchen tools, as well as baby tools and utensils and some beauty products as well.

Nick Crow: Did they make any comments about Europe specifically?

Jeff Fischer: They did. They are holding up well in Europe. Germany is strong, France is strong, and Italy has been very strong lately. When there's less certainty in the environment, two things happen. One, sales persons are more driven to make sure they have adequate income, so their sales force, which is 2.5 million people strong, tries harder during uncertain times, and it also grows. When unemployment is up and it's above 20% in Greece and Spain, I believe, if my memory serves me. When unemployment grows, of course Tupperware has a better time recruiting strong employees to sell their wares. Also Tupperware is not that expensive to buy the products, and it's about conserving food more smartly.

Nick Crow: And you get to feel like you're helping your neighbor out by purchasing some Tupperware from them.

Jeff Fischer: That's true. It's a feel-good purchase. So the quarter was good. They are spending a lot more on free cash flow, but unlike GrafTech where there's not much clarity to us how the returns are going to be generated there, and if they'll be attractive, but Tupperware it seems that they certainly will be. They are spending on more production, more factories overseas so that they can supply the demand that is growing very quickly, like 50, 60, 70% sales growth in places like Brazil and India.

So it's much easier to model Tupperware and how their capx dollars turns into a strong return on capital down the road. But as a result of increased spending the last few years, the shares have gone up quite a bit for us, which is great, of course. Well, to an extent it's good. As long-term investors, it'd be great if they were flat and we could buy more and more at lower prices, but anyway, the stock trades now at around 17 times free cash flow. When we first bought it, it was around 11 times. because shares have gone up quite a bit, free cash flow hasn't, and this year's more of the same somewhat, although free cash flow should go up 10, 15%, so that's good to see. And shares trade at 12 times expected earnings per share this year, while earnings per share should grow about 13%. So the stock looks reasonably priced. It makes sense. It's right around its fair value. The yield is 2.3%. They increased the yield 20% this year, and they are on track to grow the yield along with income growth year after year. That's the way they want to operate, so as earnings grow, our yield should grow as well.

So Tupperware could very well be, continue to be, a strong three-to-five-year holding, and we look at all our core stocks as with at least a three-year outlook. Tupperware could be quite larger in three years. That's the hope. Does that answer your question, Nick?

Nick Crow: Yes.

Jeff Fischer: Now not everything is roses at Tupperware. Their beauty department, beauty products continue to suffer. That's very competitive. They are trying to…

Nick Crow: What brand is that? Like how is that branded?

Jeff Fischer: Beauti Control is the name of it, B-E-A-U-T-I Control. Creative spelling.

Nick Crow: Zing.

Jeff Fischer: And they are focusing on skincare products because there they can really hone their message and they have a competitive advantage, they believe they do, and they are selling to the key demographic, which are women in their forties and fifties.

Nick Crow: Preserve your face like we preserve your food. I get it.

Jeff Fischer: You should run that by the CEO, Mr. Rick Goings, he may like that. They might go with that. So Tupperware is on hold, thought, and it is recently a catch-up trade where you can sell to open put options, so check out the Monday memo for that.

And to wrap it all up, GrafTech remains a Buy; Pebblebrook remains a Buy First, Tupperware right now on hold. Guys, anything else you want to add? Happy March, as we roll into March?

Male: Happy March.

Jeff Fischer: Final thought, our North Star is above 10% right now. As you know, this is our Pro's goal, to return at least the North Star on an annualized basis, every rolling three years. It's above 10%, so as we get into month three of this year, we are looking at every position in the portfolio to see if they are likely, it is likely to give us at least our North Star return, and if not, if we don't think so, how do we possibly generate that with options, or do we move the money into something we like better? So the year's going pretty fast, but it's only early March, so I feel like we have gotten a lot done this year. Including this Audio Extra, which may take us into 2013, if we…

Male: See when this gets (unclear).

Jeff Fischer: All right, well thank you guys and thank you to PRO members for being here. Thank you, Nick and Bryan. We will see you again soon, and we'll see you on the boards and in the Monday Memo, so Fool On!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here*.

Our Fair Advantage

Published Feb 27, 2012 at 12:00AM

Fellow Fools,

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Rockwood Holdings**: "Sell to open" April 2012 $50 puts for $1.10 or more, or sell to open May 2012 $50 puts for $2 or more. Sell one put for every 100 shares you can buy, up to a 5.3% allocation (approximately one put for every $100,000 you manage).
- **Tupperware** : "Sell to open" July 2012 $55 puts for $2 or more, up to a 3.1% allocation.
- **Pacer International** (Nasdaq: PACR): "Sell to open" June 2012 $5 puts for at least $0.35, or September 2012 $5 puts for at least $0.50, up to a 3% allocation.

Questions on these? Visit our "Catch-Up Trades" discussion board.

A market crash is the hardest time to make investment decisions. But a rising market is the second-hardest. During a rally, every day brings higher prices — and regret at not buying cheaper yesterday. The market's recent upward moves, coupled with a cohort of new members who are still getting acclimated to the *Pro* way, make this a great time to clarify our buying and selling disciplines and our estimate of fair value.

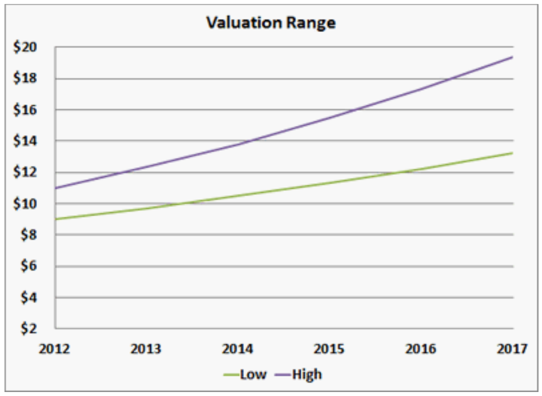
You're Disposed to Lose

A well-known tenet of behavioral finance (the study of how we actually, and often irrationally, make decisions) is the disposition effect. This principle applies to most investors, but especially to those focused on value. It states that investors sell their winners too soon and hold on to their losers too long, hoping to get back to even. I know our members appreciate fair-value and buy-around guidance, but I fear that providing those numbers without the proper context makes it too easy to anchor on specific values. A better understanding of valuation will provide that context and mitigate this effect.

Estimating Fair Value

Over long periods of time, owning great businesses is the best way for investors to build wealth. That's why we invest in stocks. Of course, investing is the act of risking capital now in return for the potential of more capital later — but there are no guaranteed returns. Thus, in order to be well compensated for risking our capital, we need to know the fair price for each stock we buy.

Think of a stock's "fair value" as the price at which you'd be OK with being a buyer *or* a seller, because each party is getting an equally good deal. There's nothing wrong with buying at fair value, except that every fair-value price is only an estimate — and all estimates are actually a range of values. Short-term predictions are usually more accurate, so the range of possible correct fair values gets wider as we expand our forecasts further into the future.



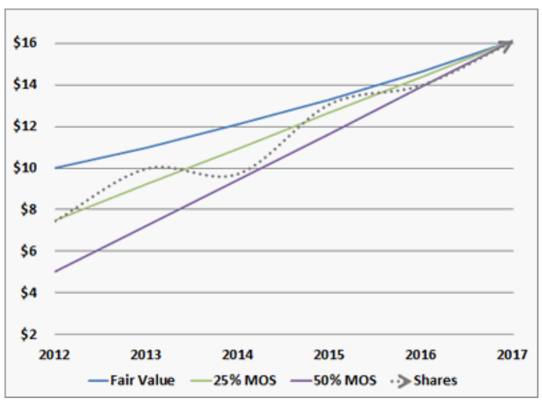
The chart above illustrates a reasonable range of values for a hypothetical company to which we might assign a fair value of $10 (the range right now being $9-$11). As you can see, the spread between low and high widens with the passage of time, adding further uncertainty to the art of valuation.

Every company's worth is equal to the present value of all future free cash flow. To arrive at present value, we discount forecasted free cash flow; as the future becomes the present, then, we should earn our discount rate (assuming our forecast was accurate). An example: You value a stock at $10 per share today and assume a 10% discount rate and a constant rate of growth. One year from now, you revalue the shares again, with nothing changing except the passage of time. The revised valuation would be $11 a share.

The lesson here is to avoid anchoring to our initial fair-value estimate as time passes. Further, great businesses with recurring revenue and higher returns on capital — you know, the type of business we want to own for a long time -- have a way of exceeding our conservative estimates of free cash flow growth … but we'll save that topic for another memo.

Buy-Around Price

Every *Pro* recommendation includes a buy-around price. This price is always at a discount to fair value, providing a margin of safety (MOS — a term borrowed from engineering) meant to provide some protection if our fair-value estimate turns out to be wrong. And it's not just a risk-reduction measure; the buy-around price also has a way of increasing our returns, i.e., when we correctly estimate the worth of a business and the market later agrees with us. Let's look at another visual example using our hypothetical business with a fair value of $10 per share.



In this example, we purchase stock today at our $10 fair-value price and hold it for five years. We expect to earn a 10% compounded annual growth rate (CAGR). Great — but what are our returns if the market gives us the opportunity to buy shares for $7.50 (or we create the opportunity ourselves by writing puts)? If we still believe the stock is worth $10, buying at $7.50 provides a 25% margin of safety. If we then hold our investment for the same five years and sell at fair value, we'll have earned a 17% CAGR — with less risk. Fortunately, we're often able to find opportunities offering a 20% to 25% margin of safety. The price you pay is a primary factor in determining future returns.

Sell Discipline

Deciding when to sell is perhaps the most difficult dilemma investors face. The disposition effect suggests we need a better framework for making sell decisions; because Tom Gardner favors ranked lists, here are my top five reasons to sell an investment, in ranked order (full sales — not allocation adjustments).

1. **Error.** As investors, we will make errors. As soon as we discover an error in our analysis that impairs the value of our thesis, we should sell.
2. **Fundamentals.** If the fundamentals of the business decline or fail to support our thesis or valuation, we should sell.
3. **Opportunity cost.** We should sell when we find a better risk-adjusted opportunity in another investment. (Cash is sometimes better; consider taxes as well.)
4. **Valuation.** If we buy a crummy business when it's mispriced, making it an attractive investment, we should sell that below-average business around fair value.
5. **Life.** If you have a use for the capital in real life, consider selling.

I try very hard not to sell great businesses at fair value (remember, it's ever-increasing) or because I have large gains. Instead, I remind myself that when you find great compounding machines, you should let them run and only sell when you have a better place for the money. It's all part of a framework that supports good decisions, helping us overcome our biases and providing a fair advantage with seemingly unfair results. It's the *Pro* way.

To discuss this Memo, visit the [Memo Musings board](). Fool on!

Nick (TMFCrow)

Community

- Catch up on **Rockwood**, **Medtronic**, and **GrafTech International** with these earnings posts.
- New members, keep your feedback coming!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Income Matters

Published Feb 21, 2012 at 12:00AM

Fellow Fools,

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **AmTrust Financial Services**: "Sell to open" June 2012 $25 puts for $0.75 or higher (at least a 3% yield in four months) for up to 5% of your portfolio. Sell one put for every 100 shares you could buy.
- **Intel**: "Sell to open" May 2012 $24 puts for $0.40 or higher (at least a 1.6% yield in less than three months) for up to 6.9% of your portfolio if you lack our full allocation.
- **Pacer International**: "Sell to open" September 2012 $5 puts for $0.50 or higher (at least a 10% yield in seven months), for up to 3% of your portfolio.

Questions on these? Visit our "Catch-Up Trades" discussion board.

At *Pro*, we hold some things to be self-evident:

1. We're always seeking excellent companies to own at good prices.
2. We seek positive returns even in weak markets, so we must use certain strategies accordingly (including option income strategies and hedging).
3. Income is important to long-term results.

Point No. 3 too often gets lost in the market's noise, when the truth is that over the last 80-some years, approximately 44% of the S&P 500's total return has come from reinvested dividends. In other words, dividends matter — a lot.

Granted, plenty of investors do well buying growth companies without concerning themselves with dividends, but because *Pro* is guided by an always-positive North Star, and because our goal is consistent gains that we can take to the bank, income is certainly part of our mix. With that in mind, let's review our income-paying positions.

Pro's Income Lowdown

We own 15 stocks and ETFs that pay us a yield and nine that do not. More than $900,000 of our portfolio is invested in dividend payers. The current yield on the entire *Pro* portfolio is 1.55%, while the average yield on positions paying a dividend is 2.4%. One of our goals for 2012 is to get our yield on the entire portfolio closer to 2% without forfeiting growth.

Below, you'll see the latest annual per-share dividend our companies pay, how much the dividend has grown the past year, today's yield, and — based on *Pro*'s allocation — how much each company should pay us this year on absolute terms. In order of highest to lowest yield:

Company	Dividend	Year-Over-Year Growth	Yield	Annual Dividend Value for the *Pro* Portfolio
StoneMor Partners	$2.33	4%	9.3%	$3,262
Plum Creek Timber	$1.68	0%	4.3%	$1,680
WisdomTree Emerging Markets SmallCap Dividend Fund	$1.69	31%	3.5%	$1,268
Intel	$0.84	8%	3.1%	$3,024
CME Group	$8.92	59%	3%	$2,384*
Broadridge Financial Solutions	$0.64	7%	2.6%	$1,344
Medtronic	$0.97	3%	2.4%	$1,843
Tupperware	$1.44	20%	2.4%	$1,008
Pebblebrook Hotel Trust	$0.48	300%	2.2%	$1,248
Covanta	$0.30	New	1.8%	$810
Wells Fargo & Company	$0.48	140%	1.5%	$576
Vanguard Energy ETF	$1.61	29%	1.5%	$741
AmTrust Financial Services	$0.36	13%	1.3%	$1,404
Bristow Group	$0.60	New	1.2%	$720
Oracle	$0.24	9%	0.8%	$576
MasterCard	$1.20	100%	0.3%	$144

Numbers as of Feb. 17, 2012. Sources: company filings, S&P Capital IQ, Google Finance. *CME Group's dividend value includes its special $3-per-share payment due in March.

Filling in some context, **StoneMor Partners**, a cemetery owner, has the highest yield on our scorecard. It's on Hold for new members as we talk with an accountant to ascertain the tax implications behind this master limited partnership (MLP). Although I don't believe those implications will be daunting, owners may need to file income taxes in several states where StoneMor operates. Because of this, we're making certain we want the stock in *Pro* before moving it back to Buy. Elsewhere, **Plum Creek Timber** pays a tall yield, but it hasn't increased it since 2006, and its payout ratio (something we keep a close eye on) is 141%.

As expected, **Pebblebrook Hotel Trust** has a fast-rising dividend (up 300% over the past year) as income at this new hotel owner rises. As a REIT, Pebblebrook *must* pay out most of its income to shareholders, so we believe its yield has plenty of room to grow. **CME Group** just increased its dividend 59% as it moves to pay out about 50%

of its free cash flow to owners; this increase *excludes* the special $3-per-share distribution we'll be paid in March, although we added that to our expected cash income above.

MasterCard just doubled its tiny dividend, and **Wells Fargo** boosted its own by 140%, en route (we hope) to much more. **Tupperware Brands** raised its dividend 20% in January, in line with earnings growth, and plans to adjust it annually to maintain a 30% to 35% payout ratio on its income. Finally, **Covanta** and **Bristow Group** have new dividends.

Wrap It Up, We'll Take It

Add up all those payouts, and we're looking at $22,000 in dividend income this year, or 1.55% of our current portfolio value. Again, we'd like to edge that toward 2%. We also know many new members don't have positions in many of our dividend payers yet. We'll work to get you into them cheaper using options (watch our "Catch-Up Trades" in this and every Monday Memo) or when their prices decline. Speaking of options, we of course supplement our dividend income with option income. We would ideally like our *annual combined income* to total 4% to 6%. If we can earn that kind of income, then our North Star (lately running above 10% annually) should be within reach most years.

However, it's going to require much more option income (without big capital requirements on our part) to reach our total desired income yield. We'll discuss how we expect to do that in another Monday Memo soon. To discuss this Memo, please visit the Memo Musings board! And don't miss our earnings coverage and more below.

Foolishly,

Jeff Fischer (TMFFischer)

Guidance Updates

- **AmTrust Financial Services**: Buy Around moves up to $24 and fair value up to $32 following strong book value growth. For now, the stock remains on Hold.
- **Rockwood Holdings**: Moved to Hold at $55 due to price and pending earnings. We'll review this morning's earnings and reassess our guidance, but we're happy to own it today.

Pro Trade Roundup

- **Apple**: Bought 4%, or 111 shares (in a little homage to Steve Jobs, who famously kept one share after being fired) for an average price of $503.56.
- **AmTrust Financial Services**: Bought to close 27 March 2012 $25 calls at $2.50 per contract, keeping 5% exposure to the stock uncovered.
- **Ebix**: Sold all shares at a net $24.09 through February 2012 $23 covered calls.

Coverage & Community

- We summarize results from **OpenText**, **AmTrust Financial Services** and **Tupperware**.
- **Rockwood Holdings** and **Medtronic** reported earnings this morning. We'll have coverage soon.
- Greece gets a bailout. Does it matter?
- Earnings are still flying at us! TMFMoosie posts a full, detailed calendar. You can also view our *Pro* calendar on the site.
- Fools talk about the **SPDR S&P 500**hedge and where we're at.
- How are new members doing? Getting started well? How can we help? The conversation is lively.
- What truly *is* Fair Value? What is the Buy Around price? Don't miss this essential Memo from last year.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Advisor Roundtable: Are Things Looking Up?

Published Feb 17, 2012 at 12:00AM

Duke Street *advisor Rich Greifner chatted recently with a group of Foolish advisors and analysts about whether this year's market rally is the beginning of a turnaround.* Pro*'s Jeff Fischer joined Fools from* Stock Advisor*,* Special Ops*, and more to share their thoughts — read on!*

Fueled by record-low interest rates and last Friday's better-than-expected jobs report, the stock market is off to its best start since 1987. Is this rally just beginning, or could European rainclouds wash out the parade? I turned to a motley group of Foolish advisors and analysts to find out.

Question 1: Temperature Check

Rich: Let's start with how warm you are on stocks: On a scale of 1 (quaking with fear) to 10 (trembling with greed), how excited are you to invest in stocks right now?

Jeff Fischer, *Motley Fool Pro*, *Motley Fool Options*: Given some reasonable valuations on great companies, I'm around a 7. But given that the Western world is overleveraged, it's likely that we'll face recurring economic challenges as far as the eye can see. Stocks will climb a wall of worry, and periodically fall off. But the reality is, where else can you invest today for returns?

Andy Cross, Motley Fool CIO; *Stock Advisor*, *Hidden Gems*: Count me as an optimist too. We're seeing some healthy business momentum right now, especially in the United States. Europe continues to lurk in the dark corner, but investors can still find high-quality companies selling at discounts to the earnings they will generate over the next five years. Investors just need the courage to look out beyond a quarter or two.

Tom Jacobs, *Special Ops*: So Andy, what's your number?

Andy Cross: I'll one-up Jeff and say 8.

Tim Beyers, *Rule Breakers*: I'm an 8 too. Tech balance sheets have never been as strong as they are now (cough, **Apple**, $97 billion, cough), which should help keep the R&D investment engine humming regardless of macroeconomic conditions. Valuations are askew in some areas, of course, but overall, I'd say between the pace of innovation and promise of dividends from rich tech mega-caps, now is a wonderful time to be investing.

Nate "The Snake" Weisshaar, *Global Gains*: I'll rate myself a 4. There have been some encouraging signs out of the U.S., and the fear of emerging markets has diminished in the past two months, but I can't get past Europe. The E.U. will not solve its problems anytime soon, and that will negatively affect many companies, including consumer staples (once thought invincible, even **Unilever**, **Coca-Cola** and **Philip Morris International** are seeing Europe drag on their results). It will also negatively affect companies that call the E.U. a major trade partner — I'm looking at you, U.S. and China.

Tom Jacobs: I'm a 3. The rise is all in go-go mo-mo stocks of low quality. But this can go on a long time because of Fed [monetary] policy and the fact that, as awful as other places are, people buy Treasuries, driving investors to higher-risk, low-quality investments (you know that's happening when my brother and friends ask me where to find higher yield). There are two large risks that make me happy to focus on what can be lost, not gained (which leads to "3"): The effect that a potential China slowdown would have on commodities, and further deflationary effects from the eurozone because it is metaphorically on the gold standard (individual countries can't devalue their currency to get out of the mess). This can turn any market bloody quickly (no matter how cheap the S&P might be).

Jim Mueller, *Stock Advisor*: I'm leaning toward a 7, maybe an 8. Things have run up pretty quickly in a short time frame. Is that mo-mo? Is that people ignoring European troubles? Am I anchoring on lower, recent prices and wanting those to return before buying? Perhaps. But I think most times are decent times to invest in stocks — if you have a long investing horizon. Short-term buying and selling could very well be a bad decision now, especially if there's another drop to come. But for the long term, I'm still buying.

Charly Travers, *Million Dollar Portfolio*: While I agree with some of my fellow Fools that there are bargains to be had, I find myself sitting at a 3. Act 2 of the financial crisis is well under way in Europe, with Greece quite likely to default next month and Portugal watching the machinations of that event closely to see what its next move should be. The repercussions of these events are neither easily predictable nor controllable by policy makers. My cautious stance is more a call on a high level of volatility, which will present ample buying opportunities on downswings, than it is on catastrophe because at heart I'm optimistic that these issues will resolve with time.

Question 2: European Woes

Rich: What advice would you give to members that are spooked about Europe? Is there a smart way to protect your portfolio from any potential fallout?

Snake: I think the best way to ease worries about Europe is to close your eyes and plug your ears. You might want to plug your nose, too. For those that still want to invest, I will riff off Tim and say that companies that continue to invest heavily in R&D and have a history of rolling out innovative products that make life easier or cheaper for consumers, governments, and other companies will be the best way to win as we wade through this debt mess.

Tom Jacobs: I don't see Europe as a specific problem except for deflationary pressures and an aging population. Nobody in the E.U. or eurozone is having babies. Ditto Japan or China. So where do you hide? The U.S. — because you can understand the accounting and the rule of law. Protection is about managing risk. Be prepared for lower portfolio returns on an annualized basis for five to 10 years. Focus on not losing money. Buy asset-backed values cheap. And expect both deflationary (shorter-term, favors cash and cash-rich companies) and inflationary pressures (longer term, favors commodities and debtors).

Jim Mueller: If Europe leads to more downturns in the market, those could be excellent opportunities to buy strong companies on the cheap, again. If you need money for the next few years, though, keep that money out of the market. For specific strategies to get through the downturn (other than gritting your teeth), talk to Jeff.

Jeff Fischer: I have to agree with Tom. Europe has a debt problem, but the fact that most eurozone countries are not competitive is just as big an issue. Unemployment is high and aging populations are going to put social systems under severe strain. In *Pro*, we're short the **CurrencyShares Euro Trust** (click here to read the recommendation) because the euro's foundation remains vulnerable, and I really doubt fiscal union among these 17 countries can ever happen.

Andy Cross: If Europe really craps out (if one of the big economies, like France, tumbles) then any asset without an atomic symbol is in trouble over the short-term. But even if that happened I would want to be an owner and buyer of solid, financially-stout, well-run, innovative companies right here in the good-ol' US of A. I look for companies that have proven their mettle through the test of time and have a management team ready to jump at opportunities. We saw stocks of such companies plummet in 2008 and 2009, and look where they are today: multi-baggers. So over a few months or a year it will hurt a bit, but it's so hard to tell when things will turn that it's difficult jumping in and out of stocks. Who thought that March 2009 was the bottom of the Great Recession when we were in it? Yet when prognosticators were calling for the end of the world, patient, forward-thinking investors were buying stocks. And they were rewarded for it.

Tom Jacobs: If you buy based on valuation, you don't have to pick market bottoms (like March 2009). A lot of people knew stocks were cheap and that there was maximum fear. Warren Buffett's *New York Times* op-ed in October 2008 (click here) said he was buying hand over fist. He didn't know when the bottom would be. But when valuations are low — especially relative to tangible book value — you buy. And eventually, there is nothing cheaper or better. If you buy when others are fearful, you don't have to know how bad it is. If you sell when others are greedy, you don't have to know how *good* it is. But no one at The Motley Fool, I believe, is a market timer. We buy on valuation regardless of strategy. What I love about this discussion is that everyone here seems to be saying: Stay focused. The macroeconomic picture may be totally crazy, but every one of us here practices something that will work given enough time, and members can find something that works for them among us.

Tim Beyers: Tom has it right. There's really never an excuse to fall out of love with a strategy that works. Document your process and run your best ideas through it. And when you find something that measures up, buy. At *Rule Breakers*, we're perfectly willing to bet on stocks others won't because they meet specified criteria designed to predict multi-baggers in the making. Macroeconomic conditions don't figure into the formula.

Lightning Round: Pick a Stock

Rich: On that note, it's time for the lightning round! Give me one company from your service's scorecard that you think looks especially attractive right now.

Andy Cross: I really like what I'm seeing from the folks at **Quality Systems**, one of our best-performing *Stock Advisor* recommendations. Electronic health record legislation is just starting to ramp up and the tailwinds for the company are blowing hard. Quality Systems generates high returns on capital, the balance sheet is solid, and I think we have more upside to come as doctors and hospitals implement their EHR systems by 2015.

Jim Mueller: I'm going to go with **Cognex**, which is below most people's radar. Helping machines see better during manufacturing coupled with improving the ability to read bar codes (e.g. when they're bent or dirty) may not sound sexy, but it's been a solid performer for David Gardner's side of the scorecard and I think it has a lot of room to grow.

Charly Travers: Despite its recent run I still like **Microsoft**. Mark my words, this company is going to surprise a lot of people this year with its new products!

Jeff Fischer: Being defensive, **Medtronic** looks healthy. The medical devices giant trades at 11.8 times expected earnings this year and yields 2.4%. The stock has gone nowhere for years as its value multiple contracted, but given how the company continues to innovate, I think it's finally at a level where investors will benefit the next three years.

Tom Jacobs: Primero Mining . A self-funding gold and silver miner with almost no debt, selling for less than 2 times operating cash flow, and run by a jockey CEO. What more do you want?

Snake: I have to go with **GDF Suez**. Sure, it's a utility based in Europe, where regulations are a complete mess; and sure, its dividend (providing a chunky 7% yield) is paid in the wobbly euro; but its massive presence in the European gas market (the cleanest fossil fuel) positions it well as countries abandon nuclear. Additionally, it has fast been developing its presence in the gas and renewable energy markets in Latin America and Asia — two great places to be in coming years.

Tim Beyers: I'll be the crazy one and say **Riverbed Technology** , a stock Duke Streeters have heard me talk about before (click here) that trades for 27 times estimated earnings. **Cisco** has had more than a decade to kill this up-and-comer, yet today Riverbed controls more than half the worldwide market for accelerating data delivery over geographically dispersed private networks. Revenue is up an average of 29.7% over the past three years; returns on capital have more than tripled over the same period.

The Foolish Bottom Line

Whether the stock market is up, down, or sideways, we Fools keep our eyes fixed on the horizon. Despite the looming dangers in Europe, our panel of advisors and analysts are still finding plenty of bargains out there for long-term-oriented investors.

You've heard from us; now we want to hear from you, Fool! On a scale of 1 (quaking with fear) to 10 (trembling with greed), how excited are you to invest in stocks right now? Head on over to our Philosophy & Strategy board and let us know!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here. Andy Cross owns shares of Philip Morris International and Microsoft. Tim Beyers owns shares of Apple and Riverbed Technology. Jim Mueller owns shares of Apple, Cognex, Coca-Cola, and Philip Morris International and has the following options: long JAN 2013 $22.50 calls on Microsoft and short JAN 2013 $25 calls on Microsoft. Nate Weisshaar owns shares of Philip Morris International. The Motley Fool owns shares of Apple, Coca-Cola, Medtronic, Microsoft, Philip Morris International, Primero Mining, and Riverbed Technology and is short CurrencyShares Euro Trust.*

Test Calculator for Moosie

Published Feb 17, 2012 at 12:00AM

Total portfolio	
Allocation %	
Stock price	

Calculate

Write Covered Calls on OpenText

Published Feb 16, 2012 at 12:00AM

- **What We're Doing:** Seeking income on our shares.
- **What We're Thinking:** These call options pay decently and still allow us ample upside for the stock.
- **What We're Expecting:** We don't expect the stock to rise enough to lose our shares by August, but wouldn't regret our sell price if we do.

Trade Essentials

- **Action:** Sell to open August 2012 $70 calls, one call for every 100 shares of OpenText you own.
- **Price Guidance:** Use a **limit order**, aiming to receive $3 or higher — or nearly a 5% yield on the $61.40 stock in about six months
- **Strategy Tip:** You write covered calls to earn income on a stock you own by promising to sell it at a higher share price if that price occurs by expiration. For more, see our guide to writing covered calls.
- **Alternative Trades:** See the end of this report.

What's New?

- **Last action:** In August 2011, *Pro* invested 3% in the stock at $58.75
- **Recent price:** $61.40

Canada's largest software company, **OpenText** (NASDAQ: OTEX), has not gained much ground for us since we bought shares in August, but writing covered calls for additional income has been on our radar from the start.

A new development makes us comfortable to write covered calls even though they cap our upside on the stock. In January, OpenText hired a new CEO: Mark Barrenechea, 46, who hails from **Silicon Graphics** (NASDAQ: SGI) and **Oracle** (Nasdaq: ORCL). OpenText has long been rumored as a takeover candidate (namely by Oracle), but now that John Shackleton has retired after 13 years as CEO and young Barrenechea has taken his place, an imminent takeover appears much less likely (otherwise Shackleton would have made a buyout his swan song). Instead, the new CEO is already speaking with Oracle about possible *partnerships*, further dampening the possibility that OpenText will be acquired soon.

OpenText just delivered a healthy second quarter, sporting 20% revenue growth and a 14% gain in non-GAAP earnings per share. We're also impressed with Barrenechea's plans to expand OpenText's reach as its software helps businesses manage content and regulatory needs. However, the $61.40 stock trades at 19 times free cash flow — not expensive, but not dirt cheap, either — because cash has yet to flow as robustly as we hoped. Plus, the covered calls we're writing provide 19% upside to a potential sell price that's above our $70 fair value estimate and equates to 23 times free cash flow. Although we expect big things from OpenText in the long run, and we hope to be owners for years, we're ready to target option income on the belief the stock won't likely exceed our call's $70 strike price by August.

How to Follow Along

As new CEO Barrenechea gets comfortable, and the stock ideally trades in the $60s during the next six months (although two earnings reports will come and go before our calls expire), let's earn short-term income. Here are more details behind our trade:

- **Trade:** Write ("sell to open") August 2012 $70 calls, one for every 100 shares you own (for *Pro*, seven contracts)
- **Option yield (at a recent $3):** 4.8% on the $61.40 stock in 184 days
- **Upside from today if called away at a net $73:** 18.9%
- **Total return on position if exercised:** 24.2%

Alternative Trades

- **If you don't own a 3% allocation yet:**

- With our rating on the stock a buy, you can purchase shares, aiming to pay $61.50 or lower, or within 5% of our buy around price.
- **If you only want to buy shares lower:**
  - Sell to open (*do not buy*) May 2012 $60 puts, lately paying you $4.10, or a 6.8% yield in three months. This results in a $55.90 potential buy price. Sell one put for every 100 shares you are willing to buy.
  - To be more defensive, sell to open May 2012 $55 puts, lately $2.20 (a 4% yield), for a $52.80 potential buy price. Sell one put for every 100 shares you are willing to buy. (See our guide to writing puts.)
- **If fewer than 100 shares is a 3% or greater allocation:**
  - You can't write covered calls or puts, but continue to own your shares, or buy a 3% stake.

Next step: If you have questions before you set up your trade, visit our OpenText discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy Apple

Published Feb 14, 2012 at 12:00AM

- **What We're Doing:** Investing in the world's largest technology company.
- **What We're Thinking:** Shares are cheap because enough people doubt Apple's staying power and ability to keep growing.
- **What We're Expecting:** Mobile computing is small relative to its future size.

Trade Essentials

- **Action:** Invest 4% of your portfolio in Apple ($4,000 for every $100,000 you manage). For *Pro*, that's about 100 shares. (Remember, it's not the number of shares you buy that matters, but the dollar amount you invest.)
- **Buy Around:** $520
- **Fair Value:** $635
- **Alternative Trades:** See the end of this report.

The Big Picture

Apple has changed how we use our phones, how we view mobile computing, even how we *feel* about the technology in our lives. But our recommendation today has nothing to do with feelings and everything to do with potential. To that end, let's get a few things out of the way:

Apple is a Buy First

We consider Apple a Buy First stock — it will appear that way on our scorecard as soon as we make a purchase.

- Yes, Apple is one of the most widely held stocks in the market. That doesn't matter; we believe the business will grow enough to attract more investors.
- Yes, Apple is the most valuable publicly traded company on the planet. This shouldn't deter us; while size can be a challenge, it can also lead to a compounding advantage.
- Yes, we know shares are at new highs. That also shouldn't matter. The stock's valuation multiple to cash flow is lower today than at almost any other time in the last 10 years.
- Yes, we know today's valuation is only attractive if Apple *maintains* and then grows its profits. We believe it will.

The Business

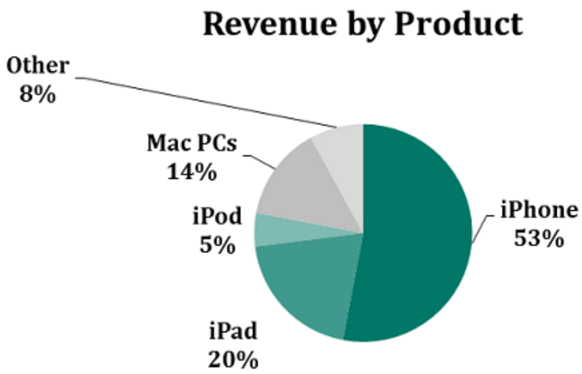
The mobile computing industry is still in its infancy, but many investors doubt that Apple can ride the crest of its own giant wave much longer. We differ. We believe a growing reliance on Apple's operating system, iOS, will lock in customers for years to come. New customers are lured in daily, and Apple is obsessed with staying at least two years ahead of its competitors. In addition, Apple's market is growing before our eyes.

With 62 million Apple iOS units sold last quarter, consumers are embracing Apple in record numbers. But the *newest* massive group turning to Apple is — drum roll, please — business customers. Nearly all Fortune 500 companies now support the iPhone on their networks, and according to Apple CFO Peter Oppenheimer, "Nearly all of the top companies within major Fortune 500 markets" are starting to use the iPad after test programs in 2011. From pharmaceutical sales reps to airline pilots, from retailers to real estate agents, from waiters to doctors, the iPad is improving daily business (and education and government). One reason: Purchase managers believe Apple's operating system is more secure than **Google**'s Android. Connect the dots, and if Apple wins the corporate tablet war, it's likely to sell many more Mac computers.

According to Bloomberg, Apple sold just 3.8 million Macs to corporations last year, accounting for a mere 3% of the business market. In the U.S. overall, Apple only has 10.9% PC market share, and worldwide, that number is in the single digits. The PC industry is expected to ship 371 million units this year, a fraction of them made by Apple.

But Apple CEO Tim Cook believes that more tablets will eventually be sold every year than PCs. In addition, if you count tablets as part of the PC market, then research firm Canalys predicts that Apple will soon be the world's largest PC vendor. In other words, Apple may finally lead the PC market by reinventing it.

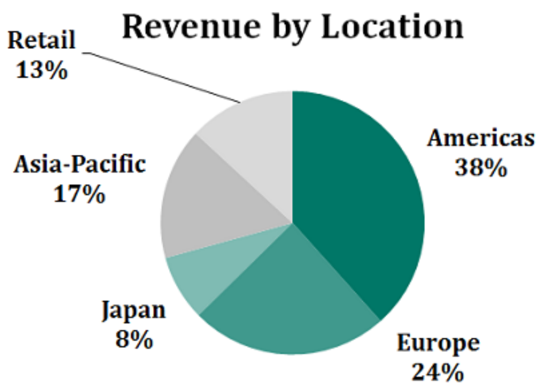
For today, though, Apple remains an iPhone story. That tiny rectangle of magic accounted for 53% of revenue last quarter, with a record 37 million units sold, compared with 15 million iPads, 15 million iPods, and 5.2 million Mac computers.



Q1 2012 ended Dec. 31, 2011. “Other” is music, hardware, and software, with music accounting for roughly half.

Despite the iPhone’s success since its launch in 2007, Strategy Analytics reports that it only holds about 6% of the worldwide mobile phone market. In smartphones, Apple’s market share was up 128% last year, landing it in the top spot with 23.9%. But more than 60% of mobile phone owners have not yet upgraded to smartphones, so the market will grow much larger. Apple increased the number of retail stores the iPhone can be bought by 35% last quarter, to 130,000 locations, but there’s plenty of expansion ahead, including in China, Brazil, Russia, and India. Apple phones aren’t yet offered on some of the largest phone carriers in the world, and CEO Tim Cook says he’d like to get into “all of them over time.”

There’s a good reason for that. Once customers buy an iPhone, Apple sees much higher odds that they’ll later buy an iPad, and finally a Mac computer. So, as with the iPod before it, every iPhone sold seeds the market for additional Apple sales. If this trend holds true in the $3.8 trillion business market, then the rapid proliferation of iPhones and iPads in the corporate world, not to mention with consumers, may fuel Apple’s business for years.



Q1 2012 ended Dec. 31, 2011. Apple reports 13% of revenue as “Retail” — that is, from various retail locations. Most of that additional 13% is from the Americas and Europe.

Meanwhile, the world is Apple’s oyster. The planet’s most populous region, Asia-Pacific, represented just 17% of revenue last quarter, so Apple is merely scratching the surface there. Overall, as large as Apple is today, its existing products (along with regular refreshes) should make the company much bigger three and five years from now. As *Pro* senior analyst Nick Crow put it, “A large market value is not an impediment to growing your sales.” But growth *will* require continued execution in innovation, design, manufacturing, and marketing.

Financials

Apple has grown earnings so rapidly that investors are actually paying a lower multiple to free cash flow now than they had to anytime the last 10 years.. The company is valued at 11.4 times $41 billion in trailing free cash flow. Include Apple’s $97.6 billion in cash and investments, and the stock fetches just 9.1 times free cash flow. Both multiples are below the S&P 500’s average in the mid-teens, and the S&P is growing earnings at less than one-twentieth the rate of Apple. (The S&P saw 5.5% average earnings growth this quarter, compared with Apple’s 115% — and Apple drove much of the S&P 500’s gains.)

Speaking of growth, analysts on average expect Apple to report an earnings-per-share jump of 54% for the current fiscal year (which will end Sept. 30) and just 10.4% in fiscal 2013. Wall Street has been making this mistake for years, assuming Apple’s growth will suddenly drop off. It’s more likely that Apple will surprise the Street again in 2013 with at least 20% growth — and much more if a new product (rumors suggest a potential TV) goes well.

Apple Results	TTM*	2011 (ended Sept.)	2010	2009	2008
Revenue	$127,841	$108,249	$65,225	$42,905	$37,491
Operating Cash Flow	$45,310	$37,529	$18,595	$10,159	$9,596
Free Cash Flow	$40,943	$33,269	$16,590	$9,015	$8,505
Weighted Diluted Shares Outstanding	938.7	936.6	924.7	907.0	902.1

*TTM (trailing 12 months) to Dec. 31, 2011. Every other year is the year ended late September. All amounts in millions. Source: S&P Capital IQ.

Apple’s diluted share count is only up 4% since the end of fiscal 2008, a reasonable climb given how much value the company has created. Cash flow is up fourfold over the same period, leading to Apple’s record balance sheet of nearly $100 billion in cash and investments (or $104 in cash per share). That giant cash hoard means Apple is widely expected to start a dividend or issue a special cash distribution, perhaps soon. A dividend should create more demand for shares, and invite a giant new class of investors, including certain mutual funds that can only invest in dividend-paying stocks.

On conservative growth assumptions, we calculate a fair value about 27% higher, at $635.

What Would Make Us Sell

Apple employs 60,400 people, including design genius Jonathan Ive, but for years Steve Jobs made the final decision on every product. Without Jobs, will Apple make mistakes or compromise in a way Jobs never would have allowed? Jobs insisted that even the insides and backsides of products looked appealing. Few personalities can hold a company to such high standards, because the desire to cut corners and save money permeates all corporations. Hopefully Apple will keep asking itself, “What would Steve do?” when it comes to such matters.

More standard risks include rising costs, falling margins, supply shortages, production problems, quality issues, failed new products (without Jobs to debut them, will they be as exciting?), or customers tiring of paying an “Apple premium” as competitors offer comparable products at lower prices. Apple needs to maintain a technological *and* design edge to keep its products on the most-desired list. If Apple starts to lose any of its edges — including the lucrative subsidies phone carriers pay to offer Apple phones — we will consider selling.

Pro’s Bottom Line

Many people believe Apple can’t get much larger. We believe it can and will. To discuss the company, head to *Pro*’s Apple board.

Alternative Trades

- If $50,000 is around a 4% allocation for you:
  - You can sell to open any put option you like to earn income or potentially buy shares lower. The April $500 put lately pays around $24 (4.8% in a few months). If you are able to write puts, you can also consider a synthetic long instead, selling puts to buy calls with a strike price near the current share price.
- If you want to invest less money and profit smartly if Apple rises:
  - Set up a January 2014 bull call spread. First idea: Buy to open Jan. 2014 $500 calls and sell to open an equal number of Jan. 2014 $600 calls, for a net debit of about $39 ($3,900 per spread). You’ll earn 156% on your investment ($61 per share) if Apple ends expiration above $600 (up 19%), but you’ll lose all $39 if Apple ends below $500. Your break-even is $539.
  - You can also set up spreads at higher or lower strikes, for higher or lower risk, depending on what makes you comfortable. For example, idea two: Buy to open Jan. 2014 $400 calls and sell to open an equal number of Jan. 2014 $500 calls for a net debit of approximately $54 per spread, leaving you a potential profit of $46 each (an 85% return) even if Apple just stays at its current price, modestly above $500.

The Earnings Circus

Published Feb 13, 2012 at 12:00AM

Fellow Fools,

Presidential Postponement

The market is closed Feb. 20 for Presidents' Day, so your next Monday Memo will hit your inbox Tuesday, Feb. 21, at 4 p.m.!

Pro Trade Roundup

- **CME Group**: Bought 200 shares at an average price of $286.55.

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Intel**: "Sell to open" July $24 puts at $0.85 or higher, for up to 6.7% in shares if you lack this allocation. Sell one put for every 100 shares you could buy.
- **Pacer International**: Sell to open September 2012 $5 puts for $0.55 or higher, for up to 3% in shares.

Questions on these? Visit our "Catch-Up Trades" discussion board .

The funny thing about quarterly earnings is that they happen regularly — my experience points to four times a year — and yet they're like a circus every time. There's much hoopla around earnings on Wall Street, where trillions are made and lost based on $0.01 beats or misses and analysts on conference calls study managers' voice inflections for clues. Those managers often take great pains to explain which numbers are worth focusing on (the good ones) and which should be ignored (the bad ones).

But while Jeff has a fondness for the bearded lady, Nick refuses to trapeze without his blindfold, and I can't stop laughing at the clown car, your *Pro* team tries its best to avoid the earnings circus, because quarterly earnings don't matter. Here's why:

Pondering the Earth's Orbit

We all learned in grade school that it takes the Earth 365 days to orbit the sun (a 940-million-kilometer journey). The Mayans, popular these days for their calendar, used both 260-day cycles (tied to the length of a pregnancy) and 365-day ones. But what do either of these measurement periods have to do with the progress of a business? Should we, as business owners and mature investors, give a hoot about the relationship between arbitrary measurement periods and the numbers reported over those fragments of time? Nope. Companies will almost certainly manage to develop their businesses, delight their customers, and reinvest their profit independent of planetary travel and human gestation periods.

Getting All Finance-y

It is widely accepted that the value of a company is attributable to the discounted present value of its future cash flow. In other words, a company's value today is a function of how much leftover cash it can generate from now until the end of time (speaking of which, we hope the Mayans were wrong about Dec. 21, 2012). That's why you hear us trumpeting businesses that generate circus tents full of cash, and why we obsess over companies that have the competitive advantages to protect their cash-printing operations. If we're focused on the excess cash the company can generate over the next 50, 100, or 200 years (or more), what affect will a single quarter have? Mathematically, and fundamentally, almost none.

Have You Ever Budgeted?

Read up on personal finance and you'll hear one tip more than any other: "Make a budget." It's good advice, but it sure does oversimplify things. For example, anyone who's ever made a budget knows month-to-month variations are the norm, not the exception. Quite often, your budget can't accurately predict when fantastic bargain opportunities will arise, or when that hot water heater will go kaput. The result is that you'll "miss your number," even though you may have done so with good reason (to buy a stock you know is cheap, or to keep your home warm). It's close to impossible to predict opportunities and problems in a household budget — we shouldn't expect it to be any easier for the businesses we own.

What *Does* Matter?

Let me be clear: We care very much about the progress of our businesses. It's the specific numbers reported over entirely arbitrary measurement periods that don't matter. If we've done our jobs — if we've found businesses with wonderful economics and competitive advantages — the numbers will take care of themselves. When we review the quarterly earnings calls and financial data for *Pro* companies, here are the things we focus on instead:

- **Assessing long-term market trends and business progress.** We focus on the fundamental forces of supply and demand for a company's product or service and the key drivers of its business strategy. These usually change gradually, and we like to monitor that evolution and how our businesses position themselves with respect to those trends.
- **Why were certain business decisions made?** As much as possible, we get comfortable with process before we obsess about outcomes. In the long run, we believe a management team with sound processes that lead to intelligent decision making will yield great long-term results, even if the short term is bumpy. As long as management appears to have a grasp on its business, competitors, and market, we'll let out slack on our leash.
- **Where is the company spending its time and energy?** Our recommendations spell out in great detail the reasons we like our businesses. Naturally, we like to see management allocating its scarce resources to protect, develop, and enhance those assets. To determine this, we typically assess the level of strategic defense and offense the management team appears to be playing.

Of course, we don't entirely ignore short-term results. But keeping our long-term perspective helps us digest those interim reports and make educated portfolio decisions in response. Keep an eye on the discussion boards for our quarterly coverage, but be sure to read those posts through the lenses of a long-term business owner.

Fool on,

Bryan (TMF42)

Community

- Bryan (TMF42) dives into earnings at **Broadridge Financial Services** and **Bristow Group**.
- Leo (stamleo) has sniffed out some free options seminars — check it out.
- MazonCreekRich warns new members that he's channeling his inner Tom.

See Pro'*s holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro's February 2012 Ketchup Report

Published Feb 10, 2012 at 12:00AM

Dear *Pro* Member:

Download!

Click here to download the
PDF.

Please read this report with your full attention. We'll keep to the point, promise! This Foolishly named Ketchup Report is meant to catch you up to all the *Pro* stocks that are currently recommended as Buys or Buy Firsts. Following our allocations to these stocks will get you well on your way to mirroring the *Pro* portfolio.

If you've already bought our Buy Firsts and the first set of Buy stocks we sent you, then this report fills out the rest of our Buys. If you haven't started at all, this report is the only guide you need today. That said, if you haven't invested since you joined us, we recommend you space out your buys from this list over the coming few weeks. Buy five at a time or so, as we've suggested over the past two weeks. (And if you'd like guidance about using IRAs, not using options, or other ways to make *Pro* fit you, check out our aptly titled article, "Making *Pro* Fit You.")

Before we get to the list of recommendations, let's cover some vitally important ground.

Terms to Know

- **Buy First:** These are the investments you should make first, setting a foundation for your *Pro* portfolio. In our opinion, these stocks usually have the best risk-to-reward profile, offering healthy upside and low downside.
- **Buy:** We like these as much as our Buy First stocks over the long haul, but they may be more volatile, and they may offer more downside risk while we wait for our thesis to play out.
- **Hold:** We currently have 10 stocks on hold, and we won't cover them in this report. They're always listed on the Recommendations page. We don't suggest buying our stocks on hold today, but if you already own them, hold them. In every Monday Memo, we'll share "catch-up" trades to help you get into stocks on hold at lower prices.

The Recommendations page is your "King of Guidance." That page is always kept current, so if something is listed there as a Buy First or Buy, we believe it can be bought today, period. The moment we no longer believe that, we'll move it to Hold on that page and announce that change on the *Pro* home page, as well as in the following Monday Memo.

You'll also need to know these terms:

- **Buy Around:** This is the ideal price around (or below) which you'll buy our recommendations, give or take 5% or even 10%. Investing is not a precise science; if we like a company enough to buy it, a 5% price difference is not going to change the outcome meaningfully. We provide this guidance to give you an initial guidepost, but if a stock is listed as a Buy or Buy First on the Recommendations page, that guidance applies regardless of the Buy Around price.
- **Fair Value:** This is the fair price for the stock — what we believe it's worth today. It is not the automatic sell price. In fact, a stock that's reached its fair value should proceed to achieve our desired rate of return (typically 10% or higher annualized). We only sell at fair value if we want a margin of safety (occasionally, there are stocks we only want to own below fair value) or we see something at a discount we like better.
- **Allocation:** We recommend each position as a percentage of the total amount you're investing in *Pro* stocks (exclude your fixed-income investments). If we say to buy 4.5% in something, then invest $4,500 in that stock for every $100,000 in your *Pro* stock portfolio. There is wiggle room here, and you should allocate in a way that makes you comfortable. Keep in mind, though, that our future guidance will assume you're matching our current allocation.

And Now, the List

Below are the positions we recommend to begin your *Pro* investment portfolio. All together, the following 14 Buys and Buy Firsts will account for about 53% of your funds — 52.8%, to be precise. That said, you needn't be precise! If you want our future allocation guidance to be relevant to your position, just aim to be close.

Buy First

- **BMC Software**, 4.5%
- **Medtronic**, 5.4%
- **Oracle**, 5%
- **Pebblebrook Hotel Trust**, 4%

Buy

- **3D Systems**, 1.7%
- **Broadridge Financial Solutions**, 3.6%
- **CME Group**, 3.5%
- **Covanta Holdings**, 3%
- **GrafTech International**, 4.3%
- **MasterCard**, 3.4%
- **OpenText**, 3%
- **Rockwood Holdings**, 5.4%
- **Wells Fargo**, 2.5% with covered strangle options (or just buy the stock if you're not using options)
- **WisdomTree Emerging Markets SmallCap Dividend Fund**, 2.5%

Short

For those who wish to short and hedge, we have two current positions:

- Short ("sell to short" or "sell to open") **CurrencyShares Euro Trust**, 3%
- Short **S&P 500 Depository Receipts** at a level that hedges 20% of the funds you have invested in long stocks. (So, if you have invested $100,000 in long stocks, short $20,000 in SPY to hedge.)

The S&P 500 ETF is our largest hedge. We may be closing it within a month or so as better opportunities present themselves, but you can still short the index if you want to hedge up to 20% of your long stock exposure over the next several weeks. You needn't short to participate successfully in *Pro*'s long-term performance.

Summary

After you've added these 16 positions in your portfolio over the coming days and weeks, we'll work to get our 10 stocks on Hold into your portfolio, too, at better prices. To that end, we'll feature Catch-Up Trades in each Monday Memo, and we will of course send official trades if prices dictate.

Remember that investing is not a sprint. It's a marathon. So don't sweat this Ketchup Report. Take your time. Ask questions on the Getting Started discussion board. Buy and short only when you're ready for and comfortable with the transactions you're making, and go at your own pace. We're here to help each step of the way.

Finally, to get our most timely Buy First, Buy, or Hold recommendation on any position in this report after today, just click on the always current Recommendations tab.

Foolishly,

Jeff Fischer, advisor (TMFFischer)

More on Our Buy Firsts, Buys, and Shorts

Listed in alphabetical order.

3D Systems (DDD)

- **Industry:** 3-D printers
- **Allocation:** Invest 1.7% of your funds ($1,700 for every $100,000 you manage)
- **Full Report**

Summary:3D Systems is working to change the world. Selling printers that actually print perfectly usable 3-D objects — from replacement kidneys to car dashboards — the company could both revolutionize and personalize manufacturing. Its latest award-winning printer, Cubify, is for retail customers who wish to print jewelry (or shoes, or toys … you name it) right at home based on designs they can find online or create themselves. The stock may be a growth story, but 3D Systems is already making a nice profit selling its machines and printing materials. We have a small stake now and may look to add more after seeing earnings in mid-February.

BMC Software (BMC)

- **Industry:** Business software
- **Allocation:** Invest 4.5% of your funds ($4,500 in BMC for every $100,000 you manage)
- **Full Reports:**

- Buy
- Buy More

Summary: Selling to 81% of the Fortune 500 companies in the world, **BMC Software** provides software that lets corporate mainframe computers, computing clouds, databases, applications, and servers all work smoothly and efficiently together. Despite recent sales weakness, BMC expects earnings per share to grow about 9% in the year ending in March and operating cash flow to increase about 8%, to $825 million. We see business improving and the stock returning to the $50s in time.

Broadridge Financial Solutions (BR)

- **Industry:** Data processing and outsourced services
- **Allocation:** Invest 3.6% of your funds ($3,600 for every $100,000 you manage)
- **Full Report**

Summary: You may have never heard of it, but **Broadridge Financial Solutions** is indispensable to the financial industry. It has a near-monopoly on the equity proxy distribution and vote tabulation business (which, by law, occurs every year), and it's happy to take on the kind of outsourced back-office work that financial firms deem a technologically cumbersome waste of time. Sure, it's boring, but it's also a highly stable, super-sticky, and very profitable business.

CME Group (CME)

- **Industry:** Financial exchange and clearing
- **Allocation:** Invest 3.5% of your funds ($3,500 in CME for every $100,000 you manage)
- **Full Report**

Summary: As the largest public exchange for trading and clearing futures, **CME Group** enjoys high margins and growing profits as futures volume grows. Manufacturers, governments, producers, and traders use futures to hedge currencies, energy prices, metals and commodities, equities and interest rates. The larger the market, the more liquid it is, helping provide giant CME with a competitive moat that also draws in new customers.

Covanta Holdings (CVA)

- **Industry:** Waste management, electricity generation
- **Allocation:** Invest 3% of your funds ($3,000 for every $100,000 you manage)
- **Full Report**

Summary: With landfill space limited, trash generation limitless, and electricity demand constant, **Covanta Holdings** gets a green ribbon for how it turns (burns) waste into energy. Covanta, which gets paid to deal with its primary resource (trash), controls roughly two-thirds of the domestic energy-from-waste industry via its 40-plus plants which can process up to 2,500 tons of refuse per day and turn it into power that feeds homes and businesses. The company won't grow to the moon, but its revenue is stable thanks to very long-term contracts and equally sustained demand for energy. Covanta is a cash cow that should serve as a steady performer, paying growing amounts back to shareholders.

CurrencyShares Euro Trust (FXE) (Short)

- **Vehicle:** This ETF only holds physical euro
- **Allocation:** Short 3% of your funds ($3,000 for every $100,000 you manage)
- **Full Report**
- **How to Short:** We suggest either a synthetic short using options or a direct short if your broker has shares. We are short directly.

Summary: The euro is under siege, and the bailout packages that Greece or other eurozone countries receive shouldn't matter in the long run. More important, many countries in the eurozone are not competitive economically. And because it's built on a fractured foundation, we believe the euro should trade cheaper to the dollar than it does. With this short of the **CurrencyShares Euro Trust** ETF, we'll profit if the euro declines in value.

GrafTech International (GTI)

- **Industry:** Carbon and graphite products, focused on the steel industry
- **Allocation:** Invest 4.3% of your funds ($4,300 for every $100,000 you manage)
- **Full Reports:**
  - Buy
  - Buy More

Summary: GrafTech International is the low-cost producer of high-quality graphite electrodes, which steelmakers use to melt and form the steel they use to build our world. Demand for steel continues to be driven by growing infrastructure in emerging markets and a rising global middle class, and as more steely things (like cars, planes, and buildings) are produced, we believe steel producers will be popping graphite electrodes like Tic-Tacs. GrafTech is well-positioned to feed their need.

MasterCard (MA)

- **Industry:** Consumer financial services
- **Allocation:** Invest 3.4% of your funds ($3,400 for every $100,000 you manage)
- **Full Report**

Summary: The second-largest payments processor in the world, **MasterCard** is enjoying the ride as payment cards steal market share from cash. The market recognizes the potential of the highly profitable business model and respects the company's quickly growing revenue, and thus, shares aren't cheap. Fortunately, the stock still trades below our $425 estimate of its fair price. Resist the temptation to anchor yourself to *Pro*'s lower entry price entry. Short-term price movements don't matter; just ask yourself where you see MasterCard five years from now.

Medtronic (MDT)

- **Industry:** Medical devices
- **Allocation:** Invest 5.4% of your funds ($5,400 for every $100,000 you manage)
- **Full Reports**
  - Buy
  - Buy More

Summary: With more than 40,000 employees and $16 billion in annual sales, **Medtronic** is a global leader in the medical technology field. A few recent small missteps, tough competition, and uncertainty surrounding future regulation have left investors questioning the company's future growth. But at this price — less than 11 times coming earnings? C'mon. The company's growth is powered by its massive research and development budget, its impressive new product pipeline, and its excellent footprint in emerging markets. With the distribution and scale to win business, we think Medtronic is well positioned to grow.

OpenText (OTEX)

- **Industry:** Business software
- **Allocation:** Invest 3% of your funds ($3,000 for every $100,000 you manage)
- **Full Report**

Summary: OpenText sells software that lets businesses manage growing reams of online data, communicate better, stay in bounds in regards to regulatory needs, and improve office efficiencies. By helping companies save money and perform better, OpenText has a strong selling point even during tight economic times. And it is No. 2 in its business, barely trailing **IBM**.

Oracle (ORCL)

- **Industry:** Business software
- **Allocation:** Invest 5% of your funds ($5,000 for every $100,000 you manage)
- **Full Reports:**
  - Buy
  - Buy More
  - Buy Even More

Summary: We recommend two large software providers among our Buy First stocks with good reason: They're inexpensive and they're strong businesses, with high recurring revenue, low costs, and gushing free cash flow. **Oracle** is the granddaddy of business software, and yet it's consistently among the fastest-growing software giants, too. Last quarter, some contracts didn't close as hoped, providing investors a lower buy price. We'll take it, and we suggest you do, too.

Pebblebrook Hotel Trust (PEB)

- **Industry:** Hotel ownership
- **Allocation:** Invest 4% of your funds ($4,000 for every $100,000 you manage)
- **Full Reports:**
  - Buy
  - Buy More
  - Buy Even More

Summary: CEO Jon Bortz knows hotels, so when he saw the fire sales taking place during the financial crisis, he came out of retirement to start **Pebblebrook Hotel Trust**. The company has since busied itself buying up cheap, marquee, luxury hotels in foreclosure and giving them new life. As Pebblebrook finishes renovating and revamping all the hotels it has purchased over the past 18 months, those hotels should become strongly profitable (as past ones have), and these profits should materialize into a growing dividend for shareholders. At the same time, Bortz continues to scout for new opportunities to acquire upscale hotels at temporarily cheap prices.

Rockwood Holdings (ROC)

- **Industry:** Specialty chemicals, TiO2, lithium
- **Allocation:** Invest up to 5.4% of your funds ($5,400 for every $100,000 you manage). Start smaller if a more volatile stock concerns you.
- **Full Report**

Summary: The disc brakes in your car, the airplanes you fly in, the paint on your home, the fibers in your clothing, the batteries in your electronics, and the pharmaceuticals in your cabinet — even the packaging around your groceries — all may contain **Rockwood Holdings**' specialty chemicals and engineered materials. Rockwood Holdings runs several divisions that all lead in their respective niches, from advanced ceramics used for hip replacements to titanium dioxide for paints and coatings. Rockwood is also one of the world's largest producers of lithium for the quickly growing lithium battery market. This is a volatile stock, but we're comfortable with its prospects.

SPDR S&P 500 (SPY) (Short)

- **Vehicle:** This massive ETF tracks the S&P 500.
- **Allocation:** Short enough to hedge 20% of the funds you have invested in stocks ($20,000 in a SPY short for every $100,000 you have invested in stocks).
- **Full Report**

Summary: This is a simple hedge, and you can employ it or not depending on your preferences and your individual situation. We have hedged 20% of our long stocks with this short of the **SPDR S&P 500** index. We will be moving out of this short this year, perhaps very soon, but it remains a worthwhile hedge if you're concerned about the market in the short term.

Wells Fargo & Company (WFC) (With a Covered Strangle)

- **Industry:** Diversified financial company
- **Allocation:** Invest 2.5% of your funds ($2,500 in WFC for every $100,000 you manage). That's half of a potential 5% allocation.
- **Full Reports:**
  - Buy
  - Write Covered Strangle

Summary: Having just completed the largest merger in banking history, **Wells Fargo** now boasts 6,239 retail banking locations and the highest customer-service rating in the industry. We expect management to continue to "out-local the nationals and out-national the locals" by providing the breadth of service expected of a major bank while building the relationship depth expected from a community bank. We predict the stock will stay in a wide range as the financial industry continues to recover over the next few years; while that happens, we own half a full potential allocation in Wells and have set up an options position on it — writing a strangle — in hopes of regular income with stock upside. So:

- Buy 2.5% of a potential 5% allocation in WFC stock around $30ish, in 100-share round lots.
- Use a "strangle order" to "sell to open" April 2012 $27 puts and April 2012 $31 calls, one of each option for every 100 shares you own, lately for a combined credit of around $1.68 per share.

This position will be profitable if the stock remains at or below $32.68. It gives us about 5.5% in a potential income yield in just over two months, and it provides 5.5% in downside protection, too. We'll take that!

The strangle above is different from our earlier official recommendation (we currently have lower strike prices, because we set ours up earlier), but in April we'll "roll" to a new strangle and everyone will be on the same page. This is the best trade for today.

If you're not using options, you can start by just buying 2.5% in the stock.

WisdomTree Emerging Markets SmallCap Dividend Fund (DGS)

- **Industry:** Diversified international ETF (industrials, financials, consumer discretionary)
- **Allocation:** Invest 2.5% of your funds ($2,500 for every $100,000 you manage)
- **Full Report**

Summary: We believe emerging markets have growth potential that makes their extra risk acceptable. To pursue this belief while guarding carefully against that risk, with this investment we've chosen to buy a basket of growing emerging-market companies that are financially sound enough to promise a healthy dividend. **The WisdomTree Emerging Markets SmallCap Dividend Fund** offers us not just a yield but also ownership in a few hundred small, growing, and promising companies in countries including South Korea, Malaysia, India, and Brazil. Given all that, it's easy to see why we like this ETF for the long haul. It's also a great way to diversify. We may add to our position in the future, but right now buying 2.5% will match us.

The Final Word

Build these 16 positions into your Pro portfolio to start to match us (or use the positions you like best and that mesh well with your other holdings), and you'll be well on your way to investing with Pro. Watch each Monday Memo for Catch-Up Trades on stocks on Hold, and watch your inbox for future trades on new stocks and options. We're here to answer your questions. For any company-specific question, please enter its ticker on the Pro site for our reports and to visit its discussion board. We're here to keep you investing Foolishly for regular income and long-term gains. Thank you for being a Pro member!

— The *Pro* Team (Jeff Fischer, Nick Crow, Bryan Hinmon, CFA)

To see our current Buy or Hold recommendation on any position in this report, just click on the always-current Recommendations tab. To ask questions, visit our Getting Started discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Reduce Written Calls on AmTrust; Let Some Shares Be Sold

Published Feb 9, 2012 at 12:00AM

- **What We're Doing**: We're uncapping the upside on the bulk of our **AmTrust Financial Services** (NASDAQ: AFSI) shares by buying to close some of our covered calls.
- **What We're Thinking**: We don't want to sell all of our shares, but if we don't take action, we'll be forced to at March expiration if the stock remains higher than $25.
- **What We're Expecting**: AmTrust will continue to be a solid performer and will grow to become an even larger part of the *Pro* portfolio.

Trade Essentials

- **Action**: "Buy to close" a portion of your AmTrust Financial Services March 2012 $25 call options. Do nothing with your owned March 2012 $20 put options.
- **Allocation**: After these options expire March 17, we want our allocation to AmTrust to be 5% (that's $5,000 for every $100,000 you manage). You need to buy back the number of contracts that allows you to maintain a 5% position in your portfolio. For *Pro*, that means we are buying to close 27 of our 39 call options. For the math behind that number, read on.
- **Limit Guidance**: These options have a wide bid/ask spread; aim to pay somewhere in the middle of that range. The current asking price is $1.75.

What's New?

- **Last trade:** In October 2011, we set up a protective collar on all of our AmTrust shares.
- **Change:** Shares are up about 20% since then.

Back in October, we believed the debt situation in Europe was unsettling enough that investors might "throw out all stocks in the financial sector — babies and bathwater alike." To guard against the effects of such a crisis on **AmTrust Financial Services**, our largest position at the time, we set up an insurance policy in the form of a protective collar.

The cost of that policy wasn't cheap (buying put options outright never is), so we defrayed the cost by capping the upside on our shares at 14% via written $25 call options. At the time, we couldn't identify a catalyst that would send AmTrust shares above $25. So naturally, shares have marched steadily north of $26 for no apparent reason (besides, of course, the fact that AmTrust is a solid, quickly growing business), and they remain in that general range today.

If we don't take any action before our protective collar expires March 17 and shares remain above $25 at that time, we'll be forced to sell our entire position in AmTrust. We don't want to do that. However, we are content to trim our position from 7.3% to 5% for three reasons:

1. We still can't figure out the precise reason for the company's $175 million debt issuance back in December.
2. Our portfolio's exposure to the financial sector has grown.
3. We believe AmTrust will be a long-term winner, but sometimes we prefer a bird in the hand (taking some profits) to two in the bush.

As defensive investors, and in light of these factors, it seems prudent to trim our AmTrust position to 5% (big, and still a top five holding) from 7.3% (super-big).

How to Follow Along

We are attempting to do two things here:

1. Repurchase most of our March 2012 $25 call options, freeing us from the obligation to sell our shares at $25 and allowing us to regain control of the potential upside in a 5% position in AmTrust, and
2. Acknowledge willingness to let some of our shares go (the amount exceeding a 5% position) in March if they are above $25.

For *Pro*, that means we want to buy to close 27 of our 39 March 2012 $25 calls. (The remaining 12 calls represent 1,200 shares subject to a likely sale at $25 in March.) Your thinking should go something like this:

	Ask Yourself ...	If Yes ...	If No ...
(1)	Do I have AFSI March 2012 calls?	Continue to (2)	Relax, smile, and count all the money you're making in AFSI
(2)	Does my AFSI position exceed a 5% allocation?	Continue to (3)	Buy to close ALL of your March 2012 $25 calls
(3)	Determine what a 5% allocation is for your portfolio, then buy to close the number of March 2012 calls that corresponds to that position. Leave your remaining March 2012 $25 calls alone.	See "The Math" below.	

The Math

Here are the calculations:

a. Portfolio Value x .05 = Dollar value of AFSI you want to hold after you complete this trade
b. (a) / $26.25 = Number of AFSI shares that dollar value represents
c. Round (b) up or down to even blocks of 100 and buy to close that number of contracts

The Foolish Bottom Line

Unfortunately, we'll likely have to pay more to close these calls than we were paid to open the position. However, we've still made money on the position overall since we opened this option trade, and this booked loss pales in comparison to the upside we believe long-term shareholders will receive. Furthermore, Europe is still enough of a concern that we want our disaster insurance (the March 2012 $20 puts) in place in case something very bad happens (and we wouldn't get much from selling them now, anyway). But with the company releasing earnings Feb. 15, and given our general long-term bullishness on the shares, we want to remove the calls covering our core 5% position in AmTrust.

We know this one could be confusing, so come on over to our AmTrust discussion board for guidance and to further discuss our thinking.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Getting Started With Options: The Essential First Steps

Published Feb 8, 2012 at 12:00AM

Fellow Fools,

Download!

Click here to download the PDF.

Motley Fool *Pro* uses stocks for the long term and options for the short term. Options are a perfect, logical complement to a long-term stock portfolio, providing near-term income, hedging, insurance, and leverage, while also allowing you better buy and sell prices on your stocks. But as versatile as options are, you can start to use them with just one simple strategy; later, if you desire, you can add more to your arsenal. In other words, one option strategy is enough to make a difference in your financial future. In this document, we'll show you how. Fool on!

— Jeff Fischer, *Pro* Advisor

Selling Put Options

The steadiest, simplest income and stock strategy is to write (or “sell to open”) put options. This is how I started using options more than 10 years ago, and it remains one of the strategies I use most. When you sell a put option, you are agreeing to buy a stock cheaper if it declines to your buy price, or lower, by the expiration of your option. You’re paid for the option you sell, and no matter what, you keep that money. Why are you paid to sell these options? Because you’re selling someone an insurance policy. By selling a put option, you’re telling someone, “If your stock falls below $25 by July (for example), I’ll buy it from you at $25.” They pay you for that insurance.

Options and Strategies

An option gives its buyer the right to buy or sell at a stock at a set price by a set expiration date. The option writer (or seller) is obligated to buy or sell the stock at the option’s strike price if the stock reaches that price at expiration, and is paid for that potential obligation. Each option represents 100 shares of a stock. You write (“sell to open”) puts to potentially buy a stock cheaper. You write (“sell to open”) covered calls to potentially sell a stock you own higher. Both are common income strategies. See more on writing puts and writing covered calls in our guides.

Let’s use a real-life *Pro* example. Here’s a trade you can consider right now.

Sell to Open Puts on Intel

Computer chip giant **Intel** is the second-largest position in the *Pro* portfolio, at 6.8%. Even as the company grows its business around the world, shares are affordable at 11 times earnings and boast a 3.1% yield. The stock has run up recently to near $27, but with any luck, it will dip sometime this year, allowing new buyers a better entry price. You could wait and hope, or you could write put options today, get paid while you wait, and set up a lower potential buy price. Today, you could:

- Sell to open July 2012 $25 puts. Sell one put for every $2,500 in Intel you can afford to potentially buy (each option represents 100 shares of a stock).
- Target an allocation that works for you. Our Intel allocation is 6.8%. You can target this large of a position or less. You would sell to open one put (potentially $2,500 worth of stock) for every $37,000 you manage.
- Collect $1.05 per share. Each July 2012 $25 put recently pays you $1.05 per contract ($105).

So you're agreeing to buy Intel at $25 if the stock falls to that price or lower by the time your options expire on July 21.
(Options are rarely exercised before expiration, but they can be.) For this agreement, you're being paid $1.05 per share. On your potential $25 purchase price, that equates to a 4.2% yield ($1.05/$25) in about five months. That's a healthy yield for this potential obligation. Here are the possible outcomes:

- Intel's stock is higher than $25 at expiration: Your put options expire. You keep the $1.05 per share, earning a 4.2% yield in just more than five months. It's income! You have no further obligation and can write new puts.
- Intel's stock is at $25 or lower at expiration: You can buy to close your puts and end your obligation before expiration if you like, earning a profit if you can buy them back for less than you were paid. If you keep them open, you're obligated to buy Intel at $25. But you still keep the $1.05 you were paid, so your start price is $23.95; that's 10% below today's price of $26.66. Nice!

In the simplest terms, selling puts is an income strategy that lets you buy stocks cheaper if they decline. When they don't decline, it results in income again and again. Income-oriented investors look to write puts each month on safe,
strong companies. We will often recommend this strategy in *Pro*.

The Flipside: Writing Covered Calls

Writing covered calls is a similar income strategy to writing puts. The key difference here is that with covered calls, you already own the stock (and you collect its dividend payments). In this case, let's say you own shares of Intel, trading at $26.66 today. If you want to generate extra income on those shares, you can "sell to open" July $28 call options on Intel — selling one call for every 100 shares you already own. Like a written put, this option pays you income. But in this case, you're agreeing to sell your existing shares if they end at or above your strike price.

Recently, the July 2012 $28 covered calls on Intel would pay you $0.91 per share ($91 per option contract), for a 3.4% yield on the current share price in more than five months. If the stock stays below $28 by expiration, you keep that income and have no obligation. You can repeat the trade for more income if you desire. If shares of Intel rise above $28 by expiration and you don't buy to close your covered calls, your shares are sold automatically at $28. You still keep the $0.91 you were paid, so your net sell price is $28.91, for an 8.4% gain plus a dividend payment. Covered calls are a popular income strategy on stable stocks, including ones with strong dividends.

To Get Started

Every week in the *Pro* Monday Memo, we'll outline "Catch-Up Trades" you can use to potentially buy into *Pro* positions at cheaper prices by selling put options. To follow along, you need to get your broker's approval to use options. Apply for level 2 or 3 options permission at your broker. It's an easy process, but it can take several days to receive approval. Then ask any questions on the Catch-Up Trades discussion board.

More Options Resources

Of course, *Pro*'s got you covered! You can learn from all of our options guides here. We use many strategies, and our guides explain each in detail. (For example, combining put writing and covered calls at the same time results in a covered strangle, a double-income position on a stock you expect to stay within a wide price range.) And because you receive membership to Motley Fool Options free with your *Pro* membership, you can also partake in our sister site's Options U. program. Finally, you're always welcome to ask any options questions on our All About Options discussion board.

Options are a powerful, logical and sensible tool, and *Pro* is here to make sure they become a highly profitable part of your investing life, making you a better investor in the process. Fool on!

Buy CME Group

Published Feb 7, 2012 at 12:00AM

- **What We're Doing:** Buying shares of the world's leading futures exchange.
- **What We're Thinking:** Trading volume will keep growing, and highly profitable CME Group will continue to lead its industry.
- **What We're Expecting:** As CME grows, management will return more profit to shareholders.

Trade Essentials

- **Action:** Invest 3.5% of your portfolio in CME ($3,500 for every $100,000 you manage; for *Pro*, that's 200 shares).
- **Buy Around:** $278
- **Fair Value:** $327
- **Alternative Trades:**
  - Seeking a lower buy price? Sell to open any puts that appeal to you, selling one put for every $26,000 or so in stock you can afford.
  - Want upside with less capital? Set up a synthetic long. Sell to open January 2014 puts and buy to open January 2014 calls. Use the same strike price (near the current share price) for both. Each contract represents 100 shares.
- **Special Considerations:** CME yields 3.3% through quarterly dividends, and 1.3% more with a $3-per-share extra dividend in March. We may use options on this stock later, but they aren't essential.

The Business

This Stock Is a Buy

CME is a Buy, and it will be reflected on our scorecard as soon as we make our purchase.

CME Group (NASDAQ: CME) operates the world's largest exchange and clearinghouse for futures contracts that financial institutions, corporations, governments, and traders use to manage risk. As a mostly electronic intermediary, the company requires few physical assets to run its business, and as a result, it's one of the most profitable companies in the S&P 500.

Investors use CME's exchange because of its size, liquidity, transparency, safety, and sheer breadth of products. The company creates trading instruments, provides a market for them, matches prices, ensures settlement, and serves as the counterparty to every transaction to help reduce credit risk. In 2011, nearly 3.4 billion contracts traded on CME's exchange, up 10% from 2010. The six investment areas currently served are:

Product Line	Average Daily Volume (in thousands)*	Percentage of Total (rounded to nearest integer)
Interest Rates	4,729	40%
Equities	3,147	27%
Foreign Exchange	820	7%
Energy	1,704	15%
Agricultural Commodities	1,004	9%
Metals	315	3%
Average Daily Volume	11,719	100%

*Q4 2011, ended Dec. 30.

Last year, 83% of CME's revenue was earned from transaction and clearinghouse fees; 13% came from market data and information services; and 4% came from market access, communications, and other fees. The company's expenses are largely fixed, so its profit goes up (or down) with trading volume. CME grows its business by introducing new products (the company has launched hundreds over the past few years), attracting more investors, and expanding to new markets. The company also offers *options* on futures — for those who *really* love exotic investments.

What Are "Futures"?

A futures contract is a standardized agreement between two parties to trade a specific asset or instrument at a set price (the "future" price) by a set date (the delivery date). Futures have been used for hundreds of years, initially allowing farmers to ensure a specific price for their crops. Today, companies, governments, farmers, producers use them to hedge any number of costs: fuel costs, metal costs (in manufacturing), food prices, currencies, interest rates and more.

Who Is CME Group?

CME Group owns the Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), the New York Mercantile Exchange (NYMEX), and the Commodities Exchange (COMEX). It also owns 90% of the Dow Jones' namesake market indexes (Dow Jones retains a 10% stake).

While we expect U.S. trading volume to grow in the coming years, we are also keen on the large opportunities that remain in Europe, Asia (including China, where the company is making inroads), and Latin America. In 2010, non-U.S. hour and international hub trading (the way CME tracks non-U.S. trading volume) was 21% of CME's total volume. This grew 16% in 2011, and CME expects more growth ahead. The company's European clearinghouse was approved in May 2011, and business is taking off; in January alone, CME Clearing Europe saw nearly 75% as many contracts trade as it had hosted from May to December last year. Soon, CME will launch interest rate swaps and new metals contracts in Europe, among other new products.

Financials

CME's operating profit tops 60%, the highest of any holding in the *Pro* portfolio. Its large marketplace provides customers liquidity that smaller competitors can't match, helping to ensure its profit margins. CME owns 90% of the Dow Jones Industrial Average namesake market indexes, and it has exclusive contracts to offer equity futures on Nasdaq indexes through 2019 and S&P indexes through 2016. (CME will almost surely seek to extend both.) Approximately two-thirds of CME's business is conducted by exchange members who pay fees to take part. In 2010, 12% of trade and clearing revenue came from one large member customer, and 13% from another, so it's important that CME maintains healthy relationships with its members. Here's a snapshot of CME's five-year financials:

CME Group	2011	2010	2009	2008	2007
Revenue	$3,280	$3,004	$2,613	$2,561	$1,756
Operating Cash Flow	$1,506*	$1,356	$1,083	$1,197	$814
Free Cash Flow	$1,350*	$1,196	$925	$997	$651
Total Trading Volume	3,385,000*	3,078,149	2,584,891	2,978,459	2,249,632

Figures in millions.
*Estimated. Estimates based on these facts: 2011 operating income grew 11% and trading volume grew 10%, while capital expenditures were $156 million. Sources: 2010 CME 10-K filing, 2011 year-end CME earnings release, S&P Capital IQ, and analyst estimates.

With $18.3 billion in market value, shares trade at an estimated 13.5 times free cash flow. Our conservative fair-value estimate is nearly 20% higher, resulting in a price of 15.6 times free cash flow. This assumes continued healthy gains in Europe and single-digit volume growth in the U.S., but no income from China or Latin America — that potential growth is all upside.

Management affirmed confidence in its free cash flow Feb. 2 by increasing its quarterly dividend 59% to $2.23 per share and adding a one-time $3-per-share dividend payable in March. In a new policy, CME will assess its cash position every January and announce a special dividend if merited. CME's aim is to return more cash to shareholders and maintain a yield that attracts more investors. As of last week, the stock yields 4.6% (including the annual dividend), double last year's average yield.

What Would Make Us Sell

CME's competitors include:

- **NYSE Euronext** Liffe Clearing
- Eurex, in Europe
- **IntercontinentalExchange**
- **Nasdaq OMX**
- LCH.Clearnet
- Electronic Liquidity Exchange (ELX), launched by 12 financial institutions in July 2009 to trade Treasury futures
- Interbank Market, a giant, private, decentralized futures exchange system used by institutions

CME runs the largest public market for futures trading, and it doesn't compete directly with any single competitor across all its product offerings. Instead, it competes in various (but still not all) product lines with the competitors listed above (and others). With Europe now blocking **NYSE Euronext**'s acquisition of Deutsch Boerse, merger activity is likely to slow. This is good news for giant CME, which would rather have smaller competitors. Management says it took market share from its three most direct competitors (the first three listed above) in 2011, but if CME's trading volume enters a lasting decline, we'll have to consider selling.

In addition, we'll keep a close eye on regulatory issues. The Dodd-Frank Wall Street Reform and Consumer Protection Act promises tighter regulation of futures trading, and although CME is ready for this (and believes parts of the bill will actually provide it new opportunities), the Act could still crimp trading volume or increase costs if it isn't implemented smartly. CME continues to partake in discussions with lawmakers. If any new regulations demand that trade clearing activities be completed by independent entities, we would need to sell.

The recent debacle involving bankrupt brokerage MF Global also remains a serious concern. CME was MF Global's auditor, and its reputation has been damaged; although management has taken steps to repair investor trust, this story isn't over yet. Futures volume was dinged industrywide when MF Global, which was a futures giant, went belly up. Trading volume at CME began to recover in January, but if trust in CME's marketplace diminishes permanently, or if its competitive position weakens, we would move to sell.

Pro's Bottom Line

Next Steps

- Visit our CME Group discussion board to ask us questions or discuss it.
- Add CME Group to My Scorecard.

CME is a strong business at a good price. Volume in options trading has grown steadily for years, and we believe trading volume in futures contracts is likely to do the same as investors, corporations, producers and manufacturers seek more ways to manage risk — whether it's commodity risk, currency risk, energy costs, or interest rate risk (and higher interest rates in the future are one catalyst for more volume). Meanwhile, we expect CME to lead its industry with new offerings and to continue to expand in new markets.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Video Extra: Inside Pro

Published Feb 7, 2012 at 12:00AM

Jeff, Nick, and Bryan discuss the *Pro* portfolio, their individual investing backgrounds, and why they think *Pro* is poised to help members achieve absolute returns. Watch below, and if you've got questions or comments, bring them to our Philosophy & Strategy discussion board!

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Transcript

Jeff Fischer, advisor: I started investing young as an interest, and realized early on that it's one of the best ways to grow your financial resources and independence, without a doubt. I think that's why most of us get into the stock market. We are not there to just get by; we are there to get ahead.

Pro has a very steady approach because we buy equities for the long term. We are buying great companies for the long term. We go into those knowing, Hey, we want to own MasterCard, say, and we want to compound with it the next five to ten years, as long as the stock is worth owning. So we have long-term stocks, and we complement those with short-term options where we are making income typically every month. All of us have it, this need for short-term gains. Options do that perfectly, and that lets us own our stocks for the long term then.

Then we also have hedges and shorts, which profit in down markets, which means we are not so prone to panic during down markets because we have positions, shorts, hedges and options, that are making money in the down market. We then harvest that profit and reinvest it into stocks that are cheaper.

Bryan Hinmon, CFA, analyst: When I am choosing a stock for *Pro*, I look for three things. First I look for a good business. It's a heck of a lot easier to invest in good businesses than bad businesses because you don't have to always make sell decisions. The second thing I am looking for is good management, and really with management what I am concerned about is how are they incentivized? Do they think long term, do they act long term and are they incentivized for long term? The third thing I am looking for is a variant perception. When every transaction is made, there is a buyer and a seller, and over time one person is proven right and one person is proven wrong. So when I come to the table to take one of those buy and sell transactions, I want to have a well thought out reason to know why I am not the patsy in that transaction.

Jeff Fischer: I began to use options more than 10 years ago to generate steady income, and I found them to be the perfect complement to a long-term stock portfolio, and that's why *Pro* uses them. They are great for income, they are great for leveraging returns and they are great for protecting what you already have.

We also use ETFs because they are a good way to get into certain sectors or areas that just a few years ago were virtually impossible to get into. Commodities, for instance, or if you wanted to easily buy into Brazil or Singapore or Malaysia, there's an ETF there for that, and to also make money on volatility.

Nick Crow, senior analyst: But in general, we like businesses with recurring revenue streams. They are more predictable over time, which allows us to get a tighter evaluation on it, and it increases our confidence in the overall business, but we like businesses with durable competitive advantages, so that recurring revenue stream that we are so attracted to, we have higher confidence that that will be sustainable over a long period of time and we can keep that stock in the portfolio for three, five, 10, 15 years, and keep that compounding machine to reward our members over the long term.

Bryan Hinmon: The thing that makes the three of us work really well together is that we complement one another. Nick is calculated and data-driven, Jeff invests from the gut, and I am somewhere in between. Each of us approaches every company from a little different manner.

Nick Crow: I am a more skeptical investor than either Bryan or Jeff. You give me any piece of information and the first thing I am thinking is one, is this in fact information or is it an anecdote? Will it continue? Where are the holes in this? What's the worst thing that can happen? That's my first look at any stock; so incredibly skeptical about everything.

What that allows me to do relative to the other guys would be just I pick up more risk factors, both in their picks and in mine, probably slows down the process too. Whereas Jeff's more optimistic, and so he will go ahead and find stocks and really see the future promise in it over a long period of time. If you put those two things together, someone very skeptical with someone with a great vision for the future, you can have a very well-rounded pick that makes it through both those filters.

Bryan on the other hand, he carries a bit of both of those, but also just a great brain for financial analysis and just finding new metrics to look at, but one more lens to overlay on our analysis. So as a team, I think we are incredibly strong at picking stocks.

Jeff Fischer: I made my first investment in 1987, the day after Black Monday when the S&P fell more than 20%. I was only 17 at the time, but I had been following markets since I was about 12, and charting stocks and reading about investing. And I had worked as a caddy, and then on the maintenance crew at a golf course near my parents' home, near the home where I grew up outside of Chicago. So I had some money saved and I had a brokerage account open, and the day after Black Monday after the market crashed, I went and bought my first two stocks.

It worked out really well for one company. It was CitiGroup and the other company went bankrupt. It was a small Florida real estate firm that I bought simply because I like the tropics in Florida and I thought, oh, it would be great to own some real estate in Florida. It was a $3 stock.

Bryan Hinmon: I got into investing as a kid. I used to collect baseball cards. The correlation really between baseball card trading and investing is you are really at an advantage if you are able to remove emotion from the situation. So with baseball card trading, my friends were always partial to the players that were on their favorite teams, but this didn't really play into the determination of the value of the trading cards. It was the players' performance that mattered.

Nick Crow: So my first memory of investing was eighth grade. It was a stock-picking contest where we could win a pizza party if we had the best portfolio. So I had a thousand dollars, could pick stocks to bet and I won that contest, but really what resonated with me was the fact that it took very little work relative to my paper route at the time, or refereeing soccer, so I could make money with the money that had already accumulated. That was a new concept for me and was like, wow, this is powerful.

I feel very strongly about the *Pro* portfolio. I think that we could withstand a tumultuous market and do very well as the economy improves in the U.S. and around the world. We have got some leading companies there. And the flexibility through options and ETFs too, truly manage the portfolio no matter what happens. Of course, to some extent that we will fall with the tide as well, but we can mitigate that more than most.

Jeff Fischer: The purpose is very specific. We are here to help Fool members make money and have better financial lives, and just be financially smarter as a whole. It's very easy to get up every day and know that's why you are coming to work, to help people improve their lives.

Bryan Hinmon: Deep down, what really drives the three of us is the passion to learn about business and the passion to help our members take control of their financial lives. You can see that in the way the team interacts with our membership base and it's really a joy and a pleasure to work alongside them, towards that central goal.

Jeff Fischer: Every day there are members helping members. Every day the team is out there helping members, so if you have a question and you post it, it's rare that you don't have an answer within 24 hours, an answer to your specific question. We are here to help Fool members make money and have better financial lives, and just be financially smarter as a whole. It's very easy to get up every day and know that's why you are coming to work, to help people improve their lives.

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3 Things Important to Pro

Published Feb 6, 2012 at 12:00AM

Fellow Fools:

These three things are of lasting importance to *Pro*, and to members, as we all invest together.

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock listed on the Recommendations page.

- **Intel**: "Sell to open" July $24 puts, lately above $0.80, for up to 6.7% in shares if you lack this allocation. Sell one put for every 100 shares you could buy.
- **Pacer International**: Sell to open September 2012 $5 puts for $0.45 or higher, for up to 3% in shares.
- **Plum Creek Timber**: Sell to open August $35 puts for $1 or more, for up to 3% of your portfolio (you'll need to select "view all strike prices" to see these puts).

Questions on these? Visit our "Catch-Up Trades" discussion board.

- Our mission, philosophy, and North Star
- What we believe as we invest
- How we think about and measure returns

I call these *Pro*'s Trifecta, and you'll see us refer back to them often. More details are available about the first two through the links above, and we'll flesh out the third, our returns philosophy, in an upcoming article. We'll then put all three together into one document for you, to serve as a one-stop reference point for the foundation upon which *Pro* is built.

Our Mission, Philosophy, and North Star

Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to meaningfully increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years.

In other words, our mission is absolute, positive returns, whatever the market does. We would prefer positive returns each and every year, of course, but we focus *more* on achieving results over every rolling three-year period. This is more "controllable," and more importantly, it will lead to better decisions on our part than managing for just one-year returns.

Our philosophy espouses that you can't live on relative returns (returns relative to a market index — especially true when that index is flat for 10 years) and that you don't want to draw funds early from your stock holdings. You want to let your stock investments compound. So we use options for short-term gains and income, and we use shorts to hedge and potentially earn intermediate-term gains we can then reinvest after the market has slipped.

Our North Star is our guiding light; it's what we aspire to. Measured as inflation (CPI-Urban, including food and energy) plus 7% a year, the North Star has gained 11.4% annualized since 1970, and has never had a negative year. Its worst year was 7.1% growth in 2008. If we can keep losses to a minimum and follow our North Star, let alone rocket past it, we'll do extremely well.

What We Believe

What we believe about our world, specifically the business world, directs where we invest. Our list of beliefs is a living document; it will be steadily refined following last week's introduction. We have more beliefs to add and others to tweak, and we intend to keep these beliefs front and center so we can be certain our investments follow our convictions. You might want to consider creating your own list at home: Write down what you believe, then ask yourself if you're invested in your strongest beliefs.

How We Think About and Measure Returns

Pro Trade Roundup

- **SPDR S&P 500**: Bought to close 835 short shares, one-third of our position. We remain 15.8% short in these shares.

Guidance Updates

- **Rockwood Holdings** moves down to Buy due to price.
- We are raising **MasterCard**'s Fair Value estimate to $425.

On our Recommendations tab (which shows you our portfolio), the table below our holdings will always feature our returns since inception, over the last rolling three-year period, and year-to-date. In a future article, we'll provide more color about our returns, including our desire for less volatility, our best and worst months, how correlated we are to the market, and more. We want to avoid large drops in portfolio value, but at the same time, we don't view 10% declines in the market as meaningful or easily maneuvered around. We focus on protecting against potential market moves that are larger than that.

Buy First, Buy, and Hold

Finally, as new members get started and veteran members stay current, all *Pro* Fools should keep in mind that our Buy First, Buy, and Hold guidance is always up to date on the Recommendations page. And this guidance is king! If we think something can be bought today, it's listed as a Buy First or Buy. Remember, our "Buy Around" guidance has flexibility. New members have already seen our Buy First stocks to purchase, and four Buys to start with as well.

We'll be sending more soon, but take your time. If you don't feel ready, just remember that investing is a marathon, not a sprint, and that we'll always have several active buys and new ones on the way. We'll also help you to potentially buy some stocks on Hold at lower prices by writing simple put options for income with our "Catch-Up Trades" displayed in every Monday Memo. (To get more information about any holding, click its ticker on the Recommendations page or head over to its dedicated discussion board.)

Many *Pro* companies are reporting earnings right now; we'll post our analysis of the results on each company's discussion board, and we'll highlight them in these Monday Memos, too. If you're getting started with us this week and have questions, drop by our Getting Started discussion board. Thank you for being a *Pro* member!

Foolishly,

Jeff Fischer (TMFFischer)

Community

- Meet and greet new members on the Meet & Greet board, or help them get started on the Getting Started board!
- Want to talk about *Pro*'s philosophy?
- Questions about the North Star? Visit the North Star board.
- More earnings on the way! Visit our Calendar board to get release dates, or see your *Pro* calendar under our Alerts & Coverage tab.
- Fools discuss how they use *Pro* and *Motley Fool Options*together.
- Nick (TMFCrow) reviews MasterCard's fourth quarter.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Your Downloadable Guide to Pro's North Star

Published Feb 6, 2012 at 12:00AM

Dear Fellow Fools,

Download!

Click here to download the
PDF.

Since *Pro* opened its doors on Oct. 7, 2008, absolute returns have been our goal. We've crafted a portfolio with that goal in mind, we've worked to educate members on what an absolute-returns strategy is all about, and we've detailed our aim to earn you consistent, recurring profits with a high level of accuracy.

But how do you know how well we're doing? What exactly is guiding our investing behavior, and what should guide it? Can we quantify consistent profits in a way you can measure?

Today, we are proud to share with you *Pro*'s North Star — a way to answer those questions and provide that quantifiable information. It also serves as a guiding light for the decisions we make at *Pro*. In this document, we'll first explain *Pro*'s mission, then tell you how the North Star helps us achieve it. (We've also included a "cheat sheet" at the end for quick reference.) Enjoy, and bring any questions to our North Star discussion board!

— The *Pro* Team

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3 More Buy Stocks and 1 Income Position

Published Feb 3, 2012 at 12:00AM

Dear *Pro* Fool,

Haven't Bought our Buy Firsts Yet?

If you're new to *Pro* and haven't yet caught up with our Buy First stocks, please do so before moving on to this report!

But I'm Already Fully Allocated, and I Have an IRA ...

No worries: *Pro* is here for you. Check out our Making *Pro* Fit You guide for expert advice on how to make our portfolio work for your individual situation.

To get you started investing with *Pro*, we recently provided you with our current thinking about our five Buy First stocks and advised you to buy each in the allocation suggested. As the next step in this journey toward profit, in this report we offer three more *Pro* Buy stocks you can purchase today and one "strangle" stock that we're using options on for income.

The allocations we suggest below will match you exactly to the *Pro* portfolio's current allocation in each holding. Realize that we're likely to later increase allocations on any position that is currently less than 3% (because we want to stay focused and make each position count), but we'll issue new trade alerts before we take any such action. For now, we assume you've already caught up with our Buy Firsts, and we suggest you continue by matching what we currently own in each Buy-rated *Pro* position, starting with these three.

We may use options in the future on any position, so buy in round 100-share lots if possible — but do realize this isn't mandatory. Do what's best for your portfolio. Finally, if you're not using options yet, you can bypass the final recommendation below, which includes options. You can start to use options when you're ready. If you have questions, visit our Getting Started discussion board!

— Jeff Fischer (TMFFischer)

3D Systems

- **Industry:** 3-D printers
- **Share price:** Low $20s
- **Allocation:** Invest 1.8% of your funds ($900 for every $50,000 you manage)
- **Full report:** Buy

3D Systems is working to change the world. Selling printers that actually print perfectly usable 3-D objects — from replacement kidneys to car dashboards — the company could both revolutionize and personalize manufacturing. Its latest award-winning printer, Cubify, is for retail customers who wish to print jewelry (or shoes, or toys … you name it) right at home based on designs they can find online or create themselves. The stock may be a growth story, but 3D Systems is already making a nice profit selling its machines and printing materials. We have a small stake now and may look to add more after seeing earnings in mid-February.

GrafTech International

- **Industry**: Carbon and graphite products, focused on the steel industry
- **Share price**: Mid-teens
- **Allocation**: Invest 4.2% of your funds ($2,100 for every $50,000 you manage)
- **Full reports**: Buy; Buy More

GrafTech International is the low-cost producer of high-quality graphite electrodes, which steelmakers use to melt and form the steel they use to build our world. Demand for steel continues to be driven by growing infrastructure in emerging markets and a rising global middle class, and as more steely things (like cars, planes, and buildings) are produced, we believe steel producers will be popping graphite electrodes like Tic-Tacs. GrafTech is well-positioned to feed their need.

WisdomTree Emerging Markets SmallCap Dividend Fund

- **Industry**: Diversified international ETF (industrials, financials, consumer discretionary)
- **Share price**: High $40s
- **Allocation**: Invest 2.5% of your funds ($1,250 for every $50,000 you manage)
- **Full report**: Buy

We believe emerging markets have growth potential that makes their extra risk acceptable. To pursue this belief while guarding carefully against that risk, with this investment we've chosen to buy a basket of growing emerging-market companies that are financially sound enough to promise a healthy dividend. The **WisdomTree Emerging Markets SmallCap Dividend Fund** offers us not just a yield but also ownership in a few hundred small, growing, and promising companies in countries including South Korea, Malaysia, India, and Brazil. Given all that, it's easy to see why we like this ETF for the long haul. It's also a great way to diversify. We may add to our position in the future, but right now buying 2.5% will match us.

Wells Fargo & Company With a Covered Strangle

- **Industry:** Diversified financial company
- **Share price:** Low $30s
- **Allocation:** Invest 2.5% of your funds ($1,250 in WFC for every $50,000 you manage). That's half of a potential 5% allocation.
- **Full Reports:** Buy; Write Covered Strangle

Having just completed the largest merger in banking history, **Wells Fargo** now boasts 6,239 retail banking locations and the highest customer-service rating in the industry. We expect management to continue to "out-local the nationals and out-national the locals" by providing the breadth of service expected of a major bank while building the relationship depth expected from a community bank. We predict the stock will stay in a wide range as the financial industry continues to recover over the next few years; while that happens, we own half a full potential allocation in Wells and have set up an options position on it — writing a strangle — in hopes of regular income with stock upside. So:

1. Buy 2.5% of a potential 5% allocation in WFC stock around $30ish, in 100-share round lots.
2. Use a "strangle order" to "sell to open" April 2012 $27 puts and April 2012 $31 calls, one of each option for every 100 shares you own, lately for a **combined credit** of around $1.78 per share.
3. This position will be profitable if the stock remains at or below $32.78. It gives us about 5.8% in a potential income yield in just over two months, and it provides 5.8% in downside protection, too. We'll take that!

The strangle above is different from our earlier official recommendation (we currently have lower strike prices, because we set ours up earlier), but in April we'll "roll" to a new strangle and everyone will be on the same page. This is the best trade for today.

Pro Summary

By purchasing shares in 3D Systems, GrafTech International, and WisdomTree Emerging Markets SmallCap Dividend Fund — and setting up a covered strangle on Wells Fargo if you're ready for options — you've made another step toward investing profitably with *Pro*. We'll see you again soon to take the next step. In the meantime, we also have brand-new trades in the works for all *Pro* members as we invest for steady profits over the coming months and years. Watch your inbox! And if you have questions as you get the ball rolling with *Pro*, please visit our Getting Started discussion board. Fool on!

— Your *Pro* Team

Jeff Fischer, Advisor
Nick Crow, Senior Analyst
Bryan Hinmon, CFA, Analyst

Making Pro Fit You

Published Feb 1, 2012 at 12:00AM

Dear Fellow Fool,

Prefer to Print?

Download a PDF copy of this report here.

We manage the *Pro* portfolio using a wide range of tools — including long and short stock, option, and ETF strategies — to earn absolute returns with reduced volatility. But we know no two members have identical investment situations, and that means not all members will have access to every portfolio strategy. That's where this report comes in. Its purpose is to help you find the best way to use *Pro* according to your individual situation.

We'll address four possible scenarios in detail. You may find that more than one applies to you:

- **Free-Range:** For members with free range to employ all the same tools as *Pro*.
- **IRA:** For members building a portfolio in an IRA account.
- **No Complex Options:** For members who lack broker permission to execute complex options strategies.
- **Old Fool, New to *Pro* / Fully Invested:** For members joining *Pro* from another Fool service or members who are already fully invested.

Whatever your situation, we recommend all members first read the "Free-Range" section. Bring any questions to our discussion boards, and Fool on!

— The *Pro* Team

Free-Range

So you're new to Pro *and able to follow every* Pro *portfolio move to a T? Here's what to do. (Again, we recommend you read this section even if you are not entirely "free-range.")*

As You Get Up to Speed
Match our portfolio positions and allocations, starting with the Buy First and Buy positions — and do so at your own pace. We recommend following along with our Buy Firsts today, or as soon as you get comfortable with the positions. You can also match our positions in all of our Buy stocks, or you can wait for summary instructions from us over the next couple of weeks. If you're comfortable with options, you can consider writing puts to try to buy some of our Buy stocks cheaper. Post on the discussion boards to get the community's feedback about any trades before you make them, if you like. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions. You can find a review of our most timely entry strategies for positions on hold in the "Catch-Up Trades" section in every Monday Memo.

Once You've Settled In
Once you've built your Buy First and Buy positions, all you need to do is wait for further trade alerts from the team. Remember, though, that trade alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want. You may decide to modify the strategy we choose for a trade; for example, you may wish to write puts instead of buying a stock outright. If you choose to deviate from our recommendation, make sure you (a) understand why we chose the strategy we did, (b) have a reason that the modified strategy better fits your portfolio, and (c) exercise caution by sizing the position a bit smaller than you would otherwise.

Your *Pro* Perspective
The most important thing to remember is that *Pro* is a portfolio service, not a collection of investment ideas. All of our positions exist in the context of our portfolio; if you elect to pick and choose *Pro* investments, it is critical that you understand how they fit into your portfolio. Our trades are intended to integrate with existing positions and to form a portfolio of assets that keeps our North Star firmly in mind.

IRA

IRAs are tax-advantaged accounts that usually prohibit shorting and all but the simplest of options strategies.

As You Get Up to Speed
Learn about our Buy First stocks and buy them, well, first. You can buy our Buy stocks right away as well, or you can build positions as you're comfortable. (There's no rush; we'll communicate with you about these stocks during the first couple of weeks of your membership.) Some IRAs don't allow put writing (though many do, if they are cash-secured), so you should simply purchase shares of these positions over time. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions. Keep an eye on the Catch-Up Trades section of each Monday Memo for timely ways to enter our positions on Hold.

Once You've Settled In
You can follow our simple stock-buying trade alerts directly. Most IRAs allow you to write covered calls, so you can also follow those trade alerts directly. Check with your broker to see if you have permission. Other options trades may not be possible in an IRA. In that case, check the trade alert for a list of alternate trades; for example, when we write puts to try to buy shares of Stock X more cheaply, you might be able to simply buy shares of Stock X. (If there are no alternate trades, we'll say so.) As for shorting, some inverse ETFs can be purchased in IRAs (purchasing an inverse of something is similar to shorting that thing). As with options, we'll mention these alternatives in the trade alerts if they exist and we approve of them.

Your *Pro* Perspective
IRAs are tax-deferred accounts, so they're great for income-generating strategies like covered calls, high-yield dividend stocks, and ETFs with large taxable distributions. They do have limitations, though, and you may find that the inability to follow all of our recommendations leaves a hole in your portfolio. If that's the case, you may be able to fill the gap with additional income-generating strategies — for example, by writing covered calls on *Pro* stocks you'd be willing to sell at your strike price.

An Important Note About IRAs

Their tax-deferred status means that IRAs are not great for high-risk, high-reward trades — losses in an IRA cannot be used to reduce the taxes on other gains. And because IRAs do not allow the use of margin or shorting, you will likely find it difficult to follow along with most of our hedging strategies using only an IRA account. If that's the case for you, we recommend keeping an eye on both your cash balance and *Pro*'s hedging strategies. When the *Pro* portfolio adds hedges, increase your cash balance; when we pull hedges off, reduce your cash balance by investing more in our Buy and Buy First Stocks. Consider opening a separate non-IRA account if possible. You can then manage both your IRA and non-IRA accounts as a single portfolio, with income-focused and shorter-term strategies in the IRA and more complex, speculative, and short trades in the second account.

No Complex Options

You need permission from your broker to undertake complex options strategies, which not all members have upon joining. Here's what to do in the meantime.

As You Get Up to Speed
Follow along with our "Free-Range" instructions for getting up to speed — match our portfolio positions and allocations, starting with the Buy First and Buy positions. Make sure you do so at your comfort level. If you're comfortable with options, you can consider writing puts to try to buy some of our Buy stocks cheaper. Post on the discussion boards to get the community's feedback about any trades before you make them, if you like. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Once You've Settled In
You can follow most of our trade alerts directly — except, obviously, those involving complex options strategies. In those cases, there's often a simpler alternative, such as writing puts, writing covered calls, or buying or shorting a stock or ETF directly. We outline possible alternatives in every trade alert. If we issue a trade alert using an income-generating strategy you're unable to employ and there are no workable alternatives, consider using the strategies you do have at your disposal to generate income elsewhere in your portfolio.

Your *Pro* Perspective
First of all, you should continue to request higher options permissions from your broker every couple of months until they are granted. Account size is one factor brokers consider when making this decision, so to up your odds of success, consider consolidating accounts or moving funds to the account in which you wish to trade options.

In the meantime, don't lose sight of the big picture; remember that we're building a portfolio. If you can't make a particular options trade, you may be able to make an alternate trade or you may need to sit that trade out — either way, it's no big deal. That said, you'll want to pay particular attention to any trade alert in which we use options for hedging purposes (for example, a synthetic short or a ratio put spread on an ETF or an index). Trades like these are important to our integrated portfolio, so don't ignore them. If alternatives are available, we'll outline them. If not, you may want to take action elsewhere in your portfolio to meet similar goals. For example, one way to accomplish this would be to raise your cash position by trimming a few holdings. As always, hit the discussion boards with questions about any particular situation.

Old Fool, New to *Pro* / Fully Invested

Members joining Pro *from another Fool service and those who are already fully invested will need to consider changes to both their portfolios and their mindsets.*

As You Get Up to Speed
If you're already fully invested, you'll need to sell existing positions to add *Pro* picks. We recommend that you do this gradually and deliberately.

- List your existing positions in order from your highest-conviction holding to your lowest-conviction holding.
- If you own stocks from another Fool service, you can use that service's guidance on those stocks in building your list.
- If you don't know why you own a stock, that's a good reason to sell it.
- Be mindful of your sector and geographic allocations. You don't want to unintentionally end up owning nothing but oil or European stocks just because they were your favorites.
- If you're struggling with what to sell, post to the discussion boards — the *Pro* team can't give you individual advice, but our community members can and frequently do.
- When you're ready, incrementally sell your lowest-conviction stocks and use the proceeds to move into our Buy First and Buy stocks. Keep an eye on the Catch-Up Trades section of each Monday Memo for timely ways to enter our positions on Hold.
- Review your positions and portfolio after studying *Pro*'s mission and reviewing our North Star. Use that analysis to craft your portfolio going forward.

Once You've Settled In
Follow the "Free-Range" instructions for this step — once you've built your Buy First and Buy positions, all you need to do is wait for further trade alerts from the team. Remember, though, that trade alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — one gradual step toward shaping the portfolio we want. You may decide to modify the strategy we choose for a trade; for example, you may wish to write puts instead of buying a stock outright. If you choose to deviate from our recommendation, make sure you (a) understand why we chose the strategy we did, (b) have a reason that the modified strategy better fits your portfolio, and (c) exercise caution by sizing the position a bit smaller than you would otherwise.

Your *Pro* Perspective
If you're joining us from another Fool service, it is critical that you understand the differences between *Pro* and some other Fool services. At *Pro*, we are building a portfolio, not offering investment ideas. *Stock Advisor* and *Rule Breakers*, for example, offer stock ideas from which members can pick and choose. In contrast, *Pro*'s trades are intended to be integrated building blocks of an overall portfolio. We cannot emphasize this enough: Anytime you decide to deviate from the *Pro* portfolio, make sure you understand how the trade in question is intended to fit with our portfolio — and how the modified trade will fit with yours. With every trade, keep the portfolio context in mind.

Further Resources

Get in the Right Mindset: What is the *Pro* Way?

- Introducing *Pro*'s North Star
- North Star Chat Transcript

Learn Your Way Around: Settle In and Get Started

- How *Pro* Works
- Go-To Resources From the *Pro* Team
- Introduce yourself! Discussion boards

Unleash the Beast: The Next Steps

- Our Buy First Stocks Today
- Get Up to Speed With Options

Video: How Pro Works

Published Jan 31, 2012 at 12:00AM

You need to have the Adobe Flash Player to view this content.
Please click here to continue.

Watch this video for a quick introduction to *Pro*

- **Buy:** 5% of **Oracle**; 3% of **The Buckle**
- **Catch Up:** Match your portfolio to *Pro*'s
- **Read:** Learn to think like a Pro

How Pro Works: Video Transcript

Published Jan 31, 2012 at 12:00AM

Watch this quick introduction from Jeff to learn more about the *Pro* site and all the exclusive resources that are now at your disposal.

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Transcript

Jeff Fischer: Hello and welcome to Motley Fool *Pro*. I am Jeff Fischer, Motley Fool *Pro*'s lead advisor, and I am very pleased that you have joined us. Our mission at *Pro* is to make you money in up, down, and sideways markets by teaching you how to implement a variety of smart investment strategies. I'd like to take a few minutes to familiarize you with the service and help you get started.

The first thing you'll want to do is get to know *Pro*. Visit our Getting Started Guide to learn more about our investing philosophy and what to expect as a new member, including how to set up your brokerage account and when to expect updates and trades. We'll also show you how to jump right into investing with Motley Fool *Pro*, as well as our take on investing with options. If you are new to options, we highly recommend our Options for Beginners handbook to get your crash course on this profitable strategy.

When you are ready to invest, check out our portfolio and read more about our Buy Firsts and our Buys. For each recommendation, you will get our full analysis, buy-around pricing, target allocation and much more. Every company we recommend has its own detailed snapshot, which includes our full recommendation, history, performance data and an archive of everything we have written about that company. You can also add the company to My Scorecard with just one click.

With My Scorecard, you can track stocks in which you have open positions or that you simply want to keep an eye on. And that's whether they are *Pro* recommendations or not. Not only will My Scorecard track the movements of the stock, it will also pull in all relevant articles and community discussions on that company.

Finally, as you get acquainted with *Pro*, we highly recommend that you drop by our friendly community of investors just like you. Learn what our analysts and fellow *Pro* members are saying about our stocks, ask questions about our strategies and dig deeper into *Pro* investing. The team and I are on the boards frequently, so if you have any questions, this is a great place to get answers.

We encourage you to take your time getting familiar with *Pro* and to work at your own pace. We are here to help you every step of the way. And coming soon is New Member Orientation Week, where we'll go into detail about our service, our philosophy, how to trade like a pro and everything else you'll need to make the most of your new service. In the meantime, if you have any questions about our service, our investments or our strategies, feel free to post on the discussion boards. The entire *Pro* team, as well as a robust community of smart investors, is ready to answer your questions.

Thank you again for joining *Pro*. We look forward to profiting alongside you for many years to come. Fool on!

How Pro Works: Video Transcript

Published Jan 31, 2012 at 12:00AM

Watch this quick introduction from Jeff to learn more about the *Pro* site and all the exclusive resources that are now at your disposal.

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Transcript

Jeff Fischer: Hello and welcome to Motley Fool *Pro*. I am Jeff Fischer, Motley Fool *Pro*'s lead advisor, and I am very pleased that you have joined us. Our mission at *Pro* is to make you money in up, down, and sideways markets by teaching you how to implement a variety of smart investment strategies. I'd like to take a few minutes to familiarize you with the service and help you get started.

The first thing you'll want to do is get to know *Pro*. Visit our Getting Started Guide to learn more about our investing philosophy and what to expect as a new member, including how to set up your brokerage account and when to expect updates and trades. We'll also show you how to jump right into investing with Motley Fool *Pro*, as

well as our take on investing with options. If you are new to options, we highly recommend our Options for Beginners handbook to get your crash course on this profitable strategy.

When you are ready to invest, check out our portfolio and read more about our Buy Firsts and our Buys. For each recommendation, you will get our full analysis, buy-around pricing, target allocation and much more. Every company we recommend has its own detailed snapshot, which includes our full recommendation, history, performance data and an archive of everything we have written about that company. You can also add the company to My Scorecard with just one click.

With My Scorecard, you can track stocks in which you have open positions or that you simply want to keep an eye on. And that's whether they are *Pro* recommendations or not. Not only will My Scorecard track the movements of the stock, it will also pull in all relevant articles and community discussions on that company.

Finally, as you get acquainted with *Pro*, we highly recommend that you drop by our friendly community of investors just like you. Learn what our analysts and fellow *Pro* members are saying about our stocks, ask questions about our strategies and dig deeper into *Pro* investing. The team and I are on the boards frequently, so if you have any questions, this is a great place to get answers.

We encourage you to take your time getting familiar with *Pro* and to work at your own pace. We are here to help you every step of the way. And coming soon is New Member Orientation Week, where we'll go into detail about our service, our philosophy, how to trade like a pro and everything else you'll need to make the most of your new service. In the meantime, if you have any questions about our service, our investments or our strategies, feel free to post on the discussion boards. The entire *Pro* team, as well as a robust community of smart investors, is ready to answer your questions.

Thank you again for joining *Pro*. We look forward to profiting alongside you for many years to come. Fool on!

What Pro Believes

Published Jan 30, 2012 at 12:00AM

Fellow Fools:

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note, you can always buy any Buy First or Buy stock from the Recommendations page.

- **Pacer International**: Sell to open September 2012 $5 puts for $0.50 or higher, for up to 3% in shares.
- **Intel**: Sell to open July $24 puts, lately about $0.95, for up to 6.9% in shares if you lack our full allocation.
- **Wells Fargo**: Buy 2.5% of a potential 5% allocation in stock around $29 or lower, and use a "strangle" order to sell to open April 2012 $27 puts and April 2012 $31 calls, one of each option for every 100 shares you own, lately for a combined credit of $1.52. You must be new to this trade to make it, and you must make it by Tuesday's close to get the next dividend, which is why it's listed here today.

First, a big welcome to our new *Pro* members! We're glad you've joined us, and we look forward to great investing success with you. Our mission is to earn absolute returns in good markets and bad. We buy strong stocks for long-term compounding; we use options for short-term income and other strategies; and we "sell short" in an attempt to profit on intermediate-term declines in price. We also focus on profiting from ETFs, long or short.

Using these strategies, we aim to earn absolute returns by following our North Star: inflation plus 7% annually. The North Star has grown 11.4% annualized since 1970, it has never experienced a negative year (its *worst* was a 7.1% gain in 2008), and it will rise as inflation does. It's a guidepost, not a benchmark, and it's one we'd be happy to meet, let alone exceed. Currently, our North Star is running around 10.3% annually.

Our investment mission and our North Star guide our portfolio decisions. But our portfolio itself is a reflection of the *key beliefs* we have about the world and investing. In this Memo, we summarize what we believe and show the ways those beliefs come to life in the *Pro* portfolio through our investments. Just as interesting are our many beliefs that don't yet have a voice (or a position) in the portfolio.

The *Pro* Portfolio Reflects Our Beliefs

First, let's account for the beliefs we have that are already reflected by at least one *Pro* investment today.

We Believe …	So Our Portfolio Contains …
Technology is essential, and the sector has plenty of growth ahead. Hardware product cycles are short, so software has more advantages, but both merit attention.	**3D Systems** , **BMC Software**, **Ebix**, **Intel**, **OpenText**, **Oracle**
Strong financial companies are inexpensive today and will reward long-term owners.	**Amtrust Financial Services** , **Broadridge Financial Solutions**, **Wells Fargo**
Oil prices are not likely to fall below $70 a barrel, and may rise.	**Bristow Group** , **Vanguard Energy**
Activity in construction, manufacturing, and building (including homes) will recover in the U.S. and grow around the world.	**Autodesk** , **GrafTech International**, **Plum Creek Timber**, **Rockwood Holdings**
Emerging markets have growth potential that makes their extra risk acceptable.	**WisdomTree Emerging Markets SmallCap Dividend Fund** , **Tupperware**
Strong health-care companies are inexpensive today, and demographics (in both mature and emerging markets) will grow industry revenue.	**Medtronic**
Cash is losing the battle to electronic commerce.	**MasterCard**
The long-term stability of the euro is at risk because the eurozone lacks a fiscal union.	Short **CurrencyShares Euro Trust**
We need to generate steady income to follow our North Star and achieve our goal of absolute returns.	**StoneMor Partners** yield, **Expeditors International** butterfly, Plum Creek Timber and Wells Fargo covered strangles — and more spreads, put and call writing, diagonals, etc., are needed ahead
We need to be hedged or sell short to ensure some gains during a falling market.	Short **SPDR S&P 500** — for now, but evolving
Miscellaneous. (Some companies don't fit a single belief, but they're compelling investments for various reasons, including valuation, management, acquisition targets, etc.)	**Covanta** , **Pacer International**, **Papa John's International**, **Pebblebrook Hotel Trust**

Of course, several positions serve dual purposes. Autodesk reflects both technology and construction, but it's most correlated with construction, so it's listed there. Plum Creek Timber is both income (with dividends and options) and construction. Rockwood Holdings serves the auto market as well as manufacturing, housing, and construction — and Rockwood sells high-grade lithium for batteries, putting it firmly in technology as well. Covanta is in the waste *and* energy industries, but we're drawn most by management's desire to unlock value through share buybacks and larger dividends.

Qualifications like these aside, I hope the table gives you a good idea of how we're thinking. Just looking at it also reminds us of something we already knew: After the sale of two industry stocks last year, we're light on health-care companies and seeking replacements.

Now for the fun part. Here are some of our beliefs that are *not yet* reflected in the portfolio, so we're seeking possible investments.

Things We Believe … and May Want to Invest In

[*Pro* Trade Roundup]

- **BMC Software**: Bought 500 shares at $34.47, for 4% total.

- U.S. automobile sales will return to their normal upward trend line, while auto sales will continue to grow in emerging markets.
- Several young ETFs and ETNs are deeply flawed; we seek to short them on their weaknesses.
- Large consumer trends (in retail, tech, and restaurants) are lacking exposure in the portfolio, both long and short.
- Water management for people and agriculture will become increasingly important.
- Some European stocks look very cheap.
- Natural gas and alternative energy have vast potential, but relatively few companies will win big.
- Web security is a big deal for companies and individuals.
- The airline industry remains a poor choice for investors; we may seek shorts there.
- Agriculture (the growing and transporting of crops) will continue to grow in importance as more middle-income earners in emerging markets acquire more demanding food habits.
- Governments will seek new ways to save money and be more efficient.

With 21 beliefs above, we need to focus on the ones we believe in most — and, most importantly, on those that offer the most compelling investment opportunities. Then, over time, we need to assess whether we're over- or under-allocated to each belief and adjust from there. We want our dollars to reflect our strongest beliefs, the ones we think represent the best profit opportunities.

Finally, keep in mind that every belief above has a flipside. If we think there's a compelling investment somewhere, there may also be a compelling short that is fueled by the same belief.

What do *you* believe? What should we add to our list? Share your strongest investing beliefs on the *Pro* Memo Musings discussion board. Welcome again to new members and thank you to veterans! We look forward to our future together. Foolishly,

Jeff Fischer (TMFFischer)

Community

- Meet and greet new members on the Meet & Greet board, and help them get started on the Getting Started board!
- Nick (TMFCrow) summarizes — in great detail! — Wells Fargo results.
- More earnings on the way! Visit our Calendar board to get release dates, or see your *Pro* Happenings calendar under our Alerts & Coverage tab.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Reduce Your Market Index Short Position by One-Third

Published Jan 26, 2012 at 12:00AM

What We're Doing: We're reducing our short of the S&P 500 index by one-third.

What We're Thinking: We need to maintain portfolio discipline and limit losses on this position.

What We're Expecting: We'll gradually exit our index short in favor of targeted short positions on individual companies and other strategies.

Trade Essentials

- **Action:** Buy to close (or buy to cover) one-third of your short position in the **SPDR S&P 500**. For *Pro*, this means closing 835 shares.
- **Allocation:** We hedged 30% of our invested assets (excluding cash). We're moving this hedge down to 20% of our invested assets ($20,000 short for every $100,000 you have in long positions).
- **Limit Guidance:** You can buy to cover at the going price.
- **Alternative Trades:**
  - If you're short any equity index, or if you own shares of an inverse ETF, reduce those positions by a total of one-third, to follow our allocation guidance. (If you have questions, please visit our SPY discussion board.)

What's Changed?

- **Last trades:** In October and November, we shorted 2,500 shares.
- **Price change (as of 1/26/12):** An average loss of 9.4%.

Europe's debt crisis has yet to be resolved, but the U.S. seems to have avoided a double-dip recession for now. That fact has sent the market steadily higher since December. But we are *not* closing one-third of our S&P 500 hedge because we believe stocks will continue to go higher in the near term. We don't make short-term stock market guesses. Instead, we're beginning the process of closing this hedge for a handful of much more tangible, disciplinary reasons:

- Yesterday, this short reached a 9.7% loss for us. In our initial report, we said we'd look to exit if it moved 7% to 10% against us. We simply need to limit our losses, even if we might disagree with the market (many people grow their losses disagreeing with the market).

- Also yesterday, the Federal Reserve suggested that it would keep interest rates near zero for nearly twice as long as previously expected — all the way through 2014. By making money cheap (and punishing savers), the Fed is hoping to increase lending and push people's assets out on the "risk curve" — into stocks and other investments that pay a return. There's at least a chance this will help prop the market up.
- We sold our 5% position in **L-3 Communications**on Monday, and we're on track to sell our nearly 5% stake in **Ebix** via February covered calls. We do plan new buys, but as we decrease our long exposure and raise cash, we can dial down our hedges.
- We moved to a new broker last week (Interactive Brokers), so we now have a full new array of shorting possibilities that should serve us better than the SPDR S&P 500 ETF. We plan to gradually move to targeted shorts and continue using options to hedge.

Since Sept. 30, 2011 (just before we started to hedge with SPY), the *Pro* Portfolio has gained a healthy 14%. Being 30% hedged has cost us three percentage points in additional upside performance (and we'll lock in 1% of that loss by closing one-third of our short). That's a price we're content to pay during such an uncertain time, especially because our total portfolio — the only number that matters — has done well anyway.

How to Follow Along

Add up the value of your index short (or inverse ETF) positions. Compare that to the value of your long stock and long ETF positions (do not include your cash!). Decrease your hedge to just 20% of your invested assets. If you are around 30% hedged, as we are, you will simply need to close one-third of your short positions. Unless we fail to find ample new hedges, we will likely close the remaining two-thirds well before SPY's next ex-dividend date in mid-March. We will need to pay a 0.5% dividend on all of our short shares on Jan. 31 (the ex-dividend date was in mid-December) — that dividend will be deducted from our account.

The Foolish Bottom Line

Europe is still at risk of implosion as the Greek debt debacle drags on, and Italy, Spain, Portugal, and Hungary are paying onerous interest rates on new debt. Banks also aren't lending in Europe, and it's likely a recession is around the corner in many uncompetitive eurozone countries. The United States is also whistling past its fiscal problems right now.

However, when we considered this short in the context of a disciplined investment approach, we concluded it's best to close one-third of it as it bumps up against our loss limit. Also, now that we can short specific companies and flawed ETFs, we're likely to find better opportunities there. We'll close one-third of this position in the coming 30 days, following our 24-hour waiting period so members can act first.

Next Step: Questions about your shorts (or pants, slacks, or knickerbockers)? Seriously, visit our SPDR S&P 500 board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

New Member Orientation Live Chat

Published Jan 24, 2012 at 12:00AM

Hey, *Pro* Fool! Whether you're new here or you've been with us awhile, we want to make sure you know all there is to know (or, at least, all you want to know!) about the *Pro* service. Advisor Jeff Fischer (TMFFischer) and analysts Nick Crow (TMFCrow) and Bryan Hinmon (TMF42) will be answering your questions live from 2 to 3 p.m. ET on Friday, Feb. 10 — bookmark this page or set an email reminder below. See you then!

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Pro's Buy First Stocks Today

Published Jan 24, 2012 at 12:00AM

Dear New *Pro* Member,

Ready for Another Go?

If you're all caught up with these Buy Firsts, check out the stocks we suggest you buy next.

But I'm Already Fully Allocated, and I Have an IRA ...

No worries: *Pro* is here for you. Check out our Making *Pro* Fit You guide for expert advice on how to make our portfolio work for your individual situation.

Welcome to your premier investment service, *Motley Fool Pro*. Below are the five companies we believe you should invest in first with us. We expect each to create value that matches or exceeds 10% annualized returns, keeping up with the current pace of our absolute-returns North Star measure.

BMC Software

- **Industry:** Business software
- **Share price:** Low $30s
- **Allocation:** Invest 4% of your funds ($2,000 in BMC for every $50,000 you manage)
- **Full Reports:** Buy; Buy More

Selling to 81% of the Fortune 500 companies in the world, **BMC Software** provides software that lets corporate mainframe computers, computing clouds, databases, applications, and servers all work smoothly and efficiently together. Despite recent sales weakness, BMC expects earnings per share to grow about 9% in the year ending in March and operating cash flow to increase about 8%, to $825 million. Recently $33.50, the stock trades at only 6.8 times free cash flow and 10 times earnings — in other words, cheap. We see business improving and the stock returning to the $50s in time.

Medtronic

- **Industry:** Medical devices
- **Share price:** High $30s
- **Allocation:** Invest 5.5% of your funds ($2,750 for every $50,000 you manage)
- **Full reports:** Buy; Buy More

With more than 40,000 employees and $16 billion in annual sales, **Medtronic** is a global leader in the medical technology field. A few recent small missteps, tough competition, and uncertainty surrounding future regulation have left investors questioning the company's future growth. But at this price — less than 11 times coming earnings? C'mon. The company's growth is powered by its massive research and development budget, its impressive new product pipeline, and its excellent footprint in emerging markets. With the distribution and scale to win business, we think Medtronic is well positioned to grow.

Oracle

- **Industry:** Business software
- **Share price:** Upper $20s
- **Allocation:** Invest 5% of your funds ($2,500 for every $50,000 you manage)
- **Full reports:** Buy; Buy More

We recommend two large software providers among our Buy First stocks for a reason: They're inexpensive and they're strong businesses, with high recurring revenue, low costs, and gushing free cash flow. **Oracle** is the granddaddy of business software, and yet it's consistently among the fastest-growing software giants, too. Last quarter, some contracts didn't close as hoped, providing investors a lower buy price. We'll take it, and we suggest you do, too.

Pebblebrook Hotel Trust

- **Industry:** Hotel ownership
- **Share price:** $20
- **Allocation:** Invest 4% of your funds ($2,000 for every $50,000 you manage)
- **Full reports:** Buy; Buy More

CEO Jon Bortz knows hotels, so when he saw the fire sales taking place during the financial crisis, he came out of retirement to start **Pebblebrook Hotel Trust**. The company has since busied itself buying up cheap, marquee, luxury hotels in foreclosure and giving them new life. As Pebblebrook finishes renovating and revamping all the hotels it has purchased over the past 18 months, those hotels should become strongly profitable (as past ones have), and these profits should materialize into a growing dividend for shareholders. At the same time, Bortz continues to scout for new opportunities to acquire upscale hotels at temporarily cheap prices.

Rockwood Holdings

- **Industry:** Specialty chemicals, Tio2, lithium
- **Share price:** Mid-$40s
- **Allocation:** Invest up to 5% of your funds ($2,500 for every $50,000 you manage). Start smaller if a more volatile stock concerns you.
- **Full report:** Buy

The disc brakes in your car, the airplanes you fly in, the paint on your home, the fibers in your clothing, the batteries in your electronics, and the pharmaceuticals in your cabinet — even the packaging around your groceries — all may contain **Rockwood Holdings**' specialty chemicals and engineered materials. Rockwood Holdings runs several divisions that all lead in their respective niches, from advanced ceramics used for hip replacements to titanium dioxide for paints and coatings. Rockwood is also one of the world's largest producers of lithium for the quickly growing lithium battery market. This is a volatile stock, but trading at 11 times free cash flow, we're comfortable with its prospects.

Summary

Buying these five companies at our suggested allocation will mean investing about 23.5% of the funds you set aside for *Pro*. It's a healthy start, but one that also leaves you much more room for our coming new trades and our Buy stocks (expect a similar report on those stocks shortly). If you have questions, please post on the Getting Started discussion board. We look forward to investing success with you. Fool on!

— Jeff Fischer, Advisor

When Stocks Attack … in Groups

Published Jan 23, 2012 at 12:00AM

New Members, New Weekly Trades

Dear *Pro* members: Tomorrow (Tuesday, Jan. 24), ***Pro* will open its doors to new members** for the first time since August. The service will be open for one week, and we plan to get new members up to speed with the portfolio quickly, so we thank you in advance for any help you can provide our newest fellow investors on the discussion boards. Also, if you have any family or friends who could benefit from *Pro*, be sure to send them our way this week.

Also, we're excited to announce a new feature in your weekly Memo: **"*Pro* Catch-Up Trades."** Every week, when we see attractive trades, we'll share them in the Memo so members who are not already fully allocated to the position in question can follow along. (Assume that we, too, would be making these trades if we weren't fully allocated!) We hope the Catch-Up Trades will help you catch up with the *Pro* portfolio, or at least make money trying. We'll also single out stocks that have been freshly moved back to a Buy rating. Now, on to the Memo! — Jeff

Fellow Fools:

In last week's Memo, Nick wrote about levels of correlation among the stocks in the *Pro* portfolio. Analyzing correlation can help us improve portfolio decisions, and therefore performance, as we seek to earn absolute returns in various market environments. After all, if every stock we owned moved in lockstep, we'd have no hope in a down market.

As Nick showed, correlation on Wall Street has shown record strength since last August, negating some of the advantages of diversification, but we have several stocks in the portfolio that *aren't* closely correlated (as well as several that are). Let's talk through the implications of what we see.

The *Star Trek* Table

First, let's bring back Nick's colorful table. You'll remember it as the one that looks like it could double for the dashboard on a spaceship. Remember, the columns (or rows) that feature the most orange and red show positions that move similarly to most other stocks in the portfolio. The columns and rows with the most green, meanwhile, show our most independent movers — stocks more likely to trade their own way. (Click on the table to see a larger version.)

	BMC	ADSK	AFSI	BR	BRS	CVA	DDD	DGS	EBIX	GTI	INTC	LLL	MA	MDT	ORCL	OTEX	PACR	PCL	PEB	PZZA	ROC	STON	TUP	VDE	WFC
BMC	1.00	0.34	0.27	0.35	0.15	0.21	0.24	0.27	0.19	0.19	0.15	0.32	0.33	0.27	0.41	0.11	-0.17	0.24	0.03	0.40	0.14	0.03	0.33	0.15	0.06
ADSK	0.34	1.00	0.45	0.54	0.58	0.19	0.48	0.68	0.46	0.69	0.70	0.64	0.32	0.49	0.78	0.53	0.43	0.62	0.66	0.53	0.73	0.38	0.44	0.72	0.51
AFSI	0.27	0.45	1.00	0.23	0.36	0.34	0.35	0.42	0.20	0.36	0.35	0.34	0.23	0.21	0.44	0.52	0.15	0.29	0.27	0.35	0.50	0.02	0.39	0.35	0.25
BR	0.35	0.54	0.23	1.00	0.38	0.22	0.13	0.50	0.44	0.44	0.45	0.52	0.46	0.39	0.48	0.29	0.27	0.44	0.45	0.46	0.47	0.10	0.31	0.48	0.16
BRS	0.15	0.58	0.36	0.38	1.00	0.17	0.24	0.62	0.16	0.67	0.47	0.64	0.32	0.41	0.45	0.35	0.24	0.58	0.52	0.34	0.61	0.47	0.26	0.67	0.48
CVA	0.21	0.19	0.34	0.22	0.17	1.00	0.21	0.42	0.30	0.31	0.17	0.13	0.23	0.25	0.34	0.15	0.09	0.22	0.01	0.13	0.37	0.08	0.36	0.34	0.25
DDD	0.24	0.48	0.35	0.13	0.24	0.21	1.00	0.40	0.36	0.32	0.27	0.37	0.07	0.36	0.42	0.46	0.22	0.33	0.44	0.16	0.55	0.20	0.42	0.52	0.36
DGS	0.27	0.68	0.42	0.50	0.62	0.42	0.40	1.00	0.53	0.77	0.48	0.58	0.45	0.49	0.57	0.51	0.43	0.63	0.53	0.43	0.87	0.42	0.60	0.78	0.49
EBIX	0.19	0.46	0.20	0.44	0.16	0.30	0.36	0.53	1.00	0.31	0.37	0.29	0.28	0.34	0.35	0.33	0.24	0.32	0.49	0.34	0.45	-0.02	0.37	0.54	0.34
GTI	0.19	0.69	0.36	0.44	0.67	0.31	0.32	0.77	0.31	1.00	0.62	0.61	0.35	0.47	0.53	0.40	0.49	0.59	0.57	0.30	0.82	0.46	0.51	0.76	0.44
INTC	0.15	0.70	0.35	0.45	0.47	0.17	0.27	0.48	0.37	0.62	1.00	0.51	0.43	0.48	0.64	0.27	0.46	0.35	0.52	0.33	0.62	0.14	0.27	0.52	0.30
LLL	0.32	0.64	0.34	0.52	0.64	0.13	0.37	0.58	0.29	0.61	0.51	1.00	0.33	0.58	0.48	0.52	0.41	0.61	0.56	0.54	0.63	0.31	0.48	0.62	0.44
MA	0.33	0.32	0.23	0.46	0.32	0.23	0.07	0.45	0.28	0.35	0.43	0.33	1.00	0.34	0.34	0.05	0.01	0.46	0.03	0.33	0.43	0.13	0.41	0.38	0.09
MDT	0.27	0.49	0.21	0.39	0.41	0.25	0.36	0.49	0.34	0.47	0.48	0.58	0.34	1.00	0.45	0.18	0.45	0.55	0.48	0.41	0.49	0.11	0.40	0.56	0.49
ORCL	0.41	0.78	0.44	0.48	0.45	0.34	0.42	0.57	0.35	0.53	0.64	0.48	0.34	0.45	1.00	0.47	0.25	0.47	0.45	0.40	0.59	0.37	0.38	0.55	0.29
OTEX	0.11	0.53	0.52	0.29	0.35	0.15	0.46	0.51	0.33	0.40	0.27	0.52	0.05	0.18	0.47	1.00	0.21	0.33	0.59	0.27	0.54	0.20	0.34	0.58	0.11
PACR	-0.17	0.43	0.15	0.27	0.24	0.09	0.22	0.43	0.24	0.49	0.46	0.41	0.01	0.45	0.25	0.21	1.00	0.31	0.46	0.12	0.49	0.19	0.25	0.42	0.45
PCL	0.24	0.62	0.29	0.44	0.58	0.22	0.33	0.63	0.32	0.59	0.35	0.61	0.46	0.55	0.47	0.33	0.31	1.00	0.40	0.38	0.65	0.42	0.52	0.64	0.59
PEB	0.03	0.66	0.27	0.45	0.52	0.01	0.44	0.53	0.49	0.57	0.52	0.56	0.03	0.48	0.45	0.59	0.46	0.40	1.00	0.44	0.51	-0.05	0.07	0.69	0.49
PZZA	0.40	0.53	0.35	0.46	0.34	0.13	0.16	0.43	0.34	0.30	0.33	0.54	0.33	0.41	0.40	0.27	0.12	0.38	0.44	1.00	0.36	-0.01	0.28	0.43	0.34
ROC	0.14	0.73	0.50	0.47	0.61	0.37	0.55	0.87	0.45	0.82	0.62	0.63	0.43	0.49	0.59	0.54	0.49	0.65	0.51	0.36	1.00	0.44	0.64	0.84	0.55
STON	0.03	0.38	0.02	0.10	0.47	0.08	0.20	0.42	-0.02	0.46	0.14	0.31	0.13	0.11	0.37	0.20	0.19	0.42	-0.05	-0.01	0.44	1.00	0.31	0.36	0.26
TUP	0.33	0.44	0.39	0.31	0.26	0.36	0.42	0.60	0.37	0.51	0.27	0.48	0.41	0.40	0.38	0.34	0.25	0.52	0.07	0.28	0.64	0.31	1.00	0.46	0.43
VDE	0.15	0.72	0.35	0.48	0.67	0.34	0.52	0.78	0.54	0.76	0.52	0.62	0.38	0.56	0.55	0.58	0.42	0.64	0.69	0.43	0.84	0.36	0.46	1.00	0.49
WFC	0.06	0.51	0.25	0.16	0.48	0.25	0.36	0.49	0.34	0.44	0.30	0.44	0.09	0.49	0.29	0.11	0.45	0.59	0.49	0.34	0.55	0.26	0.43	0.49	1.00

Our Least Correlated Stocks

Among our greenest — or least correlated — stocks, you'll find these five:

- **BMC Software**
- **Covanta Holdings**
- **StoneMor Partners**
- **MasterCard**
- **Pacer International**

Pro Catch-Up Trades

For members lacking a position or a full allocation. Please note: You can always buy any Buy First or Buy stock on the recommendation page.

- **MasterCard**: Moved freshly to Buy. Purchase up to 3% in stock around $340 or lower (that's close enough to our $325 Buy Around price). Or, sell to open April $330 puts, lately $15 each, if a $31,500 position doesn't over-allocate you.
- **Intel**: Sell to open July $24 puts, lately above $0.90, for up to 5% in shares if you lack our initial allocation.
- **Tupperware**: Sell to open July $55 puts, lately around $3.20, for up to 3% in stock if you haven't matched our allocation.

Guidance Updates

- **Ebix** moves to Sell on price around $24 (we're aiming to sell via covered calls).
- **MasterCard** returns to Buy on price.
- **Tupperware** moves down to Hold on price.
- **Intel's** Buy Around moves up to $23.50 and fair value up to $27, but shares remain a Hold.
- **GrafTech** Buy Around moves down to $16.50, but shares remain a Buy.

Others, including **OpenText**, **AmTrust Financial**, **Ebix**, and **Papa John's International**, are more green than not, too. AmTrust and Papa John's gained nearly 40% last year while the typical stock was flat. Of course, **BMC Software** is down 39% since last summer (down 19% since we bought it), while most stocks are flat, so low correlation can manifest itself in both directions. But why are these stocks less correlated to the rest of the portfolio?

To get an answer, it may help to find a common bond between our stocks that *are* highly correlated.

Our Most Correlated Stocks

The stocks we own that have been moving together the most are:

- **GrafTech International**
- **Rockwood Holdings**
- **Autodesk**
- **Vanguard Energy**
- **Bristow Group**
- **Plum Creek Timber**
- **WisdomTree Emerging Markets SmallCap Dividend**

Surprisingly, former holding **L-3 Communications** belongs squarely in this "red" group, too. That defense contractor aside, what do all of these companies — from a software provider to a timber owner — have in common?

The answers are oil and construction.

GrafTech sells electrodes used in steel production, but oil is also such a key input in its costs that its product prices can be tied to the price of oil. Rockwood sells synthetic chemicals that compete with organic chemicals like oil, so demand for Rockwood products tends to rise as oil prices go up. Autodesk sells construction-related software, and ironically, construction is more likely to increase as oil prices rise, because rising oil prices suggest rising economic activity. Vanguard Energy is all about oil, as is oil-platform helicopter provider Bristow. And Plum Creek's timber is mostly used for construction.

WisdomTree Emerging Markets SmallCap Dividend ETF is the only holding on this list that doesn't appear directly tied to construction or oil prices. But looking deeper, we see that small companies in emerging markets are likely to excel when the economy is strong — and when the economy is strong, oil prices tend to trend higher.

That may be a tenuous connection, and stocks move for all kinds of reasons, but there's no arguing that oil prices are a common thread for *many* stocks on the market. We know that, but have we pinpointed it in our portfolio until now? Loosely, but not explicitly.

So Now What?

In general, when oil prices go up, so do these stocks (at least in recent years). And vice versa. In other words, we own seven stocks that appear more sensitive to oil prices than the others we hold. Knowing this, we may want to hedge them by taking contrary (and controversial) positions. For example, we could buy an airline stock, which should benefit on a drop in oil. Or we might want to short an oil-tracking ETF, a vehicle we know has flaws to begin with, and one that would hedge our results if oil falls.

Meanwhile, if oil goes up, we should make good money overall. But this makes an extra demand of us: We need to follow the oil industry closely, so we're not blindsided by much cheaper long-term pricing. Cheap oil prices would help construction, so companies like Autodesk and Plum Creek should still benefit, but Rockwood, Vanguard Energy, and Bristow would all likely face a harder road.

What's Covanta's Correlation?

I'll close today with Covanta, our "greenest" company (in a few ways). It gets paid to incinerate trash in urban areas and sells the energy thus generated. What a steady business, right? Trash is a constant, and so is energy demand. So why has the stock drifted lower since July, and why does it trade at only 7.6 times free cash flow?

Consider this: From nearly $5 last summer, natural gas has declined to just $2.47 per British thermal unit (MMbtu), hitting a 10-year low. Covanta's energy sales, which represent just shy of one-third of revenue, compete with natural gas on price. This is why the stock has followed gas prices down month by month. The good news is that so far, we own just one stock that moves with natural gas prices, and it (and therefore we) should benefit when gas prices recover. And don't you feel better just knowing the correlation?

Correlation is important not just to understand how your positions will move in relation to one another, but in relation to outside factors, too. With the knowledge it brings, we can find ways to hedge or leverage our information if we want to, add to positions if we think external factors are changing for the better, or sell if we don't.

Want to talk about the Memo? Visit the Memo Musings discussion board.

Pro Catch-Up Trades

Be sure to look up and to the right for our new Memo feature, *Pro* Catch-Up Trades. These trades represent ways to get on board with *Pro* positions you're lacking. We've opened a new board for it, too — you got it, Catch-Up Trades.

Foolishly,

Jeff Fischer

Pro Trade Roundup

- **Cisco Systems**: Sold to close 30 January 2012 $15 calls and bought to close 30 January 2012 $20 calls (closing our bull call spread) for a net credit of $4.85, or a 34% gain.
- **L-3 Communications** : Sold 1,000 shares at $70.67, ending our position at a 6.4% loss.
- **Pacer International**: Sold to open 58 June 2012 $5 puts for $0.35 each.
- **CurrencyShares Euro Trust**: Sold short 300 shares at $129.77 each.

Community

- Rayneufeld asks, "Add to **SPDR S&P 500** shorts now?" Jeff explains where we are on shorts.
- Earnings are heating up. Don't forget TMFMoosie's full calendar (and our "Happenings" calendar above).
- Alex Pape (TMFPapester) says "au revoir" and the *Pro* community shows its support. We'll miss you, Alex, but we know where you work.

- TMFJazzysay reports on his day spent with **3D Systems**. He was blown away.
- Looking for rain clouds? We've got plenty. Can Wall Street continue to climb a wall of worry? We'll take it either way.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Trade Alert Adjustment: CurrencyShares Euro Trust

Published Jan 20, 2012 at 12:00AM

- **What We're Doing:** We're shorting shares directly instead of setting up a synthetic short. Our strategy remains the same.
- **What We're Thinking:** Our new broker (Interactive Brokers) has shares available for shorting at a 2% annual fee.
- **What We're Expecting:** The costs of the two approaches will likely be similar, but a direct short should be easier to exit.

Trade Essentials

- **Action:** Sell short 3% in **CurrencyShares Euro Trust** (NYSEMKT: FXE). (That's $3,000 worth for every $100,000 you manage; for *Pro*, it's about 300 shares.)
- **Recent Price:** $128.80
- **Price Guidance:** Short above $125.
- **Alternative Trade:** You can continue to hold or set up a synthetic short; lately, selling to open January 2014 $125 calls and buying to open January 2014 $125 puts looks best. See our former alerts for price guidance. (Our first trade alert on FXE can be found here.)

What's New

The market is taking a breather from its concerns about Europe as interest rates drop for short-term debt in Italy and Spain, helped along by the European Central Bank's new cheap money policy. However, long-term debt rates are still lingering near 7% in Italy and 6% in Spain; Italy, in fact, is only a stone's throw away from the 7% danger zone (where refinancing debt becomes too costly). Additionally, the core issues behind the crisis – too much debt and austerity programs that slow revenue — remain across much of the eurozone.

And this backdrop doesn't change our core argument that the euro is built on a flawed foundation. The 17 participating countries share a currency, but lack financial unity *and* financial autonomy. Countries don't have the right to print their own money when they need to stimulate growth, devalue the currency, and inflate away debt. Thus handcuffed, weaker countries like Greece and Portugal slip into a death spiral they can't export their way out of. Even Greece's planned default doesn't get it out from under the weight of crushing, likely unsustainable long-term debt. Something else must give.

Long story short, we continue to believe in shorting the **CurrencyShares Euro Trust**, which only holds actual euro. A synthetic option short (our original recommendation) or a direct short both work; now that we're able to short directly, we'll do so only because it's been difficult to set up the synthetic short the past month at reasonable prices. We expect limited risk with our short — it's unlikely the currency could gain more than 25% to eclipse its old all-time high — and potentially healthy rewards if the euro situation becomes still less stable. Supporting our thesis, interest rates are likely to head lower on the euro, and cheap lending is likely to continue for at least a few years to keep banks solvent and liquid. This should keep the euro's value relative to other currencies — including the U.S. dollar — subdued, if not send it lower. We hope to keep, and benefit from, this short over the next year or two.

- **Next Step:** To discuss this trade, please visit our CurrencyShares Euro Trust discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Buy More BMC Software

Published Jan 20, 2012 at 12:00AM

- **What We're Doing:** We're buying more stock following a decline.
- **What We're Thinking:** At 6.8 times free cash flow, shares are cheap.
- **What We're Expecting:** BMC will improve revenue, reassuring investors.

Trade Essentials

- **Action:** Buy 1.3% more to bring your current allocation to 4%. (That's $1,300 more for every $100,000 you manage, up to a $4,000 value.)
- **Price Guidance:** Use a limit order around market prices.
- **Recent price:** $33.50
- **Buy Around:** $43
- **Fair Value:** $56
- **Alternate Trade:** Although we're content to buy today, you can write various put options to attempt to buy shares cheaper.

What's New?

- **Last trade:** In September 2011, we bought a 3.5% stake at $41.88.
- **Change:** At $33.50, the stock is down 20%.

Disappointing second-quarter results and weak guidance in October have **BMC Software** performing poorly since our purchase. Although operating cash flow improved by 27% and earnings per share gained 6% on an 11% increase in sales, the company's new license revenue in its enterprise service management (ESM) division dropped 13% last quarter compared to a year ago. (On the bright side, it was up 25% from the prior quarter.)

Management had previously expected license booking gains in this key ESM division this year, but now foresees a single-digit year-over-year decline. One culprit was slower-than-expected hiring in its sales force; attrition was also a factor as BMC lost some key sales staff to higher-paying competitors. The company has since ramped up hiring of sales staff and is addressing its compensation package, so we expect to see business results start to improve during 2012.

Revenue has been left on the table lately because of these problems, but BMC's financials remain strong. The stock trades at only 6.8 times free cash flow, making it one of the cheapest software stocks we know. Other key divisions are doing well, too, including Cloud and SaaS (software as a service). Bookings for both are well above plan, suggesting BMC hasn't lost its competitive edge. For the year ending in March 2012, BMC expects non-GAAP diluted earnings per share to grow about 9% year-over-year, and operating cash flow to increase about 8%, to $825 million. At $33.50, the stock currently trades at 10 times expected earnings.

Quarterly results are due Feb. 1, and they may be rocky; it takes time to hire and train sales staff. But management said last October that its guidance was intentionally cautious, and the stock already looks washed out at this low multiple to free cash flow. The software sector in general is in Wall Street's doghouse at the moment after soft sales at **Oracle** and **JDA Software**. Investors rightly remain concerned about government spending in the face of austerity programs, but given BMC's strong recurring revenue, low cost structure, high cash flow, and plenty of growth potential ahead, this is a good time to buy in with a longer-term mindset. Then, all we need to do is wait for the storm clouds to pass and more reasonable valuations to return.

- Next step: Visit the BMC Software discussion board with any questions.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here*.

Welcome to Motley Fool Pro!

Published Jan 19, 2012 at 12:00AM

Learn About *Pro* Invest With *Pro*

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Sell L-3 Communications

Published Jan 19, 2012 at 12:00AM

- **What We're Doing:** We're selling our shares of **L-3 Communications**.
- **What We're Thinking:** Cuts in defense spending now seem inevitable; the only question is how deep they'll be.

- **What We're Expecting:** Defense spending will remain an easy target on Capitol Hill for years to come.

Trade Essentials

- **Action:** Sell all shares.
- **Recent price:** $70.50.
- **Limit Guidance: Sell as close to the current market price as possible.**

What's Changed?

- **Last action:** In February 2011, *Pro*'s Charter and 2011 Portfolios wrote April 2011 $80 puts.
- **Total return:** -3.5%

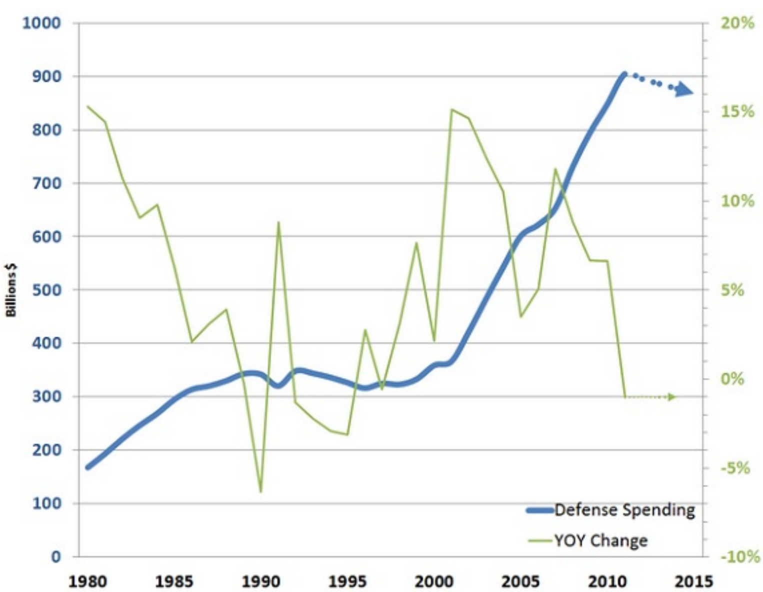
Investing, to the extent that you disagree with the crowd, is an arrogant act. And that's fine, as long as you can articulate why the market is wrong and why you are correct (and provide facts to support your case). When it comes to defense contractor **L-3 Communications**, three things over the past year have changed our thesis:

1. The debt-ceiling debacle, which made cuts to defense spending likely.
2. The subsequent failure of the congressional supercommittee on debt, which made cuts to defense spending *very* likely.
3. L-3's own management, which is now guiding for poorer performance in 2012.

After incorporating these events into our analysis, we find our view of L-3 no longer significantly differs from the market's pessimistic view. The company's free cash flow yield is mouthwatering, but we have less confidence in the stability of that cash flow, making it a less reliable pillar of our investment thesis. And modeling a likely range of operating performance now gives us a fair-value range of between $56 and $78 — much lower than the $100 fair value we placed on the shares when we first recommended the company in November 2010. The wide fair-valuation range is the result of too many potential outcomes with defense spending.

Ordinarily, we might write covered calls to exit this position at higher prices, but the upcoming spinoff of L-3's government-services operation, Engility, makes that more difficult. As L-3 shareholders, we would receive shares of Engility after the split (expected to be completed in the first half of 2012), and we'd see a commensurate reduction in LLL's share price. Engility's operating performance is worse than L-3's consolidated results, but both businesses are in decline — at least temporarily. The split could make L-3 more attractive to future investors, but as current shareholders, we'd be responsible for selling the shares of the new company on the open market. All that makes us more inclined to exit the position cleanly with a simple and direct selling of our shares.

Central to our original thesis was the idea that defense companies are less correlated to the economy than most other sectors. That was certainly the case during the defense-spending boom that followed 9/11, but is less true now given the sluggish economy, the ongoing conflict over the debt ceiling, never-ending budget revisions, base closures, general wacky political machinations, and a new commitment to lowering U.S. troop counts worldwide. Budget constraints drive fiscal decisions, and we can no longer confidently conclude that defense spending is safer than the market predicts.



Source: USgovernmentspending.com and analyst calculations.

The blue line on the graph above shows the incredible ramp up in U.S. defense spending after 2001 to its current level of $900 billion a year. Such big numbers mean that even a small annual decrease in overall defense spending could have a significant impact on defense companies' valuations. In other words, those companies' valuation multiples currently look cheap on a historic basis — but they may not be cheap when looking to the future.

In the end, politicians' decisions, budgetary realities, and — starkly — new conflicts will determine the fate of the defense industry. But right now, defense spending is under fire, making growth less likely. And we know we can invest in companies that are growing instead.

How to Follow Along

We'll sell all of our shares of L-3 in the next one to 30 days. If you're comfortable owning shares longer and are willing to accept (and later potentially sell) the shares you may receive in the Engility spinoff, consider writing near-the-money covered calls for a higher sell price. Also realize that L-3 is expected to report earnings Jan. 31; we have little insight into those results, but expectations are low.

Next Steps: Visit the L-3 Communications discussion board to post questions, and then make your trade.

See Pro*'s holdingshere. See the team's and David and Tom Gardner's holdingshere.*

Learn About Pro

Published Jan 19, 2012 at 12:00AM

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Using This Service

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Choose a Broker

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Published Jan 19, 2012 at 12:00AM

Our Mission

Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to meaningfully increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years. The *Pro* team (meet Jeff and the gang here) is accomplishing this by investing $1 million of the Fool's real money.

Our North Star

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward. ***Pro*'s North Star = inflation (as measured by the Consumer Price Index) + 7% annually.**Click here for much more on our North Star.

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The Website and Email

Published Jan 19, 2012 at 12:00AM

Here's what you'll find on the *Pro* site:

- **Home :** Start here to get a roundup of anything new on the site. The "carousel" at the top will feature the content we think is most important to share with you, and you can always find our latest memos, features, and alerts using the tabs below it.
- **Recommendations :** View our portfolios and find out how our stocks, ETFs, and options are performing; get transaction details; and see Buy First, Buy, Hold, and Sell guidance at a glance.
- **Alerts & Coverage :** See the very latest alerts, Monday Memos, and other features, and access the full archives of each. (Of course, we'll email you anytime there's an exciting new feature to share.)
- **Community :** Our discussion boards are home to investors of all levels, from beginner to expert. *Pro* Fools come here to talk stocks, share advice, and have fun.
- **My Scorecard :** Use this customized tracking tool to see how your stocks are doing and access analysis of your favorite companies.

You'll also receive email from us. Here's what to expect in your inbox (you can customize your email settings here):

- **"Trade Alert" emails:** We announce all of our trades *before* we pull the trigger so you can act before we do. We send these alerts at any time during normal market hours. Trades always come with a full report that explains our thinking. After we announce a trade, we wait one to 30 days to make the trades for the *Pro* portfolio.
- **Monday Memos:** Stay on top of *Pro* happenings — every Monday at 4 p.m. ET, we'll send you stock news, market insights, community highlights, and more.
- **Guides, Audio Extras, special updates:** Become a better investor! Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio.

Back to Learn About *Pro* | Next Section: Our Community

Our Community

Published Jan 19, 2012 at 12:00AM

We may be a tad biased, but we genuinely think the *Pro* community is among the best in Fooldom (if not the Internet in general). *Pro* Fools are knowledgeable, kind, intelligent, thoughtful, and helpful, and our discussion boards are the place to get to know them. Introduce yourself on the Meet & Greet board, get support as you get up to speed on the Getting Started board, and talk about anything and everything on the Social Banter board.

We've also got a new *Pro* wiki for you to explore (and contribute to!). It's a work in progress, but we hope you find it useful.

Fool on — and again, if you have suggestions or comments, bring them to our Member Suggestions & Help discussion board!

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Educational Resources

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Learn About Pro

Published Jan 19, 2012 at 12:00AM

Get to know *Pro* and what to expect as a member — just click on a section below to learn more:

North Star Our Mission and North Star

North Star The Website and Email

North Star Our Community

North Star Educational Resources

North Star FAQ and Wiki

North Star Meet the Team

Our Mission and North Star

Mission & Philosophy

5 Resolutions for 2012

5 Resolutions for 2011

Reigniting Our Mission

Audio: Our Philosophy

Strategy Guide

Buy First, Buy, Hold, and Sell

Philosophy & Strategy discussions

Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to meaningfully increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years. The *Pro* team (meet Jeff and the gang here) is accomplishing this by investing $1 million of the Fool's real money.

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Email Using the Site; Email and Other Communications

Community Our Community

Education Educational Resources

FAQ FAQ and Wiki

Team Meet the Team

Educational Resources Topic 1

Published Jan 19, 2012 at 12:00AM

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Close Your Bull Call Spread on Cisco Systems

Published Jan 18, 2012 at 12:00AM

- **What We're Doing:** We're closing our **Cisco Systems** bull call spread, which expires Friday.
- **What We're Thinking:** This was never intended to become a stock position, and we can lock in a gain by closing the spread**.**
- **What We're Expecting:** Cisco's stock may become more volatile after Intel reports earnings Thursday night, so we'll aim to close before then.

Trade Essentials

- **Actions:** "Buy to close" all January 2012 $20 calls; "sell to close" all January 2012 $15 calls (use a single spread order).
- **Price Guidance:** Use a **net credit limit order** that's as close to current intrinsic value as possible. This means that with Cisco stock lately at $19.55, you would aim to close the $15/$20 spread for around a $4.50 credit. (The current share price minus the $15 strike is your barometer for measuring the intrinsic value of the $15 calls you own; but you'll also need to pay a few pennies to close the $20 calls.)
- **Follow-up:** Although *Pro* won't have a position in Cisco, the discussion board will still be accessible if you did an alternative trade and own shares.

What's Changed?

- **Last Action:** In August 2010, *Pro* set up 30 spreads at a cost of $3.36 each.
- **Price Change:** Worth $4.40 today, our investment is up 31%, even though the stock is down 11.6% since our trade.

I like option spreads. You sell one option, then use the proceeds to buy the same type of option at a different strike price but the same expiration. Then, having capped your risk, you look to pocket the difference between the two prices by waiting for time to do its thing. Spreads are ideal when you want to profit on a modest move in a stock (or, as we see here, even no move at all) without much extra effort. Once you set up a spread, it's usually best to leave the trade alone until very close to expiration. In fact, it can be costly to act earlier. And even if the position doesn't work out, you know your risk is limited to your initial small investment.

As the giant in the networking business, **Cisco Systems** demanded little of our attention during the course of our bull call spread. It did report some weak quarters last year, but we knew shares were a value trading at a single-digit multiple to free cash flow, and we were confident that the breakeven price in our spread ($18.36) was reasonable.

However, we're not inclined to turn our spread into 3,000 shares of Cisco stock at that price, mainly because our portfolio has a high level of exposure to technology already — including bellwethers **Intel** and **Oracle**, two businesses we believe we understand better than Cisco. In fact, we're looking to close our Cisco spread before Intel reports earnings after market close Jan. 19. Sometimes Intel moves the whole tech sector, and although good news could send Cisco stock higher, weak news could wipe out much of the profit on our spread before Friday's expiration. So we'll take our gain and go.

Is another Cisco spread in our future? Perhaps. It's one way to invest in this inexpensive stock without committing much capital or taking much risk. What is certain is more bull call spreads on various companies are in our *Pro's* future.

Next step: If you have questions, please visit the Cisco Systems board.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Earn Higher Returns With Less Risk

Published Jan 17, 2012 at 12:00AM

Pro Fools,

In last week's Memo, Jeff discussed how the *Pro* team started the year with an aspirational eye on our North Star. Forecasting our expectations for each *Pro* position's three-year returns, then comparing those numbers to our North Star, was (and is!) helpful in informing our portfolio decisions — but it's just one factor in our process. Every stock has a role to play in our portfolio, and in the coming weeks, we'll be working on communicating those roles more plainly.

Pro Trade Roundup

- **Ebix**: Sold to open 27 February 2012 $23 covered calls for $1.10 each (covering all shares).
- **Intel**: Sold all 10 of our January 2013 $10 calls for $15.80, a 38% gain.

No Such Thing?

Don't yell "Fire!" if you want me to leap out of my chair; yell "Free lunch!" Nothing — not even a snowstorm — gets me vertical as fast as the announcement of free food at Fool HQ. In our office, no one is dumb enough to offer complimentary eatables without being able to make good on the offer. But in the investing world, there's no shortage of pitchmen offering the investing equivalent to free chow — higher returns with less risk. Such strategies, I suspect, succeed at separating investors from their money and little else.

That said, investing may actually offer a free lunch in the form of diversification. "Diversify" may be the most well-worn bit of investing advice out there, and for good reason. If you hold a range of assets, some of which zig while others zag, you should always have winners to offset temporary losers — in other words, higher returns with less risk. That seems simple enough, but how do you know how much something will zig? Or when it will zag?

Measuring Zigginess and Zagginess

Correlation is the statistical measure of how two things (in this case, two stocks) behave (zig and zag) in relation to one another. This relationship is expressed as a correlation coefficient with a value between -1 and +1. If both stocks rise and fall together, never deviating in direction, they exhibit perfect positive correlation: +1. If there is no relationship between their movements whatsoever, the coefficient is zero. And -1 means the stocks always move in opposite directions. Most stocks exhibit a correlation between 0 and +1.

Typical diversification advice is of the "don't place all your eggs in one basket" variety: Invest in eight to 30 stocks, ideally in different sectors, to avoid related business risk. This is good advice, to be sure, but it's not sufficient for *Pro* investors. The best strategy, and our goal, is to invest in uncorrelated assets, which is why it is important to actually measure correlation and not just assume it. When choosing between two stocks with similar risk and return tradeoffs, choose the one with lower correlation to your portfolio.

Pro's Correlation Matrix

The graphic below shows all the possible correlations between each pair of stocks (pairwise correlations) — omitting shorts and options — for our portfolio. (Click to make the table larger.)

	BMC	ADSK	AFSI	BR	BRS	CVA	DDD	DGS	EBIX	GTI	INTC	LLL	MA	MDT	ORCL	OTEX	PACR	PCL	PEB	PZZA	ROC	STON	TUP	VDE	WFC
BMC	1.00	0.34	0.27	0.35	0.15	0.21	0.24	0.27	0.19	0.19	0.15	0.32	0.33	0.27	0.41	0.11	-0.17	0.24	0.03	0.40	0.14	0.03	0.33	0.15	0.06
ADSK	0.34	1.00	0.45	0.54	0.58	0.19	0.48	0.68	0.46	0.69	0.70	0.64	0.32	0.49	0.78	0.53	0.43	0.62	0.66	0.53	0.73	0.38	0.44	0.72	0.51
AFSI	0.27	0.45	1.00	0.23	0.36	0.34	0.35	0.42	0.20	0.36	0.35	0.34	0.23	0.21	0.44	0.52	0.15	0.29	0.27	0.35	0.50	0.02	0.39	0.35	0.25
BR	0.35	0.54	0.23	1.00	0.38	0.22	0.13	0.50	0.44	0.44	0.45	0.52	0.46	0.39	0.48	0.29	0.27	0.44	0.45	0.46	0.47	0.10	0.31	0.48	0.16
BRS	0.15	0.58	0.36	0.38	1.00	0.17	0.24	0.62	0.16	0.67	0.47	0.64	0.32	0.41	0.45	0.35	0.24	0.58	0.52	0.34	0.61	0.47	0.26	0.67	0.48
CVA	0.21	0.19	0.34	0.22	0.17	1.00	0.21	0.42	0.30	0.31	0.17	0.13	0.23	0.25	0.34	0.15	0.09	0.22	0.01	0.13	0.37	0.08	0.36	0.34	0.25
DDD	0.24	0.48	0.35	0.13	0.24	0.21	1.00	0.40	0.36	0.32	0.27	0.37	0.07	0.36	0.42	0.46	0.22	0.33	0.44	0.16	0.55	0.20	0.42	0.52	0.36
DGS	0.27	0.68	0.42	0.50	0.62	0.42	0.40	1.00	0.53	0.77	0.48	0.58	0.45	0.49	0.57	0.51	0.43	0.63	0.53	0.43	0.87	0.42	0.60	0.78	0.49
EBIX	0.19	0.46	0.20	0.44	0.16	0.30	0.36	0.53	1.00	0.31	0.37	0.29	0.28	0.34	0.35	0.33	0.24	0.32	0.49	0.34	0.45	-0.02	0.37	0.54	0.34
GTI	0.19	0.69	0.36	0.44	0.67	0.31	0.32	0.77	0.31	1.00	0.62	0.61	0.35	0.47	0.53	0.40	0.49	0.59	0.57	0.30	0.82	0.46	0.51	0.76	0.44
INTC	0.15	0.70	0.35	0.45	0.47	0.17	0.27	0.48	0.37	0.62	1.00	0.51	0.43	0.48	0.64	0.27	0.46	0.35	0.52	0.33	0.62	0.14	0.27	0.52	0.30
LLL	0.32	0.64	0.34	0.52	0.64	0.13	0.37	0.58	0.29	0.61	0.51	1.00	0.33	0.58	0.48	0.52	0.41	0.61	0.56	0.54	0.63	0.31	0.48	0.62	0.44
MA	0.33	0.32	0.23	0.46	0.32	0.23	0.07	0.45	0.28	0.35	0.43	0.33	1.00	0.34	0.34	0.05	0.01	0.46	0.03	0.33	0.43	0.13	0.41	0.38	0.09
MDT	0.27	0.49	0.21	0.39	0.41	0.25	0.36	0.49	0.34	0.47	0.48	0.58	0.34	1.00	0.45	0.18	0.45	0.55	0.48	0.41	0.49	0.11	0.40	0.56	0.49
ORCL	0.41	0.78	0.44	0.48	0.45	0.34	0.42	0.57	0.35	0.53	0.64	0.48	0.34	0.45	1.00	0.47	0.25	0.47	0.45	0.40	0.59	0.37	0.38	0.55	0.29
OTEX	0.11	0.53	0.52	0.29	0.35	0.15	0.46	0.51	0.33	0.40	0.27	0.52	0.05	0.18	0.47	1.00	0.21	0.33	0.59	0.27	0.54	0.20	0.34	0.58	0.11
PACR	-0.17	0.43	0.15	0.27	0.24	0.09	0.22	0.43	0.24	0.49	0.46	0.41	0.01	0.45	0.25	0.21	1.00	0.31	0.46	0.12	0.49	0.19	0.25	0.42	0.45
PCL	0.24	0.62	0.29	0.44	0.58	0.22	0.33	0.63	0.32	0.59	0.35	0.61	0.46	0.55	0.47	0.33	0.31	1.00	0.40	0.38	0.65	0.42	0.52	0.64	0.59
PEB	0.03	0.66	0.27	0.45	0.52	0.01	0.44	0.53	0.49	0.57	0.52	0.56	0.03	0.48	0.45	0.59	0.46	0.40	1.00	0.44	0.51	-0.05	0.07	0.69	0.49
PZZA	0.40	0.53	0.35	0.46	0.34	0.13	0.16	0.43	0.34	0.30	0.33	0.54	0.33	0.41	0.40	0.27	0.12	0.38	0.44	1.00	0.36	-0.01	0.28	0.43	0.34
ROC	0.14	0.73	0.50	0.47	0.61	0.37	0.55	0.87	0.45	0.82	0.62	0.63	0.43	0.49	0.59	0.54	0.49	0.65	0.51	0.36	1.00	0.44	0.64	0.84	0.55
STON	0.03	0.38	0.02	0.10	0.47	0.08	0.20	0.42	-0.02	0.46	0.14	0.31	0.13	0.11	0.37	0.20	0.19	0.42	-0.05	-0.01	0.44	1.00	0.31	0.36	0.26
TUP	0.33	0.44	0.39	0.31	0.26	0.36	0.42	0.60	0.37	0.51	0.27	0.48	0.41	0.40	0.38	0.34	0.25	0.52	0.07	0.28	0.64	0.31	1.00	0.46	0.43
VDE	0.15	0.72	0.35	0.48	0.67	0.34	0.52	0.78	0.54	0.76	0.52	0.62	0.38	0.56	0.55	0.58	0.42	0.64	0.69	0.43	0.84	0.36	0.46	1.00	0.49
WFC	0.06	0.51	0.25	0.16	0.48	0.25	0.36	0.49	0.34	0.44	0.30	0.44	0.09	0.49	0.29	0.11	0.45	0.59	0.49	0.34	0.55	0.26	0.43	0.49	1.00

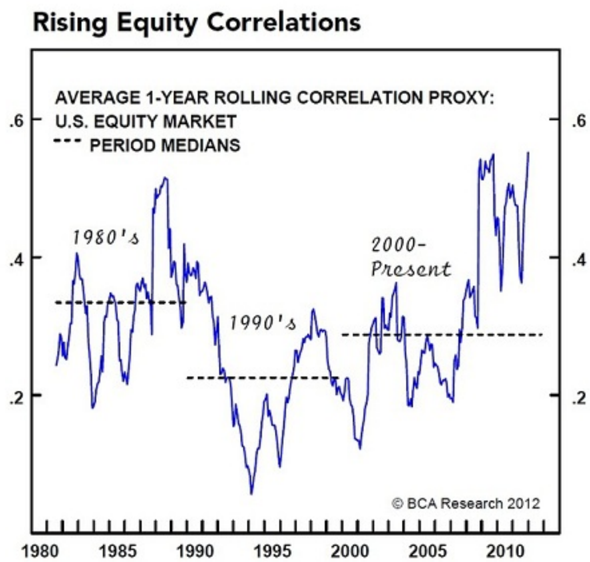
Source: Portfolio Lab Pro and analyst calculations

After last week's Memo, some members on the discussion boards expressed their concern about our modest return expectation for **Covanta**. In reply, Jeff gave his take on the company's cheapness, and Bryan explained: "We consider every stock's place within the portfolio, not just on its own. Covanta is one of our least correlated (to the other stocks in the portfolio) holdings, so it provides wonderful diversification benefits. And we care about both reward *and* risk." The matrix above offers visual representation of this diversification — it's hard to miss Covanta's lovely green color throughout, indicating a low to nonexistent correlation with the other stocks in our portfolio.

Perhaps more striking, and not to our benefit, are the reddish hues representing strong correlations between positions. (Ignore the red squares moving diagonally across the matrix; they merely state that each stock is perfectly correlated to itself, which, of course, we already knew.) As we continue to adjust our portfolio with our North Star in mind, you may notice us moving away from lower-conviction ideas, especially those that are highly correlated to our portfolio. We'll do this to remove risk without, we hope, affecting return.

How High Is High?

Jeff has quipped over the past year that all stocks are moving together, and he is correct — correlations are getting stronger.



This image from BCA Research shows that the median correlation between any two U.S. equities over the past decade is about 0.3. More recent rolling correlations are closer to 0.5 or 0.6, which is high – and that shouldn't be surprising. We're investing in a very uncertain environment in the wake of a severe credit crisis and on the back of a stock market crash. When you hear the now-popular term "risk on, risk off," know that this is, in part, what it refers to. In the "risk on" phase, investors are happy to own risky assets and bid up the prices, but when the "risk off" mood hits, they quickly change their mind. No longer wanting to own risky assets, they sell at lower prices. This leads to higher correlations between stocks — and higher volatility — than the underlying business factors would suggest. And increased correlation is bad for investors, because it makes diversification more difficult and somewhat less useful.

What's a *Pro* to Do?

Fortunately, we follow a flexible, absolute-return investing strategy that allows shorts and options. Our portfolio is well diversified, and our current S&P 500 short offers significant negative correlation to our holdings, further reducing overall riskiness. Moreover, as options investors, we build strategies with non-normal return profiles — in plain English, we hedge and collect premiums in exchange for the obligation to sell shares higher or buy shares cheaper. That means we can manage our risk *and* profit through a wide range of outcomes.

To share your thoughts on this Memo, visit our Memo Musings discussion board. Fool on!

Nick Crow (TMFCrow)

A New Role for Analyst Alex Pape

Please join us in congratulating Alex Pape (TMFPapester), who will be leaving his role as an analyst on *Pro* and *Motley Fool Options* to lead product development for the Fool. It was admittedly a tough decision, but Alex has decided he can best help the Fool pursue its purpose ("To help the world invest. Better") by working to create new and improved investment services and structures. Since Alex will still be in-house, we'll have access to him as a backup to the backup for the stocks he covers. (Every *Pro* investment is followed by at least two team members, so there will be no interruption in coverage.) We appreciate everything Alex has brought to *Pro* over the past year! To bid him farewell (or pitch your idea for a new investment vehicle), please visit our Meet & Greet discussion board.

Community

- *Pro* has made a lot of options trades lately, but it's not necessary that you use options to do well with *Pro*.
- Alex34 posts puts that match *Pro* criteria.
- Dagoddar59 is starting to deploy his assets Foolishly and asks the community for help.
- Palindrome1 is writing covered calls on **ProShares Short S&P 500**. Jeff tells all members we're aiming to wind down our index shorts in favor of company-specific shorts.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Trade Update: CurrencyShares Euro Trust

Published Jan 13, 2012 at 12:00AM

Dear *Pro* Fools,

A month has passed since we recommended that you short the **CurrencyShares Euro Trust**. Our guidance was to use a synthetic short option strategy or (assuming your broker had shares to borrow inexpensively) to short the trust directly. As always, we provided pricing guidance in the original recommendation; we said to set up the synthetic short for around a 1.5% cost to the trust price. It'd be impossible to make this trade without paying a bit of a premium to start (view it as a commission), but 1.5% was a reasonable ding to accept. So the stage was set.

Downgrades for the Euro Zone?

News is bubbling up today concerning an S&P downgrade of France's credit rating, and potentially that of other euro zone countries, too. This isn't surprising. We had certainly *hoped* to be short the euro before the downgrade, but even with it, our short thesis doesn't weaken. The downgrade actually supports our original thesis regarding the difficulties the region faces.

However, the euro began to decline quickly following our report. (We take no credit!) With its drop, the premiums on the options grew, and despite trying for four weeks, we haven't been able to place our trade at, or even near, our recommended limit. At the same time, we're in the process of moving *Pro*'s account to a new broker, and we know our new broker currently has shares available for shorting. A direct short is much easier, perhaps cheaper in the end, and remains our preferred alternative.

So here's where we stand: Even though the price of the trust has declined, our recommendation to short it has not changed.

- **If you've already set up the synthetic short, or have shorted FXE directly:** Maintain your position. Our recommendation hasn't changed, and we'll be joining you as soon as possible.
- **If you haven't established a position in FXE yet:** With the trust recently hugging $126, aim to set up the $125 synthetic short for a $1 debit, equating to a short price of around $124. Just as before, as prices change when you're initiating the trade, use the strike prices nearest the current trust price, and aim to pay only around a 1.5% penalty to set up the trade. The ugly math: $1.89 = 1.5% of $126, meaning your synthetic short can have a start price of around $124.11 when the trust trades at $126.

In other words, our suggested trade still stands: Aim to set up the synthetic short for a 1.5% cost above a straight short at the current trust price. If you're raring to get this trade done, up to a 2.5% cost is acceptable assuming you plan to hold to expiration (so you won't need to pay more friction costs to close the options early).

However, if you can short shares *directly* at no cost (they are available to short free of charge at TD Ameritrade) or for low cost (Interactive Brokers is lately charging 1.8% a year — preferable to the option trade because it'll be much easier to close the short than the synthetic short), then you should short FXE directly. That is what *Pro* will do once we've changed brokers (which should happen literally any day), if we haven't been able to execute the option trade yet at our price guidance. (Of course, we'll send a new trade alert to you before taking any action.) In the meantime, we'll continue to try to set up the synthetic short for around a 1.5% cost.

If you have questions about our FXE short, please visit the CurrencyShares Euro Trust discussion board. Fool on!

— Jeff Fischer, Advisor
Motley Fool *Pro*

Sell to Close Your Calls on Intel

Published Jan 10, 2012 at 12:00AM

- **What We're Doing:** We're taking the gain on our January 2013 $10 calls on Intel.
- **What We're Thinking:** Intel will remain our largest stock position at 7%, and profits in calls can be ephemeral, so it's often wise to take them when you can.
- **What We're Expecting:** Share-price volatility may increase after Intel reports earnings Jan. 19.

Trade Essentials

- **Action:** Sell to close all January 2013 $10 calls on Intel
- **Price Guidance:** Use a limit order and try to sell for intrinsic value — so if Intel's stock is at $25.55, look sell your calls for about $15.55
- **Follow-up:** We'll still have a 7% stake in Intel stock

What's Changed?

- **Last Relevant Action:** In November 2010, *Pro*'s Charter Portfolio bought 10 calls.
- **Price Change:** Up 34%

Don't Own Intel Calls?

Former followers of Portfolio 2011 don't own Intel calls; if this is you, ignore this trade, but keep holding Intel stock.

Our **Intel** (NASDAQ: INTC) calls are up 34% since our November 2010 purchase, earning us a long-term capital gain. And most members should have considerably higher returns than we do, given the required delay between our trade alerts and purchases. In 2011, Intel's business performed as *Pro* expected, growing earnings per share an estimated 15% even as the rest of Wall Street anticipated flat results. This growth led to a 22% gain in the stock, and a 34% gain in our calls.

At 11 times trailing earnings and with a 3.3% yield, Intel still looks reasonably priced, so we're content to keep our large 7% allocation in the stock. Wall Street (again) expects flat earnings in 2012, but we believe the company could (again) pleasantly surprise. However, we're content to sell our 1% stake in the call options now that they offer us a meaningful return. The calls don't provide a dividend, of course, and they expire in just more than a year. A recession in Europe could easily weigh on Intel and bring the stock price lower this year, and if that happens, our long calls will feel twice as much pain as the stock.

The year will be pivotal for Intel in other ways, too: Will the company start to infiltrate the mobile market? It expects to, as smartphones begin to ship with Intel chips. Intel is also banking on super-thin Ultrabooks to revitalize the computer notebook market and compete with tablets. We believe corporate upgrades and emerging markets should drive most of Intel's profits, although a slowdown in China remains a risk. In short, Intel remains a favorite long-term stock of ours, but we're happy to lock in a profit on the more sensitive — and more timely — call options we own.

Next Step: If you have questions before you sell to close your calls, please visit the Intel discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on Ebix

Published Jan 10, 2012 at 12:00AM

- **What We're Doing:** We'll earn income while setting ourselves up for a higher potential sell price.
- **What We're Thinking:** The stock is near its $24 fair value, and we don't want to keep it once it exceeds that price.
- **What We're Expecting:** We're likely to continue writing covered calls, when possible, until we sell our shares.

Trade Essentials

- **Action:** Sell to open February 2012 $23 calls, one for every 100 shares of Ebix you own.
- **Price Guidance:** Aim to receive $1.20 or higher. As prices change, accept no less than $1 (a 4% yield on the share price in five weeks).
- **Alternate Trade:** If you own fewer than 100 shares, you can't write calls, but you can sell the stock when it's near $24.

What's Changed?

- **Last action:** In June 2011, *Pro*'s Portfolio 2011 bought shares around $18.
- **Recent price:** At $22.55, Ebix is near our $24 fair value.

Shares of **Ebix** (NASDAQ: EBIX) have gained 70% from their October low, 

which is why we're writing covered calls today. This steep climb, which doesn't seem to be based on any significant business news, has the stock within striking distance of our $24 fair value — and despite steady improvements in cash flow, accounting methods, and management, this isn't a stock we want to own at higher than its fair value. Thus, covered calls are a natural, proactive strategy at this price.

The *Pro* portfolio is heavily invested in software and technology, and we feel we know the sector well. By selling Ebix at a fair price, we believe 

we'll be able to reinvest the proceeds in cheaper, more robust companies in the same sector — or elsewhere if desired.

If we receive $1.20 to write these calls, we'll set up a potential sell price 7% higher than today's share price. In the meantime, we'll receive a 5% yield on the current share price between now and expiration in five weeks.

Next step: If you have questions before you sell to open these covered calls, visit our Ebix discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Puts on Pacer International

Published Jan 10, 2012 at 12:00AM

- **What We're Doing:** We're seeking a favorable buy price on more shares of Pacer.
- **What We're Thinking:** We'll be happy to fill our position out to 3% around our initial price of $4.60.
- **What We're Expecting:** Either the share price of this volatile micro-cap will come back down, or we'll need to settle for income.

Trade Essentials

- **Action:** Sell to open June 2012 $5 puts
- **Allocation:** 2%, for 3% total (for *Pro*, that's another 58 contracts; for members, it's four contracts for every $100,000 you manage)
- **Price Guidance:** Aim to receive $0.45 or higher. As prices change, ideally accept no less than $0.40 (for an 8% yield on the share price in five and a half months).
- **Alternate Trade:** Sell to open March 2012 $5 puts for $0.20 or more; they expire sooner and pay less, but may be superior if you have a large portfolio and pay low commission rates.

What's Changed

- **Last action:** Last month, we sold to open December 2011 $5 puts; the puts were converted to shares at about a net $4.60.
- **Recent price:** $5.71, up 28%.

There's nothing new to report about **Pacer International** (NASDAQ: PACR) over the past month, but shares are up 28% anyway. Bulls project a continued turnaround for the tiny intermodal transporter of goods, bears are banking on stagnation or worse, and the company's stock price is volatile as a result.

We remain in the bullish camp, but we prefer to buy the stock more cheaply if possible. Thus, we're once again recommending writing puts to try to buy more shares at a discount. Pacer is 1% of our portfolio already, and we'll continue to write puts until it reaches 3% (or we'll just keep earning income in the meantime) — that is, as long as the stock price remains reasonable. If you don't own any shares yet, you can write enough puts for 3% this go-around.

Next step: Before writing your puts, ask any questions on the Pacer discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Are These Our 10 Best Stocks?

Published Jan 9, 2012 at 12:00AM

Fellow Fools,

The *Pro* team met three times last week to measure every investment we've recommended in the context of our service's North Star, which is currently returning 10.4% a year (inflation, recently at 3.4%, plus a never-wavering 7%). Independently, each member of the team rated every *Pro* position on this question: Do you believe it will gain more than our aspirational North Star over the next three years, or will it fall short of the North Star?

Monday Memo Skips a Day

Fool HQ is closed Monday, Jan. 16, for Martin Luther King Jr. Day, so expect next week's Monday Memo at 4 p.m. ET Tuesday, Jan. 17!

The good news is that we unanimously agree that 10 positions (nearly half the *Pro* portfolio) appear likely to closely follow or outdistance the North Star over the next three years. From recent prices, we estimate at least 10.4% annualized returns from these:

1. **3D Systems**
2. **AmTrust Financial Services**

3. **Autodesk**
4. **MasterCard**
5. **Medtronic**
6. **Oracle**
7. **Pacer**
8. **Plum Creek Timber** (with accompanying strangle)
9. **Wells Fargo** (with accompanying strangle)
10. **WisdomTree Emerging Markets SmallCap Dividend Fund**

This list naturally leads you to some questions. For instance, if we expect strong returns from Autodesk, why is it on Hold right now? The answer is twofold: We expect those returns to be earned with higher risk than average, and we assume members have already bought shares around $27, 15% lower than today's price. That said, our unanimous conclusion means we need to revisit our rating on the stock. Similarly, we need to consider removing our collar on AmTrust if its March expiration isn't soon enough and targeting more shares of Pacer, among others.

Let me be clear: This is a list of companies we unanimously agreed are strong competition for the North Star that guides us. If a company is not on this list, in most cases just a single team member predicted it would come up short of the North Star's likely performance. For example, I rated recent buys **BMC Software** and **OpenText** to outshine the North Star, but at least one *Pro* analyst disagreed. After discussing BMC and reviewing the company's prospects and its discounted valuation (at 6.2 times free cash flow, BMC is one of the cheapest companies in our portfolio), we're happy to keep it a Buy First. In other words, companies not on this list still have our confidence until you hear otherwise; context matters. Our hopes for **Rockwood Holdings**, **GrafTech**, **Tupperware**, and others haven't changed overall.

Note that two of the positions on the list are strangles. In 2011, we earned approximately a 15% return on Plum Creek Timber even though the stock price was flat — that's well north (sorry) of our North Star, thanks to the income from our strangle positions and the stock's 5% dividend. We'll generally target annualized gains at least as large as our North Star (currently 10.4% and likely to go higher) on each position we hold, however we can achieve them. (Also, the short-term income from positions such as strangles is special because you can spend it, or live on it, and keep your stock positions unchanged. For this reason, we will tabulate our income from all related income strategies every year; we remain fans of strangles, with plans to add more.)

What Might Stray Off Course?

The *Pro* team also unanimously agreed that five stocks currently in our portfolio are more likely to fall short of the North Star's 30%-plus estimated return over the next three years. That said, these stocks still might merit a place in the portfolio, at least for the time being. Not every position has to be a double-digit return generator. Some serve other purposes — low correlation to the rest of our stocks, for example, or buyout potential, or hedges and paired trades. But here are five we agreed may lose sight of the North Star from time to time:

1. **Bristow Group**
2. **Covanta Holdings**
3. **Ebix**
4. **L-3 Communications**
5. **Vanguard Energy**

We respect Bristow, but helicopters are expensive toys, so we're content to sell our shares around our $50 fair value. As a result, we recommended covered calls last week to make money on Bristow while we wait to potentially sell it by June. Trash-to-energy barn-burner Covanta Holdings is a steady cash-flow generator as a business, but without higher energy prices or a buyout offer (which may be reason enough to hold it), it may struggle to return more than 30% over the next three years. We plan to keep this bargain-priced company for now, but we're looking at potential ways to squeeze more income from it.

Live Chat on Wednesday!

Join renowned international affairs expert Niall Ferguson of Harvard University and Jeff Fischer of Motley Fool *Pro* from 1:30 to 2:30 p.m. ET this Wednesday, Jan. 11. They'll be live, answering your questions about the ongoing crisis in the eurozone, including relevant investment strategies. (Alex Pape, a Motley Fool analyst, will moderate the discussion.)

Insurance commerce facilitator Ebix is near our $24 fair value, so it's not surprising to find it on this list. Meanwhile, the story at our lone defense-industry investment, L-3 Communications, is changing as the government threatens to curtail its defense budget for the long haul. L-3 already expects lower sales and earnings next year, so we're reconsidering the investment. Finally, Vanguard Energy has done well with oil near $100 a barrel, but if oil doesn't rise higher than $130 in three years, the ETF may not grow by 30%. That said, I like this ETF as a "call option" on a spike in oil prices, even if it may not follow our aspirational North Star to the digit.

What's Next?

The 10 other portfolio positions we assessed each received at least one dissenting vote, so we're in discussion about each one. We have two goals: to concentrate on positions we believe will adhere closely to the straight path that's lit by our North Star, and to either further monetize or close positions we believe could wander off course. Expect our upcoming trade alerts to accompany the conclusions we reach. We have work to do! To talk about this Memo, visit our Memo Musings discussion board.

Fool on!

Jeff Fischer (TMFFischer)

Pro Trade Roundup

- **Expeditors International of Washington**: We set up a put broken wing butterfly income position for a net credit of $4.90 before commissions. We sold to open 13 May 2012 $42.50 puts and 13 May 2012 $42.50 calls for $5.90 per contract combined. We bought to open 13 May 2012 $30 puts and 13 May 2012 $50 calls for $1.00 per contract combined.
- **Bristow Group**: We sold to open 12 June 2012 $50 calls for $2.35 each, covering all shares.

Guidance Updates

- **L-3 Communications** moves down to Hold pending portfolio decisions.
- **Covanta** moves down to Buy following our re-evaluation, as we wrote in this Memo.
- **StoneMor Partners** moves down to Hold just while we clarify everyone's long-term tax implications with a CPA. No worries, though. We'll report back.

Community

- Set sail and invest five minutes in this fun, accurate North Star-related post by MazonCreekRich.
- If you're considering changing your broker any time soon, check out this thread on moving to Interactive Brokers.
- Jeff and Nick share ETF research sites.
- TMFMoosie posts an in-depth *Pro* calendar (on the Memo webpage, you can also see upcoming events in the sidebar to the right).
- Alex340 lists puts and calls that match *Pro* criteria.
- Another post from MazonCreekRich on Bill Gross and his paranormal market concerns.
- RockyTopBob asks for guidance on the **VelocityShares Daily Inverse VIX Short-Term ETN**. Long story short, tracking issues mean it's probably not a long-term holding.
- Did we miss any posts you think should be highlighted? Share them on the Memo Musings board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Write Covered Calls on Bristow Group

Published Jan 6, 2012 at 12:00AM

- **What We're Doing:** This strategy is meant to earn us income while we wait to sell shares near or above our estimate of fair value.
- ### Don't Own 100 Shares of Bristow?

  If you own fewer than 100 shares, look to sell them above $50. If you don't own any or would like to build out your position if shares fall, stay tuned: We'll start to get interested if this volatile stock sinks to the low $40s.

- **What We're Thinking:** Bristow operates in a tough business, and it's hard for the company to consistently book high profits. As shares reach fair value, we're willing to let them go.
- **What We're Expecting:** Bristow has great growth prospects ahead, but that growth won't be profitable enough to propel the stock price much higher.

Trade Essentials

- **Business: Bristow Group** (NYSE: BRS) ferries crews and cargo to oil exploration and production platforms far offshore using its sweet fleet of helicopters.
- **Action:** Sell to open June 2012 $50 calls, one for every 100 shares you own (for *Pro*, that's 12 contracts).
- **Limit order guidance:** As prices change, aim for a net selling price (strike price plus premium received) of $52.50 or higher, or 5% or more above our $50 fair value. At current prices, try to sell the call options for a price greater than $3.

The Strategy

Writing covered calls turns an owned stock into an income producer, offering an attractive net sell price if shares rise and providing an income cushion if they fall. We're choosing a strike price that corresponds with our estimate of fair value ($50), and if shares are above that price by the time they expire in June, we'll bid them *bon voyage* at a price 14% above today's. If the stock stagnates or declines, we've allotted ourselves 6.5% downside protection, in the form of income, by writing these call options.

What's Changed?

- **Last Action**: We wrote December 2011 put options in Port 2011 in an attempt to buy shares at $40.
- **Recent Price**: At $46.50, Bristow's stock is only 7% below our estimate of fair value.

We've said on several occasions that Bristow's stock looks attractive below $40 and fairly valued near $50 — and lately, it's flying near $50. But before deciding to potentially sell a good company, we took a fresh look at the valuation and business. That review has us more confident that Bristow *will not* be able to earn the dramatically improved returns we think are needed to justify a much higher valuation. Here's why:

- We don't believe Bristow's power to negotiate contract prices will improve, particularly as it does more business with state-owned oil companies (which operate under less public scrutiny and have lower switching costs).
- Competition will likely continue to erode the attractive margins Bristow currently enjoys in many international regions.
- Bristow's cost of growth (acquiring new helicopters, training local pilots) is high, and opportunities to lower the cost of acquisition (improved cost of capital, leasing instead of buying) won't tip the scales in the company's favor.

Bristow has recovered nicely since being unfairly punished during the Gulf oil spill disaster — the original reason we bought in. We like Bristow as a company, too. It has done a great job positioning itself in a difficult industry, and it may have a hidden asset in the form of pricing power it's not currently taking advantage of. Its assets and safety record are hard to replicate; at the right price around $40 or lower, members should look to buy. But we don't think it's likely the business will improve enough to justify an upside much higher than $50, so we're trading that upside for option income.

- **Next Steps:** Buzz on over to the Bristow discussion board to ask your questions and discuss our current strategy.
- **Need Background on Bristow?** See the full archive of our coverage.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Set up a Put Broken Wing Butterfly on Expeditors International

Published Jan 4, 2012 at 12:00AM

- **What We're Doing:** We'll earn income if the underlying stock, currently at $41, stays in a range between $37.20 and $47.80.
- ### An Iron Butterfly by Another Name

  An iron butterfly is the combination of two spreads: a bear call spread and a bull put spread. If you're unable to set up a four-legged butterfly trade in one order with your broker, you could set up the $42.50/$50 bear call spread, and $42.50/$30 bull put spread, as two trades.

  #### Butterfly Flying?

If Expeditors' stock moves sharply before you're able to make the trade, please consult the discussion board for new potential strike prices.

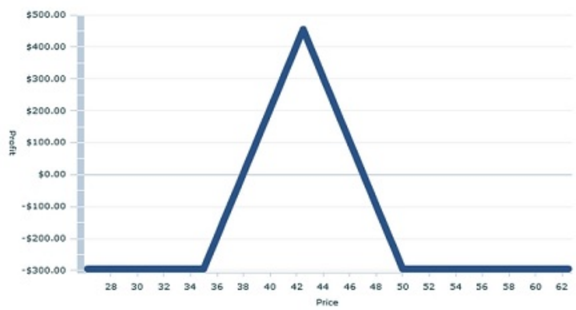
- **What We're Thinking:** We want more income as we follow our always-positive North Star.
- **What We're Expecting:** This strong company looks fairly valued, so its stock is more likely to be range-bound.

Trade Essentials

- **Business: Expeditors International** (NASDAQ: EXPD) facilitates the global transport of goods.
- **Action and Price:**
  - **Sell to open:** May 2012 $42.50 puts *and* calls (a short straddle), for a combined credit of around $6.30. As prices change, accept no less than $5.50.
  - **Buy to open:** May 2012 $30 puts and $50 calls (a protective strangle), lately for a combined cost of around $1; use a limit order.
  - **Total credit:** Around $5.30 net on the four options; no less than $4.90.
- **Allocation:** Our written put obligation will represent 4% of the portfolio at our break-even price of $37.20. For *Pro*, this means 13 contracts of each option.
- **Potential Profit:** A maximum of $5.30 if the stock is at $42.50 at expiration and a partial profit if the stock is anywhere between $37.20 and $47.80.
- **Potential Loss:** The same as a short starting at $47.80, but with losses capped if the stock reaches $50 (a potential loss of $2.20 per share); the same as stock ownership starting at $37.20, but with losses capped if the stock reaches $30 (a potential loss of $7.20 per share).
- **Follow-up:** We may buy shares if they decline to the mid-$30s or roll the butterfly to a new month before expiration.

The Strategy

With this position on Expeditors International, we aim to generate healthy income with low capital investment and reasonable risk. An "iron butterfly" is a neutral income strategy that involves selling calls and puts at the same strike price (this is called a straddle), then buying calls at a higher strike price and puts at a lower strike price (a strangle) to cap your risk in both directions. The nearer the stock price is to your straddle's strike price at expiration, the more income you keep. Here's the profit chart on a standard iron butterfly featuring a $42.50 straddle and long $35 puts and $50 calls that cap your potential loss. (Click to see larger.)

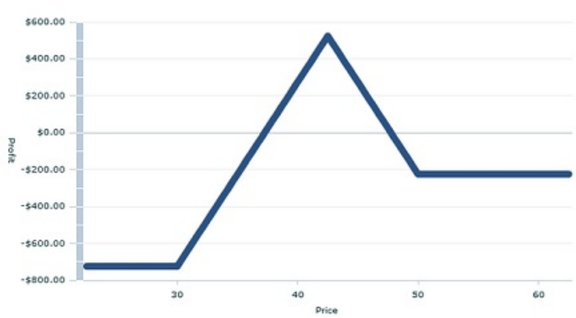


Current Price: $41.1

Price	Profit / Loss
26.25	($295.00)
33.21	($295.00)
35.00	($295.00)
37.95	$0.00
40.53	$258.00
42.50	$455.00
47.05	$0.00
47.85	($80.40)
50.00	($295.00)
55.18	($295.00)
62.50	($295.00)

Source: OptionsXpress.

Our position on Expeditors International, however, isn't a straight iron butterfly, where the wings are nicely even (see them above?). Instead, this "put broken wing" butterfly entails buying puts that are farther from our straddle strike price than the calls we purchase. This lowers the cost of our puts, increasing our potential income, but gives us less downside protection. We're comfortable with this compromise because we're ready to buy shares if they decline. The profit chart on our put broken wing butterfly looks like this (click to see larger):



Current Price: $41.14

Price	Profit / Loss
22.50	($725.00)
30.00	($725.00)
30.18	($707.30)
37.25	$0.00
38.26	$100.80
42.50	$525.00
46.34	$141.20
47.75	$0.00
50.00	($225.00)
54.42	($225.00)
62.50	($225.00)

Source: OptionsExpress.

Poor butterfly! Its left wing is hurt.

OK, back to business. If Expeditors' stock price declines, we're buying shares in the mid-$30s to wait for a recovery. We will, however, buy $30 puts to limit the capital we need to set aside for this trade, and to mitigate the risk of any surprise that might take shares below $30. And we're buying $50 calls to protect against the stock soaring.

To review, if the stock is between approximately $37 and $48 by expiration, we'll earn at least a partial profit on this income strategy. We're hoping the shares stay close to our $42.50 straddle price, where we'll earn the most premium possible. The May expiration sounds distant, but we want to collect a large enough combined option premium that we have a wide share price range in which to profit.

The Business

Expeditors keeps the wheels of commerce turning worldwide, particularly in Asia (where it generates 57% of its revenue) and the United States (24%). Rather than owning costly airplanes, whale-harassing ocean freighters, or diesel-guzzling trucks, the company buys space on these carriers at wholesale prices and resells it in smaller chunks at retail rates.

About one-third of Expeditors' customers are moving basic retail items, and another third are shipping more sensitive consumer electronics and tech products; the remainder runs the gamut from pharmaceuticals to business and government products to general consumables. A true headache-saver, Expeditors handles all the logistics and navigates the cumbersome customs laws for its shipping customers. The company is cash-rich, debt-free, and run by no-nonsense management. Veteran members will recall that *Pro* has owned — and strangled — Expeditors in the past.

Wall Street expects Expeditors to grow earnings per share 13% annually and is pricing the stock at 21 times expected 2012 earnings and 21 times free cash flow. Asset-light, well-run, and with competitive advantages in Asia (where it first put down roots in 1981), Expeditors commands a premium valuation, but in today's uncertain economy, shares look more likely to be range-bound.

Next Steps: Visit the Expeditors discussion board to post questions, and then make your trade.

See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Portfolio 2011 Archive

Published Jan 4, 2012 at 12:00AM

Portfolio 2011 was launched in January 2011 with $250,000 of the Fool's money. The goal was to help our newest members catch up to the Charter Portfolio. Click here to read more about the portfolio, and click here to download a snapshot of our holdings and performance when we closed the portfolio in January 2012.

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5 Pro Resolutions for 2012

Published Jan 3, 2012 at 12:00AM

Greetings, Fools,

Trade Roundup

Portfolio 2011

- **Oracle Corp**: Bought 230 shares (2.7%) at $25.50, for 5% total.

Guidance Updates

- Oracle was moved to Buy First.

The New Year promises to be at least as interesting as 2011. For starters, the euro's problems may finally come to a head; the presidential election is likely to be pivotal — and I'm talking about France as much as the United States; and any slowdown in the Chinese economy could slug commodity prices worldwide. And those are just the potential shakeups on the radar; add in any number of surprises, and it's doubtful we'll have a dull month the entire year.

When it comes to investing, our work is cut out for us in 2012. Whatever the economic environment, our guiding North Star (the Consumer Price Index, including food and energy, plus 7% annually) does not go negative, and it's currently running above 10% per year. Although stocks could gain more than 10% this year, to my eye there's a 50-50 chance they could go nowhere, or even down. So we'll want to sell short selectively and generate steady income, aiming to earn positive returns even if the market doesn't. I expect an active year for us.

To help us reach our goals, here are five items on our road map for 2012:

1. **Communicate efficiently, with a focus on our strategy and reasoning.** Rather than try to answer all possible questions in advance with long trade reports, we seek to write (or record, using multimedia) tight reports, later answering any and all questions on the discussion boards.

2. **Move into targeted shorts.** I'd much rather be short five hand-picked, faltering companies at 5% each than have 25% of the portfolio short the S&P 500, which is generally filled with healthy companies. This year, with a more flexible broker, we'll be able to make the switch.

3. **Generate higher income.** In 2011, our income positions were relatively few. We seek to increase them substantially in 2012 and to add new strategies as we follow our North Star.

4. **Buy the best.** Some of the best investments you'll ever make are "one-sided" decisions: You buy and hope you never need to sell. We have several companies in the *Pro* portfolio that fit the bill, including **MasterCard** and **Oracle**, but the ideal (income positions aside) is to own *nothing but* world-beating companies you're unlikely to need to sell. We want more of those in the portfolio, and we'll gradually replace names that don't pass the test.

5. **Short the obviously flawed.** The demise of stodgy retailers could be a theme of our short positions this year, but shorting terminally flawed ETFs and ETNs is just as compelling. Many ETFs are hamstrung by futures prices or the leverage they employ. Shorting opportunities on these doomed instruments are compelling for those who do their homework and allocate appropriately.

This year in *Pro* should be defined by action more than talk; our communications with you should be direct, clear, and to-the-point, and our discussion-board presence stronger than ever as we answer your questions. We should Foolishly enjoy the year together as we strive to grow value, ready ourselves to ride out or benefit from volatility, generate income, and practice patience as our stock investments play out.

What are your resolutions for 2012? Share them on the Memo Musings board.

Fool on in the New Year!

Jeff Fischer (TMFFischer)

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Community

- *Pro* member dollarfor40cents shares programs that let you screen for attractive put writing, covered call writing, and strangle writing candidates, just by entering a ticker. It looks nicely done! Thank you, dollarfor40cents.
- *Pro* is still trying to set up a synthetic short on **CurrencyShares Euro Trust** for a price that's inferior to the current trust price by only $2 or less. We'll update as needed.
- MCR, per usual, speaks of sunshine, giggles and happy times.

Happy New Year From the Pro Team

Published Jan 2, 2012 at 12:00AM

Dear *Pro* Fools,

Welcome to 2012!

The ball in Times Square has dropped, the Rose Bowl parade is under way in Pasadena, and (in a nod to Europe's dominance in the headlines) the Spaniards just ate 12 grapes for 12 months of good luck.

Here in Alexandria, Va., the *Pro t*eam and I wish to take a moment this holiday to thank you for being a *Pro* member, and to share our excitement as the New Year begins. We have a lot to look forward to in 2012 as we continue to employ the investing strategies we know work over time. Our new North Star, which is returning more than 10% annually, is here to guide our decisions. With the natural end of Portfolio 2011 behind us, we can unite the entire community behind just one portfolio, the Charter Portfolio (soon to be renamed the *Pro* Portfolio). And we see greater flexibility ahead for the portfolio as we adjust our broker this month.

We're also going to amp up the interactive nature of our service. But rather than spill the beans early, we'll let you see our new features as we roll them out as part of your *Pro* content. At the heart of it all is our desire to deliver more profitable investment recommendations to you in 2012, in a more compelling and efficient way, and to manage the portfolio toward healthy absolute profits over any reasonable time period.

On behalf of the *Pro* content team, thank you again for being a member of *Pro*! We look forward to starting the New Year with you. For now, enjoy the holiday, and Fool on!

Jeff Fischer (TMFFischer)
Pro Advisor

... and the whole team!

(Left to right: Nick Crow, Alex Pape, Jeff Fischer, Ellen Bowman, Bryan Hinmon)

What's Next for Portfolio 2011

Published Dec 28, 2011 at 12:00AM

Portfolio 2011 was launched in January 2011 with $250,000 of the Fool's money. The goal was to help our newest members catch up to the Charter Portfolio. Click here to download a **snapshot of our holdings and performance** when the portfolio reached its natural end in January 2012.

Greetings, *Pro* Fools,

We launched *Pro*'s Portfolio 2011 when we welcomed new members to *Pro* in early 2011. Its purpose has always been to help new members build positions in as many of the stocks we love from the Charter Portfolio as feasible. Now, as 2011 draws to a close, you'll see an important change in your *Pro* service: **In the final days of 2011, all followers of Portfolio 2011 will officially graduate to the Charter Portfolio.**

Commence the Commencement!

Over the course of this year, we've built Portfolio 2011 positions in all of our Buy and Buy First stocks. And now, except for four stocks on hold — **Bristow Group**, **Papa John's Pizza**, **Plum Creek Timber**, and **Vanguard Energy** — the two portfolios are aligned on stock positions. We have written puts in Portfolio 2011 on Plum Creek Timber and, in the past, Bristow Group to try to buy shares cheaper, and we'll continue to remember that many members don't own these stocks yet, offering guidance when prices are attractive.

So, it's time to say goodbye to Portfolio 2011 and ask those of you who have been following it to now follow the Charter Portfolio. There, you'll see all of the same stocks you own, with the same allocations (or very close), and our same Buy Around guidance. Although you'll no longer be able to track Portfolio 2011, we'll document it at market close the day we shutter the portfolio, and that information will remain archived on the *Pro* site.

Rest assured that the coverage, analysis, and buy and sell guidance you've come to expect from the *Pro* team and me will remain unchanged, as will our mission: We aim to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years.

To the Future

Investing has its ups and downs, and 2011 was *Pro*'s first difficult year. We failed to meet our absolute-returns goal — but we're not disheartened by any means. We know this happens over short periods, and we're excited about the opportunities ahead in 2012. With our new North Star to guide us, with the community all aligned around one portfolio, and with a dedication to offering you exceptional investment ideas in concise and educational reports, we know healthy gains are ahead.

Portfolio 2011 served its purpose in aligning new members with our existing positions, and now that the two portfolios are largely the same, we're happy that all members will be unified behind a single portfolio as we move forward. The team and I are working to make this transition as smooth as possible for you, and we're prepared to answer any questions or concerns you may have. We've put together a Q&A about the upcoming changes below, or feel free to email me directly.

Happy 2012! I look forward to years of investing and profiting together.

Fool on!

Jeff Fischer
Advisor, *Motley Fool Pro*

Portfolio 2011 FAQ

Q: Portfolio 2011 is down, and now you're taking it away. Are you still confident in the portfolio?

A: Portfolio 2011 was never meant to be an independent portfolio — it was meant as a way to help new members buy Charter Portfolio stocks, so it focused on buying those stocks one by one. Portfolio 2011 is down over its 11 months (largely because of one large loss), but this is far too short a time period to measure investment results. We're confident that *Pro*'s holdings — now represented by the Charter Portfolio — will do well over the time frame that matters: the coming few years and beyond.

Q: Why are you shuttering Portfolio 2011?

A: Portfolio 2011 wasn't created to be an ongoing, managed portfolio. It was created to help our newest members start their portfolios with us from scratch, while we committed new Fool capital to every recommendation we made. Now that Portfolio 2011 has completed its mission, it's time to close it and ask all *Pro* members to follow the Charter Portfolio.

Q: Will there be a Portfolio 2012?

A: No. Portfolio 2011 served its purpose, but it also taught us some lessons — and one of them is that we believe we can better and more efficiently serve all members by focusing on just the Charter Portfolio (which will be renamed the *Pro* Portfolio). In the future, we'll simply direct new members to buy all of our Buy First and Buy stocks incrementally. Our VXX short is one high-profile example of the effects of having two portfolios. Portfolio 2011 was called out on that position, and since the portfolios are meant to match, the Charter Portfolio had to close it, too. Such a situation can quickly get complex. Going forward, we know we can provide a stronger service when all members are following one portfolio.

Q: What will happen to Portfolio 2011?

A: We will no longer track its performance, but we will document it at market close the day it is ended, and that information will remain archived on the *Pro* site. You will still be able to evaluate the *Pro* team's performance in the Charter Portfolio. It is our experience that most members are concerned with their own scorecards and our analysis of our positions rather than the Portfolio 2011 scorecard itself. Although we've been trusted with managing some of The Motley Fool's money, our primary concern is *your* scorecard over the coming few years — because we succeed when you succeed.

Q: Are you folding the stocks and cash in Portfolio 2011 *into* the Charter Portfolio?

A: No. Portfolio 2011, including the stocks and the cash in the brokerage account, will be returned to The Motley Fool. The positions will be liquidated at the discretion of The Motley Fool's chief financial officer with no input from the *Pro* team.

Q: Will the prices of the stocks *members* own be affected by the liquidation of Portfolio 2011?

A: That's very unlikely because Portfolio 2011 doesn't own enough shares to move the market in any meaningful way.

Q: Which trade alerts should I follow now?

A: All members will receive and follow all trade alerts, since we'll only be managing one portfolio. Once Portfolio 2011 closes, trade alerts will be sent to all members as we manage the Charter Portfolio, which will be renamed the *Pro* Portfolio.

Q: I've been following Portfolio 2011 trade for trade, and the percentage of my portfolio in cash doesn't match the Charter Portfolio. How will that affect me?

A: If you have a larger cash balance than the Charter Portfolio, that's OK. Over time, the four stocks on Hold in the Charter Portfolio — which you don't own as a follower of Portfolio 2011 — will likely be sold. This will increase the cash position in the Charter Portfolio so that it will eventually come close to matching yours.

Q: I have options open on stocks I was trying to buy as I followed Portfolio 2011. What do I do?

A: Don't change your options. Let them play out. The stocks you're trying to buy are already in the Charter Portfolio, so you'll continue to receive guidance on these companies. Eventually, we hope you'll own shares at good prices. We will also offer guidance on the four stocks from Charter Portfolio that Portfolio 2011 followers don't yet own, including put-writing guidance or advice on when to buy the stock. You'll find that guidance on the discussion boards, on the recommendations page (where you'll see a stock moved to Buy or Buy First), and in our Monday Memos.

Q: When will all of this happen?

A: By year-end, we will stop actively tracking Portfolio 2011 and archive it on the *Pro* site, and the Port 2011 brokerage account will be put in the hands of the Fool's CFO.

Q: What if I have more questions?

A: If we didn't answer your question, please ask on *Pro*'s Philosophy & Strategy discussion board, and the team will get you an answer.

Portfolio 2011: Buy More Oracle

Published Dec 27, 2011 at 12:00AM

What We're Doing: Filling Portfolio 2011's allocation to Oracle.
What We're Thinking: A lower share price after a rare quarterly earnings miss is an opportunity.
What We're Expecting: In 2012, Oracle will reassure investors with stronger results.

Trade Essentials

- **Business: Oracle** is the world's largest corporate software and integrated hardware provider.
- **Action:** Buy 2.7% (in Portfolio 2011, that's 230 more shares), for 5% total.
- **Buy Around:** $27 or lower.
- **Alternate Trade:** Sell to open puts with a $26 or lower strike price.

What's Changed?

- **Last Buy:** Aug. 10, 2011
- **Price Change Since:** Down 2%

Who spiked the eggnog? Oracle tripped and stumbled last week after earnings missed expectations for the first time in years. Customers were slow to close large orders as Europe teetered and tottered, so revenue only increased 2%, less than the 7% sought by Wall Street. More optimistically, though, net income grew 6% (non-GAAP; the number was 17% under GAAP), and Oracle expanded its operating margin despite hiring 1,700 new sales staff. Oracle's CFO, Safra Catz, also suggested the next quarter will be "much more normal" because order flow started to improve after the quarter ended.

Even if it ends up taking several quarters for Oracle to get back on its horse, we're content to invest at today's discounted price of 10 times free cash flow. A 45% surge in FCF over the last 12 months (to $12.6 billion) was driven by software sales, but as companies build cloud services, Oracle's hardware business has much more growth potential than the market seems to believe.

In fact, light sales today could make the growth we expect (starting at least a few quarters from now) much more pronounced. That's because despite "more normal" patterns in the current quarter, management is guiding for just 7% growth in earnings per share; a year ago, Oracle grew EPS 40% in non-GAAP terms (75% under GAAP). Wall Street is lamenting tepid growth today, but analysts are missing the forest for the trees: Low numbers make sense at the moment compared with last year's blowout.

Oracle is still growing, and growth will accelerate year-over-year in future quarters, even if that growth is lumpy. Given the company's strong product line, healthy pipeline of orders, recurring revenue of nearly 50% of sales, proven leadership, and growing profit margins, we're happy to put more shares in the portfolio for the long haul.

- **Next Steps:** Visit our Oracle board to ask questions. Make sure more Oracle suits your portfolio, then visit your broker to make your buy.

The Motley Fool owns shares of Oracle. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro's Year in Review

Published Dec 19, 2011 at 12:00AM

No Memo Next Week: Fools, there will be no *Pro* Monday Memo the week of Dec. 26, but we'll be back in your inbox on Tuesday, Jan. 3. Have a wonderful holiday!

Dear Fellow Fools:

Big *Pro* Stories in 2011

- We lost on our **iPath S&P 500 Short-Term VIX Futures** short despite continued belief in our thesis. We learned that smaller short positions are less stressful — and that brokers matter. In January, the *Pro* portfolio will be moving from Schwab to Interactive Brokers, where it's easier to short and stay short.
- **Intel** surprised Wall Street (but not us) with strong earnings growth. Analysts went into 2011 expecting flat results, but Intel has grown earnings exactly according to our estimates. I believe Intel can surprise in 2012 as well, since Wall Street again expects a flat year.

- Short-sellers publicly attacked **Ebix** online, sending the stock down sharply, and it has yet to fully recover. Management has changed its communications strategy, bought back large blocks of shares, and reported strong results in November, and lately the stock is clawing its way back.
- With our community (that's you!), *Pro* was able to help thousands of investors learn how to generate their own income with options and hedge by shorting market indexes for the first time.
- Two of our two dozen companies were bought out at healthy premiums. Nice! We own others that are potential takeover candidates, including **OpenText** and **Covanta**.

Many money managers already want to forget 2011. Big names from John Paulson to Bill Gross suffered setbacks this year, with Paulson losing 44% on his flagship hedge fund through November. And they're far from alone: According to Bank of America Merrill Lynch, only 23% of mutual funds are doing better than the S&P 500 in 2011. The market's record-strong volatility has made it easy to lose ground on any ill-timed buys or sells, and this marks the second year in a row of significant underperformance by most mutual and hedge funds.

At *Pro*, our investing performance languished in 2011 largely because of one position. We were doing well until August; buyouts of **TradeStation** and **Kinetic Concepts**, strong gains in **AmTrust Financial** and **Intel** (our largest holdings), and strength in our defensive health-care and utility companies drove *Pro*'s results well into the green by summer.

Then came August. We were short volatility, in the form of the **iPath S&P 500 Short-Term Futures** ETN , as the U.S. credit rating was downgraded and Europe began to melt down. After two months of historically strong volatility, our broker called our short on us in late September, we lost a scalding 9% of the portfolio, and we haven't reinitiated a position on VXX yet. (We plan to.)

Because of that loss, we are down year-to-date, so we're failing our absolute return goal in 2011. But unlike many funds, we won't need to engage in acrobatics in 2012 to recover. Below, you can see our results as of Nov. 31. We have a relatively modest loss. From the most meaningful numbers to the least, left to right, here are our results:

Pro Performance

	Annualized, Since Inception	Rolling 3-Year	2011 Year-to-Date
***Pro*'s Charter Portfolio**	9.2%	9.9%	(4.5%)
North Star	8.1%	9.2%	9.7%
S&P 500 Total Return Index	7.7%	14.1%	1.1%
MSCI World	3.2%	9.9%	(7.5%)

Returns through Nov. 30, 2011, per Schwab brokerage statements.

As you can see, our newly introduced North Star — which we calculate as inflation plus 7% — scored yet another outstanding year. Going into 2012, our North Star is running north of 10%. The S&P 500 and MSCI World indexes are both shown for reference only; the former was flat in 2011 and the latter was down more than *Pro*.

What Did What?

Many of our positions are ending the year not far from where they started. We didn't set up as many option income positions this year as we have in years past, but in retrospect, we should have — high volatility that ultimately leads nowhere is ideal for writing market-neutral option income, as long as you don't expect the market to make a decision and soar or tank. Here are some stock positions that did move meaningfully:

Position	Year-to-Date Return With Dividends
AmTrust Financial	34%
Papa John's Pizza	33%
Tupperware	16%
Intel	14%
3D Systems	(43%)*
GrafTech International	(34%)
Covanta Holdings	(20%)*

*Denotes return since our 2011 purchase; measured from Dec. 30, 2010, to Dec. 16, 2011.

This wasn't a year for blowout returns. In fact, 2011 was a year of prominent *blow-ups* in the market. *Pro*'s largest loser on the year, 3D Systems, is one of our smallest positions, so its struggles haven't influenced the portfolio much. And we still like the company: The 3D printer's strong management team is expanding the business in several directions, and if margins improve in 2012, the stock could sing a different tune. We are considering adding to the position.

Another stock that's down for us, Covanta Holdings, is simply cheap. Like **BMC Software**, Covanta trades at a single-digit multiple to free cash flow, despite a strong and steady business. I can recall similar situations in which valuations were this low, and in those cases, patience led to healthy returns. Stocks as a whole aren't expensive right now, suggesting that 2012 could deliver strong results for investors, particularly if Europe is able to avoid a recession.

Cheers to 2012

I admit that I'm already looking forward to the New Year — 2012 should bring many of positive changes. The team is excited about our North Star, as you can probably tell, and we're glad to see members sharing in that excitement on the discussion boards. We're also changing brokers in January, moving to Interactive Brokers, which should make shorting *much* easier, including short positions on individual companies. I expect *Pro* to initiate steady income strategies on established leaders in the coming year, as well as invest in younger companies with an eye toward strong capital appreciation. And bonds are not out of the question given our goal of absolute returns.

This is the last Monday Memo of 2011, so I'd like to take this moment to thank you for being a *Pro* member. You make our work possible, and we start every workday with the knowledge that we (happily!) work for you and your families. From the whole team, a sincere thank you. We will always work to make *Pro* a profitable and enjoyable experience for you, and we want both of those values to grow over the years.

We expect to issue some new trades to close out the year, and we'll of course be available on the discussion boards.We wish you a joyful holiday season; Fool on!

— Jeff Fischer (TMFFischer)

Pro Trade Roundup

Charter Portfolio

- **Pacer International**: Sold to open 30 December $5 puts for $0.35. We were then "put" the 3,000 shares (1%) at a net start price of $4.66.

Portfolio 2011

- **Pacer International**: Sold to open five December $5 puts for $0.35. We were then "put" the 500 shares (1%) at a net start price of $4.66.
- **Plum Creek Timber**: Sold to open four May 2012 $33 puts (5%) for $2.05.

Community

- Fools talk about our new North Star on its discussion board.
- Alex (TMFPapester) explains why **Pacer International** and the intermodal transportation industry in general are experiencing a boon. Although many Fools were put shares like us, many weren't, so we'll share guidance soon.
- **Amtrust Financial Services**' stock price declined after the company sold convertible debt. Bryan (TMF42) has our initial take; the short version is that we're holding steady.
- **OpenText** announced the retirement of its longtime CEO, and the market wasn't happy. The new CEO has been named.
- Raleigh1208 shares his experience with iPath S&P 500 VIX Short-Term Futures (VXX to its friends), with an eye on the future.
- TD Ameritrade has shares of **CurrencyShares Euro Trust** to short directly if you like (that's easier than a synthetic short).
- MazonCreekRich shares his holiday thoughts!

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Your Guide to Our North Star

Published Dec 15, 2011 at 12:00AM

Like the real North Star, our North Star offers direction and guides our investing behavior. Learn more below.

Pro's Mission

Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years.

***Pro*'s North Star: Inflation + 7% annually**

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward.

Why inflation + 7%?

Our mission is to grow the real purchasing power of our capital. Therefore, the first competitor we need to beat is inflation, as measured by the Consumer Price Index.

We want to grow our dollars by more than the rate of inflation — that's a given. Exactly how much more is a difficult figure to pinpoint, but history tells us that if we can double the *real* purchasing power of your dollars every 10 years, we'll be doing what few manage to accomplish.

To double your dollars in a decade, we need to book a compound annual return of about 7%. To double your *real* dollars, we need to return 7% *plus* inflation. Thus, this figure is born directly out of our mission of absolute returns — returns that improve your financial standing in the real world.

More Guidance

It's a bird, it's a plane, it's our North Star discussion board!

Relive our live chat with members about the debut of the North Star

Our North Star has several important characteristics that make it appropriate, challenging, and aspirational for all of us. It:

- **Never goes negative.** This lines up with our goal of positive returns over all three-year periods.
- **Is not investable**. It's impossible to lock in a return of inflation plus 7% with some other vehicle.
- **Is not a benchmark**. By definition, benchmarks must be investable; they are used for evaluating the performance of a relative-returns strategy. Absolute returns are our goal.
- **Is not a hurdle**. A hurdle is something you must leap over to avoid tripping. Our North Star guides us to make appropriate investment decisions. We're more likely to reach our goals if we let it guide us. If we come close to our North Star, let alone jump over it, we'll be over the moon (sorry!).
- **Is not a gimmick**. We are working to better explain our philosophy and strategy to you, and our North Star will be an ever-present factor in our investment decision-making.
- **Is a challenging reference point**. Historically, our North Star has outperformed the U.S. and world stock markets. Over rolling three-year periods since 1970, our North Star has put up a compound annual return of 11.3%, versus 9.9% for the S&P 500 Total Return Index and 6.4% for the MSCI World index. Our North Star also delivered that return *much* more steadily than the market indexes, without a single down year.
- **Guides our behavior** as we invest with the tools available to us. It is a framework to explain and reinforce consistent portfolio decisions. Approached consistently over long periods, it should help us and our members achieve strong financial rewards.

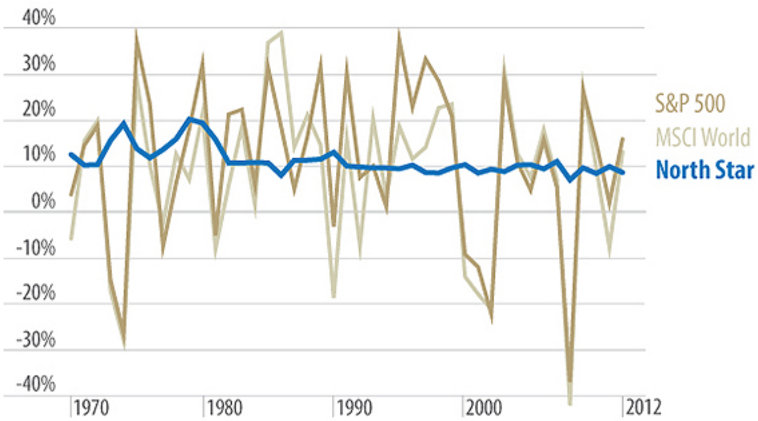
Historical Performance

How has our North Star performed historically? We're glad you asked, and we hope you like data! Here's a summary of the past 41 years. Below that are charts of the full history.

Annualized Return, 1970–2012

	Average	CAGR	Highest	Lowest
North Star	**11.3%**	**11.3%**	**20.3%**	**7.1%**
S&P Total Return	11.4%	9.9%	37.6%	-37.0%
MSCI World	7.8%	6.1%	39.1%	-42.1%

Annualized Return, 1970–2012

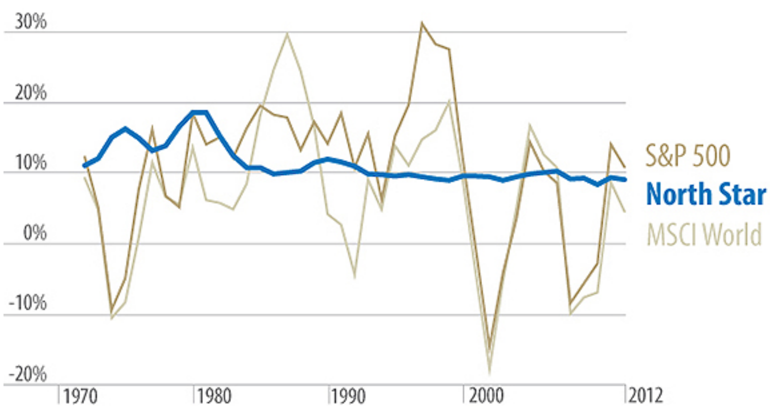


Here are the same data, showing rolling three-year annualized returns. Again, note the lack of volatility for our North Star.

Annualized Rolling 3-Year Return, 1972–2012

	Average	CAGR	Highest	Lowest
North Star	**11.4%**	**11.3%**	**18.6%**	**8.4%**
S&P Total Return	10.4%	9.9%	31.2%	-14.6%
MSCI World	6.9%	6.4%	29.7%	-17.7%

Annualized Rolling 3-Year Return, 1972–2012



Note that we included both average and compound annual (CAGR) historical growth rates. To investors, the one that matters is the CAGR. We included both to show the power of compounding: Even though our North Star has averaged an almost identical annual return to that of the S&P Total Return index over the past 43 years, the North Star (again, inflation plus 7%) has outperformed the index by about 1.4 percentage points annually. That's because when the index has those deeply negative years, much higher positive years are needed to claw its way back to positive territory. Since it never goes negative, our North Star doesn't have that problem. That is the power of steady, positive returns — see below for visual representation.

(We're including the S&P Total Return and MSCI World returns purely for the sake of education. Our investment strategies are not focused on either.)

Performance Since Inception

How has *Pro* performed against its North Star since our start in 2008? We hope you *really* like data: Here are *Pro*'s annualized returns lined up against those of our North Star. (Again purely for education, we've also included the returns for the S&P Total Return index and the MSCI World index.)

These returns are annualized, not cumulative. Annualized returns are more useful to investors because they allow easy comparisons.

A note on the recency of data: The Consumer Price Index (inflation) data is reported with a several-week lag, while *Pro*'s performance is in real time. Inflation is quite stable from month to month, so we use the previous month's inflation figure as an estimate for the current month's until the actual data are released. Any adjustment required is usually negligible, especially given the rolling three-year viewpoint we favor. This approach allows us to keep our performance tables updated all the time.

Annualized Return

To read this chart, remember that the return data are annualized, not cumulative: The chart shows the annualized return since inception *as of the end of each subsequent month*. The data begin one year after *Pro*'s start, because annualized returns based on less than a year of data aren't very useful.

And here are our rolling three-year annualized returns — again, our preferred measurement.

Annualized Rolling 3-Year Return

Date	*Pro* Portfolio Balance	*Pro*	North Star	S&P Total Return	MSCI World
10/6/08	**$1,000,000**				
10/31/08	**$1,001,292**				
...					
11/30/12	**$1,451,264**	**6.90%**	9.23%	11.25%	4.61%
12/31/12	**$1,461,698**	**6.14%**	9.20%	10.87%	4.63%

Questions We Anticipate May Be Frequently Asked

How are you measuring inflation?

We're using the change in the Consumer Price Index. The Consumer Price Index is a measure of the average change over time in prices paid for a "market basket" of consumer goods and services. In plain language, it measures how many more dollars it takes to buy things over time.

Specifically, we're using the CPI-U, or the Consumer Price Index for All Urban Consumers, which covers about 87% of the U.S. population. We're using the "all items" version of the CPI-U, which means that we aren't excluding anything. This is worth pointing out because media-reported CPI figures often exclude food and energy prices.

Wait a second. I'm pretty good at math, and you need to return 7.177346% annually to double your money in 10 years. What gives with your 7% figure?

Yes, to be precise, we'd need to return $2^{(1/10)}$-1, or about 7.177346%, per year to double a portfolio in 10 years. Spelling out our North Star as inflation + 7.177346% doesn't in any way make it more useful as a guide, though.

Is the North Star a hurdle or benchmark?

Our North Star is neither a hurdle nor a benchmark. Hurdles are things you intend to leap over, and benchmarks represent an alternative for your investment dollars. Our North Star is neither of these things. Its purpose is to offer us direction, guide our behavior, and keep our mission front and center.

What is a rolling three-year period?

Rolling three-year returns measure performance over the most recent three years. So the rolling three-year return as of Oct. 31, 2011, measures the return since Oct. 31, 2008. A month later, the rolling three-year return as of Nov. 30, 2011, measures the return since Nov. 30, 2008.

How will the North Star change how *Pro* is managed?

Our strategy will not change, but our implementation of it should improve with the North Star as a guide. Our North Star should remind us to lower our risk when we have large, abnormal returns, or increase our exposure to stocks and income if we're not close to our North Star. Thankfully, this should work well in the marketplace. If stocks are up sharply, we *should* be looking to lower our exposure, as our North Star would suggest. If returns are lackluster, we *should* be looking for more stock values or income strategies. Following a steady North Star should help us make better decisions.

Why is the North Star better than the S&P 500?

Pro has never been an alternative for the S&P 500 index. We use options for income, we short, and we hedge. The index is a long, stock-only vehicle. *Pro* is also not about returns relative to an index; we're about positive gains over any reasonable period. The North Star never goes negative, so it's a much better measure against our goal than is the volatile S&P 500, which can be negative for years.

Inflation is relatively tame lately. What happens when it soars?

Then our North Star's annual return is going to soar, too. Thankfully, stocks typically compete well with inflation, so to follow our North Star, we know we'll need to be largely invested in stocks during periods of high inflation, and we'll likely use fewer income strategies, because fixed income may not keep up with inflation.

What if you don't top your North Star?

We'll be happy if we just stay on track with it — or stay relatively close. If we *can* top it over many years, that would be excellent. But we need to realize the lofty challenge of topping a measure that *never* has a negative year while we're investing in stocks. Our North Star is our aspiration, not a hurdle or benchmark.

Can I measure the North Star against my portfolio at home?

Absolutely. Using the Bureau of Labor Statistics CPI stats, you can obtain historical CPI measures along with a monthly update to compare the CPI+7% to your portfolio. We've already done the 41-year history for you above, and we'll be updating the North Star results monthly for you.

Where can I talk about the North Star with the *Pro* team and other members?

Our North Star discussion board is always shining (sorry!).

Introducing Pro's North Star

Published Dec 15, 2011 at 12:00AM

Pro Fools,

What's This All About?

At *Pro*, we've always strived for absolute returns, and today we're introducing **two improvements to the service** that should help us do an even better job of achieving them. These features should also help you better measure our performance. This article will tell you more about our updated mission statement and the guiding light we're calling our North Star.

Can We Talk?

We'd love to! Bring questions, comments, and feedback to our new North Star discussion board.

Can We Talk ... in Real Time?

We'd love that, too! The *Pro* team is hosting a North Star-themed live chat at 2 p.m. Friday, Dec. 16, to answer any questions you might have. You can set a reminder here, and we hope to see you then!

I Want to Know More!

We want to tell you more! Check out Your Guide to Our North Star for more data than you can shake a guiding light at.

Today is an exciting day to be a *Pro* investor.

Since *Pro* opened its doors on Oct. 7, 2008, absolute returns have been our goal. We've crafted a portfolio with that goal in mind, we've worked to educate members on what an absolute-returns strategy is all about, and we've detailed our aim to earn you consistent, recurring profits with a high level of accuracy.

But how do you know how well we're doing? What exactly is guiding our investing behavior, and what *should* guide it? Can we quantify consistent profits in a way you can measure?

Today, we are proud to introduce *Pro*'s North Star as a way to answer those questions and provide that quantifiable information — and to serve as a guiding light for the decisions we make at *Pro*. But first, we'd like to share our updated version of *Pro*'s mission statement. The former statement read: "To earn members consistent, recurring profits with a high level of accuracy using a combination of stocks, options, and ETFs." Our new and improved version is below.

Pro's Mission

Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to ***meaningfully increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years***.

We're adding the bolded clause to our mission to clarify and improve it. There are four new bites to chew on:

1. **"Meaningfully grow":** If we are able to fulfill our mission, we will help *Pro* members achieve their investing goals with absolute gains measured over any rolling three-year period.
2. **"Real purchasing power":** We don't just want to increase the purchasing power of our — and your — portfolio; we want to increase its *real* purchasing power. That means taking explicit account of the pesky inflation that eats away at a dollar's value. If your portfolio is down less than a stock index, you can't spend that outperformance; similarly, if the prices of things you need or want rise faster than your portfolio's returns, your investments are losing to your real-world costs.
3. **"Every rolling three-year period":** We invest in stocks with the long term in mind, and we think any tool used to help guide our decision-making should be equally long-term in nature. Our income strategies (such as some options positions) may be shorter-term, but in investing, results as a whole are better measured over rolling three years; there is too much noise in shorter periods.
4. **“Double our real purchasing power every 10 years”**: This is an aspirational goal; we'll be doing very well in the world if we can double our buying power every 10 years.

To be clear, we are not introducing a change in our strategy, even though we *are* likely to make better investing decisions if we continue to keep these concepts, and our new North Star, front and center. Instead, our goal is to bring more clarity and transparency to the journey we are taking together as investors. And to that end, we're thrilled to introduce to you our North Star, our new way to measure our goal of absolute returns.

Pro's North Star

***Pro*'s North Star: Inflation (as measured by the Consumer Price Index) + 7% annually**

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward.

Why is inflation + 7% annually our North Star?

Our mission is to grow the real purchasing power of our capital. Therefore, the first competitor we need to beat is inflation.

We want to grow our dollars by more than the rate of inflation — that's a given. Exactly how much more is a difficult figure to pinpoint, but history tells us that if we can double the *real* purchasing power of your dollars every 10 years, we'll be doing what few manage to accomplish.

To double your dollars in a decade, we need to book compound annual returns of about 7%. To double your *real* dollars, we need to return 7% *plus* inflation. Thus, this figure is born directly out of our mission.

Our North Star has several important characteristics that make it appropriate, challenging, and aspirational for all of us:

- Our North Star **never goes negative.** This lines up with our goal of positive returns over all three-year periods.
- Our North Star is **not investable**. It's impossible to lock in a return of inflation plus 7% with some other vehicle.

- Our North Star is **not a benchmark**. By definition, benchmarks must be investable; they are used for evaluating the performance of a relative-returns strategy. Absolute returns are our goal.
- Our North Star is **not a hurdle**. A hurdle is something you must leap over to avoid tripping. Our North Star guides us to make appropriate investment decisions. We're more likely to reach our goals if we let it guide us. If we come close to our North Star, let alone jump over it, we'll be over the moon (sorry!).
- Our North Star is **not a gimmick**. We are working to better explain our philosophy and strategy to members, and our North Star will be an ever-present factor in our investment decision-making.
- Our North Star is a **challenging reference point**. Historically, our North Star has outperformed the U.S. and world stock markets. Over rolling three-year periods since 1970, our North Star has put up compound annual returns of 11.5%, versus 9.8% for the S&P 500 Total Return Index and 6.3% for the MSCI World index. Our North Star also delivered those returns *much* more steadily than the market indices, never experiencing a down year.
- Our North Star serves as a **guide for our behavior** as we invest with the tools available to us. It is a framework to explain and reinforce consistent portfolio decisions. Approached consistently over long periods, it should help us and our members achieve strong financial rewards.

Tracking Our North Star

The table below shows our results since we opened to members the morning of Oct. 7, 2008. You can already see: our North Star takes no prisoners, never gives up ground, and we like it that way. We'll be posting the performance of Pro's North Star alongside the performance of *Pro*'s portfolio, of course — in a permanent table on our scorecard page, where we'll show you our annualized return since inception, our rolling three-year return (our preferred measurement period), and year-to-date returns. The first iteration of that information is presented below.

Performance, Oct. 6, 2008, through Nov. 30, 2011

	Annualized, Since Inception	Rolling 3-Year	Year-to-Date
Pro's Charter Portfolio	9.2%	9.9%	(4.5%)
North Star	8.1%	9.2%	9.7%
S&P 500 Total Return Index	7.7%	14.1%	1.1%
MSCI World	3.2%	9.9%	(7.5%)

For much more information on our North Star — including detailed historical performance — check out our new North Star information page.

Questions? Ask Us!

Our North Star is all about guiding our behavior — and helping you understand that behavior to become a better investor as well. It's also about quantifying our goal of absolute returns; it's a true measure to guide us, one that never wavers or stagnates. If you've got questions about our North Star, including what it means for you, we're hosting a live chat at 2 p.m. (ET) Friday, Dec. 16, to answer them. Please watch your inbox for the chat reminder, and in the meantime, enjoy a plethora of data on our North Star information page. We also invite you to visit the new North Star discussion board with your comments, advice, and feedback.

Fool on!

— The Motley Fool *Pro* team

North Star Live Chat: Dec. 16, 2011

Published Dec 15, 2011 at 12:00AM

The *Pro* team hosted a live chat at 2 p.m. Friday, Dec. 16, to answer questions about our North Star, our portfolio, and our mission. Click below to read the transcript!

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Charter and 2011 Portfolios: Write Puts on Pacer International

Published Dec 13, 2011 at 12:00AM

Trade Essentials

- **Action:** Write ("sell to open") December 2011 $5 puts for a 1% position in **Pacer International** (NASDAQ: PACR).
- **Allocation:** 1% in look-through stock. In Charter Portfolio, we'll write 30 contracts; in Portfolio 2011, we'll write five.
- **Recent Stock Price:** $4.50
- **Recent Options Price:** December 2011 $5 puts (bid/ask): $0.40/$0.60
- **Preferred Price:** Initially, aim to split the bid-ask price (lately about $0.50). As prices change, ideally accept no less than $0.30 to write these puts.
- **Why Write Puts?**
  - Pacer is pulling off a well-orchestrated turnaround and is once again producing positive earnings and cash flow.
  - The share price, however, remains depressed.
  - We want to own shares, but the stock is illiquid. Writing puts offers members a much more attractive entry method.
- **Alternate Trade:** Writing puts is the best way to enter this position. If you are absolutely unable to do so, you can purchase shares directly — but **use a limit order**, and pay no more than $4.60 per share.

The Big Picture

First Things First

- **Company: Pacer International**
- **Website:** http://www.pacer.com/
- **Market value:** $161 million
- **Investment type:** Micro-cap, value
- **Options:** Yes; we're using them to avoid influencing the share price.

In the first *Pirates of the Caribbean* movie, cursed immortal pirates battle fearlessly — as immortals are wont to do — with British soldiers. During the battle, the curse is lifted, making the pirates both mortal and suddenly less inclined to carry on the fight. All they can manage is to eke out a pitiful, "Parlay?"

And that's why we are writing puts on **Pacer International** (NASDAQ: PACR).

OK, OK, we'll connect the dots for you. (Jeez, we have to do *everything* around here.) Just like the pirates, Pacer not too long ago found itself suddenly disarmed and seemingly doomed. Unlike the pirates, however, Pacer has managed to swim to shore — but the market is still pricing it as if it's sinking to the depths. Let us explain.

The Beginning: A Good Place to Start

Pacer is an asset-light intermodal transportation company. In layman's terms, customers hire it to transport large freight from endpoint to endpoint — think of it as a **FedEx** (NYSE: FDX) for giant industrial companies. If you want to get your mother's birthday present to her on time, you ship it FedEx. If you need to get 10,000 drivetrains from L.A. to Detroit — swinging through Memphis at a specific time to pick up 40,000 tires en route — you call a company like Pacer.

Pacer is an *intermodal* transporter because it uses multiple modes of transportation to get its cargo where it needs to be. Most commonly, this entails a combination of railroads and trucks. And Pacer is *asset-light* because it doesn't own any of the railroads, trucks, or even containers it uses to transport stuff. Instead, the company has relationships with railroads allowing it to use their rail networks and with trucking companies to handle that portion of the transportation, and it leases its containers.

Rough Seas

Until recently, Pacer had a crown jewel: an exclusive contract to handle all of rail behemoth **Union Pacific**'s (NYSE: UNP) wholesale intermodal business. With no competition, Pacer did what many monopolists before it had done: It got lazy. The company didn't aggressively go after new business, and management paid itself fat bonuses for performance that was uninspiring at best. Pacer let its costs gradually creep up.

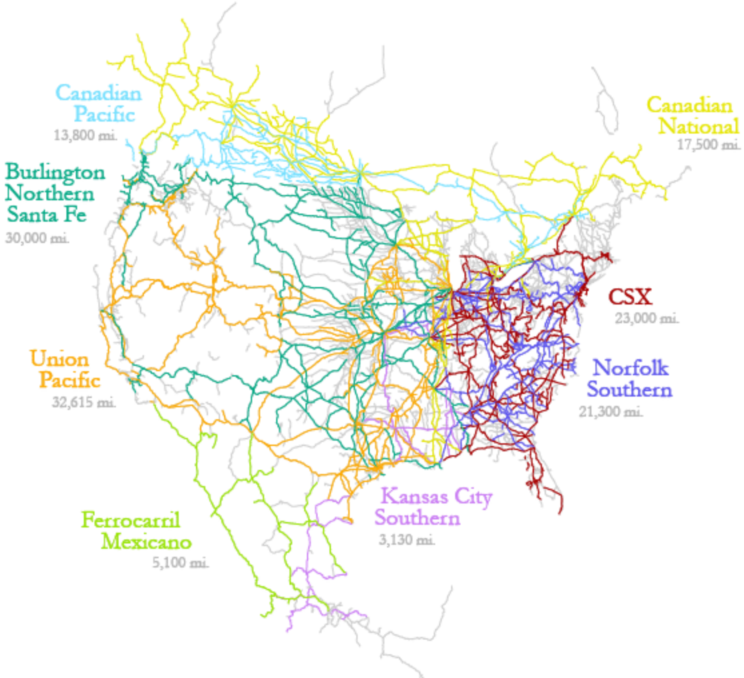
And then, abruptly, Union Pacific cancelled its contract — and this happened in 2009, a miserable time for even the best of transportation companies. Overnight, a huge hole was blown out of Pacer's revenue pipeline, and the company suddenly found itself in danger of violating its debt covenants. Earnings went deeply negative, and management cancelled the dividend. The stock cratered, and rightfully so, because bankruptcy seemed a likely outcome.

Righting the Ship

Just when it looked like the gig was up for Pacer, the company hired a new CEO who arrived with a plan. The newcomer, Dan Avramovich, paid about as much respect to the old Pacer way of doing things as John McEnroe paid to umpires. He slashed entire divisions, including Pacer's entire wholesale division, which had previously been the company's focus and had housed the Union Pacific deal. Instead, he focused on just one small, previously marginalized business: retail intermodal transport.

Avramovich realized that though Pacer doesn't own anything, it does *have* something of tremendous value: its relationships with the railroads. Such relationships are rare because railroads, which have massive fixed costs, only want to deal with large, predictable customers. This creates a chicken-and-egg scenario: An intermodal transporter that wants relationships with railroads must have lots of freight — but to get lots of freight, such a company needs relationships with railroads.

In this regard, Pacer was royalty: This small company's previous wholesale business, which involved shipping very large volumes on predictable routes for small profit margins, had landed it relationships with most of the major railroads on this continent. All told, Pacer has access to more than 60,000 miles of rail track and a whopping 41% of all shipping containers in the U.S. — more even than intermodal front-runner **J.B. Hunt Transport** (NASDAQ: JBHT), which has access to just 25%.



This map from freebase.com shows all Class I (major) railroads in North America. Pacer has relationships will all of them except Canadian Pacific and Ferrocarril Mexicano.

Armed with this asset, Avramovich decided to focus on retail intermodal transport — catering to individual customers, handling all of their shipping needs, and often effectively managing most of their supply chain for them. (For example, moving 10,000 drivetrains from L.A. to Detroit and swinging through Memphis to pick up 40,000 tires en route.) This business involves close ties with customers and customized transportation services, both of which Pacer, with its massive network of transportation assets, can deliver — and those services come with higher margins.

Financials and Valuation

The loss of the Union Pacific contract derailed Pacer's income statement, yes: Revenue shrank 25% in 2009 and then another 5% in 2010. But don't miss the forest for the trees. Removing the wholesale business (which is no more), revenue actually *increased* 15.4% last year, and earnings and cash flow are once again positive. That trend has continued this year as Avramovich's turnaround really begins to take hold. In the third quarter, Pacer's intermodal revenue was up 18%, operating income more than tripled, and earnings more than quintupled. On top of all that, the company is now debt-free. Yet shares remain depressed..

We expect intermodal revenue to continue to grow at 5% to 8% annually, and margins should gradually increase as that higher-margin business grows. Because Pacer doesn't own any of the transportation assets it uses, very little cash needs to be reinvested in the business. To value Pacer, we use a discount free cash flow model, allowing margins to gradually grow to about 12% over the next eight years, which the company should be able to accomplish (potentially and then some) with the new business model. All told, we value Pacer at more than $12 per share, making this stock an outsized long-term opportunity.

Catalysts, Risks, and How to Follow Along

As the market realizes Pacer's new business model is viable and the company isn't going bankrupt, shares should appreciate toward fair value. Strong earnings reports should help along the way; for example, we expect Pacer to report over 100% year-over-year earnings growth for 2010. A reinstatement of the dividend would also likely boost the share price.

Of course, Pacer remains a mis-valued and under-followed microcap stock. With an enterprise value of just $140 million, this is a tiny company — and that comes with heightened risk. On average, only about a million dollars' worth of its stock trades each day (thus the importance of limit orders), so even small news can move the stock meaningfully, and that can cut both ways. Because the company's market cap is so small, we are writing puts to try to buy shares without running into liquidity issues; these options expire this Friday, so barring a sharp jump in share prices, we'll own shares by the end of the week. Expect Pacer's stock to be much more volatile than the broader market — and also know that we may not be able to nimbly change course. . For all these reasons, we are targeting just a 1% position today and do not recommend you allocate more than that.

To begin, sell to open December 2011 $5 puts, aiming for at least $0.50 per share. Sell one put for every 100 shares you're willing to buy for a gross $500.

The Foolish Bottom Line

The market still thinks Pacer is on a track to nowhere, but this small company has fought its way back from the brink and is now poised for profitable growth. We're taking advantage by writing puts to open a 1% position.

Talk about this trade on our new [Pacer discussion board](#)!

The Motley Fool owns shares of FedEx and Pacer International. See Pro's holdings [here](#). See the team's and David and Tom Gardner's holdings [here](#).

Charter Portfolio: Set up a Synthetic Short on CurrencyShares Euro Trust

Published Dec 12, 2011 at 12:00AM

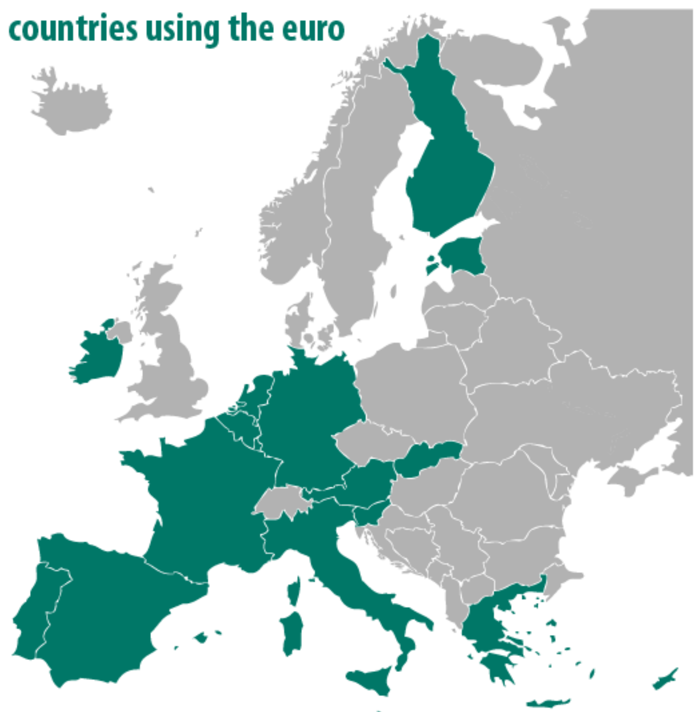
Trade Essentials

- **Action:** Set up a 3% synthetic short on **CurrencyShares Euro Trust**.
  - **Sell to open:** January 2014 $132 calls (midpoint of bid/ask: $10.33)
  - **Buy to open:** January 2014 $132 puts (midpoint of bid/ask: $12.37)
  - **Trust price:** $132
  - **Euro/U.S. dollar exchange:** $1.32
- **Price Guidance:** Use the strike price closest to the current trust price, and aim to set up the synthetic short for about a $2 net debit or less. We must pay some premium to set this up (about a 1.5% premium to the euro price), partly because this trust pays a dividend that is reflected in the call and put prices. But we think a 1.5% premium is reasonable for a currency position we intend to hold for two years.
- **Allocation:** Set up one pair of options for every 100 shares (roughly $13,200) you wish to short. For *Pro*'s Charter Port, that's three contracts of each option. (See the sidebar for Portfolio 2011 and smaller portfolio guidance.)
- **Why Short?**
  - The foundation upon which the euro is built is flawed.
  - Despite this year's trauma, the euro is *flat* with the dollar year-to-date. European banks have been bringing overseas investments home (repatriating them for liquidity), which creates extra demand for euros that should subside.
  - Interest rates in Europe are ticking lower, decreasing the euro's relative attractiveness.
- **Alternative Trades:**
  - If your broker has shares of the trust available for shorting without a fee, you can short them directly, but realize you'll be responsible for paying dividends. Our broker (Schwab) has offered shares to short for a 9% annual fee, which isn't worth it.

The Big Picture

We recommend making a two-year investment shorting the **CurrencyShares Euro Trust** (NYSEMKT: FXE) to profit if the euro loses value against the U.S. dollar.

The ink on the first euro banknotes issued in 2002 is barely dry, and already the currency is in crisis. Seventeen countries use the euro: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland (pause for breath!), Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. The euro represents the eurozone's ambitious attempt to unite vastly different economies with a common coin to improve trade and strengthen the European Union. The weaker economies in the south, however, are threatening the stability of the common currency and putting the strongest nations — Germany and France — between a rock and a hard place: Find a way to save their neighbors, or risk the young euro union.



First Things First

- **Vehicle: CurrencyShares Euro Trust** (NYSEMKT: FXE)
- **Assets Under Management:** $617 million
- **Holdings:** 100% euro
- **Annual Expense Ratio:** 0.40%
- **Annual Interest Rate (TTM):** 0.46%

Five times since 2009, European leaders have held summits to address economic challenges plaguing the euro, and five times the solutions have come up short because there is no easy fix. The foundation upon which the euro was built needs to be torn down and rebuilt. To form a true economic bond, all participating countries would need to agree to strong fiscal oversight (basically from Germany and France), invoking a loss of sovereignty and suggesting hard years of austerity ahead for many. But austerity programs cut economic growth and threaten recession, which raises the odds of a default — a classic downward spiral. Add to this brouhaha a lack of competitiveness and costly social programs that prop up aging populations, and the pressure builds higher.

Meanwhile, the European Central Bank has refused to go "all in" to buy more meaningful amounts of government debt or to lend to governments, because neither action is allowed in its treaty. Today, the ECB seems unlikely to change this stance. It probably won't unless Germany insists on it, but the Germans have been arguing against it, too, fearing inflation and arguing that bailouts send to the wrong signal to debtor nations.

The headlines are changing daily, but the bottom line seems to be that Europe lacks the will or the *means* to fix the flaws in its currency union in a timely fashion. It has a fiscal problem, with several eurozone countries drowning in debt and unable to sell bonds at attractive or sustainable rates; it has a banking problem, with banks hoarding cash; it has a competitive problem, which makes it harder to grow GDP to pay down debt; and it has a structural problem, where weaker countries *can't* print their own money to improve exports and grow, so they must cut costs, which hurts GDP. Furthermore, although 330 million people live in the eurozone, they're not nearly as mobile as Americans, because most are unwilling to move to a new country in the zone even if that's where jobs may be. Add all this up, and Europe makes your typical family reunion look easy and fun in comparison.

The Strategy

What About Portfolio 2011?

This trade is too expensive for Portfolio 2011 at our 3% allocation, because one contract would be about 5% of that $250,000 portfolio. Members should determine their allocation comfort at home dependent on portfolio size. A $400,000 portfolio is necessary for one synthetic short contract at $132 to equal about 3% of the portfolio on a look-through (or exercise) value. You could set up the trade never intending to turn it into shares, just as we don't, but realize the risk of potentially over-allocating if you do, and go small.

We're shorting the euro against the dollar using January 2014 options, so we have more than two years to potentially benefit. This is an asymmetrical investment. The euro may strengthen against the dollar, but likely only by so much (assuming the U.S. doesn't go belly-up). So even if the euro returns to its all-time high against the dollar ($1.60), the risk on our short will be only about 20%. Meanwhile, our possible upside — hard as it is to believe — may be as much as 100%. If the worst happens, the euro could fall apart. The trust we're shorting only holds physical euros, so it could end with negligible value. We don't hope for that calamity, but we can view this position as disaster insurance with relatively low downside risk.

Year-to-date, the euro is modestly higher against the dollar despite the dramatic headlines. We suspect this is because European banks have been bringing foreign investments home and converting them back into euros, which creates enormous extra demand for the currency. This sort of demand should prove temporary. Plus, with the ECB cutting interest rates on the euro by half a percentage point in the past five weeks, and with lower rates likely in 2012, euro demand in general may soften.

That's especially likely given the hurdles immediately ahead: According to Bloomberg data, eurozone countries need to pay back $1.45 trillion in debt next year, with nearly half of this due in the first half of 2012, and they'll need to raise new debt to do so. So far, the eurozone's central bank isn't eagerly offering to help. And even if it wanted to, the central budget in Europe is only 1% of GDP, compared to a much more effective 25% in the United States.

Historically, the euro has averaged $1.20 to the U.S. dollar. It reached a high of $1.60 in 2008 and a low of $0.86 nearly 10 years ago. Today's $1.32 exchange to the dollar puts the euro toward the higher end of its historical range. This suggests that even if investors begin to calm down about Europe, the euro could still deflate against the dollar in the next two years — especially if the U.S. shows the political will to contain its own debt problem. It's key to remember that all currency investments are relative. In this case, we're hoping the euro will decline against the dollar, and vice versa, so on a relative basis we need the euro to weaken, or the U.S. dollar to strengthen, or both.

With the grip of austerity tightening across Europe as new measures slowly work through the system, the continent faces the risk of recession in 2012. The pending downgrade of banks, countries, and the ECB from Standard & Poor's may not help either (at least the U.S. already got that over with!). Meanwhile, on this side of the pond, the U.S. has mandatory deficit cuts kicking in in 2013, so Congress may be motivated to work toward a more palatable resolution before then. But either way, the U.S. has a clearer path to addressing its economic problems than do the 17 euro nations, and its currency relative to the euro may come to reflect that over the next few years.

Unemployment: People 25 and Younger

- **Spain**: 49%
- **Greece**: 45%
- **Portugal**: 30%
- **Italy**: 29%
- **France**: 24%

Source: *The Economist*

Regarding the "worst-case" scenario for the euro: It seems most likely the euro would splinter *if* weaker countries with high unemployment rates (see sidebar) tire of austerity and simply conclude they can't compete with Germany's uber-strong economy. Instead, the best hope for a healthy economy in these countries may be to return to a weaker currency, which would boost exports. On the flipside, Germany wants the euro to survive mainly out of self-interest: Giving poorer countries the euro was a boon to its exports. Ultimately, poorer countries could hold this self-interest against Germany and even use it as a scapegoat to exit the euro.

How to Follow Along

To set up a synthetic short, you sell to open calls and buy to open puts, one of each, with the same expiration and strike price. For this trade, we will:

- **Sell to open:** January 2014 $132 calls
- **Buy to open:** January 2014 $132 puts
- **Pricing:** Aim to set up the short for as small a net debit as possible, but realize that since these options debuted last month, they've entailed a premium of $2 or so to set up this trade. This 1.5% premium partly reflects the dividends the trust pays over two years and is a reasonable cost for this two-year holding.

- **Allocation:** One contract of each option for every 100 shares ($13,200) you wish to short.

To measure our risk, we're looking at the position on a look-through basis — based on the value of the underlying trust. Each synthetic short represents a short of $13,200 worth of the trust. **Even if you're setting up the position on a nominal (or real-cost) basis, with no intention of converting the options to shares (which is not our intention, either), keep the look-through value in mind so you don't over-allocate.**

What Would Make Us Close

We're expecting to be in this trade for the two-year duration. Currencies fluctuate, and crisis or not, it seems likely that we'll see a profit on the dollar-to-euro exchange rate at some point over the next two years — again, unless the U.S. blows it. Should Europe's situation worsen, though, and the euro tumbles while still in use, we may take our profit early. Finally, recognize that this position could surprise us. For instance, if a weak country leaves the euro, the currency may actually grow stronger. Or if Germany does an about-face and begins to sanction Eurobonds backed by all member countries, or if the ECB becomes a lender of last resort with unlimited funds, then we are likely to end our bearish investment. But our risk should be reasonable throughout, and we'll close early only if we believe the story has changed meaningfully in the eurozone *or* in the United States.

The Foolish Bottom Line

The euro is in trouble. An easy solution is elusive. Unless the member countries, driven by Germany, get everything just right, odds seem to favor the euro weakening against the dollar the coming few years. We're shorting the euro against the dollar with the belief that our risk is acceptable and our potential profit is attractive — this is the type of asymmetrical investment we often seek. To talk about our synthetic short on CurrencyShares Euro Trust, visit our new discussion board.

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Who's Buying Stock? Companies, That's Who

Published Dec 12, 2011 at 12:00AM

Fellow Fools:

Pro Trade Roundup

Charter Portfolio

- **Plum Creek Timber**: Sold to open a covered strangle, writing 10 May 2012 $33 puts and 10 May 2012 $38 calls, for a combined average net credit of $3.01 per share.

We have some exciting things planned for the end of 2011 in *Pro*. Before the year is out, we'll review our performance over the past 12 months, announce some new recommendations, and reveal our absolute-return metric, which we're calling our North Star. Watch for more on our North Star in your inbox soon; we don't want to be hyperbolic, but it may just change how you think about investing for the rest of your life. In the meantime, let's turn our attention to the companies currently making the largest share buybacks, in case there are any opportunities to be found.

Record Buybacks: Good or Bad?

Companies in both the S&P 500 index and the small-cap Russell 2000 are buying back shares at a near-record pace. And of the 20 companies buying back the most shares, three of them are in the *Pro* portfolio. Read on to find out which — but first, a word on share buybacks, which can be good or bad or both. They're good when they decrease a company's share count, and when the stock subsequently goes up because management bought at a fair price. Share buybacks are *not* good when they merely cover up share dilution from employee stock grants, when the stock subsequently declines because it was too pricey, or when the company could have used its money more strategically.

Companies have different approaches to buybacks. Steve Jobs famously hated them, so **Apple** never made any. **Netflix** bought back hundreds of millions of dollars' worth of stock at much higher prices than it trades today, and the company now finds itself needing to raise cash at much lower prices, destroying shareholder value at both turns. Warren Buffett's **Berkshire Hathaway** recently announced the company's first buyback, and he's ready to step up to the plate whenever the stock declines to near book value.

And then there are these companies, which are buying back shares like there's no tomorrow.

Top These Buybacks

In the 12 months that ended in September, these companies were buying back shares with a vengeance. Here are the top spenders in dollar terms:

Company	Total Value of Buyback (in billions)	Percent of Market Cap
ExxonMobil	$22.39	6.07%
IBM	$15.07	7.05%
Intel	$11.70	9.73%
ConocoPhillips	$10.59	11.74%
Hewlett-Packard	$10.12	20.10%
Microsoft	$9.09	4.35%
JPMorgan Chase	$8.69	7.99%
Coca-Cola	$6.57	4.37%
Goldman Sachs	$6.24	13.71%
Cisco Systems	$6.08	6.38%

Here are the companies buying back the largest amount of outstanding shares as a percentage of total shares on the market (as of a year ago). The leader, Novellus, bought back a whopping 52% in the past year.

Company	Total Value of Buyback (in billions)	Percent of Market Cap
Novellus	$1.09	51.83%
Gap	$2.62	29.14%

Kohl's	$2.96	21.18%
Hewlett-Packard	$10.12	20.10%
R.R. Donnelley	$0.50	19.75%
Torchmark	$0.79	19.54%
DirecTV	$5.92	18.60%
L-3 Communications	$1.17	18.43%
LSI	$0.50	17.54%
Cintas	$0.58	16.04%

Sources: Barron's, S&P, Bloomberg.

What Does It All Mean?

The three *Pro* companies appearing above are Intel, Cisco Systems, and L-3 Communications. So far over the past 12 months, Intel is the only one with positive returns. In each case, though, our analysis tells us valuations should increase given more time, so hopefully our companies are making a good choice by buying shares.

The massive buyback at Hewlett-Packard, on the other hand, is a massive mistake, with shares plumbing new lows this year. We'll be looking over the *rest* of the list to see if any other companies catch our interest; for example, uniform rental company Cintas has a long track record of creating shareholder value, and it has bought back 16% of its stock over the past year. (Thoughts on which companies you like best? Visit our Stocks that Interest You board.)

A Broad Buyback Frenzy

Companies in the S&P 500 bought back $132 billion of stock last quarter, the most since the market's peak at the end of 2007. The 2008 market implosion shows us that buybacks don't always promise higher prices ahead. No management team, however talented, knows what the economy will do next, and a buyback can be done for reasons that have nothing to do with the stock market's next move.

I suspect three reasons for today's high level of buybacks: Companies are flush with cash, they don't know where to invest it, and they're diluting shareholder value with stock grants and trying to hide it. In most cases, it's likely some of all three — but in other cases, a large buyback may truly be an opportunity. Some companies actually are buying back a cheap stock that is likely to appreciate in the future, and we're going to look more deeply into the preceding lists to see if any of the companies there are among them. (Aside from three companies already in the *Pro* portfolio, of course. We already believe there's value to be had there.)

Please post any questions on the Memo Musings board. Until next time, thank you for being a *Pro* member!

Jeff Fischer (TMFFischer)

Community

- If you have December 2011 calls written on **iPath S&P 500 VIX Short-Term Futures**, what's your next move? Jeff has advice(see the link in the post).
- Down market got you down? Seek out more opportunities! Alex340 lines up puts that match*Pro* criteria. There are many!
- **Intel** lowered fourth-quarter guidance today because of the flooding in Bangkok. Our first take? It's just weather.
- TMFDatabasebob posts his detailed thoughts on the November **Ebix** earnings report.
- Fools are discussing*Pro*'s latest recommendation, a synthetic short on the **CurrencyShares Euro Trust**. What's your take?
- Get your weekly TMFMoosie *Pro* calendar.

The Motley Fool owns shares of Apple, Berkshire Hathaway, Gap, International Business Machines, JPMorgan Chase, Coca-Cola, and Microsoft. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

A Winning Formula

Published Dec 5, 2011 at 12:00AM

Fellow Fools,

As we've lamented time and again, finding mispriced stocks is hard work. At last count, American investors could choose from 669 companies peddling 8,545 mutual funds, 624 closed-end funds, and 950 exchange-traded funds. That means a lot of people out there are scouring the same investments and placing gobs of money into long or short positions on them — and *that* means that on the whole, most stocks in the market end up priced just about right. With all that cash and all those brains chasing successful investing performance, how's a Foolish investor supposed to win?

Guidance Updates

- **Papa John's International** remains on hold, but we're raising the valuation from $28 to $35 and the buy-around price from $24 to $28.
- **StoneMor Partners** moves to Buy First; we don't agree with S&P's downgrade.
- **Ebix** and **MasterCard** move to Hold on valuation.

Know Where You Differ

If we believe most stocks are priced fairly at any given time, it makes sense that we focus our investment dollars on positions where our view differs from the prevailing one; that's how we expect to achieve performance independent of the general market. If the market expects solid execution and rapid growth at **Nick's Fighter Jets**, the shares will be priced accordingly — and without an opinion that differs meaningfully, we'd stay away. Your *Pro* team focuses its research efforts on garnering insights that, when pieced together, give us a different picture than a stock's current price may reflect.

Sometimes it's easy to see where we differ from the prevailing opinion. For example, we bought **Bristow Group** in the midst of the Deepwater Horizon disaster because we believed its sector, deepwater offshore drilling and production, was too vital to the global economy to stay down for very long. In other cases, our dissenting view can be more obscure. Our investment in **StoneMor Partners** represents a bold claim that the investing public doesn't understand the company's accounting and is thus wrong in believing StoneMor's dividend is not sustainable. In each case, the opportunity to earn outsized returns is based on our research-supported views that happen to be meaningfully different from the norm.

Focus on What Matters

For each investment we make, we identify a few key factors we think will drive improvement in the business. Then we focus like heck on following the progress of those elements, paying less attention to any other stuff going on. We let the media whip up frenzies for no reason if they choose — for example, in August 2010, when **Tupperware Brands** shares plunged after the company announced an accounting error in its Russian operations and some foreign-exchange challenges. But we'd already identified our key areas of focus for Tupperware (attracting and training its army of reps, maintaining share in mature markets, achieving success in emerging markets, and containing costs), and they had little to do with Russian exchange rates. That meant we were able to largely ignore the problems in Russia; we made sure we still believed the company was executing on the things that mattered most, and then we tried to buy more shares via written puts. The Russian issues later subsided, and Tupperware shares continued their upward move.

Hang Tight … or Change Your Mind

We know the ways in which our views about our investments differ from the consensus, and we focus on analyzing the factors we believe matter most. That gives us the confidence to sit tight when things that *don't* matter as much go awry, and it gives us the heads-up to change our approach if one of our key factors isn't progressing as planned. Importantly, we relish the ability to change our minds if we find our view falling into lockstep with the market's — or if we turn out to have been just plain wrong about how our key factors would play out.

Earlier this year, for example, we sold **Quanta Services** for that very reason: We were mistaken about one of the main catalysts for the company. We weren't worried about project delays for the king of power transmission lines, but we were concerned that Congress hadn't made any progress in drafting or passing an energy bill. We knew that without such a bill to boost Quanta's results, our money was better invested elsewhere.

The *Pro* Bottom Line

Good investing is like watching paint dry: a lot of sitting around doing nothing. Identifying a framework of key factors for each investment we make helps us invest for the long term, remove emotion from our decisions, and ignore much of the jibber-jabber that pours forth from daily market commentators. It's how we remain calm and dispassionate about the goings-on in Europe, and it's how we stack the deck in our favor to win over the long run.

Foolishly,

Bryan (TMF42)

Community

- Alex (TMFPapester) turns over rocks and gravestones to make sure he hasn't missed anything at **StoneMor Partners** — and he concludes S&P's downgrade of the company is just dead wrong.
- We like simplicity: Go here to find (relatively) simple answers to some complex Euro-related questions.
- Alex340 runs down the puts and calls that could be interesting.

See Pro's *holdings here. See the team's and David and Tom Gardner's holdings here.*

Audio Extra: MDT and STON

Published Dec 2, 2011 at 12:00AM

In our latest Audio Extra, Jeff Fischer talks with Bryan Hinmon about **Medtronic**'s earnings and with Alex Pape about a Standard & Poor's downgrade of **StoneMor Partners**. Hear why Medtronic remains a healthy buy and how the company should grow in developed markets, not just emerging ones. And get our initial take on StoneMor's downgrade, which suggests that Standard & Poor's doesn't understand the company as well as it could.

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Transcript

Jeff Fischer: Welcome to a new edition of Motley Fool PRO Audio Extra. In the studio are analysts Bryan Hinmon and Alex Pape. I am Advisor, Jeff Fischer. Thank you, PRO members, for joining us. We are going to talk about Medtronic and Stonemor Partners today. Bryan, let's start with Medtronic. They reported earnings recently. They are, of course, the largest medical devices company in the country, and we know this. Legend has it the company was founded in the founder's garage.

Bryan Hinmon: They have come a long way since then, Jeff.

Jeff Fischer: It's amazing. Apple, Nike, Medtronic, garage businesses. The Motley Fool was founded in David Gardner's shed. This made me realize, I live in a row house on Capitol Hill. I don't have a garage or a shed. I have all these great ideas and nothing I can do about it. So where's Medtronic today, Bryan? Can you summarize the recent results?

Bryan Hinmon: Sure. They have come a long way from their garage days, but there was very little that was new in this quarter. The story remains that 60% of their business is doing really well, growing about 8%, and 40% of their business is shrinking, about 5% this quarter. And so that sort of netted out to 3% growth, which is not bad, but uninspiring, and so Medtronic is still sort of stuck in the mud where it wants to return to its days as a growth company. The market wants that as well, but like you said, it's a large company. It's the largest Medtech Company, pure play, and it takes a little while to turn things around.

Jeff Fischer: Domestic revenue was flat; overseas revenue grew 6% with the emerging market revenue a strong 19% jump. So what is going to be the catalyst that will make domestic revenue rise again?

Bryan Hinmon: Yeah, well they have some new products that are coming through the pipeline here, and the very encouraging thing is that typically they release their new products in Europe first, and so they have a really nice proving ground, just because it's a little easier to get products launched there. Our FDA is; they're a wet blanket if you were to ask the medical device (unclear).

Jeff Fischer: They are just being cautious, Bryan.

Bryan Hinmon: Yeah, they are just being cautious. So for instance, the company has a drug-eluting stint called the Resolute Stent that has been selling like gangbusters in Europe. They are expecting that it will get past the FDA this fiscal year, and they expect almost immediately that they'll sell 200, 250 million dollars of this one product. So they will sort of one day the FDA will say, Okay, and the next day, Medtronic will begin taking market share. So it's new products that are going to catalyze the domestic growth again.

Jeff Fischer: And Bryan, international sales are a minority of overall revenue and emerging markets are an even much smaller minority. How large can emerging markets become for this company in the next five to ten years? Do they talk about emerging markets someday rivaling the sales in North America?

Bryan Hinmon: Well, specifically no. But what the company does say is they like to communicate about populations. And so obviously if you look at the population of the emerging markets versus the population of the mature markets that they are in, the scale tips towards the sides of the emerging markets clearly. It's not an apples to apples comparison, but the point is that the numbers are in favor of emerging markets, and the thing that gives me confidence that one day those emerging markets or international markets will rival the more mature markets is the fact that the company brought in a CEO that didn't necessarily have experience in the specific product lines Medtronic was in. They brought in a CEO that had experience in international operations, and so they are clearly focused on growing the company in that direction.

Jeff Fischer: Okay, Fools, Medtronic is a buy, it's buy rated. It's in the mid-thirties lately. We have a buy-around price of up to 39, and the shares yield about 3% dividend yield right now, and trade around ten times earnings and free cash flow, so it's a value stock, very clearly a value stock, with, we believe, substantial upside in the coming few years and beyond. So if you don't have a 5% allocation, it's at a fair price where you can add shares or sell to open put options to add to your position. Thank you, Bryan.

Bryan Hinmon: Sure thing, Jeff.

Jeff Fischer: Alex, let's talk about Stonemor Group.

Alex Pape: Just as exciting news…

Jeff Fischer: Stonemor Partners, I should say.

Alex Pape: So yesterday Standard & Poor's downgraded Stonemor's publicly-traded debt from…

Jeff Fischer: This was Tuesday afternoon, to be clear. It really hit the market Wednesday.

Alex Pape: And so they downgraded from a BB- to a CCC+, so today the shares are down about 15% at the lowest point. They have come back up a little bit, so now they are down about 12%.

Jeff Fischer: That's right, and Fools, we are taping this Wednesday afternoon.

Alex Pape: I should specify these things.

Jeff Fischer: That's okay. Hopefully they'll be up 10% by the time this comes out.

Alex Pape: Hopefully this will be irrelevant by the time it gets published.

Jeff Fischer: So what does this downgrade mean?

Alex Pape: So Standard & Poor's is concerned about two things. The underlying business for Stonemor, which I take some serious beef with, and the financial statements, which I don't really blame them for misunderstanding the financials for Stonemor. Standard & Poor's and Moody's have pretty much missed every major blow-up in the last decade, so I can't blame them for getting this wrong as well. I am still digging through the report, but I don't have a lot of credence to put towards what they are saying.

Specifically what they are saying about the business though, this is a quote from the report, they said, "Stonemor has a weak business profile in the highly fragmented and competitive cemetery services industry." This is kind of silly. Stonemor is the second largest cemetery owner in the country, and by far the most profitable. They have a very unique sales process. They sell contracts for burial properties and merchandise in advance of the time of death rather than at the time of death, and this results in higher margins and more predictable cash flow. So even though they are the second largest and not the largest, they are actually more profitable than the largest.

And also the fact that it's highly fragmented is a really good thing for them because that's how they grow. They are buying up constantly small cemeteries from sort of mom and pop cemeteries all over the country, and that's what's fueling the growth of the business and their dividend.

Jeff Fischer: Right. That S&P statement struck me as very odd as well. It's how so many software companies, which I always go back to; sorry. They love fragmented industries for that very reason. That's how you grow.

Alex Pape: That's sort of why we own this, actually. It's a great thing here, so that just signaled to me a somewhat of a misunderstanding. And they also cited rising cremation rates, which is also a misunderstanding. Well first of all, cremation is a lot more popular on the west coast of the U.S. than it is on the east coast. It's a dramatically more popular thing to do there. And Stonemor is really heavy on the east coast, so 76% of their properties are in the northeast of the U.S., with another 10% in the southeast, so it doesn't affect them as much, but even there, they make money on this too. They sell urns and they have mausoleums on their properties, so it actually helps them. It's a lower dollar amount sale, but it's a much higher margin and it doesn't use up as much land because you can build up with mausoleums rather than having to acquire more properties. So neither of these things are something that concerns me.

Then on the financial side, I am still digging through the exact numbers, and it's probably more than is worth going into in an audio, but the one thing that they cited was, they cited interest coverage ratios, which is basically how easy is it for a company to pay, make the interest payments on their debt. They said that these are going down, but they cited GAAP figures, and GAAP is the accounting standards, and by those figures, Stonemor looks awful.

Jeff Fischer: That was why we bought it.

Alex Pape: Yeah, that was the whole point, is that GAAP doesn't do justice to this company, and if you look at what's actually happening in the underlying business, it's a very different story. So yes, by GAAP standards, actually they don't make enough money to pay their interest payments.

Jeff Fischer: Right.

Alex Pape: Somehow, magically they have managed to do so anyway, and that's because that by any real measure of profitability or operating profits, they are actually comfortably able to make their interest payments. So I am still digging through the details, but this does not concern me.

Jeff Fischer: All right, so Fools, thank you, Alex. That was the take-away I had as well, that I don't think the S&P analysts spent the hour speaking with the company management the way you did. Maybe they did, but this short report kind of brought to light several misunderstandings, I would think.

Alex Pape: Several iffy statements. And now the question is, stock is down to about $25. It is yielding almost 9.5%. The question is, is this the time; if you don't already own our allocation of 3%, this is probably the time to do so. The question that we'll be answering in the next couple of days is is this the time to buy more?

Jeff Fischer: Yeah, so check the board because, as Alex said, this news just really broke today, and we still wanted to make this tape today to get it out by Friday, but we are still going through the numbers and Alex will post his final thoughts on the board, very likely by the time this audio is issued to you, so it should be there by the weekend.

So thank you both, and thank you PRO members for joining us today. We'll see you in the Monday Memo, and we'll see you on the boards. Fool On!

3D Systems and Stratasys: Fight!

Published Dec 1, 2011 at 12:00AM

This article first appeared as a Motley Fool Duke Street *exclusive on Aug. 24.*

Imagine printing a complex, customized object — a replacement gasket for your '67 Mustang, or a hearing aid molded perfectly to your ear's contours — as easily as you can print out a copy of this article. It may sound like something out of a science fiction movie, but three-dimensional printing is real — and it's going to revolutionize the manufacturing industry.

There are two companies leading the 3-D printing revolution: *Motley Fool Pro* holding **3D Systems** and **Stratasys**, a *Rule Breakers* and *Hidden Gems* recommendation. Below, I'll examine every dimension of these fast-growing companies, but first, let me provide a little background on how 3-D printing works and why this market opportunity is so enormous.

The Next Dimension

Unlike in Hollywood movies, where 3-D technology adds little value to the end product (Michael Bay, I'm looking at you) and results in higher ticket prices, 3-D printing helps manufacturers produce items more efficiently and at a lower cost. The process is similar to ink-jet printing, only instead of spreading ink over paper, a 3-D printer deposits layers of ultra-thin material on top of each other and fuses them together to form a three-dimensional object. This results in less material wasted, lower manufacturing costs, and a quicker path from design to production.

Engineers and designers have been using 3-D printing techniques for over two decades, primarily to build prototypes. But as 3-D printers have become more capable and less expensive, the machines are increasingly being used to make final products. According to industry researcher Terry Wohlers, more than 20% of the output of 3-D printers is now final products rather than prototypes. He expects that figure to reach 50% by 2020. That forecast is great news for 3D Systems and Stratasys, since selling the material consumed by 3-D printers is a much higher-margin business than selling the printers themselves. As an added bonus, those materials sales are recurring in nature and much steadier, since they are tied to printer usage and not capital spending.

But while the potential for 3-D printing technology in the automotive, aerospace, and health sectors is immense, both 3D Systems and Stratasys have seen their share price flattened recently. I turned to *Rule Breakers* analyst Karl Thiel and *Pro* analyst Bryan Hinmon to determine whether these fast-growing companies might be a good fit for your portfolio.

Tale of the 3-D Tape

Company	3D Systems	Stratasys
Newsletter(s)	*Pro*	*Hidden Gems*, *Rule Breakers*
Market Cap	$821 million	$483 million
Focus	Low-end users	High-end users
Technology	Offers six "print engines," each with a different method of fusing materials	All printers use the same fusing technology; users can choose from nine different modeling materials with differing properties
Founder	Charles Hull serves as chief technology officer	Scott Crump serves as chairman and CEO
Growth Strategy	Acquired 17 companies in the last two years	Partnered with HP to distribute low-end printers

Rich Greifner: History is full of new technologies that have been wonderful for productivity but lousy for investors, like railroads, airplanes, and fiber-optic cable. Why do you believe that 3-D printing will be beneficial for shareholders as well as users?

Karl Thiel: I'm not sure investors in **Corning**(NYSE: GLW) between, say, 1985 and 2000 think fiber optic cable was a lousy investment. But in any case, those are all examples of largely public infrastructure. 3-D printing is, I believe, a different beast entirely. The razor and blade model is a lot more reminiscent of traditional printing, which launched, say, **Hewlett-Packard**(NYSE: HPQ) on an awfully nice 15-plus year run before evolving into a different sort of commodity business. The same fate could await 3-D printing, but it's a long way off.

Bryan Hinmon: 3-D printing creates the ability to customize almost anything — adding an element of self expression and individuality that consumers can't get enough of (witness the rise of boutique fashion labels, custom **Nike**(NYSE: NKE) shoes, and people making their own soda for crying out loud!). The consumer opportunity provides an added dimension that those other technologies you hit on simply didn't have.

As for the durability of the profits for shareholders, I think the key lies in the patented, or at least highly engineered supplies business. The supplies for 3-D printing are much less susceptible to knock-offs than ink cartridges.

Rich: Serving the consumer market has been a recent point of emphasis for 3D Systems. The company has made numerous acquisitions to increase its exposure to casual users — a strategy that has dinged short-term results, since these printers are less expensive and the users consume fewer materials. Is this a smart strategy?

Karl: This is the way these companies need to be thinking. Both 3D Systems and its arch-rival Stratasys have the benefit of still having their founders — and the inventors of their respective technologies—in executive positions. They both have a clear vision for where this technology can go and don't want to sacrifice long-term success to short-term performance.

3D Systems has pushed harder on the low end of the market and has been more agnostic about different 3-D printing technologies (the company offers six different "print engines"). Stratasys is likely watching to see how 3D Systems opens this market before it gets more aggressive.

Rich: Stratasys has taken a different approach to serving the consumer market: the company has teamed up with Hewlett-Packard to manufacture a line of HP-branded, low-end printers. This strategy will crimp margins, but should increase both revenue and earnings, as the company can move many more units through HP's massive distribution network. However, sales have lagged expectations, and there are questions about HP's commitment to this initiative — is this a cause for concern?

Karl: It's a concern but, at this point, not an overwhelming one. Management recently described HP as "distracted" and said it needs to increase its commitment. However, with U.S. sales of HP-branded printers beginning in the first quarter, it's reasonable to expect that commitment to increase. In the meantime, many of Stratasys' resellers are actually upselling customers to the company's high-end Fortus line, which carry better margins. That's an indication that while the future of 3-D printing may be personal, right now it's still about high-end prototyping.

Rich: OK guys, here's the $10,000 question: Which one of these companies is the best investment right now?

Bryan: I like 3D Systems because of its diversified approach to the still-evolving market. It has the largest installed base which helps with re-sales, up-sells, and recurring supply sales. And the company has been hard at work at democratizing the space too — developing less expensive printers to expand the market beyond its core manufacturing applications. It has also invested in "service bureaus" that act as outsourced printing partners. It reminds me of **VistaPrint**(Nasdaq: VPRT) — you design your own business cards, t-shirts, or mugs, submit your order on line, and they print them and ship it to your doorstep. The service bureaus do the same thing, just for items much cooler and more complex than business cards. It is just one example of how 3D Systems is spreading its bets and building the industry on many fronts.

Karl: Stratasys just went on sale after its second quarter revenues came in a little lighter than expected. The worry is that HP isn't committing enough time or resources to its marketing partnership, but at *Rule Breakers*, we believe HP will get more committed once U.S. sales begin next year. We also like the company's vision of the future. Stratasys has more focus than 3-D Systems on additive manufacturing as opposed to prototyping, and it has excelled there because its technology allows objects to be printed out of a wide range of functional materials, including durable ABS plastics. That's where we see 3-D printing going: From examples to objects you can use.

The 3-D Bottom Line

Not surprisingly, both Bryan and Karl favored the 3-D printing company recommended by their respective services. Now we want to know, Fools — which company do *you* prefer? Do you admire Stratasys' focus or 3D Systems' broad-based approach? Stop by the *Motley Fool Pro* 3D Systems discussion board and let us know!

The Motley Fool owns shares of 3D Systems and VistaPrint.

Charter and 2011 Portfolios: Plum Creek Timber

Published Nov 29, 2011 at 12:00AM

Trade Essentials

- **Actions:**
  - **Charter Portfolio: Write a covered strangle.** Write ("sell to open") May 2012 $33 puts (to potentially double your position to 5%); write ("sell to open") May 2012 $38 covered calls (one for every 100 shares you already own).
  - **Portfolio 2011: Write puts.** Write ("sell to open") May 2012 $33 puts only.
- **Allocation:**
  - **Charter Portfolio:** 10 contracts of each option; we'll potentially double our position to 5%
  - **Portfolio 2011:** 5% (for Portfolio 2011*,* that's four put contracts)
- **Recent options price (splitting the bid/ask prices):** May 2012 $33 puts: $2.15; May 2012 $38 calls: $1.30
- **Preferred strangle limit price:** $3.35 credit, combined (higher is better — check current prices and aim for at least $3.35 initially; as prices change, accept no less than $3)
- **Preferred $33 put-writing limit price:** $2.14 or higher (as prices change, no less than $2)
- **Recent share price:** $35.22
- **Buy around:** $34
- **Fair value:** $40
- **Alternative trades:**
  - **Charter Portfolio: Want a larger premium?** If you're willing to take on more risk (of either having your shares called away or being required to buy more) in exchange for a higher option payment, you can consider moving your strangle strike prices up and down, closer to the current share price with either option.
  - **Portfolio 2011: Want a better chance to buy shares?** You can write puts at a higher strike price to earn a higher premium and increase the likelihood that you will be required to buy shares — but to manage risk, make sure your strike price is only $1 or $2 higher than ours.

What's New?

Watching **Plum Creek Timber** (NYSE: PCL) is a lot like watching trees grow, gently swaying with the wind, but with little change quarter after quarter. A key driver for domestic lumber demand — and with it Plum Creek's saw logs — is new housing starts, which came in at 628,000 annualized in October, a full 18,000 (again annualized) higher than Bloomberg estimates. That may not sound like much, but construction housing permits were at their highest level since March 2010, so there is hope that the pace will quicken. We'll continue strangling Plum Creek until hope becomes reality, so we're writing our fifth covered strangle on the stock, a move that may end with us buying more shares below our original purchase price or selling our current shares for more than our estimate of fair value. For Portfolio 2011, meanwhile, we can write puts to potentially buy shares much cheaper.

Why These Strategies?

With a 4.8% yield (5.3% on cost) and our frequent option writing, Plum Creek has generated steady income for our Charter Portfolio since 2008.

- **Charter Portfolio:** This strangle provides members with a potential net buy price on new shares of $29.65, below our $34 preferred buy price. And if the stock stays between our two strike prices (a range of $33 to $38), we'll earn the full premium of around $3.35 per share (a 9.5% yield on the current price), plus two $0.42 dividend payments (not yet announced, but expected in February and May) for another 2.4% in yield. If the stock rises above $38, we enjoy a potential net sell price of $41.35, more than 17% above the current price and above our fair value estimate.
- **Portfolio 2011:** Writing puts alone nets us a potential buy price around $31 — below our preferred buy price and below Charter's cost basis. The yield on cash for the put trade is an attractive 6.5% in a low interest rate environment.

How to Follow Along

- **Charter Portfolio:** To write a covered strangle, you must own at least 100 shares of the stock, and you should be happy to buy at least 100 more at a lower price.
- **Portfolio 2011:** To write puts alone, you need to be ready and able to buy 100 shares for every put you write if the stock is below your strike price ($33 in this case) by expiration in May.

Members following Portfolio 2011 might feel a little "yield envy" because they'll miss out on the dividend provided through share ownership. If this is you, remember that the upcoming dividends are already part of the calculations behind the put premium we're getting.

Next Steps

- Questions or comments? Visit our Plum Creek Timber board.
- Check out our guide to strangles.

See all of Motley Fool Pro*'s holdings on our Recommendations page*.

Seven Principles for Investing Success

Published Nov 28, 2011 at 12:00AM

Dear Fellow Fools,

We hope everyone had a happy Thanksgiving and is ready to enjoy investing again. Wall Street has most investors on edge, but ironically, this is a much better time to invest than when the market is euphoric. Need a reminder? In 1999, the market consensus was so bright it was blinding. More than a decade after investor optimism peaked, the Nasdaq Composite remains more than 50% below its high. We'd much rather be investing when the outlook is grim, like now.

Seven Time-Tested Principles

To help everyone stay the course in a rocky market, let's review seven great investing principles from Davis Advisors.

No. 1: Accept that uncertainty is the rule, not the exception.

If you're looking for certainty in the economic world, forget it. It has never existed. Whether it was World War I, the Great Depression, World War II, the inflation of the '70s, the S&L crisis of the '80s, the Asian meltdown of the '90s, or any other number of challenges, every decade has thrown major roadblocks in front of the stock market. Yet over those decades, the market created fortunes. Investing during "certain" times is an illusion, and in rare instances where most investors have high confidence (such as 1999), your returns are likely to disappoint.

No. 2: Focus on what is important and knowable.

The stock market creates wealth over decades, so it's not a question of whether or not to invest — it's a question of *how* to invest. Nobody can consistently predict GDP growth, interest rates, commodity prices, wars, or countless other economic events. But we can hone our ability to recognize sustainable competitive advantages, attractive share prices, competent management, and strong earnings potential. We want to spend our time researching what is discoverable and knowable, rather than wasting time analyzing the unknowable.

No. 3: Be patient.

Superior businesses will create value through thick and thin if you're patient. Using turnover (or active buying and selling) as a proxy for patience, generally the more turnover in your portfolio (or the less patience demonstrated), the weaker your performance. Generally speaking, you should probably not be turning over more than 30% of your portfolio, if that, in a year. As Warren Buffett said, "For investors as a whole, returns decrease as motion increases." We want to adapt as the times change, but not change our timeless investing principles.

No. 4: Expect periods of disappointment.

All of us experience good stretches of life as well as challenging years. It's irrational to expect something different from our investments. Even the world's best investors are ranked among the very worst on average *at least* 30% of the time. So, don't expect your investments to perform all the time. Expect weak years, but have the confidence to keep using a strategy that works over the long run. We know *Pro's* strategy has rewarded handsomely over long periods.

No. 5: Engage in healthy investor behavior.

Money is part of our emotional well being, so investing can be emotional if you let it. You need to guard against this, Fools. I wrote in a recent Memo that the average investor performs *much worse* than the average mutual fund he owns, because he trades in and out of the fund based on emotion. Investors tend to give up, chase hot sectors, try to time the market, and change strategies at the *worst* times (imagine a professional golfer trying to change his swing mid-tournament). Healthy investing behavior means staying true to long-term strategies that work. It's easier to do this when you accept that you'll have periods of disappointment.

No. 6: Invest systematically (and I'll add: don't put everything in stocks).

A steady process helps you avoid emotionally tense investing. Invest on a regular basis, or dollar-cost average if that suits your income. And consider keeping a meaningful sum *out* of the stock market if that will help you maintain an even emotional keel. You may not earn much on funds you keep out of the market, but those funds could *more* than pay their keep if they enable you to stay on track with your invested assets. You'll find strong psychological benefits to having a few years' worth of living expenses stashed away in cash savings.

No. 7: Historically, periods of low returns for stocks have been followed by periods of higher returns.

The masses rush in to buy rising stocks and get frightened out of falling stocks, because it's human nature to extrapolate recent events. But events always change. Today, people are giving up on stocks even though rising prices are ultimately going to reward those who stay invested. Davis Advisors reports that every weak 10-year period of 5% annualized returns or less since the 1920s (and there are 12 such instances) is historically followed by a strong 10-year period that averages 13% annualized returns. We're investing on the heels of one of those weak periods. We may see a few more weak years, but history is already on our side for the next 10 years.

For a PDF that provides more details on these seven principles, visit this link. To talk about the Memo, take it to the Memo Musings board.

Fool on!

Jeff Fischer (TMFFischer)

Community

- **Medtronic**'s story remains unchanged in its third quarter, with emerging market sales picking up the slack from slower business in the U.S. and Europe. Bryan (TMF42) walks through the details.
- Huzzah! We just lived through the worst Thanksgiving stock market week since 1932.
- Jeff shares what to do if your **iPath S&P 500 VIX Short-Term Futures**calls are called.

- *Pro* Fools discusss "ragin' contagin,"or what's going on in Europe.
- TMFMoosie is ahead of the game, posting a *Pro* calendar to be ready for earnings in January.
- Have 20 minutes? Nick (TMFCrow) shares a Kyle Bass investing interview he finds very worthwhile.

Three Investing Megatrends

Published Nov 21, 2011 at 12:00AM

Fellow Fools:

Complete Your Portfolio ...

A sustainable environment supports a strong economy — and the reverse needs to be true as well. For either to succeed, these two goals must go hand in hand. I saw evidence of this last Thursday in Washington, D.C., at the World Wildlife Fund's "Conservation Forward" symposium, where there was more talk about business than you might expect. Though the developer of **Google** Earth, Michael Jones, did take the podium for a great presentation on how we perceive the world, most of the speakers were scientists, and it was these scientists who inadvertently offered the most investment ideas. Here are three I found particularly compelling.

Agriculture (Wheat and Soy)

After decades of growth in wheat yields, key regions of the world may be nearing their capacity for wheat production. Institute on the Environment director Dr. Jonathan Foley drew on data from a brand-new study to explain that major global breadbaskets (including North America) have seen flattening improvement in wheat yields over the past 10 years. This is surprising news that has yet to be published. While many poorer regions of the world could still increase yields with improved technology (if only they could get it), the study's conclusion is stark, especially as the world's population grows.

This revelation was all the more striking because it followed a speech by Earth Policy Institute president Dr. Lester Brown on the difficulty of feeding the world today. Seven billion people call our planet home, and 219,000 more are born every day; already a billion people — three times the population of the U.S. — are chronically hungry. Wheat supplies are vulnerable to adverse weather, and the price of wheat is up 40% since 2007. Brown believes a major food crisis is likely by 2020; you'll get a better idea why when we go into our next theme on water below. At the same time, skyrocketing demand for soybeans — used in China to feed animals for a population that's eating more meat — has turned Brazil and North America into major exporters. But much of that crop is being grown on thin soil that won't likely sustain soy for more than a few years, and unlike other crops, soy isn't very responsive to fertilizer.

Food is clearly an investing megatrend for the next decade and beyond: growing it, storing it, transporting it. (Indeed, the same day I saw these presentations, a story broke that Warren Buffett's Burlington Northern Santa Fe railroad is investing in surging grain and soy demand from China.) At *Pro*, we're responding by researching major food producers such as **Archer Daniels Midland**; farming-related businesses; agriculture ETFs; ways to invest in wheat, soy and related commodities; and transporters, including Buffett's **Berkshire Hathaway**.

Water

Water received even more attention at the symposium than food, with several speakers outlining the likelihood of severe water disruptions around the world at any time. More than half of the world's population lives in regions (including North America) that are drawing aquifers down more quickly than they can replenish; further, Dr. Brown's new book, *World on the Edge* (which speaks to economics as much as conservation), cites a World Bank estimate that at least 18 countries are currently enjoying "food bubbles" made possible only by overpumping water from aquifers.

Pro Trade Roundup

Charter Portfolio

- **Contango Oil & Gas**: We sold all shares via covered calls for a net $61 per share.
- **Wells Fargo & Company**: We set up a covered strangle, selling to open April 2012 $21 puts and April 2012 $29 calls for a combined credit of $2.55 per share.
- **Plum Creek Timber**: Our November covered strangle expired for the full profit.

Portfolio 2011

- **Wells Fargo & Company**: We set up a covered strangle, selling to open April 2012 $21 puts and April 2012 $29 calls for a combined credit of $2.55 per share.
- **Plum Creek Timber**: Our November puts expired for the full profit.
- **GlaxoSmithKline**: Our November puts expired for the full profit.

Saudi Arabia's 3-million-ton annual wheat harvest has recently been decimated after the depletion of that country's fossil aquifer, sending officials scurrying to buy land in other countries to raise food. And that's small compared to the trouble that could result if the same thing happened in India, where the World Bank estimates that overpumping makes it possible to feed an additional 175 million people every day. In China, that number is 130 million, and farmers in some provinces have had water supplies cut by 30% since 2008. The world's population is growing by 80 million per year, and if irrigation water grows scarce, food supply is the first item to suffer. A massive quantity of water is also necessary to create most forms of energy; a full 20% of water used in China goes to produce energy from coal. And large amounts of water are essential in many manufacturing and construction processes.

At *Pro*, we're diving into the water situation by considering former holdings **Flowserve**, which makes valves, pumps and seals and has a promising desalination business, and **Lindsay**, which makes efficient irrigation equipment (we've been on to this trend since our beginning).

Declining Use of Coal in Developed Markets

Between 2007 and 2010, coal use in the United States declined 8%. Coal-fired power plants are being closed here at an increasing rate, replaced by natural gas and wind, and the country has a "near de facto moratorium on the licensing of new" ones, as Brown put it. Denmark and New Zealand have banned new plants, and the province of

Ontario (where 39% of Canadians live) plans to phase out coal entirely by 2014. True, China is building coal plants like there's no tomorrow, but most developed nations are moving away from it.

I've just started to look at U.S. coal companies (those that don't export to China) to consider for possible long-term *short* positions (betting on their decline), so I can't name names, but I think there's something here.

Big, Motley Trends Abound

Humans are exhausting the world's resources at an intensifying rate, and we've put ourselves on a path where change in our behavior will be inevitable — our hand will be forced. Most change is ultimately for the better, but transitions are always rocky. Other long-term investment trends to consider include:

- **Sustainable fisheries (aquaculture).** The majority of wild fisheries are so overfished that industrial fishing on the high seas may mostly be replaced by more efficient fish farms in the next 10 years.
- **Wind energy.** Obviously, energy remains a major theme of the coming decade, and the symposium offered compelling arguments that wind energy is much more viable than I personally thought (and is already proving itself in the field).
- **Transportation**. Are electric cars the future?

Ultimately, the symposium reminded me that investing applies to all parts of life, and business needs to give back as much as it takes. Otherwise, it ultimately isn't sustainable. I'll close with another quote from Dr. Lester Brown's persuasive book: "We used to think it would be our children who would have to deal with the consequences of our deficits, but now it is clear that our generation will have to deal with them. Ecological and economic deficits are now shaping not only our future, but our present."

To discuss the Memo, please visit the Memo Musings board. Fool on!

Jeff Fischer (TMFFischer)

Jeff owns shares of Google. The Motley Fool owns shares of Archer Daniels Midland, Berkshire Hathaway, and Google.

Community

- Earnings season is slowing down, but Bryan Hinmon (TMF42) analyzes strong results from recent buy **Autodesk**.
- Jeff and Bryan discuss **Bristow Group**, **Ebix**, and Autodesk in our latest *Pro* Audio Extra.
- Alex340 posts puts that meet *Pro* criteria.
- Which columns do you want to see on the *Pro* portfolio page? Take a poll and share your thoughts (member spinningwood wants animal sounds).
- With the government dropping the budget ball again, what does it mean for defense stocks? Nick admits the outlook is hard to know, but **L-3 Communications**, for example, already looks cheap.

Audio Extra: BRS, EBIX, and ADSK

Published Nov 18, 2011 at 12:00AM

In this new *Pro* Audio Extra, advisor Jeff Fischer and analyst Bryan Hinmon discuss everyone's favorite helicopter company, **Bristow Group**, why **Ebix** is looking better again, and recent strong results from **Autodesk**. (Because of time constraints, we only cover three companies in this edition, rather than our usual four.) Enjoy!

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Transcript

Jeff Fischer: **Welcome to a new edition of Motley Fool *Pro* Audio Extra. In the studio today is *Pro* analyst Bryan Hinmon.**

Bryan Hinmon: Hey, Jeff.

Jeff Fischer: And I am Jeff Fischer, advisor, and we are glad you are here. We are here to talk about four companies today that recently reported earnings and other news. Bryan, let's start with you.

Bryan Hinmon: Sure.

Jeff Fischer: You were going to talk helicopters with us. Bristow.

Bryan Hinmon: Aw, excellent.

Jeff Fischer: Give us a rundown of the latest quarter. What should we take away from it?

Bryan Hinmon: Sure. The big story here with Bristow is we have a business that we bought really cheap and we bought it at a depressed time. The company has since recovered because people are realizing we are in fact going to continue to drill for oil in the deep sea.

Jeff Fischer: BP even just received permits to drill back in the Gulf.

Bryan Hinmon: Yeah, the Gulf. They are starting to trickle through and Bristow is actually seeing some increased business from that.

Jeff Fischer: Get your waders ready if you live near the Gulf. They will do a better job this time.

Bryan Hinmon: Let's hope so. They should at least be on tighter watch.

Jeff Fischer: So Bristow is flying these crews out to these rigs and back.

Bryan Hinmon: Crews and cargo, yeah, and they really specialize in going deep, deep, deep offshore. It's really where they have the advantage. A couple of years ago, they went through this massive fleet regeneration where they got rid of some older helicopters, some smaller helicopters, bought brand new state-of-the-art ones. It was a huge capital outlay, but it's really put them in the best position to capitalize on going further off shore, and it has really put them in the good graces of the companies that are doing this exploration, and also their production.

So what's really going on with Bristow is now we have that silly valuation that we paid. That has disappeared. The company is sort of fairly valued now and what we are waiting for is we are waiting to see if Bristow can really start to run its operations well. It's a tough business because it's so capital-intensive.

Jeff Fischer: Right, and they cannot skimp on their costs. They are all about safety, so everything has to be done right.

Bryan Hinmon: It has to be, and that's the other thing that gives them their competitive advantage is if they are safe, they are not having to spend a lot on insurance. They are not having to spend a lot when things go wrong. They are able to make more money and they are able to be pretty profitable.

Jeff Fischer: And when things do go wrong, as we saw this quarter, they had one accident.

Bryan Hinmon: One accident.

Jeff Fischer: And that hits the bottom line.

Bryan Hinmon: Yeah, so really the key takeaway here is the company does what it does really well. It does what it does better than anyone else. It's safer than anyone else by a factor of five. They just blow away the industry. They way that they have rolled out their safety program has been so effective that they have actually applied that to different areas in the business to really just make sure everything is tight and efficient.

Jeff Fisher: Lunch, like no one is going to choke at lunch.

Bryan Hinmon: That's correct. They probably have hall monitors too.

Jeff Fischer: So Bryan, it's in the high $30s or very low $40s; we put it back to Buy, a *Pro* members' Buy. It has hit $50 a few times. Let's talk about how we view it in the low $50s. What are we thinking?

Bryan Hinmon: Yeah, so the way I am thinking about Bristow is it's a "show me" story at this point. It's a business that I want to like, but I have to say [I am] dispassionate about, and I am only really going to like it if they can be incredibly profitable. At this stage in the game, they are in a mediocre way, profitable. They are sort of just earning their cost of capital and we don't like to buy businesses that are mediocre.

I do think they have some hidden pricing power that they can take advantage of. They sign fantastic contracts. The makeup of the contracts are great. That's one of the things we like about them. They make money without even flying.

Jeff Fischer: Right, these long-term, recurring revenue …

Bryan Hinmon: Right, and if oil prices stay high, oil companies are making decent profits, Bristow should be able to charge more for their services. They should also be able to charge more if in fact their services are distinguished from their competitors. And because of their safety record and because of their fleet, they are. We just have to see that flow through. They have to show me.

Jeff Fischer: Yup, that's a good company to always have on the *Pro* radar at the same time. It's in the mid-$40s right now; like I said, when it dips low $40s, high $30s, we are going to talk about writing put options for those who don't have a position yet, or buying shares. Next time it gets into the $50s, Bryan and I are always talking about possibly writing covered calls or selling if we find something we like much better.

Bryan Hinmon: Yeah, and it's important to tell members, too, that the reason we always move it to Buy when it gets down to that low valuation is the company has a really hard asset base to replicate. These helicopters are state-of-the-art. They don't just come off a factory line. They have a very unique asset base and a very unique position in the industry, and so when we feel the valuation gets silly, then we think it's a great time to buy. But at the same time, we are not likely to raise our target price on the company unless they really start to improve the way that their business is run.

Jeff Fischer: That's well said, and that's one great thing about the company, is it's such a book value decision when the price comes down, it's at or below book value; get some shares for members. So Bryan, thank you. I will talk about Ebix now, everyone's favorite dog to kick the last six months or so.

Bryan Hinmon: Let us have it, Jeff.

Jeff Fischer: It was having a great year, up until March when short sellers played some role in knocking the price down, but Ebix brought some of it on itself as well with kind of cloudy reporting, a CEO who dominated the conference calls, and some acquisitions that were hard to kind of model into the financials of the company. But the good news is in this latest quarter, I see some rays of sunshine. The CFO and the VP of investor relations led the conference call. Robin, the CEO, is still there, but he kind of took a back seat.

Bryan Hinmon: That is unlike him.

Jeff Fischer: And it was great to hear voices and opinions from other managers. The results were strong, one of Ebix's best quarters in their history. Just looking purely at the financials, not the headlines, not the press release, but at the cash flow and the way money is moving through the business and the growth that they were able to achieve, the other interesting thing is they are out shopping for new acquisitions. They see low prices right now. They have a large credit line to buy good companies at good prices, and just as we tape this, they announced that they are buying HealthConnect, an acquisition that the market has smiled upon. Short-term moves don't mean much of anything, but shares jumped on this news that Ebix is acquiring HealthConnect, which will allow it to create the first end-to-end health and benefits network in the U.S., so whether you are an insurance carrier or an agent, an employer, an employee, you can use this network for your health insurance needs. It looks like a good acquisition. Ebix says it will add to profits immediately. The company has 85% recurring revenue streams.

Bryan Hinmon: Got to like that.

Jeff Fischer: Love to see that, consistent margins. They have been around since 1991 at consistent profits and their software architecture complements and melds well with Ebix's. So looks like another good acquisition that really puts Ebix at the forefront in the online health exchange world.

Bryan Hinmon: All right, Jeff, so walk me through this. Back when the short sellers attacked, one of the claims that they were making was that when Ebix was making its acquisitions, they were not treating their acquirees very well. They were sort of gaming the books and that sort of thing. This just seems ... if companies are willing to sell to Ebix, continue to sell to Ebix, that seems like a really positive sign to me.

Jeff Fischer: It does. That's a great point. This company has been around a long time, profitable. Terms were not disclosed because it is a private company, but I think you are right; a successful company as this HealthConnect seems to be, why would they sell to a company that seems to game the system?

Ebix, to its defense, has always said that the plaintiffs filing against Ebix are incorrect. They had very clear terms where they would acquire a company; if the company then made certain revenue or profit goals within a certain time frame, the company members would get a bonus. And Ebix in these cases said no, the numbers weren't met, or just missed, so you only get part of the bonus.

Months later, employees came out and said, No, your accounting is wrong, we did make these numbers. But the lawsuits haven't gone anywhere to my knowledge. Ebix settled a couple out of court. It's not something we know with certainty, so we have to, if we are going to keep owning the stock as we are right now, give Ebix the benefit of the doubt and watch for more successful acquisitions like this one. This one looks good.

Shares are pretty inexpensive. You can see, as with Bryan's review of Bristow on the boards, you can see that Ebix review that we put up on the Ebix board and get more information there, but shares are trading at about nine, 10 times free cash flow. The market does not expect Ebix to grow earnings next year because they are paying taxes. Revenue will grow, but they started to pay taxes, which is another thing we are very glad to see. They had all these years of operating losses that they were carrying forward, but it kind of showed their earnings power through an inaccurate prism and now we are going to see what they really make with taxes, so I am glad they started that early. They intentionally did that. It's a good sign. So the market expects revenue growth next year, flat earnings, but I think with acquisitions and with more greater efficiencies, Ebix could grow earnings next year as well, even if a modest amount.

Bryan Hinmon: I think time also is something that really matters in the Ebix story. As time progresses and there isn't bad news and these allegations sort of fade away, we are going to be able to see Ebix be valued on its business and not on all of these clouds in the sky.

Jeff Fischer: Right, and *Pro* members have been on a rocky ride since the beginning. Shares soared for us, then they came all the way back down. Now they are kind of in this holding pattern. It's like we are watching the CEO grow up. He had a cat by the tail. It's a small company. It's one of the fastest growing of the past several years, and suddenly they look around and realize, Wow, we are a serious operation with great cash flow and we can really grow this thing if we ... let's slow down now and do it right. It's kind of the sense I am getting from them.

So members know that it's one of our lower-quality earnings companies, when we look at earnings and try to rank it against all the others, but it's improving, and so for now, we are happy for that. It remains a Buy. And let's talk about our next company. Bryan?

Bryan Hinmon: All right, sure. I'll talk a little bit about Autodesk. They reported yesterday; by the time this airs, I will probably have the update on the boards, and this should be a quick one to talk about. Earnings were great. They were strong across the board; they were strong across geographies. We were very opportunistic with Autodesk. It's a company that we knew well and we acted smartly on it, I think. The market was throwing out the baby with the bathwater. We knew this was an incredibly high-quality company that was trading at a less-than-average-company price, so we bought it and it's up 30% for us. Really, this is the first earnings release. Earnings were good. It's a recovery.

I think there are a couple of takeaways here. The couple of takeaways are the company is just not seeing that we are going to enter back into a recession. Even though they play into the construction market a little bit, it hasn't gone to zero. It's just not going away.

Jeff Fischer: It's, as you said, shares got clocked because of fears of a recession and construction and manufacturing and engineering would all slow down again. Autodesk, you told me just recently before the taping, Bryan, they see nothing; it's nothing like 2009 right now, having gone through the conference call …

Bryan Hinmon: Yeah, nothing. They said they can't promise we are not going back into a recession, but if we are, it looks nothing like the last one.

Jeff Fischer: So the results out just hours before this taping where it looked very good and license revenue was strong, which leads to strong maintenance, recurring revenue. They are expanding into new software lines and seeing strong demand from existing customers, which is always great. So the shares …

Bryan Hinmon: The shares are on hold right now. That 30% run-up happened really quick. They are about $36 now after a good day, and I have got a target price, or a fair value of about $38, and there could definitely be upside to that. But again, this is a company that we feel really strongly about. This is a great business, one that we think can be a great compounder over time, so we are in no hurry to sell it.

Jeff Fischer: That's so true. And it's so well-run, and we got to see that through the 2008-2009 downturn, so that gives you some piece of mind that they know how to navigate through very rocky periods.

Bryan Hinmon: Yeah, and I think one interesting thing too is anytime you build something, there's a good chance you are using Autodesk software. Only 16% of the company's sales come from emerging markets. So you think about all the infrastructure build and all of the eventual manufacturing capacity that could come from emerging markets, there's still a really big runway for Autodesk.

Jeff Fischer: Right, right, what they have to tackle there, and they are working on it, is all the pirating, software pirating.

Bryan Hinmon: Yeah, 80% to 90%, actually, of software that is in emerging markets is pirated. It's crazy; astounding.

Jeff Fischer: That's worse than New York City. All right, well thank you, Bryan, for being here.

Bryan Hinmon: Sure thing.

Jeff Fischer: And Motley Fool *Pro* members, thank you for listening. We will see you on the boards and we'll see you in the Monday Memo. If you didn't see the Monday Memo from Nov. [14], go back, take a look at that. There's a Davis Report in there that I really like. It outlines the keys to successful investing that we try to follow. One is to, of course, be prepared and expect rocky, difficult periods like we have right now. Another is to have the right perspective, time perspective, and three, of course, buy what you know to be high-quality. We are buying businesses. All right, thank you everybody. We'll see you on the boards, and Fool on!

Why Most Investors Fail, and How We Avoid It

Published Nov 14, 2011 at 12:00AM

Fellow Fools,

Guidance Updates

- **AmTrust Financial Services** and **Vanguard Energy** move down to Hold on valuation.
- **BMC Software** moves up to Buy First for the same reason.

This Week's Expirations

Charter Portfolio

- **Plum Creek Timber**: Our covered strangle is on track to expire for the full profit on both options.
- **Contango Oil & Gas**: Our covered calls are on track to be exercised (meaning our shares should be sold, as we wished).

Portfolio 2011

- **Plum Creek Timber**: Our written puts are on track to expire for the full profit.
- **GlaxoSmithKline**: Our written puts are on track to expire for the full profit.

Reliability and steadiness are essential to any successful career, whether you're a teacher, a doctor, an engineer, or a barber. That's because these qualities are directly tied to long-term performance. You won't achieve success over the years if you don't stick to your principles, if you fail to learn from your mistakes, or if you regularly change your approach without good reason. We know this to be the case in our working lives, but when it comes to investing, studies show that a majority of individual investors are just the opposite: They unreliably change course all the time, and not surprisingly, the results are dismal.

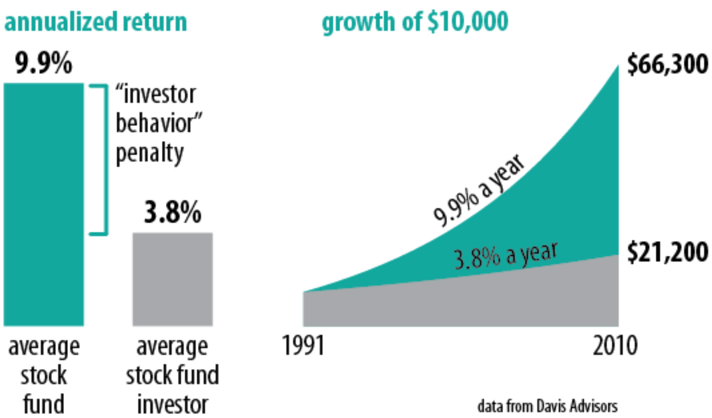
Missing Most of the Upside

The best-performing mutual fund from 2000 to 2010 was the CGM Focus Fund (CGMFX), which returned more than 18% annualized despite a flat S&P 500. The fund's outstanding track record would have turned $100,000 into more than $500,000 over those 10 years. The only problem? According to Morningstar, the average investor in the fund actually *lost* 11% annually over those same very successful 10 years. That is not a typo: The fund gained 18% annualized, but its average investor lost 11% annualized. You're not crazy to ask how that is possible.

The answer is that many fund holders tried to time the market. For example, the fund soared 80% in 2007, so hordes of investors poured money into it in 2008 — only to see it fall 48% that year. That decline led investors to pull money out in 2009, taking losses soon before the market doubled from its low. Investors were making emotional decisions based on recent events, changing their stance repeatedly, and as emotion would have it, at the most inopportune times.

Not Just One Fund; It's Universal

According to an outstanding investing study from Davis Advisors (we'll provide a link at the end of the Memo, Fools), the average stock-holding mutual fund returned 9.9% annualized from 1991 to 2010, but the average fund owner earned only 3.8% on average per year.



Not pretty. And it hurts even more if we put this performance into dollars. By trading in and out of funds, the average fund owner increased a $10,000 investment to just $21,200 over nearly two decades — while the average *fund* turned that $10,000 into $66,300. Now imagine the continuing effects of compound returns on both of those amounts and the growing difference between them over a lifetime. Feel the pain. Remember it next time you're tempted to make a trade: Davis also finds that the less trading a fund itself does, the better the fund's results tend to be. What's true for individuals is true for funds, too.

Successful Investing Includes Many Bad Years

All great investors suffer years of poor results, bar none. It's just how the market is. Warren Buffett's partner, Charlie Munger, has an outstanding lifelong record, but his annual results lagged the S&P 500 index 29% of the time. An impatient investor would have left Munger during some of his down years and missed out on riches later.

And Munger is far from alone. According to Davis Advisors, investors who achieve the strongest records aren't always at the top of the performance list. Over a 10-year period, Davis studied 192 large-cap money managers who had previously ranked in the top 25% for performance. They found that:

- A full 93% of them spent at least one three-year period in the bottom half of all performers.
- Sixty-two percent of them spent at least one three-year period among the lowest 25% of all performers.
- And 31% of the best money managers spent at least three of 10 years among the very worst 10% of all performers!

In other words, over this 10-year period, you could expect most of the best investors to be ranked among the *very* worst about one-third of the time.

This data clearly illustrates why impatient investors lose out: They go from vehicle to vehicle seeking results based on recent performance. They sell when one asset is down only to buy another asset that may be up recently, but is just as likely to go down next — because nearly *all* investments and *all* investors have weak periods. As we showed above, chasing performance by looking in the rearview mirror can turn a 9.9% annualized return into 3.8%. Sitting tight would be so much better.

Stay the Course

As with any career, steadiness and persistence are necessary for successful investing. But don't take that to mean you'll always do well. There will be years in which your results disappoint you, and years in which your successes are far greater than you thought possible. That's why it's vital to invest in ways that truly make you comfortable, so you don't lose faith during rocky periods. Because the final point to remember is that historically, 10-year periods of weak stock-market performance (like those we've just had) are followed by 10 years of much stronger results. That's the final data point in this Davis report we promised to link to, and it's a hopeful one.

Even now (especially now!), investing is a lifelong pursuit. At *Pro*, we own companies we believe will grow value over the next three years and beyond; a net 73% of our portfolio is currently invested in such businesses. We're hedged, too, because Europe is a crazy mess. But we continue to believe that good companies will drive most of the profits we generate in the coming years, and we look forward to the value we'll generate together by staying the course.

Thoughts or questions on this Memo? Please bring them to our Memo Musings discussion board.

Foolishly,

Jeff Fischer (TMFFischer)

Earnings Coverage

- **Ebix**
- **3D Systems**
- **MasterCard**
- **Bristow Group**
- **Broadridge Financial Solutions**
- **StoneMor Partners**
- **Contango Oil & Gas**
- In our latest audio coverage, we talk about **Papa John's International**, StoneMor Partners, Broadridge Financial Solutions, and **Tupperware**. Enjoy the latest *Pro* Audio Extra.

Community

- Bryan Hinmon (TMF42) answers questions about our protective collar on **AmTrust Financial Services**, reminding Fools how we've been able to make money despite the stock going against the collar so far.
- TMFMoosie posts a Weekly Calendar. (You can also scroll through our handy "Pro Happenings" calendar to the right of the Memo on the website.)
- TMFEldrehad looks for top-scoring CAPShot stocks.
- Fools discuss the pros and cons of end-of-year tax strategies.
- *Pro* members are keeping on top of European happenings on the *Pro* Philosophy board, where Jeff also posted a link to track the yield on government debt in key European countries.
- Alex340 posts puts that meet *Pro* criteria.

Jeff owns shares of AmTrust, Ebix, 3D Systems, Tupperware, and GlaxoSmithKline, and has options on BMC Software.

Charter and 2011 Portfolios: Write a Covered Strangle on Wells Fargo

Published Nov 11, 2011 at 12:00AM

Trade Essentials

- **Actions (both portfolios):** Write a covered strangle.
  - Write ("sell to open") April 2012 $21 puts (to potentially double your position to 5%)
  - Write ("sell to open") April 2012 $29 covered calls (one for every 100 shares you already own)
- **Allocation:** Each strangle you write represents 100 shares of Wells Fargo you own and 100 more shares you're willing to buy.
- **Recent Option Prices (bid/ask):**
  - April 2012 $21 puts: $1.60/$1.63
  - April 2012 $29 calls: $1.19/$1.22
- **Recent Stock Price:** $25
- **Limit Price:** Aim for at least a $2.79 credit; as prices change and time passes, accept no less than $2.50.
- **Alternative Trades:**
  - If you don't yet have a 2.5% position in Wells Fargo, you can just buy shares.
  - You can write just the puts (with modestly higher strike prices if you like) to buy up to 5% in shares.
  - We don't recommend just writing the covered calls, because the sole premium they provide isn't worth capping upside.
- **Why Write a Strangle?**
  - This income-generating strategy could earn us an 11% yield on shares.
  - It allows us to potentially buy shares 27% cheaper.
  - We can hedge against a small drop in share price.

What's Changed?

You've heard of buy-and-hold, but are you familiar with buy-and-hope? This very popular (and at times very profitable) investment strategy is tantalizingly simple: Buy a stock and hope that its price goes up. Overreliance on this strategy can leave an analyst clinging to a thesis despite new information — but I'm not that analyst, and that is not the *Pro* way.

We welcomed **Wells Fargo** (NYSE: WFC) into our portfolio in December 2010. Eleven months later, both the nation's largest traditional bank and the future of the overall economy look a little different, and our strategy needs to reflect that reality. Our ongoing analysis of Wells Fargo has given us four reasons to modify our thesis:

1. We expected that loosened federal regulation of Wells Fargo's dividend would be a catalyst for a return of dividend-seeking shareholders, general investor confidence in the shares, and a rising share price. It wasn't.
2. Now-ex-CFO Howard Atkins departed the company earlier this year without a discernable reason.
3. The Fed renewed its commitment to low interest rates through mid-2013, and its policy decisions continue to crimp bank profit margins.
4. The ongoing European debt crisis has further hurt public confidence in banks and the economy.

All of this hurts Wells Fargo's share price and increases uncertainty in the financial sector as a whole. Earlier this year, we responded to some of these factors by using a ratio put spread to hedge our position, which brought comfort over the volatile months of August and September and added a little cash to our portfolio. Our goal with that strategy was twofold, however; we also would be happy to fill out this position to a full 5% at cheaper prices, and in that the ratio put spread was unsuccessful.

Why a Covered Strangle?

A covered strangle is an income-generating strategy that allows us to profit within a wide range of stock prices. Specifically, at expiration, if shares are …

- Less than $21: We'll be assigned to buy new shares at a net price $18.21.
- Between $21 and $29: Our covered strangle will earn us the equivalent of an 11% yield on the current share price.
- Higher than $29: Our covered calls could be exercised, forcing us to sell our shares at a net $31.79 (5% above our cost basis) if we don't take action.

Note that the third bullet point above violates Rule No. 1 of writing covered calls: Don't write calls on shares you don't intend to sell. While we want to continue to hold Wells Fargo and we'd prefer to roll this strangle, if we are forced to sell our shares, we'll do so at a 27% premium to today's market price — not such a bad outcome.

This Wells Fargo position is opportunistic; we're taking advantage of current high volatility and uncertainty, along with a greater chance for a range-bound stock, and when the outlook changes, so will our strategy.

How to Follow Along

To write a covered strangle, you must own at least 100 shares of the stock. You should be willing to sell them at a higher price, and you should also be happy to buy at least 100 more at a lower price. Use a "strangle" order with your broker to sell to open April 2012 $21 puts and April 2012 $29 calls on Wells Fargo, aiming for a credit slightly higher than the combined bids of the put and call options (around $2.79 as of the day we issue this trade; realize that it will change and we recommend you accept no less than $2.50).

Head to the Wells Fargo discussion board with questions.

Nick Crow owns shares of Wells Fargo.

Audio Extra: PZZA, STON, BR, and TUP

Published Nov 11, 2011 at 12:00AM

This week, advisor Jeff Fischer leads the *Pro* team in a discussion of earnings results from **Papa John's Pizza**, **StoneMor Partners**, **Broadridge Financial** and **Tupperware**.

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Quick Links

- Papa John's discussion board
- StoneMor Partners discussion board
- Broadridge discussion board
- Tupperware discussion board

Transcript

Jeff Fischer: Welcome to a new edition of *Motley Fool Pro* Audio Extra. The whole team is here. We will introduce them one by one as we talk about four *Pro* companies today. Everyone, how are you doing?

All: Doing well, doing great.

Jeff Fischer: Good, good. Nick, we will start with Nick Crow, senior analyst, and Nick is going to talk about Papa John's Pizza. Good topic to start on.

Nick Crow: Absolutely, very tasty. Papa John's reported last week …

Male: Is it really? I mean, Papa John's? It's fairly good.

Nick Crow: I think they have great pizza, but I also think Budweiser is good beer, so what that says about me. *(Laughter.)* This was an awesome quarter for Papa John's, much like the first quarter this year, and we had some; first quarter, we had awesome revenue growth and great comp sales come in and we got a little nervous in the second quarter when that didn't occur.

Well so far this year results are great, this quarter being the best of the three with revenue growing about 12% overall, and most of that is driven through more stores. They have got 5.5% more stores than this time last year, plus great comp sales, so that's the individual increase in the stores sales that have been open for at least a year. so that has been awesome both on an international level and domestically here, which is a little bit of a surprise because the economy is hurting, you have the MBA lockout, lots of reasons where you think maybe pizza sales would be slow, but they have done really, really well. It's impressive.

Jeff Fischer: Yeah, Papa John's has been a very steady performer since we bought it. Well, we don't regret anything here, but we learn and we could have had it on as a Buy a bit longer, but it did touch up to our fair value pretty early on and we have held it ever since, and fair value has inched up a bit to the low thirties.

Nick Crow: Yeah, right now I think our fair value on the site is a lower than I actually feel like it is. We will have to update that soon. One of the key drivers there is actually store count, and over all this year it is supposed to open up 210 to 230 stores, which is a big increase over the last guidance they gave us. That's really great news, because it's happening on both ends: fewer closures and more openings than expected.

Jeff Fischer: And Nick, we were talking before the taping that store openings is really what drives this long-term story, and it is what we are thinking about as we think about this company in the long term. They have a small footprint still, relatively speaking.

Nick Crow: Absolutely. They have about 4,000 stores opened total, sometime early next year we would expect. Right now there is like 800 internationally and the rest of that is domestic, whereas their main competitor, Domino's, has over 9,000 stores, so there's a lot of room to grow.

Jeff Fischer: So Fools, we are still holding Papa John's, and we view it as a stable, steadily growing company with a long runway ahead of it, but at the same time, if we find something we like much better, Papa John's may be a place to raise cash, but right now it is on hold, and we will have the most recent valuation update up on the site soon. Thank you, Nick. What a great topic before we go on to Alex's. Here's Alex Pape, analyst Alex Pape. You are going to talk to us about StoneMor Partners.

Alex Pape: Sure, not nearly as exciting as pizza.

Jeff Fischer: They run carnivals, right?

Alex Pape: That's exactly what StoneMor does. StoneMor is the second largest cemetery owner and operator in the U.S., so not nearly as fun a topic as pizza, but a good cash flow generator business, nonetheless. So the accounting numbers around StoneMor are incredibly difficult to analyze, but the number that moves the needle the most is adjusted operating income, which is sort of a look at how much cash their operations actually brought in for the quarter after you remove all the noise. And that was down slightly in the quarter, and there were a few reasons. One was that Hurricane Irene came through and 76% of their properties, their cemeteries, are in the U.S. northeast, and so there were a lot of cleanup costs with flooding and fallen trees and things like that, so one time higher than expected costs.

Jeff Fischer: They were raking, a lot of raking going on.

Alex Pape: There were a lot of laborers out there raking the leaves up. The other thing that was happening is in times of economic uncertainty, there is an interesting thing that happened to StoneMor's sales, so people will buy less merchandise, which are things like gravestone markers and really fancy caskets and things like that, but the rate at which they sell actual burial plots usually goes up slightly. That's because of how they train their sales force. They want to keep the number of people coming into their cemeteries, the plots that are being bought very steady, because there is a really high correlation between once you have one family member in a cemetery, the other family members want to be there. I realize this is a fairly dismal topic, but it …

Jeff Fischer: No, it's fascinating at the same time.

Bryan Hinmon: I want to be buried next to all three of you.

Nick Crow: We should do this last so we don't have to listen to it. *(Laughter.)*

Jeff Fischer: Skip out now if you want to. No, but this stock has nearly a 9% yield.

Alex Pape: Yeah, and the bottom line is, when we are looking at this stock, we are not so much looking at is it poised for phenomenal growth; it's just can they sustain a dividend and one quarter of a little bit higher costs is not going to change that. They can still easily pay off that dividend and I think that over the next couple quarters we'd probably even expect them to raise it slightly. So this is a stock that remains a Buy. It is below $28, so it's a pretty great deal right now. That's about as exciting as you can get for news on StoneMor.

Jeff Fischer: All right, sounds good, Alex. I missed one thing you said. The economy is weak, of course. People are worried and a lot of anxiety out there, but that does not result in more cemetery goodies being sold.

Alex Pape: Yeah, they are doing …

Jeff Fischer: Cemetery goodies. *(Laughter.)* Trying to liven it up!

Bryan Hinmon: StoneMor just announced a burial Groupon. *(Laughter.)(Whisper)* Too soon?

Jeff Fischer: Yeah, Groupon is really scraping the bottom of the barrel there. People are worried and yet they are not planning ahead.

Alex Pape: So most of the sales that StoneMor makes are for people buying burial plots and merchandise before the time of death, so they are preparing; most of the people who want to not have their families burdened with that cost when they do pass on, and so those people are less willing to pay up for fancy stuff, the goodies, but they are equally or even more willing to pay up for the actual plot because in times of economic uncertainty, they are even more concerned about overly burdening family members later on.

Jeff Fischer: Excellent, all right, thank you, Alex. Now we will move on to an equally exciting company. Another *Pro* Buy right now, Broadridge Financial Solutions, and here is analyst Bryan Hinmon to give us the latest on earnings they had just released recently.

Bryan Hinmon: I really like to bring home the excitement (unclear).

Jeff Fischer: Hey, it's about profits, not excitement.

Bryan Hinmon: Last week it was graphite electrodes; this week, (unclear) statements.

Jeff Fischer: If your investing is too exciting, you are doing something wrong. Look at Mr. Buffett. You have got to; slow and steady wins the race.

Bryan Hinmon: Slow and steady wins the race. Well, that's pretty much what we saw from Broadridge this quarter. It was a pretty good quarter. First quarter, their first fiscal quarter, is always their smallest contributing quarter, so it is important not to get too excited by seeing the good results, but I think there are really two take-aways from this quarter. Neither of them really were big news this quarter, but it is more of the absence of what else is going on.

The first thing is the risk in this name has dissipated and no one is really talking about it, but a year ago we were talking about how the SEC and FINRA were looking into how the proxy business is done and basically looking at Broadridge as a monopoly, a monopolist, and saying is this sustainable? Do we need to change the way that proxy voting is done? People feared, investors feared that that was going to change Broadridge's business dramatically. All of that noise has died down now. Broadridge has done a ton of work hand-in-hand with FINRA and the SEC to basically prove their value. They proved that if Broadridge was out of the market, the amount of money that companies would have to pay to run their proxies would be probably twice as much. So with that risk gone, that cloud removed, I really think that that now creates a clear path for Broadridge to succeed.

And the second thing is there is also a clear path now to upside to the shares. Some of their acquisitions are really starting to perform, they are starting to streamline them in with their sales process, and they are getting some pretty good results. So as that continues to happen and we see the financial metrics come into line with that, there could be some upside that we didn't originally count on in the shares.

Jeff Fischer: That's a good summary, Bryan. We have owned shares a while now and they have been pretty range-bound, and a few times they dipped into the teens were good opportunities. We tried to point out to members, of course. You can also write put options on it right now to try to nab shares a bit cheaper, but I think this is one position that while flat for us so far, is one day over a short period of time, suddenly going to make its move 20, 30% higher, and that's where it will be (unclear).

Bryan Hinmon: Yeah, I think you are right. It is going to come like that, and it's important to realize too, we have written puts, excuse me, twice on Broadridge, and they pay a stable dividend, so even though the share price hasn't moved much, we have done pretty well being opportunistic about generating some income off this guy.

Jeff Fischer: That's true too.

Alex Pape: Bryan, I just want to thank you for choosing a company that is almost as boring as

StoneMor.

Bryan Hinmon: I just made StoneMor look good; that's incredible.

Jeff Fischer: Well you guys, if they make us money, no one will complain, and I'm going to talk about another company that we all love, an old PRO favorite, Tupperware. Do any of you own Tupperware or your wives, girlfriends?

Nick Crow: We own their competitors, Jeff.

Jeff Fischer: All right, Nick, you can leave the studio.

Nick Crow: That's only because we have no friends selling Tupperware.

Jeff Fischer: You can get it online, Tupperware.com. *(Laughter.)* I think you are required to at this point. To be fair, my wife and I just bought our first Tupperware a few years ago, as PRO became acquainted with the company once again. "Fall in love all over again with Tupperware," should be their motto. But it's a company I found; "found", that's a generous word. A company I decided that we should invest in in 2009, given the valuation, the decent yield at the time and the volatility. The premiums on the options were great, so we started writing put options in the mid-twenties and shares soon doubled. We should have just bought shares earlier than we did, but we are still making money on the shares as well.

It is a really unique business model that most members know about, but it is still worth talking about again. Tupperware has 2.7 million sales people around the world, and the U.S. Government directly employs two million, so Tupperware has more people working for it than the U.S. Government. If that's not incredible, what is? And they are making money at it.

Male: Yeah, imagine that.

Jeff Fischer: And they don't need tax revenue to do it. They benefit from their direct sales force, of course, that can go into dense markets like you name it, Hong Kong or Tokyo or any major city in India, where millions of people live and sell these products directly to them, and they are not just any Tupperware product. They are made for that market, they are priced for the market, and they really plug into the current food trends in those markets, even food trends in France change and Tupperware changes to adapt with them. Tupperware actually has the best-selling cookbooks in France, which is always surprising and fun to bring up when you are talking to people about the high cuisine of France. So what we have is a unique sales force and a unique sales channel, and inexpensive products, so it is custom made for developing markets where now some 60% of Tupperware sales are occurring every year.

They had just this last quarter, revenue was up 10% and local currency, emerging market sales were up 19%, and that includes some jumps such as 74% in Brazil and a 30% leap in Italy, which is given everything going on in Italy right now, people are saving, storing more food, but what really happened there is Tupperware, this shows that Tupperware can go into a market, focus on it and improve results there quickly. So there are so many markets that the downside is that they can't focus on all of them at once, but when they need to go into a market and strengthen it, they can.

Tupperware's largest, most advanced market is Germany actually, and they saw a 9% jump in sales in Germany last quarter. So Tupperware is not just an emerging market story, it is also growing in North America and Western Europe as well. Shares are down lately. As I said, they are volatile; below 55 they are a Buy. If they go much lower, into the forties, we probably would move it to Buy First, but right now it is a Buy. You can also write put options. Lately the $50 put options paid quite well, so sell one put for every 100 shares you are willing to buy, and the stock itself yields 2.1% and the fair value is about $15, $16 higher than the recent price, so I think it is a somewhat defensive investment in that a weak economy can help it. Their sales staff tends to grow in a weak economy and they get better quality applicants for the job as well. And of course demand for food storage products goes up in a weak economy as well, as people try to save money and eat at home more frequently. So that's it on Tupperware. It remains a Buy and around a 3% allocation in the portfolio.

So today we outlined three Buys and Papa John's, which is on hold, but the three we talked about can be bought at any time or you can also sell to open put options on all three. Now Bryan, to close, you don't have any Tupperware at home?

Bryan Hinmon: I am ashamed to say that I paid $3.99 I think, for 16 pieces of IKEA storage stuff that is far inferior to Tupperware.

Jeff Fischer: Well, at least you said that.

Bryan Hinmon: Yeah.

Jeff Fischer: Alex, you are like just out of school, you don't even have food at home.

Alex Pape: I have got to tell you, I have no idea who makes the containers that my food is in, which is now a really frightening thought, but they might be Tupperware.

Jeff Fischer: Do you frequently, do you cook for yourself?

Alex Pape: I do. I eat quite a bit of food because of all the running that I am doing, and so it's just not …

Male: There's never any left. He doesn't have to save any. He just eats it.

Alex Pape: It's not cost effective for me to eat out very frequently.

Jeff Fischer: The high metabolism of your twenties; if I could go back to that, I certainly would. Thank you all for being here, and thank you, *Pro* members, and we will be back next week to cover another handful of *Pro* companies. Until then, we will see you on the boards and we will see you Monday in the Monday Memo. Fool On!

Hedging the Pro Way

Published Nov 7, 2011 at 12:00AM

Dear *Pro* Fools,

There are some major positions in our portfolio that we sincerely hope lose money. Lots of money.

Pro Trade Roundup

Charter Portfolio

- Sold short 500 shares of **SPDR S&P 500** at $123.69 (5% for 24% total, representing a 30% hedge on our invested capital; one needn't hedge cash)

Portfolio 2011

- Sold short 85 shares of **SPDR S&P 500** at $124.07 (5% for 23% total; same as above)

Guidance Updates

- **OpenText** moves down to Buy after some price appreciation.

I'm talking, of course, about our hedges. This Memo is meant to help ensure that all *Pro* Fools understand how we're hedging, why we're doing it, and what it means.

Hedging, Not Shorting

When we talk about hedging, we're talking about a whole plethora of ways to protect our portfolio. Note that the key word here is "protect," not "profit." Hedging often involves taking a position in a security that interacts in a predictable way with things you own. You may not have a particularly strong opinion about the security itself — you set up the hedge because of the predictable interaction with a position on which you *do* have an opinion.

Shorting, on the other hand, is all about conviction. Say you short **Barlo's Buggy Whips** because you believe the stock is overvalued and the business is cratering. In that case, you are explicitly aiming to *profit* from the stock's fall. This position is also different from a hedge because Barlo's stock doesn't interact predictably with other holdings in your portfolio. Shorting Barlo's in this example is just like buying a stock, except you're betting it will go down rather than up.

In short: Hedging is a low-conviction strategy aiming for protection. Shorting is a high-conviction strategy aiming for profit.

Hedges Don't Make Us Money

Let me hammer home a crucial point: It is pretty much impossible for a hedge to make you money.

Say what? Take our current hedge on the **SPY Depository Receipts**, to which we've recommended a 30% short allocation against your invested capital (in other words, you do not need to hedge your cash). If the S&P 500 falls 10%, our short position in SPY will be up 10% — but our overall portfolio, which is more than 90% long, will assuredly be down. It just won't be down as much as the S&P 500, thanks to the hedge. On the other hand, if the S&P 500 jumps 15%, our SPY short position will lose 15% — but our portfolio will be up overall.

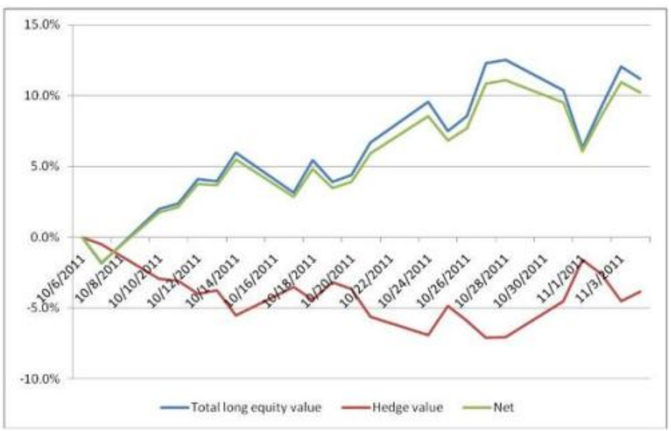
And that, Fools, is the whole point. We sincerely hope to lose lots of money on our SPY short — because every position we hold is in the context of our entire portfolio, and if our SPY short is deep in the red, that means the portfolio as a whole is strongly up. **The value of the whole portfolio is the only value that matters.**

So Why Use Them?

"But wait, Alex," you may be thinking. "If we can't make money from hedging, why do we do it?"

We hedge for three primary reasons. The first, as noted above, is for protection: Hedging can soften the blow to our portfolio if the market tanks, and we can turn those hedged positions into ready sources of cash to deploy in a then-cheaper market. In this way, hedging helps smooth returns and reduce risk — the second reason we do it and a big part of *Pro*'s mission.

The chart below shows the cumulative return of the Charter Portfolio's long equity positions and of our SPY hedge, as well as our net return since Oct. 7, when we shorted our first batch of SPY. For simplicity's sake, I've omitted all our options positions as well as our cash balance. This is just our stocks, our shorts, and the net of the two.



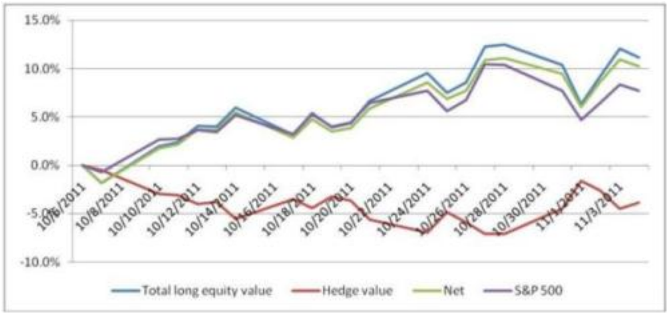
The image above represents our long stock positions and our SPY short. It does not include our options or cash positions. The purpose here is simply to show the effect of our SPY hedge on our stock portfolio.

As you can see, while our SPY short (the red line) has been unprofitable over the past month, our portfolio has continued to make money. This is exactly why it is critical to look at portfolio performance, not the returns of any one position in isolation — especially a hedge.

The third reason we hedge may be the least intuitive, but it is very real. Hedging helps us isolate our investing advantages. We're not market-timers, and we don't have a special edge when it comes to forecasting macroeconomic variables. What we *are* good at is identifying companies and stocks that will be long-term winners. By shorting broad market indices such as the SPY, we are able to isolate that advantage.

To help explain, imagine that we were to hedge 100% of *Pro*'s portfolio by shorting the S&P 500. This would mean betting that our hand-picked stocks outperform the S&P 500 and removing the effects of market volatility from our results. In that case, if the market goes up 10% and our stocks go up 15%, we make 5%. But if the market goes down 15% and our stocks only go down 10% … we still *make* 5%. Now scale this back from 100% hedged to just 30% to help understand how we are *mildly* isolating our advantages.

So is it playing out that way? It's only been about a month since we initiated our SPY short, so this is a very short time frame — but so far, the answer is yes. Here's the same chart you saw above, except I've added the return of the S&P 500 (in purple).



Our stocks (in blue) outperformed the S&P 500 (purple) during the past month's rally. Even better, our hedged portfolio (green) has also outperformed the S&P 500 — even with the drag from our SPY short. Few hedge funds are actually able to achieve this consistently over time, and of course, we are not trying to beat the S&P 500. We are aimed at producing real returns over meaningful periods of time with lower-than-market risk. It's still worth pointing out, though, that with less risk than the market, our hedged stocks beat the market over this admittedly short time period. That's what I mean by isolating our advantages.

It's All in the Portfolio

At its root, hedging is simply a way to protect what you already have. Remembering that will make you less likely to miss the forest for the trees by gauging the performance of a position, especially a hedge, in isolation. Everything we *Pro* Fools do is part of a holistic, integrated portfolio, one we are constantly tweaking and improving. Head to our Philosophy & Strategy board with any questions you have on the topic.

Fool on!

Alex Pape (TMFPapester)

Alex would probably short Barlo's Buggy Whips if it existed.

Earnings Coverage

- Jeff opines on results from **OpenText**, where growth was strong.
- **Tupperware** still rates a Buy as we go over recent results.
- **Covanta** turned 90 days into healthy quarterly results.
- **GrafTech International** is riding the economic roller coaster well.
- **Intel** reported outstanding income, surpassing even our high expectations.
- **Rockwood Holdings** more than doubled earnings per share and looks strong.
- **Plum Creek Timber** predicts more of the same: slow demand for wood, which suits our strangle fine.
- For audio coverage on **Pebblebrook**, **MasterCard**, GrafTech and Rockwood, listen to our latest *Pro* Audio Extra.

Community

- Alex340 posts puts that meet *Pro* criteria.
- MazonCreekRich asks the age-old question, "What Would a Viking Do?"
- TMFMoosie returns from a freak winter storm and what does he do? He posts a *Pro* calendar.
- TMFEldrehad looks at tags in CAPS and how they can be a useful research tool.
- aleax warns that watching market volatility too closely can lead to heart attacks. No joke. So move back from the screen, let us watch our investments for you, and enjoy your life.

Audio Extra: PEB, MA, GTI, and ROC

Published Nov 4, 2011 at 12:00AM

With earnings season in full swing, the team sat down recently to discuss earnings results from four of your *Pro* stocks: **Pebblebrook Hotel Trust**, **MasterCard**, **GrafTech International**, and **Rockwood Holdings**. Strong management at all four companies, and other factors we've found in our analysis, all point to profitable months and years ahead. And stay tuned — this is only the first installment of our *Pro* audio earnings coverage. Fool on!

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Quick Links

- Pebblebrook discussion board
- MasterCard discussion board
- GrafTech International discussion board
- Rockwood Holdings discussion board

Transcript

Jeff Fischer: Welcome to a new edition of Motley Fool *Pro* Audio Extra. Joining us today, we have analysts Bryan Hinmon and Alex Pape and senior analyst Nick Crow, and I am advisor Jeff Fischer. We are here to talk about earnings with you today. We have all kinds of *Pro* companies announcing earnings this month. We are covering four today. We will be back next week to cover several more. Let's start with Alex.

Alex Pape: Sure, so I am going to talk about Pebblebrook Hotel Trust and Pebblebrook's third quarter was an interesting one [for] two reasons. First, they bought their first hotel last June, so this is the first quarter we have year-over-year results for any one hotel. And also they didn't close many deals this month, so the results are relatively unclouded by things like legal fees and other closing costs. What we have seen is that they are actually doing a really good job. Up until now, we have sort of been on blind faith that CEO John Bortz is buying hotels at a good deal and pulling expenses out of them, but they have revenue up 10% and expenses only up 5.5%, which means that their margins are expanding even faster than we expected. And their occupancy rates in their hotels are 84%. That compares to a national average of 66%. And keep in mind when they bought these hotels they were all below the national average, so that has all come back up in a very short period of time. This was a great quarter for Pebblebrook.

Jeff Fischer: Alex, how much of your confidence in the company do you attribute to meeting management face to face several times now?

Alex Pape: So I think what I have gotten out of meeting management is I thoroughly believe that they are good at cutting costs. Before I met them, I trust that they could buy hotels cheaply because they have done it before; I could see it on paper. But I went through several of the hotels with them in New York after they closed a deal on six hotels there, and they literally showed us things that they did to reduce costs, ways that they made restaurants run more cheaply. How they changed the bottles of Coke from cans to bottles, because that is cheaper and they actually save about $5,000 a hotel a year doing that. Literally just thousands of small things. Once you see that in person, it boosts the confidence.

Jeff Fischer: Excellent. And this is a REIT, of course, so we expect the yield on it to climb as net income climbs.

Alex Pape: Absolutely, and cash has gone up really quickly, so two quarters ago, they weren't making any cash flow. On this quarter, there was just under $29 million, so it is a pretty fast jump and the dividend should follow that over time.

Jeff Fischer: So Alex, any closing thoughts on what you expect from Pebblebrook the next two to three years?

Alex Pape: So I think that acquisition activity for purchases of new hotels is sort of the unknown; it depends on the deals they see. And the dividend will go up as cash goes up, and it will also go up faster if they close fewer deals, because they have less use for that cash, so it depends on that, but either way, the dividend is going up pretty rapidly over the next two or three years.

Jeff Fischer: Excellent. The stock remains a "buy" in the portfolio right now, so we have a 3% allocation.

Alex Pape: Just over 3%.

Jeff Fischer: So match us right now; good time to buy. Nick, let's go to you.

Nick Crow: Let's talk about MasterCard, and I am going to repeat Alex's theme of expanding margins through operating leverage. That's the story here with MasterCard as well. First revenue is up an exceptional 27%, with costs going up slower at only 23%. It is actually better than that if we took out acquisitions, but that is good enough for us to raise operating income 31%, net income 38% and all the way down to us, the shareholders, with EPS of 43%.

Jeff Fischer: That's outstanding.

Nick Crow: That's the beauty of operating leverage, so the costs going up so slowly compared to revenue, all those earnings and more fall to the bottom line, and they are also buying shares. Bought some last quarter. They have got 800 million left that they can buy, and that's going to further juice earnings per share for us.

But the reason why I brought MasterCard to the table today is it is very interesting. The economy feels really shaky, kind of scary right now out there, but worldwide, at least from MasterCard's perspective, gross dollar volume, the amount processed through their cards, was $844 billion. That is an 18% increase over this time last year.

Bryan: Big time.

Jeff Fischer: And what do they attribute that to?

Nick Crow: Well, I don't think they said specifically, or at least not that I have seen yet. I haven't gone through in full detail, but my guess here is one, people are spending more, but more importantly for our long-term thesis here, they are stealing share away from cash and other payment methods.

Male: The war on cash.

Nick Crow: The war on cash; that's awesome.

Jeff Fischer: Nick, any traction on debit cards? We know Visa has lost their stranglehold on debit cards in the U.S.

Nick Crow: We have seen them pick up a couple of small ... well, not small, large regional banks, but small compared to the big five banks that we tend to look at, so they are winning some there. It's an opportunity, but it's not the most attractive opportunity. Card growth did grow about 8% and transactions grew 20%, so basically we are seeing them execute their business model perfectly and debit cards, just a portion of that.

Jeff Fischer: So right now Fools, MasterCard is a "buy," but it is about 10% above our Buy Around price. However, it's MasterCard. It's 10%. In the next three to five years, that 10% is not going to matter much. That said, the results just came out. We need to go through them fully and we will give updated guidance as soon as we do. But on first glance, as Nick just said, really strong.

Nick Crow: Very strong results.

Jeff Fischer: Bryan, let's go to you. Is your company as good as or better than MasterCard?

Bryan Hinmon: In what capacity?

Jeff Fischer: Cash flow generation. A little bit smaller, but I still love it.

Bryan Hinmon: A little bit smaller.

Jeff Fischer: Long-time portfolio holding, GrafTech.

Bryan Hinmon: It's way more fun to talk about graphite electrodes.

Jeff Fischer: I have several at my house.

Bryan Hinmon: *(Laughing.)* Do you really?

Nick: I am already falling asleep.

Bryan Hinmon: GrafTech, this I can promise our members. GrafTech has way more carbon than MasterCard does.

Jeff Fischer: Good. And carbon is (unclear); it is the foundation of life. *(Laughter.)*

Bryan Hinmon: All right, let's snap to it. So GrafTech's quarter was just fine. The numbers look good, but that's because they are including the three recent acquisitions that the company made over the past year or so, so all the numbers look really good. But the big story here, because the market obviously is forward looking and we are buying a company for what it's going to do, not what it has done. The big story here is what's going to happen with GrafTech's contracts in 2012? One of the reason we like the company is because it signs, traditionally, annual contracts. So it has pretty good revenue visibility, and as long as they manage their costs, they make pretty decent returns.

So the problem is steel makers, GrafTech's customers, people who buy the electrodes, they have no clue what economic activity in the business environment is going to be like for 2012, and so really what they are trying to do is they are trying to push off negotiating with GrafTech for their inputs until they have a better feeling for what 2012 is going to look like. And one of the things we expect for next year with GrafTech is much improved contract pricing. But with the business environment uncertain, we are not sure how much better those contract prices are going to be. We expect them to be better; we just don't know if they are going to be super better or just mediocre better.

Jeff Fischer: Right, and since 2009, 2008 really, GrafTech has had trouble on visibility and therefore on pricing. It did improve towards the end of 2009 into 2010, but now the uncertainty has risen again, same problem again.

Bryan Hinmon: Same problem all over again. Now one of the things GrafTech has done really well in 2011 is they have communicated with their customers very clearly about the rising input costs that are going into graphite electrodes, and they basically have been pounding the table saying, This is unsustainable. We can't keep being the ones who take the hit on profitability. So they have put their message out there over and over and over again, and that gives me a little more confidence that they are going to be able to get some of those price increases to stick.

Jeff Fischer: It speaks to the point management communicates very well with us, with shareholders and with customers, and I have always respected that about them. It's a well-run company.

Bryan Hinmon: It sure is.

Jeff Fischer: They really navigated the last downturn well. If we have another downturn, I know they will navigate that as well, but when the economy finally does recover, whether it is 2012 or beyond, I think we still have a value on our hands. The shares remain a "buy" at around 15 lately.

Bryan Hinmon: Yeah, I think that's true. Even though this is sort of a boring business and many people would look at it and say this is just a commodity player, GrafTech is the low-cost producer. They really run their business well, and over the cycle they are able to earn returns on capital of about 15 or 17%, and so that's nothing to shake a stick at.

Jeff Fischer: So GrafTech is a "buy." You can also sell put options to potentially buy shares lower.

Bryan Hinmon: Yeah, and this is one where we have got a lot of volatility, so a little bit of patience. You can probably build a position at a really good price.

Jeff Fischer: Thank you, Bryan. I will now just touch on Rockwood Holdings, which is another somewhat boring industrial company, but if you look beneath the surface, very interestingly, they are a leading producer of lithium and titanium dioxide, which goes into paint and sunscreen and food coloring, and also ceramics, mainly for cars and medical devices, medical hips being one of those devices.

This is really a management and an asset story as well. Strong management managing strong assets very well to grow the revenue and grow the bottom line as they de-lever, as they pay down debt, and Rockwood, as members know, went through a reorganization the past five years. Sold weak businesses, kept and added to strong ones, and is now a very focused portfolio of products that are all doing really well, except one in construction, which is marginal.

So shares are volatile. They trade at 11 times free cash flow, and as with the other three companies we just talked about, I think in three years there is a good chance they will be significantly higher, assuming the economy at least holds its ground, let alone grows a bit. So Rockwood remains a "buy first" right now at around the mid-forties.

Thank you for joining us for this *Pro* Audio Extra on earnings. We will be back next week with four more companies, and until then, we'll see you on the boards. Fool on!

Strong Earnings Drive Our Results

Published Oct 31, 2011 at 12:00AM

Fellow Fools:

Pro Trade Roundup

Charter Portfolio

- Sold short 500 shares of **SPDR S&P 500** at $128.29 (5% for 20% total).

Portfolio 2011

- Sold short 85 shares of **SPDR S&P 500** at $128.14 (5% for 20% total).
- Sold all 40 shares of **Contango Oil & Gas** at $61.80.

Guidance Changes

- **Tupperware** and **Autodesk** move down to Hold on price.

Since *Pro* first opened its doors to members on Oct. 7, 2008, the S&P 500 has returned 21.6% before dividends. *Pro*'s Charter Portfolio is up 34.5% over the same time, amounting to roughly 10% annualized and surpassing our internal aim for a healthy annualized absolute return every rolling three years. We achieved these results largely by purchasing strong companies at attractive prices, and as we look ahead to our next three years, we believe stock ownership will continue to be the most important part of our returns.

As *Pro* investors, we'll continue to reach beyond stocks to use options, short or hedge, and invest in — or against — newfangled ETFs and ETNs. But we want to put most of our capital in companies we believe will deliver healthy returns with reasonable risk even in the face of macroeconomic challenges (over-levered governments, an aging population, cash-strapped consumers). Nobody can predict the macroeconomic situation consistently, especially these days, so most of our energy needs to be focused on finding great businesses that should grow value even in a tepid economy.

Like Snickers, Earnings Season Really Satisfies

Every three months, earnings season gives us new insights into the companies where most of our cash is invested. So far this quarter, all of our companies are continuing to produce more value for shareholders, report on it in a transparent way, and invest for additional value creation. We couldn't ask for much more. Let's run through the recent results from five *Pro* holdings.

BMC Software

BMC Software is down 19% since we bought it just more than a month ago. First came rumors about the departure of some senior sales representatives, then came results that proved the rumors. Although second-quarter revenue grew 11% and operating cash flow was up 27%, new license bookings for BMC's largest software division declined 13% compared to last year. Management now conservatively guides for "low single-digit" revenue shrinkage in its enterprise service management license bookings this fiscal year, compared to previous guidance of "low double-digit" growth. What happened?

The short answer is sales-force attrition: Management says it lost too many tenured salespeople, leaving too few in the field to capitalize on growth opportunities. Management does not believe BMC is losing market share and continues to believe it has optimal products that are in high demand; to that end, the company is rapidly investing in hiring and training new salespeople, hoping that within several quarters, enterprise service sales will start to improve. Encouragingly, all other divisions — including cloud, software-as-a-service, and mainframe service management — are clipping along, with new bookings in the latter up 25%. And non-GAAP operating income grew 13% in the quarter as recurring maintenance contracts lend a strong foundation to the business.

At its recent price of $34, BMC Software trades at only 6.8 times its $875 million in free cash flow. And cash flow remains strong — in fact, management expects record cash from operations this year, adding to the company's large cash balance. Since BMC has identified its sales staff attrition problems and is focused on correcting them, the stock remains a Buy; after reviewing the SEC filings, we may bump it up to Buy First and pick up a few more shares. We'll let you know.

Covanta

Covanta serves the tail end of the consumer market, making money off everything that's thrown away after use. By burning trash and selling the steam as energy, Covanta produced another solid quarter, with revenue up 7% and free cash flow jumping 12% over last year. The company is priced at a cheap 8.3 times free cash flow, and its new dividend yields 2.1%. It remains a Buy First with a fair value up to 50% higher than its current $15 stock price. As with all investing, patience is our watchword here; Covanta is building new facilities, and energy prices may tick higher next year.

Intel

Intel's earnings report featured the highest quarterly revenue, the highest earnings per share, and the most microprocessor shipments in the company's history. We've long argued that Intel skeptics who point to its lack of mobile presence are missing the big picture. Intel dominates the lucrative business enterprise market, and demand for more computing power is growing among corporations around the world. Intel is also a leader in the PC market, which is rapidly expanding in new markets (China is now the world's largest PC market, and Brazil is third). And it's making moves in mobile, too, now that the mobile space represents a profit opportunity worth pursuing on Intel's massive scale. The company expects the first several smartphones with Intel chips to ship in early 2012.

Wrap your head around these numbers: Intel has hired 17,000 people so far this year and expects annual revenue to jump 26% to nearly $55 billion. The company is a driving force behind Ultrabooks (ultra-thin, instant-on laptops), and next year, it expects those devices to begin to replace notebook computers and offer an alternative to tablets. With a 3.3% dividend yield and a stock trading at just 10 times expected 2011 earnings, Intel remains a value even as a Hold on our scorecard. *Pro* members were ideally able to purchase shares when it was a Buy First; as results continue to top even our expectations, we may bump up our $25 fair-value estimate soon. We'll keep you posted.

Rockwood Holdings

Rockwood Holdings is hitting it out of the ballpark this year (a tip of the hat to St. Louis Cardinals fans!), with earnings per share more than doubling. Its lithium business for batteries, its surface treatment business for automotive and industrial use, and its ceramic division for the medical industry are all growing and enjoying pricing power. Total sales increased 17.4% in the third quarter to $941 million, and the company continues to invest in new plants for the future. We expect more long-term profit down the road, but this Buy First stock is sure to remain volatile. Consider selling to open puts at lower strike prices if you want to add to your position.

Tupperware

Tupperware continues to amaze with 68% third-quarter sales growth in India, 22% growth in China, 74% in Brazil, 20% in Singapore … and a 6% sales gain for its Tupperware division in mature North America. Tupperware's direct sales technique is ideal in emerging markets, where more women are beginning to work, families are starting to store food, and prices need to be reasonable. Overall, Tupperware grew sales 10% in the quarter. Shares have popped since we moved the company to Buy last month, so now we're moving it back to Hold on valuation. If you don't yet own your fill, sit tight for now.

It's Not Over

We have more earnings coverage linked below, and we'll have even more in next week's Memo and throughout the week on our discussion boards. Stay invested, stay happy, stay Foolish!

Jeff Fischer (TMFFischer)

Jeff owns shares of Intel, Tupperware, Autodesk, Rockwood, and BMC Software.

Coverage & Community

- Alex (TMFPapester) shares his thoughts on a great quarter for **Pebblebrook Hotel Trust**.
- Nick (TMFCrow) posts a summary of results from **L-3 Communications**.
- CorporalKing offers a great look back on three years of *Pro* membership and investing lessons he has learned.
- Alex reminds members who are hedging to think long-term and focus on total portfolio returns, not single positions.
- Got some time? Fools discuss **iPath S&P 500 Short-Term Futures**.

Making Volatility Pay, Part 2

Published Oct 24, 2011 at 12:00AM

"I love to think longer-term. The near term is over-analyzed, and I'm utterly bored with it … I like to go out two, three, five years ahead and make those bold calls." — Heidi Wood, Morgan Stanley analyst

VXX or No VXX …

Our recent experience with the VXX ETN has some important takeaways for all *Pro* members:

- **Don't over-allocate.** All of us may pay a price when some members don't follow the game plan. Do not over-allocate.
- **Stay in the position.** You need to be ready to ride through bad situations as long as your thesis holds and you haven't over-allocated.

There are takeaways for the *Pro* team, too:

- **Have patience.** Had I not been so keen to set up a new VXX trade on the first spike in the VIX, we might have shorted at better prices.
- **Black swans happen often.** Often, we don't see history while it's happening. With this position, we were in the wrong place at the wrong tumultuous time.

Fellow Fools:

The refreshing quote above mirrors something I heard Fool co-founder David Gardner say at a recent investing conference. To paraphrase: For investors, a long-term perspective is a key advantage in a short-term world. While others are frantically selling and buying, creating volatility, we can zero in on big-picture opportunities others either miss entirely or actually contribute to by thinking short-term.

When you invest for the long haul, you're much more likely to make a profit. To put it another way, a portfolio is most vulnerable to losses when it's being managed for the short term. This is true even when using options (because all options *strategies* should be thought of in a long-term context, even if an individual option has a shorter-term expiration), ETFs, and exchange-traded notes (ETNs) like the **iPath S&P 500 Short-Term VIX Futures**, the subject of today's Memo.

Shorting Volatility Is a Long-Term Endeavor

In last week's Memo, I shared some of our history with VXX. Our recent loss on the position was unexpected and surprising, and we're determined to learn from it. We're analyzing what went wrong, how we can prevent it from happening again, and what we can do to help ensure profits on the position over the long term.

The first answer is the easiest: We suffered a loss on VXX because we closed the position while it was working strongly against us. We did so for three reasons:

1. We were informed that our broker wouldn't let us stay short the shares after our calls were exercised.
2. We learned that many members were in the same situation and some had over-allocated.
3. Given a remarkable, rapidly changing investment landscape, we wanted some time to analyze our next strategy; given Europe's woes, we assumed volatility would not fall suddenly in the meantime.

We still believe in the thesis behind our VXX position, and not being able to easily stay in the trade has cost us in the short term. Before we get back into the position, we want to make sure all of us have staying power in it.

Too Much Exposure

Many members were over-allocated to the VXX position. Even at its worst, this short was only about 130% against us (and that was only for one day), so it should *not* have caused the liquidity troubles we saw from some members on the boards. But it did — and that, dear Fools, had an influence on what I decided to do this time. I don't plan for that to happen again.

If I were running a flight school and heard some students were taking unsafe risks in the air, I would feel obligated to ground the whole fleet until we could once again ensure safety. Being responsible for our member base means this is our obligation. Far too many members risked too much on VXX, and seeing the outcome for some of those members has been the worst part of my 15-year investing career.

The *Pro* portfolio had liquidity to spare, but some members were getting damaging margin calls, and we couldn't let that continue. We told members who had no liquidity issues that they could stick with the trade if they had ample means, but we hit the pause button for everyone else.

There were other key factors as well, of course. The VIX, the "fear index" VXX exists to track, was in a state of steep backwardation (which helps VXX retain or even grow value) instead of the much more common contango (which aids VXX's decline). And the highly unusual economic troubles in Europe were (and are) keeping markets on edge, making it unlikely that volatility will subside and contango return in the very near future.

Over the long term, though, our short thesis on VXX remains as strong as it has ever been, and we have every intention of getting back into this position. When we do, we want a sustainable position and strategy, and we don't want anyone to over-allocate.

A Bit More History

For perspective on why we're confident in this thesis over the long term, consider our history with VXX. Since we first recommended shorting it in June 2010, it has declined about 60%.

After we issued our first short recommendation, our broker informed us it lacked shares to short. So we issued a new alert, using options to establish an alternate position. Only short-term options on VXX existed at the time, and put options on this ETN are always expensive, so we focused on writing naked calls to collect premium. Whenever the underlying VIX spiked (and we knew it would sometimes), we planned to roll the calls up and keep waiting. Here's how that played out:

Date	Recommendation	Allocation	VXX Start Price	Outcome
June 16, 2010	Short VXX	3%	$105	Unable to short shares
July 15, 2010	Write Naked Calls Instead	3%	$103	Closed the calls once we earned most the profit
Dec. 1, 2010	Write New Naked Calls	6%	$47	Expired for the full profit
Jan. 21, 2011	Write New Naked Calls	6%	$32	Expired for the full profit
Feb. 25, 2011	Write New Naked Calls	6%	$32	Rolled these calls after Japan's Tsunami
Mar. 17, 2011	Roll Naked Calls	6%	$36	Expired for the full profit
July 19, 2011	Write New Naked Calls	7.5%	$23	Closed early at a loss

If we'd been able to short the shares directly — as we initially intended — and had stayed in the trade ever since, we wouldn't have a loss, or a problem, today. Lesson No. 1: Your broker matters a great deal. The naked calls we wrote instead earned us comparatively small gains, and as the ETN declined, we increased our allocation due to lower pricing.

Remember that shorting VXX isn't like shorting a normal stock, where the lower the price, the riskier it may be to short it. When we issued our first short recommendation on VXX in 2010, the underlying VIX was at 26. Today it's 31, suggesting VXX should be up — but the ETN has actually declined from $105 to a recent $42. As long as contango is in place (and it is the majority of the time), VXX loses value as time passes. Shorting this ETN at lower and lower prices does not mean you're taking on more risk as long as the VIX itself has actually held its ground or gone up.

Big Lessons

I see takeaways here for members and the *Pro* team alike. For members:

- **Don't over-allocate.** A lot of unusual events converged on our last VXX position, but what really made it fail was over-allocation. The *Pro* portfolio wasn't in danger, but many members took larger positions than we did, and some had simultaneously written puts on many stocks as well. This left them no liquidity, and thus no breathing room, when the market declined. All of us may pay a price when some members don't follow the game plan. Do not over-allocate.
- **Stay in the position.** Again, you suffer losses when you can't stay in a position when times are bleak. You need to be ready to ride through bad situations as long as your thesis holds; this is much easier if you haven't over-allocated.

And for the team:

- **Have patience.** I watched VXX fall all summer while we remained without a position on it, and I was keen to set up our next position the first time the VIX spiked. That first spike turned out to be small, and had I been more patient, we might have shorted at better prices.
- **Black swans happen often.** Often, we don't realize history while it's happening. We entered our most recent position on VXX soon before the U.S. credit rating was downgraded for the first time. We were in the wrong place at the wrong tumultuous time, and we weren't able to easily wait it out as a group. That last part is key: We need to be able to wait out the hard times any investment can face.

New Trade in the Future

We plan to short VXX again using options.Our thesis hasn't changed: Over the long run, market volatility can only be sustained for so long. Eventually, it will revert to its mean around 20, VIX futures prices will go back into contango for months at a time, and VXX will drift lower and lower.

When we establish a new position, follow our allocation recommendations. Realize that allocation is a big part of our defensive strategy. The VIX will go down to its average, but it will spike periodically. There is no question about that. So we need to be able to wait out those times. It's that simple. Don't over-allocate.

Shorting volatility is a long-term endeavor, just like owning our great stocks is. No oversized bets, Fools. Slow and steady wins the race. Let's think long-term in all things. You may be glad to know that the next time I write about VXX will be in a trade alert; after that, I plan not to write about it for months as we let time do its thing.

Jeff is short shares of iPath S&P 500 VIX Short-Term Futures.

Pro Trade Roundup

Charter Portfolio

- **StoneMor Partners (**Nasdaq: STON): Bought 300 shares (for 3% total) at a net $28.90.
- **iShares MSCI Spain Index** : Bought to close October $34 calls for $1.20.
- **iPath S&P 500 VIX Short-Term Futures** : Closed October $51/$56 bull call spread for a $0.16 credit.
- **Papa John's Pizza** : Bought to close October $32 calls for $1.90.
- **Contango Oil & Gas** : Sold to open November $55 calls for $6 each.

Portfolio 2011

- **StoneMor Partners (**Nasdaq: STON): Bought 100 shares (for 3% total) at a net $28.90.
- **iShares MSCI Spain Index** : Bought to close October $34 calls for $1.20.
- **iPath S&P 500 VIX Short-Term Futures** : Closed October $51/$56 bull call spread for a $0.16 credit.

Coverage & Community

- Another reminder: Check out (and contribute to!) our new internal Wiki pages and share your suggestions on our related Wiki board (and thank Ellen (TMFKabellen) for setting this up!).
- Billjohn4 is in love with strangles!
- Alex340 posts puts that match*Pro* critera.
- TMFMoosie shares the weekly calendar.

2011 and Charter Portfolios: Close Half of Your Ratio Put Spread on Wells Fargo

Published Oct 20, 2011 at 12:00AM

What's a Conditional Trade Alert? Our options position on Wells Fargo expires tomorrow, Oct. 21. This alert outlines the different actions we recommend depending on where the stock price settles at that time.

Trade Essentials

- **Actions:** If you followed our last recommendation on **Wells Fargo** (NYSE: WFC), you now have a ratio put spread on the company: October 2011 $25 puts and October 2011 $23 puts. Both of those positions are set to expire Oct. 21.
  - See "How to Follow Along" below for detailed guidance.
- **When:** If shares are below $25, take the appropriate action (outlined below) by the end of the day on Oct. 21 at the latest.
- **Limit Price:** Initially, set your limit order at the intrinsic value of the option (strike price minus stock price) or better.
- **Why Close?**
  - Our ratio put spread expires Oct. 21.

What's Changed?

The macroeconomic environment has worsened considerably since we established our ratio put spread hedge on Wells Fargo in June. But the bank's recent quarter looked strong; despite Europe's troubles, the debt-ceiling debacle in the U.S., and the downgrades of several major countries' debt, Wells Fargo shares are trading right about where they were when we initiated this position. This was a great hedge — we were paid up front to set it up, it provided us protection during a rocky period, and it was ultimately unnecessary. It doesn't get much better than that.

With the share price hovering just above our $25 strike price, we're issuing a conditional alert. Read the next section carefully for instructions.

How to Follow Along

- If shares of Wells Fargo are higher than $25 on Friday, Oct. 21, do nothing. Let this position expire and know you made a little money on it and enjoyed increased peace of mind.
- If shares are between $23 and $25 on Friday, "sell to close" the $25 puts for at least their intrinsic value (intrinsic value here is the option strike price minus the stock price). With shares in this range, our hedge will have kicked into gear; we'll profit most if the price is at exactly $23.
- Whatever the stock price, leave the $23 written puts alone; we expect those to expire worthless, meaning we'll earn our full cash profit on them.
- If shares are knocked below $23 on Friday (the least likely outcome, but we're including it so you're prepared), do the following:
    - "Sell to close" the $25 puts and "buy to close" half of the $23 puts. Aim for a $2 credit to close this part of the spread.
    - Let the other half of the $23 puts expire.
    - Be ready to accept shares of Wells Fargo at a great price.

Head to the Wells Fargo discussion board with questions.

Nick owns shares of Wells Fargo.

Charter Portfolio: Close Your Short Calls on Papa John's Pizza

Published Oct 20, 2011 at 12:00AM

What's a Conditional Trade Alert? Our options position on Papa John's Pizza expires tomorrow, Oct. 21. This alert outlines the different actions we recommend depending on where the stock price settles at that time.

Trade Essentials

- **Actions:** If you followed our last recommendation on **Papa John's Pizza** (NASDAQ: PZZA), you now have a short covered strangle on the company: October 2011 $30 puts and October 2011 $32 covered calls. Both of those positions are set to expire Oct. 21.
    - If Papa John's stock price is above $32 at expiration, "buy to close" the October 2011 $32 calls.
    - Do nothing with your October 2011 $30 written puts.
- **When:** Close by the end of the day on Oct. 21 at the latest.
- **Limit Price:** The spread on these options is wide, so **please use a limit order**. With expiration near, pay little more than the intrinsic value. So, if the stock price is $32.30, look to pay little more than $0.30.
- **Why Close?**
    - Our covered strangle expires Oct. 21.
    - If shares are higher than $32 at expiration, they'll be called away.

What's Changed?

The Joy of Strangles

As we wrote in "Options 703: Strangles": "You write ('sell to open') a covered strangle to profit when a stock stays within a wide price range — or, if it doesn't, to get a better buy price on new shares or a higher sell price on existing shares." Our covered strangle on Papa John's was intended to generate income, and given the steady nature of pizza sales, we tried to maximize our income by writing a tight strangle (with strike prices close to one another).

A tight strangle pays better than a looser one, but it presents its own challenges during volatile times. As expiration nears, it can be tough to know whether maintenance will be needed on either side of the position, or if we can just let it expire and enjoy the profits. Our covered strangle on **Papa John's** (NASDAQ: PZZA) is particularly tight, with just $2 separating the puts and calls — and the company's share price has easily danced below $30 and above $32 this month.

Ideally, Papa John's shares would finish this week at $31.99, maximizing the profitability of our position and requiring no further effort on our part (we could just let the strangle expire and collect our profits). Unfortunately, we have no way of knowing what the stock will actually do. Right now, shares are trading higher than the $32 strike price of our written calls, so we're issuing this conditional trade alert:

- If shares remain higher than $32 as Friday's close nears, we'll need to close our written calls to keep our shares and potentially set up more income-producing options strategies on them in the future.
- If shares are less than $32 at Friday's close, we can leave our written calls alone and let them expire worthless.

How to Follow Along

- If shares are higher than $32 near market close tomorrow (Friday, Oct. 21), "buy to close" your written October 2011 $32 calls.
- If shares are less than $32 near market close tomorrow, sit back, relax, and order a pizza from Papa — the written calls will expire worthless.
- In either case, leave your written puts alone. We expect those to expire worthless, earning us our full cash profit on that half of the position.

Shares of Papa John's are currently trading at about $32.35, and the October $32 calls ask $1.55, so they're carrying about $1.20 in time value (the other $0.35 is intrinsic value, Fool). That is a lot of time value; we'd rather pay much less, so make sure to use a limit order. Keep in mind, though, that if your limit order is too aggressive and doesn't fill, your shares will be called away from you, so don't just set it and forget it.

Papa John's reports earnings on Nov. 1; we'll wait for those results before deciding whether to renew our income-producing strangle strategy. Please bring any questions to our Papa John's discussion board.

Making Volatility Pay, Part 1

Published Oct 17, 2011 at 12:00AM

Although *Pro* invests using time-tested strategies, our approach has always pushed boundaries at The Motley Fool. When we launched in October 2008, we became the first Foolish service to invest using options, exchange-traded funds (ETFs), and exchange-traded notes (ETNs). The Fool had invested only in stocks for almost 15 years, but with *Pro*, it was time to add more tools to the toolshed. At the time, the investing industry was going through a renaissance of sorts, with new ETF and ETN products issued weekly. Some of these were better than others, and among the more flawed offerings were a few ETNs based on the market's most popular volatility index, the VIX.

Pro Trade Roundup

Charter Portfolio

- **10/13:** Set up a protective collar on **AmTrust Financial Services**, writing 39 March 2012 $25 calls and buying 39 March 2012 $20 puts, for a net debit of $0.15.

The **iPath S&P 500 VIX Short-Term Futures** ETN, launched in January 2009, was one of these. In fact, it was the first of its kind, and it remains the largest volatility-tracking exchange-traded vehicle today (as measured by assets). The VXX ETN tends to move inversely to the market because it mirrors the short-term futures contracts on the VIX, also known as the "fear gauge." The VIX uses a proprietary Chicago Board Options Exchange calculation to track the price people are willing to pay for market insurance in the form of put (in relation to call) options on the S&P 500. Higher put prices mean more fear in the market, so a high VIX means fearful investors. On the flipside, when the market is calm, put prices decline, and so does the VIX. Thus, shorting VIX-based vehicles like the VXX ETN is a thesis that market fear will diminish or stay muted — a position that makes sense if you're even mildly bullish or neutral.

The Ideal Short?

Shorting a stock is notoriously risky. The company you short could be bought out at a high premium. Its earnings could exceed your expectations. Shares could soar on speculation. In fact, if civilization is working as it should, the whole market is working against your short: Stock prices are *meant* to go higher as society advances and market valuations grow, so shorting any individual stock may mean swimming against the larger tide.

Shorting a volatility index, on the other hand, offers none of the above risks. The VIX can't be acquired. The index can't report blowout (or any) earnings. And while volatility, and thus the VIX, may soar on sudden market fears (as we've seen over the past two months), we can be confident those fears will eventually subside and the VIX will go back down.

We know this from market history, and heck, we know it from science. Human beings will only tolerate so much fear before they're compelled to act on it by making whatever changes they can. (In the case of the VIX, that would mean selling stocks or buying puts — in other words, capitulating to their emotions.) Fear can build and build as waves of investors give in to it, but eventually it hits a peak.

That doesn't mean it has to peak when you or I or anyone else expects it to, however; people have varying tolerance levels for fear, and new concerns can sometimes pile on top of old. Thus, anyone shorting volatility (in the form of VXX or anything else) needs to be ready to ride out a long-term spike in it. From its long-term average level of 20, where the VIX was sitting around the beginning of 2008, the VIX soared all the way to 80 in October of that year, and it didn't return to 20 again until 15 months later, in December 2009. This August, the VIX hit 48, and while it has declined lately, it's currently hovering around 30 — still well above its average.

Over the long term, if you can wait out a spike in the VIX, eventually you're very likely to make money shorting the VXX ETN. This is especially true because there is one additional factor working in your favor: the pricing of the futures contracts that VXX mirrors.

A Steady Pricing Drag

For this example, let's say the VIX is at 25 and the futures contracts on the VIX that expire in the next two months are at $26.25 and $27.50, respectively. The VXX ETN tracks a rolling collection of these futures contracts; every day, it assumes the exit of some of the current month's contracts and the entrance of some of the next month's, so its collection of tracked contracts always expire in an average of one month. When the price of next month's contracts is higher than the current month's (as is usually the case), the ETN experiences a resulting drag on value, called contango. Contango has depleted the VXX ETN's price by an average of 3% per month since its creation, a very substantial drag that equates to gains only for those shorting it.

Since we first suggested shorting the VXX ETN on June 16, 2010, it has declined from $105 per share to a recent $42 — a drop of 60%. Since inception in January 2009, VXX has lost 90% of its value, and this decline can continue theoretically indefinitely. That's because when VXX's share price gets low enough (into the teens), Barclay's (the issuer) is ready to conduct a reverse split, combining shares so that the price of a single share returns to a much higher price. (The total value for shareholders, and the return to date, doesn't change at all.) The long-term descent in the share price will then continue as long as the VIX is steady and contango remains in place on its futures contracts.

Coming Up Next

So if this ETN is down 60% since we first recommended shorting it and we're confident in our thesis about it, how did the position recently turn into the largest loss *Pro* has ever experienced? I'll continue the saga by explaining that outcome, and how we're going to recover from it, in next week's Monday Memo.

Until then, remember that the VXX ETN is only one of more than two dozen positions in the *Pro* portfolio. While VXX has dealt those of us using it a short-term setback, the portfolio as a whole remains positioned to prosper over the coming months and years. Because the VXX ETN is likely to continue to lose value over months and years, shorting it will likely be a steady part of our portfolio's balanced mix. First, though, we'll use next week's Memo to look at what went wrong last time so we can move forward in a positive way.

As always, visit the Memo Musings board if you wish to discuss the Memo. Fool on!

Jeff Fischer (TMFFischer)

Jeff is short shares of iPath S&P 500 VIX Short-Term Futures.

Upcoming Earnings

- **Oct. 17: Wells Fargo**
- **Oct. 18: Intel**
- **Oct. 19: Covanta , Rockwood Holdings**
- **Oct. 24: Plum Creek Timber**

This Week's Expirations

Charter Portfolio

- **Papa John's** (Nasdaq: PZZA): If shares continue to trade between the strike prices of our strangle, it'll expire for the full income, and we'll look to write another. If share prices move too much, we'll consider rolling the strangle before Friday.
- **Wells Fargo** (NYSE: WFC): The stock is between the strike prices on our ratio put spread. After we've digested this morning's earnings, we'll let you know (via a trade alert, if action is warranted) what we're going to do. Nothing too pressing, but stay tuned.
- **StoneMor Partners** (Nasdaq: STON): Our written puts will be exercised and we'll be assigned shares per our original plan. This puts more of our equity into this high-yield position.

Portfolio 2011

- **Wells Fargo**: Same as Charter Portfolio.
- **StoneMor Partners:** Same as Charter Portfolio.

Coverage & Community

- Check out (and contribute to!) our new internal wiki pages and share your suggestions on our related wiki board.
- MazonCreekRich lies when he describes this as "Kind of a Boring Post."
- Community and team members continue the discussion on volatility trades.
- Alex walks us through his valuation of **Contango Oil & Gas**.

Charter and Portfolio 2011: Contango Oil & Gas

Published Oct 13, 2011 at 12:00AM

Attention, *Pro* Fool: Contango is a thinly traded stock with thinly traded options. You **must use a limit order** when placing your trade! If you are unsure how to do so, please head to our Member Suggestions & Help discussion board.

Trade Essentials

- **Action**: Write ("sell to open") November 2011 $55 covered calls on all 100-block shares of Contango you own, one call for every 100 shares owned.
  - If you own fewer than 100 shares (or own an odd-lot number of shares), **use a limit order** to sell all shares you own on which you cannot write calls.
- **Recent Stock Price Range:** $53 to $60
- **Recent Options Prices:** November 2011 $55 calls bid/ask: $5.70/$6.90
- **Limit Guidance:**
  - Calls: **Use a limit order**, aiming for $6 or more
  - Stock: If you are selling shares directly, **use a limit order** only at the current price
- **Why Sell?**
  - We want to write covered calls to secure a sell price as close to $60 or higher as possible; alternatively, you can just sell your shares today for a bit less than that
  - Lower natural gas prices are making it hard to justify Contango's stock price
  - This is a tiny position in both portfolios, and selling will help us focus on higher-conviction investments
- **Alternative Trade:** If you cannot get the recommended $6 or more for the November $55 calls, consider writing ("selling to open") January 2012 $55 calls.

What's Changed

Our admiration for natural-gas exploration and development company **Contango Oil & Gas** (NYSEMKT: MCF) hasn't waned one iota since we purchased the stock. Led by CEO Kenneth Peak, this company continues to shun anything that doesn't create immediate value, such as employees (it has just eight), debt (it has none), and share dilution (the company is actually *negative* dilutive, meaning its share count has shrunk over time). What has changed is our opinion of the company's valuation: We no longer think it's cheap.

The value of Contango's business hinges on two main factors:

1. Natural gas prices
2. The success of the company's drilling program

Let's tackle the latter first. It costs Contango between $15 million and $25 million to drill an exploratory well. Most companies drilling the same kinds of wells in the same areas as Contango find natural gas about 25% of the time. Contango is above average at what it does, so it may actually achieve a marginally higher hit rate than that. But the company is tiny compared to many of its peers. Its small stature means it can only afford to drill about four or five wells per year, and it puts all of its focus — and money — into that drilling. This means that if Contango does hit pay dirt, it's a huge deal for the company — but there's also a very real chance that Contango could exhaust most or all of its capital very quickly and be left with just a bunch of empty holes in the ground.

Contango's value exists within a range. If the company's drilling is successful, its worth is near the upper end of that range; if not, it ebbs toward the lower end. Unfortunately, today's price is closer to the upper end, which means the market is already expecting Contango to drill some successful wells. And Contango's current share price is more difficult to justify given today's lower natural gas prices, no matter how successful its drilling might be. If that drilling is unsuccessful or natural gas prices stay this low (let alone continue to drift lower on the argument that newfound shale gas continues to be plentiful), Contango's stock has too much downside risk to make the risk-to-reward scenario attractive enough compared to other positions we own or are considering.

Contango makes up just 0.9% of the Charter Portfolio and 1.1% of Portfolio 2011. These are tiny positions from a portfolio-management perspective, but we would be uncomfortable adding to them at today's prices (which is our bogey for any small position as we focus the portfolio: build the small position to 3% to 5%, or eliminate it).

We want to write covered calls to secure a sell price as close to $60 or higher as possible; alternatively, you can just sell your shares today for a bit less than that.

How to Follow Along

Contango's options and shares are very illiquid, so it **is imperative that you use a limit order when you place your order, or the price will decline rapidly**. *Pro* will follow suit by writing covered calls within 30 days of this trade alert. If you have any questions, please head to our Contango discussion board.

The Motley Fool owns shares of Contango.

Making Pro Fit You

Published Oct 13, 2011 at 12:00AM

Update: Fellow Fools, you can find an updated version of the "Making *Pro* Fit You" report here — for maximum usefulness and enjoyment, please use that version!

Dear Fellow Fool,

We manage the *Pro* portfolio using a wide range of tools — including long and short stock, option, and ETF strategies — to earn absolute returns with low volatility. But we know no two members have identical investment situations, and that means not all members will have access to every portfolio strategy. That's where this report comes in. Its purpose is to help you find the best way to use *Pro* according to your individual situation.

We'll address four possible scenarios in detail. You may find that more than one applies to you:

- **Free-Range:** For members with free range to employ all the same tools as *Pro*.
- **IRA:** For members building a portfolio in an IRA account.
- **No Complex Options:** For members who lack broker permission to execute complex options strategies.
- **Old Fool, New to *Pro* / Fully Invested:** For members joining *Pro* from another Fool service or members who are already fully invested.

Whatever your situation, we recommend all members first read the "Free-Range" section. Bring any questions to our discussion boards, and Fool on!

Alex Pape (TMFPapester)

Free-Range

So you're new to Pro *and able to follow every* Pro *portfolio move to a T? Here's what to do. (Again, we recommend you read this section even if you are not entirely "free-range.")*

As You Get Up to Speed
Match our portfolio positions and allocations, starting with the Buy First and Buy positions — and do so gradually. Build these positions over the course of a couple of months. If you're comfortable with options, you can consider writing puts to try to buy some of our Buy stocks cheaper. Post on the discussion boards to get the community's feedback about any trades before you make them, if you like. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Once You've Settled In
Once you've built your Buy First and Buy positions, all you need to do is wait for further trade alerts from the team. Remember, though, that trade alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want. You may decide to modify the strategy we choose for a trade; for example, you may wish to write puts instead of buying a stock outright. If you choose to deviate from our recommendation, make sure you (a) understand why we chose the strategy we did and (b) have a reason that the modified strategy better fits your portfolio.

Your *Pro* Perspective
The most important thing to remember is that *Pro* is a portfolio service, not a collection of investment ideas. All of our positions exist in the context of our portfolio; if you elect to pick and choose *Pro* investments, it is critical that you understand how they fit into your portfolio. Our trades are intended to integrate with existing positions.

IRA

IRAs are tax-deferred accounts that usually prohibit shorting and all but the simplest of options strategies.

As You Get Up to Speed
Gradually move into our Buy First and Buy stocks, building your positions over several months. Most IRAs don't allow put writing, so you should simply purchase shares of these positions over time. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Once You've Settled In
You can follow our simple stock-buying trade alerts directly. Most IRAs allow you to write covered calls, so you can also follow those trade alerts directly. Other options trades may not be possible in an IRA. In that case, check the trade alert for a list of alternate trades; for example, when we write puts to try to buy shares of Stock X more cheaply, you might be able to simply buy shares of Stock X. (If there are no alternate trades, we'll say so.) As for shorting, some inverse ETFs can be purchased in IRAs (purchasing an inverse of something is similar to shorting that thing). As with options, we'll mention these alternatives in the trade alerts if they exist and we approve of them.

Your *Pro* Perspective
IRAs are tax-deferred accounts, so they're great for income-generating strategies like covered calls, high-yield dividend stocks, and ETFs with large taxable distributions. They do have limitations, though, and you may find that the inability to follow all of our recommendations leaves a hole in your portfolio. If that's the case, you may be able to fill the gap with additional income-generating strategies — for example, by writing covered calls on *Pro* stocks you'd be willing to sell at your strike price.

However, their tax-deferred status means that IRAs are not great for high-risk, high-reward trades — losses in an IRA cannot be used to reduce the taxes on other gains. And because IRAs do not allow the use of margin or shorting, you will likely find it difficult to follow along with most of our hedging strategies using only an IRA account. If that's the case for you, we recommend keeping an eye on both your cash balance and *Pro*'s hedging strategies. When the *Pro* portfolio adds hedges, increase your cash balance; when we pull hedges off, reduce your cash balance by investing more in our Buy and Buy First Stocks. Consider opening a separate non-IRA account if possible. You can then manage both your IRA and non-IRA accounts as a single portfolio, with income-focused and shorter-term strategies in the IRA and more complex, speculative, and short trades in the second account.

No Complex Options

You need permission from your broker to undertake complex options strategies, which not all members have upon joining. Here's what to do in the meantime.

As You Get Up to Speed
Follow along with our "Free-Range" instructions for getting up to speed — match our portfolio positions and allocations, starting with the Buy First and Buy positions. Make sure you do so gradually; build these positions over the course of a couple of months. If you're comfortable with options, you can consider writing puts to try to buy some of our Buy stocks cheaper. Post on the discussion boards to get the community's feedback about any trades before you make them, if you like. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Once You've Settled In
You can follow most of our trade alerts directly — except, obviously, those involving complex options strategies. In those cases, there's often a simpler alternative, such as writing puts, writing covered calls, or buying or shorting a stock or ETF directly. We outline possible alternatives in every trade alert. If we issue a trade alert using an income-generating strategy you're unable to employ and there are no workable alternatives, consider using the strategies you do have at your disposal to generate income elsewhere in your portfolio.

Your *Pro* Perspective
First of all, you should continue to request higher options permissions from your broker every couple of months until they are granted. Account size is one factor brokers consider when making this decision, so to up your odds of success, consider consolidating accounts or moving funds to the account in which you wish to trade options.

In the meantime, don't lose sight of the big picture; remember that we're building a portfolio. If you can't make a particular options trade, you may be able to make an alternate trade or you may need to sit that trade out — either way, it's no big deal. That said, you'll want to pay particular attention to any trade alert in which we use options for hedging purposes (for example, a synthetic short or a ratio put spread on an ETF or an index). Trades like these are important to our integrated portfolio, so don't ignore them. If alternatives are available, we'll outline them. If not, you may want to take action elsewhere in your portfolio to meet similar goals. As always, hit the discussion boards with questions about any particular situation.

Old Fool, New to *Pro* / Fully Invested

Members joining Pro *from another Fool service and those who are already fully invested will need to consider changes to both their portfolios and their mindsets.*

As You Get Up to Speed
If you're already fully invested, you'll need to sell existing positions to add *Pro* picks. We recommend that you do this gradually and deliberately.

- List your existing positions in order from your highest-conviction holding to your lowest-conviction holding.
- If you own stocks from another Fool service, you can use that service's guidance on those stocks in building your list.
- If you don't know why you own a stock, that's a good reason to sell it.
- Be mindful of your sector and geographic allocations. You don't want to unintentionally end up owning nothing but oil or European stocks just because they were your favorites.
- If you're struggling with what to sell, post to the discussion boards — the *Pro* team can't give you individual advice, but our community members can and frequently do.
- When you're ready, incrementally sell your lowest-conviction stocks and use the proceeds to move into our Buy First and Buy stocks. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Once You've Settled In
Follow the "Free-Range" instructions for this step — once you've built your Buy First and Buy positions, all you need to do is wait for further trade alerts from the team. Remember, though, that trade alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — one gradual step toward shaping the portfolio we want. You may decide to modify the strategy we choose for a trade; for example, you may wish to write puts instead of buying a stock outright. If you choose to deviate from our recommendation, make sure you (a) understand why we chose the strategy we did and (b) have a reason that the modified strategy better fits your portfolio.

Your *Pro* Perspective
If you're joining us from another Fool service, it is critical that you understand the differences between *Pro* and some other Fool services. At *Pro*, we are building a portfolio, not offering investment ideas. *Stock Advisor* and *Rule Breakers*, for example, offer stock ideas from which members can pick and choose. In contrast, *Pro*'s trades are intended to be integrated building blocks of an overall portfolio. We cannot emphasize this enough: Anytime you decide to deviate from the *Pro* portfolio, make sure you understand how the trade in question is intended to fit with our portfolio — and how the modified trade will fit with yours. With every trade, keep the portfolio context in mind.

Further Resources

- *Pro*'s discussion boards
- *Pro*'s options guides
- "How We Invest"
- "Breaking Down Our Portfolio"
- "Making *Pro* Fit Your Profile"

Charter and 2011 Portfolios: Close Your Bull Call Spread on VXX

Published Oct 12, 2011 at 12:00AM

Trade Essentials

- **Actions:** Sell to close your Oct. 22, 2011, $51 calls and buy to close your Oct. 22, 2011, $56 calls on the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) ETN
- **When:** Close by the end of the day on Oct. 22 at the latest
- **Limit Price:** Initially aim for a credit of $0.60 or higher. As expiration nears, you'll receive a lower credit to close the spread (unless VXX rises).
- **Why Close?**

- Our bull call spread expires Oct. 22.
- We opened this position to hedge our short on VXX; that short was recently closed.
- As we build our short position in the **SPDR S&P 500** (NYSEMKT: SPY) ETF, we no longer need this spread, and it's expiring soon anyway.

What's Changed?

We set up this bull call spread on Sept. 26 as a hedge on our large position in iPath S&P 500 VIX Short-Term Futures. Three days later, our broker told us our short of VXX (via naked calls) had been exercised and would be closed within a few days because of a lack of shares available for shorting. We opted to close the position ourselves and reassess our approach; we're now investigating ways to set up a new bearish position on VXX in a simpler, lower-risk way that all members can follow if they like.

We initially kept this VXX bull call spread in place even after we closed our VXX position, as a hedge against a falling market. But as we noted last week, we're consolidating our shorts and hedges into one main position in the SPDR S&P 500 ETF, so we have less need for this other market hedge. Thus, we're closing this spread to concentrate on our SPY position and because we're no longer short the underlying VXX. (If you are currently short VXX and want to continue hedging that position, you can keep the spread open.)

How to Follow Along

To close this position:

- Sell to close the Oct. 22, 2011, $51 calls
- Buy to close the Oct. 22, 2011, $56 calls
- Use a spread order

Based on current prices, you'll recoup about $0.60 of the $1.40 or so you paid to set up the spread — nearly half the cost. If you're still short VXX and wish to keep this hedge in place, you don't need to take any action; just realize that as expiration nears on Oct. 22, with VXX at less than $51, the spread is currently positioned to end without value.

The *Pro* Bottom Line

After four successful positions, our fifth short on VXX turned into the most difficult position in *Pro*'s history. The short was closed at a loss, and this late-to-the-party hedge on it is at a loss, too. Data suggests that only a minority of *Pro* members follow our trades on VXX, but of course, the most recent loss has been painful for those who do. Given the high probability for success over long periods of time, we plan to continue taking positions on VXX in the future. We've learned from recent events, though: With future VXX trades, we'll cap our risk each time, lower our volatility in the position, and make sure all members are ready to keep the position for a long-term outcome that should be favorable.

To discuss closing this spread by Oct. 22, please visit the VXX discussion board.

Jeff is short iPath S&P 500 VIX Short-Term Futures.

Charter and 2011 Portfolios: Close Your Synthetic Short on EWP

Published Oct 12, 2011 at 12:00AM

Trade Essentials

- **Actions:** Sell to close your Oct. 22, 2011, $30 puts and buy to close your Oct. 22, 2011, $34 calls on the **iShares MSCI Spain Index** (NYSEMKT: EWP). (You can do this with a single spread order.)
- **When:** Close by the end of the day on Oct. 22 at the latest.
- **Limit Price:** Initially aim for a debit of around $1 or lower. As expiration nears, the debit should lessen, assuming the index doesn't rise above $35. If it does, it will cost more to close the position.
- **Why Close?**
  - Our synthetic short expires Oct. 22.
  - The options are even more expensive than before, so rather than roll this position forward, we're closing it in favor of the larger hedge in the **SPDR S&P 500** (NYSEMKT: SPY) ETF we announced last week.

What's Changed?

When we set up a synthetic short on the iShares MSCI Spain Index in early September, we wrote, "Europe is the biggest black box in our investing world right now." Nothing much has changed since then on that front: Europe has continued to promise solutions to its financial crisis while kicking the "reveal date" for those solutions further into the future; Belgium's second-largest bank, Dexia, was just bailed out by France and Belgium in the first sign that the crisis has crept into the heart of Europe's stronger countries; and Greece did not meet the provisions of its austerity plan, nor is it expected to meet them in the future without still deeper cuts.

Still, the latest word is that Greece should receive its next small bailout tranche in early November, and investors are also hoping that Germany and France (unlikely co-conspirators, to say the least) will make good on their promise to propose a comprehensive solution to the entire crisis by the end of this month.

These hopes have led the market to its largest rally since March 2009. Nobody knows whether this is just the other side of downside volatility or the beginning of a true market recovery, and the stakes remain high. As we noted last week, we're consolidating our shorts and hedges into one main position in the SPDR S&P 500 ETF. We're building that position bit by bit, aiming for a 30% allocation (hedging 30% of our invested capital). With that hedge, we don't need to continue expensive option trades on the Spain index, so we'll close this synthetic short before it expires Oct. 22.

How to Follow Along

Shares of EWP are currently trading at about $34.30, but the October $34 calls ask $1.55, so they're carrying more than $1.25 in time value. Acting now is akin to paying $35.55 to close the calls. While that's not terrible, we will let a bit more time pass (and a bit more time value dissipate) before we take action. That strategy is not without some risk; if the index rises to more than $35.55 before expiration, it'll be more expensive to close our position. On the other hand, if the index dips below $34 by expiration, we'll be able to close the calls for very little (or simply let them expire).

Either way, we'll wait in hopes of a better price. If you'd rather close now, aim to close both legs of the synthetic short for around a $1 debit total. Alternatively, you could wait to close the calls but sell to close the puts you own to recoup some capital (if it's worth it after commissions). The index is unlikely to fall below $30 again by Oct. 22, although if the European credit crisis flares up, anything is possible.

To close both sides of the spread simultaneously:

- Buy to close the calls you wrote
- Sell to close the puts you purchased
- Use a spread order with a net debit limit price

The *Pro* Bottom Line

This synthetic short was like a delicious but small Spanish tapa: It was tasty at the start, but it didn't last long. The position was profitable for a while, but the market's sudden ascent removed the profit and turned it into a small loss. Rather than roll the strategy forward and pay a premium for put options again, we're focusing our hedging efforts on shorting the SPDR S&P index directly. This is another step toward focusing on a single major hedge in the *Pro* portfolio, something we think should help simplify the service for members while meeting our hedging objective.

Where Our Portfolio Is Headed

Published Oct 10, 2011 at 12:00AM

Pro Trade Roundup

Charter Portfolio

- Sold all shares of **ProShares Short S&P 500** at $45.22.
- Sold short 2,000 shares of **S&P 500 Depository Receipts** at $116.14 (10% of 30% target).

Portfolio 2011

- Sold all shares of **ProShares Short S&P 500** at $45.24.
- Set up a protective collar on **AmTrust Financial Services**, writing four March 2012 $25 calls and buying four March 2012 $20 puts, for a net debit of $1.
- Sold short 170 shares of **S&P 500 Depository Receipts** at $116.12 (10% of 30% target).

If you're a new *Pro* member, you could be forgiven for wondering whether our recent flurry of trading activity — 15 recommendations since the beginning of September — is the norm around here. But as longtime *Pro* Fools can testify, the past couple of months have been anomalous in more ways than one. We've been trading much more actively than usual in recent weeks as we work toward a portfolio that's focused, balanced, and perhaps most importantly, largely macro-agnostic for now.

At the moment, there are only two possible economic futures as far as the market is concerned: Either Greece will default or it won't. If it does, that default may or may not result in a debt and credit crisis across Europe. In response, Europe will or will not slip into a recession, and the United States will or will not do the same. We'll probably know the outcome of it all within six months — but in the meantime, the market is as jittery as a martini shaker on a Friday night. Keep in mind that the news could be nothing but positive at every turn, which would actually send stocks higher. But if the worst comes to light, the consequences for investors are bound to be significant.

In positioning the *Pro* portfolio to respond to all this, we're conscious of the binary nature of the potential outcomes. We want to maintain strong upside exposure because we believe resolutions will (eventually!) be found to today's sizable economic problems. But we also want to be hedged to a meaningful degree (and flexible with our hedges) because Europe's woes could spread and a recession could set in at home and abroad. Finally, we want to maintain a cash balance to take advantage of new opportunities.

Last but not least, we know we can't outmaneuver the market day to day or month to month. Nobody can. Smart people don't even try. Instead, we're positioning our portfolio to survive and thrive during an unpredictable economy, whatever the market does.

Balance and Flexibility

We're working toward the following allocations, which we think will serve us well at least until we have some true resolution in Europe:

Strategy (Investment)	Allocation	Positions and Process
Bullish (Stocks, Options, ETFs)	80% to 90%	We always aim to build 3% to 5% positions in strong companies with reliable revenue that are trading at attractive prices. We'll sell companies in which we already own smaller allocations if we find we don't want to add to them, and we'll protect large positions if we think it's warranted (as we did with our recent protective collar on **AmTrust Financial**.
Bearish (Index Hedges)	30%	As our other short positions expire or are closed over the course of October, we'll build to our recommended 30% short in **SPDR S&P 500**. With just one main short position, we can easily increase or decrease our allocation as the economic outlook becomes clearer. We'll also keep our ratio put spread on the **PowerShares QQQ Trust** to hedge our bullish tech holdings.
Cash	10% to 20%	We'll aim to keep 10% to 20% of the portfolio in cash for new opportunities and to employ options.

We definitely remain bullish over the next three years and beyond, and the stocks we own — superior companies with strong potential, purchased at attractive prices — represent that long-term view. But we also know it could get worse before it gets better. By maintaining hedges and cash, we'll be better able to ride out (and even see some profits from) the falling market a new economic crisis would bring. With our portfolio 30% hedged and some cash on the side, we can sidestep some (though not all) of any potential downside, and with most of our money invested in stocks, we won't miss out on upside.

To prepare for better days whenever they arrive, we've been selling some stocks that we believe have modest upside potential (for example, **GlaxoSmithKline and NextEra Energy**) to buy beaten-down stocks (such as **Autodesk** and **BMC Software**) that may be volatile for a while but offer higher potential profit when the market finds its feet again. We're also keen to sell small positions to which we don't want to commit more capital; this will allow us to give more attention (and more capital, in some cases) to the positions we like best for the long haul.

Managing, Not Trading

When a *Pro* trade alert hits your inbox, remember: Despite the name, we're not "trading" a position in isolation. We're managing a portfolio, and that means each move is made in the context of every other position. In other words, a trade alert doesn't mean "we must leap on this single idea right now!" It means "here's another step along the way as we continually work toward a balanced portfolio we like." Especially in a market this volatile, it's important to move incrementally.

We know many members pick and choose ideas from our recommendations rather than mirroring the portfolio to a T. This really upsets our senior analyst, Nick Crow, but if you're determined to go rogue, Nick will forgive you on one condition: Before you go your own way, you must promise to make sure you understand the full context behind each position we announce. That means understanding how a trade fits into our portfolio and how it may — or may not — fit into yours. We'll do what we can to help spare you Nick's wrath by writing more about our portfolio in future trade alerts.

Positions to Add

Upcoming Earnings

- **Oct. 17: Wells Fargo**
- **Oct. 18: Intel**
- **Oct. 19: Covanta**

The current stock market is literally among the most volatile in history, and it isn't reacting to the usual stimuli (business results). Instead, its current moves have been in reaction to politics — largely European politics. Given all this, very few investors are in their comfort zones right now, but choppy waters create opportunities for long-term-minded Fools like us. If you're still building your portfolio, there's no shortage of interesting opportunities on our Buy list.

Tupperware is back to a Buy based on price. With its stock down 27% since July, you'd think the company was a European bank rather than a purveyor of little plastic containers that are enjoying strong growth in emerging markets. Tupperware can do well in weak economies if it plays its cards right; such economies offer more customers (more people eating at home and storing leftovers) and better employees (a brighter and more eager employment pool of potential sales reps). Tupperware is a good buy today, but realize that in this environment, even a 50-year-old household name is volatile.

Trash-to-energy leader **Covanta** is down about 18% since we bought shares, even though it has almost no exposure to Europe and enjoys long-term revenue contracts in the U.S. This entrenched business has a $2 billion market cap and about $275 million in free cash flow expected this year, and you can buy shares at a cheap 7.2 times expected free cash flow — a 14% free cash flow yield. I'm willing to bet Covanta is buying its own shares at these prices, given its aggressive buyback program.

Specialty chemicals and lithium producer **Rockwood Holdings** has been shellacked on fears about Europe, where 54% of its 2010 net sales were generated. Rockwood has enjoyed tremendous industry- and company-specific strength since we bought shares early this year, but with the euro losing value, earnings growth may slow when overseas sales are converted back to dollars — even if Europe's woes don't get worse. Even so, it's hard not to like Rockwood at today's prices if you have a time frame of longer than a year. The stock should be a strong performer once the euro-dust settles.

Elsewhere in the portfolio, **Pebblebrook Hotel Trust** is a value, too. Our favorite REIT already yields 3.3% (and that number is due to grow), and it's priced at less than the replacement cost of its upscale urban hotels. European politicians do have their hands full these days, so perhaps they aren't traveling to swanky American hotels as often lately, but business was still very healthy at Pebblebrook last quarter. BMC Software, **OpenText**, and **L-3 Communications** are also cheap on a cash-flow basis.

Next Week's Memo

In our Monday Memo for Oct. 17, we'll look at what happened with our **iPath S&P 500 Short-Term VIX Futures** position, what we learned, and how we'll recover. In the meantime, join the conversation on our VXX discussion board or add your wisdom to the VXX wiki page.

As we shape our portfolio, we have two main considerations in mind: Stocks look like good values right now, but there's also the potential for a credit crisis and recession close ahead. We recommend buying good stocks cheaply while steadily inflating your hedges; do those things with us, and together we'll get through whatever rapids are around the next bend in the economic river. To discuss Mr. Market's wild ride or this Memo, visit the Memo Musings board.

Foolishly,

Jeff Fischer (TMFFischer)

Jeff owns shares of Autodesk, GlaxoSmithKline, Rockwood Holdings, and Tupperware Brands. He is short iPath S&P 500 VIX Short-Term Futures and has options on BMC Software.

Coverage & Community

- TMFMoosie posts a very helpful weekly calendar of *Pro* earnings and expiration events.
- MazonCreekRich's son, Tom, posts an in-depth analysis of VXX. Before he does so, MazonCreekRich shares poignant personal truths. Be sure to read them.
- Want more on *Pro*'s philosophy? Don't miss this audio extra with Jeff and senior analyst Nick Crow.
- BMC Software's stock falls on rumors of management changes.
- We celebrate Steve Jobs.

Charter and 2011 Portfolios: Set Up a Protective Collar on AmTrust Financial

Published Oct 4, 2011 at 12:00AM

Trade Essentials

First Things First

- **Company: AmTrust Financial Services** (NASDAQ: AFSI)
- **Recent price:** $22
- **Market cap:** $1.3 billion
- **Website:** www.amtrustgroup.com
- **Type of holding:** Financials, small cap, core
- **Strategy:** Protective collar (capping our downside at $20, minus the cost to set up the collar)
- **Follow it:** Add to My Scorecard

- **Action**: Set up a protective collar on your existing shares of **AmTrust Financial** (NASDAQ: AFSI).
  - Buy to open March 2012 $20 puts
  - Sell to open March 2012 $25 calls
- **Allocation**: Purchase one put and write one call for every 100 shares of AmTrust you own
- **Option prices (bid/ask)**:
  - March 2012 $20 puts: $1.05/$1.85
  - March 2012 $25 calls: $0.55/$1.25
- **Limit order guidance:** Your broker may allow you to enter this order as one transaction. Aim to split the bid/ask prices on each option for a net debit (cost) of $0.55. As prices change, try to set up your protective collar for $1 or less.
- **Alternative trade**:
  - If you don't want to cap your upside, just purchase the March 2012 $20 puts.
  - If you're less inclined to protect against financial Armageddon, you can leave your AmTrust position alone.
- **Why Set Up This Protective Collar?**
  - If there's another economic crisis, investors are likely to throw out all stocks in the financial sector — babies and bathwater alike.
  - This strategy will limit our downside to protect our gains.
  - We don't see a near-term catalyst that would cause shares to jump beyond the written call strike price of $25 (15% higher than they are now).

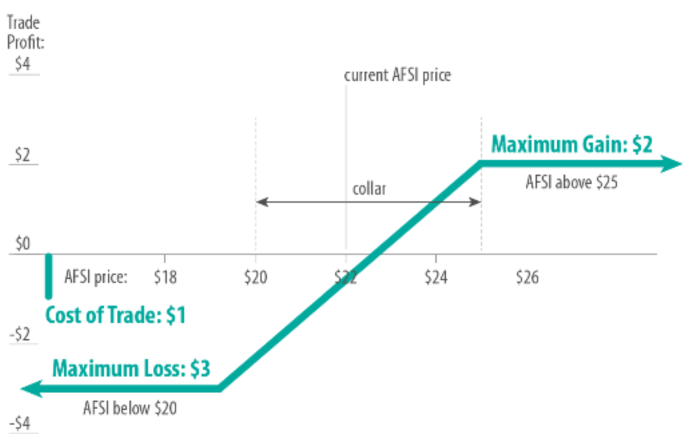
What's New?

Face it, Fools: We don't live in a vacuum. We don't invest in one, either, and worries about Europe's debt woes are beginning to spread to the market at large — first and foremost to the companies in the financial sector who may be holding those debts. If the dominoes in that sector start to fall, we could see a broad-based sell-off of anything that has even the slightest hint of financial stink. (For the details of our macro thinking, please read this recent trade alert.) The talking heads call this phenomenon "contagion," but we call it "sell and ask questions later." That means even AmTrust Financial Services — our obscure, healthy, growing warranty and workers' compensation insurer — could get shellacked without regard for its positive business attributes.

Why This Strategy?

Think of this protective collar as a six-month insurance policy to protect our largest stock position against massive distress in the financial sector. It actually has very little to do with AmTrust specifically, aside from the fact that the company operates in the financial sector. The *Pro* portfolio has already enjoyed triple-digit gains from AmTrust, and we see more in the future; we're simply acknowledging the reality that the company will likely not be spared from a broad-based sell-off of financials if it comes. It also risks being the victim of investors looking to raise cash in the face of margin calls — long-term winners like AmTrust may be the first thing such investors sell.

To protect our downside, we're buying March 2012 $20 puts, which will cap our loss if AmTrust drops below that strike price. To defray the cost of buying these put options, we're also writing March 2012 $25 call options. We're not crazy about limiting our upside (we still think AmTrust is a Buy worth $28 per share), but the lack of a near-term catalyst, the litany of macroeconomic headwinds, and the ability to adjust our covered calls if needed all combine to make us feel better. The graphic below outlines the possible results of this collar at expiration in March 2012. It assumes the collar costs us $1 to establish and uses a current share AFSI price of $22. This collar means that we will profit as our AFSI shares rise up to $25 (at which point our gains stop); our losses are capped if the shares fall beyond $20 (about 10% lower than today's price).



How to Follow Along

Next Steps

- Questions or comments? Bring them to the AmTrust discussion board.
- Afraid your collar is wrinkled or yellowed? Head over to the All About Options discussion board.

Many brokers will allow you to place this trade as one order. The options parlance is "protective collar," but it may simply be entered as any two-legged order. For every 100 shares of AmTrust Financial you own, purchase ("buy to open") one March 2012 $20 put and write ("sell to open") one March 2012 $25 call. Assess the bid/ask spread of each option and set up the collar for the lowest price possible. At current prices, you could be able to do so for a net cost of about $0.55; as prices change, that cost may rise to $1 or higher.

If AmTrust powers through the pressures on the financial sector and continues to march ever higher, we'll look to buy back our written calls or to roll them up and/or out as expiration nears. We like AmTrust and its strong business, and barring unforeseen developments, we want to own it for years to come.

If you don't already own shares of AmTrust, the near future may bring you the chance to buy shares of a super company at an even better price. Make sure you've got cash on hand, and if AmTrust is tossed aside with its catastrophe-prone financial brethren ... be greedy.

Jeff owns shares of AmTrust.

Trade Adjustment: iShares Russell 2000; Pro's Latest Short Strategy

Published Oct 4, 2011 at 12:00AM

Hey, *Pro* Fool! Is This Trade for You?

What we're doing:

- Last month, *Pro* recommended shorting shares of the **iShares Russell 2000** (NYSEMKT: IWM) ETF. Because our broker lacked shares, we were unable to short this ETF in the *Pro* portfolio, and thus we're adjusting our trade at the end of our 30-day trade window.
- We now intend to short a different index, the well-known **SPDR S&P 500** (NYSEMKT: SPY) ETF, instead. *Please note that we're also increasing the allocation to this short position from 10% to 30%.*
- We're selling our shares of the inverse **ProShares Short S&P 500** (NYSEMKT: SH) ETF because we prefer to short SPY.

How this affects you:

- If you are 10% short IWM after last month's alert, keep that position and short 20% in SPY to add to it.
- If you follow *Pro* to the letter, close IWM and the SH inverse ETF and establish a 30% short position in SPY.
- If you can't short directly, or don't want to, direct the same allocation (30%) to the SH inverse ETF.

The bottom line:

- We want our portfolio to be 30% short. Use whatever combination of SPY, IWM, RWM, and/or SH suits you.
- The market is volatile, so you may want to move into this position incrementally. *Pro* may short three 10% positions over the next month.

Trade Essentials

- **Actions:**
  - Sell existing shares of SH
  - Sell short SPY
- **Allocation:** Short (or hedge) 30% of your invested portfolio value (excluding cash) in SPY
- **Recent SH price:** $48
- **Recent SPY price:** $110
- **Sell SH around:** Market price; use a limit order
- **Short SPY around:** $107 or higher
- **Why Short SPY?**
  - If Europe's current debt woes are not resolved, markets could face another credit crisis.
  - This could contribute to another recession, and this time governments may have fewer options for recourse.
  - The stakes are too high not to continue to hedge a significant part of the portfolio.

What's Changed?

We want to make sure the *Pro* portfolio is invested only in positions in which we have high confidence. We also want the portfolio to be at least 30% hedged. To add to our short positions, we recommended shorting shares of the iShares Russell 2000 ETF last month, but our broker couldn't fulfill our order. This alternative trade will serve a similar purpose in our portfolio via the most basic hedge out there: shorting the SPDR S&P 500 ETF directly. Our broker, Schwab, assures us that there are plenty of shares of SPY available for everyone, and there's no fee to short. (Bravo.) In short (sorry), we will be shorting the world's major stock market index to the tune of 30% of our portfolio's value over the next month.

If you've been following our earlier recommendations (and were able to execute them all), you should already have the following positions:

- 10% short in IWM
- At least 5% in SH
- 7.5% short in the **iShares MSCI Spain** (NYSEMKT: EWP) ETF
- A ratio put spread on **PowerShares QQQ Trust** (NASDAQ: QQQ)

That adds up to more than 30% short, but *Pro* wasn't able to execute the IWM trade, the Spain position expires this month, and the QQQ position is relatively small on an absolute basis. Excluding the latter two, we still want to be 30% short in the major indexes, so we're shorting 30% in SPY for two reasons: It's simpler to have one big short position, and our broker claims to be able to fulfill this one.

To understand why we're still recommending a large short position, you need to consider both the macroeconomic environment and the *Pro* portfolio in general.

The Big Picture

Shorting 101

- When you sell short, you borrow shares from a broker and immediately sell them, collecting the proceeds. You hope to later buy the shares back (returning them) at a lower price. If so, you pocket the difference as your profit. If the price rises, you'll have to buy back at a higher price, resulting in a loss.
- When you short something that pays a dividend, you need to pay the dividend. SPY pays approximately 0.5% every quarter.
- You must have a margin account to sell short. However, if the market rises, the rest of your portfolio should be rising, largely negating your short position. And if the market falls, you make money on your short — meaning the margin shouldn't be an issue either way on an appropriately sized position.
- To open the position, the command is usually "sell to open" or "sell short." To later close it, it will be "buy to close" or "buy to cover."
- For more, check out the *Pro* Guide to Shorting.

The stakes are high for financial markets right now, and the potential outcome is binary. Either Europe will get its sovereign debt problems in order, or the situation will worsen across the continent. If Greece defaults in an orderly fashion, which appears all too likely, the repercussions may be felt around the world in ways we can't estimate. Portugal's debt problem may resurface next, just as banks are trying to grapple with the Greek fallout.

These are big, sweeping problems. The only way out is for the Eurozone's 17-nation governing body to find a big, sweeping solution — and unfortunately, the odds seem stacked against it. So far, the prevailing solution has been to kick the debt can down the road with more loans and to impose strict austerity measures on afflicted countries so they decrease spending. However, this causes the economic output of those countries to shrink even more, exacerbating the debt problem further and causing social unrest to boot. If the Eurozone doesn't get its financial house in order, a recession there could spread to the United States.

Speaking of these fair shores, the U.S. government is grappling with similar debt and deficit issues. Twenty years ago, politicians were talking about the need for the federal government to have a balanced budget by 2010, when the Baby Boomers would start to retire en masse and thus drain federal resources — but the warnings were ignored, and now the situation is even worse. Around the developed world, governments including our own are strapped with record debt, large deficits, and fewer prospects for strong economic growth, just as the largest part of the population starts to retire.

This is a demographic challenge we've talked about in *Pro* since early in our service's history, and it suggests enough potential for economic hardship that we should be keeping shorts in place most or all of the time. There's no question governments need to become financially healthier, but austerity measures shrink the economy rather than grow it, and that results in less federal revenue. This may qualify as the mother of all Catch-22s.

Meanwhile, should another recession arise, there may be few official options left. The U.S. government has already thrown some $2 trillion in stimulus money at the economy and has lowered interest rates as much as possible; the national debt is at record levels, and both the public and politicians are lax to keep spending. All that means a future recession may be harder to pull out of than the last one. The recession of 2008-09 ended with a feeble recovery even after a few trillion in new spending; today, home prices are barely stable, foreclosure rates remain high, and the average consumer still needs to get rid of debt. In an economy plagued by record borrowing, weakened conditions like these can take years to improve.

The Portfolio Picture

In the past, we've tried various ways of getting the *Pro* portfolio to 30% hedged. A few of those trades have proved difficult to execute for members, *Pro* itself, or both. Today's recommendation is meant to be simple for all *Pro* Fools (including ourselves) to carry out and follow.

With this trade, the *Pro* portfolio will finally be a bit more than 30% short, and upcoming planned trades should leave us with a bit more than 10% cash. Nonetheless, we'll remain about 80% to 90% long in stocks and will continue our search for worthy new positions on the cheap — meaning we'll enjoy plenty of upside should it arise. Finally, remember that when things look bleakest, stocks may be poised to perform the best they have in years (because everyone has already sold and valuations are too cheap). Are we at that point yet? Possibly not. But either way, we want to set our portfolio up to hedge a macro-driven decline, allow our selectively chosen businesses to outperform, and keep a cash balance that lets us be opportunistic.

How to Follow Along

To sell short, you simply "sell to open" the shares of the ticker you're shorting (SPY). Short the equivalent of 30% of your portfolio (so if your portfolio is worth $100,000, short $30,000 worth of SPY). But note: *Given the extreme volatility of the market, and the size of this position, you may want to short in two or three increments over a number of days or weeks. We plan to do this in* Pro *over our 30-day trade window.* If you already have other short positions on indexes, you can keep them open and short enough SPY to reach 30%. (For example, if you shorted 10% in IWM as we suggested a month ago, you can keep that position open and only short 20% in SPY.) Again, the idea is to be 30% short on market indexes.

To consolidate our short positions and raise cash, we will also be selling our shares of ProShares Short S&P 500 ETF and shorting SPY instead. If you can't or don't want to short directly (for instance, you're investing in an IRA), you can keep your shares of SH instead — to mirror our thinking, add to them incrementally to increase your allocation to 30%.

To follow along:

- Sell your existing shares of ProShares Short S&P 500
- Sell short shares of SPY instead at a 30% allocation (consider doing so in increments over time)
  - If you can't sell short or don't wish to use margin (which shorting requires), just keep your shares of ProShares Short S&P 500; add to them if you wish to match our allocation
- If you're already short iShares Russell 2000 (or own the inverse RWM ETF), you can keep that short and build your short allocation to 30% by shorting 20% in SPY. You can also close your IWM short and just short all 30% in SPY; it's up to you how precisely you want to mirror the *Pro* portfolio.

Basically, hedge your long portfolio by shorting indexes to the tune of 30% of your portfolio's value. You can reach this allocation through any combination of SPY, IWM, SH, or RWM.

What Will Make Us Close?

If Greece's problems are truly resolved (not just kicked down the road six more months) and the economic outlook improves, or if SPY gains more than 7% to 10% from our short price, we may exit this position. We may also exit incrementally if the environment suggests we can start to take on more risk.

Talk about these trades on our new SPDR S&P 500 discussion board. We'd also like to know whether this report was helpful to you, and if there's anything else you'd like to see in our reports. Let us know on the Member Suggestions & Help discussion board.

Find Your Portfolio in the Marble

Published Oct 3, 2011 at 12:00AM

Dear Fellow Fools,

What are your investing goals? There's no right or wrong answer to that question, but you should have *an* answer. After all, if you don't know where you're going, you might end up somewhere else.

New: The *Pro* Wiki

We've created a wiki for *Motley Fool Pro*! It's editable by members, and we hope it serves as a useful repository of ideas and information. Click here to check it out and add your contributions!

Purely to provoke thought, consider the goals of First Eagle Investment Management:

1. Avoid permanent impairment of capital.
2. Grow the real purchasing power of the fund over the long term.

If that leaves you thinking the First Eagle fund managers must be conservative, risk-averse, and even stodgy, you'd be right. But check out their track record — their bellwether **Global Fund** (SGENX) fund has averaged a remarkably steady 12.4% annual return for the past 41 years. That includes 12.5% annual returns for the past decade, during which time the S&P 500 rose a scant 2.4% per year.

If you also thought those two goals sound close to ours here at *Pro*, you'd be right again. Our mission — to earn you consistent, recurring profits with high accuracy and low overall risk — is similar to that of First Eagle. That's why Bryan Hinmon (TMF42) and I seized the opportunity to hear Matthew McLennan, portfolio manager of the First Eagle Global Fund, speak in Washington, D.C., last week. In his prepared remarks and his answers to our questions, McLennan waxed eloquent on First Eagle's goals, investment philosophy, and road map.

Keep It Simple

Investing in line with First Eagle's two goals is quite simple. The fund managers pay attention to what's going on in the world to avoid losing money on foreseeable risks, then try to deploy money to investments that will appreciate more quickly than inflation.

First Eagle uses a wide lens when deploying capital. All possibilities are on the table: Businesses around the globe, commodities, real assets like quarries and timberlands, and of course cash. I always think of cash as an active investment (not the passive absence of investment); McLennan, who calls cash "an option on deployment and distress," would likely agree.

Against this vast backdrop of investment possibilities, First Eagle rarely trades. This dichotomy of possibilities and actions reminds us how simple good investing can be: Look at lots of stuff, form opinions on some of that stuff, and then buy only the stuff you really, really like when the price is right.

The Least-Worst Option

Another benefit of the wide-lens approach is that it keeps you actively comparing alternatives. Is South American timberland more attractive than Australian coal mines? Is Malaysian farmland more attractive than Italian debt? When you start asking questions like this — and your first goal is to avoid permanent loss of money — you start using phrases like "the least-worst option."

The least-worst option for your money, according to McLennan, is (drum roll, please) *businesses*. We agree — after all, take a look at *our* portfolio. When your primary goal is to not lose money, investing in dynamic, living organizations, capable of adaptation and susceptible to thoughtful analysis and nuanced opinions, is a strong choice.

Is There a Portfolio in Here?

More than 16,000 public companies trade on U.S. exchanges. At *Pro*, we generally want to own about 20. (That's why we smile when we read the occasional "Why don't we own shares of Patty's Circus Snacks ? It looks cheap!!!" post on our boards.)

We don't need to have many opinions, just a few high-conviction ones. Our challenge isn't to recognize when we like something — it is getting through as many possibilities as we can. The more quickly we identify unattractive investments as such, the better. As McLennan put it, building a portfolio is like starting with a block of marble and chipping off all the pieces you don't like. The goal is to let the statue emerge from within.

Simple, Not Easy

This perspective on investing inverts the problem as most people see it. Instead of building a portfolio from the ground up, it takes the opposite approach: Pretend you own everything, then decide what to sell. This hammers home the simplicity of good investing (keep the stuff you really, really like). But it's certainly not easy.

I encourage you to take a few minutes and run through this mental exercise. Pretend you own *everything* — the South American timberland, the Italian debt, and everything in between. What would be your first obvious sells? There are no parameters on this question — anything from individual stocks to entire asset classes are fair game. Which chunks of marble would you chip off first? Share your thoughts with us and the rest of the community on our Philosophy & Strategy board.

Oh, and if you really want us to buy shares of Patty's Circus Snacks, make a case for it on the boards. We haven't yet chipped the Carnival Cookery sector off of our portfolio's marble block — but we do require fleshed-out arguments before we make any investment.

Have a great week.

Foolishly,

Alex (TMFPapester)

Pro Trade Roundup

Charter Portfolio

- **GlaxoSmithKline**: Sold all shares at $42.20
- **Pebblebrook Hotel Trust**: Bought 400 shares at $15.08
- **iPath S&P 500 VIX Short Term Futures**: Set up a bull call spread: Bought to open 25 October 2011 $51 calls and sold to open 25 October 2011 $56 calls for a net debit of $1.60

Portfolio 2011

- **Pebblebrook Hotel Trust**: Bought 75 shares at $15.09
- **iPath S&P 500 VIX Short Term Futures**: Set up a bull call spread: Bought to open three October 2011 $51 calls and sold to open three October 2011 $56 calls, for a net debit of $1.60.

Guidance Updates

- **Tupperware** : Moves up to Buy on price

Coverage & Community

- Our VIX board has exploded with activity since Friday. In case you don't wish to spend the better part of a day catching up, we recommend checking out these posts from members kmbbubba, DoubtingThomas, JTCanuck, and raleigh1208.
- Jeff has been responding to many of the VXX posts, but if you read nothing else, check out "VXX in a nutshell," "What we advise on VXX," and the "Daily VXX Log."
- TMFEldrehad congratulates the new CAPS Top Fool — yes, someone finally unseated TMFBabo.
- *Pro* members discuss the merits of *Motley Fool Special Ops*.

- spinningwood shares a frightening story of terrible investment advice (don't worry, it didn't happen to him).

Wiki: FAQ

Published Oct 2, 2011 at 12:00AM

> Also see the helpful Pro FAQ page

- Buy-Around Price
- Gambling or Speculating ?

{double-click to post your FAQ and answer here - or just ask a Q }

Target List

In the interest of keeping things moving, let's post a list of questions that we feel keep getting asked because members haven't been able to find the answer easily. Then anyone can come back and paste or contribute good answers later.

What do I do with my SA/RB/other positions when I join Pro?

This thread contains a wealth of information about how members work with recs from many different MF services.

And Alex Pape published this definitive guide on how to start to implement Pro recs.

I tried to follow the rec, but my broker said I don't have enough permissions.

What happens when/if my short calls are assigned?

How close to options expiry should I be expecting an update rec?

How do I navigate around these message boards?

What is time value / intrinsic value and how do I calculate it?

- **"Buy-Around" price**
  Q: Greenpeace11 asks:

  I am relatively new to Pro and was wondering about "Buy Around" suggested prices. Some of the technicals based newsletters and analysts suggest not to buy a stock until it has made a move up to a certain price point. Several of the Pro recommendations are currently trading at significantly lower prices than the "buy around" recommended prices. Do we wait to buy until they have moved up to the "buy around" prices or get in as low as possible? Thank you.

  A: TMFMoosie answers:
  Short answer: **buy as low as possible.**

  The technical services may see moving above a price point as a *catalyst* that will move the stock even higher.

  Pro primarily uses fundamental company analysis as the basis for the company's worth, and then setting a "buy around" comfortably *below* that point.

  Pro catalysts will vary, but will rarely, if ever, be divined by looking at a historical price chart. So, as long as the original thesis has not changed (and Pro will alert us if it does), lower prices are better.

  A: Addition by TMFMoosie: **Always use a limit order**. Set the limit at the most you're willing to pay,and then forget about it. The company recommendations at Pro are designed to be longer-term holdings. There's no rush.

- **Gambling V. Speculation**
  TMFFischer > *Far too many people treat the market like a casino even though the largest example of market success (Buffett) has always done anything but.*

  Q: *At what point are we assessing risks and probability and taking appropriate positions ? At what point are we just "Gambling" ? Is it like this:*

  - Odd 1 in 20 = Gambling
  - Odds 1 in 5 = Hedging
  - Odds 5 to 4 in favour = Investing ?

  A: spinningwood >

  - Gambling = What you call what you did, when it didn't work out and you lost big.

- Speculating = What you call what you did when you suddenly have a whole LOT more money than you used to have, at least until the speculating inevitably turns into gambling.
- Hedging = What you do until greed and boredom convince you to abandon the hedges so you can time the market. Many hedgers suffer from PHD (Post Hedge Depression) when their timing trade turns out to have been a gamble.
- Investing = You have more money than you used to have.... or will some day...or at least you hope that will be the case....

A: TMFCrowe > Knowing the probability of success is only one part of the equation. Rather than try to explain a concept you already know, I'd like to share one of my very favorite articles on investing. It's written by a professional handicapper. Here is an excerpt:

What you really want to do is determine which most-likely winners are good prices and which most-likely winners are bad prices. It is a very simple equation:

Price X Probability = Value

The entire world of investing is that simple too. Here is what I mean. If a horse has a 33 percent change of winning a race, and if you can get odds of 2-to-1 on him (which means tripling your money), there is no value - the horse is priced correctly. If a horse is 6-to-5 (which means you will only get back 120 percent of your bet) and he is only 33 percent to win, then he is a terrible bet. If you're going to get 4-to-1 (quintupling your money) on a 33 percent chance winner, then it's a great bet.

The majority of people who play horses refuse to think that way. They sometimes say that no horse is worth taking a short price on. That's just not true. If a horse is 90 percent to win a race and you're going to get a 50 percent ROI, then he is one of the greatest bets in history. They sometimes say that all long shots are over-bet and that you should never bet on a long shot. That's not true either. If a horse has a 10 percent chance of winning a race and he's 20-to-1, then you're getting double the value than you should.

You owe it to yourself to read the rest here: http://www.leggmason.com/thoughtleaderforum/2007/conference/...

Wiki: Options

Published Oct 2, 2011 at 12:00AM

Double-click anywhere on the below text to make your edits!

- Wiki A to Z of Options{in progress - feel free to add stuff}
- Wiki Options Q Questions answered by TMFers and members both.
- Moosie's famous Option spreadsheets
- Strategy Cheat Sheet

Beginners

Start with Jeff Fischer's excellent introduction to Options > Options 101

- Options 101: Basics: A Foolish introduction to the whys and hows of options trading.
- Options 201: Covered Calls: Learn how to generate cash on stable stocks you own or obtain better sell prices.
- Options 301: Writing Puts: Get lower buy prices or earn income on stocks you've got your eye on.

Beginners: Take the popular Options U course. Options U: Your Guide to the Basic Degree

Adanced:

- Refresh with MF Options: Intermediate Degree curriculum
- MF Options: Guides for our Advanced Degree

- Options 202: Rolling Covered Calls
- Options 401: Protective Collars
- Options 501: Synthetic Longs
- Options 502: Synthetic Shorts
- Options 601: Stock Repair
- Options 701: Buying Straddles
- Options 702: Writing Straddles
- Options 703: Strangles
- Options 801: Spreads
- Options 802: Bearish Spreads
- Options 803: Neutral Calendar Spreads

A - Z of Options

American style: Options contracts that can be exercised at any time after purchase and before the expiration date.
See also: European style.

Assignment: When the options writer (also called the seller) is forced to buy (for a put writer) or sell (for a call writer) the underlying stock. Essentially, your counterparty has exercised its option contract, which you wrote, to buy or sell the underlying stock.
See also: counterparty, exercise.

At-the-money (ATM): An option whose underlying stock is trading at its strike price.
See also: deep in-the-money, far out-of-the-money, in-the-money, out-of-the money, strike.

Bearish: An options strategy (and outlook) that achieves its maximum payoff when the underlying stock drops in price. For example, if you are bearish on a stock you know well, you could buy a put or a bear put spread.
See also: Bullish, long, neutral, short.

Beta: A measure of the sensitivity of the price movements of a stock in relation to the movement of the broader market. A stock with a beta of 1.00 will theoretically move 1% for every 1% move in the market. A stock with 20% more or less price volatility than the broader market will have a beta of 1.20 or 0.80, respectively. Beta can be calculated by regressing the historical returns of the stock against the historical returns of the broader market index

The concept of beta does not translate directly into option pricing. It should not be confused with implied volatility, which only measures the volatility of the stock itself and ignores the broader market. A low-beta stock could theoretically have very high implied volatility.
See also: Greeks.

Bid: The price buyers currently are offering to pay.
See also: ask, bid/ask spread, mid.

Bid/ask spread: The difference between the bid and ask prices. For very liquid markets, it might be as narrow as a few pennies, but for thinly traded markets, the spread can be very wide. Options markets are less liquid than stock markets, so it is important to use a limit order to set your price.
See also: ask, bid, limit order, mid.

Binomial Model: An options pricing model that's useful for American-style options because it can help predict when early exercise is possible. It uses an iterative process that allows for pricing options at different points prior to expiration.*See also: Black-Scholes Model.*

Black-Scholes Model: One of the most well-known options pricing models. It incorporates time until expiration, strike price, stock price, dividends, implied volatility, and interest rate. It is based on several simplifying assumptions, but put simply, it calculates the value of a call option as the stock price multiplied by the probability of ending up in-the-money, less the present value of the strike price paid on the expiration date. The model is named after Fischer Black and Myron Scholes.

See also: Binomial Model.

Break-even price: The price the underlying stock needs to reach at expiration for an option investor to neither make nor lose any money. In strategies involving more than one option, there can be more than one break-even point.

Bullish: An options strategy (and outlook) that achieves its maximum payoff when the underlying stock appreciates in price. For example, if you are bullish on a stock you know well, you could buy a call or a bull call spread.
See also: bearish, long, neutral, short.

Buying Calls

Buying a call isn't necessarily the best way to benefit from a stock's growth. It depends on the Time Value. When you buy a call you are buying Time Value and it will erode as the expiry date approaches.

On the other hand buying the right call on the right growth stock can give you great leveraged returns with not much money at risk.

Make Sense? No ? There's a good starting point here:
http://newsletters.fool.com/50/optionsu/intermediate/buying-calls.aspx

Buying Puts

Buying puts. This is a very bearish thing to do. It can be hedgey too.

Buy to close: The brokerage command to exit an option contract in which you originally wrote ("sold to open") the put or call.
See also: buy to open, close, cover, sell to open, sell to close.

Buy to open: The command some brokerages use to enter an option contract in which you intend to buy a put or call.
See also: buy to close, close, cover, sell to open, sell to close.

Call option: The right, but not the obligation, to buy the underlying stock at a set price (the strike price) at or before the option's expiration date. A call rises in value as the stock price rises and declines in value when the stock price falls.

Chicago Board Options Exchange: The largest options exchange and creator of listed options in the U.S. It is owned by the **CBOEGroup** (Nasdaq: CBOE) and also specializes in futures trading. (If you want to sound savvy at cocktail parties, refer to the Chicago Board Options Exchange by its acronym and pronounce it *see-bo*, as in, "See Bo Derrick in the film*10*.")

Contract: Each standard option contract represents 100 shares of the underlying stock, provided no splits or other adjustments (i.e., corporate mergers) take place. (We'll be very specific about what to buy or sell if any non-standard options ever make it to *Motley Fool Options*.) A contract is quoted at the price for one share, so multiply by 100 to get the full contract value. For example, buying two option contracts for $1.50 actually represents 200 (2 x 100) shares of stock and would therefore cost $300 ($1.50 x 200).

Covered Call ("Writing" or "Selling" a covered call)

Popular stategy! Basically, you sell someone the option to buy your shares at a certain strike price. You receive a premium as soon as you have sold the call. It's called "Covered" because you own the shares.

Covered Calls are a classic way to generate investment income on shares you like and believe will go up, but they won't go up too quickly.

Covered Calls are a fine way to sell shares at a price you are happy to sell at - a covered call protects your profit.

Excellent Guide! - Covered Calls At a Glance

There's more detail on Page 3 of the Options U Intermediate Handbook
http://newsletters.fool.com/50/optionsu/2011/11/11/options-u...

Aleax: Never write a covered call on a stock you own, unless you know you'd be *delighted* to let said stock go at the strike price (plus the premium). You may or may not get a decent chance to roll the call as expiration nears, but it's absolutely crucial that you be quite happy letting the stock go if it soars to the sky.

Covered Strangle

A covered strangle is where we write a **Put** at a lower price, and write a **Covered Call** at a higher price. We have strangled the stock price between lower and higher. This strategy is useful for stocks which we are expecting to stay at more or less the same price by Expiry date. Here's an example: Covered Strangle on Plum Creek Timber

And here is a guide to Strangling: Options 703 - Strangles

Note: "*you write a strangle to profit when a stock stays within a predetermined price range or is relatively stable..... Writing a strangle offers more flexibility than writing a straddle because you "split the strikes" — set it up with a different strike price on your calls than on your puts — and you use strike prices that are "out-of-the-money," or well above or below the stock's current price, giving you more room to profit.* "

Close: Exit an option contract.
See also: buy to close, cover, sell to close.

Cover: Another term for closing out a short position.

See also: buy to close, close, sell to close.

Deep in-the-money: The condition of an option that has a large amount of intrinsic value. A call option is deep-in-the-money when the underlying stock is trading at a price much higher than the strike, and vice versa for a put option. A deep-in-the-money option will typically have little time value.
See also: at-the-money, far out-of-the-money, in-the-money, out-of-the-money, intrinsic value, strike.

Delta: Delta, loosely, can be three things:

1. Delta is roughly the amount the option changes in value as the stock changes in value. If you're the sort of person who likes to spend a quiet evening alone with math, you'll recognize that delta is the first derivative of the value of the option with respect to the value of the underlying. If a call option has delta of 1.00, then it rises in value $1 for every $1 increase in the stock. A delta of 0.60 means it would rise $0.60 for every $1 increase in the stock, and so on. Since the call is less expensive than the stock, the $0.60 increase represents a greater percentage change for the option than the $1 change in the stock. Put options carry *negative* deltas, but this, if you think about it, makes sense. Since a put option profits when then underlying stock declines, and vice versa, we should expect an inverse relationship. A put with a delta of -0.60 would mean that its price rises $0.60 every $1 *decrease* in the underlying stock price.

2. Delta is roughly the probability that an option will expire in the money (though not necessarily at a profit). A deep in-the-money call is, statistically speaking, almost certain to expire in-the-money. Thus, it has a delta very close to 1.00. The negative sign on a put option's delta is unimportant in this context — the absolute value is the important thing. A put with a delta of -0.50 has a rough statistical probability of expiring in-the-money of 50%.

3. Delta is roughly the number of shares the position represents. A deep-in-the-money option trades almost the same as 100 shares of stock, so it has a delta of very close to 1.00. Here, negative delta does carry meaning. A purchased put option will have negative delta, reflecting that it is equivalent to some number of shares being sold short.

See also: gamma, Greeks.

European style: Option contracts that can only be exercised at expiration.
See also: American style, Black-Scholes model.

Exercise: Invoking the right (as granted by the option contract) to buy (if a call) or sell (if a put) shares of stock at the strike price.
See also: assignment, counterparty, strike.

Exercise price:*See: strike.*

Expiration date: The date on which the option contract becomes void, and the option holder no longer has the right to buy or sell stock granted by the option. This is typically after hours on the Friday before the third Saturday of the month.

Extrinsic value:*See: time value.*

Far out-of-the-money: The condition of an option when the underlying stock is trading at a price much lower than the strike for a call, or much higher for a put. Far out-of-the-money options have little intrinsic value but retain some time value depending on the time left until expiration.
See also: at-the-money, deep in-the-money, in-the-money, out-of-the-money, strike, time value.

Free cash flow (to the company): Money leftover for creditors and shareholders when all of a company's operational and investment expenses (think equipment upgrades, acquisitions, taxes) have been paid. This figure arguably provides a more accurate picture of the company's profits and financial strength than net income or earnings per share.

Gamma: One of the five "options Greeks" (delta, gamma, rho, theta, and vega), this shows how fast delta changes with respect to the underlying stock price. The larger the gamma, the faster delta changes; gamma is maximized when the stock price equals the option's strike price.
See also: delta, Greeks.

Greeks: The four primary Greeks are delta, rho, theta, and vega, and are risk measurements used to monitor the sensitivity of an option's price with respect to a change in one of the underlying contributors to option valuation — stock price, interest rates, time to expiration, and volatility. A fifth common Greek, gamma, measures the sensitivity of an option's delta with respect to changes in the price of the underlying.
See also: delta, gamma, rho, theta, vega.

Hedge: An offsetting position meant to reduce the price, volatility, or risk of an investment.

Historical volatility: The annualized standard deviation of the stock's price changes. Typically, daily price changes are used.
See also: implied volatility.

Horizontal spread

See: time spread.

Implied volatility: A prediction of the volatility of an underlying stock; it's calculated using the current market trading price of the option. Implied volatility may or may not bear any resemblance to actual historical volatility.
See also: historical volatility.

In-the-money (ITM): Indicates that an option has intrinsic value. Calls are in-the-money when the underlying stock is above the option's strike price (a stock is at $22 and the call has a strike price of $14, allowing the holder to buy the stock at $14). Puts are in-the-money when the underlying stock is below the option's strike price (a stock is at $22 and the put has a strike price of $30, allowing the holder to sell the stock at $30).
See also: at-the-money, deep in-the-money, far out-of-the-money, out-of-the-money, strike.

Intrinsic value: An option's value if it were to expire immediately; i.e., the value in direct proportion to the underlying stock's current price. For calls, intrinsic value is the current stock price minus the strike price. For puts, intrinsic value is the strike price minus the current stock price.
See also: premium, time value.

Last trading day: The final day on which trading takes place on an option contract prior to the settling of the contract, usually the third Friday of the expiration month.
See also: expiration date.

LEAPS (Long-Term Equity Appreciation Securities): Options that, when first offered, expire at least two years in the future. Most new LEAPS become available between September and November, depending on which option cycle the underlying company is on. They will almost always be for a January expiration, but are sometimes offered for a February or March expiration. We like LEAPS because they provide longer-term choices for an investment thesis to play out.

Leg: One piece of multi-option strategy. It also refers to entering or exiting a multi-option and/or stock strategy ("leg in" or "leg out") at disparate times and prices chosen to benefit the intended strategy, but with the potential risk that better prices will never be available.

Limit order: A modification to a brokerage command to buy or sell that allows you to buy or sell at a set price or better. These are particularly useful for illiquid stocks, as well as the option markets, for which there is often limited liquidity.
See also: market order.

Liquidity: Refers to how heavily traded a stock or option is, and usually corresponds to how wide the bid/ask spread will be. A heavily traded stock or option will have lots of liquidity and thus usually a narrow bid/ask spread.

Long: Having ownership of a security. If you own 100 shares of a stock, you're long the position. If you have purchased a whole mess of puts on something, you're long a whole mess of puts. It can also be a slang term meaning you feel positively about something. For example, TMFTheDoctor is long corgis, caffeine, and David Tennant.
See also: bearish, bullish, neutral, short.

Market-maker: Typically, a floor trader on an exchange whose job is to accept bids and offers from other traders — be they big institutional traders or Joe and Jane Optionsmember. The main job for a market-maker is to maintain liquidity and ensure that prices are more or less fair.

Market order: Typically the default order type for an options trade. It tells the broker to place your trade at whatever price is currently available on the market. Since options are often thinly traded, market orders can be very dangerous, as the bid/ask spread can be wide and a market order will simply buy at the ask or sell at the bid.
See also: bid/ask spread, limit order.

Mid: The midpoint between the bid and ask. When using a limit order, it's often advantageous to set it to the mid — sometimes called "splitting the bid/ask" — and move outward from there if the order doesn't get filled.
See also: ask, bid, bid/ask spread.

Naked: Taking a short position in an option without having a position in the underlying security as collateral. The concern of a naked position is that it carries theoretically unlimited risk. A naked call will begin showing a loss as the underlying stock rises, and the stock could possibly go to infinity (and beyond!) causing extreme loss on the naked call. A naked put does not carry quite as much risk: A stock can only fall to zero (Oh Joy!), so the position's potential loss is limited to the value of the stock.
See fully-clothed, semi-clothed

Neutral: An options strategy (and outlook) that achieves its maximum payoff when the underlying stock doesn't change in price.
See also: bearish, bullish, long, short.

Net operating profit after taxes (NOPAT): NOPAT (aka NOPLAT) is a taxed version of a company's operating income, or EBIT.
*(**NOPAT**: Net Operating Profit After Tax; **NOPLAT**: Net Operating Profit Less Adjusted Tax.)*
NOPAT is a useful metric for comparing the operating profitability of companies with different debt loads because it excludes the interest burden that comes with debt. A simple way to calculate NOPAT is EBIT x (1 - Tax Rate). A more accurate method adjusts the reported tax to exclude the *tax shield* provided by the tax exemption on interest payments: Adjusted Tax = Reported Tax + (Interest x Tax Rate); NOPAT = EBIT - Adjusted Tax.

Open: As a verb, open refers to entering an option contract; as an adjective it refers to whether you are still holding the position.
See also: buy to open and sell to open.

Open interest: The total outstanding open contracts on any particular option. If you buy or sell to open, pat yourself on the back! You've just upped the open interest. If you buy or sell to close, you've just decreased it. (Fine, you can give yourself another pat.)

Option cycle: Expiration dates available for various classes of options (not everyone gets to go at once). There are three cycles, offset monthly: January/April/July/October; February/May/August/November; and March/June/September/December. Regardless of cycle, there is always an option for the current month and the next month. Beyond that, the expirations correspond to whatever cycle the stock is assigned to. There will always be at least four expiration months trading.

Options Clearing Corp.: A middleman, operating under the Securities Exchange Commission, whose role is to police option buyers and sellers to ensure the obligations of an options contract are fulfilled. The OCC clears and settles trades for options exchanges (like CBOE) and takes on counterparty risk. It is also a useful resource for options questions.

Out-of-the-money (OTM): The opposite condition to being in-the-money. Here, an option has no intrinsic value, only time value. For example, if a stock is trading at $8, its call options with a $10 strike price would be out-of-the-money.
See also: at-the-money, deep in-the-money, far out-of-the-money, in-the-money, strike.

Premium: The total price of an option contract; the sum of an option's intrinsic value and its time value.
See also: intrinsic value, time value.

Put Broken Wing Butterfly

Poor butterfly!

But an example of this Strategy is Set up a Put Broken Wing Butterfly on Expeditors International

An iron butterfly is the combination of two spreads: a bear call spread and a bull put spread. If you're unable to set up a four-legged butterfly trade in one order with your broker, then handle the Bear Call Spread and the Bull Put Spread elements as 2 trades.

Put option: The right, but not the obligation, to sell a stock at a set price at or before the expiration date. A put's value increases as a stock's price falls.

Put ("Selling" or "Writing Naked Puts")

Writing Puts is a classic way of buying shares that you wish to buy anyway - but at a lower price. You sell the option. You receive a premium. That premium can be deducted from the strike price to give you a lower buy price!

Make sense ? No ? Read the great introduction here: http://newsletters.fool.com/50/optionsu/2009/08/10/writing-p...

More detail: Page 15 of this doc http://newsletters.fool.com/50/optionsu/2011/11/11/options-u...

Note: When you sell a Put option you are selling someone the right to sell **you** shares at a certain strike price. Now, whoever bought the Put from you can just ***make*** you buy those shares at the agreed strike price at any time up to Expiry Date!! Inconvenient if the share price is temporarily much lower than that strike price. Mind you, worry not, this "assignment of shares" doesn't happen too often.

Normally you'll reach the Expiry Date and the actual price will be lower - in which case you'll have to buy the shares at the higher strike price. Or the actual price will be higher and your put will expire for nothing. You keep the premium in either case.

It's best to keep **Cash** set aside to cover your Written Puts (i.e. buy the 100 shares at the strike price). It's best not to use margin for this. Read more in the introductions about this.

Return on equity (ROE): Return on equity is the profit earned on capital that stockholders have contributed to the company. Let's say a company has issued $100 million worth of stock, $100 million worth of bonds, and $50 million in preferred stock. This imaginary company brings in $25 million in profit, and pays out $5 million in interest payments on its debt and $5 million in dividend payments to the preferred shareholders. It is left with an adjusted net income of $15 million and total equity of $100 million, so it has an ROE of 15%.

Return on investment (ROI): Return on investment is the profit earned on funds put at risk. If you buy 100 shares of a stock trading at $10, and it rises to $12, you have an ROI of 20%.

Return on invested capital (ROIC): Return on invested capital is the profit earned on all sources of capital contributed to the company. Going back to the ROE example, the company has a total capitalization (equity + debt + preferred stock) of $250m. There are various ways to measure return on invested capital, but one of the simplest ways is to take net income and divide it by total capitalization. So if this imaginary firm brings in $25m in net income, it has an ROIC of 10%. Although slightly more complicated, we prefer to calculate ROIC using net operating profit after taxes (NOPAT) in the numerator.
See also: NOPAT, return on equity.

Rho: One of the five "options Greeks" (delta, gamma, rho, theta, and vega), this indicates an option's sensitivity to changes in short-term interest rates. Option premiums get more expensive when interest rates go up.
See also: Greeks.

Rolling forward, out,up, or down: A follow-up action in which you cover (or sell) an option you originally sold (or bought) and reinitiate that position at a different strike and/or expiration. "Rolling forward" (also called "rolling out") involves closing options that expire in the near term and opening options with longer-term expirations. "Rolling up" involves closing options with a lower strike price and simultaneously opening new options at a higher strike price (while maintaining the same expiration). "Rolling down" involves closing options at a higher strike price and simultaneously opening new options at a lower strike price.
See also: cover.

Sell to close: The brokerage command to exit an option contract in which you originally bought ("buy to open") the put or call.
See also: buy to close, close, cover.

Sell to open: The brokerage command to enter an option contract in which you intend to write (a.k.a. sell) a put or call.
See also: buy to open, open.

Spread: Any option strategy in which you buy and write ("sell to open") options of the same type (call or put) on the same underlying stock.

Straddle: A direction-neutral options strategy consisting of a call and a put with the same strike prices and expiration date. It profits from a large move, up or down, in the underlying stock.

Strangle: Similar to a straddle (a strategy consisting of a call and a put with the same expiration) but with different strike prices. It profits from large moves, up or down, in the underlying stock. A strangle is cheaper to set up than a straddle but requires a larger move in the underlying stock to become profitable.

Short: Having an obligation position in a stock or option. When you go short a stock, you're borrowing the asset, selling it, and hoping to profit by buying it back at a lower price. Shorting a stock reflects a bearish outlook. In an options context, it reflects the writing of options. In *Motley Fool Options*, we often pair our short options with our long options. For example, in a bull call spread, you are long one call at one strike and short another call at a higher strike. Despite having one short leg, it's still overall a bullish position.
See also: bullish, bearish, long, neutral.

Strike: Also known as the "exercise price," this is the price at which the option holder can buy (in the case of a call) or sell (in the case of a put) the underlying stock.

Synthetic: A way of using options, sometimes in conjunction with long or short positions in the underlying stock, to mirror the profit and loss potential of a different position. For example, a synthetic long can be created by buying a call and selling a put with the same expiration dates and strike prices. The profit payoff on such a strategy is identical to that of simply buying the underlying stock at the strike price; however, in a margin account the cost to establish the position is considerably less.

Synthetic Covered Strangle

A synthetic covered strangle is a variety of Diagonal Call. It's a 3 legged trade. We buy a long-term ITM call, and a short-term OTM Call AND finance it with a long-term ITM Put. Essentially it's a Synthetic-Long we have covered with a profitable call. It's useful when the stock is reckoned to rise over the next long time period (we're very bullish) as Synthetic Covered Call leverages capital at risk.

Here is a a live trade example using Microsoft from the Options team:
Set up a synthetic covered call on microsoft

Synthetic-Short

Some prefer a real single malt.

A Syn-Short is just like directly shorting the stock. But here you sell naked calls and buy puts at exactly the same strike price. Hopefully for a small net debit or even a net credit.

There's a great introduction here : http://newsletters.fool.com/50/optionsu/advanced/synthetic-shorts.aspx

And here's a Syn-Short in action: PRO: Set up a Synthetic Short on CurrencyShares Euro Trust

Syn-Short

Here's an insight from Aleax on the boards:

Q > I'd like to set up a syn-short but I am worried about the 'naked' unlmited loss. Should I short directly instead?

A> The upside and downside of a syn-short are exactly the same as for an outright short (net of "trading friction" aspects: a syn-short owes no payments in lieu of dividends nor shorting-fees, but options commissions are higher and bid-ask spreads wider; many of the hoped-for gains from a syn short [those due to the purchased put leg] can be taxed as long term capital gains if the position is held for > 1 year, while the outright short is always subject to short term rates [as is the short-call leg of the syn-short]; I think that's about it for trading friction aspects).

So you should be worried about the syn-short if, and only if, you would be exactly as worried about the outright short.

Tax-wise you prefer larger gains on the put leg and smaller ones on the call leg; so from this POV you want the syn short strike to be high (if you do close for gains in > 1 year, you'll have more money in your pocket, after taxes). This costs more money up front to establish than a syn short with a strike ATM or lower than ATM; but less ongoing purchasing power for maintenance margin. Also, the way-OTM short call stands hardly any risk of premature assignment.

Of course, if you set your strike so high that writing the call gives you, in your opinion, too little money to bother, you might omit writing the call (and thus avoid the theoretically unlimited risks) and turn it into a simple deep-ITM put purchase;-). (If the call would have too little TV to bother writing, the put will have too little TV to worry about buying it, either;-). Aleax

Also see Aleax's longer response to question Are there disadvantages to Syn-Long v. owning the stock ?

Theta: One of the five "options Greeks" (delta, gamma, rho, theta, and vega), this measures an option's sensitivity to time, or how much the option price decays per day.
See also: Greeks.

Time decay: The reduction in an option's value through the passage of time.
See also: theta.

Time spread

A strategy (also called a horizontal spread) with two or more legs from different expirations. Calendars and diagonals are prime examples of time spreads. A calendar involves buying an option in one expiration and, at the same time, selling that same strike in a different expiration. Strictly speaking, a diagonal is a time spread but *not* a horizontal spread.

Time value: The premium that the market is willing to pay for the potential upside of the option until expiration. Its value accounts for beneficial unknowns and volatility until expiration. For a tradable option, deduct intrinsic value from the trading price to arrive at time value. Options are wasting assets, meaning time value declines as expiration draws closer.

"Time Value" is vital in understanding options. Jeff Gilles gives a graphical introduction in "Video: The Value of Time"

See also: intrinsic value, time decay.

Uncovered:*See: naked.*

Underlying: The stock being bought or sold at the expiration of the option contract. Since stocks are pieces of businesses, it makes sense to understand that business, its valuation, and its prospects before overlaying options strategies on them.

Vega: One of the five "options Greeks" (delta, gamma, rho, theta, and vega), this indicates an option's price sensitivity to a change in volatility. Higher volatility makes options premiums more expensive.
See also: Greeks.

Vertical spread:

A strategy using two puts, or two calls, with the same expiration but different strikes. A bull call spread is a type of vertical spread.

See also: bull call spread.

Volatility: An estimate of the amount that the underlying stock's price is expected to fluctuate in a given period of time. Generally, volatility is measured by the standard deviation of the continuously compounded returns of the underlying stock.

Write: To sell an option contract. We prefer to use "write" when referring to selling an option contract in general, but specifically this refers to selling a *new* option contract. The option seller is referred to as the option writer.

Wing spread:

A strategy constructed from the combination of a pair of spreads that profits most when the stock does nothing. A trader could also construct a so-called "broken wing" spread, where one side has a slight bias. Butterflies and iron condors are good examples of wing spreads. They're referred to as such because, if you were to make a profit/loss diagram, the center has a kind of body shape (where the profit is if the spread is sold, or where the loss is if the spread is purchased), and the sides have a vague wing shape to them.

Questions about Options

FAQ from Pro Members answered by Pro staff and members

Question on Option Strategy with helpful reply:

I am still trying to figure out how to play leading company in high growth emerging market segment (enticing premium in exchange for high volatility)...

I see Jeff has provided an official answer and of course that's much more meaningful than my opinion (as I'm an amateur) but I think I'll offer that opinion anyway.

I've been well served over the years by a mixed strategy on such names -- build up (ideally buying on dips, of course, but in a very buy-and-hold mood anyway) a maybe-slightly-underweight position to never be touched again until it's a multi-bagger or the investment thesis sours; *on the side*of this core position, accumulate a somewhat smaller "trading position" meant for short- to mid-term profitable trading -- buy low, sell high.

Options help for the latter objectives (write puts on slight dips when trying to beef up the trading position rather than wait for deep dips; write covered calls on slight rallies when trying to whittle down the trading position rather than wait for steep rallies) though one could also just buy and sell shares (writing options can be more profitable when the market's implied volatility for the name is exaggerated compared to your assessment of what realized volatility is going to be).

Optimal duration to expiration for the written calls on the trading position varies, but they won't be all that long term (you want time value to erode, and it really doesn't erode fast at all for too many months if you write, say, 6-months-out or longer) and usually not too short-term to avoid excessively enriching your broker via commissions and the market makers via bid-ask spreads (the exception, where really short-term trades are warranted, is when you judge the market is badly mis-evaluating an impending event such as an earnings call or forthcoming relevant legal or regulatory decision).

As I said, this mixed approach is what overall tends to work out for me -- not every time, of course!, but often enough to keep me in the game.

For example, that's why I wrote calls on only half of my DDD shares -- I mentally re-tagged half the shares as a "trading position" and the other half as a "buy-and-hold position", so as to have my cake and eat it too.

Warning: whether this approach is psychologically tolerable to you depends on your character -- I have a sunny disposition so I tend to see the outcome of mixed strategies mostly in a "could have been worse!" [if I had picked the wrong pure strategy] mood, but if you know that your own reaction would mostly be a sour "could have been better!" [if you had picked the right pure strategy], then they're better avoided.

BTW, I'm kind of glad that my 5000th post comes on a subject where I have definite (though amateurish) experiential-based preferences that are pretty far from the mainstream -- at least this way the post should be interesting (perhaps controversial), compared to one where I just reaffirmed a broadly held opinion I agreed with, no?
-) Aleax

What are the disadvantages of a Syn-Long v. owning Stock ?

Question:

You give pros and cons for alternatives with the exception of synthetic longs. What is the "con" of this approach?

If there is no con, only pros, why does anyone buy stock?

Reply:

The disadvantages of a syn-long compared to outright stock purchase are as follows. TL;DR: there are plenty -- beware!-)

(1) You're constrained to multiples of 100 shares (except on the few stocks that now offer mini-options, in which case, multiples of 10 shares can be held) -- with stock

purchase you can size your position more precisely and adjust it as you go.

(2) Fees, commissions, and, crucially, bid-ask spreads (i.e, all components of "trading friction"), are much higher for options than for shares. No big deal if you want to buy today and hold for almost two years, but anathema for more frequent trading.

(3) Taxes can work for or against you, but for a typical syn-long (established ATM) it will be against, if the stock price does rise.

If you buy 100 shares and sell them in Jan 2015, you will have (assuming the stock price did rise) long-term capital gains, taxed somewhere between 15% and 23.8% depending on your tax bracket. (Any qualified dividends you get in the meantime are also taxed at this same rate).

If you buy an ATM Jan 15 call and write an ATM Jan 15 put, and by Jan 15 expiration the stock has risen, you'll have long term capital gains on the call -- but your gains on the puts you write are always treated as short-term, no matter your holding period.

Those gains will be the whole premium you receive today for writing the put, and they'll be taxed at your ordinary marginal rate (up to 43.4% -- don't forget the 3.8% ACA surtax on "non-earned income").

To minimize this tax effect of a syn-long, pick a strike such that the call is deep-ITM (so the put will be deep-OTM and the premium you receive for writing it will be much lower -- since that's the part of your gain that will be taxed more dearly, you want it as low as possible from a tax viewpoint). This does increase the net debit you'll need to pay to initiate the position (i.e, reduce your leverage).

(4) your written put could be exercised at any time (if the stock dips below its strike, and low enough to reduce its time-value to near 0), forcing you (esp. assuming you want to stay in the position) to incur extra commissions and fees. Picking a strike well below the money reduces this risk, as well as reducing your taxes (see [3]).

(5) in a cash account, syn-longs make no sense, since you'll need to keep aside the whole exposure the written put gives you -- i.e, for a typical ATM syn-long, the same amount you'd have to fork over to just purchase shares.

(6) in a margin account, syn-longs are a mixed blessing.

If you buy shares, your purchasing power while you hold them is only reduced by your shares' maintenance margin -- typically 25%; most of your equity in those shares is available to margin other positions, if you wish (i.e, it's part of your account's purchasing power).

Options don't work that way. Your equity in the purchased long call does not help your purchasing power at all. Your liability in the written put does require maintenance margin, typically expressed as "Proceeds of the sale plus 20% of the underlying value less out of the money amount OR proceeds of sale plus 10% of underlying value, whichever is greater" but, beware, "proceeds of sale" actually means current, mark-to-market value of the put.

Suppose for simplicity that the syn long strike is 100 and the share price dips to 70 -- low enough to leave the put with no time value.

If you own 100 shares, this makes your maintenance margin 100 * 70 * 0.25 -> $1,750, so you still have 7000 - 1750 -> $5,250 of your equity in the shares available as purchasing power (e.g to help ensure the maintenance margin for other positions).

If you're long a 100-strike call (which does not matter to margin) and short a 100-strike put, the put's current value will be [at least] 30 (all IV, no TV), the "underlying value" is 100 (what you need to be ready to pay if assigned), and there is no "out of the money amount" (since the put is way IN the money after the dip). So the maintenance margin is 100 * (30 + 0.2 * 100) -> $5,000 -- this *reduces* your account's purchasing power... so, you'd better have cash or outright-owned shares in the account, to keep your overall purchasing power positive -- otherwise, best case, you'll get a margin call (and need to urgently inject more cash into the account and/or liquidate positions), worst case, your broker will just liquidate some or all of your positions without even bothering to tell you (I believe only IB, Interactive Brokers, routinely does the latter -- most brokers do pay you the courtesy of a margin call, at least -- but it's still NOT a nice position to be in).

Of course you did have to pay about $10,000 to initiate the outright all-cash share purchase, but still, under a bad dip like the above, the net effects on margin and purchasing power are even slightly worse for the syn-long than for the share purchase. People new to syn-long may not think in term of margin because they incur no margin *debt*, but, beware, you DO risk a margin call (at best!) if you have a syn-long and fail to keep ample cash in the account (or plenty of outright-bought shares to provide purchasing power to cover your maintenance margin).

(7) it's a highly leveraged play -- don't let the fact that you're not incurring margin debt and paying interest on it fool you into ignoring the sheer fact that you ARE leveraging (a lot, if you use an ATM strike -- or worse, an OTM one -- for your syn-long; less if you choose lower strikes, committing more cash up front). When all is said and done this will amplify your gains, if gains you have, but it will also amplify your losses, if losses occur. So, be wary about position sizes in syn-longs, especially on more volatile stocks! If you would normally buy a position size of 500 shares, with a syn-long it might be more prudent to go for 4 contracts, or maybe even just 3 if the stock is very volatile. Yes, this does reduce your potential gains if all is shiny -- but it reduces your potential losses just as much.

I'm sure I've forgotten some issues, but I hope I've highlighted enough to cause readers to do careful due diligence before embarking on syn longs. Remember the key idea with options trading (and most everything else in life): TANSTAAFL -- "there ain't no such thing as a free lunch". You're wise to dig for down-sides BTW, and I hope I helped.

Me, I don't do syn-longs -- if and when looking for a stock ownership substitute, I buy deep-ITM LEAPS calls instead, if I can find a strike that's liquid enough to not kill me with wide bid/ask spreads yet have very little time value (today's very low implied volatilities help;-).

I only get a few of the above down-sides (e.g, higher commissions, fees and spread-related trading friction -- but I did mention that usually matters little [unless the spread's ridiculously wide] when intending to hold for a reasonably long time; no buying-power help -- but then I use margin only very lightly and prudently anyway). And I do get one key extra advantage: limited worst-case losses compared to either outright share purchase or syn-longs.

After all, to reduce tax hits and risks of premature assignment, as I mentioned above, one should aim for a strike way below the money even when establishing a syn-long. But -- at such a strike, the written puts pay very little. So why even bother writing them, thus incurring (albeit to a limited degree) all of the above down-sides, and NOT getting the "limited loss" effect should the company go bankrupt overnight? Just buy the deep-ITM call and be done with it... at least, that's what I do, myself!-)

Similar reasoning can be applied to syn-shorts when you're bearish on a stock -- except that the plainer alternative of outright short sale comes with plenty of baggage of its own (which the outright purchase of shares, and the option positions, don't); so I do use plenty of syn-shorts (though sometimes I just buy a deep-ITM put instead, if and when I can find a narrow-spread, very-low-TV one;-).

Which reminds me of one special case where a syn-long would be very attractive (in theory -- haven't actually done that): when you're bullish on a stock that's so heavily shorted put/call parity breaks down, so premiums on puts are stellar compared with ones on calls. In such a case, "buy low, sell high" sure looks attractive, and that translates to a syn-long (typically a split-strike one). But, this post is already too long, so I'm not going to harp on that special case!-) Aleax

Which Account Do I Use for Options?

(a very helpful post from VelobiciOptions)

> Well, there is more than one opinion regarding which type of account is best for writing covered calls and puts.
>
> One reason options have a bit of a reputation for danger, is that it is easy to lose track of how much money one is committing when writing puts. In a taxable account, one can write a put and the "buying power" decrease by a fraction, often 30%, of the amount of money required should the put be assigned. In an IRA, that is not an issue, all puts are fully cash secured and the reported "buying power" decreases by the amount of money required by assignment. In that way using an IRA account is much safer....its just not possible to get over-extended when writing puts. So, you might want to start with paper-trading, then use an IRA account, and lastly a taxable account.
>
> That said, there are certain types of positions that dont work well in IRA accounts:
>
> | **Position Type** | **IRA Account?** | **Taxable Account** |
> |---|---|---|
> | **Sell Naked Calls** | No | No (1) |
> | **Sell Covered Calls** | Yes | Yes (2) |
> | **Sell Puts** | Yes (100% cash) | Yes (margined) (3) |
> | **Sell Strangles** | No (see note) | Yes (4) |
> | **Sell Straddles** | No (see note) | Yes (4) |
> | **Buy Bull Call Spreads** | Yes | Yes (2) |
> | **Buy Diagonals** | Yes | Yes (2) |
> | **Buy Synthetic Longs** | No (see note) | Yes (5) |
>
> (1) Motley Fool Options, and as far as I know Motley Fool Pro has never written naked calls
>
> (2) In both cases the stock, or purchased call, secures the call and the profitability is the same
>
> (3) IRA's are not marginable, so 100% of the cash needed to secure the put is set aside within the account for the life of the put. Taxable accounts allow the use of margin and do NOT set aside 100% of the money required, but rather only a portion
>
> (4) Straddles and Strangles combine a sold covered call with a sold put. In an IRA this would require us to purchase the stock and 100% cash secure the put....too expensive. Often the profitability of stangles and straddles is based upon receiving both the call and put premium without having to set aside 100% of the cash required should the puts be assigned.
>
> (5) Synthetic Longs require the purchase of call options which are funded by the sale of put options. In a taxable account, the put is partially funded via margin. In an IRA the put is fully funded, which costs just as much as buying the stock at the strike price. Might as well buy the stock and receive the dividends, if any.
>
> Whew! Well, that's how I understand these at this time.
>
> Please don't be bashful with any corrections or questions.
>
> VelobiciOptions

Moosie's Option Spreadsheets

Spreadsheet page

The spreadsheets are just some tools I built, mostly to analyze various option strategies. No rocket science here. They have an embedded Black-Scholes calculator. Feel free to change these and make them your own, or use them as a guide to build your own from scratch. Or use them as is.

The charting sheet is a handy way to make profit-loss graphs similar to those Pro includes in the recommendations.

You'll be able to use these in Windows, and Mac, except not Mac Office 2008. v2004 and v2011 work fine. Microsoft left VBA out of the 2008 Mac version.

Strategy Cheat Sheet

This is some documentation included in the optiontradingtips.com spreadsheet. Nice and concise.

MARKET DIRECTION	IMPLIED VOLATILITY: Low	IMPLIED VOLATILITY: Neutral	IMPLIED VOLATILITY: High
Bearish	Buy Naked Puts Bear Vertical Spreads: Buy ATM Call/Sell ITM Call Buy ATM Put/Sell OTM Put Sell OTM (ITM) Call (Put) Butterflies Buy ITM (OTM) Call (Put) Time Spreads	Sell the Underlying	Sell Naked Calls Bear Vertical Spreads: Buy OTM Call/Sell ATM Call Buy OTM (ITM) Call (Put) Time Spreads Buy ITM (OTM) Call (Put) Butterflies Sell OTM (ITM) Call (Put) Time Spreads
Neutral	Backspreads Buy Straddles/Strangles Sell ATM Call Or Put Butterflies Buy ATM Call Or Put Time Spreads	Do Nothing	Ratio Vertical Spreads Sell Straddles/Strangles Buy ATM Call Or Put Butterflies Sell ATM Call Or Put Time Spreads
Bullish	Buy Naked Calls Bull Vertical Spreads Buy ATM Call/Sell OTM Call Buy ATM Put/Sell ITM Put Sell ITM (OTM) Call (Put) Butterflies Buy OTM (ITM) Call (Put) Time Spreads	Buy the Underlying	Sell Naked Puts Bull Vertical Spreads Buy ITM Call/Sell ATM Call Buy OTM Put/Sell ATM Put Buy OTM (ITM) Call (Put) Butterflies Sell ITM (OTM) Call (Put) Time Spreads

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Wiki: VXX

Published Oct 2, 2011 at 12:00AM

Double-click anywhere on the below text to make your edits!

On This Page

VXX in a Nutshell (10/2/11)

Jeff writes,

> I hope to go through the posts since yesterday and answer what I can soon, but for now, I'm hoping to sum up VXX in a short post:
>
> Thesis: VXX would lag any jump in the VIX considerably, by as much as 50%. So, even if the VIX spiked, VXX's gains would be modest by comparison -- though it could double or more, as we said -- and we could ride it out. It's a fairly "perfect" short in that VIX can only go so high and is guaranteed to come back down eventually. Like any investment, that could take a few years, but rarely takes more than 6 to 12 months with the VIX (historically).
>
> Support: Attending the CBOE Risk Management Conference, VXX was the butt of many jokes. Barclay's nearly apologized for launching it, saying they nearly shelved it, but ultimately launched it because there was such demand. They said they knew contango would steadily destroy its price, but that it would hedge about 50% of the jumps in the VIX on average. And that's better than nothing. So everyone, including us, I think missed the degree to which VXX could potentially perform under certain circumstances. Clearly the market missed it or the calls would never have been so cheap (in hindsight).
>
> Realization: This is the first time we've seen a serious VIX crisis since VXX started trading. In it, VXX is performing much better than even its creator suggested. It is up more than 100%, more than the VIX itself. The quick realization is that if the VIX spikes very quickly and stays up for a long time, the power of backwardation can persist and be a strong tailwind behind VXX.
>
> Where we stand: In other words, the original thesis has to be thrown out. VXX will not *always* just gain on average 50% of the gains in the VIX. During short spikes, it has. During long spikes that stair-step higher, VXX can start to gain even more than the VIX. So, it can gain as much or more than the VIX during the worst of VIX spikes. Once this reality started to be realized (and it all happened quickly), we set up the bull call spread to help wait out backwardation and make something on it. (Even so, a sudden drop in fear could cause the VIX to drop sharply and make such hedges useless. There's no way around it: volatlity positions will be volatile. Because volatility is caused by emotion as much as anything.)
>
> What to do now: If you're short VXX (as I personally am) or short VXX calls, consider hedging it with long calls or bull call spreads as long as backardation persists so strongly (we'll be tracking it daily here in the VXX Daily Log post). If you can't stay short VXX (just as we can't in Pro), then close it (we have no choice anyway) and then together we'll aim to set up a new position assuming 1) it looks good 2) we want to. I strongly believe we will set up a new position. I just don't know if it'll happen in days, weeks, or months.
>
> Bottom line is we have new information on how VXX can behave. If we could stay short, and if all members could stay short, we'd just hedge 50% to 100% of our short VXX position to ideally profit on the hedge as VXX rises, and then remove the hedge when we think VXX is ready to start declining again. Since

we can't stay short, and given that VXX is in backwardation, and given what we've learned just the last few weeks, we want to reassess to try to find the best way to approach the position again (again, assuming we want to; which I think we will).

Final context: if today's fear was caused by something else (like a nuclear reactor meltdown, for instance), there's no way we'd have the same concerns as we do now, because that fear would subside and backwardation with it. However, today's fear is caused by much larger, much longer-running concerns (and they're being decided by politics, which are extremely uncertain -- some politicians would even like to see things get worse before they get better, so they can gain power). Given the nature of the problems right now, fear or uncertainty could persist a long time. Nobody knows, but VIX could see 60 again if things don't get better. Even if VIX doesn't rise, backwardation could stay for weeks or months. So, we'd want to hedge the short at this point; and if we're forced out, we want to consider the best way to get back in given all of the context (some of it new) surrounding it in this instance.

I have to run. Sorry for the hasty post.

Best,

Jeff

P.S. VXX is actually proving, in this case, to be a very good hedge against a very big crisis of confidence. Store that away in your mind. If the VIX is in the mid-teens it can't go much lower (well, it does touch 8 or 9 sometimes); VXX may actually be a hedging tool at those levels that responds much more strongly than a drop in the market. The S&P is down about 14% and VXX is up 110%.

P.P.S. Another Fool asked why Charter should have to close VXX just because Port 2011 is. It's not an easy choice, I know, but really we want everyone on the same page as much as possible, and the portfolios are supposed to mirror one another. And plus we assume Charter will be called on its shares very soon, too.

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Daily VXX Log (10/1/2011)

Jeff writes,

Greetings,

In this thread, I'm going to post the daily close for VIX, the two-month VIX futures (that VXX uses) and VXX -- so we have a running log and can track how it behaves day by day under backwardation and, later, contango.

```
So, on 9/30/11:

VIX 42.96 +10.6%

VXX $53.37 +7.0%

S&P 500 -2.5%

Oct Futures 42.10 +3.50 +8.3%

Nov Futures 37.75 +2.45 +6.4%

1-month backwardation: 10.3%

Oct Futures expire 10/18

Nov Futures expires 11/15
```

==========

How soon will we enter the short VXX position again? Again, it depends on what comes our way. It could be days or it could be weeks. I'm personally sitting on my direct short that I've had for about a year with TD Ameritrade. I may hedge it with some calls while backwardation persists (so if I don't post on the VXX board for four days, I've made a trade and need to wait; I'll ask Nick to post the daily log), but I plan to continue to keep the short for the long term. Priorly, I planned to keep it indefinitely, but now I would plan to close it once VIX persists in the teens, and then wait for a spike at some point to short it again.

I agree with other points recently made here that VXX could go higher before it starts its long grind down along with the slowly unwinding fear of the market. This would be due to backwardation and also the slow-moving nature of European politics, and the especially combative (rather than productive) nature of U.S. politics, precisely at a time when we need smart collaboration. But isn't that what renders a nation apart? The very fact that when the stakes are high, so is the in-fighting?

Meanwhile, I've hated the dual experience that I've had with VXX. Holding it short myself after Pro couldn't put on that same position has produced close to zero stress the past year. Trying to emulate that position in Pro with options has eventually led to a small disaster (we will recover, but some of us will probably live a few years less now -- and no investment is worth that). However, I believe that with persistence we will make good on the investment, and in the coming weeks or months when volatility starts its long grind down, the gains should be relatively "easy" to make on VXX. Will it happen for certain? Usually I'd say yes, of course volatility will steadily subside with time. Right now, though, I'll say it may take longer than we think, and we may see even higher VIX prices first. I mean, either Europe and the U.S. will start to get their houses in order, or we may be headed to a major financial calamity. So, as much as I hate to say it, politics are key to our future now, more than ever.

Keep in mind that shorting VXX should afford plenty of time for profit, because it moves on the futures of the VIX, and the futures are -- as we all know -- trading at a discount to the VIX. So, even when the VIX starts to decline, the futures and thus VXX should decline a bit less for now with backwardation in place, affording us ample time to put on a position. However, depending on how large any fianncial/political shocks are in the coming weeks, VIX could be elevated a long time. From October 2008 until March 2009 the VIX stayed above 40. That's partly why I suggest those who are staying short VXX hedge it with bull call spreads or simply buy calls. As long as volatility is elevated, the calls will hold decent value, and you should be able to close them and recoupe some of your cost if it turns out you don't need them.

So, here begins our daily VXX log -- with an eye on getting back into the short in a way that will work for Pro and members who can't be short directly, taking into account all the dynamics of this position and the current "fear-trap" that the VIX and its futures are in right now. I'll make each daily post in this same thread so that it can be followed as one long threaded conversation.

Best,

Jeff

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VXX Unofficial FAQ (8/14/11)

Rhyssan writes,

Disclaimer: This FAQ is not endorsed by the Pro. It is intended to answer common questions for those who want to do their own trading on VXX.

1. What is the VIX?
1a. Why is trading on the VIX interesting?
1b. Can I buy the VIX directly? What about options on the VIX?

2. What is VXX?
2a. What are contango and backwardation?
2b. Where can I find the prices of VIX futures?
2c. Why is shorting VXX an attractive trade?
2d. What are the dangers of trading VXX?

3. What is XIV?
3a. Why is XIV an attractive trade?
3b. What are the dangers of trading XIV?

4. Which is better, shorting VXX or buying XIV?
4a. I don't like shorting VXX, what are my other options?

5. How important is understanding margin?
5a. How do I determine my risk?
5b. How can I do this trade and be completely safe?

6. My short position has been forcibly closed by my broker! What can I do?

7. The VIX just went up, but VXX went down! Is something wrong?

1. What is the VIX?

This article hits most of the common questions about the VIX:

http://vixandmore.blogspot.com/2008/04/ten-things-everyone-s...

You can display graphs and current pricing of the VIX using the ticker "^VIX" on finance.yahoo.com. There is no way to display the VIX on finance.google.com [and if anyone finds a way, please let me know!].

1a. Why is trading on the VIX interesting?

Historically, the VIX has always reverted back to the mean, usually (but not always) in a few months or less. Therefore, one can theoretically expect that betting the VIX will drop when the VIX is high will eventually be profitable.

The challenge is to stay solvent while waiting for that bet to play out.

1b. Can I buy the VIX directly? What about options on the VIX?

You can't buy or sell the VIX directly. Options exist on the VIX, but they are cash-settled European style options. Make sure you understand how European style options work before trading them.

2. What is VXX?

VXX is an ETN that mimics holding a mix of 1 and 2 month futures on the VIX. Each trading day it pretends to sell a portion of its near month holdings and use the proceeds to buy more of the next month future contract.

2a. What are contango and backwardation?

Contango and backwardation describe the shape of the futures curve. If the second-month future (the future expiring two months from now) is priced higher than the near-month future, the contracts are in contango. If the second-month future is cheaper than the near month, the contracts are in backwardation.

The VIX futures are normally in contango (prices in the future are higher, representing uncertainty). During a spike in the VIX, they are normally in backwardation (the market "knows" the VIX mean reverts, and therefore expected prices in the future are lower).

The contango or backwardation that we care about is on the near and second month futures, since those are the futures that are held by VXX. If the futures are in contango, then the monthly loss to VXX due to contango is simply (second_month - near_month) / (near_month)

http://boards.fool.com/1228/contango-is-increasing-steadily-...

2b. Where can I find the prices of the VIX futures?

http://cfe.cboe.com/products/Products_VIX.aspx

In the upper right corner, the VIX is listed first. The next line down is the near month futures contract. Each line after that is one month further out.

2c. Why is shorting VXX an attractive trade?

As one can see from looking at a graph of VXX's past performance, contango eats steadily away at the long term value of the fund. By shorting it for the long haul, one can take advantage of that steady drain on its value. Additionally, by shorting VXX when the VIX is high, over the long run both contango and mean reversion should help the trade be profitable.

http://boards.fool.com/1228/standford-to-expand-on-bills-ans...

2d. What are the dangers of shorting VXX?

i) Backwardation - during a spike in the VIX (theoretically the best time to take advantage of mean-reversion) backwardation can be very damaging.
ii) Margin - short positions require margin to hold. If the VIX/VXX spikes further than expected, margin calls can easily result. Likewise, brokers can change margin requirements, forcing a short position to be closed early.
iii) Psychology - VXX short positions that are timed badly can move heavily and rapidly in the wrong direction. This can cause very large paper losses that might be difficult to cope with.

Closing a short VXX position early (voluntarily or not), after it has moved heavily in the wrong direction can cause huge realized losses, far out of proportion to the theoretically possible profit.

3. What is XIV?

XIV is an ETN that attempts to perform as the inverse of VXX.

3a. Why is XIV an attractive trade

Going long XIV mimics a short VXX position, but without requiring margin. This removes the threat of a margin call, as well as allowing the trade in an IRA. This makes it a very attractive alternative to shorting VXX.

http://boards.fool.com/1228/xiv-backtesting-results-29188316...

3b. What are the dangers of trading XIV

Just like a short VXX position, XIV can suffer significant losses in an extended period of backwardation. There is also tracking error (XIV is a relatively new fund, so exactly how the tracking error behaves under different circumstances isn't yet fully known). Additionally, XIV is an ETN, so there is counter-party risk (if the bank that issues XIV goes bankrupt, XIV could go instantly to zero). Lastly, if the VIX made a huge spike upwards in a single day, XIV could theoretically lose so much value that it would never recover.

4. Which is better, shorting VXX or buying XIV?

There is no right answer. Neither is without risk. Both have advantages. Some in the community are using XIV for tax-deferred accounts and VXX shorts in taxable accounts, but this by no means universal.

http://boards.fool.com/1228/xiv-vs-vxx-29046993.aspx

4a. I don't like shorting VXX, what are my other options?

Each of these is likely a topic unto themselves, as they all have advantages and disadvantages. But here is a brief list of possible trades to consider:

- Shorting VXX directly
- Synthetic VXX shorts (Cons: limited time frame, friction costs. Pros: no risk of forcible closure.)
- Buying XIV
- Naked VXX calls (Cons: full risk, limited return, easy to accidentally overweight. Pros: Pro favors them, usually easy to roll defensively.)
- Very wide VXX spreads aka naked calls with deep OTM protection (Cons: less profit, potentially difficult to take defensive action if the entire spread becomes buried. Pros: quantifiable risk.)
- VXX or VIX spreads (Cons: high risk of full loss, difficult to take defensive action. Pros: tradeable in IRAs, high returns,)
- buying VXX or VIX puts (generally frowned upon, since huge premiums during a spike make decent returns difficult)

http://boards.fool.com/1228/protection-strategy-for-short-po...
http://boards.fool.com/1228/i-am-able-to-short-200-shares-at...
http://boards.fool.com/1228/due-to-account-restrictions-i-co...

5. How important is understanding margin?

Really really **really** important. Unless you fully understand the margin formula, you cannot determine how large of a short VXX position (or naked VXX calls) you can support. Naked options will rapidly increase their margin requirement as they move from OTM to ITM. Minimum margin requirements for options are set by the CBOE, but individual brokers are free to set more stringent requirements. Also be very aware that brokers can change those requirements without notice, typically at the worst possible time.

Guessing or estimating the margin requirements is not advisable, especially when calculating them out is quite easy:

http://boards.fool.com/1228/i-remember-a-post-a-while-back-a...
http://boards.fool.com/1228/i-guess-it-is-technically-about-...

There is a margin calculator here:

http://www.cboe.com/tradtool/mCalc/default.aspx

However, it only calculates the initial margin (although you can play with the "current" price to estimate maintenance margins). It also only calculates the CBOE minimum, which might not be what your brokerage uses.

5a. How do I determine my risk?

Based on simulations by dangerscott and bdyer64, if VXX had existing during the 2008/2009 spike in the VIX, it would have increased about 4x-5x from its starting point. One could therefore assume that a 5x increase of VXX from its low point might represent a good guess at a theoretical max, and then calculate out margin requirements for all VXX short positions accordingly. Given the difficulty of estimating the loss of Buying Power due to potential decreases in long positions, action by brokers to increase maintenance requirements, and other unknowable factors, this can only ever be a guess.

http://boards.fool.com/1228/lets-assume-i-have-an-account-wi...

5b. How can I do this trade and be completely safe?

Sticking to buying XIV and using spreads will prevent an unexpected margin call, but realize that this may cost some potential profits and/or increase the risk of a total loss of investment. There is no way to be sure that the trade won't fail and all money invested will be lost.

Ultimately, although going short VXX (in whatever fashion) is an attractive trade that seems likely to do well, there is no "free money" or "sure thing" here.

6. My short position has been forcibly closed by my broker! What can I do?

If you still believe in the trade you can replace it with a synthetic short, probably using the longest-dated options available. You'll typically pay significant frictional costs (several dollars per share).

7. The VIX just went up, but VXX went down! Is something wrong?

No. It happens a lot, especially when the VIX changes direction sharply. VXX is based on the VIX futures, not the VIX. And the VIX futures don't always move in the same directly the VIX does.

Credits: Everyone. Seriously, this FAQ is not in any way my original work; most of the information is drawn from many posts from a wide variety of authors. Generous contributions of time and effort from many people make this community what it is; trying to name them all would probably take more time than putting together this FAQ.

dangerscott Section

dangerscott knows a lot about the VXX !

Q > I'm curious, why do you use a long call that's higher than your short calls? I ask, because my experience with calendar spreads usually involved a lower-priced, further-out, long call and then selling a series of higher priced, short calls against the long call. Since your strategy seems at odds with my experience, I'm trying to wrap my head around the logic/math of it.

dangerscott > VXX is not a normal stock, it is expected to decline over time so you don't want to spend too much buying an in-the-money long call. The long call's main purpose is as insurance against a VXX spike. It has a second purpose to reduce margin usage on the sold short calls. For that reason, I keep the strikes fairly close.

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Wiki: The Pro Portfolio

Published Oct 2, 2011 at 12:00AM

None

Wiki: Welcome

Published Oct 2, 2011 at 12:00AM

Welcome to the new *Pro* wiki — a work in progress, but one we hope you'll find helpful. We want this wiki to serve as a "real-time" repository for ideas and information ... and to that end, we invite you to add your ideas and information! The pages in this wiki are editable by members; just double-click on the text to make your edits. (Try it out below.)

Begin editable content

{double-click here to add your own commentWOW!!

Hi New Members! The Wiki is cool. But it is a work in progress, driven by members. To ge up to speed with Pro on your own pace, follow your Welcome emails, your Getting Started steps, and watch the Monday Memos and coming trades. We'll map it all out for you. -Jeff Fischer

Get Started

Add your own content straightaway!

Click on links on the right-hand side of this page >

err..this is 3rd-party software "doowikis". It makes formatting a little hit-and-miss. It's better to have information that not have it. One day there'll be a google-style search engine :) Best thing to do is just copy and paste stuff up here in the first place - Member insights especially. Don't worry too much about formatting :)

Wiki Talk

There's a discussion board Wiki board

Here's a few usage ideas from TMFMoosie and a lot of people have put up their ideas here

Discussion about the "Structure" of the Wiki .. and ideas here

Discussion of Wiki "Best Practice" if any needed e.g. "attribution"

Questions

{double-click here to add your own Q}

ANON> can I post anonymously or **do I need to log in?**

JE > No - you don't need to log in.

Ellen > Every user's revisions are anonymous (unless you sign them). The Pro guys and I have "named" accounts that are not anonymous, but members do not.

FS > Q: Am I a god?

FS > A: MUHAHAHAHA OH THE POWER, THE POWER!

? > A2: If someone asks you if you're a god, *you say yes*.

JE > Q - good name Q but I'm not sure you are an actual top-tier God. For that you need the doowiki master root password or something

FS > Sorry for the misunderstanding though Q is a good name :D Hope my edits clarify things. I think was happy to be able sign my contributions.

JE > FS FS! We are like fellow demi-Gods at least.

End editable content

(The only exception is the *Pro* Portfolio wiki page, which is locked so that only team members can edit it.)

Members can edit pages, but not create them, so please tell us which other topics you'd like to see on our new *Pro* Wiki discussion board. We welcome any other suggestions on how to make this wiki better, too. Enjoy!

Wiki: Investment & Taxes

Published Oct 2, 2011 at 12:00AM

Double-click anywhere on the below text to make your edits!

On This Page

TMFMoosie on tax loss harvesting

I don't get too fancy with tax loss harvesting, but I do it when, like Jeff said, it makes sense for other reasons.

I'm chiming in again because if you like to be efficient about this, **GainsKeeper** is a wonderful service. I primarily use them to generate a very correct Schedule D with a single click at year-end. I love that they deal with all corporate actions that affect your holdings, like say a company issues a special dividend, part of which is a return of capital. They address proper cost basis of spinoffs (though I had to "help" them once, by pointing out they had it wrong, and they corrected it right quick).

GK flags wash sales, and points out what they feel are optimal sells from a tax perspective. (I often disagree, because of course taxes aren't my primary concern, but it is helpful nonetheless).

GK has a what-if tool that shows tax effects in your accounts before you trade.

Overall, very nice. I've used them for maybe five years now.

Cheers,
-joe

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About Master Limited Partnerships (MLPs)

The following piece of information was copied from the financial newsletter "Income Superstars" (Issue 28 | February 2013) by Nilus Mattive. I couldn't link it directly, so it's been copied exactly. I thought it nicely summarizes the issues and advantages of the tax treatment for MLPs - brief and easy to understand, yet comprehensive enough to mostly get the picture of what's going on.

Master Limited Partnerships (MLPs) ... should be kept in regular taxable accounts.
Unlike regular corporations, a master limited partnership's income is treated as if it is earned by the partners (i.e. investors) and it is allocated to them based on their individual stakes. The partners also share in any other events that typically affect taxable income such as deductions and credits.
So although an MLP's hefty cash distributions may look like regular dividends, the bulk of the money you might receive is considered a return of capital and NOT taxable investment income.
What does this mean? That much of your distributions are tax deferred — just as if they were ALREADY in a traditional IRA plan!
That's reason enough to keep MLPs out of an IRA. But there's also another reason. It's a long and boring story, but here's the short version: Any amount of income that exceeds $1,000 will be taxable even if the MLP is held INSIDE a taxsheltered account. That's because it will be considered "unrelated business income". And please note that the $1,000 limit is not applied to each individual holding but rather the income you might be receiving from all your MLPs.

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Wiki: North Star

Published Oct 2, 2011 at 12:00AM

Double-click anywhere on the below text to make your edits!

North Star

" North Star" is a new guiding light for PRO.

"*Pro*'s Mission

Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to meaningfully increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years.

***Pro*'s North Star: Inflation + 7% annually**

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward."

Excellent Articles

- Jeff Fischer Introducing Pro's North Star
- and Alex Pape TMFPapester Your Guide to Our North Star
- Your Downloadable Guide to Pro's North Star
- North Star Discussion Board

A North Star Story

Imagine that you are an intrepid soul – perhaps a Viking -- sailing over uncharted waters, striving always to sail due west. The days are monotonous and boring, long hours of rowing, day after day of nothing but ocean and sun.

Then one day, your lookout freezes, then shouts in panic – there is a storm ahead. Soon all can see it, a raging maelstrom of wind and rain, massive beyond belief, spanning the horizons and bearing down on you at speeds you could not match with ten times the oarsmen. There is no avoiding it, no chance to run – you must furl the sails, unstep the mast, and turn into the teeth of the storm, rowing furiously to the rhythm of the drum.

And then it is upon you, and there is nothing but wind -- howling, screaming wind -- and rain, rain that is different than any rain that has ever fallen on land, rain that seems to come from the sea itself, driven at speeds beyond belief. And – there is darkness, deep, abiding darkness, broken only by Olympian flashes of lightning that reveal, for a flickering instant, the mountainous waves all around you.

There are no breaks, no lulls; you understand now why the ancients worshipped, but even more, feared, Neptune and Poseidon. You row like a madman – which you are; no sane man can survive in this raging nightmare. You row for hour after hour, as adrenaline fades and you become so weary that you would almost – but not quite, not yet -- welcome the cool embrace of the depths.

And then, suddenly, it is over, somehow, you have made it through. Almost everything that was on the ship is lost to the sea, including many of your shipmates; you are blown far off course, with no idea of your location or orientation. Your weariness is overwhelming, and beneath it lurks a sense of despair and hopelessness. You are lost . . .

Then the clouds part overhead, and, joyful tears streaming from your eyes, you see the familiar constellation Hellewagen, and there, above the end of the wagon, five times the height of the wagons interior, is fabled leiðarstjarna, the Lodestar – or as we know it today, Polaris, the North Star – the one true star, always fixed in the sky, always reliable, friend to lost sailors. Keeping the North Star dead astarboard, you sail west, no longer lost.

So, my interpretation, {which is of course in no way authoritative**}, is that the North Star is not a target or a destination; it is instead a fixed and steady reference point that allows Pro to steer a course that is straight and true. Should INTC be bought or sold? We do not look merely at its value, or its dividend; we also look at the role it would play in our portfolio, and whether by adding it we continue to sail straight and true, with the North Star on our right - i.e., are we on track to earn the desired return over the long haul?.

And this is kind of an important distinction – the distinction between a guiding reference point and a target – because viewed as a target, the North Star could actually be a problem. Suppose there is a year where Pro's return is only 2% as we enter Q4 – if the North Star is a target, the pro team might be incentivized to take great risks to try to meet the North Star "hurdle." And this would be bad.

Instead, I see the North Star as a long-term guideline that helps the pro team evaluate every holding and every opportunity – the test being, over the long haul, will this investment help us stay on course to meet the North Star objectives?

Now, I recognize that this discussion may not actually be of much help in understanding the North Star, possibly because I am in error in my view of it, and more probably because of the elliptical nature of this post.

But, at a minimum, I expect that this post has achieved at least one thing – it has dissuaded you from ever sailing out of sight of shore!

MCRich

// ** PRO Fools love this story and think it great interpretation :)

My Scorecard

My Scorecard info will go here.

The following is an exhaustive list of all the good things about My Scorecard, and why it is better than some of the other alternatives for listing and tracking stock portfolios, such as Yahoo Finance or Google Finance.

JE > will be v. interested to learn why 'my scorecard' is better than Google Finance. Does it have import/export facilities as well ?

Cham> I am pretty sure this entry needs a large "Sarcasm Warning" attached to it.....the list it refers to looks pretty complete to me! // :D JE

Wiki: Acronyms, Terms, and Slang

Published Oct 2, 2011 at 12:00AM

Double-click anywhere on the below text to make your edits!

Acronyms, Terms and Slang

{JE Feb 2012 - would we be better with jus a single A to Z ? Do we need this category division here? }

- Also see Options Glossary
- Acronyms
- Pro-Specific Terminology
- Terms & Slang

Acronyms

- **BP** Buying Power
- **DCA** Dollar-Cost-Averaging
- **"Greeks"** - see Options Glossary
- **ITM** In-The-Money See Options Glossary
- **OTM** Out-Of-The-Money. We all know that feeling. See Options Glossary
- **VCA** Value-Cost-Averaging

Pro-Specific Terminology

<Tentative caveat by fullofcarp> The following caveat applies to many Pro-specific uses of words: "...and if you don't understand exactly why **that particular** definition is used here at Pro, trust us old-timers, Pro tried a few different ways to deal with this issue during its first couple of years and settled on this one because no wording has proven perfect, but this one seems to work much better than the others."

Buy around price <Tentative definition by fullofcarp> Pro's purchase-price guidance is honest enough to point out that valuation estimates are just that--estimates. Therefore, although it is always better to buy something for a lower price, even if the price rises a little bit (about 5 percent, for example), that doesn't mean that it's no longer a good deal. For smaller-sized companies with less liquidity (Pro doesn't have enough influence to affect prices at a company like Intel or Apple, but many of its recommendations are for much smaller companies), there is often a "TMF pop" immediately after a recommendation and members often complain about not getting into the trade in the opening minutes. Occasionally the price will continue to rise and refusing to pay a few pennies above the "buy around price" will mean that you never make the trade, but often the price will "eventually" settle down, perhaps hours or days or months later, providing patient members with the opportunity to open the position at their desired target price. Hence the purposeful ambiguity of the "buy around price" concept.

Addition by TMFMoosie: Always use a limit order. Set the limit at the most you're willing to pay, *and then forget about it*. The company recommendations at Pro are designed to be longer-term holdings. There's no rush.

Terms & Slang

Bearish Like a Bear. Eating fish and berries. (Delightful! -TMFKabellen)

Beta: A measure of the sensitivity of the price movements of a stock in relation to the movement of the broader market. A stock with a beta of 1.00 will theoretically move 1% for every 1% move in the market. A stock with 20% more or less price volatility than the broader market will have a beta of 1.20 or 0.80, respectively. Beta can be calculated by regressing the historical returns of the stock against the historical returns of the broader market index. (Added by JE from Options Glossary. please change/add)

Bullish Like a Bull in a China Shop (how apt! JE May 2013)

Free cash flow (to the company): Money leftover for creditors and shareholders when all of a company's operational and investment expenses (think equipment upgrades, acquisitions, taxes) have been paid. This figure arguably provides a more accurate picture of the company's profits and financial strength than net income or earnings per share. (Added by JE from Options Glossary. please change/add)

Hedge: An offsetting position meant to reduce the price, volatility, or risk of an investment. (Added by JE from Options Glossary. please change/add)

Historical volatility: The annualized standard deviation of the stock's price changes. Typically, daily price changes are used.(Added by JE from Options Glossary. please change/add)

Limit order: A modification to a brokerage command to buy or sell that allows you to buy or sell at a set price or better. These are particularly useful for illiquid stocks, as well as the option markets, for which there is often limited liquidity. (Added by JE from Options Glossary. please change/add)

Liquidity: Refers to how heavily traded a stock or option is, and usually corresponds to how wide the bid/ask spread will be. A heavily traded stock or option will have lots of liquidity and thus usually a narrow bid/ask spread. (Added by JE from Options Glossary. please change/add)

Long: Having ownership of a security. If you own 100 shares of a stock, you're long the position. If you have purchased a whole mess of puts on something, you're long a whole mess of puts. It can also be a slang term meaning you feel positively about something

Market-maker: Typically, a floor trader on an exchange whose job is to accept bids and offers from other traders — be they big institutional traders or Joe and Jane Optionsmember. The main job for a market-maker is to maintain liquidity and ensure that prices are more or less fair. (Added by JE from Options Glossary. please change/add)

Market order: Typically the default order type for an options trade. It tells the broker to place your trade at whatever price is currently available on the market. Since options are often thinly traded, market orders can be very dangerous, as the bid/ask spread can be wide and a market order will simply buy at the ask or sell at the bid.See also: bid/ask spread, limit order. (Added by JE from Options Glossary. please change/add)

Mid: The midpoint between the bid and ask. When using a limit order, it's often advantageous to set it to the mid — sometimes called "splitting the bid/ask" — and move outward from there if the order doesn't get filled. (Added by JE from Options Glossary. please change/add) See also: ask, bid, bid/ask spread.

Return on equity (ROE): Return on equity is the profit earned on capital that stockholders have contributed to the company. Let's say a company has issued $100 million worth of stock, $100 million worth of bonds, and $50 million in preferred stock. This imaginary company brings in $25 million in profit, and pays out $5 million in interest payments on its debt and $5 million in dividend payments to the preferred shareholders. It is left with an adjusted net income of $15 million and total equity of $100 million, so it has an ROE of 15%. (Added by JE from Options Glossary. please change/add)

Return on investment (ROI): Return on investment is the profit earned on funds put at risk. If you buy 100 shares of a stock trading at $10, and it rises to $12, you have an ROI of 20%. (Added by JE from Options Glossary. please change/add)

Return on invested capital (ROIC): Return on invested capital is the profit earned on all sources of capital contributed to the company. Going back to the ROE example, the company has a total capitalization (equity + debt + preferred stock) of $250m. There are various ways to measure return on invested capital, but one of the simplest ways is to take net income and divide it by total capitalization. So if this imaginary firm brings in $25m in net income, it has an ROIC of 10%. Although slightly more complicated, we prefer to calculate ROIC using net operating profit after taxes (NOPAT) in the numerator.

See also: NOPAT, return on equity. (Added by JE from Options Glossary. please change/add)

Short: Having an obligation position in a stock or option. When you go short a stock, you're borrowing the asset, selling it, and hoping to profit by buying it back at a lower price. Shorting a stock reflects a bearish outlook. In an options context, it reflects the writing of options. In Motley Fool Options, we often pair our short options with our long options. For example, in a bull call spread, you are long one call at one strike and short another call at a higher strike. Despite having one short leg, it's still overall a bullish position. (Added by JE from Options Glossary. please change/add)

See also: bullish, bearish, long, neutral.

Volatility: An estimate of the amount that the underlying stock's price is expected to fluctuate in a given period of time. Generally, volatility is measured by the standard deviation of the continuously compounded returns of the underlying stock.

Wiki: Hedging

Published Oct 2, 2011 at 12:00AM

Topiary Shrubs and Hedges :)

- Useful Hedging Articles
- Hedging
- Questions And Answers

Useful Hedging Articles

- Hedging the Pro Way Excellent article by TMFPapester
  "There are some major positions in our portfolio that we sincerely hope lose money. Lots of money..."

  Alex Pape explains "Hedging Not Shorting" and shows how hedging works within the whole portfolio to produce good returns.

  Alex explains we hedge for 3 reasons:
  1. **Protection**: Hedging can soften the blow to our portfolio if the market tanks, and we can turn those hedged positions into ready sources of cash to deploy in a then-cheaper market.

2. Hedging **smooths returns** and **reduces risk**
3. Hedging helps us **isolate our investing advantages**. We're not market-timers, and we don't have a special edge when it comes to forecasting macroeconomic variables. What we are good at is identifying companies and stocks that will be long-term winners. By shorting broad market indices such as the SPY, we are able to isolate that advantage.

- Pro: Making Volatility Pay Part 2

Hedging

Template by TMFMoosie: who knows nothing! Please fill in details, add topics.

- Holistic portfolio approach
  - Macro hedge requires macro view
  - Mental exercise: start by hedging 100% of the portfolio, so all market movement is cancelled out. What remains is pure alpha of each company.
  - Back off from that, tuning in desired level of protection.
    - Want some up market "lift", sacrifice is some loss on market drop, only partially muted by hedge. No free lunch.
- For insurance, not net profit (welcome the loss, offset by rest of portfolio)
- Sizing
- Correlation
- Vehicles to use
-
  - Flaws
    - Tracking error
    - Obfuscated calculation (VXX anyone?)
    - Shorts are always more complicated than longs (broker call shares, must pay dividends, etc.)
  - Leverage (2x, 3x ETFs)
  - ETF or ETN?
    see also ETF wiki page
  - Specific tickers...

Questions With Answers

Hedging v. Direct Shorting

Fool Pro are also thinking about targeted shorts as well as Hedging.

Jeff:

Yup, I agree, targeted shorts are best, but only once you've really done all your homework; there are some company shorts that are very easy to be comfortable with once you've turned over every stone possible. Those are rare and hard to find, but they're out there.

But Sears was a very popular short (and one I was looking at), and look at this year: it's up $159% from $32 to $82 since Jan. 1. A lot of that is likely a short squeeze. In this market, shorts in heavily-shorted stocks are getting crushed in many instances. But I would have never predicted that move and was looking at it as a possible short more than 100% ago. Research ultimately found it too opaque (its primary owner can pull too many strings).

So, like said, shorts take a long time (for me) to dig into and really become comfortable with. And then when you find them, it's nice, and usually works out. But it sure is a long process for me. And not always fruitful.

I like the idea of shorting flawed ETFs just as much. UNG is one, but there's big tail risk with NatGas around $2.40. FAZ is another. I'm not three-x bearish on financials. Are you? VXX of course once the VIX spikes. Other leveraged ones. We'll get on these or others one by one as opportunities look right.

Best, Jeff

http://boards.fool.com/1228/targeted-shorts-29913950.aspx?sort=whole#29919160

Help! PRO recommendation to short the SPY. Allocation is 30% of portfolio (excluding cash)

Q: "*Aaagh! The Pro Recommended SPY Short is 7% down, I'm "losing" money!! and the market is rising!! Is it time to exit ??*"

> **A**: **Relax**.. read more

Q "*Huh?* PRO *are now recommending reducing the Short of SPY back down to 20%. I thought we were relaxed*."

> **A: Read More. Note Highlights.**
>
> Jeff (back in February 2012) Europe's debt crisis has yet to be resolved, but the U.S. seems to have avoided a double-dip recession for now. That fact has sent the market steadily higher since December. But we are *not* closing one-third of our S&P 500 hedge because we believe stocks will continue to go higher in the near term. We don't make short-term stock market guesses. Instead, we're beginning the process of closing this hedge for a handful of much more tangible, disciplinary reasons:
>
> - Yesterday, this short reached a 9.7% loss for us. In our initial report, we said we'd look to exit if it moved 7% to 10% against us. We simply need to limit our losses, even if we might disagree with the market (many people grow their losses disagreeing with the market).

- Also yesterday, the Federal Reserve suggested that it would keep interest rates near zero for nearly twice as long as previously expected — all the way through 2014. By making money cheap (and punishing savers), the Fed is hoping to increase lending and push people's assets out on the "risk curve" — into stocks and other investments that pay a return. There's at least a chance this will help prop the market up.
- We sold our 5% position in **L-3 Communications** (NYSE: LLL) on Monday, and we're on track to sell our nearly 5% stake in **Ebix** (Nasdaq: EBIX) via February covered calls. We do plan new buys, but as we decrease our long exposure and raise cash, we can dial down our hedges.
- We moved to a new broker last week (Interactive Brokers), so we now have a full new array of shorting possibilities that should serve us better than the SPDR S&P 500 ETF. We plan to gradually move to targeted shorts and continue using options to hedge.

What do do ? Market Timing v. "Easing In"

PRO have recommended shorting the SPY index. Here, a discussion arises about when would be the best market time to close this Short SPY position. 8 % loss ? 10% loss ? There is talk of "Market Timing" which is not generally reckoned to be a Pro Foolish strategy.
Aleax gives an excellent reply and introduces us to the concepts of DCA (Dollar-Cost-Averaging) and VCA (Value-Cost-Averaging)
Q: "*Or otherwise you'd be trying to time the market which you wouldn't do*"

A : Aleax **I don't see "easing into" a position as "market timing"**. The traditional equivalents when building up a long position are the classic and often convenient "dollar cost averaging" and the less well-known, less convenient, but better-performing "value cost averaging".
In **DCA**, you set up a total amount A you're willing to spend in a position, an end time T days from now by which you want to be fully invested, and N, the number of slices you want to use in the build-up; then every T/N days you spend A/N dollars buying shares. The result is to dampen market fluctuations. It's convenient if you have funds coming in regularly and periodically, as many savings plan do.
In **VCA**, you also set T and N, but, instead of A, what you initially set up is V -- the total value you want your position to have at the end of the set-up period (as opposed to the total cost basis, which DCA uses)
So, every T/N days, you look at the current target value for your position; if this is slice I of N, you're aiming for your position at this time to be worth I/N times V -- this is "C", your "current target". Your position currently is actually worth some X which depends in part on how much you've already bought, in part on how the market has been fluctuating. If X is already larger than your C, don't buy anything (in "aggressive VCA", you'd actually sell X - C to bring you down to the target, but I prefer "lazy VCA" where no selling is done). If X is smaller than C, buy C - X more to get you up to the current target.
VCA dampens market fluctuations even further (lazy VCA does so prudently, aggressive VCA, well, more aggressively;-). In many practical real-live situations, it's not as convenient as DCA since you can't predict beforehand exactly how much you'll be spending (your cost basis) and the amount of spend per "slice" on your way to your target; however, it's more effective than DCA when the asset you're buying is trading in a very range-bound way with lots of fluctuations between a lower and an upper bound (AKA "a horizontal channel").
In case you hadn't noticed, SPY's been in a very marked horizontal channel for 10 weeks now, between about 112 and 122 with few small and very temporary excursions outside the channel. Nothing wrong in noticing this pattern and trying to trade with it, rather than against it, is there?
So here we're considering building a short position (one equal to 30% of our long-shares position) so things are a bit different than in the canonical case (of building up a long position) I just outlined.
Shorts act in a way that may be counter-intuitive if you're not experienced with them: they grow to be a larger % of your portfolio when they're performing badly for you (growing in price), and vice versa -- just the opposite of long positions. OTOH, if you have ample buying power (which you will when you're aiming to build a short position that's just 30% of your long ones' total), there's no need to worry about lacking cash to increase a position -- you get cash when you sell shares short (you do need buying power to provide margin for your short position, but I already mentioned why that should be abundant anyway, so, no worry). So DCA has no intrinsic advantage of convenience when compared with VCA for this very peculiar case.
Also, the target is a moving one -- it's "30% of your long position"... and the total value of your long position varies daily (these days it will tend to have high correlation with the market, BTW -- correlations recently have been far higher than historic norms would suggest).
I can find no literature on DCA/VCA equivalents for short positions (much less short positions w/a varying target!) -- maybe exactly because, while DCA and VCA are trading strategies, they're exactly the reverse of what traders want (maximize short-term profits by being lucky in calling the tops and bottoms of the market): they dampen variability. So, I developed my own back-of-the-envelope approach to deal with this situation.
First, I'm assuming the 110-122 channel will continue for a while -- a decisive break-out either way will cause me to reconsider, and switch tactics if I don't have the total desired hedge amount yet.
Given this, I look at the possibility of increasing the hedge size, VCA-like, every time SPY gets close to or beyond 120 -- but if I decide I should, then I do that in a fixed-size small slice, in a multiple of 100 shares (so I'm holding a multiple of 100 at all times and can switch to options-on-SPY if and when that looks best).
Depending on volatility, doing that by writing naked calls just above resistance may be best (weekly options are good for this kind of trading). Vice versa, every time SPY gets down close to 113 or so, I'll consider (aggressive-VCA-like) whether I should trim my hedge's side, maybe by writing OTM "covered puts" just below resistance.
Should Pro recommend some variation of that? Nah -- the potential advantages are truly marginal -- if everything goes perfectly I expect to make maybe 80-90 basis points (of my portfolio) from all of this trading complexity, and that's only because I'm with OptionsHouse so my commissions and fees are truly small; if my portfolio was smaller and/or my broker charged high commissions, every potential advantage would be eaten up by trading friction -- too many small transactions, you see.
Pro needs to make recommendations that are simpler and will work best for the general membership; those of us who have a little bit more trading experience, larger portfolios, and/or better brokers (aspects probably not uncorrelated to each other;-), can presumably fend for themselves (or just get three 10% slices at 10 days' apart from each other to "ease in" in the simplest way -- DCA-like). Getting this position via options is particularly strange and requires your desired position to be several hundred SPY shares short -- as well as being eager to do trades in complicated ways and paying small commissions. I applaud Pro for avoiding any such rec and just doing their own version of simplified DCA/VCA mix to ease into the position.

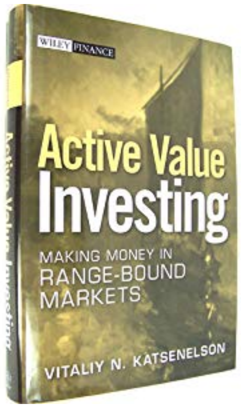
Wiki: Books and Other Media

Published Oct 2, 2011 at 12:00AM

Books and Other Media

Book Review: Active Value Investing (Making Money In Range-Bound Markets) -- Vitaliy Katsenelson

Book Review: Active Value Investing (Making Money In Range-Bound Markets) -- Vitaliy Katsenelson



This is a placeholder. I'll try to write this up in a day or so. (I haven't forgotten -- just busy ;)

-TMFMoosie.

Aleax reply to be edited // JE

I am so glad that I posed the Limit Order vs GTC question. Bob and you have thrown a lot more light on the subject than I thought was needed and I thank you both for it. However,to fortify my defensive poition, is there any book you can suggest that will give me greater understanding of Market Makers and their modus operandi.

There are cheap books (trying to cram in lots of elementary to intermediate option knowledge and maybe some technical analysis to boot and with a cherry on top about market makers), and then there's Larry Harris,http://www.amazon.com/Trading-Exchanges-Market-Microstructur... . $100 list, $60 at Amazon, $54 for the kindle edition (but you really need to read the latter on a PC, Mac or iPad -- the screens of actual kindles are too small), $53 used; 600+ pages of solid information.

It's a textbook (but not dry or heavily mathematical: quite readable actually!), intended as a complete coverage of practical market microstructure issues for, say, an MBA or the like, and covers ALL kinds of markets, not just options ones. Quite an investment of money, time, and energy. But as the top comment says, "I now run a hedge fund. We make about 10,000 trades/day. I wish I had read this book years ago. I've had to pay Mr. Market a large sum to learn many of these lessons".

I would complement it with McMillan's "Options as a Strategic Investment" (even pricier and bigger, both highly mathematical and very practical, and really options-centric of course) which is what all market makers in options have to study to get a job and also THE definitive text on options, but, that's by the by -- McMillan does not give any of the nitty-gritty of market making that Harris covers well!

Till such time that I learn more, I shall stick with LIMIT ORDERS only.

And once you do learn more, you'll use limit orders pretty exclusively: market orders (with the exception of small-ish trades in very liquid securities) are for the birds!-)

Wiki: ETFs

Published Oct 2, 2011 at 12:00AM

ETFs, or exchange-traded funds, are extra-terrestrial investment funds traded on stock exchanges.

- Foolish Use Of ETFs
- ETF Screening Links
- ETF By Category
- ETF A-Z

Foolish Use of ETFs

***Don't* hold inverse and/or leveraged ETFs** for any substantial period, especially in volatile market.

The SEC clarifies why at this URL.

In brief: perfect daily tracking of an index in a leveraged or inverse fund arithmetically *guarantees* mis-tracking cumulating on many-days periods, especially on high daily fluctuations up and down.

E.g. assume SH perfectly tracks the inverse daily result of SPY. One day SPY starts, say, at 100, and goes up 10% that day to 110; then SH, also say starting at 100, that day must go down 10% to 90. Then the next day SH goes 10% down to 99 -- note that 10% up and 10% down (in either order!) do **not** cancel each other out, but end up -1% over the two days together. Indeed, SH goes up 10% from 90 -- also to 99.

The perfect daily inverse tracking ensures that after the two days in question both SPY and SH are -1% at 99. Clearly, this shows that SH is not an acceptable hedge for SPY over longer periods of time, especially under conditions of high daily gyrations up and down.

And indeed in real life look at this graph showing YTD performance of SPY and SH (as to the date of this writing, Oct 18 2011): while apparently the way they move is an exact mirror image, the small cumulative tracking error means that as of close today they're both down -- SPY -3.67%, SH -2.33% (just yesterday it was SPY -2.52%, SH -3.49% for the year to that point -- these *are* volatile times!-). Aleax

ETF Screening Links

Looking for more data and a way to screen ETFs? Barron's highlighted two sites:

- http://www.xtf.com
- http://etfdb.com

I've used **xtf.com** and find the that way it organizes ETFs -- and shows you similar ETFs -- is useful. Best, Jeff

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ETF by Category

- **S&P**
  - SPY - S&P 500 tracker
  - SH - Inverse S&P tracker (Short)
  - IJR - S&P Small Cap 500
  - SBB - Inverse S&P Small Cap 500 (Short)
- **NYSE**
  - IWM - Russell 2000 small-caps
- **Nasdaq**
  - QQQ - Nasdaq 100 tracker
- **Geographic**
  - EWI Italy
  - EWP Spain
  - EWQ France
  - EWD Sweden (Sweden good yes?)
- **Currency**
  - FXA CurrencyShares Australian Dollar Trust
  - FXE CurrencyShares Euro Trust
- **Volatility**
  - VIX Volatility Index
  - VXX also see the VXX wiki page
  - XIV Inverse of VXX
  - V2TX - Euro STOXX 50

ETF A - Z

EWI - Italy

- PRO Forums: Aleax talks about Nov 2011 status of Italy and EWI as a vehicle to short

FXA - CurrencyShares Australian Dollar Trust

- FXA has been recommended by Fool services in the past

FXE - CurrencyShares Euro Trust (FXE)

- FXE is a PRO Rec Set up a Synthetic Short on CurrencyShares Euro Trust

IJR - S&P SmallCap 600 Index

- *Q: Is IJR or SBB a good substitute for SPY ?*
- **A:** Aleax responds: http://boards.fool.com/1228/what-about-sbb-does-sbb-track-the-inverse-of-spy-29613113.aspx

  IJR is fairly correlated with SPY of course, but "peppier" (beta 1.16), and small caps don't always move in sync with large caps (SPY is dominated by large caps, actually most of the weight is with mega-caps since the fund is weighted by market capitalization).

  Over the last month, IJR +1.28%, SBB -3.71% -- I personally would not call this acceptably close to reverse-tracking, even just on a one-month basis.

Let me try to show why on an algebraic tack since simple arithmetic does not seem to put this question to rest. Think of an index "growing by 1%" in a day as equivalent to "being multiplied by 1.01" and viceversa losing 1% as "being multiplied by 0.99". Generalize that 1.01 to a generic X which equals "1+P" with P being the percentage as a fraction (positive for growth, negative for loss). OK so far?

So if the index has a 1+P multiplier in a given day the perfect inverse will have a multiplier of 1-P -- still following?
Then the next day say 1+Q for the index, thus 1-Q for the inverse.

For the two days together, the index has (1+P)(1+Q) overall: i.e. 1+P+Q+PQ. The inverse, (1-P)(1-Q): 1-P-Q+PQ. Look at the signs carefully: the +P+Q and -P-Q parts are indeed inverse of each other; but the PQ part has the same sign for both the index and the "daily inverse" fund, as the minus signs cancel out in multiplying.
For example if the index goes up a lot one day, say P = 0.10 (a 10%-up move) and down as much the next day, Q = -P (a 10%-down move), the +P+Q cancels out -- but the PQ part is overall -0.01, so the index is overall down 1% for the wild two-days pair. But so is the inverse!!!

For less-volatile days the deterioration of the tracking is smaller, but it's cumulative -- it just keeps churning. For example, YTD, IJR is down -- -6.29%, SBB is too, -2.64% -- some "hedge"...! Depending on your holding period cash is actually a better hedge... at least it's flat YTD;-), not down together with the reference index.
This is particularly important in times of high daily volatility, which, as it so happens, is exactly what we've been experiencing for many weeks now. Stay away from inverse or leveraged funds, except perhaps for short spells of time in reasonably quiet markets...!

IWM - Russell 2000 small-caps

- IWM is a Foolish ETF
- IWM aims to match the performance of the Russell 2000 index of small-cap stocks.

QQQ - Nasdaq 100

- **PowerShares QQQ Index** tracks the Nasdaq 100.
- 2011 Pro recommended a QQQ option strategy to protect portfolios with Tech exposure: PRO Charter Portfolios: Set Up a Ratio Put Spread on QQQ

SBB - S&P SmallCap 600

- ProShares Short SmallCap600 (ETF)

- **Q:** *What about SBB? Does SBB track the inverse of SPY well enough to be a reasonable substitute? I took a quick look at the chart and yup, it looks fairly opposite! :-)*
- **A:** Aleax responds: http://boards.fool.com/1228/what-about-sbb-does-sbb-track-the-inverse-of-spy-29613113.aspx
  Inverse-tracking ETFs all track daily, which inevitably means tracking deteriorates with time -- the shape may look OK to the naked eye, but, if you look at the numbers, hmmm, not so much. Use IJR perhaps.
  Proper benchmark for SBB is IJR (S&P Small Caps) -- IJR

SH - Short S&P 500

- ProShares Short S&P 500 inverse track of S&P 500
- SH is a Foolish ETF see SH page
- *However, see this warning for why you don't want to own SH for long periods of time!*

SPY - S&P 500

- SPDR S&P 500 ETF tracks the S&P500.
- SPY is a Foolish ETF.
- See PRO discussion SPY discussion forum and Pro SPY recommendation page
- The SPY tracks the S&P500 pretty accurately. Price of S&P500 / 10 = SPY more or less.

V2TX - EURO STOXX 50 Volatility (VSTOXX)

- V2TX is based on EURO STOXX 50 realtime options prices and are designed to reflect the market expectations of near-term up to long-term volatility by measuring the square root of the implied variance across all options of a given time to expiration.
- See http://www.stoxx.com/indices/index_information.html?symbol=V2TX

VXX Volatility

- See the VXX wiki page
- VXX is an ETN that mimics holding a mix of 1 and 2 month futures on the VIX. Each trading day it pretends to sell a portion of its near month holdings and use the proceeds to buy more of the next month future contract.

VIX - Volatility Index

- VIX is the ticker symbol for the volatility index that the Chicago Board Options Exchange (CBOE) created to calculate the implied volatility of options on the S&P 500 index (SPX) for the next 30 calendar days. The formal name of the VIX is the CBOE Volatility Index.to expiration.
- See http://vixandmore.blogspot.com/2008/04/ten-things-everyone-should-know-about.html

XIV - Inverse of VXX

- XIV is an ETN that attempts to perform as the inverse of VXX.

Foolish ?

DOG ProShares Short Dow 30 SSO
IJR iShares S&P SmallCap 600 ETF

IWO iShares Russell 2000 Growth Index
XRT SPDR S&P Retail ETF

I like the idea of shorting flawed ETFs just as much. UNG is one, but there's big tail risk with NatGas around $2.40. FAZ is another. I'm not three-x bearish on financials. Are you? VXX of course once the VIX spikes. Other leveraged ones. We'll get on these or others one by one as opportunities look right.

Best, Jeff

Wiki: Resources and Tools

Published Oct 2, 2011 at 12:00AM

Also see Books and Other Media

- Market Foolery Podcast
- Motley Fool Money
- Options:
  - theoptionsguide.com (basic to advanced strategies, simply explained, with graphs)
  - optiontradingtips.com (education, and downloadable option pricing spreadsheet)
  - Moosie's spreadsheets
- Aswath Damodaran (Finance professor and author offers everything free: from spreadsheet valuation models, to video of his classroom lectures)
- Undocumented TMF Links

Market Foolery Podcast

DAILY MarketFoolery features a team of Motley Fool analysts discussing the day's top business and investing stories.

http://wiki.fool.com/MarketFoolery
Jeff Fischer sometimes chats along too

Alternative source: http://marketfoolery.libsyn.com/

Note: Daily = released after closing bell, MTWTh unless they don't feel like it.

Motley Fool Money

Motley Fool Money features a team of Motley Fool analysts discussing the week's top business and investing stories.

http://wiki.fool.com/Motley_Fool_Money_Radio_Show

Alternative source: http://fool.libsyn.com/

Note: Hate the bell & haven't figured out what time they release it on Fridays - again "unless they don't feel like it.

Moosie's Option Spreadsheets

Spreadsheet page

The spreadsheets are just some tools I built, mostly to analyze various option strategies. No rocket science here. They have an embedded Black-Scholes calculator. Feel free to change these and make them your own, or use them as a guide to build your own from scratch. Or use them as is.

The charting sheet is a handy way to make profit-loss graphs similar to those Pro includes in the recommendations.

You'll be able to use these in Windows, and Mac, except not Mac Office 2008. v2004 and v2011 work fine. Microsoft left VBA out of the 2008 Mac version.

DollarFor40Cents Option Spreadsheets

Links to the tools

There are three links in the message board post linked above. Each of the links corresponds to an online tool designed to find option strategy candidates (for put writes, covered calls, and written strangles). You provide the ticker you are interested in and the tool does some math to determine whether or not there are any mathematically attractive option possibilities based upon the published *Motley Fool Option* guidelines (fudgable rules of thumb that are a good check point).

Undocumented TMF Links

Folder of Pro Boards that you can dbl click to add to your Favorite Boards.

Folder of Options Boards that you can dbl click to add to your Favorite Boards.

Wiki: Getting Started With Pro

Published Oct 2, 2011 at 12:00AM

Template started by TMFMoosie

Please add to this list, or begin fleshing out details. Put yourself in the position of the new member. Literally "what do I do now?".

- Step 1: Read Making Pro Fit You
  - This is a good overview of adjusting to Pro as a new member. It addresses varying options permission levels and being already fully invested elsewhere.
- Step 2: *Keep reading*.
  - There's no rush to get invested. Looking back ten years from now, a week or three delay in plunking down the cash will seem insignificant.
  - Pro is much more than just recs like "Buy Company X, 2% allocation". The "other half" of Pro is what you're learning now. Read everything on the site. Pay more attention to the conceptual stuff. Reading between the lines, you'll begin to get a feel for the underlying whole.
  - *Authors: List of great links to official and boards content here, please. Point newbies to the content that most helped you! Some company stuff may be useful, but this is really "teaching someone to fish" time.*
- Step 3: On your mark...
  - Choosing a broker
  - Setting up options permissions
  - Placing complex trades
  - paper trading a new platform
  - How much investable cash do I *really* need?
- Step 4: Get set...
  - Allocations
  - Pacing
  - Hedges, and why they may be for later
  - Option catch-ups: concept (shifting strikes, expiration), pro/con
- Step 5: GO!
  - Buy Firsts
    - Yeah, but still just do thirds, or similar. Avoid inadvertent market timing. (maybe that phrase is a glossary link)
  - Buy "seconds"
    - Especially consider using written puts, or covered calls, to get a better cost basis.

Wiki: Brokerages

Published Oct 2, 2011 at 12:00AM

- TD Ameritrade (and ThinkOrSwim)
- Wells Fargo
- E*Trade
- Scottrade
- Interactive Brokers
- Charles Schwab
- OptionsHouse
- Fidelity
- OptionsXpress

If you want to add another broker, don't worry about this Table of Contents. Just create a section below, and type!

Nick published a general guide to brokerages.

Checking out that link above, it's a long thread on the boards but I couldn't see Nick's comparison table anymore, which I know for sure existed in the past. But the Fool has a brokerage table on the public sites, which can be accessed here: http://www.fool.com/how-to-invest/broker/index.aspx

For more details and the latest ranking by Barron's, please see the following links:

Barron's 2013 Online Broker Review

Barron's Best Online Brokers of 2013

What follows is some more detailed information from current users of each:

TD Ameritrade (who have acquired and integrated ThinkOrSwim)

Likes:

1. The ThinkOrSwim trading platform, which lets you do just about anything from a stock or options perspective.   Makes me feel like a professional. This is a powerful platform that is easy to learn and handles complex option trades very well.

2. The Website is very convenient for managing multiple accounts and the cash transfer functionality is excellent - basically you can initiate ACH transfers in either direction between an account and one of several registered bank accounts.

3. Customer service is exceptional. Every time I've called with a question I've been able to get an answer from a knowledgeable person. If I have an issue or just need education on something like ToS they handle it professionally and patiently. In addition, I didn't have to go through a maze of phone trees to get to a live person.

4. My TD branch has a local broker who is very helpful and responds anytime I call him. He even went so far as to give me his personal cell and to encouraged me to call anytime.

Dislikes:

1. Technical issues started appearing in Fall 2011 as they get to the advanced stages of integration with ToS - as described here.

2. Some of their rules relating to account types are irritating. For example they will only allow one account of the same type and beneficiary to have margin-level privileges, which are required to trade defined-risk spreads. Although they accommodate Coverdell ESAs, they treat them differently to IRAs, so one can't trade spreads in them at all.

Other:

Commissions: looks like I'm paying about $7 for stock trades and $2-3 per options contract.

Commissions: FYI - Depending on the size of your account you can negotiate significantly better rates. While they may not match some of the bargin basement brokers they are extremely competitive and for the level of customer service I receive I'd much rather pay a bit more. They beat the negotiated rates I had at ETrade by 50%.

In addition to the ToS platform, they also have a platform targeting less sophisticated traders called "Trade Architect". Perhaps someone who has used it could provide a description.

Note: ThinkOrSwim now works on Linux!

Wells Fargo

As one of the first online brokerages WFC offers an older web platform and user interface. Service is good, but options permissions require experience and a high net worth. If you have a banking relationship and a PMA account with the bank - e.g. if your mortgage is with them (or if you maintain at least $25k in balances and are willing to open a checking account) - then you can get 100 free equity trades per year, per account.

New...as of February 2013:

Wells Fargo Brokerage will change the 100 free trades policy. Beginning April 1, 2013, only grandfathered brokerage account holders will keep their 100 free trades per year if other conditions as mentioned above are met. New brokerage customers though will NOT get 100 free trades anymore. They offer a lower commission rate though that'll be $6.95 independently of the number of trades per year. The commission fee so far for trades above the 100 free trades is $8.95 and will stay like that for the soon grandfathered accounts.

E*Trade

Remember, making amusing commercials does not qualify you to build and operate a good brokerage service.

I used E*Trade for 15 years. Moved to Interactive Brokers in 2007 for the cheap rates. E*Trade tried several times to keep the business, but they couldn't come close to the rates, even though my account was fairly sizable. They asked me where I was going, and didn't know who IB was. They don't view them as a competitor. Interesting.

I liked E*Trade during my time there. Customer service was top notch. Darn near perfect. Cash management and movement tools were good (and still are, I still have my online banking with them). When I left, rates were competitive with TDAmeritrade, and probably Fidelity. Those are who they view as their competitors. I think it was $10 for a stock trade, and $10 *base* for an options trade, plus 70 cents per contract. Assignment was $20. Power E*Trade offered a better trading platform (IB still blows it away), and cheaper commissions, but only after you've spent a ton of money per quarter at the higher level. At the time, I found that kind of tiered system to be common. Don't know about now, but that, and pricing was why I left. But I still like them. For someone who needs a little hand holding from time to time, or someone to research a transaction, E*Trade will be a good choice, in my opinion. -- *TMFMoosie*

Scottrade

Most of the times that a new member posts a question about options permissions or how to use their broker, the broker in question is either E*Trade or ScottTrade.

Scottrade has very limited platform for trading options. If you use them, you'll want to upgrade to their OptionsFirst product, which seems to be a separate account. Pro option strategies are integrated with the whole portfolio, so make sure you can move *everything* to OptionsFirst, I guess. I have not used Scottrade, but have heard this complaint many times.
Anyone use Scottrade? Care to share your experience? *(double-click this page to start editing) -- TMFMoosie*

I used Scottrade when I first started but have since left them behind as I've moved into options trading. OptionsFirst was a separate account, and even that didn't make strangles or straddles intuitive. Not that I had some international holdings from the Hong Kong exchange and some Pink Sheets that I could not transfer to TradeKing. --kiplin

By the end of April 2015 Scottrade will have dropped the OptionsFirst platform in favor of utilizing Interactive Brokers for their complex options trading. Because I am not a high volume trader I am leaving Scottrade because of this change because IB charges $10/month/account "inactivity fee". I have four separate accounts and IB's low prices (and they are really sweet) wouldn't offset that hit for me. If most of your business is stocks, not options, then the customer service at Scottrade is unbeatable. I'll really miss them. Patrick H

Interactive Brokers

Likes:

1. Very low commissions. As low as 1$.

2. Very large inventory of shares for shorting. (During Pro's VXX experiement of Auguts 2011, IB was one of the only brokers who had shares of VXX available for shorting)

3. Allows you to engage in nearly every trade type - within the limits of your account type. So you really need to understand what you're doing or else you can get into a ton of trouble.

Dislikes:

1. The trading interface can take some time to get used to.

2. Not as many bells and whistles as other brokers. (for example no 10-minute retirement tool like available at Schwab)

3. A few complaints about IB's customer service when their system botched trades

Institutional focus: TMFMoosie's experience with IB...

IB was originally an institutional broker. And they still have a huge institutional client base (hedge funds, pension funds and the like). Because of this institutional focus, they had a Financial Advisor account setup, so if you manage money professionally, you have a master account, like an umbrella over each separate client account. Certain things can only be done by the advisor, like trading, perhaps, depending on how the advisor sets it up. And certain things, like making withdrawals, are restricted to each client.

IB hasn't changed this model for individual investors. If you have multiple personal, or family accounts, and want them linked together, you have to open a Financial Advisor/Friends & Family account structure. So, with my four "real" accounts, I now also have a fifth: the Master.

Opening accounts:

This presents some clunkiness when opening accounts. I've been with IB since 2007, so some of the details are hazy. Each account setup is separate. At some point, the advisor (you, logged in as Master) sends an invitation or something, to the client (also you). I know I had one bump because the application process wouldn't let the email address of master and client to be the same, so I had to get another freebie from gmail, just to go through the sign up. 'Cause that's where they send the verifications and stuff. Maybe they've fixed that, I don't know.

Market Data:

During the opening process, and/or afterwards, you need to decide on market data. Unlike other brokers, IB runs a very lean cost structure, which they pass along to you. They also pass along certain fees charged by the exchanges.

All brokers have to cover their market data costs somehow. Most of them keep the commission structure simple, if not very low. The problem is that you end up paying for data feeds from security types you may never use, like futures, bonds, pink sheets, indices, foreign, etc.

IB charges for market data separately from their rock-bottom commissions. It's on a cafeteria plan, so you just sign up for, and pay for, what you need.

Initially, just sign up for the US Bundle. It's all US stocks and ADRs, futures, and currencies. Real-time pink sheet data is extra ($3/month). Note, even though you may not need currencies or futures, they're included, and interestingly, by default all permissions are in place for you to trade these vehicles. I found this useful when pondering bearish positions on Europe and the Euro.

A few of the more popular indices are extra, perhaps because the exchanges understand their popularity, and charge for them. A buck or two per month. Or, you could do without, and just look at google finance once in a while.

The US Bundle costs $10/month, to the Master account, but the fee is waived if you generate $30 in commissions across any of the accounts in the month.

You can easily change your market data subscriptions via the web-based Account Management page. (Log in directly, or follow a menu item from the Java-based TWS trading platform). The changes take effect immediately.

Keep a little cash in the Master. I move $100 bucks into it once in a while. This is used to pay for any market data above the US bundle. Or the bundle itself if I don't trade much that month.

I just checked, and in the last nearly five years I've spent $185 in data fees. Most of this was $10/month in the months when I was just getting things started, and a several month period in which I had few trades. Perhaps not small enough to ignore, but I don't worry about it, either. Net, this is still much cheaper than other brokers.

Minimum fees:

IB caters to the more active trader/investor. So if you just buy stocks once in a while, and rarely sell, and want dividend reinvestment (DRIP), you may be better off elsewhere.

But run the numbers first. They do charge a monthly minimum, but the commissions are SO cheap, that even one trade can make it a wash, and two can beat most other brokers in terms of total fees.

Now, this is where it gets confusing. And this is where I get frustrated with IB. I wish they'd fix this, but overall this isn't a showstopper for me.

The minimum is $10/month per account. And I'm almost certain this even includes the Master, which is just dumb, because that's a placeholder that merely exists as an umbrella, and to attach market data to.

So, for my set up, 4+1 accounts, I have a "nut" of $50/month. If I generate $50 in commissions across any of the accounts, no fees are charged. But if it's less than the $50 total, each account is prorated. So, assuming my master generates nothing; and I spend $49 in the margin account, and zero in the IRAs. You'd think I'd owe a buck, right? I wish. I would owe 10 for each account, less any commission in that account. Since I generated no other commissions, I'd owe $40, $10 each including the master. The margin account is safe, because that's where I did the $49.

I keep tabs on this near the end of the month. If it looks to be a close call, I'll do some no-op in-and-out trade, just to spend the commission. Stupid, but spending say $5, to save $40? Worth it.

If you're like me, you're thinking, wait, if IB is this dumb, should I want to have them as my broker? I think it's useful to realize that this is one of the ramifications of the historical view of financial advisor account setups. There was no concept of all the accounts being owned by the same person, or family.

I recommend complaining about this once (so they know), and then forgetting about it. It has nothing to do with the trading platform, which is also affected by the institutional focus, but this time it benefits us. Some feel it's a steep learning curve, but I think it's worth it. It's like a 50-caliber gun. Loaded. You can shoot yourself if not careful. But with a little experience, you can really "do some damage" :)

Charles Schwab

Likes:

1. Provides a nice tool to report called "Portfolio Analysis" which calculates the Time-Weighted Return over a number of different periods and provides comparisons to benchmarks.

2. In their Guidance section, I like their "10-minute retirement assessment" tool. Gives the user some nice results to allow one to consider how much should be saved for retirement.

Dislikes:

1. Not as easy to short as other brokers such as IB, and when shorting is possible the fees can be quite high.

OptionsHouse (OH)

As of Oct 1, 2013, the stocks flat rate has increased to **$4.75** for new OH users.

Trading platform is very easy to use.

If you'd want to see all current OptionsHouse promotions, simply go to:
http://www.optionshouse.com/promotions/

Before I list the individual promotions and links to them, one word of advice. When you apply online using the promotion code, only one code can be used. But, they apparently do stack those promotions. You may have to call them though and ask for it. You can either do that by calling to open up the new account and then ask for the 100 free trades **AND** the ACAT transfer fee rebate of $100. Or you can apply for a new account using one of the promotions and then call afterwards and ask for one of the other promotions in addition. I have gotten two promotions for opening one new account in the past. So it might still work.

Now regarding the individual promotions:

I personally would see the one as most interesting that gets you 100 free trades when you open and fund a new account with $5,000 or more. The promotion code is

FREE100, but you can also use that link: http://www.optionshouse.com/signup?promo=FREE100
It's interesting that I think you get those 100 free trades also if you have already an account with OptionsHouse but open an additional, new one. This promotion always works - no need to go through a referral link for that.

Another promotion offers a $100 cash rebate to cover any transfer fees when you move your stock, option, or mutual fund holdings to OptionsHouse via an ACAT (account transfer). The promotion code is: ACAT100REFUND. And the direct link: http://www.optionshouse.com/signup?promo=ACAT100REFUND

The third promotion that's currently listed gets you a $25 cash rebate to cover the fees for a wire transfer to OptionsHouse. Promotional code: WIRE25REFUND. The direct link: http://www.optionshouse.com/signup?promo=WIRE25REFUND

Fidelity Investments

Fidelity is really into mutual funds, but since they do so much trading, they allow their customers brokerage, trusts, business, retirement, institutional, and other types of accounts. However, only one brokerage account has margin per SSN, even if you have 10 separate brokerage accounts. They try to compete with mid-priced full service online brokers, so the usual online stock trade is very competitive. However, if you have a large amount of money in various account or if you trade frequently (more than 200 per year?) you can get a decent discount on both stock ($7.95 vs. $5.95), option ($0.70 vs $0.65) and currency trade fees. I'm sure larger account balances or high trading volumes can negotiate even better rates.

Fidelity allows trade access to most major foreign exchanges and at least 7 major currencies. So you can also add currency trades to your stock and options activities. However, unless you apply as a very experience trader (and they accept), Fidelity will restrict some of the riskier activity from normal customers. They also make you apply for option and spread trades in retirement accounts, but you may not get approved at your desired level. You may have to go through a probationary period to prove you know what you're doing before they allow "riskier" trades in retirement accounts. This paternalistic approach may or may not be an irritant to someone who wants unfettered access to all trading types.

For the most part, Fidelity has no problems executing most Pro and Options trades. However, Fidelity may also not have enough shares for shorts on both stocks and index ETF, or certain option contracts. I ran into that during the Motley Fool Alpha's brief life, and a couple times with some Pro ETF trades.

OptionsXpress

Got swallowed up by chuck

Wiki: Relax

Published Oct 2, 2011 at 12:00AM

Sit back, calm down, and make sure you know where your towel is. -TMFKabellen

- Panic Questions In A Volatile Market With Relaxing Answers
- The Healthy Investor

Panic Questions In A Volatile Market With Relaxing Answers

- **Q**: *Aaagh! SPY Short is 7% down, I'm "losing" money! and the market is rising!! Is it time to exit ??*

  A: TMFPapester > **Remember our goals**. Remember our time frame. Remember why we shorted.

Absorb new information thoroughly before acting. Watch the performance of your overall portfolio, not one position, and especially not a hedge in isolation. Trade only hesitantly.

Stay calm, thoughtful, independent-minded, and long-term focused.

A: TMFFischer > I understand the desire to cap losses in any direction (on a long or short), but if you do that too much in a very volatile market, **you risk taking losses in both directions when stocks keep see-sawing**.

This has certainly been a challenging/impossible market if you're trying to maneuver it on a short-term basis. Nobody knows what the market will do next, but if you can think in terms of months at least for your hedges, and years for your longs, it may help. This month (October 2011) has presented the most volatile (to the upside) market since 1974. The month before was one of the most volatile period.

In a market like that, it's very easy for positions to face sudden losses and you to second-guess the position. But overall, you should have made a lot of money back this month. Keep that in mind (never complain with gains) and keep in mind the long-term goal of growing capital while keeping calm. These months will be a bad memory before long, and as long as you have maintained your portfolio value, we'll all be ready to grow that value, wiser for this experience.

I doubt volatility is over (is it ever really over?) but that's why we can't obsess with it. We have to invest despite it, being mostly long in businesses we believe in, and hedging or shorting as we're comfortable doing so. In good times, our longs should grow our value strongly despite hedges; in bad times, the hedges will help.

- **Q**: *Long position XYZ has tanked today! I'm down 25% !! XYZ sure does not look like a horse with 4 good legs to say the least*.

  A: Jeff Fischer: Remember we have a multi-year outlook on any stock we buy. To keep your blood pressure lower and help insure investing success over the years, keep reminding yourself of this. The **daily price moves don't mean much** of anything.

- **Q**: *Short position ABC has shot up today! I'm up 125% !! ABC sure doesn't look like a horse with 4 good legs anymore ;P*

  A: foolinsd: Personally I'd close the position if I'm happy with the return. But listen to Jeff *to keep your blood pressure lower and help insure investing success*... Check out the following link for Jeff's response to a specific example: http://boards.fool.com/1228/hi-dave-we-think-in-terms-of-3-years-with-most-of-30498752.aspx

Good Answers To Worry On Various Subjects

Patience.

The Healthy Investor

- aleax > No joke -- two independent research results, one in China and one in the US, both show correlation between **market volatility and heart attacks** (apparently, that occurs among people who own stocks and watch their performance more often, though I don't think from the Financial Times summary that this is established as firmly as the correlation itself).
  http://www.ft.com/intl/cms/s/0/d1e4dd0a-03da-11e1-864e-00144...

- **Forget Heart Attacks! Worry about...**

  Your brain.

  Here's two articles I found more than a bit scary (having just passed the annual milemarker and finding myself on the wrong side of the curve).

  #1: Summary - It's all over at 53 and you become more like a sheeple each year, eventually attaining the status of "drooling mumbling set of deep pockets with a bulleye on your back".
  http://kiplinger.com/magazine/archives/investor-psychology-p...

  #2: Summary - Maybe good news. Maybe financial skills don't begin to atrophy until 60 and maybe those who were well above average all along (should bode well for subscribers here) can hold their until much later in life (this would be my hope).

  This link even inlcudes a test. Everyone here should knock out a 10/10 on this one. Try it.
  http://www.marketwatch.com/story/our-financial-smarts-erode-...

  Ed (spinningwood)

  Who hopes some hearts were saved as a result of distracting a few from staring at the market today.....

Wiki: North Star

Published Oct 2, 2011 at 12:00AM

Charter and 2011 Portfolios: Close Your Short on VXX

Published Sep 30, 2011 at 12:00AM

Hey, *Pro* Fool! Is this trade for you? This trade is only for investors (following either Portfolio 2011 or the Charter Portfolio) who have a short position, or naked calls, on VXX from our original July trade.

Trade Essentials

- **Action:** Buy to close all of the shares you hold short. (If you have December 2011 $22 calls that haven't been exercised yet, buy to close those as well.)
- **Recent Price:** $52
- **Price Guidance:** Use a **limit order** at current prices.
- **Why Buy to Close This Short?**
  - Our naked calls were (or will be shortly) exercised and our broker doesn't have shares available for shorting.
  - Once we clear the deck, we'll reconsider how to short VXX with fresh eyes.
  - Tailwinds that won't last are pushing VXX higher now, so our next position needs to take that into account.

What's Changed?

When Calls Are Exercised

When you write uncovered calls (or calls where you don't also own shares), and those calls are exercised, you end up being short the shares. If your broker has shares to lend you indefinitely for shorting, that's not a problem — that's what you intended to do anyway. You then have a true short. If your broker doesn't have shares to lend you, though, they will close the short within a few days. That's what's happening to us on VXX: We can't stay short the shares. We'll look to initiate a new short on VXX with options in the near future.

Our short calls on the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) ETN were exercised in Portfolio 2011 today, and we expect the same in the Charter Portfolio. When you write uncovered calls and they're ultimately exercised, you automatically borrow shares and short them in your account. However, our broker doesn't have shares available to short (unless we pay high fees, and even then we have no promise that we'll be able to borrow the shares for as long as we want), so the broker is in the process of closing our short. This in itself is not a big deal: We can always reopen a new short using options, aiming to earn back returns when we think the tide of volatility is turning. Before we do that, though, we're going to take some time to decide the best way to short VXX again under current circumstances.

With Europe moving slowly to find solutions to its debt crisis, it will not be surprising if the market's volatility remains elevated for weeks, possibly months. Meanwhile, the futures contracts on the Chicago Board Options Exchanges' implied volatility measure — the VIX — are in backwardation. With the VIX at 41, the VIX futures for October, November, and December were recently bouncing around 41, 37, and 34, respectively. Lower prices on futures contracts will help to keep VXX's price high, which is why we hedged it earlier this week with a bull call spread and why VXX was up this week even though the VIX was down. (See Monday's trade for more on backwardation and what it means.)

Given Europe's unique slow-motion debt crisis, we're going to consider all of the options available to us for at least a little while before shorting VXX again. But have no doubt: We want to profit on VXX during its eventual and inevitable decline. We simply want to do so in a way that makes sense given the extra risks presented by backwardation and Europe — and the possibility that such risks could persist for awhile. For now, we'll close the short so we can look at it with detachment and determine our strategy to profit when the VXX does decline.

How to Follow Along

We realize that different members have many different positions on VXX, and that many of those positions were undertaken according to individual circumstance. You'll need to determine what is best for you and your portfolio if you choose to keep those positions open. *Pro* will decide on our next approach to VXX as soon as possible, but it may be some time before we're ready to initiate a new strategy with a new trade alert. If you're comfortable with the strategy you currently have, you should consider keeping it. For those aiming to follow the *Pro* portfolio closely, here is some general guidance:

- If you wrote December 2011 $22 calls with us and want to mirror us, buy to close those calls.
- If you are short shares and want to mirror what we do next (and don't want to risk further losses in the meantime), buy to close the short for now. Or buy to close it once you see our next VXX strategy, if you like that strategy better.
- If you already rolled your December calls to a later month and you're comfortable with your position, you can keep it; you could also close it while waiting to see what *Pro* does next. If you have concerns about your new position, you may want to close it and wait for our next strategy.

Finally, we are keeping our new bull call spread open on VXX. It serves as a hedge on further volatility and will profit if backwardation and volatility take VXX higher.

The Bottom Line

This short has more than doubled against us as VXX has gone from a net $25.50 to higher than $51 — but we know that in time, volatility will once again subside and VXX will continue its long contango-driven drift lower. (After all, VXX has lost 87% of its value since inception in 2009. In the long run, this trend won't change.)

When the tide turns, we want to earn back our losses on VXX as it drops. I don't doubt that with patience, we can earn this capital back and then some. But in the present moment, we need to face the fact that many factors are working against this short. We'll need to reinitiate it carefully; we want to get back on board when it seems most likely to start working in our favor sooner, not later.

Questions? Please visit the VXX discussion board.

Jeff is short VXX.

Audio Extra: The Pro Philosophy

Published Sep 30, 2011 at 12:00AM

Advisor Jeff Fischer and analyst Nick Crow discuss the *Pro* philosophy in this Audio Extra. Listen in as they address:

- How to feel comfortable holding a stock through volatility
- Whether it's harder for a business today to sustain a wide moat than it was a decade ago
- How options can increase our ability to match our investing theses to the opportunities we see
- Why *Pro* doesn't "overdiversify"
- What both of them are watching over the next four to six months

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Transcript

Chris Hill: Welcome to a *Motley Fool Pro* Audio Extra. I am Chris Hill and I am joined in studio by *Motley Fool Pro* Advisor Jeff Fisher and Senior Analyst Nick Crow. Guys, good to see you.

Jeff Fisher: Chris, thank you.

Nick Crow: Hi, Chris.

Chris Hill: We are going to talk about your approach at *Motley Fool Pro* and sort of what you guys are trying to accomplish over the next three to five years. But I want to start, Jeff, with something you had written when the service launched three years ago, an essay entitled "How We Invest." And the first point you make in there, "Accuracy is our top priority." What do you mean by that?

Jeff Fisher: OK, Chris, what we mean by that is we want the vast majority of our positions, whether they are long, short or options to close profitably. We put a number on it at 75%, so we want at least three out of four of every strategy we do to end with a profit. Why do we do this? That is a very high benchmark. Peter Lynch …

Chris Hill: I was going to say, that is aiming kind of high.

Jeff Fisher: Mr. Lynch always said if you can hit six out of ten times, so 60%, you will do great. So we are aiming for more than that. But really it serves to ground us. Before we make an investment, we really have to ask ourselves how confident are we that in the end we will make money on this ... stock or option strategy or combination, and we try to look at it from several different angles where if this happens, can we make money in another way. Say shares fall 20%; can we then use options to make money anyway on that position in the end? So we are always looking for a way to end positions in the green.

Chris Hill: So Nick, I mean sort of old-school Fools are sort of used to an approach where you have got a portfolio, you are looking for a total when you take all of them together, you are looking to beat the S&P 500, but in this case, you are really much more focused on absolute gains.

Nick Crow: Absolutely. When we look at the S&P 500, we see a benchmark that we are not that interested in. And benchmarking for us can be a very unprofitable exercise, as investors the last 10 years have looked at. So we want to find great businesses, hold them for a long time, use options to generate steady income, and if we can do that over a period of time, that benchmark is going to be irrelevant.

Chris Hill: Jeff, another point you make. When it comes to stocks, we are focused on superior businesses we can hold for three to five years. We have certainly seen our share of volatility this year.

Jeff Fisher: Yeah, right now especially.

Chris Hill: That seems like it is maybe tougher to achieve, holding businesses for three to five years.

Jeff Fisher: If you find a business model that gives you a lot of confidence, it is easier to hold through volatility, like right now. The type of business we like to focus on has true sustainable advantages because your profits are not worth much if a competitor can come in and start to eat at them, take them away, and has a lot of recurring revenue. By that we mean kind of naturally recurring revenue, like a software company that has subscribers who re-up every year. Or AmTrust [Financial] Services in the portfolio; 80% of their customers, insurance customers, renew their contracts every single year. Autodesk, which we bought recently, has some 40% of revenue as maintenance revenue that recurs every year. So when you have that stability, it makes it much easier for a company to maintain revenue through volatile periods and then grow during the better periods.

Chris Hill: You mentioned among those attributes the whole notion of a competitive advantage. One of the things we talk about here at The Motley Fool is the term "moat" — how big a moat does an individual business have. Is that tougher for businesses to come by today? Is it tougher for a business to really sustain a wide moat than it was maybe 10, 20, 50 years ago?

Jeff Fisher: I believe it is. It is a more competitive world right now, partly due to technology and all the information that is at your fingertips now. If you are a company who knows how to do your research and believe me, all these publicly listed successful companies know what they are doing when they research their competitors. You can find ways to nibble away at competitive advantages.

So what you will see in *Pro* is we buy a lot of companies that have been around 10, 20, 30 years already, if not longer because they have this moat that they have actually dug out over decades before that it is much harder to now cross for competitors.

Chris Hill: Nick, one of the other points in the essay, "We are not options traders." How do you think of yourselves when it comes to options?

Nick Crow: We see options as increasing our flexibility and our ability to match our investment thesis to the opportunity that we see using options. And you can't just do that in long stocks, so we can have a stock that we are very comfortable in, has great competitive advantages, but we don't see that stock price rising very much and still generate a great return off that. So whereas a trader, they might be looking at short-term price movements this week; we have no advantage in that. We look at great business and try to find the best way to profit from them.

Chris Hill: Jeff, when I think about options trading, in my rudimentary way, I just imagine guys in a room staring at a computer screen and they are executing trades just because the computer model is telling them to do that. It sounds like what you guys do is very much the opposite of that.

Jeff Fisher: It's true. It's very fundamentals-based, as Nick said. It is based on our knowledge of the underlying company and then what we expect its shares to do, and whatever our expectations are or what our analysis tells us, we can overlay an options strategy on top of that so we can make very solid businesses that may not have rising share prices, make those profitable by using options.

The great thing about options is they compliment your stock portfolio so well. We are majority invested in equities that we want to hold three or five years or longer, because that is the only way you make real money investing. You have to let your investments compound. David Gardner points out that almost everybody seems short-term these days. Everyone's focus is minute-by-minute, and that is absurd, of course, but what that does is give us the advantage by being long term because we are seeing things in a way that almost everyone else isn't, and you can find opportunities that way.

So our equities are long term. Options of course expire within a few years, so they can be shorter term within a few years to a number of months, but they complement and enhance your stock holdings and performance.

Chris Hill: One last point on how you guys invest at *Motley Fool Pro*, and that is you say, "We won't over-diversify." Is that even possible? That is like one of the first things I learned about investing. You have got to diversify.

Nick Crow: It's possible.

Jeff Fisher: Well, lately it hasn't mattered much. Literally, the market — everything is moving together, as you know. It's like 2008 again. So members, when you look at your portfolio and everything is down one day, look at the whole market. Everything is down. I met people at conferences who think that they are making mistakes with what they have bought; the market is not discriminating between one equity and another. Everything is moving together. We will get through this time and then quality will rise up again, just like it did in 2009, 2010. So Chris, your question?

Chris Hill: Well, I mean, you say "we are not going to over-diversify." What does that mean in terms of the holdings at *Motley Fool Pro*?

Jeff Fisher: If you own 18 to 30 stocks across different industries, you are well diversified. You really don't need to own more than that. Right now we own about two dozen, and we are diversified and we can follow every company closely. If you get above 30 or so, in my opinion, you start to own more than you can follow. The other advantage of owning fewer is we can then focus on what we do own and see opportunities to use options on those positions too. If we have too many positions, you take away some of your focus, you are going to miss opportunities.

Chris Hill: Nick, when you are looking at the portfolio, are some stocks or some investments sort of in a category where they are sort of off to the side? Like I don't have to focus as much on them in the short term and others are much more, getting a lot more of your attention on a week-to-week basis?

Nick Crow: Certainly. Some businesses are those types of businesses where you could really own for ten years and have no fear with them. We purchased one those recently, MasterCard. You could really hold MasterCard for a long time and feel very comfortable without watching the day-to-day business developments. Other businesses, like we talked moats earlier, might have a narrower moat. You might have to watch that business much more closely. Sometimes we are also the catalyst for (unclear) for businesses, so we are looking at those conference calls, checking on competitors much more frequently.

Chris Hill: To close, what is something that you guys are each watching over the next three to six months? It could be an individual company, a trend, an industry, something that is an opportunity that *Motley Fool Pro* members can keep their eyes on as well?

Jeff Fisher: Great, Chris. Have you heard about Europe and what's going on there?

Chris Hill: I have heard a little something about Europe, yeah. They seem to be having some financial trouble.

Jeff Fisher: So the *Pro* team has spent the last several weeks looking for opportunities there to buy, not to short, because we think it will be resolved with time and we want to be ready when we see prices that are just too cheap to pass up. So we are looking at Europe for possibilities of stocks or ETFs to buy for a recovery.

Chris Hill: Nick, what about you? What is one thing you are keeping your eyes on over the next three to six months?

Nick Crow: Three to six months, well, in addition to the Europe situation, we have also been looking at retail. Retail in the U.S. has been beat down, consumers not spending very much. Consumer confidence is back to lows again, so we are looking for opportunities in that sector as well.

Chris Hill: All right, Nick Crow, Jeff Fischer, guys, thanks for being here.

Jeff Fisher: Thank you, Chris.

Chris Hill: I am Chris Hill. Thanks for listening, and remember, the conversation continues right here on the *Motley Fool Pro* website. Just click the "community" tab and we will see you online.

Pro Wiki: How to Use the Service

Published Sep 30, 2011 at 12:00AM

None

The Motley Fool Pro Strategy Guide

Published Sep 29, 2011 at 12:00AM

Dear Fellow Fool,

You may already have noticed two things about *Motley Fool Pro*:

Download Here!

Click here to download our Strategy Guide in PDF form.

Listen In!

Advisor Jeff Fischer and analyst Nick Crow talk about the *Pro* philosophy in detail in this Audio Extra.

- Between our real-time trades, our Monday Memos and other communications, and our active discussion boards, things can move quickly in *Pro*-land.
- Despite that fact, advisor Jeff Fischer and the analyst team are some of the calmest, most reasonable investors you're likely to meet anywhere.

We think that combination of nimble thinking and sound, sensible decision-making is part of what makes *Pro* so great, and to highlight the second half of the equation, we've put together this Strategy Guide. It's a compilation of key articles going back to *Pro*'s earliest days, showing that the *Pro* approach to investing is steady and rational, featuring strategies that work over the long haul.

The articles you'll find here also tie into *Pro*'s mission statement. Our mission is to earn you consistent, recurring profits with a high level of accuracy using a combination of stocks, options, and ETFs. We use stocks for long-term gains and options for shorter-term strategies. We've updated the articles in places to reflect how our early predictions have played out three years down the road; we've also included links to the original versions of each article on the *Pro* site.

Click here to download the Strategy Guide.

Enjoy learning more about your *Pro* service, and please bring any questions or comments to our Philosophy & Strategy discussion board.

Fool on!

Ellen Bowman, *Pro* editor

Charter and 2011 Portfolios: Set Up a Bull Call Spread on VXX

Published Sep 26, 2011 at 12:00AM

Attention, *Pro* Fool! Is this trade for you?

- If you're an **experienced member** who already has a short position on the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) ETN and you want to hedge that position, this trade is for you.
- If you're an **experienced member who lacks a position on VXX**, this trade can be independently considered as a hedge against a decline in the S&P 500 and against an upswing in the VIX.
- If you're a **newcomer to *Pro***, this trade is not essential for you. You can ignore this trade alert, especially if you're already short the S&P 500 through other means, such as **ProShares Short S&P 500** (NYSEMKT: SH).
- Finally, remember that you need approval to set up options spreads.
- Questions? Visit our iPath S&P 500 VIX Short-Term Futures discussion board.

Trade Essentials

- **Action:** Set up a bull call spread on the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) ETN
  - Buy ("buy to open") October 2011 $51 calls
  - Write ("sell to open") October 2011 $56 calls
- **Allocation:** On a cash basis, we're investing as much as we care to risk, because the most we can lose on this trade is the net cost to set it up. In the Charter Portfolio, we'll have 25 contracts of each option (approximately $4,000 at risk, or 0.3% of the portfolio). In Portfolio 2011, we'll have three contracts of each (approximately $495 at risk, or 0.25% of the portfolio).
- **Recent ETN Price:** $50.35
- **Recent Options Prices (Bid/Ask):** October 2011 $51 calls: $4.55/$4.65; October 2011 $56 calls: $3.00/$3.10
- **Preferred Price:** Aim to set up this bull call spread for a net debit of about $1.65 or less.
- **Why Set Up This Bull Call Spread?**
  - We're currently short VXX via our written naked calls. We still believe in the long-term thesis behind that short, but in the meantime, we can hedge some of our short VXX position with a bullish spread on the same vehicle for relatively little cost.
  - If volatility, and thus VXX, continue to rise in the short term, this spread will mute the losses.
  - Given the "backwardation" of VIX short-term futures contracts today (whereby current months are more expensive than future months), VXX will creep higher in the short term unless the underlying VIX falls meaningfully. This position will capitalize on that creep higher.

What's Changed?

This add-on trade is intended to hedge some of our existing short position in the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) ETN.

Why are we doing this? VXX tracks the VIX, the market's measure of expected volatility, which has jumped from 23 on Aug. 1 to 41 on Friday. Our short position on VXX has more than doubled over the same time. We're currently in a situation known as "backwardation," where the short-term futures contracts VXX tracks become less expensive in each subsequent month. (This is in contrast to the usual contango slope, where the futures are more expensive in each month ahead.) Today's "backward" pricing is occurring because investors believe the VIX will decline from current levels in future months, so although the VIX trades at 41 now, the futures trade at lower prices each month ahead.

When current-month contracts are more expensive than future-month contracts, as they are now, VXX gains some monetary ground each time it "sells" current contracts to "buy" future ones, which it does on a small scale every day (we use quotes because it doesn't actually buy and sell anything – it just tracks an index that does). While this is the case, the VXX will likely continue to tick higher; all the VIX has to do is simply hold its ground.

The VIX has only spent 3% of the time since its 1990 inception at levels above 40, but it may levitate here a bit longer. This is an anxious time in the markets, with all eyes on government leaders in Europe and the U.S. (and who doesn't get tense when relying on politicians?). Greece needs to win approval for its next bailout payment by early October, and the U.S. needs to agree on a deficit-cutting budget by late November. These concerns and others may keep the VIX elevated over the coming weeks.

Why This Strategy?

In setting up a bull call spread position on VXX while at the same time holding a large short position on it, we find it comforting to remember F. Scott Fitzgerald's observation that "the test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function." We won't claim to have first-rate intelligence (we watched too many *Simpsons* episodes back in our day to make that claim), but the statement is fitting. The purpose of this new bull call spread is to make some money if volatility doesn't subside soon. At the same time, our existing short position on VXX remains in place, and we still expect it to play out in our favor as the VIX (and the volatility it tracks) eventually declines. This hedge won't cost us much over the coming weeks, and if we end up not needing it, we may be able to close it and recoup some of what we paid.

We're able to set up this spread inexpensively because the "skew" on VXX call prices is so high. In the current fearful environment (which we find childish, but that's another topic), investors are paying handsomely for all VXX calls. That means calls that are out of the money (at higher strike prices) are only modestly less expensive than at-the-money calls. This situation makes it possible for us to set up a $5 spread for a cost of only about $1.65. If VXX rises above $56 before expiration next month, we'll earn the difference, or $3.35 on our $1.65 at risk. If VXX stays below $51, the spread will move toward expiration unused, drifting toward $0, so we'll need to close it to recoup as much as our $1.65 as possible.

We're using October options because they allow for the least expensive spread possible, and because backwardation on the VIX futures is more likely to last weeks rather than months. (In other words, backwardation may cause VXX to tick up for a short while even if the VIX doesn't, but it's rare for backwardation to last for months on end.) Even if backwardation *does* last longer, we can always set up another spread once this October one plays out. The VIX futures were briefly back in contango last week, when the VIX was nearing 30, but then jumped into steep backwardation again as the market declined. It will likely take at least a few weeks for the futures to approach contango again, and that assumes the VIX doesn't go higher -- hence, this hedge.

How to Follow Along

- **Buy ("buy to open")** October 2011 $51 calls.
- **Write ("sell to open")** October 2011 $56 calls.
- **Use a spread order:** Aim to set up this bull call spread for a net debit of about $1.65 or less per spread.
- **Maximum profit:** $3.35 if VXX is higher than $56 by expiration (203% return on risk)
- **Maximum loss:** $1.65 (the cost of setting up the spread) if VXX is below $51 by expiration
- **Margin Requirement:** None. The only cost is that of setting up the spread.
- **Allocation:** Only invest an amount of money you're comfortable losing.
- **Flexibility guidance:** If the price of VXX changes considerably by the time you're ready to make this trade, you can move your strike prices up or down accordingly, aiming to set up a similar spread for the same cost or less.

The Foolish Bottom Line

Next Steps

Questions? Visit our iPath S&P 500 VIX Short-Term Futures discussion board.

Our short position on VXX is an intermediate-term position (at least) as we wait for markets to become less volatile. In the short term, we want to hedge at least some of it over the coming month with a relatively inexpensive bull call spread, which makes sense with the VIX futures in backwardation – a condition that favors VXX ticking higher unless the VIX declines. Although I believe the world's problems are too well known to go unresolved, it may be weeks or months before investors start to calm down, and volatility may stay elevated in the meantime. As long as that's the case, we'll look to set up inexpensive spreads like this to hedge our short on volatility.

Pro *will set up a bull call spread on VXX in the next one to 30 days, per The Motley Fool's trading policy. Jeff is short VXX. See the* Pro *portfolio here.*

Plan for Volatility

Published Sep 26, 2011 at 12:00AM

Dear Fellow Volatility Investors,

345% Potential in 1 to 3 Years

Like it or not, volatility is a part of today's market (hence the salutation above). At *Pro*, we initiated the latest iteration of our naked calls on the **iPath S&P 500 VIX Short-Term Futures ETN** – a bet against both a specific flawed instrument and against volatility in general – just two months ago, but when a position goes against you like this one has, time seems to stand still. If you wrote calls with us, you may also feel like these two months might as well have been an eternity in Dante's fourth circle of hell. (That's where the greedy are punished, if you were wondering.) If you're feeling shell-shocked after watching VIX breach the traditionally "fearful" $40 mark four times recently (the last spike being the most painful for those in need of relief), I want to reassure you: Have no fear -- but do have a plan.

Above: A graphical depiction of our two-month history with VIX and VXX. Source: Yahoo! Finance.

If you're wondering how to get from zero to plan, we have a few ready-made plans outlined below. They're yours for the taking, as protection against fear.

Plan A: Be Like *Pro*

If you're matching our moves trade by trade and matching our allocation percentages, you already have a plan in place. With our skipper, Jeff Fischer, at the helm, the future will be calmer (he has a calming effect on the seas*), and our course to profit is already plotted. Part of *Pro*'s plan is to off-set additional short-term losses if volatility goes higher by setting up a low-cost hedge on our position -- see today's trade as an example.

*Well, maybe not. But he does believe in worrying less while others worry more, and he is careful not to make emotion-driven or hasty decisions. Jeff is a great partner on any investing journey, and he shines during difficult periods.

Plan B: Follow in the Spirit of *Pro*

Jeff Fischer and David Gardner Live!

Motley Fool co-founder and veteran investor David Gardner will be the keynote speaker at eTrade's Investor Education Day in Washington, D.C., tomorrow, Sept. 27, from 9 a.m. to 4 p.m. David will be joined by *Pro* advisor Jeff Fischer, who will share his thoughts on how to invest for success in today's volatile market and develop a portfolio built for profits and protection. We hope you can join us for this free, informative event. Click here to register!

First things first: If you're over-allocated, over-leveraged, and/or have run out of buying power, you need to get your financial house in order – even if that means realizing losses. Investing needs to be survivable before it is profitable.

Like many of you, I invest in the spirit of *Pro*, but I don't follow *Pro* trades to the letter. Maybe your allocation to various positions is different than the *Pro* portfolio's, or you passed on VXX to invest in the **VelocityShares Daily Inverse VIX Short Term ETN** instead. (Or maybe you, like me, invested in both.) Perhaps, again like me, your written calls were assigned and your broker couldn't find shares to short. In situations like that, being out of sync with *Pro* isn't entirely of your choosing.

If that's the case, you need a plan of your own. As I tried to explain to a boastful asset manager at a cocktail party this weekend, lucky isn't a plan. This woman was telling everyone who would listen how smart she was for having moved all her clients to 90% cash in August. When pressed, she provided a glimpse of her brilliance: All of her discretionary accounts had been "stopped out" (mechanical forced selling at usually lower prices). When I asked about her plan to start moving back into equities, she had no idea; this was her first experience with stop orders. Cocktail parties are aggravating, and I need to stop going to them – but now (like her!), I'm off course.

My Plan

Backwardation and Contango

Contango is when prices for a commodity are higher on longer-dated futures contracts than near-term contracts, while backwardation is the opposite (prices get lower as the delivery date gets more distant). Find more investing definitions on our investing wiki, Foolsaurus.

If you're new to *Pro*, or if you don't currently have a position in our beloved but flawed VXX ETN, you're probably wondering whether you should establish a new position now. VXX may have topped out at $50, or it may continue to climb higher; time will tell, but in the meantime, you could certainly do worse than shorting it now. Months from now, the brilliance of shorting VXX today will likely be obvious. My guess is that backwardation will continue to drive the VXX price upward, so I will wait a bit longer. While my VXX calls were assigned, I still have exposure to volatility through XIV shares. I plan to get back into VXX by using options to create a synthetic short once backwardation returns to low single-digit levels (hopefully on its way back to contango, which eats away at VXX's value and bolsters our long-term short thesis on the position). If you need help crafting your plan, or have a plan you'd like to share, please post it on the VXX discussion board.

No Fear?!

At the top, I suggested that you should have no fear. That might sound ridiculous after watching naked calls on VXX go from negative $3.50 to negative $25 and beyond, as seen below, but I think it's very doable.

Source: AOL Daily Finance.

Over the years, I've met many "fearless" people -- enough that I feel comfortable putting them into three buckets. (I can also boast that I've learned the key to fearlessness, which I'll share in the third bucket.) The first category is, of course, fearlessness through naïveté -- it's easy to be fearless when you don't know danger is near. For most people, naïveté is ideally a transitive state, since it can easily turn into stupidity when not remedied. The second bucket is occupied by the truly insane, those who don't register fear when logic says they should. I have no expertise in this area, but I hope to avoid it and those afflicted by it (and I advise you to do the same). Then there's the third bucket, where we *Pro* Fools should aim to land. Often, you must do your time in Bucket No. 1 before you can graduate to Bucket No. 3 -- so if you've only recently been made aware of the dangers of margin, forced selling, or overallocation, there is hope.

Bucket No. 3 is fearlessness through preparation. The well-prepared have nothing to fear. They have already thought through multiple reasonable (and unreasonable!) contingencies and decided how they'll react to each one. The best part is, it's not hard to get there: If you've read this far and are considering your next actions, or if you're already following our guidance closely, you're well on your way to separating yourself from the fear-generating talking heads.

Last week, Jeff built a strong case for a fear bubble, arguing that much of the recent panic is overdone. Click here to read that article.

Thank you for being a part of *Pro*, and stay fearlessly Foolish!

Nick Crow (TMFCrow)

Pro Trade Roundup

Charter Portfolio

- **StoneMor Partners**: Sold to open three October $30 puts for $1.10.
- **BMC Software**: Bought 1,100 shares (3.5%) at $41.88.
- **Powershares QQQ Trust**: We set up a ratio put spread, selling to open 40 Dec. 17, 2011, $46 puts and buying to open 20 Dec. 17, 2011, $51 puts. Net credit: $0.17.
- **NextEra Energy**: Sold all shares at $55.03. Bought to close nine January 2012 $60 calls at $0.60. We are keeping our written puts in both portfolios open. (We're happy to buy NextEra again at a lower price. In fact, we aim to keep writing puts on it to approximate or exceed the annual dividend it was paying us, which was $2.20 per year.)

Portfolio 2011

- **StoneMor Partners**: Sold to open one October $30 put for $1.10.
- **BMC Software**: Bought 200 shares (3.5%) at $41.82.
- **Bristow Group**: Sold to open two December $40 puts for $2.50.
- **Powershares QQQ Trust**: We set up a ratio put spread, selling to open eight Dec. 17 $46 puts and buying to open four Dec. 17 $51 puts. Net credit: $0.17.

Guidance Updates

- **Intel**, **Oracle**, and **Bristow Group** move down to Hold. They're each at least 8% above our buy-around guidance.

Coverage & Community

- Rail shipments remain healthy in the U.S., suggesting a new recession is less likely.
- MazonCreekRich provides a Gloomy Gus update.
- DolonAltekar reflects on his new, *Pro*-inspired feelings about the market.

Charter and 2011 Portfolios: Buy More Pebblebrook Hotel Trust

Published Sep 23, 2011 at 12:00AM

At a Glance

- **Action:** Buy enough shares to bring your current allocation up to 3%
- **Recent Price:** $14.27
- **Buy-Around Price:** $21.50 (but **use a limit order** near current prices)
- **Alternate Trade:** None. This stock is cheap and its options rather illiquid. Stick with a simple stock purchase.

What's New?

In the time we've owned hotel REIT **Pebblebrook Hotel Trust** (NYSE: PEB), our shares have dropped more than 25%. Although I (Alex here) feel this sell-off is overdone, I'm not surprised by it. Hotels' performance is closely tied to the overall economy, which has shown signs of weakness. On top of that, investors tend to group REITs together — often unfairly. Pebblebrook, with its narrow focus on upscale, urban, independent hotels, has precious little in common with hotel REITs that own portfolios of branded (think Holiday Inn or Marriott) or economy properties. For us, that means that a stock that was cheap to start out with is now even cheaper.

I attended Pebblebrook's first analyst conference last week, and after the presentation, I spent two hours touring some of the company's recently acquired midtown Manhattan properties with the executive team. The experience reaffirmed my thoughts about Pebblebrook (that it's well-run, opportunistic, and overlooked), and I also came away with an even higher degree of respect for the management team. Here are my key takeaways:

They are really good at what they do.
Pebblebrook's management team has improving hotel operations down to a science. CEO Jon Bortz spent more than 11 years honing this process (on exactly the same kinds of hotels) when he ran **LaSalle Hotel Properties** (NYSE: LHO), and his management team at Pebblebrook includes several members of that former crew. The team describes its process as a hunt for "nickels and dimes," and team members find dozens upon dozens of these small savings in everything from energy conservation measures to laundry systems to switching from Coca-Cola bottles to cans (seriously).

They are disciplined.
Bortz and his team know their niche, and they don't stray from it. They recently removed three cities from their list of target markets because, after looking at new hotels there, they decided they didn't fully understand those markets. They don't acquire new properties unless the opportunity is elephant-sized in a world of antelope. And now, with the stock price so low, they weigh each potential acquisition against buying back their own shares. This is exactly the kind of smart, shareholder-friendly behavior we want from the stewards of our capital.

The stock has big upside.
During their most profitable periods under their previous owners, Pebblebrook's collection of hotels brought in a smashing 61% more EBITDA than they did in 2010 (keep in mind that Pebblebrook only purchased its first hotel in June 2010). Pebblebrook's management is already pushing EBITDA back up. But here's the exciting part: Those previous highs were achieved *before* Pebblebrook bought the properties and let its asset management teams loose to renovate, revamp, and streamline. All those nickels

and dimes add up fast (for example, Pebblebrook has already cut $1.5 *million* in annual savings at the Viceroy Miami), and that money flows directly to EBITDA. The upside for the company's hotel portfolio from here is huge — even if Pebblebrook never buys another property.

Why This Strategy / How to Follow Along

We love us some Pebblebrook. With the stock price so low, we want to top off our position to bring it back to 3%. We recommend you do the same. Head to the Pebblebrook discussion board with your questions.

Alex and The Motley Fool own shares of Pebblebrook.

Pro on Investing Today

Published Sep 23, 2011 at 12:00AM

Dear Fellow Fools,

The Golden Rules

Right now, the golden rules of stock investment remain truer than ever:

- Only invest money in stocks that you won't need for three to five years. Any cash you expect to need within a few years should not be in the stock market. Neither should your emergency cash savings.
- Only buy stable, thriving companies that are very likely to create value over the next three to five years — as we've done in *Pro*.
- Don't put your investment account at risk by using excessive margin or putting too much money into just a few positions.

In addition — difficult though it can be — don't sweat daily price swings. As a *Pro* Fool, your investments of last week, and last year, were made with the intention of staying in the market for several years. What stock prices do in the meantime, while sometimes hard to watch, is largely irrelevant right now. Prices are only relevant years down the road when you're ready to sell, and we do know that the lower prices go today, the greater the odds they'll be much higher years from now.

The more worried others are about the stock market, the less worried you generally need to be.

Or, as Warren Buffett famously put it, "Be fearful when others are greedy, and greedy when others are fearful." Lately, the whole world seems worried and fearful. Concerns about the economy have sent worldwide stock markets on a particularly choppy ride over the past few weeks — with most of the "chop" happening to the downside.

And our *Pro* portfolio has not been immune. We've recommended three "shorts" since the month started, but we haven't been able to place them all ourselves (our broker lacked shares and some prices changed before we could trade); we hope members acting before us had a better outcome. Even if those trades had gone off without a hitch, though, this short-term market turn would have been unkind to our long-term positions. It's inevitable that as investors, we will miss some market turns or be caught on the wrong side of some positions. This is one of those times. But as long as our analysis is correct — and we are confident that the strategies that have been successful for us for years will work again now, too — we will ultimately come out in the green. And for new members buying today, opportunities are excellent.

Fear That Serves No Purpose

Fear is sometimes useful: It kept our ancestors out of the way of enormously toothed mammals, and it keeps us out of the way of speeding cars. But it doesn't do us any good when we're focused on something as shapeless as the economy. Unfortunately, the Federal Reserve seems to have forgotten this fact, doing its part to stoke the latest fears of economic weakness. In justifying a new Treasury-buying program on Wednesday, the Fed cited "significant downside risks" to the economy, and the mere act of naming this risk seems to have brought it to life in the markets.

Perhaps as much as anything else, the collection of statistics we call "the economy" is a barometer of confidence. If the population is confident about the economic future, people will spend and companies will hire. If not, they won't. Leading U.S. companies have more cash on their balance sheets today than at any time in modern history, but lack the confidence to spend it, and the Fed's words only gave the country another reason to worry — a perfect, and unfortunate, example of FDR's famous proclamation that "the only thing we have to fear is fear itself."

The Rules of Investing

Despite the bleak headlines, it still appears likely that the U.S. economy will hold its ground or slowly improve over the coming year and beyond — but only if we keep fear at bay. If countries and societies choose to panic, they may bring their own worst fears to life. What we need right now, here and abroad, is strong leadership that can calm the masses, instill confidence, and move us toward emotional and economic recovery. Eventually all of those things will occur, but until they do, we're probably in for a bumpy ride. This means the golden rules of stock investment remain truer than ever (see the sidebar above).

Sticking to Strategies That Work

We'll continue to position the *Pro* portfolio to perform strongly over the coming three years and beyond. We do want to make steady use of shorts and hedges to smooth out any sudden declines, but when our core investments decline and we get bruised, we'll brush ourselves off and keep moving forward. Our companies are much stronger now than they were a few years ago, cash balances are high, and valuations are generally even lower than they were in March 2009, when the market last bottomed. I'm extremely confident that the investments we've made and the new ones we're making will position all of us to profit over the only time frame that will ultimately prove relevant, which is the coming few years and beyond. I believe even the short positions on volatility that have been so challenging for many veteran members over the past weeks will be a profitable strategy in the end.

In the meantime, invest for the years ahead, and remember to keep the fun in your life today. Our discussion boards offer some of both: Talk about the market's roller-coaster ways on the Philosophy & Strategy board, or get away from it all with a conversation about pirates, tomatoes, or your first car on our Social Banter board.

Thank you for being a part of *Pro*, and have a Foolish weekend.

Best,

Jeff Fischer (TMFFischer)
Advisor, *Motley Fool Pro*

Charter and 2011 Portfolios: Set Up a Ratio Put Spread on QQQ

Published Sep 21, 2011 at 12:00AM

Attention, *Pro* Fool! Read this before you make this trade. This is an options trade that aims to protect our portfolio against a major decline in our holdings in the tech sector. If you're not yet comfortable with options, if you aren't able and willing to invest at least $4,600 in this trade in the future, or if you are not heavily invested in stocks in general or the tech sector in particular, *you may not need or want to make this trade*. Visit our PowerShares QQQ Trust discussion board to talk about it further.

Trade Essentials

- **Action:** Set up a ratio put spread on the **PowerShares QQQ Trust** (NASDAQ: QQQ)
  - Sell to open two $46 puts expiring Dec. 17, 2011
  - Buy to open one $51 put expiring Dec. 17, 2011
  - Note: We are using the options that expire Dec. 17. There are also "quarterly" options on QQQ that expire Dec. 30. We are **not** using the quarterly options.

- ### Ratio Put Spreads

  A ratio put spread is a primarily defensive strategy in which you buy puts (usually with a strike price below the underlying investment's current price) and pay for them by writing twice as many puts at an even lower strike price. If the stock falls below the higher strike price, you begin making money; if it falls substantially below the lower strike price, the spread could end up losing you money. See our Introduction to Spreads or visit our Complex Option Strategies discussion board for more. You can also visit our first (now completed) ratio put spread trade to learn more about the strategy.

- **Allocation:** We'll write twice as many puts as we buy. The written puts will represent 14% of our current portfolio value, but half of this is insured by the purchased puts, so our true exposure is 7%. For Charter, we'll sell to open 40 $46 puts and buy to open about 20 $51 puts. For Portfolio 2011, we'll sell eight $46 puts and buy four $51 puts.
- **Recent ETF Price:** $56.31
- **Recent Options Prices (Bid/Ask):** Dec. 17, 2011, $46 puts (the written puts): $0.81/$0.83; Dec. 17, 2011, $51 puts (the purchased puts): $1.64/$1.65
- **Preferred Price:** Aim to set up the ratio put spread for zero cost, so that the amount you're paid for the puts you write covers the cost of the puts you buy.
- **Alternative Trade:** You could just buy the Dec. 17, 2011, $51 puts if you prefer more robust disaster insurance and are willing to pay up for it.
- **Why set up this ratio put spread?**
  - For little to no cost, we can protect our portfolio if the tech stocks we hold experience a sharp decline.
  - We have a large cushion: For us to lose money on this spread, shares of the PowerShares QQQ Trust would have to decline more than 26%, *and* we'd have to pass on buying shares of QQQ at that point in anticipation of a recovery.
  - No upside risk: We don't lose anything on this position if the market stays flat or rises.

The Big Picture

At *Pro*, we have always been fans of technology: Jeff stood in line all night outside an early Apple Store on Fiji to buy a first-generation Lisa, and Nick once killed a guy with a remote-controlled trident. (Note: Anecdotes may not be 100% true.) That affection for the innovative is reflected in the *Pro* portfolio by our current holdings in the sector, be they big names like **Intel** (NASDAQ: INTC) or lesser-known companies like **OpenText** (NASDAQ: OTEX). We have high confidence in our hand-picked tech stocks, but if the sector as a whole hits a rough patch, we want to be prepared. That's why today we're using options to set up zero-cost insurance on our tech-sector stocks.

Here are the positions we are specifically aiming to hedge with this trade, along with our current allocation to each in the Charter Portfolio:

Company	Current Allocation*
Autodesk (NASDAQ: ADSK)	3%
Intel (NASDAQ: INTC)	7.4%
OpenText (NASDAQ: OTEX)	2.9%
Oracle (NYSE: ORCL)	5.2%
BMC Software (NASDAQ: BMC)	3.5%
Total	22%

* Includes options exposure.

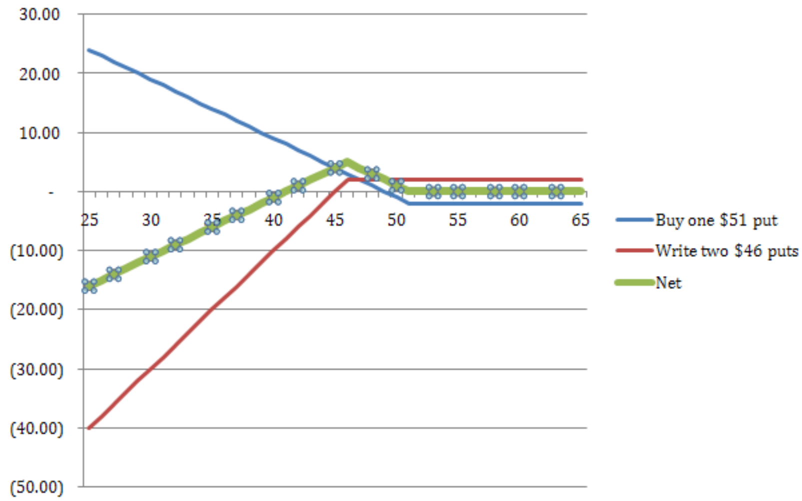
We're singling out this subset of our stocks for a specific hedging strategy because they tend to be rebels — collectively, their movements are only 49% correlated with those of the S&P 500. That's a low figure, and it means a broad index ETF, like the common **SPDR S&P 500 ETF** (NYSEMKT: SPY), isn't a suitable vehicle to hedge them, because there's not much guarantee that the stocks will actually move in tandem with the overall market. On the other hand, these four stocks are 91% correlated with the **PowerShares QQQ Trust** (NASDAQ: QQQ), which tracks an index of the 100 largest non-financial companies listed on the Nasdaq. In other words, if our tech stocks take a nosedive, we can be confident the PowerShares QQQ Trust will follow suit. We're hedging about two-thirds of our large tech exposure.

The Strategy

Again, this ratio put spread is best thought of as insurance against a large market decline. We don't expect our tech holdings to decline sharply (if we did, we wouldn't own them), but the markets have been volatile and investors emotional, and we want to protect ourselves against a greater than 10% index decline — especially since we can do so for free. If the PowerShares QQQ Trust goes up, stays flat, or declines slightly, this trade will have no effect on our portfolio (other than the buying power we need to hold open our extra $46 puts). *Only* if QQQ falls 10% or more will this spread "kick in" as our purchased $51 puts, which allow us to sell QQQ at $51, become more valuable — cushioning the blow to our portfolio in general and our tech stocks in particular.

The trade involves *writing* puts at a lower strike price and using the proceeds to *buy* puts at a higher strike price. You write twice as many puts as you buy, which allows you to set up the spread for free or possibly even for a net credit.

A visual representation might help explain. The chart below shows how much money we stand to make on this trade, assuming we set it up for zero cost. The range of possible outcomes is based on the potential price of the PowerShares QQQ Trust when these options expire Dec. 17, 2011. Remember, we're writing two $46 puts for every one $51 put we buy.



As long as the PowerShares QQQ Trust stays above $51, this position is neutral for us (it creates no profit but costs us nothing). If shares fall below $51 (a 10% drop from today's level), we begin to make money on the trade. We book our maximum profit of $5 per purchased put if QQQ is at $46 at expiration (a 19% drop). And it would have to fall more than 26%, to our breakeven price of $41, before we start to lose money on this spread.

Here's how the math breaks down: If the PowerShares QQQ Trust declines to $46 or lower at expiration — that's a fall of 19% or more — then half of our written puts will obligate us to buy a 7% allocation at $46, unless we close them instead. (Again, that allocation represents half of our written puts; the other half are offset by our purchased puts.) However, in the case of such a decline, our purchased puts will net us $5 per share in profit, so our effective buy price would be $41, or 27% below current prices.

Please note that we are *not* explicitly betting that the PowerShares QQQ Trust will decline. But if it does, it will bring our hand-picked tech stocks down with it, and we want to protect against that possibility. One more time, this is *insurance*.

How to Follow Along

For every uncovered put you write for this trade, you must be able and willing to invest $4,600 at some point down the road ($46 strike price x 100 shares = $4,600). Some brokers will allow you to set up a ratio put spread with a single trade, which saves you commissions. The details:

- **"Sell to open"** Dec. 17, 2011, $46 puts.
- **"Buy to open"** Dec. 17, 2011, $51 puts, one for every two puts you sell.
- **Limit prices:** Use limit orders near the midpoint of each bid/ask spread. This should allow you to set up the two legs of the trade with zero net cost. It may even be possible to set up the spread for a small net credit. If you have to make the legs of the trade separately (if your broker won't let you enter it as a single "spread" order), aim to complete both orders in quick succession so that a sudden move in the market doesn't affect your prices mid-trade.

If you have questions about this ratio put spread, please visit our new PowerShares QQQ Trust discussion board. You can also see our "Introduction to Spreads" lesson in Options U. over at our sister service, *Motley Fool Options*; as a Pro member, you have free *Options* access.

Jeff owns shares of Autodesk, Intel, and Oracle and has an options position on BMC Software. The Motley Fool owns shares of Autodesk.

Charter and 2011 Portfolios: Buy BMC Software

Published Sep 20, 2011 at 12:00AM

Trade Essentials

- **Action:** Buy 3.5%
- **Buy Around:** $43 (Use a **limit order**, Fool!)
- **Fair Value:** $56
- **Alternative Trade:** If you want to try buying shares cheaper, try writing puts: "Sell to open" October 2011 (or later) $41 (or lower) puts.
- **Why Buy?**
  - BMC's software allows customers to operate more productively and save money.
  - Almost 50% of its annual revenue is recurring, which means increased stability.
  - Shares trade at a healthy discount as investors fear a slowdown in the government sector.

The Big Picture

First Things First

- **Company Name: BMC Software** (NASDAQ: BMC)
- **Recent price:** $41.70
- **Market Cap:** $7.4 billion
- **Website:** www.bmc.com
- **Type of Holding:** Software, Value
- **Follow It:** Add BMC to My Scorecard

The more technology sinks its wires into every aspect of modern life, the more businesses need tools to manage that technology efficiently. If synchronizing your laptop, tablet, and smartphone to work smoothly together has your head spinning, now imagine you're running a business with thousands of employees, all relying on a giant computer network to get things done. This is where **BMC Software** (NASDAQ: BMC) strides in. Offering companies an integrated way to manage their entire electronic arsenal, BMC ties together corporate mainframes, computing clouds, applications, and databases so they work smartly and efficiently as one.

BMC Chairman and CEO Robert Beauchamp says the company's main product, Atrium, is "the glue that connects all the technology that a company buys — all the hardware, the software, the people — to what they are doing with these computers, so they know what they've got and how it's performing." Simply put, BMC products help a company manage its technology so it does the best job possible at a lower cost. Atrium can reduce network downtime up to 75%, deliver results 30% more efficiently, and help a company implement new technologies up to 50% more quickly, all while keeping a close eye on the overall system.

Productivity gains and cost savings make BMC's software an essential tool for companies, governments, and large organizations that need to manage their diverse information technology (IT) components. The company is credited with founding the software niche called Business Service Management (BSM), which is a fancy way of saying, "We'll help your business technology run better, my friend." As an industry pioneer, BMC has grown revenue every year since 2002.

The Business

BMC's solutions are used by many of the largest companies in the world, including 96% of the Forbes Global 100 and 81% of the Fortune 500. Founded in 1980 and named after the last initials of its three founders (in case you were wondering), BMC has approximately 15,000 customers, including retailers, manufacturers, hospitals, and education institutions. But its most significant clients are financial services companies (including banks) and government agencies. The company primarily sells to large enterprises that have intense (read "expensive") IT demands and that commit to services for the long haul to avoid disruptions. Like any software company worth its salt, BMC has expanded its software offerings as its client base has grown and expressed its needs. BMC now offers several dozen product lines, including IT asset management, storage management, and controls and compliance.

The company is divided into two main businesses:

- **Enterprise Service Management** (ESM): The larger of the two, this division includes IT service assurance (is the technology working?), service function and automation, support (such as problem management), and Atrium to tie it all together. In 2010, BMC started offering popular on-demand Software-as-a-Service (SaaS) in this division.
- **Mainframe Service Management** (MSM): This division focuses on IT requirements for mainframe computer data and performance, middleware management (the software that connects two separate applications), and data management, among many others, again integrated with a version of Atrium. Cloud services and virtualization are also offered as companies move more data offsite and save costs with server virtualization.

Finding and solving information bottlenecks, suggesting business priorities and better workflow processes, assuring compliance and 100% reliability — BMC's software runs the gamut of corporate technology needs. BMC considers its largest competitors to be **IBM** (NYSE: IBM), **CA,** (NASDAQ: CA), and the struggling **Hewlett-Packard** (NYSE: HPQ), and it enjoys partnerships with **Cisco Systems** (NASDAQ: CSCO), **Dell** (NASDAQ: DELL), **Red Hat** (NYSE: RHT), **Oracle** (NYSE: ORCL), and **Microsoft** (NASDAQ: MSFT), among others. The line between partners and competitors can a blurry, rapidly changing one when it comes to software, but BMC's installed base of customers and deep bench of products provide it with strong competitive advantages. Most customers sign long-term contracts that bundle BMC's software with ongoing maintenance services. The cost to customers is measured in various ways, including mainframe computing capacity, number of servers in use, number of gigabytes, number of users, and others.

Financials and Valuation

In its 2011 fiscal year, which ended March 31, BMC clocked more than $2 billion in revenue, 49.6% of which was maintenance revenue — the recurring, subscription-based revenue we like so much in *Pro* because it lends more stability and predictability to a business. Sales were split evenly between domestic and international, and operating margins (how much of every dollar was left after paying all operating costs) were a healthy 25.8%. Research and development was a respectable 8.5% of revenue, assuring us that the company isn't resting on past success. As a testament to management's focus on wringing value from the business, cash from operations is up 82.1% since 2007 while revenue is "only" up 30.6%.

BMC Annual Results (Years ended March 31)	2007	2008	2009	2010	2011
Revenue	$1,580	$1,732	$1,872	$1,911	$2,065
Operating Margin	13%	21%	20%	26%	26%
Cash From Operations	$420	$594	$580	$635	$765

Sources: BMC annual report and Capital IQ. Numbers in millions.

This is not a capital-intensive business. Capital expenditures haven't exceeded $28 million in any of the past three years, so the cash from operations shown above is nearly the same as the free cash flow generated by BMC each year. (Free cash flow is the money it has left with which to do whatever it wishes.) For the last 12 months through June 30, BMC's free cash flow was a record $839 million, pricing the stock's $7.4 billion market value at only 8.8 times free cash flow. (Include BMC's $1.58 billion in cash and equivalents against only $298 million in long-term debt, and the free cash flow multiple drops to 7.) Our fair value estimate values shares at 12 times free cash flow, or $56.

What Would Make Us Sell

The stock did in fact trade at $56 in July. It plunged to its recent $41 after first-quarter 2012 revenue grew 9% to $502 million, just landing shy of the $507 million estimate. The revenue "miss" on its own wasn't a big deal, but investors were also spooked when BMC said orders from the U.S. public sector were weak and some sales were taking longer to close in Europe (these factors *are* a big deal for anyone selling to the government). BMC's abundance of government contracts sent investors running for the doors as the U.S. debt-ceiling crisis mounted and some European governments appeared ready to teeter.

These risks aren't gone; BMC could see more softness as governments tighten belts. Much of this risk is already reflected in today's low valuation, but if business is especially weak, we'll revisit our thesis. We'll also keep a close eye on maintenance revenue and new license contracts. Both are key drivers; Wall Street continues to expect healthy growth from BMC and, as July showed, won't stand for disappointment.

The Foolish Bottom Line

Short-term thinking on Wall Street is letting us buy shares of one of the world's most successful software companies at a discount. Run by a straight-talking management team with a long-term focus, BMC has earned the business of many of the world's most prominent companies and governments and has rewarded shareholders with steady value creation that we believe will resume once current uncertainty clears. To discuss the company, visit our new BMC Software discussion board — and get ready to rock your IT knowledge!

Jeff has an options position on BMC and owns shares of Oracle. The Motley Fool owns shares of Cisco Systems, Microsoft, Oracle and IBM.

Portfolio 2011: Write Puts on Bristow Group

Published Sep 19, 2011 at 12:00AM

Pro first recommended buying **Bristow Group** in our Charter Portfolio in July 2010. For *Pro*'s original thesis, read our buy report on Bristow.

Trade Essentials

- **Action:** "Sell to open" a 3% position in December 2011 $40 puts (for Portfolio 2011, that's two contracts)
- **Recent options price (bid/ask):** $2.60/$3.90
- **Preferred price:** Fly a helicopter right down the middle of the bid/ask prices — use a limit order around $3.25 at first (that's an option yield of 8%)
  - As prices change, shoot for an option yield above 4%, because you want to be paid at least 12% annualized and these expire in three months. On a potential $40 commitment, 4% in yield equates to a minimum $1.60 option payment to you.
- **Stock fair value:** $50
- **Alternative trade:** Buy a 3% position in the stock outright near our $39 buy-around price
- **Why write puts?**
  - The long-term demand for helicopter flight hours to service deep-water offshore oil production is strong.
  - Bristow benefits from predictable and recurring revenue streams, which enable it to make sure it has the newest and jazziest fleet of helicopters.
  - Shares are undervalued already, and writing puts gives us a chance to secure an even better purchase price.

What's New?

First Things First

- **Company: Bristow Group**
- **Recent price:** $41.50
- **Market cap:** $1.5 billion
- **Website:** www.bristowgroup.com
- **Wanna buy a whirlybird?** You can!
- **Type of holding:** Long-term, energy services
- **Strategy:** Guide to writing puts
- **Follow It:** Add to My Scorecard

As shares of helicopter services company **Bristow Group** continue to hover above $40, the September puts we sold to open back in June expired on Friday. We were happy to bank 100% of our put premium, but because we weren't assigned shares, we still lack an allocation to Bristow in Portfolio 2011. Today, we're maintaining our discipline and writing another round of puts that will again allow us to get paid while we wait for shares to come into striking distance of our $39 buy-around price.

Last month, Bristow released solid first-quarter 2012 earnings and provided earnings guidance for the full year. Management expects EPS in the range of $3.55 to $3.90, which implies a forward price-to-earnings ratio of 10.5 to 11.5 — far from pricey, but not quite in the bargain-basement territory we'd like to see given the asset-intensive and politically sensitive conditions that rule Bristow's business.

With its 571 aircraft, Bristow continues to have a leading market position in the major oil and gas regions of the world. Its industry-leading safety performance helps keep costs low and provides an advantage when bidding for contracts. We steadfastly monitor Bristow's performance to make sure its balance sheet and financial returns are moving in the right direction, and we'll happily write these puts to get paid while we wait for the results to fly in.

Why This Strategy?

You need options approval to write puts, and the trade command is "sell to open" or "sell." (*Do not buy these options!*) Sell one contract for every 100 shares of Bristow you're willing to purchase later (each contract represents an obligation to buy 100 shares, or $4,000 worth, of Bristow stock). Writing these options will pay you the option premium up front, and we'll wait until expiration on Dec. 16 before taking any further action.

Our initial potential profit is whatever the puts pay us (we're hoping for at least $3.25 each); we have an obligation to purchase shares of the stock if they fall below the $40 strike price by expiration. If we get shares, our net buy price will be $36.75 (we'll buy the shares at $40, but still keep the $3.25 the puts pay us). Since we fully intend to take ownership if assigned the shares in December, we note again that you should make sure you have $4,000 available, per contract, to purchase shares. If the shares remain higher than $40 by expiration, the options expire unexercised, and we simply keep the put premium as income.

How to Follow Along

Next Steps

- Questions or comments? Still getting used to all this options jargon? Visit our Bristow discussion board.
- Stoked to learn more about writing put options? Head over to the All About Options discussion board.

You can simply buy shares near our buy-around price of $39 if you prefer, but we're cheapskates — and we want to earn income while we wait. If converted into shares, these puts would allow us to buy shares about 14.5% cheaper than the recent price and at just 0.9 times tangible book value. If the shares remain above $40 at expiration, we won't get to buy shares, but we'll earn a decent return on this trade and look to write puts again.

Portfolio 2011 will write puts on Bristow in the next one to 30 days, per The Motley Fool's trading guidelines. See Pro*'s holdings here.*

What to Expect When You're Expecting Expiration

Published Sep 19, 2011 at 12:00AM

Dear Fellow Fools,

345% Potential in 1 to 3 Years

Stocks are in a slump — down more than 10% since late July. Warren Buffett and world-class value hedge fund managers Whitney Tilson and Bill Ackman see a buying opportunity. And here at The Motley Fool, we recognize these special situations, too.

Now, the Fool's own "special ops" wiz, Tom Jacobs, is calling one stock "simply the most inefficiently priced I've ever seen." He's revealing it for **free**, along with an inside look at his service, *Motley Fool Special Ops*. To get the goods, simply click here.

Last Friday came and went without much ado in the market as a whole; the S&P barely budged. But over in our *Pro* portfolio, there was a little more excitement. Four of our options positions expired, three in Portfolio 2011 and one in the Charter Portfolio. Those new to options might not know that they always expire on the Saturday following the third Friday of each month, and if this was your first options expiration Friday (or even if it wasn't), you're probably wondering "so what?" and "what now?" We're glad you asked. Here's what happened with each position.

Bringing In More Broadridge

In May, we recommended writing September $22.50 puts on **Broadridge Financial Solutions** in both portfolios. Our aim was to bring our allocation up to 3% in both portfolios while paying even less than our $23 buy-around price. If we weren't assigned shares, we'd still happily accept the $1 we were paid for each put in exchange for maintaining our discipline. (Indeed, that's the essence of writing puts Foolishly.)

The market as a whole has fallen 9% since that recommendation, and Broadridge was down 5% as of Friday, putting us in the position to accept shares via our written puts. We did just that over the weekend, buying 700 shares in the Charter Portfolio and 300 shares in Portfolio 2011 — bringing us about in line with our 3% goal in each portfolio.

We're happy with this outcome. Broadridge is a stable business with high levels of recurring revenue, and it produces a lot of cash. We expect it to continue paying us back through dividends and smart reinvestment of that cash. While the pace of acquisitions should slow, we think Broadridge will continue to convince large financial institutions to outsource data-heavy functions. The company's dominance in investor proxy voting and other communications makes it a portfolio bedrock. If you missed out on May's written puts and the subsequent assigned shares, you can buy shares today at about $21, a discount to our $23 buy-around price and an attractive margin of safety to what we think they're worth.

Grabbing GrafTech

In the Money

Put options are "in the money" when the underlying stock is below the option's strike price. See our Options Glossary for more definitions

GrafTech International has taken us on a wild ride — we recommended writing puts in April and have been holding on to our hats ever since. The share price was cut in half in a matter of days during August's generally chaotic market, largely because global GDP growth estimates were reined in. For better or worse, GrafTech's business is tied to manufacturing and global output, and investors sprinted for the door when things seemed to be slowing down. Our puts expired in the money, and over the weekend, we purchased 500 shares.

GrafTech's stock price has recovered nicely, though we do expect more volatility in the future. We like the company because it's a low-cost manufacturer of graphite electrodes, which are used in the most efficient steel-production process. Input prices have been working against GrafTech for some time now, but we expect the company's recent price hikes to help stem that pain. GrafTech will spend the next two quarters signing contracts to build its book of business for the coming year, and we expect benefits from recent acquisitions and efficiency improvements. GrafTech's no-nonsense management continues to execute in difficult times. If you don't own shares already, take advantage of the recent pullbacks; shares are well below our $19 buy-around price.

Breaker, Breaker, 1, 2 on Bristow

We often end our written put recommendations by saying that if our puts expire worthless, we'll look to write additional puts later on. Well, that's exactly what we did with today's recommendation to write December $40 puts on **Bristow Group** in Portfolio 2011. This recommendation follows on the heels of our September $40 puts, which expired over the weekend (we earned 100% of our written premium). Our buy-around price on Bristow is $40, and writing puts to buy shares at that level maintains that discipline and pays us well if shares stay stubbornly higher.

Business continues to be strong at Bristow, and management is helpfully opening the company's playbook regarding actions that could increase profitability even further. Looking at the appropriately named "Bristow Value Added" (check out slide 14 here for details) in coming quarters, we can see where management will be focusing its attention and where future trouble spots may be. Bristow's opportunities remain strong, and we will be happy to finally establish a position in Portfolio 2011 if our December put options allow it. If not, we'll look to write additional puts later on. (You shoulda seen that one coming.)

Three Trades for Today

When our options near expiration, we're forced to ask "what now?" regarding each relevant position. That's an exercise we encourage you to go through, too. Regarding Broadridge and GrafTech, we're reminded that the strength of their competitive positions should trump near-term pressure on their shares. If you don't own these solid businesses, bone up on our original theses and consider buying. With Bristow, we're going back to the well to take advantage of the hefty premium we can earn by writing puts.

Mark your calendar for another options expiration Friday on Oct. 21!

Bryan (TMF42)

Pro Trade Roundup

Charter Portfolio

- **MasterCard** : Bought 120 shares (3%) at $324.29
- **Autodesk** : Bought 1,400 shares (3%) at $27.90
- **Broadridge Financial Solutions** : Bought 700 shares (1%) at $21.48 via put options, bringing the Charter Portfolio to a 3.3% current allocation
- **StoneMor Partners** : Sold to open three October $30 puts (about 0.6%) for $1.10

Portfolio 2011

- **MasterCard** : Bought 21 shares (3%) at $324.63
- **Autodesk** : Bought 250 shares (3%) at $27.90
- **StoneMor Partners** : Sold to open one October $30 put (about 0.6%) for $1.10

- **Broadridge Financial Solutions** : Bought 300 shares (2.5%) at $21.51 via put options
- **GrafTech International** : Bought 500 shares (3%) at $16.79 via put options

Coverage & Community

- Jeff shares his vision for the future of our portfolio.
- How should you use *Pro* with other Fool services? RockyTopBob wins our contest with his helpful answer to this age-old (okay, 3-year-old) question.
- Still catching up? No worries; most new members are. Visit our Getting Started discussion board to post your questions!
- Rwz1 asks, Jeff answers: What is "buy around" and "fair value"?
- Sonusameer asks about buying calls on Autodesk instead of the stock.
- TMFMoosie posts a *Pro*earnings calendar.
- If you've got some time to kill this afternoon, Alex posted the 99-page slide deck from **Pebblebrook**'s investor conference last week.

Charter Portfolio and Portfolio 2011: Write Puts on StoneMor Partners

Published Sep 15, 2011 at 12:00AM

Hey, New *Pro* Fool!

Read this before you make this trade. In yesterday's "Get Up to Speed With Options" feature, we promised you a "newbie-friendly" options trade soon, and voila — here it is! In this trade, we're writing puts on StoneMor Partners. When we write ("sell to open") put options, we usually have two goals in mind: to potentially buy shares of our favorite companies at better-than-market prices, and to earn income while we wait for the right price. Keep these points in mind as you follow along:

- Always use limit orders and follow our pricing guidance.
- Each put option you write obligates you to potentially buy 100 shares of the underlying stock — that's $3,000 worth of StoneMor shares. If that doesn't jive with the size of your portfolio, check out the alternate trades below.
- To play along, you'll need level 2 options approval from your broker or enough cash to cover your potential obligation.
- The trade command for writing put options is "sell to open."
- The *Pro* guide to writing puts provides granular detail on the process.

Trade Essentials

- **Action:** Write October 2011 $30 puts on **StoneMor Partners** (NYSE: STON)
  - For Portfolio 2011, we're selling to open one put. If we are assigned shares, this will bring our allocation to about 3.5%. (New *Pro* Fools are encouraged to follow Portfolio 2011.)
  - For the Charter Portfolio, we're selling to open three puts. If we are assigned shares, this will bring our allocation to 3.1%.
- **Recent Stock Price:** $29.15
- **Recent Options Prices (Bid/Ask):** October 2011 $30 puts: $1.25/$1.75
- **Preferred Price:** Aim to split the bid-ask prices (lately $1.50); initially, it's ideal to accept no less than $1.25. As prices change, ideally accept no less than a 3.3% yield (or about $1) if the stock rises.
- **Alternate Trades:**
  - Instead of writing puts, you could simply buy enough shares to bring your total allocation to 3% to 3.5%. If it's practical for you, buy in 100-share lots; this will help if we use options on these shares in the future.
  - If you'd like the potential to earn additional premium, you can sell to open January 2012 $30 puts, lately about $2.70.
  - Finally, you could buy shares worth 2% of your portfolio (the stock is within 4% of our buy-around price) and write these puts for the remaining 1% to 1.5%.

Why Write Puts?

- StoneMor's business is recession-resistant, and the stock has been remarkably steady through the recent market turmoil.
- We recently recommended selling dividend payers **GlaxoSmithKline** (NYSE: GSK) and **NextEra Energy** (NYSE: NEE), so we want to increase our exposure to this high-yielder.
- These puts will likely award us stock at a price cheaper than we would pay today; if they don't, we'll still pocket about a 5% return in 36 days.

What's New?

Precious little has transpired at StoneMor Partners since we took our initial 2% position in July — and that's exactly the way we want it. This cemetery owner and operator is the picture of stability. Sales of burial plots, caskets, and other "death care" merchandise are high on predictability and low on risk, a combination that makes this business about as recession-resistant as they come. The stock seems to reflect this: Since we bought the stock, the market has plunged 8%. StoneMor, on the other hand, is up 4%.

All that, and the shares are still yielding north of 8%. The unusual accounting requirements to which StoneMor is subject continue to befuddle the market — which allows us to keep collecting this outsized dividend yield. (For details on the accounting distortions, check out our original trade alert or the StoneMor discussion board.) And that dividend is just as safe as when we first purchased shares; the company has about $100 million in cash and liquid assets, which are the short-term fuel for the dividend, and the business (the long-term dividend generator) remains robustly healthy.

Why This Strategy?

Selling to open these in-the-money puts will have one of two outcomes for us:

In the Money

Put options are "in the money" when the underlying stock is below the option's strike price. See our Options Glossary for more definitions.

- If shares are less than $30 in October, we are obligated to buy them (100 for each put) at a net cost basis of about $28.50.
- If shares are higher than $30 in October, we have no obligation — we just keep the premium we were paid for our puts, earning 5% in income in just over a month.

Either result is attractive to us. We primarily own StoneMor stock for income (although we do expect some capital appreciation). These puts will either allow us to buy more shares at a cheaper price than today (which translates into a higher dividend yield) or simply pocket income directly, which is rarely a bad thing.

If you have yet to establish a position in StoneMor, you can catch up by following our third alternate trade listed above: Buy shares worth 2% of your portfolio (the stock is within 4% of our Buy Around price) and write these puts for the remaining 1% to 1.5%. Or, if you're a purist or don't want to use options, you can simply purchase a 3% allocation (the first alternate trade).

How to Follow Along

Write enough October $30 puts to bring your total allocation of StoneMor, if the puts are exercised, to between 3% and 3.5%. Again, the trade command is "sell to open" or "sell." (*Do not buy these options!*)

Each contract represents an obligation to buy 100 shares, or $3,000 worth, of StoneMor stock. Writing these options will pay you the option premium up front, and we'll wait until expiration nears (Oct. 22) to determine our next move.

- Questions about this trade alert? Head to our StoneMor discussion board.
- Questions about writing put options in general? Head to our All About Options discussion board.

Alex does not own shares of any company mentioned. Jeff owns shares of GlaxoSmithKline. The Motley Fool owns shares of StoneMor Partners.

Get Up to Speed With Options

Published Sep 14, 2011 at 12:00AM

Dear Fellow Fools,

A big part of *Pro*'s investment approach involves the use of options to boost profits, smooth out volatility, and maintain our valuation discipline. If you're new to the world of options, we know they can be confusing at first. We want to help you get up to speed using options so you'll have this useful weapon in your investing arsenal. To help you get comfortable, we've compiled this list of resources — consider it your road map to conquering options.

Foolishly,

Bryan Hinmon (TMF42)

Options Resources

Your membership in *Pro* entitles you to free access to our sister service, *Motley Fool Options*, which features a full curriculum of options education organized into three "degrees" — basic, intermediate, and advanced. These degrees are designed for you to learn at your own pace and to give you a reference when you need one. If you're new to options, start with the basic degree. You can find handbooks to the basic and intermediate degrees here:

- Options U: Your Guide to the Basic Degree (aka "Options for Beginners Handbook")
- Options U: Your Guide to the Intermediate Degree (aka "World Domination Cannot Be Far Behind")

If you have questions about the degrees, bring them to the *Motley Fool Options* Options U. discussion board here:

- Options U.: *Motley Fool Options* Discussion Board

And if you're a more advanced investor or are looking to tackle more complicated options strategies:

- Check out the guides for our Advanced Degree

Finally, if you have questions about which broker to use, how much money you need to trade options, or other administrative issues, check out our FAQ:

- Options Help FAQ

Whatever level you're starting from, we've got you covered. Aside from the library of information at your disposal in *Motley Fool Options*, we have an incredibly knowledgeable and gracious community of members offering their help, advice, and insights 24 hours a day. Feel free to join the conversation (or just monitor the scuttlebutt) on *Pro*'s All About Options board. We hope these resources give you everything you need to build an options education with a solid foundation. Fool on!

Charter Portfolio: Sell GSK and NEE, Buy to Close Covered Calls on NEE

Published Sep 13, 2011 at 12:00AM

What About Portfolio 2011? The following trades are for the Charter Portfolio. In Portfolio 2011, we have written puts to purchase shares of GlaxoSmithKline and NextEra more cheaply than today's prices. We're leaving those puts open because we'd be content to buy either stock lower in Portfolio 2011 — and if that happens, we'd reconsider them for Charter Portfolio, too.

Trade Essentials, GlaxoSmithKline

- **Action:** Sell all shares
- **Recent price:** $40.50
- **Alternative Trade:** You could write near-the-money covered calls (October 2011 $41 calls or October 2011 $42 calls) if you own 100 shares or more of GlaxoSmithKline and would rather try to sell higher, but this is not as defensive as selling.

Trade Essentials, NextEra Energy

- **Action:** Sell all shares; buy to close January 2012 $60 covered calls
- **Recent prices:** Stock, $53.65; January 2012 $60 calls, $0.60 ask

- **Alternative Trade:** None.

Why Sell?

- These defensive positions held up well during the market's recent rout; now they're a good source of cash.
- We'll reinvest this money in stocks we believe will have more upside in a market recovery.
- We'd also buy these stocks back cheaper in the future, so we're leaving our puts open in Portfolio 2011 and would revisit shares in the Charter Portfolio if lower prices are met.

What's Changed?

U.K.-based **GlaxoSmithKline** (NYSE: GSK) and Florida-based **NextEra Energy** (NYSE: NEE) have performed as hoped, providing us with growing dividends and playing defense for our portfolio by typically holding up better than average during market declines. We're selling them now to raise cash from two positions that didn't appreciate much during the last bull market so we can put that cash to work in positions we believe will perform better over the coming few years. Selling large dividend payers is never easy, but we're looking to earn more than 5% per year on this money in the future. The more the market declines, the more upside potential there is in the promising stocks we're considering.

How to Follow Along

We'll sell all of our shares of these two companies in the next one to 30 days. As for our covered strangle on NextEra, consisting of January 2012 $50 puts and January 2012 $60 covered calls: We'll buy to close the $60 covered calls for a profit in the next one to 30 days (at the same time we sell our shares), but we'll leave the $50 puts open. If NextEra stock is less than $50 in January 2012, we'll be obligated to buy shares (in the same amount we're selling today) in the upper $40s — more than 10% cheaper than they are today, an outcome we'd be happy to accept.

If you want to write covered calls instead of selling GlaxoSmithKline, as in the alternative trade listed above, feel free, but be aware that we plan to invest the cash raised from these two positions over the coming weeks and months.

If you have questions about these trades, please visit the GlaxoSmithKline and NextEra Energy boards.

Jeff owns shares of GlaxoSmithKline.

Riding Through Volatility

Published Sep 12, 2011 at 12:00AM

Fear and panic are ruling the markets right now. These emotions will subside eventually, as they have every time before, and calm — or something akin to calm — will return. But until it does, we need to ride out the storm.

The Recent Roller Coaster

How to Play the Coming Market Rally

Stocks are in a slump — down more than 10% since late July. Is this a buying opportunity*?* Warren Buffett and world-class value hedge fund managers Whitney Tilson and Bill Ackman certainly think so. Here at The Motley Fool, we recognize these opportunities, too. And one Motley Fool portfolio manager wants to prove it by revealing a top recommendation, for free, in an exclusive video. To make sure you see it, simply click here.

One of our goals at *Pro* is to earn steady returns with less volatility than the market overall. If you've been following all of our trades, though, you'll notice that since August, we've actually had *more* volatility than the market. There's one main reason for that: We're short volatility through the **iPath S&P 500 VIX Short-Term Futures** exchange-traded note, which aims to track the famous volatility index known as the VIX by mirroring short-term VIX futures contracts. To put it more simply, we've been short volatility during a politically charged budget squabble on Capitol Hill, the first U.S. credit-rating downgrade in history, and a looming potential default in Greece — all of which have, shall we say, rattled the market. Someday we'll be able to claim victory (and profess courage) for holding the position through these events.

But for now, this short position alone has removed 6% in value from the Charter Portfolio just since the beginning of August. We're effectively short the VXX at $25.50, and it was up to $46 as of Friday — an 80% jump. This sort of move can happen with any individual short, and it would be especially painful if we didn't believe the price would eventually come back. But we do: The VXX's price is all but guaranteed to deflate once investor fear subsides and the underlying Chicago Board Options Exchange VIX index settles down.

As mentioned, the VIX is a "volatility index" that serves as the most popular measure of implied volatility expected from the S&P 500. It was above 38 as of Friday, suggesting 38% annualized volatility. During most periods of crisis, the VIX has peaked somewhere in the 30s or 40s; 10 years ago, in September 2001, it hit 43.74. In November 2008, it climbed as high as 80.86 (that's extremely unusual) before quickly declining. In calmer times, it reverts to the teens. The VIX has only spent 3% of its time above 40 over the past two decades, and its average has been just 19.

So being short volatility as measured by the VIX has hit our portfolio in the past month. But we know the price will come back down if we just wait out the fear-driven spikes. We also know the VIX can't be acquired, can't report blowout earnings, can't buy back its own shares — in other words, there's not much else it can do to surprise us. I'd much rather be short the VIX for long periods than many, or even most, public companies.

Have Cash, Will Ride

As of Friday, our VXX short was 8.4% of the Charter Portfolio and 7.4% of Portfolio 2011. When volatility starts to go down instead of up, these positions will quickly start to add value back to the portfolios — and it is a question of when, not if. Volatility will likely begin to subside once Europe's credit crisis finds some resolution and the U.S. budget and employment picture starts to clear up. If it becomes evident by the end of the year that we'll avoid a double-dip recession, the VIX should fall sharply, and these short positions will steadily pour value back into our portfolios. But it's key that we have liquidity — the financial flexibility and means to ride out market volatility while it remains inflated. Any short can work against you for a long time, but with this particular short, we have the enormous benefit of knowing that if we wait long enough, it will work for us again.

As we're waiting, I'll repeat: While fear reigns, our portfolios are going to be more volatile than usual. When we short volatility again in the future — and we will — we may use more specific strategies, like option spreads, to mitigate the effect on our portfolio. But for now, we need to deviate from our usual goal and simply accept greater volatility. Concurrently, we're working to position the portfolio strongly for the eventual recovery we know will occur. Expect more sells (followed by new buys) as we work to refocus our investments for the coming years.

It's Not Greek to Us

At the moment, all eyes are on Greece, a nation with a long history of spectacular collapse. You usually need to fly high in order to fall far, but this time Greece never even took flight. It simply joined the Euro nations when it shouldn't have been allowed to. With a debt-to-GDP ratio topping 140% last year, Greece is not likely to get out from under its burden without technical or actual default on its debts. As frightening as that sounds, Greece represented only 1.9% of the European Union's GDP in 2010 (and less this year), so its total debt is somewhere around 2.5% of the EU's annual GDP. In other words, the EU *can* save Greece if it wants to. The alternative is to let Greece fall out of the Eurozone, which would allow the EU to shore up its strength and save its ammunition to make sure other countries with larger economies — like Italy or Spain — escape greater problems. Right now, it looks like there's a 50/50 chance at best that Greece will be saved.

The Foolish Bottom Line

We'll continue to invest in strong, promising companies. We'll continue to suggest hedges that make sense to investors who want to cushion downside risk (even if our broker leaves us unable to place some of those trades ourselves). And we'll wait for volatility to decline and our largest short position to unwind in our favor. We're even open to adding to that position at some point. We welcome your comments and questions — join us on the VXX discussion board or the Memo Musings board.

Foolishly,

Jeff Fischer (TMFFischer)

Jeff is short VXX.

Pro Trade Roundup

Charter Portfolio

- Sold all shares of **Jack Henry & Associates** at $28.95.
- Sold all shares of **Vanguard Emerging Markets** at $42.96.

Portfolio 2011

- None.

Guidance Updates

- **GlaxoSmithKline** moves to hold pending a review.

This Week's Expirations

Charter Portfolio

- **Broadridge Financial Solutions** : September $22.50 puts (for 700 shares) are due to be exercised. We will either accept more shares or roll the puts following a review of our cash position. We'll announce any roll by Wednesday.

Portfolio 2011

- **Broadridge Financial Solutions** : September $22.50 puts (for 300 shares) are due to be exercised. We will accept these, our first shares in Portfolio 2011. Members who did not write puts can buy shares cheaper directly to match.
- **GrafTech International** : September $17.50 puts (for 500 shares) are due to be exercised. We'll accept these new shares, our first in Portfolio 2011. Members who did not write puts can buy shares cheaper directly to match.
- **Bristow Group** : September $40 puts (for 200 shares) are due to expire or potentially be exercised (the stock is $41.50 and could dip by Friday). We'll accept shares if the stock declines below $40 by expiration.

Coverage & Community

- Adding to our recent Monday Memo, *Pro* member mrhumanbeing shares traits and practices of successful investors in this excellent post.
- Bryan (TMF42) walks you through how to read our trade alerts, and Ed (spinningwood) chimes in with his own thoughts on how to approach *Pro*.
- TMFMoosie posts a *Pro* earnings calendar. October isn't far away!
- Alex340 posts puts that match*Pro* criteria — and covered calls, too.
- New members continue to get started and invest steadily. Bravo!

Audio Extra: Covanta, StoneMor, and OpenText

Published Sep 9, 2011 at 12:00AM

Jeff and Alex sit down to chat about **Covanta**, **StoneMor Partners**, and **OpenText** — all recent *Pro* purchases and current Buy First or Buy stocks. Learn why the team is visiting a local trash-to-energy plant, how Alex stumbled upon a cemetery owner with an oversized dividend, and why Jeff is revisiting an old favorite stock. After listening, head to the Covanta, StoneMor, or OpenText discussion boards with your questions and thoughts.

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Transcript

Alex Pape: Hello, Fools, and welcome to today's *Pro* Audio Extra. I am analyst Alex Pape. I am joined by our advisor, Jeff Fischer.

Jeff Fischer: Hey, Alex; good to see you.

Alex Pape: Jeff, thanks for joining me. So today we are going to talk about three recent buys we have made in both the charter and Portfolio 2011. So let's get started with Covanta. Jeff, how did you come across this company?

Jeff Fischer: This is everyone's favorite trash-to-energy company. It is a well-known name, rolls off the tip of the tongue. Covanta is the country's largest, as I just said, waste-to-energy company. It brings in garbage from municipalities, things that you and I may be throwing away, and turns it into energy. It provides about 5% of the country's renewable energy source this way. It also recycles the metals that it brings in, and that adds quite a bit of revenue to the business as well.

It is a value company, to answer how I found it. It trades at only about nine times free cash flow and eight times EBIDTA, so it is inexpensive. You might expect more like a 12 multiple [for a company] like this that has steady free cash flow generation. The kicker, what makes it really interesting now, is management is finally really trying to create shareholder value. They started a dividend last year, which is about 1.9%, and a large share buyback program. They have bought back 6% of shares in about a year, and they are going to continue that. And they are raising capital. They are selling plants in other countries to raise capital and return it to shareholders as well so they can focus on their most efficient waste-to-energy plants here in this country.

Alex Pape: And Covanta actually has one of its plants right here in Alexandria, Virginia, where Fool HQ is headquartered, and the *Pro* team is very excited to go out and check it out for the first time.

Jeff Fischer: We are, and you know, I know Covanta is listening right now. They need to call me back. I have called them; we are playing phone tag. We need to get out to see that plant. We realize, though, we are not in a big rush because we may lose one team member on that visit, you know, just slip over a rail into the ... no, they are very strict about what you wear and where you can walk and it is quite an operation. From what I hear, you have to really cover your ears and everything else. They process tons of garbage per day and burn it into energy, so.

Alex Pape: Great. So we will move on to StoneMor Partners.

Jeff Fischer: Yeah, Alex, this is one you brought to our attention. Really unique ideas. Why do you think *Pro* members should own it?

Alex Pape: Sure. So StoneMor is a master limited partnership that is the second largest operator and owner of cemeteries in the United States, so it is an incredibly predictable, low-risk, recession-proof business. For some reason, it is yielding north of 8% in terms of its dividend yield.

Jeff Fischer: It is a very high yield. That usually signifies a distressed company, that the yield may not last.

Alex Pape: Sure. If one of the analysts sees a dividend that high, you instinctively think, OK, what's wrong here? What's wrong here: There is nothing actually wrong with the business, but the company StoneMor is subject to a series of bizarre accounting requirements. When they book a sale, they have to divert cash into trusts that are legal requirements to make sure that they have the financial ability to meet their responsibilities to deliver whatever they sold, be it a burial plot or a casket, later on. The exact details of all that accounting are in our buy report on the boards.

So I just want to share with you how exactly we came across this. We actually published a series of articles on Fool.com, the other side of the business, that talked about dividends that looked unsustainable, and one of the companies we mentioned was StoneMor. One of our analysts, not on our team, but one of the other services, ran into the CEO of StoneMor at a cocktail party, and the CEO went to him and said, Hey, what's this article all about? You guys don't have the story right at all.

And so we set up a phone call and I got to spend a couple of hours with the CEO going line-by-line on their entire, all of their financial statements, and he just explained to me all of the distortions that are made. When you do it all out, it is just as obvious, as simple a business as it might seem like it would be, to own and operate a cemetery, very straightforward. And so once you understand that, you can see exactly why the market misprices it. And so we simply just step in, and we are happy to accept an 8%-plus dividend on a stock that looks undervalued, and we can just take that home every day.

Jeff Fischer: Yeah, Alex, and I wonder if the story is getting out slowly because since we have purchased shares, the market has fallen sharply, and this has held up like a rock.

Alex Pape: This has, so it does make sense.

Jeff Fischer: The report spells it all out, but it is fascinating how they have taken money, their pre-sales basically, they have taken that money, but they can't really book it or use it. It goes on as a liability, and so that is why the debt looks enormous, part of the reason why the debt looks so large and the cash flow looks so small, but it is all just accounting.

Alex Pape: It is gimmickry that they have to abide by and they have no control over, but does not reflect what is happening in underlying cash situation for the company.

Jeff Fischer: So that is StoneMor, STON.

Alex Pape: So let's move on, Jeff, to OpenText, one of your recent buys. Do you want to tell the members a little bit about this one?

Jeff Fischer: It is a recent buy and an old buy too. I first came across this company several years ago and it has been a recommendation I have made a few times over the years, so that is only good; more familiar with the company. I have known the same management team for years, known the business, watched them grow up. OpenText is the largest enterprise content management software company ...

Alex Pape: That's a mouthful.

Jeff Fischer: It is. ECM for short ... in the world, second only to IBM, who has slightly more market share. But this software, all it does is help a company or a government manage and control its files, its data and its regulatory filings -- which is now a large issue, as everyone knows, for financial companies especially, but also legal companies. Any sort of company that is regulated, they have to keep their papers or e-data in order and correct. This software helps make sure they do it, that they never miss a deadline.

So OpenText has been growing steadily over the years and management has also been acquiring companies, and like many great software companies do, you can buy add-on software programs, [that's] basically what you are doing when you are acquiring a smaller company. Add it on, sell it to your existing customers, and grow that way.

So that is what OpenText is doing, and they also are moving into business process management, which just helps a company manage its strategies and its decision-making processes and all that, so it is content with thinking behind it too. It is strategy in relation to your content, so it molds very well with their enterprise content software. Now you are managing your strategy process as well.

BPM, as it is called, business process management, is about a $2 billion market right now, growing around 15% per year, and OpenText just bought two of its leaders for close to $500 million, so they put a serious commitment into it. The shares, around $58, trade around 12 times expected normalized earnings for this coming summer -- for next June. So it is reasonably priced, given that they have been growing well above that mark, and should for quite a while to come. A well-run company.

Alex Pape: Well, Jeff, thanks for joining me, and members, thank you for joining us. If you have any questions, as always, head to the boards. That's it for this Audio Extra. Until next time, Fool on!

Charter and 2011 Portfolios: Buy MasterCard

Published Sep 8, 2011 at 12:00AM

Trade Essentials

First Things First

- **Company: MasterCard** (NYSE: MA)
- **Share Price:** $340
- **Market Cap:** $43 billion
- **Website:** www.mastercard.com
- **Type of Holding:** Growth, Core
- **Follow It:** Add MasterCard to My Scorecard

- **Action:** Buy 3%
- **Buy Around:** $325 (use a limit order around or below this price)
- **Fair Value:** $390
- **Alternative Trade:** If you're investing more than $30,000 in the stock, you can consider writing puts to attempt to buy shares cheaper.
- **Why Buy?**
  - Acceptance and use of payment cards like those offered by MasterCard is growing around the world.
  - Payment cards are stealing market share from cash.
  - The company's business model is highly profitable.

The Big Picture

When it comes to moving money around, few companies rival **MasterCard** (NYSE: MA). As the second-largest payments processor in the world (after **Visa** (NYSE: V)), it processed $2.7 *trillion* in gross dollar volume in 2010, up 10.7% year over year. The company rings up revenue every time people around the world use a product bearing its name to charge, debit, or prepay their way through the cash register.

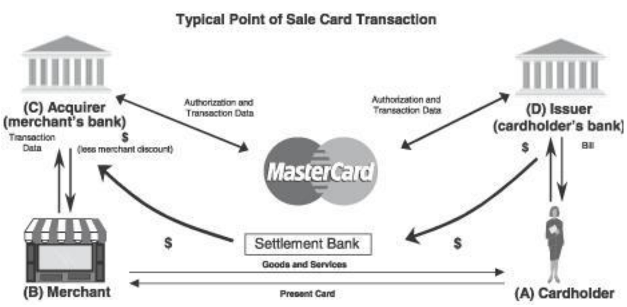
The global economy is struggling, but MasterCard can grow even as GDP stagnates. The switch from cash to plastic is an enormous, worldwide secular (read: not cyclical or seasonal) trend, one that many take for granted. And it's still in its early stages: The total amount of annual financial transactions worldwide was recently estimated to be at least $34 t*rillion*. *You* might not use the green stuff much anymore, but 85% of those transactions are still completed with cash, leaving plenty of room for MasterCard to grow.

MasterCard CEO Ajay Banga calls the company's mission "the War on Cash." Luckily for MasterCard, cash is a weak competitor, one Banga describes as "expensive" and "inefficient": "You have to print it, transport it, secure it, store it and change it." Credit, debit, and prepaid cards are a breeze by comparison. And while such cards may seem ubiquitous in the U.S., Americans actually only use them for 32% of personal consumption expenditures. Cash, check, and electronic funds transfer round out the remaining 68%. This represents an enormous opportunity for MasterCard to steal market share even as the U.S. economy continues to struggle. Globally, the potential benefits from both market growth and increased market share are even greater.

The Business

MasterCard already operates in 210 countries and more than 150 currencies, and those numbers are only growing as emerging economies across the globe accumulate wealth and become more urban. At home and worldwide, credit cards are being accepted in more places and cash is accepted in *fewer* places (including, now, on many airplanes). MasterCard is highly visible as part of all this, facilitating transactions and marketing its brand — but it's the banks and lenders who take on any credit risk and are actually exposed to the card users' finances. Relieved of those worries, MasterCard is free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

So MasterCard facilitates transactions from cardholders to merchants via the cardholders' issuing banks. This is known as a four-party payment system. Here's a map of the typical transaction (cross your eyes if that helps you read it):



Source: Company filings.

The magic begins when a cardholder (A) makes a purchase from a merchant (B) using a MasterCard bank card. The card-issuing bank (D) authorizes the transaction, then uses the MasterCard network to pay the merchant bank (C) the purchase price, minus fees.

As a major multinational company with worldwide distribution, MasterCard enjoys geographically diverse revenue streams. Only 40% of revenue is generated in the United States, and international sources make up a larger share each year. Its revenue comes from three major sources: domestic assessments, at 35% of 2010 gross revenue; transaction processing fees, at 29%; and cross-border volume fees, at 25%.

Domestic assessment fees are paid by both the issuing bank and the receiving bank when the merchant and cardholder are in the same country. These fees are set based on transaction volume. Cross-border volume fees are exactly the same except the transaction occurs across country lines and includes currency conversion fees. Transaction processing fees (for authorization of payments, clearing and settlement of those payments, and the connectivity required to make it all happen) apply to both domestic and cross-border transactions and are based on the number of transactions.

Financials and Valuation

Its operating margins of greater than 50% mean that more than half of every dollar MasterCard earns becomes operating profit. By this measure, MasterCard is one of the most profitable companies in the S&P 500. As MasterCard builds its network around the world, its incremental cost per transaction is marginal after an initial investment, so profit increases faster than revenue.

Metric	Six-year CAGR*	Three-year CAGR*
Net Revenue	13.5%	10.8%
Operating Income	39.8%	35%

Sources: Capital IQ and analyst calculations. *Compound annual growth rate.

The company boasts better than 40% returns on capital and equity, and management is guiding for continued long-term excellence. Its targets are annual net revenue growth in the 12% to 14% range, with earnings-per-share growth of greater than 20% annually. Those aren't low hurdles, but we won't be surprised if MasterCard leaps over them. In the most recent quarter, MasterCard surprised analysts with a 33% jump in net income over the same quarter last year, well ahead of its own projections as transaction volume continues to grow.

Unsurprisingly, though, quality and growth don't come cheap. This $43 billion company trades at 21 times trailing free cash flow and 18 times its earnings-per-share estimate from Capital IQ for this fiscal year. Using a free cash flow to firm (FCFF) model, we value MasterCard shares at $390 using a 9.5% discount rate, and frankly, as long as the business model doesn't change much, time may prove this much too conservative. As the table below shows, MasterCard's financials have steadily improved since its 2006 IPO.

Metric	2006	2007	2008	2009	2010
Net Revenue	$3.3 billion	$4.1 billion	$5.0 billion	$5.1 billion	$5.5 billion
Gross Volume	$2.0 trillion	$2.3 trillion	$2.5 trillion	$2.5 trillion	$2.7 trillion
Transactions Processed	16.1 billion	18.8 billion	21.0 billion	22.4 billion	23.1 billion
Operating Margin	20%	28%	40%	48%	51%
Return on Capital	21%	24%	46%	54%	40%
Return on Equity	3%	40%	(10%)	54%	42%

Sources: Capital IQ and company filings.

Competitors

Feeble, inefficient cash and checks might be MasterCard's primary competitors, but Visa, **American Express** (NYSE: AXP), **Discover Financial Services** (NYSE: DFS), and literally thousands of other payment processors are anything but weak — and they're all fighting for market share.

In time, digital transactions, not cash, will be the de facto method of payment worldwide, and that opportunity is large enough for many players to profit. That said, reigning champions Visa and MasterCard have a significant lead over smaller competitors. They also aren't burdened with credit risk like the other giants, American Express and Discover, both of which actually lend money as well as facilitating payments.

Its biggest competitor, Visa, is twice its size, but MasterCard is accepted at more locations than any other brand, not least because it boasts the only globally interoperable PIN point-of-sale network. And Visa's considerable lead in debit cards in the U.S. is actually an opportunity for MasterCard: The Durbin Amendment (which you may know as the oft-delayed legislation that outlines the specifics on debit interchange fees) contains exclusivity provisions that will allow MasterCard to enter into debit agreements with banks that once did business exclusively with Visa. MasterCard is already gaining traction in debit card agreements.

This is not to say that cards will be with us forever. The next evolution in payments may well be an application on your smartphone — but MasterCard will get a piece of that action, too, thanks to partnerships like those it has with Google Wallet and Citibank. And what if it's the major telecommunications companies, not the banks, who end up controlling the lucrative mobile-payments channel? It just so happens that MasterCard is there, too, now that the telcos' phone payment joint venture, the ISIS mobile wallet, will include the major payment networks. The bottom line is that a trusted network (and "brand" host) is necessary to connect all of the major players in any digital transaction, and that means MasterCard and its ilk will be involved with any new applications, snapping up market share.

What Would Make Us Sell

Any business model that mints cash this quickly and enjoys such tremendous economies of scale with only a few major competitors risks attracting the attention of regulators. Add the fact that it's involved with commerce, and you know MasterCard is required to give the government in every country in which it operates has a say in how it does business. If new regulation here or elsewhere were to impair the economics of MasterCard's business model, we would sell.

Expensive litigation and massive settlements are another major risk. With a company this big and profitable, we expect new litigation in general, so that won't make us sell. But if a particular case threatens the permanent viability of the business, we'll bow out. Finally, capital allocation is a key criterion by which to measure the effectiveness of any management team, so if we see MasterCard's management making questionable acquisitions as new payment processors pop up, we may have to reassess. Of course, the company may be right to acquire its most viable mini-competitors, but we'll keep a close eye on the prices paid versus the value received.

The *Pro* Bottom Line

Next Steps

- Talk about MasterCard on our new discussion board
- Add MasterCard to My Scorecard

MasterCard has one of the most attractive business models the world has ever seen. The "priceless" ad campaign won over the world and helped established MasterCard as a global brand. As the world moves from analog to digital payments, we expect each additional card, transaction, and uptick in dollar volume to increase MasterCard's profitability for shareholders.

Share of MasterCard: $340. Sharing the commercial that reminds you of the *Pro* community: priceless.

Pro's September 2011 Ketchup Report

Published Sep 8, 2011 at 12:00AM

Dear *Pro* Member,

Prefer to Print?

If you'd rather read a hard copy of this report, you can download a PDF version here. (Please note that the conclusion of the PDF version states that purchasing all of these stocks at our recommended allocations would mean investing 49.5% of your capital. The correct figure is 51.5%. We regret the error!)

As you begin your investing journey with us, we want to guide you to buy strong, healthy companies at prices that offer more than ample upside against reasonable downside risk. Buying stocks with favorable risk-vs.-reward scenarios sets your portfolio up to prosper when the market is enjoying its sunny periods and helps it hold up better during the inevitable squalls. At *Pro*, we also use options and shorts to smooth out down periods (or, if possible, avoid their effects entirely), but our long-term core stock holdings will form the backbone of our investing success.

To help you get started, this report highlights each of our Buy First stocks (which are the same in both our Charter Portfolio and our Portfolio 2011), giving you our current thinking and suggested allocation for each. We then do the same for the Buy stocks in our Charter Portfolio we think you should consider now. (Because Portfolio 2011 was designed to "catch up" to the Charter Portfolio, all Buy stocks in Portfolio 2011 are also Buy stocks in the Charter Portfolio. For more on the two portfolios, click here.) The market's wily mood swings of late mean almost all of these stocks are within our Buy Around price guidance — in other words, you've picked a good time to start.

That said, please remember it's not a race: You can buy these stocks at a pace that works for you. If you want to buy full allocations now, that's fine, but you can also start with half positions (as we frequently suggest) and look to fill your positions completely if and when better prices come along. If you have experience with options, you can also consider buying half positions and writing ("selling to open") put options to potentially buy the remainder of your desired positions more cheaply. But for now, let's focus on buying some stocks.

Fool on!

Jeff Fischer, lead advisor (TMFFischer)

Buy First Stocks

Covanta

As one of the world's largest "waste-to-energy" producers, **Covanta** turns countless tons of trash into energy that it then sells to utilities. It may not sound glamorous, but this business creates steady free cash flow that management is using to create shareholder value: The company recently initiated a dividend and a large share buyback program. — *Jeff Fischer*

- **Guidance:** Buy First
- **Recommended allocation:** 3%
- **Recommendation history**

Intel

Intel is one of the best technology companies on the planet, producing the microprocessors in 80% of the world's computers. With its exceptionally cheap stock price and dividend yield of more than 4%, Intel offers healthy upside with reasonable risk. — *JF*

- **Guidance:** Buy First
- **Recommended allocation:** 4% to start, up to 6% later (reach your maximum allocation gradually, as we did)
- **Recommendation history**

Medtronic

Leading medical-technology company **Medtronic** is known for its impressive research and development engine. Fears surrounding increased competition and a changing health-care landscape have made shares of this very profitable business available on the cheap. — *Bryan Hinmon*

- **Guidance:** Buy First
- **Recommended allocation:** 3% to start, up to 5% later
- **Recommendation history**

OpenText

OpenText sells software that helps companies and governments manage their content and data more efficiently. With market share second only to that of IBM, the company is the darling of the enterprise content management industry and a possible takeover candidate someday. — *JF*

- **Guidance:** Buy First
- **Recommended allocation:** 3%
- **Recommendation history**

Pebblebrook Hotel Trust

Pebblebrook Hotel Trust is a real estate investment trust that buys upscale hotels from financially challenged owners and turns them around. At today's price, you can purchase shares for well below the asset value of the company's hotels, and if the economy worsens, Pebblebrook will have even more opportunities to acquire additional hotels from squeezed sellers. — *Alex Pape*

- **Guidance:** Buy First
- **Recommended allocation:** 3%
- **Recommendation history**

Rockwood Holdings

One of the world's leading producers of lithium for lithium-ion batteries, **Rockwood Holdings** also sells specialized chemicals serving hundreds of industries. Management is intensely focused on increasing free cash flow, and the business is having an exceptional 2011. — *JF*

- **Guidance:** Buy First

- **Recommended allocation:** 3% to start, up to 5% later
- **Recommendation history**

Buy Stocks

3D Systems

3D Systems is a small but exciting company that produces printers — for industries and consumers — that actually print objects in three dimensions. The ability to create prototypes this way saves money on product development for automakers, health-care companies, and countless other manufacturers. The stock is volatile, but it has a bright long-term future. — *JF*

- **Guidance:** Buy
- **Recommended allocation:** 2% to start, up to 3% later
- **Recommendation history**

AmTrust Financial

AmTrust Financial believes it's good to be small. The company specializes in a slew of niche insurance businesses that aren't profitable for or attractive to the big boys and girls of the insurance industry, and its impressive technology platform for policy management helps keep costs down. — *BH*

- **Guidance:** Buy
- **Recommended allocation:** 3% to start, up to 6% later
- **Recommendation history**

Bristow Group

Bristow Group flies cargo, crew, and supplies to and from offshore oil-production rigs. It has an unmatched fleet of large, high-tech choppers to service the deepest of deep offshore activities — and a safety record that would make Smokey the Bear rejoice. — *BH*

- **Guidance:** Buy
- **Recommended allocation:** 3% to start, up to 5% later
- **Recommendation history**

Broadridge Financial Solutions

Broadridge Financial Solutions is so good at keeping tabs on investors that financial-services companies across the globe are happy to entrust it with this necessary function. Broadridge's expansive record-keeping, vote-tabulation, and distribution software helps financial institutions save money in their communications with investors and brings in stable, recurring, and contractual revenue. — *BH*

- **Guidance:** Buy
- **Recommended allocation:** 3% to start, up to 5% later
- **Recommendation history**

Ebix

Ebix provides an electronic software platform for transactions across multiple insurance businesses. Its shares offer value and growth, and this young success story should mature into something built to last.

- **Guidance:** Buy
- **Recommended allocation:** 3%
- **Recommendation history**

GrafTech International

GrafTech International is the world's lowest-cost producer of graphite electrodes — hunks of carbon used in efficiently melting and reshaping steel. GrafTech's quest to lower its input costs and make steel production greener will serve it well if the global economy strengthens. — *BH*

- **Guidance:** Buy
- **Recommended allocation:** 3% to start, up to 5% later
- **Recommendation history**

L-3 Communications

L-3 Communications is a champion defense contractor, and right now, its world-class capabilities and technology are available at a bargain price. Even if cuts to the defense budget do come, L-3's essential services that are less at risk than the average program — yet its stock is on deep discount. — *Nick Crow*

- **Guidance:** Buy
- **Recommended allocation:** 3% to start, up to 5% later
- **Recommendation history**

Oracle

The world's leading business software company, **Oracle** is growing impressively as it serves an enormously diverse customer base and product line, and the stock is currently inexpensive. — *JF*

- **Guidance:** Buy
- **Recommended allocation:** 3% to start, up to 5% later
- **Recommendation history**

ProShares Short S&P 500

ProShares Short S&P 500 is an inverse ETF that moves opposite the S&P 500. If your portfolio is heavily invested in stocks and you need a short-term hedge that can be measured in months, this ETF can help smooth out down days. However, it doesn't perform well over long periods, so it's not meant to be a long-term holding. — *JF*

- **Guidance:** Buy
- **Allocation:** 3% to start, higher if you need a larger hedge
- **Recommendation history**

StoneMor Partners

StoneMor Partners is the second-largest U.S. owner and operator of cemeteries. Thanks to unusual accounting requirements that make it easy for investors to underestimate the company's profitability, the market is consistently confused about this master limited partnership. We're taking advantage by buying units and locking in the remarkable 8.2% dividend. — *AP*

- **Guidance:** Buy
- **Recommended allocation:** 2%
- **Recommendation history**

Wells Fargo & Company

Wells Fargo & Company is the most conservative and consistent operator in the out-of-favor banking industry, and its shares are significantly undervalued given the increased earning power of the Wells Fargo and Wachovia combination.

- **Guidance:** Buy
- **Recommended allocation:** 2%
- **Recommendation history**

WisdomTree Emerging Markets SmallCap Dividend Fund

The **WisdomTree Emerging Markets SmallCap Dividend Fund** combines the best of many worlds (or countries), focusing on small companies with high growth and strong dividends in emerging markets that are typically off the beaten path. Get your international diversification with a nearly 3% dividend yield to boot, all in one easy ETF.

- **Guidance:** Buy
- **Recommended allocation:** 2.5%
- **Recommendation history**

The *Pro* Bottom Line

Purchasing all of these stocks at our recommended allocations would mean investing 51.5% of your capital. That would leave you plenty of cash left over for new recommendations and to incrementally add to your favorites in our portfolio as opportunities come along. If you prefer, you could also average into our Buy First and Buy stocks over time, committing to filling these allocations over the rest of the year. In the end, it's not vital to have every allocation exactly just so; it's more important that you're buying good stocks at good prices, comfortable with what you own, and that you're ready to let time be your ally, growing value for you as an investor.

Whether you "catch up" all at once or gradually, we're excited to have you on board, and we'll continue to have new stock buys, option trades, and short positions available for you in real time.

Welcome again to *Pro*! Please ask any questions on the *Pro* Getting Started discussion board. Fool on!

Alex owns shares of Pebblebrook Hotel Trust. Jeff owns shares of AmTrust, Ebix, Intel, Oracle, and Rockwood Holdings. Nick owns shares of 3D Systems, Amtrust, Intel, L-3 Communications, Rockwood, Wells Fargo, and WisdomTree Emerging Markets SmallCap Dividend Fund.

Charter and 2011 Portfolios: Buy Autodesk

Published Sep 7, 2011 at 12:00AM

Trade Essentials

First Things First

- **Company Name: Autodesk** (NASDAQ: ADSK)
- **Recent price:** $26
- **Market Cap:** $6 billion
- **Website:** www.autodesk.com
- **Type of Holding:** Growth, Software
- **Follow It:** Add Autodesk to My Scorecard

- **Action:** Buy 3%
- **Buy Around:** $27 (use a **limit order**, Fool!)
- **Fair Value:** $38
- **Alternative Trades:** If you want to try for shares even cheaper, try writing puts: "Sell to open" October 2011 $26 or $25 puts, or "sell to open" January 2012 $26 or $25 puts
- **Why Buy?**
  - Autodesk's software can help build nearly everything in the world. The company offers superior design products to the markets it serves, and its pricing policy is winning market share.
  - Autodesk has been successful in selling packaged suites of its existing software and signing subscription-based recurring maintenance contracts, both of which should make its products even stickier and continue to improve profitability.

- Autodesk’s end markets are cyclical and may slow more in a recession, a fear that has knocked the stock down — meaning that this great business is now selling at a pedestrian price.

The Big Picture

The first rule of carpentry is "measure twice, cut once." Carpenters are smart: Careful attention to detail helps reduce costly mistakes. (Plus, they use flat pencils that don’t roll off a workspace — why haven’t those gone mainstream yet?) Today’s carpenters are higher-tech than their brethren of yore, using computer software to concoct designs and to test, analyze, and even automatically manufacture the finished goods. But the desire to reduce errors and waste across a product’s life cycle (from drawing to testing to production) remains as strong as ever, increasing demand for software to help efficiently manage the entire design process — a market opportunity worth more than $25 billion in annual sales.

And carpenters aren’t the only ones who use such software. In the midst of an epic build-out of buildings and roads in numerous emerging countries around the world, urbanization is accelerating, and so is the infrastructure needed to support it. In developed markets, builders are modifying existing structures to embrace energy efficiency. Defense against natural disasters and terrorist threats is now a standard part of the building design process. And even everyday consumer products are becoming more technologically complex in a quest for cost savings.

In every case, computer software is essential for designing, modeling, and stress-testing the solutions. All of these factors bode well for **Autodesk** (NASDAQ: ADSK), the undisputed leader in fancy-schmancy design software — and no stranger to veteran *Pro* members.

The Business

Autodesk sells its software to creative professionals in the manufacturing, architecture, engineering, construction, media, and entertainment industries, to name a few. Over its 28 years in business, more than 10 million users at 800,000 companies have used Autodesk’s products. And whether you know it or not, you’ve probably been touched by Autodesk today: The highway you drove to work on, the building you work in, your cell phone, and the movie you watched last night could all have been designed using Autodesk software. The company claims more than 30% of the computer-aided design (CAD) market, a feat it achieves only because customers stick with it. Many Autodesk professionals are lifelong loyalists, having learned to use the software in college and proudly presenting their knowledge front and center on their resumes.

We’re big fans of Autodesk’s business model, which seeks to democratize high-tech design. Less loftily, Autodesk is good at making money, too — its automatic-upgrade "maintenance" contracts have been successful for both the company (because they bring in more profit than a regular license) and customers (who are guaranteed the latest and greatest version of the software). Renewal rates are persistently high because the software is essential and rejoining after a lapsed subscription is costly. The number of subscription users has more than doubled to 3,000 over the past five years, and recurring-maintenance revenue has grown from 18% of total revenue to 40% — we like the added stability this offers during rocky economic times.

Autodesk’s competitive advantages are also critical to its success. Those include:

- High switching costs. Learning a new design software program is difficult and time-consuming. Autodesk is the market leader, meaning a large number of designers and companies are firmly committed to using its products year in and year out.
- Network effects. Autodesk’s software has become the standard in many industries, and as companies along the design and manufacturing chain work on increasing communication and collaboration, a standard language is vital. Autodesk’s large installed base means its network of users is vast, valuable — and strengthens as it grows.
- A global ecosystem. Autodesk has more than 2,000 highly trained resellers, 3,400 developers (who have created products using the company’s open-architecture software), and 1,200 authorized training centers. This structure helps keep users trained, creates jobs, and widens the pool of people who want Autodesk’s software to continue to reign supreme.

Financials and Valuation

Autodesk plows $0.25 of every sales dollar back into research and development to keep its products top-notch, and it spends a decent chunk on training and updating its sales force (which consists of a direct sales team for large accounts and value-added resellers for higher-volume sales). Even so, net profit margins that eclipse 10% have been the norm over the past five years (which, as you may recall, included a not-insignificant recession). And when it comes to free cash flow, Autodesk is minting money — it keeps nearly $0.17 of every dollar of sales to reinvest in its business and make acquisitions.

Besides the macro trends cited above, Autodesk should also benefit from its improving product line. The company’s recent push into selling suites (bundles of existing software that work well together, like **Microsoft** (NASDAQ: MSFT) Office), expanding its simulation and collaboration features, and investing in its direct sales force should continue to drive growth. With no debt and $6 per share in cash, Autodesk is in great financial shape to survive near-term economic bumps and still take advantage of any opportunities that may arise — just as it did through the 2008-2009 credit crisis.

Autodesk’s shares have taken a pounding recently, falling from $45 to a recent low near $25. (We sold our previous shares higher last January via covered calls, ending with a 78% profit.) Current prices reflect expectations of scant growth for Autodesk over the next decade, with no further improvement in profitability. Management, on the other hand, believes the company can achieve 12% to 14% revenue growth and can sustain 30% operating margins. Even if those numbers prove too ambitious, shares of this premium business should trade higher — near $38 appears reasonable to our spreadsheet data cells. Today, we can buy shares for less than 14 times free cash flow, a steep discount to the five-year average of 26.

What Would Make Us Sell

Several factors could crimp our investment in Autodesk.

- Evidence of a prolonged global economic slowdown will affect the willingness and ability of Autodesk’s customers to upgrade their design software, hurting sales and margins.
- If the company isn’t more successful in combating the piracy of its software in emerging markets, its growth targets could prove difficult to achieve.
- Poorly performing acquisitions could dampen future returns and tie up management’s time.
- Although Autodesk has a diverse reseller network, 16% of its annual sales come through a single value-added reseller, **Tech Data** (NASDAQ: TECD). The company’s longstanding relationship with Tech Data is reassuring, but if that sours or if Tech Data’s financial health slips, we’d reconsider.
- Of course, if the money the company is spending on research and development doesn’t translate into products with features that clients want, renewal rates may fall.

The Foolish Bottom Line

Next Steps

- Add ADSK to My Scorecard.
- Talk about this trade on our Autodesk discussion board.

Autodesk is a company we know well here at *Pro*. We originally purchased shares back in the dark market days of January 2009. It remains one of our favorite businesses because of its strong competitive position, necessary (and cool!) products, recurring revenue, healthy balance sheet, and cash-generating ability. We also like that the company's management team is made up of straight shooters who own shares alongside us. Today, we can buy into a well-above-average business with solid long-term prospects at an attractive price — a formula for designing a winning portfolio.

Bryan owns shares of Microsoft. The Motley Fool owns shares of Autodesk and Microsoft.

Charter and 2011 Portfolios: Set up a Synthetic Short on the iShares MSCI Spain Index

Published Sep 6, 2011 at 12:00AM

Do You Need This Hedge?

Hey, new *Pro* Fool! Read this before you make this trade. If your portfolio is largely in stocks, a hedge like this one can help protect your portfolio from the effects of a general market decline. If you are not heavily invested in stocks, then you may not need this hedge or could make a smaller allocation. Visit our iShares MSCI Spain Index discussion board with any questions.

Trade Essentials

- **Action:** Set up a synthetic short on the **iShares MSCI Spain Index** (NYSEMKT: EWP): Sell to open October 2011 $34 calls and buy to open an equal number of October 2011 $30 puts.
- **Allocation:** 7.5% of the portfolio measured by the exercise value of naked calls we write (this allocation assumes you're largely invested in stocks — see the yellow box above for more).
- **Recent ETF Price:** $32
- **Recent Options Prices (Bid/Ask):** October 2011 $34 calls: $1.45/$1.90; October 2011 $30 puts: $1.95/$2.25
- **Preferred Price:** Aim to set up the synthetic short for as small a debit as possible. Splitting the bid/ask prices could muster close to zero cost, but more likely it'll cost around $0.40 per contract.
- **Alternative Trade:** None
- **Why Short the iShares MSCI Spain Index?**
  - If the sovereign debt crisis in Europe worsens, the cost of borrowing in Spain will continue to rise and it may not be able to pay its debts.
  - If economic problems worsen in Europe at large, Spain will likely feel a disproportionate amount of pain given its already weak economic position
  - Many European countries require financial assistance, and it's likely that (limited) aid will have to be spread too thin to be very effective.

The Big Picture

We're using options to set up a short position on the **iShares MSCI Spain Index** (NYSEMKT: EWP).

Europe is the biggest black box in our investing world right now. Greece is technically defaulting on its debt and now faces 47% interest rates on its two-year bonds, crushing its odds for an economic recovery. Ireland and Portugal have already been through sovereign debt collapses, and fears are increasing that Italy and Spain may be the next to face serious financial hardship. Further, these nations' obligations are so large that a bailout may not be possible.

Worries about the financial health of the Eurozone risk becoming a self-fulfilling prophecy. Investors are growing increasingly nervous and are demanding higher interest rates to loan money to the governments in question. As rates rise higher, the governments can no longer afford to issue new debt, at which point their existing obligations can't be paid.

The interest rate on Spain's debt has already cracked 5% for its 10-year notes, and if it continues to rise, the country's ability to pay its existing obligations faces worsening odds. Analysts suggest that rates much higher than 5% challenge the country's ability to finance its large debt burden, so the European Central Bank has been buying bonds from Spain to try to help keep rates low — but lately they're ticking higher again. If the ECB's support wavers, or if its strategy doesn't work, trouble may flare and Spain's financial situation may worsen; the country may face a possible default.

We are not predicting this will happen. We don't know. But since it's a real possibility, hedging against it makes sense. This is disaster insurance. If Europe continues to suffer, Spain — with its high unemployment rate and debt load, coupled with weak GDP growth — is likely to suffer even more.

Why This Strategy?

It is impossible to obtain shares of this index fund for direct shorting (none are available at the brokers we checked). Setting up a synthetic short, which comes close to replicating a short position using options, is our next best choice. We're using strike prices that give us a cushion on our short calls (which are the risk-bearing part of our trade). If Europe begins to get its financial house in order, Spain's ETF could rebound 7% to $34 before our short calls began to be squeezed. And if Europe can't come to agreement on how to solve its debt crisis and Spain's index falls more than 6% in dollar terms, the puts we purchase will begin to add value to our portfolio. We're using October options because they're the only ones offering a wide variety of strike prices and fairly tight pricing. As our expiration nears, we'll consider rolling into later options.

How to Follow Along

Setting up a synthetic short involves selling naked calls, so you need a margin account and ample equity to keep the trade open. "Sell to open" October 2011 $34 calls on EWP and "buy to open" an equal amount of October 2011 $30 puts. At the time of publication, you could make this trade for a net debit of around $0.40 per share. If the iShares MSCI Spain Index has moved significantly in price by the time you read this, move your strike prices accordingly so that your chosen strike prices "straddle" the ETF price the same way on either side. If you do this, the net cost to set up the trade shouldn't change much over the coming days.

If you have questions about this short, please visit our new iShares MSCI Spain Index discussion board. You can also see our guide to selling short.

Charter and 2011 Portfolios: Short the iShares Russell 2000 ETF

Published Sep 6, 2011 at 12:00AM

Do You Need This Hedge?

Hey, new *Pro* Fool! Read this before you make this trade. If your portfolio is largely in stocks, a hedge like this one can help protect you from the effects of a general market decline. If you are not heavily invested in stocks, then you may not need this hedge or could make a smaller allocation. Visit our [iShares Russell 2000 discussion board] with any questions.

Trade Essentials

- **Action:** Short the **iShares Russell 2000** (NYSEMKT: IWM) ETF
- **Allocation:** 10% of current portfolio value (assuming you're largely invested in stocks — see yellow box above for more).
- **Recent Price (Sept. 2):** $66.44
- **Preferred Price:** Not very relevant. Our approach to this trade is relatively short-term, and you can set up a position like this one whenever you want a hedge in your portfolio.
- **Alternative Trades:** You could *buy* (not short!) shares of the **ProShares Short Russell 2000** (NYSEMKT: RWM) ETF, which moves inversely to the index. Be aware, though, that this ETF doesn't do its job perfectly; it has only gained 9% this year while the index has lost 15%. You could also buy puts on IWM, paying the high premiums in exchange for limited risk (you only risk what you pay for the puts).
- **Why Short the iShares Russell 2000?**
  - Two of our previous hedges — including a [ratio put spread] on this index and a [synthetic short] on the SmallCap 600 index — expired in August, and we want new hedges in this uncertain environment.
  - We've used options to hedge with this index in the past, but shorting shares directly is less costly at the moment because options prices are so high. Shorting is also more immediately beneficial if the market declines.
  - We think the small caps in the Russell 2000 are likely to decline more than the S&P 500 index in a weak market.

The Big Picture

The **iShares Russell 2000** (NYSEMKT: IWM) tracks 2,000 of the market's small caps with a median market value of around $500 million. The index is typically more volatile than the S&P 500, and it trades at a premium to its large-cap brethren; the argument is that earnings growth at small companies is generally more impressive than at giants of industry. That may be the case when the economy is rosy, but in challenging economic times like these, small companies usually suffer more — meaning small-cap stocks can make dramatic swings downward.

We've made money investing against the iShares Russell 2000 in the past. In March, we [set up a ratio put spread] that expired Aug. 19. Today, high options prices make that strategy less appealing, so we're shorting shares directly instead.

How to Follow Along

To sell shares short, you need a margin account. Using a typical "stock trade" order, you'll enter "sell short" IWM as your trade command. Your broker will borrow shares and sell them immediately, and the cost will appear in your account as a negative value. If the underlying investment (IWM) declines, you can buy back the shares cheaper when you no longer want the short and keep the difference as your profit. If IWM goes up, you may eventually need to buy it back at the higher price, and the difference between your buy price and the price at which you sold short would become your net loss. (Hedges are unusual in that a modest loss is usually an acceptable outcome, because it means the rest of your portfolio presumably went up in value; the hedge was to soften the blow if the opposite occurred.)

Finally, be aware that shorting carries extra risk. Although it's usually unlikely, your broker could force you to cover (or buy back) the short if shares rise sharply or if the broker needs share inventory (remember, you've borrowed shares in order to sell them). That situation is unlikely to arise with a position in a large, liquid index like this one, but it's something you should always be aware of. Also, some brokers charge you an extra fee to sell short.

If you have questions about this short, please visit our [iShares Russell 2000 discussion board]. You can also see our [guide to selling short].

Charter Portfolio: Sell Jack Henry & Associates and Vanguard Emerging Markets

Published Sep 6, 2011 at 12:00AM

New to *Pro* ? These trades apply to holdings from our Charter Portfolio. If you've just joined us, you likely don't own either stock — but we invite you to read along for our latest thinking on both!

Trade Essentials

- **Actions:** Sell all shares of Jack Henry & Associates and Vanguard Emerging Markets
- **Recent Prices (Sept. 6):** Jack Henry & Associates, $27.65; Vanguard Emerging Markets, $41.60
- **Why Sell?**
  - Jack Henry stock is trading near our $30 fair value, and we see stronger opportunities elsewhere
  - Vanguard Emerging Markets is 33% invested in China and Brazil, and GDP growth in both countries is slowing; as a defensive move, we're taking our profit

What's Changed?

Jack Henry & Associates (NASDAQ: JKHY) has returned more than 45% for the Charter Portfolio since [our original recommendation] (we sold half our position about 9% lower than today's prices when [our covered calls] were exercised). We're selling our remaining shares, which make up 2.6% of our portfolio, because the stock is within striking distance of our $30 fair-value estimate and we believe we have better opportunities elsewhere.

Our remaining position in **Vanguard Emerging Markets** (NYSEMKT: VWO) has nearly doubled since our initial Charter Portfolio recommendation, hugely outpacing a 50% gain in the S&P 500 over the same period. We first purchased shares in late 2008 with the belief that emerging markets would lead us out of the recession, and they did outperform the U.S. stock market for a few years — we sold half our position in 2010 because, as we wrote then, "our thesis that emerging markets would recover more quickly than the U.S. and Europe has borne fruit."

However, the situation has flip-flopped in 2011, with the S&P 500 down much less than the emerging-market index. When the U.S. and Europe experience an economic slowdown, the pain can easily spread to emerging markets. In fact, the effects there can be even worse, since these economies are more volatile and their growth depends on strong demand from developed nations. The slowing of record GDP growth in China and Brazil is already raising concerns. China's construction boom, which has fueled the local economy, is proving unsustainable, especially as the government reins in speculative lending. And in Brazil, GDP growth has slowed by more than half from last year as the government focuses on taming inflation.

Yet as of July 31, approximately 18% of the Vanguard Emerging Markets fund was invested in China and 15% in Brazil. This 33% focus is up from 27% when we first bought in, at a time when both economies looked more promising. Vanguard Emerging Markets now looks highly concentrated in two regions that are likely to experience turbulence over the coming few years as massive internal investment slows and developed nations continue to struggle. We're content to exit our remaining 1.8% position with an excellent gain.

How to Follow Along

Pro will sell all of our shares of Jack Henry & Associates and Vanguard Emerging Markets in the next one to 30 days. Pleasantly, both positions represent long-term capital gains for us and members. Until the money is reinvested, these combined sales will add about 4.5% in cash to the Charter Portfolio. If you have questions, please visit the Jack Henry or Vanguard Emerging Markets discussion boards.

Don't Fall Prey to Doomsayers

Published Sep 6, 2011 at 12:00AM

Dear Fellow Investors,

Doomsayers have control of Wall Street right now. With the financial crisis of 2008 fresh on everyone's mind, it's easy for messages of impending disaster to take root and spread. As a result, gold is making headlines every day as investors bet against the world's entrenched monetary system. That's how dark the perception is for many at the moment.

Pro Trade Roundup

Charter Portfolio

- **OpenText** : Bought 700 shares at $58.75 (3% allocation).

Portfolio 2011

- **OpenText** : Bought 130 shares at $58.81 (3% allocation).

Guidance Updates

- **AmTrust Financial Services** was moved up to Buy after we increased our fair-value estimate and buy-around price for the stock.
- **Jack Henry & Associates** and **Vanguard Emerging Markets** have been moved to Sell (read today's trade alert).

Falling markets have always been a fact of investing life, of course. But the difference between today and, say, 30 years ago is that now, the message of doom never relents. Countless 24-hour cable news channels fill our screens, their talking heads discussing most everything in a breathless, urgent tone. On the Internet, anyone can claim the end of the world with at least some credibility if they only write well. And everywhere you turn, someone is trying to feed on — and profit from — financial fear with an email or an ad banner or a new book or a billboard. In short, the news of our financial systems' death is greatly exaggerated — and endlessly repeated.

In fact, it's so rare to hear someone offer a *positive* slant that when they do, you're almost beside yourself with relief. Warren Buffett is one such man. Jeremy Siegel is another. I'd happily put myself in their company.

But calm thoughts, even those offered by intelligent and thoughtful experts, are drowned out in today's fearful environment. The media cycle will turn again, and I can almost guarantee that the next turn will include phrases like "The economy is starting to mend," and "Europe is getting a grip on its financial problems," and "Housing and employment are finally showing signs of improvement." But until then, we need to live with a volatile, hypersensitive market amongst ongoing claims of doom — perhaps for many more months.

Sleep Better With Hedging

For most of this year, *Pro* has carried short positions (positions that profit on market declines) on three market indexes. Two of them expired Aug. 19, and today we announced two new short positions to replace them alongside our existing 6% holding in **ProShares Short S&P 500**. Combined, we'll be around 23.5% short, and in the near future, we'll likely add to these short positions or recommend new ones, potentially shorting shares worth 30% or more of our portfolio's total value — whatever amount makes us comfortable as the landscape evolves.

I don't personally subscribe to the belief that world currencies are doomed to ruin, but we're investing in a time of great uncertainty on a governmental level, and the outcomes of government decisions are impossible to predict. Sizable hedges provide peace of mind in turbulent times without capping the upside for the rest of our investments. And with a few bold moves in the right directions, governments in the U.S. and Europe could start to stabilize the situation — but that's a topic for another day.

Taking Action

Pro is likely to be active in the coming days and weeks. Expect a steady stream of trades as we position our portfolio the way we want it for the coming year and beyond. For our typical stock positions (shorts and hedges are an exception), we think in terms of three years or longer, so the moves we make in the near future will likely shape our portfolio for some time to come.

As the macroeconomic environment continues to change, we'll want to swap out some of our holdings for new ones. As we do, remember that investing is not a race. Follow our new positions when you're ready. When we buy a company, we're not investing to make money in the next day or week. We're investing to make money over the coming *years,* so follow us when you can, and don't worry if your trade comes weeks after ours.

If you're largely invested in stocks, as *Pro* is, you'll want to consider following our shorts and hedges as well, depending on your experience level and risk tolerance. If you're mostly in cash, you may not need to short or hedge at all. In that case, lower market prices — if they come along — will be a growing opportunity for you to use that cash to buy our favorite stocks.

Welcome, New Members!

We'd like to welcome all our new members once more! Get caught up on your *Pro* Memos with the Aug. 22 edition, in which *Pro* analyst Bryan Hinmon (TMF42) discusses our results, and the Aug. 29 edition, in which I outline the traits we all need to invest successfully. We'll also be sending a "Ketchup Report" this week that will help you get up to speed on our portfolio.

As we ride through a volatile time together, remember to keep a three-year perspective on the stocks you buy. Not only is the long-term view the only successful one when it comes to investing, but as a bonus, it will also help keep you calm. We'll use shorts and options to (ideally) profit in the near term, and we'll move through — and out of — this economic tumult together. Questions? Please visit the Memo Musings board.

Thank you to all members for being a part of *Pro*, and stay Foolish!

Jeff Fischer (TMFFischer)

Coverage & Community

- New members, please introduce yourselves on the Meet & Greet board! As you start to purchase our Buy First and Buy stocks, watch for new trades as well. Our special guide to help you get started will land in your inbox this week.
- How do you integrate your investments from other Motley Fool services with *Pro* investments? Don't miss this great discussion!
- Bryan (TMF42) outlines the reasons behind our guidance change on AmTrust Financial.
- Ready to think about October? TMFValuemoosie posts an earnings calendar.
- Nick (TMFCrow) provides extra guidance on how to use the boards.
- Stop by the Pro Philosophy & Strategy board anytime — it's a great place to discuss the market and *Pro*'s investment strategy.

A Special Message Regarding Your 3-Year Membership

Published Sep 2, 2011 at 12:00AM

One of the most important things we've learned over the years is that investing takes time. We couldn't be happier that you agree! Whether you're a longtime Fool or brand-new to the world's greatest investing community, we're excited to have you as we learn, grow, and take on the market together.

We'll be in contact regularly over the next couple of weeks with features to help make your transition into *Pro* a smooth one. If you have questions in the meantime, hit up our lively, members-only *Pro* discussion boards, where there's no such thing as a stupid question.

Before you go, make sure you check out this quick message from Jeff:

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Thank you again for taking us up on our longest membership term. We're investors for the long run — and we're thrilled to have that in common with you!

Transcript

Jeff Fischer: Hi, I am Jeff Fischer, your advisor at *Motley Fool Pro* and co-advisor at *Pro*'s sister service, *Motley Fool Options*. First of all, congratulations on making a very smart choice by joining *Motley Fool Pro* with a three-year membership. You have put yourself in an excellent position to prosper over the coming three years and beyond. Your long-term outlook makes you uniquely suited for *Pro* because it shows that you realize, as we do, investing is not a short-term endeavor, not something that can be declared done, let alone won, in mere months or even a year or two.

By joining our premium service for the longest timeframe we offer, you have positioned yourself to invest with us correctly, intelligently and successfully. This kind of long-term perspective is half the battle when it comes to making great money in the stock market. The other half is investing knowledge, which our *Pro* team offers you in spades.

Before I talk to you about *Pro* for a moment, let's touch on your three-year membership just a bit more. This is the first time The Motley Fool has offered a three-year, full money back guarantee to anyone, and we are excited that 75% of new *Pro* members took us up on this offer. You might think that we are being overly generous or that some will take unfair advantage of this. After all, what other financial company offers you three years of service with a full refund available any time? No one that we know of.

I have talked with Tom Gardner, The Motley Fool's co-founder and CEO, about this. Why make this offer and why now? Here's what Tom said: In today's unusually volatile market, he doesn't believe it is enough to give members 30 days to evaluate our services to determine that you have made a great, long-term decision. A three-year, full guarantee is much more beneficial to members who want to see and benefit from the investing value we are offering you.

Our three-year offer is also much more aligned with the Fool's long-term investing mission and encourages members to remember this. Although *Pro* is the first, Tom wouldn't be surprised if such long-term memberships are the future of the Fool, and could become a great boon for Fool members like you. After all, nobody invests in the stock market for just one year; your investment services should reflect the reality that any investment in the market is a multi-year commitment.

Now let's talk about *Pro*, because there is another key aspect to your three-year membership: the amount of learning you can achieve over this amount of time. *Pro* is not just about helping you achieve strong profits; that is important, of course, and that is consistently our No. 1 goal, but we believe that learning, like investing, is a lifelong pursuit. As a *Pro* Fool, you will learn an incredible amount over the next three years about investing strategies and how to develop and refine the temperament you need to succeed with investing for the rest of your life.

Perhaps your main desire is to compound your returns strongly, or perhaps you are more concerned with earning steady cash income, month after month, using sensible option strategies like we do in *Pro*. Either way, the portfolio you build with *Pro* will help you meet your goals with less risk than the market overall. In fact, on our options strategies for income, we have historically made money up front on more than 80% of our trades, month after month. We have been similarly successful on our stock and ETF positions; with our focus on achieving the highest level of accuracy possible, it means that a vast majority of our closed positions have ended profitably.

Now, *Pro* is still a fairly young service, and I know our best days are ahead of us. As our three-year anniversary rolls around in October, we are on course to have a strong track record achieved through very volatile times. But we expect the next three years will be even better, and we are excited that you have committed to investing and profiting right alongside us.

Congratulations again on a smart choice. Watch your inbox for steady investing guidance over the coming days and weeks — and, yes, years — and please let us know on the boards if there is anything we can do to help you get started. We are in this investing relationship together, to make money together, so don't be shy to introduce yourself on *Pro*'s Meet and Greet board. We are delighted you are here, and we look forward to investing successfully with you for the years to come — and enjoying ourselves along the way. Fool on!

Test Calculator

Published Sep 2, 2011 at 12:00AM

Total portfolio	
Allocation %	
Stock price	

Calculate

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Charter and 2011 Portfolios: Buy OpenText

Published Aug 31, 2011 at 12:00AM

Trade Essentials

- **Action:** Buy 3%
- **Buy Around:** $58.50 (use a **limit order** at prices around or below this price)
- **Fair Value:** $70

- **Alternative Trades:** Want to try to buy shares at a lower price? "Sell to open" October $55 puts, lately paying you $2.30, or November $55 puts, which have lately paid $3.40. Sell one put for every 100 shares you'd be willing to buy. You may also consider selling $60 puts. (New to options? See our guide to selling puts to buy shares cheaper.)
- **Why Buy?**
  - As more businesses go digital, the demand is growing for document-management software.
  - Compliance requirements have grown since the credit crisis, and OpenText's software manages this need while increasing companies' productivity.
  - OpenText may be acquired as the industry consolidates.

First Things First

- **Company: OpenText** (NASDAQ: OTEX)
- **Share Price:** $57.40
- **Market Cap:** $3.3 billion
- **Website:** www.opentext.com
- **Type of Holding:** Growth; Software
- **Follow It:** Add OpenText to My Scorecard

The Big Picture

The days of filing cabinets and hanging paper folders may be numbered, yet the need to manage data is more critical than ever. (Those of you who have visited Fool HQ know that some desktops here are cleaner than others!) Thankfully, there are new solutions to manage information in the online age: Using software to wrangle piles of digital files is called Enterprise Content Management (ECM), and **OpenText** (NASDAQ: OTEX) excels at it.

Using OpenText's ECM software, businesses can manage the entire lifecycle of otherwise unstructured data, including invoices, email, legal documents, multimedia, spreadsheets, and websites. As companies eliminate paper, Gartner Group estimates that the ECM industry will grow an average of 10% per year.

This growth is being driven by three primary factors:

- A digital flood of data, including multimedia info, that requires special archiving
- The increased need for regulatory compliance following the financial crisis
- Businesses' desire to increase productivity and lower costs through efficient data management, especially in these tight times

OpenText's software offers customers regulatory peace of mind, helps them use their data more efficiently, and gives them a healthy return on their investment. And it's one of the only companies in the world entirely devoted to all this. Its last independent pure-play competitor (the no-longer appropriately named Autonomy) is being acquired at a hefty 60% premium -- $10 billion in all -- by **Hewlett-Packard** (NYSE: HPQ), so we shouldn't be surprised if OpenText winds up in another large software provider's crosshairs as an acquisition target someday. Given that profitable software companies are usually acquired at healthy premiums to market prices, we would welcome a buyout as a viable exit from our position.

The Business

For now, OpenText is the world's largest independent ECM software provider, second in market share only to **IBM** (NYSE: IBM). Its clients include some of the biggest businesses, government agencies, and professional-services companies in the world. OpenText calls itself "The Content Experts," but it could just as easily call itself a partner expert: Its key, long-standing, and strong relationships with **Microsoft** (NASDAQ: MSFT), **Oracle** (NYSE: ORCL), and **SAP** (NYSE: SAP), along with numerous acquisitions, have helped it capture nearly 18% of the market in the growing ECM software industry. (IBM has just a hair more than 18%).

OpenText's Rivals, by Global ECM Market Share

- IBM: 18.2%
- *OpenText: 17.9%*
- EMC: 11.6%
- Microsoft: 5.9%
- Autonomy: 5.5%
- Oracle: 5.3%
- Others: 35.6%

Source: Gartner Group, 2010

What's more, OpenText is moving firmly into Business Process Management (BPM) software on the heels of two recent acquisitions valued at more than $440 million. BPM software works to optimize processes within a business, and OpenText believes that's the glue that ties all of a company's digital content together -- which makes BPM software a natural add-on to its ECM offerings. Along with new BPM products, OpenText has recently launched social-management software, cloud offerings, and mobile versions of its programs that its clients can use anywhere on the go.

OpenText serves more than 46,000 customers around the world in diverse industries and government branches. Many of them contribute regular revenue to OpenText; about $151 million, or 52% of OpenText's revenue last quarter, came from recurring maintenance sales from existing customers. Through the years, recurring revenue should become an ever larger part of OpenText's sales, adding stability and predictability to the business.

With 53% of fiscal 2011 sales coming from North America, 40% from Europe, and only 7% from Asia and elsewhere, OpenText has plenty of room to grow globally, and its recent sales in Latin America have been strong. Moreover, whenever it launches or acquires new products, OpenText has a large client base for cross-selling opportunities.

Financials

In June, just as OpenText was celebrating its 20th anniversary, the company announced that its fourth-quarter revenue grew 19% year over year, to $285 million. For all of fiscal 2011, sales rose 13%, to $1.03 billion, free cash flow grew 16%, and adjusted earnings per share jumped 30%, to $4.02 ("adjusted" includes non-GAAP measures, mainly to account for acquisitions). OpenText's 2011 operating margin was 27.5%, smack in the middle of management's 2012 target of 25% to 30% -- though recent acquisitions will likely lower that margin before it rises again. These healthy growth numbers suggest that OpenText is holding its own or gaining when it comes to market share.

As the table below shows, OpenText's financials have improved steadily over the past five years. When I first bought OpenText for my personal portfolio in 2007, Wall Street disliked its low return on equity, but I saw a business positioned to steadily improve. I think this will continue.

	2007	2008	2009	2010	2011
Revenue	$595.7	$725.5	$785.7	$912.0	$1,033.3
Net Income	$21.7	$53.0	$56.9	$89.2	$123.2
Cash From Operations	$110.9	$166.0	$176.2	$180.2	$223.2
Capital Expenditures	$5.3	$6.9	$12.2	$19.3	$36.7
Free Cash Flow	$105.6	$159.1	$164.0	$160.9	$186.5
Return on Equity	4.4%	9.1%	8.6%	11.3%	12.8%

Fiscal years end June 30. Dollar amounts in millions.

Now that we know OpenText is performing well as a business, let's look at its stock price. The $3.3 billion company trades at 17.6 times trailing free cash flow and 12.3 times estimated earnings for the year ending next June. It would be reasonable for shares to trade around 15 times expected earnings, or about $70 -- and that's 23% above the recent share price, so the stock has ample room to advance.

What Would Make Us Sell

OpenText has bought up a bunch of companies, effectively succeeding through making acquisitions -- something that's common in the software world. However, we'll be analyzing all of OpenText's new acquisitions (it still has several in mind) to see whether they make sense for the business, and we'll be wary if the company starts to overreach. Given the fragmented ECM industry, we don't want to see OpenText permanently lose any market share to its competitors. If it does, we'd have to revisit our investment thesis. After all, we're assuming that the company will continue to gain market share, and this growth is core to our long-term success with OpenText.

The Foolish Bottom Line

I've known OpenText for several years, but this investment is as interesting as ever, thanks to the company's recent acquisitions in BPM software and the industry consolidation in ECM. OpenText has plenty of room to grow independently, and one day it could even be bought by a software giant. Either way, we stand to enjoy strong profits the coming years as more companies turn to OpenText to manage data and comply with regulations. To follow along with our investment recommendation, members should buy a 3% stake in OpenText along with *Pro*. Welcome aboard!

Next Steps

- Have questions? Bring them to our new OpenText discussion board.
- Track it! Follow your returns and all of *Pro*'s OpenText coverage by adding OTEX to My Scorecard.

You can see all of Pro's holdings on our Recommendations page. The Motley Fool also owns shares of Microsoft and IBM.

A Peek at What to Expect From Pro

Published Aug 31, 2011 at 12:00AM

Have Trading Questions? You're Invited to Our Live Chat!

Tune in to our live chat from 3 to 5 p.m. ET today. Jeff and the team will discuss this morning's trade step by step and answer any questions you have about *Pro*. Please join us!

Coverage & Community

- Nick Crow (TMFCrow) provides extra guidance on how to use our vibrant discussion boards.
- Introduce yourselves on our Meet & Greet board, and tell us specifically how we can help you!

Welcome to everyone here!

Pro's doors closed to new members yesterday, and we already have a waiting list – a clear sign that more investors want to focus on making absolute profits and guarding those profits against this volatile market. But you made the cut, Fool, and now we're moving forward together. Our common goal is to earn recurring gains with a high level of accuracy, despite what the market throws our way. There's no question we'll see market volatility again, and our community will welcome the investment opportunities that only volatility can bring. Meanwhile, we'll invest where we see a high likelihood for strong returns over months and years, with reasonable risk.

If you're new to *Pro* and missed our latest Monday Memo, please read it to help you get oriented; things are going to get moving here. We plan to bring you a steady stream of new trades each week for the foreseeable future. Be sure to get options permission from your broker if you haven't already.

Pro is combining stocks, options, and ETFs to build a portfolio that profits in any market. In upcoming memos and special features, we'll share our approach to valuation, our *Pro* philosophy, tips and instructions on using margin, and more. We'll also be sending you a special "Ketchup Report" in early September that will feature our current thinking on all of our holdings and help you, well, catch up to the *Pro* portfolio.

In the meantime, you can find out more about your *Pro* service here:

- Learn our seven mantras in How We Invest.
- See our unique asset-allocation plan in Breaking Down Our Portfolio.
- Put *Pro* to work for you with Making *Pro* Fit Your Profile and Secrets of a Winning Portfolio.
- Visit What to Do: Buy First, Buy, Hold and Sell Explained for details about using our guidance.

FAQs

We've tried to tackle some of your most common questions below. If you have a question that hasn't been answered here, please post it on any of our discussion boards.

Q: What's the best way to get started?

A: Visit your getting started guide. (Invest a little time for long-term rewards. That works for more than just money, Fools.)

Q: Which portfolio – Charter or Portfolio 2011 – should I follow?

A: *Pro* began investing in the Charter Portfolio in 2008, and our veteran charter members should continue to follow it. Portfolio 2011 was established earlier this year to build positions in many of the stocks we love from the Charter Portfolio. New and veteran members alike who need to "catch up" can follow along with Portfolio 2011 trades. (Set your email preferences for trade alerts here.) Trades on brand-new positions will be done in both portfolios at the same time, until the two portfolios eventually become mirrors of each other, as intended.

Q: How do I use *Pro* and *Motley Fool Options* together?

A: *Motley Fool Options* is a sister service to *Pro*, and it's free to every *Pro* member. It offers additional options ideas, education, community support, and strategies that can complement your *Pro* portfolio if you're seeking more ideas. We spend quality time coming up with *Motley Fool Options* ideas, too, of course, and the strategies there work alongside a *Pro*-based portfolio. In fact, *Pro* inspired the launch of *Motley Fool Options*. So, use both as you see fit, but try not to confuse the two services. Always double-check your trade alert emails to see which service recommends the trade.

Q: Which positions are best in an IRA?

A: Only a handful of options trades (ones that require margin, such as spreads) and shorts won't be possible in an IRA. Otherwise, most *Pro* investments can be made either in an IRA or a regular account. Most options are short-term gains, so you might consider doing as many of those as you can in a tax-advantaged account (assuming you're not planning on using the options income anytime soon). Investments with a high dividend yield, which you might want to own for years, may pay off best in an IRA. The rest is at your discretion.

Q: Do I need to buy shares in 100 round lots?

A: Proper allocation on a percentage basis is more important than buying in round lots. If we plan to use options on a position in the future (which requires 100 share lots), we'll let you know beforehand in the trade alert.

Q: How do I get up to speed using options?

A: Gradually! Start slowly, learning one basic strategy at a time (writing puts or covered calls). Read our *Pro* guides to options, and ask questions. You can find much more information, including educational videos, in the Options U. section of *Motley Fool Options*. Our trade alerts will be as specific as possible to help you get started using options.

Q: What should I do with my existing holdings?

A: If you need to free up some capital to invest in *Pro* positions, sell your least-favorite holdings whenever you're ready to invest in a *Pro* recommendation.

Q: How are trades announced?

A: We'll email you a trade alert during business hours that includes our thoughts behind the investment. *Pro* itself will make the trade one to 30 days later, giving you first crack at it.

Get Comfortable, and Think Big

Don't feel rushed. Investing is about thinking big – big picture, big time frame – and *not* about getting wrapped up in the moment (which is the exact opposite of what you want). We're here to steadily earn profits over time, and whether you make every trade with us or half of them, we want your outcome to be just as satisfying.

Welcome once more to our new *Pro* members, and thank you again to charter members for all your help in the community. We're happy we're all in the door and can do what we like best now: invest for profits.

We'll be visiting your inbox again with another trade alert soon. Until then, Fool on!

Jeff Fischer (TMFFischer)

- Have comments or questions? Bring them to our Getting Started discussion board!

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4 Traits Great Investors Need

Published Aug 29, 2011 at 12:00AM

You're Invited to Our Live Chat!

Advisor Jeff Fischer and the *Pro* team will host a live chat from 3 to 5 p.m. on Wednesday, Aug. 31, to welcome new members and talk about an upcoming trade. Just click here to join the chat or set yourself an email reminder. See you there, Fool!

Your Next Monday Memo: Tuesday, Sept. 6

- Your next Monday Memo will arrive on Tuesday, Sept. 6, because Fool HQ will be closed for the Labor Day holiday.

Guidance Updates

- **Contango Oil & Gas** and **NextEra Energy** move down to Hold as we consider future portfolio moves.

Dear *Pro* members,

Nick, Bryan, Alex, and I would like to welcome our new *Pro* Fools -- and to thank our incredible veteran members for greeting them with such warmth and aplomb. We have an exceptional community here, and as we near the end of our third year, we're delighted that so many of you have chosen to join us for the next three years. Investing is not a one-year endeavor; it's lifelong.

Pro invests for the long term, and whether "long" or "short" stocks, that means being in the market through its inevitable ups and downs. Given the unpredictable nature of the stock market and its ability to incite fear in otherwise rational people at the worst times, it's true that without a few key attributes, it's hard to be a successful investor for long. To find success in the stock market, you *must* have:

1. A long time frame.
2. A steady temperament.
3. Liquidity.
4. The desire to keep learning.

Especially during volatile markets, it pays (literally and figuratively) to remember these. (Feel free to write them down and tape the list to your computer monitor, or print them out and stick them on your mirror, or convert them to an interpretive dance routine -- whatever will keep you from forgetting them.)

Timing *Is* Everything

Contrary to popular belief, there is one way you can time the market consistently: by committing to investing in it over an extended period of time. The Motley Fool has always espoused that you should only invest in stocks using money you won't need for at least three years, and ideally five or more. In other words, don't invest in the stock market with the money you need for the mortgage next month, your child's tuition in a few years, or a vacation to Africa in 2013. If you do, you're just inviting stress -- and unavoidable losses -- if stocks go down.

And when markets decline, our stress levels rise, which only compounds the potential heartache. The stress triggers our instinctive "fight or flight" reaction, and our time horizon shrinks. We get so wrapped up in the moment that we forget it's the distant future that matters when it comes to our investments. You can lessen the risk of falling prey to these tendencies if you truly only invest in the stock market with money you won't need for three to five years or longer.

Temperament Runs a Close Second

Besides an honest long-term commitment to investing, successful investing also requires the resolve and calm to stick with your convictions. Warren Buffett has said he believes temperament is the single most important factor in investing success, and to that end, he has spent his lifetime mastering the resolve to buy stocks when others are fearfully selling because the outlook looks dark (as it has lately). Common sense tells us this is both logical and brilliant: When the economic picture looks bleak, stock prices are discounted, but eventually the outlook will brighten, and prices will rise. So of course you want to buy when stocks are down -- and yet so many investors only buy when the outlook is bright and prices are up.

To be a successful investor, you must resolve to keep buying and holding good businesses when others are selling. Here at *Pro*, we also aim to smooth meaningful declines with hedges or shorts, a process that can help both our returns and our temperament. Our two hedges that expired earlier this month, set up with options on market indexes, added about 2% to the Charter Portfolio's coffers as the market declined more than 10%. Two percent may not sound like much, but it is, and it's a strong relative gain as the market fell. We're currently looking to set up new hedges to mute any potential losses through autumn.

Liquidity Trumps All

I'm now going to be bold and contradict Buffett a bit. I believe that ultimately, liquidity is even more important than temperament -- you can be the calmest investor in the world, but if you run out of liquid assets, you may have no choice but to sell at the worst time. To maintain liquidity, you need to hold cash, maintain healthy buying power, and have a portfolio that remains flexible even when the market (or some of your positions, whether long or short) are under great stress.

At *Pro*, we aim to maintain extra flexibility by having short positions that go up when the market declines. Selling the shorts at that point is an easy way to raise cash to invest in discounted equities, even if the rest of our portfolio has declined with the market. That said, shorting must be done prudently: Direct shorts (as opposed to using options) open you up to potentially unlimited losses, and your broker could "call you out" of your short position or increase your margin requirements to maintain the short (another reason to always maintain ample buying power and cash).

One of our current shorts (through naked calls), the **iPath S&P 500 VIX Short-Term Futures**, recently spiked from $24 a share to $42. We're willing to wait out the jump as we always said we would, but it does have us on our toes -- we need to watch our cash to make sure we can continue to ride the short higher if necessary. The steep increase in volatility (and thus in VXX) is very likely temporary, so eventually we should profit on its decline -- which is all the more reason we need to be prepared to keep riding it out.

'... What Do You Do?'

This leads to the final attribute a great investor needs: a willingness to keep learning in order to improve. Over the 24 years I've been investing, I've made plenty of mistakes -- some small, some large, but always a few every year. I like to think that I don't make the same mistake twice and that each one has helped me in a lifelong goal to become a better investor. Because in the end, investing is a lifelong pursuit. We never plan to stop. We'll be investing for a lifetime, because we believe stocks -- along with our options and other strategies -- will remain one of the strongest possible ways to grow our assets.

Our goal at *Pro* is to earn consistent returns over the years, and to do so with steadiness, strength, and a minimum of worry -- always improving along the way. As we build a track record, we're confident that over the next three years, we're going to keep improving. We'd love to hear your insights, too. Please visit our Memo Musings board and share some of the investing lessons *you've* learned. Doing so will help all of us in the *Pro* community improve together.

Foolishly,
Jeff Fischer (TMFFischer)

Jeff is short VXX.

Coverage & Community

- New members, please introduce yourselves on the Meet & Greet board, and tell us how specifically we can help you! Meanwhile, as you buy our Buy First and Buy stocks, get ready for new trades this week.
- Our Philosophy & Strategy board is a great place to discuss the market and *Pro*'s investment strategy. Stop by anytime.
- Nick Crow (TMFCrow) provides extra guidance on how to use the boards.
- Russell (TMFEldrehad) shares a lesson he gleaned from CAPS blogs.

You can see all of Pro'*s holdings on our Recommendations page.*

New Member Live Chat: Aug. 31, 2011

Published Aug 25, 2011 at 12:00AM

The *Pro* team hosted a live chat on Aug. 31. Did you miss it? No problem, Fool. Just click the player below to get the transcript and read the questions and answers at your own pace.

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Your Pudding, Ma'am

Published Aug 22, 2011 at 12:00AM

Ever since we launched *Motley Fool Pro* nearly three years ago, we've been vocal about our mission to earn consistent profits with a high level of accuracy — to make money in any market. And we've certainly been handed a variety of market conditions since *Pro*'s October 2008 opening. Intraday swings of 5% are the new normal these days, and volatility is everyone's new favorite topic. The market's daily chaos is enough to make one wonder whether the *Pro* approach to investing is working, or if we're just playing a (lower-case "f") fool's game.

The Numbers

I'm a former hedge fund guy, and my mind occasionally wanders back in that direction (it's a difficult condition to cure entirely). So when I found myself pondering whether *Pro* is fulfilling its mission, I decided to crunch some hedge fund-y risk and return statistics for *Pro*'s Charter Portfolio over two time periods:

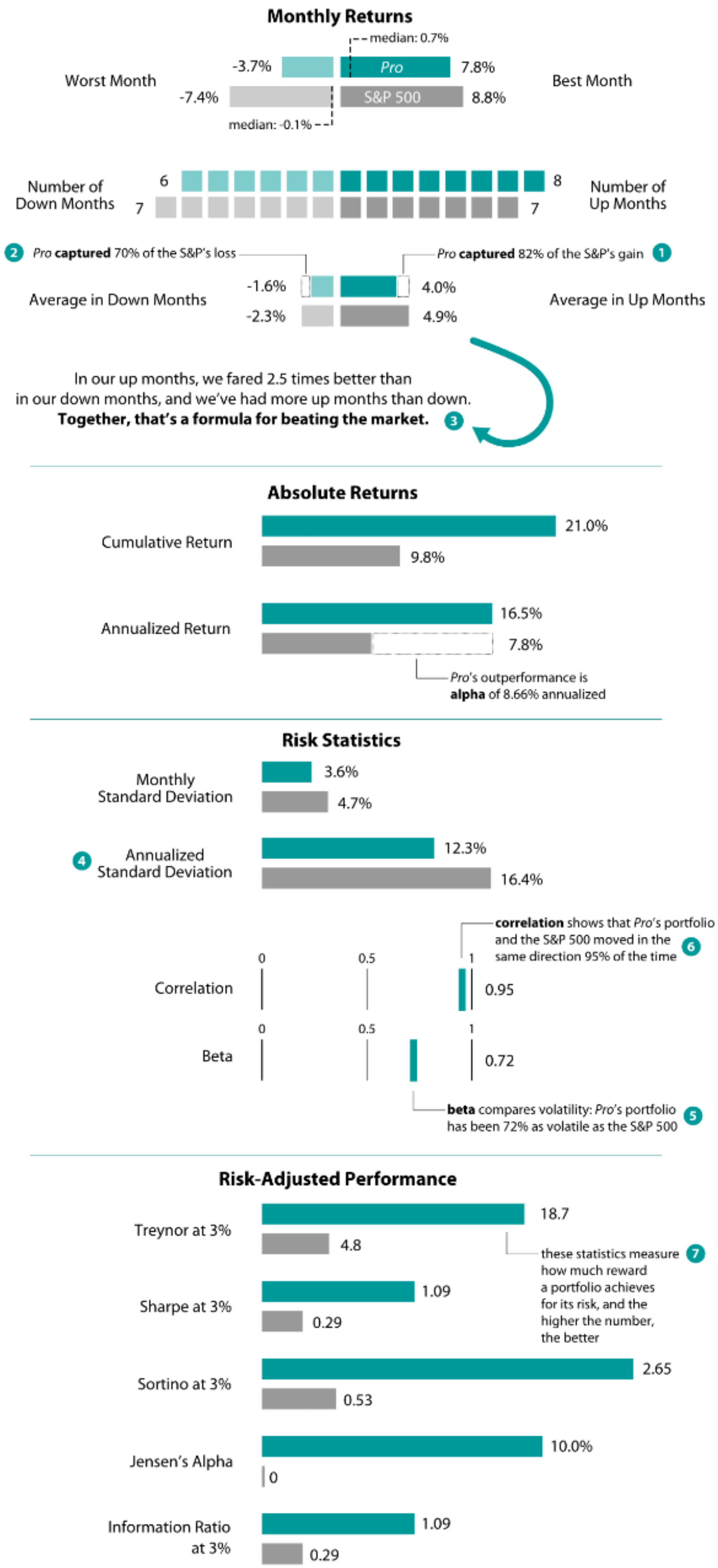
1. From inception (Oct. 7, 2008) to the present (Aug. 17, 2011)
2. From May 31, 2009 (when the Charter Portfolio was nearing our estimate of “fully invested”) to the present (Aug. 17, 2011)

The data in the graphic below highlights the second of those time periods, because *Pro*'s cash cushion in the early days distorts those statistics too much to rely on. (I'll post them on the Memo Musings discussion board for you to investigate if you choose.) In contrast, for the last 15 months or so, *Pro*'s cash position has been strategic; we've kept some cash as dry powder and some to cover any potential option obligations.

In a minute, I'll demonstrate how the numbers have reinforced my belief in the *Pro* approach — but before we dive in, remember these things:

- These statistics are based on month-end statement values for the Charter Portfolio and on the portfolio's value as of Aug. 17, 2011. They are my calculations and are intended for informational purposes only.
- We're well aware of the strengths (doesn't the chart look snazzy?) and weaknesses (we're looking at you, non-normality) of many of the statistics given. They're not perfect, but taken together, I think these statistics provide valuable information.

Fellow data lovers, let's dive in. (And if you're numerophobic, feel free to skip ahead for my takeaways!) Click on the image to see a larger version.



Sources: Month-end Charter Portfolio values (starting with market open Oct. 7, 2008, and ending with market close Aug. 17, 2011); Yahoo! Finance; author's calculations.

The Proof Is in the Pudding

So what can this data tell us about *Pro*? Use the numbers below to follow along with my key takeaways.

- **We make money while losing less.** So far, when the market goes up, *Pro* earns 82% of the S&P's average increase **(1)**. And when the market goes down, *Pro* declines only 70% as much as the S&P's average decrease **(2)**. Because our up months are 2.5 times as large as our down months **(3)**, and because we have more up

months than down, we've been able to outperform the market.
- **We zig and zag less than the market.** There are plenty of ways to measure risk, and the academic types tend to focus on standard deviation. In this case, standard deviation is just a measure of how far our returns tend to differ from the average. *Pro*'s annual standard deviation is 25% less than the market's — 12% to the S&P's 16% **(4)**. Another measure of risk is our portfolio's "beta," a metric that compares the volatility of *Pro*'s returns to the volatility of the market's returns. We're about 72% as volatile as the market **(5)**.
- **We don't invest in a vacuum.** Correlation measures the degree to which Pro moves in the same direction as the market. I was surprised to see the high correlation (0.95) between *Pro* and the market **(6)** — that number means we move with the market about 95% of the time. Over time, we hope to become less tied to the performance of the market.
- ***Pro* shines when we look at risk and reward together.** Each of the risk-adjusted performance statistics **(7)** attempts to quantify how much reward a portfolio achieves for the given risk it takes on. (Feel free to hop on the Memo Musings board to chat with me about any or all of the statistics; Wikipedia has great introductions to the Treynor ratio, Jensen's alpha, the information ratio and more.) These differ in how they measure risk and reward, but in general, the higher the number, the better — and *Pro*'s numbers are off the charts. Sure, I'm biased, but *Pro*'s risk-adjusted return statistics really are quite impressive; they indicate that we're squeezing out a bunch of return from each unit of risk we take.

The *Pro* Bottom Line

All in all, these numbers are compelling, reassuring, and impressive (we hope!) — but in the end, they're not what really counts. Let the hedge-fund consultants keep their fancy spreadsheets, risk-adjusted performance statistics, and portable alphas. At *Pro*, our performance (the cart) is a function of our investing philosophy (the horse). These stats stem from how we approach investing. They are an outgrowth of our sensible, cautious, long-term approach.

So is the proof in the pudding? Yes — but we care about a different flavor of pudding here. We believe that removing a little portfolio volatility (by owning businesses with recurring revenue streams and by using options when appropriate) gives you the mental and emotional edge you need to keep your wits about you and invest through any inevitable short-term market noise. If *Pro* is helping you do that, and if you're having fun living your life and sleeping well at night, you can rest assured that the numbers are taking care of themselves. That is investing the *Pro* way, and it's a flavor of pudding we can all dig into.

Onward,

Bryan (TMF42)

From the Boards: Good Old Rocky Top

Over on our discussion boards recently, members decided that a *Pro* Fool known as OldFart1946 needed a new user name. The contest to rename him ended today, and the former OldFart1946 (pictured at right with his loved ones) had this to say:

And the winner is:

RockyTopBob from good old Leo who now has to either accept his new name of 1110001000101 or say at least something about it ;-) I mean, come on Leo, that was so cool and Rich probably thought it up himself.

If you live anywhere near Knoxville TN, the home of the UnivTN Vols, you live to hear Pat Summit, probably the best women's basketball coach alive, sing Rocky Top. I think that darn song sticks in your brain so Leo owes a thank you to Pat.

As Nick previously said he hopes to get a T-shirt for the second-place entry which is no surprise ? TenISeeBob. Thanks Martha! I really was leaning towards this but every time I thought about it I saw Bo Derek leaving the ocean in her braided hair (I never noticed the bikini). I'm certainly less than a one and I don't want those Fools on SA calling me Bo ;-). As I said before, thanks to Rich's kids for making my life on the boards fun.

I also liked all the Boomer ones but they were all so close. How could I pick one?

Hope you liked the pictures of my better half and my better quarter. They are both the light of my life.

Regards,

Bob (RockyTopBob)

More Coverage & Community

- MazonCreekRich decides to enjoy his summer by providing some great analysis for *Pro*.
- There are a ton of valuable lessons to be learned, and relearned, on the VXX discussion board.
- Fools have a great debate on patience, opportunity, and missing the boat.
- It's fair to say we're all glad to have Jeff back.

Trade Roundup and Guidance Changes

Trade Roundup, Charter Portfolio:

- **iShares S&P SmallCap600 ETF**: closed 16 August 2011 $71 puts for $7.90
- **iShares Russell 2000 ETF**: closed 15 August 2011 $72 puts at $4.72 and closed 15 August 2011 $81 puts at $13.68
- **Rockwood Holdings**: assigned 600 shares at net $47.20 per share

Trade Roundup, Portfolio 2011:

- **iShares S&P SmallCap600 ETF**: Closed one August 2011 $71 put for $7.90
- **iShares Russell 2000 ETF**: Closed three August 2011 $72 puts at $4.69 and closed three August 2011 $81 puts at $13.65
- **Rockwood Holdings**: Assigned 100 shares at net $47.10 per share

Guidance Updates:

- **Rockwood Holdings** moves **up to Buy First** on price.
- **Bristow Group** moves **up to Buy** on price.
- **AmTrust Financial Services** moves **down to Hold** on price in relation to other positions.

Upcoming Earnings:

- **Aug. 23:** Medtronic

You can see all of Pro*'s holdings on our [Recommendations page](#).*

Charter and Portfolio 2011: Close Your Remaining Put Spread on IWM

Published Aug 17, 2011 at 12:00AM

Trade Essentials

- **Action:** Buy ("buy to close") August 2011 $72 puts; sell ("sell to close") August 2011 $81 puts
- **Recent price (bid/ask):** August 2011 $72 puts, $1.66/$1.76; August 2011 $81 puts, $10.11/10.43
- **Limit order guidance:** Use a spread order if your broker offers it, and aim for a credit close to $9 (right now, trades at $8.35 should fill, but feel free to work the spread through Friday)
- **Why Close?**
  - These options are set to expire on Aug. 20.
  - Our bear put spread is near its maximum profit.

What's Changed?

We established our ratio put spread on the **iShares Russell 2000 Index ETF** (NYSEMKT: IWM) in March as protection against completion of QE2, the government stimulus program. The Russell 2000 index has fallen 14% since then, and shares of the ETF are now below $72 — so the remaining legs of our bear put spread (we closed half of our puts earlier this month) are set to expire at their maximum profit.

Brokers have different methods of handling options expiration; this alert is to warn you to keep an eye on yours. You'll make the maximum profit possible if you let your $72 puts expire worthless, but the recent spike in market volatility has these puts trading with quite a bit of time value considering expiration is only three days away. Close this spread opportunistically until then, or if your broker will net the transaction (make a cash settlement) for you on expiration, you can just let your spread expire on its own.

- **Questions?** Visit the IWM discussion board.

Pro*'s Charter and Portfolio 2011 will close this bear spread in the next one to 30 days, per The Motley Fool's trading guidelines. You can see all of* Pro*'s holdings on our* Recommendations page.

Charter and Portfolio 2011: Close Your Synthetic Short on iShares S&P SmallCap 600 Index

Published Aug 16, 2011 at 12:00AM

Trade Essentials

- **Action:** Sell to close your August 2011 $71 puts
- **Recent price (bid / ask):** $7.90 / $8.20
- **Limit order guidance:** Use a limit order near the bid price
- **Why Close?**
  - These options are set to expire Aug. 19.
  - We bought them as a hedge, and they've done their job; we can now put that cash to work elsewhere.
  - The index these options track has fallen 14%.

- **Alternative trade:** In addition to selling the puts, consider closing ("buying to close") your August 2011 $75 naked calls, especially if you're nearing the limits of your portfolio's buying power. You can also take no action and let the calls expire at the end of this week.

What's Changed?

Our synthetic short on the **iShares S&P SmallCap 600 Index** (NYSEMKT: IJR) expires at the end of this week, and we intend to close our August 2011 $71 puts before that happens. We established this position in May as a hedge against a potential drop in value for the approximately 25% of the *Pro* portfolio that's invested in mid- and small-cap stocks. The index has dropped 14% since then, so the hedge has served its purpose well. We could have exited earlier for a larger profit, but the comfort this position gave us during volatile times was worth the price. We'd like to redeploy this capital into individual positions, but we're on the lookout for opportunistic hedges, too.

Questions? Visit the IJR discussion board.

Pro *will close its remaining IJR puts in the next one to 30 days, per The Motley Fool's trading guidelines. You can see all of* Pro*'s holdings on our Recommendations page.*

Playing Calvinball With the Market

Published Aug 15, 2011 at 12:00AM

Dear Fellow Fools,

The market let me down.

Pro Trade Roundup

Charter Portfolio

- None

Portfolio 2011

- **Medtronic** : Purchased 150 shares at $31.60
- **Oracle** : Purchased 200 shares at $26.44
- **GlaxoSmithKline** : Wrote three November 2011 $37 puts for $1.40

Upcoming Earnings

- **Aug. 16: Jack Henry**

This Week's Expirations

- **Rockwood** $50 puts: If our puts are in the money at expiration on Aug. 19, we'll accept shares.
- **iShares S&P SmallCap 600** synthetic short: Expect a trade alert this week.
- **iShares Russell 2000** spread: Expect a trade alert this week.

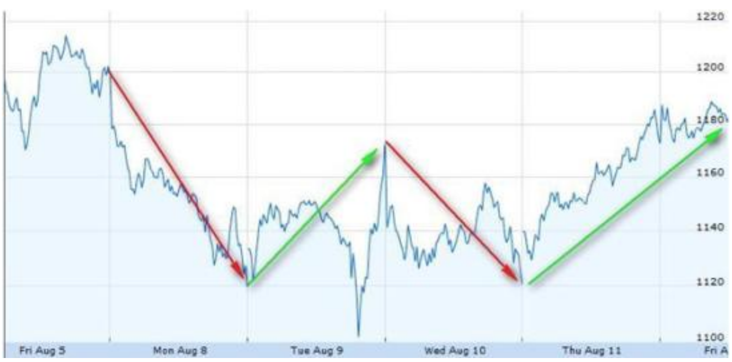
Let me explain: On Saturday, I went to another one of those affairs where the only person I knew was my spouse. You know the type of party, the kind where your other half provides strict instructions about what (and what not) to wear, where the last five minutes of the drive are spent trying to remember the names of people you expect to see but have only met once before. My favorite part of the chitchat at events like these is trying to decipher the expression on the face of my interlocutor after I say I work at a company called "The Motley Fool."

This is where the market let me down. After a week of whipsawing 5% market reversals, it seemed like investing would at last be the topic *du jour* at my spouse-sanctioned party. Surely the market crash we'd just experienced would be on everyone's mind, making for some interesting conversation.

... Nope

Turns out that as volatile as last week felt while we were in the midst of it, in the end, the S&P 500 only dropped 1.7% — from 1,199.38 on Aug. 5 to 1,178.81 one week later. If it weren't for margin calls — most induced by options clearing and settlement company Penson — and a parabolic but likely temporary VIX spike, last week would be one of many uneventful weeks in the market, the kind that immediately fade from memory and are never thought of again.

So was it a non-event? The conversations at the party I attended, centering as they did on recent high school graduates' chosen majors, whose child was working where, golf handicaps, Republican presidential candidates, Obama's second term, early retirement, and labradoodles, certainly seemed to suggest that few casual investors even noticed the market's gyrations.



Sources: Google Finance; analyst drawings.

Never the Same Game Twice

Of course, *Pro* members are not casual investors. To us, last week was *not* a week to forget — it was full of great opportunities to learn. And though the image above might seem to suggest it, "trade the S&P every other day" is not one of those lessons. To the contrary, to invest the *Pro* way, we need to invest for the long term — but that means we need to be able to hold for the long term. To that end, I'd like to introduce the three lessons of investing Calvinball (where the only permanent rule is that "you can't play it the same way twice"):

1. Beware changing rules.
2. Brokers are not to be trusted.
3. Buying power deserves a margin of safety.

To my knowledge, last week was only the second time ever that regulators have banned short-selling in an attempt to prop up the financial sector. This time it was France, Spain, Italy, and Belgium manipulating the market; last time, in September 2008, it was the SEC. Being an investor in a market where the rules are constantly changing requires caution. Even if the rules don't change, there's always the risk that you won't be able to hold onto your shorts (figuratively and quite possibly literally) as long as you'd planned. Remember that to sell shares short, you first need to borrow the shares — and if those shares are no longer available in the future, you may be forced to cover at the worst time and lock in large losses.

Try this at home: Call up your broker and ask about the margin requirements for **iPath S&P 500 VIX Short-Term Futures** (NYSE:VXX) naked calls. Listen carefully to the answer you get. Then call and ask again. Chances are that you'll hear two different answers, and both might be wrong. Worse yet, the clearinghouse, not the broker, might be the one calling the shots. Witness the pain caused when Penson doubled its margin requirements and reduced the time to cover from 72 hours to 24 hours with zero advance notice (my heart reaches out to you Fools caught by that move).

That leads us to the third lesson: Portfolio optimization and redundancy exist on a continuum. *Pro* errs toward redundancy. Demand a margin of safety when deciding how much capital you want to support your short obligations; recent history suggests that you should avoid using margin *and* make sure you have double the minimum requirement. This way you'll still have capital to invest when opportunity knocks, and you'll be able to hold your current positions longer if you so desire.

Stress-Testing Yourself

Giving your portfolio a stress test is one thing, but stress-testing *yourself* is entirely different. I think temperament is the most important predictor of investing success (notice how calm Jeff is? Not a peep all week!). The key is to align your investments with your temperament. Ask yourself how you felt last week. When the S&P dipped toward 1,100, did you start to want out? Did you suddenly feel you'd taken on more risk than you'd intended? Or were you cool and calm, hoping the stocks you wanted got even cheaper? Most Fools are somewhere in the middle of that spectrum — and last week was the perfect opportunity to gauge where *your* temperament falls. Now is the time to adjust your portfolio, your cash balance, and your leverage to levels that allow you to sleep at night when the market is tanking. A rising market is a poor time to determine your temperament, so act fast, lest you be lulled back into overconfidence.

The *Pro* Bottom Line

Markets are always changing, but a few observations apply to all of them — up, down, or sideways. In the long term, stocks will reflect the values of the underlying businesses, but over short time frames, prices are driven by fear and hope. New creations like penny pricing and 'bots that exaggerate trading volume only seem to magnify short-term swings, but these inefficiencies (offered to us under the guise of increased liquidity) bring opportunity. As a *Pro* Fool, you've got the tools and temperament to hit the fat pitches — no matter what version of Calvinball the market is playing this week.

Nick has an options position on iPath S&P 500 VIX Short-Term Futures. You can see all of Pro*'s holdings on our Recommendations page.*

Coverage & Community

- TMFEldrehad analyzes who does better in CAPS: Wall Street or Main Street.
- **AmTrust Financial** turned in solid results once again.
- Pro member antmark clues us in on the key to staying calm: Keep your head down and work hard.
- **Bristow Group** elaborated on its expanded opportunity set on its earnings call.
- The second quarter at **Ebix** brought a few new records, a composed CEO Robin Raina, and an eye on the future.
- Alex peels back the layers to reveal the underlying soundness of **StoneMor Partners**' second quarter.
- Rhyssan pulls together a cheat sheet on how the investing world measures and invests in volatility.

Portfolio 2011: Buy Oracle

Published Aug 9, 2011 at 12:00AM

Pro first recommended buying **Oracle** in our Charter Portfolio in September 2009. To read *Pro*'s original report, see the recommendation history.

Trade Essentials

- **Action:** Buy 2.3%
- **Buy around:** $27
- **Fair value:** $32
- **Preferred price:** $26
- **Alternate trades:** "Sell to open" September 2011 $25 puts or December 2011 $25 puts. Sell one put for every 100 shares you'd buy. (New to options? See our guide to selling puts.)
- **Why buy?**
  - This dominant business still enjoys solid growth prospects.
  - It's on sale.

The Big Picture

First Things First

- Company: **Oracle**
- Market cap: $131.8 billion
- Website: www.oracle.com
- Type of holding: Core; Software, Technology
- Follow it: Add Oracle to My Scorecard
- See our original recommendation of Oracle

Oracle got to be the world's largest enterprise software company — and earned its place in *Pro*'s Charter Portfolio — by demonstrating three decades of ruthless dominance in its space, and that trend shows no sign of stopping. Competitors currently in the No. 1 position in any business line in which Oracle is No. 2 should be aware they have targets on their backs. Just ask IBM: Oracle now has a larger software business and a database business twice the size of the former front-runner's. With shares trading below our buy-around price for the first time in nearly a year, now is the time for Portfolio 2011 to first invest in this core holding.

Oracle is a large company, as evidenced by the variety of other companies it's acquired, but we can simplify its offerings into three basic categories: software, which generated 68% of sales in the last fiscal year; hardware systems, with 19%; and services, with 13%. Software — which includes the licensing, updates, and support of database, middleware, and applications software -- is still the most important, but it's the business hardware segment that's drawn the most attention recently, thanks to the difficult and controversial acquisition of Sun Microsystems last year. After that acquisition, Oracle is able to boast Sun's formidable server, storage, and networking capabilities where it previously had no hardware presence. The services segment, meanwhile, includes consulting, education, and (as much as the name appears to irritate Oracle founder and CEO Larry Ellison) "Cloud Services."

Recurring revenue from its subscription-based business model made up nearly 50% of the $36 billion in revenue Oracle raked in last year which give the company a high degree of stability. Better yet, 25% of every dollar of revenue makes its way to free cash flow. We wouldn't be surprised if Oracle generated $10 billion in free cash flow in the coming year.

Valuation

At a recent $26 per share, Oracle shares are $1 below our buy-below price. That's just 11 times earnings estimates for the year (the Charter Portfolio got in at a not-too-shabby 14 times 2010 estimates) and 13 times current free cash flow (the same valuation as the Charter Portfolio's first purchase).

Risks and When We'd Sell

Honestly, our primary risk right now has nothing to do with Oracle itself: We risk buying too early into a bear market. We're guarding against that possibility by buying an innovative, well-capitalized company (it has more cash than debt ... about $13 billion more!) — one the world would notice if it were to go missing. Also, we're only buying half of the Charter Portfolio's allocation for the moment; we hope to buy the other half at even cheaper prices.

Of course, there are a few business risks as well. With a serial acquirer like Oracle, we want to see discipline in future acquisitions. During the last conference call, Ellison addressed those concerns by commenting, "Anyone who looks at the valuations today [of the smaller software companies Oracle would consider acquiring] ... we don't think they make any sense." Controversial though he may be, we're in good hands with Ellison; love him or hate him, the man turned $2,000 into a $132 billion powerhouse.

The *Pro* Bottom Line

Market corrections are no fun, but the one thing I do appreciate about them is the opportunity to buy into my favorite businesses at values I didn't think I'd ever see again. This is exactly such an opportunity — a chance to buy a dominant business that still enjoys attractive growth prospects at a good price. Jeff's closing words on our first recommendation still hold true: "At current prices, Oracle offers ample upside and limited long-term downside, while giving the *Pro* portfolio exposure to one of the world's foremost technology leaders."

Bring any questions or comments to our Oracle discussion board, and Fool on!

Pro Portfolio 2011 will buy a 2.3% stake in Oracle in the next one to 30 days, per The Motley Fool's trading guidelines. You can see all of Motley Fool Pro*'s holdings on our Recommendations page.*

Portfolio 2011: Write More Puts on GlaxoSmithKline

Published Aug 9, 2011 at 12:00AM

At a Glance

- **Action**: Write ("sell to open") November 2011 $37 puts
- **Allocation**: 4% (for *Pro*, that's three contracts)
- **Stock price**: $39.50
- **Buy around**: Below $40
- **Option price**: $1.60 (use a limit order around the market price)
- **Alternate trades**:
  - Buy a 4% allocation in shares. (*Pro* will probably continue using options, but it's not vital; you can simply own shares.)
- **Why buy?**
  - The U.K.'s largest pharmaceutical and health-care products company trades at a defensive price and offers a safe 5.2% dividend yield.
  - Most of the company's patent expirations are behind it, and it has dozens of new products in trials.
  - A focus on emerging markets diversifies the business and expands the potential for long-term revenue and profit.

What's Changed?

First Things First

- **Company: GlaxoSmithKline** (NYSE: GSK)
- **Market cap**: $100 billion
- **Website**: www.gsk.com
- **Type of holding**: Health care; defensive income
- **Follow along**: Add GSK to My Scorecard

The price. That's the only difference since our last round of **GlaxoSmithKline** (NYSE: GSK) puts expired worthless. This behemoth is now worth more than $100 billion, and it still controls an estimated 6% of the global pharmaceutical market (revenue-wise) and employs nearly 100,000 people in more than 100 countries. Now it's once again trading at our buy-around price, and better still, puts pay more than they did last time.

Why This Strategy?

Glaxo offers steady income and slow appreciation with reasonable risk. *Pro*'s Charter Portfolio has a 4.1% position, and if these shares are put to us, Portfolio 2011 will more than match that allocation at $35.40 per share. That's a full 12% lower than Charter's cost basis (though of course without the income from dividends and covered calls generated over nearly two years of ownership). If we're not put shares, the current premium still offers a 4.3% yield (15.5% annualized) in just more than three months. Writing puts is great way to aim for share ownership with less risk than current market prices offer.

How to Follow Along

You need options approval to write puts, and the trade command is "sell to open" or "sell." *Do not buy these options!* Sell one contract for every 100 shares of Glaxo you're willing to purchase later (each contract represents an obligation to buy 100 shares, or $3,700 worth of stock; we're selling three for about a 4.9% allocation, which is as close as we can get to 4% on our recently reduced portfolio balance). Writing these options will "pay" you the option premium today, and we'll wait until expiration in November to make our next move.

Our initial potential profit is the put income, and we have an obligation to buy shares if the stock falls below the $37 strike price by expiration. Since we intend to take ownership if we're assigned shares in November, be certain you have $3,700 available, per contract, to buy shares. Otherwise, just buy shares of Glaxo outright (up to 4%).

Next Steps

- Questions or comments?. Visit our GlaxoSmithKline discussion board.

- Visit our guide to writing puts.

We'll be paid $1.60 per contract, placing our net buy price 10% below the recent share price; that makes this a defensive income trade. And if we nab shares, we'll enjoy a 5.2% yield as we wait for the price to rise.

Pro*'s Portfolio 2011 will write puts representing about a 4% stake in GlaxoSmithKline in the next one to 30 days, per The Motley Fool's trading guidelines. You can see all of* Pro*'s holdings on our Recommendations page.*

Total Investing Nerds

Published Aug 8, 2011 at 12:00AM

Special Note: This Too Shall Pass

Dear Fellow Fools,

To say the markets have been getting slammed lately would be an understatement. *Pro* Fools are well aware of the various risks to our economy, so there's no need to list them here, but what might be less obvious is that we can see through these dark clouds. *We will make it through this market correction*.

There is no way to know whether what we're experiencing will turn out to be a quick 20% drop or a more prolonged, and thus more painful, bear market. What we do know is that we have the best tools possible in our toolbox. The drops in our stocks' prices are dampened by our hedges, which will eventually provide the capital we need to add to our favorite businesses and thus benefit from the mispricings and miscalculations of a panicky market.

To demonstrate just how silly a metric relative performance is: Right now, I think the *Pro* portfolio is at its all-time highest versus the S&P 500 (9.5% ahead of the index), but it sure doesn't feel that way. We would much prefer to be lagging while enjoying much higher absolute profits. Those higher profits will come again, but only if we take a long-term perspective, make measured adjustments to the portfolio, and stay the course. Brighter days always follow the storm.

If you have your doubts or just need to talk it out, come see us on the discussion boards.

Fool on!

Nick Crow (TMFCrow)

Dear Fellow Fools,

When Reza and I (Elizabeth here) joined the *Pro* service as interns eight weeks ago, we had little idea what to expect. The team seemed friendly, but a little unusual. Three analysts and an advisor sat in close proximity with no apparent hierarchical boundaries. Debates on the merits of various companies frequently transpired over the note-covered whiteboards that separate each desk. We already knew our time at The Motley Fool would be no stodgy Wall Street experience, but this brought things to a whole new level. And then they started asking *us* for our opinions.

The *Pro*-cess

Downgrade Discussion

Foolish advisors and analysts hosted a live chat this morning discussing what the S&P's downgrade of the United States' credit rating to AA+ means for your money. Read the full transcript here.

Guidance Updates

- **Intel** and **Medtronic** move up to Buy First on valuation
- **3D Systems** , **Rockwood Holdings**, **NextEra Energy**, **Oracle**, and **GlaxoSmithKline** move up to Buy on price

Pro Trade Roundup

Charter Portfolio

- **Kinetic Concepts** : Sold all shares at $64.67.
- **iShares Russell 2000 Index** : Bought to close 15 contracts at $4.23.

Portfolio 2011

- **iShares Russell 2000 Index** : Bought to close three contracts at $4.29.

Earnings Ahead

- **Aug. 8: Bristow Group**
- **Aug. 9: Ebix**
- **Aug. 10: Cisco Systems**
- **Aug. 11: Broadridge Financial**

For us as interns, this turned out to be the perfect environment in which to learn. And I hope it highlights one of the many things that make the *Pro* service so valuable: Advisor Jeff Fischer and analysts Nick Crow, Bryan Hinmon, CFA, and Alex Pape all have a serious passion for investing. They all know there's an endless amount to learn about any given company and multiple perspectives to take. Criticism is highly valued, and only the strongest ideas survive the bludgeoning of questions. That said, while there is a chain of command to process important decisions, it's highly flexible and always respectful, so every idea makes it to the floor.

The love of investing doesn't stop when the team leaves HQ, either. On our first social outing with one *Pro* analyst, it took all of 10 minutes before talk of cash flows, management, and competitive advantage infiltrated the evening. Simply put, these guys live and breathe investing. Then they deliver the crisp distillation of their best ideas to you, the *Pro* members, so you can think about other things — for at least a few hours of the day.

Lessons for Growing Investors

Reza and I aren't just interns, we're developing investors — and being immersed in this culture for two months has yielded several key lessons for us in that regard. We've learned to filter through the noise that surrounds every company. Virtually endless information is available on any potential investment, but only a few key factors actually drive a business. The *Pro* team has taught us how to synthesize these key factors to develop a coherent, simple thesis. The general rule is: If a fifth-grader wouldn't understand your thesis, it's too complicated. And there are no bonuses for the use of jargon.

With *Pro*'s recent purchase of StoneMor, we saw the team's decision-making process from the very beginning. It started with Alex exploring the company's prospects from as many angles as possible, seeking to discover what the market was missing, leaving no stone unturned. After building out a model that fit with the company, he pitched the idea in a presentation to the rest of the team. His pitch came down to one key driver that would decide the merit of this investment: Wall Street's misunderstanding of the company's financials. The entire discussion was presented in the context of this one factor. For us interns, this was like an investing epiphany: What makes a great investor is the ability to filter through all of the information, discard the noise, and identify the one or two things that really matter.

The team's knowledge of how to analyze a company astounded us throughout our time here. Each member has a level of understanding that goes beyond textbooks, one that comes from the talent and skill they've cultivated over their many years investing, both at the Fool and elsewhere. And you as members have taught us invaluable lessons, too — with your questions and comments on the boards, and by giving us insight into what you expect from an advisor. To that end, we'd like to say thank you to all members for welcoming us into your community. On behalf of *Pro* and everyone here at the Fool, we invite you to experience our community here at Fool HQ firsthand. Stop by and meet the team in person if you ever have the chance. They'll always be happy to have you.

Every member of the *Pro* community should know they are in good hands. The *Pro* team puts every ounce of their combined abilities into the recommendations they give you and into the relationship they build with you through all forms of communication. The team takes pride in the quality of its recommendations to a degree I never saw from other advisors in my previous internships. Their goal is to give the best advice they can give, no matter what other market participants are doing.

The Most Bang for Your Buck

Although we can't advise you on any particular stock, we can nonetheless leave you with a recommendation: Follow each *Pro* trade closely and diligently. Doing this will probably take you to the edge of your comfort zone from time to time (if it hasn't already), but if you've chosen to be a member of *Pro* in order to grow your investing know-how and performance *to their maximum potential*, you've got to embrace the new and slightly foreign. (As interns, we're experts on that last part.) That's how we grow as investors.

Everything we've seen here tells us you've got a great partner in the *Pro* team — and the service has the track record to back it up. The bottom line, according to two Foolish interns: Break out of your comfort zone and trust these guys. They know what they're doing.

Stay Foolish, friends!

Elizabeth Moran (TMFElleMoran) and Reza Handley-Namavar (TMFReza)

Coverage & Community

- **GrafTech International** is plugging along with the slow recovery.
- **Pebblebrook Hotel Trust** shines in its quarterly report.
- **L-3 Communications** is holding up under fire — the business, at least, if not the stock.
- **3D Systems** is small but growing. Get the latest earnings results and our outlook.
- Nick (TMFCrow) covers edible earnings from **Papa John's International**.
- Nick also provides a margin calculator.
- MikeBuckley shares thoughts on the S&P's downgrade of the U.S. debt rating; Nick compiles reactions from around the media.
- MazonCreekRich offers a starry-eyed market perspective.
- In case you haven't heard, the market is falling. Who's buying?
- Breaking news: Please thank longtime *Pro* member Rhyssan for his huge contribution to educating (and warning) members about margin requirements.

You can see all of Pro*'s holdings on our Recommendations page*.

Charter and Portfolio 2011: Close Half of Your Puts on IWM

Published Aug 5, 2011 at 12:00AM

Trade Essentials

- **Action:** Buy to close half of your Aug. 20, 2011, $72 puts on the iShares Russell 2000 Index
- **Allocation:** In the Charter Portfolio, we're closing 15 of 30 contracts; for Portfolio 2011, it's three of six
- **Recent Price, IWM:** $72
- **Recent Price, $72 Puts (Aug. 20, 2011 expiration):** $2
- **Note:** We wrote the $72 puts that expire Aug. 20, not the weekly options that expire earlier.

What's Changed?

The **iShares Russell 2000 Index** (NYSEMKT: IWM) recently hit $72, meaning we've reached the maximum profit point on our ratio put spread (as noted in our original report from March). Although the $72 puts still have time value, meaning we haven't quite reached the absolute maximum gain, we're nonetheless closing the "naked" puts in our ratio put spread, eliminating our potential obligation to buy shares of the index. We'd rather focus on putting our capital into individual positions.

We'll continue to own our $81 puts (the other half of our spread) for now, and we'll also keep half of our written $72 puts open. These two positions alone turn our ratio put spread into a bear put spread with capped risk, and we'll earn the maximum profit on the spread if the index is at $72 or lower by expiration in two weeks. Thus, you should **only buy to close one half of the $72 puts you have written** — effectively closing your ratio put spread, ending any obligation to buy shares, and retaining a bear put spread on the index.

Questions? Visit the IWM board.

See all of Pro*'s holdings on our Recommendations page*.

Portfolio 2011: Buy More Medtronic

Published Aug 5, 2011 at 12:00AM

Trade Essentials

- **Action**: Buy 2% more shares, aiming for a total of 4%
- **Recent Price**: $34
- **Buy-Around Price**: $39
- **Fair-Value Estimate**: $48
- **Why Buy?**
    - We believe Medtronic is well positioned to deal with the changing dynamics of its industry.
    - Currently trading for less than 10 times free cash flow, shares look cheap.
    - The company's focus on chronic diseases and international growth provide firm footing on which to stabilize declines in other segments.

What's Changed?

Not much has changed at **Medtronic** since I last ran down the recent goings-on. The company continues to work on clearing the name of its Infuse product line, which ran into some allegations that the company was bribing researchers for good reviews. We're not worried about that situation — the products are still considered safe by the FDA. Instead, we've been focused on what we consider to be the more important, structural changes going on in the medical technology industry.

Specifically, we expect industry profitability to contract over the long term given the increasing data and trial requirements necessary to bring products to market. Profitability will also be challenged by potentially lower reimbursement rates from federal health-care programs, which seems to be the market's current motivation in bidding shares down. Even so, we believe these factors favor large, diversified, and innovative incumbents like Medtronic, companies that have the ability to spread the costs of a more efficient global research team, offer multi-product discounts to hospitals, and continue to innovate.

Shares are trading below $34, which is less than 10 times our estimates of free cash flow — even assuming a higher cost environment, stunted sales, and lower return on research spending. Frankly, this is an attractive price at which to add to a great company with sound long-term prospects. Investors willing to wait out the current malaise should be rewarded, and in the meantime, Medtronic will continue to buy back shares and raise its dividend.

How to Follow Along

We're boosting our allocation from 2.1% to 4% in Portfolio 2011 to better align with our 4.2% allocation in the Charter Portfolio. **We're also lifting Medtronic to Buy First status**. If you've got questions, head to the Medtronic discussion board.

The Motley Fool owns shares of Medtronic. See all of Pro*'s holdings on our Recommendations page*.

Charter Portfolio: Sell Kinetic Concepts

Published Aug 3, 2011 at 12:00AM

Trade Essentials

- **Action:** Sell all Kinetic Concepts shares
- **Recent Price Range:** $66 to $68
- **Limit Guidance:** Sell as close to $68 as possible; a bit lower is fine to lock in the profit
- **Fair Value:** $68.50 (the planned price at which the company will be taken private)
- **Why Sell?**
    - Shares are only 2%-3% below the proposed buyout price, but the deal may not close until late this year
    - We can free up the cash now to use in new positions
    - If the deal falls through, the downside risk is much larger than our 2% to 3% in remaining upside

What's Changed?

As was announced on July 13, a consortium of private investors is slated to purchase **Kinetic Concepts** (UNKNOWN: KCI.DL) for $68.50 per share. Led by private equity firm Apax Partners, along with controlled affiliates of the Canada Pension Plan Investment Board (CPPIB) and the Public Sector Pension Investment Board (PSPIB), the transaction is expected to close by the end of this year. First, though, there's a 40-day period during which Kinetic Concepts can solicit other offers. We initially wanted to hold through much if not most of those 40 days, but we're halfway through that period now, and growing uncertainty regarding the economy makes it increasingly doubtful a higher offer will show up.

Although some shareholders are suing to stop the private-equity buyout, we're happy with the valuation it assigns to our shares (the $68.50 buyout price is above our $54 fair-value estimate), so we're content to sell as close to that level as we can and call this investment a success. Up nearly 200% since our 2008 and 2009 stock purchases, Kinetic Concepts has done exactly what we hoped: provided a strong return with low risk.

We're selling a bit early for another reason, too: risk management. Kinetic Concepts' management and Apax Partners have signed a financing deal with Morgan Stanley, BofA Merrill Lynch and Credit Suisse that will reportedly raise $2.6 billion in debt to take Kinetic private. These loans, along with financing from CPPIB and PSPIB, are expected to raise the $68.50 in cash required to buy out shareholders. Although we don't have a good reason to suspect the deal won't come through, there's always a chance that one piece of the equation could fall apart, especially if the economy weakens and takes credit terms with it. Rather than risk a potentially significant decline in the share price if the takeover gets tripped up, we'll forfeit a bit more upside to take our gain now and free up our cash.

How to Follow Along

KCI shares are liquid, so you won't have any trouble selling them. Ideally, sell on an up day for a modestly better price; *Pro* will need to sell within 30 days of this trade alert. (Our tax implications from selling now are the same as if we waited for the buyout: a long-term capital gain on our shares.) If you have questions, please visit the

KCI discussion board.

Jeff owns shares of KCI.

Earnings and Your Brain

Published Aug 1, 2011 at 12:00AM

Dear Fellow Fools,

Your brain is like Tiger Woods — impressive in its achievements, seemingly well-suited for its tasks, but nonetheless prone to embarrassing stunts with disconcerting frequency.

Guidance Changes

- **WisdomTree Emerging Markets Small-Cap Dividend Fund** and **L-3 Communications** move down to Buy. For the WisdomTree fund, that's because low GDP growth in the world's largest importer, the U.S., puts emerging markets at greater risk; for L-3, it's because the pending U.S. debt deal caps future federal spending increases, split 50/50 between defense and non-defense.

Pro Trade Roundup

Charter Portfolio

- **Pebblebrook Hotel Trust** : Bought 800 shares (1%) at $19.68.
- **StoneMor Partners** : Bought 1,100 shares (2%) at $28.20.

Portfolio 2011

- **Pebblebrook Hotel Trust** : Bought 140 shares (1%) at $19.69.
- **StoneMor Partners** : Bought 180 shares (2%) at $28.20.

Earnings Ahead

- **Aug. 2:** Pebblebrook, **Papa John's International**
- **Aug. 5:** StoneMor Partners
- **Aug. 8: Bristow Group**
- **Aug. 9: Ebix**

Charged with making sense of the world around us, our brains process remarkable amounts of information. Given the sheer torrent of data gushing toward us like a fire hose aimed at a teacup, our minds can't help but take shortcuts. And shortcuts, according to my high school cross-country coach, are bad.

It's the heart of quarterly earnings season, so you can find the whole *Pro* investment team — Jeff, Nick, Bryan, and me — buried under burgeoning stacks of press releases, 10-Qs, and conference-call transcripts. As we devour all of this new information, our brains will try to scuttle down their well-worn shortcuts. The best way to counter the tricks our brains are able to play on us (even *programmed* to play on us, one could argue) is simply to be aware of them. As we continue to relay our thoughts on *Pro* companies' earnings, I think this is a good time to share five "mind tricks" that I personally try to combat with cognizance.

Games Brains Play

Inconsistency Avoidance

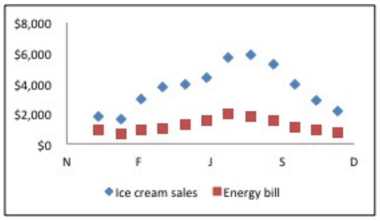
Humans don't like to change our minds, and the inertia of our past decisions can be strong. This can be positive at times — for example, an intern labeled as "smart" will strive like hell to maintain that reputation (not that we used such mind tricks on our own interns …). But unless we're vigilant, we can also anchor to past decisions that might not have been sound in the first place, or fail to update our thinking in light of new information.

Recency Bias

Recency bias is the result of overweighting recent events when drawing conclusions — for example, looking at oil companies' recent strong profits and concluding that oil stocks are great investments. Take a broader view and you'll see that while oil companies' profits are indeed high — oil is near $100 a barrel at the moment — this is a cyclical industry, one in which peaks are eventually and inevitably followed by valleys. Similarly, one could argue that technical analysis (using stock charts to make very short-term trading decisions) is a giant recency bias error.

Influence From Mere Association

The overzealous manager of an ice cream shop finds that the higher his energy bill, the higher his ice cream sales for that month. He concludes that his energy consumption drives ice cream sales.



Source: Alex, who swears he doesn't normally make up data.

Of course, this is ridiculous. Ice cream sales are higher in the summer, when temperatures are higher — and when temperatures are higher, so are energy bills. It's the weather that has a causal relationship with both ice cream sales and energy bills; the relationship between the latter two factors is mere association, not causation. As absurd as the ice cream shop manager's conclusion is, we see such conclusions made in investing all the time. Don't become a cautionary tale; focus on the true drivers of an outcome, not the often irrelevant (though sometimes distracting) associated events.

The "Loss Double-Ouch Phenomenon"

Research has shown that we feel losses twice as strongly as we do gains. You can see this on our discussion boards all the time: There is little conversation about stocks that go up, but when a stock gets a haircut, its discussion board nigh explodes. This tendency becomes even more relevant when you consider the human instinct to avoid pain and seek pleasure; if pain is more painful than pleasure is pleasurable, it can drive our risk tolerance to detrimentally low levels. There is a probably a more technical term for this, but I call it the "loss double-ouch phenomenon."

Ambiguity Avoidance

Humans do not like ambiguity. Let me rephrase that: We *loathe* ambiguity. To counter it, our brains want to reach a conclusion — often *any* conclusion — quickly. This is, in my opinion, the most dangerous of the five mental shortcuts I've outlined here. Unfortunately, it is also the most powerful, because our propensity to avoid ambiguity is both propelled and amplified by the other tricks. After all, a brain motivated to reach a conclusion but facing conflicting evidence could easily find itself clinging to a past decision (inconsistency avoidance), relying only on the most recent data (recency bias), assuming an outside factor is responsible for a current situation (influence from mere association), or deciding to hold a down stock to avoid realizing a loss (the loss double-ouch phenomenon). To combat these ill effects, always remember: Sometimes the best conclusion is no conclusion at all.

It is, I hope, with this mental gimmickry in mind that you read through your *Pro* team's earnings coverage on our discussion boards. You'll find the links under "Coverage and Community" below.

Foolishly,
Alex Pape (TMFPapester)

Coverage & Community

- **Rockwood Holdings** reported excellent results. Jeff plugs you into the story.
- **Tupperware** did well in most markets, but management focused on weak spots. Get our earnings summary.
- **Plum Creek Timber** had a tough quarter, but Nick (TMFCrow) is unfazed.
- Todd (from across the pond in London) and Alex share their thoughts on **GlaxoSmithKline**'s quarter.
- Alex (TMFPapester) answers questions on *Pro*'s newest buy, **StoneMor Partners**, and MazonCreekRich addresses relevant tax issues.
- Last week's GDP revision has Nick — and all of us — concerned.
- TMFValuemoosie shares an earnings calendar for past and present *Pro* holdings.
- Alex340 shares puts and covered calls that match *Pro*'s general criteria.
- Last week, the S&P 500 had its worst week in a year, and volatility spiked; members are discussing the shorting of volatility on the VXX board.
- MazonCreekRich reminds everyone there's so much more to life than investing.
- Ed (spinningwood) tells the community what he's been up to lately.
- Russell (TMFEldrehad) shares top *Pro* CAPShot stocks.

You can see all of Pro*'s holdings on our Recommendations page. The Motley Fool owns shares of L-3 Communications and Pebblebrook.*

Charter and 2011 Portfolios: Buy StoneMor Partners

Published Jul 28, 2011 at 12:00AM

At a Glance

Use a Limit Order

Shares of StoneMor Partners are thinly traded, so make sure you use a limit order, Fools. Also, be aware that you must own shares by Aug. 2 to receive the next $0.58 dividend.

- **Action:** Buy 2%
- **Recent price:** $26.20
- **Buy-around price:** $27 (lowered from $28 on 4/16/12) (**use a limit order** near current levels; shares are thinly traded)
- **Fair-value estimate:** $32 (lowered from $34 on 4/16/12)
- **Why buy:**
  - The 8.9% dividend yield is secure, and the payout should grow over time.
  - Bizarre accounting rules have the market thoroughly confused about this company.
  - StoneMor operates a highly predictable, low-risk, recession-proof business.
- **Alternative trades:** None. We recommend buying shares directly to get the dividend. Owning shares will set us up to use options later for additional yield if we so desire.

- **Tax considerations:** If possible, purchase StoneMor in a taxable account. If you can't, a tax-deferred account is fine — you won't be penalized, but you won't reap the additional tax benefits of holding this MLP in a taxable account.

The Big Picture

There are a million ways to make a million bucks. Death care is not among the most glamorous, but I (Alex here) know the cash it generates is worth just as much as that made by selling iPads—and it's steadier and more predictable to boot.

First Things First

- **Company:** StoneMor Partners
- **Market cap:** $510 million
- **Website:** www.stonemor.com
- **Type of holding:** Yield
- **Important date:** You must own shares by Aug. 2 to receive the next $0.58 dividend

- **Follow it**: Add STON to My Scorecard

StoneMor Partners (NYSE: STON) owns and operates 260 cemeteries and 58 funeral homes in 27 U.S. states. The company sells three things: space (burial plots or cremation niches), merchandise (burial vaults, caskets, and grave markers), and services (installation of the burial vaults, caskets, and other merchandise). About 60% of the time, sales are made at the time of a death (called "at-need" sales); the other 40% are made beforehand ("pre-need" sales).

The Business

StoneMor has plenty of space left to sell — it will take about 260 years, on average, for its cemeteries to fill up. That said, revenue at each individual cemetery only grows at about 3% annually, keeping up with inflation but not much more; this is basically a function of a steadily growing number of deaths and small price increases. StoneMor's real growth, therefore, comes from acquiring new cemeteries, and fortunately, there are plenty to choose from.

The cemetery market is highly fragmented, with the four biggest companies (StoneMor is No. 2) collectively owning just 20% of properties. Among its peers, StoneMor is unique for its pre-need sales program, which is by far the most developed in the industry and is championed by an 800-person sales team. This is an advantage for two reasons: Pre-need sales are more profitable than at-need sales, and the pre-need sales program gives StoneMor the scale to buy and operate even small cemeteries profitably (salespeople sell plots regionally rather than at each individual cemetery) — something a company relying entirely on at-need sales would be unable to do.

Let's Do the Math

So far, this sounds like a pretty straightforward business, right? Buckle up: It's about to get messy — and math-y.

StoneMor is a master limited partnership (MLP), so it pays out much of its profit to unitholders (MLP-speak for "shareholders") in the form of distributions (MLP-speak for "dividends"). Take a look at its earnings, cash flow, and payout over the past three years.

Metric	2008	2009	2010
Net income	$4,556	$(4,388)	$(1,417)
Cash flow	$21,144	$14,729	$3,106
Distributions	$25,658	$27,253	$32,443

Numbers in thousands.

Huh? A cursory glance at these numbers would send most investors running for the hills. After all, how can a company with negative earnings and shrinking cash flow increase its payout? How much longer can a company that's only generating $3 million a year in cash continue to pay out $32 million a year in distributions?

Surprisingly, the answer is: *A long time*. This company is forced to abide by accounting rules that thoroughly distort its actual financial results, and that leaves it dramatically misunderstood by the market.

The source of the problem is trust requirements. When StoneMor books a sale, it has to put 15% of the price of the burial plot into a trust. If the sale was pre-need, StoneMor also has to put 75% of the price of the merchandise into a trust. These are legal requirements designed to make sure StoneMor is able to meet its financial commitments (i.e., eventually deliver a casket it sold pre-need), but until the money is needed, it is invested by third-party investment managers. The money in trusts — a sizable chunk of at-need sales and the the bulk of pre-need sales — never shows up in the financial statements as revenue.

But here is the bizarre but absolutely critical point: *StoneMor can pull that money out of the trusts whenever it wants simply by delivering the service or product it sold*. For instance, if StoneMor sells a pre-need plot, by preparing that plot for use ahead of time, it can pull out most of the money it put in trust for that plot.

The four executives who run StoneMor are savvy allocators of capital. They pull cash from the trusts when they decide to increase the company's distributions or when they have the opportunity to buy new cemeteries. Otherwise, they leave it alone to be conservatively invested — the trusts (which are heavily over-funded) have averaged about a 6% annual return.

Financials and Valuation

So just how secure is StoneMor's distribution? If the company were to shut down its operations and liquidate its trusts, it could maintain its current distribution for 12 more quarters. That's three more years of an outsized dividend even if the business shut its doors tomorrow. How many other companies yielding 8.9% can say that?

Of course, we don't expect StoneMor's highly predictable business to suffer, let alone vanish overnight. On the contrary, assuming its future cemetery acquisitions perform as well as its past ones (and after 137 acquisitions, management has this down to a science), its new purchases should really drive growth. Management spends varying amounts on acquisitions from year to year based on the opportunities it sees, but over time we expect StoneMor to spend at least $20 million to $25 million annually to that end. Given those numbers, units (MLP-speak for "shares") are worth between $30 and $38 — but even though that would make them significantly undervalued today, we are not buying them expecting much (or any) capital appreciation. We want to lock in the 8.9% annual distribution (a fantastic yield which we might later juice even more with options), and we consider any increase in the stock price to be icing on the cake. That said, we also don't expect the stock to lose much or any ground.

What Would Make Us Sell

StoneMor's general partner (the part of the MLP structure responsible for managing the business) is majority-owned by a private equity firm. As StoneMor's payout increases, more and more of the distribution is diverted to the private equity firm instead of to the unitholders. I've (Alex here) already accounted for this in my valuation, but if management shows a willingness to maximize the distribution (perhaps under pressure from the private equity firm) to the detriment of the business, we'll likely sell our shares. We'll also sell if the dividend ever looks threatened, or if the business isn't performing well enough to at least maintain the current share price.

The *Pro* Bottom Line

I initially came across StoneMor a few months ago — and after a quick look at its yield and financials, I dismissed it, only revisiting it after fellow Fool analyst Andy Louis-Charles ran into the company's CEO and alerted me of its intriguing possibilities. That's exactly the point with this company: It is very easy to miss the real picture. StoneMor Partners is a giant math problem, and most investors are simply unwilling or unable to do the legwork necessary to see the steady profitability of the business and the security of the distribution. We're looking forward to collecting those 8.9% dividend checks, so *Pro* will invest a 2% stake in StoneMor Partners in both the Charter Portfolio and Portfolio 2011. We will make that trade in one to 30 days, per The Motley Fool's trading guidelines.

Bring any questions or comments to our StoneMor Partners discussion board, and Fool on!

See all of *Pro*'s holdings on our Recommendations page.

Charter Portfolio and Portfolio 2011: Buy More Pebblebrook Hotel Trust

Published Jul 26, 2011 at 12:00AM

At a Glance

- **Action:** Buy 1% more shares, aiming for a total of 3%
- **Recent Price:** $19.70
- **Buy-Around Price:** $21.50
- **Alternate Trade:**
  - You can write $20 puts to possibly purchase shares lower, but be sure to use a limit order — these options can be quite illiquid.

What's New?

Not much. Since both the Charter Portfolio and Portfolio 2011 bought an initial 2% stake in **Pebblebrook Hotel Trust** (NYSE: PEB) in May, little has fundamentally changed within the company. The stock, on the other hand, has fallen about 8%, even as CEO Jon Bortz and team have put a whopping $572 million more to work in new properties in just the last nine weeks. The new purchases include the Viceroy Miami, the W Boston, and a 49% interest in six New York City luxury hotels. This last purchase initially threw us — and many members — for a loop, but after detailed conversations with Pebblebrook's CFO, which I (Alex here) shared with members in an Audio Extra, we've come away with our confidence in this management team not only intact but actually enhanced.

Pebblebrook continues to have cards to play in any future economic scenario. If the economy improves, hotel profitability, which is strongly correlated with GDP growth, will get a boost, and Pebblebrook's existing hotels will generate more cash to fuel the company's dividend. On the other hand, a deteriorating economy should mean more opportunities for Pebblebrook to close fantastic deals with squeezed hotel sellers. Although shares may suffer with the market in a weaker economy, ultimately they should benefit from such a scenario. If you are feeling uncertain about the economic outlook, Pebblebrook should be a good fit for your portfolio.

Why This Strategy?

We'd like to add to our shares now because we like the price, and we'd like to buy ahead of Pebblebrook's earnings report on Aug. 3. This earnings report will be the first to include a full year's worth of numbers for any of the company's hotels (Pebblebrook made its first deal last June), so it's possible unfamiliar investors will catch a glimpse of the financials and realize just how cheap the shares remain. Also, there is a chance that Pebblebrook will announce a dividend increase. I wouldn't bet outright on either of those events, but they are possible — and with shares simply *cheap* at around $20, we'd prefer to fill out our allocation now (and possibly be pleasantly surprised next week) rather than find ourselves wishing we hadn't waited.

How to Follow Along

We're boosting our allocation from 1.8% to 3% in both the Charter Portfolio and Portfolio 2011. Buy shares using a limit order, and head to the Pebblebrook board for discussion.

Alex and The Motley Fool own shares of Pebblebrook. See all of Pro*'s holdings on our Recommendations page*.

Audio Extra: Alex on Pebblebrook

Published Jul 26, 2011 at 12:00AM

Pebblebrook Hotel Trust's recent New York City hotel deal seems unusual for this company. After hashing out the details with the CFO, though, analyst Alex Pape's confidence in this operator's savvy remains as strong as ever. Listen in as Alex tells it like it is — complete with terms like "control freaks" and "trust fund babies."

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Transcript

Elizabeth Moran: Good afternoon and welcome to the latest *Pro* Audio Extra. I am Elizabeth Moran, intern with the *Pro* team. I am joined by Alex Pape, analyst with the *Pro* team.

Alex Pape: Hey, Elizabeth.

Elizabeth Moran: And we are here to talk today about the recent Pebblebrook deal. Alex, can you just give me an overview of what is going on?

Alex Pape: Sure. So the one-liner description is, Pebblebrook bought 49% of six hotels in New York City from the Denihan Group, which is a private hotel owner and operator.

Elizabeth Moran: Okay, so this for Pebblebrook is a lot of firsts. It is their first time in New York City, it is their first time with a partnership and it is their first time with a minority stake. So let’s start with why New York?

Alex Pape: Sure. So I spent about an hour on the phone with Pebblebrook’s CFO talking about all this stuff. He said that they have been looking at New York for a while and that one of the reasons is that, in addition to Santa Monica and D.C., New York City is one of the three best markets for hotels right now and it actually sports the highest occupancy rate at about 90%. That compares to 60 to 70% for most luxury hotels elsewhere in the country.

But New York City itself is a city with a very low hotel supply. It is very hard to build there, and even more importantly, it is the city in the U.S. that benefits the most from international travel, so there is a long-run, sustainable growth factor there for New York that doesn’t necessarily apply to other cities. To D.C. somewhat, but most other cities don’t get that as much.

Elizabeth Moran: I see, so there are a lot of compelling reasons for Pebblebrook to be involved in New York City, but why these specific hotels?

Alex Pape: Sure, so these six hotels are all in Midtown Manhattan and there are two reasons why they like them: location and room size. So the locations, there is The Benjamin, is right across from the Waldorf Astoria. They have another hotel that is right across from Madison Square Garden and Penn Station. These are spectacular locations for upscale hotels.

So the average room size for all luxury hotels in New York City is between 225 and 275 square feet. These hotels are between 420 and 610 square feet, so it is substantially larger. So Pebblebrook sees an opportunity to go in and reduce room size and increase room count. So if you look at this on a price-per-key basis, they are looking at more what this could be on a price-per-key basis after they are done renovating.

Elizabeth Moran: I see. So this is still unusual for Pebblebrook and kind of diverts from their usual strategy. Can you explain why this particular deal happened? How we kind of got here?

Alex Pape: Sure. So that is really what this is all about. Pebblebrook is, besides being great at opportunistically picking off hotels at good prices, they are also; they are going to go in and improve the operations, make things more efficient, so it is really strange that they are taking a minority stake in multiple hotels.

So why this came about is a great question. As I spoke to Pebblebrook's CFO, Raymond Martz, he even described themselves, his words, not mine, as "control freaks". So this is unusual. There are a few things to keep in mind here. The hotels that they have been looking at as possibilities in New York City run between $300 and 400 million for the ones they like. Their portfolio is $1.1 billion. It is simply unreasonable for them to put that much money into one hotel in one city, and so they haven't done it yet. So buying into a portion of six hotels allows them to do this in a way that doesn't jeopardize them from a portfolio standpoint.

Now why are they working with Denihan? So Denihan has actually a really long relationship, not with Pebblebrook but with their CEO, Jon Bortz. In Bortz's previous vehicle, which is called LaSalle, he worked with Denihan. He actually had Denihan manage some of their hotels, including one right over here on Capitol Hill. Over the last decade-plus, Patrick Denihan, CEO of that company, has consulted with Bortz on hotel issues, operating issues, so they have a very close relationship.

Something very interesting has happened within Denihan, which is a totally private company, is that it is a family-run business and there are many, many family members involved, and now it spans three or four generations. Well there are essentially some "trust fund babies", for lack of a better term, who want to cash out their stake of Denihan, but they can't because it is a private company. And there are other members of Denihan that want to take the brand and take it national. There is a conflict within the family.

So Denihan went to Citigroup to find them an equity partner, and they said, Hey, you know what? We already have a relationship with Pebblebrook, why don't we approach them? And Pebblebrook was certainly receptive, for all the reasons I just gave.

So the weird thing about this is okay, why is it a 49% stake they are taking? Why are they not 50-50? Especially for a company that is self-describing as "control freaks". Well there is a very good reason, and it is a reason that cannot show up in the press release, and that is because it is saving them money. So economically it is a 49-51 split. That means cash flow, debt, everything, 49-51 economically speaking.

It is 49% economically because in New York, if you take a 50% stake, purchase 50% of a business, you trigger a transfer tax. That is about a 2.5% tax. That would run about $15 million for Pebblebrook, so they are saving $15 million by not doing that.

They also, by taking this stake and getting the debt as part of the deal, instead of taking their own loan out against hotels they would buy separately, they are saving a 2.5% recording tax, that applies in Manhattan, which is about another $15 million that they are saving.

And a third thing, this $600 million in debt that is their proportional share of the debt, is a 3.5% interest rate. It is incredibly low. If Pebblebrook were to go out and get a rate themselves in that market, they would get between 5.5% and 6.5%, so that 200 basis point difference comes out to another $20 million that they are saving just on interest payments by going this route rather than on their own. And so, according to their CFO, this is not the kind of leverage that they want to for the long term, but it is opportunistic right now and it is simply smart.

Another aspect of the deal, five years down the road, either party is allowed to make an offer to buy out the other party, and the way that it works is there are six hotels, so instead of buying like half of their stakes, they can just sell individual assets, so they will essentially say, We don't have half of six hotels; we have three and the other party has the right of first offer to buy them out.

So what this means is the way that Pebblebrook sees it, if down the road their portfolio is bigger and they can support it and they are really liking how these hotels are doing, they can buy the other half. And as of right now, that is essentially their plan.

So the two great things about this business, this deal, is that it is opportunistic and it gives them a ton of optionality down the road to expand their exposure to New York, if they want to. But if they don't, they don't have to.

Elizabeth Moran: So this deal that seems a little bit iffy on the surface, overall this doesn't make you uncomfortable, you think it is a good thing?

Alex Pape: Not at all. I mean, honestly, reading the press release I was confused. I think like a lot of members I saw this and I said, This is very un-Pebblebrook. Why are they doing this? But there are very good reasons, and if you were the CEO of Pebblebrook, you simple can't put in a press release, "Hey, we have trust fund babies who want to cash out of our partner and we are trying to avoid paying massive taxes in Manhattan." There is nothing illegal there going on whatsoever, but you cannot put that in a press release, so there are very good reasons.

Elizabeth Moran: Gotcha, makes perfect sense. So that wraps up today's *Pro* Audio Extra. Thanks for joining me. I am Elizabeth Moran here with Alex Pape, and we will see you next time. Fool on!

Ebix Uncut and Unedited

Published Jul 26, 2011 at 12:00AM

A provider of software to insurance companies, **Ebix** is a longtime holding in *Pro*'s Charter Portfolio and a recent addition to Portfolio 2011. It's also one of our most controversial stocks where Wall Street is concerned. A frequent target of short-sellers and class-action lawsuits from ambulance chasers, Ebix has been accused of everything from unsustainable tax rates to questionable acquisitions.

Management is happy to answer questions, so we jumped on the chance to connect you with Ebix's CEO, Robin Raina. Raina is the man responsible for turning Ebix from a money-losing failure into one of the best growth stories of the past decade. The following is Raina, uncut and unedited — just as Ebix wanted it — answering questions from *Motley Fool Pro* and *Motley Fool Rule Breakers* members.

Questions and Answers

Fool analyst TMFSysun (Sean Sun) asks:
Unfairly or not, Ebix is in the bear's spotlight — a position where it absolutely cannot afford to make *any* mistakes. How does Ebix plan on trying to become more like Caesar's wife — beyond suspicion entirely? How is Ebix improving its internal financial and governance controls?

Raina:

I am not sure whether Ebix is in the bear or bull spotlight but am sure that it is getting some attention at present. Leadership and management are about doing things in the most efficient manner that you can. "Caesar's wife must be above suspicion", but then suspicion lies in the eyes and minds of the beholder. Companies need to do things the right way because that is simply the right thing to do, not just because the company is being closely watched.

As long as a management team tries to put in its best at all times, in a transparent, honest & sincere manner that is good enough in my book. To quote GB Shaw, "A life spent making mistakes is not only more honorable, but more useful than a life spent doing nothing." As long as we make mistakes, that we learn from and we do not keep repeating our mistakes, I would think that is okay. We are focused on execution and performance, while ensuring that we do it with utmost integrity and efficiency. We are not trying to follow another blue chip company 3 we are trying to create hopefully an example that others can emulate in the future.

Somebody recently wrote about BDO raising a concern about our controls in the year 2003. That was the first year of their audit and SOX was the last thing on Ebix's mind at that time since Ebix was a tiny company fighting to simply survive. What was not given any attention was the fact that BDO did not cite those deficiencies in subsequent years of their audit, clearly telling you that BDO did not have any control issues after their first audit.

Ebix has some of the best internal financial and governance controls that any company in the world can aspire for. It is not just because SOX mandates you to do that — it is because that makes our business efficient, cost effective and better than others. Ebix runs all its operations and processes over the Internet using internally built systems with checks, controls and balances in it. Our entire business is run using an internally built enterprise tool "iemployee" that is accessible in an anytime, anywhere, anyplace basis over ipads, droids, iphones, blackberries, Macs, PCs etc. This was implemented in the year 2007. All our contract administration is done using that system, our sales management, travel bookings, expense tracking & payment, human resource recruitments, leave tracking, attendance management, payroll, banking, cap-ex management, PO generation, IT management, revenue tracking, expense forecasting etc. everything is done using our "iemployee" system. All processes require multiple approvals, central head office approvals, finance approvals at various levels, tracking of payments, automated PO creation etc. while an audit trail of every transaction is kept by the system. All this is done over the Internet across 6 continents in minutes while ensuring budget sanctity, approval sanctity, and controls that can be trailed back at any time. We implemented these systems because besides controls, it gave us a better handle on our business — we can predict things a bit more easily than others, we have better control over all aspects of our business as we have this systematic centralized system to check everything, and also it keeps everybody at all levels in check. To us, it is about efficiency besides checks and balances. If a company aspires to run a 40% or more operating margin business, it does not have a choice but to put internal controls and governance controls in place. We believe that we do extremely well on controls and can teach the best of firms across the world on how to do it in a systematic manner on a large scale while making their businesses more efficient. We actually plan on launching this new "iemployee" service on an on-demand basis over the cloud, to help companies implement better controls in place. We believe that there is a big market for these kinds of services in the financial world — we see us selling this on-demand product to large accounting firms besides insurance companies and banks.

Besides that, improving governance and internal controls is an ongoing continued process that can never stop. Like any other company, we keep testing our controls and fixing anything that needs improvement. That will obviously continue.

Fool member ultimatespinach asks:
When the former chief executive and board members of Peak Performance Solutions filed suit alleging Ebix wrongfully denied them a $1.5 million earn-out following the acquisition of Peak, you were quoted by Bloomberg News as saying, "It's a black-and-white issue. They had to hit $6.5 million. It's pure revenue. Nobody contested anything until the last day. It's in everybody's interest to have as much revenue as possible." Clearly, it was in everybody's interest for Peak-related revenues to blow past the threshold, but assuming they ended up somewhere in the vicinity of the threshold, isn't it true that it is in fact not in the interest of Ebix or its shareholders to pay the earn-out? Doesn't claiming otherwise threaten your credibility?

Raina:
Much has been said about the Peak suit while the Company has kept its answers to itself since it s a matter being looked at by the courts at present. Let us all reserve our judgment for now until a court either rejects the Peak accusations or holds Ebix guilty of any wrongdoing. The suit alleges understatement of revenue not overstatement as some people made it out to be. The agreement with Peak shareholders mandates audited GAAP numbers to be used for the earn out calculation. The audited numbers were a lot lower than $6.5 million. If they had a dispute with that number, then the contract mandates that they need to give Ebix a 30-day notice, then submit reasons for dispute on revenue. After all this, it could lead to arbitration, failing which it would go to a court. The funny fact is that they have not done any of that including giving us a 30-day notice or taking it to arbitration. One wonders why they were in a hurry to file a suit and report it to the public, when the contract does not even allow them to do that. So, let us hold our thoughts for now and not pass any judgment on Ebix practices or management, based on this suit that alleges a few hundred thousand in understatement.

Till recently, Ebix has been one of the few public companies that have had very few legal disputes in the last decade or so. We must be doing something right to not be the subject of many disputes over the last decade.

Public companies can not keep cutting checks for fear of avoiding any suits — we have paid many earn outs over the last decade and most of the owners, their managements and at times family members, of businesses bought by us over the last decade still work for us today. Incidentally, that includes Peak too even today. We believe that it is in the interest of shareholders that Ebix does the right thing — pay a earn out when it is due and not pay it under pressure, when it is not due.

Company credibility is hurt when company does something wrong and that is established as a fact. It might suit some people's interests to exploit an unproven allegation amounting to a few hundred thousand dollars even if it may not have any basis. But then, the same people are not going to look very good if that allegation is proven to be a complete fabrication — so let us hold our judgment for now.

ultimatespinach also asks:
As a company that owes much of its growth to acquisitions, do you believe the dispute with the former Peak executives and board members might make future possible acquisition targets question the good faith of Ebix and therefore make such acquisitions more difficult?

Raina:
Firstly, Ebix has grown by acquisitions and through organic means both. Let us talk through any acquisition we made and compare their revenue in the preceding quarter before the acquisition and say revenue from that service in Q1 of 2011 - you will immediately discover that Ebix has done a good job of growing the business. Every time we make an acquisition, we take a hair cut on deferred revenues immediately and that haircut can vary between 3 to 7% of the acquired company's revenues. All growth analysis that I have seen has ignored this 3-7% hit taken by Ebix immediately post acquisition, in revenues from the acquired player. Also this growth has been achieved at a time when the insurance industry was shrinking and having the worst years in a few decades.

As regards any suit impacting future acquisitions, people are a lot smarter than making their judgment based on an unproven exception. We have paid lots of earn outs over the years and still continue to do so. As I said earlier, most of the owners of acquired businesses still work for us including many family members of the Peak shareholders. Our acquisition pipeline is strong and not impacted by any of this. This suit does not get any attention by anybody other than the noise seekers in the investment world, who might have their reasons to do so. In the investment world today, if the Company does not have any bad news, then people become catalysts to creating the bad news — people sometimes forget that truth always finally prevails. Truth decimates everything that comes in the way — we are firm believers in the power of truth, integrity and honesty though we realize that in the short term repeated chants of "cows can fly" might unfortunately get some followers — at least for now.

TMFTypeoh asks:
Any thoughts on paying a one time, special dividend? I would think that would scare some of the shorts away, at least in the short term. It might give some credibility to EBIX as a legit business as well.

Raina:
As regards dividends, at this point nothing is ruled out. Let us wait and watch.

One thing is pretty clear that the Board has committed to purchasing $100 million of Ebix stock from the open markets and retiring that stock. Once Ebix has purchased $75 million or more of its stock, I intend to recommend to the Board to increase the purchase authorization to $160 million from $100 million.

We are buying our own stock because we see this as an accretive transaction for our shareholders and because we see this as buying stock in a Company that is producing 40% or more in operating margins, and is still trading at rather low cash multiples. We are not buying the stock because we want to support our stock price or drive the shorts out. That would be knee jerk or rather short-term thinking and we prefer to think about our shareholder's interests in the long term.

Lastly, after being in existence for 35 years, powering hundreds of thousands of users across the globe, powering hundreds of billions of insurance premiums, or having majority of the blue chip names of the insurance and financial world as customers or having 30 + offices across the world with customers in 69 countries or having one of the highest customer retention rates in the insurance industry or producing 11 years of consistent growth in terms of cash, income, revenues and EPS for a business that a decade back was a $12 million revenue business with a $19 million loss; if Ebix still needs a dividend to prove to a particular investor that it is a legit business, then something is wrong with the world we live in today. Dividend payment or non-payment should be a rational decision based on growth strategy and merits, rather than proving anything to anybody.

SimFool777 asks:
I am wondering if the current short attacks might be related to the EZ Data Puts. Does Ebix know if EZ-Data still holds the put options or if they sold them to someone who might have the financial clout to implement a short attack? Is the stock buyback intended to try to keep the price above $15.11. Does Ebix intend to offer put options in future acquisitions?

Raina:
We do not believe that it has anything to do with the EZ Data puts. Those puts anyway run out in October of 2011. We are not buying our stock back to keep the stock above a particular price. We purchase stock because it is an accretive transaction for our shareholders.

Stock puts constructed properly have a good upside for the acquired shareholder and very limited downside for Ebix. When we gave the $25 million stock put to EZ Data shareholders, it provided for us to pay them $22.5 million against that $25 million value in the 25th month. For us, that would be like an interest free payment after 2 years and we get to pay 10% less. For EZ Data owners, it gave them an upside into the future with a 10% downside cover. That interested them and ultimately got the deal done.

Whether we use it in the future for another acquisition will depend on many metrics associated with that acquisition. I do not rule it out neither can I tell you that we will use it for sure.

kcanant asks:
We are interested in your philanthropy; how are things going with the RR Foundation?

Raina:
RRF is committed to helping the underprivileged across the world irrespective of color, religion, sex, caste or creed. We believe that pain feels the same across the world. My belief is that poverty is a religion by itself and it transcends every divide.

RRF supports the education of thousands of kids today while offering them mid-day meals, clothes, medical care and hope for a possible future. One of my dreams has been to build 6,000 homes for Delhi slum dwellers that were thrown out of the city by the Govt. of India in the name of cleansing the city, for the 2010 Commonwealth Games. These homes cost around $2,000 each to build — we have handed over 1157 homes as of now while another 297 homes will be handed over by end of August 2011. Recently I produced a documentary film "Dilli" to give a voice to these slum dwellers. The film shows these homes as also traces the lives of these slum dwellers from Delhi. The response to the film has been rather overwhelming — as of now the film has won 6 film festival awards, besides being selected to the finals of 17 international film festivals. Recently NBC's Documentary channel signed an exclusive 2-year agreement to telecast the film in the US and West Indies beginning September 2011. All this has served to get the voice of these underprivileged people heard across the world and we feel rather humbled to have played a role in making that happen. You can read more about it on www.dillifilm.com

I have always believed that coffin does not have a pocket. Being in charity has given my life a balance, a perspective that keeps my feet on the ground. I realize that materialism is evanescent, while giving & peace of mind are something that nobody can take away from you. Charity is not about giving money — it is about giving one's time and care for the ones who need it. The blind kids that we educate care less for the money that we provide them, they care a lot more for the warmth of a hand that gives them the sense of belonging and affection. Sometimes people who have no money are more charitable than people who give lots of money.

The foundation is a facilitator in the process of changing lives and imparting hope — one life at a time. We will keep striving to do so.

EricLin asks:
Given the amount of cash committed to share buybacks, does this mean the end of acqusitions? If not, how will acquisitions be financed? Via debt or equity?

Raina:
Our business continues to produce good amount of cash. We expect and believe that our cash flow generation abilities will continue to grow over time, as we expand our business and sales force.

We have a strong acquisition pipeline at present. We believe that we have the means to finance these acquisitions. With interest rates being very low and our continual ability to generate strong cash flows, our preferred medium of financing an acquisition is debt. Any Company's Bankers keep a close watch on the Company's AR, cash & collection record; and they have the best understanding of whether a company deserves that debt. Thus, Bank of America could be a logical choice for us though it will always be a decision made on the best possible interest rate and the best possible flexible terms given by an institution.

pwil asks:
How does Ebix plan to support its existing US legacy systems in the future?

Raina:
Ebix has continued to support any legacy systems that it inherited from the business that the Company had before we reinvented the business as a on-demand SAAS play, a decade or so back. The good news is that the only legacy business we support today accounts for less than 1 % of our worldwide revenues.

Supporting a legacy business is like supporting an antique car. You can support it as long as you want but the spare parts and servicing keeps getting more expensive every year. Ebix intends to follow that rule and support the systems as long as we can, while ensuring that it holds viable economics for Ebix.

antmark asks:
How does Mr Raina view EBIX's tax risk exposure stateside, specifically on transfer pricing?

Without robust contemporaneous transfer pricing documentation for Code section 482 purposes, an IRS audit challenging the arm's length nature of payments to India or Singapore affiliates could wipe out a significant part of free cash flow (and impact future taxes).

On a related note, while CB&H may have "decades of experience in audits and tax work with large international accounting firms" (quoting from the Barron's article), does CB&H have (and has it demonstrated) sufficient capability to handle the transfer pricing of services and intangibles? Proof of the pudding will be whether CB&H-prepared documentation (whether for EBIX or other clients) have passed IRS audit scrutiny previously.

Raina:
To put things in perspective, BDO Tax Partners in 2005-2006 put Ebix's tax structure in place. Subsequent to that, it has been reviewed and enhanced by Ernest &Young, with help from other firms like BKD, Frazier Deeter etc. besides multiple offices of E&Y across the world. Ebix's infrastructure setup of putting development and IP in Singapore & India was put in place much before any tax planning was contemplated. Also Ebix's inheriting of NOLs in the United States was something that was not planned but happened since Ebix had lots of losses in the pre-2000 era. Our tax structure worldwide was thus driven by our infrastructure and efficiency needs of putting development & IP in a place, which could give us global economies of scale at the highest levels of efficiency.

Ebix took care not to transfer any IP out of the US and thus does not expect any issues on that account. All our IP centralized in Singapore was either built and funded by Singapore or directly acquired by Singapore through an acquisition.

Our transfer pricing is not done by CB&H. The transfer pricing, updates and reviews are done by E&Y with help from their various offices, and BKD. That is a continuous exercise and not just a onetime exercise. Every position of the Company has a strong documented basis, written by these top quality firms who are rated one of the best in this work worldwide. CB&H is our US auditor who checks all this from an auditor perspective and they have an international tax practice that specializes in this field.

Besides following the advice of the best in the business, the Company always has taken conservative positions and built large FIN 48 reserves to offset any adverse transfer pricing rulings. Also our US NOLs in all those periods serve to largely offset the cash impact of any adverse ruling.

As Ebix releases its valuation allowance in Q2 of 2011, a lot of this will become a moot issue with Ebix worldwide effective tax rates going up to 16-20%. Most of those taxes will be in the United States as our international tax rate is primarily driven by Singapore's perpetual tax rate of 10%. India's low tax rate will become a bit irrelevant once all development & IP is centralized in Singapore. At a tax rate of 16-20%, we will be paying a bit more tax than most global software companies in the United States today.

snafflekid asks:
What prevents another company from buying some Salesforce.com cloud computing time and creating an Ebix copycat?

Raina:
Ebix is not just a technology player — Ebix is an insurance domain expert. That is the biggest barrier to entry to the insurance industry that thrives on regulations that change by state and line of business. In any case, all the businesses that we power do not own any IP for the service that we provide to them. Ebix owns all IP and provides the service on a "right to use" basis. Also Exchanges in the most case require large aggregations to move from one software player to another, which is rather impractical and that is another barrier that is difficult to get over for a competitor.

***Pro*advisor Jeff Fischer (TMFFischer) asks:**
Have any current Ebix customers or potential customers mentioned *Barron's* or any of the short-seller articles as a point of concern?

Raina:
The short answer is No. My guess is that our customers know a lot more about us than any media article can tell them about Ebix.

Thank You

Thank you to everyone who asked questions, and to Mr. Raina for taking the time to respond with great detail. We hope you enjoyed hearing Ebix's CEO answer your questions. Ebix is currently rated a "Buy" in Pro, with a buy around price of $18 and fair value of $24. If you have questions about the company, please visit the Ebix discussion board. —*Jeff Fischer*

Pro's Young History: A Strong Start

Published Jul 25, 2011 at 12:00AM

Time flies when you're having fun: We're already nearing our third anniversary here at *Pro* (Oct. 17, to be specific). We'd like to sincerely thank each and every member (with a special shout-out to those charter members who have been with us from the start), and we hope you've found the journey as memorable and rewarding as we have. The traditional third anniversary gift is leather, but we regret to say we won't be shipping out any leather gifts when the big day comes this fall. (Well, maybe a digital image in your email ...)

Get Rich With ...

Covered strangles? Written puts? Buy-and-hold stalwarts? At *Pro*, we want to help you make money with all of those and more, and we'd love your suggestions on how we can improve.

We're in the heart of earnings season, the government is keeping everyone on their toes, and we have two important index hedges expiring in August, so we have to focus twice as hard right now on managing our holdings and possible new hedges. To that end, we're going to keep this Memo simple but ideally valuable. Today, I want to review our numerical history.

To See Where You've Been, Keep Good Records

This summer, *Pro* has been fortunate enough to employ two excellent interns, Reza and Elizabeth. (You'll hear both of them share their impressions of *Pro* in a Memo of their own soon.) Reza spent a good amount of time creating a new master *Pro* data spreadsheet for us — thank you, Reza! I'm going to share some of that data with you here, showing you our equity, cash, and total value since Jan. 31, 2009.

The information below is as of the last day of each listed month. The numbers are from our actual Schwab brokerage statements. We launched in October 2008; the data below begins in January 2009. Take a look at where we started, how steadily we invested, and where we've gotten so far:

Pro Charter Portfolio History

Date	Equity Value	Cash Value	Total Value
January 2009	$124,762.50	$786,704.65	$1,000,152.85
February 2009	$153,387.40	$684,930.71	$975,645.21
March 2009	$181,735.80	**$728,213.32**	$1,003,316.52
April 2009	$196,829.00	$744,778.18	$1,047,436.38
May 2009	$252,651.60	$683,871.57	$1,086,643.17
June 2009	$321,248.10	$627,546.35	$1,087,902.85
July 2009	$434,735.40	$548,500.05	$1,140,652.45
August 2009	$451,116.70	$559,336.95	$1,159,843.44
September 2009	$492,684.60	$561,218.71	$1,184,821.71
October 2009	$511,362.50	$516,933.79	$1,164,195.89
November 2009	$577,992.90	$426,764.03	$1,188,113.25
December 2009	$628,636.90	**$401,348.50**	$1,222,428.40
January 2010	$631,660.60	$405,123.72	$1,186,098.72
February 2010	$693,399.00	$402,495.97	$1,210,872.21
March 2010	$835,989.20	$285,650.03	$1,253,466.83
April 2010	$869,690.70	$286,024.57	$1,270,353.47
May 2010	$787,815.00	$260,802.06	$1,205,171.46
June 2010	$723,885.40	$258,252.58	$1,160,779.38
July 2010	$808,359.20	$232,777.34	$1,218,571.94
August 2010	$809,626.30	$190,891.88	$1,177,695.98
September 2010	$881,406.60	$203,567.60	$1,270,028.00
October 2010	$939,427.20	$193,406.08	$1,301,418.28
November 2010	$986,666.70	$99,030.52	$1,297,326.52
December 2010	$1,062,880.60	$89,984.16	$1,382,924.51
January 2011	$908,392.10	$256,671.68	$1,415,696.08
February 2011	$973,442.90	$205,135.03	$1,448,956.03
March 2011	$994,180.40	$117,178.32	$1,458,898.40
April 2011	$1,129,564.10	$34,579.67	$1,527,933.17
May 2011	$1,117,975.80	$35,145.60	$1,504,655.00
June 2011	$1,113,642.10	$99,930.10	$1,499,041.70

Groovy, Yeah?

Members sometimes ask, "How are *Pro*'s returns so far? How would you measure them?" Especially after perusing this data, I would not-so-humbly say that at this point our returns are excellent. And the chaser to that is: We need to keep our expectations in check.

Remember that our goal is steady, absolute returns with high accuracy and reasonable risk, which usually means holding some cash, shorts, and hedges. As of Friday, the Charter Portfolio was up 56.4% while the S&P 500, including dividends, was up 51.2%. We *do not* invest to beat the S&P 500. That's not our focus; steady profits are, and they're two different things. But investors who can top the index by a point or two a year on average end up with a very large advantage over time. And as you know, the vast majority of professional investors and mutual funds don't top the index at all.

Guidance Changes

- **3D Systems** : Following a sharp rebound, the 3D-printer company moves down to Hold on valuation.
- **Rockwood Holdings** also moves to Hold on valuation.

Pro Trade Roundup

Charter Portfolio

- **Covanta** : Bought 2,700 shares (3%) at $16.96.
- **iPath S&P 500 VIX Short-Term Futures** : Sold to open 45 December $22 calls at an average $3.48.

Portfolio 2011

- **Covanta** : Bought 450 shares (3%) at $16.92.
- **iPath S&P 500 VIX Short-Term Futures** : Sold to open seven December $22 calls at an average $3.50.

Earnings Ahead

- **July 25: Plum Creek Timber**
- **July 26: GlaxoSmithKline** , **Kinetic Concepts**
- **July 27: NextEra Energy** , **Rockwood Holdings**, **Tupperware**
- **July 28: 3D Systems** , **GrafTech International**, **L-3 Communications**
- **July 29: AmTrust Financial**

What's especially pleasing about our results is that we've achieved them with much less risk than we would have faced if we had put 100% of our cash into the S&P 500 index in October 2008. When the market bottomed in March 2009, we still had a giant $728,000 in cash (highlighted in bold in the data above). You could say we're idiots not to have invested it all in the market immediately at the bottom (I jest; hindsight is 20/20), but it's more important over time that we adhere to our philosophy of investing steadily for absolute gains in strong positions. Thus, we only invest at a comfortable pace. By the end of 2009, we still had $401,000 in cash (see the second bolded number above) — 40% of our starting value. Even nine months later in September 2010, we had $200,000, or 20% cash, along with some inverse ETFs that we had paid for.

I can guarantee you that very few other funds out there that were 72% in cash in March 2009 and 40% in cash in December 2009 (with some shorts as well!) have kept up with or surpassed the record-strong S&P 500 since then. This year, the *Pro* charter portfolio is up 13%, six percentage points ahead of the S&P 500's 7% gain. That is not common by any means for a hedged portfolio (like ours) in an up market. Sadly, we can't expect this all the time. I've always said, and still believe, that we'll do better than most any index over many years — but that is not our goal. Our lower-risk strategy will put up healthy relative returns in sideways markets, but will usually cost us some relative returns in strong markets.

Big Wall Street Investors Must Really Stink

Our results so far come despite the fact that *Pro* usually gets subpar prices on its own trades because of our waiting period. Sometimes, in fact, that regulation leaves us missing out altogether on some big trades. The four of us on the team easily spend 40 hours combined each week on the discussion boards, and many more hours writing reports and articles. Meanwhile, we deliver more ideas over at *Motley Fool Options*, available free to all *Pro* members. My point is that we demand a lot of ourselves here at *Pro* (and at *Options*), because we know how important your money is to you. We want to take reasonable risks and keep a balanced portfolio. I want to promise you realistic long-term returns, and I want you to have realistic expectations, even though I hope we'll over-deliver. We're off to a strong start for a young service that's investing during trying times, and we want to compound our results on our own terms over the years.

With that, it's back to earnings and investing. Read on below to see our new earnings coverage. And please post any thoughts on the Memo Musings discussion board.

Thank you for being a valued *Pro* member, and Fool on!

Jeff Fischer (TMFFischer)

Coverage & Community

- **Intel** : Solid second-quarter results and strong guidance send shares higher. Jeff has the scoop.
- **Wells Fargo** : Nick Crow (TMFCrow) delivers the goods on a quarter of improvement at our favorite bank.
- **Covanta** : Great traction across the business, with higher revenue, more cash being returned to investors, and new projects right on track. Jeff jumps into the trashy story from our newest buy.
- **Hot Off the Presses:** Get yer detailed earnings calendar from TMFValuemoosie.

Audio Extra: Veni, Vidi, Vici, VIX-y

Published Jul 22, 2011 at 12:00AM

Do your eyes cross when you see *Pro*'s trades on the VIX using VXX? Volatility got you tossed about? Listen in as *Motley Fool Duke Street*'s Rich Greifner interviews Jeff about the basics behind *Pro*'s popular bearish bets on the volatility-tracking wannabe **iPath S&P 500 VIX Short-Term Futures** ETN. Then read over our trades again and post on the VXX discussion board if you have questions!

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Transcript

Rich Greifner: Greetings, Fools. It's *Duke Street* Advisor, Rich Greifner here, and today I am joined by a special guest. We have got Motley Fool PRO Advisor, Jeff Fischer.

Jeff Fischer: Thank you, Rich.

Rich Greifner: Thank you, Jeff. Thanks for joining me.

Jeff Fischer: Of course, my pleasure.

Rich Greifner: And Jeff, I was really intrigued by a trade that you guys at PRO made this week. This week you wrote naked calls on the VXX exchange-traded note. Now this is the fifth time that PRO has taken a bearish position on this instrument. Jeff, this seems like a really cleaver trade, but I just want to make sure that I fully understand it and that members fully understand it. So let's start at a high level. Why is the VXX exchange-traded note such a compelling short?

Jeff Fischer: Because it tracks the futures contracts to the VXX and VIX, and we will explain what all of this means, of course.

Rich Greifner: So that did not sound very compelling to me, but rest assured, this is a very compelling investment thesis.

Jeff Fischer: It is tracking futures that have a higher price than the current index is worth today. So say you wanted to buy a pound of coffee two months from now.

Rich Greifner: Okay.

Jeff Fischer: Odds are you are going to have to pay up to guarantee your price right now.

Rich Greifner: Sure.

Jeff Fischer: This is the same sort of situation. People are willing to pay a premium right now to protect against volatility. The difference between paying a premium for a VXX futures contract and paying a premium for coffee is sometimes coffee won't pay much of a; say it was a bumper crop year. There won't be much of a premium, if any, on futures contracts. But with volatility, volatility, spiking volatility in the market is always a possibility so there is always a premium, almost always, 70, 80% of the time or more, a premium to buy volatility contracts on the market, which makes perfect sense.

Rich Greifner: So let's take this up to a high level. Let's just begin at the beginning, going through the nuts and bolts of this trade. The VXX seeks to track the VIX, the VIX Index. Now stay with us, folks. Jeff, can you quickly explain what is the VIX?

Jeff Fischer: Perfect. It was invented in 1993 and it is meant to provide the implied volatility or the expected volatility in the S&P 500 over the next 30 days at any given time. It is measured; the number that it is measured in is a percentage, so the VIX has averaged, back testing back to 1990, has averaged a 19 reading, which is 19% annualized volatility in the S&P expected, up or down, which makes again perfect sense if the market has averaged about 10% annualized returns, more or less, over its history.

So what the VIX does, it takes option contracts for the next two months and it uses a formula to measure the expected volatility in the market. For instance, if the VIX is trading at 15, a level of 15, that tells us that the market expects the S&P to move less than 4% or so in either direction in the coming month.

Rich Greifner: Okay, and the VIX is currently low twenties?

Jeff Fischer: It is currently; it is fairly volatile. It was 20 a day or two ago; now it is 19. It may be different a day from now.

Rich Greifner: Okay, so I think I understand the VIX, but tell me, why does the VXX do such a poor job of tracking the VIX?

Jeff Fischer: So you have the VIX, this magical fear gauge. People call it the fear gauge because it goes up when the market is going down, generally, and that is because people are willing to pay more for put prices at that time. For instance, Rich, you know this. In 2008, the VIX went from its 20 or so average; it spiked all the way up to 80 during the worst of the fear.

Rich Greifner: I recall that.

Jeff Fischer: Then it reverts to the mean; it goes back down and it has been below 20 most of this year. It spiked up for Japan up to 2 during the tsunami, but then right back down to the teens.

Rich Greifner: Okay.

Jeff Fischer: Which gets to why VXX is so good. If you can wait it out, volatility, implied volatility, is always going to revert back to the mean. I say "always" meaning measured over a period of a few years, generally speaking.

Rich Greifner: Sure.

Jeff Fischer: The market is not going to expect extreme volatility from the market indefinitely. Basically we get these hits, these surprises. Volatility spikes up, the market takes that into account and then volatility goes back down.

So why VXX is such a terrible tracker of the VIX is because it uses the forward two months' futures contracts on the VIX to derive its price. And so I can tell you right now what those futures prices are. As of our taping, the VIX is at 19 and VXX, this exchange-traded note that tries to track the VIX, is investing in July futures contracts that trade at 20.15 or 6% above the current VIX and August contracts that trade at 6.3% above the current VIX.

So it is paying the 6% premium just for one month ahead, and it rolls these contracts every single day. So it will sell these contracts as they expire and buy one a month ahead and pay a premium again. So this is called "contango", where you are always paying more for a futures contract than the contract that you are selling.

Rich Greifner: And so it is a fundamentally flawed tracker. You can't track the VIX perfectly, and it is paying a premium to attempt to do so.

Jeff Fischer: Right, and VXX is not alone in this. So many commodities' ETNs, as you know, try to track a commodity by using futures prices, and they pay contango as well. A famous one is UNG, the U.S. Natural Gas Fund. It suffered the same thing.

Rich Greifner: I recall. But what is interesting to me, though, is if that may work over the short term, but over the long term, this is just a losing strategy for the VXX, and if you go back and look at its stock chart over a long-term horizon, it is just falling off a cliff.

Jeff Fischer: Oh yeah, straight down. It has been around a couple of years now and it has lost 80, 90% of its value. It has done a couple of reverse splits, four for one, and it is in its charter that when it gets below a certain price, it will do a reverse split to get the price back up. But the result is…

Rich Greifner: That is just optics, right?

Jeff Fischer: Oh yeah, completely. For a short seller, you have made that 80, 90% and you will continue to make money, ideally. I had a point is was going to say, but go ahead, Rich, with your….

Rich Greifner: Well, I was just going to say, so because this is a fundamentally flawed tracker, then it doesn't necessarily matter what the VIX is doing over the long haul, even if the VIX does spike, we are confident that the VXX is headed down in a long, slow, downward spiral.

Jeff Fischer: Yes, there is a lot of truth to that. Now the VIX could spike, say it doubles from 20 to 40, which it can do, of course.

Rich Greifner: Sure.

Jeff Fischer: Historically, VXX has gone up less than half as much as the VIX because it is already; the futures it is tracking already takes into account at least a fair spike in the VXX at all times. So the VXX might double, the CTN might go up half as much , the VXX might go up half as much, but if you wait as the VXX goes back down, this will go back down as well.

Rich Greifner: And so that is why you are confident entering into this trade today, even though who knows what might happen. You know, debt problems in Europe, debt problems in the U.S. That doesn't overly concern you?

Jeff Fischer: Right, right. The history with PRO, and I think many *Duke Street* members will know this. We tried to short VXX initially directly last year, and the shares are hard to get. Our broker couldn't get them. So we started writing naked calls, and the benefit to this, at least, is we get a premium, to begin with. So the VXX is 19, but with the premium that that calls pay us, our short price is effectively 26 or so on the VXX, so we have that cushion built in on top of everything else.

But you are right, to your point. Over the long haul, the contango generally eats away about 3% of the value in VXX every month, which annualize that, that is a large, steady decline. For instance, VXX has lost, and I don't have the numbers in front of me, but at 36% this year while the VXX itself is actually up a little bit.

Rich Greifner: So that is really not a great tracker then.

Jeff Fischer: It is far, far from it.

Rich Greifner: Now Jeff, if members had a broker, like say hypothetically interactive brokers. I know many *Duke Streeters* choose to use them; that enabled you to short the VXX at a low cost, would you recommend that instead of writing the naked calls?

Jeff Fischer: Yes, it is an alternative trade; I have got PRO as well, to short VXX to be clear, directly, if you can do it. It is a trade we recommend. I personally am short shares. I have been since last year, and I will add to it on any spikes in the VIX, which lead to a spike in VXX. But start incrementally with the VIX only at 19 or 20, it is not that elevated, so start with a partial position. When the VIX spikes into the high twenties or the thirties, add to your short.

Rich Greifner: Well there you have it, Fools. I hope that cleared up any questions you might have had on this complicated trade. That did it for me, but if you Fools have additional questions, feel free to hit the *Duke Street* discussion boards, the PRO discussion boards, where Jeff and his tea will be happy to help you out.

Thanks for joining me, Jeff.

Jeff Fischer: Thank you, Rich.

Rich Greifner: Thanks for listening, everybody. Fool on!

Charter Portfolio and Portfolio 2011: Write Naked Calls on VXX

Published Jul 19, 2011 at 12:00AM

Trade Essentials

- **Action:** Write ("sell to open") December 2011 $22 naked calls
- **Allocation:** 7.5% if we end up shorting shares. For the Charter Portfolio, that's around 43 contracts, and for Portfolio 2011, it's seven.
- **Recent ETN price:** $23
- **Recent ETN options price (bid/ask):** $4.50/$4.80
- **Recent measure of the VIX:** 21. The CBOE's measure of put prices to call prices gauges the implied volatility expected in the S&P 500; it is measured as a percentage, so 21 means 21% expected annualized volatility.
- **Preferred limit price:** Check current prices and aim for at least $4.50 if feasible; as prices change, accept no less than $4
- **Alternative trades:**
  - Sell shares short directly, starting with a 5% allocation since you lack a price cushion
  - Write naked calls at higher strike prices if you want more breathing room
  - If you're already short shares, continue to hold your short in anticipation of more long-term price decay

What's New

First Things First

- **ETN: iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX)
- **Price (July 19):** $23
- **Type of holding:** Short
- **Past VXX reports:** Click here
- **Website:** ipathetn.com
- **Follow it:** Add VXX to My Scorecard

This trade marks the fifth time we've taken a bearish position on the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) exchange-traded note. Aside from our initial effort to short the ETN directly in June 2010, this is our most aggressive position so far. By writing modestly *in-the-money* naked calls, we're mimicking a short position down to our strike price of $22. (We would consider shorting the ETN directly, but our brokerage makes this impossible — see "How to Follow Along" below.) This strategy does offer an added bonus that shorting directly doesn't: Writing calls means we get paid a premium. The calls are currently paying about $3.50 in time value and $4.50 total, so we're effectively shorting the ETN near $26.50. A small decline to $22 or below by expiration will leave us with a full $4.50 profit, and there's a reassuring 15% cushion between the recent ETN price and our $26.50 break-even price.

This ETN aims to track the famous volatility index known as the VIX by mirroring short-term VIX futures contracts. However, it doesn't do so accurately — at best, it tends to go up less than half as much as the VIX on a daily basis, and do much worse over many months. While the VIX is up 21% in 2011 as of July 18, the VXX ETN has lost 36% of its value year to date. The data suggests that the VIX would need to jump about 25%, to 26 or higher, sometime soon for the ETN to reach our break-even price. This disparity is because of contango, to which the ETN loses an average of 3% a month — much more when the VIX goes down.

To understand contango, you first have to understand how the VXX ETN works. The ETN tracks (but doesn't actually invest in) the prices of near-term VIX futures contracts on a daily basis, "selling" near-dated VIX futures to "buy" VIX futures that expire a month later. This roll incurs a cost (or negative "roll yield") more than 70% of the time; that situation is called contango, and it reliably eats away at the ETN's value. Because the VIX can spike at any time, its futures almost always carry a premium, so the ETN is almost always hamstrung by contango. (It's unusual in that regard — most commodities that also have futures contracts don't have to worry about such sudden spikes on a continual basis.)

If this ETN loses its just 4.5% between now and its December expiration, we earn the full $4.50 profit. Contango alone between now and December should account for a loss of more than 4.5%, so unless the VIX rises more than that, the ETN will ultimately lose value.

Setting up this position now takes some nerves of steel, which may end up helping it work well. Financial anxiety is riding high these days. Wall Street is concerned with government debt, even though it's unlikely any Western government will default this year. Instead, the powers that be will try to kick the can down the road for at least another year (longer in the U.S., given the upcoming presidential election). If the VIX does reach and maintain a higher price on growing market fear (say, if European debt woes spread beyond Greece to Spain), we may look to roll our calls to a higher strike price or later expiration date by December, seeking to maintain a credit. Or we may even add to our position if the VIX rises above 30.

Why This Strategy?

Over the long term, I have more conviction about shorting this vehicle than any other short I've made. The way this ETN is structured, it's almost certain to lose value over several months, and especially over a year or more. The main risk here is liquidity, or you simply having enough assets to ride out a big loss: If you're short the ETN when the VIX suddenly goes parabolic (which does happen — it jumped from around 20 to 80 in 2008), you could suddenly be staring at a 100% or 200% loss. If you have the means in your portfolio, you can add to your short or wait it out (*Pro*'s plan in such a situation), because implied volatility will eventually subside and the ETN will deflate. But if you don't have liquidity, you could be forced to take a loss at the worst time. Thus, you should only short as much as your portfolio can reasonably handle, and remember that when a short rises against you, your allocation to it grows.

That said, recent events add to my confidence regarding the ETN's flaws. During the seven-week market decline we witnessed this spring, the VIX briefly reached a high of 22.73 on June 16, rising from a low of 14.72 on April 28 — so it gained 54% in about seven weeks. The ETN gained a much smaller 11% in the same time, to $25.74 from $23.15. That's even worse than par for the course. Contango should continue to work in our favor, steadily decaying the ETN's price to make our short profitable, and making it harder for the ETN to rise to our break-even price by a month or two from now even if the VIX does spike.

Why December? We want enough time for things to calm down, and in case volatility spikes soon, we appreciate the larger premium that December affords us compared with options expiring in earlier months.

How to Follow Along

Many brokers charge a fee to sell something short if shares are scarce. VXX shares are not available for shorting at the Fool's Schwab account unless we want to pay a 7% fee, and shorting would also mean we risk the shares being called away on us early. By writing in-the-money calls instead, we avoid paying fees and retain more control of our position. Once December nears and the calls have lost most of their time value, we can roll them if the ETN is still above $22.

You need full options approval and margin permission to write naked calls (calls in which you don't own the underlying shares). Our profit is limited to what the calls initially pay us. If you can short shares directly and cheaply (some brokers, like TD Ameritrade, don't charge for shorting), that remains an attractive long-term alternative, but you should move incrementally and increase your position if VXX spikes. A direct short gives you greater long-term profit potential, but it means you don't start with a pricing cushion the way we do with these naked calls.

Trade Details

- **Action:** Write ("sell to open") December 2011 $22 calls (one for every 100 shares you'd short).
- **Recent price (bid/ask):** $4.50/$4.80
- **Break-even price:** $26.50
- **Recent VXX price:** $23
- **Difference from break-even**: 15%
- **Maximum profit**: Whatever the calls pay you, if VXX ends below your strike price
- **Risk:** Unlimited; the higher the VIX goes, the higher VXX will go (to a lesser degree), but eventually implied volatility should deflate

Fools, if you make this trade, be aware of the risks of shorting anything, let alone a volatility-tracking note. This is a high-conviction position when time is on our side, but we might see large price movements in the meantime. In that case, we'd need to roll the position forward or update our strategy. While doing so, we may have to sit on very large paper losses. If you have more questions about this trade, our past reports should help you get up to speed. As always, please bring your questions about this trade to our VXX board.

Jeff is short shares of VXX. See all of Motley Fool Pro's holdings on our Recommendations page.

It's Time to Raise the Roof

Published Jul 18, 2011 at 12:00AM

Pro Trade Roundup

Portfolio 2011:

- **Bristow Group** : Sold to open 2 September $40 puts for $0.30 (we had to make the trade in our 30-day window).

Dear Fellow Fools,

If the little "debt war" on Capitol Hill has you singing the blues, remember it could be worse. Heck, 150 years ago the country was in a civil war that lasted four years and nearly brought the nation to its knees. Bickering over a debt ceiling doesn't compare at all, but it does have the market on pins and needles. Grab a cool spot in the shade, and let's talk about it.

Why Limit Yourself?

Congress started the debt ceiling in 1917, imposing a quaint $11.5 billion limit. Today **Apple** alone is valued 29 times higher than that. The purpose of the debt limit was *not* to restrict going above it — if that were the case, the country would soon have gone out of business — but to have a limit in place so that lawmakers would think about what they were spending and be required to increase debt in an orderly, visible fashion.

Now the debt limit stands at $14.29 trillion, a number that's hard to fathom. To put it in context, the U.S. gross domestic product (GDP) was $14.6 trillion in 2010. Because our debt has more than doubled from $6 trillion in 2002, it now nearly equals the country's annual GDP.

Putting this into even *greater* context, excluding your home mortgage, imagine if you had as much debt as your household's annual gross income, and imagine you were paying interest on it. Now imagine your monthly income left you about 40% shy of making your monthly bills. In other words, you aren't making ends meet without borrowing more dough every month! You have years of extreme parsimony ahead or need a big jump in revenue just to pay existing obligations. In fact, you start to question your ability to ever dig out.

Ebix Q&A

Have a question for Ebix CEO Robin Raina? *Pro* is hosting another question-and-answer session with him, and we want to field your questions. Post them on the **Ebix**board soon.

Take It to the Limit, One More Time

The United States is in this position. As our debt hits the limit again, Congress needs to "raise the roof" so the country can sell more treasuries and raise more money — more debt — that will merely be used to pay *existing* obligations. The country is running a monthly deficit of approximately $125 billion, so if the United States can't sell more debt, it will be unable to pay about 40% to 45% of its monthly bills starting August 2. Which entities could lose out? Perhaps interest on debt, Social Security, unemployment, park services, Medicare, veterans, and federal employees, among others. Do you see any nonessentials on that list?

What's the Holdup?

So the debt limit needs to be raised, not so we can fast-track new spending, but just so that the country can meet obligations that are already on the books. The irony is that some of the same lawmakers refusing to raise the debt ceiling already tacitly agreed to do so months ago when they signed bills requiring funding into law. Lawmakers knew the approved spending would hit the limit, so almost nobody on Capitol Hill is above reproach. But this is nothing new under the sun.

Since 1962, the debt ceiling has been raised 74 times, and 10 of those instances have occurred since 2001. If it isn't raised now and bills aren't paid, the credit rating of the United States will notch lower, interest rates will go up, and the entire country will suffer higher borrowing costs. That might be enough to bring on another recession.

What Will Happen?

Although politicians are playing hardball, it's likely that they'll reach a compromise to avert financial disaster. But there's little question that the United States needs to increase revenue or cut wasteful spending – or both – so let's hope the debt impasse helps push lawmakers in the right direction. The trajectory of our debt compared with our revenue is not sustainable. With adjustments, the trajectory can be changed gradually, and that alone should start to bring greater peace of mind. But it's not going to be easy.

How to Invest

The uncertainty, doubt, and pessimism of others are an investor's three best friends. Without an abundance of these emotions, asset prices would always be too high, and nobody could ferret out opportunities to buy stocks at discounts. Uncertainty such as that in today's current market can create opportunities, especially when so many companies remain cash-rich and highly profitable. We just need to be as certain as possible that solutions will appear and the market will right itself.

Keep reading for more *Pro* goodness, but to see a less-than-happy chart of our debt, click here. Click the following links to see how other countries stack up on GDP and on debt-to-GDP as of 2010.

Jeff Fischer (TMFFischer)

Jeff and The Motley Fool own shares of Apple.

Coverage & Community

- Good news! Charter Port holding **Kinetic Concepts** is slated to be bought out at a healthy premium. We like the price and may have guidance soon.
- Members discuss our newest recommendation, trash-to-energy producer **Covanta**.
- Alex340 posts puts that match*Pro* criteria.
- Bryan Hinmon (TMF42) updates members on **Medtronic**, while stamleo does a great job (as always) posting news.
- Ebix is changing its foreign headquarters and tax outlook. Shares tick up on the news.
- Earnings season begins this week with **Intel**, **Wells Fargo** and Covanta. See TMFValueMoosie's calendar.
- *Pro* member shzin96 (Cindy) is riding her bike across the Midwest and is looking for *Pro* members to meet along the way.

See all of Pro's holdings on our Recommendations page.

Charter and 2011 Portfolios: Buy Covanta

Published Jul 15, 2011 at 12:00AM

First Things First

- **Company: Covanta** (NYSE: CVA)
- **Guidance:** This is a **Buy First** stock in *Pro*'s portfolios.
- **Market cap:** $2.4 billion
- **Dividend:** $0.30 per share, or 1.8%
- **Website:** www.covantaenergy.com
- **Type of Holding:** Renewable energy, long-term
- **Options:** We may write puts or covered calls later, but options aren't essential to this investment.
- **Follow along:** Add Covanta to My Scorecard

At a Glance

- **Action:** Buy 3%
- **Recent Price:** $16.45
- **Buy Around:** $17.50 or below (use a **limit order** at current prices)
- **Estimated fair value:** $24
- **Why buy:**
  - Covanta turns trash into energy and controls more than two-thirds of the industry's U.S. market share.
  - Management is focused on returning value to shareholders with a new dividend and share buybacks.
  - The stock is inexpensive enough to be a take-over target, though it should rise independently, too.
- **Alternate trade:** Sell to open December $17.50 puts, targeting a potential buy price of about $16 or lower.

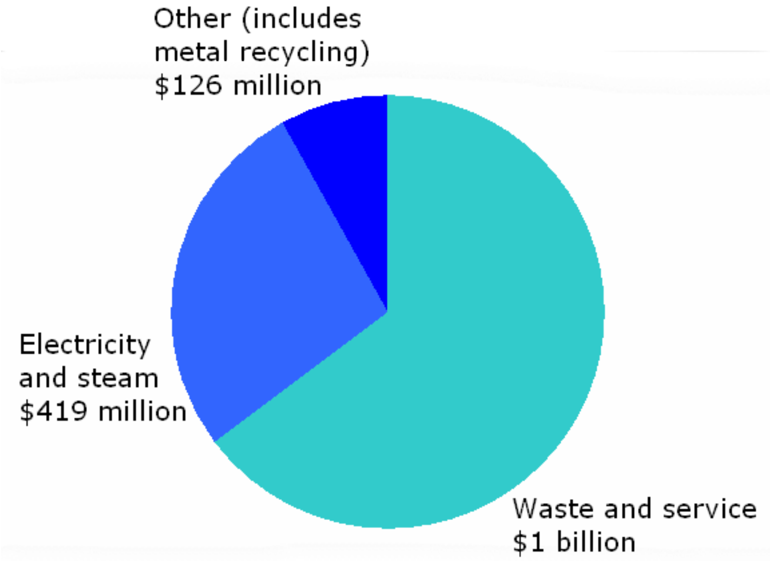
The Big Picture

Covanta (NYSE: CVA) makes money three ways — and they'll all pretty trashy. The company is paid by municipalities to dispose of their garbage, and it processes approximately 5% of all U.S. waste. It then turns most of this trash into power, which it sells to utilities, generating more than 5% of the country's renewable energy (excluding hydro power). Finally, it recycles the metal that comes through its plants (enough to make 300,000 hybrid cars a year), earning a revenue stream that grows as garbage volume and metal prices increase. Put it together, and Covanta stands to clean up whenever trash volume increases, energy costs go up, and metal prices rise.

Covanta owns and operates 44 energy-from-waste (EFW) plants, the largest of which can process up to 2,500 tons of refuse per day. Most of Covanta's operations are in the United States, but the New Jersey-based company is expanding in Europe, where governments are friendly to EFW companies.

EFW is a growing business as landfills are overflowing, coal plants are being shuttered, oil prices are rising, and nuclear power plants are on a path to be decommissioned in places like Germany. Covanta is taking advantage of this and has more than half a dozen major new projects in the works worldwide.

Covanta 2010 Revenue



Source: 2010 10-K filing.

The Business

The United States is the proud producer of 370 million tons of garbage a year. That's nearly 1.2 tons per person and accounts for almost 20% of the world's trash. About 24% of it is recycled, 69% is dumped into landfills, and 7% is turned into energy. Covanta accounts for more than two-thirds of that conversion, and it's one of the world's largest EFW facility owners.

About half of Covanta's trash-disposal business is done through long-term contracts that are directly linked to an inflation index, so as inflation rises, Covanta should at least maintain margins and increase its profit. Much of its energy is sold on a contract basis, too. Each ton of trash reliably generates about 550 kilowatt hours of electricity and 50 pounds of recycled metal.

This business appears to have hit a new level of reliability and stability. Management expects its "trash to cash" model to generate steady free cash flow for years, so it recently initiated a $0.30 per share annual dividend -- for a 1.8% yield -- and an aggressive stock buyback program, repurchasing 6% of outstanding shares so far. Covanta plans to return an additional $100 million to shareholders through various means after it sells two coal-powered operations in India and Bangladesh this year for about $280 million.

Covanta is flying under the radar even though it enjoys dominant market share and steady (if slow) growth opportunities. It's run by an experienced management team that is candid and detailed in its financial reporting. Insiders own 18% of the stock, and a handful of respected value investor shops own an equally large combined stake, including Neuberger Berman with 7.6%.

Financials and Valuation

Despite the maintenance costs on its monster-sized plants that run to hundreds of millions of dollars annually, Covanta consistently churns out free cash flow, lately to the tune of about $300 million annually. This lets the company return money to shareholders and continue to invest in new plants, many of which are funded at least in part by the municipalities requesting them.

Year-Ended	2005	2006	2007	2008	2009	2010
Revenue	$979	$1,267	$1,431	$1,402	$1,384	$1,582
Operating cash flow	$208.3	$319.0	$363.3	$402.6	$397.2	$431.0
Free cash flow	$184.8	$264.7	$277.6	$314.7	$323.6	$316.2

Source: Capital IQ. Numbers in millions.

As of March 31, Covanta held $327 million in cash, $1.5 billion in long-term debt, and $636 million in project debt — debt that municipalities raised to pay for plant construction. A municipality will pay a fee over the life of its contract with Covanta that goes to retire this debt, so even though it's on the balance sheet, it's low-risk debt that's covered by existing contracts. Overall, Covanta's leverage ratio stands at a reasonable 2.5, even as it's building plants that will add to cash flow.

Management expects 2011 free cash flow of $250 million to $300 million, valuing the $2.4 billion company at 8.1 to 9.7 times this year's expected free cash flow. Management expects adjusted 2011 EBITDA (earnings before interest, income taxes, depreciation and amortization) of about $500 million, putting the company's price tag, including all net debt (even municipality-sponsored debt), at 8.5 times 2011 EBITDA. That's "acquisition worthy" territory, with 10 to 12 times EBITDA, or up to 44% higher, justifiable to a buyer, which is in line with a fair value estimate of up to $24. Let's not forget that Covanta also enjoys the benefit of owning several plants that each have a replacement value of hundreds of millions of dollars and would take years to get permits for and build. Chris Mayer of the Capital & Crisis newsletter estimates that 11 of Covanta's plants combined are worth $17 per share in replacement value alone.

What Would Make Us Sell

As compelling as Covanta is from a business and valuation standpoint, it's not without risk. Although its returns are above its costs of capital, Covanta earns a single-digit return on capital and equity, and municipalities are aiming to reduce their costs, which could crimp negotiations as contracts come due. Low natural gas prices decrease the price paid for energy from waste, and a drop in metal prices has a direct effect on Covanta's income.

As a holding company, Covanta's structure is complex, and its investments in projects around the world add uncertainty. Additionally, the company is subject to energy regulations wherever it operates, and it spends steadily to keep plants running — last quarter they ran at 90% capacity. Any plant slowdown can affect profits.

Pro Bottom Line

Because Covanta's garbage-to-energy services improve the world, demand for them should continue to grow. Run by a long-term-minded management team with high insider ownership, Covanta is starting to unlock shareholder value even while it continues to invest in growth. This should lead to a higher valuation down the road. For now, *Pro* will invest a 3% stake in Covanta in both the Charter Portfolio and Portfolio 2011. We will make that trade in one to 30 days, per The Motley Fool's trading guidelines.

- **Have questions?** Visit our Covanta discussion board.
- **Follow along:** Add CVA to My Scorecard.

See all of Pro's holdings on our Recommendations page.

The Unprecedented Present

Published Jul 11, 2011 at 12:00AM

On what principle is it, that when we see nothing but improvement behind us, we are to expect nothing but deterioration before us?

> — Thomas Babington Macaulay, *Review of Southey's Colloquies on Society*, 1830

Dear Fellow Fools,

Pessimism is pervasive these days. The world banking system nearly collapsed, unsustainable debt loads threaten to dismantle several European countries, and world trade has taken a battering, just to name a few of the more poignant ailments.

Pro Trade Roundup

Charter Portfolio:

- **7/7/11:** Sold all shares of **Sprott Physical Gold Trust** at $13.26.

Portfolio 2011:

- **7/7/11:** Sold all shares of **Sprott Physical Gold Trust** at $13.27.

Pessimism is also enticingly newsworthy, and it has become a hallmark of the intellectual. Matt Ridley, author of *The Rational Optimist* (which I recently read and recommend, and which may or may not have influenced my choice of topics in today's Memo), says that "If you say the world has been getting better, you may get away with being called naive and insensitive. If you say the world is going to go on getting better, you are considered embarrassingly mad."

This Time Is No Different

The media seem to suggest that, at this moment in history, all improvement is behind us, and the future holds nothing but economic and social decay. We are at no such inflection point.

Pessimism is nothing new — thinkers since Socrates have argued that our decline is imminent. Think even within your own lifetime: A fresh batch of pessimists seasons each decade, each just as audaciously confident that it is perched precariously on the fulcrum of history. So far, they have all been wrong.

Frankly, pessimism is irrational, given any reasonably long time horizon. Human progress has been indomitable — check out Hans Rosling's excellent video of the history of human progress, 200 years in four minutes. The world we live in is richer and healthier, better fed and entertained, and more disease-free, sanitary, and interconnected than it was even a decade, let alone two centuries, ago.

Progress is not just about hoping genius will strike someone, somewhere. Systematic factors contribute to consistent improvement; chief among them is our propensity to trade and barter — that is, to participate in markets. Markets allow the transfer of goods, services, financial assets, and, just as importantly, ideas. It is the exchange of ideas — a better way to build a bicycle, a method to prevent cholera, a smarter way to invest — that leads to progress. Through this lens, the "problems" of our time, just as those in the past, actually present tremendous opportunity for clever business people, entrepreneurial thinkers, and savvy investors.

Skeptically Optimistic or Optimistically Skeptical?

What does this mean for how we invest at *Pro*? Regardless of your personal style, no investment is made in a vacuum. They are all in context, and every investor's mental framework is inextricably tied to the investment decisions she makes. We all harbor heuristics — our simplified models for solving problems — and we must force ourselves to regularly evaluate them. And when we do so, we can commit no greater error, in my opinion, than to give too much weight to the present or recent past in drawing our conclusions.

Not that your *Pro* team is blindly optimistic — far from it. In fact, we might be described as professional skeptics. That's why we limit our portfolio's position sizes, hedge our exposure, and use options to define and limit our risk. We each bring a healthy dose of skepticism to new investment ideas; with so many companies out there, we insist on putting any promising possibility through the wringer. But skepticism and pessimism are not the same thing, and at the end of the day, the weight of economic history tells us that optimism is the rational viewpoint.

Fools, I encourage you to evaluate your own view of the world. Optimists are contrarians these days, and though it can be difficult to go against the grain, evaluating evidence independently and drawing your own conclusions is critical to becoming an outstanding investor. Of course, you're never alone, so share your thoughts with the *Pro* community on our Philosophy & Strategy discussion board.

Foolishly,

Alex Pape (TMFPapester)

Coverage & Community

- Dustyrd kicks off a discussion of the "stock yield enhancement" programs some brokers offer.
- After checking out the latest employment report, spinningwood says that if you love volatility, get ready to party.
- tfrisbee argues that volatility shouldn't be a meaningful consideration when picking a stock.

The Investor's F-Word

Published Jul 5, 2011 at 12:00AM

Did You Know ...

No investor goes into an investment thinking it's going to happen to them. We spend our days and nights reading the Ks and Qs with a skeptical eye and trying to filter signals from the noise of conference calls. As careful analysts, we make adjustments for operating leases, underfunded pension-benefit obligations, and poorly reserved loan loss accounts to arrive at our estimate of a business' fair value. Still, it happens: One of our brethren goes down. Another investor, this one with a reputation for near-prescience — and with the benefit of better information — loses big because of the investor's F-word: fraud.

Sadly, this scenario is far from hypothetical. I'm referring to hedge-fund manager John Paulson's recent $107 million whipper on **Sino-Forest** — and that's a generous estimate; he lost about $700 million from the peak. Yes, one of the few people anywhere to profit from the housing crisis, a man who made billions on what's been called "the greatest trade ever" — using complex derivatives like credit-default swaps to short the housing market and the financial firms leveraged to it — just lost hundreds of millions investing in … trees.

Nearly a Zero

Source: Google Finance.

The catalyst for Sino-Forest's crash was Muddy Waters Research. The short-sellers there uncovered fraud at Sino-Forest (overstating volume by treating an entity as both the customer and the supplier), then told the world about it using a megaphone (aka a widely distributed 39-page sell report — sound familiar?). The stock opened at $18.21 before the report was issued and has traded as low as $1.29 in the weeks since — ouch. Without getting into the details, suffice it to say that Paulson's hedge fund was Sino-Forest's largest investor, had been invested in the company for years, and even had direct access to management. In Paulson's company's own words:

Pro Trade Roundup

Charter Portfolio:

- **NextEra Energy** covered strangle: Sold to open nine January 2012 $50 puts and nine January 2012 $60 calls. Combined credit: $2.40.

Portfolio 2011:

- **NextEra Energy** : Sold to open three January 2012 $55 puts. Credit: $2.60.

Ex-Dividend Dates

- **Cisco** , today (July 5)
- **Medtronic** , July 6

> Our investment team conducted considerable due diligence on Sino-Forest. We reviewed Sino-Forest's public filings, participated in conference calls with the investment community, followed up privately with management on specific questions, discussed Sino-Forest with analysts that covered the company, and regularly met in-person with management. A member of our team also went to China to visit Sino-Forest's operations and to meet with a major customer and representatives of the Chinese government on forestry matters.

It's humbling for a respected investor to come forth with that level of disclosure. It certainly appears that Paulson and his team did their homework, and based on the size of the position and the length of time they'd owned it, they were seemingly certain management was honest. In other words, if it can happen to them, it can happen to anyone.

What's a *Pro* Investor to Do?

Fraud is a particularly worrisome risk factor for every investment we make. We base our analysis on publicly available information, and we reach our conclusions based on our insights and unique interpretation of the facts. When any of those facts turn out to be lies, the *entire* analysis is therefore no good. Even more analysis is unlikely to help in that case — we need another tool to protect us.

Position Size Matters

Once we decide on an investment to buy (or short), we determine how much we want to invest. Position size is a key component of portfolio management, closely linked to our level of diversification and the overall volatility of our portfolio. This is a delicate balance, because our holdings need to be large enough to move the performance needle when they work out but small enough that they don't permanently impair the portfolio if we're incorrect — or, much worse, if management turns out to be perpetrating fraud.

Though we're confident in everything we buy, our confidence exists on a continuum — it isn't an on/off switch. Thus, if we find an exceptional company with a large margin of safety, we may invest 5% over multiple purchases. We don't make initial investments larger than that (except as a portfolio hedge), no matter how lucrative the opportunity appears — we're far too aware of the risks of overconfidence. If we find a business we are less certain of, or one with risks that are highly correlated to our portfolio, we may only allocate 2.5% to it. Sticking to these guidelines means the most we can lose on any investment is about 5% of our capital — a poor result, to be sure, but readily recoverable.

Foolishly and always vigilant,

Nick Crow (TMFCrow)

Coverage & Community

- Jeff (TMFFischer) asks what was behind the market's "strongest week in a year."
- Take a peek behind the curtain to see the inner workings of *Pro*.
- Do you thrive on volatility, or do the market's moves make you queasy? Chime in here.
- Alex (TMFPapester) answers questions about **Pebblebrook**'s liquidation value.

See all of Pro's holdings on our Recommendations page.

Charter and Portfolio 2011: Sell Sprott Physical Gold Trust

Published Jul 1, 2011 at 12:00AM

At a Glance

- **Action: Sell all shares** (use a limit order near current market prices)
- **Recent price (7/1/2011):** $13
- **Why sell:**
  - As the U.S. stops pumping money into the treasury market, it's likely that interest rates will head higher, competing with commodities that do not provide cash flow. Freeing up this cash will allow us to act more quickly on new, more compelling investing ideas as they arise.
  - We remain more confident in our ability to analyze businesses than gold.

What's Changed?

We originally purchased shares of **Sprott Physical Gold Trust** (NYSEMKT: PHYS) to guard our uninvested cash against inflation and the decline of the dollar as the Federal Reserve pumped money into the economy. In the original trade alert, we wrote:

Don't confuse gold with an investment *per se*; instead, think of it as a place to hold wealth until you're ready to invest in something else. In that sense, holding gold is like holding cash — except hopefully much better, since cash is being devalued. Also, remember that ownership of a strong business is better than gold, because high-quality equities should increase in price with inflation ...

Gold served its purpose for us as a passive, protective holding; in the Charter Portfolio, we made 9% on cash that would otherwise have been idle. Now, as the Fed's program ends and interest rates look ripe to rise in coming months, we're selling so we can deploy that cash elsewhere. Rising interest rates can have a dampening effect on commodity prices, since commodities don't provide investors with interest or cash flow. As more investors are drawn to interest-bearing investments, they may sell commodities, which are currently a "crowded" or popular investment class.

Plus, gold is, at heart, a play on perception. As is true of any asset, its price is determined by supply and demand. Because industrial uses for gold are scarce (just one-quarter of 1% of the world's total gold supply was consumed in industrial processes last year), its supply and demand comes from investors, rather than businesses. Therefore, it is important to know who these investors are and on what basis they buy and sell gold.

Unsurprisingly, central banks as a group own the most gold — but they don't have as much as you might think. Together, they hold just 18% of the 162,000 tonnes of global supply, and that figure doesn't tend to change much; central banks bought almost exactly as much gold as they sold last year. Gold-focused ETFs also don't own much — the largest, **SPDR Gold Trust** (NYSEMKT: GLD), owns just 1,213 tonnes, or about 0.7% of the total. That means that about 80% of the gold supply, or 130,000 tonnes, is owned by *everybody else*. It's nearly impossible to sort out how much is held institutionally, but suffice to say that a boatload (that's the official term) of gold is held by retail investors.

Fear — of inflation, depreciating currency, political unrest, economic stagnation, or recession — is likely the primary driver of retail-level investment in gold. And (un-Foolish) retail investors are notorious for their emotion-driven, fear-and-greed-based investment decisions. An *active* investment in gold (as opposed to our current passive "placeholder" exposure) would have to be at least partially based on our perception of the general investing community's perception of fear-inspiring macroeconomic variables.

Feeling dizzy yet? This is how gold became a hedge, at least in recent years: It went up as the economic outlook worsened and investors piled in. Today, we're not convinced the economy will continue to worsen; we strongly believe governments are going to end "easy money" policies (in fact, they already are), after which interest rates will eventually rise to higher levels more in line with the historical norm, perhaps sapping interest in some commodities like gold.

To be sure, we are *not* arguing that gold is overpriced — or that it is under- or fairly priced, for that matter. But the government stimulus that helped drive commodities higher is ending, and we still have much more confidence in our ability to analyze businesses that produce cash flow than we do in our skills at predicting investors' reactions to gold.

How to Follow Along

We'll be selling all of our shares in Sprott Physical Gold Trust from both portfolios in the next one to 30 days. Lately, Sprott trades at a greater than 3% premium to its Net Asset Value, so be sure to use a limit order near current market prices to exit your position. Head to the Sprott Physical Gold Trust discussion board with your questions and thoughts.

Jeff and Alex do not own shares of any company mentioned. The Motley Fool owns shares of Sprott Physical Gold Trust.

Charter Portfolio and Portfolio 2011: Write Naked Calls on VXX

Published Jul 1, 2011 at 12:00AM

Trade Essentials

- **Action:** Write ("sell to open") January 2012 $17 naked calls
- **Allocation:** If we end up shorting shares around a net $23, our allocation will be 5%. For the Charter Portfolio, that's 32 contracts, and for Portfolio 2011, it's six contracts.
- **Recent ETN price:** $21
- **Recent measure of the VIX** (CBOE's measure of put prices to call prices to gauge the implied volatility expected in the market, measured as a percentage): 17
- **Recent ETN options price (bid/ask):** $6.00/$6.30
- **Preferred limit price:** Check current prices and aim for at least $6 if feasible; as prices change, accept no less than $5
- **Alternative trades:**
  - Sell shares short directly, starting with a 5% allocation
  - Write naked calls at higher strike prices if you want more breathing room
  - If you're already short shares, continue to hold your short in anticipation of more long-term price decay

What's New

First Things First

- **ETN: iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX)
- **Price (June 30):** $21
- **Type of holding:** Short (short naked calls)
- **Past VXX reports:** Click here
- **Website:** ipathetn.com
- **Follow it:** Add VXX to My Scorecard

This trade will mark the fifth time we've taken a short position in the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) exchange-traded note. Aside from our initial effort to short the ETN directly in June 2010, this is our most aggressive position yet. By writing *in-the-money* naked calls, we're mimicking a short position, right down to our strike price of $17. (We would consider shorting it directly, but our brokerage makes this impossible — see "How to Follow Along" below.) In addition, the calls will pay us around $2 in time value, so we're effectively shorting the ETN near $23. We stand to profit on a fall to $17 or below, and we have a reassuring price cushion of nearly 10% between the recent price and our $23 break-even price.

This ETN aims to track the famous volatility index known as the VIX by mirroring short-term VIX futures contracts. Fortunately for us, it's not very good at it: While the VIX remains near the 17.75 level at which it started 2011, the VXX ETN has lost 43% of its value year-to-date. This is largely because of contango, to which the ETN loses an average of 3% a month (and much more when the VIX goes down). The VXX ETN tracks (but doesn't actually invest in) the prices of near-term VIX futures contracts on a daily basis, selling near-dated VIX futures to buy VIX futures that expire a month later. This roll incurs a cost (or negative "roll yield") more than 70% of the time; this situation is called contango, and it reliably eats away at the ETN's value. And because the VIX can spike at any time, its futures almost always carry a premium, unlike most commodities that also have futures contracts..

If this ETN loses its typical 3% a month between now and our calls' expiration in mid-January 2012, it will end around $17 per share. Of course, in some months it could lose more, and if there's extreme volatility, it could gain ground. However, as long as the VIX remains within its recent range of 14 to 20 for most of the time between now and January, this short should end profitably for us.

Wall Street is concerned with government debt these days, but it's unlikely any Western government will be allowed to default. Instead, the powers that be will probably kick the can down the road for at least another year — longer in the U.S., given the upcoming presidential election. If the VIX does reach and maintain a higher price on growing market fear (say, if woes spread beyond Greece to Spain), we'll look to roll our calls to a higher strike price or later expiration if need be, while seeking to maintain a credit.

Why This Strategy?

Over the long term, I have more conviction about this short than any other I've made. The way the VXX is structured, it is almost certain to lose value over months and (especially) years. The main risk here is liquidity: If you're short the ETN when the VIX suddenly goes parabolic (which does happen — it jumped from around 20 to 80 in 2008), you could suddenly be staring at a 100% or 200% loss. If you have the means in your portfolio, you can add to your short or wait it out (*Pro*'s plan in such a situation), because implied volatility will eventually subside and the ETN will deflate. But if you don't have liquidity, you could be forced out at the worst time. Thus, you should only short as much as your portfolio can reasonably handle, and remember that when a short goes against you, your allocation to it grows.

That said, recent events add to our confidence in VXX's flaws. During the six-week market decline we witnessed this spring, the VIX briefly reached a high of 22.73 on June 16, rising from a low of 14.72 on April 28 — so it gained 54% in about seven weeks. The ETN gained a much smaller 11% from $23.15 to $25.74. That's even worse than par for the course; the ETN generally gains a maximum of half as much as the VIX on spikes, so the VIX probably needs to jump at least 20% to 25%, to above 21, for the ETN to rise 10% (which would bring it to our $23 break-even price). Keep in mind that contango will be working in our favor most or all of the time, steadily decaying the ETN's price to make our short profitable.

The VIX was at 17.27 as of Wednesday. Its July futures closed at 18.50, August's at 19.35, September's at 21.50, October's at 22.60, November's at 23.05, December's at 23.20 and January's at 24.75. The VXX ETN only mirrors contracts for the next two months, but these numbers illustrate its ongoing uphill climb. Right now, the contango from the current VIX price to its August futures is a large 12%. The lower the VIX, the steeper the contango tends to be, which helps explain the ETN's tepid reaction to the VIX's 54% rise this spring: The futures had already priced in the possibility of a large jump.

How to Follow Along

Many brokers charge a fee to sell an investment short if shares are scarce. Shares are not available at the Fool's Schwab account unless we want to pay a 7% fee to short them, which would also bring the risk of the shares being called away on us early. By writing in-the-money calls, we avoid paying fees and retain more control of our position. Once January nears and the calls have lost most of their time value, we can roll them if VXX is still above $17.

You need full options approval and margin to write naked calls (calls in which you don't own the underlying shares). Our profit is limited to what the calls initially pay us. If you can short shares directly and cheaply (some brokers, like TD Ameritrade, don't charge for shorting), that remains an attractive long-term alternative, but you should move incrementally and increase your position if VXX spikes. A direct short does give you more profit potential, but it means you don't start with a pricing cushion the way we do with these naked calls.

Trade Details

- **Action:** Write ("sell to open") January 2012 $17 calls (one for every 100 shares you'd short)
- **Limit price:** Near market prices, recently $6
- **Break-even price:** $23
- **Current VXX price:** $21
- **Difference from break-even**: 9.5%

Fools, if you make this trade, be aware of the risks of shorting anything, let alone a volatility index. This is a high-conviction position when time is on our side, but we might see large price movements in the meantime. In that case, we'd need to roll the position forward or update our strategy. While doing so, we may have to sit on very large paper losses. If you have more questions about this trade, our past reports should help you get up to speed. As always, please bring your questions about this trade to our VXX board.

Jeff is short shares of VXX.

Audio Extra: Shorts and Hedges

Published Jul 1, 2011 at 12:00AM

Synthetic shorts, ratio put spreads, paired trades … the team must be talking about shorting and hedging! Join in as the whole *Pro* team discusses how we view shorts and hedges, using them to smooth returns and profit on falling prices and increase our financial security. Happy Fourth of July weekend!

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Transcript

Jeff Fischer: Welcome to a new edition of Motley Fool *Pro* Audio Extra. The whole team is here with us today. There is senior analyst Nick Crow.

Nick Crow: Hey, Jeff.

Jeff: Analyst Bryan Hinmon.

Bryan Hinmon: Howdy.

Jeff: And analyst Alex Pape.

Alex Pape: Hey, guys.

Jeff Fischer: I am advisor Jeff Fischer. Thank you for joining us. We are here today to talk about shorting versus hedging.

Nick Crow: Jeff, why don't you define for us the difference between shorting and hedging?

Jeff Fischer: That's a good place to start, Nick. We'll start with shorting. The way we think about shorting is it is when you are looking to profit directly on a decline, no matter what the market does. So you are shorting a certain sector of the market or typically a certain stock, and you are hoping that it declines no matter what the market does, so it isn't exactly a hedge; it's a short. It's a conviction trade, just like a long is.

Nick Crow: We are trying to profit directly from that short.

Jeff Fischer: From a fall, exactly, whatever the market does. Hedging, on the other hand, is to protect a part of your portfolio or your entire portfolio by hedging out some of its downside. We have done that in *Pro* lately by hedging three different indexes. Now the thing about hedging an index, you know when the market is going down, the index is going down. There is no way around it, so it is the perfect hedge. What it does is smooth out some of the losses that you will see elsewhere in your portfolio.

Bryan: So Jeff, do you view shorting directly as a little more aggressive than hedging?

Jeff Fischer: I do. I think you need to have high conviction to short an equity. Let's talk about an individual equity because one, it can be acquired. News could break that you don't anticipate. There's of course risk of a short squeeze, or any other sort of news that can send a stock much higher. So when you are shorting shares directly, you need to have a high conviction.

Additionally, you can only make so much in a short. If we look at a short and think that we can make 20% or 30%, then we need to make sure that is our best idea as opposed to a stock we could buy and make at least that much with lower risk.

Bryan Hinmon: And that is a good segue into what I look for when I am shorting, when I am looking for a short candidate. And really I like to look at three things. The first is sort of a combination of two, but the most important thing that I look for is the match up of what the expectations are for the company and how that relates to the company's valuation. Because you can have a wonderful business, but if the expectations that are baked into that stock are so out of whack, even fantastic results can be a huge disappointment to the market, and that can be a real opportunity there. So the combination of sky-high expectations or unrealistic expectations with an expensive valuation is a really good place to start, I think, for a short candidate.

Jeff Fischer: It's a good place to start, Bryan, I agree, as long as you understand that valuation arguments can take a long time to play out, which you know they can. I shorted, this was, what a mistake. I owned Amazon for years, did really well on it. Several years ago when it looked very expensive, I shorted it on valuation. It didn't work out. It did for a short while, actually.

Bryan Hinmon: Yeah, that goes perfectly into my second point. The second thing I look for is a catalyst. Now those are always hard to identify and they are always hard to quantify, but if you can find at least a clear catalyst, then you have really got the makings of a decent short candidate.

Jeff Fischer: What about you, Alex? What do you look for in a short or what sort of hedging do you prefer to do?

Alex Pape: Sure, I will answer both of those questions. First, I am very much aligned with Brian, to look for shorts. General details, I strongly dislike shorting stocks that have a high dividend, because you have to pay that dividend, of course. I also dislike shorting stocks that have a lot of hard assets (unclear) short stocks have more intangibles.

Although I do like a valuation that has become detached from reality, if it is totally detached, I shy away from that, just because once the market decides to be totally unreasonable, you have no idea how long it will be unreasonable for. It is just like your Amazon story.

Bryan Hinmon: Playing in the tales can be dangerous.

Alex Pape: But personally, I am a big fan of pairs trades. So pairs trades are when you buy a stock and simultaneously short usually a similar stock. I like these trades for industries or situations in which there is one factor that affects both stocks or an industry that is totally out of your control. So a good example would be, say the for-profit education industry right now, which there is looming regulation and the whole industry kind of swings and ebbs and flows the various news.

But if you could pick out a mismatch between how one company is run qualitatively versus another or is valued versus another and you buy the better run or undervalued stock, in short you overvalue a poorly-run stock, you are now purely betting on those two stocks converging and you have totally eliminated the industry argument.

The same idea would be for oil stocks. You have no control over the price of oil, but if you can bet that two stocks are mispriced relative to each other, I think that is a good bet.

A few things to keep in mind with pairs trades. First, I would always think of the two stocks together as one position. You are not directly betting that the stock you are shorting is going to go down; all you are betting is that the difference between those is going to converge. So not necessarily saying that stock X is going to go down and stock Y is going to go up; all I am saying is that that is going to converge and they might both go up, might both go down. It can make money either way.

The second thing is to remember that because you have two separate positions, you could lose money on both sides, so you definitely need a strong stomach for these. You need to have high conviction.

Nick Crow: Pairs trades are also leveraging trades. You sell that one stock short, use those proceeds and buy the others. So people who run full funds full of long/short portfolios that way, use those to leverage their portfolio in the same way that we might use options here.

Jeff Fischer: Have any of you had a pairs trade go bad on you, where both positions are going exactly the wrong way, and if so, how emotionally and then how tangibly did you deal with that?

Alex Pape: I have never had one end that way.

Jeff Fischer: You are setting expectations high. *(laughter.)*

Alex Pape: I have had one move that way before I closed it out. It hurts. You really question your convictions, so you really have to stick to your guns.

Jeff Fischer: Or be right, and eventually be right.

Alex Pape: We can't all be Nick Crow.

Jeff Fischer: That's the way many options trades start out. They may start looking completely wrong, but if you stick to your convictions, they work out. Nick, let's talk about using options to short and hedge.

Nick Crow: We like options obviously here at *Pro* and use them frequently. One of my favorite things is our ability, like you said, to hedge for actually no cost, like we have done here with Wells Fargo, and in a lot of ways, same with our small-cap index we have been doing it on. The nice thing there is that it kind of does two things for us. One, hedges generally are going to reduce your return as the market goes up, but in this case, using options instead of shorting something, whether it be a cost to carry or maybe you have to pay the dividend or other considerations, there is no cost for us here. That is not to say that there is a free lunch; the downside is that we have promised that at some later date that if these drop a lot further than we are expecting, that we are willing to pick up shares or pick up some of that index.

Jeff Fischer: That's true, but I find it much easier to short in the way that we have when there is no cost, or even a credit up front. Like we have heard, everybody wants insurance and wants protection, but nobody wants to pay for it.

Nick Crow: Yup.

Jeff Fischer: And the options strategies that we have used give you kind of the best of both worlds.

Nick Crow: Absolutely. And you had mentioned earlier that you only short an individual security when you have really high conviction, and these are perfect that way because they aren't necessarily high conviction trades; our high convictions trades are the rest of our portfolio, all the things that we own in there. That's what we have high conviction in. What we are doing is reducing the risk overall using these costless hedges. It's excellent.

Jeff Fischer: That's true. So overall on *Pro*, what we are aiming to do is smooth out returns with our hedges and cushion any downside, and we focus on shorting indexes to do that, because there is no question an index is going down if the market is going down.

When we see stocks that we want to short, specifically we will do that when we have high conviction. Then we have not done any pairs trades yet, and I know we are looking at a small handful now, especially now that the team is larger and Alex is here and has a lot of interest in them, as does Bryan. So there may be pairs trades in our near future as well.

Thank you for joining us; thank you, guys.

Alex Pape: Thanks, Jeff.

Bryan Hinmon: My pleasure.

Jeff Fischer: And we will see you on the boards, and Fool on!

The Motley Fool Pro Touchstone Report

Published Jun 29, 2011 at 12:00AM

Dear Fellow Fools,

Before we find ourselves enveloped by July's earnings season, we want to take a moment to review the investments we've made together over the past several months. In each case, we want to be sure you know our thesis, our perception of the risk, why we invested how we did, and what to do today if you're still catching up. This Touchstone Report focuses on 11 of our new positions initiated over the past three months in one or both *Pro* portfolios — including those investments that haven't yet behaved the way we want them to. Download it here, and enjoy! If you have questions, please bring them to our Philosophy & Strategy discussion board.

Foolishly,

Jeff Fischer (TMFFischer)

There's More to Pro Than Profits

Published Jun 27, 2011 at 12:00AM

Unique and profitable investment ideas, a lower-risk portfolio thanks to hedging strategies, and portfolio management done in plain view — these things are *Pro's* bread and butter, and they're the main reasons you're here. That said, if that's all you know about *Pro*, you're likely missing out. There's much more to the *Pro* site, and today I'd like to point out some features you may be overlooking.

Get Rich With ...

Covered strangles? Written puts? Buy-and-hold stalwarts? At *Pro*, we want to help you make money with all of those and more, and we'd love your suggestions on how we can improve.

Happy Fourth!

Your next *Pro* Memo will hit your inbox Tuesday, July 5. Have a spectacular holiday!

Cogent Content

Given that you're reading this particular Monday Memo, it's a safe bet you know the Memos exist. These columns are our weekly chance to touch base with you, and we hope you find them as valuable to read as we do to write. We use the Memos to tweak guidance on existing positions; if there's action we feel you should take, we'll always send a Trade Alert, but if we're making minor guidance changes, we'll list them in the Memo. We'll also use the Memo to point you to our earnings and other news coverage and to share updated thoughts behind our investing philosophy.

You are hereby invited to grab a hammock and a refreshing beverage and settle in to read every Monday Memo ever written — you can find them all in our Memo archive. (If for some crazy reason you'd rather start smaller than that, try the "Don't-Miss Memos" listed on this page.) If you peruse the archive, you'll notice that at least once every year, we review our philosophy from start to finish in a three- or four-part series. Additionally, I personally like to review our old Memos occasionally to make sure we're staying consistent with what we've said — and if we're not, to make sure any changes are for the better.

Our Extras archive also holds a small mountain of premium content. Here you'll find our Audio Extras: taped segments in which the *Pro* team discusses businesses, explores strategies, and interviews the management teams at our companies. You'll also find all of the extra or special content we send you, including guides to valuation, options strategies, articles explaining our investing philosophy, and more. If you scroll to the earliest pieces listed under "Extras," you'll find original content like "Secrets of a Winning Portfolio" that I wrote to provide a framework for *Pro* as the service launched.

Guidance Updates

- **GrafTech International** moves up to Buy because of a lower price.
- **Ebix** moves down to Buy from Buy First, since it's already more than 10% above our buy-around price.
- **3D Systems** moves down to Buy as a nod to our increased risk aversion while we continue to go through its financials.
- **Vanguard Emerging Markets** moves down to Hold while we consider its increased exposure to China.

Pro Trade Roundup

Charter Portfolio

- **NextEra Energy** covered strangle: Sold to open nine January 2012 $50 puts and nine January 2012 $60 calls. Combined credit: $2.40.

Portfolio 2011

- **NextEra Energy** : Sold to open three January 2012 $55 puts. Credit: $2.60.

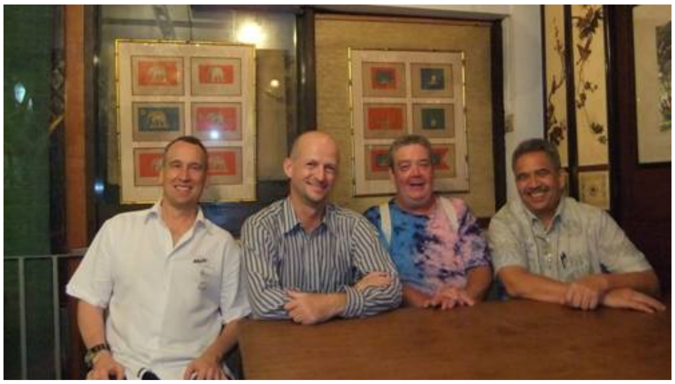
You'll find all of the Memos and Extras under the "Alerts & Coverage" tab atop the *Pro* site. If you click that tab, you'll find all of our *Pro* options guides listed on one page — including our latest, on neutral calendar spreads — along with every Trade Alert we've issued. You can access all of our trades from that list, or, if you know the ticker of the company you want information about, just enter it in the search box at the top right of any page to get all of the trade alerts, news coverage, audio features and other information we've provided on that company. Your search results will also provide any ticker's CAPShot report, which is an exclusive *Pro* measure of certain qualities of a stock or ETF.

Under our Recommendations tab, you'll find a list of every position in both *Pro* portfolios, as well as details on performance, current guidance on each position, and our levels of cash on hand. From the portfolio itself, you can click on any ticker to jump to the trade alerts.

Beyond this, don't forget that your *Pro* membership grants you ongoing free access to *Motley Fool Options*, which includes several a la carte options recommendations each month, a large options-using community, and Options U., where you can learn even more options strategies.

Commonsensical Community

Here at *Pro*, if you're not making good use of our outstanding member community, you're missing a great opportunity. There are *Pro* members all around the globe, and they bring their diverse experiences, professional proficiencies, and investing knowledge to our boards. Ask a question, and you're likely to get a helpful answer within a day, if not sooner. The community holds many more discussions than the *Pro* team can follow (though we try!), so it's living up to the Fool's dream of "investors helping investors." Friendships arise there, too, as you'll see in the following photos. You're looking at the first-ever Bangkok, Thailand, *Pro* member meeting, which was arranged entirely on our Social Banter board. Four *Pro* members who reside in the Land of Smiles met to discuss investing and much more. From left to right: Ron (asiatraveler), Andy (elbrombo), JR (HarryWho), and "Duke Street Jim." By the time the second photo was taken, it appears JR had run home to research a hot stock tip.



My (Multitalented) Scorecard

Finally, the My Scorecard tool is a great way to track your portfolio and performance. While My Scorecard doesn't handle options yet, it keeps tabs on all your stocks and ETFs, measures your performance against the market index, feeds you news on your positions from all of your premium Fool services including *Pro*, and shows you whenever someone has posted to a discussion board for any of your positions. My Scorecard is an easy way to keep up with your investments at the Fool.

Coming Up Next

This week, we expect a new trade alert or two and a new Audio Extra in which the entire *Pro* team discusses hedging and shorting. We're also soliciting your feedback through this survey, so please tell us how you think *Pro* can be improved. Finally, enjoy your Fourth of July holiday next Monday! We'll be back Tuesday, July 5, with a new Memo.

Foolishly,

Jeff Fischer (TMFFischer)

Coverage & Community

- Jeff says **Oracle** ended its fiscal 2011 with strong results, and it's on deck for a possible trade in Portfolio 2011.
- **Pebblebrook Hotel Trust** gets some *Wall Street Journal* coverage, and Fools discuss a big New York deal.
- Nick (TMFCrow) has Basel and SIFI on his mind, along with **Wells Fargo**, as bank regulation heats up.
- Alex340 shares puts that match *Pro* criteria (some are on former *Pro* stocks), as well as covered call ideas.
- Russell (TMFEldrehad) looks at short-term picks in CAPS.
- We've got interns! Elizabeth Moran (TMFElleMoran) and Reza Handley-Namavar (TMFReza) have joined the *Pro* team for the summer. Look for these great young Fools on the boards, too!

See all of Pro's holdings on our Recommendations page.

Charter and 2011 Portfolios: NextEra Energy

Published Jun 24, 2011 at 12:00AM

Trade Essentials

- **Actions:**
  - **Charter Portfolio: Write a covered strangle.** Write ("sell to open") January 2012 $50 puts (to potentially double shares already owned); write ("sell to open") January 2012 $60 covered calls (one for every 100 shares already owned).
  - **Portfolio 2011: Write puts.** Write ("sell to open") January 2012 $55 puts only.
- **Allocation:**
  - **Charter Portfolio**: Nine contracts of each option; we'll potentially double our shares owned to about 6%
  - **Portfolio 2011:** 6% (that's three put contracts)
- **Recent option prices (in between the bid/ask prices):** January 2012 $50 puts, $1.40; January 2012 $60 calls, $1.25; January 2012 $55 puts, $3.05
- **Preferred strangle limit price (Charter Portfolio):** $2.65 credit, combined (higher is better; check prices and aim for at least $2.65 or more initially, and as prices change, accept no less than $2.30)
- **Preferred $55 put writing limit price (Portfolio 2011):** $3 or higher (as prices change, accept no less than $2.50)
- **Recent share price:** $56.30
- **Buy around:** $53.50
- **Fair value:** $58
- **Alternate trades:** Buy shares directly if they drop to $53.50 or lower.

The Big Picture

First Things First

- **Company: NextEra Energy** (NYSE: NEE)
- **Market cap:** $23.7 billion
- **Website:** http://www.nexteraenergy.com/
- **Type of holding:** Income, utility
- **Original report:** [Stock Buy]() (October 2009)
- **Follow it:** [Add NEE to My Scorecard]()

When the economy gets cloudy, investors get defensive — and few things on Wall Street spell "defense" better than a stable utility business. **NextEra Energy** (NYSE: NEE) is one of North America's largest energy providers and the continent's top producer of wind and solar energy. Headquartered in Florida, NextEra operates in 28 states and Canada. More than 50% of the company's power-generation capacity comes from cheap natural gas, while wind chimes in second at nearly 20% of capacity, followed by nuclear at 13% and oil around 11%.

This company operates in two divisions. The first, Florida Power & Light Company, is a regulated utility in Ohio (fine, fine, we mean Florida) that serves 4.5 million customers, primarily with natural gas, wind, and nuclear energy. The second is the unregulated NextEra Energy Resources division, which is the country's largest producer of renewable energy. NextEra Energy Resources serves customers nationwide, primarily with wind and natural gas energy. Its top-of-the-list A- credit rating and its history of steady growth in both earnings and its dividend make NextEra one of the most respected utilities in the country, winning multiple "sustainability" awards each year.

Risks to the company include greater regulation of nuclear energy, although these plants make up a minority of the company's power base, and a failure to eventually win rate hikes in the regulated Florida market. To see our past coverage of NextEra, [click here]().

Why This Strategy?

Charter Portfolio: We already own a stake of NextEra in the Charter Portfolio, so we're looking to amp up our profits while staying defensive. This January 2012 $50/$60 strangle stands to pay us around $2.65 per share, for a 4.7% yield on the current share price and about a 3.8% payment on the equity needed to hold the strangle open. Meanwhile, we'll enjoy two more dividend payments on our existing shares that will add to our seven-month return. Should a sale come into play, our existing shares would be sold at a net $62.65, well above our estimate of fair value.

Portfolio 2011: With its 3.9% yield, NextEra is one of the most generous dividend stocks in the Charter Portfolio. But buying on dips is especially wise with a slow-moving utility stock, so we prefer to write puts for Portfolio 2011 to earn a healthy profit while waiting for a better buy price. And we're not in a hurry: We want to maximize income. Writing January 2012 $55 puts at $3.05 equates to a 5.5% yield on cash in about seven months — likely better than the return we'd get from buying the stock outright, and with less risk. And if we end up with shares, our price at acquisition will be $51.95, well below our $53.50 Buy Around price and with a greater than 4% dividend yield.

How to Follow Along

- **To write a covered strangle (Charter Portfolio):** You must own at least 100 shares of the stock and be willing to sell them at a higher price, and you should also be happy to buy at least 100 more at a lower price. Use a "strangle" order with your broker to sell to open January 2012 $50 puts and $60 calls on NextEra, aiming for a credit of around $2.65 the day we issue this trade.
- **To write puts alone (Portfolio 2011):** You need to be ready and able to buy 100 shares (totaling $5,500 in this case) for every put you write if the stock is below the $55 strike price by expiration next January. Your net buy price in this case would be about $51.95. If you are required to have cash set aside to write puts, you need to have all the cash for the potential stock purchase idle. If you write puts on equity (or your buying power), you'll only need 10% to 30% of the total potential purchase price set aside in cash, but you still should be prepared to buy the stock next year with 100% cash rather than using margin.

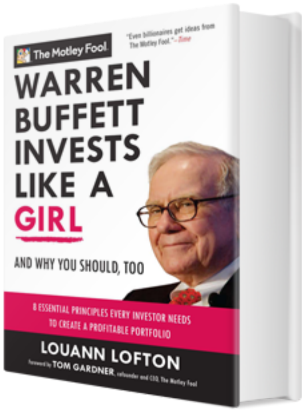
Next Steps

- Questions or comments? Visit our [NextEra Energy board]().
- Check out our guides to [strangles]() and [writing puts]().

See all of Motley Fool Pro*'s holdings on our [Recommendations page]().*

TradeStation: Cashing In on a Thesis

Published Jun 20, 2011 at 12:00AM



Reserve Your Copy Now and Save 35%

Ready to embrace your feminine side a little? Or are you just a diehard Buffett groupie looking to learn something and have fun? There's only one way to guarantee you won't be left out tomorrow, June 21 … when The Motley Fool's brand-new book, *Warren Buffett Invests Like a Girl*, hits shelves. Click here to preorder your copy. Your copy will be guaranteed and you'll save 35% off the list price!

By any measure, **TradeStation Group** was a successful investment for *Motley Fool Pro*. In the Charter Portfolio, we purchased shares of the small brokerage on Oct. 1, 2010 for $6.65 each. In Portfolio 2011, we bought shares on March 10 for $6.79 each. On April 20, the company announced it was being acquired by Monex Group, a Japanese broker, at $9.75 per share — a 32% premium to the market price and about a 45% profit for both *Pro* portfolios.

As Done a Deal as Could Be Done

When we heard the news of the acquisition, we shared our happiness with members on our TradeStation discussion board and cited the deal in some Monday Memos. The cash offer was completed two weeks ago, and TradeStation owners who tendered their shares through their brokers had them sold away at $9.75 each. If you did *not* tender your stock, you will still receive cash of $9.75 per share from your broker, but it may take several more days. Your broker should have been in touch with you about this, but judging by posts on the discussion boards, many *Pro* members didn't notice any communication from their brokers about whether to tender shares, and some of those who did receive this information didn't know whether to accept the offer or not.

If other stocks we own receive tender offers in the future (and we might see many over the years), we'll communicate our intentions as clearly as we can — you shouldn't have any doubt on where we stand.

Prescient Prognosticators

When we initially shared the news of the TradeStation acquisition, we reminded members of two key theses that originally made us buy the stock: that interest rates would eventually head higher, catapulting the company's earnings, and that TradeStation was an attractive takeover candidate (likely at a strong premium) as the brokerage industry continued to consolidate.

Pro Trade Roundup

Charter Portfolio:

- **Wells Fargo** ratio put spread: Sold to open 24 October $23 puts; bought to open 12 October $25 puts. Net credit: $0.22 per share.

Portfolio 2011:

- **Ebix** : Bought 400 shares (about 3%) at $20.65.
- **Wells Fargo** ratio put spread: Sold to open 4 October $23 puts; bought to open 2 October $25 puts. Net credit: $0.25 per share.

Earnings & Events

- **June 23: Oracle** is scheduled to report earnings. (We own Oracle in the Charter Portfolio.)
- Jeff published a new strategy guide: Neutral Calendar Spreads.

We'd started with a partial position in the company and had planned to add to it this spring or summer, based on how soon we expected interest rates to change. Then the buyout arrived, albeit earlier than anticipated. Our second thesis was fulfilled, and the acquisition price was smack-dab at *Pro*'s fair-value estimate (flashback reminder: the "fair" in "fair value" applies to a seller *or* a buyer).

Collect Your $9.75; We'll Seek More

As TradeStation shareholders collect their buyout payments, we're busy seeking the next acquisition target. We believe more consolidation is likely in the brokerage industry. In March, **Schwab** agreed to pay a premium to buy **OptionsXpress**. Majority owner Thomas Peterffy may eventually want to sell his baby, **Interactive Brokers**, and the company would almost surely fetch a healthy premium. **MF Global Holdings** is struggling, perhaps making it a candidate for acquisition as well.

Beyond brokerage houses, the major market exchanges are sure to continue to consolidate — the competitive benefits of doing so are undeniable. With this in mind, I've been evaluating **CBOE Holdings**, aka the Chicago Board Options Exchange; **Intercontinental Exchange** and **CME Group**, the leading futures exchanges; and **Nasdaq OMX**, which will need to merge with another company if it wants to better compete with **NYSE Euronext**.

Time will tell if we want to invest in any of these in hopes of owning another company before it's scooped up at a premium by an acquirer.

Have comments on the Memo? Please visit the Memo Musings board.

Fool on,

Jeff Fischer (TMFFischer)

Jeff owns shares of CBOE. The Motley Fool owns shares of Interactive Brokers.

Coverage & Community

- Are stocks cheaper than they've been in 26 years?
- Members talk about protection strategies.
- BrokeInTheBurgh stops by to say hello, renew, and talk bubble wrap.
- Elsewhere on the Social Banter board, jimw3326 seeks tips on giving a wedding toast.
- CAPS shows how "stock spam" ideas downright bomb.
- Seeking more high-yield stocks? Consider Todd Wenning's "Dividend Edge."

Options 803: Neutral Calendar Spreads

Published Jun 17, 2011 at 12:00AM

Why use neutral spreads?

- To earn a profit on a range-bound or flat stock or index.
- To earn a high percentage return on your capital at risk.
- To limit your risk, even if the stock or index moves sharply.

Pro's Options 801 guide introduced spreads, and Options 802 detailed the popular bearish spreads (you can see all of *Pro's* guides to options strategies under our Coverage tab). Now we'll begin to examine neutral spreads, starting in this guide with the neutral calendar spread (also called a time spread). If you believe the market or a stock is going to stay within a specific range, a neutral spread can generate profits with limited risk.

The Neutral Calendar Spread

If *Back to the Future* had been about options, Michael J. Fox and Christopher Lloyd would have put their heads together over calendar spreads. Calendar spreads are also called "time spreads," because in essence, you're selling time. You write an option that expires in the near future, and you also *buy* the same strike-price option with a much later expiration date. The "spread" you're looking to capitalize on is a growing difference in time value. The near-term option you write should lose its time value quickly, while the option you purchase (which protects your written option) will retain most of its time value. You usually close the spread as the earlier option nears expiration, thereby profiting from its larger erosion of time value compared with your later option. You are not predicting the movement of the underlying investment, which can travel within a certain price range and still allow you to profit. You're just looking to capture time value with limited risk.

Calendar Spread Details

Actions: Write ("sell to open") an at-the-money or near-the-money option typically expiring in a few months. Buy ("buy to open") an option at the same strike price with an expiration date typically two to three months later than that of the written option.
Trade type: Net debit. You pay to set up the trade.
Desired outcome: The option you write expires worthless or with little value; you close it and the later- dated option (which retains more of its value) simultaneously, keeping the difference in time value erosion as your profit.
Maximum loss: The debit you pay to set up the trade. If the underlying investment moves too sharply in either direction, the time value difference between your two options will diminish (as both options turn into intrinsic value, starting to mirror the stock price), leading to losses that can't exceed your initial debit.

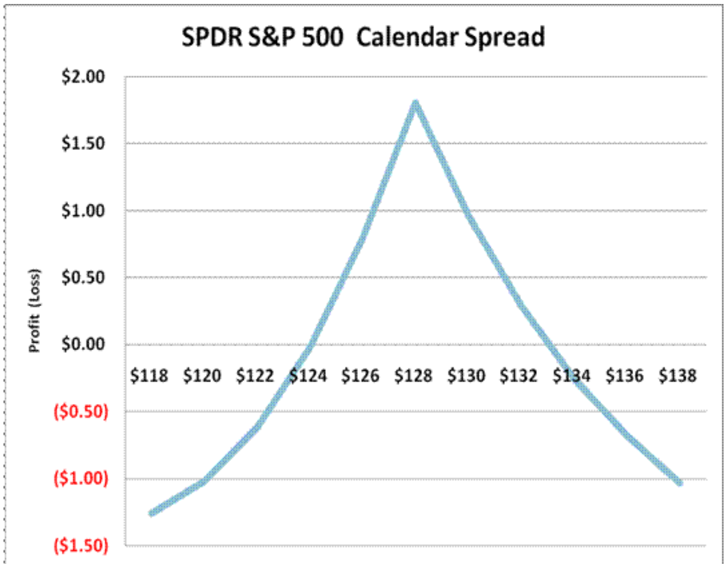
As the "time spreader" setting up this trade, you should be mindful that volatility could alter the dynamics of the position. If the share price becomes more volatile as your near-term option reaches expiration, your longer-term option could increase in price, increasing your profit as you sell it. If volatility declines, however, your long-term option may lose more time value than you anticipated, lowering your profit potential. Either way, because you use this strategy on an underlying investment you expect to remain relatively flat, you should be anticipating relatively flat volatility, too.

Example Trade

Using the **SPDR S&P 500** ETF, let's set up a calendar spread example. The S&P 500 ETF trades at $128, and you believe it will stay near that price for the next few months. You write (or sell) $128 calls that expire in two months, for which you're paid $3.34 per contract. You also buy $128 calls that expire in four months, which cost you $4.88 each. Your net debit for the spread is thus $1.54 per option ($154). Here's how your trade could work out, with the index at various prices, as expiration nears on your two-month written calls:

Index price at expiration of written two-month $128 calls	Value of two-month written calls at expiration (originally written for $3.34)	Written calls profit/(loss)	Value of purchased four-month $128 calls (originally bought for $4.88) with two months remaining	Long calls profit/(loss)	Spread profit/(loss)
$118	$0	$3.34	$0.28	($4.60)	($1.26)
$120	$0	$3.34	$0.52	($4.36)	($1.02)
$122	$0	$3.34	$0.92	($3.96)	($0.62)
$124	$0	$3.34	$1.52	($3.36)	($0.02)
$126	$0	$3.34	$2.33	($2.55)	$0.79
$127	$0	$3.34	$2.82	($2.06)	$1.28
$128	$0	$3.34	$3.34	($1.54)	$1.80
$129	$1	$2.24	$3.98	($0.90)	$1.34
$130	$2	$1.34	$4.50	($0.38)	$0.96
$132	$4	($0.66)	$5.83	$0.95	$0.29
$134	$6	($2.66)	$7.29	$2.41	($0.25)
$136	$8	($4.66)	$8.86	$3.98	($0.68)
$138	$10	($6.66)	$10.51	$5.63	($1.03)

As the table shows, this calendar spread would be profitable after two months as long as the ETF is within about 6% band around its starting price (between $125 and $133). If the index remains flat, this time spread could pay about $1.80 per option, for a 117% return on the $1.54 in capital at risk. If the index moves approximately 2% to 4% (down or up), the trade could still offer a strong return on your risk.



You can see in our table the trade is slightly more profitable as the ETF moves *above* the $128 strike price rather than when the ETF is slightly below it. This is because our example uses call options, and your purchased call will have more value if the index is higher. You would consider using put options to set up a calendar spread if you were more bearish than bullish (but still expected a generally flat market), because a put calendar spread will perform a bit better than a call calendar spread when prices decline. A careful investor will look at current call and put prices and weigh market sentiment to decide whether to use calls or puts. In most environments, though, calls hold value longer, so call calendar spreads are preferable (because you want the option you buy to retain as much value as possible).

Follow-Up Trades

As your written calls near expiration, you should "buy to close" them if they trade near parity — that is, if they are in-the-money, have almost no time value remaining, and move up and down in unison with the underlying stock. Close them to avoid having them exercised. If you still believe in the trade, you might then write new calls that expire in only a month. Otherwise, you should "sell to close" the longer-term calls you purchased earlier. If the underlying investment hasn't wandered much, you'll be left with a profit. Either way, you should be prepared to close the entire spread by the expiration of the first option if you don't want to extend the strategy.

If something drastic happens before then — say, the underlying investment drops 7% — you might close your purchased calls early to capture as much value as you still can, thus shrinking your loss, while letting your written calls expire (assuming you can hold them on margin). However, if you do nothing, your loss is still capped at the initial debit you paid to set up the trade ($1.54 in our example). Conversely, if you use puts to set up a calendar spread and the underlying investment moves sharply higher, you could close the puts you had purchased to recoup some value. When a neutral calendar spread ends around breakeven or offers a small profit or loss, and your opinion hasn't changed, it's usually easy to continue the strategy with new trades.

Pro's Bottom Line on Calendar Spreads

When neutral calendar spreads are profitable, the return on your investment can be large. However, the underlying investment needs to stay in a fairly tight range for this type of spread to earn a profit, and if it's more volatile than expected, you need to be ready to forfeit your whole investment. Thus, when you think an investment is going nowhere and you want returns from it anyway, consider a neutral calendar spread with money you can afford to lose. You won't lose more than that initial cost, and you may earn a strong return thanks merely to time — even while the underlying investment earns nothing at all.

- **Questions?** Visit *Pro*'s All about Options board.
- **Next in this *Pro* series:** More neutral spreads, including condors and butterflies.

Portfolio 2011: Write Puts on Bristow Group

Published Jun 15, 2011 at 12:00AM

Note: *Pro* first recommended buying **Bristow Group** in our Charter Portfolio in July 2010. For *Pro*'s original thesis, read our buy report on Bristow.

Trade Essentials

- **Action:** Write ("sell to open") September 2011 $40 puts
- **Allocation:** About 3% (for Portfolio 2011, that's two contracts)
- **Stock price:** $44.25
- **Buy around:** $39
- **Option price (bid/ask):** $1.00/$1.75
- **Preferred price:** Use a limit order around the middle of the bid/ask (lately, around $1.40), but don't go lower than $1.20 (for a 3% cash yield in three months)
- **Stock fair value:** $50
- **Alternative trades:**
  - Buy a 3% position in the stock if it declines to near our $39 buy-around price
- **Why write puts?**
  - The long-term demand for helicopter flights to service deepwater offshore oil production is strong.
  - Bristow benefits from predictable and recurring revenue streams that help it ensure it has the newest and jazziest fleet of helicopters.
  - We like the financial improvement we've seen so far, but being defensively minded, we're writing puts to potentially secure an even better purchase price.

What's New?

When the Deepwater Horizon rig caught fire and oil began spewing into the Gulf of Mexico in April 2010, every stock associated with oil saw its "blowout preventer" fail, too, and shares across the industry plummeted as a result. Your *Pro* team used this market overreaction to pick up shares of helicopter services company **Bristow Group** for 0.84 times tangible book value — a pretty good discount to the historical multiple.

We were comfortable overlooking market sentiment because business in the Gulf doesn't drive our thesis on Bristow. Only 6% of its operating profits come from the Gulf of Mexico, and the company earns 65% of its revenue from "reservation fees" (i.e., without even flying). Bristow has a dominant position ferrying crew and cargo to deepwater production platforms in every major production region from Norway to Nigeria. As well, the company's recent investment in the leading chopper service company in Brazil — Lidér — provides it with exposure to another booming deepwater market. Judging by Lidér's fourth quarter performance Bristow's investment is already paying off.

Why This Strategy?

Bristow continues to improve its balance sheet and financial returns. We'd love to begin building a position in this company for Portfolio 2011 near our $39 buy-around price, and writing puts may allow us to do so.

How to Follow Along

The trade command is "sell to open" or "sell." (*Do not buy these options!*) Sell one contract for every 100 shares of Bristow you're willing to purchase later. (Each contract represents an obligation to buy 100 shares, or $4,000 worth of Bristow stock.) Writing these options will "pay" you the option premium up front, and we'll wait until expiration nears (on Sept. 16) to determine our next move.

Our initial potential profit is whatever the puts pay us (we're hoping for $1.40, or $140 per contract); we have an obligation to purchase shares of the stock if they fall below the $40 strike price by expiration. If we get shares at that price, our net buy price will be $38.60 ($40 minus the $1.40 the puts pay us). Since we fully intend to buy the shares if we're assigned them in September, make sure you have $4,000 available, per contract, to purchase shares.

You can buy shares outright if shares dip to within a dollar or two of our $39 Buy Around, but we're happy to write puts and earn income while we wait for the stock to near that level. If converted into shares, these puts would allow us to buy shares about 13% cheaper than the recent price and for just 0.95 times tangible book value. If the shares remain above $40 at expiration, we won't get to buy them, but we'll earn a decent return on this first put trade (3% on our cash in just over three months).

Next Steps

- Questions or comments? Still getting used to all this options jargon? Visit our Bristow discussion board.
- Stoked to learn more about writing put options? Head over to the All About Options discussion board.

Portfolio 2011 will write puts on Bristow in the next one to 30 days, per The Motley Fool's trading guidelines.

What's Up With the Market?

Published Jun 13, 2011 at 12:00AM

So, Fool … what's up with the market? The obvious answer is "not much." As you've doubtless noticed, stocks have declined over each of the past six weeks; the Dow Jones Industrial Average booked its longest losing streak since 2002, and the Nasdaq Composite and Russell 2000 have both dipped into negative territory for the year. That said, as of Friday's close, the mighty S&P 500 is still up 1% for 2011, and *Pro*'s Charter Portfolio is up 4.2%.

Pro Trade Roundup

Charter and Portfolio 2011

- **TradeStation** : All of our shares were tendered as the company was acquired. Like all shareholders, we received $9.75 per share in cash.

Granted, that single-digit number might seem like small comfort after watching Charter Portfolio stocks **Bristow Group** and **GrafTech International** decline 16% and 20%, respectively, from their recent peaks, along with other decliners in our midst. But let's keep our perspective: Most of our Charter stocks remain much more valuable than they were mere months ago, and the S&P 500 ended Friday only 7% below its May 2 high. By this measure, the market's drop has not even qualified as a "correction" yet —the S&P would have to be down 10% to 15% for that description to apply.

What would happen if we *did* see a so-called correction? Like any other change in the market, it would bring us some new opportunities; perhaps we'd sell some positions that had held up well in order to buy new stocks at greater discounts. It would mean a profit for our short positions, which we could then close to reinvest the proceeds in discounted stocks. Is such a correction likely? By some measures, sure — the average stock market decline since 1946 has lasted four months and sent the S&P 500 14% lower, and by that measure, we're already halfway there.

Declines of this sort are common, happening an average of once every two to three years. That's one good reason not to sweat such things too much. You don't want to lose your hair, go gray (or grayer!), eat badly, be cranky around the house, or just plain stress out over something that happens regularly every few years. Plus, if you're investing for tomorrow, what's the point of excessive worry today?

Short Exposure

Even so, we have strategies to help us comfortably earn profits in weak markets, too. In the Charter Portfolio, our short and defensive exposure shapes up like so:

Position	Portfolio Allocation (as of Friday, June 10)	Details
ProShares Short S&P 500	5%	$74,000 position
Ratio Put Spread on **iShares Russell 2000 Index**	8.4%	15 August puts at $81 strike = 1,500 shares @ $81 = $121,500 look-through value
Synthetic Short on **iShares S&P 600 SmallCap**	7.8%	16 August puts at $71 strike = 1,600 shares @ $71 = $113,600 look-through value
Total Short Allocation	**21.2%**	

Cash	7.1%	$103,005 in cash on $1.44 million total value
Sprott Physical Gold Trust	3.3%	$47,260 position (we view gold as a cash equivalent, though it's more volatile than currency)
Total Shorts and Cash/Hard Assets	**31.6%**	

With nearly 32% of its current "look-through" assets defensively positioned (not including the puts we've *written*, which lower our defensiveness), the Charter Portfolio is reasonably ready for a larger decline, although we could certainly add to our short positions if our concern grows. We may also benefit from raising more cash to invest later, presumably at lower prices, since the put options we own don't represent much buying power down the road.

Here's how that works: In the Charter Portfolio (as well as in Portfolio 2011), we bought August 2011 put options on two market indexes to profit on a potential decline. Those puts carry "time value" that will diminish as expiration nears, making them less effective as a hedge by about $1 per share by expiration — about one-third of the current total put value. And the absolute value of the puts is modest. Selling our defensive puts in the Charter Portfolio would only raise $12,800 in new cash (although selling the ProShares Short S&P 500 ETF, which we own outright, would raise a considerable $74,000). So the puts we own are not a large source of future cash; the role of these shorts is to help hedge us against sharper market declines, at which point their value would grow more rapidly.

Portfolio 2011

By comparison, Portfolio 2011 is still 59% in cash as we're working to thoughtfully build its positions (although we do have several written put options that restrict a portion of this cash). It also carries about 18% in look-through short exposure, some from purchased puts and some directly in the form of the ProShares Short S&P 500 ETF. Portfolio 2011 can easily afford to buy stocks when they decline. And keep in mind: Our short positions achieved through options didn't cost us anything; in fact, we set them up for a small credit. So Portfolio 2011 may be quite defensive, but we didn't pay up for it.

Made in China

Rule Breakers analyst Sean Sun and the Fool's international investing experts are headed to China to research companies in the world's fastest-growing economy. You can follow along with the team's photos, videos, tweets, and commentary, and sign up to receive email dispatches from the road.

Why a Drop May Be Modest

Now let's dabble in the dangerous game of market predictions. There are several reasons why a potential market decline may be more "reasonable" than "rout" this time. The S&P 500 trades at a reasonable 12.8 times forward earnings estimates, and earnings are what ultimately drive market prices. As long as U.S. companies can maintain their earnings trajectory, the market may ultimately not care much about unemployment, Europe's problems, the Middle East, or much of anything else. After all, stocks rise through horrible wars, natural disasters, and persistent unemployment and wage stagnation — the market is not known for its compassionate nature.

That said, companies have already cut costs to the bone, surprise macro-economic shocks are always possible, economic growth may slow, and governments worldwide need to reel in debt and spending. Given all this, hedging (especially in low-cost ways) remains attractive, and *Pro* is here to help you do it.

Foolishly,

Jeff Fischer (TMFFischer)

Coverage and Community

- The *Pro* team discusses **3D Systems** and **Pebblebrook** in the latest Audio Extra.
- Bryan Hinmon (TMF42) summarizes recent results at Bristow Group.
- airforcemama20 shares her interview with The Motley Fool. Nicely done, Ali!
- Stamleo runs numbers on the IJR short, showing how it grows as the market falls.
- Time to buy a house? Members chime in.
- Ebix looks to expand its share buyback program; stamleo shows how it's possible.
- Russell (TMFEldrehad) highlights some of the best "pitchers" on CAPS — see what they're thinking.

Charter and 2011 Portfolios: Set up a Ratio Put Spread on Wells Fargo

Published Jun 10, 2011 at 12:00AM

Note: *Pro* first recommended buying **Wells Fargo** (NYSE: WFC) in our Charter Portfolio in December 2010. For *Pro*'s original take, read our initial buy report.

Trade Essentials

- **Action:**
- Buy ("buy to open") one October 2011 $25 put for every block of 100 shares you already own. Then write ("sell to open") *two* October 2011 $23 puts for every put you just bought.
- **Allocation:** 5% if we end up buying the shares at these prices (for the Charter Portfolio, that's 12 bought puts and 24 written puts; for Portfolio 2011, it's two bought and four written).
- **Recent stock price:** $25.75
- **Options prices (bid/ask):** $1.74/$1.76 for the $25 puts; $1.06/$1.08 for the $23 puts
- **Preferred price:** Aim for a $0.35 or higher net credit initially; as prices change, accept no less than break-even.
- **Alternative trades:**
  - Wells Fargo is rated a Buy, so if you don't yet own shares, consider buying a partial position today and setting up this ratio put spread on those shares.
- **Why set up a ratio put spread**?
  - We collect a small premium and sacrifice zero upside to establish this hedge.
  - It partially protects us against short-term threats to the stock price, such as increased regulation.

- If the stock price is down 10.7% when these options expire, we can add to our position with a net cost on new shares of $20.64 — a 20% discount from today's price.

What's New?

Wells Fargo's stock price has fallen 15% since the Charter Portfolio first bought shares at $30.39. When a stock we own gets cheaper, we consider adding to our position — but not before we consider the changing landscape. In this case, the share price dropped even though critical elements of our thesis unfolded as expected. The Fed loosened the reins on the stagecoach last quarter, allowing Wells Fargo to raise its quarterly dividend to $0.12 per share (up from just $0.05) and to repurchase 200 million shares (worth about $6.4 billion). This exceeded the expectations we outlined in our original report but fell short of the catalyst we'd hoped for.

Even this increased dividend is lower than my (Nick, here) estimate of what Wells Fargo could safely pay shareholders. And these few bits of good news did little to outweigh the other challenges Wells Fargo has faced in the past seven months — the CFO leaving with little explanation, Moody's placing the company's debt "on review for possible downgrade," and the increased uncertainty created by Fed Governor Daniel Tarullo when he spoke of raising bank capital requirements "20% to more than 100% over the Basel III requirements." All of this plus a poor lending environment made us revisit our choices given the current share price.

Why This Strategy?

A ratio put spread combines a bear put spread with a written put. There are two possible outcomes in this case:

- If the stock's price dips moderately between now and October, but ends that period above $23, we will partially hedge the decline in our existing shares.
- If the stock is below $23 by expiration and we don't close it, we will buy additional shares at a discount to today's price.

The ratio put spread itself is most profitable if the stock is at $23 when the options expire. If it's below $23, it will offer us a net purchase price on new shares of $20.64, 20% below the recent share price. And if the share price climbs from here, we keep the $0.26 credit per share (a 1.4% yield), meaning we profit either way.

How to Follow Along

Buy one October 2011 $25 put for every block of 100 shares you already own. Then write two October 2011 $23 puts for every put you just bought. Of those, one will be an uncovered written put, meaning it represents the potential obligation to buy 100 more shares — so be aware that for each uncovered put you write, you need to be willing and able to invest $2,300 if Wells Fargo's share price is below $23 at expiration. Finally, try to set this up in one trade if your broker supports it. To review:

- **Buy ("buy to open")** October 2011 $25 puts, one for every 100 shares you own
- **Sell ("sell to open")** October 2011 $23 puts, two for every put you buy
- **Recent prices:** The $25 puts cost $1.76; the $23 puts pay $1.06 each
- **Limit price:** Aim for a $0.35 or higher net credit if feasible; don't pay a debit.

The Foolish Bottom Line

By setting up this ratio put spread, we're getting paid a bit for the privilege of protecting our position in Wells Fargo from a moderate drop in share price, and we're giving ourselves the opportunity to buy shares 20% cheaper. If we purchase more shares as a result of this strategy, we'll have a full 4% to 5% position in Wells Fargo — and good reason to look forward to the resurrection of the banking industry.

Next Steps

- Questions? Comments? Need a helping hand? Please visit our Wells Fargo discussion board.
- Excited to learn more about ratio put spreads? (Who wouldn't be?) Head over to the All About Options discussion board.
- Add WFC to My Scorecard.

Pro *will establish a ratio put spread in both portfolios, representing an additional 2.5% stake in Wells Fargo, in the next one to 30 days, following The Motley Fool's trading guidelines.*

Nick owns shares of Wells Fargo. See all of Motley Fool Pro*'s holdings on our Recommendations page.*

Audio Extra: 3D Systems and Pebblebrook Hotel Trust

Published Jun 10, 2011 at 12:00AM

Join *Pro* advisor Jeff Fischer and analysts Bryan Hinmon and Alex Pape as they discuss Buy First stock **3D Systems** — find out why the *Pro* team came away from a company event impressed. Next, hear more about another new Buy First, **Pebblebrook Hotel Trust**. What's so appealing about this upscale hotel owner, and how will the company benefit even if the economy weakens? Listen in and then join the conversation on the Pebblebrook discussion board!

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Portfolio 2011: Buy Ebix

Published Jun 7, 2011 at 12:00AM

Trade Essentials

- **Action:** Buy 3%
- **Buy around:** $18
- **Fair value:** $24
- **Preferred price: Use a limit order** to buy shares near market prices, ideally around $18.
- **Alternate trades:** "Sell to open" July $17 or $18 puts (sell one put for every 100 shares you'd buy), or do the same with later-dated puts near these strike prices. (New to options? See our guide to selling puts.)
- **Why buy?**
    - Providing a comprehensive software platform to insurance providers, Ebix boasts strong customer retention and cross selling opportunities

- Steady recurring revenue has led to record annual free cash flow, from $5 million in 2005 to $53 million today
- The shares can be volatile, but they appear inexpensive at the moment, trading at only 12 times earnings

The Big Picture

Ebix is one of the most volatile positions in our Charter Portfolio, which is surprising given how steady the business has been. The company provides software that's helping to bring the enormous insurance industry into the digital age. A *Pro* member who goes by 4wheelfool on our discussion boards describes it well.

First Things First

- Company: Ebix, Inc.
- Market cap: $724 million
- Website: http://www.ebix.com
- Type of holding: Small-cap, software
- Follow it: Add Ebix to My Scorecard

"What Ebix does is tie all the insurance pieces together with [its] back-end software," 4wheelfool writes. Insurance companies produce mounds of data, and all of it needs to be tracked and transferred between departments. As 4wheelfool puts it, "You need to track payments on policies, claims, sick days, name changes, beneficiary changes. You need to track workers comp, managed home care, employee benefits, annuity transfers and balances in variable life insurance. You need to comply with governmental policies, and therefore need to track whatever statistics you need to show you are in compliance for an audit. Any delay or mix-up in transferring or recalling data usually leads to egg on your face at best, a lost customer at worst."

Ebix has six areas of focus: property and casualty, life and annuity, risk management, business process outsourcing, software development services, and health and employee benefits. Currently, there are various companies that deal with each of these areas, and Ebix is consolidating these smaller businesses as quickly as it can, to smooth the flow of information across these segments with an all-in-one solution.

To consolidate multiple insurance needs into one software package — and grow its customer base in the process — Ebix has been making several small acquisitions each year, buying into new areas of business and incorporating them into its multinational software. In this way, management is able to both create cross-selling opportunities and increase the value of its insurance "network" as more customers join it. The company's main commerce-driven product, EbixExchange, brings in recurring revenue.

Valuation

Ebix does business with many major insurance companies, but the company itself remains small, with only $140 million in trailing-12-month sales. Management suggests the total possible market size is much larger. The leadership team isn't content to focus on North America; it sees large opportunities overseas, including in Australia and South America, both areas where Ebix has made acquisitions. At its current price near $18 per share, the company trades at 14 times free cash flow and 12 times estimated earnings for 2011.

Management recently tripled the size of its share buyback program to $45 million and suggests that more will follow. And last Friday, the company's CEO, Robin Raina (already a 10% stakeholder with nearly 4 million shares), bought $500,000 worth of new stock on the open market at $17.29 per share.

Risks and When We'd Sell

Even with several years of profitable growth behind it, Ebix still has the feel of a scrappy young company. The strong-willed CEO dominates each conference call, and his less-than-conventional approach has drawn short-sellers to the stock. Additionally, the company's acquisitions lend themselves to complex accounting, and most of its research and development staff is based in India (the CEO's home country), both of which have caused critics to call into question the company's tax practices in the United States. These factors have led many investors to bet on the stock to fall, which has made the shares extremely volatile. Here at *Pro*, we believe in the integrity of the company and remain focused on the business results. We will sell if we ever come to doubt management's word in any instance, or if the business appears to be experiencing lasting weakness.

The *Pro* Bottom Line

Consistently on *Forbes*' list of fastest-growing companies, Ebix is a young success story. Its shares offer value and growth, and the company should mature into something built to last. Right now, skeptics have created a buying opportunity, sending shares 38% lower since March. If Ebix can prove those skeptics wrong, we will be quite happy to own shares for a long time to come. Following the CEO's lead, we're using the price opportunity to buy a stake for Portfolio 2011. Buy ahead of us if you're comfortable with a volatile small-cap company.

Next Steps

- Questions or comments? Visit our Ebix board.
- Once you've bought Ebix, add it to My Scorecard.

Pro Portfolio 2011 will buy a 3% stake in Ebix in the next one to 30 days, per The Motley Fool's trading guidelines. Jeff owns shares of Ebix. You can see all of Motley Fool Pro*'s holdings on our Recommendations page.*

Pro's Biggest Lessons Learned

Published Jun 6, 2011 at 12:00AM

Profitable investments bring excellent investing lessons … but we're saving that merry topic for another Memo. Today, I'd like to discuss some of the also-valuable lessons *losers* can provide. In the stock market, having losers is inevitable, and while revisiting them to learn from them won't necessarily make us feel like dancing, it will help us avoid making the same mistake twice. You'll laugh, you'll cry, you'll be glad you're sitting down — join us as we take a look at our largest value-destroyers and find some intelligence-increasers.

Pro Trade Roundup

Charter Portfolio

- **Plum Creek Timber**: Wrote a covered strangle, selling to open November 2011 $35 puts and November 2011 $43 calls, for a combined credit of $1.73 per contract.
- **iShares S&P SmallCap 600 Index** ETF: Set up a synthetic short, selling to open August 2011 $75 calls and buying to open August 2011 $71 puts, for a combined credit of $0.25 per contract.
- **Rockwood Holdings**: Wrote August 2011 $50 puts, receiving $2.80 in credit.

Portfolio 2011

- **Plum Creek Timber**: Sold to open November 2011 $35 puts for $0.94 per contract in credit.
- **iShares S&P SmallCap 600 Index** ETF: Set up a synthetic short, selling to open August 2011 $75 calls and buying to open $71 puts, for a combined credit of $0.15 per contract.
- **Rockwood Holdings**: Wrote August 2011 $50 puts, receiving $2.90 in credit.

U.S. Natural Gas Fund

In October 2009, the price of natural gas dipped to $3.80 per million BTUs after trading at nearly $14 a year earlier. I'll take full "credit" for the way this one played out: I believed that natural gas prices would rebound in the next 18 months, so we set up a synthetic long (writing 2012 puts and buying 2012 calls) on the **U.S. Natural Gas Fund**, the country's largest natural-gas ETF. As of Friday, natural gas trades at $4.70, up 23% from late 2009, but the U.S. Natural Gas Fund is down an indigestion-causing 50% over the same period. The big lesson here: Seeing your thesis play out is meaningless if you chose a poor investment to express that thesis.

The culprit in this case was contango. A fund that buys futures contracts to track the price of something often pays a premium for new contracts each month (or each day) and sells its older contracts for less. This continual price drag is called contango, and it eats away at the value of the fund — in some cases even as the underlying commodity or vehicle goes up in price. The impact of contango was stronger than I expected with the U.S. Natural Gas Fund, and within four months of setting up our investment, we were writing diagonal calls to offset our losses. In retrospect, we should have just closed the position entirely at that point.

We hung on another eight months, but finally, less than a year after setting up our synthetic long, we exited for a $15,657 loss, losing 1.56% of the Charter Portfolio's starting value. Ouch. But it wasn't for naught: The experience drove home the dangerous reality of contango, and now we seek to *short* investments suffering from it. My favorite has been the **iPath S&P 500 VIX Short Term Futures** exchange-traded note. In June 2010, we suggested shorting this contango-hampered vehicle with a target allocation of up to 10% of the Charter Portfolio's value — I was that confident we'd be successful.

The ETN is down a whopping 78% since then, a drop that could have added 5% to 8% to our total portfolio returns (a multitude greater than the loss we suffered from U.S. Natural Gas). Unfortunately (as veteran members know), *Pro* was unable to short shares after issuing the trade alert. We resorted to writing naked calls, and we've earned a healthy (but relatively small) $14,100 so far. That gain does largely cover our U.S. Natural Gas Fund loss, and I expect with time this will turn into a large overall profit — and a Foolish example of learning from a mistake.

- See our UNG trade history and VXX trade history

MELA Sciences

With **MELA Sciences**, we saw a speculative opportunity that had the potential for strong profits — but in chasing it, we bought a company that didn't match up with our lower-risk, absolute profit philosophy, and we did so when both excitement and the share price were riding high.

MELA Sciences' lone product was a skin-cancer detection machine called MELAFind, and FDA approval seemed probable after Phase III trial results. We purchased call options in anticipation. After several review delays, an independent FDA advisory panel *did* actually (narrowly) suggest market approval for MELAFind. This would have been a success for us — but the FDA itself criticized the trial so strongly that nobody expects the agency to follow the panel's advice when it finally does make its final ruling. MELA Sciences' stock languishes around $3, our calls expired worthless, and we walked away from making speculations like it again (while reaffirming to members our mission of steady profits with lower risk).

Despite losing $7,900 on MELA Sciences (0.79% of the Charter Portfolio's starting value), we've made money on the health-care sector overall. And our experiences with MELA Sciences taught us that, as our mission dictates, we want to stick to profitable leaders rather than rolling the dice on revenue-lacking upstarts.

- See our MELA trade history

Covered Calls

The U.S. Natural Gas Fund and MELA Sciences are our two big losers since *Pro* launched in 2008. We've had a few smaller losers, too — including bearish spreads on **Caterpillar** and **Abercrombie & Fitch** — but they were minuscule by design, not risking more than 0.3% of the portfolio. So our other large financial mistakes took place on the "sell side" — capping our upside too early on winning positions, notably **Autodesk** and **Kinetic Concepts**.

Writing covered calls on Autodesk was mainly a defensive decision, because the stock looked aggressively valued. If we hadn't done it, we may not have held the stock much longer anyway, as it continued to increase in price. Kinetic Concepts was arguably the bigger gaffe: Fearing a weak quarter, we set up a protective collar (writing covered calls to buy puts). Earnings were healthy, and the stock didn't fall, so we should have closed the covered calls all but immediately. Waiting in an effort to save a few bucks ultimately made us forfeit $19,700 in upside as the stock gained ground. In the future, if we find ourselves there again, we'll close the calls and not mind the few thousand dollars in cost.

Other companies on which we wrote covered calls that led to shares being sold away from us, only to rocket higher afterward, include **Lindsay** and **Waters**. And while all of these positions did earn us a profit, they still serve as a great reminder: Think twice before using covered calls on smaller companies (those with market caps of less than $5 billion), because these stocks can surprise you with quick upside. As we've always said (and as these stories prove), covered calls are usually best as an income strategy on sleepy stocks that you won't likely regret selling — usually the giants of Wall Street.

In Summary

We won't berate ourselves for being defensive — that's how we invest, seeking to earn healthy returns with reasonable risk. But buying U.S. Natural Gas Fund despite its contango and going "off charter" to speculate on MELA Sciences easily count as mistakes, as does not closing our covered calls on Kinetic Concepts. The good news: We've learned from each instance, and they've made us better investors. We'll always have some losers (no investor is perfect), but our goal is to make money overall, minimize the losses, and avoid repeating mistakes. This meshes well with *Pro*'s mission to earn you consistent, recurring profits using stocks, ETFs, options, and shorts with a high level of accuracy. We might add to our mission one more goal: to keep improving along the way.

Want to share your own biggest mistakes? Join us on the Memo Musings board.

Jeff owns and has options on Kinetic Concepts and is short iPath S&P 500 VIX Short Term Futures ETN. See all of Motley Fool Pro*'s holdings on our Recommendations page.*

Coverage & Community

- TMFDatabasebob posts his in-depth quarterly analysis of **Ebix**.
- Jeff reviews *Pro*'s goals for 2011 — how are we doing?
- macroBill asks what it means to write puts on buying power rather than all cash.
- alex340 lists put options that meet *Pro* criteria (some are on stocks no longer in *Pro*).
- goateyes asks about stop-loss orders, and stamleo points the way.

Charter and 2011 Portfolios: Write Puts on Rockwood Holdings

Published Jun 2, 2011 at 12:00AM

Trade Essentials

- **Action:** Write ("sell to open") August 2011 $50 puts
- **Allocation:** About 2%, for a total of nearly 5% (for the Charter Portfolio, that's six contracts; for Portfolio 2011, it's one)
- **Option price (splitting the bid/ask prices):** $2.40 (after reviewing prices, try a limit order around $2.40 if feasible; as prices change, accept no less than $1.50)
- **Stock price:** $51.40
- **Buy around:** $49
- **Alternative trades:**
  - Write July 2011 $50 puts, recently $1.50
  - Consider buying shares directly if you don't own any yet, starting with up to a 3% allocation. Rockwood is a Buy.
- **Why write puts?**
  - Rockwood's business is likely to improve throughout the year
  - We want to own more than our current 2.8% allocation, but we'd like a lower buy price
  - Ideally, we can keep writing puts for income until all our dreams come true — that is, until we can buy Rockwood at a lower price or retire on a monkey-filled island

What's New?

Pro last wrote puts on **Rockwood Holdings** (NYSE: ROC) in March, and they expired as income in May; in April, meanwhile, the company reported record earnings. The only significant news since then was the sale of 8 million shares of common stock by Rockwood's primary shareholder, Kohlberg Kravis Roberts & Co — the firm that turned Rockwood around over the past several years and earned a large profit in the process. KKR still owns more than 7 million shares of Rockwood after selling the aforementioned 8 million to **Goldman Sachs** (NYSE: GS) at an agreed $53.77 per share. We don't read much into the sale — KKR is probably lightening up on Rockwood to invest in other turnaround opportunities.

As we explained in our original buy recommendation, Rockwood (with KKR's help) spent much of the past decade reorganizing to focus on its most profitable businesses, including its lithium division, which is expected to grow sales 30% this year. Across business lines, Rockwood is seeing increasing pricing power, and management has expressed confidence for the year ahead.

Why This Strategy?

Although Rockwood remains a Buy and all *Pro* members should ideally own at least a partial position, its shares can be volatile. Writing puts is simply more defensive than chasing share prices that have been rising for several months. If the price does keep rising, we'll benefit in two ways — appreciation of the shares we own and more income from the puts. If shares dip below $50 by our expiration, we'll get to fill out our allocation at a more attractive price.

How to Follow Along

Do not buy these puts. We're *selling* (writing) them and being paid in the process. For every put you write, you're obligated to buy 100 shares of stock if the stock price is below the strike price by expiration. Here's the math behind the trade:

- **Trade:** "Sell to open" August 2011 $50 puts
- **Option price:** $2.40 (use a limit order; higher is better, but as prices change, accept no less than $1.50)
- **Potential net stock buy price:** $47.60
- **The stock is:** 2.7% above our strike price and 7.3% above our potential breakeven price
- **The puts yield:** 4.8% on cash in 79 days (16% if using equity or buying power to hold the trade open)

Next Steps

- If writing puts is new to you, check out our guide. If you have questions about this trade, visit our Rockwood Holdings discussion board.
- Want a refresher on Rockwood? Visit its trade history.
- To track your Rockwood returns or watch the stock, add it to My Scorecard.

Jeff has an options position on Rockwood. See all of Motley Fool Pro*'s holdings on our Recommendations page.*

Charter and 2011 Portfolios: Plum Creek Timber

Published Jun 1, 2011 at 12:00AM

Trade Essentials

- **Actions:**
  - **Charter Portfolio: Write a covered strangle.** Write ("sell to open") November 2011 $35 puts (to potentially double your position to 5%); write ("sell to open") November 2011 $43 covered calls (one for every 100 shares already owned)
  - **Portfolio 2011: Write puts.** Write ("sell to open") November 2011 $35 puts only
- **Allocation:**

- Charter Portfolio: 10 contracts of each option; we'll potentially double our position to 5%
  - **Portfolio 2011:** 5% (for Portfolio 2011, that's four put contracts)
- **Recent options price (splitting the bid/ask prices):** November 2011 $35 puts, $0.97; November 2011 $43 calls, $0.90
- **Preferred strangle limit price:** $1.87 credit, combined (higher is better — check current prices and aim for at least $1.85 initially; as prices change, accept no less than $1.50)
- **Preferred $35 put writing limit price:** $0.95 or higher (as prices change, no less than $0.80)
- **Recent share price:** $40.10
- **Buy around:** $34
- **Fair value:** $40
- **Alternate trades:**
  - **Charter Portfolio: Want a larger premium?** If you're willing to take on more risk (of either having your shares called away or being required to buy more) in exchange for a higher option payment, you can consider moving your strangle strike prices up and down, closer to the current share price with either option.
  - **Portfolio 2011: Want a better chance to buy shares?** You can write puts at a higher strike price to earn a higher premium and increase the likelihood that you will be required to buy shares — but to manage risk, make sure your strike price is only $1 or $2 higher than ours.

The Big Picture

Plum Creek Timber (NYSE: PCL) is the largest private landowner in the United States, with about 7 million acres of timber nationwide. The company's experienced management aims to harvest timber sustainably when prices are healthy and let the assets grow (literally) when they aren't. The company also profits from buying and selling land, sometimes selling to developers, other times to conservation groups.

First Things First

- **Company: Plum Creek Timber** (NYSE: PCL)
- **Market cap:** $6.5 billion
- **Website:** www.plumcreek.com
- **Type of holding:** Long-term, income, natural resource asset
- **Strategy:** Strangles Guide
- **Follow it:** Add PCL to My Scorecard

Plum Creek earns enough free cash flow, one way or another, to finance its healthy $1.68 yearly dividend, giving the stock a 4.1% yield today (and 5% on the price at which the Charter Portfolio first bought the stock in 2008). We're happy to keep earning this hearty yield in the Charter Portfolio, and we want to boost our income further (once again) with our fourth covered strangle on the stock. We also want to position Portfolio 2011 to potentially buy shares at lower prices. (New investors wishing to learn much more about the business can check out our original buy report.)

What's New

Though the prices of many commodities have grown like the mighty oak, Plum Creek Timber has yet to benefit from the higher prices for sawlogs (timber grown primarily for lumber) and pulpwood (timber grown primarily for paper), nor has the company enjoyed enough of an increase in volume to move the profit needle. We've been holding off on repeating our covered strangle here for several months as a precaution against commodity speculation sending shares much higher, but timber has not caught fire like many other commodities. Even if timber were to increase substantially in price, Plum Creek can only harvest so much each year, so benefits will likely be muted.

With little new construction demand on the horizon, we feel comfortable writing our fourth covered strangle on the stock, a move that may end with us buying more shares around our preferred buy price or selling our current shares for more than our estimate of fair value. For Portfolio 2011, meanwhile, we can write puts to potentially buy shares much cheaper. We're satisfied to focus on Plum Creek options while we wait for a housing recovery.

Why This Strategy?

With a 4.1% yield (and our frequent option writing), Plum Creek has generated steady income for our Charter Portfolio since 2008, though the shares alone have gained only modestly compared to the S&P 500. We're choosing an expiration nearly six months in the future because it pays higher premiums than an option with an earlier expiration.

- **Charter Portfolio:** This strangle provides members with a potential net buy price on new shares of $33.11, below our $34 preferred buy price. And if the stock stays between our two strike prices (a range of $35 to $43), we'll earn the full premium of around $1.87 per share (a 4.6% yield on the current price), plus two $0.42 dividend payments (not yet announced, but expected in August and November) for another 2% in yield. If the stock rises above $43, we enjoy a potential net sell price of $44.87, more than 10% above the current price and our fair value estimate.
- **Portfolio 2011:** Writing puts alone nets us a potential buy price near $34 — our preferred buy price and about 20% less than the recent share price. The yield on cash for the put trade alone isn't large (2.8% in nearly six months), but it's around 9% if you're writing puts on buying power rather than cash. Portfolio 2011 members may or may not end up with shares at our low desired price, but we'll at least earn option income.

How to Follow Along

- **Charter Portfolio:** To write a covered strangle, you must own at least 100 shares of the stock, and you should be happy to buy at least 100 more at a lower price.
- **Portfolio 2011:** To write puts alone, you need to be ready and able to buy 100 shares for every put you write if the stock is below your strike price ($35 in this case) by expiration in November.

Members following Portfolio 2011 might feel a little "yield envy" because they'll miss out on the dividend provided through share ownership. If this is you, remember that the upcoming dividends are already part of the calculations behind the put premium we're getting.

Next Steps

- Questions or comments? Visit our Plum Creek Timber board.
- Check out our guide to strangles.

See all of Motley Fool Pro*'s holdings on our Recommendations page*.

What Makes Our Stocks Special — and Better

Published May 31, 2011 at 12:00AM

There are two qualities that should be evident in every position we take and every strategy we use here at *Pro*. We want our investments to be special (compelling, serving an important need or opportunity, worth your attention), and we want them to be better than the competition (better fundamentals, better management, better returns with less risk). We look for businesses with a competitive edge and investing strategies that offer us flexible advantages. Today, let's discuss how two of our positions measure up.

Trade Roundup

Charter Portfolio

- **SPDR KBW Regional Banking ETF** ETF: Sold all 2,200 shares at $25.67.
- **Broadridge Financial Solutions**: Wrote 7 September 2011 $22.50 puts for $1.05 credit.
- **Pebblebrook Hotel Trust**: Bought 1,400 shares at $21.67.

Portfolio 2011

- **Broadridge Financial Solutions**: Wrote 3 September 2011 $22.50 puts for $1.05 credit.
- **Pebblebrook Hotel Trust**: Bought 230 shares at $21.67.

Tupperware Brands

This one is easy. **Tupperware** CEO Rick Goings mentions three things he thinks make his company better than others (and we agree):

1. **The company owns its sales channel.** Rather than relying on retailers who have a say in product pricing and shelf placement (and can thus make sellers charge less), Tupperware enjoys a network of more than 2 million employees who earn a living selling its products.
2. **Its products have a gross margin of 60% to 80%.** To avoid becoming a "commodity" business (one whose products are indistinguishable from competitors'), Tupperware only green-lights products that provide a strong profit margin. If a container can be sold for $10, Tupperware will pay between $4 and $2 to produce it, generating gross margin of 60% to 80%. To command this type of sales margin, something has to be special about those products.
3. **It aims to generate 25% of sales each year from new products.** This goal forces Tupperware to innovate, places new products in play for the sales staff, and keeps Tupperware parties lively.

Combine these qualities with a massive opportunity in emerging markets (sales in South America rose 60% last quarter, 80% in India, and 44% in Indonesia; the latter is the world's fourth-most populated country), six decades of resilience in developed markets (sales in North America jumped 17% last quarter), a steady share buyback program, and a dividend that is slated to rise as earnings do, and you have a dynamic growth company with lower-than-average risk.

Yep, "dynamic growth" — believe it or not, that's Tupperware. When I first turned the company up on a value-stock screen, I thought, "What new tricks can this old dog have?" This one proves you can't judge a container by its lid. You need to pop the top to see what's really going on — what makes it special and better.

Both *Pro* portfolios currently hold Tupperware. If you want to increase your exposure to the company, you can consider writing ("sell to open") October 2011 $60 puts, recently bidding $2.55 per contract (that's about a 4% yield on cash in four and a half months).

3D Systems

Much younger than Tupperware and dependent on technological advantages, **3D Systems** (NYSE: DDD) is still special: The company invented 3D printing, and it has important ties with the automotive and health care industries (among others). Its sights are also set on a larger consumer market, as the company realizes that 3D printing could one day be a tool for mass personalization. Management targets recurring revenue of about 75% of annual sales and expects margins to rise as it sells more and more patented printing materials.

In the past year, 3D Systems introduced 10 new printers and expanded its patent trove to more than 400. For much more about the business, check out Bryan Hinmon's (TMF42) summary of last week's Investor Day. We sent Bryan on an adventure involving an Amtrak train and several New York City cabs so he could meet company brass and bring his story back to *Pro* members.

Why This? Why Now?

With every investment we make, we should be telling you why we've chosen this opportunity for our money now — in other words, what makes it special and better. Whether it's the strong track record of CEO Jon Bortz at **Pebblebrook Hotel Trust**, or the wicked contango that makes shorting **iPath S&P 500 VIX Short-Term Futures** delightfully profitable, or the reported 98% customer retention rate at **Ebix**, *all* of our positions should have key qualities that make them worthy of *Pro* — and ultimately profitable as well. In our next quarterly review, we'll outline these qualities for each position we hold.

Questions or comments? Visit our Memo Musings board.

Fool on,

Jeff (TMFFischer)

Jeff owns shares of Tupperware, 3D Systems, and Ebix and is short shares of iPath S&P 500 Short-Term VIX Futures.

Coverage and Community

- The tender offer for **TradeStation**, highly profitable for members at $9.75 per share, should be completed in June. Members don't need to take action but may vote for or against the takeover if they wish. *Pro* cannot legally provide voting guidance.
- Check out *Pro*'s take on **Medtronic**'s earnings.
- Bryan (TMF42) summarizes his experiences at **3D Systems**' Investor Day event and members share their thoughts.
- Did ya catch it? Jeff, Nick (TMFCrow), and Bryan sang the praises of three *Pro* companies in Friday's Audio Extra.
- Want to get upset? Nick shares that Congress and their aides are somehow great stock pickers. Go figure.
- Alex340 posts put options that meet *Pro* criteria.

Charter and 2011 Portfolios: Set Up a Synthetic Short on iShares S&P SmallCap 600 ETF

Published May 27, 2011 at 12:00AM

At a Glance

- **Actions:**
  - Write ("sell to open") August 2011 $75 calls
  - Buy ("buy to open") August 2011 $71 puts
- **Allocation:**
  - 8% in Charter Portfolio (16 contracts of each)
  - 3% in Portfolio 2011 (one contract of each)
- **ETF price:** $73.77
- **Options prices (bid/ask):**
  - $75 calls: $2.05/$2.25
  - $71 puts: $0.80/$5 (this will tighten as trades begin, but you must use **limit orders**)
- **Limit order guidance:** Using a "spread order," aim to set up the synthetic short for around zero cost.
- **Why set up a synthetic short?**
  - With little or no out-of-pocket costs, we can profit on a decline in small-cap stocks, hedging more of our equity exposure.
  - We lose nothing on the trade if the market stays within our range.
  - If the index gains more than 2%, our short will lose money by expiration, but the accompanying gains in the stocks we own should more than compensate.

The Big Picture

Approximately 25% of *Pro*'s Charter Portfolio is invested in mid- and small-cap stocks — companies like **3D Systems** (NYSE: DDD), **GrafTech International** (NYSE: GTI), and **Tupperware** (NYSE: TUP). These stocks are more prone to volatility than their larger counterparts. Over the past two years, smaller and riskier stocks have led the market rally, but if investors' moods sour as government stimulus wanes, those same smaller stocks will likely experience the brunt of the selling. With today's recommendation of a synthetic short on the **iShares S&P SmallCap 600** ETF (NYSEMKT: IJR), the aim is to hedge more of this portion of our portfolio, smoothing our returns if the market declines.

First Things First

- **ETF**: **iShares S&P SmallCap 600 Index** (NYSEMKT: IJR)
- **Type of holding:** Short/hedge; U.S. small caps; must use margin account
- **Website:** [us.ishares.com]
- **Follow along:** [Add to My Scorecard]
- **Learn more:** *Pro*'s [guide to synthetic shorts]

The Charter Portfolio has 12.5% short exposure through our holdings in the **ProShares Short S&P 500** ETF (NYSEMKT: SH) and a ratio put spread on the **iShares Russell 2000 Index** ETF (NYSEMKT: IWM). When we add today's short of the iShares S&P SmallCap 600, we'll have about 20.5% short exposure in the Charter Portfolio as we head into June (and 17% in Portfolio 2011, but we have ample cash in that portfolio). That's not as risky as it might sound at first, though: The majority of our short exposure is in options positions that won't harm us if the market goes up (as with our ratio put spread) or if the market goes up a little (as with this new synthetic short).

The Vehicle

The iShares S&P SmallCap 600 ETF holds (unsurprisingly) [600 stocks], the bulk of which weigh in (also unsurprisingly) on the smaller side. With more uncertainty here regarding earnings than at larger companies, but also the potential for greater earnings growth, small caps are typically more expensive on a price-to-earnings basis than large companies (except when small caps are in a bear market), and that's true today. As of April 29, iShares puts the average P/E of the stocks in this index at a lofty 25 (the current average for the S&P 500 is just 16). In fact, plenty of companies in the SmallCap 600 don't enjoy any earnings at all — but that said, we're shorting the index as a hedge against a market decline in general, not pointing fingers at ugly businesses.

How to Follow Along

You set up a synthetic short by writing naked calls and using the proceeds to buy puts. (You can learn much more in our [strategy guide].) For every naked call you write, you're effectively shorting $7,500 worth of this index. **If this is too rich for your portfolio, don't place this trade.** At our strike prices ($75 for the calls, $71 for the puts), this position won't end better than breakeven unless the index falls at least 3.7% and will turn unprofitable if the index gains 2%. However, the short protects more of our portfolio against a large market decline (say, 5%, 10% or more), which is the goal.

To set up the trade:

- **"Sell to open"** August 2011 $75 calls
- **"Buy to open"** August 2011 $71 puts
- **Net cost to set up the trade:** As close to $0 as possible — possibly even a net credit
- **Allocation:** Set up one synthetic short (one contract of each option) for every $7,500 worth of the index you wish to short.

The *Pro* Bottom Line

This strategy has little or no out-of-pocket cost (only the margin necessary to write naked calls). It will be profitable for us if there's a modest to meaningful decline in the small-cap stock index between now and the Aug. 20 options expiration.

Alternative Trades

- Instead of setting up the synthetic short, you could just write naked calls if you want to be a little defensive but aren't very bearish. If you do, realize that this is a short with limited upside (just what the calls pay you) and unlimited risk.
- You might only buy the puts (or similar puts) if you're bearish, don't mind the cost, and don't want to short naked calls.
- You could short the ETF directly if you don't wish to use options and want more short exposure. Realize it pays a 0.9% dividend.
- Hold tight and do nothing if you have ample cash and don't feel a need to short.

Next Steps

- Questions or comments? Visit our iPath SmallCap S&P 600 discussion board.
- Track IJR in My Scorecard.

Pro *will write naked calls and buy puts on the iShares S&P SmallCap 600 ETF in the next one to 30 days, per The Motley Fool's trading policy. Jeff owns shares of 3D Systems and Tupperware. You can see* Pro*'s holdings on our Recommendations page.*

Audio Extra: Pro Talks TUP, AFSI, and WFC

Published May 27, 2011 at 12:00AM

Join advisor Jeff Fischer and *Pro* analysts Nick Crow and Bryan Hinmon as they talk about three *Pro* stocks: **Tupperware**, **AmTrust Financial Services**, and **Wells Fargo**. They discuss what makes Tupperware special, how AmTrust plans to continue to grow, and why they expect Wells Fargo to create shareholder value.

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Charter and 2011 Portfolios: Buy Pebblebrook Hotel Trust

Published May 26, 2011 at 12:00AM

At a Glance

- **Action:** Buying a 2% allocation in Pebblebrook Hotel Trust.
- **Current price:** $21.03
- **Buy around:** $21.50 **(use a limit order)**
- **Fair-value estimate:** $35
- **Why buy:**
    a. Desperate sellers are leading to great deals on hotels right now.
    b. We get to piggyback on an industry veteran's opportunistic purchases.
    c. A rising yield should mean either a rising stock price or fat dividend checks.
- **Alternative Trades:** None.

I had to sell my car before I left for college, and to minimize my vehicular downtime, I waited until the last minute. With a week to go, I desperately listed the car on eBay, and much to my relief, an out-of-state buyer quickly expressed interest. When the fellow flew in to close the deal, though, my relief turned to horror: He was a used-car dealer prepared to nickel-and-dime me to the bitter end. With no leverage (I *had* to sell this car before I left), I was forced to accept a price I didn't like while the buyer made out like a bandit.

Use a Limit Order

This stock is thinly traded, so **make sure you use a limit order on this trade**, Fools.

First Things First

- **Company:** Pebblebrook Hotel Trust
- **Market cap:** $1.1 billion
- **Website:** www.pebblebrookhotels.com
- **Type of holding:** Real estate; distressed assets
- **Follow it:** Add PEB to My Scorecard

I learned a valuable investing lesson that day: The best time to buy is when the seller has no choice but to sell. Today, we have a chance to put my extracurricular education to work with **Pebblebrook Hotel Trust** (NYSE: PEB), a REIT that's buying upscale hotels from distressed sellers on the cheap.

You Can Check Out Anytime You Like ...

Remember 2005, when everyone and their grandma was suddenly a real estate expert? The same thing happened in hotels, as industry laypeople — in this case private equity firms, sovereign wealth funds, and the like — woke up thinking they knew how to invest in hotels. These newcomers fueled a tremendous spike in the value of hotels changing hands: 2007 deals reached $45 billion, 10 times the amount of just five years earlier. But when the real estate market crashed and occupancy rates kept dropping, those brand-new hotel owners began to wish they hadn't taken out such big loans to buy their properties. And just as their interest payments began to look insurmountable, the liquidity in the hotel market vanished, leaving our speculative hoteliers high and dry.

Then came the storm. The hotel loans began coming due in 2010, and many poorly performing hotels simply haven't generated enough cash to pay them off. Refinancing isn't an option (banks have their eyes wide open about real estate risks these days), and the commercial mortgage-backed security market, historically a go-to hotel financing source, barely exists right now. Many hotel owners are left like me the day before college, with only one choice: to sell for whatever they can get.

Let's Be the Buyer This Time

An abundance of desperate hotel sellers can lead to opportunistic deals aplenty for a savvy buyer. That's exactly what we have in Jon Bortz, the hotel industry veteran who came out of retirement to launch Pebblebrook Hotel Trust and get in on the fun. Pebblebrook's modus operandi is simple: The company buys upscale hotels in major coastal U.S. cities as cheaply as it can. Bortz focuses on these upscale, urban properties because they're hit hardest in recessions but bounce back the fastest and perform the best in good times. And since the U.S. economy is just coming off record lows, this is the place to be.

Pebblebrook has four ways of creating value for shareholders:

1. **Buy without the debt.** Pebblebrook buys the hotel itself, not the company that previously owned it, so it acquires the properties without any of the accompanying debt. Sometimes it's as easy as that, as with the Doubletree Bethesda (not too far from Fool HQ), which was making interest payments four times the size of its operating income. The moment Pebblebrook signed the purchase papers, the debt was wiped away and the hotel was instantly profitable.

2. **Buy at a discount.** Bortz has plenty of cash and lots of hotels to choose from (Pebblebrook's CFO told me the company evaluated more than 100 properties last year). Meanwhile, the seller on the other side of the table might be underwater on a loan and desperate to sell before the bank forecloses on the property. The result is spectacular deals, with Pebblebrook picking up hotels at an average 10% to 15% discount to their replacement value.
3. **Economic recovery.** Hotel profitability correlates strongly with general economic growth, and hotel fundamentals are bouncing back, with industry average revenue per room jumping by 5.6% in the first quarter of 2011. An improving economy will make the purchase prices of Pebblebrook's hotels seem even cheaper as the company is able to raise rates and bring in more cash.
4. **Operational improvements.** Before handing off the day-to-day operations to a management company, Pebblebrook puts its new hotels through the hotel equivalent of fraternity initiation, sending in specialized teams (a food and beverage team, for example) to wring out inefficiencies. Bortz doesn't make new purchases based on potential improvements, but sometimes the company finds gold under the pillows: At the Sir Francis Drake hotel, the teams were able to realize a quarter of a million dollars in annual savings.

Financials and Valuation

Simply put, Pebblebrook's financials are a disaster. The company bought its first hotel in June 2010, meaning it hasn't quite been a full year since any of its properties came under the Pebblebrook umbrella — so year-over-year comparisons are impossible and quarterly comparisons close to meaningless. Further, many of the newly acquired hotels need some love (hotel owners underwater on their mortgages rarely devote cash to upkeep), so the capital expenditures for the first three to 15 months after buying each hotel aren't representative of their levels going forward. The bottom line is this: Unless an investor is willing to do a ton of homework, he or she will woefully lowball Pebblebrook's true worth.

And what is that true worth? If you take the value of all of the company's hotels, add its remaining cash, and subtract debt, you get $19.84 per share. Of course, hotels are businesses that generate cash flow. But even leaving that out of it, those calculations mean that if the company were to liquidate tomorrow, the stock's value would be just 5% below today's price. That's not much of a downside.

On the upside, keep in mind that since REITs pay out almost all of their income as dividends, they often end up priced based on yield, like bonds. Once Pebblebrook invests all of its currently available capital, which I think will happen by the end of 2012, I estimate the company will have the capacity to pay $1.48 to $1.62 per share in dividends. Based on average hotel REIT yields, that would imply a share price in the low $40s, which discounted back to today gives a fair value of about $35. And here's the best part: If the market doesn't bid up the shares as the dividend increases, we could find ourselves receiving 7% dividend checks (at today's prices) within a couple of years.

What Would Make Us Sell

This investment relies heavily on two things: the availability of great deals and the guy who closes on them. If the stock appreciates toward our fair value and the hotel deal pipeline dries up, we'll move on. And if Jon Bortz checks out, we likely will, too.

The *Pro* Bottom Line

Next Steps

- Add Pebblebrook to My Scorecard.
- Talk about this trade on *Pro*'s Pebblebrook discussion board.

Hotel deals abound for savvy buyers, but you and I can't go out and make them (what do I know about running a hotel?). Pebblebrook allows us to take advantage of this situation without having to take on a second job at the concierge desk. With shares trading well below fair value and a clear dividend path to getting them there, we're going to book a few rooms and stay awhile.

Alex and The Motley Fool own shares of Pebblebrook Hotel Trust. See Motley Fool Pro*'s holdings on our recommendations page.*

Charter Portfolio: Sell SPDR KBW Regional Banking ETF

Published May 24, 2011 at 12:00AM

At a Glance

- **Action:** Selling all shares
- **Recent Price (5/24/2011):** $25.22
- **Why Sell:**
  - By selling a lower-conviction holding, we can raise cash to put to work elsewhere.
  - The level of uncertainty in the banking industry is not improving as much as we expected, and small banks like those tracked by this ETF are seeing fewer benefits than the giants.
  - As community banks continue to languish, we prefer to concentrate our exposure to the sector in one large, leading bank: **Wells Fargo** (NYSE: WFC).
- **Alternative trade:** Write June $25 covered calls to facilitate a sale. Write ("sell to open") one call for every 100 shares you own. If the stock's price is higher than $25 when the options expire June 18, your shares will be sold at that price, plus the $0.60 per share the calls pay today.

What's Changed?

The sleepy **SPDR KBW Regional Banking** (NYSEMKT: KRE) ETF has barely changed since *Pro* first purchased it a year ago. Its 50 banks continue to look cheap on a historical basis, trading at an average of 1.3 times book value (up from 1.1 when we first bought shares, and still well below the 1.7 to 1.8 multiple they fetched before the financial crisis). Other key ratios, like net interest margin (up to 3.8% from 3.7%) and return on equity (a meager 5.3%), are largely unchanged as well. Demand for loans has remained low, and an increase in that demand is the only thing that can drive small banks like these to a higher return on equity and thus a higher multiple to book value.

What *has* changed in the meantime is *Pro*'s Charter Portfolio. We now own shares of Wells Fargo, and our exposure to the financial sector has also grown through the price appreciation of earlier purchases **AmTrust Financial Services** (NASDAQ: AFSI) and **Jack Henry** (NASDAQ: JKHY). We continue to have hope for **Broadridge Financial** (NYSE: BR), as well. Given this ample exposure to the sector, selling SPDR KBW is a prudent way to raise cash that can be put to better use in higher-conviction ideas.

The banking industry will probably face an improving — but still challenging — lending environment throughout this year and next. In Wells Fargo, we're confident that we've backed a leader that should gain market share as the industry recovers, so we can say a peaceful goodbye to the smaller players that make up SPDR KBW. To demonstrate, let's compare the two (using the same ratios that were well-covered in SPDR KBW's original recommendation):

Wells Fargo vs. SPDR KBW

Investment	Price-to-Book Ratio	Return on Equity	Dividend Yield	Tier 1 Capital	Net Interest Margin	Non-Performing Loans
Wells Fargo	1.2	11%	1.7%	11.5%	4.3%	3.3%
SPDR KBW	1.3	5.3%	1.9%	13.8% (20 of 50 reporting)	3.8%	2.3% (24 of 50 reporting)

Data as of May 13. Source: CapitalIQ, a division of Standard & Poor's.

How to Follow Along

We'll be selling all of our shares in the next one to 30 days. If you own shares, we recommend you sell them, as well, using a limit order at your desired sell price. At the time of publication, selling would net us a small profit — one we can add to the dividends we received from SPDR KBW over the past year, solidifying our profit. Be disciplined, however; there's no impending reason to rush for the exit, so take care to get the price you want. To discuss this trade, please visit the SPDR KBW Regional Banking discussion board.

Pro *will make this trade sometime in the next one to 30 days. See our holdings on our Recommendations page.*

Wobbly Market Ahead?

Published May 23, 2011 at 12:00AM

When the stock market is rising, many of us look at our portfolios and feel a sense of control. We think we've made good choices that are playing out well, resulting in profits. (We might say, "I rock! I need to keep investing this way.") And when the market is tumbling, we look at our shrinking portfolios and start to question what we've done, wondering whether bad decisions are behind the losses. ("Am I losing control?")

Kick Back in the Hammock ...

... next Monday for Memorial Day! Your next *Pro* Memo will be published Tuesday, May 31. Have a wonderful holiday!

Guidance Updates

- **AmTrust Financial Services** moves down to Buy on valuation.
- **Tupperware** moves down to Hold on valuation.

Upcoming Earnings

- **Medtronic**: May 24

Coverage and Community

- BrokeintheBurgh's son posts his analysis of **Contango Oil & Gas**. This 16-year old has chops!
- 4wheelfool works in the industry, so he explains just what **Ebix** does. Meanwhile, stamleo shares a summary of the conference call.
- IMWINN points out that **Broadridge Financial Services** is a bit below $22.50; *Pro* explains why options aren't usually exercised until expiration.
- Capitalappreciat asks if *Pro* would consider **Altria Group**.
- Alex340 posts put options that match *Pro's* general criteria (note that some stocks listed are no longer in *Pro*).
- TMFEldrehad tackles some interesting CAPS blogs, including silver, Mexico and politics.

In either case, little has generally changed except the mood of the market. You probably own the very same stocks in both scenarios — ones you liked initially, but then started to question without any good reason as prices slipped. But we don't have to fall victim to Wall Street's mercurial whims. The best investors *know* they don't have control over share prices — ever. So they don't celebrate quick gains any more than they blame themselves for quick declines.

Instead, the Warren Buffetts (and *Pro* members) of the world buy stakes in companies that are delivering growing free cash flow to shareholders in the form of higher earnings, dividends, and share buybacks, and through simple business growth. We don't buy slips of paper that change in price by the hour. We buy partial ownership in living, breathing organizations. And we know that we can't control a stock's price on any given day, week, or month — but we can control the prices at which we buy and sell.

As we described in a recent Monday Memo, for each company we recommend, we suggest a "buy around" price that's less than our estimate of fair value. We buy at these discounted prices in hopes that we can stack the eventual results far in our favor. From our fair-value estimate, we expect a typical stock we recommend to provide an annualized return of at least 9% to 11%.

And when do we sell? In most cases, when a company has risen about 10% to 20% above our fair-value estimate, it's essentially a year or two ahead of itself. In that case, the potential rewards may not be worth the potential risks any longer, so we'll consider selling. We'll sell in other situations, too (our thesis isn't playing out; we've found something better; we want to be defensive), but in most cases, fair value guides us.

But We're About More

What I've described above is fundamentals-based, valuation-based investing. We know it works over the years.

But *Pro* is about more than that. As a member of this service, you're also here to sell short, use sensible options strategies, and produce regular income with high accuracy. When we combine these approaches with our long-term stock investments, we believe we have the best of all investing worlds.

The market has been steadily rising for the past few months, so some of our more defensive tactics have lain dormant (thankfully), usurped for the time being by a buy-and-hold approach. But other times, we'll need to work harder than that to make the kind of profits we aim for. As the government's various stimulus programs slowly wane, we may be entering a tougher investing environment over the coming months and years, and I want to start putting more of our strategies to good use again.

Of course, the government may have still more monetary tricks up its sleeve. But sooner or later, the stock market must stand on its own, and like a toddler, it's likely to wobble at first. That's where *Pro*'s multifaceted approach can return in full Technicolor. Ideally, our tactics will help you profit in various environments, but keep in mind that dipping prices do *not* mean your stock investments are no longer sound. Those living, breathing companies you bought haven't stopped creating free cash flow overnight; a falling price simply means that nervous investors are selling.

Few of us enjoy watching our shares decline, but volatility is a given on Wall Street — and to those of us who keep our eyes open, it brings new opportunities for profit. Meanwhile, we'll work to create profits during dips, too.

Fool on,

Jeff (TMFFischer)

Jeff owns shares of AmTrust, Ebix, and Tupperware. See Motley Fool Pro'*s holdings on our Recommendations page*.

Charter and 2011 Portfolios: Write Puts on Broadridge Financial Solutions

Published May 17, 2011 at 12:00AM

First Things First

- **Company: Broadridge Financial Solutions** (NYSE: BR)
- **Market cap:** $2.8 billion
- **Website:** www.broadridge.com
- **Type of holding:** Long-term, information technology
- **Strategy:** Guide to Writing Puts
- **Follow It:** Add BR to My Scorecard

At a Glance

- **Action:**Write ("sell to open") September 2011 $22.50 puts
  - 1% for *Pro*'s Charter Portfolio (for 3% total); seven contracts
  - 3% for *Pro*'s Portfolio 2011; three contracts
- **Recent options price (bid/ask):** $1.45/$1.70
- **Preferred price:** Use a limit order at the mid price, but don't go lower than $1.35 (for a 6% yield in four months)
- **Stock fair value:** $27.50
- **Alternative trades:**
  - For Charter Portfolio, buy an additional 1% position in the stock outright (our Buy Around price is $23).
  - For Portfolio 2011, buy a 3% position in the stock outright.
- **Why write puts?**
  - Broadridge has a dominant position in investor communications and is becoming a go-to provider for outsourced securities processing.
  - The company earns stable revenue thanks to recurring communication schedules and multiyear contracts.
  - Sluggishness in the company's event-driven segment is masking progress in new, higher-growth business lines.

What's New?

Shares of our favorite proxy manager and securities processor, **Broadridge Financial Solutions** (NYSE: BR), haven't done much lately. The market voted "nay" on the company's second-quarter earnings back in February as management lowered fiscal 2011 earnings targets by 15.6%. Although third-quarter earnings provided investors a bit of reassurance, the lack of event-driven mutual fund communications has caused the first nine months of the fiscal year to be a rough period for Broadridge. But we don't think the event-driven business is dead and gone — we just think it ebbs and flows, and we're in a serious ebb right now. Still, the company's earnings power remains strong, and cash flow is robust.

Additionally, we've become more confident in the growth of Broadridge's securities processing segment. During the second quarter, an as-yet-unidentified global bank decided to outsource its securities processing duties to Broadridge. The contract is the largest and most profitable one Broadridge has ever won and affirms the value that financial institutions see in outsourcing their mundane but mission-critical tasks. Contract wins such as this recent one, combined with the company's 99% client-retention rate (read: happiness quotient), should provide firepower when Broadridge's sales force sits on the business end of the mahogany desk at the next big bank.

The company's most recent deal, an agreement to distribute sales-reporting data to the hundreds of fund clients of **Charles Schwab** (NYSE: SCHW), could open the door for additional high-margin recurring revenue as those clients demand additional data reports. Broadridge is uniquely positioned to provide this data, and it represents a deepening of the relationship between Broadridge and mutual fund families.

Why This Strategy?

You need options approval to write puts, and the trade command is "sell to open" or "sell." (*Do not buy these options!*) Sell one contract for every 100 shares of Broadridge you're willing to purchase later (each contract represents an obligation to buy 100 shares, or $2,250 worth of Broadridge stock). Writing these options will "pay" you the option premium up front, and then we'll wait until expiration on Sept. 16 to know our next move.

About This Trade

Fools with a discerning eye may notice that the puts we're writing are in-the-money, meaning that the current stock price ($22.42) is below the strike price ($22.50) of the put options we're selling. Given the sleepy nature of Broadridge's stock and the wide strike-price availability, we're able to get healthy option premiums by writing our options so close to the money. The cost of doing so is that we're highly likely to be assigned shares, but given our view on Broadridge stock and the net purchase price of these additional shares, we feel the risk is justified.

Our initial potential profit is whatever the puts pay us (the options are bid $1.45); we have an obligation to purchase shares of the stock if they fall below the $22.50 strike price by expiration and we don't adjust our trade. If we get shares, our net start price will be around $21.05 (we buy our shares at $22.50, but still keep the $1.45 the puts pay us). Because we fully intend to take share ownership if assigned the shares in September, make sure you have $2,250 per contract available to purchase shares. Otherwise, just buy Broadridge shares in the suggested allocation (1% for Charter and 3% for Portfolio 2011) per the alternative trade.

How to Follow Along

You can simply buy shares if you prefer, but we're cheapskates and want to earn income while we wait to buy shares closer to $21. If converted into shares, these puts would allow us to buy shares about 6% cheaper than the recent price and at just 14 times average free cash flow. If the shares remain above $22.50 at expiration, we won't get to buy shares, but we'll earn a decent return on this trade and look to write puts again.

Next Steps

- Questions or comments? Still getting used to all this options jargon? Visit our Broadridge board.
- Stoked to learn more about writing put options? Head over to the All About Options board.

Pro Charter Portfolio and Portfolio 2011 will write puts on Broadridge in the next one to 30 days, per The Motley Fool's trading guidelines.

See Motley Fool Pro's *holdings on our Recommendations page.*

*See*Motley Fool Pro'*s holdings on our Recommendations page.*

Staying on Top of 3D Systems and Ebix

Published May 16, 2011 at 12:00AM

Cancel Your *Pro* Membership!

This week only, The Motley Fool is asking you to "give up" your *Motley Fool Pro* membership. And you'll never receive another invitation from us again. Here's why: For a few days only, you can apply your current membership fees to the one service that offers everything you'll ever need as an investor — including uninterrupted, full access to *Motley Fool Pro* and *Motley Fool Options*! *Motley Fool Duke Street* is our response to the No. 1 request we receive from you and your fellow members. If you're interested, please click here to go to dukestreet.fool.com.

Dear Fellow Fools,

Two of our stocks recently suffered bruising declines — **3D Systems** and **Ebix** — so let's take a renewed look at both.

When any of our stocks fall by 5% to 15% without news, it usually doesn't mean much. Fickle market volatility of this nature will correct itself if we're buying good companies at good prices. But when a position falls by 20% or more, we automatically take a new look to make sure we're not missing something, our estimates are reasonable, and we've roundly considered the risks. If the stock in question is trading far below our fair value estimate, we look especially hard, because such a sizeable discrepancy suggests either that we're seeing something the market isn't, or we're missing something.

Upon making these reviews, we need to decide whether we want to use the opportunity to buy more, just sit tight, or find our error and sell.

3D Systems Flattened

In barely a month, 3D Systems has declined by 25% from our purchase price, more than that for many members. Recently at $37, the stock trades at a 47% discount to our fair value estimate, so either something is amiss with our analysis or Wall Street is badly mispricing the company. We believe it's the latter. Wall Street appears to be punishing 3D Systems for a quarter that merely *met* expectations, and for *growing* the operating margin, but at a rate that didn't meet some analysts' high expectations.

Before making too much of the stock's recent spelunking, though, we must acknowledge that this is a volatile stock. Over the past 52 weeks, shares remain up by more than 140%. Of course, we would like to have discovered 3D Systems earlier, but its recent ascent, rather than scaring us off, suggests to us that other investors have been seeing the same thing we are: a company with excellent long-term potential, still selling at a discount to that potential.

Today, 3D Systems trades at 19.9 times earnings estimates for 2012, with earnings expected to grow by 66% this year and 36% in 2012. In addition, the company's steady stream of small acquisitions adds extra upside potential to earnings. On a measurement we like better, the stock trades at a reasonable 36 times trailing free cash flow — a reasonable number, given how strongly free cash flow should compound from today's small starting base.

The long-term potential is what truly attracts us to this investment. The company is valued at less than $1 billion, although in 10 years or less, if it maintains a market value north of 5 times sales as margins expand, we could come to own a $3 billion business, for a clean triple. In other words, 3D Systems' $176 million in annual revenue could expand this decade to $500 million as more and more large companies and industries move to 3D prototyping and manufacturing.

We started with a partial position (3%), and patience and study have kept us from adding to it. **But for new investors, we're moving 3D Systems up to Buy First** because of its cheaper valuation and long-term potential. Buy only if you can own it for years (although we may eventually use options, too) and you don't mind volatility. In the housekeeping department, 3D Systems will split its stock 2-for-1 on May 19, so when you wake up that day, you'll own two shares instead of one, each at half the previous price. The company is also moving its listing to the New York Stock Exchange on May 26, with the new ticker symbol of DDD. It's switching to the granddaddy of the U.S. exchanges in hopes of generating more worldwide visibility and respect. That same day, 3D Systems is holding an investor conference in the Big Apple. *Pro* will cover it for you.

Flummoxed by Ebix

Our early days with Ebix in *Pro*'s Charter Portfolio remind me of our start with 3D Systems. Soon after our purchase, Ebix fell through the floor (a rare event for a *Pro* stock), and some investors wondered whether we'd made a grave error. We bought more after it declined. Hardly a year later, shares were hitting new highs, we had a 70% gain, and it seemed that we were vindicated for sticking to the financials and ignoring less-than-flattering rumors about Ebix's accounting and tax treatment (you can read more here).

Alas, since March, the stock has lost a third of its value as rumors and short sellers haunt it again, and we're back to about breakeven. If we saw a good reason for the decline, it might not be as frustrating, but no relevant news has come from Ebix — just another healthy earnings report.

Putting aside the qualitative argument that Ebix has a CEO who's difficult to pin down, on quantitative measures the business looks healthy and inexpensive. Shares trade at 14.6 times free cash flow, 13.3 times estimated earnings for 2011, and 300 times our patented "What the Heck?" index. Recent financials, which I'm still going through, don't raise obvious red flags. **Ebix remains on Hold** for now, but when we emerge from our analysis, we need to decide whether the stock still belongs in the Charter Portfolio. If so, we'll seek to buy it in Portfolio 2011, too. Stay tuned.

What's Your Take?

For general questions or comments, visit our Memo Musings board. Want to chime in on 3D Systems or Ebix? Click on the company names.

Foolishly,

Jeff (TMFFischer)

See Motley Fool Pro'*s holdings on our Recommendations page. Jeff owns shares of Ebix and 3D Systems and has options on 3D Systems.*

Guidance Changes

- **3D Systems** moves up to Buy First on price.
- **SPDR KBW Regional Banking** ETF and **Sprott Physical Gold Trust** move down to Hold pending portfolio management decisions.

Options Expirations on May 21

- **Both Portfolios:** Written puts on **Rockwood Holdings**, naked calls on **iPath S&P 500 VIX Short-Term Futures**, and covered calls on **ProShares Short S&P 500 ETF** are all set to expire as full cash gains. No action is needed by you. Happy with the income, we're looking to initiate new positions, and we'll issue trade alerts if we do.
- **Charter Portfolio only:** Written puts on **Plum Creek Timber** are set to expire as a full cash gain.
- **Portfolio 2011 only:** Written puts on **GlaxoSmithKline** are due to expire as a full cash gain.

Coverage and Community

- New *Pro* analyst Alex Pape (TMFPapester) jumps right in with analysis of results from **Contango Oil & Gas**.
- Buy First stock **AmTrust Financial Services** is scoring new highs. We have a summary of strong first quarter results.
- Bryan (TMF42) tackles quarterly results at sleepy (so far) **Broadridge Financial Solutions**.
- *Pro* member Wrenchbender57 asks where to find free cash flow. Bryan (TMF42) points him to a source.
- Lately $98, is oil's fair value only $60 per barrel? Fools discuss the claim that comes from ... Exxon Mobil.
- Russell (TMFEldrehad) has the weekly scoop on CAPs.
- Jeff (TMFFischer) dedicates his work to his dad.

See Motley Fool Pro'*s holdings on our Recommendations page. Jeff has options on Rockwood Holdings, is short iPath S&P 500 VIX Short-Term Futures, and owns shares of GlaxoSmithKline and AmTrust Financial Services.*

Wherefore Art Thou, Fair Value?

Published May 9, 2011 at 12:00AM

At *Pro*, we concentrate on bringing two vitally important features to you, our members: profitable investment ideas and clear guidance. We know that either one is all but useless without the other. Today, we want to focus on the latter aspect of our mission, explaining once and for all what we mean by "fair value," "buy around," and other key terms with starring roles in our recommendation alerts and on our Portfolio pages.

Cancel Your *Pro* Membership!

On Tuesday, May 17, 2011, The Motley Fool will ask you to "give up" your *Motley Fool Pro* membership. And you'll never receive another invitation from us again. Here's why: For a few days only, you can apply your current membership fees to the one service that offers everything you'll ever need as an investor — including uninterrupted, full access to *Motley Fool Pro* and *Motley Fool Options*! *Motley Fool Duke Street* is our response to the No. 1 request we receive from you and your fellow members. If you're interested, please click here to go to dukestreet.fool.com.

Fair-Value Estimate

I'm beginning to believe that we should call this a "fair-price" estimate, because too many investors read "fair value" to mean "*full* value," and that certainly isn't true. A fair value means a fair price — for a seller *and* a buyer. When a stock reaches fair value, it's trading at a level that should provide our desired rate of return (usually 9% to 11% or more annualized, depending on the risk involved) if all goes well.

So why do so many people *sell* at fair value? The argument is that a fairly valued stock no longer has a "margin of safety." Since the stock doesn't trade at a discount any longer, any missteps by the company could result in a haircut for the share price. Investors will also sell a stock that has reached its fair value so they can buy a new stock that's currently at a discount. This is how "fair value" has come to mean "sell price" in many investing circles.

That's not often the case at *Pro*. If we buy a stock at a healthy discount and it rises to our fair-value estimate (as with **Oracle**, for example), we read that gain in price to mean that our analysis was on the mark — we accurately identified an undervalued stock. We then double-check to make sure the stock could continue to reward investors. We may just be starting our long partnership with a stock when it reaches fair value — it could still bring us steady returns on an annualized basis from then on. We'll also consider options strategies to complement returns on fairly valued holdings.

But not all "fairly valued" stocks will stay in our portfolio. When we see a discounted stock worth buying and need cash to do so, we will sell our least favorite stocks that are at or above fair value. Or, if we want to get more defensive, we'll sell some shares near fair value. Whatever the situation, though, remember that fair value doesn't mean full value. It means *fair* — and we'll keep holding as long as we believe there's steady upside potential.

Buy-Around Price

If we believe a stock has especially low risks involved, our buy-around price may actually be close to the stock's fair-value estimate, as was the case with utility leader **NextEra Energy**. Over most of its history with *Pro*, the stock had a buy-around price of $52 and a fair-value estimate of $55. We were comfortable with only a 5% or so "margin of safety" (discount to fair value) because we believed the downside risk was modest.

Contrast that with **Rockwood Holdings**, which had an original buy-around price of $43.50 and a fair value of $56. We advised you to buy that stock at a 22% discount to fair value because it's a younger business that's new to us and thus may pose more risks. However, as we see Rockwood pay down its debt and strongly improve its operations, we are more comfortable buying closer to fair value. (See below for our updated price guidance on Rockwood and other stocks.)

We suggest buy-around prices to you as a way to manage risk. If you only buy stocks at a discount to fair value, your risk should be lower in good markets and bad. Keep in mind, though, that this guidance is flexible; if you buy within 5% to 8% (roughly) of the price we recommend, you should be capturing the favorable risk-to-reward outcome we always seek for you.

Always try to buy stocks as cheaply as possible, of course, but don't risk missing out on a healthy investment because you insist on buying 5% cheaper. Look at our fair-value estimate as your barometer: You can still expect a healthy return even from a fairly valued stock, but it has little room for error, so risks may be higher. As always, average in over time, consider options strategies to get a lower price, and buy companies that really interest you — ones you want to own and keep learning more about with us.

Limit Orders

In most cases, we suggest using limit orders to make a purchase (or a sale). This is partly to keep market makers from taking advantage of you and filling your order at a suboptimal price, and partly to help ensure we *Pro* members don't all trample in at once and make pricing worse for everyone. Even if you want to buy a stock around current market prices, use a limit order at those prices so you don't get a "bad fill."

Guidance Summed Up

- **Fair Value:** The price from which to expect your desired annualized return (usually at least 9% to 11% for us, dividends included).
- **Margin of Safety:** The difference between the current share price and the fair-value estimate — if a stock is below fair value, it's said to have a margin of safety.
- **Buy Around:** Our rough guidance of where to buy a stock (within 5% to 8% of this price); the more defensive we want to be, the lower our buy-around price in relation to our fair-value estimate. If we see very low risk in a position, we may even advise that you buy near fair value.
- **Limit Orders:** Generally, use limit orders to assure you get a decent price, even if it's the market price at the time.

Please read below for important news about the introduction of a new *Pro* team member, Alex Pape, and our guidance changes. Questions or comments? Visit the Memo Musings board.

Foolishly,

Jeff Fischer (TMFFischer)

Welcome Analyst Alex Pape!

Since joining the Fool through its highly selective Analyst Development Program, analyst **Alex Pape** (TMFPapester) has delivered value with winning ideas in *Special Ops*, *Income Investor*, and *Million Dollar Portfolio*. Today, we're excited to welcome Alex as an analyst exclusively on *Motley Fool Pro* and *Motley Fool Options*. Alex is at heart a value investor with a soft spot for investments with identifiable catalysts, and we're confident he'll bring interesting, profitable new ideas to the forefront for members.

At the same time, we wish Andrew Sullivan (TMFRedwood) all the best as he leaves The Motley Fool to travel the Far East before moving out west. We know he'll enjoy the adventures of travel and his life in a new location, but we'll miss Andrew and thank him for his great work here. (Every *Pro* investment is followed by at least two team members, so there will be no interruption in coverage.) To welcome Alex and bid Andrew farewell, please visit our Meet & Greet board.

Coverage and Guidance Updates

- **GrafTech International**: As the newly merged business begins to show its promise, our fair value rises from $21 to $25 and our buy-around price from $17.50 to $19 (writing $20 puts is possible).
- **Jack Henry**: The business continues to grow as it digests acquisitions. Shares remain on hold.
- **NextEra Energy**: Stabilizing results in Florida and continued improvements in its unregulated segments increase the standing of this green utility leader. We're raising our fair-value estimate from $55 to $58 and our buy-around price from $52 to $53.50 (writing $55 puts is possible).
- **Papa John's International**: A strong quarter is tempered by an outlook for rising food costs; our covered strangle remains our preferred strategy. No guidance change.
- **Rockwood Holdings**: Increased confidence in the business and its pricing power, as well as early repayment of debt, lead us to bump our buy-around guidance higher yet again, this time from $45 to $49 (fair value remains $56, and writing $50 puts is possible).
- Following these updates, Charter Port and Portfolio 2011 will consider new positions soon, so be on the lookout for upcoming official trades. Get all current buy-around and fair-value guidance on the Charter Portfolio page.

Community

- U.S. member Ron (asiatraveler) has moved to Thailand and checks in with the *Pro* community as he gets settled into his new home. Can other *Pro* members around Bangkok reach out to Ron and show him around?
- Member OrangeAndBlue asks how to protect a 401(k) from a downturn, and *Pro* members step up to help.
- It has been a little quiet lately as the *Pro* team works through earnings — member DolonAltekar asks what to expect next for Portfolio 2011, and Jeff chimes in.
- Jeff summarizes the CBOE Risk Management Conference he attended (this is Part One; more to come later).
- Russell (TMFEldrehad) takes a look at the "concentrated pick list" and its implications for CAPS.

Earnings Calendar

- **May 10**: **Broadridge Financial**, **Bristow Group**, **Contango Oil & Gas**, **Ebix**
- **May 11**: **Cisco Systems**

Jeff owns shares of Oracle and Ebix and has an options position on Rockwood Holdings.

Doing the Quarterly Shuffle

Published May 2, 2011 at 12:00AM

Attention Fools: Your *Pro* team will not be online this Thursday and Friday, May 5 and 6, as we attend our annual company meeting — what we Fools call Foolpalooza. We'll see you next Monday with your regularly scheduled Monday Memo.

Guidance Updates

- **Intel** moves down to Buy after a large price gain.
- **NextEra Energy** and **GlaxoSmithKline** move down to Hold on valuation.
- **3D Systems** , **Tupperware**, and **Rockwood Holdings** are still being evaluated after earnings.

Dear Fellow Fools,

The *Pro* team spends four months of every year going through our few dozen companies' quarterly earnings reports — as well as the earnings releases of the many other companies we're watching. It's a job in and of itself, with our typical review period stretching several days as we comb through SEC filings and conference call transcripts and dig for answers to new questions. Options prices often change after earnings reports are released and investors reassess a company's risks, so we review options chains to find new opportunities.

This is why, during earnings season, *Pro* goes relatively quiet while we put our heads down and work — but there's no way around this. Knowing our investments closely is key to our success.

Mind Your 10's and Q's

Public companies put their best faces forward when they issue quarterly press releases. To get the full picture, we need to weed through a company's SEC filing — better known as the 10-Q report.

All public U.S. companies are required to file 10-Q's within 40 to 45 days of the end of the fiscal quarter. Some companies make it easy, filing the 10-Q the same day as the earnings release — as **3D Systems** did last week. Others make you wait. Without seeing the 10-Q, we may be missing pertinent information, so we're not likely to raise our guidance for a company until we've studied its filing.

SEC reports give us financial information that we can't usually find in the press release. We analyze the cash flow statement and look for revealing footnotes tucked under the balance sheet or income statement. We also look for more details on debt and credit terms, stock grants, and upcoming share dilution. We compare the SEC filing with our own estimates for a company, making sure that the two are similar as a sign that our valuation isn't challenged.

Sometimes after particularly strong earnings news — as **Rockwood Holdings** had last week — members ask whether we'll raise our fair value estimate. Sometimes we will, but that's mainly because we're conservative with our fair value estimates to begin with. One quarter alone is rarely enough to increase a company's fair value (no matter what any Wall Street broker tells you). A discounted cash flow model aims to forecast a few decades of earnings, so it would take a big surprise to move a value range that already has a built-in margin for error.

If you want to review a company's 10-Q, bookmark this SEC page. Enter your company's name or ticker symbol, and you can check out the 10-Q and the mother of all reports — the annual 10-K. We spend a whole lot of time in 10-K land here at *Pro*.

We're on Call

Community & Coverage

- Jeff (TMFFischer) summarizes the results from **Rockwood Holdings**.
- Nick (TMFCrow) chops up recent numbers from **Plum Creek Timber**.
- Andrew (TMFRedwood) summarizes **3D Systems**' first quarter and reminds investors to be patient. Meanwhile, members actively discuss the company and its volatile stock.
- Member Angelstar888 joined *Pro* in January but is just getting started. Several members help him get the ball rolling.
- Another new member, trouttt, asks, "Should I still buy near fair value?" and Jeff responds. (Watch for an upcoming Memo all about this topic.)
- Some CAPS participants have picks that are highly concentrated in one industry. TMFEldrehad discusses the implications.

Another key part of *Pro*'s quarterly review involves going over the conference call that most management teams host immediately after reporting results. Here you can get candid answers and insights that aren't in the press release or the 10-Q filing. In fact, I'd say that conference calls tell me more about the state of the world economy than anything else because management teams at multinational businesses frequently discuss the economy as they see it region by region.

Most companies post audio replays of their conference calls on their investor relations website for weeks afterward. However, audio is a time-consuming way to review the call. We usually wait for the transcript of the conference call from Capital IQ (a service the Fool subscribes to), which usually posts it within a day or two. Going through the call point-by-point drives home our understanding of the situations a company faces. Analysts usually ask questions that dig into any concerns surrounding the company, and various mangers answer. Then, we summarize the conference calls for you on *Pro*'s company discussion boards (see our links to the side in each Monday Memo).

Conference calls also tell you about a company's culture. **Tupperware** and **Ebix** are run by CEOs who like to answer most questions — Ebix almost to a fault. At **Oracle**, CEO Larry Ellison plays a small but vocal role in most conference calls, making his points, but letting his management team answer most queries. The conference call is where we learned about Tupperware's plans to improve its situation in Japan and why it believes it has tremendous room to grow in emerging markets. We learned that **Intel**'s management team believes the PC corporate refresh cycle isn't even half over yet and that Ebix plans to launch software that integrates all of its offerings. We also learned that 3D Systems' management team believes the company is right on track.

Putting It All Together

Upcoming Earnings

- May 3: **AmTrust Financial Services**, **Jack Henry & Associates**, and **Papa John's International**

Each time a *Pro* company announces results, right after reading the press release, we scoot over to the SEC website for the full details in the 10-Q filing, review the conference call, and assimilate the new information (and, quarter by quarter, our knowledge grows). We compare all the financials in the SEC filing with our estimates to make sure we're still in the ballpark. This can take several days for each company, so we'll go where we're most needed — 3D Systems' stock has fallen every day since the company announced earnings last week, so that's where our focus is right now rather than on a company whose stock jumped after earnings, such as Tupperware or Rockwood.

As veteran *Pro* members know, depending on the quarter (did a lot of companies surprise us?), we'll issue a full quarterly update the month after earnings, updating all of our relevant holdings. Guidance changes also trickle in through every Monday Memo as stock prices make big moves (see our sidebar). Questions? Please visit the Memo

Musings board.

Foolishly,

Jeff Fischer

Jeff owns shares of AmTrust Financial, Intel, Tupperware, GlaxoSmithKline, Ebix, Oracle, and 3D Systems, and has options positions on Rockwood Holdings and 3D Systems.

Don't Fire Until You See the Whites of Their Eyes: Part 3

Published Apr 25, 2011 at 12:00AM

If you missed the first two parts of our Memo series on evaluating management, check out Part 1 on **TradeStation** and Part 2 on **Ebix**.

I sit next to *Pro* analyst Andrew Sullivan (TMFRedwood) every day, but I know next to nothing about his investment process. (We're usually too busy chatting about his international escapades to actually discuss important stuff like that.) So it was great to steal a few minutes of his time to learn how he evaluates management and what he looks for on company visits. Along the way, we talked about his recent sit-down with the brain trust at **3D Systems**, *Pro's* most recent new Buy recommendation.

Guidance Change

TradeStation , a stock in both our Charter and 2011 portfolios, is set to be acquired by **Monex**. We've moved it to Hold.

What to Look For: Sullivan-Style

Bryan Hinmon: I'll start with the same question I asked Fool.com analyst Eric Bleeker last week: What role does investigating a company's management play in your investment process?

Andrew Sullivan: It plays a huge role — management is an essential part of the investing process. Companies are collections of people working together to achieve goals; understanding people and culture opens a window into how successful the company will be. Management is important, but more so is the culture of the rank and file that drives the company.

BH: Have you ever been surprised by a culture during a company visit?

AS: Absolutely. Culture is almost impossible to understand unless you step foot in the offices and meet the people. One culture in particular surprised me: that of **PowerSecure International**, an energy-services company I've written about. After reading SEC filings and doing my research, I had a negative opinion about the company — I didn't like the rapid changes in its business units. But I decided to visit anyway.

My initial impression couldn't have been more wrong. During my visit, I saw that PowerSecure is essentially a company of entrepreneurs, and innovation courses through its corridors. Once I understood that, my qualms eased, and I became excited about PowerSource; companies like this are rare and can create tremendous value. Sometimes the surface (financials, reports, documents) looks unflattering, but under the surface (culture, innovation) lies a powerful engine. Those crucial, sub-surface ingredients didn't show up in any 10-K or proxy statement I read, but even if they did, I still wouldn't have known how real they are without seeing for myself.

BH: When you visit a company, what are you looking for?

AS: Every company's business, industry, and situation are so different that you can't compare them, but in general, I look for frugality, humility, and honesty in management. Another thing I'm on the lookout for is a sense of engagement in employees.

Upcoming Earnings

And they're off!

- **April 25: Plum Creek Timber**
- **April 26: Kinetic Concepts**
- **April 27: GlaxoSmithKline** , **Rockwood Holdings**, **Tupperware**, and **GrafTech International**
- **April 28: 3D Systems**
- **April 29: NextEra Energy**

BH: Both Eric and I have a few go-to questions we like to ask managers. Do you have any "can't-miss" questions?

AS: I always ask about the company's background. To understand where a company is going, you have to know where it has been and what it's capable of. Another question is what the CFO and CEO spend most of their time on — this gives you insight into short-term performance. Finally, I ask about the biggest challenges facing the company and, similarly, what its biggest competitive threats are. This helps me gauge how long a company's competitive edge will last.

Staring Into the Eyes of 3D Systems

BH: You recently met with the team at 3D Systems. How did management respond to your questions?

AS: First, I learned that 3D Systems invented the technology behind 3-D printing. Chuck Hull, who came up with the idea in 1986, founded the company and is still chief technology officer. Second, it was clear that management is spending a lot of time making 3-D printing accessible to the masses. The company is creating consumer-focused software and applications — sort of like an app store, if you will — for 3-D printing. The easier the company makes 3-D printing, the more the market will grow. 3D Systems' other priorities include expanding sales to the health-care market and making acquisitions, an area in which management is skilled. Lastly, on competition, I learned that the replacement materials for 3D Systems' printers are highly engineered, and this gave me confidence that the company can protect its competitive position for a good amount of time.

Community & Coverage

- Jeff (TMFFischer) digs into **Intel's** earnings and prints a fine (albeit 2-D) post on 3D Systems.
- Nick (TMFCrow) covers **Wells Fargo**'s latest earnings.
- Bryan (TMF42) explains why you shouldn't feel sorry for *Pro;* we signed up for this gig.
- In case you were wondering: How Bullish is the Pro?

BH: What were you able to learn that you hadn't known from simply reading up on the company?

AS: Honestly, I was lukewarm on the stock given its then-recent run-up, so I wasn't expecting to be excited. That opinion was reversed by a few factors. First, I discovered that the management team is a true gold mine. It's focused on business strategy, and I think it will guide the company in ways very rewarding to shareholders. I also learned that the company's growth is for real — it is on the cusp of something great. Finally, the people are very engaged; one new executive even relocated from San Francisco to 3D's headquarters in South Carolina because of the passion she feels for the company. So, the total experience was completely different than seeing the company on paper.

BH: But knowing you, I'm sure you've maintained a dose of skepticism. What should we look for to make sure the company is progressing as you expect?

AS: We need to watch sales growth and margin expansion. I'm confident in the company, but if growth isn't as strong as we think, it could affect 3D Systems' value.

The *Pro* Bottom Line

Andrew's final answer is a good takeaway for our three-part series: If the strategic direction and culture that management builds don't actually drive operational execution, we shouldn't care about management. So if you're taking the time to investigate the wizards behind the curtain, make sure you're also linking it all back to business performance. The jury is still out on 3D Systems, but Andrew sure likes what he sees.

Bryan Hinmon (TMF42)

Next Steps

- Have any interesting company culture stories? Share them on our Memo Musings discussion board.
- If you'd like to ask Andrew any questions about his visit to 3D Systems, give him a holler on the 3D Systems discussion board.
- Follow all our coverage of 3D Systems by adding it to My Scorecard.

Trade Roundup

Portfolio 2011

- **GrafTech International** : Wrote five September 2011 $17.50 puts for $0.75 each.

Andrew owns shares of PowerSecure International. Jeff owns shares of Intel. Nick owns shares of Wells Fargo.

Portfolio 2011: Write Puts on GrafTech International

Published Apr 20, 2011 at 12:00AM

First Things First

- **Company: GrafTech International**
- **Market cap:** $2.9 billion
- **Website:** www.graftech.com
- **Type of holding:** Long-term, industrials
- **Strategy:** See our guide to writing puts
- **Follow It:** Add GrafTech to My Scorecard

At a Glance

- **Action:** Write ("sell to open") September 2011 $17.50 puts
- **Allocation:** About 3% (for *Pro*'s Portfolio 2011, that's five contracts)
- **Stock price:** $20
- **Buy around:** $17.50
- **Option price (bid/ask):** $0.85/$1.25
- **Preferred price:** After reviewing prices, try a limit order of about $1 if feasible; as prices change, ideally accept no less than $0.80 (or 1% yield per month to expiration).
- **Why write puts?**
  - GrafTech is one of the leading manufacturers of graphite electrodes used to produce steel and has few competitors, but its stock trades a bit higher than where we'd like new buyers to jump in.
  - We expect electric arc furnace steel production (more on that later) to keep swiping market share from traditional steel-making methods, which should boost demand for GrafTech's products.
  - While we're waiting for a global economic recovery and infrastructure build-out, GrafTech is focused on constraining costs and investing in its less cyclical, growing, highly engineered business segment.

What's New?

Pro first recommended buying **GrafTech International** in our Charter Portfolio in December 2008. Since then, GrafTech has grown larger and bought out its leading supplier. For *Pro*'s most recent analysis, read our updated guidance.

Guidance for Charter Portfolio Members

The Charter Portfolio already has a full position in GrafTech (4.9%). If we choose to increase our target allocation, we'll let you know, but we're not taking new action in our Charter Portfolio at this time. However, if you're a veteran member who doesn't yet own shares or you're looking to own more, you can follow this trade alert for Portfolio 2011.

Why This Strategy?

When it comes to supporting global economic growth and infrastructure build-out (i.e., building bridges, rail lines, and the like), steel is a hot commodity. The most economical and energy-efficient way to melt steel is by using an electric arc furnace to melt scrap metal, which can then be formed, cooled, and used for all sorts of projects. GrafTech makes graphite electrodes, which serve as conductors of heat and electricity inside those furnaces. (We're talking extreme heat here: Temperatures reach half that of the sun!) In short, if you need steel, graphite electrodes are your friend, and GrafTech has 14% global market share selling them.

Plus, thanks to its April acquisition of Seadrift Coke, GrafTech now looks to be the low-cost leader in its industry. It has few competitors, and any company that wants to shoulder its way into this industry faces high barriers to entry, including cost, manufacturing knowhow, and the importance of long-term customer relationships — barriers that allow GrafTech to keep cranking out healthy (and growing) profits with relatively little interference from new competition. Combine these advantages with a straight-shooting long-tenured CEO and a healthy balance sheet, and we don't mind owning what others may consider to be a simple cyclical manufacturing firm.

As for growth, we expect global economic growth and infrastructure spending to increase eventually. Until then, GrafTech will continue to benefit as electric arc furnace production grabs market share from traditional steel production methods. Also, GrafTech's smaller segment, high-tech engineered solutions, has strong growth potential thanks to its exposure to expanding alternative energy and electronics markets.

How to Follow Along

We're looking to add shares of GrafTech near or below our $17.50 Buy Around price by writing puts. If shares don't drop below our strike price, we'll be patient and happily keep our option income. We think shares are reasonably valued at current prices, as reflected in our Hold rating. But at a net price around$16.50, we would want to scoop up shares to initiate a 3% (3.3% to be exact) position. If you can't write puts, sit tight and wait for an opportunity to buy shares outright near $17.50.

You need options approval to write puts, and the trade command is "sell to open" or "sell." (*Do not buy these options!*) Sell one contract for every 100 shares of GrafTech you're willing to purchase later. (Each contract represents an obligation to buy 100 shares, or $1,750 worth of GrafTech stock.) Writing these options will "pay" you the option premium up front; then we'll wait until expiration nears (on Sept. 17) to determine our next move.

Our initial potential profit is whatever the puts pay us; we have an obligation to buy shares of the stock if they fall below the $17.50 strike price by expiration. If we get shares, our net start price will be around $16.50. (We buy our shares at $17.50, but still keep the $1 or so the puts pay us.) Since we fully intend to take share ownership if assigned the shares in September, make sure you have $1,750 available, per the contract, to snap up shares.

Next Steps

- Questions or comments? Still getting used to all this options jargon? Visit our GrafTech discussion board.
- Stoked to learn more about writing put options? Head over to the All About Options board.
- Want to track GrafTech? Add it to My Scorecard.

Pro Portfolio 2011 will write puts on GrafTech in the next one to 30 days, per The Motley Fool's trading guidelines.

Don't Fire Until You See the Whites of Their Eyes: Part 2

Published Apr 18, 2011 at 12:00AM

In last week's Monday Memo, I wrote about taking tally of company management, how I've built that step into my investing process, and what I looked for and learned during my visit to **TradeStation Group**'s headquarters.

My process works for me, but it ain't for everyone. So I sat down with Fool.com tech guru Eric Bleeker to learn about his process and hear whether he uncovered any valuable information during the **Ebix** investor conference and his face-to-face chats with CEO Robin Raina and CFO Robert Kerris. Here are excerpts from our conversation:

Guidance Change

Kinetic Concepts , a stock in our Charter Portfolio, moves down to Hold on valuation.

Important Dates

Did someone say earnings?

- **Monday, April 18: TradeStation Group**
- **Tuesday, April 19: Intel**
- **Wednesday, April 20: Apple** and **Wells Fargo**
- **Thursday, April 21: L-3 Communications**

What to Look For: Bleeker-Style

Bryan Hinmon: What role does investigating management play in your personal investment process?

Eric Bleeker: It's important because having a candid talk with the CEO can give you impressions you might not get from a highly scripted conference call or other speaking events. For a company with a flamboyant CEO, I think it's even more important — and that's true of Ebix's Robin Raina. His character and charity dealings were part of a recent short-seller attack, and he tends to have an infectious optimism about the business, which makes it difficult to take some of his statements at face value. Being face-to-face with a manager allows me to ask some change-up questions or probe more deeply into his focus on creating long-term value. The answers to these sorts of questions are much more valuable to me and provide me more insight into management than just looking at compensation or stock ownership.

BH: Has one of your "change-up" questions ever led to a surprising revelation?

EB: We had a prominent fund manager stop by the Fool to give a talk. In the late 1990s, he spoke with Enron's Jeff Skilling, and during the course of the interview, Skilling revealed that he'd transferred a manager to England to move her farther away from corporate upper-level managers. After hearing about such poor managerial decisions, the fund manager decided to exit his Enron position — well before the company's implosion. Such examples of mismanagement aren't common, but speaking to managers in a setting where they feel comfortable makes them more likely to shoot from the hip. You can glean insight into whether their decision-making is long-term and in step with shareholders' interest.

BH: That makes my skin crawl. What sort of things do you look for when you visit a company?

EB: My purpose is almost always focused on assessing how strong a company's competitive advantages are and whether management is properly focused on the long term. I try to get management talking about the company's strengths and weaknesses, and then I can see whether recent decisions align with their responses. If the CEO highlights a weakness and the company hasn't taken any actions to shore it up, you can have a problem. Even worse, management could be flat-out in denial and tell you that no weaknesses exist. I like to see management be candid about self-criticism.

BH: Anything else?

EB: I like to keep it big-picture. At the Ebix event, many of the other analysts seemed to care only about a relatively minor valuation allowance. I understand that accounting questions can be a canary in the coal mine, but I was stunned by the complete lack of focus on the larger issues that will drive Ebix's value.

Can't-Miss Questions

BH: What are a few questions you always ask managers?

EB: I've got a few. For one, I like to ask about the two main areas driving the business. You get to see managers' thought process on what they think their main strengths are and how well they can articulate a long-term plan for them.

Also, it's always nice to see management independently bring up Foolish traits. For example, when I spoke to Jason Rhode, CEO of **Cirrus Logic**, he independently brought up the fact that creating an award-winning culture keeps talent in place and inspires the company's design process. His praise of the company's unique culture as a key strength wasn't something I was used to hearing from semiconductor CEOs, but it really impressed me.

Then, a question that nicely dovetails with that is asking who the company thinks of as its main competition — and what advantages its competitors possess. This is a bit like the "What is your greatest weakness" question" we all dreaded heading into college. You have to give credit to executives who give a really honest and humble answer.

Staring Into the Eyes of Ebix

BH: There has been a lot of noise around Ebix lately. A poignant opinion piece published on an investing website attacked the company and basically called it a fraud. Did Ebix address this when you were there?

Coverage & Community

- *Pro* members explore how after-hours trading may affect your expiring options.
- Member alex340 runs down calls and puts that look attractive.
- Jeff (TMFFischer) ambles down memory lane with an old Rule Breaker.

EB: The company refuted the article point by point. Ebix remains a heavily shorted stock, but management has become better about addressing short-seller concerns. The fact that the company is still being targeted says something about a need for more transparency, but the presentation at the investor conference was also geared toward addressing each concern as directly as possible. Providing more transparency on these issues will only better reward shareholders, and Ebix should be able to do that without compromising any of its strategic interests.

BH: What's your take on the business?

EB: The company's EbixExchange platform looks very well entrenched in the insurance industry. Some of the low-hanging fruit seems to have been taken, and larger cross-sales — such as expensive customer-relationship-management modules — will be difficult to sell to larger issuers. But Ebix still has quite a bit of room for growth with its products that allow information to flow more freely from insurance originators to the carriers who hold the policies.

BH: So Ebix isn't a fraud?

EB: That's the billion-dollar question, isn't it? I'll say this: I think management did a pretty good job of addressing recent short-selling accusations. There's still more work to be done, but better research has shown that many of the short-seller complaints were the result of sloppy analysis. Some of the company's recent acquisitions do make me a bit gun-shy, though. I don't find them as core to the business, which plays into the line of thinking that the company is obscuring organic growth through an overly acquisitive strategy.

BH: What could derail the company's further growth?

EB: Kind of leaning back on that last response, Ebix is making more acquisitions, and the way it proceeds with its acquisition strategy might define the company's future.

BH: Can you expand on that?

EB: I'd be leery of future acquisitions that push the company away from its core operating fields. By this, I'm talking about areas such as health care. Although the company may feel strongly about its A.D.A.M. acquisition, it strikes me as getting further and further away from Ebix's key strength of creating software to automate an insurance industry. A.D.A.M. is essentially a health portal that ties into health-benefits packages. I can see how this presents some cross-sale opportunities, but expanding into this area also strikes me as a large risk. I'd rather see the company putting its cash to work in establishing exchange networks in lucrative developing markets. For now, Ebix should focus on enhancing its presence in attractive and hard-to-disrupt fields, and then come back for the more tangential growth areas later.

The *Pro* Bottom Line

It's clear that Eric likes to focus on the big picture when talking with management. Consequently, his concerns about Ebix center more on the quality and direction of recent acquisitions than anything else. Next week, we'll get *Pro* analyst Andrew Sullivan's takeaways from his visit with our most recent Buy recommendation, **3D Systems**.

Foolishly,
Bryan Hinmon (TMF42)

Next Steps

- Think speaking to management is bunk? Some investors do — *Pro* analyst Nick Crow (TMFCrow) included. Share your thoughts on our Memo Musings discussion board.
- Have a question for Eric about his Ebix visit? Shout it out on our Ebix discussion board.

Trade Roundup

Charter Portfolio

- **3D Systems** : Bought 600 shares (2%) at $49.90 on April 11.
- **Contango Oil & Gas** : Bought 200 shares (1%) at $60.69 on April 12.
- **Papa John's Pizza** : Bought to close 14 April $27 calls at $4.50 each. Sold to open 14 October $30 puts and 14 October $32 calls (a covered strangle) for $2.90 combined, all on April 15. Our April $25 puts expired for the full cash gain.
- **Apple** : Bought to close 2 April $330 puts at $0.83 on April 15.
- **L-3 Communications** : Bought 500 more shares (2.7%) at a net $77.70 via put options on April 16.

Portfolio 2011

- **3D Systems** : Bought 150 shares (2.8%) at $50.06 on April 11.
- **Medtronic** : Bought 154 shares (2.5%) at $40.44 on April 11.
- **Contango Oil & Gas** : Bought 40 shares (1%) at $60.99 on April 12.
- **L-3 Communications** : Bought 100 more shares (3%) at a net $77.70 via put options on April 16.

Eric owns shares of Cirrus Logic. Jeff owns shares of Apple and Kinetic Concepts. The Motley Fool owns shares of Apple and Cirrus Logic. Motley Fool Alpha LLC owns shares of L-3 Communications.

Charter Portfolio: Buy to Close Puts on Apple

Published Apr 14, 2011 at 12:00AM

At a Glance

- **Action:** "Buy to close" April 16, 2011, $330 puts *if* Apple shares dip below $330 by Friday
- **Recent option price** (bid/ask): $0.74/$0.77
- **Preferred price:** As little (and as little time value) as possible; if the stock remains above $330 Friday, you can just let the puts expire for $0.
- **Recent share price:** $334
- **Allocation:** Close all puts (2 in Charter Portfolio)

What's New?

On January 4, we announced a trade to write ("sell to open") April $330 puts on **Apple** (NASDAQ: AAPL), and the next day we received $18.50 per share as payment. At the time of that alert, Apple traded at $332 — nearly the same price as today. Since then, however, the value of our puts has shriveled to $0.77, paying us almost everything they possibly can. We want to capture this income, so if the stock dips below $330 on Friday, we'll buy to close these puts for a profit, rather than accepting the shares.

Why This Strategy?

First, this is a useful strategy for Fools who want to protect their capital while pocketing some profits (two main goals of *Pro*'s Charter Portfolio). Plus, we continue to believe that, at least for now, we may be able to make more money — or as much money — by writing puts on Apple as we could by owning shares, and with less risk. In fact, we're already about $17 per share ahead of where we'd be had we bought the stock.

There's also the fact that Steve Jobs has been on medical leave since January 17. Wall Street has high expectations of Apple, and Jobs' absence is concerning, at least in the short term, given the company's need to keep innovating. Finally, anytime you write puts and can earn most or all of the "expiring" income they offer, rather than accept the shares, it usually makes sense to take the timely income and look to write puts again — unless you believe the stock is bound to rise sharply soon. Taking all these factors into consideration, we will buy to close our puts if the stock declines below $330 by Friday. If it doesn't, we'll just let the puts expire for the full gain.

How to Follow Along

To make this trade, "buy to close" your existing April $330 puts. **If Apple shares stay above $330 by the end of Friday, you would not need to close your puts — they would simply expire. We're assuming that this will happen, but we're ready to close the puts if Apple shares slip.** Either way, we stand to make most or all of the profit on our written puts.

Profit on Written Apple Puts	
Premium received from selling April $330 puts	$18.50
Current cost to buy to close	($0.77)
Net gain*	$17.73
Gain on cash	5.3%
Annualized gain	Around 19%
Return on equity (using 30% cash, or $99 per share)	17.9%

* Gain is based on the cash or equity needed to hold the trade open and excludes commissions.

Our returns will be higher if Apple shares stay above $330 Friday and the puts simply expire for the full cash gain. To repeat, that's what we're hoping for, but if it doesn't turn out that way, we'll buy to close these puts — and then consider our next possible position on Apple.

- Questions? Please visit our Apple discussion board.
- *Pro*'s Charter Portfolio will buy to close its puts on Apple if the stock is below $330 on Friday.

Jeff owns shares of Apple. The Motley Fool owns shares of Apple.

Charter Portfolio: Roll Your Covered Strangle on Papa John's

Published Apr 13, 2011 at 12:00AM

At a Glance

- **Actions:** Buy back ("buy to close") your April 2011 $27 calls. Using a strangle order, write ("sell to open") October 2011 $30 puts, and write ("sell to open") October 2011 $32 covered calls. (We also wrote $25 April 2011 puts as part of our original covered strangle, but we are leaving those alone because we expect them to expire worthless. See below for more details.)
- **Recent share price:** $30.79
- **Allocation:** No change; we are still covering all of our shares in Papa John's, about half of our targeted 5% allocation, and we're writing puts to potentially buy the other half.
- **Alternative trades:**

  - **If you own at least 100 shares but don't want to buy more:** You can just write the covered-call side of the strangle, which will bring you income.
  - **If you don't want the obligation of holding two sets of puts on Friday, April 15:** Either buy back ("buy to close") both legs of your original strangle first, or just close the covered-call leg, let the puts expire, and wait until Monday, April 18, to reestablish the covered strangle.

What's New?

Papa John's International (NASDAQ: PZZA) has performed well despite rising commodity costs and competitive discounting. Another challenge beyond the company's control is the NFL lockout. As David Flanery, former CFO, said in a recent conference call, "football and pizza work great together." Let's hope negotiations go well so players can return to the gridiron — and give fans an excuse to stock up on extra pies for the game.

Papa John's shares have continued to appreciate since we bought them, but if we don't take any action now, we'll lose our shares upon expiration because they're currently trading above our written calls' strike price. We like the steady nature of Papa John's business and aren't keen on letting go of our shares too soon. So, to hold onto them and capture more upside, we're rolling our calls and reinstituting our covered strangle.

Why This Strategy?

If you're starting to feel a hint of déjà vu, it's for good reason: Last October, we rolled our covered strangle on this pizza purveyor (back when the stock traded for $26.90). Now, rather than let our calls be exercised at the $27 strike price, we can roll our covered strangle for a $2.25 credit. The new covered strangle offers us $34.25 as a potential net sell price, 15% better than our current strangle's $29.80. If the stock stays between $30 and $32 by expiration, we get to pocket the premium.

What We're Doing	What It Costs
Payment received for writing April $25/$27 strangle	$2.70
Cost to "buy to close" April $27 calls	($3.90)
Net cost to close April calls	**($1.20)**
Payment received for writing October 2011 $30/$32 strangle	$3.30
Total net credit from "rolling up"	**$2.10**
New net sell price if called	$34.25
Net sell price from last roll if called	$29.80
Return from "rolling up" to October (excluding commissions)	**14.9%**

How to Follow Along

We recommend you:

- **Buy back ("buy to close") the April 2011 $27 calls for about a dime more than intrinsic value, currently $3.90.** (You can leave your April 2011 $25 puts alone; we expect those to expire worthless this Saturday.)
- Then, using a strangle order, **write ("sell to open") October 2011 $30 puts, and write ("sell to open") October 2011 $32 covered calls.**

Remember: To write a covered strangle, you must own at least 100 shares of the stock, and you should be happy to buy at least 100 more at a lower price. In this case, write one covered call for every 100 shares of Papa John's you own, and write one put for every 100 additional shares you would be willing to buy.

Trade Details

- **Use limit orders, Fools:** These bid/ask spreads are wide, so aim for execution around the midpoint of each.
- **Recent options bid/ask:**
  - Sell to open October 2011 $30 puts, $1.70/$2.00
  - Sell to open October 2011 $32 calls, $1.60/$2.00
- **Combined credit target:** $3.30 or so per share, net credit (use a strangle order)
- **Effective options yield:** 10.7% of recent share price ($30.79) in six months; half that on the full potential purchase
- **Potential net buy price of new shares:** $27.90 (9.4% below current price)
- **Potential net sell price on our current shares:** $34.10 (10.8% above current price)

Keep in mind that anytime you write puts, your broker sets cash or equity aside to cover your potential stock purchase. In this case, these $30 puts pay a 6% yield on cash set aside over the next six months. If Papa John's stock is between $30 and $32 on expiration, both options will expire for the full cash gain, allowing us to renew this strategy once again.

Next Steps

- Questions? Please visit our Papa John's discussion board!
- Track it! Add Papa John's to My Scorecard.

Don't Fire Until You See the Whites of Their Eyes: Part 1

Published Apr 11, 2011 at 12:00AM

Trade Roundup

- April 11: Portfolio 2011 bought 154 shares of **Medtronic** at $40.44.
- April 11: Charter Portfolio bought 600 shares of **3D Systems** at $49.90.
- April 11: Portfolio 2011 bought 150 shares of **3D Systems** at $50.06.

The above command is attributed to William Prescott, an American officer at the Battle of Bunker Hill. (My time living in Boston taught me that the battle was actually on Breed's Hill, but I won't quibble here.) And while I'm a fan of American history, I'm an even bigger fan of investing, so I can't help but view Prescott's command through my investing lenses. Doing so reminds me of the need to gaze into the eyes of the decision-makers at the companies where we park our hard-earned investing dollars.

After all, companies are driven by the handful of leaders who shape a culture that guides decision-making at every level of an organization. And here at *Motley Fool Pro*, we don't like to make a full allocation to a company unless we've gazed into the eyes of its key leaders.

So today's Monday Memo is the first in a three-part series that will pull back the curtain on what we Fools do, think, and look for when we investigate, talk with, or visit company management teams. Today, I'll describe my recent visit to **TradeStation Group** to show you how I evaluate management, and in your next two Memos, I'll interview Fool.com analyst Eric Bleeker and *Pro* analyst Andrew Sullivan about their recent visits to **Ebix** and **3D Systems**.

If digging down on management isn't central to your investing process, I urge you to consider adding it.

Important Dates

This Friday, April 15, is expiration Friday! We have three options positions to keep an eye on:

- **Apple** $330 written puts: Beware! Each Apple written put represents a $33,000 potential obligation. If you don't want these shares, "buy to close" your puts.
- **L-3 Communications** $80 written puts: We're prepared to take shares if the stock closes below $80 on Friday.
- **Papa John's International** $25/$27 covered strangle: We're considering our options, but rolling this strangle before the end of the week looks likely.

What to Look For

That's because management is a key investing consideration. It's so important that it's one of the first steps in my investment process — No. 3, to be specific. I like to weed out as many companies as fast as I can to avoid wasting time, so some of the first things I read about a company are its proxy statement (SEC form DEF14A) and its annual shareholder letters. Then I try to answer three questions:

1. Are the members of the executive team also owners in the business?
2. Are the compensation incentives properly aligned to encourage good, long-term decision making?
3. Is there a long-term vision in place, and is it clearly articulated?

If the answers are yes, I've improved my chances of investing in a management team that will keep a long-term mindset, even if it means minor turbulence in the short term. The best situations arise when a management team meets the above conditions *and* diplays passion for the company.

When I visit a company, I always take note of inconsistencies. If a company touts its cost-consciousness, I balk upon seeing lavish headquarters. Or if the company prides itself on being egalitarian, I'll raise my eyebrows at assigned parking spots. These things may sound inconsequential, but I'll bet that rank-and-file employees are aware of such discrepancies and that it affects their daily attitudes and actions.

Can't-Miss Questions

Whether you're speaking to management over the phone or in person, every investor should have a few go-to questions. For example, I always ask:

1. Which CEOs outside your industry do you admire, and why? Which competitor do you most admire, and why?
2. How do you allocate your time on a daily basis?
3. What qualities are must-haves when you're looking at a new hire?

I also try to hit on the metrics the company looks at internally, five-year plans and expectations, how success will be measured for key initiatives, reinvestment opportunities, and how budgets are set and capital projects assessed.

Staring Into the Eyes of TradeStation

I recently visited the company headquarters for *Pro* holding TradeStation. The visit left me with a more positive view of the company and its place in our *Pro* portfolio: I have a clearer picture of the company's culture, the stickiness of its software, and its avenues for growth. Equally as reassuring, though, were the answers to the can't-miss questions I tossed at CEO Sal Srendi and CFO David Fleischman.

Srendi cited Steve Jobs as a CEO he admires because of Jobs' ability to create products that consumers "don't even know they want." With its trading software, Srendi said, TradeStation is trying to take a problem and create an entirely new solution that becomes indispensible, just as Jobs has so successfully done.

As for which of TradeStation's competitors Srendi admires, he chuckled and said he respects all of his competitors because they have built big businesses. He said he has to respect them because of their size relative to TradeStation. But his undertones were clear and full of confidence: Bigger doesn't mean better.

The two executives told me that they spend their time meeting with department managers (the decentralized organization lends itself to this), listening to customers' suggestions, and thinking about how to enlarge the business. They noted that a mediator runs the company's strategy meetings, which ensures that everyone has a voice. And both men are incredibly data-driven and like to be in tune with how business is trending. Fleischman carries around an accounting calculator (an HP 12C for you finance geeks out there) and keeps another in his car.

When I asked about the characteristics of new employees, Fleischman reiterated that TradeStation is a technology-driven company that happens to have a brokerage business built around its software. The problem is that the average techie doesn't necessarily fit the profile of a brokerage employee. So the key, he said, is to find an incredibly talented tech-minded worker who genuinely cares about customer service. That combination lends itself to hiring workers who buy in to TradeStation's mission and will stay with the company for a long time.

The *Pro* Bottom Line

Company visits and management conversations can be dangerous: You're unlikely to hear any bad news, and many executives have climbed the corporate ladder because they're charming. But at *Pro*, we believe that making an investment without trying to get a feel for management is little-f foolish. Instead, we'll continue to research this valuable piece of the investment puzzle, take our management interactions with a slug of skepticism, and only invest our dollars alongside decision-makers we believe in.

Fool on!
Bryan Hinmon (TMF42)

- Think speaking to management is bunk? Have interesting stories about interacting with a CEO? Chime in on our Memo Musings discussion board.

The Motley Fool owns shares of Apple. Motley Fool Alpha LLC owns shares of L-3 Communications.

Portfolio 2011: Buy Medtronic

Published Apr 8, 2011 at 12:00AM

Pro first recommended **Medtronic** in our Charter Portfolio in July 2009. We've since written puts and bought additional shares. Click here to see our complete recommendation history.

First Things First

- **Company**: **Medtronic**
- **Market cap**: $42 billion
- **Website**: www.medtronic.com
- **Type of holding**: Core; health care
- **Options**: We may eventually write puts to increase our allocation to 5%.
- **Tax considerations**: Medtronic pays a 2.5% dividend.
- Add Medtronic to My Scorecard.

At a Glance

- **Portfolio 2011 action**: Buy 2.5% (for Portfolio 2011, that's 150 shares)
- **Recent price**: $40
- **Buy around**: $39
- **Fair-value estimate**: $48
- **Alternative trades**: If you prefer to write puts, the May $38 contracts (recently $0.60) and August $38 contracts (recently $1.27) are reasonable ways to try to purchase shares.
- **Why buy**:
  - Medtronic has a bulging product pipeline, dominant market share in key segments, and underappreciated growth potential.
  - Innovation is hard-wired into the company's culture, where nearly $0.10 of every sales dollar flows right back into research and development.
  - Medtronic generates an enviable profit margin and high returns on capital and has a strong balance sheet.

The Big Picture

It's not all rainbows and unicorns in the medical-technology world. Competition puts constant pressure on the leading technologies, the recession has slowed surgery volumes, hospitals are trying to cut costs at the expense of device makers, and the Patient Protection and Affordable Care Act is poised to levy a 2.3% excise tax on medical devices beginning in 2013. If that weren't enough, the Food and Drug Administration is adding complexity and cost to its clinical trial process by requiring more evidence-based data.

Even so, the medical-technology business is attractive, in part because the global population is growing older. In the United States alone, the 60-plus crowd is expected to grow from 18% to 25% of the population over the next 20 years. Add in the facts that chronic disease is the leading cause of mortality in the world (responsible for 60% of all deaths) and that spending on health care has historically risen at a rate faster than per capita incomes, and the medical-technology market remains large and growing.

Why Buy?

Our favorite medical-technology company hails from Minnesota and generated nearly $16 billion in revenue last year. **Medtronic** is the largest independent med-tech company, which has allowed it to outspend its rivals on research and development and build a global sales and distribution network to bring products to market faster than other companies. Its broad product portfolio (spanning cardiac rhythm, cardiovascular, diabetes, spinal, and other markets) aids it in negotiating with the hospitals, physicians, and governments that buy its products. And because physicians must be trained specifically to use the company's products, once the purchasing decisions are made, switching to a competing product is costly in terms of time and money.

The result of these competitive advantages is a financially healthy company. Medtronic generates gobs of free cash flow — about $3.8 billion per year over the past five — that it uses to acquire promising technologies, pay dividends, and buy back its stock. And although the company caries $10.8 billion in debt, investors aren't worried about Medtronic's ability to pay its bills. In early May, the company issued $1 billion worth of bonds at a rate less than 1 percentage point above Treasury rates.

But the sector-based fears cited above, combined with some slowing end markets and the search for a replacement CEO (Bill Hawkins is planning on stepping down this month) give long-term investors a chance to buy shares of this health-care bedrock at only 10.7 times forward earnings. We think shares are priced for little growth, which simply doesn't jive with the company's current products or bulging pipeline. If medical-technology companies regain investors' favor, the shares should have heart-pounding upside. Open your 2.5% stake in Medtronic today.

Next Steps

- **Questions or comments?** Chat it up on the Medtronic discussion board.
- **Want to follow Medtronic?** Add it to My Scorecard.

The Motley Fool owns shares of Medtronic.

Portfolio 2011 will buy a 2.5% stake in Medtronic in the next one to 30 days, per The Motley Fool's trading guidelines.

Charter and 2011 Portfolios: Buy 3D Systems

Published Apr 7, 2011 at 12:00AM

First Things First

- **Company: 3D Systems** (NYSE: DDD)
- **Market value:** $1.4 billion
- **Type of holding:** Long-term
- **Options:** Available, but you don't have to use them.
- **Follow along:** Add 3D to My Scorecard.

At a Glance

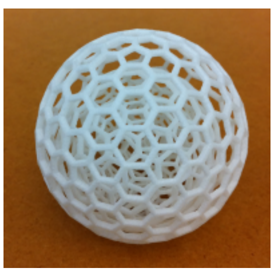
- **Buy around:** $21
- **Fair value:** $27
- **Alternative trade:** Write ("sell to open") any puts that would allow you to potentially buy shares cheaper, selling one put for every 100 shares you could buy.
- **Why buy:**
  - Immense growth potential
  - Leader in a disruptive industry
  - Attractive recurring revenue model

The Big Picture

If you haven't heard of three-dimensional printing, get ready — because it's revolutionizing design and manufacturing. The technology works like a souped-up ink-jet printer, but rather than putting ink on paper, it deposits layers of material and fuses them together, over and over on top of one another, until you've created a three-dimensional object. The value is immense because you reduce scrap, tooling costs, and the time it takes to get a product to market.

Company Visit: Inside 3D Systems

I had the privilege of visiting 3D Systems' headquarters in Rock Hill, S.C., last month. It is a fascinating and futuristic place (think machines building machines humming behind glass enclosures.) The lobby has a model Formula 1 car, a vacuum cleaner, and a car dashboard — all made by 3D Systems. I was impressed with the energy and the extremely competent and frugal executive team.



This is a ball manufactured using 3D Systems' printing technology. The company can print 300 of these balls at a time!

I'll share more about my visit in an upcoming Monday Memo. Stay tuned!

Three-dimensional printing is still a tiny market; the two biggest players reported combined annual sales of just $282 million last year. But industry leader **3D Systems** (NYSE: DDD) sees $1.4 billion in potential annual sales to the medical, dental, and aerospace markets alone — all industries that need high-value, low-volume parts that lend themselves to 3-D printing. Beyond that opportunity, the price of 3-D printers has come down to just $1,300, which could lead to incredible growth in personal printing, creating applications and industries no one's even thought of yet. We want to get ahead of this trend, so we're buying 3D Systems, the leading 3-D printing company.

Business

3D Systems invented the 3D printing industry in 1986, the year Chuck Hull founded the company and patented its first printing technology, stereolithography. Stereolithography uses a polymer resin that is cured by an ultraviolet laser one layer at a time, eventually building three-dimensional objects. Since those early days, 3D Systems has added five more 3D printing technologies, including selective laser sintering, which is similar to stereolithography except that it uses plastic and metal powder instead of liquid as the base material. These two technologies are the core of the company's business, although 3D Systems has a total of six so-called print engines, which gives it the flexibility to address all sorts of needs.

3D Systems has three major revenue lines: printers, printing materials, and services. Here's how they break out in terms of revenue and recent growth rates.

	Description	2010 Revenue	2009 Revenue	Year-Over-Year Growth
Printers	Large-scale production and personal printers	$55 million	$31 million	77%
Materials	The highly engineered "ink" of the production process	$58 million	$50 million	16%
Services	A business that creates parts on demand for end users	$47 million	$32 million	47%
Total		$160 million	$113 million	42% (27% organic)

Source: 3D Systems

The power of the company's business model is in the sale of consumable materials. They're not just ink in a cartridge — these materials are highly engineered, and 3D Systems sells them in a smart unit with electronics, which means they're unlikely to be quickly commoditized by the Lexmarks of the world. Materials revenue correlates with printer use and generates high margins, so unless customers stop using their printers, 3D Systems should benefit from highly predictable and profitable revenue growth from materials as it sells more printers each year.

Strategy

3D Systems' management team understands business strategy. Unlike its competitors, 3D Systems knows that its business isn't selling printers — it's helping creative minds turn design into reality. That's why it has the broadest product line in the industry and has bought many custom-order parts businesses over the past two years. Another way 3D Systems distinguishes itself from its competitors is that it's not vertically focused on pushing a particular printer out the door. Instead, it creates a horizontal set of solutions that meets all the needs of the design-to-manufacturing business. This also extends the company's brand.

Financials

The strategy is bearing fruit, as the numbers show. Sales jumped by $47 million in 2010 and profit expanded $19 million — a huge year-over-year improvement that shows how 3D Systems' operating leverage increases as its fixed costs are absorbed.

	2010	2009	2008	2007	2006
Revenue	$160 million	$113 million	$139 million	$157 million	$135 million
Operating Income	$21 million	$3 million	($6 million)	($5 million)	($19 million)
Net Income	$20 million	$1 million	($6 million)	($7 million)	($31 million)
Operating Cash Flow	$32 million	$8 million	($4 million)	$3 million	($9 million)

Source: Capital IQ.

Management expects it can earn $111 million in operating income on $300 million of sales, a stunning 37% operating margin. Even better, more than 70% of those sales would be recurring. This would translate into earnings of $66 million (a 22% net margin). Given 3D Systems' 27% organic growth last year, not to mention the potential for accretive acquisitions, I'm betting the company will hit these numbers quickly. Considering 3D Systems' potential to generate $66 million worth of earnings in fairly short order, today's $1.4 billion market cap is reasonable.

Valuation

3D Systems trades at only $1.4 billion with essentially no debt. It has fantastic (and improving) margins and is growing quickly. It's already revolutionizing the manufacturing process in many industries and looks poised to continue this trend. The opportunity here is tremendous, and I think 3D Systems' upside is a multiple of its current market cap — perhaps about $3 billion.

For another look, here's how 3D Systems stacks up with its closest competitor, **Stratasys** (NASDAQ: SSYS). As you can see, the two companies have similar market caps but diverging financials.

	3D Systems	Stratasys
2009 Sales	$113 million	$98 million
2010 Sales	$160 million	$117 million
Year-Over-Year Sales Growth	42%	19%
2009 Operating Income	$3 million	$6 million
2010 Operating Income	$21 million	$13 million
Patents and Applications	502	245
Market Cap	$1.4 billion	$1.1 billion

Source: 3D Systems.

Although both companies should do well as the 3-D printing industry develops (and Stratasys' growth could accelerate as its distribution arrangement with **Hewlett-Packard** (NYSE: HPQ) matures) we think 3D Systems is the better opportunity.

Egad! How Do They Do That?

How does 3D printing work? *The Economist* breaks it down in a fascinating article.

What Would Make Us Sell

As with any cutting-edge company, new disruptive technologies and competitors are key risks, but we think 3D Systems has a large enough lead and moat to maintain its leadership in 3-D printing. We expect the overall 3-D printing market to expand prodigiously, which would benefit all players. Still, we are wary of new technologies or signs that 3D Systems' products are losing appeal, so we'll keep close watch on both revenue growth and margins.

The Foolish Bottom Line

3D Systems' technology is breathtaking, and more importantly, so is its business model, characterized by low capital spending, immense operating leverage, recurring revenue, and fantastic growth potential. By investing in 3D Systems, we're buying into a classic growth story — one in which the riskiest years are already behind the company. I expect 3D Systems to solidify its leading position and become the industry standard in 3-D printing. What's more, the technology could lead to markets and profits we can't even conceive of yet. Don't hesitate to open a 3% position in 3D Systems today.

Next Steps

- **Have questions?** Get answers on our 3D Systems discussion board.
- **Follow along:** Add 3D Systems to My Scorecard.

Do You Behave Like a Pro?

Published Apr 4, 2011 at 12:00AM

We Love Your Inbox

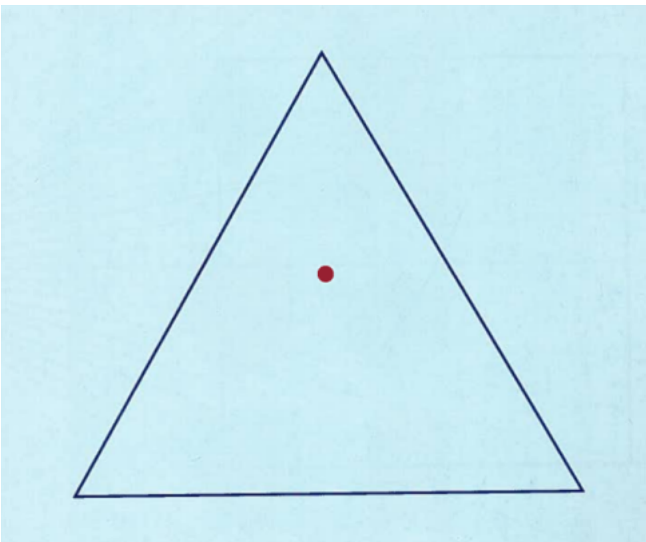
Fools, we're making two small changes to simplify your *Pro* email experience. Instead of sending you Trade Complete emails when our *Pro* portfolios have made the trades already recommended to you, we will now provide a new Trade Roundup section in each Monday Memo, outlining all of our transactions from the week before. We will of course continue to email you our buy and sell trade alerts in real time, allowing you to make the trades before we do — and ideally at better prices.

At least half of being a *Pro* investor is having the right temperament. Fortunately, if you weren't born this way, it's something you can learn. In today's Memo, I'll show you how to improve your ability to think about investments.

Heuristically Thinking

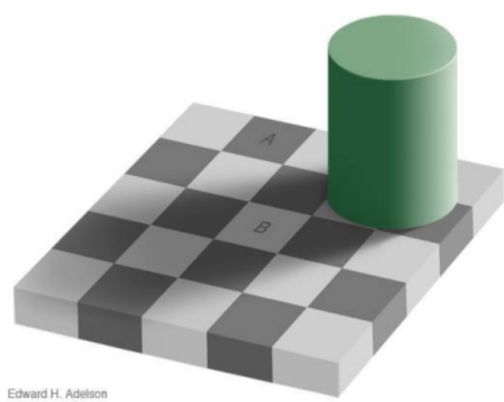
Our brains are hard-wired to help us survive in the wild — just think about our fight-or-flight instinct. But we often have to solve problems that can run counter to our pattern-seeking, choice-comparing, fleeing-to-safety mental coding. So we use heuristics, experience-based methods learned through trial and error, to quickly solve problems. This elaborate system of shortcuts serves us very well in "the real world," but when it comes to investing, heuristics might cause you to zig when you should be zaggin'. Check it out:

Is the red dot halfway up the triangle?



If you're like most people, the dot appears to be higher than halfway up, even though halfway is exactly where it is. Here's another example, just for fun:

Which square is darker, A or B?



It might take some convincing, but both squares are exactly the same shade of grey. They look different because we use our eyes to determine the color of objects in the world — not the amount of light being reflected off a surface. Our visual system, like the rest of our cognitive systems, is very good at solving particular problems but not other, related problems.

To tie all this back to investing, it would be good to know when we might be as easily tricked; that way, we can fight back.

Upcoming Earnings

Pro Fools, keep your eye on the boards in the coming weeks, as your team covers any significant earnings announcements from *Pro* holdings.

Beginning on Monday, April 18, and continuing for a solid month, we'll have timely updates on company progress, Buy Around prices, and fair-value estimates — all available on the company discussion boards. See you there!

Cognitive Errors

The field of behavioral finance has helped identify the mental shortcuts we use and the cognitive errors associated with them. Here are a few cognitive errors *Pro* investors should defend themselves against:

Anchoring: Focusing on a number is one of the most dangerous traps investors can fall into. If you've ever hesitated to make an investment simply because the price moved a bit, you were probably anchored. Alternatively, if you're holding a losing position just to get back to breakeven, you're anchoring on the price you originally paid.

- *Pro* tip: Focus on value, not price, and allocate your money to the most promising opportunities — even if that means recognizing loss.

Hindsight Bias: Through the deceptive gift of hindsight bias, past events appear to be more predictable than they were in real time. Worse yet, when we look back, we actually believe that we knew what would happen before it did, even if we didn't make a prediction.

- *Pro* tip: The future is inherently unknowable. Keeping a journal and writing down the reason you bought a stock or your thoughts on the market will help keep you from tricking yourself.

Myopic Loss Aversion: We are more sensitive to investment losses than gains, and we measure outcomes too frequently. In fact, our emotional ability to take on risk increases the less frequently we measure results. When we measure results too frequently, we make decisions based on the next minute, day, or month rather than a longer period consistent with our investing goals. This results in higher stress and lower returns over time because our decisions are inconsistent with our actual time horizon.

- *Pro* tip: Check your portfolio performance infrequently, and base your decisions on your actual investing horizon.

Coverage & Community

- Andrew (TMFRedwood) talks about a company too small for *Pro*.
- TMFDoodleBugger shares his thoughts on Contango's risks.
- Stamleo defends *Pro*'s performance while flexing his own muscles at the same time.

Overconfidence: In the example above, how sure were you that the "B" square was lighter than the "A" square? Even upon close inspection of the graphic, you may have doubts. Overconfidence is being surprised more frequently than you anticipate. For example, analysts might set their valuation ranges too narrowly (i.e., the high end is too low and the low end is too high), which can lead to surprises when a stock quickly outruns their top-end valuation scenario. That's one reason *Pro* doesn't always insist on selling when a stock reaches our fair-value estimate.

- *Pro* tip: Let your winners run (and let us let your winners run, too).

Investors make interesting choices when faced with risk and uncertainly. After all, what's investing if not risking capital to earn a return in the uncertain future? By being aware of your biases and using our tips, you too can behave like a *Pro*.

Give Back

Investors join *Pro* because they want to steadily grow their portfolio while managing their risk. Jeff, Bryan, Andrew, and I work vigilantly to deliver on this goal. But after they join *Pro*, many members express their amazement not about the *Pro* team's efforts but about our vibrant community. If you haven't visited or posted on the boards recently, you're missing out! Here are some easy boards to participate in:

- Meet & Greet: Light social atmosphere. Get to know your fellow *Pro* Fools and even share success stories, like paying off your membership in one week.
- Philosophy & Strategy: Talk about *Pro*'s strategy and investing tenets in general. This is also where you'll find the ever-popular earnings calendar brought to you by TMFValuemoosie.
- Social Banter: If you have something to talk about that's not related to investing, this is the place to go. The bar is low here: If *you* find it interesting, someone else will, too.

There's also a message board for every *Pro* holding, past and present. Just head here and look for the ticker you're interested in whenever you need the latest scuttlebutt or want to share your analysis. Some members thrive on doing their own research or on sharing their expertise in the industry in which they've made a career. Great examples of giving back are Stamleo's recent post on **Ebix** and community Fool TMFDoodleBugger's discussion of **Contango Oil & Gas**.

Last but not least, if you have an emergency of the Pro 911 variety, you can reach us on the poorly named *emergency only*24-hour board. Be sure not to cry wolf — we have families, too.

Pro Fools are always polite and use descriptive subject lines when they post to our boards. We hope to see your first post soon!

Foolishly,
Nick Crow (TMFCrow)

Nick owns shares of Ebix. The Motley Fool owns shares of Contango.

- Questions about this Memo? Post them on our Memo Musings discussion board.

Charter and 2011 Portfolios: Buy Contango Oil & Gas

Published Mar 31, 2011 at 12:00AM

Pro wrote put options on Contango Oil & Gas in November 2011 that expired as income — here's the original recommendation. Buying shares directly was an alternative trade then. With today's trade, we're going to buy shares first and aim to write puts later. But as with the first time, we fear a rising stock price on our buy alert, so **please use a limit order**.

First Things First

- **Company: Contango Oil & Gas** (NYSEMKT: MCF)
- **Market Value:** $970 million
- **Type of Holding:** Energy, commodities
- **Options:** They're available, but you don't have to use them.
- **Follow Along:** Add Contango to My Scorecard.

At a Glance

- **Action:** Buy 1% of a potential 4% position
- **Recent Price:** $61.80
- **Buy Around:** $62.50 (This stock is very thinly traded. **Please use a limit order!**)
- **Fair Value:** $70; higher if natural gas prices rise
- **Alternative trades:** Write any $60 puts, or May, July, or October 2011 $55 puts.
- **Why Buy:**
  - As the lowest-cost natural gas producer, Contango Oil & Gas profits even on today's depressed gas prices.
  - Contango's estimated reserves on hand are worth more than the company's market value, and *much* more if natural gas prices increase.
  - This conservative company is debt-free and well-managed.

What's New?

Everything we admired about **Contango Oil & Gas** (NYSEMKT: MCF) when we wrote puts on the stock last November remains true. With just eight full-time employees, Contango outsources all of its gas exploration and only pays contractors when they hit pay dirt. Eschewing debt and shareholder dilution, this prudent company has bought back 13.5% of its shares since June 2007. Meanwhile, it remains the lowest-cost natural gas producer.

Contango estimates that its 2011 finding-and-development costs are running at just $1.20 per million cubic feet equivalent (Mcfe) of natural gas. The company's total production cost in the final quarter of 2010 was just $2.76/Mcfe, compared with the industry average of $5.72/Mcfe (an average of 42 competing companies). Even with natural gas at a low price of $4.28/Mcfe, Contango earns a healthy profit. Plus, because it doesn't hedge, if natural gas prices rise, Contango's earnings will, too. With oil prices up nearly 40% since last November and nuclear power now under fire, the future of natural gas looks more promising than before.

Plus, just a few days ago, the company delivered 37.5 billion *new* reasons to like it: the discovery of another estimated 37.5 billion cubic feet equivalent (Bcfe) of natural gas.

Why This Strategy?

This stock is thinly traded, with fewer than 100,000 shares changing hands on a typical day. That's why we tried writing $55 puts last November to buy our shares (when the stock was $53), but the stock increased, and we ended up with only our option income. This time, we'll buy just a 1% position of the stock to start, hoping that by starting small, we won't move the stock much. We want to own some shares, and we'll probably write puts later to try to add to our stake. **Please use a limit order to buy your shares** — if we all do, we shouldn't push up the stock price much.

Given the higher prices for oil and Contango's new gas discovery, our fair-value estimate for the stock has increased and is about 13% above the current price. Remember: Fair value is the price from which to expect your desired annualized return (fair value means "fair" for both a buyer and a seller, after all); any buy price *below* fair value represents your so-called margin of safety. In this case, the company's fair value will increase further if natural gas prices rise. But what we like about Contango is that it's making money even on today's lower gas prices.

How to Follow Along

Buy 1% to start — dip your toe in with a limit order. Let's see how much the stock moves before considering our next strategy. If you'd rather, consider our alternative trades (listed at the top) of writing puts. Remember that you're obligated to buy 100 shares for every put you write if the stock drops below your strike price by expiration. Finally, to see a recent (and Foolish) overview of the company, check out the slides for its March 28 investor presentation (opens a PDF file).

Next Steps

- For our full company report, read our original recommendation.
- Questions or comments? Visit our Contango discussion board.

Pro will buy shares of Contango Oil & Gas in both portfolios in the next one to 30 days, per The Motley Fool's trading rules.

The Motley Fool owns shares of Contango.

Ketchup Report: Portfolio 2011

Published Mar 30, 2011 at 12:00AM

Dear Fellow Fools,

We're delighted you've joined *Pro*, one of The Motley Fool's premier services. You've made a great choice. Since 2008, we've been helping members just like you own outstanding businesses at good prices, earn steady income, expand your investing toolbox with education and new strategies, and find little-known ways to earn profits. In January, we introduced Portfolio 2011 with $250,000 of the Fool's own money. This portfolio is just getting started and holds mostly cash, so it's easy to get up to speed with us. We believe the best way to succeed with us to invest with us, so we've put together this exclusive Ketchup Report to show you which stocks to invest in today. Welcome again! We look forward to helping you profit year by year.

Jeff Fischer, advisor
Motley Fool Pro

Buy First Stocks

If your portfolio doesn't yet mirror ours, start by matching our percentages in these stocks. They represent the most attractive risk-to-reward opportunities today.

AmTrust Financial Services

- **Allocation:** 3%
- **Buy Around:** $18.50

Synopsis: By selling workers' compensation insurance to small companies as well as extended service and warranty coverage, **AmTrust Financial Services** targets specialized, profitable insurance niches in North America and Europe. The strategy has worked, with AmTrust's gross written insurance premiums and operating income growing faster than 30% and 40% each year over the past five. The $18.50 stock trades at just 7.6 times expected earnings and 1.5 times book value — a good deal for a solid stock. —*Jeff Fischer*

- **Read more:** See AFSI's recommendation history.
- **Have questions?** Head to our AFSI discussion board.
- **Follow along:** Add AFSI to My Scorecard.

Intel

- **Allocation:** 5%
- **Buy Around:** $20.50

Synopsis: About three-quarters of the computers shipped today have **Intel** inside, and the company rakes in high-margin revenue by selling high-powered chips for servers, too. Wall Street is down on Intel for missing the mobile market up to this point, but Intel argues the economics of mobile haven't made sense until recently. Now, the company is going after the cellphone and tablet markets with promising new chips. At the same time, chip use in emerging markets is growing, and computer users in developed markets are upgrading their machines after a lull during the recession. Intel trades at just 10 times earnings. —*JF*

- **Read more:** See INTC's recommendation history.
- **Have questions?** Head to our Intel discussion board.
- **Follow along:** Add INTC to My Scorecard.

L-3 Communications

- **Allocation:** 2.5%
- **Buy Around:** $80

Synopsis: L-3 Communications is the sixth-largest company in the defense industry and has only been around since 1997. It provides high-tech electronic systems to the Department of Defense and other government agencies, and it has a growing position in the intelligence and surveillance markets. L-3 generates impressive free cash flow (7% of sales), and because investors are concerned about budget cuts for defense spending, you can now buy the stock for less than our $80 buy-around price and write puts to fill out your position at attractive prices. We believe the mission-critical nature of L-3's products and services will insulate it from cuts in defense spending. (Note: Be careful to buy shares of LLL, not LVLT. The company name is L-3, *not* Level 3!) —*Bryan Hinmon*

- **Read more:** See LLL's recommendation history.
- **Have questions?** Head to our LLL discussion board.
- **Follow along:** Add LLL to My Scorecard.

WisdomTree Emerging Markets SmallCap Dividend Fund

- **Allocation:** 3%
- **Buy Around:** $55

Synopsis: Most of the large, established companies in the *Pro* portfolio have international exposure — but **WisdomTree Emerging Markets SmallCap Dividend Fund**, or DGS (we try not to waste too pixels by repeating the fund's long name), gives us even more. The exchange-traded fund exposes us to emerging markets — countries like Taiwan, Korea, and South Africa. But the fund is careful to avoid investing in ultra-speculative small caps; it requires that its holdings have the financial wherewithal to pay dividends. We like the fund's balance of financial conservatism that comes with dividend discipline combined with its exposure to growing markets. Historically, dividend-paying emerging-market small caps have outperformed their non-dividend-paying brethren, and right now they're a good bargain, too. The average P/E ratio of the fund's holdings is only 12. —*BH*

- **Read more:** See DGS' recommendation history.
- **Have questions?** Head to our DGS discussion board.
- **Follow along:** Add DGS to My Scorecard.

Buy Stocks

After you've invested in our Buy First stocks, we suggest you buy these strong stocks next as you build your portfolio.

ProShares Short S&P 500

- **Allocation:** 5%
- **Buy Around:** $43.50

Synopsis: The **ProShares Short S&P 500** is an exchange-traded fund that trades *inverse* to the S&P 500, so when the market index falls, this ETF will *rise*, providing us a 1:1 inverse relationship on a daily basis. Buy this ETF if you want a hedge or a short for your portfolio. If you're mostly in cash, you may not need one. —*JF*

- **Read more:** See SH's recommendation history.
- **Have questions?** Head to our SH discussion board.
- **Follow along:** Add SH to My Scorecard.

Rockwood Holdings

- **Allocation:** 4.5%

- **Buy Around:** $45

Synopsis: Rockwood Holdings is the country's leading low-cost, high-quality lithium producer, providing battery-grade lithium to electronics makers and the growing electric auto industry. Rockwood also makes synthetic chemicals used in hundreds of industries, treating things like disc brakes, airplane bodies, paints, and stains. The company is paying down debt and improving its margins. The stock is trading above our buy-around guidance, but remember that buying shares 5% to 7% higher than our buy-around price is reasonable. You can buy some to start your position, or you can follow the spirit of our recent put-writing trade. *—JF*

- **Read more:** See ROC's recommendation history.
- **Have questions?** Head to our ROC discussion board.
- **Follow along:** Add ROC to My Scorecard.

Sprott Physical Gold Trust

- **Allocation:** 3%
- **Buy Around:** $12

Synopsis: We're always on the lookout for reasonably priced portfolio insurance here at *Pro*, and gold fits that mold. We view gold as protection against inflation, a decline in the value of the U.S. dollar, and in the worst case, an economic collapse. Although we generally focus on the performance of individual companies and their competitive positions, it's silly to ignore the macroeconomy altogether, so we chose the **Sprott Physical Gold Trust** as a vehicle to own gold bullion. (The bars are held at the Royal Canadian Mint if you want to touch them). Shares of Sprott Physical Gold Trust are a bit higher than our suggested buy-around price, but given the metal's volatility, you should have an opportunity to start a position before long. *—BH*

- **Read more:** See PHYS' recommendation history.
- **Have questions?** Head to our PHYS discussion board.
- **Follow along:** Add PHYS to My Scorecard.

TradeStation

- **Allocation:** 1.5%
- **Buy Around:** $7

Synopsis: Named by *Barron's* as "best overall" and "best for frequent traders," online broker **TradeStation** caters to active, highly valuable rules-based traders, such as small hedge funds. In addition to profiting from this niche, TradeStation stands to cash in on its customers' cash balances if interest rates rise. Given all this, we think TradeStation could be an attractive acquisition target for a larger broker. Establish your position near $7 a share, but **use a limit order** because this small cap is thinly traded. *—Nick Crow*

- **Read more:** See TRAD's recommendation history.
- **Have questions?** Head to our TRAD discussion board.
- **Follow along:** Add TRAD to My Scorecard.

Tupperware

- **Allocation:** 3%
- **Buy Around:** $55

Synopsis: This isn't your mother's Tupperware. Flying under most people's radar, **Tupperware** has been growing strongly all over the world as consumers in emerging markets are becoming wealthy enough to buy food for storage. Tupperware continues to innovate and plug into local cultures everywhere it operates, so much so that Tupperware sells the best-selling cookbooks in … *France*! Who would have guessed it? The stock price can be choppy (and you might need to pay a bit more than our buy-around price), but we expect continued growth in emerging markets. *—JF*

- **Read more:** See TUP's recommendation history.
- **Have questions?** Check out our TUP discussion board.
- **Follow along:** Add TUP to My Scorecard.

Wells Fargo

- **Allocation:** 2.5%
- **Buy Around:** $31

Synopsis: Now the country's fourth-largest bank (after acquiring Wachovia in the throes of the financial crisis), **Wells Fargo** has more locations in more communities and the highest customer satisfaction rating of any large bank. The injection of Wells Fargo's sales culture into Wachovia branches offers an opportunity for meaningful growth. The stock is significantly undervalued compared with its earning power, and we expect to be rewarded with ever-increasing dividends as the bank's best-in-class management team returns equity to shareholders. Buy some shares to start your position or write puts for the potential to pick up the stock cheaper. *—NC*

- **Read more:** See WFC's recommendation history.
- **Have questions?** Check out our WFC discussion board.
- **Follow along:** Add WFC to My Scorecard.

In Summary

Welcome again to *Pro*! We hope our Ketchup Report helps you catch up with the trades Portfolio 2011 has made since late January. Remember, Portfolio 2011 is aiming to mirror *Pro*'s Charter Portfolio, so that's what we're building toward. If you want to skip ahead a bit, you can look at the Charter Portfolio and consider additional positions there that interest you.

Finally, please note that we didn't include options positions in this report because options prices can change quickly. We'll have plenty of new options trades for you, and experienced options users can try to mirror the options already in place in Portfolio 2011 as long as the trades are still viable.

Thank you again for joining *Pro*! We look forward to becoming better investors together.

Jeff Fischer owns shares of AmTrust, Intel, and Tupperware and has written puts on Rockwood. Nick Crow owns shares of AmTrust, Intel, L-3, Wells Fargo, and WisdomTree Emerging Markets SmallCap Dividend Fund. Motley Fool Alpha LLC owns shares of L-3.

Pro in 500 Words

Published Mar 29, 2011 at 12:00AM

Live Chat Tomorrow!

Join the *Pro* team for a live chat tomorrow, Wednesday, March 30, from 2 to 3 p.m. ET. We'll answer all of your investing questions in real time — click here to join in and set yourself an email reminder, and we'll see you there, Fool!

Portfolio 2011 Ketchup Report

Whether you've been investing with Portfolio 2011 since January or since last week, you might have some catching up to do. That's why we've created our Ketchup Report, coming your way this week. Stay tuned for this quick-and-dirty run-down of all the stocks in Portfolio 2011.

Welcome, *Pro* Fools,

The ambitious goal of today's brief Memo is to encapsulate *Pro* in 500 words or less. As we invest together, our strategy drives our success, so it's important to reevaluate often to ensure that we're on the right track — whether you're a new *Pro* member or a veteran.

What We Do

- We invest for absolute profits with high accuracy; we want at least 75% of our positions to close profitably, well above Peter Lynch's 60% benchmark for investing success.
- We buy strong businesses at reasonable prices for long-term performance.
- We use options (writing them, mainly) for short-term profits.
- We sell short and use hedges to target profits when prices fall and to smooth returns.

Are You New to *Pro*?

Welcome! Take your time getting to know us by checking out the links below. Try to read one a day in the coming week.

- Own Stocks the Pro Way
- Use Options Like a Pro
- Pro Tips and ETF Strategies
- Building Shorts Into Your Portfolio
- Making Pro Fit Your Profile
- Four Pro Investing Truths

And please introduce yourself to the vibrant *Pro* community. Come on over to our Meet & Greet discussion board. We're excited to meet you!

How We Do It

- Our portfolio can have as many long or short positions as we like. We've mainly been long since our launch in 2008. (Charter Portfolio is about 12% short right now; Portfolio 2011 has a bigger short position because it's not as fully invested.)
- We don't sweat small market moves of 10% or less. You can't outmaneuver those. Instead, we're like a blue whale in the vast investing ocean, large and unshakable. But we want to be agile enough to swim the best direction when the market makes large waves, moving much more than 10%.
- We believe cash flow should be an important part of most portfolios. We generate regular cash flow by writing options, which provides us with extra income we can actually *use*. (Stocks are long-term compounding vehicles, not short-term cash-flow generators like options.)

Guidance Changes

- **Intel** moves up to Buy First because of its low price.
- **Rockwood Holdings** moves down to Buy because of its price and because we're writing puts to try to fill out our position. But we're moving our buy-around price up modestly, to $45, and if you don't own shares, you should feel confident about buying the stock even a bit above $45. We want you to own shares of the largest lithium producer in the country.

Coverage & Community

- Veteran member antmark shares his take on *Pro*.
- Fools discuss the sudden volatility in **Ebix**.
- Jeff expounds on *Pro*'s purpose.
- Fools discuss the differences between *Pro* and *Motley Fool Options* (and how to use them and other Foolish services).
- This Week in CAPS: Member TMFEldrehad looks at some shooting five-star stocks.
- Our favorite discussion of the week: Fools shares their poems about the joy of options.

Why You're Here

- *Pro* is a flexible, balanced way to invest. I've been working on this process for about 10 years — and it's become stronger with the team and community here. It's worked well in strong and poor markets.
- *Pro* is driven by a lasting desire for financial independence. It has nothing to do with beating a market but with living a life.
- Many *Pro* members have told us that *Pro* has markedly improved their investing, including their approach, emotions, flexibility — and performance. We've enjoyed investing together during incredibly challenging times.

How You Should Measure the Service

- We announce our trade intentions before we make the trades, so you can invest before we do. *Pro* usually pays a price for this, but that's because we put you first.
- Judge your returns, not ours. Only *your* returns correspond to achieving your goals.

- Ask yourself: Do our recommendations make you money? Do we respond to potential changes in an investment? Do we make our strategies and intentions clear? That's how we serve you.
- Investing is a long-term endeavor. We realize you want reassurance that your *Pro* membership is money well spent. So to start, judge our past accuracy, judge our level of involvement in the service, and then judge your returns over time. We're confident that *Pro* will *make* you money over time, not cost you — and, importantly, make you a better investor.

I'm almost out of words, Fools. Thank you for taking the time to review our investment strategy, and if you're new to *Pro*, welcome! We hope this overview was helpful. We're glad you're a *Pro* member. We'll be in touch again soon!

Jeff Fischer (TMFFischer)

Jeff owns shares of Ebix and Intel and has written puts on Rockwood Holdings.

- Questions about this Memo? Post them on our Memo Musings discussion board.

Charter and 2011 Portfolios: Write Covered Calls on ProShares Short S&P 500

Published Mar 25, 2011 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") May 2011 $44 covered calls
- **Allocation:** Write one call for every 100 shares owned
- **ETF price**: $41.55
- **Option price (bid/ask):** $0.45/$0.55 (After reviewing current prices, try a limit order of $0.50; don't sweat over nickels, but try not to accept less than $0.40.)
- **Potential ETF sell price:** $44.45 to $44.55
- **Alternative trades:**
  - Write May 2011 $45 calls for more breathing room.
  - Don't own shares yet? If you want a hedge in your portfolio, buy shares in 100 round lots and write these covered calls on them. (You can do a buy/write covered calls order for a net debit in the low $41-range.)
- **Why write covered calls:**
  - We defray the cost of this hedge.
  - We still have meaningful upside on the position.
  - We can roll the covered calls higher if we seek more upside later.

What's New?

"Honey, it's time to hedge the hedges!"

This is one resilient stock market. Portugal's finances are reeling; Libya is in a revolution; Yemen, Bahrain, Syria, Egypt, and other countries are politically unstable; Japan is struggling through multiple disasters; radiation is drifting over Europe; and U.S. home-sales numbers are the worst in generations. And through all this, the S&P 500 is still gaining ground, sending the inverse **ProShares Short S&P 500** (NYSEMKT: SH) ETF lower.

As we said when we recommended the ETF, we don't believe the stock market is overvalued. Still, it's vulnerable to shocks or — dare I say? — a return to the realization that *things aren't great out there*, economically or otherwise, and that the risks we see today are real and that more risks lie ahead. So, why cover our short at all?

Why This Strategy?

Stock markets are resilient. They notoriously climb walls of worry, especially if valuations are reasonable. Even though we own this inverse ETF (which goes up whenever the S&P 500 goes down) to protect against market shocks, we can also hedge our position to defray its costs. So we like writing reasonably priced covered calls on the ETF — they allow us to offset the cost of hedging while retaining the upside we see in the position.

How to Follow Along

Remember, **do not buy these calls** — we're selling them and being paid in the process. For every 100 shares of ProShares Short S&P 500 you own, write ("sell to open") one covered call. You're obligated to sell your ETF position if it's above the strike price by expiration and we haven't adjusted the trade. Let's review the trade details:

- **Trade:** "Sell to open" May 2011 $44 calls
- **Option price:** $0.45/$0.55 (aim for $0.50; ideally, accept no less than $0.40)
- **Net sell price:** $44.45 to $44.55
- **ETF price:** $41.55
- **The ETF is:** 5.6% below our strike price and 6.6% below our net sell price
- **The option yields:** About 1.8% on the current ETF price, in 56 days

Next Steps

- If this strategy is new to you, read our guide to covered calls; then visit our ProShares Short S&P 500 discussion board to ask questions.
- **Follow Along:** Track your ProShares Short S&P 500 returns in My Scorecard.

Charter Portfolio and Portfolio 2011 will write covered calls on ProShares Short S&P 500 in the next one to 30 days, per The Motley Fool's trading guidelines.

Charter and 2011 Portfolios: Write Puts on Rockwood Holdings

Published Mar 23, 2011 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") May 2011 $45 puts
- **Allocation:** About 2% for a 4.5% total (for *Pro*'s Charter Portfolio, that's six contracts; for Portfolio 2011, it's one)
- **Stock price**: $48.50
- **Buy around:** $43.50
- **Option price (bid/ask):** $1.45/$1.55 (After reviewing prices, try a limit order around $1.50 if feasible; as prices change, accept no less than $0.90.)
- **Potential buy price:** $43.50 to $44.10
- **Alternative trades:**
  - Write August 2011 $45 puts, recently $3.
  - Consider buying shares directly if you don't own any yet, starting incrementally, and looking to buy more at lower prices.
- **Why write puts?**
  - Rockwood's first earnings report since we bought shares was strong.
  - We want to own more Rockwood than the 2.5% position we already hold, but we'd like to target a lower buy price.
  - Ideally, we can keep writing puts for income until all our dreams come true — that is, until we can buy Rockwood at an unbelievably low price or else we get a pony.

What's New?

Rockwood Holdings (NYSE: ROC), which produces specialty chemicals and lithium, has gained 11.6% in the six weeks since *Pro* bought shares. The S&P 500 lost 3% in the same time. That is fine and dandy, but we'd like to own more Rockwood shares. The company reported record strong earnings last month, and it voluntarily paid off more than $400 million in long-term debt, decreasing its annual interest expense by about $40 million. That's a very large plus to add to the bottom line of a company that had net income of just $239 million last year.

As we explained in our original buy recommendation, Rockwood has spent much of the past decade reorganizing itself to focus on its most profitable and promising businesses, including its key lithium division, which is expected to grow 30% this year. As of February, the company is seeing increasing pricing power in its key markets — and plans to use it — and remains confident about the year ahead. Furthermore, as oil prices rise, Rockwood's synthetic products offer a lower-cost alternative.

Why This Strategy?

Although Rockwood remains a Buy First and all *Pro* members should ideally own a partial position, its shares are nearly 3 times as volatile as the S&P 500. In a market downdraft, we might get our desired price for new shares. If not, at least we own a partial position, and we'll seek to earn more put-option income.

Writing puts is more defensive than chasing shares in a market that's risen for several months. Although Rockwood has little direct exposure to Japan, it remains to be seen how the disaster there will affect the hundreds of industries — including batteries for electronics — that Rockwood serves, not to mention the overall global economy.

How to Follow Along

Remember, **do not buy these puts** — we're *selling* them and being paid in the process. For every put you write, you're obligated to buy 100 shares of the stock if it's below the strike price by expiration and we haven't adjusted the trade. *Pro* would be ready and happy to buy shares in the mid-$40s. Here are the trade details:

- **Trade:** "Sell to open" May 2011 $45 puts
- **Option price:** $1.45/$1.55 (try a limit of $1.50; accept no less than $0.90)
- **Net start price if we get shares:** $43.50 to $44.10
- **Stock price:** $48.50
- **The stock is:** 7.7% above our strike price and about 10% above our breakeven
- **The option yields:** 3.3% on cash in 59 days

Next Steps

- If writing puts is new to you, check out our guide on the strategy. If you have questions about this trade, visit our Rockwood Holdings discussion board.
- To track your Rockwood returns or watch the stock, add it to My Scorecard.

Charter Portfolio and Portfolio 2011 will write puts representing about 2% in Rockwood Holdings stock in the next one to 30 days, per The Motley Fool's trading guidelines.

Jeff is short April $40 puts on Rockwood.

Pro and Japan

Published Mar 21, 2011 at 12:00AM

Coverage and Community

- This Week in CAPS: Russell (TMFElderhad) highlights how you can help make CAPS even better.
- Member spinningwood shares a link (get it?) on the complexity of Japan's economic issues.
- Are corporate profit margins due to shrink? Perhaps a little.
- Jeff asks you to keep liquidity in mind — but not without explaining how he views it.
- Member stamleo continues to provide value all over our discussion boards, including his look at results from **Ebix**. TMFDatabasebob also shares his analysis, while Jeff says *Pro* has every intention of holding the stock.
- Member alex340 shares puts that match our criteria. (Just note that some are on stocks long gone from the portfolio.)
- Vote spinningwood for the Feste award!

Dear Fellow Fools,

As tragedy roils Japan, our thoughts remain with the families and friends affected by the disaster. When something this monumental happens, we'll help the victims however we can, and we'll also reassess our investments as we continue to work toward earning absolute profits with you.

Last week, the *Pro* team combed through all of our holdings to discover how the companies may be affected by the news in Japan. In today's Memo, we've summarized our findings and provided you with discussion board links for more information.

Although the regions hit hardest by the earthquake, tsunami, and nuclear disaster account for just 3.6% of Japan's economy, the area is home to many electronics factories, and that could cause supply-chain disruptions for companies across the globe. Japan is still the silicon wafer capital of the world but not nearly as much as it was 10 years ago. Chip manufacturing is now spread across many countries; however, Japan's sophisticated plants remain unmatched in some niches. So we must consider not only the impact of temporarily lower sales to the world's third-largest economy but also the possibility of supply-chain problems for our companies. Fortunately, few of them appear meaningfully vulnerable:

Immediately Affected by Japan	Why?
iPath S&P 500 VIX Short-Term Futures ETN	Implied market volatility — as measured by the VIX index — spiked last week, sending our exchanged-traded note higher. We rolled up our naked calls to a more defensive strike price. But if nuclear fears subside, the VIX should settle down.
ProShares Short S&P 500 ETF	We planned to short the S&P 500 even before the disaster in Japan. If economic concerns grow, this hedge may help.

Potentially Affected by Japan	Why?
Apple	Japan accounted for 5.9% of Apple's 2010 sales, and several key components for the iPad are probably made only in Japan, so Apple could face worldwide product delays in coming weeks. The iPad launch in Japan was delayed. But our long-term thesis here is unchanged.
Cisco Systems	About 3% to 4% of annual sales come from Japan. Product disruptions aren't likely but are possible.
GlaxoSmithKline	More than 7% of annual sales come from Japan, but our thesis remains unchanged.
Intel	About 10% of 2010 sales came from Japan, but Intel CEO Paul Otellini sees little effect from the disaster and says Intel's sales could pop as Japan rebuilds. We bought more of the cheaper shares in Portfolio 2011.
Medtronic	An estimated 6% of Medtronic's sales come from Japan, so we expect some effects but nothing that changes our thesis.
NextEra Energy	Operating a handful of nuclear power plants in the U.S., the company may face more scrutiny leading to higher costs. Our concern is moderate today, though.
Oracle	About 5% of sales come from Japan, and 14% of Oracle's long-lived assets are there. Still, the impact should be minimal given the recurring nature of Oracle's subscription revenue.
Tupperware	Contributing 2% of sales, Japan is small but still meaningful to Tupperware.

Little to No Likely Effect	Why?
Ebix	Ebix has an office in Japan and sells software in Japanese, but its sales there are small.
GrafTech International	Many competitors are based in Japan. Needle coke pricing may increase, benefiting GrafTech.
iShares Russell 2000 ETF	We're 12.5% short including this position and ProShares Short S&P 500, which could be helpful. But this ratio put spread needs until August to bear real fruit.
Kinetic Concepts	The company entered the Japanese market in 2010, so the country is likely to be less than 1% of 2011 sales.
L-3 Communications	L-3 sells mostly to the U.S. government; however, some electronics supplies may be delayed, although we have no evidence or reason to suspect it.
Rockwood Holdings	None of Rockwood's companies have offices or listings in Japan. Sales to the country are likely modest, although several competitors reside there.
Vanguard Energy ETF	Several of the ETF's holdings supply chemicals, oil, or gas to the Japanese electricity markets, but the crisis seems to have spared most of the large integrated oil companies and servicers.
Wells Fargo & Co.	Wells Fargo has no direct exposure to Japan.
WisdomTree Emerging Markets Small Cap Dividend Fund	No assets are allocated to Japanese companies.

No Apparent Relationship to Japan	Read More on the Boards
AmTrust Financial	AFSI and Japan
Bristow Group	BRS and Japan
Broadridge Financial	BR and Japan
Jack Henry & Assoc.	JKHY and Japan
Papa John's	PZZA and Japan
Plum Creek Timber	PCL and Japan
SPDR KBW Regional Banking	KRE and Japan
Sprott Physical Gold Trust	Gold may rise if global instability does.
TradeStation Group	TRAD and Japan
Vanguard Emerging Markets ETF	VWO and Japan

Now that we've reviewed *Pro*'s 29 positions, we're able to report that the devastating events in Japan haven't changed our long-term outlook for any of them. We may see some periods of weakness, but if so, we'll also look to seize opportunities.

Upcoming Events

- **March 24: Oracle** reports earnings after the market closes.
- **Next Monday Memo: Tuesday, March 29.** Your next Monday Memo will arrive one day later than normal, on Tuesday, March 29, because Fool HQ will be closed Monday. We're moving our office that day — please pardon our dust.

If the economic ramifications of Japan's disaster grow more serious, we may become more defensive on the positions that are most likely to be affected, so we're monitoring them closely. (For example, we look forward to learning more about Oracle's results on Thursday.)

As always, you can see where we stand on every position by visiting our Charter Portfolio page and noting our Buy First, Buy, and Hold guidance. If you have questions or comments, please visit our Memo Musings discussion board.

Wishing Japan a swift recovery,
Jeff Fischer (TMFFischer)

Jeff owns shares AmTrust, Apple, Ebix, GlaxoSmithKline, Intel, Kinetic Concepts, Oracle, and Tupperware. He is short VXX and has options positions in Rockwood Holdings. Motley Fool Alpha LLC owns shares of Cisco Systems and is short IWM.

Live Chat: March 30, 2011

Published Mar 18, 2011 at 12:00AM

The *Pro* team hosted a live chat on Wednesday, March 30. Did you miss it? No problem, Fool. Just click the player below to get the transcript and read the questions and answers at your own pace.

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Charter and 2011 Portfolios: Roll Up Naked Calls on VXX

Published Mar 17, 2011 at 12:00AM

At a Glance

- **Action:** "Buy to close" March 19, 2011, $34 calls; "sell to open" an equal number of May, 21, 2011 $39 calls
- **Recent Options Prices:** March $34 calls: $1.80; May $39 calls: $3.80
- **Preferred Price:** Roll up for a net credit of $2 per contract or higher (see "How to Follow Along" below if prices have changed considerably when you read this)
- **Allocation:** -6% (as a short) if turned into short shares
- **Recent VXX price:** $35.60
- **Recent Measure of the Volatility Index (VIX):** 26
- **Alternate Trades:**
  - Sell short VXX directly, starting with a partial allocation, or adding to one
  - "Sell to open" June $39 calls, to have more time
  - Sell to open June $43 calls, to have more breathing room
  - Buy shares of **VelocityShares Daily Inverse VIX Short-Term Futures** (NYSEMKT: VXX) exchange-traded note. If you do this, know that the ETN doesn't track as well as a short of VXX. Still, it's the best available alternative if you're not writing naked calls or shorting VXX.

What's New?

Must you ask? The famous VIX index is a measure of market fear, and few things frighten people more than a potential nuclear accident. While Japan grapples with a life-and-death situation, the VIX has jumped from 20 on March 11 to 29 at yesterday's close, for a 45% gain. This sent the **iPath S&P 500 VIX Short-Term Futures** (NASDAQ: XIV) exchange-traded note up 14% over the same period, from $33 to yesterday's $37.63. It also put our $34 naked calls on the VXX under water, so we're going to take action.

We know that the volatility index moves in two ways: It spikes higher, and then it grinds down as fear subsides and investors stop buying put options (which drive the index). Given how the index moves, we don't want to run away from a VIX-related short on a spike — we want to stand our ground, short more if we can, or start a new short if we don't have a position. Because we already have one, we're adjusting it.

Even though the world has utterly changed for Japan (and for all of us, in indirect ways), market volatility will eventually accept these new realities as normal. As panic subsides, the volatility index will probably decline, as it has historically done, making our short profitable. Japan's potential nuclear crisis obviously remains the largest-known risk we face. We need to try to compensate for that risk as best we can while not running away from a position at the precise time when, historically, we should hold our ground. To help guide us, we're using the history of the VIX and our knowledge of the inferior performance of this ETN.

Why This Strategy?

That's why we're rolling our calls out and up, which gives our trade more time to play out and allows us to get paid in the process. After Japan's crippled nuclear reactors are calmed, the market is bound to stabilize, as will volatility. What we don't know is how long this will take. But we do know the history of the VIX. Here are key peak measures:

Date	VIX Level
Aug. 23, 1990	36
Oct. 30, 1997	38
Oct. 8, 1998	46
Sept. 20, 2001	44
Aug. 5, 2002	45
Aug. 16, 2006	31
Nov. 12, 2007	31
Nov. 20, 2008	81
May 20, 2010	45
Yesterday (March 16, 2011)	29

Source: Chicago Board Options Exchange

Remember, those are key *high* points in the volatility index. Historically, the VIX has traded above 30 just 9.5% of the time since 1990. It has traded above 40 only 3% of the time. The index's historic average level is 19. That compares with volatility in the S&P 500 of 16.2% since 1928, using rolling five-year realized volatility calculated by Societe Generale. (This shows how the VIX trades at a premium to realized volatility, which is partly why our short of volatility works over the years.)

Anyway, all these numbers suggest that if Japan's situation worsens, the VIX could potentially gain 50% or so more from this morning's 26, to hit levels reached during other crisis peaks. A 50% gain would put the VIX near 40, a level it rarely hits. Now, stay with us here: If the VIX gains 50%, to 40, the ETN we're betting against could gain about 25%, putting it at about $45 compared with this morning's $35.60. (Even Barclays Capital, which issues the ETN, says the best rule of thumb is that the ETN will gain about half as much as an increase in the VIX — again, because the futures prices that the ETN tracks already carry a premium that assumes higher volatility.)

As we roll up our naked calls, we're using a $39 strike price and receiving about a $2.50 net credit, so our breakeven on this trade is $41.50. This is close to the $45 the ETN could reach in a severe situation if the volatility index rises to 40. If that happens, we should be able to roll the position again without much hardship. So we're aiming to set up a position that remains flexible even if the VIX soars to 40. And if the VIX rises 30% or less, our new naked calls should end with a partial to full profit. (A 30% gain from 26 would put the VIX at 34 — and should put the ETN at about $41.)

So we're not running away from volatility when it spikes. We still have a fairly assertive position that will end in a good profit in two months if the VIX cools down, but it's also a defensive position that should allow us to roll again if the VIX soars to 40.

How to Follow Along

To make this trade, "buy to close" your existing March 19 $34 naked calls — paying the going market price when you're ready — and at the same time, "sell to open" the same number of May $39 calls. **Prices change rapidly, so if they're much different from the ones in this report, you'll want to adjust your trade so you still get a net credit as you roll. Also, if the ETN is below $34 by Friday, you may not need to close your naked calls at all — they may expire. But we're assuming we'll need to close.** If you look into possible rolls beyond the one we're suggesting here, you can follow this math as an example:

Rolling Up Cost and Credit	Call Prices
Premium on hand from writing March $34 calls	$0.52
Cost to close March $34 calls	($1.80)
Net cost	($1.28)
Premium gained from writing May $39 calls	$3.80
Net credit (possible profit)	$2.52

Trade Details

- **Action:** Buy ("buy to close") March 19, 2011, $34 calls. Sell ("sell to open") May 21, 2011, $39 calls.
- **Allocation:** Charter Portfolio is again writing 25 contracts, and Portfolio 2011 is writing four. Our original -6% allocation for both portfolios still fits (it's negative because it's a short). Each written call represents a $3,900 short of the VXX exchange-traded note.
- **Preferred pricing:** Roll up for a net credit, ideally $2 or higher. If you have to change strike prices because the options prices have changed, aim to do so.
- **Break-even price (if rolled at a $2.50 credit):** $41.50
- **Recent VXX price:** $35.60
- **Difference to breakeven**: 16.6%

As we've said each time we've recommended a trade on VXX: If you make this trade, be aware of the risks of shorting a volatility-tracking instrument. This is a high-conviction position when time is on our side, but we might see large price movements in the interim. In that case, we'd need to roll the position forward or update our strategy. So you need liquidity to stay in the position. Finally, if you don't already have a position in VXX, shorting the exchange-traded note directly — if you can get shares — is still the preferred course of action. View the direct short as a long-term position to profit on slow pricing decay.

Next Steps

- As always, please bring your questions about this trade to our VXX discussion board.
- Track VXX in My Scorecard.

Pro *will roll its naked calls in both portfolios in the next one to 30 days, per The Motley Fool's trading rules.*

Jeff is short shares of VXX.

Portfolio 2011: Buy More Intel

Published Mar 17, 2011 at 12:00AM

At a Glance

- **Action**: Buy 2% for a total 5% (for Portfolio 2011, that's 250 more shares for a total of 600)
- **Recent Price**: $20
- **Buy-Around Price:** $20.50
- **Fair Value:** $25
- **Alternate Trades**:
  - Write ("sell to open") May 2011 $20 puts or May $19 puts
  - Write June 2011 $19 puts to be most defensive

What's New?

Since Portfolio 2011 bought a 3% stake in **Intel** in February, little has changed with the company. Yet the world at large has changed. Even as Intel continues to produce high-quality chips that power most of the world's computers, Japan — home to the world's third-largest economy — is experiencing its worst crisis since World War II. The human suffering is unimaginable, and our thoughts are with everyone in the country.

We hope that life and business can soon go on as usual in Japan, and, indeed, Intel's assessment of the situation may indicate at least business stability ahead for the country. Surprisingly, the company expects the effects of the earthquake and tsunami to have a minimal impact on its business.

That's because although Japan produces about 60% of the world's silicon (according to research from IHS iSuppli), most of the production is in the southern part of the country, away from the destruction in the north. Intel's suppliers indicate that shortfalls may be negligible. Additionally, silicon plants in other countries are moving to pick up production slack. Furthermore, Intel doesn't do any manufacturing in Japan and said most of its customers manufacture computers in China.

Perhaps the larger concern to Intel, then, is the fact that more than $4 billion of its $43 billion in 2010 revenue came from Japan. Sales to Japan could be dented at least this quarter and the next one as business takes a back seat to survival and safety. As Japan digs out and rebuilds, however, new technology — containing lots of computer chips — may demand plenty of its investment yen. Intel's CEO Paul Otellini has suggested that there may be a spending pop on technology as Japan rebuilds infrastructure.

Why This Strategy?

Hugging $20, Intel's stock trades at 10 times trailing earnings, a discount of about 50% to the S&P 500's average multiple. We're not greedy — we don't think Intel deserves to gain 50% to trade at 15 times earnings, but our $25 fair-value estimate is at least 25% higher than the current stock price (and still just 12.5 times earnings).

In the current frenzy over computer tablets (which seems overblown to us), Intel needs to prove to investors that the mobile and desktop PC markets will remain integral to the world economy and that the company won't get left behind in the tablet wars. Intel's chips are slated to appear in several tablets this year, and its server and traditional PC markets (in which mobile computing is expected to increase sales by double digits this year) remain strong enough to keep the company growing. After initially cannibalizing some mobile computer sales, tablets will probably boost the overall computing market.

The largest short-term risk is of course Japan. The national disaster could end up affecting Intel more than the company (and we) currently estimate. That should be a temporary hit to Intel's business, but not a fundamental change. If Japan's situation worsens, Intel's sales in the country may be hit harder this year, and its supply chain could still weaken. These are short-term risks.

Intel's stock is down 8% since we first bought it for Portfolio 2011, with most of the decline occurring in the last two weeks. The current dividend yield is 3.6% at $20 per share, allowing us to capture both a healthy yield and a low stock price as we fill out the position.

How to Follow Along

We have plenty of cash in Portfolio 2011, so we're comfortable investing despite uncertainty about Japan's economy. If the market continues to decline, we'll be buying more stocks, averaging in at lower prices. If you lack our cash cushion or need to be more defensive, consider our alternate trades of writing ("sell to open") puts on Intel for a lower potential buy price or income if shares stabilize. Write one put for every $2,000 you'd be willing to invest in Intel. Portfolio 2011 plans to buy 250 shares directly, giving us 600 total, for a 5% allocation in the technology giant. We might write covered calls on Intel later, but using options isn't essential to this investment.

Next Steps

- Questions or comments? Visit our Intel board.
- Once you've bought Intel, add it to My Scorecard.

Portfolio 2011 will buy an additional 2% stake in Intel in the next one to 30 days, per The Motley Fool's trading guidelines.

Jeff owns shares of Intel.

Charter and 2011 Portfolios: Buy ProShares Short S&P 500

Published Mar 14, 2011 at 12:00AM

At a Glance

- **Action:** Buy 5%
- **Recent Price:** $42
- **Buy Around:** $43.50 or less
- **Alternative Trade:**
  - Write puts at $42 or less. If the market *rises*, you could be sold shares, starting your short at a lower price.
- **Why Buy:**
  - This short ETF moves inversely to the S&P 500, making it a hedge for a mostly bullish portfolio.
  - If the market declines, the value of this position will increase, becoming a greater source of cash for new bullish buys at lower prices.
  - We plan to write covered calls on this ETF in the future, lowering our cost basis and increasing our odds for a gain. Not many shorts allow for that strategy.

First Things First

- **ETF: ProShares Short S&P 500** (NYSEMKT: SH)
- **Type of holding:** Short-term short/hedge; U.S. large-cap index
- **Options:** We'll probably write covered calls later, so consider buying 100-share lots if you want to follow along (though you don't have to use options).
- **Tax considerations:** Short-term gains or losses are likely.
- **Follow along:** Add ProShares Short S&P 500 to My Scorecard.

The Big Picture

When you want to hedge your many long positions, the inverse **ProShares Short S&P 500** (NYSEMKT: SH) ETF is a relatively simple, low-cost, and liquid way to put a short position into play. The reasons for investing inverse to the S&P 500 today read like a boilerplate list of market risks: rising commodities costs, stagnant wages, low consumer confidence, stubborn unemployment, the approaching end of federal stimulus, enormous deficits on a state and federal level, unrest in the oil-rich Middle East, a weak Oscars show, a stock market that has gained for months on end, and more. We know that stocks can climb a wall of worry, but with market indexes reaching levels last seen before the financial crisis, investors might be getting ahead of themselves.

The S&P 500 — home to **ExxonMobil** (NYSE: XOM), **Apple** (NASDAQ: AAPL), and **General Electric** (NYSE: GE), the index's three largest components — is trading at a reasonable 14 times forward earnings and yielding about 2.2%, so by going short, we're really hedging against the possibility of unpleasant surprises in the coming months, whether in the Middle East or the United States or from earnings that start to roll out again in April. Perhaps the largest risk on the immediate horizon, though, is the chance of still higher oil prices. If oil were to rise an additional 10% to 20%, it would be more likely to crimp the economic recovery, which could lead to lower earnings. And the mighty S&P 500 would not be spared.

The Vehicle

We first owned shares of ProShares Short S&P 500 from November 2009 to October 2010, and although the market gained significant ground over that time, we sold the ETF at a modest loss partly because we wrote covered calls on it three times, lowering our cost basis.

We don't intend to hold the ETF as long this time, because although it tracks the inverse of the S&P 500 well over a handful of months, its tracking historically slips over long periods. This is because the ETF uses derivatives (mostly swaps) to achieve its investment objective. The good things about the ETF are that we don't pay to borrow shares for shorting and we don't need to reimburse anyone for the dividends the S&P pays — but we still face friction costs given how the ETF invests. Its tracking should be admirable over our targeted time period of less than a year, though:

Vehicle	Q4 2010 Returns*	2010 Returns	3-Year Returns	Returns Since Inception (June 2006)
ProShares Short S&P 500	-10.35%	-16.59%	-5.51%	-5.46%
S&P 500	10.76%	15.06%	-2.85%	2.48%

**All returns as of Dec. 31, 2010.*

Source: ProShares Short S&P 500. Includes 0.92% net expense ratio. (Google Finance and other sources show a much weaker long-term performance for the ETF because they wrongly exclude the distributions made in profitable years, namely in 2008.)

On a quarterly or even one-year basis, the inverse ETF has tracked well. Looking back three years, however, the ETF failed on its promise, declining even though the market dropped 2.8%. When we short anything in *Pro,* we do so with months rather than years in mind, and in this case we'll be more diligent than ever about that. We also know the ETF can track a bit less well when the market drops than when it rises, but we're ready to miss a few points in exchange for the ease of use and liquidity of the ETF — as well as our ability to alter the risk and reward profile by using covered calls.

Future Strategy

As we did the last time *Pro* owned shares of the ETF, we plan to write covered calls (one for every 100 shares of the ETF owned) in the near future, hedging our hedge and lowering its cost basis in the process. In fact, the ability to write calls on a short position is what first attracted me to this ETF, and it helped *Pro* considerably the first time we owned it. The idea is to write covered calls that expire in about two months and allow for 7% to 8% upside before they would come into play. If the market declines, sending the ETF *up* that much for us, we'll consider taking our profit (letting our shares get called away) or rolling our covered calls up to a higher strike price, targeting more profit potential from the short ETF. If the market *rises*, making the ETF *decline*, we'll try to roll our covered calls down for another payment to help insure a profitable outcome — or at least minimize any loss. Watch your inbox for a potential covered-call trade alert, where we'll provide all the details.

How to Follow Along

If you want to take a position in your portfolio that moves inverse to the S&P 500, join us by buying ProShares Short S&P 500 ETF. If you wish to potentially write covered calls, buy the ETF in 100-share lots, for about $4,200 per lot (invest up to 5% of your portfolio).

The Foolish Bottom Line

As of Friday, the S&P 500 was just 2.9% below its recent high, even though volatility has increased lately. Taking an inverse position on the S&P 500 will either reward us as the market finally gives up some of its healthy gains, or we'll chase this position with covered calls if the market regains its footing and scores new highs. Ultimately, the market will enter a down spell (it always does) — but we don't know when. Just the same, adding this hedge is a sensible way to lower the downside risk of our long-biased portfolio.

Next Steps

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Pro will buy shares of ProShares Short S&P 500 ETF in both portfolios in the next one to 30 days, per The Motley Fool's trading rules.

Jeff owns shares of Apple. The Motley Fool owns shares of ExxonMobil and Apple.

Charter and 2011 Portfolios: Buy ProShares Short S&P 500

Published Mar 14, 2011 at 12:00AM

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Next Steps

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- Once you've bought the ETF, track ProShares Short S&P 500 in My Scorecard.

Pro will buy shares of ProShares Short S&P 500 ETF in both portfolios in the next one to 30 days, per The Motley Fool's trading rules.

Jeff owns shares of Apple. The Motley Fool owns shares of ExxonMobil and Apple.

Charter and 2011 Portfolios: Set up a Ratio Put Spread on IWM

Published Mar 9, 2011 at 12:00AM

At A Glance

- **Action:** Write ("sell to open") August 2011 $72 puts; buy ("buy to open") August 2011 $81 puts (buy one put for every two puts you write).
- **Allocation (based on the written puts):** 15%, but half of this is insured by our purchased puts, so our true exposure is 7.5%. Charter Portfolio is writing 30 puts and buying 15, and Portfolio 2011 is writing six puts and buying three.
- **Index price (as of 3/8/11 close):** $82.50
- **Option prices:** For the $72 puts, $2.75. For the $81 puts, $5.50.
- **Limit prices:** Aim to set up the spread for about zero net cost.
- **Why set up this ratio put spread:**
  - With little or no out-of-pocket costs, we can profit on a decline in small-cap stocks.
  - We'll buy a 7.5% stake in the index if it declines at least 12.7%, and we benefit by having a break-even price that's another 12.5% below that.
  - We'll lose nothing if the market stays steady or continues to rise.

First Things First

- **ETF**: **iShares Russell 2000 Index** (NYSEMKT: IWM)
- **Type of holding:** Short/Hedge; U.S. small-cap index
- **ETF info:** us.ishares.com
- **Follow along:** Add iShares Russell 2000 Index to My Scorecard.

The Strategy

Pro's ideal shorting strategy earns us meaningful profit if the underlying investment declines, has low risk of permanent losses, and — the Holy Grail of shorting — doesn't work against us if the market goes up. Ratio put spreads fit the bill nicely. The strategy involves writing puts (as we've often done), and using the proceeds to *buy* puts at a higher strike price. You write twice as many puts as you buy, which sets up the spread for zero cost (or better yet, a credit to your account).

Ratio put spreads offer two strategic possibilities at once: They allow you to profit on a decline, and, *if* your bearish expectations play out, they set you up own shares of the underlying investment at much lower prices.

In a nutshell: The strategy conserves your cash while increasing your bearish exposure, ensures that you don't lose anything if the market doesn't decline, and commits you to purchasing shares only at much lower prices. Overall, the defensive part of this strategy works best when there's a reasonable decline in an investment's price — around 10% to 15%. The following table explains how the trade could play out:

iShares Russell 2000 Index (NYSEMKT: IWM) market price:	**$82.50**
Write ("sell to open") August $72 puts:	Receive $2.75 per contract
Buy ("buy to open") August $81 puts:	Pay $5.50 per contract (buy half as many contracts as you wrote)
Net cost to set up trade:	$0 (Note: you don't need to target the above prices, which of course will change; just seek prices that net you near zero cost; if the market moves meaningfully, you can even adjust the strike prices to do so.)
Maximum profit:	$9 per share at $72 (12.7% lower than the market price)
Break-even price:	$63 (23.6% lower)
Partial profit:	Anywhere from $63 to $81 at expiration
Upside risk:	None. If the ETF remains above $81, the trade expires at no cost.
Downside risk:	If the index declines 12.7% or more, half of our written puts obligate us to buy a 7.5% allocation in the ETF at $72 (unless we close the puts early). (The other half of our written puts are canceled out by purchased $81 puts.) However, since our purchased puts will earn $9 per share in *profit* when the ETF hits $72, our break-even point on the total strategy, and our effective buy-price on our 7.5% allocation, is actually $63, or 23.6% lower than today's market price. If the index falls more than that, we start to suffer losses.
Sounds great. So what's the catch?	If you write 100% cash-secured puts, you need to set aside $7,200 per uncovered written put. If you're using equity as collateral, you'll need much less. Either way, this is cash that will not be invested in the market during the coming months. Additionally, most profits on a spread won't be earned early on, but closer to expiration. Finally, to repeat, we'll see losses on our 7.5% allocation if the ETF falls below our break-even price of $63.

The Big Picture

In the seven months since the unflappable Ben Bernanke hinted that the Federal Reserve would go on an asset buying spree, the **iShares Russell 2000 Index** (NYSEMKT: IWM) ETF has gained 35%. (The ETF tracks the Russell 2000 Index, a measure of U.S. small caps.)

The average company in the venerable index now trades at an estimated 20.7 times trailing earnings (excluding the unprofitable companies!), though the index has averaged just 17.7 times earnings over the past 20 years. That's a 14% difference.

If the market runs into trouble, the 2,000 small companies in the index — which have a median market value of just $510 million — are more likely be tossed around than are the giants of Wall Street. In fact, the Russell 2000 was 20% more volatile than the S&P 500 in the past year, so a 10% decline in the S&P could bring the Russell 2000 within our buy range. At our break-even price of $63, we'd be buying the index for about 15.8 times average earnings, below the long-term average.

Why bet against the index in the first place? Well, along with its rich-looking valuation, as commodity prices rise, many smaller companies have fewer ways to hedge or pass higher costs on to customers — and that makes them vulnerable to earnings disappointments. Several other factors also give us reason to be cautious: Many government stimulus programs initiated in 2009 are quietly winding down, the latest quantitative easing program (QE2) is slated to end in June (although it's very possible it'll continue), and the specter of inflation and higher interest rates is growing. Plus, higher oil prices threaten to derail GDP growth, and political uprisings in the Middle East may continue.

We don't want to throw the whole market under the bus, however. We still like the stocks we own, and we believe in the long-term value offered by strong companies. (The S&P 500 only trades at 15.5 times reported earnings, compared with 19.7 at the end of the average bull market, according to Bloomberg.) So, we continue to hold and buy promising companies, and this is why we're willing to *buy* the index that we're effectively shorting, but in this case, only at much lower prices, and only after we use it as a short or hedge first.

How to Follow Along

For every uncovered put you write for this trade, you need to be willing to invest $7,200 down the road. Some brokers allow you to set up a ratio put spread with a single trade, saving commissions. Here's the rundown:

- **"Sell to open"** August 2011 $72 puts
- **"Buy to open"** August 2011 $81 puts, one for every two puts you sell
- **Recent prices:** $72 puts pay $2.75; $81 puts cost $5.50.
- **Limit prices:** Split each bid/ask price with limit orders that would have you pay a net sum of zero to set up the two trades. It may even be possible to be paid a small credit. If entering the trade as a single spread order, aim for zero cost or a small net credit.

If you have to make the legs of the trade separately, aim to complete one right after the other so a sudden move in the market doesn't throw off your prices mid-trade.

Here's how the profit table looks on the smallest possible position (writing two puts to buy one):

iShares Russell 2000 Index price	One purchased $81 put	Two written $72 puts	Total return (or loss)
$81 and higher	$0	$0	$0
$80	$1 x 100 = $100	$0	$100
$75	$6 x 100 = $600	$0	$600
$72 (maximum profit)	$9 x 100 = $900	$0	$900
$70	$11 x 100 = $1100	($2) x 200 = ($400)	$700
$67	$14 x 100 = $1400	($5) x 200 = ($1000)	$400
$65	$16 x 100 = $1600	($7) x 200 = ($1400)	$200
$63 (breakeven)	$18 x 100 = $1800	($9) x 200 = ($1800)	$0
$60	$21 x 100 = $2100	($12) x 200 = ($2400)	($300)

Our Charter Portfolio plans to buy 15 puts, making our maximum profit at $72 per share $13,500 (1,500 x $9 per contract). With no cash outlay to set up the trade, this would be a healthy gain as the index declines 12.7%. Portfolio 2011 will buy three puts.

Keep in mind that the above returns won't occur smoothly or immediately. The table represents returns *at expiration*. Before then, if the market falls, our written puts will be a "two-timing" drag on our returns, even as our purchased puts deliver gains. As with most spreads, we'll need to wait for expiration to achieve full results. Additionally, if the index falls more than 12.7%, the defensive benefits of our strategy start to diminish and will disappear if the index drops 23.6%.

The Foolish Bottom Line

With little or no out-of-pocket cost to us, this strategy profits on a meaningful decline in small-cap stocks. We'll be positioned to buy a 7.5% stake in the index if it declines 12.7% or more, while we'll enjoy a break-even price that's an additional 12.5% below that. But we lose nothing if the market stays steady or continues to rise.

Next Steps

- Questions or comments? Visit our iShares Russell 2000 Index discussion board.
- After you've set up a ratio put spread, track the **iShares Russell 2000 Index** in My Scorecard.

Pro will write puts and buy puts on the iShares Russell 2000 index as outlined above in the next one to 30 days, per The Motley Fool's trading policy. Motley Fool Alpha is short the iShares Russell 2000 index.

Pro Tips and ETF Strategy

Published Mar 7, 2011 at 12:00AM

Coverage & Community

- Recently, Jeff shared a short sale report that *Pro* wrote up but couldn't make. Today, he shares a *Pro* report on an ETF that's been on his radar, **Physical Palladium Shares**. Check it out!
- Member anxu starts the debate on the future of the Chinese yuan, suggesting flaws will hold it back.
- This Week in CAPS: Russell (TMFEldrehad) thinks you should check out Fool blogger GuruEbby, who is just starting to invest and offers simple lessons.
- *Pro* members discuss when to buy and buy-around guidance.
- On our Social Banter board, members are debating the merits of the dish versus DirectTV. Join in!

Dear Fellow Fools,

Investing is a bit like painting: When you start with a blank canvas, you're usually not sure what you're going to end up with, and it typically turns out differently than what you imagined. Fortunately, any blemishes in your work won't diminish your long-term success — in investing, anyway. In fact, blemishes are a necessary part of the process. With this in mind, let's review three key aspects of your *Pro* service and how they can help you. Then I'll talk a little bit about ETFs and how we use them in *Pro*.

1. Buy-Around Price

For every stock we recommend, we provide a buy-around price for day one, and then you can find that guidance on our portfolio pages forevermore. "Around" is part of the name for a reason. Usually, buying anywhere *around* the stated price is in the spirit of our recommendation. Investing is sloppy, valuation models are imprecise, and market prices change by the second. For any investment that turns out to be a winner, it won't matter if you bought 5% higher than our idealized price from day one.

We provide buy-around guidance for two reasons: We hope to help keep the investment trading in a tight range on the day we make the recommendation, and we want to provide a general benchmark from which we believe the position meets a healthy risk versus reward. Buying 5%, 6%, or 7% higher than our buy-around price isn't going to ruin that because the upside potential in the stock is also imprecise — and will almost surely rise above our original expectations with enough time and business success. Be patient, try to buy at attractive prices, but also realize that buy-around prices aren't precise — they're a guideline.

2. Fair-Value Estimates

Speaking of imprecise, anyone's fair-value estimate is an exercise in horseshoes and atom bombs: You're just trying to get close; you're aiming to be in the ballpark. Usually at *Pro*, we create a range for a stock's potential fair value by running three outcome scenarios and then using a price in the more conservative side of that range. But you should keep in mind precisely what "fair value" means: It's a fair price for a transaction, and any transaction includes a seller — *and a buyer*.

Upcoming Events

- **March 14: Ebix** earnings
- **March 19: iPath S&P 500 VIX Short Term Futures** calls expire

When a stock trades at its estimated fair value, it suggests that from that price on, the stock will provide your desired rate of return going forward (with stocks, generally 9% to 11% annualized). So when a stock is trading at fair value, that doesn't automatically mean you should sell. You should only sell at fair value if you're defensive and only want to own stocks trading at *discounts* to fair value. Otherwise, holding stocks that trade around fair value is fine. They should continue to reward you steadily until more than a few years of growth are prematurely factored into the share price (for example, if they're 18%, 20%, or more above fair value). At that point, you should consider swapping the stock for ones that trade at a discount to fair value instead.

3. *Pro*'s Trades

We don't have a crystal ball for short-term price movements. After we announce a trade alert, *Pro* must wait 24 hours before we can make the trade, and we have 30 days before we *need* to complete it. We'll usually try to complete trades early in our time window (at which point our Trade Complete email is sent to you) because prices can easily move against us if we wait, especially with options. But we don't have a magic formula for getting better short-term prices. We issue trade alerts when a trade is attractive, and then we hope the price cooperates with us within reason. Once again, *investing is an imprecise art*. *Pro* historically receives weaker prices on the majority of its investments (you can't expect otherwise when you announce trades and then must wait to make them), but even so, we're fast on the heels of our goals.

Using ETFs to Prosper

In our recent Monday Memos, we've been discussing how to run a *Pro* portfolio. We talked shop on stocks, comparing them to a marriage, and provided an overview of options. Now it's time to touch on exchange-traded funds and how we use them at *Pro*.

Like mutual funds, these handy investment vehicles can hold large baskets of investments (such as stocks, bonds, or commodities). ETFs trade on an exchange like stocks do, provide transparency by regularly reporting holdings, and in most cases, they charge reasonable fees. All of that goes a long way in explaining why they're the fastest-growing investment class on Wall Street.

Investors use ETFs to execute a variety of strategies, such as investing in commodities, foreign markets, sectors, and currencies; or to make inverse or leveraged bets (just to name a few). ETFs play an important role in a *Pro* investor's portfolio, making it easier to diversify and own stakes in many kinds of assets. As such, ETFs will typically make up about 15% to 20% of our *Pro* portfolios. We tend to hold an ETF as long as we believe an attractive, long-term, macro investment argument remains in place.

A Few ETFs We Own

In 2008, our Charter Portfolio bought our first stock-based ETF, **Vanguard Emerging Markets**. The fund invests in more than 800 companies concentrated in developing countries, such as China, Brazil, India, and Korea. As we suspected, rumors about the end of the world back in 2008 proved a tad premature, and the ETF gained 80% in the following months, prompting us to sell half our position. We still own the rest, and it remains a long-term Buy alongside our more recent addition, **WisdomTree Emerging Markets SmallCap Dividend Fund**. Although they're been out of favor lately, emerging markets should return to the limelight as investors realize that the United States has slow growth prospects without the Fed priming the pump.

A few months after our Charter Portfolio bought into emerging markets, we invested in the **Vanguard Energy** (NYSE: VDE) ETF, which holds the largest U.S.-based oil and gas companies. Oil was trading near $40 per barrel then, pushing down the share price and making the fund a value. The shares have since appreciated along with oil prices — which have been soaring lately. If you believe — as we do — that leading energy companies will continue to create value in the coming years, this ETF is an easy way to own many of the best energy companies in the country.

Our Charter Portfolio also owns the **SPDR KBW Regional Banking** (NYSE: KRE) ETF, which holds 50 of the country's leading regional banks and trades in aggregate modestly above book value. The ETF provides a diversified way to invest in an out-of-favor sector and spread out your risks while waiting for a recovery.

Each of the ETFs we hold in our Charter Portfolio is a Buy or Buy First, so you can expect us to start investing in them in Portfolio 2011, too.

New ETFs and Pitfalls to Avoid

Newfangled ETFs are rolling out all the time. One that's caught my eye is the **U.S. Commodity Index Fund**. It invests in a basket of 14 commodity futures after choosing from 27 possibilities every month. It bases its selections on quantitative-based models that consider every aspect of the futures prices. In a nutshell, the ETF seeks to minimize contango (the pesky nature of futures contracts typically costing more each month) and maximize backwardation (the relatively rare condition in which futures contracts become cheaper). So far, the young ETF has performed well, and according to the prospectus, the fund's methods would have returned 20% annualized the past 10 years.

Your *Pro* team considers new ETFs on a regular basis, but they all have one important thing in common: None of them uses much leverage. Many of today's ETFs are leveraged to seek 2, 3, or even 4 times the daily price movement of an underlying asset. Leverage like this will diminish the value of an ETF over long periods of time, so you won't see *Pro* embracing "ultra" or leveraged ETFs. We're also looking to *short* vehicles that simply track futures contracts to try to mirror the price of a commodity, rather than owning the commodity itself. Contango and the monthly cost of rolling futures contracts eats into the value of these investments. This is part of the reason we're bearish on the **iPath S&P 500 VIX Short-Term Futures** (NYSE: VXX) ETN.

Keys to ETF Investing

With ETFs — as with any investing — the key to being successful is knowledge. Specifically, before you open a position, be sure you:

- Understand how the ETF invests and have confidence in the method.
- Invest in ETFs that charge reasonable fees, generally less than 1% per year, although more complex ETFs can merit higher fees to get the job done.
- Know your time frame. Some ETFs are longer-term investments (such as emerging markets), while others are shorter-term (such as shorting ETFs).

To learn more about ETFs, visit The ABCs of ETFs and our discussion board, ETF Center. Do you have an ETF you particularly like (or dislike)? Please post it on our board!

Invest well!
Jeff Fischer

Jeff owns shares of Ebix and is short VXX.

Charter Portfolio: Buy to Close Covered Calls on Kinetic Concepts

Published Mar 7, 2011 at 12:00AM

- **Action:** "Buy to close" March 2011 $45 calls
- **Options price:** $6
- **Share price:** $50.80
- **Time value:** $0.20

What's New?

In a fascinating turn of events, wound-care company **Kinetic Concepts**' (UNKNOWN: KCI.DL) stock recently went into hyperdrive when the company told the SEC that it no longer plans to pay royalties on patents it had been licensing from Wake Forest University for years. The patents relate to Kinetic Concepts' negative pressure wound therapy products, which represent the majority of the company's revenue. But following a multi-year battle, a Texas federal district court ruled in October 2010 that the patents Kinetic Concepts was licensing were invalid. This ruling increases the chances that competitors, such as **Smith & Nephew** (NYSE: SNN), may eat into market share, but Kinetic Concepts is turning that financial risk on its head, at least for now.

Kinetic Concepts' management figures that if the courts don't recognize the patents, why should the company continue to pay royalties on them? In an apparent breach of its contract with Wake Forest, the company plans to stop writing licensing checks, saving itself more than $80 million per year. (It paid Wake Forest $86 million, $89 million, and $93 million each of the past three years.) The company expects Wake Forest to fire back with a lawsuit (nobody walks away from that much coin without a fight), claiming breach of contract or patent infringement. But because the patents were ruled invalid in at least one court, Wake Forest may have a tough case on its hands, and Kinetic Concepts plans to fight vehemently.

Why This Strategy?

The company earned $267 million in free cash flow last year, and that could jump at least 20% more than previously expected this year if Kinetic Concepts simply stops making royalty payments. This certainly wasn't factored into our fair-value estimate, which could climb much higher if Kinetic Concepts escapes all future royalty payments. This outcome remains to be seen, though. If the courts find the company in breach, shareholders could be slapped hard when Kinetic Concepts has to pay fines and back payments. Meanwhile, rather than rumbling in the courtroom, the company is choosing to fight competitors in hospital rooms, aiming to offer better products at competitive prices. Although we believe the company has several key edges (including some of its own patents), pricing pressures could increase.

Thus, we have a true investing conundrum: Free cash flow, which drives valuation, may leap this year. The company trades at 13.9 times trailing free cash flow, but a lack of royalty payments could boost free cash flow enough to knock that multiple down to nearly 11 in a year's time. However, the company may have to fight long legal battles to undermine the patents after years of previously fighting to *support* them. Kinetic Concepts' past may come back to haunt us if a judge holds the company's previous arguments against it. So, which way to turn?

For now, we'll let free cash flow be our guide. The sudden upside surprise to our free-cash-flow estimate suggests a higher potential valuation for Kinetic Concepts. Although we're not quite ready to increase our fair-value estimate given the uncertain nature of the outcome here, we are closing our covered calls on the stock. We'll revisit the strategy a bit later, confident that we'll find ways to earn extra income on Kinetic Concepts if its stock stagnates but happy to uncap our upside right now as this news unfolds.

How to Follow Along

For every covered call you originally wrote on Kinetic Concepts, "buy to close" the same number using a limit price at or near current market prices. Keep your stock. If you have questions about this trade, please visit our Kinetic Concepts board.

Charter Portfolio will make this trade in the next one to 30 days, but before expiration on March 19, per The Motley Fool's trading rules.

Jeff owns shares of Kinetic Concepts.

Charter and 2011 Portfolios: Buy Tupperware Brands

Published Mar 3, 2011 at 12:00AM

Pro first recommended **Tupperware Brands** (NYSE: TUP) in our Charter Portfolio in June 2009. For our earlier takes on the company, see the recommendation history.

At a Glance

- **Action**: Buy 1% in Charter Portfolio for a 3% total; buy 3% in Portfolio 2011.
- **Recent price**: $55.65
- **Buy around:** $55 (use **a limit order** to promote price stability)
- **Fair value estimate**: $64
- **Alternative trade**: Write ("sell to open") April 2011 $55 puts, recently $1.80; or July $50 puts, recently $1.55. Sell one put for every 100 shares you'd buy. (See our guide to writing puts).
- **Why buy**:
  - Even with 56% of its 2010 sales coming from emerging markets, Tupperware's potential revenue overseas is much larger.
  - The company benefits from its sales system, which relies on personal representatives and group parties rather than shelf space in competitive retail chains.
  - Tupperware's strong financial footing means an increasing dividend, a healthy share buyback program, and continued investment in innovation and growth.

First Things First

- **Company**: **Tupperware Brands** (NYSE: TUP)
- **Market cap**: $3.6 billion
- **Website**: www.tupperwarebrands.com
- **Type of holding**: Consumer discretionary; mid-cap
- **Options**: Available but not necessary
- **Tax considerations**: Tupperware pays a 2.1% dividend.
- **Follow along**: Add Tupperware to My Scorecard.

The Big Picture

Tupperware (NYSE: TUP) keeps on cooking. This longtime purveyor of plastic storage goods for the kitchen is as fresh as ever, with 15% sales growth in emerging markets last year and record levels of free cash flow creation. The secrets to Tupperware's success include a local, "feet-on-the-ground" sales force in every region it enters (it had 2.6 million sellers at the end of 2010, up 8%), innovative products that are tailor-made for the local food market (for example, rice products figure prominently in regions such as China, where sales grew 23% last year), and its unique "group presentation selling" that inspires representatives to sell a large amount of products in social settings while also teaching customers how best to use the products.

Tupperware's sales in Asia-Pacific emerging markets jumped 28% last year in local currency, with Indonesian sales growing 40% — even though Tupperware has done business in the country for 19 years and sales there had already doubled in 2009. Revenue in Malaysia and Singapore grew 24% last year, and Indian sales rose 50% as that country ended 2010 with 50% more sellers than a year before. Despite this growth, India is still a small part of sales.

Although Tupperware had a banner year in France (and is the leading seller of cookbooks in that global culinary capital, if you can believe it), its sales in many developed markets aren't growing much or at all. But the United States, for example, represents less than 5% of the world's population, and the emerging regions where Tupperware *is* growing are home to the bulk of the world's people.

The wind should be at Tupperware's back as the world's most populous regions host a growing middle class (who can finally afford to buy food for storage) and as more women enter the workforce (some as Tupperware sellers). This is a long-term megatrend that Tupperware could enjoy for years as long as it continues to innovate against competitors, train new staff well, and smartly manage its finances. As CEO Rick Goings says, the company is "still in the early stages of geographic penetration in our emerging markets" — and it can expand geographically *and* increase productivity in the regions.

Financials

Given Tupperware's exceptionally strong growth in emerging markets last year, 2011's year-over-year comparisons will be tougher, but the company still expects to remain a growth company. For the full year, excluding one-time items, the company foresees earnings per share of $4.23 to $4.33, up 14% to 16% compared with $3.72 in 2010. The stock trades at 13 times the middle of that range. Free cash flow is expected to moderate compared with last year's $243 million as the company invests more in working capital to support higher sales, but we welcome that investment in the future. Cash is also slated to be spent on a $400 million share buyback program (a significant sum for a $3.6 billion company) through 2015, while the dividend is anticipated to grow in line with earnings.

Next Steps

- Questions or comments? Visit our Tupperware board.
- Once you've bought TUP, add it to My Scorecard.
- If you want to buy shares gradually or try to buy lower, consider our alternative trades above: writing puts.

Pro's Portfolio 2011 will buy a 3% stake in Tupperware, and our Charter Portfolio will buy 1% more for a 3% total in the next one to 30 days, per The Motley Fool's trading guidelines.

Jeff owns shares of Tupperware.

Portfolio 2011: Buy TradeStation

Published Mar 1, 2011 at 12:00AM

Pro first recommended **TradeStation** in our Charter Portfolio in September 2010. For our original take, read the full buy report.

At a Glance

- **Portfolio 2011 action:** Buy 1.5%
- **Recent price:** $6.70
- **Preferred price:** About $6.70 or lower (use a limit order)

- **Type of holding:** Intermediate-term, interest rate and volatility hedge; financial brokerage
- **Alternate trade:** None
- **Why buy:**
  - Online broker TradeStation caters to active, highly valuable rules-based traders, such as small hedge funds.
  - If interest rates rise, TradeStation stands to profit on customers' cash balances; if volatility increases, customers will make more trades and pay more commissions.
  - TradeStation operates in a profitable niche and is an attractive acquisition target.

The Big Picture

Brokerages make most of their money in two ways: by (1) charging commissions on trades and (2) earning interest income on their customers' cash balances and margin accounts. **TradeStation**'s management recently moved to boost both of these revenue streams by entering foreign exchange (a.k.a. Forex) trading and securities lending (that is, it lends investors stocks to short).

The key drivers to our investment thesis — short-term interest rates and volatility — have remained low since we first recommended TradeStation in September 2010. But eventually, short-term rates and volatility will rise, giving the company a boost. We'd rather buy shares now and wait for the eventual turn of the business's driving forces. We're opening a 1.5% position in Portfolio 2011 to match the Charter Portfolio's allocation.

Why Buy?

TradeStation caters to highly profitable, active, and rule-based traders — a niche of the online brokerage community. On average, its clients generate more revenue and interest income and carry larger balances than its major competitors', such as **optionsXpress** and **TD Ameritrade**.

TradeStation is only the seventh-largest online broker, with just more than 3% of the estimated active investor accounts in the United States. But its award-winning trading platform continues to attract new accounts, and it should thrive in a market with even marginally higher interest rates and volatility. At today's price of $6.70, TradeStation would make an attractive acquisition for any number of online brokers.

A Special Request

TradeStation is a thinly traded stock with a diminutive $262 million market cap. The last time we recommended it, shares popped as much as 6%. **Please use limit orders and be patient.** With discipline, you, all of your fellow *Pro* members, and *Pro* itself will be able to buy TradeStation at an attractive price. Please start with a very tight limit order near the current price ($6.70) and work from there.

Next Steps

- Questions or comments? Chat it up on our [TradeStation discussion board].
- Want to follow TradeStation? [Add it to My Scorecard.]

Portfolio 2011 will buy a 1.5% stake in TradeStation in the next one to 30 days, per The Motley Fool's trading guidelines.

Four Pro Investing Truths

Published Feb 28, 2011 at 12:00AM

Pro Extra: Chat With Medtronic

The Fool is hosting a live chat with **Medtronic** tomorrow, Tuesday, March 1, from 4 to 5 p.m. ET. Just head over to Fool.com to ask *your* questions!

Dear Fellow Fools,

In our recent Monday Memos, we've discussed how *Pro* invests in stocks and options, and we'll talk about how we use ETFs and shorts soon. But because the market dipped last week, now is a good time to explain a bit more about how *Pro* views investing in general. That's because whenever market volatility increases, we want you to know where we stand and how we're thinking. Here are four of our key investing truths:

- We're not knee-jerk investors who zig and zag with every market move.
- We use options mostly for short-term gains and own stocks for the long haul (to us, that's years, not months).
- We will adjust our strategy most when we believe a *serious* change is afoot — meaning a market decline (or gain) of *at least* 10%.
- We are moving toward being more concentrated and making larger investments in our strongest-conviction ideas.

Earnings

Finally, no earnings to watch out for — the first time in seven weeks! Now we can focus more on updating our positions and making adjustments.

Let's expound a bit more on each point.

We're Not Ginger Rogers to the Market's Fred Astaire

Dancing this way and that, the stock market can be volatile — in both directions — but its motions mean little if it's just retreading where it was before. And basically, that's all the market has done since 1999: jitterbug around without actually going anywhere. Only good stock pickers and options investors have created value on Wall Street during long spans in which index returns have been modest. For this reason and so many others, we don't try to zig and zag with modest market moves. Doing so is costly, it can't be done well (if at all), and it typically ends up destroying value even while the market ends up flat.

Instead, we use options (and shorts) to target shorter-term gains, and we aim to hold our core stocks in superior companies and ETFs for long-term gains. We'll only seriously adjust the slant and strategy of our portfolios — by rapidly raising cash, for example, or initiating large shorts or hedges — when we believe there is a strong chance the market will decline at least 10% and really 15% or more. There's simply not enough wiggle room in a 5% or 10% decline to risk chasing it, and these small moves usually happen too quickly to merit changing your investment strategy to try to benefit.

So small zigs and zags in the market don't faze us. We look for new opportunities within those price moves. But if we believe a *more serious* market change is in the cards, then it's our imperative to take much greater action beforehand. To be clear, nobody can predict the market's next dance step, but valuation and the macro-environment are our guides, and they've provided good "leads" in the past.

If you're not into dancing, try this as a visual reminder: As a *Pro* investor, you're not a twitchy little mouse; no, no; you're a giant Blue Whale, swimming at your own pace while the market (perhaps represented by krill) skitters all around. We know our ultimate destination: forward, and at an even pace.

Manage Risk, Swim Forward, and Concentrate — All at the Same Time

We may be bullishly oriented for much of the time and only adjust course when risk seems too great or we see many more shorting opportunities than potential buys. Even so, at all times, we need to manage our investments with risk in mind. With the Fed's easing program likely to end, interest rates probably heading higher, local governments in dire straits, commodity costs rising, politics in the Middle East flaring, and Europe in a straitjacket, there are plenty of reasons to be on guard. As you read this, I'm at the Chicago Board Options Exchange Risk Management Conference, busy learning the latest strategies for managing portfolio risk. But the key will be to manage our risk while continuing to swim forward as much as we can, rather than stopping entirely. This is right in line with our goal:

Coverage & Community

- Nick (TMFCrow) covers **TradeStation**'s earnings.
- **GrafTech**'s results get early approval from *Pro*, with more analysis coming.
- Jeff (TMFFischer) shares a short idea that came oh so close to becoming an official *Pro* recommendation.
- Russell (TMFEldrehad) shares his thoughts on gaming the system in CAPS.

Pro's mission is to earn you consistent, recurring profits with a high level of accuracy using a combination of stocks, options, and ETFs.

Another way we'll achieve stronger results over the years (now speaking to bullet point four above), is by concentrating our dollars in our highest-conviction ideas. We'll probably always own at least a few dozen positions, but some may only make up a few percent of the portfolios, and others may eclipse 7%, 10%, or even more of our portfolios. We want to put more of our cash into the positions we're most convinced will have a profitable outcome. Shorting the **iPath S&P 500 VIX Short-Term Futures** ETN is one such position — with time, short sellers are almost certain to continue to make money due to the structural flaws of the ETN. From day one, our potential allocation to this short has been as high as 10%. It could rise even higher given the right opportunity.

Healthy Returns, Lower Risk, and a Good Life

Sum it all up, and we want to achieve robust returns through concentration, with reasonable risk while maintaining — quite simply — a good, Foolish life. You don't need to be tied to your computer to succeed on Wall Street — not with our *Pro* strategies. Instead, you just need to use proven strategies that consistently work, and use them on good opportunities. It's our job to help you find them. And it's *your* job to not sweat the small stuff. Zigs and zags are just part of the fun. It's major dislocations that we need to keep an eye out for.

Fool on!
Jeff Fischer (TMFFischer)

Jeff is short the iPath S&P 500 VIX Short-Term Futures ETN.

Next Steps

To talk about this Memo, please visit our Memo Musings board.

Charter and 2011 Portfolios: Write Naked Calls on VXX

Published Feb 25, 2011 at 12:00AM

First Things First

- **ETN: iPath S&P 500 VIX Short-Term Futures** (NYSE: VXX)
- **Closing price (Feb. 24):** $33.68
- **Website:** ipathetn.com
- **Type of holding:** Short (short naked calls)
- Add VXX to My Scorecard

At a Glance

- **Action:** Write ("sell to open") March 19, 2011, $34 naked calls
- **Allocation:** 6% if we end up shorting shares; for our Charter Portfolio, that's 25 contracts. For Portfolio 2011, it's four contracts.
- **Recent options price (bid/ask):** $1.30/$1.34
- **Preferred price:** Use a limit order near current price; if trading later, accept no less than $1.
- **Recent ETN price:** $31.80
- **Alternative trades:**
  - Sell shares short directly, starting with 3%.
  - Write naked calls at higher strikes (or later months) for more breathing room.
  - Set up a January 2013 synthetic short ("sell to open" calls near the recent share price, and "buy to open" the same strike puts).
  - Buy the *inverse* of this ETN, the **VelocityShares Daily Inverse VIX Short TermETN** (NASDAQ: XIV), starting with 3%.
  - If you're already short shares directly, continue to hold your short for more long-term price decay.
  - If you're unable or not ready to make this trade yet, no problem. We plan to repeat this in the future, and you can join in when you're ready.

What's New

This is the fourth time we're taking a short position in the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) exchange-traded note, and it almost surely won't be the last. The reasons are simple: First, when stock market volatility spikes, it's always been temporary. Investors have yet to expect high volatility in the S&P 500 indefinitely. Second, this ETN follows the short-term futures of the popular VIX (or volatility) index, and those futures contracts almost always carry a premium that erodes day by day, eroding the value of this ETN. These two factors make this vehicle a preferred short at *Pro* at opportune times.

The S&P 500 declined Tuesday through Thursday, sending the VIX to its largest weekly gain since May 2010, when fears about Europe's debt problems rocked the market. The VIX gained 30% between last Friday and yesterday, from 16.43 to 21.32. (The index isn't quoted in dollars, by the way; the number of the VIX represents the expected level of annualized volatility in the index, so as of yesterday, it was calling for 21.3% annual volatility.) In typical fashion, the VIX Short-Term Futures ETN gained much less than the VIX's 30% jump this week — just 16%, from $29.03 to $33.68. The lag is because the futures contracts it mirrors already assume a higher future price at nearly all times — it's already baked in. What's most important now is the question of whether volatility will continue to rise considerably during the next month while we're shorting volatility. Nobody can know for certain, but we have our doubts.

Unrest in Libya and higher oil prices have been blamed for this week's spike in market volatility, and although Libya's woes are serious and we wish the people well, the country is only the world's 15th-largest oil producer, accounting for 2% of the world's supply. What's more, Saudi Arabia, other OPEC members, and the United States have said they can cover any oil shortage. Speculators are sending oil prices higher on the assumption that turmoil in the Middle East will worsen, and it might, but given OPEC's statute to supply the market, it's unlikely that the total oil supply will be adversely affected. Once this sinks in with the speculators, oil prices will probably deflate a bit. That, in turn, may decrease market volatility. But even if volatility remains elevated, our short position has breathing room.

Why This Strategy?

With the volatility index at 21.3 at yesterday's close, the short-term VIX futures contracts that our exchange-traded note tracks closed at 21.85 for March and 22.35 for April. Blended together (as the ETN does, tracking both), that's a 3.7% premium to the VIX. Further, the options we're writing have a strike price of $34, or 6.9% higher than the ETN's recent market price. And they'll pay us about $1.30, adding 3.8% more to our break-even price, to $35.30. In sum, the ETN needs to gain about 11% from the current price before our short position is at breakeven. For the ETN to do that, the VIX likely needs to gain at least another 14%. Even that may be understated because futures prices typically rise each day the VIX rises, causing the ETN to pay more as it rolls its futures contracts daily, weighing on the ETN.

Although the VIX could of course gain 14% if investors remain frightened, we're comfortable with our cushion in the next 21 days to expiration. We know that if the VXX rises more than this, we can roll our naked calls up (to a higher strike) and out (to a later month). We could also close the position and convert it to a synthetic short.

Why start with this strategy, then? We *are* interested in setting up a 2013 synthetic short, and/or buying the *inverse* ETN to the VXX (see the alternative trades above — that's an easier way to start this strategy). Ideally, though, we'd start those longer-term positions when the VIX is higher than today's 19.6 (its lifetime average is 19), because those positions don't carry a cushion before breakeven. But barring a higher VIX, we're able to emulate one by writing naked calls at a higher strike. That said, you should know that we want long-term positions in this short, so we're actively considering a 2013 synthetic short or owning the inverse ETN alternative trade starting this year, too, to complement short-term opportunities like writing naked calls.

How to Follow Along

You need full options and margin approval to write naked calls — these are calls in which you don't own the underlying shares. Our profit is limited to what the calls initially pay us, unless the ETN rises above our strike price and we're able to short shares (although we're more likely to roll the calls for another payment or change strategies; shares for shorting are unavailable at our broker). If you can short shares directly, that's still an attractive long-term choice, though you should move incrementally and short more on further spikes. You have more profit potential shorting directly, but you don't start with a pricing cushion the way you do with naked calls.

Trade Details

- **Action:** Write ("sell to open") March 19, 2011, $34 calls (one for every 100 shares you'd short).
- **Allocation:** For our Charter Portfolio, that's 25 contracts. For Portfolio 2011, it's four contracts. We recommend a 6% allocation for both portfolios. Each written call represents a $3,400 short of VXX. **Note: Options are available that expire March 4; we're writing the March 19 options.**
- **Limit price:** Near market price, recently about $1.30 or higher (accept no less than $1)
- **Break-even price:** $35.30
- **Current VXX price:** $31.80
- **Difference to breakeven**: 11%
- **Return on investment (at $1.30):** 4.1% if the calls expire, earned in 21 days

Fools, if you make this trade, be aware of the risks of shorting anything, let alone a volatility index. This is a high-conviction position when time is on our side, but we might see large price movements in the meantime. In that case, we'd need to roll the position forward or update our strategy. If you have more questions about this trade, our past reports should help you get up to speed. As always, please bring your questions about this trade to our VXX board.

Jeff is short shares of VXX.

Charter and 2011 Portfolios: Write Puts on L-3 Communications

Published Feb 24, 2011 at 12:00AM

Pro first recommended buying **L-3 Communications** (NYSE: LLL) in our Charter Portfolio in November. We recommended it for in Portfolio 2011 in January. To read either of these reports, see the recommendation history.

First Things First

- **Company**: **L-3 Communications (NYSE: LLL)**
- **Market cap**: $8.9 billion
- **Website**: www.l-3com.com
- **Type of holding**: Defensive, value
- **Use of options**: *Pro* may continue to use options, but they're not vital. (You can simply own shares.)
- **Important date**: L-3 goes ex-dividend Friday, Feb. 25. **To receive the next dividend, buy shares today.**
- **Tax considerations**: Shareholders enjoy a 2.3% dividend; options could increase short-term returns.
- **Follow along**: Add L-3 Communications to My Scorecard.

At a Glance

- **Action**: Write ("sell to open") April 2011 $80 puts for a potential 2.5% in our Charter Portfolio or 3% in Portfolio 2011
- **Charter Portfolio**: Write 5 contracts for a potential 2.5% (nearly 6% total)
- **Portfolio 2011**: Write 1 contract for a potential 3% (6% total)
- **Stock price**: $80.50
- **Buy around**: $80

- **Option price (bid/ask)**: $2.70/$2.90 (use a limit order around market prices, generally between the bid/ask; later, accept no less than $2)
- **Alternate trades**: Buy shares directly, or write $75 puts to be more defensive.
- **Why buy?**
  - The defense contractor offers world-class capabilities and technology.
  - Its stock is an excellent value.
  - This defensive company's business isn't dependent on the general economy.

The Big Picture

We like the value that defense contractor L-3 offers: It's a leading player in an industry that's well out of favor, which means we're getting a good price for a quality company. We also like its defensive qualities in today's uncertain market. Growth might be slower for defense companies than their private-sector counterparts, but defense contractors for the most part enjoy steady revenue that doesn't depend on the economy or consumers.

The key issue here is the government's budget, and with defense accounting for about two-thirds of Uncle Sam's discretionary spending, the industry's allotment is being pressured on both sides of the aisle. But as we said in our earlier write-up, we don't expect this to have much of an impact on L-3.

That's because L-3 provides mission-critical technology and defense services that should survive budgetary tightening. Plus, as we've now seen, the Pentagon doesn't plan to shrink the defense budget much at all. In fact, defense spending is scheduled to grow modestly through 2014, and then flatten, not plunge. Leading defense companies should still perform satisfactorily in this environment — and their cheap shares should recover. Indeed, since *Pro* first bought shares in November, L-3 stock has started to gain some ground.

What's more, since our latest recommendation, L-3's board of directors increased the quarterly dividend by 12.5%, from $0.40 to $0.45 per share. This puts the annual dividend at $1.80, or a 2.3% yield.

Why This Strategy?

We started a half position in L-3 in the low $70s because it was a fantastic price for the company. We've been rewarded with an 8% rise in the stock, but we still want to fill out our position.

Although $80 is still a good price for the stock, another sensible strategy at this point is to write put options, which allow us to collect income and have a chance at eventually buying the shares several dollars cheaper than the current price.

How to Follow Along

You need options approval to write puts, and the trade command is "sell to open" or "sell." **Do not buy these options!** Sell one contract for every 100 shares of L-3 you're willing to purchase later. Each contract represents an obligation to buy 100 shares, or $8,000 worth of stock; we're selling five contracts for about a 2.5% allocation in the Charter Portfolio and one contract in Portfolio 2011. Writing these options will "pay" us the option premium today, and we'll wait until expiration in April to see the outcome.

- **Initial potential profit:** About $2.70 per share, or 3.3% cash income in 51 days; the return is 11.1% if buying power is used to hold the trade open, alongside 30% cash.
- **Break-even (or start price):** $77.30, or 3.9% lower.

Because we intend to take ownership if we're assigned shares in April, be certain you have $8,000 per contract available to buy shares. Otherwise, just buy L-3 stock outright per our alternative trade, bringing it to 5.5% to 6% of your portfolio.

Next Steps

- Questions or comments? Still getting your feet wet with options? No worries. Visit our L-3 Communications board to ask questions, and check out our guide to writing puts.
- Add L-3 Communications to My Scorecard.

Charter Portfolio and Portfolio 2011 will write puts potentially representing about a 2.5% to 3% stake, respectively, in L-3 Communications in the next one to 30 days, per The Motley Fool's trading guidelines.

Andrew has an options position in L-3 Communications.

Returns: What Matters Most?

Published Feb 22, 2011 at 12:00AM

Upcoming Earnings

- **Feb. 22: Medtronic**
- **Feb. 23: Papa John's Pizza**
- **Feb. 24: GrafTech International**

Returns are always a hot topic on our *Pro* discussion boards, and most investors fall into one of three camps. There are investors who pay attention to:

1. Relative returns
2. Absolute returns
3. Or — gulp — those who don't measure their returns

Relative-return investors measure their investing performance against a benchmark — usually the market or a proxy for it, like the S&P 500. They're like competitive runners who are constantly checking the lanes next to them to make sure they're beating their rivals.

Absolute-return investors, on the other hand, tend to be happy as long as their portfolios are growing, regardless of how the overall market is performing. They usually have some hurdle rate or other measurable goal. These are the runners who are happy simply to be putting one foot in front of the other, moving forward at their own pace and ignoring the other racers.

Investors in the third group don't measure their performance at all, and they're in the worst shape.

Which camp are you in, Fool? Sometimes it's not the one you think. Here's one way to find out.

Cash Balances Hold the Key

The history of your cash balance might hold the key to whether you're an absolute- or relative-return investor. Look back over your time investing. Do you tend to be fully invested? If so, you're probably in the relative-return camp. These investors tend to be more fully invested than their absolute-return brethren, and this makes sense because, by definition, there will always be stocks that will beat the average return of a benchmark. On a relative basis, it makes sense to buy your fill.

Or do you build up a cash pile every now and again? Absolute-return investors can't always find stocks that meet their desired rate of return, or the available opportunities don't fully compensate them for the risk, so cash often makes up a larger percentage of their portfolio.

Bull Markets: An Achilles Heel

Both of these measurement methodologies have weaknesses — and they're related. Bull markets are the Achilles heel for both types of investors (and runners), though they affect the portfolios differently. In a bull market, one investor might permanently impair his capital as he chases returns, and the other might suffer from performance envy that could lead to a strategy shift.

Coverage & Community

- Jeff (TMFFischer) weighs in on earnings from *Pro*'s newest stock: **Rockwood Holdings**.
- We love to see this type of conversation on our Philosophy & Strategy discussion board.
- This week in CAPS: TMFEldrehad shares his thoughts on contrarianism in CAPS.
- Looking to boost your knowledge using covered call options? Check out the class going on at *Motley Fool Options* right now!

Here's why. When all stocks are rising in bull markets, fully invested relative-return investors seem like heroes. They put every new dollar to work as soon as it's earned lest the returns lag behind the market. Each subsequent purchase quickly shows a profit, further emboldening the investors. Unable to resist the allure of more upside, they can be nearly blind to the increasing risk in their portfolios. As they chase the market all the way up, these investors risk exposing their heels to the potent arrow of a market correction. After a drop, and without a significant cash cushion to deploy, they can face a permanent loss of capital.

Absolute-return investors, on the other hand, might start selling their shares at lofty prices, writing calls, or building hedges to reduce their portfolio's risk during a bull market. But they can also suffer from return envy as their cash pile drags on their portfolio and as their fully invested brethren's returns keep climbing — especially as attractive opportunities evaporate in the quickly rising market. If a bull market lasts long enough, some absolute-return investors will question whether their targeted return of 10%, 12%, or even 15% is attractive enough. The seemingly easy money made in an index might prove too tempting. But if they change strategy now, they too may be shot in the heel with Paris's deadly arrow.

The *Pro* Way: Measure What Matters

Here at *Pro*, we're absolute-return investors. It's not that we have anything against the relative-return camp — we're just not in the same race. We focus on meeting our financial goals — and yours. For most of us, that means investing as a means of providing and maintaining a comfortable lifestyle for ourselves and our families. We strive for measured growth and income while not risking the nest egg that took so long to build. That's why we focus on accuracy and use options to limit our risk while earning income. This is the *Pro* way!

Returns that provide for your financial goals are what matters most in investing. So when you're looking at your results, measure what matters. If your returns provide for your goals and your current strategy has a high probability of continuing to provide that level of return, why would you care what anyone else is doing? Or what the market is doing? Keep your eyes on your goal, and you'll run a good race — and likely end up ahead.

As always, thank you for being a member of *Motley Fool Pro* and for making our community the best one in all of Fooldom. Please share your thoughts and experiences on our Memo Musings board.

Fool on!
Nick Crow (TMFCrow)

Portfolio 2011: Write Puts on GlaxoSmithKline

Published Feb 16, 2011 at 12:00AM

Pro first recommended buying **GlaxoSmithKline** in our Charter Portfolio in December 2009. To read *Pro*'s original report, see the recommendation history.

First Things First

- **Company: GlaxoSmithKline**
- **Market cap**: $97 billion
- **Website**: www.gsk.com
- **Type of holding**: Health care; defensive income.
- **Use of options**: *Pro* will probably continue using them, but they're not vital. (You can simply own shares.)
- **Tax considerations**: Shareholders enjoy a hefty dividend; options could increase short-term returns.
- **Follow along**: Add GlaxoSmithKline to My Scorecard.

At a Glance

- **Action**: Write ("sell to open") a 4% position in May 2011 $37 puts (for *Pro*, 3 contracts)
- **Stock price**: $38.27

- **Buy around**: Below $40
- **Option price**: $1.20 (use a limit order around the market price)
- **Alternate trades**:
  - Buy a 4% allocation in shares.
- **Why Buy?**
  - The U.K.'s largest pharmaceutical and health-care products company trades at a defensive price and offers a safe 5.3% dividend yield.
  - Most patent expirations are behind the company, and it has dozens of new products in trials.
  - A focus on emerging markets diversifies the business and expands the potential for long-term revenue and profit.

The Big Picture

GlaxoSmithKline is a $97 billion behemoth that controls an estimated 6% of the global pharmaceutical market (revenue-wise) and employs nearly 100,000 people in more than 100 countries. The U.K-based company is the second-largest industry bellwether behind competitor **Pfizer** (NYSE: PFE), and it has strong, steady cash flow; a diverse portfolio of drugs; and a stable of consumer products now entering new markets, including China.

We like Glaxo's focus on smaller, bolt-on acquisitions and the way it has diversified its business in the face of potentially game-changing patent expirations. CEO Andrew Witty initiated a three-pronged strategy in 2008 to simplify the operating model, become more globally diversified, and deliver greater value to customers (hey, great idea!).

Drug sales in the United States and Europe remain weak due to generic competition, but emerging markets offer an especially large opportunity. According to a study by UBS, seven developing countries — Brazil, Russia, India, China, Korea, Mexico, and Turkey — could account for 70% of drug-sales growth by 2020.

Why This Strategy?

We never expected fireworks from Glaxo — instead, we sought steady income and slow appreciation with reasonable risk. *Pro*'s Charter Portfolio has earned enough dividends and covered-call premiums to generate nearly 7% in income on our investment in just over a year, while the stock has gone … nowhere. Shares are down 5% from our average purchase price. Litigation costs related to older drugs have weighed on the company, and although legal concerns remain, the company is confronting them head on, and good news continues to float up from the business.

Management increased the annual dividend 7% in 2010 and announced a $1.6 billion to $3.2 billion share buyback program last month. (That's potentially more than 3% of outstanding shares). Add in the 5.3% dividend yield, and the potential exists for up to 8.3% in "earnings yield" per share over a year before the stock moves anywhere. After the 2010 results were released, the CEO said:

> "*…whilst our operating environment remains challenging, I believe we have made significant progress through restructuring. … Our business is more balanced and is generating underlying sales growth. Our broad and diverse pipeline is generating increasing potential. Our cash generation is strong and we are enhancing returns to shareholders. …I remain confident that we can generate increased value for shareholders and deliver even better outcomes to patients and consumers.*"

The underlying sales growth that Witty refers to has primarily been driven by the company's focus on emerging markets. This is where Glaxo shines. With a clear focus on developing drugs for emerging markets, Witty has helped increase sales to these growth markets to 13% of Glaxo's total revenue. We expect further growth, too, as the company's 13,000 emerging-market sales reps continue to grow sales at an impressive 20% rate.

These efforts have transferred to the company's financials, with cash from operations rising 9% last year excluding legal costs. Yet the company trades at only 7 times levered free cash flow and 11 times expected earnings. For a company with more than 30 product candidates in late-stage trials (10 reached Phase 3 trials in the past year), the price looks inexpensive. With Glaxo trading at a discount to the market and offering an above-average yield, the rewards should outweigh the risks in the coming year.

In today's high-flying market, however, we're content to be defensive and approach the stock by writing puts — insuring that we only potentially buy shares at a cheaper price and earn income while we wait. Writing puts alone will pay us more over time if the stock stays in a range. That said, if you want to buy the stock outright, shares are below our $40 buy-around price and offer a 5.3% yield, with the next dividend payment due in early May.

How to Follow Along

You need options approval to write puts, and the trade command is "sell to open" or "sell." *Do not buy these options!* Sell one contract for every 100 shares of Glaxo you're willing to purchase later (each contract represents an obligation to buy 100 shares, or $3,700 worth of stock; we're selling three for about a 4.4% allocation, as close as we can get to 4%). Writing these options will "pay" you the option premium today, and we'll wait until expiration in May to make our next move.

Our initial potential profit is the put income, and we have an obligation to buy shares if the stock falls below the $37 strike price by expiration. If we get shares, our net start price will be about $35.80 (we buy our shares at $37, but we still keep the $1.20 that the puts paid us). Since we intend to take ownership if we're assigned shares in May, be certain you have $3,700 available, per contract, to buy shares. Otherwise, just buy Glaxo outright (up to 4%) per the alternative trade.

Paying us $1.20 per contract, these puts yield 3.2% in income on the potential share purchase price in just over three months, or about 13.4% annualized. Our potential net buy price is 6.5% below the recent share price, making this a defensive income trade. And if we nab shares, we'll begin to enjoy a 5.4% yield and wait for the price to rise.

Next Steps

- Questions or comments? Still getting your feet wet with options? No worries. Visit our GlaxoSmithKline board to ask questions.
- Visit our guide to writing puts.

Pro*'s Portfolio 2011 will write puts representing about a 4% stake in GlaxoSmithKline in the next one to 30 days, per The Motley Fool's trading guidelines.*

Jeff owns shares and has written covered calls on GlaxoSmithKline.

Use Options Like a Pro

Published Feb 14, 2011 at 12:00AM

Next Memo: Tuesday, Feb. 22

Fool HQ will be closed Monday for Presidents Day, so we'll send your Memo next Tuesday.

Dear Fools,

Last week, a new *Pro* member stopped by Fool HQ in Alexandria, Va., and told me that he's having trouble keeping up with our trade alerts. I reminded him that investing isn't a race and that it's OK to take more time to get started.

Maybe you're feeling the same way, so today, I'll remind you to act when *you're* ready. If you can't make all of our trades when we do, pick and choose your favorites, and invest in those. You'll be able to catch up on many of our trades later.

Earnings and Expirations

Feb. 15: AmTrust Financial Services earnings

Feb. 16: Rockwood Holdings earnings

Feb. 18: Naked calls on **iPath S&P 500 VIX Short-Term Futures** expire

Feb. 24: GrafTech International earnings

We're excited to get Portfolio 2011 up to speed and to keep sharing new ideas for both portfolios — and we have more investing ideas than we can write up — so please know that trade alerts will continue to arrive in your inbox at a steady pace. But don't feel rushed; use our research and ideas to move at your own pace.

Options the *Pro* Way

For now, let's keep learning about the ways we'll put those ideas into action. Last week, we discussed the *Pro* approach to buying stocks. Today, I'll outline the options side of our *Pro* investing strategy.

While we generally seek long-term capital gains from stocks, most of our options are used for *short-term* income or gains. By combining these strategies (along with ETFs and shorts, which we'll cover in our next Memos), *Pro* investors can make profits in the coming weeks *and* the coming years, accomplishing our goal of earning steady, recurring profits with high accuracy in both the short and long term.

Coverage & Community

- Bryan (TMF42) tackles **Broadridge Financial Solutions**' results.
- Nick (TMFCrow) chops up **Plum Creek Timber**'s earnings.
- Member "becomeit" asks, "What's a realistic goal with options investing?"
- Jeff elaborates on what makes **Rockwood Holdings**attractive for the long haul.
- Andrew (TMFRedwood) shares his very favorite recent article about risk.
- Russell (TMFEldrehad) writes about finding top Pro CapShot stocks. Don't miss it.

Options in Two Minutes

Let's go over a few key points about options. If you're new to the concept, I hope this explanation will show you that they're not as intimidating as they may seem. If you're an old hand, keep reading for a few *Pro* trades we like right now.

First, the basics: An option gives its owner the right to buy (with a call) or sell (with a put) a stock at a set price (the "strike price") by a set expiration date. An option's value depends on the price of its related stock; a "call" option goes up when a stock rises, while a "put" increases in value when a stock falls. ("Call up, put down" is an easy way to remember this.) Each option contract represents 100 shares of stock, so options allow you to control many shares for less money than it could cost you to buy the shares outright. However, the *Pro* approach often assumes we'll convert the options into a full stock trade, so we'll use this leverage sparingly.

Options FAQ

- *Pro* is a separate service from *Motley Fool Options*. Both services offer similar educational material that can be used together (and both have a great community of Fools), but *Motley Fool Options* recommendations are not part of the *Pro* portfolio. However, they do provide strong additional, even complementary, ideas.
- Options can be exercised (turned into a stock transaction) by the owner (the buyer) at any time, but they are rarely exercised before expiration.
- The option writer *does not* control when an option is exercised. The owner (buyer) does. Any option that has value at expiration is automatically exercised unless you close it beforehand.
- You can trade options in an IRA, including writing covered calls and, in some cases, writing puts.
- Options are priced based on intrinsic value (the difference between the strike price and the stock's share price) and time value (the amount of time until expiration). The longer until expiration, the more time value an option holds. We like to "sell" time value.
- The more volatility expected in a stock, the higher its option prices (reflected in time value).
- Option writers generally want to write options that expire in six months or less, to collect income more quickly. Option buyers generally want to buy options that expire in one year or longer, to have more time to be right.
- Not all stocks have options traded on them; options require enough investor interest and volume.
- U.S. options expire at the end of the third Friday of the month of expiration.
- To see options prices, obtain a stock quote at your broker and click "option chain."
- To get started using options, apply for options trading permission with your broker; level 2 or 3 will get you started.

We write options (or "sell," "short," or "sell to open" — they all mean the same thing) much more often than we buy them. That's because the odds are stacked in favor of the option writer: Writing options means we get *paid* to make the trade, and given a pricing cushion, we are typically able to profit on the option even when the related stock bounces around. The option *buyer*, meanwhile, *pays* to make the trade — and to make any money, the buyer must be correct about the price of the stock by a certain date. That's difficult to do, which is why we write (or "sell to open") options more often than buying them.

We use options strategically, as part of portfolio management. Options work hand in hand with stocks, and your *Pro* portfolio should come to reflect that. Finally, although most options do make money in the short term, we're not *traders* of options. We use them tactically and appreciate the fact that they expire in a matter of weeks or months.

Strategies — and Trades — We Like Today

Pro will use more than a dozen options strategies, depending on what's most appealing at the time. But we rely on just a handful, and knowing how to use even one or two strategies is enough to change and improve how you invest. The following two strategies are likely to be the most useful over your lifetime.

Writing Puts

If you'd be happy to buy shares of a stock for less than the current price, you can write ("sell to open") put options. You would write, or sell, one contract for every 100 shares of stock you're willing to buy at a set price (the strike price of the option). A real-life *Pro* example — a trade you can consider making today — serves as the best illustration.

Let's say you want to buy some shares of medical devices giant **Medtronic**, but you'd prefer to pay less than the recent market price of $39.50. You could write ("sell to open") May 2011 puts at a strike price of $38, which would recently pay you $1.30 per contract (a total of $130 for each put you write, as each option contract applies to 100 shares of stock). Given the potential stock buy price of $38, receiving $1.30 per share equates to a 3.4% option payment (or yield) in only about three months — around 13% on an annualized basis. That's decent income on the money you should set aside to maintain this trade.

By selling these puts, you've sold a contract into the market that says, "If Medtronic declines below this $38 strike price before this option contract expires, I'll buy it at that set price." In exchange, you get paid the $130 for each put the moment you sell the contract.

If Medtronic does fall below $38 by the time the option expires in May (earnings reports could sharply change the stock price, of course), your brokerage account will buy the shares automatically at expiration. Because you keep the $1.30-per-share option payment you received, your net start price on Medtronic is actually only $36.70 — nicely below today's price. If Medtronic is *above* $38 by the expiration date, the options expire unused, you still keep the option income you were paid, and you can write another put.

Let's look at another example. **Intel** recently traded at $21.70. Its May 2011 $21 puts pay you about $0.70 per share right now, and you could buy shares for $20.30 if Intel falls below $21 by expiration. If not, that's a 3.3% yield on cash you'd set aside for only three months.

This strategy can work well on our *Pro* stocks listed as Holds due to valuation, too, because you can target a buy price in our preferred range. For example, helicopter services provider **Bristow Group** is currently a Hold because it's trading near $46, and our preferred buy-around price is $39. But you can write ("sell to open") September 2011 $40 puts on Bristow and recently be paid about $2 per share. That's a 5% payment in seven months, so it isn't a huge profit, but it would net you a buy price far below today's if Bristow declines: about $38. If Bristow simply stays above $40, you'd get to keep the income and could write new puts.

Whether you're looking to build a portfolio, add to an existing position, or earn income, writing puts on companies you admire is an excellent options strategy. At *Pro,* we frequently also own some shares of the targeted stocks, so we have upside exposure, too. This is a good move if you believe a stock has meaningful upside — after all, you won't want to miss all of that potential gain by only writing puts.

Writing Covered Calls

The flipside of writing puts is writing covered calls. Writing covered calls on stable companies is a steady income strategy used by active hedge funds and poolside retirees alike. When you *already* own at least 100 shares of a stock, and you're willing to *sell* it a bit higher, you can write ("sell to open") covered call options. (They're called "covered" because they cover a stock you already own.) This strategy does limit your upside on that stock because you're obligated to sell it at the strike price even if it rises higher (you can adjust your option trade later to gain more upside — this is called "rolling up"). But on the plus side, the amount of the strike price (or sell price) is your decision, made when you set up the trade.

Let's look at a real-life *Pro* trade you could make using this strategy. For every 100 shares of **SPDR KBW Regional Banking** ETF that you buy around a recent $27, you could write one June 2010 $28 *call* option that recently pays you around $1 per share. You collect $100 right now on one covered call contract, and you promise to sell your 100 shares at $28 if they reach that price (or higher) by the June expiration. (Including the call income, your net sell price per share would be $29.) The $1 per share you're paid for the contract is a 3.7% yield (and downside cushion) on a $27 purchase price. That income is earned in about four months. And if you do sell at a net $29, you'll see a 7% total return on your stock over the same time (excluding dividends). On the other hand, if the ETF is still *below* $28 by the June expiration, you keep the option income, keep your stock, and can write new covered calls for more income. Meanwhile, the covered calls cushion against a decline in the stock. You can see why so many income-oriented investors enjoy this strategy.

Start There

These two *Pro* options strategies may be the ones you use most as you get started. *Pro* will use many others, including buying calls to leverage gains; buying puts to protect positions or to short a stock; writing covered strangles (selling both puts *and* covered calls on a stock to double our income, which we're doing with **Papa John's International** (Nasdaq: PZZA) in the Charter Portfolio; using option spreads to earn large returns on investment with low risk; buying straddles to profit on big price moves in either direction; and more. All of these strategies and others are explained in our Options Guides. But you should start with just one or two strategies — the ones we outlined today.

More Options Resources

It's a lot of information to absorb, but remember that the more you read about options, the better you'll understand them. Here are some of the options education materials available to you as a *Pro* member:

- Options 101: The Basics and Four Key Strategies Outlined
- Options 201: Writing Covered Calls
- Options 301: Writing Puts
- All About Options discussion board

There's even more good info in our Options FAQ sidebar, and please ask any questions on our All About Options discussion board.

Invest well, and Fool on!
Jeff Fischer

Jeff owns shares of AmTrust Financial Services and Intel and is short VXX.

Charter Portfolio: Buy to Close Plum Creek Covered Calls

Published Feb 14, 2011 at 12:00AM

At a Glance

- **Action:** "Buy to close" May 2011 $39 calls on Plum Creek Timber
- **Current prices:** May 2011 $39 call bid/ask: $3.45/$3.60
- **Preferred prices:** Use a limit order near the ask price, recently $3.60

What's New?

Our May 2011 covered strangle on **Plum Creek Timber** (NYSE: PCL) is three months from expiration, but we're taking some action early. That's because the stock's $0.42 quarterly dividend payment exceeds the scant $0.25 in remaining time value on our covered calls. So with the ex-dividend date of Feb. 16 quickly approaching, we'll "buy to close" our May 2011 $39 calls early. This lets us keep our stock and uncap its upside potential — which is in line with our belief that limiting the upside opportunity on commodity investments could be a suboptimal strategy in today's resource-focused world.

That said, we'll leave the other leg of our strangle — the May 2011 $36 puts — alone, expecting either to earn the full cash gain or to buy additional shares at this lower, attractive price. Overall, our covered strangle is still earning us a small profit even though we're closing the covered-call leg at a loss — meanwhile, we've also enjoyed significant share price appreciation. And we've earned these gains with less risk, thanks to our strangle.

Why This Strategy?

To review, a covered strangle has two components, or legs: You write ("sell to open") covered calls on shares you already own to potentially sell higher, and you also write puts that could potentially purchase you additional shares if the stock falls below the puts' strike price by expiration. You can make both trades at once, or you can "leg into" them, making one side of the trade at a time, sometimes weeks or months apart (as we did for our first strangle on Plum Creek).

By closing our covered calls, we'll keep our shares and uncap further appreciation potential in the stock, which is likely if lumber prices keep climbing. We're happy to own Plum Creek and enjoy its healthy dividend, and (for now at least) we no longer want to risk losing our small ownership stake in American timberland.

How to Follow Along

Buy back your written calls by placing a "buy to close" limit order near the ask price. Do nothing with the written put and stock portions of this strangle. If you have questions about this trade, please let us know on the Plum Creek Timber board.

Charter and 2011 Portfolios: Buy Rockwood Holdings

Published Feb 10, 2011 at 12:00AM

First Things First

- **Company: Rockwood Holdings** (NYSE: ROC)
- **Guidance:** This is a **Buy First** stock in *Pro*'s portfolios.
- **Market cap:** $3.2 billion
- **Website:** www.rocksp.com
- **Type of holding:** Materials, natural resources; core, long-term
- **Options available:** Yes; we may write puts or covered calls later, but options aren't essential here.
- **Important date:** Earnings on Feb. 16
- **Follow along:** Add Rockwood Holdings to My Scorecard

At a Glance

- **Action:** Buy 2.5% of a potential 5%
- **Recent price:** $42.30 per share
- **Preferred price:** $43.50 or lower (**use a limit order near current prices**)
- **Estimated fair value:** $56
- **Why buy:**
  - This diverse company sells specialty chemicals and engineered materials that make much of modern life possible.
  - As the leading producer of lithium, which is used in batteries and electronics, Rockwood should ride the growing waves of mobile computing, green energy, and electric cars.
  - Trading at 11 times expected 2010 free cash flow, stock gains are in the cards — this management team is obsessed with increasing Rockwood's free cash flow.
- **Alternate trades:**
  - Write ("sell to open") March 2011 $40 puts, or write May 2011 $40 puts.

The Big Picture

The ingenuity of the human race is on full display at **Rockwood Holdings** (NYSE: ROC), and the results touch your life every day. The disc brakes in your car, the airplanes you fly in, the paint on your home, the fibers in your clothing, the batteries in your electronics, and the pharmaceuticals in your cabinet — even the packaging around your groceries — all may contain Rockwood's specialty chemicals and engineered materials.

The company's revenue grows as industrial, manufacturing, and consumer activity increase. Even during weak economies, though, Rockwood is able to maintain healthy sales because it provides critical components to products (not optional add-ons). If that's not enough to pique your interest, Rockwood is also the world's leading producer of lithium, the critical component in batteries used in mobile phones and computers — and now for green energy and electric cars.

The Business

Rockwood's modest $3.2 billion in market value belies its global reach. With 87 manufacturing facilities in two dozen countries, Rockwood serves more than 60,000 customers, including many of the world's most-respected companies, such as Daimler, **Arcelor Mittal** (NYSE: MT), **Sherwin-Williams** (NYSE: SHW), and others — and many have been customers for 10 or more years.

Rockwood's customized solutions are often critical to an end product's success, but the cost it charges is usually small compared with the total cost of the end product. This gives Rockwood long-term pricing power in some of its business lines. It takes specialized expertise to manufacture many of the company's offerings, and they're expensive to master and bring to production, so would-be competitors face a high barrier to entry.

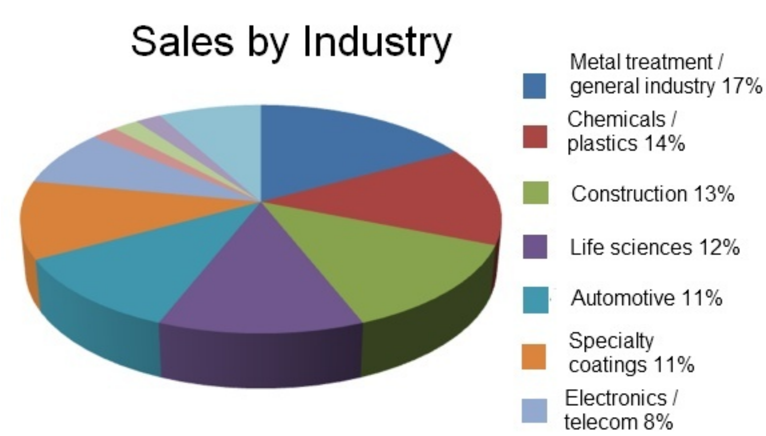
Now, on to these offerings. Our cars, airplanes, bridges, and ships would corrode rapidly without Rockwood's products, our paint would run down the walls, our tires would lose their shape, and wood would decay much sooner. To begin to understand a company this diverse, we need to take a birds-eye view of it. To see each of Rockwood's five business lines and which types of industries they serve, let's cue our massive (but infinitely helpful) table:

Business	% of Total 2009 Sales	Principal Products	Principal End-Use Markets
Specialty Chemicals	34%	• Lithium compounds & chemicals • Metal surface treatment, corrosion protection • Synthetic metal sulfides • Maintenance chemicals	• Auto and aircraft metal treatment • Batteries for mobile computing, electronics, cars, and green energy storage • Steel and metal working • Disc brakes • Life sciences (pharmaceutical synthesis and polymers)
Performance Additives	23%	• Iron-oxide pigments • Wood protection • Synthetic and organic thickeners	• Construction and renovation of all kinds, coatings, plastics • Personal-care products, paper manufacturing, foundries • Water treatment
Everyone's favorite: Titanium Dioxide Pigments	22%	• You guessed it: titanium dioxide pigments • Barium compounds • Zinc compounds	• Synthetic fibers for clothing (valuable as cotton prices increase) • Plastics, paper, paints, coatings • Pharmaceuticals
Advanced Ceramics	14%	• Hip and joint replacements • Ceramic tapes and cutting tools • Wear and corrosion • Armor components	• Medical (hip-replacement surgeries) • Industrials • Electronics • Automotive • Defense (vehicle protection)
Specialty Compounds	7%	• High-specification compounds, such as thermoplastic elastomer	• Voice and data transmission • Cables • Food and beverage • General packaging • Footwear

Source: Rockwood's 2009 10-K filing

Because Rockwood sells thousands of solutions to countless industries, no single customer accounts for more than 2% of the company's net sales. In fact, Rockwood's top 10 customers combined account for just 8% of total revenue. Geographically, more than 50% of 2009 sales came from Europe (weighted heavily in Germany), 27% came from North America (mostly in the United States), and 21% came from the rest of the world.

Rockwood has a leading or respectable position in each of its five businesses, though some of them, such as performance additives, are filled with competitors and are therefore fragmented. (This allows Rockwood to make small, bolt-on acquisitions to increase its earnings.) Its largest business is specialty chemicals — Rockwood is the world's second-largest supplier after Henkel. This business line focuses on surface-treatment products and solutions, where Rockwood sells more than 5,000 flavors — many proprietary — to the auto, air, and general industry markets. (Eat that, Baskin-Robbins!) Here's how total sales break down by industry (with 22% of sales not shown because they're small and split among multiple industries):



Source: Rockwood's 2009 10-K filing

Leadership in Lithium

Although Rockwood doesn't rely on any single industry, it's the global leader in lithium, with 40% to 50% market share. Lithium is the world's lightest metal and (chemistry pop quiz!) the least dense solid element. All living things contain a trace of lithium, including you and me. Still, it's rare, and no element has a greater ability to store energy, making lithium essential in the creatively named lithium and lithium-ion batteries that power most portable electronics. Lithium is also used in industrial applications, including alloys, ceramics, and glass (other Rockwood niches).

The market for lithium has grown 10% annualized for the past 10 years, and management expects the rise to continue. The company is developing a new generation of conductive lithium salts for the battery market that executives believe can drive "significant growth." Rockwood also offers a more diverse range of products and specialty compounds than its biggest lithium rivals, **FMC** (NYSE: FMC) and **Sociedad Quimica** (NYSE: SQM).

So just where can you find all this lithium? It's used in cell phones, laptops, consumer electronics, tablets, airplane bodies, and batteries that capture the energy created at wind and solar power plants, as well as in electric cars — including the new Chevy Volt and Nissan Leaf (which use hundreds of battery cells). But whereas a phone needs a few grams of lithium, a car battery needs several *kilograms*.

Meryl Witmer, general partner at Eagle Capital Partners in New York, estimates that having 1 million electric cars on the road would double the world's demand for battery-grade lithium. Already working with multiple car companies, Rockwood mines lithium out of enormous brine ponds it owns in Nevada and Chile. Rockwood believes it has more than enough supply to meet future demand, so it's not looking to acquire smaller companies, even though there's a gold-rush mentality elsewhere in the lithium industry. Rockwood believes it is the world's lowest-cost producer of high-grade lithium, giving it an enviable position to increase profit as demand grows.

The market for electric cars may indeed become large eventually. **FedEx** (NYSE: FDX) recently deployed test electric vehicles, and CEO Federick Smith said that in some cases, the company achieved 70% to 80% cost savings per vehicle compared with its fleet of gas guzzlers. As battery production grows (lowering the cost to customers), electric vehicles may find widespread appeal. The Chinese government is committed to an electric vehicle future, and President Obama ambitiously aims to put 1 million electric cars on the road by 2015. Germany wants 1 million by 2020. Still, less than one-third of Rockwood's total sales come from lithium, so there's plenty of room for this business line to grow — and plenty of other lines to fall back on.

Financials and Valuation

Buyout company **Kohlberg Kravis Roberts** (NYSE: KKR) created Rockwood in 2000 by acquiring the chemical product lines of Laporte for about $1.2 billion. Mix in a number of acquisitions, some dispositions, and just five years later KKR took Rockwood public. With results improving under strong management, Rockwood shareholders have done well — the stock is up 110% since August 2005, driven by steady gains in revenue and operating cash flow. Here's how the numbers have progressed:

Year-End	12/2005	12/2006	12/2007	12/2008	12/2009	LTM to 9/30/2010
Revenue	$2,584.7	$2,714.7	$3,065.2	$3,380.1	$2,962.9	$3,355.6
Operating Cash Flow	$257.6	$302.6	$368.5	$296.6	$369.6	$445.7
Long-Term Debt	$2,640.8	$2,697.4	$2,450.2	$2,783.9	$2,457.6	$2,125.6

Source: Capital IQ. Numbers in millions.

The company still carries significant debt of $1.9 billion net of cash (as of Sept. 30, 2010), but that's down from $2.5 billion in 2005. Chief Financial Officer Robert Zatta is intent on generating strong free cash flow and using it to pay down debt or make small, highly accretive acquisitions.

Rockwood is on track to generate nearly $4 per share in free cash flow in 2010 — we'll see results on Feb. 16. *Pro*'s conservative fair-value estimate of $56 a share equates to about 12.7 times 2011 estimated free cash flow. Like our Charter Portfolio holding **Plum Creek Timber** (NYSE: PCL), Rockwood is partly an investment in natural assets, so it might look expensive on a price-to-earnings basis (17.5 times 2011 estimates), but we need to include extra value for Rockwood's lithium holdings. The mines are admittedly hard to value but appear conservatively priced.

What Would Make Us Sell

Since its IPO in 2005, Rockwood has posted relatively low and sporadic net margins and returns on equity, although it now seems to be on the right track. It faces pricing pressure in some of its more commoditized markets, so we need to be ready for bumpy results. And since Rockwood carries meaningful debt, more than ever we'll keep a close eye on the company's free cash flow (the company is well below its debt covenant, so it has breathing room). Our investment case could be weakened by poor management decisions, a fall in lithium prices, loss of multiple key customers, a failure to innovate, key management departures — basically, a litany of boilerplate risks could make us reconsider. For instance, if oil prices fall sharply, incentives for electric cars would decline, and that could affect lithium pricing. Thankfully, there's no apparent *single* risk that could mortally wound our long-term investment case, but if many things go wrong, we'd need to reconsider the position.

Pro Bottom Line

Rockwood's long-term promise in many diverse businesses, its lithium leadership, a reasonable valuation, improving financials, and strong management make the company a compelling long-term investment. As long as management continues to prudently manage cash, profitably grow the business, and leverage the opportunities ahead, we look forward to owning this growing business alongside you. Power up your portfolio with lithium — we'll start with a half position and look to "recharge" it later.

- **Talk About It:** To ask questions or share your thoughts, please visit our new Rockwood Holdings discussion board.
- **Follow Along:** To track your Rockwood returns or watch the stock, add Rockwood Holdings to My Scorecard.

Pro's charter and 2011 portfolios will buy a 2.5% stake in Rockwood Holdings in the next one to 30 days, per The Motley Fool's trading guidelines.

Portfolio 2011: Buy Intel

Published Feb 8, 2011 at 12:00AM

Pro first recommended buying **Intel** in our Charter Portfolio in November 2008. Since then, we have used various strategies on the stock. For *Pro*'s past Intel trades, check out our recommendation history.

At a Glance

- **Action**: Buy 3% of a potential 6%
- **Recent price**: $21.69
- **Preferred price**: Use a limit order to buy shares below $22
- **Fair value**: $25
- **Alternate trade**: "Sell to open" April or May 2011 $21 puts (see our guide to selling (or writing) puts).
- **Why Buy?**
  - Intel has dominant competitive advantages in growing markets.
  - The company continues to manage for the long term, spending on R&D and manufacturing capacity.

- Its dividend and share-buyback program would entice conservative investors if the stock falls much beyond the current price, so the stock is unlikely to drop much lower than its current level.
- The stock is cheap and has an attractive risk-return profile.

First Things First

- **Company: Intel**
- **Market cap**: $121 billion
- **Website**: www.intel.com
- **Type of holding**: Large-cap tech; core
- **Options available**: Yes; we may use options later.
- **Follow along**: Add Intel to My Scorecard.

The Big Picture

Every three or four years, the personal computer dies — or at least that's what the technorati would have us believe. The most recent assassins: tablets and smartphones. More specifically, **Apple**'s iPad and iPhone, which the technorati argue are changing the way the world computes — and that any company that's not part of the Apple ecosystem will suffer a long, painful demise. But here at *Pro*, we just don't buy it.

PC shipments increased 13.8% in 2010 and have averaged 10% annual growth since 2006. The PC revolution should continue this momentum: Research firm Gartner expects worldwide PC shipments to rise 15.9% this year. We think this PC refresh cycle has sturdy legs, as its catalysts appear diverse and robust:

- PC affordability is higher than ever
- Mature PC markets continue to grow as having multiple PCs in one household becomes more common
- Demand from emerging countries continues to rise
- Corporate upgrades are strong thanks to Windows 7 and business visibility

Server markets have been plugging along, too. Corporations are cash-rich and have been spending on their technological infrastructure. Taken together, demand for the brains (microprocessors) and nervous systems (chip sets) of the world's PCs and servers should remain strong for years to come.

Why Buy?

Intel dominates its market niches — chips for PCs and servers — and those markets should remain viable for years. The company expects to generate more than $50 billion in revenue this year, an increase of 15% from 2010. We expect Intel to bolster its competitive position in key markets by spending $7.3 billion on research and development this year. That's more than competitors **Advanced Micro Devices** and **ARM Holdings** generated in revenue during all of 2010, combined! This stable cash cow of a business allows Intel to expand its reach into the higher-profile and still-developing world of mobile computing.

Simply put: Intel has the size, technological savvy, and financial resources to compete and win in whichever markets it chooses. Although much of Wall Street thinks Intel has missed the boat on tablets and smartphones, starting "late" isn't of much concern because of the speed, scale, and accuracy with which Intel can flex its design, manufacturing, and partnership muscles. We say, tablets and phones beware!

- Intel has two current chip offerings for tablet computers, dubbed Moorestown and Oak Trail. As sales of non-iPad tablets grow, Intel will benefit.
- The company's presence in phones has been in the works for some time, and its Medfield chip is currently being beta-tested by customers and further fine-tuned. It should contribute to revenue in 2012.

Even though Intel's core business looks strong and its new products appear ready to tackle new markets, the stock trades near historical lows in terms of EBITDA, earnings, and cash flow (with the current price at about 12 times free cash flow). We wouldn't be surprised if management decided to send a message by snapping up shares — which currently yield 3.4% in dividends — under Intel's recently upped $14 billion repurchase program.

Intel is the largest holding in *Pro*'s Charter Portfolio (assuming we exercise our purchased calls), and the stock is a Buy given the company's low risk profile and our $25 estimate of fair value. We're putting Intel into Portfolio 2011, and we recommend you add it to your holdings, too.

Next Steps

- Questions or comments? Visit our Intel board.
- Once you've bought INTC, add it to My Scorecard.

Pro Portfolio 2011 will buy a 3% stake in Intel in the next one to 30 days, per The Motley Fool's trading guidelines.

The Motley Fool owns shares of Apple.

Own Stocks the Pro Way

Published Feb 7, 2011 at 12:00AM

Coverage & Community

- Bryan (TMF42) digs into the earnings from **Bristow Group**, which remains on Hold.
- Newly minted Londoner Todd (TMFPhila) shares his thoughts on **GlaxoSmithKline**'s earnings in proper English.
- Be ready for your companies' earnings releases by following along with Joe's (TMFValuemoosie) earnings calendar.
- Russell (TMFEldrehad) posts his 100th CAPS commentary, sharing what he's learned along the way.
- Member SLader100 asks how many positions are too many.
- There's a groundswell of support that *Pro* member spinningwood be nominated for the Fool's Feste Award.

Dear Fools,

I've said it before, but it bears repeating: Buying a stock is a little like a marriage.

That's because if you want to compound your (investing) happiness over the years, you need to focus on having a long-term relationship (with strong companies).

Here at *Pro*, we put our faith in the fact that quality businesses increase shareholder value over the years. And of course, we need to be invested in order to benefit. This is why, although we will occasionally sell short and use options, the majority of *Pro*'s assets will predominantly be invested in strong companies.

In fact, we'll be 70% or more invested in stocks most of the time — the remainder will be dedicated to options, ETFs, shorts and cash. It may surprise you to hear this, but stocks — not options or shorts — have been the most volatile part of our portfolio and have demanded the most patience.

Given the fickle nature of stocks, you should only buy them when you're ready to hold a company for a number of years, or as long as the business merits that line of thinking. Of all the assets you'll hold in your *Pro* portfolio, stocks are the longest-term investment. Remember that as you step up to buy.

Upcoming Earnings

- Tuesday: **Broadridge Financial Solutions**
- Thursday: **Cisco Systems**
- Feb. 15: **AmTrust Financial Services**

What We Buy

Let's go back to our marriage analogy for a moment. When you buy a stock (or tie the knot), you hope the relationship only gets better for years and years, but realistically, you need to be ready for some rough patches along the way. Thus, you need to choose your (stock) partner carefully. At *Pro*, we do that by focusing on:

- Sustainable competitive advantages (this protects profits)
- A diverse and expanding customer base (this provides growth)
- Recurring revenue streams (this lends stability)
- Strong and expanding free cash flow (the lifeblood of any company)
- A healthy balance sheet (it's easier to take advantage of opportunities when you're cash-rich)

Most of our companies are valued using discounted cash flow models that lay out at least a few possible scenarios. We seek strong potential appreciation with only reasonable downside risk. Our primary goal is to close our positions profitably, avoiding permanent losses. We need to be comfortable with what we own and the price we're paying, because this allows us to wait out market volatility and not lose sleep.

Why We Sell

As long as our stocks are reasonably valued, we want to avoid paying commissions and taxes, skipping dividends, and missing upside — meaning we don't want to trade in and out of our long-term stocks. Instead, we'll consider selling when:

- The position looks fully priced
- The original thesis has been fulfilled or has weakened
- The stock no longer fits with the portfolio, or we find something we like better
- The potential reward in the position no longer seems worth the risk

More Resources

- Making *Pro* Fit Your Profile
- How We Invest
- Secrets of a Winning Portfolio
- *Pro* 's Guide to Finding Great Stocks
- The *Pro* Way to Value Stocks
- *Pro* 's Guide to Selling

We want to defensively raise cash, selling our least favorite holdings (maybe on our way to shorting the market in a bearish environment).

Although we don't try to time price swings in our long-term stocks, we'll often use options on them when we see pricing opportunities. This can give us the best of both worlds: long-term gains in our stocks, and short-term gains with their options.

Finally, we're not shy about revisiting stocks we've sold for new opportunities (although this is almost certainly bad marriage advice). After all, it makes sense to leverage the time investment we've made in learning a company's business. In any case, we'll review each sale with you at least a year later to see what's happened since and what we could learn.

Stocks are the longest-term part of what we do here at *Pro*. But we're also here to earn profits in the short term, even when the market doesn't go up. We'll discuss that topic in next week's Memo on options.

Stay tuned as we plan more new trades for you this week, putting our words into action.

Jeff Fischer (TMFFischer)

- Next Step: Visit our Memo Musings board to ask questions or post your thoughts.

Jeff owns shares of AmTrust.

Portfolio 2011: Write Puts on Wells Fargo & Co.

Published Feb 2, 2011 at 12:00AM

Pro first recommended buying **Wells Fargo & Co.** in our Charter Portfolio in December 2010. For *Pro*'s original take, read our initial buy report on Wells Fargo.

At a Glance

- **Portfolio 2011 action:** Write ("sell to open") a 2.5% position in March 2011 $33 puts (for *Pro*, two contracts)
- **Recent options price (bid/ask):** $1.19/$1.21
- **Preferred price:** Use a limit order at the bid, initially $1.19 or higher (3.6% yield).

- **Stock fair value**: $37
- **Alternative trades:**
  - Buy stock instead.
  - Write (“sell to open”) April $32.50 puts, recently $1.32, to be more defensive.
- **Why buy:**
  - Wells Fargo features a best-in-class management team.
  - The stock is significantly undervalued.
  - The injection of Wells Fargo’s sales culture into Wachovia stores offers an opportunity for meaningful growth.

First Things First

- **Company: Wells Fargo & Co.**
- **Market cap:** $176 billion
- **Website:** www.wellsfargo.com
- **Type of holding:** Long-term, diversified financial company
- **Strategy:** Guide to writing puts
- **Follow it:** Add to My Scorecard

What's New?

We’re happy to report that not much has happened at **Wells Fargo & Co.** since we first purchased shares in December. In the recent fourth-quarter earnings release, management shared its excellent business results and record net income figures. We weren't surprised, but the future — not the past — is the real story. We consider this to be the best-of-breed financial institution, with a sales culture that benefits customers and stakeholders alike.

Deposits are growing at a much faster rate than loans, which bolsters the already strong balance sheet while providing huge future earnings potential, if or when a demand for loans returns. Even if recovery-driven loan demand is far off, shareholders should expect to profit anyway, as Wells Fargo implements its "cross sell" culture into its acquired Wachovia footprint.

One catalyst on the horizon, outside of the excellent business trajectory, is the potential to regain control of the company's dividend — currently held captive thanks to those pesky TARP restrictions. Management has submitted a request to regulators to increase its ability to return capital to investors. Even if the request is delayed, today's inexpensive share price is an opportunity for *Pro* to build what we expect to be a profitable long-term holding.

Why This Strategy

You can simply buy shares if you prefer, but we're writing puts to earn income while we wait to buy shares a bit cheaper. If converted into shares by the time the options expire in March, these puts would allow us to buy shares about 3.6% cheaper than the recent price. We're writing the at-the-money puts ($33 strike-price puts on a $33 stock) to maximize the premium we earn and have better odds of getting shares. If the shares end up above $33 at expiration, we won’t get to buy shares, but we'll earn an att ractive annualized return on this trade and look to write puts again.

Charter Port

Since Charter Port bought a 2.8% stake in Wells Fargo shares recently, we’re not taking new action there at this time. However, if veteran members don’t own shares yet, or are ready to potentially buy more, you can follow this trade alert for Portfolio 2011.

How to Follow Along

You need options approval to write puts, and the trade command is “sell to open” or “sell.” (*Do not buy these options!*) *Sell one contract for every 100 shares of Wells Fargo you’re willing to purchase later (each contract represents an obligation to buy 100 shares, or $3,300 worth of Wells Fargo stock). Writing these options will “pay” you the option premium up front, and then we’ll wait until expiration on March 18 to know our next move.*

Our initial potential profit is whatever the puts pay us; we have an obligation to purchase shares of the stock if they fall below the $33 strike price by expiration. If we get shares, our net start price will be $31.81 (we buy our shares at $33, but still keep the $1.19 the puts pay us). Since we fully intend to take share ownership if assigned the shares in March, make sure you have $3,300 available, per contract, to purchase shares. Otherwise, just purchase Wells Fargo in the suggested starting allocation (2.5% up to 3%) per the alternative trade.

Next Steps

- *Questions or comments? Is this your first options trade and you need a hand? Visit our Wells Fargo board.*
- *Stoked to learn more about writing put options? Head over to the All About Options board.*

Pro Portfolio 2011 will write puts representing a 2.5% stake in Wells Fargo in the next one to 30 days, per The Motley Fool's trading guidelines.

Nick owns shares of Wells Fargo.

Charter Portfolio and Portfolio 2011: Buy Sprott Physical Gold Trust

Published Feb 2, 2011 at 12:00AM

Pro first recommended **Sprott Physical Gold Trust** (NYSEMKT: PHYS) in our Charter Portfolio in October 2010. For our original take, read the full buy report.

At a Glance

- **Portfolio 2011 action:** Buy 3%
- **Charter Portfolio action:** Buy an additional 1% (for a total 3% position)
- **Recent price:** $11.80
- **Preferred price:** Around $12 or lower, and around a 4% premium or lower to net asset value (found here)
- **Type of holding:** Defensive
- **Why buy:**
  - Protect capital from currency devaluation.

- Hedge against inflation.
- Diversify with a commodity that doesn't always correlate to market indexes.

The Big Picture

We're initiating a 3% position in Portfolio 2011 and adding just under 1% to our original portfolio's 2.2% position in **Sprott Physical Gold Trust** (NYSEMKT: PHYS).

You'll find our original rationale for buying gold here. We still believe in this thesis, and a pair of events since then supports it. First, in a bid to create inflation and kick-start the economy to life, the Federal Reserve announced a massive $600 billion purchase of Treasury debt, a move that further devalues the dollar in relation to gold. And in perhaps the highest-profile mainstream public comments favorable to gold, World Bank President Robert Zoellick made this statement in November in the *Financial Times*:

"The [new monetary] system should also consider employing gold as an international reference point of market expectations about inflation, deflation, and future currency values. Although textbooks may view gold as the old money, markets are using gold as an alternative monetary asset today."

Zoellick's comments were pleasantly unexpected but clearly in sync with our views. Gold is money and becomes even more coveted when central banks like the Federal Reserve debase their paper currencies. As this saga continues, gold is an asset you can turn to to protect your wealth.

Why Buy?

It's always a good idea to have some assets defensively positioned, but even more so today given high levels of unemployment, government spending, and arguably, the stock market. Plus, the Federal Reserve is propping up asset prices and bent on creating inflation. This strikes us as a heady brew of optimism mixed with poor fundamentals, and our response is to position some assets outside of the stock market. Our goal at *Pro* is not only the appreciation of wealth, but also the *protection* of wealth — and gold meets those standards. Gold also provides potential insurance should another financial catastrophe occur, so why wait? Now is an excellent time to get started by adding Sprott to your portfolio.

Next Steps

- Questions or comments? Chat it up on our Sprott board.
- Once you've bought PHYS, add it to My Scorecard.

Portfolio 2011 will buy a 3% stake in Sprott Physical Gold Trust in the next one to 30 days, per The Motley Fool's trading guidelines. The Charter Portfolio will increase its stake in Sprott Physical Gold Trust to a total of 3% in the next one to 30 days, per The Motley Fool's trading guidelines.

A Peek at Our 30-Day Plan

Published Jan 31, 2011 at 12:00AM

Welcome to everyone here!

Pro's doors closed to new members last week, and we already have a waiting list — a first for us and a clear sign that more investors want to focus on making absolute profits. But you made the cut, Fool, and now we're moving forward together. Our common goal is to earn recurring gains with a high level of accuracy, despite what the market throws our way. There's no question we'll see market volatility again, and our community will welcome the investment opportunities that only volatility can bring. Meanwhile, we'll invest where we see a high likelihood for strong returns over months and years, with reasonable risk.

Charter Port Upcoming Earnings

With so many earnings reports the coming weeks, expect action for either portfolio if we get pricing opportunities.

- Jan. 31:**Plum Creek Timber**
- Feb. 1: **Jack Henry & Associates**, **Kinetic Concepts**, **Tupperware**
- Feb. 2: **Bristow Group**
- Feb. 3: **GlaxoSmithKline**

Coverage & Community

- TMFValuemoosie posted a full earnings calendar.
- New *Pro* members continue to introduce themselves on the Meet & Greet board.
- Andrew (TMFRedwood) shares thoughts on **L-3 Communications'** earnings.
- Jeff posts a summary of **Apple's**recent results.
- **Intel** increased its dividend 15% and authorized a $10 billion share buyback. It also closed on its Infineon acquisition, increasing Q1 revenue guidance, although Intel will pay to fix a chipset flaw (remember when it found flaws much more frequently?).
- Two long threads: Should investors relax standards to chase the S&P 500? And Andrew shares his bear case, starting a great discussion.
- *Pro's* social banter board has hosted discussions about everything from beer, to food smokers, to where to get the best pizza — but right now, the topic has turned to mortgages. Fools can't help but talk about finance!
- Russell (TMFEldrehad) takes a look at what it takes to be “average” in CAPS — and discovers that the “average” CAPS participant may be anything but.

If you're new to *Pro* and missed last week's Monday Memo, please read it to help you get oriented; things are going to get moving here. We plan to bring you a steady stream of new trades each week for the foreseeable future, including our first options trade for Portfolio 2011. Be sure to get options permission from your broker if you haven't already.

Veteran members, we're also working on new recommendations for our Charter Portfolio, so stay tuned.

Here's a look at what you'll be learning in these Memos in the month ahead:

- **Feb. 7:** How to buy stocks like a pro
- **Feb. 14:** Our options strategies and how to make them work for you
- **Feb. 22:** Our ETF and short strategies

- **Feb. 28:** Putting it all together — stocks, options, ETFs, and shorts — to build a *Pro* portfolio

We'll also be analyzing the ongoing earnings season (see the sidebar each week for links to our discussion board posts), and bringing you continuing coverage of all our *Pro* investments.

FAQs

Your *Pro* team hosted a live chat last week, and we were honored that more than 1,200 *Pro* members participated. Nick, Bryan, Andrew, and I answered as many questions in 90 minutes as we could, but of course we didn't get to them all. If you still have a question for us, please post it any on of our discussion boards. A transcript of the chat is available for reading at your leisure, and we thought it would be useful to zip through some of your most commons questions here:

Q: What's the best way to get started?

A: Visit your getting started guide. (Invest a little time for long-term rewards. That works for more than just money, Fools.)

Q: Which portfolio – Charter or Portfolio 2011 – should I follow?

A: *Pro* began investing in the Charter Portfolio in 2008 and our veteran charter members should continue to follow it. Portfolio 2011 is starting now, and it's for all new members to follow. The new portfolio will buy the most attractive positions in the Charter Portfolio, so veteran members who need to catch up can also follow along with Portfolio 2011 trades. (Set your email preferences for trade alerts here.) Trades on brand new positions will be done in both portfolios at the same time, until the two portfolios eventually become mirrors of each other, as intended.

Q: How do I use *Pro* and *Motley Fool Options* together?

A: *Motley Fool Options* is a sister service to *Pro*, and it's free to every *Pro* member. It offers additional options ideas, education, community support, and strategies that can complement your *Pro* portfolio if you're seeking more ideas. We spend quality time coming up with *Motley Fool Options* ideas, too, of course, and the strategies there work alongside a *Pro*-based portfolio. In fact, *Pro* inspired the launch of *Motley Fool Options*. So, use both as you see fit, but try not to confuse the two services. Always double-check your trade alert emails to see which service recommends the trade.

Q: Which positions are best in an IRA?

A: Only a handful of options trades (ones that require margin, such as spreads) and shorts won't be possible in an IRA. Otherwise, most *Pro* investments can be made either in an IRA or a regular account. Most options are short-term gains, so you might consider doing as many of those as you can in a tax-advantaged account (assuming you're not planning on using the options income anytime soon). Investments with a high dividend yield, which you might want to own for years, may pay off best in an IRA. The rest is at your discretion.

Q: Do I need to buy shares in 100 round lots?

A: Proper allocation on a percentage basis is more important than buying in round lots. If we plan to use options on a position in the future (which requires 100 share lots), we'll let you know beforehand in the trade alert.

Q: How do I get up to speed using options?

A: Gradually! Start slowly, learning one basic strategy at a time (writing puts or covered calls). Read our *Pro* guides to options, and ask questions. You can find much more information, including educational videos, in the Options U. section of *Motley Fool Options*. Our trade alerts will be as specific as possible to help you get started using options.

Q: What should I do with my existing holdings?

A: If you need to free up some capital to invest in *Pro* positions, sell your least-favorite holdings whenever you're ready to invest in a *Pro* recommendation.

Q: How are trades announced?

A: We'll email you a trade alert during business hours that includes our thoughts behind the investment. *Pro* itself will make the trade one to 30 days later, giving you first crack at it.

Get Comfortable, and Think Big

We have an active month (and year!) ahead of us, but don't feel rushed. Investing is about thinking big – big picture, big timeframe – and *not* about getting wrapped up in the moment (which is the exact opposite of what you want). We're here to steadily earn profits over time, and whether you make every trade with us or half of them, we want your outcome to be just as satisfying.

Welcome once more to our new *Pro* members, and thank you again to charter members for all your help in the community. We're happy we're all in the door and can do what we like best now: invest for profits.

We'll be visiting your inbox again with another trade alert soon. Until then, Fool on!

Jeff Fischer (TMFFischer)

- Have comments or questions about this Memo? Post them on our Memo Musings discussion board.

Portfolio 2011: Buy AmTrust Financial Services

Published Jan 27, 2011 at 12:00AM

Are You New to *Pro*? Start Here!

Jeff recommends new Portfolio 2011 members begin with a stake in **AmTrust Financial Services**. *Pro* first recommended AmTrust in our Charter Portfolio in April 2009. For *Pro*'s original take, read our initial buy report on AmTrust.

At a Glance

- **Action**: Buy 3%
- **Recent price**: $18.30
- **Preferred price**: Use a limit order to buy shares near market prices, ideally below $19.
- **Fair value**: $21 to $23
- **Alternate trade**: "Sell to open" June 2011 $17.50 puts (sell one put for every 100 shares you'd buy). These puts recently pay $0.70 for a potential stock buy price of $16.80 (see our guide to selling (or writing) puts).
- **Why buy**:
  - AmTrust has a history of profitable growth and a well-defined strategy for the future.
  - The company benefits from conservative management and strong recurring revenue in attractive niche insurance markets.
  - The stock should appreciate as the company's book value grows, giving shares significant long-term potential.

When a young Warren Buffett recognized the attractive qualities of insurance companies early in his career, it had a profound implication for his success. It helped him realize what makes for an attractive business model: one that collects cash up front, allows the company to use that cash (invest it), requires much less cash to run the business (in this case, to pay insurance claims), and makes sure customers pay for the service on a *recurring* basis. These factors make for the most attractive businesses in the world — and happen to perfectly describe insurance companies.

First Things First

- **Company**: **AmTrust Financial Services**
- **Market cap**: $1.1 billion
- **Website**: www.amtrustgroup.com
- **Type of holding**: Financials, small cap, core
- **Follow along**: Add AmTrust to My Scorecard.

Why Buy?

The insurance company *Pro* is recommending today, **AmTrust Financial Services**, went public in 2006 and has increased its book value — a key measure of a financial company's worth — from less than $300 million to nearly $700 million in less than five years, more than doubling the company's worth. AmTrust offers specialty property and casualty insurance products — namely, workers' compensation for small businesses that typically have five to 20 employees. It also sells extended service and warranty coverage on consumer and commercial products, offering extended warranties on a diverse array of third-party products and services, including TVs and computers. By tracking claims in real time, the company can adjust warranty premiums on the fly, increasing rates for suspect products. AmTrust is active in the United States and Europe.

The company targets under-served and fragmented niches, where there are fewer larger insurance company competitors. This translates to profits: AmTrust's return on equity is routinely above 20%. And the company continues to grow by buying small competitors and "rolling them" into AmTrust's larger, farther-reaching, and better-oiled machine. Leveraging AmTrust's technology, geographic reach, sales force and risk assessment capabilities, the acquisitions become more profitable than they would have been on their own (it's economies of scale in action). The strategy has worked, with gross written premiums and operating income growing faster than 30% and 40% each year over the past five.

Because customers renew their policies with AmTrust more than 80% of the time (there's that recurring revenue we talked about), AmTrust's management is able to invest its float — the cash earned on its policy premiums — in various ways. We like that management has remained conservative and stuck to investing in top-rated, short-term bonds. While cautious, this choice will enable easy reinvestment into bonds that pay more if interest rates rise, providing an additional boost to book value.

Finally, with its stock trading at 1.4 times expected book value for 2010 and less than 8 times expected 2011 earnings, AmTrust is selling for the same value multiple as it did when we initially bought shares in 2009. The stock has appreciated steadily as the insurer's book value has grown, and patient investors should be rewarded with much more appreciation. As we wrote in our original buy report, we hope to own AmTrust for many years, enjoying the value creation made possible by a steady, lower-risk business.

Next Steps

- Questions or comments? Visit our AmTrust board.
- Once you've bought AFSI, add it to My Scorecard.

Pro Portfolio 2011 will buy a 3% stake in AmTrust Financial Services in the next one to 30 days, per The Motley Fool's trading guidelines.

Jeff owns shares of AmTrust.

Portfolio 2011: Buy DGS

Published Jan 26, 2011 at 12:00AM

Pro first recommended **WisdomTree Emerging Markets SmallCap Dividend Fund** in our Charter Portfolio in November 2010. For our original take, read the full buy report.

Charter members, you don't need to participate in this trade unless you missed the recommendation in November 2010 and want to get on board now.

At a Glance

- **Action:** Buy 3%
- **Recent price:** $53
- **Preferred buy price:** $55 or below (and as close to the NAV as possible)
- **Why Buy:**
  - Small companies in emerging markets provide strong long-term growth opportunities.

- The ETF gives your portfolio diversification into growing foreign companies that are otherwise difficult to access.
- The dividend reflects stability among the ETF's leading small-cap holdings.

The Big Picture

Investing in small companies in growing countries such as South Korea, Turkey, and Taiwan was difficult before exchange-traded funds (ETFs) came along, and one in particular has caught our attention: **WisdomTree Emerging Markets SmallCap DividendFund**.

First Things First

- **ETF: WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSE: DGS)
- **Total assets:** $743 million
- **Website:** WisdomTree
- **Type of holding:** International, small-cap, yield, core
- Add DGS to My Scorecard.

The ETF's name is a mouthful, but it says it all. (We'll save ourselves some breath and just call it by its ticker, DGS.) With one simple purchase, we can invest in hundreds of small companies that aren't listed on U.S. exchanges but are thriving in 19 developing countries, including Brazil, Chile, India, Israel, the Czech Republic, and more. With a healthy dividend that will likely range from 3% to 4% annually and the promise that DGS will "grow up" with emerging markets, this small-cap ETF is a great core holding for a portfolio seeking international exposure.

Why Buy?

According to Ibbotson Associates, companies with small market values outperformed large companies by an average of 2.1% per year from 1926 to 2008, and by an even greater amount in recent decades — 3.6% annually from 1973 to 2008. Additionally, companies that pay dividends outperform those that don't, and Standard & Poor's reports that dividends accounted for 44% of the S&P 500's return over the past 80 years. Finally, in the decade that ended on Dec. 31, 2009, the MSCI Emerging Markets index returned 10.2% annualized, while the MSCI USA Index dropped 1.2% per year. Past results can't guarantee future performance, it's true — but for eight decades, small has outperformed large and dividend-payers have topped the alternative, and for many years, emerging markets have outdone developed ones. With this investment, we seek to capitalize on all three factors.

At the same time, we want to avoid the big risks that are usually associated with emerging markets and small companies. The ETF owns more than 400 stocks spread across five continents (all except North America and Australia), so our risk is greatly diversified by country, sector and business. Our valuation risk is reasonable. As of Jan. 24, the index that the ETF tracks traded at 12.8 times trailing earnings and had a dividend yield of more than 4%. The allocation by country was recently led by Taiwan, Korea, South Africa, Thailand, and Turkey – followed by Israel, Brazil, Hong Kong, Malaysia, Chile and seven others.

Investing in small companies in these countries would have been difficult (or impossible) in years past, but this ETF gets the job done for a reasonable 0.63% annual expense ratio (which is taken out of the dividends). This is the type of diversification we hope to buy and let ride for years, enjoying the quarterly dividend and business expansion along the way.

Next Steps

- Questions or comments? Chat it up on our DGS board.
- Once you've bought DGS, add it to My Scorecard.

Portfolio 2011 will buy a 3% stake in DGS in the next one to 30 days, per The Motley Fool's trading guidelines.

Here Comes Portfolio 2011

Published Jan 24, 2011 at 12:00AM

Live Chat on Thursday

From 2 to 3:30 p.m. Thursday, Jan. 27, your *Pro* team will be on hand to answer your questions in real time. Just click here to join the conversation and send yourself an email reminder.

With *Pro's* doors now closing, we'd like to again welcome our new members, and we look forward to beginning to invest in Portfolio 2011 with you this week! The three most important things you need to know before you begin are:

- How to get around our website
- How the *Pro* service works
- How we invest

So that's exactly what we'll cover in today's Memo. Veteran members, I ask for your indulgence and hope you'll find this Memo useful as well.

Orientation

We've developed a three-step welcome kit for new *Pro* members. It explains how we invest (which I'll also outline below), how trade alerts work, and much more. If you're new, I highly encourage you to start with these three steps by clicking here. If you've already gone through the steps, here's a brief refresher:

- The *Pro* Monday Memo is sent to your inbox every Monday at 4 p.m. ET. This is your weekly touchstone column for *Pro*. I suggest you read it (including all the sidebars) carefully because it aims to concisely keep you up to date with your *Pro* service. (You can see all of our Memos here.)
- As a new member, you'll want to follow the trade recommendations for Portfolio 2011. We'll invest Portfolio 2011 to match the holdings of our Charter Portfolio as closely as possible — by suggesting that you start positions in our current favorites. When we discover a new trade that's relevant and appropriate for both portfolios, we'll recommend it to both portfolios simultaneously. If you're a veteran *Pro* member, you should continue to follow our Charter Portfolio, but you might enjoy making the "catch-up" trades we're recommending for Portfolio 2011, too. We're starting by buying **L-3 Communications** in Portfolio 2011.
- You can set your email preferences to receive trade alerts for both portfolios or just one. We send Trade Alerts anytime during market hours, and they explain the investments we're recommending. After we send an alert, *Pro* makes the investment at some point during the next one to 30 days. Once we make the trade, you receive a Trade Complete email.

- *Motley Fool Options* is the sister service to *Pro*, free to you as long as you're a *Pro* member. It offers *a la carte* options ideas, education and more — and every Friday at 2 p.m., *Motley Fool Options* will send its Options Weekly column to your inbox. Just don't confuse the two services, and we believe you'll greatly enjoy both!

Community & Coverage

- Drop by the Meet & Greet board to say hello. The *Pro* team and veteran members like spinningwood, fullofcarp, silverhawk27, and many others are there to greet you. (Thanks, veterans!)
- *Pro* senior analyst Nick Crow (TMFCrow) has the lowdown on **Wells Fargo**. Its recent earnings look promising.
- This Week in CAPS: Member TMFEldrehad discusses why CAPS stock ratings are relative — and why that's important.

Charter Portfolio Trades

We start the week with a slightly different Charter Portfolio following a slew of options expirations. Namely, we:

- Let **Autodesk** and **Procter & Gamble** be called away (sold) above or at our fair-value estimates, via covered calls.
- Had covered calls on **GlaxoSmithKline** and puts on **Contango Oil & Gas** and **Tupperware Brands** expire as income.
- Let naked calls on **iPath S&P 500 VIX Short-Term Futures** expire as income.
- Had long calls on **MELA Sciences** expire as worthless despite the company's product getting a nod from an FDA advisory panel. Oh well.

Upcoming Earnings

- Jan. 25: **NextEra Energy**
- Jan. 27: **L-3 Communications**
- Jan. 31: **Plum Creek Timber**
- Feb. 1: **Kinetic Concepts**, **Tupperware Brands**, and **Jack Henry & Associates**

Education

Your *Pro* team is happy to help you invest every step of the way, but understanding what you're doing is key to enjoying it — and making sure you can profit from our strategies for a lifetime.

- For the broadest overview of our investment strategy, you'll want to read our Go-To Resources, including how we invest, and introductory guides to exchange-traded funds (ETFs), shorting and options, and more. Take your time. We're using strategies developed over more than a decade. You can learn them over the course of a few months.
- If you're using options strategies with us (you don't need to, though we recommend it), bookmark our Options Guides homepage. We'll keep adding guides, and there's more in our sister-service *Motley Fool Options*' Options U., too.
- The *Pro* community is outstanding. If you have questions, post them on our vibrant discussion boards, and you'll get help.

Invest Like a Pro

Finally, the reason we're all here: to grow value. Furthermore, to become better investors — expert investors — who have financial freedom and enjoy investing in many more ways than before. You need to know where we stand, so let's summarize:

- *Pro* invests for absolute profits, not relative returns. That means we want positive returns measured over any meaningful time period (generally, every rolling two years or so — one year is too short), regardless of what the market does. We don't care about the S&P 500, which has been flat for nearly 11 years. Instead, we want to earn profits regardless of how the market performs.
- We invest with financial freedom in mind. You can't live on the proceeds of a flat index, and you can't live on relative returns. You *can* live on regular proceeds earned from recurring options income and positive absolute gains.
- Our mission is to earn you strong, recurring profits with a high level of accuracy — while taking reasonable risks.
- Building focused portfolios, we use stocks and ETFs to earn long-term returns, and we use options and shorts to earn shorter-term returns.
- Read our Trade Alerts carefully when they hit your inbox. We offer alternate trades and try to anticipate (and answer) your questions in the alert. Please ask any questions on our discussion boards before you make the trade.

Finally, let's not forget that we're investing during extraordinary times. The market has seen record-breaking volatility over the past two years, making Wall Street seem more like a slot machine than a sensible venue that allows participants to own equity and businesses to raise equity to grow. Keeping in mind what the market *really* is, we don't fear volatility and falling prices. In fact, we welcome both as opportunities.

Welcome Again

Take your time as you get started with *Pro*. If you're going to do well as an investor, you'll want to be disciplined, practiced, and patient. We're here to help, and we're ready to get started — but you're the boss, and you should only start when *you're* ready.

We look forward to announcing new trades this week. It's going to be an active 2011, but always take your time, ask questions, and don't rush. Welcome to *Pro*! We'll invest smartly together and earn strong profits in the coming years.

Foolishly,

Jeff Fischer (TMFFischer)

Jeff owns shares of Apple, GlaxoSmithKline, Kinetic Concepts, Tupperware, and is short the *iPath S&P 500 VIX Short-Term Futures*.

Charter Portfolio: Write New Naked Calls on VXX

Published Jan 21, 2011 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") February 2011 $35 naked calls
- **Allocation:** 6% if we end up shorting shares; for *Pro*, about 24 contracts
- **Recent options price (bid/ask):** $1.35/$1.45
- **Alternate trades:**
  - Sell shares short directly, but do so incrementally
  - Write naked calls at higher strikes (or later months) for more breathing room
  - Set up a January 2013 synthetic short ("sell to open" calls at the recent share price, and "buy to open" the same strike puts)
  - If you're already short the shares directly, continue to hold your short for more long-term price decay

What's New

Since we recommended you invest against (or sell short) the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) exchange-traded note in December, this clunker has declined 33% while the VIX index it's based on has dropped 23%. And since we first recommended this short last June, it's lost 70% while the VIX has lost 33%.

First Things First

- **ETN: iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX)
- **Recent price: $31.77**
- **Website:** ipathetn.com
- **Type of holding:** Short (short naked calls)
- Add VXX to My Scorecard

Although the VIX — the market's most popular measure of implied volatility — is one point below its lifetime average of 19 now and could tick higher, our confidence in shorting this flawed VIX-tracking vehicle remains strong. Veteran *Pro* members should know the VIX, the VXX, and this exchange-traded note's tracking issues well by now, but if you don't, our past reports will get you up to speed.

Why This Strategy

With the VIX recently at 18, the short-term VIX futures contracts that VXX tracks were recently priced near 19 for February and 21 for March — so the ETN we're shorting is already priced for a VIX of around 20, or about 10% above the recent VIX price. This suggests that the index needs to gain at least 10% in the coming month just to keep the price of the ETN at current levels. If the VIX doesn't rise that much, the futures (and the ETN) will slowly lose value. Aiding us further, we're writing naked calls that are 10% above the current ETN price, so we estimate we'd need the VIX to gain about 20% to bring the ETN near our strike price, and even more to get the ETN near our break-even price.

Even that may be understated because futures prices will go up each day the VIX goes up, causing the ETN to pay more as it rolls its futures contracts daily. Because of this drag, on days when the VIX jumps, the ETN has typically continued to gain about half as much or less. On Thursday morning, the VIX was up 8% and the ETN was up less than 3%. Given how the futures work, we might even need a 25% move or higher in the VIX to get to our break-even price of near $36.40 on this written naked call. We're comfortable with that, especially because we can roll the naked calls up if necessary and keep waiting for the VIX to settle down and for decay to eat the ETN's value.

But how likely is a 20% to 30% jump in the VIX during the coming month? It would require a meaningful series of declines in the S&P 500 or a large shock to the market. According to Barclay's (the ETN issuer), we would probably need at least a few consecutive days of 2% to 3% declines in the S&P 500 for a gain in the VIX to build to something close to 20 — or a one-day decline of more than 4%.

If the S&P 500 loses in a day ...	... then the average increase in the VIX is ...
0% to 1%	1.05%
1% to 2%	6.86%
2% to 3%	10.33%
3% to 4%	14.88%
Greater than 4%	17.21%

Sources: Barclays Capital Analysis, 1/90 – 4/10, and Bloomberg

But even if the VIX jumps 22% in a day on a large market decline (from 18 to 22, say), the ETN may go relatively nowhere for the pricing reasons we just discussed. For example, in the last full week of November, the VIX jumped the most in a single week since May 2010 – from 18.7 to 22.2, or 18%. But the ETN gained less than 1% the same week. Why? The futures it tracks already assumed a VIX above 20, just like now. The ETN won't always do so poorly (sometimes it will jump even more than the VIX), but this displays how badly the ETN *can* lag. And that's why we're comfortable shorting it at higher strike prices even with the VIX near its lifetime average.

How to Follow Along

You need full options and margin approval to write naked calls (meaning calls where you don't own the underlying shares). Our profit is limited to what the calls initially pay us, unless the ETN rises above our strike price and we're able to short shares (although we're more likely to roll the calls for another payment and keep waiting; shares for shorting are unavailable at our broker). If you can short shares directly at your broker, that's still an attractive long-term choice, although you might move incrementally and short more on spikes. You have more profit potential shorting directly, though you don't start with a pricing cushion the way you do with naked calls.

Trade Details

- **Action:** Write (sell to open) February 2011 $35 calls (one for every 100 shares you'd short — for *Pro*, about 24 contracts for a 6% allocation; each written call represents a $3,500 short of VXX)
- **Limit price:** Near market prices, recently around $1.40 or higher
- **Break-even price:** $36.40
- **Current VXX price:** $31.77
- **Difference to break-even**: 14.5%
- **Return on investment:** 4.1% if the calls expire, earned in 29 days

Fools, if you make this trade, you need to be fully aware of the risks of shorting anything, let alone a volatility index. This is a high-conviction position when time is on our side, but we might see very large price movements in the meantime. In that case, we'd need to roll the position forward.

Please bring your questions to our VXX board.

Jeff is short VXX.

Charter Portfolio: Buy to Close Your Tupperware Covered Calls

Published Jan 19, 2011 at 12:00AM

At a Glance

- **Action:** "Buy to close" all January $45 calls
- **Preferred price:** Use a limit order near or at current market prices (lately, $1.95).
- **Recent share price:** $46.80

What's New?

Since *Pro* set up a covered strangle on **Tupperware** (NYSE: TUP) in September, the stock has gained 15% thanks to the company's plas-tastic third quarter. Our strangle, made up of $35 puts and $45 calls, has padded this profit a bit further. But now that these options are about to expire, we're closing our January $45 calls. That lets us keep the stock for more upside and allows us to use additional options strategies on Tupperware down the road.

We'll also let our existing January $35 puts expire for a full income gain on Friday without taking any action. After that happens, we'll hold no options on the stock -- for now. Because Tupperware is only a 2% position in our Charter Portfolio and shares trade below our $50 estimate of fair value, we don't need to defensively cap the upside today, and if the stock declines following Tupperware's Feb. 1 earnings, we may want to take advantage of the dip and buy more shares.

Why This Strategy?

Simply put, at today's valuation, Tupperware may have more room to run.

The stock trades for less than 13 times its expected 2010 earnings of $3.62 per share and for 11.3 times its estimated 2011 earnings (though that estimate could always change). With a dividend yield of 2.5%, the company's business isn't too shabby either: Return on equity has increased to a stellar 34%, up from 27% just five years ago.

And the company's growth in emerging markets also remains compelling: Developing economies accounted for 59% of Tupperware's recent sales. And with its at-home sales-force, Tupperware provides *Pro* with exposure to consumer retail without needing to rely on margin-sapping retail outlets.

The company expects a fairly modest 4% to 6% gain in fourth-quarter revenue measured in local currency, though earnings-per-share growth is expected to reach 17% in 2010, followed by a 14% gain in 2011. A weak euro might create a slight challenge in 2011, but the stock's current price seems to already account for this.

How to Follow Along

Simply "buy to close" your January 2011 $45 calls on Tupperware, using a limit price close to current market prices. Try to pay as little as possible above the current market value. So, if Tupperware is trading at $47, pay as close to $2 as possible to close your $45 calls. Currently, we can close the calls at a modest profit, and we'll simply let the $35 puts expire for the full profit.

Questions? Please visit our Tupperware board.

Jeff owns shares of and has covered calls on on Tupperware.

Intel's Surf Shop and Apple's Jobs Loss

Published Jan 18, 2011 at 12:00AM

I'm delighted to welcome new members to *Pro* this week! Ours is a great community of investors, and it shows every day. Case in point: Many veteran *Pro* members have already given our newest investors a warm welcome on our discussion boards. Please consider joining in if you haven't already, or you can send a shout-out during *Pro*'s next live chat on Thursday, Jan. 27.

This Week's Trades

Pro's Charter Portfolio will issue a few maintenance trades on existing options positions this week. If you're new to *Pro*, you can ignore these trades — but rest assured that this is the type of ongoing guidance and coverage you can expect from *Pro* as you follow along with Portfolio 2011. For now, we recommend new members open a position in **L-3 Communications** (read our trade alert) and keep an eye on your inbox for our next idea. It's headed your way next week!

I'm also happy to be initiating Portfolio 2011, a $250,000 real-money portfolio that our new members will be able to follow from scratch. It's been created to help new members optimally build their portfolios to match *Pro*'s Charter Portfolio, so veteran members don't need to follow along with Portfolio 2011 — unless you want to, of course. If you have any questions about the new portfolio, check out our FAQ on Port 2011. We also have a guide on using our newly revamped website.

And now, let's turn our attention to the one reason we're all here: strong investments for consistent profits.

Intel, Surfing, and One Great Wave

Last week, one of our favorite tech companies — and one that we've recommended both buying outright and via call options — **Intel**, delivered a record fourth quarter thanks to strong sales of microprocessors used in servers.

What's more, Internet traffic in 2010 surpassed *all* of the previous years combined, and with *1 billion* additional people expected to start surfing the Net over the next five years, the demand for servers is not likely to subside. Intel provided record first-quarter guidance and predicted that "everything gets better" in 2011, with refreshed products, a better economy, and more potential customers. The company expects 10% revenue growth in 2011 as computer shipments increase 13% to 14% from last year. You'd think investors would be excited by all this, but they shrugged instead, and Intel's stock drifted downward. Maybe they were simply stunned by the numbers: Most of Wall Street seems downbeat on Intel, with many analysts talking about impending doom for the chip giant because of tablets and smartphones.

Upcoming Earnings

- Today: **Apple**
- Jan. 19: **Wells Fargo**
- Jan. 25: **NextEra Energy**

Coverage & Community

- Jeff digs deeper into Intel's earnings.
- This week in CAPS: TMFElderhad considers the "follow the leader" phenomenon.
- kan100 joins *Pro* and gets an extremely warm welcome.
- Introduce yourself on our Meet & Greet board.
- Many of you have posted your New Year's Resolutions — take a look!
- TMFValuemoosie shares an earnings and dividend calendar.

It's true that Intel is arriving "late" to the smartphone market (although, truly, this market is just getting started), but management insists that getting into the niche didn't make economic sense until recently. Instead, Intel needed to focus on making higher-margin server and PC chips until it could produce a mobile phone product at margins that counted. Now it's doing so with its Atom chip. You can't say that Intel is late to the tablet market, though, because demand began in earnest just last year, and Intel says its chips will be used in dozens of tablet designs starting this year. Yet since last summer, Wall Street's common refrain has been that Intel will lose out to mobile devices. Intel claims the opposite: that mobile devices will expand the computing market, benefiting the company. *Pro* has a 6% stake in Intel, so you know which side of the argument we take.

In our *Pro* community, even usually skeptical members like spinningwood are impressed with Intel's new Sandy Bridge chip capabilities. We're also optimistic about the company's plans to put security on a chip, which is important for mobile devices. Beyond these technological advantages, Intel offers the world's best and most reliable microprocessor manufacturing. Intel rival **ARM Holdings** doesn't manufacture it own chips; it simply designs them and then outsources the building.

Not all is perfect at Intel. The company will spend about $4 billion more than last year on new manufacturing capabilities, putting a dent in free cash flow. And competition in mobile devices will remain heated. So even if investors once again come to appreciate Intel's many advantages, it's unlikely the $21 stock will soar more than 20% anytime soon (our fair value is in the mid-$20s). But we'd happily take that gain given the low risk we see in this stock. Intel trades at only 10 times earnings estimates for 2011, and its dividend yields a nice 3%. Your *Pro* team is still digging through the recent earnings, but we like what we see at Intel, so the stock remains a Buy in our Charter Portfolio.

A Temporary Loss of Jobs?

Steve Jobs is taking a third leave of absence from **Apple** to focus on his health. He'll remain CEO and make key decisions, but he's handed operations over to COO Tim Cook. Cook took over for five months in 2009, and Apple's stock gained more than 60% during that time. We hope Jobs, who turns 56 this year, will find health. *Pro* never invests in any company expecting management to remain the same forever, so Jobs' news doesn't change our investment argument — even though Jobs casts a longer shadow than most CEOs do. If he doesn't return to Apple soon, we'll need to closely watch the company's progress. (The second-generation iPad is expected to come out this spring and the iPhone 5 later this year.) In the meantime, Apple announces its latest earnings this afternoon, so join us on our Apple discussion board to talk shop and ask questions.

That's it for the Memo this week, Fools. Thank you for being a *Pro* member, and welcome again to our new members! We'll be in touch with investment ideas soon.

Jeff Fischer (TMFFischer)

Jeff owns shares of Apple and Intel.

Portfolio 2011: Buy L-3 Communications

Published Jan 14, 2011 at 12:00AM

L-3 has been a Buy First stock in *Pro*'s Charter Portfolio since November 2010. You can read our original recommendation of the company here.

Few industries were less beloved by investors in 2010 than the defense industry, and shares of **L-3 Communications** didn't escape that scorn. The stock declined more than 16% over the past year even as the S&P 500 gained 12% — and this is where we see opportunity. When a sector becomes so disliked, it typically means stocks are being mispriced. That's especially true if you can find a company in the sector that doesn't deserve to be beaten up along with its lesser peers.

LLL, Not LVLT

Make sure you buy the right company! We're recommending **L-3 Communications** (NYSE: LLL), *not* **Level 3 Communications** (NYSE: LVLT).

At a Glance

- **Action:** Buying 2.5% of current portfolio value
- **Estimated fair value:** $100
- **Preferred buy price:** Around $80 or lower
- **Type of holding:** Long-term, defense contractor
- **Why buy:**
  - World-class capabilities and technology
  - Fantastic price
  - Defensive company that is not closely correlated to the economy

We believe L-3 fits that mold. The stock is at a historically low valuation because of fears that U.S. defense spending will shrink — fears we don’t share. First, L-3 provides mission-critical technology and defense services that should survive budgetary tightening. Second, as we've now seen, the Pentagon doesn't plan to shrink the defense budget much at all. In fact, defense spending is scheduled to grow modestly through 2014, and then flatten, not plunge. Leading defense companies should still perform in this environment — and their cheap shares should recover. Indeed, since our first purchase in November 2010, L-3 stock has started to gain some ground.

We still believe it's inexpensive, and we appreciate its other fine qualities, too: Defense industry stocks like L-3 offer stability because the Pentagon will keep spending even if the economy weakens. The sector isn't closely correlated to the market, so it can hold up better during market declines. And while L-3 is priced for flat or no growth in the coming years, we believe the company can grow enough to pleasantly surprise investors. This is a contrarian investment, the kind that usually offers lower risk and good results to patient investors. We recommend starting a position of about 2% to 3% to match the Charter Portfolio.

Click here to view our full report, and here to discuss the company.

Live Chat Transcript: Jan. 27, 2011

Published Jan 14, 2011 at 12:00AM

The *Pro* team hosted a live chat on Jan. 27. To read the transcript of members' questions and the team's answers, just click the player below.

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Charter Portfolio: Roll Up Your Kinetic Concepts Covered Calls

Published Jan 14, 2011 at 12:00AM

At a Glance

- **Action:** Buy to close January 2011 $39 calls; sell to open March 2011 $45 calls
- **Preferred limit price:** $4 debit on the two trades combined
- **Recent option prices:**
  - January 2011 $39 calls: $6.50
  - March 2011 $45 calls: $2.40
- **Alternate trades:**
  - If you prefer a higher call payment with more upside, you can roll up to options with later expiration dates (and potentially higher strike prices) — for example, June 2011 $46 calls or January 2012 $47.50 calls.

What's New?

The protective collar we set up on **Kinetic Concepts** (UNKNOWN: KCI.DL) prior to its October earnings release has turned into a menacing strangler choking the life from our stock. That's been especially true this week as shares jumped amid rumors that **Johnson & Johnson** (NYSE: JNJ) may be considering a buyout of Kinetic competitor **Smith & Nephew** (NYSE: SNN). Such an action would make Smith & Nephew a more formidable foe, so Kinetic Concepts' spiking share price seems curious. It's likely the market is simply slapping an acquisition-related premium on the whole industry, but we're not impressed by such short-term influences. Instead, we're focused on Kinetic Concepts' business.

The Story So Far

We initially wrote our protective collar as protection against a possible drop in Kinetic's share price. However, the stock has climbed higher. We closed the put half of the collar in October, but our written call has increased in value significantly since then. We aren't eager to sell our shares, since they're still below what we think they're ultimately worth. These new calls are meant to be the first in a series that will allow us to regain our upside and earn back what we've missed due to the covered calls.

After two sketchy quarters in early 2010, performance appears to be stabilizing. Management reiterated its fourth-quarter 2010 sales guidance this week, suggesting flat year-over-year revenue, which should bring healthy (though not skyrocketing) earnings. On an estimated 4% increase in 2011 revenue, the company is expected to grow earnings 6% this year.

Speaking of acquisitions, Kinetic Concepts recently acquired TechniMotion Medical. Incorporated in 2007, TechniMotion offers ergonomic products (like lifts and chairs) for the safe handling of patients. Terms were not disclosed, so we suspect it's a small acquisition. Kinetic would market any new products gained in the purchase through its large sales network.

Sales are down lately in the therapeutic side of Kinetic's business, and margins are low. Of all the company's divisions, we've been least excited about this one; we even believed Kinetic might put its therapeutic bed division up for sale, which would have boosted overall margins. This acquisition of TechniMotion makes that unlikely. We don't want to read too much into it, but the acquisition suggests that growth opportunities may be lacking in other areas of the business (otherwise, why expend resources on this division?) and that Kinetic remains committed to lower-margin therapeutics.

However, we still estimate Kinetic's fair value is around $54, so it makes sense to keep the $45 shares as long as we believe in the business — even if we need to roll up our ill-fated covered calls at a net cost. We will work to earn our way out of this deficit over time.

Why This Strategy?

We're rolling up to a call with an expiration in the near future this time. This is much more common when using diagonal calls, so why are we doing it in this situation? Because writing at-the-money calls expiring in just two months means that any dip in share price below $45 would benefit us quickly, allowing us to make back $2.40 in option value; we could then write new covered calls. Plus, with only two months until expiration, gains in the stock are more likely to be modest (acquisition rumors aside), making it easier to roll up if necessary. Also, we're paid much more on a *daily* basis by writing covered calls that expire soon, given that time decay is more rapid as expirations near. Finally, with implied market volatility so low as measured by the VIX, we'd rather not lock into writing options that expire a year from now (for example), since the VIX is bound to increase at some point, which would help lift options prices across the board.

There's also a healthy incremental gain to be earned here over the next two months, so this makes sense as the first step in what could be many more rolls. Let's look at our roll-up:

Math of Rolling Up	
Cost to close January 2011 $39 covered calls	**($6.50)**
Premium on hand from original collar (from closing puts early)	$0.18
Total cost to close calls	**($6.32)**
Payment received writing March 2011 $45 calls	$2.40
Total cost of rolling up	**($3.92)**
Strike price increase	$6 (from $39 to $45)
Total extra upside gained	$2.08
New net sell price if called	$41.08
Incremental return on stock	**5.3%**
Incremental return on cost to roll	**53.2%**

See? Clear as mud!

Seriously, let's look it over. The cost of rolling this time is $3.92, but we gain $6 in our potential stock sales price, for a net $2.08 gain. We don't plan to let the shares be called away, but if they were, our return would be 5.3% higher than we would have received this month (not bad for a difference of just two months). The incremental return on our cost to roll is also worthwhile. Again, we'll pay a net $3.92 to roll, and we stand to earn $2.12 extra if our shares are called away — that's a 54.6% return on the capital we're adding to the trade over these two months. That's certainly a worthwhile endeavor, especially since the new position will start with 5.3% downside protection in Kinetic Concepts (the premium received for the $45 calls).

The ideal outcome: Kinetic shares remain around $45 or a bit below, so we earn the full call premium by March and repeat the process. If Kinetic heads higher, we'll look to roll up again, ideally for a credit on the next trade (by expiration, we'll have until the stock reaches $47.40 to roll at a credit). As with a diagonal call (which Jim Gillies has demonstrated so well over in *Motley Fool Options*), if the stock takes a breather, we'll start to earn back some of our lost upside, and we can reload the trade in just 60 days. If shares keep going higher, we'll be earning more than we would have by doing nothing today, and we'll have flexibility to keep pursuing it with new strategies as March nears. Since the stock is still safely below our fair-value estimate, shadowing it higher with an incremental covered call strategy makes sense. But the flatter Kinetic's stock remains, the more we'll ultimately earn from the strategy.

How to Follow Along

Simply buy to close your existing calls and write an equivalent number of the new calls, using limit orders near market prices. Some brokers allow you to close and roll to new covered calls with one trade command (for a reduced commission). In that case, look to roll for a $4 debit or less. Questions? Please visit the [Kinetic Concepts board](). Jeff will be there licking his wounds from this broken collar — which we'll now seek to mend.

Jeff owns shares of Kinetic Concepts. The Motley Fool and Motley Fool Alpha *own shares of Johnson & Johnson, which is also an* Inside Value *and* Income Investor *recommendation.* Motley Fool Options *has a diagonal call position on the stock to boot. (J&J gets around!) Smith & Nephew is a* Global Gains *recommendation.*

Get to Know Our New Site

Published Jan 11, 2011 at 12:00AM

Welcome, *Pro* member, to our new site! As you've no doubt noticed, we've done a lot of updating, and there's even more to come over the rest of this month as we welcome a new set of members and launch a new portfolio. We're excited about the changes we've made, which were developed directly from your feedback, and we want to make sure you're finding your way around your new home. This page is our attempt to provide you with all the tools you need to make the most of *Motley Fool Pro*!

Check Your Email Preferences

Members who have been with us for awhile will receive alerts for the Charter Portfolio. New members (starting in January 2011) will receive alerts for Portfolio 2011. If we recommend a trade for both portfolios, everyone will get it. You can manage the email you get from *Pro* and any other Fool services [here]().

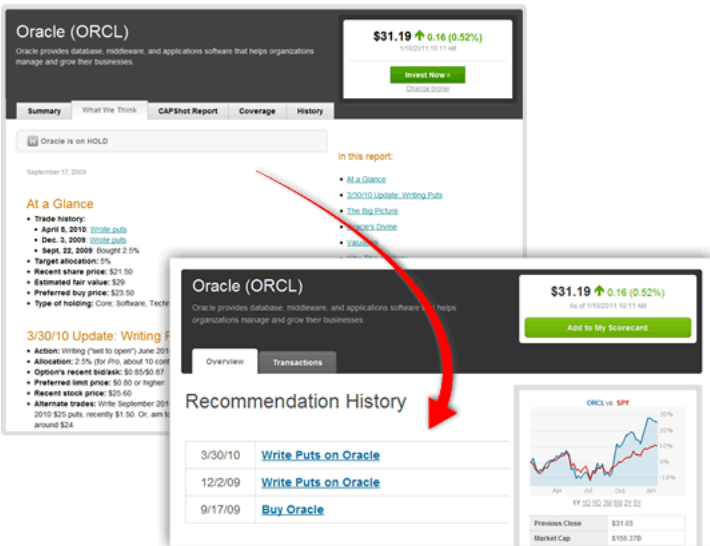
Tutorial

We've put together a short video in which Jeff shows you how to navigate the new site. Check it out for a quick-but-comprehensive overview of what's changed.

After you've watched the video, check out the new home page, which we've designed to be the hub of *Pro*. We brought much of what you love about the old *Pro* site front and center. Here you'll find the latest alerts, our Monday Memos, up-to-date details on the market in general, timely messages from the *Pro* team, and the latest community board posts, all in one place.

Navigating the Recommendations

Previously, all of our recommendations, re-recommendations, sell recommendations, and other coverage on a holding was concentrated in one big file. We thought that was unwieldy (and we know many of you did, too), so we've changed the format. Now, instead of clicking on "What We Think" to see all our coverage, you can click on "Overview" and choose from a chronological list of everything we've written on that holding:



Looking for Something?

Trade Alerts

Old Site: Alerts were shown in the yellow box at the top of the home page (and on individual recommendation pages, where applicable).
New Site: Use the "Alerts & Coverage" tab at the top of the home page or the "Latest Alerts" tab located below the "carousel" (less formally known as the big box) at the top of the page. You can also see a list of our most recent content — alerts, memos, extras, board posts, and more — in the "watercooler" that extends down the center of the home page.

Monday Memos

Old Site: The most recent Monday Memo was always linked from the top of the home page, and the archive could be found under "Memos" by clicking on the "Features" tab.
New Site: The "carousel" at the top of the home page will link to whatever content we think is most important to share with you — this will sometimes be the memo, but not always. Either way, you can find the most recent memo by clicking the "Monday Memo" tab below the carousel. A complete archive of our memos can be found under "Memos" by clicking on the "Alerts & Coverage" tab.

Cast Your Vote

Did you know you can now recommend a story you particularly enjoyed on the *Pro* site? Use the "Rec This" box (beneath the yellow square in the top right corner of the page).

Portfolio Information

Old Site: The "Portfolio" tab showed all of our holdings and gave relevant information about them.
New Site: The "Recommendations" tab displays the most recent recommendations for both our Charter Portfolio and Portfolio 2011. You can click on either to see a full listing of our holdings (current and closed) and transactions, as well as new information like our fair-value estimate and buy-below price.

CAPShot

Old Site: By clicking on the CAPShot tab at the top of the home page, you were able to enter a ticker to learn more about the company, see its CAPShot score, and generate a CAPShot report.
New Site: You can now access the CAPShot Score by typing in a ticker in the search box at the top of any page. However, the CAPShot report is currently under construction; we will notify you when it's up and running.

Portfolio 2011 Questions?

Check out our FAQ for the answers to common questions about the upcoming new portfolio.

Give Us Feedback

We genuinely want to know your thoughts on the new *Pro* site — so much so that we've created a board for you to share them. Click here to tell us how you feel on the New Site Feedback board.

Jeff Shows You the New Site

Published Jan 11, 2011 at 12:00AM

Welcome to the new *Pro* site! In the video below, Jeff gives an overview of our new features and how to use them. Enjoy!

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Questions? Comments? Bring them to our New Site Feedback board.

Frequently Asked Questions About Portfolio 2011

Published Jan 11, 2011 at 12:00AM

We launched Portfolio 2011 when we welcomed new members to *Pro* in early 2011. Here are some questions and answers to help you determine what it means for you.

What is the new portfolio all about?

Portfolio 2011 was introduced to help new members (or those who aren't yet caught up) build positions in many of the stocks we love from the Charter Portfolio (*Pro*'s flagship $1 million portfolio, which was launched in October 2008). Portfolio 2011 was loaded with $250,000 of the Fool's money that Jeff is investing to resemble the Charter Portfolio.

Will Portfolio 2011 exactly resemble the Charter Portfolio?

No. We won't buy every Charter Portfolio stock in Portfolio 2011. Why? Some stocks have climbed in price or are too risky for new purchases right now. We can use options, however, to target lower buy prices on some stocks.

Which *Pro* portfolio should I follow?

If you joined before 2011, we recommend that you follow *Pro*'s Charter Portfolio. Of course, Jeff and the *Pro* team will continue to actively manage this portfolio and will send you Charter Portfolio trade alerts when they have new recommendations for you.

If you're new, we recommend you follow along with Portfolio 2011, beginning by establishing positions in our Buy First stocks. Any member who just wants an extra layer of investment advice may elect to follow both portfolios (you can change those settings here). Just remember, the Charter Portfolio is the "master" portfolio, and Portfolio 2011 intends to build toward mimicking it, rather than deviating from it.

Will I receive Charter Portfolio / Portfolio 2011 trade alerts?

If you want them! You can customize your email settings here.

When you have new recommendations, which portfolio gets them?

When Jeff and the *Pro* team find a brand-new investment idea, one email will be sent to both groups with the subject line, "Trade Alert: Charter Portfolio and Portfolio 2011." All brand-new investments will be made in both portfolios.

As always, if you have any questions, just bring them to the boards and we'll be on hand to answer!

How You Can Score a Goal

Published Jan 10, 2011 at 12:00AM

MLK Day

***Pro* will arrive in your inbox one day later than normal next week**, on Tuesday, Jan. 18, after the country celebrates Dr. Martin Luther King.

Last week, Jeff shared his resolutions for *Pro* in 2011. Specifically, he wants all of us to:

- Have fun together
- Invest only in high-conviction ideas
- Ignore meaningless volatility
- Focus our capital in the best ideas
- Spend our time on value-adding activities

Jeff's list motivated me to set my own personal investing resolutions for the New Year. As I looked over my list, I realized that some of my resolutions could also benefit you. By sharing them, I hope they inspire you to set your own goals — more on that front in a moment. For now, here are my goals for 2011. See if you recognize yourself if any of them.

My Foolish Resolutions

Coverage & Community

- Earnings season begins soon, kicking off with **Intel** (Nasdaq: INTC) on Jan. 13. TMFValuemoosie posted an earnings calendar.
- This week in CAPS: TMFEldrehad looks at cold 1-Star stocks and shares a personal investing lesson.
- Jeff and *Duke Street*'s Rich Greifner talk about **Apple**. Listen to their conversation here.

Upcoming Events

- Stay tuned for official guidance on our options positions expiring on Jan. 22.
- Meet **Tom Gardner, Bill Mann, Tim Hanson, and Joe Magyer** — plus Steve Forbes and dozens of top market commentators — at the **World MoneyShow Orlando.** It's **February 9-12**, **2011,** at **The Gaylord Palms Hotel & Convention Center**. Call **800-970-4355** and mention **priority code 020967** to register FREE today.

1. **More closely match *Pro*'s portfolio.** I'm ashamed to say that my portfolio looks nothing like *Pro*'s, and I imagine I'm not alone here. But I want this year to be different. As I've often quipped around Fool HQ, I think advisors and analysts owe it to you to eat our own cooking by deploying our money side-by-side with yours. Thanks to recently revamped and more Foolish trading restrictions, my portfolio will look much more like *Pro*'s by the end of the year. And thanks to our soon-to-be-released Portfolio 2011, you'll have the guidance you need to do the same. (Watch your inbox for more info on Portfolio 2011 — the details are coming soon.)
2. **Control my emotions, not ignore them.** At the extreme, markets are generally governed by fear and greed, so it's easy to conclude that smart investing should be emotionless. But we shouldn't lose sight of the value emotions bring to both life and investing. After all, they're what make us human. Plus, research in behavioral finance teaches us that people who, through illness or injury, have lost the ability to feel emotions are also unable to make decisions. Investing is about making decisions based largely on opportunity cost and the opportunities provided by other investors' overreactions. Embracing and controlling my emotions will make me a better investor.
3. **Learn something new and share it.** It's been said that to teach something is to learn it twice. I love to learn — and teach — so this goal serves as a reminder to share what I learn as I learn it.
4. **Switch to a better, cheaper broker.** Are you paying commissions that are too high? Does your broker make shorting or options more difficult than they need to be? Me too. This is a long time coming: I'm going to switch brokers or renegotiate my rate with my current broker.
5. **Be interesting and interested.** You *Pro* members have taught me a lesson through our Social Banter board: Not everyone is comfortable chatting about investing. I hadn't realized that! But as soon as we opened our new banter board, I saw that everyone seems to be willing to share a little about topics they're knowledgeable about. As a general rule, if you find something interesting, so will someone else. So I can be *interesting* by posting to our boards, and I can show that I'm *interested* not only by recommending posts I like but also by writing a line or two in response to someone else's post. My favorite off-topic topic: cars!

So there you have it, Fools. I hope some of my goals struck a chord with you. Now, I encourage you to come up with your own. Doing so is a powerful motivator as long as you follow a few rules:

1. Keep your goals simple and attainable.
2. Write them down.
3. Hold yourself accountable by sharing your goals with others.
4. If possible, track your performance.

Pro can help you with the second and third parts: Just share your goals on our Memo Musings board. No excuses — it's open 24 hours!

Better Every Day

I stole the "better every day" concept from my fellow analyst Bryan Hinmon. It's one of his Motley core values, and it aptly demonstrates Bryan's commitment to learning. So whether you plan to join me in the resolutions above or you want to write your own, I challenge you to get better every day. Stop by our Memo Musings board to share your goals — and to encourage your fellow Fools to achieve theirs.

Thank you for being a *Motley Fool Pro* member and for making our community the best one in all of Fooldom.

Fool on!
Nick Crow (TMFCrow)

The Pro Guidebook

Published Jan 7, 2011 at 12:00AM

Quick Links: Our Most Important Resources, One Click Away.

Are you curious what we think the most relevant steps are for *you* to take as a *Pro* member? Take our survey now and find out (it’s just a few questions)!

Mission & Philosophy

- Strategy Guide (PDF)
- Our North Star
- What We Believe
- Audio Extra: The *Pro* Philosophy
- Philosophy & Strategy discussion

Investing With *Pro*

- Make *Pro* Fit You (PDF)
- Guide to Finding Great Stocks
- Guide to Selling
- Catch-Up Trades
- What We Think Now

Tools & Help

The Pro Guidebook

Using Options

- [FAQ]
- [How *Pro* Works]
- [Manage Your Email]
- [The *Pro* wiki]
- [Getting Started & Help discussion]

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- Manage Your Email
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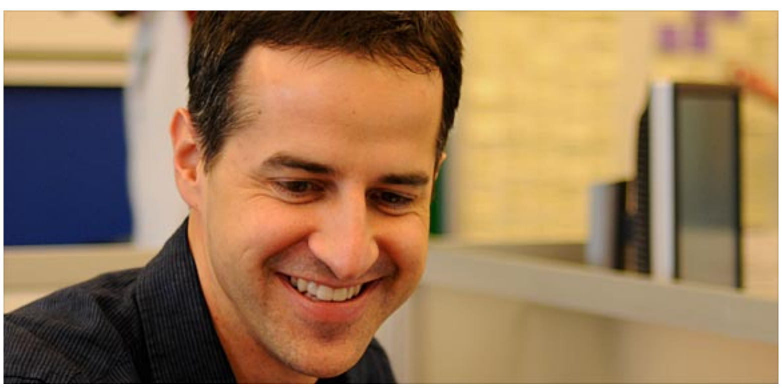
Step 1: How Pro Works

Published Jan 7, 2011 at 12:00AM

Using Options

- Options in 3 Steps
- Use Options Like a Pro
- Options U.
- Options Glossary
- Options discussion



Welcome to *Motley Fool Pro*! Get ready to start building a robust portfolio, learn smart new investing strategies, and profit in any market.

New Member Orientation Week: Feb. 6 — Feb. 10!

Monday, Feb. 6, through Friday, Feb. 10, is New Member Orientation Week, when we'll share everything you need to know to make the most of your new service and start building your *Pro* portfolio! Here's what you can expect:

- **Monday:** New-member Monday Memo featuring our exclusive North Star report, the ultimate navigational guide to *Pro* investing.
- **Wednesday:** Must-have options guide to make sure you have the knowledge you need to use these important tools.
- **Friday:** The Ketchup Report, to help you get in lockstep with the *Pro* portfolio, no matter what your portfolio looks like now.
- **Also Friday:** Live chat with the team, where you can ask any questions you may have about the service, our philosophy, or our trades.

Jeff Fischer and the rest of the *Pro* team are here to help. Let's start with the key things you can expect as a *Pro* member.

How We Invest

Pro's mission is to earn you consistent, recurring profits with a high level of accuracy using a combination of stocks, options, and ETFs. The *Pro* team (meet Jeff and the gang here) is accomplishing this by investing $1 million of the Fool's real money. Our tool kit is full of strategies to help you achieve double-digit returns while minimizing risk.

How *Pro* Works

Watch this quick introduction from Jeff to learn more about the *Pro* web site and all the exclusive resources that are now at your disposal. (You can find a transcript of this video here.)

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Staying in Touch

Our Members Say ...

"What *Pro* and the *Pro* community have done for my investment knowledge, confidence and ability to build a portfolio that I can sleep with at night are immeasurable." — *Gerald H., Wichita, Kan.*

"My experience has simply been more than words can adequately describe and I cannot imagine not being a member. My best investment ever was joining the Fool, and *Pro* in particular." — *Matt D., Pittsburgh*

All the important news from *Pro* gets delivered directly to you via email. Here's what to expect in your inbox:

- **Trade Alerts**: We announce all of our trades ***before*** we pull the trigger so you can act before we do. We send these email alerts at any time during normal market hours (we post them here on the *Pro* web site, too). Trades always come with a full report that explains our thinking. After we announce a trade, we wait one to 30 days to make the trades for the *Pro* portfolio.
- **Monday Memos**: Stay on top of *Pro* happenings — every Monday at 4 p.m. ET, we'll send you stock news, market insights, community highlights, and more.
- **Guides, Audio Extras, special updates**: Become a better investor! Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio.

Next Step: Invest

Now that you know what to expect at *Pro*, you're ready for your next step: building your portfolio alongside us. To get started, head over to Step 2: How You Make Money with *Pro*.

Audio Extra: Jeff Fischer on Apple

Published Jan 6, 2011 at 12:00AM

Jeff sits down with *Motley Fool Duke Street*'s Rich Greifner to discuss *Pro*'s latest recommendation, a little company you've probably never heard of called Apple. Just click the player below to hear why Jeff likes Apple, why using options is attractive (though a direct purchase works, too), and which three apps he thinks you should download..

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Sell Quanta Services

Published Jan 5, 2011 at 12:00AM

At a Glance

- **Action:** Selling all shares
- **Recent Price (1/5/11):** $21
- **Why Sell:**
  - We're raising cash from one of our lower-conviction, higher-valued stocks.
  - The power industry continues to operate under uncertainty, with Congress unlikely to agree on a progressive energy bill anytime soon.
  - Large projects may continue to be delayed, but after a recent spike, we can sell the stock into strength.

What's Changed?

We have no reason to throw a company we bought nearly a year ago under the bus. **Quanta Services** (NYSE: PWR) has performed well in a difficult time for the energy industry — our investment has gained nearly 20% in 11 months. However, our portfolio is almost fully allocated, and we want to raise cash to be more defensive and ready for new opportunities — and only hold high-conviction ideas along the way. This makes Quanta a natural candidate for freeing up some funds. At 27 times earnings and 20 times estimates for 2011, Quanta is one of the more expensive stocks in the *Pro* portfolio, even though the business continues to move slowly.

Quanta will probably face an improving but still challenging business environment in 2011. We expect activity in the power transmission industry will likely remain subdued thanks to the lack of an energy bill from Capitol Hill, and large projects may face more delays. Quanta still has the long-term promise that we outlined in our original report — building transmission lines, natural gas lines, and other telecommunications infrastructure — but the lack of traction in its industry, Quanta's negative free cash flow the first three quarters of 2010, and our desire to raise cash makes taking our profit a sensible choice.

How to Follow Along

We announced our intent to purchase Quanta on Jan. 27, 2010, so we're a bit shy of one year in holding the position. If taxes matter to you, you could wait until you lap the one-year point since your purchase so that your gains are taxed at long-term capital gains rates, although of course you'll risk the stock declining.

If you'd like to write covered calls instead of selling today (for instance, you may not need to raise any cash), you could consider writing February 2011 (or even later-dated) covered calls at $21 or thereabouts. Downside risk in the stock should hold in the high-teens. To discuss this trade, please visit the Quanta board.

Write Puts on Apple

Published Jan 4, 2011 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") a 4.4% position in April 2011 $330 puts (for *Pro*, two contracts)
- **Recent option price:** $20
- **Preferred price:** $17 or higher (5% yield)

First Things First

- **Stock: Apple** (Nasdaq: AAPL)
- **Market Cap:** $304 billion (at $332 per share)
- **Website:** www.apple.com
- **Type of Holding:** Consumer tech, long-term
- Add to My Scorecard

- **Why Write Puts:**
  - All three of Apple's core products serve the booming mobile computing market
  - Shares look reasonably valued, but we're being defensive by targeting a lower net start price
  - We're seeking 15% or greater annualized returns with less risk
- **Alternate trades:**
  - Buy stock
  - Write puts at higher or lower strike prices, and other months of expiration, depending on your risk tolerance and desired time frame
  - Write January 2013 puts and buy calls of the same strike and month, setting up a synthetic long

The Big Picture

Aldous Huxley, the author of Brave New World, once noted "man's almost infinite appetite for distractions." He didn't mean it as a compliment, but it would be hard to argue with his point. Humans' love for an entertaining diversion shows no sign of slowing, and thanks to mobile devices like notebooks, smartphones, and tablets, we can satisfy our desire for diversion wherever we are. We can also work, shop, get oriented, socialize, play games, and more, so it's no surprise the world is embracing mobile technology at a rapid pace.

Research firm IDC expects the worldwide mobile computer industry to grow unit shipments by a strong 22% in 2011, 19% in 2012, 17% in 2013, and 15% in 2014. Gartner Research estimates that smartphones currently account for just 19.3% of worldwide mobile phone shipments, even though smartphone shipments soared by 96% in the third quarter of 2010. In other words, about 200 million smartphones were sold in the past year, but more than double that number — at least 500 million — could be shipping annually by 2015. Then there's the nascent tablet market — from fewer than 15 million in 2010, it could reach annual unit sales as high as 57 million in 2015, according to ABI Research.

The personal-technology boom that has accompanied the ubiquity of the Internet over the past 10 years is now going mobile and spreading around the world, entering emerging markets and gaining speed. There's one company in this sector with an industry-leading brand but a relatively small share of the global market — and it can't make enough products to satisfy demand during product launches. It's **Apple** (NASDAQ: AAPL), of course, and its best days are almost surely still to come.

The Business, Financials, & Valuation

The world's most valuable consumer technology company, Apple ended its fiscal 2010 in September with a record $65 billion in revenue, representing 52% growth over the prior year. Revenue broke down like so:

- iPhones (now in their fourth year) accounted for $25 billion in sales (39% of the total), up 93% from last year.
- Mobile computers topped $11 billion in sales (17% of the total), up 18%.
- The iPod brought in $8 billion in revenue (13% of the total), up 2%.
- Music-related sales were nearly $5 billion (8% of the total), up 23%.
- iPad sales were nearly $5 billion as well (8% of total), up from zero.
- Desktop computers topped $6 billion in sales (9% of total), up 43%.
- Odds and ends made up the rest, including $2.5 billion in software revenue.

Although Apple's total sales are those of a giant company, you can see in our handy list above that many of its individual product lines remain relatively modest in size — especially given the vast global market — and most should continue to grow as the iPhone and iPad continue to draw in new customers.

For more context on Apple's place on the world stage, consider that the United States accounted for 37% of the company's revenue last year, while the Asia-Pacific region accounted for just 13% — despite growth of 160% over the prior year, Apple only had $8 billion in Asia-Pacific revenue. A potentially giant market remains available for tapping as this enormous region grows wealthier.

If mobile computer, smartphone, and tablet sales growth comes anything close to expectations into 2014 (and if the company's other segments remain on track), Apple could handily top $100 billion in annual sales. (It will take 20%, 15%, and 12% sales growth over the next three years, respectively, to get there.) In that scenario, Apple could rake in approximately $24 billion in yearly free cash flow by 2014, ballooning its current $51 billion cash and investment balance. If this occurs, the stock could gain 50% by 2014 and still be priced at a free cash flow multiple in the mid-teens. Add in the company's cash balance, and the valuation looks even more reasonable. Today, Apple trades at 17 times expected earnings for the year ending in September 2011 — and about 14 times those earnings when you subtract cash and investments per share.

Apple looks even better when you consider that it's likely to grow its computer sales at a faster clip than the industry as a whole; its current share of the U.S. market is a modest 10%, and that number is even lower internationally. Apple is expected to dominate the booming tablet market at least through 2012 — being one generation ahead of most competitors — and maintain strong market share beyond then. In the first two quarters of the product's existence, Apple sold 7.5 million iPads; those gadgets are likely to drive new Apple computer sales, too, just like the iPhone before them. For its part, the iPhone will get new life in the U.S. once it's no longer exclusive to **AT&T**

(NYSE: T). According to Gartner, Apple has 17% market share in the worldwide smartphone industry, and this market could more than double in size over the next four years.

With a growing customer base and steady product "refreshes" (including a new iPad expected early this year), Apple is riding the mobile computing wave to secure its place as one of the most profitable companies in the tech world.

The Strategy

You can simply buy shares if you prefer, but we're returning to our old friend, thewritten put, to take a bullish stance on Apple that's a bit more defensive. If converted into shares at expiration four months from now, these puts would allow us to buy shares 6% cheaper than the recent price. If we don't get the shares, we'll earn about a 15% annualized return on this trade and will look to write puts again.

- **Trade:** Sell to open April 2011 $330 puts
- **Allocation:** 4.4% (for *Pro*, two contracts)
- **Recent option price:** $20
- **Return on cash**: 6% in 102 days
- **Return on buying power**: 18%
- **Break-even price**: $310 (6.6% below the recent share price)
- **Alternate trade**: If writing a put for a potential $33,000 stock purchase is too rich for your blood, you can simply buy shares to establish a position. See our other alternate trades atop this report.

Keep in mind that buying the stock would outperform this put-writing trade (on an all-cash basis) if Apple rises to $352 or higher over the same time frame.

What Would Make Us Sell

The magnitude and speed of Apple's recent success has led some skeptics to proclaim they don't believe it can last. In a highly competitive consumer industry, Apple offers some of the highest-priced (and highest-margin) products. But margins are due to come down as Apple's product mix shifts and technology prices continue their long, slow decline. Apple is already losing market share in the smartphone market as **Google** (NASDAQ: GOOG) Android phones are sold across multiple networks; Apple's phone sales will continue to grow overall, but at a slower pace as the law of large numbers comes into play.

Looking ahead, Apple needs to continue to innovate faster than the competition to command premium prices on its products, and it can't miss any game-changing technology breakthroughs. Add to this pressure cooker the unfortunate fact that CEO Steve Jobs has had health issues. If Jobs leaves the company, its stock price will likely fall until investors are reassured that Apple will continue to thrive without his leadership. Slowing growth, reliance on a CEO, lower margins, and competing product launches could all make the stock volatile. If the business appears threatened in a lasting way, we'll exit our position.

Pro Bottom Line

The rebirth of Apple is one of the greatest business stories of our generation, but it's still in its early chapters. Skeptics question Apple's staying power, even though **Microsoft** (NASDAQ: MSFT) has proven that dominance in computers can last decades once people rely on your technology. Apple's growth is driven by younger generations who are forming tech alliances early in life and who are spending a larger percentage of their budgets on the sector. Apple has a nearly fanatical fan base, it's true — but there's substance to the company itself, and its trajectory appears to be set for at least the coming years as mobile computing devices take hold. With shares reasonably priced, the upside potential still appears to outshine the risk. Buff up that shiny silver MacBook and meet us on the Apple board to discuss it.

Jeff owns shares of Apple and Google. The Motley Fool owns shares of Apple and Google.

	2006	2007	2008	2009	2010
Net Revenue	$3.3 billion	$4.1 billion	$5.0 billion	$5.1 billion	$5.5 billion
Gross Volume	$2.0 trillion	$2.3 trillion	$2.5 trillion	$2.5 trillion	$2.7 trillion
Transactions Processed	16.1 billion	18.8 billion	21.0 billion	22.4 billion	23.1 billion
Operating Margin	20%	28%	40%	48%	51%
Return on Capital	21%	24%	46%	54%	40%
Return on Equity	3%	40%	(10%)	54%	42%

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5 Pro Resolutions for 2011

Published Jan 3, 2011 at 12:00AM

Welcome to a new year with *Pro*! We hope your holidays were relaxing and enjoyable, and that you're as excited as we are to get back to business in 2011. To start off on the right foot, we're devoting this Memo to five resolutions (or principles) we believe all investors should follow. We'll also touch on where *Pro* is going next — with some exciting news.

Coverage & Community

- Members share their wishes for a happy new year.
- Earnings season begins soon, kicking off with **Intel** on Jan. 13. TMFValuemoosie posted an earnings calendar.
- Jeff summarized the recent strong results at **Oracle**.
- Care to give a dime to charity? Keep posting on the boards! *Pro* is leading the pack in number of posts made during this year's Foolanthropy campaign.

Jan. 22 Options Expirations

Pro has a slew of options up for expiration in 19 days; we'll take action on some of them well before that, and we'll keep you posted even when no action is required.

But first, a quick look back: The *Pro* portfolio closed 2010 with a 13.7% return. For the record, that's ahead of the indexes we care any modicum about (the MSCI World, the S&P 500, the Schwab Hedged Equity Fund, and a couple of others). Of course, we continue to invest *not* for relative returns, but for positive (absolute) gains with high accuracy and, ideally, less risk — but for those keeping score, beating the market in a short period is a small bonus.

That said, while investing is serious business, we must also remember that we're all Motley Fools, and our quality of life outside of investing matters greatly as well. At *Pro*, we honor that by using strategies that give us a high level of confidence (and income in most any market), which keeps us calm and lets us enjoy our Foolish lives. What better way to start 2011 than by recommitting to our focus on this — and all of our core values?

Our 5 Resolutions

1. **Let's enjoy the year.** Maybe it goes without saying, but if you're not enjoying what you're doing, it might not be worth your time. We want membership in *Pro* to continue to be an enjoyable experience, without losing sight of protecting our assets and generating strong returns. As a model, we can look to a great example of having fun while investing: the contests run by Ed (spinningwood) on the Social Banter board. To help you enjoy your investing overall (and to boost your performance), it's key to keep a longer-term perspective.
2. **Invest in high-conviction ideas.** Life has plenty of uncertainties, and investing will always have them, too — but you can mitigate their impact by only investing in high-conviction ideas that let you sleep at night. You won't always be right, but if the majority of your portfolio is earning you returns over the years while keeping you confident, that's great success.
3. **Recognize the difference between price volatility and business health.** Tragically, countless investors are shaken by price volatility (wide movements in the market that affect a stock); they forget that a stock's price action sometimes has nothing to do with the actual business behind it. Was **Kinetic Concepts** dying as a company when the stock fell from $52 to $18 in 2008? On the contrary; the business — and its profit — continued to grow. Don't let market volatility shake your confidence in high-conviction ideas.
4. **Focus your capital.** When you have a strong idea, consider adding *more* money to it. It's rare that any single position should take up more than 7% to 10% of your initial capital, but too often investors find excellent ideas and then don't commit *enough* to them. You can be focused yet remain amply diversified with as few as 12 positions.
5. **Don't be penny-wise and pound-foolish (small "f"!).** And finally, here's a resolution that's more touchy-feely, but just as important: Focus your attention, time, and energy on things that *add* value to your life and weed out the things that don't.

Ready for What Comes

Pro's approach to investing this year will depend on what the market gives us, but currently it's likely that we will:

- Add more company or sector-specific shorts to hedge our largely invested portfolio.
- Sell lower-conviction ideas to add to higher-conviction ones (new or existing).
- Add new option-writing strategies to continue to generate significant income without needing to add capital.
- Buy options to leverage the cash we have.
- Continue to watch the evolving ETF industry to profit on the knowledge we've gained along the way.

We're also excited to share that *Pro* has a new site debuting soon! The shiny new interface will offer you a more interactive home page, a redesigned portfolio page with useful information all in one place, and much more; you can expect to see us announce the new site in the next few weeks. Also, *Pro* will open to new members this month for the first time since June. In doing so, we'll offer every member (both new and old) the chance to follow a new real-money portfolio: Portfolio 2011. As we did with our current portfolio (which we're calling the "Charter Portfolio"), we'll be building this portfolio from the ground up, providing advice on exactly what we'd buy or use options on right now. Keep in mind that the new portfolio will be designed to allow new members and veterans alike to "catch up" to the Charter Portfolio, rather than break new ground. We'll share more details with you soon.

All of that, plus more special reports, company interviews, live chats, and (of course) new investment ideas, mean the whole team is ready to have an excellent year with you.

Left to right: Adrienne Perryman, publisher; Bryan Hinmon, CFA, analyst; Andrew Sullivan, CFA, analyst; Jeff Fischer, lead advisor; Todd Wenning (now in the UK, but just an email away); Nick Crow, senior analyst; Ellen Bowman, editor.

We'll remain focused on our resolutions, and also on *Pro*'s bottom line: to earn you profits while following our mission.

With that, Happy New Year to everyone! Thank you for being a *Pro* member. You'll hear from us again soon. In the meantime, visit the Memo Musings board for any questions or comments.

Foolishly,

Jeff Fischer (TMFFischer)

Jeff owns shares of Kinetic Concepts, Intel, and Oracle.

Pro Looks Back — and Forward

Published Dec 20, 2010 at 12:00AM

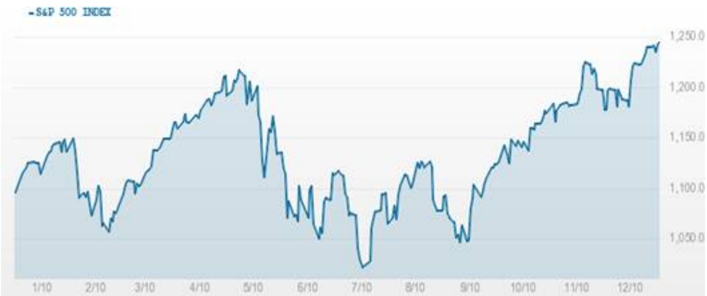
No Memo Next Week

Just a reminder: There will be no *Pro* Monday Memo on Dec. 27, but we'll be back in your inbox on Jan. 3. Enjoy your holiday!

At *Pro*, we've always believed that the unexamined investing life is not worth living — nor is it illuminating. So with 2010 drawing to a close, let's review some highlights of our last lap around the sun and the lessons we learned from each.

Will the Past Be Prologue?

Stocks took a brief breather in January from the soaring heights of 2009, but they were back to their old ways from February through May, then took a nosedive for much of the summer only to return with renewed energy in late August. At that point, the propane in the market's tank was ignited courtesy of Alan Greenspan's show of "unending" support from the Federal Reserve, along with healthy earnings announcements across the market. As of Friday, the S&P 500 had gained 11.5% this year — a more than respectable showing.



Source: Google Finance

These gains are helping soothe a nation that is still in "wound-licking" mode, with unemployment remaining near 10% and well-known financial problems on both the federal and state levels. If the stock market is any indication, though, the nascent economic recovery may be here to stay. Even the threat of debt default in Greece and Ireland didn't derail the train for long, and Europe's leaders are as eager as Fed chief Ben Bernanke to keep the new economic gains on track.

So we're entering 2011 with two-fisted support for market stability from the reserve banks of the world, and with a decent chance of up to 3% GDP growth in the United States. According to *Barron's*, the average S&P 500 company could turn that gain into 7% to 8% sales growth, and around 11% to 15% earnings growth — making the index's current P/E of 13 on 2011 earnings estimates appear reasonable. Some of the least expensive sectors in the market include health care and large-cap technology, and *Pro* is heavily weighted in both.

How Long Can the Government Hold the Line?

All that said, we'd be silly to think the New Year will offer nothing but smooth sailing. At some point, governmental stimulus efforts will need to wane, and the economy will be left to stand on its own two feet. And of course, when it comes to the stock market, the only certainty is uncertainty; markets are always being rocked by surprises from left field. And despite decent growth prospects, there are business fundamentals to consider, too.

Companies have learned to do business on the cheap over the past few years, and operating margins are collectively near record highs. As hiring reignites, those margins are likely to decline, so don't expect a lower unemployment rate (when it finally happens) to necessarily mean better stock market performance right away. In fact, it may mean the *opposite* for a while. Companies need to invest in people to achieve the benefit of higher sales, and the market usually dislikes the decline in margins that process initially brings. Additionally, year-over-year growth comparisons were quite easy in 2009 and 2010, but for many companies, relative growth will look much smaller in 2011.

2011 Prediction Foolery

Last year, I predicted the S&P 500 would stay in range of 1,000 to 1,200 (hardly a bold call on my part). The actual results:

- **Low (July 1):** 1,010
- **High (Dec. 13):** 1,246

This year, with the index at 1,245, I suggest it'll stay in a range of about 1,100 to 1,425. That suggests 11% downside risk and 14% upside. Again, not so dramatic! So in the name of fun, I'll be a bit more specific below.

Given:

- the market's valuation
- the likelihood of slow but steady GDP growth as business and consumer confidence ticks upward
- the fact that deleveraging of debt has likely passed the halfway point, at which time recoveries usually improve

… my Foolish prediction for this year is a 6% to 14% gain in the S&P 500. Now, nobody can predict the market, so *Pro* won't bank on those numbers; we'll keep investing for absolute returns and accuracy with lower risk. But this certainly tells you my leanings going into the new year.

Looking Back at 2010

On the broadest of measures, *Pro* had a respectable year. Our portfolio can be long or short, extremely hedged or un-hedged (as opposed to "unhinged"!). We went through most of the year with a short or two, covered calls on many positions, and six figures in cash, but we still came out ahead.

Vehicle	YTD Return (through Dec. 17)
Pro Portfolio	12.2%
S&P 500	11.5%
MSCI World Index	7.6%
Schwab Hedged Equity (SWHEX)	6.2%

We made some losing decisions this year (more on those below), and our shorts were proven unnecessary in a rising market. Given that, we're fortunate to have a lead. We invest for absolute gains and accuracy, rather than consciously chasing any index (we think that way danger lies). However, we know many of you care about index performance, and in the long haul we believe we'll handily top the S&P 500 — but that's not our yearly ambition; we'll leave such short-term concerns to edgy Wall Streeters.

Some other indexes are relevant to us as well. The MSCI World Index is an apt comparison for our portfolio — it captures all the markets in the world, and *Pro* can invest anywhere. If other parts of the globe are doing well, this index will show it. Meanwhile, a popular hedged equity fund provides an idea of how unmitigated equity hedging strategies performed this year (in a nutshell, not great on a relative basis, since the market went up).

Where the Wild Gains Are

The *Pro* portfolio didn't have any monster gainers this year, but we did profit from respectable gains in a majority of positions, and our losses were mild. That added to our index-topping results, even considering some losers that aren't listed because we sold them.

Company	YTD Return Through Dec. 17
Bristow Group*	54.1%
Autodesk	53.9%
AmTrust Financial	47.9%
Ebix	42.9%
GrafTech Intl	28.7%
Oracle	28.3%
Jack Henry	28.1%
Cameco	22.6%
Vanguard Energy	17.0%
Vang. Emerging Markets	15.1%
Quanta Services*	11.6%
Papa John's Intl.*	10.4%
Kinetic Concepts	9.7%
Procter & Gamble	6.9%
Tupperware*	4.8%
Intel	4.7%
NextEra Energy	2.9%
WisdomTree Emerg. Mrkt. SmallCap Dividend (NYSE:DGS)*	2.0%
Sprott Physical Gold*	1.5%
KBW Regional Banking*	-1.5%
TradeStation*	-1.8%
L-3 Communications*	-4.0%
Broadridge Financial*	-4.3%
Plum Creek Timber	-5.7%
GlaxoSmithKline	-6.4%
Medtronic	-14.9%

These stock and ETF returns include live positions only. *Indicates the return is from *Pro*'s purchase date this year through Dec. 17. Otherwise, the return shown is from Dec. 31, 2009 through Dec. 17, 2010.

When we include dividends and options income (which are not shown above) in our returns, the only meaningful loser in 2010 that we currently hold is **Medtronic**. The company is down 15% this year, but overall we're still profitable on the position. We used this year's decline to buy more shares, because we believe higher prices are ahead for the medical-devices giant. It's not surprising that health care, finance, and defense stocks are sulking on the bottom of our list, since they were the market's worst-performing sectors. It also makes sense that many of our new positions (noted with a star in the chart above) are flat or down. Usually it takes time for a thesis to play out, so ideally these young positions will help lead the way in years to come.

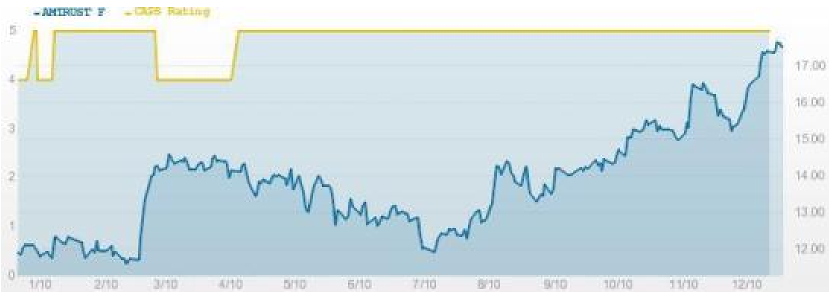
Favorite 2010 Investments

One of my favorite new *Pro* investments in 2010 was shorting the **iPath S&P 500 VIX Short-Term Futures** ETN. That's ironic, given that *Pro* couldn't actually short shares itself (the price of doing business with Schwab); we've only made a few thousand dollars writing naked calls, instead of the at least $30,000 we'd have enjoyed from shorting directly. Many *Pro* members, myself included, were able to short directly, while the Fool was stuck with Schwab — as you can tell, I'm not hiding my disappointment. But there is good news: As long as this ETN exists, opportunities exist to short it or use options against it, and we intend to do that as often as we're able. This may be as perfect a short as you'll find, since the VIX index drifts downward following its every spike (if history is a guide), and futures prices dilute this ETN day after day.

Next up, I fell for **Bristow Group** nearly as soon as Bryan Hinmon (TMF42) brought it to the team's attention. Buying the leading offshore helicopter services provider below book value during the dreadful **BP** oil spill was a great move, rewarding us soundly. Bristow is up 54%, while the oil-services company we defensively sold — **Flowserve**— is only up 28% from our sell price. Our only regret: We should have bought even more Bristow! Our desire to focus more dollars on our highest-conviction ideas will guide us next time. Here's Bristow versus Flowserve and the S&P 500 (six months):

Source: The Motley Fool

Other favorites from this year included sleepy little **AmTrust Financial Services**, up 47%. I've followed the company since its 2006 initial public offering, and I enjoy that it's still largely under the radar. Also, giant **Oracle**, up 28%, is outperforming my early expectations by a wide margin. Last week, Oracle showed again how it's hitting on all cylinders, with a 47% increase in revenue year-over-year. Both stocks were rated "Buy First" for most of the year, and AmTrust still is. Here's AmTrust's 2010 ascent (it still trades at a mighty low P/E of 7.7, and 1.5 times book value):



Source: The Motley Fool.

Costly Decisions and Lessons Learned

You can't invest without making mistakes. In fact, even profitable investments likely contain a mistake or two (selling too soon, buying later than you could have, or not buying enough, for example). So in a sense, there are *no* mistakes in investing — because *every* position includes small mistakes!

Instead of mistakes, then, let's think in terms of good decisions and bad decisions (and all kinds in between). Holding some top winners un-hedged was a good decision on our part. Writing covered calls on **Autodesk**, **Cameco**, and **Lindsay** were bad decisions.

Cameco and Lindsay are partly investments in commodity prices (uranium for Cameco, agriculture for Lindsay). Capping your upside on a commodity-driven investment is a bad decision. The valuations of Cameco and Lindsay did beg for covered calls, but that ignored the potential for a surge in the price of the commodities underlying each investment. Uranium and wheat prices soared the last three months, and both stocks climbed well past our fair value and net sell price. We should have left the stocks uncapped to sell when prices took off.

Autodesk looked richly priced, too, but it's a high-margin business, so gains in sales excited investors and ignited the stock to levels well above our potential sell price. The lessons to remember here are meaningful:

- **Rarely write covered calls on commodity-driven businesses** (or a commodity); you still have all the downside risk of the commodity, but you're capping the upside. It doesn't make good sense.
- **Rarely write covered calls on high-margin, recurring-revenue, low-cost business models** like software. These stocks have strong upside if you give them time and they keep succeeding.
- **Write covered calls on your income-generating positions** that you buy specifically for covered-call writing, and on stocks with business models that don't lend themselves to fast or leveraged upside (like utilities).

I won't belabor the following points (we've talked about them often this year), but holding the **U.S. Natural Gas Fund** ETF as long as we did was unnecessary and grew our losses. We believed in our thesis, but that was no match for an ETF rife with flaws. We no longer plan to invest in futures-based ETFs, and in fact, we'll be shorting them until we make back this loss and more. Who knows — these types of funds may be our favorite shorts for years to come (for as long as investors will tolerate their existence).

Finally, **MELA Sciences** was a bittersweet pill that knocked nearly 1% off the *Pro* portfolio's starting value. The company's one product actually won approval from a FDA advisory panel, but the FDA is likely to reject it anyway. We hope MELA succeeds eventually, but this investment ended *Pro*'s toe-dipping in speculations, so we can focus on our core mission.

Here's to 2011

As we roll into 2011, our mission is clear: We want strong conviction in everything we own, and we will continue to focus on earning you absolute profits with high accuracy.

Our outlook on the year ahead is less guarded than at any time since our inception, but we're under no illusions. The economy and stock market could turn on a dime, so we'll continue to be as diligent as possible in our decisions. You need to take a stance in investing if you hope to make money, and we will, but we'll adjust that stance if we see lasting storm clouds on the horizon. (For the record, if they appear, we think they're likely to come from overseas right now.)

Barring that, we're happy to enter 2011 with the confidence that, yes, the world *can* come through a financial debacle of massive proportions and grow even stronger afterward. There are still many problems to be handled, of course — the record budget deficits and debt of today may bring larger challenges in future years — but an improving economic world seems likely in 2011. It's not worth hoping for anything less.

The *Pro* team and I thank you for being a member, and we wish you and your family a peaceful holiday — and a happy 2011. As always, to share your thoughts, please visit the Memo Musings board.

Jeff Fischer (TMFFischer)

Jeff owns shares of AmTrust, Oracle, and Intel. He is short the iPath S&P 500 Short-Term VIX Futures ETN, has covered calls on Tupperware, and has written puts on GlaxoSmithKline.

Recent Action

- This weekend, covered calls on **NextEra** and written puts on **Broadridge Financial** expired as income. And covered calls sold away our shares of **Cameco**. We'll watch for follow-up trades on each position.

Coverage & Community

- TMFEldrehad looks for stocks currently in the doghouse that are worthy of further research.
- spinningwood provides some leaked video of Jeff and Nick at TMF's Christmas party.
- Alex340 shares puts and calls that match Pro criteria.

A Pro Grab Bag

Published Dec 13, 2010 at 12:00AM

Today's Memo is a Foolish holiday grab bag, wrapped up in bright paper with a ribbon on top. Below, we'll touch on the time frame for our investments, fair-value adjustments, our future, some trade ideas, and more. Think of it as a festive buffet table full of delicious *Pro* morsels (minus the fruitcake).

Guidance Changes

- **AmTrust Financial**: Fair value raised to $21 (from $18). Buy Around price increased to $17. Remains Buy First.
- **NextEra Energy**: Shares returned to Buy (from Hold) on price. But Buy Around guidance lowered to $52 from $55.

Long-Term Vs. Near-Term

Sing it with us: *On the first day of* Pro*, our employer gave to us … $1 million to invest*. As has been our goal since the beginning, a large portion of that money is being invested in core stocks for the long haul — as long as ownership looks attractive, that is. Such a long-term view will sometimes mean waiting through periods where a stock may have "gotten a bit ahead of itself" — because we believe the years ahead will provide still more rewards. So when we put a stock on Hold due to price, as we did with **Oracle**, it usually isn't because we believe the company's future is getting weaker (if we did, we'd sell). It simply means new investors face more risk because of price than those who bought at lower levels with us, but we're happy to keep holding the position — and we still have good expectations for the stock.

Fair Value and Buy-Below Adjustments

On the second day of Pro, we started to give / investment gui-i-i-dance. (OK, so it's a little clunky — we're not professional songwriters!) Today, we're moving our fair-value estimate for **AmTrust Financial Services** up from $18 to $21. The $17.35 stock is up 67% for us and still trades near the same price-to-book valuation as it did on Day One, because the company has grown its book value just as rapidly as its share price. The stock remains a Buy First because risks still look moderate. Our Buy Below price moves up to $17, which still allows at least 23% upside.

Options Extravaganza

We've compiled all of our options guides (so far) into one printer-friendly document — download it here!

Upcoming Events

- **Dec. 16: Oracle** earnings release. $0.46 per share expected.

Coverage & Community

- **Ebix** shared a corporate update that suggested good organic growth.
- We're stunned by the activity on the Social Banter board, which already has more than 2,200 posts — largely thanks to Ed (Spinningwood), who has been heading up multiple fun winter contests. For every post you make, the Fool will donate $0.10 to a deserving school, so pitch in!
- Can it be? January earnings season is already around the corner. TMFValuemoosie posts an earnings calendar.
- Want more *Pro*-based put-writing and call-writing ideas? Alex340 delivers again — we could call him Santa Claus!
- Bryan (TMF42) shares an article on **Procter & Gamble**'s franchising businesses.
- TMFEldrehad checks out some five-star CAPS stocks with the wind at their backs.

Also, we're moving our Buy Below price on **NextEra Energy** to $52 or lower, from $55 originally. We lowered our fair-value estimate on NextEra to the mid-$50s (from $60) in our October review because of the company's failure to obtain rate hikes and its ambitious capital-raising activities. NextEra remains an income position; you can write puts to buy the stock in the low $50s or below, and write covered calls to sell in the mid-$50s or higher.

Fully Invested Pro = More Discipline

On the third day of Pro, we took stock of all we owned. We're more invested than we've ever been, but that doesn't mean we'll slow down. Far from it: Being invested is only half the battle. We always need to make sure we're invested where we want to be, and we must keep seeking ideas that are *better* than what we already own. Some positions — such as NextEra and **Procter & Gamble** — are slow-moving, so if we find something with more potential, we'll swap for it. That said, we seek to maintain a balance of smaller (if riskier) companies with more potential, and large, unshakeable companies for stability.

Our options investing also becomes more disciplined the more invested we become. With the bulk of our capital committed to positions, if an option has earned us most of what it can pay us, we'll be even more compelled to close it early and open a new one for more income.

Cash in Hiding and Ready for Trading

We'll let **Cameco** be sold away this weekend through covered calls. There's a good chance **Autodesk** will be sold in 2011, too. We view these positions, and others such as Procter & Gamble, in large part as "cash in hiding." If we want cash for brand-new positions, we have a short list of current positions (typically on Hold) that we could sell today for that purpose. So we're never really done — and we're never really out of cash or cash proxies. Acknowledging this, we always aim to make our investing sensible: long-term in nature, but active when we believe activity will benefit us. We never want to become so active that it becomes a chore, and we never want our activity to ultimately cost us results.

When Do We Go Short?

Sometime in the future, there will likely come a time when we are big sellers of stocks and enter many short positions. That time isn't right now, despite the gains we've seen this year. Governments around the world have committed nearly everything they have (or can print) to keep asset prices stable or rising. And whether or not it's the right choice in the long run, this strategy is working in the near term. This is a powerful market driver; the U.S. Federal Reserve is hoping that a rising stock market becomes a confidence-building loop that feeds the economy, too. Meanwhile, the S&P 500 trades at about 13 times estimated 2011 earnings, so it doesn't appear expensive yet.

Pro Trades You Can Make

If you're lacking some *Pro* positions and want to try to buy lower, you can consider writing put options. Below, I've listed some ideas that look attractive. (These aren't official *Pro* recommendations, but they are trades I'm confident are worth your consideration if you're lacking exposure.) Remember not to over-allocate to any one position, and realize that all of these stocks could also be bought directly today, too — instead of writing puts. Not all of these meet the guidelines for income put-writing that I created, but they are all attractive when it comes to potentially buying the stock.

- Write (sell to open) January 2011 $70 puts on **L-3 Communications**, recently $1.70.
- Write February 2011 $35 puts on **Medtronic**, recently $1.
- Write March 2011 $41 puts on **Kinetic Concepts**, recently $2.10.
- Write March 2011 $50 puts on NextEra Energy, recently $1.20.
- Write March 2011 $17.50 puts on AmTrust Financial, recently $0.85.

Comments or questions? Visit the Memo Musings board. As always, we thank you for being part of the community of successful investors at *Motley Fool Pro*.

Foolishly,

Jeff Fischer (TMFFischer)

Jeff owns shares of AmTrust and Oracle.

Buy Wells Fargo & Company

Published Dec 10, 2010 at 12:00AM

At a Glance

First Things First

- **Company name:** Wells Fargo & Company
- **Market cap:** $156 billion
- **Website:**www.wellsfargo.com
- **Type of Holding:** Long-term, diversified financial company
- **Follow It:** Add to My Scorecard

- **Action:** Buy 2.5% of current portfolio value
- **Recent Price:** $30 per share
- **Preferred price:** $31 or lower
- **Estimated fair value:** At least $37
- **Why buy:**
  - Best-in-class management team
  - Significantly undervalued
  - The injection of Wells Fargo's sales culture into Wachovia stores offers an opportunity for meaningful growth
- **Alternate Trades**
  - Write ("sell to open") April 2011 $29 puts for $1.75 (recent bid/ask: $1.77/$1.80)
  - Write ("sell to open") April 2011 $28 puts for $1.40 (recent bid/ask: $1.41/$1.42)
  - If you really want shares, write ("sell to open") January 2011 $30 puts for $1 (recent bid/ask: $1.04/$1.07)

The Big Picture

By Nick Crow (TMFCrow)

Our little financial crisis is really growing up. It's now more than 40 months old, which means that according to child development experts, it should be able to ride a tricycle without assistance. Sadly, the Fed is still far too overprotective, continuing to provide assistance to the big banks while many small regional banks go on failing (there have been nearly 150 failures this year alone).

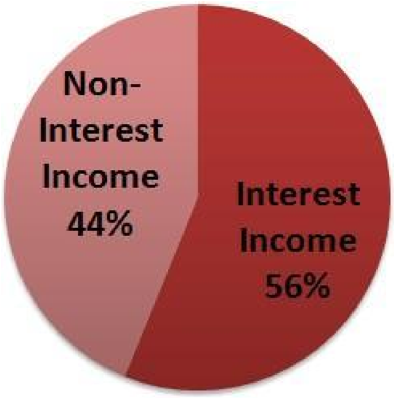
Mortgage servicers' lack of diligence is the current issue *du jour*; foreclosure reports are so bad, in fact, that all 50 state attorney generals are investigating. The potential losses to the industry have been estimated as high as $52 billion. Regulation is another hot topic; though we've yet to see sweeping changes, we do expect capital requirements to increase perhaps after a second round of regulatory bank stress tests. Banks that fail the stress tests (which determine under which extreme circumstances a bank can remain solvent) may have to raise equity capital, diluting the value of existing shares.

Concerns like these have brought the **SPDR KBW Bank ETF** (NYSEMKT: KBE), which represents 24 of the largest banks in the U.S., down 20% from its April peak; meanwhile, the S&P 500 has been essentially flat. But when an industry is mired in uncertainty, courageous investors can profit handsomely. When the banking sector as a whole is down, why not buy the best company within it? *Pro* Fools, it's time to take a renewed look at **Wells Fargo** (NYSE: WFC), a 158-year-old American institution that can still be had for a bargain price.

The Business

Banks have such a simple business model that I used to think any idiot could run one. And as the last couple of years have proven, some idiots did just that. In essence, banks make their money in two ways. First, they borrow money in the short term (for example, through deposits) and lend it long-term (for example, through mortgages); the spread between those interest rates, minus losses on the loans, is profit for the bank. (If it's obvious to you that a bank would want a cheap, stable deposit base, and that it should only lend money when it's confident it will be paid back, then you could have been a better CEO than many banks enjoyed over the past few years.)

The other way banks make money is by collecting fees for services (for example, credit card fees or service charges; this is known as non-interest income). Wells Fargo does a great job of managing both profit streams better and more consistently than its peers, and it maintains a steady balance between the two:



It also earns a much better spread than other banks. The best way to observe this is through an industry metric known as net interest margin (NIM):

Metric	Wells Fargo	Average, Peers*	Average, All Banks
Net Interest Margin	4.25%	2.93%	3.75%

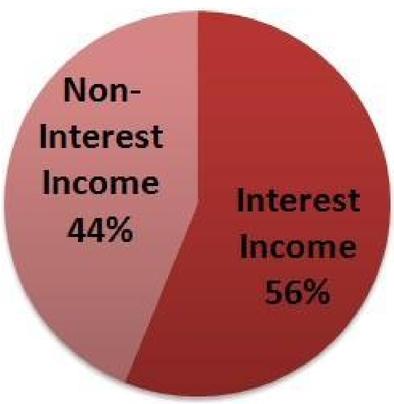
*Peers: Citigroup, Bank of America, and JPMorgan Chase. Sources: Capital IQ and Federal Reserve.

A high net interest margin isn't the source of competitive advantages, but the result of them — specifically, a lower cost of deposits and being a low-cost producer in a commodity business.

Metric	Wells Fargo	Average, Peers
Cost of Funds	0.8%	1.2%

Source: Capital IQ.

I expect Wells Fargo's NIM to continue to expand (it's typically closer to 5%) as the company's lower cost of acquisition for deposits and better lending process continue to spread to the branches it acquired in its takeover of Wachovia in 2008. The company also benefits greatly from operating in 80 different business lines — check out the diverse non-interest income stream below:



Though many of these areas are under regulatory scrutiny — most recently debit and credit card fees — this income stream is diversified enough that changes in one area will not permanently impair Wells Fargo's earning power.

Wachovia: Not a Wasteland

When you double the size of your business overnight, there's a huge opportunity for error. But if you can double your business for free, it's hard to go wrong — even if the business you acquire is in crisis. I think Wells Fargo showed some serious managerial brilliance when it paid up to snatch the struggling Wachovia out from under **Citigroup** (NYSE: C), and the market is overlooking all the benefits Wells Fargo is reaping from the move.

First, there's the savings. Wells Fargo will save an estimated $19.4 billion in taxes because of the acquisition (partially thanks to the $74 billion in writedowns on Wachovia portfolios). This savings exceeds the announced purchase price by more than $5 billion — not bad at all for a business that CEO John Stumpf expects to be a real winner. Better yet, thanks to increased efficiency resulting from the takeover, Wells Fargo has already saved a spectacular $4.25 billion annually in costs.

Much more important to shareholders are the long-term benefits of applying Wells Fargo's cross-sell culture to Wachovia. According to the American Customer Satisfaction Index, Wachovia was No. 1 in customer service among major banks for many years — by carrying over those best practices, Wells Fargo can benefit from that legacy. Given the companies' complementary strengths and the relative lack of overlap in geographical distribution, Wells Fargo should be able to tap the Wachovia sales channel to help hit its stated objective of eight products per customer. This potential source of growth is underappreciated by the market — and feared by Wells Fargo's competitors.

Financials & Valuation

Wells Fargo's excellent business results also show up in the return ratios below. Generally, we'd like to see a bank's return on assets (ROA) higher than 1% and a return on equity (ROE) approaching 15%. As you can see below, banks in general are nowhere near those numbers — but Wells Fargo is posting more attractive numbers and is quickly regaining its strength. When comparing ratios, it's important to remember that assets may vary in quality from bank to bank; for that reason, I've also included a couple of bank-specific asset quality ratios.

Metric	Wells Fargo	Average, Peers	Average, All Banks
Return on Assets (ROA)	1.1%	0.1%	0.6%
Return on Equity (ROE)	11%	1.3%	5.4%
Asset Quality Ratios:			
Allowance for Losses on Loans & Lines / Total Loans	3.1%	5.3%	3.6%
Non-Performing Loans / Total Loans	3.7%	3.1%	5.4%

Sources: Capital IQ and Federal Reserve.

Wells Fargo is also undervalued relative to its worth. The typical free cash flow model of valuation doesn't work for banks, because it's impossible to forecast a bank's capital expenditures and working capital needs. Instead, I assumed in my calculations that Wells Fargo would pay out its available free cash flow to investors as a dividend once regulators allow it to once again control its own dividend policy. Among other resources, regulators use Tier 1 capital ratios to determine how well-capitalized a bank is; I used the same projections under a few different scenarios to determine how much of a dividend management would be able to pay and when.

Under one less–than-rosy scenario, I assumed Wells Fargo would be forced to keep its dividend at the current $0.05-per-quarter level through 2012, rising to $0.10 by 2013. This increase and timing would be punitive, because the company should be able to return to a much more substantial dividend by next year. In this scenario, I gave management free rein by 2014, assuming it would raise the payout ratio to 35% that year, later peaking in 2016 at 40%. That would mean quarterly payments as high as $0.44 — much closer to historic levels and consistent with management's long-term goal of returning capital to shareholders.

At this rate, capital ratios should improve every year thanks to retained earnings, even under the more strict calculations that accompany the Basel III banking supervision proposals currently under development. By discounting these dividends at 11%, I arrive at fair value of about $37 a share. If the economy in general (and the banking sector in particular) regains its footing, this valuation will prove too conservative — which would not be a bad thing.

What Would Make Us Sell

We expect further pain for the banking industry, so such pain alone is unlikely to spur us to sell. We will continue to monitor changes in regulation and in Wells Fargo's financial position. If changes in either one seem to represent permanent changes to the economics of the business, we'll consider selling. However, we're prepared to wait out any short-term volatility — in fact, we may actually add to this position if better prices present themselves. This is a long-term holding based on a best-in-class management team and a difficult-to-replicate sales culture in an important industry.

Pro Bottom Line

Wells Fargo's top-notch management team fosters a competitive cross-sales culture with a banking network that now spans the country, thanks to the Wachovia acquisition. The market isn't giving enough value to the Wachovia half of the company; that nearsightedness, combined with the continued uncertainty surrounding the industry as a whole, affords us an attractive entry price. The coming months (and years) may be bumpy, but we expect to profit as management returns to a shareholder-friendly dividend policy. To discuss Wells Fargo & Company, hop aboard the stagecoach over to its board.

The Fool owns shares of Bank of America and JPMorgan Chase.

Accurate Investing, Reasonable Risk

Published Dec 6, 2010 at 12:00AM

We've redoubled our focus on our mission at *Pro*, as I wrote in a memo last month. In that memo, I noted high accuracy (at least 75%) and reasonable risk as two of our main goals, which led *Pro* member bwe53 to the boards to ask what exactly we mean when we talk about those two concepts.

It's an excellent question, and one I was happy to tackle in a board post. But I also felt it deserved a more public explanation. I want every *Pro* member to feel confident in our mission — not just how we achieve it, but just as important, what it means.

What We Seek

When we say we seek high accuracy, we mean we want *at least* 75% of our positions to close profitably. Peter Lynch made famous the idea that if you're right 60% of the time on Wall Street, you'll do well investing. No offense to Mr. Lynch, but we want to make money much more often than that. By the time we close our position, we want each stock or ETF to be profitable, with options and dividends included if need be.

Talk for Good

As part of our annual Foolanthropy mission, for every post you make on any Fool discussion board, we're donating $0.10 to Washington, D.C.'s Thurgood Marshall Academy. Why not head to our Social Banter board? Do it for the kids!

Upcoming Events

- **Dec. 16: Oracle** is set to announce earnings.
- **Dec. 18:** Our covered calls on **Cameco** will be exercised, selling our shares; written puts on **Broadridge** and covered calls on **NextEra Energy** will expire as income. We don't currently plan any action on these.

Coverage & Community

- Andrew (TMFRedwood) posts a strong valuation work on gold, leading to a lively discussion.
- Members discuss *Pro*'s own trading rules and how they could be tweaked to get *Pro* more timely prices.
- *Pro*'s new Social Banter board is smokin'! Topics vary from smoked food to Ed (Spinningwood) lamenting the cold in Florida. (Those of you in, say, Buffalo may or may not have sympathy.)
- Meanwhile, we hope our new 24-Hour Questions board won't be *quite* as active, though we look forward to helping you get your questions answered fast.
- Alex340 generously shares puts and covered calls that meet *Pro*'s criteria.
- Russell (TMFEldrehad) posts about catalysts in CAPS and **Netflix** .

And as for risk: What does "reasonable risk" mean to us? First, it means our eyes are not closed to market realities. We know Wall Street can get ugly fast, and we'll take our lumps at times like everyone else. But on any stock or ETF we buy, we estimate that the maximum downside risk from our start price is at most 20% to 30% — any more than that, and shares start looking stupid cheap.

So, the first part of "reasonable risk" is that we want only around 30% downside, tops, from our entry price. But we also want to avoid permanent loss of capital at all costs. Happily, as long as our thesis about an investment remains unchanged, we don't believe any losses in that investment will be permanent. In other words, even if a position does fall, we won't panic — in fact, we'll most likely think it's become such a bargain that we'd love to buy more. Then ideally all it takes is a bit of patience for our thesis to play out, and our investment should be right back to profitable.

That said, our 75% guideline exists for a reason. Even the best investors are tripped up occasionally, and we're no different; some of our investments will fall and never recover, and we'll no longer want to own them. In some cases, we may even choose to sell at a loss. Nonetheless, these three goals continue to guide our investment choices:

- Accurate absolute profits
- Reasonable downside risk
- Avoidance of permanent losses

If we're able to achieve all three, our gains will compound all the more, because avoiding losses is half the battle to investing success.

So, How Are We Doing?

After a bit more than two years and about 50 investments, *Pro* has closed six positions at a loss (12%), and they were all shorts or speculative positions (the latter of which we no longer seek):

- **U.S. Natural Gas Fund** — a futures-based ETF
- **MELA Sciences** — a speculation
- **ProShares Short SmallCap 600** — a short ETF
- **ProShares Short S&P 500** — a short ETF
- **Abercrombie & Fitch** — bear spread
- **Caterpillar** — bear spread

The market's upward swing contributed to losses in any short position we took, and given that those investments are hedges, that's not actually the worst thing in the world. Some members even say they *hope* their shorts lose money, because it means the rest of their portfolio is going up. We wouldn't go that far — we want our shorts to be accurate, too — but we understand their point. The U.S. Natural Gas Fund has been by far our largest loser, clipping $15,000 from the portfolio, or 1.5% of our starting value. Speculative MELA Sciences was our second-largest loss, costing us about $8,000.

Combined, the two took 2.3% of our starting capital. We'll never make those types of mistakes again. In fact, now we're aiming to make the natural-gas-fund losses back by shorting other futures-based vehicles, like **iPath S&P 500 VIX Short-Term Futures**. And MELA Sciences is a good example of another Peter Lynch lesson: He went 0-for-25 whenever he bought companies with great stories but no revenue. Every single one lost him money. Upstart MELA Sciences won an approval recommendation for its product from an FDA advisory panel last month, so we may be proven right about its great story — but we still lost money on the investment.

So those were our losers. What about the rest (read: the vast majority)? Looking at our core, longer-term holdings, only a handful are down, most notably the **SPDR KBW Regional Banking** ETF at 6% and **Medtronic** at 5%. We remain confident in our theses on both and believe time will cure these losses. Overall, our accuracy on open and closed positions is well above our 75% goal (in fact, it's closer to 90%). If we hadn't strayed into speculations like the U.S. Natural Gas Fund and MELA Sciences, we'd be sitting prettier, but we've learned good lessons — and that holds value for us now and in the future.

Headed to Miami

Jim Gillies (of *Motley Fool Options*) and I are headed to Miami this Saturday to present on butterfly and condor options strategies at an OptionsXpress event. Attendance is free — we look forward to meeting many of you there! Click here for more info. (And speaking of accuracy, we have a similar goal in the *Motley Fool Options* service, and over there, 87% of our selections — 35 of 40 — are profitable.)

Our New 24-Hour Board

Pro's discussion boards are active and wide-ranging, which is a feature, not a bug — but it does mean it can take time for us to find and answer some of your questions. That said, we know you sometimes have a question you'd like answered within 24 hours at most (like "Do I still make this trade?" or "How do I make this trade?").

To meet your needs on that score, we've created a new 24-hour question board where you can post any timely query that needs quick attention, and we'll make sure you get an answer (from us or other members) within 24 hours, weekends excluded. Please use the board sparingly, only when you truly need a response that day (its usefulness is diminished if we all cry wolf!). Our company-specific boards are always available as a first resort. We hope you find the 24-hour question board useful!

Foolishly,

Jeff Fischer (TMFFischer)

Jeff owns shares of Oracle and is short shares of iPath S&P 500 Short-Term Futures.

Write Naked Calls on iPath S&P 500 VIX Short-Term Futures

Published Dec 1, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") January 2011 $47 calls
- **Allocation:** 6% if turned to shares; for *Pro*, about 18 contracts
- **Recent price (bid/ask):** $4.20/$4.80
- **Alternate trades:**
  - Sell shares short directly, but do so incrementally
  - Write naked calls at higher strike prices for more breathing room

What's New

Pro first recommended selling short shares of the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) exchange-traded note (ETN) on June 16. At the time, the ETN traded at a split-adjusted $105, and the VIX index — the market's most famous measure of volatility, which the ETN aims to emulate — traded at 25.9. (The VIX index isn't measured in dollars, but as a percentage that shows the S&P 500's expected volatility over the next month, annualized — so in June, it was 25.9%.)

First Things First

- **ETN: iPath S&P 500 VIX Short-Term Futures (NYSEMKT: VXX)**
- **Website:** ipathetn.com
- **Type of holding:** Short (short naked calls)
- Add to My Scorecard

Today, the ETN trades at $46, and the VIX is at 22. In other words, the ETN has lost 56% of its value since June, while the VIX has only dropped 15%. We've argued before that this ETN tracks the VIX poorly, a thesis that has rewarded *Pro* short sellers in the past and is likely to remain true the majority of the time. In fact, the more we watch and study this ETN, the more comfortable we are investing against it.

Why This Strategy

Since the iPath ETN aims to move in tandem with the VIX index, we initially only wanted to short it when we expected the VIX to decline (when we issued our June recommendation, it was above 30). The Chicago Board Options Exchange VIX — otherwise known as the "fear gauge" — had averaged 19 since inception, with 2008 and 2009 being the only years its average for the year was higher than 30. We figured that if we effectively shorted the VIX anytime it climbed to 30 or above, we'd eventually be rewarded. According to Bloomberg, the VIX has traded above 40 a mere 3% of the time since 1990, so our upside risk going short at 30 looked reasonable, and we expected our rewards to be realized when the VIX drifted back down to its average level of around 20.

Today, the VIX is only about 22, but the iPath ETN tracks it so poorly that we're comfortable betting against the ETN even now. Why? Because the iPath ETN actually mirrors not the VIX itself but the VIX short-term futures index, which is invested 50/50 in futures contracts that expire one and two months in the future. The index rolls these contracts daily to keep a constant maturity of one month. Most of the time, futures contracts on the VIX carry a premium (rather than a discount), so rolling daily means paying up daily, along with racking up other fees. This has made for dismal price and tracking performance from the ETN compared with the VIX. Even when the VIX soars when market fear jumps (as it did last week), the ETN tends to jump only about half as much, if not less, because the futures contracts it mirrors already have some premium built in. (Take a look at how the VIX short-term futures have moved in relation to the VIX itself with this PDF.)

Barclays, the issuer of the ETN, warns investors in its documents that VXX is not usually meant to be a long-term position, but rather a short-term trading vehicle; that's due to all the factors we just cited, not to mention its 0.89% yearly fee. On Sept. 30, Barclays showed how the VIX short-term futures index that the ETN tracks has performed recently compared with both the VIX itself and the S&P 500:

Vehicle	3-Month Return	6-Month Return	1-Year Return
S&P 500 VIX Short-Term Futures Index (which the ETN tracks)	(44.65%)	(17.30%)	(64.79%)
CBOE SPX Volatility Index (VIX)	(31.38%)	34.74%	(7.46%)
S&P 500 Index	11.29%	(1.42%)	10.16%

Source: Barclays, www.ipathetn.com. Numbers as of 9/30/2010.

During the last three months measured in the table above, the S&P 500 jumped 11%, and the VIX fell 31%. The VIX short-term futures index on which the iPath ETN is modeled fell nearly 45%, or 1.5 times as much as the VIX. Over longer periods of time, that relationship gets even worse. Over the prior six months, the VIX actually increased 34% as the S&P 500 dipped, but the VIX short-term futures index *fell* 17%. And over the past year, the VIX only declined 7%, but the VIX short-term futures index fell nearly 65% (taking the ETN with it). All of this is the cost of doing business when you're paying a premium to roll futures contracts daily and the market is stabilizing.

So we know that the iPath ETN is poised to perform poorly in a stable and rising market. But as short sellers, are we at risk when implied volatility jumps and the VIX rises? Yes — but the risk seems more moderated than one might think. During the week ending Nov. 26, the VIX jumped the most in any week since May — from 18 to 22, a 23% change. The ETN, meanwhile, gained less than 3%, rising to $45.80 from $44.50 during that same period. The ETN won't always do so poorly in comparison (sometimes it will jump even more than the VIX), but this does illustrate just how badly the ETN *can* lag behind — and why we're comfortable betting on its deterioration over time.

It's helpful to know how high the VIX might leap when the market falls. According to Barclays:

If the S&P 500 Loses This Much in a Day:	Then the Average Increase in the VIX Is:
0% to 1%	1.05%
1% to 2%	6.86%
2% to 3%	10.33%
3% to 4%	14.88%
Greater than 4%	17.21%

Sources: Barclays Capital Analysis, 1/1990 – 4/2010, and Bloomberg.

Losses in the S&P 500 over many days running could lead to higher and higher volatility, putting a squeeze on our short position. As the table above shows, even a 2% drop in the S&P could add 10% to the volatility index. With just a few bad days from the S&P, we could see a very large leap in volatility — for example, in the event of a new crisis, the VIX could easily soar from its current 22 to 40 or more. In such a case, we'd need the deep pockets and patience to ride it out. We should be helped by the fact that the ETN has lately tended to gain only about half as much as the VIX (or even less) during strong jumps in volatility, and it loses much more value over stable periods measured in months. Thus, time should be on our side as short sellers. As our first table reminds us, even a 34% gain in the VIX over six months resulted in a 17% loss in the ETN. That type of scenario won't always be the case, but the facts argue that it *usually* will.

Additionally, we're being paid a premium (all in the form of time value) to write naked calls, so our effective short price is already more than 10% above the ETN's current price, providing a cushion as we get started. As time value in the calls dissipates, we can roll into new calls aggressively as VXX falls or rises, effectively staying "short" this ETN for as long as we believe that's a good position. If the ETN moves against us, we'll look to roll up our naked calls as time value diminishes, so we can keep the position going while waiting for a decline in volatility -- and for the position to move in our favor.

The world may look sketchy right now, with the two Koreas firing literal and verbal potato bombs, Ireland in a pickle, and the rest of Europe in a financial jam. But we've been seeing governments do all they can to support stability, and we don't believe they'll back down now. Plus, each shock wave to the market seems smaller than the last. When Europe's problems first surfaced in May, the VIX soared from 15 to 40 in mere days. Now, on the recent news from Ireland and Korea, the VIX has only hopped from 18 to 23. Most important, our long-term conviction level about this short is strong, and we want to capitalize on it.

How to Follow Along

You need full options and margin approval to write naked calls (i.e., calls where you don't own the underlying shares). This is effectively the same as shorting a stock, except that our profit is limited to what the calls initially pay us. If you can short shares directly at your broker, that's an attractive choice in this case, too. You will have more profit potential if you short directly, but you won't start with a time-value pricing cushion the way we will with our naked calls. In fact, we at *Pro* would short shares directly, averaging into our position over time, but our broker (Schwab) does not have shares available for shorting. Other brokers do, so if you're interested, check with yours. Meanwhile, our naked calls are a way to profit in the same direction.

If our short calls were turned to a short stock position, it would equate to 6% of the *Pro* portfolio's value (about 18 contracts). That's unlikely, however; instead, we'll look to roll the calls whenever time value is low. We want to stay on top of the position.

Trade Details

- **Action:** Write (sell to open) January 2011 $47 calls (one for every 100 shares you'd short)
  - For Pro, about 18 contracts
  - Each written call represents a $4,700 short of the ETN
- **Preferred limit price:** $4 or higher
- **Break-even price:** $51
- **Current price:** $46
- **Return on investment:** 8.7% if the calls expire, earned in 52 days

Make this trade carefully; you need to be fully aware of the risks of shorting anything, especially an ETN that attempts to track futures on a volatility index. This is a high-conviction position when time is on our side, but we may experience big price movements in the interim, and we'll need to use our equity if that's the case. Finally, although it's unlikely, if volatility is expected to fall in the future, this ETN may be able to roll its futures contracts for a *profit* each day, meaning it will trade higher even when the market isn't falling. We'll watch futures prices for any signs of this. Please ask any questions on the VXX board.

Jeff Fischer is short shares of VXX.

What Would Ben Graham Think of Pro?

Published Nov 29, 2010 at 12:00AM

Here at the Fool, we're dedicated to helping everyday investors achieve wealth. At the core of what we do is the belief that you — not a fund manager who follows the crowd, not a financial advisor whose fees are the same whether she makes you money or loses it — are in charge of your financial destiny. By making investing accessible, comprehensible, and hopefully even fun, we want to help you ensure that destiny is a prosperous one.

Do Some Good

Foolanthropy 2010 begins today! For every post you make on any Fool discussion board, we'll donate $0.10 to Washington, D.C.'s Thurgood Marshall Academy. Why not head to our Social Banter board to chat for a good cause?

Important Goings-On

- It's not too late to see Jeff (TMFFischer) in Miami! Click here to register for the free optionsXpress seminar on Saturday, Dec. 11.
- Todd's (TMFPhila) new UK service, *Dividend Edge*, is officially open! Check it out by visiting the Fool UK website.
- If you still haven't checked out the Fool's *Stocks 2011*, you can find it here— it's free for *Pro* members.
- *Pro* values its communications with you. Jeff discusses what that means.

Coverage & Community

- Jeff explains what's meant by "reasonable risk" and 75% accuracy.
- Fools discuss *Pro*'s newest recommendation (code name DoGS).
- Andrew's column on the Fed incites a long and Foolish discussion.
- SilverHawk27 inquires about the **Broadridge Financial Solutions** annual shareholder meeting.
- **Medtronic**'s earnings get a nod from Jeff, even though challenges to the company are rampant.
- We continue to examine recent earnings from *Pro* companies, and are still fine with what we see.
- TMFEldrehad revisits how to find top-scoring CAPShot stocks using the CAPS Stock Screener.

Given all that, I can't help but wonder what Ben Graham would think of the Fool, and of *Motley Fool Pro* in particular. Known as "the father of value investing," Graham is the author of *The Intelligent Investor*, dubbed "the best book about investing ever written" by Warren Buffett. The genius of *The Intelligent Investor* is in its accessibility; Graham's goal was to make investing comprehensible to the readers of his time (sound familiar?). In the book, he advocated thinking like a business owner and preached that investors shouldn't be concerned with short-term movements in stock prices.

In fact, he noted that he wished every day to do something foolish, something creative, and something generous. So it seems safe to say that Graham was a very Foolish man indeed. But what would he think of *Pro*?

Do It Yourself

To put it politely, Graham was skeptical of Wall Street. He noted that advisors, bankers, brokers, and investment counselors are all willing to take your money in exchange for investment advice, but he warned that investors who choose that route "should not expect better than average results." His cautionary tale on this topic actually takes up an entire chapter in *The Intelligent Investor*. Ever the teacher, Graham advised being a bit more enterprising; he suggested working "in active cooperation" with your chosen advisor. If that isn't an endorsement of the *Pro* community — investing alongside other like-minded investors and engaging in spirited conversation on the discussion boards— I don't know what is.

Po-tay-to, Po-tah-to

Graham constantly extolled the difference between a speculation and an investment. An investment, of course, is based on thorough analysis, and it provides safety of principal and therefore a satisfactory return. In essence, this concept is called "margin of safety," and Graham demanded it of his investments. At *Pro*, we're in total agreement. Our search for bargain-priced businesses with recurring revenue streams and advantageous competitive positions is our way of ensuring safety of principal and a margin of safety. Our suggested buy prices and Buy First/Buy/Hold classifications are simply more tangible gauges of this concept.

Go Exotic

The Graham-Newman Corporation, Graham's investing vehicle, was not afraid to use exotic strategies. Aside from investing in the "cigar butts" he is so well known for (companies discarded by the market at large but that still contain some value), Graham was willing to buy companies in liquidation, engage in merger arbitrage, go long-short, or even take an active role in demanding change at the companies he owned. While *Pro* hasn't yet used these techniques, we have embraced numerous options and shorting strategies. In both cases, the goal is to identify a situation in which the risk we take on with our investment is outweighed by an adequate reward. I think our focus on maintaining the value of principal through the Foolish use of options and shorting would have gotten a nod of approval from Graham.

Where We Differ

Graham did not have much confidence in his ability to forecast. As a result, his analysis focused on balance sheets rather than income statements. He preferred to buy assets for less than they were worth — what he called "bargain issues." In a perfect world, Graham would have wanted to purchase a hundred or so companies trading at two-thirds of their net current assets (defined as current assets less total liabilities) or less. *Pro*, on the other hand, has no such issues in its portfolio; the ever-increasing availability of information since Graham's time has made these companies difficult to find. And while we're no more confident in our ability to forecast than Graham was, we are much more reliant on the use of "guesstimates" of future cash flows to assess what we think a business is worth.

Toward the end of his investing career, Graham turned sour on in-depth fundamental analysis. In 1976, he proclaimed, "In the old days any well-trained security analyst could do a good professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their cost." Here at *Pro*, we respectfully disagree; we think bargains can still be found with a bit of legwork and elbow grease. It's definitely tough to do, though, which is one reason *Pro* prudently uses options to tilt odds in our favor.

Value, in Graham's eyes, was mathematical fact. Stocks were either statistically cheap relative to their assets, or they weren't — in which case, he wasn't willing to pay up. Graham disciple Warren Buffett once held to this belief, too; it was Charlie Munger who convinced Buffett to change his mind by pointing out that a business franchise can have quite a bit of value. We're with Munger (and now Buffett) on this one: We look for great businesses first, then use patience and options to get a better price. And we're willing to pay up from time to time — our former position in **Expeditors International of Washington** and current holding in **Autodesk** are prime examples.

Value Investing the *Pro* Way

Pro is far from a traditional Graham-centric value investing service — and that's OK. *Pro*'s mission of achieving high accuracy, finding superior businesses, and using options to tweak our risks and returns doesn't read like an excerpt from *The Intelligent Investor*. But our focus on developing our investment community, ensuring a margin of safety, and maintaining principal is right out of the Graham gospel. Given his willingness to adjust his thinking to reflect current realities (a trait that can be seen in each subsequent publication of his treatise *Security Analysis*), I think Ben Graham would be open to *Pro*'s way of investing.

Do you think the Father of Value Investing would enjoy *Pro*? Let us know on the Memo Musings board.

Bryan Hinmon, CFA (TMF42)

Andrew Is Fed Up With the Fed

Published Nov 22, 2010 at 12:00AM

Join Jeff and Jim in Miami!

optionsXpress has invited our very own Jeff Fischer and *Motley Fool Options* Associate Advisor Jim Gillies to present at its seminar in Miami on Saturday, Dec. 11, and you're invited! Jeff and Jim will present on iron condors and butterfly spreads — both strategies let you sell premium for income while capping your risk, and can even be done in your IRA. If you'd like to attend, click here to register today. Admission is free!

By Andrew Sullivan, CFA (TMFRedwood)

I've had it with the Federal Reserve. In fact, you could say I'm fed up with the Fed. It doesn't understand how the economy works. As our central banking system, it should be forward-thinking, a model for other nations — but instead, it's stuck in the past, man!

In my first memo, I'm going to show you why I think the Fed's economic models — and its entire way of thinking — are out of date, and I'll introduce you to the exciting new economic concepts taking their place. By the end, I hope to convince you that the Fed is playing the wrong game — and that its actions are therefore ineffectual and maybe even deleterious to the economy.

Economics According to the Fed

The Federal Reserve follows neoclassical economics. In a nutshell, neoclassical economics is the mainstream thinking you read in textbooks — that individual actors pursue profit and happiness in a marketplace, resulting in equilibrium between supply and demand. According to this theory, fluctuations and disturbances to the equilibrium are due to external shocks (for example, the oil embargo of 1973).

NYC Tweetup!

Meet Tom Gardner at an investor Q&A **Wednesday, Dec. 1,** at 6 p.m. at the ING Direct Cafe on 58th and 3rd. Warm up with snacks and giveaways, and bring your questions! For more information and to RSVP, click here, and if you can't make it, follow the event on Twitter @themotleyfool.

Guidance Changes

- **SPDR KBW Regional Banking ETF** and **Broadridge Financial Services** move down to Buy to tighten the focus of our Buy First list, and pending a possible portfolio addition in the financial sector.
- **Quanta Services** moves down to Hold pending our full review of recent results.

Upcoming Event

- Tuesday: **Medtronic** releases earnings.

Coverage & Community

- Bryan serves up his take on **AmTrust Financial**'s solid quarter.
- Andrew shows why rumors of the defense budget's demise are overstated.
- Bryan shares some of what drives his investment thinking.
- spinningwood responds to Nick's take on the economy.
- Alex340 shares puts and calls that match Pro criteria.

Neoclassical economics is the culmination of two centuries of work on reducing the big, messy, interconnected world of economics into a rational, mathematical science in order to make the economy seem explainable and predictable. Of course, in the real world, the economy is incredibly complicated, so to fit it neatly into models, economists had to take shortcuts. For example, neoclassical economics assumes: a closed, static, and linear system; the absence of transaction costs; rational behavior on the part of all participants; and that excess profits are arbitraged away. Without these simplifications, it would be almost impossible to model the economy — at least, so says the Federal Reserve, which pays an army of 17,000 people $1.5 billion a year to crunch and analyze numbers with this model in mind.

The problem, however, is that many of those assumptions are plain wrong, resulting in a model with unstable foundations. It's as if economists spent scores of years constructing a beautiful mansion only to find out they'd been building on quicksand. The reality is that neoclassical economics (whether Keynesian or supply-side) doesn't explain actual economic activity very well at all.

How the Economy Really Works

The economy is very different than what textbooks and famous economists tell us. It isn't a system in which supply and demand settle neatly at equilibrium — in fact, this fundamental tenet of neoclassical economics is almost entirely wrong. Equilibrium means a state of balance between opposing forces, yet markets are almost always in disequilibrium because supply and demand are constantly changing and there's an inevitable time lag as these changes are communicated to the marketplace.

The economy is more like an ecosystem than the static, closed system that traditional economics suggests. It is both complex and open, meaning that energy flows into and out of it, and this (and evolutionary dynamics) produces change. Contrary to established thought, there is really no useful distinction between micro- and macroeconomics: Macro behavior emerges out of, and is thus directly connected to, the interactions of all the units in the system. Individual agents learn, adapt, and change their behavior over time through interactions with other agents and the environment, rather than through the faceless auction mechanism neoclassicists assume.

This means that large fluctuations, change, and unpredictable behavior arise *from within the system*, not just from external shocks. Experiments like the beer distribution game have shown that rational behavior at the individual level does not, in fact, lead to equilibrium in the system as a whole — instead, it produces large, macro-level fluctuations. This is completely at odds with traditional economic theory.

So we have a system that is nonlinear, open, evolving, in flux, and with endemic change based on the actions of individual members. Contrast this with the linear, closed, static, and equilibrium-based view of traditional economics. Perhaps the most important implication is that business cycles are an intrinsic part of economic growth *driven by the dynamics above* — and, therefore, policy measures designed to increase growth and employment *based on traditional, neoclassical thought* might not be correct or adequate. Plus, they may be applied at the wrong times.

Implications

It seems apparent that the models the Federal Reserve uses don't adequately explain how the economy really works. So if the Fed is taking actions based on those models, how can they be the right ones? I'm convinced the Fed is playing a game of checkers in a world with knights, pawns, rooks, and bishops. So long as it adheres to outdated, inaccurate theories, I expect its actions to produce little, if any, positive benefit for the economy — unless it happens to get lucky.

We need a better solution. What would that look like? Well, a case can be made for jettisoning the Federal Reserve and returning to sound money (backed by gold or silver). But outside of monetary policy, the clear solution is to invest in ourselves by supporting growth and innovation. We should spread best practices in education, increase science and technology spending, unchain the patent office, reduce regulation for small businesses and entrepreneurs, simplify the tax code, and increase communications spending. America needs to be the world leader in nanotechnology, robotics, genetics, social media, and other exciting growth areas. Money should be spent laying the foundations for growth, not propping up a system that is practically begging to be cleared out.

You and I are two of the individual agents making up this economic ecosystem, and (if you believe what I've told you!) great, sweeping changes will arise from *us*, not from outside stimulus. So bring your thoughts to the Memo Musings board, and let's talk (economic) revolution!

Andrew Sullivan, CFA (TMFRedwood)

Stocks 2011 Is Available Now

Published Nov 22, 2010 at 12:00AM

The Fool's *Stocks 2011* special report was released recently, and *Pro* members can read it for free! Download it here and be the envy of your friends.

Buy DGS

Published Nov 22, 2010 at 12:00AM

At a Glance

- **Action:** Buy 3%
- **Recent price**: $52
- **Preferred price:** Below $55 (and as close to NAV as possible)
- **Why Buy:**
    - Small companies in emerging markets provide strong long-term growth opportunities.
    - Allows diversification into growing foreign companies that are otherwise difficult to access.
    - The ETF's 3.5% dividend reflects stability among its leading small-cap holdings.

The Big Picture

First Things First

- **ETF: WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS)
- **Total assets:** $743 million
- **Website:** WisdomTree
- **Type of holding:** International, small-cap, yield, core
- Add to My Scorecard

By Jeff Fischer

According to Ibbotson Associates, companies with small market values outperformed large companies by an average of 2.1% per year from 1926 to 2008, and by an even greater amount in recent decades — 3.6% annually from 1973 to 2008. Additionally, companies that pay dividends outperform those that don't, and Standard & Poor's reports that dividends accounted for 44% of the S&P 500's return over the past 80 years. Finally, in the past 10 years measured to Dec. 31, 2009, the MSCI Emerging Markets index returned 10.2% annualized, while the MSCI USA Index dropped 1.2% per year. Past results can't guarantee future performance, it's true — but for eight decades, small has outperformed large and dividend payers have topped the alternative, and for many years, emerging markets have outdone developed ones. By buying shares in the **WisdomTree Emerging Markets SmallCap Dividend** (NYSEMKT: DGS) ETF, we seek to capitalize on all three factors.

The Fund

With the ability to invest in 19 emerging economies, this ETF holds 486 stocks, each weighted by size based on the yield of the regular cash dividends it pays. To qualify for the fund, a company must have paid at least $5 million in cash dividends on the common stock in the past year, and the top payers get the highest weighting. That said, only two positions represent more than 2% of the fund, and the vast majority are less than 1%; this diversifies our risk, but ideally it won't mean sacrificing long-term performance. The fund's dividend yield currently tops 3.5%, with payouts that are taxed as ordinary income, and the expense ratio is a reasonable 0.63% a year. Resizing or adjusting holdings based on yield led to turnover of 38% in the past year (in other words, nearly four out of 10 positions were sold or bought), which is a bit high, but not unacceptable.

The fund seeks to mirror the WisdomTree passive index of the same (long) name, which draws its positions from the smallest 10% of companies in the WisdomTree Emerging Markets Index. The average company size in the small-cap index is about $1.3 billion. For comparison, that makes each company about 93% smaller than the average $17.9 billion company held in the **Vanguard Emerging Markets** (NYSEMKT: VWO) ETF, which *Pro* also owns. These two international ETFs (one large-cap and one small) are attractive individually and when held together. Further, the WisdomTree Emerging Markets SmallCap Dividend ETF is invested primarily in smaller economies rather than hotly followed giants like China and Brazil. We like that its focus is mostly off the beaten path.

Fund by Country	Allocation	Fund by Sector	Allocation
Taiwan	19.19%	Industrials	23.43%
South Africa	11.04%	Financials	18.99%
Korea	10.54%	Consumer Discretionary	17.60%
Thailand	9.80%	Information Technology	10.91%
Turkey	9.04%	Materials	9.07%
Israel	8.29%	Consumer Staples	6.96%
Brazil	7.78%	Utilities	6.42%
Hong Kong (China)	5.95%	Health Care	2.87%
Malaysia	4.59%	Energy	2.21%
Chile	4.23%	Other	1.54%

Source: WisdomTree, 11/17/10.

The number of middle-income families in the countries named above is growing, and these nations are becoming more urbanized. Thus, it's reassuring that nearly 25% of the ETF is invested in consumer discretionary and consumer staples, and nearly a third is in industrials and materials — key sectors for budding economies. The heavy weighting in financials is also reassuring (no, we're not joking; local finance is driving much of the regional growth). Other countries represented include Indonesia, India, Argentina, Czech Republic, Hungary, Philippines, South Korea, Mexico, and Poland.

Many of the top countries represented in this ETF lack the eye-popping growth in gross domestic product that you see from the likes of China and India, but this doesn't worry us, because Vanguard studies have shown that GDP growth is actually not tied closely to stock performance. In fact, high GDP growth can invite speculation, and that often burns investors in the form of high stock prices. By sticking to companies with strong yields, we hope this ETF will avoid many high-flying economies and their low-yielding stocks, but still appreciate thanks to value, yield, and reasonable growth. Let's look at its top holdings.

Top ETF Holdings (click for website)	Country	Industry	Allocation
Discount Investment Corp	Israel	Holding company	2.44%
Ford Otomotiv Sanayi AS	Turkey	Automobiles	2.29%
CorpBanca SA	Chile	Financials	1.52%
AES Tiete SA	Brazil	Utilities/energy	1.30%
Dogan Sirketler Grubu	Turkey	Holding company	1.21%
WisdomTree India Earnings Fund	India	Diversified India ETF	1.19%
U-Ming Marine Transport	Taiwan	Marine cargo transport	0.97%
Foschini Ltd	South Africa	Retail and consumer finance	0.89%
Oil Refineries Ltd	Israel	Yeah, oil refineries	0.75%

Hanwha Chem Corp	South Korea Petrochemicals	0.75%

Source: WisdomTree, 11/17/2010.

Beyond the top 10 holdings, the ETF owns 476 more companies spread over its 19 countries, offering us as good a glimpse into the world of small business as we are likely to get. These aren't fly by-night operations but rather solid companies averaging a bit more than $1 billion in market value, typically growing handsomely in developing economies and paying healthy dividends.

Valuation

We didn't spend two years running all 486 companies through discounted cash flow models in local currencies, but WisdomTree tracks the average valuation of the companies comprising the ETF's underlying index. As of Sept. 30, 2010 (the last date available), the index traded at an average price-to-earnings ratio of 12.69, suggesting reasonable downside risk and plenty of long-term potential. Accounting for recent appreciation, the current price puts the index at about 13 times earnings, 1.7 times book value, 9 times cash flow, and less than 1 times sales.

Prices for these small caps appear reasonable in aggregate, with our ETF fair-value estimate closer to $60 per share. Consider that the average company in the Vanguard Emerging Markets ETF trades at 16 times earnings and 2 times book value, and the small caps we're buying here look attractively priced, with the valuation taking into account the extra risk and added potential of small companies. We don't want to brush over valuation, but we're investing in this diverse ETF based on the long-term macro thesis that emerging-market small caps will reward investors over many years, and dividends only add to the attraction.

What Would Make Us Sell

If this ETF underperforms other emerging-market indexes for a long period (perhaps due to high turnover), its fees increase unreasonably, or the valuation starts to look aggressive, we will consider selling. We'll also monitor the financial strength of WisdomTree itself. We're not likely to sell just because emerging markets happen to decline for a period. We're ready to wait out the volatility that we all know emerging markets and small caps can throw at us. This is a long-term holding based on a broad macro argument.

Pro Bottom Line

Combine reasonably priced healthy small caps, emerging markets, and a decent dividend yield. Now add time. We should have a recipe for long-term rewards. To discuss the Emerging Markets SmallCap Dividend ETF, jet on over to its board. (By the way, we'll shower accolades on the Fool who can best shorten the ETF's name down to something palatable.)

Reigniting Our Mission

Published Nov 15, 2010 at 12:00AM

Join Jeff and Jim in Miami!

optionsXpress has invited our very own Jeff Fischer and *Motley Fool Options* Associate Advisor Jim Gillies to present at its seminar in Miami on Saturday, Dec. 11, and you're invited! Jeff and Jim will present on iron condors and butterfly spreads — both strategies let you sell premium for income while capping your risk, and can even be done in your IRA. If you'd like to attend, click here to register today. Admission is free!

As *Pro* begins its third year, members are renewing their subscriptions in record numbers and reporting widespread satisfaction with the service. We're immensely grateful for that — we're here for your benefit, after all — and we're dedicated to maintaining your confidence in us. Currently, that means buying more of our Buy First stocks and making certain our portfolio only holds high-conviction ideas in allocations large enough to really count.

Looking Toward Our Junior Year

Year to date as of Friday, the *Pro* portfolio is a bit ahead of the S&P 500's 7.5% gain. Although short-term results usually mean little to us (we don't pay great heed to the index, either, except over many years), I'm still glad for this small victory. Why? Because this has been my least favorite investing year since 2004. While most positions performed well in the *Pro* portfolio in the past year, I nonetheless made more mistakes and spent more time on problem positions over that time than in several previous years combined.

Important Dates This Week

- Tuesday: FDA releases briefing on **MELA Sciences**' clinical trial.
- Thursday: FDA advisory panel issues recommendation for MELA Sciences' product. **Autodesk** reports earnings.
- Saturday: November 2010 puts written on **Caterpillar** and **Plum Creek Timber** expire. We're taking no action on these.

Coverage & Community

- Alex340 shares puts that match *Pro* criteria and covered calls to consider.
- Thinking about buying a straddle on a stock that may rocket or tank? Share that monkey on your back on our new Speculative Trades board.
- Traveling soon and have questions? Want to meet *Pro* Fools near you? Read a great book? Post on our new Social Banter board to get the discussion going.
- TMFEldrehad discusses CAPS and *The Cat in the Hat*.

I'll pin these disappointments on a sophomore slump; while we learned a great deal (and made some money) during our second year, I'm happy to be starting year three. Year one was filled with excitement as we launched this ship in search of a successful maiden voyage; year two was partly about finding our service's boundaries by pushing them a bit. We did that with some novel positions that have created our only meaningful losses to date. We're still dealing with some of those, but their flaming remnants light our way to a more certain path. We know our boundaries without question now, and our mission for you is lit brightly:

With at least 75% accuracy, earn members consistent, recurring profits alongside strong, long-term capital appreciation using a combination of stocks, ETFs, options, and shorts in a strategic portfolio of reasonable risk.

As always, we'll use options and shorts to achieve near-term gains in weaker markets, while stocks and ETFs will create long-term value; by combining the two, we strive for strong annualized returns over our lifetime.

Our Renewed Focus

I don't like making mistakes. I don't like having to explain losing investments. I don't like permanent losses — and I've always been better at addition than subtraction. In running a service this large, with this many successful members, I don't think we're best served by spending time on speculations, tiny allocations, and investments that don't move the needle. I also don't want to own or follow anything other than exceptionally high-conviction ideas, and we aim to find investments so strong you'll almost never want to sell them.

So what does all this mean for you? Year three is about making sure we're focused where we want to be, and that every position counts. The more focused we are, the more nimble we are, because we know our positions more intimately. Finally, all of this makes us even more likely to create value over time.

How We'll Win

Our ideal number of portfolio positions hasn't changed, but we've tweaked some other numbers. We seek to own stocks and ETFs in the numbers shown below, as well as shorts and options as a varying percentage of the portfolio:

Investment	Hold at Least	Hold at Most	Current Holdings
Stocks	15	25	21
ETF Positions	5	10	4
Total Core Holdings (Stocks & ETFs)	**20**	**35**	**25**
Options (Port %)*	0%	Undefined, but likely 10% to 20% on average	About 10% (today, it's our long calls and short put obligations)
Shorts (Port %)	0%	50%	About 2% (currently, all short calls)

* It's not necessary to use options to employ our strategy, but we will often recommend their use in varying degrees. Measuring the percentage of the portfolio that an option represents depends on whether we plan to convert that option to shares or not, so it's not cut-and-dried; percentages may vary greatly.

Our core holdings should each make up around 3% to 5% of the portfolio (measured by capital invested, not current value), a large enough percentage to ensure each one is meaningful. Some of our very highest-conviction ideas may get as much as 10% of our capital. With some strategies, such as option strangles, we may only own 2.5% of an actual stock, but our use of options could potentially double that position. Our shorts and options will vary in size depending on what opportunities we see in the market. In every case, though, it's most important that *each position should count*. That means we should only own as many stocks as we can know and follow extremely well, and our conviction in each position should be rock-solid — if it isn't, we should cut or replace it.

My Scorecard Contest Winners!

Anita Carty of Portsmouth, Va., won an array of Fool goodies; **Mike Guiremand** of Thousand Oaks, Calif., won a year's subscription to a Foolish publication; and a Fool with the username of **SMK1**, hailing from Westerly, R.I., won a year's subscription to a Foolish publication, plus one to give away to a friend or family member. Relive the *Pro* My Scorecard contest here!

Meanwhile, stock-based ETFs are a great way to further diversify the portfolio, making macro-based investments in regions, assets, or sectors that we don't want to (or can't) address with individual stocks. Overall, we're aiming for a portfolio that's well-diversified without losing any focus.

The above has always been *Pro*'s approach to investing, but as we go into our third year, we want to recommit to it — and to firmly set our boundaries against deviations from it, such as outright speculations or tiny positions. We want to be highly accurate with our investments, make each position count, and rarely close anything at a loss. This means making very careful buy decisions.

This is *Pro*. We know why we're here, and we want our results to count for you.

Earnings and New Boards

We've seen several earnings reports recently. If we ever find information suggesting that the thesis behind any position is in danger, we'll let you know immediately. Barring that, though, we need time to examine each report and SEC filing thoroughly to bring you the best analysis we can. We'll update each holding as soon as possible.

In the meantime, to keep expanding the excellent *Pro* community, we've added two new discussion boards. The first is called "Speculative Trades." *Pro* is investing for accurate profits, not speculating — but if you do get that speculative itch every once in a while, you can share your ideas here with fellow members. The second board, "Social Banter," is our new social board. Share your favorite pizza joint in your area (really, please do!); list books you've enjoyed; ask questions before you travel to a new city. Discuss anything *except* investing or politics.

We hope *Pro* is one of your favorite homes for investing ideas, commentary, and advice — and that these boards make that home even warmer for the coming winter.

To comment on the Memo, visit the Memo Musings board. Forward we go. Fool on!

—Jeff Fischer (TMFFischer)

Sell MELA Sciences Stock; Buy Calls

Published Nov 11, 2010 at 12:00AM

At a Glance

- **Actions:**
  - **Sell all shares** with a limit order near current market prices
  - **Buy to open** one January 2011 $7.50 call for every 100 shares previously owned (or now desired); again, use a limit order near market prices

- **Allocation:** Lowered from 0.5% to 0.15% (but the calls allow us to keep the upside potential of a larger position)
- **Nov. 10, 2010, Prices:**
  - Stock: $7.00
  - Options: $1.50
- **Why Sell Stock and Buy Calls?**
  - The FDA advisory panel is set to release briefing documents on the company's only potential product, MelaFind, on Nov. 16, and the risk of product denial or delay appears greater than it did a year ago.
  - This strategy allows us to greatly reduce our capital at risk while still keeping most of the upside potential.
- **Alternate Trades**
  - **Don't want to own calls?** You can continue to own the stock if you wish, but realize that it's a speculation; downside risk is both immediate and extremely high. *Only speculate with money you can afford to lose.*
  - **Don't have a position in MELA Sciences**, perhaps because it's been on Hold in the *Pro* port? Buy calls with us now if you want to speculate on the product's outcome. *Again, only speculate with money you can afford to lose.*
  - **Already own calls, a strangle, or a straddle?** If you're comfortable with your existing position and your capital at risk, you can keep it.
  - **Want to buy puts for defense?** We'd advise you to think again; the puts are so expensive that it deters us from buying them. These cheap calls are our best way of limiting risk.

What's New?

In October 2009, *Pro* made our first speculative investment, buying $5 call options on **MELA Sciences** (NASDAQ: MELA) in anticipation of an imminent FDA decision on the company's only potential product, skin-cancer detector MelaFind. The FDA panel was subsequently delayed, our call options were exercised into stock in April, and we've been waiting for a new FDA action ever since. Now, the big day is finally near: The FDA is set to release its briefing documents on MelaFind's clinical trials on Nov. 16 (this Tuesday), and an FDA advisory panel is scheduled to provide a product recommendation to the FDA on Nov. 18.

Basically, MELA Sciences' fate is now in the hands of a small group of professionals who will either suggest FDA approval for MelaFind or recommend denying it. A denial would likely send the stock into the dustbin for years, while a recommendation to approve the product could at least double the stock price. Either way, while the FDA probably won't issue its final say for a few months, the stock should react immediately to the panel recommendation; the FDA rarely deviates from a panel's advice.

Which outcome is most likely? Last year, the odds seemed to favor product approval due to strong trial data and convincing benefits from this non-invasive device (as noted in our original report below). MelaFind screens for the most dangerous type of skin cancer, known as melanoma; the condition is curable when found early but deadly when it's not, so the need for a product like MelaFind is so strong that the FDA granted it an expedited review.

Today, though, even though the recent abstract of the MelaFind study shows promise, it also raises more questions than we would have expected from an airtight trial. The final data actually suggest to us that the FDA may delay approval and request further studies, which would imply years more work before another shot at approval. Thus, we'll say it yet again: *Only speculate on MELA Sciences with money you can absolutely afford to lose*. The only reason we're continuing to speculate at all is because we can do so with extremely limited downside while still capturing most of the upside.

To provide more context, let's review what has transpired with MELA Sciences this year.

- **The Good:**
  - After receiving a non-approvable letter from the FDA in March, MELA Sciences immediately began working with the agency to arrange a panel hearing at which it answered questions outlined in the letter. Together, the two further defined how MelaFind should be used, and this increased specificity may increase its odds of approval.
  - MelaFind detected 98% of all melanomas in the phase III trial (on more than 1,800 lesions), making it far more accurate than the typical dermatologist. As a complementary tool for dermatologists, MelaFind makes sense.
  - The FDA recognizes the need for a tool to help doctors with this deadly disease. MelaFind appears safe as a backup tool along with traditional procedures.
  - Company insiders have continued to buy shares this year. It's doubtful they'd invest even small sums in the stock unless they had confidence in the outcome.
- **The Questionable:**
  - Management has not been forthright in answering detailed questions about the statistics used in the trials, nor has the company disclosed the questions the FDA originally asked in its non-approvable letter in March. This is highly unsatisfactory and would normally make us run; as it is, we're *almost* running by significantly decreasing our capital.
  - The trial appeared to be less than perfect, with 8.8% of lesions in the sample having to be thrown out because of device problems; the use of MelaFind did not meaningfully lower the number of biopsies needed; and there's no hard data on MelaFind's relative sensitivity, because any melanomas missed by doctors (but found by MelaFind) were not recorded. The trial largely relies on other, earlier studies to suggest that MelaFind works better than doctors.
  - Mela Sciences admits that the general population is materially different from the subjects of the study. The study only included lesions tagged by doctors as possibly being melanoma. MelaFind's task was to identify which were cancer. It did so with 98% accuracy, but the FDA may argue that more studies on other population groups are needed. (Countering this potential risk, the company suggests MelaFind should be used in cases where cancer is suspected, like those in the trial, to confirm or deny it.)
  - The company sold 2.2 million new shares in July at $7.50 each. Management may have been hedging its bets by raising more money before the FDA panel's decision. If management were confident that approval was imminent, it might have waited for a higher share price before diluting the stock.
  - Finally, the way management has talked around some trial questions suggests the company may have been somewhat sloppy (statistically speaking) in some aspects of the trial. Again, it's not as "airtight" a trial as we'd like; it infers a lot, and we prefer to see proof.

Weigh the good against the questionable, and it's truly anyone's guess whether MelaFind will be approved. In the year since our original recommendation, the questions surrounding the product have increased considerably. So, to stay invested but greatly decrease our risk, we're going to sell our 1,000 shares of stock for proceeds of around $7,000 and invest just $1,500 or so in 10 call options instead. By doing so, we'll take our exposure down from 0.5% of the Pro portfolio to less than 0.15%. This is simply risk management, which is exactly the right way to use options sometimes. If MelaFind fails, this investment will barely nick our portfolio. If it succeeds, we'll be happy owners.

Why This Strategy

With a binary situation like an FDA product approval, the outcome is either ticker-tape parades and champagne bottles or gloomy, empty defeat; there's no in-between. Thus, it makes little sense to risk a meaningful amount of capital in such a situation when you can risk 20% of that amount and still maintain most of the upside. This is why we originally bought call options on MELA Sciences rather than stock, and it's why we want to be in that position again as the big day approaches.

To illustrate the reasons we've chosen this strategy, let's consider the advantages and trade-offs. The following table compares your gain or loss at various share prices if you own 10 January 2011 $7.50 call options at a cost of $1.50 each, versus owning 1,000 shares of the stock at a recent value of $7 each.

MELA Sciences' Potential Share Price	Gain (Loss) on 10 $7.50 Calls Bought for $1.50	Gain (Loss) on 1,000 Shares From Recent $7 Price
$0	($1,500)	($7,000)

MELA Sciences' Potential Share Price	Gain (Loss) on 10 $7.50 Calls Bought for $1.50	Gain (Loss) on 1,000 Shares From Recent $7 Price
$2	($1,500)	($5,000)
$4	($1,500)	($3,000)
$6	($1,500)	($1,000)
$8	($1,000)	$1,000
$10	$1,000	$3,000
$12	$3,000	$5,000
$14	$5,000	$7,000
$16	$7,000	$9,000
$18	$9,000	$11,000
$20	$11,000	$13,000

Obviously, no matter how bad it gets, the most we can lose on our 10 call options is the $1,500 it cost to buy them. That's much easier to absorb than a potential $7,000 loss, which is what we'd face if we owned the equivalent amount of stock and it subsequently went to $0. And the higher the stock goes, the more gains we capture with our call options anyway. At $20 per share, the call options capture four-fifths of the upside of the stock while only risking one-fifth the capital. We like those numbers. If MelaFind is approved, we expect the stock to head at least into the mid-teens, and we'll compound our small investment several times. If it's denied, the stock's likely headed to about $2 and we'll walk away empty-handed — but relatively unscathed.

How to Follow Along

- **Sell your stock.** Use a limit order near current market prices; we don't want *Pro* members pushing the share price down.
- **Buy to open January 2011 $7.50 call options.** Use a limit order near current market prices (lately, $1.50 per contract, or $150 each). Buy one contract for every 100 shares of MELA Sciences you previously owned or currently want exposure to.

Any transactions you make should be done before Tuesday, Nov. 16. When the FDA releases its trial debriefing that day, it will likely provide big clues about what the panel is going to decide on Nov. 18, and the stock will almost certainly react. On the 18th, the stock will probably be halted from trading until the final recommendation is issued. We expect to lose the full value of our calls with any outcome other than approval, so one more time: *Only speculate here with money you can afford to lose*.

Pro Bottom Line

Given *Pro*'s stated goals of steady returns with high accuracy and lower risk, MELA Sciences, which we brought on board early in the game, may be the last of its kind in our portfolio. It never seemed to quite fit in, so others like it aren't likely to follow. Therefore, enjoy the thrill of a pure speculation while we have it! Furthermore, the amount of time the team spent reading and thinking about this position was entirely too much for a 0.5% holding. This illustrates another problem with speculations: Your mind is always trying to find an edge, to figure out what's inside the "black box" of the speculation, and that energy usually ends up being wasted. We can spend our energy much more effectively and profitably on companies we know will increase cash flow over time.

We wish MELA Sciences great luck next week; its product could save lives. If MelaFind is approved, we'll be thrilled for patients. If it's denied, we'll be disappointed — but again, for patients more than for ourselves. To discuss MELA Sciences, please visit its board. —*Jeff Fischer*

Buy More of Medtronic

Published Nov 9, 2010 at 12:00AM

At a Glance

- **Action:** Buy enough shares to bring your allocation up to 5% (for *Pro*, that's about 530 more shares, giving us 1,900 total)
- **Preferred price:** Around $36 or lower
- **Current price:** $35.75
- **Alternate trades:** You can write puts to possibly purchase shares lower if you're a stickler for price. December 2010 $35 puts pay around $1, while January 2011 $35 puts recently paid $1.55.

What's New?

Chicken Little is making a cameo in the health-care arena, with *Pro* Buy First recommendation **Medtronic** (NYSE: MDT) and its medical technology friends significantly underperforming the S&P 500 over the past six months. The issues *du jour*, however, haven't changed in more than a year: lower-than-expected patient procedure volume, longer product development cycles, and the ever-present "health-care reform uncertainty." Medtronic did little to allay those fears with its first-quarter earnings in August, when it lowered its fiscal 2011 earnings guidance.

We believe Medtronic is managing its business properly to survive these temporary industry issues. First, it's continuing to invest in research and development — the company expects to launch 60 new products over the next two years. In fact, it invests more each year than **Stryker** (NYSE: SYK), **Zimmer Holdings** (NYSE: ZMH), and **St. Jude Medical** (NYSE: STJ) combined. We also think Medtronic's broad product line and launch experience give it a leg up in dealing with heightened FDA trial and testing demands. Rolling in new products through acquisitions (such as those of Invatec and ATS Medical) adds growth through Medtronic's global distribution and offers good reinvestment rates. The company's competitive position is intact, and the lowered stock price compensates us more than fairly for the industry's risks.

Why This Strategy?

We're buying shares outright instead of writing puts because we think shares are cheap enough already. Paying 9 times free cash flow and 10 times the low end of forward earnings estimates for a company with excellent tailwinds and a culture of innovation makes good, Foolish sense.

How to Follow Along

We're giving our allocation a jolt from 3.4% to 5% of the *Pro* portfolio's current value, and we suggest you do the same. Buy shares using a limit order, and join us on the Medtronic board for discussion. —*Bryan Hinmon, CFA*

The Dollar's Death ...

Published Nov 8, 2010 at 12:00AM

By Nick Crow (TMFCrow)

If you've spent any time at all on *Pro*'s Philosophy & Strategy board recently, you know that many members have abandoned our "We're Defensive, Not Apocalyptic" mind-set in favor of fear, despair, and perhaps preparations for the apocalypse. And why not? The stock market has crashed not once but twice in the last decade or so. We at *Pro* recently bought gold — the ultimate defensive investment, some would say — through the **Sprott Physical Gold Trust**. The Fed is expanding its balance sheet by another $600 billion through the new round of quantitative easing (QE) it announced last week. Listen to the talking heads and you'll become convinced that everything is being manipulated and nothing is real. If your head is spinning, it should be: You and I *are* being manipulated.

Earnings on Deck

- Tuesday: **Ebix**
- Wednesday: **Cisco Systems**

Coverage & Community

- **Broadridge Financial Services** reported results, and Bryan (TMF42) has the skinny. The stock remains a Buy First. You can also write puts.
- **GrafTech International** chimed in with strong results but a subdued outlook. What does that say about the world economy? We like the direction of the business, but the stock remains a Hold on price.
- Is it time to be even less defensive? Jeff is leaning in that direction.
- Pro member alex340 posted puts and calls (for writing) that match *Pro* criteria.
- Get the full earnings calendar from TMFValuemoosie.
- TMFEldrehad pits Main Street against Wall Street in his latest CAPS analysis.

Get Your Bearings

Any time you find yourself in peril, whatever the specifics, you need to do two things to avoid further danger: Breathe deep, and find a point of reference. Then, just take the next rational course of action. The same is true when thinking about macroeconomics. With that in mind, take that deep breath now, and take the following quiz to find your point of reference.

- **Question 1:** What is currently backing the U.S. dollar?
- **Question 2:** How much has the United States' total net borrowing (private and public) increased since the financial crisis?

If you don't know the exact figures, give a general answer (for example, "it exploded" is a common response to question two).

Are you finished? Great, now we know where we *think* we are — which may be an entirely different place from where we *actually* are.

Rumors of My Death

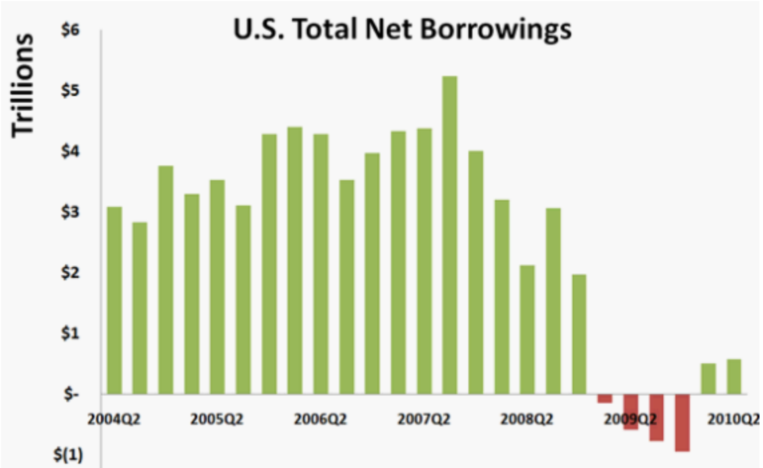
If you answered "nothing" to question one, at face value, you are correct. The U.S. dollar is not redeemable for gold (or any other commodity). However, our currency does bear the inscription, "This note is legal tender for all debts, public and private." Because dollars are legal tender, they are "backed" by all of the goods and services in our economy. And even in its current weakened state, we have one hell of an economy. For this reason, it follows that as long as this country produces desirable goods and services, our dollars are worth more than the paper they're printed on.

To paraphrase Mark Twain: Rumors of the dollar's demise are greatly exaggerated. Intelligent monetary and fiscal policy are indeed important, but I believe the importance of a commodity backing for any given currency is overstated, and I don't think fiat currencies — those without such a backing — are headed for an imminent collapse.

Ideologies aside, I'd bet most answers to question one were pretty similar. Question two, on the other hand, is a doozy. I mentioned above that you and I are being manipulated; this is where much of that manipulation of our perceptions is taking place. We're being told that the Fed is bankrupting us through the monetization of our debt (also known as "quantitative easing," or QE in shorthand) and that because of the crushing load of this debt, the world will no longer want our dollars. Thus, the argument goes, hyperinflation — and with it, soaring interest rates — will follow.

The thing is, if this explosion of our debt load were actually occurring, it would show up in the total net borrowing of the U.S., and there would be a commensurate increase in interest rates; investors would demand a higher return in exchange for taking on the increased risk of our increased debt load. This brings us to the *real* answer to question two.

Americans' borrowing (federal, state, local, financial company, nonfinancial company, and household) has actually decreased dramatically since the start of the financial crisis. Yes, that's right, our debt has actually *imploded* – not exploded, as you may well have thought. When we're talking about trillions of dollars, it's easy for our heads to start spinning again, so here's a chart to focus on:

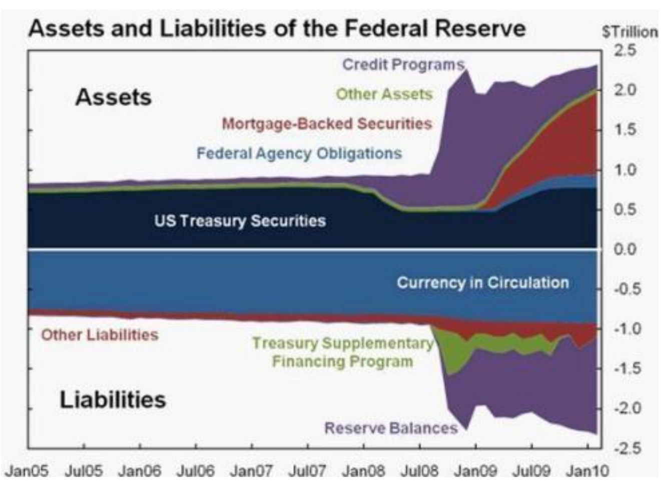


Source: Federal Reserve

So what happened here? Why didn't borrowing shoot through the stratosphere? As it turns out, we, the people (and businesses) of America actually have some influence. While the U.S. government was ramping up its borrowing at record rates, U.S. households and companies of all types were de-leveraging even faster. Reducing expenditures to pay off debt is Foolish with a capital F, but when we move *en masse* — well, we move *en masse*. Every dollar we save or use to pay down debt is a dollar that's not being spent — in other words, it's not contributing to economic activity. Fortunately (as much as it pains me to characterize it that way), the government stepped in via the first round of quantitative easing, stimulus spending, bank bailouts, and so forth, or that red area you see in the chart above may have dipped into the trillions, which would have further slowed our economic recovery by negatively affecting GDP and therefore our ability to service debt.

Both Sides of the Coin

At its core, QE is simply a way for the Fed to lower long-term interest rates and add to banks' lendable reserves by buying large quantities of Treasuries or other financial assets from member banks. You may have heard that this is akin to printing money, but the reality is more nuanced. Let's start by taking a quick look at how the Fed accounts for changes on its balance sheet. When the Fed makes loans or buys assets, it creates both an asset on its balance sheet (loans and securities) and a deposit liability (reserves). In essence, the Fed borrows from member banks to buy assets from other member banks. The net increase in liabilities, therefore, is zero. The following chart shows the overall effect on the Fed's balance sheet from the last round of quantitative easing and stimulus; we should expect a similar change in the balance sheet from the next $600 billion in purchases over the next eight months.



Source: Federal Reserve

Though the balance sheet has expanded, assets still offset liabilities, as the fundamental rules of accounting would suggest. Look at just one side of this coin, as many commentators have, and it's easy to assume that $2 trillion change and means Fed Chair Ben Bernanke & Co. are trying to destroy us. While the expansion of the balance sheet does illustrate the gravity of our economic difficulties – things are bad — it doesn't in and of itself put America in the poorhouse.

Nothing to Fear?

I know what some of you are thinking: If the dollar is backed by all the goods and services we produce, and our nation's debt as a whole is lower now than before the crisis, *and* the Fed is taking action to lower already low interest rates … why are we hearing so much talk about inflation?

This question gets to the crux of the dilemma of reality vs. perception. Unless we're all concerned about — perhaps even terrified of — future inflation, low interest rates won't stimulate consumers to borrow and spend or businesses to borrow and invest. Without increased demand, there will be no new jobs, all those bank reserves won't be borrowed and reinvested, and we won't pull ourselves out of this slump.

It's an economic version of the chicken-or-the-egg question. Expectations of high inflation are one way to stimulate demand and investment; if you think everything is going to get more expensive, you'll buy and invest now before that happens. And increasing demand for goods and services is the only sustainable way out of our mess. So far, low interest rates and costly incentives have only helped to maintain current levels of consumption. For that small success, we should be thankful — and when thinking of the future, we should in fact be hopeful, for this too shall pass ... eventually.

So, Fools: Breathe deep, ignore the noise about hyperinflation (or appreciate it for its potentially demand-stimulating effects; just don't believe it unquestioningly), and let's get back to being defensive, not apocalpytic.

Bring your comments and questions to our Memo Musings board — and Fool on!

Nick Crow (TMFCrow)

Roll Your Covered Strangle on Plum Creek Timber

Published Nov 8, 2010 at 12:00AM

At a Glance

- **Action:**
  - Buy back ("buy to close") November 2010 $36 calls at market price.
  - Write ("sell to open") new strangle: May 2011 $36 puts (to potentially double shares owned to 5%) and May 2011 $39 covered calls (one for every 100 shares owned).
- **Preferred strangle price:** $4.20 net credit, combined
- **Recent share price:** $38.97

Questions?

Please visit our guide to strangles for more on the strategy.

Important Date

Plum Creek's dividend is set to be registered on Nov. 16; to keep your shares, you'll want to roll your November covered calls before that date.

- **Alternate trades:**
  - **If you don't own Plum Creek:** Write one leg of this strangle, the May 2011 $36 puts, for $2 or more.
  - **If you own at least 100 shares but don't want to buy more:** You can just write the covered calls, or simply keep holding your shares.
  - **If you don't want the obligation of holding two sets of puts:** We're letting our November $31 puts from our last strangle expire Nov. 20. If you want to close those early, "buy to close" both legs of your existing strangle at once.
  - **Want more room to roam?** You can consider strike prices above and below ours, moving your strangle up or down.

What's New

Plum Creek Timber (NYSE: PCL) reported sapling-sized revenue and earnings for its third quarter but made operating improvements in each division, though business remains challenging. The stock held up after the news, maintaining its stature among investors as a hard asset and a hedge against inflation. We bought in two years ago to own timber assets and enjoy a 5% dividend, and we've added significantly to our earnings since then by writing options. We don't want to sell now — especially since we can continue our covered-strangle strategy to gain more potential income, a higher net sell price, and a reasonable potential buy price on new shares. Our main arguments for owning Plum Creek remain in place: If the economy mends, housing and timber demand will grow, and a resurgence in the economy could lead to inflation, which in turn would lead to higher commodity prices.

Why This Strategy?

We want to keep our Plum Creek shares but also remain defensive given the surge the market has enjoyed since August. Buying to close our November $36 calls for a net cost of about $1 per share, we can roll into a May 2011 strangle that currently pays us $4.20 per share. We're choosing an expiration six months in the future to receive considerably higher option payments compared with earlier expiration months — this allows us to be more defensive should downward volatility return to the market, and also enjoy a higher net sell price if stocks keep rising. Here's a look at our roll-up:

What We're Doing	What It Costs
Payment received for writing original November 2010 $31/$36 strangle	$1.90
Cost to "buy to close" November 2010 $36 calls	($2.90)
Net cost to close November $36 calls	**($1.00)**
Payment received for writing May 2011 $36/$39 strangle	$4.20
Total net credit from rolling up	$3.20
New net sell price if called away	$42.20
Original net sell price if called away	$37.90
Upside from rolling up (excluding commissions)	**11.3%**

Aside from achieving a higher potential sell price, the strangle also provides a potential net buy price on new shares of $32.80, below our $34 preferred buy price. And if the stock stays between our two strike prices, we'll earn the full net income of $3.20 per share. This is a tighter strangle than we usually write (with strike prices only $3 apart), reflecting that we want to maximize our option income despite lower-than-usual option premiums and that we're comfortable with the stillwide effective price range this strangle provides (shown below).

How to Follow Along

We recommend that you:

- **Buy back ("buy to close")** the November $36 calls using a limit price near the market price (recently $2.90). (You can leave your November $31 puts alone if you're comfortable doing so; we expect those to expire worthless on Nov. 20.)
- Then, using a strangle net credit order, **write ("sell to open")** May 2011 $36 puts and May 2011 $39 covered calls.
- **Preferred strangle price:** $4.20 net credit (remember, this credit will go down over time; a lower credit is still acceptable if you make the trade later).

To write a covered strangle, you must own at least 100 shares of the stock, and you should be happy to buy at least 100 more at a lower price.

Trade Details

- **Roll-up credit:** About $3.20 after paying to close our November covered calls
- **Potential net buy price of new shares through $36 puts:** $32.80 (15.8% below current price)
- **Potential net sell price on current shares through $39 calls:** $42.20 (8.3% above current price)

Anytime you write puts, your broker sets cash or equity aside to cover your potential stock purchase. In this case, the $36 puts pay a 5.3% yield on cash set aside over the next six months. Questions? Please visit our old-growth (hey, we've had it since 2008!) Plum Creek Timber board. *—Jeff Fischer*

Sell to Close Your Puts on Caterpillar

Published Nov 5, 2010 at 12:00AM

At a Glance

- **Action:** Sell to close November 2010 $80 puts
- **Allocation:** Sell all contracts
- **Recent option price (bid/ask):** $0.59/$0.61 (use a limit price near current prices)
- **Recent share price:** $83.33
- **Why sell:**
  - Expiration is nearing and the stock is above our option's $80 strike price.
  - The option still has time value that we can recapture, decreasing the loss on our bearish spread.
- **Alternate trades:**
  - If you have a bearish spread on Caterpillar that expires later than November, you can wait on it.

What's New?

Since we announced a bear put spread on **Caterpillar** (NYSE: CAT) on Aug. 17, the S&P 500 has gained nearly 12%, experiencing its best September since the 1930s. On the heels of this rally, time is running out for this spread; with expiration just two weeks away, the stock has rushed higher with the market, putting it above the $80 strike price and threatening our $75/$80 bear put spread with a full expiration. We can sell to close our $80 puts early to regain some value (they still carry time value, given how volatile these shares can be), and we will let our written $75 puts expire, taking no action on that leg of the trade. We'll earn 100% of what the $75 puts paid us, but lose most of what we paid for the $80 puts, making the trade a loser overall.

Thankfully, this has been a modest loss, since spreads cap the risk to our initial investment. Had we shorted 500 shares of Caterpillar directly at $69.50 (the stock's price when we issued the spread), we'd be begging for mercy right now. This bearish trade has been a good reminder of how quickly the market can smash short positions, and why spreads — even though they limit profit potential — can be a good approach to shorting when you're looking for a reasonable hedge with less risk. Our thesis left room for the shares to move 9% before our spread turned unprofitable, but the market was so strong that it wasn't enough.

So what's up with Caterpillar specifically? The company turned in strong results last quarter, partly because high commodity prices are driving more demand for mining equipment. That demand may not subside anytime soon, since commodity prices are rising as the Fed continues to pump money into the economy. However, the stock doesn't look inexpensive, and even after earnings, it didn't gain ground. Instead, broader market gains stepped in to drive Caterpillar higher.

All in all, this was still a reasonable short with reasonable risk. We'll take our loss and step aside for now. We've learned more about Caterpillar in the process, and the company will take its place in our possible investment arsenal.

If you have questions on selling to close the $80 puts, visit the CAT board. And remember: For now, we're taking no action on the $75 puts we wrote, instead planning to let them expire on Nov. 20. You can close them for more than a 90% gain if you'd rather clear the deck today. Finally, we have from now until the Nov. 20 expiration to sell to close our $80 puts; if shares fall enough, we'll get a higher price, and if they go up, we'll get less. *—Jeff "get that earth mover off of me" Fischer*

Buy L-3 Communications

Published Nov 4, 2010 at 12:00AM

At a Glance

Note: It's LLL, not LVLT. Make sure you buy the right company! We're recommending **L-3 Communications** (NYSE: LLL), *not* **Level 3 Communications** (NYSE: LVLT).

- **Action:** Buying 2.5% of current portfolio value
- **Target allocation:** 5%
- **Estimated fair value:** $100
- **Preferred buy price:** Around $80 or lower
- **Type of holding:** Long-term, defense contractor
- **Alternate trade:** Write January 2011 $70 puts for a 2.5% to 5% position
- **Why buy:**
  - World-class capabilities and technology
  - Fantastic price
  - Defensive company (see what we did there?) that is not closely correlated to the economy

The Big Picture

By Andrew Sullivan, CFA (TMFRedwood)

The deck appears to be stacked against defense companies. After a years-long surge in spending for two wars, America has removed combat troops from Iraq and is working on doing the same in Afghanistan. There's also the small problem of tight purse strings at home (have you heard about our deficit?) as well as growing sentiment among policymakers that defense contractors need to take on more risk, and possibly more loss, when it comes to cost overruns in the development stage of contracts.

The Community's Take

L-3 is more value than growth, so it has a low CAPShot score. However, nearly all of the CAPS All-Stars who've rated it believe the stock will outperform.

Given all this, investors worry that revenue growth at defense contractors will slow or even turn negative in the coming years and that profit margins will be squeezed. These fears have pushed contractors' stocks down to historically low multiples of earnings and free cash flow. This gets us excited for two reasons. First, we think worries about cuts in defense spending are overblown, and at any rate, a certain amount of softness is already built into share prices. And second, some companies can still excel under these circumstances yet have been unduly lumped in with the unimpressive masses, giving us bargain-shopping opportunities. We think we've found one of those bargains in **L-3 Communications** (NYSE: LLL).

It's clear that we live in a dangerous world — Iraq and Afghanistan remain unstable, Iran and North Korea are working toward acquiring nuclear weapons, and terrorist attacks (planned and executed) are common. Unfortunately, none of this is likely to disappear anytime soon, meaning we'll have to keep spending money on preparation and prevention. And while spending has ramped up, it is still low in historical terms: Defense spending is 4.8% of our GDP, far below the almost 10% it reached in the 1960s and even the 6% of the 1980s.

Some companies are better positioned than others to navigate an uncertain future, and we think L-3 is one of them. It's a surprisingly agile large cap with a wealth of mission-critical technology and capabilities at an appealing price. New, unproven, and frequently over-budget programs are common, but companies like L-3 with proven products and solutions in high-growth areas like electronics and communications should fare much better than their peers.

Defense in general is a wonderful industry to own because of its predictability, barriers to entry, and stability during uncertain economic times; even if the market is in a funk, defense tends to hold steady, a plus for our portfolio. So we're happy to get exposure to the industry at a great price. But we're choosy here at *Pro* — we want the very best companies, no matter what the industry. When it comes to defense, this means companies that are insulated from budget declines and that have excellent growth prospects. Given those criteria, L-3 stands out above the rest.

The Business

Founded in 1997, L-3 has spent more than a decade assembling a portfolio of cutting-edge businesses in intelligence and communications, electronics, aircraft maintenance, and government services. In that time, sales grew from $700 million to $15.6 billion, turning L-3 into the sixth-biggest company in the defense industry.

L-3's products include aircraft black boxes (they're actually orange), thermal imaging sights, secure smartphones, sophisticated data links, unmanned aerial vehicles, aircraft flight simulators, metal detectors and baggage-screening systems, and even missile protection systems for head-of-state aircraft. The company also trains foreign militaries and police forces, provides linguistic services, and upgrades aircraft for new missions.

A sterling example of the way in which L-3's many skills can come together is Project Liberty, a contract to convert small King Air aircraft into intelligence-gathering assets. L-3 delivered the first such aircraft last year, only eight months after receiving the contract, an unheard-of pace for a program of this nature. For Project Liberty, L-3 built on its skills in aircraft modification as well as sensors and electronic communications; in total, it used five of its divisions to create a compelling package, one it delivered to the Air Force in record time.

This captures one of the things we like about L-3: Because it owns both the mission-critical surveillance and communications equipment that senses and transmits data *and* the facilities that physically integrate it onto the aircraft, it is in an excellent competitive position when it comes to bidding on work like Project Liberty.

L-3's aircraft modification business has garnered a lot of attention, and for good reason: With the pace of advancing technology, it is often cheaper simply to upgrade planes with new equipment than it is to procure new ones. In our view, that means L-3's skills here should pay off. But its electronics and communication businesses are also in the sweet spot of Defense Department needs. Products in those categories add a lot of value and are becoming more prevalent in combat; their importance and critical nature insulate the company from budget cuts. Typically, it's the expensive jets, ships, and untested programs that are most vulnerable to cuts — areas where L-3 doesn't have much exposure.

Financials and Valuation

This $73 stock generated earnings per share of $7.60 in each of the past two years and should earn just more than $8 this year and next. Simple math ($8 divided by $73) puts the earnings yield at an attractive 11%, of which 2 percentage points ($1.60) is a dividend. Except for a brief time in early 2009, L-3 is currently trading at all-time low multiples for just about every valuation metric you can think of. For a strong company with low-risk, world-class assets and attractive growth prospects that are only slightly correlated to the economy, this appears to be an ideal investment opportunity. We peg fair value for L-3's shares at more than $100.

What Would Make Us Sell

Although fears of a slowdown in defense funding are reflected in L-3's stock price, a sharp decline in the nation's defense budget is still a significant risk. Other risks include contract losses and, to a lesser extent, ballooning costs in fulfilling contracts. And while we like the aircraft upgrade business, work in that field can experience turbulence, making it harder to forecast. Finally, because L-3 isn't particularly correlated to the economy, its stock could underperform the broader market should the economy take off.

Pro Bottom Line

L-3 has an impressive array of capabilities and technology, all of which remain in high demand by our military services. Since most of L-3's sales are to the government, an investment provides us stability should the broader market fall, making it an economically defensive stock. And to top it off, we're getting a wonderful price. This company is rarely on sale, and we're eager to take advantage of it.

Please discuss L-3 on our board.

Andrew owns call options on L-3 Communications.

Earnings Galore and a Fond Farewell

Published Nov 1, 2010 at 12:00AM

Life has many exuberant moments, but compromise is nonetheless a part of each day. You'd love to pursue your dreams in every spare minute, but the garbage isn't going to take itself out. You want to see the world, but you could probably stand to explore your own neighborhood first. When it comes to investing, you want to make money with less risk, but when you hedge, you cap your upside. And none of this is necessarily a bad thing — in the end, the point of any good compromise is to make things better than before.

Who's Cheating Who?

Don't miss the *Pro Education Extra* we published last week — "First, Do No Blunder" — in which Bryan Hinmon (TMF42) makes sure no *Pro* positions are "cheating" on us.

Earnings on Deck

- Tuesday: **Jack Henry & Associates**
- Wednesday: **AmTrust Financial**, **Papa John's International**, and **Quanta Services**
- Thursday: **Bristow Group** and **Broadridge Financial**

Coverage & Community

- Looking to write more puts or covered calls? Alex340 posted possibilities on *Pro* stocks.
- Hungry for even more earnings? TMFValuemoosie shares an earnings calendar.
- Who's got the "write" stuff on CAPS? TMFEldrehad highlights the superstars of stock pitches.
- Stamleo started a thread on *Pro's* approach to shorting thus far. It's sure to be an active conversation!
- Member Kzeek asks,"Why not roll these Cameco covered calls for more upside?" That question can be asked of several positions, and Jeff gives his answer.

That's true of the news we want to share with you today, too. Analyst Todd Wenning (TMFPhila) has been a steady part of *Pro* since day one, offering calm advice on the boards, sharing insightful stock ideas, and living up to the *Pro* mission every day. Todd has done so well, in fact, that he's been asked to move to London to be the advisor on The Motley Fool U.K.'s newest service, *Dividend Edge*. He's a dividend investor at heart (and a lover of British comedy), so Todd and his wife are excited to pack up the dog and move across the pond. The flip side, of course, is that he hates to distance himself from the *Pro* community.

First, we want to sincerely congratulate Todd. We look forward to watching the new service launch, and we're certain it will be a transcontinental success. Second, we want to commemorate his departure — and while we'll certainly miss having Todd as a full-time part of *Pro*, this compromise makes sense for him as he takes the next step in his investing career. Plus, as busy as Todd will be learning the ropes in a new country (driving on the left, learning the proper use of "Cheerio"), we won't lose sight of him. He still plans to cover some of the companies he brought to *Pro,* and he'll show up on the boards, too. We're even hoping for a special report every once in a while, with Todd serving as our eyes and ears in the U.K., providing us additional investing perspective from Europe.

The expanding *Pro* team continues to cover all of our existing holdings (and pursue new ideas, many of which are in the works right now). But before we move forward, we pause to show Todd our gratitude. Working with him has been a pleasure over the past two years, and he's left a strong legacy at *Pro* with stock positions like Plum Creek, Kinetic Concepts, and Jack Henry. Now I look forward to the next phase of our relationship. To join us in wishing Todd well at his new service, please post on the Meet & Greet board.

Earnings Onslaught

Last week was a reminder of why we find ourselves needing blood-pressure medication every three months. Earnings were issued at a fast and furious pace, and we worked to maintain a calm, long-term disposition despite the excitement. Four *Pro* companies reported, all of which look decent upon first study.

Kinetic Concepts had the type of quarter we've been waiting for after two quarters of somewhat worrisome results. The third quarter wasn't perfect, but it was a step in the right direction as margins improved and earnings were stronger than anticipated. Revenue is still on the soft side, with no real growth, but the company is meeting with early success in Japan and plans to enter India and China, so there is plenty of potential ahead. At a discounted valuation, KCI remains a Buy. You can also write (sell to open) various put options in the mid-$30s to potentially get shares cheaper. Meanwhile, our protective collar on the shares (which we entered into in case a disappointing earnings announcement brought the stock price down) has proved unnecessary, and we're aiming to end it for zero cost. We've sold to close our puts and are now managing our covered calls.

Plum Creek Timber reported ho-hum results; the buzz saws aren't being used much since demand remains soggy. Management is letting its forests grow and will increase its sustainable harvests when demand increases. Meanwhile, real-estate transactions are adding value. These tranquil results are fine with us, because we want to continue our covered strangle income strategy on Plum Creek. Our current options expire in November, so we'll look to roll our strangle into a new one this month. You can write puts in the lower $30s if you don't have a position yet. We have a preferred buy price of $34 or below.

Procter & Gamble hit on all cylinders in its most recent quarter, growing unit volume by 8% and organic sales by 4%. Bryan Hinmon (TMF42) provides a strong review of the quarter, but the stock remains on Hold solely because of its valuation. We also plan to continue writing covered calls on our shares as long as we own them. Our current $65 covered calls expire in January, and so far they've earned 41% of what they could pay us.

GrafTech International reported a 55% jump in revenue and nearly triple the previous quarter's net income as graphite electrode demand increased at steel mills. The company expects a flat fourth quarter as the economic recovery remains tenuous (steel-mill operating rates are falling again lately), but management has made GrafTech exceptionally profitable even in this mixed environment. We're still going through its results and will have updated guidance soon.

To discuss any of our companies, please visit their respective boards. To discuss the Memo, head over to the Memo Musings board. Again, we wish Todd all the best in London, and we can't wait to see if he develops a British accent on the boards.

Foolishly,

Jeff Fischer (TMFFischer)

Buy Calls on Intel

Published Nov 1, 2010 at 12:00AM

At a Glance

- **Action:** Buy ("buy to open") January 2013 $10 calls
- **Allocation:** 1% of *Pro*'s starting value, for a 6% total allocation to Intel.
- **Details:** We'll invest about $10,000 in the calls, buying about 10 contracts.
- **Recent stock price:** $20.55
- **Option price:** Lately, about $10.65. Use a limit order that results in an effective buy price ($10 strike, plus what you pay for the call options) as close to Intel's current stock price as possible.
- **Alternate trades:**
  - Buy shares of Intel directly; it remains a Buy First stock.

- Or, buy to open January 2013 $12.50 or $15 calls if you'd rather invest less capital. These options have a bit more time value attached, though.
- Or, write ("sell to open") $20 puts if you'd rather try to buy the stock cheaper.
- If you already own January 2012 call options, we think holding until they're profitable makes sense. You can roll to the 2013 call options later, or add those options independently.

What's New

Intel (NASDAQ: INTC) is already the second-largest position in the *Pro* portfolio, sitting at a 5% allocation. Our call purchase will put us near 6%, and we'll be at 7% if we turn these new calls into shares. We're comfortable investing this much in the computer-chip giant given its current price — just over 10 times free cash flow and earnings, which is about a 40% discount to the S&P 500's average valuation. Management expects the PC market to show solid growth again next year (12% to 18%) and broad-based strength in computing devices to continue in the long term thanks to emerging markets, corporate upgrades, and growing tablet and Internet TV markets, among other factors. Wall Street is still pricing Intel as if it's a highly cyclical, boom-and-bust company, but those cycles appear to be smoothing out as the computing industry grows more diverse and global.

In addition, the *Pro* team (along with some lucky *Pro* members) met with Intel in San Francisco last month, and each of us came away impressed. We would never base an investment decision on a meeting alone, but we feel Intel's growing technological lead over its competition in the core computer processor market (where it's about two years ahead of rivals), along with plans to put **McAfee** (UNKNOWN: MFE.DL) security software onto chips, may further cement the company's CPU leadership for years. Meanwhile, it's nearly all upside for Intel's mobile chip division, where the company holds minimal market share. Now that Intel has the production capacity for both computers and mobile devices, it doesn't need to choose one or the other.

Imagine the U.S. without computers. It's impossible, isn't it? Five years from now, that'll be true in even more places around the world. We believe Intel will remain profitably dominant in the meantime, so we're willing to increase our investment in it while it's down.

Why This Strategy?

The market's measure of expected volatility, the "VIX," is trading near its historical average of 20, meaning option prices are relatively low. This can be a good time to buy options, because if expected market volatility goes up, option prices can increase as well (even if stocks don't). Meanwhile, we're buying deep-in-the-money calls on Intel that have virtually no time value (meaning no extra cost above the stock price). So we're controlling shares of Intel for about half the capital outlay of buying stock (around $10 per share instead of $20) without paying a penalty to do so. This leaves more cash in the *Pro* portfolio, and if Intel shares gain 25% at some point (which we think is likely, given that our estimate of their intrinsic value is in the mid-$20s), our calls should gain 50%. Plus, we have a lot of time. These new LEAP options expire in January 2013, giving us two years and two months for Intel to appreciate.

The downside is that we'll miss Intel's 3.1% dividend yield (since the calls won't be paid the dividend), but 5% of our portfolio is already invested in Intel stock that does collect the dividend. And our $10 calls will have value in 2013 as long as Intel is above $10 (and it hasn't been below that price since 1996). We can turn the calls into shares at any point (especially if we want more time for the strategy). But for now at least, we plan to own just the calls in this case and (hopefully) enjoy significant capital appreciation on them as Intel's stock recovers.

How to Follow Along

Buying call options is a similar process to buying stock, except the command at many brokers is "buy to open." Buy one call option for every 100 shares of Intel you want exposure to. At recent prices, each call you purchase will cost $1,065 and represent $2,065 worth of Intel stock. The call will appreciate or depreciate with the stock, and may gain additional value if market volatility increases.

If Intel stock ...	Then January 2013 $10 calls on Intel ...
Gains 10%, to $22.50	Gain about 20%, to $12.50
Gains 22%, to $25	Gain about 40%, to $15
Gains 46%, to $30	Gain about 90%, to $20
Falls 26%, to $15	Fall 55%, to $5
Stays in a range and is ultimately unchanged	Do the same, and we can turn the calls to shares or sell by expiration

If you have questions, please visit our Intel board.

—Jeff Fischer

Write Puts on Contango Oil & Gas

Published Nov 1, 2010 at 12:00AM

Portfolio Manager's Corner: In researching natural gas companies, I kept returning to an unconventional leader, **Contango Oil & Gas** (NYSEMKT: MCF). Employing only eight people, outsourcing all of its exploration, and only paying contractors when gas is discovered, the company also has the cheapest known gas production costs in the industry and a deeply invested management. With this investment, we're seeking a way to profit if natural gas prices rebound — if that happens, this company will benefit directly, but it's also profitable today. The author of this report, *Motley Fool Special Ops* analyst Toby Shute, is a respected expert in the energy field, and his work brought Contango Oil & Gas to my attention. We're grateful that he agreed to be a guest here. Enjoy! *—Jeff Fischer*

At a Glance

- **Action:** Write (sell to open) January 2011 $55 puts. Both the options and the stock are thinly traded, so be sure to use a limit order.
- **Allocation:** 4% (for *Pro*, about nine contracts)
- **Option price (bid/ask):** $3.50/$4.70
- **Limit price:** Aim to split the bid/ask (in other words, somewhere between the two, but realistically closer to the low end)
- **Preferred stock buy price:** About $53
- **Fair Value Estimate:** $60 (will increase if natural gas prices rise)
- **Recent share price:** $52.90
- **Type of holding:** Energy/natural gas
- **Alternate trades:** Don't want to write puts? Buy shares with a strict limit order. The stock is thinly traded, so we're writing puts to try to net a buy price closer to $50 without driving the stock up in the process. If you buy shares instead, buy slowly in 1% increments and use limit orders. And if you only want to buy at an even lower price, write January 2011 $50 puts, recently about $2.
- **Why buy:**

- As the lowest-cost natural gas producer, Contango Oil & Gas profits even on today's low gas prices.
- Estimated reserves on hand are worth more than the company's market price, and *much* more if natural gas increases in price.
- This conservative company is debt-free and well managed.

The Big Picture

By Toby Shute (TMFSmashy)

Poor natural gas. While commodities like copper, gold, and coffee are zooming higher, this handy hydrocarbon fetches a seriously depressed price today. Recently priced on the spot market at $3.37 per million British thermal units (BTU), natural gas isn't trading at much of a premium to the industry's average cash cost of production. This suggests that the industry as a whole is not profitable today.

Contango's Ready for Its CAPShot

The company scores a scorching 10 out of 12 on its CAPShot, and 98% of the top CAPS players expect it to outperform. To hear more from the company, read "The Contango Story" (PDF).

A swift reduction in drilling would cut onshore gas supply and boost prices, but several factors have so far prevented this. First, many producers hedged their production early enough to lock in significantly higher prices. Second, vast swaths of acreage in places like the Haynesville shale needed to be drilled in order for producers to hold on to their leases. Third, a lot of foreign energy giants have partnered with smaller independents on these gas shale plays, and for these companies, learning how to exploit the deposits is at least as high a priority as turning a short-term profit. Finally, lots of producers are targeting "wet gas" or hybrid plays that also produce higher-value liquids. These plays offer strong profits even at very low natural gas prices.

Some of these factors should abate in the year ahead, but as with any prediction, it's unclear exactly when supply will roll over and gas prices will recover. For that reason, we need to choose an investment vehicle that allows us to be patient as we wait for this market's self-correcting mechanisms to kick in.

About a year ago, *Pro* looked to capitalize on the eventual rebound in natural gas prices via the **United States Natural Gas Fund** (NYSEMKT: UNG) ETF. That didn't work out, since the "contango," or upward-sloping curve, of futures prices ended up eroding the value of the fund as it rolled its contracts from month to month. Now, we're more interested in picking up a producer that can operate profitably today as well as offering exposure to higher prices down the road. To this end, the company we want to own is called — oddly enough — Contango Oil & Gas.

The Business

The average natural gas producer might be suffering today, but Contango isn't average in any sense. Among North American companies, it's the lowest-cost producer of natural gas that I'm aware of, with an all-in cost structure barely north of $2 per thousand cubic feet equivalent (mcfe) — about a third cheaper than the average company's cost.

This cost leadership didn't come about by accident. Rather, it directly flows from the operating philosophy of the company's CEO and chairman, Ken Peak, who founded the company with his life savings of $400,000 in 1999. By that time, Ken had already worked in the energy industry for 26 years and had learned all the ways that an exploration and production company can run itself into a ditch. Contango is structured to avoid these pitfalls, which generally stem from excessive costs, misaligned incentives, and perhaps the greatest danger of all, too much debt.

Exploration (or "finding") costs are kept low at Contango through partnerships with proven freelance prospect generators. These explorers are paid nothing up front; they only make money when Contango drills successful wells. The outsourcing of nonessential functions extends well beyond prospect generation — the company has just eight employees. That keeps general and administrative costs extremely low. Contango also carries no debt, so interest costs are negligible.

It should be fairly obvious that piling financial leverage (debt) on top of operating leverage (sensitivity to small changes in revenue) in a business as volatile as oil and gas production is not the greatest idea for a small company, but countless companies go down this path. They risk bankruptcy when commodity prices drop, whereas Contango is essentially bulletproof.

In addition to avoiding debt like the plague, Contango also seeks to minimize shareholder dilution. The company has actually repurchased a higher dollar value of shares than it has issued since inception. Contango's management and board of directors control approximately 22% of the stock, so their incentives are very well aligned with those of outside shareholders.

As an operator, Contango focuses on "wildcat" exploratory drilling in the shallow waters of the Gulf of Mexico. These are high-risk wells that cost about $15 million to drill, assuming failure (and failure is to be expected most of the time). Successful wells cost more to bring into production — and Contango has had some seriously successful wells.

Specifically, the Dutch and Mary Rose finds were the two largest discoveries on the Gulf of Mexico shelf in 15 years — combined, they were the largest in 25 years. With 10 of the company's 12 offshore wells producing from these fields, Dutch and Mary Rose account for the lion's share of the company's production and reserves. Contango is unlikely to find a field this size again, but this discovery underlines the talent of its partners in exploration.

In addition to its offshore focus, Contango has an onshore joint venture drilling low-risk wells. These tend to generate an unspectacular rate of return, but the operation is a way of putting cash to work that would otherwise earn close to 0% in Treasury bills. The company has also placed the occasional "side bet" on other ventures, including a liquid natural gas project and an early shale gas play. These returned 34 times and 8.6 times Contango's investment, respectively. Other investments in the past have been a bust, but they were small enough not to have a material impact on the company's financial well-being. Peak has proven to be a phenomenal allocator of risk capital.

Financials and Valuation

In its fiscal year that ended in June, Contango averaged a price of $5.74 per mcfe sold. Natural gas, which averaged $4.47 per mcfe, accounted for 76% of production. Oil and other liquids, while a much smaller component of production, kicked in more than 40% of revenue, so they're picking up the slack while natural gas slumps. By policy, the company doesn't hedge any of its production, so it keeps full exposure to any gains in natural gas prices.

Contango is currently producing at a rate of approximately 100 million cubic feet equivalent per day. Using last year's average, that translates to around $17.5 million in monthly revenue. After $3 million for production expenses and overhead, that leaves $14.5 million in monthly pre-tax cash flow, or $174 million annually.

Contango last reported approximately $60 million in net cash on hand. With an enterprise value of roughly $765 million, the business therefore trades for 4.4 times estimated pre-tax cash flow. That is cheap (bordering on stupid cheap!).

Another way of looking at Contango's valuation is to look at the PV10 number, which is the pre-tax present value of the company's reserves, discounted at 10%. Contango had 314 billion cubic feet equivalent (Bcfe) of proved reserves as of June 30, worth an estimated $970 million. That's at a price of roughly $4 per mcfe of gas and $76 per barrel of oil, so a rebound in gas prices would send this figure hurtling higher.

What Would Make Us Sell

Contango's Dutch and Mary Rose field is a killer asset that should be producing for the next 15 to 20 years. The field did have a downward reserve revision this year of 48.5 Bcfe, which is disappointing (though executives gave up some bonuses and stock options as a result, which is not). We don't expect further negative surprises, but if they arrive, we will have to question the reliability of Contango's reserves.

Contango's other great asset is its people. Peak's role at the helm is key to our thesis, and the continued engagement of the company's brilliant exploration partners is important as well. If any of these critical players packs it in, we're likely to follow suit. At age 65, Peak may well be looking to sell the company at an opportune moment over the next few years. (He already tried to do so in 2008, before the sharp decline in commodity prices derailed that plan.) A profitable sale of the company could be our most likely exit.

Why This Strategy?

Contango is lightly traded, with fewer than 100,000 shares trading on a typical day. For this reason, and to net a buy price closer to $50, *Pro* is suggesting you write (sell to open) January 2011 $55 puts, recently bidding $3.50 and asking $4.700. These options guarantee that we'll get shares in January unless the price (recently $52.90) increases to more than $55. If it does, we'll at least earn healthy option income of about 8% over the holding period, and we'll try this strategy again. Use a limit order on your options, and write one put for every 100 shares (worth $5,500) of Contango stock you want to buy.

Pro Bottom Line

Given its emissions profile relative to coal — the dominant source of electric power in this country — we think natural gas has a bright future in the decades ahead. Its sudden abundance is weighing on short-term prices but should encourage the industry and lawmakers to use natural gas as a bridge to even cleaner energy sources. Contango, an unhedged, low-cost producer, offers us a way to capitalize on higher gas prices down the road while we ride the coattails of one of the industry's best capital allocators.

To discuss the company, visit our new board.

The Motley Fool owns shares of Contango.

Pro Extra: First, Do No Blunder

Published Oct 27, 2010 at 12:00AM

Long before Greek financial negligence threatened the stability of the European Union, Greek moral prudence shaped the ethics of modern medicine. The concept behind the phrase *primum non nocere,* which translates to "first, do no harm," is thought to have originated in Greece in the fifth century B.C.E., and to this day, these are often the first words uttered by new physicians. That maxim, properly finance-ified, can do wonders for the health of your portfolio as well — so we're taking our stethoscope to the chest of our *Pro* portfolio to make sure we're not doing any harm.

"Primum Non Peccare"

Primum non peccare. Directly, this translates to "first, do no blunder"; Foolishly, it translates to "c'mon, just don't invest in blowups." In fact, it seems like one of the only aspects of investing that everyone can agree on:

"*Rule No. 1: Never lose money. Rule No. 2: Never forget rule No. 1.*"
—Warren Buffett

"'*Avoiding loss should be the primary goal of every investor.*"
—Seth Klarman

"*My basic advice is don't lose money.*"
—Jim Rogers

"*Don't focus on making money; focus on protecting what you have.*"
—Paul Tudor Jones

At *Motley Fool Pro,* we believe the best way to employ this rudimentary wisdom is to focus on accuracy and avoid big losses. And the math backs us up; an investment that loses 75% needs to return 300% to get back to even, while a loss of 20% needs to recover only 25%. The lesson is clear: Avoid blowups.

Identifying Blowups

When we analyze businesses for possible inclusion in our *Pro* portfolio, we spend a considerable amount of time assessing their prospects. We strive to add only companies with bright and stable futures, and we keep an eye on them to make sure our thesis remains sound. Sometimes, though, a company's financial statements begin to provide clues that all is not well. When our portfolio and watch-list companies start to display yellow flags, we are quick to step back and dig deep to figure out what's going on, so if a blowup is coming, we can step safely away.

One of our tools is noted value investor James Montier's "C-Score," which we like because it's easy to use, quick to administer, and statistically proven to be an effective tool for avoiding massive losses. The C-Score ("c" is for "cheating") captures the likelihood that a company is engaging in six common flavors of earnings manipulation. Because of the vagaries of GAAP accounting, a "fail" in any one test isn't necessarily damning; Montier advises being concerned only about companies that fail five or six of the pass/fail criteria. As you'll see, all but one of our *Pro* companies are well within these guidelines. (As for the one that isn't, appearances can be deceiving — we'll explain why we remain confident in that one, too.)

The Select Six

You don't have to be a CPA (or wear a trench coat and smoke a pipe!) to uncover financial shenanigans. Some basic arithmetic and a healthy dose of skepticism go a long way. Below are the six items Montier pinpointed, the ones we at *Pro* keep a close eye on to make sure a company's reported numbers match economic reality. The Foolish explanation of each in the third column should help debunk the belief that measuring earnings quality is akin to brain surgery.

Warning Sign	How We Measure It	What It Means
Increasing net income	Recent NI/CF vs. historical	Cash flow is harder to fudge than net income, and the two should be approximately equal over time. If we notice a

(NI) vs. cash flow (CF)	NI/CF	spike in NI relative to CF, we need to find the cause and make sure it's legitimate, not just loose accounting.
Increasing days sales outstanding (DSO)	Recent DSO vs. historical DSO	DSO measures how long it takes for a company to collect the sales it has booked. Rising DSO indicates that the company may be forcing sales and not demanding payment on normal terms. Remember, it's the cash collected that's available to spend — not the booked sales.
Increasing days sales of inventory (DSI)	Recent DSI vs. historical DSI	DSI tells us how long it'll take a company to clear out its inventory. It's like the produce in your fridge — the longer it's in there, the more likely it is that you'll have to throw it away. Rising DSI may indicate a slowing of sales.
Increasing other current assets (OCA) vs. total assets (TA)	Recent OCA/TA vs. historical OCA/TA	You've got a junk drawer, right? The OCA line item on a company's balance sheet is basically the CFO's equivalent of a junk drawer, where many a pesky item can be stashed. If the level of OCA/TA jumps substantially, we worry that something may be lurking inside that closed drawer.
Declining rate of depreciation	Recent depreciation rate vs. historical depreciation rate	Depreciation is an expense that represents past investments in physical plants and equipment. Managers have some leeway in determining how much of a previous investment is applicable in current periods. If this figure starts to plummet, we take note.
High total asset growth	Recent TA growth/sales growth vs. historical TA growth/sales growth	Two possible explanations for asset growth that outpaces sales growth are decreasing efficiency and earnings goosing by way of acquisitions. We don't like to see either one.

Checking *Pro*'s Blowout Preventer

So how does the *Pro* portfolio stack up? Pretty well, it turns out (and we'd expect nothing less!). Using the most up-to-date information filed with the Securities Exchange Commission, we found that only one *Pro* equity investment fails five or more of the yellow-flag tests. We had one perfect score, and more than 90% of our stock holdings failed three or fewer of the challenges. (Keep in mind that we excluded our investments in ETFs and focused solely on our 23 direct equity or options positions.) Two or three failures are very rarely enough to raise a yellow flag, and we remain confident in each *Pro* holding.

Number of Tests Failed	Number of Companies	% of Total
Zero	1	4.4%
One	6	26.1%
Two	7	30.4%
Three	7	30.4%
Four or more	2	8.7%

Studs and Duds

Leading the pack with a perfect score is **GrafTech International**. We weren't surprised at this result: GrafTech has one of the most forthright and honest management teams of any company we own, and it's no wonder this translates into lucid financial statements. In fact, most top C-Score performers have top-notch management.

On the other hand, **Plum Creek Timber** is the cellar dweller among our companies, failing all six tests. Given that, we felt justified in wondering whether Plum Creek is cooking the books. After looking deeper, though, we think the company's failing score is more reflective of a unique business than of fraud or financial chicanery.

Plum Creek makes money from its timberland assets in one of two ways: It sells wood from its trees, or it sells off the land. As illogical as it may seem at first glance, sometimes this means doing nothing. For example, if management finds sawlog and pulpwood prices to be unacceptably low, Plum Creek simply won't sell its wood. Along the same lines, if real estate prices are irrationally low in management's opinion, the company is just fine with sitting on its assets. Because of the long-term mindset and asset-management nature of Plum Creek's business, it's difficult to compare the company's results from quarter to quarter or even year to year — its business picture differs dramatically in each reporting period.

While we think cash flow is important (and we love the company's fat dividend), the value of Plum Creek is derived from its timberland assets, and we don't think that value is easily tracked via GAAP accounting. As a result, we aren't concerned with its DSO, DSI, or depreciation schedules. When we dig deep into the company's filings, we find that the cryptic "other assets" category is mostly made up of "assets held for sale." Given that this is a legitimate part of Plum Creek's business, we're comfortable that this category doesn't represent anything fishy either.

The Foolish Bottom Line

As Foolish investors, we have to remain objective. It's important to make sure we aren't explaining away yellow flags because we're in love with a company or a thesis. In the case of Plum Creek, we're fully aware of the business pressures it faces as a result of nonexistent new-home construction and low timber prices. But beneath the bark, everything checks out. We'd be more concerned if a company that produces high-tech products, such as **Intel**, had rising DSO, DSI, and assets — its products become obsolete and outdated much more quickly. But the value of Plum Creek's wood is still good in our view.

Yellow flags can turn red in a hurry. At *Pro*, we're always on the lookout to avoid costly blunders, and we aren't afraid to sell if need be. We guard against these situations with thorough investigation of a company's financial statements and careful assessment of its management before we make each recommendation, but even we may be fooled (lower-case "f") from time to time. With periodic checkups and sober judgments, though, we can make significant progress in our aim to *primum non peccare*.

Write Covered Calls on GlaxoSmithKline

Published Oct 27, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") January 2011 $41 calls
- **Allocation:** Write one call for every 100 shares of GlaxoSmithKline owned (for *Pro*, that's 14 contracts)
- **Recent share price:** $39.20
- **Option price (bid/ask):** $0.80/$0.90
- **Preferred limit price:** Aim to split the bid/ask, recently getting about $0.85
- **Special requirement:** You must own at least 100 shares to write a covered call.
- **Alternate trades:**
    - **Don't own 100 shares?** The stock remains a Buy with a 5% yield, and you can own it without covered calls on it, too.
    - **Don't own any shares?** Buy shares directly; or write December 2010 $39 puts; or write January 2011 $39 or $37.50 puts.

What's New?

When we originally purchased **GlaxoSmithKline** (NYSE: GSK) in December 2009, we didn't expect fireworks from the U.K.'s largest pharmaceutical company, especially given its beleaguered state. But we did expect a good margin of safety, a growing 5% dividend, and the possibility of writing options on the position to generate more income.

The company has delivered on two counts: The stock has ultimately stayed in a close price range despite several product setbacks, including the downfall of diabetes drug Avandia, and the dividend has been hiked higher. Regarding the third part of our strategy, however, we've yet to pursue option income — until now.

Quarterly results last week were flat, but management expects better days given Glaxo's resilience through recent hardships. With most large patent expirations now behind it, the company can focus on growing in emerging markets and developing new products for mature markets. But both initiatives will take time.

Why This Strategy?

We're maintaining our fair-value estimate in the upper $40s but are beginning to write covered calls to align with our income objective on this position. The stock just went ex-dividend, meaning current shareholders will be awarded the next dividend payment on Jan. 6, 2011. Therefore, our January covered calls will expire before the *next* ex-dividend event in late January. That means our shares are safe from an early, dividend-related exercise of the covered calls while we collect extra option income along the way.

We plan to manage these calls actively, though, rolling them if the stock is higher than our strike price by expiration. We don't want to let GlaxoSmithKline go at too cheap a price, and we should be able to avoid that and still make some money along the way.

Here are the potential outcomes:

If:	Then:	*Pro* 's Take:
Shares are greater than $41 at expiration ...	Our position would be called away at an effective sell price of around $41.85.	Assuming we still want to own the stock, we would roll our covered calls before expiration, keeping our shares.
Shares are less than $41 at expiration ...	We keep our shares, and the option payment becomes income.	Great. Ideally, we can do this several times in 2011 — and however long we own the shares.

How to Follow Along

For a refresher on covered calls, please see *Pro*'s guide to covered calls. Remember, you write one call for every 100 shares you own. You may cover all of your shares or just some — we're covering all of ours. Here are the numbers:

- **Trade:** Write ("sell to open") January 2011 $41 calls
- **Recent share price:** $39.20
- **Recent option bid/ask:** $0.80/$0.90
- **Option yield (at $0.85):** 2.1% of the share price (in 86 days)
- **Upside to our potential sell price ($41.85):** 6.7%

Since we view Glaxo primarily as an income position, we're willing to write lower-paying covered calls not too far from the current share price, with the intention of rolling the calls if need be. The point is to get extra income started here in case the stock continues to trade sideways. Only if Glaxo soars well beyond $41 by January will the strategy backfire by capping our upside, and we consider that scenario very unlikely.

Writing puts? If you place the alternate trade and write puts, you're obligated to buy shares of Glaxo if they decline below your strike price and you don't take follow-up action. Glaxo put options pay fairly well.

To discuss our Glaxo trade, please visit its board. —*Jeff Fischer*

Sell to Close Puts on Kinetic Concepts

Published Oct 26, 2010 at 12:00AM

At a Glance

- **Action:** Sell to close November $35 puts
- **Recent share price:** $38.55
- **Option price (bid/ask):** $0.25/$0.30
- **Limit price:** Aim to split the bid/ask, or set a limit at the market bid. The clock is ticking!

What's New?

As we noted in our last update, **Kinetic Concepts** (UNKNOWN: KCI.DL) had us spooked. The company had posted two weak quarters, and other U.S. medical-device companies had posted lackluster results recently as well, with hospitals in the U.S. and governments in Europe both looking to rein in spending. Some of our fears were realized when Kinetic reported its third-quarter results on Tuesday — revenue came in below expectations, barely higher than a year ago. But Kinetic's earnings per share pleased investors, thanks to higher profit margins. The company spent less than expected on research and development (a timing issue), enjoyed a lower tax rate thanks to more product sales in international markets, and took advantage of the weak U.S. currency when turning foreign sales back into dollars.

All this spelled relief for investors, who sent shares up more than 5% on Tuesday, to more than $38. Barring any shocks, this news renders our protective $35 November puts unnecessary, and even though they bid little, we're going to sell them to recapture the remaining value. Meanwhile, we're keeping our January 2011 $39 covered calls in place for now. We'll manage those just like any covered call, looking to roll up (to a higher strike price) or out (to a later expiration month) before the January expiration if needed to keep our shares and upside potential.

Why This Strategy?

We set up our protective collar (writing covered calls and buying puts) to buy ourselves insurance against an earnings disappointment for essentially no out-of-pocket costs. With the earnings news behind us, that insurance is no longer necessary, and our goal now is to capture as much of the remaining time value in our puts as is possible while maintaining our upside on the shares.

The first step is to sell to close the puts we own for their residual value. The second step will be to manage our covered calls. Since Kinetic Concepts remains a Buy, and we currently don't want to sell our shares at $39, we'll look to manage our calls as need be. If the stock remains below $39 by expiration, the covered calls will expire and the whole protective collar will end with a small profit. If KCI rises above $39 before expiration, we'll look to roll the calls.

How to Follow Along

Today, simply "sell to close" the puts that you had earlier *purchased* (not written). There's no need to do anything else. If you only bought one or two puts, make sure they're worth selling after commissions are taken into account. If not, then you can keep them as very cheap insurance against any shock to KCI over the coming month.

The protective collar has served its purpose. Now, we aim to unwind it one part at a time. Please post any questions on the Kinetic Concepts board. *—Jeff Fischer*

Fools for San Francisco

Published Oct 25, 2010 at 12:00AM

Getting to Know You

By Nick Crow (TMFCrow)

Let's face it: I'm not Jeff Fischer. And since *Pro* and *Duke Street* members are remarkably intelligent people, I knew they would immediately pick up on that fact when I took the stage at last weekend's member event in San Francisco. I figured there was a real risk of being booed offstage, but even though members had to hear from me and Todd instead of Jeff, not one piece of fruit was thrown. In fact, our members were absolutely spectacular — greeting us warmly, asking many intelligent questions, and even passing along their compliments. I was humbled that so many people were profiting along with us. Most members seemed to match our portfolio very closely, and every Duke Streeter I polled said that *Pro* was their favorite service. (Oh, hi, *Duke Street*, how you doin' over there?)

Live From San Fran ...

If you missed our member event in San Francisco, you can check out the PDF of the accompanying slides right here!

Earnings on Deck

- Today: **Plum Creek Timber**
- Tuesday: **Kinetic Concepts**
- Wednesday: **Procter & Gamble**
- Thursday: **GrafTech International**

Coverage & Community

- Bryan talks **Tupperware**here.
- Bruce sheds light on **GlaxoSmithKline**.
- Jeff discusses the **TradeStation** thesis and Todd analyzes costs.
- TMFEldrehad explains how accuracy ratings work in CAPS and why they're important, despite their imperfections.
- alex340 posts puts and calls that match *Pro* criteria.

For me, the most enjoyable part of the event was meeting our members and putting faces to screen names. The first members I met at our happy hour came from as far as Fairbanks, Alaska. That really put the pressure on — when people travel to hear from you, it's especially important to make that trip worthwhile.

We fully intend to have more member events in the future, but for those of you who couldn't make it to this one, let me run through the Foolish presentations:

After kicking off the event, *Duke Street* advisor Rich "I Like Big Moats" Greifner taught an awesome class on the sources of competitive advantage. With an abundance of wit and audience participation, he covered economies of scale, network effects, intellectual property, and switching costs. (**Autodesk**'s investor relations guy must have wished that this class had come *after* his presentation, because he later fumbled his answer to a member's question on competitive advantage. Fortunately, another member clued him in on the idea that, once a customer is trained on the company's software, Autodesk benefits from high switching costs.)

To kick off *Pro*'s portion of the agenda, Todd gave a presentation called "We're Defensive, Not Apocalyptic" describing *Pro*'s outlook for the economy. His argument hung on a headwind-and-tailwind framework. The headwinds — such as lingering high unemployment and continued problems in the housing market — have generally been well-covered by the media, but Todd gave even more insight into these ideas with excellent graphs and commentary.

Recent events have made everyone and their mother experts on macroeconomics (*Pro* members even more so than the average!), and audience members had fun trying to pick Todd apart, lobbing unanswerable questions like "Will the market go up or down?" and "Will we have inflation or deflation?" that I think were designed just to see how well Todd could dance. Always a show-stopper, Todd answered each of these queries with a detailed version of "it depends" that elucidated the complications of trying to forecast the un-forecast-able.

I was up next, and luckily for me, the audience turned out to be hungry for more education on options. In a presentation called "Why Use Options?," I explained four options strategies, illustrating them with companies familiar to *Pro* and *Options* members. Each strategy was designed to either buy stock lower, sell stock higher, earn income, hedge, or profit from leverage. The real highlight, at least for me (and hopefully for the members who asked questions!), was the robust question-and-answer period.

Million Dollar Portfolio lead advisor Ron Gross also joined us in San Fran, leading a discussion on portfolio construction. He offered a timely update on **Infinera**, whose shares had plunged 35% just a few days earlier. He assured investors that the market had overreacted and that this was a great *MDP* "Buy First" stock, but that it was not without risks. (And after a 35% drop in one day, was there any doubt?)

We had a wonderful time meeting members, and we're already hearing feedback that the members enjoyed it, too. Nothing is more gratifying than spending time with fellow *Pro* Fools — we hope to see you in the audience next time.

Intel and Autodesk Meetings

By Todd Wenning (TMFPhila)

In addition to spending time with *Pro* Fools in San Francisco, we also had the opportunity to meet with representatives from two of our portfolio companies, **Intel** and Autodesk. Together, these two represent more than $150,000 in market value for our portfolio, so suffice it to say that we were really looking forward to these meetings.

On Thursday morning, we headed over to Autodesk's beautiful downtown gallery, which shows off the many ways Autodesk software touches lives — from the buildings we live and work in to the cars we drive and the movies we watch. It was an impressive display, to say the least. Still, we tried not to let the enormous Lego dinosaur or the *Avatar* exhibit distract us from the business at hand.

The issue I most wanted to address in the meeting was software piracy, and to their credit, the Autodesk representatives we met were forthcoming about the issue, even describing a scavenger hunt they conducted in Bangkok, Thailand, to find the cheapest knock-off of AutoCAD they could find. (In 20 minutes, one guy found a $10 version of a $15,000 piece of their software.)

As alarming as that may sound, management believes that the dispersion of pirated versions of their software is actually helping them gain acceptance in emerging markets, much as it did for **Microsoft**'s Windows years ago. In addition, as nascent companies become legitimate, they also want legitimate software, and Autodesk works with them to transition from pirated versions to the real thing.

Both Intel and Autodesk gave presentations at our member event on Friday. (Much of what we heard from Autodesk on Thursday was repeated at the member event, so I won't cover it again here.) Just about everyone I spoke with after the meeting came away impressed with the Intel presentation — and impressive it certainly was. Among other things, the Intel representative showed how the company's processors were technologically one to two years ahead of competitors' chips and how embedding McAfee security directly into the silicon chip will vastly improve upon current security standards.

Our biggest question for Intel was why it effectively exited the mobile device business in 2006, only to work toward getting back in the game today. The representatives' response, in short, was that at the time, they didn't yet have enough production capability to efficiently manufacture tiny processors alongside the larger processors used in PCs and servers; today, on the other hand, they do. I'm sure there's some regret within the company that they didn't stick to mobile over this period; however, it does sound like they are better prepared to ramp up production today.

Overall, the two meetings confirmed our current strategies regarding both companies. Intel, with its strong competitive advantages, massive cash-flow generation, and healthy 3.2% dividend, deserves to be a cornerstone of our portfolio, while Autodesk — though it's technologically astounding — is best left as a hold in combination with a covered-call strategy.

Bring your questions and comments to the Memo Musings discussion board.

Todd owns shares of Microsoft, TradeStation, and Kinetic Concepts. The Fool owns shares of Infinera and Microsoft.

If You Didn't Go to San Francisco ...

Published Oct 25, 2010 at 12:00AM

... Be sure to put some PDFs on your screen. Actually, even if you *did* join us at our member event in San Francisco on Oct. 21 and 22, you might want to take a look at this PDF of the slides that accompanied our presentations. Enjoy!

Set Up a Protective Collar on Kinetic Concepts

Published Oct 21, 2010 at 12:00AM

At a Glance

- **Actions:** Write January 2011 $39 calls; buy November 2010 $35 puts
- **How many contracts?** Buy enough puts to protect all of your Kinetic shares, then write an equal number of calls. For *Pro*, that is 18 puts and 18 calls.
- **Recent share price:** $36.57
- **Option prices (bid/ask):**
  - **January 2011 $39 calls:** $1.15/$1.30
  - **November 2010 $35 puts:** $0.80/$0.95
- **Limit price:** Use limit orders at or near the current market prices. Because we'll earn more for writing the January calls than we'll pay for the November puts, this protective collar should result in a small net credit.
- **Alternate trades:**
  - **Don't own 100 shares?** Strap in and sit tight. Kinetic is still a value, rated Buy.
  - **Don't want to partake in both parts of this trade?** You can choose just one or the other — either write the covered calls for a small price cushion, or buy the puts for protection. You could do neither and just continue to hold your shares. Or you could protect just some shares.

What's New?

Halloween is just around the corner, but it's **Kinetic Concepts** (UNKNOWN: KCI.DL) that has us a bit spooked. Although not blood-curdlingly horrible, the company's past two quarters were less than stellar. Management blamed hospital and government austerity measures, price competition in Europe, and poor currency exchange rates, among other factors, and the weak performance drove the company to modestly lower full-year sales and earnings guidance in July. We wonder if that will be the last time we see a warning flag.

Too often, one quarter's disappointment can lead to another. Kinetic is set to announce third-quarter reports before the stock market opens on Oct. 26; investors are already sensitive to bad news thanks to the recent adverse patent ruling, and a third earnings whiff in a row would leave Kinetic wounded, so we want to protect our shares just in case. We recommend protecting the downside on your shares of Kinetic by establishing a protective collar.

Why This Strategy?

There are two parts to establishing a protective collar. To protect ourselves on the downside, we purchase put options. And because we're cheap, we then write covered calls with a longer expiration and higher strike price, which bring us income to pay for our puts. In other words, we protect our downside and retain access to more upside. This is no trick; it's nearly all treat.

We're choosing to write covered calls that expire in a few months so we can ensure the premium will be sufficient to finance the purchase of protective puts. The puts, meanwhile, expire in just a month — long enough for the market to digest Kinetic's earnings and come to grips with the recent court ruling.

If ...	Then ...	*Pro* 's Take
Shares are below $35 at the November put expiration	Our puts will have value, offsetting a decline below $35 in the stock.	Since we're taking away the cost of the puts (by writing calls), any value they have is upside. If Kinetic falls, we're protected below $35.
Shares are above $35 at the November put expiration	If we still own them, the puts will expire without value.	Our covered calls paid for the puts, so this is fine — we have no net loss. Our attention would then be on our covered calls.
Shares move above $39 before the January call expiration	Our covered calls will be in a position to make us sell our shares.	We'll consider rolling or closing our covered calls if we want to keep our stock.

The main risk to our strategy will appear if Kinetic's stock moves higher than $39; at that point, we'll start to miss out on upside. It's unlikely we'll want to sell at $39 if the business remains healthy, so if the stock does exceed $39, we'll look to roll our covered calls or close them out. How likely is that outcome? The currency situation has improved since management's last comments, with the euro recovering lost ground, but other than that, it seems unlikely Kinetic will surprise strongly to the upside this quarter. As always, though, you never know!

How to Follow Along

It doesn't matter whether you write the covered calls or buy the puts first, but *please* use a limit order for each trade. Cover all of your Kinetic shares by purchasing puts, and write an equal number of calls. Use a limit price near the current bid (to write calls) and ask (to buy puts) — or try splitting the bid/ask.

Trades

- **Write ("sell to open") January 2011 $39 calls, recent bid/ask:** $1.15/$1.30
- **Buy ("buy to open") November 2010 $35 puts, recent bid/ask:** $0.80/$0.95
- **Amount**: Purchase one put for each 100 shares of Kinetic you own, and write an equal number of call options.

If Kinetic's stock price disappoints and falls to $33, for example, our $35 puts will be worth $2 per share, covering most of the stock's drop. On the other hand, if it jumps to $40, we'll need to take follow-up action on our written calls to keep our shares.

This is our first protective collar, so read up on the strategy if you need a refresher, and please post any questions on the Kinetic Concepts board.

—Jeff Fischer

Go-To Resources From the Pro Team

Published Oct 20, 2010 at 12:00AM

Updated Feb. 1, 2012

Dear *Pro* Fool,

We've put together this list of resources to serve as an overview of the content available on the *Pro* site and as an easy reference guide you can use anytime you find yourself feeling stuck. (Of course, if you're just hungry to know everything there is to know about *Pro*, it can help with that, too.) To share suggestions or let us know what you think, please visit the Member Suggestions & Help discussion board.

Onward!

A Brief Overview

Here's what you'll find on the *Pro* site:

- **Home :** Start here to get a roundup of anything new on the site. The "carousel" at the top will feature the content we think is most important to share with you, and you can always find our latest memos, features, and alerts using the tabs below it.
- **Recommendations :** View our portfolios and find out how our stocks, ETFs, and options are performing; get transaction details; and see Buy First, Buy, Hold, and Sell guidance at a glance.
- **Alerts & Coverage :** See the very latest alerts, Monday Memos, and other features, and access the full archives of each. (Of course, we'll email you anytime there's an exciting new feature to share.)
- **Community :** Our discussion boards are home to investors of all levels, from beginner to expert. *Pro* Fools come here to talk stocks, share advice, and have fun.
- **My Scorecard :** Use this customized tracking tool to see how your stocks are doing and access analysis of your favorite companies.

You'll also receive email from us. Here's what to expect in your inbox (you can customize your email settings here):

- **"Trade Alert" emails:** We announce all of our trades *before* we pull the trigger so you can act before we do. We send these alerts at any time during normal market hours. Trades always come with a full report that explains our thinking. After we announce a trade, we wait one to 30 days to make the trades for the *Pro* portfolio.
- **Monday Memos:** Stay on top of *Pro* happenings — every Monday at 4 p.m. ET, we'll send you stock news, market insights, community highlights, and more.
- **Guides, Audio Extras, special updates:** Become a better investor! Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio.

Our Mission and Philosophy

Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to meaningfully increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years. The *Pro* team (meet Jeff and the gang here) is accomplishing this by investing $1 million of the Fool's real money.

Our North Star

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward. ***Pro*'s North Star = inflation (as measured by the Consumer Price Index) + 7% annually.** Click here for much more on our North Star.

More on Our Mission

- 5 *Pro* Resolutions for 2012 (Monday Memo, 1/3/12)
- 5 *Pro* Resolutions for 2011 (Monday Memo, 1/3/11)
- Reigniting Our Mission (Monday Memo, 11/15/10)

More on Our Philosophy

- Audio Extra: The *Pro* Philosophy (9/30/11)
- The Motley Fool *Pro* Strategy Guide (9/29/11)
- Buy First, Buy, Hold and Sell, an explanation of our guidance (2/10/09)
- The *Pro* Philosophy & Strategy discussion board

Investing With Us

Before you begin investing with *Pro*, we recommend you take a look at our "Making*Pro*Fit You" guide. Whether you're fully invested elsewhere, investing in an IRA, unable to secure complex options permission from your broker, or completely "free-range" (or some combination of the above!), we've got specialized tips on making the service work for you.

Once you've done that, check out our latest Ketchup Report, which gives you an at-a-glance overview of the team's current thinking on our Buy First and Buy stocks. (Our guidance, including the Buy and Buy First terminology, is explained here.) After reviewing both of those reports, you should be ready to start building positions in our Buys and Buy Firsts — but (as the Ketchup Report notes) please remember it's not a race. Take your time, and buy at a pace that works for you.

More on Investing With Us

- Hedging the *Pro* Way (11/7/11)
- *Pro* on Investing Today (9/23/11)
- *Pro*'s Guide to Bonds (1/27/09)
- *Pro*'s Guide to Selling (2/19/09)
- The ABCs of ETFs (10/15/08; updated 6/19/09)
- The *Pro* discussion boards (one for every recommendation we've ever made)

Getting Started: Options

A big part of *Pro*'s investment approach involves the use of options to boost profits, smooth out volatility, and maintain our valuation discipline. If you're new to the world of options, we recommend you check out the list of resources in our "Get Up to Speed With Options" feature.

Your *Pro* subscription also includes free membership to our sister service, *Motley Fool Options*. That service's Options U. content (shepherded by Prof. 42 — you might know him as Bryan Hinmon, or TMF42, on the *Pro* team) has everything you need to master the use of options, no matter where you're starting from.

If at any point you're confused about terminology, our Options Glossary and the Options Glossary wiki section can help.

More on Options

- *Pro* 's Complete Options Guides (8/18/10)
- Taxes and Options (12/15/09)
- Video Extra: Options in 3 Steps (5/22/09)

Getting Started: The Community

We may be a tad biased, but we genuinely think the *Pro* community is among the best in Fooldom (if not the Internet in general). *Pro* Fools are knowledgeable, kind, intelligent, thoughtful, and helpful, and our discussion boards are the place to get to know them. Introduce yourself on the Meet & Greet board, get support as you get up to speed on the Getting Started board, and talk about anything and everything on the Social Banter board.

We've also got a new *Pro* wiki for you to explore (and contribute to!). It's a work in progress, but we hope you find it useful.

Fool on — and again, if you have suggestions or comments, bring them to our Member Suggestions & Help discussion board!

Buy Sprott Physical Gold Trust

Published Oct 19, 2010 at 12:00AM

At a Glance

Portfolio Manager's Corner: We've owned silver in the past here at *Pro*, so we're no strangers to the value of holding precious commodities. The granddaddy of shiny metals, gold — which is as divisive an investment as any — will serve the portfolio as a kind of "short sale" on government policies. If currencies continue to lose value because of debt and inflationary policies, then gold should appreciate. On the other hand, if investors regain confidence in major currencies, then gold will likely stagnate or decline — but our stocks will gain value. It's best to view gold as another form of currency: a place to put some cash to protect against dollar devaluation. Gold also hedges our new **TradeStation Group** (NASDAQ: TRAD) stock. If interest rates decline, TradeStation will suffer, but gold should gain value, and vice versa. Enjoy Andrew Sullivan's first *Pro* report, and then join in the discussion on the board. *—Jeff Fischer*

- **Action:** Bought 3%
- **Preferred buy price:** Around $12 or lower, and around a 4% premium or lower to net asset value (found here)
- **Type of holding:** Insurance/defensive
- **Why buy:**
  - Protect capital from currency devaluation
  - Hedge against inflation
  - Diversify with a commodity that doesn't always correlate to market indexes

The Big Picture

By Andrew Sullivan, CFA

Gold is the classical music of finance: Modern thinkers often consider it boring and out of date, but its intrinsic beauty never goes away. Assets like stocks, bonds, and mortgages usually outperform gold, it's true, but the precious metal always has value. And it does outperform other investments at times — in fact, it has done just that for the past decade. If you're seeking full diversification and stability against economic hardship, gold can have a place in your portfolio.

Gold protects against the decline of the dollar and inflation, both of which appear likely, if not inevitable. A decline in the dollar's buying power is particularly probable; a weak dollar is stated Treasury Department policy, and our national budget and trade deficits will likely lend heft to such a decline. Meanwhile, the Federal Reserve is so scared of deflation that it actually wants inflation, something that's rarely happened before. The Fed is aiming for estimated annualized inflation of 1% to 2%, and it has the tools to make this happen. America's money supply is not tied to a fixed quantity of gold or silver, and this kind of system tends to be highly inflationary.

Unlike paper currency, gold bullion is ideal for protection against economic collapse — and as a currency in its own right. Its "hard" money characteristics are one reason why we wouldn't be surprised to see the return of gold-backed currencies in the future, especially if confidence wanes in key currencies like the U.S. dollar, the British pound, and the euro. Fortunately, as investors, we can own gold directly — and cheaply — through the **Sprott Physical Gold Trust** (NYSEMKT: PHYS) fund.

Our Vehicle

There are many ways to invest in gold, including the physical material itself, mining companies, mutual funds, and exchange-traded funds. The most attractive and direct option is simple physical gold, and luckily, there's a vehicle that makes such an investment easy: Sprott Physical Gold Trust, a closed-end fund that invests almost all of its assets in gold bullion. That bullion is stored at the Royal Canadian Mint, and the fund's shares trade on the New York Stock Exchange.

How It Works

Sprott is a trust but is similar to a closed-end fund in that its units trade on an exchange. Shares can therefore trade above or below net asset value (NAV). Since Feb. 25, the premium has ranged from 0% to 24%. Unlike most closed-end funds, the trust has the ability to offer new units, but we expect these offerings won't meaningfully dilute existing holders. Learn more about Sprott on its website.

Sprott's trading on an exchange is certainly convenient, but it also means its price can rise above or below its net asset value (NAV), suggesting it might not track gold perfectly. We're not worried, though; since its inception in February, its premium to NAV has ranged from 0% to 24%, with an average of 8% to 13%. At $12, you're buying at about a 4% premium, well below the average. We have more upside than downside here; it's unlikely that the premium would go much lower before opportunistic buyers stepped in. In addition, a slight premium seems fair given that transaction costs with a gold dealer would be at least 4%.

It's also possible that this investment might not track gold perfectly because of expenses and fees. But it's important to note these costs are low compared with the cost of a safe-deposit box, for example, or of insurance if you own gold at home. Annual expenses and fees at Sprott are only 0.65%, even lower than those of the popular **SPDR Gold Trust** (NYSEMKT: GLD) ETF.

We've chosen Sprott over well-known exchange-traded funds (ETFs) like the SPDR Gold Trust and **iShares Gold Trust** (NYSEMKT: IAU) for three reasons. First, the tax rate on the sale of those ETFs is 28%, compared with a potential 15% for Sprott (see below). Second, individual investors are able to withdraw actual gold from Sprott, unlike the SPDR and iShares offerings. Third, we judge counterparty risk to be much higher with the others. (That means that when push comes to shove — if there's a run on gold, for example, or a global currency collapse — if you own the SPDR Gold Trust or iShares COMEX Gold Trust, you might not have claim to as much physical gold as you think.)

As mentioned, there's a potential tax benefit with Sprott: If you make a Qualified Election Fund (QEF) election and hold them for more than a year, your Sprott units may be taxed at 15%, rather than the 28% rate that applies to gold bullion. (The trust is based in Canada, and Canadian withholding taxes may apply to distributions, if any. See here for more details, and consult a tax advisor if necessary.)

Valuation

A good way to measure the relationship between gold and the dollar is to divide the market value of the United States' gold reserves (currently 8,133.5 tons) by the money supply — the total number of dollars in circulation. A higher percentage suggests high uncertainty (and fear). This index usually hovers in a range of 2% to 4% but has reached a high of 12% in the past (1980). Today, even after gold's steady rise to more than $1,300 per ounce, it stands at just 4%. In other words, we are nowhere near prior highs, because the increase in the price of gold (the numerator) has been more than outmatched by a record high increase in the money supply (the denominator).

Beloved for Centuries

In ancient Egypt, gold was used primarily for religious purposes, as a divine symbol of the sun. It was first used as currency in modern-day Turkey by King Croesus of Lydia in the 6th century B.C.

We also need to remember that the "record high prices" we're reading about are misleading, because gold's former high of $850 in 1980 isn't adjusted for inflation. That number would be close to $7,000 in today's dollars when using the original consumer price index (CPI) methodology and about $2,200 when using revised methodologies. In other words, we aren't even close to the inflation-adjusted highs we reached in 1980 — we're 70% below them. All that aside, history is on the side of gold. Currencies come and go, and debt-laden governments are backed into a corner today with record deficits. As long as that remains the case, gold could slowly rise as a store of value. We'll have plenty more to say on gold's price on Sprott's discussion board.

What Would Make Us Sell

Gold is a speculative investment; it offers no yield and no guarantee of its future selling price. You should view it the same way you'd view owning any hard currency. Don't confuse gold with an investment *per se*; instead, think of it as a place to hold wealth until you're ready to invest in something else. In that sense, holding gold is like holding cash — except hopefully much better, since cash is being devalued. Also, remember that ownership of a strong business is better than gold, because high-quality equities should increase in price with inflation — that's why *Pro* urges you to maintain a diversified, equity-based portfolio alongside your gold holdings.

Our risks include:

- Timing (gold prices could fall or stagnate for years)
- Interest-rate hikes, which we expect will come eventually and which will make gold less attractive compared with dollars
- Increased gold scrap-metal supply bringing more gold onto the market
- Government confiscation or taxation of gold
- A possible collapse in prices (a possibility with any commodity bull market)
- Underperformance in a crisis (gold declined along with stocks in 2008, for example)

We would likely recommend that you sell your shares if fear or uncertainty builds into a crescendo over several quarters or years, sending gold much higher. Or we may advise you to sell if world economies and currencies stabilize and gold thus seems less necessary as a hedge. Finally, we may suggest you cap your losses if gold falls more than 20%. A 20% loss on a 3% position would ding the portfolio 0.6% overall. We'll keep our eye on potential inflation, the state of currency, central banks' actions, and mining supply.

Pro Bottom Line

The Community's Take

Sprott Physical Gold Trust scores four stars out of five on CAPS, with 46 of 50 All-Star members expecting outperformance. To learn still more about Sprott, visit its website.

We're recommending gold to protect some of our dollars against inflation and currency depreciation; it can also serve as insurance against another financial crisis. On an inflation-adjusted basis, gold isn't anywhere close to its historical highs, and yet currency risks are probably greater today than at any time in recent history, and the monetary supply continues to rise. All this makes us confident that this is still a logical time to shift some wealth away from paper and into gold.

To discuss Sprott Physical Gold Trust, please visit its discussion board.

New Investment Ideas Headed Your Way

Published Oct 18, 2010 at 12:00AM

As we shared with you in September, the *Pro* team added three new analysts in recent months in order to better serve the growing service and our growing portfolio. All of us — new analysts and old-timers alike — are excited about making *Pro* better, stronger, and more robust, and we've spent a lot of time figuring out how we can best work together to achieve that end.

I've been investing the *Pro* way for several years, so I'm comfortable with how well this full-portfolio solution works over time. Now, every analyst on the team brings something different that we can incorporate — and this means a wider range of individual strengths dedicated to bringing high-quality investment ideas to you and to the *Pro* portfolio. Of course, every step of the way, we're focused on staying true to our mission of earning steady returns with reasonable risk and high accuracy.

Guidance Changes

- **Tupperware** moves to Hold on valuation.

Visiting *Pro* Companies

- Todd Wenning and Nick Crow head to California this week, where they'll meet some Fool members — and visit with execs from **Autodesk** and **Intel**. We look forward to their report!

Earnings on Deck

- Oct. 21: Tupperware and **TradeStation Group**
- Oct. 23: **GlaxoSmithKline** and **Caterpillar**

Coverage & Community

- We summarized **Intel**'s Q3 conference call and results. The stock is in the doghouse — but is it deserved?
- It's getting busy. TMFValuemoosie posted an earnings calendar for past and present *Pro* stocks.
- Alex340 posted interesting put writing opportunities and covered call possibilities on *Pro* stocks.
- TMFEldrehad moves up to the No. 2 ranking across all of CAPS! And other stars appear, too.

"Be a Fool" Contest Update: New Deadline

Still interested in winning a free trip to Fool HQ? Good news! We're extending the deadline on our "So You Want to Be a Fool" contest to Oct. 28. Submit a writeup on a stock not on our scorecard for a chance to win an all-expenses-paid trip to our *Million Dollar Portfolio* member event in December. See the revised rules here!

People sometimes whisper that I know every industry inside and out, that I can read a company's return on equity in its CEO's eyes, and that I never sleep. Well, those rumors — while flattering — aren't actually true: There are industries and investments I don't follow or know well. But now there's an even better chance someone at *Pro* may know them front to back, providing us with a clear avenue into new areas. That means broader diversification, more coverage, and the ability to cash in on opportunities that we might otherwise miss. Plus, our ideas are stronger and our theses more solid because of the additional perspective each analyst brings.

After the secret *Pro* initiation ceremony (involving candles, a cliff ledge, and a hair clipping from Warren Buffett), I asked each (surviving) new analyst to share his absolute strongest investment idea. These are smart guys, so they will have many great suggestions through the months — and I want to hear the ones they are *most* passionate about right now. They're working on just that, and in each case, if the idea passes muster and there's a sensible place for it in the portfolio, then we'll work to move forward with it and get it issued to you. Of course, not every idea will pass the test, but if an analyst fights hard to recommend something he strongly believes members should own (or short), he will naturally have every chance to be heard. That's why he's on the team. When it's for *Pro*'s benefit, a strong argument may put us into ideas we wouldn't have otherwise considered.

Where the Ideas Are

The first of these new ideas will roll out to you soon, with a new trade alert from Andrew Sullivan (TMFRedwood). This is just the start of the research and recommendations to come as Nick Crow (TMFCrow), Bryan Hinmon (TMF42), and Andrew work to put their stamp on the *Pro* portfolio.

You should know that Bryan has already brought **Bristow Group** and **Broadridge Financial Services** into the *Pro* fold. (Both are solid companies that just happen to start with “Br,” just like “Bryan” … coincidence?) Over the last two years, too, Todd Wenning (TMFPhila) suggested many of *Pro*'s featured companies, from **Kinetic Concepts** to **Lindsay** to **Plum Creek Timber** and others. Our Australian correspondent, Bruce Jackson (TMFGoogly), brought us **GlaxoSmithKline** and **Medtronic**. (Often, I'll add options strategies to the stock ideas presented.) All that said, a majority of our holdings (some 60% — or 23 of our 39 tickers) have been my sole original brainchild (or mistake!). And now that our team has grown, I should have even more time to add original ideas.

Finding new ideas and strategies is one of the things I enjoy most about investing. (The other is the *Pro* community, and I hope this larger team will give me more opportunity to talk with you on the discussion boards.) Selfishly, I want the best ideas in the portfolio to be my own, and the new *Pro* analysts want the same for theirs. This is the kind of healthy competition that's mutually beneficial for all of us, and for you as a member. Still, we'll always require that every recommendation we issue makes sense in a portfolio context; serves a need among our holdings; and matches our mission and philosophy at least 95% of the time. (Sometimes we may deviate for special situations — *Pro* can, and should, remain open to anything. But we expect those to be few and far between.)

Working Together to Prosper

To sum up, *Pro* remains a cohesive service with a single portfolio manager, and our growing pool of talented analysts is widening our landscape. This promises to make the service stronger, more diverse, and more nimble. Meanwhile, the team and I always need to keep a close eye on the macro events going on in the world. We need to keep up on whether we want the portfolio to stay mostly long, as opposed to going much more short; to be clear on when to sell stocks and which ones; to know when to do more hedging; and so on — the same research we've always done, but with even more minds behind it. (For the record, since 2009, it has paid to be mostly long, as we have been.)

Enjoy the new investment recommendations we'll be sending your way soon! And remember to stay diversified. Aim to match the *Pro* portfolio as well as you can, since we diversify for a reason.

To discuss the Memo, please visit the Memo Musings board.

Foolishly,

Jeff Fischer

Jeff owns shares of GlaxoSmithKline.

Roll Your Covered Strangle on Papa John's Pizza

Published Oct 14, 2010 at 12:00AM

At a Glance

Written by Nick Crow

- **Actions:** Buy back ("buy to close") your original October 2010 $25 calls. Using a strangle order, write ("sell to open") April 2011 $25 puts, and write ("sell to open") April 2011 $27 covered calls. (We also wrote $22.50 October 2010 puts as part of our original covered strangle, but we are leaving those alone because we expect them to expire worthless. See below for more details.)
- **Recent share price:** $26.90
- **Allocation:** We are covering all of our shares in Papa John's, about half of our targeted 5% allocation, and we're writing puts to potentially buy the other half.

Got Questions?

Please visit our guide to strangles for more on the strategy, and feel free to ask away on the Papa John's or All About Options discussion boards!

- **Alternate trades:**
  - **If you don't own Papa John's:** We suggest writing one leg of this strangle, the April $25 puts, and aiming for a payment of $1.20 per share or more.
  - **If you own at least 100 shares but don't want to buy more:** You can just write the covered-call side of the strangle, which will bring you income.
  - **If you don't want the obligation of holding two sets of puts on Friday, Oct. 15:** Either buy back ("buy to close") both legs of your original strangle first, or just close the covered-call leg, let the puts expire, and wait until Monday, Oct. 18, to reestablish the covered strangle.

What's New

When we first bought shares of **Papa John's International** (NASDAQ: PZZA) in August, we set up a covered strangle. As we explained at the time, this strategy entails buying the stock itself, writing puts to potentially buy more shares cheaper, and writing covered calls to potentially sell our existing stock higher. The shares have appreciated nearly 13% since we bought them, quickly outpacing the market. While this is a welcome outcome (though it's too short-term to warrant excessive celebration), there's a downside as well: We're now at risk of losing our shares, because they're currently trading above our written calls' strike price. Since we like the slow and steady nature of this pizza purveyor, we think we can capture more upside by rolling our calls and keeping our shares.

Pro member thinkingman99 recently posted a poll on the *Pro* discussion boards asking what members thought we'd do, and about 90% of those who responded said they expected us to allow our shares to be called away at the end of this week. It's nice that we're still able to surprise some of you more than two years into this journey!

Why This Strategy?

Rolling the covered strangle is a low-risk way to continue to earn income on Papa John's, a company that just recently joined the *Pro* portfolio. We'd rather not let our calls be exercised at the $25 strike price, because we can roll our covered strangle (in other words, renew our current strategy) for a $2.80 credit. The resulting new covered strangle offers us $29.80 as a potential net sell price, 13.7% better than the original $26.20, and is at the top of our conservative valuation range.

The Math	The Numbers
Payment received for writing October $22.50/$25 strangle	$1.20
Cost to "buy to close" October $25 calls	($2.00)
Net cost to close October calls	**($0.80)**
Payment received for writing April 2011 $25/$27 strangle	$3.60
Total net credit from "rolling up"	**$2.80**
New net sell price if called	$29.80
Original net sell price if called	$26.20
Return from "rolling up" (excluding commissions)	**13.7%**

How to Follow Along

We recommend that you:

- **Buy back ("buy to close") the October 2010 $25 calls for around $2.** (You can leave your October 2010 $22.50 puts alone; we expect those to expire worthless this Saturday.)
- Then, using a strangle order, **write ("sell to open") April 2011 $25 puts, and write ("sell to open") April 2011 $27 covered calls.**

Remember: To write a covered strangle, you must own at least 100 shares of the stock, and you should be happy to buy at least 100 more at a lower price. In this case, write one covered call for every 100 shares of Papa John's you own, and write one put for every 100 additional shares you would be willing to buy.

Trade Details

- **Use limit orders:** These bid/ask spreads are wide, so aim for execution around the midpoint of each.
- **Recent options bid/ask (as of Oct. 14):**
  - Sell to open April 2011 $25 puts, $1.30/$1.70
  - Sell to open April 2011 $27 calls, $2.15/$2.45
- **Combined credit target:** $3.60 or so per share, net credit (use a strangle order)
- **Effective options yield:** 13.4% of recent share price ($26.90) in six months; half that on the full potential purchase
- **Potential net buy price of new shares:** $22.20 (17% below current price)
- **Potential net sell price on our current shares:** $29.80 (10.8% above current price)

Keep in mind that anytime you write puts, your broker sets cash or equity aside to cover your potential stock purchase. In this case, these $25 puts pay a 5.6% yield on cash set aside over the next six months. If Papa John's stock is between $25 and $27 on expiration, both options will expire for the full cash gain, allowing us to renew this strategy once again.

Questions? Please visit the Papa John's discussion board!

Video Extra: Controlling Emotions in a Rocky Market

Published Oct 12, 2010 at 12:00AM

Jeff Fischer talks to the Fool's Erin Corr about the rewards of remaining calm when the market is anything but.

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4 Tips for Investing Success

Published Oct 11, 2010 at 12:00AM

When it comes to knowing our companies well and keeping up with each, we have you covered. Our recent Thesis Review is just one small part of the steady work we do to ensure we know our investments inside and out — and to share that knowledge with you.

But while knowledge is undeniably important, there's *another* side to investing that you need to master: your emotions. How you think about investing drives your approach to the subject, which feeds your investing behavior, which in turn brings you success or failure. So it's important that you have a level head as you make your way through your investing career. The following tips will help you keep calm, whatever the market throws at you.

Options Expirations

- Oct. 16: **Papa John's International** covered strangle. We plan to let it be exercised but will of course alert you if this changes before Friday.

Earnings Ahead

- Oct. 12: **Intel**
- Oct. 19: **Tupperware**
- Oct. 21: **GlaxoSmithKline** and **Caterpillar**

Community & Coverage

- Read our summary of **Oracle**'s recent record-strong quarter.
- Alex340 posted puts that meet Pro guidelines and calls that do, too.
- BrokeInTheBurgh makes his 500th board post both epic and educational.
- Bryan (TMF42) follows up on TPap's live chat question about the management pay structure at **Ebix**.
- Todd (TMFPhila) waxes macro.
- Russell (TMFEldrehad) revisits "Stocks in the Doghouse" on CAPS — and the big gainers you can find there.

Tip No. 1: Diversify

Being diversified is the only way to achieve success over the years. Owning various sectors and assets ensures you'll have exposure to any that do well — and at various times, most of them eventually will; you just don't know when. Nearly as important, diversification gives you peace of mind. If your portfolio is too concentrated, volatility can shake your confidence at the worst times. To that end, the *Pro* portfolio is made to work as a whole; you should own as many of its positions as you can. For proper diversification, we suggest owning at least 12 stocks across various industries, as well as some stock-based ETFs. Once you own more than a few dozen stocks or so, the benefits of diversification can start to diminish.

Tip No. 2: Accept Losses

You should diversify because you never know which positions will do well and which won't. You will always have losers when you're investing in stocks; what's most important is how your portfolio performs overall, despite those losses. Peter Lynch said, "In this business, if you're good, you're right six times out of 10," suggesting that 40% of your investments will lose money. Don't beat yourself up about that; it's just part of investing. Focus on how your portfolio does as a whole, learn what you can from your losers, and move forward happily when you have profits overall. The bottom line is that losses are an inevitable part of the landscape. You can't keep them from happening; you can only control your reaction when they do.

Tip No. 3: Have a Three- to Five-Year Time Frame

Any time you buy a stock or stock-based ETF, be thinking in terms of at least three to five years. You may not end up actually holding the investment that long, but every step along the way, you should be thinking, "Is this something I want to own in the next three to five years?" If you lack a meaningful time frame, you're gambling on short-term outcomes that you can't control. The longer you give a healthy business to perform, the more "control" you have over the outcome.

Tip No. 4: Follow the 20% Rule

When I worked with Tom Jacobs, now the advisor for *Motley Fool Special Ops*, I heard this rule from him. He in turn had heard it from former hedge-fund manager (and returning Fool) Matthew Richey, and it was originally put forth by Bernard Baruch: You'll rarely buy or sell a stock within 20% of the bottom or top of its price range, so aim to make money in the larger, safer 60% "middle" range instead. This rule helps you make rational investing decisions — without fretting about missing the top or grabbing the very bottom. Logical, calm investing leads to a higher rate of accuracy, and we're aiming for accuracy of at least 75% — well above Peter Lynch's guideline. We're better equipped to meet, and surpass, this goal when we go after the "sweet spot" in a stock's price range, rather than wasting energy trying to be perfect market-timers.

Always Be Ready for the Fat Pitch

Sometimes, investing is about earning steady returns while waiting for that really fat pitch that puts your returns far over the top. While you're waiting, you want to keep your portfolio growing gradually, so you can succeed even if that fat pitch doesn't come along. But if you stay in the game, you're likely to encounter a handful of fat pitches every decade — and they can make a large difference.

Add It All Up

Follow these four tips, and you'll be well on your way to becoming a calmer and more successful investor. At *Pro*, we're investing to make money as steadily as we can with reasonable risk. Mistakes don't make us lesser investors. In fact, learning from them actually makes us *better* investors. What matters most is our total return, but it's also important to enjoy the process.

Trades en Route

Pro is working on several new trades for the coming days and weeks. As always, you'll first receive our "Trade Alert" email, with a full report on the company in question and an explanation of why we've chosen our position. We'll then have 30 days to make the trade ourselves; when we do, you'll receive our "Trade Complete" email. We look forward to continuing our journey together — so be patient, understand each investment, and enjoy the process!

Please visit the Memo Musings board to comment or share *your* tips for your fellow *Pro* investors.

Jeff Fischer (TMFFischer)

Jeff owns shares of Oracle.

Portfolio Survival

Published Oct 4, 2010 at 12:00AM

In his book *Deep Survival: Who Lives, Who Dies and Why,* Laurence Gonzales paints the ability to survive as a philosophy as much as a set of skills. A mix of fascinating science and thrilling anecdotes, the book is a great read for investors even though there isn't a lick of finance in it.

Fresh on the heels of our *Pro* thesis review, we've decided to engage in some portfolio survival training ourselves. How should you react to new information, guidance changes, and prime avalanche conditions? Well, we're glad you asked …

Guidance Changes

- **MELA Sciences** moves to Hold today pending a possible strategy change on our part.
- **ProShares Short S&P 500** moved to Sell last week. We've moved **U.S. Natural Gas Fund** ETF to Sell as well, as we look to close all our positions in it.
- **Ebix** , **NextEra Energy**, **Oracle**, and **Procter & Gamble** moved to Hold in our thesis review. **Quanta Services** moved to Buy.

October Expirations

- Our **Papa John's International** covered strangle expires Oct. 15. We'll announce any trade adjustments before then.

Trades Completed

- We sold our remaining shares of **Lindsay** and bought shares of **TradeStation Group**.

This Week's Special Event

- We're having a live chat about our thesis review on Wednesday, Oct. 6. Set your reminder!

Coverage & Community

- October earnings are already here! TMFValuemoosie posts an earnings calendar for past and present *Pro* stocks. Kicking things off: **Intel**(Nasdaq: INTC) on Oct. 12.

- Always helpful, Alex340 posts puts and calls that meet *Pro* criteria. For example, there are put-writing opportunities available on Ebix.
- Member cindyjeffsmith is building his *Pro* portfolio with a heavy initial emphasis on options and asks, "Am I moving too fast?"
- To sell at fair value or not? Jeff says it's all situational.
- **GrafTech** (NYSE: GTI) expects its Seadrift acquisition to close by the end of 2010.
- **Bristow Group** (NYSE: BRS) provided details about its new CFO.
- Russell (TMFEldrehad) shows once again how the data suggest that CAPS stock ratings matter.

Don't Get Sloppy

Most climbing accidents occur on the descent. Why? On the climb up, you're inspired and motivated to achieve your goal: Reach the summit! But when you get there, the "oh no" moment hits you — the summit was only the halfway point. Now tired, less motivated, and likely without a clear plan, you must descend.

With investing, finding a great investment can feel like reaching that summit. After days of studying 10-K filings, debating competitive positioning, and building financial models, you finally pull the trigger. It's hard not to feel victorious, but the footing is still treacherous. If we don't keep abreast of new information and make good decisions about when to sell or when to use options, we can find ourselves struggling, like climbers who get sloppy on their descent.

When Jeff recommended writing puts on **Nasdaq OMX Group**(Nasdaq: NDAQ) in late 2008, the company appeared to be building out its global footprint and taking market share. Luckily, Jeff didn't get sloppy. Nearly a year later, he noted that "small, cutting-edge competitors with much lower cost structures, including BATS and Direct Edge, have been eating away at Nasdaq OMX's market share." He remained objectively focused on the developing competitive landscape, changed his growth assumptions, made sure the stock had a solid floor beneath it, and became open to capping upside by writing covered calls.

Don't Fall in Love With the Plan

Things change. Experienced thrill-seekers know that minor changes in environmental factors can have disproportionate effects on outcomes. Think about setting out to hike a snow-covered peak: You spent hours planning the trip, plotted your course, bought new snowshoes, and took several days off work. Now let's say an unexpected storm begins rolling in just as you're departing from the lodge. After investing all this time and energy, would you have the sense not to embark on your dream hike after all? Delaying the start time might mean you wouldn't make it to the peak, and you remember reading that avalanche conditions are worst after a fresh snowfall ... I know, I know, you bought new snowshoes and took time off from work — you couldn't possibly just call it quits and sip hot chocolate!

At this point, as Gonzales would say, the hiker has "fallen in love with the plan" — her decision-making, even in light of the new weather information, is clouded.

This happens to investors all the time — we won't forget *Pro*'s investment in the **U.S. Natural Gas Fund**(NYSE: UNG) ETF. We were so confident in our thesis that we initially thought we could overcome the weaknesses in the investment vehicle we were using. Then we tried to buy more time for the thesis to emerge — and for the ETF to align with it — by writing covered calls. Alas, time ran out, and in the end, all of our best-laid plans were for naught. The "weather" around the fund kept worsening, but we had fallen in love with the plan, so we kept pushing ahead to the bitter end. We were trying to profit on a rise in natural gas prices, but this investment was not the way to do that. Next time, we need a better plan.

Do the Next Right Thing

Gonzales writes of a man — lost in a national park for several days and on the verge of hypothermia — who refuses to build a fire because he knows campfires are not allowed in the park! A fire would provide warmth, and the smoke could alert rescuers, but the man is unwilling to allow new information (being lost, hungry, and freezing!) to influence his plan. This shows a remarkable respect for Smokey the Bear — and even more remarkable stupidity.

If your plan — or investing thesis — has changed, take the next right action. When we saw slowing growth, lowered guidance, and stalling regulatory support for **Quanta Services**' (NYSE: PWR) business, we paused. Based on that information, coupled with the company's constantly changing rules about management compensation, we lowered our recommendation from Buy First to Buy. Sure, we still like the long-term thesis, but we see more risk than we did previously, and tempering our support was the right thing to do with this new information. Quanta will stay on close watch.

Foolish Survival

Together we can survive, and thrive, in today's market. In fact, I believe that using the *Pro* philosophy — finding solid businesses with recurring revenue streams at attractive prices, coupled with calculated options positions and timely macro positions — is the best way to do just that. It's a winning formula of strategic positioning and tactical adjustments. So please, give the *Pro* thesis review a read, revisit the companies in your portfolio, assess how the businesses are performing in light of new information — and do the next right thing. That's what we're aiming to do in *Pro*, every step of the way.

To discuss our thesis review and ask any questions you might have about *Pro*, don't miss our live chat for *Pro* members from 3 to 4:30 p.m. Wednesday, Oct. 6. The whole team will see you there.

Foolishly,
Bryan Hinmon (TMF42)

Motley Fool Pro's Thesis Review

Published Sep 30, 2010 at 12:00AM

Welcome to *Motley Fool Pro*'s thesis review! To download this special report, click here.

Our review looks at each active holding in the *Pro* portfolio to see if it is performing as we originally expected, and gives you investable actions, a fair-value estimate, and guidance advice for every pick. (For a summary of the changes you'll find in the report, see our table on the very last page.) Many of our positions look appealing for buyers right now.

If you have any questions or comments, post them on the discussion boards or bring them to our live chat about the portfolio review from 3 to 4:30 p.m. ET on Wednesday, Oct. 6.

As we start our third year, we're in the best position yet to invest for steady returns with low risk. We're glad you're with us at *Pro*. Let's make the coming year highly, accurately profitable.

Click here to download the review!

Close All Positions in United States Natural Gas Fund

Published Sep 30, 2010 at 12:00AM

At a Glance

- **Action:**Close all positions in UNG
  - Sell to close January 2012 $10 calls
  - Buy to close January 2012 $12 puts
- **Recent prices (9/30/10):** Calls, $0.45; puts, $6
- **Alternate trades:**
  - If you own shares of UNG, we recommend selling them.
  - If you only wrote puts or only bought calls, we recommend closing them.

Take Note

To close an existing options position, you must take the alternate side, netting your position to zero. We are "selling to close" our long calls. We are "buying to close" our short puts.

Natural-gas spot prices are up modestly since we recommended a position in the **U.S. Natural Gas Fund** (NYSEMKT: UNG) ETF nearly a year ago (at $4/MMBtu today, compared to about $3.80 then). But that hasn't been enough to help the ETF, which has declined 48% over the past year. The culprit was the fund's ever-increasing contango, or costs associated with rolling monthly futures contracts. We placed the ETF on hold at the beginning of the year, then wrotecovered calls that defrayed our loss by more than 12% ($2,000), but our synthetic long option position on UNG is still the biggest loser in the *Pro* portfolio's history: Though it's only about 3% of our total holdings, it has knocked about 1.5% from the portfolio's starting value.

We've spent a lot of time discussing this ETF's shortcomings and how to overcome them. As we outlined in our most recent Memo, we've decided that our time would be much better spent instead finding ways to *short* ETFs like this: specifically, ETFs that use futures contracts in attempts to track the price of an underlying asset. Futures contracts are like options — they carry time value, which stacks the odds against the buyer. Owning ETFs that are *buying* time value runs counter to our own practice of *selling* time value month after month in many of our options trades. With the U.S. Natural Gas Fund ETF, we made the classic mistake many call buyers make: believing that a large enough jump in price (natural gas prices, in this case) would lead to a profitable outcome regardless of the erosion of time value. Of course, natural gas costs never rose enough to send UNG sustainably higher, and contango was far worse than estimated. (In many cases, "backwardation" in futures prices can actually *help*, but not this time.)

However, there is some good news. We've learned a lot about ETFs and the natural gas industry from this experience, and we're now looking to invest directly in the industry or its companies. We still believe gas prices will eventually appreciate, and some low-cost producers are making a profit selling gas even at today's low prices. Though natural gas supplies in storage still sit near record levels, part of our thesis is nonetheless environmental: Fracking (hydraulic fracturing) for natural gas needs to be better regulated for safety, which would increase costs and slow production. We had hopes that the Environmental Protection Agency would take a stand on the issue — but either way, we want some exposure to the industry's most profitable sellers.

There's a second bit of good news, as well: We could (and hope to) earn back these losses in the future by shorting ETFs similar in structure to UNG. Finally, if you're considering the tax implications, we've had many short-term gains this year, and booking this loss in UNG will offset many of them.

How to Follow Along

Some of you may have never closed options positions before, so proceed deliberately.

- We will **"sell to close"** the January 2012 $10 call options we own, lately getting about $0.45 per share (not horrible, given that the ETF trades near $6).
- And we will **"buy to close"** the January 2012 $12 puts, paying out around $6 per share (this will take cash from our account).

If you have any bullish position in the ETF (be it owning the shares directly or owning calls), we suggest selling it. If you have questions, please post them on our U.S. Natural Gas Fund board.

Sell ProShares Short S&P 500

Published Sep 30, 2010 at 12:00AM

At a Glance

- **Action:** Selling all shares
- **Recent price (9/29/10):** $48.75
- **Alternate trade:** Write October $48 covered calls on your shares to potentially sell a bit higher.

Although we're closing our shares of the **ProShares Short S&P 500** (NYSEMKT: SH) ETF at a modest loss, it wasn't a wasted investment. We initiated our position in November 2009, so for 10 months, this holding acted as a small insurance policy against market disasters. Ultimately, this insurance cost us only about 0.28% of the portfolio's starting value (as of Wednesday's closing price). That's a reasonable cost to carry a short position over such a relatively long time, and if the S&P 500 had fallen 10%, 20%, or more, the profits would have made our position very worthwhile. For those keeping score, at recent closing prices, we lost about 8% of our investment in the ETF (or $5,000), but we earned $2,200 writing covered calls, so our net loss is about $2,800.

We could continue to write covered calls on the ETF and keep the position as a hedge, so why aren't we? In one word: tracking. The ProShares Short S&P 500 ETF has been inversely tracking the S&P 500 less accurately than we'd like. If you look at the table of numbers from our original November 2009 report, you'll see that at the time, the ETF was tracking well — especially over a time period of six months or so, which is about as long as we expected to hold it:

SH Change	Time Frame	S&P 500 Change
(0.68%)	1 day	0.65%
2.20	5 days	(2.25)
(2.20)	1 month	1.72
(6.70)	3 months	5.61
(18.76)	6 months	18.83

As of Nov. 2, 2009. Source: Google Finance charts.

Today, these numbers are not as pretty. Because the ETF aims to inversely track the S&P 500 on a daily basis, and one day builds onto the next, the market's mostly sideways action in 2010 appears to be eating into returns more than usual, especially over longer time periods.

SH Change	Time Frame	S&P 500 Change
(2.81%)	5 days	2.54%
(9.72)	1 month	9.96
(12.33)	3 months	11.91
(2.27)	6 months	(1.69)
(8.25)	Year-to-date	3.43
(16.8)	History	(3.7)

As of Sept. 29, 2009. Source: Google Finance charts.

Most disturbing, the S&P 500 is *down* over the past six months, but shares of SH are down even more (a 2.27% loss in the ETF vs. a 1.69% loss in the index). And year-to-date, the S&P 500 is up only 3.4%, but the ETF is down more than 8%. Since we've been holding the ETF longer than we expected, that's *far* too wide a discrepancy for us to accept over our time frame. Finally, over the ETF's history — which began June 21, 2006 — the S&P 500 has lost more than 3%, but the ETF is down nearly 17%. If you had bought the ETF in 2006 to protect your portfolio, you'd be livid.

We purchased the ETF because, unlike most inverse ETFs, it *isn't* leveraged 2-to-1, but even on its simple 1-to-1 basis, we're seeing that it doesn't work well over time. The 0.95% annual fee doesn't help. Add it up, and — especially if you believe in the S&P 500's potential over the coming few years — this ETF may be a much better *short* candidate than something to own for any longer than a few months. Fortunately, we've paid a very modest price to come to this conclusion.

How to Follow Along

We'll be selling all of our shares in the next one to 30 days. If you own shares, we recommend you plan to sell them, as well.

- If this is the only short you own, and you want to keep a short in your portfolio a bit longer, realize this *isn't* a panic sale. You can take your time. The ETF should track well over the coming month; we just don't want to own it for months on end.
- If you own calls in SH, or have written puts, we recommend closing those positions in due course, too.

We're also *not* suggesting with this sale that we think the market is going to keep going higher. It very well may not do so in October, and we're seeking a better way to hedge the market while we prepare to sell these shares.

Long story short: This ETF is more of a trader's vehicle than an investor's, so we're preparing to exit. It served its purpose over the past 10 months as we came to this conclusion, we ended up paying modestly for the "insurance" it provided, and we've learned something valuable for the future. If you have questions or comments, please visit the ProShares Short S&P 500 board.

Sell Lindsay

Published Sep 28, 2010 at 12:00AM

At a Glance

- **Action:** Selling all shares
- **Recent price (9/28/10):** $43.27

On Sept. 17, we sold 300 shares of **Lindsay** (NYSE: LNN) when the covered calls we wrote expired above the $40 strike price. We were pleased to sell our shares at a net $49.50 (including what the puts in our strangle paid us). This left us with a somewhat awkward and very lonely 20 shares; luckily, the recent bull market in commodities allows us to sell these shares at a good price within our fair-value range.

Use a Limit Order

This is a thinly traded stock, so please enter a **limit order** near the current price, rather than using a market order.

How to Follow Along

Since the majority of our shares were called away, many *Pro* members don't own shares of Lindsay at all. If this is you, sit tight.

- If you own orphaned shares alongside us, a sell is an easy choice to avoid further risk — after all, we've made a very healthy 37% on these shares without accounting for option income.
- If you own a full position in Lindsay, we recommend selling for the same reasons we are. If you have shares that are already covered with calls, you can let that trade play out.
- If you've written puts that would net you shares in the low $30s, you can also wait on those.

We'll continue to watch Lindsay with an eye toward buying it back when the risk-to-reward ratio is more favorable; at least, we'll look to write $35 puts when they pay well. The stock's price has been quite volatile since day one, and given the irregular nature of irrigation-systems sales and the volatility of commodity prices, we may have the opportunity to reestablish a position in the future.

To discuss this trade, please visit the Lindsay board.

Portfolio Review Live Chat

Published Sep 27, 2010 at 12:00AM

We released a comprehensive review of our entire portfolio on Thursday, Sept. 30, and we took your questions and comments about it (and about anything else you wanted to discuss) on Oct. 6. Download the review here, and check out the transcript of the live chat below!

A Door Slams Shut on Flawed ETFs

Published Sep 27, 2010 at 12:00AM

Pro's My Scorecard Contest, Week 3!

The final week of our My Scorecard contest also features the biggest challenge: Community Picks. Head to *Pro*'s My Scorecard Contest board and guess the three companies, in order, that are most widely held by the *Pro* community on My Scorecard (as of today, Sept. 27). Submit your guess by Monday, Oct. 3, to be in the running for a one-year subscription to your choice of the following: *Motley Fool Stock Advisor, Motley Fool Hidden Gems, Motley Fool Inside Value, Motley Fool Rule Breakers, Motley Fool Rule Your Retirement,* or *Motley Fool Global Gains*, as well as one to give away to a friend or family member!

Changes are at hand for the *Pro* portfolio. Soon, we will no longer be buying or owning any ETFs that use futures contracts to attempt to track an underlying asset — whatever that asset may be, from a commodity like natural gas to an inverse index like the short S&P 500. On the flipside, we are now actively looking for funds like this that we can *short*, as we recommended with **iPath S&P 500 VIX Short-Term Futures**.

Annual Review Coming Soon!

- Watch your inbox this week for *Pro*'s annual review. We'll look at every live recommendation in the portfolio and offer our latest guidance. Don't miss it — and set a reminder now for our live chat about the review, coming Oct. 6!

Our Chat With Ebix CEO Robin Raina

- On Thursday, Sept. 23, *Pro* members took part in a live chat with Ebix CEO Robin Raina. Click here for the transcript!

Recent Trades

- On Sept. 23, we wrote a covered strangle on **Tupperware**, as per our Sept. 2 recommendation.

Coverage & Community

- Want to be part of the annual review? Please answer these three brief *Pro* polls: What do you want next? What's most memorable? What do you enjoy most?
- Alex340 shared puts and calls that meet *Pro* criteria.
- With October around the corner, TMFValuemoosie posted an earnings calendar for *Pro* stocks, past and present.
- Jeff is looking ahead to the next year of investing.
- **Caterpillar** is scratching our returns (meow-ch!); we're hoping to close half the spread profitably and wait on the rest.
- TMFEldrehad puts the word out: Make the case for your favorite stock in CAPS.

Win a Trip to Meet Fools!

Have you ever wanted to write stock recommendations like those you see in *Pro*? Our "So You Want to Be a Fool" contest gives you that chance! Compete to get your recommendation published, win free subscriptions, and earn an all-expense-paid trip to Fool HQ for our annual *Million Dollar Portfolio* member event. For details, click here!

Tracking Hot Air

To explain this move, let's start by examining our investment in the **U.S. Natural Gas Fund** ETF, which has been listed as a hold for most of the year because of its problems tracking the price of natural gas. The commodity's price has remained steady since we released our investment thesis last year, but the ETF that attempts to track it has fallen 44%, making it our biggest absolute loser and knocking about 1.5% from the *Pro* portfolio's return.

The problem is that every month, when this ETF rolls old futures contracts on natural gas into new ones, it typically pays up to do so. This "contango," as it's called, eats away at the ETF's value. We realized this early and started writing covered calls against the calls we own on the ETF; our hope was to significantly counter the erosion in value, while waiting for a large enough gain in natural gas prices to provide the ETF a boost and provide us an exit. That hasn't happened, and now the covered-call-writing opportunities are slim, too. With the ETF below $6.50, we could write January 2011 $7 calls, but the calls we own have a $10 strike price, so we're exposed to $3 of uncovered risk if UNG gains ground. That's hardly logical.

In other words, our options are running out on UNG. We've done all we can to give it a second and third chance. It remains on hold, on its way to a sell. We have been holding out for the coming winter, which *may* provide a spark to natural gas prices that would benefit UNG, but as natural gas supplies grow, even that hope is dimming.

Tracking Only Losses

Up next is **ProShares Short S&P 500**. For awhile this year, the S&P 500 was down year-to-date, and yet our holding in this inverse ETF was barely breakeven for us. We've been writing covered calls against this position, too, and thank goodness, because this ETF's performance has also worsened with time — again, largely because it uses futures contracts.

As of Monday morning, the S&P 500 is up 2.75% for the year, while the ProShares Short S&P 500 ETF is down a much greater 7.5%. Even when the S&P 500 was *down* for the year in August, this inverse ETF was down modestly, too. It hasn't worked as intended. We moved this to a hold, too, as its tracking performance worsened.

It'll be an easy choice to exit this position soon, because its performance has worsened the longer we've held it. Over the past 12 months (as of Monday morning), the S&P has gained 9.92% and SH has lost 14.6%. Since the ETF's inception in 2006, the S&P 500 has lost 8% and the ETF has *lost* … 29%. Abysmal. We always intended to hold this inverse ETF for a relatively brief time, since we knew that over many years, tracking issues would be a concern. But even over the months we've held it, tracking has been disappointing, and we would have lost much more if we hadn't written covered calls (instead, we're not that far from breakeven). Once we finally sell it, we may even look to *short* it. Watch your inbox for pending trade alerts. Our only remaining decision is whether to sell directly soon, or aim to exit with a short-term in-the-money covered call to get paid extra.

Problems Become Opportunities

Recognizing the flaws with these ETFs, we're looking for more to sell short or use bearish options on. That's because over time, funds using futures contracts are fighting an uphill battle thanks to their constantly eroding value. If we do conduct more short or bearish trades on these funds, we just need to make sure the fund managers don't change the way they manage the funds while we hold them.

Eventually, though, they'll need to — because most ETFs that track this way are going to end up dead. And on the way to the trash heap, they're going to become an even bigger media story than they are now. That *Pro* ever purchased two of them was unfortunate. As with buying call options, we thought we could beat time's slow decay and win on catalysts, but decay worsened and big enough catalysts didn't pop up. However, now we can turn the tables and make money on these flawed vehicles in the other direction, as we did with VXX. In the end, I think we'll even end up with net profits on the knowledge we've gained. We've learned, and we're moving forward.

Meanwhile, we'll continue to enjoy the use of strictly *stock-based* ETFs, like **Vanguard Energy**, **Vanguard Emerging Markets**, **SPDR KBW Regional Banking** and the other stock-based or direct-investment-based ETFs on our radar.

Questions? Please visit our Memo Musings board.

Pro Chats With Ebix CEO Robin Raina

Published Sep 22, 2010 at 12:00AM

Early this month, Sean Sun and Karl Thiel of *Rule Breakers* joined me to chat for nearly an hour with **Ebix** CEO Robin Raina. Ebix is rated a "Buy" in the *Pro* portfolio, and shares are up 28% year-to-date while the S&P 500 is up just 1%. And this winning performance isn't new; since 2006, Ebix has been one of the market's best-performing stocks, up 870% while the major indexes are down.

Bite-Sized Ebix

Want just the highlights of our chat with Raina? Check out the short version of this transcript here.

Driving this success is Ebix's desire to be an end-to-end provider of software solutions to the immense insurance industry, which is mired in slow and costly paperwork and eager to move into the digital age. The company's senior management team hasn't changed in the past 10 years; they've all been busy building a business that serves more than 300,000 users, almost all of which renew their contract with Ebix each year.

More than 71% of Ebix's revenue is derived from its insurance exchange, a virtual marketplace where insurance agents, brokers, and providers meet to quote, write, conduct, and mange insurance transactions, using Ebix's end-to-end solutions. Along the way, Ebix's software auto-processes and corrects mistakes; makes a policy binding with electronic signatures; registers the transaction; and services the policy over the years. Ebix can also port the policy to another carrier and provide ongoing data regarding commissions and rates as policies are renewed and adjusted. Every step of the way, Ebix collects a small transaction fee, as well as an annual membership fee from exchange users.

To become the industry standard, Ebix is acquiring niche insurance software players and adding them to its growing network. Each acquisition has added to Ebix's earnings, and as you'll read in our transcript, Raina feels that Ebix is on very solid footing as it continues to seek growth through acquisitions, new products (like annuities and life insurance), new markets, and cross-selling. Along the way, the company is focused on the values of integrity, perseverance, transparency, and giving back to society.

Enjoy the transcript of our talk, and then be sure to join us Thursday for a live chat with Ebix's CEO, so you can ask your own questions!

Further resources:

- Pro's Ebix Buy Report
- Ebix discussion board

Fool on!

Jeff Fischer

Interview Transcript

Sean Sun: So, Robin, I am going to kick this off by asking you to explain very quickly what Ebix does, and particularly if you could walk us through the exchange system that has really become the main revenue driver for Ebix recently. If you could also walk us through who the players are and where we, as laymen, fit?

Robin Raina: Understood. Ebix is mainly in the business of deploying exchanges; 71% of our business as of last quarter was exchanges. We are overall, in addition to exchanges, an enterprise-level player. That is a key word to remember with Ebix, and this is a key differentiator with respect to anybody else in the market--and I mean anybody across the world of insurance.

What I mean by "enterprise-level player" is that we are an end-to-end player. Our entire focus is straight-through processing, which means we provide not only exchanges, but all the other facets that come with an exchange

Now, we interact with wire houses, broker-dealers, investment advisors, banks who are trying to sell insurance, so we provide them a CRM (customer relationship management) system. That CRM system will interface with our exchange and then that exchange would interface with our carrier's system, our company back-end system, (and) all could interface with some other back-end system, anybody's system.

When you deploy an exchange, you are dealing with almost 100+ entities in any transaction. And when you are dealing with these entities that is a cross-selling opportunity for us. To cross sell them a system that they can use not only to exchange; but that allows data to flow into the back-end system that they use each and every day.

Karl Thiel: Robin, can I just jump in there and ask you to explain what an insurance exchange is?

Robin Raina: An exchange can have different meanings in different contexts, but [in our case]... we only do B-to-B (business-to-business) exchanges. We don't do B-to-C (business-to-consumer) exchanges. An exchange is basically a system to drive paper out. When stock exchanges weren't there, or the E*Trades of the world weren't there, you ultimately had a paper-based process. Then E*Trade came in and they drove the paper out. Exchanges came through and you were able to do online transactions on the fly.

Now, what we do in insurance is we will remove the entire paper out of the process. In insurance, you are either buying insurance as a consumer, as a broker or a bank, a wire house, or an investment broker dealer. You are buying insurance, so ... you are trying to get multiple prices. An exchange comes into the process to allow you to buy that insurance (and) to get multiple quotes. (The) first (step) is to get multiple quotes, (and) be able to do what's called a sales illustration, (which is a presentation of) the multiple choices we have available from each carrier and the permutations of it.

The second step is (when) you want to buy a policy. Your option is to do it over paper or do it through an exchange, and if you do it through an exchange, that exchange will make sure that when a policy data is sent to the carrier, it is always the data that the carrier wanted. Because, in the industry today, 70% of the time, when brokers send the end-policy data to the carrier -- this is (an) industry figure in life insurance, for example -- ... carriers say this is not in good order, this is missing data.

So that is called auto processing. You are processing a policy. Now, when you are processing the policy, you might want to bind the policy online, which means electronic signatures might be required. We do that also. We provide electronic signatures to bind the policy legally online.

Thirdly, you want to maybe do a money clearance transaction. You want to transfer money from one bank to another, and register the transaction, let's say, with a regulatory body. Let's say (it's) a new dealer tax-deferred instrument. You need to register that transaction and make sure first of all (that) it's FINRA (Financial Industry Regulatory Authority)-compliant, but it also ends up with the DTCC (Depositary Trust & Clearing Corporation) to make sure the transaction is registered. We do all of that also.

Now let's say the policy is sold. This policy has to be serviced because in a post-sales scenario, the insured will have needs. You could do it over the phone, but even if you did it over the phone, you need to use ideally an exchange to be able to service that policy, and that is what we also do.

Now, we also go beyond that and we are now deploying newer tools to port the policy. S(ay) you are a Merrill Lynch, you are a large client, and you could be a large wire house, a bank, whatever, and you are dealing with multiple carriers and you want to port the policy - (in other words) move the policy from one insurance company to another. We are now deploying portability exchanges for you to be able to do that online.

So, when you consider all of this, it is ultimately now (a) process (of) a broker working with a carrier. (For example) the broker wants to find out, what (his/her) commission. (The broker asks) What is my commission split (because there might be a split on commission)? The installment split? What is my billing? What is happening on my billing? All of that data needs to be downloaded back into the broker's system. We do all of that, too.

So, it is an entire end-to-end process, and now we interface these exchanges into a CRM system. ... That user that broker, that producer, that IBD guy, the wire house user could now (be) sitting within the CRM, (and) do a transaction. To that user, it doesn't even matter. They don't need to be on an exchange. They don't even need to see the exchange because exchange works in the background.

Sean Sun: So who is accessing the exchange?

Robin Raina: Everybody. All these entities that I talked about would be, in this example, accessing it. We could hand over the data to (any) one and they could access it, so everybody will see only the portion that they need to see.

Sean Sun: So, to clarify one point, you said that you guys work specifically with B-to-B. Now that means that if I, the individual, want to get insurance, I am not going to be able to access your exchange product.

Robin Raina: I will give you a real example. Let's say you are on HSBC Bank's website... (and) you want to buy life insurance. You can. You can get quotes from their website. When you get those quotes you are a consumer. That quote is coming from our system in the background. That is our internal exchange, but..., to the consumer, it is unknown that they are using our system. For us, that website is interfacing into their backend. We do that for tons of other players.

Jeff Fischer: Right. Robin that was a great explanation. Thank you for that...Hopefully I can state this question clearly, too. So among all these B-to-B transactions, if a business isn't on your exchange yet and they are trying to make a transaction with someone who is, how does that play out?

Robin Raina: Let's say there is a large broker, or a large bank. Pick any name, Wachovia, Merrill Lynch, Ed Jones; they are large players in life and annuities, for example. They are working with 20 different carriers. Does a Wachovia producer want to go into 20 different systems? Because every carrier will have their own system. Today, that is what happens typically. If Wachovia hadn't deployed our platform, now each one of those people would have had to go in 20 different systems to get 20 different codes, all to process 20 different policies. They don't want to do that. It is a terrible waste of time and money.

Jeff Fischer: Of course.

Robin Raina: The carrier also realizes that the broker doesn't want to do that. So there is no carrier who (will) tell you 'I don't like exchanges.' Those days are completely gone. Today it is a matter of time and pace. Carriers tend to be slow, and they have tons of systems internally. They (also) make acquisitions, so when you have made acquisitions, you now have 40 different systems and you are trying to make ... sense out of all these 40 systems.

So that takes a long time, and then they have to convince their business folks, we like the exchange, go with it. But you know what (they say)? Make sure it doesn't impact us at all. We don't want even for one day, our business being down. So, that is where the organization has to have a little bit of courage because it will be a bit painful. When you are trying to replace 40 systems with one, everybody has to be in sync and so that is what takes people internally a little bit of time, but nobody debates it.

Karl Thiel: So where do you see the industry heading in the future?

Robin Raina: The industry is definitely headed the electronic way. There is absolutely no carrier who will tell you that it's not going to happen. It is definitely (going in) that direction.

Karl Thiel: Do you think it naturally heads towards a very limited number of exchanges?

Robin Raina: With or without Ebix, that is the way it will head.

Jeff Fischer: And Robin, are many of your new customers just showing up at your door because of network effects?

Robin Raina: Absolutely, absolutely. The network effect, day after day, creates opportunity for us. What is a pressure point in the industry? We focus on the pressure point. (For example, say the) largest producer of annuities (is) Wachovia. Or you know the second largest is Merrill. Wouldn't it be nice to just bring Wachovia and Merrill to your platform first? Because you already know that if they are working with 20 carriers each, all of those carriers will want to be on a platform the next morning because they don't want to lose the business, correct?

Sean Sun & Jeff Fischer: Right.

Robin Raina: That is how the industry works. So when we launched [an annuity exchange], we didn't go to the carriers first. We went to the brokers, the largest distributors. (We) convinced them even before we built it. Once we convinced them, we had 67 carrier representatives in one room, even before we had started building the system. Why did that happen? Because we didn't call them. Those distributors called them, and distributors drive the industry, so you have to focus on the pressure point, and that creates a network effect.

Sean Sun: So are these exchange points going to obsolete your traditional insurance brokers?

Robin Raina: No, not really. I don't think that is going to happen because people still want consulting, knowledge and so on, because we are not disintermediating the broker. At the end of the day, these brokers are the ones who are also using our system, so you are not really disintermediating. That is a totally different dynamic. It can happen, but it is not going to happen because we created exchanges. .

Karl Thiel: If I can change gears slightly, can you talk about healthcare as a strategy for growth? It seems like a fair number of your recent acquisitions have been focused in that area.

Robin Raina: Absolutely.

Technologically, [health care reform] is creating a lot of issues for carriers to understand what the government is going to do. How it is going to do it and what is the framework in which it will operate. But look outside the U.S. and you will see that you could go into any African country, any Middle Eastern country, any Asian country and what is the hot topic in every country? Health insurance. Everybody is talking about it. Any of these countries where the quality of health insurance isn't as great is an opportune area for us, because everybody wants to change it. There is no government which will say we don't want to change it. Today we at least are in front of extremely large deals across the world. These are very large deals which could change possibly the future of this company.

Now, I can't guarantee that those deals will happen, but the good news is we are bidding on those deals. We are getting short-listed on those deals, and these are deals of large sizes, $20 million deals, $70 million deals. We didn't have that opportunity earlier. That opportunity has come to us because first our size grew; we became a respectable name worldwide, but besides that, the health sector is where the larger size deals are happening worldwide.

In the U.S. itself, we think there is uncertainty, but uncertainty shouldn't be confused with a lack of opportunity. If anything, the Health Reform Act cleared up a lot of doubt, good or bad. Where the uncertainty now lies is more in the area of how is the government going to define certain frameworks across the states? How is it really going to implement what it has said? ... Because insurance companies can't do it alone. We'll wait for the government to define the framework so that they can accordingly adapt their technology around it.

Sean Sun: One thing that I am really interested in, and I know a lot of our members are as well, is your Robin Raina Foundation. I have been reading stuff about how you guys have been building free homes in India, right? That was one of the biggest initiatives that you guys have done. Would you care to talk a little bit about that?

Robin Raina: Absolutely. That is my passion, to be honest. If I was told to choose between work and charity, I could give up on my work in a microsecond. My board understands that, it is not a hidden fact. My board understands that Robin is a complete package. This is how he is, good or bad, it is not impacting his work, but this is my passion.

I get very inspired by the underprivileged how they fight every day. 1 I am not religious at all, but I always have believed that poverty is the single biggest religion that binds the underprivileged across the world.

Whether you are in Pakistan or Middle East or you are in the U.S. or Russia, pain always feels the same, and the underprivileged have a lot of pain. At the end of the day, our job is to try and do something about it, so from that perspective, the foundation today does multiple things. Our prime focus is education for the underprivileged child. That is our prime focus because we think that will change, that can help build their future, and not only of those children, but of their families. Because in underprivileged areas, if you can have one good, educated child or all the children educated, their future will change, because the parents will benefit from it.

Having said that, we have deployed a lot of schools in the slums. We also have around 4,000 kids that we educate today at any time, and these are kids who are now in engineering school, medical school, lawyers. There are blind kids who have finished their masters; there are blind kids who are doing software development now. And then you have small kids from the age group one-and-one-half years old to virtually 27 years old, who are basically getting educated. We provide the meals, the breakfast, the lunch and healthcare and so on.

Then we started on this home project, which has become my passion in the last three years. In October 2010, India is going to be hosting the Commonwealth Games.

I am one of the strongest critics of the government in India now. To give you an example, I just came out of India three weeks back. I did the rounds of probably 50 different television stations and newspapers being extremely critical of the government. Some people think it is unpatriotic. I have not really cared about it because to me what is unpatriotic is not taking care of your own citizens. What they did when they decided to host the Commonwealth Games, they threw the slum dwellers of Delhi out, to cleanse Delhi, to show it off to foreigners that are coming for the Commonwealth Games.

In the name of cleaning the city, they threw them out. They created the second largest slum in the Indian subcontinent. It has 50,000 families now who basically are living in shanties, in slums, grass huts. There is no water. There is no drainage. There is no healthcare, and the government seems completely immune and seems more concerned about putting palm trees to hide them, and that is what they are doing for Commonwealth.

On one side, the government is spending an estimated $20 billion on this game, to make the infrastructure better. They are spending $227 million on one stadium, to refurbish it. Worse is, they could have spent a few million dollars just trying to provide a simple drainage system, which they didn't do.

Many years back, we were pleading with the government of India to at least, if you threw them out, give them some land. The government of India legalized their land for a very small sum of money that these slum dwellers had to pay, which they did. It was very, very small, like $150, which is incidentally a lot of money for a slum dweller there.

I came up with this project to build 6,000 homes. The 6,000 homes that we are trying to build are all concrete homes on the small pieces of land, but the idea is to provide everybody at least a basic civility of two rooms.

And that is all we are trying to do. I started on that project towards, I think, the end of 2007. Now we have handed over 1,157 homes.

Absolutely free, but this will continue for a decent amount of time. The challenge is not only to build the homes, but to provide the mechanisms around it--the healthcare, the medical facilities, the educational means. We are building schools also. The government hasn't woken up to anything as yet.

Karl Thiel: If you don't mind my asking, how do you balance that with your work life, just time wise?

Robin Raina: I feel that life is too short and you have to live it fully. I am one of those (people) who doesn't like sleeping. I feel sleeping is something you just have to medically do to just handle yourself. So basically, every day, I go to sleep at 3:30 AM. That is my cycle seven days a week. I start early in the morning, and if I get three and a half hours of sleep, I am pretty happy. If I am lucky on a weekend, I get four and a half hours sleep, but typically that is my cycle.

Jeff Fischer: That is brutal. Incidentally...

Robin Raina: If somebody called me and said my son fell into a swimming pool and I am in the midst of a big meeting, a large $20 million deal, what am I going to do? I am going to leave, get out and run to the hospital. Because it is my son, because he is my priority.

That is what I tell people. If you make charity a priority, it will automatically become easy. You will work, it's easy, you have to do work; it is not a choice. But in today's world, everything happens over the Internet. I could be at a U.S. Open and I could do exactly the amount of work that I do in the office because I could carry my iPad. I could do virtually everything across the world and be connected on a minute-to-minute basis. As you know, everybody does that today.

Jeff Fischer: Robin that is just really commendable what you are doing. It is just fantastic. Incidentally, I heard Bill Gates only sleeps three to four hours a night as well, so you are in great company there.

Robin Raina: Well, I think very highly of Bill Gates. And I am a Buffett fan. My thinking in business was influenced in early days by Buffett a lot purely because I like simplification. You see (in the) early days, when I joined (Ebix) in '99 and this company was heavily in losses, people used to say: 'What is your vision?' I used to say, 'I will tell you my great vision as long as you don't tell anybody outside the room. And the vision was (that the) selling price has to be a lot more than the cost price, and people would laugh at it. They would say, that is your plan? I would say, yes, exactly.

I like simplification in life. We get so caught up into all our plans and visions that, at the end of the day, we lose the basic premise of business...like selling price has to be a lot more than the cost price. I started talking about 30% margins in those days when this company was losing money and everybody thought I was nuts. Then I started talking about 40% once we got to 30% and so on.

Buffett has always been my hero. I think it takes a lot of courage to do what he did recently by donating the kind of money he did. Bill Gates, also, is a fantastic human being. Then there is a gentleman that I am always in awe of, and that is Chuck Feeney, the gentleman who owned the DFS Duty-Free Shops. There is a book on him called *The Billionaire That Wasn't*. He basically had donated everything except $1 million of his holdings to charity when everybody thought he was a billionaire.

I think I am one of those. I am not religious. I never worried about what country I belong to. I feel we are all human. We just create all these boundaries around ourselves.

Sean Sun: So Robin, you have obviously had some really extraordinary achievements. I am curious, as a younger person, how did you become you? Not only on your philanthropic side, but also from a business perspective. You joined Ebix when you were 30, I think, right? Then you were quickly promoted and...

Robin Raina: Thirty-two.

Sean Sun: And you have obviously taken Ebix to incredible heights in just the past decade, and yet you also harbor this strong desire to do right by humankind and the underprivileged. How does that develop? Was this something that came from a family background or did this just come independently? I would love to hear about that.

Robin Raina: Well, thank you. I think what I did gain from my father and my mom was ...I think from my father I gained a lot of integrity. My father always taught us the value of sincerity and integrity and that hard work has no substitute. My family was extremely secular, My parents were Hindus, but I was given a Christian name on day one. I didn't change my name in the U.S. I have studied in a convent in school. The names in my own family, my son has a Muslim name, my daughter has a Russian name, and so on.

My mom transferred a lot of her courage to me. I could see she was a housewife, but I saw the courage she had, that intense courage always that I grew up with. I will tell you an interesting story. When I was 23 years old, I had finished my engineering (degree) and I was starting to work for Dell. Dell had a joint venture in India and I was brought in as a management trainee. I was considered one of the top guys in sales in the country at that time. And my picture came up in the largest IT magazine as the top sales guy in the country. In those days, the numbers used to be different, but I was considered to have done well.

I got three promotions in one year, meaning I was young and I lived on it. At the age of I think 24 or so, Compaq asked me to be a managing director and go to Ho Chi Minh City and head Vietnam for Compaq, because I was quite well known at that time...(as) a troubleshooter. (People thought), 'he will solve (it); he will do some good stuff.' I rejected it, and most people at that time thought he is either too arrogant or he is absolutely nuts.

People used to say, what do you want to be when you grow up? And I used to say I want to be famous. And that was a standard line I used to say, and I just felt that when I was a kid, I had this yearning that I can do bigger stuff. I always felt if I walked into that Compaq job, I will be lost in that company and I will never be on my own. At that time I was a young kid who virtually didn't know what I was doing, but there was an internal fire and I think what has probably helped me to whatever little success I have had, has been that I go by my convictions. I have always believed that if you want to do anything in life, you should be able to match eyeball to eyeball and do it. Because you can only do it if you have integrity. You can only do it if you are a straight talker. You can only do it if you don't have anything to hide.

Also, I have always believed that the simple way to success in business is hard work, sincerity, perseverance, and transparency. You have to be transparent with your clients. If you have a problem, don't hide it; pass it on. Tell the client sooner rather than later. That client will respect you more. Let's say you are trying to hide it and then the problem becomes a bigger problem. I have always felt that if you can be open with your clients, committed to your clients, sincere to your clients and you believe in what you do, and lead from the front, everything will happen for you.

I, to some extent, feel that some of those values have gone through Ebix worldwide. That is probably my biggest achievement, forgetting all the numbers. I think my biggest achievement there (has been that) I have been able to hold my entire senior management team. My senior management team has stayed 10 years now. Secondly, I also have had the customer attention. Why don't we lose any clients versus others? We have 300,000+ users; we might be losing some retail brokers somewhere. But anybody who even accounts for $50,000 of revenue for us annually? In seven years, we haven't lost that client.

So why haven't we done that? I think it is the attitude of our employees, that they are absolutely transparent to their customers. I think that helps.

Sean Sun: I think that is a great message. I personally benefit from listening to that, and I think our members are certainly going to benefit from knowing what makes Ebix (tick). We are always asking, what is Ebix's special sauce? Why is it so different and why has its performance been so good? We love insights like this.

Robin Raina: Thank you.

Jeff Fischer: Members ask a lot of questions, so I am just going to fire some off really quickly and help them get answers. The first one is: Can we continue to expect more acquisitions in the next few years? We know you are growing through acquisitions that then result in a lot of up selling and cross selling.

Robin Raina: Yes, absolutely, yes. Ebix has cash. We see Ebix as a growth story. So having said that, we don't want to issue dividends simply because we believe that we can reinvest this money and get better returns for our shareholders. I will give you a simple example. What is the largest-growing market for insurance in the world right now? It is Brazil. If you look at Brazil, when the market is growing at that pace, last year it grew at around 28%. The overall economy has continued to grow. I believe the timing is absolutely right for Ebix to take a much larger place in that market as an enterprise, end-to-end local player. We will pursue acquisitions in that area...because we want to take an early position so that as a market keeps expanding, we can take the gains out of that market, and of course the cross-selling helps. Similarly, in different geographies, you would possibly see us moving in terms of acquisitions.

Jeff Fischer: How do you feel about the whirlwind of activity that Ebix has had the last two years -- say of acquisitions? Do you ever have fears that you are trying to grow too quickly or do you feel that you are on very solid footing?

Robin Raina: We think we are on extremely solid footing simply because we have not had one acquisition go wrong for us. One of the reasons we are successful is because we ... have a very financially disciplined approach. We walk away from acquisitions if one metric moves left and we wanted it to be in the center, and we are absolutely adamant on financial metrics and on discipline. Having said that, every acquisition we have made has been accretive from day one.

When we have made acquisitions, we don't only look at the positives of that acquisition, we calculate what is the worst that can happen. We look at when the worst happens, assuming the worst happens, what will it do to the company? We don't want that answer to be that it will hurt the company badly. If that is the answer, we will stay away from that acquisition. We try to balance our risk from that perspective, so I think that has been one of our reasons for our success.

Jeff Fischer: Great, great.

Robin Raina: There is one question which I would like you to ask, if you don't mind. Because I saw two days back an article from The Motley Fool that a gentleman wrote on margins and A/R and cash flows. And I would like to address that for a minute.

Jeff Fischer: Sure, please.

Robin Raina: Thank you. I don't know who wrote it, but I give him credit for doing the math. I think sometimes people don't realize that when you look at operating cash flows, they are looking at operating cash flows at a given point of time. So let's say somebody said in '08 Ebix recovered operating cash flow of 90% with respect to its income. That is not a good way to look at it. What the good questions should have been, is simply asking the company how much money, A/R, do you have? Which is out in the open for more than 12 months? How much A/R do you owe? Because that will tell you whether ‘08's 10% difference, or whatever the difference was, whether that money was collected or not -- the difference between cash flow and income. Because you immediately know there is a timing issue rather than anything wrong with any difference between the two.

The simple answer to that is, as of second quarter of 2010, Ebix A/R, for more than 12 months, was around $600,000, total, across the world. For a company which did $32.1 million last quarter to have $620,000, and I must tell you, all of that is fully reserved for. In addition let me also tell you that we will get that money. Let's say there is a client sitting in China. (With) the Chinese government, you need approvals to send money out. Sometimes it gets delayed for whatever reason internally because a company gets acquired...I can't go into names, but this is very normal.

It becomes a red flag when there is a difference between net income and cash flow. That difference never gets collected or does not get collected to the fullest degree. The answer that I just gave you, the $600,000, tells you that everything in '08 was collected, which means that operating cash flow...the net income and operating cash flow, there was no difference between the two in reality. Because operating cash flow is measured at a given point of time, and that given point of time could be driven lower or higher because of any reason. It could be a vendor paid either more or less in that quarter, it could be any reasons. People at times pay attention only to the; they need to look at the overall picture rather than at a given point of time.

Karl Thiel: Robin, just on the general theme of skeptics, it is certainly notable that there is a fairly high level of short interest in Ebix and I just wonder if you have any thoughts on why that is or what you think about that?

Robin Raina: Well, I think first of all, I respect the shorts. I am not going to go and beat them in any way because I feel we live in a democratic country and in a democratic country, some people think President Obama is a genius and some think exact opposite of him. I don't know which one is true, time will tell. His results will show whether he is making dumb decisions or he is making the smartest decisions in the world.

So from my perspective, I think of the shorts the same way. They are making decisions for themselves. I would like to believe they are making the wrong decisions, but when you look at it, ultimately I have gone through some of the documents and so on, and one of the things that has been talked about is Ebix has had frequent auditor changes. That has been one of the main topics of discussion. The implication is that Ebix probably has had bad relations with their auditors. I will address that as directly as I can.

Who has been our auditor in the last, let's say, eight years? In eight years, our international auditor was BDO. What they don't remember is when we moved from BDO in the U.S. to another firm. BDO is still our auditor for six years plus in all other countries where they were. If we had bad relations, BDO would not be our auditor in Australia, Singapore, Sweden, and so on. They are still our auditor.

Has another previous auditor, HA&W, has had bad relations with us? I will tell you something which you probably don't know. The main partner on our account, with HA&W, just nominated my CFO Robert Kerris for the CFO of the Year in *Atlanta Business Chronicle*. That doesn't look like a partner who was unhappy with us. He was the partner throughout on our account. Also, HA&W still works for us. They do our FAS109; help us with FIN48) and so on.

Our present auditors, I think I will let them talk about it, but we have a fantastic relation with them. They recently nominated us for an exemplary client award. The website is ClientAdvisorAwards.com. So I think that was one of the topics that was talked about by the shorts.

Then there are others; I could go (into) and address each one of them. For example, one was the same issue about maybe their cash flows aren't catching up with their net income, and that is not true. I just gave you the answer to that one.

I also would like to say to your community, a good way to look at whether a stock should be shorted is (to ask) what is the management and what is the CEO (is) doing with his own stock? No senior manager of Ebix is in a selling mode in the last four years. Ebix, when I joined, was a few-cent stock. My buying prices are a few cents. When you look what the price has done, from there to here, there is a big difference.

How much stock have I sold in 10-plus years? I think I have sold slightly higher than a hundred thousand shares. I have donated a bit to charity. Everything else I have held on to, which means I had 4.5 million shares. I think I still own 4.2 million shares after being here for almost 10 plus years. I think either I am absolutely stupid or I am a genius. Time will tell what am I, and I am not honestly very sure about what am I. But I know that I believe in myself and I believe in the company, so I am holding on to my stock.

Want more on Ebix? Attend our live chat with Ebix CEO Robin Raina on Sept. 23.

Pro Chats With Ebix CEO Robin Raina (Short Version)

Published Sep 22, 2010 at 12:00AM

*The full transcript of our interview with **Ebix** (Nasdaq: EBIX) CEO Robin Raina can be found here, but we've picked out some highlights below!*

Sean Sun, *Motley Fool Rule Breakers* analyst: So, Robin, I am going to kick this off by asking you to explain very quickly what Ebix does, and particularly if you could walk us through the exchange system that has really become the main revenue driver for Ebix recently. If you could also walk us through who the players are and where we, as laymen, fit?

Robin Raina: Understood. Ebix is mainly in the business of deploying exchanges; 71% of our business as of last quarter was exchanges. We are overall, in addition to exchanges, an enterprise-level player. That is a key word to remember with Ebix, and this is a key differentiator with respect to anybody else in the market — and I mean anybody across the world of insurance.

What I mean by "enterprise-level player" is that we are an end-to-end player. Our entire focus is straight-through processing, which means we provide not only exchanges, but all the other facets that come with an exchange

Now, we interact with wire houses, broker-dealers, investment advisors, banks who are trying to sell insurance, so we provide them a CRM (customer relationship management) system. That CRM system will interface with our exchange and then that exchange would interface with our carrier's system, our company back-end system, (and) all could interface with some other back-end system, anybody's system.

When you deploy an exchange, you are dealing with almost 100+ entities in any transaction. And when you are dealing with these entities that is a cross-selling opportunity for us. To cross sell them a system that they can use not only to exchange; but that allows data to flow into the back-end system that they use each and every day.

Karl Thiel, *Motley Fool Rule Breakers* analyst: If I can change gears slightly, can you talk about health care as a strategy for growth? It seems like a fair number of your recent acquisitions have been focused in that area.

Robin Raina: Absolutely.

Technologically, [health care reform] is creating a lot of issues for carriers to understand what the government is going to do. How it is going to do it and what is the framework in which it will operate. But look outside the U.S. and you will see that you could go into any African country, any Middle Eastern country, any Asian country and what is the hot topic in every country? Health insurance. Everybody is talking about it. Any of these countries where the quality of health insurance isn't as great is an opportune area for us, because everybody wants to change it. There is no government which will say we don't want to change it. Today we at least are in front of extremely large deals across the world. These are very large deals which could change possibly the future of this company.

Now, I can't guarantee that those deals will happen, but the good news is we are bidding on those deals. We are getting short-listed on those deals, and these are deals of large sizes, $20 million deals, $70 million deals. We didn't have that opportunity earlier. That opportunity has come to us because first our size grew; we became a respectable name worldwide, but besides that, the health sector is where the larger size deals are happening worldwide.

In the U.S. itself, we think there is uncertainty, but uncertainty shouldn't be confused with a lack of opportunity. If anything, the Health Reform Act cleared up a lot of doubt, good or bad. Where the uncertainty now lies is more in the area of how is the government going to define certain frameworks across the states? How is it really going to implement what it has said? ... Because insurance companies can't do it alone. We'll wait for the government to define the framework so that they can accordingly adapt their technology around it.

Jeff Fischer: Members ask a lot of questions, so I am just going to fire some off really quickly and help them get answers. The first one is: Can we continue to expect more acquisitions in the next few years? We know you are growing through acquisitions that then result in a lot of upselling and cross-selling.

Robin Raina: Yes, absolutely, yes. Ebix has cash. We see Ebix as a growth story. So having said that, we don't want to issue dividends simply because we believe that we can reinvest this money and get better returns for our shareholders. I will give you a simple example. What is the largest-growing market for insurance in the world right now? It is Brazil. If you look at Brazil, when the market is growing at that pace, last year it grew at around 28%. The overall economy has continued to grow. I believe the timing is absolutely right for Ebix to take a much larger place in that market as an enterprise, end-to-end local player. We will pursue acquisitions in that area...because we want to take an early position so that as a market keeps expanding, we can take the gains out of that market, and of course the cross-selling helps. Similarly, in different geographies, you would possibly see us moving in terms of acquisitions.

Jeff Fischer: How do you feel about the whirlwind of activity that Ebix has had the last two years — say, of acquisitions? Do you ever have fears that you are trying to grow too quickly or do you feel that you are on very solid footing?

Robin Raina: We think we are on extremely solid footing simply because we have not had one acquisition go wrong for us. One of the reasons we are successful is because we ... have a very financially disciplined approach. We walk away from acquisitions if one metric moves left and we wanted it to be in the center, and we are absolutely adamant on financial metrics and on discipline. Having said that, every acquisition we have made has been accretive from day one.

When we have made acquisitions, we don't only look at the positives of that acquisition, we calculate what is the worst that can happen. We look at when the worst happens, assuming the worst happens, what will it do to the company? We don't want that answer to be that it will hurt the company badly. If that is the answer, we will stay away from that acquisition. We try to balance our risk from that perspective, so I think that has been one of our reasons for our success.

Jeff Fischer: Great, great.

Karl Thiel: Robin, just on the general theme of skeptics, it is certainly notable that there is a fairly high level of short interest in Ebix, and I just wonder if you have any thoughts on why that is or what you think about that?

Robin Raina: Well, I think first of all, I respect the shorts. I am not going to go and beat them in any way because I feel we live in a democratic country and in a democratic country, some people think President Obama is a genius and some think the exact opposite of him. I don't know which one is true, time will tell. His results will show whether he is making dumb decisions or he is making the smartest decisions in the world.

So from my perspective, I think of the shorts the same way. They are making decisions for themselves. I would like to believe they are making the wrong decisions, but when you look at it, ultimately I have gone through some of the documents and so on, and one of the things that has been talked about is Ebix has had frequent auditor changes. That has been one of the main topics of discussion. The implication is that Ebix probably has had bad relations with their auditors. I will address that as directly as I can.

Who has been our auditor in the last, let's say, eight years? In eight years, our international auditor was BDO. What they don't remember is when we moved from BDO in the U.S. to another firm. BDO is still our auditor for six years plus in all other countries where they were. If we had bad relations, BDO would not be our auditor in Australia, Singapore, Sweden, and so on. They are still our auditor.

Has another previous auditor, HA&W, has had bad relations with us? I will tell you something which you probably don't know. The main partner on our account, with HA&W, just nominated my CFO Robert Kerris for the CFO of the Year in *Atlanta Business Chronicle*. That doesn't look like a partner who was unhappy with us. He was the partner throughout on our account. Also, HA&W still works for us. They do our FAS109; help us with FIN48) and so on.

Our present auditors, I think I will let them talk about it, but we have a fantastic relation with them. They recently nominated us for an exemplary client award. The website is ClientAdvisorAwards.com. So I think that was one of the topics that was talked about by the shorts.

Then there are others; I could go (into) and address each one of them. For example, one was the same issue about maybe their cash flows aren't catching up with their net income, and that is not true. I just gave you the answer to that one.

I also would like to say to your community, a good way to look at whether a stock should be shorted is (to ask) what is the management and what is the CEO (is) doing with his own stock? No senior manager of Ebix is in a selling mode in the last four years. Ebix, when I joined, was a few-cent stock. My buying prices are a few cents. When you look what the price has done, from there to here, there is a big difference.

How much stock have I sold in 10-plus years? I think I have sold slightly higher than a hundred thousand shares. I have donated a bit to charity. Everything else I have held on to, which means I had 4.5 million shares. I think I still own 4.2 million shares after being here for almost 10 plus years. I think either I am absolutely stupid or I am a genius. Time will tell what am I, and I am not honestly very sure about what am I. But I know that I believe in myself and I believe in the company, so I am holding on to my stock.

Want more on Ebix? Attend our live chat with Ebix CEO Robin Raina on Sept. 23.

Buy TradeStation Group

Published Sep 22, 2010 at 12:00AM

At a Glance

By Todd Wenning and Jeff Fischer

- **Action:** Buying 1.5%
- **Target allocation:** 3%
- **Estimated fair value:** $9 to $11
- **Preferred buy price:** Around $6.70 or lower
- **Type of holding:** Intermediate-term; financial brokerage
- **Alternate trade:** None
- **Why buy:**
    - TradeStation caters to active, highly valuable "rules-based" traders like small hedge funds; the company increased the number of its accounts during the recession.
    - If interest rates rise, TradeStation stands to profit on customers' cash balances; if volatility increases, customers will make more trades and pay more commissions.
    - TradeStation is in the process of becoming a "risk-free principal" dealer in the forex (foreign exchange) market.

Keep in Mind

Please be sure to **use a limit order** on this trade! At $240 million (the smallest company we've recommended), TradeStation's size means it can have a wider bid-ask spread than a larger company, so limit orders are your best bet for getting the price you want. Don't push the stock up with market orders.

CAPShot: 3 of 12. TradeStation is currently in a down cycle, but it should score much higher in "normalized" periods, especially on profit margin, revenue growth, and return on equity.

The Big Picture

Brokerages make most of their money in two ways — through commissions on trades and interest income from customers' cash balances and margin accounts. Unsurprisingly, these companies suffered during the economic crisis of the past three years, as industry competition brought commissions lower and interest rates fell to essentially nil.

While commission rates are likely to remain competitive, we believe interest rates will inch higher at some point in the next two to three years, which will provide brokerages with a much-needed boost in income. We also think the market's volatility and volume will increase over the next three to five years, which will bring more trading activity by institutional investors and day traders, particularly in the derivatives market. The proceeds from that activity should more than offset any commission revenue lost to fierce competition. In short, we think this industry has strong upside potential in the coming years.

Brokerages that cater to individual investors, like **TD Ameritrade** (NYSE: AMTD) and **optionsXpress** (UNKNOWN: OXPS.DL), will benefit in this environment, but we think those focused on active and institutional investors will do even better. According to a Celent Communications report, "active" traders (those who trade at least 10 times per month) make up just 5% of the 30 million to 40 million online brokerage accounts in the U.S. That 5% is only 1.5 million to 2 million accounts — but that small fraction generates roughly 50% of the total revenue for the industry. (This figure doesn't include the institutional investor market, such as hedge funds, money managers, and commodity traders, which oversees trillions of dollars in assets.)

TradeStation Group (NASDAQ: TRAD) is only the seventh-largest online broker, with just more than 3% of the estimated active investor accounts in the U.S. But its award-winning trading platform has attracted new accounts during the recession, and it's poised to thrive in a market with higher interest rates and volatility.

The Business

TradeStation began in the early 1980s as a software producer. It became a broker-dealer in 2001, but sophisticated trading software is still at the heart of what the company does, and it remains perhaps its strongest competitive advantage.

Specifically, the TradeStation trading platform provides an important resource to "rules-based" traders, those whose trades are based a customized set of rules encompassing a number of predetermined factors. The platform allows investors to back-test rules-based equity, options, futures, and foreign exchange (forex) strategies against years of intraday data (18 years for domestic equity, 27 years for futures, and six years for forex), then see how those strategies would perform in real time today. The company also augmented its portfolio testing offerings with its recent $5 million acquisition of Portfolio Maestro, a small investing software company.

The platform's strategies are created with TradeStation's proprietary EasyLanguage software code, which allows traders to create unique sets of rules. Clients pay monthly platform fees unless they meet rather low thresholds for trading activity, in which case the fee is waived.

In March, the company launched TradeStation Strategy Network, an online marketplace that allows traders to share their codes with others (sort of like "apps" for a smartphone). We believe this offering will strengthen the TradeStation community and create a stronger competitive advantage for the company.

TradeStation is respected in its industry, having won several *Stocks & Commodities* magazine readers' choice awards: best institutional and professional platform eight years running, best online analytical platform seven years running, and best stock, options, and futures trading system six years running. It also won *Barron's* top award for online brokers in 2009, beating out well-regarded competitors ThinkorSwim (since acquired by TD Ameritrade) and **Interactive Brokers** (NASDAQ: IBKR).

Competition for new accounts is intense among brokerages, but TradeStation is making bold and wise moves to attract sophisticated, active traders. Last year, it reorganized its futures trading business from one that simply introduced accounts to a third party (which maintained custody and control of the client assets) into a futures commissions merchant, which allows TradeStation itself to retain custody and control. It's also in a similar process regarding its forex business, working to become a "risk-free principal" dealer, which will connect the company's trading platform to a liquid forex market.

Finally, TradeStation announced just this week that it is entering the securities lending business for its prime brokerage clients. This is another move that will give it more control over these lines of business, and it will allow the company to better serve its clients by making the trading process more seamless.

With about 50,000 accounts, TradeStation is well behind optionsXpress (with 365,500) and TD Ameritrade (with 7.8 million). But the accounts it does have are much more profitable than these competitors'.

Metric	TradeStation	optionsXpress	TD Ameritrade
Client Assets Per Account	$45,170	$19,157	$47,500
Daily Average Revenue Trade Per Account	1.86	0.13	0.05
Sales Per Account (TTM)	$2,832	$670	$329
Interest Income per Account (TTM)	$179	$50	$47
Client Cash Per Account	$25,614	$2,438	$436

Data as of most recent quarter. TTM = trailing 12 months.

TradeStation clients not only trade more frequently but also generate more interest income. That's because they keep more money in cash to secure derivatives trades (derivatives trading makes up 54% of TradeStation's commissions and fees) and trade on margin more often.

This setup is why we believe TradeStation is in a strong position to benefit from higher interest rates. In the last conference call, management stated that an increase of just 1 basis point (one-hundredth of 1%) in the yield of Treasury bills and notes would increase the company's net income by roughly $45,000.

For reference, in 2006, when one-year Treasury bills yielded about 4.5% (compared with less than 0.5% today), TradeStation made roughly $1,300 per account on interest income (versus $179 today) — $4,000 per account overall with commissions and software fees included. Further, the average duration of TradeStation's investment portfolio is between six and seven months, meaning that its bonds will mature rather quickly. Thus, if interest rates rise, the company will be in a strong position to roll its fixed-income investments into higher-yielding bonds.

Financials and Valuation

Most brokerage companies have a net cash position (more cash than debt), but TradeStation's net-cash-to-market-capitalization ratio (17%) is especially impressive, and it makes the company an attractive acquisition target.

Free cash flow generation has been consistent as well, thanks in part to the company's strong operating leverage. Because TradeStation is built around its software platform, it makes significant investments in software upgrades every few years. Between cycles, though, it doesn't need to spend as much, which leads to faster net income growth relative to sales growth (hence the leverage).

For our valuation, we assume TradeStation will continue to pick up new accounts at an annualized rate of between 6% and 7% over the next decade. That's well below the company's 20% account growth rate over the past five years, and it would mean a likely increase of just more than 1 percentage point in TradeStation's market share. We also believe TradeStation's strong position in the derivatives market, its growing forex business, and its appeal to rules-based traders will keep accounts coming in.

We also assume that interest rates will inch up slowly starting in 2013, leading to average revenue per account of $3,100 for the next decade — conservatively below the 2006 average of $4,000.

In our discounted-cash-flow-to-equity model, we model for 2% terminal growth and discount the cash flow at 12%, which gives us a fair value range of $9 to $11. With TradeStation's stock recently trading near $6.40, this provides you with substantial upside of 40% to 71% and a comfortable margin of safety.

What Would Make Us Sell

First, if market volatility decreases and remains at those lower levels, it would dampen growth in the derivatives markets — and, by extension, the number of trades from which TradeStation generates revenue.

Second, if low interest rates persist longer than we expect, TradeStation's interest income per account would remain near today's low.

Third, if TradeStation's move into the futures and forex markets isn't well received by active traders, account growth could fall behind our expectations.

Finally, a large, ill-advised acquisition of a competitor would force us to reevaluate our valuation. We did factor in the need for more capital expenditures to support our growth estimates, but that doesn't extend to a major acquisition.

The Pro Bottom Line

By our estimates, TradeStation is trading near fair value today, assuming interest rates and volatility remain the same over the next decade. That said, we expect interest rates and volatility to *rise* in the next three to five years. TradeStation would benefit from that, as well as from the growing derivatives market. Today, it's winning market share in its prime demographic, and we think its long-term trajectory looks strong. The likelihood of higher interest rates and volatility down the road only sweeten the story.

To ask questions, join us on the TradeStation board.

Todd Wenning owns shares of TradeStation. The Motley Fool owns shares of Interactive Brokers.

Monday Memo: Pro Grows Bigger and Better

Published Sep 20, 2010 at 12:00AM

We hope you participated in Week 1 of the *Pro* My Scorecard Contest — and we're here to kick off Week 2.

Pro **'s Picks:** Go to My Scorecard and add at least two of *Pro*'s Buy First stocks to your stocks or watch list by Sunday, Sept. 26. Perhaps you've just upped your allocation or just haven't had time to enter a past purchase into the tool — well, now's the perfect time! Many of you may already have two Buy First stocks on your Scorecard (shiny gold stars for you), in which case, you'll automatically be entered to win this week's prize: a one-year subscription to the Motley Fool newsletter of your choice!

If you want more details, you can find them here. Stay tuned for next week's challenge, which will be announced in the Sept. 27 Memo. Fool on!

We're never content with *Pro* — and that's fantastic news for you. We want to continually improve the service and steadily increase your returns while taking reasonable risk. To both ends, we're excited to announce that the *Pro* team here at Fool HQ has recently expanded, adding to our skill set, and with the new team in place we have many new initiatives in store for you as we start *Pro's* third year.

In a moment, you'll hear directly from the new *Pro* analysts. But before that, we have a *Pro* first: *You* can participate in a live chat this week with **Ebix** CEO Robin Raina. Set your reminder for the Thursday event, and bring your questions for the company. Mr. Raina has kindly offered a full hour of his time while he's working in Brazil, and you can bet we were thrilled to fill that slot in his schedule. Be sure to join us!

And Ebix is just the start. We're scheduling talks with execs from all of our *Pro* companies, making steady access to management one of our priorities. You'll hear everything they have to say as our meetings take place month by month. This goes hand-in-hand with offering you more multimedia events, including more *Pro* Audio Extras, Video Extras, and live investing chats. *Pro* will become a bit more of a multimedia service, and we'll publish more special features, too, including new valuation guides, brand-new options strategies, CAPS reports, and more (did I mention that we've added three new analysts?).

Of course, "more" isn't better unless there's more *value* involved, so our goal is to continue improving as investors, come to know our companies and strategies even better, and grow our returns together—and for you to enjoy it each step of the way.

Guidance Changes

- **Oracle** moves down to Buy due to valuation after a large earnings-driven gain.
- **SPDR KBW Regional Bank ETF** moves up to Buy First due to valuation.
- **Quanta Services** increases to Buy First due to valuation.

Recent Trades

- Sold most **Lindsay** and about half **Jack Henry & Associates** via covered calls, due to valuation. Short puts on Lindsay expired as a full gain.
- Covered calls on **ProShares Short 500 S&P ETF** and on **U.S. Natural Gas Fund ETF** expired as full gains. We're considering our next moves.

Still Pending

- We need to write a covered strangle on **Tupperware**, per our Sept. 2 recommendation.

Coverage & Community

- With shorting on his mind as the Fool launches *Big Short*, Russell (TMFEldrehad) revisits one way that he uses CAPS to find shorting candidates worthy of further consideration.
- dk1000 opines that **Netflix** may do serious damage to cable companies, as almost 30% of young people surveyed are using Netflix instead of cable.
- Earnings are getting closer: TMFValuemoosie has an earnings calendar.
- Alex340 posted puts and calls that meet *Pro* criteria.

This Weekend's Sells

One last bit of business before the analyst introductions: In a recent Monday Memo, I wrote that "this market may require more" from us as it trades in a range. In that spirit, and following three positive weeks for the S&P 500, we let most of our shares of **Lindsay** and half our shares of **Jack Henry & Associates** be called away this weekend through covered calls. We're happy to sell Lindsay near our fair value estimate, and to lock in a profit on many of our Jack Henry shares after the company made an expensive acquisition. Jack Henry was one of our largest positions but is now a more modest 2.5%. We sold shares at a net $26.29 including our option income, for a

35% gain in more than a year. Including option premiums, we sold our Lindsay shares at a net $50.50 (the strangle paid us well). We still have 20 shares of Lindsay left, because we owned an odd lot — but we'll deal with those in the future.

Meet the New *Pro* Analysts

Now, the more exciting stuff: Three new analysts are joining Todd, Bruce, and me as we dig for the best investment ideas for you here at *Pro*. You'll find their introductions below — have fun getting to know them a bit better!

Nick Crow (TMFCrow)
Senior Analyst

Hi, *Pro* Fools! I recognize many names on the *Pro* boards, and since I'm joining this community from our sister service, *Motley Fool Options*, I hope that I'm familiar to most of you, too. Here's what you might not know about me: My professional life began as a paratrooper in the U.S. Army, after which I worked as a rock-climbing instructor during college. Realizing that if I continued on that course my brain would outlast my body (or they might otherwise both perish prematurely), I turned to banking, where I witnessed the perils of behavioral finance first-hand. I left the bank just two months before the financial crisis (who says timing doesn't count) and moved my family cross-country to enter The Fool's rigorous Analyst Development Program. Now I give back to that program by leading our next crop of market beaters in stock-pitch meetings here at Fool HQ.

My investing style is as eclectic as my background. I've been investing for about 15 years and am a deep value guy at heart. I like to use options to manage my portfolio, but I invest in special situations and distressed debt, too. After stints on *Inside Value* and *Champion Funds*, I think I've found my home because — like *Pro* — I'm a go-anywhere, risk-averse investor. Of course, risk is subjective; for me, it means trying to altogether avoid permanent impairments of capital and investment situations that don't pass the sniff test. When I'm not digging for investment ideas for *Pro* and *Options*, you'll find me spending quality time with my wife and daughter.

Bryan Hinmon, CFA (TMF42)
Analyst

Howdy, *Pro* Fools! I joined the Fool and the *Pro* team in late February, which makes me pretty new around here — but I've logged a decade of Fooldom altogether. Hopefully by now we've run across one another on the boards. Prior to landing at the Fool, I managed money for a small hedge fund in Boston. Earlier in my career I split time between the beach and investment research responsibilities for an asset management firm in Naples, Fla.

All along, my investment philosophy has centered on patience, risk management (often using options), and a focus on valuation. I'm naturally drawn to boring and ugly companies, and I refuse to pay too much for them . Seeking balance, I married an incredible woman who is adventurous and beautiful, and she doesn't refuse to pay too much for anything . I became a CFA charter holder this year, and right now I'm celebrating the playoff-bound Tampa Bay Rays and the return of football season (Go Bucs!).

Andrew Sullivan, CFA (TMFRedwood)
Analyst

*Sziasztok**, *Pro* members!* My background is in equity research, specifically aerospace and defense stocks. After school, I spent five years on Wall Street and managed to find time to earn a CFA charter. I soon realized the sell side wasn't for me and took some time off to travel, which included a 5,753-mile train trip across Russia and stints in Japan, Hungary, and the Czech Republic. But investing is my true love, so in 2008 I joined the *Inside Value* team and have since worked on *Income Investor* as well.

My investing style is overwhelmingly focused on safety of capital and usually this translates into "buy low" — not in terms of generic ratios, but in terms of business worth. In that vein, much of my time is spent on the little-known second course of Warren Buffett's imaginary business school: "How to Think About Markets." This course (to my understanding) teaches patience and careful entry points for investments. You can never change your buying price, so my philosophy is to make it exceptional. Average entry points will earn you average returns.

One final note: I'm bearish on the market and a big fan of gold (putting me in the minority at Fool HQ), but I hope to unearth undervalued stocks for you — because they exist in every market. And I'll be keeping my oculi open for potential short candidates.

**Sziasztok is hello (plural) in Hungarian*.

Say *Your* Hello!

If you'd like to greet our new analysts or ask them questions, please visit the Meet & Greet board — they'll be checking in to respond. If you have questions about today's Memo, please visit our Memo Musings board. And we all hope to see you on Thursday in the chat room with Ebix. Don't miss the sidebar for more *Pro* links and news.

Stay Foolish!

Jeff Fischer (TMFFischer), *Pro* advisor

Jeff owns shares of Oracle.

Audio Extra: Pro's Take on KCI, INTC, and BRS

Published Sep 15, 2010 at 12:00AM

The *Pro* team talks about two recently bruised *Pro* stocks, **Kinetic Concepts**(NYSE: KCI) and **Intel**(Nasdaq: INTC), and why we like their valuations today. We also take a fresh look at helicopter maven **Bristow**(NYSE: BRS); shares are up 18% since our recent purchase, but the business continues to improve.

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Once you've heard from the Pros, come share *your* thoughts on our Kinetic Concepts, Intel, and Bristow discussion boards.

Live Chat With Ebix CEO Robin Raina

Published Sep 13, 2010 at 12:00AM

Pro members took part in a live chat with Ebix CEO Robin Raina on Thursday, Sept. 23, at 2 p.m. You can read the transcript below, check out our latest thinking on Ebix, read the transcript of Jeff's talk with Raina, or get in-depth about the company on our Ebix discussion board!

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Pro My Scorecard Contest Official Rules

Published Sep 13, 2010 at 12:00AM

Here are the official rules for the *Motley Fool Pro* My Scorecard contest. They will be updated as each challenge is announced. Enjoy!

Week 1 Challenge: Your Pick
Winner: Anita Carty, Portsmouth, Va.

1. ENTRY: No purchase necessary to enter or win. The contest will start on Sept. 13, 2010, and end on Sept. 19, 2010, at 11:59 p.m. ET. To be eligible, you must have at least one (1) stock in My Scorecard (as a purchase or on your watch list) by Sept. 19, 2010. If you already have a stock listed, you are automatically eligible and don't need to do anything further. If you don't have any stocks listed, please add at least one before the end of the contest period.

   To enter without inputting any stocks in My Scorecard or other obligation: On a piece of paper or 3x5 card, print your name, address, city, state, ZIP code, and email address; list a stock you own or are watching; and mail it in a stamped envelope to Motley Fool Pro Contest, The Motley Fool, 2000 Duke Street, Alexandria, VA 22314. Although you may enter as often as you'd like, only one entry per postmarked envelope is permitted. All entries must be postmarked no later than Sept. 19, 2010.
2. WINNER SELECTION: The Motley Fool will randomly select one winner from among the eligible participants. Therefore, the chances of winning depend on the number of eligible entries.
3. PRIZES: The winner will receive a copy of Jason Zwieg's *Your Money and Your Brain* signed by the *Pro* team (approximate retail value: $15) and a Motley Fool T-shirt, mug, and jester cap.

Week 2 Challenge: *Pro*'s Picks
Winner: Michael Guiremand, Thousand Oaks, Calif.

1. ENTRY: No purchase necessary to enter or win. The contest will start on Sept. 20, 2010, and end on Sept. 26, 2010, at 11:59 p.m. ET. To be eligible, you must have at least two (2) *Motley Fool Pro* "Buy First" stocks in My Scorecard (as a purchase or on your watch list) by Sept. 26, 2010. If you already have two *Motley Fool Pro* "Buy First" stocks listed, you are automatically eligible and don't need to do anything further. If you don't have two active "Buy First" stocks listed, please add the requisite amount before the end of the contest period.

   To enter without inputting any stocks in My Scorecard or other obligation: On a piece of paper or 3x5 card, print your name, address, city, state, ZIP code, and email address; list two *Motley Fool Pro* "Buy First" stocks; and mail it in a stamped envelope to Motley Fool Pro Contest, The Motley Fool, 2000 Duke Street, Alexandria, VA 22314. Although you may enter as often as you'd like, only one entry per postmarked envelope is permitted. All entries must be postmarked no later than Sept. 27, 2010.

2. WINNER SELECTION: The Motley Fool will randomly select one winner from among the eligible participants. Therefore, the chances of winning depend on the number of eligible entries.
3. PRIZES: The winner will receive a free one-year subscription to any of the following: *Motley Fool Stock Advisor, Motley Fool Hidden Gems, Motley Fool Inside Value, Motley Fool Rule Breakers, Motley Fool Rule Your Retirement,* or *Motley Fool Global Gains* (approximate retail value: $149-$299).

Week 3 Challenge: Community Picks
Winner: SMK1, Westerly, R.I.

1. ENTRY: No purchase necessary to enter or win. To be eligible, you must make a post or reply on the Motley Fool Pro My Scorecard Contest discussion board guessing the top three (3) stocks held or being watched by *Motley Fool Pro* subscribers, in order, as of Sept. 27, 2010. The contest will start on Sept. 27, 2010, and end on Oct. 3, 2010, at 11:59 p.m. ET. Only one entry per person. If you post more than one entry, only the first post will be considered for purposes of this contest. **Alternate Means of Entry:** On a piece of paper or 3x5 card, print your name, address, city, state, ZIP code, and email address; write your prediction of the top three stocks owned by *Pro* members; and mail it in a stamped envelope to Motley Fool Pro Contest, The Motley Fool, 2000 Duke Street, Alexandria, VA 22314. Only one entry per postmarked envelope is permitted; if you enter more than once, only the entry received first will be considered for purposes of this contest. All entries must be postmarked no later than Oct. 4, 2010.
2. WINNER SELECTION: The Motley Fool will randomly select one winner from among the eligible participants. Therefore, the chances of winning depend on the number of eligible entries.
3. PRIZES: The winner will receive a free one-year subscription to any of the following: *Motley Fool Stock Advisor, Motley Fool Hidden Gems, Motley Fool Inside Value, Motley Fool Rule Breakers, Motley Fool Rule Your Retirement,* or *Motley Fool Global Gains* (approximate retail value: $149-$299) and an additional free one-year subscription to give to a third party as a gift.

Rules Applicable to All Challenges

1. ELIGIBILITY: This contest is open only to legal U.S. residents, over the age of 18. Employees and contractors (and their families) of The Motley Fool, LLC, or any of their affiliates are not eligible. Void where prohibited by law. Contestants residing in those areas where the contest is void may participate in the contest but may not win any prizes.
2. WINNER NOTIFICATION: The winners will be notified within 14 days after the determination date. Inability to contact a winner may result in disqualification and selection of an alternate winner.
3. GENERAL CONDITIONS: The winners will be required to execute and return a Certificate of Eligibility, Consent and General Release form within 14 days of notification. The winners may also be required to complete and return a W-9 for tax purposes. Non-compliance within this time period may result in disqualification and selection of an alternate winner. Any income tax liability is the sole responsibility of the winners. By acceptance of the prize, the winners consent to the use of his or her name and/or likeness for purposes of advertising or trade without further compensation, unless prohibited by law.
4. USE OF CONTEST INFORMATION: All entries become the property of The Motley Fool. The Motley Fool reserves the right to use any and all information related to the contest, including submissions provided by the contestants, for editorial, marketing, and any other purpose, unless prohibited by law.
5. CONDUCT: All contest participants agree to be bound by these Official Rules. The Motley Fool, in its sole discretion, reserves the right to disqualify any person it finds to be tampering with the entry process or the operation of this website or is otherwise in violation of these rules.
6. LIMITATIONS OF LIABILITY: The Motley Fool will not be responsible for late, lost, or misdirected email or for any computer, online, telephone, or technical malfunctions that may occur. If for any reason, the contest is not capable of running as planned, including infection by computer virus, bugs, tampering, unauthorized intervention, or technical failures of any sort, The Motley Fool may cancel, terminate, modify, or suspend the contest. Entrants further agree to release The Motley Fool from any liability resulting from or related to participation in the contest.
7. WINNERS LIST: The names of the winners may be obtained by sending a self-address stamped envelope to Motley Fool Pro My Scorecard Contest, The Motley Fool, 2000 Duke Street, Alexandria, VA 22314.

The Pro My Scorecard Contest

Published Sep 13, 2010 at 12:00AM

We Have Winners!

Winners of the My Scorecard contest are:

- **Week 1: Anita Carty** of Portsmouth, Va., has won an array of Fool goodies!
- **Week 2: Mike Guiremand** of Thousand Oaks, Calif., has won a year's subscription to one of the following: *Motley Fool Stock Advisor, Motley Fool Hidden Gems, Motley Fool Inside Value, Motley Fool Income Investor, Motley Fool Rule Breakers, Motley Fool Rule Your Retirement,* or *Motley Fool Global Gains*!
- **Week 3:** A Fool with the username of **SMK1,** hailing from Westerly, R.I., has won a year's subscription to any of the above publications, plus one to give away to a friend or family member!

Thanks to all who participated!

Maybe it's the start of another football season. Maybe it's the multi-day, 64-person office ping-pong tournament we just finished. Whatever it is, Fool HQ is abuzz with competition these days — and we've decided to bring a little of this killer instinct to you. Put up your dukes and get yourself ready, Fool: We're having a contest, and there are prizes at stake!

We'll have three challenges in all, and we'll announce each one in the Monday Memos on Sept. 13, 20, and 27. We'll update this page with details of each challenge as it is announced, so check back! You can also read the official rules here.

Week 1: Your Pick

- Start Date: Monday, Sept. 13

Head to My Scorecard between now and next Sunday, Sept. 19, and enter Your Pick. Did you just buy a stock? Add it! Is there one out there you're watching? Add it without entering buy information. Then head to the My Scorecard board to tell us about the stock you just entered.

What's at stake? We'll randomly select one winner to receive an array of glorious Foolish goodies. Be prepared to impress your friends; you are now one step closer to being decked out in Fool gear!

Week 2: *Pro*'s Picks

- Start Date: Monday, Sept. 20

To be eligible to win this one, you'll need to have at least two of *Motley Fool Pro*'s "Buy First" stocks in My Scorecard (as a purchase or on your watch list) by Sunday, Sept. 26. If you already have two "Buy First" stocks listed, you're automatically eligible and don't need to do anything further; if you don't, head over to My Scorecard now to add them!

What's at stake? We're upping the ante on this one. One randomly selected winner will receive a free one-year subscription to one of the following: *Motley Fool Stock Advisor, Motley Fool Hidden Gems, Motley Fool Inside Value, Motley Fool Rule Breakers, Motley Fool Rule Your Retirement,* or *Motley Fool Global Gains*. And tell us what you're doing on the My Scorecard discussion board!

Week 3: Community Picks

- Start Date: Monday, Sept. 27

The final week of our My Scorecard contest also features the biggest challenge: Community Picks. Head to *Pro*'s My Scorecard Contest board and guess the three companies, in order, that are most widely held by the *Pro* community on My Scorecard (as of today, Sept. 27). Submit your guess by Monday, Oct. 3, to be in the running for a one-year subscription to your choice of the following: *Motley Fool Stock Advisor, Motley Fool Hidden Gems, Motley Fool Inside Value, Motley Fool Rule Breakers, Motley Fool Rule Your Retirement,* or *Motley Fool Global Gains*, as well as one to give away to a friend or family member!

Banking On Patience

Published Sep 13, 2010 at 12:00AM

Calling all members! As you'll recall from last week's Memo, we're kicking off our three-week-long My Scorecard contest *today*.

Your Pick: Head to My Scorecard between now and next Sunday, Sept. 19, and enter Your Pick. Did you just buy a stock? Add it! Is there one out there you're watching? Add it without entering buy information. Then head to the My Scorecard board to tell us about the stock you just entered.

What's at stake? We'll randomly select one winner to receive an array of glorious Foolish goodies. Be prepared to impress your friends; you are now one step closer to being decked out in Fool gear!

Stay tuned for next week's challenge, which will be announced in the Sept. 20 Memo.

Struggling Industries

There's one bad thing about having a concentrated portfolio: Sometimes it doesn't listen to you, because it's concentrating too hard.

… Anybody? Is this thing on? I'm here all week …

Ahem. In any case, *Pro* does have a focused portfolio, and lately, some of the industries we're focused on have been lackluster.

Breaking News

- Our $21 September puts on **Intel** were exercised early, netting us 1,800 more shares at $20.27. Intel is one of our largest positions, and we remain confident in the computing leader.
- We're having a live chat with **Ebix** CEO Robin Raina on Sept. 23, and you're invited! Get the details here.

Guidance Changes

Medtronic moves up to Buy First; **GlaxoSmithKline** moves down to Buy; **ProShares Short S&P 500** moves down to Hold; and **Lindsay** and **Plum Creek Timber** move down to Hold on price.

Coverage & Community

- Got Twitter? Now you can follow *Pro*!
- See the top-scoring CAPShot stocks as of today.
- TMFEldrehad looks at shooting stars (five-star stocks, that is) on CAPS.
- TMFValuemoosie provides an earnings calendar for *Pro* stocks.
- Alex340 posts puts that meet *Pro* criteria, and covered calls that do, too.
- Share your scorecard selection on the My Scorecard board!

Unhealthy Health Care

Of the $1 million *Pro* has invested in the stock market, more than 15% is in large health-care companies: **GlaxoSmithKline**, **Kinetic Concepts**, and **Medtronic**. As of Friday, those companies are down 7%, 12%, and 24% respectively this year, excluding dividends. All three trade at single-digit multiples to free cash flow, making them among the least-expensive stocks in the portfolio. Why? Because investors remain wary of the recent health-care bill and of lower government spending in Europe, and worry that hospitals might be unwilling to ramp up investments.

But where there's concern, there's opportunity. The health-care bill may slow the industry for now, but as the uncertainty lifts, it should result in millions more people with insurance — and that means more customers for health-care businesses. Europe may be talking tough, but we've yet to see a government actually commit to less health care for its people (unsurprising, as that would be a career-ender for any politician). Finally, demographics favor the health industry as baby boomers worldwide need ever-increasing care.

Meanwhile, each of our three health-care companies trade at about 9 times free cash flow, so downside risk should be limited, making them good defensive plays. Today, we're moving beaten-down Medtronic to Buy First from Buy. You can also write attractive puts on the company in the low $30s. As for Kinetic Concepts, we're waiting to see how management executes next quarter; the last two quarters were light, but KCI remains a Buy on price. Finally, GlaxoSmithKline rebounded smartly this summer, and we're starting to look at defensive covered calls on the company — despite its valuation, a larger recovery in price may be slow in coming. Glaxo is moving to Buy from Buy First.

Uncool Tech

We have even more money invested in technology and software than we do in health-care stocks, with greater than 35% of our invested capital dedicated to shares of **Intel**, **Oracle**, **Autodesk**, **Ebix**, and **Jack Henry & Associates** — as well as a spread on **Cisco Systems**. We could also count **Broadridge Financial** in the industry.

For years, I've preferred software and technology investments to most others, thanks to their strong profitability, growth, and recurring revenue. So our high weighting here doesn't concern me; I'd be more worried if we *lacked* exposure. However, Intel has been weighing on our portfolio, declining sharply this summer after management retracted overly optimistic guidance and moved to buy **McAfee** for $7.7 billion. I believe this acquisition is promising for Intel's positions in cloud computing, mobile, and enterprise security, and the company's core business looks inexpensive today at 9 times free cash flow and with the stock yielding 3.5%. Intel remains a Buy First.

Tech Needs Health Care; We Need Patience

All told, some of our tech stocks need a little "health care" to perk up, while some of our health-care stocks are counting on tech to make their industry more efficient and able to reach more people. Meanwhile, about 50% of our invested funds are in two industries that require patience — but we're sitting on good prices while we wait. Also on the bright side, stocks such as GlaxoSmithKline, Ebix, Autodesk, and Broadridge have shown signs of life lately, and options can aid us in the meantime. The bottom line: Our outlook remains positive for both industries and the companies we own within them. If you're lacking positions among our Buy First and Buy stocks (see them all here), look to pony up or at least write puts.

Options Expirations and Reversing Course on SH

This Friday is shaping up to be a busy one, with four options positions set to expire at the end of trading on Sept. 17. Our $21 puts on Intel were exercised early, and they doubled our stake in the chip giant, with a start price on new shares of $20.27 (the stock is around $18.30 today). Our $25 covered calls on part of our Jack Henry position will expire as a nice cash gain as long as the stock remains below $25. Our $35/$40 strangle on **Lindsay** is close to expiring as a full cash gain, but if Lindsay runs above $40 by Friday, we're likely to let our stock be sold away for a good profit.

Our diagonal calls on **U.S. Natural Gas Fund** are going to expire for the full gain, and we'll either write new diagonal calls very soon, or exit the losing UNG calls we own if we can't write attractive calls again. With UNG near $6, our January 2012 $10 calls are a crazy long shot now, but they continue to carry some value today that we don't want to forfeit.

Finally, our covered calls on **ProShares Short S&P 500** are due to expire as a full gain for the third time. However, this short ETF isn't tracking as well as it did last year. As of Friday, it's down 4% for the year while the S&P 500 is down 0.5%. Obviously, the short ETF should be up 0.5% if it were tracking closely, but it isn't, and its deviation has grown worse lately rather than improved. We're putting the ETF on Hold and looking at an exit plan. Don't buy it now, and we'll have more about it soon. In the meantime, we seek much better short-selling or hedging opportunities.

If you have questions about today's Memo, please visit our Memo Musings board.

Coming next week: What's in store for *Pro* in the coming year, including our growing team and ambitious service goals.

Jeff owns shares of Oracle and GlaxoSmithKline.

Monday Memo: Measuring Up and Calling All Members

Published Sep 7, 2010 at 12:00AM

Measuring Up

By Jeff Fischer

Welcome to this special Tuesday edition of the *Pro* Monday Memo! In a minute, I'll be introducing *Pro* publisher Adrienne Perryman for a special announcement. But before I do, let's take a look at two key metrics for each company in our portfolio. Looking at these key measures will help us understand how financially strong and flexible our businesses are, as well as where most sales are coming from, so we can better pinpoint the geographic risk and diversification each company presents.

We'll start with price-to-free cash flow, which measures the market value of a company against the amount of free cash flow it creates annually. Free cash flow is the actual value generated by a business — the money brought in that is unencumbered, and thus available for the business to spend how it wishes. Historically, the stock market has averaged a free cash flow multiple around the mid-teens, but as with so many things in investing, the devil is in the details. A high-growth business may trade at 80 times free cash flow — as **Google** did when it went public — and still end up being a great buy. But a weak company may fetch only 10 times free cash flow and still not be worth considering.

The *Pro* portfolio holds many healthy businesses trading at low multiples to free cash flow, most notably **Intel**, **Broadridge Financial**, and our health-care businesses — not surprising given that health care and technology are out of favor at the moment. The upside is that odds favor a meaningful rebound in price if these businesses stay steady or improve.

Company	Share Price (9/3/2010, 11 a.m.)	Price to Free Cash Flow (or to book value where appropriate)	Percentage of Sales *Outside* the United States (trailing 12 months)
AmTrust Financial Services	$14.25	1.3 times BV	53.0%
Autodesk	$29.60	16.5	69.3%
Bristow Group	$34.80	0.9 times BV	80.2%
Broadridge Financial	$22.00	9.4*	27.5%*
Cameco	$25.88	28.6	51.0%
Cisco Systems	$20.90	13.0	50.0%
Ebix	$18.75	16.5	24.9%
GlaxoSmithKline	$39.10	8.9	64.0%
GrafTech International	$15.50	28.0	82%
Intel	$18.25	9.2	85%^
Jack Henry & Assoc.	$24.40	12.7	0%
Kinetic Concepts	$33.20	9.3	25.9%
Lindsay	$39.50	12.4	40%
Medtronic	$32.85	9.4	41%
MELA Sciences	$7.00	N/A	N/A
NextEra Energy	$54.55	1.7 times BV	0%
Oracle	$22.65	13.4	57.2%
Papa John's Int'l	$25.22	11.7	3.9%
Plum Creek Timber	$35.40	19.8	0%
Procter & Gamble	$60.00	13.0	58%
Tupperware Brands	$42.50	12.7	68%
Quanta Services	$18.75	51.0	3.3%
Average		16.4~	40.2%

*BR's FCF excludes gains from discontinued operations, and its amount of foreign sales is a *Pro* estimate.
^Many Intel sales to Taiwan and China end up in products sold to the United States.
~ Excludes those measured on book value and our MELA speculation.
Trailing-12-month free cash flow and sales outside the U.S. calculated by *Pro* using Capital IQ, company SEC filings, and *Pro* estimates.

Some outliers in this list do appear expensive, including **Quanta Services** and **Cameco**. But Quanta deals with large contracts that can suddenly send cash flow much higher, and Cameco's valuation is largely dependent on the value of its uranium holdings in the ground. In all, we're comfortable with the valuation of our stocks on this measure.

Coverage & Community

- Member jgunnar provides look-through earnings on *Pro* companies. He also asks, "Is it time to retire the tech label?" David Gardner responds, "Yes!"
- Jeff spoke with **Ebix** CEO Robin Raina on Friday in a Foolish interview. The transcript will be available later this month.
- Alex340 posts puts and covered calls that match *Pro* criteria.
- It's never too early to plan for earnings! TMFValuemoosie posts a calendar.
- Bruce Jackson (TMFGoogly) asks if large-cap stocks are the bargain of a lifetime.
- In the wholly Foolish department, Bob (trurl9) shares how a golfer set a course on fire — literally.
- Interesting stuff: Tom (tcsonic) shares that China is looking deep undersea for commodities.
- Our **U.S. Natural Gas Fund** investment (on Hold) continues to suffer. Jeff shares thoughts on its fate.
- *Pro* analyst Bryan Hinmon (TMF42) likes **Intel**'s strategy.
- TMFEldrehad discusses how to use the CAPS screener as a tool to find possibly high-scoring CAPShot stocks.

The second factor we're looking at, as you can see in the table, is the percentage of sales derived *outside* the United States in the past year. Although last week's positive economic news on unemployment and manufacturing helped lighten the mood in the U.S., many investors are still concerned about American economic strength and are wondering whether they should increase their international exposure. Personally, I'm more concerned about international markets than I am about the United States' economy. Either way, though, we at *Pro* have significant overseas exposure, and we're paying attractive prices for it, while avoiding the many sovereign risks that buying a stock in China (for example) can present. We are likely to add more direct international exposure in the future, but we don't feel we're lacking exposure overseas.

Coming up later this month, we'll issue a special full review of each company in the *Pro* portfolio, examining whether our thesis for each investment remains strong. And with that, I'll hand the reins over to Adrienne — thanks for reading!

Calling All Members!

By Adrienne Perryman

Maybe it's the anticipation of football season. Maybe it's the multi-day, 64-person office ping-pong tournament we've got going on (unfortunately, I was knocked out in round 1, but I will have my revenge). Whatever it is, Fool HQ is abuzz with competition these days — and we decided to bring a little of this killer instinct to you. Put up your dukes and get yourself ready, Fool: I'm here to declare a contest, and there are prizes at stake!

Starting next Monday, Sept. 13, we'll announce the first of three parts of the *Pro* My Scorecard Challenge. You use the tool, right? All truly Foolish investors do (see what we meant about that smack-talkin'?). If you haven't added any stocks yet, give it a whirl — it's simpler than you think. Simply enter the ticker of a company you own or are thinking about buying in the Add More Positions box, then click "ADD." You can also add stocks from *Pro*'s portfolio page by selecting "Add" in the "I Own This Stock" column. From then on, every article published by any service you own, every board post, and every Fool.com article about *your* companies will be delivered to your (virtual) doorstep. And although My Scorecard doesn't handle options trades, you can still enter the underlying stock to see how the company is performing.

We'll announce the first My Scorecard Challenge in the next Monday Memo, so be on your toes. The next two Memos, on Sept. 20 and 27, will feature details on the following challenges, and the contest will wrap up on Oct. 4. As I mentioned, there will be prizes (and bragging rights). In the meantime, head to the new My Scorecard board to talk strategy, talk smack, or talk stocks — we'd love to hear it!

Write a Covered Strangle on Tupperware

Published Sep 2, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") January 2011 $45 covered calls on all shares owned, and write ("sell to open") an equal number of January 2011 $35 puts.
- **Allocation:** We own half of our targeted 4% allocation in Tupperware, and we're writing puts to potentially buy the other half (for *Pro*, that means five calls and five puts).
- **Preferred limit price:** Enter a strangle net credit order for $3.90 or more.
- **Alternate trades:**
  - **If you don't own Tupperware:** We suggest writing one leg of this strangle, the January $35 puts, aiming for a payment of $1.60 per share or more.
  - **If you own at least 100 shares but don't want to buy more:** You can just write the covered call side of the strangle, which will bring you income.
  - **If you aren't using options:** Buy 2% of Tupperware around $40 or lower.

What's New

After **Tupperware Brands** (NYSE: TUP) reported second-quarter results in July, the stock melted 7.5% because of accounting problems in the company's Russian division. We hate this kind of surprise as much as anyone, but management dealt with these head-on, finding and reporting them of its own volition. Because of adjustments in earnings to correct past mistakes and unfavorable foreign-currency conversions, Tupperware lowered its full-year earnings estimates from $3.72 to about $3.56 per share.

Apart from the Russian accounting adjustments, which the company corrected (and which it assures us are not to be repeated), the rest of Tupperware's business remains largely on track. Management is forecasting full-year local currency sales growth of 6% to 8%, with emerging markets leading the way, particularly China, India and Indonesia — three countries that represent *half* of the world's population. In other words, the impressive earnings growth of the past two years is likely to continue. If economies weaken, Tupperware should be able to hire more qualified sales staff, who can then sell to more people looking to save money on food storage. If the global economic picture strengthens, on the other hand, emerging-market sales should continue to grow as more people can afford extra food.

With Tupperware's stock hovering around $41, it trades at an inexpensive 11.5 times the new 2010 earnings estimates and 13.2 times trailing free cash flow, and it has a dividend yield of 2.5%.

Why This Strategy?

This is the fourth time in the past 15 months that we've recommended using options to buy Tupperware stock, sell it, or generate income. We generated income with our first two trades, and in February, we bought a 2% allocation of the stock and wrote a covered strangle to potentially buy our second 2%. Somewhat conveniently, that $40/$50 covered strangle expired just before Tupperware's second-quarter earnings, generating 100% income for the *Pro* portfolio.

We are again writing a covered strangle on our Tupperware shares — writing puts to potentially buy more stock lower and writing covered calls to potentially sell the shares we own higher. We'll be happy either way, and while we wait until the January expiration, we're also happy to keep our existing stock and earn the 2.5% annualized dividend in the meantime.

On Tupperware alone, the *Pro* portfolio has now cleared $7,650 in realized option income and $250 in dividends. That's $7,900 on our $22,765 cash investment. This 34% return doesn't show in Tupperware's numbers on our portfolio page, but it makes the holding an easy winner; when accounting for the buying power that we put aside to write Tupperware puts, the return on investment is still well above 20%, demonstrating how option income strategies can add to your returns even in tepid markets.

How to Follow Along

We recommend buying shares around $40, and continuing to write options on Tupperware if you're using options; our fair value on the stock is still around $50.

To write a covered strangle, you must own at least 100 shares of the stock, and you must be happy to buy at least 100 more at a lower price. You write a covered call on every 100 shares you own, and write a put for every 100 additional shares you would buy. A strangle uses different strike prices, which means it provides a wide range in which to profit. Generally, you write a strangle when you expect a stock to stay in a certain range. Remember, you can also execute only one side of the strangle, if that suits your situation better.

Trade Details

- **Recent options bid/ask (as of Sept. 2):**
  - Sell to open January 2011 $35 puts, $1.60/$1.80
  - Sell to open January 2011 $45 calls, $2.10/$2.35
- **Combined credit target:** $3.90 or more per share, net credit (use a strangle order)
- **Effective options yield:** 9.4% of recent share price ($41.40) in less than five months
- **Potential net buy price of new shares:** $31.10 (24.9% below current price)
- **Potential net sell price on our current shares:** $48.90 (18.1% above current price)
- **Profit range on options:** Anywhere above $31.10

Again, this covered strangle provides you a wide range in which to profit — anywhere from $31 to $49, without the need to involve a stock transaction if you don't want to. If Tupperware is between $35 and $45 by Jan. 20, 2011, both options will expire for the full cash gain, which is what happened last time we used this strategy. At that point, we may repeat our strategy.

If you're new to covered strangles, you may want to review our strangles guide, and ask any questions on our Tupperware board.

Bruce is short Tupperware options.

Monday Memo: Framing the Big Picture

Published Aug 30, 2010 at 12:00AM

In investing as in life, the way you frame things can make a big difference.

Even if you start out calm, regularly proclaiming "My stocks are going down!" will eventually leave you concerned or fearful — and this could make you want to sell for no other reason but to escape falling prices. The implication there, though, is that you would only buy again when prices are already on their way *up* — with the end result that you'd be selling and buying at exactly the wrong times.

Now let's frame the whole concept differently. Instead of "My stocks are going down," we can say, "Investors are valuing businesses less generously lately, so the small slice of each business I own is worth less right now, too." This framing offers a logical look at the situation, gives you context on why it's happening, reminds you that you're not alone with your investments, and even lends itself to a logical response: "I don't want to sell while others have pushed prices lower. I'll wait for a time when investors are paying *up* for these businesses."

Coming Up

- **Labor Day:** Next week's Monday Memo will hit your inbox on Tuesday, Sept. 7. Have a great holiday!
- **Coming to *Pro* in September:** A special report that reviews the thesis behind every investment we hold; a member contest that begins next week; a new options guide; trades (of course); and more.

Review: Last Week's Trade Alerts

- Write a covered strangle on **Plum Creek Timber**.

Coverage & Community

- *Pro* analyst Bruce (TMFGoogly) provides the lowdown on **Medtronic**'s latest quarter.
- **Ebix** will merge with A.D.A.M., a provider of software solutions to the health-care industry. This should add to earnings in year one.
- *Pro* member learninbyfoolin posts a creative video sharing suggestions on how to improve *Pro* — talk about effective! We're already talking about the ideas.
- Ever-popular *Pro* member alex340 shares new puts that meet *Pro* criteria — and now (hold onto your caps) covered calls that meet *Pro* criteria, too!
- *Pro* member latimerburned shares his Fool-inspired investor-revolt blog post.
- Bryan (TMF42) provides an updated *Pro* stock fair-value table.
- Joe (TMFValuemoosie) has a *Pro*-related earnings calendar.
- Russell (TMFEldrehad) highlights the usefulness of tags in CAPS to find investment ideas.

In the way you frame a situation, you can replace an emotional response ("My stocks are falling! Should I sell?") with a logical one ("Businesses are being given lower valuations by investors today. It's not a great time to sell my part of them. In fact, could I buy more?").

A Portfolio Suitable for Framing

Framing is also important when it comes to your portfolio. Once you have a portfolio that's close to fully allocated, each new investment decision you make should, at least in part, be framed by the context of your existing portfolio and its many holdings.

When we saw **Cisco Systems** decline sharply on Aug. 9 — even though the outlook for the business over the next few years looks exceptional — I was drawn to the potential opportunity. However, the *Pro* portfolio already has large positions in several technology leaders, including **Intel**, **Oracle**, **Autodesk**, and **Ebix**. A Cisco stock purchase would have added even more exposure to the industry, which didn't make sense from a portfolio perspective (unless we had sold existing tech holdings to make room for Cisco, which we didn't want to do).

Our other alternative was to use a less capital-intensive strategy. This led to the decision to set up a bull call spread on Cisco. Our net investment representing 3,000 shares of Cisco (with a potential net cost of $55,080 in 2012 if turned to stock) cost us only $10,000 today. The spread also gives us ample downside protection, which is especially important because of our already large exposure to technology. Since our spread cost us a net $3.36 per share and could return $1.64 per share, we stand to achieve a 49% return on investment in 17 months if Cisco is above $20 when our options expire. Earning nearly $5,000 on a $10,000 investment, with the main requirement being that Cisco doesn't decline much, looks like an attractive return with reasonable risk. Even in the context of the tech stocks we already own, we could justify this extra investment. However, if we didn't already own Intel and Oracle, we would have bought shares of Cisco outright. The "frame" of our other holdings helped us determine our course of action.

As the Portfolio Churns

As investors, we need to think about each new investment we make in the context of the entire portfolio we already own. At *Pro*, we continue to offer alternate trade ideas whenever we can, to help you do just that. Since we are close to fully invested, we also need to look over the portfolio on a regular basis and trim or adjust positions based on updated information and beliefs.

When you're building a portfolio, no matter how carefully, you can't be certain how it will all come to look once it's close to fully invested. Once that point is reached, it's time to step back, take an objective look at your creation, and then start to manage it. Since we're running a portfolio, which is made up of interdependent components (not just a list of stocks that operate in a vacuum), we'll sometimes be tasked with cutting some positions even if we still like them. For instance, we may feel overexposed to an industry that isn't as attractive as it was when we bought in. Or we may simply want to be more defensive or free up more capital, and the best way to do so may be to trim many positions at once.

The lesson here is twofold: First, don't fall in love with any single position. Once you have a fully invested portfolio, you need to manage it as a whole, rather than looking upon each individual holding with any strong preference (other than to weed out weaklings). And second, don't look down upon portfolio adjustments as "active trading" or as going against your earlier beliefs. There's a big difference between managing allocations in an evolving portfolio and selling your entire position in a company because it's failing to live up to your thesis. If we make good buy decisions, we'll be managing and adjusting our allocations much more often than we'll be selling entire stocks at a loss. And however you frame it, that's a good position to be in.

Questions? Thoughts? Please mosey on over to the Memo Musings board.

- **How We Do It:** Invest the Pro Way

Jeff owns shares of Oracle.

Write a Covered Strangle on Plum Creek Timber

Published Aug 24, 2010 at 12:00AM

At a Glance

- **Action:** Using a strangle order, write ("sell to open") November 2010 $31 puts, and write ("sell to open") November 2010 $36 covered calls.
- **Preferred limit price:** Enter a strangle net credit order for $2.08 or so (higher if you can).
- **Recent share price:** $33.50.
- **Allocation:** We own about half of our targeted 5% allocation in Plum Creek and are covering all shares, and we're writing puts to potentially buy the other half (for *Pro*, that means 10 calls and 10 puts).
- **Alternate trades:**
  - **If you don't own Plum Creek:** We suggest writing one leg of this strangle, the November $31 puts, and aiming for a payment of $1.20 per share or more.
  - **If you own at least 100 shares but don't want to buy more:** You can just write the covered call side of the strangle, which will bring you income.
  - **If you aren't using options:** Buy a 3% allocation of Plum Creek below $34.

What's New

While we're busy earning options income on its stock, **Plum Creek Timber** (NYSE: PCL) is keeping itself busy as the largest independent landowner in the United States. Its diverse groves of timber serve as an inflation hedge as well as a source of future earnings power. There's not much new with the business lately, and that's fine with us. As we shared last week, Plum Creek continues to be well-managed. Much of its timber is currently being left to grow while the company waits for better log prices. Meanwhile, the company is buying and selling land for profit — but management sees the economy merely smoldering, rather than catching fire. While all this is going on, we want to earn more than the 5% dividend payment (generous though it is), so we're continuing to write lucrative options on the stock.

Why This Strategy?

This will be the fourth time in the past 18 months that we've written a covered strangle on our Plum Creek shares. In a covered strangle, we write puts to potentially buy more stock at a lower price, while also writing covered calls to potentially sell the shares we already own at a higher price. As with our previous Plum Creek covered strangles, our primary aim here is to earn options income while keeping our stock and its 5% dividend yield. This strategy has paid off exceptionally well since we started employing it in February 2009.

On Plum Creek alone, the *Pro* portfolio has now cleared approximately $8,170 in realized options income and $2,520 in dividends. That's $10,690 on our $31,960 stock investment. This 33% return isn't reflected in Plum Creek's numbers on our portfolio page (where we simply show the stock up 5%), but it makes the holding a clear market-beater (even including the equity set aside to hold open the puts we've written, which lowers the total gain on capital). The results demonstrate how options income strategies can add to our returns over time even if the market goes nowhere and how they can help build our wealth with less hand-wringing than owning stocks alone often entails.

How to Follow Along

We recommend buying shares in the lower $30s; these can serve as an inflation hedge while paying a 5% yield. We also recommend writing options on Plum Creek regularly if you're using options in your portfolio; our fair value on the stock still touches $40, although the tepid economy will be a factor.

To write a covered strangle, you must own at least 100 shares of the stock, and you must be happy to buy at least 100 more at a lower price. You write a covered call on every 100 shares you own, and write a put for every 100 additional shares you would buy. A strangle uses different strike prices, which means it provides a wide range in which to profit. Generally, you write a strangle when you expect a stock to stay in a certain range.

Trade Details

- **Recent options bid/ask (as of Aug. 24):**
  - Sell to open November 2010 $31 puts, $1.21/$1.25
  - Sell to open November 2010 $36 calls, $0.87/$0.91
- **Combined credit target:** $2.08 or so per share, net credit (use a strangle order)
- **Effective options yield:** 6.2% of recent share price ($33.50) in three months
- **Potential net buy price of new shares:** $28.92 (13.6% below current price)
- **Potential net sell price on our current shares:** $38.08 (13.6% above current price)
- **Profit range on options (not including the stock):** Anywhere above $28.92

Again, this covered strangle provides a wide range in which to profit — we can make money on the options if Plum Creek shares are anywhere from $28.92 to $38.08 at expiration, without the need to involve a stock transaction if we don't want to. If Plum Creek is between $31 and $36 by Nov. 20 (just 88 days away — have you made your Thanksgiving plans yet?), both options will expire for the full cash gain. At that point, we may repeat our strategy a fifth time.

Keep in mind that anytime you write puts, your broker sets cash or equity aside to cover your potential stock purchase. These $31 puts pay a 3.9% yield on cash set aside over the next three months, and a much higher effective yield if you're using equity. If you're new to covered strangles, you may want to review our strangles guide. Please bring any questions to our Plum Creek discussion board.

Monday Memo: Avoid the Pitfalls of Valuation

Published Aug 23, 2010 at 12:00AM

When Jeff and I attended medical technology company **Kinetic Concepts**' annual investor day last November, we were fortunate enough to score some face time with NYU finance professor, author, and valuation guru Aswath Damodaran, who also graciously provided us with the latest edition of his valuation classic, *The Dark Side of Valuation*.

Guidance Change

- Up sharply since earnings, **Ebix** moves to Buy from Buy First.

Pro Events

- Aug. 24: **Medtronic** earnings.
- Sept. 14: **Cisco Systems** analyst day.

Review: Last Week's Trade Alerts

- Initiate a bear put spread on **Caterpillar**.
- Initiate a bull call spread on Cisco Systems.
- Buy to close puts on **Plum Creek Timber**.
- Write covered calls on **Cameco**.

Coverage & Community

- TMFEldrehad highlights a live chat with one of the "best of the best" in all of CAPS.
- New *Pro* analyst Nick Crow (TMFCrow) starts a discussion on "if deflation happens."
- Alex340 posts put-writing trades that match *Pro* criteria (and *Motley Fool Options* puts, too).
- Leaning on his professional experience, member 4stree posts about land prices in relation to banks and Plum Creek Timber.
- TMFValuemoosie shares an earnings calendar.
- *Pro* members discuss the news that **Intel** will buy **McAfeeSoftware**.

The first edition of the book was published in late 1999 to address "the inability of traditional valuation models to explain [then-]stratospheric stock prices for technology companies," as well as "the willingness of analysts to abandon traditional valuation metrics and go to the 'dark side' of valuation, where prices were justified using a mix of new metrics and storytelling." The timing couldn't have been better, as the dot-com bubble burst just a few months after the book was published.

It's easy to look back at the dot-com era and laugh at the analysts who used metrics like price-to-page views, price-to-click-throughs, and price-to-downloads to value high-flying (but unprofitable) companies. Yet similar shenanigans — almost as laughable as our favorite, price-to-meringue pies — are common in many of today's Wall Street research reports.

The dark side of valuation is a seductive force for analysts who need to come up with frequent buy recommendations for clients. A tweak to a model's inputs here or there — intentional or unintentional — can make any stock appear undervalued.

Because of this, whenever we do valuation work at *Pro*, we remember the common pitfalls Damodaran outlined in *The Dark Side of Valuation*. Here are a few of them:

1. **The input phase:** When gathering information, analysts often fall victim to "base year fixation" — using the last 12 months of data as a good starting point for making projections. Doing so isn't always accurate, which is why for cyclical firms (such as **Lindsay**), we prefer to use a "normalized" base year. This way, we can

capture the underlying business trends, independent of cyclical ups and downs, to feed into our valuation analysis.
2. **The valuation phase:** As we begin to make projections, we want to make sure our assumptions for future growth are consistent with the company's (and the industry's) past, and that they account for the company's size. **Procter & Gamble**, for example, is a $170 billion company, and it's therefore unlikely to grow as fast on a percentage basis as a smaller company. Also, reversion to the mean is a powerful force; a company that has been growing at high rates in previous years is likely to face stronger competition, and thus reduced profitability, down the road.
3. **The post-valuation phase:** After our model spits out a fair value, we don't "garnish" the valuation to make it fit our thesis. Because discounted cash flow (DCF) valuations are largely determined by the company's terminal value (the value we assign assuming the company will exist forever), an easy way to make the valuation fit your thesis is to arbitrarily increase the terminal growth rate. Even a small change in that rate can make a big difference; the seemingly minor change from 3% to 4% could increase a valuation result by 25% or more.

Valuation is part art and part science, so there will always be subjective judgments in any analysis. But our aim is always to avoid the dark side of valuation and provide an honest assessment of any given investment.

Up Next

In the next Monday Memo, Jeff talks about our recent Cisco and Caterpillar trades in the context of your whole portfolio. Watch for it in your inbox on Aug. 30!

Will we misjudge a company at times? Absolutely. But by erring on the conservative side and making sure our estimates are grounded in reality, we hope to produce fair valuations that will help us avoid permanent losses and meet our goal of closing at least 75% of our positions profitably.

Have a question about valuation? Post it on the Philosophy & Strategy board.

Foolish best,

Todd Wenning

Todd owns shares of Procter & Gamble and Kinetic Concepts.

Write Covered Calls on Cameco

Published Aug 20, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") December 2010 $28 covered calls on all of your Cameco shares
- **Allocation:** Write one call for every 100 shares of Cameco owned (for *Pro*, that's seven contracts)
- **Recent stock price:** $25.60
- **Option's recent bid/ask (Aug. 19):** $1.00/$1.10
- **Preferred limit price:** About $1
- **Special requirement:** You must own at least 100 shares of Cameco to write a covered call.
- **Alternate trades:**
  - **Don't own 100 shares of Cameco?** Continue to hold your position.
  - **Don't own any shares of Cameco?** The stock is on hold, but you can sell December 2010 $23 puts for around $1 to potentially add shares at a net $22.

What's New?

As we noted in our review of **Cameco**'s (NYSE: CCJ) second-quarter results, the news has been uninspiring lately at our favorite uranium miner. Sales fell and profits slumped, and the company reduced its 2010 uranium sales forecast to 30 million pounds from a previous range of 31 million to 33 million pounds.

Cameco's quarterly results can be lumpy, and we're not overly concerned about the company having one off quarter, especially as uranium is hardly a deteriorating asset. On the upside, Cameco is still on target with its long-term goal to double uranium production by 2018.

The favorable long-term trends for this "clean" energy source remain firmly intact, with Cameco recently signing its first long-term sales agreement with a Chinese utility — CNEIC, a subsidiary of China National Nuclear Corporation. Cameco will supply 23 million pounds of uranium concentrate to CNEIC through 2020.

Despite this, Cameco stock is down year-to-date, reflecting a cooler short-term uranium market and softer results. At around $25.60, CCJ shares currently trade at a P/E of around 24 (which is hardly cheap), falling to around 21 next year (again, not cheap). Even though Cameco's short-term valuation needs to be considered, its long-term uranium supplies will drive its earnings power and give us confidence in holding the shares if they aren't called away.

Why This Strategy?

We're maintaining our fair-value estimate of $31 and preferred buy price of below $24.50, but with the company's near-term valuation looking stretched, we're going to take the opportunity to write covered calls again: this time, December 2010 $28 calls. This strategy will create a modest hedge while either earning us income or allowing us to sell our shares at a net $29, just a couple of dollars shy of our fair-value estimate.

If Cameco moves up on news that makes us want to keep our shares, we can also consider rolling our covered calls to a later month and/or a higher strike price.

Here are the potential outcomes of the trade:

If:	Then:	*Pro* 's Take:
Shares are greater than $28 at expiration ...	Our position is called away at an effective sale price of $29 — a 76% gain on our original purchase.	We're perfectly comfortable with this, and we'd free up more than $19,000 to invest elsewhere.
Shares are below $28 at expiration ...	We keep our shares, and the $1 premium stays in our bank account, thank you very much.	We're fine with this result, too, and we'd look to write new covered calls to generate more income.

How to Follow Along

If you need a refresher on covered call strategies, see *Pro*'s guide to covered calls. Remember, you write one call for every 100 shares of stock you own. You may cover all of your shares or just some — we're covering all of ours. Here are the numbers behind the trade:

- **Trade:** Write ("sell to open") December 2010 $28 calls on your stock position, in 100-share increments
- **Option yield (at recent $1 bid):** 3.9% of the $25.60 share price, in four months
- **Option yield on our $16.52 average cost basis:** 6.1%
- **Upside from today's price ($25.60) to the $28 strike price:** 9.4% (total return on the trade from today's prices would be 13.3%)
- **Total return on position if exercised:** 76%
- **Downside protection:** 3.9%; the $1 we earn on each call means that a decline to $24.60 is hedged

When you write ("sell") an option, the going price is paid into your account, and that money is yours to keep. In this case, if you write these calls and take no further action, you'll be obligated to sell shares of Cameco if they're above the strike price by the expiration date.

Writing puts? If you place the alternate trade and write puts, you'll be obligated to buy shares of Cameco if the stock declines below your strike price.

We'll make this trade in the next one to 30 calendar days. To discuss it or ask questions, please visit our Cameco board.

Bruce Jackson does not own shares of Cameco.

Buy to Close Puts on Plum Creek Timber

Published Aug 19, 2010 at 12:00AM

At a Glance

- **Action:** Maintenance trade — "buy to close" all of your August 2010 $35 puts
- **Conditions for trade:** Make the trade if Plum Creek shares are below $35 on Friday, Aug. 20 (or earlier, if you wish)
- **Preferred limit price:** Aim to pay only the difference between the share price and the strike price, plus a nickel. For example, if Plum Creek is trading at $34.50, aim to pay $0.55 or less to close the puts.
- **Reason:** Rather than buying more shares of Plum Creek, we want to keep writing options on what we own.
- **Alternate trades:**
  - **If you only wrote puts:** If you don't own any Plum Creek yet but have written puts and want to own the stock, then do nothing and let your puts exercise into stock.
  - **If you aren't using options:** If you're not using options, the stock remains a buy with a preferred price around $34 or lower, giving you a 5% dividend yield.
- **Follow-up trade:** Expect a new Plum Creek options trade from *Pro* soon.

What's New

When we wrote our last $35/$40 covered strangle on **Plum Creek Timber** (NYSE: PCL) in March, we received nearly $3 per share. After the market closes tomorrow, our $40 covered calls are set to expire as a full cash gain. But with the stock currently around $34.50, unless we close them early, our $35 puts would turn into new shares over the weekend. These puts paid us $1.90 per share, so they're highly profitable, and we prefer to take the majority of this profit tomorrow — by buying to close the puts — rather than accept more shares of stock.

Why This Strategy?

Last quarter's results continued to demonstrate a steady hand on Plum Creek's tiller, but management has a cautious outlook for the remainder of the year, with any good news largely dependent on a steady housing recovery and steady demand for timber. Currently, management believes sawlog prices will decline modestly the next two quarters.

Meanwhile, we already own 1,000 shares of Plum Creek, and writing options on these shares has been more profitable over the past 18 months than doubling our share count with puts would have been. We believe this will remain the case, since Plum Creek's stock will likely stay in a range while the economy muddles along. Along with its 5% dividend yield, the stock has been one of our most lucrative for covered strangle options income, and we want to continue writing generously paying options on our stake. Owning only half of an allocation (2.7% of our 5% target) allows us to continue to write covered strangles.

How to Follow Along

If you only wrote puts and don't own the stock yet, you could let your puts be exercised into shares, and then look to write new covered options with us soon. But if you already own half a position in Plum Creek, taking your profit on the current strangle to write a new one will keep you in line with *Pro*. You should "buy to close" as many puts as you originally sold to open, and let your $40 covered calls simply expire. Finally, if you're not using options, Plum Creek remains a Buy with a preferred price around $34 or lower, granting you a 5% dividend yield. Please visit the Plum Creek discussion board with any questions.

Options Guides

Published Aug 18, 2010 at 12:00AM

Pro employs options strategies as part of our portfolio, and if you're new to these, they can seem confusing. Get up to speed on options with our first three guides, then dive into more advanced techniques with the rest. And if you prefer a hard copy, all of our guides can be downloaded in one PDF here.

More Options Know-How

- Options Glossary
- Taxes and Options
- Video Extra: Options in 3 Steps

Your Course in Options

- Options 101: Basics: A Foolish introduction to the whys and hows of options trading.
- Options 201: Covered Calls: Learn how to generate cash on stable stocks you own or obtain better sell prices.
- Options 301: Writing Puts: Get lower buy prices or earn income on stocks you've got your eye on.

Advanced Options

Initiate a Bull Call Spread on Cisco Systems

Published Aug 18, 2010 at 12:00AM

At a Glance

- **Strategy:** Bull call spread
- **Trade:** Buy to open January 2012 $15 calls and sell to open January 2012 $20 calls
- **Allocation:** 5% (for *Pro*, about 30 contracts); buy and sell an equal number of calls
- **Limit price:** About $3.60 or lower
- **Profit potential:** About $1.40, or 39% return on investment
- **Special instruction:** Use the "spread" order command to save on commissions.
- **Alternate trades:** Write (sell to open) January 2011 $20 puts; or, just buy the January 2012 $15 calls (without a spread) for the long haul. Finally, you could buy shares directly.

The Opportunity

Spreads Got You Scrambled?

If you have any questions about spreads, please post on the Cisco Systems board.

Cisco Systems (NASDAQ: CSCO) reported the best quarter in its history last week, and the company's leadership voiced strong confidence in its future. Wall Street, however, pushed the stock lower in response to management's parroting of the Federal Reserve in suggesting "unusual uncertainty" in the economy. The disproportionate response to these comments is best illustrated with a quote from the Aug. 11 conference call (courtesy of Capital IQ), sharing Cisco CEO John Chambers' words in their full context:

"Our business ... continue[s] to grow at a very strong rate, and mathematically, would indicate very solid growth over the upcoming quarter. We feel very good about those areas that we can control or influence. However, balancing this strong optimism, there are some challenges that are contributing to an unusual amount of conservativism [sic] and even caution.

"In short, we see the same opportunities and challenges that you're reading about in regards to the market. Those challenges [range] from GDP growth and future GDP projections continuing to slow in the U.S., [to] job creation challenges and concerns coming out of Europe, just to mention a few. We are seeing a large number of mixed signals [in] investor markets and from our customers ... and we think the words "unusual" or "uncertainty" are an accurate description of what is occurring."

Cisco and the *Pro* Port

Our portfolio already has positions in some tech leaders, including **Intel** (NASDAQ: INTC) and **Oracle** (NYSE: ORCL). That's part of the reason we're using a spread on Cisco instead of buying shares directly — the spread requires and risks much less capital, and doesn't overweight us on tech at this point. But we're confident enough in Cisco that we'll convert to shares should that be beneficial later.

After air-quoting Bernanke's key words, Chambers went on to say:

"The Federal Reserve's comments yesterday, that the pace and output of the recovery has slowed in recent months and that the recovery is likely to be more modest in the near term than has been anticipated just a few months ago, are comments that most of our large customers that I've talked with recently would agree with.

"Also, the same customers would agree, with few exceptions, that they still expect a very gradual return to more normal economic conditions. In summary, on those areas that we can control or influence from an innovation point of view or an operational execution point of view, we feel we are extremely well-positioned. Almost all of our product families are in the early stages of their life cycle and gaining solid momentum, as we discussed earlier."

In response to these reasonable statements, Cisco lost more than $14 billion in market value the next day. Granted, the conference call did raise other areas of concern, including lower margins because of product mix; component shortages (which required paying up); and plans to hire 3,000 employees in the coming quarters. But product mix should improve, component supply issues are expected to be remedied, and investing in the future is rarely a bad thing for a good company — especially one as strong and fast-growing as Cisco. Put the pieces together, and we see value in this giant.

The Nitty-Gritty

Whether you realize it or not, you almost certainly use Cisco's technology every time you're online. Cisco is the world's leading producer of routers and switches that direct and manage the planet's ever-growing Internet traffic, and if a certain technology is related to this (for example, wireless, security, optical networking, and videoconferencing, just to name a few), Cisco has products for that, too. The company has a knack for acquiring smaller technology firms, which allows it to integrate the latest and greatest developments into its next generation of products, keeping it one step ahead of the formidable competition.

Cisco is so integral to the Internet that during the financial meltdown of 2008, revenue only hit a small road bump, dipping 8.6% to $36.1 billion in fiscal 2008. For fiscal 2010, which just ended, sales rebounded to a record $40 billion, while operating income hit a record $9.1 billion. Management expects 18% to 20% sales growth for the first quarter of 2011 (which is already under way), and in the long term, the company models for 12% to 17% annualized net income growth. Meanwhile, a net cash position of $27.7 billion gives Cisco plenty of firepower to continue acquiring the young companies it likes best.

Following its recent swoon, Cisco is valued at only 8.8 times enterprise value to EBITDA, and 13.7 times trailing free cash flow. Management saw value last quarter, buying back $2.3 billion in stock at $23.33 per share; today the stock trades at $22, fetching 12.7 times expected earnings for the current year. Our bull call spread aims to earn nearly a 40% return on investment with a breakeven price (and, thus, valuation) that's 15% lower than today's price, providing even more margin of safety.

The Strategy

We're not ignoring economic uncertainties — we know orders could slow again. Thus, we're using a conservative options strategy that offers a breakeven price of $18.60.

A bull call spread always involves buying and selling an equal number of options. You use different strike prices to set up the spread, but the same expiration date. The most you can earn is the difference between the two strike prices, minus the net cost to set up the trade. The most you can lose is your initial investment, but you can set up defensive spreads to help avoid this, and still potentially earn strong returns.

By using strike prices well *below* Cisco's recent share price, we'll earn the full profit on this spread even if Cisco goes nowhere or is down modestly over the next 17 months. Here are the details on the Cisco spread:

Cisco Systems Bull Call Spread Specifics	Price Per Share
Buy to open January 2012 $15 calls	$8.35
Sell to open January 2012 $20 calls	$4.75
Enter as a spread trade, net debit limit price	$3.60
Spread difference	$5
Profit potential	$1.40 (39% return on capital)
Capital at risk	$3.60

Once you set up the trade, here's how your position could play out:

If Cisco Shares Do This ...*	Their Price Will Be ...	And Our Result Will Be ...
Go up, go nowhere, or fall less than 10%	Above $20	Maximum profit
Fall more than 31.8%	Below $15	Full loss
Fall exactly 15.4%	$18.60	Breakeven
Are anywhere above $15 and we want to own shares	Higher than $15, so we'll convert the $15 calls into shares at a net $18.60	Ownership of Cisco for the longer haul (which is an alternate trade today, as well, given the company's price and dominance)

*Recent share price $22.

Cisco needs to fall a hard-to-imagine 31.8% by January 2012 for our spread to end without value. Nothing is impossible, of course, but if that happens, something will have gone seriously wrong. As long as Cisco doesn't lose more than 10% by expiration and stays above $20 (a much more likely outcome in our eyes), we'll earn our full profit on the position. Finally, as long as the stock is above $15, if we decide we want to own it, we can turn the $15 calls into stock after closing the $20 calls — but our main objective initially is to make money on the spread, ideally the full amount.

If you have any questions, please visit the Cisco Systems board.

Jeff owns shares of Oracle.

Initiate a Bear Put Spread on Caterpillar

Published Aug 17, 2010 at 12:00AM

At a Glance

By Jeff Fischer and Todd Wenning

- **Trade:** Buy to open November 2010 $80 puts and sell to open November 2010 $75 puts
- **Allocation:** 3% (for *Pro*, about five contracts of each)
- **Net debit limit price:** About $4 or lower
- **Profit potential:** About $1, or 25% return on investment by Nov. 20
- **Special instruction:** Use the "spread" order command to save on commissions. **Use a limit order.**
- **Alternate trade:** Short Caterpillar directly if the stock price rises above $76 (current price is $69.50).

The Big Picture

If it's yellow and has large wheels, there's a good chance it's a **Caterpillar** (NYSE: CAT) machine. Headquartered in Peoria, Ill., Caterpillar is one of the most recognized brands in the world — even the dirt on the ground knows to get out of the way when one of these monsters rolls into town. We're not here to bad-mouth a stolid Midwestern business. It's a winner. But after gaining more than 50% over the past 12 months, Caterpillar's shares look as heavy as its machines. The stock is ready to idle for a while even if the economy continues to ramp up. And if the economic recovery slows, Caterpillar's shares may shudder. In either case, our conservative bear spread is a hedge against our several bullish positions in other companies.

The Nitty-Gritty

Caterpillar's many product offerings align its business with major industries like agriculture, mining, construction, and oil and gas — all highly cyclical sectors that tend to boom when the economy is improving, but suffer significantly when times get tough.

Caterpillar was hit hard during the recession — sales fell nearly 37% from 2008 to 2009 as companies scaled back spending on heavy machinery. In fact, U.S.-based sales in 2009 were down 25% compared with 2004. What kept Caterpillar growing were its international sales, which are up 35% over the same period.

Region	2004	2005	2006	2007	2008	2009
U.S.	$14,198	$17,348	$19,636	$17,091	$17,291	$10,560
Non-U.S.	$16,108	$18,991	$21,881	$27,867	$34,033	$21,836
Total	**$30,306**	**$36,339**	**$41,517**	**$44,958**	**$51,324**	**$32,396**

Data provided by Capital IQ. All figures in millions.

2009 was an unusual year, and the market is expecting Caterpillar to make a full recovery by 2012. Analyst consensus calls for sales growth of 22% this year, 15% in 2011, and 13.5% in 2012, which would bring total sales back to their 2008 high of $51 billion. In anticipation of 2012 results, investors have already pushed the stock close to its 2008 highs.

But where will all this growth come from? Developed markets like the U.S. and Europe are still licking their wounds after the construction implosion, and they're unlikely to return to pre-recession activity anytime soon — certainly not while empty homes, offices, and malls still litter the countryside. Caterpillar notes that emerging markets are currently driving its business, but two biggies — China and Brazil — have problems of their own. China is concerned about its own asset bubble, and Brazil is arguably growing at an unsustainably fast rate. So we're not convinced that emerging markets will be able to both make up for the slowdown in developed markets *and* drive high growth rates for years at Caterpillar — at least, not enough to justify these optimistic value multiples:

Ratio	Current	5-Year Average	10-Year Average
Enterprise value-to-EBITDA	19.31	13.16	13.21
Price-to-book	4.67	4.77	4.10
Price-to-sales	1.27	0.98	0.96

Data provided by Capital IQ.

Using a two-stage discounted free cash flow to firm model, we assumed an 8.2% cost of capital as our discount rate and 2% terminal growth, resulting in a fair value estimate between $57 and $60. If we increase the terminal growth rate to 3%, we get $71 to $74 — still below the strike prices on our bear put spread.

The Strategy

A bear put spread involves both buying and selling. You buy and sell (or write) an equal number of puts on a stock. The puts have different strike prices; the most you can earn on the trade is the difference between the two strike prices, minus the net cost to set up the trade. You need a high level of options approval to set up a bear put spread, even though your risk is limited to your original investment and you can set up defensive trades like this one. By using strike prices well *above* Caterpillar's recent share price, we'll earn the full profit on this spread as long as Caterpillar;s stock doesn't gain more than 10%. Here's how the spread shakes out:

Caterpillar Bear Put Spread Specifics	Price
Buy to open November 2010 $80 puts	$12.15
Sell to open November 2010 $75 puts	$8.30
Enter as one spread trade, net debit limit	$4 (or lower)
Strike price difference	$5 (the "spread")
Profit potential	$1 (25% return on capital)
Capital at risk	$4

Once you set up your trade — ideally using a "spread" order command — here is how your profit could play out by the Nov. 20 expiration:

If CAT Shares Do This ... *	Its Price Will Be ...	And Our Result Will Be ...
Gain less than 8%	Below $75	Maximum profit
Gain more than 15%	Above $80	Full loss
Are exactly 9.4% above current price	$76	Breakeven
Are anywhere below $80 and we want more time to be short	Convert $80 puts into short CAT shares at a net $76	More time in strategy

*Current share price is $69.50.

Caterpillar is an enormous company already, and its stock would need to gain more than 15% in about three months for our spread to expire worthless. That appears unlikely. Meanwhile, as long as the stock gains less than 8% (which we believe *is* likely), we earn our full profit. Near expiration, we'd close both options when their time value is gone for a net credit of $5, resulting in a $1 profit on our $4 investment (25%). If Caterpillar is cooperating, we may then set up another bear put spread.

Finally, if the stock is anywhere below $80 at expiration, we could let our $80 puts be exercised into a short sale. That way, we'd be directly short the stock if we want more time for our thesis to play out — although our main objective with this trade is to make money on the spread.

If you have any questions, please visit the Caterpillar board.

Monday Memo: This Market May Require More

Published Aug 16, 2010 at 12:00AM

In Friday's weekly column for *Motley Fool Options*, I outlined why the past 12 months have been less than ideal for options investors. The S&P 500 is down since last October (although it was on the ascent until May of this year, making shorting a losing strategy during that time). Volatility has for the most part declined all year, sending option prices lower. With many stocks looking reasonably valued, the siren song of hedging or shorting (and thus making money on an inaccurately valued stock) has been neither loud nor clear. Last but not least, so far in 2010, the S&P 500 is just plain old flat.

A flat market is an option buyer's enemy, because you need a meaningful move in an underlying investment for an option to gain value. But when you *write* options, a flat market is your friend — you'll make money without missing out on anything when a stock stays within a certain range. At *Motley Fool Pro*, we've been writing options throughout the year without buying any to speak of (just in-the-money calls on the short S&P 500 ETF), and we have more than a dozen positions closed for a profit in 2010 to show for this strategy. But when writing options is practically the only way we're making steady returns, even my patience starts to grow a little thin.

Guidance Changes

- **Tupperware** , **Lindsay**, and **Plum Creek Timber** move up to Buy on price.

Earnings

- **Autodesk**
- **Broadridge Financial**
- **Cameco**
- **Ebix**

Option Expirations

- **Aug. 21:** Plum Creek Timber covered strangle. We plan to let it all expire; if need be, we'll close one side early to write a new strangle (we'll send an alert, of course).

Coverage & Community

- TMFEldrehad discusses a few of the ways one can sort through the many thousands of pitches in CAPS to find the ones that might be most meaningful. In addition, he introduces readers to TMFBigVice, a CAPS portfolio that asks the question, "When it comes to investing, which pays better, sin or virtue?"
- *Pro* members debate whether to be a market optimist or pessimist.
- TMFValuemoosie posted an earnings calendar.
- Alex340 shared puts that match*Pro* criteria.
- Tupperware has put its accounting corrections behind it, and inventory levels don't worry *Pro*.
- Writing a straddle on **Lindsay** still looks interesting to Jeff. See our guide on writing straddles. If you're expecting a flattish market or stock, straddles can rack in option income.

Is This Indeed the New Market?

Here at *Pro*, we've been expecting a stuck market for a long time, and as it turns out, the S&P 500 has indeed been flat since the day *Pro* launched — October 6, 2008. How can that be? Well, the market was ridiculously volatile at that point, such that our tracking date and price happened to fall on a day when it was sharply lower. The S&P 500 is now up 20% from that particular day — but if you consider a few days before or after, or the day our doors actually opened, the index is anywhere from flat to down since then. In other words, the month was so volatile that it's a poor barometer, but overall the index is more or less unchanged since then.

This stagnant market has challenged everyone's returns over not only the past two years, but also the past *10 years* and more — and this state of affairs may continue even longer than we first thought. If it does, we will need to adjust our strategy in reaction to this "new market," acting more aggressively to generate stock returns alongside our option gains. We won't turn into mere traders; as always, our focus will remain on the longer term with stocks. But if the market goes basically nowhere, as we expect, we'll need to be ruthless with our valuation estimates — and act on them.

How So?

GrafTech International has been trading in a 52-week range between $12 and nearly $18. **Autodesk** has been between about $22 and $35. **Cameco** has traded between $21 and $34 in the past year. Those are wide ranges in a market that has ultimately gone nowhere.

We moved GrafTech to Buy or Buy First when it fell to $12, and we put it back on Hold above $15. We also changed our guidance on Autodesk and Cameco as those shares moved about in their price ranges, and we wrote covered calls on those two stocks. As you've followed along, hopefully we've been guiding many of you to buy our companies at good prices and hold off at higher points. But all three of these stocks did touch our fair-value estimate at some (typically brief) point, and in retrospect, covered calls may have been too passive. If we expect stocks to trade within a certain range for a long time, then we should be selling more assertively when our stocks hit the top of our value range.

So if we continue to believe that the market will go basically nowhere, we need to keep writing options for income, and we also need to be less hesitant to sell our stocks when pricing opportunities turn up. We can't hold on hoping for more upside unless we have enough confidence that things will be much better 12 months down the road. Barring that, in a market like this, we should exit *mas rapido* and wait for a lower buy price.

There *Was* That Little Meltdown

Why haven't we done just that before now? Well, you may have heard about the little worldwide financial meltdown that began in 2008. Since then, investors around the world — your *Pro* team included — have been trying to figure out how quickly, and to what degree, sales growth and earnings will rebound. If the economy's recovery is healthy enough, leading companies should have much more upside than is currently priced into their stocks. We've been working to get a read on whether that's likely before acting rashly and selling too soon. After all, we admire all of our companies. On the other hand, if the recovery disappoints, that means a much longer wait for good returns; in that case, we should amp up our option writing even more — as well as our shorting. Finally, if the recovery is somewhere in the middle, that means stocks right now look reasonably priced — so next time they near our fair-value estimates, we should be ready to sell more.

Elevators Are for Exiting

Right now at *Pro,* we suspect we're in for a middle-of-the-road recovery but more challenges ahead, which will keep a reasonable cap on stock prices. Our expectations for less-than-robust market gains mean we'll be more inclined to sell some positions directly when they get near our fair-value estimate the second time around. Basically, if the market is going to be in a rut, we don't want to keep riding the same elevator up and down unless we can step off when appropriate, and then step back on for another ride up. The more tepid the economic recovery looks, the more a rut seems likely. As long as this is the case, we won't be shy to take our sell prices when they come along.

To ask questions or discuss this, please visit the Memo Musings board.

Foolishly,

Jeff Fischer (TMFFischer)

Buy to Close Your Entire Short Position on iPath S&P 500 VIX Short-Term Futures

Published Aug 11, 2010 at 12:00AM

At a Glance

- **Action:** Buy to close/cover entire short position
- **Trade:** If you followed our original recommendation, cover your short position by buying to close the same number of shares you sold short. If you followed our adjusted trade by writing options, buy to close the same number of calls you wrote.
- **Recent share price:** $21.50
- **Preferred buy-to-close price:** Close your shorted stock using a limit price near the current market price, as long as it remains in the low $20s or below. Buy to close your written August $30 calls at $0.05.

What's New

Well, that was fun! When the market's most famous measure of expected volatility — the VIX "fear gauge" — increased to more than 30, we initiated a short position on the exchange-traded note (ETN) that aims to track it, the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX). As implied volatility in the market declined, so did the VXX, meaning that our short made good money in the last month. Now, as summer starts to wane, it's time to take our profit and wait for volatility to increase again — with hopes of repeating this trade when it does.

A quick glance at the latest headlines reveals that an uneasy sense of calm has settled over the market. The IMF is reporting that Greece's restructuring goals are "well under way," **BP** (NYSE: BP) has seemingly stopped the Gulf oil leak and is moving forward with its "static kill" procedure, and even the weather-folk are predicting fewer named tropical storms this season. Combine all that (well, except maybe the weather) with a decent earnings season, and you can see why the VIX has declined by about 36% since the start of June.

Not even eight weeks have passed since our original recommendation, but our thesis has largely played out. Back then, we said: "We expect trading volume to decline (as generally happens when the weather heats up in the Northern Hemisphere), the reality of the new worldwide economy to settle in, and market volatility to start to subside — bringing the VIX back to more average levels." The VIX is now at 22, compared with a historical average of 19. It could certainly still move a bit lower, and eventually the VXX ETN could be almost worthless due to the futures contracts it uses. However, we prefer to take our profit now and wait for another opportunity to repeat this short position, because we don't believe volatility is gone for good.

How to Follow Along

If you followed our original recommendation, you sold shares of VXX short somewhere near $30. *We recommend you "buy to close" or "buy to cover" an equal number of shares of VXX to cover your short position, at a price in the low $20s or less*. Completing the trade should net you zero shares in your account, of course.

If you could not make the original trade, you may have followed our advice and written uncovered August $30 call options on VXX for about $1.10 per contract. These call options have only time value remaining and are trading with a bid/ask spread of $0/$0.10. *We recommend that you buy to close the same number of contracts you originally sold, for $0.05 if possible*.

Upon ending this profitable trade, we wouldn't mind seeing market volatility spike again, so we can take a new short position. An affection for market volatility may seem strange at first, but knowing we can profit from it certainly helps us sleep more easily!

To discuss this trade, please visit the iPath S&P 500 VIX Short-Term Futures board.

Monday Memo: Invest the Pro Way

Published Aug 9, 2010 at 12:00AM

Allocation and diversification are two of the most challenging skills an investor can master, and they're also two of the most important. Too many investors buy only a small handful of stocks and then squirm and gasp as their shares swing to and fro. Inevitably, a few positions don't work out, and the investor – already frazzled from the high volatility – becomes disenchanted, wondering why the market is so harsh. This frustration compounds when someone expects results in only a few short months.

When you invest, you have to come to terms with the idea that not every investment will work out at the same time. Some will never work out, and others will perform much better than you could ever have dreamed. But *you don't know which those are, or when they'll take off*. So you need to be diversified, and you need to stay in the game if you want to be rewarded eventually.

Enter a Full Stock Portfolio

This is true for us as we build the *Pro* portfolio. We like every stock we buy, but we don't know when any particular position will perform. In the past few years, nearly every sector in the market has moved up and down in unison because the recent economic challenges are larger than any single industry. But historically, different industries perform better at different times; utilities will go up while health care languishes, for example, or technology will do well as basic materials fizzle.

In other words, over the years, you shouldn't expect your *entire* portfolio to do exceptionally well at once. While it makes sense to allocate more money to the sectors you like best, you need to own different sectors to benefit at different times. This is why it's so important to invest in stocks and ETFs across multiple sectors and to allocate fairly.

The Big One

Guidance Changes

Cameco and **Lindsay** have been moved down to Hold due to price, and **Tupperware** is also now on Hold while we await a new quarterly SEC filing. **QuantaServices** is now a Buy based on price.

Pro Earnings

Coverage results are in the bag, and as always, we're providing coverage of what's happening at our companies and guidance. See our thoughts on:

- **Quanta Services**
- **Bristow Group**
- **AmTrust Financial Services**

- **Procter & Gamble**
- **GrafTech International**

Coverage & Community

- Bryan Hinmon (TMF42) provides a *Pro* stock fair value table.
- *Pro* members discuss last week's jobs report.
- Joe (TMFValuemoosie) posted an earnings calendar.
- *Pro* member ksag owns shares of **Apple** at $79 and asks, "What would you do?"
- Jeff talks about index investing vs. investing for absolute returns.

This Week's Earnings

- Aug. 12: **Autodesk** and **Broadridge Financial Services**
- Aug. 13: **Cameco**

There's no such thing as a get-rich-quick scheme using stocks, but you *can* grow significant wealth – with less risk, when you're diversified – over many years. *Pro* invests for accuracy and absolute returns, and we aim for more consistent gains with less risk. But we're also always seeking The Big One (or two), meaning those few stocks that go up 300%, 500%, or more. As long as you keep your portfolio healthy, you'll be positioned to give it a propane boost when you find and latch onto one of these investments. Even a few of these each decade can make all the difference (especially if you leverage that gain using options). Diversified portfolios are a must for steady returns, but much of our outperformance may end up coming from a few stellar positions.

Near-Term Gains: Options (and Shorts)

Options provide a steady way to feed your desire for short-term gains while you're allowing your long-term stocks the necessary time to bear oversized fruit. And you can use options in whichever way best suits your investment needs.

If you're just building your portfolio, you'll be writing (selling to open) many put options, which will allow you to potentially buy shares of your desired companies at cheaper prices. If your stocks are near fair value, you'll be writing covered calls to potentially sell shares or earn income. If you're at a place in life – retirement, for example – in which you're more interested in cash flow than in long-term capital gains, you'll be writing a lot of covered calls on strong companies, as well as writing conservative puts (or combining the two to write covered strangles).

These are just a few examples of more than a dozen options strategies we'll ultimately use in *Pro*. In every case, options should work alongside your stocks to provide near-term returns – or leverage or protect your gains – without compromising your stock portfolio. And you can amp up (or lower) your options use to suit your needs.

Make Each Player Count

Investing is a team sport. Every stock in your portfolio should have a role to play, and every stock should bring strengths to the table; you should set up your portfolio's "team" to best suit your goals. You can build your portfolio in a way that suits your current objectives while following the *Pro* philosophy, and we're here to help.

Pro's official portfolio is smack in the middle of the road: We're not jumping head-first into risk, but we're also not cautious beyond good reason. We seek a healthy mix of long-term capital gains with stocks and ETFs. From options, we most often look for steady, near-term income or better stock transactions. We're diversified from tech to health care, from basic materials to financials, and more. We'll be mostly bullish (rather than short) until we see reason to switch, and we'll usually keep some cash on the sidelines for opportunities.

Having come through almost two years of volatility, *Pro* is still just getting started. Now that the worst of the economic storm is over, we expect some companies – many of them young – to seize the opportunities that open up during economic dislocations. So we're always on the lookout for new players to add to our investment team. Meanwhile, our current roster remains focused on winning over the long haul. Make sure you have a full team in your portfolio (and on your Scorecard), as well – not just a few players.

Related *Pro* Resources

- Making Pro Fit Your Profile
- Secrets of a Winning Portfolio
- Use Stocks the Pro Way
- Use Options the Pro Way
- Use ETFs the Pro Way
- Short Stocks the Pro Way
- Questions? Post them on the Memo Musings board.

Jeff owns shares of AmTrust and Apple.

Monday Memo: Let's Run Our Race

Published Aug 2, 2010 at 12:00AM

Busy Week

Last week was active for the *Pro* portfolio. We wrote covered calls on **Procter & Gamble**, **ProShares Short S&P 500**, and **U.S. Natural Gas Fund**. We also wrote puts on **Broadridge Financial Solutions** and **Intel**. If you bought or sold any stock in your portfolio, be sure to enter the data into My Scorecard, so you can track your returns and get the latest on the stocks you own.

Earnings

- Aug. 3: **Papa John's International**, Procter & Gamble, **Amtrust Financial Services**
- Aug. 4: **Quanta Services**, **Bristow Group**
- Aug. 9: **EBIX**
- Aug. 12: **Autodesk**, Broadridge Financial Solutions

Coverage & Community

- TMFEldrehad highlights a presentation by a game designer who asked, "Can gaming make a better world?," and draws some parallels to CAPS.
- Todd comments on the earnings of **Plum Creek Timber** and discusses the good and bad happenings at **Kinetic Concepts**.
- *Pro* members discuss how **GrafTech International**'s earnings affect their existing options positions. Stay tuned for *Pro*'s take on the new look of GrafTech.
- Short interest in shares of Ebix stirs up a rousing discussion among the Fool community.
- *Pro* Fool JPStockMaster shares his Option Tracking spreadsheet on the Pro: Member Suggestions & Help board.

Do you know who Samuel Kamau Wansiru is?

OK, that was a tough one. Now what about Usain Bolt?

Ring a Bell?

Both of these men won gold medals in track-and-field events at the 2008 Beijing Olympic Games. Wansiru won the marathon, and Bolt, of course, won the 100-meter dash. Both set Olympic records, to boot, but only one of them became a household name.

Part of the reason we know Bolt's name and not Wansiru's is the sexiness factor of being crowned the "world's fastest man." Somehow, the "world's steadiest runner" just doesn't have the same ring to it.

Maybe Wansiru would have liked to have received all the attention Bolt got, but it would be folly for him to try his hand (or foot) at sprinting in order to prove his value as a world-class athlete. His gift is endurance, not speed — Wansiru would easily outlast Bolt in a 26.2-mile run. For those of you keeping score at home, that's 421.6 100-meter dashes!

By focusing on what he does best, Wansiru has excelled in his sport of marathon running. Whatever goes on in the other track-and-field events is of little consequence to him.

Slow and Steady

From the early days at *Pro*, we've made it known that while we keep tabs on the S&P 500, we're not in a race with it, with any other index, or with other investors. We're running our own race — a race to earn you consistent, recurring profits with a high level of accuracy.

By "consistent, recurring profits," we mean income generated by dividends and options strategies as well as periodic capital gains from sales. A "high level of accuracy" means that we want to avoid permanent losses of capital — losses you can never earn back — and close at least 75% of our positions profitably. In short, our focus is on *absolute* returns.

This is a different strategy from most mutual funds, which seek to outperform an index on a *relative* basis. In fact, if you look through the top holdings of most major funds, you'll find that their holdings don't deviate much from the S&P 500's top holdings and sectors. This is intentional, because fund managers who deviate too much from the market and are wrong typically don't keep their jobs very long.

The Market's Slings and Arrows

None of this is to say that *Pro* won't be affected by market movements. We primarily hold long positions, after all, so if the market falls 30%, we'll feel it. But by including a helping of shorts, a strategic cash position, and most importantly, options strategies, we aim to reduce the volatility of our returns.

So far, we've achieved this goal. Since we launched *Pro* in October 2008, our worst monthly return was in May 2010, when we lost 5%. (Prior to that, our worst month was January 2010, when we were down 3%.) Even though the market was down 8% in May, that 5% loss still irks us. We learned some valuable lessons in May, and we don't intend to make the same mistakes twice.

Whether you just joined us or you've been here since we started two years ago, as you move ahead with us at *Pro*, remember that we're running our own race here. We can't control the market, but we can control our portfolio. By focusing on generating consistent, recurring profits and obtaining a high level of accuracy, our returns relative to the market should take care of themselves.

Stay focused. Stay patient. Stay Foolish.

Todd Wenning

Pro Fair Value Estimates

By Bryan Hinmon

Like the rest of you, we hate unnecessary clicking from Web link to link. After all, this Internet thing is supposed to make our lives easier, right? Consider this our official apology for all the extra clicking your right index finger has endured trying to find the fair value estimates of *Pro* stocks. Here's a summary table that requires no additional clicking:

Position	Current Price	Fair Value Estimate	Margin of Safety
BUY FIRST			
Ebix	$17.00	$24.00	29.2%
Intel	$21.56	$25.00	13.8%
Amtrust Financial Services	$12.94	$18.00	28.1%
Oracle	$24.44	$29.00	15.7%
GlaxoSmithKline	$35.63	$47.50	25.0%
Broadridge Financial Solutions	$20.98	$27.50	23.7%
BUY			
Tupperware	$39.88	$50.00	20.2%
ProShares Short S&P500	$50.74	NA	NA
SPDR KBW Regional Banking	$24.11	$36.00	33.0%
Vanguard Energy ETF	$78.89	NA	NA
Cameco	$25.42	$31.00	18.0%
Kinetic Concepts	$35.14	$54.00	34.9%

Lindsay	$34.20	$42.50	19.5%
Medtronic	$37.09	$52.00	28.7%
MELA Sciences	$6.60	NA	NA
NextEra Energy	$53.00	$62.00	14.5%
Procter & Gamble	$62.83	$70.00	10.2%
Bristow Group	$33.15	$50.00	33.7%
HOLD			
Plum Creek Timber	$36.85	$40.00	7.9%
GrafTech International	$16.46	$18.00	8.6%
Quanta Services	$21.77	$26.00	16.3%
Jack Henry & Associates	$25.81	$30.00	14.0%
Vanguard Emerging Markets	$41.63	NA	NA
Autodesk	$29.01	$32.00	9.3%

A quick analysis of this table shows that, as you might expect, the average margin of safety on our Buy First stocks (23.8%) exceeds the average margin of safety on our Buy stocks (23.7%), which in turn exceeds the average margin of safety on our Hold stocks (11.2%). However, valuation isn't the only factor we consider when we decide where to place these stocks. We also consider risk, catalysts, and tactical considerations.

Also note that we have slightly lowered the fair value estimate of **GlaxoSmithKline** — largely because of weakness in the British pound. Todd and Bruce have been hashing things out to revalue Glaxo, and you can read their analysis here.

Finally, I'll begin posting an updated copy of this table on the Pro: Stocks That Interest You board every week or so. Join us and your fellow *Pro* members there for the latest numbers and some lively discussion.

Todd owns shares of Procter & Gamble, Kinetic Concepts, and Amtrust Financial Services.

Write Puts on Intel

Published Jul 27, 2010 at 12:00AM

At a Glance

- **Action**: Write ("sell to open") September 2010 $21 puts
- **Allocation**: 3% (for *Pro*, 18 contracts), with a potential total of 6%
- **Option's recent bid/ask**: $0.72/$0.73
- **Preferred limit price**: $0.70, or an income amount and start price acceptable to you
- **Alternate trade**: Intel is a **Buy First** stock and can be bought directly at current prices.

What's New

Intel (NASDAQ: INTC) recently reported the best quarterly profit in its history, and the company expects strong tailwinds to continue throughout the year. Several factors are boosting Intel's performance, including improving consumer spending, widening computer usage, and increasing upgrades to computer systems. Computers are becoming an integral part of life in more countries around the world, and in areas where computer usage is already well established, corporations must ensure their systems are up-to-date. Given that most computers are four to five years old, Intel projects that today's strong spending cycle will last at least a few more years.

Meanwhile, shares trade at 11 times trailing free cash flow and 10.4 times expected 2010 earnings. Both valuation multiples are well below the market's average, which is in the mid-teens. This suggests that investors aren't convinced the strong spending cycle has staying power, despite management's assurances.

However, we think Intel's prospects look good. Developing economies continue to drive entirely new sales, and developed economies are well overdue for upgrades. The return on investment for an upgrade is compelling — not only do new machines bring greater efficiency, but additional depreciation write-offs can lower a company's taxes as well. Management is also optimistic about the tablet market, which it believes will create a new category in the computer industry rather than cannibalizing notebook sales.

Moving south on the income statement, we see that Intel reduced costs and notched a record profit margin. Its new line of chips, code-named Sandy Bridge, will begin to ship at the end of 2010, and management is encouraged by early reviews and strong customer interest — so much so that production is ramping up earlier than planned. Put it all together, and management offers many reasons for more optimism than Wall Street is displaying.

Why This Strategy?

We recommend that you own at least a 3% stake in this Buy First stock, and we're comfortable with up to 6%. We own 3%, but we're only looking to add shares at especially cheap prices right now, since we already have heavy exposure to technology (through **Oracle** (NYSE: ORCL), **Ebix** (NASDAQ: EBIX), and others). Also, there's the nagging fact that Intel first hit $21 in 1997 — and 13 years later, it's still at $21. Although we believe that the stock could reach the high $20s, we're not eager to buy our whole allotment at once, given that Intel has basically been flat for years. We'd rather own some shares and continue to bolster returns by earning option income, as we've been doing since *Pro*'s debut.

How to Follow Along

You write ("sell to open") puts when you're ready to buy a stock if it declines below the strike price by expiration, as explained in our put-writing guide. Sell one put for every 100 shares of Intel you'd be willing to buy in September. Here are the numbers behind this trade:

- **Option payment or yield (at $0.70 preferred price)**: 3.3% in 52 days (Sept. 18 expiration)
- **Option strike price**: 3.3% below Intel's recent $21.71 share price
- **Break-even price**: 6.5% below the recent $21.71 share price, at $20.30
- **Cash or buying power needed**: Each put you write represents a potential $2,100 purchase of Intel shares

This $21 strike price is near the current share price, reflecting our confidence in Intel's valuation and our willingness to buy more shares. (If we do fill out our allocation to 6%, we may write covered calls on some of that position, but we don't want to cap the upside of our existing shares.) Factoring in our put income, our break-even price is a comfortable 6.5% below the current share price. And since we're writing September options, the trade will play out well before Intel's October earnings report.

If you can't write puts, buy your first shares of Intel when you're ready; aim to buy more on a dip (just as we would through these puts); and hold your position for upside. To discuss this position, please weigh in on our Intel board.

Jeff owns shares of Oracle.

Write Covered Calls on ProShares Short S&P 500

Published Jul 26, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") September 2010 $53 covered calls
- **Allocation:** Write one call for every 100 shares owned
- **Option's recent bid/ask:** $0.95/$1.10
- **Preferred limit price:** $0.95 or higher
- **Alternate trades:**
  - **Don't own any shares?** If you want to hedge holdings you remain bullish on, this inverse ETF is a Buy. If you buy at least 100 shares, you can also write covered calls.
  - **Own fewer than 100 shares or not using options?** Hold the position.
  - **Want to potentially buy shares cheaper?** Write ("sell to open") September 2010 $50 puts, recently $1.25.

What's New

With earnings season half over, the risk of large negative surprises is subsiding, and we're more comfortable writing covered calls on our **ProShares Short S&P500** (NYSEMKT: SH) position. For *Pro* members new to this investment, this inverse ETF gains ground whenever the S&P 500 declines, and works against us when the market advances.

The S&P 500 continues to look neither expensive nor greatly undervalued, but persistent economic uncertainties in Europe, the U.S., and China mean we want to keep this short position in the portfolio. The ability to write covered calls on the position adds to its versatility and attraction. This is the third time we've written covered calls on the ETF, the first two expiring as full cash income.

Why This Strategy?

We can get paid well writing covered calls, lower our cost basis in the ETF, and still have a hedge with upside potential. The S&P 500 needs to decline 6% by Sept. 18 to reach our potential sell price with the covered calls, and at that point we could roll the covered calls up if we wanted to seek more gains from the ETF.

How to Follow Along

When you own 100 shares or more of a stock or ETF, you can write covered calls on the position. After choosing your potential sell price (or strike price), you "sell to open" one call for every 100 shares owned. You're paid income while waiting for the underlying investment to appreciate to your potential sell price. If it doesn't, the options expire as income, and you can write calls again. If it does, your shares will be sold unless you adjust your covered calls.

Let's check out our numbers:

- **Trade:** Write ("sell to open") September 2010 $53 calls on your full SH position (for *Pro*, that's 11 contracts)
- **Option payment or yield on $50.80 ETF price (at $0.95 bid):** 1.9% in 54 days
- **Option strike price:** 4.3% above the ETF price
- **Potential sell price:** 6.2% above the recent share price

We think the 1.9% option yield we could earn in less than two months is sufficient payment for capping our upside. Besides, having room for a 6% move on the large S&P 500 before our net sell price is generous enough to place the trade. To ask questions about it, please visit our ProShares Short S&P500 board.

Write Covered Calls on United States Natural Gas Fund

Published Jul 26, 2010 at 12:00AM

At a Glance

Don't own a position in U.S Natural Gas Fund? We don't recommend that you make this trade. Instead, continue to build positions in our Buy First and Buy stocks. **Questions?** As always, we're here for you on our discussion boards.

- **Action:** Write ("sell to open") September 2010 $8 calls on existing *purchased* calls
- **Allocation:** Write one call for every call or every 100 shares owned (for *Pro*, that's 25 contracts)
- **Option's recent bid/ask:** $0.42/$0.44
- **Preferred limit price:** Seek enough income to make the trade worthwhile for you. *Pro* will earn $1,050 at the current price.
- **Recent ETF price:** $7.65
- **Special requirement:** You must own at least 100 shares of UNG, or one UNG call option, to write a call on it.
- **Alternate trades:**
  - Consider writing the October 2010 $8 calls, recently near $0.55, if you want a higher payment.
  - **Don't own UNG or UNG calls?** UNG is a Hold, so pass on this recommendation if you don't already have a position.

What's New

The price of U.S. Henry Hub natural gas has declined 20% this year, from around $5.50 per million British thermal units (MMbtu), to $4.50 recently. The **U.S. Natural Gas Fund** (NYSEMKT: UNG) ETF has declined 24% over the same time. We continue to believe that natural gas prices should trend higher, but while we wait for that outcome, we're writing calls against our position -- creating a diagonal call -- to defray costs and earn income. Hurricanes and tropical storms can disrupt natural gas production in the Gulf of Mexico and send prices higher, but aside from this, few catalysts exist for the month of August. Our July calls expired for a full cash gain, so we're ready to light this income fire up again.

Why This Strategy

The $10 January 2012 call options that we own on this ETF have a value of just $1.10 per share -- and with the ETF trading at only $7.65, that $1.10 in value will slowly erode. We should only continue to hold these calls if we believe the ETF can rise above $11.10 by expiration (the strike price plus the current value of the calls), *or* if we can write enough calls against the position that we'll make $1.10 or more, while being able to keep the calls for a potential rebound. If the ETF rises above $8 before our September expiration, we'll roll the written calls to a later date and perhaps a higher strike price.

How to Follow Along

Cover the Spread

To write $8 calls on a $10 call that you own, you'll need a margin account to cover the $2 strike price difference. Although you won't use or be charged margin interest, you are agreeing to deliver shares at $8 (the September written calls) that you have promised to buy at $10 (the January 2012 purchased calls). The equity balance in your brokerage account will need to cover this difference. We don't intend to exercise either call, though. And if we needed to buy shares, we'd buy them on the open market, where they're cheaper than $10.

For every call that you already own in UNG, write ("sell to open") one September 2010 $8 call. If you own 100 or more shares of the ETF instead, write one call for every 100 shares owned. If you only own a few calls or a few hundred shares, writing diagonal calls for only $0.25 per share may not be worthwhile to you after commissions. You might consider writing the October $8 calls instead, for 30% more. That said, even the September calls pay a very attractive yield on the current ETF price and the 2012 call price. Here's the math on our trade:

- **Trade:** Write ("sell to open") September 2010 $8 calls on our full UNG call position (25 contracts)
- **Option yield on the ETF price (at $0.42 bid):** 5.5% of the $7.65 share price, in 54 days.
- **Option yield on our January 2012 $10 call price (at $1.10):** 38.2%

We'll be writing calls against our January 2012 purchased calls as often as we can over the next 18 months (or however long we hold them) to eat away at our investment's cost. To retain upside potential in our original position, we'll manage this diagonal call actively if need be. Please post your questions and comments on the U.S. Natural Gas Fund board.

Monday Memo: Short Stocks the Pro Way

Published Jul 26, 2010 at 12:00AM

Next at *Pro*: More Stocks

We have many options trades on deck (including options trades on existing stocks that keep our monthly income train rolling), but we also have brand-new stock ideas in the hopper. We continue to think our Buy First and Buy stocks are good values, even if you don’t want to participate in the accompanying options trades we publish. So, if you’re not using options yet, fret not, and focus on building up your positions in our Buy First and Buy stocks.

Earnings Ahead

- 7/26 (after market close): **Plum Creek Timber**
- 7/27: **Kinetic Concepts**
- 7/29: **GrafTech International**
- 8/3: **AmTrust Financial Services**, **Papa John’s International**, and **Procter & Gamble**

Jeff Fischer owns shares of AmTrust Financial and GlaxoSmithKline.

We’ve talked about using stocks, options, and ETFs the *Pro* way, and that brings us to today’s topic of short selling, a investing strategy that allows us to profit when a stock's price goes down. You don't have to sell short to succeed with *Pro*, but if you're willing to give it a try, you can achieve healthy profits even in down markets.

How Short, How Long?

We usually recommend having at least some short positions and hedges for your portfolio at all times, both as a form of insurance and to maintain some ways to profit in a down market. But when we believe the stock market is likely to decline 15% or more, or when we find businesses that are likely to fall short or fail, we’ll implement more shorting strategies than usual.

The few shorts and hedges that we currently have in the *Pro* portfolio function as longer-term insurance. Our recommended positions in **ProShares Short S&P 500** and **iPath S&P 500 VIX Short-Term Futures** are examples of this thinking. At some point, however, the stock market is likely to start behaving like it did in 2000 or 2007, when investors were putting expensive price tags on most stocks. In times like these, we’ll likely sell our fully valued stocks and start defensive or bearish positions, which could mean that the *Pro* portfolio would hold more shorts than anything else.

Shorts So Far

Shorting has played a relatively small role in the portfolio so far, but that has largely been a function of the market we’ve witnessed since early last year, in which good stocks are inexpensive — so we've been buying those good values. Furthermore, shorting can be risky, and you want the odds on your side as much as possible. Even shoddy, beaten-down companies have caused seasoned short sellers heartache this year, so we’re fortunate that we didn’t participate. Today, prices still favor buying good companies, rather than giving greater-than-normal attention to short positions.

Shorting Essentials

Pro Community

- Russell (TMFEldrehad) explains how "deep" CAPS data is and shows you how to slice and dice it in a way that is most meaningful to you.

- Bruce (TMFGoogly) summarizes earnings at **Tupperware**. Shares are volatile but remain a longer-term Buy. We will likely use options on Tupperware again after we see the new 10-Q filing in a few weeks.
- Jeff reviews **Intel**'s record results and no-holds-barred outlook. The company remains a Buy First.
- We're still going over results at **GlaxoSmithKline**, but we aren't likely to change our buy guidance.
- The FDA has moved **MELASciences**' MelaFind product review from August to November. Investors didn't like the delay, although the company's potential remains unchanged.
- New member John (simonjw5101) likes how *Pro* has made money on Tupperware options even though the stock is down, illustrating a key *Pro* advantage.

Here are the ways we can profit from falling prices:

1. **Short a stock or ETF directly**. When we borrow shares and sell them, we profit when we can buy the shares back at a cheaper price. However, our losses grow as the price rises, and lately you have to pay your broker interest for the privilege of shorting borrowed shares.
2. **Short indexes or sectors using inverse ETFs**. You don't need to borrow these shares, so the cost to short with inverse ETFs is usually modest. We prefer inverse ETFs that don't use leverage. To short indexes, we've bought **ProShares Short SmallCap600** and **ProShares Short S&P500**, the second of which remains an active holding.
3. **Use options.** If we expect prices to fall for an investment, we can buy ("buy to open") put options and only risk the small amount of capital invested; we'll profit if the price of the underlying investment falls sufficiently by the time the puts expire. We can also use option spreads to profit on flat or declining prices with low invested capital and contained risk. Finally, in certain situations we will write naked calls, as we've done on **iPath S&P 500 VIX Short-Term Futures**.
4. **Writing covered options.** Whenever you write ("sell to open") an option, you're shorting that option. You're getting paid the value of the contract up front, and profiting as the value of the option declines on the open market. Writing covered calls, as we're doing on **NextEra Energy**, **Procter & Gamble**, and others, is a small way of setting up a short position that hedges a position you own.

Allocating According to Risk and Reward

Because there are more potential long-term rewards to be gained by owning stock in strong companies, we'll usually keep short selling in our back pocket until the risk-to-reward situation is strongly reversed — that is, when there's much more risk in owning a position than there is in investing *against* it. When the odds have flip-flopped (for valuation or business reasons), we'll put on our short seller's hat.

Sometimes the whole market looks risky; other times it's just particular positions. When we're hand-picking shorts in an otherwise attractive market, we may only allocate 5% to 10% (tops!) of our money to shorting. But when we see much more risk in the market than potential reward, our allocation to shorts could balloon to 20%, 30%, or more, and our cash balance will grow, too, as we sell bullish holdings.

Overall, if your money is in the stock market for the right reasons, your short-selling allocation should be reasonable (10% or less) until there are excellent reasons to ratchet it higher.

For more on the strategy, please see our Guide to Shorting — and to ask questions, visit our Memo Musings board. Remember to check out the sidebar for more *Pro* Foolishness!

Next Up in the Memo

- **Aug. 2:** *Pro* analyst Todd Wenning discusses how to stay focused on your long-term goals — no matter what's going on in the market.
- **Aug. 9:** Jeff wraps up his series on investing the *Pro* way, showing you how to put all of the pieces of a *Pro* strategy together to earn smoother returns.

Ready to invest with *Pro*? View the Pro portfolio.
Already invested? Track your stock and ETF positions in My Scorecard.

Write Covered Calls on Procter & Gamble

Published Jul 22, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") January 2011 $65 covered calls on Procter & Gamble
- **Allocation:** Write one call for every 100 Procter & Gamble shares you own (for *Pro*, nine contracts)
- **Option's recent bid/ask (July 21):** $1.60/$1.70
- **Preferred limit price:** $1.60 or whatever income amount is acceptable to you
- **Recent stock price:** $61.55
- **Special requirement:** You must own at least 100 shares of Procter & Gamble to write a covered call.
- **Alternate trades:**
  - If you don't own 100 shares of Procter & Gamble, continue to hold your position.
  - If you don't own any shares of Procter & Gamble, the stock is a Buy; you can buy shares to hold for the long haul, or buy shares and write these covered calls with us.
  - Finally, to be more defensive, you can write ("sell to open") January $60 puts for $3.20 to potentially add shares to your portfolio at $56.80.

What's New

Procter & Gamble (NYSE: PG) was a victim of the "flash crash" in May and faced a Pampers controversy that same month, but its shares have nonetheless held up well this year, ticking up 1.8% while the S&P has traded down 2.8%. P&G's steadiness is thanks in part to a solid fiscal third quarter, and it probably also benefited from investors seeking higher-quality investments in the wake of renewed concerns about the economic recovery.

Why This Strategy?

Procter & Gamble remains a buy around $62, but with our fair value estimate near $70 and the January 2011 $65 calls currently paying $1.60, we think now is a good time to generate some additional income from this anchor of the *Pro* portfolio.

Here are the potential outcomes of the trade:

If:	Then:	*Pro* 's Take:
Shares are greater than $65 at expiration and we don't close or roll up our covered calls.	Our position is called away at an effective sale price of around $66.60 -- a 20% gain on our initial purchase (not including dividends received).	It's not ideal, but we'd be comfortable with this, and we'd free up $58,500 to invest elsewhere. However, because we'd prefer to squeeze some extra income out of this position rather than sell P&G, we'd first look to roll the calls if this scenario becomes more likely.
Shares are below $65 at expiration.	We keep our shares and the $1.60 premium as additional income, while effectively reducing our breakeven price to $54.08 ($55.68 minus $1.60).	We're happy with this result, too, and we'd likely write new covered calls to generate even more income.

As the table notes, if our shares aren't called away, the option premium received will provide 2.9% downside protection on our cost basis of $55.68. That's a fair deal given P&G's durable, well-diversified revenue stream and relatively steady share price.

How to Follow Along

If you need a refresher on covered-call strategies, please see *Pro*'s guide to covered calls before placing this trade. Remember, you write one call for every 100 shares of stock you own, and you may write covered calls on all of your shares or just some. (We're writing calls on all of ours.)

Here are the numbers behind the trade:

- **Trade:** Write ("sell to open") January 2011 $65 calls on your stock position, in 100-share increments.
- **Option yield (at recent $1.60 bid):** 2.6% of the $61.55 share price, in five months
- **Option yield on our $55.68 average cost basis:** 2.9%
- **Upside from today if sold at a net $66.60 ($65 strike plus $1.60):** 8.2%
- **Total return on position if exercised:** 20%
- **Downside protection:** 2.6%; a decline to $59.95 is hedged

When you write ("sell to open") an option, the going price is paid into your account, and that money is yours to keep. In this case, you'd then be obligated to sell shares of Procter & Gamble if they're above the strike price by the expiration date and you don't take any other action.

Writing puts? If you place the alternate trade and write puts, you'll be obligated to buy shares of Procter & Gamble around a net $56.80 if the stock declines below $60 by expiration.

We'll write covered calls in the next one business to 30 calendar days. To discuss it or ask questions, please visit our Procter & Gamble board.

Todd owns shares of Procter & Gamble.

Write Covered Calls on NextEra Energy

Published Jul 22, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") December 2010 $55 covered calls on NextEra Energy
- **Allocation:** Write one call for each 100 NextEra Energy shares you own (for *Pro*, that's 9 contracts)
- **Option's recent bid/ask (July 21):** $1.40/$1.50
- **Preferred limit price:** $1.40, or whatever income amount is acceptable to you
- **Special requirement:** You must own at least 100 shares of NextEra Energy to write a covered call.
- **Alternate trades:**
  - If you don't own 100 shares of NextEra Energy, continue to hold your position.
  - If you don't own any shares of NextEra Energy, you can buy shares directly to hold, or buy shares and write these covered calls with us.
  - Finally, to be more defensive, you can write ("sell to open") December 2010 $50 puts for $2 to potentially add shares at $48.

What's New

NextEra Energy (NYSE: NEE) has recovered nicely from its February 2010 lows near $45. At the time, it was coming off a messy rate case in Florida and a lackluster earnings report, but it has since been helped by a number of analyst upgrades and some renewable energy wins in California and Ontario, Canada.

The name change from FPL Group to NextEra Energy may have played a tiny part in the recovery, too. It's still the same company, but the rebranding was intended to better reflect the company's renewable energy businesses in locations other than Florida. Of course, wiping some of the dirt off the FPL brand following this winter's rate-case brouhaha didn't hurt, either.

Why This Strategy

We continue to believe NextEra is a good buy below $55, but being a utility, it's hard to imagine the shares soaring in the near term. This presents a good opportunity to generate additional income from our position by writing covered calls on it.

Here are the potential outcomes of the trade:

If:	Then:	*Pro* 's Take:
Shares are greater than $55 at expiration and we don't close our calls or roll them out (to a later month) or up (to a higher strike).	Our position is called away at an effective sale price of $56.40 -- a 14% gain on our purchase (not including dividends received).	We're perfectly comfortable with this, and we'd free up $49,500 to invest elsewhere. We may even turn around and write lower-priced puts on NextEra.
Shares are below $55 at expiration.	We keep our shares (and the $1.40 premium becomes income) and effectively reduce our breakeven price to $48.01 ($49.41 minus $1.40).	We're happy with this result, too, and we'd likely write new covered calls to generate even more income.

As the above table notes, if our shares aren't called away, the $1.40 premium received will provide 2.83% downside protection on our average buy price of $49.41. That's not an enormous cushion, but for a low-volatility slow grower like NextEra Energy, it's good additional income in only five months on top of our 4% annual dividend.

How to Follow Along

If you need a refresher on covered call strategies, please see *Pro*'s guide to covered calls before placing this trade. Remember, you write one call for every 100 shares of stock you own, and you may write covered calls on all of your shares or just some (or none, if you wish). We're writing covered calls on all of ours.

Here are the numbers behind the trade:

- **Trade:** Write ("sell to open") December 2010 $55 calls on your stock position, in 100-share increments
- **Option yield (at recent $1.40 bid):** 2.66% of the $52.60 share price (in five months)
- **Option yield on our $49.41 average cost basis:** 2.83%
- **Upside from today if sold at a net $56.40 ($55 strike plus $1.40):** 7.2%
- **Total return on position if exercised:** 14%
- **Downside protection:** 2.66%; a decline to $51.20 is hedged

When you write ("sell") an option, the going price is paid into your account, and that money is yours to keep. In return, with this trade, you agree to sell shares of NextEra Energy if they're above the strike price by the expiration date, unless you take follow-up action on your covered calls first, closing the obligation.

Writing puts? If you place the alternate trade and write puts, you'll be obligated to buy shares of NextEra Energy around a net $48 if the stock declines to the strike price or lower by expiration.

We'll write covered calls sometime between one business day from now and 30 calendar days from now. (Note that NextEra reports earnings tomorrow, July 23.) We look forward to booking more income! To discuss this trade or ask questions, please visit our NextEra Energy board.

Monday Memo: Use ETFs the Pro Way

Published Jul 19, 2010 at 12:00AM

Options Expirations

Our covered strangle on **Tupperware** and diagonal calls on **U.S. Natural Gas Fund** both expired as 100% cash gains this weekend. We're looking at new possibilities.

Upcoming Earnings

- 7/19 (after market close): **Tupperware** (NYSE: TUP)
- 7/21: **GlaxoSmithKline**
- 7/23: **NextEra Energy**
- 7/26: **Plum Creek Timber**
- 7/29: **GrafTech International**
- 8/3: **AmTrust Financial Services** and **Papa John's International**

Pro Community

- TMFEldrehad explains how to use CAPS to dig deeper into some of the top-ranked CAPShot stocks.
- Alex340 posted put options (to "sell to open") that match *Pro* criteria.
- TMFValuemoosie posted a full earnings calendar.
- Have questions about our recent trade alert to write puts on **Broadridge Financial Solutions**? Just ask on the Broadridge discussion board!

NextEra Energy and My Scorecard

FPL Group recently changed its name and ticker to **NextEra Energy** (NYSE: NEE). We're working on changing it across the *Pro* site -- including on My Scorecard (live now!) for members who have added it there.

Jeff owns shares of AmTrust Financial and GlaxoSmithKline

In our last few memos, we've been discussing how to run a *Pro* portfolio. We've talked shop on stocks and provided an overview of options; now it's time to chat about exchange-traded funds (ETFs) and how we use them at *Pro*. Like mutual funds, these handy investment vehicles generally hold large baskets of diversified stocks (or they could own an asset like gold), but ETFs trade on the market like a stock.

ETFs have skyrocketed in popularity, with investors using them to invest in commodities, foreign markets, specific sectors, and currencies, and to sell short. ETFs play an important role in a *Pro* investor's portfolio because they make it easier to diversify and to own stakes in assets that are otherwise hard to buy. They'll typically make up about 15% to 20% of the *Pro* portfolio. As with any investment, there are also some pitfalls to avoid. I discuss those in detail below, but first, let's take a peek at the ETFs we own and others we're considering.

ETFs We Own

Back when the world was ending in 2008, we bought our first stock-based ETF, **Vanguard Emerging Markets**, a fund of more than 800 companies concentrated in developing countries such as China, Brazil, India, and Korea. Rumors of the world's end proved a tad premature, and the ETF gained 80%, so we sold half our position and moved the remaining shares to hold because of valuation. We believed that emerging markets would rebound sharply, and this ETF provided a cheap and convenient way to capitalize on this.

A few months after buying into emerging markets, we bought the **Vanguard Energy** ETF, which holds the largest U.S.-based oil and gas companies. Oil was trading near $40 per barrel, pushing down the share price and making the fund a value. The shares have since appreciated along with oil prices. Vanguard Energy is still a buy, and has dropped to better prices since the BP Gulf disaster, even though the ETF doesn't hold BP. If you believe that energy companies will create value in the coming years, this ETF is an easy, inexpensive way to own many of the best ones in the United States.

We also own the **SPDR KBW Regional Banking** ETF, which holds 52 of the country's strongest regional banks and trades in aggregate just above book value. We recognize the risks in the financial sector, but we believe these inexpensive and conservatively managed banks will create value from today's prices. This ETF remains a buy, as does the **ProShares Short S&P 500** ETF. This *short* ETF gains ground whenever the S&P 500 falls, acting as hedge against broad market declines. If you want to own good banks cheap or have a market hedge, consider these two ETFs.

We also hold an option position in the **U.S. Natural Gas Fund** ETF, purchased on the thesis that natural gas prices would rebound from multi-year lows. However, this position is on hold because the ETF hasn't been tracking natural gas prices reliably (see our pitfalls section below). We're waiting to see better results. We've had better fortune — and profits — in the past owning silver through **iShares Silver Trust** and the yen with **CurrencyShares Japanese Yen Trust**, but we don't hold positions in either ETF today. We're keeping an eye on them for new opportunities, though. Speaking of which …

ETFs on Watch

We're always looking for new ways to make money with ETFs that move counter to stocks or increase in value regardless of what the market is doing. We're also always seeking strong long-term investments that diversify your portfolio and put you (and us) into promising areas. For instance, **Market Vectors Brazil Small-Cap** ETF has been on our radar for months. It offers a way to buy into consumer-centric small companies in South America's economic leader. We'd like a price below $40, and if we wait, we just may get it. The ETF recently traded around $45, down 10% from its high. We may write puts on this ETF to buy it cheaper.

To play the same emerging middle-income thesis, but in China, we've been investigating **Claymore/AlphaShares China Small Cap**. As the standard of living increases in China, small, consumer-focused companies should prosper, and our Vanguard Emerging Markets ETF owns mostly mid- and large-cap companies rather than small. Given the history of small caps outperforming large-cap stocks in the U.S., we want to own small caps in emerging economies. However, we want to own large baskets of those types of stocks through ETFs, since nobody knows which of these small companies will thrive.

We also believe that the dollar is likely to gain value against the euro and other key currencies, making us consider **PowerShares DB U.S. Dollar Index Bullish**. But we're not bullish on everything in the U.S. **iShares Barclays 20+ Year Treasury Bond** may be worth shorting when we believe interest rates are headed higher. You won't want to own 20-year Treasuries with a low coupon rate once rates start ticking up. We're also considering the short side of municipal bond ETFs in especially weak U.S. states, where local governments face daunting budget shortfalls. And back on the bullish side, alternate energy ETFs hold promise, but we believe it's too early to buy.

As a final example, the **Consumer Discretionary Select Sector SPDR** ETF has caught our eye for neutral to bearish options strategies. More than 50% of the fund is invested in consumer services that consumers don't necessarily need — and can be put off or avoided in a tough economy. However, because this ETF has positions in strong companies such as **McDonald's** and **Amazon.com**, rather than short it, we may want to set up neutral options strategies that will make money as long as the ETF doesn't gain meaningful ground in a few months. With consumer spending still weak, this may work out well.

Pitfalls to Avoid

We're considering many ETFs, but they have one important thing in common: None of them is leveraged. Yes, in a sign of our times, many of today's ETFs *are* leveraged, seeking to earn 2, 3, or even 4 times the daily price movement of an underlying asset. Leverage like this will almost surely destroy the value of an ETF over long periods of time, so you won't see *Pro* embracing "ultra" or leveraged ETFs.

We're also avoiding ETFs that trade futures contracts to try to track the price of a commodity, rather than owning the commodity itself. The monthly cost of rolling futures contracts eats into the value of the ETF. This is why our U.S. Natural Gas Fund position is on hold, and it's part of the reason we're shorting the **iPath S&P 500 VIX Short-Term Futures** ETN.

The Keys to ETF Investing

With ETFs — as with any investing — the key to being successful is knowledge. Specifically, before you open a position, be sure you:

1. Understand what you're buying and know what each ETF owns.
2. Know the fees and invest in ETFs that charge reasonable ones. We like 1% or less per year.
3. Know your time frame. Some ETFs are longer-term investments (like emerging markets), while others are shorter term (such as short ETFs or currencies).

For more on ETFs, visit The ABCs of ETFs and our discussion board, ETF Center. Have an ETF you particularly like (or dislike)? Please post it on that board!

Coming up, we'll finish our rundown of the strategies we use at *Pro* with a discussion of shorting. Then, we'll explain how to put all of our strategies together in a *Pro* portfolio to earn profits in up, down, and flat markets.

To join the discussion, visit our Memo Musings board.

Invest well!

Jeff Fischer

Write Puts on Broadridge Financial Solutions

Published Jul 16, 2010 at 12:00AM

At a Glance

- **Action**: Write ("sell to open") December 2010 $20 puts
- **Allocation**: 2.5% (for *Pro*, 14 contracts)
- **Option's recent bid/ask**: $1.45/$1.70
- **Preferred limit price**: $1.55, $1.45 minimum, or whatever income/break-even price is acceptable to you.
- **Alternate trades**: Broadridge is a **Buy First** stock and is trading below our preferred buy price. Buy shares directly at around $20; or, write September 2010 $20 puts for $0.90.

What's New?

Broadridge Financial Solutions (NYSE: BR) has been busy since *Pro* recommended it in late April. Broadridge was one of only 25 companies to receive the prestigious "Gallup Great Workplace Award" for 2010; soon after, it was voted the best large company to work for in New York State. While we're happy to see Broadridge taking care of its employees, we're even more pleased that the company announced another $0.14 quarterly dividend and approved a 10-million-share repurchase program (perhaps we're a tad selfish).

Third-quarter earnings coincided with a general downturn in the market, and the stock fell from our $22.88 entry price. In typical Wall Street fashion, investors don't seem to be paying attention to the business fundamentals. Broadridge has signed two new clients to multi-year deals and has continued to expand and improve its service offerings. It has also closed its transaction with **Penson Worldwide** (NASDAQOTH: PNSNQ); in exchange for its clearing business, Broadridge received an 11-year contract to provide processing and back-office support for Penson, as well as some financial compensation. As we'd hoped, it looks like this transaction will free up more than $200 million in restricted cash for Broadridge to play with. This cash is already being used productively – witness the stock repurchase and the acquisition of internationally focused software business City Networks. Broadridge remains extremely healthy, and Fitch recently raised its credit rating to BBB+ from BBB.

Why This Strategy?

By writing out-of-the-money puts (meaning that the $20 strike price is below the current stock price), we're attempting to buy another chunk of Broadridge at an attractive price. If the stock is below our $20 strike price at expiration, we will purchase our 1,400 shares for $18.55 each (including our put option premium). We would be happy to own Broadridge at an average cost basis of around $20.72, which we feel represents an adequate margin of safety for this slow-and-steady, recurring revenue juggernaut. (Remember, we already have 1,400 shares at a basis of $22.88.) If we don't get our stock, we'll keep our put payment and likely try again later – after all, Broadridge remains a **Buy First** stock, and we'd like to fill out our position at attractive prices.

If you're unable to write puts, or would prefer not to, consider purchasing Broadridge stock outright. The stock is currently below our preferred buy price of $23, and we think snapping it up at or below $20 will work out well in the long run. Whether you're buying Broadridge for the first time or filling out your position, keep in mind that our preferred buy price is just a guideline; our fair-value estimate of $27, outlined in our original trade report, remains intact.

We'll make this trade in the next one business to 30 calendar days. To discuss this trade or ask questions, please visit our Broadridge board.

How to Follow Along

You write ("sell to open") puts when you're ready to buy a stock if it declines below the strike price by expiration, as explained in our put-writing guide. Here are the numbers behind the trade:

- **Option payment or yield (at $1.45 bid)**: About 7.1% in five months
- **Option strike price**: 2.3% below the recent $20.47 share price
- **Break-even price**: 9.4% lower, at $18.55
- **Cash or buying power needed**: Each put you write represents a potential $2,000 purchase of Broadridge stock.

If we're able to buy new shares at a net $18.55, we'll be paying 12 times management's earnings guidance for the 2010 fiscal year (and about 10 times likely free cash flow), providing us with a substantial margin of safety for this **Buy First** stock.

Adjust Your Trade on iPath S&P 500 VIX Short-Term Futures

Published Jul 15, 2010 at 12:00AM

At a Glance

Trade Adjustment: *Pro* recommends an options trade on VXX.

Special Notice: At *Pro*, we try hard to make the same transactions in our portfolio that we tell you to execute in yours. Sometimes, though, it gets a little sticky, and this is one of those times. We still believe in the thesis we advanced on June 16, but in order to participate in a short position on VXX, we need to adjust the trade — using options instead of a direct stock short, because shares were unavailable at our broker for shorting. For new *Pro* members, we don't recommend this advanced trade unless you have considerable experience with options or shorting. It's a small, short-term portion of our portfolio, so don't sweat sitting this one out. For those of you who followed our original trade: Congratulations, you've likely made money, and our adjusted trade aims to follow in your footsteps.

What's New

When investors see high volatility in the stock market, the famous VIX index goes up. As volatility concerns wane, the VIX goes down. The **iPath S&P 500 VIX Short-term Futures** (NYSEMKT: VXX) is meant to track the movement of the VIX, moving up and down with volatility. Buying or shorting this investment allows you to profit on increasing *and* decreasing volatility. It's perfect for investors looking for an edge in a choppy market.

Your Next Steps

- **If you shorted VXX as per our original recommendation, or are able to:** Continue the strategy as planned.
- **If you are unable to short VXX directly:** Consider this new strategy using options.
- **If you aren't ready to short or use options yet:** No problem! Watching is great experience, and we aim to repeat this strategy later.

As you know, *Pro* is focused on making money in any market, be it bear, bull, or just plain volatile. We saw an opportunity to profit from the latter state last month, and we announced our intent to sell short shares of VXX. We intended to place the trade when the price was above $30, then profit when volatility in the S&P 500 declined. (See our original report below.) Believing that heightened volatility couldn't last forever, we reasoned that shorting this volatility-tracking investment would result in handsome profits as the market calmed down.

Alas, when VXX broke above $30, the Fool's broker did not have shares available for shorting. *Pro* Fools using other brokers were able to short VXX, and with its price now at $25, we're happy that they're profiting. So you know exactly where we stand, the *Pro* portfolio is *obligated* within 30 days to take a position in the spirit of any original recommendation, and we're always glad to do just that. Thus, in this case, we will short VXX using an alternate strategy: writing ("sell to open") calls.

Why This Strategy

Since we're not currently able to borrow shares to sell short directly, our next best alternative is to write naked calls. "Naked" means that we don't own the underlying investment, and the higher it goes above our break-even price, the more our loss grows, just as with any direct short. But we're confident in this trade for a number of reasons.

First, writing August $30 calls on VXX, we'll be paid around $1 per share, which is the same as shorting VXX at around $31 per share – above our preferred short price. Second, the investment recently traded at $25, giving us a 24% cushion before our calls are in-the-money. Third, if shares of VXX rise to our strike price, we can roll our calls up to a higher strike price and/or out to a later expiration date, still have a potential profit on the trade, and wait for market volatility (and VXX) to drift lower again.

The most we can earn by writing these calls is what they initially pay us, so it's less attractive than shorting the shares directly (the more VXX falls, the more a direct short is rewarded). But our risk is manageable, and the potential reward is still attractive given the level of confidence we have in this short's ultimate success. Additionally, we hope to repeat this trade month after month as our options expire, growing our profits along the way.

How to Follow Along

Only experienced investors with ample funds should consider following this short sale. Short sellers often need to wait out market volatility before seeing profits, and that requires having the financial means to hold tight as a position potentially works against you. Additionally, writing naked calls requires trade maintenance and monitoring – *Pro* provides that, but you shouldn't make this trade if you expect to leave your brokerage account unmonitored for a meaningful period of time. Again, that's true of any short sale.

Trade Details

- **Action:** Write ("sell to open") August 2010 $30 calls (one for every 100 shares you want to short – for *Pro*, 12 contracts for a 3% allocation)
- **Value:** Each written call represents shorting $3,000 of VXX
- **Preferred option limit price:** $1.10 or higher
- **Trade's break-even price:** $31.10
- **Current VXX price:** $25
- **Cushion before break-even:** 24.4%
- **Return on investment:** 3.6% if the calls expire, earned in 37 days (about 40% annualized).

Although we hope to profit by shorting VXX often in the future, this position is a small component of the *Pro* portfolio. It's not necessary to follow along if this trade doesn't appeal to you or if you aren't experienced with options and the idea of writing naked calls. Only make this trade if you're comfortable with the strategy and understand its mechanics. If you don't, please post your questions on the VXX board. We'll help get you ready for next time!

Close Your Covered Strangle on Intel

Published Jul 12, 2010 at 12:00AM

At a Glance

- **Trade:** Close covered strangle: "Buy to close" July 2010 $22 calls and $20 puts. Continue to hold your shares of Intel, as we are. The stock remains a Buy First.
- **Price:** Use a limit order near current market prices (if allowed, close both options at once with one trade)
- **Why this trade:** By closing early, we can capture most of the option income from this strangle. The stock remains a Buy First, and we'll maintain our position size until we digest Intel's upcoming earnings report.
- **Alternate trade:** Aside from closing your options, we suggest waiting to make any new trades on Intel until after it reports earnings on Tuesday.

What's New

We've made most of the potential profit on our **Intel** (NASDAQ: INTC) covered strangle, having earned 90% of the potential income on our covered calls and 70% of the possible put option income. A covered strangle involves writing both puts (to potentially buy more shares cheaper) and covered calls (to sell existing shares higher). With the computer chip giant reporting earnings Tuesday after the market closes, we're going to "buy to close" both legs of our July covered strangle to claim our profits before the big news event.

When you write an option, the most profit you can make is the amount it pays you. Since we've earned most of this payment already, it makes sense to lock it in. That way, we eliminate the risk that the profit could dissipate because of a large move in the stock (in either direction) after the earnings announcement. After we dig into the company's results, we plan to set up a new options strategy. So if you don't have a position in Intel yet, wait until after earnings, and you can follow along with *Pro*.

How to Follow Along

Whether you wrote *Pro*'s original $19/$21 covered strangle or our adjusted $20/$22 strangle, with Intel sitting a bit above $20, both trades are showing a handsome profit and can be closed today ("buy to close").

If you wrote a different July strangle on Intel and have earned a majority of the possible profit, we suggest you close it before earnings Tuesday. If you wrote a strangle expiring in later months, you can let it be and keep waiting. If you don't own Intel yet, we suggest you wait until after earnings to make any new trades -- there's no reason to embrace risk a day before the event. We'll have guidance soon after we see the results. Once we close our strangle, we'll just own a position in Intel stock, which remains a Buy First.

Have questions? Please ask on the Pro Intel board.

Monday Memo: Use Options the Pro Way

Published Jul 12, 2010 at 12:00AM

Gold and Beyond, Yours Free

The Fool’s latest premium report, *Gold and Beyond: 7 Surprise Plays to Inflation-Proof Your Portfolio*, is hot off the press – and it’s free with your *Pro* membership! Get our analysts’ recommendations on protecting your purchasing power right here.

What’s Next

- 7/13: **Intel** earnings

- 7/17: Intel strangles, **Tupperware** strangles, and **U.S. Natural Gas Fund** diagonal calls expire
- 7/19: Tupperware earnings
- 7/21: **GlaxoSmithKline** earnings

In the *Pro* Community

- TMFValuemoosie posted a *Pro*earnings calendar.
- New *Pro* member Scott introduced himself Foolishly. We invite you to chime in, too!
- We talk about *Pro*portfolio performance.
- On the Philosophy board, we discuss how hedge funds are unsure what to do, mortgages, gold, and more. Join in!

Jeff owns shares of GlaxoSmithKline.

In last week's Memo, we discussed the *Pro* approach to buying stocks. Today, we'll outline the options side of the *Pro* investing strategy.

While we generally seek long-term capital gains from stocks, most of our options strategies are used for *short-term* income or gains. By combining these strategies (along with ETFs and shorts, which we'll cover next week), *Pro* investors can achieve profits in the coming weeks *and* the coming years, accomplishing our goal of steady, recurring profits with high accuracy in both the short and long term.

Options in Two Minutes

Let's go over some key points about options. If you're new to the concept, this explanation should show you that they're not as intimidating as they may seem, and if you're an old hand, it can serve as a Foolish refresher.

First: An option gives its owner the right to buy or sell a stock at a set price (the "strike price") by a set expiration date. An option's value is dependent upon the price moves of its related stock; a "call" option goes up when a stock rises, while a "put" increases in value when a stock falls ("call up, put down" is an easy way to remember this). Each option contract represents 100 shares of stock, so options make it possible to control many shares for a lower cost than buying them outright. However, the *Pro* approach to options often assumes that we could convert them into a full stock trade, so you should use leverage sparingly.

We write options (or "sell," "short," or "sell to open" – they're all the same thing) much more often than we buy them. That's because the odds are stacked in favor of the option writer: Writing options means we get paid to make the trade, and we are typically able to profit on the option even when the related stock swings in price. The option *buyer*, meanwhile, *pays* to make the trade – and to make any money, the buyer must be correct about the price of the stock by a certain date. That's difficult to do, which is why we write (or "sell to open") options more often than buying them.

We use options strategically, as part of portfolio management. Options work hand in hand with stocks, and your *Pro* portfolio should come to reflect that – so push away any inclination to trade options in a separate account. Finally, although most options do make money in the short term, we're not *traders* of options. We use them tactically, while appreciating that they expire in a matter of weeks or months.

Strategies – and Trades – We Like

There are more than a dozen options strategies *Pro* will use, depending on what's most appealing at the time. However, we primarily rely on just a handful, and knowing even one or two is enough to change and improve how you invest. The following two strategies are likely to be the most useful over a lifetime.

Writing Puts

Options FAQ

- *Pro* is a separate service from *Motley Fool Options*. Both services offer similar educational material that can be used together (and both feature a great community), but *Motley Fool Options* recommendations are not part of the *Pro* portfolio. However, they do provide strong additional ideas.
- Options can be exercised (turned into a stock transaction) by the owner (the buyer) at any time, but they are rarely exercised before expiration.
- The option writer *doesnot* control when an option is exercised. The owner (buyer) does. Any option that has value at expiration is automatically exercised.
- You can trade options in an IRA, including writing covered calls and, in some cases, writing puts.
- Options are priced based on intrinsic value (the difference between the strike price and the stock's share price) and time value (the amount of time until expiration). The longer until expiration, the more time value an option holds.
- The more volatility expected in a stock, the higher its option prices (reflected in time value).
- Option writers generally want to write options that expire in six months or less, to collect income more quickly. Option buyers generally want to buy options that expire in one year or longer, to have more time to be right.
- Not all stocks have options traded on them; options require investor interest and volume.
- U.S. options expire at the end of the third Friday of the month of expiration.
- To see options prices, obtain a stock quote at your broker and click "option chain."
- To get started using options, apply for options trading permission with your broker; level 2 or 3 will get you started.

When you would be happy to buy shares of a stock cheaper than the current price, you can write ("sell to open") put options. You would write, or sell, one contract for every 100 shares of stock you're willing to buy at a set price (the strike price of the option). Three real-life *Pro* examples – trades that you can consider making today – serve as the best illustration.

Say you'd like to purchase some shares of Buy First stock **Oracle**, but you'd prefer to buy a bit cheaper than the recent market price of $23.30. You could write ("sell to open") September 2010 puts at a strike price of $23, which would recently pay you $1 per contract (a total of $100 for each put you write, since each option contract applies to 100 shares of stock). Given the potential stock buy price of $23, receiving $1 per share equates to a 4.3% option payment (or yield) in only about two months – about 25% on an annualized basis. That's great income on the capital you set aside to maintain this trade.

By selling these puts, you've sold a contract into the market that says, "If Oracle declines below this $23 strike price before this option contract expires, I'll buy it at that set price." In exchange, you get paid the $100 per put the moment you sell the contract.

Now, if Oracle does go below $23 by the time the option expires on Sept. 18, your brokerage account buys shares automatically. Since you keep the $1-per-share option payment you received, your net start price on Oracle is actually only $22 – very nice. (Remember, each option is 100 shares, so if you write one put, you need to be ready to buy $2,300 worth of Oracle.) If Oracle is *above* $23 by the expiration date, the options expire, you still keep the option income you were paid, and you can write another put.

Let's look next at a Buy-rated stock: **NextEra Energy**, which is recently above $51. Perhaps you only want to buy this utility at a price lower than $50. You can write December 2010 $50 put options today and be paid $3 per contract. That's a 6% yield in about five months. Come Dec. 18, if NextEra is below $50, you get to buy shares at a net $47. If it’s above $50, you just keep your strong option income and try again (if you so desire).

This strategy can even work on a *Pro* stock that’s listed as a Hold due to valuation, because you can target a buy price in our preferred range. For example, software leader **Autodesk** is currently a Hold; it’s trading near $25, while our preferred buy price is around $22.50. But you can write October 2010 $23 puts on Autodesk, which would recently pay you $1.30 per contract. That’s a 5.6% payment in three months (around 23% annualized), and it nets you a potential buy price of $21.70 if you are "put" Autodesk shares. If Autodesk stays above $23, you get to keep the income, and you can write new puts.

Whether you’re looking to build a portfolio, add to an existing position, or earn income, writing puts on companies you admire is an excellent strategy. At *Pro,* we frequently also own some shares of the targeted stocks, so we have upside exposure. This is a good move if you believe a stock has meaningful upside, since you won’t want to miss all of that potential gain by only writing puts.

Writing Covered Calls

The flipside of writing puts is writing covered calls. Writing covered calls on stable companies is a steady income strategy used by young hedge funds and poolside retirees alike. When you *already* own at least 100 shares of a stock, and you’re willing to *sell* it a bit higher, you can write (“sell to open”) covered call options. (They’re called “covered” because they “cover” a stock you already own.) This strategy does limit your upside on that stock, since you’re obligated to sell it at the strike price even if it goes higher (you can adjust your option trade later to gain more upside, but we’ll save that lesson for another day). On the plus side, the strike price (or sell price) is your decision, made when you set up the trade.

Again, let’s examine a real-life *Pro* trade you can make. For every 100 shares of **Tupperware** you buy at $41, you could write one August 2010 $45 call option that pays you $1 per share. Thus, you collect $100 right now on one covered call contract, and you promise to sell your 100 shares at $45 if the stock reaches that price (or higher) by Aug. 21 (so your net sell price per share would be $46). The $1 per share you’re paid for the contract is only a 2.4% yield on the $41 purchase price, but that income is earned in less than six weeks, so it’s around 23% annualized. And if you do sell at $45, that’s a 12% total return on your stock. On the other hand, if Tupperware is *below* $45 by Aug. 21, you keep the option income, keep your stock, and can write new covered calls for more income. Meanwhile, the covered calls also cushion against a small decline in the stock. You can see why so many investors enjoy this strategy.

Start There!

These two key *Pro* options strategies may be the ones you use most, or even exclusively. *Pro* will use many other strategies, including buying calls to leverage gains; buying puts to protect positions or to short a stock; writing covered strangles (selling both puts and covered calls on a stock to double our income, which we’re doing with **Papa John’s International** and other companies); using option spreads to earn large returns on investment with low risk; using straddles to profit on big price moves in either direction; and more. All of these strategies and others are explained in our Options Guides. But you can, and should, start with just one or two strategies – the ones we outlined today.

Options Resources

Here is just some of the options education material available to you as a *Pro* member:

- Options 101: The Basics and Four Key Strategies Outlined
- Options 201: Writing Covered Calls
- Options 301: Writing Puts
- “All About Options” discussion board

Please see our options FAQ sidebar above, and ask your questions on the options board. Invest well, and Fool on!

Jeff Fischer

Jeff owns shares of Oracle.

Buy and Set Up a Covered Strangle on Papa John's Pizza

Published Jul 8, 2010 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Estimated fair value:** $27 to $29
- **Preferred stock buy price:** $24 or lower
- **Type of holding:** Defensive, option income
- **Why buy:**
  - Papa John's has strong U.S. operations and growing market share in the quick-serve pizza industry.
  - Pizza translates well internationally, and Papa John's is amping up its overseas business.
  - The company is led by an engaged and invested founder.

The Big Picture

By Jeff Fischer and Todd Wenning

If one food could conquer the world, it's pizza. These versatile pies appeal to vegetarians, carnivores, and omnivores alike, making them a good fit for every culture and eating habit on the planet. Pizza is a low-cost meal that borders on recession-resistant — hey, ya gotta eat! — making it an affordable indulgence for many families. Given pizza's popularity and the low barriers to entry in the industry (storefronts, ovens, simple ingredients), it's no wonder that 17% of all restaurants in the U.S. are pizzerias.

The industry is crowded and has cutthroat pricing, so only the strong can thrive. Two of the most successful chains — Pizza Hut (a unit of **Yum! Brands** (NYSE: YUM)) and **Domino's Pizza** (NYSE: DPZ) — were founded about five decades ago, making them the early movers in the domestic pizza industry. Pizza Hut and Domino's control 27.5% and 16.2%, respectively, of the U.S. quick-serve pizza chain market today, and few pizza chains have been able to replicate their success.

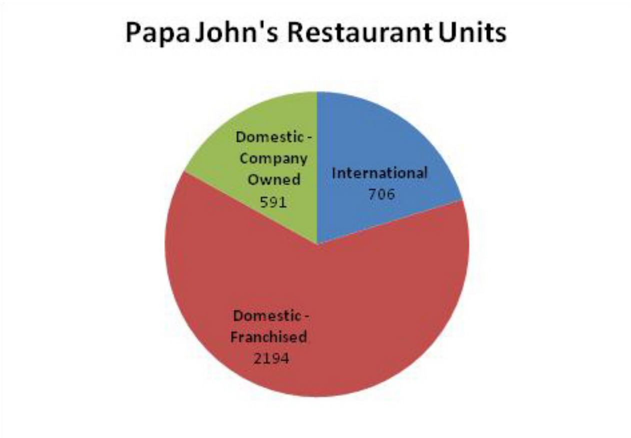
What the Community Thinks

The CAPS community is lukewarm to cold on Papa John's, rating the stock two stars out of five. However, more than 80% of All-Star members expect the stock to outperform, and our option strategy increases our profit potential. The company scores poorly on the CAPShot because it hasn't grown enough over the past few years. But we just seek profitable stability, and Papa John's offers that — with a high return on equity to boot.

A big exception is **Papa John's** (NASDAQ: PZZA), which opened its first restaurant in 1984 and today commands 11% of the U.S. pizza-chain market. That's up from10.5% in 2005, and it's worth noting that Pizza Hut and Domino's *lost* share over the same period. Using better ingredients to make better pizza (as its slogan claims), Papa John's was rated No. 1 in the 2010 American Customer Satisfaction Index, scoring even higher than **Starbucks** (NASDAQ: SBUX). It also scored highest in product quality, service quality, and customer loyalty. Put simply, Papa John's is doing pizza right, the company's financials reflect this, and we smell an investing opportunity.

The Business

As of March 2010, Papa John's had 3,491 restaurants in all 50 states and in 29 countries:



Source: Papa John's investor presentation

Seventeen percent of the restaurants are company-owned, versus 83% that are operated by franchisees. Management expects the percentage of company-owned stores to decline as franchised store growth increases. In the U.S., Papa John's expects to add 250 units over the next four years. Internationally, about 1,100 new units are in the pipeline, with most expected to open in the next seven years.

Papa John's growth-by-franchising strategy is a double-edged sword. On the positive side, the company can increase sales with little investment on its part and lower ongoing costs. Papa John's makes its money from franchisees by collecting between 4.75% and 5% of monthly net sales, while the franchisee is responsible for the initial investment and day-to-day expenses. However, on the flip side, the company will only be as good as its franchisees, so it's important to only approve financially qualified and professional franchisees and to ensure that product quality doesn't suffer. To that end, and to ensure taste consistency, Papa John's requires each domestic franchisee to purchase dough and tomato sauce from its company-run commissary and other ingredients from either the commissary or an approved supplier.

As for the company's history, Papa John's is a true American success story. Founder, chairman, and co-CEO John Schnatter (you know him from the commercials) started making pizza in 1983 out of the back of his father's tavern in Jeffersonville, Ind. His pizza was such a hit that he opened his own store in 1984, and the rest is history. Schnatter remains the company's namesake and the face of its advertising campaigns, and he owns about 21% of outstanding shares. Suffice it to say, he's engaged and invested in the company's future. When investing in smaller companies, these are exactly the qualities you want to see in management.

Financials and Valuation

Average sales on a per-store basis have been reassuringly consistent over the past seven years, ranging from a low of $307,734 in 2003 to a high of $334,936 in 2008. By comparison, Domino's average sales per store over the same period were just $173,668.

Because franchisee capital fuels growth, the company has less need to carry debt. As a result, Papa John's has a total debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) ratio of 0.8, well below the restaurant-industry average. The company has also been a consistent free-cash-flow machine, generating $57 million over the past 12 months, which puts the stock at 11 times free cash flow. Papa John's returns most of its free cash to shareholders via stock repurchases; since 1999, management has repurchased more than $748.9 million in stock, representing more than half of the company's current market value of $630 million.

Papa John's	2007	2008	2009
Revenue (millions)	$1,064	$1,132	$1,106
Net Income	$33	$37	$58
Diluted Earnings per share*	$1.09	$1.30	$2.06
Return on Equity	24%	29%	37%

Source: Capital IQ. *Excludes special items.

Using a free-cash-flow-to-firm model to account for Papa John's debt and operating leases, we used the low side of company projections to forecast store growth, five-year average sales per store, a 7% to 8% operating margin, a 2% terminal growth rate, and an 8.75% cost of capital as our discount rate. After adding back cash and backing out debt and executive stock options, we see a fair valuation of $27 to $29 per share.

This helps explain our strategy. Alternate trades – shared in the "At a Glance" section at the top of this report – are numerous. You can just buy this undervalued pizza stock alone; or, only write puts; or, buy shares and write covered calls. But we're overachievers, so we're doing all three: buying the stock, writing puts to potentially buy more shares cheaper, and writing covered calls to potentially sell our existing stock higher. This defensive, income-generating strategy is called writing a covered strangle, and it allows us a wide profit range on the stock. Take a look at the numbers:

- **Action:** Buy 2.5% of Papa John's under $24 (recently $23.85)
- **Action:** Write (sell to open) October 2010 $22.50 puts, for a quantity of shares equal to another 2.5%, recently $1.20 (each put you sell or write represents a potential purchase of 100 shares by expiration)
- **Action:** Write (sell to open) October 2010 $25 covered calls (1 for every 100 shares of Papa John's already owned), recently $1

- **Total option income:** Around $2.20
- **Potential second 2.5% buy price:** $20.30
- **Average buy price if we get all shares:** $21.90 (11.7 times 2010 EPS estimates)
- **Potential sell price on our first 2.5%:** $27.20 (14.5 times 2010 EPS estimates)
- **Effective options yield:** 9.4% in 100 days
- **Stock gain if sold through calls:** 15.7% in 100 days

Our option income provides us a cushion should the stock decline and affords us an attractive sell price when the shares gain ground. If the stock stagnates, we can continue to write options for more income. (Please note: *Do not buy* these options. We are writing – "selling to open" -- both the calls and puts, and being paid in the process.) If you're not using options, you can still partake by purchasing a half-position (2.5% of our target 5% allocation) in the stock and selling closer to fair value.

Why We'd Sell

Despite a steady history of growth and a promising future, we would consider closing the position for any of the following reasons:

1. In foreign markets, Pizza Hut and Domino's have a good head start (once again) on Papa John's, so if the company's concept fails to gain traction overseas, we'll have to reevaluate our growth projections.
2. Store growth is reliant on some franchisees' ability or desire to obtain credit. If credit markets remain weak, it could dampen planned store openings.
3. The company's commissary maintains a fixed markup on ingredients, so while a sharp rise in food prices would help the commissary's sales, it would also likely hurt the franchisees' bottom lines.
4. Competition is always going to be fierce in the pizza industry, and if our guy begins to lose market share, we'll revisit our valuation.
5. As the face and leader of the company, John Schnatter is a key figure. If he were to leave the company for any reason, we'd reconsider the position.

Finally, using a defensive covered strangle, we're happy to sell near our estimate of fair value.

Pro Bottom Line

We don't expect Papa John's to be one of our portfolio's big growth stories, but its consistent performance, attractive business model, valuation, and tasty options premiums make it an attractive income-producing position with upside. So now you know what's for supper! Take your Papa John's questions to its new discussion board.

Monday Memo: Use Stocks the Pro Way

Published Jul 6, 2010 at 12:00AM

Dear Fools,

In last week's Memo, we outlined what's in store for the month of July. We began on July 1 with a new buy recommendation -- beaten-down helicopter services leader **Bristow Group**. Our lifelong investing journey continues in this Memo, in which we'll review how we think about stock investments in the *Pro* portfolio and share some favorite investments. In our coming Monday Memos, we'll continue this overview with our other strategies:

- **July 12:** Our options strategies and some trades you can make.
- **July 19:** Our ETF and short strategies, and some available trades.
- **July 26:** Putting it all together -- stocks, options, ETFs, and shorts -- to build a *Pro* portfolio.

Meanwhile, throughout the month, we plan to keep issuing new *Pro* investment recommendations -- so keep a Foolish eye on your inbox. With that, let's dive into today's topic.

Pro Earnings

- July 13: **Intel**
- July 19: **Tupperware**

Options Expirations on July 17

Watch your inbox for new possible trades on these positions:

- Intel covered strangle
- Tupperware covered strangle
- **U.S. Natural Gas Fund** diagonal calls

Pro Coverage & Community

- New *Pro* members: Please introduce yourself on the Meet & Greet board!
- Jeff covers the strong earnings at **Oracle**.
- Alex340 lists numerous possible option writing trades on stocks meeting *Pro* guidelines.
- Russell (TMFEldrehad) shares his weekly CAPS analysis, rolling the dice on Vegas.
- Joe (TMFValuemoosie) posts a *Pro*-centric earnings calendar -- July will be good and busy.
- New member Amy shared her question on the Getting Started board -- feel free to ask yours!

Live Chat!

Read the recap of our latest live chat here.

Jeff owns shares of AmTrust Financial, Oracle, and GlaxoSmithKline.

Stocks to Grow By

Anyone who wants to grow wealth at a rate greater than inflation (which is bound to return someday!) has no better choice than long-term ownership of strong companies. At *Pro*, we always keep our eyes on the macro environment for possible dangers that are too large for our companies to fend off, but ultimately, we need to put our faith in the fact that quality businesses grow shareholder value over the years. And, of course, we need to be invested in order to benefit. This is why, while the *Pro* portfolio can sell short and use options, the majority of our assets will nonetheless usually be invested in strong companies at good prices.

By “majority,” I mean that anywhere north of 50% of our assets will be in stocks, and at times we’ll be 80% or more in stocks (the rest will be rounded out by options, ETFs, shorts and cash). It may surprise you to hear this, but as a whole, stocks -- not options or shorts -- are likely to be the most volatile part of our portfolio. This is partly because they’re the largest part, but also because they’re in a sense the most binary. In other words, stocks can only go up or down -- you make money, or you lose it. But options can steadily make you money even if a stock moves over a wide range (more on that next week).

Given the fickle nature of stocks, you should only buy when you’re ready to hold a company for a number of years, or as long as the business merits it. Unlike with options, there is little that’s tactical about owning a stock -- either you want to own it or you don’t, and if you do, you buy it and simply wait and stay current on the business. Thus, of all the assets you’ll have in your *Pro* portfolio, stocks are the longest-term investment. Remember that as you step up to buy.

What We Buy

Buying a stock is a little like a marriage: You hope the relationship only gets better for years and years, but realistically, you’ve got to be ready for some rough patches along the way. Thus, as with a marriage, you need to choose your (stock) partner carefully. At *Pro*, we focus intently on sustainable competitive advantages; a diverse and expanding customer base; recurring revenue streams; strong and expanding free cash flow; a healthy balance sheet; and more, all of which is detailed in our guide to finding great stocks. If there’s one thing that’s guaranteed with stocks, it’s volatility, so we want to be entirely comfortable with what we own and the price we’re paying. This allows us to wait out volatility and not lose sleep.

Why We’d Sell

On average over the past four decades, there’s been a period every two years in which the stock market has declined by 10% to 20%. It’s a cyclical fluctuation. When we’re concerned that the market is being irrationally exuberant and we see shorting opportunities, we’ll take action, shorting some positions to profit on an expected decline. At times, we may even be 50% short in our portfolio -- or more. But we’re not likely to sell our long-term stock positions just because we believe the market may take a breather.

As long as our core stocks are reasonably valued, we want to avoid commissions, taxes, skipping dividends and missing upside -- meaning we don’t want to trade in and out of our long-term stocks. We sell only when these positions look fully priced, the thesis has weakened, the stock no longer fits with the portfolio, or we find something better. Although we don’t try to time price swings in our long-term stocks, we’ll often use options on them when we see pricing opportunities. This can give us the best of both worlds: long-term capital gains in our stocks, and short-term gains with their options. This strategy can go a long way toward smoothing returns, evening out some of the volatility of stocks alone.

What We Like Now

Declining share prices since April suggest that investors were too hopeful regarding the strength of the economic recovery. It seems that they’re starting to agree with our long-held view that any real recovery is likely to be tepid and drawn-out (in fact, it’s likely to be a start-and-stop-and-start-again type of affair). But there is good news, and it’s two-pronged: Stock valuations already look reasonable, and the stocks we own showed their grit during 2008 and 2009. That means we know our management teams can steer through rough markets and continue to generate, and even grow, free cash flow. All of our Buy and Buy First stocks are within our preferred price range, and many have more attractive value multiples than before, since they’ve grown earnings. Even so, buy gradually, and average in over time.

If you’re just starting out, niche insurance provider **AmTrust Financial** (click here to get our report) offers value at 1.2 times book value and 5.4 times earnings, and it pays a 2.3% dividend. And software giant **Oracle** reported strong quarterly results and a healthy outlook, and it trades at a modest 12 times free cash flow. Both companies enjoy significant recurring revenue and competitive advantages, and each is targeted as 5% portfolio allocations. When you buy shares of any *Pro* stock, add them to the “My Scorecard” section of the site (click “Add”) to track performance.

Stocks in Summary

We hope this helps explain how we view stocks in the *Pro* portfolio. They’re the longest-term part of what we do. But we’re also here to make returns in the *short term*, even when the market doesn’t go up. We’ll dive into that topic in next week’s Memo on options. To comment or ask questions, please visit the Memo Musings board. Below are more resources on today’s topic. Until next time, stay Foolish!

Is China Collapsing?

Is China collapsing? Not according to the *Global Gains* team. They’re returning to China to investigate a once-in-a-generation opportunity. Receive their FREE live dispatches from China and No. 1 investment idea beginning July 6, 2010. For daily reporting, visit their China site at china2010.fool.com and enter your e-mail address.

Pro on stock investing:

- Making *Pro* Fit Your Profile
- How We Invest
- Secrets of a Winning Portfolio
- *Pro* ’s Guide to Finding Great Stocks
- The *Pro* Way to Value Stocks
- *Pro* ’s Guide to Selling

Foolishly,

Jeff Fischer, *Pro* advisor

Buy Bristow Group

Published Jul 1, 2010 at 12:00AM

At a Glance

- **Target allocation:** 5%

- **Estimated fair value**: $50
- **Preferred buy price**: Below $33
- **Type of holding**: Long-term; Energy services
- **Alternate trade**: Write ("sell to open") September $30 puts recently around $2.50; or write December $30 puts, recently near $3.50.
- **Why buy**:
  - Bristow Group is one of only two global helicopter services companies serving the offshore energy industry, and it enjoys the dominant position in most of the established and emerging deepwater markets.
  - Bristow has a recurring revenue stream that is impervious to oil prices and oil exploration and production spending.
  - Trading near a historic low price-to-book value, shares are priced considerably lower than the replacement value of the company's helicopter fleet.
  - We disagree with the market's view that the Gulf of Mexico oil spill will have a meaningful long-term impact on deepwater offshore oil and gas production.

The Big Picture

By Jeff Fischer and Bryan Hinmon
July 1, 2010

Get Personal With Bristow

- **Headquarters**: Houston, Texas
- **Website**: bristowgroup.com
- **CEO**: Bill Chiles since 2004; 61 years old
- **FY 2010 revenue (millions)**: $1,168
- **FY 2010 net income (millions)**: $112
- **Employees**: 3,410

Does anyone even remember what made the headlines before April 20 of this year? (Hint: Ash spewing from an unspellable mountain, lots of unplanned, extended European vacations). Since the *Deepwater Horizon* explosion, the media — not to mention environmentalists, citizens, and politicians — has been fixated (rightfully so) on the oil that continues to spill into the Gulf of Mexico at alarming rates. What really got the *market*'s attention, though, was President Obama's moratorium on deepwater drilling in the Gulf. While the U.S. Court system has since overturned that decree (though the White House is appealing the decision), shares of oil services companies on average have declined by 21% since late April on fears that the deepwater game has fundamentally changed. The *Pro* team disagrees with that assessment, and we think the market is overreacting.

Western societies are so dependent on energy that curtailing oil production is not a viable option. Additionally, emerging market economies are increasing the worldwide demand for energy. Old wells, tar sands, horizontal drilling, liquefied natural gas — the list of techniques and sources for trying to meet that demand is long. But no method has been as successful or proven as offshore exploration and production.

Worldwide, there are more than 8,700 production platforms and 500 offshore rigs. Unfortunately for direct investors, exploration is inherently risky and prone to all-or-nothing payoffs. We think the superior way to approach this area is by air. Really. **Bristow Group** (NYSE: BRS) gets people and equipment to those offshore deepwater platforms by helicopter, a business that has landed the company lots of stable, recurring revenue and a phenomenal competitive position.

The Business

The Community's Take

The CAPS Community agrees that Bristow shares are ready for take off, rating it 5 out of 5 stars. Every one of the 66 CAPS All Stars who rate Bristow believes that it will outperform. The company doesn't fare as well on our backwards-looking CAPShot report (not much does these days), tallying only 6 out of 12 points. Bristow's major shortcomings according to CAPShot are related to growth rates.

Bristow uses its wholly owned fleet of 305 flying taxis to transport rig crews, supplies, and machinery to its customers with offshore deepwater operations. It also has ownership stakes in another 204 helicopters, bringing its total working fleet to more than 500 aircraft. More than two-thirds of the company's fleet is medium or large helicopters, which are more versatile and earn higher revenue than smaller helicopters. In fiscal 2010, Bristow generated nearly $1.2 billion of revenue from providing these necessary taxi services. Vital to success in this business, Bristow has a safety record that is the envy of the civil helicopter universe.

We estimate that Bristow's 500-strong fleet makes it twice as large as its closest competitor, CHC Helicopter. While the company faces regional competition in each market, it enjoys a dominant position in each of its major deepwater markets, including the North Sea, Brazil, Nigeria, and Australia. New competitors are kept at bay by substantial aviation regulations and the high costs associated with entering the business: A new midsized helicopter costs around $25 million.

In addition to its dominant market position, Bristow has an enviable business model — one that brings in reliable, recurring revenue. The company generally signs two- to five-year contracts that call for a monthly reservation fee as well as hourly flight charges. That's pretty sweet, but it gets better: Bristow earns the reservation fee (which makes up 65% of revenue and 70% of operating income) even if no helicopters leave the ground. Many contracts also stipulate a minimum number of flight hours (a revenue floor), and Bristow gets to pass on fuel costs to its customers. Additionally, long-term contracts allow Bristow to build solid relationships with clients and give it an advantage in bidding for new business.

The market has given us the opportunity to invest in this stellar business at a discount because Bristow's exposure to the Gulf of Mexico and deepwater exploration is widely misunderstood. In 2008 and 2009, the company cut back its presence in the Gulf because of increased competition. Today, only 6% of its operating income is tied to that market — a fact that makes the stock's recent slide seem excessive.

As for the impact of the U.S. drilling moratorium, roughly 65% of Bristow's work comes from rigs already producing oil, not exploratory or drilling ones, so the short-term impact is even more watered down. In fact, it's possible that Bristow could experience increased long-term demand following the Gulf spill as oil executives feel more pressure to keep close tabs on all their deepwater platforms, or as new regulations demand rigs be more heavily staffed. (BP itself has hired Bristow to help deal with the current blow-out).

Finally, you can only get your crew to a deepwater rig in essentially two ways: Slow boat or a fast helicopter (we won't even get into how much more debilitating seasickness is than airsickness). The IHS Cambridge Energy Research Associates estimates that by 2020 a full 40% of U.S. oil could come from offshore. So as companies start drilling new wells farther from shore, that becomes an even easier choice.

Financials and Valuation

Bristow needs to spend consistently to keep its fleet state of the art and ahead of its competitors'. Over the past five years, the company has spent $1.4 billion on new aircraft. It paid for these expenditures by issuing debt, equity, and using cash from operations. Today, the company appears financially healthy, with debt representing only 35% of total capital. Bristow has adequate capacity to make payments on its debt, and we expect the company to refinance at even better rates using new government import/export facilities that should help the company keep more of the revenue it generates. As for revenue, flying larger helicopters to deeper waters should raise hourly flight charges and improve contract terms, raising Bristow's returns on capital.

Shares of Bristow are selling at only 84% of tangible book value ($36), which is 40% below its 10-year average price-to-tangible book value of 1.42. If shares were to trade at their historical average P/TBV again, Bristow would be priced around $52. Moreover, Bristow has significantly upgraded its fleet over the past five years. As Foolish investors, we are happy to pay less for shiny new helicopters than for 20-year-old clunkers! The fact that we can buy Bristow's 12-year-old (average life) fleet for 0.84 times tangible book value today, when other investors were willing to pay 1.56 times for its 19-year-old fleet five years ago leaves us flying high. If we bought all of Bristow today, we could probably pawn off the helicopters (there is a surprisingly liquid secondary market for aging helicopters), pay off its debt, and still have a nice chunk of change as profit. Although we've run conservative discounted cash flow models that show the stock has ample upside if business just grows modestly, because of the higher level of uncertainty associated with predicting cash flow, we're basing our investment case foremost on the company's asset value.

What Would Make Us Sell

Bristow's long-term success is tied to continued oil exploration, drilling, and production, so if the worldwide industry experiences a sea change that slows it dramatically, we would need to reassess our thesis. As a global operator, Bristow is subject to onerous aviation-related ownership rules, and as a result, it has a complex ownership structure for some of its foreign operations. While we're not terribly concerned about this, it is worth noting. Additionally, the company operates in some notoriously sketchy areas (such as Nigeria and Egypt), and we need to keep an eye on how foreign governments interact with the international oil companies.

Finally, current CEO Bill Chiles took over in mid-2004, only to discover some accounting shenanigans and poor internal controls. After self-reporting these issues and conducting internal reviews, he instilled a culture of safety and integrity (along with a brand new management team). Nevertheless, it's difficult to put these types of issues completely out of mind.

Pro Bottom Line

Bristow wins new business because of its superior safety record, global scale, and technologically advanced and newer aircraft. With the largest fleet in the industry — and one of the newest — the company is positioned to increase its profits as offshore drilling and production moves into even deeper waters. Those deepwater connections are also causing the market to misprice Bristow's stock. But we believe investors will ultimately refocus and see Bristow's enviable competitive position and discount to tangible book value.

For patient *Pro* investors, shares of Bristow could one day take off. Meanwhile, we'll enjoy owning part of a giant helicopter fleet — at below cost!

Please join us on the new Bristow board to discuss this investment.

Portfolio Review: Get Up to Speed With Pro

Published Jun 30, 2010 at 12:00AM

With the stock market down since late April, valuations on the companies we own have become ever more attractive, making our *Pro* Portfolio Review a delight to share with you. You can purchase any of our Buy First and Buy stocks near or below our preferred buy prices today. Even so, we always suggest that you buy gradually, average into positions over time, understand what you're buying and consider using options -- when you're ready -- to target even more attractive buy prices. We hope you enjoy our new *Pro* Portfolio Review as you build your own portfolio along with us.

Download this PDF special report and get up to speed on all our *Pro* holdings.

Monday Memo: A Promising Month Ahead

Published Jun 28, 2010 at 12:00AM

Welcome to *Pro's* Monday Memo, sent every Monday (well, most of the time*) at 4 p.m. ET with the latest thoughts, news, and a look ahead from the *Pro* team.

*Because of the Fourth of July holiday (which the market is celebrating on July 5!), you'll receive next week's Monday Memo on Tuesday.

Getting Started & Pro's Community

- Jeff shares guidance on many commonly asked questions from new members.
- Ready to enter a position in Buy First stock **Intel**? We review what a covered strangle is and its recent pricing. (Note, our options on Intel expire in July, at which point we'll likely issue a new trade.)
- Buy First stock **Oracle** reported strong quarterly results and guidance. We'll have more soon.
- Russell (TMFEldrehad) shares his great weekly CAPS analysis, this time on finding outperformance.
- Our *Pro* Member of the Week (and possibly the year) is spinningwood! A big shout out to Ed for all of his help answering questions on the boards and providing guidance. To learn more about Ed, visit our Foolish interview.

Chat With the Pro Team

The *Pro* team will be hosting a Live (online) Chat this week, Thursday, July 1 at 3 p.m. Don't miss your chance to ask Jeff, Todd, and Bryan your *Pro* questions. Sign up for your email reminder right here.

Whether you've been with *Pro* since we launched in October 2008, or you've just joined our merry band, we're all here for the same reason: To earn good and steady returns on our money while taking on reasonable (or low!) risk. If you're seeking longer-term capital gains in stocks and ETFs, monthly income from options, or near-term gains on shorts — or you want to make *all three* strategies work together — you can invest for your future following the moves of the *Pro* portfolio.

To help new members get started and veteran members stay the course, we have a full lineup for you over the coming weeks. I'll outline it today — so you know exactly where we're headed together.

Guidance, New Investments, and More

This week, we're getting this investing party started by issuing a special, full portfolio review on Wednesday, June 30. We continue to suggest that members average into our carefully chosen Buy First and Buy stocks, working to match *Pro*'s portfolio allocations. Listed on our Portfolio page, all of our buy-rated companies are attractively priced, strong businesses. Pay special attention to the "short" among this bunch**: ProShares Short S&P 500**. To hedge your stocks, this ETF will make money for you whenever the S&P 500 falls. If you want to be defensive and already own many stocks, match our allocation.

Now, let's run down the rest of the week. Here's what will arrive in your inbox:

- **June 30:** We'll publish your full *Pro* portfolio review (and email you when it's ready).
- **July 1:** A new *Pro* investment recommendation is slated to go out.
- **Also July 1:** A live (online) chat with the *Pro* team is scheduled for at 3 p.m. ET. Show up and ask questions! (You can sign up for an email reminder right here.)

July Promises Fireworks

Independence Day!

The market (and therefore the Fool) is taking off next Monday, July 5, in celebration of our country's birthday.

Next week's Monday Memo will arrive in your inbox on Tuesday, July 6.

Things will really heat up in July. Of course, you should continue to average into *Pro*'s buy-rated stocks, and we'll have more guidance and new investments for you throughout the month. Here's the weekly play-by-play:

- **July 6**: *Pro*'s Monday Memo, issued at 4 p.m. ET, will outline our stock strategy and name some favorite holdings.
- **July 7-9:** We expect to issue another new *Pro* investment recommendation.
- **July 12:** This Monday Memo will outline our options strategies and highlight options trades you can make.
- **July 13-16:** We expect at least one more new investment recommendation. Also this week, our existing July options expire, so we'll likely have a few "upkeep" option trades and possibly related new ones for all members.
- **July 19:** In this Monday Memo, we'll discuss how we use ETFs and shorts, and the related trades you can make now.
- **July 26:** In our final Monday Memo of the month, we'll put all of our strategies together, explaining how we work to earn consistent, recurring profits in various markets with a high level of accuracy.
- **July 20-30:** We'll likely have at least two more new *Pro* investment recommendations for you, but we can't guarantee that quite this far ahead.

Get Tracking!

As you build your *Pro* portfolio, hold us accountable: Enter your purchases in My Scorecard to see how our selections perform for you. (The Scorecard can't handle shorts or options yet, but everything else is fair game.) Visit our portfolio page, and click "Add" to enter your stocks.

New members and old alike, please ask your questions on our discussion boards. Introduce yourself, pose queries, share your stories and investing goals. We're all here for the same reasons, and we're enjoying the journey along the way.

Thank you for being a *Pro* member. We'll be in touch again soon!

Invest Foolishly,

Jeff Fischer, *Pro* Advisor

Coming Soon! Live Chat With the Pro Team

Published Jun 21, 2010 at 12:00AM

We're hosting a members-only Live Chat on July 1 from 3 p.m. to 5 p.m. Don't miss your chance to chat with the Jeff, Todd, and Bryan and get your questions answered. Just enter your email address below to sign up for an email reminder.

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Monday Memo: Pro’s Keys to Great Investing

Published Jun 21, 2010 at 12:00AM

Welcome to Pro

As a member of *Motley Fool Pro*, you will receive the Monday Memo, your weekly digest of macro news, portfolio progress, company updates, and even a bit of folly. Check your inbox every Monday at 4 p.m. for the latest from Jeff Fischer and the *Pro* team.

Recent Trades

- Bought 1,200 shares of **Oracle** at a net $24.17 with written puts.
- Bought 400 shares of **ProShares Short S&P 500** at a net $49.62 with calls.
- Wrote (sold to open) September $25 covered calls on about half of our **Jack Henry** shares for $1.30 per share.

Guidance Changes Due to Price

- **Lindsay** and **Quanta Services** moved from Buy to Hold.
- **Cameco** moved from Hold to Buy (we own 1.3% of a 3% target).

Pro Community

- Todd interviews the CEO of **Plum Creek Timber**, who also takes a moment to kindly praise *Pro’s* research.
- Zaya101 returns from China and shares an inside take on the country.
- **Kinetic Concepts** receives FDA approval for Prevena.
- TMFEldrehad looks at more stocks in the CAPS doghouse.
- Fools cover the gamut from socially conscientious investing to gold to GDP growth and more on the Pro philosophy board. (We love these conversations!)

Jeff owns shares of Oracle.

I recently asked each member of the *Pro* team to rattle off the top three qualities a person must have to be a good investor. You might be surprised to learn that nobody said "the ability to create discounted cash flow models and analyze competitive advantages", or "a passion for SEC filings." Those things are important, of course, but just as vital (or, according to our team, even *more* important) are your emotional state and mental discipline. You could be the best analyst in the world, but still buy and sell at the worst times if you let your emotions take over.

In 1934, Benjamin Graham famously said, “An investor’s chief problem — and even his worst enemy — is likely to be himself.” More than seven decades later, the only thing we'd change about that statement is to make it gender-neutral. The rest needs no updating, as evidenced by the independent responses from the *Pro* team:

Todd Wenning (TMFPhila)

1. Patience — having nerves of steel
2. Good judgment — of character, particularly for company management
3. Insatiable curiosity — a desire for knowledge

Bryan Hinmon (TMF42)

1. Patience — thinking long term is how individual investors get an edge over the big boys
2. Skepticism — a "guilty until proven innocent" mindset that focuses on risk first
3. Critical thinking — think rationally and think hard to counter your emotions

Bruce Jackson (TMFGoogly)

1. Discipline — only swing when the odds are in your favor
2. Patience — and with that …
3. Temperament — "Success in investing doesn't correlate with IQ once you're above the level of 125. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing." (Warren Buffett)

Jeff Fischer (TMFFischer)

1. Calm and steady reasoning in your decisions
2. An evolving knowledge of a business and its valuation
3. Patience

All four of us focused on an investor's emotional state and time frame, with knowledge being a third leg in the tripod of investing success. Because so many people buy high with excitement and sell low in fear, the ability to keep your emotions in check — and actively act *against* them — is key. Typically, you should be buying when others think you're crazy, and selling when you least want to, if at all.

More Ways to Succeed

Coming Soon!

***Pro* Portfolio Review:** The Pro team is hard at work reviewing all our portfolio holdings. Watch for this valuable feature soon at **pro.fool.com**.

Live Chat: We're hosting a live, members-only chat on July 1 from 3 p.m. to 5 p.m. Don't miss your chance to ask Jeff and team any questions you have about our holdings, the service, and more. Sign up here for your email reminder.

In doing this exercise, other important qualities for investing success rose to the surface on my list (written while I was stuck on a Metro train above the Potomac River). To invest well, you should have:

- Discipline to stick with strategies that you know are effective
- Portfolio positions that will earn profits in up or down markets, making stressful times less so and staying the course easier
- A real understanding of what makes a business' advantages sustainable
- Cash for opportunities, so your hands aren't tied
- Indifference to paper losses that are the result of mere price volatility
- A proper time frame for the money you have in the market, not one that will make you impatient

Our stated mission at *Pro* is to earn you consistent, recurring profits with a high level of accuracy. But in addition to that, we aim to help you achieve all of the qualities the team and I listed above. By putting all of the investing pieces together at *Pro* — uncovering attractive investments at good prices, using strategies on them that are profitable, and being patient and disciplined — odds remain high that we'll continue to create pleasing value with less risk. And that's why we're here.

In your experience, what did *you* need to learn to become a successful investor? Please bring your comments to the Memo Musings board.

Foolishly,

Jeff Fischer

Audio Extra: Todd Chats With Plum Creek CEO

Published Jun 18, 2010 at 12:00AM

Welcome to the latest *Pro* Audio Extra! In this edition, *Pro* analyst Todd Wenning asks **Plum Creek Timber** CEO Rick Holley about lessons learned during the recession, the company's land purchase strategy, the opportunity in renewable energy in the Southeast, and more.

Just click on the player below to listen in!

J2a2doMTrVMtt4aWp1b73Oyjx_RMrJV8

Write Covered Calls on Jack Henry & Associates

Published Jun 17, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") September 2010 $25 covered calls **on half your shares**
- **Allocation:** Write calls on half of the shares you own, in 100 share increments. In the *Pro* portfolio, we own 2,700 shares, so we are going to sell 14 contracts out of a possible 27.
- **Option's recent bid/ask (June 17):** $1.20 / $1.60
- **Preferred limit price:** Attempt to split the difference of the bid/ask, so around $1.35.
- **Special requirement:** You must own at least 100 shares of Jack Henry to write a covered call.
- **Alternate trades:**
  - **Don't own 100 shares of Jack Henry?** Continue to hold your position.
  - **Don't own any shares of Jack Henry?** The stock is on hold, but you can sell December 2010 $22.50 puts for around $1.25 to potentially add shares at $21.25.

What's New

As I noted in my recap of **Jack Henry & Associates**' (NASDAQ: JKHY) analyst day, "We still think Jack Henry is a strong business with solid client relationships and, of course, a lot of recurring revenue," but we've grown concerned about the company's growth-by-acquisition strategy and believe it may have paid too much for its latest acquisition, iPay Technologies. Because of this, we no longer think Jack Henry is worthy of a full 5% position in the *Pro* portfolio. We think we'll find better opportunities for those funds down the road, so we're writing covered calls on half of our position to potentially bring the investment size more in line with the growth prospects we see for the stock. Our new target allocation on Jack Henry is around 2.5% at current prices.

Why This Strategy?

Despite our concerns about slowing growth, we don't see significant downside risk to the stock, either, mostly because of Jack Henry's strong recurring revenue stream. So rather than outright sell half of our stake, we'd prefer to generate additional income from our large position by using covered calls, or nab a higher effective sale price than the market currently offers.

Here are the potential outcomes of the trade:

If ...	Then ...	*Pro*'s Take
Shares are greater than $25 at expiration	Half of our position is called away at an effective sale price of $26.20 -- a neat 40% gain on our purchase.	We're perfectly comfortable with this, and we'd free up $35,000 to invest elsewhere.
Shares are below $25 at expiration	We keep our shares and the $1.20 premium and effectively reduce our breakeven price to $17.51 ($18.71 minus $1.20).	We're fine with this result, too, and we'd likely write new covered calls to generate even more income.

As the table notes, if our shares aren't called away, the $1.20 premium received will provide 6.4% downside protection on our average buy price of $18.71. That's not bad for taking on three months of risk.

How to Follow Along

If you need a refresher on covered call strategies, see *Pro*'s guide to covered calls before placing the trade. Remember, you write one call for every 100 shares of stock you own; and you may cover all of your shares, or just some. We're covering about half of ours. Here are the numbers behind the trade:

- **Trade:** Write ("sell to open") September 2010 $25 calls on half of your stock position, in 100 share increments.
- **Option yield (at recent $1.20 bid):** 4.8% of the $24.98 share price, in three months
- **Option yield on our $18.71 average cost basis:** 6.4%
- **Upside from today if sold at a net $26.20 ($25 strike plus $1.20):** 4.9%
- **Total return on position if exercised:** 40%
- **Downside protection:** 4.8%; a decline to $23.78 is hedged

When you write ("sell") an option, the going price is paid into your account and the money is yours to keep. In this case, if you don't take further action on your calls, you're obligated to sell shares of Jack Henry if they're above the strike price by the expiration date.

Writing puts? If you place the alternate trade and write puts, you'll be obligated to buy shares of Jack Henry if the stock declines below your strike price.

We'll make this trade in the next one to 30 calendar days. To discuss it or ask questions, please visit our Jack Henry board.

Short iPath S&P 500 VIX Short-Term Futures

Published Jun 16, 2010 at 12:00AM

At a Glance

- **Target allocation:** 3% if converted to shares (for *Pro*, 12 contracts)
- **Special requirements:** You need a margin account and a high level of options permission (level 3 or 4) to make this trade. It may require follow-up action, details of which we will of course provide.
- **Alternate trades:** As per our original recommendation, sell short VXX shares directly at a preferred price of $30 or above if your broker has shares; or, write ("sell to open") $30 or higher strike calls for months after August for higher option payments (we plan to write these calls monthly if we can).

The Big Picture

June 16, 2010

- **Trade:** Sell short 3%
- **Target allocation:** 10%
- **Preferred price:** $30 or above. You can wait for the exchange-traded note (ETN) to rise above $30, or short a partial position at reasonably lower prices.
- **Special requirements:** You must have a margin account to sell an investment short. Also, this ETN could rise significantly before we see a profit, so you need the staying power and equity to ride that out.
- **Alternate trade:** Sell naked calls. The strategy is equivalent to shorting; however, you can only make as much as the calls pay unless you convert to shares.
- **Why short:**
  - We profit when investors begin to expect lower, more average volatility from the S&P 500.
  - Our long-term risk is limited because expectations for market volatility can realistically only climb so high, and almost surely can't remain elevated indefinitely.
  - This ETN tracks a short-term futures index that incurs costs by rolling futures contracts, making the index underperform the VIX. That's good for us as short sellers.

The Big Picture

By Jeff Fischer

How to Short

You must have a margin account and shorting permission. You sell short (or at some brokers “sell to open”) as many shares of the ETN as you wish to short. You’re paid the going market price, and you start to see profits if the ETN declines. If the short goes against you, you need the equity available to cover your losses, even if you plan to wait it out. In the end, we aim to buy the shares back much cheaper, closing the trade and keeping the difference.

All this market volatility can bring an investor down, but we have just the profitable pick-me-up for you.

Debuting in 2009, the **iPath S&P 500 VIX Short-Term Futures** (NYSEMKT: VXX) exchange-traded note tracks the value of the market’s most famous volatility index, the VIX (pronounced like the cough medicine — we prefer cherry, thank you). The VIX measures investor sentiment: It climbs when investors expect market volatility to be high, and goes down when investors expect a smoother ride. Measured not in dollars but in percentages, the VIX has averaged around 19 historically, and the pros (us included) consider any reading above 30 to be elevated. To break it down further, a 30 means investors expect 30% volatility in the S&P 500 over the coming year; a 19 suggests 19% volatility.

As we enter summer, the VIX sits near 30. We expect trading volume to decline (as generally happens when the weather heats up in the Northern Hemisphere), the reality of the new worldwide economy to settle in, and market volatility to start to subside — bringing the VIX back to more average levels. Thanks to this new ETN — a similar vehicle to the more well-known exchange-traded fund (ETF) — we can profit in our belief in a lower VIX by selling iPath S&P 500 VIX short, just like a stock.

Another wonderful thing about this short: Our long-term risk is more limited compared with shorting a company’s stock. Nobody will acquire the VIX at a higher price (as could happen with a company), and there won’t be any earnings surprises or company-specific risks. The largest risk we face is that we may need to wait through a spike in the VIX — perhaps for months or longer — with a loss on our hands until the index declines. In a worst-case scenario, a repeat of October 2008 could send the VIX soaring. If that happens, a few factors work in our favor. By attempting to duplicate the performance of the VIX, this ETN assumes the same monthly costs as its underlying benchmark (a near-term index on the VIX that rolls futures contracts), and the ETN has ongoing management fees. In fact, the ETN managers themselves suggest that it will underperform the VIX both to the upside and the downside. That will nibble away at the value of the ETN, making it an even more sensible short.

The Fear Gauge Explained

The Windy City is home to the losing Chicago Cubs, the Sears Tower, that [giant reflective jelly bean], and the mood-measuring VIX. In 1993, the Chicago Board Options Exchange (CBOE) introduced this tracking tool — nicknamed the "fear gauge" because it tends to go up when the market is falling — to little fanfare. Today, the VIX is the industry standard. It represents a live, options-market-derived estimate of the expected (or implied) volatility in the S&P 500 over the coming month. Here's how it works.

The VIX calculates investors' expectations for volatility based on what they’re willing to pay for options. For the technically inclined, to arrive at that number, CBOE’s proprietary formula uses live market prices for out-of-the-money calls and puts that expire in the next two months. These inputs spit out the implied volatility that options investors expect to see. Bottom line: The more volatility investors expect for the next 30 days, the higher options prices go — and the higher the VIX soars. Inversely, the less volatility investors anticipate, the more options prices decline, and the lower the VIX drifts.

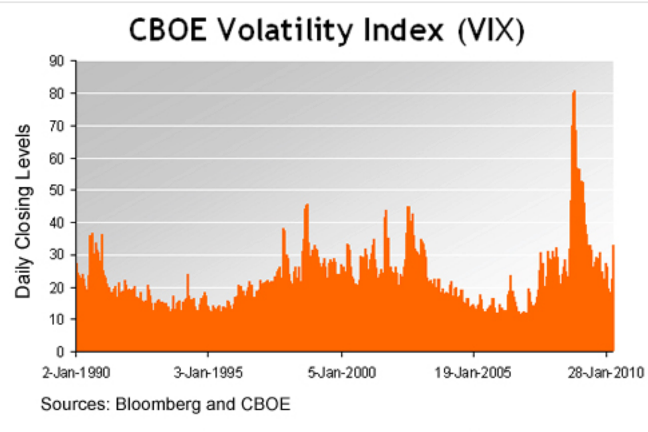
The VIX briefly hit its all-time high in October 2008 at more than 80. Its all-time low, 9, was in 1993. If the stock market averages an annualized return of 9% to 11% over history, the VIX value might ultimately double that to account for volatility in *either* direction — and it has, averaging 19 since inception.

A Note About Volatility

Remember, volatility can mean either downward or upward moves. A high VIX won’t always mean the market is due to fall; it simply means the market will be volatile. Throughout the late-1990s bull market, for example, the VIX was consistently above 20.

As a contrary indicator, the VIX has proved a reliable measure of investor emotion. When investors are fearful and paying dear prices for put option insurance, the VIX is up — but the market may be hitting a bottom. When the VIX is low, it means investors expect little volatility, put options are cheap, and everyone is at ease — so the market may actually be running out of steam.

Anytime the VIX is above 30, investors expect volatility to be well above the historical average (30% or greater annualized moves in the S&P 500 are anticipated). According to Bloomberg, the VIX has traded above 40 a mere 3% of the time since its debut. Even in September 2001, it only averaged 35. Based on that history, the VIX reading today signals a level of volatility that has yet to prove sustainable, offering us a good short-selling opportunity.



That said, we must be ready to ride out long periods where the VIX may move against us, levitating above 30 for months on end. Again, history (and the chart above) serves as our guide. From 1997 to 2003 — a six-year stretch that included a presidential impeachment, the Internet bubble, a hotly contested presidential election, 9/11, two wars, a recession, and the return of bell-bottom pants — the VIX mostly hovered between 20 and 40. So it can remain elevated for long periods. Unlike with other shorts, though, we should be comfy, because it’s almost certain that market volatility will decline eventually — and the VIX with it. When this ETN dips into the teens, we’ll be looking to close our short.

How the ETN Tracks the VIX — or Doesn’t

Barclays Bank launched this ETN as a brilliant (for Barclays) promissory note that mirrors the S&P 500 Short-Term Futures index. That index continually rolls two months' worth of futures contracts on the VIX in order to track the VIX (there’s no way to invest directly in the VIX). The rolling of futures can eat up value through transaction costs and contango (paying more for forward futures contracts than you get selling your current ones). Plus, the ETN has an annual fee of 0.89% as well as other daily accruing charges.

In 2019, Barclays will pay ETN owners a sum based on the then-value of the VIX as represented by the short-term futures index tracking it — as represented by the ETN, minus fees (got that, Fools?). The ETN launched on January 30, 2009, at $100 per note while the VIX was 43. Recently, the VIX is 28 (down 35%), and the ETN is down 72%. In other words, the performance has been dismal.

Barclays doesn't mind, though, since it pocketed the IPO funds and gets to wait until 2019 to repay just a fraction of those funds. Betting that the VIX would be much lower in the years ahead and that nine years of fees would help its cause, Barclays seems to have developed a brilliant way to make money — for itself. We ran all the numbers on the ETN since its inception and it lags the VIX in each direction over time, but especially when the VIX rises.

Risks and What Would Make Us Close

As with any short, waiting can be the hardest part. Another financial meltdown or a deepening of the recession could send the VIX soaring above 40 as stocks fall. Indeed, 2008 and 2009 are the only years on record where the VIX averaged above 30, and this trend could continue. We expect to wait out our short until it's profitable, but when a short works against your portfolio, it eats into your equity and your buying power.

Get to Know the Players

- Facts on the CBOE VIX Index
- Facts on the iPath S&P 500 VIX Short-Term Futures ETN

If the VIX soars as stocks tank, our short obligation will grow as well, and we'll have less cash available to invest in beaten-down stocks — right when prices are enticing. So keep your position size reasonable and have extra cash on the sidelines. We plan to start small and add to our position if the VIX jumps. The worst-case scenario is one where the world economies hit extreme turbulence and the VIX soars to record levels for quarters or years on end. If that happens, our portfolio will experience more volatility and paper losses, but I believe we'll be vindicated in the long run.

Pro Bottom Line

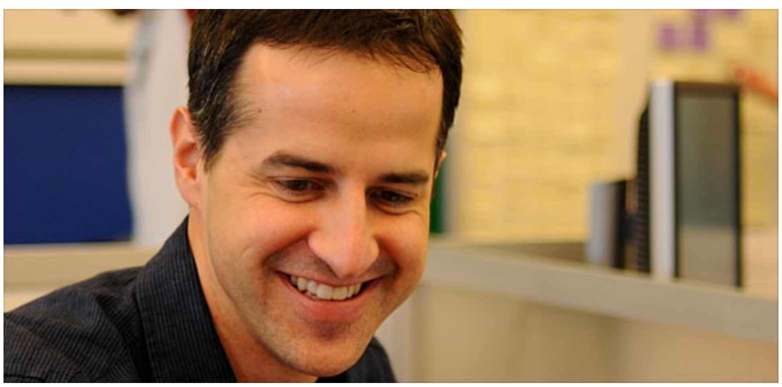
We don't believe investors will expect 30% or greater volatility in the S&P 500 index forever (or even for a long time). Eventually, the VIX is likely to return to the teens (it was just there in April), making this ETN an attractive short candidate at prices well above that. We'll have more to say about the ETN on its new discussion board, so stop by!

Meet the Pro Team

Published Jun 15, 2010 at 1:00AM

Jeff Fischer

Advisor



Jeff Fischer (TMFFischer), advisor of *Motley Fool Pro* and *Motley Fool Options*, started working at the Fool in 1996, soon after he won the Fool's first year-long online portfolio contest. Jeff co-managed the original Fool Portfolio with co-founders David and Tom Gardner, and co-founded and managed the Fool's Drip Portfolio. Jeff also wrote *Investing Without a Silver Spoon* and served as editor on several other Motley Fool best-sellers. All four of the real-money portfolios Jeff has managed or co-managed publicly since 1996 have beaten the S&P 500, although that isn't his first objective, which is steady returns with reasonable risk. Jeff is married to an actress/professor and has a young son.

Billy Kipersztok

Senior Analyst

Billy Kipersztok (TMFTailwind) was introduced to investing by his father, and began reading The Motley Fool as a teenager. He is a voracious reader of investment literature, and he enjoys scouring the market for investments with two characteristics: (1) favorable economics and (2) a fair price.

Prior to joining the Fool, he interned in the analytics department of the NBA's Atlanta Hawks, picked up an MBA and a master's degree in sport business management at the University of Central Florida, and earned a bachelor's degree in chemistry from the University of Florida. He enjoys learning, playing/watching sports, and cheering on his alma mater. (Go Gators!)

JP Bennett

Research analyst

JP Bennett's (TMFYossarian) route to working at The Fool was a circuitous one; he was previously a Ph.D. psychology student before coming to the realization that he'd rather turn his favorite hobby (investing) into a career. Because of this, he left the Ph.D. program and got an MBA before eventually landing an internship with the Fool in 2013. He's not quite sure why, but apparently he did something right that summer because he's managed to hang around ever since. To this day, investing remains his favorite hobby and the primary use of his free time, but he is also an avid runner and enjoys taking his Boston Terrier to the park whenever the humidity in D.C. isn't too oppressive. JP has also passed all three levels of the CFA Program and may be awarded the charter upon completion of the required work experience.

Ellen Bowman

Editor/publisher

Ellen Bowman (TMFKabellen) has been with The Motley Fool since 2006, first as a copy editor for Fool.com and then as an editor (and publisher, and chief bottle-washer) of various subscription services. She has worked on services from *Stock Advisor* to *One* and beyond, but considers *Pro* and *Options* "home." Ellen is a proud alumna of the University of Houston, and is amazed every day at how much an English major can learn about investing when she has teachers like these!

Options Lesson With Todd

Published Jun 15, 2010 at 12:00AM

Meet the Team

Published Jun 15, 2010 at 12:00AM

Jeff Fischer

Video Extra: Inside *Pro*

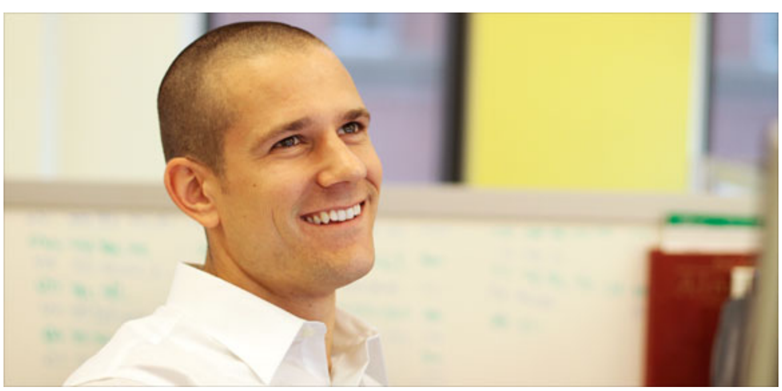
Jeff, Nick, and Bryan discuss their investing backgrounds and the *Pro* approach in [this video extra].

Jeff Fischer ([TMFFischer]), advisor of *Motley Fool Pro* and *Motley Fool Options*, started working at the Fool in 1996, soon after he won the Fool's first year-long online portfolio contest. Jeff co-managed the original Fool Portfolio with co-founders David and Tom Gardner, and co-founded and managed the Fool's Drip Portfolio. Jeff also wrote *Investing Without a Silver Spoon* and served as editor on several other Motley Fool best-sellers. All four of the real-money portfolios Jeff has managed or co-managed publicly since 1996 have beaten the S&P 500, although that isn't his first objective, which is steady returns with reasonable risk. Jeff is married to an actress/professor and has a young son.

Nick Crow

Hardwired for frugality, senior analyst Nick Crow, CFA ([TMFCrow]), had a childhood newspaper route and a penchant for hoarding cash in doorknobs and hollowed-out books. That soon led to an early interest in investing — including a first-place finish in a middle school stock-picking contest. Ever the value hunter, he chose to jump out of airplanes as a U.S. Army paratrooper to have Uncle Sam foot the bill for his higher education. When flying home on leave, an older investor recommended he read Benjamin Graham's *The Intelligent Investor*, and Nick's been studying the great investors and honing his skills ever since. Nick spent six years at a major bank before joining the Fool. Now he's hard at work as senior analyst for *Motley Fool Pro* and *Motley Fool Options*. When he's not digging into annual reports, looking for his next option idea, scrutinizing special situations, or dabbling in distressed debt, you can find him spending time with his family and helping his daughter with her homework.

Bryan Hinmon



Bryan Hinmon, CFA ([TMF42]), who comes to the *Pro* team as part of the Fool's Analyst Development Program, has been a loyal member of the Fool community for more than a decade. After cutting his teeth managing some *serious* real money for students and faculty at Stetson University, where he co-founded the CMH Investment Board, Bryan moved to sunny Naples, Florida, to work as an investment analyst for LUMA Capital. At LUMA, he helped manage the portfolios of high-net-worth individuals and launch a hedge fund focusing on large-cap equities with a covered call overlay — in a similar vein as *Pro*'s strategy, but not nearly as brilliant. Hungry for more, Bryan moved to Boston to open and co-manage Bulwark Capital Management, a hedge fund with a broad purview. Small stuff, ugly stuff, and option income were par for the course at Bulwark. As part of the *Pro* team, Bryan enjoys being surrounded by smart and fascinating people at Fool HQ, but as a new D.C. resident, he wants Dan Snyder and Mike Shanahan to know that he will forever stay loyal to the Tampa Bay Buccaneers. Converting his wife, a die-hard New England Patriots fan, will prove even more futile — so don't even try, D.C.

Monday Memo: Why We Don't Fear Volatility

Published Jun 14, 2010 at 12:00AM

Upcoming Option Expirations: Saturday, June 19

- Short **AmTrust Financial** (Nasdaq: AFSI) $12.50 puts — on track to expire as cash.
- Short **Oracle** (Nasdaq: ORCL) $25 puts — on track to convert to shares at $24.17.
- Long **ProShares Short S&P 500** (NYSE: SH) calls — we might sell early for a profit or accept new shares. We'll let you know this week.

Earnings on the Way

- June 24: **Oracle**, with $0.54 per share expected on $9.52 billion in sales.

This Week in Caps

TMFEldrehad revisited some of the stocks that made the "Hot 5-Star Stocks" list in January to see how they've fared. He also identifies today's candidates. Read all about it right here.

Coming Soon!

The *Pro* team is hard at work on a full portfolio review. Watch for this valuable feature — with the team's latest thinking on all our stocks — in late June.

Jeff owns shares of AmTrust and Oracle.

Congratulations, *Pro* Fools! You've just made it through another volatile week in the markets.

The recent day-to-day movements of the markets and individual stocks have been quite extraordinary. Last week, for example, on the back of poor U.S. payroll numbers for May, more uncertainty in Europe, and the Gulf oil spill, the market went into one of its periodic depressive states, and stocks were hammered indiscriminately.

Several news sources summed up the mood of the markets, including these two quotes from last week after the Dow closed below 9,900:

> People are just traumatized … The wall of worry today is bigger than almost any other time I can remember.
>
> The volatility daily is, even for a veteran … unnerving, unsettling, as it implies instability.

Shaken, But Not Stirred

In the early part of last week, even the *Pro* portfolio was shaken by this volatility, bar our **ProShares Short S&P 500** (NYSE: SH) shares and call options.

But your trusty portfolio managers weren't fazed. Sure, no one likes to see his stocks in freefall. But we weren't going to be scared out of our stable of solid companies just because their *stock prices* had fallen when the value of the underlying *businesses* has remained largely unchanged. No siree.

Some people mistake volatility for risk. They think a stock like **Tupperware** is a riskier proposition at $36 than it was at $40 or even at the $54 it traded for in April. In their distorted view, they'd prefer to buy Tupperware's stock at $50 than at $36. Worse, some investors would sell at $36, fearful that the stock would keep falling, falling, falling.

I hope you can see the pure folly of such thinking and behavior. Investing should be a long-term endeavour, a lifetime one at that. In the course of your long investing life, you'll encounter bull markets and bear markets. Stock prices will move up and down. Your challenge, should you wish to accept it, is to buy stocks when they are cheap, sell stocks when they are fully valued, and in between, hang on for the ride.

The old saying goes that stocks go up stairs and down elevators. After just over a year of the market seemingly only going up, May and early June have given us a stark reminder that they can fall, and often fast.

Here at *Pro*, we don't fear a falling market, nor do we fear a volatile market. On the contrary, we like the stock prices that a fearful, volatile market can bring us. This time around, we haven't yet dipped our toes back into the water to make direct new buys — though we did buy more shares of **Medtronic** and **SPDR KBW Regional Banking ETF** through put options last month. We've got some excellent new stock ideas in the *Pro* hopper, too, so keep your eyes peeled for some new trades.

Options for the Right Reasons

Speaking of which, this Saturday, our June options expire. Depending on what the individual stocks do between now and then, it looks likely that we'll be proud owners of more **Oracle**. We also have choices to make about the **ProShares Short S&P 500** calls we own and the **AmTrust Financial Services** $12.50 puts we wrote.

I used to get all worked up about upcoming options expirations, watching the movements of the stock prices, wondering whether I'd be put shares or my options would expire as 100% gains.

These days, I sleep through the whole event (admittedly, living in Australia, in a completely different time zone, does help). If I am put the shares at close to the strike price, come the following Monday I can hang onto them, sell covered calls to generate more income or to sell the shares at a better price, or just sell them outright. No stress, no worries.

I'd respectfully suggest that, as your options approach expiration, if you are genuinely worried about getting put shares that you don't really want or can't afford, you're probably using options to *speculate* rather than as an investing tool.

I hope you'll agree that speculation goes against *Pro*'s purpose, which is "to earn you consistent, recurring profits with a high level of accuracy using a combination of stocks, ETFs, and options in a strategic portfolio."

In the near future, as well as making more trades, we're in the process of conducting our periodic full portfolio review. Speaking for myself, I like what I've seen in the stocks I've reviewed. I've seen good to great companies, with strong competitive positions and solid growth prospects, that are trading at attractive prices. With such holdings, we'd like to think we're firmly on track to fulfilling Motley Fool *Pro*'s purpose.

Happy investing.

Bruce Jackson

Bruce has stock or options positions in ProShares Short S&P 500, Tupperware, Oracle, and AmTrust Financial. It's fair to say he's drinking the Pro *Kool-Aid.*

Monday Memo: Pro Adapts and Improves

Published Jun 7, 2010 at 12:00AM

Community Highlights

- The **Vanguard Energy** ETF is down, but it's not an easy buy.
- Fools are talking shorts, and Jeff names some names and shares thoughts.
- Russell (TMFEldrehad) shares the good CAPS news: Now you can see a strong stock pitch from the community highlighted every week. Don't miss it!
- Bruce (TMFGoogly) asks, "Has the Penny Finally Dropped?" after the market's 3% decline on Friday.
- July isn't that far away. TMFValuemoosie is preparing with an earnings calendar.
- Friday's employment report looked weak. Could that affect **AmTrust Financial**? Bruce answers.

Upcoming Option Expirations: June 19

- Short **AmTrust Financial** $12.50 puts — on track to expire as cash.
- Short **Oracle** $25 puts — on track to convert to shares at $24.17.
- Long **ProShares Short S&P 500** calls — we're likely to exercise them into profitable shares.

Jeff owns shares of AmTrust and Oracle.

Sometimes experience is the only way to learn. As investors, we aim to learn from everything the market throws at us — and recently we've had plenty of opportunity to gain valuable insight.

We didn't know how well our young *Pro* portfolio would hold up in a sharply declining market, but the S&P 500's recent 14% drop gave us a reliable way to figure it out. Of course, as we were investing, we considered the beta of our stocks — how much and in which direction they would likely move in relation to the market. We also calculated how much our options would benefit us and how a short on the index would help. But we could only know for sure how our holdings would fare *after* the market made a dramatic move. Now we have that knowledge, so we can adjust our portfolio and improve it before a similar situation comes along — that is, one where we want to be more defensive.

Improving the Mix

Although I'm about to point out some things that didn't go as well as we hoped during this recent market decline, overall we're more than happy with where our portfolio stands today — and we hope you are, too. When making decisions during highly uncertain times, we need to reconcile our longer-term investing opportunities with any expected short-term bumps. We like each company we own, we accept market volatility, and we're glad we've kept cash available to invest in new opportunities.

Those key positives said, there are some things we plan to do differently when we expect another market decline, because our portfolio hasn't held up quite as well as I calculated or hoped. There are a few reasons for this. First, just as with the decline in 2008 and 2009, the recent slide hasn't spared much of anything. Even defensive sectors such as health care and utilities — where the *Pro* portfolio is more heavily weighted — performed poorly. Additionally, as market volatility increased, option prices jumped more than expected, and since we're mostly short options — we've primarily written them — our options didn't hedge some positions nearly as much as they otherwise would. They actually moved against us in some cases. Of course, this is temporary and the extra time value in these options will dissipate.

Any shifts in our approach don't have to be drastic, though. In fact, I wouldn't expect to change our portfolio's directional bias radically unless we think the stock market is likely to fall 20% or more. That's because if you expect only a 10% to 15% decline in stocks — a typical correction — then selling most positions, changing course to mostly shorts, and hoping to switch back in time to catch the next move up is fraught with risk. It's like trying to turn a tanker around in a tight channel. By the time you change direction — and possibly pay commissions and taxes — you need to start getting ready to turn again. Too often, little is gained by your maneuvering during a normal market drop. In the worst case, you end up losing ground and getting locked out of good companies.

So we need to believe that a pending decline is going to be substantial and extended before we'll change the direction of the whole portfolio. It's likely that someday we will invest mostly on the short side, but for more typical downturns, we can take less drastic steps to improve our results. After all, 10% declines happen every two years on average, so we want to make them work for us.

What Will Change

For starters, we'll want more shorts if we're taking on a more defensive position in the future. We've owned **ProShares Short S&P 500** since last year, and we bought calls on it before the market began to decline. But as a 4% holding, it's still a modest short. If we believe a 10% to 15% decline in the index is on the way, we should aim to be at least 10% to 15% short. We'll also want to buy put options to protect our short. The market's measure of volatility — the VIX — was extremely low this spring, which is usually a sign of complacency. That can be a good time to buy put options, because premiums are low. (This time around, we didn't find compelling options to buy.)

We're also going to use the VIX more to help guide us on directional changes in the market. Since the VIX's inception in 1990, it has been above 40 only 4% of the time (it's been in the 30s lately). When it is at those elevated levels, fear is high, option writers get paid well, and stocks are usually getting cheaper. When the VIX is in the teens, as it was just before the market fell in May, the opposite is the case. Often you'll want to prune your highest-valued stocks and consider buying puts. This isn't news to us, but it's time to start following the VIX in *Pro* because we use options steadily and we want to make money in up and down markets.

Finally, now that we're more invested and have less cash, we'll be quicker to take profits on stocks that look fully valued — especially when prices are up and complacency is high.

To Tomorrow!

History never repeats itself *exactly*, so we'll never experience precisely the same situation in the market that we just came through. From January until May, we were cautious, but the market's relentless climb coupled with reasonable valuations made us reluctant to go heavily short. (Using covered calls was the least risky way to hedge, despite the low option premiums — which is why we often doubled up and wrote strangles.) However, we will experience similar situations frequently, and we want to be ready so that our portfolio will be less affected by future declines than it was by this recent one. We're happy with where our portfolio landed after the past 19 months, but we're always working to be better.

Have comments or questions? Please share them on our Memo Musings board.

Jeff Fischer

Motley Fool Pro Terms of Service

Published Jun 1, 2010 at 12:00AM

Welcome to *Motley Fool Pro* (the "Service"). This page sets forth the special Terms and Conditions by which The Motley Fool provides you with access to the Service (the "Terms"). It supplements the Fool's Rules (our standard terms and conditions), which are incorporated by reference. By subscribing to, and using the Service you are agreeing to abide by these Terms as well as the Fool's Rules INCLUDING THE BINDING ARBITRATION AND CLASS ACTION WAIVER DETAILED IN SECTION 10 OF THE FOOL'S RULES.

Motley Fool Pro

The Service is an actively managed $1 million real-money portfolio that employs a wide range of trading strategies, including all forms of options, leverage and shorting. The Service can be involved with any asset class, including stocks, bonds, ETFs, commodities, currencies, and anything which can conceivably be publicly traded. The Service may use unlimited leverage on any or all of its positions, but will never have more than 120% long exposure. The Motley Fool is funding the portfolio and consequently, any realized gains or losses will belong to The Motley Fool.

The Motley Fool strives to operate with the highest level of integrity and to treat everyone — our customers, employees and community — fairly. With that in mind, we've put in place guidelines with respect to the Service in addition to our standard trading rules. They include:

- Employees and contractors cannot trade based upon any knowledge of an upcoming pre-announcement. They may only trade in the security after the trade confirmation has been published.
- The Service is committed to making its transaction between the next business day and 30 days from the time the pre-announcement has been published.

Please note there may be occasions where the Service takes a position with respect to a security that is counter to that of another Fool premium service.

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A Word of Caution

As stated above, the Service may use a mix of investing strategies including buying, selling, and shorting securities as well as options (in all its forms and permutations), leverage, and other trading methods permissible under U.S. law. Regardless of the action taken by the Service, it is in the capacity of a responsible investor and not a speculator. That doesn't mean our trades will always turn out to be winners. It means that we have done our best to do our homework and consider the inherent risks before pledging our money. We urge you to do the same. Some of these inherent risks include:

- Leveraging increases the risk of total loss, as small fluctuations in value may have far greater impact on your portfolio.
- Illiquid or hard to trade assets can rapidly fluctuate in price, and may be hard or impossible to trade without a specialized broker or a significant margin account.
- Trading in currencies can be riskier than trading in other assets, as currencies are subject to the control of their respective governments.
- When shorting an asset, the risk of loss is hypothetically unlimited, as investors who short may be required to purchase shares to cover at any time, and at any price.
- Shorting requires a margin account. Your broker may require additional capital in your margin account based on their policies and applicable regulations. These amounts may be significant, and failing to have access to sufficient capital may cause your broker to liquidate or close your positions without warning, in accordance with their policies.
- A stock can become the subject of a short squeeze whereby many short positions attempt to cover at the same time. This can drive up the price and force investors to cover at unexpectedly higher prices.
- Investors are liable for any dividends paid out during the time they hold a short position.
- If a stock is heavily shorted, your broker may charge a "hard-to-borrow" fee before borrowing shares for your account, or may charge the fee while the shares are held short. These fees can be incurred without prior notice, and can be in excess of 100% annualized.
- Most brokers will pay you interest based on the cash they receive from shorting, subject to "short rebate fees". These fees are levied regardless of the general interest rate. In times of low interest rates, you are responsible for paying the difference between the interest rate and the rebate fee.

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Last updated August 12th, 2016

Monday Memo: Why Investing Requires Uncertainty

Published Jun 1, 2010 at 12:00AM

Did You Sell Flowserve?

Last week, we announced that we're selling our full position in **Flowserve** (NYSE: FLS). Check out the details — and our reasoning — right here.

Community Highlights

- Bruce (TMFGoogly) reviewed **Medtronic**'s quarterly results.
- Jeff summarized the **Autodesk** conference call.
- **MELA Sciences** announced that the FDA will review its MelaFind product on Aug. 26.
- In his weekly CAPS analysis, TMFEldrehad asks, “What makes a great investment?” CAPS members are chiming in on the top 10 CAPS stocks.
- Is **GlaxoSmithKline** ready to recover?
- Todd dusts off a 2005 interview Fool co-founder Tom Gardner did with Professor Aswath Damodaran on valuation and investing.

To all of you investing your own money, we want to take a moment to praise you. Since late 2008, the market has been anything but normal, calm, or reassuring — and, frankly, it's been far from fun.

Sure, the market rose from March 2009 through early this year, but that's easily overshadowed by the sharp declines and extreme volatility over the same period. And on top of the market mayhem, the news has been surreal — trillion-dollar bailouts, record home foreclosures, automakers on the brink, the death of the dollar (remember those rumors?), a massive oil spill, the financial crisis in Greece, and more.

If you weren’t resilient and ultimately optimistic, you’d be hiding under your bed right now (of course, maybe you *are* and you're reading this on your iPad). You were out there investing, though — and for that we salute you.

Is This Investing?

Given all the extreme events since we launched *Pro*, you might wonder (as have I) whether what we’ve been doing since Day One is truly *investing*. Yes, we’re working to earn steady returns with less risk. But given all the uncertainty, is *anyone* really investing these days, or are we all just speculating? The answer is an emphatic, “Yes! We are investing.”

In fact, finding ways to put our money to work in a market like this is exactly what investing is all about. We’re putting capital into businesses that we believe will create value despite the mayhem all around us, and we’re willing to wait through the market volatility to earn our rewards. Sure, we’re also hedging, and we're not counting on a market that will move steadily (or quickly) upward, but what we’re doing is still the epitome of investing: accepting uncertainty to earn an eventual return.

After all, without uncertainty, there would be no potential reward in stocks. They would be priced to perfection. So we are investing — and with verve! — despite being in the most uncertain times we've ever seen in the world economy.

Granted, we wouldn't mind a little *less* uncertainty, but it's an unavoidable part of investing. And given the sheer volume of uncertainty that we’ve all faced since the financial meltdown, I want to congratulate you for keeping your cool (on our boards and in your investing decisions); maintaining your Foolish perspective and patience; making our work with you truly enjoyable; and accepting the highs and lows that have come our way.

The Journey Continues

We all share the same investing objectives: steady gains over time (with longs and shorts), less risk, and long-term appreciation. We made it through these volatile years and managed to profit without taking unreasonable risks, so I know we can make it through the next few years, too, and continue to grow value. And, Fools, let’s remember: Enjoy the journey. Once you reach your financial destination years from now, you'll wonder what all the fuss and worry was about.

Together we’ve come through one rocky situation after another and we've done it without too much shorting when we should have been mostly long and vice versa. We’re in a good place despite a few mistakes and despite the risks. We'll continue to keep an even keel, create steady gains with various strategies, manage risk, and — beyond profitable investing — streamline and improve your service. We are committed to making *Pro* the best service it can be.

We hope you're committed to taking full advantage of your service. Be sure to check the sidebar above for highlights from the community; hit the Memo Musings board to share your thoughts; and visit the Suggestions boards to tell us about improvements you’d like to see.

We thank you for continuing to invest along with us and for helping us build *Pro* into the service you want it to be.

Fool on!

Jeff Fischer

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Published Jun 1, 2010 at 12:00AM

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- Leveraging increases the risk of total loss, as small fluctuations in value may have far greater impact on your portfolio.
- Illiquid or hard to trade assets can rapidly fluctuate in price, and may be hard or impossible to trade without a specialized broker or a significant margin account.
- Trading in currencies can be riskier than trading in other assets, as currencies are subject to the control of their respective governments.
- When shorting an asset, the risk of loss is hypothetically unlimited, as investors who short may be required to purchase shares to cover at any time, and at any price.
- Shorting requires a margin account. Your broker may require additional capital in your margin account based on their policies and applicable regulations. These amounts may be significant, and failing to have access to sufficient capital may cause your broker to liquidate or close your positions without warning, in accordance with their policies.
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Sell Flowserve

Published May 25, 2010 at 12:00AM

At a Glance

- **Action:** Selling all shares
- **Recent price (5/25/10):** $90.50

Guidance Change

We're moving our preferred buy price for **Flowserve** (NYSE: FLS) from $87 to $79 or lower -- about a 10% change to reflect a more defensive stance. If you're writing puts, you can aim to buy shares even lower. We still believe in the company's management and long-term prospects, but its near-term prospects are cloudy enough that we're taking our current profits and suggesting more caution to those initiating put-writing trades now.

The fact that 25% of Flowserve's 2009 sales occurred in Europe doesn't bother us. However, its European exposure combined with other factors are creating the potential for significant headwinds. Even though shares remain 20% below our best-case fair value estimate, we think "best-case" results are unlikely right now. With the stock at $90, we are happy to take our 44% gain, raise more cash for the portfolio, and wait to see how the next few quarters pan out.

Flowserve benefits from recurring service contracts and maintenance revenue, but in order for the company to grow, it must land new contracts -- and Europe's financial woes may crimp orders for the foreseeable future. Many of the company's projects are big ticket and infrastructure-related -- things that European governments may curtail to help decrease debt and European companies may delay if credit gets too hard to come by or too expensive. At the same time, Asia's infrastructure spending spree is bound to slow down, and that could affect Flowserve's sales in the Asia-Pacific region (19% of total sales in 2009).

Additionally, while Flowserve engages in some currency hedging, we are unsure of the stance it has taken regarding its exposure. The stronger the dollar grows against foreign currencies, the more substantial the potential risk to Flowserve's earnings per share. We believe that the euro may have considerably more room to fall, and we don't like not knowing how much this could hurt our investment. Furthermore, the rising dollar may be a double whammy for a company like Flowserve, because a strong dollar also pushes oil prices down. The less expensive oil is, the less companies will spend on new oil infrastructure, which accounted for 36% of Flowserve's 2009 business. Plus, the **BP** (NYSE: BP) Gulf of Mexico disaster should bring about new regulations that would slow down the expansion of offshore drilling.

All of these concerns together give us ample reason to sell our position to protect from possible earnings disappointments. The stock is still above our *initial* fair value estimate and modestly below our updated value estimate that projected a smoother worldwide recovery -- and that didn't take into account Europe going into a tailspin. Even today, the stock is not expensive at 12 times earnings, but there's now a stronger chance that sales or earnings could slip in the coming year or two, and this cyclical stock could get considerably cheaper.

How to Follow Along

Flowserve has been on hold since the stock broke into the $90s last year, so many *Pro* members don't own shares. If you don't, sit tight. If you own shares alongside us and agree with our assessment, a sell is an easy choice for risk aversion. If you've written puts to buy shares considerably cheaper, you shouldn't lament that decision. The stock is still reasonably priced today; only the risks have increased. We will continue to watch Flowserve to perhaps buy it back when the risk-to-reward ratio is more favorable. If you keep them open, your written puts will be aiming to do the same thing. To discuss this trade, please visit the Flowserve board.

Monday Memo: How Europe Can Help America

Published May 24, 2010 at 12:00AM

Guidance Changes:

- **Lindsay** (NYSE: LNN): Moved to Buy
- **Plum Creek Timber** (NYSE: PCL): Moved to Buy

Last Week's Trades

- Bought more **SPDR KBW Regional Banking** through puts, now at 4.5%
- Bought more **Medtronic** through puts, now at 5%
- Sold all **Expeditors International** through covered calls
- Sold all **Waters** through covered calls

Stocks Newly in Preferred Price Territory

- **Oracle** : Still a Buy First
- **Lindsay** : Moved to Buy
- **Tupperware** : Still a Buy
- **Plum Creek Timber** : Moved to Buy

Earnings Up Next

- May 25: **Medtronic** (NYSE: MDT) (before market opens)

Jeff owns shares of Oracle.

Investors' knees shook last week when the S&P 500 took a quick 10% dive down from its April highs. But here's the real news: This isn't new at all. On average, market declines of this magnitude have happened once every two years since 1962. Only the context around them changes.

This time the context was Europe, and the market's fall was a reminder that the world economy isn't in the clear yet. Yes, our old friend volatility is back -- driving up options prices and rattling investor confidence. But we're not worried, because there are no real surprises here. This drop was bound to happen eventually. Now we can start looking forward.

What will happen next? In Europe, I suspect the financial crisis will subside just as it did in the U.S. in 2009. The drop of confidence in the euro seems more reactionary than predictive: The market is reacting to Greece, to the EU's $1 trillion rescue plan, to riots and fear. But now that Europe's woes are known -- and we've seen this knee-jerk reaction -- market fears in the Old World may already be peaking. Sure, the next shock may come from China, but let's not cross that continental bridge today.

Instead, let's focus on the home front, the U.S. stock market -- where it's headed and how we can plan to profit from it.

Cash Flow Rules

First, we have to understand what drives U.S. stocks in the long run. In a word, it's earnings. In three words, it's free cash flow.

FCF is the lifeblood of any business, and it ultimately underpins the valuation of any stock. Just as a bond provides cash flow to bondholders, companies must do the same for their shareholders. The market assigns a value to stocks based on the certainty of that cash flowing and its growth trajectory, the risk of shocks, and the interest investors could get paid if they put their money elsewhere.

With interest rates at rock bottom, U.S. stocks are one of the best ways to grow your money today. The S&P 500 trades near its historical average valuation based on earnings (a multiple right around 15), and the best companies are producing strong free cash flow despite the hamstrung economy.

The Country With the Cash

Furthermore, with Europe and emerging markets appearing weak, relatively stable U.S. companies look more attractive to investors around the world. Plus, the dollar starts to look like the most resilient currency again, worthy of being the world's reserve money. The U.S. needs this to be the case, because it relies on worldwide demand for dollars to fund its deficit.

So, weakness in Europe (and potentially Asia) may actually help the U.S. in a few key ways. A slow worldwide recovery could keep interest rates low, which would give the economy more time to find its footing, keep housing stable, and promote borrowing and spending by businesses and consumers. An added bonus: Low rates and strong demand for the dollar allow the U.S. government to sell debt on favorable terms.

So Where Is the U.S. Market Headed?

Community Highlights

- Is this just the long-awaited dip in market prices?
- Buy First **Ebix** made an interesting acquisition, and we summarized the company's earnings conference call.
- Alex340 posted options trades that meet *Pro* criteria.
- What's down with **Tupperware**?
- *Pro* missed closing its covered calls on **Waters** Friday due to unusual circumstances. Whether you closed your calls early or sold the shares like us, we'll offer guidance on the board or officially if we approach it again.
- **This Week in CAPS:** TMFEldrehad recommends John Keeling's blog post last week discussing ways to better integrate Tom Gardner's 5 Ps into CAPS.

Here at *Pro*, our projection hasn't changed: The stronger dollar may ding earnings at multinational companies, but we expect the U.S. stock market to remain flat -- or waffle within a certain range. If I had to predict, I'd say the S&P 500 (recently at 1,080) will stay between about 1,000 and 1,200. For how long? I usually only make one *f*oolish prediction at a time, but a year or more doesn't seem out of the question.

With our goal of investing for recurring profits -- with a high level of accuracy and lower risk -- a calm market would serve us just fine, especially given the strategies we have at our fingertips.

More importantly, I think a calm market and a *slowly* recovering economy are what the world needs right now: not high growth, but stability. Then we can all figure out how to move ahead sensibly, in a sustainable way, and perhaps avoid another crisis years down the road. Sometimes current events look dark, but they may actually bring about the circumstances that you need. Anything that keeps interest rates low may help the economy and the strongest stocks in the coming few years.

Foolish best,

Jeff Fischer

Two Possible Trades

Published May 20, 2010 at 12:00AM

Executive Summary: Stay calm and read on for how we plan to approach each *Pro* option position that expires at market close tomorrow (Friday, May 21).

Several *Pro* options positions are set to expire after the market closes tomorrow, Friday, May 21, and, because of this week's market volatility, several of these positions have changed status today. Many of you have come to our discussion boards seeking guidance. Your questions, along with all this volatility so close to expiration on so many positions, have led us to a *Pro* first: **This email serves as a *potential* trade alert.**

Below I outline the events that could occur tomorrow that would cause us to take action. If these events *don't* happen, we won't make the trades -- we'll let the options in question expire or be exercised.

We have several option positions in play tomorrow, but only two that we could act on. Let's start with those two.

ProShares Short S&P 500 $54 Covered Calls

Months ago, we wrote $54 covered calls on our existing shares of **ProShares Short S&P 500**. (Please note that this has nothing to do with our purchase of $44 calls on the same ETF that expire in June. We're keeping those!) In the past few days, the ETF has jumped to nearly $53.

Possible trade: If the ETF cracks $54 tomorrow, we will buy to close our $54 covered calls because we don't want to sell our shares yet. If the ETF stays below $54, we'll do nothing and let the covered calls expire.

Waters $65 Covered Calls

Waters has fallen from $73 to $64 this month, giving us covered call returns in exchange for a lower stock price. We had planned to let the stock be called away, but now the calls may simply expire unused. This will depend on whether Waters is above or below $65 tomorrow. If Waters is above $65 but below $66, we will buy to close our covered calls, which originally paid us $3.22 per share. Why? Because in this case we could capture most of the option return and still keep the stock to write new covered calls. The August $65 covered calls pay $4.

Possible Trade: If Waters is between $65 and $66 late Friday, we will buy to close our covered calls, earning most of the income, and keep the stock. If Waters is below $65, we don't need to do anything. The calls will expire, and we'll keep the shares. If Waters is $66 or above, we'll do nothing and let the shares be sold via the calls.

The following options positions will also expire tomorrow, but, for these, no action is required:

Expeditors International $35 Covered Calls

Our covered strangle on **Expeditors International** nets us a $39 sell price while the stock is lately around $38. As long as Expeditors remains above $35 tomorrow, our shares will be sold from our account over the weekend, and the position will be closed. We'll likely have other opportunities if we want to invest in Expeditors again, but, with both Europe and Asia showing weakness, we'll consider shares of the freight-leasing giant carefully. This position has worked well for us, providing strong returns in a down market while giving us downside protection. Thanks, Expeditors.

Trade: Do nothing, and if the stock is above $35, our shares will be sold automatically.

Medtronic Short $44 Puts

About 13% of our portfolio is invested in health care, and we're ready to accept another 2% in **Medtronic** tomorrow. With the stock recently around $41, our puts will net us new shares at $41.70. The stock is down nearly 10% over the past month, so this option position has fulfilled its purpose of allowing us to buy more shares well below where the stock traded when we wrote these contracts in January. Health care is traditionally a defensive play, and the sector is undervalued compared with the rest of the market. That said, as our allocation grows, we're likely to write covered calls on some of our health-care stocks and perhaps on our new shares of Medtronic.

Trade: Do nothing, and if the stock is below $44, we'll get new shares at our net start price.

SPDR KBW Regional Banking Short $26 Puts

As with Medtronic, a recent drop in banking ETF **SPDR KBW Regional Banking** has brought our $26 puts into play. If the ETF is below $26 on Friday, we'll accept new shares of the ETF through our puts at a net price of about $25.10, lowering our overall cost basis. Of course, if the ETF climbs above $26 (it's close), the puts will expire as income, and we're free to write new ones.

Trade: Do nothing, and if the ETF closes below $26 on Friday, we'll get new shares in our account automatically over the weekend.

Pro Bottom Line

It's always tempting to close your short put positions and avoid new shares when the market is falling, but that's precisely the time you should buy shares. It's cheaper than the alternative of buying when shares are rising!

True, we don't know how much deeper the decline may go, but in most cases, we will stick to our original trade -- and the discipline and thinking behind it -- rather than letting a volatile market bring out our emotions and talk us out of a position. By accepting new shares of Medtronic and KBW Regional Banking, we are following our original plan -- and getting the lower prices we'd hoped for. Meanwhile, selling some shares at fair value is also in our best interest. The market always has new opportunities.

If you have questions about these *potential* trades, please visit the Pro community boards. If we make either of these trades tomorrow, you will receive a confirmation at market close tomorrow.

Monday Memo: Todd Visits Jack (Jack Henry, That Is)

Published May 17, 2010 at 12:00AM

Executive Summary: Jack Henry is on Hold. Now, carry on, Fools!

A Big Week of Expirations

After the market closes this Friday, May 21, several *Pro* options will expire. We may close some early or adjust some, depending on market prices. If we do, we'll send you an official trade alert no later than Thursday. Here's the rundown:

- Short $26 puts on **SPDR KBW Regional Banking**: Currently would expire as income.
- Short $44 puts on **Medtronic**: Currently would turn into shares starting with a small profit. We may close early if we don't want to buy more this month.
- Short $54 covered calls on **ProShares Short S&P 500**: Currently would expire as income.
- Short $29 covered calls on **Cameco**: Set to expire as income.
- Short $55/$65 covered strangle on **Waters**: Set to sell our shares for us at a net $70 per share (above the current market price). We may close the covered calls early if the profit to do so becomes attractive.
- Short $30/$35 covered strangle on **Expeditors International**: On track to sell our shares for us at a net $38.90 (below the current market price). We may close the calls early if we wish to keep the shares and roll up the covered calls.

Although we could change our minds this week, we'll likely let Waters and Expeditors be sold. We'd be getting good prices and locking in more profit following nice price appreciation the past year.

Remember, if you want an option to be exercised and it's in the money (like our covered calls on Waters and Expeditors and our puts on Medtronic), you don't need to do anything. It will automatically exercise over the weekend. If you *don't* want an in-the-money option exercised, you need to close it early.

To borrow a line from George Strait, "Texas is the place I'd dearly love to be" (though maybe that's because I don't have any exes there). The people are nice, the steaks are top-notch, and the taxes are low. So I wish I could have left the Dallas-Ft. Worth airport to take in some sights during my 20-hour trip to **Jack Henry & Associates**' analyst day last week (held at the DFW Airport Grand Hyatt). But spending that time on the ground getting the latest on this *Pro* company was almost as good.

Since we bought Jack Henry in April 2009, it's been ballast for our portfolio thanks to its strong recurring revenue, deep client relationships, and solid balance sheet. However, one of the concerns we noted in our original buy report was the company's increasing reliance on acquisitions for growth. The practice is not always problematic -- **Oracle** and **Ebix**, to name just two, also grow largely through acquisitions. But the price has to be right. Unfortunately, we think management may have paid too much for too little with its recent purchase of iPay Technologies for $300 million.

As a result, we're moving Jack Henry from Buy to Hold.

4 Factors to Fathom

Even without the sight-seeing and mouth-watering steak dinner, there were some bright spots from my trip to Texas. I was impressed with the Jack Henry employees I met, some of whom had left the company only to return quickly after realizing how good they had it. I also met an executive at Louisiana-based **IberiaBank** who lauded Jack Henry's quick reaction time in implementing software changes for the four FDIC-assisted (bank failure) acquisitions the bank had made in the past year.

That said, I did depart the Lone Star state concerned about four key areas:

1. **Organic growth:** Jack Henry seems to be running out of organic growth opportunities as de novo (new bank formation) activity has slowed to a trickle with few signs of a near-term recovery. According to the FDIC, consolidation in the industry and bank failures have reduced the number of banks with assets up to $49 million by 18.5% from 2008 to 2009 and those with $50 million to $99 million by 7%. Now, Jack Henry's sweet spot is banks and credit unions with $100 million to $10 billion in assets, a group that has been more stable than their tiny brethren, but this area hasn't grown much, either. Additionally, the contraction in the smaller end of the bank spectrum means fewer potential new clients with whom Jack Henry can build long relationships.
2. **The economy and financial reform:** With financial reform and a still-struggling economy hanging over the banking industry, Jack Henry's clients remain hesitant to spend on discretionary items such as hardware and new software licenses. Although one of Jack Henry's clients -- the CEO of a Texas-based credit union -- told me that technology was the one part of the business that he didn't cut back on during the recession, he didn't say the company would be *increasing* its spending, either.
3. **Paying too much for iPay:** As I mentioned above, Jack Henry likely paid too much ($300 million) for iPay Technologies, the leader in the electronic bill payment industry and a long-time Jack Henry business partner. This was Jack Henry's largest-ever acquisition, and as one analyst put it, the price it paid was very "un-Jack Henry" in nature. We agree with that assessment. In 2006, a group of private equity investors bought iPay. If that group paid the same EBITDA multiple as Jack Henry did (17.1) this time around, they bought the company for roughly $90 million -- and generated a nice 230%-plus return in three years. Since 2006, iPay's subscriber count has nearly quadrupled and sales have doubled, so you can see why it would be attractive to a potential suitor. Unfortunately, Jack Henry had the chance to bid for iPay in 2006, but either couldn't or wouldn't pay up for it then. It's certainly paying up now, and we're not sure iPay's high-octane growth will continue -- or at least enough to justify the price.
4. **The competition:** When I asked CEO Jack Prim about iPay's competitive advantages, he said the company is perhaps the most focused in the industry on online bill pay and has a solid client base, with more than 3,600 financial institutions subscribing to its services and 98% customer retention rates. In the same discussion, however, Prim noted that **Fiserv** has been marketing its CheckFree product (in 3,100 financial institutions) aggressively and **Fidelity National Information Services**, which is in acquisition talks with **The Blackstone Group**, has placed its bill pay product in another 2,300 financial institutions. Even though iPay is the leader now, this is a crowded field, so pricing and margins will likely come under pressure.

Earnings Up Next

- May 19: **Autodesk**
- May 25: **Medtronic**

This Week in CAPS

TMFEldrehad highlights TigerPackFund, a CAPS project that finds the best CAPS picks from some of the best CAPS participants and puts them together all in one place.

Pro Bottom Line

We still think Jack Henry is a strong business with solid client relationships and, of course, a lot of recurring revenue. However, we're concerned today about its acquisition strategy in light of the iPay price tag. Because of this, and with the stock already near our $26 to $30 fair value estimate, we're moving Jack Henry to Hold as we review the company in greater detail.

As always, we hope you join us and the *Pro* community on the boards to discuss this move.

Foolish best,

Todd Wenning

Monday Memo: 5 High Hurdles

Published May 10, 2010 at 12:00AM

Community Highlights

- Alex340 posts new puts that match *Pro* criteria.
- We discuss our overall strategy and the nuance of covered calls with members.
- TMFValuemoosie posted a *Pro*earnings calendar.
- This Week in CAPS: TMFEldrehad revisits the Fool community effort to track stock spam.

Next on the *Pro* Calendar

- Todd is headed to Texas for **Jack Henry & Associates**' May 11 analyst day — and he'll be reporting back to *Pro* Fools! Post any last minute questions!
- May 19: **Autodesk** reports its results.
- May 22: Call options on **Waters** and **Expeditors International** are due to be exercised, selling away our shares. If we decide to roll up, we'll announce official trades in advance. Put options on **Medtronic** are currently due to be turned into shares unless we close early. We'll decide that week.
- **Electro-Optical Sciences** filed its full response to the FDA's recent questions on May 7.

Pro holdings **Jack Henry & Associates**, **Expeditors International**, and **Ebix** reported healthy-looking quarterly results — but Todd and I (Jeff here) may have been the only ones who noticed, given the market's antics last week. Thursday was one of the most volatile days in the stock market's history, and the aftershocks continue to ripple through the market. We'll, of course, continue to cover earnings news for our holdings on their respective discussion boards, but we're devoting this week's Memo to the major events in Europe that are rocking the market — and the potential opportunities among our stocks. Todd gets things started by highlighting our thoughts on what the market may face in the coming few years. Then, I'll chime back in to update our guidance on *Pro* positions that have made big moves this past week.

5 Things to Watch

As any chess player can tell you, the key to success lies in your ability to think not just one or even two moves ahead, but three or more. Similarly, when it comes to finding today's best investment ideas, you can't focus on what's going on right now. Rather, you need to consider potential scenarios months and years ahead — and then be patient. This is a gargantuan task because the market is forward-looking and extremely efficient at pricing in potential outcomes. As Jeff and I (Todd here) see it, however, the market is currently *under-appreciating* five key scenarios that could play out in the near future:

1. **Higher interest rates**: The White House budget projects that federal debt interest payments will equal 18% of tax revenue by 2018 — the outer limit for a AAA rating from Moody's. But if interest rates are forced higher by the bond market, we could hit that 18% mark a lot sooner and risk a credit downgrade. This would force global interest rates even higher, creating a headwind for the economy and stocks.
2. **Higher volatility:** In April, market volatility (as measured by the Chicago Board Options Exchange's Volatility Index) hit pre-crash lows, but has since *doubled*. We don't think this is an anomaly. In fact, we expect more volatility in the coming months thanks to many unanswered questions about the economic recovery: the stability of the European Union and the consequences as global stimulus packages unwind, to name just two.
3. **Higher taxes:** Although many states are already implementing a number of Greek-like austerity measures — some 300,000 teachers nationwide are expected to be laid off at the end of this school year as states struggle with balancing their budgets — we don't expect the federal government to cut back its spending anytime soon. One way to bring down the federal deficit, then, is to increase taxes, which could slow down the economic recovery and consequently decrease tax revenue, a catch-22.
4. **Higher inflation:** Based on the spread between the yields of 10-year Treasuries and 10-year TIPS, the market is more optimistic about the prospects for inflation over the next decade than it was a year ago. Last May, the market's implied rate of inflation was 1.47%versus 2.16% today . If the U.S. economy *does* make a strong recovery, it will be a tall task for the Federal Reserve to reduce the money supply it's grown by $800 billion since April 2008 in an orderly manner. In other words, inflation will be hard to fight if it rears its head.
5. **Higher U.S. dollar:** If budget woes in Europe worsen, the dollar will likely continue to strengthen against the Euro, reducing the overseas earnings of U.S.-based multinationals. On the flipside, a higher dollar may lead to lower commodity prices.

All of these scenarios could dampen the economic recovery over the next two to five years. With the S&P 500 dividend yield near 2% and long-term earnings growth expected to be 2% to 3% (it typically follows GDP growth), returns could be quite modest for the overall market.

What Do We Do?

We're considering how each of the scenarios Todd outlined could affect our positions and how we may be able to position our portfolio to benefit through new investments, long or short. Once investors calm down, we believe the stock market may stay remain flat-ish or offer just modest returns for a long time. The large bounce following the rout of 2008 and 2009 made sense; giving back some of those gains is also logical and expected, whatever the catalyst (it happens to be Europe). Next, the reality of our challenging economic situation could settle in as the above factors come to light, and stocks may churn. But that prospect doesn't bother us because we have ways to profit anyway.

This scenario does mean, however, that it's more important than ever for members to follow our valuation-based Buy First, Buy, and Hold guidance. In a market that's reluctant to offer large gains, you need to place even more emphasis on valuation and a proper margin of safety. Following the turmoil of last week, we're able to move a few stocks from Hold back to Buy and others up to Buy First:

Company	New Guidance
Kinetic Concepts	Buy
Oracle Corp	Buy First
Intel Corp	Buy First (and strangle or not)
Tupperware	Buy — buy half a position and write an October 2010 $40 put/$50 covered strangle for around a $5 credit.
AmTrust Financial	Buy First

For the full list of *Pro* Buy First and Buy stocks, please visit our portfolio page. But as always, *take your time*. We are not pounding the table saying to buy all these stocks at once. We're merely moving these back to buy ratings based on valuation. As ever, average in or write puts to potentially get lower prices on some shares, and only buy if you have a long time horizon, since the market can do crazy things in the short term. Todd and I are on the philosophy board if you want to talk about these positions and how to approach the market now. Keep in mind, if the winds are changing for the long term, there's time to adjust. If they're only changing for a short time, there's not much reason to adjust. It's situations like this that the versatility of the *Pro* strategy can pay off.

Fool on!

Jeff Fischer and Todd Wenning

Jeff owns shares of Oracle; Todd owns shares of Kinetic Concepts.

Buy Calls on ProShares Short S&P 500

Published May 5, 2010 at 12:00AM

At a Glance

- **Trade:** Buy ("buy to open") June 2010 $44 calls
- **Allocation:** 1.5% if exercised (four contracts for *Pro*), for 4% total
- **Limit price:** Use a limit order that makes your net purchase price as close to the ETF's current share price as possible (split the bid/ask and aim for, recently, about $5.10)
- **Alternative trades:** Buy June 2010 $45 calls instead, around $4.20; buy shares directly; or write June 2010 $49 puts, recently above $1

What's New

The S&P 500 index is up more than 10% since November, as investors rallied alongside gains in manufacturing, employment, and home sales. As a result, our shares of the **ProShares Short S&P 500** (NYSEMKT: SH) ETF have lost about 11%, although we've written covered calls to partially offset the loss.

But though the S&P is up, economic gains remain modest — and are now overshadowed by trouble in Europe, including the massive Greece bailout and related debt concerns in Portugal and Spain. If the dollar continues to strengthen against the euro, U.S. businesses will likely take a hit in two ways: They'll have lower sales to a weakened Europe, and they'll have negative currency effects as overseas sales are converted into stronger dollars. At the largest multinational companies in the U.S., many of which are in the S&P 500, this situation could put current earnings estimates at risk.

Meanwhile, the U.S. stock market's P/E is hovering around the historical norm even though we're not on strong economic footing. With government stimulus waning, debt concerns weighing, and interest rates eventually headed higher, increasing our ProShares Short S&P 500 position from 2.5% to 4% will bolster our hedge during these uncertain times.

Why This Strategy?

We're buying June 2010 $44 call options with the goal of converting them to shares of ProShares Short S&P 500 at a net price of around $49.10. These deep in-the-money calls carry little time value, making them particularly appealing. If market volatility increases, let alone if the S&P 500 falls, the call price should increase.

Additionally, increasing our stake in ProShares Short S&P 500 to a full 4% will lower the cost basis of our shares to the low $50s. This will make it easier and more profitable to continue our strategy of writing covered calls on the ETF.

How to Follow Along

Buying calls is simple: The command is usually "buy to open," and you purchase one call for every 100 shares of the underlying investment you wish to eventually purchase. Use a limit order that nets you a purchase price as close to the current share price as possible. (With the ETF recently near $49, the $44 calls may be bought for around $5.10 — giving you nearly the same net buy price of $49.10). When you purchase these calls, it'll cost about $510 per contract. The possible outcomes before expiration are:

If the S&P 500 ...	ProShares Short S&P 500 will be ...	ProShares Short S&P 500 June $44 calls will ...
Falls 5%	Around $51.45	Gain about 26%
Falls 10%	Around $54	About double
Gains 5%	Around $46.50	Lose more than 50%, but we'll convert to shares at a 5% loss
Gains 10%	Below $44	Expire worthless; we have no recourse
Stays in a range	Unchanged	Be converted to shares around $49.10; we'll hold

A reasonable decline in the S&P will reward our hedge well, but if the market gains ground, we should still be able to convert the calls to shares and continue to write covered calls against our full ETF position. As long as the S&P 500 doesn't gain more than 10% between now and our expiration in 45 days, these calls can be turned into shares and the position continued. If the S&P soars more than 10%, we'll lose the full amount invested in these calls.

If you have questions on our decision to fill out our allocation to ProShares Short S&P 500, please post them on the ETF's dedicated discussion board.

Monday Memo: Bouncing Into a Recovery

Published May 3, 2010 at 12:00AM

Guidance Change

GrafTech International moves from Buy to Hold on price.

Earnings Aplenty

- **GlaxoSmithKline** : TMFGoogly details the company's solid results.
- **Procter & Gamble** : Todd (TMFPhila) believes P&G is recovering well.

- **Plum Creek Timber** : The quarter wasn't all that bad, says Todd.

Earnings Up Next

- May 3: **AmTrust Financial**
- May 4: **Cameco**
- May 5: **Jack Henry**, **Quanta Services**, **Flowserve**, **Expeditors International**
- May 10: **Broadridge Financial**

Community Highlights

- Join the discussion as *Pro* Fools chat about the Greece crisis.
- This Week in CAPS: TMFEldrehad shows how CAPS can be used to find investing ideas from Wall Street's best

With earnings reports flying at us left and right, the *Pro* team is working at a steady pace, sharing thoughts with you as we go (making this month a great time to visit our discussion boards), and — as we do each quarter — updating our thoughts on each position as soon as possible.

Earnings season is hectic, so it's important to remember that a quarterly report is just a snapshot in time; it's a single look at a company that will report results 12 *more* times in the next three years, 24 times in the next six years, and so on ... forever and ever. In an interconnected world where most everything is immediate, we're here to remind you that investing should (usually) be anything but instant. Investing is an endeavor best measured over several years — anything less is mere sport.

That said, earnings reports do provide us with new information that helps us assess our holdings' *long-term* prospects. So let's partake in some good sport and look at recent *Pro* company results.

GrafTech Reaches New Heights

Everyone's favorite graphite-electrodes producer for the steel industry, **GrafTech International**, soared 28% on Thursday after stronger-than-expected results and news that the company plans to acquire one of its key materials suppliers, Seadrift Coke. Providing GrafTech with more control of its pricing destiny and allowing it to capture more of the value that's created by the steel industry, management expects the acquisition and a smaller acquisition of C/G Electrodes to substantially add to earnings in a year.

Meanwhile, GrafTech's first-quarter results benefited from a large bounce in steel production that management expects to increase over time. Providing full-year guidance of $170 to $180 million in operating income, the company has already booked orders that are on track to fulfill 95% of that goal. In other words, GrafTech's results for the year look fairly certain and predictable now, and there's a good chance for an upside to the existing guidance.

Before we can update our thoughts on the company, we need to study Seadrift, C/G, and the new-look GrafTech. For now, the stock is moving from Buy to Hold for new buyers. We're happy to hold our shares given the positive developments, and shares may continue to gain a bit on the promise of the new company. Stay tuned.

Intel Shines, Tupperware Pops, and Waters Bubbles

Intel reported record results last month, and with the $23 stock trading at 12 times reasonable earnings prospects for 2010, an eventual move closer to our fair value in the mid $20s is possible. We are planning to roll up our July covered strangle on the stock before July, and we'll provide guidance whether you wrote our original or adjusted strangle. For members lacking any Intel position yet, you can write ("sell to open") puts to start. With hopes of getting shares, writing June 2010 $23 puts would pay $0.85. You could also buy shares recently near $23.10 and write October 2010 $25 covered calls for around $0.85.

Tupperware also had record results, and we're still sorting through all the containers and lids. If we like the outlook and valuation, we may roll up and out our July covered strangle on the plastics purveyor. As we've done in the past, we will take the action that provides upside for the price of taking on moderate risk.

Waters' results were strong, so this is another case where rolling up and out could capture more upside. We'll decide our course of action before the May expiration, but we're *inclined* to let this stock be called away, locking in our net sell price of a little more than $70. Following large gains that have a stock approach or surpass our fair value, as Waters has, we're happy to take the gain and have the cash ready for better opportunities. Only a much brighter outlook for Waters, or an especially attractive roll-up trade, could make us keep the shares instead.

Staying Calm

Despite the heady buzz surrounding earnings, and price swings that can occur, we're staying calm and sticking to our investing discipline. Investing is a life-long pursuit, so you need to approach it with a long-term outlook. The more excited Wall Street gets, the more we need to remember that it can be irrational. Consider this grounding thought from **Johnson & Johnson**'s CFO Dominic Caruso shared last week in the company's conference call:

"We are not assuming a significant rebound in the economy. We see it stabilizing. We see a modest return to economic conditions back to normal, but not at all any V-shaped or accelerated recovery, so that's not in our thinking."

While Wall Street seems intent on celebrating every incremental gain in the economy, what we're seeing is a government-supported bounce from a terribly frozen economy; a true recovery will be different from this bounce, and it almost surely won't be as dramatic. Things will settle down, and we will be ready for that, too.

Foolishly,

Jeff Fischer

Jeff owns shares of AmTrust Financial Services and has written puts on GlaxoSmithKline.

Buy Broadridge Financial Solutions

Published Apr 27, 2010 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Estimated fair value:** Upper $20s

- **Preferred buy price:** Around $23 or lower
- **Type of holding:** Long-term; Information technology
- **Alternate trade:** Write ("sell to open") puts for a lower potential buy price.
- **Why buy:**

  - Broadridge has been working its proxy-processing magic since the 1960s, but its stock is currently flying under Wall Street's radar.
  - With 90% market share in its core investor communications division and more than 80% recurring revenue, this stable business continually generates healthy cash flow — and it pays a handsome dividend, too.
  - There are growth opportunities ahead, including selling new services to existing clients, acquisitions, increased communication with shareholders, and more companies going public.

The Big Picture

April 27, 2010

Ever wonder who handles the mountains of shareholder-related paperwork that public companies process every day? **Broadridge Financial Solutions** (NYSE: BR) is the market leader in helping financial firms untangle mundane but mission-critical tasks such as proxies, prospectuses, trade confirmations, and account statements — the kind of administrative work nobody else wants to do. Its diverse customer base includes retail and institutional brokers, global banks, mutual funds, annuity companies, institutional investors, and corporate issuers. The core business is subscription-based, providing sticky, recurring revenue at high margins and generating strong free cash flow.

Although a lot has happened in the global markets since the company was spun off from giant **Automatic Data Processing** (NASDAQ: ADP) in March 2007, Broadridge has flown under Wall Street's radar — only four analysts were on the last conference call. In three short years, the company has worked to lessen its debt load, more than doubled its quarterly dividend, repurchased stock, and acquired some nice complementary businesses. We're always on the lookout for market leaders with solid business models that generate consistent cash flow. And when we can buy into that combination at less than 15 times earnings and cash flow as we can with Broadridge, we'll gladly punch our ticket.

The Business

Get Personal With Broadridge

- Founded: 1971
- Headquarters: Lake Success, NY
- Market cap: $3 billion
- Website: broadridge.com

The jewel in Broadridge's crown is its Investor Communication Solutions division, which provides annual proxy services for a whopping 90% of public companies and mutual funds in the United States. The bulk of Broadridge's recurring business comes from this area, driven by ProxyEdge — the company's electronic proxy delivery and voting service — and its Investor Mailbox financial portal. The division also processes and distributes account statements and trade confirmations, personalized document fulfillment, and marketing communications.

All of this might sound like standard administrative fare, but Broadridge isn't afraid to push the envelope (ba-dum dum) with new products and services aimed at satisfying customers' appetites for social media. The company now offers a social network for share owners; forums for public companies to convene with shareholders on the Web; and a virtual meeting tool that allows shareholders to vote online and tabulates the results instantly.

The rest of Broadridge's revenue — about 24% — stems from its side division, Securities Processing and Outsourcing Solutions. Here, the company's end-to-end platform can trade virtually any security on any market, including order capture, execution, confirmations, settlement, accounting, and archival. According to Broadridge, customers who use its offerings for a broad range of services can cut costs by more than 30%, avoiding the expense and ongoing investment in technology and operations for brokerage services.

A Broad Competitive Advantage

The Community's Take

Broadridge scores a perfect 5 stars on CAPS, with 100% (62 of 62) of All-Stars rating it to outperform. In fact, it scores in the top 14% of all stocks rated on CAPS. On the *Pro* CAPShot, the five-year data is incomplete for this 2007 IPO.

Broadridge benefits from high switching costs — typical for companies that deal with administrative solutions. Its products are deeply integrated into its clients' processes, so moving to another provider entails a major business disruption. The company also enjoys strong economies of scale: Once built, its tech-based automation platforms are increasingly profitable. And the company's size and scale, distribution channel, and client base make acquisitions more successful, as complementary businesses are worth more and are more efficient under the Broadridge umbrella than they are standing alone.

Broadridge has excellent, long-lasting customer relationships — and happy customers lead to high retention rates and recurring revenue. The company is regularly ranked high in leading industry surveys such as The Black Book of Outsourcing, which ranks Broadridge first in 14 of the 18 categories in which it competes. Clearly, the company has earned its $3 billion market cap on the back of reliability and customer satisfaction.

Financials and Valuation

The company believes that as a provider of mission-critical services, its clients, as well as regulators, will benefit from the peace of mind associated with a rock-solid service provider when it comes to its own financials. With consistent cash flow and high return on equity, Broadridge has been getting stronger every year.

Saddled with debt after its spinoff from ADP in 2007, Broadridge set out to shore up its balance sheet. In just three years, management paid off more than $400 million in debt while still investing back into the business and retaining a cash position of $147 million. All told, this means that the company has net debt of just $177 million compared with more than $200 million in trailing free cash flow.

Sales have grown at a compounded rate of 7% over the past five years, registering almost $2.2 billion in 2009. Impressively, Broadridge has converted nearly 10% of those sales into net income and even more than that into free cash flow for investors. On conservative assumptions, we put fair value for the stock in the mid to upper $20s. The company models for annualized revenue growth of 5% to 8%, and we believe margins have room for expansion, creating additional upside.

What Would Make Us Sell

This business was built on fast, accurate, and reliable solutions. Any breach of those qualities or trust could open the door to customer defection. We also need to keep an eye on large mergers and acquisitions, which can have the effect of removing Broadridge clients from existence. After the most recent wave of financial consolidation, one of the company's 15 largest clients left to process securities in-house — a loss of $23 million in revenue for Broadridge. A more general slowdown in the stock market may affect sales, but not to a dramatic degree. Finally, there's regulation risk. The SEC and self-regulatory organizations could change the nature and roles of broker-dealers in the proxy process, and Broadridge would need to adapt to new rules and regulations.

Pro Bottom Line

Dominant in a vital, behind-the-scenes niche in a capitalistic society, Broadridge benefits as stock listings grow, it implements new ways to manage data for its broad client base, and it acquires related businesses. Stable, recurring revenue and steadily improving financials point to continued success, making a share purchase at today's 14 times earnings and 12 times cash flow (with a 2.3% dividend yield) a rewarding prospect. One thing's for certain: We'll never look at proxy filings the same way! Please post your questions on our new Broadridge board.

Monday Memo: This Stock Has Gone Nowhere

Published Apr 26, 2010 at 12:00AM

Pro Stock Guidance

Changes in share price have led to changes in buy guidance:

- Moving up to Buy First: **Ebix**
- Moving down to Buy: **FPL Group**, **Oracle**, **SPDR KBW Regional Banking**

In the short term, the stock market is a frenzy of quick-buck artists — money made and lost without much rhyme or reason. But over the long run, stocks settle down as prices more accurately mirror cash flow and earnings power, with valuations gradually reverting to a mean. Even for the greatest businesses of all time.

Bargain Prices, Low Returns

Few companies reflect this better than **Wal-Mart**. Since 1999, the retail steamroller has expanded around the world at break-neck speed, more than *tripling* earnings per share — yet the share price has essentially gone nowhere for 10 years.

The reason? Investors had already priced in that earnings growth. You can behold the story by looking at Wal-Mart's price-to-earnings multiple: After hitting 60 in 1999, the P/E has fallen steadily, to a recent 15 — the market average.

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Price	$61	$47	$51	$45	$48	$48	$43	$43	$45	$55	$53
P/E	60	37	37	30	28	24	18	17	16	17	16
EPS	$1.02	$1.27	$1.41	$1.45	$1.74	$2.03	$2.39	$2.62	$2.84	$3.13	$3.35

Dividend-adjusted share prices are as of the final trading day of the calendar year. P/E is calculated using trailing 12 month normalized diluted EPS. All data from CapitalIQ.

Profit on the Roll-Back King

Wal-Mart may be a good candidate for a buy/write trade or a diagonal spread. In the former, simply buy the stock and write covered calls on it (you'll also get the dividend). In the latter, buy 2012 LEAP calls and write near-term covered calls against them. If the stock remains range-bound, you can rack up covered call income on a stable giant.

That means an investor who bought shares around $60 in 1999 watched Wal-Mart grow its earnings power year after year — for nearly *40 quarters* in a row — but still faces a capital loss, and it's far worse with inflation. The only benefit has been a slowly growing dividend, recently paying 2.2%. Frustrating. Any time investors pay up for a stock, they potentially face this painful outcome.

When the stock market rises sharply, it's discounting future growth. In a sense, if today's investors are willing to pay for five years of assumed growth, they should expect five years of flat stock prices in return.

You won't often see us pay up for future assumed growth at *Pro*. Instead, we aim to buy stocks that are aren't priced to perfection.

A Different Cycle

Pro holding **Intel** tells another story. Tech spending often occurs in waves, so as a cyclical business, this computer chip giant has a fluctuating stock price — one that looks expensive when business is down (like in 2002, when it had a 30 P/E), but quickly reverts to a market-average valuation when business is strong, as it is now.

Below, you can see that buying Intel at $14 in 2002, just off the bottom of a cycle, was a good decision even though its P/E was 30 — the stock closed at $28 a year later. But (as often happens) investors got overexcited during the rebound, and the stock is still down seven years later.

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Price	$36	$26	27	$14	$28	$21	$22	$19	$25	$14	$20
P/E	37	26	98	30	36	21	17	26	25	15	21

Dividend-adjusted share prices are as of the final trading day of the calendar year. P/E is calculated using trailing 12 month normalized diluted EPS. All data from CapitalIQ.

Earnings to the Extreme!

Get the story on the *Pro* boards soon after earnings are announced:

- April 26: **Plum Creek Timber**

- April 27: **Kinetic Concepts**, **Waters**, **FPL Group**
- April 28: **GlaxoSmithKline**
- April 29: **GrafTech International**, **Procter & Gamble**

Other *Pro* News

- **This Week in CAPS:** TMFEldrehad follows up on last week, showing you how to use CAPS to dig even deeper into **Atwood Oceanics** (NYSE: ATW).
- **Portfolio error:** Our portfolio tracker has not properly calculated our return on our **Autodesk** covered calls for several days. We're working to correct this — it's the only position affected.

To avoid getting burned by cyclical stocks, investors should be wary of buying when the P/E is expanding and business is already booming — that often means the top of the cycle is near. Once the cycle plays out, earnings may decline for a few years, and the P/E will come back down. Buying when the P/E is low and business is slow, like it was when we first bought Intel in 2008, is a better way to approach cyclical stocks.

During the past decade, Intel's diluted, normalized earnings per share typically bounced along with business cycles, well above and below $1 per share year after year. This year, Intel is on track to set a new earnings record, and the stock trades at a reasonable 12 times next year's expected earnings. We intend to roll up our covered calls on Intel (watch your inbox for a trade alert), staying hedged and keeping our heads straight even during a boom because we know it won't last forever.

Investing Despite the Market

The stock market's earnings as a whole are rising fast as they bounce off last year's depressed levels — and with many stocks, investors are paying up for the bounce, extrapolating more growth to come. When stocks were in decline last year, we were buying shares steadily; but now that they've risen so much, we're being more particular about the prices we'll pay. Although the stock market *always* looks ahead, we'd rather not pay up for years of growth while the economic recovery is so fragile. When you pay too dear a price, eventually your returns suffer when the economy stumbles or growth slows. After all, we want our stocks to go somewhere.

Have a comment or question? Please visit our Memo Musings board. And remember to read the sidebars above for important *Pro* updates.

Options 202: Rolling Covered Calls

Published Apr 23, 2010 at 12:00AM

When to follow up on covered calls:

- Shares have moved sharply higher, and you want to capture additional upside.
- Shares have *dropped* considerably, and you want to remain hedged.
- Your original covered calls have little value remaining.

Foolish facts to know:

- Rolling up, rolling down, and rolling out can be good ways to increase profits or minimize losses, but they aren't always the right choice. Leaving covered calls unmodified can provide good discipline for investors.
- If you're dealing with more than 100 shares, you don't have to take the same action across your entire position — you can diversify your strategy.

Greetings, *Pro* Fools! Today we're going to build on your knowledge of writing covered calls (read Options 201 for a refresher) with a little something called follow-up action.

As you know, when you write covered calls, you need to be ready to have your stock or ETF sold away at your call's strike price. However, you always have the choice of adjusting your trade before that happens. In cases where the stock moves sharply, or when you've earned most of what you can from your call options, you can roll your calls up, down, and/or out, modifying your strategy to your benefit. Let's start with one of the most common moves: rolling up and out.

Rolling Up and Out to Gain More Upside

When you write covered calls on a stock, only to see the shares lift off through your strike price and keep ascending, you're leaving potential profits on the table. It may be time to follow up by bringing out the "roll up and out" trade. To do this, you "buy to close" your original covered calls and then "sell to open" new covered calls at a higher strike price (that's the roll *up*), usually with a later expiration date (the roll *out*). This strategy provides you with additional upside in the stock before it's potentially called away. It can also be a useful tactic if you're concerned about losing shares of a strong dividend-paying stock (see Options 201 sidebar).

For example, assume you bought a stock at $12 and wrote $15 covered calls that paid you $1.50, for a potential net sell price of $16.50; today the shares are $17, and you think they'll go higher. Your adrenaline is pumping, but being a Fool, you decide to rationally and calmly roll up and out to a higher strike price to gain more upside. Here are the numbers:

Math of Rolling Up and Out
(Stock Bought at $12, Now at $17)

Payment for writing $15 calls expiring in six months from start	$1.50
Cost to "buy to close" $15 calls now expiring within days	($2.10)
Net cost to close $15 calls	**($0.60)**
Payment for writing $17.50 calls expiring three months later	$1.20
Total credit for rolling up	$0.60
New net sell price	$18.10
Benefit of rolling up	9.7% additional upside

In this scenario, you're able to roll your covered calls up to a higher strike price, and out to a later expiration date, earning a 10% higher net sell price on the stock and still maintaining a credit on your covered calls (meaning you were paid overall to write them).

In some cases, you'll need to pay to roll up your covered calls (a net debit) because the net cost of closing your original calls exceeds the amount that writing new calls will pay you. To minimize or eliminate this, you roll your options out to even later expiration months that pay more. Additionally, when rolling up and out, you usually close your original calls only when they have *little time value remaining* — in other words, once they're near expiration, or when they're so deep in-the-money (meaning the stock is far above the strike price) that the options have little time value even if expiration is months away.

Pro's Call-Rolling Tips

- Every covered call you write should have a strike price at which you're happy to sell and should pay you enough for capping your upside (see Options 201).
- Roll up and out to a higher, later strike price when you want to capture more upside in a stock; when most time value is gone from your existing calls; when rolling will provide stronger returns; and when the new options still offer downside protection.
- Remember the rule of options: Aim to buy intrinsic value and sell time value.
- If your original calls still have time value left, but there's a particularly appealing roll-up trade available to you, exceptions can be made. And if you're only rolling up, not out, don't concern yourself with time value.
- *Don't* roll up if it will greatly increase your break-even price on the stock (in this case, because you need to pay excessively to roll up), or if it doesn't offer much more upside along with meaningful downside protection.
- Roll *down* a covered call to get more defensive (earn more income) on a falling stock.
- Consider buying to close your existing calls when you've earned 85% or more of what they paid and you can roll out to a future month for a much higher payment.
- Covered calls encourage disciplined selling, so unless the valuation story has changed, let some shares be sold after large gains simply by allowing your original trades to go to completion.
- Finally, if you've changed your mind about being covered, expecting more gains in the stock, just close your existing calls — don't write new ones.

An option's time value (the value it holds above its true value to account for possible changes in the underlying stock price before expiration) will begin to disappear more steadily once expiration is 90 days away, as long as overall volatility is not increasing. At 60 days, this decay speeds up, but only at 30 days will time value really begin to evaporate quickly and, finally, almost disappear (some time value will remain right up to the last day). Thus, it's usually during the expiration month (or even week) that you'll close your original calls to roll them out. Writing new covered calls that expire in 90 days or more will reward you with ample time value again, while you want to pay little time value to close your old calls (in our example, a $15 call asking $2.10 on a $17 stock only has $0.10 in time value).

So, roll up and out when:

- You see more upside in the stock, want to keep dividend payments, or aren't ready to sell after all.
- You believe the stock won't decline much (not more than 10% or so).
- The extra profit potential of rolling up is worth the cost (with a debit roll-up) and is worth the extra risk of continuing to hold the stock.

Rolling Up But Not Out

Sometimes, when a stock gains ground, you may want to roll your covered calls up, but not out — capturing some of that upside even if it means you incur a net debit. Perhaps you're feeling bullish and think the stock will keep climbing. By just rolling up, you can make a quick correction to your trade. In this case, you "buy to close" your original covered calls and write new ones at a higher strike price but the same expiration month. Since the options expire simultaneously, you don't need to worry about time-value dissipation before making the trade. Simply adjust your position, and if the stock goes higher, you'll end with a larger gain than if you hadn't rolled up.

Rolling Down to Reduce Risk

On the other hand, when a stock declines, you may want to roll *down* your covered calls to earn another option payment and marginally decrease your risk. As shares fall in price, your original covered calls offer you less additional income and become a less effective hedge. Booking your profit and rolling down to a lower strike price — usually, but not always, with the same expiration — will increase your option income.

Be warned that rolling down lowers your overall profit potential on a stock sale and should only be considered if you no longer believe shares will appreciate in value anytime soon. Rolling down when a stock is bruised means that you're accepting a more modest payment for a lower strike price, so it's not an ideal situation — only consider it when you want to be especially defensive. Finally, make sure it's not a better idea just to sell the underlying position rather than writing new calls.

Rolling Out to Move On

If you've earned most of what an option-writing trade can pay you (as a general rule, we say 85% or more), start to consider taking the risk off the table by closing it early. When covered calls reach this point, you have little left to earn but are still completely capping your upside by keeping the position open — so the risk/reward trade-off is unfavorable. If you want to keep the stock covered, consider closing your calls and writing new ones for a later month and higher payment. If you no longer want to cover your shares, simply close your calls for most of the gain and uncap your potential profit on the stock.

Bottom Line on Rolling Covered Calls

Not all covered calls should be rolled up, down, or out when a stock moves. If rolling your options only pays a little extra, greatly increases your break-even price on the stock (because closing your calls results in a net debit), leaves you with little downside protection, or lowers your sell price too far (when rolling down), then the strategy should be shelved.

That's not a bad thing: Covered calls encourage disciplined investing. Rather than chasing a stock, the strategy makes you stick to your thesis and anticipated sell price. Too often, investors chase stocks higher only to regret paying to roll up when the stocks fall back. In many cases, letting some calls be exercised and taking some profits following a strong move is ultimately the better alternative.

At *Pro*, we'll roll up covered calls when our estimate for the stock has gone higher and we want to partake in that upside. We'll roll down when we no longer believe in the underlying stock as much and want to be defensive. And we'll roll out anytime we have a status-quo situation and wish to keep earning income.

So, are you ready to roll? Bring your questions and comments to *Pro*'s All About Options board.

Monday Memo: Will the Real Market Please Stand Up?

Published Apr 19, 2010 at 12:00AM

Coming Up in *Pro*

- **New to the portfolio:** Our call options on **Electro-Optical Sciences** became shares over the weekend. We now have about a 0.5% position in this medical technology venture.
- **Earnings season action ahead:** First up, **Tupperware** reports on April 21. You can see *Pro*'s full earnings calendar here.
- **Company visit:** Todd is headed to **Jack Henry & Associates**' analyst day in May! Have a question you'd like Todd to bring to Dallas? Share it on our Jack board.

Community Highlights

- TMFEldrehad digs deeper into the top-ranked *Pro* CAPShot stocks.
- *Pro* members discuss the big **Goldman Sachs** news.
- Fools discuss the prospect of taking more short hedges against the market.

What Buffett Is Really Thinking

Inside Value advisor Philip Durell and analyst Joe Magyer are headed to the 2010 Berkshire Hathaway annual meeting to continue their hunt for deeply undervalued stocks. To sign up for free email dispatches with their expert take on each day's events, including Warren Buffett's outlook on his favorite industries, companies, and the U.S. economy, just enter your email address here.

There's something happening here / What it is ain't exactly clear

With the uncertain state of the stock market these days, I can't get those opening lines of Buffalo Springfield's classic, "For What It's Worth," out of my head. Depending on where you look, you get two very different pictures of what's going on in the market. Let's start with the positives.

Take 1: Shiny Happy Market Data

- The market has been on the rise for more than a year now — and with low volatility. As of Thursday, Chicago Board Options Exchange's Volatility Index sat around 16, the lowest level since summer 2007, while the put-to-call premium ratio is near January 2008's five-year low of 0.34 — meaning that sellers of calls are demanding a higher price for taking the risk of a stock going higher. Both metrics imply strong investor optimism.
- Forward-looking metrics such as building permits, average weekly manufacturing hours, and yes, stock prices, have been rising for nearly a year as measured by the Conference Board Leading Economic Index. This indicates a recovering economy.
- Finally, consumers — as we said in *Pro*'s Audio Extra last week — have been resilient. Spending has been up every month since September, and retail sales were up 1.6% in March, led by strong car and clothing sales.

By anchoring on these rosy facts, you could reasonably assume that things are going well in the economy and in the markets. Unfortunately, the picture isn't quite as pleasant on Main Street.

Take 2: Sick at Home

- The average length of unemployment is 31 weeks — its highest level since records began in 1948 — and the "real" unemployment rate, which includes discouraged workers and part-timers who want to work full-time, is close to 17%. At this point, there are few signs that hiring will accelerate rapidly.
- Small businesses, which supply half of all jobs in the private sector, continue to suffer. A survey by the National Federation of Independent Business in March found that poor sales and uncertainty continue to plague this area of the economy. The NFIB's economist said the reading was "very low and headed in the wrong direction."
- Lending for small businesses remains tight, too (as *Pro* member and small-business owner US133 recently noted on the boards). The NFIB survey reported that 15% of members have found credit more difficult to come by lately.
- Interest rates are expected to march higher, while consumer credit is contracting, so future spending will likely be with cash rather than debt. While this is a good thing on the individual level, it could stifle macroeconomic growth.
- On the back of lower tax revenue, many states and municipalities across the country are slashing budgets and raising taxes to make ends meet. While this belt-tightening may be the fiscally prudent thing to do, it will also lead to fewer dollars in consumers' pockets.

Common sense tells us that this dichotomy between Wall Street and Main Street cannot continue indefinitely. If Main Street continues to suffer, it will show up in corporate earnings. Eventually, something's got to give.

What's Next

The longer the market gives the illusion of stability in the economy, the more severe the correction could be if the outlook doesn't strengthen for Main Street. From January 2006 to September 2008 (when Lehman Brothers collapsed), the Volatility Index averaged a relatively low 17.28 despite mounting concerns about subprime mortgages and consumer debt.

At *Pro*, we don't expect a repeat of the 2008 to 2009 crash. We're comfortable buying good companies incrementally, with some hedges, but we do not believe that it's time to short aggressively — as we've seen so far, a rally can be much steeper than most expect. In the meantime, we're confident that our current lineup of stocks, ETFs, and options puts us in a strong position to make money no matter what the market deals us next. During these uncertain times, it's important as ever to remain patient, focused, and Foolish.

What's your take on your local economy? Are you seeing a recovery, or are you skeptical of Wall Street's optimism? Sound off on our Philosophy & Strategy board right now.

Foolish best,

Todd Wenning

Audio Extra: Pro's Take on Today's Market

Published Apr 13, 2010 at 12:00AM

After a record-strong rebound, what's the best way to approach the stock market today? Pull up a chair as Jeff Fischer and Todd Wenning chat with analyst Bryan Hinmon about the *Pro* investing philosophy and how they're thinking about the future, some positive signs (and a few lingering concerns) about the economy, and one trade they each recommend you make today. Just click the player below to listen in!

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Once you've heard from the Pros, come share *your* thoughts on our Philosophy & Strategy board — or, if you have a stock idea you'd like to share, speak up on our Stocks That Interest You board.

Monday Memo: Spotlight on Strangles

Published Apr 12, 2010 at 12:00AM

Pro News and Events

- **GrafTech International** is up 12% since we moved it to Buy First on March 15, so we're moving it back to Buy.
- TMFValuemoosie has posted a new *Pro* earnings calendar. **Intel** reports on April 13, then **Kinetic Concepts** and **Tupperware** next week.
- Our purchased calls on **Electro-Optical Services** expire this weekend. This week, we'll announce whether we'll take shares at $5 or sell to close and consider buying new options.

The market's steady buying spree has lifted the S&P 500 a staggering 13% since Feb. 8, and the overall value of the *Pro* portfolio continues to reach new highs. Yet compared with the S&P, *Pro*'s more defensive stance has muted our returns. Earning profits even when the market turns south is part of *Pro*'s mission, so hedged positions are crucial — but should we be wary of lost upside? Some of you have expressed this concern on our boards, so today I'll share my thinking on the topic — namely, by looking at our covered strangles and the potential follow-up action we'll take to maximize our gains.

Hedges With Upside

We don't want to chase stocks to sky-high valuations, especially in the short term — it raises our risk and lowers potential returns. At *Pro*, we set up covered calls and covered strangles with this in mind, knowing that we'd happily part ways with the underlying stock at the sell price afforded by our options. Meanwhile, these strategies have the potential to earn us cash even if stocks stay flat or fall *and* offer us plenty of downside protection (often in the realm of 8% to 10%).

Need a Refresher?

Brush up your knowledge of this strategy with Options 703: Strangles.

On the flip side, even after a strong market rally, all of the stocks underlying *Pro*'s covered strangles have more room to run — and reward us with profits — before they reach our sell prices (counting options income). Plus, as these positions get closer to expiration, we'll have the opportunity to roll many of them up (to higher strike prices) and/or forward (to later expiration dates), capturing more potential upside if we wish.

Our Strangle Angle

With the goal of maximizing upside in mind, let's take a closer look at where *Pro*'s covered strangles stand today and the possible follow-up action we may take:

Position	Puts	Covered Calls	Our Net Sell Price	Current Price	*Possible* Follow-Up
Intel , *Pro*'s adjusted strangle	July $20 puts paid $1.23	July $22 calls paid $0.57	$22 + $1.80 in options = **$23.80**	$22.55	Close the options and roll up to higher strike prices as expiration nears.
Intel, original strangle that *Pro* missed	July $19 puts paid $1.27	July $21 calls paid $0.93	$21 + $2.20 = **$23.20**	$22.55	Close and roll up to higher strike prices as expiration nears.
Plum Creek Timber strangle	August $35 puts paid $1.92	August $40 calls paid $0.93	$40 + $2.85 = **$42.85**	$40.13	Let expire or close to write a new strangle as expiration nears.
Tupperware strangle	July $40 puts paid $0.98	July $50 calls paid $2.02	$50 + $3 = **$53**	$47.85	Let expire or close and roll forward as expiration nears.
Expeditors International of Washington strangle	May $30 puts paid $2.05	May $35 calls paid $1.85	$35 + $3.90 = **$38.90**	$37.20	Close near expiration and consider writing new strangle at higher strikes, or let shares go.
Waters strangle	May $55 puts paid $1.81	May $65 calls paid $3.22	$65 + $5.03 = **$70.03**	$69.23	Close soon before expiration and consider a new strangle, or let shares go.

As you can see, all of these positions still offer upside compared with today's share price. So, even in the mother of all rallies, our hedges haven't yet lowered our potential profits — in fact, if allowed to go to completion, today they'd translate into greater returns than the stocks alone. Meanwhile, they offer significant downside protection, and as the time value in our covered calls dissipates, we'll enjoy incremental returns in our portfolio even if the stocks go nowhere. Once most of the time value is gone, usually near expiration, we can consider our next move.

What’s Next?

This is the fun part, Fools (Todd's already sipping an appletini at his cubicle). Last week, we gave you a small preview of what may come, announcing that we'll roll up our deep in-the-money covered calls on **Autodesk**. Next, as our first strangles near expiration in May and time value erodes, we may allow some positions to be sold away, locking in gains at attractive sell prices; or, we may roll some strangles forward to keep that income train chugging along while we hold onto our shares. It will depend on pricing. As you build your *Pro* portfolio alongside us, we're aiming to profit in up and down markets, minimize risk, and still enjoy strong upside potential. So stay calm and stay tuned, watch your inbox for our trade alerts, and if you have any comments or questions, please visit the Memo Musings board.

Fool on,

Jeff

Fishing for Attractive Business Models With CAPS

Published Apr 8, 2010 at 12:00AM

Today's CAPS screen comes to you courtesy of the newest member of the Pro team *, analyst Bryan Hinmon (TMF42 on the boards). Bryan has been part of the Fool community for more than a decade.*

Sometimes investing feels like fishing in the wide open ocean — there are so many places to lay your line for ideas. To help whittle down the universe of potential investments, the team at *Pro* often starts by looking at CAPS (where the Fool community has rated more than 6,480 stocks), our proprietary CAPShot tool, and some easy-to-screen financial metrics.

I recently ran a screen for companies that score at least a 9 on our 12-point CAPShot scale, eliminating some of the less-attractive opportunities and narrowing the field to just 109 stocks. Next, I screened for bargains by selecting only the stocks in sectors with flat or negative returns over the past three months. Three sectors in the S&P meet this criterion — utilities, technology, and energy — and shrink the pool of ideas to a more manageable 38 companies.

Finally, as we search for great investments, the *Pro* team loves companies with recurring revenue and light business models. Businesses with these characteristics have visible revenue streams, tend to generate tackle boxes full of cash, and have the potential to generate strong returns over the long term. Software companies, such as current *Pro* holdings **Oracle** and **Autodesk**, are great examples of such businesses. To select for these business-model traits, I investigated each company one by one (the *Pro* team's constant task), and in doing so, three ideas grabbed my attention. Let's take a look at these CAPShot catches.

3 Ideas From Our Research Pond

Company	Sector	Industry	CAPShot Score	Market Cap
Dresser-Rand Group	Energy	Equipment and services	9 out of 12	$2.7 billion
j2 Global Communications	Technology	Internet software and services	9 out of 12	$1 billion
NIC	Technology	Internet software and services	9 out of 12	$0.5 billion

First up is Dresser-Rand Group (see its CAPShot here), which makes turbines and compressors used in every stage of oil and gas production — and with more than 62,000 steam turbines and 9,000 turbomachinery units in operation, it's safe to say this company is entrenched in its niche. Dresser-Rand makes money in two ways. First, it builds and sells equipment to clients like **Chevron**, **ExxonMobil**, and **Dow Chemical**. This business is cyclical and swings with energy prices. Then, it makes money in the aftermarket, servicing and providing parts for its massive installed base. This revenue tends to be high-margin, recurring, and predictable because the client's operating assets are mission-critical. On top of that, the business doesn't require a ton of cash to run, leaving more coins in the coffers of equity holders. The CAPS community loves Dresser-Rand, giving it a rating of 5 stars — and they're onto something. Capital-light businesses are rare in the energy sector, so we'll be looking further into this company's prospects.

The next idea from my screen is j2 Global Communications (see its CAPShot here), a company that helps customers stay connected by making sure they can fax, phone, listen to voice messages, or check email at all times. The bulk of its business comes from selling fax-via-email services, which take the hassle of fax-machine jams and busy signals out of the equation. The company owns an inventory of local and toll-free telephone numbers that it sells for its fax-via-email services, allowing businesses to establish a local presence from across the globe. Recurring revenue comes from subscription and usage fees, the business is asset-light, and returns on capital and margins are impressive. Although CAPS Fools give j2 a 5-star rating, the tough competition, low barriers to entry, and new technology make this a difficult business to stand behind over the long term.

Finally, if red tape is your problem, NIC (see its CAPShot here) is here to help. The company builds Internet portals to help local government agencies manage payments and documents online — think parking ticket and property tax payments — and then manages its systems under three- to five-year contracts. NIC operates a self-funded model, meaning that it fronts the cost of designing and building the portals and then shares in the recurring revenue that's generated. State and local government agencies love the self-funded model because they aren't required to make an initial cash outlay (as if they even could!). NIC keeps its business model light by referring to its broad platform of portal templates for new contracts — so it doesn't have to reinvent the wheel each time it scores a new deal. NIC is proving that its attractive business model works, and it's winning new contracts. The CAPS community rates NIC 4 stars, a vote in favor of government efficiency, but we need to get a better sense of how NIC's well-heeled competitors will respond before we get too excited.

What's Next

Now it's your turn to go fishing. If you have a stock idea with an attractive business model, enter the ticker in our CAPShot tool, and then tell us how the company fares over on the Stocks That Interest You board.

Roll Up Covered Calls on Autodesk

Published Apr 7, 2010 at 12:00AM

- **Action:** Buy to close existing July 2010 $24 covered calls, and write ("sell to open") January 2011 $30 calls
- **Recent option prices:** July 2010 $24 calls, $7; January 2011 $30 calls, $4
- **Preferred limit order:** Aim to complete these two trades for a net debit of $3 or lower.
- **Alternate trades:** If you don't own Autodesk, consider writing ("sell to open") January 2011 $25 puts (recently $1.50). No nearer-term options pay enough at low strike prices. If you own Autodesk but can't cover it with calls, the stock remains a Hold.

What's New

Our recent stance on **Autodesk** — which spurred us to write $24 covered calls in February — has proven too defensive, so it's time to take action to recapture some upside. The stock made a beeline up to our fair value estimate in the low $30s after the company beat expectations on a year-end surge in large customer orders. Meanwhile, reports on U.S. employment suggest hiring has begun (modest as it is so far) — a turnaround that should eventually help Autodesk, which sells software by the seat (so sales are per-employee).

Investors are bidding up the stock because they believe this high-margin business will grow rapidly in a recovery. But even management doesn't know whether last quarter's strength was a genuine shift or an aberration — either way, at this point, our best strategy is to roll our covered calls up to capture more of the stock's recent gains. As far as problems go, this is a good one to have.

Why This Strategy?

Because our original July covered calls are deep in-the-money, they have little time value remaining ($0.40) even though three months remain until they expire. So, we want to close them rather than risk our shares being called away early, which becomes more likely as time value evaporates. Rolling our covered calls up by several strike prices (and out by several months) for a modest net cost, we can capture much more upside in the stock than our original calls allowed. Our original $24 calls paid us $2.10 and gave us a net sell price of $26.10. Now let's walk through the math of adjusting our covered calls:

Math of Rolling Up	
Payment received for writing July 2010 $24 calls	$2.10

Cost to "buy to close" July calls	($7)
Net cost to close July calls	**($4.90)**
Payment received for writing January 2010 $30 calls	$4
Total cost of rolling up	**($0.90)**
New net sell price if called	$29.10
Total return on investment (excluding commissions)	**77.8%**

It's worth making this trade-off because the end result is a potential sell price that's $3 per share higher than our previous calls, offering a 77% return on investment versus 59%, calculated on our $16 cost basis for the stock. Plus, even though we will in effect *pay* a bit ($0.90 net) to roll up our covered calls, the $30 calls will be in our portfolio as a hedge, providing $4 in downside protection. If Autodesk declines below $30 by expiration, our portfolio earns the $4.

The main downside to rolling up is that we'll be more exposed. Our original covered calls currently hedge for a $7 decline in the stock, to about $23, but our new covered calls will only hedge for about $4 in downside risk, to around $26. But this is acceptable. If Autodesk declines sharply, it's a recurring-revenue business that we're comfortable holding for the long haul.

Another downside: We *are* adding six months to our trade with the new calls' later expiration date. Because the stock ran much higher than our original strike price, and we want to roll to a much higher strike, we need to go forward many months. Again, this is a fairly good problem to have. By following a stock higher with your covered calls, you can increase your upside — recapturing gains that have already been achieved by the stock — while still keeping a hedge in place. All we need is more patience, just as we do when owning any stock.

How to Follow Along

Tip: Broker Commands

If your broker won't let you roll your covered calls with a single "roll" command, you'll simply need to "buy to close" your existing calls, and then "sell to open" the new ones separately.

Enter a two-legged order to "buy to close" your existing $24 calls, and write ("sell to open") an equal number (if you want to cover the same amount) of January 2011 $30 calls (as always, one call for every 100 shares you wish to cover).

Because the $24 calls cost around $7, and the $30 calls offer about $4, a net debit of $3 or lower is worth shooting for, splitting the bid/ask prices. (Remember, even though you're now paying $3 or so on this trade, you were originally paid about $2 to write the $24 covered calls, so your net cost to roll up from a $24 strike to a $30 strike is around $1.) You can aim for lower than a $3 debit if you have patience. As long as your shares aren't called away early, time will generally work in your favor when rolling covered calls because the time value on your soon-expiring options will erode much more quickly than the time value on later-expiring covered calls.

If you have questions about rolling your covered calls, or on Autodesk trades in general, please visit the Autodesk board.

Write Puts and Covered Calls on Lindsay

Published Apr 7, 2010 at 12:00AM

At a Glance

- **Puts:**
  - **Action:** Write ("sell to open") September 2010 $35 puts
  - **Allocation:** 3% (for *Pro*, 10 contracts), for 4% total
  - **Option's recent bid/ask:** $2.35/$2.55
  - **Preferred limit price:** $2.35 to start ($2.10 is a preferred minimum; 6% in five months)
  - **Alternate trade:** Write June 2010 $35 puts, recently $1. Or, wait and aim to buy the stock on a drop to around $34.50.
- **Covered calls:**
  - **Action:** Write ("sell to open") September 2010 $40 calls
  - **Allocation:** Write one call for every 100 shares owned (for *Pro*, 3 contracts)
  - **Options recent bid/ask:** $3.20/$3.50
  - **Preferred limit price:** $3.20 to start.
  - **Alternate trade:** If you don't own shares of Lindsay yet, just write puts (see above). If you own fewer than 100 shares, continue to hold them.

What's New

Tip: Is This a Strangle?

Yes, writing puts and covered calls on a partial position is usually called a covered strangle, but what we're doing here is lopsided — heavy on the puts. Read on!

The market has given irrigation equipment provider **Lindsay** (NYSE: LNN) a bumpy ride over the past six months, as the stock swung from our preferred buy price of $34.50 to our sell price in the mid $40s at least twice. We wrote puts and covered calls to profit on the volatility while maintaining a modest 1% position (of a targeted 5%).

We continue to be impressed by Lindsay's strong balance sheet and cash flow despite its sharp drop-off in sales over the past year as farmers slowed spending in the recession. Lindsay's net cash position (cash minus debt) is $69.1 million, which is encouraging for a $490 million company caught in a down cycle. When farming sales pick back up, Lindsay is positioned for growth, and its cash provides plenty of dry powder for strategic acquisitions. CEO Rick Parod said Lindsay is looking to acquire companies in water conservation and management businesses, rather than just remain in water infrastructure. Although risky, this diversification could certainly boost Lindsay's market size.

On the infrastructure side of the business, where Lindsay provides, among other things, movable barrier systems to redirect traffic, a Mexico City project is complete, and a halt in the federal highway spending bill in Congress has created uncertainty about the division's U.S. sales. We consider these domestic challenges to be temporary and ultimately expect that international projects will offset any weakness in the U.S. side.

Why This Strategy

The prospect of Lindsay making acquisitions in a related market is enticing, but we can't bank on added value before it arrives — so we're sticking with our preferred buy price and estimate of fair value on the stock. After Lindsay's fairly good earnings report, for the first part of this trade, we're writing September 2010 $35 puts that could potentially net us another 3% (10 contracts for *Pro*) at around $32.65, yielding us 6.7% in less than six months. For our second trick, we're writing $40 covered calls on the 300 shares we already own, since we'd be comfortable selling them at a net price of $43.20 (and an effective price above $50 including what the puts pay us). Combining these option payments, at the very least we'll earn strong income on the stock.

How to Follow Along

You know the drill. You write ("sell to open") puts when you're ready to buy a stock if it's below your strike price by expiration. You write ("sell to open") covered calls when you're ready to sell shares of a stock you already own if they trade above your strike price by expiration. In this case, the numbers stack up like so:

- **Puts:**
  - **$35 put option yield (at $2.35 bid):** 6.7% in 5.5 months
  - **Strike price:** 10% below Lindsay's market price of $39
  - **Break-even:** $32.65, 16.2% below the current share price (not including the covered call income)
  - **Cash needed:** Each put you write represents a potential stock purchase of $3,500.
  - **Return on buying power:** Writing puts with a 30% cash-secured requirement, the potential return on buying power is 22.3%.
- **Covered calls:**
  - **$40 call option yield (at recent $3.20 bid):** 8.2% of the $39 share price
  - **Option yield on our $31.55 average cost basis:** 10.1%
  - **Upside from today if sold at a net $43.20:** 10.7% (not including the put income)
  - **Total return on position if exercised:** 36.9% (not including the new put income or our past options trades on Lindsay)

Combined, the 10 puts and three covered calls will pay the *Pro* portfolio approximately $3,300. Questions? Please visit our Lindsay board.

Monday Memo: Browse the Business Before You Buy

Published Apr 5, 2010 at 12:00AM

What's New: *Options* Team Chat, My Scorecard Upgrade

Live options chat today: *Pro*'s sister service, *Motley Fool Options*, is hosting a live chat today from 6 to 9 p.m. ET. Bring your questions about calls, puts, straddles, and strangles to the *Options* team (which includes *Pro*'s own Jeff Fischer) right here.

New-look My Scorecard: Have you given *Pro*'s revamped My Scorecard a test-drive yet? Click on over to add multiple tickers at once, create a watch list, gather Fool content related to your stocks, and more; then, read how we're working on your suggestions by visiting our My Scorecard Foolsaurus wiki page. And don't forget to tell us what you think on our boards!

This Week in CAPS: TMFEldrehad demonstrates how to catch rising and falling stock stars using the CAPS screener.

An investment should never be a blind date. As business-focused investors at *Pro*, we don't trade based on temporary market moves or chart patterns, but rather on the health and promise of an underlying business that can be purchased at a good price.

In a special feature last month, I gave you a closer look at how*Pro*values companies — but valuation is actually one of the *last* steps we take before we make a formal trade recommendation to you. Today, I'll cover two ways we can take our first look at a company. Using a real-life example, I'll walk you through two handy frameworks that help us better understand a business's inherent risks, competition, and growth potential.

A Toast to SWOT and OATS

The framework I typically start my stock analysis with is SWOT, which stands for strengths, weaknesses, opportunities, and threats. This gives us a good initial sense of the business side of a company's prospects. OATS, which stands for ownership, allocation, tenure, and stewardship, actually comes to us from our fellow Fools at *Million Dollar Portfolio*. They use OATS to gain insight into management, including whether the team is experienced and proficient, how it's incentivized, and if the company's leaders have personal stakes in the fate of the business.

Using SWOT and OATS, I've been getting a taste of **Boston Beer**, better known as the brewer of Sam Adams, over the past few weeks for *Pro*. Let's go over what these tools revealed in my first official look at the company.

SWOT

- **Strengths:** A strong reputation for quality and flavor helps Boston Beer maintain pricing power, while its status as the largest independent, publicly traded brewery based in the U.S. gives it some clout with distributors and consumers. It has a proven track record of turning innovations into commercially successful products, a solid balance sheet with no debt, and consistently generates free cash flow.
- **Weaknesses:** The business is sensitive to commodity prices — malt, hops, and yeast for beer production, and oil and packaging materials for transportation. Consumers have many substitutes (i.e., wine, liquor, and Jeff's favorite, wine coolers), and a change in taste trends could affect the entire beer business.
- **Opportunities:** Nearly all sales come from the U.S., so future international expansion could provide sustainable sales growth. What's more, the "Better Beer" category (Sam Adams is No. 3 in this category after imports Corona and Heineken) has plenty of room to get even better: It accounts for just 20% of the total U.S. beer market. Boston Beer recently shifted brewing and distribution channels from contracted to company-owned, which should improve quality, reduce costs, and strengthen the brand overall.
- **Threats:** The competition is no joke. Two large conglomerates (**Anheuser-Busch InBev** and MillerCoors) already control 94% of U.S. beer production, excluding imports, and are entering the Better Beer category through innovation and acquisition of craft brewers.

OATS

- **Ownership:** Chairman and founder Jim Koch (yeah, the guy from the commercials) owns 32% of total shares and all Class B voting shares. The few rights of Class A shareholders (potentially, us) are approving certain mergers, acquisitions, and by-law amendments, as well as electing a minority of directors.
- **Allocation:** Returns on capital and equity are consistently in the 17% to 20% range, while tangible book value has grown an annualized 17.4% over the past five years. Management has done a fine job creating shareholder value.

- **Tenure:** Koch founded the company in 1984 and remains engaged as chairman and sole Class B shareholder. CEO Martin Roper has held his position since 2001 and been with the company since 1994. Koch's father, Charles, serves on the board, but is a retired brewmaster himself — in fact, he passed down the Sam Adams recipe, which has been in the family since the 19th century.
- **Stewardship:** The company has a compensation-recovery policy, which allows it to recover incentive income from executive officers who engage in intentional misconduct. Executive compensation benchmarks change annually, but in 2009, the CEO's bonus goals were mainly based on depletions growth (distributor sales to retailers), cost reductions, and profit margins. Admirably, CEO Roper did not take a salary increase in 2009 due to the economic downturn.

Putting It All Together

My SWOT and OATS analysis shows that there's a lot to like about Boston Beer's business, including its sound balance sheet, the Koch family passion for making beer, and solid returns on the business model. As a side note, I was blown away by the three-hour wait when I visited the Sam Adams brewery in Boston this winter. Sure, it was *free beer*, but how many breweries have hundreds of people happy to wait in the freezing rain for a few pints? Clearly, the Sam Adams brand carries real clout with its core consumers.

The next step in our process is to dig further into the financials and, finally, run a valuation. A quick glance shows that the company is trading at a trailing price-to-earnings ratio of 24, so initially I'd say the stock is a little pricey in this market. Truth be told, getting a good price for Boston Beer isn't easy, as it's one of those premium businesses that usually carries a premium multiple to the market. We'd prefer to nibble closer to its 10-year average price-to-tangible book value of 3.7, or about $44.50 (16% below current prices). The put options pay pretty well, so depending on our valuation results and if shares give up some ground, we could consider writing puts to potentially gain entry into this strong consumer brand. I think we will have a chance if we stay patient, focused, and Foolish.

Now, let's hear from you: What do you think of Boston Beer? Sound off on the Stocks That Interest You board.

Foolish best,

Todd Wenning

Write Puts on Oracle

Published Mar 30, 2010 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") June 2010 $25 puts
- **Allocation:** 2.5% (for *Pro*, about 10 contracts)
- **Option's recent bid/ask:** $0.85/$0.87
- **Preferred limit price:** $0.80 or higher
- **Recent stock price:** $25.60
- **Alternate trades:** Write September 2010 $24 puts, recently $1.14, or September 2010 $25 puts, recently $1.50. Or, aim to buy shares outright if they decline to around $24.

What's New

Enterprise-software behemoth **Oracle** (NYSE: ORCL) grew sales a solid 17% in its fiscal third quarter of 2010, while boosting earnings per share 9% (including adjustments to GAAP earnings), to $1.9 billion. Meanwhile, new software licenses jumped 13%, to $1.7 billion, a strong sign of the company's future prospects — and management expects a heady 35% to 40% increase in revenue in the upcoming fourth quarter. The pipeline for new sales contracts is large and robust, management says, and the integration of Sun Microsystems is moving along smoothly and successfully.

Why This Strategy?

Oracle recently bought back $250 million worth of stock at about $24.28 per share — a buy price we find attractive, too. Recently trading at $25.60, shares fetch a reasonable 16 times free cash flow, but this multiple should decline as the business grows over the coming year. Our main goal with writing $25 puts, using a strike price near the current share price, is to have a shot at getting our second slug of shares soon — but closer to our desired buy range of $23.50 to $24. The stock trades at 15 times earnings estimates for the year ending May 2010, and with any luck, we can get shares cheaper.

How to Follow Along

When you write puts, you agree to buy 100 shares of the underlying stock for every put you write if the share price falls below your strike price by expiration. You want to target an attractive buy price and be paid well enough to make the strategy worthwhile.

- **Option payment or yield (at $0.85 bid):** 3.4% in about 80 days
- **Option strike price:** 2.3% below the recent share price
- **Break-even price:** 5.7% lower, at $24.15
- **Cash or buying power needed:** Each put option you write represents a potential purchase of $2,500 in Oracle stock.
- **Return on buying power:** Writing puts with a 30% cash-secured requirement, the return on buying power is 11.3% in less than three months. If you write 100% cash-secured puts, the return is 3.4%.

We'll complete this trade in the next one to 30 days. To discuss it, please visit our Oracle board.

Jeff owns shares of Oracle.

Monday Memo: 4 Lessons From a Fall

Published Mar 29, 2010 at 12:00AM

Coming Up: My Scorecard

We're upgrading My Scorecard! You'll soon be able to enter multiple tickers in one click, customize the Fool coverage *you* want, and watch stocks you don't yet own, all while still tracking your performance. The new and improved My Scorecard debuts later this week, so stay tuned!

Pro Earnings and Events

- Shares of **Plum Creek Timber** recently rose to $39, so we're moving this stock back to Hold.
- **Oracle** reported strong quarterly results Thursday. We'll have more on this Buy First stock soon — including the possibility of another trade, as Jeff hints in his post.
- **Lindsay** reports results on March 31. Average estimates call for $0.33 per share in earnings on $78.7 million in revenue.
- The FDA has questions about **Electro-Optical Sciences**' pre-market approval application for the company's only product, MelaFind, and has extended the review another 180 days. Read Jeff's update here.

Pro Community

- *Pro* member Brent asks, "What's the value of *Pro* without options?" and members chime in with their experiences.
- *Pro* member Hoping2Retire is wondering about **Kia Motors**. Do you know much about the company?
- This Week in CAPS: TMFEldrehad turns to CAPS as a way of finding stocks that might be all sizzle and no steak.

The stock market's current chapter will be studied for generations — but for those of us investing to grow wealth during *this* lifetime, we don't have the luxury to reflect for years on end. And while we may not see anything quite like the crash of 2008-09 in the future, the market will certainly drop sharply at some point again. Given that, what recent lessons can we hold onto as we aim to improve and thrive as investors?

1. **Don't panic.** The S&P 500 fell off a cliff in October 2008 and didn't touch bottom until March 2009. The tumble tested the will of every investor — and those who stuck it out, holding onto the stocks of strong companies rather than selling in fear, are grateful today. So the next time the market declines, remind yourself that solid stocks can only fall so much before they offer great value, attract buyers, and rebound. (And if you forget, we'll be here to nudge you.)
2. **Know your investments and your time frame.** When you're confident about your favorite companies' cash flows, balance sheets, businesses, and management teams, it's much easier to ride out a storm. A good test is to think about a favorite stock five years from now: Is the company likely to be larger and its shares worth more? If not, why own it in the first place — bear market or *any* market?
3. **Keep some powder dry.** After sitting on a vast stash of cash for years — even as stocks climbed in the mid 2000s — Warren Buffett and Charlie Munger finally invested $15.5 billion during the recent financial crisis. The investing gurus had liquidity when others didn't, so they were able to score great deals. Patience and a strategic supply of cash allow you to scoop up rare opportunities and can propel your investing career.
4. **You don't need to go all in or all out.** Even during the crisis, Buffett stuck to his discipline of buying stocks gradually and only invested *some* of his cash. He still sits on a mountain of money today, and although it's earning a pittance, he says he sleeps well knowing it's there.

That last point is crucial: Like Buffett, aim to be a calm, thoughtful tortoise rather than a frenetic hare. Along with a steady discipline, this is the key to investing success. At *Pro*, we're investing at our own pace, keeping some cash on the side, and using hedges — helping you earn healthy returns while taking less risk. When we do hedge, a one-way, straight-up market may test our patience, but leaving ourselves ample upside helps keep us happy, and making valuation-based sell decisions keeps us disciplined. Along those lines, covered calls provide a good lesson in sticking with a strategy until the time is right to change it.

Bonus Lesson: Rally Markets and Covered Calls

The market has continued to climb since February — and some of you on our boards have expressed concern about your covered calls and strangles. The fear is that you'll miss additional upside. But rest assured: We're on it.

We're watching all of our covered call and covered strangle positions, and as they get closer to expiration and the calls lose time value, we'll often aim to roll them up to new, higher prices (buying to close our existing options, and writing new ones) in a way that maximizes our potential profit while keeping the stock. It's even easier to do this profitably with a covered strangle (since you've made money on the puts you wrote), but it's usually beneficial to wait until closer to expiration. The covered call expirations we have coming up are:

- May: **Expeditors International of Washington** strangle, **Waters** strangle, **ProShares Short S&P 500** covered calls
- July: **Intel** strangle, **Tupperware** strangle, **Autodesk** covered calls, **U.S. Natural Gas Fund** diagonal calls
- August: **Plum Creek Timber** strangle

Right now, it's in our best interest to let these trades keep going as is. *All* of these positions except Autodesk have more upside in the stock compared with today's net sell price (taking option income into account). So, even in this roaring bull market, we have breathing room before we may start to miss upside in our hedged positions. While we wait, our covered calls cancel out some of our stock gains, but this return-dampening affect will wane (if not disappear entirely) as expiration draws closer and time value in the calls diminishes. Meanwhile, we have downside protection via the covered call premiums. All this helps us breathe easier.

Why We Invest Foolishly

A parting thought: When you invest in individual stocks rather than just putting your money in an S&P 500 index, you're making an active choice. As a *Pro* Fool, you use options (and own some high dividend-payers) for steady income; you hedge to decrease your risk and smooth your results; and you gain exposure to wide swaths of the market via ETFs. Earning healthy returns with less risk is an excellent way to build a portfolio. And what will eventually make Foolish investing much more worthwhile than investing in an index are those few exceptional winners — stocks that skyrocket 200%, 300%, 500% — that push you far over the top. As we achieve some exceptional winners over the years, and we combine them with our other *Pro* strategies, we'll have a great deal to be happy about as we invest together — and work toward financial freedom.

Invest well,

Jeff Fischer (TMFFischer)

Quick Note: A Portfolio Hiccup

Who melted the **Tupperware**? On *Pro*'s all transactions page, you'll see some "buy to close" Tupperware call-option trades last week. The Fool elves who make our trades accidentally wrote twice as many calls in our covered strangle as was intended. The position was closed for the same price, so commissions are our only cost. Even though we may be Fools, we're only human.

Jeff owns shares of Oracle.

Write Covered Calls on Cameco

Published Mar 23, 2010 at 12:00AM

At a Glance

4/22/10 Update

Fools, we no longer recommend you make this trade. *Pro* is obligated to complete our trades within 30 days, so although these calls only paid us $0.04 each (ouch!), we've chosen to write them. This keeps us aligned with you. What's next? These calls are set to expire in 30 days, after which we'll decide our next move.

- **Action:** Write ("sell to open") May 2010 $29 covered calls.
- **Allocation:** Write one call for every 100 shares of Cameco owned (for *Pro*, seven contracts)
- **Option's recent bid/ask:** $0.75/$0.80
- **Preferred limit price:** $0.75 or higher; if needed, no lower than $0.65
- **Recent stock price:** $27.50
- **Special requirement:** You must own at least 100 shares of Cameco to write a covered call.
- **Alternate trades:** If you don't own Cameco, consider writing September 2010 $24 puts, recently $1.15, or September $25 puts, recently $1.45.

What's New

Cameco (NYSE: CCJ) represents an interesting dichotomy: On one hand, management expects sales and earnings to dip in 2010 because it sold off gold assets for a large gain last year and uranium sales are expected to soften this year. Most utilities are well-stocked with the commodity, and the U.S. government continues to sell uranium on the open market.

But on the other hand, Cameco sees uranium demand growing considerably by 2015 as more than 50 nuclear power plants — now in various stages of production — start to get fired up and begin to lock in uranium supply beforehand. To prepare, Cameco aims to double its uranium production by 2018. However, this is obviously still years away, and the stock trades near our fair value of $31 — although even at a recent $27.50, Cameco fetches nearly 22 times this year's normalized estimated earnings per share, quite a sunny valuation.

Why This Strategy?

As in January, we're writing covered calls to create a modest hedge while earning income or selling our shares at a higher price (one near our fair value estimate). The May 2010 $29 calls expire in less than two months and would afford us an exit around $29.75 (an impressive 80% gain for *Pro*). That said, if Cameco moves up on news that makes us want to keep our shares, we can consider rolling our covered calls up and out, to a higher and later strike. The early expiration date of these options might make that easier.

How to Follow Along

Pro's guide to covered calls explains this income-generating, stock-selling option strategy — please revisit the guide if you need a refresher. You can write ("sell to open") one call for every 100 shares of stock owned.

- **Option yield at $0.75 bid:** 2.6% of the $29 strike price, expiring in 60 days
- **Option yield on our $16.52 purchase price:** 4.5%.
- **Return from today's price if sold at a net $29.75:** 8.2%
- **Total return on position if exercised:** 80%

We'll complete this trade in the next one to 30 days. To discuss or ask questions, please visit our Cameco board.

Write Puts on SPDR KBW Regional Banking

Published Mar 23, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") May 2010 $26 puts
- **Allocation:** 2% (for *Pro*, about 10 contracts) for 4.5% of 5% total
- **Option's recent bid/ask:** $0.85/$0.95
- **Preferred limit price:** $0.90 to start; $0.75 minimum (3.4% yield in two months)
- **Alternate trade:** Buy shares of the ETF around $25 to $26

What's New

Nothing has materially changed since our recent purchase of **SPDR KBW Regional Banking** (NYSEMKT: KRE) ETF earlier this month. Read our original report below to get our full take.

Why This Strategy?

We believe that, as a group, the 50 regional banks in SPDR KBW Regional are in fair health, and the valuation offers long-term potential returns. We'd like to buy as much of our position near $25 (or lower) as possible.

Meanwhile, investor confidence in the economic recovery seems to be growing — and while there could be setbacks along the way, it's likely that this diversified ETF will continue to trade with less volatility than the market overall (in fact, its three-year beta is 0.76 — 24% less volatile than the S&P 500 over the same period). Over the next two months, these puts should provide us the opportunity to buy more shares a bit cheaper than our original stake, or earn income if not.

Option Specifics

You write ("sell to open") puts when you're ready to buy shares of a stock or ETF if it declines below your strike price by expiration.

- **Option payment or yield (at $0.90):** 3.4% in 60 days
- **Option strike price:** 1.9% below current share price ($26.50)
- **Break-even price:** 5.3% below current share price
- **Cash needed:** Each put you write represents a potential stock purchase of $2,600

Can't Write Puts?

If you're unable to write puts, consider buying shares of the SPDR KBW Regional ETF outright, especially on price dips. This Buy First holding remains close to our preferred buy range, around $25. To discuss the new trade or the ETF, please visit our KRE board.

Monday Memo: Time to Get Active With Pro

Published Mar 22, 2010 at 12:00AM

Pro News and Events

- Our March covered calls on **Cameco** and **Lindsay** expired for a full cash gain this weekend.
- **Oracle** will report earnings on March 25.
- **Lindsay** will report earnings on March 31.

In the *Pro* Community

- Health-care stocks racked up some gains as the health-care bill survived the House. The many health-care stocks in *Pro* still look inexpensive.
- **Intel** is up. Members ask, what now?
- In CAPS, TMFEldrehad looks at more shooting 5-stars.

Ch-ch-ch-ch-Changes

- **FPL Group** plans to change its name to **NextEra Energy**.
- Meanwhile, **Electro-Optical Sciences** is switching its name to **MELA Sciences**.
- Maybe Warren Buffett should change careers: Watch him kick out the jams in a new Geico video.

As the *Pro* portfolio becomes more fully invested, things are going to change a bit. We'll be quicker to sell positions that we deem fairly valued in order to buy undervalued stocks — and we'll start to manage many of our option positions more actively.

At *Pro*'s sister service, *Motley Fool Options*, Jim Gillies recently talked about follow-up steps that you can consider on covered call trades, and I wrote about the lesser-used follow-up steps to consider on puts you write. Combine the two strategies, and what do you have? That's right: Covered strangles. These double-your-options strategies can double your fun, because you'll often enjoy double the benefits from follow-up action.

Our current lineup at *Pro* includes covered strangles on **Plum Creek Timber**, **Tupperware**, **Intel**, **Waters**, and **Expeditors International of Washington**. In many cases, even when the stocks appreciate a reasonable amount, we'll have the ability to earn a profit on the combined options *and* keep the stock for more appreciation by managing the strangle before expiration.

Shake, Strangle, and Roll

New dance craze, or profitable options strategy? The typical follow-up action on a covered strangle includes rolling it *out* to a later expiration month, and sometimes rolling it *up* (or down if necessary) to a different strike price. Often, it makes the most sense to adjust your strangle after most of the time value from the original covered calls has been squeezed out. There will be times, however, when rising stock prices will demand a call to action with some time value still in place.

So get ready to get rolling, *Pro* Fools, because we'll be initiating more follow-up activity on our options in the near future. We'll do so wherever possible to maximize profits while still keeping risk in check. We're also working on new options guides to help you along the way, including how to master following up on covered calls, written puts, and strangles, as well as a guide to using in-the-money options (both long and short).

You’re in the Money

Greece 2010: The End of the Euro?

New from the Fool: Get full coverage of how the crisis in Greece could affect the euro, global finance, and your portfolio at foolgreece2010.com.

Speaking of in-the-money options, that's another activity you'll see more of from *Pro* in the coming months: *buying* options (calls or puts), often in-the-money, to help us profit with greater magnitude on the movement of a stock, yet with manageable risk and less capital required. As our cash balance starts to diminish, we can get more bang from our remaining bucks and — since we'll have most of our funds in stocks and ETFs — have less overall portfolio risk when buying options. All of these together mean it's in our favor to be options buyers more often than we have in the past.

Remember, Fools, it takes time and patience when you're building a portfolio and trying to get all of its parts moving harmoniously, especially considering the topsy-turvy economy and stock market we've had over the past 18 months (and counting). We're looking forward to the next stage of *Pro* and building a winning portfolio with you, helping you begin to more actively manage your *Pro* stocks for the most potential benefit.

Are you fully invested? Chime in on the Memo Musings board.

Fool on!

Jeff Fischer

Trading Window Update

With The Motley Fool's recent launch of *Special Ops*, we're making an adjustment to the trading window for all of the Fool's real-money portfolio services. Once any of our real-money services announces a trade alert, that service will wait at least 24 hours (rather than two days, our previous minimum window) to buy or sell the stock, fund, or ETF. (Our options trading rules remain unchanged.) As before, the services must execute any announced trades within 30 days. This across-the-board adjustment ensures that all of our real-money services are restricted to the same trading rules. This change takes effect March 31, 2010.

You can rest assured that our revised policy does not affect how you use the Foolish investing services you've come to rely on — and profit from — and still allows you to get in the game ahead of us on every real-money trade we make. And if you have any questions, the Motley Fool customer service team is ready to help. Just call 888-665-3665, 9 a.m. to 5 p.m. ET, Monday through Friday.

The Pro Way to Value Stocks

Published Mar 16, 2010 at 12:00AM

There's little consensus on the right way to value a stock — except that it's part art, part science. Compare it with valuing a piece of artwork such as Andy Warhol's "200 One Dollar Bills" silkscreen, which recently sold for a staggering $43.8 million. How would you justify that price when the *materials* probably cost 200 one-dollar bills? To start, you could attribute much of the value to the Warhol name. Then you'd probably consider the meaning to the buyer, the piece's importance relative to other works, and what someone else might pay for it down the road.

Using that same thought process, how would you justify a $560 price tag for a share of **Google**, or for that matter, the price given to *any* particular stock?

Some rely on "relative" valuation (described in this Monday Memo), comparing multiples such as price-to-earnings with the same metrics for competitors, but at *Pro*, we prefer to focus on the company's underlying fundamentals — like cash flow and earnings — rather than where the stock may trade relative to competitors.

The Value of Future Cash

More often than ever, earnings per share is manipulated by one-time charges, non-GAAP accounting, and subjective management teams that do all they can to make earnings look better. But cash is *fact*. By estimating how much cash a company will make available to shareholders after it invests in new assets and satisfies other obligations (i.e., to lenders and pensions), we can begin to determine how much that future cash is worth in today's dollars — and can then estimate the intrinsic value of a stock. This is known as discounted cash flow, or DCF, analysis.

To illustrate, say your friend Steve offered you $1,000 today or the promise of $1,000 five years from now. You'd be foolish (lower case "f") not to take the $1,000 today, because you can put that money to work earning interest — and assuming inflation follows history, $1,000 will buy more goods today than it will in five years. But what if Steve asks how much you'll *pay him* today for his promise of $1,000 five years from now (just as you pay a company for the promise of future cash flows)? This is a tougher question. You need to factor in expected inflation over the next five years in addition to a decent rate of return relative to Steve's trustworthiness (for this exercise, we'll consider his word his bond). Let's say the rate that we believe fairly compensates us for expected inflation and for the risk of lending to Steve is 6%. The equation to determine how much you'd lend Steve today would be:

Future value / (1 + interest rate)$^{\text{number of years}}$

or

\$1,000 / $(1.06)^5$ = \$747.26

So, the amount we should pay today for Steve's $1,000 in five years is $747.26.

Taking it a step further, if Steve said he'd pay us $1,000 in year five and another $1,000 in years six and seven, now how much would we pay today?

Time of Cash Flow	Amount of Cash Flow	Formula	Present Value
Year 5	\$1,000	(\$1,000 / $(1.06)^5$	**\$747.26**
Year 6	\$1,000	(\$1,000 / $(1.06)^6$	**\$704.96**
Year 7	\$1,000	(\$1,000 / $(1.06)^7$	**\$665.06**
Sum			**\$2,117.28**

Put simply, you would give Steve $2,117.28 today for the promise of three $1,000 payments delivered in years 5 through 7.

This second example is closer to what we do at *Pro* when we value a company: We estimate future cash flows, discount that cash at a rate that adequately reflects its risk, and come to a fair value for the cash today.

Two Kinds of Free Cash

Unfortunately, there's no "Steve" in the stock market telling us exactly how much he'll give us down the road. So, how do we determine which cash flows to measure? When valuing a company, we target the cash flows left over — the "free" cash — after the company has invested in projects to further grow the business (i.e., capital expenditures and acquisitions). In other words, this is the cash that *could* be paid out to investors and is thus cash we can use to measure value. There are two major types of free cash: free cash to firm and free cash to equity.

- **Free cash flow to firm (FCFF)** is what's left over before the company has paid interest to debt holders and after corporate reinvestment needs.
  - **How to calculate FCFF**: Start with after-tax operating income, add back non-cash depreciation expenses, and subtract capital expenditures and changes in working capital (current assets minus current liabilities).
  - **What's the discount rate**? Because you're factoring both the cost of debt and equity for the firm, you discount FCFF at the company's weighted average cost of capital, a mix of its cost of debt and equity.
  - **Done. Then what?** Back out all non-equity commitments (debt obligations, operating leases) and add back cash to arrive at the equity value — the number we care about as equity investors. Divide that amount by the number of shares outstanding to get the fair value per share.
- **Free cash flow to equity (FCFE)** is cash left over after all non-equity obligations have been met.
  - **How to calculate FCFE**: Start with net income, add back non-cash depreciation expenses, and subtract capital expenditures and changes in non-working capital. Any new debt proceeds received by the company could theoretically be paid out to equity holders as a dividend, so that should also be added to the calculation.
  - **What's the discount rate?** FCFE is discounted at the company's cost of equity, traditionally measured by the capital asset pricing model, or CAPM, which factors in a risk-free rate (for valuations done in U.S. dollars, this is the 10-Year Treasury rate), the investment's beta (to measure relative risk to the market), and the equity risk premium (compensates investors for extra risk with stocks over bonds).
  - **Done. Then what?** Divide the equity value by number of shares outstanding to get the fair value per share.

Valuation models using either free cash flow to firm or equity should arrive at the same conclusion, but depending on the type of company being analyzed, one model can be "better" than the other. For instance, companies with fluctuating levels of debt makes projecting future equity cash flows difficult, so it's more prudent to value the entire firm using free cash flow to firm and back out all non-equity obligations. On the other hand, for companies with no debt or stable debt ratios, like **Expeditor's International of Washington**, free cash flow to equity valuations can be much clearer.

Play With Numbers

More DCF Fodder

There's much more to learn about discounted cash flow analysis, so if you're interested in learning more, we recommend two books by our friend, NYU Professor Aswath Damodaran: *Damodaran on Valuation* and *The Dark Side of Valuation*. His website also offers tremendous information on the markets and has various valuation spreadsheets.

At *Pro*, we test various scenarios for each company's projected free cash flows to determine a range of potential values. We believe valuing a company to the penny, as many Wall Street analysts do, is an exercise in futility because it assumes you've perfectly modeled the future. We're not so overconfident to think that we know a company's exact standing five years from now or more, so we use fair value ranges based on various scenarios to provide you with our best estimate of the company's value.

The ultimate objective to valuing a stock is to make sure you're paying at least a fair price for your investment — one that should generate attractive returns — and obtaining a suitable margin of safety. The primary goal at *Pro* is to close at least 75% of our positions profitably, so ensuring that we don't overpay for investments is paramount. Overpaying for a stock is one of the most common causes of permanent loss of capital.

Pro Bottom Line

Just as each art appraiser has a slightly different method of valuing art, each investor will have a different formula for valuing stocks — but we consider DCF analysis the best way to value the underlying business, which in turn helps us make smarter long-term investments and better options trades. If you have more specific questions on valuation, please post them on the Philosophy & Strategy board.

Monday Memo: Pro's Biggest Update Ever, Plus Moves for Today

Published Mar 15, 2010 at 12:00AM

Happenings in *Pro*

- March 16: **Plum Creek Timber**'s Analyst Day.
- March 20: Our **Cameco** and **Lindsay** covered calls expire.
- March 25: **Oracle** reports quarterly results.
- TMFValuemoosie shares *Pro*'s latest earnings calendar.
- This Week in CAPS: TMFEldrehad explains how you can participate in an academic study being conducted by a CAPS member.

The Death of the Euro?

Greece's economic crisis could reshape global finance — and rattle your portfolio. Follow the story in real time as Tim Hanson and the *Global Gains* team head to Greece for on-the-ground coverage. To learn how you can profit from this historic development, enter your email address here.

With its steady climb since early February, the market seems intent on sustaining its year-long rally, the largest in 76 years. Although the surge makes for dramatic headlines, stocks are just reclaiming some of their losses from the March 2009 low — the largest *panic* in generations. Given the economy's weakness, the market probably won't reclaim all of its losses anytime soon — but making up *some* ground for now is enough for us to profit.

At *Pro*, we're investing to build value over the coming years by purchasing reasonably priced stocks of strong companies that we believe will grow and be more profitable in the future. More than ever, we're attuned to the macro picture; we want to make healthy returns but with less risk in this uncertain economy. We're not relative-returns investors, but if we can keep up with the biggest rebound in our lifetimes while investing in lower-risk stocks with strong potential and initiating occasional hedges and shorts (not to mention while having cash, too), we'll be in good shape when the market gives up ground, too.

Our Latest Guidance

So, where do we stand now? After going over the most recent results for every *Pro* holding, it's time to update our guidance and provide suggestions for some new trades that you can make today.

You'll see a new batch of Buy First stocks (most are out of favor, which is when you *want* to buy — but they may require patience), and we raised some stocks' preferred buy prices. Which brings us to an important reminder, Fools: Just because a stock ticks above its preferred buy price doesn't mean the investment has lost its luster. We're buying companies we expect to significantly appreciate in value over the coming years, so if you buy within 5% to 7% of the preferred range, you'll still have a margin of safety and more than enough upside.

Now let's quit chatting and get to the visual — starting with our latest guidance on every *Pro* position.

Pro Positions, All in One Take

Investment	Recent Price (3/12/10)	Preferred Buy Around Price	Fair Value Estimate	What to Do	Quick Take
AmTrust Financial Services	$14.20	Increased from $12 to $13	$18	Moved from Buy First to Buy	Book value is above $9 and management expects a strong year. AmTrust still offers growth potential.
Autodesk	$29.16	$22.50	$32	Hold	Was the strong fourth quarter due to an increase in year-end orders or does it signify an upward trend? Even management doesn't know. We wrote covered calls on our shares.
Cameco	$28.21	$24.50	$31	Hold	Utilities are well-stocked with uranium for 2010, but Cameco is investing for strong growth in the years to

					follow as new power plants come online. We wrote covered calls on our shares.
Ebix	$17.23	$18	$24	Buy	Earnings grew 40% last quarter, and estimates call for just 16% growth this year. As acquisitions take root, there's the potential for upside surprises.
Expeditors International of Washington	$37.21	$30	$38	Moved from Buy to Hold	After a climb in stock price, Expeditors is on Hold for new stock purchases; if you already own shares, you can write a covered strangle.
Flowserve	$105.12	Increased to $87 from $80	$110	Hold	Earnings per share are expected to level off this year before growing again at this well-run valve, seal, and pump producer.
FPL Group	$47.07	$55	$62	Moved from Buy to **Buy First**	This green utility has a stock that offers value, the stability of a regulated business, and pays a dividend. Compared with book value, shares are near their lowest valuation in a decade.
GlaxoSmithKline	$37.82	$44	Low $50s	**Buy First**	The stock's been knocked around on concerns surrounding a few notable, but not vital, drugs. Europe's largest drug maker rewards patient investors with its 6% dividend yield.
GrafTech International	$13.03	$13.50	$18	Moved from Buy to **Buy First**	GrafTech has nearly eliminated its debt, free cash flow remains strong, and as steel demand increases, the company may be able to pass rising material costs onto customers. With the decline in share price, we're moving it to Buy First.
Jack Henry & Associates	$23.83	Increased from $21 to $22	$30	Buy	With 90% recurring revenue, this banking software company offers stability at a reasonable price.
Kinetic Concepts	$48.92	$41	$54	Moved from Buy First to Hold	A favorable patent trial outcome sent shares up 14% last week. We're moving KCI from Buy First to Hold on price.
Intel	$21.27	$20.50	$25	Buy	This dominant tech company has a reasonably priced stock and is a good candidate for options strategies (like our recent covered strangle).
Lindsay	$43.47	$34.50	Low $40s	Hold	This volatile stock has made the round trip from the low $30s to low $40s a few times already. We aim to sell high via covered calls, buy low by writing puts, and hang onto shares for when business rebounds.
Medtronic	$43.94	$42	$52	Buy	This medical devices giant continues to grow earnings and cash flow above 10% year-over-year.
Oracle	$25.05	Increased from $22.50 to $23.50	$29	**Buy First**	Earnings are due March 25. Given Oracle's diverse, recurring customer base, we expect stability and growth.
Plum Creek Timber	$37.10	$34	$40	Moved from Hold to Buy	Timber prices seem stable and demand may slowly increase. You can buy half a position in Plum Creek and write a covered strangle to obtain an average buy price of $34 or lower *and* enjoy the 5% yield.
Procter & Gamble	$63.32	$62	$70	Buy	P&G's last quarter showed that it's gaining traction with customers around the world once again.
ProShares Short S&P 500	$50.42	N/A	N/A	Buy	This inverse ETF will benefit us if the S&P declines. We'll continue to write covered calls to lower our cost basis while allowing for ample upside.
Quanta Services	$19.13	$20	$26	Buy	Truly a long-term investment, Quanta will grow as America invests in its energy grid. With 34% earnings growth expected this year, the stock is attractive.
SPDR KBW Regional Banking	$25.70	$25	$36	**Buy First**	This ETF trades near book value, and holding 50 relatively healthy banks should create value down the road.
Tupperware	$48.55	$40	$50	Moved from Buy to Hold	Who knew Tupperware could be so profitable? Millions of party throwers, that's who. The options pay well, so we wrote a covered strangle, but recent stock gains make this a Hold for new buyers.
Vanguard Emerging Markets	$41.35	N/A	N/A	Hold	We still like the potential of emerging markets, but the major indexes trade at a premium, which historically has led to underperformance. We sold some VWO recently, but still have exposure overseas: Most U.S.-based *Pro* stocks have meaningful international sales.
Vanguard Energy	$85.38	N/A	N/A	Buy	Energy leaders have plenty of long-term potential if the global economy continues to grow.
Waters	$64.84	$55	$66	Moved from Buy to Hold	The stock has recently surged above a reasonable buy range for new investors.
Options-Only Positions					
Electro-Optical Sciences	$9.23	N/A	N/A	Buy	In April, our calls on this speculative holding could be exercised and turned into a 1% stock position at $5 per share. The FDA's decision on the company's only potential product is hoped for in 2010, but there's no firm date.
U.S. Natural Gas Fund	$7.97	N/A	N/A	Hold	Natural gas remains volatile, swinging between $4 and $6/mcf in the past few months. We're writing covered calls on our long calls, and the ETF is on Hold for new investors until it tracks gas prices more consistently.

Moves You Can Make

As promised, I've put together a list of new *Pro* trades you can consider making as of March 12, including many put-writing moves to help you build out your portfolio along with us. A few tips:

- Consider spacing out your puts by expiration month rather than writing a slew of them that expire all at once. Averaging in may afford better opportunities should the market suddenly turn south.
- You don't need to use options to build and manage a *Pro* portfolio — many stocks can be purchased outright today. Just be a bit more flexible in relation to our preferred buy prices.

Underlying Stock	Trades You Can Make	Quick Take
AmTrust	Sell to open September $15 puts, recently $1.50. You can also buy the	Writing September $15 puts nets a $13.50 start price and pays 10% if you

Financial, Buy	$14.30 shares if you don't own any yet; they're slightly above our preferred buy range.	don't get shares.
Autodesk, Hold	Sell to open October $23 puts, recently $0.85.	Though seven months out, these puts potentially land you shares near *Pro*'s buy range. The payment is only 3.7%, however.
Cameco, Hold	Sell to open September $24 puts, recently $1.20.	With flat earnings expected in 2010, patience may pay off for would-be buyers who aim for the low $20s. If not, you'll earn 5% in six months.
Ebix, Buy	Buy shares and/or sell to open June $15 puts, recently a generous $0.80 — a 5.3% payment in three months.	A volatile stock with options that pay well, there are a few ways to average into this long-term investment.
Expeditors International, Hold	Sell to open August $32.50 puts for about $1 — a 3% yield in five months.	Having jumped to $37, the stock is on Hold for new buyers, but new put-writing remains possible.
Flowserve, Hold	Sell to open July $90 puts, recently $2.50, a 2.8% yield in four months.	Management continues to impress, but the potentially cyclical nature of the business makes us want a discounted price for new buys.
FPL Group, Buy First	Buy shares and/or sell to open June $45 puts recently at $1.20; or September $45 puts recently $2.15.	The stock is in the dog house, but patient investors should eventually be rewarded while they collect a 4% yield.
GlaxoSmithKline, Buy First	Buy shares and/or sell to open April $37.50 puts, recently $0.75; or May $37.50 puts, recently $1.40.	Also in the dog house (which, again, is when you should want to buy), this stock offers value along with a 6% yield.
GrafTech International, Buy First	Buy shares and/or sell to open April $12.50 puts, recently $0.50, or June $12.50 puts, recently $0.90.	As with all investing, patience is required. Sustained increases in steel demand will drive GrafTech's business.
Jack Henry & Associates, Buy	Sell to open June $22.50 puts, recently $0.70. Shares can also be purchased, especially on a dip, since they're 7% above our preferred range.	Jack Henry should slowly continue to grow value over the years.
Kinetic Concepts, Hold	Sell to open September $40 puts, recently $1.20.	Following a spike in share price, patience *may* offer more opportunities to write puts for higher premiums later.
Intel, Buy	Buy shares alone, and/or buy half your shares and write a covered strangle, with the July $20 puts and $22 calls paying about $1.70 combined.	You don't need options to profit on Intel's expected recovery over the next few years, but we like using them to increase our chances and income.
Lindsay, Hold	Sell to open June $35 puts, recently $0.80; or Sept. $35 puts, recently $1.90.	Lindsay is currently near our sell price, but the puts near our buy price still pay decently; waiting for a drop in share price, if it comes, should increase put premiums.
Medtronic, Buy	Buy shares and/or sell to open April $43 puts, recently $1.	Medtronic appears to be taking a breather after last year's large gain — providing a chance to average in on down days or via put writing.
Oracle, Buy First	Buy your first shares (recently 6% above our preferred range), or sell to open June $24 puts, recently $0.92.	Oracle announces results March 25, so you may prefer to wait until that news.
Plum Creek Timber, Buy (to strangle)	Sell to open May $35 puts, recently $1, or August $35 puts, recently $2. Or, buy half a stake near $37 or lower and sell to open an August covered strangle with $35 puts/$40 calls for nearly $3.	Plum Creek's volatility seems to be decreasing, but options still make net buy prices below $34 possible.
Procter & Gamble, Buy	Buy shares and/or sell to open April $62.50 puts, recently $0.88.	This is simply one of those investments that lets you sleep at night.
ProShares Short S&P 500, Buy	Buy shares as a hedge.	Sell to open covered calls on your shares at strike prices at least a few dollars higher if you'd like to hedge your hedge. (Yes, we said that!)
Quanta Services, Buy	Buy shares and/or sell to open May $17.50 puts, recently $0.50; or August $17.50 puts, recently $1.	A recent *Pro* buy, we like it as much as before.
SPDR KBW Regional Banking, Buy First	Buy shares and/or sell to open April $25 puts for $0.50 or June $25 puts for around $1.20.	A new Buy First stock, we believe this ETF of 50 small banks could steadily regain value the coming years.
Tupperware, Hold	Sell to open October $45 puts, recently $3.40; or October $40 puts, recently $1.70.	On Hold even for strangle writers, though writing puts is still viable — although October requires patience.
Vanguard Emerging Markets, Hold	You can sell to open various June or September puts that net potential buy prices in the mid to lower $30s.	After a steep gain in China and Brazil market indexes, we're eyeing other international stocks rather than depending so much on this index ETF. But lower buy prices are worth considering.
Vanguard Energy, Buy	Buy shares and/or sell to open almost any $80 or $85 puts. They pay well but are thinly traded.	An ETF of industry giants, this is a straightforward investment in the world's long-term energy needs.
Waters, Hold	Sell to open August $55 puts, recently $1.10.	Near our fair value, buying the stock is on hold, even with a covered strangle. Put writing remains viable, although patient investors may get better prices later.
Options-Only Positions		
Electro-Optical Sciences, Buy	Buy to open July $5 calls, recently $4.50 — so you have less at risk than buying the stock outright.	Pure speculation, with no new word on when the mighty FDA will review the company's only possible product.
U.S. Natural Gas Fund, Hold	Sell to open July $8 puts, recently $0.71.	This trade idea is only for those comfortable going ahead despite our Hold guidance. We're not recommending buying new calls now.

Fools, don't fret if you're feeling overwhelmed. Just focus on the Buy First and Buy stocks initially, especially those that you're lacking in your portfolio and want to own sooner rather than later, and only make a few trades at a time rather than a dozen at once.

Allocation Tweaks

Finally, although you needn't adjust anything, you'll notice that we're moving our target allocations for Ebix, Expeditors, FPL Group, and Waters from 6% to 5%. This is merely a clerical tweak for *Pro* as we start to base our target allocations on the portfolio's current value rather than its starting value. (We're using a blend of those two values — we don't want to assume all of our current gains are permanent gains already! Remember, investing is never perfect.) All other allocations remain the same. You may note that our target allocation numbers total more than 100% — that's because we don't expect to get to full allocations on all positions, only on those that present more opportunities.

For an updated snapshot of today's Buy Firsts, Buys, and Holds, along with target allocations, just visit our portfolio page. If you have questions about these new trades, please post on the Memo Musings board.

Remember: You want to own good companies at reasonable prices, so don't *just* write puts — we recommend you *buy* some shares of your favorites, too.

Fool on!

Jeff

Jeff owns shares of AmTrust Financial Services and Oracle and has written puts on GlaxoSmithKline.

Write Covered Calls on ProShares Short S&P 500

Published Mar 9, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") May 2010 $54 covered calls
- **Allocation:** Write one call for every 100 shares owned
- **Option's recent bid/ask:** $0.65/$0.80
- **Preferred limit price:** Split the bid/ask, recently about $0.70.
- **Alternate trades:** If you don't own shares of ProShares Short S&P 500 and would like to hedge your bullish stock positions, buy at least 100 shares at current prices and write these covered calls on them; or, write May 2010 $50 puts, recently $1.10, to potentially get your first shares cheaper.

What's New

Since we first wrote covered calls on **ProShares Short S&P 500** (NYSEMKT: SH) in early December, little has fundamentally changed. The stock market is up more than 3% since then (all of it in the past week), and our first covered calls expired as a cash gain, lowering our cost basis in this position to $54.36 per share.

For *Pro* members who are new to ProShares Short S&P 500, this inverse ETF gains ground whenever the S&P 500 declines and works against us whenever the market advances. Our goal is to keep this reasonable hedge in the portfolio, gradually lower our cost basis by writing covered calls on it, and sell it profitably on a market decline.

Today, the S&P 500 continues to look neither expensive nor undervalued, trading in a middle ground that suggests economic uncertainty. Should the economic recovery weaken, stocks are almost certain to head down. If the recovery gathers momentum, the market would likely follow suit and tick higher. In either case, we'll ideally manage this position to end with an overall gain.

Why This Strategy?

Rather than just hold ProShares Short S&P 500 while we wait for a market decline, we can get paid something while we wait — and still have upside in the short. The S&P 500 needs to decline about 6.5% for the ETF to reach our strike price via these new covered calls.

- **Option payment or yield (at $0.70 bid):** 1.3% in 74 days
- **Option strike price:** 6.5% above the recent ETF price ($50.60)
- **Potential sell price:** 7.6% above the recent share price

How to Follow Along

When you own 100 shares or more of a stock or ETF, you can write covered calls on the position. You "sell to open" one call for every 100 shares owned. You're paid income while waiting for the underlying investment to appreciate to your sell price. We'll aim to write covered calls again if these expire in May, and we may roll the calls up to a higher strike and later date if the market falls and we want to keep our hedge longer.

We must make this trade in the next one to 30 days. To ask questions, please visit our ProShares Short S&P 500 board.

Monday Memo: Mind Your ETFs

Published Mar 8, 2010 at 12:00AM

Pro Earnings and Events

- Congratulations to PapaRhino, the winner of our February contest!
- Utilities are still well-stocked with uranium, so **Cameco** remains a Hold. See Jeff's conference call notes for more.
- Buy stock **Ebix** reported record-strong results this morning. We'll have more coverage this week.
- Buy First stock **Kinetic Concepts** is approved for reimbursement in its newest market: Japan.
- This Week in CAPS: TMFEldrehad looks at 5-star stocks in the doghouse.
- TMFValuemoosie shares a full earnings calendar for *Pro* holdings, including some former *Pro* stocks.
- **New Fool:** We'd like to warmly welcome the newest member of the *Pro* team, Bryan Hinmon, who goes by TMF42 on the boards. Come say hi to Bryan, who comes to us from the Fool's Analyst Development Program.

Coming Up

- Next week's Memo offers trades you can make on many *Pro* stocks and options, along with valuation and stock-rating updates.
- *Pro*'s guide to valuation and *Options 803: Neutral Spreads*.
- We're meeting with more management teams this year, so come tell us which *Pro* holdings you want us to visit most.

Though it's a little embarrassing to admit, I'm not a man who knows a lot about cars — I just want one that can safely get me from Point A to Point B. Chalk it up to living near public transportation or not getting behind a wheel until age 17 (thanks, New Jersey), but I've just never been interested in the automobile's inner workings. That is, of course, until something goes wrong. Then I want to know what happened, why, and what I can do about it. But by that point, it's usually too late, and I curse myself for not knowing more so I could have prevented costly repairs.

It's this same promise of getting from point A to point B that's helped exchange-traded funds catch on like wildfire during the past decade. Before, it cost big bucks for individual investors to enter niche markets such as commodities, currency, or shorting, but with ETFs, all you need is a regular brokerage account.

Yet the world of ETFs is far from perfect. According to the Investment Company Institute, there are more than 800 on the market today controlling $731 billion in assets. There's nothing wrong with having many choices, but it requires an investor to have a more discerning eye. Look under the hood of many of these specialized vehicles, and you'll find that a lot of them aren't doing a great job of getting you where you want to be.

What to Watch For

We've experienced the downside of ETFs at *Pro* with our synthetic long on **U.S. Natural Gas Fund**. Though it's done a better job tracking the price of natural gas following some changes to its portfolio structure, the ETF's underlying system of rolling forward futures contracts at increasing prices (known as "contango") has resulted in disappointing performance even though natural gas has held relatively steady. As you know, we're using covered calls to recover some of the paper losses from this trade.

Other ETFs don't seem to do what their names imply. For instance, the **SPDR S&P Homebuilders ETF** may seem like a great way to play the fortunes of actual homebuilders like **Lennar** and **Toll Brothers**, but a closer look reveals that the majority of holdings have only indirect relationships with homebuilding. In fact, retailers like **Sherwin Williams**, **Bed, Bath & Beyond**, and **Home Depot** are among the ETF's top 10 holdings — in all, two-thirds of this "homebuilders" ETF is invested in consumer discretionary companies.

And then there are "theme" ETFs, which invest based on shaky historical trends. The **WisdomTree Equity Income ETF**, for instance, is based on a historical back-test from 1964 to 2005 that suggested dividend-weighted portfolios outperform the S&P 500. At the end of 2008, the ETF held large positions in high-yielding stocks like **General Electric**, **Pfizer**, and **Bank of America** ... all of which slashed their payouts when the entire dividend landscape diverted sharply from the 41-year period the WisdomTree team analyzed. Adding insult to injury, the ETF is only allowed to rebalance once a year, so it had to hold many stocks with low yields or *no* yields until December 2009.

As ETF companies continue to churn out new and exciting ways to access diverse areas of the market, it's imperative that investors be cautious, making sure any ETF holds logical positions given its objective, and then tracks the underlying investments accurately (and charges a reasonable fee).

Pro, ETFs, and You

Tip: Make the Trade vs. Trade Complete

Pro always emails you *before* we make a trade so you can make it first. First, *Pro*'s **Make the Trade** announcement hits your inbox. Then, we have 30 days to make the trade ourselves. Once we do, we send you a **Trade Complete** email with our real-money transaction details.

ETFs remain an integral part of *Pro*'s strategy, and it remains essential that we thoroughly analyze their inner workings before we add any to the portfolio. Before recommending the **SPDR KBW Regional Bank** ETF, for instance, we not only researched its 50 regional banks, but wanted to make sure this ETF was the best vehicle to achieve our thesis. Other ideas were presented, from a basket of a few top-notch regional banks to a hybrid regional bank stock/ETF trade, but in the end, we concluded that the methodology of SPDR KBW Regional — to be more or less equal-weighted across 50 mid-cap regional banks at a low cost — provided the best risk/reward scenario for everyone.

If you own an ETF outside the *Pro* portfolio, now is a great time to re-read its prospectus and analyze its holdings — you may find that a little research now saves you from expensive portfolio repairs down the road. Meanwhile, if you've ever been taken for a ride by an ETF that wasn't what you thought it would be, join the dicussion on *Pro*'s ETF Center board.

Stay patient. Stay focused. Stay Foolish.

Todd Wenning

Todd owns shares of Home Depot

Buy SPDR KBW Regional Banking

Published Mar 4, 2010 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Price when we released our original intent:** $24.50
- **Estimated fair value:** $34 to $38
- **Preferred buy price:** $25 or lower
- **Buy guidance:** Use a limit order near the ETF's net asset value (recently $24.58)
- **Type of holding:** Core; Financials
- **Alternate trade:** Write ("sell to open") puts for a lower potential buy price — recently, April 2010 $24 puts bid $0.70, and June 2010 $24 puts bid $1.30. We may write puts for our next shares.

The Big Picture

March 4, 2010

While U.S. banking behemoths like **Citibank** (NYSE: C) and **Bank of America** (NYSE: BAC) struggle with rotten balance sheets, White House scrutiny, and public backlash, the best of the conservatively managed regional banks are plugging along, progressing toward a better day. This is our case for the **SPDR KBW Regional Banking** (NYSEMKT: KRE) ETF, a compelling play that holds shares of 50 mid-cap U.S. regional banks, most with market caps below $2 billion. Much smaller than "super-regional" banks like **Fifth-Third** (NASDAQ: FITB) and **BB&T** (NYSE: BBT), these community banks tend to have more conservative lending practices — on average, less than 3.5% of all loans (and 2.1% of total assets) held by the select banks in SPDR KBW Regional are considered non-performing, compared with the sector average of 4.3% non-performing loans.

Even if its banks' number of bad loans ticks higher, this ETF's low valuation today should help support the share price. The average bank in SPDR KBW Regional trades at just 1.1 times book value, whereas regional banks on average traded at 1.7 to 2.2 times book value for most of the past decade — meaning there's room for 50% appreciation just to return to the lower end of the range. Add in future growth in book value, and the ETF could appreciate even more. We may just need patience.

Inside the ETF

Get Personal With KRE

- **Founded:** 2006
- **Holdings:** 50 U.S. stocks, equal-weighted
- **Average holding market cap:** $1.3 billion
- **Dividend yield:** 1.87%
- **Website:** www.spdrs.com

Mirroring the KBW Regional Banking Index and charging a slim 0.35% annual fee, SPDR KBW Regional is a low-cost way to gain diversified exposure to an important slice of the economy. Since it's an equal-weighted ETF, each of its 50 hand-selected mid-cap regional bank stocks represents the same allocation — about 2% — and the ETF is examined quarterly for rebalancing to maintain that weighting.

SPDR KBW Regional's holdings include **Associated Banc-Corp** (NASDAQ: ASBC), at 2.5% of assets; **City National** (NYSE: CYN), 2.2%; and **Bank of Hawaii** (NYSE: BOH), **Prosperity Bancshares** (NYSE: PB), and **Valley National Bancorp** (NYSE: VLY), all around 2%. These names are among the best in the business and well-recognized by industry watchers. Forty-five other select regional banks fill the ETF, greatly diluting its risk profile. Thankfully absent among these 50 banks: Big operators in troubled spots such as Florida, Arizona, and Michigan.

Regionals on the Rise

As we delve into our case for the SPDR KBW Regional ETF, you'll notice that we use price-to-book value, an equity-based metric, to value the ETF. Along with the industry analysts, we focus on equity rather than total firm value because a bank's levels of debt and capital expenditures are often unclear, making it difficult to determine cost of capital or cash flow.

Providing us with less downside risk, the current historically low valuation of regional banks implies an anemic recovery to continue *indefinitely*. As prospects improve, we believe there's at least 40% upside opportunity here. The low-risk valuation along with a strong potential reward has the markings of a good contrarian investment, as long as we believe the risks are reasonable — and we do.

Below we've gathered key data on all 50 of SPDR KBW Regional's holdings; you'll notice that the numbers aren't perfect, but aren't so dismal they call for today's low price-to-book values:

Metric	Price-to-Book Value	Net Interest Margin	Tier 1 Capital	Non-Performing Loan / Total Loan
What It Means	Market price divided by the company's equity (assets minus liabilities).	What a bank is earning from its investments over what it is paying in interest relative to its income-generating assets.	Measures bank's ability to absorb losses.	A loan not meeting stated principal and interest payments, usually 90 days or more behind
Guidance	Over the past decade, regional banks have traded between 1.7 and 2.2.	The higher the better, but 3% to 5% is considered a healthy range.	Banks expected to maintain at least 4%, but anything over 15% could imply inefficient use of capital.	The lower the better — ideally, less than 1% in a good economic setting. Anything over 5% can mean the bank is on shaky ground.
Average KRE Holding	1.1	3.7% (44 of 50 holdings reporting)	12.7%(30 of 50 holdings reporting)	3.35% (43 of 50 holdings reporting)

Data provided by Capital IQ, as of March 3, 2010. All figures are arithmetic averages.

Overall, we believe the metrics of the underlying holdings are not nearly as weak as the low price-to-book ratio implies. When small businesses start to recover, regional banks — as their primary lenders — should loosen the purse strings again, and return on equity should improve at the banks, which tends to drive book value multiples higher.

We don't expect things to turn around overnight. But after the economy has regained its balance, regional banks should see a rebound to the lower-end of their historical average of 10% to 12% return on equity. We're investing now because all it takes is others to have this general thesis to start to push prices higher. Year-to-date, the ETF is up 10% while the S&P 500 has been flat.

What Would Make Us Sell

The Community's Take

Based on the well-known concerns about banks and commercial real estate, we're not surprised by SPDR KBW Regional's low ratings on both CAPS (2 of 5 stars) and *Pro*'s ETF CAPShot (2 of 12 points). Most of the ETF's underlying holdings are also rated 3 stars or below. Although some banks held by the ETF may falter, our risk is well-diversified. And, historically, the best time to buy stable banks has been soon after financial crises, when the banks trade near book value. For example, in the early 1990s, investors willing to go where most others weren't were richly rewarded in the following years as buyers returned. That could very well happen again, and the valuation risk appears reasonable while we wait.

Given all that's happened with banks in the past two years, spelling out the risks is essential.

Despite the improving outlook for regional banks over the next few years, there's an elephant in the room: the fate of commercial real estate loans. Now that the housing bubble has burst, loans for hotels, office buildings, and shopping centers are pegged as the next dominoes to fall — and to wreak havoc on smaller banks, which hold a larger proportion of commercial real estate loans than bigger banks. From 2010 to 2014, an estimated $1.4 trillion in these loans will reach the end of their terms, and according to the Congressional Oversight Panel, roughly *half* are underwater.

Scary stuff, we know. But this is a major reason why regional banks trade at such low valuations today. At present, SPDR KBW Regional's average holding's exposure to commercial real estate as a percentage of total loans is 32%, and while this isn't slight, it's not as high as some of the larger super-regionals like Fifth-Third (53% commercial) and BB&T (48%). Even if the ratio of non-performing loans increases by 10% across the average SPDR KBW Regional holding (we believe this is a high estimate), it wouldn't push the ETF's portfolio into the danger zone.

But researching the ETF's underlying banks closely, we're encouraged by three things. First, following the residential mortgage debacle, banks are more prepared this time around, raising or preserving capital to absorb potential losses. Second, many banks have refinanced or restructured current loans to run into 2012 with the expectation that if the economy recovers further by then, they'll be in much better shape to keep the loans on favorable terms. Finally, commercial loans have stricter lending guidelines than residential loans, placing a heavier emphasis on cash flow of the occupying businesses and typically requiring a substantial down payment of 20% to 25%. And keep in mind: Since the average bank in the ETF has a market value of only $1.3 billion, even loans in the mere millions of dollars are meaningful to it, and are thus underwritten and tracked carefully.

All that said, if the U.S. economic picture doesn't show signs of improvement by next year, or if interest rates jump sharply and unexpectedly, it would not only have a negative impact on the regional banks through their commercial real estate exposure, but would also crimp net interest margins (revisit our table above for an explanation) In either case, we would consider closing our position early. Furthermore, regional banks are complaining that the capital constraints put on the giant banks are hampering their ability to lend — and regional bank lending fuels small business growth, which fuels the economy. If the government doesn't loosen capital requirements for the healthier, smaller banks, a recovery may take much longer. This is being discussed by regulators.

Pro Bottom Line

Our top priority at *Pro* is accuracy — closing at least 75% of our positions profitably — and this often requires a contrarian look at the market. We believe regional banks as a group, especially the 50 banks that we've analyzed in this ETF, are undervalued due to well-known concerns that these banks are managing for already. All told, we believe the upside potential (40%, 50%, or higher) outweighs the downside risk of approximately 15% to 20%. That's an investment case we like. Have questions? Visit our new SPDR KBW Regional Banking discussion board.

Monday Memo: No Need for Market Mysticism

Published Mar 1, 2010 at 12:00AM

Guidance Change: UNG Moves to Hold

We moved **U.S. Natural Gas Fund** to Hold last week. The ETF needs several more months of accurate natural gas price tracking before we can get enthusiastic about it again. If you already own shares *or* calls on UNG, we recommend writing covered calls per last week's recommendation.

Last Chance to Win a Free Year of *Pro*

Fools, your time to enter *Pro*'s latest contest ends at midnight ET, so enter your active *Pro* stocks and ETFs into My Scorecard, stat!

This Week in CAPS: Outperform Giants

Track the market-beating predictions of some of CAPS' top swamis with help from *Pro*'s resident CAPS expert, TMFEldrehad.

Predicting the future isn't as easy as it sounds — though if you're lucky enough to be right, you've got great resume material for your future career as a crystal-ball reader. With my track record, I think I'll stick to stock analysis.

In December, Jeff, Todd, and I (your *Pro* analyst down under) made a few tongue-in-cheek forecasts for 2010. Two months into the new calendar year, most of my predictions are looking a little shaky. Especially problematic is my call for interest rates of 2.25% by the end of 2010. Last week, Fed Chairman Ben Bernanke told Congress that economic conditions are "likely to warrant exceptionally low levels of the federal funds rate for an extended period." Bernanke's comments effectively tell us to expect a long, slow economic recovery — nothing new to us *Pro* Fools, though not too promising for my prediction that rates will jump 2% in 10 months time.

Bound, Bound in a Range

I also predicted reduced volatility, reduced trading volumes, and a flat-ish stock market in 2010. The market is essentially flat since mid October, so maybe there is hope for my budding career as a palm reader after all. But despite little overall change, the market has experienced plenty of ups and downs this year as investors react (somewhat manically and moodily) to the daily deluge of economic and company news.

Take last week, for example. One day, the market slumped as a gauge of consumer confidence decreased to its lowest level since April 2009. The next day, after Bernanke's testimony, stocks jumped back up. (One pundit even said that low interest rates for an extended period were "music to a bull's ear.") But the euphoria was fleeting, because the following day, Moody's announced plans to downgrade debt in Greece, and jobs and manufacturing figures trailed forecasts. (This time, the pundit said, "The economy is going into a little bit of a fits-and-starts period. We don't see any job creation coming along. That's by far our biggest concern.") With all this volatility, what's an investor to do?

Flat-Out Profits

We *don't* recommend selling one day, buying the next, and then selling again — the only person who gets rich from that behavior is your broker. A volatile yet ultimately flat stock market is actually a welcome thing here at *Pro*. Armed with an arsenal of options strategies, we can help you generate decent income even from range-bound stocks. We're already taking aim, announcing three new option trades and a straight buy in the past 12 days alone.

The key for investors in these volatile and uncertain times is to remain patient and not to panic. I don't think another major stock market crash is on the horizon, although there may be periodic corrections and general uneasiness. Meanwhile, as ever, the *Pro* analysts will continue to closely monitor the portfolio, looking for opportunities in any market. Now that's a prediction you can bank on.

Invest patiently,

Bruce Jackson (TMFGoogly)

P.S. Come share your thoughts on the recent market ups and downs on our Memo Musings board.

Earnings Roundup: Solid Results From 6 *Pro* Companies

A Financial Planning Option for You

Thought about getting advice from a financial planner but didn't know who to trust? Want more hands-on help managing life's many financial decisions? The Motley Fool has partnered with Garrett Planning Network, a group of trustworthy, transparent, fee-only financial planners and advisors, and for a limited time, new Motley Fool clients get a 10% discount. Click here and look for the Motley Fool icon to identify participating advisors.

Jeff, Todd, and Bruce continue to dig into all the earnings news on our *Pro* companies; you can always access our latest coverage on *Pro*'s dedicated discussion boards. Here are the highlights from the past week.

- **Autodesk** shares jumped 8% on the tail of strong fourth-quarter results, which Jeff covers here. The stock now trades at 31 times free cash flow, which on its face is expensive. For the time being, we're sitting on our covered calls, but closely monitoring our options.
- **Expeditors International of Washington** solidly beat expectations in the fourth quarter, and the stock rose 8%, to around the $37 mark. Our covered strangle paid us $3.90 combined, so we'd be selling our shares at a net $38.90 or buying more at $26.10. We continue to monitor the position — we expect Expeditors will remain an attractive option stock for a long time.
- **GrafTech International** exceeded expectations in the last quarter of 2009. The stock trades at about 12 times estimated earnings for 2010, which isn't dirt cheap, but we believe there's more upside potential than there is a risk of disappointment.
- **Medtronic** produced another solid quarter, and we remain comfortable with our estimated fair value of around $52 and preferred buy price of around $42. Writing puts remains a viable option.
- **Flowserve** reported fourth-quarter earnings per share of $1.96 versus a $1.87 average estimate, while maintaining its guidance for 2010. We'll cover the results in more detail in the coming days.
- **Cameco** performed well in the fourth quarter, though it projected lower 2010 uranium sales and lower profits as it invests for the future. The company takes a very long-term perspective to its business, as necessary in the world of uranium. Cameco is still on Hold, and we'll keep our eyes open for future option trading opportunities that could net a price below our preferred buy guidance.

Bruce Jackson owns shares of Autodesk and has an options position in Medtronic.

Write Covered Calls on United States Natural Gas Fund

Published Feb 25, 2010 at 12:00AM

At a Glance

Don't own a position in UNG? We don't recommend that you make this trade. Instead, continue to build positions in our Buy First and Buy stocks. **Questions?** As always, we're here for you on our discussion boards.

- **Action:** Write ("sell to open") July 2010 $10 covered calls on existing *purchased* calls
- **Allocation:** Write one call for every call owned (for *Pro*, 25 contracts)
- **Option's recent bid/ask:** $0.53/$0.55
- **Preferred limit price:** $0.50 or higher, day order; if needed, no lower than $0.45
- **Recent ETF price:** $8.86
- **Special requirement:** You must own at least 100 shares of UNG, or one call option, to write a covered call.
- **Alternate trades:** None at the moment. We're moving UNG to Hold.

What's New

It's been a wild ride since we initiated a synthetic long (writing puts and using the payment to buy calls) on the **U.S. Natural Gas Fund** (NYSEMKT: UNG) ETF in October. Ever volatile, the Henry Hub natural gas benchmark has swung as low as $4 MMBtu (million British thermal units) and as high as $6 MMBtu over the past three months. After a volatile ride, natural gas prices are about where they were in October, but UNG initially didn't track well while it reconfigured its investments. Returns were further compromised when fund managers had to sell futures at a loss in order to buy the next month's futures at a higher price. Now, UNG trades about 30% below our starting price. Lately, the ETF is tracking natural gas futures well again, giving us more confidence to continue to hold the position to write covered calls on it.

Weather-wise, we couldn't have asked for better luck (appeasing our Dec. 7 Memo demands), as freezing temperatures and major snowstorms in the U.S. have put a nice dent in the record-high natural gas stores. In fact, as of today, there's less natural gas in storage than there was a year ago. Yet gas prices have not reacted sharply, as some patient drillers start producing again whenever gas nears $6 MMBtu. This situation may keep a cap on natural gas prices at least for the coming months, if not longer. So, in the interest of ultimately making our position profitable, we're going to start writing covered calls on the calls we purchased — turning it into a diagonal bull spread.

Why This Strategy

Pro approaches investing a bit differently. Our No. 1 goal is accuracy, so if a position's eventual profitability appears to be in jeopardy, we'll often take action. This may limit the position's upside, but it gives us a better chance to profit in the end *and* lowers our risk.

So, for our struggling synthetic long on UNG, we can run the numbers to see what's necessary for us to profit.

- Our net cost to set up the trade in October 2009 was $1.20: We wrote January 2012 $12 puts, receiving $3.40 each; and bought January 2012 $10 calls, paying $4.60.
- We break even or earn a profit on the puts as long as the ETF trades at or above $8.60 by expiration (our $12 strike price minus $3.40 option payment). If our puts expired today, we'd earn a small profit on this leg.
- However, we'd lose the full value of the $10 calls we bought ($4.60) if the position were to expire today, putting us in a sizable hole overall.

Thankfully, with almost two years until expiration, our 2012 calls still have $1.80 in time value left, but time is ticking against us. To help ensure that the calls end profitably (or closer to it), we'll write covered calls against them to defray their cost. Called a diagonal spread, this involves repeatedly writing near-term calls (effectively, covered calls) on the much longer-term calls that you own, in an effort to lower the cost of the long-term calls.

We'll begin by writing the July 2010 $10 calls, recently paying $0.53. This position will be managed more actively than some of our other covered calls, since we don't necessarily want to lose our long-term calls yet. If the ETF moves close to $10, we may roll the covered calls forward and up rather than let them be exercised. We want to own our 2012 calls as long as possible, and write covered calls against them several times over the next two years to defray our cost.

How to Follow Along

If you already purchased calls on UNG along with us, write one call for each call owned. If you bought 100 or more shares of the ETF directly, you can write covered calls against your holding.

As long as the ETF continues to track natural gas prices well and natural gas stays between about $4.50 and $6 MMBtu (or higher), this should become a solid, albeit unplanned, diagonal call spread position; the volatility of natural gas is high enough that the calls we'll write pay relatively well, but the value of natural gas should stay in a range, limiting our risk. However, we don't recommend starting a new position in UNG at this time. We want to see the ETF string together a few more months of accurate gas-price tracking before we'd give the green light to newcomers at this point.

So, to recap: We own January 2012 calls on UNG, and we'll be writing covered calls against those calls as often as we can over the next two years to begin eating away at our purchased calls' cost. To retain upside potential, we'll manage this diagonal bull call spread actively. Please bring any questions, comments, or flames (we can take the heat) to the U.S. Natural Gas Fund board.

Adjust Your Strangle on Intel

Published Feb 24, 2010 at 12:00AM

At a Glance

- **Adjusted trade:** Writing July 2010 $20 puts and July 2010 $22 covered calls (instead of $19 and $21) because Intel increased in price before we could make our trade, and the original strangle is no longer as attractive for newcomers.
- **Recent options bids:** July 2010 $20 puts $1.18, July 2010 $22 calls $0.73, for $1.91 total
- **Strangle limit order:** $1.90 or better to start
- **What this means for you:** If you already placed an Intel trade earlier this month, you don't need to do anything. At lower prices, the original trade was more attractive and you can let it ride. If you haven't placed an Intel trade yet, you can consider today's adjusted trade.
- **Alternate trades:** Just write the puts to potentially buy shares cheaper; buy the stock and just write covered calls on it; or just buy the stock.

What's New

Since we announced that we would buy shares of **Intel** (NASDAQ: INTC) and write ("sell to open") a covered strangle on them (writing puts to potentially buy more shares lower, and writing covered calls to possibly sell our existing shares higher), the stock has gained ground without us. The closure of Fool HQ during a double snowstorm kept us from making the trade right after we announced it, and today the original July 2010 $19/$21 strangle is no longer as attractive for new stock buyers simply because Intel is near $21. If we bought today, we'd have little upside in the stock before our covered calls would come into play.

Therefore, we're moving our strangle up one strike price on each side, now writing the July 2010 $20 puts and the $22 covered calls. This new trade is less attractive than the original (if you'd made it earlier), but still offers nice upside with good downside protection.

Why This Strategy

Moving our strike prices up doesn't change the option income we could make compared with the original trade, but does provide us with $1 extra upside in the stock itself, effectively making up — though at a higher cost — for the $1 in gains that we've already missed. So, the only reason we're changing the spreads is to have enough upside potential to keep the trade attractive.

The numbers on this trade:

- **Action**: Buy 3% in Intel, recently $20.55
- **Action**: Write ("sell to open") July 2010 $22 covered calls (one for every 100 shares owned), recently $0.73
- **Action**: Write July 2010 $20 puts (one for every 100 shares you'd buy), recently $1.18
- **Total option income**: $1.91 per share
- **Potential second 3% buy price**: $18.11
- **Average buy price if we get all shares**: $19.33
- **Potential sell price on our first 3%**: $23.91

How to Follow Along

There is no need to make any changes to your trade if you already placed the $19/$21 trade. You should have a profit so far, and should let it continue to ride. If you haven't made the Intel trade yet, you can now consider this adjusted strangle or the alternate trades above. As always, post your questions on the boards.

We will make this trade after two business days and before March 4 (30 days after our original trade announcement).

Buy More of NextEra Energy

Published Feb 23, 2010 at 12:00AM

At a Glance

- **Action:** Buying 1% (for 4% of our 6% target)
- **Recent share price:** $46
- **Alternate trade:** Write ("sell to open") June 2010 $45 puts, recently $1.65; be ready to buy the stock if it declines by expiration.

What's New

A weak Florida economy, an adverse regulatory ruling, and a public relations mess have created a triple-whammy of trouble for **FPL Group** (NYSE: NEE) (now called NextEra Energy) in recent weeks. But as contrarian investors, we see this as an opportunity to step up and buy more shares.

First, the ruling: The Florida Public Service Commission (the PSC) rejected most of FPL's $1 billion rate hike last month. Without that added income on the way, the company responded by saying it would cut $10 billion in planned energy investments in Florida over the next five years. As we discussed on the boards, some political wrangling is to be expected with utilities, but these businesses ultimately need to charge a reasonable rate to be able to upgrade and grow existing energy capacity. As long as the Florida economy improves, FPL will likely apply for another hearing in 2011. In fact, the terms of two of the five members of the PSC will expire in January 2011, and Governor Charlie Crist has announced that he will not seek reelection so he can pursue a Senatorial seat, so the deck will be reshuffled and may become more friendly. But even without a rate hike, there is value in the stock.

Meanwhile, we're slightly more concerned about recent allegations that FPL forced employees to manipulate data for the PSC rate case. Both FPL and the PSC have launched investigations. After reviewing the two allegations, dated Jan. 20 and Feb. 3, the letters appear to be an opportunistic move by disgruntled employees, and we don't believe the claims will affect FPL's business. There may be more controversy on the horizon given the current economy and the politically charged rate case decision, but we're willing to ride it out on the merits of FPL's regulated (or all but guaranteed) business strength and valuation.

Why This Strategy

All this negative press has helped drive shares of FPL deeper into value territory, and as contrarian investors in this stock, we're using the opportunity to buy another 1% for the *Pro* portfolio. Recently trading at 1.6 times book value, FPL has not averaged a lower price-to-book value than this for a full year since 1994 (as far back as our data goes) — suggesting that this price won't last too long. This new purchase will reduce our cost basis below $50 on a stock we believe is ultimately worth about $60. While we wait for FPL to grow shareholder value, we're happy to collect a 4.1% dividend on our new shares, and 3.8% on the full position.

How to Follow Along

If you don't own any shares of FPL, consider buying up to a 4% position at current prices to match *Pro*'s 4% position. If you'd rather write puts to potentially get shares at a lower price, consider writing ("sell to open") June 2010 $45 puts, recently $1.65; be ready to buy the stock if it declines by expiration. If you have questions, please post on the FPL Group board.

Monday Memo: Why You're Here

Published Feb 22, 2010 at 12:00AM

Upcoming Earnings

- Feb. 23: **Autodesk**, **Expeditors International**, **GrafTech International**, and **Medtronic**
- Feb. 24: **Flowserve** and **Cameco**

Get Your Money From Uncle Sam

Don't miss the Fool's new *Investor's Tax Report*! Just click here to access a host of Foolish tax tips and resources in this free gift from *Rule Your Retirement*.

What about options? Check out *Pro*'s options-specific tax guide for help.

When *Pro* analyst Todd Wenning interviewed Chuck Akre earlier this month (you can catch the Audio Extra here), the famed fund manager said the No. 1 challenge investors face is "the same as always: ignorance." People who don't know their investments from the ground up are facing an uphill battle. That's where we come in.

A Team of Pros, at Your Service

At *Pro*, investing is what we do — all the time. It's our job. We're here to help busy Fools like you — who may not have hours upon hours of free time every week to research investments — gain financial freedom. We don't want a parade for what we do (though Todd loves a good skyscraper-sized Barney); we just want to provide you with the highest-quality investing advice we possibly can. So we devour every news item, quarterly report, and SEC filing while keeping in tune with an investment's competitive landscape. We also watch the big picture, staying on top of trends in business, consumer well-being, government, and international relations.

You're part of *Pro* because you want investment ideas that are deeply vetted, followed continually, and have strong odds to make you money — with reasonable risk. And you're seeking *more* than many other investors, because you want strategies that will profit in flat and down markets, too. That's why many of you are using options with us to consistently generate short-term gains alongside your long-term stocks, making for a dynamic double-duty portfolio.

Profits for Every *Pro* Fool

For New *Pro* Fools

Questions about using an IRA, a smaller portfolio, or *not* using options? In case you missed these handy links to help you profit with *Pro*, check out:

- Make *Pro* Fit Your Profile
- Go-To *Pro* Resources

Like all of you, we want to create value in the world — to make it a better place for the people around us, and especially for those who put their trust in us. Yes, being part of *Pro* comes at a cost — annualized, and not including the free access to *Motley Fool Options*, the typical *Pro* membership costs about $130 a month, the same as my cell phone bill — but we're confident that you'll earn much more investing alongside *Pro* over the years than you ever spend on it. That's our goal: For *Pro* to be profitable for you, creating value for every Fool who is here with us.

Essentially, your membership has landed you a team of experts, here to give you investment advice on both stocks and options, long and short strategies, macro and micro, while offering a full portfolio of positions that are meant to work together. On a per-hour basis, you're getting a heck of a deal. But we want it to translate to your bottom line — whether you're just buying our stocks, only using options, looking to protect what you have, or mirroring the *Pro* portfolio. No matter how you use our ideas, *Pro* should ultimately make you money. If we're not doing this for you over time, chime in and tell us why not.

Thank you for investing with us. We have much more Foolishness below and in the sidebars. Don't miss it!

Jeff Fischer (TMFFischer)

Earnings News and Community Highlights

- **Contest update:** You have one week left to enter for a chance to win a free year of *Pro*!

- **AmTrust Financial** reported strong results last week, sending the stock to a new 52-week high. It's still a value, though, and remains a Buy First, as Jeff explains in his conference call summary.
- This morning, **Quanta Services** announced fourth-quarter results that sent the stock up 7%, putting it among today's biggest market gainers. We'll summarize the conference call and earnings soon.

- Fools continue to discuss how to invest well and live a good life, too.
- Fools talk about making *Pro* fit your profile.
- Jeff answers member chefm's question on how to protect stock gains.
- What's next for **Autodesk** and the **U.S. Natural Gas Fund**? Find out here and here.
- **GlaxoSmithKline** hit a bump on negative drug news. Fools are discussing it, while *Pro*stands pat.
- Member usexpat asks, "Am I the unluckiest Fool?" when it comes to investing. Fools chime in.
- Jeff explains how the recent strangles on **Plum Creek Timber** and **Tupperware** have new buyers of the stock effectively buying the shares at or near our preferred buy price.
- In his weekly CAPS rundown, TMFEldrehad talks about rising stars in the CAPS community.

Jeff owns shares of AmTrust Financial.

Sell to Close Higher-Strike Puts on Abercrombie & Fitch

Published Feb 18, 2010 at 12:00AM

At a Glance

Please note: Our order for this trade went unfilled, so we were unable to close our $34 puts early. They will just expire worthless. See Jeff's post and ask any questions on the Abercrombie board.

- **Action:** Closing ("sell to close") February 2010 $34 puts (we'll let our $27 puts expire)
- **Limit price:** Whatever the market bids; recently, $0.11
- **Special considerations:**
  - Only bought one or two contracts? Make sure closing is still profitable if you include commissions.
  - Bought puts with a different strike price? If they expire Friday, we still recommend selling to close your puts to gain back some proceeds.

What's New

Although **Abercrombie & Fitch** (NYSE: ANF) has an overvalued stock, a troubled business in decline for years, a dated brand, and waning market share, it's been a challenging short-sale candidate for us. The company's persuasive management team always contends that things are going to improve, pointing to the few bright spots in the business (the small international arm, in the case of this week's earnings release), while downplaying the many larger failings and challenges. As long as investment analysts who rate the stock buy into the recovery story, the stock holds its ground, and short sellers are left in the cold. This is especially true when your short strategy involves put options with an expiration date.

Our bear put spread on Abercrombie is set to expire on Friday, and with the stock trading above $35, our $34 puts will expire worthless — so we will close them ("sell to close") to at least get back a hundred bucks or so. Meanwhile, the lower-strike $27 puts that we wrote will expire for a full cash gain, paying for 39% of the cost of our higher-strike puts. But the trade is still an overall loss for us, knocking 0.3% off the total value of the *Pro* portfolio. We'll aim to earn back this loss with a lower-risk option trade.

The irony of this loss is that our thesis has largely played out as expected. Since we set up the trade in October, Abercrombie has continued to lose customers, it posted lower sales and earnings over the holiday compared with last year's dismal results, its margins declined, it shuttered more stores, and it didn't increase earnings guidance — all reasons that this expensive stock should trade lower. It might in the future, but not in time for us with this trade.

What's Next

We'll continue to analyze recent results to consider shorting Abercrombie again in the future. But for now, you'll find us sulking in our **Aeropostale** (NYSE: ARO) sweatshirts and Fool jester caps, pining for another chance to take down the Abercrombie & Fitch giant.

If you have questions about closing your higher-strike puts on this spread trade, please ring the register at our blighted Abercrombie board.

Write a Covered Strangle on Plum Creek Timber

Published Feb 18, 2010 at 12:00AM

At a Glance

Trade summary: We're writing covered calls on our existing shares of Plum Creek Timber and writing puts to potentially buy more shares at a lower price. This covered strangle strategy provides a wide range in which to profit. If you **don't own shares** of Plum Creek, we recommend **writing puts**. See below for details and ask any questions on our Plum Creek board — we're here to help!

- **Action**: Writing ("sell to open") August 2010 $40 covered calls on all shares owned, recently $1.30, and writing August 2010 $35 puts, recently $2.70, representing another 3%.
- **Allocation**: 3% each (for *Pro*, 10 contracts of both calls and puts)
- **Preferred limit price**: Enter a "strangle order" for a net credit of $4 or more. If your broker requires you to do separate transactions, write covered calls and then write puts for a total payment of $4 or more; if necessary, later, accept as low as $3.50 combined.
- **Alternate trades**:
  - **Don't own Plum Creek yet?** We suggest writing one leg of this strangle — the August 2010 $35 puts — aiming for a payment of $2.50 per share or more.
  - **Don't want to use options?** Aim to buy 3% of Plum Creek below $34.
  - **Can't write puts?** Buy 3% of Plum Creek and write August 2010 $35 covered calls, recently $3.40.

What's New

After a tough year, things are looking up for **Plum Creek Timber** (NYSE: PCL) — yet we remain cautious. The timber REIT expects sawlog prices to rise, but new home production in the U.S. will likely be modest as buyers work through the existing supply. Plum Creek plans to keep harvests at 2009 levels until prices improve, protecting shareholder value while retaining operational flexibility to see what demand dictates. And in the meantime, management is using real estate transactions to generate substantial value — with plans for at least $350 million in real estate sales this year, projecting total earnings of $1.25 to $1.45 per share.

We applaud these moves and remain confident as ever in Plum Creek's management. The team has calmly steered the company through the downturn while achieving healthy profitability and cash flow. Plum Creek continues to serve the *Pro* portfolio as a unique asset-based, income-producing position. We've generated recurring option income on the stock (worth nearly 20% of our original purchase price so far) and collected 5.3% in dividend income on top of nearly 15% share price appreciation. Our last option strategy expired in November — so, armed with the new 2010 guidance from Plum Creek, this is a good time for us to saddle up for more option income.

Why This Strategy?

A strangle has two legs: You write ("sell to open") calls on a stock you own, and at the same time, write puts to potentially buy more shares. The calls have a higher strike price; the puts, a lower strike; both legs should expire in the same month. You need to be ready to sell your existing shares if they increase enough, or buy more if shares drop — however, the strangle gives you a wide range in which to profit on the options alone, if you like, by closing the options early (or letting them expire) as long as the stock stays in that range.

In this case, we're writing August 2010 $35 puts while Plum Creek's stock is around $36 — a more aggressive put-writing trade than we've usually made on the stock. As our confidence in management has grown and the sawlog market has stabilized — and given the large premiums we're collecting — we're more comfortable moving our strike price up. However, if sawlog prices reverse, the recession returns, or the housing market worsens, we may need patience for Plum Creek's stock to recover, and we'll own twice as many shares. If this happens, we're prepared to wait, collect the 4.6% dividend, and possibly write covered calls.

How to Follow Along

New to this trade? As always, we recommend buying shares in the lower $30s and writing options regularly on Plum Creek if you can; our fair value on the stock is still as high as $40. All of our alternate trades above adhere to this guidance.

For the strangle, remember, each option represents 100 shares of stock, so you need to own 100 shares to write covered calls, and you must be able and willing to buy 100 shares to write puts. And remember, we're selling these options, *not* buying them.

Let's take a look at some math behind the trade (prices as of Feb. 18):

- **Recent options bid/ask:** August 2010 $35 puts, $2.70/$2.75; August 2010 $40 calls, $1.25/$1.45
- **Total option income**: About $4 per share net credit (split the bid/ask prices)
- **Effective options yield**: 11% of share price in six months
- **Potential second 3% buy price**: $31 (13% below current price)
- **Average buy price if we get all shares**: $31.48
- **Potential sell price on our first 3%**: $44 (23% above current price)
- **Profit range:** Anywhere above $31

Like any good strangle writing trade, this position provides a wide range for us to profit. We will potentially buy more shares around $31, or sell our existing shares at $44. Any share price between these two points will result in option income and a profit on the strangle. Finally, if Plum Creek is between $35 and $40, both options expire for the full cash gain, and nothing else happens. At that point, we can repeat our strategy.

If you're new to covered strangles and haven't read our strangles guide, please dive in, and ask any questions on our Plum Creek discussion board. For more on how to place a covered strangle trade, please see our original covered strangle on Plum Creek below.

Buy More of GlaxoSmithKline

Published Feb 17, 2010 at 12:00AM

At a Glance

- **Action:** Buying 2% (for 5% of our 5% target)
- **Recent share price:** $39.25
- **Alternate trade:** Write May 2010 $37.50 puts, recently $1.33; or write May 2010 $40 puts, recently $2.70

What's New

Since we bought our first 3% in pharmaceutical giant **GlaxoSmithKline** (NYSE: GSK) in December (at about $42 a share), the company reported solid earnings for the fourth quarter and the full year. Some encouraging signs include:

- A return to sales growth, albeit only 3% on a constant-currency basis and boosted substantially by fourth-quarter sales of H1N1 vaccine Relenza. Still, this is a welcome achievement because U.S. revenue continues to decline as Glaxo's drugs come off patent.
- Increased earnings per share, which rose by 2% for the year and 43% in the fourth quarter, again boosted by Relenza. For the full year, EPS was a strong $3.83.
- The dividend, which Glaxo raised 7% in 2009 (in British sterling terms).
- Free cash flow is strong, up 23% in 2009, from $8.4 billion to $10.4 billion.
- A focus on emerging market growth; the percentage of sales from Western markets is shrinking, while emerging market sales grew 20% and now represent 10% of total revenue.
- A focus on cost reduction, especially R&D, where return on investment has been a modest 11%. It's nice to see CEO Andrew Witty bring more accountability to Glaxo.

Meanwhile, the stock has slipped to around $39 and now trades at an attractive 10 times free cash flow and 10 times expected 2010 earnings, with a dividend yield of nearly 6%. More U.S. legacy brands will go off-patent this year, and we don't expect a repeat of Relenza's strong 2009 sales, so growth in 2010 is likely to be modest — but we still like this share price. Since 1997, Glaxo's shares have rarely traded below $40, while EPS has doubled over the same period.

Why This Strategy

Our goal with Glaxo is to generate solid dividend income alongside steady, long-term earnings growth of about 5% annualized. In addition, there should be less downside risk here at today's price, making Glaxo an attractive defensive play for this economy.

Meanwhile, the U.S. health-care bill remains a big unknown. Depending on the outcome, we could see Glaxo's share price climb soon — or we may need to wait longer for the stock to inch toward our fair value estimate, which sits in the low $50s. But as we wait, we'll enjoy a near-6% dividend yield on our new shares.

How You Fit In

You can consider writing puts (see our alternate trades above) either to buy the stock a bit cheaper or generate income. For *Pro*, we simply couldn't look past the excellent yield and today's valuation, so we're filling out our position directly. That said, writing puts on Glaxo is a good income strategy unto itself, and we may increase our allocation later to write puts.

Please post any questions on the GlaxoSmithKline discussion board.

We will make this trade in the next two to 30 days.

Adjusting Put Intent on GrafTech International

Published Feb 16, 2010 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") June $7.50 puts (ticker +GTIRU) for the second 2% of our 4% if we get the shares
- **Option's bid/ask:** $0.75/$0.85
- **Initial limit price:** $0.75 or higher
- **Minimum limit price if necessary:** $0.60
- **Special note:** If you don't own 2% yet, we still recommend you buy shares today. If you've matched our 2% stake already and are not writing puts, consider a limit order near $7 for another 2%.
- **Alternate option trade:** You may write the September $7.50 puts (ticker +GTIUU), recently priced at $1.25/$1.40.
- **Why write puts:**
  - The $7.50 puts expiring in less two months pay a 10% premium.
  - GrafTech management expects customer orders to improve in the second half of 2009.
  - The stock looks inexpensive, which is why we also own shares.

What's New

When we announced on March 31 that we intended to write June $5 puts on **GrafTech** (NYSE: GTI) for about a 10% payment, we were smiling. Alas, our hopes were dashed as the stock jumped from $6.16 to $7.60 over the next two days — and it hasn't looked back since. Fortunately, we own some shares already. But now that those $5 puts bid a paltry $0.10, we need to look elsewhere (as we had to in February, when we adjusted our **Plum Creek Timber** (NYSE: PCL) covered call trade) to get a worthwhile option payment within our 30-day trading window (by April 30). Luckily, we still see opportunity.

Although they have a much higher strike price, the June $7.50 puts also pay a 10% premium and would net us an attractive buy price of $6.75 if we get the shares. So, we will pony up to Mr. Market and attempt to make this updated trade before *Pro*'s mandated deadline on April 30 — which is also the date GrafTech announces quarterly earnings.

If you already wrote the June $5 puts, you can close them early if you'd like, for a recent $0.20 (a 50% to 60% profit), and join us on this new trade; or you could let them expire, which currently appears likely (commissions should play a role in your decision). Both are good positions. If you have questions on our adjusted trade or options on GrafTech in general, please visit our GrafTech board.

Monday Memo: Win With Pro's Proven Strategies (and a Contest!)

Published Feb 16, 2010 at 12:00AM

Get Started in 3 Steps

Step 3: Become an Options Pro: To help generate returns no matter what the market does, *Pro* uses dependable, repeatable options strategies based on a Foolish understanding of the underlying businesses. In Step 3, watch our options tutorials, learn two of our favorite strategies, and see one trade you can make today.

Congratulations! You've completed all three steps. Next, come tell us why you're here on our Meet & Greet board and explore our handy list of resources to round out your experience with us.

Update on Abercrombie

Same-store sales declined again for **Abercrombie & Fitch**, but today's results still sent the stock higher. With our bear put spread on Abercrombie set to expire as a loss on Friday, we'll let our $27 puts expire for the full gain and sell our $34 puts — if we can capture a little value (and if so, we'll send you a trade alert). Once we've fully studied today's earnings release, we'll decide whether to invest against this pricey retailer again.

Note: Along with our Abercrombie options, on Friday our covered calls on **ProShares Short S&P 500** will expire as a cash gain. We'll consider new covered calls soon.

Upcoming Earnings

- Feb. 17: **AmTrust Financial Services**
- Feb. 22: **Quanta Services** (NYSE: PWR)
- Feb. 23: **GrafTech International**, **Autodesk**, **Medtronic**, **Expeditors International**
- Feb. 24: **Flowserve**, **Cameco**

Mother Nature fooled the Fool last week, as a record-breaking snowfall forced the closure of our Alexandria, Va., headquarters for four days. But now that we've dug out and defrosted, *Pro* is ready to get back to the steady (and Foolish!) investing you've come to expect from us, with plenty of new trades in the wings.

We're planning our next moves in one of the most uncertain times investors have ever known. More than ever, *Pro* Fools are asking us, "What do you make of this market?" and "What's next?" These are excellent questions. Never before has there been such calamity in the U.S. economy. The problem isn't just unemployment — the outlook remains troubled for housing, the auto industry, the entire financial sector, manufacturing, and now, our government's debt.

Be Contrary

But there *is* a ray of sunshine among the gloom. With the world on pins and needles, the best stocks are attractively priced — so patient, contrary buyers of strong companies should land respectable returns. If everything was moving along at a nice clip, we'd be paying a dear price for stocks — and we'd face soggy returns in the years ahead. The best part? We're still near rock bottom as far as market confidence is concerned, so we merely need the global economy to improve incrementally for investment outlooks to improve.

Be Patient

That doesn't mean returns will be easy or immediate. When Fools ask what I think about the coming years for the stock market, more and more, I'm reminded of how I felt in 2000 and 2001. Back then, I didn't expect decent returns because valuations were so high. Today, valuations are more reasonable — but I don't expect the U.S. economy to recover quickly or without setbacks, so stocks may stay in a range. And that's fine with us.

Audio Extra: Todd Chats With Chuck

In our latest Audio Extra, *Pro* analyst Todd Wenning talks with legendary money manager Chuck Akre in an exclusive *Pro* interview. Pull up a chair as Akre discusses the magic of compounding, fighting investor ignorance, bank stocks, and more. Click here to listen in.

Your Free Gift: *Motley Fool Masters*

Your free educational course with Tom Gardner is now available! Learn how to uncover great businesses in this five-step video series. Watch the introductory message from Tom and Jeff, or jump right in by visiting the *Masters* website here.

Why? Although the "oughties" was an awful decade for equities (the S&P 500 fell by more than 20%, excluding dividends), the income strategies that we use in *Pro* did perfectly well over the period. What's more, by being a patient investor and buying companies with proven business models; strong, recurring free cash flow; sustainable competitive advantages; and selling them at reasonable prices, I was relying on an enduring strategy — so most of the stocks that I owned over the past decade did well, too.

Stay Focused

At *Pro*, we'll continue to buy companies that we believe will create long-term shareholder value, including **Kinetic Concepts**, **AmTrust Financial Services**, and **GrafTech International**, and we'll use options strategies — including shorts and hedges — to generate near-term returns and income. Working together, these strategies performed well over the past decade despite two market bubbles and record-poor index returns; in this decade, they should do even better.

In closing, whenever you saddle up to your computer and check in on our investments, remember to think in terms of months for your options, and years for your stocks — and we'll have an enjoyable time as we continue to build value through the ups and downs. To new members, we hope that you're getting comfortable with *Pro*! We're here to help each step of the way, so continue to ask questions on the Getting Started board.

Invest well,

Jeff Fischer (TMFFischer)

Jeff owns shares of AmTrust Financial Services.

Around the *Pro* Community

- Member BrokeInTheBurgh asks fellow *Pro* members how to make the most of life while still investing well — a Foolish question indeed.
- spinningwood suggests that Goldman Sachs is the face of evil, helping Greece destroy its balance sheet.
- Are you writing puts or covered calls on **Autodesk**? Jeff discusses why we recommended these trades, and how investing is never perfect.
- In response to last week's Memo, Fools around the globe discuss the Tao of *Pro*.
- This Week in CAPS: Russell highlights the most-pitched stocks in CAPS.

Contest: Invest With Us and Win a Free Year of *Pro*!

The best way to succeed with *Pro* is to invest alongside us — and in our latest contest, we're rewarding you for doing just that. On March 1, 2010, at 11:59 p.m. ET, any *Pro* member with three or more active *Pro* stock or ETF holdings in My Scorecard will be entered into our random drawing to win a free year of *Pro* (valued at $1,999).

It's easy to enter: Just visit *Pro*'s Portfolio page and click "Add" in the "I Own This Stock" column next to any *Pro* stock or ETF you own. You must have at least three active *Pro* holdings to be eligible. If you already have three or more active *Pro* holdings in My Scorecard, you'll be automatically entered in the drawing for the prize.

We'll choose one winner at random and announce the lucky Fool in the March 8 Memo. For the complete rules and to ask any questions, please see TMFAllyzay's new post on the Memo Musings board. Good luck!

Audio Extra: Todd Checks In With Chuck Akre

Published Feb 16, 2010 at 12:00AM

Welcome to our latest Audio Extra, *Pro* Fools! Before the D.C. area got three feet of snow dumped on it, *Pro* analyst Todd Wenning recorded an interview with Chuck Akre, manager of the Akre Focus Fund (AKREX) and longtime friend of the Fool. If the name sounds familiar, it's because Akre's investment approach was the inspiration behind the Jan. 5 CAPShot report. Listen below as Todd asks Chuck about the U.S. market, the beauty of compounding interest, and the benefits of patient investing. Can't get enough of Chuck? You can read his most recent letters to shareholders by clicking here.

Here's a breakdown of the audio:

3:00 – Chuck talks about the importance of finding “little compounding machines”

7:21 – How Chuck maintains his long-term, low-turnover focus in a hectic market

9:47 – Why the U.S. is the “least worst” place to invest today

13:54 – What are the best sectors for the next decade?

15:03 – Are banks a good buy right now?

Just click on the player below to listen in!

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Todd owns shares of Akre Focus Fund.

Introducing Motley Fool Masters

Published Feb 15, 2010 at 12:00AM

Welcome to *Motley Fool Masters* with Tom Gardner! As part of our promise to deliver high-quality investment education to you, we've granted all *Motley Fool Pro* members free access to this exciting new video series from The Motley Fool's co-founder. The Fool's first comprehensive business evaluation course, *Masters* is designed to improve your investing skills and help you uncover the next great business in five steps.

Before you begin, learn more about *Masters* by watching the special introductory message from Tom and *Pro* advisor Jeff Fischer below. Then, click the link at the bottom of this page to reach the *Masters* website and start your learning journey.

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Ready to begin? Access *Motley Fool Masters* right here!

Buy Shares and Write a Covered Strangle on Tupperware

Published Feb 9, 2010 at 12:00AM

At a Glance

Trade summary: We're buying a half-position in Tupperware (2% of 4%), writing covered calls on it for income, and writing puts to potentially buy our second 2% at a lower price, generating more income. A covered strangle provides a wide range in which to profit. If you don't want to buy Tupperware today, you can just write puts.

- **Action**: Buying 2% of Tupperware and setting up a covered strangle: Writing ("sell to open") July 2010 $50 covered calls, recently $2.10, and writing July 2010 $40 puts, recently $2.15, representing another 2%.
- **Allocation**: 2% of 4% (for *Pro*, 500 shares and five contracts of each)
- **Preferred limit price**: Enter a "strangle order" for a net credit of $4.25 or better. If your broker requires separate transactions, write covered calls and then write puts for this amount or more, combined. Later, if necessary, aim to accept no less than $3.80.
- **Alternate trades**:
  - **Don't want to use options?** Aim to buy 2% of Tupperware around $40.
  - **Can't write puts?** Buy 2% to 4% of Tupperware and write July 2010 $45 covered calls, recently $4.
  - **Don't want to buy Tupperware now?** Write April 2010 $40 puts to potentially buy shares near $39; or, write July $40 puts to buy shares near $38.

What's New

"One word: Plastics."

The Graduate was on to something. The economic downturn has been a boon for leading plastics monger **Tupperware** (NYSE: TUP). In fact, you might say last year was downright Tupp-tastic: The company expanded its sales force as the unemployed sought new work, grew its customer base as people stored more food to save money, and generated record sales in emerging markets and Europe. In fact, results were so strong that the stock price now sits comfortably above Tupperware's 2007 high — when the market last blew its lid. Yet we still believe this valuation is reasonable.

When our January 2010 $40 puts expired as cash, it was the second time our put-writing endeavors resulted in income rather than shares. We're happy for the durable, dishwasher-safe income, but we had underestimated the stock's potential and still believe there's upside left in Tupperware. Thanks to last year's 165% pop in free cash flow, the stock now trades at 13 times free cash flow, much cheaper than when we first wrote puts (25 times 2008 results).

We believe these free cash flow gains are sustainable. What's more, management projects sales growth of 6% to 8% in 2010 (in local currency), and 9% to 12% earnings-per-share growth (the average estimate calls for 14%). With shares trading around $45, the stock fetches a reasonable 12.7 times this year's earnings estimates. Our new estimate of fair value reaches to $50, or about 15 times both EPS estimates and likely free cash flow. Put it all together, and it's time to buy some shares of Tupperware with help from our old friend, the covered strangle.

Why This Strategy

Although Tupperware is doing well, we remain defensive as we invest new funds. As government stimulus wanes, it's uncertain how well global economies will fare on their own or how the stock market will react. This covered strangle allows for ample upside over the next five months, while also providing income and downside protection even if Tupperware stays flat or falls nearly 10%.

We know that as rosy as the plastics future appears, cracks can occur where you least expect them. If the dollar strengthens, it will dampen Tupperware's overseas profits and could threaten earnings estimates. If the job market rebounds, Tupperware could lose part of its sales staff to salaried positions elsewhere, potentially denting sales. Meanwhile, further economic weakness and lengthy unemployment woes would likely continue to benefit Tupperware.

How to Follow Along

If you're ready to strangle the plastics purveyor, buy a half-position along with us — use a "strangle order" with your broker (if you can) to buy shares in lots of 100 and write ("sell to open") covered calls on them (one per 100 shares); you'll also write puts to potentially buy your second slug of plasticky goodness cheaper.

If you only want to buy the stock or partake in one leg of this trade (write puts *or* buy shares and write covered calls), you can do that instead. Please see our alternate trades above.

For our strangle, the numbers shake out like this:

- **Recent share price:** $45
- **Recent options bid/ask:** July $40 puts, $2.00/$2.30; July $50 calls, $2.05/$2.25.
- **Total option income**: $4.25 per share (splitting the bid/ask prices)
- **Effective options yield**: 9.4% of share price in 5 months
- **Potential second 2% buy price**: $35.75 (21% lower)
- **Average buy price if we get all shares**: $40 (11 times earnings estimates)
- **Potential sell price on our first 2%**: $54.25 (21% higher)
- **Option income range:** $35.75 to $54.25
- **Get on the income train:** If the stock trades anywhere between $40 and $50, the options represent pure income.

Pro will make this trade in the next two business to 30 calendar days. To discuss or ask questions, please pop on over to the Tupperware board.

Monday Memo: Is Warren Buffett a Taoist?

Published Feb 9, 2010 at 12:00AM

Get Started in 3 Steps

Step 2: Invest With *Pro*: Now that you learned how to make *Pro* work for you in Step 1, it's time to get invested along with us. To find out which stock we recommend you buy today, just click here for Step 2!

Coming up next week: *Step 3: Become an Options Pro*

Upcoming Earnings

- Feb. 16: **Abercrombie & Fitch**, before the market opens
- Feb. 17: **AmTrust Financial Services**
- Feb. 23: **Autodesk**, **Expeditors International**, and **GrafTech International**

Next Week

Please note that the next Monday Memo will be published on **Tuesday, Feb. 16,** in observance of President's Day.

The Taoist concept of *wu wei* is about natural action — knowing when to act and when *not* to act. Literally "non-doing," the principle of wu wei is found in the martial arts disciplines of aikido and judo, where the goal is to use an attacker's force to the defender's advantage. The ancient Chinese military strategist Sun Tzu preached wu wei in *The Art of War*, advising men "to avoid what is strong and to strike at what is weak."

Separating Yin From Yang, *Pro*-Style

Motley Fool Pro might not be engaging in hand-to-hand combat, but we know how to use the market's emotions to our advantage. Warren Buffett's famous quote, "Be fearful when others are greedy and to be greedy only when others are fearful," whether intentional or not, is quite Taoist in principle. In essence, the Oracle of Omaha is saying that the key to long-term investing success is to avoid what is temporarily strong and buy what is temporarily weak.

To illustrate, let's hop in our Delorean and set the flux capacitor to Feb. 8, 2000. The St. Louis Rams had just won the Super Bowl, boy bands ruled the airwaves, and "new economy" technology stocks were all the rage. Meanwhile, industries like energy, railroads, and machinery were largely ignored and written off as antiquated.

Looking back, it seems obvious what investors *should* have done — the Nasdaq is still down more than 50%, while the **Vanguard Energy Index** (VGENX) fund is up 180% — but in 2000, the choice wasn't so simple. At the time, crude oil was just $27 a barrel, and with other commodities also under pressure, demand for industrial products and services was quite low. These gloomy fundamentals, in contrast with the allure of promising new technology, made it *psychologically* easier for investors to buy, say, Pets.com over **Caterpillar**. It may have been the easy choice, but it wasn't the right choice. Again, buying what was temporarily weak would have been the better investment in the long run even though it was the harder decision to make.

Be a Contrary *Pro* Fool

If *Pro* is to achieve its lofty goal of 75% accuracy, it's imperative that we keep a year 2020 perspective and use the market's short-term swings in 2010 to our long-term advantage. In our first 18 months at *Pro*, we've tried our best to be contrary investors in the face of a bumpy market — for instance, buying stakes in **Vanguard Emerging Markets**, **Plum Creek Timber**, and **GrafTech International** in late 2008; **Autodesk** in March 2009; and **FPL Group** while it's battling a weak Florida economy. Not every investment will be a winner, but if we consistently invest in strong businesses that are temporarily out of favor, over time we'll be in a strong position to achieve our goals.

Do you have a wu wei story? Tell us about a time you bucked a market trend either by acting or *not* acting on our Memo Musings board.

Fool on!

Todd Wenning (TMFPhila)

Earnings Action Roundup

By Jeff Fischer (TMFFischer)

Kinetic Concepts believes hospital spending will stabilize and anticipates 8% to 12% earnings per share growth in 2010, to about $4.40 per share; that means the $39 stock trades at only 8.8 times expected earnings. With nearly $300 million in free cash flow last year, KCI is paying down debt and expects to start selling its products in Japan this year. KCI remains a Buy First stock; it's also attractive for writing ("sell to open") puts.

Plum Creek Timber continues to defer wood harvests, but it expects stability in lumber prices and an upward trajectory this year. The company cranked out $540 million in cash flow from operations in 2009, and provided guidance for 2010 that was greener than the average analyst estimates. The stock is near our preferred buy price of $34, has a hefty 4.6% dividend yield, and remains a strong stock for earning option income, too — so expect more options trades on it from *Pro*. If you don't own Plum Creek, you can write ("sell to open") puts to potentially obtain a lower buy price, or be paid well if not.

Procter & Gamble is finding its footing and gaining traction in today's economy, capitalizing on its brands and wide distribution, launching new products, and making headway in emerging markets. With more than $3 billion in free cash flow last year, management expects more than $4 in earnings per share in the new year. This puts the $61 stock at 15 times expected earnings, while yielding nearly 3% in dividends. Shares remain a long-term, core Buy.

GlaxoSmithKline reported strong growth in the fourth quarter and increased its already-sizeable dividend by 7% for a total annual yield of more than 5%. For the year, free cash flow surged 12%, to $8.4 billion, which means shares of the $100 billion British drug leader are trading at an inexpensive 12 times free cash flow. Led by a young CEO who is pushing the company into growing emerging markets, Glaxo remains a Buy First stock.

Jack Henry & Associates posted flat organic sales, but its backlog improved 14% over last year as the banking software company with strong recurring revenue waits for improvements in the beleaguered financial sector. Results remain solidly profitable, the shares remain a Buy, and the stock trades in our preferred buy range.

Community Highlights

- New member **mikemacf11** asks about protection from a downturn, and Jeff responds.
- Patience goes a long way: If you're a new member, and the market's got you down, read this.
- Health care stocks — including **Kinetic Concepts** — have caught a cold because of market fears surrounding the health care bill. Get *Pro*'s take on the resulting opportunity.
- **Alex340** posts options trades meeting *Pro* criteria.
- New member **limitedtime** shares his first sure steps with *Pro*.
- The recent market decline shouldn't change your steady approach to building a *Pro* portfolio to earn profits in up, flat, and down markets. We're preparing for a new market (with more volatility), and Jeff shares that all is good.
- The Fool is still being affected by extreme weather. Thank you for understanding!
- Did you like the covered strangle strategy on **Intel**? You can do the same type of trade on **Expeditors International**. Just keep in mind that Expeditors announces earnings on Feb. 23.
- **TMFEldrehad** takes a look at five ice-cold 1-star stocks in CAPS.

Write Covered Calls on Autodesk

Published Feb 4, 2010 at 12:00AM

If you don't own shares of Autodesk yet, you can still make a trade on this stock today. See "Alternate trades" below.

- **Action:** Write ("sell to open") July 2010 $24 covered calls on Autodesk
- **Allocation:** Write one call for every 100 shares of Autodesk owned (for *Pro*, 24 contracts)
- **Option's recent bid/ask (Feb. 3):** $2.05/$2.15
- **Preferred limit price:** $1.85 or higher, day order; if needed, no lower than $1.70
- **Recent stock price:** $23.70
- **Special requirement:** You must own at least 100 shares of Autodesk to write a covered call.
- **Alternate trades:**
  - **Don't own 100 shares of Autodesk?** Continue to hold your position.
  - **Don't own any shares of Autodesk?** The stock is on Hold, but you can write ("sell to open") puts to potentially buy shares at a lower price. The July 2010 $22 puts recently bid $1.45.

What's New

Autodesk sells its 3-D design software by the "seat" — one subscription per user — so weakened employment in construction, engineering, architecture, and technology means weaker sales for the company. Yet the stock is trading at a premium — and not because investors are still gaga over the role of Autodesk's software in the *Lord of the Rings* trilogy. Shares are priced at an aggressive 35 times depressed free cash flow and 22 times estimated earnings for the year ahead because investors project that Autodesk's high margins and free cash flow will return once the economy gains some real ground.

But so far, companies aren't hiring. Despite increased government stimulus in fields related to Autodesk, we'll likely need to wait at least a few more quarters before customer numbers start to improve. That means the dire jobs situation may continue to push Autodesk's recovery farther down the road. Although *Pro* has done well with Autodesk, enjoying a nearly 50% profit in less than a year (we've had the stock on Hold since the summer), given the stock's valuation and the weak jobs picture, we want to hedge our gains with covered calls.

What's a Covered Call?

- Check out *Pro*'s guide to covered calls.

We write covered calls when we're ready and willing to sell a stock we own at a higher price (the strike price) by our options' expiration date. Or, if the stock doesn't rise to our strike price by expiration, we keep our shares, and may write covered calls again, generating more income.

Why This Strategy?

Based on the current malaise, Autodesk's complete rebound could take many more years — but by writing covered calls, we're paid while we wait, or we obtain a favorable sell price in much less time. Our fair value estimate of the stock is in the mid $20s to low $30s, but that assumes Autodesk recovers about three-fourths of its former glory (measured by sales and free cash flow). Instead of waiting for that rebound, we'd be happy to sell the stock in the mid $20s and take our profits, earning most of our gains in much less time *and* with less risk, since the calls provide a hedge.

Meanwhile, if our shares aren't called away, we cushion our downside. The July 2010 $24 calls on Autodesk will yield us 8.6% (at a recent $2.05 per share) on the recent share price of $23.70, or 12.5% on our average purchase price on the stock. By choosing calls that expire in less than six months and have a strike price modestly above Autodesk's current share price, we are paid well on an absolute basis and better protected if the stock declines. We could write April 2010 calls instead, but if Autodesk declines in the coming months, we'll enjoy a much lower absolute payment compared with the July calls. The July calls also provide us with a higher potential sell price — and more than a year-long holding period on all of our shares.

How to Follow Along

If you need a refresher on covered call strategies, please see *Pro*'s guide to covered calls before placing the trade. Remember, you write one call for every 100 shares of stock you own; and you may cover all of your shares, or just some. We're covering all of ours. Here are the numbers behind the trade:

- **Trade:** Write ("sell to open") one July 2010 $24 call for every 100 shares owned
- **Option yield (at recent $2.05 bid):** 8.6% of the $23.70 share price, in 5.5 months
- **Option yield on our $16.36 average cost basis:** 12.5%.
- **Upside from today if sold at a net $26.05 ($24 strike plus $2.05):** 9.9%
- **Total return on position if exercised:** 59.2%
- **Downside protection:** 8.6%; a decline to $21.65 is hedged

When you write ("sell") an option, the going price is paid into your account and the money is yours to keep. In this case, you're then obligated to sell shares of Autodesk if they're above the strike price by the expiration date.

Writing puts? If you place the alternate trade and write puts, you'll be obligated to buy shares of Autodesk around a net $20.55 if the stock declines.

We'll make this trade in the next one business to 30 calendar days. To discuss it or ask questions, please visit our Autodesk board.

Buy Shares and Write a Covered Strangle on Intel

Published Feb 2, 2010 at 12:00AM

At a Glance

Trade summary: We're buying a half-position in Intel (3% of 6%), writing covered calls on it for income (and to be defensive), and writing puts to potentially buy our second 3% cheaper, generating even more income. This strategy is called a covered strangle, and it provides a wide range in which we can profit and strong short-term income. Read on for more!

- **Action**: Buying 3% of Intel and setting up a covered strangle: Writing ("sell to open") July 2010 $21 covered calls, recently $0.97, and writing July 2010 $19 puts, recently $1.23, representing another 3%.
- **Allocation**: 3% (for *Pro*, 18 contracts)
- **Preferred limit price**: Enter a "strangle order" for a net credit of $2.20 or better. If your broker requires you to do separate transactions, write covered calls and then write puts for a total payment around $2.20 or more.
- **Alternate trades**:
  - **Don't want to use options?** Simply buy 3% of Intel.
  - **Can't write puts?** Buy 3% to 6% of Intel and write July 2010 $21 covered calls.
  - **Don't want to buy Intel yet?** Write July 2010 $19 puts to potentially buy shares near $17.77.

What's New

Pro first bought shares of computer chip behemoth **Intel** (NASDAQ: INTC) and wrote covered calls on it in October 2008, when the stock traded near $16. Intel has gained 23% in the 15 months since, as major economic uncertainty has faded and the outlook for the company has brightened. The company's dominant market share, improving results, reasonable valuation, and size — which makes it unlikely to soar or fall sharply — make it an attractive candidate for generating option income. Although *Pro* hasn't had a position in Intel since last summer, we're aiming to profit from the stock again today.

Last quarter, the company reported a record gross profit margin and strong demand, although sales were in part driven by restocking bare-bones inventories. Still, management predicts revenue will remain strong this year as consumers upgrade to Windows 7 and companies start to refresh aging computer assets. Research group Gartner estimates that commercial PC sales will grow a robust 10% in 2010 and another 13% in 2011, an encouraging sign in a still sluggish economy. Valuation-wise, Intel should face limited downside. The stock trades at 12 times expected 2010 earnings per share, free cash flow is growing, and this year the company's bottom line is expected to double from recent lows, followed by further 10% growth in 2011.

Why This Strategy?

Tip: Get to Know the Covered Strangle

Never strangled a stock before? It's fun! Here are the basics:

- Buy half a position in a stock you want to own
- Write covered calls on the stock for income and to be defensive
- Write puts to potentially buy your second half cheaper
- The two key benefits are strong near-term income and a wide range in which to profit.

Stability is the key for our covered strangle strategy, and Intel's low valuation relative to its expected earnings growth increases our margin of safety and odds for success. A covered strangle involves buying a half-position in a stock you want to own; writing covered calls (one for every 100 shares owned) on that stock; and writing the same number of puts to potentially buy the next half-position at a lower price. The strategy is defensive, potentially generating substantial near-term income even if the stock moves within a wide range, yet attractive, giving us downside protection while still allowing for a profitable exit if Intel's stock goes higher.

How to Follow Along

For *Pro* members new to options, begin with our guides Options 101 (basic intro) and 201 (covered calls). The first piece of a covered strangle is writing the covered call: You're paid to commit to sell a stock you already own if shares increase above your option's strike price by its expiration date. If the stock doesn't increase above the strike price, the calls expire, you keep the option income along with your shares, and you can write new covered calls. If the stock does increase above the strike price, your shares are sold at that price and you keep the option income, raising your total sales price. This is a great way to earn income, especially on stable stocks.

The second piece of a covered strangle is writing puts (Options 301), which pays you for the commitment to buy shares of a stock if it declines to your strike price. The strangle thus allows you to potentially earn income in two ways on the same stock, along with giving yourself a wide profit range.

Here's the math behind the Intel trade (prices as of Feb. 2):

- **Action**: Buy 3% in Intel, recently $19.97
- **Action**: Write ("sell to open") July 2010 $21 covered calls (one for every 100 shares owned), recently $0.97
- **Action**: Write July 2010 $19 puts (one for every 100 shares you'd buy), recently $1.23
- **Total option income**: $2.20 per share (11% of current share price)
- **Potential second 3% buy price**: $16.80 (with July 2010 $19 puts and the $2.20 per share the options paid you)
- **Average buy price if we get all shares**: $18.39 (11 times 2010 EPS estimates)
- **Potential sell price on our first 3%**: $23.20 (with July 2010 $21 calls plus the $2.20 the options paid you) (14 times 2010 EPS estimates)
- **Effective options yield**: 11% in 5.5 months
- **Stock gain if sold via covered calls**: 16% in 5.5 months
- **Option income range:** Any price above $16.80.

Already Bought Calls With *Motley Fool Options*?

If you bought the January 2012 $17.50 Intel call LEAPs along with *Pro*'s sister service, *Motley Fool Options*, you can sit tight on your bullish trade. As you know, you may write covered calls on your call options to defray your cost. Just make sure that you'll end with a profit if your shares are called away.

The option income is equal to nearly 12% of our buy price on Intel; plus, we'll be on track to earn another 0.8% in Intel dividends (1.6% for *Pro* members who buy before the ex-dividend date, Feb. 3) (corrected from original; see our note here). If our shares are called away in July via our $21 covered calls, we'll earn around 16% in less than six months and be selling Intel at a reasonable valuation (factoring in our option income). Meanwhile, as long as Intel trades above $16.80 and below $23.20, we can close our strangle for a gain (and not get the shares involved); and if the stock falls, we'll get shares and can write calls again while we wait for it to recover. If Intel trades anywhere between $19 and $21 at expiration — about a 10% range — both of our options will expire for the full cash gain, and we can set up the trade again.

To sum up: If Intel is below $19, we'll be ready to buy more shares, and if it's above $21, we'll be ready to sell our shares — always keeping the option income. If we decide to close the options early, we'll still keep some of the income *and* our shares. As you can see, writing a covered strangle gives us plenty of room to breathe easy — and profit.

If you have questions about Intel or this trade — and the many alternate trades available to you above — please post on *Pro*'s Intel board.

We will make this trade in the next two to 30 days.

Monday Memo: Don't Lose Your Edge

Published Feb 1, 2010 at 12:00AM

Get Started in 3 Steps

Step 1: Get to Know *Pro*: Welcome, new members! As you begin with us, just follow our 3-step plan. In Step 1, let us show you how to use our site and service, how to make *Pro* work for you in just minutes a month, and how to follow along with us in a way that fits your investing needs. Just follow this link to get started!

Coming up Monday, Feb. 8: *Step 2: Invest With* Pro

New! **Jeff and Todd Go Audio:** Hear *Pro*'s take on 2010 — and the one thing Jeff and Todd believe is the key to successful investing in any market — in *Pro*'s brand-new Audio Extra.

Earnings Ahead

- Feb. 1: **Plum Creek Timber**
- Feb. 2: **Jack Henry & Associates**
- Feb. 4: **GlaxoSmithKline**

Tip: Buying During Earnings Season

As you continue to build your *Pro* portfolio, keep in mind that stocks can be especially volatile around earnings news. *Pro* will likely buy more shares of some of our companies after earnings season, since quarterly reports impart new information. Watch this sidebar every Monday for the next *Pro* companies to report.

If you believe the economy is going to improve over the next three years (as we do), then a down market this year would be a blessing. It would offer Foolish investors like us more opportunities to buy strong stocks at a discount — and ample room to make money with options and shorts. This means *Motley Fool Pro* is preparing for a busy February as we adjust our portfolio for the new market and welcome the challenges ahead.

Here's how we believe the timeline will likely play out. Like most investors, we weren't surprised to see the market bounce back after 2008's drubbing (although the magnitude of the bounce was surprising). And for a while, we've expected the market to give back some of these gains — which seems to be happening right now. Later, we expect stocks to settle into a range, allowing us to average in to our favorite stocks and generate steady options income as we have from the start. In the quarters and years to follow, our stocks should steadily grow value, too. What's not to like?

Stick to Your *Pro* Knitting

Together, we can approach these possibilities with confidence by focusing on *Pro*'s overarching goals: to close at least 75% of our positions profitably (we're above 90% now); to earn strong total returns with less risk and volatility than average; and to generate gains in up, down, and flat markets, compounding value over time.

If you just joined us, this is a great time to take stock and get started with your *Pro* portfolio. For veteran members, it's an important time to better position your portfolio for 2010. Whether you want long-term capital gains, consistent near-term income, portfolio protection, or all three, *Pro* strategies can help you reach your goals.

Don't Get Investing Brain Freeze

As you work toward these goals, remember that there are some things in life you don't want to rush: eating ice cream, a marriage proposal — and of course, investing. We're going to announce several new trades this month, but take your time, read our reports, and only move forward when you're comfortable. Investing isn't a race. It takes years for most of us to *earn* our money — so we should invest it with care.

Patience goes hand in hand with *Pro*'s current defensive stance. We have ample cash and expect some downside volatility, so we're buying our stocks *gradually*. For most of our existing positions, we aim to average in further if better prices come along. We're also writing puts to potentially buy some stocks more cheaply. So, as you purchase our Buy First and Buy stocks, take partial positions to start, aiming to buy more over time. If you'd like to hedge your portfolio, open a position in **ProShares Short S&P 500**, an ETF that moves inverse to the index — and stay tuned, because we plan to have more hedges ahead.

Learning Options

Upcoming *Pro* options trades will include links to *Pro*'s appropriate options guide so you can understand clearly what we're doing. You don't need to use options to make *Pro* profitable for you, but I've used them for almost 10 years and can confidently say that they're an excellent investing tool. Finally, remember that *Motley Fool Options* is a separate service from *Pro*, and its options trades and weekly commentary are not related to the *Pro* portfolio.

Gearing Up for a Profitable 2010

The weeks ahead will be busy, Foolish, and fun for you as a member of *Pro*. And as a community of investors, we have plenty of time to grow value together. We appreciate all of the help that seasoned *Pro* members are giving to new members in the *Pro* community — thank you! For new members who have questions about IRAs, what to do with your existing holdings, how our trade alerts work, and more, please see our Q&A below covering these topics. Don't forget to see the sidebar for important dates and more, and visit our Getting Started board with your questions.

To new members, we look forward to showing you a new way to invest in 2010. To veteran members, we thank you for being with us during these fascinating times — times which are sure to continue!

Foolishly,

Jeff Fischer (TMFFischer)

Q&A: Getting Started

1: When does *Pro* announce its moves?

First, we announce our trades — about four to six per month — before we make them ourselves. You'll get these "Make the Trade" emails at any time during normal market hours along with a link to details on the reasoning behind our trade. Then, in the following two to 30 days (for stocks and ETFs) or one to 30 days (for options), we'll make our actual trade and send you a "Trade Complete" email at market close (4 p.m. ET) that day. We preannounce our trades so you can invest before us if you wish.

- **Tip:** Only when you get the "Trade Complete" email is the position added to *Pro*'s real-money portfolio. At that time, you can see our start price, commissions, and other trade details on either the Portfolio page or on the stock's History tab.

2: What do I do with my losers?

If, like most Fools, you already own an array of stocks and want to sell some to buy *Pro* stocks, move gradually. We don't recommend going all to cash at once; instead, sell your least favorite stocks when you need funds to buy *Pro* stocks and ETFs you like better.

- **Tip:** If you own stocks recommended by other investment services and need to sell some, first sell those that are not core holdings or recent recommendations. And sell those you simply like least.

3: How quickly should I get invested?

All of our holdings that are rated "Buy First" and "Buy" on the portfolio page can be bought at will; we believe in all of 'em. But in this volatile market, we also believe you should gradually average into anything you're buying. In fact, *we're* still in the process of averaging into most of our holdings — so we're patiently investing right alongside you.

- **Tip:** Take your time and don't sweat price swings — we'll let you know if something is no longer attractive. Keep in mind that you're also learning option strategies you can use to buy our stocks more cheaply down the road.

4: What is a "preferred buy price," and how firm is it?

All of our trade reports (the tab labeled "What We Think") on stocks include a preferred buy price in the "At a Glance" section atop the report. However, paying modestly more won't make the investment a poor one. The preferred range is an *ideal*.

- **Tip:** Also look at our fair value estimate for any stock (in the "At a Glance" section) and use that to help you determine whether the current price is attractive enough for you.

5: Can I make options trades with an IRA?

Most likely. Many IRAs will allow you to buy options and write covered calls, and some will let you to write cash-secured puts. Ask your broker.

- **Tip:** Writing options is an especially savvy IRA move, since the income you generate is tax-free.

6: Should I make the options trades that are already in play?

Option trades are timely and opportunistic even when you use them strategically in relation to an underlying stock, as we do. Thus, new *Pro* members should typically wait for new option trades from us in order to get started. We'll have our first new option trades in a matter of days, so if you're ready to jump in (if not, that's fine — keep following along with our 7-step plan!), make sure your brokerage account is approved for options trading (and brush up with our how-to video). Ask your broker for options permission — typically, level two or three is ample. For now, you want to be able to buy calls and puts, write covered calls, and write cash-secured puts.

- **Tip:** Each option trade we announce (with a "Make the Trade" email) will clearly explain the trade we're going to make and how you can follow along.

7: What can I expect as I start to trade options?

Profits can arrive regularly with options, but remain patient as you get started. A few months into this new way of investing you're going to realize that these strategies are available to you the rest of your life — and they're "renewable," so there are always new option opportunities. The key is to find great businesses, at fair prices, and use what you know about them to put together sensible options strategies. (And of course, we're here to help you with that.)

- **Tip:** When writing options, let them be your shorter-term ATM machine; let the stock be your retirement-minded holding.

8: What is the meaning of life?

OK, we can't help with that one today. But the name of the game here at *Pro* is all about working with what the market hands us. We *welcome* a fair amount of volatility. It allows us to buy shares more cheaply and use more lucrative option strategies. For investors who know businesses well, price volatility presents opportunity.

Audio Extra: Jeff and Todd Tackle Your Top Questions

Published Feb 1, 2010 at 12:00AM

In the newest Audio Extra with the *Motley Fool Pro* team, Jeff Fischer and Todd Wenning sit down with *Pro* teammate Jill Ralph, answering her questions about what they believe is in store for investors in 2010. Not surprisingly, Jeff and Todd are excited about the year, whether the market decides to speed ahead or stall a bit. To hear why — and the one thing they believe is the key to successful investing in any market — grab your earphones or turn up your speakers, and enjoy *Pro*'s latest Audio Extra.

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Have another question for the team — or just want to let us know what you thought about this Audio Extra? Weigh in on *Pro*'s Member Suggestions & Help board.

Buy Quanta Services

Published Jan 27, 2010 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Price when we released our original intent:** $18.40
- **Estimated fair value:** $26
- **Preferred buy price:** Below $20
- **Type of holding:** Core; Energy infrastructure
- **Alternate trades:** Write ("sell to open") puts that pay at least 4% of your strike price to potentially buy shares at a lower start price — right now, you can consider March 2010 $17.50 puts, recently bidding $0.70.

The Big Picture

Have you grokked the grid lately? Aging, polluting, and overtaxed, much of the power network in the U.S. is in dire need of an upgrade, especially as renewable energy and natural gas become more integral to the equation. Now, as the recession eases and stimulus money is put to work on infrastructure projects, **Quanta Services** (NYSE: PWR) is positioned to benefit.

With a market value of nearly $4 billion, Quanta is the world's largest builder of power transmission lines. Delivering solutions for electric power, renewable energy, and natural gas, the company helps power plants deliver energy from source to customer, upgrades transmission systems, and maintains power networks. Quanta also works with fiber optic, telecommunications, and broadband networks. The company is poised to grow as America invests in both its power and communication grids, leading our network into the 21st century.

Power to Expand

Get Personal With Quanta

- **Headquarters:** Houston, Tex.
- **CEO:** John Colson, since 1997; 62 years old
- **2008 revenue:** $3.7 billion
- **2008 net income:** $166 million
- **Employees:** About 14,000
- **Revenue per employee:** $270,000
- **Scope of operations:** North America

According to J.P. Morgan, spending on transmission projects is on track to double from 2008 to 2012. Combine that growth with new, stimulus-driven renewable energy projects, and you can see why Quanta expects its hydro, solar, and wind power revenue to triple this year, driving nearly $300 million in 2010 sales. But it's not just stimulus money at the wheel. The U.S. has voiced a commitment (via the American Clean Energy and Security Act (ACES) and the American Recovery and Reinvestment Act (ARRA) in 2009) to focus on alternative energy, a smart electricity grid, and broadband — all pieces of Quanta's operations. Tens of billions of dollars are earmarked for alternative energy projects, while $11 billion has been set aside to upgrade the energy grid and another $7 billion for broadband initiatives.

What's more, a large portion of the stimulus bill is going to rebuilding and repairing infrastructure — about $30 billion for highways, bridges, and airports — which usually requires removing and replacing transmission lines of all types, further putting Quanta's skills to good use. Following a drop in revenue in 2009, management expects double-digit sales growth across its entire power transmission business this year — and impressive growth should continue in the years ahead.

The Business of Transmission

Community and CAPS Insight

Quanta scores a perfect 5 stars on CAPS, with 100% of All-Stars rating it "outperform," putting the stock in the top 1.4% of all stocks rated on CAPS (it's also the top-ranked company in Construction and Engineering on CAPS). On *Pro*'s proprietary CAPShot, the company earns a respectable 7 of 12, missing on the margin and return on equity criteria. The business has lower margins than we usually seek, but it's strong enough in other areas (including growth and balance sheet) to compensate.

Quanta splits its end-to-end network and transmission businesses into four areas of expertise.

Electric Power Infrastructure Services is the company's largest division, comprising 66% of 2009 revenue through September. This encompasses Quanta's work on major traditional electric power transmission networks as well as hydro, solar, wind, and other renewable energy facilities. Repairing networks, especially after outages, provides the company with sporadic high-margin revenue, and though much smaller in scope, the company also handles industrial wiring and cable and control systems for light rail lines.

The Natural Gas and Pipeline Infrastructure Services division (19% of revenue) was given a big boost when the company acquired Price Gregory Services in October 2009. The move makes Quanta one of the largest full-service providers of natural gas solutions in North America and should add nearly $1 billion in profitable annual revenue in the first year alone. Meanwhile, with coal plants continuing to switch to natural gas and government regulations that could cap carbon emissions, business here should only accelerate. In fact, CEO John Colson says, "We haven't been as bullish on the natural gas market as we are today. That's going to spur growth over the next several years."

The remaining divisions are Telecommunications Infrastructure Services (12% of revenue) and Fiber Optic Licensing (3% of revenue). These aren't crucial to our investment case compared with the much larger electric and natural gas divisions, but if broadband initiatives take root, Quanta may benefit here as well.

Financials and Valuation

As you can imagine, the business of designing and building power transmission lines is capital intensive — so Quanta has relatively low returns on capital, free cash flow, and margins. However, it sports a strong balance sheet (nearly $600 million in cash and only $125 million in convertible debt), an industry-leading position, and steady financial discipline — delivering reliable profits. This has given the stock a premium valuation over the past several years.

Quanta's earnings per share is expected to increase by nearly 30% in 2010 as revenue rebounds with help from its $2 billion service backlog. The stock, currently around $18, trades at 19 times estimated 2010 earnings. To value Quanta, we used a discounted cash flow to firm model (valuing the cash left over for suppliers of capital — debt and equity — after the company made its investments) with an 11% discount rate; based on scenarios using varying growth rates, we put a fair value of $24 to $26 on Quanta, or 30% to 40% above the current market price. However, given how large Quanta's contracts can be, if more key deals come the company's way than expected, that valuation could tick even higher.

Meanwhile, our downside risk should be reasonable at today's valuation (and considering Quanta's $5.5 billion backlog as a safety net), and the share price lends itself well to future options strategies.

What Would Make Us Sell

Energy in the *Pro* Portfolio

With partial stakes in **FPL Group** (NYSE: FPL), **Vanguard Energy** (NYSEMKT: VDE), and Quanta, the *Pro* portfolio is starting to have meaningful exposure to domestic energy and utilities. We may manage these three positions together, adding more money to stocks we end up liking best.

Follow-up Action

Options-wise, Quanta may be a good candidate for writing covered strangles in the future — first writing puts, then writing covered calls after some appreciation.

Although maintenance and service agreements provide Quanta with recurring revenue, most large sales are based on one-time contracts. If management consistently fails to win key contracts (*or* execute on them), we may sell. What's more, the industries Quanta serves — namely, utilities and telecom — are highly regulated, dependent on large sums of financing, and cyclical, so results will be lumpy. Market conditions suggest that we're entering an upswing in the spending cycle, but patience is still the watchword. Investments in major energy projects are by nature long term, and projects can be further delayed by government squabbling. *Pro* holding **FPL Group** (NYSE: FPL), for instance, just put $10 billion in capital upgrade projects on hold because Florida's governing body denied most of FPL's desired rate increase. The regulatory environment remains a risk, although it is mitigated by federal stimulus funds coming down the pike. That said, if Washington cuts spending significantly, it could dampen near-term prospects for Quanta, too.

Pro Bottom Line

As the U.S. starts to revamp its energy grid, Quanta Services is in a sweet spot to profit no matter what power source we're talking about — natural gas, oil, or renewable energy. Upgrading and expanding our energy plants and transmission lines will take many years, and the work is not a matter of *if*; it's a matter of *when*. Meanwhile, America also needs to improve and build out its broadband and telecommunications network. With its strong balance sheet, full service solutions, and respected expertise, Quanta's phones should be ringing steadily for years to come.

To discuss Quanta and ask questions, please visit its new board.

Sell Half Your Position in Vanguard Emerging Markets

Published Jan 26, 2010 at 12:00AM

At a Glance

- **Action:** Selling about half our stake in Vanguard Emerging Markets (for *Pro*, about 560 shares; we'll be keeping 600)
- **Guidance change:** Moving from Buy to Hold
- **New target allocation:** 2%
- **Recent ETF price (1/25/10):** $39.74
- **Recent ETF NAV (1/25/10):** $39.68

- **Why we're selling half:**
  - Our thesis that emerging markets would recover more quickly than the U.S. and Europe has borne fruit.
  - We're taking some money off the table in a hot market.
  - The full repercussions of 2009's global stimulus programs remain to be seen, increasing the ETF's risk as programs are reduced.

Alternate Trade

Write ("sell to open") March 2010 $37 covered calls, recently bidding $2.90.

Only Own Half a Position?

Continue to hold if you like. *Pro* is keeping around 2%.

When we first bought **Vanguard Emerging Markets** (NYSEMKT: VWO), we wrote, "When emerging markets recover and start to rally again, foreign equities could become too aggressively valued, driving us to lighten our position or sell our entire stake." We believe that's happened — our shares have gained more than 70% while the S&P 500 has climbed 30% — and now it's time to enjoy our profits and take some money off the table by selling about half our stake.

Today, emerging markets are perhaps *too* hot — but when we first bought this ETF, the story was much different. Months before Lehman Brothers went bankrupt in September 2008 and sank the U.S. stock market, emerging market stocks had fallen sharply; Vanguard Emerging Markets dropped about 65% from May to November 2008. At the time, *Pro* believed that emerging markets would recover more quickly than the U.S. and Europe, so we took advantage of Wall Street fear and opened a position in Vanguard Emerging Markets. The ETF's underlying stocks were trading at an average trailing P/E of just 11, giving us exposure to the world's fastest-growing economies — including China, Brazil, and India — on the cheap. We knew that even if earnings held steady, we'd still be getting a value. Now Vanguard Emerging Markets' average P/E sits at 24, as popularity has pushed shares to a premium.

The Emerging Rebound

Since we bought this ETF, emerging markets have improved — fast. China's $585 billion stimulus kick-started massive infrastructure projects, which increased demand for building materials at such a large scale that they helped revive commodity-rich emerging economies like Brazil (iron ore), Indonesia (coal, rubber), and Chile (copper). Naturally, rosier economic prospects helped propel emerging market stocks. Consider these amazing dollar-adjusted index returns since December 2008:

Country (Index)	% Return (in dollar terms)
China (SSEB)	134.5%
Brazil (BVSP)	148.5%
Russia (RTS)	146.4%
Indonesia (JSX)	133.5%
Chile (IGPA)	100.7%
Argentina (MERV)	101.2%
Turkey (ISE)	119.4%

Data as of Jan. 21, 2010; provided by The Economist.

But just as a shot of espresso in the morning can jolt you into action, *several* shots can give you the shakes and squash your productivity. In recent weeks, emerging economies such as China, Russia, and Brazil have taken measures to rein in rapid growth and avoid outsized inflation, which could lead to social unrest and destabilizing asset bubbles. Knowing when to tap the brakes on an economy and when to give it gas is never an easy task and can lead to mistakes and unintended adverse consequences. We saw what happened when the U.S. economy got too hot — most evident in our real estate bubble — and likewise, the largest emerging markets face the risk of overheating today.

An Overripe Market

Last year, U.S. equity funds were crippled by net outflows of $40 billion. Yet according to EPFR Global, emerging market mutual fund *inflows* hit $80 billion in 2009, beating 2007's previous record by a comfortable $25.9 billion. Such investor enthusiasm for one area of the market gives us pause. What's more, we question the sustainability of such huge inflows. The BRIC markets (Brazil, Russia, India, and China), which captured roughly three-quarters of the $80 billion inflow to emerging market funds, grew from 37% of Vanguard Emerging Markets' assets in 2008 to 49% today. We caught the updraft of the BRIC recovery via the ETF, but any future decline in these countries would hurt the ETF disproportionately.

Meanwhile, emerging market stocks look ready for a retreat. A 2009 study based on decades of data from 53 countries found that stocks in high-growth emerging economies actually underperformed stocks in economies with much lower GDP growth, averaging just 6% annualized gains compared with 12% in developed economies. Valuation is the key: Emerging market stocks deserve to trade at a discount to developed countries because they carry more risk. After trading at a premium, as they do now, emerging market stocks have historically fallen. We don't see why this time would be different. China, Brazil, and other emerging nations still face many more challenges and risks than developed economies.

What's Next

As Mark Twain wrote, "Whenever you find yourself on the side of the majority, it is time to pause and reflect." But selling half our stake in this ETF doesn't mean we won't invest more funds in emerging markets in the future. There are several regionally focused emerging market ETFs that we'd consider at the right price. Additionally, whereas Vanguard Emerging Markets is invested in large caps, we'd like to gain more exposure to smaller companies in the emerging markets realm, especially if the market declines a bit.

Meanwhile, we'll hold about half our stake to help keep our portfolio broadly diversified and allow room for more profits if stocks keep gaining. However, we don't recommend adding new money here at current prices. That's why we're moving Vanguard Emerging Markets to **Hold**. If you're looking to add new money, keep in mind that many of our Buy First and Buy stocks have significant international exposure *and* lower valuations, including **Procter & Gamble** (NYSE: PG), **Graftech International** (NYSE: GTI), **Oracle** (NYSE: ORCL), and **GlaxoSmithKline** (NYSE: GSK).

If you have any questions or comments, please share them on the Vanguard Emerging Markets board.

We will make this trade in the next two business days to 30 calendar days. Jeff owns shares of Oracle, Todd owns shares of Procter & Gamble, and Bruce owns shares of GlaxoSmithKline.

Monday Memo: Get Ready for the New Market

Published Jan 25, 2010 at 12:00AM

Pro Earnings Dates

- Jan. 26: **Kinetic Concepts**, **FPL Group**, **Waters**
- Jan. 28: **Procter & Gamble**
- Feb. 1: **Plum Creek Timber**
- Feb. 2: **Jack Henry**
- Feb. 3: **GlaxoSmithKline**

In the *Pro* Community

- Last week, Kinetic Concepts donated $2 million worth of advanced wound care products to Haitian relief. We applaud its generous donation.
- This Week in CAPS: Russell (TMFEldrehad) checks up on his recent CAPS screens for strong stocks.

Coming Up Next in *Pro*

Along with a steady stream of new trades, we'll soon have a new guide for you, Options 803: Neutral Spreads. Then, stay tuned for interviews with Plum Creek Timber management as well as expert fund manager Chuck Akre.

As new members join *Motley Fool Pro* for just one more day (welcome!), something seems to be rumbling in the market. The whole investing world is wondering whether the U.S. economy is beginning a sustained recovery — or if current improvements just represent a short-term bounce courtesy of Uncle Sam's pockets. But one thing seems clear: As the market enters a new phase, we're going to use a variety of *Pro* strategies to continue to profit.

Right now, two potential fates are battling it out. A recovering economy could provide more lift, sending stocks higher — not out of the question given that the S&P 500 is trading at a middling 15 times expected earnings in 2010 — or, the recovery could falter, sending stocks lower. Given the uncertainty, stocks could stay in a range over the coming months, moving up and down with more volatility than we've seen for almost a year. At *Pro*, we believe this third scenario is most likely, but we want to invest to perform no matter what the outcome.

As *Pro* members have seen from day one, we welcome uncertainty in the market. Buying opportunities arise when prices are sporadic, and we have plenty of cash ready to invest in strong stocks while keeping our risk profile low. Meanwhile, volatility opens the door to better options prices (for option writers) and increased option income. By combining options, shorts, and core stocks, *Pro*'s strategies help generate steady income while stocks are down or flat, and long-term gains as stocks rise. As we like to say, it's the best of both investing worlds.

Buy Stocks, Write Puts

If you're new to *Pro*, or wondering how to adjust as the market changes, our defensive game plan starts with our current Buy First stocks, which offer value, lower risk, and growth. These are the place to start with new money (keep in mind stocks may be more volatile after earnings are announced; see our sidebar for dates). Then, move to our Buy stocks, paying attention to our preferred buy ranges.

Stocks on Hold due to valuation are strong candidates for writing puts in order to buy shares later at lower prices. Writing puts (*not* buying them) is a defensively bullish options strategy that pays you income while you wait for your preferred price range on shares. You sell one put for every 100 shares of stock you'd be willing to buy at your option's strike price. So, among our Buy First and Buy stocks, you can begin to put together or adjust your *Pro* portfolio. When you're ready to use options, you have even more ways to move forward.

Want to Be More Defensive?

Helpful *Pro* Links

- Pro's three-step getting started plan
- Our latest buy guidance
- Answers to your top questions
- Key *Pro* resources
- A classic Memo: This Is *Pro*'s Mission
- Our FAQ
- The *Pro* Community: Post to the Getting Started or Meet & Greet board

There are a handful of ways to protect or hedge your recent gains. If you're new to *Pro* and bringing your own stocks to the table, you can write ("sell to open") covered calls if you hold at least 100 shares of a company and believe its stock is near fair value — so you'd be happy to sell if it increased a bit. When you write covered calls, you're paid income for the promise to sell your stock if it goes up in price by the option's expiration date. The income helps you hedge a reasonable decline in your stock. If shares decline or hold steady, you earn the full option income and can write new covered calls for more.

If you want to start with a direct short, consider opening a 2% to 4% position in **ProShares Short S&P 500**. This exchange-traded fund (ETF) moves inverse to the daily movements of the S&P 500, rising when the index declines. (More advanced? If you own 100 shares, you can write covered calls against them as *Pro* has done, gradually lowering your cost basis. We'll have new official covered call writing guidance as our February 2010 calls near expiration. You don't need to start with covered calls on the short ETF.)

Finally, if you're feeling more defensive, you might simply *buy* puts on any of your holdings that you think might fall — or insure them against a sharp decline with protective collars. At *Pro*, we're still building out the portfolio, so we're looking to add to many of our positions if they decline. This means we may be less defensive than you. If you want to buy puts or use protective collars on some of your holdings, and have questions, post on our All About Options board.

New Trades on the Way!

We'll end with a few words of advice:

- As you wait for new *Pro* trade alerts, if you're ready to begin investing, start with our Buy First stocks. Buy at least half of your intended position to start.
- If you have more to invest today, start to purchase our Buy stocks.

- If you want to get defensive, buy shares of the ProShares Short S&P 500 ETF.
- Finally, if you have options experience, use them to protect your current portfolio as you deem necessary while getting up to speed with the *Pro* portfolio as new trades arrive. If you haven't used options before, take your time to study *Pro*'s options guides — and ask us questions. Although you can still benefit with *Pro* without using options, we'll be using them steadily.

Welcome again to new members! Please see the sidebar above for other *Pro* news and helpful links. And thank you to the more seasoned *Pro* members who are helping so much in the community. You're a big part of what makes the Fool exceptional.

Jeff Fischer (TMFFischer on the boards)

Jeff owns shares of AmTrust and Oracle; Todd owns shares of Kinetic Concepts.

Special Update: Your First Steps With Pro

Published Jan 21, 2010 at 12:00AM

We're excited to have you with us at *Motley Fool Pro* as we seek consistent profits no matter which way the stock market moves. You'll be able to invest along with us as we buy strong, long-term stocks at attractive prices; use ETFs to capitalize on big-picture opportunities; hold shorts or hedges to profit on market declines; and incorporate sensible options strategies for income, leveraged gains, defense, and better buy and sell prices on stocks.

Look for *Pro*'s Monday Memo next week, and you'll receive a new investment recommendation from us in the coming days. In the meantime, here are three important pieces of advice for you as a new member.

How do I use *Motley Fool Options*?

As part of your *Pro* membership, we're happy to give you access to *Pro*'s sister service, *Motley Fool Options* (where you'll also find me as co-advisor). We hope that you enjoy this service as a source of more options ideas. However, selections made in *Motley Fool Options* are not part of the *Pro* portfolio; *Pro* stands alone as a complete portfolio service. Watch your inbox tomorrow for Options Weekly, *Motley Fool Options*' regular Friday update on its recommendations along with news and options strategies.

I bought my stake in Kinetic Concepts, and now I'm ready to add more *Pro* positions. What should I buy next?

That's great! We strongly believe that the best way to succeed with *Pro* is to invest alongside us, so by picking up shares of **Kinetic Concepts** (NYSE: KCI), you're already on your way. Next, invest in our Buy First stocks (see our portfolio's "What to Do" column), buying at least half of your intended position and then averaging in to match our target allocations. Then, begin to match our Buys, keeping an eye on our preferred buy prices (see our handy new guidance table here).

This market has me wary, and I'm ready to play investing defense. What do you suggest?

Stay tuned for our next Monday Memo, which will lay out some defensive strategies you can consider to protect your current positions. If you're ready to add a hedge to your portfolio today, consider opening a 2% to 4% position in **ProShares Short S&P 500** (NYSE: SH), an inverse ETF that moves *opposite* the market, rising as the S&P 500 falls. We've already picked up our stake, but today you can grab it at an even better price. Plus, as an ETF, ProShares Short S&P 500 trades just like a stock, so you don't need special permission from your broker to take part in this defensive strategy.

Tools for Fools

There's a lot going on in *Pro*. But never fear: Just take your time, get to know our time-tested strategies, and you'll realize that it's simply Foolish to use more investing tools to make money whether the market is up, down, or flat; smooth out your returns; and protect your gains. Thank you for being a member of *Pro*, where we invest to earn consistent profits. If you have questions, please post on the Getting Started board. We'll be in touch again soon.

Fool on!

Jeff Fischer (TMFFischer on the boards)

Monday Memo: This Is Pro's Mission

Published Jan 19, 2010 at 12:00AM

Welcome, New Fools!

The *Pro* team is happy to welcome new members this week for the first time since June 2009. If you're new, start with our three-step plan, including a stock to buy today. Then, please introduce yourself on our Meet & Greet discussion board!

Earnings on Tap

Jan. 26: **Kinetic Concepts** and **Waters**

Jan. 28: **Procter & Gamble**

Feb. 1: **Plum Creek Timber** and **GlaxoSmithKline**

In Case You Missed It

- Where *Pro* stands: To see our latest guidance on every stock and ETF in the *Pro* portfolio, see last week's special update.
- New *Pro* member pietdup posts an introduction (and a generous offer) from his home in South Africa, while EK40, CaptLukey, tsladner, kai327, and others introduce themselves on the Meet & Greet and Getting Started boards.
- spinningwood wraps up his contest on the **AmTrust Financial Services**board, rewarding a hand-spun wooden pen to fellow member CodeJedi.
- stamleo observes that, since Nov. 2, the **U.S. Natural Gas Fund** ETF has been tracking gas prices well.

- Also from stamleo, analysis on **GrafTech International**'s continuing volatility and how it can work to an option investor's advantage.
- This week in CAPS: TMFEldrehad shares new 2009 data on the Fool tool's community intelligence abilities.

When we're researching a business (which is basically all the time), one of the things we examine is its *purpose*: Why does the company exist? How does it improve people's lives? And what makes it stand out from competitors?

When marketing and advertising guru Roy Spence visited Fool HQ last month, he inspired us to think about the most admired (and feared) companies of our time — and how each has a clearly defined purpose. Two that quickly come to mind are **Wal-Mart**, with "Saving people money so they can live better," and **Southwest Airlines**, with "Giving people the freedom to fly." Both of these companies have built success on simple, yet meaningful statements.

A clear purpose helps drive smart corporate decisions and gives employees, customers, suppliers, and shareholders a better sense of how they can contribute to *and* benefit from a company's success. Of course, it follows that to make *Motley Fool Pro* the best it can be, we need to clearly define *our* purpose and revisit it often.

Mining for Meaning

After a few dozen emails and a gallon or so of coffee, the *Pro* team came up with a single, concise sentence that sums up what defines us as an investment service and separates us from the rest of the pack:

Pro's purpose is to earn you consistent, recurring profits with a high level of accuracy using a combination of stocks, ETFs, and options in a strategic portfolio.

Armed with this mission statement, you'll finally be able to explain what *Pro* is to your friends at the next cocktail party — and your *Pro* team has a clear guide for making investment decisions, helping us deliver on our strategy and avoid veering off course. Of course, there's much more to what we work to provide for you — the guidance, the education, our vibrant community of *Pro* Fools — but in terms of our *investment* approach and the final real-money decisions that we deliver to you, this purpose statement sums us up well.

Straight and Steady Wins the Race

Profiting with precision is a key part of our purpose. Since *Pro* launched in 2008, our goal has been to close at least 75% of our positions profitably. As our closed positions grow in number, we get an early look at how we're doing: So far, a full 92% have finished in the green. By focusing on accuracy, we're *not* chasing an index — though we believe that by closing at least three-quarters of our investments profitably over many years, we'll come to beat most any index's return.

Consistency is another key. We want to accomplish our accuracy with less risk and volatility than the market average. This means strategic use of hedges and shorts and a focus on making money not just when the market is up, but when stocks fall, too.

Pro's focus on accuracy and gains in up *and* down markets is what sets us apart, and it forces us to think a bit differently. Before committing capital to an investment, we have to be as confident as possible that we'll end up making money on the trade without taking undue risks. This lofty aim requires us to look for certain types of companies and do rigorous research to make sure we're not overpaying; for our options trades, it means using strategies that put the odds in our favor, again and again. Only when we're achieving our goals across the portfolio might we add — when we're so compelled — a select group of riskier positions designed to boost portfolio growth.

Now It's Your Turn

We'd love to hear your take on our new purpose statement. What do you think *Pro*'s mission is? Chime in on the Memo Musings board.

Meanwhile, today we heartily welcome new *Pro* members! Please introduce yourself on the Meet & Greet board and tell us *your* goal as a new member.

We're glad you're here. Fool on!

Jeff Fischer (TMFFischer), Todd Wenning (TMFPhila), and Bruce Jackson (TMFGoogly)

New Option Tickers Ahead

Prepare yourself, Fools: The option ticker world as we know it will be changing in the coming weeks. Instead of four- or five-letter tickers, brokers and exchanges are set to switch over to 21-digit codes. Yes, the new options tickers will be *long*. Here's a quick look at how to build the new codes, using our recent puts on **Medtronic** (NYSE: MDT) as an example:

Ticker (always six characters; add spaces when necessary)	Expiration (year/month/date)	Call or Put (C or P)	Strike price (always five characters; precede with zeros when necessary)	Strike price decimals (always three characters; add zeros when necessary)
MDT [followed by three spaces]	100522	P	00044	000

So, JIWQR, the ticker for our May 2010 $44 puts on Medtronic, would become:

MDT   100522P00044000

With most brokers, to make an options trade, all you'll need to do is quote the underlying stock, then click to get its options chain (as you've done before). From there, choose the strike price and expiration month you want, calls or puts, and make the trade. Both in our trade reports and on our portfolio page, *Pro* will continue to refer to our trades in the way we believe is most useful: The underlying stock and ticker, expiration month, strike price, and whether it's a call or a put.

Any questions? Stop by our All About Options board — we're here to help.

Write Puts on Medtronic

Published Jan 14, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") May 2010 $44 puts (JIWQR; note that option ticker standards are changing soon, so stay tuned for more guidance in a future Memo)
- **Allocation:** 2.5% (for *Pro*, six contracts)
- **Option's recent bid/ask:** $2.25/$2.30

- **Preferred limit price:** $2.25 to start; no lower than $2 if necessary
- **Alternate trades:** Write May 2010 $43 puts, recently $1.90, or May 2010 $45 puts, recently $2.65.

What's New

When our January 2010 $37 puts on **Medtronic** (NYSE: MDT) expire as cash on Friday, that will make two times our puts have resulted in income rather than shares. Pocketing some cash is nice, but ultimately, we'd like to own more shares of this leading medical-device manufacturer. That's why we're writing new puts to potentially round out our position.

Since we last wrote puts, Medtronic knocked out a strong second quarter, with revenue up nearly 8% over the previous year while non-GAAP earnings per share jumped 15%. New and revamped products as well as increasing demand, especially in younger markets, helped the company's sales. Management followed up with optimistic guidance that sent shares around 10% higher.

Following the big news, we increased our preferred buy price to $42 and fair value estimate to $52. With shares recently near $46, our best chance to buy more in the low $40s is by writing puts.

How to Follow Along

You write ("sell to open") puts when you're ready to buy a stock if it declines below the strike price by expiration, as explained in our put-writing guide. Here are the numbers behind this trade:

- **Option yield (at $2.25 bid):** About 5.1% in four months
- **Option strike price:** 3.5% below the recent $45.60 share price.
- **Break-even price:** 8.4% lower, at $41.75
- **Cash or buying power needed:** Each put you write represents a potential $4,400 purchase of Medtronic shares.

If we're able to buy new shares at a net $41.75, we'll be paying 12.9 times management's earnings guidance for the year ending April 2010 (and about 14 times likely free cash flow), providing us with a margin of safety and the potential for meaningful appreciation in the years ahead. Meanwhile, management expects earnings to grow 11% to 13% this fiscal year, enough to make us happy to purchase shares near these multiples.

Can't Write Puts?

If you're unable to write puts and still need to buy your first shares of Medtronic (or your second 2.5%, like us) consider placing a limit order near $42 to potentially get shares on a downdraft. But remember, Fools, our preferred buy price is just a guideline; our fair value estimate of $52 is a more meaningful figure.

We'll make this trade in the next one business to 30 calendar days. Please note, we'd only place this trade as soon as Friday if it's clear that our $37 January puts will be expiring. With Medtronic trading near $46, this looks likely. To discuss this trade or ask questions, please visit our Medtronic board.

Write Covered Calls on Cameco

Published Jan 13, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") March 2010 $33 calls on Cameco, using a limit order near the bid price.
- **Allocation:** Write one call for every 100 shares of Cameco owned (for *Pro*, seven contracts).
- **Option's recent bid/ask:** $1/$1.10
- **Preferred limit price:** $1 or higher, day order; if needed, no lower than $0.80.
- **Recent stock price:** $30.70
- **Special requirement:** You must own at least 100 shares of Cameco to write a covered call.

What's New

Uranium is trading for $9 *less* than when we first tapped **Cameco** (NYSE: CCJ) last January — so why are shares of the world's largest uranium miner fetching double what they were then?

There are a few reasons. Of course, there's the market's recovery, but we can also thank the ascent of gold (Cameco owns gold assets, too), the company's ability to increase uranium production, and a steady stream of nuclear power plants scheduled for construction promising greater-than-expected uranium demand in the future. What's more, Cameco was able to sell its stake in Centerra Gold for $820 million, which we believe is a good move. Meanwhile, the company is no closer to putting its giant Cigar Lake mine into production, so we're simply keeping this endlessly delayed potential out of the equation.

Why This Strategy?

In light of these positive developments, we've raised our fair value estimate on Cameco from $26 to $31. So, with the stock trading near $31 today, we're content to write covered calls to sell our shares a bit higher or earn income if the stock doesn't advance. At our potential sell price of $34, we'd be exiting our Cameco shares at 20.5 times 2010 earnings estimates and a multiple to free cash flow nearly twice that — more than a fair price. Even so, given Cameco's dominance in uranium, shares could trade higher. That's fine with us, because we know that valuation needs to guide our decisions.

How to Follow Along

If you need a refresher on covered call strategies, please see *Pro*'s guide to covered calls before placing this trade. Remember, you write one call for every 100 shares of stock owned. Here are the numbers behind the move:

- **Option yield at $1.00 bid:** 3% of the $33 strike price, in 65 days
- **Option yield on our $16.52 buy price:** 6%.

- **Return from today if sold at a net $34:** 10.7%
- **Total return on position if exercised:** 105%

We'll make this trade in the next one business to 30 calendar days. To discuss the trade or ask questions, please visit our Cameco board.

Write Covered Calls on Lindsay

Published Jan 13, 2010 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") March 2010 $45 calls on Lindsay, using a limit near the bid price.
- **Recent option bid/ask:** $2.40/$2.65
- **Initial limit price:** $2.50 or higher, day order
- **Secondary limit price if needed:** $2 or higher
- **Recent stock price:** $44
- **Allocation:** Write one covered call contract for every 100 shares of Lindsay owned. (For *Pro*, that's three contracts)
- **Special requirement:** You must own at least 100 shares of Lindsay to write a covered call.
- **Alternate trades:** Write February 2010 $45 covered calls, recently bidding $1.65, or June 2010 $45 covered calls, recently bidding $4.

What's New

Companies in highly cyclical lines of business can provide a patient investor tremendous returns. In many cases, it's as simple as buy in a down cycle, sell in an up cycle; rinse, repeat. When we originally recommended **Lindsay** (NYSE: LNN) in June, prices on corn, wheat, and soy had fallen sharply, causing shares of this producer of irrigation systems to suffer -- and presenting us with a buying opportunity.

Since then, a string of bad weather has put a dent in our food supply, driving prices higher. Additionally, in June 2010, the EPA may call for more ethanol in our gasoline, a move that would increase corn demand in 2010 and beyond.

Why This Strategy?

The rosier agricultural outlook isn't the only thing that's lifted Lindsay's shares from $36 on Dec. 1 to $44 today. In another boon for the company, Lindsay's infrastructure group is finally bringing in cash from the previously delayed Mexico City barrier project. With our fair value estimate in the low $40s, we consider shares slightly overvalued and would be happy to part with the stock at a net sale price near $47.50.

That said, if our shares aren't called away in March, we'd be equally content holding them and pocketing the generous call premium. In fact, if Lindsay declines to the mid $30s again, we'd be looking to add to our small 1% position.

How to Follow Along

If you need a refresher on covered call strategies, please see *Pro*'s guide to covered calls before placing this trade. Remember, you write one call for every 100 shares of stock owned. Here are the numbers behind the move:

- **Option yield at $2.50 bid:** 5.5% of the $45 strike price in 65 days
- **Option yield on our $31.55 buy price:** 7.9%.
- **Return from today if sold at a net $47.50:** 8%
- **Total return on position if exercised:** 50.5%

We'll make this trade in the next one business to 30 calendar days. To discuss the trade or ask questions, please visit our Lindsay board. Finally, please note that Pro owns 320 shares of Lindsay, so by necessity 20 of our shares won't be covered.

New Year, New Pro Guidance

Published Jan 12, 2010 at 12:00AM

Digging through data is what we do. Each quarter, your *Motley Fool Pro* team combs through conference calls and cash flow statements, studies SEC filings, and bones up on balance sheets to make sure our investment theses still hold water. We revisit our ETF and options strategies and — where appropriate — update our valuation estimates.

Over the past year and change, we were conservative with many of our estimates while we waited to see how the government's attempts to stabilize and stimulate the U.S. economy fared. Today, with more information at hand, we're able to update numbers on all *Pro* holdings — you'll see a summary of our latest guidance in the table below. As you continue to add new money to your *Pro* portfolio, use our Buy First, Buy, and Hold categories as well as our preferred buy prices as your guides.

Moving On Up

Tip: Writing Puts

Higher preferred buy prices give you more room to write puts on these stocks and buy in our desired range. Questions? Head to our All About Options board.

Strong performances in 2009 from **Cameco**, **Flowserve**, **GrafTech International**, **Kinetic Concepts**, and **Medtronic** have led us to bump up our preferred buy prices and fair value estimates for each company. In each case, these companies did better than we expected, as superb management teams created value during tough times by making smart decisions early.

Hold It

The only *Pro* position moving to Hold is **Plum Creek Timber**. The shares are trading near $38, which is close to our $40 fair value estimate.

Now in Range

Kinetic Concepts, **Ebix**, **FPL Group**, **GlaxoSmithKline**, and **Procter & Gamble** are trading below our preferred buy prices. Many of our stocks — including **AmTrust Financial Services**, Medtronic, **Oracle**, and GrafTech — are trading low enough for put-writing strategies to potentially buy more shares below our preferred buy prices.

Guidance At a Glance

Happily, we aren't giving any of our holdings a valuation downgrade. All the *Pro* companies are performing well, and although we believe the market will be rocky at times, we're comfortable holding our stocks. Given this stance, you can expect us to start writing covered calls on more of our positions that are close to fair value rather than selling them outright.

The super-sized table below gives you our latest advice in one place, and serves to guide our new investment decisions as we start 2010.

Investment	Recent Price*	Preferred Buy Price	Fair Value Estimate	What to Do	Quick Take
AmTrust Financial	$12	$12	$18	**Buy First**	With book value above $9 a share, AmTrust offers us a combination of lower risk and long-term growth potential.
Autodesk	$26	$22.50	$32	Hold	Autodesk's business is stable, but it's recovering slowly. We still like its market dominance and stimulus possibilities.
Cameco	$31	$24.50	$31	Hold	More nuclear power plants are being planned than we originally expected. Last year, Cameco was able to increase its uranium output and sell its Centerra Gold stake for $820 million, increasing our valuation.
Ebix	$17	$18	$24	Buy	Expected to grow earnings more than 20% this year, Ebix is entering new markets and investing for future growth.
Expeditors International of Washington	$35	$30	$38	Buy	Our covered strangle (buy shares and write a strangle) trade is still viable today because Expeditors' share price has stayed in range.
Flowserve	$107	$80	$110	Hold	We're raising our valuation estimate thanks to Flowserve's stronger-than-expected results in mid 2009.
FPL Group	$52	$55	$62	Buy	One of the cleanest, greenest utilities in the country, this stock offers value, regulated-business stability, and a good dividend yield.
GlaxoSmithKline	$42	$44	Low $50s	**Buy First**	Europe's largest drug maker offers value with a 4.6% yield.
GrafTech International	$16	$13.50	$18	Buy (changed 1/26)	Exceptional cost management has lowered operational expenses, while free cash flow has held strong, leading us to increase our valuation.
Jack Henry & Associates	$23	$21	$30	Buy	This company boasts 90% recurring revenue, offering us stability at a reasonable price.
Kinetic Concepts	$39	$41	$54	**Buy First**	Free cash flow has been stable and growing, so our valuation has crept higher. Competitive concerns that we discount continue to keep the stock inexpensive.
Lindsay	$46	$34.50	Low $40s	Hold	With lumpy quarterly results, Lindsay remains volatile. It's now in our fair value range, so it's on Hold.
Medtronic	$46	$42	$52	Buy	Our price guidance has increased after the medical devices leader exceeded our hopes in the last quarter, and provided strong guidance.
Oracle	$24	$22.50	$29	**Buy First**	Oracle continues to grow free cash flow by double digits (11% year over year) and trades at a discount to market averages.
Plum Creek Timber	$38	$34	$40	Hold	Plum Creek is nearing our fair value estimate, so we're moving it to Hold.
Procter & Gamble	$60	$62	$70	Buy	P&G's latest quarter showed better execution as management adjusts to a tough new economic reality and consumer price sensitivity.
ProShares Short S&P 500	$51	N/A	N/A	Buy	This inverse ETF (or short) will benefit us if the index declines. We'll continue to write covered calls to lower our cost basis, while allowing for ample upside.
Vanguard Emerging Markets	$42	N/A	N/A	Hold (changed 1/26)	Growth in emerging markets remains a long-term macro investment; as long as we believe in the thesis and price, it's a buy.
Vanguard Energy	$88	N/A	N/A	Buy	Energy leaders should still have plenty of growth potential ahead if the global economic recovery gains traction.
Waters	$62	$55	$66	Buy	Our covered strangle (buy shares and write a strangle) trade is still viable today because Waters' share price has stayed in range.
Options-Only Positions					
Abercrombie & Fitch	$32	N/A	Low $20s	Short	Our bear put spread on Abercrombie expires in February. The stock is slightly above our $31 break-even price; we're waiting to see Q4 results.
Electro-Optical Sciences	$10.50	N/A	N/A	Buy	Our call option can be exercised and turned into stock in April at $5 per share. We expect the FDA's decision on the company's only potential product in 2010. This speculative holding is just 1% of the portfolio.
United States Natural Gas Fund	$10	N/A	N/A	Buy	Natural gas remains volatile around $5; a recovery to above $7 should make this synthetic long trade profitable — if the ETF tracks natural gas properly.

**Rounded closing price as of market close Jan. 11, 2009.*

We'll update this table again following January and February quarterly earnings. Please post your questions on our Philosophy and Strategy board. Fool on!

Jeff owns shares of AmTrust Financial Services and Oracle.

Step 2: How You Make Money With Pro

Published Jan 12, 2010 at 12:00AM

The best way to succeed with *Pro* is to **invest alongside us**. We do the heavy lifting for you, spending hours researching and vetting every investing recommendation and delivering it to you in easy-to-use trade reports.

What's more, since we're ultimately building a portfolio of **long-term, core holdings**, you don't need to make use of options in order to be a successful *Pro* investor. Fools solely following along with our stock and ETF positions are building winning portfolios as well. Now let's start building yours!

Get Your Account Ready

You don't need to trade options to make money with *Pro*, but if you ever want to, you'll need approval from your brokerage, so we suggest you apply now. Here's how:

1. Ask your broker for full options approval, typically level 2 or 3 (it can vary by broker).
2. Fill out, sign, and mail in your broker's application.
3. After a week or so, you'll be approved! Visit our All About Options board if you have questions.

(New to options investing? Check out our guide, "Get Up to Speed With Options." Or skip straight to our options handbook for beginners.)

Our Approach

By investing alongside *Pro*, you'll minimize your risk and smooth out your returns. Rather than chase an irrational market, we focus on *accuracy*, striving to close at least 75% of our positions profitably. We're well above that goal three years into *Pro*'s young life.

Inside *Pro*'s portfolio, you'll find the following (rough) allocations:

- **Stocks: 70%.** The bulk of our portfolio consists of superior businesses that we intend to hold for three to five years.
- **ETFs: 15%.** We seek top-notch ETFs to profit on broad trends such as emerging markets, energy, commodities, and more.
- **Options: 5% to 10%.** Our options strategies are easy to follow and based on underlying stocks and their valuations.
- **Shorts:** Up to 30%.
- **Cash:** Managing a portfolio includes knowing when to hold cash. We'll help guide you here, too.

What to Buy First

We recommend that you wait for **New Member Orientation Week** (Feb. 6 through Feb. 10) to start investing with *Pro*, so that you know how to take full advantage of the service. But if you're itching to get started, then check out our active trade alerts and watch your inbox for our **Trade Alert emails**, which will connect you to our full guidance for each specific trade. If you have any questions, don't hesitate to post on our boards.

Once you've reviewed (and hopefully invested in) our active alerts, take a look at our **Buy First stocks**. Buy Firsts represent the companies that we think offer the best risk-to-reward ratio. Read through the analysis and guidance of each of our Buy First picks, then start trading! As you purchase our recommendations, you'll want to match our buy-around price and our target allocation. Our buy-around price for each pick is the preferred buy price at which we recommend making a purchase. These aren't set in stone; just aim to make your purchase *around* these prices.

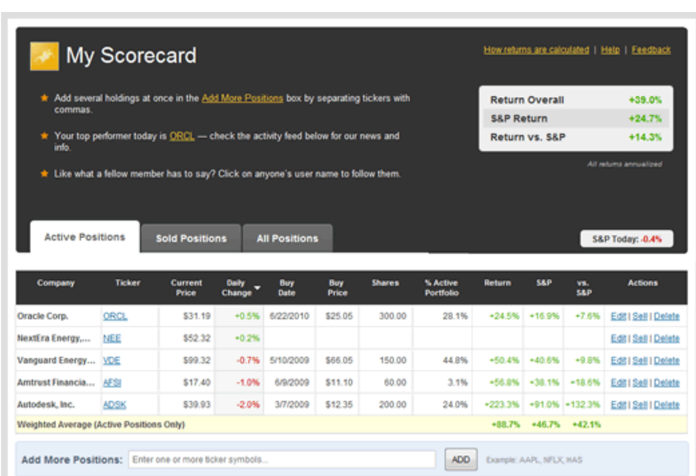
What to Buy Next

Once you've filled up on our Buy Firsts, we suggest that you take a look at our **Buy stocks**. (We'll be sending a special report on those stocks as part of our New Member Orientation Week, which is Feb. 6 through Feb. 10.) These are companies that have strong valuations and the analysis to back them up. As you purchase Buy stocks, make sure you match our target allocations.

All of our holdings and target allocations are on the Recommendations page. If any pick is no longer a worthwhile opportunity, we'll put it on Hold and direct you to the best alternatives for new money.

Tracking Your Progress

Whether you're ready to buy our Buy Firsts right now, or just want to watch them for a while, be sure to add your picks and ideas to the My Scorecard tool. Adding a stock to My Scorecard allows you to track its performance, compare it to the S&P 500 index, and view all *Pro* analysis related to that stock in one place. (A beta version of My Scorecard is even available as a mobile app, so you can check your portfolio from your smartphone.)



Next Step: Join the Conversation!

We have a vibrant, intelligent community of investors who love to discuss stocks, ETFs, and options, ask and answer questions, swap ideas, and help each other build their portfolios. Come say hello on our Meet & Greet board, or take your pick of the whole collection right here!

Step 3: Become an Options Pro

Published Jan 12, 2010 at 12:00AM

Our Gift to You: *Motley Fool Options*

As a member of *Pro*, you are also a member of *Motley Fool Options*. Members looking for more options ideas will find this a la carte, all-options service a great complement to *Pro*. Learn more at options.fool.com.

Options in 3 Steps

Please note: The trade details in this tutorial are from a trade we made in the past, so we don't recommend you follow along with the specifics. Always check our Recommendations tab for the latest trade information.

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A big part of what sets *Pro* apart from other Fool services is our use of options and short selling to improve returns. Whether the market is up, down, or flat, we have strategies that will help you generate profits — and hedge your *Pro* positions, too.

That doesn't mean we're option "traders." Our use of options is tied to a Foolish understanding of the underlying holding, and our approach is valuation based. We thoroughly analyze and value businesses first and foremost before determining the best options strategy to take.

Ready to add options to your investing toolbox?

- Set up your brokerage account.
- Watch our video above, "Options in 3 Steps" with Jeff.
- Below, dig into two of the strategies you'll see us use most often.

Writing Puts

Our Guides to the Options Basics

- Check out *Options*' helpful (and non-intimidating!) PDF, "Options for Beginners."
- Need a guide to the terminology? Have no fear, the *Pro* Options Glossary has you covered.
- Want a step-by-step learning experience? *Pro* and *Options* analyst Bryan Hinmon has put together an "Options U" course on the *Options* discussion boards. Join more than 200 of your fellow Fools who have participated and boosted their returns with options!
- Ready to trade? Great! Download our handy checklist to keep you on track.

When you'd be happy to buy a stock at a lower price, you can write ("sell to open") puts.

The option's strike price is your desired buy price for the stock. If the shares don't decline to your buy price or lower, you keep the option income and can write more puts. If the shares *do* decline by your option's expiration date, you still keep the option income, but you also get to buy the shares at your desired price (they're automatically sold to your account by the time the option expires).

The option income lowers your cost basis in the shares even further. Read more.

Covered Calls

When you already own at least 100 shares of a stock and would be willing to sell at a higher price, you can write covered calls at your chosen strike price. It's just the reverse of writing puts: You already own a stock, and you write calls on it that pay you income.

If the shares don't increase to your desired sell price before the option expires, you keep the option income and can write calls again. If the shares *do* jump to your sell price, your shares are sold from your account at the strike price by the option's expiration date. You still keep the option income, which increases your net sell price. As with writing puts, covered calls pay you income while you wait for your desired outcome. Read more.

Calls and Puts

Important Options Tip!

Sell, don't buy: Please be careful and make sure the command you use when writing covered calls and puts is "sell to open," "sell," or "write."

On the surface, both of these strategies are quite simple once you become comfortable with them. What takes more work is choosing strong buy and sell prices on exceptional companies and then making sure the options pay you enough. But we're here for you. Follow our trades and guidelines for a helping hand as you learn.

Congratulations!

Now that you've completed all three steps, you're a full-fledged *Pro* Fool! Be sure to introduce yourself on our Meet & Greet board and explore our handy list of resources to round out your experience with us. Now let's make some money!

We'd love your feedback on this *Pro* "Getting Started" guide. Click here to tell us your thoughts.

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Published Jan 12, 2010 at 12:00AM

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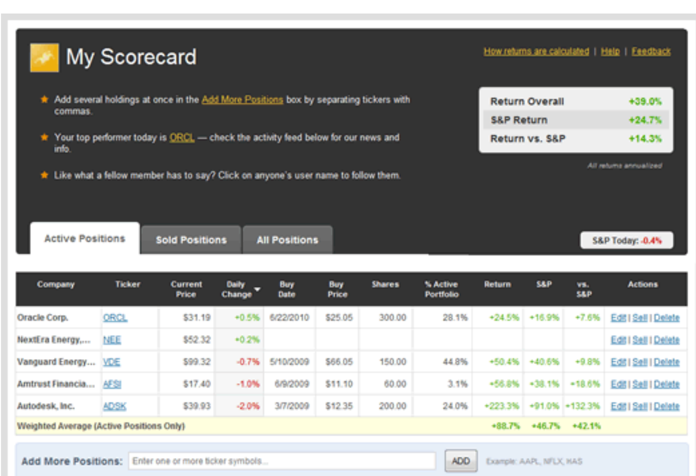

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Monday Memo: Don't Sleep on Rising Interest Rates

Published Jan 11, 2010 at 12:00AM

Next Week

- Starting Jan. 19, *Pro* will open to new members for the first time since last June. We'll be briefly unlocking our doors exclusively to Fool members who have expressed interest. Thank you for welcoming them to our community!
- In observance of Martin Luther King Jr. Day, the Fool will be closed Jan. 18. Your next Monday Memo will be delivered on Tuesday, Jan. 19.

Options Expiring

- **Puts:** Our January 2010 puts on **Medtronic**, **Oracle**, and **Tupperware** are set to expire as full cash profits this weekend.
- **Strangle:** Our January 2010 puts on **iShares Silver Trust** are set to expire, and our calls are set to be exercised. If you wrote this strangle along with us (*or* wrote covered calls), there is no need to do anything. Your shares will be sold from your account over the weekend.

In the *Pro* Community

- Member stamleo posts the upcoming earnings dates for *Pro* holdings. We'll share our analysis as earnings season begins.
- spinningwood is hosting a contest on the **AmTrust Financial Services** board. Win a pen made by the man himself!
- In his weekly CAPS take, TMFEldrehad features stocks in the doghouse.
- Jeff shares his thoughts on this stock market.

Extra! Can't get enough of Jeff and Todd? The *Pro* duo will be hosting a live discussion on the main Fool.com site Wednesday, Jan. 13, from 11 a.m. to 1 p.m. ET.

Back when he was President Clinton's political strategist, James "Ragin' Cajun" Carville said he wanted to be reincarnated as the bond market because "you can intimidate everybody."

Years later, in a world overly dependent on debt and credit, bond investors are wielding power again — and will probably play a larger role in determining economic growth than any government body this year.

Borrowing Ourselves Into a Corner

If you only made $7 an hour and decided to drop $20,000 on a shopping spree in Milan, your credit card company would get pretty upset. It's the same with bond investors — they get irked when the companies or government agencies they loan money to spend more than they can comfortably afford.

When a lender believes you've borrowed too much, it sees you as a bigger risk — and jacks up your interest rates. Naturally, you then spend, and thus borrow, less and start paying off your debt. It's the same with corporations.

Government borrowers can be a different story, particularly those with mounting obligations and liabilities that require frequent funding via debt. Bond investors today are generally more lenient with government borrowers, which can bring in taxes and, for a lucky few countries such as the U.S., Japan, and the U.K, print money in their own currency to pay back principal and interest. But their patience isn't infinite.

Hot Yields Revealed

In Greece, spooked bond investors sent government yields higher amid mounting deficits even though the country is part of (and thus implicitly backed by) the European Union. Similar concerns about the fiscal health of Portugal, Italy, Ireland, and Spain (together with Greece, informally referred to in bond circles as the "PIIGS" economies) have creditors on edge these days.

While the U.S. is in better shape than Greece, higher rates are finding their way here as well. The 10-year Treasury yield jumped from 3.2% on Nov. 30 to just over 3.8% today — a significant 19% increase in five weeks (and one that surprisingly got little press). Bond investors are not just concerned about U.S. inflation and weak dollar; they're worried about the Fed's "quantitative easing" program (a nice way to say "creating money"), which is set to end in March. At this point, it's unclear who will buy the hundreds of billions worth of Treasuries necessary to keep rates low once the Fed stops waving its magic wand. Last year, according to Morgan Stanley, the Fed bought $1.6 trillion in government bonds, while the private sector bought a mere $200 billion worth.

The Fed essentially has two choices: extend the QE program to keep rates low and risk further devaluation of the dollar, or stop the QE program in March and risk much higher interest rates. With mid-term elections just months away and incumbent politicians banking on an economic recovery, I expect the political pressure will force the Fed to extend the QE, but rates will still be forced higher by weak demand in the private sector.

What This Means for *Pro*

Unless governments, particularly in developed countries, can show bond investors that they have a plan to get their respective deficits under control and wind down the massive stimulus programs, it's safe to assume that interest rates will continue to inch higher in 2010. How *much* rates go higher will largely determine the potency of this recovery, as higher rates would increase corporate interest expenses that eat away profits, which is why the bond markets matter so much right now.

At *Pro*, we're closely watching the bond market, and we've taken steps over the past year to prepare our portfolio for potentially higher interest rates and inflation. Our portfolio is filled with cash-rich companies including **Autodesk**, **Expeditors International of Washington**, and **Jack Henry & Associates**. Most of our companies don't rely on debt, financing their spending with internal cash generation — so rising interest rates won't hurt them. Meanwhile, our companies that do carry debt, such as **Procter & Gamble**, have locked in today's low rates. To further combat higher interest rates, we own commodity-linked inflation fighters in **Plum Creek Timber**, **Vanguard Energy**, and **Cameco**. We may add more inflation and interest-rate fighters in 2010.

There's still plenty of cash left to invest in the *Pro* portfolio, so we'll be able to pounce on any long-term opportunities created by intimidating "bond vigilantes" in the short run. What's your take on interest rates? Come join the discussion on our Memo Musings board.

Stay patient. Stay focused. Stay Foolish.

Todd Wenning

Todd owns shares of Procter & Gamble.

A CAPS Screen Inspired by Greatness

Published Jan 5, 2010 at 12:00AM

What can we learn from one of the best small-cap fund managers in the business? With the right tools, quite a bit.

During his 13 years as portfolio manager at the **FBR Focus Fund** (FBRVX), Chuck Akre generated 12.6% annualized returns and never trailed the S&P 500 over any rolling five-year period. And while the average turnover rate for mutual funds is nearly 100%, or about a one-year holding period for a given investment, Akre kept his holdings at FBR Focus for an average of five years — a mere 17% turnover rate. That record serves as a testament to patient, long-term investing.

In August 2009, Akre cut his ties with FBR and opened his own mutual fund. Just two months later, the newly minted **Akre Focus Fund** (AKREX) earned a spot on the Kiplinger 25, a well-regarded list that spotlights the best mutual funds, focusing on consistent results, low expenses, and a sound approach.

Even though we had a good laugh about Kiplinger's lightning-fast anointment of Akre's new fund, one thing is clear: This is a guy worth observing. And by using a CAPS screen, combined with *Pro*'s proprietary CAPShot tool, we can even attempt to recreate his recipe for finding great small-cap stocks.

Bottling the Akre Formula

Akre cites three driving principles to his success:

1. Select investment opportunities to preserve and grow capital.
2. Develop a focused portfolio that seeks to identify compounding machines.
3. Invest for long term results, recognizing that volatility can create powerful opportunities.

Based on Akre's criteria, I searched for stocks with three-year average returns on capital greater than 15%; market caps between $100 million and $2 billion; and insider ownership greater than 5%; then, I cross-referenced what I found with our CAPShot tool, looking for scores above 8 out of 12. (Remember, as with any screen, these results are just jumping off points for further research.) While the screen didn't pull up any CAPShot scores of 11 or 12, I did find a few stocks worth a closer look:

Company	Market Cap (in millions)	Return on Capital**	% Shares Insider Owned	CAPShot Score
Quality Systems	$1,830	29.7%	34.2%	10
Buckle	$1,380	36.8%	44.5%	10
Universal Travel	$154	36.5%	24.4%	10
VSE	$239	28.6%	20.8%	9
Female Health	$127	34.1%	25.4%	8

**Data as of Jan. 4, 2010. **Trailing 12 months.*

First up is Quality Systems, which designs software that digitizes medical records at doctors' offices and hospitals. The founder and current chairman, Sheldon Razin, has been with the company since 1974 and owns some 18% of shares. There's been a lot of hype about digitizing medical records over the past year, however, and at current lofty valuations, I'd refrain from adding money here. **Verdict:** Avoid for now.

With its stores strategically placed outside of major metropolitan areas, youth apparel retailer Buckle flew under Wall Street's radar for a long time. But with consistent double-digit margins and returns on capital, Buckle now has more than a dozen sell-side analysts following its every move. I like that founder and chairman Daniel Hirschfeld owns a substantial 37% of shares, but with 400-plus stores strewn across 41 states, Buckle may not have much room left for expansion. The recently announced quarterly dividend, though not bad in itself, could be a sign that management expects lower growth in future years. **Verdict:** Worth further research — I like its second-city niche.

Based in China, Universal Travel has the potential for tremendous upside, but I grew a bit skeptical when I read its claim that its Speedy Dragon subsidiary "has already built a perfect and nationwide logistic network." I'm sure it's good, but *perfect*? Maybe something is lost in translation. **Verdict:** Let's move on.

Next is VSE, a company that provides technical and engineering support to the government (and it's headquartered less than two miles from Fool HQ — I smell a company visit!). Its principal clients are the five branches of the U.S. military; its largest shareholder, Calvin Scott Koonce, owns 16.6% of shares and has served on the board since 1992. **Verdict:** Worth researching in light of increasing government spending.

Finally, there's Female Health, the designer and manufacturer of the only FDA-approved female condom. In 2009, Female Health made more than 90% of its sales outside of the U.S., and CEO O.B. Parrish has been at the helm since 1994. The company has struggled mightily in the past, but thanks to some favorable government actions, it has benefited from increased HIV/AIDS spending, particularly in developing areas like Africa and South America. **Verdict:** The company's future is too uncertain for my taste.

Foolish Bottom Line

I'm a big fan of Akre's approach to finding high-quality small-cap stocks, and paired with CAPShot, I was able to uncover some intriguing research ideas based on his thinking. If you're looking for a good screening tool, try out the new-and-improved CAPS screener by clicking here.

What do you think about these stocks? Please weigh in on our CAPS Corner board.

Monday Memo: A Visit From the Ghost of Pro Past

Published Jan 4, 2010 at 12:00AM

The Week Ahead

- Jan. 5: **Ebix** shares trade on a 3-for-1 basis.
- Jan. 7: **Abercrombie & Fitch** announces December sales.

Pro Community Highlights

- Russell (TMFEldrehad) posts five 5-star stocks from CAPS in his weekly commentary for *Pro*.
- Well wishes for the new year were shared by many *Pro* members on our boards, including 1putt2pin from Shanghai.

As we enter our third calendar year, *Motley Fool Pro* is starting to develop a history. Notching more time under our belt doesn't just give us a little bit of distinction; it helps you hold us accountable. What's more, by examining our past, we can improve our future together.

With that in mind, I thought it would be fun *and* enlightening to look back at some of what we've written in this space over the past two years. For our first stop, let's rewind to February 2009 — when the market was diving to prices not seen since 1996.

Dark Days and the Ensuing Rally

It was about two weeks before the S&P 500 hit rock bottom, yet as you can see by our Feb. 23, 2009, Memo, we were more opportunistic than worried. That's because we were looking ahead:

> While we've started the *Pro* portfolio defensively, our current roadmap has us getting much more aggressive as the year goes on ... Current logic suggests at least the *start* of a recovery by 2010, and we want to be ahead of that curve. If the coming months continue to hold this logic, we're going to become a much more bullish portfolio as the year progresses. We like strong returns as much as the next Fool. And we love a bull market — especially one that should follow a beating like this.

When I wrote that, we still had nearly $700,000 in cash. And as projected in that Memo, we increased our buying steadily over the ensuing nine months, putting more than $400,000 into stocks and committing even more via options. We did this even as many investors (including us!) were questioning the sustainability of the ongoing rally — a steep 38% jump by May 8 seemed aggressive.

Sticking to Our Guns

As the market surge continued, we remained committed to our core principles, as you can see in our Memo from May 11, 2009:

> At *Pro*, we will continue to:
>
> - Average into investments that show us strong potential over the coming years.
> - Use valuation as our guide in writing puts and covered calls.
> - Consider reasonable hedges based on risk versus potential reward.
> - Keep our emotions in check and focus on a long-term plan.

Discipline is a key to investing well — emotional discipline *and* the discipline to act on your research, convictions, and long-term plans, and then stick with them.

For another example, let's step back a bit. *Pro* launched in October 2008, and by Nov. 24 of that year, we had our sights on potential new investments:

> We're buying stocks we believe will perform despite the economic illness that has infected literally everything — from banking to commodities to technology. A few companies we're considering involve infrastructure (because governments must invest in themselves), commodities and energy (both will recover in price), and timber as an inflation hedge.

In the following months, we bought shares of **GrafTech International**, **Vanguard Energy**, **Plum Creek Timber**, **Cameco**, **Autodesk**, and **Flowserve**, among others, sticking to our wealth-building plan despite the crumbling market around us.

Profits, Period

Now let's go back even further, to one of our earliest Memos. On Nov. 3, 2008, we wrote:

> We're not so concerned with what the S&P 500 does as long as at least 75% of our investments are profitable by the time we close them. We're making investments that we believe will provide gains in the end, whether the market goes up or down, or slips along sideways for the next year. Accomplishing our goal of absolute returns will fill our portfolio with a lot of green numbers. By reaching this goal, we should also outperform the S&P 500 — that's icing on the cake.

Today, we still believe that the S&P 500 should matter less and less to us as our wealth grows. Once you have ample wealth, your first goal should be to protect it. So at *Pro*, we want to earn profits, period, with less risk than the market overall. To that end, more than 90% of our positions today, both closed and open, are profitable. That's not surprising given the market's strength, but limiting our number of hedges and shorts over the past nine months has been the right move. As a long *and* short portfolio, we're judged not just on what we do, but on what we *don't* do.

Limber Investing

Finally, no matter what we do, we need to remain flexible. On Dec. 8, 2008, the Market Swami paid a little visit. We predicted that "a flat market appears to be the most likely scenario for the near future." (I wish we had defined *near future* in that Memo, but we probably meant over the next year or so.) However, from Dec. 8, 2008, to Dec. 8, 2009, the S&P 500 rose 20%. That doesn't qualify as flat, so if we were thinking just one year ahead, we were wrong.

Fortunately, by February 2009 — quoted first above — we ramped up our buying in response to the values we saw. Even if you proclaim an investment stance that turns out to be completely wrong, the bigger question may be: Did you adapt your stance in time to ultimately be much more correct? We must remain flexible at *Pro*, because much of what we say about macro events won't prove to be accurate. That's just the nature of the business. It's more important that we remain open to changing our stance, and that most of our investments win regardless of what the rest of the market is doing.

Ghost of *Pro* Yet to Come

On that note, let's kick off 2010! We have a healthy schedule of investing moves planned over the coming weeks, and we hope that you'll enjoy this year's journey as much as we plan to.

Thank you for being with us … and welcome to 2010!

Jeff Fischer

Monday Memo: Here's Looking at You

Published Dec 28, 2009 at 12:00AM

Pro News and Events

- **Lindsay** has been moved to **Hold** after share price appreciation.
- Dec. 29 and 31: **Vanguard Energy** and **Vanguard Emerging Markets** pay annual dividends of $1.19 and $0.54 per share, respectively. This will put about $1,180 in *Pro*'s pocket.
- Jan. 5: **Ebix** begins to trade on a 3-for-1 split adjusted basis.

In the *Pro* Community

- This Week in CAPS: Russell (TMFEldrehad) highlights the newly launched TMFStockSpam, a Foolish community project that tracks stock spam over time.
- Members spinningwood, upnup8, stamleo, jog100, trurl9, and others post holiday wishes to everyone on the *Pro*philosophy board.
- Remember that the Fool gives $0.10 to charity for any and every post you make between now and Jan. 8. Happy New Year!

The flow of information has exploded since the last market meltdown (that'd be in the 1920s). Investors are inundated with a fire hose of news on a daily basis — federal reports, earnings, economic numbers — all of which Wall Street tries to interpret instantaneously. This instant-read atmosphere often leads to more trading volume and larger price swings. But being an active trader doesn't make you a better investor.

It's ironic that Warren Buffett, the greatest investor of our time, is an extremely long-term minded guy when it comes to his core stock holdings, yet most of the media is focused on short-term events and has a "best trade right now" mentality. Still, everyone falls prey to this trap of short-term thinking at some point. Even at *Pro*, if a new position isn't up within weeks or months, some members on our boards start to wonder: "What's wrong with it?" It's always good to ask (that's what our community is for), but lacking any news, we're usually just going to remind you of our time frame. On the flipside, if an investment gains ground for us within days or weeks, we may feel like celebrating even though we aim to hold for years and the price is bound to change many times until the company gradually builds lasting value.

Learning to balance constant information and always-changing share prices with the long-term pursuit of building a strong portfolio is one of the great challenges for all investors. It involves controlling your immediate emotions and accepting near-term uncertainty in return for, ideally, long-term benefits. If you're an "active" investor — trading on news and minding short-term price moves — you may feel like you're making progress, but in actuality, there's a man in Nebraska who didn't make any trades at all on the same news, and who will be richer for it in the years ahead. Now that's something to think about.

Pro Members From All Walks of Life

Buffett isn't the only investor we're highlighting today. To wrap up 2009, we want to turn the spotlight around and shine it on *you*, the many *Pro* members who make our service come to life. The Motley Fool knows a thing or two about deciphering information to help you make better investment decisions — so it's no shock that we also spend time digging into stats to learn about the thousands of investors who love the Fool. Here's a bit of what you've told us.

First, where are you? *Pro* members are concentrated in these metro areas (by order of magnitude):

1. San Francisco
2. Los Angeles
3. New York
4. Washington, D.C.
5. Houston
6. Seattle
7. Boston
8. Chicago
9. Dallas
10. Denver

Many more *Pro* Fools are concentrated elsewhere around the country, from Georgia to Minnesota to Cincinnati (Todd's home town) to Palm Beach. More than 30 *Pro* members reside in the Honolulu area (hopefully all enjoying the good life on the islands), and there's even a *Pro* member in Cuba City, Wisconsin (population 2,000).

Outside the U.S., *Pro* members are abundant in Canada (350 strong as of this summer) and the U.K. Next in popularity are Singapore, Switzerland, Ireland, Australia, and Germany. Several *Pro* members also reside in Hong Kong, Italy, the Netherlands, Israel, Belgium, Mexico, Japan, and the Caribbean islands. We have a dozen members in Bermuda but just 11 in giant China; we have some in South Africa, Brazil, Saudi Arabia, Qatar, Portugal, and Uruguay — even Tanzania and Brunei Darussalam, among many other countries. *Pro* truly hosts a global base of investors taking an active role in their financial futures. Combined, all of you logged 243,000 *Pro* site visits during the past six months.

About 10% of *Pro* members are CAPS-rated players; more than 12% of all members post on *Pro*'s discussion boards (half of those for the first time in the past year), while countless more read the boards; and 17% of members use the My Scorecard feature, where **Kinetic Concepts**, **GrafTech International**, and **Vanguard Emerging Markets** are among the most widely tracked *Pro* stocks. The average member tracks about eight *Pro* stocks in My Scorecard.

Here's to *Pro*!

If we could get all *Pro* members together in an airport hangar, it'd be one of the most amazing parties any of us could attend. We'd have people from all walks of life and backgrounds, from every U.S. state and dozens of countries, all with a common goal of investing successfully: Building wealth, reducing risk, and providing a better life to those you care about.

Our Foolish caps are off to you. In closing, if you have any final thoughts on 2009 or predictions to share for 2010 — or if you just want to say hello to the Pro neighbors living near you — visit our Memo Musings board.

We wish each of you a prosperous and healthy 2010!

Jeff Fischer, on behalf of the entire *Pro* team: Todd Wenning, Bruce Jackson, Jill Ralph (publisher), Allyson Cohen (editor), Russell Carpenter (CAPS All-Star), Barbara Eisner Bayer (board stroller), and David and Tom Gardner (the guys behind all this Foolishness).

Monday Memo: So Long to a Down Decade

Published Dec 22, 2009 at 12:00AM

How's this for a quick-hit holiday charity pitch? Give the Fool a piece of your mind, and we'll donate a dime to Thurgood Marshall Academy in Washington, D.C. The public charter high school is in one of the most impoverished neighborhoods in our nation's capital, and it's doing amazing work: Its first five graduating classes had *a 100% college acceptance rate*.

Here's how you can help. The Motley Fool will donate $0.10 to the school for every post on our discussion boards through Jan. 8. So give back this season. Visit your *Pro*discussion boards and post any questions you have — that's $0.10 to a worthy cause. Or respond to your fellow members' questions — another $0.10. Or just say hello. As Fools well know, dimes add up. So enjoy this week's Memo, and get posting!

Checking the Rearview Mirror

As 2009 winds down, many investors are reflecting on the year and fixating on the S&P 500's 66% vault from its March low. But we know better than to get too caught up in this market exuberance. After all, the index is actually up a much more modest 26% for the whole year, and despite this year's gain, the S&P 500 is still 40% below its late-2007 highs (excluding dividends). In fact, if you invested $10,000 in the S&P 500 on Jan. 1, 2008, your money would have shrunk quite a bit:

Date	Investment Value
Jan. 1, 2008	$10,000
Jan. 1, 2009	$6,100 (after a 37% decline in the S&P)
Dec. 18, 2009	$7,300 (with this year's 26% bounce)
Two-Year S&P Return	**-27%**

**Source: Google Finance. Dividends excluded.*

As you can see, it's been a rough couple of years for stocks. What's more, it's been a rough decade — the worst 10-year period for equities since the 1950s, with the S&P 500 index down 21% from Dec. 22, 1999, to now. (If you reinvest dividends, the decline is about 7%).

Unless Santa brings us a time machine, we can't change the past 10 years. But we can look at market trends to help us anticipate the future. Historically, underperforming decades have been followed by much stronger decades (1929 to the 1950s aside), though we shouldn't bank on an immediate revival come New Year's Day. There's a strong chance that market returns will be mediocre in the coming years. The U.S. government has more debt on a nominal basis than ever before, and the country's debt-to-GDP level is approaching what it was during World War II. This time around, we have an aging population and ballooning Social Security and Medicare liabilities — a recipe for financial frustrations as tax proceeds fall and government liabilities leap. Adjustments will need to be made (higher taxes, anyone?) that will probably curtail growth.

Events

- Dec. 19: **Oracle**topped earnings expectations, sending the Buy First stock to new highs.
- Dec. 21: **Ebix** shareholder meeting to approve a 3-for-1 stock split.
- Dec. 22: **Lindsay** reported estimate-stomping earnings thanks to a large Mexico City road barrier contract.
- Mid-January: Exclusive *Pro* interview with **Plum Creek Timber**.

Community Highlights

- Pro member Alex340 posted numerous, current options ideas meeting Pro's general guidelines.

- Jeff summarized the success we've had writing puts on **Nasdaq OMX** the past year.
- Stamleo posted how the **U.S. Natural Gas Fund** is performing, while Jeff elaborates on why the ETF was selected.
- In relation to Plum Creek Timber, Todd and *Pro* members discuss a new bill on timber harvesting.
- With **GrafTech International** shares recently near $16, a few Fools are thinking of writing covered calls.
- Pro member HPHamilton posted his favorite options resources.
- TMFEldrehad shared the three most-recommended CAPS blogs from the past week.

The Road Ahead

That's why we'll probably keep at least 20% of our *Pro* portfolio in cash in 2010, so we can remain defensive, have money for new opportunities, and generate options income. (Our portfolio is currently about 40% cash.) We aim to earn about 5% of our portfolio's assets from options income alone in 2010, or about $4,200 a month on average.

We remain focused on infrastructure and energy investments. **Autodesk**, **Cameco**, **GrafTech International**, **Flowserve**, **FPL Group**, **Plum Creek Timber** and **Vanguard Energy ETF** all stand to benefit from programs to rebuild North America's infrastructure and energy grid, while emerging countries are just starting to build those projects. We believe large projects such as these will help lead us out of the recession and bring years of growth to leading companies. We know that's a fistful of infrastructure-related companies, but we don't think we're overweight in this sector. Each company has a different focus and serves different industry needs.

Elsewhere in our *Pro* portfolio:

- **GlaxoSmithKline** , **Medtronic**, **Kinetic Concepts** and, in a related field, **Waters** provide us with strong exposure to the health-care industry (the least expensive sector in the S&P 500 right now), and we'll try to buy more of these companies at the right price.
- We're seeking a few carefully chosen investments in consumer retail, a sector where we're light.
- We're considering more exposure to commodities, including agriculture.
- We're targeting more exposure to innovative technology leaders.
- We're seeking some straight covered call income positions.
- We want to put money in emerging-market small caps in Brazil, China, India, and elsewhere, but only at reasonable prices.

Finally, as our 2010 option goal suggests, we expect to continue to write strangles and start writing straddles to capitalize on a range-bound market with income. We may also see more opportunities to use spreads and, with a meaningful dip, buy long-term bullish call options. Meanwhile, despite stock appreciation in most of them, we continue to favor every company we own for long-term capital appreciation, while monitoring valuation quarterly.

Predictions for 2010

Last week, Todd and Bruce took a shot at making some market calls for 2010. Todd's "bwak-bwak-chicken" taunts are getting pretty old, so I'll take the leap, too. Of course, we do these tongue-in-cheek (or, tongue-in-beak). Although we always take the pulse of macro events to help inform our decisions, investing in strong companies at good prices is our true ticket to returns because nobody can consistently predict what the economy will do. That said, here are my predictions:

- Most everyone is bearish on the U.S. dollar. Being contrary, I think this will lead to dollar gains in 2010.
- Despite a rising dollar, oil prices will rise modestly as economic activity increases, especially in emerging markets. (And China will continue to stockpile commodities.)
- Most people are bullish on gold, but I don't think it can pull off a repeat performance. I expect prices to cool off.
- If interest rates don't start to increase in 2010, they will soon after. (How do you like that one?)
- Housing prices will limp along and the jobs situation will improve, but not enough to repair even a third of the damage done.
- The U.S. economy will grow more than the 2.6% expected, but this won't benefit industries equally.
- The market will stay in about a 20% range, up 10%, down 10%. This would suit us nicely (as would more gains). Only select stocks will do well — that is, the "one rally lifts them all" situation will end.

On behalf of the *Pro* team, I wish you a joyful holiday season. Thank you for being with us at *Pro*. We always appreciate it — we wouldn't be here without you! As you celebrate and reflect with friends and family, remember this most liberating reality: It's only money. Life can be just as rich without much of it as it can be with plenty. Enough is as good as a feast.

Happy holidays!

Jeff Fischer

Jeff owns shares of Nasdaq OMX Group and Oracle.

Audio Extra: Todd Chats With Economics Expert Deborah Hewitt

Published Dec 18, 2009 at 12:00AM

Happy holidays, *Pro* Fools! As you'll recall from our Nov. 23 Monday Memo, *Pro* analyst Todd Wenning laid out our plan to bring you more access to company executives and industry experts so that we can become a smarter investment community. He's kicking off that initiative today with Dr. Deborah Hewitt, clinical professor of economics and finance at The College of William and Mary (and a former teacher of Todd's). In this special *Pro* Audio Extra, Todd and Dr. Hewitt discuss the future of the dollar, the health of the global economy, and one promising country for long-term investors.

Just click on the player below to listen!

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Buy GlaxoSmithKline

Published Dec 17, 2009 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Estimated fair value**: $47.50
- **Preferred buy price:** Around $40 or lower
- **Dividend yield:** 5%
- **Type of holding:** Core income; Healthcare: Major drugs

The Big Picture

It's no secret that big pharmaceutical companies are in the midst of a multi-year bear market. Patent expirations on major drugs and government interest in lower health-care costs continue to take a toll on these stocks, pushing share prices of leading drug companies down over the past decade

At *Motley FoolPro*, we see an opportunity. We aim to buy stocks when they're trading at depressed valuations for known reasons, as we did with **Procter & Gamble** (NYSE: PG), **FPL Group** (NYSE: FPL), and **Kinetic Concepts** (UNKNOWN: KCI.DL). Pharmaceutical giant **GlaxoSmithKline** (NYSE: GSK), which is facing well-known challenges along with the rest of the drug industry, already has these issues priced in, so its shares are attractively valued. And although the returns from a low-risk stock like Glaxo won't knock your socks off, the substantial 4.6% dividend yield — as well as potential options strategies on the stock in the future — should help us generate steady income over time.

The Business

Tip: ADRs and You

Based in Britain, Glaxo's primary listing is on the London Stock Exchange, and the company reports its numbers (including dividends) in sterling, which are then translated into dollars. For our purposes, one American Depositary Receipt, or ADR, is equal to two U.K.-listed shares. There is some exchange-rate risk, but no more than we'd see with any other large, diversified, global company. As owners of the ADRs, we'll receive our dividends in dollars, and all else being equal, we'll receive more when the dollar weakens and vice-versa.

Based in the U.K., Glaxo is a $109 billon pharmaceutical behemoth that controls an estimated 7% of the global market (revenue-wise) and employs 99,000 people in more than 100 countries. It's the second-largest drug-maker in the world behind competitor **Pfizer** (NYSE: PFE), making it larger than the likes of **Merck** (NYSE: MRK) and **Bristol Myers Squibb** (NYSE: BMY). Glaxo boasts strong, steady cash flow and a diverse portfolio of drugs treating diseases such as asthma, infections, mental illness, diabetes, and digestive ailments. Leading brands include Avandia, Lamictal Seretide/Advair, Relenza, Paxil, Zofran, Requip, and Valtrex. Glaxo also has a consumer products division with many leading brands, especially in the U.K.: Panadol, Aquafresh and Macleans, Nicorette/NiQuitin, and many more.

Trading at about 13 times earnings, the stock is not necessarily as cheap as Pfizer — whose share price has fallen more than 50% over the past decade compared with Glaxo's 22% drop — but Glaxo faces fewer challenges than Pfizer. We also like Glaxo's less-risky strategy of bolt-on acquisitions (it announced four in the second quarter). In the recently ended third quarter, Glaxo also walked away from two or three other potential deals, looking to only buy complementary businesses at reasonable valuations. That said, we expect acquisitions in the coming years to add to growth.

At the helm of Glaxo is 44-year-old Andrew Witty, relatively new to the position but promising so far. The CEO's three-pronged strategy seeks to grow a diversified global business, deliver more products of value, and simplify the operating model. Emerging markets, where sales grew 25% in the last quarter, offer a large opportunity in particular; according to a study by UBS, seven emerging nations — Brazil, Russia, India, China, Korea, Mexico, and Turkey — could account for 70% of pharma sales growth by 2020.

The Community's Take

Glaxo scores a respectable 7 out of 12 in our proprietary CAPShot Report, falling short on industry rating, and growth and debt ratios, things we feel comfortable with.

On CAPS, Glaxo rates 5 out of 5, with 95% of members recently rating the stock a buy, and 96% of All-Star Members also rating it a buy.

Meanwhile, business in the U.S. is presenting a challenge, with Glaxo's third-quarter sales in the region down 12% largely due to the impact of generic drugs, as products including Lamictal, Paxil, and Zofran are now off-patent. On the bright side, U.S. sales of products *not* subject to generic competition grew 10% from a year ago in the recent quarter. Glaxo currently has six products filed for FDA approval and 12 new products have been launched in the U.S. since 2007.

The Glaxo research and development pipeline looks promising, with approximately 30 candidates in late-stage development including treatments for chronic bronchitis and emphysema (COPD), prostrate cancer, cervical cancer, and meningitis.

Although the U.S. in particular is a challenging market, Glaxo is a strong, diversified, global business. We particularly like its focused strategy as it moves away from a dependency on western markets to foster strong growth in emerging countries.

Valuation

Glaxo has strong free cash flow, making its $14 billion net debt relatively modest and manageable. The shares, currently priced around $42, trade on a forecast 2010 P/E of 12 and a forecast 2010 dividend yield of around 4.9%.

Our discounted cash flow model, using a modest growth rate around 5% and a 9% discount rate, gives a fair value for the shares of between $50 and $58. Being conservative, we estimate fair value in the lower $50s.

If we can achieve a conservative gain of 8% to 9% per year (more than half of it currently in dividends), the stock will more than pay its way in the *Pro* portfolio until it reaches fair value. If we use options on the stock as well (covered calls, for example, after shares appreciate), we should be able to target double-digit capital gains, along with the nearly 5% dividend, all with relatively low risk.

Risks

The blockbuster drug revenue model of yesteryear is fading quickly as big pharma shifts its focus to a more diversified portfolio of consumer health products, "personalized therapy" drugs, and treatments for niche diseases. Patents on major drugs, including Pfizer's Lipitor and Glaxo's Seretide/Advair, expired recently, while generics have gone mainstream. It's still uncertain how successful the industry's transition will be.

To cope, many major pharmaceutical companies have been diversifying away from pure drug plays by acquiring or expanding upon existing lower-margin businesses. Pfizer's recent $68 billion acquisition of Wyeth takes the company into the over-the-counter consumer health-care and animal-health markets, both of which have traditionally posted lower profit margins than pharmaceuticals. Meanwhile, unknowns associated with U.S. health-care reform continue to put pressure on the industry. However, we believe that these concerns, being priced in already, provide us the opportunity to buy shares at a low price and with little risk over the coming years.

What Would Make Us Sell

We need to see steady results from Glaxo's annualized $6 billion R&D expenditure program. Over time, we want to see annualized growth of between 5% to 8% in sales and net earnings. A large acquisition would make us reevaluate our investment thesis. Furthermore, the high dividend yield is a large part of the attraction, and a large acquisition could put it in jeopardy — as was the case when Pfizer acquired Wyeth in January. Glaxo's dividend recently grew 7% over the previous year; we want to see the dividend at least maintained, and ideally, increase over time.

Pro Bottom Line

With Glaxo, we're getting one of the strongest names in one of the most inexpensive industries today. The company's strong cash flow and focused strategy, combined with reasonably valued shares and an attractive dividend yield, have us convinced that adding one more health-care position to the *Pro* portfolio is a smart move. As Glaxo joins our **Medtronic** (NYSE: MDT) and Kinetic Concepts (NYSE: KCI) holdings, the portfolio will have ample exposure to medical devices and drugs in the most undervalued industry in the S&P 500. Questions? Please post on the new GlaxoSmithKline board.

Analyst Bruce Jackson owns shares of and has written options on GlaxoSmithKline. Pro *will make this trade in two business to 30 calendar days.*

Tax Questions? We've Got Answers

Published Dec 15, 2009 at 12:00AM

When you write (or "sell to open") equity calls or puts and buy them back ("buy to close") before expiration, or let them expire for a 100% cash gain, they're always counted as a short-term capital gain (or loss), no matter how long you held the trade. Even if you write a put or call that doesn't expire for two years, and hold it open to the bitter end, the option is still a short-term taxable event. This law assumes the option you write doesn't get exercised and that there is no stock involved — you simply closed it at some point or it expired.

When you buy ("buy to open") a call or put, and don't get the stock involved, it is treated the same way as a stock for tax purposes. If you buy an equity option and hold it for more than a year before closing it or before it expires, it becomes a long-term capital gain or loss. If you hold it less than a year, it's treated as a short-term capital gain or loss.

Taxes on options become a bit more complex once the underlying stock becomes involved. However, for the bulk of your trades, there are simple rules to follow. If an option you wrote is exercised, the premium you originally received for writing the option is factored into your new stock trade price, and your transaction date for tax purposes becomes the date of exercise. Likewise, if you exercise an option you bought, you factor the premium you originally paid for the option into the new stock transaction, too. It's as follows:

Action	Tax Treatment
Call owner exercises (buys the stock)	Add call premium you originally paid to your new stock cost (nothing to report for taxes until you sell the stock). Start date for the holding becomes date of exercise.
Put owner exercises (sells an existing stock)	Subtract put premium you originally paid from your stock proceeds (taxable that year, since the position is closed). Trade date is date of exercise.
Call writer has calls assigned (stock is called away)	Add call premium you originally received to your stock proceeds (taxable that year, since the position is closed). Trade date is date of exercise.
Put writer has puts assigned (made to buy stock)	Subtract put premium you originally received from your stock cost (nothing to report for taxes until you sell the stock). Start date for the holding becomes date of exercise.

In each case above, you adjust the cost basis, or sales proceeds, on the underlying stock to reflect the original option premium related to the trade. If you were paid an option premium as part of a stock trade, the IRS wants to know. If you paid a premium, you can use that to lower your effective tax bill on the resulting stock trade. In any case, you don't need to report anything to the IRS in the above examples until the trade is completely closed — for instance, in some cases you may be "put" a stock and not sell it for years. So, keep good records of your option trades that result in long-term stock holdings.

Nowhere else is this saying more true than when it comes to taxes. One area where it gets tricky is when you already own a stock and then write covered call options on it. In general, be aware that if you've owned the shares for less than a year and then write covered calls against them, you need to write calls that are out-of-the-money (above the current share price) in order to maintain your original purchase date on the stock for tax purposes. If you write deeply in-the-money covered calls, your original stock purchase date is eliminated. So be careful! But if you've owned a stock for nine months, for example, and then write out-of-the-money calls on it that end up being exercised in month 13, your stock qualifies as a long-term holding.

Generally, double-check tax laws before you start to get options involved on stocks you've owned less than a year. In some cases, the options will reset your holding period for tax reporting. Also, realize that an option position that is essentially a "short sale" — such as writing naked calls — is like all short sale positions: they're all taxed as short-term capital gains or losses, no matter how long you hold them.

Additionally, if you own a stock less than a year and then buy put options to protect it, you wipe out the holding period you've had so far, and can't even start the clock again until you sell the put. Once you sell the put, that date becomes the new adjusted purchase date for the stock you're still holding. So, if you own a stock 11 months and buy puts on it, you've just wiped out those 11 months as far as Uncle Sam is concerned. The only way to avoid this is to own the stock more than a year before you buy puts on it, or buy the puts the same day you buy the stock (a "married" put). In this latter case, the puts ideally don't expire for at least a year, and if they do expire sooner, you can't marry any other put to the stock.

Keep in mind that the 30-day wash-sale rule on stocks applies to options, too. If you sell a stock at a loss and then take an option position within 30 days that approximates owning the same or even a similar stock, you won't be able to claim the first tax loss until this new position is closed, too. If you take a similar option position on a stock within 30 days *before* selling it, the wash-sale rule also applies. So, there is a 60-day window around the sale of any losing stock where the wash-sale rule will apply if using equivalent options. It works the other way, too: if you sell a call option at a loss and then buy the stock within 30 days, you'll invoke the wash-sale rule. Treat options as you would a stock when considering the wash-sale rule.

You've probably surmised that trading options in a tax-advantaged account has many, uh, advantages. Most IRAs allow for covered call writing and option purchases. Some even allow cash-secured put writing. If you can trade options in a tax-free account, you'll avoid all short-term gains taxes, and you can let your option income compound unimpeded.

This overview helps you get started, but isn't at all a complete guide to options and taxes, and this topic isn't one in which we'll be experts or provide specific guidance (we can't). You'll want to consult an accountant if you need help. But, in general:

- If you write any option and it expires or you close it, it is a short-term gain or loss no matter how long you hold the trade.
- If you buy an option and later sell it or let it expire, it is taxed long- or short-term just like a stock.
- If put options are exercised and result in you buying or selling a stock, adjust the stock trade price for the put premium you paid or received, and use the exercise date as a trade date. There's nothing to report for taxes until the resulting stock trade is closed.
- The above is also true if call options result in you buying or selling a stock.

It's relatively rare that you'll hold an option trade longer than a year, so in many cases — if not most — your options trades will be short-term tax events. When the underlying stock gets involved, the stock becomes the benchmark for whether it's a long- or short-term event, and the date the options are exercised becomes a transaction date for your trade. Once any resulting stock position is closed, you'll report the adjusted gain or loss on the combined option and stock trade to the IRS, but not before then.

Fun stuff? Hey, it's not so bad. Fool on!

Monday Memo: Todd and Bruce Take on 2010

Published Dec 14, 2009 at 12:00AM

Inside Scoop: Ebix Analyst Day

Jeff was on hand for **Ebix**'s analyst day last week, gathering insight on the information-management software company to share with you. A few of his top takeaways:

- There are large, untapped opportunities in international markets.
- Ebix has many new products in the works, including annuities and e-forms.
- The company's focus on cash flow and costs suggests steady value creation ahead.

For much more, see Jeff's complete notes on the Ebix board. Meanwhile, the company's 3-for-1 stock split has been moved to early January while the company awaits a proxy vote. Management didn't handle the split as smoothly as we'd like, but the company remains promising.

Pro Company News

- After a 33% gain in **Medtronic**'s stock price, we're moving the company from **Buy First** to **Buy** on valuation. It remains attractive, though, and following an exceptionally strong third quarter, we're increasing our preferred buy price 10%, to around $40.
- Buy First stock **Oracle** reports earnings on Dec. 17 after market close.
- Four *Pro* put positions are set to expire as 100% cash gains on Dec. 19: **Lindsay**, **Nasdaq OMX Group**, **GrafTech International**, and **Kinetic Concepts**. We'll email you if price changes necessitate any action, but we don't expect that to happen. We'll be looking to repeat these puts soon.

Community Highlights

- TrojanFan shares that natural gas supplies declined, helping shares of **U.S. Natural Gas Fund** ETF.
- Alex340 offers put writing trades that match *Pro* criteria on **Autodesk**, **Lindsay**, **Plum Creek Timber**, and others.
- Moneyshaker asks: With so much bullishness surrounding it, why not short gold?
- This Week in CAPS, Russell (TMFEldrehad) highlights a few pitch-writing superstars.

As we near the end of a historical year for investors, we're also wrapping up one of the market's most volatile decades. The past 10 years were scarred by two price implosions, from 2000 to 2002 and 2008 to 2009 — and though each fall was followed by a steady climb, the S&P 500 is down more than 20% overall since December 1999.

If history is any guide, the next 10 years should bring relatively healthy returns, but the only real certainty is that there will be shocks to the system — whether political, financial, or resource-based — as well as periods better than anyone expects. Great new companies will be born, and many well-known ones will fade away. Through it all, our mission at *Motley Fool Pro* is clear: To help you generate steady, stable returns in leading stocks and macro-minded ETFs, while greatly complementing those returns with options — *and* going short when it's worth the risk. No matter what, we must remain flexible, with absolute gains remaining the primary goal.

For this week's Memo, I asked *Pro* analysts Todd Wenning and Bruce Jackson to share a few thoughts on the year ahead. Todd is ready for politics to become even more closely tied to Wall Street, and Bruce expects a flat market at best. Let's hear their takes.

Fool on,

Jeff Fischer

Feeling the Fed in 2010

By Todd Wenning (TMFPhila)

If you think this has been a politically charged year, brace yourself for 2010. Next November, 36 Senate seats, all 435 seats in the House of Representatives, and 36 gubernatorial seats are up for grabs. With so much at stake for both parties, and on both the local and federal levels, expect to see incumbent politicians do all they can to win the public's favor leading up to Election Day. Most important, this means increased government spending in the short run to further reduce the unemployment rate and boost economic growth.

What does this mean for us as investors? First, it means staying patient and trying to get a better understanding of what actions taken now will mean a few years down the road. For instance, it's likely that increased spending will lead to higher tax rates on income and capital gains down the road. I also expect that if the economy does gain some traction in 2010, we'll see the Federal Reserve raise interest rates, and it will do so quickly in order to stave off inflationary pressures caused by the multi-trillion dollar government stimulus. This would be bad news for longer-term bonds and assets benefiting from the dollar carry trade (the selling of dollars for currencies that pay higher interest), namely oil, gold, and emerging economies. We have our eyes focused on this possibility and are looking at investments that could benefit in 2010, so stay tuned.

A Slow Recovery

By Bruce Jackson (TMFGoogly)

Following one of the most savage recessions on record, economic recovery will be a long, slow process. The S&P 500 is at its highest valuation to earnings since 2002 despite shockingly high unemployment in the U.S. and struggling personal balance sheets. The obvious conclusion is that the stock market is riding for a fall in 2010 at worst — flat, at best.

But it rarely works like that. A number of forces are in action at any one time. Right now, we have interest rates at zero. We have massive government stimulus spending, both in the U.S. and abroad, particularly China. We have a truly enormous government deficit and a very weak dollar.

An optimist might say, given the record-low interest rates and government spending, a speedy economic recovery will ensue. A pessimist might say it's all going to end in tears, and we're in for a Japan-like lost decade or two. The truth is, no one knows. When it comes to making economic predictions, almost nobody can get it right, even some of the time.

But it's fun to play amateur economist these days — so on that note, I'll make a few predictions (but I'll keep them brief, since they're likely to be wrong anyway):

- The S&P 500 will close 2010 at 999.9 (it's currently 1,107).
- We'll have reduced volatility and reduced trading volumes in 2010 as people get bored with a flatish stock market.
- Gold will end 2010 below $1000.
- The U.S. dollar will rally.
- Official U.S. interest rates will end 2010 at 2.25%.
- The *Pro* portfolio will make exactly 39 trades in 2010.
- The *Pro* portfolio will (hopefully!) make a positive return in 2010, with dividends and option income generating 7% returns. It's money making money.

See You Next Monday

We'll be back next week when Jeff will share his thoughts on what's in store for the *Pro* portfolio in 2010. Don't forget to visit the sidebar above — we have plenty of news to share, including several *Pro* put option trades that are set to expire on Friday. And start making your predictions for 2010 on our Memo Musings board.

Fool on!

The *Pro* Team

Monday Memo: What a Gas

Published Dec 7, 2009 at 12:00AM

Coming Up

- In next week's Memo, the *Pro* team shares its outlook for 2010, including which sectors should perform best, whether the dollar will recover, and much more. Don't miss it!
- Today, Jeff is at the first **Ebix** analyst day, and he'll report his findings to you this week. Remember, the stock splits 3-for-1 before market open on Dec. 10. For every share, you'll own three. Ebix options will split by three, too, giving you more contracts at a lower strike price.

Community Highlights

- **Abercrombie & Fitch** reported weak November sales, with same-store revenue down an unstylish 17%, more than the 9% drop that was estimated. The stock has slumped. Read the latest thoughts from Jeff, Todd, and your fellow Fools on the Abercrombie board.
- Member spinningwood starts a discussion on benchmarking. What do you use to measure *your* returns? This led to Jeff's post on how *Pro* is doing.
- Good news, to us: Howard Buffett wants to stay on **Lindsay**'s board.
- Jeff and Todd explain further how *Pro* is aiming to actively manage its hedge, **ProShares Short S&P 500**, with covered calls.
- Fools discuss our covered calls on **iShares Silver Trust**.

I turned up the heat in my house to 85 degrees. And despite my cat's sweaty paws, I don't plan on turning it down.

Ever since *Motley Fool Pro* set up a synthetic long on the **U.S. Natural Gas Fund**, I've been cursing the D.C. weather — painfully warm for this Chicago native — and bemoaning that we aren't using more natural gas. This may hardly be the ringing endorsement you want from your investment advisor, but it's the truth.

When my wife says, "Can you imagine? It's 63 degrees out and gorgeous in December," I grumble, "Stupid global warming. I want it to be *cold*!" Living in D.C. also means watching mile-long trains loaded with coal crawl toward our nation's capital day after day. Yes, the U.S. Capitol and White House run largely on coal. How quaint.

So far, all that's made me smile about our U.S. Natural Gas Fund trade is seeing noisy D.C. buses drive by with "This Bus Runs on Clean, Natural Gas" painted on the side. Score one for *Pro*.

Getting Burned

In reality, we have history on our side with this trade — even if the position is going the wrong way for us so far. Natural gas is cleaner and cheaper than other fuels, and eventually, many more power plants will use it rather than coal. When the sun doesn't shine or the wind doesn't blow, green power plants will use natural gas as a backup.

But while we wait for that cleaner future, a steady decline in the U.S. Natural Gas Fund has erased nearly $10,000 from the *Pro* portfolio, a hit equal to 1% of the portfolio's starting value. Since we announced our trade on Oct. 7, shares of the ETF have declined 29% (as of Dec. 4), from about $12 to $8.50, and the loss is compounded in our options — our $10 calls have lost more than half their value, and our $12 puts are suffering as well. Investing real money alongside you, and tracking our returns in real time, we're well in tune with how you may be feeling about this trade.

While the quick decline is unfortunate, we realize that natural gas is volatile and could easily rise much higher in the coming months. But part of what makes the U.S. Natural Gas Fund's slide so hard to stomach is that natural gas hasn't actually fallen in price since we announced our trade.

In fact, the spot price of natural gas has *gone up*.

Left in the Cold

What's going on? You see, the U.S. Natural Gas Fund doesn't trade according to the spot market, but rather by (mostly) using futures contracts. Translation: The ETF pays what traders are pricing natural gas contracts deliverable a month from now. And while the spot price for natural gas is up nearly 10% since Oct. 7, from $3.65 per million btu to about $4, the forward month contracts have fallen from about $4.90 to $4.53, down by nearly 8%.

What's more, the U.S. Natural Gas Fund has been handed a bit of bad luck this fall, as the ETF was forced to sell its expiring contracts at a lower price than what it paid for new forward month contracts. The forward month contracts soon declined in value, too, compounding the ETF's losses.

Still, our thesis continues to suggest that natural gas is too inexpensive — incidentally, it traded at $6.70 a year ago — and the increase in the commodity's spot price over the past two months, despite a mild autumn, may support our argument. *Pro* member stamleo has posted excellent analysis suggesting that the price discrepancy may be seasonal, and in recent history, the forward month contracts have not traded at a large premium to the spot price for most of the year. That would be good news, because lately, the ETF has been buying natural gas futures at prices that essentially include a lot of "time value" (much like an out-of-the-money call option), and then selling them, as the value erodes, for a loss. Unless the natural gas spot price also goes up, the loss is unavoidable. So, we'll definitely be watching to see that this premium dissipates in early 2010.

Better Prices Ahead?

Foolanthropy 2009: You Can Help

This year, the Fool is taking action in its own community, focusing on a local school in need — and you can help. Through Jan. 8, for every community action you take (comments on discussion boards, articles, and blogs), the Fool will donate $0.10 to the Thurgood Marshall Academy in D.C. You can learn more about the Fool's campaign right here.

Natural gas is still in a bear market, but the largest explorer, **Chesapeake Energy**, expects prices to jump in 2010 and 2011, as production has slowed sharply this year. Our thesis remains that shale extraction of natural gas will prove more challenging and less profitable than hoped; demand will steadily increase as natural gas remains cheap; and supply will slowly dissipate enough to send prices higher. If the commodity enters a bull market, the ETF should benefit, period.

But for now, we've been hit with a rough few months in which the U.S. Natural Gas Fund has compounded losses even though natural gas has not moved much. So far, this investment shows us the added risks inherent in ETFs of this nature. But we remain hopeful that the pendulum will swing back. Meanwhile, if you use natural gas heat in your home, could you crank it up, please? Along with many *Pro* members, we wouldn't mind the boost.

Don't forget to see the sidebar above for important *Pro* events and posts, and share your comments on the Memo Musings board. Fool on!

Jeff Fischer (TMFFischer)

The Motley Fool owns shares of Chesapeake Energy.

Write Covered Calls on ProShares Short S&P 500

Published Dec 2, 2009 at 12:00AM

At a Glance

- **Trade:** Write ("sell to open") February 2010 $56 calls (QRSBD)
- **Allocation:** Write one call for every 100 shares of ProShares Short S&P 500 owned, and please use a limit order
- **Recent option price:** $1.10 bid/$1.50 ask
- **Limit price:** Attempt to split the bid/ask
  Alternate trade: If you don't own shares, you can consider writing puts in the lower $50s as a market hedge. If the market declines, ProShares Short S&P 500 will appreciate, and your puts will expire as income. If the market advances, dropping the ETF's price, you'll be obligated to buy shares.

What's New

When we approached the **ProShares Short S&P 500** (NYSEMKT: SH) ETF as a market hedge, we in part chose it simply because it has options available. This way, even if the market continues to advance, we can write covered calls to lower our cost basis on Short S&P 500 and (we hope) eventually close the position profitably.

Since we set up our synthetic long on Short S&P 500 (which turned into straight ownership of the ETF), stocks have continued their record advance, although nothing has fundamentally changed. Investors continue to pin their hopes on an economic recovery in 2010, as the broadest of measures imply mild promise — namely, GDP ticking up slightly, manufacturing not contracting, and fewer new unemployment claims. The question is, will even a mild recovery in 2010 be strong enough to merit continued share price appreciation? We have concerns, but we also want to manage our short of the S&P actively.

The Options Numbers

The February 2010 call options don't pay a tremendous amount, but Short S&P 500 represents an entire market index, so it should be much less volatile than an individual stock. With Short S&P 500 recently trading near $53, the February 2010 $56 call options bid $1.10. That represents about a 2% yield or payment on our $55.42 purchase price, earned in less than three months, and it lowers our break-even price to $54.32 before commissions.

On the upside, the $56 calls net us a potential sell price of $57.10, or nearly 8% above today's level. That represents a meaningful decline in the S&P 500. If our shares are called away, we'd be closing the short at a small profit. Meanwhile, it buffers any market decline, serving its purpose.

By writing covered calls on Short S&P 500, we're limiting our potential gains, but we're being cautious and improving our break-even price. If the market doesn't decline, we can consider writing new covered calls after we've earned most of the gains on these. So, we're proactively being defensive on our short, but leaving room for it to end profitably if stocks decline.

If you have questions, visit us on the [ProShares Short S&P 500 board](#).

Write Puts on Oracle

Published Dec 2, 2009 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") January 2010 $22.50 puts (ORQMJ)
- **Allocation:** 2% (for *Pro*, about 10 contracts)
- **Option's recent bid/ask:** $0.87/$0.89
- **Preferred limit price:** Around $0.87 (a 3.7% payment in 45 days); you may accept a lower payment if need be.
- **Alternate trade:** Use a limit order to buy more shares around $21.65. If you don't own any shares yet, consider buying them outright.

What's New

Since we bought our first shares of **Oracle** (NYSE: ORCL) in September, the stock has been steady, rising more than 5% — ahead of the S&P 500 over the same period. In terms of our portfolio's current value, we're about 2% invested in Oracle, so we'd like to make our position more substantial. Writing near-the-money $22.50 puts could net us more shares close to our initial purchase price, just above $21.50.

Since late summer, small-cap stocks have underperformed while larger companies are beginning to draw more interest and performance. A giant in the tech industry, Oracle could benefit as the market rally continues on — usually, small (and thus more speculative) companies start a rally, and eventually, large-cap value stocks draw more buyers.

Europe's regulating body is still holding up Oracle's pending acquisition of **Sun Microsystems** (UNKNOWN: JAVA.DL), costing Sun $100 million per month in lost business. However, this is well known, and we believe Oracle represents value even without Sun; the business currently trades at 14 times free cash flow and 14.7 times earnings estimates for the year ending May 2010. Assuming approval, the main risk the company faces will be integrating Sun.

Oracle has not reported meaningful news since September, but it will report quarterly results in mid December. If the stock declines, we'll welcome the chance to buy more shares via our January puts. If it holds steady or appreciates, our partial stock position will benefit, and though we won't get new shares, we'll still profit from our puts.

How to Follow Along

You write ("sell to open") puts when you're ready to buy a stock if it declines below the strike price by expiration. This trade is more aggressive than our [put-writing guidelines](#) typically suggest, but that's because we're making the trade with a strong desire to buy more shares and we're comfortable with the valuation.

- **Option payment or yield (at $0.87 bid):** 3.7% in 45 days

- **Option strike price:** Close to Oracle's current stock price ($22.50)
- **Break-even price:** 3.9% lower, at $21.63
- **Cash or buying power needed:** Each put option you write represents a potential purchase of $2,250 worth of Oracle stock

Can't Write Puts?

If you're unable to write puts and don't own Oracle, consider purchasing shares of this Buy First stock today or on a dip. It's currently hugging our $22.50 Buy Around price.

To discuss this trade or ask questions, please visit our Oracle board.

Monday Memo: It's Coming Into Focus

Published Nov 30, 2009 at 12:00AM

Pro aims to earn absolute returns in flat, up, and down markets; for us, this means we seek to close at least 75% of our positions — stocks, options, ETFs, shorts — profitably. So far, we've closed 21 of 23 positions at a profit, so we've been 91% accurate. Sure, we'll make occasional speculations, such as buying calls on biotech **Electro-Optical Sciences**, but only if we are exceptionally accurate in the rest of the portfolio.

How we're different: Our focus on absolute — rather than relative — returns should lead to better investment decisions. The S&P 500 can be irrational and mispriced. Investors who chased it over the past 10 years did so at an unnecessary cost given that the S&P was ultimately *down* 26% over that time. *Pro* won't get into a foot race with the market. In fact, the only positions we've closed at a loss so far have been shorts against indexes — hedges we made to lower our portfolio's risk.

We're here to help you build a portfolio that profits with less volatility and, wherever possible, less risk. This can mean hedging stock positions with options, holding shorts to hedge market risk, or even holding meaningful cash — which we can then use to snatch up opportunities as they appear. *Pro* is an active portfolio, so we'll usually keep around 5% to 10% in cash — though this could change given the circumstances.

How we're different: We don't eschew cash; we view it strategically and are confident we'll put it to good use. We're seeking steady results over the years rather than swinging for the fences day after day.

Of course, any strategy comes with a cost. Hedges and cash will relatively dampen our performance during powerful market advances. But we'll have less downside risk in weak markets; do well in flat markets thanks to neutral, income-generating options strategies; and overall, help you build a portfolio with lower volatility and, ideally, few permanent losses.

Since inception, the *Pro* portfolio has gained about 19% while never being down more than a few percentage points; the S&P 500 is up about the same amount, but it's fallen 25% twice along the way. We've been able to achieve strong returns with low volatility by holding about 50% cash for much of the year (some of that simply because it takes time to invest) and choosing lower-risk, high-quality investments. Which leads us to another core *Pro* principle: While much of this year's rally has been fueled by speculation in risky stocks, we've profited by buying industry-leading companies that should be strong holdings for at least three to five years, and we've bought at attractive prices.

Most *Pro* members wish to achieve or maintain the financial security that comes with a stable and growing portfolio. The ultimate aim is to earn steady enough returns to be financially independent, regardless of what an index does. Overall, we're seeking to achieve smarter and safer returns, and so far, we've been able to perform with less risk and less exposure (given our cash). The market won't always make large gains like this year, of course, and *Pro* should be well-positioned for the other side of the coin, too.

Have questions about our strategy? Please post on the Pro Philosophy and Strategy board.

Fool on!

Jeff Fischer (TMFFischer)

Write a Strangle on Waters

Published Nov 24, 2009 at 12:00AM

At a Glance

Alternate Trades

- Place a limit order at $55 per share
- Write February 2010 $55 puts, recently bidding $1.80
- Buy shares near $59 and write May 2010 $60 covered calls for around $5
- Write a February 2010 $55/$65 strangle for around $3 combined

- **First action:** Buy 3%
- **Second action:** Set up covered strangle: Write ("sell to open") May 2010 $65 covered calls (WATEM) on your shares and write May 2010 $55 puts (WATQK) representing another potential 3%.
- **New target allocation:** 6%
- **Preferred buy price:** $55 or lower (using this strategy; see "Why This Strategy")
- **Recent option prices:** Calls $2.60 bid; puts $3.10 bid
- **Limit order:** Aim to write the strangle for around $5.70 *combined*. The options have wide bid/ask spreads, so by splitting the spreads, you may be able to net $5.90 or so.

What's New

Our initial strangle on **Waters** (NYSE: WAT) has expired, and our shares were called away on Nov. 21 for a healthy profit. Now, we're picking up where we left off, this time writing a May 2010 $55/$65 strangle for more upside.

We're keeping our fair value range of $65 to $69 for Waters following third-quarter earnings, in which management said that the weakest demand for scientific instruments has passed. The future looks stable, if not outright improving, as Waters' customers begin to reinvest cash in their businesses — and thus spend more on research equipment — to keep up with competitors and drive growth. Waters' management also expects to see more government and university spending from stimulus funds aimed at scientific research.

Perhaps the biggest near-term risk for Waters is a broad-market sell-off that drags the stock down with it. We'll also see two more earnings report (in January and April) before our options expire. Recognizing the near-term risks, our average buy price on all of our shares would be about $54 if Waters declines below the $55 strike on our puts, and we're content to buy our position in this strong company at about 16 times trailing free cash flow on average.

Why This Strategy

Numbers Behind the Strangle

- **Action:** Buy 3% of Waters around $59 (about 500 shares for *Pro*)
- **Action:** Write May $65 covered calls for about $2.60
- **Action:** Write May $55 puts for 3% more for about $3.10
- **Potential second 2.5% net buy price:** $49.20
- **Average buy price if we get all shares:** $54.10
- **Potential sell price on our first 3%:** $70.80
- **Effective options yield:** 10% over 179 days
- **Stock gain if sold:** 20%

Prices as of Nov. 23, 2009.

If you're not using options, buying shares of this healthy business in the low to mid $50s remains a compelling long-term investment. With the stock trading above that level today, we're writing a strangle in order to be more defensive.

Waters is recently flirting with $59, and our May 2010 $55/65 strangle pays us about $5.80 *combined* per share. This positions us to either buy another 3% (for a total 6%) near a net $49.20 or sell our existing shares around $70.80 — an attractive range over about six months.

We also considered a February 2010 $55/$65 strangle (and have listed it above as an alternate trade), which pays about $3 rather than $5.80 over just three months. However, we're vying for the May 2010 strangle because it offers more upside and a bit more defense for nearly as strong a daily payment (taking commissions into account and assuming we'd be able to repeat the trade in February).

The option income here represents nearly a 10% yield on our $59 purchase price (not including the buying power set aside for the puts we'll write, which lowers our yield), while offering nearly 20% upside if our shares are called away at a sell price $1 above our fair value. If the stock declines, we'll effectively buy our next shares 17% cheaper — at 14 times free cash flow.

How You Fit In

- If you don't own any shares of Waters, consider matching our 6% target by entering a limit price at $55 or lower.
- If you still own shares of Waters (i.e., they weren't called away), consider writing May 2010 $65 covered calls and writing May 2010 $55 puts if you'd like to buy more shares of Waters lower.
- If you don't own shares of Waters and have no interest buying them ... then why are you still reading? (We jest, of course.)

If you have any questions about this new strangle, please post on the Waters board.

Monday Memo: The Experts Weigh In

Published Nov 23, 2009 at 12:00AM

At *Pro*,we're determined to give you access to execs of the companies we own, and we're tapping industry experts as well. Following **Kinetic Concepts**' analyst day in New York two weeks ago (read our recap here), Jeff and I headed downtown to meet with Professor Aswath Damodaran at New York University's Stern School of Business. Professor Damodaran, who is widely regarded in the investment community as the best valuation teacher around, was gracious enough to let us buy him a cup of coffee and pepper him with questions for an hour.

It was a full day of learning, to be sure. We were impressed with KCI's latest vacuum-assisted closure, or VAC, therapy innovations, and Professor Damodaran reminded us to stay focused on the long run (you can read the highlights of our conversation with him right here). He said that much of this market rally has been focused on near-term factors, and that investors should be more concerned about the implications of the massive government stimulus and bailouts. This is the sort of insight that you simply can't get sitting behind your computer all day.

The *Pro* team is committed to expanding our — and your — knowledge base through meetings like these, helping us deliver smarter returns for you. On Dec. 7, Jeff is headed back to New York for portfolio newcomer **Ebix**'s first-ever investor conference. If you have questions for Jeff to ask Ebix management, please post them on the board.

In the coming weeks, we will be bringing you access to even more of our companies' execs and industry experts and sharing what we learn with you. Is there someone you'd like us to chat with? Let us know on the Memo Musings board.

As always, stay focused, stay patient, and stay Foolish — and to our U.S. members, have a great Thanksgiving!

Foolish best,

Todd Wenning

Todd owns shares of Kinetic Concepts.

Options 802: Bearish Spreads

Published Nov 19, 2009 at 12:00AM

The most common bearish spread involves *buying* a higher-strike put and financing some of the purchase by *writing* a lower-strike put with the same expiration date on the same underlying stock. The put you purchase will appreciate in value if the underlying stock declines. Since our potential loss is 100% of the capital we invest, we prefer setting up bear put spreads that can return at least 50% to 100%, making the risk worthwhile. Ideally, we'll do this using strike prices that are within 20% of the current share price so we're not reaching too far.

Bear Put Spread Specifics

Action: Write ("sell to open") a lower-strike put and buy ("buy to open") a higher-strike put (usually, but not always, straddling the stock price).
Trade type: Net debit; you always pay out to set up the trade.
Maximum loss: The amount you pay to set up the trade. This occurs when the stock ends above the strike of your higher-strike put.
Maximum profit: The difference between your two strike prices, minus your initial debit. This occurs when the stock ends at or below the strike of your lower-strike put.
Break-even price: The higher strike price minus your initial debit.

Let's walk through an example. Suppose a retail company that sells poorly made, overpriced products is trading at what you deem a too-high $30 a share. The stock appears ripe for a decline, so you set up a bear put spread, buying $33 puts, which cost $5, and writing $28 puts, which pay $2.50, for a net debit of $2.50 per share. Since $5 separates the two strikes, the most you can make is $2.50 per share ($5 minus the $2.50 debit), or double your investment. The most you can lose is $2.50 per share as well. Your break-even price is $30.50, and if the stock falls below $28 by expiration, you make the full 100%; if it trades above $33, you lose your full investment. By choosing your strikes carefully and making sure the options pay a reasonable price, you've set up a bear put spread with strong profit potential.

To be especially defensive, you could set up a bear put spread with strikes *above* the current share price: In this case, you could buy $36 puts and write $32 puts on the $30 stock. As long as shares stay below $32, you'll earn the full amount possible on your spread. However, defensive spreads usually don't pay much. On the flipside, an aggressive bear put spread would use strike prices *below* the current share price, such as buying $28 puts and writing $25 puts. The $30 stock needs to fall below $25 for you to earn the full profit, but the profit will be handsome.

Usually, we'll write moderately minded bear put spreads, similar to our first example.

Yes, Fools, you can use *call* options to make outright bearish investments. Bear call spreads have a compelling draw: You start with a net credit to your account. To set one up, you buy calls at a higher strike, and then write calls at a lower one. (Since lower-strike calls are always worth more, you always start this trade with a net credit.) As with all spreads, one side of your trade protects against the other, capping your risk.

Bear Call Spread Specifics

Action: Buy ("buy to open") calls with a higher strike, and write ("sell to open") calls with a lower strike.
Trade type: Net credit; you're always paid to set up the trade.
Maximum loss: The difference between your two strike prices, minus your net credit.
Maximum profit: Your original net credit.
Break-even price: The lower strike price plus the credit received.

Let's assume you set up a bear call spread on the same $30 retailer from our bear put spread example. You buy calls at $33, which cost you $2, and then write calls at $28, which pay you $4; your net credit is $2 per share. If the stock ends below $28, both calls expire and you keep the $2 per share. If it rises above $33, you'd close both calls before expiration, and your cost would be the difference between the two strikes, or $5. Given your $2 credit, you've lost the maximum $3 per share.

Stock Price at Expiration	Buy $33 Call for $2; Value at Expiration	Write $28 Call for $4; Value at Expiration	Bought Call Profit at Expiration	Written Call Profit at Expiration	Total Spread Profit at Expiration
$28 or lower	$0	$0	($2)	$4	$2
$29	$0	$1	($2)	$3	$1
$30	$0	$2	($2)	$2	$0 (break even)
$31	$0	$3	($2)	$1	($1)
$32	$0	$4	($2)	$0	($2)
$33	$0	$5	($2)	($1)	($3)
$34	$1	$6	($1)	($2)	($3)
Every price above $34					($3)

To be most defensive, you would use strike prices above the underlying share price, or both out-of-the-money. This way, even if the stock goes up, as long as it stays below the lower of the two strikes, the spread will end profitably. Aggressive bear call spreads are rare (since bear put spreads work better for strong bearish cases), but these are initiated with both strikes *below* the share price.

Bear call spreads are popular because they start with a net credit, but they have disadvantages compared with bear put spreads. First, if you write an in-the-money call (which your lower-strike call often is), an early exercise will derail your strategy. Second, calls tend to hold time value longer than puts. A bear call spread will not respond as quickly as a bear put spread to a favorable move in the stock, thus forcing you to wait longer before you can close the trade for your desired profit. Finally, bear call spreads still require buying power. The difference between your strikes minus the credit you receive will be locked out of your account. Still, for the hedge- or short-minded investor, bear call spreads have merits.

Calendar spreads are also called "time spreads," because you're using different expiration dates on your two trades. Selling a near-term put (expiring in a few months) and buying a longer-term one (expiring at least a few months later), both with same strike price, sets up a bearish put calendar spread. The idea is the near-term put that you write will lose value more rapidly than the longer-term put that you buy *and* finance the purchase of your put, especially if you're able to write near-term puts a few times while waiting for your longer-term puts to pay off. But this strategy comes with a caveat.

You're generally hoping that the stock or index holds up long enough for your written puts to expire and *then* declines, making your purchased puts profitable. In other words, you're bearish, but you want some time before prices decline — so perhaps you see a catalyst for decline on the distant horizon. That said, if the underlying investment falls rapidly, your long-term puts will have more value than the ones you wrote, and you could close both for a net profit.

Bearish calendar spreads using puts can be set up for very little cost. Your expectation should be that most times, you'll lose your entire investment, but when it *does* work out, it will more than compensate for every loss. If your net cost for a put is $0.50, when the stock falls sharply, your profits will soar.

Bearish Calendar Spread (using puts)

Action: Write ("sell to open") puts expiring soon, and buy ("buy to open") the same strike puts expiring much later.
Trade type: Net debit. You pay to set up the trade.
Maximum loss: Your net debit.
Maximum profit: Once your written puts expire, your potential profit on the puts you bought is unlimited, until the stock goes to zero.
Break-even price: N/A.

Building upon what you've learned, a calendar spread that uses the same strike prices and different expiration dates is called a *horizontal* spread. One that uses different strike prices and different expiration dates is called a *diagonal* spread. For example, you might write near-term puts at a higher strike for a larger payment and buy long-term puts at a lower strike to set up a diagonal bear put calendar spread. (Yes, it's a mouthful!)

You usually want to close the vulnerable leg of your spread soon before expiration to avoid it being exercised. Furthermore, if the underlying stock makes a dramatic move that makes one side of your trade especially profitable (generally, the written side), you can consider closing it early and writing new options at a more advantageous price for another payment. A dramatic move that earns you much of your spread's potential profit long before expiration may merit closing the trade out entirely, although in many cases you'll need to wait until right before expiration to achieve your maximum profit. A dramatic move against you may severely limit your potential responses, other than to salvage what value still remains.

There are many other follow-up possibilities with spreads — including turning them into entirely different option strategies. We'll have a guide devoted solely to the topic ahead.

Our next three guides in this series will cover neutral spreads, bullish spreads, and follow-up action on spreads. Stay tuned! And if you have any questions, please visit *Pro*'s Complex Options board.

Buy and Set Up a Covered Strangle on Expeditors International of Washington

Published Nov 18, 2009 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Recent share price:** $33
- **Estimated fair value:** $38
- **Preferred buy price:** $30
- **Recent option prices:** Calls $2.50 bid, puts $2.05 bid
- **Limit order:** Aim to write the strangle for around $4.50 *combined*
- **Type of holding:** Core growth; Transportation
- **Dividend yield:** 1.2% (semiannual dividend of $0.19)
- **Alternate trades:** Place a limit order at $30 per share; or only write $30 puts; or buy shares and only write covered calls.

The Big Picture

Financing greases the wheels of global commerce. So, when credit markets froze during the recent economic turmoil, international trade withstood its sharpest decline since World War II. Now, with credit starting to flow again, trade is recovering, and emerging markets have resumed their high-octane growth. Yet inventory levels remain low. As a result, production will eventually need to ramp up, leading to a renewed expansion in global trade..

Rather than invest in an asset-heavy transportation company like **FedEx** (NYSE: FDX) or **DryShips** (NASDAQ: DRYS) to profit from this trend, *Motley Fool Pro* is looking to tap one of the most unique — and Foolish — companies out there: **Expeditors International of Washington** (NASDAQ: EXPD).

Unlike other transporters, Expeditors doesn't actually own any airplanes, trucks, or ships — instead, it buys space on carriers at wholesale prices, portions it out, and resells it at higher prices. The company also provides services that make moving goods easier for its customers, offering custom brokering services, cargo insurance, and distribution management. Meanwhile, the company is run by one of the most Foolish, transparent CEOs in the business — but more on that in a bit. Let's start with how Expeditors gets the job done.

Ships Ahoy!

Say you're an asparagus canner, and you need to ship two tons of your green goodies from the U.S. to China. Moving your product across an ocean is about as difficult as it sounds. For instance, do you know the customs rules for two tons of canned asparagus? How to negotiate a price for space on the freighter? Which Chinese port to deliver to? How to track your shipment?

Probably not. Anyway, your time is better spent honing your asparagus-canning craft than figuring out logistics and customs laws. Expeditors can handle all this for you. Plus, by filling larger shipping containers with products from multiple customers, the company can negotiate a better price than you could on your own. What's more, freight operators appreciate Expeditors because it buys space on their ships or planes by volume, reducing the uncertainty and inconsistency of unfilled loads. It's a win-win for all parties.

And because Expeditors' scope is truly global, those parties can be shipping to and from almost anywhere in the world. By contrast, competitors like **UPS** (NYSE: UPS) and FedEx do less than 30% of their business outside of the United States, are focused on smaller parcels (under 150 pounds), and have airplanes to manage. Moreover, Expeditors has established tremendous relationships in Asia over the past three decades. That's right: The company's had sales offices in Hong Kong and Singapore since 1981, long before Asia was the "it" place to be.

Expeditors' 252 offices can be found on every continent except Antarctica, though operations are highly concentrated in Asia:

Region	Percentage of Sales
United States	27%
Other North America	3%
Latin America	2%
Asia	49%
Europe and Africa	15%
Middle East and India	6%
Australia	2%

Data for the nine months ended September 2009; not adjusted for inter-company accounts and transactions.

Meanwhile, Expeditors' top 200 accounts, which make up about half of overall sales, represent the following sectors:

Sector	Percentage of Sales

Retail	33%
Hi-Tech and Consumer Electronics	31%
Manufacturing and Consumer Products	20%
Pharmaceutical and Health Care	7%
Automotive	5%
Oil and Energy	3%
Other	1%

Data as of March 2009.

This focus on Asia and consumer goods allows Expeditors to participate in the economic story of the century so far: the growth of the Chinese middle class. And management isn't just focused on Chinese *exports*; it's also expanding its services for moving goods *within* China. All told, if Chinese consumers start to spend more, Expeditors is well positioned to benefit.

A final point about Expeditors: This isn't a "one-way" business. Behind China and Germany, the U.S. exports more merchandise than any other country. So, when the dollar slides and U.S. goods are cheaper, Expeditors benefits from the uptick in exports. On the flip side, when the dollar is stronger, American consumers can buy imports at better prices. Benefiting from trade going in any direction, Expeditors has been able to grow for nearly three decades straight.

One Unique CEO

Get Personal With Expeditors

- **Founded:** 1979
- **Headquarters:** Seattle, Wash.
- **Website:** expeditors.com
- **Employees:** 12,000
- Q&A with Management
- Most recent 10-Q quarterly filing

Now about that Foolish culture. At the helm of Expeditors sits Peter J. Rose (no, not the guy banned from baseball), who has been leading the company since 1981. A former hockey player (he nearly went pro) and 44-year shipping industry vet, Rose has a well-documented distaste for Wall Street analysts and their opinions on running Expeditors' business. Consider this gem from the 2008 annual report: "When the investment community routinely disconnects the ties between accomplishment and reward, you might understand why at Expeditors we trust our own values, learn from our own experience, and take our own advice more seriously than what the make-believe analysts call 'analysis.'" Instead of conference calls, Rose collects analysts' questions in advance and answers them in 8-K SEC filings, allowing him to respond more thoroughly. Though we appreciate his spirit, this attitude doesn't win him many fans on Wall Street; but overall, we're pleased with Rose's experience and Expeditors' trajectory since he began his stint.

Financials and Valuation

Rose likes debt about as much as he likes Wall Street analysts, and it shows on the balance sheet — Expeditors is fortified with nearly $1 billion in cold, hard cash and zero debt. It does have some operating leases on its books, but they are largely inconsequential relative to the company's size. Though being this cash-rich muffles return on equity figures and frustrates analysts, Rose is proud — and justifiably so — that Expeditors didn't need a bailout and was able to invest in the business when everyone else was panicking.

Given its stellar balance sheet, significant barriers to entry (namely, international regulatory and licensing requirements), and dominance in its space, Expeditors rarely trades at a deep discount. At the nadir of the recession, Expeditors traded only 25% below current prices. Fortunately, with lingering concerns about a Department of Justice investigation (more on that in a moment) and the vitality of the global economy, shares currently trade for 18.6 times free cash flow versus the level of 50 times free cash flow it commanded on average between 2004 and 2006.The current multiple isn't cheap, but it's reasonable.

We used a discounted cash flow model to estimate a value for Expeditors. Using a discount rate of 9%, our estimates assume 12% sales growth from the recent bottom, followed by 8% growth in later years, and ending in 3% terminal growth. Tossing in the $4-plus per share of cash puts a fair value on Expeditors between $35 and $38, but possibly higher if global trade rebounds more than expected.

Why This Strategy?

The Community's Take

Expeditors scores a strong 5 stars in CAPS, with more than 90% of All-Stars expecting outperformance. On the *Pro*CAPShot, it scores a respectable 7 of 12, coming up shy on trailing growth numbers because of the recession. It's also a lower-margin business than we normally target, but given its focus on asset-light services, we're OK with this.

Buying shares of this healthy business around $30 is a compelling long-term investment, so if that's all you aim to do, we support it; but we're also going to use options to ideally increase our returns, generate shorter-term profits, or lower our cost basis. Strangle writing lets us be defensive and at the same time participate if market gains keep coming.

With Expeditors recently skimming $33, the covered strangle we intend to write for about $4.55 *combined* per share positions us to either buy the second half of our position near a net $25.45 or sell our existing shares around $39.55 — a wide range for a stable stock, even over 185 days (or about 6 months).

The option income represents a 13.7% yield on our $33 purchase price (not including the buying power set aside for the puts we'll write, which lowers our yield), while offering a 19.8% gain if our shares are called away in six months at the upper end of our valuation range. If the stock declines, we'll effectively be buying our next shares about 20% cheaper — at 15 times free cash flow.

Here's the math behind the trade (prices as of market close Nov. 17):

- **Action:** Buy 3% of EXPD, around $33
- **Action:** Write May 2010 $35 covered calls, for about $2.50
- **Action:** Write May 2010 $30 puts representing another 3%, for about $2.05
- **Potential second 3% net buy price:** $25.45
- **Average buy price if we get all shares:** $29.22
- **Potential sell price on our first 3%:** $39.55

- **Effective options yield:** 13.7% over 185 days
- **Stock gain if sold:** 19.8%

What Would Make Us Change Our Strategy

There are a few risks we'll be keeping our eye on with Expeditors. The main risk is a drawn-out global recession, with consumer and international trade growth that slogs along, or even slows again. There's also a legal risk, as Expeditors is a named party in an ongoing DOJ investigation into price-fixing fuel surcharges with airlines. Little information is available, and we don't know how this investigation will end, but we take comfort in the fact that Expeditors has the balance sheet to absorb a litigation shock.

Additionally, Expeditors needs to adjust its business whenever shipping companies raise rates; usually, it passes higher costs onto its customers — but to maintain good relations, it sometimes raises its rates slowly and accepts lower margins. While a refreshing change of pace, Expeditors' insistence on avoiding conference calls and selecting which questions it wants to answer is also a risk. Fortunately, the company is traditionally forthcoming in its formal responses, but if that changes and management goes mum, we'll need to reevaluate.

Finally, the shares aren't exactly cheap. Even at our potentially cheaper start price (via our puts), the stock carries a premium to its growth rate — although on free cash flow it does trade at a discount to the market average.

Pro Bottom Line

Expeditors is a financially strong, well-run, and globally diversified business that provides us with exposure to consumer growth in emerging markets, as well as the promise of recovering global trade overall. To discuss Expeditors, please jet over to its new board. And let us know which trade you're making: Are you writing a covered strangle like us, or just writing puts, or a limit order on the stock? Chime in, and Fool on!

Meet a Fellow Pro: A Visit With Protovist

Published Nov 17, 2009 at 12:00AM

Mike and his wife Chryssa in Alaska.

You've heard fullofcarp share his tale. You've gotten the dish on spinningwood. Now, in our third installment of Meet a Fellow Pro, it's time to meet another prolific *Pro* poster, Protovist — real name, Mike. Always cool-headed, goal-oriented, and helpful on the boards (if you haven't seen his handy options calculator yet, you're missing out), Mike is an exemplary member of the *Pro* community. I was fortunate enough to catch up with him recently and learn more.

Jeff: I want to thank you for all the value you've added to the *Pro* community over the past year. To start things off, I've got to ask: What is the meaning of your screen name, "Protovist"?

Mike: It's a combination of *proto* (meaning original or earliest form) and *atavist* (throwback, reversion). I like to think of myself as a "net.atavist," harkening back to a simpler time — before the Internet was completely full of spam and phishing scams. Of course, then we wouldn't have all the great online investing tools and information resources that are available to us now.

Jeff: Fools can certainly be thankful for that. Can you tell us a bit about your background? How did you become interested in technology and investing?

Mike: I grew up in Salt Lake City. My father is an antiquarian book dealer and somewhat of a Luddite at heart, so it's unclear how my technology and investing interests developed. But I do share a healthy appreciation of books and a penchant for acquisition.

After graduating college with a degree in computer science, I decided that Silicon Valley was the place to pursue a technology career. I moved to California just in time to ride the crest of the dot-com wave — and watch it come crashing down. Now in the San Francisco Bay area, I have worked mostly on software tools and automation at several technology companies, as well as an animation studio, where I met my wife. I've continued to indulge my passion for technology and finance, though demands on my time are about to increase, as we are expecting our first child in December.

Jeff: Congratulations! Now that you'll have more responsibilities, let's talk investing. What's your overall approach?

Mike: My strategy has always been to take control of my own finances, learning as much as I can and trying to profit from putting it into practice. I discovered The Motley Fool early on, so I was heavily influenced by the long-term, buy-and-hold philosophy. Buying quality companies at reasonable prices just made sense. Of course, determining what constitutes "quality" and "reasonable" is the tricky part, as I've learned the hard way on more than one occasion. After being exposed to employee stock options for the first time, I branched out into options and had some limited success with writing covered calls.

Jeff: Do you have a favorite investment strategy?

Mike: I can't resist "free" money, so credit card arbitrage — taking advantage of zero-percent balance-transfer offers by investing the proceeds in short-term CDs or MMAs — has been one of my more enjoyable endeavors, though the profits are limited by available credit. More traditional arbitrage opportunities are harder to find, but I was able to profit nicely from the acquisition of ProBusiness by **ADP** some years back.

Since joining *Pro*, my favorite strategy has been aggressively selling naked puts for additional investment income and potential stock acquisition, holding the stock (or selling covered calls if overweight) when assigned, and then repeating the process as appropriate.

Jeff: I know that's a lucrative income strategy, as long as you can fulfill the put obligations — which goes without saying — and also own enough stocks to enjoy long-term appreciation. Shifting gears, since we obviously aren't perfect, how do you think we could improve the *Pro* service?

Mike: I have a strong technology bias, but I firmly believe that the Fool needs to invest significantly more resources into its own online infrastructure. It's an unfortunate blemish for an otherwise excellent service.

Jeff: The Fool's CEO, Tom Gardner, loves reading this feature, so he's going to see your recommendation. Now, for the flip side: What do you like best about *Pro*?

Mike: The focus on accuracy and absolute returns. Last fall, as the markets were collapsing, I started thinking about taking advantage of the investing opportunities that were being created. The invitation to join *Pro* serendipitously arrived in my mailbox and provided the impetus to proceed with my somewhat risky plan. It has been a turbulent ride, but with *Pro* as a guide, over the past year my portfolio has grown 85% in value. What's not to like about that?

Jeff: We're glad to hear it. And yes, although we've taken more speculative positions lately — calls on the U.S. Natural Gas Fund and on Electro-Optical Sciences — accuracy and absolute returns remain our focus. In closing, Mike, what drives you to invest? What's your ultimate aim?

Mike: While I certainly enjoy the challenge of investing, I think what ultimately drives me is the desire for independence. I would eventually like to build enough wealth to allow myself and my family to focus on what makes us happy, without having to worry about financial obligations like a mortgage in California.

Jeff: I certainly hope the Fool helps you get there. Thank you again, Mike. Best of luck this winter, keep us posted, and Fool on!

Have friendly parenting advice for Mike and his wife? Or just well wishes? Share them with him on our Meet & Greet board.

Monday Memo: Pro Takes Some Lumps

Published Nov 16, 2009 at 12:00AM

The S&P 500 scored a new 12-month high last week, and *Pro* was close to achieving the same. That's the good news: Our portfolio has largely held its own. However, we've taken some hits lately. Since opening positions in **Abercrombie & Fitch**, the **U.S. Natural Gas Fund**, **Ebix**, **Electro-Optical Sciences**, and **ProShares Short S&P 500**, each has moved against us. What's going on? Let's start with the short story.

My kingdom, for a hedge! Two of our uncooperative positions — Abercrombie and ProShares Short S&P — are shorts. Unless investors agree with our view that Abercrombie is overvalued, and unless the S&P 500 turns south, we can't expect the shorts to work for us.

However, after landing shares this coming Friday, we'll likely write covered calls against our S&P short ETF soon. Our ultimate aim will be to end that short profitably. Abercrombie, meanwhile, has moved far against us, and we're currently considering our alternatives. The stock market has had a record-breaking advance, so fortunately our shorts and hedges have been a modest part of our strategy this year.

Price volatility is also throwing us for a loop. Since we set up our synthetic long on the U.S. Natural Gas Fund, the price of gas has declined about 20%, the ETF has declined nearly 30%, and our options have fallen a bit more. But our options don't expire until 2012, so this volatility is something we can wait out.

The last time we bought a commodity, via **iShares Silver Trust**, we originally saw a price decline. But by being patient and using follow-up option strategies, we've earned a nice profit. Down the road, we could use new options to help us on the U.S. Natural Gas Fund, too (writing calls on our purchased calls, for example). We'd like to see a bounce in natural gas before considering this.

Electro-Optical Sciences rivals natural gas for its volatility, and is even more challenging to price. The medical-device wannabe is waiting on the FDA to approve its sole product, the skin cancer-detecting MelaFind. With full approval, $160 million Electro-Optical could be a $300 million to $400 million company just on the initial hopes for sales of the new device. But a lack of approval, or a significant product setback, will mean this investment is all but a lost cause for at least a few years, if not indefinitely. We recognize this, and thus have only risked 0.6% of the *Pro* portfolio (less than we're slated to make in dividends over the next year). Since we bought our calls a few weeks ago, the stock has fallen on news that an FDA ruling isn't likely to happen until 2010.

Finally, when *Pro* welcomed Ebix into the room, it was like letting a hyperactive puppy into a room full of — if we do say so — proven, well-behaved growth stocks **Medtronic** and **Oracle**. But Ebix may mature and fit right in. Already, the majority of its revenue is recurring and high margin, and its customer base is growing. We're simply not used to its level of volatility here in *Pro*.

We've taken our stable portfolio and introduced a bit more speculation in recent weeks because we saw compelling opportunities. These have added volatility and some quick losses on paper — something we haven't really experienced before. Overall, though, we remain focused on absolute returns and more than 75% accuracy. This won't change. While we will take some riskier positions, these are an exception rather than the norm. Accuracy, absolute gains, and smoother returns in both up and down markets remain *Pro*'s *modus operandi*.

This is your service. What do you want most from us? Speak up on the Memo Musings board.

Fool on!

Jeff Fischer

Buy More of Ebix

Published Nov 12, 2009 at 12:00AM

At a Glance

- **Action:** Buying 2% (for 5% of our 6% target)
- **Recent share price:** $52.45
- **Price guidance:** On this thinly traded stock, please use a limit order at your desired buy price or near the current ask price.
- **Alternate trade:** Write December 2009 $50 puts (IFQXJ), recently near $2.70, or March 2010 $50 puts (IFQOJ), recently near $5.75.

What's New

In the mere three weeks we've owned **Ebix** (NASDAQ: EBIX), the stock has already moved quite a bit, peaking near $68 before falling back to around $52 a share. This is the kind of volatility we need to expect given the company's small size, share float, and the high expectations of investors. But despite these choppy waters, we can keep our eyes on the horizon and take comfort in the fact that the shares are reasonably priced and the business is strong.

Ebix's third quarter was healthy, and management expects the business to continue to advance in 2010. The company is growing, with two promising new acquisitions and the signing of several substantial clients (which remain undisclosed due to confidentiality terms). Recently trading near $53, shares fetch 15 times our free cash flow estimate for this year and 15 times estimated 2010 earnings per share — inexpensive considering that 20% earnings growth is expected.

By buying another 2%, we're hoping to take advantage of volatility and in the process lower our cost basis. A final note: Keep in mind that Ebix plans a 3-for-1 stock split around Dec. 10, so every share we own will become three at one-third the price. This doesn't affect the business or its valuation. As we add to our Ebix position, let us know if you have questions.

Buy More of NextEra Energy

Published Nov 12, 2009 at 12:00AM

At a Glance

- **Action:** Buying 2% (for 3% of our 6% target)
- **Recent share price:** $51.19
- **Price guidance:** Use a limit order at your desired buy price or near the current ask price.
- **Alternate trade:** Write January 2010 $50 puts, recently bidding $1.60.

What's New

Regulatory clouds and a weak Florida economy continue to hover over **FPL Group** (NYSE: NEE), keeping shares near their lowest price-to-book value and best dividend yield (3.7%) in years. If you're interested in owning a well-run utility, *this* is the time to be a buyer — rather than when everyone is paying a higher price and singing FPL's praises. So, although it's been only two weeks since we bought our first 1%, we're ready to pick up another 2%.

There are a few reasons we're buying more now. Since our first purchase, FPL has released quarterly results that show the business remains under pressure due to Florida's housing and economic woes. But with shares recently trading at $51, the stock price is a reasonable 12 times updated 2009 earnings guidance of $4.10 to $4.20 per share. Meanwhile, Florida's governing body has moved the FPL rate-hike judgment from January to at least March, so the outcome no longer hangs directly over the company's head. Finally, the company's woes are well-known, and we want to steadily buy shares while FPL is still in the dog house rather than after it's recovered — similar to our strategy with **Procter & Gamble** (NYSE: PG) when it traded in the $50s earlier this year.

Keep in mind, we view this as a long-term investment that we'll ideally hold for years, enjoying both the dividend yield and capital gains. Speaking of the dividend: FPL goes ex-dividend on Nov. 24, so you'll have to pick up shares before then to get the next $0.47 quarterly payment. Questions? As always, swing by the FPL board.

Buy to Close Covered Calls on Plum Creek Timber

Published Nov 11, 2009 at 12:00AM

At a Glance

- **Action:** "Buy to close" all November 2009 $35 calls (PCLKG) on Plum Creek Timber, using a limit near the ask price.
- **Recent November 2009 $35 call bid/ask:** $0.10/$0.25
- **Follow-up action:** We may initiate a new covered strangle in the future.

Our latest strangle on **Plum Creek Timber** (NYSE: PCL) is nearing expiration, but with the stock recently above $34, we're going to "buy to close" our November 2009 $35 calls early. At this point, we've earned most of what we can on the calls, and with the stock going ex-dividend on Nov. 12 and trading near $35, there's the added risk that call holders will exercise early, grabbing our shares and the dividend from us if we keep this call open.

Meanwhile, we'll allow the other leg of our strangle — our November $30 puts — to expire next Friday for the full cash gain.

To review, a covered strangle has two components, or legs: You write ("sell to open") covered calls on shares you already own and also write puts that could potentially net you additional shares if the stock falls below the puts' strike price by expiration. You can make both trades at once (as we did last time with Plum Creek), or "leg into" them, making one side of the trade at a time, sometimes weeks or months apart (as we did for our first Plum strangle).

As we consider setting up a new covered strangle, our main concern now is to avoid selling our shares too cheaply, especially if a strong recovery in the sector is on the horizon. We'll address that in our next trade decision.

By closing our covered calls, we'll keep our shares and pocket the upcoming dividend payment. We're happy to own Plum Creek, which is proving to be an excellent income-generating stock as well as a solid investment in American timberland. If you have questions about this trade, please let us know on the Plum Creek Timber board

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Monday Memo: Knuckling Down Through Those Daily Dips; Plus, 6 Helpings of Earnings

Published Nov 9, 2009 at 12:00AM

Though it's easy to forget, most daily stock movements are simply noise — and volatility is part and parcel of investing. Take one of our newer positions, **Ebix**. Jeff recommended the insurance software company when it traded around $60. Not long after, it rose to $68, before slipping all the way back to around $54 after earnings. All in the space of 15 trading days.

Over the long term, Ebix's recent 20% drop should turn out to be the tiniest of blips. But right now, it's hard not to get fixated on the share price or the paper loss it's showing in our portfolio.

There are two ways you can look at it. You can lament your bad timing, wishing you had waited to buy. Or you can consider yourself lucky — now you can fill out your Ebix position at much cheaper prices.

When these dips happen, it's also worth reminding ourselves why we bought the stock. In his original Ebix trade alert, Jeff wrote, "With a large potential market, outstanding margins, and the advantages of network effects, Ebix has a chance to grow from a $660 million company to one worth a few billion dollars or more over the coming decade." That's right: *decade*.

As Warren Buffett says, "Only those who will be sellers of equities in the near future should be happy at seeing stocks rise. Prospective purchasers should much prefer sinking prices."

Pro stands firmly in Buffett's camp: We don't desire a sharply lower market, but we're happy when individual stocks are beaten down to what we think are irrationally low prices. When you view investing as a multi-year endeavor, it makes withstanding these bumps much easier.

Earnings season is almost over, and the good news is that we've had no blowups. None of our companies missed earnings estimates by a large margin or disappointed on its outlook. That's just the way we like it — steady as she goes. Meanwhile, your faithful analysts here at *Pro* have been burning up their keyboards covering earnings releases and conference calls:

- **AmTrust Financial** , our small specialty insurer, reported commendable third-quarter earnings, with book value jumping 12.4% in the quarter. Jeff covers the conference call in this post, saying *Pro* Fools can consider writing in-the-money puts to potentially net a lower buy price.
- Everyone's favorite uranium company, **Cameco**, slightly missed analyst expectations. Nevertheless, it had a solid, if unspectacular, quarter. You can read my similarly solid but unspectacular summary of the conference call here. The trend for uranium is positive, so Cameco should continue to grow and prosper in the years ahead. Our remaining shares are currently rated a Hold.
- **Ebix** had another record quarter, with higher revenue, net income, and net margin than ever before, continuing a long streak of growth. As Jeff says in this summary of the conference call, the stock now trades at about 15 times the 2010 earnings estimate, with about 23% growth expected. All in all, things appear to be on track. With the stock down a bit, we may look at buying more, possibly via writing some puts.
- **Jack Henry & Associates** , our financial software and data-processing company, had a decent quarter, especially given the spending constraints from banking customers. Todd took a timeout from the Fool's game room to post his summary of the earnings call. On the whole, we're pleased with Big Jack's progress.
- **Nasdaq OMX Group** reported third-quarter results in line with expectations. Despite competitive pricing pressure, the business is showing stability. *Pro* has written December 2009 $19 puts, so with the stock trading around $18, there's a chance we will get the shares. If we do, as Jeff explains in his conference call summary, we may take follow-up action, such as writing covered calls, or wait to see more improvements.
- **Abercrombie & Fitch** released yet another dire trading update, with October same-store sales down 15%. You'd have thought such news would be enough to finally bring down the stock price of this richly valued teen retailer of yesteryear (OK — we're biased). But no. Nothing seems to stick to this Teflon stock. Still, as Todd says, it's important to stick to the original investing thesis and stay patient.

Once we've had a chance to regroup from this earnings onslaught, we'll summarize the portfolio's holdings. Stay tuned. In the meantime, I urge you to read and participate on the very lively *Pro*discussion boards (and don't forget to give posts you like a "rec"!). There's much more to *Pro* than the trade alerts and Monday Memos.

Fool on!

Bruce Jackson

Bruce owns shares of AmTrust Financial and Nasdaq OMX Group and has written puts on Ebix and Nasdaq OMX Group.

- stamleo queries the tracking difference between the Henry Hub gas price and the performance of our **U.S. Natural Gas Fund**. You can read all about it in this thread, including a summary of the phone call he had with the distributor of UNG.
- spinningwood has been as prolific and entertaining as ever on the discussion boards. In this post on the **ProShares Short S&P 500 ETF** board, he writes about hedging and whether a position in the ETF will ultimately add value.
- Our Philosophy & Strategy board often has some excellent insights and views. This thread discusses *Pro*'s total investing allocation to date, and this thread discusses Warren Buffett's purchase of Burlington Northern.
- Outperform! Read Russell's (TMFEldrehad) This Week in CAPS update number 40 for his roundup of CAPS members with the best track records of finding stocks that will outperform as well as some of their recent picks.

Set Up a Synthetic Long on ProShares Short S&P 500

Published Nov 3, 2009 at 12:00AM

At a Glance

- **ETF price at original recommendation:** $57
- **Target allocation:** 4%
- **Type of holding:** Short/hedge (non-core)
- **If you're new to this trade:** You can purchase shares of this ETF outright. We recommend starting with a half-position (2%), and depending on how much stock exposure you already have in your portfolio, eventually matching our 4% target allocation.

The Big Picture

Nov. 3, 2009

The stock market's advance since March is the stuff of legend. We haven't seen such a rapid and steep ascent — the S&P 500 has climbed more than 50% in seven months — since the Great Depression. However, volatility of this magnitude rarely moves in just one direction, so we expect some gains to be surrendered as reality sets in: Unemployment remains high, housing is fragile, consumers are pinched, and both local and national governments are constrained by record deficits. The tea leaves for an economic recovery don't read "strong" — tepid is more like it.

Much uncertainty still lies ahead, so we're looking both to profit if the S&P 500 declines and to hedge our portfolio and the many positions we hold that are included in the index: **Autodesk** (NASDAQ: ADSK), **Flowserve** (NYSE: FLS), **FPL Group** (NYSE: FPL), **Medtronic** (NYSE: MDT), **Oracle** (NYSE: ORCL), **Plum Creek Timber** (NYSE: PCL), **Procter & Gamble** (NYSE: PG), and **Waters** (NYSE: WAT). With this trade, we're using a synthetic long option strategy — which equates to *bullishly* *buying* the underlying investment — on the **ProShares Short S&P 500** (NYSEMKT: SH) ETF. If the S&P declines, this inverse ETF will appreciate, in which case both options in our synthetic long will earn value.

With analysts expecting strong earnings growth in 2010, the S&P 500 is currently priced at about 19 times expected operating earnings for 2009, putting it at a premium to its historical average in the mid teens. Even if earnings deliver, we may have a profitable way out of this hedge — but if it looks like they will come up short, then *being* short will pay off.

Synthetic Long: Why This Strategy?

Tip: It's Not a Spread

Remember, Fools, a synthetic long isn't a spread. It's simply selling a put to buy a call. Most brokers will require you to enter the trades separately, writing the puts first, then buying the calls.

With a synthetic long you:

- Write ("sell to open") puts with a strike at the current share price
- Buy ("buy to open") calls with a strike at the current share price

This gives you an effective long position without having to own shares outright, and it can usually be set up for little or no out-of-pocket cost. In this trade, if the S&P 500 advances and ProShares Short S&P 500 *declines*, shares of the ETF will be put to us, and we can then consider writing covered calls down the line.

At *Pro*, we try to avoid "trap door" investments — in which there's only one way in, and there's no profitable way out if the trade goes against us. Unfortunately, most shorts work that way: Prices need to go down, or your investment is cooked. But a synthetic long on a short ETF gives us a few more chances to be right. If we're wrong initially, we merely end up owning shares of ProShares Short S&P 500 at today's price. Then, we can write covered calls against it — for example, the February 2010 calls would currently provide us with about 5% downside protection and room for a 5% profit to the upside, for a 10% range. That's a wide profit range to play with on the index. Looking closer, December call options would provide us 3.2% downside protection and an exit price that's 3.5% higher.

Here's a roundup of the possible scenarios:

If ...	Then ...
The S&P 500 falls	Our puts expire as a full gain. With our calls, we break even if the index falls around 2%, and we double our money if it falls about 4% — earning more the further the index falls.
The S&P 500 rises	Our puts are exercised (unless we close early), and we end up owning shares of the ETF, starting at a loss that equals the S&P's gain. We will then consider writing covered calls. Our initial calls expire without value, but this isn't a concern since we didn't pay out of pocket for them.
The S&P stays flat	Both our puts and calls could expire with little to no value — making the trade a wash. We may repeat.

The best-case scenario for this trade (but not what we're necessarily hoping for, big-picture!) would be the index tanking rapidly, making our puts expire for a full gain and our calls appreciate several times over. We could then "sell to close" the calls and take our gains, or exercise them and hold the ETF if we believe the market will continue to decline. But we're not banking on this. Rather, while seeking a short, we're glad that we've found a way to short the S&P 500 while still having a back-up plan for profits if the trade doesn't go our way.

Managing a Short-Term Trade

When you go short, it's usually a *short-term* endeavor, so currently only the November options have ample volume and reasonable bid/ask pricing for the ProShares Short S&P 500 ETF.

With so little time before expiration, the position will be actively managed — the way shorts usually are — and we'll alert you of any follow-up decisions ahead of time. If the S&P 500 declines by Nov. 21, we'll have profitable options on our hands and can let the puts expire, sell the calls, and then open a new synthetic long if desired. If the S&P appreciates, we're ready to be put shares of the ETF and go from there.

What Would Make Us Change Our Strategy

If the market dances another happy jig, bounding higher, it may be difficult to exit this position profitably even using covered calls. And while we're waiting for covered calls to play out, the market could continue to increase — so we may need to cut our losses, as with any short.

Additionally, ProShares Short S&P 500 has tracked well against the S&P over the past six months, but less accurately over other time periods. The ETF invests in S&P 500 swaps and faces pricing and counter-party risks. Also, the 0.95% annual fee will eat into its value. So to avoid fighting a headwind, and because it's a short, we don't plan to hold the position longer than one to six months, max.

Time Frame	ProShares Short S&P 500 Change	S&P 500 Change
1 day	(0.7%)	0.7%
5 days	2.2%	(2.3%)
1 month	(2.2%)	1.7%
3 months	(6.7%)	5.6%
6 months	(18.8%)	18.8%
Year-to-date	(21.2%)	15.5%

As of Nov. 2, 2009. Source: Google Finance charts.

Finally, if we end up owning the ETF, we may receive distributions that are taxed as income. Any gains shouldn't be significant given the market's ascent this year, but be aware.

Setting Up the Trade

For every 100 shares of ProShares Short S&P 500 you'd be willing to buy ($5,700 worth), write ("sell to open") one put. Use the proceeds to buy ("buy to open") a call at the same strike price, with the same expiration date. Most brokers will require you to enter the trades separately, writing the puts first, then buying the calls. Keep in mind our alternate trades are to just buy the ETF, or just write puts. Just buying the calls is possible, too, but not recommended given the cost. If you finance the calls yourself, you need at least a 2% fall in the index to break even by Nov. 21, and you forfeit the money you invested in the calls if they end out-of-the money.

Pro Bottom Line

In times of high volatility, a hedge can provide comfort and profits when most other positions won't. Shorting often requires good timing, but with this position, we have more tools at our fingertips to make the trade profitable even if timing works against us. To discuss our synthetic long on ProShares Short S&P 500, visit its new board.

Monday Memo: Market Behaving Badly? Plus, Earnings Everywhere

Published Nov 2, 2009 at 12:00AM

On the boards, *Pro* member Foolfor7 asked how far the market might drop. Many investors are now nervous any time stocks decline because the last bludgeoning is still a recent memory. It's highly unlikely, though, that we'll return to the level of fear and uncertainty we saw last October through March. Any giveback would likely be much more contained — perhaps a 15% or so decline, putting the S&P 500 back around 900 — a reasonable-looking valuation if everything just stays steady-state.

For tax-paying Fools, some quick math shows that a 15% or even 20% decline in stocks is a smaller hit than you'd pay in short-term taxes if you sold any *Pro* positions held less than a year. So, if our businesses are still promising, selling them, paying taxes, and eradicating any upside potential doesn't pass the mathematical sniff test. Even if you're investing in a tax-free account, selling good businesses at reasonable prices is an iffy proposition: You don't know if you'll have ample opportunity to buy them back cheaper down the road. And will you actually do so?

Although the question of what's next must remain unanswered, what we *can* do is be prepared for a variety of outcomes. If the economy shows signs of progress, next year could easily bring more gains. A range-bound market would be a welcome opportunity for more option writing. And if the recovery is slower than hoped — assuming it is coming — we could see reasonable losses.

Since Mr. Market is so fickle, we hope to initiate some modestly bearish-to-neutral positions soon, balancing out the *Pro* portfolio after months of mostly long positions. Doing so, we're acting on our belief that the market could indeed give back some ground, or at least stay in a range, as the new economic reality settles in. We like what we own, and we like being optimistic — but we're keeping an eye on that pit bull in the corner.

Several *Pro* companies reported earnings last week. When earnings season wraps up, we'll update all of our guidance (Buy First/Buy/Hold, preferred buy price, etc.) as necessary.

For now, we haven't seen any surprises. Results and outlooks looked satisfactory to quite good at:

- **Flowserve** (NYSE: FLS): The valve and pump leader improved margins yet again. Its market share continues to be healthy, but bookings and revenue leaked slightly below estimates. Management expects bookings to improve next quarter. As with all of our companies so far, Flowserve appears to be climbing out of a trough — but how long that climb will take remains to be seen. Read more.
- **GrafTech International** (NYSE: GTI): Management raised guidance, calling for operating income of $80 to $85 million this year (up from its previous guidance of $60 to $70 million), along with cash flow of about $150 million. The company is still profitable even though the steel business remains record slow, and management expects improvement next quarter. Read more.
- **Plum Creek Timber** (NYSE: PCL): The timber giant topped revenue and earnings estimates, and price and demand improved. If our existing covered strangle expires this month, we'll likely leg into a new one as we hang onto our shares. Read more.
- **Procter & Gamble** (NYSE: PG): With $19.8 billion in quarterly sales, billions of dollars in debt getting refinanced to much lower rates, and $1.06 in quarterly earnings per share (6% above the top end of management's guidance), the consumer products behemoth appears to righting the ship. In line with that, the company's outlook has brightened. Read more.
- **Waters** (NYSE: WAT): Moderately improving demand and recurring revenue helped Waters net a fine quarter. If our shares are called away this month, we'll likely write puts or set up a new covered strangle. Read more.

Meanwhile, our newest addition to the portfolio, **FPL Group** (NYSE: FPL), lowered earnings guidance (read more). We've only bought 1%, so we have a long way to go, and we may use options to buy more of Florida's green energy producer.

We have many more earnings reports this week (please see the sidebar), and we'll summarize the portfolio's holdings after we do our due diligence.

Fool on!

Jeff Fischer

Jeff owns shares of AmTrust Financial Services and Nasdaq OMX Group.

Buy Calls on MELA Sciences

Published Oct 26, 2009 at 12:00AM

The Big Picture

Oct. 27, 2009

One of the most widespread cancers in the U.S., melanoma is also one of the deadliest. Once this type of skin cancer reaches advanced stages, there is no cure — but if caught early, it's nearly 100% treatable. Now, **Electro-Optical Sciences** (NASDAQ: MELA) (now called MELA Sciences), a $200-million medical devices company, has a product in development that could revolutionize how doctors diagnose the disease.

MelaFind, a handheld skin scanner, uses multiple wavelengths of light that look 2.5 millimeters *under* the skin (allowing for early detection), spot abnormalities, and immediately compare the findings with the company's proprietary database of malignant and benign cancer cells for quick initial diagnosis. In Phase 3 studies, the non-invasive instrument was found to be much more efficient and accurate in detecting skin cancer than doctors; plus, thanks to its speed, MelaFind allows doctors to see patients more quickly (reducing appointment delays that can otherwise stretch weeks) and prevents countless unnecessary biopsies. Best of all, because it spots skin cancer early, it can save lives.

Currently under expedited FDA review, with approval MelaFind would begin to generate recurring revenue for Electro-Optical Sciences, which plans to collect a fee on every patient tested. Although needing additional approval, the company also has its sights on selling the product overseas, starting with Europe. Millions of people worldwide visit the doctor for skin cancer, and the World Health Organization estimates that 2 to 3 million cases of melanoma occur annually. In development for more than a decade, an FDA decision on MelaFind is expected between December 2009 and early 2010.

The Business

MelaFind on the Web

To see the device in action, take two minutes to watch this Sept. 27 *ABC World News* report.

Lacking any revenue today, Electro-Optical's only hope for developing its business is approval and market acceptance of MelaFind. Nothing is ever certain with the FDA or in the medical industry, but MelaFind's odds for success appear as strong as one could hope.

The American Cancer Society cites more than 68,000 new cases of deadly melanoma per year in the United States. Doctors may miss spotting the disease as often as a third of the time (cited in the report in the sidebar) to 40% of the time (cited by doctors in an Electro-Optical conference call), while MelaFind identified the disease 98% of the time. Additionally, the product cuts unnecessary biopsies by 90%, reducing the cost of care, let alone the pain and suffering of patients.

The Community's Take

Electro-Optical Sciences rates 5-stars on CAPS. It's not enough of a going concern to rate well or meaningfully on the *Pro* CAPShot, but it scores a 5 — better than some going concerns (amusingly).

In its final Phase 3 clinical trial this year, 1,383 patients participated in the largest melonoma detection study to date. MelaFind was also able to rule *out* disease in patients with 2.5 times more accuracy than doctors (who might otherwise perform biopsies). In addition, MelaFind detected 125 of the 127 potential melanomas (the 98% accuracy reading), and half of these melanoma were the easiest to cure but the most difficult to detect. Melanoma kills one American every hour, and its occurrence is on the rise among young people — yet many patients avoid doctor visits because they so often result in biopsies that prove benign.

An estimated 650,000 U.S. patients a year visit the doctor for skin cancer checkups; melanoma is the most common cancer, and leading killer, among women in their 20s and 30s. MelaFind provides a quick, painless scan, finally catapulting the detection of the disease into the modern age, away from the "ABCD" visual-scan protocol used by doctors for decades. When it's found early, melanoma can usually be cured. This is why the American Cancer Society is recommending everyone starts to get an annual scan.

Finances

Electro-Optical raised $13.7 million this summer with share dilution, and today has an estimated $19.5 million in cash — that's just over 10 month's worth of cash at recent burn rates of $3.9 million per quarter. Even if MelaFind receives FDA approval, Electro-Optical will need to raise more funds to commercialize the product. On the plus side, the company — which went public in 2005 — does not carry debt.

One analyst covering the company expects sales to reach $10 million the year following approval and $40 million the next — but this is a wild guess. Sales could be much stronger, or much weaker. Remember, this company is a speculation. Management plans to primarily be paid on a per patient case, effectively earning a portion of the doctor's fee for performing each scan with MelaFind. The company's continually updated computer database is the lifeline or connection that doctors will rely on for diagnosis.

Management

The mostly middle-aged management (click "Team") has years of experience in biotech, medical devices, and the commercialization of products. This gives us confidence that Electro-Optical has put together a team that can execute on sales if product approval is granted. Management — directors and officers — have been buyers of the stock over the past year.

Risks

The risks are many. Commodities like silver and natural gas aside, this is *Pro*'s first pure speculation; that's why we're only allocating a portion of the portfolio that can be lost if bad news hits. The FDA is the first wild card: They may demand more trials before approving the product, and that would set Electro-Optical back months, if not years, and require more funding. Or, approval may not be as broad as the company hopes, limiting the market potential. If the company wants greater commercial uses down the road, it would need to conduct more trials. Even with full approval, risks include market acceptance — doctors are often slow to change — and Medicare and insurance reimbursement decisions. If insurance companies don't reimburse the cost of MelaFind scans, the product may never take off. There's also liability risk. If MelaFind misses a cancer, the company could be sued.

Furthermore, there's competition. Electro-Optical's management doesn't know of any direct competition that offers the full diagnosis package offered by MelaFind, but the broader market for optical imaging devices themselves is extremely competitive, and large competitors the likes of **General Electric** (NYSE: GE) or **Raytheon** (NYSE: RTN) could target MelaFind. Already, at least half a dozen small competitors have various related products in development or on the market, and someone could develop something superior to MelaFind. The company needs commercialization soon, and needs to grab market share quickly if it's going to succeed.

Why This Strategy

We're buying in-the-money call options on Electro-Optical to lower the cost of our investment while enhancing our possible returns. Additionally, with the $5 calls, we have better odds of being able to convert to stock by April expiration (as long as shares are $5 or above) if we want or need to. An FDA decision is likely by December 2009 or early 2010, and shares will likely respond strongly to the news (good or bad), but even if approval is delayed, they're unlikely to fall below $5 (risking our full investment). Meanwhile, a jump to the high teens would about double our investment in the calls. As alternates, you could buy shares of the stock straight out if you're seeking a stock speculation, or buy calls at other strike prices to increase or decrease your risk and/or your cost.

Pro Bottom Line

The medical field is strewn with the hopes and dreams of thousands of small companies, many of which never succeed. Electro-Optical hopes to be one of the few to commercialize a product successfully enough to become a going (and growing) concern. Given the product's ease of use, success rate in trails, and need for modern skin cancer detection and diagnosis, odds for success appear much stronger than average. However, we can't take that for granted. We invest knowing that this is a speculation that may work out wonderfully, or may go completely bust. To discuss the company, please visit its *Pro* board.

Monday Memo: Why Stocks Reign Supreme; Plus, Earnings News From KCI and LNN

Published Oct 26, 2009 at 12:00AM

By Todd Wenning

On Wednesday, the market sent shares of **Kinetic Concepts** down 7.6% on concerns about growth in the company's regenerative medicine business. The relative slowdown in these sales — which were actually 17% higher than last year — was due to higher-than-expected demand for the Strattice and Alloderm products; Kinetic's inventory thus fell short. But high demand is a good problem to have — and one I expect to be corrected over the next two quarters. Meanwhile, I remain impressed with the company's smart international expansion plans and its launches of innovative products that complement its vacuum-assisted closure therapy. The balance sheet again improved as CFO Marty Landon, whom I spoke with two months ago, continues to pay down debt with free cash flow. You can read my full report on Kinetic Concepts' earnings on the boards. Kinetic remains a Buy First stock, recently trading near our preferred buy prices.

Lindsay's full-year earnings were weak, as we expected — sales down 29% and profits down 65% from record levels last year. Fortunately, we didn't buy Lindsay last year when it was ringing in record sales and profits at the height of the agriculture boom. Instead, as is our aim with cyclical stocks like Lindsay, we buy when things look bad. Eventually, higher crop prices will return, and when they do, farmers will be more willing to invest in irrigation equipment. As with any small cap, and especially one as volatile as Lindsay, patience and deliberate investing are the keys to success. So, with shares of Lindsay near our buy-below guidance of $34.50, we're moving Lindsay back to a Buy on the scorecard. Please see our full report on Lindsay's earnings on the boards.

To discuss our Memo or ask us questions, please visit the Musings board.

Todd owns shares of Kinetic Concepts.

Buy NextEra Energy

Published Oct 21, 2009 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Recent share price:** $53
- **Estimated fair value:** Mid-$50s
- **Preferred buy price:** $55
- **Type of holding:** Core income; Utilities
- **Dividend yield:** 3.5%
- **Alternate trade:** Write puts that net you a buy price of $55 or lower
- **Follow-up strategy:** We may write puts to buy future shares. Later, at a higher price, we may write covered calls in order to generate additional income.

The Big Picture

Oct. 21, 2009

Get Personal With NEE

- **Headquarters:** Juno Beach, Fla. (nice digs!)
- **Website:** fplgroup.com, nexteraenergy.com
- **Employees:** 15,000

Until the power goes out, most of us don't realize how much we rely on electricity. Without it, life quickly shuts down — and where there's a necessity, there's often a good investment.

Over time, utility conglomerate **NextEra Energy** (NYSE: NEE) (formerly FPL Group) has certainly delivered results. Its stock is up 59% over the past five years compared with a small loss for the S&P 500. Extend that to the past 10 years, and NextEra has gained a hefty 123% while the S&P has lost 12%. This year, however, the stock is relatively flat, up just 8% — and we're glad. Utilities have been left behind in the rally, remaining reasonably priced and providing *Motley Fool Pro* with a good opportunity to add exposure to the sector.

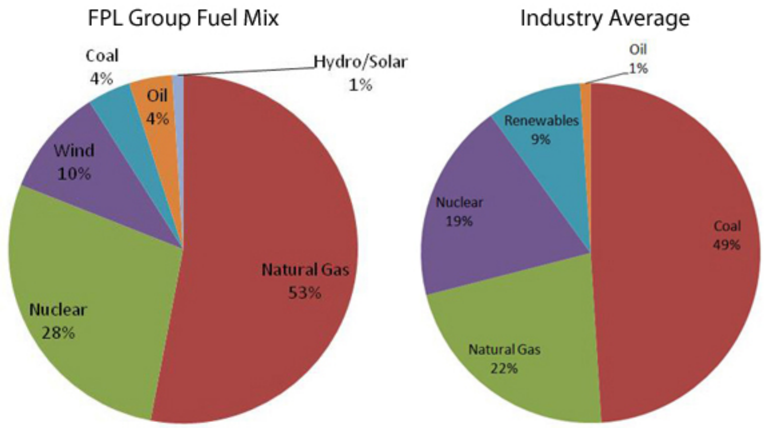
Looking ahead, we expect more steady gains from the company that *Fortune* named one of the "most admired" in America thanks to its strong financials and leading position as a producer of clean, renewable energy. But first, let's take a look at how this $22 billion company operates.

Running on Two Cylinders

NextEra operates two divisions. Representing 71% of 2008 sales, Florida Power & Light is a regulated utility that provides electric power to some 8.7 million residents in Florida's east and lower west coasts. Over the past three years, the division has consistently generated about half its operating revenue from residential customers and another 40% from commercial customers. As with any regulated utility, its rates are controlled by a state agency — in this case, the Florida Public Service Commission — to ensure that energy generation and distribution is reliable, affordable, and safe for consumers while allowing for a reasonable level of profits for the utility company. The division hasn't seen a rate increase since 1985, so it's lobbying for a 31% price increase in 2010. More on this a bit later.

Checking in with 28% of 2008 sales is NextEra Energy Resources, a wholesale power generator. Unlike Florida Power & Light, NextEra isn't regulated; rather, it owns and operates power plants and sells the output to companies, power cooperatives, and municipalities for a total of 96 operating projects in 25 states and Canada. NextEra is the nation's leading renewable-energy provider, with 17,000 net megawatts of capacity, 95% of which is derived from renewable sources.

Together, Florida Power & Light and NextEra produce an energy profile that's quite different from the typical competitors:



Source: FPL presentation, September 2009.

Let There Be Light

As you can see, NextEra Energy is heavily weighted toward cleaner energy sources — 39% of its power generation produces zero emissions, ranking the company first in the nation for energy efficiency. Moreover, NextEra is larger than the next three wind-power generators combined, and it's the country's largest solar energy producer. This emphasis on clean energy gives NextEra important advantages:

- **Natural gas leadership:** Converting a coal plant to natural gas can cost upwards of $1 billion, but NextEra is well ahead of its coal-heavy competition. Its primary energy source is natural gas, which is inexpensive, emits half the carbon of coal, and is plentiful in the U.S. — the domestic supply is 1,800 trillion cubic feet, equivalent to 320 billion barrels of oil (by comparison, Saudi Arabia has 264 billion barrels). These natural gas benefits allow NextEra to charge lower rates than competitors.
- **Regulatory tailwinds:** If economics don't force utilities to move toward lower-carbon energy sources, the government just might. The 2009 stimulus package provides tax credits and cash grants for companies building wind, solar, and hydro properties — up to 30% of a project's qualified costs, much to NextEra's benefit. We expect the government's focus will continue to be on clean, renewable, and domestic energy sources. NextEra is in a strong position to profit from this trend.

Leadership-wise, NextEra's respected management team has helped the company win numerous industry awards each year. The company has a long reputation for being a "clean" and admired business — case in point, NextEra's 53-year old CEO, Lewis Hay III, was invited to privately dine and discuss climate change with President Obama recently.

And then there's the dividend. We want to boost the *Pro* portfolio with another income-generating investment while also gaining exposure to the steady-natured utilities sector. With a 3.5% dividend yield and a track record of regularly boosting payouts (15 consecutive years of dividend increases and 8.5% annualized dividend growth since 2004), NextEra meets the bill. Add potential stock price appreciation and income from covered calls down the road, and the picture is complete.

Financials and Valuation

NextEra's balance sheet is in the upper echelon of utilities — it's one of only three with a credit rating of A or better. This is encouraging because the rating gives NextEra the opportunity to borrow funds at lower interest rates than competitors and then use that money to invest in higher-return projects — a win-win for investors.

In 2006, NextEra set a goal to grow adjusted earnings per share by at least 10% per year through 2012. With 2009 guidance near $4.20, that would equate to 8% to 9% remaining annualized growth through 2012 to achieve that goal. Although a 2010 rate hike remains to be seen, we believe the goal is achievable, but we're still staying on the conservative side of guidance. Using growth rates between 6% and 8%, our free cash flow model pegs a fair value range for the company in the low $60s.

Why This Strategy

Our strategy here is to build slowly, beginning with just a 1% position, because of a significant event on the horizon: As noted, NextEra has sought a 31% rate increase from customers, and Florida's governing body is weighing the case. There are a few things in NextEra's favor. First, it hasn't had a rate increase since 1985. Second, NextEra provides some of the lowest-cost energy in the country, so even with a rate increase, the company expects its average customer bill will actually go *down* $9 per month in 2010. In addition, management argues, NextEra needs a rate increase to help the business continue to invest in clean energy.

So far, Florida's governor has bumped heads with NextEra, calling the proposed rate hike excessive — so expect some sparks. A ruling is expected as soon as January 2010. An unfavorable outcome could send NextEra's stock lower at that point, but the stock may climb beforehand (making it a potential wash). A favorable ruling could benefit the stock. We may continue to build our position, but we likely won't exceed 3% (half our eventual target of 6%) before the ruling to be cautious.

What Would Make Us Change Our Strategy

There are a few other risks that could lead us to alter our investment thesis, and even possibly sell:

- The economy, on both a national and local level, could take another turn for the worse, further reducing demand for energy. Florida has already been hit hard by foreclosures, and NextEra has closed thousands of inactive accounts. Still, this is well-known and seems to be priced into the stock.
- Higher interest rates could lead to less investor demand for utility stocks as well as increase the company's cost of capital.
- Similarly, an inability to access reasonable capital to finance investments would dampen growth prospects.
- Unusually warm winters or cool summers in Florida could reduce energy demand.

Finally, there's the chance that future public policies may not benefit renewable energy investments. If this happened, or if NextEra nears full value, we'd consider changing our strategy.

Pro Bottom Line

A healthy dividend, a solid balance sheet with smart use of debt, and a respected business with substantial growth opportunities in greener power generation make NextEra an electrifying (work with us here) addition to the *Pro* portfolio — while providing us with our first exposure to the steady utilities sector. Now that's something every investor should consider. Have any questions? Post away on our new NextEra Energy board.

Write Puts on Medtronic

Published Oct 20, 2009 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") January 2010 $37 puts (JIWMB.X)
- **Allocation:** 2.5% (for *Pro*, seven contracts)
- **Option's recent bid/ask:** $1.90/$2
- **Preferred limit price:** $1.90 or higher to start; later, no lower than $1.50 (4% of the strike)
- **Alternate trade:** Write December 2009 $37 puts (JIWXB.B), recently $1.50; or, write December 2009 or January 2010 $36 puts to be more defensive. If you're unable to write puts, consider buying stock outright with a limit order near $36.

What's New

We last wrote puts on **Medtronic** (NYSE: MDT) in September, and they expired as a full cash gain on Oct. 16. We're happy for the income, but we're still aiming to increase our 2.5% position to 5%. So we're writing new puts in another attempt to net shares of this medical-device king at $36 or below.

Since last month, Medtronic has not reported any news of note, but competitors have. **Boston Scientific** (NYSE: BSX), **St. Jude Medical** (NYSE: STJ), and **Johnson & Johnson** (NYSE: JNJ) all reported lower-than-expected medical-device sales or weak outlooks, primarily in heart-related devices, citing soft hospital demand. Following St. Jude's news — as shared by *Pro* member stamleo — Medtronic stood by its quarterly revenue guidance and noted that it had already lowered its sales growth guidance early in the year to reflect expected weakness. Additionally, management believes it's maintaining, and possibly gaining, market share in the cardiovascular business. All in all, we remain comfortable with our target valuation (for a refresher, see our Sept. 1 update).

How to Follow Along

You write ("sell to open") puts when you're ready to buy a stock if it declines below the strike price by expiration. This trade is more aggressive than our put-writing guidelines generally suggest, but that's because we're making the trade with a strong desire to buy more shares and we're comfortable with the valuation.

- **Option payment or yield (at $1.90 bid):** About 5.1% in three months (more than 20% annualized)
- **Option strike price:** Close to Medtronic's current stock price ($37.25)
- **Break-even price:** 5.7% lower, at $35.10
- **Cash or buying power needed:** Each put option you write represents a potential purchase of $3,700 in Medtronic.

Why This Strategy

We're writing January puts partly to diversify our exposure — we already have several puts expiring in December. In addition, if January options expire, the income won't be taxed until 2011. But the main reason is that the January 2010 $37 puts pay nearly $2, offering us both an attractive potential start price and the opportunity to invest defensively following the market's record rally.

Can't Write Puts?

If you're unable to write puts and still need to buy your first shares of Medtronic (or your second 2.5%, like us) consider placing a limit order near $36 to potentially get shares on a downdraft. Remember, buying shares a bit above our preferred price is also acceptable.

We'll make this trade in the next one business to 30 calendar days. To discuss this trade or ask questions, please visit our Medtronic board.

Monday Memo: A Stock That Got Away

Published Oct 19, 2009 at 12:00AM

As it turned out, March 9 marked the *very bottom* of the market. Within a week, TSC had jumped 13%; a week after that, another 11%, to about $37. Having experienced a very bumpy market during the winter, we patiently waited for another chance -- we weren't about to chase a retail stock higher in that environment. But before long, our window of opportunity was slammed shut. Since March 9, TSC shares have risen 80%, to $52.50 a share -- well above my original fair value range.

Yes, we missed out on some nice gains, but we made a cautious and deliberate decision not to chase the stock higher. In a highly volatile market, this approach is a double-edged sword: It can work for you, or it can work against you. And in this case, it worked against us.

Tractor Supply is a fine company with good growth prospects, but as with any company we consider for the *Pro* portfolio, we don't want to overpay for those prospects. Though we loved TSC at $30, we liked it less at $40 -- and now trading above $50 a share, we'll just shake our heads. (Interestingly, the CAPS community has dropped its rating on TSC from 5 stars in March to just 2 stars today. Is a price decline coming?)

As we've said from the beginning, accuracy is one of our top priorities at *Pro* -- and paying dearly for a stock only increases your odds of being wrong. What's more, our concern for consumer spending remains strong -- witness our recent bear put spread on **Abercrombie & Fitch** (NYSE: ANF). We aim to stay consistent by investing alongside our convictions, even if it means missing some gains. Although, next time I go digging into a company like Tractor Supply, I'll remember to pick up some mulch.

Have thoughts to share on Tractor Supply or on any stocks *you* missed? Visit the Memo Musings board.

Todd owns shares of Home Depot.

In case you missed it, we've gathered a few *Pro* community highlights from the past week:

- Member alex340 shares new option trades meeting *Pro* criteria.
- Bruce (TMFGoogly) posts several good articles on the economy and why many remain cautious.
- Following Jeff's Memo last week on making sense of the market, *Pro* members share their own thoughts on the boards. The slant? Cautious.
- In his latest This Week in CAPS, Russell (TMFEldrehad) shines his spotlight on some top CAPS stops.
- Todd (TMFPhila) recommends an article on what to do if bond prices fall.
- Jeff (TMFFischer) shares an update on **iShares Silver Trust** (NYSE: SLV) (and **Medtronic** (NYSE: MDT), whose puts just expired for *Pro*).

Buy EBIX

Published Oct 16, 2009 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Estimated fair value:** $24
- **Preferred buy price:** $18
- **Type of holding:** Technology/Software
- **Alternate trades:** Write puts that net you a buy price below $18.

The Big Picture

Oct. 16, 2009

Get Personal With Ebix

- **Headquarters:** Atlanta, GA
- **Website:** ebix.com
- **CEO:** Robin Raina since 1999; 42 years old
- **2008 revenue:** $74 million
- **2008 net income:** $27 million
- **Employees:** About 650

When it comes to what I (Jeff here) look for in a business, **Ebix** (NASDAQ: EBIX) hits nearly every mark: It has high margins, strong recurring revenue (almost 80% of its total), and beneficial network effects — meaning the more customers it adds, the stronger its offerings and deeper its competitive moat. Meanwhile, if there's a company moving more aggressively to become the dominant software provider to the insurance industry, we haven't found it — making this $660 million business an intriguing growth story as well.

The hunting ground for Ebix's potential growth is the enormous — yet fragmented — global insurance industry. Major customers in every insurance category — including property and casualty coverage, health and employee benefits, and life insurance and annuities — look to Ebix's software to manage their transactions and data. In addition, banks, financial advisors, and more than 300,000 brokers and agents use the company's niche offerings of risk-management software and business-process outsourcing. Currently, Ebix generates close to $100 million in annual sales; but if the company can tap even a fraction of the (perhaps hyperbolic) $60 billion market potential that management sees in the U.S. alone, there's still plenty of opportunity to expand.

Diving Into a Platform

Community and CAPS Insight

Ebix has scored 4 to 5 stars since CAPS began to track it, with nearly every All-Star rating it to outperform. On *Pro*'s CAPShot, the company grabs a strong 9 of 12, coming up short on CAPS industry rating, current ratio, and revenue per employee (which we want to see increase).

Where Ebix is most established is also where it's most promising. Its largest offering, EbixExchange, generates more than 50% of revenue and provides e-commerce solutions for insurance agents, brokers, carriers, consumers, and third-party providers. EbixExchange allows customers all along the chain to instantly communicate all necessary data for any transaction. By providing this backbone, Ebix is building a deep competitive moat, evidenced by its nearly perfect customer retention rate. Meanwhile, the antiquated insurance industry is in need of standardization, giving Ebix a large opportunity to help clients modernize. Plus, the platform has strong network effects, growing more valuable and profitable as more customers take part. As management explains, Ebix is striving to be the airport rather than the airplane — the hub upon which all its customers rely.

The highly fragmented nature of the industry means Ebix has no direct competition spanning all of its business lines, but there are many small niche competitors — the best of which are ripe for the plucking. Ebix can "roll up" these companies, making frequent acquisitions and bringing more clients under its wing as a result.

All of these factors add up to a strong competitive position and bright future that's only bolstered by the company's recurring revenue. But that doesn't mean this is an investment without risk.

Financials and Management

3-for-1 Stock Split Coming

With just two analysts covering the stock and only 12 million shares available, Ebix will execute a 3-for-1 stock split in early December. It did this last year, too, and the goal is to increase liquidity and garner more mutual fund interest — and perhaps more analyst coverage. The split will not affect the company's total valuation, but you'll own three shares for every share previously owned, at one-third the previous share price ($20 to today's $60). Option prices and contracts will also split accordingly.

Ebix represents a first in the *Pro* portfolio: We're buying a stock without offering a fair value estimate. Trying to put a fair value on such a fast-growing company (something I'm familiar with from years of working with David Gardner on the original Rule Breaker portfolio) this early on is suspect; instead, we're looking for a high ceiling — a large potential market opportunity compared with current sales. Ebix offers this in spades. However, there's also higher risk, so you shouldn't buy this stock unless you can tolerate high volatility for many years if necessary — and don't mind facing potential losses.

That said, we're not just speculating. Recently $60, Ebix trades at 16.5 times the December 2010 earnings estimates from two analysts, while earnings per share is expected to grow about 23% over the next year. The stock currently fetches 22 times trailing earnings, a discount to its recent growth rate. More important, for a company of its size, Ebix enjoys healthy free cash flow, which neared $30 million over the past 12 months; that puts the stock at about 22 times free cash flow. It is not inexpensive today, but continued growth could later make this price seem like a bargain.

Meanwhile, the balance sheet doesn't raise any red flags, with about $15 million cash and investments, $25 million in short-term debt, and $15 million in convertible debt. The company may grow debt to make more acquisitions, or it could issue new shares and add dilution (nothing unusual with a small, growing company). However, management is committed to making acquisitions that add shareholder value and grow earnings quickly. Young, hard-driven Robin Raina has been at the helm for a decade, and he's hungry to change the world. His total annual compensation was recently $2.7 million, reasonable given the hundreds of millions in shareholder value he's helped create. Ebix has grown sequentially (quarter-to-quarter) for the last seven years running; revenue jumped 74% in 2008, while diluted earnings per share grew 90%.

What Would Make Us Change Our Strategy

As a small, high-growth company, Ebix is one of our riskier investments. We'll keep a close eye on share dilution and acquisitions because the company needs to maintain momentum. Given its nearly perfect customer renewal rates, if these numbers tick lower, we'll quickly try to figure out why — New competitors? Product dissatisfaction? — and decide on a course of action.

While accepting the lumpiness that sometimes comes with small companies, we want to see revenue grow in all of Ebix's four business lines year-over-year, or we'll reconsider our growth thesis. Finally, there are the tax benefits Ebix enjoys from years of rolling operating losses forward. Over the next few years (management is unsure how soon), these losses will likely be used up, and the company will start to pay more taxes.

Pro Bottom Line

With a large potential market, outstanding margins, and the advantages of network effects, Ebix has a chance to grow from a $660 million company to one worth a few billion dollars or more over the coming decade. And while it presents more risk than most *Pro* stocks, the risks are at least mitigated by Ebix's 80% recurring revenue among its dedicated, interconnected customer base. We hope to grow our money alongside Ebix in the years ahead. Questions? Please post on *Pro*'s new Ebix board.

Video Extra: Jeff and Todd on Pro's First Year and Beyond

Published Oct 13, 2009 at 12:00AM

Happy anniversary, *Motley Fool Pro*! As a special thanks to all of you for being part of our service, we've put together a new video interview below. Get Jeff and Todd's take on strategies in bear and bull markets, the biggest mistakes investors make, and where *Pro* is headed next. (And in case you missed it, you can see *Pro*'s full review of the year that was right here.)

Just click on the player below to watch!

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Monday Memo: Making Sense of the Market

Published Oct 12, 2009 at 12:00AM

Last Thursday, retail stocks soared on news that average same-stores sales in September were positive for the first time in a year, up a modest 0.6%. In other words, shoppers returned in large enough numbers to make top-line results a little better than they were a year ago (though we can't help but note that two-thirds of last year's Labor Day shopping weekend actually occurred in August, making this year's comparison even easier). Many investors are interpreting this uptick to mean the economy is sustainably on the mend.

Maybe. Or, it may just mean that the economy bottomed out, and off those lows, more consumers are emerging from their bunkers to do some shopping. But credit remains tight, unemployment is still ticking up, manufacturing is still in contraction, there's record debt everywhere (personal and federal), and foreclosures are still going higher. (Wait, did someone turn out the lights? Sorry — back on again.)

But a "things-aren't-as-bad-as-they-were" dynamic seems to be a growing influence on the whole market regardless. And with third-quarter earnings starting to roll in, this dynamic is probably about to kick up a notch. Why? Quarterly results could look quite good compared to the end-of-the world numbers of a year ago. Now and in the coming few quarters, investors will see what *looks* like heady growth, choosing to ignore the fact that we're comparing results with the very depths of the economic bottom. So stocks are bid higher.

At the same time, we have other market dynamics at work, namely supply and demand. So-called "weak hands" sold their stocks early this year. But strong hands held on. They didn't sell when the world was on fire, so they're not going to sell now (unless they become concerned about valuation).

Now, as prices increase, emotional investors who sold are capitulating and buying again from more reluctant sellers, pushing stocks higher as trillions of dollars flow back in. Many send their money to mutual funds, which are then obligated to put it to work — so the buying continues despite some fund managers' reluctance. So stocks are bid higher. And now, many stocks are breaking to new 52-week highs, attracting momentum buyers.

Just as we were in a heavy selling cycle for about six months, we're now in a buying cycle. And buying cycles can typically last much longer than selling cycles; the market is built to go up, not down, and down periods are usually relatively quick. So if this ascent is going to subside, what would bring it about?

What the Market Faces

It's likely that 2010 will answer the biggest questions we face today:

- Will this be a V-shaped economic recovery, or much more tepid?
- How likely is a double-dip recession? The current bounce is stimulus-driven.
- Will this be a jobless recovery in the U.S.? What would that mean?
- If earnings estimates are met in 2010, stocks will likely head higher. If the size of the recovery misses expectations, stocks will likely decline and languish.

People often think in terms of years. For almost all of this year, Wall Street has been focused on 2010. ("Let's just get through this junky year; the economy will be better in 2010!") This means *any* news that has suggested 2010 will be better has been good for stocks. (Another answer to the "why.") Once 2010 gets here, though, there's a chance it won't live up to the hype.

I wasn't going to talk about valuation, but stocks are priced for exceptional earnings growth in 2010. There's scant evidence yet that these expectations will be met — the economy may have bottomed, but robust sales growth is not yet on the horizon. If disappointment ensues, 2010 may be a lot like 2003: Then, earnings grew as we emerged from a recession, but stocks declined more than 20% because results weren't as strong as hoped.

That's one possibility. The other: The recovery could turn out *stronger* than hoped, and everyone buying stocks this year will be rewarded sooner rather than later.

Usually we wouldn't be quite so obsessed with the macro economy, but at no time do I remember it looking so black and white. Our going investments at *Pro* aim to straddle these two possible outcomes. We want strong rewards if 2010 is a good year. But we want to be defensive in case it's not — because if a recovery is pushed back, or if it's too tepid, then stocks will pay a price and probably be lower for a long time to come. The stakes look high as we approach 2010 — we aim to make sure *Pro* and its members are prepared and ready to react.

Visit the Memo Musings board to share your thoughts.

Jeff Fischer

Enact a Synthetic Long on United States Natural Gas Fund

Published Oct 7, 2009 at 12:00AM

At a Glance

- **ETF price (Oct. 7, 2009):** $12
- **Target allocation:** 3%
- **Type of holding:** Energy

The Big Picture

October 7, 2009

Look out: We're getting gassed up about natural gas. But not because it's the popular market sentiment. Rather, we're looking to capitalize on a commodity that's been beaten down, and we'll use a long-term, low-cost strategy that gives us plenty of time to see gas rebound.

Natural gas prices hit seven-year lows recently as supply has outstripped demand. Much of the natural gas used in the U.S. is domestically mined and stored, and the country's storage is nearing capacity. Hitting this ceiling, as producers reduce natural gas output, we expect prices of the commodity to gradually rebound, returning to a level that makes more economic sense. At recent prices, natural gas is less expensive to burn than coal, and it's selling at prices that don't reflect the true cost of mining it.

In the November futures market (a good way to measure prices), natural gas recently topped $5 per MMBtu (million British thermal units), roughly 35% below last year. As competing energy sources, oil and natural gas usually maintain an average price difference. For most of this decade, oil was six to 15 times more expensive than natural gas (demand is much higher for oil, and transporting it is easier), but lately, there's a big disconnect: This ratio recently jumped as high as 27, making natural gas the much cheaper fuel source. This spread should ultimately tighten, either by oil prices falling, or natural gas prices rising, or both. A rebound in natural gas prices is the most likely outcome because market forces are already at work. The number of drilling rigs seeking gas has decreased by some 56% in the past year, as more producers wait for higher prices. Additionally, more power plants are considering using cheaper natural gas. Overall, we believe natural gas recently hit bottom, or close enough to make for a compelling investment.

More UNG on the Web

- The latest natural gas prices
- Visit the UNG site for its recent NAV
- See a chart of the recent natural gas story
- Learn all about natural gas and you

For this thesis, we've chosen to set up a synthetic long (see Options 501) on the **United States Natural Gas Fund** (NYSEMKT: UNG) ETF. Founded in 2007, it seeks to mirror natural gas prices by purchasing futures contracts on the commodity and rolling them monthly. (Conveniently, UNG recently traded near its net asset value.) Buying LEAP call options gives us more than two years to see a rebound in gas prices and could leverage our returns if we're right; writing puts to pay for the calls lets us set up the trade for little out-of-pocket cost. From $5 per MMBtu, it would be reasonable to see gas prices gain at least 50% in the next few years, back above $7.50 per MMBtu. If it does, our calls could about double, and our puts would expire as 100% income.

What Makes Gas Go

The Community's Take

UNG rates 4 out of 5 stars on CAPS as of Oct. 5, with a gushing 96% of All-Stars rating it to outperform (more than 570 bulls versus 21 bears). On *Pro*'s ETF CAPShot, it only scores a 5 of 12. This poor showing is logical given that gas prices, and the ETF, have cratered, with UNG down 60% the last year. This is not an investment in momentum. It's a contrarian position, investing for a rebound.

Several forces aside from oil can drive natural gas prices up or down:

Production. The more natural gas produced without increased demand, the lower you can expect prices to go. It's supply and demand. In 2008, production jumped more than 8% as new drilling techniques tapped into giant shale beds in North America. As new supply came online, prices fell, until finally production began to decline as it is now, and mines are being capped. Burned once, producers likely won't make the same mistake twice if they can help it.

Inventory. Natural gas inventory is at a record high. With U.S. storage now near capacity, these peak inventories will eventually be used, even partly burned off, until supplies reach levels that support price stability. It makes sense to invest in a commodity when it's at maximum supply, and thus prices are likely near a bottom.

Imports. Liquefied natural gas imports to the U.S. declined 23% in 2008 and are expected to decline again this year due to the high transportation expense, plenty of domestic supply, and a greater demand for the gas in the local competing markets of Europe and Asia. The trend toward lower gas imports in the U.S. isn't likely to reverse, leaving more room for domestic gas prices to recover.

Demand. Natural gas demand will increase if industrial production increases in an economic upturn, and as power plants turn to this cheap alternative.

Politics. Natural gas can be domestically produced, and it's a much cleaner fuel than oil or coal (dare we say "greener"), hence the cries to use more of it ringing through Capitol Hill.

New uses. Major car manufacturers, including Honda and Mercedes Benz, are producing natural gas vehicles, and more than 1,500 natural-gas fueling stations have been quietly built in the U.S. Need to fill up? The average price was just $0.63 per gallon in 2008. The U.S. government offers large tax incentives for buyers of natural gas vehicles, and the credits will likely be extended beyond 2010.

Weather. Cold winters increase gas demand and prices, and vice versa. Obviously, we have no control over this, but it could affect our investment. Hurricanes can also affect supply and pricing of natural gas.

Of course, some of these factors present downside risk. The economy could enter a double-dip recession, sending industrial gas demand — and therefore gas prices — even lower. There's also a possibility we'll see warmer-than-expected winters.

But overall, we see greater potential reward than risk today. Natural gas prices aren't likely to fall much further from multi-year lows — though they may stay weak for quite some time. Restoring the equilibrium of supply and demand is likely to move prices upward, as could an economic recovery, inflation, and simple gains in demand due to current beneficial prices. In other words, most factors suggest that natural gas prices could recover over the next two years and beyond, while few factors suggest even lower prices would sustainably occur.

Why This Strategy?

Setting Up the Trade

- **Action**: Write ("sell to open") January 2012 $12 puts (KANML), recently $3.60/$4
- **Action:** Buy ("buy to open") January 2012 $10 calls (KANAJ), recently $4.40/$4.80

When you're bullish over a period of a few years, but don't want to invest much cash up-front, a synthetic long just may be the ticket. We can place this trade for little out-of-pocket cost (although our broker will set aside buying power on the puts we write). We'll write puts, buy calls, and profit on both if UNG increases. With no price changes, both options could end with little lost or gained.

The worst-case scenario is UNG goes down sharply, and we're on the hook to buy shares in January 2012 around $12 (plus the $0.80 or so cost of setting up the trade), a bit above the current price. As with any put-writing trade, we'd be ready for that and could then wait for the ETF to increase. If natural gas prices rebound well before 2012, our calls should earn a much higher return — assuming UNG does its job tracking gas prices (which it has to date, with some amplification on the downside) — and our puts would become full income.

Note that a straight synthetic long involves writing puts and buying calls at the same strike price. Here, we're "splitting the strikes," writing puts at a higher strike than the calls we're buying. The $10 January 2012 calls are $4.80, while the $12 calls are $4. We'd rather pay a bit more and have a more conservative strike price on our calls so there's less chance of them expiring without value (and ultimately, there's more upside potential).

Alternate Trades

You could simply buy the calls; but if the ETF doesn't increase enough by 2012, you will lose on the investment and not have any recourse. Or, you could simply buy the ETF near its NAV. It has a 0.97% expense ratio and has unusual tax implications, so visit its website. Finally, you could just write puts. In that case, start by writing puts that expire much sooner, in early 2010.

What Would Change Our Strategy

We're likely to let the trade go to completion if it's working against us, taking shares of UNG at $12 in January 2012 to then wait for appreciation. So large that it may be influencing the natural gas market, UNG has faced scrutiny, but it has addressed recent issues. UNG also faces counter-party risk in its investments (it holds contracts that would harm the ETF if the counter-party to the contracts defaulted — but that is not at all likely). If the fund's viability comes into question, we'd likely exit our position quickly — but we obviously don't expect this outcome. That said, our primary risk here isn't likely the long-term fate of natural gas; it's any adverse events at UNG itself. However, in the time we've been reviewing the ETF, natural gas has rapidly doubled from its recent lows around $2.50 MMBtu. It's still inexpensive, but it may be exceptionally volatile from here. Patience may be required to ultimately see more gains.

Pro Bottom Line

We believe the current view on natural gas — a commodity with obvious and growing utility — is so bearish that it will pay to be contrarian. With new 2012 LEAP options available, we can take a position for little out-of-pocket cost and stand to profit if natural gas recovers some of its odor-free, invisible attractiveness. Questions? Please post on our new UNG board.

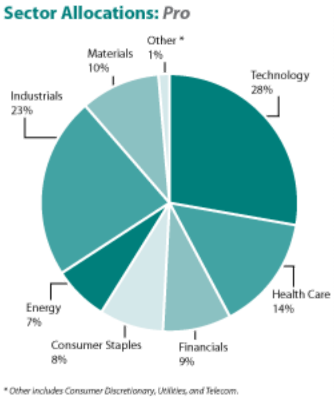
Pro's First Year: One for the Record Books

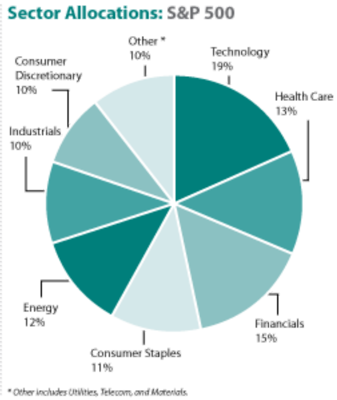
Published Oct 7, 2009 at 12:00AM

A year passes quickly; gone are 365 days, of which only about 250 were trading days. With 65 transactions in our first year (including all open and closed options), *Pro* averaged about one every four trading days. Sounds extreme when you put it that way ("What are you guys, day traders?"), but as you know from spending time with us, our process has actually been calculated and gradual — at times, it may even seem downright slow.

For those 65 trades, a strategy we often used to help build the portfolio was writing puts, either to get better buy prices on stocks we want to own or to earn income if prices continue to climb. Of our $560,000 cash, a full $220,000 is potentially obligated for stock purchases between now and January via existing open puts. We'll either be happily buying new shares of companies including **Tupperware** (NYSE: TUP), **Medtronic** (NYSE: MDT), and **Lindsay** (NYSE: LNN), or earning income if the puts expire unexercised, keeping us about 50% in cash.

Investing gradually and using options defensively, we're managing *Pro*'s money as we would our own — it's the Fool's real money, after all. For me, a key part of the process is preserving what you have and, therefore, only taking risks when you have a high level of confidence. Given this, we're secure in how we've invested so far and in the progress we're making, step by step.





To see how we're faring so far, let's revisit the main goals we had when *Pro* launched:

- **Absolute returns:** We want positive gains overall, no matter what the market throws our way, as measured over any reasonable amount of time (generally, any trailing year or two). So far, we've booked 13 realized gains, one loss, and are looking at mostly unrealized profits with the rest of our positions.
- **Accuracy:** We want at least 75% of our positions to close profitably. I'd actually like us to achieve much better than this, and we're off to a good start. Almost all of our positions, including 94% of those we've closed, are profitable.
- **Low volatility:** Although this isn't a stated goal, we want to achieve our returns with less volatility than the market overall. We're achieving this so far by using strategies that profit in both up and down markets (writing strangles, covered calls, and shorting), smoothing out returns when the market falls. As we add more options strategies to the mix, we'll have more ways to achieve this.
- **Buying great companies at good prices:** We've been targeting companies with sustainable competitive advantages, strong recurring revenue, expanding free cash flow, and healthy cash management. Of course, these stocks also make for strong option-trading candidates.

We also managed to earn steady income, picking up about $4,300 in dividends (a 0.43% return on the portfolio) and $27,000 (2.7%) in realized option-writing profits, for more than 3% income altogether. We hope to earn 3% to 5% a year in income of this sort. As we mark our first anniversary, we're happy to have earned upwards of 3% this way, and we expect that number to grow as we put much more of our cash to work.

By sticking to our strategies and remaining focused on what we've set out to achieve from the start, we fully expect to continue to reach our goals at *Pro* and compound our profits over time.

The past 12 months has been an amazing and challenging time to be an investor, one that's offered some incredible opportunities — but we believe our second year will be just as interesting and challenging, if in different ways.

It's too early to write a history of what happened in the global economy over the past year; the many ramifications are still unfolding. But perhaps we'll be able to do that when we bring you our five-year review — in 2013, when we hope the portfolio will be at least $2 million.

Right now, we just want to thank you again for sharing an unforgettable year with us — and welcome you to year two with Pro. To get started, let's review each position in the *Pro* portfolio.

By Jeff Fischer and Todd Wenning

We currently have 13 stocks, three ETFs, and 14 option positions in the *Pro* portfolio. Most of our stocks are considered core, long-term investments. We have relatively more exposure to health care, industrials, and software, while we want to put more money in small-cap emerging markets, technology (hardware), and energy, and we'll be adding many more option strategies.

Our largest position is **Kinetic Concepts** (NYSE: KCI), with a market value of about $64,000 (representing 6.4% of our original million). Kinetic also has the distinction of being one of our top performers, alongside **GrafTech International** (NYSE: GTI), **Cameco** (NYSE: CCJ), **Vanguard Emerging Markets** (NYSE: VWO), and **Flowserve** (NYSE: FLS). Kinetic has always looked inexpensive, and the market has started to agree with us. Meanwhile, our belief that emerging markets, commodities, and industrial materials would be the first areas to lead the market higher has held up well, boosting our portfolio along the way — and it's likely that these areas will continue to perform.

We currently have two small losers: **Oracle** (Nasdaq: ORCL), a new holding we'll discuss below; and **Plum Creek Timber** (NYSE: PCL), down 6% while the S&P has gained 33%. But factor in our options strategies, and we've made money on Plum Creek; and as an investment in hard assets and an inflation hedge, it isn't necessarily a stock we expect to lap the S&P 500. We're likely to always have *some* losers — that comes with investing. But by maintaining our discipline and using our best strategies, we hope to remain consistently profitable and grow over time.

Below you'll find our latest take on every position that currently resides in the *Pro* portfolio, along with advice on how you can invest in them today.

AmTrust Financial Services (Nasdaq: AFSI) (target 5%; current allocation 4%): This small workers' comp and warranty insurer hasn't reaped recent gains along with the market, but its book value jumped last quarter and should continue to grow. As a defensive play, it will likely hold up well if the market declines, and meanwhile, the shares still offer plenty of value. Below our preferred buy price recently, AmTrust remains a stock you can Buy First.

- Preferred buy price: $12 or less
- Fair value estimate: $17
- Alternate action: Write $12.50 or $10 puts

Kinetic Concepts (NYSE: KCI) (target 5%; current allocation 4%): Despite lingering competitive concerns regarding Kinetic's negative pressure wound therapy patents, management continues to impress by growing the bottom line, paying down debt, expanding its portfolio of vacuum-assisted closure products, and integrating LifeCell's regenerative medicine business. We still predict healthy growth, and the stock still looks inexpensive. Since we own a large amount already, our preferred buy price is more conservative for additional shares, but it's still a Buy First; all *Pro* members should consider owning some even today. (In fact, our My Scorecard data — which is gathered anonymously — shows that Kinetic is also the most widely held stock among *Pro* members.)

- Preferred buy price: $34 or less
- Fair value estimate: $48
- Alternate action: Write $35 puts

Medtronic (NYSE: MDT) (target 5%; current allocation 2.5%): This leading medical device seller aims for double-digit earnings-per-share growth. Uncertainty surrounding health care reform weighs on the stock, but that could lift once the fog clears and the government comes to some decisions. We're aiming to buy more just below $36 via our October $37 puts, so recent prices — on down days — represent a good time to pony up and grab a piece of this medical giant.

- Preferred buy price: $36 or less
- Fair value estimate: Up to low $50s
- Alternate action: Write puts in the mid $30s

Oracle (Nasdaq: ORCL) (target 5%; current allocation 2.5%): The largest software company to grow free cash flow strongly over the past five years, Oracle is a competitive powerhouse and the world's leading business software provider. Management believes a **Sun Microsystems** (Nasdaq: JAVA) acquisition will put Oracle on the path to a leading position in business hardware, too. For now, investors await Europe's approval of the merger, keeping the stock depressed — so we're taking the opportunity to start a position. Today, you can buy shares, write $20 puts, or both.

- Preferred buy price: $22.50 or less
- Fair value estimate: Upper $20s
- Alternate action: Write puts in the lower $20s

Waters (NYSE: WAT) (target 5%; current allocation 2.5%): Spending on scientific instruments, such as Waters' liquid chromatography systems and mass spectrometers, retreated in 2009. This was in large part because drug companies, which make up about half of Waters' sales, pulled back spending. Government spending on scientific research, on the other hand, is on the rise — a good sign for Waters' products in 2010 and beyond. The stock bounced up from $51 immediately after our recommendation, but it remains a good option-writing candidate. We also hope to own shares for the long haul.

- Preferred buy price: $52.50 or less
- Fair value estimate: $60s
- Alternate action: Write puts in the $50s or buy half and write a covered strangle

Autodesk (Nasdaq: ADSK) (target 4%; current allocation 4%): The 3-D design software leader continues to wait for a recovery in construction, but 2010 should see many more government stimulus programs kick in, especially in North America. The stock is a bit above our preferred buy price, and we're content with our stake for now, waiting to see how the next quarter goes. You can write puts if you're looking to add to or open your position.

- Preferred buy price: $22.50 or less
- Fair value estimate: Up to low $30s
- Alternate action: Write puts in the lower $20s

iShares Silver Trust (NYSE: SLV) (target 5%; current allocation 3%): This ETF is a hedge against inflation, the dollar, and a weak stock market, but our core strategy here is to generate option income. We've written covered calls and a covered strangle, which we recommend if you're looking to pick up more shares. We don't foresee this repeatable strategy, which has been successful for us so far, changing anytime soon, although prices will naturally fluctuate.

- Preferred buy price: $14.25 or less
- Fair value estimate: N/A
- Alternate action: With Silver Trust recently above $16, a February or April $14/$17 (or close to that) put/call strangle may be applied to new positions

Jack Henry & Associates (Nasdaq: JKHY) (target 5%; current allocation 5%): Capital spending at small- and mid-tier banks may continue to come under pressure over the next few quarters as the FDIC considers ways to replenish its depleted funds. Nevertheless, Jack Henry remains in fine financial shape, continues to generate substantial free cash flow, and is profiting from the growth of electronic banking transactions. Its high level of recurring revenue lends us confidence in the business, and if we didn't already own our full allocation, we would be buyers on dips near our preferred price range, or write $22.50 puts to get there.

- Preferred buy price: $21 or less
- Fair value estimate: Up to $30
- Alternate action: Write $22.50 puts

Plum Creek Timber (NYSE: PCL) (target 5%; current allocation 3%): In what one industry CEO called "the most severe depression in the wood products industry since the 1930s," Plum Creek management has stayed focused on the long-term drivers of the industry while stemming short-term losses by selling non-strategic lands in Montana. Although volatility in the shares has slackened, this remains a strong option-writing candidate, and the stock pays a 5% yield. We like writing covered strangles on Plum Creek, generally writing puts when shares are near or below $30 and covered calls when it nears the mid $30s.

- Preferred buy price: $34 or less
- Fair value estimate: Around $40
- Alternate action: Write $30 puts if you'd like to buy shares or add to your shares; wait to write covered calls right now

Procter & Gamble (NYSE: PG) (target 5%; current allocation 5%): Management was slow to react to a shift in consumer spending patterns, but it's beginning to correct for its oversight. We're also encouraged by new CEO Robert McDonald's international focus; P&G has lagged competitors, including **Unilever** (NYSE: UL), overseas. Meanwhile, P&G continues to be a strong dividend payer. We're happy to own this stalwart for its long-term potential and growing dividend. Newcomers can consider buying on dips or writing puts anytime.

- Preferred buy price: $55 or less
- Fair value estimate: Mid $60s
- Alternate action: Write $55 puts

Vanguard Emerging Markets (NYSE: VWO) (target 5%; current allocation 2.6%): China, Brazil, and other emerging markets have strongly outperformed the U.S. market this year, making this ETF one of our top winners. Emerging markets look more expensive now, but they still offer long-term potential and belong in a well-rounded portfolio. Look to buy on a decline, which may pop up on occasion thanks to the volatility that typically visits emerging markets.

- Preferred buy price: $32.75 or less
- Fair value estimate: N/A
- Alternate trade: Write puts in the mid $30s

Vanguard Energy (NYSE: VDE) (target 3%; current allocation 3%): An ETF investment in the largest oil and gas producers in the world, Vanguard Energy was our way to buy industry giants when oil prices were much lower. Today, watch for dips to gain exposure to leaders in some of the world's most vital commodities.

- Preferred buy price: $74 or less
- Fair value estimate: N/A
- Alternate trade: Write $75 puts

Cameco (NYSE: CCJ) (target 3%; current allocation 1.6%): The world's largest uranium producer continues to prepare its giant Cigar Lake mine for production, but results are at least a few years away. China is stockpiling uranium as more nuclear plants move toward construction. Long-term demographics suggest strong uranium demand — but at current share prices, Cameco may offer limited upside for the time being.

- Preferred buy price: $21 or less
- Fair value estimate: Mid $20s (but under review)
- Alternate action: Write puts in the mid to low $20s

Flowserve (NYSE: FLS) (target 4%; current allocation 3%): This pump, seal, and valve leader has been a phenomenal story of execution, even in a tough market. Flowserve boasts strengthening margins, healthy free cash flow, lower debt, and expanding market share. But as a volatile industrial stock that's run up recently, Flowserve remains a Hold at least until we see next quarter's results.

- Preferred buy price: $75 or less
- Fair value estimate: Mid $90s
- Alternate action: Write puts in the $80s or lower

GrafTech International (NYSE: GTI) (target 5%; current allocation 3%): Management has paid down debt and generated free cash flow during its most challenging year in decades. When steel demand increases, GrafTech should benefit smartly, but we prefer lower buy prices on this volatile stock.

- Preferred buy price: $12 or less
- Fair value estimate: High teens
- Alternate action: Write $12.50 puts, or write $15 puts if they pay enough to net a $12 buy price

Lindsay (NYSE: LNN) (target 5%; current allocation 1%): In what has proven to be a miserable year for agricultural spending — farmer net income is expected to fall 38% in 2009 — Lindsay has maintained balance sheet discipline and costs, and the company is poised to profit once the economy recovers. Global stimulus spending on infrastructure in 2010 should help drive sales in road and traffic safety products. Recently above $40, it became a Hold on valuation. We've written $35 puts to potentially get shares much cheaper.

- Preferred buy price: $34.50 or less
- Fair value estimate: $40s
- Alternate action: Write puts in the $30s

Rounding out the portfolio, we also have a few options-*only* positions, including puts on **Nasdaq OMX Group** (Nasdaq: NDAQ) and **Tupperware** (NYSE: TUP) — perhaps these will be stocks in the portfolio before our year two review — and a new bearish options strategy on **Abercrombie & Fitch** (NYSE: ANF).

Meanwhile, we look forward to adding more high-caliber businesses to the portfolio in the coming year: some you've heard of and some you probably haven't; some small and promising and others large and successful — all with the goal of growing our profits smartly. Care to discuss a company with us, or ask a question about it? Visit the *Pro* boards. And thank you for being with us!

Jeff owns shares of AmTrust Financial, Nasdaq OMX Group, and Oracle. Todd owns shares of Kinetic Concepts and Procter & Gamble.

Monday Memo: A Stock We Skipped

Published Oct 5, 2009 at 12:00AM

Endo first blinked onto our radar in late 2008 thanks to a strong CAPShot that bounced between 10 and 11 (of 12), along with a perfect 5-star rating on CAPS and a 100% outperform ranking from All-Stars. Even if you don't realize it, you probably know this purveyor of powerful prescription painkillers; Endo produces both pain patch Lidoderm and the well-known drug Percocet. When I first started looking into the company last November, it had grown its $1 billion in annual sales by more than 18% in the third quarter, and its adjusted income from operations clocked in 39% higher year-over-year. The company had also just increased its earnings guidance for the year, to $2.30 per share. Wonderful!

The stock traded at $23 -- only 10 times management's 2008 earnings guidance. It also fetched only about 10 times free cash flow, and the company held twice as much cash as debt. All in all, it appeared to be a small, healthy pharma trading at a reasonable price.

But after looking further, we balked. We had to.

Sometimes you analyze a company and everything looks good, but you continue to have concerns. Heed that hesitation. In this case, I was having a hard time getting past the fact that one drug, Lidoderm, accounted for $550 million of the $900 million in sales achieved in Endo's previous nine months (remember, it's late 2008).

This might be OK if Lidoderm's patents had years before they ran out, but its five patents would start expiring in 2009, and would all expire by 2015. Given this, we would need a severely lower valuation on the stock -- mid-single digits on free cash flow -- before we'd consider it.

Add to this a recent management shakeup, and we had to turn away. The company had one basket and, basically, one egg in it. And that egg was slowly starting to rot. So we left the stock at $23 and moved on.

By early 2009, Endo's shares were around $16. The stock was now cheap enough that -- despite the businesses' weaknesses -- it merited another look; it traded at about 7.5 times free cash flow. What happened? The market didn't like a pending acquisition, and in the first quarter, Lidoderm sales showed a surprising decline that management chalked up to customers eating through inventory before placing new orders. Endo was convinced sales would tick higher again.

Adding to the risk, however, was the remaining aftermath of the wide shakeup at the top. The CEO had been there less than a year, and the whole company was being restructured for the acquisition of Indevus Pharmaceuticals, which added product lines in urology and oncology, diversifying Endo away from pain. No, the market didn't like the acquisition; but by making it during the financial meltdown, it appears Endo got an excellent price. And I actually liked the acquisition because it allayed some of our concerns about Endo being a one-product company. I also believed, after looking at past years, that Lidoderm sales would indeed rebound. Suddenly, I was getting interested again.

But then, news broke that the FDA was considering additional regulations on powerful opioid pain killers, including Percocet. These drugs are highly addictive and need greater oversight, the FDA said. And that was it for me.

Despite the acquisition and two new drugs close to launching, nothing was going to end Endo's reliance on a few key painkillers anytime soon -- the largest of which faced patent expirations, and the other a named plaintiff in FDA reports. The stock was cheap, but not worth the risk -- even my idea of writing $15 puts wilted. As the market rallied into the summer, Endo stayed stuck in the mid teens.

On July 1, an FDA panel urged the U.S. to ban Percocet. I wrote Todd that night, thinking the stock would be toast the next morning and celebrating that we had truly made the right decision to pass on the stock (maybe we'd even short it now). But Endo hovered around $17 on the news. The market had already priced in such a potential disaster, apparently.

Today, shares of Endo sit at $22, right back where they were about a year ago, and they've underperformed the market. I still wouldn't buy, but it's been an interesting stock to follow. My conclusions:

- Passing on it at $23 was the right choice -- soon after, we instead bought companies like **GrafTech International** (NYSE: GTI) and **Autodesk** (Nasdaq: ADSK); and in health care, we continued to build our position in **Kinetic Concepts** (NYSE: KCI) and eventually picked up **Medtronic** (NYSE: MDT), too.
- Still, reconsidering Endo in the mid teens was merited due to valuation. And if the FDA hadn't stepped into the picture, we might have bought some shares or at least written puts, turning a stock we originally passed on into a profitable trade or two. We were actually looking to buy around $16 with plans to sell around $23 -- a nice gain.
- If Endo falls into the mid teens again, we'll probably look at it again. *Probably*. But we'll have to take its pulse anew -- see how the acquisition is going, see how the new drugs are doing, and check that basket of eggs.

Ah, yes -- the time you spend flirting without dating. It adds up. But it's a big part of the work we need to do as investors. In our second year at *Pro*, we'll regularly share reports like this with you to make use of the trades we *don't* make. Have comments or suggestions -- or want to share the story of a stock you've skipped? Please post on the Memo Musings board!

Fool on!

Jeff Fischer (TMFFischer)

Enact a Bear Put Spread on Abercrombie & Fitch

Published Oct 2, 2009 at 12:00AM

At a Glance

- **Strategy type:** Bear put spread (write a lower-strike put and buy a higher-strike put)
- **Preferred option prices:** Try to pay a net debit for the two trades of around $3.50, allowing for a 100% potential return.
- **Maximum amount to pay:** Paying a net debit of $4 provides a potential 57% gain.
- **Recent option prices:** $2.15 bid for the February 2010 $27 puts you write, and $5.30 ask for the February 2010 $34 puts you buy, or a net debit price of $3.15 ($315 before commissions to set up this trade with one contract of each)
- **Recent share price:** $31.40
- **Potential benefits:** You earn the full profit if the stock declines below the lower strike by expiration.
- **Potential risks:** You lose your full investment if the stock increases above the higher strike by expiration.
- **Allocation:** 0.3% (for *Pro*, a net debit of about $3,150 — or 10 contracts of each)
- Trade requirements: You need a high level of options approval to create spreads. You can enter the trade using your broker's spread order entry page, saving on commissions. Set up the trade as a "net debit" spread; your limit price is the maximum net payment you're willing to make for the trade.

The Big Picture

You can't miss **Abercrombie & Fitch** (NYSE: ANF) at your local mall. (Warning: Cranky tone from Todd ahead.) From the store's Adirondack-inspired decor to its thumping music, wall-sized prints of scantily clad models, and the crushing stench of cologne, its 9,000 square feet of sensory overload. And that's intentional: The company is proud of its store "experience," which is designed to capture — in the words of management — "the essence of privilege and casual luxury." During the early 2000s, this approach worked well, and Abercrombie's high-priced, All-American casual style was all the rage with teens.

But privilege and luxury is for now a bygone era. Combine the ever-fickle teen consumer with high teen unemployment (25.5% in August), parents whose net worth has been clocked over the past 18 months, and a secular shift in spending habits, and you have a toxic brew that could hamstring a teen-apparel retail company like Abercrombie, which built its brands to "compete on quality, aspiration, and the unique store experience ... not on price."

Breaking the Brand

Abercrombie management readily admits that it missed the massive change in consumer behavior, but it's been too proud to make real price cuts or offer sales promotions throughout the downturn. Last December, chairman and CEO Mike Jeffries (more on him in a bit) called discounting a "short-term solution with dreadful long-term effects." Even after Abercrombie folded its Ruehl brand (designed for 22- to 35-year-old males) in June, it still wasn't budging on prices in its other stores, which include Abercrombie & Fitch, Hollister (a Southern California style), abercrombie (kids), or the new Gilly Hicks (women's lingerie) line.

Management wants to protect the brand and its high-cost image, banking on having a strong enough balance sheet to weather a temporary storm. A worthy notion, but it's probably the wrong bet to make as the consumer pullback lingers. Abercrombie's recent same-store sales figures (year-over-year sales at stores open at least one year) versus lower-priced competitors **American Eagle** (NYSE: AEO) and **Aeropostale** (NYSE: ARO) illustrate the error:

Company	May 2009	June 2009	July 2009	August 2009
Abercrombie	(28%)	(32%)	(28%)	(23.9%)
American Eagle	(7%)	(11%)	(11%)	(7%)
Aeropostale	19%	12%	6%	9%

Other value competitors in the youth market, including **Ross Stores** (NASDAQ: ROST), **Buckle** (NYSE: BKE), and **TJX Companies** (NYSE: TJX) (T.J. Maxx, Marshalls) also showed positive same-store sales figures in August — so it's apparent that younger shoppers are opting for lower-priced alternatives. The price difference between Abercrombie and its competitors is stark:

	Abercrombie	Aeropostale	American Eagle
Graphic t-shirt (men)	$30	$10	$19.50
Hoodie (men)	$90	$24.75	$39.50
Skirt (women)	$70	$20	$29.50
Jeans (women)	$90	$24.75	$39.50

Data from company websites as of Sept. 24, 2009.

Abercrombie contended for the longest time that it had enough cash on hand — $522 million in January — to avoid discounting, but in mid August, with that war chest shrinking quickly to $367 million and sales continuing to plunge, the company finally changed its stance on pricing and agreed to reduce price points. But here's the kicker: The prices in the table above are from late September — *after* the price reductions. They're still well above the competition and arguably too high for today's average teen shopper.

Successful CEO, or Willy Wonka of the Fashion Industry?

Despite the troubles brewing at the company over the past few years, chairman and CEO Mike Jeffries — a 64-year-old stuck in a world of perpetual adolescence — has made no effort to sacrifice his generous benefits package. According to The Corporate Library, in 2008 Jeffries was the tenth-highest-paid CEO in the U.S., raking in $71.8 million in realized compensation, including $1.1 million for personal use of the company-owned aircraft.

In the past, *maybe* you could make the argument that Jeffries was worth that much. He improved the company's gross margin from 38.5% in 1998 (the year he became CEO) to a high of 67% in 2007. Oddly enough, despite that dramatic improvement in gross margin, operating margin only improved about 340 basis points because non-sales-based expenses, including salaries, credit, and advertising, ballooned out of control, growing 1,421%.

What's Ahead for Abercrombie

With sales under pressure and sales prices ticking lower (even if modestly), we're skeptical that the company can meet current analyst estimates and grow earnings more than 70% over the next year. This looks especially challenging given that 598 of its 1,125 stores (about 53%) are in states where the unemployment rate is over 9.5%, including 140 stores in California where unemployment is 12.2%. Nor do we believe that same-store sales will tick positive next year, as abysmal same-store sales figures — down more than 20% year-over-year — continue, indicating little-to-no renewed interest in Abercrombie products.

The best case for Abercrombie is luring in more customers with lower prices, and consequently, dealing with lower margins going forward. There's some international growth potential, but it's still in its infancy — outside the U.S. and Canada, there's one Abercrombie & Fitch and five Hollister stores in the U.K. Abercrombie plans to open more stores in the U.K. this year, as well as one in Tokyo and another in Milan. While these operations may do well, they will not be able to completely offset the massive losses from the U.S. operations.

Valuation

At first glance, Abercrombie appears to be a financially strong company — it pays a dividend, it's free cash flow positive, and it has a decent amount of cash on the balance sheet with only a small amount of long-term debt. Dig a little deeper, though, and the holes begin to show.

1. **The dividend**. Currently, it pays $0.70 per share annually, for a trailing earnings payout ratio of 132%. This means Abercrombie's profits over the past year haven't been enough to cover its payouts.
2. **Free cash flow.** Sure, free cash flow appears sufficient to cover the dividend and fund international expansion, but if you strip out temporary inventory reduction and substantial stock-based compensation benefits, Abercrombie's ability to organically generate free cash appears questionable.
3. **Balance sheet.** Ever wonder why so many retailers appear to have little or no long-term debt? In general, retailers rent their stores rather than own them, and according to GAAP, those rent payments are considered operating expenses rather than interest expenses. This is off-balance-sheet financing and should thus be accounted for when measuring a company's value. At the end of fiscal 2008, Abercrombie operated a total of 1,125 stores, most of which are mall-based and leased. If those operating leases were instead treated as financial expenses (as if Abercrombie owned the stores), it would have a *profound* effect on the balance sheet, adding approximately $2 *billion* to the debt load, lifting interest expenses much higher, and likely pushing the already-thin return on capital and equity figures into negative territory.

With the market currently valuing the company at more than 20 times next year's aggressive-looking earnings expectations, Abercrombie doesn't have a lot of room to disappoint. The upside risk to our trade, then, seems reasonable relative to the potential benefits from continued weakness. If meaningful sales improvements don't materialize this fall and winter, expect to see more analyst downgrades and lower earnings estimates for calendar year 2010. If these things happen, we think Abercrombie could easily trade in the mid-to-low $20s again, low enough to make our bear put strategy 100% profitable.

Why This Strategy

We considered all kinds of ways to bet against Abercrombie — from trying to short shares outright, to doing a synthetic short (write calls to buy puts), to just buying the (rather expensive) puts — before deciding to set up a bear put spread. This strategy limits our downside to only the net amount we invest, although it also caps our upside. With a bear put spread, you write a lower-strike put and use the proceeds to buy a higher-strike put. The most you can make on the trade is the difference between the two strike prices minus what you paid to set up the trade. If the stock falls below the lower strike price by expiration, you'll earn the full profit. Ideally, we can set up this trade to earn about a 100% profit on the capital we invest. Take a look:

- **February 2010 $27 puts (ANFNC):** Recently bid $2.15
- **February 2010 $34 puts (ANFNL):** Recently ask $5.30
- **Spread:** $7 between strike prices
- **Cost:** $3.15 net debit to place the trade
- **Potential profit:** $3.85 (the difference between the net credit and strike prices), or more than 100% on your $3.15 cost. Paying up to $3.50 to place this trade, with a $7 spread between strike prices, gives the potential of a 100% gain on your investment. You can pay a bit more, but your potential profit decreases.

The $34 strike price gives us about 10% breathing room above the current stock price before we risk losing our full investment. The $27 strike price is achievable, especially by February, if the company's year-end sales don't match or exceed expectations. Meanwhile, the spread between the two allows us fairly ample room for profit. If the stock ends near $30.85, we break even on the trade; below that price, we have a net profit before commissions; above that price, and we have a net loss. We make the full profit if the stock is below $27 and risk the full investment (if we don't close early) if it ends above $34.

What Would Change Our Strategy

Abercrombie's same-store sales have been dismal since April 2008 — so even a lackluster improvement from here could make investors believe the chain is on the mend. This perception alone could send shares of this strong brand much higher.

If same-store sales do improve meaningfully, and sales start to recover overall, we may need to close our position early and at a loss. The struggles at the chain are well-known already, so mere weakness won't surprise investors. We need the weakness to continue on the same scale as it has been, or worse. If it doesn't, we may try to cap our losses before February.

Pro Bottom Line

When you take on the risk of betting against a company, you're hoping that you know something the market doesn't. And the way Abercrombie is being valued, analysts seem to believe the consumer of yore will soon return and international expansion projects will help drive sales. But we don't believe these are realistic expectations. Much more likely, in our opinion, Abercrombie will continue to limp along as lower-priced competitors draw in the teen crowds that the chain has always been so reliant upon — because this time, it *is* different. To discuss this trade, please visit our new Abercrombie & Fitch board.

Monday Memo: A Surprising Short Story

Published Sep 28, 2009 at 12:00AM

On Nov. 21 last year, we highlighted several weak companies that weren't likely to see better financial results anytime soon. Indeed, most of these businesses haven't improved at all since then, yet their stocks have soared. Generally, stocks of weak, speculative companies have jumped the most this year, signaling that an appetite for risk remains alive and well among some investors (for better or worse). Consider these results**:**

Company	11/21/08	9/25/09	Change
Wynn Resorts (Nasdaq: WYNN)	$32.02	$70	+119%
Abercrombie & Fitch (NYSE: ANF)	$14.22	$31	+118%
Brinker International (NYSE: EAT)	$3.82	$15	+292%
Collective Brands (NYSE: PSS)	$4.73	$17	+259%
CRBL Group (Nasdaq: CBRL)	$11.36	$34	+199%
Darden Restaurants (NYSE: DRI)	$14.01	$35	+150%
DineEquity (NYSE: DIN)	$8.24	$25	+203%
Winnebago Industries (NYSE: WGO)	$5.01	$12	+140%
Radio Shack (NYSE: RSH)	$8.50	$16	+88%

If you had invested in a debt-heavy casino operator, a struggling clothing retailer, a mall restaurant company (malls and restaurants are both suffering!), a shoe retailer, Cracker Barrel's owner, Red Lobster's owner, iHop and Applebee's, a slumbering RV seller, or Radio Shack, your stock has rocketed since last November.

This tells us a few things: First, it was indeed too late to go short, even last November, which was well before the market hit its low in March. Second, either these companies were beaten down far too much, or they've since risen too much. I suspect the answer is somewhere in between. They didn't deserve to be so low (they were priced to fail), but they don't deserve today's prices, either.

Where do we stand today with the stock market and the economy?

- Investor optimism has been growing since March
- Stocks are at historically high valuations, with the S&P 500 trading at 19.8 times estimated 2009 operating earnings -- a new high since 2004
- Expectations for an economic rebound are running high
- Consumers are saving more but still carry historically high debt
- Investors expect and want strong financial improvements starting *now*

Overall, *this* is a much more enticing market in which to consider going short than last November. Even so, it's not ideal. The economy is in a trough -- obviously not at a peak. As a short seller today, your thesis needs to hold that the economy will not recover as quickly or as sharply as most investors are estimating. If that proves true, stocks would likely surrender a good portion of their recent gains, and speculative stocks would likely give up the most. If the recovery is strong and arrives soon, however, the painful squeeze of short sellers would likely continue.

However, shorting individual stocks today seems much more feasible and reasonable than at any time in *Pro*'s short history. Short sellers need to move cautiously and use strategies that limit downside risk -- including put buying or bear put spreads -- but today's market is more interesting for shorting individual stocks than last year. And that's surprising.

Options 801: Introduction to Spreads

Published Sep 22, 2009 at 12:00AM

No matter what kind of spread we're setting up, usually we'll aim for at least a 50% return — ideally, 100% or more — to make the risk, which is a full loss of the investment, worthwhile. Here are some of the spreads you'll encounter most often:

Bull call spread: A bullish strategy in which you write a call with a higher strike price (usually above the underlying stock's current price) and buy a call with a lower strike price. You earn the full potential profit if the stock increases above the higher strike by expiration; you lose the full investment if the stock falls below the lower strike by expiration.

Bull put spread: A bullish strategy, even though it uses puts; you purchase lower-strike puts and write higher-strike puts, for a net credit. If the stock ends above the higher strike at expiration, you earn the maximum profit.

Bear put spread: A bearish strategy in which you write a put with a lower strike price (usually below the stock's current price) to buy a put with a higher strike price. You earn the full profit if the stock declines below the lower strike by expiration; you lose your full investment if the stock increases above the higher strike by expiration.

Bear call spread: A bearish strategy that uses calls; you purchase higher-strike calls and write lower-strike calls, earning the full profit if the stock ends below the lower strike at expiration. Bear *put* spreads are generally superior to bear call spreads if you're exceptionally bearish, but bear call spreads are attractive because they start with a credit and can use less buying power.

Butterfly spread: This neutral strategy combines a bull spread with a bear spread (there are four possible ways to set it up); you profit most if the underlying stock does not rise or fall much by expiration. Like all spreads, it has limited risk and limited profit potential.

Calendar spread: A generally neutral strategy in which you write a nearer-term option and purchase the same option (in this case, at the same strike price) but with a much later expiration date. Time erosion should cause the value of the nearer-term option (which you wrote) to decay more quickly than the longer-term option that you bought; if it works as intended, you'll show an overall profit as the near-term option reaches expiration.

Ratio spreads: Also a generally neutral strategy, here you buy a certain number of calls (called a ratio call spread) or puts (called a ratio put spread) and then write a *larger* number of calls or puts (say, two for every one you've bought) that are out-of-the money. Your profit is maximized if the stock ends exactly at the strike price of the written options. Ratio spreads have increased risk because not all of your written options are "covered" by purchased options.

We'll get into these and other spreads in greater detail in future *Pro* guides; for this introduction, we just want you to become familiar with the many terms and basics behind spread strategies. And — if you need to — you can take this opportunity to apply for approval to use spreads at your broker (it's usually Level 4).

When setting up a spread trade, the combined premiums are labeled like so:

- **Debit spread, or net debit:** Here, you pay more in premiums to set up the spread than you collect.
- **Credit spread, or net credit:** Much less common than a net debit, in this case, the spread's total option premiums collected pay you more than you need to pay out. In other words, the options you write pay you more than you need to shell out to buy the other options to complete your spread.
- **Spread order:** This kind of special order allows you to make two or more options trades (usually for a lower commission) with your broker at the same time — thus setting up your spread. Usually, the trade is entered as a limit order at the maximum net debit you're willing to pay or the minimum net credit you want to receive. This is similar to using a limit price when trading a stock.

Moreover, spreads can be described more precisely depending on where the strike prices and expiration dates fall:

- **Vertical spreads:** The most common spreads fit this description, including basic bull and bear spreads. In a vertical spread, the options have different strike prices but the same expiration date. It's called "vertical" because the strike prices are above and below one another in an option-quote chain.
- **Horizontal spreads:** In this case, the options have the same strike price (so they're horizontal to one another in a quote chain) but different expiration dates.
- **Diagonal spreads:** Here, the options you buy have a later expiration date than the options you write, along with a different strike price. You can set up diagonal bull spreads, diagonal bear spreads, and diagonal butterfly spreads, to name a few. We'll address why and how in later guides.

Now let's illustrate what we've covered so far with a real-life (OK, a very fake) example.

As the result of a questionable federal government-backed merger, a new company comes into existence called **Fannie Madoff**. Most investors are optimistic, pointing out that anything the Fed does, it does well, so they're sure the firm will be a resounding success.

You, on the other hand, are fairly certain this house of cards will topple. The company has questionable management and is crippled with debt — yet investors continue to bid the stock higher. Since you don't want to risk your net worth going short, you set up a bear put spread, limiting your potential losses.

With the stock trading at $34, to set up a bear put spread, you could write $32.50 puts for a $1.50 payment and use the proceeds to buy $35 puts for $2.50. Your net debit is $1 per share. That's the most you can lose. How much can you make if Fannie Madoff faces the music? Since the difference between your strike prices is $2.50, and the trade cost you $1, the most you can make is the difference between the two, or $1.50 per share. That's great, given that you only paid $1 to set up the trade. It's a potential 150% return on your investment.

What are the possible outcomes? If the stock falls anywhere below $32.50 by expiration, you capture the maximum gain. For example, let's say it falls to $30. The $35 puts you bought will be worth $5 per share, while the $32.50 puts you wrote will be worth ($2.50). You hold a net $2.50 profit following your $1 net investment, so you've cleared $1.50 per share while only risking $1.

On the flipside, if the Fed gives our fake Fannie another boost, and the stock is above $35 at expiration, your whole investment is lost -- but at least you only paid a net $1 per share. Other possible outcomes: If the stock trades at various price points between the two strikes, you'll have either a partial profit or partial loss when you exit the trade at expiration. (When to close a spread early is a topic for another day.) This is the essence of how a spread works: You limit your risk while potentially earning a large — though capped — percentage return on a lower out-of-pocket cost.

To sum up, spreads involve both buying and writing the same type of option on the same stock, usually with different strike prices, while aiming to profit on the difference in strike price, after your net cost, between the two. Your maximum profit is capped to these price differences, and your maximum loss is the net debit that it takes to set up the trade. Spreads have numerous variations, so we'll enjoy discussing different ways to set them up, and why, in future *Pro* guides. Meanwhile, we plan to start with some real-money spreads in the *Pro* portfolio, so get ready — and please post any questions on the All About Options board.

Jeff owns no shares in Fannie Madoff.

Monday Memo: Pro's Approach to Valuation

Published Sep 21, 2009 at 12:00AM

According to Aswath Damodaran, a professor at New York University's Stern School of Business, relative valuation is "pervasive" on Wall Street. His data show that:

- Almost 85% of equity research reports are based on valuation multiples and comparables.
- More than 50% of all acquisition valuations are based on multiples.
- Rules of thumb based on multiples are not only common but are also often the basis for final valuation judgments.

If this doesn't scare you, it should. Why? Because if most stocks are trading at 30 times earnings, relative valuation could make a stock trading at 25 times earnings appear undervalued and therefore worth buying. But if it turns out that all stocks are overpriced and should be trading at just 15 times earnings, you'll lose money along with everyone else when the market declines. Your stock wasn't undervalued at all.

Despite its flaws, it's easy to see why relative valuation is prevalent on Wall Street. Using relative numbers, analysts can always find undervalued stocks, and portfolio managers can always justify being fully invested at all times. Because money managers make their bread by having assets under management, Warren Buffett aside, you won't find many of them saying, "I can't find anything to buy, so it's time to cash out."

Finally, when your own performance is judged *relative* to other analysts' and portfolio managers', it's much safer to ride with the herd and make relative valuations. After all, you only need to be marginally better than your peers to become a red-carpet star in the financial media and ratings-agencies circles. Similarly, if you use relative valuations and you're wrong, you'll have lots of company; on the other hand, if you deviate from the herd and are proven wrong, you're often wrong alone and your time as an analyst will likely be short-lived.

The biggest problem with relative valuations is that they're based on what other people are doing, not on fundamentals. To borrow a theme from many an after-school special, remember that what's right is not always popular, and what's popular is not always right. If the herd chooses to do something, it's going to do it. Whether it's the right thing to do is an entirely different matter.

The inherent volatility spawned by this irrational behavior creates opportunities for business-focused investors with longer time horizons.

At *Pro*, we stick to the business fundamentals -- think profits and cash flows -- to estimate a stock's fair value. By taking this approach, though, we implicitly assume three things:

1. That the market can be irrational in the short term.
2. That we have something the market doesn't have.
3. That the market will eventually correct itself.

I think we can all agree on the first point that the market can be irrational. As for the second point, we think our greatest advantage over the market is our ability to be patient and remain focused on an investment's underlying business, regardless of the market's happy days or temper tantrums.

This type of patience is uncommon. The average holding period for a stock on the NYSE is *months,* not years, according to Agora Financial. When we buy a stock at *Pro*, we plan to own it for at least three years, or as long as the valuation and business make it worth owning. In fact, the longer our time horizon, the better our chances of being proven correct -- by giving the market more time to revert to the company's proper value (and meanwhile, a growing company will continue to add value). So as long as we can stay patient, we have a distinct advantage over other investors.

This leads us to our third point, which is the biggest assumption because it requires a catalyst that's beyond our control. Whether it's a positive earnings report, a change in management, or an unexpected event, an undervalued stock can't reach its fair value without *something* knocking some sense back into the market.

Admittedly, the longer we need to wait for the market to recognize a company's fair value, the more trying it becomes to hold onto the position, especially if the stock continues to underperform. To resist our human tendencies to follow the herd, we deliberately review our businesses' fundamentals to determine whether we should keep holding our stocks.

In all of our *Pro* buy reports, we give you our fair-value range for the company and a preferred price range in which to buy the stock. The numbers are our best estimates at the time -- so they're not set in stone. Sometimes following good results our forecast will improve later, and we'll tell you when that happens -- as was the case with **Kinetic Concepts** (NYSE: KCI). Sometimes it will decline, as with **Procter & Gamble** (NYSE: PG).

There's no such thing as a precise valuation, which is why we're comfortable setting a fair-value range that includes good and bad scenarios. If our worst-case scenario still reveals an undervalued stock, as with **Autodesk** (Nasdaq: ADSK) when it was in the mid-teens, our margin of safety from sizeable losses is greatly increased.

Our preferred buy price can change, too. If a stock is trading just above our preferred buy price, that shouldn't stop you from buying it if you want to. Remember, the Buy First, Buy, Hold, and Sell ratings shown on our Portfolio tab are our final word on any position at the time. (If you really want to buy a stock that's on Hold, you can often write puts on it to buy shares closer to our preferred buy price.)

By taking a long-term, business-focused approach to valuing stocks, we should have a distinct advantage in an irrational market. Over time, it will help us build a diverse portfolio that generates winning returns.

Todd owns shares of Kinetic Concepts and Procter & Gamble.

Last week, *Pro* member alex340 kindly posted a host of put-writing trade suggestions that meet our guidelines:

- **Nasdaq OMX Group** (Nasdaq: NDAQ): right here
- **Lindsay** (NYSE: LNN): right here
- **GrafTech International** (NYSE: GTI): right here
- **Flowserve** (NYSE: FLS): right here
- **Cameco** (Nasdaq: CCJ): right here
- **Vanguard Emerging Markets** (NYSE: VWO) right here

Thank you, alex340! *Pro* members, let us know if you'd be interested in this as a regular feature. Two other notable discussions:

- Jeff discusses *Pro*'s returns and benchmark start date with members right here. Watch for Jeff's concluding post on the topic today.
- This Week in CAPS, Russell (TMFEldrehad) highlights a new feature that will make getting CAPS blog information on stocks that interest you a whole lot easier.

Buy Oracle

Published Sep 17, 2009 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Recent share price:** $21.50
- **Estimated fair value:** $29
- **Preferred buy price:** $23.50
- **Type of holding:** Core; Software, Technology

The Big Picture

Sept. 17, 2009

I've (Jeff here) followed **Oracle** (NYSE: ORCL) for years, and I've come to view it as one of the hungriest, most competitive companies on the market. With a ruthless focus on being No. 1 in any business it enters, Oracle has left countless rivals in its wake, acquired those that didn't fall easily, and expanded its revenue, margins, and profits along the way.

Oracle has more than 320,000 corporate customers who primarily use its database software to manage, utilize, share, and protect information. But the title of world's largest business software company isn't enough for Oracle. Management is intent on becoming the world leader in at least two more enormous markets: The first is "middleware," which allows two or more existing programs or systems to work together, bridging what would otherwise be a gap in software communication. Here, Oracle Fusion addresses everything from content management to developer tools. Second, there's Oracle's business-related applications, which include software built for customer-relationship management (Siebel), human resource management (Peoplesoft), industry-specific offerings such as Oracle Health Science, supply-chain management, governance, risk and compliance management, and much more.

Additionally, last year Oracle launched its first hardware product, the Exadata database machine. Running at speeds 10 to 50 times faster than previous setups on **IBM** (NYSE: IBM) or **Hewlett Packard** (NYSE: HPQ) systems, Exadata is taking market share rapidly. Meanwhile, Oracle's pending acquisition of **Sun Microsystems**

(UNKNOWN: JAVA.DL) will only improve its hardware offerings.

Put it all together, and Oracle is the largest one-stop solution for business software, with a foot in the door in business hardware, too. And thanks to its diverse — and *dispersed* — customer base, the company has grown right through the recession.

Oracle's Divine

Get Personal With Oracle

- **Founded:** 1977
- **Headquarters:** Redwood Shores, Calif.
- **Full-time employees:** 86,000
- **Market cap:** $109 billion
- **Website:** oracle.com

There are several key characteristics that make Oracle stand out as both a software and technology company and an investment.

Strong, recurring revenue and free cash flow: Of the more than $23 billion in revenue Oracle generated in fiscal 2009 (ended May 31), 50% was subscription based. Most Oracle customers pay an annual fee to receive software license updates and product support, and this recurring revenue provides the company with a fire hose of cash — about $1 billion a month on renewals alone. And for the trailing 12 months (to Aug. 31), the company's total free cash flow grew 14% in U.S. dollars, to $8.49 billion — and this period included two of the most challenging quarters the economy has seen in years.

High, expanding margins: Oracle achieved the highest operating profit margin in its history in fiscal 2009, up 2.4 points to 51%. And that wasn't all due to cost cutting, as we've seen with many other companies in this downturn — Oracle spent more on research and development than any competitor last year. What's more, the company expects margins to continue inching upward thanks to its growing base of recurring revenue.

A diverse customer base and broad opportunities: Oracle's products are unsurpassed in a range of industries around the globe: the top 20 banks and the top 20 telecom companies in the world run its software; so do the world's top 10 universities, more than 1,500 public sector organizations, and all 100 firms in the Fortune 100, according to the company. Oracle serves more than 320,000 customers in 145 countries — name a business and it's likely a customer, whether it's **China Telecom** (NYSE: CHA) or 7-Eleven, **Lockheed Martin** (NYSE: LMT), **Perry Ellis** (NASDAQ: PERY), **Norfolk Southern** (NYSE: NSC), or **Johnson & Johnson** (NYSE: JNJ). What's more, Oracle claims it's taking market share from competitors such as **SAP AG** (NYSE: SAP), **Salesforce.com** (NYSE: CRM), **Teradata** (NYSE: TDC), and IBM thanks to its aggressive worldwide sales staff. Even better: Given Oracle's diverse product offerings, cross-selling business software to existing customers is an enormous and lucrative opportunity.

An innovative culture: Since its founding, Oracle has developed creative ways to make business software more profitable and useful for customers. Today, it's continuing along that path by providing services under three operating models: (1) buy Oracle programs to run yourself on location in your data center; (2) run programs yourself on-demand, hosted in Oracle's data center; or (3) run programs on-demand in your own data center while Oracle manages and oversees it. The last model is the newest and the one Oracle finds most compelling. Few if any competitors provide all three alternatives, let alone a full suite of integrated software options to meet a full array of business needs.

Valuation

The Community's Take

After scoring a solid 4 stars for two years, Oracle recently dipped to 3 stars, so we're investing a bit against the community trend — but we expect star No. 4 to return eventually. The vast majority of All-Stars who have rated the stock think it will outperform, at 707 bulls to 35 bears.

On our proprietary CAPShot report, Oracle rates a 7 out of 12, coming up short on three of the CAPS-specific ratings, but clearing most of our fundamental hurdles. It would score a 10 with more support from the community.

At a recent $21.50 per share, Oracle trades at 13.9 times earnings estimates for the year ending May 2010 and 13 times current free cash flow (excluding tax benefits from options, which pushes the multiple to 14). Analysts expect the company to grow earnings 7% this fiscal year (nine months remain) and nearly 10% the following year. However, these estimates appear a bit conservative. This summer, management stated that Oracle has "a lot of company-specific momentum," and existing customers are adopting more Oracle-integrated products to save on costs. Says management, "We're in a very good position, and our pipelines are growing faster than our reported revenue."

Using a discounted cash flow model with an 11% discount rate projecting near-term growth rates near double-digits, followed by high-single digits over the intermediate term, we get a fair value for the stock near $29, or 35% higher than current prices. What makes this possible return attractive is the high margin of safety accompanying it, since it's unlikely that Oracle would trade more than 10% to 15% below current prices, and if it did, then not for long. Plus, our growth estimates may prove conservative: Oracle grew free cash flow 38% to 50% each quarter in 2008 when measured year-over-year on a trailing 12-month basis, and grew this free cash flow 14% to 20% each quarter in 2009 — until the final quarter, when growth dropped to 8%, before rebounding to 14% in the first quarter of 2010. Free cash flow growth could average in the mid teens, and even reach higher rates in a stronger economy, well surpassing our estimates.

Why This Strategy

As a $109 billion company — one set to digest a multi-billion dollar acquisition of Sun Microsystems — Oracle should perform well, but we don't expect it to blow the doors off. We believe we can buy the stock alone to profit over time, but we also expect we'll be able to take advantage of Oracle's steady performance with options strategies in the future. Before long, we may write puts to buy more Oracle, or use a covered strangle, writings puts and covered calls — that's a strategy we continue to like in this market. But for now, we're happy to start with a half position in the stock and potentially leg into options on it down the road.

What Would Make Us Change

Oracle keeps a long-running tab of its acquisition conquests. The company has a proven history of making billion-dollar acquisitions that benefit the whole, but each buyout presents a new challenge. Certainly, its pending $5.6 billion net acquisition of Sun will be another hurdle, leaving Oracle to integrate Java and Solaris software across its products. Oracle and Sun have long been partners, however, so odds favor success. In fact, Oracle expects the acquisition to add at least $0.15 per share ($1.5 billion in operating income) in non-GAAP earnings in the first year. However, the acquisition is still being reviewed in Europe, and certain qualifications may be attached. Also, Oracle expects Sun to temporarily decrease its overall margins modestly, before moving them higher again. If it appears Oracle is having problems integrating Sun, we may need to revisit our investment case. Another concern: new software license revenue remains weak in today's economy, so we'll be watching to see if pipeline improvements, as outlined by management, translate into new sales.

Pro Bottom Line

Oracle has long seemed like the forgotten software behemoth, always playing second fiddle to **Microsoft** (NASDAQ: MSFT). Yet it arguably faces more growth opportunities — and fewer competitive threats — than Bill Gates' company. At current prices, Oracle offers ample upside and limited long-term downside, while giving the Pro portfolio exposure to one of the world's foremost technology leaders. To discuss this trade, please visit our new Oracle message board.

Jeff owns shares of Oracle.

Close Puts and Write New Puts on Tupperware

Published Sep 15, 2009 at 12:00AM

At a Glance

- **First action:** "Buying to close" our October $25 puts (TUPVE) at a limit price of $0.05
- **Second action:** Writing ("sell to open") January 2010 $40 puts (TUPMH)
- **Allocation:** 3% (for *Pro*, about 10 contracts)
- **Option's recent bid/ask:** $3.70/$3.90
- **Preferred limit price:** $3.80 or higher to start; no lower than $2 later (5% of the strike price)
- **Alternate trade:** Write January $35 puts (TUPMG) around $1.75 if you're more defensive. Write October $40 puts (TUPVH) if you're more aggressive; they'd net you a buy price above $38. If you're unable to write puts, consider buying stock outright using a limit order near $36.

What's New

You might say **Tupperware** (NYSE: TUP) is the **Apple** (NASDAQ: AAPL) of the plastic container business. If you think that sounds over the top, consider that Tupperware gets higher prices for its products thanks to smart design; it has a unique sales environment; and it has a growing history of surpassing expectations. Last quarter was no exception, as earnings per share clocked in 41% above expectations. While we estimated the company's results would top Wall Street's numbers, we didn't foresee such a blow-out quarter while the world is hobbling through a recession.

This generations-old product leader is positioned to continue to grow handsomely as it keeps reinventing itself and expanding around the world. Following Tupperware's recent results, we've moved our conservative valuation estimate on the business 30% higher, to $45 per share. Today, we can write $40 puts on Tupperware that should give us room for error and will pay us very well (again) if we're right about the stock. Worst-case scenario, we end up with shares at a price near $36, equal to 13 times 2009 earnings-per-share estimates.

Why This Strategy?

Tupperware's stock jumped so quickly this summer that we didn't have time to react with a new trade while still doing our due diligence on its numbers. Today, though, we can write puts to potentially get our 3% allocation in the mid $30s, a reasonable price. And if we don't get shares, we won't fret, since we continue to view Tupperware as a strong candidate for option-writing profits.

With today's trade, we chose the January $40 puts even though the stock isn't trading much above that strike price — making this a bullish move that allows us to earn a higher premium from the options. A few valuation numbers:

- Our potential $36 buy price is 13 times 2009 earnings estimates and 11.8 times 2010 estimates.
- A $36 buy price is 16 to 17 times our estimated 2009 free cash flow, in line with the market average; yet Tupperware arguably has below-average risk.
- Analyst earnings estimates continue to look a bit too conservative.
- At $36, the stock yields a dividend of 2.4%.

How to Follow Along

Write ("sell to open") puts when you're willing and ready to buy the stock if it declines below the strike price at expiration. This trade works out as follows:

- **Option payment or yield (at $3.70 bid):** About 9.2% in four months (123 days to Jan. 16), or more than 27% annualized.
- **Option strike price ($40):** Very close to Tupperware's recent $40.70 — so this is a more bullish trade than discussed in our guide to writing puts.
- **Break-even price:** About 10% lower, near $36
- **Cash needed:** Each put option you write represents a potential stock purchase of $4,000.

Can't Write Puts?

If you're unable to write puts on this position, consider placing a limit order near $36 to potentially get shares if the market weakens. Our target allocation for this trade is 3%.

We'll make this investment in the next one business to 30 calendar days. To discuss this or ask questions, please visit our never plastic, always real Tupperware board.

Write Puts on Kinetic Concepts

Published Sep 15, 2009 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") December $35 puts (KCIXG)
- **Allocation:** 1% (for *Pro*, three contracts)
- **Option's recent bid/ask:** $1.90/$2.05
- **Preferred limit price:** $1.95 to start; later, no lower than $1.40 (4% of the strike price)
- **Alternate trade:** Write January 2010 $35 puts (KCIMG); if you're unable to write puts, consider buying stock outright using a limit order at $34, our preferred buy-below price.

What's New

Quarter after quarter, **Kinetic Concepts** (UNKNOWN: KCI.DL) has proven doubters wrong. First, the company has succeeded in the face of increasing competition in the negative-pressure wound therapy business. What's more, Kinetic has used its substantial free cash flow to deleverage its balance sheet from the debt it incurred acquiring regenerative medicine-maker LifeCell in 2008.

Kinetic has been particularly impressive when it comes to innovation. In the past nine months, the company has launched two commercially viable complements to vacuum-assisted closure (VAC) therapy: the GranuFoam bridge dressing for foot ulcers and the AbThera open-abdomen dressing. The medical community's rapid adoption of LifeCell's AlloDerm and Strattice products, especially together with VAC therapy, validates why Kinetic was so excited to acquire LifeCell in the first place. We're also encouraged by the company's recent announcement that it expects regulatory approval to enter the lucrative Japanese market, with reimbursement potentially beginning in the first half of 2010.

Year-to-date, Kinetic shares are up more than 80%, but we still consider the stock a value around current prices. At $36, for instance, Kinetic trades for just eight times forward earnings and about eight times trailing free cash flow. Shares are still undervalued, in our opinion, due to lingering concerns about negative-pressure wound therapy competition, patent disputes, and more generally, health-care reform in the U.S. We think all of these concerns are already priced into the stock, so we're adding to our current position with a nice margin of safety.

Why This Strategy?

By writing puts, we're attempting to fill the remaining 1% of our targeted 5% position in Kinetic Concepts at a net buy price of $34 or better (in this case, about $33). If exercised, this would increase our average buy price only slightly, from $22.79 to about $24.25; our fair value estimate remains in the mid-to-high $40s, and our preferred buy price remains up to $34.

Why not buy 1% outright? Thanks to appreciation, our current position in Kinetic is worth more than our targeted 5% already. But keep in mind, we've only bought 4% in Kinetic, and we base our 5% target allocation on what we'd *like* to invest in a business, not including money gained through appreciation. So although we'd be comfortable bumping Kinetic up to 6% in terms of *Pro*'s market value after adding more shares around $36, we want to maintain price discipline and only add our final 1% in our preferred buy range. If we don't get more shares (just making option income), we remain happy with our current allocation.

How to Follow Along

You write ("sell to open") puts when you're ready to buy the stock if it declines below the strike price. Here's how the trade works out:

- **Option payment or yield (at $2 bid):** About 5.7% in three months (more than 20% annualized)
- **Option strike price:** About 3% below Kinetic 's current stock price ($36), so this trade is modestly more bullish than usual
- **Break-even price:** 8% lower, at $33
- **Cash needed:** Each put option you write represents a potential purchase of $3,500 in Kinetic.

Can't Write Puts?

If you're unable to write puts or are just beginning to build a position in Kinetic, consider buying at least some shares outright even now (it remains an attractively valued Buy First position); or, place a limit order near $34 (our ideal buy range) to potentially get shares on a downdraft.

We'll make this trade in the next one business to 30 calendar days. To discuss the trade or ask questions, please visit our Kinetic Concepts board.

Monday Memo: New Q&A With the Pros

Published Sep 14, 2009 at 12:00AM

Cameco Calling!

Our covered calls on **Cameco** (NYSE: CCJ) expire on Friday, and 1,000 shares (about 62% of our stake) are due to be sold from our portfolio at a net $26.70. We'll let you know ahead of time if we're going to take action, or we'll keep quiet if we're just letting the shares get called away.

On the Boards

- Member 00jane posts thoughts on an article about the hope rally of the 1930s.
- Jeff offers a quick recap of *Pro*'s recent **Waters** (NYSE: WAT) trade.
- Russell (TMFEldrehad) checks in with his weekly CAPS take, calling out the TMFInsideFoolHQ blog and asking for your favorite CAPS blog.

In the spirit of our new Meet a Fellow Pro series, today's Memo features *Motley Fool Pro* team members Jeff Fischer and Todd Wenning answering key questions about today's market, the best way to approach investing now, what they're avoiding, and what's ahead for *Pro*. Over the next month, we'll continue to take stock of the *Pro* portfolio as we close in our first anniversary, looking back on the year that was and previewing the year ahead. Let's jump in.

Allyson (*Pro* editor): Todd, you were telling me that the market has actually been about flat over the past month. Has the rally finally stalled?

Todd: Though it's slowed down over the past few weeks, it's been an incredible -- and unlikely -- six-month rally. I found some Deutsche Bank analysis saying that since 1928, the most common stock market gain over any six-month period is 2.5% to 5%. Gains like we've seen since March 9 -- more than 50% in six months -- are incredibly rare, about a 1-in-200 event. The only other time the market gained so much in six months was 1933.

But this rally's been fueled primarily just by improvements in investor expectations -- or mere hope -- and artificial stimulus, not by organic fundamentals like customer demand and sales growth. I think we're at a crossroads here. If fundamentals, particularly revenue, don't begin to improve, expectations will wilt and drag the market lower. But regarding a stall right now: We can't be so sure. On Thursday (Sept. 10), the U.S. market set new highs for the year, so the rally may still be on.

Allyson: Jeff, what's your take on the rally?

Jeff: Analysts have exceptionally high growth expectations for 2010 -- they're calling for about a 25% jump in earnings for the S&P 500 next year. I read on Bloomberg that many analysts believe most of this growth will come from emerging markets, and the U.S. and Europe will keep limping along.

As Todd said, for that kind of earnings growth to occur, we'd need large gains in revenue -- and I don't see where that's coming from on the demand side, especially in a sustainable way. And with stocks trading at a forward P/E of 14 -- a valuation right near the historical average -- based on 2010 operating earnings estimates that are *six quarters* ahead, strong expectations are already priced in. It may be reminiscent of what happened in 2002: We were rebounding from the 2001 recession, so earnings jumped 19% that year -- yet the S&P 500 fell 23% over the same period. Could such an outcome repeat next year? Sure, if earnings don't increase enough to please investors.

Allyson: So if things are so tenuous right now, what's the best approach to investing?

Jeff: Remember that you're not investing for just one year. The word "invest," to me, implies a multi-year outlook. That said, we remain *defensively* bullish. We're still bullish on the strong companies that we're buying at reasonable prices, but we're defensive in terms of what the market might throw our way in the near term. We expect some giveback. At *Pro*, we're writing more defensive options, like covered strangles; these give us a downside cushion but also pay us well right from the start and offer plenty of upside in case stocks keep rising. I will say that the market in general is doing what we expected, just to a *much* greater degree. We expected -- I think we all did -- a bounce after last winter's rout. But the bounce has been much higher than what I expected so soon. Next, I would expect (and love to see) a range-bound market. That would be ideal for things like more strangle writing and averaging into great businesses. We'll see if we get it.

Allyson: I'll do what I can. OK, back to Todd: Name an investment you're avoiding right now.

Todd: Long-term bonds. Interest rates are near record lows, and inflation is looming, so long-term fixed income is a risky place to be putting your money right now. And whenever the economy begins to recover in earnest, monetary policies will need to be tightened quickly. The president of the Philadelphia Fed said that interest rates will have to rise very rapidly in order to prevent inflation -- this is part of the reason I'm so wary of the government stimulus. Swift interest-rate hikes would spell disaster for long-term bond prices. If you're looking at bonds, I'd look at higher-quality, short-term corporates or inflation-protected TIPS.

Allyson: Jeff, what investments are you keeping at a distance these days?

Jeff: Most big banking or large financial stocks. I've never loved them -- they're opaque at best -- and I think they're still a gamble that most investors don't understand. There are exceptions, of course, including the two big ones that Warren Buffett owns -- **Wells Fargo** (NYSE: WFC) and **Goldman Sachs** (NYSE: GS) -- but they're already priced as standouts. Either way, it's good to stick to your core competencies.

Allyson: One final question for you, Jeff. We're coming up on our one-year anniversary at *Pro*. What's next?

Jeff: Well, it's been a fun first year -- I think we're ready to hang it up. Kidding! Seriously, we'll get into this question more in the coming weeks. I can tell you that as we become more fully invested, we're going to introduce more options strategies since we won't primarily be in build-out mode anymore. And allocation-wise, our portfolio is getting closer to being fully allocated in health care -- a key, underpriced sector (at 11 times earnings estimates) with demographics in its favor -- but we're lacking technology exposure. That'll change this year. Also, we're still bullish on commodities and basic materials. Emerging markets need these commodities, and in greater volume than today's supply can fill.

We'll have more on the year ahead soon, along with a full portfolio review in early October. That'll be our shareholder letter, so to speak.

Allyson: Great. Thanks, Jeff and Todd.

Jeff: Thanks!

If you have questions about the market or what's next for *Pro*, you can ask the *Pro* team yourself -- just head over to our Memo Musings board. Fool on!

Sell ProShares Short SmallCap600

Published Sep 11, 2009 at 12:00AM

At a Glance

- **Action:** Selling all shares
- **Recent ETF price (9/10/09):** $42.59
- **Recent ETF NAV (9/10/09):** $42.52
- **Limit price to use:** Since Short SmallCap600 is so thinly traded, you may want to use a limit order at a price within 1% or so of the current market price.
- **Why we're selling Short SmallCap600:**
    - Our shorting on valuation thesis has not played out.
    - We originally said we'd aim to cap our loss on this short at 20%, and we're at that point now, so we're staying disciplined and sticking to our thesis.

As Kenny Rogers sang, "You got to know when to hold 'em, know when to fold 'em ..." Alas, we are taking his advice and closing out this short position, even though it pains us to do so. Here's why.

When we re-recommended the **ProShares Short SmallCap600** (NYSEMKT: SBB) ETF on May 11, the S&P 600 index had rallied nearly 50% in two months. The market, it seemed, had gotten too expensive too quickly on a move that was unsubstantiated, lacking economic fundamentals, instead being driven by investor enthusiasm or hope.

Our biggest risk with going short was, we wrote, "a continued resurgence in market confidence," adding that "in bull markets, valuation takes a back seat to excitement and hope, and short-sellers who are short based on valuation get clobbered." Well, that's what has happened — and given that one of our portfolio objectives is to avoid permanent, irrevocable capital losses, it's time to take our 20% hit with this investment and move on. Although we still believe the market is ahead of itself, capping losses on shorts is an important discipline to maintain.

This small short position was a fair insurance policy to have while we went about adding more long exposure to the *Pro* portfolio over the summer. Though our thesis didn't play out — yet — we continue to believe that making defensive moves like this is a good tack in an uncertain market.

What's Next

Even though we are saying goodbye to ProShares Short SmallCap600, that doesn't mean we've given up looking for new short positions. In an artificially sweetened market such as this one, though, where government spending is propping up whole industries and words from officials' mouths can send the whole market higher, we're targeting specific individual companies for our next shorts.

We will make this trade in the next two business to 30 calendar days. To discuss this sell, please visit the ProShares Short SmallCap600 board. To review our general reasons for selling, check out *Pro*'s Guide to Selling.

Meet a Fellow Pro: From the Top With spinningwood

Published Sep 10, 2009 at 12:00AM

Ed enjoying some free time on the water.

In this second installment of our new feature spotlighting some of our favorite members of the *Motley Fool Pro* community, we're bringing you our chat with another one of the most helpful, generous Fools in all of *Pro*-dom: Ed, known on the boards as spinningwood. How did Ed become an expert investor -- and what makes him tick? Read on to get the lowdown on this friendly and humorous Fool from Florida.

Jeff: Thanks for taking time to chat, Ed. First, please tell us a little about yourself.

Ed: I grew up in South Florida with the ambition of becoming an oceanographer. In the mid '70s, I graduated with a degree in chemistry and math and no desire to spend years in school to get the Ph.D. necessary for a career in oceanography. But I didn't want to leave South Florida, so I worked for two years running a Bridgeport mill in a machine shop. The money was good, but I quickly realized milling wasn't what I wanted to do for the rest of my life. So I invested a year and a chunk of my savings to get an MBA in finance, then spent the following year touring the U.S., burning through the remainder of the money I had saved up.

The money ran out in 1980, and I ended up taking a job in the oilfield services industry in Houston. This provided me with a post-graduate education in bare-knuckle capitalism and was the most valuable life experience I've ever had. The money I earned was fantastic, and my lifestyle was even grander. Then, in the mid '80s, the oil boom went bust, and I found myself broke, divorced, and working for a company in Chapter 11 bankruptcy that looked to be heading for Chapter 7.

Jeff: Probably like many *Pro* Fools, you've had some up-and-down decades! What happened next?

Ed: Hitting rock bottom was a liberating experience, and it provided me the opportunity to reboot my life. I ultimately got a great new job, a great new wife, and a new outlook on money and investing.

My wife (the good one) and I lived substantially below the very generous compensation we received from my new job (at AT&T). We saved the surplus and invested profitably. By the late '90s, I was struggling with the question of how much money was "enough" -- and my wife and I decided we had surpassed it. I retired in 1999, and we returned to South Florida, where we happily find ways to fill up our days. My favorites are woodworking, scuba diving, photography, investing, and pontificating in the *Pro* forums.

Jeff: Woodworking -- a rare talent these days, and now everyone knows where your "spinningwood" moniker comes from. Can you tell us about how you invest? Do you have a favorite strategy?

Ed: My style is eclectic. I believe that no single strategy is the right choice all the time. My favorite strategy involves analyzing vast amounts of data looking for that elusive "tell" that will give me an edge in short-term trading. That said, the degree of enjoyment I get from any particular strategy is completely irrelevant. I believe you have to use all the tools available to you to maximize your chances for success.

Jeff: Speaking of finding investing success, do you have a stance these days -- bullish? Bearish? Neutral?

Ed: I find this question impossible to answer. I'm a little bit of everything at the moment.

Jeff: I like that answer. Regardless of the market, what are your top pieces of investing advice?

Ed: Don't put too much weight on what has worked (or not worked) for others. Use what you can from what people are willing to share, but find your own voice.

Add as many tools to your strategy toolbox as you can, but only use those tools that you are willing or able to master. An appropriate but poorly executed strategy will often underperform a less appropriate but well-executed strategy.

Finally, don't discount the impact of luck in the success of your role models (particularly true for anyone foolish enough to use me as a role model). Many people achieved their success largely as a result of being in the right place at the right time. This is acknowledged a lot less than it should be. Results will not be easily duplicated by those who try to follow the same path.

Jeff: Well said. And now a self-serving question: In terms of your time with *Pro*, what would you say is your favorite part of the service?

Ed: I particularly enjoy the forums and the sense of community. I have benefited from some very generous mentors in other aspects of my life, and these forums provide an opportunity for me to give back a little.

Jeff: You've certainly played a key role in helping countless others in our community. Frequenting *Pro* as much as you do, is there anything you'd want us to improve?

Ed: I would like to see *Pro* consider developing a series of tools that would be available to members to address common issues faced by the members. I think many would benefit and it would increase the bond between *Pro* and its subscribers.

I also would like to see the introduction of interactive simulations as training tools. These could be single user or community wide competitive type "games." There are almost limitless possibilities that could be introduced that would enhance member learning.

Jeff: That sounds a bit like CAPS, the Fool's first step in that direction. Want a job helping to build CAPS out? Maybe our last question will answer that -- personally, my favorite question: If you could wake up anywhere in the world tomorrow, where would you want to wake up, and why?

Ed: In my own bed in South Florida. I have the luxury of being able to live pretty much anywhere I want, and I am where I want to be. That said, I've always been happy anywhere I found myself in the world. Happiness is a lifestyle choice -- and, with few exceptions, independent of location and circumstances.

Jeff: Ed, thank you for being with us, and for your hundreds (perhaps thousands) of contributions in the community the past year. We hope to see you on the boards whenever you're not on your boat, enjoying the outdoors, or simply spinning wood.

To chat or post a message to spinningwood, visit *Pro*'s Meet & Greet board.

Buy Waters and Write a Covered Strangle

Published Sep 8, 2009 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Recent share price:** $59
- **Estimated fair value:** $66
- **Preferred buy price:** $55
- **Type of holding:** Core; Healthcare and industrials

The Big Picture

Sept. 8, 2009

Get Personal With Waters

- **Founded:** 1958
- **Headquarters:** Milford, Mass.
- **Full-time employees:** 5,100
- **Revenue per employee:** $300,000
- **Website:** waters.com

What do the health-care industry, the industrial sector, education, and the government have in common? They all use an abundance of laboratory equipment for research and development. Walk around a biotech lab, and you'll be sure to find high-end precision equipment like liquid chromatography instruments, mass spectrometers, and thermal-analysis devices.

These rather expensive machines identify and measure characteristics of materials and chemicals (i.e., how much oxygen is in a formula). For the industries served, this equipment isn't "nice to have" — it's "need to have." Government-backed laboratories use the machines to test for food, water, and environmental safety; industrial chemical companies use them to perfect new alloys and substances; pharmaceutical and biotech companies, as well as universities, use them extensively in research. And in case you were wondering how the forensic scientists on *CSI* dramatically discover that a suspected killer had traces of zinc oxide on his overcoat, now you know — they use liquid chromatography and mass spectrometers.

Along with the hobbling economy, spending on this precision equipment has naturally slowed. But thanks to billions of dollars in grants being poured into scientific research by the government, along with slowly thawing pocketbooks at large research-based corporations, better times may be just around the corner. This is good news for **Waters** (NYSE: WAT), the leader in liquid chromatography in the United States, Europe, and Asia — and a manufacturer of many other kinds of fancy analytical equipment. Following a hibernation in new spending and government grants, Waters will benefit as the world reawakens to the importance of scientific research.

Waters Works

The Community's Take

Waters earns a solid 4 stars on CAPS, and as of Sept. 8, an impressive 104 of the 107 All-Stars who ranked the stock called it an outperform. Among all CAPS members, 282 of 292 rate it outperform.

On our proprietary CAPShot report, Waters rates a respectable 7 out of 12, coming up short on our lofty revenue benchmarks, the industry ratings, and debt-to-equity ratio. The debt level is manageable, and we think the other measures could turn positive in a year or two.

The scientific equipment sector is competitive, but we believe 51-year-old, $4.8 billion Waters is tops in the field for four major reasons:

- **International exposure.** Waters has been more aggressive in its global expansion than competitors such as **Thermo Fisher Scientific** (NYSE: TMO), particularly in Asia. In 2008, Waters conducted just 30% of its sales in the U.S., while Thermo Fisher did 68% of its business in the U.S. Being a first-mover in the Asian markets has allowed Waters to establish relationships with regulatory agencies, especially in China, where such ties are critical to success. As testing requirements strengthen in the emerging Asian economies, Waters stands to capitalize.
- **Consistently strong margins.** Waters' gross margin has remained in the 57% to 60% range over recent years, while its operating margin is consistent, too, ranging from 24% to 26%. Not only do these steady margins show a strong understanding of the products in demand in the industry — and cost control by management — but they're well ahead of industry averages. According to Capital IQ, the median gross margin for Waters' comparables — including Thermo Fisher, **Life Technologies** (NASDAQ: LIFE), and **Affymetrix** (NASDAQ: AFFX) — is 50%, with an operating margin of 14%.
- **Strong recurring revenue.** Another compelling business attribute is Waters' high level of recurring revenue. In 2008, recurring sales made up 43% of the company's total revenue. Long-standing customers sign maintenance service contracts on Waters equipment and steadily replace consumable Waters test materials.

- **Track record of benefiting shareholders.** Waters does not pay a cash dividend, but it repurchases stock each year to reduce the outstanding shares on the market — another way to complement shareholder returns. From 2003 to 2008, Waters spent a net $1.65 billion repurchasing shares. The investments are paying off, as Waters' stock is trading higher than its average purchase price.

Valuation

With about 50% of Waters' business coming from the global pharmaceutical and biotechnology industries, it's easy to understand why the market might be concerned about negative effects from potential health-care reform in the U.S. Fortunately, Waters' business is globally diversified and will benefit from increased government spending on scientific research. In fact, the National Institutes of Health has a whopping $10 billion in funds from the economic stimulus package to spend on R&D, in particular toward cancer research.

Waters' shares have recovered from March lows, but are still trailing the S&P 500 over the past year. Despite this recent run, Waters is still trading near multi-year low valuations based on earnings, book value, and cash flow:

Metric	Current	5-Year Average
Price to earnings*	15.8	25
Price to book	6.6	7.2
Price to free cash flow*	16.3	17.5

*Source: Capital IQ. *Trailing 12 months.*

Using conservative growth estimates of 8% to 10% over the next five years, a discount rate of 11%, and assuming Waters continues its steady repurchase program, we can peg a fair value for the stock between $66 and $70, representing a 30% to 38% premium from today's prices.

Why This Strategy?

Buying shares of this healthy business around $50 is a compelling long-term investment, so if that's all you do, excellent; but we're also going to use options to ideally increase our returns, generate a near-term profit, or lower our cost basis. This decision is partly driven by market conditions. Following a 49% gain in the S&P 500, we're feeling defensive, but at the same time we want to continue to participate in market gains if stocks don't relent. Buying Waters and writing a covered strangle is a way to have it both ways, making the covered strangle a strategy we favor in today's market.

With Waters recently skimming $51, the covered strangle we intend to write (which will net us near $4 combined per share) positions us to either buy our second 2.5% near $46 or sell our existing shares near $59. That's a wide range for a stable stock, especially over just 73 days. Although we value shares in the high $60s over the next three years, if we can sell near $60 in just a few months, we would be capturing most of our potential gains very soon — and could, ideally, redeploy the money elsewhere to better effect. In addition, keep in mind that, even if Waters is $58 by November, we could close our covered calls early if we want to keep our shares and still earn a small profit on our combined options. So the strangle gives us flexibility.

Here's the math behind the trade (prices as of market close Sept. 4):

- **Action:** Buy 2.5% in WAT at $50.70
- **Action:** Write November $50 puts, for another 2.5%, for about $2.75
- **Action:** Write November $55 covered calls for about $1.30
- **Potential second 2.5% buy price:** $45.95
- **Average buy price if we get all shares:** $48.32 (13 times 2010 EPS estimates)
- **Potential sell price on our first 2.5%:** $59.05 (16.4 times 2010 EPS estimates)
- **Effective options yield:** 7.9% over 73 days
- **Stock gain if sold:** 16.3% over 73 days

What Would Change Our Strategy

Waters adds to its organic growth strategy via acquisitions of complementary companies. If management makes unwise acquisitions or starts paying too much, we'll need to revisit our valuation estimates.

Meanwhile, innovation is king in a market of formidable competitors, including Thermo Fisher, Life Technologies, and **Varian** (UNKNOWN: VARI.DL). Right now, Waters is ahead of the curve with its ultra-high performance liquid chromatography machine, which is superior to existing HPCL equipment — but that advantage won't last forever. Waters can't rest on its heels, so we'll expect to see more commercially viable products in the next year or two. Fortunately, the current pipeline is promising, including a new mass spectrometry platform due in the second half of the fiscal year.

Finally, since its core sales come from the health-care sector — as well as industrials and education — Waters is often seen as a more defensive investment. So while we expect it to perform well in a strong stock market, one advantage we see here is the likelihood that it will hold up better than more aggressive stocks in a poor market.

Pro Bottom Line

Waters complements the existing Pro portfolio well -- it's a high-margin, well-established, generator of strong recurring revenue and free cash flow. An industry leader, it also offers a way to invest in the growing worldwide need for more scientific research. To discuss Waters and this investment, please visit our Waters board, where we'll also post some additional research thoughts.

Monday Memo: Pro Begins to Take Stock

Published Sep 8, 2009 at 12:00AM

Pro Board Highlights

As usual, *Pro* members kicked off outstanding discussions in the past week:

- See the highest-rated *Pro*-proprietary CAPShot stocks
- We talk about the possible depth of a market correction.
- What do you do when you're near-term bearish but long-term bullish?

- Fools are asking, "Why not short China?"
- This Week in CAPS, Russell (TMFEldrehad) digs into new data and checks on two of his screens.
- Can stocks continue to rally without gains in revenue?

Given this turbulence, we're glad we kept our heads and hands inside the roller coaster car at all times. We didn't zig when we should have zagged, or stand up when we should have ducked. We have 13 closed positions — each one profitable. Twelve of our 15 current stock and ETF holdings are profitable, on their own and including options strategies on some of them. We're above our 75% accuracy goal so far (actually, we're about 90% accurate, not counting live option trades), and we haven't greatly sacrificed returns in the process. Most of our holdings have performed better than the index, and we still have more than $500,000 to put to work.

In sum, we probably couldn't have asked for a much better first year without taking much bigger risks than we did, which isn't our style. If we know we can make money while keeping risks manageable, we'd be lowercase-f fools to do otherwise. After all, a key piece of making investing a lifetime pursuit, in my opinion, is learning how to make money without taking unnecessary risks. In other words: Learn the most consistent, reliable, and successful ways to make money, apply that knowledge time and again, and the miracle of compounding will do the rest for you.

And if you *enjoy* the challenge of investing — as we do — then so much the better. You're essentially paying yourself to partake in a pursuit you love. Think about that when you compare your returns with an index's. If you've come out on top, or if you typically do over the years, that's wonderful. But if you're trailing an index at times, remember why you're investing in the first place — because you love it. It's like tennis: Few of us win every match we play, but we still love the game. In the meantime, you're getting other benefits from investing: You're enjoying it, you're learning, you're staying sharp and connected. And down the investing road, you'll probably be beating an arbitrary index again (assuming you care much about that). Because if you love what you do, you're bound to do it well.

We're honored by everyone who has been with us through *Pro*'s first year — you've already shared an unforgettable part of history with us. And this wild ride can't be over yet — but I'm getting ahead of myself. Our review *and* preview will go during this entire month. We'll bring you reviews of each *Pro* holding, ideas about our next investments, our thoughts on the market and how to best invest today, we'll introduce new strategies, and much more. So, here we go — again.

As always, chime in with any thoughts on the Memo Musings board.

Fool on!

Jeff Fischer (TMFFischer)

Write Puts on Medtronic

Published Sep 1, 2009 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") October $37 puts (ticker +JIWVB)
- **Allocation:** 2.5% (for *Pro*, seven contracts)
- **Option's recent bid/ask:** $1.20/$1.30
- **Preferred limit price:** $1.20 or higher to start; no lower than $1 if possible
- **Alternate trade:** Write November $36 puts (ticker +JIWWA); if you're unable to write puts, consider buying stock outright using a limit order at $36.

What's New

Medtronic (NYSE: MDT) had a solid quarter, with sales and earnings up 10% over last year excluding currency fluctuations and non-operating charges. The $42 billion medical-device manufacturer now trades at just over 13 times trailing free cash flow, which was strong at more than $3 billion. Shares appear to be a good value, trading at 12 times the average earnings estimate for the year ending April 2010, well below the market average of 15. Management's latest guidance for the year is 5% to 8% sales growth (excluding currency changes) and 8% to 12% growth in earnings per share (excluding unusual items). Meanwhile, the stock has jumped 18% from our $32.50 July buy price, and although we're pleased to have grabbed a good value, we don't want to chase the stock — it could easily give back some ground. We believe the stock looks reasonably priced considering today's uncertain health-care environment, and we're maintaining our preferred buy price of $36 or below.

Why This Strategy?

By writing puts, we're attempting to fill the remaining 2.5% of our targeted 5% position in Medtronic at a net buy price of around $36. This will potentially bring our average price paid to about $34; our fair value remains in the mid $40s to low $50s. If we get to buy these shares, 9% of *Pro*'s $1 million will be invested in health care (including **Kinetic Concepts** (UNKNOWN: KCI.DL)); eventually, we may allocate as much as 15% or more of our funds to this industry, buying other strong companies, too. Healthcare has a number of things working in its favor: demographics (an aging population), a greater need for care, and stocks trading at reasonable valuations.

We chose the October $37 puts specifically because:

- We're happy with a potential $36 buy price — it's equal to a valuation of 11.3 times earnings estimates for the year ending April 2010 and about 11 times likely free cash flow.
- We want to write options that expire soon in order to get our shares before next quarter's earnings release, or else to be free to write new options by mid October. So, while these options pay less than we usually seek, they fit our strategy.
- The *Pro* portfolio has a growing list of options set to expire in November and December, and we want to make sure we diversify our risk across more than just two months.

How to Follow Along

You write ("sell to open") puts when you're ready to buy the stock if it declines below the strike price. The numbers behind these puts fall short of our put-writing guidelines, but we're comfortable with the trade because of the reasonable valuation at our potential buy price and the fact that the options expire in just 46 days, on Oct. 17.

- **Option payment or yield (at $1.10 bid):** About 3% in 1.5 months (more than 20% annualized)
- **Option strike price:** About 3% below Medtronic's current stock price ($38)
- **Break-even price:** 5% lower, at $36
- **Cash needed:** Each put option you write represents a potential purchase of $3,700 in Medtronic.

Can't Write Puts?

If you're unable to write puts due to the size of the trade, and still need to buy your first shares of Medtronic — or your second 2.5%, like us — consider placing a limit order near $36 to potentially get shares on a downdraft.

We'll make this trade in the next one business to 30 calendar days. To discuss the trade or ask questions, please visit our Medtronic board.

Monday Memo: An Artificially Sweetened Market

Published Aug 31, 2009 at 12:00AM

To illustrate, say we had researched a potential investment in **Ford** (NYSE: F) in April 2009. (Fat chance, right? But bear with me.) We would have pored over data and calculated valuation estimates on Ford's stock for the next few years — but just three months later, those figures would have gone out the window when the government first announced the (then $1 billion) cash for clunkers program. Such a juicy incentive enticed otherwise-hesitant buyers into auto showrooms, but it also enticed folks planning on buying later this year to move up their purchase.

If this quarter is huge for automakers, what will the same quarter next year look like? Ditto for the $8,000 first-time home buyer credit, set to expire in December: What will happen to home sales after this program ends?

These programs beget lumpy results — "mini-bubbles," if you will — in the economy that disrupt the normal cycle of business, thus fueling and perpetuating uncertainty in the market. Unfortunately, we find it unlikely that these programs will end anytime soon; mid-term elections coming next fall mean that politicians will want a stable economy come election time. Indeed, only about a quarter of the $800 billion stimulus package has been spent so far. Until these programs end — and the mini-bubbles begin to pop — we cannot say with conviction that we've returned to a normal business cycle.

So again, we'll ask the question, where *does* it end? If history teaches us anything, it's that government actions taken during an economic crisis will continue to influence the economy after the crisis subsides. Consider the legacies of FDR's New Deal that remain with us today, including Social Security, market regulation, minimum wage, and the FDIC. No matter what you think of them, you can't deny that these programs permanently transformed the American landscape. In fact, the late Alexander Heard, former advisor to three presidents and chancellor of Vanderbilt University, who worked in the Civilian Conservation Corps as a young man, once reflected, "In a sense, what remains of the New Deal is the United States."

It stands to reason that one day we'll look back on these times and similarly remark, "What remains of the bailouts and stimulus programs is the United States." What our country will look like then is anyone's guess, but the specter of mounting deficits, a weaker dollar, higher taxes, and slower economic growth looms large.

Of course, we continue to believe in the U.S. economy for the long term, but as investors, we must prepare our portfolios for any scenario. And that's exactly what we've been doing for you at *Motley Fool Pro*. How? By staying conservative with our growth estimates, ensuring that we make investments at the right prices, and diversifying into non-dollar-based investments like **Vanguard Emerging Markets** (NYSE: VWO) and inflation-fighting assets like timber, uranium, and steel (**Plum Creek Timber** (NYSE: PCL), **Cameco** (NYSE: CCJ), and **GrafTech International** (NYSE: GTI)). As we build out the portfolio, we'll keep on top of these developments and position ourselves for success now and in the future. What are your thoughts on investing in this economy? Come share your view on the Memo Musings board.

Fool on!

Todd Wenning (TMFPhila)

- *Pro* Buy First stock and medical-device giant **Medtronic** (NYSE: MDT) announced healthy first-quarter 2010 results, with sales growing in each key division and earnings pumping higher, too. *Pro* analyst Bruce Jackson (TMFGoogly) covered the news for members, and TMFKitKat also posted analysis of the results.
- *Pro* member ChrisBuehler shares his published paper analyzing the U.S. crude oil-importing biz.
- When the market bottomed in March, more CAPS All-Stars were bearish than in other months. Say what? Todd starts the discussion.
- This Week in CAPS, Russell (TMFEldrehad) asks for your thoughts on how to improve CAPS. Plus, see three new biotech selections from a CAPS All-Star.
- Todd asks, "Is the market at a crossroads?"

Write a Strangle on Plum Creek Timber

Published Aug 25, 2009 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") November 2009 $35 calls (ticker +PCLKG) on existing shares of Plum Creek
- **Second action:** Write November 2009 $30 puts (ticker +PCLWF) for 2% more shares
- **Preferred limit price:** $3 or more *combined* for the calls and puts (or nearly 10% of Plum Creek's current price)
- **Recent November $35 call price:** $0.90/$1.10
- **Recent November $30 put price:** $2.20/$2.30

Now that our strangle (which we "legged into," writing the calls and puts weeks apart) on **Plum Creek Timber** (NYSE: PCL) has expired as income, it's time to revisit the strategy anew. To review, when writing a covered strangle, you write ("sell to open") covered calls on the shares you already own and simultaneously write ("sell to open") puts that could potentially net you additional shares if the stock falls below the put's strike price by expiration.

In the *Pro* portfolio, we already hold a 3% allocation in Plum Creek shares and seek a target allocation of 5%. With this trade, then, we'll be writing covered calls on our existing 3% position and writing puts that could ultimately fulfill our 5% goal.

At current prices, we'll be paid a *combined* $3.10 or so from writing the calls and puts, which we keep no matter what. Here are the potential outcomes of the trade:

If Plum Creek shares ...	Then ...
Fall below $30 by expiration	The puts are exercised and our effective net buy price on 2% worth of new shares would be $26.90
Remain between $30 and $35	We keep our shares, the options expire, so we notch a nice $3.10-per-share income gain (10% in three months)
Jump above $35	The calls are exercised and our effective net sale price on the current 3% position would be $38.10

All three scenarios should work in our favor. A 100% income gain is always welcome, and is probably our ideal outcome. But we'd also be happy to buy more shares of Plum Creek below $30 if our puts are exercised; similarly, with our fair value estimate of Plum Creek between $36 and $40 a share, we'd be content parting with our shares in that range. Overall, the trade provides us a comfortably large range in which to profit: from $26.90 to $38.10. If the stock is anywhere between those prices before expiration, we could also consider closing our options early for a total profit and keeping our existing stock position the same as it is today. The biggest risk with this strangle? If Plum Creek takes off in either direction (below $26.90 or above $38.10) between now and expiration on Nov. 20. With a stock as volatile as Plum Creek, either scenario is possible, but we believe the benefits of this trade outweigh the risks.

While there's been mounting sentiment against the timberland sector from the likes of *Barron's* in recent months, we think those concerns are overblown and mostly without merit. Moreover, in the first quarter of 2009, management seized the opportunity to scoop up 3.3 million shares of Plum Creek at an average price of $26.60. Given that we consider Plum Creek management to be the best in the business, its decision to buy back $87 million worth of shares at those prices — in what was then a highly uncertain environment — was reassuring. If Plum Creek falls below $30, and we buy another 2% at an effective net price of $26.90, we're in good company.

The other risk — that the shares surge above $38.10 before November — is perhaps the greater one at the moment. That's a 22.6% increase from current prices. With significant short interest on shares persisting over the past few months, Plum Creek hasn't participated in the broader market rally. If the construction markets show signs of improvement, and Plum Creek reports better-than-expected earnings in late October, shares could be in store for healthy gains. Fortunately, by writing the $35 calls *alongside* the $30 puts, the combined premiums give us significant breathing room and a wide range in which to profit.

Specifics on Writing Covered Calls and Puts

The command to write covered calls and write puts is "sell to open." You write one covered call for every 100 shares of the underlying stock you own and write one put for every 100 shares you'd like to potentially buy. With some brokers, you can enter this trade as an actual "short strangle" — doing both trades at once through a special order entry window, lowering your commissions.

Don't forget to use a limit order at or near the current bid price, if that price is attractive enough for you. Or, if entering the trade all at once, use a combined premium limit of $3 or higher. Combined, these option payments easily meet the guidelines we provide in our covered call and put-writing guides.

How You Fit In

- If you don't own any shares of Plum Creek, consider matching our 3% allocation (if that's 100 shares or more). Then write covered calls on that 3%, and write cash-secured puts for the next potential 2%.
- If you already own shares of Plum Creek and don't want to potentially buy more, consider writing covered calls, but only if the shares increase closer to $35 and provide better premiums. There isn't an urgency to write covered calls today with the stock $31 if you're not also writing puts. The November covered calls only pay about $1.
- If you already own shares of Plum Creek, and they're covered by calls already: Consider writing puts, as we are, if you're comfortable potentially buying more and increasing your allocation.

If you have any questions about this strangle, please post on the Plum Creek Timber board.

Monday Memo: How We're Staying on Top; Jack Henry and Plum Creek News

Published Aug 24, 2009 at 12:00AM

Our latest company to pedal to the podium and declare its worth is financial software vendor **Jack Henry & Associates** (Nasdaq: JKHY). Results showed stability in sales, margins, earnings, and cash flow, leaving Jack Henry strong and ready for a rebound. The stock increased more than 5% following the news, striking a new 52-week high. For its upcoming fiscal 2010, Jack Henry expects revenue to grow 3% to 5% and operating income to grow 6% to 8%. In a comment you rarely hear, management said that if the economy continues to stabilize, it could hopefully raise guidance down the road.

What's more, the 125 or so bank failures across the country this year won't have a material impact on Jack Henry's business, says management. Meanwhile, about 75% of revenue this quarter could be chalked up to recurring sales -- a nice sign of stability. The $23 shares trade at about 17 times forward earnings estimates, but the company is at a more modest 9 to 10 times estimated cash from operations. So if you don't own shares yet, Jack Henry remains a reasonably priced Buy, with our recommended allocation steady at 5%.

- On the boards: Bruce (TMFGoogly) offers a summary of the conference call.

Autodesk's (Nasdaq: ADSK) software business is stabilizing (as we noted last week), and it looks well positioned for the recovery. After reviewing the conference call, we've gathered some more details on how the business is performing. Management is not convinced the world is on a path to a sustainable recovery, but it believes China, India, and Brazil are bouncing back. However, the Americas are skipping along a bottom, Europe is a point of concern, and Russia isn't good. Knowing that, we'll want to see sales increase at Autodesk next year. You can still write puts to potentially net shares in the low $20s.

- On the boards: Read my full summary of the conference call.

Flowserve (NYSE: FLS) keeps rocking the pump and valve world. The company is executing extremely well, gaining market share, and growing margins. Plus, recent strength in pump sales means more valve and seal sales are close behind. As we shared in the Aug. 10 Memo, we've increased our fair value on the stock and upped our preferred buy-price range. Hold onto this puppy.

- On the boards: Get my mercifully condensed take on the (very) long conference call.

Nasdaq OMX Group (Nasdaq: NDAQ) is busier than ever, with new initiatives and growing businesses, including its options and commodities exchanges, expansion into Europe, and a pending interest rate swap exchange. What's more, the company sees its U.S. equity volume market share on the Nasdaq exchange stabilizing. We continue to support at least writing puts on the stock; in fact, the December $19 puts that we wrote actually pay as much or more today.

- On the boards: Our summary gives you the full scoop.

Finally, the calls and puts we wrote on **Plum Creek Timber** (NYSE: PCL) both expired for 100% cash gains over the weekend. The company has been under a steady attack from *Barron's* and others, so I went through the conference call again — and I do believe these barbs are unfounded. Management is executing well and minding the long-term value of it assets.

We "legged into" this strangle on Plum Creek, and it turned out favorably — both the calls and puts expired as income, as the stock stayed within a large range over our options' time frame. Now, we can take our money and consider a new options strategy on Plum Creek. Meanwhile, if you're looking to pick up shares outright, the stock remains a Buy and is below our preferred buy price.

- On the boards: Get my renewed review of Plum Creek as well as a great post from member ricklorim on what he calls the "best option play and maybe the best overall stock pick" from *Pro*.

Stay Foolish!

Jeff Fischer

Monday Memo: Get Set for Motley Fool Options; Cameco and Autodesk News

Published Aug 17, 2009 at 12:00AM

In Case You Missed It: Community Highlights

- How are you doing with *Pro*? SilverHawk27 weighs in, noting that he's up more than 30% and is applying what he's learned at *Pro* to his preexisting portfolio, too.
- Bruce (TMFGoogly) kicks off a discussion about consumer spending.
- On the **Plum Creek Timber** (NYSE: PCL) board, members chat about Barron's recent article on trouble in the forest; meanwhile, *Pro* member and tree insider 4stree offers commentary.
- On the **ProShares Short SmallCap600** (NYSE: SBB) board, member CaveatEmptorFool shares thoughts on the ecomony -- do you agree that the robins are singing "horribly off-key?"
- On the **Lindsay** (NYSE: LNN) board, there was a good discussion about following along with our trade.
- Finally, Russell (TMFEldrehad) talks about boosting your CAPS score in his regular This Week in CAPS post.

Our argument that growing demand for nuclear energy will boost **Cameco**'s (NYSE: CCJ) fortunes is coming true at a fever pitch -- even Cameco can't keep up. Sure, the uranium-mining giant had a respectable second quarter, growing revenue 25% from a year ago, although adjusted earnings per share were flat. However, while the company increased its revenue projection for 2009, to 5% to 10% growth, it projects that its uranium costs will increase 20% to 25% from last year, rising more than sales. Why? Namely, because Cameco's mining output can't keep up with demand -- so it's been buying uranium on the open market, where it's more expensive.

Blame at least some of this soaring demand on China. The country has been stockpiling millions of pounds of uranium, not in a move toward world domination (we hope!), but because it has more than 10 nuclear reactors under construction and its existing plants are running at full capacity. Cameco could probably *double* its mining output and still barely meet the demand for uranium in coming years -- but it has no means to double output until well beyond 2011, and that assumes its flooded Cigar Lake mine comes into operation by that time.

The company's finances will soon benefit from the uranium contracts it signed a few years ago at much higher prices, but at the same time, it's pouring big cash back into operations in hopes of increasing output. It's looking to take on more debt, too. Cameco has an indisputable strength -- the world's best and probably largest uranium mines -- but it's going to need to spend big money to extract more of it.

We'll be happy to book a profit by selling some shares in September via our covered calls if the stock is above $25, but given Cameco's dominance, industry trends, and fairly priced (although not cheap) stock, we're also happy to keep nearly half our shares. If you don't own shares yet, you can write ("sell to open") puts to net shares below $21 -- look for options that expire in early 2010.

- On the boards: Bruce (TMFGoogly) has more thoughts on Cameco

Things are stabilizing at **Autodesk** (Nasdaq: ADSK). The creator of 2-D, 3-D, and 6-D imaging software (OK, not 6-D -- *yet*) met revenue expectations for its second quarter, clocking in at $415 million, while adjusted earnings per share of $0.24 beat expectations by a nickel. Although results continue to be down sharply from last year's levels, third-quarter guidance is flat -- and that's good news! This is the first time the company hasn't lowered its quarter-to-quarter guidance since late 2008, which suggests that Autodesk's markets are finding a floor -- and growth may be down the road.

Meanwhile, even during the dismal first half of the year, Autodesk raked in $50 million in free cash flow and added a bit to its nearly $1 billion in cash and investments. Again, as with all of our companies, Autodesk is remaining profitable despite the recession -- cutting costs and positioning itself to emerge stronger. The company remains a Buy, but since it's currently trading a bit above our preferred prices, you can attempt to write puts to net prices in the low $20s or below.

- On the boards: Watch the Autodesk board for my conference call summary later this week

As always, please post any questions or comments (or share your life's dreams!) on the Memo Musings board. No post is left unread.

Invest Foolishly,

Jeff Fischer

Adjust Puts on Lindsay

Published Aug 13, 2009 at 12:00AM

At a Glance

- **Adjusted action:** Writing ("sell to open") December $35 puts (ticker +NRRXG)
- **Recent option price:** $1.75/$2 bid/ask
- **Preferred limit price:** $1.50 or higher (use a limit order at the current market bid if that's enough for you)
- **Recent share price:** $45
- **Alternate trade:** Write January 2010 $35 puts (ticker +NRRMG) for a higher payment
- **Note:** *Pro* must make this trade on Aug. 14 to meet our 30-day trading rule

Option Specifics

- **Share price:** $44.50
- **Option bid/ask:** $1.75/$2.00
- **Option strike:** $35, about 21% lower than today's price (clearing our 7% hurdle)
- **Break-even price:** $33.25
- **Option yield (at $1.55):** 4.4% of $35 strike price (this is lower than our desired payment for an option expiring in four months, but the strike price is much lower than our hurdle)

We have good news and bad news. The good news is that our stocks continue to find favor with investors. **Lindsay** (NYSE: LNN) is up more than 35% in the past month — even though the only announcement has been a 7% dividend increase. The bad news? We're still building our position in the stock, and the best five-month stock market performance since 1938 has put serious distance between Lindsay's price today and our desired buy price. The rally has also negated the value of our intended option trade announced last month — in fact, it did so from day one, making us miss our trade.

We're adjusting our trade to write the December $35 puts, which would net us a buy price close to $33.50, within our preferred buy range of below $34.50. Our update below still holds: Management is doing an outstanding job in this economy, but results will likely remain lumpy. We think the few analysts covering Lindsay are being too conservative on both margin stability and earnings estimates — meaning surprisingly good results in the future could send the stock higher still. However, we don't want to rush to buy shares on that hypothesis yet, so we're willing to patiently write put options on the volatile shares while owning some outright already from our initial purchase.

If You Already Wrote the September $30 Puts

If you got last month's "Make the Trade" at our desired prices, congratulations! Those September $30 puts options currently ask just $0.15, so you should consider closing them early ("buy to close") in order to write these new puts for a much higher new premium. You can chalk that trade up as a success already.

Questions?

Remember, when you write put options, you must be ready to buy the underlying stock. Each option contract represents 100 shares. If you have questions about this "Make the Trade" adjustment, please us know on the Lindsay board.

Audio Extra: Pro Chats With Kinetic Concepts

Published Aug 13, 2009 at 12:00AM

We're thrilled to bring you exclusive access to one of our companies (currently a Buy First) in our latest Audio Extra. Listen in as *Motley Fool Pro* Analyst Todd Wenning chats with the chief financial officer of *Pro* holding **Kinetic Concepts** (NYSE: KCI), Marty Landon. The two discuss the wound-therapy manufacturer's deleveraging process as well as its plans for geographic expansion, product innovations, and potential health-care reform. Just click the player below to listen in!

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After you listen, let us know what you thought on our Kinetic Concepts discussion board.

The unedited transcript is below:

Todd Wenning: Welcome to a special edition of *Motley Fool Pro Audio Extra*. I am Todd Wenning and I am excited to be joined over the phone by Kinetic Concepts' Chief Financial Officer, Marty Landon, who has been gracious enough to spare us some of his time this morning. As *Pro* Fools know, KCI was the first stock recommendation for the *Pro* portfolio and it is one of the most widely-held recommendations among *Pro* members.

Before we get started, I do need to mention that this call this morning may include forward-looking statements about KCI's business, including guidance on future plans, revenues and earnings. These statements are based on the company's current expectations and are subject to a number of risks and uncertainties which could cause actual results to differ from our expectations. More information about potential risk factors may be found in KCI's filings with the SEC. Whew!

All right, with those formalities out of the way, welcome to the call, Marty.

Marty Landon: Good morning, Todd.

Todd Wenning: So before we get to the business questions, let's start with a very Foolish question: what book are you reading right now?

Marty Landon: *(Laughs.)* That is a good question. It is actually a book about the history of the central Texas area written by Robert Caro.

Todd Wenning: OK, is it any good?

Marty Landon: It is kind of deep for me. I try and keep things simple, but it is a good read so far, yeah.

Todd Wenning: Have you read any good business or financial books recently?

Marty Landon: You know, keeping track of KCI keeps me pretty busy on that front, but I will tell you I am paying attention to the activity around healthcare reform.

Todd Wenning: Excellent. That is one of the questions I have for you today, so we will get to that in a moment. But first I just wanted to talk about why we got into KCI in the first place. Normally we prefer companies with lower levels of debt, but we were very impressed with your experience of deleveraging the business before, back between 2003 and 2007, and that increased our confidence in this position.

You noted in last year's *Analyst Day* that you hoped to be net-cash positive by the year-end 2012. A few quarters have passed since that outlook. Has anything changed and how is this process different than the last one?

Marty Landon: So not a lot has changed in terms of how we see the business operating. Thank you for your comments around our ability to deleverage something that we are proud of. We like to think of ourselves as good stewards of capital and we have a business that is not highly capital intensive, so we have had a well-established history of good cash flow generation and we see that continuing. We have kind of made a priority around financing our initiatives internally, so we take our cash flow and we use it to fund innovation and development and then assuming that we have gotten the things done that we need to for growth of the business, then we certainly take those monies and delever as quickly as possible. We think that is a good use of cash. And we will continue that focus going forward.

Todd Wenning: That's great, that's great. We were always impressed with your ability to generate cash and it seems over the last few quarters, the market has begun to recognize that and it has really helped us as investors.

So obviously competition has stepped up in the negative pressure wound therapy arena, both here in the U.S. and in European and Australian markets, investors are somewhat concerned it seems that new entrants will be able to take away a lot of the market share by offering lower prices. What is KCI doing to maintain and increase its competitive advantages?

Marty Landon: You know, a lot of the things that we have done for some time now, what we are; maybe one of the misconceptions that we think there are in the marketplace is that these are generic-type products and that you put foam and tubing and a vacuum source together and you have negative pressure wound therapy.

Todd Wenning: Right.

Marty Landon: There is a lot more to this than the materials and we think it is around the things that we have developed over a long history, in 15 years with the product, including the clinical support and the clinical research that goes with the product to know the right kinds of wounds to place the product on, the right placement of the product, so education of physicians and caregivers so that you make sure that we are always focused on the patient and getting a differentiated outcome and by getting that differentiated outcome, we believe and we have studies to show that we actually do save real healthcare dollars and we think that that is what helps us continue to lead.

Just given our history, we have learned a lot about what happens in that wound bed in terms of physiologically and so that has helped us in terms of our innovation. So you see us bring out new products and offerings that actually address real, unmet clinical needs and I think that hopefully will help us maintain a leadership, regardless of the number of competitors in the market.

Todd Wenning: Right, and I remember when I was down for the Analyst Day in October and I saw the ABThera. I don't think it was called "ABThera" at the time, but some of the new innovations that I saw in your R&D facility were pretty impressive.

Marty Landon: Well thank you, and they are really just getting to the point of commercialization, so we are all looking forward to them with great expectations and I would tell you that the early indications around the ABThera product on the first placements are getting good reception from physicians and really seeing a difference in the outcomes associated with the open abdomen, so we look forward to that continuing to progress as well as the other new products that we will bring to market in early 2010.

Todd Wenning: That's great, that's great. Geographic expansion into developed markets is already well underway, both in Europe and Asia and in the U.S. Could you give some idea of where you currently stand in Japan and Germany or emerging markets in your sights after you penetrate the developed markets?

Marty Landon: Sure. In terms of; we don't really have a large, established presence in Asia to this point. We have been doing a lot of work around getting regulatory and reimbursement approvals in the Japan marketplace, which we think is a very good market for us. It is a market that is hoping to get access to negative pressure wound therapy, and in particular the V.A.C., and so we think we are tracking well there.

I certainly don't want to get ahead of the Japanese agencies. They are doing the work and asking us to meet their requirements in terms of clinical research, etc., so we think that gives us a pretty good head start in terms of the competition in that area and so we hope to be on the market there sometime in 2019, as we have said. The entire Asia-Pac region as a whole remains attractive for us in terms of the negative pressure therapy platform franchise, as does bringing the regenerative matrices and regenerative medicine outside the U.S. as a whole and just speaking to outside the U.S. and Germany in particular, you know we have been after homecare reimbursement there and that is a very competitive market for us. We continue to grow there for those reasons that I enumerated earlier in terms of that value 360, 360 degrees of value.

The product, the clinical set, the support, the service that comes with that, even in a difficult environment such as Germany today, that is, for us, we have continued to grow units and we have our highest number of units out at any point in time in Germany's history and naturally with a growing company, that is going to continue, hopefully, but the point there is that in very competitive environments, we continue to lead.

Todd Wenning: That's great. And for our members out there who may not understand the differences between the U.S. healthcare system and say Japan or Germany, can you give us a brief idea of what differences there are when you try to go into these types of markets?

Marty Landon: Sure. Probably the biggest difference is that the U.S. healthcare area has made use or has come to recognize the lower cost of care and the importance of a patient to be mobile and to be able to receive treatment in the home. In the U.S., you see a business that has both an acute care as well as a post-acute environment, both in nursing homes, skilled nursing facilities and the home environment. Outside the U.S., it historically has been more of an acute care environment. They are moving more towards what they will call the "community offering", but still primarily an acute care offering and so we are developing markets in terms of home care reimbursement.

We'd tell you that in Asia we will primarily focus on the acute care right out of the box, but over time we think in all these markets there is an opportunity to build business in the home care environment again. Again, we think that reduces costs and is good for patients because a mobile patient tends to have better physiology around the body.

Todd Wenning: I agree with that. The potential synergies between V.A.C. and LifeCell are pretty obvious, but the synergies with the therapeutics support systems segment are less clear to me, so how does the TSS segment really fit into the future of KCI?

Marty Landon: Well certainly it is our heritage business. It is how we grew up. I think the one thing it did very well for us was establish the clinical relationships that were important as we brought new products to market like the V.A.C. and even with LifeCell. Many of those physician relationships were established many, many years ago and in terms of servicing the market, it also helped us from a points-of-contact standpoint. I think that that business, it is important to note that while it is a little bit different, that business continues to be profitable. So for us, we have said that is a more mature business.

The right thing to do here is to continue to focus on profitability and make selective investments where it makes sense. I think in terms of longer term, well that kind of depends upon what the portfolio ultimately develops into and we discussed that a fair amount here, but for the moment we think there are selected opportunities for growth, particularly in critical care where we have an expertise and so we look at those selected areas where we can grow, grow profitably and bring improved levels of outcomes to patients. If we can have a differentiated therapy, not a supply, but a therapy, then we can tend to be a market leader and therefore produce growth. So that is kind of the strategy there is manage that business for profitability with selected investments where it makes sense.

Todd Wenning: Right, and I remember seeing the Rotoprone put on display at the Analyst Day and that was a pretty impressive machine itself.

Marty Landon: It is a lifesaving machine is what we have found and so it is one of those deals that it is not for every patient, just like V.A.C. is not for every patient, but for those patients who really need it and can benefit for it, it saves, in Rotoprone's case, lives; in V.A.C.'s case, certainly limbs and oftentimes lives. Those are the kinds of things that will continue to help you be successful as you look into the future.

Todd Wenning: All right. So going back to what we were talking about earlier about the healthcare reform, a lot is hanging over the healthcare sector when it comes to what is going to happen with potential healthcare reform. There has been a lot of debate in the news recently, pretty vocal debate, so in recent calls, you have noted that the patient mix has changed towards more government pairs, like Medicaid. You are looking at lower prices for KCI and that stems from larger unemployment through private insurers. Could you give us some general information about how KCI might handle more government-funded payers in the future?

Marty Landon: Yeah, I think that, once again, just kind of important to note that within the majority of our payers, whether they be acute care facilities, skilled nursing facilities or let's say managed care in the home, we are not seeing pricing declines, per se. It is, as you mentioned, Todd, more of a mix issue as where do those patients fall. We continue to work with the payers, all the payers really, to ensure that they understand the value proposition around V.A.C. therapy and how it is differentiated from other products and that how they can actually save real healthcare dollars by utilization of the product.

We are certainly having dialogues with the Obama administration and with Congress and with industry leaders to ensure that our voice and position as an innovator and leader in the field are heard. As you know, it is quite a dynamic environment right now and you are starting to see people have quite strong reactions to where it might go. We are just trying to make sure and ensure that people have access to quality healthcare, that innovation, real innovation is rewarded so that you can afford to continue to invest and improve outcomes and then we are certainly going to make sure that our infrastructure, to the request of the administration, that our infrastructure is as lean as possible such that we can be as cost efficient in how we bring our products and therapies to market and we are going to do that and then we hope just to receive an adequate return for our shareholders so that we can continue to innovate. And so it all makes sense if it is all focused around improved outcomes and so that has kind of been our message to the administration is if you focus on outcomes-based alternatives, we are absolutely in. Please don't just cut price at the cost of quality.

Todd Wenning: Marty, that is great and thanks so much for your time today. We do appreciate it. Are there any final thoughts or anything you would like to say to the KCI shareholders out in the *Pro* community?

Marty Landon: Certainly we thank everybody for any interest and their interest in KCI. We are here trying to work hard for them and hopefully we will provide a good investment and return on their investment and hopefully we do that, again, through focusing on the patient, which is how we grew up.

Todd Wenning: Thanks so much. And that wraps up this special of *Pro* Audio Extra. I hope you have learned as much as I have about our investment in KCI from CFO Marty Landon. Until next time, Fool on!

Todd owns shares of Kinetic Concepts.

Monday Memo: Your Post-Rally Guide to Pro; FLS, GTI, LNN, and SBB on Hold

Published Aug 10, 2009 at 12:00AM

These businesses have done well under tremendous pressure. Management has reduced costs, focused on the customers, improved balance sheets, and positioned these companies to thrive once the economy turns around -- all while maintaining profits. However, as much as we like these companies, we're moving them to Hold. This is based solely on stock price. While we're not recommending you sell, our Buy First and Buy stocks offer better risk-to-reward potential for your new money at today's prices. If you want to buy more shares of these new Holds, or if you haven't bought yet, consider writing put options to net lower potential buy prices within our preferred buy range. Here's a closer look at these outperformers:

- **Flowserve** (NYSE: FLS): This company is surpassing our expectations, and recent strong pump sales -- a leading indicator -- should mean even better valve and seal sales down the road, according to management. We're happy to be Flowserve shareholders, and our new fair value estimate is around $95. At that figure, the company would trade at only about 12 times this year's earnings estimate (below the market's average), and adjusted earnings per share have grown an impressive 8% the first half of this year despite the dismal economy. We've increased our preferred buy price to $75 because risk has diminished as the company has proven to be a strong operator in this tough economy. This should make it easier for you to get shares via puts (you can write $80 or $75 puts) or buy on dips.
- **GrafTech International** (NYSE: GTI): Again, management is doing superb work here. Gross margin increased by 5 percentage points last quarter, and that should be sustainable. That means when the economy recovers, GrafTech should do very well. But now trading at $15, the stock sits at about 15 times 2010's earnings estimate -- a little aggressive for us here -- so we've moved GrafTech to Hold, though our preferred buy range has ticked up to $12. As with Flowserve, risk here has diminished, so buy shares via puts or on dips in our new higher range. You can write $12.50 puts for a start.
- **Lindsay** (NYSE: LNN): We increased our preferred buy range to $34.50 partly due to the high margins and free cash flow of the last quarter. But with the stock recently above $41, there is less upside for our risk, so we've moved Lindsay to Hold for new purchases. Write $35 or possibly $40 puts to potentially net a buy price in the mid-to-low $30s on this volatile small cap.

With data on the economy at large -- including manufacturing activity and unemployment -- coming in better than expected of late, we must revisit our macro short and valuation argument for **ProShares ShortSmallCap600** (NYSE: SBB). So for now, we're putting this ETF on Hold. Investing against an improving economy is becoming an increasingly suspect proposition. If economic fundamentals continue to improve the slightest bit, shorting even an expensive-looking stock index may invite excess risk -- after all, if investors see better days ahead, they could price stocks aggressively for a long time. We've lost about 16% on this ETF this time around and may want to cap our losses soon if we don't see a meaningful change in economic sentiment based on hard data.

We're bumping **Jack Henry & Associates** (Nasdaq: JKHY) and **Vanguard Emerging Markets** (NYSE: VWO) down to Buy based solely on price. We're awaiting earnings on Jack Henry next week, so stay tuned. Meanwhile, we've raised our preferred buy price on Vanguard Emerging Markets. With emerging markets up anywhere from 60% to 70%, you should tread carefully here; but if shares fall about 20%, to the low $30s, the ETF becomes more attractively priced. Consider writing puts to net shares in the low $30s if you haven't bought yet.

As we adjust some of our preferred buy prices, please keep in mind that this guidance is not rigid (just as fair value estimates can't be) and assumes flexibility of around 5%. So even if a stock is a bit above our preferred buy price, it should still be on the table for a purchase -- or you can write puts to get within our range. Ultimately, valuations are by nature imprecise. This is why we believe it's vitally important to buy the best business models we can find, run by management that can adapt to change. We definitely believe we're doing this so far at *Pro*.

We've knocked our preferred buy price on **Procter & Gamble** (NYSE: PG) down to about $55, and we've lowered our fair value estimate to the mid $60s. P&G is struggling in the current economy, which will weaken its earnings power for at least the next year. We still like this behemoth as a core holding in consumer staples, and we think it's still worth owning thanks to its healthy dividend yield, low valuation, and the likeliness that P&G will recover as consumer confidence returns -- and be even stronger when it does.

We've gathered a quick summary of our buying guidance for you in the table below:

Investment	Recent Price*	Preferred Buy Price	Fair Value Estimate	What to Do	Quick Take
AmTrust Financial Services (NYSE: AFSI)	$11.70	Moving from $11.50 to $12	$18	Still a Buy First	Increased preferred buy price given the 18.7% per share jump in book value this quarter
Autodesk (Nasdaq: ADSK)	$23.76	$22.50	$32	Still a Buy	Q2 results on Aug. 13
Cameco (NYSE: CCJ)	$30.21	$21	Mid $20s	Still a Hold	Q2 results on Aug. 12
Flowserve (NYSE: FLS)	$87.89	Moving from $70 to $75	Moving from $88 to mid $90s	Moving from Buy to Hold on price	Strong Q2 results; write puts to net lower buy prices
GrafTech International (NYSE: GTI)	$15.25	Moving from $9.50 to $12	$17 (a move higher is pending)	Moving from Buy to Hold on price	Write puts to net lower buy prices
iShares Silver Trust (NYSE: SLV)	$14.39	$14.25	N/A	Still a Buy	Buy and write covered calls or covered strangle
Jack Henry & Associates (Nasdaq: JKHY)	$21.90	$21	$30	Moving from Buy First to Buy on price	Q2 results Aug. 18
Kinetic Concepts (NYSE: KCI)	$32.64	$34	$48	Still a Buy First	Still looks like a value
Lindsay (NYSE: LNN)	$40.92	Moving from $31.50 to $34.50	Low $40s (a move higher is pending)	Moving from Buy to Hold on price	Write puts to seek lower buy price on this volatile stock

Medtronic (NYSE: MDT)	$35.33	$36	$52	Still a Buy First	Earnings out Aug. 25
Plum Creek Timber (NYSE: PCL)	$35.09	$34	$40	Still a Buy	Good income and option-writing stock
Procter & Gamble (NYSE: PG)	$52.03	Moving from $62 to $55	Moving from $70 to mid $60s	Still a Buy	Strategies not working great in current economy, but remains a powerhouse
ProShares Short SmallCap600 (NYSE: SBB)	$43.98	N/A	N/A	Moving from Buy to Hold	We're reviewing our investing thesis on this macro short
Vanguard Emerging Markets (NYSE: VWO)	$35.98	Moving from $30 to $32.75	N/A	Moving from Buy First to Buy on price	Write puts to net a lower buy price on emerging markets after this record run
Vanguard Energy (NYSE: VDE)	$74.32	$74	N/A	Still a Buy	Oil has rebounded sharply, so add patiently to this ETF

*As of market close Aug. 7, 2009.

To get another snapshot of our updated Buy First, Buy, Hold, and Sell guidance, just click over to our portfolio page. And if you have questions, please post on the Memo Musings board.

Invest well!

Jeff Fischer (TMFFischer)

Jeff owns shares of AmTrust Financial and Nasdaq OMX Group.

Meet a Fellow Pro: Our Fishy Friend fullofcarp

Published Aug 7, 2009 at 12:00AM

Bill T., a.k.a. fullofcarp

We're excited to introduce a new feature at *Motley Fool Pro* in which we'll spotlight some of our highest-profile members from time to time. These *Pro* Fools go the extra mile on the boards, offering round-the-clock insight, never hesitating to lend a hand to a Fool in need, and cracking jokes when we could all use a laugh. Our first guest of honor has been with us from the start: Bill T., a.k.a. fullofcarp. What makes Bill such a diehard Pro? Read on for a closer look at the man behind the fish.

Jeff: First, please tell us a little about yourself.

Bill: I grew up in California in a redwood forest (my father was a forest ranger). I have a degree in math and a PhD in business with a minor in finance. I've worked in a variety of vocations (college professor, business consultant) and now work as a safety analyst in the field of aviation. I'm basically a quant/spreadsheet jock and safety data analyst. My main hobby: gardening (nicknames at work include "townhouse farmer" and "worm rancher"). And for anybody who hasn't noticed yet, I feel that life wouldn't be worth living if it wasn't for a bit of sarcasm now and then (hence my self-deprecating user ID). If you aren't sure how to interpret something strange that I say on the boards, please give me the benefit of the doubt and assume that I'm simply exhibiting lame middle-aged humor and that I didn't actually intend to insult anybody.

Jeff: We would never think differently! Turning to investing, how would you describe your strategy?

Bill: I've been a member of The Motley Fool for many years but was never very active until I proved my amazing talent for market timing and began seriously investing in *Million Dollar Portfolio* in December 2007. After losing quite a bit during the market collapse, and thanks to inspiration from *Pro*, I've now developed a primarily option-centric approach, where I am overleveraged, but only to a level that I'm comfortable with and using techniques that I understand. I've now grown my money back to the balances of 2007!

Jeff: Today, if you could give one piece of advice to a fellow investor, what would it be?

Bill: During the dot-com boom-and-bust, I turned $30,000 into $200,000 then into $5,000 in a matter of months. I learned two lessons the hard way: know when to take profits, and know your limits. The latter lesson was reinforced this past spring when I had trouble sleeping a few consecutive nights and decided that I would back out of some riskier strategies since obviously my subconscious wasn't comfortable with them. The fact that they would have turned out very very well is not important. Only do things that you're comfortable with.

Jeff: We certainly preach that at *Pro*. Speaking of which, is there one thing you like most about this service?

Bill: The power of the group. For me, the mathematics of options is instinctive, like breathing, but I am far from normal in that regard. However, I believe that everybody has their own strengths and weaknesses and the power of the group is in sharing our own distinctive abilities, and I'm highly impressed with the combined abilities and power of the group. I've learned a lot from people who've shared their thoughts on the boards, even as I have tried to help out with what I consider to be the more mundane mechanics of things.

Jeff: Turning to the big picture, where do you stand on the market right now?

Bill: I feel that the market has overreached based on a bit of irrational exuberance. However, I've grown to feel more comfortable with the saying, "the market can remain irrational longer than you can remain solvent." As a result, I am taking my positions very cautiously, but not bailing out of anything. I am taking profits when it makes me feel more comfortable, and I am using more long calls as substitutes for long positions — or else buying protective puts for long positions — in order to protect myself in case of a serious snap back. Options are so cheap now compared to last winter that it's cheaper to be careful now than then. In the medium term (i.e., one to three years) I'm neutral, as I feel that the overall economy won't snap back to levels supporting stock prices much higher than this for a while. I expect that this will be a slow recovery.

Jeff: Well said — it sounds like we agree. For *Pro*, as we work through earnings reports, we expect to discover where we need to be more defensive. Now one last question for you: If you could wake up anywhere in the world tomorrow, where would you be, and why?

Bill: On a beach somewhere near the equator, where I could enjoy warm ocean breezes, ocean sunrises or sunsets, and wonderfully fresh tropical fruits every day. And where I could have an interesting garden year-round without worrying about winter freezes.

Jeff: That sounds ideal. I noticed in your picture you're wearing a shirt from Costa Rica, a favorite country of mine, and it sounds like you just described it! Thank you for joining us, fullofcarp, and thank you a hundred times over for your great contributions to the *Pro* community. I know our appreciation is shared with hundreds of members out there.

To chat with fullofcarp — about investing, gardening, whatever — hop on over to our Meet & Greet board. Fool on!

Adjust Your December Puts on Nasdaq OMX Group

Published Aug 6, 2009 at 12:00AM

At a Glance

- **Adjusted action:** Writing ("sell to open") December $19 puts (ticker +NQDXL)
- **Recent option price:** $1.15 bid/$1.25 ask
- **Preferred limit price:** $1.15 or higher
- **Minimum limit price if necessary:** $1.00 (use a limit order at the current market bid if that's enough for you)
- **Recent share price:** $21.50
- **Alternate trade:** Write December $17.50 puts (ticker +NQDXT) for $0.70 or better (more defensive)
- *Pro* must make this trade on Aug. 7 to meet our 30-day trading rule

Nasdaq OMX Group's (NASDAQ: NDAQ) second-quarter results met Wall Street's expectations, although revenue declined 13% from last year and profit margins on equity transactions shrank again. Small, cutting-edge competitors with much lower cost structures, including BATS and Direct Edge, have been eating away at Nasdaq OMX's market share in this space: In the past year, Nasdaq OMX has dropped from hosting 30% of all U.S. equity trades to just 20% — a large enough decline to give us serious pause.

On the plus side, Nasdaq OMX is pursuing new growth avenues. Its newer options exchange is growing rapidly (see how trendy you are?), and the company's International Derivatives Clearing group has been testing its interest rate swaps-clearing platform. In this potentially huge business, Nasdaq has already cleared $450 billion in contracts and signed on 12 large participants. But while management estimates revenue could be in the hundreds of millions annually, that outcome is likely years away, and competition from **CME Group** (NASDAQ: CME), among others, could be stiff.

Looking at the valuation, the stock is down 12% this year (while the S&P 500 is up 10%) on concerns about market share and profit margins. At our potential buy price of $17.85, the stock trades at 9.6 times earnings per share estimates for the year. Though competition is rising, Nasdaq OMX is pursuing new growth avenues, and its loss of market share in equity trading should diminish once profit margins find a sustainable level among all competitors. In sum, despite the challenging situation, the shares are inexpensive enough and the possibilities good enough to keep our put-writing thesis attractive.

Option Specifics

Last month, we announced a Make the Trade to write December $15 puts for $0.80 or higher. The trade got away from us, but Fool rules obligate us to make the trade or a similar one within 30 days. Our adjusted trade still involves the December options (thus we'll be on the same calendar as the many *Pro* members who *did* get our earlier trade), but we'll now write puts with a $19 strike price instead. They're the only ones currently paying well enough, meeting most of our hurdles, and still netting us a potential buy price in the mid-teens. Take a look:

- **Share price:** $21.50
- **Option bid/ask:** $1.15/$1.25
- **Option strike:** $19, or 11.6% lower than today's price (clearing our 7% hurdle)
- **Break-even price:** $17.85, or 17% lower (within our 14% to 17% hurdle)
- **Option yield (at $1.15):** 6% of $19 strike price (just misses our 7% hurdle for options expiring in 4 months or more)

As an alternate trade, the December $17.50 options can be written for $0.70 a share. They don't clear as many of our desired hurdles, but are still attractive and more defensive. We're choosing the $19 options because they recently pay 50% more than the $17.50 options while netting a break-even price just 6.3% higher. This sort of comparison isn't always valid — the percentage difference between different option payments will always dwarf your potential underlying share price difference. But this is enough of a difference in the option payment, with a relatively modest difference in our potential start price on the stock, to make us choose the higher strike price. Especially considering we still see value at the break-even price of $17.85, or 9.6 times 2009 earnings.

If You Already Wrote the December $15 Puts

If you got last month's Make the Trade at our desired prices, congratulations! Those options currently ask just $0.35, so you can consider closing them early ("buy to close") in order to write these new puts for a higher premium. If you write the new puts for $1.15, for example, you'll have a net credit of $0.80 per share after closing your old puts, effectively more than doubling what you could still earn on this strategy between now and December. The trade-off: You'd be on the hook to buy Nasdaq OMX shares around $17.85 rather than a current $14.20 — a meaningful difference. Also keep trading commissions in mind. If you're only looking to close one or two contracts early in order to write new ones, it may not be worthwhile after commissions.

Questions?

Remember, when you write put options, you must be ready to buy the underlying stock. Each option contract represents 100 shares. If you have questions about this Make the Trade adjustment, please let us know.

Monday Memo: Flowserve, GrafTech, Kinetic, and Plum Creek Serve Up the Goodies

Published Aug 3, 2009 at 12:00AM

Shares of **Flowserve** (NYSE: FLS) (recent price $81; click the ticker for our original buy report) blew a gasket on Thursday, surging 11% after solid second-quarter earnings were announced. Revenue at the pump, valve, and seal manufacturing giant fell a modest 6% from last year, to $1.1 billion, but earnings per share hit $1.92, well above the $1.79 estimate. Management increased earnings guidance for the year to a range of $7.15 to $7.75 per share, putting the stock at about 10.5 times this year's guidance. Backlog stands at a strong $2.7 billion, essentially flat with Dec. 31, 2008, while management said new bookings improved markedly in the second quarter compared to the first. We're currently crunching the numbers because our fair value estimate of up to $88 -- based on cautious estimates -- may prove too low.

- **What's next:** Flowserve is still a Buy, but we're reviewing our investment strategy and will report back in next week's Memo.
- **Alternate trade:** You can still write puts ($75, $70, or even $65 puts going out to January) that will potentially net you a buy price well below our preferred buy range, which is up to $70.

Second-quarter sales at **GrafTech International** (NYSE: GTI) (recent price $13.80) increased 18% from the first quarter to $158 million, but that's still half last year's number. On a 5-point gain in gross margin, a lower tax rate, and fortuitous order timing, earnings per share clocked in at $0.12, tripling the $0.04 estimate. Management foresees a weaker third quarter (about breakeven), typical of the steel mill shutdown that occurs every summer in Europe, followed by improvement in the final quarter of the year. Free cash flow for 2009 so far is still a strong $30 million, and management continues its incredible balance sheet improvement, knocking net debt down to $48 million (it was $370 million at the end of 2007). Overall, management is performing exceptionally well in the worst environment it has ever seen.

- **What's next:** Following a steep jump in the stock, we're considering moving it to Hold. We need another week to go through the facts. Stay tuned.
- **Alternate trade:** You can still write $10 puts (recently, January or March 2010) to net a potential buy price in our preferred range below $10. We may increase this range marginally next week, which would incidentally make it possible to write $12.50 puts for a much better payment.

Despite increasing competition in the field of negative pressure wound therapy and a legal brouhaha with U.K.-based rival **Smith & Nephew** (NYSE: SNN), **Kinetic Concepts** (NYSE: KCI) (recent price $31) is proving to the market with each passing quarter that it's committed to being the market leader -- and delivering on that. Kinetic's potential synergies between its wound healing and closure business and its regenerative medicine unit, LifeCell, appear boundless and could provide Kinetic with another competitive advantage down the road. Recurring revenue and free cash flow remain strong -- while management continues to deleverage the balance sheet. For more, see this post. We'll speak with Kinetic's CFO on Aug. 6 and report back to you soon after.

- **What's next:** Kinetic is still a Buy First. Given its free cash flow growth, which has been much stronger than we cautiously modeled last October, we're increasing our fair value estimate to $48, up from our previous high-end estimate of $39. This also means our preferred buy price increases, to $34 or below. Realize that Kinetic's recent strong performance means the stock could give back some ground in the near term, but we still see long-term value.
- **Alternate trade:** You can write $30 puts to potentially buy more shares or earn income.

During what's been called "the most severe depression in the wood products industry since the 1930s" by a rival CEO, **Plum Creek Timber** (NYSE: PCL) (recent price $31) is doing a bang-up job. The timberland management company is navigating the economy's deep, dark wood by selling off non-strategic lands, allowing it to pay down debt and reward long-term shareholders by funding its generous dividend. Plum Creek's focus on prudent, long-term capital management is impressive, and we expect it to recover with more verve than its competitors once the economy turns around. For more, see Todd's post on what he calls not a "peaches and cream" quarter, but not a terrible one, either.

- **What's next:** Plum Creek is still a Buy. The stock is below our preferred buy price and offers more than a 5% dividend yield, making it attractive today.
- **Alternate trades:** You can write ("sell to open") $30 or lower put options if you'd like to potentially buy shares at a lower price, or consider writing $35 covered calls on a stock bounce above $33.

We'll have earnings from **Procter & Gamble** (NYSE: PG) on Aug. 5, and **AmTrust Financial** (Nasdaq: AFSI) and **Nasdaq OMX Group** (Nasdaq: NDAQ) on Aug. 6. Visit our boards for a post on how we're going to approach our pending option trade on Nasdaq OMX, announced July 8, which needs to be completed by the end of this week. As for our pending**Lindsay** (NYSE: LNN) option trade, we have until mid August to reassess that trade. Given how volatile the stock is, we may still get our price. At any rate, you'll hear more from us this week regarding Nasdaq OMX.

Invest well, and Fool on!

Jeff owns shares of AmTrust Financial and Nasdaq OMX Group. Todd owns shares of Kinetic Concepts.

Write a Strangle on iShares Silver Trust

Published Jul 31, 2009 at 12:00AM

At a Glance

- **Action:** Write ("sell to open") January 2010 $15 calls (ticker +SLVAO)
- **Second action:** Write January 2010 $13 puts (ticker +SLVMM)
- **Allocation:** Increasing from 3% to 5%
- **Preferred limit price:** $1.50 or more *combined* for the calls and puts (or about 10% of Silver Trust's current price)

What's New

In the next one business to 30 calendar days, we'll be writing a strangle on our shares of **iShares Silver Trust** (NYSEMKT: SLV).Writing a covered strangle is simple: We write covered calls to sell shares of a stock we already own if the price goes much higher, and also write puts to buy more shares if the price declines. Meanwhile, we collect more option premiums and grant our investment greater flexibility and room for profit. Here, we're also increasing our allocation to Silver Trust from 3% to 5%, so we're ready to potentially buy more should shares of the ETF sink below $13.

We'll be paid (at recent prices) $1.85 *combined* to write these covered calls and puts, and we keep this premium whatever the outcome. That means our potential net buy price on new shares (via our puts) would actually be about $11.15 per share. Since 2005, silver has averaged $11.25 per ounce, starting with an average price of $8.60 in 2005 and steadily climbing. This provides us comfort in potentially adding to our position a bit above $11.

On the other side, our potential net sell price (via our covered calls) would be about $16.85 per share. With Silver Trust currently trading around $13.40, this gives us a wide range in either direction. And if we don't want an outcome that involves buying or selling shares by our January expiration, we may still be able to close the options early and profit on them within this range of roughly $11 to near $17.

This strangle provides much more flexibility than just writing a covered call. The January $15 calls pay just $0.90 per share, so we're about doubling our potential premium income by also writing puts. The combined payment of the strangle actually serves to increase our potential upside while offering a comfortably low potential new buy price *and* increasing our overall option income.

As for the big picture, that hasn't changed since our original February report on silver. The commodity has performed largely as we expected: When the market was falling, silver often moved opposite the index, as a hedge. As the market soared, silver didn't do much (it declined about 7%), but our option income has made the overall position profitable regardless. We still believe a strong recovery in the economy will ultimately sustain and possibly lift silver prices as demand for this high-utility metal increases; inversely, a continued downturn in the economy could increase the attractiveness of silver as a hedge. Silver also remains an inflation hedge. However, since we're not silver bugs, we like the position best as an option-income holding.

Specifics on Writing Covered Calls and Puts

The command to write covered calls and write puts is "sell to open." You write one covered call for every 100 shares of the underlying stock or ETF you own and write one put for every 100 shares you'd like to potentially buy. With some brokers, you can enter this trade as an actual "strangle" -- doing both trades at once through a special order entry window at your broker, lowering your commissions.

Don't forget to use a limit order at or near the current bid price, if that price is attractive enough for you. In this case, with the combined options currently bidding $1.85 per share ($0.95 on the puts, and $0.90 on the calls), we're hoping to earn $1.85 -- or, at least $1.50 if option premiums keep declining. However, this combined income of $1.85 should not change much over the next few days, since whichever way the ETF moves, one of the options should become more expensive and the other cheaper, balancing out. Combined, these option payments easily meet the guidelines we provide in our covered call and put-writing guides.

How You Fit In

- If you don't own any shares of Silver Trust, consider matching our 3% allocation (if that's 100 shares or more). Then write covered calls on that 3%, and write cash-secured puts for the next potential 2%.
- If you already own shares of Silver Trust and don't want to potentially buy more, just consider writing the covered calls.
- If you already own shares of Silver Trust and they're covered by calls already, consider writing puts, as we are, if you're comfortable potentially buying more and increasing your allocation.

If you have any questions about this strangle, please post on the iShares Silver Trust board.

Options 703: Strangles

Published Jul 29, 2009 at 12:00AM

Here's how to initiate a strangle (no necks necessary):

- To buy a strangle, buy to open an equal number of calls and puts, typically out-of-the money by one or two strike prices, with the same expiration date.
- To write a covered strangle, sell to open puts and calls, also out-of-the money and usually with the same expiration date. However, the number of puts you write is dependent on how many additional 100 share blocks you'd like to potentially buy, and the number of calls you write will depend on how many 100 share blocks you already own and would be willing to sell at your higher price.

For example, we've had a covered strangle on *Motley FoolPro* holding **Plum Creek Timber** (NYSE: PCL) for most of 2009. We wrote $22.50 puts and $40 covered calls on the stock. This obligates us to buy more shares if Plum Creek falls below $22.50 or to sell our existing shares if the stock exceeds $40. We profit on both options if the stock stays within this wide price range by expiration.

Usually, you write (or if it's a buying strategy, buy) both sides of your strangle at the same time, but sometimes you can increase your option payments by "legging into" the strategy — setting up one side of your trade at a different time than the other; for example, writing calls on your targeted stock when it's near the high of your expected range and then writing puts when it's nearer the low end. We did this with Plum Creek, writing calls when the shares were $33 and writing puts when the stock slid to $26 — legging into our strangle over the course of a few months.

Buying a strangle (also called a long strangle) is a low-cost way to profit if the stock makes a dramatic move in either direction. Since you're buying out-of-the money options that have relatively small value attached, your cost can be marginal. Your potential gains are unlimited, but it's easy to lose most or all of your investment.

For example, *Pro* stock holding **GrafTech International** (NYSE: GTI) recently traded at $12.50. Say you believe it will be exceptionally volatile in either direction. Recently, you could purchase a $10 put expiring in eight months (the longest-dated available) for $1.20, and purchase a $15 call option expiring in eight months, also for $1.20. If you buy one contract of each, you've invested just $240 to enter the strategy. That's the main advantage of a long strangle: low costs to initiate.

However, because your options are far out-of-the money, GrafTech needs to make a dramatic move in either direction for you to ultimately make money by expiration, either falling below $7.60 or rising above $17.40. Because you paid $2.40 for your options, your $10 puts don't really end profitably unless the stock falls to $7.60 or lower, and vice versa on the call side. And if the stock doesn't move much, your options will steadily lose value and expire worthless.

Buying a strangle works best if a stock makes a meaningful move quickly. This way, your calls or puts can see a significant percentage gain long before expiration, more then offsetting the loss on the other side of your strangle, so you can book an early profit. But it's not easy. Using out-of-the-money options makes buying a strangle cheaper than buying a straddle (which uses more expensive at-the-money options), but it also means you're more likely to lose your full investment.

It follows, then, that *writing* a strangle puts the odds in your favor.

Writing a covered strangle (also called a short strangle) is a way to profit on a stock you own and would be willing to either buy more of or sell at the right price. Writing strangles can be superior to writing straddles because splitting the strike prices provides more flexibility and room for profit, as our Plum Creek example above illustrates. The options won't pay as much as a straddle, but the stock has more room to roam.

For example, say you own shares of *Pro* holding **iShares Silver Trust** (NYSE: SLV), and you're willing to buy more if the ETF declines meaningfully (potentially doubling your position, we'll suppose); or, you're willing to sell your existing shares higher. With the ETF recently near $14, you could write the $13 puts expiring in six months for $1, and write $15 covered calls expiring at the same time for $1 as well, collecting $2 in total option premiums (or 14% of the current share price).

Consider the possible outcomes:

- **SLV ends the expiration period between $13 and $15:** You keep the whole $2 per share the options paid you, and keep your shares, and can consider your next move.
- **SLV increases above $15 by expiration:** You're on the hook to sell your existing shares for a net $17, including the $2 the options paid you.
- **SLV falls below $13:** You're obligated to buy new shares at a net $11, again including the $2 the options paid you. You've now doubled your ownership in SLV, and lowered your cost basis. (It might be time to write covered calls!)

Of course, in most cases you could also "buy to close" your options early or upon expiration, and still have a profit on the combined option trades assuming the ETF hasn't moved too dramatically (in this case, as long as it's between $12 to $16).

As you can see, a covered strangle can give you a wide profit range, and it's more powerful and flexible than a covered call strategy alone — as long as you're ready and willing to buy more shares if it comes to that. As with any time you write puts, you need to be confident in the stock or ETF you're exposing yourself to and ready to buy it. With a covered strangle, you also must be ready to sell your existing shares if they increase in price. However, given how much the two combined options pay you, you also have more flexibility — or possibility — to close your options early if you wish, keep your shares, and still have a profit.

Some daring investors write uncovered strangles when they strongly believe a stock won't break above or below a certain (generally wide) price range, aiming to profit via option premiums on both ends. We're unlikely to partake in this risky strategy without buying calls to protect ourselves — otherwise, the losses can be unlimited.

Buying a strangle is a way to profit if a stock makes a severe move in either direction — but if it doesn't, you risk whatever you invested in the calls and puts. On the other hand, writing a covered strangle is a way to generate option profits on a position if you already own at least 100 shares, would be happy to add at least 100 more shares at a lower price, or sell your existing shares at a higher price. More flexible than just writing covered calls, strangle-writing can provide a wide window of profit using options on a strong company that you believe will stay in a stable range.

Questions? Please post on the All About Options board!

Monday Memo: Is This Market Inferno Too Hot?

Published Jul 27, 2009 at 12:00AM

Many stocks have pushed the market higher by reporting second-quarter earnings above drastically reduced estimates. They've accomplished this mostly through cost cutting, while revenue is still coming in light. On July 23, Standard & Poor's reported that of the 197 S&P 500 companies that have announced results so far, as-reported GAAP earnings declined 4.5% from a year ago (and 30% including "one-time" events). But sales fell even further, averaging a 9.7% drop.

A near-10% decline in sales is nothing to sneeze at when you're talking about any business, let alone 500 of the country's largest. That's the past, though. What I'm more concerned about are the earnings estimates for *next* year: According to Bloomberg, Wall Street stock analysts (as opposed to economists) are projecting S&P 500 companies to earn a combined $74.55 per share in 2010 — representing ambitious growth of 25% over this year. Recently priced at 980, the S&P 500 trades at 13 times that $74.55 estimate; so for the index just to reach its historical average P/E of 16.5, it would have to jump 26%.

Break out the bubbly — that gain sounds fantastic, right? But those estimates come from Wall Street analysts who base their projections on recent net earnings (they're "bottom-up," or company-centric, estimates), while economists and portfolio strategists who calculate estimates with an eye on the broad economy first ("top-down") have a more pessimistic view of 2010. According to Standard & Poor's, top-down estimates for next year put the S&P 500 at a forward P/E around 20, or well above the 50-year average.

Whose estimates will prove correct? If history is any guide, top-down economists are usually closer to the mark, while the auspicious Wall Street analysts are prone to over-reaching and then needing to backtrack — as they did in 1999 to 2002 with tech companies, pharmaceuticals, biotechs, and others. More recently, 2009 estimates made by top-down economists in November are proving correct — while those of bottom-up analysts have needed to come down by 33%.

As we saw above, average earnings are down 5% this quarter while sales are down 10%, so cost-cutting measures are keeping earnings afloat. Management can't keep cutting costs indefinitely, and — by any measure — the only way for S&P 500 companies to average that 25% earnings growth predicted by optimistic Wall Street analysts next year is through strong increases in revenue. But how will large companies achieve that kind of growth?

Unless results we're seeing now are greatly and artificially depressed due to economic fears and frozen credit, it's hard to fathom where heady revenue growth could come from so soon. Companies are reluctant to rehire the millions who have been laid off because that would increase expenses and tamp down any earnings growth. However, if one in 10 Americans remains unemployed next year, and the rest of the population is cautious about keeping a job, how can you expect strong sales growth across much of the economy? And without strong sales growth, how can you expect 25% earnings growth when you've already cut costs to the bone?

In my opinion, much more modest growth is the likely scenario next year because the world will still be licking its economic wounds. Rather than the sharp V-shaped recovery that some Wall Street analysts project, economists' estimates suggest we're likely to bounce around meagerly for a while. If that's the case, the public earnings estimates for 2010 appear to be too high, in which case stocks already look fairly valued.

Just as we have an aversion to two-headed parrots, we have an aversion to expensive-looking stocks. However, we continue to believe in the companies we're buying, most of which are trading at earnings and free cash flow multiples well below average, and we'll continue to seek ways to hedge prices when they get out of line. Additionally, we would happily welcome a market that bounces around a year or longer, as we could generate increased option income and continue to average into good companies at good prices.

So overall, it may be business as usual at *Pro* even though we're cautious on what Wall Street analysts are projecting — and therefore the market's valuation as a whole. If 2010 earnings jump as much as these analysts suggest, it's going to be a banner year, and we'll be participating. But if the 2010 estimates start to look too high, we want to make some money on the market's subsequent decline, continue to profit with options if the market stagnates, and scoop up high-quality, beaten-down stocks that could result. Patience, value, option strategies, and hedging remain our modus operandi.

Last week, we saw glowing results from **Kinetic Concepts** (NYSE: KCI), and **Tupperware** (NYSE: TUP) blew the lid off earnings estimates. Both are strong businesses at good prices, so we'll keep targeting both for profits. Todd posted analysis of Kinetic's results, while Bruce shared Tupperware's highlights. Despite the recent jump in Kinetic's share price, it remains a Buy First stock at current prices. Following two strong quarters, we're going to officially raise our fair value estimate soon. Shares trade at a lower free cash flow multiple today than when we first bought them! Also watch for more on Tupperware soon — our existing puts have earned much of their potential profit already, so we could benefit with a new strategy.

Please post any comments on the Memo Musings board.

Onward, Foolishly!

Jeff Fischer (TMFFischer)

Write Puts on GrafTech International

Published Jul 23, 2009 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") December $10 puts (ticker +GTIXB)
- **Allocation:** 2% (for *Pro*, about 20 contracts)
- **Option's recent bid/ask:** $0.75/$0.90
- **Preferred limit price:** $0.70 or higher (7% of the strike price)
- **Acceptable limit price if necessary:** $0.60 or higher

What's New

GrafTech International (NYSE: GTI) has remained profitable despite what may have been the darkest period for steel production in years. Now demand for steel is increasing in China and the U.S., infrastructure programs continue to roll out, steel prices are lifting, and steel mills are running at more than 50% capacity after falling below 40% early this year. Meanwhile, KeyBanc Capital Markets suggests mills could be running at 65% capacity in the coming months. Overall, the emerging facts suggest that the steel business — being so essential to industry in general — bottomed out in the first quarter.

Where We Stand on GrafTech

The *Pro* portfolio has strong exposure to GrafTech already (our $30,000 investment has grown to more than $42,000, or about 4.2% of the initial portfolio), so we're writing the December $10 puts to earn additional option income on a situation we know well, or to buy new shares — but only at a price in our preferred buy range.

GrafTech announces earnings on July 30 — so why are we writing the puts now? First, with the stock 20% above our options' strike price, we have ample downside cushion. Only if management provides especially weak guidance for the second half of 2009 is GrafTech likely to fall below $10. Judging from industry trends, that appears unlikely, but if it does happen, we'd want to buy more stock on weakness via these puts. It's just a matter of time before this dominant company sees a recovery.

Analysis suggests earnings will be a slight improvement from last quarter, and guidance will improve upon that, in which case these puts would likely become income — a way to leverage a stock we already know and own. If this analysis is wrong, and a recovery is delayed, we'll be happy to fill out our remaining allocation in the stock below $10.

Where You Stand on GrafTech

If you don't own any shares yet, the best approach right now is to write puts for a *partial* position, getting you at least some exposure to the company (we suggested writing $10 puts in the Monday Memo a few weeks ago, too).

Then, if GrafTech declines after earnings, buy your remaining allocation to the stock outright if the share price gets attractive enough, falling to $10 or below. If GrafTech holds up or rises after earnings, consider writing more puts (perhaps $12.50 puts at that point, if the stock is near that price or higher, for income or to potentially get shares on a later decline). Finally, if you already own shares of GrafTech (it's been a Buy all along), sit tight just as we are. We think there's plenty of long-term potential, but if we're buying additional shares, we don't want to chase the stock.

Put-Writing Specifics

You "sell to open" puts when you're ready and willing to buy the stock if it declines below the strike price. The numbers here meet our put-writing guidelines:

- **Option payment or yield (at $0.75 bid):** 7.5% in five months ($0.75/$10)
- **Strike price (with GTI at $12.50):** 20% below the stock's recent price
- **Break-even price:** 26% lower, at $9.25

We'll make this trade in the next one business to 30 calendar days. To discuss this trade or ask questions, please visit our GrafTech board.

Options 702: Writing Straddles

Published Jul 22, 2009 at 12:00AM

A straddle involves an identical number of calls and puts with the same strike price and expiration date on the same underlying stock or index. As you know from Options 701: Buying Straddles, you *buy* the calls and puts to profit in either direction from high volatility. Inversely, *writing* the calls and puts is a way to profit from low or declining volatility. How? Simply by collecting option premium payments on either side of a potentially sleepy position. There are risks, however. Let's start with the basics:

- Write ("sell to open") an equal number of puts and calls on the same stock or index.
- Use the same strike price and the same month of expiration on both options.
- The strike price with a straddle is "at-the-money": as close to the current underlying stock price as possible.
- When you write an *uncovered* straddle, you don't own the underlying stock, so your risk is high (more on this in a minute).
- When you write a *covered* straddle, you own the stock, lowering your risk. Here the straddle works like a covered call strategy — but your returns are potentially goosed with additional put-writing income.
- The most you can earn writing straddles is what the options pay you initially.

When writing an uncovered straddle, you usually don't intend to get the underlying stock involved. You're just looking to profit on the value erosion of the options you write, and you'll plan to "buy to close" them (or let them expire) once you've earned your targeted profit. (Note: You need a margin account to write an uncovered straddle.)

As an example, suppose a recently volatile stock just announced earnings, and you expect its volatility will now all but cease. The options still pay well, though, so you'd like to capture the option premium as income. The stock is trading at $25, so you write $25 calls and $25 puts and get paid $2 for each contract — that's $4 total in option premiums per straddle. This means as long as the stock ends the expiration period between $21 and $29 ($4 above or below $25), you'll at least break even before commissions — and in most cases, earn a profit on the trade. (We'll call this the "profit range.")

- For example, if the stock ends the period at $27, the puts you wrote expire (giving you the full $2 value), and the calls break even, so the trade pays you $2 per share overall.
- If the stock ends lower in our profit range, let's say $23, the calls expire and the puts break even, so you profit $2 per share overall here, too.

However, outside your profit range, it's another story. You face unlimited potential losses as the stock rises above $29 per share, and you facing growing losses (along with an obligation to buy the stock and wait for a recovery) the further it falls below $21.

As the table below shows, the maximum profit from an uncovered straddle occurs when the stock ends exactly at the strike price; you keep the entire $4 per share you were paid in this example. Your total profit *declines* as the stock moves away from the strike price in either direction — which is why you want minimal volatility whenever you write straddles.

Take a minute to study the table and grasp how this works. As the stock rises, the naked (or uncovered) calls you wrote increase in value, working against you. As the stock declines, the puts you wrote work against you, but you'll still profit anywhere between $22 and $28, and break even at $21 or $29. Remember, you were paid $2 for each call and put, or $4 total. But since you *wrote* the options, your desired outcome is that their value goes to $0, or as low as possible:

Ending Call Value	Stock Price at Expiration	Ending Put Value	Your Total Profit per Share
$0	$20 and lower	$5 and higher as the stock falls	($1) and worsening as the stock falls
$0	$21	$4	Break-even
$0	$22	$3	$1
$0	$23	$2	$2
$0	$24	$1	$3
$0	$25 (the strike price)	$0	**$4**
$1	$26	$0	$3
$2	$27	$0	$2
$3	$28	$0	$1
$4	$29	$0	Break-even
$5 and higher as the stock rises	$30 and up	$0	($1) and worsening as the stock rises

To help achieve a successful uncovered straddle, you want the widest possible profit range (in other words, you want to capture generous option premiums). In our example, the range is significant — $4 in either direction — assuming the underlying stock isn't exceptionally volatile and your options expire in two to five months (rather than longer). But remember, the trade creates unlimited potential losses outside the profit range.

One way to greatly mitigate that risk: When you write your straddle, use some of your option proceeds to simultaneously *buy* far out-of-the-money calls and/or puts, too — with strike prices at the two ends of your profit range (for this example, you might buy $30 calls and $20 puts; or just buy calls to protect you on that side and be ready to buy the stock via your written puts if it falls). Doing so, you've hedged and "covered" your written straddle, and because buying these options generally costs little, you'll still begin with a net credit from your option writing and keep that profit if the stock stays in a now slightly tighter range. For example, if you paid $0.80 total for the protective calls and puts, your profit range decreases by that amount on either side of the strike price. If you *don't* buy protective options initially, be ready to do so if the trade starts to work strongly against you.

Given that a steady stock can suddenly make a big move for any number of reasons, it's risky to write uncovered straddles without this added protection. However, another route is to simply own the underlying stock outright. Let's take a look.

Owning the underlying stock takes away all of the naked call option risk when writing a straddle. In fact, a covered straddle-writing strategy is basically a covered call strategy (as simple as Options 201), but it generally offers more profit potential because you're also writing puts on the stock. The key difference with a straddle is that both options are at-the-money, so you're more likely to see your options exercised. As with a covered call, it's important that you're ready to sell your stock if it rises. And as with writing puts, you need to be ready to buy more stock if it declines (or close the options early). The benefits of writing a covered straddle are two-fold:

1. Your profit can be higher and your profit range wider than with a mere covered call.
2. You have more ways to close your options profitably — and still keep your stock if you like.

Continuing our earlier example, let's assume you want to write a straddle on a steady $25 stock — but in this case, you own the underlying shares. You write $25 calls and puts, getting paid $2 each, with the same expiration date. Since you own the stock, no matter how high it climbs, you're covered on that side of your trade. Let's consider some potential outcomes:

- You end up selling your stock via the covered calls, but you keep the $4 option premium you were paid on the puts and calls, netting a sell price of $29 (compared with just $27 if you'd only done a covered call and not a straddle).
- The stock declines below $25. You end up buying more shares, but at a net $21 given the option premiums you were paid. You've added to your existing stock holding.
- The stocks holds steady, around $24 to $26. You can "buy to close" both the calls and puts by expiration and capture much of the profit while keeping your existing shares. Nice!
- Finally, as an example of the added flexibility here: Assume the stock increases to $28 by expiration, and you decide you want to keep your shares. Since you were paid $4 per share in option income, you could close your calls for $3, still have a $1 per share profit on your straddle, and keep your stock. If you had only written covered calls and not a straddle, you'd need to book a loss if you wanted to keep your stock.

Writing *uncovered* straddles requires keeping a close tab on your trade. If the stock is moving sharply against you in either direction, you may want take action to limit your losses. One way to do so is to close the losing side of your straddle when the stock reaches your break-even price. In our example, if the stock rises to $29, you might close your call options for a loss and let your puts go, presumably to expiration, keeping your overall losses marginal. If the stock falls, just be ready to buy it via your puts. Uncovered straddles don't usually lend themselves to rolling forward (to a later expiration date), rolling up (to higher strike prices), or rolling down (to lower strike prices), so you can't depend on these defensive follow-up moves being available to you. As mentioned above, if you *buy* out-of-the money protective calls (and puts, if you like) when you set up your straddle, your potential profit on the straddle is lower, but you won't need to consider follow-up action.

Writing covered straddles is much less risky and requires less upkeep, but you still want to keep a watchful eye on your strategy, since only your calls are truly covered. You need to be ready to accept more shares if the stock falls below your puts' strike price. For this reason, some investors will use a lower strike price on the puts they write, providing more leeway — but once you start to stagger strike prices on your calls and puts, you're not using a straddle anymore, you're using a *strangle* — and that's next in our series!

At *Pro*, we're not likely to write uncovered straddles without using some protective options as well. Writing covered straddles, however, is a sensible way to increase option profits on a covered call strategy as long as you're also willing to buy more shares if need be. With this strategy, you have another tool to profit no matter what the market throws your way — in this case, even if the market goes nowhere.

Please post your questions on our All About Options board.

Next in this series: Strangles

Monday Memo: A Close Look at Pro's Double-Digit Gains

Published Jul 20, 2009 at 12:00AM

From a sector standpoint, *Pro* measures up against the composition of the S&P 500 index like so (and note that the S&P is just a point of reference, not an aspiration):

Sector	***Pro*** **Stock**	***Pro*** **Allocation (excluding cash)**	**S&P 500 Allocation to Same Sector**
Technology	**Jack Henry & Associates** (Nasdaq: JKHY), **Autodesk** (Nasdaq: ADSK)	20.1%	18.8%
Health care	**Kinetic Concepts** (NYSE: KCI), **Medtronic** (NYSE: MDT)	14.1%	13.8%
Financials	**AmTrust Financial Services** (Nasdaq: AFSI)	10.9%	13.7%
Consumer staples	**Procter & Gamble** (NYSE: PG)	11%	12.1%
Energy	**Vanguard Energy ETF** (NYSE: VDE)	7.4%	12.1%
Industrials	**Lindsay** (NYSE: LNN), **Flowserve** (NYSE: FLS), **GrafTech International** (NYSE: GTI)	15.1%	9.9%
Consumer discretionary	n/a	0.2%	9%
Utilities	n/a	0.2%	4%
Telecom	n/a	0.7%	3.3%
Materials	**Plum Creek Timber** (NYSE: PCL), **Cameco** (NYSE: CCJ), **iShares Silver Trust** (NYSE: SLV)	20.3%	3.2%

All data as of 7/17/09.

A few notes: This includes the **Vanguard Emerging Markets** (NYSE: VWO) ETF's allocations, but we didn't include any outstanding options contracts (so no **Tupperware** (NYSE: TUP)). Also, you can divide our allocations by half given that our portfolio is still 50% cash -- for example, we're *overall* about 10% invested in technology rather than 20%.

Two things jump off the page: It looks as if we're relatively underexposed to consumer discretionary stocks and relatively overexposed (though we disagree) to materials. If you know how we think at *Pro*, neither of these things should come as a surprise -- we've been wary about consumer spending since last fall and were first bullish on commodities last winter. We still believe commodities and materials-related stocks will be among the first to lead us out of the recession.

Looking ahead, we also want significant exposure to technology (at the right price, of course), so we may want to double our allocation. We also want more international exposure, especially to smaller companies that are serving consumers. These present strong potential as enormous consumer populations in emerging markets garner more buying power. Speaking of size, let's look at the average value of the companies we've been buying.

Here's the *Pro* market-cap breakdown:

Invested Market Cap	***Pro*** **Portfolio**	**U.S. Stock Market***
Large (> $10 billion)	23%	68%
Mid ($2 billion-$10 billion)	33%	25%
Small (< $2 billion)	38%	7%

Source: MSCI U.S. Broad Market Index as of 6/30/09.

We're fairly evenly spread between large, mid, and small caps (if you include the **ProShares Short SmallCap600** (NYSE: SBB) ETF, which brings our net exposure to small caps closer to 33%). However, the median market cap of our holdings is $4 billion, so we're slightly skewed toward the smaller end of the spectrum. That's fine with us: Larger companies tend to be less volatile overall, but they typically sport slower growth; small caps are generally more volatile but have higher potential returns. So in the quest for handsome returns, we should benefit from having a bit more small-cap exposure than average, especially given that we're buying companies that generate strong free cash flow.

Yet there's a case for large-cap companies too, especially now. Large-cap valuations, primarily in the U.S., look cheaper than other areas of the market, so we're assessing the opportunities there. We're also looking at large caps in part to add more dividend payers. Our total dividend yield is currently 1.67% -- below the S&P 500 average of 2.2% simply because we've bought some companies that don't pay any dividends. But add to this about $20,200 in realized option income and another $5,100 in unrealized (but likely) option income, and we're well on track to "yield" 4% to 5% combined in our first year -- and that's with half of the portfolio still in cash. Despite this strong option and dividend income, we still want to increase our dividend income while yields remain attractive at some large companies.

All in all, we're pleased with the current positioning of the *Pro* portfolio -- and to be up by double digits today. In fact, excluding our cash, we're up more than 20% on what we've invested since October, while the market is relatively flat overall. But a portfolio cannot remain static, and we'll continue to make investment decisions for the long run. You can likely expect more exposure to large-cap dividend payers, international small caps, technology, and perhaps even some consumer discretionary companies. And remember: Stocks don't only go up, of course! We continue to seek shorts and hedges, and we're also focused on new option trades, including new strategies we haven't used yet. Meanwhile, where do you see the most opportunity today? Come weigh in on our Memo Musings board!

Fool on!

Jeff Fischer (TMFFischer) and Todd Wenning (TMFPhila)

A Smorgasbord of Discussions

- *Pro* Fools discuss trying to write puts on Nasdaq OMX.
- Todd shares his thoughts on the market from a technical perspective.
- Jeff shares some thoughts on **Intel** (Nasdaq: INTC).
- Which sectors will lead the next bull market?
- Russell posted his weekly CAPS analysis, focusing on the community's favorite sectors of late.

Portfolio Upkeep

- We bought another 2% stake in **Flowserve** (NYSE: FLS) at $63.34 and 1.5% in **Autodesk** (Nasdaq: ADSK) at $20.17 via our puts that were exercised over the weekend.
- Our July covered calls on **iShares Silver Trust** (NYSE: SLV) expired for a 100% cash gain. We'll look to write more calls for income soon.
- Finally, there's a lot going on at *Pro*, but always remember: We're calm, focused, and playing to win the both in short and long term -- there will always be new opportunities in stocks and options. And if you've posted questions that we've missed on the boards, please post again!

Audio Extra: Talking Shop With the Pros

Published Jul 17, 2009 at 12:00AM

In our latest Audio Extra, Jeff Fischer and Todd Wenning sit down for a casual chat about what they're seeing in the market, what lies ahead, and how *Pro* is taking advantage. Plus, earnings season is right around the corner -- get a preview of what's to come. Just click the player below to listen in!

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The full transcript is below.

Jeff Fischer: Welcome to a new edition of *Motley Fool Pro*'s Audio Extra. I am Jeff Fischer. With me here is Todd Wenning.

Todd Wenning: Hey, Jeff.

Jeff Fischer: Hi, Todd. We are here to talk to you today about the market, about the *Pro* portfolio, what we have done recently, what we are looking at doing in the future, and about the coming earnings season. Let's start with the market, Todd. It was down five weeks in a row; it is up recently, these past several days.

Todd Wenning: It has been a really funny market, Jeff. Over the past nine months or so, if you take out that crazy pessimistic period between mid-February and early March, we are pretty much where we were back in early November. We have been trading sideways for the most part; it has been a pretty volatile ride. We have been saying that for a while now on the boards and we have been investing appropriately.

Jeff Fischer: That is true. It has been a 30%-40% swing, up and down, to get back to where we started. So if you were making the wrong moves at the wrong time, it could be really painful; if you were moving methodically and patiently and focusing on the quality of the companies that you are buying, then you should be OK; focus on the quality and the price.

Todd Wenning: That's right. And the investors have had a funny reaction to the volatility of the past 18 months or so. Recent data that I have pulled to show that over the past six months, $140 billion has been put into bond mutual funds while there has been a net outflow, a very small net outflow, into equity funds.

Jeff Fischer: Which I find fascinating, we find fascinating.

Todd Wenning: Yeah.

Jeff Fischer: Despite the market rallying so much since March, there is an outflow.

Todd Wenning: And it is sort of almost like investors are falling into two camps. One of them is they don't want to experience the same trauma they had experienced last year, so they are going into a lot more conservative investments like fixed income. On the other hand, there is also a school that is trying to get their money back and taking extremely high risks. Through May, there was $4.9 billion of inflow into emerging market funds and $12.6 billion into junk bond funds while there was an $11.2 billion outflow from large-cap U.S. stocks. So people are trying to get this money back as quick as possible and we don't think that is the right approach.

Jeff Fischer: That is interesting it mirrors the market pretty much, very volatile market up and down and now we have two sets of investors: those going for safety, and those taking the risk to presumably get back what they have lost.

Todd Wenning: Right.

Jeff Fischer: And I guess I would put us right in the middle.

Todd Wenning: I think that is the best place to be right now.

Jeff Fischer: I think so too and speaking of that, we have more option guides on the way, regularly and we are going to start to be able to introduce to you as more option strategies. We are only nine, ten months old; we have been focused on building the portfolio and of course those first many months, being very defensive given what we were seeing happen. But now that we have a foundation and we begin to have some companies where we own them at a good price and we have some stability and some profits there, we can start to introduce more option strategies on top of those and expand our portfolio that way, as well as continuing to buy good companies at good prices.

I think what we all need to do is remain calm and focused. You don't want to get excited when the market is up sharply, just as you don't want to become fearful when the market is down. So much of investing, as Warren Buffet says, is about temperament and just keeping your calm and keeping your system and your strategy in place.

Todd Wenning: And there is still a lot that is going on in the market that has yet to really reveal itself. You are still dealing with a lot of government stimulus in the market that could be playing with the natural ups and downs of the reports that we are reading, so personal income was up, but they hedge it by saying, well there was money put in by the stimulus and there is also unemployment checks.

Jeff Fischer: Right, the bounce that we are seeing is perfectly logical, but we expected to see a bounce after a descent of that magnitude, but we are not seeing any strength yet to carry any momentum forward.

Todd Wenning: There is no traction.

Jeff Fischer: Right; it would just be a bounce, period. But let's hope not. We are investing to do well either way, ideally. And speaking of that, we will have earnings coming up all this month and next month. Most of our companies are announcing results: **KCI** (NYSE: KCI), **Flowserve** (NYSE: FLS), **GrafTech** (NYSE: GTI), **Proctor & Gamble** (NYSE: PG), and we will be covering them on the boards and in the Monday Memos, so we hope to see you on the discussion boards. Todd, any closing thoughts?

Todd Wenning: These will be really interesting earnings reports because now you are dealing with the second quarter. The first quarter was sort of a wash. People expected it to be really bad. Now we are hoping to see some better signs from these companies, so we are hoping to see them deliver on those expectations.

Jeff Fischer: Right, like we saw from **Intel** (Nasdaq: INTC) recently and stronger results, a lot of it is inventory has been run down at their customers and so customers are now starting to buy inventory again. I think a lot of companies will see that. It is good to see. It means there is some bottom to the economy. It doesn't necessarily mean that there is growth about to follow, but still, it is a step in the right direction.

So thank you for being with us here at *Motley Fool Pro* and we will see you on the discussion boards and Fool on!

Write Puts on Lindsay

Published Jul 16, 2009 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") September $30 puts (ticker +NRRUF)
- **Target allocation:** Increasing from 4% to 5%
- **Trade allocation:** 3% (for *Pro*, 10 or 11 contracts)
- **Existing allocation:** 1%
- **Option's recent bid/ask:** $1.40/$1.60
- **Preferred limit price:** $1.20 or higher (4% of the strike price; please use a limit order at the going bid or higher — not lower — if that bid is acceptable)
- **Alternate trade:** Sell to open December $30 puts, recently bidding $3.10

We continue to see attractive long-term potential with **Lindsay** (NYSE: LNN), but we're building our position gradually because a recovery may take time. This round, we're writing ("sell to open") puts to potentially get an additional 3% at a cheaper price.

Lindsay's recent earnings were encouraging. Although third-quarter revenue fell 41% to $85 million from a year ago, margins held their ground, and net earnings totaled $5.3 million, or $0.42 per diluted share. Lindsay has shown superb cash management during this recession, increasing cash and equivalents by $19 million over the past year, decreasing long-term debt by $6 million, and achieving $18 million in free cash flow over the past nine months. Management has cut administrative costs, savings it suggests will remain intact even when the economy recovers.

As with many small companies, it's the ability to maintain profits despite severe adversity that suggests much more potential when the economy recovers. Lindsay's cost structure suggests profits will balloon as soon as orders start to increase and the company signs significant, large-ticket deals — either in infrastructure or irrigation. What's more, management believes that today's irrigation system prices are about the best farmers can expect (due partly to low steel prices), so many buyers are watching the market and likely preparing to make a move. With corn prices up 25% in the past quarter, farmer confidence may gradually return.

With today's announcement, we're also increasing our target allocation on Lindsay from 4% to a full 5%. It isn't often you find a superbly managed small-cap company that thrives on big-ticket orders yet remains nicely profitable even in an economic rut. Although shares don't look dirt cheap based on the past year's depressed results, they do look inexpensive on even modestly better results that we're likely to see in the future.

Put-Writing Specifics

You write ("sell to open") put options when you're willing and ready to buy the underlying stock should it decline below your strike price. Each put option represents a commitment to buy 100 shares of stock. With volatile Lindsay recently trading at $34.50, the September $30 puts are bidding $1.40 per share. The numbers meet our put writing guidelines:

- **Option payment or yield:** 4.6% in 64 days ($1.40/$30)
- **Strike price:** 12% below the stock's recent price
- **Break-even price:** 17% lower than $34.50, at $28.60

We'll make this trade in the next one business to 30 calendar days. To discuss this trade or ask questions, please visit our Lindsay board.

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3 Put-Writing Candidates From CAPS

Published Jul 15, 2009 at 12:00AM

So how do you find a company that fits the bill? A great tool is the CAPS screener, which scours the CAPS community's 132,000 investors and 3 million stock picks (and counting) to find investment ideas. At *Pro*, we use CAPS to help us search for both long and short opportunities, and in conjunction, options. We can also use it to find strong candidates for a writing puts. I screened for stocks with a:

- CAPS rating of 4 or 5 stars (improving our odds for finding a good company)
- Market cap of more than $500 million
- Price-to-earnings ratio below 13 (the S&P 500 average)
- Price-to-book ratio below 2 (the S&P 500 average)
- 3-year beta greater than 1.2 (higher volatility equals higher option premiums)
- Long-term debt-to-equity below 50%
- Return on equity greater than 10%

This screen spit out 44 companies -- but for now, let's take a closer look at three of the more well-known businesses (keep in mind that these are not formal *Pro* recommendations):

Company	Industry	CAPS Rating	CAPShot Score

Corning (NYSE: GLW)	Technology	5 stars	8 of 12
Baker Hughes (NYSE: BHI)	Oil and gas equipment and services	5 stars	8 of 12
General Dynamics (NYSE: GD)	Aerospace/defense	4 stars	5 of 12

Data as of July 15, 2009.

While these companies are from diverse industries, they've all fallen on tough times along with the broader market. Corning generates the majority of its sales from display technologies, such as LCD screens for computers and TVs. As consumer spending on these big-ticket items declined over the past year, Corning's share price fell with it -- as low as $7.36 in late November. Meanwhile, Baker Hughes is involved in all stages of oil and natural gas extraction -- exploration, drilling, completion, and production -- so unsurprisingly, its business prospects are very reliant on expectations of oil and gas prices, which can be quite volatile. And General Dynamics generates most of its sales from government defense spending for things like combat vehicles and weapons systems, but also manufactures Gulfstream business-class jets, sales of which can be more sensitive to global economic changes.

Each of these companies also shares some of the characteristics we look for when evaluating put writing candidates. They're each free cash flow positive over the past 12 months, carry manageable levels of long-term debt, are undervalued relative to the market, and are supported by the CAPS community at large.

Next, let's check out some of the current put options available on the three stocks:

Company	Recent Share Price	Option Exp. Month	Strike Price	Premium (or Option's Bid)	Income % (Premium/Strike)	Break-even Price on the Stock
Corning	$15.75	August	$15.00	$0.50	3.33%	$14.50
Corning	$15.75	November	$15.00	$1.25	8.33%	$13.75
Baker Hughes	$37.00	August	$35.00	$1.35	3.86%	$33.65
Baker Hughes	$37.00	October	$35.00	$2.50	7.14%	$32.50
General Dynamics	$53.00	November	$50.00	$2.65	5.30%	$47.35
General Dynamics	$53.00	January	$50.00	$3.40	6.8%	$46.60

Data as of July 15, 2009 from Yahoo! Finance.

Again, none of these should be taken as formal *Pro* recommendations, but only as starting points for further research. That said, the Baker Hughes puts best satisfy the criteria set forth in Options 301. When we're looking at put options expiring in three months or less, we want the strike price to be more than 4% below the current market price, and we want to receive a premium that's higher than 4% of the strike, together giving us a break-even price at least 8% below the current market price. Both the August and October puts currently meet this requirement.

If this piques your interest, the next step is to do a business valuation on Baker Hughes to determine whether or not you'd be comfortable owning the stock at these potential buy prices. This is what we're always doing for you behind the scenes at *Pro* before we make any trade recommendations, and it's a crucial part of the investing process.

Hopefully this has helped shed some light on how *Pro* approaches put writing as well as how you can use CAPS to find additional ideas. As always, if you have any questions about options, please post them on our All About Options board.

Fool on!

Todd Wenning (**TMFPhila**)

Monday Memo: A Portfolio Review

Published Jul 13, 2009 at 12:00AM

These *Pro* stocks have attractive upside along with the most reasonable downside risk at recent prices.

AmTrust Financial Services (Nasdaq: AFSI) (target: 5%; current allocation: 4%)

Our niche insurance provider continues to sport outstanding performance numbers. With book value expected to grow nicely this year, the stock still looks inexpensive.

- Alternate action to buying stock today: Write ("sell to open") December $10 puts

Jack Henry & Associates (Nasdaq: JKHY) (target: 5%; current allocation 5%)

With software tailored to small- and mid-tier banks and credit unions (all of which may gain customers following the financial meltdown at the banking giants), a stellar balance sheet, high recurring revenue, and shares still trading at about 12 times free cash flow, Jack Henry remains a healthy risk-to-reward stock.

- Alternative to buying the stock today: Write December $17.50 or $20 puts

Kinetic Concepts (NYSE: KCI) (target: 5%; current allocation: 4%)

The majority of Kinetic's recurring revenue comes from renting its vacuum-assisted closure, or VAC, wound therapy system -- but its acquisition of regenerative medicine company LifeCell in 2008 gave the company myriad opportunities for future products. We love the results we're seeing from LifeCell so far this year.

- Alternative to buying the stock today: Write $25 or $22.50 puts

Medtronic (NYSE: MDT) (target: 5%; current allocation: 2.5%)

A *Pro* newcomer, this medical device giant will benefit from the aging of the baby boomer population and has significant competitive advantages that should support healthy profit margins for years to come.

- Alternative to buying the stock today: Write $32.50 or lower puts

Vanguard Emerging Markets (NYSE: VWO) (target: 5%; current allocation: 2.6%)

This low-cost ETF provides owners with wide exposure to mostly large companies located in rapidly developing economies like China, India, and Brazil. Emerging markets have been on a tear in 2009, so we recommend buying on dips. It remains a Buy First because we believe all portfolios should have some exposure to emerging markets.

We like our Buy recommendations as much as our Buy Firsts -- remember, we're building a portfolio that's meant to work as a whole. Some of these stocks may actually present more upside potential than the five stocks above, but they're also likely to be more volatile and present a bit more risk.

Autodesk (Nasdaq: ADSK) (target: 4%; current allocation: 2.5%)

Sluggish sales of Autodesk's ubiquitous AutoCAD software drew us to this beaten-down stock, as we believe business will rebound over time. So far we're up 20%, but we still see plenty of upside here. This high-margin business should begin to see orders recover in the design, construction, manufacturing, and engineering industries it serves, especially as government stimulus plans take hold and employment rates return to normal.

- Alternative to buying the stock today: Write $17.50 or lower puts

Flowserve (NYSE: FLS) (target: 4%; current allocation: 1%)

An investment in infrastructure, energy, water, and more, Flowserve still trades on the cheap -- about 10 times earnings. Margins continue to be strong for this valve, pump, and seal leader, and we look forward to seeing how backlog is holding up in the next quarter.

- Alternative to buying the stock today: Write $60 or lower puts

GrafTech International (NYSE: GTI) (target: 5%; current allocation: 3%)

As global demand for steel has cooled over the past year, we were able to start buying our graphite electrode maker on the cheap. GrafTech is an industry leader with a diverse global customer base, so we have great expectations for this stock as the economy recovers -- though as we've seen, it may be a rocky ride until then.

- Alternative to buying the stock today: Write $10 or lower puts

iShares Silver Trust (NYSE: SLV) (target: 3%; current allocation: 3%)

We continue see an opportunity to hedge inflation with this ETF, which owns actual silver bullion. But we're not silver bugs, so we only recommend this holding as part of an option strategy. Recent prices around $12 could be appealing for newcomers.

- Trades we like today: Write $12 puts or buy Silver Trust and write $13 or $14 covered calls

Lindsay (NYSE: LNN) (target: 4%; current allocation: 1%)

This maker of agricultural irrigation systems and road safety equipment stands to profit from a number of macroeconomic trends, including increasing demand for food, new infrastructure in emerging market countries, diminishing usable water supplies, and biofuels as an alternative energy source.

- Alternative to buying the stock today: Write $30 puts

Plum Creek Timber (NYSE: PCL) (target: 5%; current allocation: 3%)

A somewhat volatile stock, Plum Creek has fallen along with commodity prices, from $34 last month to below $30 today. But our opinion hasn't changed: With more than 7 million acres of timberland, Plum Creek is a solid commodity and asset play and an inflation hedge. Its solid (and tax-advantaged) 6% dividend doesn't hurt either.

- Alternative to buying the stock today: Write $25 puts; when the stock is back in the mid-$30s, consider writing $35 to $40 covered calls, as we've also done

Procter & Gamble (NYSE: PG) (target: 5%; current allocation: 5%)

The consumer staple giant remains best-of-class, but it's been struggling to grow in today's tough economy. A strong dollar and cautious consumer have made for headwinds since we bought. However, the stock looks inexpensive -- any lower and we'll be tempted to move it to Buy First status.

- Alternative to buying the stock today: Write $50 puts

ProShares Short SmallCap600 (NYSE: SBB) (target: 3%; current allocation: 3%)

We recently started a position in this ETF for the second time, as we still think small caps look expensive. What's more, Short SmallCap600 provides the *Pro* portfolio with a hedge against potential market declines. We'll continue to track this near-term investment closely.

Vanguard Energy (NYSE: VDE) (target: 3%; current allocation: 3%)

Over the past few months, the price of crude oil has recovered from lows (though it remains highly volatile) -- and so has this ETF, which holds dominant names like **ExxonMobil** (NYSE: XOM) and **Chevron** (NYSE: CVX) that should withstand the volatility nicely. Any real economic recovery or a slide in the dollar should bring oil prices higher -- so it may be a win-win for patient oil investors.

We don't recommend new purchases at current prices here, though you can still consider writing puts at lower strike prices for a potential purchase.

Cameco (NYSE: CCJ) (target: 3%; current allocation: 3%)

After a 40% gain, we put this company on Hold back in May. The world's largest uranium producer sees increasing interest in nuclear power and steadily growing demand for uranium. The company also has a controlling interest in Centerra Gold, which provides our portfolio with marginal exposure to the gold mining industry, another inflation hedge. We've written covered calls on part of our position due to valuation, but given Cameco's industry dominance, we'd also like to hang onto some exposure here.

- Trade we suggest: Write $20 or lower puts to buy Cameco in the high teens

So far, our companies are performing as well as we could hope in today's environment. All remain profitable and are cutting costs through the economic implosion. We look forward to the next batch of earnings starting this month (see the sidebar) and will keep you posted with the latest updates. Meanwhile, as we invest more of the portfolio with you, we anticipate plenty of new opportunities and strategies to come.

Stay Foolish!

Jeff Fischer (**TMF Fischer**) and Todd Wenning (**TMF Phila**)

Options 701: Buying Straddles

Published Jul 10, 2009 at 12:00AM

Before we walk you through an example, let's go over what can go right or wrong. On the plus side, when you buy a straddle, your profit potential is unlimited — the more the underlying stock moves in one direction, the more you can profit on that side of your trade. However, as with any option you *buy* (as opposed to writing options), you can lose your whole investment — in this case, if the stock stays tightly range-bound, the options would eventually expire with little or no value.

The clock also plays a large role, as the biggest drag on a straddle purchase is the *time-value erosion* of the options. Buying a call and a put, you've paid two option premiums, and with each passing week their value erodes unless the stock's volatility increases. If the underlying stock doesn't make a significant move in either direction, your options will steadily lose value. Plus, the underlying stock needs to move *enough* so that one side of your straddle (either the calls or puts) gains enough value to offset the losses on the other side.

Now let's "straddle up" and see how the strategy works. Here are the basics:

- You buy ("buy to open") an equal number of calls and puts on the underlying stock or index (usually you'll do this as a stand-alone strategy, so you won't own the underlying stock).
- The strike prices of the calls and puts should be the closest available to the current price of the underlying stock or index (also called "at the money").
- The expiration month on the calls and puts should be the same, and usually you'll choose an expiration up to four months ahead if you expect volatility soon, or six months or more if you want more time. Having more time for the strategy to work can be an advantage, but will cost more up front.

Let's use a real world example. *Motley Fool Pro* holding **Autodesk** (Nasdaq: ADSK) has been volatile as investors try to determine when business will improve. Suppose you believe the stock will move aggressively, in one direction or another, depending on the company's outlook in its next quarterly report. With shares at $17.50, you could set up a straddle that expires in three months, buying the October $17.50 puts for $1.65 each and the October $17.50 calls, also for $1.65 each. Your combined cost per contract is $3.30 ($330) — so, if you buy three contracts of each, your up-front investment is $990.

Say management sees business improving, and the stock returns to $22.50 the next month. Your calls are now worth at least $5 each, up from $1.65 each, while the puts are worth very little — you're losing money on them. Overall, though, your $990 investment is worth more than $1,500, a gain of more than 50%. On the flipside, if Autodesk's guidance is weak and the stock falls to $12.50, your puts are worth more than $5 each and your calls have little value. Your profit in this case, as with the opposite side of the spectrum, is 50%.

What if your thesis is wrong, and Autodesk stays within a few dollars of $17.50 for a few months? You're losing money on both the calls and puts in this case, and you might want to close them ("sell to close") early to get some capital back — unless you believe volatility will increase significantly and soon.

Straddles can benefit from more active management once the position is in place. There are two ways to potentially boost your profits while being defensive:

- If the price of the underlying stock increases to the next higher strike price (compared to the strike price you used to set up the trade), you may want to — depending on the number of contracts in play and your commission costs — close your existing puts and buy puts at that next-higher strike price to increase your profit potential. This is called "rolling up" the puts.
- Inversely, if the underlying stock *declines* to the next lower strike price, you should consider selling your calls and buying new calls at that next-lower strike price. This is called "rolling down" the calls.

While increasing the total cost of your strategy, these follow-up moves increase your chance for higher profits on any subsequent stock move. Roll up and roll down sparingly, though — reacting to every zig and zag in the stock can be a detriment when you consider the commissions, option premium costs, and the fact the stock could easily swing the other way again.

If your original thesis holds true and a stock makes a big move, you'll make more money on one side of your options than you'll lose on the other. If you believe volatility is subsiding, consider closing ("sell to close") both of your positions at the same time to lock in your profit. If you wait until expiration, you may slowly lose extra value in your options, or the stock may reverse on you again.

If your strategy isn't working in time, you may want to close both positions early to recoup some capital and rethink your strategy. Your calls and puts serve to hedge each other in the early going. However, both options will steadily lose value if the stock isn't making a move one way or another.

Finally, although it's unorthodox, if you earn a quick profit on one side of your straddle, you may want to lock in that profit and let the losing side stay active. You won't have much value left on that side anyway, and if the stock reverses, you may regain some of the losing option's worth without risking the profits you've already secured on the closed side.

If you believe a stock is going to move significantly — but you don't know which way — buying a straddle is a way to profit on either side. The enemy of the straddle-buying Fool is a stable or merry-go-round stock price, as the value of your purchased options will steadily erode unless the stock makes a lasting, meaningful move in one direction or another. But when you expect a big move either up or down, consider buying a straddle. Questions? Please visit our All About Options board.

Next in this series: Options 702: Writing Straddles

Write Puts on Nasdaq OMX Group

Published Jul 8, 2009 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") December $15 puts (ticker +NQDXC)
- **Allocation:** 5% if we get the shares (about 36 contracts for *Pro*, for a potential $50,000 stock purchase)
- **Recent option price (bid/ask):** $0.85/$0.95
- **Preferred limit price to use:** $0.80 or higher (*use a limit order*)
- **Minimum preferred limit price:** $0.70
- **Recent share price:** $18.90
- **Estimated stock fair value:** Mid-$20s
- **Strategy:** Puts pay you while you wait for a lower buy price. Please see Options 301 for details.

- **Special requirement:** You must be ready and willing to buy at least 100 shares (representing one put option) of Nasdaq OMX at $15 anytime between now and the option's expiration date.
- **Alternative trade:** Instead of writing puts, if you'd rather buy shares of Nasdaq OMX outright, we recommend entering a limit order at $15.

If You're New to *Pro*

We write ("sell to open") put options when we'd like to buy a stock, but at a lower price; we use this strategy often to build positions at better prices, or generate income. If the shares decline, our puts buy us the stock at our strike price by the option's expiration date. Meanwhile, the puts pay us a premium — income — that we can keep whether the stock declines or not.

Pro writes *cash-secured* puts, meaning you must have the money ready to buy the stock if it is put (sold) to you. You need permission from your broker to write put options, and getting that permission may take a few days. Once you have it, you can follow along using our guidelines in Options 301.

These instructions may look different from your broker's trading page. If *at any point* you're confused, just pick up the phone (or fire up a live chat) and have your broker walk you through the trade — better safe than sorry.

- First, make sure you have the means to buy at least 100 shares of Nasdaq OMX in case the put options are exercised. Given our strike price of $15, you need $1,500 in buying power for each put contract you write.
- **Do not buy these puts**.The order you want to make is "sell to open," "sell," or possibly "write" one put for every 100 shares of Nasdaq OMX common stock you're interested in buying. If 300 shares of Nasdaq OMX would be a 5% allocation for your portfolio, write three puts.
- The most you can profit from selling options is the amount you're paid to write the contract. That's it! So make sure it's worthwhile.
- The only possible outcomes here are that you buy shares at $15 (if the stock falls to that price or lower) and your options disappear (you still keep the option premium you were paid), or the stock ends the period above $15 and the options expire for a 100% cash gain. So don't sweat any big option swings between now and expiration.

Once your trade is made, your account will be credited cash for the puts you wrote, and you're on the hook to buy shares of Nasdaq if the stock drops below $15. If the stock holds steady or increases, your put options will show a bigger profit for you week by week. This option position will show up in your portfolio essentially as a short (a negative number) and your desire is that it is eventually worth $0, meaning you keep every dollar you were paid to write the put.

Questions? Visit our Nasdaq OMX board!

This is the third time that we'll write ("sell to open") put options on **Nasdaq OMX Group** (NASDAQ: NDAQ), the largest electronic stock exchange in the world. Since we first wrote puts in December, shares have been stagnant, and we've pocketed a nice chunk of income (see our closed positions) using a strategy of writing $15 puts while the stock traded in the high teens.

Today is more of the same. By selling puts with a strike price of $15 that net us a potential stock price of about $14.15, we're taking a cautious approach on the company and expect — most likely — the trade to become more income for the *Pro* portfolio. Our potential start price on the stock is just 7.5 times the average 2009 earnings estimate, so even if estimates decline modestly (as they have the past two quarters), we would be netting an inexpensive start price if we get the shares. In fact, it's inexpensive enough that we're willing to allocate up to 5% of the portfolio to the position at this price.

There are a few new developments this time around. First, Nasdaq OMX is seeing the first uptick in IPOs since the financial meltdown, a sign of a pending thaw. Following successful IPOs from **Rosetta Stone** (NYSE: RST) and **OpenTable** (NASDAQ: OPEN), among others, Nasdaq remains "cautiously optimistic" about IPOs the rest of the year and suspects greater strength in 2010. The best IPOs can attract significant trading volume and restart investor interest in other stocks, too.

Second, Nasdaq OMX's trading results for May show that its average daily trading volume in U.S. securities was up 16% year over year. It grew volume elsewhere, too, but market share battles and pricing wars with multiple competitors still keep us cautious, so we're sticking to our $15 puts. Plus, if a strategy is working, there's no reason to change it.

Put Specifics

If you're new to writing puts, please read our Options 301 guide. You write puts on stocks you're happy to buy at a cheaper price if that price comes along. Each option contract represents 100 shares of stock, so you must be willing and able to buy at least 100 shares of Nasdaq OMX ($1,500 worth) if your option is exercised. In this case, writing these options at recent prices would pay $0.85 per share per contract into your account. So if you write 10 contracts, you'll be paid $850 and you need to be ready to buy 1,000 shares ($15,000) if Nasdaq OMX declines below $15 by Dec. 19.

These options easily meet our put-writing guidelines, with the strike price more than 20% below the stock's current price. The options offer an effective 5.6% yield (more than 11% annualized) on the money you'll set aside for this potential buy (an $0.85 payment on a potential $15 purchase). Our break-even price of approximately $14.15 is 25% below the stock's current price. If you accept our lowest preferred option payment of $0.70 per contract, the yield is still an acceptable 4.7% over less than six months (about 10% annualized).

Pro Bottom Line

Investing is sometimes about building knowledge in a business and then leveraging that knowledge. If you can pull the same profit lever again and again, you should. Ideally, we'll be writing puts on Nasdaq OMX for a long time to come — or we'll get shares at an excellent price. We'd be happy buyers in the mid teens. Barring that, we'll take the income.

If you have questions about this trade, please post on the Nasdaq OMX board!

Buy ProShares Short SmallCap600

Published Jul 6, 2009 at 12:00AM

At a Glance

Short selling is usually a near-term endeavor (measured in months rather than years), so we've already developed some history with this ETF. **ProShares Short SmallCap600** (NYSEMKT: SBB) shorts, or moves inversely to, the daily performance of the SmallCap 600 index, thus serving as a meaningful hedge against our bullish positions. We first bought shares in January, only to sell them all for an attractive gain in March. In early May, we returned to the ETF and took a new 2% stake, and in the next two business to 30 calendar days, we'll be filling out our targeted 3% position with another 1% stake.

Since May, the U.S. market — and this ETF — has remained flat. So we're still looking at the same valuation today as we enter the July earnings season — and the public's doubts about an imminent economic recovery begin to resurface. Meanwhile, the S&P SmallCap 600 index continues to look expensive: It's heavily weighted in industrials (17%) and financials (18%), and after rising nearly 50% from March to May, it's trading at a lofty 26 times earnings. Looking ahead, analysts are calling for 15% earnings growth in the index, while we believe earnings will likely decline.

Our total 3% investment in ProShares Short SmallCap600, about $30,000, will represent 6.6% of the *Pro* portfolio's currently invested value ($455,000), a meaningful hedge. As before, we seek to earn 10% to 15% here and will consider closing if the ETF works against us by 10% or more. If earnings in July are surprisingly strong, we may be inclined to close the hedge.

Feeling defensive? Want to own a position that goes up when the market goes down? Remember that to do this short, you only need to *buy* the ETF. The ETF is designed to move inverse to the SmallCap 600 index. If you have questions, please post on the SBB board.

Monday Memo: Get Up to Speed With Pro

Published Jul 6, 2009 at 12:00AM

1: When does *Pro* announce its moves?

First, we announce our trades — about four to six per month — before we make them ourselves. You'll get these "Make the Trade" emails at any time during normal market hours along with a link to details on the reasoning behind our trade. Then, in the following two to 30 days (for stocks and ETFs) or one to 30 days (for options), we'll make our actual trade and send you a "Trade Complete" email at market close (4 p.m. ET) that day. We preannounce our trades so you can invest before us if you wish.

Tip: Only when you get the "Trade Complete" email is the position added to *Pro*'s real-money portfolio. At that time, you can see our start price, commissions, and other trade details on either the Portfolio page or on the stock's History tab.

2: What do I do with my losers?

If, like most Fools, you already own an array of stocks and want to sell some to buy *Pro* stocks, move gradually. We don't recommend going all to cash at once; instead, sell your least favorite stocks when you need funds to buy *Pro* stocks and ETFs you like better.

Tip: If you own stocks recommended by other investment services and need to sell some, first sell those that are not core holdings or recent recommendations. And sell those you simply like least.

3: How quickly should I get invested?

All of our holdings that are rated "Buy First" and "Buy" on the portfolio page can be bought at will; we believe in all of 'em. But in this volatile market, we also believe you should gradually average into anything you're buying. In fact, *we're* still in the process of averaging into most of our holdings — so we're patiently investing right alongside you.

Tip: Take your time and don't sweat price swings — we'll let you know if something is no longer attractive. Keep in mind that you're also learning option strategies you can use to buy our stocks more cheaply down the road.

4: What is a "preferred buy price," and how firm is it?

All of our trade reports (the tab labeled "What We Think") on stocks include a preferred buy price in the "At a Glance" section atop the report. However, paying modestly more won't make the investment a poor one. The preferred range is an *ideal*.

Tip: Also look at our fair value estimate for any stock (in the "At a Glance" section) and use that to help you determine whether the current price is attractive enough for you.

5: Can I make options trades with an IRA?

Most likely. Many IRAs will allow you to buy options and write covered calls, and some will let you to write cash-secured puts. Ask your broker.

Tip: Writing options is an especially savvy IRA move, since the income you generate is tax-free.

6: Should I make the options trades that are already in play?

Option trades are timely and opportunistic even when you use them strategically in relation to an underlying stock, as we do. Thus, new *Pro* members should typically wait for new option trades from us in order to get started. We'll have our first new option trades in a matter of days, so if you're ready to jump in (if not, that's fine — keep following along with our 7-step plan!), make sure your brokerage account is approved for options trading (and brush up with our how-to video). Ask your broker for options permission — typically, level two or three is ample. For now, you want to be able to buy calls and puts, write covered calls, and write cash-secured puts.

Tip: Each option trade we announce (with a "Make the Trade" email) will clearly explain the trade we're going to make and how you can follow along.

7: What can I expect as I start to trade options?

Profits can arrive regularly with options, but remain patient as you get started. A few months into this new way of investing you're going to realize that these strategies are available to you the rest of your life — and they're "renewable," so there are always new option opportunities. The key is to find great businesses, at fair prices, and use what you know about them to put together sensible options strategies. (And of course, we're here to help you with that.)

Tip: When writing options, let them be your shorter-term ATM machine; let the stock be your retirement-minded holding.

8: What is the meaning of life?

OK, we can't help with that one today. But the name of the game here at *Pro* is all about working with what the market hands us. As I wrote last week, we *welcome* a fair amount of volatility. It allows us to buy shares more cheaply and use more lucrative option strategies. For investors who know businesses well, price volatility presents opportunity.

Hey, old-school Pros! For those of you who got all of our questions right, take this opportunity to chime in on our Member Suggestions & Help board with the No. 1 thing you've learned during your months with *Pro* that's made your time here easier. We'll share the best tips in the next Memo.

Recent *Pro*recommendation Lindsay released encouraging results last Wednesday, with gross and operating margins holding strong in a difficult quarter (March through May) for both irrigation and infrastructure, the company's two business lines. Food prices have rebounded since April, but most farmers will wait to see if these levels hold before making a big-ticket purchase like a center-pivot irrigation system.

Lindsay management did a masterful job with the balance sheet, increasing net cash by more than $50 million year over year on the back of a cash-flow positive quarter. If Lindsay is operating this ably while the economy is in the dumps, we expect great things when it turns around. Looking ahead, China will be a huge growth opportunity for Lindsay, and stimulus funds earmarked for road improvements are only starting to have an effect. Most money will start to flow from the U.S. stimulus package in 2010. For more from Todd, please see his recent post.

Let the Pro Times Roll!

Please post your comments and questions on the Memo Musings board. You'll hear from us again soon. Fool on!

Jeff Fischer (**TMFFischer** on the boards)

Buy Medtronic

Published Jul 1, 2009 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Price when we released our original intent:** $34.60
- **Estimated fair value:** High $40s
- **Type of holding:** Core; Healthcare
- **Dividend yield:** 2.3%
- **Alternate trades:** Write puts.
- **Why buy:**
  - Medtronic leads five of six key medical-device markets, including pacemakers and other cardiac devices, and it has growing product lines to treat diabetes, spinal conditions, and more.
  - An aging population means an increasing number of people with cardiovascular and other health problems.
  - Trading at 1998 levels, Medtronic offers investors an opportunity to buy shares at just 10 times forward earnings estimates, a discount to average market prices.

The Big Picture

July 1, 2009

As we strive to anticipate — and take advantage of — emerging trends, the shifting global population is always on our radar. One of the biggest changes ahead is something we can all relate to: getting older.

According to the latest U.S. census figures, the world's 65-and-older population has increased 23%, to 516 million, over the past decade — and another huge influx is under way. Over the next five to 10 years, as Baby Boomers hit their golden years and China's 1960s generation follows suit, the percentage of elderly people in the world will continue to rise. Meanwhile, people are increasingly reliant on medical treatments to prolong and improve life — exactly the needs **Medtronic** (NYSE: MDT) delivers.

Although best known for its advancement of pacemakers, there's much more to Medtronic's business today. This $38 billion company has become the world's largest independent provider of medical technology, treating a range of chronic conditions with products and services such as deep-brain spinal cord stimulators, heart valves, implantable cardioverter-defibrillators, and drug delivery systems.

The company's reach and depth give it strong competitive advantages. Medtronics' 250-plus facilities, from research to manufacturing to education, serve customers and patients in 120 countries. The company aims to grow sales by 5% to 8% per year and hike earnings per share by at least 10% annualized over the long haul. Shares of the company trade at 11 times free cash flow (inexpensive by industry standards) and pay a healthy dividend yield of 2.3%.

Medtronic combines strong margins, a dominant market presence, and exposure to favorable demographics and emerging markets — not to mention an aim of growing earnings by double digits annually. At these prices, Medtronic is an enticing way to increase our portfolio's exposure to health care in the niche — medical devices — that has the most sustainable competitive advantages.

Our Take

In 1949, inspired by the workings of a metronome, Earl Bakken sat in his garage determined to build a better pacemaker — and so Medtronic was born. Over the years, the company's co-founder worked with leading surgeons to make huge strides in medical device technology. Today, Bakken's mission remains intact — and the company has grown to six major divisions, each focused on a specific condition or therapy:

1. **Cardiac Rhythm Disease Management** (34% of FY09 revenue, or $5 billion): Products include implantable pacemakers and implantable cardioverter-defibrillators, or ICDs. ICDs represent the company's biggest product line, generating $3 billion in fiscal 2009.
2. **Spinal and Biologics** (23% of revenue, or $3.4 billion): Products include artificial disks and bone graft stimulants.
3. **Cardiovascular** (17%, or $2.4 billion): Stents, heart valves, and open heart surgery grafts.
4. **Neuromodulation** (10%, or $1.4 billion): This division treats diseases and conditions of the nervous system. Products include neurostimulation systems and implantable drug delivery systems for chronic pain, movement disorders, and urologic and gastrointestinal disorders.
5. **Diabetes** (8%, or $1.1 billion): Medtronic has the world's leading prescription insulin pump, and its glucose-monitoring device is one of the company's fastest-growing products, with a 30% uptick in sales last year.
6. **Surgical Technologies** (6%, or $0.9 billion): Products for the diagnosis and treatment of ear, nose, and throat diseases as well as cranial, spinal, and neurologic conditions.

As you can see, Medtronic is pursuing multiple avenues of long-term growth. It's the market leader in five of its six divisions (and a still-impressive No. 2 in Cardiovascular offerings). Management has a strong focus on product innovation (it spent a massive $1.3 billion on R&D last year), targeting its fastest-growing markets, including diabetes and spine treatment. The company is looking to broaden its global footprint while making selective acquisitions, most of them small companies offering medical devices that complement and add to Medtronic's range. As CEO Bill Hawkins said recently, "Although we have much work to do, we still have the most comprehensive line of innovative products in the market ... No one can compete with the breadth of our portfolio."

Hawkins knows what he's talking about: Although he's only been chairman and CEO since 2007, he began his medical technology career back in 1977; his stint at Medtronic actually dates back to 2002, when he joined the company as president and chief operating officer. In his roles, he's proven to be a steady leader with a talent for making acquisitions. Overall, management has long been shareholder-friendly, consistently paying a growing dividend. Nearly half of the company's free cash flow was returned to shareholders via dividends and share repurchases over the past year, in line with management's long-term objective.

The Community's Take

Medtronic has fluctuated between 4 and a perfect 5 stars on CAPS over the past year, while the vast majority of top players — 98% — expect it to outperform. The company scores only a 6 out of 12 on *Pro*'s CAPShot; however, it was an 8 until a few days ago, when its CAPS industry rating and its rank in the industry ticked down. Medtronic also comes up shy on our aggressive growth hurdles (which most companies will miss in a recession), but overall it just misses on a few metrics that would otherwise kick it up to a 10. Thus, we're comfortable with its score.

Valuation and Financials

Medtronic's financial performance is impressive. We're especially drawn to the company's double-digit bottom-line growth rate and its strong gross and operating margins. But management isn't content to sit on its laurels, committing to finding $1 billion in cost savings by fiscal year 2012. Good news: They're already 40% of the way there.

For fiscal year 2010, Medtronic forecasts revenue growth of 5% to 8%, with earnings per share of $3.10 to $3.20, reflecting growth of 8% to 12% — strong in today's environment. We expect free cash flow, which clocked in at a solid $3.4 billion over the past 12 months, to grow in kind. This strong free cash flow also makes the $6.7 billion in debt on the balance sheet — versus $3.9 billion in cash and investments — easier to accept.

At a recent $34.60, Medtronic trades at a forward P/E (on April 2011 estimates) of 10. Looking ahead and assuming a modestly stronger market and an improving economy, a company with Medtronic's dominance, margins, and growth rate should merit a P/E closer to the market's historical average, which is in the mid teens. Assuming a P/E of 15 on 2011 EPS forecasts of about $3.45 gives us a stock price of $51.75, some 50% higher than today. Using an 11% discount rate, our discounted free cash flow model puts fair value in the high $40s to low $50s. Looking at all the possibilities, we put a fair value on the stock around $50 to $51.75.

What Would Make Us Sell

Product recalls and pricey litigation are rampant in the medical device industry, and Medtronic hasn't been immune. In October 2007, Medtronic voluntarily recalled its Sprint Fidelis defibrillation leads, which may have been responsible for 13 deaths. The recall shrank the company's market share in implantable cardiac devices from 53% to 46% as competitors such as **Abbott Laboratories** (NYSE: ABT) prospered.

In fiscal 2009, Medtronic booked a post-tax $364 million charge for litigation, including the settlement of royalty disputes with **Johnson & Johnson** (NYSE: JNJ). In fiscal 2008 the corresponding figure was $274 million — so these are ongoing costs, though Medtronic excludes litigation when calculating normalized earnings.

We'll also eyeball future acquisitions, making sure the company doesn't overpay or take on an excessive level of debt. We'll be particularly wary of a mega merger or acquisition, as it may signal Medtronic is worried about its organic growth prospects. We do expect steady small acquisitions, however, as a way for it to stay ahead in a highly competitive field. **Boston Scientific** (NYSE: BSX) is half the size of Medtronic, but still a formidable foe, while J&J's $150 billion market cap is four times larger than Medtronic's.

The Obama Health-Care Plan

As with most health care companies, Medtronic will feel the effects of changing U.S. government regulation. However, CEO Hawkins says the company is part of the solution to rising health-care costs — and that it "has and will take a leadership position in enabling more efficient and effective health care."

Right now, some 46 million Americans lack insurance and are unable to receive the care they deserve — in a perfect world, reform will benefit both health-care companies and patients. For the time being, we believe health-care reform should not materially affect Medtronic's sales or profitability. In the future, reform may even expand Medtronic's addressable market base.

The Foolish Bottom Line

Medtronic is an expanding, recession-resistant company with solid operating margins and substantial free cash flow. Its international growth is impressive in emerging regions such as China, Central and Eastern Europe, Latin America, and the Middle East and Africa.

Meanwhile, Medtronic remains a technology leader. Thanks to solid free cash flow, it continues to invest big in research and development. And the company is shareholder-friendly, with a strong commitment to share buybacks and its dividend. With an inexpensive stock price, Medtronic is poised to generate healthy returns in the years ahead.

To welcome and discuss the newest entrant to our portfolio, please skip on over to our new Medtronic board.

Monday Memo: Your "Aha!" Investing Moment

Published Jun 29, 2009 at 12:00AM

Speaking of making money, on the *Pro*portfolio page, you may see five or six positions in the red — but nearly all of our strategies are going our way. For example, our iShares Silver Trust ETF holding is down a few percentage points, but the covered calls we wrote on it from day one have made us money on the position overall. Plum Creek Timber's stock is down about 8%, but the position as a whole is well in the green when you include the simple puts and calls we've written.

In fact, every *Pro* strategy has made money overall so far except one. Our only turkey? Mighty **Procter & Gamble** (NYSE: PG), down about 7%. Given P&G's dominance, management, and price, we don't think we need much more than patience, and we're happy to just hold the stock. Patience is an investor's best ally, so we'll "buy and watch" many of our core holdings like this — but we're always mindful of other tools at our disposal to ensure we keep booking gains. With each new position, we ask, "How much downside is possible here, and how do we repair that downside if it comes about?" If patience isn't the answer, we want to have a Plan B.

Do you have an "Aha!" investing moment? Tell your story on our Memo Musings board. Meanwhile, here's hoping for some volatility this summer!

Fools in China

At *Pro*, we have China exposure with **Vanguard Emerging Markets** (NYSE: VWO), but if you're craving more, you're in luck: The *Global Gains* team is visiting China and offering their email dispatches for free. Sign up here.

If you didn't see last week's Monday Memo, head there now for more on our strategies, what's ahead, and how you can get started today, along with commonly asked questions.

Next up: A brand-new buy announcement is coming your way this week.

Foolishly,

Jeff Fischer (**TMFFischer** on the boards)

Audio Extra: David and Jeff Give Their Top Pro Tips

Published Jun 26, 2009 at 12:00AM

Grab your headphones: David Gardner and Jeff Fischer are here to say "Welcome!" as you begin building your portfolio with *Motley Fool Pro*. Find out their top tips for *Pro* investors, including where to start and how to improve your returns with our help. The two long-time Fools even offer a few priceless pieces of investing advice while they're at it. Just click the player below to listen in!

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Have a question? Visit our Getting Started board.

We'll be posting the transcript in the next few days.

Buy Lindsay Corporation

Published Jun 25, 2009 at 12:00AM

At a Glance

- **Target allocation:** 5%
- **Price when we released our original intent:** $31
- **Estimated fair value:** Low $40s
- **Preferred buy price:** $34.50
- **Special note:** This small-cap stock is thinly traded, so we request that you use a limit order and only buy at that set price.
- **Type of holding:** Core; Agriculture machinery
- **Dividend yield:** 1%
- **Why buy:**
  - Major macroeconomic and demographic trends favor Lindsay's two product lines: efficient irrigation systems for agriculture and highway equipment to build and repair infrastructure.
  - A strong balance sheet, smart management, healthy margins, and a diverse customer base combine durability with potential.
  - Although Lindsay shares often move in sync with prices of commodities and basic materials — where we have ample exposure — they are most closely tied to agriculture prices, where we're looking to gain exposure.

The Big Picture

June 25, 2009

In the coming decade, the greatest macroeconomic challenge will be managing the world's growing masses. The U.N. predicts the population will balloon to 7.3 billion by 2015 (a 500 million increase in just six years), placing enormous strain on resources and infrastructure — everything from food and water to transportation and energy. **Lindsay Corporation** (NYSE: LNN), a small manufacturer of agriculture irrigation systems as well as road safety and traffic management equipment, is an excellent way to invest in these two major, growing areas of need the world over.

Rapidly advancing economies including China, India, and Brazil are leading to higher incomes and a greater rate of consumption of food — especially protein, which is highly dependent on grain production. Simultaneously, roughly 15% of the world's population — more than 1 billion people — receives fewer calories than are necessary to remain healthy. Not all hunger is supply related, but all hunger requires more food being available in the right places. As a producer of irrigation systems that increase efficiency of land use, food productivity, and longevity of water resources, Lindsay provides a solution in a world that needs to greatly increase its arable land and crop production in a sustainable fashion.

When it comes to roads and rails, Morgan Stanley reports that emerging economies are expected to spend more than $22 trillion building infrastructure over the next decade. Since its stimulus was announced in November, China has already built more than 12,000 miles of rural roads and 276 miles of highway. Though road safety equipment is a new and smaller part of Lindsay's business, accounting for one-fifth of sales, it's growing — and it represents a second catalyst for value creation at this mere $380 million company.

Add it up, and we have a well-managed, small business positioned to profit from two key markets.

What We Think

From its origins as a sleepy farm equipment business in 1950s Omaha, Nebraska, Lindsay has grown into one of the top makers of irrigation systems in the world. Over the decades, it has learned to adapt to the volatile demand for food by expanding its business overseas, focusing on efficiency, and growing through acquisition. New technology is a recurring theme for Lindsay — in 2007, for example, it launched the Web-based FieldNet software suite, which allows farmers to manage their irrigation systems from anywhere in the world.

Water Works

Irrigation equipment accounted for 79% of Lindsay's sales in fiscal 2008 — but these aren't your average backyard sprinkler systems, folks. A typical Lindsay center-pivot system is approximately 1,300 feet long and irrigates up to 135 acres of a land (in circles, like so). There are three primary drivers for farmers to pick up Lindsay's pivot systems:

1. **Replacing antiquated equipment:** Lindsay estimates that half of the center-pivot systems in North America are more than 10 years old — and the typical life span of a system is 20 years. Replacing these represents a large market opportunity of about $5 billion.
2. **Switching from wasteful and labor-intensive irrigation methods:** The predominant irrigation system in the U.S. is gravity flow (aka flood irrigation), which uses ditches and pipes to distribute water across fields. Though popular, this method is extremely inefficient, is unable to irrigate uneven terrain, and wastes water and chemical treatments. Since the late 1970s, gravity flow has been in decline in favor of center-pivot systems, which have increased their market share from 17% in 1979 to more than 40% in 2003 (the most recent data).
3. **Converting from dry-land farming (where rain is scarce) to irrigated farming:** Only 13% of the total cropland in the U.S. (about 53 million acres) is irrigated at all. Because irrigation improves yields and profits, the appeal of adopting these systems is strong — and grows stronger as agriculture prices increase, which is likely over time.

Internationally, Lindsay has only just started to penetrate the irrigation market. A whopping 91% of the estimated 563 million irrigated acres overseas still use a form of gravity flow. Over the past five years, Lindsay has seen promising success abroad, increasing its international revenue more than four-fold, from $38.4 million in 2003 to $165.9 million in 2008. Lindsay has production and sales operations in four continents, and opened shop in China, the world's second-largest agriculture market, in 2005.

On the Road

Since agriculture prices — and thus irrigation sales — can be cyclical, we want to see Lindsay's infrastructure division steadily grow in size, too. In fiscal 2008, this branch represented 21% of Lindsay's revenue and grew 53% from 2007. In 2006, Lindsay made two acquisitions to build upon its own nascent infrastructure business: California-based Barrier Systems, a manufacturer of movable traffic barrier systems and road-safety equipment such as crash cushions, and Snoline, an Italian outfit specializing in road marking and safety.

The bulk of Lindsay's infrastructure business is conducted in the U.S. and developed Europe, but its next logical step is expanding further into emerging markets, including China, South Africa, and Brazil, areas it has existing offices. As countries around the world build, improve, and safeguard their roads and rails, Lindsay only needs to capture a tiny portion of the overall market to greatly increase the company's earnings power. Though a recent moveable barrier project in Mexico City has been delayed, the $19.6 million contract shows that the opportunities in infrastructure are lucrative.

Buffett on Board!

Lindsay's executive team is led by CEO Richard Parod, who has been in charge since 2000. He has extensive experience in agricultural irrigation, having served as an executive at Toro Irrigation prior to arriving at Lindsay. Parod has overseen seven acquisitions for Lindsay in the past eight years while keeping the balance sheet healthy, and expanded operations into Brazil, South Africa, and China.

And then there's Howard Buffett — son of the one and only Warren Buffett — who is himself a farmer and has graced Lindsay's board since 1995. Although Howard has stated that he'll let his term expire in January 2010 to focus on the family foundation and charitable organizations, the connections and experience he has brought to Lindsay over these 15 years are no doubt immeasurable and increase our confidence in management.

The Community's Take

Lindsay's CAPS score has been on a rapid ascent in recent months, moving from 2 stars on Jan. 2 to 4 stars today. Some 90% of CAPS participants expect the stock to outperform. The company scores a respectable 9 out of 12 on *Pro*'s CAPShot report. In fact, Lindsay was first spotted as a potential research candidate during a regular *Pro* team CAPShot analysis looking for companies with scores from 9 to 12.

Valuation and Financials

Lindsay's growth opportunities are intriguing, and the company's financial health lends us confidence as we wait. As of February, Lindsay sported $41.1 million in cash and equivalents versus $22.5 million in long-term debt; it's historically free cash flow-positive; and despite the cyclical nature of the agriculture business, it has turned in a profit each year for more than a decade.

Using a three-stage discounted cash flow model (to help determine the present value of estimated future cash flow) and conservative growth estimates for the next 10 years with 3% terminal growth, we estimate a fair value for Lindsay between $39 and $42. This gives us a strong upside from current prices of $31 a share.

Shares currently trade for just over 14 times trailing free cash flow and 12 times earnings, a discount to Lindsay's peers in the machinery industry. However, 2009 and 2010 earnings are expected to significantly lag 2008's strong results, making the stock look more expensive on a forward basis. This is partly why we're going to average into Lindsay shares slowly. At the same time, we recognize that when a turnaround arrives and irrigation orders begin to resume in greater numbers, Lindsay's earnings could easily catapult much higher than now expected.

Here are the company's long-term financial goals:

	Goal	Past 5-Year Average
Revenue growth	10% to 15%	25%
Operating margin	9% to 14%	8%
Return on equity	9% to 15%	10%

Considering the growth potential in emerging markets, we consider these goals attainable over time. How efficiently management can control operating costs and maintain balance sheet discipline will be the bigger question. We'll keep tabs on Lindsay's progress here.

Competition and Risks

Lindsay is not a well-known name on Wall Street — only five analysts currently cover the stock. That's somewhat surprising given that it controls an estimated 30% of the global pivot and lateral irrigation market. Its main competitor, the larger **Valmont Industries** (NYSE: VMI), controls 43%, but Lindsay's irrigation business has been growing faster — from 2003 to 2008, its irrigation division grew 148% versus Valmont's 94%. Valmont has a host of other businesses to tend to, including metal coatings, engineering support (for stadium lighting poles, microwave communications, and wireless towers), and utility support structures, that together constitute about 70% of sales. So Lindsay is the more focused company in its space, which should help it maintain a technological lead.

Another major competitor, so to speak, is Mother Nature herself. The more it rains, the less need there is for large-scale irrigation equipment, hurting Lindsay's sales. Lindsay's operations are primarily located in areas where rain is less abundant — in the U.S., that's west of the Mississippi River, and in China, the northern and western provinces. It's no surprise, for example, that Lindsay's Chinese operations are based out of Beijing, in the northeastern part of the country.

There's also the cost of Lindsay's products and the lumpiness of its sales: A center pivot will set you back about $50,000, and the average payback time is five to seven years — a significant investment for most farmers. But as crop prices rise, as we expect they will over time, upgrading to a center-pivot system becomes more attractive. It's important to remember, however, that farmers read the same headlines as everyone else, so in the short-run they may delay large purchases. Eventually this, too, shall pass. Meanwhile, large agricultural businesses (as well as governments) have the deep pockets to invest in watering systems even during a downturn, but we're still prepared for choppy results from quarter to quarter given that these are big-ticket items.

What Would Make Us Sell

Hunger is at its core a political issue (*see Revolution, French*), and one that world leaders can't afford to ignore. A global effort to increase crop yields is the best way to sustainably combat rising food prices, but political issues could pressure world leaders into fixing prices to keep food affordable. Artificially low prices for agricultural commodities would provide less incentive for farmers to upgrade to Lindsay's irrigation systems. A sustained global economic slowdown could have a similar effect on commodity prices. Additionally, most of the world's infrastructure projects are funded by government spending, so if these funds are reduced or delayed, it could impede Lindsay's road-safety business.

Significant and lasting challenges on any of these fronts could be enough to make us sell our stake. However, the more hopeful outcome is that the stock reaches or exceeds fair value in the coming years as orders resume and grow and commodity prices increase. Since cyclical stocks often overshoot on the upside, we'd view that as an opportunity to sell.

Foolish Bottom Line

Even assuming conservative growth over the next decade, Lindsay's stock presents an attractive opportunity at current prices — and a great way to invest in two global macroeconomic trends through just one small, well-managed company. If you have questions about Lindsay, please post on its new discussion board. And if you buy shares, *please use a limit order* at your desired buy price.

For more information on Lindsay, visit our board post on the topic.

Monday Memo: Pro Gears Up for the Future

Published Jun 22, 2009 at 12:00AM

Our strategy is designed to produce results in any market. We're working to build long-term wealth with core stock holdings, and our returns are greatly complemented with steady option income. In addition, we seek to capitalize on global trends, overpriced sectors, and market volatility with ETFs, hedges and shorts, and potentially bonds, too. We'll have slow and challenging periods, too, but the positive results we generate should compound over the years, packing on more and more heft — to allude to Warren Buffett's snowball analogy — as we roll along.

We're doing this first by buying strong companies that are undervalued — building and diversifying our portfolio. We've been augmenting this process with two key option strategies so far: writing ("sell to open") puts, which pay us income or net us a lower buy price on a stock we want to add; and writing covered calls on select stocks in order to sell shares at higher prices, or earn income if higher prices don't materialize. Both of these strategies continue to create income for the portfolio while we buy companies positioned to produce long-term rewards, too.

Here's a peek at some of what's in store for coming weeks:

- We'll add brand new stocks and ETFs to the portfolio (don't miss our newly updated ABCs of ETFs guide).
- We'll continue to average into our favorite existing positions (letting you get in first with "Make the Trade" emails).
- We'll write new put options to potentially build stock positions or generate income (get a refresher with our newly updated Options 301 guide). We just had three positions expire this weekend for full cash gains.
- We'll continue to write covered calls on some positions bought for that purpose, including the **iShares Silver Trust** (NYSE: SLV) ETF (our Options 201 covered call guide is also newly updated).
- We're seeking potential shorts in order to profit on a possible decline in stocks or indexes that we believe have become overvalued since March.
- We'll highlight a market trend we're seeing unfold with a new CAPS screen in the coming weeks, among other things.

But despite the abundance ahead, I want to remind everyone that we remain patient and disciplined. We're ultimately focused on the long term, even as we use near-term income strategies. And of course, the whole *Pro* team is here to help you. So take your time, get to know us and our strategies, and enjoy yourself.

Our FAQ pages cover much more, but here's a start:

- **Can I make option trades in an IRA?** Yes, you can buy options and write covered calls in an IRA, tax free. Some IRAs will also let you write cash-secured puts. Ask your broker.
- **What level of options permission do I need to follow *Pro*?** It varies by broker, but level 2 to 3 (the ability to buy and write calls and puts) is typically sufficient for now.
- **How much of each *Pro* stock do I buy?** If you want to mirror *Pro*'s portfolio, see our buy reports and buy our committed (or actual) allocation so far, rather than our full target allocation (unless we've met that target already). In most cases, we're still averaging into our positions.
- **What is a good broker to use?** From Scottrade to TD Ameritrade, ThinkorSwim to OptionsXpress, Schwab, Interactive Brokers, and others, *Pro* members use 'em all. If you're looking to trade options, just about any discount broker will work, but some have stricter options permission policies than others, and IRA policies differ. The Motley Fool's Broker Center is also a great resource.
- **Should I buy every stock right now?** We typically buy positions gradually, especially in a market this volatile. You might consider buying partial positions in our Buy First stocks each week, gradually building. Keep your existing positions, only selling them gradually when you like a *Pro* buy better.
- **How are trades announced**? "Make the Trade" emails come to you at least two business days (one day for option trades) and no more than 30 calendar before we make our trade. This gives you the chance to beat our price. After we execute a trade, we will send you a "Trade Complete" email alert with details after market close (4 p.m. ET) on the day the trade was made to keep all our members on an even playing field.
- For more of the most common *Pro* questions, please see our FAQ.

We're ready to have an active summer, but we're never too busy to help you grow as a Foolish investor. Please ask us your questions on the boards (no question is too basic) — we're here to help.

Invest Foolishly,

Jeff Fischer (**TMFFischer** on the boards)

Step 7: Make Your First Options Trade

Published Jun 15, 2009 at 12:00AM

Part of our **Profit With *Pro* in 7 Steps** series. Return to start page

Now that you're approved to trade options, it's time to put our strategies to work. If you're just beginning to use options, we're here to help (ask any question on our All About Options board). Here's a brief review of the strategies we've used so far at *Pro*.

Our Members Say ...

"I'm excited to say that my *Pro* subscription has been worth every penny so far. I did not expect I would become this experienced this soon in options." - **K. Willis, San Jose, Calif.**

Writing Puts

- When you'd be happy to buy a stock at a lower price, you can write puts. The option's strike price is your desired buy price for the stock.

When you write puts, if the shares do not decline to your buy price or lower, you keep the option income and can write more puts. If the shares *do* decline enough by your option's expiration date, you still keep the option income, but you also get to buy the shares at your desired price (they're automatically sold to your account by the time the option expires). The option income lowers your cost basis in the shares even further.

Writing Covered Calls

Important Options Tip!

Sell, don't buy: You're not buying these options; you're the seller! Please be careful and make sure the command you use when writing covered calls and puts is "sell to open, "sell," or "write."

- When you already own at least 100 shares of a stock and would be willing to sell at a higher price, you can write covered calls at your chosen strike price.

With covered calls, it's just the reverse of writing puts: You already own a stock, and you write calls on it that pay you income. If the shares do not increase to your desired sell price before the option expires, you keep the option income and can write calls again. If the shares *do* jump to your sell price, your shares are sold ("called away") from your account at the strike price by the option's expiration date. You still keep the option income, which increases your net sell price.

In both cases, the options pay you income while you wait for your desired outcome.

On the surface, both of these strategies are quite simple once you become comfortable with them. What takes more work is choosing strong buy and sell prices on exceptional companies and then making sure the options pay you enough. Follow our trades and guidelines for a helping hand as you learn.

What's Next?

If you're ready to put options to work in your portfolio, we suggest you begin with our covered call trades, such as **iShares Silver Trust** (NYSE: SLV), keeping in mind our price guidance — which you can find in the "At a Glance" section of the buy reports (a.k.a. our "What We Think" reports). Next, watch for new put-writing trades (or visit those recently added to our portfolio). Writing puts is a great way to start building your *Pro* portfolio.

Once you've made your trade, come to our All About Options board and let us know how it went! Remember, you're never out there alone: On our boards, you can find the *Pro* team and an entire community of Fools to help answer questions as you go.

Completed all seven steps? Now you're ready for our bonus step!

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Step 1: Get to Know Pro

Published Jun 15, 2009 at 12:00AM

Part of our **Profit With *Pro* in 7 Steps** series. Return to start page

Ready to start building a robust portfolio, learn smart new investing strategies, and profit in any market? It's easy to begin. Here are the key things you can expect as a new *Pro* member.

Our Members Say ...

"For those new to *Pro*, this stuff really works. I've generated steady streams of income in the past few months as this market has gyrated up and down."

– S. Busco, Simi Valley, Calif.

"I'm so impressed by the dedication of the staff (and members as well) at *Pro*. This is the first TMF service that actually teaches us how to fish rather than just just laying fish at our feet."

– B. Spurlock, Gainesville, Fla.

Pro, Straight to Your Inbox

All the important news from *Pro* gets delivered directly to you via email. Here's what to expect in your inbox:

"Make the Trade" emails: We announce all of our trades *before* we pull the trigger so you can get in before we do. We send these alerts during normal market hours. If it's a brand new stock or ETF, you'll get access to our full buy report, too.

"Trade Complete" emails: On the day we make our actual trade, we'll notify you soon after market close (4 p.m. ET) with an email that includes all the transaction details.

Monday Memos: Stay on top of *Pro* happenings — every Monday at 4 p.m. ET, we'll send you stock news, market insights, and trade ideas. It's your Monday must-read!

Guides, Audio Extras, special updates: Become a better investor! Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio.

Get to Know the *Pro* Site

Watch Our Site Walk-Through

Though you'll probably start at Home, the *Pro* site has four main areas that we'd like to call attention to:

- Portfolio: Find out how our stocks, ETFs, and options are performing, get transaction details, and see Buy First, Buy, Sell, and Hold guidance. Then track your own performance with My Scorecard.
- CAPShot: Get proprietary, in-depth reports on our holdings or enter a ticker into our tool to analyze any stock according to *Pro*'s 12 key criteria.
- Features: Here you'll find all our Memos, Audio Extras, guides, and other articles. We'll of course email you any time there's something new for you to read.
- Community: Our discussion boards are home to investors of all levels, from beginner to expert. *Pro* Fools come here to talk stocks, share advice, and have fun.

What's Next?

Now that you know us, help us get to know you! We have a vibrant community at *Pro*, so don't be shy — come introduce yourself on our discussion boards. Let us know where you're from and how long you've been investing, ask a question, or just say hello. (New to the boards? Watch our how-to video on *Pro*'s community page!)

We can't wait to hear from you and welcome you to the *Pro* community!

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Step 6: Become an Options Pro

Published Jun 15, 2009 at 12:00AM

Part of our **Profit With *Pro* in 7 Steps** series. Return to start page

Our Members Say ...

"With the help of *Pro*, I stopped the bleeding and reversed the flow. With options added in with stock purchases, I have made close to 30% since I signed up."

– Barry M. Buford, Ga.

You'll notice that a big part of what sets *Pro* apart from other Fool services is our use of options and short selling to improve returns. Whether the market is up, down, or flat, we have strategies that will help you generate profits — and hedge your *Pro* positions, too.

That doesn't mean we're option "traders." Our use of options is tied to a Foolish understanding of the underlying holding, and our approach is valuation based. We thoroughly analyze and value businesses first and foremost before determining the best options strategy to take. Ready to add options to your investing toolbox? Let's get started!

Print Our Options Guide: It's easy on the eyes! Learn options basics the *Pro* way with our printer-friendly version of Options 101, 201, and 301.

Choosing a Broker

Our members say Scottrade, TD Ameritrade, ThinkorSwim, OptionsXpress, Schwab, and Interactive Brokers are all good choices. Some discount brokers have stricter options permission policies, and IRA policies differ, so just take a minute to dig a little and find the broker that's right for you.

Get Your Account Approved

If you want to trade options along with *Pro*, first you'll need to get approval from your brokerage. It's easy!

1. Ask your broker for full options approval, typically level 2 or 3 (it can vary by broker).

2. Fill out, sign, and mail in a simple one-page document.

3. After a week or two, you'll be approved!

Slide on over to our All About Options board if you have any questions.

Pro Video: Options in 3 Steps

As a bonus, we've put together a short video for you to help kick off your options experience. Watch as *Pro*'s own Jeff Fischer and Todd Wenning explain the basics of options trading, show you how to apply for approval, and even walk you through an online options trade step by step:

What's Next?

While you wait for approval, read those options guides (a printer-friendly bundle of Options 101, 201, and 301 can be found here) and become familiar with calls and puts. Then, come chat about what you've learned on our All About Options board.

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Profit With Pro in 7 Steps

Published Jun 15, 2009 at 12:00AM

Now that you're a full-fledged member of *Motley Fool Pro*, it's time to start making money. The best way to be successful with *Pro* is to invest alongside us as we build a winning portfolio of long-term stock holdings, ETFs, and options.

Our **Profit With *Pro* in 7 Steps** plan is designed to help you begin investing with us at your own pace — though we recommend mastering one step a week. To keep you moving, we'll send you a gentle reminder and bonus tip in each of our upcoming Monday Memos.

Ready? Let's get started!

Print it! For a printer-friendly version of our 7-step plan, click here.

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Step 4: Diversify With ETFs

Published Jun 15, 2009 at 12:00AM

Part of our **Profit With *Pro* in 7 Steps** series. Return to start page

Using CAPS to Dig Deeper

To find top ETFs on CAPS, just select the ETF tag and sort by rating. Or go to the CAPS screener and follow these steps:

1. For sector, select "Financial."
2. For industry, select "Financial Services."
3. For market cap, select "Mid Cap."
4. Under CAPS Rating, select "Rated Between 4 Stars and 5 Stars."

5. Click on "Search Now."

About 15% of *Pro*'s holdings will be exchange-traded funds, or ETFs — portfolios of stocks, bonds, commodities, or currencies united by a specific focus. Streamlined and cheap, ETFs are the ultimate investment tool when it comes to diversification, flexibility, and hedging.

Pro mainly focuses on long ETFs, but we'll short sectors we think are mispriced. Now it's your turn to take advantage of rising or falling global trends along with us by adding an ETF or two to your portfolio!

Here are *Pro*'s current ETF selections:

- **ProShares Short SmallCap600** (NYSE: SBB): In the course of just two months, the S&P SmallCap index has jumped 50% on what we consider to be weak or unsubstantiated economic data. Short the index with this ETF.
- **Vanguard Emerging Markets** (NYSE: VWO): We believe emerging markets are poised to grow much more robustly than developed markets, and this ETF allows us to profit from that trend.
- **Vanguard Energy** (NYSE: VDE): The sharp decline in oil and natural gas prices over the past six months has created a window of opportunity for long-term investors.

You'll also see **iShares Silver Trust** (NYSE: SLV) listed on our portfolio page; this is part of a covered call strategy (more on that later), so we don't recommend buying it outright.

What's Next?

Now that you're familiar with ETFs, it's time to dive in and diversify! Start with any of our ETFs labeled Buy First, then add our Buys. Questions or comments about ETFs? Visit our ETF Center board!

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Step 3: Let Us Know How You're Doing

Published Jun 15, 2009 at 12:00AM

Part of our **Profit With *Pro* in 7 Steps** series. Return to start page

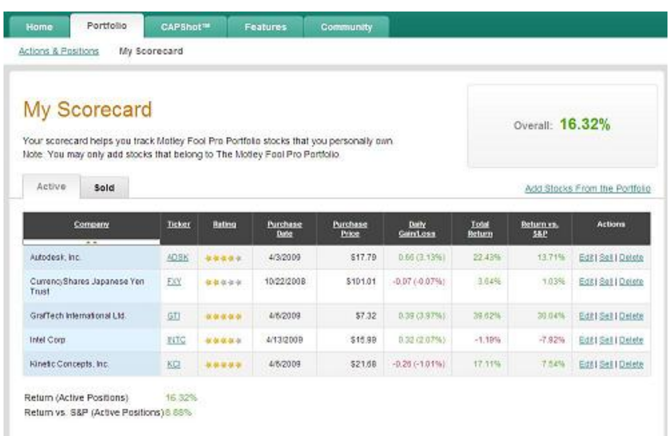
Congratulations, Fool! Now that you've invested with *Pro*, you've taken your first big step toward building a diverse, well-balanced portfolio.

Next, track the performance of your *Pro* holdings (options support coming soon!) with My Scorecard, a new Fool's tool that allows you to see your stock returns on a single page.

It's a snap to start tracking — just follow these steps:

1. From our portfolio page, find the stock or ETF you've purchased and select "Add" in the "I Own This Stock" column.
2. Enter your purchase date and purchase price, then select "Save."

That's it! You're all set to begin watching your *Pro* portfolio's progress.



What's Next?

Now you're ready to see how your *Pro* portfolio is performing — and you'll be letting us know how you're doing, too. Keep adding new stocks and ETFs as you make more purchases with us.

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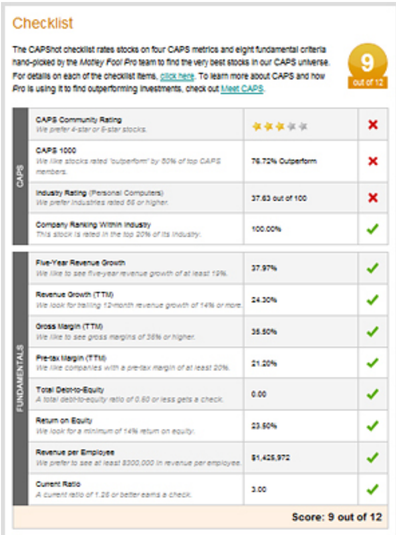
Step 5: Rate Your Portfolio

Published Jun 15, 2009 at 12:00AM

Part of our **Profit With *Pro* in 7 Steps** series. [Return to start page]

As a member of *Pro*, you have access to our proprietary CAPShot Report, designed to identify the strongest stocks in the CAPS universe — those with leading growth rates, strong margins, and healthy financials.

At *Pro*, we use the CAPShot as an additional screening tool to make sure only top-notch holdings make it into our — and your — portfolio.



The CAPShot checklist rates stocks on four CAPS criteria (CAPS community rating, CAPS 1000, industry rating, and company ranking within industry) and eight of our own hand-picked fundamental criteria (5-year revenue growth, trailing 12-month revenue growth, gross margin, pre-tax margin, total debt to equity, return on equity, revenue per employee, and current ratio). [Learn more here].

What's Next?

Now that you're familiar with the CAPShot, run your holdings through the tool and let us know how *you* score on the [Stocks That Interest You board]!

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Monday Memo: Watching What's Driving the Market

Published Jun 15, 2009 at 12:00AM

While we're gearing up for a busy week at *Pro*, the S&P 500 isn't exactly sleeping, either. The index's 38% bounce since March has been impressive, but much of the gain has been driven by cyclical stocks — companies that are highly reliant on the ebb and flow of the economy, including commodity-based industries such as steel, oil, and basic materials, as well as machinery and construction.

On the one hand, it makes sense that these stocks have bounced first. They were punished most severely in the downturn, so they have the most ground to regain. Defensive stocks that are less reliant on a healthy economy — including food packagers, consumer staples, and health care — have less to gain from a recovery because these businesses slackened less to begin with.

On the other hand, these gains seem to have gotten, well, out of hand. According to AXA Investments (and quoted in [Bloomberg]), at current prices, basic resource and machinery stocks are trading at 1.3 times the average valuation of traditional defensive stocks — that's a 30% premium. Characterized by less-stable profits, cyclicals usually trade at a 10% *discount* to defensive stocks, so these valuations are rare.

At *Pro*, our decision to buy cyclical stocks before they regained popularity has given our portfolio a nice boost. We invested early and often in hard-hit companies like GrafTech (steel), **Cameco** ([NYSE: CCJ]) (uranium), and **Flowserve** ([NYSE: FLS]) (industrial fittings) — and as we expected, they bounced back first as recession fears eased. While Cameco is currently on Hold, GrafTech and Flowserve remain Buys at *Pro* despite their run-ups: These are attractive businesses, and they provide good hedges against inflation and a weakening dollar.

But as the market shifts, so do opportunities. We now see more value in defensive industries such as health care, software, insurance providers, and international consumer staples. Expect to see more of *Pro*'s attention focused on these areas. As slow starts in **AmTrust Financial Services** ([Nasdaq: AFSI]) and Jack Henry & Associates may attest, this isn't the hottest area of the market right now — but we're willing to be patient. Stay tuned as we keep working to find the best new ways to position ourselves for more gains.

The *Pro*[community boards] are consistently one of our favorite daily stops. Here are just a few examples of why we're hooked:

- Our new [Getting Started board] is for any question you have about starting any aspect of your investing with *Pro*. Even if you've been with us since the beginning, you may periodically have questions for this board.
- **johnnyvol** explores the common conundrum of [leaving money on the table].
- **Smorgasbord1** started an excellent discussion on [solar technology stocks].
- **intellivestor** has his [eye on IPOs] — and so does *Pro*.
- **dentilfooling** wonders which is best, [writing options that expire soon] or that expire in a several months?
- I posted about [possible put writing] on **Procter & Gamble** ([NYSE: PG]).
- Finally, **TMFEldrehad** (Russell) [explores a hot topic] of late: Is buy and hold investing dead? See what CAPS All-Stars are thinking.

We'll be making more trades soon. Meanwhile, stay Foolish, and ask any questions on the [Memo board]!

Jeff Fischer (**TMFFischer** on the boards)

Jeff owns shares of AmTrust Financial and Nasdaq OMX Group; Todd owns shares of Kinetic Concepts and Procter & Gamble.

Step 2: Invest With Pro

Published Jun 15, 2009 at 12:00AM

Part of our **Profit With *Pro* in 7 Steps** series. Return to start page

Finding Top Stocks

Jeff Fischer and his team diligently screen every stock that lands in the *Pro* portfolio. For the seven qualities Jeff looks for in a top-notch stock, see our Guide to Finding Great Stocks.

The best way to succeed with *Pro* is to invest alongside us. We do the heavy lifting for you, spending hours researching and vetting every investing recommendation and delivering it to you in easy-to-use buy reports.

What's more, since we're ultimately building a portfolio of long-term, core holdings, you don't have to make use of options in order to be a successful *Pro* investor. Fools solely following along with our long stock and ETF positions are building winning portfolios as well. Now let's start building yours!

Stocks the Pros Recommend

Make *Pro* Work for You

- Already fully invested or adding new cash?
- Using an IRA or have "only" 5 or 6 figures to invest?
- Don't want to use options?

No problem! Learn how to make *Pro* work for you and your needs.

Ready to dive in and begin investing with us? Great! (Hey options experts — you can fast forward to Step 7 now.)

To see all of our holdings, just pop on over to *Pro*'s portfolio page. The team's current favorites are labeled Buy First in our portfolio's "What To Do" column.

Start with any of our Buy First stocks or ETFs and then add our Buys.

Don't feel rushed, especially in this volatile market. Space your buys over a few weeks and slowly build positions incrementally.

Finally, pay special attention to our preferred buy prices, which you can get in each holding's detailed report — just click on a ticker, then select "What We Think."

Our Buy Firsts

Quick Stock Tip

You haven't missed the boat just because a stock has gone up since *Pro* bought shares. We believe all of our holdings are buys at current prices. If a stock is no longer a worthwhile opportunity, we'll put it on Hold and direct you to the best alternatives for new money.

As of June 15, 2009

- **AmTrust Financial Services** (Nasdaq: AFSI)
- **Jack Henry & Associates** (Nasdaq: JKHY)
- **Kinetic Concepts** (NYSE: KCI)
- **Vanguard Emerging Markets** (NYSE: VWO)

AmTrust, Jack Henry, and Kinetic Concepts all have strong, recurring revenue and are trading at a discount. Vanguard Emerging Markets is a great way for diversified investors to average into international stocks.

Fools looking to profit with *Pro* today need look no further than our Buy First stocks. Still, we understand that buying four stocks at once may not be for you, so don't feel like you need to match our positions in all of our Buy Firsts at once. Patience is a good thing! Build your portfolio slowly and deliberately and make each selection count.

What's Next?

Put it all together: As a stock holder, you're a part owner in a company — and that can be both rewarding and fun. Come share your progress toward building your portfolio with the *Pro* community on our Meet & Greet board.

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Let the Profiting Begin!

Published Jun 15, 2009 at 12:00AM

Congratulations, Fool! You've completed *Pro*'s 7-step plan. Return to start page

You should now feel well-versed in how to use all the *Pro* tools at your disposal — from our team of talented investors working tirelessly to identify only the best holdings for your portfolio, to our members-only website, to our vibrant community discussion boards. It's all here for you.

Now, it's time to let us do the work. You can follow along as we build a diversified *Pro* portfolio, telling you what to buy and when along the way.

We look forward to years of investing and profiting together, and as always we're willing and happy to answer any questions you may have — check out our Getting Started board today.

Fool on!

David Gardner, Jeff Fischer, and the entire *Pro* team

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Write Puts on Tupperware Brands

Published Jun 11, 2009 at 12:00AM

At a Glance

- **Target allocation:** 4%
- **Price when we released our original intent (6/11/09):** $26.40
- **Estimated fair value:** $50
- **Preferred buy price:** Up to $40
- **Type of holding:** Non-core; Discretionary consumer; Good for option income

The Big Picture

June 11, 2009

What's a piece of nostalgia worth to you? We're not talking your typical pet rock or hula hoop. This is an investment poised to benefit from shifting global trends, including how people shop for food, how they spend, and even how they eat. Toss in a reasonable valuation, decades-old competitive advantages, and fresh pasta salad for at least three days — and what do you have? Yes, we're talking about **Tupperware Brands** (NYSE: TUP). But this isn't your mother's Tupperware.

A seminal icon of '50s Americana, today the business earns most of its revenue overseas. Although its famous plastic containers are still the star of the show, Tupperware recently expanded into beauty and personal-care products, and overall the company is nicely profitable: In its fiscal 2009, gross margins topped 65% and net profit margin was a healthy 7% (the average profit margin across all businesses is 5%). A 5-star stock on CAPS, Tupperware trades at a cheaper-than-average price-to-earnings ratio of 11 and 13 times the year's free cash flow estimates, while paying an above-average dividend yield. At today's price, the shares appear to have good downside protection.

What's more, Tupperware is one of those well-positioned companies we love at *Motley Fool Pro*: It's weathering this downturn (even growing, when you strip out currency exchange rates) and is positioned to earn stronger results in better times, too. Although it's a consumer discretionary company, its storage containers aren't found in stores — rather, a direct sales force of a few million is on the front lines and growing as the unemployed look for nontraditional jobs. And while the share price is relatively volatile, with a beta of 1.65, that means the options pay well — making Tupperware a good candidate for writing puts and (if we get shares) covered calls.

Our Take

"No woman wakes up in the morning and says in her first hour, 'Geez, I've got to have some Tupperware.'" So says CEO and Chairman Rick Goings — and he's got a point. After all, burping bowls (so called because of the noise their lids make) are certainly not essential or repeat-purchase products. Yet even in this downturn, compelling big-picture arguments make Tupperware an appetizing opportunity:

- To save money, more people are cooking in batches and storing meals for later.
- Many people in emerging countries are starting to store food for the first time. Such economies account for about half of sales and are growing much faster than the U.S. economy.
- The Tupperware direct-sales army is now 2.3 million people strong and spans 100 countries — and it's still growing. It's also attracting superior talent as the rising ranks of the unemployed strike out on their own.
- The parties rage on: In 2008, there were 3 million more Tupperware parties than in 2007, and the average attendee spends less than $20 — a cost easily justified even in a recession.

Put it all together, and you've got a healthy business with positive catalysts that will help keep Tupperware fresh even if the economy stays sour.

Tupperware Everywhere

The company has five divisions (no points for creativity here): Tupperware Europe, Tupperware Asia Pacific, Tupperware North America, Beauty North America, and Beauty Other. Based on recent annual results, Tupperware products made up 65% of sales and 78% of profits, with beauty products making up the remaining 35% and 22%, respectively. Tupperware Europe, which includes the Middle East and Africa, is the company's biggest division, representing 35% of sales and 44% of profits. By contrast, Tupperware North America makes up just 14% of sales and 10% of profits. (We hereby urge North American readers to host a Tupperware party at their earliest convenience!) Meanwhile, emerging markets such as Russia, Indonesia, Brazil, and Venezuela are showing strong sales growth — 10% in Tupperware's fiscal first quarter.

Because 65% of Tupperware's business is generated outside of North America, foreign exchange rates have weakened the company's results due to the strong dollar earlier this year. In the first quarter of 2009, sales in local currencies grew 1%, yet when translated back into U.S. dollars, sales *decreased* 16%. This can cut both ways, of course. Since early March, the dollar has weakened against most major currencies, providing some relief. If this trend continues, Tupperware's reported sales figures are likely to increase sharply.

Meanwhile, CEO Goings — at the helm since October 1997 and with the company since 1992 — is an eccentric enthusiast for Tupperware. On conference calls, he comes across as part CEO, part motivational speaker for his sales teams and part globetrotter for the company — a plus in our book.

A Plastic Empire

Tupperware benefits from two primary competitive advantages: its brand and its sales model. The brand name is so strong that it's actually what's called a genericized trademark — that is, "Tupperware" is synonymous with the class of products it makes (think Kleenex, Q-Tip, Band-Aid — even Google). Tupperware is considered the benchmark of high-quality storage containers: It even backs its copious catalog of products with lifetime guarantees.

Out in the field, Tupperware's sales force is a highly trained, dedicated group mostly consisting of women. Many report feeling empowered and liberated by their self-determined career path — and these millions of saleswomen can earn impressive compensation, too.

The Community's Take

Tupperware earns a perfect 5 stars on CAPS. As of June 9, a hefty 85 of 87 (98%) All-Stars ranked the stock an outperform, and among all CAPS participants, 260 of 273 (95%) rate the stock an outperform. The stock's composite CAPS score is 89, nearly placing it among the top 10% of all stocks rated, while it rates in the top 4% of all stocks in its industry.

On our proprietary CAPShot Report, Tupperware is a soggy sandwich, only earning 6 out of 12 points. Why? Like many stocks at the moment, Tupperware comes up short on our aggressive five-year and annual revenue growth hurdles. It's also light on our very aggressive net-profit-margin hurdle. Ideally, we'd like Tupperware to rate higher on CAPShot, but we're comfortable with the reasons it rates a 6 — especially because we're approaching it with an options strategy.

Cupboard of Challenges

As iconic as the brand may be, Tupperware's core plastic-storage container business faces constant generic competition. With people trading down all over the world, consumers may eschew Tupperware parties for a visit to their local **Wal-Mart** (NYSE: WMT) and its many cheap offerings, including Ziploc, Glad, and **Newell Rubbermaid** (NYSE: NWL) brand containers. In its beauty and personal-care division — forged via acquisitions in 2000 and 2005 — the company houses seven brands, including Avroy Shlain, BeautiControl, Fuller, NaturCare, Nutrimetics, and Nuvo. Here, Tupperware faces significant competition from the much larger, similarly modeled **Avon Products** (NYSE: AVP). Avon is the world's largest direct seller, marketing to women in more than 100 countries with a sales force topping 5.8 million.

Meanwhile, Germany — one of Tupperware's biggest markets — has seen its economy shrink faster than a cheap plastic container in a dishwasher. The U.S. market is facing challenges, too. In fact, Tupperware's established markets as a group were down 7% in Q1 2009.

Despite these challenges, we believe Tupperware will continue to produce steady, sustainable results — and grow. Emerging markets still present a large and expanding opportunity, and the U.S. market should at least remain stable and ultimately grow again. Time and again, at least in our households, Tupperware products ultimately outdo the generic competition in terms of design and durability. (Plus, they can be safely put in the dishwasher, keeping the housework-allergic among us very happy.) Finally, Tupperware's containers may seem to last forever, but they're often lost (left at a picnic or friend's house) or need to be replaced after a few years (those spaghetti sauce stains are hard to get out!). Tongue only slight in cheek, you might be able to sum up modern day kitchen life in just one sentence: People always need more Tupperware.

Valuation and Financials

With shares around $26, Tupperware sports a market cap of $1.6 billion, making it a smallish mid cap. It has net debt of a reasonable $490 million, bringing its enterprise value (market cap plus debt, minus cash) to around $2.1 billion. In 2008, sales were $2.16 billion, so the company doesn't trade at a premium to sales. Gross margin was an impressive 65% and operating margin 11%. All of this translated to a net profit of $161 million, or $2.56 earnings per diluted share, last year. Tupperware is absolutely committed to its dividend, paying $0.88 per share in 2008. (However, it has not increased in more than a decade.)

Tupperware expects full-year 2009 sales to increase in local currency (measured in every country where sales occur) by 2% to 5% over 2008 levels. When translated into U.S. dollars, the forecast calls for reported sales falling by 8% to 11%. Diluted earnings per share is expected to be $2.16 to $2.26, down from $2.56 in 2008.

Wait, you're probably thinking — you said Tupperware is growing! Well, excluding one-time charges, 2009 would represent an earnings increase over the prior year of 3% to 8% in local currency. Tupperware therefore trades at a modest P/E of around 11 times this year's expectations, and 13 times this year's estimated free cash flow (it's currently at 16 times slightly depressed free cash flow for the past 12 months). Our potential buy price via puts is $22.85, or 11 times estimated free cash flow for 2009 and 10 times estimated 2009 earnings per share — conservative prices.

In a better market and a stabilizing economy, Tupperware would likely see margin expansion (investors willing to pay a higher valuation multiple); the historical market average P/E of 14 to 15 would price shares above $30. At the upper end, $35 per share would put the stock at 14.5 times the 2010 consensus earnings estimates — which appear reasonable — of $2.40 per share. Our discounted cash flow model, though, with a high discount hurdle of 12% factoring in inflation and currency risk, values shares up to $30. Given the competitive nature of Tupperware's low-tech business, we favor our conservative valuation. Therefore, we're beginning with an options strategy to potentially buy shares lower.

Put-Writing Specifics

We write ("sell to open") put options when we'd be happy to buy a stock cheaper, but will be happy to earn income if we don't get the shares. With options expiring in four months or longer, we want the puts to pay us at least 7% to 10% of our strike price (that's our effective yield). Bidding $2.15, the October $25 puts currently pay more than 8% and expire in just over four months. Netting us a potential buy price of $22.85, the stock is currently 14% above our break-even price. Both figures meet our guidelines in Options 301. Remember, each option contract represents 100 shares of the stock, and you must be ready buy the stock anytime it falls below your strike price. Other options you could consider selling to open include July $25 puts and October $22.50 puts.

What Would Make Us Change Our Strategy

Excluding the effect of currency exchange rates, Tupperware is forecasting steady year-over-year growth. However, most of Tupperware's products (including its beauty division) are discretionary, so consumers may cut back more than management expects if the recession drags on. If sales began to drop on an absolute basis, we'd seriously question our big-picture reasons to own this stock or use options on it. We'll also be the party police, keeping a close eye on Tupperware's sales force and how its party numbers are holding up. These are absolutely key metrics for the business — and therefore leading indicators of potential problems.

Pro Bottom Line

Tupperware Brands is an easy-to-understand business with macro trends — emerging market growth, more consumers eating at home and packing lunches for work — in place to support its usual steady long-term results and promote international growth. The company has competitive advantages, demonstrated by its long history and the enduring (endearing, even) qualities of the Tupperware party. The stock is modestly valued, and with any luck we can use options on it — and potentially own it — for a long time to come. Questions? The party is over on Tupperware's new discussion board. We'll bring the chips and dip.

Monday Memo: Most Stocks Are Losers

Published Jun 8, 2009 at 12:00AM

Awake the Sleeping Options Giant!

We'll likely have more option trades soon as our puts on **Nasdaq OMX Group** (Nasdaq: NDAQ), **GrafTech International** (NYSE: GTI), and **Intel** (Nasdaq: INTC) all look set to expire as 100% cash gains one week from Friday. If we see a new trade we like, we may close these early to take advantage.

Are stocks a loser's bet?

This was the question posed in a recent *Money* magazine article. The facts: A study from Dimensional Fund Advisors looked at the University of Chicago's total equity market database and came to the conclusion that a mere 25% of the stocks in the U.S. market were responsible for *all* the gains from 1980 to 2008. While the U.S. market as a whole generated a 10.4% annualized return, take out these "superstocks" (*Money*'s term), and the remaining 75% of stocks actually generated an annualized *loss* of 2.1% over the past 29 years.

That's right: Three-quarters of U.S. stocks lost value. This actually makes sense — just look at your local strip mall: As the likes of **Wal-Mart** (NYSE: WMT), **Best Buy** (NYSE: BBY), and **Home Depot** (NYSE: HD) eat up real estate and market share, smaller businesses struggle just to maintain a foothold. Many simply disappear. Across all industries, that's the nature of a free-market economy (unless you get bailed out by Uncle Sam — but I digress).

What Does This Mean for Investors?

The study goes a long way in explaining why most investors and mutual fund managers fail to beat the averages. With three out of four stocks losing money, even a skillful stock selector faces formidable odds.

So what should you do? First, you need to buy truly strong and lasting businesses at reasonable prices. Our *Pro*stock criteria are designed to help us do just that — and let's not forget that the young and growing CAPS community is also identifying outperformers.

Second, as The Motley Fool has always espoused, some of your money should be in passive indexes. Index funds cast a wide enough net to catch a number of winners — and grow in value overall, just like the market. We've taken this approach with the **Vanguard Emerging Markets** (NYSE: VWO) and **Vanguard Energy** (NYSE: VDE) ETFs. The small-cap universe, where the winners win big but the losers are many, is another sector where an index may be our best strategy.

Third, strategies that go beyond stocks increase your potential for overall success. Options are great tools for producing your own returns and income, rather than merely relying on a stock to go up. And fixed-income investments become more important the closer you get to retirement.

In a market where a majority of stocks lose value over time, you can't simply cherry pick your way to winning returns. The odds are against you. But by recognizing superior stocks and adding indexes, fixed income, and options, we position ourselves to profit steadily over time — and achieve life's many financial goals along the way.

Around Pro: On the Boards

Here are a few of our favorite discussions on the *Pro* boards over the past seven days:

- Todd Wenning (**TMFPhila**) posted about the patience required for research when looking for our investments.
- **Randy8118** blasted off a discussion about the possibility of hyperinflation.
- Mike (**SilverHawk27**) generously posted his spreadsheet that runs option calculations.
- Finally, Russell Carpenter's (**TMFEldrehad**) latest This Week in CAPS post discusses reading between the lines when you're looking at CAPS data.

Have thoughts to share on the Memo? Click over to the Memo Musings board.

Fool on!

Jeff Fischer

Write Puts on Autodesk

Published Jun 5, 2009 at 12:00AM

If you don't own shares of Autodesk yet, you can still make a trade on this stock today. See "Alternate trades" below.

- **Action:** Write ("sell to open") July 2010 $24 covered calls on Autodesk
- **Allocation:** Write one call for every 100 shares of Autodesk owned (for *Pro*, 24 contracts)
- **Option's recent bid/ask (Feb. 3):** $2.05/$2.15
- **Preferred limit price:** $1.85 or higher, day order; if needed, no lower than $1.70
- **Recent stock price:** $23.70
- **Special requirement:** You must own at least 100 shares of Autodesk to write a covered call.
- **Alternate trades:**
  - **Don't own 100 shares of Autodesk?** Continue to hold your position.
  - **Don't own any shares of Autodesk?** The stock is on Hold, but you can write ("sell to open") puts to potentially buy shares at a lower price. The July 2010 $22 puts recently bid $1.45.

What's New

Autodesk sells its 3-D design software by the "seat" — one subscription per user — so weakened employment in construction, engineering, architecture, and technology means weaker sales for the company. Yet the stock is trading at a premium — and not because investors are still gaga over the role of Autodesk's software in the *Lord of the Rings* trilogy. Shares are priced at an aggressive 35 times depressed free cash flow and 22 times estimated earnings for the year ahead because investors project that Autodesk's high margins and free cash flow will return once the economy gains some real ground.

But so far, companies aren't hiring. Despite increased government stimulus in fields related to Autodesk, we'll likely need to wait at least a few more quarters before customer numbers start to improve. That means the dire jobs situation may continue to push Autodesk's recovery farther down the road. Although *Pro* has done well with

Autodesk, enjoying a nearly 50% profit in less than a year (we've had the stock on Hold since the summer), given the stock's valuation and the weak jobs picture, we want to hedge our gains with covered calls.

What's a Covered Call?

- Check out *Pro*'s guide to covered calls.

We write covered calls when we're ready and willing to sell a stock we own at a higher price (the strike price) by our options' expiration date. Or, if the stock doesn't rise to our strike price by expiration, we keep our shares, and may write covered calls again, generating more income.

Why This Strategy?

Based on the current malaise, Autodesk's complete rebound could take many more years — but by writing covered calls, we're paid while we wait, or we obtain a favorable sell price in much less time. Our fair value estimate of the stock is in the mid $20s to low $30s, but that assumes Autodesk recovers about three-fourths of its former glory (measured by sales and free cash flow). Instead of waiting for that rebound, we'd be happy to sell the stock in the mid $20s and take our profits, earning most of our gains in much less time *and* with less risk, since the calls provide a hedge.

Meanwhile, if our shares aren't called away, we cushion our downside. The July 2010 $24 calls on Autodesk will yield us 8.6% (at a recent $2.05 per share) on the recent share price of $23.70, or 12.5% on our average purchase price on the stock. By choosing calls that expire in less than six months and have a strike price modestly above Autodesk's current share price, we are paid well on an absolute basis and better protected if the stock declines. We could write April 2010 calls instead, but if Autodesk declines in the coming months, we'll enjoy a much lower absolute payment compared with the July calls. The July calls also provide us with a higher potential sell price — and more than a year-long holding period on all of our shares.

How to Follow Along

If you need a refresher on covered call strategies, please see *Pro*'s guide to covered calls before placing the trade. Remember, you write one call for every 100 shares of stock you own; and you may cover all of your shares, or just some. We're covering all of ours. Here are the numbers behind the trade:

- **Trade:** Write ("sell to open") one July 2010 $24 call for every 100 shares owned
- **Option yield (at recent $2.05 bid):** 8.6% of the $23.70 share price, in 5.5 months
- **Option yield on our $16.36 average cost basis:** 12.5%.
- **Upside from today if sold at a net $26.05 ($24 strike plus $2.05):** 9.9%
- **Total return on position if exercised:** 59.2%
- **Downside protection:** 8.6%; a decline to $21.65 is hedged

When you write ("sell") an option, the going price is paid into your account and the money is yours to keep. In this case, you're then obligated to sell shares of Autodesk if they're above the strike price by the expiration date.

Writing puts? If you place the alternate trade and write puts, you'll be obligated to buy shares of Autodesk around a net $20.55 if the stock declines.

We'll make this trade in the next one business to 30 calendar days. To discuss it or ask questions, please visit our Autodesk board.

Monday Memo: The Case of the Disappearing Analysts

Published Jun 1, 2009 at 12:00AM

See, analysts provide classes of investors with critical company information, stoke interest in a wide range of stocks, and consequently make the markets more *liquid*. That liquidity means increased trading, which tightens securities' bid-ask spreads, which in turn makes it easier to buy and sell stocks without drastically affecting the price. That's crucial — especially when it comes to small caps.

Smaller companies generally have less analyst coverage to begin with, but they're losing even more this year. According to the FactSet study, in the first five months of 2009, a whopping 25.7% of small-cap companies announced an instance of dropped analyst coverage. In 2007, that figure stood at just 6.4%. By contrast, larger companies have reported a 15.5% dropped coverage rate so far this year, but many still enjoy sufficient coverage from Wall Street.

What's more, the lack of information in the market makes it more costly for small caps to raise public money. This was the topic of a 2007 study demonstrating that companies without analyst coverage have substantially higher cost of equity (that's the minimum return that equity holders demand from their investment). The more capital costs a company, the greater the risks it will need to take to satisfy its investors — which can lead to more volatile results.

Still, there have always been some advantages to a lack of Wall Street coverage. Individual investors can beat the big boys to the punch on underfollowed stocks, digging up "hidden gems" — especially in the small-cap arena. This advantage still holds true, of course, but the further decline in analyst coverage means it could take even longer for the big money to recognize a small company's success story.

When it comes to *Pro*'s small-cap holdings, such as **AmTrust Financial Services** (Nasdaq: AFSI), we need to remain patient even if investors don't boost the shares on good news. As we explained in Thursday's intent to buy another 1.5%, although AmTrust reported a solid first quarter in early May, shares have lagged during the latest market rally. Perhaps that's because just three analysts — and all from smaller regional firms — cover the stock. But we still believe in the company, which continues to generate cash and has strong growth prospects in its niche insurance markets. It may take a little longer to reach our goals, but over the long term, lack of analyst coverage should only augment our profits.

Elsewhere, discussions with fellow *Pro* members ran the gamut on the boards last week. Some highlights:

- Jeff (**TMFFischer**) discusses the giant synthetic long order placed on **iShares Silver Trust** (NYSE: SLV) last week.
- Our Audio Extra with *Global Gains* co-advisor Tim Hanson stirred up a conversation about **The China Fund** (NYSE: CHN).
- **FlorisHJ** wonders if **Vanguard Emerging Markets** (NYSE: VWO) is still a Buy First recommendation after the rally in emerging market stocks.
- Inflation fears are growing, and the dollar is falling. How should a Pro hedge? Bruce Jackson (**TMFGoogly**) and Jeff offer some answers.
- Finally, Russell Carpenter (**TMFEldrehad**) shows how the CAPS community has been rightly bearish on**General Motors** (NYSE: GM) for more than three years — and how he learned about the impending housing and banking collapse from CAPS.

As always, to respond to the Memo, please visit our Memo Musings board.

Fool on!

Todd Wenning (**TMFPhila**)

Audio Extra: Spanning the Globe for Stocks

Published May 28, 2009 at 12:00AM

Think you have enough international exposure? Find out with our latest Audio Extra featuring Tim Hanson, advisor of The Motley Fool's *Global Gains* service. Jeff Fischer and Todd Wenning grill Tim on his favorite global investing opportunities today, including insight on the China consumer, African "stuff," and an under-the-radar country that's poised to bridge the gap between China and Brazil. Plus, get Tim's take on *Pro* Buy First holding **Vanguard Emerging Markets** (NYSE: VWO) as well as other ETFs and stocks that'll send your portfolio on a global voyage. Click on the player below to listen in!

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If you have thoughts on Tim's international take or want to weigh in on the **China Fund** (NYSE: CHN) or **Market Vectors Africa** (NYSE: AFK), please post on our ETF board!

The unedited transcript follows.

Jeff Fischer: Welcome to a new edition of *Motley Fool Pro* Audio Extra. I am Jeff Fischer. With me here is Todd Wenning.

Todd Wenning: Hey, Jeff.

Jeff Fischer: And we are glad to have with us special guest, Tim Hanson. Tim is the advisor to *Motley Fool Global Gains*.

Tim Hanson: How's it going, guys?

Jeff Fischer: Thank you for being with us here today, Tim.

Tim Hanson: Pleasure to be here; I admire *Pro*.

Jeff Fischer: Did you just; you flew in from China or Peru or ...

Tim Hanson: Actually we are hopefully heading out to China in July, so people should be on the lookout for the dispatches that will be coming back.

Jeff Fischer: Excellent. Tim, can you tell us what you do for *Motley Fool Global Gains* and how you invest?

Tim Hanson: Sure. We are a global newsletter, so we are basically looking for the best stocks we can find anywhere in the world, besides the United States. We think that should be a big part of everybody's portfolio. We like to think people should have somewhere 50% to 60% international exposure and basically we try to take a global perspective, very much in the tradition of John Templeton, which is to say using countries all over the world, we want to find the cheapest stocks, the best companies and then hopefully some sort of tailwind, some sort of macroeconomic tailwind that you are getting in, let's say China, that you won't necessarily get in Mexico or the United States.

Jeff Fischer: Now when you say 50% to 60%, can you give a little color on that?

Tim Hanson: Sounds aggressive, it sounds aggressive.

Jeff Fischer: It does.

Tim Hanson: Well, it is not as aggressive as it sounds, because you take an American blue chip like Microsoft (Nasdaq: MSFT); about 50% of its revenue is derived from foreign countries. So we would consider Microsoft to be about a 50% international global position. You can look at your portfolio holistically and you want to have some stuff focused on China or focused on Brazil, individual countries, but you also want a **Procter & Gamble** (NYSE: PG), I know you guys have in the *Pro* portfolio. I would consider that part; you can add that in to achieve your 50% international exposure.

Jeff Fischer: Excellent.

Todd Wenning: And Tim, we totally agree. You mentioned Procter & Gamble, but our most direct foray into the emerging markets so far has been the **Vanguard Emerging Markets** (NYSE: VWO) ETF.

Tim Hanson: Yes.

Todd Wenning: We really like that. It is diversified, but it is focused primarily, I think 28% or so in China and Brazil, two countries that we like.

Tim Hanson: Well it is a little deceiving I think on the China side because a lot of that exposure is in Taiwan and a lot of it is on the very large end of the market cap spectrum, so you are not really playing the Chinese consumer as much, which maybe we will get to talk a little bit about, but you are playing more that export part of the economy, which is really the part of the economy that is suffering the worst right now in China and I think as you guys build out that position or try to complement it, move down the market cap spectrum and go after the consumer in China or in Brazil.

Jeff Fischer: It's true. We started with large caps purposely ...

Tim Hanson: It's a good place to start; it's a good place to start.

Jeff Fischer: And we plan to make Vanguard, the Emerging Markets ETF, about 5% of the portfolio, so a fraction of our overall global exposure and as we see it, we need to move into smaller companies, mid cap, small caps, internationally because that is where all the growth is going to be.

Tim Hanson: Yeah, and funny to think about, a lot of these economies are much smaller than ours, so if you look at a place like Mexico, a large cap in Mexico is probably a four or five billion dollar market cap company, whereas a large cap here in the States, probably you don't get there until at least ten and maybe even 40 or 50. We have some hundred million dollar Chinese companies in the *Global Gains* portfolio and they look, to an American investor, extraordinarily speculative, but I think they are bigger in China than they would appear.

Todd Wenning: Tim, are there any names of stocks or ETFs or closed-end funds that you think are good complements?

Tim Hanson: Well I think in terms of increasing China exposure, one of the things about the Vanguard Emerging Market Stock ETF that makes me a little wary is it has more than 20% of its assets in financial companies.

Jeff Fischer: Yeah, we wrote about that as well.

Tim Hanson: Yeah, China just had a very aggressive loan program in the Q1, first quarter, to spur their economy and all those banks in China are state run and so it is unclear at this point who they were giving loans to. Probably to state-owned enterprises, SOEs, and if history holds, they are giving them at way too low interest rates in an effort to spur the economy, which means you might see some defaults down the line and the financial sector around the world, especially in the emerging markets, could suffer, but in terms of complementing that, there is a great closed-in fund called the **China Fund** (NYSE: CHN). The ticker is CHN and that I think is pretty close to what you are looking for because it has a lot of mid- and small-cap exposure. About 70% of its portfolio is mid to small and then it also has a lot of consumer exposure and health care exposure, which are both sectors in China we are pretty excited about at *Global Gains*.

Jeff Fischer: Tim, can you say what regions or countries are you most interested in at *Global Gains* right now?

Tim Hanson: I think everybody knows we like China. Like I said, we are going back there in July. It is a huge and fascinating country with a lot of opportunities going forward. In terms of sort of lesser-traveled countries, one that we are looking at right now is actually Peru and the reason we are looking at Peru is because Peru has two really nice big picture catalysts that we think it has going for it. The first is that it is very much a metals economy and a commodities economy. If you think those are going to rebound, I think I have seen some of the moves you guys have been making in *Pro* you sort of agree with that. That is an economy that should come around pretty fast. They also are doing pretty well today because they saved a lot of that revenue they got from the windfall profits they were making not too long ago so they can spend on some stimulus.

The second really interesting part is that it is sort of becoming the trading crossroads between China and Brazil, which I think are going to be real major economic players in the future and because the Pacific coast ports in Peru are where the ships come across and then in 2010 to 2011, they are going to complete this transcontinental highway that is going to run from the Pacific coast of Peru to the Atlantic coast of Brazil and all those countries have free trade agreements with China, so it could be a region to look for.

Jeff Fischer: So China, Brazil, Peru, we have been looking a little bit at Africa. What are your thoughts on Africa in general?

Tim Hanson: Well gosh; Africa is horribly oversold right now. I don't know if you guessed, looking at the currencies and things like that, obviously people consider it probably one of the riskiest places in the world.

Jeff Fischer: It has been that way a long time too.

Tim Hanson: It has been that way a long time too, but it is very much a stuff place. They have a lot of stuff and if anything looks like it is going to govern the world over the next decade, it is probably that people want stuff. That is food, oil, metals and those sorts of things, so I think there is potential in Africa, especially if you get outside South Africa, which is predominantly where most of the index funds are playing.

There is a great little fund that we have written about at *Global Gains* called the **Market Vectors Africa** (NYSE: AFK) ETF. The ticker on that is AFK and it has a lot of plays in Nigeria, some consumer plays like beverage companies. It has got some banks in Nigeria and some resource companies around Africa, so you guys might want to take a look at that if you are interested.

Jeff Fischer: Well thank you, Tim, for joining us today; we appreciate it.

Tim Hanson: Pleasure to be here.

Jeff Fischer: You can find Tim Hanson at *Motley Fool Global Gains*. We enjoyed the conversation today. For *Motley Fool Pro* members, we will continue to average into Vanguard Emerging Markets. It is a buy-first stock. We think it is a great core position to gain international exposure and we are also looking in other countries as well and it was very helpful to have Tim here with us. we are looking at Brazil, as we mentioned, Africa, Peru is a new one; hadn't thought about that and China, of course, as well is high on our radar as we grow our international exposure in the portfolio. So thank you everyone for listening. We will see you on the *Pro* boards. Fool on!

Monday Memo: Weighing Our Options; Autodesk Surges

Published May 26, 2009 at 12:00AM

In other portfolio news, engineering and design software leader **Autodesk** (Nasdaq: ADSK) pleasantly surprised us on Friday, as shares jumped 10% following quarterly results. Similar to **GrafTech International** (NYSE: GTI) last month, Autodesk reported a small profit and modest free cash flow, but results were stronger than expected.

Management said deceleration in the economy is slowing and may have bottomed in North America, but it doesn't see signs of an imminent recovery. Even so, as we expected, federal stimulus packages are goosing software sales for Autodesk as companies gear up to build and upgrade roads, bridges, airports, railroads, and federal buildings, both in the U.S. and abroad.

The company expects to cut $250 million in expenses this year, yet remain ready for the eventual economic recovery. Autodesk is winning bidding wars and expects a surge in license sales once the business environment starts to improve. The stock remains a Buy. For much more, please see my conference call notes on the Autodesk board.

What's on our minds here at *Pro*? Hot topics include Standard & Poor's downgrade of the U.K.'s economy from stable to negative — and what a possible downgrade to the U.S. would mean for its debt-raising prowess. Other news items flirting for investor attention include commercial real estate woes, more residential prime mortgages falling into foreclosure, and the continued elusiveness of credit. Even though consumer confidence is up, as Autodesk's management suggested (see above), signs of an imminent recovery are still lacking. We still like every stock we own in *Pro*, however, and are glad to have a small hedge with **ProShares Short SmallCap600** (NYSE: SBB).

Elsewhere, discussions with fellow *Pro* members ran the gamut on the boards last week. Some highlights:

- **Cabbie66** thinks the market's ascent is a dead cat bounce (sorry, cat lovers!), so asks about shorting stocks.
- Answering **TrojanFan**, I provide a few ways to use options on **iShares Silver Trust** (NYSE: SLV) at recent prices.
- **RafesUserName** asks, given its size, "Why buy**Procter & Gamble** (NYSE: PG)?" Where's the upside? Todd Wenning (**TMFPhila**) and others share thoughts.
- In a thread called Economic Slump 101, members discuss why a recovery may be long and slow.
- **Stamleo** starts a discussion on using options to protect recent gains.
- Here's an easy way to keep current on all *Pro* boards.
- Finally, Russell Carpenter (**TMFEldrehad**) lauds the valuable CAPS screener tool in his weekly CAPS Corner post.

The *Pro* team wishes Todd a happy birthday today! As always, to respond to the Memo, please visit our Memo Musings board.

Jeff Fischer (**TMFFischer**)

Video Extra: Options in 3 Steps

Published May 22, 2009 at 12:00AM

Greetings, Fools! We know many of you have yet to begin using *Motley Fool Pro*'s option strategies in your portfolio, and that's OK — our new Video Extra is here to help. Watch as *Pro*'s own Jeff Fischer explains the basics of options trading. Just click on the player below to begin!

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It's never too late to start using options to earn income, hedge, and land better buy and sell prices on stocks. *Pro* is steadily announcing new intents to trade so you can follow along with us, and as always, we're on the boards if you have any questions!

Buy GrafTech International

Published May 20, 2009 at 12:00AM

At a Glance

By increasing our target allocation to **GrafTech International** (NYSE: GTI) last week from 4% to 5%, we have another $10,000 (1% of the *Pro* portfolio) to put to work in this stock. We're doing so with a direct purchase.

Management has done a superb job during the worst industry upheaval in the company's history. In the first quarter, despite order flow from steel producers nearing a standstill, GrafTech still found ways to be profitable. As steel producers work through inventory, and orders for GrafTech's steel-producing electrodes start to resume (most likely later this year), profits should grow soundly. Meanwhile, shares still present value; we merely need to wait for steel demand to tick upward for this near-monopoly business to benefit.

With today's announcement, we'll be purchasing more GrafTech stock outright to increase our exposure to a more meaningful 3%. Meanwhile, when our June $7.50 puts expire (as income, most likely), we'll revisit our put-writing strategy to potentially buy our last 2% a bit more cheaply. The $7.50 puts currently don't pay much unless you go to December, so — depending where shares trade — next month we may consider the July or September $10 puts, which currently net a buy price of $9 to $8.50. If you have questions on a put strategy you might consider today, please post on the GrafTech board.

Buy Procter & Gamble

Published May 19, 2009 at 12:00AM

At a Glance

It isn't hard to see why **Procter & Gamble** (NYSE: PG) remains a core holding in the *Pro* portfolio. In the third quarter, the consumer products behemoth was able to grow organic sales 1% despite worldwide contraction in GDP. What's more, as margins expanded, core earnings per share grew 8% compared to last year and would have increased by "strong double digits" if not for currency fluctuations. P&G increased its dividend 10%, the 53rd year in a row that it upped its payout to shareholders; free cash flow in the quarter was a healthy $3.5 billion; and so far this fiscal year, management has repurchased $6.3 billion in stock, lowering the share count significantly even for a company this large.

We're also pleased with the company's persistent focus on building long-term value. It continues to innovate, enter new markets, and educate consumers on the value of its products. And although management is keeping a lid on expenses, it doesn't want to be *too* defensive during a recession; instead, P&G is positioning itself to emerge from the downturn even stronger.

The shares, meanwhile, remain at multi-year lows, trading at about 12 times earnings and free cash flow and yielding 3.4%. Although we can't predict when the recession will truly relent or when the U.S. dollar will lose some value (a great thing for P&G when it happens), we're happy to buy our last 1% at current prices. As long as the business performs, Procter & Gamble has a long-term home — and ideally, a profitable one — in the *Pro* portfolio.

Questions? Comments? Visit our Procter & Gamble discussion board.

Monday Memo: A Fresh Look at Options and CAPS

Published May 18, 2009 at 12:00AM

Of course, there are more option strategies that can come into play when you're writing covered calls and puts, such as writing in-the-money options when you're ready to transact on the underlying stock soon. *In the money* means the stock is already trading at a price where the option would automatically be exercised upon expiration. Suppose a stock is trading at $14, and you really want to buy it. You could write $16 puts, for example, that would net you a buy price of about $13.50 — lower than the current price — and you'd have a better chance of getting the shares than you would using a lower strike price. At long as the $14 stock stays below $16 before your option expires, you'll get to buy shares. We would generally only do this when we're strongly bullish on a stock.

When you're trying to sell something quickly, you can write in-the-money covered calls to net a higher sell price. Suppose you're ready to sell a $22 stock. You might write $20 covered calls to help insure a sale for your shares, and those calls might pay you $3, netting you a nice sell price of $23. We used near-the-money calls to sell our shares of **CurrencyShares Japanese Yen Trust** (NYSE: FXY) early this year.

A future *Pro* option guide will explain in-the-money option strategies with much more detail. For now, Todd is going to talk about using CAPS. Take it away, Todd!

CAPS and Other Spicy Burritos

Another valuable resource for finding new investing ideas in CAPS is to read Russell Carpenter's (**TMFEldrehad**) recurring This Week in CAPS series on the *Pro* boards. Each week, our resident CAPS master analyzes top players' picks, pulls apart data, and explores new investment strategies.

And in the fun and Foolish department, *Pro* member **RockenD** posted — while vacationing in Cabo — about the options he's writing. Sounds like the salsa is good down in Mexico!

With more than 130,000 Fools making more than 3 million ratings on 5,277 stocks, CAPS offers a veritable cornucopia of stock research ideas. All you need to know is how to slice and dice all that data to find what you want. That's easier said than done, of course, so I'm here to help get you on the right track, whether you're a CAPS newbie or an old pro.

A great place to start your research odyssey is the CAPS stock screener, which has four preset screens — Value, High Growth, Small Cap, and Dividend — that were created by some of the Fool's top advisors and analysts based on key criteria they look for in their favorite stocks.

The Small Cap screen, for example, looks for 4- and 5-star stocks with significant insider ownership, strong balance sheets, and better-than-average growth opportunities. When I ran the screen this morning, there were 25 results, including at-home health-care provider **Almost Family** (Nasdaq: AFAM) and packaged baked-goods company **Flowers Foods** (NYSE: FLO). In fact, this is the screen that first led me to research recent *Pro* portfolio addition **Jack Henry & Associates** (Nasdaq: JKHY) last fall.

Have you found an interesting stock idea using CAPS? Share your story with other members on the CAPS Corner board.

Thank you for being a *Pro* member! We hope to see you on the boards.

Jeff Fischer and Todd Wenning

Special Update: CCJ on Hold; New Buy Firsts, Allocations, and More

Published May 13, 2009 at 12:00AM

How do we differentiate between Buy First and Buy? If you're thinking Buy First is a shorter-term judgment call, you're generally right. We don't have a crystal ball, of course, but our Buy First stocks should currently present lower risk with attractive potential reward. This may simply mean we believe they're more undervalued than other positions, or that they won't decline as much in a weak market.

Our Buy Firsts as of today:

- **AmTrust Financial Services** (Nasdaq: AFSI)
- **Jack Henry & Associates** (Nasdaq: JKHY)
- **Kinetic Concepts** (NYSE: KCI)
- **Vanguard Emerging Markets** (NYSE: VWO)

AmTrust, Jack Henry, and Kinetic Concepts all have strong, recurring revenue, adding stability to their businesses; plus, they still look inexpensive on past 12-month results, not just on iffy future estimates (unlike many stocks). Vanguard Emerging Markets remains a Buy First because we believe diversified investors should continue to average into international stocks.

Moving from Buy First to Buy:

- **Autodesk** (Nasdaq: ADSK)
- **GrafTech International** (NYSE: GTI)
- **Plum Creek Timber** (NYSE: PCL)
- **Vanguard Energy** (NYSE: VDE)

When we put Autodesk and GrafTech on our Buy First list, they appeared significantly undervalued; after nearly 50% gains in both these stocks, the risk-to-reward equation has become less favorable. However, we still see plenty of promise in these stocks over the long haul even if they're not as cheap as they were a few months ago. Elsewhere, Plum Creek remains a key inflation hedge, but our estimated fair value is only 20% higher than current prices after a steady increase since March — which is why we've written covered calls and moved it to Buy. Oil has rebounded significantly, from $40 to $58 a barrel, so a Buy is ample for the Vanguard Energy ETF. All other holdings in the *Pro* portfolio (except one — more on that below) are also Buys — we believe in them as strongly as before. If you haven't already, we recommend averaging into these after you've matched our Buy First positions.

On Hold:

- **Cameco** (NYSE: CCJ)

We're pleased to see Cameco gain more than 50% in three months as uranium prices have ticked higher, and the company remains a world leader with a strong competitive moat. However, price matters to us. This $26 stock now trades in our fair value range, at about 25 times likely earnings this year, so we're placing it on Hold; this means we don't recommend buying shares if you haven't already. We've written covered calls to potentially sell some of our shares while still planning to keep about 40%. If you're not writing covered calls and would like to sell some profitable shares directly, we believe a partial sale makes sense at current levels.

The longer we own some of our earliest core holdings, the more we like and believe in them. Accordingly, we're increasing our target allocation on four favorites to 5%. We won't rush to invest additional funds, but we'll gradually average in — as always, sending you an intent to trade before each new buy — assuming prices remain attractive. We aren't obligated to reach these target allocations should prices get away from us — but we will try.

Stock	Old Target Allocation	New Target Allocation
GrafTech	4%	5%
Kinetic Concepts	4%	5%
Procter & Gamble (NYSE: PG)	4%	5%
Vanguard Emerging Markets	4%	5%

This does *not* mean fewer new ideas will enter the *Pro* portfolio (probably the contrary). It does mean our portfolio will be more focused — and focused investors tend to outperform. Plus, you ultimately pay less in commissions, benefit more from your gains, and get to know your investments better. Additionally, focused investors are more likely to sell a holding when it nears fair value because a fairly valued stock is occupying a coveted spot in the portfolio that could be better served by a new, undervalued stock. Being focused also makes it easier to trade more options on core holdings and sell partial positions for profits should we wish, while maintaining a meaningful stake.

Meanwhile, we have a long way to go as we build the *Pro* portfolio. Even if we fill these four positions to 5% each, we'll still be less than 50% invested.

Now for our last guidance tweak of the day: We've been listing "preferred buy price" and "acceptable buy price" atop our reports, but this feels like splitting hairs. To simplify (and improve!), we're only going to use preferred buy price in the future. By offering you our preferred buy price and our estimate of fair value, you have a clear picture of a stock's potential and where you should aim to buy it. Meanwhile, you'll know when the *Pro* team no longer believes a buy is attractive because we'll officially announce a move to Hold status, as we've done with Cameco. This is the most visible and direct way for us to tell you we no longer believe you should buy a stock, at current prices, in the *Pro* portfolio. Our portfolio page, with its Buy First, Buy, and Hold ratings, is your touchstone.

If you have any questions about today's changes, please visit us on our Member Suggestions & Help board.

Invest Foolishly!

Jeff Fischer (**TMFFischer**)

Buy ProShares Short SmallCap60

Published May 11, 2009 at 12:00AM

At a Glance

- **Special instructions:** Remember, we are *buying* this ETF — not shorting it. It is designed to move inverse to the underlying index it tracks. Also, this ETF is very thinly traded most days, so *you must use a limit order* at or slightly above the current ask price. If you don't get shares on day one, continue to use a limit order at or near the ETF's net asset value (NAV). You can find the closing NAV price on the ETF's website daily after market close.
- **Allocation:** Buying 2% of a target 3%
- **Price when we released our latest intent:** $50.39
- **Fair value:** N/A
- **NAV price (5/8/09 market close):** $50.26
- **Why buy:**
    - While concerns of an economic free fall have diminished, the underlying fundamentals of the market and the economy remain on shaky ground.
    - A two-month rally has sent the S&P SmallCap600 index up nearly 50% since early March and has consequently made the index look pricey on reasonable earnings estimates.
    - Short ETFs are an effective, low-cost option for hedging against down markets.
    - As with most shorts, this is anticipated to be a short-term holding, measured in months.

What's New

It's time to say hello to an old friend. Last December, we believed that following a post-election market rally, the fourth-quarter earnings season would be a bad one, likely sending stocks lower. We thought small caps were particularly vulnerable in that environment because they generally have less access to credit than their large-cap counterparts and would feel more pain from order cancellations and tough business conditions.

In the **ProShares Short SmallCap600** (NYSEMKT: SBB) exchange-traded fund, we found an investment vehicle to help us capitalize on our thesis. To review, this fund seeks daily investment results that correspond to the inverse of the daily performance of the S&P SmallCap600 index. In other words, if the S&P SmallCap600 is down 2% in a given day, this ETF will seek to be up 2%.

Over the three months following our December buy, the market indeed traded downward and reached a point of extreme pessimism in the first week of March. By the time we closed our Short SmallCap600 position on March 2, the S&P 500 had plunged 29% while our short ETF *gained* 22%, producing 51 percentage points of market outperformance.

In our sell report, we noted that "we may invest in Short SmallCap600 again later if the market begins an unsustainable or unsubstantiated rise." That may have turned out to be the case in nearly no time at all. In the course of just two months, the S&P SmallCap index has jumped 50% on what we consider to be weak or unsubstantiated economic data. Moreover, comments expressed by a number of management teams in first-quarter earnings calls lead us to believe that businesses remain concerned about the macroeconomic picture for this year and even into 2010.

The recent rally has once again assigned lofty valuations to this small-cap index. As of April 28, the S&P SmallCap600 traded with a trailing price-to-earnings ratio of 26 and a forward ratio of 21 based on what we consider to be very rosy 15% earnings-growth estimates for 2009. Incredibly, a number of highly speculative and unprofitable members of the index have more than tripled since March 2, including **Ruby Tuesday** (NYSE: RT), up 660%, **Stein Mart** (NASDAQ: SMRT), up 346%, and **DineEquity** (NYSE: DIN), up 307%. These types of gains are almost always unsustainable.

New Risks

The main risk we face in taking a short position now is a continued resurgence in market confidence. Even though we believe in our analysis, if the market at large only wants to see the worldwide recession becoming *less severe*, then stocks could continue to ascend. And in bull markets, valuation takes a back seat to excitement and hope, and short-sellers who are short based on valuation get clobbered. So if investors continue to send stocks higher, or economic data strengthens more than we expect, we'll look to cap our losses on this short position in the 15% to 20% range at most, as always with a short.

Foolish Bottom Line

Once again, we have an opportunity to profit from a potential market decline as well as hedge our increasing long positions using ProShares Short SmallCap600. To learn more about this ETF, please read our original report below.

We will make this trade in the next two business to 30 calendar days. To discuss this buy, please visit the ProShares Short SmallCap600 board. To review our general reasons for shorting, check out *Pro*'s Guide to Shorting. Please remember to use a limit order to buy these shares.

Monday Memo: Mr. Market's Merry-Go-Round

Published May 11, 2009 at 12:00AM

With all the market volatility we've seen so far this year, you'd think the S&P 500 was actually going somewhere. But the S&P started the year at 903, dipped as low as 676 on March 9 (down 25%), and has since rebounded about 33%, all the way back to ... the very same level where it began. That's right: No real change on the year; just a big fat Funyun.

In light of five months of incredible volatility, all merely to break even, we were compelled to check where the *Motley Fool Pro* portfolio stood on Jan. 1. We began the year just a smidge above $1 million, so our current balance above $1,060,000 puts us up more than 6% this year — and up about 20% on the cash we've invested — against a flat S&P. These returns, as we all know, are short term and could change in an instant; but so far, in these choppy waters, we're making progress. Even more important, we hear from many *Pro* members that you are doing better than we are. And not just over the short term — but that you're succeeding thanks to repeatable, long-term investing strategies, like writing options, that land you profits again and again. That's our ultimate objective.

Emotions in Motion

This market right now is moving on nothing more than emotions. Guess what? It almost always moves on emotions. — David Bach, author of *The Automatic Millionaire*

The market's volatility has set a series of traps for anyone acting on emotions. The drumbeat to go short banged loudest near the recent bottom at the end of February and into early March. As Todd wrote last week, according to some in the media, that was the "time for hysteria." Yet, if you'd sold your stocks then — or even worse, sold and gone short — you've suffered. Your emotions betrayed you, as they often will if you let them direct investment decisions.

Now, on the heels of an eight-week ascent that is one of the swiftest and steepest in stock market history, more and more analysts are now saying this rally is for real. Others are saying the buying is fueled by those *afraid* to miss gains.

We have two responses. First, you shouldn't invest for rallies. Strike that very word from your vocabulary unless you're starting a revolution or leading a union. Investing is a long-term, analytical, and disciplined endeavor, so thinking of it in terms of rallies is the wrong context. Second, fear is a horrible reason to invest. If *fear* is making you buy a stock, what would make you sell it? Greater fear, when it's falling.

Make Investing a Good Thing

Why not invest your assets in the companies you really like? As Mae West said, 'Too much of a good thing can be wonderful.' — Warren Buffett

The two quotes I've cited, from Bach and Buffett, seem to work together. The first presents a problem; the second provides a solution wrapped in a lesson. As long as the market is driven by investor emotion, it's going to be irrational, especially during uncertain times. The lows will be too low, the highs too high — and they'll come swiftly. One way to avoid falling prey to the emotions of the day, as Buffett so simply suggests, is to invest your assets in companies you *really like to own*. And, as the lesson implies, don't over diversify.

Rather than trying to own too many kinds of holdings or outmaneuver a volatile stock market, stay focused on companies you like to own and use an investment discipline that keeps you calm and happy.

At *Pro*, we will continue to:

- Average into investments that show us strong potential over the coming years.
- Use valuation as our guide in writing puts and covered calls.
- Consider reasonable hedges based on risk versus potential reward.
- Keep our emotions in check and focus on a long-term plan.

Around Pro: On the Boards

Last week on the boards, many *Pro* Fools asked if it's smart to sell winners; others lamented that the "gains train" has already left the station (we don't believe it has). Here are some interesting threads we answered:

- **Evan1974** asks about selling **GrafTech** (NYSE: GTI) after a 100% gain.
- **SPinSA** asks, "Is GrafTech still a buy at $9.50?"
- **dlbrundage**, who sports big gains in *Pro* stocks, asks, "Sell or hold?"
- **casspow** fears having missed the market train; we remind Fools to try not to anchor on March lows.
- **mdelalay** questions, "After a 55% gain, what do I do now?"
- **boilerup** takes a break from stock talk to ask the community, "What do you do?" (boilerup, it turns out, is a pilot.) Come share your own answer on the thread.
- Finally, **TMFEldrehad** talks about the role of sector rotation in his weekly CAPS analysis.

Invest Foolishly,

Jeff Fischer

Write Puts on Flowserve

Published May 9, 2009 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") July $70 puts (ticker +FLSSN)
- **Allocation:** 2% (for *Pro*, three contracts)
- **Option's recent bid/ask:** $5.10/$5.50
- **Initial limit price:** $5.10
- **Acceptable limit price if necessary:** $3 (4% of the strike price)
- **Alternate trade:** If you're not writing puts, consider a stock limit order for more shares near $65.
- **Why write puts:**
  - These puts would buy us more Flowserve shares at about $65.
  - We estimate fair value in the $80s, so we'd rather attempt to buy in the $60s than the current share price of $74.

What's New

The late John Lennon once sang, "Life is what happens to you while you're busy making other plans." The stock market has plans of its own, too, soaring over the past two months and taking many stocks we've been averaging into much higher. Rather than chase the market, our calmest strategy at the moment is to continue building positions in our selections at more favorable prices if we're able. Writing puts is the most obvious way to do so.

We recently began to average into **Flowserve** (NYSE: FLS), and the story has not changed meaningfully. First-quarter results were record-strong, but backlog during the quarter weakened more than 20% from a year ago. Management said orders began to increase in March, but we remain somewhat cautious since we have no confirmation that a bounce in orders means a new trend. This lack of confirmation remains true for the economy as a whole.

Put-Writing Specifics

The July $70 puts on Flowserve recently bid $5.10 per share, representing a 7.2% yield on the cash we'll maintain for this potential buy for the next 70 days (until July 18). The puts net us a purchase price of around $65 if we get shares. This is 12% below the current share price, easily imaginable for a stock this volatile. Our $70 strike price is 5% below the recent $74 stock.

If you have questions on this new trade, please visit the Flowserve board.

Audio Extra: Jeff, Todd, and Bruce on AFSI, NDAQ, and the Market

Published May 8, 2009 at 12:00AM

For this week's Audio Extra, we're thrilled to be joined in the studio by *Motley Fool Pro*'s analyst down under: Bruce Jackson, known to you as **TMFGoogly** on the boards. Listen in as Bruce chats with Jeff Fischer and Todd Wenning about the latest market zigzags and what the economy looks like in Australia these days. Plus, earnings news from **AmTrust Financial Services** (Nasdaq: AFSI) and **Nasdaq OMX Group** (Nasdaq: NDAQ).

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Questions? Comments? Come chat on our discussion boards.

The unedited transcript appears below.

Jeff Fischer: Welcome to a new edition of *Motley Fool Pro* Audio Extra. I am Jeff Fischer; with me here is Todd Wenning.

Todd Wenning: Hey, Jeff.

Jeff Fischer: And all the way from Australia, Bruce Jackson.

Bruce Jackson: G'day, Jeff. Good to be here.

Jeff Fischer: Thank you, Bruce. Now you know, you could have just phoned in or Skyped in or ...

Bruce Jackson: Well with the time difference, Jeff, it is so hard to sync everything up and I thought I would jump on a plane and be over here in person, so great to be here.

Jeff Fischer: Well it is good to see you. Bruce, Australia. Let's talk about it just really briefly. How does the world look from your perspective down under? How does the U.S. look?

Bruce Jackson: Well the U.S. looks pretty; it looks like it is struggling. We can see, we read in the press how the economy is struggling and comparing that to Australia, our market is down 50% from its peak as well. We are a commodity-based market so we have been hit by the same sort of things that the U.S. has been hit by. Lack of demand in the U.S., especially in the consumer segment eventually goes back to China and so China has really cut back their production. They need less commodities and so our stocks have been really pummeled as well.

Jeff Fischer: So it is truly a global economy now, for maybe the first time in modern history and so it makes sense; a recession becomes a global recession.

Bruce Jackson: It makes absolute sense, yeah.

Jeff Fischer: Well Bruce, Todd and I are here to talk about AmTrust earnings, Nasdaq OMX earnings and then the market in general, so let's start with AmTrust. I am surprised; they reported strong results early this week and the shares did not react at all. Even though book value was up, gross premiums written, another term for revenue was up strongly, operating earnings were up strongly, so the shares are still below ten and we are going to look to buy more shares to round out our position. Everything looks good on operational.

Bruce Jackson: I am surprised that the shares didn't react strongly, especially with the market going wild in the last few weeks as well, so they left a little bit behind, but ...

Jeff Fischer: Yeah, they have been very quiet.

Bruce Jackson: Well, that could play into our hands as we look to increase our position.

Jeff Fischer: And we just saw earnings from Nasdaq OMX, which were decent, above expectations, but the shares were down. What Nasdaq is facing exactly what we thought it might face, which is increased competition and some trading volume concerns. It has seen strong competition in the U.S. from the New York Stock Exchange, the BATS Exchange, Direct Edge and this results in lower trading revenue for the company.

Bruce Jackson: Yeah, we are obviously cautious about the trading volumes because of the state of the market, but then the competition is the real thing that we want to keep an eye on because they have got a strong competitive position and if that starts to be eaten away, then they are going to be struggling to increase earnings in the years ahead. They have relied on acquisitions in the past and probably overpaid in hindsight, as a lot of people have, and so we will certainly be keeping an eye on them.

Jeff Fischer: And lately you are right; the competition has been chewing away Nasdaq's profits. Since October, they have lost market share bit by bit, so what we are doing there, we have written $15 puts because if we are going to buy shares, we only want to get them bargain-basement price. That strategy probably will not change. Our current puts expire in June; they look safe to be cash in common and we will go from there.

Bruce Jackson: Absolutely.

Jeff Fischer: So now let's talk about this soaring market, the S&P 500, Todd, is up 35% or so since the March low?

Todd Wenning: That's right, Jeff, and there has been some really crazy rallies in individual stocks. I think **Ruby Tuesday** is up 700% in two months. So is **DineEquity**. They are up, I think, 300 or 400% and there is like...

Jeff Fischer: Why didn't we buy these?

Todd Wenning: These companies are...

Jeff Fischer: It is interesting. They are dog companies with weak balance sheets and one-star ratings on CAPS.

Todd Wenning: These were companies that were heavily shorted to, with the expectation they would go under and basically what has happened over the past two months is that they have been able to reconfigure their debt structure, reorganize a little bit and if proven that they are going to be going concerns, at least for a little while longer, which is why the stocks have really rallied.

Jeff Fischer: Interesting. The businesses still don't look attractive.

Todd Wenning: No, they are unprofitable.

Bruce Jackson: There has been a big dash for trash; the trash stocks have been leading this recovery.

Jeff Fischer: Yeah, the financial; everything that brought us down has now bounced. And so they fell 80%, financials in general and now they have since doubled, which means that they are still well, well below where they once were.

Bruce Jackson: And there are still a lot of headwinds as well; that is the main thing we have been looking at in *Pro*. There are still a lot of economic headwinds. The market has bounced substantially, but the economy hasn't bounced substantially. We are seeing; people were talking not so long ago about looking for green shoots of recovery; now it seems to be finding oak trees. All of a sudden it is a big turnaround from just two months ago, March the ninth when we had those lows.

Jeff Fischer: Right, things have slowed down; the slow down has slowed down, but it hasn't even stopped yet. We haven't even touched bottom yet and then once we finally do, it is going to be stability for a while, we will need to see before we eventually see growth.

Bruce Jackson: Yeah, and I think some of the valuations on the companies that we are seeing at the moment. Intel, we were talking this morning about Intel. They are on a forward P/E of 30 for the current year, falling to 20 next year. Now next year is a long way away in this economy and the P/E of 20 is highly prized.

Jeff Fischer: Right and that is based on a wild guess for what 2010 earnings may be.

Bruce Jackson: Well Intel, along with many others, are just not giving guidance at the moment. They still don't know where the economy is going.

Jeff Fischer: So what are we doing at *Pro* here in this market?

Todd Wenning: We are really staying patient. I think we have found; we still find good ideas like we did with Jack Henry, but the valuations on some of the companies that we had our eye on, like Tractor Supply, got away from us. We are just going to stay patient and wait for the right times to buy. We don't want to chase into this rally.

Jeff Fischer: I read in the *Los Angeles Times* the other day and a columnist wrote that first everyone was afraid of losing money and now everyone is afraid of missing a gain. And that is, by far, not the way we want to invest, not out of fear. We will just stick to our strategy of buying strong companies at good prices and averaging in over time.

Bruce Jackson: Absolutely. Fear and greed drive this market a lot of the time and certainly greed is winning at the moment, but we are very patient and we will wait for the right companies at the right prices.

Jeff Fischer: Well thank you guys; it has been a pleasure. Bruce, thank you for flying all the way in for this five-minute chat.

Bruce Jackson: You are welcome.

Jeff Fischer: Have a good trip back.

Bruce Jackson: Thank you.

Jeff Fischer: And thank you for listening and we look forward to seeing you on the *Pro* discussion boards. Fool on!

Making Pro Fit Your Profile

Published May 7, 2009 at 12:00AM

Way back in October 2008, the *Pro* portfolio began with a blank slate and $1 million cash. That cash sits in a non-retirement account in the Motley Fool name, separate from all other Fool money, and receives no additional injections of cash (other than the income we generate from *Pro*'s investments). And while we aim to reduce tax obligations where possible, we do not deduct taxes from the portfolio, and we don't let taxes dictate our investment decisions.

From the start, many *Pro* members have mirrored our moves as closely as possible, matching our percentage allocations, while others pick and choose their favorite *Pro* holdings. And that's great: We're building a diversified portfolio with energy stocks, technology and software, commodities, health care, international, and more — so our offerings are flexible enough that you can follow along according to what suits your profile best. After all, most Fools don't start with a blank slate and a million bucks in cash.

No matter how you're following along with us, many of you have had questions about how to make *Pro* fit your investing situation. Below we've gathered our best advice on common portfolio management issues to help you make the most of our service.

If you're already fully invested as you arrive at *Pro*:

- Don't sell everything you own at once. You own your stocks for a reason!
- Begin by reviewing your current holdings. Then, consider selling your least-favorite stocks to free up cash as you need it for new *Pro* trades.
- Gradually move freed-up cash into our Buy First stocks and then our Buy stocks.

- Consider your sector allocations and stay diversified as you add *Pro* buys.

If you're adding new cash over time:

- Averaging new money into stocks over time helps you achieve better returns. Do this if you can.
- Determine how much you plan to contribute over the next year and base your target allocations on *that* figure rather than on your current portfolio value. If you have $50,000 and expect new cash will grow it to $60,000 by year-end, keep that in mind as you allocate.
- Be mindful of commissions as you build your positions — ideally, you want commissions to cost less than 2% of any trade. A $20 commission for a $500 investment, for instance, would be 4% — that's not cost-effective. (This is much less true when writing options, where you simply want the cash you're paid to be worthwhile; commissions will typically be a larger part of your overall trade.)

If you're using an IRA:

- IRAs are tax-deferred accounts, so they're ideal for income-generating trades like covered calls, high-yielding dividend stocks, and any ETFs with large, taxable distributions.
- IRAs are *not* so great for more speculative trades because any losses generally cannot be used to reduce your taxes.
- Keep in mind that IRAs do not allow short selling or buying on margin, and will not allow more aggressive option strategies, such as writing puts on even modest margin.
- Consider opening a separate non-IRA account to take advantage of these *Pro* strategies. Then, manage this second account and your IRA together as *one* portfolio.

If you have "only" a 5- or 6-figure portfolio:

- Match our allocation percentage with your overall stock portfolio. For example, if we recommend a 4% buy that means a $40,000 investment for our $1 million, but it would be $4,000 for a $100,000 portfolio and $2,000 for a $50,000 portfolio.
- If your portfolio isn't large enough to keep up with all of our trades, don't worry! Pick among your favorite *Pro* ideas while being mindful of commissions and diversification.
- Look to write options mostly on our lower-priced stocks (below, say, $25 or so). And you can *buy* options whenever we do, as that's relatively inexpensive.
- Use *Pro* to help you grow your portfolio now — while learning strategies to use down the road as you build toward your own million (and beyond!).

If you want to reinvest dividends:

- If a *Pro* stock is rated a Buy or Buy First, reinvesting any dividend it pays into more shares is a good strategy to consider. Go ahead if you like.
- *Pro* is *not* reinvesting dividends simply because it's difficult for us to track. It results in partial shares, which also complicates option strategies on the stock. We take all dividends as cash and will invest them ourselves.

If you don't want to use options:

- That's OK — we're building an equity-based portfolio. Focus on buying *Pro* stocks in our preferred buy price range (stated at the top of each What We Think report) to give you the largest margin of safety. Use limit orders if you're waiting for a stock to decline first.
- Diversification helps reduce portfolio volatility, so make sure your *Pro* stocks keep your portfolio well-balanced along the lines of our allocation advice.

If you can't sell puts because of brokerage restrictions:

- Focus on buying stocks in our preferred buy price range to give you the largest margin of safety.
- Read up on our covered call strategy. This is another way to generate income from options and is allowed by most brokers and even in IRAs.

We don't expect every *Pro* member to start with our same $1 million cash and match us dollar for dollar -- though if that's you, congratulations! For the majority of you, it won't be difficult to develop a strategy to fit *Pro* to your existing portfolio, whatever its size. Follow our advice above, and if you have any questions, our *Pro* message boards are just a click away.

Monday Memo: Battle of the Bull Run

Published May 4, 2009 at 12:00AM

Much of that unforgiving pessimism we witnessed in early March has been traded for seemingly blind optimism today. Last Wednesday, for instance, it was reported that GDP fell 6.1% in the first quarter — a marginal improvement over the 6.3% drop in the previous quarter, but still far worse than the 4.7% expected by economists. Despite this bad news and mounting fears over swine flu, the market shrugged it off and closed the day up 2%. A day earlier, it was announced that the closely watched Case-Shiller home price index fell 18.6% year over year but stopped its 16-month streak of setting record declines. Once again, the market shrugged off the bad news.

A number of economists and analysts took these "less bad" reports and spun them in a positive light, noting that "the worst of the recession is behind us" and that the data point to "an end to the recession by late 2009." An economics professor at Northwestern even proclaimed, "The end of the tunnel may only be weeks away."

Weeks away? Two months ago, we were stocking up on potatoes and ammunition — now all of the sudden, we're Pollyanna. My, how quickly sentiment has shifted.

Pollyannas aside, there's simply more to the story here. One of the major reasons economists got excited about the latest GDP numbers was shrinking inventories, which they predict means businesses will need to increase orders, which would ramp up production at manufacturers. But let's not put the cart before the horse here. Inventories *always* appear bloated after an economic bubble bursts (think of the post-dot-com bust warehouse full of Pets.com mascots) and naturally slim down to meet the new economic reality. But until there's an increase in *real demand* for those products again, who's to say inventories won't remain low?

Bottom line, credit remains tight, unemployment continues to rise, and housing prices — while "less bad" — are still on shaky ground. In other words, we're no longer falling off a cliff; you might say we're rolling down a rocky hill. The rebound will happen, but it's definitely not weeks away. As investors, we need to be patient.

At *Pro*, we're pleased to see more green in our portfolio from the recent rally, and we're still finding undervalued companies worth buying at current prices — but we remain cautious. We continue to research new ways to hedge against a possible (if not probable) market sell-off. After all, it's our mission to find ways to profit no matter what the market does. We hope you're investing patiently along with us.

We had a number of earnings reports last week from companies in the *Pro* portfolio:

- **Procter & Gamble** (NYSE: PG) was operationally strong but couldn't overcome the sting of a stronger U.S. dollar. You can read my take on the quarter on the P&G board.
- It was a long winter for our favorite Saskatoon-based uranium producer **Cameco** (NYSE: CCJ), which reported light results according to Jeff and Bruce. Read their thoughts on the Cameco board.

- The market rewarded **Flowserve**'s (NYSE: FLS) quarterly results with a higher share price, but Jeff had some minor concerns about a decline in the company's new orders.
- Despite a struggling lumber market, **Plum Creek Timber** (NYSE: PCL) prudently allocated its capital resources and made a number of moves that I believe will increase long-term shareholder value.
- Graphite electrode-maker **GrafTech** (NYSE: GTI) played the little engine that could in a very weak quarter for steel demand and used its low-cost business model to turn a modest profit despite a plunge in sales. Jeff was dazzled by management's intellectual footwork and operational efficiency — you can read his thoughts here.
- Finally, congratulations to *Pro* member **trurl9** for his winning post in our "5 Covered Call Candidates" challenge. He'll be receiving an authentic Fool hat for his efforts!

As always, if you have any comments, come visit our Memo Musings board.

Fool on!

Todd Wenning (**TMFPhila**)

Audio Extra: The Pros on Flowserve, P&G, and GrafTech Earnings

Published May 1, 2009 at 12:00AM

Greetings, Fools!

Your latest installment of *Pro*'s Audio Extra features our take on hot-off-the-press earnings news from valve maker **Flowserve** (NYSE: FLS), consumer goods behemoth **Procter & Gamble** (NYSE: PG), and graphite electrode supplier **GrafTech International** (NYSE: GTI). How did these *Pro* holdings do in the past quarter — and what's our latest guidance for your new money? Find out as *Pro* team member Jill Ralph chats with Jeff Fischer and Todd Wenning — just click the player below to listen in!

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What do you think about the earnings news — and are you picking up shares (or writing puts) on any of these stocks? Let us know over on the *Pro* discussion boards:

- Chat about Flowserve
- Chat about Procter & Gamble
- Chat about GrafTech

Todd owns shares of Procter & Gamble.

Below is the complete unedited transcript.

Jill Ralph: Hi, I am Jill Ralph, part of your *Motley Fool Pro* team, and I am seated next to Jeff Fischer and Todd Wenning.

Jeff Fischer: Hey, Jill.

Todd Wenning: Hello.

Jill Ralph: And we are here with the latest rendition of *Pro* Audio Extra. A couple of our *Pro* holdings have reported earnings this week and we wanted to come and give you the *Pro* take.

We are going to kick things off with Flowserve. Jeff, for those of us who may not be familiar, let's just talk through. What does Flowserve actually do?

Jeff Fischer: They are one of the world's leading sellers of valves, pumps and seals. So whether you are moving gasoline or oil or water, you may be using Flowserve.

Jill Ralph: So we can all agree it is one of the sexier companies out there.

Jeff Fischer: I'd say top two.

Jill Ralph: So how were the earnings? They just came out today, yesterday.

Jeff Fischer: Good, record-strong first quarter. The stock reacted as you would expect on these strong results. It gained 5 to 10%, but we are a little more concerned about bookings, which are just another word for orders. They were down 30% in this quarter from a year ago and actually they were down 20% when you include currency adjustments, so let's say 20%, 25% overall. We expected only a single-digit drop in bookings more or less, 7, 8%, so we need to keep an eye on this.

However, on the good side, management said bookings improved in March and as March went on, so the first two months of the year were very weak, but they seen an improvement now and I think that is partly why the shares reacted so favorably.

Jill Ralph: So it was a mixed bag; there was some good, there was some bad. Clearly the market reacted well. Now for someone out there who owns this company or is thinking about adding some shares, what is the guidance?

Jeff Fischer: Across the board for the most part, there were strong results. Record margins, record results. We are just watching for 2010 numbers to be high as well, which is what these bookings will tell us. So to get to your question, overall the company is strong, it remains strong. We are glad that we have bought a little bit. We think in the sixties it is fair to continue to average in and if you can buy 100 shares or more, you have the ability to sell $65 or $60 price puts, which will get you shares into the fifties. So two good ways to approach the stock.

Jill Ralph: Great. And let's move on to our second company here. Todd, tell us, Procter & Gamble also came out with its latest earnings, also a mixed bag, all things good, all things bad? We hope that is not the case.

Todd Wenning: Well it was really a mixed bag. The last thing was out of Procter & Gamble's control. For example, for the quarter, organic sales were up 1% and diluted earnings per share should have been up double digits. However, and it is a big "however", since Procter & Gamble does 60% of its revenue sales outside of the United States, it is really suffering from the for-ex markets, the foreign exchange markets. So the U.S. dollar has strengthened tremendously over the past six months.

Now how does that affect Procter & Gamble? There are two ways. One way is when they make money in the local currency and they convert it back to dollars, it buys fewer dollars. The other thing is that commodity prices are mostly priced in dollars, so when they have to buy the commodities with the local currency in U.S. dollars, they can buy fewer commodities, so they have to raise their prices which hurts them in an already weak economy, so the foreign sales were hurt more.

Jill Ralph: So Procter & Gamble makes an array of things that we consider staples and perhaps maybe surprised that there has been a big dip in that market. Is it something that you guys see continuing?

Todd Wenning: I don't think there was a big dip in the staples so much; it was more in the discretionary area with fragrances and grooming where people are stretching their hair salon visits longer or…

Jeff Fischer: Todd, we wanted to talk to you about that.

Jill Ralph: I know; it's not looking good, Todd. You might want to go back in.

Todd Wenning: My beard is getting a little long here.

Jeff Fischer: The other thing is the currency effect, the negative currency effect. We don't foresee that continuing either. This record strong dollar, or very strong dollar anyway, is not likely to continue, so when it finally subsides a bit, it should benefit Procter & Gamble, and Flowserve, by the way, and many of our companies, considerably.

Jill Ralph: So let's get to the bottom line for *Pro* members who either again are thinking about buying Procter & Gamble or already have a position. What is the take-away?

Todd Wenning: Well now is a great time to buy Procter & Gamble; $50 a share currently. Dividend yield at 3.5%. They recently raised the dividend. They have generated $3.5 billion of free cash flow this past quarter. The company is operationally strong. It just has some macroeconomic things going on that it can't control.

Jill Ralph: So you are not shaken by this latest earnings report.

Todd Wenning: No.

Jill Ralph: In fact, possibly encouraged about the future.

Todd Wenning: Yeah.

Jeff Fischer: I think you just need patience. It could be at least a few quarters before things begin to really improve.

Jill Ralph: Absolutely. It feels like a common thread throughout the market.

Jeff Fischer: Not with any of our other stocks. *(Laughter.)*

Jill Ralph: No, no, and great segue, Jeff. Here we go; we'll get to the third and final stock on the docket for today, GrafTech. Jeff, give us a quick idea of what GrafTech does.

Jeff Fischer: GrafTech is a leading supplier of graphite electrodes to steel mills which allow steel mills to then produce steel.

Jill Ralph: Naturally.

Jeff Fischer: So if steel demand is low, demand for GrafTech's electrodes is low as well.

Jill Ralph: So let's get to the good part. Why is steel demand low?

Jeff Fischer: Yes, very, very low in quarter one, which was expected. GrafTech, as a result, had $130 million in revenue compared to nearly $300 million a year ago this same quarter, so a gigantic drop off and yet they were still profitable during the quarter, which is a surprise and made investors happy and really speaks to how well management is managing expenses.

Jill Ralph: So is that how they were able to be profitable after seeing that big decline?

Jeff Fischer: Yes, they run a very low-cost business, so during downturns, which they experience fairly regularly, they can ride it out.

Jill Ralph: And so again, we will get to the bottom line for our *Pro* members here. Own it or considering it, what is the take from the *Pro* team?

Jeff Fischer: It was a really interesting reaction from the market. The shares jumped on the news, even though the results were so-so and the guidance was very lackluster. The guidance was…

Jill Ralph: Was it vague or…

Jeff Fischer: Quarter two is going to be more of the same they said, so maybe break-even, small loss or small gain. Quarter three is usually very weak because it is summer; orders are very slow. A lot of steel mills shut down for the summer months. And the fourth quarter, they have no idea at this point. They say they have no visibility. They don't see any up tick yet.

Jill Ralph: Should we as investors be worried about that, for a management team that we trust so much?

Jeff Fischer: No, that is a great question, Jill, but no. I don't think we should because we are getting a good price. We still have a good price. We are happy to own it. You can continue to sell $7.50 puts on the stock to possibly get more shares. It is just a waiting game until orders pick up. They do think orders will resume towards the end of the year, but earlier they said in the summer they expected orders to pick up, so it is a waiting game.

Jill Ralph: But you guys are still happy with having it in the portfolio?

Jeff Fischer: Yes, we own 2% of a 4% position; we wrote puts for the other half and we may; we are definitely continuing to pursue greater ownership in this company.

Jill Ralph: So there we have it. It was perhaps not surprisingly a mixed bag of earnings for some of the holdings in the *Pro* portfolio. It has been a tough operating environment out there. Jeff, Todd, thank you guys for taking the time.

Jeff Fischer: Thank you, Jill.

Todd Wenning: Thank you.

Jill Ralph: And for all of you *Motley Fool Pro* members out there, feel free to join us on the boards. If you have any questions or concerns, we are out there perhaps too often, almost 24/7, so hop on and we will be back with another take of *Pro* Audio Extra in the near future. Fool on!

Write Calls on Cameco

Published Apr 29, 2009 at 12:00AM

At a Glance

- **New action:** Writing ("sell to open") one September $25 covered call (ticker +CCJIE) for every 100 shares of Cameco owned, up to 1,000 shares (60% of the 1,700 shares we own)
- **Recent stock price:** $22.50
- **Option's recent bid/ask:** $1.75/$1.85
- **Preferred limit price:** $1.75 or higher, day order
- **Acceptable limit price, if needed:** $1.50 or higher
- **Special consideration:** We are only covering 1,000 of the 1,700 shares we own, leaving some shares uncovered for additional potential upside. If you only own 100 shares, we recommend covering all of them with one call option. If you own 200 or more shares, we'd cover just half or slightly more than half.
- **Why write covered calls:**
  - To earn income while waiting for Cameco to appreciate to our estimated fair value.
  - To lower our cost basis on our covered shares by about 10%.
  - If our shares are called away, we'll close the trade with a 62% gain.

What's New

Uranium producer **Cameco** (NYSE: CCJ) has appreciated more than 50% since February, when management sold more shares to the public and we bought our stake via $17.50 puts. The stock is now near our fair value estimate of the mid to high $20s. By writing $25 covered calls on Cameco that expire Sept. 19 (four and a half months from now), we set up a potential sell price of about $26.75 per share on more than half of our position. This would give us a 62% gain on these shares while selling them in our current fair value range considerably sooner than we ever expected. Meanwhile, we'd keep about 40% of our shares in case our fair value estimate proves too conservative — say, if uranium prices begin to spike.

Remember, writing covered calls is a hedge strategy that nets you an option payment and can effectively lower your cost basis, but it obligates you to sell your shares if they reach the option's strike price or higher by expiration. The math behind this trade meets our covered call criteria: With Cameco recently $22.50, the September $25 strike price calls are paying $1.75 per share. This nets us more than a 10% payment (or effective yield) over the next 21 weeks on our $16.50 cost basis in Cameco. This payment also gives us 7.5% downside protection on our covered shares from the current $22.50 share price.

On the upside, the stock needs to increase 11% to hit our $25 strike price — and gain 19% to reach our $26.75 net sell price including the call option premium we'll be paid. If these shares are sold from our account, we'll end with a 62% gain.

"Risks" to the Upside

There are a handful of reasons we might see Cameco's stock continue to climb above $25. So far, it's shown considerable strength on the hope that uranium prices have bottomed. What's more, with investor concerns over inflation shifting hither and thither, Cameco's uranium and gold exposure make it an enviable inflation hedge. And while we believe that quarterly earnings results (announced May 1) could keep the stock in check — earnings are due to be flat this year — any optimism in the report could send shares even higher.

If you're writing covered calls, you always must be prepared to leave some additional upside on the table. Covering just part of our position with covered calls, and leaving 42% uncovered, lowers our risk of missing extra gains in the coming few months.

Covered Call Reminders

- The order is "sell to open," "sell," or "write."
- You may write one covered call for every 100 shares of Cameco owned. Remember, you don't need to cover all of your shares (unless you only own 100) — we're only covering 58% of our shares.
- If Cameco increases above the option's strike price, you need to be ready to have your shares sold away.
- You can close the calls early ("buy to close") if you wish to exit the covered call trade. If we make 85% or more, we'll consider this. Also, if Cameco is above $25 but below $26.75 by expiration, we may close the calls to book some option profits and keep our shares. We'll see in good time!

Please post your questions on the Cameco board!

Options 601: Stock Repair

Published Apr 29, 2009 at 12:00AM

To set up a stock repair, for every 100 shares of a losing stock you (woefully) own:

1. Buy one call option at a strike price below the current share price.
2. Sell (write) two call options at a strike price above the current share price.
3. Use the same expiration date for the options you buy and sell.
4. Typically, use options that expire in 90 days or less.

These option trades result in minimal or no cash outlay for you because the call you buy is paid for by the two calls you sell. Plus, the strategy does not bring new risk to your stock — your options are neutral and covered: They largely cancel each other out, and the first call option you sell (or write) is covered by the 100 shares of stock you already own, while the second call you sell is covered by the new call you just bought. Got that? Let's turn to an example to show how it works.

Assume you purchased 100 shares of a stock at $40 per share, and it now trades at $30. You're down 25%, lack hope for the stock's recovery, and don't want to hold your shares any longer. At the same time, you don't believe there's high risk left in the stock — otherwise, you'd simply sell. It seems your best move to get to breakeven is to initiate a stock repair strategy.

To start, you purchase a $30 call option for $2.50 that expires in 60 days. You then sell two $35 call options for $1.25 each. Your option trades have paid for themselves. Your positions look like this:

- Original stock, bought at $40, is now $30
- Buy one $30 call option costing $2.50
- Sell two $35 call options for $2.50 total income

Here are your possible outcomes:

IF the $30 stock ...	THEN ...
Declines or holds steady at $30	All the options expire, nothing changes (you just lost on commissions). You can try again.
Ticks up a few dollars — say, to $32.50	You make $2.50 per share on your $30 call option (because you bought it for $0 net cost) and by selling the call for the gain, you've effectively lowered your stock's cost basis to $37.50. The calls you wrote expire. You can use the strategy again.
Recovers to $35 — bingo!	Your $30 call is now worth $5 per share, all profit, so your cost basis in the stock is now $35. You can sell or close all positions and break even (commissions aside).
Soars to $40	No problem. You are breakeven on the stock, and your options cancel each other out. You can close everything and move on.
Catapults beyond $40	All of your positions still cancel each other out, and you can still sell your stock at breakeven. You've foregone a profit in the stock, though.

As you can see, the stock repair strategy has three possible results: (1) no change at all if the stock doesn't move or declines; (2) a lower cost basis if the stock ticks up; or (3) a break-even sale if the stock cooperates even halfway.

But what if you set up a stock repair trade only to change your mind and turn bullish on your stock again? The situation is salvageable. Let's say your stock returns to $40 on good news, and you wish to keep owning it. In that case, you can close all of your option trades at or near breakeven (they'll largely cancel each other out) and continue to hold the stock.

In general, this strategy works best when you're down about 20% on a stock. You buy your lower-priced call options at a strike price that is about 20% below your stock's start price (or, at about the current share price), and you write your two other call options at the midway point between the current share price and your stock's start price, splitting the two. So, in another example, if you bought 100 shares of a stock at $50 that is now $40, to repair it, you'd buy one $40 call and write two $45 calls.

When you're down a reasonable amount on a lagging stock and simply want out at breakeven, setting up a stock repair strategy may help you meet your goal more quickly. The strategy does not increase or decrease your risk in owning the stock, but (unless you close the options early) it does limit your upside to your break-even price. You must be happy to just breakeven and confident the stock won't fall sharply while you wait. To discuss this strategy or see if it'll work on some of your current holdings, please visit the All About Options board!

Monday Memo: Keys to Cash Flow

Published Apr 27, 2009 at 12:00AM

When we study a company's free cash flow, the measure we run first is *true free cash flow*, or TFCF. It's calculated using three numbers from the cash flow statement:

Cash from operations - Capital expenditures - Tax benefits from options = True free cash flow

For example, if a company had $1 billion in cash from operations, spent $300 million on capital equipment (such as factories), and received $100 million in tax benefits due to options granted employees, its TFCF comes to $600 million. We would then compare $600 million to the company's market cap — its market value based on shares outstanding — to arrive at its TFCF value multiple. Our recent intent to buy, **Jack Henry & Associates** (Nasdaq: JKHY), trades at 10 times TFCF. This tells us the company is cheaper than its price-to-earnings ratio of 15 suggests.

A second measure we run is *structural free cash flow*, or SFCF. This is what Warren Buffett dubs "owner's earnings": the income actually left over for stakeholders to enjoy. SFCF is calculated as:

Net income - Capital expenditures + Depreciation and amortization = Structural free cash flow

Sometimes, SFCF and TFCF results will vary considerably — and we dig deeper to figure out why. Typically, the two results are quite similar. Our recent intent to buy, **Flowserve** (NYSE: FLS), is valued at 14 times TFCF and 9.3 times SFCF. Why the difference? One explanation is changes in working capital, or current liabilities and current assets, which aren't reflected in both measures. Still, we find both multiples attractive and reasonable.

There are a few rules to remember about cash flow. First, it's important to calculate free cash flow on a company's past 12 months of operations because cash flow results can be lumpy quarter by quarter. Although it's much easier and less time consuming to calculate one quarter and annualize it, your estimate may be inaccurate — so don't do it.

Second, use a company's SEC filings to get the numbers for your calculations rather than a third-party data feed or even company press releases. SEC filings are the only authoritative source immune to error.

Finally, companies can spend loads of capital during certain stages of development — for instance, a young retail chain adding hundreds of new locations to help it grow. In this case, we back out the one-time capital expenditures that won't recur in future years to arrive at a fair estimation of the company's long-term cash flow creation. This calculation is called *maintenance free cash flow*, or MFCF — we'll address it further if we buy a stock where it applies.

Without consistent free cash flow, a company is hamstrung: It won't grow, it won't create lasting shareholder value, and it can't get ahead of competitors. If you have questions about our free cash flow measures, please post them on our Philosophy & Strategy board. Meanwhile, you can rest easy knowing we do our free cash flow homework on all *Pro* companies every quarter.

We're in the thick of earnings season, so we're making sure each *Pro* company is performing up to snuff. We saw solid results from **Kinetic Concepts** (NYSE: KCI) a week ago, and as the sidebar shows, more companies go under our Foolish microscope soon. *Pro* also has the following on deck for you:

- Do you own stocks that are down 20% or so and you just want to get back to breakeven? A conservative option trade can repair those stocks for you, helping you get to even! Our "stock repair" option strategy guide lands in your inbox this week.
- We'll email a new CAPS screen to you showcasing promising companies in a timely industry.
- Are you writing options? A coming option guide will explain the liberating process of "rolling out" your existing options to future months.

- We'll be visiting a *Pro* company soon — we'll let you know which one and when.
- As expected, new investments are in the works as we continue to build our real money portfolio.

Thank you, as always, for being a key part of *Pro*. Have a Foolish week!

Jeff Fischer (**TMFFischer**)

Buy Jack Henry & Associates

Published Apr 23, 2009 at 12:00AM

At a Glance

- **Target allocation:** 2.5%
- **Price when we released our original intent:** $17.50
- **Estimated fair value:** $30
- **Preferred buy price:** $22
- **Special note:** *Use a limit order at your desired price.*
- **Type of holding:** Long-term, Software/Tech
- **Dividend yield:** 1.9%
- **Why buy:**
  - Jack Henry's software serves small- and mid-tier banks and credit unions that have held up well in the banking crisis.
  - The company has a stellar balance sheet, high recurring revenue, and consistent free cash flow.
  - Its strong existing customer relationships help it cross-sell new products and grow revenue.

The Big Picture

Just two years ago, banking giants including **Bank of America** (NYSE: BAC), Wachovia, and **Citigroup** (NYSE: C) were revered by Wall Street and heralded as the future of finance. A few decades of deregulation and interstate consolidation saw these supermarket banks spread from coast to coast, offering services from deposit banking to investment banking and wealth management to credit cards.

Along the way, lending decisions moved from small towns and communities to banking centers in New York and Charlotte, N.C., creating unfamiliarity between lenders and borrowers — not to mention confusion about what's really at the heart of banking. The big banks' aggressive approach to subprime loans and nontraditional banking practices is precisely what's gotten them in all this trouble. And customers have literally paid the price: Bank of America generates more than half its revenue via commissions, credit card fees, and advisory fees — this is the new "normal" in big banking.

This stands in stark contrast with more than 8,000 community banks that primarily serve Main Street clients and represent more than 98 percent of all federally insured institutions. This segment of the banking industry has survived the financial meltdown better than its big-dog counterparts because it stayed true to traditional local lending practices and largely avoided the subprime debacle. This plays right into the hands of financial software and data-processing company **Jack Henry & Associates** (NASDAQ: JKHY). Jack Henry's two key markets are recently chartered de novo banks (state banks in operation less than five years) and mid-tier banks with $750 million to $10 billion in assets. Add that to the fact that 92% of banks in the U.S. have less than $1 billion in assets, and we see a wide market opportunity for Jack Henry as the industry repositions itself following the meltdown.

Our Take

If you've ever used a debit card, paid bills online, or had your paycheck direct-deposited via an electronic funds transfer, then you've had experience with the kinds of software and processing services Jack Henry offers to more than 8,700 community banks and credit unions. As electronic banking becomes an industry standard, small banks need software applications and systems that process transactions quickly, securely, and at a lower cost to stay competitive.

Jack Henry has a suite of software products to fill these needs, generally signing five-year contracts with customers — 98% of which renew automatically at the end of the term. Moreover, because fees are based on the institutional client's asset size, Jack Henry's revenue will increase as customer asset bases grow.

The company's revenue breaks down into three categories:

Software licenses represented 8% of total revenue in the first half of fiscal 2009 (the company's fiscal year ends June 30). Jack Henry licenses its proprietary software on a per computer basis to banks that process all transactions in-house. This part of the business is getting weaker as more banks elect to outsource these services to cut costs; today just 56% of all financial institutions and 73% of credit unions still use in-house processing. Fortunately, Jack Henry also offers outsourcing services, and in fiscal 2008, 27 of its in-house bank customers migrated to its outsourcing offering. A major advantage Jack Henry has over competitors is that its software is compatible when a bank decides to outsource — so no technical retraining of bank employees is needed.

Support and service fees, the fastest-growing division, represented 82% of total revenue over the past six months. This part of the business provides in-house software support, electronic transfer support, and the outsourced data processing we just talked about.. Despite the slowdown in bank mergers during the past year, this division has been supported by electronic transfer support sales that have grown with increased use of ATM and debit cards and bill payment transactions. The more people move money about electronically, the more need there is for Jack Henry software.

Hardware sales make up about 10% of total revenue. This division supplies hardware system solutions including servers, workstations, and check scanners compatible with the Jack Henry software suite. In this area, Jack Henry has a 30-year history with **IBM** (NYSE: IBM) and sells its IBM Power System hardware along with **Dell** (NASDAQ: DELL) servers and Lenovo work stations.

The backlog for Jack Henry's services increased 16% to $277.9 million as of December 2008 (representing about 37% of last year's total sales), with $61 million for in-house products and $216 million for outsourcing services. Clearly, Jack Henry products have serious demand despite a weakness in the broader banking community.

You Don't Know Jack

Jack Henry & Associates is a quintessential American success story. In 1976, Jack Henry co-founders Jack Henry and Jerry Hall sketched out an integrated banking software system on the back of a coffee shop napkin. At the time, small banks couldn't afford the expensive processing programs that big banks used, and consequently they had to send their business information elsewhere to be processed. Using a borrowed computer in a rented engine repair shop, Henry wrote the code for the original software program based on "intuition" and "common sense." Just nine years later in 1985, Jack Henry's IPO hit the Nasdaq Stock Market, and from 1991 to 2001 the shares grew at an *annualized* 77% rate, turning a modest $1,000 into $307,000 over a decade.

Certainly we don't expect that type of success to be repeated with our investment, but we do believe the shares offer excellent value today. We're particularly attracted to Jack Henry's strong business model, with 74% recurring revenue and high customer retention rates. Its credit union processing unit, for example, has lost only five credit unions to competitors in the unit's 23-year history. Moreover, we're impressed with Jack Henry's commitment to customer service, which the company calls a primary competitive advantage. That's not just corporate speak, either: It provides 24/7/365 support from its Monett, Mo. (pop. 7,000) headquarters, while a number of its competitors' support is based overseas. That makes a real difference to customers in need.

The Community's Take

Jack Henry earns a perfect five stars on CAPS and has an impressive raw score of 97.61, putting it in the top 5% of the CAPS universe. As of April 21, 2009, 35 out of 37 All-Stars ranked the stock an outperform, and among all CAPS participants, 134 out of 140 rate the stock an outperform.

On our proprietary CAPShot Report, Jack Henry rates a respectable 7 out of 12, coming up short on our steep annual revenue growth hurdles, revenue per employee, and its current ratio. Its industry (software) is rated poorly right now, but Jack Henry ranks in the top 1% of all software companies on CAPS.

Valuation and Financials

There's a lot to love about Jack Henry's financial statements, including strong operating margins of 21%, no long-term debt, and plenty of free cash flow to reinvest in the business and pay a dividend that management has increased each year as a public company since 1985 — recently by 13%.

Using a three-stage discounted cash flow model (to help determine the present value of estimated future cash flow) and conservative growth estimates below average analyst estimates with 3% terminal growth, we see a fair value for Jack Henry between $26 and $30 — offering strong upside from the current $17-ish prices. Shares currently trade for just over 10 times trailing free cash flow and 15 times earnings.

The company's healthy balance sheet and large, loyal customer base also make it a potential takeover target for an old friend like IBM or an outsider such as **Oracle** (NYSE: ORCL), which could be looking to make a foray into the growing electronic payments business. Of course, we're happy to own Jack Henry shares even if a buyout doesn't happen.

Jack Henry's major competitors are the larger **Fiserv** (NASDAQ: FISV) and **Fidelity National Information Services** (NYSE: FIS); the latter recently acquired another competitor, **Metavante** (UNKNOWN: MV.DL) for $2.94 billion. While competition from Fiserv and Fidelity National is fierce, both companies are mired in debt and have deep links with the troubled larger banks. Fidelity National has relationships with 40 of the top 50 global banks, including nine of the top 10. To these firms, small banks are a lesser priority. Needless to say, we believe Jack Henry, with its focus on smaller banks and no long-term debt, is in the best position to serve its niche.

What Would Make Us Sell

Over the past five years, Jack Henry has completed 15 strategic acquisitions of companies in the businesses of check and document imaging, fraud detection, and payment processing solutions, among others. Adding complementary services like these to the Jack Henry software suite is an ideal way to cross-sell products and increase revenue — and so far, it's proved successful. However, if the company makes a large acquisition we believe does not fit its core business then we would need to reexamine the value of the shares. Similarly, if Jack Henry is unable to find suitable acquisitions to help fuel growth, we may need to reconsider its valuation.

While Jack Henry itself isn't regulated or chartered by federal and state banking regulators, its clients certainly are, and its software needs to be compliant with any existing and future legislation. A major regulatory overhaul that adversely affects small- and mid-tier banks and credit unions could hamper spending for Jack Henry's clients and would force Jack Henry to quickly retool its existing software to meet the new standards. If it failed to become compliant and its customers were fined, the company could ultimately face litigation and liability damages. Obviously, management is not likely to let this happen, but you should know about it.

Finally, if Jack Henry's target market of 8,400 commercial and savings banks and 8,200 credit unions begins to rapidly dwindle due to industry consolidation (particularly big banks who don't use Jack Henry products buying small banks that do) or financial failure, we would need to readjust our growth estimates downward and determine if holding the shares still presented a value.

Pro Bottom Line

As an undervalued business with strong recurring revenue, a good balance sheet, and a leadership position in the healthiest niche of the small banking sector, we're happy to welcome Jack Henry & Associates to the *Pro* portfolio. If you have questions about Jack Henry, please post on its new discussion board. And if you decide to buy shares, please consider using a limit order in your desired buy range.

For more information on Jack Henry's corporate values and insider ownership, please see our board post with the subject line "More on Jack Henry."

Write Puts on Intel

Published Apr 22, 2009 at 12:00AM

At a Glance

- **Action:** Writing ("sell to open") June $15 puts (ticker +NQRC)
- **Allocation:** 6%
- **Recent share price:** $15.60
- **Option's recent bid/ask:** $0.82/$0.84
- **Preferred price for put options:** $0.75 or higher (5% of the strike price)
- **Acceptable price for put options:** As low as $0.60 (4% of the strike price)
- **Alternative trade:** Write July $15 puts for $1.00 or better
- **Why write puts:**
  - Intel's management told the world that the PC market has bottomed, and order patterns are stabilizing.
  - The stock is reasonably priced but likely to remain in a range, so we can continue earning income writing options.
  - If the shares are put to us near a net price of $14.25, we'd be happy buyers and would then consider writing covered calls.

With any luck, **Intel** (NASDAQ: INTC) will remain a profitable friend of *Pro* for years to come. This stable, dominant business provides a lasting opportunity to write options on a stock that is currently range-bound with a valuation floor beneath it that's probably in the low teens. We've written covered calls on Intel twice since November 2008, and recently, our shares were called away from us at a net $16.32. Rather than buy the stock back, we're going to write puts to potentially buy shares lower.

When you write puts, you're ready and willing to buy the underlying stock at a lower price if it arrives. Writing the June $15 puts obligates us to buy shares of Intel if the stock trades below $15 by the June expiration. Our net buy price would be in the low $14 range. These options recently pay 5.3% of the strike price — that's also the yield on our trade — while expiring in 58 days. Our net buy price if we get the shares is 9% below the share's recent $15.60 price, so the trade meets our put-writing guidelines.

We've increased our allocation from 5% (for our initial trades) to 6% today. We have increased confidence on Intel's business following its first-quarter profits and management's belief that business is stabilizing. Even in a recession, computers must be replaced and purchased. Given the relative stability of Intel, the reasonable nature of the downside risk, and our ample cash resources, we're increasing our allocation to greater capitalize on the stock.

Other Foolish Option Positions on Intel

If you already own Intel and have written covered calls, we suggest you continue to let your trade play out; if the calls get exercised, you can next consider writing puts. If your calls just expire, you can write new covered calls. Writing a put is in many ways equivalent to writing a covered call, especially when your strategy is income.

If you're unable to write puts but wish to follow along with Intel in some way, we recommend trying to buy the stock in the low $15's and concurrently writing July $16 covered calls for about $1.00 in payment.

If you have questions about our new intent to write puts on Intel, please post on the Intel board!

Monday Memo: Getting Greener With Pro

Published Apr 20, 2009 at 12:00AM

You see, in this fast-moving market, with six straight weeks of gains at our backs, it's tempting to just pile in and buy stocks with the hope that they'll zoom higher on the back of rising market sentiment. But that strategy is flawed for at least two reasons:

1. There are no guarantees the market will keep appreciating. Although it's had a good run, and President Obama sees "glimmers of hope" while Federal Reserve Chairman Bernanke sees "tentative signs that the sharp decline in economic activity may be slowing," the economy is far from out of the woods.

2. There is no substitute for thorough research and patience.

We continue to steadily and patiently invest $1 million of the Fool's real money into the *Pro* portfolio knowing that in this volatile market, opportunities will always arise. Even now, the S&P 500 is only back to prices last seen in *early February*, and it is far below prices for all the months and many years (about 10!) before then.

Tech bellwether **Intel** (Nasdaq: INTC), whose shares were called away from the *Pro* portfolio this weekend, was our first holding to report earnings this season. Intel -- a stock we've been specifically using to generate income via covered calls -- beat earnings estimates but failed to give revenue guidance for the second quarter or full year, citing a still-uncertain economic environment. This was despite Intel calling the bottom of the PC market, saying it had returned to more "normal patterns."

I covered the conference call in more detail in this post, but my main takeaway is that "normal patterns" does not mean a reversion to the go-go days of 2007. More likely, it means Intel is close to a new base level, one it will hope to grow from in the quarters and years ahead. It will likely take quite some time for it to return to the sales and profits enjoyed in 2007. And I think we'll see a similar theme among many companies throughout this reporting season.

Pro has earned a profit writing covered calls on Intel since November, and we'll likely revisit the stock with a similar (if not the same) strategy soon. If you haven't bought Intel or traded options on it yet, you'll have an opportunity to follow along with *Pro* on this stock in the near future -- assuming we see a strategy we like.

One of the beauties of options is that investing opportunities arise virtually every day, particularly while the market remains volatile. *Pro* Fools are regularly swapping investing ideas on the boards, such as this thread on our recent intent to buy, **Flowserve** (NYSE: FLS).

While opportunities abound, we caution Fools about getting *too* carried away with their options investing. At *Pro*, we're aiming to generate up to 5% additional income per year from our option writing (buying options is more open-ended). That said, we are always seeking especially attractive option opportunities. In case you missed it, Todd came up with 5 Covered Call Candidates From CAPS last Wednesday. Chime in with your vote on which is best -- we're giving a Fool hat to our favorite entry!

The *Pro*discussion boards are a wealth of information on our stocks and investing in general. We encourage you to participate as actively as possible -- you won't be disappointed. This week's highlights:

- Jeff suggested amendments to *Pro*'s Buy Below guidance on the **AmTrust Financial** (Nasdaq: AFSI) board two weeks ago, with many Fools weighing in with their thoughts. Today, Jeff posted our official new policy.
- Todd posted a poll asking which *Pro* company you'd like us to visit next. If you haven't already done so, it's not too late to cast your vote. Jeff and Todd are itching to hit the road and report back to you.
- Russell (**TMFEldrehad**) offers up his latest weekly take on CAPS on our CAPS Corner board.

Coming up, we have earnings from **Kinetic Concepts** (NYSE: KCI) Tuesday and many others soon, listed in the sidebar. As usual, we'll be covering them on the discussion boards. As ever, please feel free to comment about today's Memo on the Memo Musings board!

Foolish Best,

Bruce Jackson (**TMFGoogly**)

Bruce owns shares of Autodesk, AmTrust Financial, GrafTech, Intel, Nasdaq OMX, Procter & Gamble. He is short Cameco puts, Intel calls, and Kinetic Concepts puts.

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5 Covered Call Candidates From CAPS

Published Apr 15, 2009 at 12:00AM

Generating income is one of the major reasons to consider a covered call strategy — one we've already put to work in the *Motley Fool Pro* portfolio with **Intel** (Nasdaq: INTC), among other holdings. To set up a covered call, we want to identify a stable, healthy business with a reasonably priced stock that also pays a dividend. This way, we generate income in two ways: the quarterly dividend payments *and* the premium income we receive from writing the call. Ultimately, we should also enjoy some capital appreciation from the stock itself.

So how do you find a company that fits the bill? A great tool is the CAPS screener, which scours the CAPS community's 132,000 investors and 3 million stock picks (and counting ...) to find investment ideas. At *Pro*, we use CAPS to help us search for both long and short opportunities, and in conjunction, options. We can also use it to find strong candidates for a covered call strategy.

Screening for Green

Using the CAPS screener, I looked for stocks with a:

- 4- or 5-star CAPS rating
- Market cap over $7 billion
- Current price between $12 and $35 a share (making 100 share lots more affordable)
- Price-to-earnings ratio below 12
- Dividend yield between 2% and 7%
- Return on equity greater than 10%

Of the 39 results the screener generated, here are five of the more well-known companies (remember, none of these is a formal *Pro* recommendation):

Company	CAPS Rating	Dividend Yield
Emerson Electric (NYSE: EMR)	*****	4.2%
CSX (NYSE: CSX)	****	3.0%
Merck (NYSE: MRK)	****	5.8%
Kraft Foods (NYSE: KFT)	****	5.2%
Texas Instruments (NYSE: TXN)	****	2.3%

Data as of April 14, 2009.

Each of these companies shares some of the characteristics we looked for when we recommended Intel as a covered call strategy. They're all fairly large, steady businesses that have taken their licks along with the market during this recession, but have a number of built-in competitive advantages that should help them rebound when the economy recovers. Plus, they generate enough free cash flow to cover their current dividend payments. With a record 367 firms cutting dividends by $77 billion in the first quarter of this year alone, that's saying something about the strength of these underlying businesses.

Chat With Todd, Win a Hat!

With that in mind, I invite you to join me in discussing these covered call opportunities over on our All About Options board. Which of these stocks would you write a covered call on — and why? We'll be giving a bona fide Fool hat to our favorite board post on the topic over the next week. For *Pro* members who are unfamiliar with covered calls, this will be a good introduction to the strategy; for our more experienced options traders, it could also provide some new investment ideas. Finally, one of these stocks might even end up in the *Pro* portfolio as a covered call position. So join the discussion!

Fool on!

Todd Wenning (**TMFPhila**)

Evergreen

Our Guide to Hedging Like a Pro

Published Feb 12, 2018 at 3:40PM

Fellow Fools,

In pursuit of our North Star, the *Pro* portfolio explores every corner of the market: We go long, we go short, we use options. That flexibility and creativity helps us find upside, but it also means that if we're not careful, we can be exposed to risk from every corner of the market, too.

We mitigate this by carefully using hedges. A hedge is a position that reduces a portfolio's overall exposure to risk, and over the course of *Pro*'s history, we've hedged in several different ways. In every case, we begin by deciding what exactly we want to accomplish with our next hedge. As we drill down on how exactly to rein in our exposure to risk, we focus on:

1. **Target selection.** What kind of potential decline are we trying to guard against -- a black swan, or a more moderate, run-of-the-mill slump? What are the risk factors that make us want to hedge, and which vehicle should we choose? Would an index do the best job of isolating those risks and protecting us against them, or do we want to target individual stocks?
2. **Size.** How much of the portfolio do we want to hedge out? Will this be the only position we'll use to do it, or will we have other approaches to reducing our long exposure in place as well?
3. **Time frame.** How long do we want the hedge to last? Do we prefer a set-and-forget type strategy, or one that requires maintenance?

Developing answers for each of these criteria has traditionally been a good way of narrowing down our possible hedging strategies to a select few. From there, if there are still two or more hedges we like equally, we'll consider pricing to try to break the tie. Here, we're considering the potential trade-off between the costs -- both direct (option premiums or losses on shorts) and indirect (missed upside from holding cash) -- and the potential benefits, given the current market environment and our portfolio positioning.

We'd love if there were a simple checklist to apply to every hedge, one that would both simplify the process and ensure we achieve our desired results every time. Sadly, it doesn't work that way. Hedging, like all of investing, is both an art and a science, one that requires constant learning and evolution for long-term success. That said, there are some hedging maxims we always keep in mind when picking a strategy:

- **Be miserly.** It's possible that at a given point in time, paying up for a hedge might be the right thing to do -- but the odds are heavily stacked against you in the long run if you do so repeatedly. (Just look at all the failing hedge funds.)
- **The goal of hedging is twofold.** In order for *Pro* to continue to achieve its lofty goals over a full market cycle, our hedges must do more than just reduce volatility; they will also need to provide us with enough capital that we can be aggressive during significant market declines.
- **Do no harm (or at least as little as possible).** Since 1896, the market has risen 78 years out of 119, or 66% of the time. This means you need to pay just as much attention to the risks of your hedge as you do to the potential benefits, since odds are you won't end up needing it. In most cases, a hedge will be a drag on your returns.

And now for the details behind our favorite approaches to hedging. Many of these strategies use options, so look for links to the relevant section of *Motley Fool Options*' Options U if you need a quick refresher.

Cash

- **How it works**
  - Arguably the most straightforward hedging strategy, cash works as a hedge by reducing a portfolio's long exposure. For example, a portfolio that has a 20% weighting in cash (and is thus only 80% long), all else equal, exhibits only 80% of the volatility of a similar portfolio that's fully invested.
  - Maximum gain: Interest earned on the cash
  - Maximum loss: You typically lose to inflation
- **Advantages**
  - Simplicity. Time spent constructing and monitoring more complex hedges is time *not* spent looking for the next long position that could double or triple in five to 10 years. Using cash to hedge your portfolio requires only a small initial investment in time and essentially zero maintenance.
  - Flexibility. Besides protecting a portfolio from untimely declines, one of the major reasons we hedge is as a source of funds: money you can use to take advantage of said declines by purchasing shares of your favorite companies at a discount. Some hedging strategies can be difficult to unwind at a moment's notice, meaning you could miss a buying opportunity, but that's not the issue with cash, which can be immediately deployed.
- **Drawbacks**
  - Missed upside. During bull markets, holding cash comes with a meaningful opportunity cost. Although you're not explicitly paying for a hedge out of pocket, you *are* missing additional upside on the cash you don't have invested. Compounded over multiple years, those missed gains add up. Consider two $100 portfolios: one that is fully invested and one that is only 80% invested, with the remaining 20% in cash. Assuming an average market return of 9% over various investment horizons (as well as a 1.5% annualized return on your cash), you can see how the cost of holding excess cash really adds up the further out in time you go.

	Portfolio A	Portoflio B	
year	100% long	80% long & 20% cash	difference in portfolio returns
1	9%	8%	1%
2	19%	16%	3%
3	30%	25%	5%
4	41%	34%	7%
5	54%	45%	9%
10	137%	113%	24%
15	264%	216%	48%
20	460%	375%	85%

- **When to use**
  - For investors seeking a straightforward approach to reducing volatility who are less concerned with missing out on upside, cash works as a standalone hedging strategy.
  - It also works as a great compliment to other hedges, especially those that are options-based and cannot be closed until close to expiration.

- **What to target**
  - Your primary considerations here are: By how much do you want to reduce the volatility of your portfolio? and What role will cash take in your overall hedging approach? *Pro* typically targets a net long exposure (long-shorts and hedges) of 70% to 80%, with cash being only part of our overall strategy for volatility reduction. Historically, we've targeted about 15% in cash (resulting in a reduction in volatility of 15%, *ceteris paribus*), though we've taken this number as low as 6.4% and as high as 22.8%. In an ideal world, our cash position will act as a counterbalance for the portfolio. As markets fall, our cash balance will fall, too, as we take advantage of depressed stock prices. But as markets climb higher, our cash holdings will likely rise as we sell out of overvalued securities (or investments where the thesis has run its course) and wait for better opportunities.

Shorting an ETF

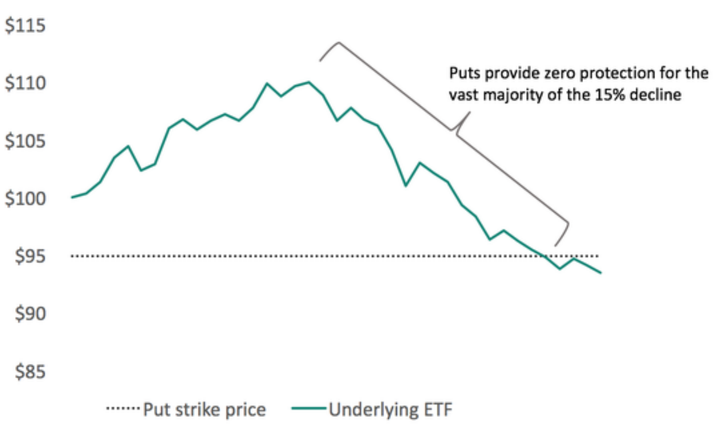
- **How it works**
  - Another straightforward approach, this is when you to sell short the ETF of a relevant index (e.g., the **SPDR S&P 500 ETF Trust** (NYSEMKT: SPY) or the **PowerShares QQQ Trust** (NASDAQ: QQQ)). For example, if you had a $1,000,000 portfolio and wanted to hedge out 20% in order to reduce your net long exposure to 80%, you would short $200,000 in your desired index ETF.
  - Maximum gain: Achieved if the ETF falls to zero
  - Maximum loss: Technically unlimited, but realistically confined to the amount the ETF can rise during the period you hold your short position open
- **Advantages**
  - Simplicity. Pick your ETF and your desired short weighting, then sell borrowed shares into the market at the current price.
  - Reactive. With a direct index short like this, if the underlying ETF falls by 2% the day after you set up the short, you can close your hedge and capture that gain immediately if you so desire. Many hedges, especially those that combine multiple options, are not nearly as immediately reactive.
  - Potential for outperformance over cash. An investor who targeted a net long position of 80% in a long-plus-cash portfolio would need to hold 80% of that portfolio in stocks. But in a long/short portfolio, this goal can be achieved with a greater weighting in stocks, as long as the short position results in a net of 80% long (e.g., 90% long and 10% short, 100% long and 20% short, 120% long and 40% short). If the "extra" long holdings (say, 20% in the case of a portfolio that's 100% long, 20% short) over the long-plus-cash portfolio outperform the ETF underlying the short, the long/short portfolio will outperform the long-plus-cash portfolio.
  - Liquid. In relation to being reactive (covered above), these positions can be put on and taken off at a moment's notice, which means you can take advantage of declines by reinvesting hedging profits as soon as you want.
- **Drawbacks**
  - Losses if the market rises. Unlike cash, shorting an ETF has a direct cost associated with a rising market. (Remember, when you short something, your payoff diagram is reversed: You make money when the underlying instrument declines in value and *lose* money when it rises.) The higher the market climbs, the greater your loss on the short, and potentially the larger a percentage of your portfolio the short becomes.
  - Shorting fees. Although they tend to be modest on larger ETFs, these fees do add up and weigh on returns if the short is held for long enough.

- **When to use**
  - When you're looking for a straightforward, highly reactive hedge, you're OK with paying a fee to borrow shares, and you don't mind that the hedge will act as an anchor on the portfolio if the market rises.
- **What to target**
  - As with cash, your primary consideration here is your desired target net long weighting for your portfolio as a whole, and what role you want this particular strategy to play.
  - Given how common this approach is, prices don't fluctuate much, so pricing discipline and discovery aren't much of a concern. The issue is more whether you're willing to pay up to use the hedge.

Buying Puts

[Options U link]

- **How it works**
  - For an up-front payment, puts protect the portfolio (or a position in it) from all downside below the strike price.
  - Maximum gain: Achieved if the underlying falls to zero
  - Maximum loss: The premium paid to purchase the puts
- **Advantages**
  - Simplicity. This is arguably the most straightforward options-based approach to hedging.
  - Upside exposure. You don't risk missing out on upside should the market move higher while your hedge is active. You only risk losing what you paid for the puts.
  - Accessible. This is a strategy that most investors will be able to set up in their accounts even if they have limited options-trading permission.
  - Reactive. This single-legged strategy will show profits if the underlying instrument falls by a large enough degree prior to expiration, in which case you don't need to wait until close to expiration to close.
- **Drawbacks**
  - Cost. Cost-wise, buying puts is essentially the opposite of using cash to hedge: You're not at risk of missing upside should the market rise, but you *are* required to make a payment in order to set up the hedge. Depending on the market environment, you could end up spending a significant percentage of your assets (say 3%-5%) per year for strike prices that are only reasonably out of the money -- meaning the strategy really starts to drag on portfolio performance if used for long enough. It's not impossible to imagine a situation in which the gains you receive when your hedge finally pays off — which will probably require multiple rounds of buying puts, unless you get really lucky with your timing — fail to even offset the cost you've incurred to buy those puts time and again, meaning you're actually worse off for hedging despite witnessing a decline in the market. At *Pro*, we guard against this by trying to find various ways to finance our put purchases, such as writing puts on longs we like to pay for the protective puts we buy.
  - Timing matters a lot. For the most part, puts only start paying off once they are in-the-money, so you run the risk that your hedge might be largely irrelevant by the time the market finally declines. For example, if you buy puts that are 5% out-of-the-money, but the market rises 10% before falling 15%, your hedge would only be reactive for the final 1.4% of the decline.



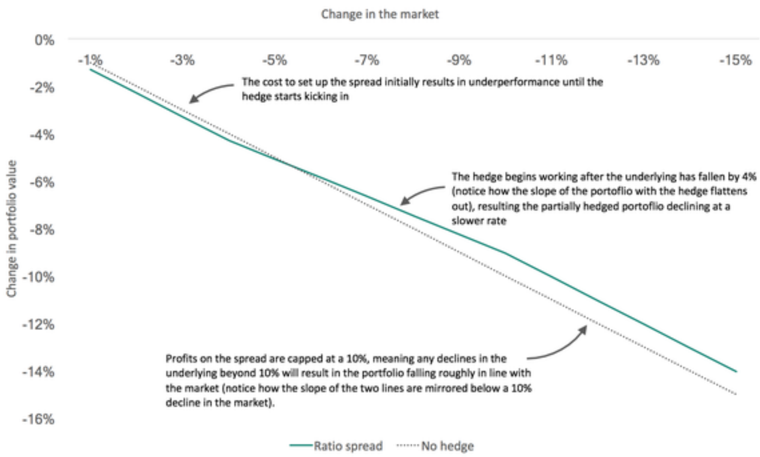
- **When to use**
  - When option prices are cheap (i.e., they favor the buyer) and your concerns about missing upside outweigh your dislike of paying to set up a hedge.
- **What to target**
  - There are two approaches you can take when looking to hedge by buying puts. The first is to target an intermediate length of time (typically 11 months or less) you'd like the hedge to be in place, then look to purchase puts, knowing it's likely you'll lose the entire premium you've paid if you hold them until expiration. When *Pro* takes this approach on an individual stock, we typically target puts that are somewhere around 10% out-of-the-money and pay no more than 5%-6% of the holding's value per year, with hopes that we'll sell the puts and get at least some of that back. The second approach is to purchase long-dated puts (typically expiring in a year or longer) and plan to roll them to a higher strike price if necessary to keep them closer to the underlying ETF's current price (and therefore more reactive as a hedge). In this case we target put strikes typically 10% to 15% out-of-the-money, and still aim to pay no more than about 6% per year of the position's value, initially, with hopes of recouping some of that when we sell, whether we roll up or not.

Bear Put Spread

[Options U link]

- **How it works**
  - With this options-based hedge, you purchase a put on an index or stock while financing some of the cost by simultaneously writing (selling) a lower-strike put with the same expiration date.
  - Maximum gain: Achieved if the underlying falls at least to the lower strike price of the written put
  - Maximum loss: The net premium paid to set up the spread
- **Advantages**

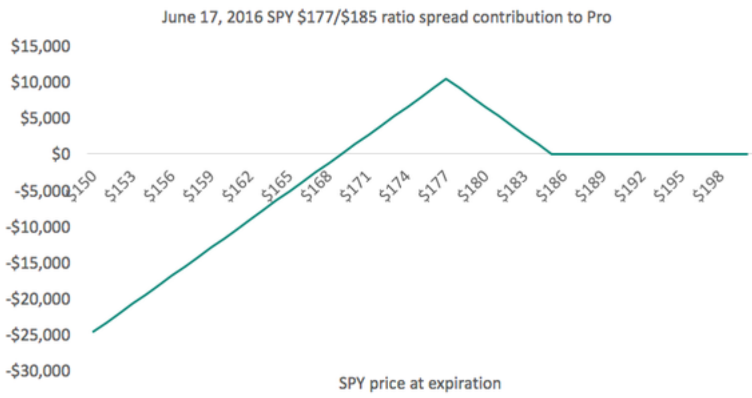
    - Cost, relative to just purchasing puts. Because you're selling puts with a lower strike price, you're able to meaningfully reduce the cost of setting up the hedge. This serves to minimize the drag on the portfolio if the market does not decline, while also raising your breakeven price and increasing the odds that your hedge makes money if the underlying instrument *does* go down.
    - Upside exposure. You don't risk missing out on upside should the market move higher while your hedge is active.
- **Drawbacks**
    - Cost. Although a bear put spread is cheaper than buying puts outright, you're still making an up-front payment for something that may never actually benefit you.
    - The amount of downside you can capture is limited. Selling puts helps reduce the cost, but it also caps the maximum profit you can make from a given spread.
        - To see these two drawbacks in action, let's say you set up a 20% hedge using a spread that starts making money when the underlying ETF falls by 4% and has a maximum gain at a 10% decline. Such a spread would leave you worse off in any market situation that's *better* than a 4% decline, because you had to pay to set up the strategy -- but once the hedge did kick in, your portfolio's value would decline at a slower pace than without it. However, that's only true until the decline reaches 10%. After that, you won't receive any additional protection.



- **When to use**
    - As with buying puts, you can set up a bear put spread if you desire a hedge that doesn't result in any missed upside (just the cost of your spread). But because your maximum gain on the hedge is capped, you should generally limit its use to situations where you're not overly bearish.
- **What to target**
    - Although you can set up a spread of any size and duration, typically we target a spread that is roughly 3% to 5% out-of-the-money, with about a $10 difference between strike prices. The cost for this type of hedge will largely depend on its duration, but a four-month position should cost about $2-$5 in most market environments. Your maximum profit in this example is $10 per spread, or at least a double, which is what we target since we risk a 100% loss of capital along the way. We generally target large ETFs including SPY, IWM, and QQQ, though you can also hedge individual stocks.

Ratio Spread

- **How it works**
    - A two-part, options-based hedge, a ratio spread requires the investor to sell twice as many puts as they purchase for a given expiration date. The written put's strike price must be lower than the purchased put's strike price. (For example, you might write 20 January 2018 $175 puts while simultaneously purchasing 10 January 2018 $190 puts.) At worst, the spread is set up for a very small debit; breakeven, or even a slight credit, can at times be achieved. It provides protection starting at the strike price of the purchased put, but if the underlying instrument falls far enough below the strike of the written put, the spread becomes a liability that also shows a loss.
    - Maximum gain: Achieved if the underlying falls to the strike price of the written put, but not below
    - Maximum loss: Achieved if the underlying falls to zero
- **Advantages**
    - Cost. Because you can set it up for little to nothing out of pocket, a ratio spread overcomes one of the most common drawbacks to hedging, which is that the long-term costs might outweigh any gains achieved when the market finally does fall.
    - Upside exposure. You don't risk missing out on upside should the market move higher while your hedge is active.
- **Drawbacks**
    - Cash necessity. Since written puts are a potential obligation, you need buying power or free cash to keep this position open, and that's cash that isn't invested elsewhere in most cases.
    - Downside protection is limited. That's the tradeoff for not spending any money out of pocket: A ratio spread's maximum gain is captured if the underlying falls exactly to the written put's strike price, but if it continues to fall beyond that, the protection the hedge provides starts to lessen. If it declines enough, you eventually arrive at breakeven, which can be calculated thusly: Written put strike price — (purchase put strike price — written put strike price). Below this price, the hedge is actually a liability.



- **When to use**
  - Ideal for situations when you are bullish but looking to hedge for small to moderate corrections.
  - When pricing is favorable (see below).
- **What to target**
  - There are a lot of moving parts here, but generally speaking, here's what to aim for:
    - Set up the position for a slight net credit or breakeven (a small debit is the worst-case scenario for this type of hedge, and that's not bad) while also achieving all of the criteria listed below. If pricing is unfavorable, consider an alternative hedge.
    - Your purchased put's price should be about 3% to 5% less than the current price of the underlying ETF.
    - Your written put's price should provide an acceptable gap between the purchased put's price and your maximum profit. (The smaller the gap, the greater the risk your ratio spread becomes a liability.) For shorter ratio spreads of three months or so, this can be as small as 5%, if that makes the spread between the maximum profit and the current price of the underlying instrument at about 10% (so, you earn your max profit if the index falls 10%). For ratio spreads of nine months or more, the gap between maximum profit and the current price of the underlying ETF should be 15% or more.
    - Expiration dates can be tailored as needed. We have previously targeted spreads from as short as three months to as long as one year.

Synthetic Short

Options U link

- **How it works**
  - This is an options-based approach that mirrors the performance of directly shorting an ETF by selling an at-the-money call in order to finance the purchase of an at-the-money put.
  - Maximum gain: Achieved if the underlying falls to zero
  - Maximum loss: Technically unlimited, but realistically confined to the amount the ETF can rise during the period you are short it. (This is calculated as the current price of the underlying less the short call's strike price.)
- **Advantages**
  - Reactive. As with purchased puts, this strategy should show a profit even if the underlying immediately falls after the strategy is set up (because the puts will start gaining value while the calls lose it).
  - Fewer fee events. By using options to short an index ETF, you avoid paying shorting fees on the ETF, and you don't need to pay out any dividend payments the index pays, either.
- **Drawbacks**
  - Losses if the market rises. You will not only miss out on upside above the written call's strike price, you'll also begin to see losses on the hedge in a rising market.
  - Costs. Setting up two options may cost more commissions than would just shorting the ETF directly for short periods of time.
- **When to use**
  - When looking for an alternative approach to directly shorting an ETF.
- **What to target**
  - Depending on the position of your strike price in relation to the underlying instrument, you should be able to set this position up for little to no cost. Generally speaking, you should use the single strike price on both the calls and puts that is closest to the current ETF share price, while adjusting both options up or down a strike or two (while still using the same strike on both option) if you want to avoid paying to set this up.
  - As with cash and directly shorting an ETF, the primary consideration here is your desired target net long weighting for the entire portfolio. Consider the role you want this particular strategy to play within that context.

Split-Strike Synthetic Short

- **How it works**
  - Essentially a more conservative, options-based alternative to shorting an ETF. With this strategy, you purchase an out-of-the-money put while simultaneously selling an out-of-the-money call. Both have the same expiration date, and the call typically offsets the cost of the put.
  - Maximum gain: Achieved if the underlying falls to zero
  - Maximum loss: Technically unlimited, but realistically confined to how much the ETF can rise during the period you are short it. (That's calculated as the current price of the underlying instrument less the short call's strike price.)
- **Advantages**
  - This strategy is more conservative than directly shorting an ETF. Because you're shorting an out-of-the-money call, your hedge has some headroom before it starts to guarantee you a loss on the short calls at expiration. Essentially, you're trading the ability to profit from small declines for more wiggle room on your short should the market rise.
  - Reactive. This strategy will, however, show a profit if the underlying instrument immediately falls after setting up the strategy, because the puts will start gaining value while the calls lose it.
  - Cost. By selling calls, you're typically able to offset a large portion of the cost (and sometimes all) of the purchased puts.
- **Drawbacks**

    - Losses if the market rises enough. You see a loss on this hedge if the ETF ends above the written call's strike price.
- **When to use**
    - If you're looking for an approach that's similar to directly shorting an ETF, but more conservative.
- **What to target**
    - As with most of the options-based approaches, there is a lot of flexibility here depending on how aggressive -- or defensive -- you want to be. More aggressive approaches start capturing declines sooner but risk showing losses with smaller increases in the underlying instrument, while more conservative strategies don't show losses as quickly but require the underlying instrument to fall further before showing gains. We generally like to target a small net debit in order to purchase puts closer to the current price of the underlying instrument (for example, we might purchase puts that are 5% out-of-the-money and sell calls that are 7% out-of-the-money).
    - There's a lot of flexibility possible with expiration dates, too. You can go short-term (three to four months) with the goal of just holding the position until expiration, or longer-term (nine months to a year) with the intention of being more active and periodically rolling the position higher or lower if need be.

Buying a short ETF

- **How it works**
    - A friendly trade for those with restrictions on their accounts, this establishes a short position by buying shares in an inverse ETF (e.g., the ProShares Short S&P 500 (NYSEMKT: SH).)
    - Maximum gain: Achieved if the underlying falls to zero (so, for example, the ProShares Short S&P 500 achieves its maximum gain if the S&P 500 falls to zero).
    - Maximum loss: Limited to your initial investment.
- **Advantages**
    - Ease of use. Since you're buying shares, you don't need permission to short or trade high-level options, although some short ETFs have extra requirements for ownership.
    - Reactive. This strategy should show a profit if the underlying instrument falls immediately after you set it up.
    - Imperfect tracking. We'll discuss this in greater detail in the "drawbacks" section, but these instruments deliver their inverse performance on a daily basis -- an imperfect measure and one that can at times work in your favor.
- **Drawbacks**
    - Losses if the market rises. If this happens, the ETF will decline in value.
    - Imperfect tracking. These ETFs seek to replicate the inverse of the daily performance of an index, but their long-term results will almost always differ from the true inverse of that performance. For example, over the past five years (as of Feb. 12, 2018), the S&P 500 has risen by 72.40%. Over that time, arguably the most well-known S&P 500 index, the Spider S&P 500 (SPY), has risen by 72.02%. But the corresponding short ETF, the ProShares Short S&P 500, has only declined by 51.71%. This discrepancy is most pronounced over long stretches of time, but it can occur over shorter stretches, as well. (In those cases, it's usually less extreme and can even work in your favor.)
    - Cash outlay. Since you're buying shares, this form of hedging reduces your cash balance on day one.
- **When to use it**
    - When restrictions on your account prevent you from participating in other strategies.
- **What to target**
    - As with cash, the primary consideration here is what you want the target net long weighting for your portfolio to be, and what role you want this particular strategy to play within it.

Hedging an Individual Stock in Your Portfolio

- **How it works**
    - When you have a large position in a single stock that you'd like to hedge (instead of hedging the entire portfolio), you can reduce volatility by hedging out that single stock using any one of the strategies listed above.
    - Maximum gain: Depends on the strategy
    - Maximum loss: Depends on the strategy
- **Advantages**
    - Pinpoint accuracy. Foolish investors tend to have stocks that aren't perfectly correlated with a single ETF, meaning an ETF-based hedge doesn't completely remove company-specific risk from the portfolio. By targeting a specific stock, you're able to exercise greater control over the business risk you hedge against.
- **Drawbacks**
    - Market risk. The odds are higher that a single stock won't correlate with the market than that an entire portfolio will go rogue, meaning you run the risk of hedging out a stock that continues to crush its performance while the market (and your overall portfolio) tanks.
- **When to use**
    - When you're primarily concerned about a single stock, but aren't ready to sell your shares just yet (perhaps you just want to hedge through earnings).
- **What to target**
    - Depends on the strategy selected.

Thoughts? Questions? Don't hedge your bets! We're here for you on the Hedging discussion board.

Pro FAQ

Published Oct 26, 2016 at 12:08PM

Welcome to our Frequently Asked Questions about *Motley Fool Pro* and how you can get the most out of the service. Have a question that's not addressed here? Ask us on the Member Suggestions & Help discussion board!

About Pro

What is Motley Fool Pro?

Motley Fool Pro is a $1 million real-money portfolio being managed for accurate, recurring, and absolute profits (rather than relative returns). The portfolio buys all types of equities, uses several different options strategies, and employs ETFs, hedges, shorts, and other advanced strategies to make money in flat, down, and up markets. Over the years, however, the main bent of the portfolio should be that of long-term stock ownership. All trades are announced to *Pro* members well before we make them, and all returns are tracked publicly for you.

How can I see a list of the team's holdings?

You can see the *Pro* team's holdings here: Tom Gardner | David Gardner | Jeff Fischer | JP Bennett | Billy Kipersztok | Ellen Bowman

Recommendations Help

If I'm a new member, where do I begin?

Begin by establishing a position in our Buy First stocks, then follow our moves in that portfolio. We'll preannounce trades just for you — always sending you a "Trade Alert" email before we make a move — to help you build your portfolio with us.

What do Best Buy Now, Buy, Hold, and Sell mean?

- **Best Buy Now:** If your portfolio doesn't yet mirror ours, start by matching our percentages in these stocks. They represent the most attractive risk-to-reward opportunities today.
- **Buy:** We suggest you buy these strong stocks next as you build your portfolio.
- **Hold:** This means to keep your shares if you own them, but don't add more cash or open a new position in the stock.
- **Sell:** We're selling all or a partial stake in this position, and we recommend you do, too. You'll get a full sell report with any position we decide to jettison.
- **Short:** We recommend you sell short these positions. If you haven't shorted before, get a lesson from our Guide to Shorting.

What do the three portfolio tabs contain?

- Open Positions includes all active positions in the portfolio.
- Closed Positions offers details on positions that are no longer active (this does not include positions that have been *partially* sold).
- Transactions is a complete list of every transaction we've made from the start: buys, sells, dividend payments, interest on cash and more.

Building Your Portfolio

What is a good broker to use?

From Scottrade to TD Ameritrade, ThinkorSwim to OptionsXpress, Schwab, Interactive Brokers, and others, *Pro* members use 'em all. If you're looking to trade options, just about any discount broker will work, but some have stricter options permission policies than others, and IRA policies differ. Do your homework! The Motley Fool's Broker Center is also a great resource.

Should I buy every stock at once right now?

In a volatile market, it pays to move steadily. In building out your *Pro* portfolio, consider our **Buy First** holdings first; those are the companies we think are the best opportunities for your money right now.

How much of each Pro stock do I buy?

If you want to mirror *Pro*'s portfolio, see our buy reports and buy our committed (or actual) allocation so far.

How should I use Pro if I'm already fully invested?

Don't sell everything you own at once. You own your stocks for a reason! Begin by reviewing your current holdings, then consider selling your least-favorite stocks to free up cash as you need it for new *Pro* trades. Gradually move freed-up cash into our Buy First stocks and then our Buy stocks. Consider your sector allocations and stay diversified as you add *Pro* buys.

How should I use Pro if I'm adding new cash over time?

Averaging new money into stocks over time helps you achieve better returns. Do this if you can. Determine how much you plan to contribute over the next year and base your target allocations on *that* figure rather than on your current portfolio value. If you have $50,000 and expect new cash will grow it to $60,000 by year-end, keep that in mind as you allocate. Be mindful of commissions as you build your positions — ideally, you want commissions to cost less than 2% of any trade. A $20 commission for a $500 investment, for instance, would be 4% — that's not cost-effective. (This is much less true when writing options, where you simply want the cash you're paid to be worthwhile; commissions will typically be a larger part of your overall trade.)

I'm using an IRA for Pro. How should I proceed?

IRAs are tax-deferred accounts, so they're ideal for income-generating trades like covered calls, high-yielding dividend stocks, and any ETFs with large, taxable distributions. IRAs are *not* so great for more speculative trades because any losses generally cannot be used to reduce your taxes. Keep in mind that IRAs do not allow short selling or buying on margin, and will not allow more aggressive option strategies, such as writing puts on even modest margin. Consider opening a separate non-IRA account to take advantage of these *Pro* strategies. Then, manage this second account and your IRA together as *one* portfolio.

Should I reinvest dividends?

You can go ahead and reinvest any dividends, if you'd like, on any *Pro* stock that is rated a Buy or Buy First. *Pro* is *not* reinvesting dividends simply because it's difficult for us to track. It results in partial shares, which also complicates option strategies on the stock. We take all dividends as cash and will invest them ourselves.

Where can I learn more about ETFs?

Please read our guide, The ABCs of ETFs, for more on exchange-traded funds.

What broker does Pro use? Does Pro reinvest dividends? Pay commissions? Rebalance the portfolio?

- *Pro* currently trades via Interactive Brokers.
- We do not reinvest dividends so that we can deploy our cash to the best opportunities at any given time (that could be the company the dividends came from, but it may not be).
- Commissions vary per trade, but all costs are shown on our transactions page, and commissions are included in our prices and returns.
- Finally, though we won't rebalance in order to meet certain arbitrary allocation guidelines, we will manage the portfolio to avoid excessive risk in any one position.

How do you track your performance?

The Motley Fool measures the *Pro* portfolio's performance from its launch date in October 2008. The portfolio's cash balance is included (lowering returns when we have cash). We track relative returns for members' benefit, focusing on annualized rolling-three-year periods (which is consistent with our mission), even though *Pro* is managed for absolute returns (profits, period). *Pro*'s total returns and the S&P 500 Total Return Index include dividends. Our North Star is measured using the CPI-U (the Consumer Price Index for All Urban Consumers, as calculated by the Bureau of Labor Statistics) as its measure of inflation. For more on our North Star, click here.

Options Help

What should I know before investing in options?

Read our Options 101 guide and our Options Glossary to become familiar with the terms, strategies, and purposes behind using options before you consider placing any option trades. If options are new to you, we recommend that you watch a few of our trades play out before you start to follow them in your own portfolio.

What is a good broker to use?

From TD Ameritrade to ThinkorSwim to OptionsXpress to Schwab to Interactive Brokers — and others! — *Pro* members use them all. Just about any discount broker will work, but some have stricter options permission policies than others, and IRA policies differ. Do your homework! The Motley Fool's Broker Center is also a great resource.

How do I apply for option trading?

Ask your broker for full options approval, typically level 2 or 3 (it can vary by broker). Fill out, sign, and mail in a simple one-page document. After a week or two, you'll be approved! Slide on over to our All About Options board if you have any questions, and watch our Options in 3 Steps video for a visual walk-through of the process.

How much money do I need to trade options?

To buy an option, you need very little money: just enough so that your commission is, ideally, less than 2% or 3% of your total transaction cost. To write options, you need to have a margin account. Also remember that different brokerages have different requirements. You'll need anywhere from $10,000 to $50,000 to gain brokerage approval for option writing, depending on your broker. We recommend that you have at least $25,000 in your portfolio if you want to trade options with Pro, and $100,000 if you want the flexibility to follow along with most options trades we make. The smaller your portfolio, the more likely you'll need to pick and choose which of our options trades you follow.

What level of options permission do I need?

It varies by broker, but level 2 to 3 (the ability to buy and write calls and puts) is typically sufficient for now.

Can I make option trades in an IRA?

Yes, you can buy options and write covered calls in an IRA, tax-free. Some IRAs will also let you write cash-secured puts. Ask your broker.

I can't sell puts because of brokerage restrictions. What should I do?

Focus on buying stocks in our preferred buy price range to give you the largest margin of safety. Also, read up on our covered-call strategy. This is another way to generate income from options and is allowed by most brokers and even in IRAs.

CAPS and the CAPShot

What is CAPS?

CAPS is The Motley Fool's vibrant investing community filled with stock pitches, blogs, screens, and a host of proprietary data based on members' ratings of every stock's ability to outperform over time. For much more about CAPS and how to get involved, check out Meet CAPS and Using CAPS to Find Great Stocks. Here at *Motley Fool Pro*, we use proprietary CAPS data as another screen to find great stocks, sectors, and ETFs.

What is a CAPShot report?

Coming soon!

We created a special checklist to help *Pro* members find the strongest growth stocks in the CAPS universe -- those with leading growth rates, strong margins, and healthy financials. The CAPShot Report checklist rates stocks on four CAPS criteria and eight of our own hand-picked fundamental criteria. It then applies a score from 1 to 12, with 12 being highest. Few stocks will score 11 or 12, but when they do, you can bet that we'll be taking a closer look. We're currently working on getting the CAPShot report up and running and will notify you when you can begin generating your own reports.

My Scorecard

What is My Scorecard?

My Scorecard is your personalized one-stop shop for information about the stocks that matter most to *you*. It's part scorekeeper and part coverage collector:

- Add your holdings, and we'll track your performance for each position, as well as your overall returns versus the market.
- Add stocks you're interested in but don't own (enter the ticker, but don't add purchase data), and we'll track those companies' prices, too.
- Below your list of stocks, you'll see an activity feed of all your premium Motley Fool services' coverage of your companies — updates, articles, discussion board posts, and more. You can filter this list to zero in on just the type of content you're looking for.
- Finally, at the top of the page, you'll see quick bites of personalized information and Foolish fun facts. Every time you visit, you'll see a different set, so refresh the page and come back often!

Can I have a watchlist in My Scorecard?

Any stock you add without entering purchase information is treated as a watchlist pick. You will see the current price and commentary will start to appear in the feed. However, it will not affect your overall returns.

Can I enter the number of shares I own?

Now you can! When you add a stock, enter the number of shares you bought, along with the date and price of each position. We'll show you how much of your portfolio each stock makes up.

How are my returns calculated?

- **The overall return of your scorecard**, shown at the top of the page, is calculated using the annualized effective compounded return rate, commonly known as the internal rate of return (IRR). The best way to think about this return is as an interest rate — it represents the interest rate you would need to earn over the period you have been investing to end up with your current position. This takes into account all of your active and sold positions, as well as the dates you bought and sold each holding. IRR is an annualized figure, so if you've returned 40% over two years, your IRR will be 18.3%. Dividends are not automatically included for the individual stock positions, so you'll need to manually adjust your purchase price to account for dividends.
- **S&P Return** is calculated the same way, by mirroring each of your investments with similarly sized investments in the dividend-adjusted SPDR S&P 500 ETF (SPY).
- **The weighted average returns**, at the bottom of the Active and Sold tabs, are calculated using a the cost-weighted average of all your active or sold positions. Unlike IRR, the weighted average doesn't include the total of all of your positions (just the active or sold), and it is not annualized.

How do I add multiple tickers?

Just type them into the box below your scorecard (separated by commas or spaces) and they will appear in your scorecard. Click on Edit for each stock to add the purchase information.

How do I add a closed position?

Click sell and then enter all the information in at once. Your position will then be moved to the Sold tab of My Scorecard.

What happens when I delete a stock?

Poof! It's gone. When you delete a stock, it's gone from My Scorecard, and so is all the content associated with it. (We've put in a pop-up that checks to make sure you meant to delete it.) If you deleted a stock by accident, you can always readd the stock, and the appropriate information will reappear.

Does My Scorecard support splits and other corporate actions?

No. You will have to make these adjustments manually, by changing the purchase price.

A stock is newly listed on the NYSE or Nasdaq. Can I add it to My Scorecard?

Your Fool tech team will manually add these to our database. If you find a ticker that needs to be added, just give us a holler on the boards.

Getting the Most Out of My Scorecard

My Scorecard isn't a comprehensive portfolio tracker. It doesn't track options, warrants, mutual funds, and stocks on foreign exchanges. It also doesn't track cash; however, there is a workaround for tracking cash explained here. For corporate actions such as dividends and splits, you'll have to change a holding's Buy Price to adjust your cost basis.

The tool is a work in progress, though, so if you have suggestions or ideas for My Scorecard, bring them to our feedback discussion board, and we'll let you know what we can do!

Where can I get the latest information about the Foolish plans for My Scorecard?

You can find the latest and greatest information about what's next on the Foolsaurus page for My Scorecard, and if you have any questions, post them on the My Scorecard Feedback discussion board.

Emails, Memos, Audio Extras, and Guides

What are "Trade Alert" emails?

"Trade Alert" emails come to you at least 24 hours and no more than 30 calendar days before we make our trade. This gives you the chance to beat our price. You can manage the email you get from *Pro* and any other Fool services here.

When is the Monday Memo made available? Can I print it?

You can find our weekly news update both in your email box and here on the *Pro* site every Monday (imagine that!) at 4 p.m. ET. If Monday is a holiday, we'll publish it on Tuesday.

To print the Monday Memo, just look for the "Print This Page" link at the bottom of the page.

I'm feeling overwhelmed by all the guides and lessons on Pro. Where should I start?

Follow our simple three-step plan to help pace yourself. Reading a few of our recent (and brief!) Monday Memos is another great way to catch up. Just take your time. By reading just one of our feature articles or guides each week, within a few months you'll have read all of them, and you'll be completely in-the-know with *Pro*.

I want to learn all I can from Pro. What are the essentials?

Visit our resources page for the *Pro* team's favorite guides and investing lessons.

How can I view a list of all published articles?

Just go to our Alerts & Coverage tab and make your choice of content (Alerts, Memos, or Extras) on the sub-navigation bar. You'll see an archive of all *Pro* content in that category; click "Next" at the bottom of the Articles page to continue further back through our archives.

Will you post transcripts of your Audio Extras?

Yes! Transcripts of all Audio and Video Extras will be posted soon after publication.

Community and Discussion Boards

How do I use the discussion boards?

The basics: Only *Pro* subscribers can access the *Pro* community, whereas the at-large Fool Community, with more than 4,000 active boards, is accessible to anyone. For more general information on Fool discussion boards, visit the Fool's Help Centerfor a tutorial.

How can I keep up with the discussion boards when I only have 15 minutes a week?

Just check the "Most Recommended Discussions" section of *Pro*'s Community tab for members' favorite posts of the week.

Click the **heart** on each *Pro*discussion board that interests you. Now you can access it in the My Boards section of your My Fool page.

If you just want to find responses to your own questions, follow the Favorites & Replies link in the navigation bar at the top of the board page, and then click "Replies to Your Posts." Your replies will be automatically filed for you.

When using the discussion boards, what do "unthreaded" and "threaded" mean?

Unthreaded means the posts are listed in chronological order. This is our default setting. *Threaded* discussions are grouped according to a specific subject. For example, you might start a thread by posting on the subject of "Intel's Earnings." If I respond to your message, my post will be "Re: Intel's Earnings," and so forth. All of the replies to your subject will be kept together. This makes it easy to follow each small discussion on a board. The difference between threaded and unthreaded is that threaded takes the subject into consideration first and the chronological order second. If you have questions about this or are still confused, email customer support at FoolBoards@fool.com.

How do I write a post?

On every message, there's a link called "Post Reply." Just click there. A new page will come up, with the original post and a box to type your message in. Once you finish the message, click "Preview Reply" to make sure it looks like what you thought it would look like (if it doesn't, no worries; just click "Edit Reply" to make any fixes). Then click "Submit Reply," and it's on the way! Your message will show up as the last message on the board in chronological order.

Once you've posted a message, you can't go back and delete or edit it.

Technical Support

How do I change my username and password?

To change your username or password, click here. Please note: You can only change your username three times per year. Your password must have at least six characters (no spaces or special characters, please). You can change your password as often as you like.

My email address changed. How do I update it?

Note: When you change your email address, your account will be suspended temporarily. We'll send an email to your new address, with a link to a page that will unlock your account. Click that link and follow the instructions on the page. Please be sure to let us know when you change your email address. Failure to do so may result in the delay or non-delivery of online products or messages regarding any paid subscriptions.

What is your refund policy?

We sincerely believe in everything we sell. Yeah, it sounds hokey, but it's true. If you're not completely satisfied for any reason, just let us know within the first 30 days, and you'll get a complete refund. If you joined or renewed as part of our special three-year promotion in August 2011 or January 2012, you can cancel for a full refund anytime during your three-year subscription. Otherwise, after the first 30 days, you'll receive a pro-rated refund for the remaining portion of your subscription term. Our complete refund policy can be found here.

How do I renew my subscription?

You don't have to lift a finger. Your subscription will be automatically renewed each year on the same day that you originally purchased. Thirty days before your subscription renewal, we'll send you an email renewal reminder. If you don't want your subscription automatically renewed, or if you want to change your billing preferences, just contact us at membersupport@fool.com.

How do I change my billing or shipping address?

To update your mailing address, click here. Or click on the "Edit Your Account" link on your My Fool page or the newsletter's website.

What if I need more help?

If your question has gone unanswered or you are experiencing difficulties accessing the site or downloading an issue, please contact us at membersupport@fool.com. In your email, answer as many of the following questions as you can:

Are you using a Mac or a PC?

What operating system and version are you using? (Windows 98, Windows NT, Mac OS 9, Mac OS X, etc.)

What version of Adobe Acrobat are you using?

Did you see any error messages? What did they say?

Pro Resources

Published Oct 17, 2016 at 1:10PM

Getting Started

- Allocation calculator
- What to know if you're investing in an IRA
- Getting Started discussion board
- FAQ

Options/Hedging/Expanding Your Skills

- *Pro*'s options guides
- Our Guide to Hedging Like a Pro
- Our sister service, *Motley Fool Options*
- The *Motley Fool Options* brokerage discussion board

***Pro* Philosophy**

- Some thoughts from Jeff on fair value
- A guide to our North Star
- Finding Great Companies: *Pro*'s 8 Qualities
- Why most investors fail, and how we avoid it
- How we target *Pro*'s returns

Account

- Manage your email settings
- Contact member services

***Pro* in 300 Words or Less**

Motley Fool Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star.

We expect most of our gains to occur in our long-term stocks, since we target owning companies that are "compounding machines" -- those special few earning outsized profits that are protected by long-term competitive advantages, and that invest those earnings in still more profitable growth. Alongside stock ownership, we sell short weaker companies to profit on downside and market declines; we use options to generate income, leverage our results, or protect ourselves. And we hedge market indexes as an extra form of insurance.

Many *Pro* members only buy our stocks. Because we are a portfolio service, we recommend that you buy as many of our long stocks as possible, and try to match or come close to our allocations. You don't need to short or use options unless you want to. We run a concentrated portfolio (typically fewer than 30 long positions); we aim to have very low turnover (we want to own long-term winners and let them compound); and we construct our portfolio to be diversified, but still invested where we see the most opportunity and best business models.

We're glad you're here at *Pro*! We hope that our streamlined yet powerful approach -- whether you use our shorts and options or not -- will help guide your investment portfolio to new highs over time. -- *Jeff Fischer, advisor*

Using Scorecard in Motley Fool Pro

Published Oct 17, 2016 at 11:01AM

Welcome, *Pro* Fool! This TMF scorecard app does not track options positions at this time, but we do have options tracking spreadsheets for download here, here, and here. You can, of course, still track your *Pro* long and short positions here, and you can also:

- Personalize the coverage you get from us. Follow (for example) FB in Scorecard, and you'll get a daily or weekly email (your choice) whenever there's any coverage of FB in any of your TMF services. For *Pro*, that means earnings coverage, updates on strategies, and info from all of our Monday Memos.
- Keep a watch list of stocks you are interested in and track their hypothetical returns.

For questions, please come to the Member Suggestions board. Fool on!

-- The *Motley Fool Pro* team

Portfolio Positioning Report

Published Sep 21, 2016 at 11:22AM

November 2018 Note: This report needs a refresh! Please stay tuned -- we'll let you know when it's up-to-date again.

Dear *Pro* Member,

Our first three Portfolio Building Reports provided you guidance on all of *Pro*'s Buy First and Buy stocks. This final report will do the same for our active short and timely option positions, some of which we use as hedges. For reasons we'll explain, we don't expect that many of you will initiate all of the positions in this report right away, or perhaps at all. And that's perfectly fine!

Hedging is about lowering your exposure to the risks of the market; to a lesser extent, shorting is as well. These additional investment tools tweak or adjust the risk profile of your *invested* portfolio, so if you're still building your collection of long-term stocks, concentrate on that first. Stock investments are the core of the *Pro* portfolio, and by owning *Pro* stocks, you are positioned to compound your value over time. We know there's a learning curve for strategies that are new to you, so it's important that you know there's no rush with shorts, options, and hedges; you can incorporate the positions in this report, or our future updated ones, when you're ready. We're here for you in the meantime.

Before outlining the current positions you can take, let's review how each strategy works. We'll begin with shorts — a sort of "anti-investment" that we believe will decline in value, adding profits to our portfolio in the process.

Shorting in Short

When you sell a stock short, you borrow shares of a company or an ETF from your broker and immediately sell them, collecting the proceeds. At various brokers, this trade action is called "sell short," "sell to open," or just "sell." In the future, you'll need to buy the same number of shares back to replace the ones you borrowed and sold. This second step is called "cover," "buy to cover," or "buy to close." You hope to profit from buying the shares back at a *lower price* than when you opened, or sold, the position originally.

The difference between your original sell — or short — price and the price you later pay to buy back (and return) the borrowed shares is your profit or loss. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock rises to $30, you've lost $10 per share when you buy it back. We use shorts in *Pro* because they're one way to profit when the market or a targeted company falls, but they come with their own risks — shares can be hard to borrow, shorting fees are often involved, and a short can get closed on you (you're forced to buy it back) if the broker wants the shares back early. So, we need to size each of our short positions appropriately small.

Hedging ... in Short

A hedge is similar to a short because it gains value when prices fall, but it's different in intent; these positions are taken only to *offset* the risk we have in another position or in our market exposure as a whole. So, when we sell short (or use bearish options on) a market-index proxy like the **SPDR S&P 500** (NYSEMKT: SPY) ETF or **PowerShares QQQ** (NASDAQ: QQQ), we are hedging our exposure to the stock market or to a particular index as a whole. A hedge is a form of insurance; it only pays you when you need it, and it usually won't make any money. But we *know* a market-index hedge will increase in value whenever the market goes down — making it an effective hedge during bad times. We just always remember that if the market doesn't fall (or doesn't fall enough), our hedge will go unused.

For this reason, we try to spend very little to hedge, but sometimes costs can't be avoided. We have to reconcile this with the fact that hedging lets us stay *more* invested in stocks than we might otherwise be. In other words, one key way we profit from our hedges is by using them to help us keep our long stock exposure higher! We own more great companies because we soften our total risk by hedging. As with shorting, you should only hedge if you have stock market exposure you want to "hedge out." You don't need to hedge or short to succeed.

Your Exposure

To know whether hedging is for you, it's helpful to think about your stock market exposure. This is simply how much of your total portfolio is invested in long stocks. Excluding options and shorts, *Pro* is about 73% invested in long stocks as of this writing. That's high for a typical absolute-return portfolio like ours, which is part of why we want to short and hedge! Many hedge funds are market-neutral (net 0% long) or only 10% to 20% net long. Pro is much more invested, and has benefited. Like many members, you may own other stocks beyond *Pro*'s, so if you've also bought all of our stocks, you might be even more exposed to market risk than we are. Lately, we typically hedge the *Pro* portfolio down to about 60% market exposure with our index hedges and other shorts, and you could (but do not need to) follow along today. In other market situations, we'll likely hedge much more.

The bottom line is: As you consider adding hedges and shorts to your portfolio, first know how much of your assets are invested in stocks. That helps dictate how much shorting or hedging you want to initiate to reach the *net* market exposure you desire. *Pro* has averaged about 73% net long exposure since January 2012, but that number will move up and down as our opportunities change. Our exposure is always shown at the bottom right of the Recommendations page. For many years, I've found that about 72% market exposure, along with the use of options, can be enough to earn strong (market-topping) returns with less risk. This pleasing result rests on investing in superior long-term stocks, and the past is no promise of future returns, but we're aiming to continue that success.

This Stuff Is Optional

Not every *Pro* member is comfortable with shorting or hedging, and there are practical considerations to take into account as well. First, you need a margin account to sell short, so (unless you use options to go bearish) you can't sell short in an IRA. Second, you have to accept that shorts can run strongly against you, so you need cash to cover that risk. Third, you'll usually pay an annualized fee of anywhere from 1% to 7% of a particular short's daily value to short it. Fourth, in many cases it's hard to borrow shares to short, period. That is the situation with some of our shorts today. Finally, short shares can be bought away from you at the worst time, when they're up in price (called a "forced buy-in"). If brokers can no longer find shares to borrow, you can be forced to "buy in" at market prices to return your borrowed shares.

So what to do given all this? You can use options to short in some cases -- we do, and we explain how to do so wherever appropriate. You can also consider opening a brokerage account that is particularly friendly to shorting. Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does, and does not charge a fee for shorting. You could also wait and see whether shares become available in your existing, traditional brokerage account, though note that at many brokers, certain shares are basically never available for shorting. Or, if you're not drawn to it, you don't need to short.

Options Are Optional, Too — but Advised!

Our options positions are also ... optional, but we strongly advocate learning to use options and following along with ours over time. Options are powerful tools for income, hedging, greater upside, and more. We know from experience they're well worth the time it takes to learn them, and we're here to help. Options can make you a much more confident and versatile investor, and they can generate a whole new stream of income for you and your family. So, if you're new to using options, you're certainly in the best place! Use *Motley Fool Pro* and our sister service, *Motley Fool Options* (free for the life of your *Pro* membership), to learn how to use these great tools. On a personal note, if you're going to learn just one simple strategy, I suggest learning how to write puts (link goes to *Motley Fool Options*) for steady income or to buy a stock lower.

About This Report

The *Pro* service will (when you're ready!) help you short vehicles we believe could decline; teach you how to hedge your portfolio; and set you up to generate returns from options. To that end, keep in mind that today's report is just a start; we'll have many *brand-new* investment recommendations arriving to your inbox as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way!

On the other hand, if this looks overwhelming right now — or if you're still catching up with our core stock positions — that's perfectly fine. You don't need to start these positions now. As mentioned, long positions are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and often rewarding — aren't necessary to succeed with *Pro*. As you learn these strategies and progress with us, just keep your exposure to the stock market in mind.

In closing, I'll stress again that you shouldn't feel pressured to act right away. We will continue to make updated recommendations on our holdings for newcomers on an ongoing basis in our Monday Catch-Up Trades — and as brand-new opportunities emerge. That's part of the fun! Building over time is the most rewarding process. So take your time, and make an investment only when you're ready. Finally, please bring any questions to our live event on Friday, Dec. 16, or to our Making *Pro* Fit You discussion board.

Foolishly,

— Jeff Fischer, *Pro* advisor

The Positions Themselves

Shorts

- **CurrencyShares Euro Trust** (NYSEMKT: FXE): Sell short 1.7%, on our thesis that the U.S. dollar will appreciate against the euro as U.S. interest rates increase. If you can't borrow shares, skip this position rather than using options, because we may close this short soon (we've had it for years in anticipation of today's current situation), and the options have significant friction costs if you only use them a short while. So, short shares directly, or don't start a position.
- **Domino's Pizza** (NASDAQ: PZZA): Sell short 2.1% only if you own about 3.9% in **Papa John's** (NASDAQ: PZZA). The Domino's short is a partial hedge of our Papa John's investment.
- **Direxion Daily Financial Bear 3x Short** (NYSEMKT: FAZ): Sell short 0.2% as a long-term leveraged investment in financial stocks going higher. If you can't borrow shares, but you have options approval in a margin account, you can set up a January 2018 synthetic short instead by selling to open January 2018 $20 calls and buying to open an equal number of January 2018 $20 puts. Set up one synthetic short for every $2,000 in value you can short, but only up to a very small portion of your portfolio. If you can't set this up, simply invest 0.2% more in one of our financial stocks, such as **Visa** (NYSE: V).
- **Gogo** (NASDAQ: GOGO): Sell short 0.5% directly. If you can't sell short directly, the options are not attractive enough to use.
- **Shake Shack** (NYSE: SHAK): Sell short 0.6% directly. Again, the options are expensive to use. Be aware we're down 18% on this short ourselves, so we will reconsider it, per our policy, at about a 20% loss. We may close it, protect it, or add to at that point. We shall see.

Hedges

- A live, new alert for a sizable market index hedge is scheduled to hit everyone's inbox (and the *Pro* site) soon. So watch for our new hedge soon, and all who wish can get on board.

Options

- **American Tower** (NYSE: AMT): Assuming you first have established your 3.5% American Tower stock allocation (the stock is a Buy First), set up diagonal calls per our recent alert; however, instead of selling to open April 2017 $115 calls, sell to open $110 calls. Follow allocation guidance in the alert, and ask any questions on the AMT board linked at the end of the alert.
- **Parexel** (NASDAQ: PRXL): If you already own at least 100 shares of Parexel, "sell to open" one March 2017 $65 call for every 100 shares of the stock you own. We are selling these covered calls for income and to potentially exit our position at a higher price. If you don't yet own Parexel, **do not** buy the stock or write these covered calls; the stock is rated Hold.
- **Skyworks Solutions** (NASDAQ: SWKS): Assuming you own shares of Skyworks (a Buy on our scorecard), "sell to open" Jan. 20, 2017, $75 calls, selling one call for every 100 shares of stock you own. We are selling these covered calls as income, and will manage the position for members at each expiration. The recent price you'll get paid for the calls is adequate.
- **Verisign** (NASDAQ: VRSN): Buy 1.5% in shares and set up a covered strangle for income and another potential 1.5% in stock, per our recent alert.

The Rest: On Hold

Any position not shown as Buy First, Buy, or Short is on Hold. And any option not listed here but still on the Recommendations page is either ending soon, no longer timely, or no longer recommended. So if you have started positions in all of our Buy First, Buy, and Short stocks, and then followed along with the shorts and options in this report that you're able to, you will be caught up to *Pro!* Sit back, bask in your success, and simply follow our new trade alerts to keep up (as well as our Monday Catch-Up Trades for any positions you might still lack). If you are not yet caught up, continue to take your time, follow our Monday updates, and ask questions on the boards. There's no rush. Good things come to those who move gradually, including investors.

Welcome again to the esteemed *Pro* community! We'll talk with you again soon.

Pro Portfolio Building Report No. 3: Our Buy Stocks, Continued

Published Sep 6, 2016 at 12:26PM

Welcome, Fools! As new members continue to learn more about *Pro*, we get a lot of questions about fair value. The most common one is this:

> **Q:** If a stock is rated Buy or Buy First, but its current price is higher than *Pro*'s stated fair value, is that stock still a Buy or Buy First right now? Should I really buy it today? At this price?
>
> **A:** Yes. Yes, at least *start* to buy your allocation. Dip your toes in if you're not buying the whole stake yet (which is also fine!). Today's price should still provide the long-term annualized return we seek.

This may seem counterintuitive at first, but with some context, we think you'll see how this approach makes sense for our portfolio. Make sure you read Jeff's important Memo, "The Flaws of Fair Value," to understand how a great company has multiple extra ways to increase value that we can't bake into our long-term projections, partly because we don't know everything management is planning. (And to read more on fair value, click here.)

Moving on to today's report: Presented below are the rest of *Pro*'s Buy stocks; with these and our previous two reports, plus judicious application of the advice above, you should be ready to keep adding to your *Pro* portfolio as you're comfortable! Stay tuned for our next live chat, which we'll tell you about on the site and via email, and bring us your questions on the Getting Started & Help discussion board. We're glad to have you.

Best,

-- The *Motley Fool Pro* team

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Buy: Johnson & Johnson (NYSE: JNJ)

At eight out of eight of our Pro Quality Checklist criteria, Johnson & Johnson is a quintessential Pro-quality stock.

Suggested Allocation: About 3.1% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (2/22/17)
- Talk about Johnson & Johnson

The eighth largest company in the U.S. by market cap, J&J is one of the world's leading health-care companies, conducting business in virtually every nation of the globe.

The business is organized as a holding company, with more than 250 operating companies that are separated into three business segments: consumer (19% of 2016 sales), pharmaceutical (46%), and medical devices (35%). The consumer segment sells dozens of familiar brands (think Band-Aid and Listerine). The pharmaceutical business is the company's largest; in fact, J&J is the world's sixth largest pharmaceutical company by annual sales. And the medical devices segment includes a broad range of products used in the orthopedic, surgery, cardiovascular, diabetes-care, and vision-care fields.

For such a large company, J&J has an outstanding financial profile (which provides evidence for the company's competitive advantages). As a top-notch business, this is one we expect to hold for a long time. While its large size means we don't expect runaway growth and upside from J&J, we do expect to earn North Star-challenging returns with low downside risk from one of the safest stocks you are likely to find in the entire investment universe.

Buy: OpenText (NASDAQ: OTEX)

This company's information management software keeps the digital lives of businesses in order, and its exchange software platform drives business transactions and earns recurring revenue.

Suggested Allocation: About 3.2% (see Recommendations page for real-time allocation)

For More

- Most recent earnings coverage (5/15/17)
- *Pro*'s original recommendation (8/31/11)
- Talk about OpenText

Based in Canada, **OpenText** (NASDAQ: OTEX) provides Enterprise Information Management (EIM) software to governments, legal firms, financial institutions, and other corporations that need to manage growing reams of digital data. Its overall goal is to provide customers with a singular software platform for managing, analyzing, and exchanging enterprise information; it also wants those customers to conduct business transactions over OpenText's business commerce exchange.

To these ends, OpenText steadily acquires smaller companies to add their services to its wares. Management made four acquisitions in mid-2016 that should fuel about $300 million in new revenue over the coming year (adding to its current $1.9 billion in annual sales), along with strong earnings-per-share (EPS) growth. As these acquisitions are assimilated, margins should continue to improve and the company's market share should rise. About 85% of OpenText's revenue is of a naturally recurring nature, being subscription-based.

This cloud and license software seller is under the radar of many investors, but it's the largest independent EIM software provider after IBM. Recently $63, the stock has been a strong long-term performer, up about 1,200% since its 1996 market listing, compared with 255% for the S&P 500. Today, the stock trades at 15.3 times estimated earnings for the coming year, while non-GAAP earnings per share are expected to increase by 15.5%.

Buy: Paycom Software (NYSE: PAYC)

Pro is looking to add more high-growth positions to the portfolio, and this company can sign that check -- so to speak.

Suggested Allocation: About 3% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (11/30/16)
- Talk about Paycom

Paycom Software is a profitable, young, cloud-based provider of payroll and human capital management (HCM) software, which manages the employment life cycle for employers and employees. It's differentiated by its comprehensive, integrated Software-as-a-Service (SaaS) solution that saves customers money and makes HR systems more efficient.

Revenue has compounded at 46% annualized over the past three years, and profitability and free cash flow much more rapidly than that. The company sports more than 15,000 clients and stores data on 2.1 million employees, and its average three-year retention rate (recurring revenue) was 91% as of Dec. 31, 2015. In the most recent quarter, 98% of revenue was recurring. It notches $300 million in annual sales, meaning the company can grow for years before it takes significant market share in the immense payroll and HCM industries. And its comprehensive and growing HR solution is ahead of competitors', promising market-share gains for years. Finally, at the time of our rec, the stock traded at 31.8 times expected non-GAAP earnings for 2018, in line with the company's estimated growth rate.

Be sure you've got a long-term outlook of at least three to five years, some comfort with high price volatility, and comfort with the potential for at least a partial loss of capital, then welcome Paycom as a high-growth, North Star-friendly addition to your portfolio.

Buy: ProShares Short VIX Short-Term Futures ETF (NYSEMKT: SVXY)

Profit from the long-term nature of stock market volatility to revert to an average level after each spike.

Suggested Allocation: About 2% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (11/25/14)
- Talk about SVXY

Buying shares in — let's make it easy and use the ticker, shall we? — SVXY is a recommendation for *Pro* members who are comfortable owning a small stake in a volatile position that we *may* add to during market downturns. *Pro* is a portfolio service, so all positions are meant for everyone, to the extent you can invest in them and wish to. But this position is not core to what we do, and will be especially volatile, so only follow it if you're comfortable with high volatility in a holding.

This unusual vehicle should increase in value when stock market volatility — as measured by the CBOE Volatility Index (or the VIX) — goes down or is range-bound. This ETF *sells short* futures contracts on the VIX that have one month and two months to expiration. Unless expected volatility from the S&P 500, as measured by the VIX, increases above and beyond the premium already baked into the futures contracts being shorted, the positions turn a profit in the ETF and the ETF goes up in value. Helping further, VIX futures contracts are historically in a state of "contango" as much as 90% of the time. Contango means that future-month contracts are increasingly more expensive than earlier months' and than the current VIX itself (much like a call option has a premium above the current stock price). This is a tailwind for SVXY. As long as volatility is ultimately rangebound overall (as it is historically), then just holding this small stake over the years should reward us.

We recommend starting at 1.1% (or round to 1% if you want), and we may add more when the VIX soars — meaning when volatility in the market is high and SVXY is low. But even if we don't, we believe this small position should create compounded value for us over the long term thanks to the regressive nature of volatility in the market: It spikes, and then grinds back down, and is usually range-bound.

Buy: Skyworks Solutions (NASDAQ: SWKS)

This leading designer of analog modules for smartphones and connected Internet of Things devices is growing sharply.

Suggested Allocation: About 4.4% (see Recommendations page for real-time allocation)

For More

- Latest earnings coverage (5/15/17)
- *Pro*'s original recommendation (8/5/14)
- Talk about Skyworks

The loftily named **Skyworks Solutions** (NASDAQ: SWKS) supplies customized analog semiconductor modules and related products to major smartphone makers around the world. As Wi-Fi connectivity grows, Skyworks' complementary Internet of Things business is growing, too, recently representing about one-fourth of total revenue. Company profit margins continue to expand as Skyworks increases its market share as well as the amount of its components it sells into many devices.

We're now seeing a move to higher-speed LTE wireless coverage in China and in most emerging markets; this is a long-term opportunity unfolding for Skyworks, even as smartphone sales level off in mature markets and at the company's largest customer, **Apple** (NASDAQ: AAPL). On July 21, Skyworks guided for 10% to 11% sequential revenue growth next quarter -- a bump higher than the 8% guidance given for the same quarter a year ago, suggesting healthy if not mind-blowing expectations for the iPhone 7. Management expects sequential growth to continue for the quarter after that, too, clearing current inventory concerns. As a technology leader growing faster than its market and with improving margins (a rarity in the chip industry), Skyworks, at about $74, is trading at 12.6 times earnings expected for the next year. The stock looks to us like a reasonably priced way to invest in the long-term ascent of mobile connectivity and the Internet of Things through a strong niche leader.

Buy: Starbucks (NASDAQ: SBUX)

You only think you're there for the coffee — the ubiquitous java purveyor has big plans.

Suggested Allocation: About 3.5% (see Recommendations page for real-time allocation)

For More

- Most recent earnings update (3/27/17)
- *Pro*'s original recommendation (8/22/2012)
- Talk about Starbucks

In the global coffee giant's fiscal third quarter, **Starbucks** (NASDAQ: SBUX) achieved 4% same-store sales (SSS) growth in the United States. Before that quarter, the company had generated at least 5% U.S. SSS growth for 25 consecutive quarters, so the "miss" grabbed some headlines.

But following a small dip in growth, there's no reason to see this green-and-white cup as half-empty. Revenue was up 7% year-over-year, and Starbucks now has more than 12 million active Rewards loyalty members, representing 18% growth from the prior year. A net 474 new Starbucks locations opened across the globe over the quarter, and we still believe that Starbucks is one of the highest-quality growth companies in the world. Revenue has increased for 23 of the past 24 years (1991 through 2015), and the company's 5- and 10-year average returns on invested capital are higher than 20%. Management is guiding for revenue growth of 10% for the full year (down from 10%-plus), and we expect Starbucks to provide at least a 10% forward rate of return.

Also this past quarter, management announced an investment in "Italian artisan bakery" Princi; the press release notes that Princi is "known for its artisan breads created from traditional family recipes" and that its "five locations have become beloved experiences for customers across Milan and London." Princi will also provide the food at Starbucks Reserve stores, showing that management is focusing on expanding and improving the food business as one way to give its growth a jolt. (Yes, that pun was intended. We might be working too mocha.)

Buy: Verisk Analytics (NASDAQ: VRSK)

This prototypical Pro *holding provides us with exposure to powerful tailwinds within the financial, energy, and health-care industries, among others.*

Suggested Allocation: About 2% (see Recommendations page for real-time allocation)

For More

- Most recent earnings coverage (2/27/17)
- *Pro*'s original recommendation (6/23/15)
- Talk about Verisk

Founded in 1971 by insurance-industry giants, **Verisk Analytics** (NASDAQ: VRSK) provides decades-old proprietary data and contemporary analytics to risk managers, property and casualty insurers, and financial institutions -- and after an acquisition to expand its data offerings, to the global oil and gas, chemicals, energy, and mining industries, as well. Company-wide, more than 80% of annual revenue comes from subscriptions to its services, and customers renew at an outstanding 98% rate as of 2015.

Verisk has pricing power, allowing it to increase prices regularly, including during the mayhem of 2009. How so? The company offers data that its customers need and others don't have; it has deep domain expertise, allowing it to work closely in each industry it sells to; it invents new analytic methods and better algorithms; and it's deeply embedded in customer workflow, becoming part of a user's process. Without Verisk's analysis, an insurance giant might have a hard time pricing policies.

Public since 2009, Verisk counts every major insurance company as a customer, and became part of the S&P 500 index in 2015. Historically fetching a premium valuation, the $83 stock recently trades at 26 times expected earnings for the year ahead, and 22 times free cash flow. We like the thought of new members starting a position here.

Pro Portfolio Building Report No. 2: Our Buy Stocks

Published Aug 30, 2016 at 11:56AM

Welcome, *Pro* Fool! This report details our current thinking on nine of the Buy positions in our portfolio; the Buy stocks not listed here are included in our third report. Once you've read theses and the previous report detailing our Buy First positions, you're ready to start (or continue) building your *Pro* portfolio as swiftly or as slowly as you like.

We want our advice to be uncomplicated: Purchase our Buy Firsts first (again, taking your time according to your situation — there's no rush); purchase our Buys after that; match our allocations as closely as you can (but don't worry about needing to buy in 100-share lots — fewer is fine); and stay tuned for our next monthly live chat, during which we answer member questions in real time. Also, please read this note on fair value as you move toward matching your portfolio to *Pro*'s.

We're glad you're here, learning to become an investor who will come out on top in all markets. Bring any questions to the Getting Started & Help discussion board, and Fool on!

Best,

The *Motley Fool Pro* team

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FactSet Research Systems (NYSE: FDS) | **Gentex** (NASDAQ: GNTX)
Mastercard (NYSE: MA) | **Medtronic** (NYSE: MDT)
Oracle (NYSE: ORCL)
O'Reilly Automotive (NASDAQ: ORLY) | **WisdomTree Emerging Markets Small Cap Dividend Fund** (NYSEMKT: DGS)

Buy: Amazon (NASDAQ: AMZN)

You will be assimilated.

Suggested Allocation: About 3.4% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (1/26/17)
- Talk about Amazon

When *Pro* first bought Apple in 2012, it was already the most valuable company in the world, sporting a massive $127 billion in annual revenue. Less than five years later, revenue is up 69%, and our investment (to which we later added) is up 72% excluding dividends. Apple has outperformed a majority of our positions, despite its giant size. Enormous **Amazon.com** could follow the same path, and may even have superior avenues for sustained growth:

- According to the U.S. Census Bureau, only 8% of U.S. retail sales occur online, but the shift to the Internet continues -- Amazon's revenue rose by 29% last quarter.
- Gartner estimated in 2015 that Amazon Web Services (AWS) for the cloud had 10 times the utilized capacity of its next 14 competitors *combined*, and this lucrative business increased revenue by 70% in 2015.
- Alexa is a leading artificial-intelligence operating system in the home.
- Amazon Prime may have as many as 80 million global subscribers, each paying $99 a year for free shipping and streaming video.
- And more ...

Amazon has so many business arms that a more fitting name could have been Octopus. Consumer retail sales drive massive cash flow to the company daily, but today it's cloud services that generate most of the profits. Amazon's cloud is heavy in machine learning and AI; relatedly, Alexa's early success is driving Amazon Echo and Dot product sales, and manufacturers around the world are now building Alexa into new devices and cars. Amazon has hundreds of fulfillment centers, and investment bank Piper Jaffray says 44% of U.S. citizens now live within 20 miles of one -- that's a strong competitive advantage. Drone delivery is in the works, and Amazon is investing in more of its own delivery to save on costs. U.S. sales account for about two-thirds of retail revenue, but international is growing and largely untapped. In an unconventional surprise, the company is launching a physical bookstore in Manhattan, and Amazon Go grocery stores around the country. And then there's Amazon's award-winning original content.

Sometimes lost in the breathless coverage of all these initiatives is what helps drive the success of each: data. Founder and CEO Jeff Bezos, 53, is driven by the intelligent use of information and cutting-edge technology to do business better than others. As the world's largest online retailer, Amazon has a better understanding of consumer retail behavior than any internet competitor, allowing it to anticipate customer desires. Couple that with the relentless pursuit of improving the customer experience, and Amazon always seems two steps ahead. In its own words, Amazon is "guided by four principles: customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking." Management has a history of reinvesting cash flow for more growth, learning from mistakes, and pushing new boundaries. This bodes well for long-term growth, and for us as shareholders.

Buy: Apple (NASDAQ: AAPL)

The leader in mobile computing products should see more long-term growth than anyone expects.

Suggested Allocation: About 4.8% (see Recommendations page for real-time allocation)

For More

- Most recent earnings update (2/27/17)
- *Pro*'s original recommendation (2/14/12)
- Talk about Apple

Led by its iPhone, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the smooth Apple operating system, iOS, which centers on the iTunes and App Store marketplaces, as well as the new Apple Pay. iTunes alone earns more revenue each year than two-thirds of the companies in the Fortune 500, while Apple itself is the most valuable company in the world, with more than $220 billion in annual sales. The company's integrated hardware and software make for a sticky consumer experience that provides disincentives to switch to a competitor, and as more people use multiple computing devices, Apple makes it easy to transition seamlessly from one of its products to another.

The company regained some shine with third-quarter earnings on July 26; while sales and earnings declined as expected, revenue of $42.4 billion and gross margin of 38% were at the high end of expectations. The new, cheaper, 4-inch iPhone SE is seeing strong demand in emerging markets (India and China included), becoming the first smartphone many consumers buy. Meanwhile, the number of customers switching to Apple products from other phone models hit its highest level ever. Apple sold 40.4 million phones this quarter, and the active installed base of iPhone users rose by more than 10% year-over-year. This helped drive services revenue in the Apple ecosystem (iTunes, Apps) up 19%, to $6 billion, for a $24 billion annual run rate.

Though Mac sales were down following new product releases a year ago, iPad revenue was up 7%, for the best result in 10 quarters, on the roll-out of the 9.7-inch iPad Pro. Overall, product sales have been strong (especially for phones) and inventories are at good levels as Apple reportedly readies a new phone model for release this fall. At $106, the stock trades at 12 times earnings, while EPS is expected to grow again in 2017. We're not counting on a revolutionary product anytime soon, but we are counting on record numbers of phones being sold to both existing and new customers over the coming years.

Buy: Broadridge Financial Solutions (NYSE: BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: About 5.4% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (4/27/10)
- Most recent earnings update (2/15/17)
- Talk about Broadridge

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in its fiscal 2015, its platforms processed approximately 85% of all shares in the United States. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider for managing investor communications.

The company's smaller division, Global Technology and Operations (GTO), accounts for 26% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance this Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy: FactSet Research Systems (NYSE: FDS)

Stable, predictable, and meeting every one of Pro*'s quality criteria, this data and analysis provider is no myth.*

Suggested Allocation: About 2% (see Recommendations page for real-time allocation)

For More

- Buy More recommendation (4/28/17)
- *Pro*'s original recommendation (5/18/16)
- Talk about FactSet Research Systems

The ideal *Pro* company has predictable recurring revenue, pricing power, a dependent customer base, expanding opportunities, and smart management. FactSet Research scores eight out of eight on our company quality checklist, and while most companies are struggling to grow these days, FactSet increased its revenue 9% in 2015 to more than $1 billion, with earnings per share growing 16%. That made for 35 consecutive years of revenue growth, and 19 consecutive years of earnings growth -- every year since FactSet went public in 1996. Over the past 21 quarters, earnings per share have grown by more than 10% year-over-year each quarter. The business has the traits we look for most: stable, predictable results with the ability to reinvest healthy free cash flow for more growth.

Founded in 1978, FactSet's data and analysis platform has become integral to the daily operations of thousands of financial professionals, including investment bankers, institutional investors, hedge funds, and asset and risk managers. Serving more than 3,000 customers with a total of 63,500 users, FactSet prides itself on personalized attention, making its customized data a core part of its customers' daily workflow and decision-making. FactSet's consultants paid 46,000 visits to its 3,000-plus customers in 2015, making sure to meet individual needs. Clients in turn reported 97% satisfaction with FactSet's customer service.

Meanwhile, FactSet doesn't carry any of the risks inherent with most "financial"-related companies; it's a subscription business model, selling data. It doesn't have balance-sheet risk. Should competitors start to cut prices to win market share (not likely, but possible), we'll need to reassess. But as long as FactSet retains pricing power and can steadily add new clients, it should create North Star-challenging long-term returns. We're happy with our position of about 2.2% today, and may potentially build it higher (with new trade alerts) as opportunities dictate.

Buy First: Gentex (NASDAQ: GNTX)

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: About 2.9% (see Recommendations page for real-time allocation)

For More

- Most recent earnings update (3/8/17)
- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex

In 1982, a small company in Zeeland, Mich., called **Gentex** made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands more than 90% of that market.

Currently, about 26% of cars made worldwide have an auto-dimming rearview mirror, and only 8.5% have auto-dimming exterior mirrors. For context, prior to 1987, those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher usage; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror (including the newly launched full-display mirror), both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy First: Mastercard (NYSE: MA)

With approximately 85% of the world's commerce still happening in paper money, electronic payment leaders have a lot of room to grow.

Suggested Allocation: 5% (see Recommendations page for real-time allocation)

Mastercard (NYSE: MA) is among the most attractive businesses in the world. The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns running a largely fixed-cost transaction network that becomes more profitable the more people use it.

For More

- Latest earnings update (2/9/17)
- *Pro*'s original recommendation (9/8/11)
- Talk about MasterCard

The company "charged forward" again in 2015 despite slow international commerce and a strong U.S. dollar. For the year, net revenue in local currency advanced 8%, and EPS gained 18% before special items. But right now, an investment in MasterCard -- as with **Visa** (NYSE: V) -- is an investment in growth *beyond* this year, because 2016 looks tepid as emerging markets struggle and the dollar remains strong. Much of the company's growth potential is being coiled up like a spring. That spring should pop when more economies begin to expand again and the dollar weakens. The market knows this, so the stock maintains a premium valuation.

Buy: Medtronic (NYSE: MDT)

The medical-device industry is complex and regulated, and it provides entrenched leaders with a competitive moat; our leading company is growing in international markets.

Suggested Allocation: About 2.9% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (7/1/2009) ...
- ... and our second buy recommendation (11/9/10)
- Talk about Medtronic

In March of 2016, the CEO of Medtronic put it like this: "Our formula for long-term success is to deliver consistent mid-single-digit revenue growth, with 200 to 400 basis points of EPS leverage, [and to] return a minimum of 50% of our adjusted free cash flow to shareholders through dividend growth and share repurchases. The expected net result is creating enormous value, with sustainable double-digit [at least 10%] total shareholder returns."

As shareholders of Medtronic, this is exactly what we've seen over the years: Our annualized return on the position is above 11%, and we think something close to this can continue going forward. Medtronic is a market leader in vital medical devices, be they for the heart, spine, knee, or one of four other key categories. The stock yields nearly 2%, and the dividend has increased annually for the past 39 years, resulting in an 18% compounded annual growth rate (CAGR). Expect continued dividend increases, sales growth of about 4% to 6%, and earnings-per-share growth considerably higher than that. Medtronic has a sound strategy to deal with the more regulated and costlier health-care environment. We're confident the business remains competitively advantaged, operates in an attractive industry, and is well-positioned to grow, especially in emerging markets. With reasonably priced shares, we target North Star-type returns.

Buy: Oracle (NYSE: ORCL)

This old-guard tech giant at a low price has more room to grow.

Suggested Allocation: About 3.7% (see Recommendations page for real-time allocation)

For More

- *Pro*'s original recommendation (9/17/09)
- Talk about Oracle

Oracle (NYSE: ORCL) is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems** (NASDAQ: CSCO), **Dell**, and **Microsoft** (NASDAQ: MSFT) — Oracle's value has steadily risen as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe, and its own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

We've been waiting patiently for the company to turn the corner in its transition to a cloud-based software-as-a-service (SaaS) business model, and it looks like that corner is now safely behind us. New software license sales declined 10% in the fiscal fourth quarter as demand for cloud-based applications increased, but a 4% increase in software updates and product support mostly closed the gap, resulting in a 2% overall decline. Fortunately, the cloud business has finally reached the size where its sales growth will more than make up for the slow decay of the on-premise business.

In the quarter, the company blew past the high end of management's estimates for SaaS/platform-as-a-service (PaaS) sales growth, posting a 68% increase over the previous year and 17% sequential growth over the previous quarter. Cloud sales now account for 8% of Oracle's revenue, compared with 5% a year ago. Though the top line will likely continue to grow at a modest low-single-digit pace for the next several quarters, the company is increasing the lifetime value of its customer base and becoming more profitable. Oracle is currently trading at a free-cash-flow yield of about 7.5%, which is attractive considering the likelihood of improved profitability as the cloud business scales. The company is a full-service solution, one that's poised to enjoy long-term growth in free cash flow.

Buy: O'Reilly Automotive (NASDAQ: ORLY)

Auto-parts retailers are boring, right? Right! But an investment here is up 670% over the past 10 years, and we expect additional returns around the corner.

Suggested Allocation: About 4.4% (see Recommendations page for real-time allocation)

For More

- Latest earnings update (3/6/17)
- *Pro*'s original recommendation (4/15/14)
- Talk about oh, oh, O'Reilly

America's second-largest auto parts retailer, **O'Reilly Automotive** (NASDAQ: ORLY) operates more than 4,500 stores, about one-quarter of them in California and Texas. Auto parts are a big business, estimated at $231 billion, and O'Reilly is an exceptional competitor, with an addressable market size of about $131 billion. Running 24 regional distribution centers and 240 hub stores as part of a two-tiered distribution strategy, the company provides same-day or overnight availability on more than 142,000 items, including many its competitors don't usually stock. Basic auto parts, tools, and services complement those hard-to-find treasures. As a result, O'Reilly's sales are historically split between "do-it-yourself" retail customers and lucrative, repeat-sales professional-services customers (such as auto repair shops), a luxury many smaller competitors don't enjoy.

On July 28, the company reported its 30th consecutive quarter of 15% or greater earnings-per-share growth. The results also featured a 7% increase in revenue and same-store sales (SSS) growth of 4.3%, on top of 7.2% SSS gains a year earlier. Operating margins continue to trend higher, now at 19.5%.

O'Reilly has opened 89 new auto-parts stores so far in 2016, pushing it toward 4,700 locations in 44 states, with a goal of 200 new stores total before the year is out. Besides the advantages listed above, O'Reilly's tailwinds include cheaper gas prices, more people working, and cars staying on the road longer (which means more repairs). For the year, the company increased earnings-per-share guidance to $10.30 to $10.70, implying a P/E of 27.5 on the $288 stock. Given the consistent track record of strong value creation at O'Reilly, a P/E in the lower 20s seems justifiable; shares trade at about 25 times expected earnings one year from now. This stock has always appeared a bit expensive, yet has rewarded handsomely.

As one of our largest positions, O'Reilly remains a stock we own for the long haul. Shares remain rated a Buy even though they currently (and historically) trade a bit above our fair-value estimate. After earnings per share rose 25% in 2015, we expect at least 16% growth in 2016, with the chance for acquisitions to move that number higher.

Buy: WisdomTree Emerging Markets Small Cap Dividend Fund (NYSEMKT: DGS)

Diversification in emerging markets with some of the best small, high-yield companies you've never heard of.

Suggested Allocation: About xxx% (see Recommendations page for real-time allocation)

For More

- *Pro*'s most recent Buy recommendation (4/28/17)
- Talk about DGS

At *Pro*, we like the idea of investing in emerging-market small caps to diversify and target higher growth. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) (the longest ETF name in the world!*). This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index, and yields between 3% to 4% per year.

For *Pro*, owning shares of this well-managed ETF offers exposure to up to 600 of the most promising international business that we couldn't easily buy in any other way. Serving as direct exposure to emerging markets, this is an excellent way to invest in small companies in locations where we don't have a discernible edge but where growth exists — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The benefits of diversifying outside our home market are equally important over long periods. Emerging markets have badly lagged developed markets for the last several years, but eventually they should take the performance baton again, and we'll be in good stead with this position.

*Statement may not be 100% "true"

Pro Portfolio Building Report No. 1: Our Buy First Stocks

Published Aug 15, 2016 at 8:29PM

Welcome, Fool! We're glad you're here. This first report is meant to get you up to speed on our Buy First stocks — the companies in your *Pro* portfolio that we believe you should start purchasing first. But before we get to that, a few words about how best to use *Pro* ...

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that aims to generate winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, hedges, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* fit you.** We know not all investors are in the same situation! We can help you figure out how to buy *Pro* investments given your personal situation, including investing in an IRA or coming to *Pro* already fully invested. Check out our advice for every approach to *Pro*: Invested Elsewhere | "Free-Range" | Whoever You Are
3. **Catch up with our portfolio at your own pace.** Start with the stocks in this report, and follow along with our subsequent reports. You can always see our Buy First, Buy, and Hold guidance (which is the most important -- more important than valuation estimates) on the Recommendations page, and you can get a succinct, up-to-date take on all of our stock positions on our What We Think Now page.
4. **Don't freak out about fair value.** Instead, read Jeff's explanation of how it's calculated and what it means.

Bring any questions to the Getting Started & Help discussion board, and Fool onward!

-- The *Motley Fool Pro* team

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Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: About 4.1% (see Recommendations page for real-time allocation)

For More

- *Pro* 's original recommendation (5/6/13)
- Most recent earnings update (4/28/17, from our sister service, *Motley Fool Options*)
- Talk about AMT

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Global mobile data traffic is expected to increase at a compounded annual growth rate (CAGR) of 53% between 2015 and 2020, and global mobile 4G connections are expected to grow from 1.1 billion in 2015 to 4.7 billion by 2020 (a 34% CAGR). Communications site operator **American Tower** is well-positioned to benefit from this trend.

AMT leases antenna space on more than 100,000 cell sites (towers, rooftops, and more) to wireless service providers across the globe. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, can't be canceled, and feature contractual annual price escalations. More than half of AMT's properties are located in 12 (soon to be 13) different countries outside the U.S., including India, Brazil, Colombia, Mexico, Nigeria, and South Africa, and management is intent on expanding the company's international portfolio as it continues to build and acquire more towers.

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE, or to increase coverage density. When they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; about 98% of AMT's customers up for renewal each year do so, and more than 60% of its current leases don't renew until 2021 or later.

The stock may experience volatility in the short term because of its tendency to trade alongside the interest-rate-sensitive REIT sector, but over the long term, the underlying strength in business fundamentals should shine through. We expect to earn modest income from a growing dividend and strong appreciation as AMT continues to build out its international tower portfolio.

Buy First: Coherent (NASDAQ: COHR)

Specific devices may come and go quickly, but we have our eyes on the lasers that help put them together.

Suggested Allocation: 2.5%

For More

- *Pro*'s original recommendation (5/17/17)
- Talk about Coherent

Microelectronics. Miniaturization. Mobile computing. Wearables. Artificial intelligence. The Internet of Things. Moore's Law. All of these help to fuel the business of **Coherent**, a leading producer of commercial and industrial lasers and laser services. Coherent was founded near the dawn of the laser, in 1966, and its recent acquisition of peer Rofin-Sinar for $942 million gives today's business a leading breadth of products and worldwide reach -- even as the utility of lasers continues to grow.

The company sells dozens of laser models to dozens of industries, and 26% of last quarter's revenue was recurring (parts, consumables, repairs, and related services). That's nice to have, but the real story here is an ever-greater need for lasers in the manufacturing of ever more electronic devices and other items. This is a volume story -- and a story of rapid change. As the components that companies use in technology products rapidly evolve, the lasers used to build the products and test them must evolve, too, resulting in new sales for Coherent. We see how quickly tech is evolving, so rather than investing in one particular technology, we're investing in a means for putting most any technology together.

Buy First: Facebook (NASDAQ: FB)

Although it's lately riding a wave of popularity, we believe the strong stock is justified, and the business should grow handsomely in coming years.

Suggested Allocation: About 7.3% (see Recommendations page for real-time allocation).
You can buy in thirds, or halves, over a few quarters. Experienced investors can write put options to target buying some of their shares cheaper; to do this, "sell to open" one put option for every 100 shares you could buy. Because you want to be assigned shares, sell "near-the-money" puts, with a strike price near the current share price, that expire in just a month or two.

For More

- Latest earnings update (5/15/17)
- *Pro's* original recommendation (9/18/12 – dated by now! But this shows how we thought about it back then when it was $20 and most were bearish)
- Talk about Facebook

Facebook remains a young story about monetizing the largest, most engaged online audience ever hosted by one company. The company's future is in strong hands; management is showing patience and care as it starts to monetize more of its properties, putting visitor experience first. So far, this approach has paid off, with user engagement up even as more ads appear. The billions of connections maintained on Facebook's properties are making the sites extremely sticky, offering the potential for increased value to advertisers (and thus Facebook shareholders) -- especially as the advertising gets smarter and more targeted.

It's our largest position at a recent 6.5%, and the size of our investment in Facebook feels appropriate given how much growth potential lies ahead and how well-managed the company is. Even from today's price, we estimate Facebook could return about 15% annualized for shareholders over the next five to seven years. Though shares are currently a bit above our fair-value estimate, the stock is rated Buy First on its long-term potential. Key risks include users moving away from Facebook, but so far the company has shown great skill in *increasing* user engagement and stickiness, rather than stunting it. It's also possible that management could spend more than Wall Street expects, though that should mainly be a short-term concern.

Buy First: Visa (NYSE: V)

With its mission to "accelerate the electrification of commerce," industry leader Visa has most of the world left to conquer.

Suggested Allocation: About 3.1% (see Recommendations page for real-time allocation)

For More

- Buy More recommendation (3/30/17)
- *Pro*'s original recommendation (4/28/15)
- Talk about Visa

The ubiquitous nature of credit and debit cards in America means that many of us can go through life rarely touching cash. Yet even in the U.S., cash still accounts for approximately 40% of transactions, followed by debit cards at 25% and credit cards at 17%. And globally, cash is truly king: MasterCard estimates that 85% of all consumer transactions still take place with old-school paper and coins. But all of that is slowly changing as economies modernize and middle-income families proliferate, bringing more converts to the benefits of electronic payment. With its mission to "accelerate the electrification of commerce," industry leader **Visa** (NYSE: V) has most of the world left to conquer.

We like Visa for many of the same reasons we like MasterCard. And with the recent acquisition of Visa Europe, the company will be adding 523 million card accounts that resulted in 38 billion transactions and $1.67 trillion in point-of-sale spending last year. For the fiscal third quarter, revenue was up 3% year-over-year, primarily because of foreign-exchange headwinds and slow global growth. Management is guiding for 7% to 8% revenue growth for the full year.

Having closed on its acquisition of Visa Europe, the company can start taking advantage of some of the deal's long-term benefits, such as greater scale, increased market share, and growth in free cash flow (FCF). Visa has also formed a key partnership with PayPal, under the terms of which PayPal will no longer steer users toward paying with a bank account (and not Visa), and in return Visa will allow users to pay with PayPal in any stores that have Visa contactless payment technology. We like this deal, which both shows Visa's entrenched position and negotiating leverage and also effectively turns a major competitor into a financial partner; with the bank-account obstacle removed, we think more customers will likely pay with a credit card in order to build up points. Management has repurchased $5.5 billion of stock so far this year, with an authorization to buy back an additional $7.3 billion. After taking on $16 billion of debt to fund the Visa Europe acquisition, the company has net debt of about $7.1 billion, which is equal to about one year of FCF.

Visa is valued at about $195 billion, and given its tiny market share, its ceiling should be much higher than that. It fits into *Pro* as a recurring-revenue business that invests its free cash flow in more growth at still higher rates of return, making it a compounding vehicle.

Get to Know the Pro Universe

Published Jun 16, 2016 at 2:55PM

The *Pro* Universe is a screening tool powered by *Motley Fool One*'s Fool IQ and the Fool's central research database to show you Foolish analysts' conviction level on each company. In the following video, TMF head of product Tim Hanson explains the tool from a *Million Dollar Portfolio* perspective.

{% video %}

Fool IQ is a powerful research tool that we have inside of *Motley Fool One* that makes sense of all the stocks that our 50-some-odd analysts around the world are following.

My name is Tim Hanson, and I'm the head of product here at The Motley Fool. You know, one thing about Fool IQ that I think — or that I hope — is fun is that it's appealing to investors who are novices or experts. So if you're a novice investor, we've made some buttons that you can literally just click once and they will make the universe drill down to retirement-type stocks, or small-cap stocks, and so on and so forth. If, on the other hand, you're an expert investor who really likes diving in, you can build your own filters ... your own complicated screens ... to find what you're looking for.

It's a database of all the ideas that our analysts are working on, or of all the ideas inside the service in which you are a member. The way it's like a screener is it allows you to find our favorite ideas tagged by asset class (like small cap or large cap), or industry (such as energy or consumer discretionary). Or by criteria you might be looking for in a stock (if you were looking for a dividend yield, or lower-than-average volatility). Or you'd like to combine several of those elements to find the stock that's really a good fit for your portfolio and what you're looking for.

So the reason it's a little bit unique is that while it does include financial information that you'd find in most screeners, what it also includes is our conviction, or our covering analyst's conviction in the ideas. So we keep track of everything our analysts are following and how they feel about one stock relative to another, and then we aggregate them all into what we call a leaderboard so we can identify someone's favorite idea over an idea that they don't feel quite as strongly about. It's a way for you to personalize our picks, rather than based on what our advisors decide is the best at any given month without knowing your circumstances.

The Fool IQ universe within *MDP* includes all the stocks that you have access to. Those are *MDP* recommendations as well as *Stock Advisor*, *Hidden Gems*, *Rule Breakers*, *Income Investor*, and *Inside Value*. For the first time ever, you're able to access all of those stock picks, all of that investing IP, without having to leave the *MDP* site. We also want to give members the opportunity to engage with the universe of front-end recommendations that they have access to in the same way that the *MDP* advisors do. They're looking for certain strategies. You can look for ideas in those same strategies using the Fool IQ experience inside of *MDP*.

You could use it to suggest potential ideas on the discussion boards, if you wanted to. You could use it to find stocks that would be complementary to what you own. Or if you think, for example, that you want to have more exposure or less exposure than the portfolio managers, you can do that. Or if you come into cash at a time when *MDP* doesn't have cash, or vice versa, you can still get actionable advice from the service without waiting for them to transact.

You know, no one's obligated to use it. We're not taking away the recommendations that come out every month in features such as Best Buys Now and Starter Stocks and Core Stocks and all the things that we've tried to do to help people better navigate the universe. We just want to give people another tool that they can use to really make sense of the stock recommendations that they have access to, find the ones that are right for them, and really help you and our company, The Motley Fool, achieve our mission of helping the world invest better. And that's building a portfolio of stocks that you feel great about, on your terms, that can last you a lifetime.

Portfolio Positioning Report: April 27, 2016

Published Apr 27, 2016 at 12:06PM

Join our live event at 2 p.m. May 4

Dear *Pro* Member,

Our first three Portfolio Building Reports provided you guidance on all of *Pro*'s Buy First and Buy stocks. This final report will do the same for our active short and option positions, many of which we use as hedges. For reasons we'll explain, we don't expect that many of you will initiate all of the positions in this report right away, or perhaps at all. And that's perfectly fine!

Hedging is about lowering your exposure to the risks of the market; to a lesser extent, shorting is as well. These additional investment tools tweak or adjust the risk profile of your *existing* portfolio, so if you're still building your collection of long-term stocks, concentrate on that for now. Stock investments are the core of the *Pro* portfolio, and by owning *Pro* stocks, you are positioned to compound your value over time. We know there's a learning curve for strategies that are new to you, so it's important you know there's no rush; you can incorporate the positions in this report when you're ready. We're here for you in the meantime.

Before explaining these positions, let's review how each strategy works. We'll begin with shorts — a sort of "anti-investment" that we believe will decline in value, adding profits to our portfolio in the process.

Shorting in Short

When you sell something short, you borrow shares of a company or an ETF from your broker and immediately sell them, collecting the proceeds. At various brokers, this trade action is called "sell short," "sell to open," or just "sell." In the future, you'll need to buy the same number of shares back to replace the ones you borrowed and sold. This second step is called "cover," "buy to cover," or "buy to close." You hope to buy the shares back at a *lower price* than when you opened the position. You profit directly on the position if you are able to close it at a price that's advantageous to you.

The difference between your original sell — or short — price and the price you later pay to buy back (and return) the borrowed shares is your profit. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock rises to $30, you've lost $10 per share when you buy it back. We use shorts in *Pro* because they're one way to profit when the market or a company falls, but they come with their own risks — shares can be hard to borrow, fees are often involved, and a short can get closed on you (you're forced to buy it back) if the broker wants the shares back early. So, we need to size our short positions appropriately small.

Hedging ... in Short

A hedge is similar to a short because it gains value when prices fall, but it's different in intent; these positions are taken to *offset* the risk we have in another position or in our market exposure as a whole. So, when we sell short (or use bearish options on) a market-index proxy like the **SPDR S&P 500** (NYSEMKT: SPY) ETF, we are hedging our exposure to the stock market as a whole. A hedge is a form of insurance; it only pays out when you need it, and usually it won't make money. We *know* a market-index hedge will go up in value whenever the market goes down — and that's nice to know. But most times, the market won't fall (or won't fall enough), and our hedge will go unused.

For this reason, we try to spend very little to hedge, but there are sometimes still costs. We have to reconcile this with the fact that hedging lets us stay *more* invested than we otherwise would, given our goal of absolute positive returns. In other words, one key way we profit from our hedges is by using them to help us keep our long stock exposure higher! As with shorting, you should only hedge if you have specific stock market exposure you want to "hedge out." Recently, *Pro* issued a new market hedge using options on the SPDR S&P 500. Tweaked a bit for today (see below!), that is our current market-hedge recommendation for anyone who wants to hedge out 10% of their long exposure, as we are doing (bringing *Pro* right now to about 65% net long).

Your Exposure

To know whether hedging is for you, it's helpful to think about your stock market exposure. This is simply how much of your total portfolio is invested in long stocks. Excluding options and shorts, *Pro* is about 80% invested in long stocks as we work through quarter one earnings. That's high for an absolute-return portfolio (which is part of why we want to short and hedge!). And like many members, you may own other stocks beyond *Pro*'s, so if you've bought all of our stocks, you might be even more exposed to market risk than we are. We're hedging the *Pro* portfolio down to about 70% market exposure with our SPY hedge (other shorts make up the other 5%, bringing us to the aforementioned 65%), and you could (but do not need to) do the same.

The bottom line is: As you consider adding hedges and shorts to your portfolio, first know how much of your portfolio's assets are invested in stocks. That helps dictate how much shorting or hedging you want to initiate to reach the *net* market exposure you desire. *Pro* has averaged about 73% net long exposure since January 2012, but that number will move up and down as our opportunities change. Our exposure is always shown at the bottom right of the Recommendations page. For many years, I've found that about 72% market exposure, along with the use of options, can be enough to earn strong returns with less risk. The past is no promise of future returns, but we're aiming to continue that success.

This Stuff Is Optional

Not every *Pro* member is comfortable with shorting or hedging, and there are practical considerations to take into account as well. First, you need a margin account to sell short, so (unless you use options to go bearish) you can't do it in an IRA. Second, you have to accept that shorts can run strongly against you, so you need cash to cover that risk. Third, you'll usually pay an annualized fee of anywhere from 1% to 5% of the short's daily value to short something. Fourth, in many cases it's hard to borrow shares to short, period. That is the situation with some of our shorts today. Finally, short shares can be bought away from you at the worst time, when they're up in price (a "forced buy-in"). If brokers can no longer find shares to borrow, you're forced to "buy in" at market prices to return your borrowed shares.

So what to do? You can use options to short in some cases -- we do, and we explain how to do so wherever appropriate. You can also consider opening a brokerage account that is particularly friendly to shorting. Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does, and does not charge a fee for shorting. You could also wait and see whether shares become available in your existing, traditional brokerage account, though note that at many brokers, certain shares are basically never available for shorting. Or, if you're not drawn to it, you don't need to short at all.

Options Are Optional, Too — but Advised!

Our options positions are also ... optional, but we strongly advocate learning to use options and following along with ours over time. Options are powerful tools for income, hedging, greater upside, and more. We know from experience they're well worth the time it takes to learn them, and we're here to help you. Options can make you a much more confident and versatile investor, and they can generate a whole new stream of income for you and your family. So, if you're new to using options, you're in a great place! Use *Motley Fool Pro* and our sister service, *Motley Fool Options* (free for the life of your *Pro* membership!), to learn how to use these great tools. On a personal note, if you're going to learn just one simple strategy, I suggest learning how to write puts (link goes to *Motley Fool Options*) for income or to buy a stock lower.

About This Report

Let's return to the main show. This Portfolio Positioning Report and the special live event and Q&A following it on May 4, will (when you're ready!) help you short vehicles we believe will decline; teach you how to hedge your portfolio; and start to generate returns from options. But keep in mind that this is just a start; we'll have many *brand-new* investment recommendations arriving to your inbox as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way!

On the other hand, if this looks overwhelming right now — or if you're still catching up with our core stock positions — that's perfectly fine. You don't need to start these positions now. As mentioned, long positions are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and often rewarding — aren't necessary to succeed with *Pro* in the long term, let alone immediately. As you learn these strategies and progress with us, just keep your exposure to the stock market in mind.

In closing, I'll stress again that you shouldn't feel pressured to act immediately. We will continue to make recommendations on an ongoing basis, including in our Monday Catch-Up Trades — and as brand-new opportunities emerge. That's part of the fun! So take your time, and make an investment only when you're ready. Finally, please bring any questions to our Making *Pro* Fit You discussion board.

Foolishly,

— Jeff Fischer, *Pro* advisor

The Positions Themselves

Shorts

- Deere & Company (NYSE: DE)
- Direxion Daily Financial Bear 3X Shares ETF (NYSEMKT: FAZ)

Hedge

- SPDR S&P 500 (NYSEMKT: SPY)

Options

- American Tower (NYSE: AMT)

All the Rest (On Hold)

- Caesars Entertainment (NASDAQ: CZR) short
- CurrencyShares Euro Trust (NYSEMKT: FXE) short
- American Airlines (NASDAQ: AAL) calls
- Expeditors International (NASDAQ: EXPD) strangle
- Gentex (NASDAQ: GNTX) short puts
- ProShares UltraShort Real Estate (NYSEMKT: SRS) short
- Wells Fargo (NYSE: WFC) short puts

Shorts

Deere & Company (NYSE: DE): Sell Short

The farm equipment giant just ended a cycle of tremendous sales growth, and now we believe air is coming out of the tires.

Suggested Short Allocation: 2% to match us
(and this assumes you own about 2% in *Pro* stock **Valmont Industries** (NYSE: VMI)

How It Fits Into *Pro*

For More

- *Pro*'s recommendation history
- Talk about DE on our discussion board

We recently sold short shares of Deere & Company because we believe investors are currently overestimating the true normalized earnings power for this farm equipment manufacturer. As JP writes in our recent report, the latest agricultural "super cycle" gave rise to what we believe was an unsustainable increase in farm equipment sales. If we're right, this has positioned John Deere, the world's leading manufacturer of agricultural and forestry equipment, to report disappointing results going forward as the industry works its way back toward equilibrium.

But this short also serves another purpose – it's a low-cost macro hedge that reduces the impact on our portfolio of potential adverse developments in commodities, the U.S. economy, the global economy (both developed and emerging markets), and currency exchange rates. And given Deere's large book of financing receivables (debt owed to it), the stock also serves as a small counterbalance to our sizable exposure to the financial industry. Finally, it directly hedges our 2% long position in Valmont Industries, which also sells farm equipment, namely irrigation machines.

Availability

Interactive Brokers has 6.4 million shares available for shorting as of April 26 – so that should be enough for anyone here, wink wink. The annual fee to short is about 0.5%. Most all brokers should have Deere shares readily available for shorting. Just be ready to lose money on this short/hedge hybrid if Deere runs against us. It's far from a fly-by-night operation. As long as Valmont goes up more than Deere (and so far it has), then this "paired trade" is making us money.

Direxion Daily Financial Bear 3X Shares ETF (NYSEMKT: FAZ): Sell Short

Daily leverage keeps steady downward pressure on this bearish ETF that we're short.

Suggested Short Allocation: 0.3% to 0.6% (we are currently short only 0.3%, as the position has shrunk nicely, but we may add to it opportunistically)

How It Fits Into *Pro*

For More

- *Pro*'s recommendation history
- Talk about FAZ on our discussion board

This bearish ETF is meant to provide 3 times (300%) the daily *inverse* results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. By shorting this ETF, we're effectively 3 times long, on a daily basis, the U.S. large-cap financial sector, which includes the likes of *Pro* holdings **Wells Fargo** (NYSE: WFC) and **Visa** (NYSE: V).

Leveraged, inverse ETFs like this one are flawed because they rebalance their derivative positions daily in order to maintain a constant exposure. Over long holding periods, the costs involved with rebalancing eat away at returns, keeping downward pressure on the vehicle as a whole. Also, returns are compounded daily, which adds to tracking errors. As our original buy report details, we continue to believe that large-cap U.S. financials are inexpensively priced — and we own several of them as a result. That belief makes shorting this flawed bearish financial ETF all the more attractive.

That said, shorting FAZ has become difficult over the years, and our position size has dwindled severely. We lately have a 78% profit on our short! But similar profits should keep coming over the long haul -- like us, any newcomer to a short can make up to 100% on the short, and no more. So, new short sellers like you are in a fine position as this inverse, short, leveraged ETF can keep going down. That said, new members can skip this position if shorting it proves difficult, or use options instead (see the Alternative Trade below) if you have a six-figure account. We own plenty of strong financial companies serving a similar purpose in the portfolio. You have plenty of exposure to the upside we see in financial leaders if you own our stocks.

Availability

This ETF is hard to borrow. Lately, only 80,000 shares of FAZ were available for shorting at Interactive Brokers at a 6.1% annual fee. Periodically, TD Ameritrade has shares available with no fee. Members have sometimes been "bought in" on their shares at Interactive Brokers, for a forced closing of the short.

Alternative Trade

If you can't short shares directly, then you can set up a synthetic short in a margin account. "Sell to open" January 2018 $40 calls on FAZ, and "buy to open" an equal number of January 2018 $40 puts. Lately you will collect a net credit of about $2 to set this up. This makes you short FAZ with a start price of about $38, and sets you up to profit if FAZ declines in price. Only sell one call for every $3,800 in FAZ you are able to comfortably short. On a $380,000 account, one contract of each option would be a 1% allocation. That's about as much as we recommend.

Eagle-eyed members will notice that *Pro*'s short position on FAZ is 0.3% of our portfolio. We're recommending 0.6% to newcomers because we know you'll be unable to short at least one other position in the *Pro* portfolio, namely SRS (more on that later). There are no IRA-friendly alternatives for this short. If you can't short it at all, you could add between 0.3% and 0.6% to one of our three financial companies — Wells Fargo, MasterCard, or Visa — instead.

Hedge

SPDR S&P 500 (NYSEMKT: SPY): Set Up a Put Ratio Spread

Set up for no cost, this market hedge lowers our exposure to stocks and will pay us if the S&P falls about 4% to 10%.

Suggested Allocation: 10% or so; you would set up one spread for every $200,000 you manage

For More

- *Pro*'s original recommendation (please note, we recommend a higher strike price on the lower of the two put options now -- $192 instead of $190. You'd set up a trade as described, but using $192/$200 strike prices.
- Talk about the SPY hedge on our discussion board

Requiring a margin account, this June put ratio spread we set up last month can still be set up for no cost if you move your lower strike price up a bit. So, "sell to open" two June 17, 2016, $192 puts for every one June 17, 2016, $200 put you "buy to open." Again, this can be set up lately for no cost. Each $200 put represents a $20,000 short of SPY, so you would buy one for every $200,000 you manage, to set up a 10% position. Use the trade alert for more allocation guidance (again, simply adjusting your lower strike to $192, and still paying nothing to set up each spread).

Be aware that we plan to issue a second hedge to all members in future, one that profits if the S&P 500 falls further than this June hedge allows for. The two hedges will work together if the market falls more, the new one picking up where this one leaves off.

Alternative Trade

- **If you're hedging in an IRA or can't write naked puts, or are managing less than $200,000:** For a small cost, you can set up a **bear put spread** instead, a strategy with defined, capped risk that most IRAs allow. Using a spread order, "buy to open" June 17, 2016, $200 puts and "sell to open" *an equal number* of June 17, 2016, $190 puts. Recently, this will cost you about $1.15 ($115) per spread, and that is your maximum risk. Buy as many spreads as you care to risk. This strategy would be worth up to $10 ($1,000) per spread on a decline to $190 or any lower price, but you should be prepared to lose your whole $115 per spread if SPY doesn't decline below $200 by expiration.

Options

American Tower (NYSE: AMT): Buy to Open January 2018 $80 Calls

Suggested Allocation: 0.6%

These calls target long-term upside on American Tower, adding to our existing stock holding.

For More

- [*Pro*'s original recommendation]
- [Talk about American Tower on our discussion board]

We're recommending 2018 calls on American Tower today, but you may notice that *Pro* owns January 2017 $80 calls instead. We bought them before the 2018 calls were listed, and newcomers should consider buying January *2018* $80 calls, to give the investment thesis more time to play out. *Pro* will likely roll its calls out to 2018 (or potentially 2019 later this year) before they expire in 2017, as long as the investment thesis doesn't change. We're seeking leveraged returns if American Tower stock appreciates by 2017 (or 2018 or 2019).

Because we recently established a diagonal call position (our owned long-dated call, plus an overlaid short-dated written call for income) that expires this week, **our guidance for this position is conditional.** We recommend that you **do not** establish this full position immediately, instead waiting until Friday, April 26, when American Tower reports first-quarter 2016 earnings before the market opens.

- **Condition 1:** On Friday after earnings, American Tower's stock price is above $105 and it looks like *Pro* will need to take action to either close the diagonal call position or roll our written call up and/or out.
  - **Action:** New *Pro* members should wait until *Pro* sends out our official rolling or closing alert on Friday and heed the guidance for new *Pro* members in the "Alternative Trades" section of the alert.
- **Condition 2:** On Friday after earnings, American Tower's stock price is below $105 and it looks like our $105 written calls will expire worthless.
  - **Action:** New *Pro* members can go ahead and buy a 0.6% allocation to American Tower January 2018 $80 calls, using a limit order and aiming for a price near the midpoint of the bid/ask spread.

A 0.6% allocation at current prices most closely equates to buying one call for every $450,000 or so you manage. This is a small position by design, so be careful not to over-allocate to the calls; you already own the stock, after all! We may seek to add more to our position later, though, if volatility provides us with lower prices. Members for whom one contract would over-allocate their portfolios can consider buying 0.6% more in stock, bringing your stake to approximately 4.3%. Realize you won't benefit from the leverage the calls will provide, although you will have a better breakeven price and no expiration.

All the Rest of *Pro*'s Positions

As a *Pro* member with an especially keen eye (and great memory!), you will note that we haven't updated you on *every* position in the portfolio yet. Pricing opportunities being what they are and with expirations right around the corner, not all of our positions are primed for new action right now, and not all options positions are timely. Worry not. We will publish Catch-Up Trades when we see new *Pro* opportunities on existing positions, and many of our positions will require upkeep in the form of a whole new alert emailed to everyone, so you can get on board then! One by one, it won't take us long to get there. Here's the status on our remaining positions that are currently "on pause for newcomers" — either on hold or not timely.

American Airlines (NASDAQ: AAL)

Long January $35 2017 calls on hold

Last year, we bought call options to profit on a rising, very inexpensive airline stock. Instead, our first foray into an industry fraught with a legacy of failure is, so far, failing. Our calls are down about 74%, and we're not sure how much longer we'll give them. American Airlines just reported earnings this week that came with lackluster guidance on key metrics, and with our expiration about eight months away, we may soon take our remaining money and go home, tail between our legs. Airlines are not a typical *Pro* investment, which is why we used low-cost call options to dip our toe in the water. So far, color us burned. If the winds change and we believe new members should get on board, we'll alert you. But for now, steer clear.

Caesars Entertainment (NASDAQ: CZR)

Short on hold

Pro is short shares of America's largest casino operator, **Caesars Entertaiment** (NASDAQ: CZR), which has put one of its units into bankruptcy proceedings. The stock is volatile -- we booked a 35% profit on half of our short last year, and our remaining short shares show a 40% profit of late. The outcome of this short position is partly dependent on the courts; lawsuits from large investors are being weighed, but operationally the business (shed temporarily of some debt on the books, and split into new units) is looking better. The court is dragging its heels on proceedings, so we're deciding whether we want to stay short or take our gains and move on. This makes us comfortable telling new members to hold off – wait and see what we decide. If we stay short, we'll tell you, and you can short shares then.

CurrencyShares Euro Trust (NYSEMKT: FXE)

Short on hold

We've been short the euro against the dollar since late 2011. We view this position as a quiet anti-investment; the risk to us is relatively known (and reasonable), and the profit potential remains worth pursuing. As the euro has declined from about $1.30 to a recent $1.10 to the dollar, we currently have a 15% profit on the position. But we pay fees to keep this short, and with interest rates now unlikely to rise quickly in the U.S., the dollar may not strengthen much more against the euro anytime soon. So we are considering closing this short position. Earnings results (taking place right now) may help us to consider how the Fed may act next regarding interest rates, which may help us decide what to do with this currency short. We should have a decision in May and will let you know! If we move from Hold back to Short, you can get on board.

Expeditors International (NASDAQ: EXPD)

Synthetic covered strangle on hold

Shares of shipper Expeditors International have run up sharply the past few months. Our synthetic long expires next January, but we'll have to address our May covered strangle before then. These options were written for income and will need to be rolled to higher strike prices. When we do that by the May expiration, we'll guide newcomers on exactly how to set this income position up.

Gentex

Puts on track to expire

Pro has written May 2016 $15 puts that, if exercised, would have us add about 1.5% in stock to our **Gentex** (NASDAQ: GNTX) position. The goal with these puts is to earn income and potentially add to our existing stock position at lower prices. Since this position is just a few weeks from expiration, we don't recommend that new members join us now. We'll aim to write puts again whenever we see good pricing after these expire -- and at that point all members can join in.

ProShares UltraShort Real Estate

Short on hold

We have a small (0.3%) short remaining in the **ProShares UltraShort Real Estate ETF** (NYSEMKT: SRS). We enjoy watching its slow descent in price, but the ETF only has $36 million in assets now, making it too small to recommend to new members. Plus, outside of our broker (Interactive Brokers), it appears impossible to borrow shares to sell short now — and if you do find them, the annual percentage fee to short is high (recently 5% at IB). Instead, as shared above, we recommend that you sell short 0.6% in FAZ as a long-term alternate. Or just sit this small position out.

Wells Fargo

Puts on track to be assigned

Our $52.50 written puts on **Wells Fargo** (NYSE: WFC) expire in May, and with the stock currently trading slightly below $51 per share, our puts are in-the-money. If current pricing stands and we do not take action, *Pro* will be assigned on its written puts, adding about 1.5% to our Wells Fargo stock allocation. New members are advised not to set up this position yet and to wait for an official follow-up alert from *Pro*.

Within the next few weeks (and dependent upon the price action of Wells Fargo stock), *Pro* will either roll our puts out to a later month -- targeting further income -- or we will let the puts expire and accept shares to increase our stock allocation. If we roll our puts out to a later month, new *Pro* members can write the new puts alongside us (there will be specific guidance for new members in the "Alternative Trades" section of the alert). If we accept new shares of Wells Fargo, new *Pro* members can add 1.5% to their stock allocation **if and when *Pro* does so via assignment of its written puts.**

In Conclusion

We'll likely recommend some of these positions (except the SRS short) to new members once we reaffirm that there's sufficient opportunity still afoot, when pricing improves, or after our options expire. Just watch your inbox for official trade alerts! Also, Monday's Catch-Up Trades could pertain to a few of these.

At the same time, we're not standing still. In this and our three previous Portfolio Building Reports, you have many great *Pro* investments -- all rated Buy First or Buy -- to move into. And of course, we'll continue to send brand-new investment recommendations to all members.

It's not vital that your portfolio be 100% identical to ours (many members deviate considerably), but by becoming familiar with how we invest, learning the strategies we use that you can also employ, and owning many of our core stocks, you should be positioned to succeed well with *Pro* over the time frame that matters. Meanwhile, if you're new to shorts, hedges, and options, start to dip your toes in as your comfort allows. We're here to help, and we believe you'll see many, many great benefits as the years unfold.

Fool on!

The *Pro* team:

— Jeff (TMFFischer), Ellen (TMFKabellen), Billy (TMFBillytheKid), JP (TMFYossarian)

Pro Portfolio Building Report No. 2: April 20, 2016

Published Apr 19, 2016 at 7:49PM

Welcome, *Pro* Fool! This report details our current thinking on eight of the Buy stocks in our portfolio. The rest of our Buys will be featured in our third report, coming Friday. Once you've read these and the previous report detailing our Buy First positions, you're ready to start (or continue) building your *Pro* portfolio as swiftly or as slowly as you like.

We want our advice to be uncomplicated: Purchase our Buy Firsts first (again, taking your time according to your situation — there's no rush); purchase our Buys after that; match our allocations as closely as you can (but don't worry about needing to buy in 100-share lots — fewer is fine); and stay tuned for our Portfolio Positioning Event on May 4, when the team will be answering your questions in real time.

We're glad you're here, learning to become an investor who will come out on top in all markets. Bring any questions to the Getting Started & Help discussion board, and Fool on!

Best,

The *Motley Fool Pro* team

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A Note on Fair Value >>

Buy: AmTrust Financial Services (NASDAQ: AFSI)

This shrewd insurer looks to enter markets optimistically, when pricing is favorable because others are struggling.

Suggested Allocation: 5.1%, perhaps bought in two to three blocks over the next two or three months

For More

- *Pro*'s original recommendation (4/3/2009)
- Most recent earnings update (3/7/2016)
- Talk about AFSI

AmTrust Financial Services (NASDAQ: AFSI) was founded in 1998, making it one of the new kids on the block in an industry where many of its competitors have been around for 100 years or more . But this newbie insurer has some serious street smarts. AmTrust likes to compete in niche markets (for example, small, low-hazard workers' compensation policies), waiting until a rough patch demonstrates that the incumbents in a space have loosened their underwriting standards. It's then able to grab market share in an environment favorable to itself, as rivals attempt to cope with prior losses by raising prices.

Over the past 12 months, AmTrust has written $2.8 billion of workers' comp premiums, making it highly likely to finish the year as one of the top five workers' comp underwriters in the United States. But we don't think that means it's doomed to the glacial pace of growth common to many of the larger insurers. The company is moving into the commercial package insurance business (which includes workers' comp); SNL Financial estimated this as a $241.3 billion market in net written premiums as of 2014. AmTrust management believes its commercial package business can become its next billion-dollar platform, and we believe management will continue to find markets ripe for disruption.

Buy: Apple (NASDAQ: AAPL)

The leader in mobile computing products should see more long-term growth than anyone expects.

Suggested Allocation: 3.8%

For More

- Pro's original recommendation (2/14/12)
- Most recent earnings update (2/4/16)
- Talk about Apple

Led by its iPhone, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the smooth Apple ecosystem, which centers on the iTunes and App Store marketplaces, as well as the new Apple Pay. Apple services (iTunes, App Store, Apple Music, etc.) generated more revenue last year than more than 70% of the companies in the Fortune 500, while Apple itself is the most valuable company in the world, with more than $230 billion in annual sales. Despite this massive size, the company continues to grow and generate increasing profits for shareholders -- earnings per share were up 27% this past year. The company's integrated hardware and software make for a sticky consumer experience that provides disincentives to switch to a competitor, and as more people use multiple computing devices, Apple makes it easy to transition seamlessly from one of its products to another.

We expect the recently launched Apple Watch and Apple TV to help further entrench the Apple ecosystem into people's daily lives, all while Apple continues to work on developing its next major product and returning massive amounts of capital to shareholders through dividends and buybacks (almost $50 billion in fiscal 2015!). We're not counting on a revolutionary product anytime soon, but we are counting on record numbers of phones being sold to both new and existing customers over the coming years. We want to be in on that conference call.

Buy: Medtronic (NYSE: MDT)

The medical-device industry is complex and regulated, and it provides entrenched leaders with a competitive moat; our leading company is growing in international markets.

Suggested Allocation: 3.1%

For More

- *Pro*'s original recommendation (7/1/2009) ...
- ... and our second buy recommendation (11/9/10)
- The next earnings update is coming in May.
- Talk about Medtronic

In March, the CEO of Medtronic put it like this: "Our formula for long-term success is to deliver consistent mid-single-digit revenue growth, with 200 to 400 basis points of EPS leverage, [and to] return a minimum of 50% of our adjusted free cash flow to shareholders through dividend growth and share repurchases. The expected net result is creating enormous value, with sustainable double-digit [at least 10%] total shareholder returns."

As shareholders of Medtronic, this is exactly what we've seen over the years: Our annualized return on the position is 11.25%, and we think something close to this can continue going forward. Medtronic is a market leader in vital medical devices, be they for the heart, spine, knee, or one of four other key categories. The stock yields 2%, and the dividend has increased annually for the past 38 years, resulting in an 18% compounded annual growth rate (CAGR). Expect continued dividend increases, sales growth of about 4% to 6%, and earnings-per-share growth considerably higher than that — all of which should combine for North Star-challenging returns. While Medtronic has touted itself as a play on international markets, growth in the U.S. has lately regained traction, too. International markets still account for a small minority of revenue, and are growing smartly.

Buy: OpenText (NASDAQ: OTEX)

This company's information management software keeps the digital lives of businesses in order, and its exchange software platform drives business transactions and earns recurring revenue.

Suggested Allocation: 3%

For More

- *Pro* 's original recommendation (8/31/11)
- Most recent earnings coverage (3/10/16)
- Talk about OpenText

A leader in Enterprise Information Management (EIM), OpenText offers customers (governments, universities, corporations) a full suite of software solutions to manage growing reams of digital data. Its three areas of focus are data and information management; information exchange platforms within and across organizations; and analytics, where "big data" is used to gain insights and better run a business. Said differently, OpenText helps customers go digital with their data, or manage what is already digital, including transactions.

The leading independent provider of EIM software, Canada-based OpenText is enjoying strong cloud sales as well as steady license contracts. Its EIM market should increase sales by least 10% annualized (our estimate) over the next four years. In turn, we're looking for at least 10% annualized returns from our ownership of OpenText shares. The year 2016 is an important and exciting one for the company; its new software, called Release 16, is rolling out after its fall 2015 debut. It's designed to integrate nearly everything OpenText software can do, and success should bring many more cross-selling opportunities, as well as new clients. At the same time, deep data analytics is embedded throughout the software for the first time, adding upsell opportunities. OpenText enjoys strong recurring revenue (which represented 84% of its sales in fiscal 2015). We may sometimes recommend options on the stock, as we've done several times in our sister service, *Motley Fool Options*.

Buy: Skyworks Solutions (NASDAQ: SWKS)

This leading designer of analog modules for smartphones and connected Internet of Things devices is growing sharply.

Suggested Allocation: 3.4%

For More

- *Pro* 's original recommendation (8/5/14)
- Latest earnings coverage (3/2/16)
- Talk about Skyworks

Beyond having one of the coolest names in our portfolio, Skyworks Solutions makes technology that powers wireless connectivity in a wide variety of products: Apple and Samsung smartphones, **Medtronic** (NYSE: MDT) medical devices, **Alphabet** (NASDAQ: GOOGL) and **General Electric** (NYSE: GE) products. In the "Internet of Things," millions of physical objects are going online, and Skyworks is uniquely positioned to benefit. Not only does it serve *all* smartphone makers, but the company is diversified across industries to total more than 2,000 customers. How so?

Skyworks sells more than 2,500 high-performance analog semiconductors and related products, supported by more than 2,200 patents. The product list includes amplifiers, attenuators, receivers, switches, diodes, modulators, GPS power and voltage regulators, and more, often sold together as a module for a phone or connected device. Skyworks earns industry-beating operating margins of more than 30% (and they're headed higher) by selling specialized solutions to giant customers with growing connectivity needs. Plus, as wireless complexity increases, fewer companies can deliver the integrated modules customers need, putting Skyworks in an even stronger position. The China opportunity is large as well.

This can be a volatile "chip" stock, but its long-term outlook (which is the time frame we care about!) remains compelling. The company expects its long-term total addressable market to increase by about 15% a year, and Skyworks is increasing its profits more quickly than that.

Buy: Starbucks (NASDAQ: SBUX)

You only think you're there for the coffee — the ubiquitous java purveyor has big plans.

Suggested Allocation: 3.8%

For More

- *Pro*'s original recommendation (8/22/2012)
- Most recent earnings update (2/5/2016)
- Talk about Starbucks

You may not realize it, but "**Starbucks**" (NASDAQ: SBUX) is no longer just a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense, it's just a front. We *think* we go to Starbucks for the coffee, but those green-and-white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

Starbucks began opening America's eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 24,000 stores in 70-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences in more than 80 million transactions each week This company is continually finding new ways to reach customers; we're grabbing a latte and a cake pop and coming along for the ride.

Buy: Verisk Analytics (NASDAQ: VRSK)

This prototypical Pro *holding provides us with exposure to powerful tailwinds within the financial, energy, and health-care industries, among others.*

Suggested Allocation: 2.2%

For More

- *Pro*'s original recommendation (6/23/15)
- Most recent earnings coverage (3/1/2016)
- Talk about Verisk

Verisk Analytics (NASDAQ: VRSK) may not be a familiar name, but with a strong competitive advantage, high customer retention, robust and contract-based cash flows, a scalable business model, and large (and growing) markets, the company is in many ways a prototypical *Pro* holding. Verisk started as an information utility for the insurance industry, but nowadays it's is a data and analytics powerhouse that provides customers with solutions in all sorts of arenas: raw data, tailored analytics, enterprise reporting systems, policy fraud detection solutions, competitive benchmarking, and legally tested policy language, just to name a few.

One way to invest successfully is to buy out-of-favor industries, and three to five years from now, we may look back and realize that Verisk did exactly that by entering into the energy industry (via its May 2015 acquisition of Wood Mackenzie) in the midst of the current energy slide. We tend to shun commodity-based businesses here at *Pro*, but we believe Verisk's purchase of WoodMac was a good one: The latter is pretty much a copy of the former, but with a different end market. WoodMac is a leading provider of data analytics to the global energy, chemicals, metals, and mining markets, and it actually has higher margins and a greater percentage of subscription-based revenue than Verisk's other business units. We don't profess to have the ultimate insight into what the next six months have in store for WoodMac and Verisk, but we believe shareholders will be very happy with the results over the next three years.

Buy: Visa (NYSE: V)

With its mission to "accelerate the electrification of commerce," industry leader Visa has most of the world left to conquer.

Suggested Allocation: 2.5%

For More

- *Pro*'s original recommendation (4/28/15)
- Most recent earnings coverage (11/25/2015 — this quarter's update is on the way)
- Talk about Visa

The ubiquitous nature of credit and debit cards in America means that many of us can go through life rarely touching cash. Yet even in the U.S., cash still accounts for approximately 40% of transactions, followed by debit cards at 25% and credit cards at 17%. And globally, cash is truly king: MasterCard estimates that 85% of all consumer transactions still take place with old-school paper and coins. But all of that is slowly changing as economies modernize and middle-income families proliferate, bringing more converts to the benefits of electronic payment. With its mission to "accelerate the electrification of commerce," industry leader **Visa** (NYSE: V) has most of the world left to conquer.

We like Visa for many of the same reasons we like MasterCard. And with the recent acquisition of Visa Europe, the company will be adding 523 million card accounts that resulted in 38 billion transactions and $1.67 trillion in point-of-sale spending last year

. Visa is valued at $195 billion, and given its tiny market share, its ceiling should be much higher than that. It fits into *Pro* as a recurring-revenue business that invests its free cash flow in more growth at still higher rates of return, making it a compounding vehicle.

Pro Portfolio Building Report No. 1: April 13, 2016

Published Apr 12, 2016 at 8:51PM

Welcome, Fool! We're glad you're here. This first report is meant to get you up to speed on our Buy First stocks — the companies in your *Pro* portfolio that we believe you should start purchasing first. But before we get to that, a few words about how best to use *Pro* ...

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that aims to generate winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, hedges, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* fit you.** We know not all investors are in the same situation! We can help you figure out how to buy *Pro* investments given your personal situation, including investing in an IRA or coming to *Pro* already fully invested. Check out our advice for every approach to *Pro*: Invested Elsewhere | "Free-Range" | Whoever You Are
3. **Catch up with our portfolio at your own pace.** Start with the stocks in this report, and follow along with our subsequent reports between now and our live event on May 4. You can always see our Buy First, Buy, and Hold guidance (which is the most important -- more important than valuation estimates) on the Recommendations page, and you can get a succinct, up-to-date take on all of our stock positions on our What We Think Now page.

Bring any questions to the Getting Started & Help discussion board, and Fool onward!

-- The *Motley Fool Pro* team

A Note on Fair Value >>

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Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 3.8%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Global mobile data traffic is expected to increase at a compounded annual growth rate (CAGR) of 53% between last year and 2020, and global mobile 4G connections are expected to grow from 1.1 billion in 2015 to 4.7 billion by 2020 (a 34% CAGR). Communications site operator **American Tower** is well-positioned to benefit from this trend.

For More

- *Pro*'s original recommendation (5/6/13)
- *Pro*'s "Buy More" recommendation (3/17/14)
- *Pro's* "Buy Calls" recommendation (12/17/14)
- Most recent earnings update (2/27/16)
- Talk about AMT

AMT leases antenna space on more than 100,000 cell sites (towers, rooftops, and more) to wireless service providers across the globe. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, non-cancellable, and feature contractual annual price escalations. More than half of AMT's properties are located in 12 (soon to be 13) different countries outside the U.S., including India, Brazil, Colombia, Mexico, Nigeria, and South Africa, and management is intent on expanding the company's international portfolio as it continues to build and acquire more towers.

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE, or to increase coverage density. When they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; about 98% of AMT's customers up for renewal each year do so, and more than 60% of its current leases don't renew until 2021 or later.

The stock may experience volatility in the short term because of its tendency to trade alongside the interest rate-sensitive REIT sector, but over the long term, the underlying strength in business fundamentals should shine through. We expect to earn modest income from a growing dividend and strong appreciation as AMT continues to build out its international tower portfolio.

Buy First: Broadridge Financial Solutions (NYSE: BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 4.9%

For More

- *Pro*'s original recommendation (4/27/10)
- Most recent earnings update (2/5/16)
- Talk about Broadridge

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in its fiscal 2015, its platforms processed approximately 85% of all shares in the United States. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider for managing investor communications.

The company's smaller segment, Global Technology and Operations (GTO), accounts for 26% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance this Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy First: Facebook (NASDAQ: FB)

Although it's lately riding a wave of popularity, we believe the strong stock is justified, and the business should grow handsomely in coming years.

Suggested Allocation: 6.2% (buy in thirds, or halves, over a few quarters; or, experienced investors can write put options to target buying some of their shares cheaper; "sell to open" one put option for every 100 shares you could buy; since you want shares, sell "near-the-money" puts, with a strike price near the current share price, and that expire in just a month or two)

For More

- Latest earnings update (3/2/16)
- *Pro's* original recommendation (9/18/12 – dated by now! But this shows how we thought about it back then when it was $20 and most were bearish)
- Talk about Facebook

Facebook remains a young story about monetizing the largest, most engaged online audience ever hosted by one company. The company's future is in strong hands; management is showing patience and care as it starts to monetize more of its properties, putting visitor experience first. So far, this approach has paid off, with user engagement up even as more ads appear. The billions of connections maintained on Facebook's properties are making the sites extremely sticky, offering the potential for increased value to advertisers (and thus Facebook shareholders) -- especially as the advertising gets smarter and more targeted.

It's our largest position at a recent 6.2%, and the size of our investment in Facebook feels appropriate given how much growth potential lies ahead and how well-managed the company is. Even from today's price, we estimate Facebook could return about 15% annualized for shareholders over the next five to seven years. Though shares are currently a bit above our fair-value estimate, the stock is rated Buy First on its long-term potential. Key risks include users moving away from Facebook, but so far the company has shown great skill in *increasing* user engagement and stickiness, rather than stunting it. It's also possible that management could spend more than Wall Street expects, though that should mainly be a short-term concern.

Buy First: Gentex (NASDAQ: GNTX)

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 2.6%

For More

- Most recent earnings update (3/3/16)
- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex

In 1982, a small company in Zeeland, Mich., called **Gentex** made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands more than 90% of that market.

Currently, about 26% of cars made worldwide have an auto-dimming rearview mirror, and only 8.5% have auto-dimming exterior mirrors. For context, prior to 1987, those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher usage; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror (including the newly launched full display mirror), both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy First: MasterCard (NYSE: MA)

With approximately 85% of the world's commerce still happening in paper money, electronic payment leaders have a lot of room to grow.

Suggested Allocation: 4.5%

MasterCard (NYSE: MA) is among the most attractive businesses in the world. The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns running a largely fixed-cost transaction network that becomes more profitable the more people use it.

For More

- *Pro*'s original recommendation (9/8/11)
- Latest earnings update (3/14/16)
- Talk about MasterCard

The company "charged forward" again in 2015 despite slow international commerce and a strong U.S. dollar. For the year, net revenue in local currency advanced 8%, and EPS gained 18% before special items. But right now, an investment in MasterCard -- as with **Visa** (NYSE: V) -- is an investment in growth *beyond* this year, because 2016 looks tepid as emerging markets struggle and the dollar remains strong. Much of the company's growth potential is being coiled up like a spring. That spring should pop when more economies begin to expand again and the dollar weakens. The market knows this, so the stock maintains a premium valuation.

Even so, we recently moved MasterCard back to Buy First and increased its fair-value estimate. The stock trades a bit above that price, but that's been the case for as long as we've been following it. From this price, we target about 11% annualized returns over the long haul.

Buy First: Oracle (NYSE: ORCL)

This old-guard tech giant has reinvented itself into a cloud software leader, with expanding margins and fast-growing cloud revenue.

Suggested Allocation: 3.9%

Oracle is the largest business software provider in the world, with more than 420,000 customers and $37 billion in annual revenue. The giant built its legacy by selling database management software licenses and related hardware, but in recent years it's begun transitioning customers to its new cloud software offerings, in the process hosting customer data on its own premises.

For More

- Latest earnings update (4/1/16)
- *Pro*'s original recommendation (9/17/09)
- Talk about Oracle

This transition has cost it money in recent years. First, Oracle had to invest in hardware, software development, and sales staff. Second, cloud customers bring in less up-front revenue compared with traditional software license sales, creating a strong revenue headwind in the short term. Over the long term, however, cloud customers are more lucrative than old-timey license customers, with the benefits generally starting about three years after making the switch. Oracle is in early stages of this transition, but enough customers are moving to its cloud that Oracle's revenue has not been growing lately.

The good news: Now that investments and other transition costs are slowing, gross margins for the cloud business are going higher, and Oracle expects profit growth to result, especially as cloud revenue increases. We believe Oracle's comprehensive software solutions will help it keep most of its giant installed base and continue to win it new customers, ultimately leading to a larger, more profitable business. After several years of patience, we should start to see this healthy scenario unfold soon and for the coming many years. This Buy First stock looks undervalued today, and we model for at least 10% annualized total returns with relatively low risk.

Buy First: Wells Fargo (NYSE: WFC)

At heart, banks are simple businesses, and Wells Fargo is one of the best of the breed.

Suggested Allocation: 3.2%

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** (NYSE: WFC) is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 8,600 branches and 12,900 ATMs. It's the third-largest bank in America by total deposits, it has a reputation for high customer loyalty and satisfaction, and it's the U.S. leader in residential mortgage and small-business lending.

For More

- *Pro*'s original recommendation (12/10/10)
- *Pro*'s "Buy More" recommendation (7/29/14)
- Most recent earnings update (1/20/16)
- Talk about Wells Fargo on our discussion board

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up roughly half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During low-interest lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

Wells Fargo's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. In a world of continued low interest rates, we should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But if and when long-term interest rates rise and loan demand accelerates, Wells Fargo's earnings power — bolstered by growth in fee-based revenue — will hit its full stride.

Shares are trading at less than our estimate of fair value, and at recent prices they yield a growing 3.2% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. With its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

Invest Like a Pro: If You're Invested Elsewhere

Published Nov 12, 2015 at 10:00AM

How to build a *Pro* portfolio — investing gradually as you sell other holdings or accumulate funds.

If you're already fully invested, you may need to sell existing positions to add *Pro* picks. We recommend that you do this gradually and deliberately, and we've offered advice on how to approach this task.

Freeing Up Cash

List your existing positions in order from your highest-conviction holding to your lowest-conviction holding. If you own stocks from another Motley Fool service, you can use that service's guidance on those stocks in building your list. If you don't know why you own a stock, that's a good reason to sell it. When you're ready, incrementally sell your lowest-conviction stocks and use the proceeds to build your *Pro* portfolio.

Be mindful of your sector and geographic allocations. You don't want to unintentionally end up owning nothing but oil or European stocks just because they were your favorites. If you're struggling with what to sell, post to our discussion boards — the *Pro* team can't give you individual advice, but our community members can and frequently do weigh in with helpful guidance.

Building Your *Pro* Portfolio

Start Here: Portfolio Building Reports

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new *Pro* portfolio.

Part 1: Our Buy First Stocks
Part 2: Our Buy Stocks
Part 3: Our Buy Stocks, Continued
Portfolio Positioning Report
Important: A note on fair value

What's Next?

As you're building your *Pro* portfolio, participate alongside us with new trades if possible. If you don't have cash available, make the new trades the first ones you buy when the time is right. Each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want.

You may decide to modify the strategy we choose for a trade; for example, writing puts instead of buying a stock outright. If you choose to deviate from our recommendation, though, make sure you:

Uniquely *Pro*

If you're joining us from another Motley Fool service, it is critical that you understand what makes *Pro* so powerful. At *Pro*, we are building a portfolio, not simply offering investment recommendations. *Stock Advisor* and *Rule Breakers*, for example, offer stock recommendations from which members can pick and choose.

In contrast, *Pro*'s trades are intended to be integrated building blocks of an overall portfolio. We cannot emphasize this enough: Anytime you decide to deviate from the *Pro* portfolio, make sure you understand how the trade in question is intended to fit with our portfolio — and how the modified trade will fit with yours. With every trade, keep the portfolio context in mind.

1. Understand why we chose the strategy we did
2. Have a reason that the modified strategy better fits your portfolio
3. Exercise caution by sizing the position a bit smaller than you would otherwise

If you have any questions about our trades or making a strategy fit your investing goals, drop by our Making Pro Fit You discussion board, where the *Pro* team and community are happy to help.

You'll also receive the team's Monday Memo email every Monday afternoon, with commentary, news, and any updates to our guidance.

If You're Investing in an IRA

IRAs are tax-deferred accounts that usually don't allow shorting and allow only simple options strategies. If you're building your *Pro* portfolio in an IRA, you can follow our stock-buying trade alerts directly. Most IRAs allow you to write covered calls, so you can also follow those trade alerts (check with your broker to see if you have permission). For trades that go further afield, here are several points to consider:

Writing Puts: Some IRAs don't allow put writing (although many do, if they are cash-secured), so you should simply buy shares in these positions over time. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Other Options Trades: If you can't make a trade in your IRA, check our trade alert for a list of alternative trades. For example, when we write puts to try to buy shares of Stock X more cheaply, you might be able to simply buy shares of Stock X. (If there are no alternate trades, we'll say so.)

Shorting: Some inverse ETFs can be purchased in IRAs (purchasing an inverse of something is similar to shorting that thing). As with options, we'll mention suitable alternatives in the trade alerts.

As tax-deferred accounts, IRAs are well suited for income-generating strategies like covered calls, high-yield dividend stocks, and ETFs with large taxable distributions. If being unable to follow all our recommendations leaves a hole in your portfolio, you may be able to fill the gap with additional income-generating strategies — for example, by writing covered calls on *Pro* stocks you'd be willing to sell at your strike price.

Because IRAs do not allow the use of margin or shorting, you will likely find it difficult to follow along with most of our hedging strategies. If that's the case, we recommend keeping an eye on both your cash balance and *Pro*'s hedging strategies. When the *Pro* portfolio adds hedges, increase your cash balance; when we pull hedges off, reduce your cash balance by investing more in our Buy and Buy First stocks.

Finally, you may want to consider opening a separate, non-IRA account if possible. You can then manage both your IRA and non-IRA accounts as a single portfolio, with income-focused and shorter-term strategies in the IRA and more complex, speculative, and short trades in the second account.

If You Can't Trade Complex Options

You can still follow most of our trade alerts directly — except, obviously, those involving complex options strategies. In those cases, we offer simpler alternatives whenever possible, such as writing puts, writing covered calls, or buying or shorting a stock or ETF directly. If we issue a trade alert using an income-generating strategy you're unable to employ and there are no workable alternatives, consider using the strategies you do have at your disposal to generate income elsewhere in your portfolio.

If you want to expand your repertoire, you should continue to request higher options permissions from your broker every couple of months until they are granted. Account size is one factor brokers consider when making this decision, so to up your odds of success, consider consolidating accounts or moving funds to the account in which you wish to trade options.

In the meantime, don't lose sight of the big picture; remember that we're building a portfolio. If you can't make a particular options trade, you may be able to make an alternate trade or you may need to sit that trade out — either way, it's no big deal. That said, you'll want to pay particular attention to any trade alert in which we use options for hedging purposes (for example, a synthetic short or a ratio put spread on an ETF or an index). Trades like these are important to our integrated portfolio, so don't ignore them. If alternatives are available, we'll outline them. If not, you may want to take action elsewhere in your portfolio to meet similar goals. For example, one way to accomplish this would be to raise your cash position by trimming a few holdings. As always, we're available on the Making Pro Fit You discussion board to field your questions.

Hungry for more *Pro* goodness? Check out our strategy guide!

Go to the Strategy Guide

The Motley Fool Pro Guidebook

Published Oct 16, 2015 at 10:28AM

Start Here: Portfolio Building Reports

To get started with the funds you have available to invest, we'll be providing a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new *Pro* portfolio. **The reports will be linked below on the dates noted.** All dates are subject to change depending on market activity.

Part 1: Our Buy First Stocks Part 2: Our Buy Stocks Part 3: Our Buy Stocks, Continued

Portfolio Positioning Report and Live Chat: Sept. 21

Important: A note on fair value

**What should I expect
from *Pro*?**

• Guidance on a winning portfolio
• A weekly Memo with commentary and market analysis
• Trade Alerts whenever we see an opportunity worth acting on
• A monthly live chat with the *Pro* team
• A ton of help on our discussion boards

Strategy Guide

Follow these features, and you'll be investing like a Pro in no time:

- How We Invest
- Inside the Portfolio

- Our North Star
- Finding Great Stocks

Open the Strategy Guide

I want to learn more

- Check out our advice for every approach to *Pro*:
  - Invested Elsewhere
  - "Free-Range"
  - Whoever You Are
- See guidance on every active position in What We Think Now
- Get a breakdown of how much you might want to invest in each *Pro* position with our allocation calculator

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Meet the Team

Motley Fool Options

Your *Pro* membership also includes full access to *Motley Fool Options*, an options-only service led by Jeff Fischer, the rest of the *Pro* team, and options guru Jim Gillies. *Options* scours the Foolish universe of stocks to provide a steady stream of actionable options ideas to complement your stock portfolio. The vibrant *Options* community is a great place to cut your teeth, talk shop, and learn new strategies in Options U.

Visit Motley Fool Options

Resources

- Allocation calculator
- Our sister service, *Motley Fool Options*
- What to know if you're investing in an IRA
- Getting Started discussion board
- *Pro*'s options guides
- Some thoughts from Jeff on fair value

- A guide to our North Star
- Finding Great Companies: *Pro*'s 8 Qualities
- Manage your email settings
- FAQ
- The *Motley Fool Options* brokerage discussion board
- Contact member services

List of Pro Ticker Guides

Published Apr 15, 2015 at 2:14PM

This is a list of all the Ticker Guides in the *Pro* universe and the companies they're following.

What are Ticker Guides? They're members who help facilitate discussions on their respective boards, offering thoughts and helpful information regarding their company as well as stimulating Foolish conversation. You'll know them by the lamplight charm next to their name. This program is one way we've tried to harness the energy of our greatest asset -- our community.

Company	Ticker Guide	Link
American Tower (AMT)	CMF_bru5ce	Go to the board
Apple (AAPL)	CMF_muji	Go to the board
Broadridge Financial Solutions (BR)	CMFTurningItBlue	Go to the board

Company	Ticker Guide	Link
Celgene (CELG)	TMFTypeOh	Go to the board
Facebook (FB)	CMF-mazske	Go to the board
FactSet Research Systems (FDS)	CMFKBecks	Go to the board
Gentex (GNTX)	CMFSwift	Go to the board
Gilead Sciences (GILD)	CMFMLove	Go to the board
MasterCard (MA)	CMFCochrane	Go to the board
Medtronic (MDT)	CMF_AMDG4	Go to the board
Open Text (OTEX)	CMFSoloFool	Go to the board
Oracle (ORCL)	CMF_bru5ce	Go to the board
O'Reilly Automotive (ORLY)	CMF_bru5ce	Go to the board
Papa John's International (PZZA)	CMFKBecks	Go to the board
Skyworks Solutions (SWKS)	CMFbuyn2hold	Go to the board
Starbucks (SBUX)	TMFPoinkie	Go to the board
TD Ameritrade (AMTD)	CMFKBecks	Go to the board
Visa (V)	CMFPeterB	Go to the board
Wells Fargo (WFC)	CMFBLSH	Go to the board

The Pro Portfolio

Published Dec 5, 2014 at 10:07AM

What Is Exposure?

The "Exposure" table at the bottom of our Recommendations page shows how exposed we are to the market's upside and downside. We're simply measuring the amount of the *Pro* portfolio that's invested long versus short as a percentage of total portfolio value.

- "Long" includes all the stocks, bullish ETFs, and options we own – and positions expected to increase in price as the market increases, and decline when the market declines, including our shorts of bearish ETFs.
- "Short" includes all the short stocks, owned shares in bearish ETFs, and options we've written in the portfolio. This excludes our shorts of inverse or bearish ETFs, because those behave like longs.
- Our long exposure *plus* our short exposure equals our gross exposure (or total exposure to the market, long and short).
- Our long exposure minus our short exposure equals our net exposure (or total long exposure to the market). A net number higher than 50% means we're more than 50% long. A number of 70% means we're net 70% long. And so forth.
- "Hedged Out": The percentage of our long portfolio that is currently hedged by in-the-money options (typically covered calls). Once in-the-money, these positions do not offer us more upside, so they're tracked as "hedged out" unless and until they decline below the hedging strike price.
- "True Long": The amount of our assets that is invested long and unencumbered by shorts or hedges. This provides us a clear view of the amount of capital that currently has uncapped upside potential.
- "Cash Ex-Shorts" is the cash we have left *after* the current cost to close all of our short stock, ETF, and option positions, so it's our true cash balance.
- "Short Put Exposure" shows how much cash we would need to spend if all our written (or short) puts were exercised. Keep in mind, we can roll or close our written puts, so we don't often plan to turn all our written puts into cash-based positions. This means this number can be larger than our cash balance for long periods, even though we're not borrowing any funds.

Portfolio Building Report No. 4

Published Dec 1, 2014 at 4:19PM

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new Pro *portfolio.*

Part 1 **Part 2** **Part 3** **Part 4** **Portfolio Positioning Event**

Dear *Pro* member,

The stocks in your fourth Portfolio Building Report range from one of the strongest and fastest-growing biotech companies in the world, to the company earning by far the most profit on the young mobile computing revolution. Once you've read this report, you'll have our updated thinking on the rest of the *Pro* stocks that are rated Buy or Buy First, and our recommendation that you buy them. As always, though, take your time, ask questions on the discussion boards, and only invest as you're comfortable doing so. Average in over time if you prefer, or as you have cash available. We are investing to win over the long haul — that's the only time frame that ultimately matters. Nobody knows what the stock market will do over the coming months (so take your time), but we feel strongly that our companies will create great value over the coming years.

Next up is our Portfolio Positioning Report and live event with you on Dec. 3. We can't wait to see you there! During that event, we'll talk about shorting, hedging, and options, and the accompanying report will provide recommendations on those positions. As you gradually build your *Pro* portfolio of stocks, it becomes time to consider hedges, shorts, and options if you're following along with us in these versatile and promising investment tools. We look forward to the event and then to helping you every step of the way to long-term investing success.

Have a great Thanksgiving! Be Foolish!

— Jeff and the *Pro* Team

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[Download this report as a PDF]

Buy: Apple (NASDAQ: AAPL)

The leader in mobile computing products could see more growth than anyone expects.

Suggested Allocation: 4.6%

What It Does

Led by its iPhone and iPad, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the smooth Apple operating system, iOS, which centers on the iTunes and App Store marketplaces. iTunes alone earns more revenue each year ($18 billion) than two-thirds of the companies in the Fortune 500, while Apple itself is the most valuable company in the world, approaching $200 billion in annual sales — and still growing strongly, with 20% earnings-per-share growth last quarter. The company's uniquely integrated hardware and software have made for a sticky consumer experience that provides disincentives to switch to a competitor, and as more people use multiple computing devices, only Apple makes it easy to transition from one to the other seamlessly.

For More

- *Pro*'s original recommendation (2/14/12)
- Talk about Apple
- Most recent earnings update (11/22/14)

How It's Working

Over the past year, Apple refreshed all of its product lines and announced Apple Pay and Apple Watch. The Watch rolls out in early 2015, while the new iPhone 6 is already achieving record sales with demand far outstripping ready supply. Tim Cook teases that Apple has more product ideas in the works. Meanwhile, Apple has maintained its magic touch and is not chasing the lower-priced phone market, instead protecting profit margins. We like this choice. Apple earns by far the highest profits in the mobile computing industry, making it the most cash-rich company on earth, with $50 billion in free cash flow last year.

What We Expect

In the longer term, we expect more great innovations from Apple, including other new product categories. We believe customer loyalty will drive healthy recurring sales of phones, tablets and Macs, and new customers and market expansion will add more growth. The stock is priced to produce North-Star type returns as long as Apple maintains its healthy glow, as we believe it will.

Buy: The Buckle (NYSE: BKE)

This well-managed retailer has fit into its jeans admirably over the past decade.

Suggested Allocation: 2.5%

What It Does

Your *Pro* team doesn't know much about fashion, but we can read financial statements. And if the next decade of business performance by **The Buckle** (NYSE: BKE) looks anything like the last one, we'd be willing to wear whatever getup the company suggests. The Buckle sells jeans, other apparel, and accessories at 463 retail locations across the United States, and we think the fantastic management team has figured out a formula that works: measured growth, middle-of-the-road merchandising, and great service. The store concept is in the middle of its life cycle, and the company's financial prudence and operational acumen should lead to a growing stream of free cash flow, dividends, and extra payouts — all of which can help the *Pro* portfolio in our pursuit of our North Star.

How It's Working

The Buckle is a surprisingly steady operator in the notoriously fickle specialty retail space. The company's same-store sales are down 0.5% year to date, while online sales are up 2.8%. We accept a degree of lumpiness here and don't get too bent out of shape when these numbers bop around — The Buckle's target demographic is fickle teens and twentysomethings, after all. We simply monitor these figures for clues about the overall shopping experience and brand relevance. Management's stellar performance has earned the benefit of the doubt:

Metric	2003	2013	Annual Growth
Stores	316	450	3.6%
Sales per Store	$1,354	$2,335	5.6%
FCF per Store	$121	$326	10.4%
Sales per Square Foot	$274	$461	5.3%
Inventory Turnover	4.1 times	4.9 times	1.8%

Dollars in thousands. Per-store calculations based on average stores open during the period. Sources: SEC filings, S&P Capital IQ, analyst estimates.

What We Expect

For More

- *Pro*'s original recommendation (6/20/12)
- Most recent earnings coverage (11/25/14)
- Talk about The Buckle

With 463 stores located in 43 states as of the end of the most recent quarter, we believe The Buckle has plenty of room to grow as it expands from the middle of the country to both coasts; it should be able to achieve wonderful store economics with the 650 to 850 locations we ultimately expect. Recent expansion into footwear, accessories, and children's offerings should provide enough fuel to keep same-store sales healthy, while a commitment to customer service entices repeat visits.

The Buckle also has a history of paying special dividends with its excess cash; since 2008, it's paid out almost $15 worth. This past January, *Pro* members holding the stock received a $1.42-per-share payout from the company (after a 1:16 stock split) in addition to the regular $0.22 dividend. While we can't count on special dividends, the average yield over the past six years, including special dividend payouts, has approached North Star-level returns. We're typically leery of the risks of investing in retail, especially fashion, but the proof is in the numbers for The Buckle.

Buy First: Gilead Sciences (NASDAQ: GILD)

One of the strongest biotech companies on earth, Gilead is positioned to keep rewarding owners.

Suggested Allocation: 4%

What It Does

Gilead Sciences (NASDAQ: GILD) helps millions of people fight life-threatening diseases. Its HIV drugs are prescribed to 9 out of 10 new HIV patients, and are already helping millions enjoy much better lives. The company's HIV products represented the majority of Gilead's revenue until its Hepatitis C cure, Sovaldi, was approved this year. The most successful drug launch in history, Sovaldi topped $8.5 billion in sales in three quarters, though it has only been prescribed to about 117,000 patients so far (as of Sept. 30).

An estimated 2.7 million to 3.2 million hepatitis C patients reside in the United States, and a whole 2.8% of the world (almost 200 million people) is thought to have this common blood-borne infection. That means tens of millions could conceivably benefit from Sovaldi or its newer single-pill version, Harvoni, and this would still leave plenty of room for upcoming competing drugs to do well, too.

How It's Working

Gilead's revenue rose 117% in the quarter just reported, sending earnings per share up 255%. The company's products have a healthy lead over competitors' Hepatitis C drugs still awaiting approval, first in the U.S. and then in other countries where it will take even longer. And because Gilead's Hep C drugs look as or more effective than competing products, doctors have few reasons to wait or switch. Gilead's new Harvoni drug, approved in October, is the first single-pill regimen for curing Hepatitis C, and competitors aren't likely to match it anytime soon. Meanwhile, the company's HIV franchise remains unparalleled, and Gilead has more than 200 compounds in clinical trials.

For More

- *Pro*'s original recommendation(4/30/14)
- Talk about Gilead
- Most recent earnings update (11/22/14)

What We Expect

Going into 2015, we expect more growth as Harvoni is prescribed to tens of thousands of new patients around the world. And that won't stop next year; countries will slowly approve the drug and its reimbursement over many years, and we expect Gilead to be the leader in the cure of Hepatitis C. Even if new competitors bring about a slip in pricing, the profits should remain substantial. And by signing generic drug agreements, Gilead is poised to lead the industry in providing a Hep C cure to 90 emerging-market countries. Meanwhile, we expect Gilead's refreshed HIV franchise and growing oncology franchise to keep increasing shareholder value even beyond the Hepatitis C market.

Buy: MasterCard (NYSE: MA)

Plastic — and digital — is overtaking paper as the world's way to pay, and MasterCard leads the charge.

Suggested Allocation: 4.5%

What It Does

MasterCard (NYSE: MA) is among the most attractive businesses in the world. Here's why: The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders, who are actually exposed to the card users' finances; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

Though MasterCard competes with a large number of well-heeled and (in some cases) innovative businesses, the company's profitability is growing quickly even though the global economy isn't. And that makes perfect sense, because when it comes to paying for stuff, the global market leader isn't **Visa** (NYSE: V), or PayPal, or banks ... it's still cash. Cash has a still-astounding 85% market share of transactions, but it's slow and inefficient, and with no one managing its brand, it's quickly losing out to better alternatives -- like MasterCard.

How It's Working

For More

- *Pro*'s original recommendation (9/8/11)
- Talk about MasterCard
- Most recent earnings update (11/22/14)

This trend has already taken hold in the U.S., where we use cards for a third of our personal expenditures, so Americans often underestimate the opportunities — especially in developing nations. In the first nine months of 2014, MasterCard processed $3 trillion in purchase volume, $2 trillion of which came from outside the United States. Growth in its U.S. business was 8.3%, strongly outpacing our economy (as measured by GDP). And worldwide growth, excluding the U.S., clocked in at a tremendous 14.8% in local currencies. Cash is losing, and fast, but there's a long way to go — and a lot of opportunity for MasterCard. In its October conference call, MasterCard called out India, Japan, Europe, Australia and China as being some of its largest opportunities. Cash is by far the leading means of transaction in each place.

What We Expect

Management recently confirmed guidance for continued 11% to 14% compounded annual revenue growth and 20% earnings-per-share growth through 2015. We think this is possible under current (difficult) conditions, and we expect even better if economies around the world can turn the corner in 2015 and beyond. CEO Ajay Banga and team are doing a tremendous job moving the company forward, and keeping it at the vanguard in new ways to pay, too. Digital payments are another avenue for growth as

MasterCard's invaluable connections to banks and millions of merchants make it a leading choice, along with Visa, for digital payment platforms such as **Apple**'s (NASDAQ: AAPL) Apple Pay. Though we value it conservatively, we expect MasterCard will continue to surprise the world with strong growth for years to come.

Buy: Medtronic (NYSE: MDT)

For once, maybe we can all profit from growing older.

Suggested Allocation: 3.2%

What It Does

No matter how good Grandma and Grandpa look at Thanksgiving, the honest truth is that ever more people in developed nations are advanced in age — and getting more advanced (that's the nicest way we can say it!). Global health care is a growth market we'd be silly to miss. Since 2009, *Pro* has stood by **Medtronic** (NYSE: MDT) because of its global reach, unrivaled commitment to research and development, and attractive financial profile. In that time, shares have risen 90%, but only now does the business finally looked poised to consistently grow, offering more upside to long-term owners like us.

Medtronic is in business to "alleviate pain, restore health, and extend life" for the chronically ill. The company has grown from a garage operation into one of the world's largest medical technology companies by keeping its patient-centric mission front and center. Today, Medtronic has a vast suite of high-tech products; it boasts market-leading share in key technologies; and it has successfully defended that position over time by keeping the pedal to the metal regarding research and development. And with approximately 9% of sales directed back into R&D, there are research dollars left over to keep the company's new product pipeline humming. Finally, Medtronic has made selective acquisitions to target higher-growth areas and fill product holes, and it now racks up nearly half of its annual sales in international markets. That trend will only grow stronger: Revenue was up 12% in emerging markets last quarter and only 5% in the U.S. Meanwhile, Medtronic prepares to acquire European-based Covidien, which should drive more growth.

How It's Working

Over the past few years, some of Medtronic's core markets have come under duress; in some cases, competition has picked up, while in others, product efficacy and sales practices have been questioned. As of late, though, all that has been stabilizing — and the company's other businesses, and its growth in emerging markets, were busy picking up the slack. Product diversification has been a big help in maintaining sales levels, and management's deft execution of its goals and impressive expense management have turned modest sales performance into admirable bottom-line results and cash generation.

Although sales have only advanced 3% annually over the past five years, earnings, dividends, and free cash flow have grown faster as management has cut costs, consistently rewarded shareholders, and maintained discipline with its reinvestments.

For More

- *Pro*'s original recommendation (7/1/09)
- Talk about Medtronic on our discussion board
- Most recent earnings update (11/22/14)

What We Expect

Under CEO Omar Ishrak (who came aboard in 2011), we expect Medtronic to continue its clinical excellence and focus on chronic diseases. We are also witnessing disciplined execution, a strong focus on building the infrastructure for ongoing emerging-market growth, and a healthy balance between the clinical benefits of the company's products and their economic value. Management expects the company to generate $25 billion worth of free cash flow over the next five years, and half of that is likely to be returned to shareholders in the form of dividends and share buybacks. The diagnosis is healthy for Medtronic to continue its North-Star topping returns.

Buy: Parexel International (NASDAQ: PRXL)

Outsourced drug development benefits this respected contract research organization.

Suggested Allocation: 3.3%

What It Does

Parexel (NASDAQ: PRXL) is one of the world's largest and most respected contract research organizations (CROs). Over more than 30 years, it has built a stellar reputation on helping drug makers navigate complex clinical trial processes quickly, which has enabled it to cement important relationships and have a role in developing more than 90% of the top 200 selling drugs.

For More

- *Pro*'s original recommendation (12/23/13)
- Most recent earnings update (11/10/14)
- Talk about Parexel

How It's Working

From 2004 to 2013, outsourcing penetration -- the number of development dollars outsourced to CROs -- has increased by almost 50%. Outsourcing is a cheaper alternative to the traditional high-fixed-cost model of staffing lots of white coats across various therapeutic specialties all around the globe. For large drug developers, letting CROs handle the development work (and those massive staffing needs) can boost profits and time to market, and for smaller drug developers who can't afford a huge staff, there is no other choice. As regulators require more efficacy data, larger patient participation, and increasingly global results, navigating the challenges of the 110,000-plus trials being conducted globally has become frustratingly complex. That makes a large, proven CRO with expertise and global capabilities more of a value-adding partner than a transactional customer.

Although Parexel's revenue and backlog growth have been lumpy recently as it competes for new partnerships, margins have already expanded as the company uses its assets more often and more efficiently. Since the first quarter of 2014, which ended Sept. 30, 2013, the company has increased gross margins from 32.5% to 35.2% and operating margins from 9.3% to 10.9%, leading to 34% earnings-per-share growth on a trailing-12-month basis.

What We Expect

From today's price, we believe the company's business performance will drive its stock to out-earn our North Star over the next decade. A continued industry shift from transactional, project-based relationships to integrated partnerships should ultimately make revenue more reliable. The company's operating leverage should lead to margin expansion over time as the company uses its assets ever more efficiently and revenue growth outpaces expense growth. And if our forecasts of the company's core business and industry tailwinds prove too optimistic, we could still see a nice return from its rapidly growing technology division, PAREXEL Informatics (PI) -- whether that's in the form of a possible spinoff, or just the market's acknowledgement of PI's hidden value.

Portfolio Building Report No. 3

Published Oct 29, 2014 at 2:43PM

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new Pro *portfolio.*

Part 1 **Part 2** **Part 3** **Part 4** **Portfolio Positioning Event**

Dear *Pro* member,

From the most popular social website in the world to a small-but-great software company you've probably never heard of, from the top manufacturer of "smart" car mirrors to the leading producer of irrigation systems — the six *Pro* stocks we cover in today's report span various industries across the globe. That's especially true when you include the emerging-market ETF that tops off our list today. We believe each of these investments will offer healthy returns over the coming years, with reasonable risk. Along with the other holdings delineated in our first and second reports, adding these is another step toward building your *Pro* portfolio. If you have questions about any of these positions, please visit the company-specific discussion board linked in the report. If you have questions about your portfolio as a whole, visit the Making *Pro* Fit You board.

Enjoy! And Fool on!

— Jeff and the *Pro* team

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Download this report as a PDF

Buy: Facebook (NASDAQ: FB)

The world's leading social network — and most-trafficked website, period — is being well managed for long-term growth.

Suggested Allocation: 4.6%

What It Does

More than 1.3 billion people use **Facebook** (NASDAQ: FB) to connect to friends, families, companies, organizations, marketers and celebrities each month. Incredibly, more than 850 million people visit daily. Most traffic arrives through mobile devices, and the company has had great early success monetizing that traffic with ads in its popular mobile news feed. Over the longer term, management wants to make the ads on the site as targeted and relevant to users as are the updates from their friends and family. Meanwhile, Facebook keeps working to stay on the edge of social technology. The company has the equity to acquire competing platforms and then build traffic before monetizing them once it hits critical mass — which in Facebook's opinion is 1 billion users.

How It's Working

For More

- *Pro*'s original recommendation (9/18/12)
- Our most recent earnings coverage (10/31/14)
- Talk about Facebook

Facebook reported strong third-quarter results in October, with revenue up 59%, ad revenue up 64%, and operating costs only up 41%. The company's three-year plan is to increase additional value for users and businesses, so it's investing heavily in the site and in new ad platforms to do so. The five-year plan includes monetizing platforms like Messenger, WhatsApp and Instagram, which intentionally aren't running any ads yet. The 10-year plan includes Internet.org initiatives to connect the world, the majority of which is still not online.

What We Expect

Facebook will greatly increase spending in 2015 as it hires for future growth. Demand for advertising is outpacing Facebook's ability to serve widespread customers adequately, and — like **Google** (NASDAQ: GOOGL) in its early days — it wants to stay ahead of its technological needs with ample hiring and spending. Lately, the stock trades at 40 times expected earnings for the next 12 months, making it reasonable for its growth rate, and attractive for the coming years. We're reminded of when Google went public, and we expect Facebook's increased spending will pay off in higher revenue and earnings, ultimately pleasing investors like us.

Buy: Gentex (NASDAQ: GNTX)

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 3.4%

What It Does

In 1982, a small company in Zeeland, Mich., called **Gentex** (NASDAQ: GNTX) made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands almost 90% of that market, and it sells eight times more units than its closest competitor.

How It's Working

In 2000, the company sold 6.8 million units; in 2013, it sold 26.2 million. That growth has been driven by an increased focus on safety, higher car sales, and greater market penetration (more car makers offering Gentex mirrors as a trim option). Gentex has turned these market dynamics into wonderful financial performance. Revenue has risen by nearly 20% annually since 1990, and over the past decade, the company's net margins have bounced around the mid-to-high teens. Those numbers are shockingly good for an auto-parts supplier, showing that its fancy mirrors are showing up in more and more new cars.

What We Expect

For More

- *Pro*'s most recent update (11/10/14)
- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex

Currently, fewer than one in every four cars made worldwide has an auto-dimming rearview mirror, and only 6% have auto-dimming exterior mirrors. For context, prior to 1987 those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher penetration; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror, both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy: OpenText (NASDAQ: OTEX)

This company's information management software keeps the digital lives of businesses in order, and its exchange platform drives business transactions.

Suggested Allocation: 3.7%

What It Does

OpenText (NASDAQ: OTEX) is a leading provider of solutions in enterprise information management (EIM). It sells software (both in the cloud and on premises) that lets companies organize their electronic content, and it offers a leading business exchange platform for enterprise commerce. OpenText's products help companies, governments, and universities operate more efficiently and effectively, meet compliance requirements, communicate with colleagues, customers, and partners, and make transactions. Its software helps its customers manage digital information, and its Information Exchange platform lets customers manage their business-to-business communications and transactions. Both units generate strong recurring revenue.

How It's Working

For More

- *Pro*'s original recommendation (8/31/11)
- Most recent earnings coverage (11/16/14)
- Talk about OpenText

OpenText has increased sales and cash from operations by more than 14% annualized over the past three years, and the goal is to continue to grow by at least 10% annualized as its industries expand. Sales were up 40% last quarter, and operating cash flow jumped 73%. Margins have trended higher as growth continues, and OpenText expects recent upgrades to its software to continue to drive demand.

What We Expect

Electronic content management industries served by OpenText should increase top-line demand by at least 10% annualized over the next several years, and OpenText should take market share, too. The company has a long history of steady growth through acquisition, and it enjoys diversified software sales to multiple industries. With new products rolling out in cloud services (off-site servers), renewed sales execution through more distribution channels, exciting acquisitions in the works, and an intense focus on its financial performance, this medium-sized company looks to have a big future.

Buy: Papa John's Pizza (NASDAQ: PZZA)

Deliver a slice of the profit pie right to your doorstep.

Suggested Allocation: 3.9%

What It Does

Papa John's International (NASDAQ: PZZA) operates and franchises more than 4,500 pick-up and carry-out pizza joints in more than 36 countries. For the past 30-plus years, Papa John's has been making pizza and building its brand around the "Better ingredients, better pizza" tagline. Bringing that unwavering focus to each pie has resulted in the company's perceived quality advantage over its big-chain pizza competitors, which allows it to consistently price a dollar or two higher and attract the best franchisees. Now that its brand advantage is sufficiently established in North America, Papa John's is turning its sights abroad, believing that delicious American pizza is a language every taste bud speaks.

How It's Working

For More

- *Pro*'s most recent update (11/10/14)
- PZZA position review (5/23/14)
- Talk about Papa John's

As sure as a fresh pizza will be gobbled up by hungry kids, Papa John's delivers results. For 11 consecutive years, the company has recorded positive or even North American comparable-store sales growth. Recently, international comps have been in the 5% to 8% range, offering lip-smacking evidence that Papa John's flavors travel well. It has opened between 200 and 300 restaurants in the past two years, a pace that should continue — expectations are for about 230 new units this year. And because Papa John's is primarily a franchisor, it doesn't have to bear the cost of that expansion (it is taken on by the franchisees). Competing for a share of the global appetite is tough business, but Papa John's has been able to increase sales and profits at commendable rates over the past decade, which has resulted in plenty of cash generation. Management initiated a dividend in 2013 and has consistently bought back stock over the years.

What We Expect

We believe the company will maintain its brand positioning, modestly improve underperforming franchise locations, and continue to be an attractive entrepreneurial outlet for new franchisees abroad. We think the brand can easily support 6,600 worldwide locations by 2023. The company should also be able to take modest market share from mom-and-pop pizza shops in established markets as digital ordering continues to gain adoption; it's a tough hurdle for smaller players to overcome. With a little bit of menu innovation and the maturation of new markets, we believe 3% same-store growth is sustainable over this period. We rate shares a Buy and encourage members to do plenty of field research on this one.

Buy: Valmont Industries (NYSE: VMI)

Providing irrigation systems and support structures, this company benefits as agriculture needs increase and countries build infrastructure.

Suggested Allocation: 2.4%

What It Does

Valmont Industries (NYSE: VMI) offers investors a consistent suite of four business divisions, each serving a growing need around the world. Founded in 1946, Valmont's engineered products division supplies steel and aluminum poles to infrastructure projects worldwide, including road and traffic lights; stadium and parking lights; and wireless communications poles and support towers. This division also sells highway safety products including barriers and road grating. In addition, because it sells steel and concrete support structures for the global utilities industry, Valmont profits as electrical grids are renovated or built out.

Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot and mechanized irrigation systems are the world's leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient mechanized irrigation, so there's lots of room to run.

To top it all off, the company provides hot-dip galvanizing (just like Mom used to make), anodizing, and other coatings to protect aluminum and steel from corrosion. One of the largest custom galvanizers in the world, Valmont expects continued growth because it still captures only a small percentage of the total market. Overall, the company operates in more than 80 countries and has more than 10,000 employees.

For More

- *Pro*'s original recommendation (11/5/13)
- Our most recent earnings coverage (11/2/2014)
- Talk about Valmont

How It's Working

Valmont's stock has returned 14% annualized since 1993, outperforming the vast majority of stocks on the market, even the likes of **Starbucks** (NASDAQ: SBUX) and **Whole Foods** (NASDAQ: WFM) over the past 10 years. By focusing on strong returns on invested capital, smart acquisitions, new markets, and product-line expansion, Valmont has been able to increase profits as the world economy expands. Yet it's still a relatively small company (at $3.4 billion) with plenty of potential in all business lines, and it trades at valuation multiples below market averages.

What We Expect

With outstanding management and four business divisions that continue to expand around the world, we expect Valmont to grow at more than 11% overall — riding through cyclical bumps — and the stock to ultimately perform admirably in our pursuit of our North Star. As mentioned, we will have to ride through cyclical downturns along the way. But as management says, each low is higher than the previous one, and each high is a record high. We hope to have a long, rewarding relationship with this recent *Pro* stock. It's going to require patience, but that patience should be rewarded.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund (NYSEMKT: DGS)

Diversification in emerging markets with some of the best small, high-yield companies you've never heard of.

Suggested Allocation: 2.3%

What It Does

At *Pro*, we like to invest in emerging-market small caps to diversify and target higher growth. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS) (the longest ETF name in the world!*). This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields more than 3%). For *Pro*, owning shares of this well-managed ETF offers exposure to up to 600 of the most promising international business we couldn't easily buy in another way.

Serving as direct exposure to emerging markets, this ETF gives us an excellent way to invest in unfamiliar companies in locations where we don't have a discernible edge but where growth exists — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The diversifying benefits of investing outside our home market are equally important over long periods.

How It's Working

It's no surprise that small-cap companies (even dividend-paying ones) in emerging markets are volatile. We expect DGS to continue to experience higher-than-average volatility. So far, emerging markets have badly lagged U.S. markets. But eventually that will change.

For More

- *Pro*'s original recommendation (11/22/10)
- Talk about DGS

We'd always prefer to own great businesses over great ETFs, so this holding has a permanent spot on our short list of positions we'll sell if we need cash or find a higher-conviction alternative. In the meantime, though, for a low expense ratio, we get a basket of businesses with a history of exceptional performance, weighted by the size of their annual cash dividend. The fund's heavy weighting toward financials, industrials, and the consumer discretionary sector leaves it well positioned to benefit from an economic recovery if and when one comes along.

What We Expect

This is a top-notch fund, and you don't have to take our word for it; Morningstar has bestowed its coveted five-star rating on DGS. It's also made Morningstar's list of the top eight funds in its category in each of the past three years, and it's ranked No. 2 when considering five-year performance. We expect these impressive long-term results to accrue to us eventually. In the meantime, the watchword with small caps, emerging markets, and this ETF is: patience.

**Statement may or may not be accurate.*

Portfolio Building Report No. 2

Published Oct 29, 2014 at 2:35PM

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new Pro *portfolio.*

Part 1 Part 2 Part 3 Part 4 Portfolio Positioning Event

Dear *Pro* Member,

This report marks Part 2 of your *Pro* portfolio-building experience. We recommend that you add capital to these stocks next, as you continue to build your *Pro* portfolio. Once we build your foundation in strong *Pro* stocks, we'll address hedging, shorting, and options for those members who want to use these versatile extra tools — which, as we know, is many of you. For now, we're starting easy as a Sunday morning by introducing you to our stars — our core holdings, which should compound our core capital over the years. Each Portfolio Building Report introduces you to a selection of them one by one and explains why we like owning them, the upside we see, and how much we believe you should allocate to each right now. When you have questions on any company, please visit its discussion board; all of them are linked in the report.

Welcome again to *Pro*! Enjoy the process and ask questions. We're here to help. Fool on!

— Jeff and the *Pro* team

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Download this report as a PDF

Buy: American International Group (NYSE: AIG)

Time and even average performance should lead to solid returns from this undervalued insurer.

Suggested Allocation: 3.6% stock, 0.7% warrants

Today's **American International Group** (NYSE: AIG) is not the same company that disgraced itself so profoundly in 2008. AIG has divested itself of whole business units since the financial crisis, managing to eliminate almost all of its previous exposure to the nasty derivatives that nearly brought down the economy. Left behind are three steadfast and improving insurance businesses.

What It Does

Insurance is a business of collecting premiums, investing the float, and paying out claims — and AIG is getting ever better at it. Improved underwriting is showing up in a lower loss ratio, which in turn is driving a lower adjusted accident-year combined ratio. All that is a fancy way of saying that the company's insurance operations are stronger than they've been in years and are poised for continued improvement.

For More

- *Pro*'s original recommendation (8/24/12)
- Most recent earnings update (11/5/14)
- Talk about AIG

At Your Broker: AIG Warrants

- eTrade: AIG.WS
- Fidelity: AIG/WS (paste CUSPID 026874156 into the quote page)
- Interactive Brokers: Find AIG; select "warrants" from the drop-down menu
- optionsXpress: AIGwS
- Schwab: AIG/WS
- TD Ameritrade: AIG+
- Vanguard: AIG_t
- OptionsHouse: AIG.WS

Helpful Links

- AIG's explanation of the warrants
- AIG's warrant registration statement filed with the SEC

AIG's insurance offerings consist of three divisions: AIG Property Casualty, AIG Life and Retirement, and Mortgage Guaranty. The first provides casualty, property, financial, and specialty insurance to commercial clients and consumers, typically through brokers. The life and retirement division offers domestic life insurance and retirement products (annuities, mutual funds, financial planning) through a diverse network of financial-services companies, brokers, agents, and advisors. The mortgage guaranty division insures lenders against losses from defaulted mortgage loans. Overall, AIG is writing fewer premiums at better prices than it was in past years, which is a great indication of improved underwriting discipline.

How It's Working

When we recommended buying AIG stock and warrants in August 2012, we were confident in the momentum of the company's turnaround, but we underestimated the rapid rate at which our thesis would unfold. In late 2012 (after our recommendation), the U.S. Treasury sold another $26.5 billion worth of its AIG shares. Management wisely used the opportunity to purchase billions of dollars' worth of stock at about half book value; that, of course, further increased book value in a virtuous cycle. Management continues to repurchase shares and, reflecting the company's remarkable improvement in balance-sheet strength, has paid a dividend (lately $0.125 per share) for the last five quarters.

What We Expect

Underwriting discipline will continue to drive increased earnings and a higher valuation. That plus a renewed focus on capital management will improve AIG's credit rating, reducing its cost of debt and providing another lever for higher profitability. We expect newly installed CEO Peter Hancock to stay laser-focused on improved underwriting and capital allocation, repurchasing shares so long as AIG continues to trade meaningfully below book value and maintaining or increasing the quarterly dividend if business performance supports it.

The *Pro* Bottom Line

We recommend buying 3.6% of AIG stock and 0.7% of AIG warrants (see below for more on those). AIG has cleaned up its business, so by purchasing now, you get in after all the hard work has been done. Book value — the best measure of an insurance company's worth — is steadily growing. And AIG's current share price is right around 0.7 times book value. That's cheap, especially given the company's momentum. Investors who buy AIG now are positioning themselves for outsized future returns with less risk. That's contrarian investing at its best.

A Note on Warrants

Warrants are similar to call options, except that they are issued by the underlying company. They offer the purchaser the right (but not the obligation) to buy the stock in question at the specified price. The warrants we're recommending on AIG are valid for 10 years from the date of issue (Jan. 19, 2011), and they can be exercised at any point before they expire on Jan. 19, 2021. When exercised, they allow the holder of the warrant to buy shares of AIG at $45 per share, regardless of the market price.

That $45 strike price adjusts favorably in the event of dilution or annual cash dividends greater than $0.675 per share (which would also lower the share price). Warrants are illiquid, and Goldman Sachs is the designated market maker for them; when you buy them, be sure to use a limit order so Goldman doesn't get more than a fair price.

Be aware that if our investment in AIG works out, those who own warrants will earn leveraged returns on them. But it's possible that the warrants could end up as a total loss if AIG's stock price is below the $45 strike price at expiration (even though they're currently in-the-money by a few bucks).

Buy: AmTrust Financial Services (NASDAQ: AFSI)

Its talent at capitalizing on human laziness is just part of what we love about this insurer.

Suggested Allocation: 7.4%

What It Does

At *Pro*, we speak a lot about the importance and power of recurring revenue — mostly because we know that humans are inherently lazy. Insurance purveyor **AmTrust Financial Services** (NASDAQ: AFSI) handily proves this point for us; many of the policies it writes (more than 80% in most lines!) renew at the end of their term without their owners even shopping for a better rate. Most of us, it seems, are guilty of preferring inertia to bargain-hunting, and AmTrust and its fellow insurers are the beneficiaries.

AmTrust focuses on insurance niches (workers' compensation, product warranties, and Italian medical malpractices, just to name a few) that are low-hazard and generally too small for large insurance companies to care about. But though AmTrust writes small policies, it's no small fry. Its high renewal rates and predictable cash flow allow it to focus on writing new policies, acquiring new books of business at prices that range from fair to an outright steal, and hunting for obscure investment opportunities.

How It's Working

AmTrust's focus on specific niches, its use of technology to keep its expenses low, and its opportunistic acquisition of policies other insurers struggle to find profitable have all resulted in impressive growth. Gross written premiums have risen from about $1.1 billion in 2008 to more than $4 billion this past year. But AmTrust is no one-trick pony; income from its high-margin and equally sticky service and fee business grew from $29 million to more than $331 million during the same time span. This growth, combined with a laser-like focus on low expenses, has resulted in consistent increases in earnings, dividends, and book value.

What We Expect

For More

- *Pro*'s original recommendation (4/3/09)
- Talk about AmTrust

The insurance market works in cycles, and AmTrust's strategy is built around taking advantage of this. The company targets markets in which pricing has risen as other companies struggle to deal with losses from policies written in prior years. Pricing has remained favorable in AmTrust's largest markets as of late, which means it can do one of two things: either charge as much as its competitors and make more in profit thanks to its lower expense structure, or undercut the competition on price in a bid to take market share, since it isn't dealing with legacy losses. If the economy continues to improve, the small businesses AmTrust insures should hire more workers and consumers should purchase more insurable goods, so there seems to be plenty of growth ahead.

AmTrust stock has consistently traded higher than our estimate of fair value, but we believe the company's premium valuation is warranted given the consistency of its growth, quality, and profitability. AmTrust is *Pro*'s largest holding and we're happy to let this winner run, expecting to increase our fair-value estimate over time.

Buy: Broadridge Financial Solutions (NYSE: BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 4.2%

What It Does

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in its fiscal 2014, which ended June 30, its platforms processed more than 80% of all shares in the United States. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider to manage investor communications.

The company's smaller division, securities processing solutions, accounts for 27% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

How It's Working

Both earnings and free cash flow are modestly depressed because mutual funds have been scrimping on investor communications recently and investor skepticism around the global economic recovery has led to low trading volume. Still, in fiscal 2014 Broadridge's sales were up 5%, earnings per share rose 25%, and the company hiked its dividend by 17%. The business is positioned for strong sales and margin performance for years to come. And Broadridge continues to serve its customers masterfully; its 98% retention rate sets the stage for recurring revenue (and deepening relationships) in future years.

What We Expect

For More

- *Pro*'s original recommendation (4/27/10)
- Talk about Broadridge

We think Broadridge will continue to write the e-book on electronic investor communications. Its dominance of this market should strengthen its competitive advantages, making it indispensable as transparency in the financial system increases. We also expect banks and brokerages to continue outsourcing their non-core operations to save money and increase flexibility; this should bring increased business and greater efficiency to Broadridge. We expect modest sales growth to translate to earnings growth of around 10%. Much of Broadridge's revenue is recurring, making its sales and earnings growth highly reliable, and its impressive free cash flow will likely bring an ever-higher dividend and increased share buybacks.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy First: Skyworks Solutions (NASDAQ: SWKS)

This leading designer of analog semiconductors for smartphones and connected devices is growing sharply.

Suggested Allocation: 3.2%

Skyworks Solutions (NASDAQ: SWKS) makes technology that powers wireless connectivity in a wide variety of products: **Apple** (NASDAQ: AAPL) and Samsung smartphones and tablets, **Medtronic** (NYSE: MDT) medical devices, **Google** (NASDAQ: GOOG) and **General Electric** (NYSE: GE) products, and the list goes on. In what's being called the "Internet of Things," billions of physical objects are being connected to the Internet for the first time -- and Skyworks is uniquely positioned to benefit. Not only does it serve all of the top-tier mobile device makers, the company is also diversified across industries to serve more than 2,000 customers.

What It Does

Skyworks sells more than 2,500 high-performance analog semiconductors and related products, supported by nearly 1,000 patents. The list includes amplifiers, attenuators, receivers, switches, diodes, modulators, GPS power and voltage regulators, and more, often sold together as components of a phone or other connected device. Skyworks earns industry-beating operating margins of 30.5% selling specialized solutions to giant customers with growing connectivity needs. Here are just a few examples:

- GE plans to connect all of its industrial products to the Internet -- from jet engines to dishwashers.
- Medtronic will connect many of its medical devices to the Web for monitoring.
- A majority of new automobiles will be connected to the Internet by 2017.
- Smartphone sales are expected to surpass 1 billion by 2016

All told, **Cisco Systems** (NASDAQ: CSCO) expects 50 billion devices will connect to the Internet by 2020.

How It's Working

Skyworks is already reaping some benefits, and it's ready for much more. As CFO Donald Palette said this summer, "We've spent the last decade investing significant resources and leveraging our technology to expand our presence in traditional analog markets like automotive, medical, and industrial. We have established significant traction in these higher-margin growth avenues, and we see tremendous opportunity ahead."

Whatever the device being connected to the Internet, the smaller, more complex, and more efficient the technology needs to be, the more Skyworks benefits. Also, as more data flows through networks and more connection nodes are required, the company's products become even more indispensable. As Palette said in the July conference call, "Complexity for us drives profitability. And there are fewer and fewer people in the space that can do it" -- even as complexity accelerates. Given this, Skyworks expects profit margins to continue to move higher.

What We Expect

We expect continued strong growth, and we think the reasonably-priced stock will ultimately appreciate at rates higher than the market average. CEO David Aldrich recently said, "Skyworks is entering a new and exciting growth phase driven by global wireless proliferation and the Internet of Things. Quite simply, we are capitalizing on the macro trend to connect virtually everyone and everything, all the time." Most significantly, he continued: "Skyworks is setting the pace for analog semiconductor industry growth in terms of both revenue and value creation." In the quarter just ended, revenue jumped 51% year over year, while operating income soared 81%. And for the fiscal 2015 that just began, Skyworks increased first-quarter guidance.

For More

- *Pro*'s original recommendation (8/5/14)
- Talk about Skyworks

CEO Aldrich summed things up on Nov. 6: "Our advanced solutions are at the heart of mobile connectivity and the Internet of Things, and are empowering exciting new applications spanning mobile payments, to streaming music services, to on-demand media. Given our accelerating design win momentum and deep product pipeline, we have never been better positioned to grow demonstrably faster than our addressable markets and in turn, to deliver best-in-class financial returns." Here at *Pro*, we hope to be owners for many fruitful years — as long as is merited.

Buy: Starbucks (NASDAQ: SBUX)

A global powerhouse devoted to creating experiences stands poised to brew up great returns going forward.

Suggested Allocation: 2.8%

What It Does

You may not realize it, but "**Starbucks**" (NASDAQ: SBUX) is no longer a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense it's just a front. We *think* we go to Starbucks for the coffee, but those little white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

Starbucks began opening America's eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 21,300 stores in 65-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences to fill more than 70 million mouths and hearts each week.

How It's Working

By placing the customer experience first, Starbucks has cemented its role in the daily lives of consumers worldwide. People demand their Starbucks products at home, too, which has allowed the company to build out a consumer packaged-goods division that sells more than $1.5 billion worth of products in more than 100,000 locations worldwide. And the company is cultivating a portfolio of other brands (Evolution Fresh juices, Teavana tea bars, La Boulange bakeries, Starbucks Reserve) whose products can be sold in Starbucks stores and grocery stores alike. Between coffee, health foods, and tea, Starbucks believes its end markets are a massive $140 billion and growing.

Recent results have been robust. Starbucks continues to add stores at a rapid clip, and its same-store sales have been rising by an average of 7% per year over the past five years. Earnings and cash-flow performance have increased even faster, and all of this growth has been achieved by doubling down on the in-store experience and refocusing on quality. Starbucks constantly seems to be setting new records for sales, operating profits, and earnings.

What We Expect

For More

- Most recent earnings update (10/30/2014)
- *Pro*'s original recommendation (8/22/2012)
- Talk about Starbucks

Given its very recognizable brand, artfully crafted business, and fanatically loyal customers, we expect Starbucks' diversified growth to continue. We believe the world's coffee and tea drinkers will happily support 30,000 or so stores across the company's various brands, and that products bearing the aspirational Starbucks brand will expand the company's real estate on grocery-store shelves.

The company's scale and its ability to raise prices should help profits, as will its unique advantages in low-cost marketing. Starbucks is also the leader when it comes to incorporating technology into a physical store experience – 90% of mobile payments in the U.S. took place in a Starbucks store in 2013.

At around 29 times trailing earnings, Starbucks might look expensive to some, but the company has been knocking it out of the park since CEO Howard Schultz's return to power in 2008; it now has so many levers to pull that capturing its potential value in a spreadsheet is very difficult. Starbucks offers a truly unique blend of growth and cost-reduction opportunities that leave it poised to deliver North Star-beating returns going forward. We want to tag along for the caffeinated ride.

Portfolio Building Report No. 1

Published Oct 29, 2014 at 2:31PM

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new Pro *portfolio.*

Part 1 **Part 2** **Part 3** **Part 4** **Portfolio Positioning Event**

Dear *Pro* Member,

Pro is a premier service at The Motley Fool not only because it's a portfolio service that incorporates options, shorts, and hedges alongside core stock investments — but because it is a full portfolio solution, period.

Thought goes into each part of the portfolio, the allocation we give to every position, and how the positions all work together. This means that every addition to the portfolio serves a specific purpose. The following report (as well as those to come on Nov. 13 and Nov. 20) outlines our current thinking on all of *Pro*'s positions, as well as suggested allocations and the thesis behind each one.

Welcome to *Pro*. We're glad to have you!

— Jeff Fischer, advisor

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Getting Started With *Motley Fool Pro*

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that aims to generate winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* fit you.** We know not all investors are in the same situation! We can help you figure out how to buy the *Pro* investments given your personal situation, including investing in an IRA or coming to *Pro* already fully invested. Check out our advice for every approach to *Pro*: Invested Elsewhere | "Free-Range" | Whoever You Are
3. **Catch up with our portfolio at your own pace.** Start with the stocks in this report, and wait for our next two reports coming Nov. 13 and Nov. 20. You can always see our latest take on all of our positions on our What We Think Now page. As you explore our recommendations, it's important to remember that a stock's "scorecard status" (Buy First, Buy, or Hold) is the best indicator of how we feel about it. If a stock is listed as a Buy or Buy First on the What We Think Now page, that means we think you can buy it today.

Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 3.9%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Total U.S. mobile data traffic is expected to increase by more than 2,000% between 2012 and 2018, and the number of U.S. mobile lines in service (including smartphones, computing devices, and machine-to-machine applications) is expected to jump from 360 million in 2012 to 648 million in 2018. Communications site operator **American Tower** (NYSE: AMT) is well positioned to benefit from this trend.

What It Does

AMT leases antenna space on more than 69,000 cell sites (towers, rooftops, and more) to wireless service providers across the globe. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, non-cancellable, and feature contractual annual price escalations. About 60% of AMT's properties are located in 11 different countries outside the U.S., including India, Brazil, Germany, and South Africa, and AMT is intent on expanding its international portfolio as it continues to build and acquire more towers.

How It's Working

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE (or, in Africa, from voice to data), or to increase coverage density. Every time they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; 98% to 99% of AMT's customers up for renewal each year do so, and more than 85% of its current leases don't renew until 2019 or later.

What We Expect

Revenue is up 25.3% year-over-year in the most recent trailing-12-month (TTM) period, with the international division up 27.2%, outpacing the domestic side. We expect revenue to roughly double over the next five years through a combination of price escalations, new towers, and upgrades; year-to-date 2014 results suggest that the company is well on its way.

After its 2011 conversion into a real estate investment trust (REIT), AMT is required to pay out 90% of taxable income to shareholders. It currently distributes $1.44 annually, a 1.5% yield, and management expects to increase the dividend 20% annually over the next five years. (Importantly, only the U.S. business and a small portion of the international business is organized as an REIT. For more, see our original write-up, linked here and in the sidebar.)

For More

- *Pro*'s original recommendation (5/6/13)
- *Pro*'s "Buy More" recommendation (3/17/14)
- Talk about AMT

Management reduces taxable income though the use of net operating losses. And because the useful life of its tower properties exceeds the depreciation schedule, AMT also uses a depreciation shield, which further reduces taxable income and understates the value of some assets on the balance sheet. Thus, typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

The *Pro* Bottom Line

We value AMT at about $110 a share. Today's price provides an acceptable margin of safety for a business of this caliber. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network.

Buy First: Oracle (NYSE: ORCL)

This old-guard tech giant has more room to grow.

Suggested Allocation: 4.2%

What It Does

Oracle (NYSE: ORCL) is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems** (NASDAQ: CSCO), **Dell**, and **Microsoft** (NASDAQ: MSFT) — Oracle's value has steadily risen as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe. And when it comes to hardware, Oracle's own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

Combining hardware with boxed software and cloud services, Oracle is a full-service solution, one that's poised to enjoy long-term growth in free cash flow. The business is incredibly sticky — companies don't trust their data to just anyone, and it's tricky and even risky to make a switch. To add to its massive recurring revenue base, Oracle cross-sells new products to existing clients and continues to rope in new customers with its comprehensive software and hardware solutions, whether on site or in the cloud. The company has also been known to make some (read: *many*) acquisitions to propel growth.

How It's Working

Leading software sellers can write a program once and sell millions of copies, then provide small but critical updates on a regular basis. These updates drive a subscription business model, which leads to recurring revenue. Most of Oracle's customers renew annual software contracts that represent more than 40% of its revenue. This is stability upon which Oracle grows. Even better, as more customers move to a cloud-based relationship (rather than licensing on-premise software), Oracle enjoys growing, monthly, recurring cloud revenue, even as customers save money because they no longer need to host their own software. For Oracle, economies of scale make hosting inexpensive.

In the quarter that just ended, Oracle's core cloud revenue was up 33%, while total software-plus-cloud sales gained a respectable 6% to $6.6 billion. Following some quarters of slow license sales growth (the increasingly popular cloud contracts bring in revenue more gradually), the stock has dipped, providing a good buying opportunity.

More Resources

- *Pro*'s original recommendation (9/17/09)
- Latest earnings coverage (10/3/14)
- Talk about Oracle

What We Expect

At about $39, Oracle trades at about 13 times free cash flow, well below the S&P 500's average, and management expects more operating leverage ahead and greater overall profits as cloud revenue steadily increases.

The *Pro* Bottom Line

This is a good buying opportunity for a proven business that still has plenty of room to grow. From this valuation, we think the stock should produce a North Star-topping, 10%-plus annualized return over the coming three years.

Buy First: TD Ameritrade (NYSE: AMTD)

Assets and investment fees are rising; earnings should surge when interest rates head higher.

Suggested Allocation: 3.1%

Entrusted with more than $650 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NYSE: AMTD) hosts around 400,000 stock, options, and futures trades on an average day, collects investment fees, and earns interest on billions in cash.

What It Does

Aside from being a leading discount broker, TD Ameritrade has a partnership with **TD Bank** (NYSE: TD) (which owns 41% of the company), giving it a unique position in its industry. The partnership allows TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank, and with cross-selling opportunities and below- average risk to boot. So, when the current record-low federal funds interest rate (targeted between 0% and 0.25%) increases, TD Ameritrade will earn much higher interest income, all of it pure profit. Meanwhile, it continues to focus on increasing client assets and launching more investment products.

But about that federal funds rate: In 2007, it was 4.75%, up from 1% in 2003 during the last recession. Today, it's hovering between zero and 0.25%. The first year that it increases by 100 basis points (to 1.1% from today's 0.1%), management estimates TD Ameritrade's earnings per share will rise by an extra 26% compared with the prior year, on top of any other growth. And as history shows, interest rates could rise by much more than 100 basis points over the next three, five, and seven years.

How It's Working

TD Ameritrade has increased client assets by at least 10% annualized for the last six years and counting. Management says this rate of growth has been about double that of its nearest competitor. For context, the S&P 500 (including dividends) has delivered about a 43% total return since 2007, but client assets held at TD Ameritrade are up by 235% over the same period. Operating margins are strong, too, lately in the low-40% range.

Diligent capital management led Standard & Poor's to upgrade the business to an "A" credit rating in 2012 (and reaffirmed that rating in July 2014), which has helped fuel recent dividend increases (the quarterly dividend has grown 44% annualized since Q1 2011). With steady gains in customer accounts, decreasing shares outstanding, and a commitment to paying out roughly two-thirds of earnings to shareholders, the business should continue to reward owners — with the added benefit of much higher profits when interest rates increase. Meanwhile, the stock is trading right around its 10-year average price-to-book value of 4, although the company is more diverse and stronger now than over the past decade.

For More

- *Pro*'s original recommendation (7/11/13)
- Monday Memo on TD Ameritrade's business model (9/15/14)
- Talk about TD Ameritrade

What We Expect

Management will continue to be excellent stewards of capital, returning profits to shareholders and increasing additional investor value. All the while, we know higher interest rates will someday lead to much higher net income. But even as we look forward to that, we can admire the company's current results and should enjoy healthy returns.

The *Pro* Bottom Line

Our current fair-value estimate on TD Ameritrade is $34. The company's earnings are likely at a cyclical low. Believing as we do that TD Ameritrade's profit potential is much greater than recent results suggest, we think the stock is a compelling buy in anticipation of higher interest rates. TD Ameritrade's business model is powerful when rates are headed upward. Most investors have probably forgotten that power since 2007, but will remember it when earnings start to jump.

Buy First: Tupperware (NYSE: TUP)

This is not your mother's Tupperware.

Suggested Allocation: 2.8%

What It Does

Tupperware Brands (NYSE: TUP) earns 70% of its revenue from giant emerging markets including China and India, where its sales reps are still only scratching the surface of the vast potential markets in dense urban population centers. As these countries, Brazil, Malaysia, and others begin to enjoy disposable income, shoppers able to store food for the first time can afford inexpensive kitchen products offered by Tupperware. In addition, Tupperware offers women in these regions steady employment, something that's still tragically hard to find for many women in emerging markets.

Elsewhere in the world, the company's sales through its iconic "Tupperware parties" still thrive in places as erudite as France and as prosperous as Germany, as well as in the good ole U.S.A. Cutting out retailers to focus on direct sales continues to set Tupperware apart from the rest of the pack, and with a sales force of 3 million and new products every year, the company still has plenty of potential ahead.

How It's Working

Tupperware has been increasing sales in key emerging markets by 20%, 30%, even 50% or more year over year, and overall in those regions by 10% or more. Including its legacy businesses in developed markets, the company targets long-term annual sales growth in the mid-single digits and earnings growth higher than that. Today, storage products only account for about 30% of sales, while region-specific kitchen tools have the lead. For example, in China water purification products are top sellers, while Tupperware vegetable steamers do well in France. The company's diverse product line, driven largely by the requests of local sales representatives, gives Tupperware relevance and success across different markets. A significant part of sales come from new products each year, a fact in which management takes pride. Tupperware creates innovative products and then outsources production to keep costs down.

A few quarters of soft sales, partly because of challenges in the Ukraine and South America, have led to a pricing opportunity for new buyers, making the stock a Buy First.

More Resources

- *Pro*'s latest buy recommendation (7/30/14)
- Talk about Tupperware on our discussion board
- Latest earnings coverage coming soon!

What We Expect

The $63.75 stock trades at 14.7 times earnings and yields 4.3% in annual dividends. After a soft year, the company is set up to have much easier year-over-year financial comparisons in 2015, and we expect the stock to handily return more than 11% annualized the next three years as headwinds dissipate. Feisty emerging markets should continue to drive sales, but we expect developed markets to hold steady (and even grow slowly) as well.

The *Pro* Bottom Line

You don't have to attend a party in someone's living room to enjoy the benefits Tupperware can bring to your portfolio (though you can if you want to). The company's innovative approach to products and sales continue to set it apart, and the future looks bright.

Buy First: Wells Fargo (NYSE: WFC)

At heart, banks are simple businesses, and Wells Fargo is one of the best of the breed.

Suggested Allocation: 4.1%

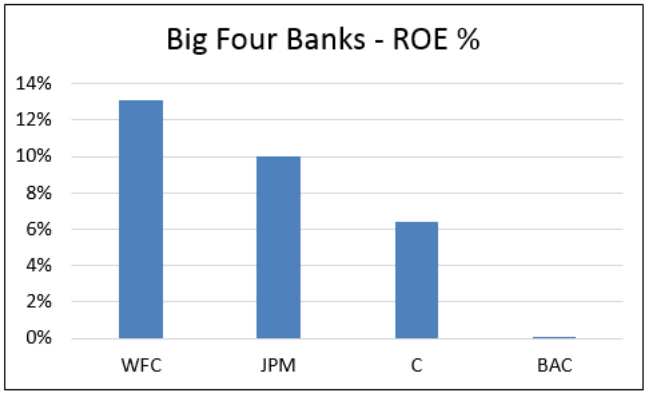
What It Does

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** (NYSE: WFC) is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 8,800 branches and 12,700 ATMs. It's the fourth-largest bank in America, it has a reputation for high customer loyalty and satisfaction, and it's the leader in mortgage and small-business lending.

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During tough lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

How It's Working

CEO John Stumpf and team are truly the best of the breed. Return on assets and equity for the most recent quarter (Q3 2014) were rock-solid, at 1.4% and 13.1% respectively — great results given the low interest-rate environment and new regulations that require higher liquidity levels (i.e., less leverage) than before the financial crisis. A look at ROE figures for the other three big banks shows how Wells Fargo is best in breed:



Source: Q3 2014 company filings (figures represent return on common equity)

Total revenue growth has been elusive, but expense reductions and improvements in credit quality have driven quarter after quarter of earnings growth, leading to higher earnings than before the financial crisis. Deposit growth has been tremendous (coming in at almost 10% in the third quarter of 2014), and as Wells Fargo grabs additional "wallet share," fee income increases as well. The credit quality of the loan portfolio is impressive and continues to improve. All of this has contributed to a very well-capitalized balance sheet, allowing Wells Fargo to comply with the aforementioned capital regulation requirements well ahead of schedule.

What We Expect

For More

- *Pro*'s original recommendation (12/10/10)
- *Pro*'s recent "Buy More" recommendation (7/29/14)
- Talk about Wells Fargo

Wells Fargo's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. In the current low-interest-rate environment, we should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But when the U.S. economy picks up, interest rates rise, and loan demand resumes, Wells Fargo's real earnings power — bolstered by growth in fee-based revenue — will hit its full stride. And many customers who start a deposit account or mortgage with Wells Fargo will explore the company's offerings in other areas, too.

Shares are trading at less than fair value, and they yield a growing 2.6% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. *Pro* has also used options in the past to generate even more income from this position, so try to invest using round, 100-share lots if it keeps you within half a percent (plus or minus) of our 4.1% allocation. If that's not feasible for you, share ownership alone is fine, too; with its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

Better yet, Tom Gardner and his *Motley Fool ONE* team have offered to give loyal *Motley Fool Pro* members like you access to *an entire week's worth* of in-depth coverage on this stock (and two of Tom's other top holdings) — *at absolutely no cost to you*. All they ask in return is that you simply follow this link and answer a few quick questions.

Pro: What We Think Now

Published Jul 29, 2014 at 2:12PM

See all our active trades at a glance, including our strategies and high-level thinking. We've highlighted recent changes with icons, and you can click on any column header to sort the table, which is initially sorted by allocation.

Holding	Ticker	Rating	Summary
SPDR S&P 500 ETF	SPY	Option: Put Ratio Spread	We're using low-cost hedge strategies called put ratio spreads to protect against downside in the S&P 500 while not risking anything if the market goes higher.
Facebook	FB	Buy First	Facebook remains a young story about monetizing the largest, most engaged online audience ever hosted by one company, and Facebook's future is in strong hands because management is showing patience and care as it monetizes more of its properties, putting visitor experience first. The billions of connections maintained on Facebook's properties are making the sites extremely sticky, offering the potential for increased value to advertisers (and thus Facebook owners) for years to come.
Broadridge	BR	Buy First	Increased regulation and a focus on productivity (doing more with fewer employees) will push financial firms and public companies to outsource more obscure but critical back- and middle-office tasks to Broadridge. We expect modest but reliable recurring revenue growth to translate to stout earnings and cash flow generation as Broadridge converts the investor communications industry to a more engaged and increasingly digital standard.
O'Reilly Automotive	ORLY	Buy	With exceptional management in the driver's seat, O'Reilly Automotive will grow impressively by adding new auto parts stores, acquiring others, and growing same-store sales.
AmTrust	AFSI	Buy	Under the radar, AmTrust is a disciplined underwriter of workers' comp and warranty insurance policies that is expanding opportunistically into other low-hazard areas and new geographies. Book value should continue to grow.
MasterCard	MA	Buy First	MasterCard's global network is a financial toll road that takes a small slice of each transaction. Though there are many established and upstart competitors, the leader is cash with 85% market share, representing plenty of room for MasterCard to grow.
Wells Fargo	WFC	Hold Option: Write Partial Covered Calls	Given recent scandal being uncovered at Wells Fargo, the position is on hold while we assess whether we want to go on owning call options on Wells or not. We have to believe there is upside in a few years or we'll sell our calls to get back time value.
American Tower	AMT	1Buy	A U.S.-based global tower operator, this business with excellent returns on incremental capital benefits from exponential growth in worldwide demand for mobile bandwidth. We expect strong growth as international markets continue to invest in wireless technology. We are invested in some LEAPS call options to leverage upside.
Apple	AAPL	Buy	Apple is the leader in mobile computing products, and the number of people buying into its ecosystem continues to grow. Apple capitalizes on this by making its operating system work seamlessly across devices, increasing stickiness. The mobile computing revolution is still in early stages, and Apple still has no equal.
Oracle	ORCL	1Buy	Oracle is an "old guard" tech giant that continues to grow strongly thanks to its expanding database software and hardware sales. It also has room for more margin expansion.
Papa John's	PZZA	Buy	Franchising is a good, capital-light business and we think the Papa John's brand will translate well internationally. We expect technology, improved advertising, and menu innovation to propel domestic sales and fund the company's vast international expansion opportunities. Near-term headwinds (commodity prices and technology investments) have proved temporary and Papa John's should deliver improved financial performance.
OpenText	OTEX	Buy	Selling software that lets companies and governments manage growing reams of digital information, OpenText should grow steadily for years. Plus, we plan to write options on it for income along the way, as long as the options pay well.
Starbucks	SBUX	Buy	The world's specialty coffee leader will continue its global retail expansion and will leverage its brand to offer consumers more choices — including tea, carbonated beverages, and juice — at more times in more convenient locations. The company has dynamic growth opportunities, operational discipline, and deft management. Starbucks stores and its trusted brand are a powerful platform off of which to introduce locally relevant new products, build relationships with customers, and compound intrinsic value.

Holding	Ticker	Rating	Summary
Parexel International	PRXL	Buy	Helping pharmaceutical companies get drug candidates to market, Parexel is poised to benefit as those companies gradually outsource more of this process to select CRO partners who can perform the work better, faster, and cheaper. We also expect margin expansion as recent investments and restructuring costs pay off as well as continued growth of the Parexel Informatics technology segment.
Medtronic	MDT	Buy	Medtronic has a sound strategy to deal with the more regulated and costlier health-care environment. We're confident the business remains competitively advantaged, operates in an attractive industry, and is well-positioned to grow, especially in emerging markets. With reasonably-priced shares, we target North Star-type returns.
Skyworks Solutions	SWKS	Buy Option: Write Covered Calls	Skyworks Solutions is positioned to keep increasing profits at a healthy clip as more smartphones are sold and connected devices (the Internet of Things) proliferate. Long-term growth rates overall could remain above 10% for many years.
Expeditors International	EXPD	Option: Synthetic Covered Strangle	The shipping logistics leader offers a stable business on which to set up an income position. The *Pro* team is targeting leveraged income with upside.
Gentex	GNTX	Buy First Option: Write Puts	Gentex's safety-enhancing mirrors continue to earn their way into new cars across the globe, resulting in historically high (but we believe sustainable) margins and significant cash flow generation. Technology from acquisitions and in-house R&D should fuel new product development and continue to drive adoption of its feature- and technology-rich auto-dimming mirrors worldwide. The company's strong engineering culture and manufacturing advantages provide competitive advantages that should strengthen over time. We're also writing puts for income or to potentially buy more shares lower.
Gilead Sciences	GILD	Buy Option: Write Covered Calls	Gilead Sciences has seen surging free cash flow thanks to its market-leading Hepatitis C treatments, which accounted for nearly 60% of 2015 revenue. As sales growth tapers, the stock is cheap, and we believe management can find future growth opportunities through acquisitions. Meanwhile, Gilead has a large pipeline of drug candidates targeting deadly diseases including cancer, but for the coming few years, it's our belief in a stable Hepatitis C market and good use of its growing capital that makes the stock worth owning in *Pro*.
Visa	V	Buy	Expected to grow earnings per share by at least 14% to 18% annualized for several years, Visa's giant payment network should keep driving results as electronic money replaces cash, affluence increases, and new markets are added.
TD Ameritrade	AMTD	Buy	TD Ameritrade is bringing in more client assets every year, leading to higher revenue, and when interest rates increase, the company is positioned to grow earnings sharply.
FactSet Research Systems	FDS	Buy First	Selling subscription data and analysis tools to investment professionals, FactSet enjoys a 95% contract renewal rate and has 35 consecutive years of sales growth. With high returns on capital, it meets *Pro*'s criteria for a compounder.
Verisk Analytics	VRSK	Buy	Also owned by Buffett but still under the main Wall Street radar, this leading provider of rich data to insurers and other industries has a strong competitive position, recurring revenue, and pricing power. It's a long-term buy we want to own and add to over time.
Domino's Pizza	DPZ	Short	As a paired trade, we are shorting the leading pizza chain only as a way to hedge 2% of our long exposure in Papa John's, since the two stocks have historically moved together. These two positions should be taken together.
Valmont Industries	VMI	Buy Option: Write Covered Calls	Valmont's end markets remain weak and we considered selling to harvest the tax losses, but recent news that Congress is making progress on a new highway funding bill leads us to believe it's worth holding on to this solid business for a bit longer.
WisdomTree Emerging Markets SmallCap Dividend Fund	DGS	Buy	This emerging-markets ETF is a large fund of nearly 500 stocks; its fate is tied to emerging economies (mainly Taiwan, South Korea, Thailand, Malaysia, Brazil, China). The ETF is well-managed and yields more than 3% while owning small, consumer-centric companies. Moved back to Buy 3/28/16 after review.
CurrencyShares Euro Trust	FXE	Short: Hold	The euro is held together by rubber bands and scotch tape (and financial threats). We believe the currency should be worth much less to the dollar. We may manage this short by adding to it when it spikes.
Deere & Company	DE	Short	John Deere should serve *Pro* both as a short with favorable odds of generating a North Star-like return and as a macro hedge to reduce our portfolio's sensitivity to the strength of the global economy.
ProShares Short VIX Short-Term Futures	SVXY	Buy	Over the long term, the futures on the CBOE VIX index should persistently trade at a higher level than the spot VIX level, until they dissipate into expiration. This situation — known as contango — will ultimately make this ETF go up in price, because it sells short the futures, which are a wasting asset. We expect price volatility, though, and we will look to add to the position on large drops. So, keep your allocation small.
Pier 1	PIR	Short: Hold	Coming soon!
Caesars Entertainment	CZR	Short: Hold	With interest on debt consuming all operating profits and then some, Caesars' back is against the wall as competition increases and traffic slows. We believe a restructuring is fairly likely, and equity holders may not end up with snake eyes, but something close to it. So, we're short.
Direxion Daily Financial Bear 3X Shares ETF	FAZ	Short	We believe financial stocks are inexpensive, so we're shorting the bearish financial ETF, which also suffers from compounding flaws that work in the favor of shorts like us.
SRS	SRS	Short: Hold	We're bullish on a real estate recovery, so we're shorting this flawed, leveraged, bearish real estate ETF -- but it has become too small for new investors to short.

See the team's and David and Tom Gardner's holdings here.

Your Slow-Mover Advantage Over Wall Street

Published Mar 17, 2014 at 12:42PM

Wall Street's short attention span makes it seem like the odds are stacked against snail-paced Fools like us. But in reality, high-frequency traders, big-pressure hedge fund managers, and supercomputers that calculate moves by the millisecond make our investing strategy even more successful.

In this exclusive glimpse at *Motley Fool One*, Morgan Housel reveals evidence for your single greatest — possibly even your only — advantage over Wall Street, along with three easy steps for maximizing your edge. Plus, listen to the *Fool One* podcast to hear Morgan and analyst Bryan White talk about how you can invest against the market's shortsightedness.

Get the PDF of Morgan Housel's report

Listen to the Podcast

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Run time: 10 minutes; originally aired January 2014

We hope you enjoyed this free bonus content brought to you by *Motley Fool One*. If you'd like a further behind-the-scenes look at this premier, all-access service — as well as the opportunity to take advantage of a wide range of free special gifts and exciting content from Motley Fool co-founder and CEO Tom Gardner and his entire *Motley Fool One* squad — simply click here.

Podcast Transcript

BRYAN WHITE:

Welcome to EP Weekly. I'm Bryan White joined in the studio today by Morgan Housel. Thanks for joining us today, Morgan.

MORGAN HOUSEL:

Thanks for having me.

BRYAN WHITE:

And today, folks, it's just me and Morgan. Jason and Robert Brokamp and Chris Hill couldn't make it today, so you're stuck with just both of us, but we should have a great discussion today as Morgan has put out another special free report. It's called "Your Slow-Mover Advantage over Wall Street." We'll dig into that and also earnings season is just beginning for our EP companies. Coach reported yesterday and Starbucks reports today after hours.

First let's dig into this report, Morgan. A very interesting report -- another one from you. What gave you the motivation? Why did you pick this topic?

MORGAN HOUSEL:

I think there have been a lot of investors over the past couple of years -- maybe not necessarily all of our members from *Motley Fool One* -- but I've seen a lot of investors really start to question why is it worth being an individual investor when the evidence seems overwhelming that Wall Street has an edge over you. That the game is rigged in their favor against the individual investor. Things like high-speed trading, insider trading. We hear all these stories about how Wall Street can succeed over you.

But I think there's one huge advantage that individual investors have over Wall Street and it's this concept of *time arbitrage* -- which very simply put is if Wall Street is focusing on the next five months and you, the individual investor, are focusing on the next five years, that is a tremendous advantage that you have over them.

And you have that advantage over them because the way that Wall Street is set up ... And when I say Wall Street, I'm really talking about hedge funds -- big institutional, professional investors. They're by and large graded on the short term. They have to focus on the next quarter or else their clients start firing them. It's really a very short-term focus game. So, they're kind of stuck in that short-term bubble. If individual investors can get away from that and focus on years, it's a huge advantage.

So, I had some statistics in the chart about if you go and look back the past 150 years of the S&P 500 ... If you're looking at the market based on a one-day basis or a one-month or three-month basis, the odds of you making money is pretty close to a coin toss. The market goes up, goes down. That's what it is. If you can invest for five or ten years, your odds of making money are very good. And that flows down to individual companies, as well. If you're talking about stocks that miss earnings by a penny per share and then fall 20% after hours ...

BRYAN WHITE:

Yes ...

MORGAN HOUSEL:

... well that's Wall Street's game. But if you're in this for the next five years -- not only does that not affect you, but that becomes your opportunity at that point. So, really I think when investors focus on this, it becomes that this is the advantage that you hold over Wall Street and this is why individual investors can, indeed, outperform the market over the long run.

BRYAN WHITE:

Well, I think as One members, you do have an advantage. I think as members of One, you have a huge collection of great companies to choose from ... from all of the different services here at the Fool. And then, taking some cues from this report, we're likely to continue to see dramatic moves based on headlines, based on earnings reports, and especially with the more-and-more high-frequency trading that's going on in the market.

So, there's two different perspectives. One, the game's rigged against me or the perspective that hey, prices are going to jump quite a bit, and if I can only get my hands on a nice list of great companies for the future, I can be patient and wait for the most part. Or at least set my portfolio and then my incremental investments going forward -- part of them can be some of these things that move huge based on headlines and the news.

Obviously, you want to look at the fundamentals because sometimes a stock deserves to get hit, but a lot of times we're seeing an earnings season that stocks are just getting crushed just based off the headlines. The headline barely comes out and the stock's moved double digits.

MORGAN HOUSEL:

And I think it's really tempting for some investors to look at those moves and think, "What does Wall Street know that I don't?"

BRYAN WHITE:

Yes.

MORGAN HOUSEL:

My stock is down 20% after hours. Do they know something that I don't and should I be worried about that? And maybe sometimes that is the case, but I think most of the time the answer is no. It's just that they're just focused on the next 90 days. So, this move after hours or in the short run really doesn't apply to your goals as a long-term investor.

BRYAN WHITE:

Let's flip the coin on the other side. The short-termism, let's say, and let's say the advantage of high-frequency trades. What would be one negative that you would point out for individual investors like us that take the long-term approach -- but one negative that we should be mindful of because it's a true negative. Not everything is a positive story. What is one thing that we should watch out for?

MORGAN HOUSEL:

Well, I think it's really interesting. About two years ago at Fool.com, there was a group of writers that did this long, in-depth report on the flash crash which happened in May, 2010. The Dow fell a thousand points in a matter of minutes. So, they did this report and they set out to do this big investigation. They wanted to find an individual investor who had been harmed by the flash crash ...

BRYAN WHITE:

Okay ...

MORGAN HOUSEL:

... and they looked for weeks and weeks and they could not find one.

BRYAN WHITE:

Yes ...

MORGAN HOUSEL:

The flash crash -- the Dow fell a thousand points and then about five minutes later, it regained most of that. It's called a flash crash because it was over before most people knew it ...

BRYAN WHITE:

Yes.

MORGAN HOUSEL:

So really, I think when we're talking about high-frequency trading, it might harm individual investors if for whatever reason you need to sell stocks right this minute. I don't know why you would need to do that -- because you've got to raise money to pay a bill or whatever. Then, you know, it makes the day-to-day action more volatile.

But in terms of the value as an investor, and that we look at it, is owning real businesses for the long term, just like you would as a private investor. You own a McDonald's franchise and that's your business. If you think of investing that way, I really, firmly believe that high-frequency trading does not pose any risk to you whatsoever.

BRYAN WHITE:

I think you bring up a good point in your perspective. For investors [00:05:59] your portfolio is one of your small businesses. You may own another small business, but one of your small businesses ... it's your portfolio.

MORGAN HOUSEL:

Right.

BRYAN WHITE:

And to make snap decisions ... I mean, why not view it as if it was a small business? Would you run around and make snap decisions every day?

MORGAN HOUSEL:

Right.

BRYAN WHITE:

Every week? Acquire a company. Sell it off. Hire someone. Fire them the next day.

MORGAN HOUSEL:

You know, I've made the analogy before. If you own your home, let's say, and you go to Zillow.com one morning and you look up the value of your home and Zillow's having problems with its servers and it says your home is worth zero dollars ... Your home isn't actually ... Like, nothing happened to your house. Like, it's still warm. You've still got a roof over your head. Just because you get a bad quote or you get a problem in your servers -- nothing happened to the value of that house. And it's really the same thing when we're looking at stocks and talking about volatility and high-frequency trading.

BRYAN WHITE:

Well, it's a great report, Morgan. I hope everyone reads it. It's out there on the One home page if you haven't seen it yet, and we'll be looking forward to the next report, Morgan.

MORGAN HOUSEL:

Thanks.

BRYAN WHITE:

Now moving onto Coach. Coach reported yesterday. Basically the quick summary for Coach is the same struggles are still there. Comparable store sales, comps, in the United States or in North America fell 13.5%, which is a pretty disappointing result. They're still in the middle of a turnaround. The financials are not looking great right now. There's sort of a debate internally and within the market that Coach is a great value right now, great buy ... and then there's also the argument from the bears that Coach is in some big trouble. There's legitimate arguments on both sides.

We're obviously going to hold pat. We bought it for at least the next five years when we did buy it, so we've got about four years to go with Coach. Where I stand ... See, we all think differently. Between Tom, Jason and myself ... Jason tends to be more bullish on the name. I came into Coach incredibly bullish, but there are some warning signs out there. Number one -- fashion. Fashion is fickle. You can invest in a genius, but when it comes to fashion, if it turns on you, it turns on you. Not one person can really turn that around.

MORGAN HOUSEL:

Do you remember B.U.M. Equipment from the 1990s?

BRYAN WHITE:

Yes. Yes, I do. Wow!

MORGAN HOUSEL:

Things go from huge to laughable really quickly.

BRYAN WHITE:

Well, yes, and I wouldn't compare that ...

MORGAN HOUSEL:

No, I'm not making that equation, but when you said fashion is fickle ...

BRYAN WHITE:

Well, I think Coach is a great example, because Coach is one of those iconic brands ... and if it can happen to Coach, it can definitely happen to anybody out there. And then at the same time, it's almost a perfect storm for Coach. Huge management turnover. Both their lead designer and their leader and CEO, Lew Frankfort, stepping down. A lot of turmoil.

And at the same time, you have a category that Coach dominated, which was the affordable luxury category. The price point for handbags -- they dominated it for years. And now, all of a sudden, out of the woodwork, while you have management turnover, you have companies like Michael Kors and others that come into your territory and start taking share and they're very successful ...so far taking shares. So, Coach is under some pressure. Come to the boards. Jason's going to have a recap of the quarter after going through the conference call. We'll have further discussion on Coach. Tom's been out on the boards talking about Coach in the past, so you'll find his board posts out there. And then after hours today, Starbucks reports, so that'll be a big report. We'll be covering that today after the market.

All right, folks. That's all we have today. We will see you next week.

Live Advisor Roundtable With Tom Gardner and Jeff Fischer

Published Mar 10, 2014 at 1:29PM

In preparation for the reopening of *Motley Fool One*, the Fool hosted a roundtable discussion with Fool co-founder Tom Gardner, *MDP* and *Deep Value* advisor Ron Gross, *Pro* and *Options* advisor Jeff Fischer, and *Supernova* Odyssey 1 mission lead Matthew Argersinger.

Miss the action? Click the player below or read the transcript to see what they said.

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Transcript

TOM GARDNER:

Welcome to the *Motley Fool One* Live Chat. We're going to get right into it. We've got an hour together. I have the promise of my panelists that this will be the most interesting and entertaining one hour of investment programming …

RON GROSS:

We made no such promise.

TOM GARDNER:

And the reason we make the promise is because we've heard that Ron Gross, our advisor in *Million Dollar Portfolio* and *MDP Deep Value* … his parents are watching today, so …

RON GROSS:

Hi mom and dad. Thanks for joining us.

TOM GARDNER:

So, we've got Ron. We've got Jeff Fischer — *Motley Fool Options*, *Motley Fool Pro*. The original Fool portfolio, as well. And we've got Matt Argersinger — *Supernova*, *Rule Breakers*, in *Stock Advisor* probably pitching in some ideas there …

MATT ARGERSINGER:

I'm on there — sure …

TOM GARDNER:

They're all over the place. Someday — perhaps not that far away — Motley Fool Germany, as well.

MATT ARGERSINGER:

That's right.

TOM GARDNER:

Pre-announcement there. So, we're going to get right into it. We have a couple of conversations that we're going to start with. Then we're going to talk to a member of *Motley Fool One*, Mark Timmerman. Very excited about that. And then we're going to be taking your questions throughout, so please know that you can submit questions about our conversations or any questions you have about *Motley Fool One*. We have a number of analysts out in the chat ready to answer your questions directly there. And, of course, we'll take some of your questions and answer them here as a panel.

I just want to start, team, with a conversation about where the market is today and what it makes you think about investing. Are you thinking the same way about investing in stocks that you did three years ago, or has there been a change because of the remarkable performance? Or even one year ago, before the market had risen 30%-plus? So, where are you now …

RON GROSS:

Hm. Can I jump in?

TOM GARDNER:

Yes …

RON GROSS:

My preferred answer, when anyone ever says to me, "What do you think of the market," is to say, "I don't know. I honestly don't know." If you had asked me on January 1 of 2013 when unemployment was high and GDP was low … interest rates were also very low …would the market have been up 32%, the S&P 500 … I would have never guessed. I think it's very difficult to opine where the market, as a whole, is. What I prefer to do is each day, every day, look at stocks, look at stocks, look at stocks …

TOM GARDNER:

Blind to what's happening with the macro issue.

RON GROSS:

It's there. I'm educated on it, but I don't make predictions and I don't make investment decisions by it. But what I can see as I analyze stocks every day, all day, is some patterns that are emerging …

TOM GARDNER:

It's getting harder.

RON GROSS:

… is it's harder to find good stocks.

TOM GARDNER:

Is it harder to find good stocks?

RON GROSS:

I am definitely finding it harder to buy stocks, especially if you're looking at stocks in the *Deep Value* service. We're almost 50% cash in that service. Very hard to find deep value stocks. In *Million Dollar Portfolio*, a little bit easier because we can look at growth stocks, high-growth stocks, innovative rule breakers …

TOM GARDNER:

Which is more important to you, Ron, when you're looking for these stocks? Are you looking for stocks that are going to make you money over the next five years, or stocks that are going to beat the market over the next five years or the next three years? If you knew that you were going to buy a stock and the market would be down 8% and you'd be down 2%, is that satisfying to you, or is the baseline that it's profitable?

RON GROSS:

It's a really difficult question to answer — but my standard answer to that is that I'm looking to beat the market under the assumption that over periods of time, the market does very well. Let's call it 9 or 10%. And if I can consistently beat it, even in bad years, then not only will I outperform the market, but I will also make investors money.

TOM GARDNER:

Now just before we came on air, you were calling the person to your left and to the audience's right fanboy Jeff Fischer. There are so many fanboys for Jeff Fischer. So, great answers, but I guess the world wants to know what Jeff thinks.

JEFF FISCHER:

That must be true. It must be true. And I'll start by saying to Ron's parents that Ron is really a nice guy.

RON GROSS:

Thank you, Jeff.

JEFF FISCHER:

He's nice to work with and he's genuine.

RON GROSS:

I appreciate that.

JEFF FISCHER:

He's the real deal.

RON GROSS:

Very thoughtful.

JEFF FISCHER:

Well, it's true. Speaking the truth. On the market. When I look ahead, the next three to five years, I'm excited. I'm excited about what good companies, what good stocks could do over the next three to five years. When I think in the next one to two years, it's more of a random guess. I don't know.

TOM GARDNER:

Is that always true for you, or do you have a particular feeling that the market, having gone up quite a bit over the last couple of years, it's cloudier …

JEFF FISCHER:

Yes. I think it's cloudier. The higher the valuations go in general, the more uncertainty there is in the next couple of years. Because you could say a stock needs some time to catch up to the valuation as much as we may dislike that phrase. So, yes. When the market, as a whole, was 20% or 30% cheaper a year ago, it was much more easy to be excited about the next year or two. But now, where they're at …

TOM GARDNER:

Getting a little harder. But your view of three to five years forward not seriously impacted by valuations today.

JEFF FISCHER:

I agree with Ron. It's harder to find things you're clamoring to buy, but there are still good companies that we're very happy to own and to recommend today, especially given our rolling three-year outlook.

TOM GARDNER:

Matthew?

MATT ARGERSINGER:

I tend to pay attention to the headlines.

RON GROSS:

What about my parents?

MATT ARGERSINGER:

When I'm not paying attention to Ron's parents, I tend to pay attention to the headlines because I think understanding market sentiment is kind of important. And what I see is there is a lot more enthusiasm about the market today. At the same time, there's still definitely a genuine level of skepticism. And I think as long as that's out there, I feel pretty good about investing and like Jeff, I feel very good about the next three to five years. But there are pockets, I would say, of the market that I would say are probably a little beyond their expectations …

TOM GARDNER:

What's a pocket for a company?

MATT ARGERSINGER:

As much as I love the social media companies, I think they're pricing in a lot of future growth today. They might very well be worth what you're paying for them today several years from now. I just don't know if they've earned that yet. We all know Seth Klarman. I don't know if he's been mentioned in previous …

TOM GARDNER:

Baupost Capital …

MATT ARGERSINGER:

Sure. Tremendous track record. He was out the other day saying, "Listen. The market's pretty high in certain places." And I look at that as a little bit of a shot across the bow. I think he's early and I think there's still a lot of skepticism.

RON GROSS:

Value investors are typically …

TOM GARDNER:

He's closer in the deep value camp, so he's going to come out with those shots earlier, but there's an analogy that I can't come up with here, but it's basically … Well, you can say *canary in the coal mine* … But it's basically an early indicator that you should consider thinking a little bit differently about what's happening than what's been the environment that we've been in over the last couple of years …

JEFF FISCHER:

I agree with that Tom, and I think you could easily look at this video a year from now and talk about, "Oh my gosh, so many stocks were overpriced or declined quite a bit in the year since," but then look at the video two or three years from now and most good businesses will be worth more.

TOM GARDNER:

Absolutely.

MATT ARGERSINGER:

Absolutely.

RON GROSS:

One thing I love about Foolish investing is you'll rarely hear someone in the building say, "The S&P 500 is 16x forward earnings — therefore we're moving to cash." You're more likely to hear that on CNBC. We're more company-centric. One company at a time. Is Tesla overvalued? Has it run its course? Is Netflix overvalued? Does Intel represent a good value? Do I want to own that? Rather than making these big, big macro stock market calls.

TOM GARDNER:

Quick question from each of you about your personal portfolio and then we're going to go to Mark Timmerman. We're going to start with MattyA this time and go from the audience's right to left. What percentage of your personal portfolio is in cash? Or you don't have to share your personal details. You could say what percentage of a portfolio that you would buy someone to manage right now would be in cash?

MATT ARGERSINGER:

I'd say less than 10%.

TOM GARDNER:

Less than 10%. But more than 1%?

MATT ARGERSINGER:

More than 1%.

TOM GARDNER:

But some cash on the sidelines.

MATT ARGERSINGER:

There's something on the sidelines for sure.

JEFF FISCHER:

Mine is around 25-30%.

TOM GARDNER:

Twenty-five to thirty percent in cash.

RON GROSS:

Woo!

TOM GARDNER:

Okay.

JEFF FISCHER:

That's pretty standard.

TOM GARDNER:

That's standard.

JEFF FISCHER:

It's close to standard. It fluctuates. But when you're chugging along …

TOM GARDNER:

Why is that happening?

JEFF FISCHER:

I use options, so the cash secures a lot of those options. Pro members see this in Pro where we have about 20% cash and that's partly defensive given Pro has absolutely …

TOM GARDNER:

If you were not using options at all — you had an all-equities portfolio and it was all long — what percentage in cash would you feel comfortable having? Or what would your standard …

JEFF FISCHER:

Well, then at my age, I would think I'd be more 90% invested maybe …

TOM GARDNER:

Because you're what? You're 26?

JEFF FISCHER:

I'm 44.

TOM GARDNER:

You're 44. Very healthy.

JEFF FISCHER:

So, I think I'd have less cash.

TOM GARDNER:

You'd have less cash.

JEFF FISCHER:

I'd have less than 30%.

TOM GARDNER:

But let's modify the question. I apologize. You're a 58 to 64-year-old right now. How much would you have in cash?

JEFF FISCHER:

Whatever money you need in three years should be in cash.

TOM GARDNER:

Got it. Ron?

RON GROSS:

Personally, about 10-11% in cash, *Million Dollar Portfolio* is 5% in cash. I don't see a huge difference between that. There's a 5% swing.

TOM GARDNER:

And is 5% a statement that it's difficult to find stocks or 5% …

RON GROSS:

No, I think having 95% of your capital at work means you can still find stocks to purchase. At any given time, we may have sold something and not put the cash back to work yet because we are managing a finite amount of money. So, portfolio management is all about sometimes selling a good stock to buy a great stock. So, sometimes we'll have some cash on the sidelines as that's taking place.

But as I mentioned earlier, *Deep Value* is almost 50% in cash because it's very difficult to find deep value stocks right now, and that's exactly how that philosophy is supposed to work.

TOM GARDNER:

I mean, Seth Klarman … It will not be unusual for Seth Klarman to be 40%-plus in cash and yet he's delivered something like 18% per year results going back 20-plus years. He's obviously a brilliant investor. One of the things I love about investing …

Obviously some investors or some members of The Motley Fool are trying to have it done for them as much as possible and trying to minimize the amount of time you're spending on investing. Others want to dive deep and learn more about business, about your portfolio, about portfolio strategies.

As somebody in the latter group for all four of us — it's really fascinating and has been for 21 years to study how other people are investing. Because Seth Klarman could sit down with growth investors at our company that are in that camp and I think they would find, actually, a fair amount of common ground, but they've taken a different path to getting extraordinary long-term results.

JEFF FISCHER:

Well, Tom, Warren Buffett, too, has quite a bit of cash. I don't know, offhand, how much right now, but he almost always carries cash for opportunities.

TOM GARDNER:

And Wally Weitz, I know, who's in Buffett's circle of great investors … He's often 30-40% in cash, even though he's all equity, all long. Okay. We're going to put our headphones on and we're going to tune in with Mark Timmerman from Des Moines, Iowa. First of all, Mark. Is it Des Moines or Des Moynes?

MARK TIMMERMAN:

It's Des Moines. Des Moines, Iowa. Thanks for having me here.

TOM GARDNER:

I'm sure you're passionate about making sure that people know how to pronounce your hometown.

MARK TIMMERMAN:

Oh, absolutely. We get really touchy about it, especially after the kind of winter we've had.

TOM GARDNER:

Actually, yes. Before we talk investing with you, just give us a quick snapshot of the winter in Des Moines — this winter.

MARK TIMMERMAN:

Did anyone see the movie *Frozen?*

RON GROSS:

Yes.

MARK TIMMERMAN:

That's pretty much it. We had more school snow dates because of temps below 10, 15 below and wind chills up around 35 to 40 below. But that's the Midwest. Anyone can live in Florida, can't they?

TOM GARDNER:

I love that. Trash talking. So, Mark, before we talk a little bit about your experience as a Motley Fool member and a *Motley Fool One*, I just want to hear a little bit about your investment philosophy. How do you think about investing and how's your portfolio been doing the last couple of years?

MARK TIMMERMAN:

The investing philosophy has evolved a lot. One of the things … I was just getting ready to talk to you folks. It's just amazing to look back — since I joined the Fool back in 1997 — and really not knowing much about how to do any of this. I knew I needed to save. I knew I needed emergency reserves.

It's evolved so much over the years, but I do understand and have refined so much more of the long-term focus on owning not stocks, but great businesses and sticking with them through the long term. That's grown a lot, but I always had that seed and that's grown so much with all my learning that's taken place over the last 17 years or so.

TOM GARDNER:

What is an example of a great business that you have held and enjoyed the fruits of their success? And what is an example of a great business that you sold too soon?

MARK TIMMERMAN:

Whoa!

TOM GARDNER:

Sorry.

JEFF FISCHER:

Shudder …

MARK TIMMERMAN:

My largest position, actually, is one of my smallest investments … Netflix. I've talked a lot about it on the boards. That was something I invested in, in 2004. My cost basis in Netflix was between $10-12 a share …

TOM GARDNER:

They're $440 now …

MATT ARGERSINGER:

Bravo …

MARK TIMMERMAN:

Yes. That's the fun part. But to me, the much more important part of that story is that I rode it down 85% in what was it? 2011? 2012? I've tried to block it from my memory completely. But I rode it down maybe 5%. Didn't sell a single share and continued to believe in what the company was doing. They hit some road bumps, but that taught me so much about sticking with a company that I felt like I truly understood.

Some of the other ones — I've owned Starbucks since 1998. Obviously, that's been very rewarding. Buffalo Wild Wings I've owned since 2004. That's been rewarding. One of the things I wanted to mention is it's really rewarding when you, Tom, select companies like that for another five-year holding period in the Everlasting Portfolio and the conviction is there to add your own money to those positions after all that growth. So, I'm really excited about just holding onto companies for the long term and really watching them blossom.

TOM GARDNER:

I notice that you've avoided the second question.

MARK TIMMERMAN:

I picked up — I invested — my first position in Tesla. My cost basis was around $30 a share. It must have been probably two, two and a half years ago — whenever it was $30 a share. I held it for about a year and just before earnings were coming out at that particular time, the price was hovering around $63 a share.

I just didn't have the conviction of understanding that company. I completely am amazed by Elon Musk — I admire him greatly — but I just didn't understand the size of the market with electric cars and what he was trying to do. One of my faults is that I sold it at $63 just before earnings. Obviously they blew out earnings and it's been on a rocket ride since.

TOM GARDNER:

Out of curiosity Mark, do you view that as a mistake, or do you view that as just the natural course of having conviction and you're thankful that, that conviction caused you to hold Netflix and certain times that conviction will steer you wrong, but it's important to follow through your belief and thesis and then try and learn from it after.

MARK TIMMERMAN:

That's a really good point, and I firmly believe that the discipline of following a process where I feel like I understand what I'm doing, I know why I'm doing it and I can stand by it — I've built into the assumption that I'm going to make some mistakes like that. I certainly can't own all the stocks that are going to do wonderfully out there. I'm certainly not going to sell all the stocks that should have been sold — but I'm going to be right more than I'm wrong and the winners have more than made up for my mistakes. So, on balance, I'm very happy about it. Still, when you put a microscope on it, it's a little tough to look at, but that's just part of how this works.

TOM GARDNER:

Sorry to pull the microscope out. So, we have Ron Gross, Jeff Fischer and Matthew Argersinger here with us from *Million Dollar Portfolio*, Options Pro, *Supernova*, *Rule Breakers*. I just wanted to talk a little bit, Mark, about your experience in Pro and Options and how that has impacted your investment approach. I'm presuming that in 1997, you were not using options when you joined The Motley Fool.

MARK TIMMERMAN:

No. Back then, remember, options were evil back then.

TOM GARDNER:

Absolutely.

MARK TIMMERMAN:

We didn't talk about options then. I was listening in on your conversation as I was waiting to join and I heard you talking about cash. My personal position on cash or percentage is hovering around 22-23%. By contrast, in 2001 when we had the big recession and 2007 and 2008, I was fully invested both times. That stuck with me, because I was stuck in not being able to act or have any opportunity to take advantage of the situation. And that, to me, was really painful.

As far as having cash now, the ability to use options — to productively use that money — while I'm waiting for opportunities and the ability, now that my portfolio has grown to the extent it has … I have the ability to hedge in a way that I never had before. So, the tools I've learned through Pro and Options have been priceless. Jeff's guided a real neophyte through this process. I was very apprehensive and had a lot of anxiety about making a mistake or doing something that was really going to cost me a lot of money by doing something stupid.

TOM GARDNER:

Out of curiosity, because of the deployment of options in your portfolio, does that cause you to feel less anxious about where the market is or what's happening in the macro environment because you have some built-in protections and hedges with options?

MARK TIMMERMAN:

It really does. I have an even more holistic view of how things are playing out. I just have more tools in the toolbox to use. Obviously the meat and potatoes of my portfolio is long-term positions that I anticipate growing nicely over the years, but while I wait for that, while there is volatility in the market, there's a nice opportunity for part of your portfolio to generate returns that not only add to your returns, but also stabilize your portfolio a little bit more.

In 1997, I was starting a family. Now I have kids that are going into college and I'm within 10 years of retirement. My objectives have evolved over time, and now I'm thinking about how can I generate income at sufficient levels? How can I take advantage of a special opportunity? That's allowed me to do it.

JEFF FISCHER:

That's a great point, Mark. So many people nearing retirement or in retirement use these really conservative options strategies, as you know now, to generate income month after month … and meanwhile you can let your stocks be for the long term to appreciate. So, I love how you put that … that the meat and potatoes of your portfolio remains great businesses …

TOM GARDNER:

Are meat and potatoes really recommended, though, at this point?

RON GROSS:

In Iowa, I think.

TOM GARDNER:

In Iowa.

MARK TIMMERMAN:

If you come to Iowa, that's all we have.

TOM GARDNER:

Okay, got it.

RON GROSS:

Mark, it's Ron Gross. Thank you so much for joining us. I really appreciate it.

MARK TIMMERMAN:

Hi, Ron.

RON GROSS:

I was curious. Obviously, you really like your experience with Jeff at Pro and Options. So what made you join One and how do you use the service?

MARK TIMMERMAN:

One of the things that drew me to One is that with things changing in our family's life where my wife is almost six years younger than I am, so my objectives for some of the IRA portfolios I've been managing were starting … I could see retirement or at least I was going to start working for fun and stop having to work at a certain time within 10 years. Pro became a really big lever for that.

But my wife — I've moved more of the new money and she's adding more money on a regular basis, too. So, *Supernova*, Odyssey 1 …

MATT ARGERSINGER:

Right on …

MARK TIMMERMAN:

… and the Everlasting Portfolio have been home for that new money.

TOM GARDNER:

How is your wife connected into the investment decisions and what success have you had in getting your children investing? But really looking at the entire family and trying to get every family member of a *Motley Fool One* member investing has been an aim of ours, but it's going to become a much more intentional aim in the year and years to come. So, how's that going in the Timmerman household?

MARK TIMMERMAN:

I'm really excited about the future, but I can tell you right now. I have a 17-year-old that's getting ready to go into a pre-law program, and I've not been as successful at luring him in or interesting him in the way I want, but I'm giving that time. I'm also trying to make sure that I do the right things to meet him where he's at rather than try to bring him along where I'm at. My daughter is more focused on probably being a teacher some day and has not shown any interest at this point. That's a development area for me.

But my wife is an actuary by profession. She's hardwired for number crunching. She leaves the more organic side to investing to me, but we talk about it constantly and she's very interested and has a tremendous amount of confidence in watching my experience over the last 17 years with the Fool. So, very supportive. She's hands-off, but very interested in hearing about how things are working.

MATT ARGERSINGER:

Mark, Matt here from *Supernova*. Thanks for joining us. How are you doing?

MARK TIMMERMAN:

Hi, Matt.

MATT ARGERSINGER:

I love the story about Netflix, Starbucks and Buffalo Wild Wings. You've held those companies for so many years. That really is the game that we're trying to play in *Supernova* with Odyssey 1 and I know Tom's playing that game with the Everlasting Portfolio. Is there a company that you see in *Supernova* or in the Everlasting Portfolio that you say, "This is the one. I'm going to hold this one for many, many years. I see so much upside for it. This is going to be a driver, a meat and potato of my portfolio for a long time."

MARK TIMMERMAN:

Oh, gosh. I should have my portfolio in front of me.

MATT ARGERSINGER:

I'm putting you on the spot, I realize.

MARK TIMMERMAN:

I'm really excited by what I see in LinkedIn. I've been very fortunate to get in well under $100 on that one and the growth has been nice. One of the most valuable parts of any of the services — and with *Motley Fool One* — you get access to all them … are the discussion boards. And the education I've received is literally priceless. In my estimation, you could almost get a finance degree really, if you wanted to dig in deep enough with all the information that's available to you.

LinkedIn is one of those companies that I've learned a lot more about. I knew very little about it. I apologize …

TOM GARDNER:

Here's what we're going to do for you, though, Mark … or at least I've got a couple of ideas … and then if anyone wants to chime in any. I've got some stocks for your kids. I'm going to make a couple of recommendations for your children …

MARK TIMMERMAN:

Excellent.

TOM GARDNER:

They may not have taken to the subject yet, but maybe if we go into the center of their area of interest … So, for the lawyerly son, there's a company called RPX Corporation. I believe it's Rational Patent Exchange. It has to do with patents — essentially large technology companies helping this organization buy patents that they then rent to the larger businesses. It came public in the last year and a half.

And in general, when trying to get a child interested, it is more important to pick something that's interesting to them than to pick a winner … although both is the ideal. But for your daughter that's interested in becoming a teacher, I would say obviously Amazon. That's the place to go for all the reading materials that you can find. LeapFrog or K12. That's a *Rule Breakers* recommendation, I believe. Do you all have any legal or educational stocks to give to Mark before we let him go?

RON GROSS:

Hm.

MATT ARGERSINGER:

Hm. [00:24:39]

RON GROSS:

Coach. They're going to need briefcases.

TOM GARDNER:

I love that …

RON GROSS:

I vote for Coach.

TOM GARDNER:

And Coach is …

MATT ARGERSINGER:

He's got to play video games, too. Activision and Blizzard's out there.

TOM GARDNER:

Yes. Activision Blizzard. Okay, Jeff. You're on the spot now. Everyone's got one.

JEFF FISCHER:

I would say eBay. Let's do — when you're filling up your dorm room — that's eBay's price point.

MATT ARGERSINGER:

And probably going to be involved in some big legal dispute over the next few months.

TOM GARDNER:

Sounds like it. [crosstalk 00:25:02]

MARK TIMMERMAN:

MercadoLibre is one of the ones that I've been very pleased with lately. It's [00:25:10] nicely and that's the one I've followed which is kind of a Latin American sister to eBay.

MATT ARGERSINGER:

Absolutely.

TOM GARDNER:

Mark, let me say in closing, it's our honor to serve you as an investor and to provide tools and ideas to help you build your portfolio and a financial plan of that portfolio. But I also just want to say how much I've enjoyed talking to you at the last member events. Hanging at the Minor League baseball game in St. Paul, Minnesota. That was a really great summer two-day that we had there. So, thanks so much, and I look forward to seeing you again at a future event.

MARK TIMMERMAN:

You're very welcome, and it was a real pleasure. It was a real thrill to talk with all of you folks.

RON GROSS:

Thanks, Mark.

TOM GARDNER:

Fool on!

JEFF FISCHER:

Thanks, Mark. Fool on!

TOM GARDNER:

Now we turn, without headphones, to your questions. I'm just going to take them in order. So, we've got Hilltop Gray has written in. "Should options be a part of every investor's portfolio?"

JEFF FISCHER:

I'll take that, and I'll say no.

MATT ARGERSINGER:

Thank you.

JEFF FISCHER:

I'll say no. You should give it a try, like anything. If you have a goal to make income stay or to protect your portfolio or you're adverse to downside and you want to hedge — then options are a tool you can certainly use. And see if you're comfortable with it. I honestly believe there's no better place than The Motley Fool to learn to use options in a Foolish way as an investor — when you use them as investors, not as traders.

And so, if you have a goal such as income, protecting yourself, or leveraging for upside with less money at risk … Like you can buy calls on Coca-Cola instead of buying Coca-Cola stock and pay a fraction of the money and have the upside. But then, there's a place for it. So, give it a try and see.

RON GROSS:

Awesome. Jeff, would you agree that it takes a little bit more activity, you need to pay a little bit more attention … or maybe a lot more attention … to your portfolio if options are a part of it?

TOM GARDNER:

This is Ron competing with you.

RON GROSS:

No, no. It's literally a question …

TOM GARDNER:

… over the *Million Dollar Portfolio*.

RON GROSS:

It's literally a question … versus a [00:27:06] like *Million Dollar Portfolio*? Shameless plug. Would you agree that it does require some more attention?

JEFF FISCHER:

It depends on the strategy you use, but in general, it requires a bit more. But you can do — as we did recently in Pro — we set up a 2016 option position on Coca-Cola …

RON GROSS:

Mm-hmm …

JEFF FISCHER:

So, we can let that go for two years.

RON GROSS:

That's great.

JEFF FISCHER:

If you're making income every month, then as those ideally expire, you write a new one. So, that's some monthly activity.

TOM GARDNER:

For regulatory reasons, I'm not going to be able to say very much about this right now, but I know that you have heard about our new solution that's part of *Motley Fool One* and that's separately managed accounts. And separately managed accounts — there will be a separately managed account option for *Motley Fool Pro*, so you will be able to have your money essentially managed by Jeff's ideas, and that will bear no assets-under-management fee. That's a really incredible … Just one statement on that.

You're not going to find many places out there in the financial world that are going to manage or help you manage your money without an assets-under-management fee. But when you actually look at that fee play out over — not just a year or three years or five years … but over ten years, fifteen years, twenty years where you're paying 1-2% of your portfolio in fees — what I think is going to happen here is we're going to see subscription membership at The Motley Fool significantly undercut that and our move to offer separately managed accounts where you can have *Motley Fool Pro*-like performance without having to spend any time should you choose not to.

Now we go to Pinky who says something in here … Pinky, you're going to upset one member of our panel with this. "I'm a Pro member. I'm an ex-*Supernova* member …"

MATT ARGERSINGER:

Oh …

TOM GARDNER:

Oh, wow. There have been some great returns in *Supernova*, but you had your reasons, Pinky, I'm sure.

"Now my question is in *Motley Fool One*, how do you suggest a member divide their capital between all the services? Is it only for those who have enough to create a reasonable portfolio in each of the multiple services?" I'll take a shot at that first, and then if anybody wants to jump in …

No, it is not our belief that you should have a full-blown portfolio that matches up with each one of the services. In fact, one of the key features in *Motley Fool One* is our Top Recs ranking of … Gosh, there are more than 450 active recommendations across all of our services. And what the Top Recs list does — and our analysts and advisors work on that each month — is it ranks from 1 to 50 the recommendations across all of our services. What we're trying to do is to help you build the right portfolio for yourself.

Now, there are certainly *Motley Fool One* members that are managing multiple portfolios. There are people who are running family offices. There may be a reason to set up multiple portfolios. But our goal in *Motley Fool One* is to set up the right portfolio for you that meets your needs, your risk temperament, your interests, the businesses that you want to learn about and focus on and your style of investing. No, our goal isn't … We're not trying to push you to a huge, huge allotment across each service.

From Diane. "I'm very interested in joining. I currently have *Motley Fool Options*, *Stock Advisor*, *Rule Breakers*. I am really enjoying Options and what I'm learning. Is *Motley Fool Pro* — which I'm interested in joining — is *Motley Fool Pro* part of *Motley Fool One*, Jeff?"

JEFF FISCHER:

Yes. A beautiful, easy answer. *Motley Fool One* is all access to all full services and big extras, including Tom's Everlasting Portfolio that is only in *Motley Fool One* … financial planners financial planning tools and the separately managed accounts that Tom mentioned. So, yes, you get everything and that's the beauty of this service. And you get to apply your current membership as a credit towards your One membership, so it all rolls over into One.

TOM GARDNER:

I guess I'll put it this way. I think that what we're trying to set up is the easiest pathway for you to be as involved and to build as much of your portfolio around our concepts as possible — and one of the key principles in that is the one-year money-back guarantee.

So, if I were living in Missoula, Montana, as I once did, and I were tapping into The Motley Fool not working for the organization — I would take advantage of that one-year money-back guarantee because you can come in, look around. Any service — whether it's *Motley Fool One* or any other service you're interested in — enjoy it for a day, a week, a month, 362 days. And if you decide it's not right for you, you let us know and we refund you in full. Our desire is to set you up on the right path for the next 10 to 20 years, and if a particular service is or isn't right for you, we want you to check it out.

I love the screen name of this next Fool member. MFNorway, which is awesome because MF used to be our nomenclature for somebody working on our staff back in the days when were on AOL. We were all MF … MFJoe … and now we're TMF out there. But MFNorway harkens back to another era.

"Hi, Fools. Given that as you discussed initially, it's more difficult to find attractive investments after the five-year bull market … and that some shares that are attractive long term but which missed their market may feel have run ahead of themselves … the question that I have is should *Rule Breakers* and *Supernova* customers rotate away from the growth stocks which tend to struggle in volatile market times?"

MATT ARGERSINGER:

Ow. [crosstalk 00:32:13] My initial answer would be no, and that's because we are looking at all these companies with three to five-year time horizons in mind and I would say … One thing David will often say and that I repeat — because I like to repeat everything he says — is that we are always interested in buying high.

It might look like we're paying an expensive price for a stock, but that's because we love the fact that the market's recognized that we're paying a high multiple and generally that's a little bit contrarian. Most investors out there are looking to buy the bargains. They're looking to buy cheap stocks. Stocks have come down in value.

We're actually the opposite. We get actually more excited about stocks that have run up quite a bit because we actually think there's a lot more to go and we think that says something about the business behind the stock, as well. So, we're not afraid of high-priced stocks.

TOM GARDNER:

What happens in an environment where so many companies have seen their stocks rise? In other words, is there a period at which you or the *Supernova*/*Rule Breakers* philosophy says it's no longer a distinguishing feature to be considered overvalued because …

MATT ARGERSINGER:

Yes, because everything's overvalued …

TOM GARDNER:

… because the market has gone up. It's like at 2000 and everything looks overvalued. Is that a time where you change or modify your approach or literally it's, "Hey, rolling ten years. We're trying to optimize it. If we have a roller coaster ride that takes us down 30% in an 18-month period, that's not going to present us a problem."

MATT ARGERSINGER:

No, not at all. One thing I always harken back to is that you could look at an investor who came in, in October of 2007, which was the month prior to the peak of the last bull market before … Of course, we know what happened in 2008. And that person, even if they invested their entire net worth, at that point in time … as long as they were investing a proportionate amount every month beyond that into the index or into their favorite companies … a few years later, they were not only in positive territory, they were way ahead of the market.

TOM GARDNER:

So, if you have income and you're getting into the market on a monthly, quarterly, annual basis … you really should be much less concerned about what the overall market's telling you …

MATT ARGERSINGER:

Right …

TOM GARDNER:

If you are at a point where you have no new income and you need to draw off that portfolio, does your philosophy change at all if your time horizon or need for the capital changes or not?

MATT ARGERSINGER:

I'd probably say it does. I mean, I would have to say if you don't have new income coming in, and you know you're going to need money within a five-year time frame, then I think your decision making changes a little bit.

TOM GARDNER:

Got you. But so many people in semi-retirement or retirement — they've got 30 years. We've got more time in our lives in semi-retirement or full retirement. I think at The Motley Fool we're probably big advocates of semi-retirement. Staying active …

MATT ARGERSINGER:

Right …

TOM GARDNER:

… working as Mark said because you love it, not because you have to … so, finding something you love, continuing to generate some income and invest that. But regardless, we're going to live much longer and I think many people are not preparing their portfolio for that and are fearful of the equities market short-term blips when they really should be reminding themselves that "Hey, rolling 10 and 15 and 20-year periods are exactly the place to be."

MATT ARGERSINGER:

Right.

JEFF FISCHER:

And I think if you're concerned about a downturn, which will inevitably happen at some point … maybe this year …

TOM GARDNER:

I hope so. Are you aware …

JEFF FISCHER:

I know you are. I know you're rooting for lower prices …

TOM GARDNER:

Yes, yes. I have to explain that in a second.

JEFF FISCHER:

So, remember that. Mark that down. This is going to take ten minutes, but …

TOM GARDNER:

Good. Go for it. I love it. I'm going to see if I can find water.

JEFF FISCHER:

Uh, where is my train of thought? So, it's important to have a positive action that you can take when prices fall. The people who are saving money — of course, they have something to do with it — so their mind is in the right place. Like, "Great. I can invest this money." But if you're not saving any money — if you're 100% invested and the market falls, your reaction is to start to worry …

TOM GARDNER:

The only positive action would be departure from looking at my portfolio …

JEFF FISCHER:

That would be good.

TOM GARDNER:

So, my positive action … If I have no new income, the market's down 30%, I will not go look, because I can't make, really, any meaningful changes.

JEFF FISCHER:

But as every action calls out for a reaction, too many people, as we know, will sell, because that's all they can really do. They feel trapped, so they'll sell. So, that goes back to having some cash, especially if you need money or you're not adding money …

TOM GARDNER:

Mm-hmm …

JEFF FISCHER:

… or, like we do in Pro, hedging frequently and when the market declines, your hedge pays you and you can then reinvest that cash.

TOM GARDNER:

Jeff, I really love the concept of what's your positive action when the market declines. What have you created that's going to allow you to be somewhat excited by a 10-20% recline? Ron?

RON GROSS:

The question focused on Mr. Market and I would really prefer that investors don't think about Mr. Market. Think about companies.

TOM GARDNER:

Anti-Buffett. This is an anti-Buffett play from you.

RON GROSS:

I would prefer that the individual investor focus on companies. We talked once before about it. I wish it was called the "company market," and not the stock market, because you're truly an owner of each of these companies.

And, as Buffett says, you can buy the same steak on Friday that you bought on Monday at a discount, you should be a happy man, because you're getting a steak at a discount. And that's the way I think about stocks, as well. If I can buy a company that I love at a cheaper price than I bought it a month, a year earlier … then I'm a happy man. I am not sad in any way. Because I am a long-term investor and I have a long-term time horizon — I will let Mr. Market do whatever he wants to do and I will be an owner.

TOM GARDNER:

These are the days when saying you're a long-term investor looks really, really smart … and you know there are a lot of people out there … and there were a lot of headlines in the financial media … and I read a lot of people that I see giving investment advice out there that were saying, "Long-term investing is dead," four years ago or six years ago or ten years ago. And now, you see the benefits of sticking with businesses in the company market and thinking about the prospects and adding money in down periods.

What I want to do now is I want to start with Ron. Put you on the spot first with a slightly trick question. Whoever goes first should be allowed to defer — but here's what it is. I want to know what your most controversial belief is. What your most unorthodox, unusual or flat-out controversial belief is about investing.

It could be about a particular company. It could be about the market. It could be about a philosophy. It could be something you disagree with that you've heard others say at The Motley Fool.

RON GROSS:

I come from a relatively traditional Wall Street background. I used to be a hedge fund manager. I lived and worked in New York for years and I come from that realm. And when I get together with friends or former colleagues that are still of that mind-set — which I am no longer. I am a proud Fool — I get those same kind of conversations and those same kind of questions. What do you think of the markets? What do you think of this? What do you think of that? What are you doing? What deal are you doing?

And I just want to say to that person, "You've got to calm down. Turn off CNBC. Focus on companies one at a time for the long term. It's not about what are you going to do this month or this quarter and what kind of returns did you put up and what kind of fees can you generate? Relax. Invest in companies long term."

TOM GARDNER:

Love it. Jeff. Be radical.

JEFF FISCHER:

Be radical. Well, I don't know how radical this is, but I will say I think probably all of us here, and maybe everyone watching, would have more money in the end if they just never made any sell decisions ever. But how do you get there? That means you're trapped. Why are you investing, then, if everything you invest you can never touch?

TOM GARDNER:

Well, you touch it if you need the cash or have something you want to enjoy. You don't sell because of the valuation, the business, anything that's going on. You let all of your existing investments just run until the end of time and you say, "Recognize that you may need to take cash out at different points along the way." But you're saying, "Leave that factor aside. That portfolio will outperform what you're doing right now."

JEFF FISCHER:

I believe so. And now that may signal that we're at the end of a five-year bull market. But really looking back even further from … Say you started in 1987, as I did. Almost everything I've sold along the way has been a mistake — almost everything — and the few things that I sold that then went down … well, they've become minuscule over time …

TOM GARDNER:

Thanks for the feedback there …

JEFF FISCHER:

… next to the things that I held or would have held.

TOM GARDNER:

Your losers get smaller and less relevant every day.

JEFF FISCHER:

Yes. Now, we're not about to go there in Pro …

TOM GARDNER:

Why not? You just told me this is the best way.

JEFF FISCHER:

Because it's over a lifetime and it's in aggregate and Pro is a very focused portfolio. Twenty positions, twenty-five is all we have. And we don't have new money coming in. So, if we see something we like better, we need to sell to buy it. But for most of us who are fortunate to be working and have savings, we should take some [crosstalk 00:40:31] …

TOM GARDNER:

So, if you have someone in your family that's under the age of, let's say 30, your primary advice to them as an investor to get the maximal, optimal results, is to buy the things according to a variety of factors that we teach at The Motley Fool and never sell …[00:40:44]

JEFF FISCHER:

Find what we call in Pro — taking it from Chuck Akre — find compounding machines like a MasterCard or a Google. Buy those and keep adding to them. Don't think about selling, especially at this age.

TOM GARDNER:

Love it. Radical!

MATT ARGERSINGER:

Oh, God!

TOM GARDNER:

Okay. Matthew. Shake the world.

MATT ARGERSINGER:

Jumping off Jeff, here. I think the buy high, buy higher idea … It's just not practiced enough by most investors. I think what David says often — we're so willing to trim the flowers and water the weeds and you should almost be doing the opposite. You should be ignoring the weeds and forgetting the weeds and continuing to buy and invest in your flowers. And I think that's so hard to do.

If I look at some of our biggest winners in *Supernova* … Zillow, for example. We've bought Zillow three times, and each time it's been at a much, much higher price.

TOM GARDNER:

And it's been volatile. There have been times when it's down and you're like …

MATT ARGERSINGER:

It's very volatile …

TOM GARDNER:

… wow. Could be we made the wrong decision. But if that happens, that's going to happen. However, it's ended up being, obviously, an unbelievable business.

MATT ARGERSINGER:

Right. This might sound crazy because we're in a big bull market and we have nothing but rising stock prices — but back to Jeff's point — over time, if you look at long periods of time, if you just added to your winners … the winners are the ones that are usually being recognized, not only just because the stock market's excited and people are excited about the stock, but people are excited about the business. And the business is going places and it's being recognized by the market. And it's achieving a higher value for a reason and you should double down on those all the time as much as you can.

TOM GARDNER:

Love it. I'm going to go, contrary to Jeff, for the fun of it … even though I basically agree with Jeff …

RON GROSS:

Just to confuse everyone …

TOM GARDNER:

I really do. I think that for the most part, our discipline should be to never sell … not just because we don't lose a great winner … which is the greatest mathematical pain to your portfolio is to watch something rise 5-20x and you sold it. Because how many bankrupt investments are you going to have to make to catch up to the losses that you didn't get by holding that incredible winner?

But I'm also going to agree with Jeff before taking him out at the knees for a second for another reason, and that is that if you have the mentality of "I never sell," you look for very different types of businesses. You look at the culture of the company. You look at the leadership differently. You look at the product line. It's not like, "Wow. They have one incredible innovation right now." It's, "Do they have a system for innovation that's going to lead to greatness over 15 years from now when we can't even know what the consumer marketplace will look like?"

There may not even really be malls. There may just be warehouses where products are being dropped off in driverless cars and it's all incredibly convenient for us to just sit at home and order everything, and it's all the home-related things we should be focused on, as investors now.

We don't know what the world is going to look like, but what do I think is a company that can adapt through those multiple different environments? And so, those are two great reasons to never sell. Mathematically you'll do better and number two, you'll look at the companies that you invest in differently before you make the investment.

I do think that there are a couple of situations where I would sell and I want to share those now. I guess it's not radical, but I just wanted to go contrary to Jeff. As Ron was saying, everyone loves Jeff and Ron's parents are watching, so it's indirectly a way of saying, "Solidarity to the Gross family!"

Here are a couple of sell rules that I have and in the Everlasting Portfolio and *Motley Fool One*, we're mandated to hold at least five years every single investment. We're going to learn from them. We're going to get the best long-term results out of all of them. I know it's surprising to some to think that you would continue to hold something you don't believe in, but I can assure you that some things you don't believe in now end up delivering awesome results. They just had a downturn and a bad cycle in their industry or bad performance with this leadership and something changes. And of course, we'll have some losers that just remain losers … but your best results will come from what Jeff said.

But here are my four sell rules, if I can remember them all *after* holding a business for five years.

1. If there is a major shift competitively in the marketplace that makes me think the business is losing pricing power. Warren Buffett's number one factor is he looks back across all the investments he made through his life. The single factor that he sees matches up with the best performance in his portfolio is pricing power. They have the ability to raise prices.

That's why when I interviewed Jim Sinegal in *Motley Fool One*, I just loved what he said about Costco … that they feel they have always had pricing power, but they have never fully utilized it and they never will. That is true pricing power. It's not like, "Wow. We have pricing power and we're extracting every additional dollar we can from our buyers." No. "We have pricing power and will never do that because we want to maintain a great relationship with our buyers."

So, if I see loss of pricing power, that's a real concern.

2. Succession. Leadership change. Will Thorndike, the author of *The Outsiders*, which is a great part of our *Motley Fool One* experience right now in the member lobby … I highly recommend that you join us. *The Outsiders* is a wonderful book that shows eight CEOs that allocate capital in an unorthodox way and have run their businesses differently and have delivered in excess of 20% a year, in most of those 8 cases, for more than 20 years.

And I can tell you that if you run the numbers on your calculator to what happens when you invest in something and it rises 20% a year for 20 years, you have your family taken care of financially with small, regular investments in businesses like those.

And when I talked to Will and interviewed him about the book about three or four weeks ago, he told me that he spends, in evaluating the CEO — just the CEO of his investments — 30-50% of his investment time is just on the CEO.

First of all, I love seeing that. As we talked about, I love the opportunity to study how different people invest … Seth Klarman, different approaches and all the rest. And I believe that you could crush the market by spending 50% of your time on just the CEO, because you'd start to see things about leaders that are different and a distinguishing factor. And so when I see succession away from an awesome leader, I get concerned.

Talking to John Mackey, our board member … co-founder and co-CEO of Whole Foods … we were talking about the difficulty in succession at Coach, which is a wonderful business under Lew Frankfort. It's a tough industry, and we'll see whether the next CEO can manage things as well as Lew Frankfort did, but it's definitely a concern point. None of these are automatic sell. They're just, "Hey, I have to start thinking what I should make of this situation."

3. The third one I'll say is companies that are too big to succeed. I know this is going longer than we expected. There will be a quiz. So, companies that are too big to succeed worry me. The data going back to 1950 shows that the largest company by market capitalization in the world loses to the market by 40% over the next 10 years.

It still makes money. It just doesn't do as well as the market, so I look very closely when a company is just the largest in the world or the largest in its industry. Those, actually, tend to become points where they slightly underperform and the disrupters come along and take a lot of the market opportunity in that industry away from the frontrunner. So, that's a concern.

4. And then the fourth one is whenever a stock, for me, has become more than 20-25% of the overall value of the portfolio. That would be a time to sell and bring it back into line so that I don't have 60% of my portfolio in a single position. We all feel differently about that, but those are my four sell rules.

JEFF FISCHER:

Nice.

RON GROSS:

Your sell rule about the companies that get too large — is that your proxy for valuation in the sense where you think at a certain point the stock goes up so much that it's unlikely to get you market-beating [crosstalk 00:48:03] …

TOM GARDNER:

That's a really beautiful way of thinking about that, and I'm not just saying that because your parents are watching. I think that's really a great way to view it. I mean, you look at Apple, and Apple's trading at 9x earnings. And everybody's like, "This is shocking." And in a way, it *is* shocking because Apple's a much better company than trading at a multiple … almost a 35-40% discount to the market's average multiple.

But I think that if you look back at the last great performing market … Well, let's go back to the late nineties … Microsoft, Intel, Cisco — they were basically like sure things. They had Bill Gates, Andy Grove, John Chambers. They were like lock-ins. They had balance sheets that were bigger than Fort Knox. They had the future on their side. Software. Chips. Networking. I could imagine so many different ways that they could take their businesses, but their size made it difficult.

Google has been an awesome investment for us across The Motley Fool and in the Everlasting Portfolio. I didn't expect it to essentially double since we recommended it, and it's done better for others who recommended it earlier. Google, to me, is one of if not the greatest companies in the last 100 years. And given how more difficult it is to run a company today — more global, 50,000 people — it's more difficult to run a business today than it was 50 years ago, so I think Google's probably the greatest company in the last 50 years.

But it's of such a size and scope now that I definitely don't feel I'm getting a triple from Google over the next seven years or eight years. And so, it just becomes a little bit less interesting to me as an investment, although as a company I love reading and studying and learning about they're doing.

JEFF FISCHER:

Sounds good.

TOM GARDNER:

Wow.

JEFF FISCHER:

I was going to say. It will be interesting, when Google is twice as big, to see what you're thinking at that point. In the next seven to ten years, it may be twice as big …

TOM GARDNER:

I certainly think it could double in the next seven to ten years. You know, one think you learn from *The Outsiders* is that I wonder whether these companies should begin spinning off divisions and paying special dividends. Essentially, you could have had Microsoft … In fact, I said this on CNBC in 2003, I think, on … What's that? I forget the name of the show. I'm sorry. I'll remember it.

But I said basically Microsoft should voluntarily break themselves up right now. Create entrepreneurial units and essentially give all the shareholders stakes because it happened to Standard Oil, and what happened to those oil companies over the next 70 years? Their market performance was unbelievably outperforming. I mean Exxon — you had incredible performers, and when you broke them apart, you gave them a new entrepreneurial lease on life.

RON GROSS:

Especially with companies like Google or Amazon, where there are going to be so many business lines that are not core to search or online retailing, it may make very good sense …

TOM GARDNER:

To capitalize them and spin them off. Yes. I guess I'll say that maybe my most controversial belief is that I have a little anxiety about the large … [00:50:58] about social media companies … about the large technology companies and the almost can't miss feeling about them that develops because of their incredible performance. That would be an area of a little caution that I would be placing as an investor.

JEFF FISCHER:

Tom, that makes me think of Everlasting Portfolio and *Motley Fool One* and it makes me want to ask …

TOM GARDNER:

Bring it!

JEFF FISCHER:

… to share your vision for Everlasting Portfolio and then for One, as a whole for the investors out there.

TOM GARDNER:

Great. So, Everlasting Portfolio adds $100,000 every quarter. We buy five separate investments. We have the option to leave some of that money in cash or to make investments. We've made investments all the way through. We're about 29 percentage points ahead of the market, maybe 27 percentage points ahead of the market today. That's been awesome. It doesn't compare to Odyssey. So, *Supernova*, which is part of One … That's the great thing, is that anyone who beats me, is a part of *Motley Fool One*.

MATT ARGERSINGER:

It makes it tough to be an employee.

TOM GARDNER:

Just so you know. I created *Supernova*. No. So, the Everlasting Portfolio benefits from all of the research that's happening at The Motley Fool. I get kind of a bird's-eye view, as a *Motley Fool One* member does, on everything that's going on in *Income Investor, Inside Value, Million Dollar Portfolio*, *Supernova*, Pro, Options, *Hidden Gems*. So, I've got a great view.

And then we do all of our own original research, as well, alongside that. So, we're building with a team of about ten investors now, our approach. We'll make five rounds of investments. We mandate holding for five years.

And I guess my view is we've got about $1 million in the portfolio now and I'm excited about looking down and seeing that at $5 million, $10 million, $15 million, $25 million and higher. I think when you run the numbers and show what happens if you generate 13-14% a year — which I think is possible with great long-term business focus, tax-deferred investing — and you run that forward 20-40 years, it's unbelievable the snowball that grows.

JEFF FISCHER:

When does your next investment take place?

TOM GARDNER:

Our next scheduled investment takes place on April 1. And then overall, *Motley Fool One* … Guys, I'm speaking quite a bit right now. I apologize … *Motley Fool One*, by integrating all of the services, is designed to give you the dashboard for what we believe in most. It gives you the opportunity to learn from each of our advisors and to see their most highly beloved investments right now and to see those investments compared across services with a ranked list.

I think what you're going to find in The Motley Fool — now we are adding separately managed accounts as we mentioned. There are pretty much two pathways with *Motley Fool One*. One of them is … Let's put it in the "lite beer" commercials from fifteen years ago.

One of them is Tastes Great. I'm avid. I'm passionate about this. When John Mackey joined our board he had, a couple of months before, become a member of *Motley Fool One* and he called and told me, "Pretty much, I'm done almost nothing for the last two days. I am totally obsessed. I've read through all back issues of *Rule Your Retirement*. I've read *Inside Value, Income Investor*. I'm not just improving my investment portfolio. I am actually learning a lot about these companies and I'm learning a lot about business that's useful for me." So that's the Tastes Great group that wants to dive in and loves this subject.

Then there's the Less Filling group and I think we're going to build out a lot of Less Filling services, particularly because our Tastes Great member has family members … a spouse, children, grandchildren … that they want to pass this onto …

MATT ARGERSINGER:

Plus parents …

TOM GARDNER:

… connecting them in through the Less Filling. Like, "I don't have a lot of time or interest, or my temperament isn't right to be an investor." Separately managed accounts. The access to a financial planner. And I frankly believe that more and more of your investing and financial advice that you see out there is going to be initiated by human research and proven, long-term public performance records which you don't see across the financial services industry.

Please tell me when you meet with an advisor or broker if you can look at their record and if that record is published and compare it to everyone else. It's very difficult to do, but that's coming because of the Internet, and I think that you're going to find a lot of this will be automated. Off of the initial research that is done, you'll be able to put your personal factors, your needs, essentially in surveys, building a profile, and then you'll get the guidance that really works most effectively for you. And that will happen for your kids, your spouse, your parents, etc.

JEFF FISCHER:

And *Motley Fool One* is already going down that route with [crosstalk 00:55:33] …

TOM GARDNER:

That's a big focus of ours. I kind of feel like the best comparison for our company right now … It's very nice to say this with our stock at $250 a share having gone up almost 10x in value in the last two years … but I think of us, a lot, like Tesla because I think that what we're doing does run contrary to the industry, so I'm sure we'll get some complaints.

But that's not important. We want them to follow. Tesla wants as many electric cars out there in the market as possible and we want as much long-term business focus investing with transparency, performance records that you can follow and that have beaten the market over long periods of time — we want as much of that out there for the individual as possible and it's not readily available and hasn't been in my lifetime. So, that's one of the biggest motivators for us. Team!

JEFF FISCHER:

Thank you.

RON GROSS:

It's great.

TOM GARDNER:

Okay. One stock from each person. Here we are. It's 6:13. I guess we have two minutes left, although Steve, our producer. Steve, you have appeared to check out on this. I'm looking at you looking down at the monitor as if you're playing World of Warcraft or Ticket to Ride, which is integrated into *Motley Fool One*. But we probably have about two minutes? Would that be right? Yes, excellent. Two minutes. Each one of us will share one investment that we think is a market beater over the next five years.

RON GROSS:

This is a little staid. It's not too sexy, but it's just a wonderful company …

MATT ARGERSINGER:

It's Markel.

RON GROSS:

It's Markel. MKL is the ticker symbol. Specialty insurer run by wonderful people who are Foolish in their own right. Tom Gayner, the chief investment officer, has an incredible track record. Not only does Markel make money on insurance which many insurance companies don't, but they invest their capital and they're great stewards of investors' capital, as well. I would be happy to own that company forever.

RON GROSS:

MKL.

JEFF FISCHER:

MKL. Markel is sexy compared to the company I'm about to …

TOM GARDNER:

Okay, love it. I think I know where you're going. I know where we're going here.

JEFF FISCHER:

At the *Motley Fool One* member event here in Alexandria last month, I brought this up …

TOM GARDNER:

Telephone poles.

JEFF FISCHER:

Telephone poles and light poles and utility poles. Valmont Industries. Ticker is V as in victory, M - I. And it's beaten down right now because irrigation sales were … they also sell irrigation systems for farmers … were a record high in 2012 and softened up last year and they're going to be softer this year, too. But we like that. It's in a down cycle. The stock is inexpensive in a relatively more expensive market. It's a defensive investment and it should grow well over the next five years. And it's been an outrageously great stock for the past 20 or 30 years topping pretty much everything I can look at.

TOM GARDNER:

Out of curiosity, do you expect your stock to double over the next five years? Markel? Valmont? Are you thinking 15% a year? Is that your target when you make an investment?

RON GROSS:

The Rule of 7 would say 7 years at 10%. So, can we do five years? Yes, I think we can. I think Markel can.

JEFF FISCHER:

We're hoping for that, too.

TOM GARDNER:

Double in five years. Right on.

MATT ARGERSINGER:

I'm going with the outsider theme here. One stock that makes up a big part of my personal portfolio is Biglari Holdings. It's ticker BH run by Sardar Biglari who counts, among a lot of his heroes, Henry Singleton which is certainly one of the premier outsiders I think for the last 50 years in terms of investing. So, you've got Sardar Biglari, Biglari Holdings. They own Steak 'n Shake, which is a Midwest burger chain. Pretty well known. They own a big chunk of Cracker Barrel.

And they recently, a week and a half ago, bought *Maxim* magazine. Talk about sexy, right? But he's amalgamated all these businesses together and I think, more than any investment that I've known … and I've studied Biglari. I've met him several times. I've been to every annual meeting over the last five years. And I think this is a company that I'm confident he can deliver 15-20% annual returns per year.

TOM GARDNER:

Love it. Is that a *Supernova* or *Rule Breakers*? Is that a Live Rec?

MATT ARGERSINGER:

I have tried and I have tried … [crosstalk 00:59:19]

TOM GARDNER:

There's a team-based approach.

MATT ARGERSINGER:

[00:59:23]

RON GROSS:

He's an activist, and something …

MATT ARGERSINGER:

He's a bit of an activist …

RON GROSS:

… and he rubs some people the wrong way.

TOM GARDNER:

So, Biglari is not a Live Recommendation anywhere because of you at the Fool. Is it a Live Recommendation?

RON GROSS:

It used to be a *Million Dollar Portfolio* one when it was Steak 'n Shake.

MATT ARGERSINGER:

When it was Steak 'n Shake …

RON GROSS:

Then he took it over and we said bye.

TOM GARDNER:

Got it. Got it. So, there's a disagreement about Biglari as a leader of a public company.

RON GROSS:

Yes.

TOM GARDNER:

Awesome.

MATT ARGERSINGER:

I would say he's the meaner version of Selim Bassoul. Of course, as the CEO we love him and Middleby that you own in Everlasting Portfolio …

TOM GARDNER:

And why do you say that out of curiosity? What do you read in him? Obviously you favor him. What is the edge to him and how do you …

MATT ARGERSINGER:

So, Sardar. If you look at Buffett or Selim, to a certain extent … I mean, these guys are always trying to do friendly deals. Friendly investments. "We want to work with you." Sardar is a guy who comes in and says, "No. I think I can do it better than you."

TOM GARDNER:

Like icon, a little bit. There's a little icon flavor.

MATT ARGERSINGER:

A little bit of icon. Better than icon, but certainly more of an icon flavor.

TOM GARDNER:

But would we say an icon? He's been an unbelievable investor, right?

MATT ARGERSINGER:

Absolutely.

TOM GARDNER:

Interestingly, about these three companies, because I'm actually going to add four to them, but it's the four outsider companies that we're following right now in *Motley Fool One* in our showdown to our March Madness of finding the best one to invest in. But what's interesting to me is that each of you has essentially picked an outsider company. I don't know about Valmont's leadership, but with a 20-30 year return, I'm going to be interested to learn more with them having done so well.

But these are three companies that the average person has never heard of. I mean, please tell me if anyone in your family has ever heard of Markel, Valmont Industries or Biglari Holdings. I'm going to guess that the answer is no for 99% of the adult U.S. population. And we need to remind ourselves at certain points in time that the stock market is an auction market and where everyone is bidding, two things can be happening. One, there's something unbelievable there and the bidders are right. Rembrandt is Rembrandt — but remember there was also a time in Rembrandt's life where Rembrandt could barely sell his paintings to pay off his debts in the end of his life.

So, you guys have identified three unknown companies that there aren't a lot of conversations about — therefore there aren't casual buyers of the stock who don't really follow it, because they've never heard of it. And I'm going to add to those three Leucadia, which is an outsider business that we're following, Valeant Pharmaceutical, Amazon, which is known, and Berkshire, which is known.

So of the seven stocks we've given you, two of them you've heard of. You would never really have heard of Berkshire Hathaway if it weren't for the fact that Buffett became, essentially, a legend as an investor. The businesses that he is buying, for the most part, and the way he's run his company is much more Markel-like or Biglari-like and not necessarily would you ever follow and get to know what that holding company is all about.

So, there are seven stocks. I'm going to put these seven stocks in the CAPS portfolio. I believe these seven stocks are going to deliver excellent returns over the next five years and I am interested to see in this environment — maybe it was or wasn't in this environment — that we've all focused on companies that are unknown great performers. And that's how I tend to think. When the market starts to look a little bit stretched to me, I look for the underfollowed and the unknown star performer to find the better values out there.

The most important point I can close with is that we're super long-term investors. Morgan Housel has done so much great work for us in *Motley Fool One* over the last year — the special reports — one of them showing that the market falls 10% every 11 months going back more than 100 years and that those drops are pretty evenly distributed. It's not like they're all bunched into a six-year period and then you have fourteen years with no 10% drops …

RON GROSS:

And your earlier comment that you were rooting for …

TOM GARDNER:

You're right, Ron. Thank you for reminding me. I made a bet in our *Motley Fool One* membership on January 1 that given a variety of factors, I felt that this year we would have a 10% decline. And again, they come every 11 months, pretty evenly distributed. We haven't had one for about two years. And so, my bet is that if the market does not fall 10% at some point in this year …

So, in a sense I'm cheering for like, "Well, let's rip it up a little higher here before the summer doldrums start to slough off a little." If it doesn't decline 10% peak to trough at some point this year, I will be walking a marathon on my treadmill desk each day for five days in a row. You know, it was so easy to write that sentence … and now I'm had like an Ironman in our member community and a couple of people here at the Fool that are marathoners go, "You know what? Day four you're going to be in pain, because walking a marathon, you'll be fine." Plus, I can space it out. It's not like I have to do it continuously throughout the day. I can do six hours here and there. But it's going to be a long five days for me.

The reason I did that is I want to make sure that we set ourselves up, eloquently said by Jeff, to have positive actions should the market decline. That we're prepared and expect that a natural course of investing is to see a 10% decline. Because I can promise you one thing. The media's going to make it sound disastrous. They already made it sound disastrous in early January when the market fell 5.5%. So, you can only imagine what's going to happen when it's down 10% and that's going to happen multiple times along the way as our portfolio grows throughout the year.

So, Ron Gross, Jeff Fischer, Matthew Argersinger, thank you all.

RON GROSS:

Thank you.

JEFF FISCHER:

Thank you.

MATT ARGERSINGER:

Thank you.

TOM GARDNER:

Some of my happiest times at The Motley Fool is hanging with the three of you and with our advisors and talking investments and working with you and for you in The Motley Fool. So, I've got some comments that I need to make here in closing our conversation.

First of all, thank you for spending your time with us. I hope you found this valuable and useful in its own right for you as an investor. If you're interested in *Motley Fool One*, the *Motley Fool One* member lobby is a really great place for you to go. If you click the link below, you begin the application process and you join us in our member lobby and our member lobby is fully free.

You're going to find everything from the four outsider companies that I mentioned — but more importantly, the explanation behind those businesses and why we believe they're going to deliver excellent results. You also gain access to my CEO interviews with Jim Sinegal and John Mackey and Selim Bassoul and Monty Moran, the co-CEO at Chipotle, which has been such an incredible investment for us.

We love to sit down and talk on camera with our CEOs, with the companies that we're invested in, not just to learn about the company and its prospects, but we learn things about the industry and about other businesses they love. We've learned so much from those interviews.

Finally, you gain access to interviews at our most recent member event, which I know many of you attended — but for those of you who didn't — our Malcolm Gladwell interview and Pete Miller's great talk, the CEO of National Oilwell Varco who will be a part of a spinoff out of that business and run the spinoff which is a really interesting dynamic that we've talked about in *Motley Fool One*.

So, *Motley Fool One* gives you access to all of our services, to these advisors, to my brother David, to *Income Investor, Inside Value, Hidden Gems*. We're very excited that in the next year it's going to provide you access to all of our international services, as well. It also gives you access to a financial planner. It's going to help you build a financial game plan around your investment portfolio so you really are thinking through not just the equities that you have, but what about allocation with bonds? What about insurance? What about building out your estate and taxes and thinking through the tax efficiency in your portfolio. That's a really important part of *Motley Fool One*.

We have the separately managed accounts coming. For regulatory reasons, I'm not going to go into great detail about it here other than to say that we want you to be able to invest with us whether you want to spend a lot of time on it or not. We want to make sure that you and members of your family can invest the Motley Fool way and aim for great, long-term returns that are tax efficient.

Beginning April 1, our *Motley Fool One* members will see the winner of our Final Four showdown and March Madness of our four outsider companies. If you'd like to see that and be a part of *Motley Fool One*, click the link below to join and apply to join *Motley Fool One*.

Last point is that it bears a 100% money-back guarantee. I have talked to members who have been members of particular services of ours and have stuck with it for 190 days and then felt bad bailing and taking the refund — but that's the nature of what we're trying to do. That's our purpose at The Motley Fool — to help you invest better.

I'll begin inviting members into *Motley Fool One* on March 20. I look forward to working with you, with our entire team … that's what you get as a *Motley Fool One* member …and to helping you invest better for the rest of your life and to set your family up for generations to come. Thanks so much for spending time with us. Ron, Jeff, Matthews …

JEFF FISCHER:

Ron's parents …

RON GROSS:

Bye, mom. Bye, Dad.

TOM GARDNER:

Thank you all and Fool on!

Fool One Podcast: Can Whole Foods Pair Price With Purpose?

Published Mar 3, 2014 at 12:44PM

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Rather listen on the go? Stream this podcast on your mobile device by clicking here.

With a $20 billion market cap already, just how much upside does **Whole Foods Market** (NASDAQ: WFM) have for investors still considering whether to grab a piece of the all-natural pie?

In this exclusive sneak peek inside the world of Tom Gardner's "crown jewel," all-access service, analysts Bryan White, Alyce Lomax, and Motley Fool chief investment officer Andy Cross join host Chris Hill to talk about why they see green pastures ahead for the conscious capitalism pioneer. Listen in below!

{% ooyala id="Awc3B2azqYTUxYiU29mYiWRwI7n3kvx4" width="580" height="326" %}

Run time: 11 minutes

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Transcript

CHRIS HILL:

Welcome to EP Weekly. I'm Chris Hill joined in-studio this week by Bryan White, Alyce Lomax and chief investment officer here at The Motley Fool, Andy Cross. Thanks everyone for being here.

ANDY CROSS:

Chris.

ALYCE LOMAX:

Hi.

CHRIS HILL:

We've got Middleby's earnings to talk about, but I should kick things off by officially welcoming Alyce Lomax to the Fool One team. Alyce has been working for years at Fool.com. I'm sure a lot of our listeners know her writing from there. And Alyce, before we get to Middleby's earnings, I wanted to touch on one company that I know you follow very closely because a big part of the work you've been doing at Fool.com … a big part of your focus as an investor … is on conscious capitalism. I think it's fair to say there's no one at The Motley Fool we identify more closely with conscious capitalism than John Mackey from Whole Foods.

Where are we now with Whole Foods? When you look at this as a company, you and I are both shareholders … longtime shareholders of this company. But I am curious. What do you see when you look at Whole Foods right now? What stands out to you in terms of their business today?

ALYCE LOMAX:

Well, I'm not sure that everybody is aware of just that holistic sense of conscious capitalism that Whole Foods and John Mackey have tried to further. I think that, that is such a wonderful thing for business. It's such a wonderful example to make that you can have that sense of all stakeholders and do well. I think that it's actually an exciting time right now because of the value. They're trying to get away from "Whole Paycheck." I think that's great for actually spreading the word about their business …

Showing people that you can take care of your employees, you can take care of the environment, customers … And I think that a lot more people are going to start to understand that as opposed to a lot of the other grocers.

CHRIS HILL:

On the one hand, if they're lowering prices … if they're offering more value opportunities within their stores … that's potentially great for getting more people in the door. On the other hand, selfishly, as a shareholder, I'm wondering what this is going to do to margins. At least in the short term, it's got to hit them.

ALYCE LOMAX:

Absolutely. Unfortunately, that is going to hit them, but I believe that it's worth the risk right now, especially in the current environment, too. I mean, consumers aren't exactly feeling too flush right now. But I believe that they still have the sense of … I mean, they do still have a lot of … let's face it … high-margin products …

ANDY CROSS:

I had heard, I think, both John Mackey and Walter Robb, who is the …

CHRIS HILL:

Co-CEO …

ANDY CROSS:

Co-CEO and co-founder, talk about much more … When I heard him at the Conscious Capitalism Conference a couple of years ago, he talked about it's really about education. You really want to find consumers … We want to go into highly educated markets because that's as important as the demographics when it comes to how much money they make and how wealthy they are …

ALYCE LOMAX:

Absolutely …

ANDY CROSS:

… because they're a more educated consumer. So, this is the one thing Whole Foods had done very well and they continue to do, and that is try to educate the consumer around the benefits of living a healthy lifestyle. Eating healthier. Organics. Not everyone can afford organics, but when they go into Detroit … And they just went into another, I think, inner city market. They're not offering a ton of organic food because they can't get the supply and also they know a lot of the customers can't necessarily afford it. But these are from customers who have no access at all to any kind of fresh …

ALYCE LOMAX:

They're food deserts. Yes, absolutely.

ANDY CROSS:

Absolutely. So, Whole Foods is going in and they're trying to educate the market. They're doing this in just little test markets, but it really does align with what John wants to do from a conscious capitalism perspective.

ALYCE LOMAX:

Yes, and from a strategy perspective, absolutely. I mean, you're going in where there's a major need for better food, basically. Like you were saying, there's really no fresh food in a lot of these places. And also, the community aspect … Some of them are hooked up with nonprofit things that are actually educating …

ANDY CROSS:

Yes …

ALYCE LOMAX:

… helping people get job skills. Actually supplying the Whole Foods. So, this is exciting, holistic stuff for the long term.

ANDY CROSS:

And as we think about how they are actually expanding their store footprint and trying to increase sales per square foot with including things like the bar that they have in there …

CHRIS HILL:

Right …

ANDY CROSS:

Coffee, much more. It's actually a little bit … I'm kind of mixed on this. Sometimes it gets a little crowded because they're using the floor space to kind of peddle and introduce you to new goods. It gets a little bit crowded in there, but expanding into other lines and trying to make the experience of Whole Foods as not just going to a grocer, but you're actually going to almost a restaurant.

CHRIS HILL:

That's what you want to hear if you're a shareholder, right? The place is too crowded.

ANDY CROSS:

Yes.

ALYCE LOMAX:

Yes. And they're being entertained and having a nice drink …

ANDY CROSS:

Yes. And if only they can continue to push the throughput through the line, which is really important. That's a premium I'm willing to pay for.

CHRIS HILL:

I was just going to say. I'm still bitter about the fact … Right before we started taping, I felt really good about the Whole Foods closest to us here at The Motley Fool because they do have the bar where they have espresso drinks and all that sort of thing. Then I heard about the one near where Bryan lives where it's so big they have multiple restaurants. And a sports bar?

BRYAN WHITE:

A sports bar right at the front door. Yes.

CHRIS HILL:

Hoh! Now, I'm just bitter that there's not a sports bar in the one near me.

ANDY CROSS:

How long will it be until Whole Foods is actually in a sports arena? They may be. I don't even know.

ALYCE LOMAX:

Well, see, expanding the demographic like that … We do not know what is going to happen in 20 years, 10 years. Who knows? Maybe next year.

ANDY CROSS:

And that's a very important point. The stock really has pulled back pretty dramatically here over the last say …

BRYAN WHITE:

Yes …

ANDY CROSS:

… six months …

CHRIS HILL:

Yes …

ANDY CROSS:

… and some members who are listening, who own the stock, may be wondering what's going on. It's a $20 billion market cap and they do probably $1 billion in free cash flow. That's double where it was five years ago during the financial crisis. You have to understand that as they continue to expand that — whether it's internationally, domestically, new markets, test different store concepts, large, small — they are really trying to live up to their mission and do it in a way that is good for all stakeholders, which is a big principle of conscious capitalism. Over time, that's proven to win out and I think it still will. Twenty billion dollars — it's not a real large company.

CHRIS HILL:

Let's move over to Middleby and their latest earnings. Bryan, profit's up 36% …

BRYAN WHITE:

Yes …

CHRIS HILL:

… revenue up nearly 40%. Stock hitting an all-time high today. I mean …

ANDY CROSS:

It's making me hungry. Talking about Middleby now is making me hungry …

CHRIS HILL:

It's really …

ANDY CROSS:

For the stock and for …

BRYAN WHITE:

Well, they're executing against their strategy — which is essentially acquisitions fuel growth — so the top line near 30% growth is not a surprise. Organic growth was around 8.5%. It's that bottom line that long-term investors need to keep an eye on, because the strategy is to acquire smaller players that are inefficient, roll them into Middleby's system and improve the profitability. And then also the reach, too. When you flow them through Middleby's system, you expect some revenue growth, also. But the core reason to go out and acquire these businesses is to really improve their operations and their profitability. And quarter after quarter, they continue to show that they're having success.

ANDY CROSS:

Not just quarter after quarter. Selim's been …

BRYAN WHITE:

Yes, exactly.

ANDY CROSS:

… doing this for years. I mean, they shell out anywhere between … I don't know. Call it $50 million and $300 million in cash …

BRYAN WHITE:

Yes …

ANDY CROSS:

… acquisitions per year. They've gobbled up probably maybe more than 40 …

BRYAN WHITE:

More, yes …

ANDY CROSS:

… companies that are entering different markets with the Viking Range into the consumer market. So, Selim really has this and Bryan's exactly right. They have it down to a model and Selim's going to continue to operate it. He's a sales guy. I feel like he could … What's it? Sell me sand if I'm stuck in the desert. I just feel like he has that. And that's really what you want from a person who is an acquisitive CEO who's going to go in there and turn things for the better, absorb those companies and really drive sales higher. That's been good for shareholders. The stock's more than doubled here in 10 months, maybe. Something like that, right?

BRYAN WHITE:

Yes.

CHRIS HILL:

Well, and one of his strengths must be hiring. I'm assuming he has a smart team around him because …

BRYAN WHITE:

Oh, yes …

CHRIS HILL:

… it's one thing to make acquisitions. It's another thing to make them work well. A lot of companies, regardless of the industry, really struggle with acquisitions and it seems like Middleby is the exception to that.

BRYAN WHITE:

Well, that's an excellent point, Chris. A lot of times we'll focus on the capital allocator and give them all the credit. But absolutely, the managers underneath Selim are doing a lot of work … a ton of work. And look at what they've done with Viking. I mean, this was a business where their sales got cut in half during the downturn …

ANDY CROSS:

Yes …

BRYAN WHITE:

… and they're turning that around. EBITDA margins were up over 15% and that's way ahead of schedule, so they're doing really well.

ANDY CROSS:

And astute, outsider-esque CEOs, to borrow a phrase from Will Thorndike's book, they are very effective users of capital strategies … so, whether it's debt or equity … In Middleby's case, it's mostly debt equity benefitting from low interest rates. Going out there and finding companies they can acquire, bringing them into the family and improving operations. I mean, that's a recipe for success that you can do again and again.

CHRIS HILL:

Brian, last question on Middleby. The market cap's only about $5.5 billion …

BRYAN WHITE:

Yes …

CHRIS HILL:

Over the next five years, how much bigger can this company get?

BRYAN WHITE:

Oh, it can get quite a bit bigger, and I think over the next year or two … maybe three years … it's going to start to become more of an emerging-market story, and I think the investors will appreciate that a little bit more. We're a little ahead of the game because we look at the business and we focus on the business so much — but their food processing segment has a lot of opportunity out there in emerging markets. There's demand that's expected to pick up quite a bit in emerging markets for processed food — the food that we're used to shopping and filling our fridges with here in the U.S. Demand in emerging markets is expected to pick up.

And then we also have the big story in terms of food safety. Middleby will be rolling out its solutions in emerging markets, and we know that's a big story in China with Yum! brands. So, food safety's also going to drive sales from emerging markets for Middleby. It's got a ways to go. The story is far from over for Middleby.

CHRIS HILL:

All right. For Bryan White, Alyce Lomax and Andy Cross, I'm Chris Hill. Thanks for listening. We'll see you next week.

The Next Market Meltdown

Published Feb 24, 2014 at 1:18PM

In this exclusive glimpse at the *Motley Fool One* weekly podcast, listen as Robert Brokamp invites expert analyst Morgan Housel onto the show to discuss his new *Fool One* exclusive report, The Next Market Meltdown. Topics include:

- Why we should always expect a pullback (34 seconds in)
- Whether bigger drops lead to sharper rebounds (3:21)
- What caused the 10 biggest drops (5:17)
- What's a better predictor of the market: earnings growth or ... rainfall? (5:53)
- Is our optimism just survivorship bias? (7:35)
- How individual investors can increase their odds of landing gains (10:45)

Get the PDF of Morgan Housel's report

Listen to the Podcast

{% ooyala id="djOTV4ZDo02LHZT3CoBvkgTrEJ9xO7rJ" width="580" height="326" %}

Run time: 11 minutes; originally aired Aug. 22, 2013

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Podcast Transcript

Robert Brokamp: Hello everyone and welcome to the EP Weekly. This is Robert Brokamp sitting in for Chris Hill, and of course we're joined by Bryan White as always. But today we have a special guest, Morgan Housel, down from all the way in Baltimore. How are you doing, Morgan?

Morgan Housel: Doing well, thanks for having me.

Robert Brokamp: Great to have you here and we have you here because you are writing a special report that One members will get this week. It's called *[The] Next Market Meltdown*. So Morgan, are you a market timer?

Morgan Housel: I am absolutely not a market timer, but when I talk to fellow investors, when I communicate with readers at The Motley Fool and talk to my friends about investing, one question that keeps coming up quite a bit recently is look, stocks have come so far. Stocks recently hit all-time highs. We've pretty much gone straight up for the past four years. Are we due for some sort of market pullback, maybe something more like a market crash? And many people I have talked to are looking at this and getting nervous about it in a sense of is this a bad time to invest with stocks at an all-time high?

So I just want to think of different ways that I can think about stock crashes and pullbacks with the market at an all-time high, and I think there are two things that I thought about with this report. One is that the stock market being at all-time highs right now is really a matter of perception when you think about the rally we've had over the past four years. So yes, stocks are up about 170% since March 2009, which is an incredible four-year period. It's actually one of the best four-year periods in the history of the stock market.

But that's just anchoring, really focusing to the March 2009 lows. If you think about the last five or six years, since 2007, stocks have barely kept up with inflation, so it really depends on what starting point you're looking at when you talk about how far stocks have come. Two rational investors could look at the stock market and be amazed at how far it's come, or shocked at how flat we've been for the past six years, right?

Robert Brokamp: And I think even since 2000 on an inflation-adjusted basis, it's still not reached its peak.

Morgan Housel: Right, exactly. And then so the other thing I think about with market crashes is in this report I went back and looked at the long history of the Dow and the S&P 500, and I just counted the individual times that stocks have pulled back 10%, 15%, 20%, 30%, 50%, from its recent highs. If you look at 10% market pullbacks, that's happened 89 times since the 1920s, which is about once every 11 months.

So when people ask the question, Should we expect a market pullback, the answer is always yes, no matter what the economy is doing, no matter what that stock market has done recently, the answer should always be yes. These are just intrinsic things that the stock market does. It's a natural phenomenon on the stock market. And when you look at even big drops like 20%, that usually happens about once every four years, so I think most investors at The Motley Fool are investing for more than four years. We're talking about hopefully 10, 20, 15, 20 years we'll be investing for. So when you think that 20% drops happen on average every four years, you are going to experience hopefully several of those during your lifetime as an investor, so when I put those two together, that it's really not that clear how far, how overbought the stock market is and that these drops are much more inevitable than we think.

Really the conclusions that I come up with is that these things are unpredictable and that rather than trying to think about and time around them, we should just accept that they are parts of the stock market and that's just life as an investor.

Robert Brokamp: Right, so you have the drop; those drops are going to happen. The question then is how long does it take to get back to where you were, and you include some of that in your research as well.

Morgan Housel: Right, so historically the bigger the drop, the sharper the rebound that occurs after it. One of my favorite examples is in 1929, which is the massive crash of the Great Depression. From peak to trough, the stocks fell almost 90% during that period, but when you factor in inflation and dividends, stocks were back at an all-time high within six or seven years after that. And that was true for the financial crisis in 2009 too. That was the worst financial crisis in 80 years. It took four or five years for stocks to get back to an all-time high, so there's little precedent in American history at least, for stocks when you include dividends to crash and then not return to their all-time highs in less than a decade, and usually much faster than that.

Robert Brokamp: Right, and then there's the question of all right, so you were saying it happens pretty regularly, so you could think, well, if it happens that regularly, maybe I can predict it, maybe I do know what happens. And also in your report you talk about, all right, so what causes these crashes?

Morgan Housel: Right.

Robert Brokamp: And the answer is really, they're pretty unpredictable.

Morgan Housel: Right, it's really we don't know. You know the biggest factor is it moves stocks around when we have crashes like this is just human psychology. It's people getting optimistic and then people getting fearful. People move in hordes and in droves, they all move together. There's a great quote that I like that says, "Nobody knows what the American people are going to do next, but we know that they're all going to do it at the same time. And that's really true for the stock market. We really don't know when people are going to get fearful or greedy next and there's really no way that you can forecast human emotions like that. We know that people are going to change their moods significantly from time to time, but it's really difficult to nail down the precise timing of that.

Robert Brokamp: Right, and you cite some research by Jeremy Siegel about the causes of the top ten biggest drops. There are things you couldn't predict, like the September 11 attacks, things like that.

Morgan Housel: Right, yeah, so Siegel went back and looked at I think the 20 biggest market drops in the last hundred years, and at least ten of them were tied to things that nobody could have seen coming before hand. President Eisenhower having a heart attack, the start of wars, September 11, things like that. No one could have predicted those things, even 24 hours before they occurred.

Robert Brokamp: Right.

Morgan Housel: So it's certainly not something that we can sit here and try to guess what the stock market's going to do over the next ten years.

Robert Brokamp: Right, so there are events, but then there are various metrics you might want to look at and say like, Oh, this tells me that what the stock market's going to do and some other research you cite is from Vanguard. So you tell us, what has the biggest correlation to future returns: P/E ratio, 10-year Treasury yield or the amount of rain?

Morgan Housel: Right, so there's this really interesting report. Vanguard, the fund giant, looked back at all these interesting metrics that analysts use to forecast where stocks might go next. They just looked at these metrics and said, Okay, in hindsight, how good are they at explaining what the stock market is going to do over the following ten years? So they looked at things like the P/E ratio, the trend growth that the economy is growing at, how fast earnings are growing, things like interest rates and profit margins. Virtually all of them explain next to nothing about where stocks are going to go next during the following ten years.

The biggest, the most important variable that tells us where stocks are going next is the P/E ratio. That's just the basic idea that you buy stocks when they're cheap and they'll do well over the following period; buy stocks when they're expensive, they'll do poorly after that. But even the P/E ratio explains only a minority of stock returns over the following ten years. And things like earnings growth and interest rates and profit margins tell us literally nothing at all about where stock might go in the next ten years, and that really all comes back to the point that what's really driving the stock market over time, in short periods of time especially, are human emotions, just how optimistic and fearful people are about the future.

Robert Brokamp: So I can get rid of that barrel in my backyard that measures the amount of rain? Because that's not going to help me.

Morgan Housel: That's not helping you at all.

Robert Brokamp: Darn, right. All right, so I'm going to play Devil's Advocate because this is all good news. This is all very encouraging. Sounds like you just have to buy and hold, that type of stuff. Some people might say this is actually a bit of survivorship bias and that we're looking at the U.S. market, twentieth century, the American century. We all know that the Japanese stock market is still down about 70% from where it was in 1990 and through most of that period it was the second biggest economy in the world. Great economy, bad stock market, only recently surpassed by China.

So are we focusing too narrow here or is there something so awesome about being American that we can believe in our stock market?

Morgan Housel: Well I think there are two things to think about. If you look at the long history of stock markets, there's one even that consistently throws all of this analysis out the window. There's one event that can really destroy long-term stock returns, and that's of course war. We really saw that a lot in the twentieth century with large developed countries that saw their stock markets go to zero and never recover. During World War II when your currency is destroyed, when you have a dictator in power that's going to really run roughshod over the economy, that's really the variable that can destroy stock returns. But that's not a way of living that I think is very intelligent and to sit here and to think that we're going to have another war and worry about that...

Robert Brokamp: Or zombies.

Morgan Housel: Or zombies. That might be something to worry about. I think when you talk about Japan, the key variable there is that the Japanese stock market has done nothing for the past 25, almost 30 years. The big factor there is that the bubble that they had when stocks peaked around 1990 was like nothing we have ever seen in the United States. It put our dot.com bubble to shame really.

And really when you look at the Japanese stock market over a longer period, when you're not starting at the top of the bubble, but you look at the Japanese stock market over the past 40 or 50 years, it's done quite well. so really that just goes back to valuations, like we were talking about earlier, and that yes, if you buy stocks when they are grossly expensive, just off the charts expensive, then you're not going to do very well.

That's true of the Nasdaq too. The Nasdaq peaked in 2000 at around 5,000; I think today it's somewhere in the three thousands. It could be another decade or more before we return to an all-time high, so that would be 20 years or more before the Nasdaq recovers.

Robert Brokamp: Right, and the other aspect with Japan was they had a huge real estate bubble as well, and that never happens in America. But I was going to bring up the Nasdaq as well as my other devil's advocate because you looked at the S&P 500, and that says a lot about someone who owns an S&P 500 index fund, but individual investors, especially stock pickers, those are how fans of The Motley Fool, have different portfolios. I would say some of them probably have a portfolio that's closer to the Nasdaq. Still 30% down from where it was in 2000. From here you've got to get a return of about 40 or 45% just to get back to break-even.

So even if you are a U.S. investor investing in a major U.S. index, it doesn't necessarily mean that you will recover as well as the S&P 500 has.

Morgan Housel: That's absolutely right, and I think what that really shows is the power of diversification. If you have a portfolio that is heavily weighted toward one industry or even one broad sector like technology, that certainly increases your chances that you're going to go through very long periods of disappointment. It's really imperative for all investors I think to have a well-diversified portfolio.

That's not only true for individual stocks and sectors, but across assets too between stock, bonds, cash and real estate.

Robert Brokamp: Right, right, which I personally am a big fan of. The readers of *Rule Your Retirement* will know that that's one of our major points.

So that's all good stuff. The report will be available soon, if not by the time you listen to this podcast. Morgan, thanks for stopping by, and everyone else thanks for listening in and we'll talk to you next week.

Morgan Housel's Cash Strategy for Beating the Market

Published Feb 18, 2014 at 10:42AM

Do you hold cash in your portfolio? Many Foolish investors dismiss cash strategies as market-timing, short-sighted, or worse. But Morgan Housel disagrees. Find out why he believes the "optionality" value of cash is one of the biggest hidden opportunities for investors looking to build lasting wealth. Your cash isn't sitting ... it's waiting.

Get the PDF of Morgan Housel's report

Plus! Check out the *Fool One* podcast to hear our team talk with Morgan about what it takes to follow his cash optionality plan — and an investing exercise to try even if you can't stomach his strategy (starting at about 4 minutes in).

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Run time: 11 minutes

We hope you enjoyed this free bonus content brought to you by *Motley Fool One*. If you'd like a further behind-the-scenes look at this premier, all-access service — as well as the opportunity to take advantage of a wide range of free special gifts and exciting content from Motley Fool co-founder and CEO Tom Gardner and his entire *Motley Fool One* squad — simply click here.

Podcast Transcript

JASON MOSER:

Welcome to EP Weekly. I am your host this week, Jason Moser. Chris Hill is out of the office. I thought maybe it was just because of the snowstorm, but I think he's still up in Philly for whatever reason, so we'll go forward without him. It's going to be a slow week anyways, so not much to talk about today. We've got what? MasterCard news and really the news of the week for us we want to talk about — Morgan Housel's report that just dropped yesterday, if I'm correct...

MORGAN HOUSEL:

Yes...

JASON MOSER:

I'm joined in the studio today with Bryan White and Morgan Housel. Guys, thanks for being here.

MORGAN HOUSEL:

Good to be here.

JASON MOSER:

So, really quickly let's just cover this MasterCard news because, you know, share splits seem to always make a bit more news than they're worth. Stock splits to me are — we know they don't create a whole heck of a lot of value, but they do create a perception out there, at least, that shares maybe are cheaper than they were before, and with MasterCard you're getting ten new shares for one old one. You don't see many 10:1 splits like that — or much more you see reverse splits with big numbers — but not the other way around.

But I think the bigger news of this MasterCard release was the 83% boost in the quarterly dividend along with the new $3.5 billion share repurchase program. Bryan, you know, when I was looking at this news, the two things that stood out to me were the share repurchase program and the dividend because those are the way that MasterCard really returns their capital to shareholders first and foremost. The stock split, not so much. I mean, maybe they open that share base up to a new buyer. Who knows? What's your take on that?

BRYAN WHITE:

Well, I'd say the number one thing would be the buyback. That's probably going to add the most value for shareholders. The dividend — they still don't pay a very high dividend, so you're talking around the 1% range. The dividend's not a big deal. It's nice to see them up that and in the future maybe we can get to a 2% yield and then you can talk about a somewhat significant yield there at 2%.

The interesting thing about the stock split is obviously it's going to open up liquidity in the market. You're going to have a share price around $80. It's going to be more accessible for folks. And we don't care too much about that. We want management focused on the long term. But the good thing is the CEO and the leadership team has shown that they are focused on the long term. They let the stock run to $800 a share — so it's obvious that we're not talking about a company that splits every time they get to $100 a share and brings it back down to $50 or $25 a share.

So, this is a company that obviously there's been plenty of discussion ... and most likely from the institutional side ... asking for a split and things like that, so it's not such a big deal. They've shown that they're focused on the long term. They let the stock run to $800 a share, so it's not as if they're a company that always does stock splits and things like that.

JASON MOSER:

Yes, and again it's worth remembering too, with the share repurchases, that they do bring that share account down. I think that's really what you want to look for in the share repurchase authorizations is it's just an authorization. It gives them the ability to execute those buybacks — but really at the end of the day you want to see those buybacks resulting in the share count coming down ... which for MasterCard it has. Since 2009, it's down about 7%, so that's good. That means that they're not just offsetting a bunch of dilution and inflating earnings per share.

MORGAN HOUSEL:

So many share buybacks are just offsetting share issuances...

JASON MOSER:

Yes, absolutely...

MORGAN HOUSEL:

...and from options from the managers and whatnot...

JASON MOSER:

No question...

MORGAN HOUSEL:

...and it's really almost a trick that some companies can play on their shareholders by announcing, "Look. We're doing this major buyback," and it's really not doing anything to the share...

JASON MOSER:

It's always a headline, too. I think that's one of the first things I learned really quickly was to approach every share buyback headline with skepticism. I mean, the first thing I look at is to see what are they doing with those buybacks? Is that share count coming down...

MORGAN HOUSEL:

You know, really interesting. In 2007, it was the biggest year for share buybacks in history, and among the S&P 500, the actual number of shares outstanding went up that year...

BRYAN WHITE:

That is incredibly interesting...

MORGAN HOUSEL:

It was more buybacks than ever and shares went up — because that was the year, 2007, that companies were paying their CEOs $50 million a year in stock and options, so buybacks were just offsetting that...

JASON MOSER:

Yes, and with all these social media companies (Twitter, Facebook and the like) out here you know you're missing a lot of restricted stock awards ... options being granted to employees and stuff like that. So, tech companies you do see more of that dilution. But, yeah, it's one of those things to always keep an eye on.

MORGAN HOUSEL:

Yes.

JASON MOSER:

Well, we also want to talk this week ... Morgan, you had a report that just came out that really, when I read it last night, I was thrilled, because I share the same perspective. It's titled, "My Cash Strategy for Beating the Market..."

MORGAN HOUSEL:

Right...

JASON MOSER:

"See why Morgan Housel keeps up to 40% of his assets in cash." And I think this is a question that we deal with a lot in members asking, "I have this lump sum in cash. What do I do with it? I want to earn something on it. I don't want to just stick it in a savings account that's going to pay 0.1% or whatever." But you know, I've always felt that having that cash is an opportunity. It serves as what you called "optionality" in the report...

MORGAN HOUSEL:

Yes...

JASON MOSER:

...and so to me, when I read this report it makes a lot of sense. It's how I look at things, and I was really thrilled to read it. What prompted you to write this?

MORGAN HOUSEL:

Well, first I think it's important to point out that just because I keep this high level of cash in my portfolio, I'm not recommending that all of our members go out and do the same. It's really different for everyone. It's dependent on how much money you have, your risk tolerance, your age. So, it's really important to point out that this is not advice for people.

But how I think about cash ... You know, for the past five years, all investors have been looking at the yield that they earn on their cash. It's probably 0% or something close to that. And they say, "Well, look. I'm earning 0% on my cash. We've got 2% inflation. I'm losing money here and that's painful." And I think that's pushed a lot of investors maybe into bonds where maybe there's a lot more risk. Putting more money into stocks than they might be comfortable with.

But I think, as I explain in this report, there's another return you can earn on your cash. It's invisible. It's sort of this theoretical return. But I refer to it as "optionality," which is basically the idea that sometime in the future, stocks are going to crash again. If you have cash on hand to take advantage of those low prices, the value you get from having that cash around can be massive, and that extra value is basically a yield that you are earning on your cash by holding it today that you don't really know of yet. And it's really important.

There's one quote that I had in the report from Warren Buffett and his quote was, "Cash combined with courage in a crisis is priceless." And that's really true. Having cash around hurts when the market is going up. When the market crashes, it's just the most beneficial thing you can ever have around.

And the other point I made in the report, too, is that for your long-term wealth measured over decades, what's really going to hurt your wealth is not necessarily earning a low return on your cash. It's being forced to sell stocks when you don't want to because of unemployment or illness or divorce or whatever it may be. If you're forced to sell stocks when the market is down, that's going to crush your long-term net worth.

JASON MOSER:

Yes, I guess that brought out the economist in me and I'm sure in you, right there ... just the whole idea of being a desperate seller ... whether it's stocks or a house or whatever it may be. You don't want to get caught in a position of being a desperate seller because you really limit your options at that point. Bryan, what stood out to you in this report as far as maintaining cash balances? Is that something you agree with? Is it something you prefer to stay 100% invested or get your money elsewhere where it's even earning some small yield?

BRYAN WHITE:

First, I would say it is an excellent report, Morgan. I enjoyed it thoroughly...

MORGAN HOUSEL:

Thanks.

BRYAN WHITE:

And I agree with what Morgan said to start off. Everything is different, right? I'm young. I tend to skew toward I want, throughout my investing career, to be able to take advantage of the major opportunities. We saw one in '08, '09. I'm young enough where I think I can get one or two or maybe three of those. Those are massive wealth-building opportunities and you cannot really take advantage of them unless you have some cash. So, it's different. If I was in retirement, I'd think much differently. I hope that would not be my focus, because I may not see one of those. It depends where you are in your time frame.

And then Morgan, the quote that you brought up is fabulous. So, if you're at home and you're a member, and you're thinking about this report and it appeals to you ... here's the thing that you have to definitely think about also and prepare for. You have to prepare for the emotional ... the feeling that's going to happen. If stocks drop 20% — if the market drops 20% — are you truly going to be willing to pull into your cash file and go all in or go a significant portion in?

Because it's easy to say, but it's hard to do. The good thing is, for everyone at home, we have a good measuring stick ... '08, '09. How did you feel? What were your emotions like? Were you scared? Were you mad at everything in the world in terms of stocks and market? Did you think it was all rigged against you? Those kinds of things will tell you probably how you're going to feel next time. So, it's not really smart to go after a strategy of 20, 30, 40% cash if you know you're the type of person that is going to become very, very fearful when everybody else is.

MORGAN HOUSEL:

Right. It's much easier said than done...

BRYAN WHITE:

Yes. You need to know your personality if you're going to employ something similar.

JASON MOSER:

I think there's a technical term for having the ability to pull the trigger like that. It's called "intestinal fortitude."

MORGAN HOUSEL:

Right.

JASON MOSER:

Make sure you have the intestinal fortitude to pull the trigger. In one other part of this report, I will encourage members to go through and actually do this exercise. You know, Morgan, you provide a road map...

MORGAN HOUSEL:

Yes...

JASON MOSER:

...and I know this road map would be different for everyone depending on what stage you are in life. Are you protecting your wealth? Are you growing your wealth or whatnot? And maybe it's not even a road map that you adhere to strictly, but it's a first step. It gets it down on paper. It gets your thoughts out there of if the market falls by this much, I would invest this much. And how often may this happen? It really, I think, helps to provide a lot of perspective and I think that no matter what stage you are as an investor, it could be a helpful exercise to do and then to also go through and revisit maybe once a year. I think that having a road map like that is just a wonderful exercise.

MORGAN HOUSEL:

Yes. It's really important to think of these things before they happen — because when a crash comes, you're probably not going to be thinking straight — and if you're just trying to figure it out ... if you're trying to figure out what to do with your cash in October 2008, you're probably not going to be thinking ... It's good to figure this out beforehand. Have it written down on paper. Here's what I would like to do. Here's what I plan to do. You might not follow it to a T when it actually arrives.

BRYAN WHITE:

Well, here's the thing, Morgan. Actually in 2008, if you were heavy in cash, you'd feel like you were the smartest man alive.

MORGAN HOUSEL:

Sure. Absolutely...

BRYAN WHITE:

...and you're probably pretty hesitant to dip into that and go into the stock market because you're laughing at all the fools that are 100% invested and rah rah through 2006, 2007...

MORGAN HOUSEL:

And that cash just saved your rear end. You don't want to get rid of it. It's your best friend.

BRYAN WHITE:

Yes. So, it's tough. You definitely need to think it through.

JASON MOSER:

Cash will save your rear end. Let's leave it there, guys. For Bryan White, Morgan Housel ... guys, thanks for being here...

MORGAN HOUSEL:

Thanks a lot.

JASON MOSER:

...and we'll see you next week.

Portfolio Building Report

Published Nov 20, 2013 at 12:00PM

AmTrust Financial Services (NASDAQ: AFSI) | **Apple** (NASDAQ: AAPL) | **Broadridge Financial Solutions** (NYSE: BR)
The Buckle (NYSE: BKE) | **Gentex** (NASDAQ: GNTX) | **Intel** (NASDAQ: INTC) | **MasterCard** (NYSE: MA) | **OpenText** (NASDAQ: OTEX)
Oracle (NYSE: ORCL) | **Papa John's International** (NASDAQ: PZZA) | **Starbucks** (NASDAQ: SBUX) | **Wells Fargo** (NYSE: WFC)
WisdomTree Emerging Markets SmallCap Dividend Fund (NYSEMKT: DGS) | **The *Pro* Bottom Line**

Download this report as a PDF

Dear *Pro* Member,

The way we manage *Pro* is pretty simple: We own a portfolio of investments that we expect to earn healthy positive returns over every rolling three-year period, so we can double our real purchasing power (that's after inflation) every 10 years. We own strong stocks and promising ETFs; we hedge to protect gains; we "sell short" to profit on falling prices; and we use options strategically and for income. Whether you use all of our strategies or just own *Pro* stocks, our mission is to earn you strong returns over our time frame. That's likely the prime reason you're here. Not all of our investment decisions will be right, and we won't always come close to our constantly positive North Star goal, but with a firmly plotted course, a stellar crew of analysts, and our wonderful community, we expect to stay firmly on track and enjoy the journey together — and to come out far ahead.

In our Most Recent Buys report last week, we highlighted our latest portfolio additions. Although those holdings may be our newest, shiniest toys, their true value is only apparent as a part of our larger portfolio puzzle. To complete that puzzle and execute our mission, we present to you this Portfolio Building Report, which summarizes our remaining Buy First and Buy positions.

Here are a few things to consider along the way:

- **Don't anchor on fair value.** We expect every investment we rate Buy First or Buy to play a role in helping us achieve the return goal stated in our mission. Yes, that's true even if the current stock price is a touch higher than our estimate of fair value! For one thing, our fair-value estimate is an imprecise figure, and for another, a "fair value" is really a range of values, one that doesn't take into consideration the holding's part in the portfolio puzzle.
- **Where to look first.** The reason we distinguish between Buy First and Buy is simple: We want to draw attention to our most compelling return opportunities at the moment for those members with limited capital available, or for those who don't follow the Pro portfolio step-for-step. Our decisions, however, are made in the context of all of the pieces of the portfolio puzzle, working in concert toward our mission.
- **What about Tupperware?** In October, we recommended writing puts on **Tupperware Brands** (NYSE: TUP). Those puts expired in November; some members may own shares (around 3%) as a result of that position or of our Alternative Trade recommendation. Although Pro has no official position in Tupperware right now, we will likely have an official follow-up recommendation soon. New members should hang tight and wait for the Trade Alert.
- **Say hello.** If you haven't already, please introduce yourself on our Meet & Greet discussion board. More than anything else, it's Pro's community that differentiates us from every other investing service in the world. Stop by, say hi, and carpool with the other intrepid members on this journey with us.

Onward,
— Bryan Hinmon, CFA, senior analyst

Buy: AmTrust Financial Services

Its talent at capitalizing on human laziness is just part of what we love about this insurer.

Suggested Allocation: 6.9%

What It Does

At *Pro*, we speak a lot about the importance and power of recurring revenue — mostly because we know that humans are inherently lazy. Insurance purveyor **AmTrust Financial Services** (NASDAQ: AFSI) handily proves this point for us; many of the policies it writes (more than 80% in most lines!) renew at the end of their term without their owners even shopping for a better rate. Most of us, it seems, are guilty of preferring inertia to bargain-hunting, and AmTrust and its fellow insurers are the beneficiaries.

AmTrust focuses on insurance niches (primarily workers' compensation and product warranties) that are low-hazard and generally too small for large insurance companies to care about. But though AmTrust writes small policies, it's no small fry. Its high renewal rates and predictable cash flows allow it to focus on writing new policies, look for struggling insurers to acquire, and hunt for obscure investment opportunities.

How It's Working

AmTrust's strategy — being a disciplined underwriter of low-hazard, small policies in well-defined niches; using technology to keep its expenses low; and opportunistically acquiring policies other insurers struggle to find profitable — has resulted in impressive growth. Gross written premiums have risen from about $1.1 billion to about $3 billion over the past five years, and this increase, combined with a laser-like focus on low expenses, has resulted in consistent growth in earnings, dividends, and book value.

What We Expect

More Resources

- [*Pro*'s recommendation history]
- [Talk about AmTrust on our discussion board]

The insurance market works in cycles, and recent signs indicate an upswing on the horizon, which means pricing and profit should improve across the board. AmTrust should thrive in a strengthening market: It can charge as much as its competitors and make more in profits thanks to its lower expense structure, or it can undercut the competition on price in a bid to take market share. If the economy continues to improve, the small businesses AmTrust insures should hire more workers and consumers should purchase more insurable goods, so there seems to be plenty of growth ahead.

AmTrust has consistently traded higher than our estimate of fair value, but we believe the company's premium valuation is warranted given the consistency of its growth, quality, and profitability. AmTrust is *Pro*'s largest holding, and we're happy to let this winner run, expecting to increase our fair-value estimate over time.

Buy First: Apple

The leader in mobile computing products is cheaper than it's been in years.

Suggested Allocation: 3.5%

What It Does

Led by its iPhone and iPad, **Apple** (NASDAQ: AAPL) designs computing devices that people love to use. Its products tie into the Apple operating system, which centers on its iTunes and App Store marketplaces. Apps turn a piece of hardware into a personalized, go-anywhere computer that becomes ingrained into the user's daily life.

The company's uniquely integrated hardware and software have made for a great consumer experience that provides disincentives to switch to a competitor. Apple will have to fight harder to win new customers as competitors close the quality gap, but we maintain that it remains one of the best companies in the world, with the best products in its class, and it has one of the least expensive stocks among large caps.

How It's Working

Apple refreshed all of its product lines over the past 12 months, with the iPhone 5S achieving record debut sales and brand-new iPad models reportedly selling like hotcakes (literally, they're so thin). The iPad may set new sales records, too, this holiday quarter. This year's product refreshes show that Apple has not lost its touch and is not chasing the lower-priced market, instead aiming to protect profit margins. We like this choice. We also like that Apple is taking time to debut a new product category, which it hints it may do in 2014. Whether it's a TV, watch, or something else, Apple needs to get the product right and should take its time. It remains the most cash-rich company on earth, and generates tens of billions of new free cash flow every year.

More Resources

- [*Pro*'s original recommendation] (2/14/12)
- [Talk about Apple on our discussion board]

What We Expect

In the longer term, we expect more great innovations from Apple, including whole new product categories. Meanwhile, we believe customer loyalty will drive healthy recurring sales, and new customers, new market expansion, and product refreshes will fertilize stability and growth. The stock is too inexpensive for such a high-quality company at the very heart of the mobile computing revolution.

Buy: Broadridge Financial Solutions

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 4.0%

What It Does

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. **Broadridge Financial Solutions**' (NYSE: BR) investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in 2013, its platforms processed 85% of all shares in the U.S. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider to manage investor communications.

The company's smaller segment, securities processing solutions, accounts for 27% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance Broadridge technology kicks into action — the company processes more than $5 trillion worth of global stock and bond trades each day.

How It's Working

Both earnings and free cash flow are modestly depressed because mutual funds have been scrimping on investor communications recently and investor skepticism around the global economic recovery has led to low trading volume. Still, in fiscal 2013 Broadridge grew sales 6%, grew earnings 11%, raised its dividend by 17%, and continued to position its business for strong sales and margin performance for years to come. And Broadridge continues to serve its customers masterfully; its 99% retention rate sets the stage for recurring revenue (and deepening relationships) in future years.

What We Expect

More Resources

- *Pro*'s original recommendation (4/27/10)
- Talk about Broadridge on our discussion board

We think Broadridge will continue to write the e-book on electronic investor communications. Its dominance of this market should strengthen its competitive advantages, making it indispensable as transparency in the financial system increases. We also expect banks and brokerages to continue outsourcing their non-core operations to save money and increase flexibility; this should bring increased business and greater efficiency to Broadridge. We expect modest sales growth to translate to earnings growth around 10%. Much of Broadridge's revenue is recurring, making its sales and earnings growth highly reliable, and its impressive free cash flow will likely bring an ever-higher dividend and increased share buybacks.

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns.

Buy: The Buckle

This well-managed retailer has fit into its jeans admirably over the past decade.

Suggested Allocation: 3.0%

What It Does

The Buckle (NYSE: BKE) sells jeans, other apparel, and accessories at 452 retail locations across the United States, and we think the fantastic management team has figured out a formula that works: measured growth, middle-of-the-road merchandising, and great service.

Your *Pro* team doesn't know much about fashion, but we can read financial statements. And if the next decade of business performance by specialty retailer **The Buckle** (NYSE: BKE) looks anything like the last one, we'd be willing to wear whatever getup the company suggests. The store concept is in the middle of its life cycle, and the company's financial prudence and operational acumen should lead to a growing stream of free cash flow, dividends, and extra payouts — all of which can help the *Pro* portfolio in our pursuit of our North Star.

How It's Working

The Buckle is a surprisingly steady operator in the notoriously fickle specialty retail space. The company reported modest same-store sales growth of 2.1% last year and has notched another 2.2% gain through two quarters so far this year. We accept a degree of lumpiness here and don't get too bent out of shape when these numbers bop around — The Buckle's target demographic is fickle teens and twentysomethings, after all. We simply monitor these figures for clues about the overall shopping experience and brand relevance. Management's stellar performance has earned getting the benefit of the doubt:

Metric	2002	2012	Annual Growth
Stores	304	436	3.7%
Sales per Store	$1,339	$2,387	6.0%
FCF per Store	$57	$406	21.6%
Sales per Square Foot	$274	$475	6.0%
Inventory Turnover	4.7x	6.0x	3.0%

Dollars in thousands. Per-store calculations based on average stores open during the period. Sources: SEC filings, S&P Capital IQ, analyst estimates.

What We Expect

More Resources

- *Pro*'s original recommendation (6/20/12)
- Talk about The Buckle on our discussion board

With 452 stores at the end of fiscal second-quarter 2013, we believe The Buckle has plenty of room to grow as it expands from the middle of the country to both coasts; it should be able to achieve wonderful store economics with the 650 to 850 locations we ultimately expect. Recent expansion into footwear, accessories, and children's offerings should provide enough fuel to keep same-store sales healthy, while the company's commitment to customer service entices repeat visits.

The Buckle also has a history of paying special dividends with its excess cash; it's done so for six of the past seven years. Just last December, *Pro* members holding the stock received a $4.50-per-share payout from the company in addition to the regular $0.20 dividend. Naturally, we encouraged all members to celebrate by buying themselves and their loved ones a few new pairs of jeans. While we can't count on special dividends, the average yield over the past six years, including special dividend payouts, has been approaching North Star-level returns.

We're typically leery of the risks of investing in retail, especially fashion, but the proof is in the numbers for The Buckle.

Buy: Gentex

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 3.5%

What It Does

In 1982, a small company in Zeeland, Mich., called **Gentex** (NASDAQ: GNTX) made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors.

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. Today, the company commands almost 90% of that market, and it sells eight times more units than its closest competitor.

How It's Working

In 2000, the company sold 6.8 million units; in 2012, it sold 23.8 million. That growth has been driven by an increased focus on safety, higher car sales, and greater market penetration (more car makers offering Gentex mirrors as a trim option). Gentex has turned these market dynamics into wonderful financial performance. Revenue has risen by nearly 20% per year since 1987, and over the past decade, the company's net margins have bounced around the mid-teens. Those numbers are shockingly good for an auto-parts supplier, showing that its fancy mirrors are showing up in more and more new cars.

What We Expect

More Resources

- *Pro*'s original recommendation (5/29/12)
- Talk about Gentex on our discussion board

Currently, fewer than one in every four cars made worldwide has an auto-dimming rearview mirror, and only 6% have auto-dimming exterior mirrors. For context, prior to 1987 those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher penetration; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More and more technology is finding its way to the auto mirror, both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. Gentex makes the rear view look good, but the view out the windshield looks even better for this steady-growth company.

Buy: Intel

Rumors of the PC's death have been greatly exaggerated.

Suggested Allocation: 4.6%

What It Does

Intel's (NASDAQ: INTC) goal is to be "the preeminent computing solutions company that powers the worldwide digital economy." Whether it's a high-speed server for a data center, a new Ultrabook with a touchscreen and detachable tablet, a new smartphone, a tablet, a car, or just about anything else: Now more than ever, Intel has the computing technology to drive it.

Admittedly, the company was late to the smartphone and tablet markets, but there's a silver lining: As these devices eat into PC sales, investors' fear about Intel's tardiness brings us the value opportunity we see in the stock. And because smartphones and tablets have very short life cycles, Intel can catch up quickly by steadily inserting its technology into new product designs.

How It's Doing

Intel asserts that the tablet is broadening the PC market, not shrinking it, and we agree. Tablets are wonderful for what they are, but it seems likely that the PCs of tomorrow will have the best qualities of both a tablet and a PC. If not, people will continue to need tablets for some uses, and PCs for others (which is fine with us, too!). Intel's new Atom chips are making their way into an increasing number of new tablets and smartphones – and Intel's chips continue to power the vast majority of all PCs, in whatever form they take. High-powered servers are also selling in record numbers as the cloud is built.

More Resources

- *Pro*'s recommendation history
- Talk about Intel on our discussion board

Intel is investing for greater growth in computing devices, period, whatever shape they take. Wall Street is leery of the company's expensive capital investment plans, designed to maintain its leading-edge manufacturing abilities, but we view this spending as a strong indicator for the company's future. Intel's confidence in the future of microprocessors seems well-placed in our increasingly digital age; as the number of devices connecting to the Web grows exponentially, so does the need for more computing power.

What We Expect

Historically, buying true blue chips (Coca-Cola, Johnson & Johnson, IBM …) when they're out of favor has been an excellent investment strategy. We believe Intel will fit that bill, too. Eventually, we believe Wall Street will realize Intel is here to stay -- and is indeed at the heart of a worldwide computing revolution. When that happens, investors will start to price the stock at a valuation that at least matches,if not exceeds, the market average. In the meantime, we can buy it at a good discount and enjoy a 3.7% yield, too.

Buy: MasterCard

Plastic is overtaking paper as the world's way to pay, and MasterCard leads the charge.

Suggested Allocation: 4.8%

What It Does

MasterCard (NYSE: MA) is among the most attractive businesses in the world. Here's why: The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders, who are actually exposed to the card users' finances; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

Though MasterCard competes with a very large number of well-heeled and (in some cases) innovative businesses, the company's profitability is growing quickly even though the global economy isn't. And that makes perfect sense, because when it comes to paying for stuff, the global market leader isn't **Visa** (NYSE: V), or PayPal, or banks ... it's cash. While MasterCard's stock price has risen since we recommended buying in September 2011, our thesis remains intact: Cash has a still-astounding 85% market share of transactions, but it's slow and inefficient, and with no one managing its brand, it's quickly losing out to better alternatives.

How It's Doing

More Resources

- *Pro*'s original recommendation (9/8/11)
- Talk about MasterCard on our discussion board

This trend has already taken hold in the U.S., where we use cards for a third of our personal expenditures, so Americans often underestimate the opportunities — domestically and especially in developing nations. In the first nine months of 2013, MasterCard processed $2.1 trillion in purchase volume, $1.4 trillion of which came from outside the United States. Growth in its U.S. business was 7%, strongly outpacing our economy (as measured by GDP). And worldwide growth, excluding the U.S., clocked in at a tremendous 15.4% in local currencies. Cash is losing, and fast, but there's a long way to go — and a lot of opportunity for MasterCard.

What We Expect

Management recently confirmed guidance for continued 11% to 14% compounded annual revenue growth and 20% earnings-per-share growth through 2015. We think this is possible under current (difficult) conditions, and we expect even better if economies around the world can turn the corner. CEO Ajay Banga and team are doing a tremendous job moving the company forward, so much so that results have outpaced our expectations every quarter since we bought shares. We expect MasterCard will continue to surprise the world with its strong growth for years to come.

Buy: OpenText

This company's information management software keeps the digital lives of businesses in order.

Suggested Allocation: 3.1%

What It Does

OpenText (NASDAQ: OTEX) sells software that lets companies organize and manage their growing reams of electronic content. Its products help companies, governments, universities, and others operate more efficiently and effectively, meet compliance requirements, and communicate with colleagues, customers, and partners.

OpenText is the leading independent provider of solutions in the enterprise content management (ECM) market and a leader in the broader enterprise information management (EIM) industry. Its top competitor, **IBM** (NYSE: IBM), may be larger, but OpenText enjoys longstanding sales relationships with **Microsoft** (NASDAQ: MSFT), **Oracle** (NYSE: ORCL), and **SAP** (NYSE: SAP).

With its newly planned acquisition of privately held GXS Group for $1.1 billion, OpenText is also positioned to become the largest provider of business-to-business transactions in the world, ahead of IBM. This should lead to strong recurring, high margin, transactional revenue, and more customers to whom to cross-sell.

How It's Doing

More Resources

- *Pro*'s original recommendation (8/31/11)
- Talk about OpenText on our discussion board

OpenText has increased sales and cash from operations by more than 14% annualized over the past three years, and seeks to continue to grow by at least 10% annualized as its industry expands. Trading at 14.5 times free cash flow, the business is attractively priced to increase shareholder value by at least its annualized cash-flow growth rate.

What We Expect

Electronic content management industries served by OpenText should increase top-line demand by at least 10% annualized over the next several years, and OpenText should take market share, too. OpenText has a long history of steady growth through acquisition, and enjoys diversified software sales to multiple industries. With new products rolling out in cloud services (off-site servers), renewed sales execution through more distribution channels, exciting acquisitions in the works, and an intense focus on its financial performance, this medium-sized company looks to have a big future.

Buy First: Oracle

This old-guard tech giant has more room to grow.

Suggested Allocation: 4.4%

What It Does

Oracle (NYSE: ORCL) is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems** (NASDAQ: CSCO), **Dell** (NASDAQ: DELL), and **Microsoft** (NASDAQ: MSFT) — Oracle's stock price has steadily risen as its business has grown.

Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe. And when it comes to hardware, Oracle's own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

By combining its software expertise (both in the traditional sense and in the cloud) with its young hardware business, Oracle is poised to experience another period of growth. The business is incredibly sticky — companies don't trust their data to just anyone, and it can be tricky and even risky to make a switch. So to add to its revenue base, Oracle mainly needs to cross-sell new products to existing clients, while continuing to rope in new clients with its great breadth of modular software solutions.

How It's Doing

Leading software sellers can write a program once and sell millions of copies, then provide small but critical updates on a regular basis. These updates drive a subscription business model, which leads to recurring revenue. Most of Oracle's customers renew annual software contracts that represent more than 40% of its revenue. This is stability on which Oracle can grow.

Where is it looking to grow? Oracle is targeting new cloud software sales, software as a service (SaaS), and groundbreaking data hardware sales — and we're pleased with its progress to date and the prospects of all three.

More Resources

- *Pro*'s original recommendation (9/17/09)
- Talk about Oracle on our discussion board

In the fiscal year 2013 that ended May 31, Oracle's new software sales topped a record $10 billion, up 6% in constant currency. Non-GAAP earnings per share rose 11% to $2.68, non-GAAP operating margin hit an all-time high of 47%, and free cash flow hit a record $13.6 billion.

What We Expect

Wall Street loves growth, but it especially loves growth that comes with higher margins. Oracle trades at 11.4 times free cash flow, well below the S&P 500's average in the mid-teens. With management expecting more operating leverage ahead and growth in hardware sales, the stock should produce a North Star-topping, 10%-plus annualized return over the coming three years. We expect the company's hardware and modular software combinations to continue to create a clear value proposition, driving new sales. We also expect Oracle's transition into more SaaS and cloud sales to go smoothly. With 390,000 customers, including all 100 of the Fortune 100, Oracle is the company we admire most and want to own in the enterprise software market.

Buy: Papa John's International

Deliver a slice of the profit pie right to your doorstep.

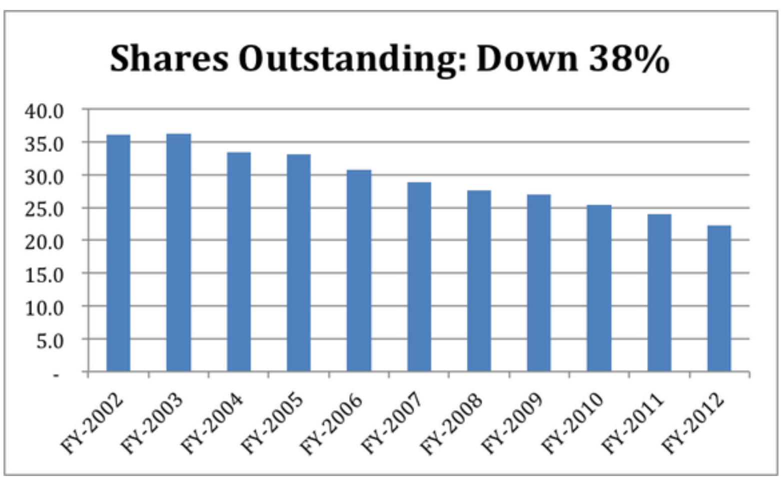
Suggested Allocation: 3.7%

What It Does

Papa John's International (NASDAQ: PZZA) operates and franchises more than 4,000 pick-up and carry-out pizza joints in more than 35 countries. For the past 30-plus years, Papa John's has been making pizza and building its brand around the "Better ingredients, better pizza" tagline. Bringing that unwavering focus to each pie has resulted in the company's perceived quality advantage over its big-chain pizza competitors, which allows it to consistently price a dollar or two higher and attract the best franchisees. Now that its brand advantage is sufficiently established in North America, Papa John's is turning its sights abroad, believing that delicious American pizza is a language every taste bud speaks.

How It's Working

As sure as a fresh pizza will be gobbled up by hungry kids, Papa John's delivers results. For nine consecutive years, the company has recorded positive or even North American comparable-store sales growth. Recently, international comps have been in the 7% range, offering lip-smacking evidence that Papa John's flavors travel well. It has opened more than 230 restaurants in both of the past two years, a pace which should continue. And because Papa John's is primarily a franchisor, it doesn't have to bear the cost of that expansion (it is taken on by the franchisees). Competing for a share of the global appetite is tough business, but Papa John's has been able to increase sales and profits at commendable rates over the past decade, which has resulted in plenty of cash generation. Management recently initiated a dividend and has consistently bought back stock over the years.



Source: S&P Capital IQ. Shares in millions.

What We Expect

More Resources

- Pro's most recent update (10/18/13)
- Talk about Papa John’s International on our discussion board

We believe the company will maintain its brand positioning, modestly improve underperforming franchise locations, and continue to be an attractive entrepreneurial outlet for new franchisees abroad. We think the brand can easily support 6,600 worldwide locations by 2023. The company should also be able to take modest market share from mom-and-pop pizza shops in established markets as digital ordering continues to gain adoption; it's a tough hurdle for smaller players to overcome. With a little bit of menu innovation and new markets maturing, we believe 2% same-store growth is sustainable over this period. We rate shares a Buy and encourage members to do plenty of field research on this one.

Buy: Starbucks

You only think you go for the coffee — Howard Schultz & Co. are serving up an experience.

Suggested Allocation: 3.4%

What It Does

You may not realize it, but “**Starbucks**” (NASDAQ: SBUX) is no longer a synonym for “coffee.” In January 2011, the company dropped the word “coffee” from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense it’s just a front. We think we go to Starbucks for the coffee, but those little white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

Starbucks began opening America’s eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 19,700 stores in 60-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences to fill more than 70 million mouths and hearts each week.

How It’s Working

By placing the customer experience first, Starbucks has cemented its role in the daily lives of consumers worldwide. People demand their Starbucks products at home, too, which has allowed the company to build out a consumer packaged-goods division that sells more than $1 billion worth of products in more than 100,000 locations worldwide. And the company is cultivating a portfolio of other brands (Evolution Fresh juices, Teavana tea bars, La Boulange bakeries) whose products can be sold in Starbucks stores and grocery stores alike. Between coffee, health foods, and tea, Starbucks believes its end markets are a massive $140 billion and growing.

Recent results have been robust. Starbucks continues to add stores at a rapid clip, and its same-store sales have been growing by an astounding 7% per year. Earnings and cash-flow performance have increased even faster, and all of this growth has been achieved by doubling down on the in-store experience and refocusing on quality. Starbucks constantly seems to be setting new records for sales, operating profits, and earnings.

What We Expect

More Resources

- *Pro*’s original recommendation (8/22/12)
- Talk about Starbucks on our discussion board

Given its very recognizable brand, artfully crafted business, and fanatically loyal customers, we expect Starbucks’ diversified growth to continue. We believe the world’s coffee and tea drinkers will happily support 30,000 or so stores across the company’s various brands, and that products bearing the aspirational Starbucks brand will expand the company’s real estate on grocery-store shelves.

The company’s scale and its ability to raise prices should help profits, as will its unique advantages in low-cost marketing. Starbucks is a pioneer in social marketing, and is perhaps better positioned than any other brand to reach out to its customers, nurture their relationship with the company, offer deals, and customize experiences.

Starbucks is riding high since CEO Howard Schultz’s return to power in 2008, and it now has so many levers to pull that capturing its potential value in a spreadsheet is very difficult. We’re not worried that shares trade higher than our fair-value estimate; we think Schultz & Co. have many tricks up their sleeves that will allow Starbucks to grow into and beyond its current valuation, and we want to be along for the caffeinated ride.

Buy: Wells Fargo (WFC)

At heart, banks are simple businesses, and Wells Fargo is the best of the breed.

Suggested Allocation: 2.7%

What It Does

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** (NYSE: WFC) is the type of company you’ll want to own before you take the plunge. It’s large, it’s strong, its operations are diversified, and its customers love it. Wells Fargo’s community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 9,000 branches and 12,000 ATMs. It’s the fourth-largest bank in America, it’s consistently No. 1 in customer satisfaction for American large banks, and it’s the leader in mortgage and small-business lending.

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up half of Wells Fargo’s business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During tough lending environments like this one, it’s easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

How It’s Doing

CEO John Stumpf and team are truly the best of the breed. Return on assets and equity for the most recent quarter (Q3 2013) were very attractive, at 1.5% and 14% respectively — great results given that the bank is using less leverage than before the financial crisis. Total revenue growth has been elusive, but expense reductions and improvements in credit quality have driven quarter after quarter of earnings growth, leading to record earnings. Deposit growth has been tremendous, and as Wells Fargo grabs additional "wallet share," fee income increases as well. The credit quality of the loan portfolio is impressive and is continuing to improve. All of this has contributed to a very well-capitalized balance sheet, allowing Wells Fargo to comply with upcoming capital regulation requirements well ahead of schedule.

What We Expect

More Resources

- *Pro*'s original recommendation (12/10/10)
- Talk about Wells Fargo on our discussion board

Wells Fargo's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. In the current low-interest-rate environment, we should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But when the U.S. economy firms up and loan demand resumes picks up, Wells Fargo's real earnings power — bolstered by growth in fee-based revenue — will hit its full stride. And many customers who start a deposit account or mortgage with Wells Fargo will explore the company's offerings in other areas, too.

Shares are trading at less than fair value, and they yield a growing 2.8% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. *Pro* has also used options in the past to generate even more income from this position, so try to invest using round, 100-share lots if it keeps you within half a percent (plus or minus) of our 2.7% allocation. If that's not feasible for you, share ownership alone is fine, too; with its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund

Diversification with some of the best small companies you've never heard of.

Suggested Allocation: 1.9%

What It Does

At *Pro*, we would love to invest in emerging-market small caps if it were easily accomplished and we could diversify. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund** (NYSEMKT: DGS).

This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields about 3.5%). For *Pro*, it offers exposure to 521 of the most promising business we've never heard of.

This ETF gives us an excellent way to invest in unfamiliar companies in locations where we don't have a discernible edge — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The risk-reducing benefits of investing outside our home market are equally important.

How It's Doing

It's no surprise that small-cap companies (even dividend-paying ones) in emerging markets can be volatile. We expect DGS itself to continue to experience higher-than-average volatility, even though the diversification it brings to our holdings will likely lower the portfolio's volatility overall.

More Resources

- *Pro*'s original recommendation (11/22/10)
- Talk about DGS on our discussion board

We'd always prefer to own great businesses over great ETFs, so this holding has a permanent spot on our short list of positions we'd sell if we needed cash or found a higher-conviction alternative. In the meantime, for a reasonable 0.64% expense ratio, we get a basket of businesses with a history of exceptional performance, weighted by the size of their annual cash dividend. The fund's heavy weighting toward financials (23%), industrials (16%), and the consumer discretionary sector (14%) leaves it well positioned to benefit from an economic recovery if and when one comes along.

What We Expect

This is a top-notch fund, and you don't have to take our word for it; Morningstar has bestowed its coveted five-star rating on DGS. It's also made Morningstar's list of the top eight funds in its category in each of the past three years, and it's ranked No. 2 when considering five-year performance. We expect these impressive long-term results to continue. In the meantime, the watchword with small-caps, emerging markets, and this ETF is: patience.

The *Pro* Bottom Line

Once you've purchased our most recent buys, and the Buy First and Buy stocks in this report, you will be on your way to building your *Pro* portfolio with us! If you want to start slowly and average in, that is a Foolish approach, too. Some members buy positions in halves, or thirds, over several months. Just be sure, over time, to at least approximate our allocation guidance, since that's key to our portfolio approach. In the coming weeks and months, we will also lead you into *Pro* shorts and options (for members using those strategies with us) with real-time opportunities. Just watch your inbox for trade guidance.

Welcome again to *Pro*! We'll enjoy investing with you. Fool on!

— Jeff Fischer, advisor

See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Pro's Most Recent Buys: November 2013

Published Nov 12, 2013 at 6:01PM

Dear *Pro* Member,

Pro is a premier service at The Motley Fool not only because it's a portfolio service that incorporates options, shorts, and hedges alongside core stock investments — but because it is a full portfolio solution, period.

Thought goes into each part of the portfolio, the allocation we give to every position, and how the positions all work together. This means that every addition to the portfolio, including our most recent, serves a specific purpose. The following report outlines *Pro*'s five most recent stock purchases. These investments are our newest "core holdings" that we believe every *Pro* member should own; we believe they'll bring very healthy returns over the coming years.

Welcome to *Pro*!
— Jeff Fischer, Advisor

Getting Started With *Motley Fool Pro* | **American International Group** (NYSE: AIG) | **American Tower** (NYSE: AMT)
O'Reilly Automotive (NASDAQ: ORLY) | **TD Ameritrade** (NYSE: AMTD) | **Valmont Industries** (NYSE: VMI)

Download this report as a PDF

Getting Started With *Motley Fool Pro*

1. **Know who we are and what we're after.** *Motley Fool Pro* is here to help you build a diverse portfolio that generates winning returns no matter what the stock market throws our way. Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star, which is inflation + 7% annually. For more, see our Strategy Guide.
2. **Make *Pro* Fit You.** We know not all investors are in the same situation! Our "Make *Pro* Fit You" PDF will help you figure out how to buy the Pro investments given your personal situation, including investing in an IRA or coming to Pro already fully invested.
3. **Catch up with our portfolio at your own pace.** Start with our most recent buys, delineated in this report. Then move on to the rest of our Buy and Buy First stocks in our Portfolio Building Report (hitting your inbox Nov. 20). You can always see our latest take on all of our positions on our What We Think Now page. As you explore our recommendations, it's important to remember that a stock's "scorecard status" (Buy First, Buy, or Hold) is the best indicator of how we feel about it. If a stock is listed as a Buy or Buy First on the What We Think Now page, that means we think you can buy it today.

Buy First: American Int'l Group (NYSE: AIG)

Time and even average performance should heal the company's wounds.

Suggested Allocation: 3.8% stock, 0.6% warrants

Today's **American International Group** (NYSE: AIG) is not the same company that disgraced itself so profoundly in 2008. AIG has divested itself of whole business units since the financial crisis, managing to eliminate almost all of its previous exposure to the nasty derivatives that nearly brought down the economy. Left behind are two steadfast and improving insurance businesses and an aircraft leasing company, and AIG plans to rid itself of the leasing business, too.

What It Does

Insurance is a business of collecting premiums, investing the float, and paying out claims — and AIG is getting ever better at it. Improved underwriting is showing up in a lower loss ratio, which in turn is driving a lower adjusted accident-year combined ratio. All that is a fancy way of saying that we're seeing underwriting profits for the first time since Q3 2010.

AIG's insurance offerings consist of two divisions: property and casualty, and life and retirement. The former provides casualty, property, financial, and specialty insurance (think aerospace) to commercial clients and consumers, typically through brokers. The life and retirement division offers domestic life insurance and retirement products (annuities, mutual funds, financial planning) through a diverse network of financial-services companies, brokers, agents, and advisors. Overall, AIG is writing fewer premiums at better prices than it was in past years, which is a great indication of underwriting discipline and a hardening market.

How It's Working

When we recommended buying AIG stock and warrants in August 2012, we were confident in the momentum of the company's turnaround, but we underestimated the rapid rate at which our thesis would unfold. In late 2012 (after our recommendation), the U.S. Treasury sold another $26.5 billion worth of its AIG shares. Management wisely used the opportunity to purchase billions of dollars' worth of stock at about half book value; that, of course, further increased book value in a virtuous cycle. Management continues to repurchase shares and has even instituted a dividend for the past two quarters.

For More

- *Pro*'s original recommendation (8/24/12)
- Talk about AIG

At Your Broker

- eTrade: AIG.WS
- Fidelity: AIG/WS (paste CUSPID 026874156 into the quote page)
- Interactive Brokers: Find AIG; select "warrants" from the drop-down menu
- optionsXpress: AIGwS
- Schwab: AIG/WS
- TD Ameritrade: AIG+
- Vanguard: AIG_t

Helpful Links

- AIG's explanation of the warrants
- AIG's warrant registration statement filed with the SEC

What We Expect

Underwriting discipline will continue to drive increased earnings and a higher valuation. That plus a renewed focus on capital management will improve AIG's credit rating, reducing its cost of debt and providing another lever for higher profitability. Management is still ridding the company of non-core assets, including the aircraft leasing business mentioned above. We expect CEO Bob Benmosche to stay laser-focused on capital allocation, repurchasing shares so long as AIG continues to trade meaningfully below book value and maintaining or increasing the quarterly dividend if business performance supports it.

The *Pro* Bottom Line

We recommend buying 3.8% of AIG stock and 0.6% of AIG warrants (see below for more on those). Benmosche has cleaned out the business, so by purchasing now, you get in after all the hard work has been done. Book value — the best measure of an insurance company's worth — is steadily growing. And AIG's current share price is just over 0.7 times book value. That's cheap, especially given the company's momentum. Investors who buy AIG now are positioning themselves for outsized future returns with less risk: contrarian investing at its best.

A Note on Warrants

Warrants are similar to call options, except that they are issued by the underlying company. They offer the purchaser the right (but not the obligation) to buy the stock in question at the specified price. The warrants we're recommending on AIG are valid for 10 years from the date of issue (Jan. 19, 2011), and they can be exercised at any point before they expire on Jan. 19, 2021. When exercised, they allow the holder of the warrant to buy shares of AIG at $45 per share, regardless of the market price.

That $45 strike price adjusts favorably in the event of dilution or annual cash dividends greater than $0.675 per share (which would also lower the share price). Warrants are illiquid, and Goldman Sachs is the designated market maker for them; when you buy them, be sure to use a limit order so Goldman doesn't get more than a fair price.

Be aware that if our investment in AIG works out, those who own warrants will earn leveraged returns on them. But it's possible that the warrants could end up as a total loss if AIG's stock price is below the $45 strike price at expiration (even though they're currently in-the-money by a few bucks).

Buy First: American Tower (NYSE: AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 2.5%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Internet traffic from mobile devices in 2012 was nearly 12 times total Internet traffic in 2000, and the average connection speed of a mobile device doubled from 2011 to 2012. Communications site operator **American Tower** (NYSE: AMT) is well positioned to benefit from both trends.

What It Does

AMT leases antenna space on more than 57,000 cell sites (towers, rooftops, and more) to wireless service providers. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, non- cancellable, and feature contractual annual price escalations. About 60% of AMT's properties are located in 10 different countries outside the U.S., including India, Brazil, Germany, and Uganda, and AMT is intent on growing its international portfolio as it continues to build and acquire more towers.

How It's Working

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE (or, in Africa, from voice to data), or to increase coverage density. Every time they do, AMT increases the lease rate — on top of the scheduled price escalations. Switching costs in this space are high; 98% to 99% of AMT's customers up for renewal each year do so, and more than 80% of its current leases don't renew until 2018 or later.

What We Expect

Revenue was up 17.7% year over year in 2012, with the international division up 34%, well outpacing the domestic side. We expect revenue to double from 2012 levels in the next five years through a combination of price escalations, new towers, and upgrades; year-to-date 2013 results suggest that the company is well on its way.

After its recent conversion into a real estate investment trust, AMT is required to pay out 90% of taxable income to shareholders. It currently distributes $1.12 annually, a 1.4% yield, and management expects to increase the dividend 20% annually for the next five years. (Importantly, only the U.S. side of this business is organized as an REIT. For more, see our original write-up, linked in the sidebar.)

For More

- *Pro*'s original recommendation (5/6/13)
- Talk about AMT

Management reduces taxable income though the use of net operating losses. And because the useful life of its tower properties exceeds the depreciation schedule, AMT also uses a depreciation shield, which reduces taxable income and understates the values of some assets on the balance sheet. Thus, typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

The *Pro* Bottom Line

We value AMT at about $100 a share. Today's price provides an acceptable margin of safety for a business of this caliber. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network.

Buy First: O'Reilly Automotive (NASDAQ: ORLY)

One of the best-managed companies in a growing space — with a great stock to match

Suggested Allocation: 3.3%

O'Reilly Automotive (NASDAQ: ORLY) is America's second-largest auto parts retailer, with more than 4,000 stores. Auto parts are a big business, estimated at $231 billion, and O'Reilly is an exceptional competitor, with an addressable market size of about $131 billion.

What It Does

Running 24 regional distribution centers and 240 hub stores as part of a two-tiered distribution strategy, O'Reilly provides same-day or overnight availability on more than 142,000 items, including many its competitors don't usually stock. Basic auto parts, tools, and services complement those hard-to-find treasures. As a result, O'Reilly's sales are historically split between "do-it-yourself " retail customers and more lucrative professional-services customers (such as auto repair shops), a luxury many competitors don't enjoy.

How It's Working

Since going public in 1993, O'Reilly has achieved 20 consecutive years of record revenue and operating earnings and has increased same-store sales every single year. Diluted net earnings per share have jumped more than 20% annually over the past decade, with 25% growth in 2012. All signs point to more growth ahead.

O'Reilly will open about 200 net new stores in 2013, increasing its 2012 year-end store count by 4.8%, and same- store sales are expected to rise by 3% to 5%. By clustering stores together, O'Reilly is able to rapidly achieve economies of scale, and by serving professionals and retail customers, it's able to enter smaller markets where competitors don't often tread. There's also no shortage of independent stores or chains to acquire in this highly fragmented industry. In 2012, O'Reilly acquired 56 locations on top of opening 180 net new stores. O'Reilly has steadily improved profitability, generated strong free cash flow, and maintained a healthy balance sheet while growing. As a result, shareholders have been greatly rewarded. But it's still young.

What We Expect

More Online

- *Pro*'s original recommendation (4/15/13)
- Talk about O'Reilly

By opening new distribution centers in key locations, and surrounding them with "spoke" stores, management sees more growth and operating leverage in its business model. Plus, cars last longer these days — meaning used cars are on the road longer, needing more costly repairs when something goes wrong.

The *Pro* Bottom Line

O'Reilly trades near our fair-value estimate today, but remember: Fair value is the price from which we can expect our desired rate of return, which is around 11% annualized on this stock. Plus, we think there's upside to that estimate as past success points to more to come. Last quarter, O'Reilly increased its earnings per share by a strong 28% year-over-year. This is a business we want to own for the long haul.

Buy First: TD Ameritrade (NYSE: AMTD)

Assets and investment fees are rising; earnings should surge when interest rates head higher.

Suggested Allocation: 3.1%

Entrusted with more than $500 billion in assets from retail investors and registered investment advisors (RIAs), discount broker **TD Ameritrade** (NYSE: AMTD) hosts about 378,000 stock, options, and futures trades on an average day, collects investment fees, and earns interest on billions in cash.

What It Does

Aside from being a leading discount broker, TD Ameritrade has a partnership with **TD Bank** (NYSE: TD) (which owns 45% of the company), giving it a unique position in its industry. The partnership allows TD Ameritrade to earn high-margin interest income on client cash without being saddled with the same capital requirements as a bank, and with cross-selling opportunities and below- average risk to boot. So, when the current record-low Federal Funds interest rate (targeted at 0%) increases, TD Ameritrade will earn much higher interest income, all of it pure profit. Meanwhile, it continues to focus on job No. 1: Increase client assets and launch more investment products.

But about that Fed Funds rate: In 2007, it was 4.75%, up from 1% in 2003 during the last recession. Today, it's hovering between zero and 0.25%. The first year that it increases by 100 basis points (to 1.1% from today's 0.1%), management estimates TD Ameritrade's earnings per share will rise by an extra 27% to 32% compared with the prior year, on top of any other growth. And as history shows, interest rates could rise by much more than 100 basis points over the next three, five, and seven years.

How It's Working

TD Ameritrade has increased client assets by at least 10% annualized for the last four years and counting. Management says this rate of growth has been about double that of its nearest competitor. For context, the S&P 500 is nearly flat since 2007, but client assets held at TD Ameritrade have more than doubled over the same period. Operating margins are strong, too, lately in the mid-30% range.

Diligent capital management led Standard & Poor's to upgrade the business to an "A" credit rating in 2012, which helped fuel a recent 50% increase in the dividend (likely the first of many). With steady gains in customer accounts, decreasing shares outstanding, and a commitment to paying out roughly two-thirds of earnings to shareholders, the business should continue to reward owners — with the added benefit of much higher profits when interest rates increase. Meanwhile, the stock trades about 20% below its 10-year average price-to-book value of 4, although the company is more diverse and stronger now than over the past decade.

What We Expect

For More

- *Pro*'s original recommendation (7/11/13)
- Talk about TD Ameritrade

Management will continue to be excellent stewards of capital, returning profits to shareholders and increasing additional investor value. All the while, we know higher interest rates will someday lead to much higher net income. But even as we look forward to that, we can admire the company's current results and should enjoy healthy returns.

The *Pro* Bottom Line

Our current fair-value estimate on TD Ameritrade is $34. The company's earnings are likely at a cyclical low. Believing as we do that TD Ameritrade's profit potential is much greater than recent results suggest, we think the stock is a compelling buy in anticipation of higher interest rates. TD Ameritrade's business model is powerful when rates are headed upward. Most investors have probably forgotten that power since 2007, but will remember it when earnings start to jump.

Buy First: Valmont Industries (NYSE: VMI)

The company's income is increasing as infrastructure expands around the world.

Suggested Allocation: 3%

Valmont Industries (NYSE: VMI) offers investors a proven, consistent suite of four business divisions, each serving a growing need around the world.

What It Does

Founded in 1946, Valmont's engineered infrastructure products division supplies steel and aluminum poles to infrastructure projects across the globe, including road and traffic lights; stadium and parking lights; and wireless communications poles and towers. This division also sells highway safety products such as barriers and road grating. In addition, by selling steel and concrete support structures for the global utilities industry, Valmont profits as electrical grids are renovated or built out.

Then there's water, essential to the world's farmers. Under the name "Valley," Valmont's center-pivot and mechanized irrigation systems are the world's leading brand. More than 80% of the planet's irrigated acres still use inefficient "flood" watering methods, rather than efficient mechanized irrigation, so there's lots of room to run.

To top it all off, the company provides hot-dip galvanizing (just like Mom used to make), anodizing, and other coatings to protect aluminum and steel from corrosion. One of the largest custom galvanizers in the world, Valmont expects continued growth because it still captures only a small percentage of the total market.Overall, the company operates in more than 80 countries and has more than 10,000 employees.

How It's Working

Valmont's stock has returned 17% annualized since 1993, outperforming the vast majority of stocks on the market, and the likes of **Starbucks** (NASDAQ: SBUX) and **Whole Foods** (NYSE: WFM) over the past 10 years. By focusing on strong returns on invested capital, smart acquisitions, new markets, and product-line expansion, Valmont has been able to steadily increase profits as the world economy expands. Yet it's still a relatively small company with plenty of potential in all business lines, and it currently trades at valuation multiples well below market averages.

What We Expect

For More

- *Pro*'s original recommendation (11/5/13)
- Talk about Valmont

With outstanding management and four business divisions that continue to expand around the world, we expect Valmont to continue to grow at a healthy rate (any cyclical bumps aside), and the stock to perform admirably in our pursuit of our North Star.

The *Pro* Bottom Line

Our fair-value estimate on Valmont is $170, providing plenty of upside. And remember, fair value is the price from which to expect your desired rate of return. A growing company's fair value will go higher annually. We hope to have a long, rewarding relationship with this new *Pro* stock.

The Motley Fool owns shares of Whole Foods Market. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Part 1, Step 2: Using This Service

Published Oct 30, 2013 at 12:00AM

How *Pro* Works

In this video, advisor Jeff Fischer walks you through the *Pro* experience.

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Email

Here's an overview of the email you can expect from *Pro*.

Trade Alerts: We send these email alerts at any time during normal market hours; they contain a link to our full recommendation on the *Pro* site. After we announce a trade, we wait one to 30 days to make the trade for the *Pro* portfolio. Click here to see an archive of all trade alerts »

Monday Memos: Stay on top of *Pro* happenings — every Monday at 4 p.m. ET, we'll send you stock news, market insights, community highlights, and more. Click here to see an archive of all Monday Memos »

Guides, Audio Extras, Special Updates: Become a better investor! Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio. Click here to see an archive of all Extras »

Manage Your Email: [Click here to customize your Motley Fool email settings »]

Help and Contact

Help: Our comprehensive FAQ covers recommendations, options, and much more. Click here for the *Pro* FAQ »

Contact: If you have a question we didn't answer, help is close by. Contact our Member Services team, post on our Member Suggestions & Help discussion board, or email us at membersupport@fool.com.

← Think Like a Pro Next Step: Meet the Team

Learn About *Pro*

Part 2, Step 1: Get Ready ...

Published Oct 30, 2013 at 12:00AM

Choose a Broker

You'll need a place for your money to reside and a platform to buy and sell. Any broker will do, but we prefer ones with low costs, transparent fee structures, a good options platform, and robust features. We don't endorse any broker in particular, but *Pro*'s account is housed at Interactive Brokers. You may find these resources helpful when deciding where to set up your account:

- ***Options* Brokerage Board:** Over at *Motley Fool Options*, which you receive free as part of your *Pro* membership, we've got a whole discussion board about brokerages. Visit the board »
- ***Options* Weekly:** If you think you're going to branch out into advanced options investing, be sure to read this can't-miss analysis from our sister service every Friday. See the *Options* Weekly archive »
- **TMF Broker Center:** This table compares features of six popular online brokerages. Visit TMF's Broker Center »

Request Options Permissions

Ask your broker (via the Options Permissions section in the account application, or just call them to request a form) for full options approval. Typically, this means level 2 or level 3 approval (it can vary by broker). The "levels" refer to what type of options strategies are allowable, so the higher your approval level, the more strategies you'll be able to participate in. Fill out, sign, and mail in the simple document, and after a few days you'll be approved. If you aren't granted a high level, be sure to submit another request after a few weeks with an account. You should be able to get promoted to higher levels over time and as your account size and experience grow.

Update Your Beneficiaries

Chances are, your account has a beneficiary designation. That is, when you set the account up, you answered the question: "Who should get my dough if space matter falls from the sky and makes me one with a crater?" That person, or entity, is your beneficiary, and now is a great time to make sure it is accurate. Life changes quickly and these things can be outdated. Your broker will have a beneficiary designation form that should be simple to fill out and submit.

← Back to Index Next Step: Get Set ...

Invest With Us

Part 1, Step 1: Think Like a Pro

Published Oct 30, 2013 at 12:00AM

Our Mission

Pro's mission is to earn members consistent, recurring profits with a high level of accuracy.

Our Philosophy

In this Audio Extra from September 2011, titled "The *Pro* Philosophy," Jeff and former *Pro* analyst Nick Crow discuss how to feel comfortable holding a stock through volatility; how options can increase our ability to match our investing theses to the opportunities we see; and why *Pro* doesn't "overdiversify." Click here to listen in or read the transcript »

Our Strategy

Using a combination of long and short stocks, options, and ETFs, we aim to meaningfully increase the real purchasing power of capital over every rolling three-year period and to double our real purchasing power every 10 years. The Motley Fool *Pro* Strategy Guide is a compilation of key articles going back to *Pro*'s earliest days, highlighting this approach and demonstrating a philosophy that is steady and rational, featuring strategies that work over the long haul. Click here to read »

Our North Star

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward. ***Pro*'s North Star = inflation (as measured by the Consumer Price Index) + 7% annually.** Click here to view your guide to our North Star »

Learn About *Pro*

Part 1, Step 3: Meet the Team

Published Oct 30, 2013 at 12:00AM

Jeff Fischer

Advisor

Jeff Fischer (TMFFischer), advisor of *Motley Fool Pro* and *Motley Fool Options*, started working at the Fool in 1996, soon after he won the Fool's first year-long online portfolio contest. Jeff co-managed the original Fool Portfolio with co-founders David and Tom Gardner, and co-founded and managed the Fool's Drip Portfolio. Jeff also wrote *Investing Without a Silver Spoon* and served as editor on several other Motley Fool best-sellers. All four of the real-money portfolios Jeff has managed or co-managed publicly since 1996 have beaten the S&P 500, although that isn't his first objective, which is steady returns with reasonable risk. Jeff is married to an actress/professor and has a young son.

Billy Kipersztok

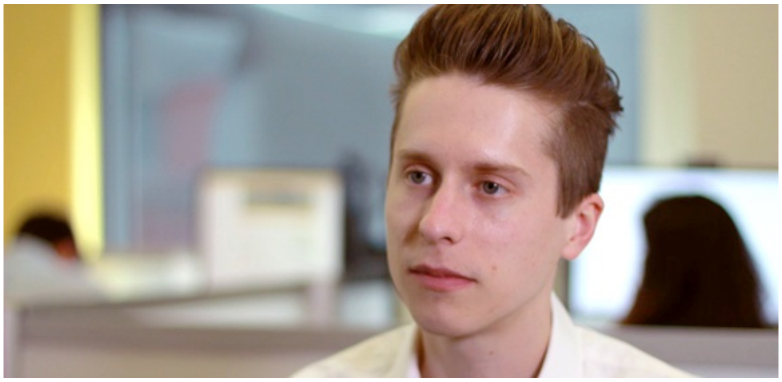
Research Analyst

Billy Kipersztok (TMFTailwind) was introduced to investing by his father, and began reading The Motley Fool as a teenager. He is a voracious reader of investment literature, and he enjoys scouring the market for investments with two characteristics: (1) favorable economics and (2) a fair price.

Prior to joining the Fool, he interned in the analytics department of the NBA's Atlanta Hawks, picked up an MBA and a master's degree in sport business management at the University of Central Florida, and earned a bachelor's degree in chemistry from the University of Florida. He enjoys learning, playing/watching sports, and cheering on his alma mater. (Go Gators!)

JP Bennett

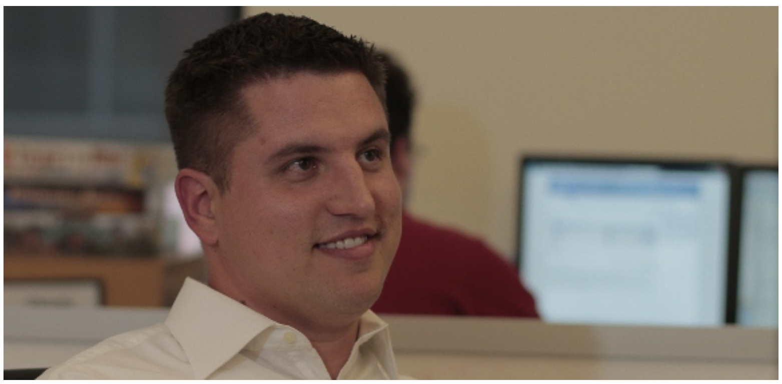
Research Analyst



JP Bennett (TMFYossarian) was once a doctoral student in psychology who thought that investing was destined to remain merely his favorite hobby. But following a career-changing epiphany, a very Foolish internship, and an MBA degree, he has returned to The Motley Fool to become a member of the *Pro* and *Options* teams. JP spends most of time researching companies and reading anything that might make him a better investor. He is also an avid runner and road cyclist, since these activities serve to counteract most of the negative consequences of his sedentary job and primary hobby (and also the fact that his favorite course of every meal is dessert). He is also a 2015 Level III CFA candidate.

Jeremy Myers

Analyst



Jeremy Myers, CFA (TMFTank) is a senior analyst for *Hidden Gems* and *Motley Fool Pro*. Jeremy joined The Motley Fool in 2009 after spending five years teaching ninth-grade biology and coaching football at a nearby public high school -- and, in his spare time, reading every investment book he could get his hands on. Jeremy attended the University of Virginia, where he majored in economics and spent two years as a member of the football team. After graduating, he started his career as an investment advisor for a large insurance company before returning to school to pursue a graduate degree in education.

As a devoted Fool since college, Jeremy developed a healthy skepticism for the financial establishment, which complements his deeply ingrained tendency to buy quality on the cheap. He also believes that the biggest advantage we have as individual investors is our ability to control our time frame and temperament. When he's not searching for the next 10-bagger, Jeremy can be found spending time with his young family, taking on home renovation projects that are over his head, or pursuing the elusive single-digit handicap on the golf course.

Ellen Bowman

Editor/publisher

Ellen Bowman (TMFKabellen) has been with The Motley Fool since 2006, first as a copy editor for Fool.com and then as an editor (and publisher, and chief bottle-washer) of various subscription services. She has worked on services from *Stock Advisor* to *One* and beyond, but considers *Pro* and *Options* "home." Ellen has a degree in creative writing from the University of Houston, and is amazed every day at how much a liberal-arts major can learn about investing when she has teachers like these!

← Using This Service Next Step: Community

Learn About *Pro*

Part 2, Step 2: Get Set ...

Published Oct 30, 2013 at 12:00AM

Know How We Think

Check out this strategy guide, full of tips for developing a diverse portfolio that generates winning returns regardless of the market environment — what we call investing like a *Pro*. Inside, you'll learn:

- How We Invest: Six rules we live by
- How we'll allocate between stocks (long and short), ETFs and options
- Some thoughts on portfolio management, including letting winners run and allocation sizing
- Insight into the types of businesses we love and how to value them

Click here to read »

← Get Ready ... Next Step: Go!

Invest With Us

Part 2, Step 5: Options Resources

Published Oct 30, 2013 at 12:00AM

Options in 3 Steps

Jeff explains options in not two, not four, but three easy steps.

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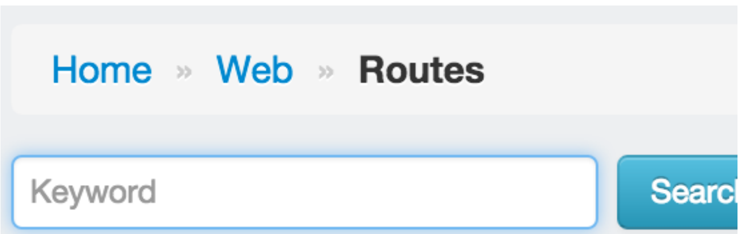
Ensure you have a Route model configured in the admin that matches the request path. Yes that is a regular expression for matching the path.



Pro's Sister Service: Motley Fool Options

Your subscription to *Motley Fool Pro* includes full access to *Motley Fool Options*, an options-only service led by Jeff Fischer, the rest of the *Pro* team, and options guru Jim Gillies (TMF Canuck). *Options* is designed to root among the Foolish universe of stocks and provide a steady stream of actionable options ideas to complement your stock portfolio. It's up to you to determine how you wish to use *Options* in conjunction with Pro, but the vibrant *Options* community is a great place to cut your teeth, learn new strategies, and talk shop. Click here to visit *Motley Fool Options* »

Get Up to Speed With Options

You don't need to use options to follow *Pro*, but we view them as a valuable tool for retaining maximum flexibility in response to what the market throws at us. For sure, options can be confusing at first, but we've got you covered with our Options University (housed over at *Motley Fool Options*). Earn your Basic and Intermediate degrees, explore advanced strategies, and ask for help along the way. Here is a roll call of options education resources available to you:

- Options U Essentials
- Options U Strategies
- Discussion Boards: Options U and All About Options
- *Pro*'s 14 Option Strategy Guides
- Get Up to Speed With Options
- Options Glossary
- Options FAQ

← Keep TrackBack to the *Pro* Homepage

Invest With Us

Part 2, Step 3: Go!

Published Oct 30, 2013 at 12:00AM

Ratings/Guidance Overview

For each of the holdings in the *Motley Fool Pro* portfolio, we will keep you updated on what to do — check out the "What to Do" column on our Recommendations page to see the Buy First, Buy, Hold, and Sell categories for all of our stocks and exchange-traded funds.

- **Recommended Allocation %**: If we were building a portfolio today, we'd invest this much (match us!).
- **Fair Value**: The price around which we think investors will earn a fair return for the risk taken.
- **Buy First**: Start here when building or adding to your portfolio. This is the best place for limited capital.
- **Buy**: After matching the Recommended Allocation % of the Buy Firsts, turn here next. We expect North Star-like returns or better over the next three years.
- **Hold**: This position is under review.

Make *Pro* Fit You

Check out the links on the Guidebook page to figure out how to buy the *Pro* investments given your personal situation. Consider it a choose-your-own-adventure: Figure out which category best applies to you, then follow along.

- **Free-Range**: You're new to *Pro* and able to follow every *Pro* portfolio move to a T.
- **IRA**: You invest predominantly through a tax-advantaged account that prohibits shorting and all but the simplest of options strategies.
- **No Complex Options**: You like to "Keep It Simple Stupid" and either aren't down with complex options strategies or don't have the requisite permissions.
- **Old Fool, New to *Pro* / Fully Invested**: You came from another Fool service or already have a fully invested portfolio of stocks.

Click here to find your style »

Allocation Calculator

Tell us how much you are interested in investing with *Pro*, and our handy tool will calculate how much we think you would need to put toward each holding in the *Pro* portfolio.

Click here to calculate »

Portfolio Building Reports

Our Portfolio Building Reports will get you invested in all the *Pro* stocks that are currently recommended as Buys or Buy Firsts. The first highlights our Buy First positions, the second addresses our Buys, and the Portfolio Positioning Report will help you align with our options and short positions. These updates will serve as your buy recommendations (we'll also link to our original buy reports, of course), so purchase these stocks to get started with *Pro*. You'll be getting some very good prices! They're available on the Guidebook page.

Catch-Up Trades

In most of our Monday Memos, we'll highlight a few trades that represent ways to get on board with *Pro* positions you're lacking. Typically, these will be ways to build positions in stocks we have on Hold. If you've got your own ideas, bring them to our Catch-Up Trades discussion board.

Our Most Current Thinking

The "What We Think Now" page holds our current thinking in brief on every position in the *Pro* portfolio, showing you where we stand on each of our investments right now, all on one page. Click here to see what we think now.

← Get Set ... Next Step: Keep Track

Invest With Us

Part 2, Step 4: Keep Track

Published Oct 30, 2013 at 12:00AM

Measure Us

We all have different investing goals, but the bond that holds together all *Motley Fool Pro* investors is the desire to better control our financial lives (present and future) so that we can fully embrace life outside of our brokerage accounts. When you're trying to assess *Pro*'s performance, your goals are the best place to start: Is *Pro* helping you progress toward your financial goals? Are you learning and having fun? Are you sleeping well at night and able to enjoy your life outside of investing?

You can always find our results at the bottom of our Recommendations page. For something a little more detailed, try this on for size:

- **The Truest Way**: We'd like to help you double your money, taking inflation into account, every 10 years. In a nutshell, that is our North Star, an omnipresent fixture that offers us direction and reminds us what we're striving toward. If we are able to meet or approach this goal, it will mean that many Fools are achieving financial success.
- **The Simplest Way**: While you're likely most focused on whether your investment portfolio is achieving your goals, the investing community demands relative return comparison to a stock index. The most common stock indexes don't have much in common with our strategy, and we don't care much how any given stock index performs — but we realize many investors appreciate the reference point, and we cite the performance of the S&P 500 Total Return Index and the MSCI World Index on our Recommendations page.
- **The Risk-Adjusted Way**: Looking at returns in isolation is a dangerous game. For instance, it could be silly to compare two investments with completely different risk profiles, or two investments with completely different goals. We realize that the absolute level of returns is only one component in assessing the returns we achieve. A few of our favorite performance measurements, popular with academics, institutional investors (like pension plans), and hedge funds, attempt to adjust returns for the level of risk taken. Even though these measures are far from perfect (some assume returns conform to a normal distribution and/or that price variability is a good measure of risk, among other deficiencies), they shed some light on the outcomes of our investing process. We'll do the math for you from time to time and show you our score.

Measure You

Track your stocks using My Scorecard. My Scorecard is your personalized, one-stop shop for information about the stocks that matter most to you. It's part scorekeeper and part coverage collector. Enter your holdings, and it'll keep track of your performance and whether you're beating the market; enter more stocks you're interested in, and it'll help you follow your watch list.

Plus, My Scorecard brings together all of the premium Foolish coverage for your companies — updates, articles, discussion board posts, and more. You can filter this feed, below your list of stocks, to zero in on just the type of content you're looking for.

Unfortunately, My Scorecard doesn't yet handle options, but it's a great tool to help follow the stocks that you are long and short. Check out My Scorecard here »

← Go! Next Step: Options Resources

Invest With Us

Portfolio Positioning Report

Published Jul 18, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1 • Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our portfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

PDFDownload this report as a PDF file

Introduction

Dear Pro Fools,

The majority of the recommendations in this report are "shorts" of vehicles we consider to be flawed — they're investments that should slowly decline in value, adding profits to the short part of our portfolio. But let's take the pressure off right away: For reasons I explain below, we don't expect that many of you will initiate most of the positions in this report right away, or perhaps at all.

Shorting in Short

For those new to shorting, let's step back for a quick overview. When you sell something short, you borrow shares from a broker and immediately sell them, collecting the proceeds. In the future, you'll need to buy shares back (called "cover" or "buy to cover") to replace the shares you borrowed. You hope to buy those shares back at a lower price. The difference between your original sell — or short — price and the price you pay to buy back (and return) the borrowed shares is your profit. If you short a stock at $20 and buy it back later at $10, you've made $10 per share in profit. However, if the stock soars to $30, you've lost $10 per share when you buy it back.

Why do we short in *Pro*? It's one way we're able to profit when the market (or a weak company) falls. We also like to short flawed investments that, because of the way they're constructed, are destined to lose value in most environments. Most of these instruments use leverage and/or hold futures contracts that eat away at their daily value; when we sell short a vehicle like this (two of which are outlined below), we anticipate this steady decline in price.

Shorting Is Optional

As interesting as it is, not every *Pro* member is comfortable with shorting. Practical considerations can have an impact as well. First, you cannot sell short in an IRA — you need a margin account. Second, you have to accept that shorts can run strongly against you. Third, you'll usually pay an annual fee of anywhere from 1% to 5% (of the short value) to short something. Finally, in many cases it's hard to borrow shares to short, period. That is the unfortunate situation with our suggested shorts today. When we initiated the short positions in this report, they were a bit easier to borrow, but today, most brokers don't have shares of these vehicles available for shorting.

So, what do you do? You can use options to short in some cases; we explain how to do so below. You can also consider opening a new brokerage account (Interactive Brokers consistently has shares available for shorting; TD Ameritrade often does); or you can wait and see if shares become available in your existing, traditional brokerage account. Or, not short at all, if you're not drawn to it.

This Positioning Report

Returning to the main show, this Portfolio Positioning Report (and the special live chat accompanying it at 1 p.m. July 18) will — when you're ready! — help you short vehicles we believe will decline, and generate options income. Keep in mind that this is just a start — we'll have many brand-new trade recommendations as we move forward together, and we'll walk you through them as they're announced in the coming days and weeks. So, if this leaves you wanting more, know that more is on the way! On the other hand, if all this looks overwhelming at first — or if you're still catching up with our long positions — that's OK, too. You don't need to make all of these trades now. Stock investments are the core of the *Pro* portfolio, and our shorts, hedges, and options — while useful and rewarding — aren't necessary to succeed with *Pro* in the long term.

As you progress with us, just keep your exposure to the stock market in mind; hedging is about portfolio exposure. If you've bought all of our stock recommendations to date, your *Pro* portfolio is only about 63% invested, meaning you have enough cash that you don't need to hedge yet! We've kept that in mind in putting together this report (which does not carry any market hedges), and we'll do so with our future recommendations to you, too. That said, we do plan new market hedges for all members who are interested soon.

In closing, I'll stress again that you don't need to feel pressured to act. We will continue to make recommendations on an ongoing basis — there are always new opportunities. So, as always, take your time, and make an investment only when you're ready. Finally, please bring any questions to our Making*Pro*Fit You discussion board.

Foolishly,
Jeff Fischer, *Pro* advisor

Short: CurrencyShares Euro Trust (FXE)

Shorting the euro against the dollar is relatively low-risk disaster insurance

Suggested Short Allocation: 3.4%

We're shorting the euro against the dollar. We view this position as an asymmetrical investment where the downside is relatively known (and reasonable) and the upside, while less known, is much larger. For this position to work against us, the euro would strengthen against the dollar, but likely only by so much (assuming the U.S. doesn't go belly-up).

Even if the euro returns to its all-time high against the dollar ($1.60 — currently one euro is worth $1.31) our losses will be tolerable. Meanwhile, our possible upside — hard as it is to believe — may be as much as 100%. If the worst happens, the euro could fall apart completely. The trust we're shorting only holds physical euros, so it could end with negligible value. We don't hope for that calamity, but we can accordingly view this position as disaster insurance with relatively low downside risk.

More Resources

- *Pro*'s recommendation history
- Talk about FXE on our discussion board

Alternative Trade: Shares of FXE are available for shorting at various brokers, but if your broker does not have shares available, and you're trading in a margin account, you can instead "sell to open" January 2015 $100 call options on FXE. These calls currently pay you about $30 each (that price will fluctuate). This naked shorting of calls will provide you profits on any decline in FXE down to $100. Just realize that you are, just like us, short the vehicle at today's price, and you will have paper losses if FXE's price goes up. Only sell to open one call option for every $13,000 in FXE you can afford to be short, at a reasonable total allocation of around 3.4%, remembering that each option represents 100 shares. There are no IRA alternatives at this time that are attractive enough to merit your IRA dollars.

Short: Direxion Daily Financial Bear 3x (FAZ)

Rebalancing costs keep constant downward pressure on this bearish ETF

Suggested Short Allocation: 1.3%

This bearish ETF is meant to provide 3 times (300%) the daily inverse results of the Russell 1000 Financial Services Index, which measures the performance of the U.S. large-cap financial services sector. By shorting this ETF, we'll effectively be 3 times long, on a daily basis, the U.S. large-cap financial sector. Leveraged ETFs like this one are flawed vehicles because they rebalance their derivative positions daily in order to maintain a constant leverage. Over longer holding periods, the costs involved with rebalancing eat away at returns, keeping constant downward pressure on the vehicle as a whole. As our full report linked below details, we continue to believe that large-cap U.S. financials are cheaply priced — and we own several of them as a result. That belief makes shorting this flawed bearish financial ETF all the more attractive.

More Resources

- *Pro*'s recommendation history
- Talk about FAZ on our discussion board

Alternative Trade: Shares of FAZ are available for shorting at only one broker we know of right now — Interactive Brokers — and sometimes at TD Ameritrade. If you can't short shares directly, then in a margin account you can "sell to open" January 2015 $20 naked calls on FAZ, lately paying you about $10 per contract. This effectively makes you short FAZ at $30 (just as we recently did, adding to our position), and sets you up to earn as much as $10 if FAZ falls to $20 or lower by expiration. Be sure to use the "standard" FAZ $20 call option, not the "NS" option. Again, it will pay you around $10 (or $1,000) for every call you write. Only sell one call for every $3,000 in FAZ you are able to comfortably short, up to a 1.4% allocation. Never over-allocate to a short, whether you're shorting with naked calls or shorting directly. Given the expense of FAZ put options, there are no IRA-friendly alternatives for this short.

Option Trade: Write a Covered Strangle on OpenText (OTEX)

Earn income while you wait to potentially buy more shares of this *Pro* holding on a decline

Suggested Allocation: Write one put option and one call option for every 100 shares you own

In our Catch-Up Report No. 2, we recommended that you invest about 3% of your funds in software leader OpenText. Now, to catch you up to our option position on this stock, we recommend you write a covered strangle on your shares. This means you'll write (or "sell to open") one put option and one call option for every 100 shares of the stock you already own. (If you don't own 100 or more shares, but already own 3% in the stock, simply keep holding the stock.)

A covered strangle pays you significant option income. It also sets you up to buy more shares (in this case, doubling your share count) if the stock falls enough, or sell your existing stock if it rises enough. Most likely, though, is we'll continue to manage our covered strangle together for income, rolling it to later months when expiration nears. So, to get started, you should:

- Use a strangle order if you can, and "sell to open" November 2013 $65 puts and November 2013 $70 calls on OTEX. Sell one of each option for every 100 shares of OTEX you already own (and we're assuming you only own a 3% allocation in the stock). Do not buy these options — sell them.
- Lately, look to get paid about $7.60 to $7.80 combined to sell this strangle. So, you'll collect about $760 to $780 per strangle that you write, or sell.

More Resources

- *Pro*'s recommendation history
- Talk about OpenText on our discussion board

This sets you up to potentially buy more shares around a net $57.40 (using the low end of recent prices), or sell your existing shares around a net $77.60. That's a nice wide range. If the stock stays between our $65 and $70 strike prices at expiration, we simply earn all $7.60 as income. We'll manage the position together with a real-time trade alert, if necessary, as expiration gets closer in November. But mostly, we'll just wait for these options to slowly lose value, paying us in the process.

If you have questions about this trade, please visit our OpenText board. And remember, you don't need to use options if you don't want to. We enjoy just owning the stock, too, and see good long-term things ahead for it.

Short: UltraShort Real Estate ProShares (SRS)

Another leveraged ETF with rebalancing flaws from which we benefit

Suggested Short Allocation: 1%

This ETF is meant to provide twice (200%) the daily inverse results of the Dow Jones U.S. Real Estate Index (from here out, "the index"). In other words, if the index goes up 1% in a day, the ETF will decline 2%, and vice versa. By setting up a short position on this inverse ETF, we are setting up a bullish position on the underlying index, and thus on U.S. commercial real estate. This is another leveraged ETF where we benefit from compound flaws as the ETF is rebalanced to maintain its 2:1 leverage.

More Resources

- *Pro*'s recommendation history
- Talk about SRS on our discussion board

Availability and Alternative Trades: Lately, shares of SRS are only available for shorting at Interactive Brokers and perhaps a few other brokers. This ETF does not have long-term options on it, so there are no alternative shorting trades available for anyone. However, if you want to follow the spirit of this trade, you can instead buy about 1% in shares of the bullish **iShares U.S. Real Estate ETF**, with its current 3.8% dividend yield. Our real estate investment thesis, and this alternative purchase, is outlined further in the full report link at right.

The Motley Fool owns shares of OpenText. The Motley Fool is short CurrencyShares Euro Trust, FINANCIAL BEAR 3X, and UltraShort Real Estate ProShares and has the following options: short January 2014 $25 calls on UltraShort Real Estate ProShares and long January 2014 $25 puts on UltraShort Real Estate ProShares.See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Catch-Up Report: Part 4

Published Jul 16, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1 • Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our portfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

Buy: AmTrust Financial Services | Its talent at capitalizing on human laziness is just part of what we love

Buy: The Buckle | This well-managed retailer fits into its jeans admirably

Buy: Starbucks | You only *think* you go for the coffee

Buy: Wells Fargo | Banks are simple businesses, and Wells Fargo is the best of the breed

PDFDownload this report as a PDF file

Buy: AmTrust Financial Services (AFSI)

Its talent at capitalizing on human laziness is just part of what we love about this insurer.

Suggested Allocation: 6.9%

At *Pro*, we speak a lot about the importance and power of recurring revenue — mostly because we know that humans are inherently lazy. Insurance purveyor **AmTrust Financial Services** handily proves this point for us; many of the policies it writes (more than 80% in most lines!) renew at the end of their term without their owners even shopping for a better rate. Most of us, it seems, are guilty of preferring inertia to bargain-hunting, and AmTrust and its fellow insurers are the beneficiaries. Even better, companies with such high renewal rates can actually grow their recurring revenue stream by raising prices a teensy bit at renewal time. This is just one of the characteristics of AmTrust's business we love, and it contributes to our confidence in making it *Pro*'s largest holding.

What It Does

AmTrust is an insurance underwriter. In general, insurance companies make money in two ways. First, they get paid to take on risks other people don't want (like the cost of repairing your car if you get in an accident); if a company takes in more in these policy premiums than it pays out in policy claims and handling, it makes an underwriting profit. Second, because policyholders pay for their coverage up front, insurance companies can invest that money — the industry calls it "float" — until they need it to pay claims.

AmTrust focuses on insurance niches (primarily workers' compensation and product warranties) that are low-hazard and generally too small for large insurance companies to care about. But though AmTrust writes small policies, it's no small fry. Its high renewal rates allow it to focus on writing new policies and looking for struggling insurers to acquire — and AmTrust has proven to be a very opportunistic acquirer.

How It's Working

AmTrust's strategy — being a disciplined underwriter of low-hazard, small policies in well-defined niches; using technology to keep its expenses low; and opportunistically acquiring policies other insurers struggle to find profitable — has resulted in impressive growth. Gross written premiums have risen from about $1.1 billion to $2.7 billion over the past five years, and this increase, combined with a laserlike focus on low expenses, has resulted in consistent growth in earnings, dividends, and book value.

What We Expect

The insurance market works in cycles, and recent signs indicate an upswing on the horizon, which means pricing and profits should improve across the board. AmTrust should thrive in a strengthening market: It can charge as much as its competitors and make more in profits thanks to its lower expense structure, or it can undercut the competition on price in a bid to take market share. If the economy improves at all, the small businesses AmTrust insures should hire more workers and consumers should purchase more insurable goods, so there seems to be plenty of growth ahead.

More Resources

- *Pro*'s recommendation history
- Talk about AmTrust on our discussion board

The *Pro* Bottom Line

Although AmTrust currently trades for more than our $33.50 estimate of fair value, we believe the company's premium valuation is warranted given the consistency of its growth, quality, and profitability. AmTrust is *Pro*'s largest holding and we're happy to let this winner run, expecting to increase our fair-value estimate over time. We have high confidence that owning a piece of this business will help *Pro* Fools achieve satisfactory returns.

Buy: The Buckle (BKE)

This well-managed retailer has fit into its jeans admirably over the past decade.

Suggested Allocation: 3.6%

Your *Pro* team doesn't know much about fashion, but we can read financial statements. And if the next decade of business performance by specialty retailer **The Buckle** looks anything like the last one, we'd be willing to wear whatever getup the company suggests.

What It Does

The Buckle sells jeans, other apparel, and accessories at 443 retail locations across the United States, and we think the fantastic management team has figured out a formula that works: measured growth, middle-of-the-road merchandising, and great service. We're typically leery of the risks of investing in retail, especially fashion, but the proof is in the numbers for The Buckle. Shares are modestly undervalued, the store concept is in the middle of its life cycle, and the company's financial prudence and operational acumen should lead to a growing stream of free cash flow, dividends, and extra payouts — all of which can help the *Pro* portfolio in our pursuit of our North Star.

How It's Working

The Buckle is a surprisingly steady operator in the notoriously fickle specialty retail space. The company reported a modest same-store sales increase of 2.2% so far this year, but that's an improvement from the 1.2% increase through April. We accept a degree of lumpiness here and don't get too bent out of shape when these numbers bop around — The Buckle's target demographic is fickle teens and twentysomethings, after all. We simply monitor these figures for clues about the overall shopping experience and brand relevance. With this performance, we feel confident that the 13 stores management expects to open this year should be solid contributors. As the company expands cautiously, we marvel at its ability to boost margins, improve inventory management, and boost profitability per store.

What We Expect

With 443 stores at the end of fiscal third-quarter 2012, we believe The Buckle has plenty of room to grow as it expands from the middle of the country to both coasts; it should be able to achieve wonderful store economics with the 650 to 850 locations we ultimately expect. The table below outlines the key metrics we monitor for a retailer, and as you can see, The Buckle has fit into its jeans pretty well over the past decade.

Metric	2002	2012	TTM Q1 2013	Annual Growth
Stores	304	436	441	3.7%
Sales per Store	$1,339	$2,387	$2,398	6.0%
FCF per Store	$57	$406	$484	21.6%
Sales per Square Foot	$274	$475	n/a	6.0%
Inventory Turnover	4.7x	6.0x	n/a	3.0%

Dollars in thousands. Per-store calculations based on average stores open during the period. Sources: SEC filings, S&P Capital IQ, analyst estimates.

Not only has the company's footprint grown wider than a pair of bell-bottoms, it has sold more — and earned more — at each location thanks to its tight control over operations. The Buckle also has a history of paying special dividends with its excess cash; it's done so for six of the past seven years. Just last December, *Pro* members holding the stock received a $4.50-per-share payout from the company in addition to the regular $0.20 dividend. Naturally, we encouraged all members to celebrate by buying themselves and their loved ones a few new pairs of jeans.

More Resources

- *Pro*'s original recommendation (6/20/12)
- Talk about The Buckle on our discussion board

The *Pro* Bottom Line

To us, The Buckle has two sides: a very healthy operating business and a not unimpressive bank account. We trust management to allocate the cash in that bank account appropriately, and we appreciate their propensity to return any extra to shareholders. While we can't count on special dividends, the average yield over the past six years, including special dividend payouts, has been approaching North Star-level returns. Meanwhile, the company's operating business has grown bigger, more profitable, and more valuable. An investment in The Buckle suits *Pro*'s penchant for superior businesses, steady income, and a favorable risk/reward profile.

Buy: Starbucks (SBUX)

You only think you go for the coffee — Howard Schultz & Co. are serving up an experience.

Suggested Allocation: 3.3%

You may not realize it, but "**Starbucks**" is no longer a synonym for "coffee." In January 2011, the company dropped the word "coffee" from its logo and has never looked back. Yes, java will be a major driver of the business for decades to come, but in a sense it's just a front. We think we go to Starbucks for the coffee, but those little white cups have been planting the magic beans of a simple but powerful experience, one rooted in comfort, quality, health, community, and conscience.

What It Does

Starbucks began opening America's eyes to Italian-style coffee shops and beverages more than 40 years ago. Today, it has more than 18,000 stores in 60-plus countries, all of which serve as hubs in its distribution network as they dish out coffee, food, snacks, and experiences to fill more than 70 million mouths and hearts each week.

By placing the customer experience first, Starbucks has cemented its role in the daily lives of consumers worldwide. People demand their Starbucks products at home, too, which has allowed the company to build out a consumer packaged-goods division that sells more than $1.2 billion worth of products in more than 100,000 locations worldwide. And the company is cultivating a portfolio of other brands (Evolution Fresh juices, La Boulange bakeries) whose products can be sold in Starbucks stores and grocery stores alike. Between coffee, health foods, and tea, Starbucks believes its end markets are a massive $140 billion and growing.

How It's Working

Recent results have been robust. Over the past three years, Starbucks has added almost 1,500 stores, its same-store sales have grown by more than 7% per year, and it has more than doubled earnings. All of this growth has been achieved by doubling down on the in-store experience and refocusing on quality. Starbucks constantly seems to be setting new records for sales, operating profits, and earnings. And if the lines at the two locations nearest to Fool HQ (where we perform our daily channel checks, purely for science) are at all indicative of larger business trends, Starbucks' mojo remains strong.

What We Expect

Given its very recognizable brand, artfully crafted business and fanatically loyal customers, we expect Starbucks' diversified growth to continue. We believe the world's coffee and tea drinkers will happily support 30,000 or so stores across the company's various brands, and that products bearing the aspirational Starbucks brand will expand the company's real estate on grocery-store shelves.

The company's scale and its ability to raise prices should help profits, as will its unique advantages in low-cost marketing. Starbucks is a pioneer in social marketing, and is perhaps better positioned than any other brand to reach out to its customers, nurture their relationship with the company, offer deals, and customize experiences.

More Resources

- *Pro*'s original recommendation (8/22/12)
- Talk about Starbucks on our discussion board

The *Pro* Bottom Line

Starbucks is riding high since CEO Howard Schultz's return to power in 2008, and it now has so many levers to pull that capturing its potential value in a spreadsheet is very difficult. We're not worried that shares trade higher than our fair-value estimate; we think Schultz & Co. have many tricks up their sleeves that will allow Starbucks to grow into and beyond its current valuation, and we want to be along for the caffeinated ride.

Buy: Wells Fargo (WFC)

At heart, banks are simple businesses, and Wells Fargo is the best of the breed.

Suggested Allocation: 3%

If you plan on being cryogenically frozen for 30 years (or more!), **Wells Fargo** is the type of company you'll want to own before you take the plunge. It's large, it's strong, its operations are diversified, and its customers love it. Wells Fargo's community banking, wholesale banking, and wealth, brokerage, and retirement divisions provide services through more than 9,000 branches and 12,000 ATMs. It's the fourth-largest bank in America, it's consistently No. 1 in customer satisfaction for American large banks, and it's the leader in mortgage and small-business lending.

What It Does

At heart, banks are very simple businesses. They borrow money in the short term, through deposits, and lend it long-term, through mortgages and other loans; the spread between the short-term and long-term interest rates, minus losses on the loans, is profit for the bank. That interest income makes up half of Wells Fargo's business; the other half mainly comes from fees, including deposit service charges, commissions, and mortgage-related fees. During tough lending environments like this one, it's easy to see why we appreciate these other sources of income growth. Diversification is as important in banking is it is in investing.

How It's Working

CEO John Stumpf and team are truly the best of the breed. Return on assets and equity for 2012 were very attractive, at 1.4% and 13% respectively — great results given that the bank was using less leverage than before the financial crisis. Total revenue growth, while modest, has combined with expense reductions to drive quarter after quarter of earnings growth, leading to record earnings. Deposit growth has been tremendous, and as Wells Fargo grabs additional "wallet share," fee income grows as well. The credit quality of the loan portfolio is impressive and is still improving. All of this has contributed to a very well-capitalized balance sheet, allowing Wells Fargo to comply with upcoming capital regulation requirements well ahead of schedule.

What We Expect

Revenue growth will be slow until U.S. loan demand resumes, but management's focus on cutting costs and driving efficiency means further profit growth is in the cards. Management will selectively increase total loans in two ways — by upping lending in general, and by keeping more Wells-Fargo-originated loans on the books. We should expect ever more deposits, declining yields on earning assets, and a continued contraction in net interest margins. But when the U.S. housing market emerges from its general malaise, Wells Fargo's real earnings power — bolstered by growth in fee-based revenue — will hit its full stride. And many customers who start a deposit account or mortgage with Wells Fargo will explore the company's offerings in other areas, too.

More Resources

- *Pro*'s original recommendation (12/10/10)
- Talk about Wells Fargo on our discussion board

The *Pro* Bottom Line

Shares are trading at less than fair value, and they yield a growing 2.8% dividend. Given current conditions, we expect to continue to earn North Star-like returns from the business. Pro has also used options in the past to generate even more income from this position, so try to invest using round, 100-share lots if it keeps you within half a percent (plus or minus) of our 3% allocation. If that's not feasible for you, share ownership alone is fine, too; with its impressive assets and a history of good management, Wells Fargo should be galloping along for years to come.

The Motley Fool owns shares of AmTrust Financial Services, Starbucks, The Buckle, and Wells Fargo. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Catch-Up Report: Part 3

Published Jul 9, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1 • Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our porfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

Buy: Broadridge Financial Solutions | This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Buy: Gentex | The maker of auto-dimming car mirrors has a bright future.

Buy: Intel | Rumors of the PC's death have been greatly exaggerated.

Buy: Medtronic | For once, maybe we can all profit from growing older.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund | Diversification with some of the best small companies you've never heard of.

PDF Download this report as a PDF file

Buy: Broadridge Financial Solutions (BR)

This well-run company dominates the critical behind-the-scenes niches of the financial sector.

Suggested Allocation: 3.5%

Broadridge Financial Solutions helps the global financial system work. It operates the technology and logistical plumbing behind the scenes of global securities trading and the communication between banks, brokers, funds, and shareholders, and it made about $2.3 billion last year doing so. It's not sexy, but Broadridge dominates its niches, has remarkably steady recurring revenue and cash flow, and has recently broadened its suite of products and services with some small acquisitions. We expect the company to be a slow grower, but its consistent earnings growth and a healthy 2.7% dividend should help achieve North Star-like returns over time.

What It Does

Stock geeks like us know that as shareholders, we're business owners, so our votes on business matters count. Broadridge's investor communications solutions segment ensures this democracy keeps swinging.

Collecting shareholder votes is a difficult process. It's also annoying, highly regulated, and inefficient on a small scale. Broadridge has alleviated all of this pain, and it's come to dominate these activities — in 2012, more than 85% of shares voted electronically used the company's platform. With its decades of shaping the proxy voting market, Broadridge has become the go-to service provider to manage investor communications.

The company's smaller segment, securities processing solutions, accounts for 28% of sales, but it's no less critical to the financial services industry. Every time you click "buy" or "sell" at your brokerage, there's a good chance Broadridge technology kicks into action — the company processes more than $4.5 trillion worth of global stock and bond trades each day.

How It's Working

Mutual funds have been scrimping on investor communications recently, and low trading volume has dinged sales and profit growth. Still, it's a testament to the company's resilient business model that sales growth, profit margins, and free cash flow remain attractive — revenue grew 6% last year and earnings advanced 13%. And Broadridge continues to serve its customers masterfully; its 99% retention rate sets the stage for recurring revenue (and deepening relationships) in future years.

What We Expect

We think Broadridge will continue to write the e-book on electronic investor communications. Its dominance of this market should strengthen its competitive advantages, making it indispensable as transparency in the financial system increases. We also expect banks and brokerages to continue outsourcing their non-core operations to save money and increase flexibility; this should bring increased business and greater efficiency to Broadridge. Management expects 3% to 4% revenue growth this year, which should translate to more than 9% earnings growth. Much of Broadridge's revenue is recurring, making its sales and earnings growth highly reliable, and its impressive free cash flow will likely bring an ever-higher dividend and increased share buybacks.

More Resources

- *Pro* 's original recommendation (4/27/10)
- Talk about Broadridge on our discussion board

The *Pro* Bottom Line

Broadridge is a model of niche domination. Its pricing power, scale-based competitive advantages, and low reinvestment needs turn modest top-line growth into strong bottom-line results — and should result in attractive returns. While we wait for the market to come around to the Broadridge story, we believe management is buying back shares at an attractive price. We think shares are worth $27.50 today.

Buy: Gentex

The maker of auto-dimming car mirrors has a bright future.

Suggested Allocation: 3.1%

In 1982, a small company in Zeeland, Mich., called **Gentex** made an illuminating change. Before that time, Gentex was in the exciting business of manufacturing smoke detectors, but scientists deep in its R&D lair had stumbled upon the technology to make glare-control mirrors for automobiles. In 1987, Gentex mastered electrochromic (auto-dimming) technology, amassed a large patent portfolio, and began its quest to lead worldwide production of automatically dimming mirrors. Today, the company commands almost 90% of that market, and it sells eight times more units than its closest competitor.

What It Does

If you've ever driven at night, you know why auto-dimming mirrors are important. Any joker who creeps up behind you on the highway can accidentally start a game of ping-pong between their headlights, your rearview mirror, and your retinas, temporarily blinding you. Plus, ever-larger mirrors capture ever more glare. Gentex's auto-dimming mirrors render all of that moot, and they've become wildly popular. In 2000, the company sold 6.8 million units; in 2012, it sold 23.8 million. That growth has been driven by an increased focus on safety, higher car sales, and greater market penetration (more car makers offering Gentex mirrors as a trim option).

How It's Working

Gentex has turned these market dynamics into wonderful financial performance. Revenue is up by nearly 20% per year since 1987, and over the past decade, the company's net margins have bounced around the mid-teens. Those numbers are shockingly good for an auto parts supplier, showing that its fancy mirrors are showing up in more and more new cars. Gentex has reinvested in its business to sustain its advantages; it pioneers its own manufacturing technologies; it owns all of the manufacturing plants it builds (the land, too); and it sets aside 7% of sales for research and development. It's also got almost $5 per share in cash and investments, sending a strong signal to automakers that Gentex should easily avoid any potholes in auto demand.

What We Expect

Currently, less than one in every four cars made worldwide has an auto-dimming rearview mirror, and only 6% have auto-dimming exterior mirrors. For context, prior to 1987 those numbers were 0% and 0%, so that's heady penetration growth. We expect these mirrors' safety and affordability to spur higher and higher penetration; global acceptance could more than double, to 50%, about the level the U.S. enjoys today.

We also believe Gentex's dominant market share will create a virtuous cycle, allowing it to capture attractive profits from that growth. Because Gentex pioneered electrochromic mirror manufacturing, it has more know-how and experience in the field than any other company on the planet. Those decades of experience mean better quality, which fuels Gentex's market-share lead and allows it to achieve efficiencies of scale its competitors can't match.

More Resources

- *Pro* 's original recommendation (5/29/12)
- Talk about Gentex on our discussion board

The *Pro* Bottom Line

More and more technology is finding its way to the auto mirror, both because it's a natural interface for drivers and because it's a flexible platform that doesn't require a redesign of the car's interior. Those new technologies can be bundled with Gentex's mirrors to improve pricing and increase demand. With shares trading around our estimate of fair value, we think Gentex reflects a great opportunity.

Buy: Intel

Rumors of the PC's death have been greatly exaggerated.

Suggested Allocation: 5.2%

The world's leading producer of microprocessors and chipsets for computing devices, **Intel** trades at less than 12 times earnings, or more than a 35% discount to the average S&P 500 stock. It also pays nearly twice the average dividend yield, at 3.8%. That's cheap enough to indicate that all is clearly not right in Intel's corner of Silicon Valley.

While the media loves to talk about the demise of the personal computer, it's our job at *Pro* to sift through that constant chatter to see the truth and invest accordingly. And to our minds, the death of the PC has been erroneously predicted. Mobile computing is indeed changing our online behavior, and PCs are evolving as a result. But the outcome is more computing devices, not fewer, and Intel is positioning itself to be the brains behind ever more of them.

What It Does

Intel's goal is to be "the preeminent computing solutions company that powers the worldwide digital economy." Whether it's a high-speed server for a data center, a new Ultrabook with a touchscreen and detachable tablet, a smartphone, a tablet, a car, or just about anything else, Intel has the computing technology to drive it.

Admittedly, the company was late to the smartphone and tablet markets, but there's a silver lining: As these devices eat into PC sales, investors' fear about Intel's tardiness brings us the value opportunity we see in the stock. And because smartphones and tablets have very short life cycles, Intel can catch up quickly by steadily inserting its technology into new product designs.

How It's Working

Intel asserts that the tablet is broadening the PC market, not shrinking it, and we agree. Tablets are wonderful for what they are, and the hype surrounding them is admittedly intense. But it seems likely that the PCs of tomorrow will have the best qualities of both a tablet and a PC.

In emerging economies, PC unit volume has steadily risen for years; in North America, it slipped in 2012 for the first time in 11 years, but we believe that was because consumers are excited about the novelty of tablets, not done with PCs forever. Even as the market is expected to shrink, data company IDC expects 2017 shipments to be less than 5% lower than in 2012. We view this as a mature market where Intel will continue to dominate — and generate cash for reinvestment elsewhere.

What We Expect

More Resources

- *Pro* 's recommendation history
- Talk about Intel on our discussion board

Intel is investing for greater growth ahead. Wall Street is leery of the company's expensive capital investment plans, designed to maintain its leading-edge manufacturing abilities, but we view this spending as a strong indicator for the company's future. Intel's confidence in the future of microprocessors seems well-placed in our increasingly digital age; as the number of devices connecting to the Web grows exponentially, so does the need for more computing power.

The *Pro* Bottom Line

Historically, buying true blue chips (Coca-Cola, Johnson & Johnson, IBM …) when they're down has been an excellent investment strategy. We believe Intel will fit that bill, too. Our fair value on the stock is about $27; on a price-to-earnings basis, that would still leave the stock trading at a healthy discount to the S&P 500. We don't expect this value gap to be bridged immediately — first, Wall Street needs to believe in the company's future again. But this year or next, we expect Intel to show skeptics that it's here to stay.

Buy: Medtronic

For once, maybe we can all profit from growing older.

Suggested Allocation: 3.2%

Bryan likes to tell people that the mounting gray strands in his hair represent rapidly increasing wisdom. Nick claims his sore back is the result of lifting cars over his head. Jeff … well, Jeff just thinks cruising around on a Hoveround makes him look hip (it doesn't). The honest truth is that your *Pro* team is aging, and global demographics are shifting in that direction, too. Cost issues aside, global health care is a growth market we'd be silly to miss. Since 2009, *Pro* has stood by **Medtronic** because of its global reach, unrivaled commitment to research and development, and attractive financial profile.

What It Does

Medtronic is in business to “alleviate pain, restore health, and extend life” for the chronically ill. Sure, it also makes money for its shareholders and provides a good life for its employees, but the company has grown from a garage operation into the world’s largest medical technology company by keeping its patient-centric mission front and center.

Today, Medtronic has a vast suite of high-tech products; it boasts market-leading share in key technologies; and it has successfully defended that position over time by keeping the pedal to the metal regarding research and development. And with more than 9% of sales directed back into R&D, there are research dollars left over to keep the company’s new product pipeline humming. Finally, Medtronic has made selective acquisitions to target higher-growth areas and fill product holes, and it now racks up $7.5 billion a year in international sales (45% of the company’s $16.6 billion total).

How It’s Working

Over the past few years, some of Medtronic’s core markets have come under duress; in some cases, competition has picked up, while in others, product efficacy and sales practices have been questioned. As of late, though, all that has been stabilizing — and the company’s other businesses, and its 20% annual growth in emerging markets, were busy picking up the slack. Product diversification has been a big help in maintaining sales levels, and management’s deft execution of its goals and impressive expense management have turned modest sales performance into admirable bottom-line results and cash generation.

Although sales have only advanced 4% annually over the past five years, earnings, dividends, and free cash flow have grown faster as management has cut costs, consistently rewarded shareholders, and maintained discipline with its reinvestments.

What We Expect

Under new CEO Omar Ishrak (who came aboard in 2011), we expect Medtronic to continue its clinical excellence and focus on chronic diseases. However, we expect more disciplined execution, a stronger focus on building the infrastructure for ongoing emerging-market growth, and an evolving balance between the clinical benefits of the company’s products and their economic value. Management expects the company to generate $25 billion worth of free cash flow over the next five years, and half of that is likely to be returned to shareholders in the form of dividends and share buybacks.

More Resources

- *Pro* ’s original recommendation (7/1/09)
- Talk about Medtronic on our discussion board

The *Pro* Bottom Line

We recommend you match our 3% allocation in this leading medical technology company. If it’s as good an investment as we believe, we can all buy Hoverounds to chase Jeff — and truly profit from getting older.

Buy: WisdomTree Emerging Markets SmallCap Dividend Fund

Diversification with some of the best small companies you've never heard of.

Suggested Allocation: 2.1%

At *Pro*, we think we could develop an edge when it comes to investing in emerging-market small caps — but the investment in time and energy would be tremendous. Enter **WisdomTree Emerging Markets SmallCap Dividend Fund**.

What It Does

This exchange-traded fund seeks to match the performance of the WisdomTree Emerging Markets SmallCap Dividend Index, which measures the performance of the smallest 10% of stocks within the Emerging Market Dividend Index (and yields about 3.5%). For *Pro*, it offers exposure to 521 of the most promising business we’ve never heard of.

This ETF gives us an excellent way to invest in unfamiliar companies in locations where we don’t have a discernible edge — countries like Taiwan, South Korea, Thailand, Malaysia, and Turkey. The risk-reducing benefits of investing outside our home market are equally important.

How It’s Working

It’s no surprise that small-cap companies (even dividend-paying ones) in emerging markets can be volatile. We expect DGS itself to continue to experience higher-than-average volatility, even though the diversification it brings to our holdings will likely lower the portfolio’s volatility overall.

We’d always prefer to own great businesses over great ETFs, so this holding has a permanent spot on our short list of positions we’d sell if we needed cash or found a higher-conviction alternative. In the meantime, for a reasonable 0.64% expense ratio, we get a basket of businesses with a history of exceptional performance, weighted by the size of their annual cash dividend. The fund’s heavy weighting toward financials (23%), industrials (16%), and the consumer discretionary sector (14%) leaves it well positioned to benefit from an economic recovery if and when one comes along.

What We Expect

Let’s be frank: We’ve lost a bit of money on DGS since recommending it in November 2010. But you shouldn’t fault DGS for our timing — it had great returns in 2010, before we bought it, and great returns in 2012, too. It’s the middling 2011 results that have us just now breaking even.

This is a top-notch fund, and you don’t have to take our word for it; Morningstar has bestowed its coveted five-star rating on DGS. It’s also made Morningstar’s list of the top eight funds in its category in each of the past three years, and it’s ranked No. 2 when considering five-year performance. We expect these impressive long-term results to continue.

More Resources

- *Pro* ’s original recommendation (11/22/10)
- Talk about DGS on our discussion board

The *Pro* Bottom Line

Overall, DGS provides cheap diversification and income for us, and it remains a well-run fund that has earned its place in the *Pro* portfolio. All that said, it needs to do its part in helping us achieve North Star-like returns over the coming years if it wants to stick around. We still believe that income and value within growing economies are worth investing in, and we suggest you match our 2.1% allocation now.

The Motley Fool owns shares of Broadridge Financial Solutions, Gentex, Intel, Medtronic, and WisdomTree Emerging Mkts Small Cap Div. See Pro*'s holdings here. See the team's and David and Tom Gardner's holdings here.*

Catch-Up Report: Part 2

Published Jul 2, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1 • Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our porfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

Buy: American Tower | Providing antenna space to wireless providers keeps this company buzzing.

Buy: GrafTech International | Steelmaking is evolving, and graphite electrodes will help build the emerging world.

Buy: MasterCard | As plastic overtakes cash, MasterCard leads the charge.

Buy: OpenText | This company's information management software keeps our digital lives in order.

PDF Download this report as a PDF file

Buy: American Tower (AMT)

Providing antenna space to wireless providers keeps this company buzzing.

Suggested Allocation: 2.7%

The Internet isn't just for computers anymore; people are getting online everywhere they go, carrying their connections in their pockets. Internet traffic from mobile devices in 2012 was nearly 12 times *total* Internet traffic in 2000, and the average connection speed of a mobile device doubled from 2011 to 2012. Communications site operator **American Tower** is well positioned to benefit from both trends.

What It Does

AMT leases antenna space on nearly 55,000 cell sites (towers, rooftops, and more) to wireless service providers. Think of it as a multi-tenant apartment building that benefits from sweet lease agreements: The "tenants" are wireless companies, the "apartments" are space to house their equipment, and the "lease agreements" are long-term, noncancellable, and feature contractual annual price escalations.

About 60% of AMT's properties are located in 10 different countries outside the U.S., including India, Brazil, Germany, and Uganda, and that percentage is growing quickly as AMT erects more towers.

How It's Working

As wireless data usage grows, AMT benefits. AMT's customers are continually upgrading their antennas, whether it's to improve coverage, to allow their customers to make the leap from 3G to 4G LTE (or, in Africa, from voice to data), or to increase coverage density. Every time they do, AMT increases the lease rate — on top of the scheduled price escalations.

Switching costs in this space are high; 98% to 99% of AMT's customers up for renewal each year do so, and nearly 80% of its current leases don't renew until 2022 or later.

What We Expect

Revenue was up 17.7% year over year in 2012, with the international division up 34%, well outpacing the domestic side. We expect revenue to double in the next five years through a combination of price escalations, new towers, and upgrades. After its recent conversion into a real estate investment trust, AMT is required to pay out 90% of taxable income to shareholders. It currently distributes $1.04 annually, a 1.3% yield, and management expects to grow the dividend 20% annually for the next five years. (Importantly, only the U.S. side of this business is organized as an REIT. For more, see our original writeup.)

Management reduces taxable income though the use of net operating losses. And because the useful life of its tower properties exceeds the depreciation schedule, AMT also uses a depreciation shield, which reduces taxable income and understates the values of some assets on the balance sheet. Thus, typical valuation multiples (price-to-earnings, price-to-book) are misleading in AMT's case, making the company look like less of a value than it really is. Investors large and small likely gloss over how impressively AMT towers over its competitors, and how it benefits from meaningful advantages in an ever-growing industry.

More Resources

- *Pro* 's original recommendation (5/6/13)
- Talk about American Tower on our discussion board

The *Pro* Bottom Line

We value AMT at about $100 a share. Today's price provides an acceptable margin of safety for a business of this caliber. We expect to earn modest income from a growing dividend and strong appreciation as AMT builds out its international tower network.

Buy: GrafTech International

Steelmaking is evolving, and graphite electrodes will help build the emerging world.

Suggested Allocation: 2%

The International Monetary Fund reduced global GDP estimates three times during 2012, an admission that its rosy outlook for the world economy had been too sanguine. Currently, it expects global growth of 3.25% this year and 4% next year. The share price of **GrafTech International**, a leading supplier of graphite electrodes that are used in the production of steel, dances pretty closely with GDP, so 2012 was an electric slide downward for this economically sensitive *Pro* holding. The first quarter of 2013 wasn't much better, but there are plenty of reasons we think this bumpy ride in the short term will pay off for *Pro* investors in years to come.

What It Does

With a diverse customer base and six facilities on four continents, GrafTech creates products used in the electronics, defense, oil and gas exploration, and aerospace industries. Its customers span 70 countries, and it's well positioned to grow as governments increase their spending on infrastructure, technology, and energy. Its worldwide factory network puts the company near its customers and renders more than 70% of GrafTech's annual sales outside the United States.

How It's Working

Unfortunately, demand for graphite electrodes is driven by economic activity, and prices are set (for the most part) by that demand relative to the industry's supply. This suggests that GrafTech is largely a price-taker, and it leads to lumpy results that can look ugly for long periods. Accordingly, when we analyze GrafTech, we pay particular attention to the long-term trends for steel demand (and our outlook on same), GrafTech's strategic positioning, and how the company manages the costs it can control.

On each of these points, things look bright. Steel use should grow modestly as the emerging world builds out infrastructure, and environmentally friendlier electric arc furnaces should take share from dirty, costly blast furnaces in the production of steel. Strategically, GrafTech recently took control of its primary input (needle coke) so it could better control costs and quality. It also retains a reputation for being the highest-quality producer of electrodes. Finally, the company continues to wring costs out of its structure under the guidance of experienced management.

What We Expect

While supply expansion from other industry players will keep downward pressure on electrode prices, this sort of behavior is not uncommon in the steel supply chain that GrafTech inhabits, and the company has successfully navigated such turbulence in the past. If Chinese suppliers persist in exporting their product at a loss, we think the most likely outcome is that GrafTech's low-quality, high-cost competitors will suffer the most — maybe even go belly-up. Meanwhile, as a large, high-quality, low-cost producer, GrafTech is the best positioned in the industry to weather this storm. The company has the financial wherewithal to withstand a downturn; all we have to do is wait.

More Resources

- *Pro* 's original recommendation (12/16/08)
- Talk about GrafTech International on our discussion board

The *Pro* Bottom Line

At about $7 per share, GrafTech is selling for just about the book value of its assets, but it's the electrode kingpin with a history of strong profitability and a portfolio of graphite science patents. In any given period, we're along for the economic ride — but over entire cycles, GrafTech is proving it is a business worth owning.

Buy: MasterCard

Plastic is overtaking paper as the world's way to pay, and MasterCard leads the charge.

Suggested Allocation: 4.2%

Simply put, **MasterCard** is among the most attractive businesses in the world. Here's why.

What It Does

The company rings up revenue every time someone uses a product bearing its name to charge, debit, or pre-pay their way through the cash register. Any credit risk falls to the banks and lenders, who are actually exposed to the card users' finances; MasterCard only facilitates transactions and markets its brand. That leaves the company free to earn high returns on capital running a largely fixed-cost transaction network that becomes more profitable the more people use it.

Though MasterCard competes with a very large number of well-heeled and (in some cases) innovative businesses, the company's profitability is growing quickly even though the global economy isn't. And that makes perfect sense, because when it comes to paying for stuff, the global market leader isn't **Visa**, or PayPal, or banks ... it's cash. While MasterCard's stock price has risen since we recommended buying in September 2011, our thesis remains intact: Cash has a still-astounding 85% market share of transactions, but it's slow and inefficient, and with no one managing its brand, it's quickly losing out to better alternatives.

How It's Working

This trend has already taken hold in the U.S., where we use cards for a third of our personal expenditures, so Americans often underestimate the opportunities — domestically and especially in developing nations. Last quarter, MasterCard processed $947 billion in gross dollar volume, $653 billion (69%) of which came from outside the United States. Growth in its U.S. business was 4%, outpacing our economy (as measured by GDP) like America was standing still. And worldwide growth, excluding the U.S., clocked in at a tremendous 16% in local currencies (15% in USD). Cash is losing, and fast, but there's a long way to go — and a lot of opportunity for MasterCard.

What We Expect

More Resources

- [*Pro* 's original recommendation (9/8/11)]
- [Talk about MasterCard on our discussion board]

Management recently confirmed guidance for continued 11% to 14% compounded annual revenue growth and 20% earnings-per-share growth through 2015. We think this is possible under current (difficult) conditions, and we expect even better if economies around the world can turn the corner. CEO Ajay Banga and team are doing a tremendous job moving the company forward, so much so that results have outpaced our expectations not once but twice in the short time we've owned shares. We wouldn't bet against a three-peat.

The *Pro* Bottom Line

MasterCard's current share price is near our $550 estimate of fair value, a fair price for a great business that's strengthening every year. Buy now, then sit back and enjoy your take every time millions of people around the world present their MasterCards.

Buy: OpenText

This company's information management software keeps our digital lives in order.

Suggested Allocation: 3%

As you may have noticed, the world is going paperless. Most of us have fewer files and binders lying around our homes and offices these days. But there's a flip side: Right now, your computer is storing ever-growing piles of email, not to mention digital documents so numerous that, if you're like me, you're getting ready to unfurl the white flag of surrender. This is where **OpenText** comes in.

What It Does

Put very simply, OpenText provides information management software. Specifically, it sells software that lets companies organize and manage their growing reams of electronic content. Its products help companies, governments, universities, and others operate more efficiently and effectively, meet compliance requirements, and communicate with colleagues, customers, and partners. OpenText is the leading independent provider of solutions in the enterprise content management market and a leader in the broader enterprise information management industry. Its top competitor, **IBM**, may be larger, but OpenText enjoys longstanding sales relationships with **Microsoft**, **Oracle**, and **SAP**.

How It's Working

In quarterly results announced in May, OpenText's revenue rose 15.5% year-over-year, and adjusted earnings per share were up 25%, reaching record levels. New license revenue jumped a strong 13.3% last quarter. The company's profit margins grew substantially over the past year, as did cash flow.

The stock trades at around 13 times free cash flow (below the market average by a significant degree). Most customers only have one to three of the company's software product modules, leaving OpenText strong opportunities to sell many more product suites to existing customers, not to mention new ones, as its sales force expands (see below).

What We Expect

We estimate that the electronic content management industries OpenText serves will grow top-line demand by at least 10% annualized over the next several years, and OpenText will continue to take market share — perhaps even surpassing IBM in its niches. OpenText has a long history of steady growth through acquisition, and its young CEO (who's only been at the helm for about a year) is also intent on growing the sales team, both to reach out to new markets and to upsell more products to current clients. OpenText already enjoys diversified software sales to numerous industries, most notably financial services, general services, technology, basic materials industries, consumer goods, and the public sector.

More Resources

- [*Pro* 's original recommendation (8/31/11)]
- [Talk about OpenText on our discussion board]

The *Pro* Bottom Line

No one-trick pony, OpenText has multiple growth avenues ahead across all industries as the world's piles of electronic data grow ever larger and in need of management. With new products rolling out in cloud services (off-site servers), renewed sales execution through more distribution channels, and an intense focus on its financial performance, this medium-sized company looks to have a big future.

Note: Although you don't need to use them, we also recommend options alongside owning OpenText stock. For those who want them, we'll recommend a complementary OpenText options strategy on July 18 in our *Pro* Positioning Report.

The Motley Fool owns shares of American Tower, GrafTech International Ltd., International Business Machines, MasterCard, Microsoft, OpenText, and Oracle. See Pro*'s holdings [here](). See the team's and David and Tom Gardner's holdings [here]().*

How We Think About Options

Published Jun 21, 2013 at 12:00PM

Pro's Sister Service: Motley Fool Options

Your subscription to *Motley Fool Pro* includes full access to *Motley Fool Options*, an options-only service led by Jeff Fischer, the rest of the *Pro* team, and options guru Jim Gillies (TMF Canuck). *Options* is designed to root among the Foolish universe of stocks and provide a steady stream of actionable options ideas to complement your stock portfolio. It's up to you to determine how you wish to use *Options* in conjunction with Pro, but the vibrant *Options* community is a great place to cut your teeth, learn new strategies, and talk shop. Click here to visit *Motley Fool Options* »

Get Up to Speed With Options

You don't need to use options to follow *Pro*, but we view them as a valuable tool for retaining maximum flexibility in response to what the market throws at us. For sure, options can be confusing at first, but we've got you covered with our Options University (housed over at *Motley Fool Options*). Earn your Basic and Intermediate degrees, explore advanced strategies, and ask for help along the way. Here is a roll call of options education resources available to you:

***Pro* resources**

- *Pro*'s 14 Options Strategy Guides
- Get Up to Speed With Options
- Options Glossary
- Options FAQ

***Motley Fool Options* resources**

- Options U: Your one-stop shop for a complete options education

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How We Think About Options

Published Jun 21, 2013 at 12:00AM

Options in 3 Steps

Jeff explains options in not two, not four, but three easy steps.

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Inside the Portfolio

Published Jun 17, 2013 at 1:00AM

Once you've decided what to buy, the next crucial question is how much. Here's how we approach allocation for our portfolio — and yours.

Pro Strategy Guide

Get up to speed in no time with this series of articles that will show you how to invest like a Pro:

As your portfolio managers, the *Pro* team is here to help you with allocation, diversification, and reassessing your holdings (many people call that last one rebalancing — a name we don't love, for reasons we'll explain shortly). Luckily, because we're managing a diverse portfolio and we want all of the pieces working in unison, the answer to "How much?" is quite clear.

Allocation: How We Decide How Much

When it comes to a long-term portfolio, the goal is to preserve what you have while boosting it with sensible growth. There's no reason to swing for the fences by throwing half of your savings into just a few equities or by crossing your fingers and taking enormous bets on just a few options.

At *Pro*, when we're right about a position, we want to be amply rewarded — and we want you to be rewarded along with us. When we're wrong, we want us all to easily live to see another day. We can never know everything about the investments we make, so we must remain humble, and we must allocate accordingly. That said, the more we know, the more we may allocate into the strongest opportunities.

Here's how we generally divide our portfolio into strategies, along with the typical starting size for new positions:

Strategy	Portfolio Allocation	Starting Position Size
Core Stocks	70%	3% to 5%
ETFs and Indexes	15%	1% to 4%
Options	15%	0.5% to 3%

That works out to 33 to 38 total positions, with an average allocation of 2.5% to 3%.

As you can see, our average starting size will be about 3%. This suggests we could own about 33 positions, along with typically holding 3% to 5% in cash.

Stocks: 70%

The majority of our portfolio will be in stocks that we believe will deliver steady returns over the long run. The size of each position will generally stay in the 3% to 5% range.

When it comes to *Pro*'s core stock holdings — those with truly exceptional potential and an outstanding margin of safety — we may invest up to 5% of the portfolio, most likely over the course of a few purchases. We're confident in any position we buy, but if we decide to make a position larger than 3%, that means we're extremely confident. We often buy a stock across two transactions to spread our timing and volatility risk. You'll know quickly where we stand on a stock buy: if we like it, 3%; if we're ga-ga over it, 4%; if we can't even sleep because we like it so much, 5%. As of October 2015, only seven stocks make up 4% or more of the *Pro* portfolio.

ETFs: 15%

We're going to use 15% of the portfolio to make sector-based decisions via exchange-traded funds. There are hundreds of specialized ETFs, and they offer tremendous opportunities to take advantage of macro and micro trends in the global economy. As you follow along, you'll find that most of the ETF investments will take a long position, but you'll also be able to go short in sectors we believe are mispriced.

These calls could be a bit riskier in nature than the stock portion of the portfolio, particularly if we buy an ETF that uses leverage, but we will be sure to fully explain any added risks in our trade alerts.

Our allocation to exchange-traded funds will average 2% to 3% in size. With ETFs, we're betting on a whole sector — or area of the globe — to move in a certain direction. Where there's more uncertainty involved, we may only invest 2% or less, and when we're very confident in an ETF and its core holdings, we may invest up to 4%. More often, we'll invest 3% or less.

Options: 15%

The final 15% of the portfolio will be reserved for options. This includes the premiums paid as option buyers, the credits we receive as option sellers, and the money we set aside to purchase the underlying stock when we sell puts.

Options are by nature smaller investments, and most of ours will average around 1.75% of the portfolio at the start — sometimes much less, rarely much more. If we do put 2% or more into, say, a call option, we'll do so very carefully.

Long vs. Short

Even though we'll go short with ETFs and options, *Pro* is primarily focused on the long term. Most often, the short positions we take will be used to hedge downside risk. Overall, we don't expect shorts to represent more than 30% of the portfolio.

And Then There Was Cash

We'll also keep about 5% of the portfolio in cash most of the time so we can catch extraordinary opportunities that pop up and write options.

We know what you're thinking: Wait, all this adds up to 105%! It does, but what we're saying is that while we'll keep an overall mix of 70/15/15 in stocks/ETFs/options, we'll save room for a modest but worthwhile cash balance.

Diversification

As we build the portfolio, we're mindful not to have too much exposure to any one industry, sector, or region, and we'll hedge if our exposure to one area is too great. Meanwhile, if we're missing a piece of our portfolio puzzle, we have the luxury of CAPS data to help us find the most compelling opportunities we're lacking. With a maximum of less than 40 positions, we're striving for diversification with focus.

Reassessment

What's the harm in rebalancing? Whenever part of a portfolio gets out of line with the rest, many investors trim it back; if it shrinks, they add to it. Makes sense, but if you're not smart about it, rebalancing can translate to selling your best winners — and buying more of your worst losers. Now *that* doesn't make sense.

At *Pro*, we prefer to call our portfolio upkeep process *reassessment* — flows off the tongue, doesn't it? — and we'll reassess on a regular basis, most ardently after quarterly earnings or any other significant events. But rather than letting a stock's size in our portfolio dictate our investing decisions, we let a stock's valuation and fundamentals guide us.

Our reassessments start with a vigorous study of every filing our companies make, every quarterly report, and every quarterly conference call as well as all the data at our fingertips. We want to know our companies so well that we could recite their business models in our sleep — so when there's volatility (and there will be!), we'll know how it affects our companies and whether it requires action. To us, reassessment is constant — but that doesn't mean trading is.

Letting Winners Run

In the original Motley Fool and Rule Breaker Portfolios, we outperformed the market by buying high-growth companies and letting them grow — while we held on for years. We didn't trim our biggest winners just because they had come to represent more of the portfolio than other positions — though we would trim back our position in a stock if the business started to merit doing so.

We won't be afraid if a 4% position doubles to become an 8% position, and then a 12% position. We want that! But we'll be mindful of our largest positions and do everything to ensure we don't let our biggest gains evaporate. We have the power to hedge or protect our positions, too, which provides us with more breathing room to let them grow.

Slowly, Slowly, Slowly

In "*Slowly, Slowly, Slowly*" *Said the Sloth*, Eric Carle's sloth hangs from a tree in the rain forest while animals scamper by — toucans, peccaries, a jaguar, and a howler monkey — and ask him why he is so slow, so boring, so calm ... and so lazy. The sloth says, "I am not lazy." He just likes to take his time, think about things, and not rush.

It's the same with a portfolio: Build it slowly. Enjoy each step, and make each selection count. Know every selection before you make it. You're embarking on what should be a long-term relationship with a company — even with options, as you can employ the same options, on the same stocks, again and again.

We manage the *Pro* portfolio thoughtfully (with our own money on the line, we're managing our own portfolio right alongside you). Sometimes we'll be rather active, but sometimes we'll be quite quiet. That's how investing works. Regardless of how often we're trading, you can always find us talking stocks on our members-only discussion boards.

Allocating Your Own Dollars

So how do you mirror our real-money portfolio, assuming that is your goal — even if you have $100,000 or less? In most cases, you can simply follow our percentage allocations rather than our dollar-based actions.

If you have a $100,000 portfolio, and we invest 2% of our funds into a certain position, it's easy for you to do the same thing. However, if you have $50,000 or less, you'll want to watch your commissions and try to keep them well below 2% of any trade you make.

If you're using a smaller account, you also may not want to write many options until you have more assets. For put writing, we recommend an account value of at least $75,000. You may write covered calls with considerably less, and you may buy puts or calls with very little money if you wish. That's one of the advantages of options. But put writing typically requires greater funds.

To discuss your situation and how you can best benefit from our investment decisions, please post your questions on our discussion boards. We'll be there to help.

Next Step: Finding Great Companies →

Invest Like a Pro: If You're Free-Range

Published Jun 17, 2013 at 1:00AM

How to build a *Pro* portfolio — if you have money to invest now and are ready to own what we own.

We manage the *Pro* portfolio using a wide range of tools — including long and short stocks, options, and ETFs — to earn absolute returns with reduced volatility. But we know no two members have identical investment situations, and that means not all members will use all of our strategies. That's where we can help you find the best way to use *Pro* for *your* individual situation.

The most important thing to remember is that *Pro* is a portfolio, not merely a collection of investment ideas. All of our positions exist in the context of our portfolio; if you elect to pick and choose *Pro* investments, it is critical that you understand how they fit into *your* portfolio. Our trades are intended to integrate with existing positions and to form a portfolio of assets that keeps our North Star firmly in mind.

Building Your *Pro* Portfolio

Start Here: Portfolio Building Reports

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new *Pro* portfolio.

Part 1: Our Buy First Stocks
Part 2: Our Buy Stocks
Part 3: Our Buy Stocks, Continued
Portfolio Positioning Report
Important: A note on fair value

What's Next?

Once you've matched the guidance in the Building Your *Pro* Portfolio reports, all you need to do is wait for further trade alert emails from the *Pro* team. However, our alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want.

You may decide to modify the strategy we choose for a trade; for example, writing puts instead of buying a stock outright. If you choose to deviate from our recommendation, though, make sure you:

Uniquely *Pro*

If you're joining us from another Motley Fool service, it is critical that you understand what makes *Pro* so powerful. At *Pro*, we are building a portfolio, not simply offering investment recommendations. *Stock Advisor* and *Rule Breakers*, for example, offer stock recommendations from which members can pick and choose.

In contrast, *Pro*'s trades are intended to be integrated building blocks of an overall portfolio. We cannot emphasize this enough: Anytime you decide to deviate from the Pro portfolio, make sure you understand how the trade in question is intended to fit with our portfolio — and how the modified trade will fit with yours. With every trade, keep the portfolio context in mind.

1. Understand why we chose the strategy we did
2. Have a reason that the modified strategy better fits your portfolio
3. Exercise caution by sizing the position a bit smaller than you would otherwise

If you have any questions about our trades or making a strategy fit your investing goals, drop by our Making Pro Fit You discussion board, where the *Pro* team and community are happy to help.

You'll also receive the team's Monday Memo email every Monday afternoon, with commentary, news, and any updates to our guidance.

If You're Investing in an IRA

IRAs are tax-deferred accounts that usually don't allow shorting and allow only simply options strategies. If you're building your *Pro* portfolio in an IRA, you can follow our stock-buying trade alerts directly. Most IRAs allow you to write covered calls, so you can also follow those trade alerts (check with your broker to see if you have permission). For trades that go further afield, here are several points to consider:

Writing Puts: Some IRAs don't allow put writing (although many do, if they are cash-secured), so you should simply buy shares in these positions over time. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions.

Other Options Trades: If you can't make a trade in your IRA, check our trade alert for a list of alternative trades. For example, when we write puts to try to buy shares of Stock X more cheaply, you might be able to simply buy shares of Stock X. (If there are no alternate trades, we'll say so.)

Shorting: Some inverse ETFs can be purchased in IRAs (purchasing an inverse of something is similar to shorting that thing). As with options, we'll mention suitable alternatives in the trade alerts.

As tax-deferred accounts, IRAs are well suited for income-generating strategies like covered calls, high-yield dividend stocks, and ETFs with large taxable distributions. If being unable to follow all our recommendations leaves a hole in your portfolio, you may be able to fill the gap with additional income-generating strategies — for example, by writing covered calls on *Pro* stocks you'd be willing to sell at your strike price.

Because IRAs do not allow the use of margin or shorting, you will likely find it difficult to follow along with most of our hedging strategies. If that's the case, we recommend keeping an eye on both your cash balance and *Pro*'s hedging strategies. When the *Pro* portfolio adds hedges, increase your cash balance; when we pull hedges off, reduce your cash balance by investing more in our Buy and Buy First stocks.

Finally, you may want to consider opening a separate, non-IRA account if possible. You can then manage both your IRA and non-IRA accounts as a single portfolio, with income-focused and shorter-term strategies in the IRA and more complex, speculative, and short trades in the second account.

If You Can't Trade Complex Options

You can still follow most of our trade alerts directly — except, obviously, those involving complex options strategies. In those cases, we offer simpler alternatives whenever possible, such as writing puts, writing covered calls, or buying or shorting a stock or ETF directly. If we issue a trade alert using an income-generating strategy you're unable to employ and there are no workable alternatives, consider using the strategies you do have at your disposal to generate income elsewhere in your portfolio.

If you want to expand your repertoire, you should continue to request higher options permissions from your broker every couple of months until they are granted. Account size is one factor brokers consider when making this decision, so to up your odds of success, consider consolidating accounts or moving funds to the account in which you wish to trade options.

In the meantime, don't lose sight of the big picture; remember that we're building a portfolio. If you can't make a particular options trade, you may be able to make an alternate trade or you may need to sit that trade out — either way, it's no big deal. That said, you'll want to pay particular attention to any trade alert in which we use options for hedging purposes (for example, a synthetic short or a ratio put spread on an ETF or an index). Trades like these are important to our integrated portfolio, so don't ignore them. If alternatives are available, we'll outline them. If not, you may want to take action elsewhere in your portfolio to meet similar goals. For example, one way to accomplish this would be to raise your cash position by trimming a few holdings. As always, we're available on the Making Pro Fit You discussion board to field your questions.

Hungry for more *Pro* goodness? Check out our strategy guide!

Go to the Strategy Guide

Invest Like a Pro: Whoever You Are

Published Jun 17, 2013 at 1:00AM

How to build a *Pro* portfolio — whether you have cash to deploy or you want to go slowly.

We manage the *Pro* portfolio using a wide range of tools — including long and short stocks, options, and ETFs — to earn absolute returns with reduced volatility. But we know no two members have identical investment situations, and that means not all members will use all of our strategies. That's where we can help you find the best way to use *Pro* for *your* individual situation.

The most important thing to remember is that *Pro* is a portfolio, not merely a collection of investment ideas. All of our positions exist in the context of our portfolio; if you elect to pick and choose *Pro* investments, it is critical that you understand how they fit into *your* portfolio. Our trades are intended to integrate with existing positions and to form a portfolio of assets that keeps our North Star firmly in mind.

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Start Here: Portfolio Building Reports

To get started with the funds you have available to invest, we've created a series of Portfolio Building Reports to explain our holdings and give our guidance on how to incorporate them into your new *Pro* portfolio.

Part 1: Our Buy First Stocks
Part 2: Our Buy Stocks
Part 3: Our Buy Stocks, Continued
Portfolio Positioning Report
Important: A note on fair value

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our portfolio page's Recommended Allocation to help build your portfolio.

We recommend that you invest along with the reports in the order in which they are released, as they will contain our latest guidance and thinking on every stock in the *Pro* portfolio, and will make it a snap to match your portfolio to *Pro*'s.

What's Next?

Once you've matched the guidance in the Portfolio Building Reports, all you need to do is wait for further trade alert emails from the *Pro* team. However, our alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want.

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IRAs are tax-deferred accounts that usually don't allow shorting and allow only simple options strategies. If you're building your *Pro* portfolio in an IRA, you can follow our stock-buying trade alerts directly. Most IRAs allow you to write covered calls, so you can also follow those trade alerts (check with your broker to see if you have permission). For trades that go further afield, here are several points to consider:

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Finally, you may want to consider opening a separate, non-IRA account if possible. You can then manage both your IRA and non-IRA accounts as a single portfolio, with income-focused and shorter-term strategies in the IRA and more complex, speculative, and short trades in the second account.

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In the meantime, don't lose sight of the big picture; remember that we're building a portfolio. If you can't make a particular options trade, you may be able to make an alternate trade or you may need to sit that trade out — either way, it's no big deal. That said, you'll want to pay particular attention to any trade alert in which we use options for hedging purposes (for example, a synthetic short or a ratio put spread on an ETF or an index). Trades like these are important to our integrated portfolio, so don't ignore them. If alternatives are available, we'll outline them. If not, you may want to take action elsewhere in your portfolio to meet similar goals. For example, one way to accomplish this would be to raise your cash position by trimming a few holdings. As always, we're available on the Making *Pro* Fit You discussion board to field your questions.

If You're Already Fully Invested

If you're already fully invested, you may need to sell existing positions to add *Pro* picks. We recommend that you do this gradually and deliberately, and we've offered advice on how to approach this task.

List your existing positions in order from your highest-conviction holding to your lowest-conviction holding. If you own stocks from another Motley Fool service, you can use that service's guidance on those stocks in building your list. If you don't know why you own a stock, that's a good reason to sell it.

Be mindful of your sector and geographic allocations. You don't want to unintentionally end up owning nothing but oil or European stocks just because they were your favorites. If you're struggling with what to sell, post to our discussion boards — the *Pro* team can't give you individual advice, but our community members can and frequently do weigh in with helpful guidance.

When you're ready, incrementally sell your lowest-conviction stocks and use the proceeds to move into our Buy First and Buy stocks. Review your positions and portfolio after studying *Pro*'s mission and reviewing our North Star. Use that analysis to craft your portfolio going forward.

Hungry for more *Pro* goodness? Check out our strategy guide!

Go to the Strategy Guide

Finding Great Companies

Published Jun 17, 2013 at 1:00AM

Nearly three decades of investing have helped us home in on the qualities we seek in each company we consider for *Motley Fool Pro*.

Pro Strategy Guide

Get up to speed in no time with this series of articles that will show you how to invest like a Pro:

- 1. Sustainable Competitive Advantage
- 2. Pricing Power
- 3. Dependent Customer Base
- 4. Predictable Revenue
- 5. Growing Free Cash Flow With Compounding Returns
- 6. Financial Resilience
- 7. Expanding Possibilities
- 8. The Three C's of Management

Not every business we buy or use options on will possess all eight of these qualities — but for core stock positions, we prefer to see as many of the following strengths as possible. These qualities aren't in order of importance, but you'll often find that one quality builds to the next. They typically all combine to produce a company that could compound our returns.

Quality 1: Sustainable Competitive Advantage

Healthy profits in a business attract competition; everyone wants a piece of the profit pie. The only way a company can maintain its profit margin and grow is to have a sustainable competitive advantage that serves as a protective moat around the business.

You often hear this quality talked about, from Warren Buffett on down, but many investors typically fail to find companies that sustainably meet the bill. That's because it's the rare company that truly has lasting advantages — but they're out there.

They are usually mid-sized or larger and enjoy assets or market share that provide enduring advantages over all others. Think **Gentex**, which commands the market in auto-dimming rearview mirrors; **Broadridge Financial Solutions**, which has provided annual proxy services for 90% of the public companies and mutual funds in the United States since 1999; and **Facebook**, whose network effects have enabled the company to continually occupy the top spot in the social media space -- and buy would-be competitors. Each of these businesses has traits that keep competitors at bay, helping it maintain healthy profit margins.

Quality 2: Pricing Power

We're always on the lookout for companies that enjoy a degree of pricing power, those that can pass on rising costs to customers. The strongest companies may also implement modest price increases every few years without losing or alienating customers. A leading example of this is **Verisk Analytics**, a leading risk-assessment and decision-analytics firm. The company was able to push through annual price increases for many of its offerings to the insurance industry between 2007 and 2010 (some of the worst years for insurers in recent memory) without seeing any negative effects on customer retention. **Netflix** and **Chipotle** have also demonstrated pricing power. Pricing power gives a company one more important arrow in its quiver as it hunts for strong long-term annualized growth.

Quality 3: Dependent Customer Base

A competitive advantage may *not* be worth much if the business depends on only a few customers, or if its customers can get the service provided just as conveniently elsewhere. We're excited to find a captive or at least loyal customer base. In some cases, this might take the form of a product being integrated into customers' daily lives, a la **Starbucks**. It could also be evident in customers' desire to work with that company, as is the case with **Parexel,** a leading biopharmaceutical and medical device contract research organization. Such customer dependence often supports quality no. 2, pricing power.

Quality 4: Predictable Revenue

If a business exhibits the first three qualities and also has significant predictable or recurring revenue, we become even more interested. This means we're looking for sales that repeat all but automatically, often with the same customers again and again, and usually without the company needing to spend more on marketing or reinventing itself or its products.

Some examples from our *Pro* portfolio: **Oracle** and **OpenText** get a majority of their revenue in the form of long-term contracts with high renewal rates. Insurance companies enjoy recurring revenue every time a policy is renewed, which happens more than 80% of the time at the best providers, including our own **AmTrust**. Transaction-based revenue driven by network effects, like with **MasterCard** and **Visa**, also qualifies as predictably recurring; so does "platform access" that is heavily relied upon and not easy to replicate, which is exactly what we have with **American Tower**.

Predictable revenue helps management plan its future better, and it helps maintain a business even during recessions. For a contrast, consider apparel manufacturers, which are constantly battling with one another to win your business and capture fashion that's inherently fickle. This can result in feast-or-famine financial results – which we try to avoid here in *Pro*.

Quality 5: Growing Free Cash Flow With Compounding Returns

The qualities we've mentioned so far will usually lead to strong free cash flow, which is the lifeblood of a company. By definition, free cash flow is cash from operations minus capital expenditures and any other nonoperational cash income, such as tax benefits from stock options.

We're looking for free cash flow that's likely to increase by at least 10% annualized over the long term. No company grows in a straight line, but over time we want expanding free cash flow to drive the value of the businesses we own -- and that cash flow should be investable in more growth for compounding business returns. Free cash flow is a much more important proxy for value at *Pro* than are earnings per share, which are easily manipulated.

Quality 6: Financial Resilience

These first five qualities go far toward building strong financial statements — if not right away, then with time. On the balance sheet, the appropriate amount of leverage and cash on hand will depend on the industry and a particular company's business model; however, we seek to invest in companies that can do more than just weather the storm when times are tough. We want to find companies that can take advantage of turmoil to gain additional market share and maneuver for an even brighter future – and that's difficult to achieve if the financials aren't resilient enough to let management strive to grow even during hard times.

Quality 7: Expanding Possibilities

A company can increase its bottom line either by cutting costs to expand margins or by growing its top line. But there is a limit as to how much fat can be cut out of any business, and being too aggressive in slashing costs can actually be detrimental in the long run. So, in order to find companies poised to deliver North Star-like returns over the next rolling three years, we seek businesses that can both control costs *and* profitably expand operations. Often, that means companies that are riding long-term (rather than cyclical) tailwinds; this can lead to years of above-average growth. And this growth can take the form of increasing market share at home as well as developing new products or entering new markets. **Apple**, **Skyworks Solutions**, **O'Reilly Automotive, Gilead Sciences** -- most of the companies in our portfolio exhibit this characteristic.

Quality 8: The Three C's of Management

Warren Buffett once recommended investing in businesses that even a fool (with a lower-case “f”) can run, because someday a fool will be in charge. This may be true, but here at *Pro* we believe you can have the best of both worlds: great businesses that are also run by top-notch management teams. Every situation is unique, but as a starting point, we generally look for the following in company management:

- **Clarity:** Do they have a vision for the company and can they succinctly articulate how they’re going to get there?
- **Consistency:** It isn't enough to talk the talk; we want management teams that have also proven they can walk the walk. We avoid revisionist historians and look for managers that achieve what they said they would.
- **Capability:** Are they the right people for the job? Sometimes this means going with a founder-led company early on (the Fool invested in **Amazon** shortly after it went public); other times we’re looking for a track record of smart capital allocation decisions (**Verisk Analytics** has generated an average annualized return of about 20% on all of its deals from 2002 to 2012).

Combine our eight qualities, and the company is likely to be a long-term performer on par with -- or stronger than -- our relentless North Star.

We’re not making it easy on ourselves by using our North Star as our investing guidepost; however, we wouldn’t have chosen to do so if we didn’t believe it was possible. One of the keys to this approach is to have a high rate of accuracy when it comes to selecting stocks, and this quality checklist is just one of the many tools we use in our attempt to do exactly that.

To talk about the business qualities we seek — and to share your own — join us on the Philosophy & Strategy discussion board. Invest Foolishly!

Back to the *Pro* Guidebook

Strategy Guide

Published Jun 17, 2013 at 1:00AM

Our mission is to earn you consistent, recurring profits with a high level of accuracy using stocks, options, and ETFs. This Strategy Guide takes you behind the scenes, detailing the steady, rational approach that makes *Motley Fool Pro* so successful.

How We Invest: 6 Pro Principles

See the ways we turn our flexible approach into a comprehensive strategy.

Our North Star: Inflation + 7%

To stay on course toward a winning portfolio, we take our direction from this guidepost.

Inside the Portfolio: Stocks, ETFs, and Options

For each type of investment, we have a plan for how we decide how much.

Finding Great Companies: 8 Qualities We Seek

Two decades of investing experience help us home in on the best positions for the *Pro* portfolio.

Our Guide to Hedging Like a Pro

A hedge is a position that reduces a portfolio's overall exposure to risk. We hedge in several different ways.

How We Invest

Published Jun 17, 2013 at 1:00AM

6 *Pro* Principles: We always want you to know how we're thinking as we invest — and why — so see how we tie together our broad tools into a comprehensive strategy with focus and direction.

Pro Strategy Guide

Get up to speed in no time with this series of articles that will show you how to invest like a Pro:

Motley Fool Pro is here to help you build a diverse portfolio that generates winning returns no matter what the stock market throws our way. You can trust that our team relies on years of investing experience and on our array of tools and collective insight to produce outstanding long-term results — and we're thrilled that you're here investing along with us.

Our *Pro* portfolio has incredible flexibility — we can go long or short and use options and ETFs. We'll invest wherever we see the best opportunities — any sector, stock, country, or option. This makes our overall strategy wide and deep, but we'll do our best to clearly explain the specifics behind our actions.

Pro Principle 1: Accuracy Is Our Top Priority

Some portfolio managers are happy to speculate — and often be wrong — so long as their few big winners more than compensate for the losers. That is not our approach at *Pro*.

Our aim is to be correct the vast majority of the time. We will only put our cash to work when we feel extremely confident about an investment — and on that note, our ambitious goal is to have at least three out of four positions profitable by the time we close them. Yes, that's a sterling 75% success rate — and it includes all of our stocks, options, ETFs, and hedges.

In fact, it's more important to us to achieve absolute gains on each position than beat the S&P 500. Why is that? Because gains are our first goal. Period. But heck, if most of our positions are profitable, we should beat the S&P 500, too, over the years.

Pro Principle 2: When It Comes to Stocks, We Are Focused on Superior Businesses We Can Hold for 3 to 5 Years

Our portfolio primarily consists of long positions. The goal is to hold these stocks for three to five years — or as long as the investment merits. Each stock will have a catalyst (or several) that should kick our returns into gear through our target time frame.

The *Pro* team has found that the stocks that perform the best over the years have a lot in common. These companies have superior business models that we believe will remain strong in any market, strong and lasting competitive advantages, margins ripe for expansion, and growing market opportunities. We like dynamic companies with light business models — they don't need hefty, constant infusions of capital — and plenty of naturally recurring revenue. After we've found a company that makes the grade, we then aim to buy at a price that gives us both ample upside and a solid margin of safety.

Pro Principle 3: When It Comes to ETFs, It's the Big Picture That Counts

For exchange-traded funds, broad is the way to go. Say you want to invest in Brazil, which is growing rapidly. But which companies will lead the way? If you can't devote months to learning Brazil's competitive landscape, you can buy into the entire economy with a Brazilian ETF.

ETFs are an excellent way to invest in the rise or fall of just about any broad category — financials, biotech, China, Brazil — especially when you wouldn't otherwise know where to invest in a sector. These investments, long or short, are more macro-focused than business-focused. We study any ETF we buy to make certain that we agree with its largest holdings, but we'll still be betting on a macro trend — up or down — when we pick up an ETF.

With our ETFs and options, our outlook is usually a bit shorter than with stocks. We may take advantage of a 12-month option opportunity; we may buy an ETF in gold, only to sell it nine months later if the price of gold jumps. ETFs can be long-term macro investments, too; we bought into **Vanguard Emerging Markets** in 2008 to profit on a rebound, selling nearly three years later. Many of our short sales also have a shorter-term outlook, usually measured in months or a year.

Pro Principle 4: We Are Not Options Traders

When we invest with puts and calls, we're not twirling our pretend mustaches, making slick statistical bets, or using formulas and complicated computations. Our options investments are based on extensive knowledge of the underlying stock and its valuation.

So if we believe a stock is priced exuberantly, we can short it by buying a put option. If a stock looks deeply undervalued, we can use long-term call options to capture greater upside. In the end, all of our option trades are based on a full analysis of the underlying equity.

Pro Principle 5: We Won't Over-Diversify

We expect to hold no more than 40 positions. For a carefully constructed portfolio, that's plenty of diversification, especially because we'll use ETFs to gain broad exposure to various categories.

An investor diversifies for safety but still needs to stay focused when hoping to perform much better than the market average. Along these lines, it's likely that we'll usually only carry about 24 to 28 core positions, with open options positions representing other possible buys down the road, and always with stocks coming and going from the portfolio as necessary. With focus, we have an especially good chance of being rewarded strongly whenever we're right with a position.

We prefer to let our winners run as long as merited, so we won't rebalance just for the sake of doing so. But we will continually reassess. As of October 2015, we recommend buying 24 core stock positions — right in our sweet spot.

Pro Principle 6: We Never Want to Lose Money

As we strive for accuracy, we will always try to avoid permanent loss of capital. It's not about avoiding mere paper losses — these are common, as stock prices fluctuate. We're talking about losses you never earn back because you invested in a failing business or paid too much for a stock.

While we're more than comfortable with temporary losses that come about with the market's ups and downs, we'll do everything in our power to avoid permanently losing money — although keep in mind that this doesn't apply to options or shorts, in which permanent losses are part of the risk. So far, as of October 2015, we have only closed a few positions at a loss without recourse.

Putting It All Together — the *Pro* Way

We're here to help you become a more profitable investor in any market. We want you to learn, but remember, you're also here to have fun! So dive into our library of investing know-how, read about our array of strategies, and if you ever have any questions, visit us on the discussion boards! We're at your service.

Next Step: Our North Star →

Catch-Up Report: Part 1

Published Jun 17, 2013 at 12:00AM

These Catch-Up reports provide in-depth guidance on our active recommendations — a plan for starting to build your *Pro* portfolio:

Part 1• Part 2 • Part 3 • Part 4 • Shorts & Options

You can also see all our active positions, with Buy First, Buy, and Hold ratings, along with our latest opinions, in What We Think Now. Use this alongside our porfolio page's Recommended Allocation to help build your portfolio.

Remember, there's no need to rush into any trades, so take your time. We're here to help — if you have any questions, the *Pro* team and fellow members have the answers in our *Pro* Community.

In This Report

Buy First: AIG | Time and even average performance should heal the company's wounds.

Buy First: Apple | The leader in mobile computing products is cheaper than it's been in years.

Buy First: Oracle | This old-guard tech giant has more room to grow.

Buy First: O'Reilly Automotive | Exceptional management should deliver impressive growth.

PDF Download this report as a PDF file

A Note on Pricing

We've classified the four stocks in this initial report as "Buy First" positions for *Pro* members, because they are attractively priced and will remain so even if the price moves around a few dollars. As long as these stocks remain listed as Buy First on our scorecard, then we recommend that you buy them first for your *Pro* portfolio. If that status changes, we'll let you know in our Monday Memo and note the change on our scorecard.

Buy First: American International Group

Time and even average performance should heal the company's wounds.

Suggested Allocation: 2.8% stock, 0.7% warrants

Today's **American International Group** is not the same company that disgraced itself so profoundly in 2008. AIG has divested itself of whole business units since the financial crisis, managing to eliminate 95% of its previous exposure to the nasty derivatives that nearly brought down the economy. Left behind are just two steadfast insurance businesses and an aircraft leasing company, and AIG plans to rid itself of the leasing business, too.

What It Does

Insurance is a business of collecting premiums, investing the float, and paying out claims — and AIG is getting ever better at it. Improved underwriting is showing up in a lower loss ratio, which in turn is driving a lower adjusted accident-year combined ratio. All that is a fancy way of saying that we're starting to see underwriting profits for the first time since Q3 2010.

AIG's insurance offerings consist of two divisions: property and casualty, and life and retirement. The former provides casualty, property, financial, and specialty insurance (think aerospace) to commercial clients and consumers, typically through brokers. The life and retirement division offers domestic life insurance and retirement products (annuities, mutual funds, financial planning) through a diverse network of financial-services companies, brokers, agents, and advisors. Overall, AIG is writing fewer premiums at better prices than it was in past years, which is a great indication of underwriting discipline and a hardening market.

How It's Working

When we recommended buying AIG stock and warrants in August 2012, we were confident in the momentum of the company's turnaround, but we underestimated the rapid rate at which our investment thesis would unfold. In late 2012 (after our recommendation), the U.S. Treasury sold another $26.5 billion worth of its AIG shares. Management wisely used the opportunity to purchase billions of dollars' worth of stock at about half book value; that, of course, further increased book value in a virtuous cycle.

What We Expect

Underwriting discipline will continue to drive increased earnings and a higher valuation. That plus a renewed focus on capital management will improve AIG's credit rating, reducing its cost of debt and providing another lever for higher profitability. Management is still ridding the company of non-core assets, including the aircraft leasing business mentioned above; once that's complete and coverage ratios are in check, CEO Bob Benmosche will likely reinstate a dividend (provided the Federal Reserve gives the go-ahead).

More Resources

- *Pro*'s original recommendation (8/24/12)
- Talk about AIG on our discussion board

At Your Broker

- **E-Trade:** AIG.WS
- **Fidelity:** AIG/WS (paste CUSPID 026874156 into the quote page)
- **Interactive Brokers:** Find AIG; select "warrants" from the drop-down menu
- **optionsXpress:** AIGwS
- **Schwab:** AIG/WS
- **TD Ameritrade:** AIG+
- **Vanguard:** AIG_t

Helpful Links

- AIG's explanation of the warrants
- AIG's warrant registration statement filed with the SEC

The *Pro* Bottom Line

We recommend buying 2.8% of AIG stock and 0.7% of AIG warrants (see below for more on those).

Benmosche has cleaned out the business, so by purchasing now, you get in after all the hard work has been done. Book value — the best measure of an insurance company's worth — is growing quickly. And AIG's current share price is two-thirds of book value. That's cheap, especially given the company's momentum. Investors who buy AIG now are positioning themselves for outsized future returns with less risk. That's contrarian investing at its best.

A Note on Warrants

Warrants are similar to call options, except that they are issued by the underlying company. They offer the purchaser the right (but not the obligation) to buy the stock in question at the specified price. The warrants we're recommending on AIG are valid for 10 years from the date of issue (Jan. 19, 2011), and they can be exercised at any point before they expire on Jan. 19, 2021. When exercised, they allow the holder of the warrant to buy shares of AIG at $45 per share, regardless of the market price.

That $45 strike price adjusts favorably in the event of dilution or annual cash dividends greater than $0.675 per share (which would also lower the share price). Warrants are illiquid, and Goldman Sachs is the designated market maker for them; when you buy them, be sure to use a limit order so Goldman doesn't get more than a fair price.

Be aware that if our investment in AIG works out, those who own warrants will earn leveraged returns on them. If we're wrong, though, the warrants will be a total loss, because they're out-of-the-money.

Buy First: Apple

The leader in mobile computing products is cheaper than it's been in years.

Suggested Allocation: 3.3%

There's only one type of apple we like to buy when it's bruised, and it's not a Red Delicious. Once the largest corporation in the world, the **Apple** we want to own has fallen from the market's good graces on investors' worry about declining profit margins, slowing growth, and a lack of innovation.

Is this commonly chirped refrain right? Has Apple lost its edge in the marketplace? We don't believe so, because the company's uniquely integrated hardware and software have made for a great consumer experience that provides little incentive to switch to a competitor. We do realize the company will have to fight a harder and more expensive battle to win new customers as competitors close the quality and experience gap, but we maintain that Apple shares are one of the greatest deals in the Pro portfolio.

What It Does

Led by its iPhone and iPad, Apple designs computing devices people love to use. Its products tie into the Apple operating system, which centers on its App Store marketplace. Apps turn a piece of hardware into a personalized, go-anywhere computer that gets ingrained into the user's daily life.

The gadget that kicked off the company's renaissance, the iPod, is joined not just by the iPhone and iPad but also by Mac computers, iCloud, software, and the small Apple TV to round out the surprisingly compact product line. By selling relatively few products, Apple can generate production efficiencies to earn higher margins and more effectively guide consumer behavior.

How It's Working

Apple's recent second-quarter results disappointed many investors, even though the numbers were just fine. Total sales were up 11% to $43.6 billion; gross margin, a measure of profitability, decreased to 37.5% from 47.4%; and operating cash flow climbed to $35.9 billion. The quick read is that Apple continues to sell a huge number of devices, but as product cycles ebb and flow, the company's profitability will do the same (because of differing pricing and cost structures for each product). One thing remains consistent: Apple's free cash flow is absurd — more than $45 billion over the past 12 months. That's enough to give $5 and a free iTunes song to every person on earth!

What We Expect

Apple refreshed nearly all of its product lines in 2012, driving sales but dinging margins. The company was unable to meet consumer demand for its two newest iPhone models, its new MacBooks, and its iPad Minis, so it wasn't running as efficiently or profitably as it could have. But it is ramping up production to keep that situation from happening again, which should also soften production costs per unit and set Apple up for a respectable 2013.

More Resources

- *Pro*'s original recommendation (2/14/12)
- Talk about Apple on our discussion board

In the longer term, we (like everyone else) expect more great innovations from Apple. While we wait, we think customer loyalty will drive healthy recurring sales, while new customers, emerging markets, and brand-new products fertilize growth. The resulting earnings should reassure investors that Apple isn't going bad.

The *Pro* Bottom Line

As much as we miss the late Steve Jobs at the helm, we believe he built a company that will continue to delight the world with its products. With investors running scared from one of the most groundbreaking businesses in recent history, we believe now is a good time to put our jester caps on and buy when others are selling.

Buy First: Oracle

This old-guard tech giant has more room to grow.

Suggested Allocation: 4.5%

Leading software sellers can write a program once and sell millions of copies, then provide small but critical updates on a regular basis. These updates drive a subscription business model, which leads to recurring revenue. **Oracle** is no exception, with most of its customers renewing annual software contracts that represent more than 40% of its annual revenue. This is stability on which Oracle can grow.

Where is it looking to grow? To name three areas, Oracle is targeting new cloud software sales, software as a service (SAAS) in general, and groundbreaking data hardware sales — and we're pleased with its progress to date and the prospects of all three.

What It Does

Oracle is one of the world's largest providers of software for corporations, but unlike other old-school tech giants over the past 10 years — including **Cisco Systems**, **Dell**, and **Microsoft** — Oracle's stock price has steadily risen as its business has grown. Oracle's software runs databases, middleware, applications, and hardware for thousands of clients around the globe. And when it comes to hardware, Oracle's own groundbreaking Exadata and Exalogic machines provide extreme data processing with industry-leading speed.

By combining its software expertise (both in the traditional sense and in the cloud) with its young hardware business, Oracle is poised to experience another period of growth. The business is incredibly sticky — companies don't trust their data to just anyone, and it can be tricky and even risky to make a switch. So to add to its revenue base, Oracle mainly needs to cross-sell new products to existing clients, while continuing to rope in new clients with its great breadth of modular software solutions.

How It's Working

In the fiscal year 2013 that just ended May 31, Oracle's new software sales topped a record $10 billion, growing 6% in constant currency. Non-GAAP earnings per share grew 11% to $2.68, non-GAAP operating margin hit an all-time high of 47%, and free cash flow hit a record $13.6 billion. Total revenue was up a modest 2% to $37 billion after very strong growth in fiscal 2010. Such a pause is not unusual, especially given that Oracle has sliced low-margin hardware products from its product line and hired thousands of salespeople to sell cloud software. On June 20, management doubled the dividend and announced a new $12 billion share buyback.

What We Expect

More Resources

- *Pro*'s original recommendation (9/17/09)
- Talk about Oracle on our discussion board

Wall Street loves growth, but it especially loves growth that comes with higher margins. Oracle trades at 10.8 times free cash flow, well below the S&P 500's average in the mid- teens. With management expecting more operating leverage ahead and growth in hardware sales, the stock should produce a North Star-topping, 10%-plus annualized return over the coming three years. We expect the company's hardware and modular software combinations to continue to create a clear value proposition, driving sales and resulting in pleasing growth — even for this large company.

The *Pro* Bottom Line

With 390,000 customers, including all 100 of the Fortune 100, Oracle has few equals in the enterprise software market. Now it's making headway in the related hardware market, and we believe this hard-driving company will continue to reward shareholders.

Buy First: O'Reilly Automotive

Exceptional management should deliver impressive growth.

Suggested Allocation: 3.4%

What It Does

O'Reilly Automotive is America's second-largest auto parts retailer, with more than 4,000 stores. Auto parts are a big business, estimated at $231 billion, and O'Reilly is an exceptional competitor, with an addressable market size of about $131 billion.

Running 24 regional distribution centers and 240 hub stores as part of a two-tiered distribution strategy, the company provides same-day or overnight availability on more than 142,000 items, including many that its competitors don't usually stock. Basic auto parts, tools, and services complement those hard-to- find treasures. As a result, O'Reilly's sales are historically split between "do-it-yourself " retail customers and more lucrative professional-services customers (such as auto repair shops).

Personalized customer service by long- tenured store managers paves the way for continued success. More than 800 managers have worked an average of 13 to 18 years with the company.

How It's Working

Tenured employees share a common history and learn to improve a business in a consistent fashion. Since going public in 1993, O'Reilly has achieved 20 consecutive years of record revenue and operating earnings and has grown same-store sales every single year. Diluted net earnings per share have jumped more than 20% annually over the past decade, with 25% growth in 2012. All signs point to more growth ahead.

O'Reilly plans to open 190 net new stores in 2013, upping its 2012 year-end store count by 4.8%, and same-store sales are expected to increase 3% to 5%. By clustering stores together (one-quarter of its locations are in California and Texas), O'Reilly is able to rapidly achieve economies of scale, and by serving professionals and retail customers, it's able to enter smaller markets where competitors don't often tread. There's also no shortage of independent stores or chains to acquire in this highly fragmented industry. In 2012, O'Reilly acquired 56 locations on top of opening 180 net new stores.

O'Reilly has steadily improved profitability, generated strong free cash flow, and maintained a healthy balance sheet while expanding. Rewarding this consistent showing, the stock has been a steady, top performer over the past five and 10 years.

What We Expect

Management should continue to build value as the auto store retail industry consolidates (O'Reilly may lead the way in acquisitions), and customers will continue to walk through the doors in record numbers as used cars last longer than ever. For every neighbor buying a brand-new car, somebody is buying the used one they're trading in, keeping it on the road. We expect and will demand steady, reliable business performance from O'Reilly over any reasonable time period, or we'll show it a stop sign.

More Resources

- *Pro*'s original recommendation (4/15/13)
- Talk about O'Reilly on our discussion board

The *Pro* Bottom Line

Older cars require more maintenance. The average car in America was 10.8 years old in 2011, near a record high. The number of registered cars in the United States increased 15% in the past decade. Even as more new cars drive off the lots, older cars are rarely being destroyed. O'Reilly is well positioned to be profitably supplying car parts and accessories to your grandchildren, who may very well be driving souped-up versions of today's Lexuses and Acuras decades down the road.

The Motley Fool owns shares of American International Group, Apple, Microsoft, Oracle, and O'Reilly Automotive and has the following options: Long Jan 2014 $25 calls on American International Group. See Pro's holdings here. See the team's and David and Tom Gardner's holdings here.

Our North Star

Published Jun 17, 2013 at 12:00AM

Our North Star is a guide for our investing behavior, and like the real North Star, we can use it to navigate on our course to a winning portfolio.

Pro Strategy Guide

Get up to speed in no time with this series of articles that will show you how to invest like a Pro:

- How We Invest
- ▼ **Our North Star**
  - Inflation + 7%
  - Historical Performance
  - *Pro*'s Performance
  - FAQ
- Inside the Portfolio
- Finding Great Companies

Motley Fool Pro's mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years. To stay on course, we developed a guide — our North Star.

Pro's North Star: Inflation + 7% annually

This isn't a specific destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward.

Why inflation + 7%? our mission is to grow the real purchasing power of our capital. Therefore, the first competitor we need to beat is inflation, as measured by the Consumer Price Index.

We want to grow our dollars by more than the rate of inflation — that's a given. Exactly how much more is a difficult figure to pinpoint, but history tells us that if we can double the real purchasing power of your dollars every 10 years, we'll be doing what few manage to accomplish.

To double your dollars in a decade, we need to book a compound annual return of about 7%. To double your real dollars, we need to return 7% plus inflation. Thus, this figure is born directly out of our mission of absolute returns — returns that improve your financial standing in the real world.

Our North Star has several important characteristics that make it appropriate, challenging, and aspirational for all of us. It:

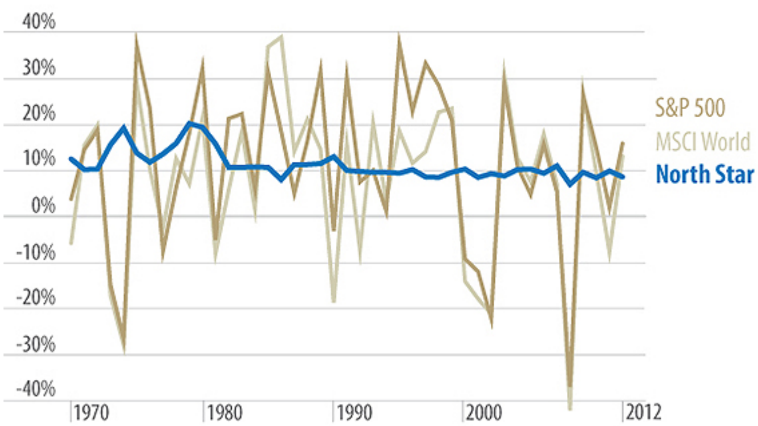
- **Never goes negative.** This lines up with our goal of positive returns over all three-year periods.
- **Is not investable.** It's impossible to lock in a return of inflation plus 7% with some other vehicle.
- **Is not a benchmark.** By definition, benchmarks are investable; they are used for evaluating the performance of a relative-returns strategy. Absolute returns are our goal.
- **Is not a hurdle.** A hurdle is something you must leap over to avoid tripping. Our North Star guides us to make appropriate investment decisions. We're more likely to reach our goals if we let it guide us. If we come close to our North Star, let alone jump over it, we'll be over the moon (sorry!).
- **Is not a gimmick.** We are working to better explain our philosophy and strategy to you, and our North Star will be an ever-present factor in our investment decision-making.
- **Is a challenging reference point.** Historically, our North Star has outperformed the U.S. and world stock markets. Over rolling three-year periods since 1970, our North Star has put up a compound annual return of 11.3%, versus 9.9% for the S&P 500 Total Return Index and 6.4% for the MSCI World index. Our North Star also delivered that return much more steadily than the market indexes, without a single down year.
- **Guides our behavior** as we invest with the tools available to us. It is a framework to explain and reinforce consistent portfolio decisions. Approached consistently over long periods, it should help us and our members achieve strong financial rewards.

Historical Performance

Here's a summary of the past 43 years:

Annualized Return, 1970–2012

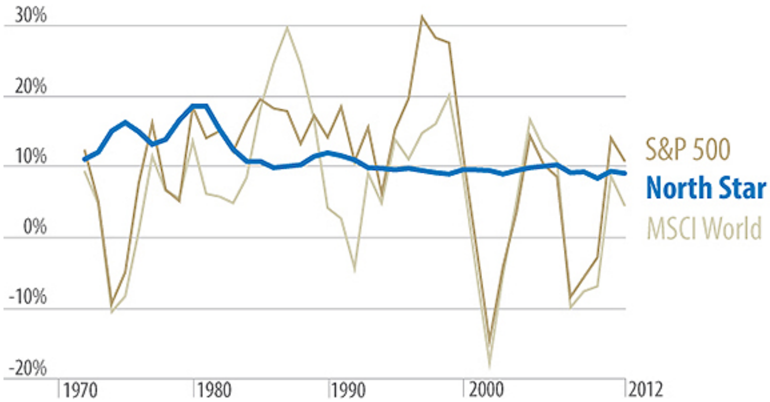
Target	Average	Compound Annual Growth Rate	Best Year	Worst Year
North Star	11.3%	11.3%	20.3%	7.1%
S&P Total Return	11.4%	9.9%	37.6%	-37%
MSCI World	7.8%	6.1%	39.1%	-42.1%



Here are the same data, showing rolling three-year annualized returns. Again, note the lack of volatility for our North Star:

Annualized Rolling 3-Year Return, 1972–2012

Target	Average	Compound Annual Growth Rate	Best 3 Years	Worst 3 Years
North Star	11.4%	11.3%	18.6%	8.4%
S&P Total Return	10.4%	9.9%	31.2%	-14.6%
MSCI World	6.9%	6.4%	29.7%	-17.7%

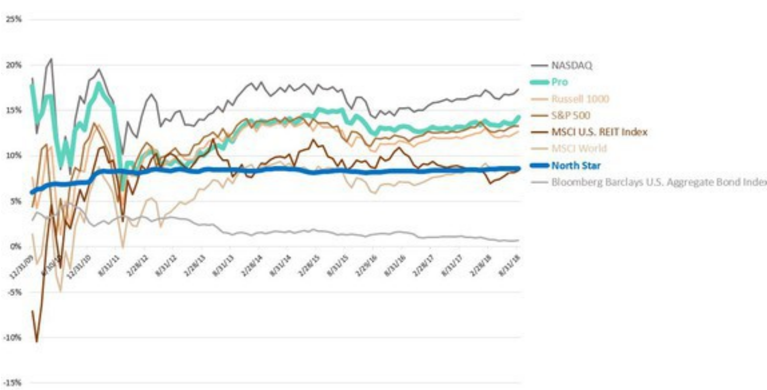


Note that we look at both average and compound annual historical growth rates. To investors, the one that matters is the CAGR. We include both to show the power of compounding: Even though our North Star has averaged an almost identical annual return to that of the S&P Total Return index over the past 43 years, the North Star — inflation plus 7% — has outperformed the index by about 1.4 percentage points annually. That's because when the index has those deeply negative years, much higher positive years are needed to claw its way back to positive territory. Since it never goes negative, our North Star doesn't have that problem. That is the power of steady, positive returns.

Pro's Performance

Here are *Pro*'s annualized returns lined up against our North Star. (Again purely for education, we've also included the returns for the S&P Total Return and MSCI World indexes.) The chart shows the annualized return as of the end of each month. The data begin one year after *Pro*'s start, because annualized returns based on less than a year of data aren't very useful.

These returns are annualized, not cumulative. Annualized returns are more useful to investors because they allow easy comparisons. Also, a note on the recency of data: The Consumer Price Index (inflation) data is reported with a several-week lag, while Pro's performance is in real time. Inflation is quite stable from month to month, so we use the previous month's inflation figure as an estimate for the current month's until the actual data are released. Any adjustment required is usually negligible, especially given the rolling three-year viewpoint we favor. This approach allows us to keep our performance tables updated all the time. (Updated October 2018; click for larger version.)



More on the North Star

It's a bird, it's a plane, it's our North Star discussion board!

Relive our live chat with members about the debut of the North Star

FAQ About Our North Star

How are you measuring inflation?

We're using the change in the Consumer Price Index. The Consumer Price Index is a measure of the average change over time in prices paid for a "market basket" of consumer goods and services. In plain language, it measures how many more dollars it takes to buy things over time.

Specifically, we're using the CPI-U, or the Consumer Price Index for All Urban Consumers, which covers about 87% of the U.S. population. We're using the "all items" version of the CPI-U, which means that we aren't excluding anything. This is worth pointing out because media-reported CPI figures often exclude food and energy prices.

Wait a second. I'm pretty good at math, and you need to return 7.177346% annually to double your money in 10 years. What gives with your 7% figure?

Yes, to be precise, we'd need to return $2^{(1/10)}$-1, or about 7.177346%, per year to double a portfolio in 10 years. Spelling out our North Star as inflation + 7.177346% doesn't in any way make it more useful as a guide, though.

Is the North Star a hurdle or benchmark?

Our North Star is neither a hurdle nor a benchmark. Hurdles are things you intend to leap over, and benchmarks represent an alternative for your investment dollars. Our North Star is neither of these things. Its purpose is to offer us direction, guide our behavior, and keep our mission front and center.

What is a rolling three-year period?

Rolling three-year returns measure performance over the most recent three years. So the rolling three-year return as of Oct. 31, 2011, measures the return since Oct. 31, 2008. A month later, the rolling three-year return as of Nov. 30, 2011, measures the return since Nov. 30, 2008.

How will the North Star change how *Pro* is managed?

Our strategy will not change, but our implementation of it should improve with the North Star as a guide. Our North Star should remind us to lower our risk when we have large, abnormal returns, or increase our exposure to stocks and income if we're not close to our North Star. Thankfully, this should work well in the marketplace. If stocks are up sharply, we *should* be looking to lower our exposure, as our North Star would suggest. If returns are lackluster, we *should* be looking for more stock values or income strategies. Following a steady North Star should help us make better decisions.

Why is the North Star better than the S&P 500?

Pro has never been an alternative for the S&P 500 index. We use options for income, we short, and we hedge. The index is a long, stock-only vehicle. *Pro* is also not about returns relative to an index; we're about positive gains over any reasonable period. The North Star never goes negative, so it's a much better measure against our goal than is the volatile S&P 500, which can be negative for years.

Inflation is relatively tame lately. What happens when it soars?

Then our North Star's annual return is going to soar, too. Thankfully, stocks typically compete well with inflation, so to follow our North Star, we know we'll need to be largely invested in stocks during periods of high inflation, and we'll likely use fewer income strategies, because fixed income may not keep up with inflation.

What if you don't top your North Star?

We'll be happy if we just stay on track with it — or stay relatively close. If we *can* top it over many years, that would be excellent. But we need to realize the lofty challenge of topping a measure that *never* has a negative year while we're investing in stocks. Our North Star is our aspiration, not a hurdle or benchmark.

Can I measure the North Star against my portfolio at home?

Absolutely. Using the Bureau of Labor Statistics CPI stats, you can obtain historical CPI measures along with a monthly update to compare the CPI+7% to your portfolio. We've already done the 41-year history for you above, and we'll be updating the North Star results monthly for you.

Where can I talk about the North Star with the *Pro* team and other members?

Our North Star discussion board is always shining (sorry!).

Next Step: Inside the Portfolio →

What's Next for You

Published Jun 6, 2013 at 12:00AM

In this video, *Pro* advisor Jeff Fischer explains what makes *Pro* different from other Foolish services. With far less risk than an "all-in" investor, we've earned double-digit annualized returns since we began, and we always have cash at the ready for great opportunities. Watch Jeff's three reasons why our *Pro* journey together is so compelling:

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Make sure you don't miss our next trade alert — update your account information today!

Click Here to Make Sure You Receive Our Next Trade

The Motley Fool owns shares of AmTrust Financial Services and Papa John's International.

Portfolio Positioning Live Event

Published Mar 14, 2013 at 12:00AM

The final piece of the “catching-up-with-Pro” puzzle, our Portfolio Positioning Report, will be released Tuesday, March 19. In that report, we’ll walk you through all of our current shorts, options positions, and hedges, and explain how you can get on board alongside us now. We’ll also have a live member event on this page that day; the whole team will be on hand to answer any questions you have about those positions specifically or catching up with us in general. Set a reminder below, and we'll see you on the 19th!

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Alpha Transition Reports

Published Mar 8, 2013 at 12:00AM

Welcome, Fool! These Catch-Up Reports are designed to provide you with the guidance you need as you transition from *Alpha* to *Pro*. Start with Report No. 1, and watch this space for new reports through March 18.

Alpha Transition Report No. 1: March 8, 2013

- Download (PDF)

Alpha Transition Report No. 2: March 12, 2013

- Download (PDF)

Alpha Transition Report No. 3: March 15, 2013

- Download (PDF)

Alpha Transition Report No. 4: March 18, 2013

- Download (PDF)

Pro Academy

Published Feb 28, 2013 at 12:00AM

Looking for the info from our "*Pro* Academy"? You can find it here!

Video 1 (PDF)

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Video 2 (PDF)

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Video 3 (PDF)

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Pro's Investment Strategy Guide

Published Feb 13, 2013 at 12:00AM

Getting Started With *Pro*

1. Catch-Up Report No. 1
2. ***Pro* 's Investment Strategy Guide**
3. What *Pro* Believes
4. Use Options Like a Pro

Back to Guidebook | Site Directory

You may already have noticed two things about *Motley Fool Pro*:

- Between our real-time trades, our Monday Memos and other communications, and our active discussion boards, things can move quickly in *Pro*-land.
- Despite that fact, advisor Jeff Fischer and the analyst team are some of the calmest, most reasonable investors you're likely to meet anywhere.

We think that combination of nimble thinking and sound, sensible decision-making is part of what makes Pro so great, and to highlight the second half of the equation, we've put together this Investment Strategy Guide. It takes you behind the scenes, detailing the steady, rational approach that has made Pro so successful. Our mission is to earn you consistent, recurring profits with a high level of accuracy using a combination of stocks, options, and ETFs. We use stocks for long-term gains and options for shorter-term strategies. This Investment Strategy Guide shows you all the ingredients to our secret sauce, including how we invest, how we allocate our capital, details on our North Star, and more.

Click here to download the Investment Strategy Guide

Pro's Investment Strategy Guide

Published Feb 13, 2013 at 12:00AM

Getting Started With *Pro*

1. Catch-Up Report No. 1
2. ***Pro* 's Investment Strategy Guide**
3. What *Pro* Believes

Back to Guidebook | Site Directory

You may already have noticed two things about *Motley Fool Pro*:

- Between our real-time trades, our Monday Memos and other communications, and our active discussion boards, things can move quickly in *Pro*-land.
- Despite that fact, advisor Jeff Fischer and the analyst team are some of the calmest, most reasonable investors you're likely to meet anywhere.

We think that combination of nimble thinking and sound, sensible decision-making is part of what makes Pro so great, and to highlight the second half of the equation, we've put together this Investment Strategy Guide. It takes you behind the scenes, detailing the steady, rational approach that has made Pro so successful. Our mission is to earn you consistent, recurring profits with a high level of accuracy using a combination of stocks, options, and ETFs. We use stocks for long-term gains and options for shorter-term strategies. This Investment Strategy Guide shows you all the ingredients to our secret sauce, including how we invest, how we allocate our capital, details on our North Star, and more.

Click here to download the Investment Strategy Guide

"Invest Like a Pro" Live Event

Published Feb 12, 2013 at 12:00AM

Don't miss our upcoming LIVE event for new *Pro* members (current members welcome too, of course)! On Thursday, Feb. 28 at 1 p.m. ET, Jeff and the *Pro* team will release our second catch-up report for new members — and then answer your questions on video and via a live chat. If you can't participate live, don't fret; the Catch-Up Report and archives of the video and chat will all be available on the *Pro* site immediately following the event.

The live event is a great chance for new and veteran members alike to get to know the *Pro* team and ask your burning questions about the service, how to align your portfolio with *Pro*'s ... anything at all. We look forward to "seeing" you on this page on Thursday, Feb. 28!

Use Options Like a Pro

Published Feb 11, 2013 at 12:00AM

Getting Started With *Pro*

1. Catch-Up Report No. 1
2. *Pro* 's Investment Strategy Guide
3. What *Pro* Believes
4. **Use Options Like a Pro**

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How Options Fit the *Pro* Portfolio

While we generally seek long-term capital gains from stocks, most of our options are used for *short-term* income or gains. By combining these strategies, along with ETFs and shorts, *Pro* investors can make profits in the coming weeks *and* the coming years, accomplishing our goal of earning steady, recurring profits with high accuracy in both the short and long term.

We use options strategically, as part of portfolio management. Options work hand in hand with stocks, and your *Pro* portfolio should come to reflect that. Finally, although most options do make money in the short term, we're not *traders* of options. We use them tactically and appreciate the fact that they expire in a matter of weeks or months.

The Strategies We Love

Pro will use more than a dozen options strategies, depending on what's most appealing at the time. But we rely on just a handful, and knowing how to use even one or two strategies is enough to change and improve how you invest. In addition to writing puts and writing covered calls — two of our favorite strategies — we will be buying calls to leverage gains; buying puts to protect positions or to short a stock; writing covered strangles (selling both puts *and* covered calls on a stock to double our income); using option spreads to earn large returns on investment with low risk; buying straddles to profit on big price moves in either direction; and more.

How to Learn More

If you are new to options investing, or just need a refresher, we recommend that you take advantage of the great educational resources at *Motley Fool Options* (to which you have unlimited access, as part of your *Pro* membership). Start at the Guidebook, take our quick survey, and then follow the steps to (re)learn the basics.

Catch-Up Reports

Published Feb 8, 2013 at 12:00AM

Ready to Become a *Pro* Investor? These Catch-Up Reports give you everything you need to match your portfolio with ours — quickly, painlessly, and (we hope) enjoyably. Start with Report No. 1, and watch this space for new reports through March 19. (Veteran *Pro* Fool? The guidance in these reports is not new, but if you need some help catching up with us, feel free to peruse them!)

Catch-Up Report 1: Feb. 14, 2013

- Download (PDF) (All in Cash Version)
- Download (PDF) (Currently Invested Elsewhere Version)

Catch-Up Report 2: Feb. 28, 2013

- Download (PDF)

Catch-Up Report 3: March 7, 2013

- Download (PDF)

Catch-Up Report 4: March 14, 2013

- Download (PDF)

Portfolio Positioning Report: March 19, 2013

- This report will tell you how to short, hedge, and use options to match our exposure and general portfolio position, even if you can't or don't want to engage in every strategy we employ. We'll also have a live chat at 1 p.m. ET on March 19 to address any questions you may have about this report.
- Download (PDF)

Building Your Pro Portfolio

Published Feb 8, 2013 at 12:00AM

Pro is designed to make it easy for you to invest alongside our portfolio and stay up-to-date with the latest news that affects your stocks.

- **Trade Alerts:** When we see an opportunity, you're the first to know. Anytime during normal market hours, we will issue a real-time Trade Alert email with a link to our full recommendation — including details on why and how to make the trade — on the *Pro* site. See the archive here »
- **Monday Memos:** Every Monday at 4 p.m. ET, we'll send you our latest thoughts on the *Pro* portfolio, plus market insights, community highlights, and a list of active *Pro* positions we think still represent good opportunities for new money. See the archive here »
- **What to Do:** The *Pro* portfolio shows at-a-glance — and in real time — which positions the team thinks are ripe for new money now, and which are best to hold for the moment. See the portfolio here »
  - **Buy First:** Just what it says. If you're starting to build your *Pro* portfolio and plan to mirror us, we recommend allocating your capital here first.
  - **Buy:** We believe in these as much as our Buy First stocks and suggest you buy them next as you build your portfolio. (We like to buy these in chunks over time.)
  - **Hold:** This means to keep holding the position if you own it already, but don't add more cash to it. If you don't own this position yet, don't buy unless you can get shares near our preferred Buy Around price.
  - **Sell:** 'Nuff said. We're selling this position and recommend you do, too.
- **What We Think Now:** See the team's current thinking in brief on every position in the *Pro* portfolio. You'll know where we stand on each of our investments right now, all on one page. See What We Think Now »
- **Guides, Audio/Video Extras, Special Updates**: *Pro* helps you navigate the market by delivering market-beating recommendations right to your inbox. But we also aim to teach you how to find those gems yourself. Learn about *Pro*'s strategies, listen to the team talk stocks, and get the latest on happenings in your portfolio. See the archive of extras »

Catch-Up Report No. 1

Published Feb 8, 2013 at 12:00AM

Getting Started With *Pro*

1. **Catch-Up Report No. 1**
2. *Pro* 's Investment Strategy Guide
3. What *Pro* Believes

Back to Guidebook | Site Directory

Welcome to *Motley Fool Pro*! This Catch-Up Report is designed to help you match your portfolio to *Pro*'s. You'll find the two stocks we recommend you buy right away — along with our analysis, allocation guidance, and much more — on pages 2 and 5. But first, we'll start with the portfolio you have right now. Since you have cash ready to deploy into your new *Pro* portfolio, we recommend you follow along with us as closely as you're able — and we provide guidance on exactly how.

Download the report to get started!

Catch-Up Report No. 1

Published Feb 8, 2013 at 12:00AM

Getting Started With *Pro*

1. **Catch-Up Report No. 1**
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Download the report to get started!

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Download the report to get started!

Your Guide to Our North Star

Published Feb 5, 2013 at 12:00AM

Like the real North Star, our North Star offers direction and guides our investing behavior. Learn more below.

Pro's Mission

Our mission is to earn members consistent, recurring profits with a high level of accuracy. Using a combination of long and short stocks, options, and ETFs, we aim to achieve positive returns over every rolling three-year period and to double our real purchasing power every 10 years.

***Pro*'s North Star: Inflation + 7% annually**

Our North Star is a guide for our investing behavior. Like the real North Star, we can use it to navigate. It is not a destination; rather, it's an omnipresent fixture that offers us direction and reminds us of what we're striving toward.

Why inflation + 7%?

Our mission is to grow the real purchasing power of our capital. Therefore, the first competitor we need to beat is inflation, as measured by the Consumer Price Index.

We want to grow our dollars by more than the rate of inflation — that's a given. Exactly how much more is a difficult figure to pinpoint, but history tells us that if we can double the *real* purchasing power of your dollars every 10 years, we'll be doing what few manage to accomplish.

To double your dollars in a decade, we need to book a compound annual return of about 7%. To double your *real* dollars, we need to return 7% *plus* inflation. Thus, this figure is born directly out of our mission of absolute returns — returns that improve your financial standing in the real world.

Our North Star has several important characteristics that make it appropriate, challenging, and aspirational for all of us. It:

- **Never goes negative.** This lines up with our goal of positive returns over all three-year periods.
- **Is not investable**. It's impossible to lock in a return of inflation plus 7% with some other vehicle.
- **Is not a benchmark**. By definition, benchmarks must be investable; they are used for evaluating the performance of a relative-returns strategy. Absolute returns are our goal.
- **Is not a hurdle**. A hurdle is something you must leap over to avoid tripping. Our North Star guides us to make appropriate investment decisions. We're more likely to reach our goals if we let it guide us. If we come close to our North Star, let alone jump over it, we'll be over the moon (sorry!).
- **Is not a gimmick**. We are working to better explain our philosophy and strategy to you, and our North Star will be an ever-present factor in our investment decision-making.
- **Is a challenging reference point**. Historically, our North Star has outperformed the U.S. and world stock markets. Over rolling three-year periods since 1970, our North Star has put up a compound annual return of 11.3%, versus 9.9% for the S&P 500 Total Return Index and 6.4% for the MSCI World index. Our North Star also delivered that return *much* more steadily than the market indexes, without a single down year.
- **Guides our behavior** as we invest with the tools available to us. It is a framework to explain and reinforce consistent portfolio decisions. Approached consistently over long periods, it should help us and our members achieve strong financial rewards.

More Guidance

It's a bird, it's a plane, it's our [North Star discussion board]!

[Relive our live chat] with members about the debut of the North Star

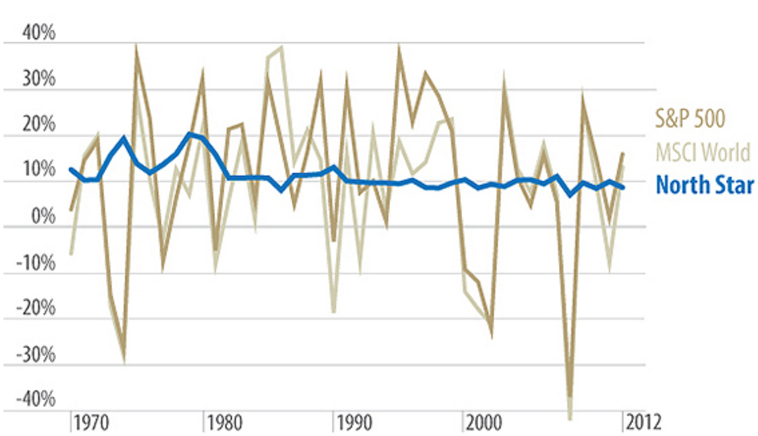
Historical Performance

How has our North Star performed historically? We're glad you asked, and we hope you like data! Here's a summary of the past 41 years. Below that are charts of the full history.

Annualized Return, 1970–2012

	Average	CAGR	Highest	Lowest
North Star	**11.3%**	**11.3%**	**20.3%**	**7.1%**
S&P Total Return	11.4%	9.9%	37.6%	-37.0%
MSCI World	7.8%	6.1%	39.1%	-42.1%

Annualized Return, 1970–2012

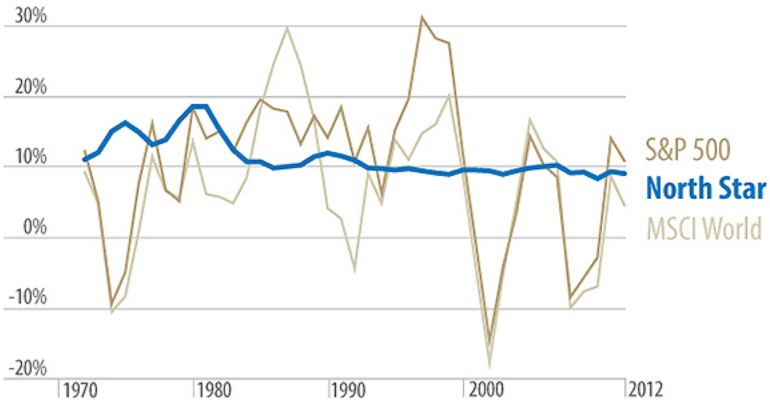


Here are the same data, showing rolling three-year annualized returns. Again, note the lack of volatility for our North Star.

Annualized Rolling 3-Year Return, 1972–2012

	Average	CAGR	Highest	Lowest
North Star	**11.4%**	**11.3%**	**18.6%**	**8.4%**
S&P Total Return	10.4%	9.9%	31.2%	-14.6%
MSCI World	6.9%	6.4%	29.7%	-17.7%

Annualized Rolling 3-Year Return, 1972–2012



Note that we included both average and compound annual (CAGR) historical growth rates. To investors, the one that matters is the CAGR. We included both to show the power of compounding: Even though our North Star has averaged an almost identical annual return to that of the S&P Total Return index over the past 43 years, the North Star (again, inflation plus 7%) has outperformed the index by about 1.4 percentage points annually. That's because when the index has those deeply negative years, much higher positive years are needed to claw its way back to positive territory. Since it never goes negative, our North Star doesn't have that problem. That is the power of steady, positive returns — see below for visual representation.

(We're including the S&P Total Return and MSCI World returns purely for the sake of education. Our investment strategies are not focused on either.)

Performance Since Inception

How has *Pro* performed against its North Star since our start in 2008? We hope you *really* like data: Here are *Pro*'s annualized returns lined up against those of our North Star. (Again purely for education, we've also included the returns for the S&P Total Return index and the MSCI World index.)

These returns are annualized, not cumulative. Annualized returns are more useful to investors because they allow easy comparisons.

A note on the recency of data: The Consumer Price Index (inflation) data is reported with a several-week lag, while *Pro*'s performance is in real time. Inflation is quite stable from month to month, so we use the previous month's inflation figure as an estimate for the current month's until the actual data are released. Any adjustment required is usually negligible, especially given the rolling three-year viewpoint we favor. This approach allows us to keep our performance tables updated all the time.

Annualized Return

To read this chart, remember that the return data are annualized, not cumulative: The chart shows the annualized return since inception *as of the end of each subsequent month*. The data begin one year after *Pro*'s start, because annualized returns based on less than a year of data aren't very useful.

And here are our rolling three-year annualized returns — again, our preferred measurement.

Annualized Rolling 3-Year Return

Date	*Pro* Portfolio Balance	*Pro*	North Star	S&P Total Return	MSCI World
10/6/08	**$1,000,000**				

Date	*Pro* Portfolio Balance	*Pro*	North Star	S&P Total Return	MSCI World
10/31/08	**$1,001,292**				
...					
11/30/12	**$1,451,264**	**6.90%**	9.23%	11.25%	4.61%
12/31/12	**$1,461,698**	**6.14%**	9.20%	10.87%	4.63%

Questions We Anticipate May Be Frequently Asked

How are you measuring inflation?

We're using the change in the Consumer Price Index. The Consumer Price Index is a measure of the average change over time in prices paid for a "market basket" of consumer goods and services. In plain language, it measures how many more dollars it takes to buy things over time.

Specifically, we're using the CPI-U, or the Consumer Price Index for All Urban Consumers, which covers about 87% of the U.S. population. We're using the "all items" version of the CPI-U, which means that we aren't excluding anything. This is worth pointing out because media-reported CPI figures often exclude food and energy prices.

Wait a second. I'm pretty good at math, and you need to return 7.177346% annually to double your money in 10 years. What gives with your 7% figure?

Yes, to be precise, we'd need to return $2^{(1/10)}$-1, or about 7.177346%, per year to double a portfolio in 10 years. Spelling out our North Star as inflation + 7.177346% doesn't in any way make it more useful as a guide, though.

Is the North Star a hurdle or benchmark?

Our North Star is neither a hurdle nor a benchmark. Hurdles are things you intend to leap over, and benchmarks represent an alternative for your investment dollars. Our North Star is neither of these things. Its purpose is to offer us direction, guide our behavior, and keep our mission front and center.

What is a rolling three-year period?

Rolling three-year returns measure performance over the most recent three years. So the rolling three-year return as of Oct. 31, 2011, measures the return since Oct. 31, 2008. A month later, the rolling three-year return as of Nov. 30, 2011, measures the return since Nov. 30, 2008.

How will the North Star change how *Pro* is managed?

Our strategy will not change, but our implementation of it should improve with the North Star as a guide. Our North Star should remind us to lower our risk when we have large, abnormal returns, or increase our exposure to stocks and income if we're not close to our North Star. Thankfully, this should work well in the marketplace. If stocks are up sharply, we *should* be looking to lower our exposure, as our North Star would suggest. If returns are lackluster, we *should* be looking for more stock values or income strategies. Following a steady North Star should help us make better decisions.

Why is the North Star better than the S&P 500?

Pro has never been an alternative for the S&P 500 index. We use options for income, we short, and we hedge. The index is a long, stock-only vehicle. *Pro* is also not about returns relative to an index; we're about positive gains over any reasonable period. The North Star never goes negative, so it's a much better measure against our goal than is the volatile S&P 500, which can be negative for years.

Inflation is relatively tame lately. What happens when it soars?

Then our North Star's annual return is going to soar, too. Thankfully, stocks typically compete well with inflation, so to follow our North Star, we know we'll need to be largely invested in stocks during periods of high inflation, and we'll likely use fewer income strategies, because fixed income may not keep up with inflation.

What if you don't top your North Star?

We'll be happy if we just stay on track with it — or stay relatively close. If we *can* top it over many years, that would be excellent. But we need to realize the lofty challenge of topping a measure that *never* has a negative year while we're investing in stocks. Our North Star is our aspiration, not a hurdle or benchmark.

Can I measure the North Star against my portfolio at home?

Absolutely. Using the Bureau of Labor Statistics CPI stats, you can obtain historical CPI measures along with a monthly update to compare the CPI+7% to your portfolio. We've already done the 41-year history for you above, and we'll be updating the North Star results monthly for you.

Where can I talk about the North Star with the *Pro* team and other members?

Our North Star discussion board is always shining (sorry!).

Ready to Become a Pro Investor?

Published Jan 28, 2013 at 12:00AM

Get Started Now!

As an experienced investor, you probably don't need too much ramp-up time to start making money the *Pro* way. (Want to take our survey again? Click here.)

{% ooyala id="x0b2xkNToYBbOOwQBbaPwQbHIXYlMzjb" width="264" height="201" %}**Video**: Jeff gives a quick introduction to *Pro*

Create Your *Pro* Portfolio
Read our first catch-up report
+ Catch-Up Report 2: 2/28/13
+ Catch-Up Report 3: 3/7/13
+ Catch-Up Report 4: 3/14/13
+ Check-In Event: 3/19/13

- ***Pro*'s Investing Strategy Guide**
  The recipe to our secret sauce
- **What *Pro* Believes**
  NEW: Jeff's investing outlook for 2013

Quick Links: Our Most Important Resources, One Click Away

Mission & Philosophy

- Investing Strategy Guide (PDF)
- Our North Star
- What We Believe
- Audio Extra: The *Pro* Philosophy
- Philosophy & Strategy discussion

Catch Up With Us

- All of Our Catch-Up Reports
- Investing Strategy Guide (PDF)
- Make *Pro* Fit You
- Building Your *Pro* Portfolio
- Use Options Like a Pro

Tools & Help

- FAQ
- Get Oriented
- Manage Your Email
- The *Pro* wiki
- Getting Started & Help discussion

Using Options

- Use Options Like a Pro
- Make Your First Options Trade
- Options in 3 Steps
- Options Glossary
- Options discussion

How Pro Works

Published Dec 31, 2012 at 12:00AM

How *Pro* Works: In this video, lead advisor Jeff Fischer walks you through the *Pro* experience.

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Back to Using This Service | Next Section: Email

Sub-Subtopic Page

Published Dec 31, 2012 at 12:00AM

Lorem ipsum Pro ipsum. Lorum.

Back to Subtopic Page | Next Section: XXXX

Subtopic Page 1

Published Dec 31, 2012 at 12:00AM

Lorem ipsum Pro ipsum. Lorum.

Back to Topic Page | Next Section: Xxxxx

Worldwide Fool Meetups on Sept. 25

Published Sep 11, 2012 at 12:00AM

As you know, The Motley Fool is dedicated to helping the world invest better. We think one of the best ways to do that is to have the support and help of a community around you — so this Sept. 25 (Invest Better Day), we encourage you, our members, to meet fellow Fools in your local community and make some Foolish connections offline.

In fact, we are sending our investing team to 12 different cities on Invest Better Day. They'll be sharing their thoughts on how to invest better and discussing some companies on their radar. Join them and your fellow Fools in these locations:

Washington, D.C.	New York	Chicago
Los Angeles	San Francisco	Miami
Seattle	Boston	Denver
Philadelphia	Minneapolis	Portland, Ore.

Meetups in these locations are filling up fast, but if your local meetup is at capacity — or if you're not near one of those cities — you can still participate. There are enthusiastic members starting meetups in cities all across the globe. Check here to find your local Fool meetup, then scroll down for tips on how to host it!

Host Your Own Motley Fool Meetup

As a Fool, you're already part of our awesome online community — but we want to help empower Fools to get to know each other offline, too. Here are some tips for putting together your own Motley Fool Meetup for Invest Better Day on Sept. 25:

Time and Place
The date should remain Sept. 25 to be connected to Invest Better Day. Set the time and place for your meetup as early as possible, as scheduling is a big determining factor for attendees. If someone already has a meetup in the same general location you're considering, contact that organizer and see if you can collaborate.

Promotion
By **solidifying the time and place early**, you leave ample opportunity for grassroots promotion. You can simply by sharing the event details with your local friends and colleagues who invest (non-Fools are welcome, too!). Creating a Facebook event can help you reach an audience; you can also send interested investors to your local Motley Fool Meetup page, where they can RSVP.

Format
An Invest Better Day meetup can be **just about any shape and size**. It could be a packed house listening to prominent local keynote speakers. Or (perhaps more likely) it could be an informal get-together of investors at a coffee shop, bookstore, or bar, discussing how they invest now and how to get even better.

Steps to Take

Here's exactly what to do to create your own Motley Fool Invest Better Day event:

1. Visit The Motley Fool's Meetup Everywhere page.
2. Your location will display directly below the map. If this is where you want to host your meetup, click the "Start a new community in…" link. (If you want to use a different location, type it into the search box at the top; that location will then display atop the list of nearby locations.)
3. Enter a name for your new community in the input field. Just use the name of your city (for a meetup in Des Moines, simply enter "Des Moines"), and hit the "Create" button.
4. Click on the "Needs a location, Got one?" link just below the event title. Add the event's location and time. You also can share details and comments about the event.
5. Consider getting the word out by sharing your Motley Fool Meetup on Twitter, Facebook, and the Fool's message boards. Let us know about it, too! Send a note with the details to meetup@fool.com.
6. Check your location's Motley Fool Meetup page frequently to answer questions and start the conversation with attendees before the event begins.

David Gardner on Pro

Published Aug 6, 2012 at 12:00AM

In this video, Motley Fool co-founder David Gardner welcomes you to the *Pro* service and explains why he thinks it's so special. Watch below, then bring any questions to our Getting Started & Help discussion board!

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Ketchup Reports: Terms to Know

Published Jul 20, 2012 at 12:00AM

As you use our Ketchup Reports to get, well, caught up with the *Pro* portfolio, make sure you're familiar with the terms on this page. As always, if you have any questions, ask us on the discussion boards — we are available from 3 to 4 p.m. ET every weekday through the end of August on our Office Hours board!

Terms to Know

- **Buy First:** These are the investments you should make first, setting a foundation for your *Pro* portfolio. In our opinion, these stocks usually have the best risk-to-reward profile, offering healthy upside and low downside.
- **Buy:** We like these as much as our Buy First stocks over the long haul, but they may be more volatile, and they may offer more downside risk while we wait for our thesis to play out.
- **Hold:** We currently have 10 stocks on hold, and we won't cover them in this report. They're always listed on the Recommendations page. We don't suggest buying our stocks on hold today, but if you already own them, hold them. In every Monday Memo, we'll share "catch-up" trades to help you get into stocks on hold at lower prices.

The Recommendations page is your "King of Guidance." That page is always kept current, so if something is listed there as a Buy First or Buy, we believe it can be bought today, period. The moment we no longer believe that, we'll move it to Hold on that page and announce that change on the *Pro* home page, as well as in the following Monday Memo.

You'll also need to know these terms:

- **Buy Around:** This is the ideal price around (or below) which you'll buy our recommendations, give or take 5% or even 10%. Investing is not a precise science; if we like a company enough to buy it, a 5% price difference is not going to change the outcome meaningfully. We provide this guidance to give you an initial guidepost, but if a stock is listed as a Buy or Buy First on the Recommendations page, that guidance applies regardless of the Buy Around price.
- **Fair Value:** This is the fair price for the stock — what we believe it's worth today. It is not the automatic sell price. In fact, a stock that's reached its fair value should proceed to achieve our desired rate of return (typically 10% or higher annualized). We only sell at fair value if we want a margin of safety (occasionally, there are stocks we only want to own below fair value) or we see something at a discount we like better.
- **Allocation:** We recommend each position as a percentage of the total amount you're investing in *Pro* stocks (exclude your fixed-income investments). If we say to buy 4.5% in something, then invest $4,500 in that stock for every $100,000 in your *Pro* stock portfolio. There is wiggle room here, and you should allocate in a way that makes you comfortable. Keep in mind, though, that our future guidance will assume you're matching our current allocation.

Walkthrough, Part 2: Invest With Us

Published Jul 12, 2012 at 12:00AM

ProHa Get Ready ...

ProHat Get Set ...

ProHa Go!

ProHat Keep Track

ProHa Options Resources

Help and FAQ

Download this info as a PDF

Walkthrough, Part 1: Learn About *Pro*

Walkthrough, Part 1: Learn About Pro

Published Jul 12, 2012 at 12:00AM

ProHa Think Like a Pro

ProHat Using This Service

ProHa Meet the Team

ProHat Community

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Walkthrough, Part 2: Invest With Us

What Pro Believes

Published Jul 12, 2012 at 12:00AM

Getting Started With *Pro*

1. Catch-Up Report No. 1
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4. Use Options Like a Pro

Back to Guidebook | Site Directory

Our investment mission and our North Star guide our portfolio decisions. But our portfolio itself is a reflection of the key beliefs we have about the world and investing. We attempt to make those beliefs come to life in the *Pro* portfolio, though some beliefs don't yet have a voice.

Below are many of Jeff's strongest big-picture beliefs in 2013.

Jeff Believes ...	So We Own ...
Technology is essential to our world; the sector will grow and become even more important. But tech will remain cutthroat, with players rapidly coming and going, allowing both long and short opportunities.	**3D Systems** , **BMC Software**, **Intel**, **OpenText**, **Oracle**
Well-managed financial companies are still inexpensive and will reward long-term owners.	**AIG** , **Amtrust Financial Services**, **Broadridge Financial Solutions**, **Wells Fargo**
U.S. home construction will continue to recover.	**GrafTech International** , **Rockwood Holdings**
Cash and checks will continue to lose market share to electronic payments.	**MasterCard**

The euro is overvalued compared to the dollar.	Short **CurrencyShares Euro Trust**

The 14 positions listed above represent nearly 60% of the assets in the *Pro* portfolio (as of Jan. 22, 2013). We carry the other positions because we believe they'll help us keep pace with our always-positive North Star, or because we believe in management or the notion that (for example) the world could almost never have too many coffee bars. Below are some of Jeff's other beliefs that we'll also seek to capitalize on in 2013:

- Energy prices will be relatively stable and will potentially decline as the U.S. taps new reserves.
- Flawed ETFs will continue to offer profit opportunities, especially for shorting.
- Auto sales will recover and reach new records, and autos will offer many more technological bells and whistles.
- Our interaction with technology will evolve to commonly include voice commands.
- Most all products will eventually contain a computer chip of some sort.
- Big data will drive ever more pinpointed marketing, and social websites will become still more popular (and profitable).
- Paper media of all forms in the U.S. will come close to disappearing within 10 years.
- Younger generations will want to be memorialized online more than with a tombstone.
- I will live to at least 100 years of age, as will all *Pro* members.
- Healthy eating will remain a growing theme in the U.S.
- Many dominant U.S. companies will thrive, if not lead, in emerging markets.
- Some big retailers will revive and prosper by offering a specialized experience unavailable online.
- Cloud computing — storing files on remote servers — will be an even larger business than expected.
- A sustainable competitive moat will be more important than ever to strong stock performance.
- Interest rates will start to tick up in the next 24 months, but not by much initially.
- Alongside owning great businesses, *Pro* will do well by generating increased income and doing more targeted shorting.

What about the rest of the *Pro* team? Well, Bryan Hinmon's (TMF42) beliefs are listed below. Nick Crow's (TMFCrow), on the other hand, are not; he said his job is to talk us *out* of our beliefs. He'd rather not think in terms of beliefs as he looks for investments — a diverse viewpoint we welcome. Here are Bryan's:

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- Outsourcing will slow, but jobs won't necessarily return to the U.S.; plant and factory automation (robots) will play a big role in productivity.
- Governments at all levels will begin to peel away conservatism by trying new ways to save money.
- People will try to be healthier, but they will fail and look for quick fixes.
- Web security is a big deal, for companies and for individuals.
- People will see their houses as homes, not investments. (Sub-belief: Kitchens will get bigger and more high-tech.)
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What Do You Believe?

There you have it, Fools — many of our beliefs updated and laid bare. What are your key investing beliefs? Share them on *Pro*'s Philosophy discussion board so we can discuss whether and how to put them into play in 2013.

Catch-Up Trades

Published Jul 12, 2012 at 12:00AM

First introduced in our Jan. 23, 2012 Monday Memo, Catch-Up Trades are our weekly suggestions for members who aren't yet entirely aligned with the *Pro* portfolio. As Jeff wrote then:

> Every week, when we see attractive trades, we'll share them in the Memo so members who are not already fully allocated to the position in question can follow along. (Assume that we, too, would be making these trades if we weren't fully allocated!) We hope the Catch-Up Trades will help you catch up with the *Pro* portfolio, or at least make money trying. We'll also single out stocks that have been freshly moved back to a Buy rating.

As well as in the Monday Memo, you'll always find the most recent Catch-Up Trades on our discussion board for the topic. Fool on!

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Published Jul 12, 2012 at 12:00AM

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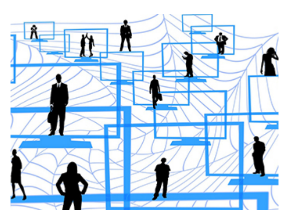

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Practice, Vertical: The Motley Fool Pro Walkthrough

Published Jul 12, 2012 at 12:00AM

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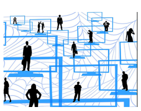

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What Pro Believes

Published Jul 12, 2012 at 12:00AM

Getting Started With *Pro*

1. Catch-Up Report No. 1
2. *Pro* 's Investment Strategy Guide
3. **What *Pro* Believes**

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Our investment mission and our North Star guide our portfolio decisions. But our portfolio itself is a reflection of the key beliefs we have about the world and investing. We attempt to make those beliefs come to life in the *Pro* portfolio, though some beliefs don't yet have a voice.

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The Motley Fool Pro Site Directory

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Making Pro Fit You: If You're Fully Invested Elsewhere

Published Jul 2, 2012 at 12:00AM

Members joining Pro *from another Fool service and those who are already fully invested will need to consider changes to both their portfolios and their mindsets. Here's how to begin.*

As You Get Up to Speed

If you're already fully invested, you'll need to sell existing positions to add *Pro* picks. We recommend that you do this gradually and deliberately.

- List your existing positions in order from your highest-conviction holding to your lowest-conviction holding.
- If you own stocks from another Fool service, you can use that service's guidance on those stocks in building your list.
- If you don't know why you own a stock, that's a good reason to sell it.
- Be mindful of your sector and geographic allocations. You don't want to unintentionally end up owning nothing but oil or European stocks just because they were your favorites.
- If you're struggling with what to sell, post to the discussion boards — the *Pro* team can't give you individual advice, but our community members can and frequently do.
- When you're ready, incrementally sell your lowest-conviction stocks and use the proceeds to move into our Buy First and Buy stocks. Keep an eye on the Catch-Up Trades section of each Monday Memo for timely ways to enter our positions on Hold.
- Review your positions and portfolio after studying *Pro*'s mission and reviewing our North Star. Use that analysis to craft your portfolio going forward.

Once You've Settled In

Once you've built your Buy First and Buy positions, all you need to do is wait for further trade alerts from the team. Remember, though, that trade alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — one gradual step toward shaping the portfolio we want. You may decide to modify the strategy we choose for a trade; for example, you may wish to write puts instead of buying a stock outright. If you choose to deviate from our recommendation, make sure you (a) understand why we chose the strategy we did, (b) have a reason that the modified strategy better fits your portfolio, and (c) exercise caution by sizing the position a bit smaller than you would otherwise.

Your *Pro* Perspective

If you're joining us from another Fool service, it is critical that you understand the differences between *Pro* and some other Fool services. At *Pro*, we are building a portfolio, not offering investment ideas. *Stock Advisor* and *Rule Breakers*, for example, offer stock ideas from which members can pick and choose. In contrast, *Pro*'s trades are intended to be integrated building blocks of an overall portfolio. We cannot emphasize this enough: Anytime you decide to deviate from the *Pro* portfolio, make sure you understand how the trade in question is intended to fit with our portfolio — and how the modified trade will fit with yours. With every trade, keep the portfolio context in mind.

Next Steps

- **Got questions?** Bring them to our Making *Pro* Fit You discussion board.
- **Second opinion?** To see how we recommend you approach *Pro* under other circumstances (say, if you're building your portfolio in an IRA), download the entire "Making *Pro* Fit You" PDF by clicking here.

Making Pro Fit You: If You're Free-Range

Published Jul 2, 2012 at 12:00AM

So you're new to Pro *and able to follow every* Pro *portfolio move to a T? Here's what to do.*

As You Get Up to Speed

Match our portfolio positions and allocations, starting with the Buy First and Buy positions — and do so at your own pace. We'll be sending you four Catch-Up Reports designed to help you do just that, one per week through March 14. You'll find them in your inbox and on the Pro website, and they will include everything you need to know to make the trades. If you're comfortable with options, you can also consider writing puts to try to buy some of our stocks cheaper. Post on the discussion boards to get the community's feedback about any trades before you make them, if you like. Wait for us to issue new guidance before you establish positions in our stocks on hold, our options strategies, and our short positions. You can find a review of our most timely entry strategies for positions on hold in the "Catch-Up Trades" section in every Monday Memo.

Once You've Settled In

Once you've built your Buy First and Buy positions, all you need to do is wait for further trade alerts from the team. Remember, though, that trade alerts don't mean "Act on this immediately!" Rather, each trade alert is part of a holistic strategy — another gradual step toward shaping the portfolio we want. You may decide to modify the strategy we choose for a trade; for example, you may wish to write puts instead of buying a stock outright. If you choose to deviate from our recommendation, make sure you (a) understand why we chose the strategy we did, (b) have a reason that the modified strategy better fits your portfolio, and (c) exercise caution by sizing the position a bit smaller than you would otherwise.

Your *Pro* Perspective

The most important thing to remember is that *Pro* is a portfolio service, not a collection of investment ideas. All of our positions exist in the context of our portfolio; if you elect to pick and choose *Pro* investments, it is critical that you understand how they fit into your portfolio. Our trades are intended to integrate with existing positions and to form a portfolio of assets that keeps our North Star firmly in mind.

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Pro Philosophy

Published Jul 2, 2012 at 12:00AM

This is a collection of articles illustrating the *Pro* team's philosophy on how to invest and why. Want to talk philosophy? We have a discussion board for that!

Resources

Strategy Guide (PDF): How we invest, breaking down our portfolio, our guide to finding great stocks, valuation, and more.

Our North Star: Like the real North Star, our North Star — inflation plus 7% annually — offers direction and guides our investing behavior.

What We Believe: Our portfolio itself is a reflection of the key beliefs we have about the world and investing.

Philosophy & Strategy discussion: Talk it out with the *Pro* team and your fellow Fools.

Market Musings

- *Pro* in 500 Words
- 5 Things Every Investor Should Know: Time frame, thesis, and more
- 4 Investing Truths
- Keeping Sight of Our North Star: And 2012 in review
- Why Most Investors Fail — and How We Avoid It
- Hedging the *Pro* Way

Portfolio Management

- A Fresh Start ... Every Day: Bryan outlines *Pro*'s approach to portfolio management
- On Hedging: Why investors can (and should) lose on purpose
- On Selling: Nick explains when and why
- On Allocation: Every stock has a role to play in our portfolio
- Our Fair Advantage: Nick explains how we value stocks

The Best of *Pro*'s Early Years

- 2008: Here and Now
- 2008: Swami Says ...
- 2009: Getting Through a Deep, Dark Wood
- 2009: *Pro* Makes a Buffett Move
- 2009: Mr. Market's Merry-Go-Round
- 2009: An Artificially Sweetened Market
- 2009: A Surprising Short Story
- 2009: So Long to a Down Decade

- 2010: [Don't Sleep on Rising Interest Rates]
- 2010: [Time to Get Active With *Pro*]
- 2010: [How Europe Can Help America]
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Ready to Become a Pro Investor?

Published Jun 24, 2012 at 12:00AM

Get Started Now!

We've got everything you need to know to build your new *Pro* portfolio — including step-by-step options guidance. (Want to take our survey again? Click here.)

{% ooyala id="lhcGxkNTp1aIbPOMHklSnixAQly_GKTJ" width="268" height="201" %} Watch this video for a quick introduction to *Pro*

- **Buy:** 5% of **Oracle**; 3% of **The Buckle**
- **Catch Up:** Convert your portfolio to *Pro*'s
- **Learn:** Get up to speed with options

Want a More In-Depth Tour?

Our Walkthrough offers a step-by-step guide to using *Pro*: how we think, who we are, what to expect, and how to invest alongside us. We hope you'll find it an invaluable companion as you explore your new service.

- **Learn:** Click through (or print out) our Walkthrough

Quick Links: Our Most Important Resources, One Click Away

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- The *Pro* wiki
- Getting Started & Help discussion

Ready to Become a Pro Investor?

Published Jun 24, 2012 at 12:00AM

WxC – Invested, no options guidance

In the welcome boxes, list the future catch-up reports, but gray them out with dates they're be published, so members could see that they're coming and we can keep them foaming at the mouth and coming back for more

- Updated & redesigned Strategy Guide
- What Pro Believes
- Catch-up Report (invested version)

Using Options

- Options in 3 Steps
- Use Options Like a Pro
- Options U.
- Options Glossary
- Options discussion

Email series:

1. Using This Service + Go! + strategy guide
2. Catch-up report (invested version)
3. Strategy guide

Get Started Now!

As an experienced investor, you probably don't need too much ramp-up time to start making money the *Pro* way. (Want to take our survey again? Click here.)

{% ooyala id="42cGxkNToc1JApruSzUh6fWw4QuG7S5B" width="268" height="201" %} Watch this video for a quick introduction to *Pro*

Buy: 5% of **Oracle**; 3% of **The Buckle**

Catch Up: Convert your portfolio to *Pro*'s

Read: Learn to think like a Pro

Want a More In-Depth Tour?

Our Walkthrough offers a step-by-step guide to using *Pro*: how we think, who we are, what to expect, and how to invest alongside us. We hope you'll find it an invaluable companion as you explore your new service.

Learn: Click through (or print out) our Walkthrough

Quick Links: Our Most Important Resources, One Click Away

Mission & Philosophy

Strategy Guide (PDF)

Our North Star

What We Believe

Audio Extra: The *Pro* Philosophy

Philosophy & Strategy discussion

Investing With *Pro*

Make *Pro* Fit You (PDF)

Guide to Finding Great Stocks

Guide to Selling

Catch-Up Trades

What We Think Now

Tools & Help

FAQ

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WxB – Cash, options guidance

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- What Pro Believes
- Updated version of Use Options Like a Pro, containing:

a. How (and how often) Pro uses options
b. Link(s) to Options resources for new options investors
- Catch-up Report (cash version)

Email series:

b. Using This Service + Go! + strategy guide
c. Catch-up report (cash version)
d. Use Options Like a Pro
e. Strategy guide

Using Options

Options in 3 Steps

Use Options Like a Pro

Options U.

Options Glossary

Options discussion

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We've got everything you need to know to build your new *Pro* portfolio — including step-by-step options guidance. (Want to take our survey again? Click here.)

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- What We Think Now

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WxD – Invested, options guidance

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Allocation Calculator

Published Jun 4, 2012 at 12:00AM

Introduction and instructions go here

Total Portfolio

Allocation %

Strategy

Calculate

Stock Price

Round Lots

Shares

Cost

Allocation

Strike

Call Price

Long Price:

Short Price:

	Strike	**Price**
Long :		
Short :		

Contracts

Allocation

Using Options

- Options in 3 Steps
- Use Options Like a Pro
- Options U.
- Options Glossary
- Options discussion

Test Calculator III

Published May 6, 2012 at 12:00AM

Allocation Calculator Strategy: Calculate

Total Portfolio

Allocation %
Stock Price
Round Lots
Shares
Cost
Allocation
Total Portfolio
Allocation %
Strike
Contracts
Liability
Allocation
Total Portfolio
Allocation %
Call Price
Contracts
Liability
Allocation

Video: How Pro Works

Published Jan 31, 2012 at 12:00AM

You need to have the Adobe Flash Player to view this content.
Please click here to continue.

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- **Catch Up:** Match your portfolio to *Pro*'s
- **Read:** Learn to think like a Pro

How Pro Works: Video Transcript

Published Jan 31, 2012 at 12:00AM

Watch this quick introduction from Jeff to learn more about the *Pro* site and all the exclusive resources that are now at your disposal.

JpaXBjMzpRfVbdWoa59OPBqPckuB1Ycu

Transcript

Jeff Fischer: Hello and welcome to Motley Fool *Pro*. I am Jeff Fischer, Motley Fool *Pro*'s lead advisor, and I am very pleased that you have joined us. Our mission at *Pro* is to make you money in up, down, and sideways markets by teaching you how to implement a variety of smart investment strategies. I'd like to take a few minutes to familiarize you with the service and help you get started.

The first thing you'll want to do is get to know *Pro*. Visit our Getting Started Guide to learn more about our investing philosophy and what to expect as a new member, including how to set up your brokerage account and when to expect updates and trades. We'll also show you how to jump right into investing with Motley Fool *Pro*, as well as our take on investing with options. If you are new to options, we highly recommend our Options for Beginners handbook to get your crash course on this profitable strategy.

When you are ready to invest, check out our portfolio and read more about our Buy Firsts and our Buys. For each recommendation, you will get our full analysis, buy-around pricing, target allocation and much more. Every company we recommend has its own detailed snapshot, which includes our full recommendation, history, performance data and an archive of everything we have written about that company. You can also add the company to My Scorecard with just one click.

With My Scorecard, you can track stocks in which you have open positions or that you simply want to keep an eye on. And that's whether they are *Pro* recommendations or not. Not only will My Scorecard track the movements of the stock, it will also pull in all relevant articles and community discussions on that company.

Finally, as you get acquainted with *Pro*, we highly recommend that you drop by our friendly community of investors just like you. Learn what our analysts and fellow *Pro* members are saying about our stocks, ask questions about our strategies and dig deeper into *Pro* investing. The team and I are on the boards frequently, so if you have any questions, this is a great place to get answers.

We encourage you to take your time getting familiar with *Pro* and to work at your own pace. We are here to help you every step of the way. And coming soon is New Member Orientation Week, where we'll go into detail about our service, our philosophy, how to trade like a pro and everything else you'll need to make the most of your new service. In the meantime, if you have any questions about our service, our investments or our strategies, feel free to post on the discussion boards. The entire *Pro* team, as well as a robust community of smart investors, is ready to answer your questions.

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The first thing you'll want to do is get to know *Pro*. Visit our Getting Started Guide to learn more about our investing philosophy and what to expect as a new member, including how to set up your brokerage account and when to expect updates and trades. We'll also show you how to jump right into investing with Motley Fool *Pro*, as well as our take on investing with options. If you are new to options, we highly recommend our Options for Beginners handbook to get your crash course on this profitable strategy.

When you are ready to invest, check out our portfolio and read more about our Buy Firsts and our Buys. For each recommendation, you will get our full analysis, buy-around pricing, target allocation and much more. Every company we recommend has its own detailed snapshot, which includes our full recommendation, history, performance data and an archive of everything we have written about that company. You can also add the company to My Scorecard with just one click.

With My Scorecard, you can track stocks in which you have open positions or that you simply want to keep an eye on. And that's whether they are *Pro* recommendations or not. Not only will My Scorecard track the movements of the stock, it will also pull in all relevant articles and community discussions on that company.

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Wiki: FAQ

Published Oct 2, 2011 at 12:00AM

> Also see the helpful Pro FAQ page

- Buy-Around Price
- Gambling or Speculating ?

{double-click to post your FAQ and answer here - or just ask a Q }

Target List

In the interest of keeping things moving, let's post a list of questions that we feel keep getting asked because members haven't been able to find the answer easily. Then anyone can come back and paste or contribute good answers later.

What do I do with my SA/RB/other positions when I join Pro?

This thread contains a wealth of information about how members work with recs from many different MF services.

And Alex Pape published this definitive guide on how to start to implement Pro recs.

I tried to follow the rec, but my broker said I don't have enough permissions.

What happens when/if my short calls are assigned?

How close to options expiry should I be expecting an update rec?

How do I navigate around these message boards?

What is time value / intrinsic value and how do I calculate it?

- **"Buy-Around" price**
  Q: Greenpeace11 asks:

I am relatively new to Pro and was wondering about "Buy Around" suggested prices. Some of the technicals based newsletters and analysts suggest not to buy a stock until it has made a move up to a certain price point. Several of the Pro recommendations are currently trading at significantly lower prices than the "buy around" recommended prices. Do we wait to buy until they have moved up to the "buy around" prices or get in as low as possible? Thank you.

A: TMFMoosie answers:
Short answer: **buy as low as possible.**

The technical services may see moving above a price point as a *catalyst* that will move the stock even higher.

Pro primarily uses fundamental company analysis as the basis for the company's worth, and then setting a "buy around" comfortably *below* that point.

Pro catalysts will vary, but will rarely, if ever, be divined by looking at a historical price chart. So, as long as the original thesis has not changed (and Pro will alert us if it does), lower prices are better.

A: Addition by TMFMoosie: **Always use a limit order**. Set the limit at the most you're willing to pay,and then forget about it. The company recommendations at Pro are designed to be longer-term holdings. There's no rush.

- **Gambling V. Speculation**
  TMFFischer > *Far too many people treat the market like a casino even though the largest example of market success (Buffett) has always done anything but.*

  Q: *At what point are we assessing risks and probability and taking appropriate positions ? At what point are we just "Gambling" ? Is it like this:*

  - Odd 1 in 20 = Gambling
  - Odds 1 in 5 = Hedging
  - Odds 5 to 4 in favour = Investing ?

  A: spinningwood >

  - Gambling = What you call what you did, when it didn't work out and you lost big.
  - Speculating = What you call what you did when you suddenly have a whole LOT more money than you used to have, at least until the speculating inevitably turns into gambling.
  - Hedging = What you do until greed and boredom convince you to abandon the hedges so you can time the market. Many hedgers suffer from PHD (Post Hedge Depression) when their timing trade turns out to have been a gamble.
  - Investing = You have more money than you used to have.... or will some day...or at least you hope that will be the case....

  A: TMFCrowe > Knowing the probability of success is only one part of the equation. Rather than try to explain a concept you already know, I'd like to share one of my very favorite articles on investing. It's written by a professional handicapper. Here is an excerpt:

  What you really want to do is determine which most-likely winners are good prices and which most-likely winners are bad prices. It is a very simple equation:

  Price X Probability = Value

  The entire world of investing is that simple too. Here is what I mean. If a horse has a 33 percent change of winning a race, and if you can get odds of 2-to-1 on him (which means tripling your money), there is no value - the horse is priced correctly. If a horse is 6-to-5 (which means you will only get back 120 percent of your bet) and he is only 33 percent to win, then he is a terrible bet. If you're going to get 4-to-1 (quintupling your money) on a 33 percent chance winner, then it's a great bet.

  The majority of people who play horses refuse to think that way. They sometimes say that no horse is worth taking a short price on. That's just not true. If a horse is 90 percent to win a race and you're going to get a 50 percent ROI, then he is one of the greatest bets in history. They sometimes say that all long shots are over-bet and that you should never bet on a long shot. That's not true either. If a horse has a 10 percent chance of winning a race and he's 20-to-1, then you're getting double the value than you should.

  You owe it to yourself to read the rest here: http://www.leggmason.com/thoughtleaderforum/2007/conference/...

Wiki: Options

Published Oct 2, 2011 at 12:00AM

Double-click anywhere on the below text to make your edits!

- Wiki A to Z of Options{in progress - feel free to add stuff}
- Wiki Options Q Questions answered by TMFers and members both.
- Moosie's famous Option spreadsheets
- Strategy Cheat Sheet

Beginners

Start with Jeff Fischer's excellent introduction to Options > Options 101

- Options 101: Basics: A Foolish introduction to the whys and hows of options trading.
- Options 201: Covered Calls: Learn how to generate cash on stable stocks you own or obtain better sell prices.
- Options 301: Writing Puts: Get lower buy prices or earn income on stocks you've got your eye on.

Beginners: Take the popular Options U course. Options U: Your Guide to the Basic Degree

Adanced:

- Refresh with MF Options: Intermediate Degree curriculum
- MF Options: Guides for our Advanced Degree

- Options 202: Rolling Covered Calls
- Options 401: Protective Collars
- Options 501: Synthetic Longs
- Options 502: Synthetic Shorts
- Options 601: Stock Repair
- Options 701: Buying Straddles
- Options 702: Writing Straddles
- Options 703: Strangles
- Options 801: Spreads
- Options 802: Bearish Spreads
- Options 803: Neutral Calendar Spreads

A - Z of Options

American style: Options contracts that can be exercised at any time after purchase and before the expiration date.
See also: European style.

Assignment: When the options writer (also called the seller) is forced to buy (for a put writer) or sell (for a call writer) the underlying stock. Essentially, your counterparty has exercised its option contract, which you wrote, to buy or sell the underlying stock.
See also: counterparty, exercise.

At-the-money (ATM): An option whose underlying stock is trading at its strike price.
See also: deep in-the-money, far out-of-the-money, in-the-money, out-of-the money, strike.

Bearish: An options strategy (and outlook) that achieves its maximum payoff when the underlying stock drops in price. For example, if you are bearish on a stock you know well, you could buy a put or a bear put spread.
See also: Bullish, long, neutral, short.

Beta: A measure of the sensitivity of the price movements of a stock in relation to the movement of the broader market. A stock with a beta of 1.00 will theoretically move 1% for every 1% move in the market. A stock with 20% more or less price volatility than the broader market will have a beta of 1.20 or 0.80, respectively. Beta can be calculated by regressing the historical returns of the stock against the historical returns of the broader market index

The concept of beta does not translate directly into option pricing. It should not be confused with implied volatility, which only measures the volatility of the stock itself and ignores the broader market. A low-beta stock could theoretically have very high implied volatility.
See also: Greeks.

Bid: The price buyers currently are offering to pay.
See also: ask, bid/ask spread, mid.

Bid/ask spread: The difference between the bid and ask prices. For very liquid markets, it might be as narrow as a few pennies, but for thinly traded markets, the spread can be very wide. Options markets are less liquid than stock markets, so it is important to use a limit order to set your price.
See also: ask, bid, limit order, mid.

Binomial Model: An options pricing model that's useful for American-style options because it can help predict when early exercise is possible. It uses an iterative process that allows for pricing options at different points prior to expiration.*See also: Black-Scholes Model.*

Black-Scholes Model: One of the most well-known options pricing models. It incorporates time until expiration, strike price, stock price, dividends, implied volatility, and interest rate. It is based on several simplifying assumptions, but put simply, it calculates the value of a call option as the stock price multiplied by the probability of ending up in-the-money, less the present value of the strike price paid on the expiration date. The model is named after Fischer Black and Myron Scholes.

See also: Binomial Model.

Break-even price: The price the underlying stock needs to reach at expiration for an option investor to neither make nor lose any money. In strategies involving more than one option, there can be more than one break-even point.

Bullish: An options strategy (and outlook) that achieves its maximum payoff when the underlying stock appreciates in price. For example, if you are bullish on a stock you know well, you could buy a call or a bull call spread.
See also: bearish, long, neutral, short.

Buying Calls

> Buying a call isn't necessarily the best way to benefit from a stock's growth. It depends on the Time Value. When you buy a call you are buying Time Value and it will erode as the expiry date approaches.
>
> On the other hand buying the right call on the right growth stock can give you great leveraged returns with not much money at risk.

Make Sense? No ? There's a good starting point here:
http://newsletters.fool.com/50/optionsu/intermediate/buying-calls.aspx

Buying Puts

Buying puts. This is a very bearish thing to do. It can be hedgey too.

Buy to close: The brokerage command to exit an option contract in which you originally wrote ("sold to open") the put or call.
See also: buy to open, close, cover, sell to open, sell to close.

Buy to open: The command some brokerages use to enter an option contract in which you intend to buy a put or call.
See also: buy to close, close, cover, sell to open, sell to close.

Call option: The right, but not the obligation, to buy the underlying stock at a set price (the strike price) at or before the option's expiration date. A call rises in value as the stock price rises and declines in value when the stock price falls.

Chicago Board Options Exchange: The largest options exchange and creator of listed options in the U.S. It is owned by the **CBOEGroup** (Nasdaq: CBOE) and also specializes in futures trading. (If you want to sound savvy at cocktail parties, refer to the Chicago Board Options Exchange by its acronym and pronounce it *see-bo*, as in, "See Bo Derrick in the film*10*.")

Contract: Each standard option contract represents 100 shares of the underlying stock, provided no splits or other adjustments (i.e., corporate mergers) take place. (We'll be very specific about what to buy or sell if any non-standard options ever make it to *Motley Fool Options*.) A contract is quoted at the price for one share, so multiply by 100 to get the full contract value. For example, buying two option contracts for $1.50 actually represents 200 (2 x 100) shares of stock and would therefore cost $300 ($1.50 x 200).

Covered Call ("Writing" or "Selling" a covered call)

Popular stategy! Basically, you sell someone the option to buy your shares at a certain strike price. You receive a premium as soon as you have sold the call. It's called "Covered" because you own the shares.

Covered Calls are a classic way to generate investment income on shares you like and believe will go up, but they won't go up too quickly.

Covered Calls are a fine way to sell shares at a price you are happy to sell at - a covered call protects your profit.

Excellent Guide! - Covered Calls At a Glance

There's more detail on Page 3 of the Options U Intermediate Handbook
http://newsletters.fool.com/50/optionsu/2011/11/11/options-u...

Aleax: Never write a covered call on a stock you own, unless you know you'd be *delighted* to let said stock go at the strike price (plus the premium). You may or may not get a decent chance to roll the call as expiration nears, but it's absolutely crucial that you be quite happy letting the stock go if it soars to the sky.

Covered Strangle

A covered strangle is where we write a **Put** at a lower price, and write a **Covered Call** at a higher price. We have strangled the stock price between lower and higher. This strategy is useful for stocks which we are expecting to stay at more or less the same price by Expiry date. Here's an example: Covered Strangle on Plum Creek Timber

And here is a guide to Strangling: Options 703 - Strangles

Note: "*you write a strangle to profit when a stock stays within a predetermined price range or is relatively stable..... Writing a strangle offers more flexibility than writing a straddle because you "split the strikes" — set it up with a different strike price on your calls than on your puts — and you use strike prices that are "out-of-the-money," or well above or below the stock's current price, giving you more room to profit.* "

Close: Exit an option contract.
See also: buy to close, cover, sell to close.

Cover: Another term for closing out a short position.

See also: buy to close, close, sell to close.

Deep in-the-money: The condition of an option that has a large amount of intrinsic value. A call option is deep-in-the-money when the underlying stock is trading at a price much higher than the strike, and vice versa for a put option. A deep-in-the-money option will typically have little time value.
See also: at-the-money, far out-of-the-money, in-the-money, out-of-the-money, intrinsic value, strike.

Delta: Delta, loosely, can be three things:

1. Delta is roughly the amount the option changes in value as the stock changes in value. If you're the sort of person who likes to spend a quiet evening alone with math, you'll recognize that delta is the first derivative of the value of the option with respect to the value of the underlying. If a call option has delta of 1.00, then it rises in value $1 for every $1 increase in the stock. A delta of 0.60 means it would rise $0.60 for every $1 increase in the stock, and so on. Since the call is less expensive than the stock, the $0.60 increase represents a greater percentage change for the option than the $1 change in the stock. Put options carry *negative* deltas, but this, if you think about it,

makes sense. Since a put option profits when then underlying stock declines, and vice versa, we should expect an inverse relationship. A put with a delta of -0.60 would mean that its price rises $0.60 every $1 *decrease* in the underlying stock price.

2. Delta is roughly the probability that an option will expire in the money (though not necessarily at a profit). A deep in-the-money call is, statistically speaking, almost certain to expire in-the-money. Thus, it has a delta very close to 1.00. The negative sign on a put option's delta is unimportant in this context — the absolute value is the important thing. A put with a delta of -0.50 has a rough statistical probability of expiring in-the-money of 50%.

3. Delta is roughly the number of shares the position represents. A deep-in-the-money option trades almost the same as 100 shares of stock, so it has a delta of very close to 1.00. Here, negative delta does carry meaning. A purchased put option will have negative delta, reflecting that it is equivalent to some number of shares being sold short.

See also: gamma, Greeks.

European style: Option contracts that can only be exercised at expiration.
See also: American style, Black-Scholes model.

Exercise: Invoking the right (as granted by the option contract) to buy (if a call) or sell (if a put) shares of stock at the strike price.
See also: assignment, counterparty, strike.

Exercise price:*See: strike.*

Expiration date: The date on which the option contract becomes void, and the option holder no longer has the right to buy or sell stock granted by the option. This is typically after hours on the Friday before the third Saturday of the month.

Extrinsic value:*See: time value.*

Far out-of-the-money: The condition of an option when the underlying stock is trading at a price much lower than the strike for a call, or much higher for a put. Far out-of-the-money options have little intrinsic value but retain some time value depending on the time left until expiration.
See also: at-the-money, deep in-the-money, in-the-money, out-of-the-money, strike, time value.

Free cash flow (to the company): Money leftover for creditors and shareholders when all of a company's operational and investment expenses (think equipment upgrades, acquisitions, taxes) have been paid. This figure arguably provides a more accurate picture of the company's profits and financial strength than net income or earnings per share.

Gamma: One of the five "options Greeks" (delta, gamma, rho, theta, and vega), this shows how fast delta changes with respect to the underlying stock price. The larger the gamma, the faster delta changes; gamma is maximized when the stock price equals the option's strike price.
See also: delta, Greeks.

Greeks: The four primary Greeks are delta, rho, theta, and vega, and are risk measurements used to monitor the sensitivity of an option's price with respect to a change in one of the underlying contributors to option valuation — stock price, interest rates, time to expiration, and volatility. A fifth common Greek, gamma, measures the sensitivity of an option's delta with respect to changes in the price of the underlying.
See also: delta, gamma, rho, theta, vega.

Hedge: An offsetting position meant to reduce the price, volatility, or risk of an investment.

Historical volatility: The annualized standard deviation of the stock's price changes. Typically, daily price changes are used.
See also: implied volatility.

Horizontal spread

See: time spread.

Implied volatility: A prediction of the volatility of an underlying stock; it's calculated using the current market trading price of the option. Implied volatility may or may not bear any resemblance to actual historical volatility.
See also: historical volatility.

In-the-money (ITM): Indicates that an option has intrinsic value. Calls are in-the-money when the underlying stock is above the option's strike price (a stock is at $22 and the call has a strike price of $14, allowing the holder to buy the stock at $14). Puts are in-the-money when the underlying stock is below the option's strike price (a stock is at $22 and the put has a strike price of $30, allowing the holder to sell the stock at $30).
See also: at-the-money, deep in-the-money, far out-of-the-money, out-of-the-money, strike.

Intrinsic value: An option's value if it were to expire immediately; i.e., the value in direct proportion to the underlying stock's current price. For calls, intrinsic value is the current stock price minus the strike price. For puts, intrinsic value is the strike price minus the current stock price.
See also: premium, time value.

Last trading day: The final day on which trading takes place on an option contract prior to the settling of the contract, usually the third Friday of the expiration month.
See also: expiration date.

LEAPS (Long-Term Equity Appreciation Securities): Options that, when first offered, expire at least two years in the future. Most new LEAPS become available between September and November, depending on which option cycle the underlying company is on. They will almost always be for a January expiration, but are sometimes offered for a February or March expiration. We like LEAPS because they provide longer-term choices for an investment thesis to play out.

Leg: One piece of multi-option strategy. It also refers to entering or exiting a multi-option and/or stock strategy ("leg in" or "leg out") at disparate times and prices chosen to benefit the intended strategy, but with the potential risk that better prices will never be available.

Limit order: A modification to a brokerage command to buy or sell that allows you to buy or sell at a set price or better. These are particularly useful for illiquid stocks, as well as the option markets, for which there is often limited liquidity.
See also: market order.

Liquidity: Refers to how heavily traded a stock or option is, and usually corresponds to how wide the bid/ask spread will be. A heavily traded stock or option will have lots of liquidity and thus usually a narrow bid/ask spread.

Long: Having ownership of a security. If you own 100 shares of a stock, you're long the position. If you have purchased a whole mess of puts on something, you're long a whole mess of puts. It can also be a slang term meaning you feel positively about something. For example, TMFTheDoctor is long corgis, caffeine, and David Tennant.
See also: bearish, bullish, neutral, short.

Market-maker: Typically, a floor trader on an exchange whose job is to accept bids and offers from other traders — be they big institutional traders or Joe and Jane Optionsmember. The main job for a market-maker is to maintain liquidity and ensure that prices are more or less fair.

Market order: Typically the default order type for an options trade. It tells the broker to place your trade at whatever price is currently available on the market. Since options are often thinly traded, market orders can be very dangerous, as the bid/ask spread can be wide and a market order will simply buy at the ask or sell at the bid.
See also: bid/ask spread, limit order.

Mid: The midpoint between the bid and ask. When using a limit order, it's often advantageous to set it to the mid — sometimes called "splitting the bid/ask" — and move outward from there if the order doesn't get filled.
See also: ask, bid, bid/ask spread.

Naked: Taking a short position in an option without having a position in the underlying security as collateral. The concern of a naked position is that it carries theoretically unlimited risk. A naked call will begin showing a loss as the underlying stock rises, and the stock could possibly go to infinity (and beyond!) causing extreme loss on the naked call. A naked put does not carry quite as much risk: A stock can only fall to zero (Oh Joy!), so the position's potential loss is limited to the value of the stock.
See fully-clothed, semi-clothed

Neutral: An options strategy (and outlook) that achieves its maximum payoff when the underlying stock doesn't change in price.
See also: bearish, bullish, long, short.

Net operating profit after taxes (NOPAT): NOPAT (aka NOPLAT) is a taxed version of a company's operating income, or EBIT.
*(**NOPAT**: Net Operating Profit After Tax; **NOPLAT**: Net Operating Profit Less Adjusted Tax.)*
NOPAT is a useful metric for comparing the operating profitability of companies with different debt loads because it excludes the interest burden that comes with debt. A simple way to calculate NOPAT is EBIT x (1 - Tax Rate). A more accurate method adjusts the reported tax to exclude the *tax shield* provided by the tax exemption on interest payments: Adjusted Tax = Reported Tax + (Interest x Tax Rate); NOPAT = EBIT - Adjusted Tax.

Open: As a verb, open refers to entering an option contract; as an adjective it refers to whether you are still holding the position.
See also: buy to open and sell to open.

Open interest: The total outstanding open contracts on any particular option. If you buy or sell to open, pat yourself on the back! You've just upped the open interest. If you buy or sell to close, you've just decreased it. (Fine, you can give yourself another pat.)

Option cycle: Expiration dates available for various classes of options (not everyone gets to go at once). There are three cycles, offset monthly: January/April/July/October; February/May/August/November; and March/June/September/December. Regardless of cycle, there is always an option for the current month and the next month. Beyond that, the expirations correspond to whatever cycle the stock is assigned to. There will always be at least four expiration months trading.

Options Clearing Corp.: A middleman, operating under the Securities Exchange Commission, whose role is to police option buyers and sellers to ensure the obligations of an options contract are fulfilled. The OCC clears and settles trades for options exchanges (like CBOE) and takes on counterparty risk. It is also a useful resource for options questions.

Out-of-the-money (OTM): The opposite condition to being in-the-money. Here, an option has no intrinsic value, only time value. For example, if a stock is trading at $8, its call options with a $10 strike price would be out-of-the-money.
See also: at-the-money, deep in-the-money, far out-of-the-money, in-the-money, strike.

Premium: The total price of an option contract; the sum of an option's intrinsic value and its time value.
See also: intrinsic value, time value.

Put Broken Wing Butterfly

Poor butterfly!

But an example of this Strategy is [Set up a Put Broken Wing Butterfly on Expeditors International]

An iron butterfly is the combination of two spreads: a bear call spread and a bull put spread. If you're unable to set up a four-legged butterfly trade in one order with your broker, then handle the Bear Call Spread and the Bull Put Spread elements as 2 trades.

Put option: The right, but not the obligation, to sell a stock at a set price at or before the expiration date. A put's value increases as a stock's price falls.

Put ("Selling" or "Writing Naked Puts")

Writing Puts is a classic way of buying shares that you wish to buy anyway - but at a lower price. You sell the option. You receive a premium. That premium can be deducted from the strike price to give you a lower buy price!

Make sense ? No ? Read the great introduction here: http://newsletters.fool.com/50/optionsu/2009/08/10/writing-p...

More detail: Page 15 of this doc http://newsletters.fool.com/50/optionsu/2011/11/11/options-u...

Note: When you sell a Put option you are selling someone the right to sell **you** shares at a certain strike price. Now, whoever bought the Put from you can just ***make*** you buy those shares at the agreed strike price at any time up to Expiry Date!! Inconvenient if the share price is temporarily much lower than that strike price. Mind you, worry not, this "assignment of shares" doesn't happen too often.

Normally you'll reach the Expiry Date and the actual price will be lower - in which case you'll have to buy the shares at the higher strike price. Or the actual price will be higher and your put will expire for nothing. You keep the premium in either case.

It's best to keep **Cash** set aside to cover your Written Puts (i.e. buy the 100 shares at the strike price). It's best not to use margin for this. Read more in the introductions about this.

Return on equity (ROE): Return on equity is the profit earned on capital that stockholders have contributed to the company. Let's say a company has issued $100 million worth of stock, $100 million worth of bonds, and $50 million in preferred stock. This imaginary company brings in $25 million in profit, and pays out $5 million in interest payments on its debt and $5 million in dividend payments to the preferred shareholders. It is left with an adjusted net income of $15 million and total equity of $100 million, so it has an ROE of 15%.

Return on investment (ROI): Return on investment is the profit earned on funds put at risk. If you buy 100 shares of a stock trading at $10, and it rises to $12, you have an ROI of 20%.

Return on invested capital (ROIC): Return on invested capital is the profit earned on all sources of capital contributed to the company. Going back to the ROE example, the company has a total capitalization (equity + debt + preferred stock) of $250m. There are various ways to measure return on invested capital, but one of the simplest ways is to take net income and divide it by total capitalization. So if this imaginary firm brings in $25m in net income, it has an ROIC of 10%. Although slightly more complicated, we prefer to calculate ROIC using net operating profit after taxes (NOPAT) in the numerator.
See also: NOPAT, return on equity.

Rho: One of the five "options Greeks" (delta, gamma, rho, theta, and vega), this indicates an option's sensitivity to changes in short-term interest rates. Option premiums get more expensive when interest rates go up.
See also: Greeks.

Rolling forward, out,up, or down: A follow-up action in which you cover (or sell) an option you originally sold (or bought) and reinitiate that position at a different strike and/or expiration. "Rolling forward" (also called "rolling out") involves closing options that expire in the near term and opening options with longer-term expirations. "Rolling up" involves closing options with a lower strike price and simultaneously opening new options at a higher strike price (while maintaining the same expiration). "Rolling down" involves closing options at a higher strike price and simultaneously opening new options at a lower strike price.
See also: cover.

Sell to close: The brokerage command to exit an option contract in which you originally bought ("buy to open") the put or call.
See also: buy to close, close, cover.

Sell to open: The brokerage command to enter an option contract in which you intend to write (a.k.a. sell) a put or call.
See also: buy to open, open.

Spread: Any option strategy in which you buy and write ("sell to open") options of the same type (call or put) on the same underlying stock.

Straddle: A direction-neutral options strategy consisting of a call and a put with the same strike prices and expiration date. It profits from a large move, up or down, in the underlying stock.

Strangle: Similar to a straddle (a strategy consisting of a call and a put with the same expiration) but with different strike prices. It profits from large moves, up or down, in the underlying stock. A strangle is cheaper to set up than a straddle but requires a larger move in the underlying stock to become profitable.

Short: Having an obligation position in a stock or option. When you go short a stock, you're borrowing the asset, selling it, and hoping to profit by buying it back at a lower price. Shorting a stock reflects a bearish outlook. In an options context, it reflects the writing of options. In *Motley Fool Options*, we often pair our short options with our long options. For example, in a bull call spread, you are long one call at one strike and short another call at a higher strike. Despite having one short leg, it's still overall a bullish position.
See also: bullish, bearish, long, neutral.

Strike: Also known as the "exercise price," this is the price at which the option holder can buy (in the case of a call) or sell (in the case of a put) the underlying stock.

Synthetic: A way of using options, sometimes in conjunction with long or short positions in the underlying stock, to mirror the profit and loss potential of a different position. For example, a synthetic long can be created by buying a call and selling a put with the same expiration dates and strike prices. The profit payoff on such a strategy is identical to that of simply buying the underlying stock at the strike price; however, in a margin account the cost to establish the position is considerably less.

Synthetic Covered Strangle

A synthetic covered strangle is a variety of Diagonal Call. It's a 3 legged trade. We buy a long-term ITM call, and a short-term OTM Call AND finance it with a long-term ITM Put. Essentially it's a Synthetic-Long we have covered with a profitable call. It's useful when the stock is reckoned to rise over the next long time period (we're very bullish) as Synthetic Covered Call leverages capital at risk.

Here is a a live trade example using Microsoft from the Options team:
[Set up a synthetic covered call on microsoft]

Synthetic-Short

Some prefer a real single malt.

A Syn-Short is just like directly shorting the stock. But here you sell naked calls and buy puts at exactly the same strike price. Hopefully for a small net debit or even a net credit.

There's a great introduction here : http://newsletters.fool.com/50/optionsu/advanced/synthetic-shorts.aspx

And here's a Syn-Short in action: [PRO: Set up a Synthetic Short on CurrencyShares Euro Trust]

Syn-Short

Here's an insight from [Aleax] on the boards:

Q > I'd like to set up a syn-short but I am worried about the 'naked' unlmited loss. Should I short directly instead?

A> The upside and downside of a syn-short are exactly the same as for an outright short (net of "trading friction" aspects: a syn-short owes no payments in lieu of dividends nor shorting-fees, but options commissions are higher and bid-ask spreads wider; many of the hoped-for gains from a syn short [those due to the purchased put leg] can be taxed as long term capital gains if the position is held for > 1 year, while the outright short is always subject to short term rates [as is the short-call leg of the syn-short]; I think that's about it for trading friction aspects).

So you should be worried about the syn-short if, and only if, you would be exactly as worried about the outright short.

Tax-wise you prefer larger gains on the put leg and smaller ones on the call leg; so from this POV you want the syn short strike to be high (if you do close for gains in > 1 year, you'll have more money in your pocket, after taxes). This costs more money up front to establish than a syn short with a strike ATM or lower than ATM; but less ongoing purchasing power for maintenance margin. Also, the way-OTM short call stands hardly any risk of premature assignment.

Of course, if you set your strike so high that writing the call gives you, in your opinion, too little money to bother, you might omit writing the call (and thus avoid the theoretically unlimited risks) and turn it into a simple deep-ITM put purchase;-). (If the call would have too little TV to bother writing, the put will have too little TV to worry about buying it, either;-). Aleax

Also see Aleax's longer response to question Are there disadvantages to Syn-Long v. owning the stock ?

Theta: One of the five "options Greeks" (delta, gamma, rho, theta, and vega), this measures an option's sensitivity to time, or how much the option price decays per day.
See also: Greeks.

Time decay: The reduction in an option's value through the passage of time.
See also: theta.

Time spread

A strategy (also called a horizontal spread) with two or more legs from different expirations. Calendars and diagonals are prime examples of time spreads. A calendar involves buying an option in one expiration and, at the same time, selling that same strike in a different expiration. Strictly speaking, a diagonal is a time spread but *not* a horizontal spread.

Time value: The premium that the market is willing to pay for the potential upside of the option until expiration. Its value accounts for beneficial unknowns and volatility until expiration. For a tradable option, deduct intrinsic value from the trading price to arrive at time value. Options are wasting assets, meaning time value declines as expiration draws closer.

"Time Value" is vital in understanding options. Jeff Gilles gives a graphical introduction in "Video: The Value of Time"

See also: intrinsic value, time decay.

Uncovered:*See: naked*.

Underlying: The stock being bought or sold at the expiration of the option contract. Since stocks are pieces of businesses, it makes sense to understand that business, its valuation, and its prospects before overlaying options strategies on them.

Vega: One of the five "options Greeks" (delta, gamma, rho, theta, and vega), this indicates an option's price sensitivity to a change in volatility. Higher volatility makes options premiums more expensive.
See also: Greeks.

Vertical spread:

A strategy using two puts, or two calls, with the same expiration but different strikes. A bull call spread is a type of vertical spread.

See also: bull call spread.

Volatility: An estimate of the amount that the underlying stock's price is expected to fluctuate in a given period of time. Generally, volatility is measured by the standard deviation of the continuously compounded returns of the underlying stock.

Write: To sell an option contract. We prefer to use "write" when referring to selling an option contract in general, but specifically this refers to selling a *new* option contract. The option seller is referred to as the option writer.

Wing spread:

A strategy constructed from the combination of a pair of spreads that profits most when the stock does nothing. A trader could also construct a so-called "broken wing" spread, where one side has a slight bias. Butterflies and iron condors are good examples of wing spreads. They're referred to as such because, if you were to make a profit/loss diagram, the center has a kind of body shape (where the profit is if the spread is sold, or where the loss is if the spread is purchased), and the sides have a vague wing shape to them.

Questions about Options

FAQ from Pro Members answered by Pro staff and members

Question on Option Strategy with helpful reply:

I am still trying to figure out how to play leading company in high growth emerging market segment (enticing premium in exchange for high volatility)...

I see Jeff has provided an official answer and of course that's much more meaningful than my opinion (as I'm an amateur) but I think I'll offer that opinion anyway.

I've been well served over the years by a mixed strategy on such names -- build up (ideally buying on dips, of course, but in a very buy-and-hold mood anyway) a maybe-slightly-underweight position to never be touched again until it's a multi-bagger or the investment thesis sours; *on the side*of this core position, accumulate a somewhat smaller "trading position" meant for short- to mid-term profitable trading -- buy low, sell high.

Options help for the latter objectives (write puts on slight dips when trying to beef up the trading position rather than wait for deep dips; write covered calls on slight rallies when trying to whittle down the trading position rather than wait for steep rallies) though one could also just buy and sell shares (writing options can be more profitable when the market's implied volatility for the name is exaggerated compared to your assessment of what realized volatility is going to be).

Optimal duration to expiration for the written calls on the trading position varies, but they won't be all that long term (you want time value to erode, and it really doesn't erode fast at all for too many months if you write, say, 6-months-out or longer) and usually not too short-term to avoid excessively enriching your broker via commissions and the market makers via bid-ask spreads (the exception, where really short-term trades are warranted, is when you judge the market is badly mis-evaluating an impending event such as an earnings call or forthcoming relevant legal or regulatory decision).

As I said, this mixed approach is what overall tends to work out for me -- not every time, of course!, but often enough to keep me in the game.

For example, that's why I wrote calls on only half of my DDD shares -- I mentally re-tagged half the shares as a "trading position" and the other half as a "buy-and-hold position", so as to have my cake and eat it too.

Warning: whether this approach is psychologically tolerable to you depends on your character -- I have a sunny disposition so I tend to see the outcome of mixed strategies mostly in a "could have been worse!" [if I had picked the wrong pure strategy] mood, but if you know that your own reaction would mostly be a sour "could have been better!" [if you had picked the right pure strategy], then they're better avoided.

BTW, I'm kind of glad that my 5000th post comes on a subject where I have definite (though amateurish) experiential-based preferences that are pretty far from the mainstream -- at least this way the post should be interesting (perhaps controversial), compared to one where I just reaffirmed a broadly held opinion I agreed with, no?
-) Aleax

What are the disadvantages of a Syn-Long v. owning Stock ?

Question:

You give pros and cons for alternatives with the exception of synthetic longs. What is the "con" of this approach?

If there is no con, only pros, why does anyone buy stock?

Reply:

The disadvantages of a syn-long compared to outright stock purchase are as follows. TL;DR: there are plenty -- beware!-)

(1) You're constrained to multiples of 100 shares (except on the few stocks that now offer mini-options, in which case, multiples of 10 shares can be held) -- with stock purchase you can size your position more precisely and adjust it as you go.

(2) Fees, commissions, and, crucially, bid-ask spreads (i.e, all components of "trading friction"), are much higher for options than for shares. No big deal if you want to buy today and hold for almost two years, but anathema for more frequent trading.

(3) Taxes can work for or against you, but for a typical syn-long (established ATM) it will be against, if the stock price does rise.

If you buy 100 shares and sell them in Jan 2015, you will have (assuming the stock price did rise) long-term capital gains, taxed somewhere between 15% and 23.8% depending on your tax bracket. (Any qualified dividends you get in the meantime are also taxed at this same rate).

If you buy an ATM Jan 15 call and write an ATM Jan 15 put, and by Jan 15 expiration the stock has risen, you'll have long term capital gains on the call -- but your gains on the puts you write are always treated as short-term, no matter your holding period.

Those gains will be the whole premium you receive today for writing the put, and they'll be taxed at your ordinary marginal rate (up to 43.4% -- don't forget the 3.8% ACA surtax on "non-earned income").

To minimize this tax effect of a syn-long, pick a strike such that the call is deep-ITM (so the put will be deep-OTM and the premium you receive for writing it will be much lower -- since that's the part of your gain that will be taxed more dearly, you want it as low as possible from a tax viewpoint). This does increase the net debit you'll need to pay to initiate the position (i.e, reduce your leverage).

(4) your written put could be exercised at any time (if the stock dips below its strike, and low enough to reduce its time-value to near 0), forcing you (esp. assuming you want to stay in the position) to incur extra commissions and fees. Picking a strike well below the money reduces this risk, as well as reducing your taxes (see [3]).

(5) in a cash account, syn-longs make no sense, since you'll need to keep aside the whole exposure the written put gives you -- i.e, for a typical ATM syn-long, the same amount you'd have to fork over to just purchase shares.

(6) in a margin account, syn-longs are a mixed blessing.

If you buy shares, your purchasing power while you hold them is only reduced by your shares' maintenance margin -- typically 25%; most of your equity in those shares is available to margin other positions, if you wish (i.e, it's part of your account's purchasing power).

Options don't work that way. Your equity in the purchased long call does not help your purchasing power at all. Your liability in the written put does require maintenance margin, typically expressed as "Proceeds of the sale plus 20% of the underlying value less out of the money amount OR proceeds of sale plus 10% of underlying value, whichever is greater" but, beware, "proceeds of sale" actually means current, mark-to-market value of the put.

Suppose for simplicity that the syn long strike is 100 and the share price dips to 70 -- low enough to leave the put with no time value.

If you own 100 shares, this makes your maintenance margin 100 * 70 * 0.25 -> $1,750, so you still have 7000 - 1750 -> $5,250 of your equity in the shares available as purchasing power (e.g to help ensure the maintenance margin for other positions).

If you're long a 100-strike call (which does not matter to margin) and short a 100-strike put, the put's current value will be [at least] 30 (all IV, no TV), the "underlying value" is 100 (what you need to be ready to pay if assigned), and there is no "out of the money amount" (since the put is way IN the money after the dip). So the maintenance margin is 100 * (30 + 0.2 * 100) -> $5,000 -- this *reduces* your account's purchasing power... so, you'd better have cash or outright-owned shares in the account, to keep your overall purchasing power positive -- otherwise, best case, you'll get a margin call (and need to urgently inject more cash into the account and/or liquidate positions), worst case, your broker will just liquidate some or all of your positions without even bothering to tell you (I believe only IB, Interactive Brokers, routinely does the latter -- most brokers do pay you the courtesy of a margin call, at least -- but it's still NOT a nice position to be in).

Of course you did have to pay about $10,000 to initiate the outright all-cash share purchase, but still, under a bad dip like the above, the net effects on margin and purchasing power are even slightly worse for the syn-long than for the share purchase. People new to syn-long may not think in term of margin because they incur no margin *debt*, but, beware, you DO risk a margin call (at best!) if you have a syn-long and fail to keep ample cash in the account (or plenty of outright-bought shares to provide purchasing power to cover your maintenance margin).

(7) it's a highly leveraged play -- don't let the fact that you're not incurring margin debt and paying interest on it fool you into ignoring the sheer fact that you ARE leveraging (a lot, if you use an ATM strike -- or worse, an OTM one -- for your syn-long; less if you choose lower strikes, committing more cash up front). When all is said and done this will amplify your gains, if gains you have, but it will also amplify your losses, if losses occur. So, be wary about position sizes in syn-longs, especially on more volatile stocks! If you would normally buy a position size of 500 shares, with a syn-long it might be more prudent to go for 4 contracts, or maybe even just 3 if the stock is very volatile. Yes, this does reduce your potential gains if all is shiny -- but it reduces your potential losses just as much.

I'm sure I've forgotten some issues, but I hope I've highlighted enough to cause readers to do careful due diligence before embarking on syn longs. Remember the key idea with options trading (and most everything else in life): TANSTAAFL -- "there ain't no such thing as a free lunch". You're wise to dig for down-sides BTW, and I hope I helped.

Me, I don't do syn-longs -- if and when looking for a stock ownership substitute, I buy deep-ITM LEAPS calls instead, if I can find a strike that's liquid enough to not kill me with wide bid/ask spreads yet have very little time value (today's very low implied volatilities help;-).

I only get a few of the above down-sides (e.g, higher commissions, fees and spread-related trading friction -- but I did mention that usually matters little [unless the spread's ridiculously wide] when intending to hold for a reasonably long time; no buying-power help -- but then I use margin only very lightly and prudently anyway). And I do get one key extra advantage: limited worst-case losses compared to either outright share purchase or syn-longs.

After all, to reduce tax hits and risks of premature assignment, as I mentioned above, one should aim for a strike way below the money even when establishing a syn-long. But -- at such a strike, the written puts pay very little. So why even bother writing them, thus incurring (albeit to a limited degree) all of the above down-sides, and NOT getting the "limited loss" effect should the company go bankrupt overnight? Just buy the deep-ITM call and be done with it... at least, that's what I do, myself!-)

Similar reasoning can be applied to syn-shorts when you're bearish on a stock -- except that the plainer alternative of outright short sale comes with plenty of baggage of its own (which the outright purchase of shares, and the option positions, don't); so I do use plenty of syn-shorts (though sometimes I just buy a deep-ITM put instead, if and when I can find a narrow-spread, very-low-TV one;-).

Which reminds me of one special case where a syn-long would be very attractive (in theory -- haven't actually done that): when you're bullish on a stock that's so heavily shorted put/call parity breaks down, so premiums on puts are stellar compared with ones on calls. In such a case, "buy low, sell high" sure looks attractive, and that translates to a syn-long (typically a split-strike one). But, this post is already too long, so I'm not going to harp on that special case!-) Aleax

Which Account Do I Use for Options?

(a very helpful post from VelobiciOptions)

> Well, there is more than one opinion regarding which type of account is best for writing covered calls and puts.
>
> One reason options have a bit of a reputation for danger, is that it is easy to lose track of how much money one is committing when writing puts. In a taxable account, one can write a put and the "buying power" decrease by a fraction, often 30%, of the amount of money required should the put be assigned. In an IRA, that is not an issue, all puts are fully cash secured and the reported "buying power" decreases by the amount of money required by assignment. In that way using an IRA account is much safer....its just not possible to get over-extended when writing puts. So, you might want to start with paper-trading, then use an IRA account, and lastly a taxable account.
>
> That said, there are certain types of positions that dont work well in IRA accounts:
>
> | Position Type | IRA Account? | Taxable Account |
> |---|---|---|
> | **Sell Naked Calls** | No | No (1) |
> | **Sell Covered Calls** | Yes | Yes (2) |
> | **Sell Puts** | Yes (100% cash) | Yes (margined) (3) |
> | **Sell Strangles** | No (see note) | Yes (4) |
> | **Sell Straddles** | No (see note) | Yes (4) |
> | **Buy Bull Call Spreads** | Yes | Yes (2) |
> | **Buy Diagonals** | Yes | Yes (2) |
> | **Buy Synthetic Longs** | No (see note) | Yes (5) |
>
> (1) Motley Fool Options, and as far as I know Motley Fool Pro has never written naked calls
>
> (2) In both cases the stock, or purchased call, secures the call and the profitability is the same
>
> (3) IRA's are not marginable, so 100% of the cash needed to secure the put is set aside within the account for the life of the put. Taxable accounts allow the use of margin and do NOT set aside 100% of the money required, but rather only a portion
>
> (4) Straddles and Strangles combine a sold covered call with a sold put. In an IRA this would require us to purchase the stock and 100% cash secure the put....too expensive. Often the profitability of stangles and straddles is based upon receiving both the call and put premium without having to set aside 100% of the cash required should the puts be assigned.
>
> (5) Synthetic Longs require the purchase of call options which are funded by the sale of put options. In a taxable account, the put is partially funded via margin. In an IRA the put is fully funded, which costs just as much as buying the stock at the strike price. Might as well buy the stock and receive the dividends, if any.
>
> Whew! Well, that's how I understand these at this time.
>
> Please don't be bashful with any corrections or questions.
>
> VelobiciOptions

Moosie's Option Spreadsheets

Spreadsheet page

The spreadsheets are just some tools I built, mostly to analyze various option strategies. No rocket science here. They have an embedded Black-Scholes calculator. Feel free to change these and make them your own, or use them as a guide to build your own from scratch. Or use them as is.

The charting sheet is a handy way to make profit-loss graphs similar to those Pro includes in the recommendations.

You'll be able to use these in Windows, and Mac, except not Mac Office 2008. v2004 and v2011 work fine. Microsoft left VBA out of the 2008 Mac version.

Strategy Cheat Sheet

This is some documentation included in the optiontradingtips.com spreadsheet. Nice and concise.

MARKET DIRECTION	IMPLIED VOLATILITY: Low	Neutral	High
Bearish	Buy Naked Puts Bear Vertical Spreads: Buy ATM Call/Sell ITM Call Buy ATM Put/Sell OTM Put Sell OTM (ITM) Call (Put) Butterflies Buy ITM (OTM) Call (Put) Time Spreads	Sell the Underlying	Sell Naked Calls Bear Vertical Spreads: Buy OTM Call/Sell ATM Call Buy OTM (ITM) Call (Put) Time Spreads Buy ITM (OTM) Call (Put) Butterflies Sell OTM (ITM) Call (Put) Time Spreads
Neutral	Backspreads Buy Straddles/Strangles Sell ATM Call Or Put Butterflies Buy ATM Call Or Put Time Spreads	Do Nothing	Ratio Vertical Spreads Sell Straddles/Strangles Buy ATM Call Or Put Butterflies Sell ATM Call Or Put Time Spreads
Bullish	Buy Naked Calls Bull Vertical Spreads Buy ATM Call/Sell OTM Call Buy ATM Put/Sell ITM Put Sell ITM (OTM) Call (Put) Butterflies Buy OTM (ITM) Call (Put) Time Spreads	Buy the Underlying	Sell Naked Puts Bull Vertical Spreads Buy ITM Call/Sell ATM Call Buy OTM Put/Sell ATM Put Buy OTM (ITM) Call (Put) Butterflies Sell ITM (OTM) Call (Put) Time Spreads

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